First Capital

First Capital Research

Local markets panic, but current policy stance desired

PRE-POLICY ANALYSIS

28TH SEP 2018

Lead Analyst: **Amanda Lokugamage**
Secondary Analyst: **Dimantha Mathew**

Local markets panic, but policy change not required

- Rupee depreciate by 4.6% while yields jump by 100bps
  - Heavy foreign outflows, considerably lower foreign currency reserve position and lower bond yields resulted in the currency suffering a MTD depreciation of 4.6% against the green back in Sep 2018. Over the last 3 weeks overall yield curve experienced a steep upward movement as the yields of more liquid short to mid tenure maturities spiked by almost 100bps
  - Stabilization of LKR:USD at LKR 169 levels was witnessed subsequent to the upward shift in the overall yield curve, coupled with relatively weaker dollar witnessed over the last couple of days
  - Further, US Federal Reserve as expected, increased rates by 25bps to 2.25% in Sep 2018. On a negative note on the back of stronger US economy and upgraded GDP growth target, Federal Reserve expects additional rate hikes to take place predicting 3 hikes for 2019 compared to the previously expected 2 hikes
  - Expected debt driven inflows from the USD 1Bn Syndicated loan from the China Development Bank and USD 250Mn from the issuance of Panda Bond is key to improving the reserve position
- The vulnerable external environment and lower GDP growth level provide less scope for the monetary board to increase rates while possibility of a rate cut is almost completely eliminated amidst continuous weakening in the currency and continued foreign outflows [A rate cut may further aggravate the foreign outflows]
  - Considering the prevailing economic conditions of the country, First Capital Research believes that **policy rate change is not required**. However, we are of the view that a 20% probability exists for a rate hike, depending on CBSL expectations of the timing on the debt driven foreign inflows. The expected debt driven inflows have so far delayed by almost 5 weeks and is of paramount importance to boost the reserve position

Expected Monetary Policy Stance

First Capital Research expects Monetary Board to hold rates as hike would hamper growth and cut would increase foreign outflows. However, we recognize a 20% probability of a 25bps rate hike considering the lower foreign reserve position and delay in expected debt driven inflows.

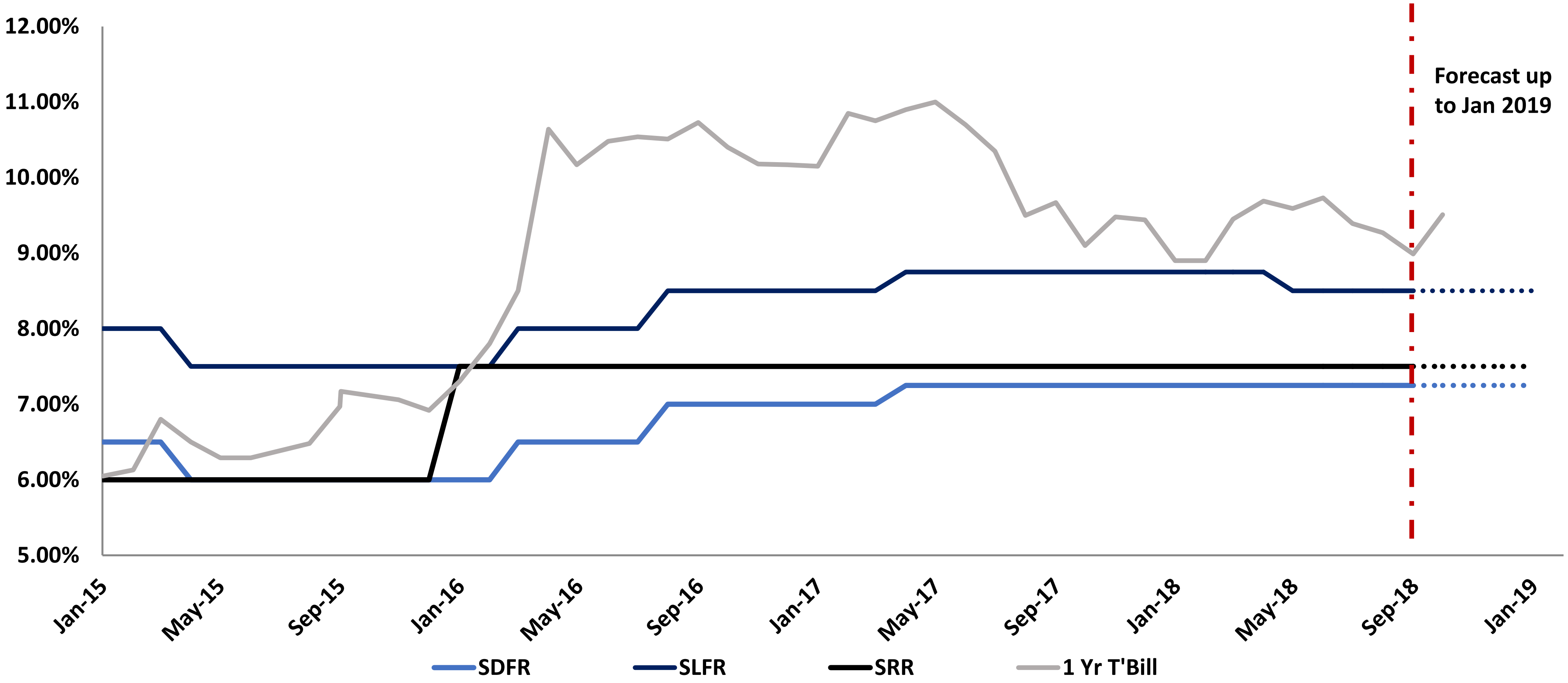
Expected Monetary Policy Stance by CBSL	Probability
Raising Policy Rates by 50bps	0%
Raising Policy Rates by 25bps	20%
Policy Rates to remain unchanged	***80%***
Cutting Policy Rates by 25bps	0%
Cutting Policy Rates by 50bps	0%

20% Probability to identify lower reserve position and high debt repayments.

Current Policy Rates	
Standing Deposit Facility Rate (SDFR)	7.25%
Standing Lending Facility Rate (SLFR)	8.50%
Statutory Reserve Ratio (SRR)	7.50%

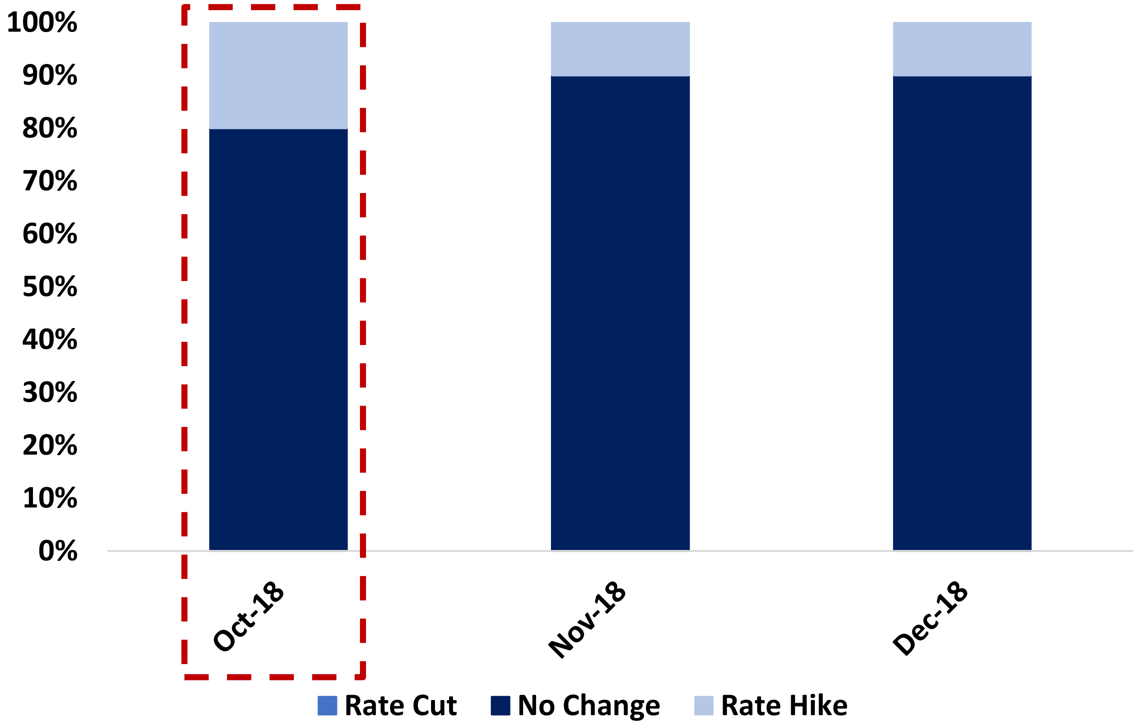
We expect the CBSL to keep Statutory Reserve Ratio (SRR) unchanged at 7.50%

Policy Rates vs 1-Yr T'Bill rate (2015 to date)



Graph 1 : Policy Rate Expectations – First Capital Research

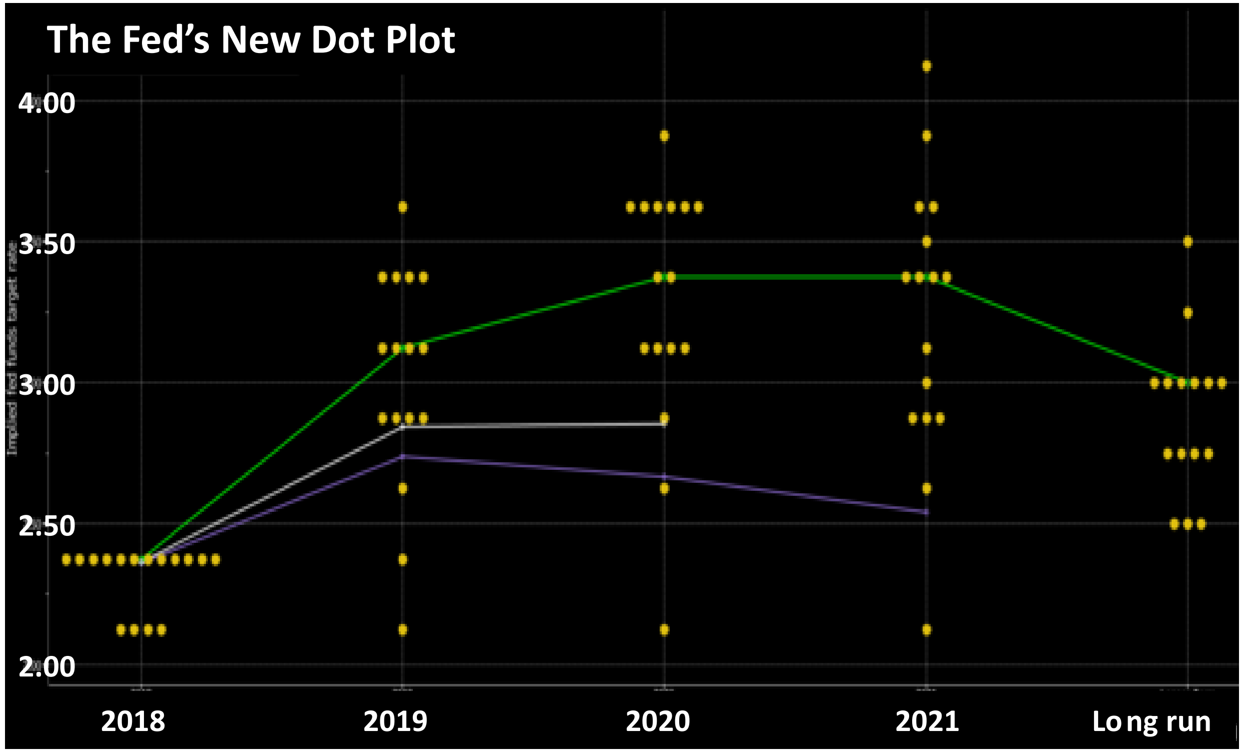
Our base case expectation is no change in policy rates. However, in spite of considerably low GDP growth and sluggish credit growth we recognize a 20% probability of a rate hike in order to boost the considerably low foreign reserve position while fortifying the LKR from continued pressure amidst foreign sell offs in debt and equity markets. The requirement may be heavily dependent on timing of the expected debt driven inflows



Source: First Capital Research Estimates

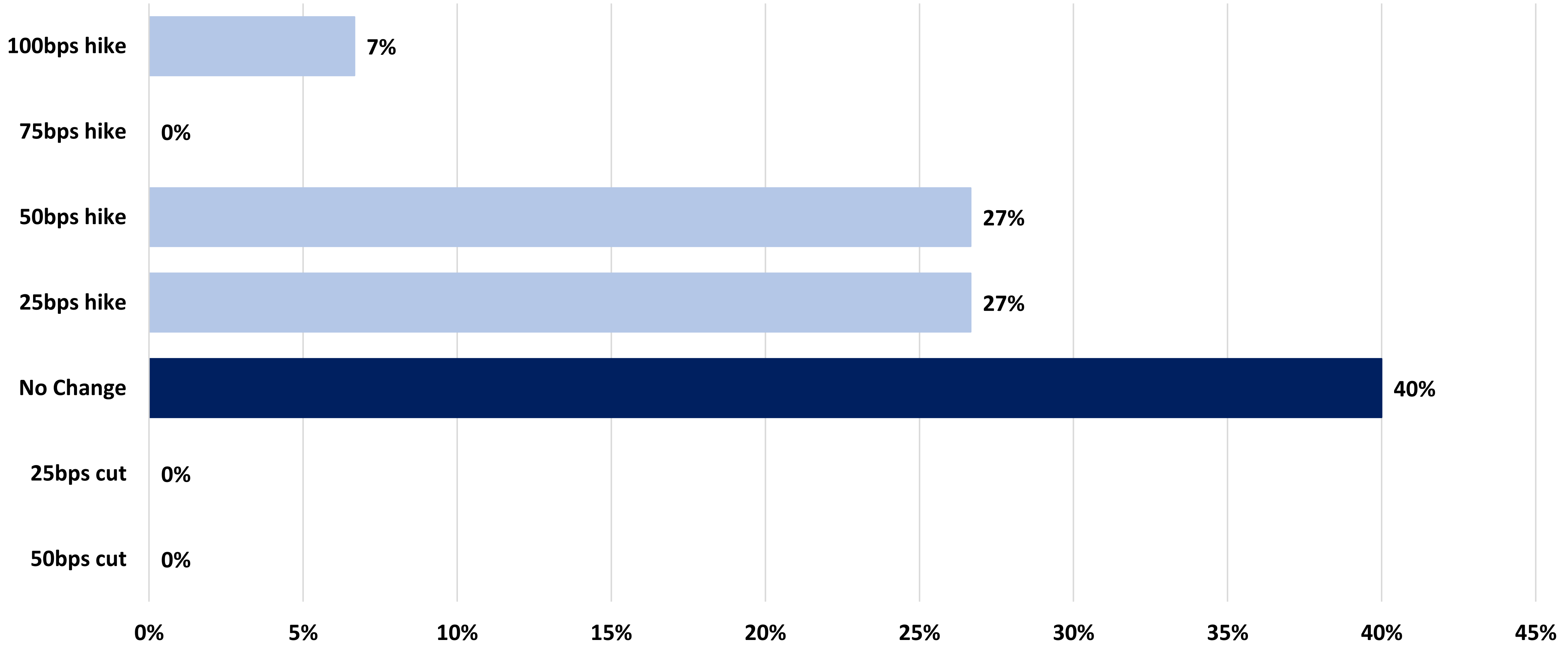
Graph 2 : Fed Rate Hike Expectations – up to end 2019

Fed reserve officials raised interest rates by 25bps boosting the benchmark federal funds rate to a spread of 2.00%-2.25% in Sep 2018. On the back of strong economy and moderate financial vulnerabilities, Fed officials estimates 3 rate hikes in 2019 from previously expected 2 hikes for 2019.



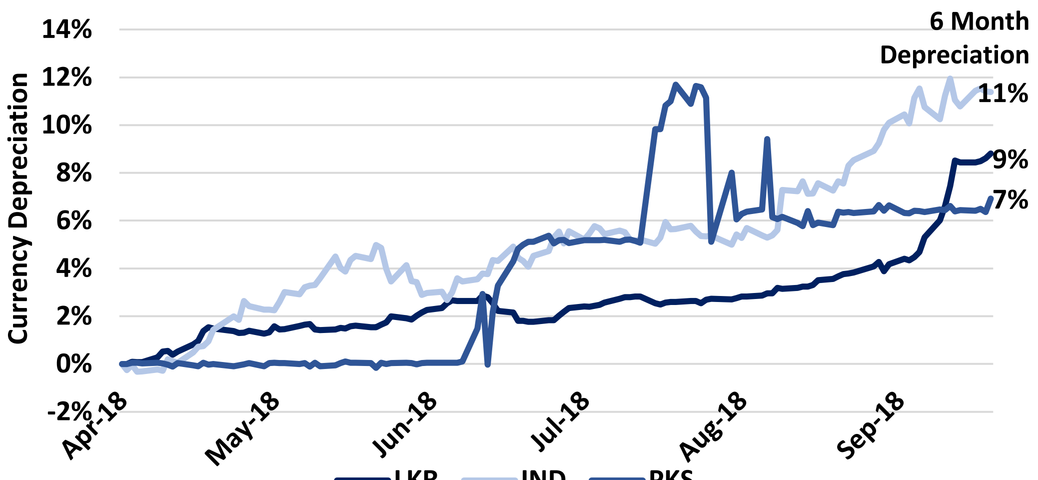
Source: Bloomberg

Reuters Survey on Policy Rate Expectations



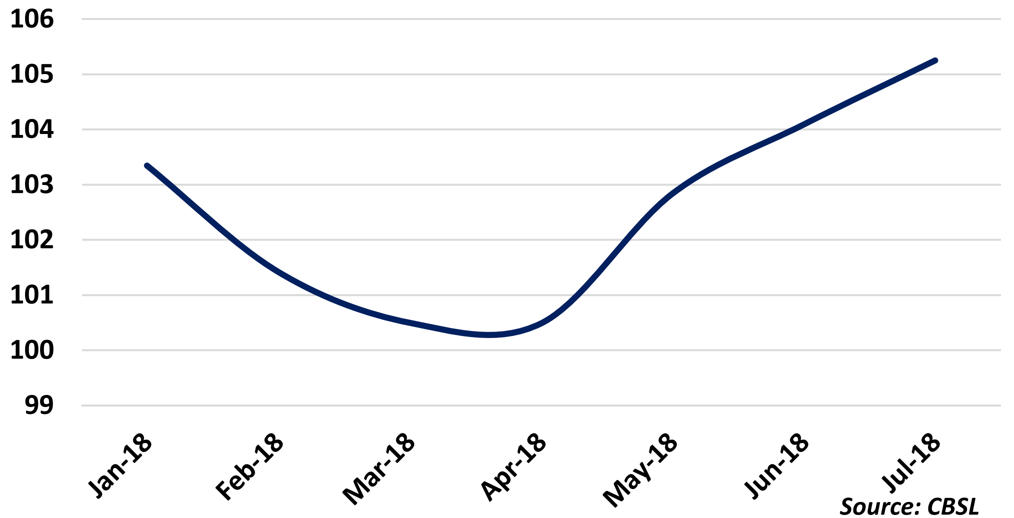
Source: Reuters

Graph 3 : LKR, INR and PKR weakened on the back of strengthening of USD



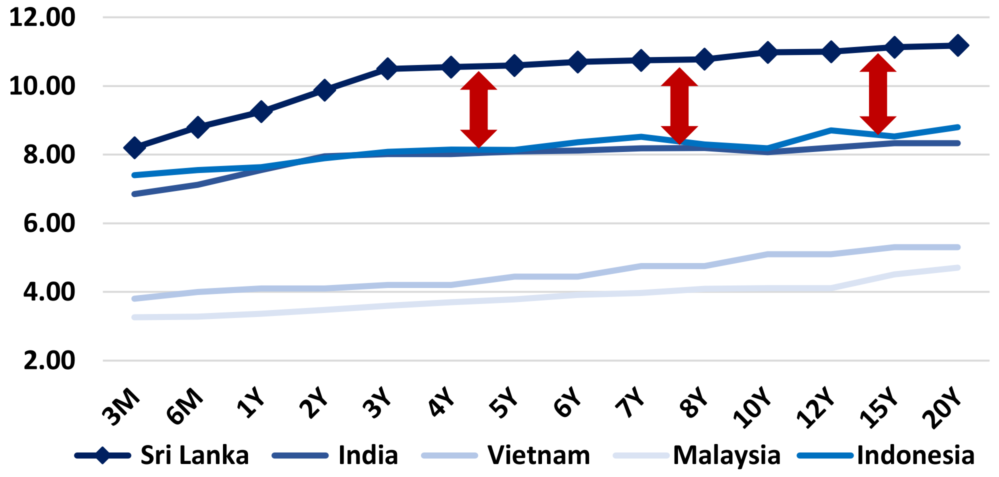
Source: Bloomberg

Graph 4 : Real Effective Exchange Rate reaches 105.25 in Jul 2018



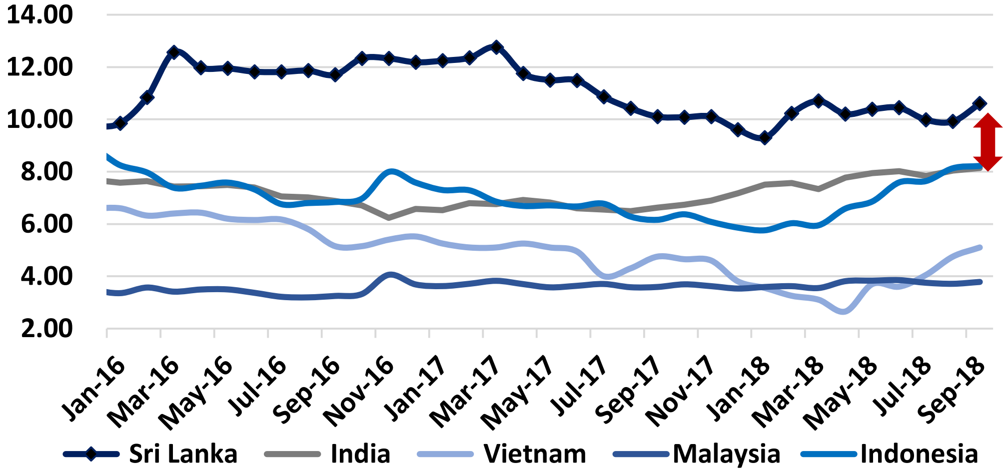
Source: CBSL

Graph 5 : Comparative Yield curve as at Sep 2018 signifies the attractive yields premium attached to bonds



Source: Bloomberg

Graph 6 : Sri Lanka's 5-Yr Bond Yield Premium adjust upwards



Source: Bloomberg

Disclaimer

This Review is prepared and issued by First Capital Holdings PLC. based on information in the public domain, internally developed and other sources, believed to be correct. Although all reasonable care has been taken to ensure the contents of the review are accurate, First Capital Holdings PLC and/or its Directors, employees, are not responsible for the correctness, usefulness, reliability of same. First Capital Holdings PLC may act as a Broker in the investments which are the subject of this document or related investments and may have acted on or used the information contained in this document, or the research or analysis on which it is based, before its publication. First Capital Holdings PLC and/or its principal, their respective Directors, or Employees may also have a position or be otherwise interested in the investments referred to in this document. This is not an offer to sell or buy the investments referred to in this document. This Review may contain data which are inaccurate and unreliable. You hereby waive irrevocably any rights or remedies in law or equity you have or may have against First Capital Holdings PLC with respect to the Review and agree to indemnify and hold First Capital Holdings PLC and/or its principal, their respective directors and employees harmless to the fullest extent allowed by law regarding all matters related to your use of this Review. No part of this document may be reproduced, distributed or published in whole or in part by any means to any other person for any purpose without prior permission.

CONTACT US

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