Mid-Year Outlook 2021

Fiscal weakness threatens Bumpy Recovery; Hints IMF

Sri Lanka has been struck by multiple Covid-19 waves disrupting the recovery efforts in place. But Sri Lanka's economic woes are not a result of the recent disruptions but have resulted from a long-term structural issue.

We expected Sri Lanka to go through a W-shaped recovery (Sep-20) amidst the continuous waves and possible shocks while a Bumpy Road to Recovery (Jan-21) was explained subsequently. On a continuation note, with potentially 2 double-digit budget deficit years (2019 & 2020) supported by the difficulty in raising foreign currency borrowings, Sri Lanka is likely to face a major shock over the next 12 months, which threatens SL's recovery prospects with potentially requiring to move into an IMF program.

OUTLOOK FOR 2021

In analyzing the outlook for the economy over the next 12 months, it is an important first look at the primary criteria that may affect the economy and understand the expectations or forecasts for the relevant criteria and form an opinion on the economic outlook based on a set of criteria. There are a large number of criteria that could affect an economy, but broadly it can be categorized into 3 different segments Political, Economic, and External.

POLITICALLY STABLE; BUT POLICIES VOLATILE: MEDIUM-LOW

No elections are likely to be held until 2023

Provincial Council Elections:

Govt seems to be quite comfortable running the Provincial Councils via the Governors. Therefore, in the current environment, elections are unlikely to be held in 2021 while it seems unlikely whether there is any hurry or plans to hold in 2023 either.

Local Government Elections:

The biggest challenge for the Govt can therefore be identified as the Local Govt Elections. Though period of local govt expire in Feb 2022, the relevant Cabinet Minister has the power to bring in relevant amendments to extend the period by 1 Year up to Feb 2023, which is likely to be the most probable scenario in the current environment.

New FM takes control, but economic woes reduce overall policy stability:

SLPP brings in President's brother, Basil Rajapaksa as New Finance Minister for the Government at a critical juncture where the Govt is struggling economically to raise revenue. A number of decisions and fiscal issues in the Govt is creating a politically unpopular climate for the Govt, questioning the overall policy stability. A couple of issues that were critical were the delay in importing vaccines, fertilizer ban, teacher salaries. The gravity of the policy instability forced the Govt into a cabinet reshuffle which may not have solved the unpopularity.

LOOMING UNCERTAINTIES HIT ECONOMY: HIGH RISK (Downgraded)

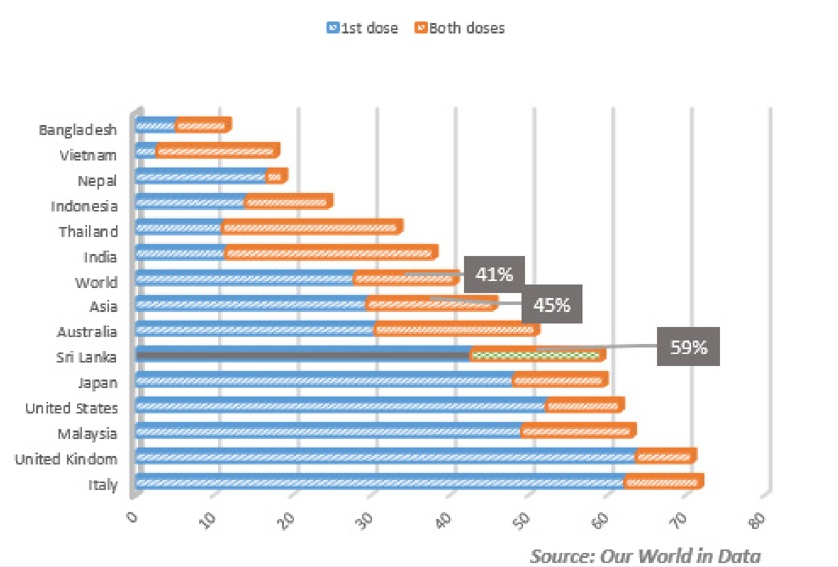
4th Wave hits the island nation:

Sri Lanka is currently facing the 4th Wave of Covid-19 with the daily number of new positive cases exceeding 5,000 on certain days. Hospitals and Intermittent Centres are overflowing with patients. The country went through the 1st wave in Apr-Jun 2020 period while the 2nd and 3rd waves were in Nov 2020-Mar 2021 and May 2021-Jul 2021. However, the 4th wave started in Aug 2021 even before the completion of the 3rd wave. The 4th wave has hit country badly with a massive spread in the Delta variant of the virus. Due to the Delta variant of Covid-19 has been spreading at an ultra-fast pace resulting Sri Lanka being one of the highest in terms of daily new cases per million among the regional peers. With the spread the death toll surged with over 200 deaths on a daily basis.

Accelerated Vaccination Drive:

Though the Government implemented lockdowns from time to time in order to control the spread, from April 2021 onwards a higher concentration was placed to order the required number of vaccine and to fully implement a vaccination drive. Though it took a bit of time to implement the program, with the support of the health staff and armed forces Sri Lanka managed to implement an accelerated vaccination drive by Jul 2021 with the support of 24-hour vaccination centres. Accelerated vaccination drive on certain days saw over 500,000 doses been administered bringing Sri Lanka among the countries that have implemented one of the fastest vaccination programs.

Chart: Vaccination reaching near 60% of population



Fully Vaccinating Population:

As at 8th Sep, the vaccination has reached near 60% of the population who have at least received one dose of the vaccine while over 40% has reached both doses. In relation to the 30+ population, Sri Lanka has vaccinated 100% of the 30+ population with 1 dose, while over 80% is vaccinated with both doses. The elderly population who were not able to travel were vaccinated at their houses itself through a mobile vaccination campaign. The country has commenced vaccinating 20-30 age group, where over 40% has been vaccinated with the 1st dose. In the final phase, Sri Lanka plans to vaccinate the 12-20 population as well. With this vaccination drive, it is planned to fully open up the economy by the 4Q2021.

First Capital upgrades its GDP forecasts amidst the stronger than anticipated 1st quarter of 2021:

SL recorded GDP growth of 4.3% during 1Q2021 well above our target of 2.4%. However, it needs to be noted that 3Q2021 may have an adverse impact due to the 4th wave while the previous comparative quarter in 2020 was an extremely strong quarter just after the 1st lockdown. Thereby, we upgrade GDP forecast for 2021E to 4.0% as against a previous forecast of 3.2% while upgrading 2022E to 4.3% as against the previous forecast of 3.8%.

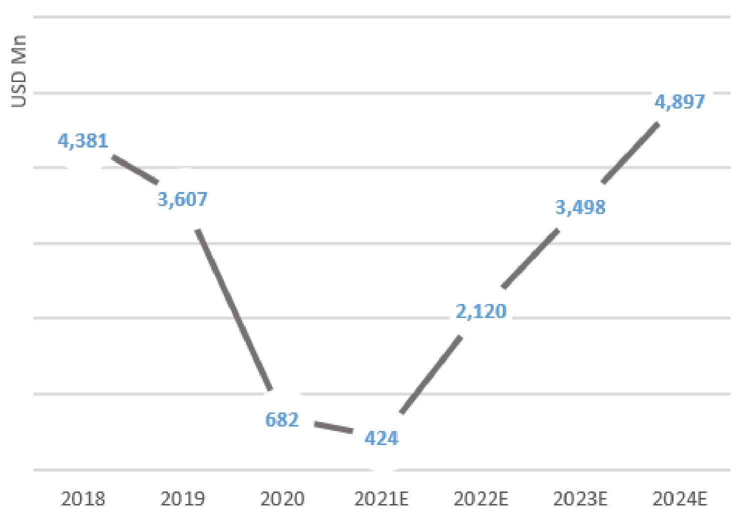
Trade Deficit to widen:

This research expects import growth to accelerate faster than export growth resulting in the trade deficit widening during 2021E and 2022E. The significant increase in fuel prices and the accelerated infrastructure development programs are the primary reasons for the sizable growth in imports despite the ongoing import restrictions. The trade deficit for 2021E may reach USD 7.7Bn from USD 6.0Bn in 2020 while further expanding to USD 9.3Bn by 2022E.

Current Account to be supported by Tourism:

Despite the widening of the trade deficit, the comfort factor would be the recovery in tourism. However, tourist arrivals for 2021E are likely to be at a minimal level, with less than 65,000 tourists. The recovery is likely to take place from next year 2022E, reaching 740,000 tourists and recovering at a rapid rate thereon with having forecast to reach 1.6Mn in 2023E and fully recovering above the peak level of 2018, only by 2024E by reaching 2.7Mn tourists. Thereby, it can be identified that the tourism industry's recovery would be a more gradual one, with tourism earnings expected to rise to over USD 2.0Mn by 2022E and to near USD 3.5Mn by 2023E. Therefore, though the current account deficit increases this year to USD 2.3Bn due to the expansion in the trade deficit, in 2022E with supported by the recovery in tourism earnings, it is expected to narrow down to USD 1.5Bn.

Chart: Tourism Earnings reaching nearly USD 5Bn by 2024E



Limited Borrowing options:

The high debt to GDP ratio coupled with the current Covid-19 environment where most governments are going through quantitative easing programs, it has become an extremely difficult environment for the Government of Sri Lanka to borrow. The country is grappled with limited funding options. Sri Lanka in August 2021 received a couple of funding options that were targeted from IMF (Rapid funding facility of USD 787Mn) and a SWAP from Bangladesh (USD 150Mn). In addition, there are plans to work on sale of underutilized assts amounting to USD 400Mn, loan from China Development Bank of USD 300Mn, potential SWAPs from India of USD 400Mn and receipts from forex purchases and inflows due to ownership of International Sovereign Bonds by local banks amounting an estimate of USD 500Mn.

FDIs also a struggle:

FDI options in Sri Lanka are limited in the current pandemic environment falling to a lowest level of USD 687Mn in 2020. However, we believe 2021E FDI expectations are likely to be lower and First Capital Research estimates stands at USD 550Mn. It is important to also note that Sri Lanka's unique Port City project is of interest to some of the global and local investors believing in a financial hub concept for Sri Lanka within the port city.

Thereby we expect some investments to materialize from 2022E onwards as we estimate USD 950Mn, still falling below the USD 1Bn mark.

Foreign Reserves to slip to dangerously low levels:

With the inability to rollover bulk of the debt amidst the limited borrowings options and lower FDI flow translates to Balance of Payment deficits of USD 2.1Bn in 2021E and USD 789Bn in 2022E. Though there is an improvement, the Balance of Payments is still in deficits, further deteriorating the foreign reserve position. We expect foreign reserves to fall to dangerously low levels of USD 3.5Bn by Dec 2021 and USD 3.0Bn by Jun 2022.

CBSL Holdings skyrocket; Liquidity dries up:

Government's strategy to boost the economy via infrastructure spending continues for yet another year despite the inadequate Tax Revenues to the Government coffers and the additional spending requirements resulting from the pandemic situation. As a result, Sri Lanka is expected to record the 2nd consecutive double digit (10%+) budget deficit in 2021E before some possible improvements in the coming years. The mega deficits are massive strain to the system as credit soars led by the public requirement for credit. However, with the lower interest rate environment the private sector credit has also recorded a significant improvement in the recent months recording YTD growth of 8%. Amidst the significant demand for credit, the liquidity in the system dried up. Further SRR hike of 2% was also given by the CBSL implemented on 1st Sept resulting in liquidity turning negative amounting to LKR -205Bn. With the Government's spending spree continuing, the quantitative easing program has also continued as CBSL Holdings reached a new high exceeding LKR 1.2Tn.

Credit growth to remain at 12%:

The accelerated credit growth situation is likely to slow down over the next 2-3 month with the negative liquidity situation in the country. However, we believe the private sector credit growth target of 12% can be reached for 2021E. In addition, we maintain that credit growth is likely to remain around the 12% mark in 2022E as well with bulk of the growth likely to take place during 1H2022.

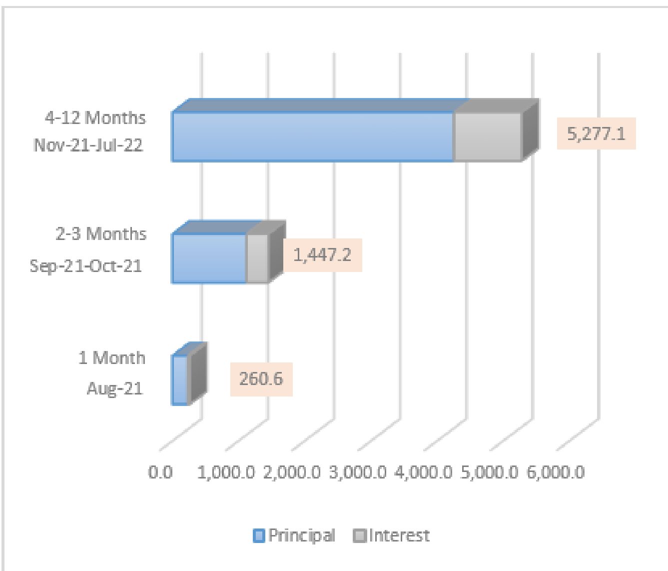
Inflation to rise as Cost Push Inflation:

Inflation has been broadly in the targeted range of CBSL of 4.0%-6.0% so far. With Sri Lanka being an import-dependent country, the continuous depreciation of the currency is expected to cause cost-push inflation. We expect inflation to start trending upwards to a range of 5.0%-7.0% by the 1H2022. Since inflation is led by cost increases adjustment of monetary policy may not impact inflation, however, it may support stabilization of the currency.

DEBT, Sri Lanka's primary concern:

Sri Lanka's debt obligations are rising at a rapid pace. The Rupee and Dollar Bond obligations alone, which includes International Sovereign Bond, Sri Lanka Development Bond and Rupee Bond maturities, amounts to a near LKR 1Tn (USD values translation at LKR 200.0) for 2021E and above LKR 1Tn for 2022E. Out of the overall debt obligations, foreign debt repayments are a major concern considering the dwindling of foreign currency reserves. Foreign Currency debt repayment for the next 12 months amount USD 7.0Bn compared to USD 2.8Bn of reserves as at Jul 2021.

Chart: Foreign Currency Debt for next 12 months amounts to USD 7.0Bn



With the IMF Rapid Funding Facility and Bangladeshi SWAP inflows, reserves are estimated to rise to around USD 3.5Bn which is still well below par. As at now, the foreign currency reserves are far short of the foreign currency debt obligations which is the biggest risk to the system at the moment and the primary cause of the weak currency. 1Q2022 and 3Q2022 are likely to be the biggest concerns in relation to repayment of debt. We are likely to experience a high level of stress and pressure during the 2 abovementioned periods. However, the problems do not stop there as 4Q2022 also has a high level of debt obligations, but the bulk of it is Rupee Debt.

External Outlook weakens further: High Risk (Downgraded)

More downgrades from Rating Agencies:

With the heavy debt burden and lower foreign reserves, two out of the three rating agencies have indicated potential downgrades. Moody's Rating for Sri Lanka currently stands at Caa1. The outlook was recently changed to "Under Review". Similarly, S&P Global has a rating of CCC+ for Sri Lanka and the agency recently downgraded the Outlook to Negative. Fitch, however, has affirmed the rating for Sri Lanka at CCC. Fitch does not provide "Outlook" for countries with ratings of CCC and below.

ISB yields surge:

Two of the rating agencies changing their outlook on Sri Lanka has had a negative impact on the sovereign bond market as well. The short-term yields, especially the 3Yr and low maturities has witnessed a major surge in their market yields. The Jan 2022 saw its yields spiking to 45%, while Jul 2022 maturity saw its yields spiking to 40%.

Fund flows towards SL might be remote:

Inflows to Sri Lanka has been weak amidst the struggling macroeconomic environment. Rating downgrades are further dampening interest as illustrated by the selling pressure on ISBs. Central Banks around the world make HAWKISH turn reverting funds to developed markets. Rate hikes by a number of Central Banks and possible tapering in the US are expected to shift the fund flow towards the developed markets while raising capital or debt is going to be challenging for countries like Sri Lanka.

	Apr 2021	May 2021	Jun 2021	Jul 2021	Aug 2021
Net Change	+25 bps	+50 bps	-95 bps	+1,055 bps	+325bps
Total Rate Cuts	500 bps	100 bps	350 bps	None	None
Total Rates Rises	525 bps	150 bps	255 bps	1,055 bps	325 bps
Rate Cuts	Congo	Ghana	Uganda, Congo and Seychelles	None	None
Rate Rises	Belarus, Ukraine, Russia, Kyrgyzstan, Georgia and Tajikistan	Armenia, Brazil and Iceland.	Russia, Armenia, Brazil, Hungary, Czech Republic and Mexico	Angola, Chile, Belarus, Ukraine, Russia, Kazakhstan, Kyrgyzstan, Hungary, Tajikistan and Moldova	Armenia, Georgia, Brazil, Czech Republic, Uruguay, Mexico and Peru
Global Monetary Policy Rate	**4.86%**	**4.87%**	**4.85%**	**4.96%**	**4.99%**

POTENTIAL IMF PROGRAM

As predicted IMF program is now more likely than not:

In line with the forecast of our Fixed Income Health score in Jan 2021, First Capital Research expected that Sri Lanka might negotiate an IMF program within 3Q2021. Though there are rumours of negotiations, so far such a program has not materialized, but the Govt has obtained the Rapid Funding Facility of USD 787Mn from the IMF. Considering current situation of the economy, the economic indicators seem to be slightly worse than our initial estimates (Eg: Jun-2021 Foreign Reserves dipped to USD 4.0Bn 6 months earlier than our expectations). Analysing the economic indicators and the forecast, we believe there seems to be an 85% probability that Sri Lanka may consider moving into an IMF program as soon as possible.

RECOMMENDATIONS

Bond Market: Steep upward pressure on Yield Curve, Yields to rise by a further 150-200bps

Pressure on yields in the Government Securities market is expected to rise due to the following reasons:

Higher Borrowing requirement:

Heavy COVID spending and continued infrastructure spending is expected to lead to over 10% budget deficit for the 2nd consecutive year, significantly increasing Govt's borrowing requirement.

Uncertainty over access to creditors:

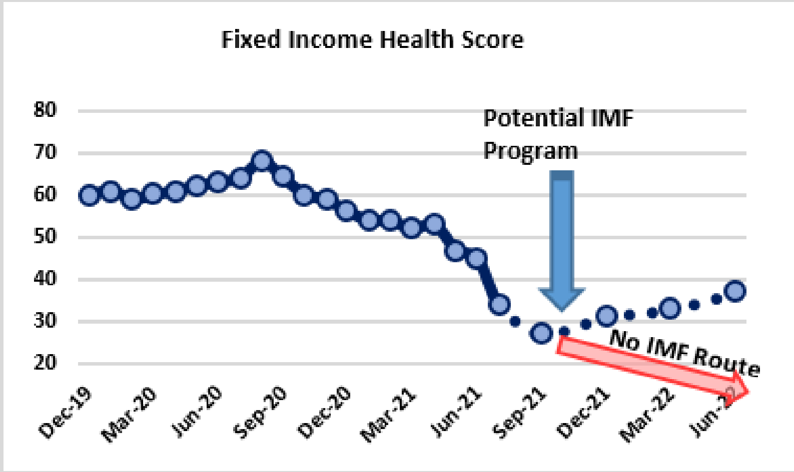
Weaker external profile due to a high share of dollar-denominated debt exposures has continued to increase the uncertainty over access to official creditors resulting in inadequate foreign currency inflows forcing Govt to shift to more short-term higher risk SWAPs.

Weaker conditions may lead to downgrade:

Funding from multilateral/ bilateral partners may not be sufficient to cover external financing needs over the next 12 months while Foreign Reserves are also at a dangerously low level which are likely to be some of the key facts that may be seriously looked at, as it may potentially lead another rating downgrade.

Fixed Income Health Score plunge well below our expectations:

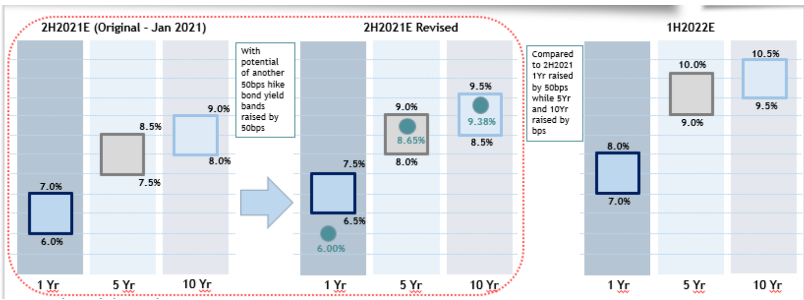
Fixed Income Health was already in the weak territory during the 1H2021. However, the score has further deteriorated and dropped below our forecasted values. Going forward it is forecasted to stay at a dangerously low level until a potential IMF program is implemented.



Policy rate Outlook maintained:

In our Jan-21 Report we forecasted 2 hikes in 2H2021 (3Q/4Q). In Aug, Monetary Board hiked rates by 50bps. We maintain our forecast that 1 more rate hike is possible in 2H2021. In 1H2022, the extremely weak economic indicators may force the Monetary Board to further tighten the monetary policy. Thereby, we expect further 2 rate hikes in 1H2022 as well.

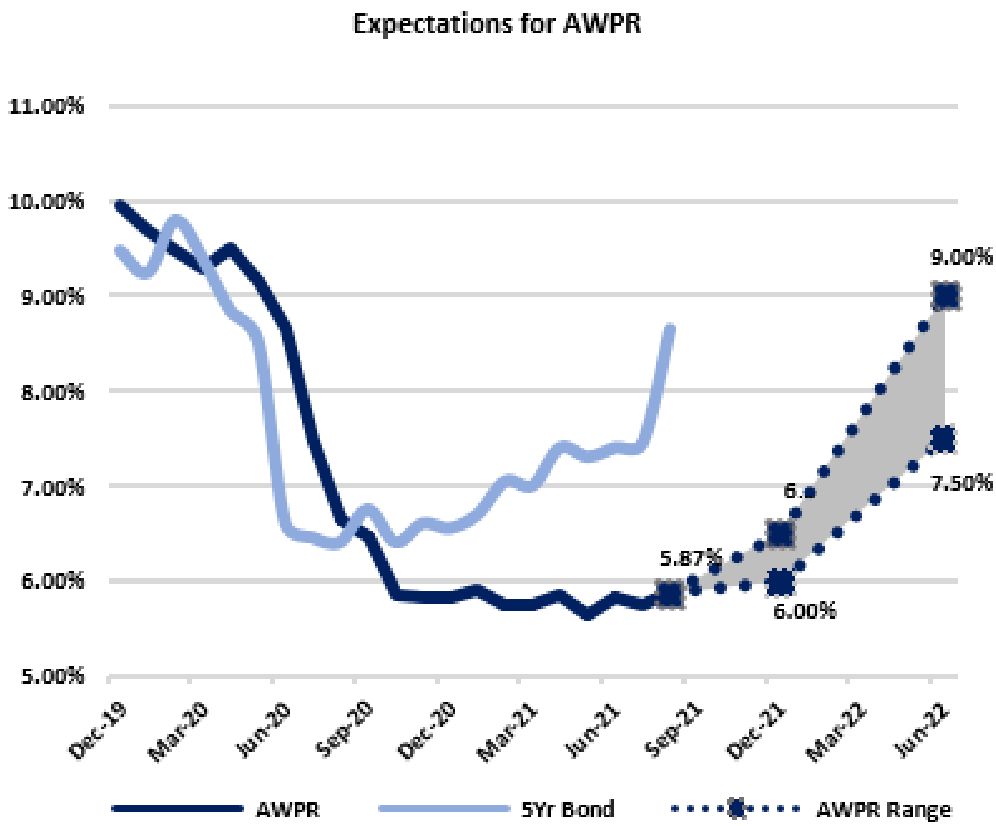
Yield Curve may rise by another 150-200bps and reach our upper bands of the yield curve by Jun 2022



Banking Rates: Pressure on banking rates to rise

Banking Rates (AWPR) to change course and shift upwards rising by at least 150bps by Jun 2022:

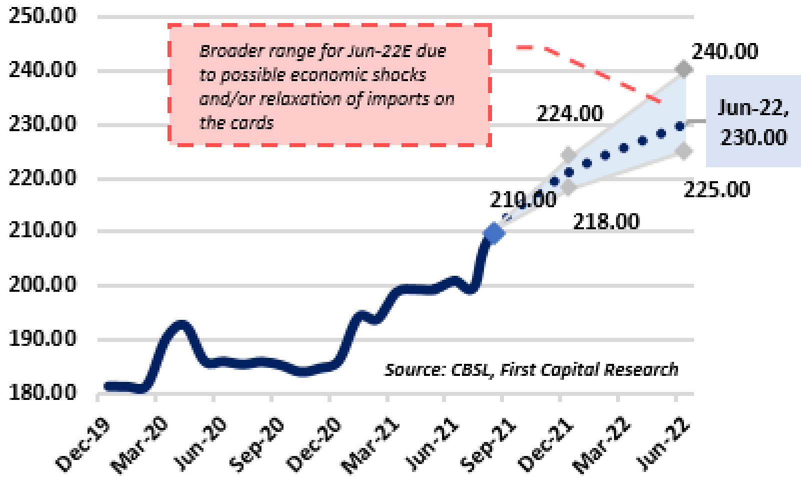
AWPR didn't move as early as we expected amidst the high level of liquidity due to continuous quantitative easing strategies adopted by CBSL. We expect the AWPR to have bottomed out and is likely to rise amidst the rate hike, SRR hike, negative liquidity, and high demand for credit in the system. With bond yields expected to move up, we expect AWPR to rise to a range of 6.0%-6.5% by Dec-2021 and further move towards 7.5%-9.0% by Jun-2022.



Exchange Rate: Exchange rate target for Dec-2021 downgraded to LKR 218.0-224.0 and Jun-2022 target introduced at LKR 225.0-240.0

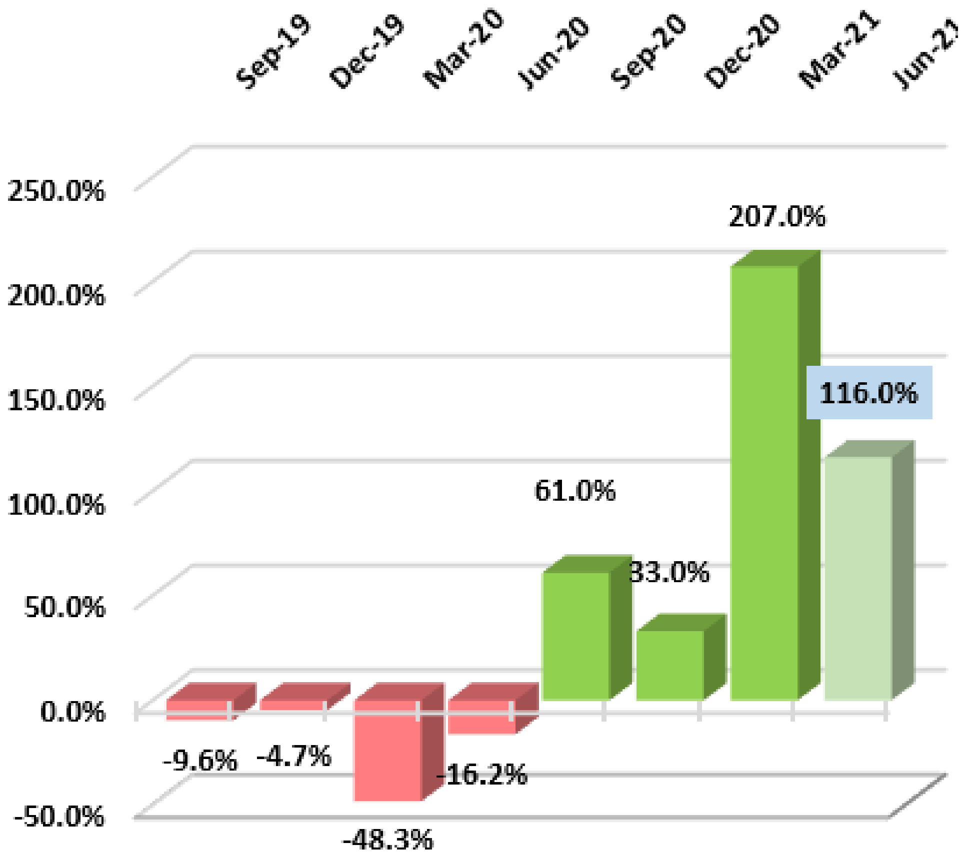
Strong Depreciation:

Sri Lanka's lower foreign reserve position and high foreign currency debt repayments are the primary concerns for the significant weakness in the currency. The recent surge in imports despite the ongoing import restrictions is an added concern. Taking the situation into consideration, we expect a strong depreciation of the currency over the forecasted period. We further downgrade our Dec-21 target from LKR 205.0-215.0 to LKR 218-224.0 while targeting LKR 225.0-240.0 for Jun-22.



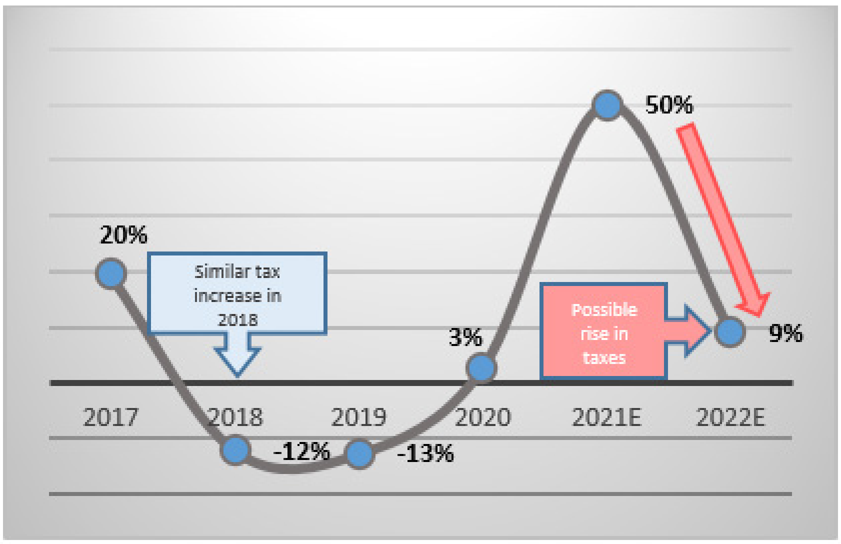
Equity Market: Reduce exposure to 50%

Market earnings records its 2nd triple-digit growth



Potential rise in taxes leads to a further downgrade in the target for market valuations:

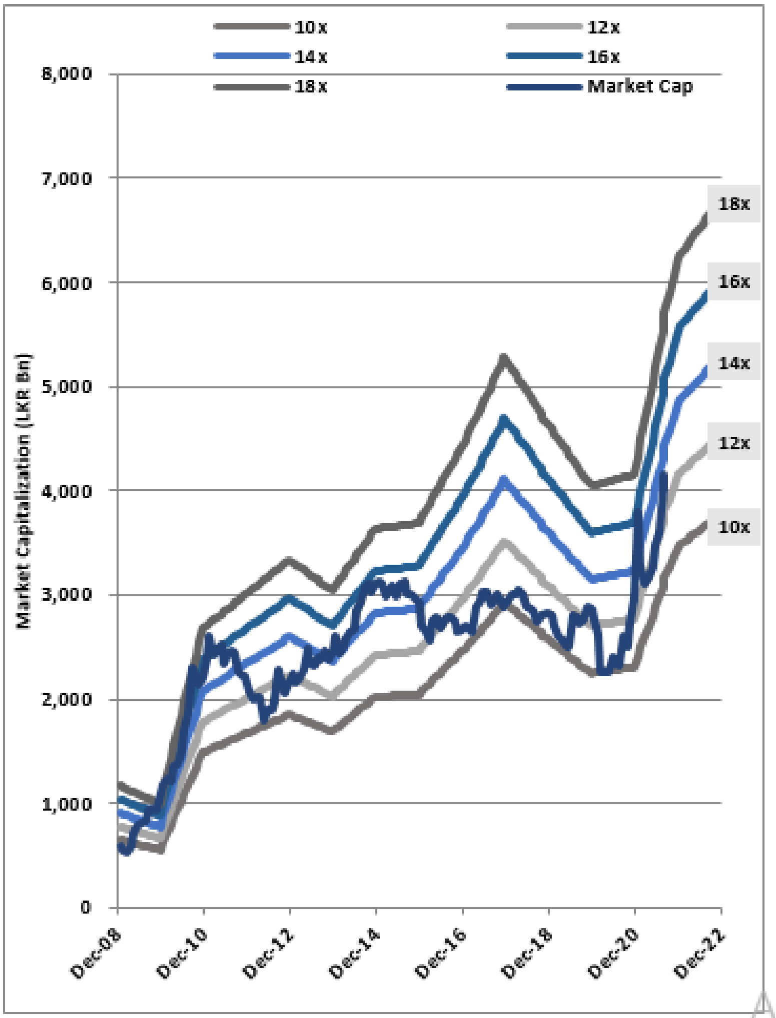
Considering the dire need for tax revenue, there seems to be a reasonable chance that tax rates are likely to be raised either at the consumer level or corporate or both. Current Govt Revenue is less than half of its expenditure and it is potentially the 2nd consecutive year that the Govt is likely to register a double-digit (10%+) budget deficit. Whether Sri Lanka goes through an IMF program or not, Govt may have to revise its tax rates in order to improve the Govt coffers.



Earnings expectations arise…

…But 2022E growth dips amidst possible economic shock and potential tax hikes

Market Valuations Spike…



Reduce exposure to 50% from 65%; Cash 50%
2nd Option – Switch to Defensive counters

Overall Interest rates to rise;

Continuous rise in interest rates is more likely than not considering the major deterioration of the economic indicators. With the rise more risk-averse investors may shift their investments towards fixed income instruments, adversely impacting the equity market over the next 3-4 months.

FD Ceiling to rise:

Considering the historic trend sharp switch from equity investments to fixed investments could be seen when FD rates reach 10.0% mark. By Oct-21, we are likely to witness the FD ceiling for finance companies to be raised to 8.0%-9.0%.

Possible tax hike:

As Sri Lanka is in the 2nd year of 10%+ budget deficit, potentially with an IMF program coming in there is a significant possibility for tax rates to be revised upwards. Historically hike in tax rates have shown to be negatively correlated with positive market returns. As a result, if implemented, it's a big negative for the market.

Aggressively reduce equity exposure to 50%:

On 19th Aug, ASPI was around 8,250 mark when recommended to reduce equity exposure to 65% on the expectation of further upside in the market. As at 4th Sep, the market has surged passed 9,300 and continues to be expensive even beyond the upgraded earnings. As the risk rises in the system supported by an increase in rates, it is recommended to further reduce the portfolio to 50% or aggressively shift the portfolio to defensive counters. Banking (mainly COMB, HNB, SAMP, NDB), selected dollar income companies (HAYC, TJL, WIND & LVEF – others have surged in price and cannot be highlighted as defensive anymore, Eg: EXPO, HAYL, MGT), dividend-yielding counters (CTC, NEST, LLUB) and Life Insurance companies are the preferred defensive counters.

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