



First Capital
First Capital Research

First Capital Fixed Income Recommendation

23RD MAY 2018

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ANALYST CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 17

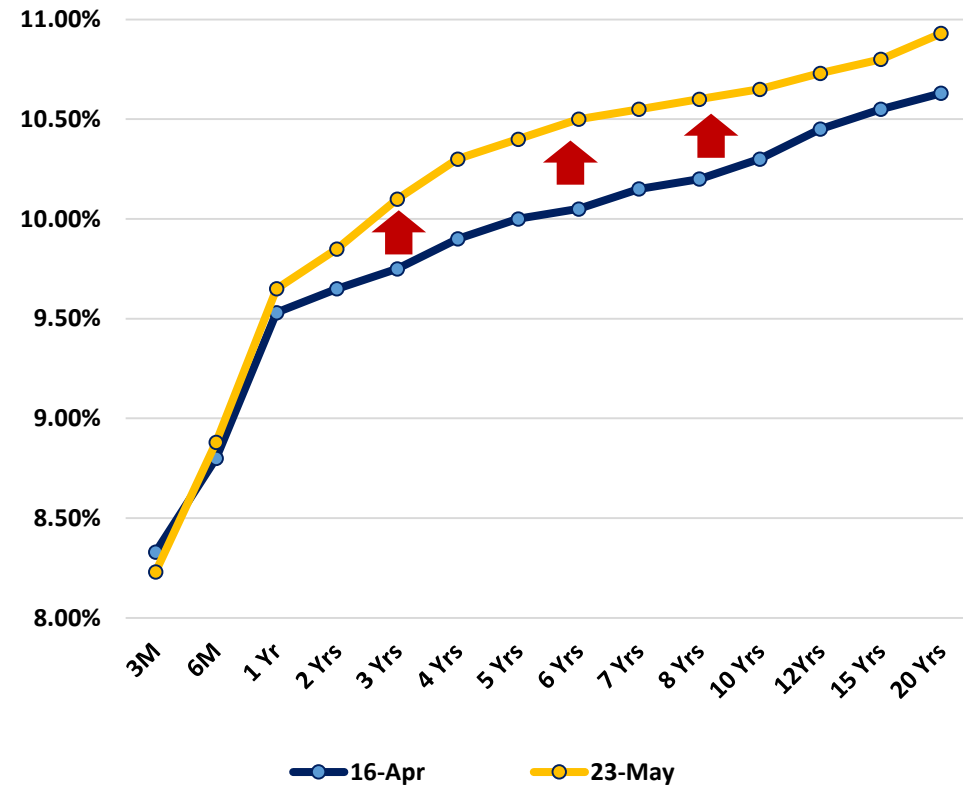
Previous Month 16th Apr Recommendations and Yield curve movement afterwards

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Slowly Reduce** overall portfolio **to 50%** from previous 60% mainly on mid-long tenors (5Y to 10Y).

- **Reduce Trading portfolio to 10% from 20%.** (Primarily into 5Y to 10Y).
- Carry portfolio to be maintained at 40%.

We expect economic health score to improve in May and June with successful issuance of USD 2.5Bn sovereign bond. Afterwards, health score to slowly deteriorate towards Jul and Aug due to high maturities in 3Q2018.



Rate Movement Review (Last 30 days)

Interest Rate Change (bps)			
Tenure	16-Apr	23-May	Change (bps)
3M	8.33%	8.23%	-10
6M	8.80%	8.88%	8
1 Yr	9.53%	9.65%	12
2 Yrs	9.65%	9.85%	20
3 Yrs	9.75%	10.10%	35
4 Yrs	9.90%	10.30%	40
5 Yrs	10.00%	10.40%	40
6 Yrs	10.05%	10.50%	45
7 Yrs	10.15%	10.55%	40
8 Yrs	10.20%	10.60%	40
10 Yrs	10.30%	10.65%	35
12Yrs	10.45%	10.73%	28
15 Yrs	10.55%	10.80%	25
20 Yrs	10.63%	10.93%	30

- ❑ Following our previous report on 16th Apr 2018, yields registered 20-40bps upward movement in 2Yr to 20Yr.
- ❑ Overall yield curve shifted upwards amidst some foreign and local selling pressure in the mid to long tenors.
- ❑ Heavy foreign outflow of LKR 15.0Bn was observed over the last 3 weeks with some profit taking and uncertainty on the currency movement.
- ❑ Monetary Board maintained policy rates notifying the increase in the foreign reserves to USD 9.9Bn through Sovereign bond issue, the highest level recorded in history.

1.0 Economic Health Score

May 2018 Economic Health Score

Health score bounce back from short dip

Primary Criteria - 55 + 4 - 2 - 57

Secondary Criteria - 10 + 1 - 1 - 10

Economic Health Score (May 2018) - 67

- [As against 65 in Apr 2018 & 49 in Apr 2017 (1 Year ago)]

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Apr 2018 Reserves improved to USD 9.9Bn, record highest in history with issuance of USD 2.5Bn Sovereign Bond and CBSL net purchasing USD 76.0Mn from the market.	11/15	+03	14/15
Liquidity	Low liquidity level witnessed last 2 weeks.	08/15	-01	07/15
Inflation	CCPI at 3.8%, lower than First Capital Research expectation of 4.2%; Core Inflation remained at 3.5%.	13/15	+01	14/15
Foreign Buying	Net outflow LKR 15Bn over the last 3 weeks; Foreign holding reaches 7 month low to 6.1%.	06/10	-01	05/10
Credit	Mar 2018 private sector credit growth accelerated to LKR 122Bn; Need to check whether it is one off.	09/10		09/10
CBSL Holdings	CBSL Holdings remained LKR 60Bn with some fluctuation.	08/10		08/10

Primary Criteria - 55 + 4 - 2 = 57

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	Rupee continuously remain weak.	01/05		01/05
BoT & BoP	BOP was further strengthened by sovereign bond issue which helping to counter balance widening of the trade deficit and outflow in the government securities.	01/05	+01	02/05
Political Risk	Uncertain environment slowly subsiding with coalition government.	02/05		02/05
Investor Confidence	LMD-Nielson Business Confidence index further slump 19 bps to 98 Apr, which is represent 70 months low.	01/05	-01	00/05

$$\text{Secondary Criteria} \quad - \quad 10 + 1 - 1 \quad = \quad 10$$

2.0 Recommendation

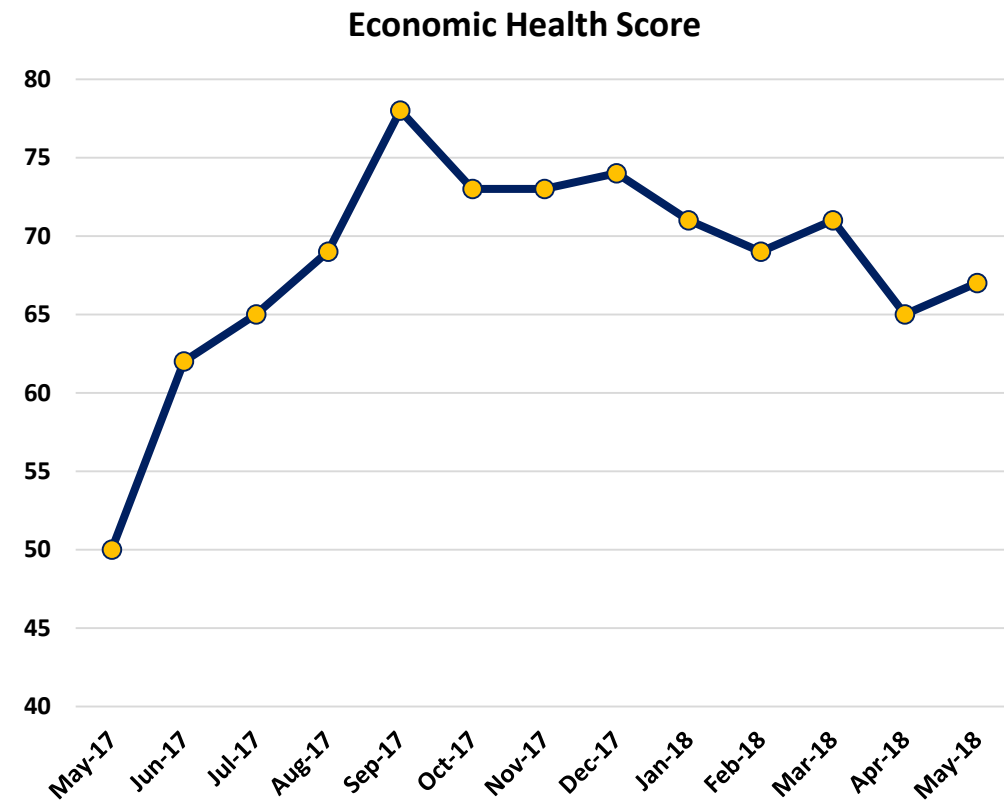
Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: Maintained overall portfolio at 50%.

- Carry portfolio to be maintained at 40%.
- Trading portfolio to be maintained at 10%

We expect economic health score to improve further in June with expected inflows from IMF tranche, final payment of Hambantota port sale and proceeds of a syndicated loan. Subsequently, health score likely to slowly decline towards Jul and Aug due to high maturities in 3Q2018.



Sequence of Events

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%.

16th Apr 2018 - **Reduced** overall portfolio to 50% from previous 60% mainly on mid-long tenors (5Y to 10Y). Cut Trading portfolio to 10% from 20%. (Primarily into 5Y to 10Y). Carry portfolio to be maintained to 40%.

23rd May 2018 - Maintained overall portfolio to 50%. Carry portfolio to be maintained to 40%. Trading portfolio to be maintained to 10%

3.0 Recap of Jan 2018 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

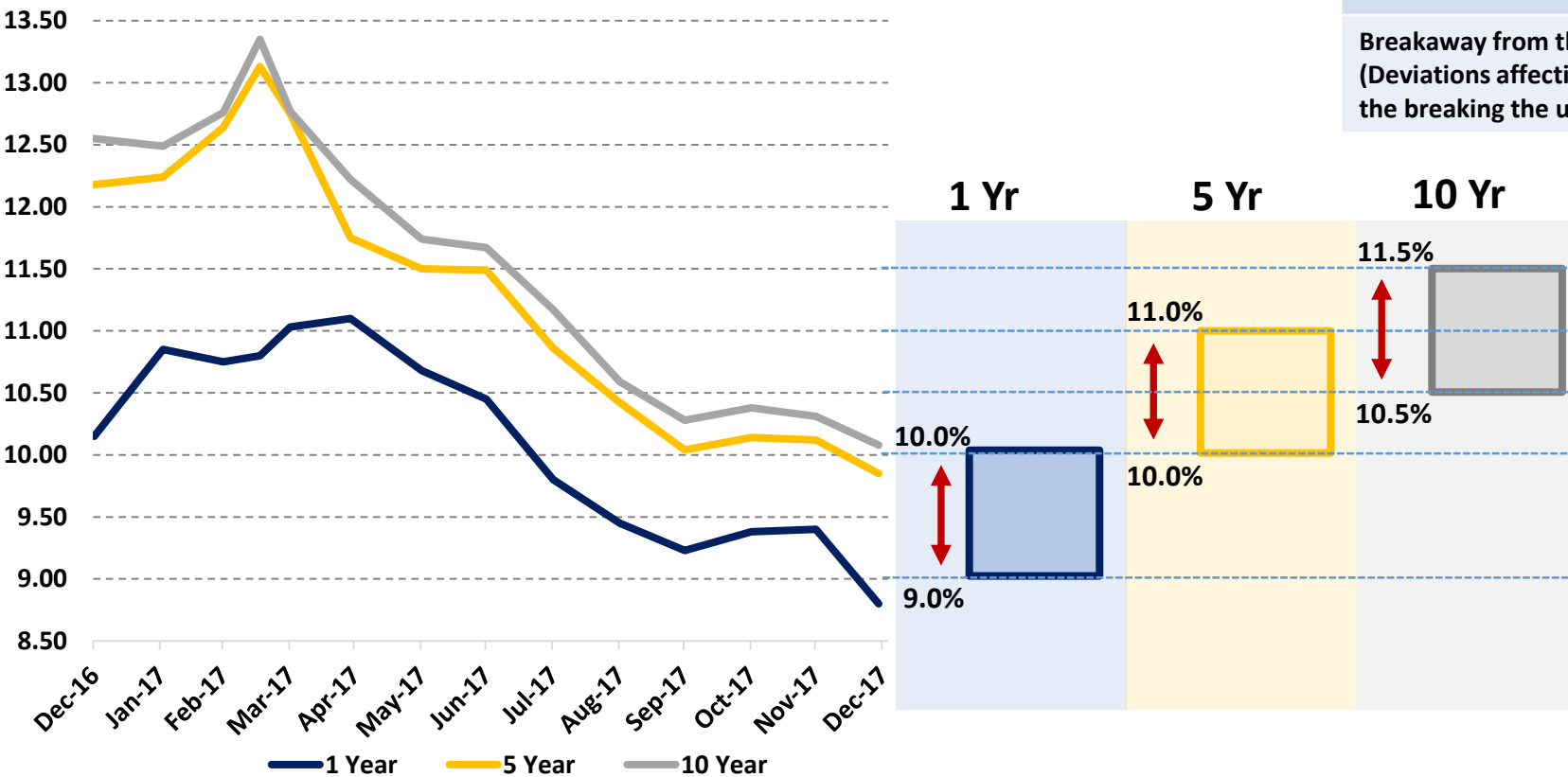


Current Period

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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