Strategy Report 2021

The second leg of 'W'; bumpy road to 'Recovery'

Sri Lanka's economic growth has been slowing down over the last 5-6 years, as the country closes in on the upper middle-income band. The country has many structural issues which require massive painful reforms in order to achieve accelerated growth. So far no political party has had the will to guide Sri Lanka through the reforms, as Government after Government considers and implements temporary measures kicking the can down the road. In the present state, ignoring the fundamental problems is increasing becoming a daunting task.

Covid-19 & Sri Lanka's W-shaped recovery

The spread of the Covid-19 virus across the world has had a major blow to all economies across the world, with Sri Lanka being no exception. The economic downturn driven by the virus was a significant setback for the already fragile economy.

Following the gradual opening up of the economy after the release of the 1st lockdown in Sri Lanka, the economy registered a steep recovery in specific sectors especially led by manufacturing, food and beverage and construction sectors.

Considering the heavy CBSL Holding volume and inevitable relaxation of import restrictions, economy may showcase a currency spike followed by an interest rate spike resulting in another shock to the economy which may prevent a V shaped recovery while inducing a W-shape for the recovery process.

OUTLOOK FOR 2021

In understanding the outlook for 2021, lets first look at the factors that needs to be considered for 2021. For ease of structuring the factors have been divided into 3 main segments, political, economic, and external.

POLITICAL & POLICY STABILITY REMAINS HEALTHY: LOW RISK

Stability ensued with 2/3 majority:
In line with the historical trend, General Elections results followed the Presidential Elections providing an overwhelming majority to the ruling party. With the government maintaining its 2/3 majority, for investors, it provides confidence in relation to policy stability which is a priority for long term investments.

Provincial Elections may follow in 2021:
We expect Provincial Council Elections to be held possibly towards 2H 2021. The PC Elections are also likely to provide a similar trend to the General Election potentially providing a 'majority' for the ruling party for most of the Councils. In such a situation it is likely to further strengthen the stability on the political front favouring long term investments.

BOUNCY ROAD AHEAD FOR THE ECONOMY: *MODERATE RISK*

How some of the Covid-19 vaccines compare

Company	Type	Doses	How effective*	Storage	Cost per dose
Oxford Uni-AstraZeneca	Viral vector (genetically modified virus)	x2	62-90%	Regular fridge temperature	£3 ($4)
Moderna	RNA (part of virus genetic code)	x2	95%	-20C up to 6 months	£25 ($33)
Pfizer-BioNTech	RNA	x2	95%	-70C	£15 ($20)
Gamaleya (Sputnik V)	Viral vector	x2	92%	Regular fridge temperature (in dry form)	£7.50 ($10)

Source: BBC

The 2nd Wave:
Covid-19 2nd Wave forced a 2nd lockdown in 4Q 2020 which may slowdown economic growth again. However, it may minimize the impact for 2021 with the number of new Covid patients towards Jan 2021 coming under control, improving the number of active cases to a more manageable level.

Vaccinations to start:
Sri Lanka's Covid-19 vaccination program is likely to kick start as early as Feb 2021 with vaccinations expected reach Sri Lanka by the 27th January 2021.

Sri Lanka has currently chosen the Oxford – AstraZeneca Covid-19 vaccine. However, the Government has informed that it is considering the Chinsese and the Russian vaccines as well.

GDP growth for 2020E maintained at -5.8%; 2021E upgraded to 3.2%:
We factored in a 2nd wave in 3Q 2020, thereby we maintain our annual expectations for 2020E at -5.8%. With the 2nd wave lockdown materializing in 4Q (instead of 3Q), we revise our 4Q 2020 GDP expectations downwards to a range of (- 4.5%) - (- 5.0%) from our previous expectations of (- 0.8%) - 2.0%. However, in relation to 2021E and 2022E, we upgrade our expectations to 3.2% from our previous 2.8% and 2022E to 3.8% from the previous 3.3%.

The second leg of W; Bumpy road to 'Recovery':
As you are well aware considering the dip in 2020E, SL's recovery outlook seems to be well intact. But the sluggish growth is expected continue. Sri Lanka's surge in CBSL Holdings and foreign debt payment requirements may lead to a major depreciation in currency possibly leading to a spike in interest rates towards 2Q 2021, illustrating a "Bumpy road to Recovery". Considering the shocks, we expect SL to go through a W-shaped recovery as explained in Our Sep 2020 Mid-Year Outlook. Amidst the possible shocks, we believe SL to be in the second leg of "W".

Money Printing Spree:
Globally, Central Banks are using every tool in the book with monetary policy measures such as policy rate cuts, liquidity support schemes, SWAP lines and Central Bank asset purchase schemes. Further in order to mitigate external economic shocks selected Central Banks have adopted foreign currency interventions and capital flow measures. Central Bank globally have introduced supported systems for banks for distress situations with easing countercyclical capital buffers, easing domestic capital buffers, use of capital buffers and liquidity buffers while also supporting via making adjustments to provisioning require -ments. Certain Central Banks improved access to capital and relief to borrowers by state loans or credit guarantees and restructuring of loans or moratorium on payments. The measures have actually led to a money printing spree, where printing their way out of the mess is the mantra heard worldwide. Most justify the case via the Modern Monetary Theory.

CBSL Holdings spike:
Sri Lanka too, is following a similar course to other global central banks, illustrated by the unprecedented surge in CBSL Holdings. CBSL Holdings have spiked to LKR 725Bn by Dec 2020 compared to a mere LKR 74Bn in Dec 2019. Supported by the rise in CBSL Holdings, market liquidity has surged passed LKR 200Bn by Dec 2020.

Credit Growth to rise:
With liquidity AWPR, representing the lending rate for prime customers plunged below 6.0% Decade low lending rates and rising consumer demand may accelerate private sector credit growth to c.12% in 2021E while also maintaining the same momentum for 2022E to reach 12%.

Inflation though may trend upwards is likely to continue to remain under check:

With the potential currency devaluation we may experience cost push inflation towards the middle of the year. However, despite the cost push inflation, we continue to expect inflation to remain single digit throughout 2021E broadly maintaining a 4.0% - 6.0% range.

Balance of Payment to a struggle:

Trading activity may recover back in 2021E to at least 90% of 2019 level, provided the Govt allows a gradual relaxation of trade restrictions. We expect export to recover to USD 11 Bn while imports are also likely to recover at a slightly faster pace to reach USD 17.5 Bn generating a higher trade deficit of USD 6.5Bn. Yet, the recovery in Tourism Earnings may pull the current account balance to a marginal surplus in 2021E. Tourism earnings are likely to recover to 65% in 2021E. However, Balance of Payment may improve on short term funding but may continue in negative territory reaching a deficit of USD 1.6 Bn amidst challenges in rolling over maturing foreign debt via fresh funds.

Higher budget deficit:

A surge in capex with the resumption of Govt's infrastructure drive may curtail any expectations of a lower budget deficit. We expect Government Budget deficit to a range of 9.0% - 1 0.0% for 2021E, possible only marginally lower than 2020E supports by the Government major drive towards infrastructure spending.

Foreign currency borrowing, a challenge:

Foreign currency borrowing options continue to be limited to short term funding as SWAPs take centre stage. We expect Government to raise at least USD 2.5 Bn via SWAPs from India and China combined while other channels of fund raising such as Commercial Loans and Bilateral or Multilateral funding may account for a further USD 1.5 Bn. We also expect FDI to improve this year with Port City investments and investments into Eastern Container Terminal on the cards. On a conservative note, we expect USD 600 Mn to be generated via FDIs.

Foreign Reserves may further dip:

With a balance of payment likely to reach a deficit of USD 1.6Bn we expect foreign reserves gradually decline over the next 12 months. Foreign Reserves are likely to fall to USD 5.0Bn by Jun 2021 while falling below comfortable levels to USD 4.0 Bn by Dec 2021.

Debt Repayment stands tall: Total Rupee and USD Bond obligations are high closing in on LKR 1 Tn in 2021E with total debt obligations including project loans rising to 2.7 Tn 2021E from 2.4 Tn in 2020. Foreign currency reserves which were at USD 5.7Bn as at Dec 2020, have now marginally fallen below the total foreign debt obligations for the first time in the recent past as foreign currency reserve cover falls below 1.0x. During 2021E, Rupee debt maturity spikes in 4Q hile foreign debt maturity is high in 2Q & 3Q with an ISB maturity of USD 1.0 Bn in Jul 2021. Even in the Government Securities market it is important to note that the treasury bill stock whas spiked to 24% of the Government Securities portfolio, one of the highest levels in the recent past which clearly illustrates the risk in the system as most investors prefer to invest in the shorter tenors identifying the possibility of a spike in rates in the future.

EXTERNAL OUTLOOK REMAINS WEAK: *MODERATE RISK*

Rating Downgrades:

The expected downgrades by the rating agencies materialize during the Sep – Dec 2020 period which are as follows:

- Fitch downgrades SL Credit Rating to CCC on 27th Nov 2020
- S&P downgrades SL Credit Rating to CCC+ with Outlook Stable on 11th Dec 2020
- Moody's downgrades SL Credit Rating to Caa1 with Outlook Stable on 28th Sep 2020

Global fund flows may continue in developed markets:

Foreign flows into Sri Lanka as portfolio investments has virtually been non-existent for a long period amidst weak macro environment in Sri Lanka leading to multiple downgrades over the past 3-4 years. Foreign Holding in Government Securities has fallen to LKR c.7Bn . However, on a positive note it reduces the risk of further outflows from the system. Fund flow into Emerging Markets are unlikely to improve during 2021. With the global pandemic potentially easing off towards 2H 2021, developed markets are likely to raise interest rates and / or reverse quantitative easing to prevent inflation in the system which may attract portfolio funds reducing attraction for more riskier assets.

RECOMMENDATIONS

Bond Market: Bearish 1Q 2021 onwards

Pressure on Bonds yields to rise from 1Q 2021 onwards, but rise may be slower due to higher liquidity: Pressure on Bond yields are likely to mount, due to the following reasons,

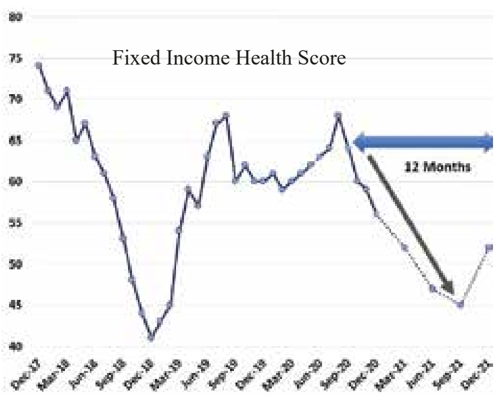
- Foreign Debt Repayments - Foreign debt repayments are high during 2021. Lower foreign reserve position may push local yields higher.

- High budget deficits - Lower revenue and higher infrastructure spending may lead to a continued higher budget deficit in 2021 resulting in strong rupee borrowing requirement.

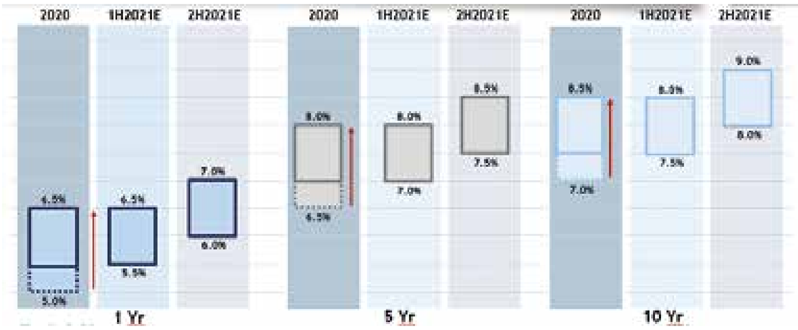
- Rising Private Sector Credit Growth - Stronger private sector credit growth may push yields higher amidst Govt's focus to borrow from domestic market.

Fixed Income Health Expectations may register a steep depreciation while A potential IMF program towards Jun 2021 cannot be ruled out.

	3 Months Outlook Jan - Mar 2021	3 - 6 Months Outlook Apr - Jun 2021	6 - 9 Months Outlook Jul - Sep 2021	9- 12 Months Outlook Oct - Dec 2021
Health Score Estimate	50 - 55	45 - 50	45 - 50	50 - 55
Risk Level - Jan 2021	Medium - High	High	High	Medium - High
Previous Expectations- Sep 2020	Medium - High	High		



Yield Curve may rise by 150-200bps and reach our upper bands of the yield curve



Bond Yields to gradually trend up from 1Q 2021 onwards followed by 2 policy rate hikes in 2H 2021:

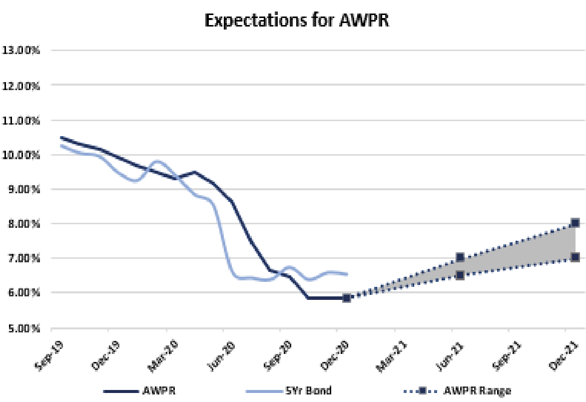
With the rise in Govt borrowing requirement, rising consumer demand and private credit, we expect a gradual increase in pressure on bond yields during 1Q 2021 and afterwards gradually move up further during 2021. On a base case we expect a stable policy environment upto Jun 2021 followed by policy rates reverting upwards with potential 2 policy hikes in 3Q/4Q.

Banking Rates: Pressure on banking rates to rise

Banking Rates (AWPR) to gradually trend upwards and readjust above the 5Yr Bond yield:

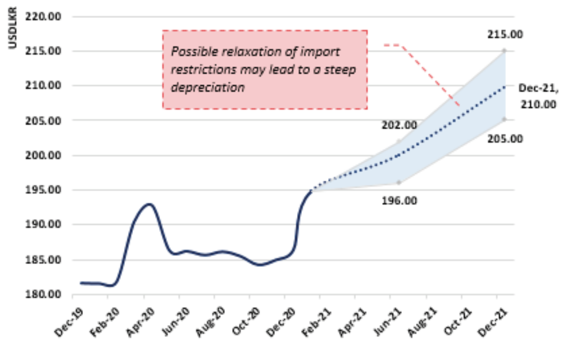
With the lack of credit, AWPR fell below the 5-Yr bond, breaking the historical trend of moving in line with the 5-Yr Bond. As private credit picks up AWPR may return to the historical trend.

We expect the AWPR to have bottomed out and is likely to rise amidst the competition for debt from Govt and Private Sector as Private credit picks up. With bond yields expected to move up, we expect AWPR to fall to a range of 6.5% - 7.0% by Jun - 2021 and further move towards 7.0% - 8.0% by Dec - 2021.



Exchange Rate: Target for 1H2021 narrowed down to LKR 196.0-202.0 with 2021 Year End target at LKR 205.0-215.0

Steep Depreciation:
With the weak foreign currency reserve position, high foreign currency debt repayment and possible spike in consumer demand triggering higher imports are likely to result in a steep depreciation in 2021. We expect LKR to depreciate approximately



Equity Market: Cut Portfolio Increase cash allocation to 10%

Earnings Outlook Upgraded

Earnings recover faster than anticipated:
The earnings dip in the 1Q and 2Q was quite steep, but 3Q2020 has shot up amidst the strong recovery in Food and Beverage, Capital Goods, Transportation and Material sectors. Genuine recovery was witnessed in the F & B sector while selected companies in the Capital Goods and Transportation sectors had a major benefit with a spike in demand for their products and services due to Covid-19.

Potential rise in Consumer Demand:
We are unlikely to witness any pressure on banking rates during 1H 2021 as well, supported by the 6-month lag effect between Government Securities and bank interest rates. The extended period of lower interest rates would have a favourable impact towards consumers. We expect a rise in consumer demand during 1H 2021 to positively influence earnings.

Earnings for 2020E upgraded to -16% and growth of +19% for 2021E:
With the improved earnings outlook, we upgrade overall earnings expectations for 2020E improving to -16% on the back of stronger than expected outlook. Nevertheless, earnings growth expectations are maintained at +19% for 2021E. Despite growth for 2021E being similar with the upgrade of 2020E earnings, absolute earnings for 2021E improve closer towards 2019, indicating a strong recovery for companies.

With the steep spike in 3Q 2020 earnings we revise our Market Earnings forecast upwards despite a partial lockdown in 4Q 2020:
We have adjusted our earnings outlook 4Q upwards pushing 2020E earnings to a dip of 16% from the previous dip of 22%. 2021E earnings growth is maintained at 19%. With the adjustment of 4Q 2020 earnings upwards absolute earnings for 2021E is now closer towards 2019.

ASPI target of 7,000-7,500:
The market has already achieved our fair value target of 7,000-7,500 for 2021E which illustrates a PER of 14.0x-14.5x. We believe market is attractive when the market trades below a forward PER of 14.0x - 14.5x. We maintain our fair value target for 2021E at 7,000 - 7,500.

Reduce Equity Exposure by '10%' to 90% (from 100%):
We recommended investors to increase equity exposure in their equity portfolios (equity allocated funds) to 100% in our Equity Strategy Reports released 12 months ago in Jan 2020. That was in a period where the ASPI was trading well below the expected fair value. However, in the Bull Run the ASPI has surged well over our expected fair value justifying a gradual reduction in equity portfolio. Thereby, we raise our cash allocation in the equity portfolio to 10% from the previous 0%.

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