



First Capital
First Capital Research

First Capital Fixed Income Recommendation

22ND MARCH 2018

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ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 17

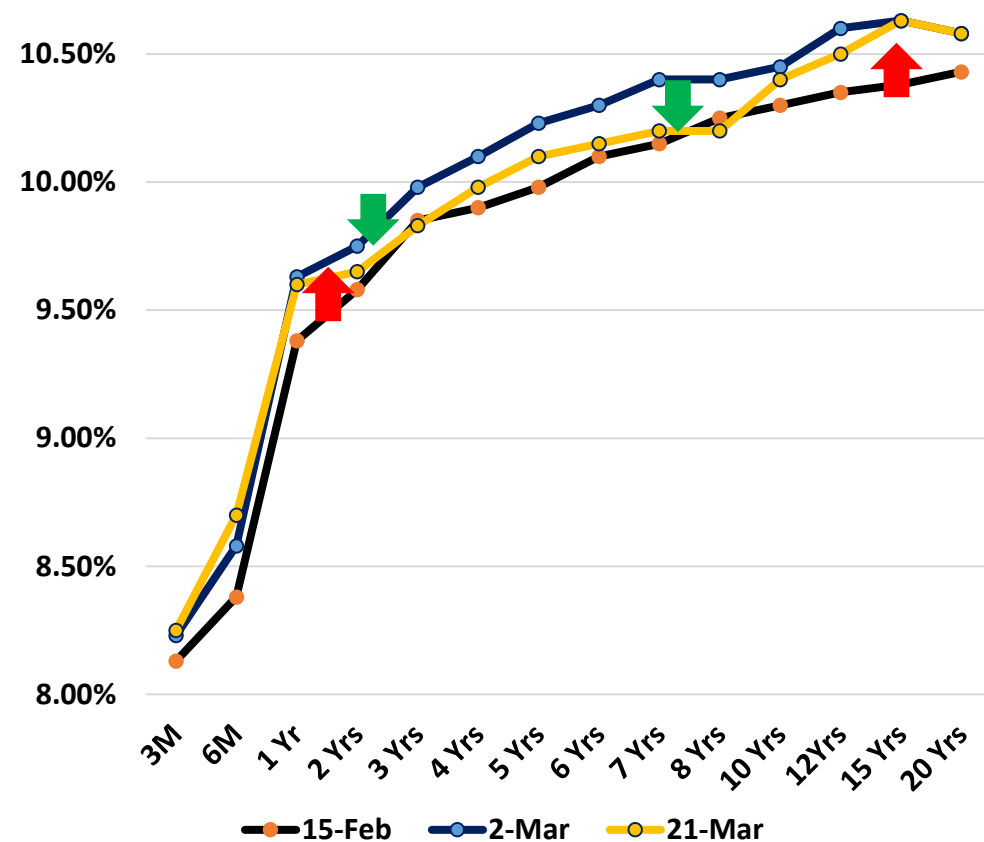
16th Feb & 5th Mar Recommendations and Yield curve movement

Recommendation for 16th Feb 2018 (Last month)

- Portfolio Recommendation: **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y
- Portfolio exposure: Overall portfolio to be **increased to 40%**.
 - **Increase Trading portfolio to 10% from 0%.**
 - Carry portfolio to be maintained to 30%.

Recommendation for 05th Mar 2018

- Portfolio Recommendation: **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y
- Portfolio exposure: Overall portfolio to be **increased to 50%**.
 - **Increase carry portfolio to 40% from 30%.**
 - Trading portfolio to be maintained to 10%.



Rate Movement Review (Last 35 Days)

Interest Rate Change (bps)					
Tenure	2-Mar	21-Mar	Change (bps)	15-Feb	Change (bps)
3M	8.23%	8.25%	2	8.13%	12
6M	8.58%	8.70%	12	8.38%	32
1 Yr	9.63%	9.60%	-3	9.38%	22
2 Yrs	9.75%	9.65%	-10	9.58%	7
3 Yrs	9.98%	9.83%	-15	9.85%	-2
4 Yrs	10.10%	9.98%	-12	9.90%	8
5 Yrs	10.23%	10.10%	-13	9.98%	12
6 Yrs	10.30%	10.15%	-15	10.10%	5
7 Yrs	10.40%	10.20%	-20	10.15%	5
8 Yrs	10.40%	10.20%	-20	10.25%	-5
10 Yrs	10.45%	10.40%	-5	10.30%	10
12Yrs	10.60%	10.50%	-10	10.35%	15
15 Yrs	10.63%	10.63%	0	10.38%	25
20 Yrs	10.58%	10.58%	0	10.43%	15

- ❑ Following our previous report on 16th Feb 2018, yields registered 20-25bps upward movement after LG polls result
- ❑ First Capital Research on 5th Mar 2018 further increase portfolio exposure to 50%, after that market rates marginally dropped across mid tenors.
- ❑ Overall yield curve shifted downwards and low buying pressure was observed in the mid-long tenors.
- ❑ Further small amount of net foreign inflow was also witnessed over the last 2 weeks

1.0 Economic Health Score

Mar 2018 Economic Health Score

Health score moved above 70 despite a marginal dip Feb 2018.

Primary Criteria	-	59 + 1	-	60
Secondary Criteria	-	10 + 1	-	11

Economic Health Score (Mar 2018)

- 71 

- [As against 69 in Feb 2018 & 47 in Mar 2017 (1 Year ago)]

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Feb 2018 Reserves improved by USD 244Mn to USD7.9Bn which is equivalent to 4.6 months of imports, in spite of CBSL purchasing USD 93Mn from the market.	13/15		13/15
Liquidity	Liquidity level was moderate at LKR 30Bn during last 2 weeks.	09/15		09/15
Inflation	CCPI at 4.5%, lower than First Capital Research expectation of 5.1%; Core Inflation remained 3.5%.	12/15	+01	13/15
Foreign Buying	Net outflow of LKR 781.9Mn over the last 4 week suggests slowdown in foreign interest	06/10		06/10
Credit	Nov & Dec 2017 credit improved to LKR 60.0Bn	09/10		09/10
CBSL Holdings	CBSL Holdings drop below LKR 1Bn.	10/10		10/10

Primary Criteria - 59 + 1 = 60

Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No major changes	05/05		05/05
External Environment	Fed rate increased by 25bps. Currency continuously remain weak.	01/05		01/05
BoT & BoP	Marginal improvement in BOP MoM in DEC Continuous widening trade gap increases risk.	01/05		01/05
Political Risk	Uncertain environment slowly subsiding with coalition government.	00/05	+01	01/05
Investor Confidence	LMD-Nielson Business Confidence index climbed to 128, well above 12 month average of 118 but behind the all time mean of 134 – 16% state that economy will improve in the coming 12 months as against 23% 1 month ago and 18% 3 months ago	03/05		03/05

Secondary Criteria - 10 + 1 = 11

2.0 Recommendation

Expectations for (Apr-Jun 2018)

PRIORITY CRITERIA

Foreign Reserves	13/15	-01
Liquidity	09/15	
Inflation	13/15	-01
Foreign Buying	06/10	-01
Credit	09/10	
CBSL Holdings	10/10	

Total - 60/75 -03

SECONDARY CRITERIA

Rating Outlook	05/05	
External Environment	01/05	-01
BoT & BoP	01/05	
Political Risk	01/05	
Investor Confidence	03/05	

Total - 11/25 -01

Total	71 - 04	= 67
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Reasons for Expected 1Q2018 Health Score

We expect Economic Health Score to start to slowly deteriorate towards 2Q2018 due to:

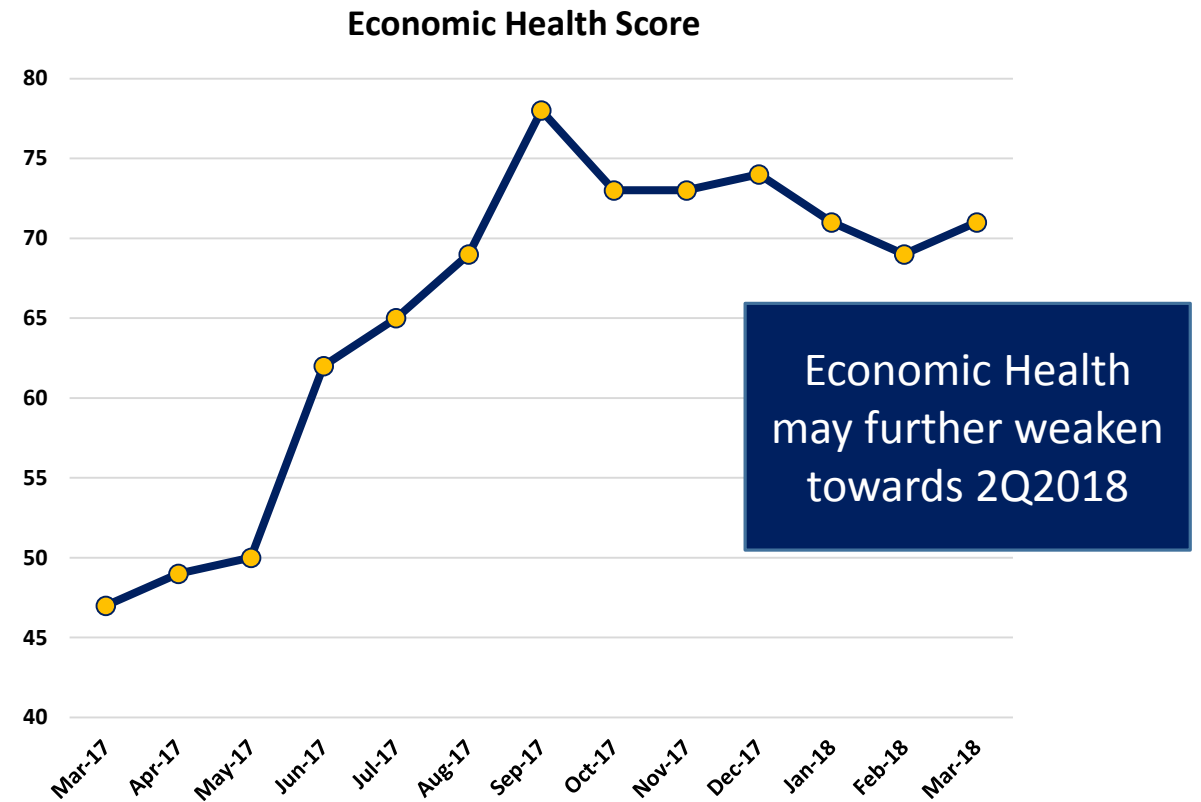
- High debt payments towards 2Q-3Q2018
- Possible rise in inflation and core inflation towards 2Q2018
- Lower levels of liquidity in the market

Recommendation

Fixed Income Portfolio Recommendation

- Portfolio Recommendation: **BUY** primarily into the long tenors (8Y, 10Y)
- Portfolio exposure: Overall portfolio to be **increased to 60%**.
 - **Increase Trading portfolio to 20% from 10%**. (Primarily into 8Y,10Y on the back of sovereign bond)
 - Carry portfolio to be maintained to 40%.
- Yields of short tenors 3Y and 4Y have fallen into a buy range

We continue expect the overall yield curve to move upwards amidst the pressure in rates towards the 2Q and 3Q of 2018.



Sequence of Events

17th Oct 2017 – Hold position as carry portfolio. Capacity Utilization maintained at 40%

24th Nov 2017 – Hold position as carry portfolio. Capacity Utilization maintained at 40%. Watch out for the effects of the Fed rate hike on the market

22nd Dec 2017 – Cautiously BUY primarily into the short tenors of 2Y, 3Y and 4Y at or above 9.5%, 9.75% and 10.0% levels. Increase carry portfolio to 50% from 40%.

18th Jan 2018 – Previous plans of increasing carry portfolio to 50% failed as rates further fell sharply. Cut carry portfolio to 30% from 40%. Trading portfolio to be maintained at 0%. SELL primarily the shortest tenors of 3M and 6M and consider lending in the REPO market

16th Feb 2018 – **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y. Overall portfolio to be increased to 40%. Increase Trading portfolio to 10% from 0%. Carry portfolio to be maintained to 30%.

5th Mar 2018 - **BUY** primarily into the short tenors (2Y, 3Y, 4Y) and mid tenors of 5Y, 6Y. Overall portfolio to be increased to 50%. Increase carry portfolio to 40% from 30%. Trading portfolio to be maintained to 10%.

22nd Mar 2018 - **BUY** primarily into the long tenors (8Y, 10Y). Overall portfolio to be increased to 60%. Increase Trading portfolio to 20% from 10%. (Primarily into 8Y, 10Y on the back of sovereign bond). Carry portfolio to be maintained to 40%.

3.0 Recap of Jan2018 Economic Wrap

Re-cap [Jan 2018]: Time Period vs Health Score

	3 Months Outlook Jan-Mar 2018	3-6 Months Outlook Apr-Jun 2018	6-9 Months Outlook Jul-Sep 2018	9-12 Months Outlook Oct-Dec 2018
Health Score Estimate	65-75	65-75	60-65	65-75
Risk Level – Jan 2018	Medium-Low	Medium-Low	Medium	Medium-Low

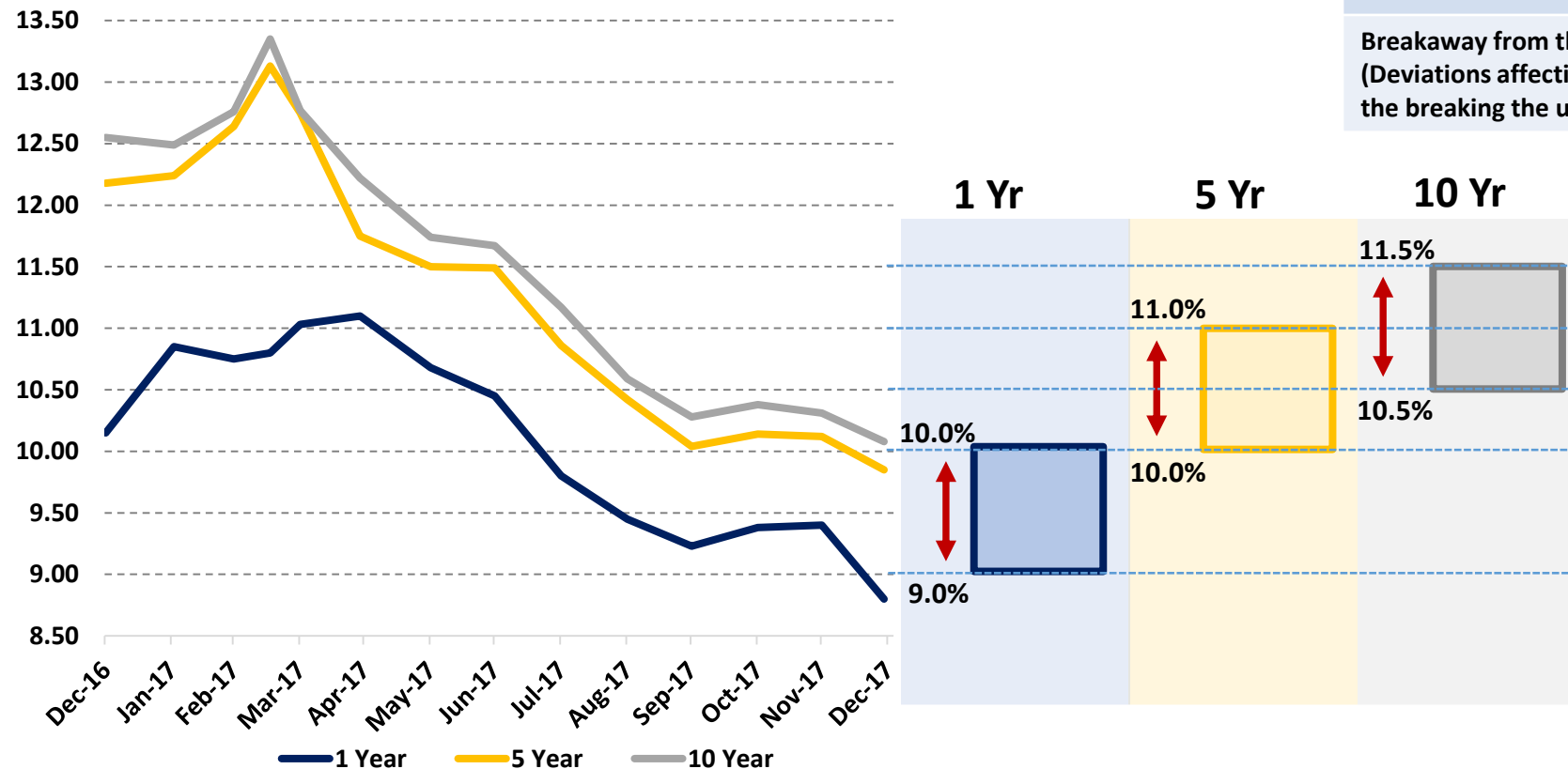


Current Period

Interest Rates to be Bearish towards 2Q-3Q2018 (12 months)

Expectations: **Bearish** towards 2Q-3Q2018

Jan 2018 – Dec 2018	Probability	Impact
Interest Rates to be upward trending towards 2Q-3Q2018 and reaching upper bands	65%	Moderately Bearish / Stable
Breakaway from the continuous reform program (Deviations affecting IMF program) may result in the breaking the upper bands	35%	Very Bearish



Base Case (65% Probability) – Explanation

With higher borrowing requirement resulting in tight monetary conditions and increase in inflation could push the yield curve towards the upper bands. It could result in an increase in CBSL Holdings as well to manage interest rates.

Pressure could ease somewhat in 4Q2018, but will be short lived as debt payments continue to be high in 1Q & 2Q in 2019 with the maturity of the Sovereign Bonds

Policy Rate Expectations

On a base case First Capital Research expects a policy rates to remain stable throughout 2018. However, if GDP growth fails to pickup we expect policy rates to be cut by 25 basis points towards end of 3Q2018

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