

FC Fixed Income Recommendation

24TH NOVEMBER 2017

**ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES
BEGIN ON PAGE 17**



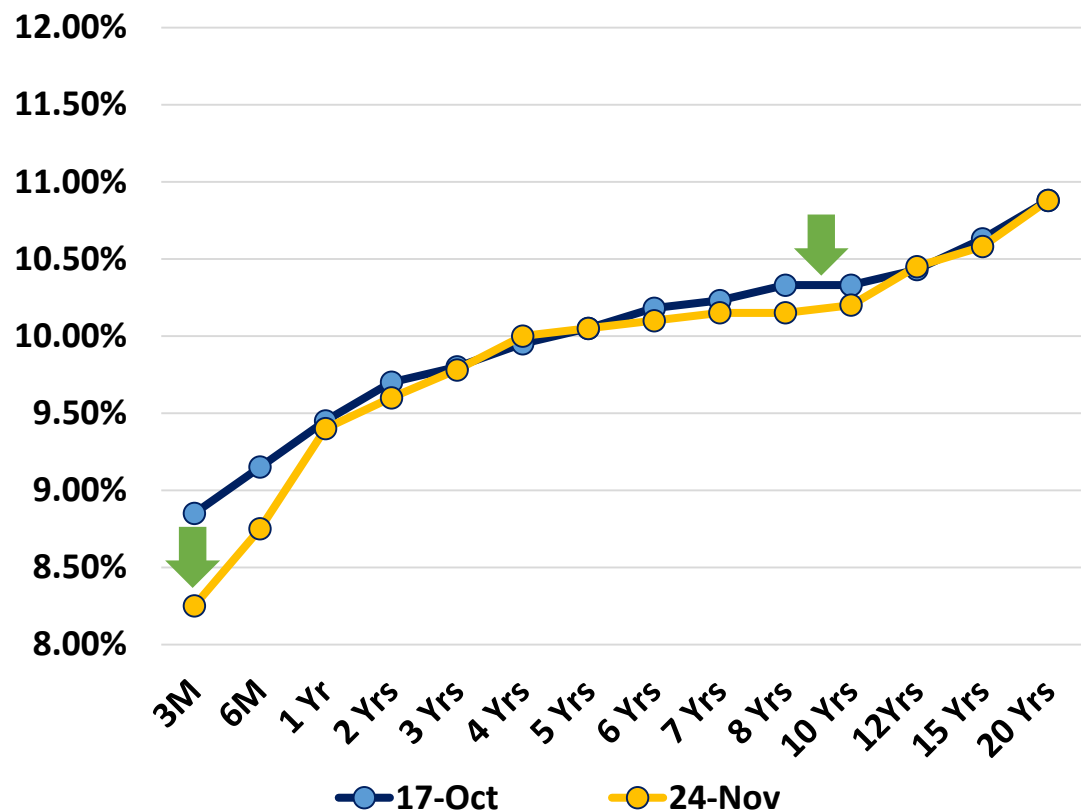
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Previous Month 17th Oct Recommendations and Yield curve movement afterwards

Recommendation for 17th Oct 2017 (Last month)

- Portfolio exposure: **HOLD [Already reached minimum level]**
- Capacity Utilization to be maintained at 40% as carry portfolio
- All remaining positions to be held in short term securities

Yield Movement [17th Oct - 24th Nov]



Rate Movement Review

| Interest Rate Change (bps) | | | |
|----------------------------|--------|--------|--------------|
| Tenure | 17-Oct | 24-Nov | Change (bps) |
| 3M | 8.85% | 8.25% | -60 |
| 6M | 9.15% | 8.75% | -40 |
| 1 Yr | 9.45% | 9.40% | -5 |
| 2 Yrs | 9.70% | 9.60% | -10 |
| 3 Yrs | 9.80% | 9.78% | -2 |
| 4 Yrs | 9.95% | 10.00% | 5 |
| 5 Yrs | 10.05% | 10.05% | 0 |
| 6 Yrs | 10.18% | 10.10% | -8 |
| 7 Yrs | 10.23% | 10.15% | -8 |
| 8 Yrs | 10.33% | 10.15% | -18 |
| 10 Yrs | 10.33% | 10.20% | -13 |
| 12Yrs | 10.43% | 10.45% | 2 |
| 15 Yrs | 10.63% | 10.58% | -5 |
| 20 Yrs | 10.88% | 10.88% | 0 |

Following our previous report on 17th Oct 2017, market saw some mixed reactions with yield across the board marginally moving up in latter October and then during the 1st and 2nd weeks of November registering a strong down trend with 10-30bps dip immediately after US Fed decision to hold rates on the assumption that CBSL will also hold rates.

The attractive shorter tenors less than 1 year had the biggest drop of 40-60bps with no major volatility in the downtrend.

The downtrend also backed by foreign buying interest that was prevalent in the market.

1.0 Economic Health Score

Nov 2017 Economic Health Score

*Health score show mixed results as **Economic Health remains in Strong territory (above 70)**;*

****New indicator for Secondary Criteria introduced to "Other" category as investor confidence*

| | | | | | |
|--------------------|---|--------------|---|----|---|
| Primary Criteria | - | 59 + 02 | - | 61 | ↑ |
| Secondary Criteria | - | 14 + 01 - 03 | - | 12 | ↓ |

Economic Health Score (Nov 2017) - 73 [No Change]

- [As against 73 in Oct 2017 & 47 in Mar 2017 (6 months ago)]

Changes to Health Score – Priority Criteria

| Criteria | Update | Current Score | Add / Deduct Score | New Score |
|-------------------------|--|---------------|--------------------|-------------|
| Foreign Reserves | Governor announces reserves move back to USD 7.5Bn in Oct 2017 | 14/15 | | 14/15 |
| Liquidity | Remains positive and sustained LKR10-20Bn continuously | 09/15 | | 09/15 |
| Inflation | CCPI at 7.8%, higher than FC Research expected target was 7.3%; Steep jump above expectations led by food prices. Core inflation remains under control | 13/15 | | 13/15 |
| Foreign Buying | Net inflow slowed down to LKR 8 Bn over the last 5 weeks with foreign holdings reaching 6.37% | 06/10 | | 06/10 |
| Credit | Sep 2017 credit increased by LKR 50Bn with no signs of acceleration | 08/10 | +01 | 09/10 |
| CBSL Holdings | CBSL Holdings further dipped to LKR 19Bn from LKR 60Bn | 09/10 | +01 | 10/10 |
| Primary Criteria | | - | 59 + 02 | = 61 |

Changes to Health Score – Secondary Criteria

| Criteria | Update | Current Score | Add / Deduct Score | New Score |
|-----------------------------|--|---------------|--------------------|-----------|
| Rating Outlook | Outlook upgrade by S&P from Negative to Stable | 04/05 | +01 | 05/05 |
| External Environment | Possible Fed Rate hike affecting global fund flows towards US; Currently SL inflows have reduced | 02/05 | | 02/05 |
| BoT & BoP | BoP remains strong at USD +2.2Bn. But trade deficit continues to widen | 01/05 | | 01/05 |
| Political Risk | As LG election comes closer, policy implementation have started to get difficult | 02/05 | -01 | 01/05 |
| Other (Investor Confidence) | <u>Measuring investor sentiment is the new indicator;</u> LMD-Neilson Business Confidence index remains below the average of 120 - little more than 1 in 10 state that economy will improve in the coming 12 months as against 1 in 5 (21%) respondents which said the same 2 months ago | 05/05 | -02 | 03/05 |

Secondary Criteria - 14 - 03 + 01 = 12

2.0 Recommendation

Expectations for December 2017

PRIORITY CRITERIA

| | | |
|------------------|-------|-----|
| Foreign Reserves | 14/15 | -01 |
| Liquidity | 09/15 | -01 |
| Inflation | 13/15 | |
| Foreign Buying | 06/10 | |
| Credit | 09/10 | |
| CBSL Holdings | 10/10 | |

SECONDARY CRITERIA

| | | |
|-----------------------------|-------|-----|
| Rating Outlook | 05/05 | |
| External Environment | 02/05 | -01 |
| BoT & BoP | 01/05 | |
| Political Risk | 01/05 | -01 |
| Other (Investor Confidence) | 03/05 | |

Total - 57/75 -02

Total - 14/25 -02

| | | | |
|--------------|------------------|----------|-----------|
| Total | 73 + (-4) | = | 69 |
|--------------|------------------|----------|-----------|

Reasons for Expected December 2017 Health Score

We expect Economic Health Score to stay stable in 4Q2017 & slowly deteriorate towards 2Q2018 due to:

- Rising debt payment levels that exist in 2018
- Slowdown in foreign inflows as fed rate hike draws closer (Possibly in Dec 2017 according to US Economic Analyst surveys)

Recommendation

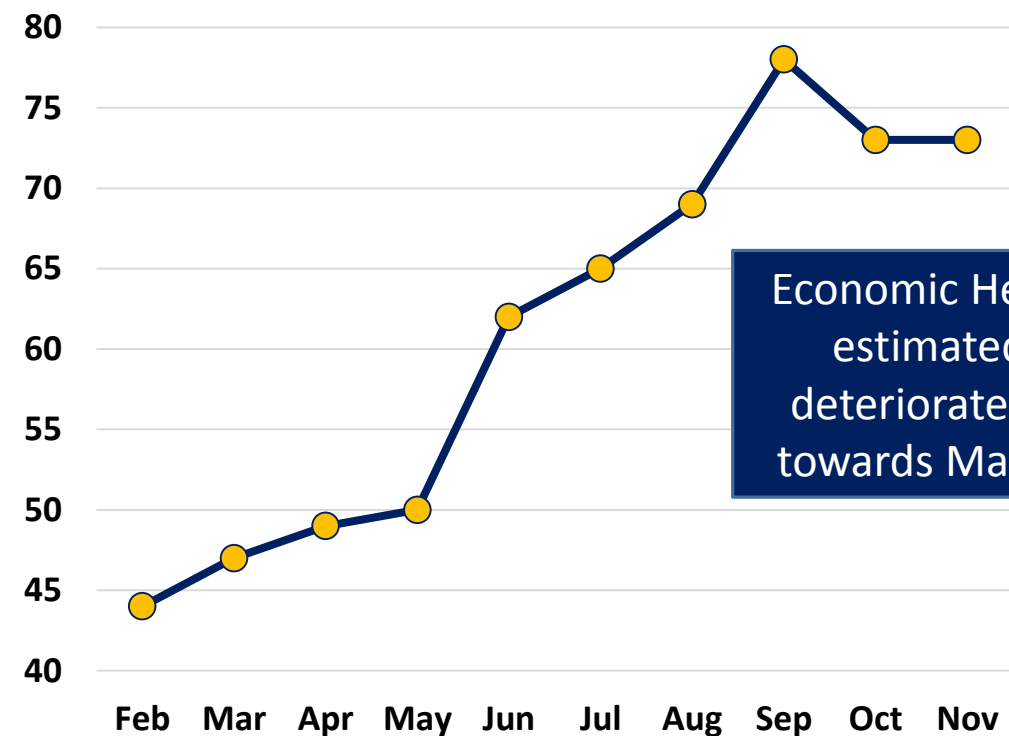
Fixed Income Portfolio Recommendation

- Portfolio exposure: HOLD [Already reached minimum level]
- Capacity Utilization to be maintained at 40% as carry portfolio
- All remaining positions to be held in short term securities.

Short tenors have now reached the lower bands on FC Research expectations. We expect mid-long tenors to adjust upwards to reach FC Research lower bands over the next few months possibly supported by the expected US Fed Rate hike

Despite stability returning to the market and possible chances to increase carry portfolio remains we would prefer to see the Fed rate hike and its effects on the market before increasing exposure to the carry portfolio

Economic Health Score



Economic Health is estimated to deteriorate to 65 towards Mar 2018

Sequence of Events

Jun 2017 – Concrete signs of future risk reducing; Increase capacity utilization to 70% from 60%; Possibility of overall yield curve touching bottom bands over next 2 months; But watch out for Inland Revenue Act

18th Jul 2017 – Sell all longer tenors (10y, 15y, 20y, 30y) and invest in the shorter tenors. Continue to HOLD mid tenor bonds. Continue to watch out for Inland Revenue Act

31st Jul 2017 – SELL all mid tenors (4y, 5y, 6y, 8y). Capacity Utilization to be reduced to 60%

14th Aug 2017 – Start reducing position in shorter tenors. Capacity Utilization to be reduced to 50%

21st Sep 2017 – Further reduce position. Capacity Utilization to be reduced to 40%

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

3.0 Recap of Aug 2017 Economic Wrap

Re-cap [Aug 2017]: Time Period vs Health Score

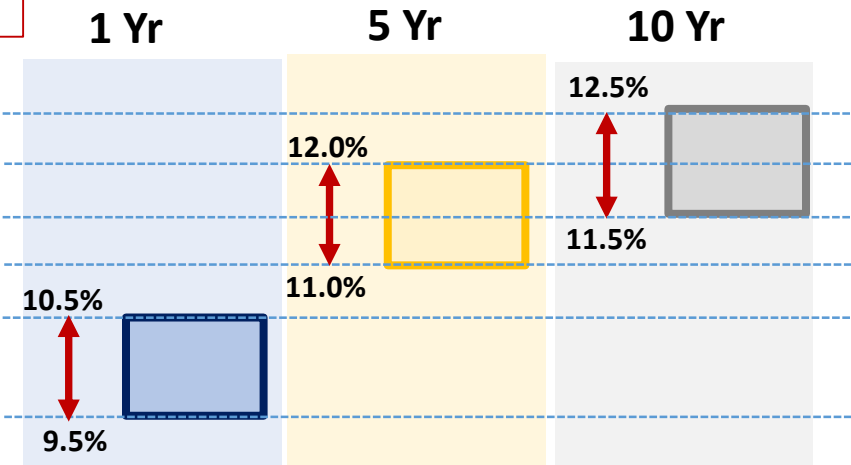
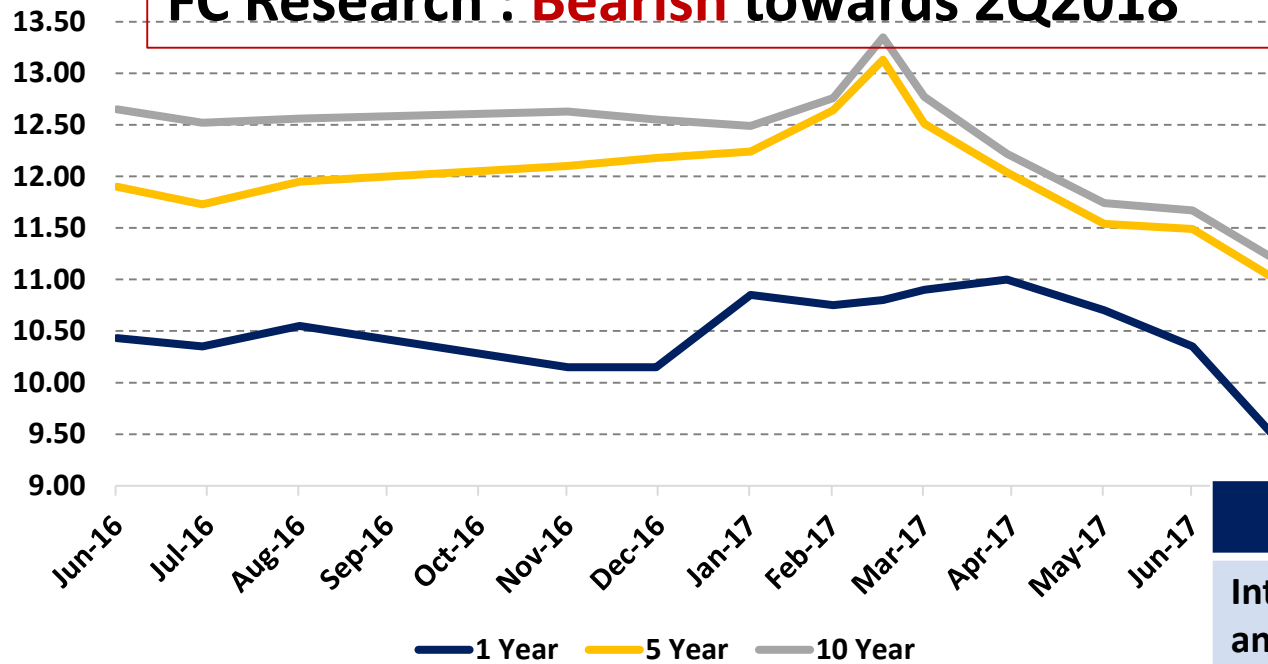
| | 3 Months Outlook Jul-Sep 2017 | 3-6 Months Outlook Oct-Dec 2017 | 6-9 Months Outlook Jan-Mar 2018 | 9-12 Months Outlook Apr-Jun 2018 |
|-----------------------|----------------------------------|------------------------------------|------------------------------------|-------------------------------------|
| Health Score Estimate | 75-100 | 65-75 | 60-65 | 50-60 |
| Risk Level | Remote | Medium-Low | Medium | Medium-High |



Current Period

Interest Rates to be Bearish towards 2Q2018 despite stable 2H2017 (12 months)

FC Research : Bearish towards 2Q2018



| Jul 2017 – Aug 2018 | | Probability |
|--|--|-------------|
| Interest Rates to be upward trending towards 2Q2018 and reaching upper bands | | 65% |
| Strong Foreign inflows stabilizing interest rates around the lower bands | | 35% |

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