First Capital
First Capital Research

“THE BULLS IN BONDS ARE BACK”

First Capital Fixed Income Recommendation - 20th SEP 18

Lead Analyst: Atchuthan Srirangan
Secondary Analyst: Dimantha Mathew

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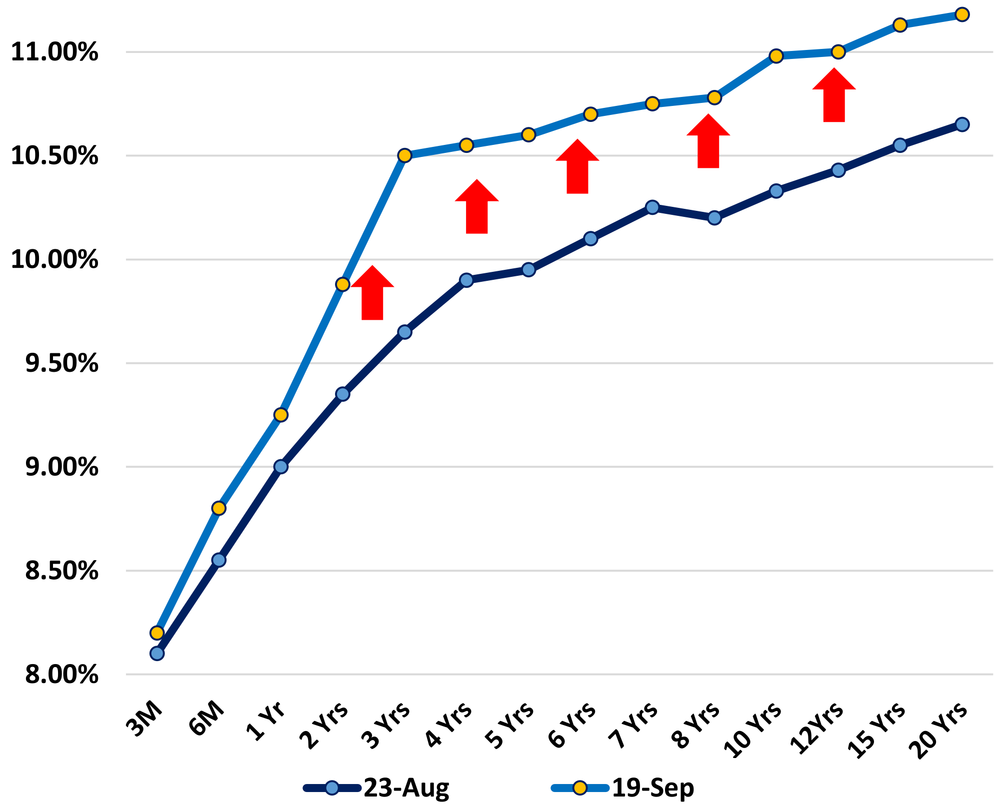
Fixed Income Portfolio Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Reduce** overall portfolio to 30% from previous 40%

- Cut Carrying portfolio to 30% from 40%.
- Trading portfolio to be maintained at 0%.

We expect economic health score to remain low next couple of months.



Rate Movement Review (Last 30 days)

Interest Rate Change (bps)			
Tenure	23-Aug	19-Sep	Change (bps)
3M	8.10%	8.20%	10
6M	8.55%	8.80%	25
1 Yr	9.00%	9.25%	25
2 Yrs	9.35%	9.88%	53
3 Yrs	9.65%	10.50%	85
4 Yrs	9.90%	10.55%	65
5 Yrs	9.95%	10.60%	65
6 Yrs	10.10%	10.70%	60
7 Yrs	10.25%	10.75%	50
8 Yrs	10.20%	10.78%	58
10 Yrs	10.33%	10.98%	65
12Yrs	10.43%	11.00%	57
15 Yrs	10.55%	11.13%	58
20 Yrs	10.65%	11.18%	53

- Following our previous report on 23rd Aug 2018, yields registered 50-85bps upward movement in 2Yr to 20Yr.
- Overall yield curve shifted upwards amidst some foreign selling pressure in the mid to long tenors.
- Heavy foreign outflow of LKR 15.9Bn was observed over the last 4 weeks with some profit taking and uncertainty on the currency movement.

1.0 Economic Health Score

Sep 2018 Economic Health Score

Health score slipped again

Primary Criteria	-	50	-	04	-	46
Secondary Criteria	-	08	-	01	-	07

Economic Health Score (Sep 2018) - 53

- [As against 58 in Aug 2018 & 78 in Sep 2017 (1 Year ago)]

Changes to Health Score – Priority Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Foreign Reserves	Aug 2018 reserves improved to USD 8.6Bn from USD 8.4Bn in Jul 2018. CBSL sold net USD 24.0Mn to the forex market.	09/15		09/15
Liquidity	Liquidity level was heavily volatile with CBSL conducting few reverse repo auctions during last 2 weeks to maintain liquidity.	09/15	-03	06/15
Inflation	CCPI in Aug at 5.9%, higher than First Capital Research expectation of 5.6%; Core inflation remains under 4.0%.	10/15	-01	09/15
Foreign Buying	Net outflow LKR 15.9Bn over the last 4 weeks; Foreign holding reaches 5.39%.	05/10		05/10
Credit	Credit growth remains under control.	09/10		09/10
CBSL Holdings	CBSL Holdings remained below LKR 30.0Bn.	08/10		08/10

Primary Criteria - 50 - 04 = 46

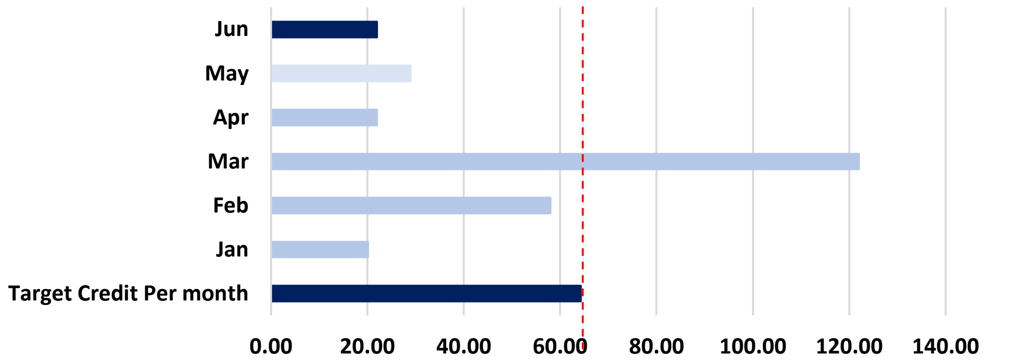
Changes to Health Score – Secondary Criteria

Criteria	Update	Current Score	Add / Deduct Score	New Score
Rating Outlook	No major changes.	05/05		05/05
External Environment	Rupee remains weak.	00/05		00/05
BoT & BoP	Deficit in the trade account continued to expand in Jun 2018 with slowdown in exports.	02/05		02/05
Political Risk	Signs of PC Polls early 2019.	01/05	-01	00/05
Investor Confidence	High taxes, the policy regime and inflation are among the major concerns for businesses. BCI index dipped to 95 in Aug compared to 101 in July.	00/05		00/05

Secondary Criteria - 08 - 01 = 07

Graph 1 : Credit Growth remains slow at 7%YTD

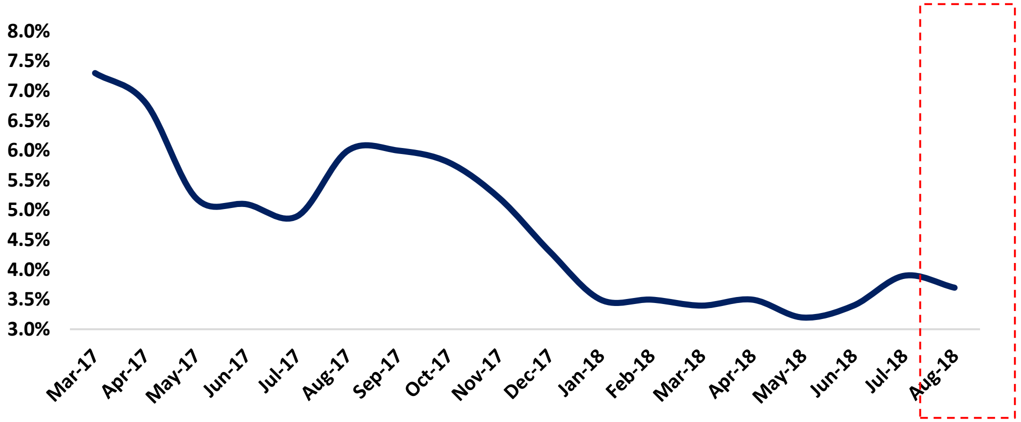
Credit growth remains sluggish at 7%YTD, below First Capital Research target of 16%, private sector credit growth is expected to pick up towards 2H2018.



Source: CBSL

Graph 2 : Core Inflation spikes but remains below par at 3.9% in Aug 2018

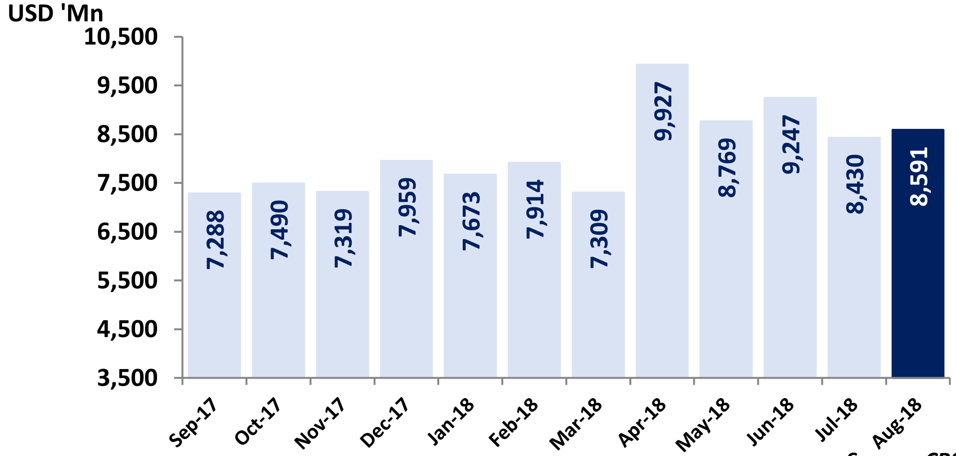
Core inflation is expected to increase with the implementation of pricing formula



Source: Census and Statistics

Graph 3 : Official Reserves increase to USD 8.6Bn in Aug 2018

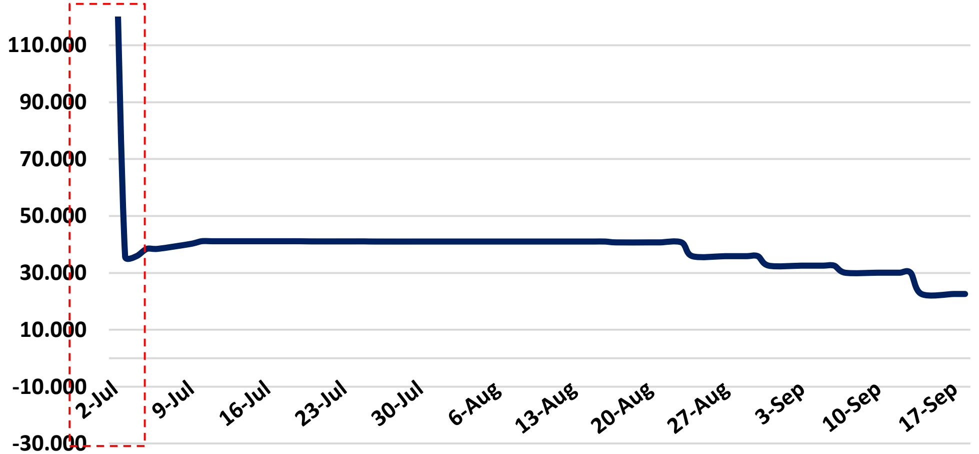
Aug 2018 reserves improved to USD 8.6Bn from USD 8.4Bn in Jul 2018. CBSL sold net USD 24.0Mn to the forex market.



Source: CBSL

Graph 4 : CBSL holding in Gov Sec maintained above LKR 41Bn

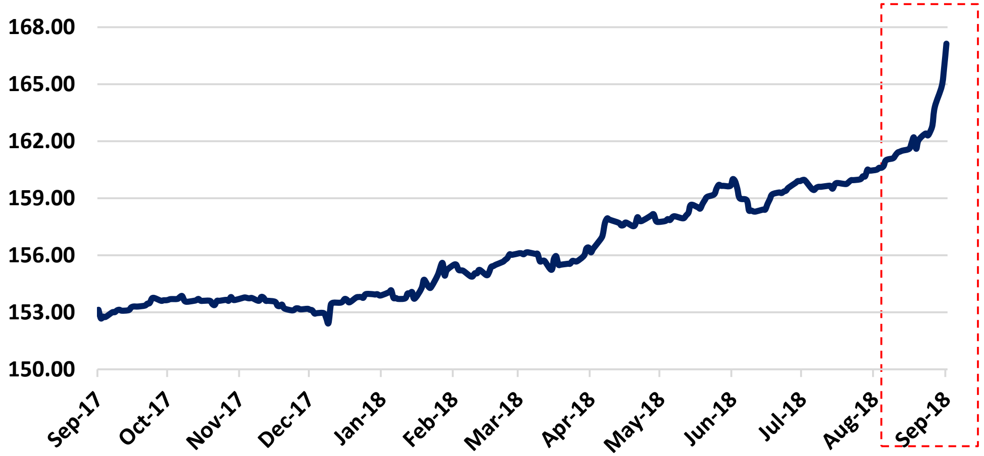
CBSL holding in Government Securities dipped to LKR 22.0Bn on 14 Sep 2018 and stabilized and maintained above LKR 20.0Bn.



Source: CBSL

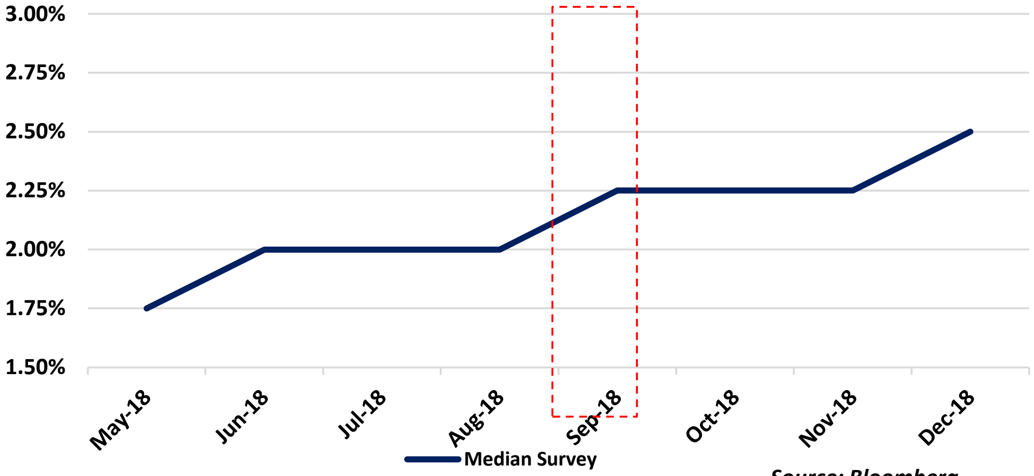
Graph 5 : LKR weakens against strengthened USD

LKR was seen at a new low around LKR/USD 167 levels on 19th Sep.



Graph 6 : Fed Rate Hike Expectations - 2018

Surveys indicated two rate hikes (Sep and Dec) for 2018.



Source: Bloomberg

Graph 7 : 5Yr Bond compare against Frontier Economics

Country	3-Jan-18	19-Sep-18	Change bps
Sri Lanka	9.60	10.60	100
Philippines	4.72	7.10	238
Malaysia	3.53	3.78	26
Vietnam	3.80	5.10	130
India	7.18	8.14	97
Pakistan	7.89	9.55	166
Indonesia	5.86	8.22	235
China	3.88	3.49	-38
Brazil	9.44	11.27	184

Source: Bloomberg

Table 1 : Bond Maturities – Next 6 Month

ISIN	Series	Issue Date	Maturity Date	Outstanding (LKR) Mn
LKB00418J150	08 75 2018 A	10/15/2014	10/15/2018	36,532
LKB00718K151	08 00 2018 A	11/15/2011	11/15/2018	102,691
LKB00819A158	05 65 2019A	1/15/2011	1/15/2019	32,244
LKB00219A151	10 75 2019A	1/15/2017	1/15/2019	48,479

Series	ISIN	Maturity Date	Outstanding (USD)
SLDB2019B	LKG00419A301	1/30/2019	196
SLDB2019C	LKG00219C178	3/17/2019	403
SLDB2019C	LKH00219C177	3/17/2019	7

Source CBSL

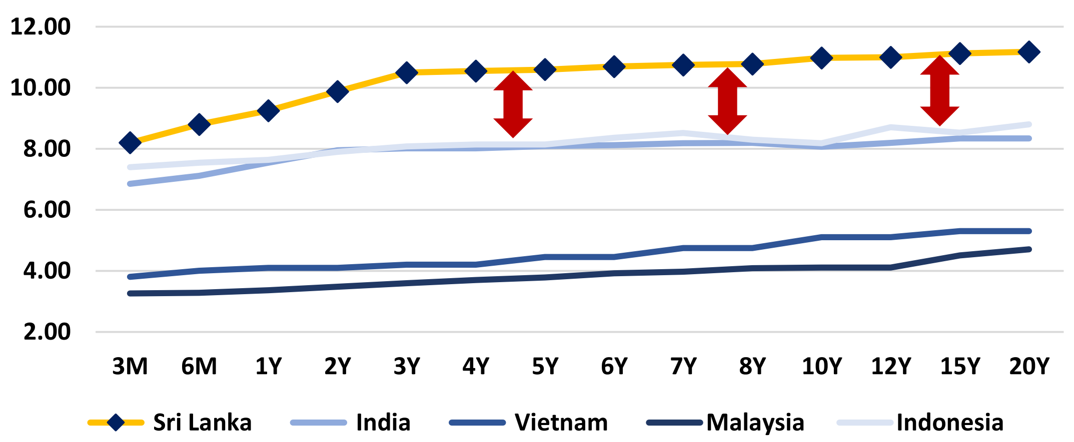
Sri Lankan Bond trade at an attractive premium

YIELD TO MATURITY FOR 15 YEARS

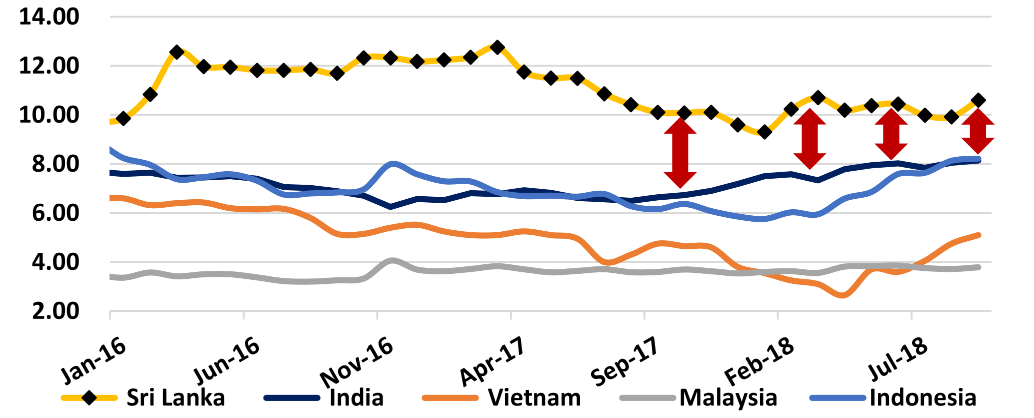
Yields have been volatile over the years but have slowly shifted to a lower interest regime.

	Yield to Maturity (%) (At the end of the Year)				
	1 Yr	2 Yr	3 Yr	5 Yr	10 Yr
2003	7.59	8.90	9.17	9.52	9.47
2004	7.65	9.75	9.75	8.99	9.60
2005	10.37	11.10	11.38	12.00	10.88
2006	12.98	13.16	13.37	13.69	14.00
2007	19.96	17.47	17.00	16.15	16.84
2008	18.50	20.15	19.38	19.07	17.65
2009	9.25	10.51	10.91	11.52	12.10
2010	7.60	8.01	8.23	9.39	9.60
2011	9.30	9.57	9.88	9.99	10.06
2012	11.65	11.65	11.74	11.94	12.32
2013	7.90	8.86	9.05	10.29	10.90
2014	5.90	6.22	6.94	7.26	7.99
2015	7.10	7.65	8.96	9.63	10.41
2016	10.15	11.38	11.80	12.18	12.55
2017	9.85	9.20	9.45	9.85	10.15
Sep-18	9.25	9.88	10.50	10.60	10.98

COMPARATIVE YIELD CURVE AS AT SEP 2018 SIGNIFIES THE ATTRACTIVE YIELDS PREMIUM ATTACHED TO BONDS

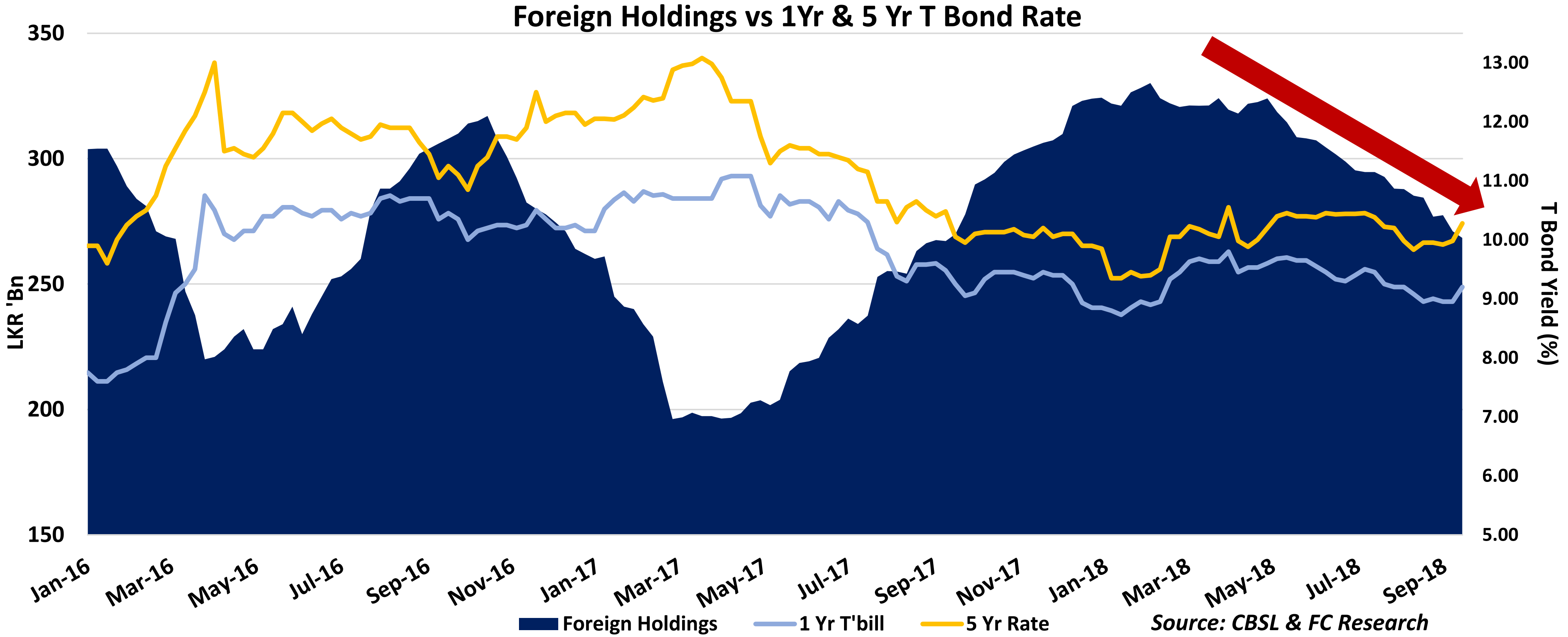


SRI LANKA'S 5 YR BOND YIELD PREMIUM IS RE-ADJUSTING



Foreign Interest in Sri Lanka's Bonds has shown a decrease over last 9 months

Foreign holding in Government securities has decreased to 5.39% over last 9 months on the back of strengthening dollar and increased US treasury rates pushed fund flow towards US.



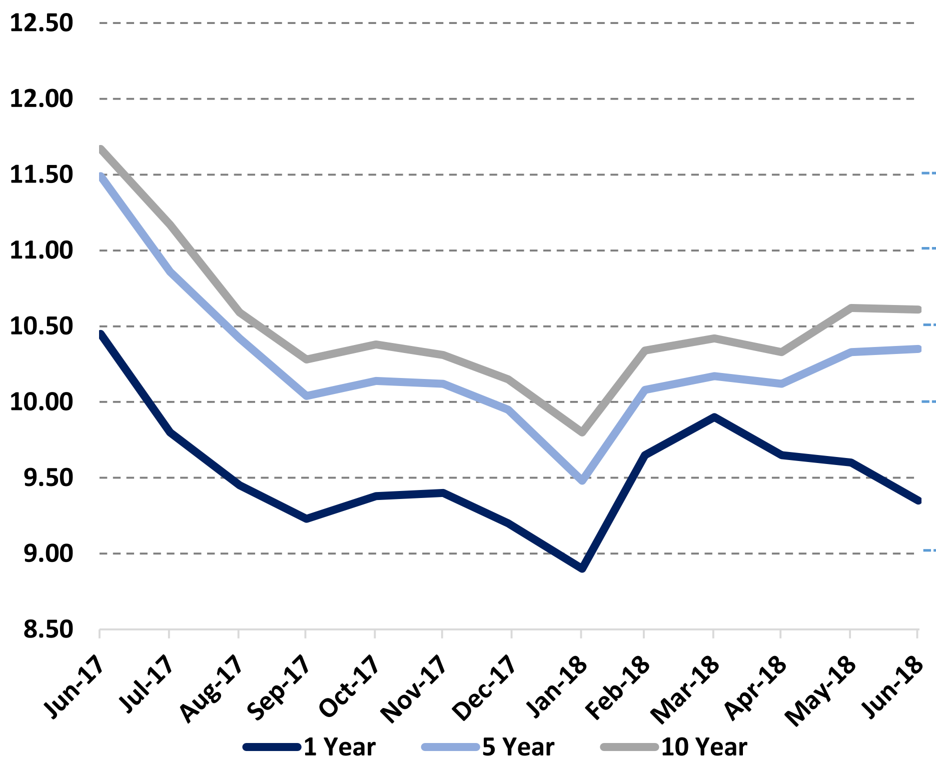
Source: CBSL & FC Research

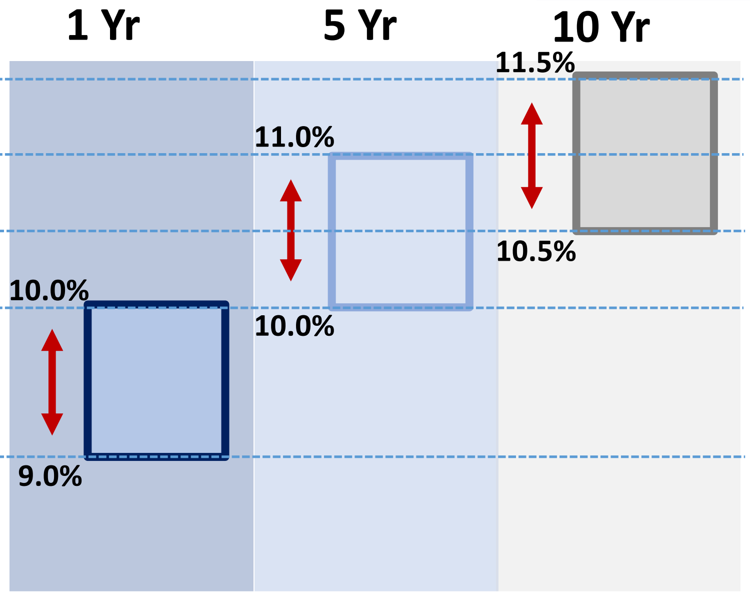
2.0 Recommendation

Jul 2018 Re cap:
Bond Rates to peak in 3Q2018 and gradually ease (12 months)

Expectations: Moderately Bullish beyond 3Q2018

Jul 2018 – Jun 2019	Probability	Impact
Bond Rates to peak in 3Q2018 and gradually ease	65%	Moderately Bullish / Stable
Breakaway from reform program (Deviations affecting IMF program) or political deadlock may result in the breaking the upper bands	35%	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

THE BULLS IN BONDS ARE BACK

Current Status, Crisis or Expectation?

First Capital Research (FCR) estimated bond yields to rise and peak in 3Q2018 (as mentioned in Slide 14), however despite high debt rollovers and foreign outflows bond yields continued to trend down causing an accelerated depreciation in the currency well passed our initial estimates. Despite the initial delay, bond yields have begun to adjust upwards within the 3Q2018 in line with the initial expectation. As yields spiked over the last 2 weeks the 1 year and 5 year reached attractive levels rising closer to our upper bands (as illustrated in Slide 14).

First Capital Research Bullish on Bonds

First Capital Research is bullish on short and mid tenor bonds which are already adjacent, but below, our upper bands. We believe the upper bands are likely to hold on the back of possible debt driven inflows from the planned USD 1Bn Syndicated loan from China Development Bank and USD 250Mn Panda Bond by the CBSL which may also support the current lower reserve position and stabilize the currency. The already spiked yields, may ease off selling pressure from both local and foreign investors, and lead to less outflows from bond market. The planned inflows have so far delayed over the last 4 weeks while existing outflows resulted in an accelerated depreciation of currency as the expected Fed rate hike draws closer (26th Sep).

Our bullishness on Bonds are also dependent on the lower Government debt maturity profile in 4Q2018 as mentioned in our "Mid-Year Economic Outlook – Jul 2018 – Fundamentals remain Strong, Growth remains Key" Report.

What to BUY?

Currently we recommend investors to significantly increase exposure in Short and Medium tenor maturities. However, on the long run investors should be mindful of a further uptick in yields by 40-50bps. Adequate room to increase exposure should be maintained in case the bond yields rise further. Presently the biggest risk is whether the debt driven inflows would be disbursed on time.

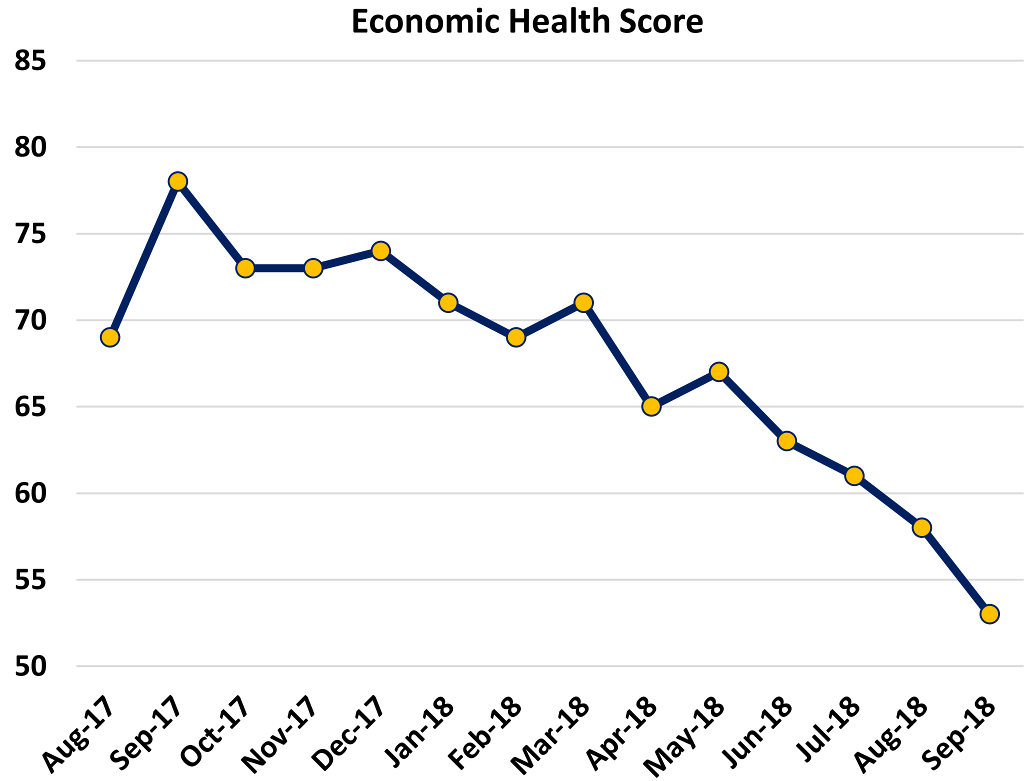
Portfolio Recommendation

Fixed Income Portfolio Recommendation

– Portfolio Recommendation: **Increase portfolio to 50% from 30%**

- Increase Trading Portfolio to 20% from 0%.
- Carrying Portfolio to be maintained at 30%.

Yields of short-mid tenors 3Y, 4Y and 5Y have fallen into a buy range while 7Y and 8Y have also registered attractive price levels to initiate accumulation



Sequence of Events

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 - **Reduce** 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 maintain to 40%.

23rd May 2018 – Maintain overall portfolio to 50%. Carry portfolio to be maintain to 40%.Trading portfolio to be maintained to 10%.

19th June 2018 - Maintain overall portfolio to 50%. Carry portfolio to be maintain to 40%.Trading portfolio to be maintained to 10%.

26th Jul 2018 - **Reduce** overall portfolio to 40% from previous 50%. Cut Trading portfolio to 0% from 10%. Carry portfolio to be maintained at 40%.

23rd Aug 2018 - **Reduce** overall portfolio to 30% from previous 40%. Cut Carrying portfolio to 30% from 40%. Trading portfolio to be maintained at 0%.

19th Sep 2018 - **Increase portfolio to 50% from 30%.** Increase Trading Portfolio to 20% from 0%.Carrying Portfolio to be maintained at 30%.

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CONTACT US

First Capital

Dimantha Mathew	+94 11 2639 853	Hiruni Perera	+94 11 2639 864
Atchuthan Srirangan	+94 11 2639 863	Nisansala Kuruppumudali	+94 11 2639 866
Amanda Lokugamage	+94 11 2639 868		