



First Capital  
First Capital Research

# *“SURPRISE EARLY FUND RAISING TO PUSH BOND YIELD EXPECTATIONS LOWER”*

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First Capital Fixed Income Report – 24<sup>th</sup> June 19

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# Recap of Previous Recommendations:

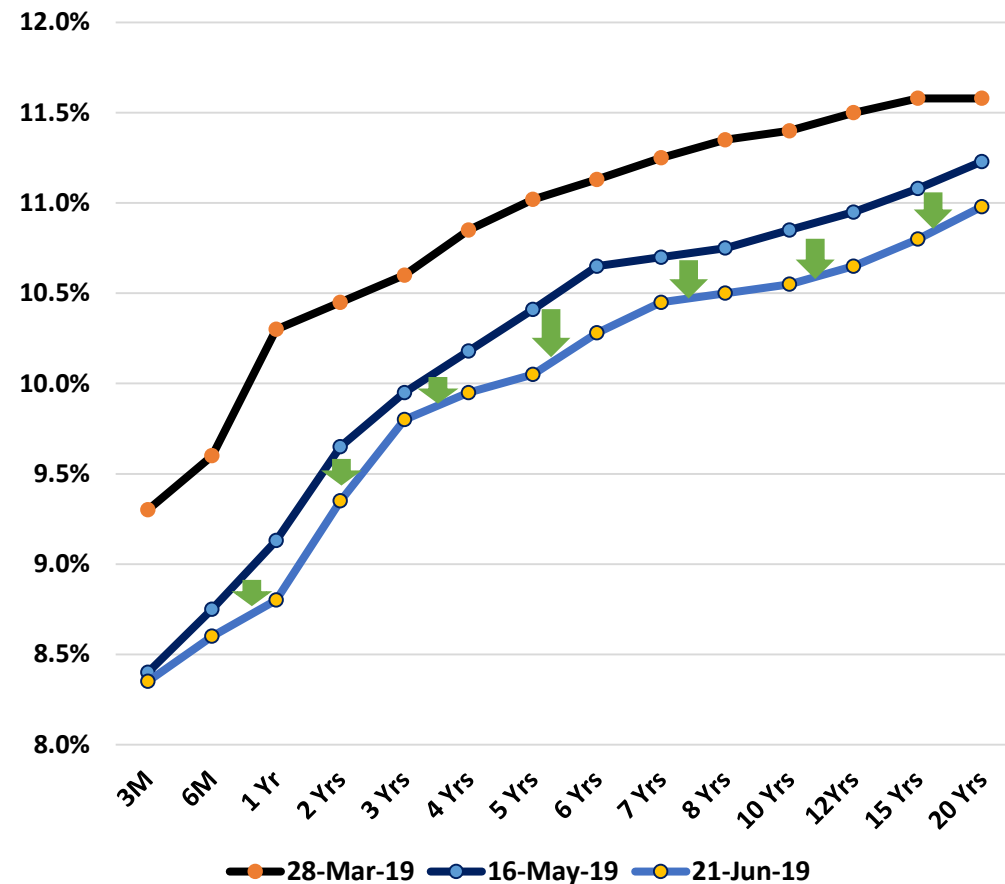
## 28<sup>th</sup> Mar & 16<sup>th</sup> May Recommendations and Yield curve movement

### Recommendation for 28<sup>th</sup> Mar 2019

- Portfolio Recommendation: **Increase overall portfolio to 70% from 55%.**
  - Increase Carrying Portfolio to 50% from 45%.
  - Increase Trading Portfolio to 20% from 10%.

### Recommendation for 16<sup>th</sup> May 2019

- Portfolio Recommendation: **Reduce overall portfolio to 40% from 70%.**
  - Cut Carrying Portfolio to 40% from 50%.
  - Cut Trading Portfolio to 0% from 20%.



# Surprise early fund raising to push bond yield expectations lower

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## ***Reduction in Bond Yield bands***

In our last fixed Income report on 24<sup>th</sup> May 2019, we reduced our yield curve band expectation by 50bps across the yield curve. Improved First Capital Economic Health Score, which suggests a lower risk profile as Sri Lanka returns to the status quo prior to Oct 2018 in terms of economic health, justifies a lower yield expectation in the bond market similar to the same period.

## ***Sovereign bond issue further strengthens foreign reserves***

Sri Lanka successfully raised USD 2.0Bn by conducting an International Sovereign Bond (ISB) offering tenors of 5 and 10 year. In the 5 Year Bond category USD 500.0Mn was raised at 6.35% (down by 50bps from Mar 2019) and USD 1.5Bn was raised via the 10-year bond category at 7.55% (down by 30bps from Mar 2019). In Mar 2019, USD 1.0Bn of 5-year sovereign bonds were issued at 6.85% and USD 1.4Bn of 10 year were issued at 7.85%. Following the issuance, we expect the foreign reserves to show significant improvement reaching above USD 8.0Bn in Jun 2019 while maintaining above USD 7.5Bn during Jul to Dec 2019. Cabinet approval was obtained to raise up to LKR 480.0Bn for debt management through liability management act, which provides leeway for CBSL to raise further USD 2.5Bn as indicated to manage debt in 2020, which would be a year with multiple election. Sri Lanka's next international sovereign repayment is only due in Oct 2020 amounting to USD 1.0Bn while 1Q and 2Q each constitute USD 0.4Bn of SLDBs maturing. Raising funds well in advance for repayments is expected to significantly strengthen macro economic outlook for Sri Lanka and to reduce unnecessary volatility.

## ***Revision in Yield curve Bands***

Amidst the continuous progress SL is making in managing future risk, we upgrade our expectations in the First Capital Economic Health Score, mainly supported by the successful issuance of USD 2.0Bn sovereign bond and possible further issue of additional bonds amounting to USD 2.5Bn to manage debt in 2020. A surge in foreign currency reserves and stability in all other indicators may result in a lower yield expectation. Accordingly we reduce our yield curve band expectations across the yield curve by 50bps.

# Justification for Revision of Bond Yield

- Previous Expectations for 2019 as at May 2019

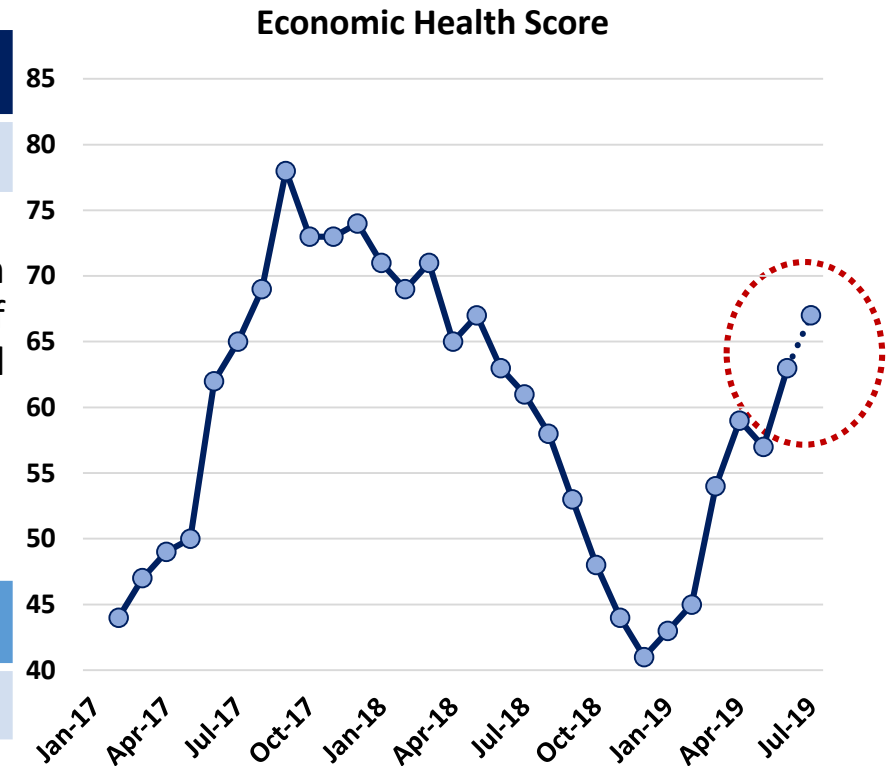
| As at May 2019 | 1 Yr       | 5 Yr        | 10 Yr       |
|----------------|------------|-------------|-------------|
| Beyond 2Q2019  | 9.0%-10.0% | 10.0%-11.0% | 10.5%-11.5% |

As at 24 June 2019, with further reduction in the future risk resulting from announcement of issuance of USD 2.0Bn Sovereign and approval of another USD 2.5Bn, we expect foreign reserves to be above the desired level, we revisited our band expectations as follows:

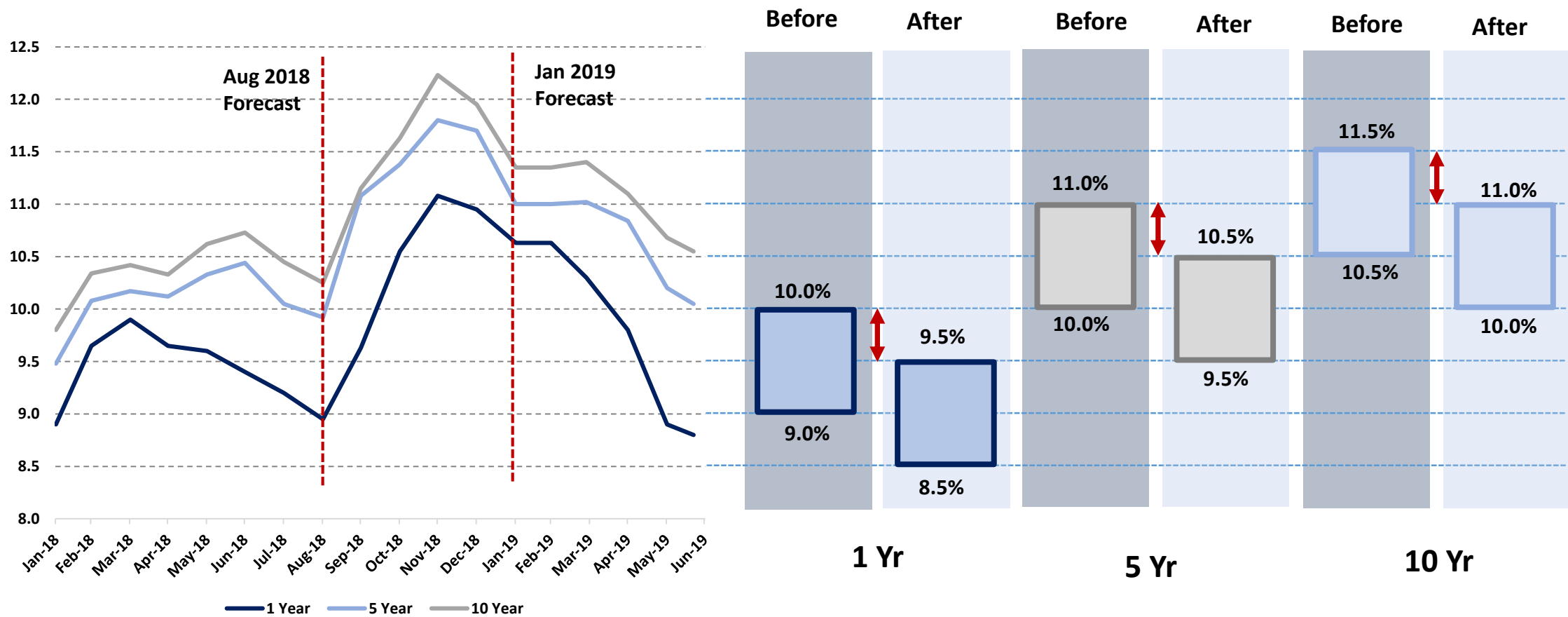
Yield expectation across the yield curve is brought down by 50bps.

- New Expectations for 2019 as at Jun 2019

| As at Jun 2019 | 1 Yr      | 5 Yr       | 10 Yr       |
|----------------|-----------|------------|-------------|
| Beyond 2Q2019  | 8.5%-9.5% | 9.5%-10.5% | 10.0%-11.0% |



# Revision of Bond Yield



# 1.0 New Recommendation

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# Portfolio Recommendation

## Fixed Income Portfolio Recommendation

– Portfolio Recommendation:

Portfolio Recommendation: **Increase overall portfolio to 60% from 40%.**

- Increase Carrying Portfolio to 50% from 40%.
- Increase Trading Portfolio to 10% from 0%.

**We recommend to add 2021 and 2022 maturities to the carrying portfolio while increasing the trading portfolio by adding 2023 and 2024 maturities.**



# 2.0 Economic Health Score

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# Jul 2019 Economic Health Score

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*Health score further improves*

|                    |   |    |      |   |    |
|--------------------|---|----|------|---|----|
| Primary Criteria   | - | 52 | + 03 | - | 55 |
| Secondary Criteria | - | 11 | + 01 | - | 12 |

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Economic Health Score (Jul 2019) - 67

- [As against 63 in Jun 2019 & 61 in Jul 2018 (1 Year ago)]

# Changes to Health Score – Priority Criteria

| Criteria         | Update   | Current Score | Add / Deduct Score | New Score |
|------------------|--|---------------|--------------------|-----------|
| Foreign Reserves | Issuance of new sovereign bond boost foreign reserves above USD 8.0Bn during Jul to Dec 2019.            | 12/15         | +02                | 14/15     |
| Liquidity        | CBSL continuously conducting term repo auctions to absorb excess liquidity.                              | 12/15         |                    | 12/15     |
| Inflation        | CCPI at 5.0% in May, lower than First Capital Research expectation of 5.4%.                              | 11/15         |                    | 11/15     |
| Foreign Buying   | Net inflow of LKR 537.0Mn in government securities over the last 4 weeks; Foreign holding reaches 2.63%. | 05/10         | +01                | 06/10     |
| Credit           | Private credit turned sharply negative to LKR 43.4Bn during Apr 2019.                                    | 06/10         |                    | 06/10     |
| CBSL Holdings    | CBSL sold down LKR 30.0Bn in the CBSL Holdings.  | 06/10         |                    | 06/10     |




Primary Criteria - 52 + 03 = 55

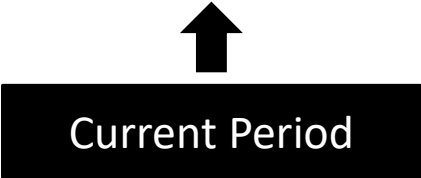
# Changes to Health Score – Secondary Criteria

| Criteria             | Update  | Current Score | Add / Deduct Score | New Score |
|----------------------|---|---------------|--------------------|-----------|
| Rating Outlook       | No major changes.   | 02/05         |                    | 02/05     |
| External Environment | Rupee continued to flat over last 4 weeks close at 176.54 on 23 June 2019 supported by foreign inflows. | 02/05         | +01                | 03/05     |
| BoT & BoP            | Deficit in the trade account slowed down with contraction in imports in Mar 2019.                       | 03/05         |                    | 03/05     |
| Political Risk       | Political stability reinstated to some degree amidst the possible Presidential election in 2019.        | 03/05         |                    | 04/05     |
| Investor Confidence  | BCI dropped to 62 in May to its lowest level since July 2008.   | 01/05         |                    | 01/05     |

Secondary Criteria - 11 + 01 = 12

# Revisiting Health Expectations

|   | 3 Months Outlook<br>Jan-Mar 2019 | 3-6 Months Outlook<br>Apr-Jun 2019   | 6-9 Months Outlook<br>Jul-Sep 2019   | 9-12 Months Outlook<br>Oct-Dec 2019  |
|---|----------------------------------|--|--|--|
| Health Score Estimate                   | 40-50                            | 50-60  | 65-70  | 65-70  |
| Risk Level – Jun 2019                   | High                             | Medium  | Medium-Low  | Medium-Low  |
| <i>Previous Expectations – Jan 2019</i> | High                             | Medium-High  | Medium   | Medium   |



**Risk Levels:-** High: 40-50, Medium High: 50-55, Medium: 50-65, Medium Low: 65-75, Low:75 above

# Sequence of Events

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

12<sup>th</sup> Oct 2018 - **Increase portfolio to 60% from 50%**. Increase Carrying Portfolio to 35% from 30% and Trading Portfolio to 25% from 20%.

9<sup>th</sup> Nov 2018 - **Reduce overall portfolio to 40% from previous 60%**. Cut Trading portfolio to 5% from 25%. Carrying portfolio to be maintained at 35%.

19<sup>th</sup> Dec 2018 - **Increase portfolio to 50% from 40%**. Increase Trading Portfolio to 15% from 5%. Carrying Portfolio to be maintained at 35%.

11<sup>th</sup> Mar 2019 - **Increase overall portfolio to 55% from 50%**. Increase Carrying Portfolio to 45% from 35%. Reduce Trading Portfolio to 10% from 15%.

28<sup>th</sup> Mar 2019 - **Increase overall portfolio to 70% from 55%**. Increase Carrying Portfolio to 50% from 45%. Increase Trading Portfolio to 20% from 10%.

16<sup>th</sup> May 2019 - **Reduce overall portfolio to 40% from 70%**. Cut Carrying Portfolio to 40% from 50% and Trading Portfolio to 0% from 20%.

24<sup>th</sup> June 2019 - **Increase overall portfolio to 60% from 40%**. Increase Carrying Portfolio to 50% from 40%. Increase Trading Portfolio to 10% from 0%.

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