

Frontier

— Research —



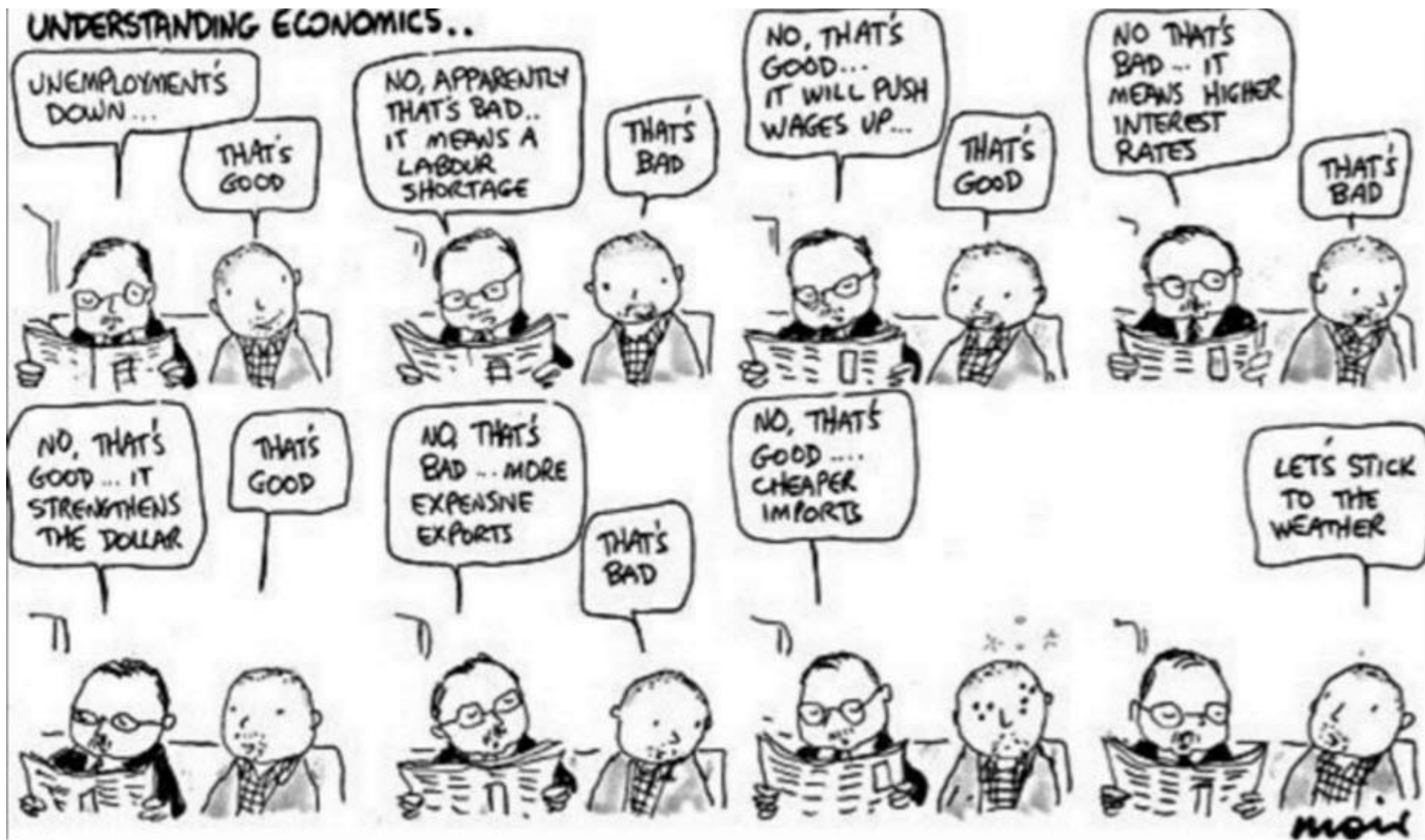
Outlook and an Assessment of the Sri Lankan economy

- What matters and what doesn't in understanding the economy
- Understanding Sri Lanka's Rates/LKR cycle
- Why our base case is that the cycle is turning positive
- Why we are vigilant and telling you to prepare for outlier risk
- What does this mean to you – the key takeaways

What matters and what doesn't



UNDERSTANDING ECONOMICS..



Budget bungled?

■ Parliamentary

SL-China trade grows six fold to cross \$ 4 b threshold

■ Second China Product Expo launched in Colombo

"This exhibition is a strong platform for Sri Lankan and Chinese



Euromonitor research confirms Sri Lanka as star attraction for tourism investment

■ Government praised for making travel sector a priority



Euromonitor International Research Analyst Vishnu Vardhan

AN exhaustive and independent report into Sri Lanka's tourism prospects by one of the world's leading providers of global business intelligence, has confirmed that the Indian Ocean island currently offers some of the region's best opportunities for investment.

The report by Euromonitor International is not uncritical: Infra-

good, but, the report points out, it will be put under considerable strain as visitor numbers grow, and the railways need urgent improvement to take some of the burden.

Colombo airport is a bottleneck, already operating above capacity, according to the report. It says expansion plans are due to be completed in 2020, more than doubling capacity. And fast road and rail links to the capital are in hand.

hotel chains, bears this out. AHTIC will bring international leaders of the hospitality industry to Sri Lanka.

It will be a forum for high-level discussion of the region - speeches by leaders, a unique chance for business leaders' views first-hand. It will be a forum for high-level discussion of the region - speeches by leaders, a unique chance for business leaders' views first-hand. It will be a forum for high-level discussion of the region - speeches by leaders, a unique chance for business leaders' views first-hand.



Sumanthiran, the fiscal assessment of the Budget 2017 is the first report presented by the current committee. "Although the committee worked without a parliamentary budget office this year, we are indebted to the service rendered to us by a few individuals including Dr. Anila Dias and Arunaratne, Rose Cooray, Hemiya Hurulle, Sarath Jayadunne and a team of economists working through Verite Research, including Dr. Nishan de Silva, who gave invaluable input and assistance without any remuneration," said Sumanthiran.

More Page 4

Govt. revenue from fags halves after price hike

■ October revenue from CTC down 51% to Rs. 4.2 b

■ Latest figure sharp drop compared to January to September average of Rs. 8.3 b a month

■ Beedi taxes hold steady, poised for growth

CEYLON Tobacco Company has contributed Rs. 75 b in Government revenue dur-

ing the first nine months of 2016 at an average of Rs. 8.3 b per month but prospects for State coffers look bleak going forward according to industry analysts.

Consequent to the excise hike on 4 October 2016, the price of the most popular brand of cigarettes sharply increased to Rs. 42, a 20% increase.

More Page 4

Expert calls on Government to streamline tax administration

By CHARUMINI DE SILVA

ALTHOUGH Government's revenue collection efforts



Budget 2017: Unwise move to reduce plantation lands for RPCs

By Lloyd F Yapa

Budget 2017, it must be stated, is comprehensive in its coverage and includes almost all the key result strategies (and sub strategies) required for boosting economic development in Sri Lanka (SL) despite certain shortcomings.

The national development strategies suggested by this budget to achieve the

cal grounds rather than on merit and the feeling that the Treasury will bail them out, if losses occur. So the answer should be a well-crafted, foolproof process of part privatization on the basis of public private partnerships (PPP), listing them in the stock exchange as suggested in the mentioned above. The other leaks are due mainly to deep rooted corruption.

Poverty alleviation

To deal with poverty alleviation, the



fully consolidate the state holdings after giving most of them are held by the state (which is the under restrictive conditions limit agricultural about \$1000 per acre in SL compared to most Malaysia and more Singapore, in constant World Bank, 2014). son for the poverty in SL and the inequ

Sri Lanka revenue reform, step towards stronger finances - Fitch

16 November 2016

- 79

Budget deficit the root cause for Lanka's economic woes: CB Chief

By Deek Jayasinghe

FINANCE MINISTER FIRM ON RESTRUCTURING BANKING REGULATOR

- Terms Central Bank "unsuccessful" and responsible for failed finance companies
- Ravi K denies politicisation of



amics and
II Immediate Past



Sri Lanka Ceramics and Glass
Council Elected President

Proposal on Colombo Intl. Financial Centre before Cabinet in two weeks: Ravi K

By CHARUMINI DE SILVA

THE Government's ambitious plan to establish an International Financial Centre (IFC) in Colombo is in the offing as it will be tabled in Cabinet within the next two weeks.

"In the next week or two we will get it to Cabinet and we will ensure it through Parliament to be ratified by end of January," Finance Minister Ravi Karunanayake told journalists.

To establish the IFC, the Government will draw up new regulations covering banking and financial transactions, company law, recruitment and employment rules, arbitration laws and all special regulations and laws needed. He said the IFC will be located in the Financial City, which is currently being constructed by the China Harbour



Finance Minister Ravi Karunanayake
-Pic by Lasantha Kumara

- RUPEE STEADY SAYS RAVI K -SEE PAGE 9
- PROPOSAL TO RAISE CAPITAL FLOOR TO BENEFIT BANKING SECTOR: FITCH -SEE PAGE 8

RAVI K JUSTIFIES TELCO

- Win-win for Govt. and service providers

economy' e often in nowadays it really v develop-a city prom-in project, of knowl-political

ongoing rked for p towards ky heavily ability to

Knowledge economy, a political slogan far from reality



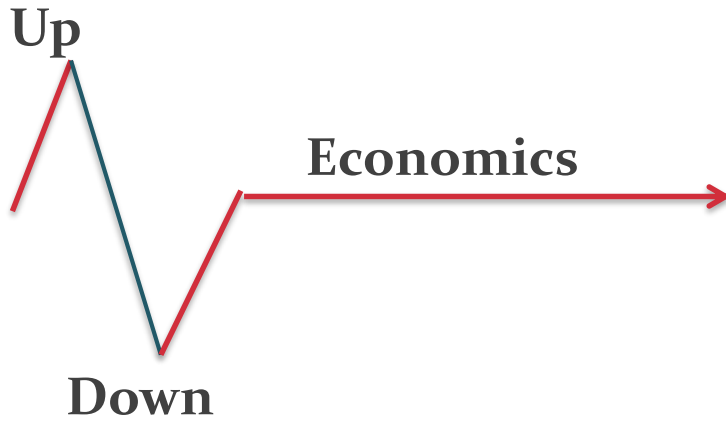
innovate high-tech products with their own brand names, instead of merely assembling foreign products using imported technology and foreign capital.

Such knowledge-led growth process cannot be expected from the ongoing mega projects which are to

FIRST COUNTRY WHERE GSP+ CONCESSIONS WERE WITHDRAWN

Questions still ahead as Sri Lanka prepares for EU scrutiny for GSP+ resumption

What matters to you?



- ✓ Interest rates
- ✓ LKR movements
- ✓ Local demand conditions

So we look at developments relevant to these variables

Rather than spend time with a wish list about what policies the government should do in the long run

How our view is formed

Credit
Growth

Repayment
Schedule

Inflation
data

Money
Supply &
Liquidity

USD
borrowing
costs

Currency
movements of
EMs/FMs

Global fund
flows to
EMs/FMs

Reserves
and External
Data



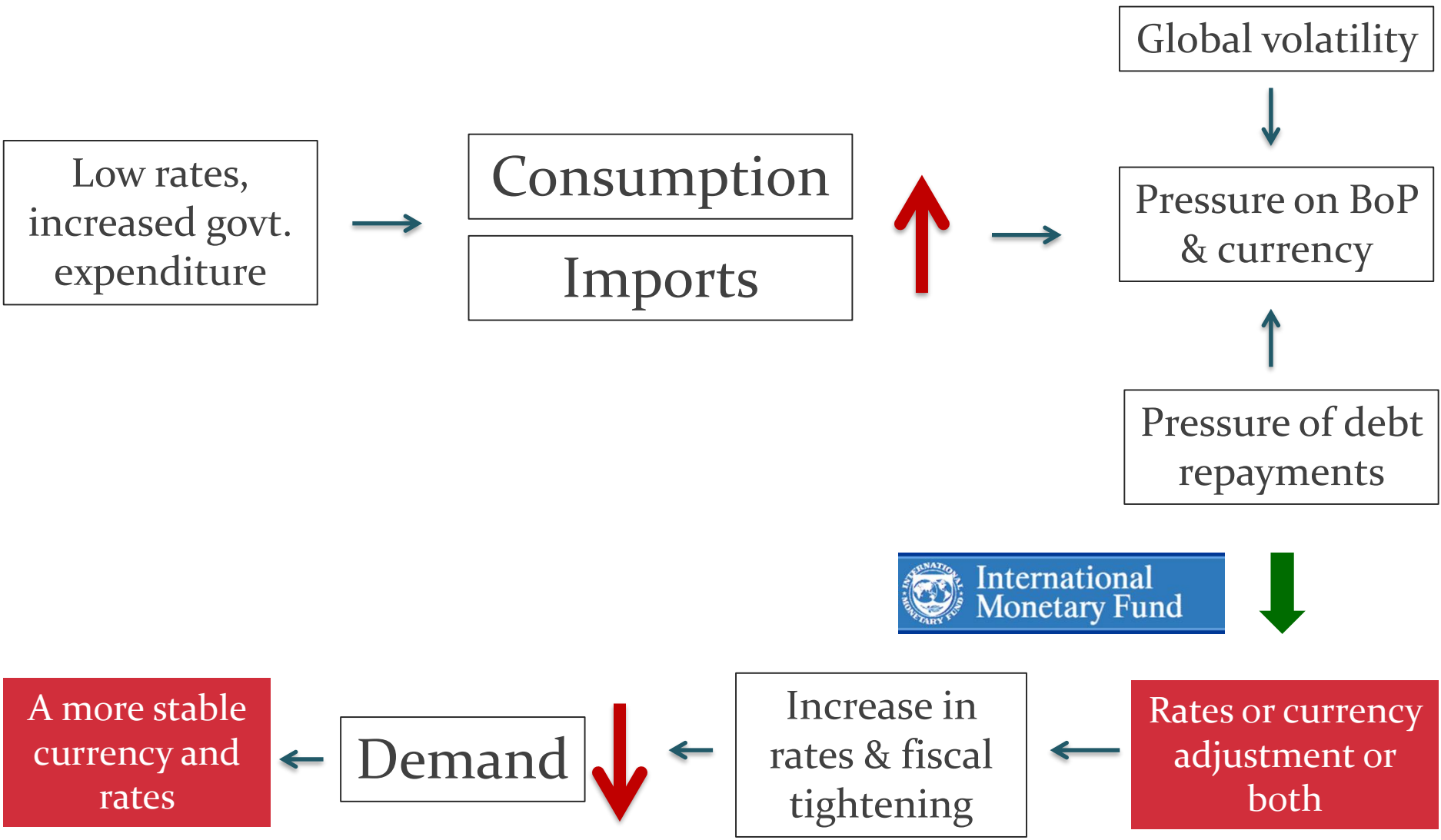
Key areas we look at to
build a view on rates/LKR

Things we don't focus on much

- ✓ GDP
- ✓ Unemployment
- ✓ Long-term policy statements and discussions around it
- ✓ Planned Trade Agreements – which are going to take a long time to come through
- ✓ Social Indices provided by Government

Understanding the Rates/LKR cycle





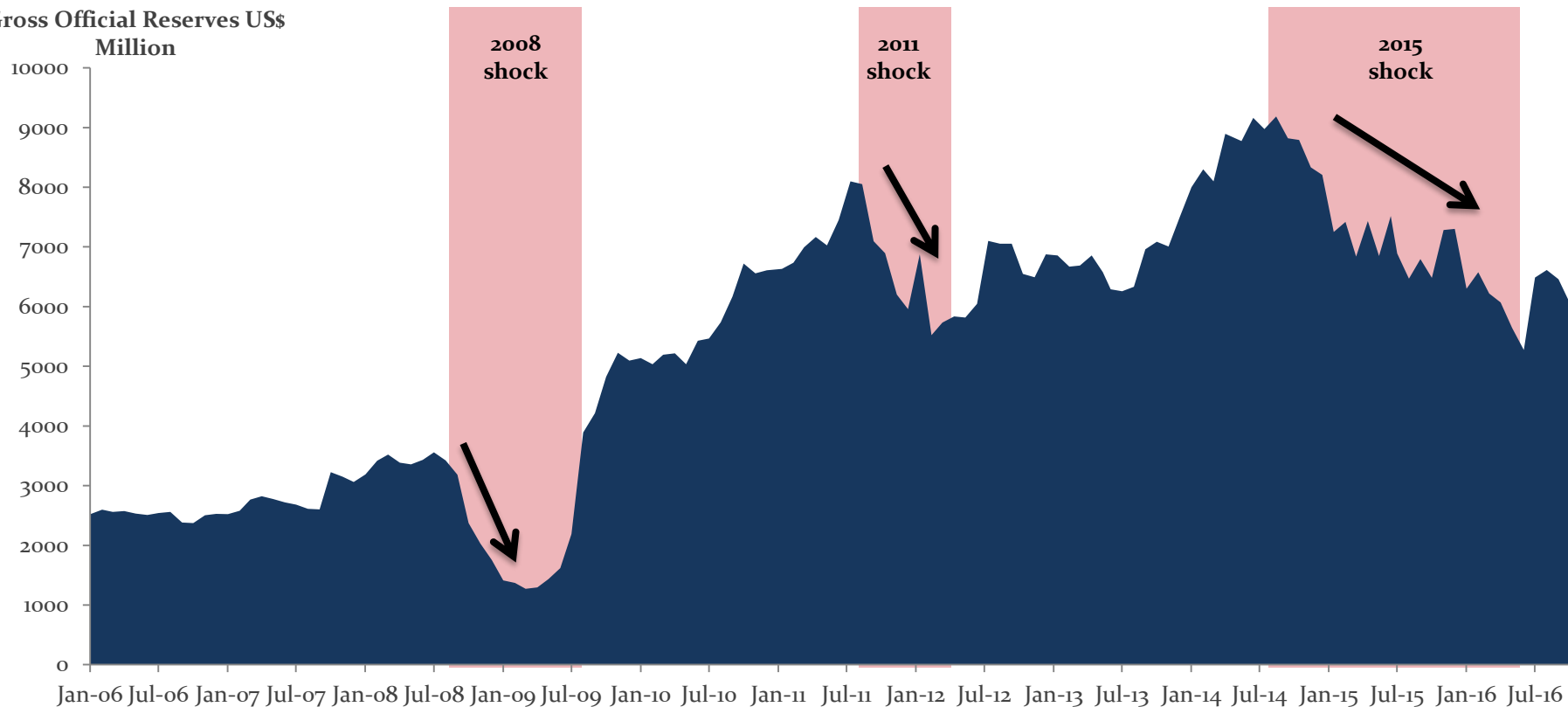
Foreign Reserves

**\$2.3bn fall in
8 months**

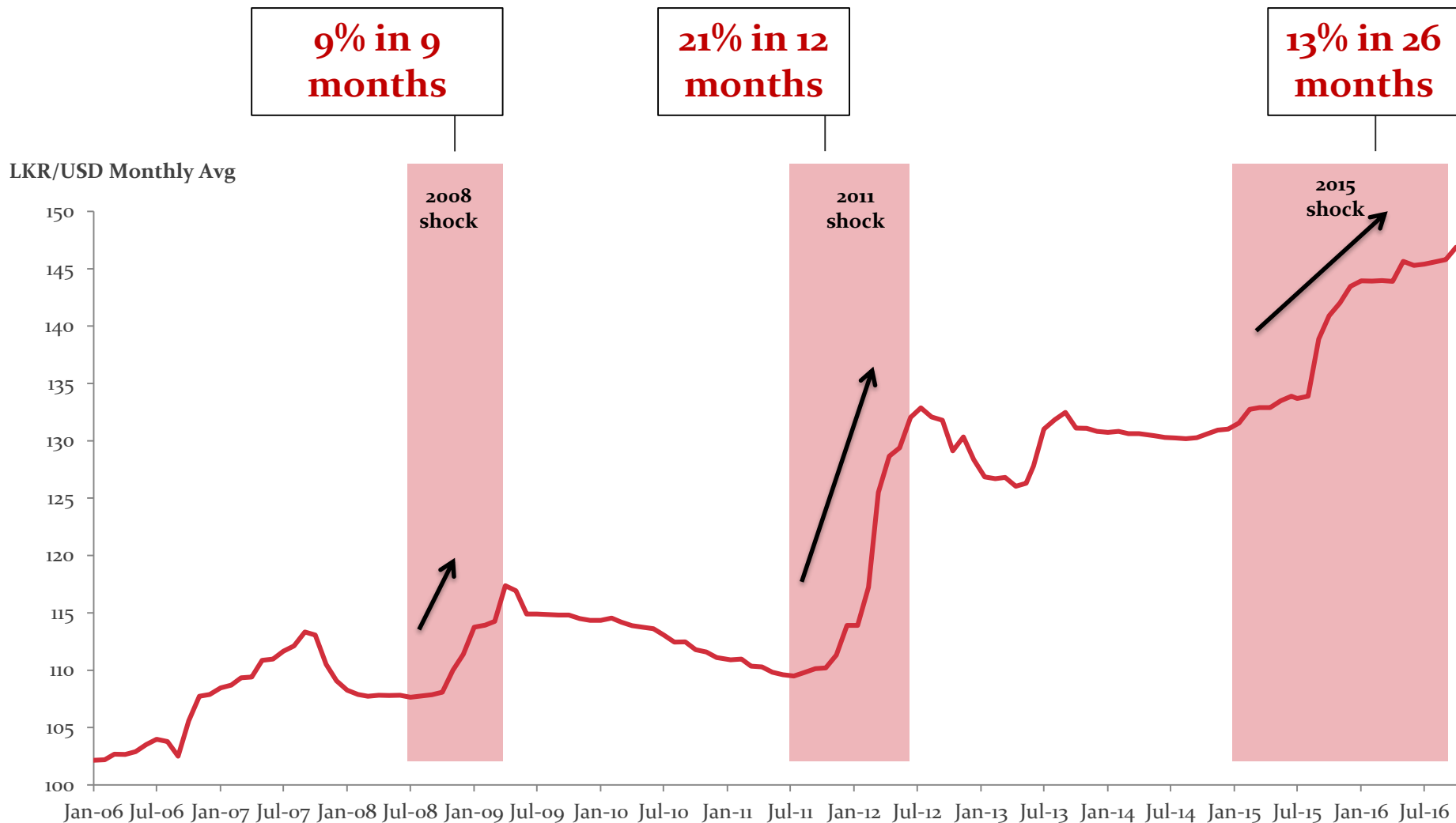
**\$2.6bn in
7 months**

**\$3.9bn in
22 months**

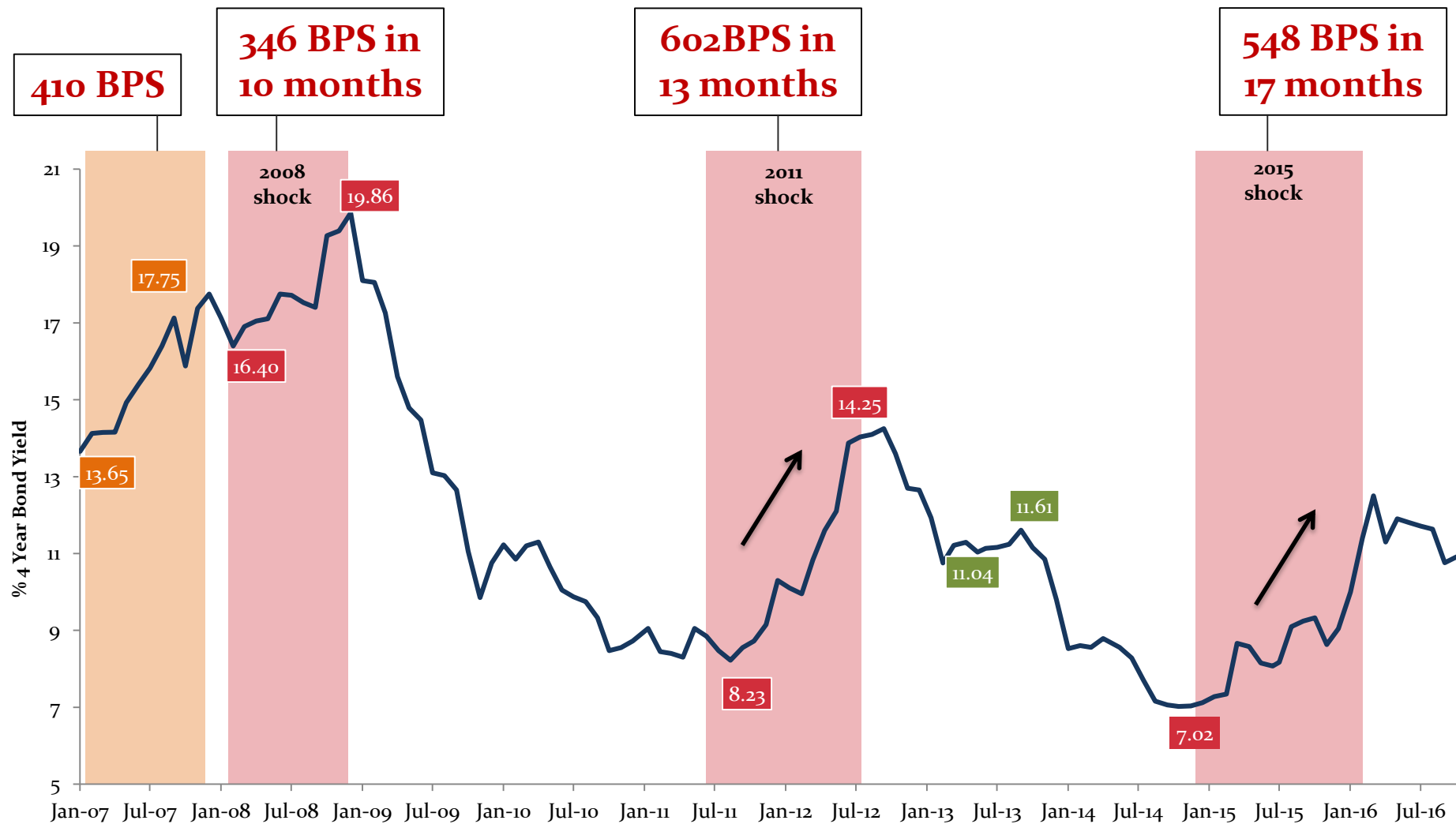
Gross Official Reserves US\$
Million



LKR



4-year Bond Yield

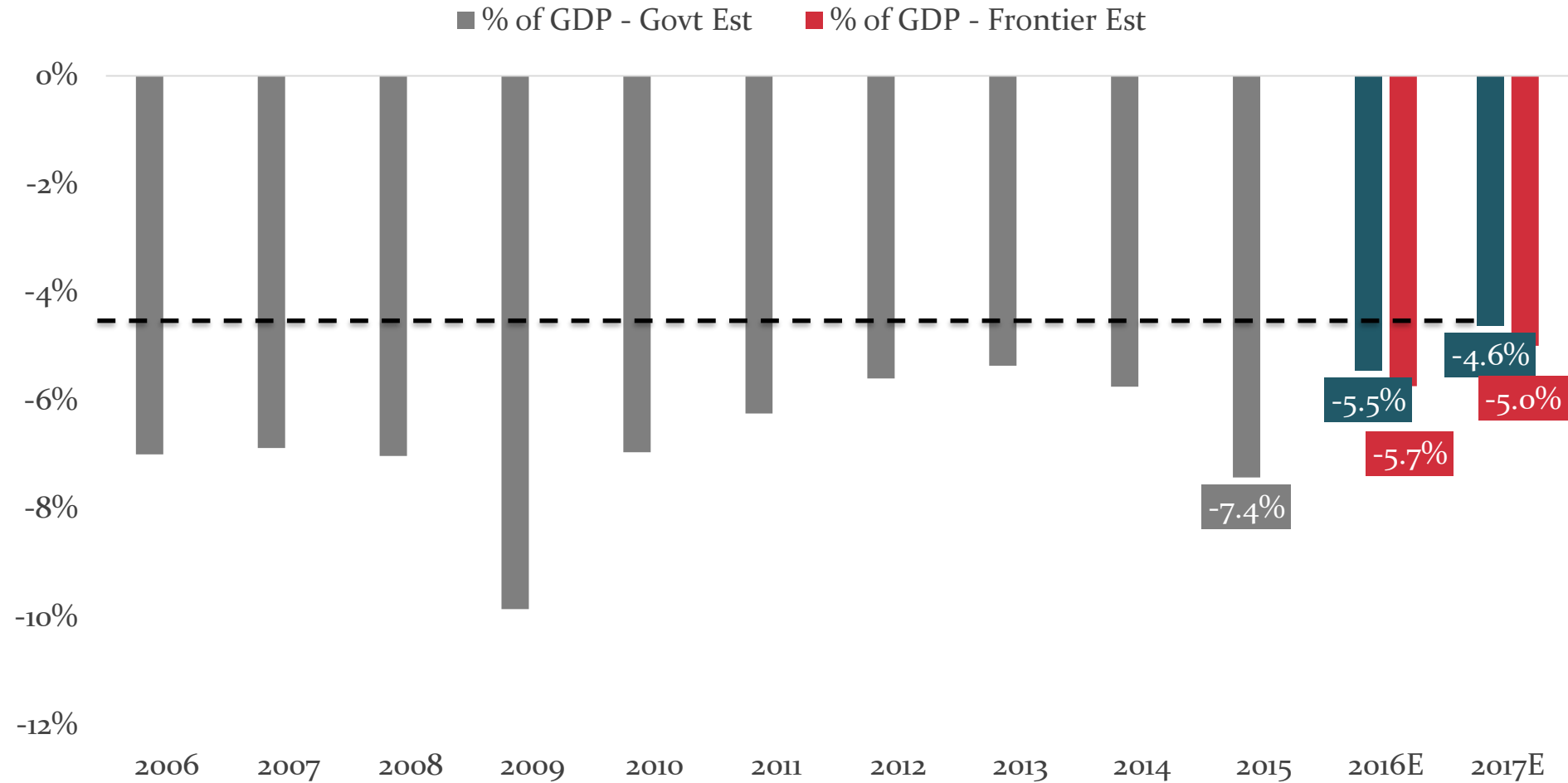


Why our base case is that the Rates/LKR
cycle is turning positive



IMF program in place

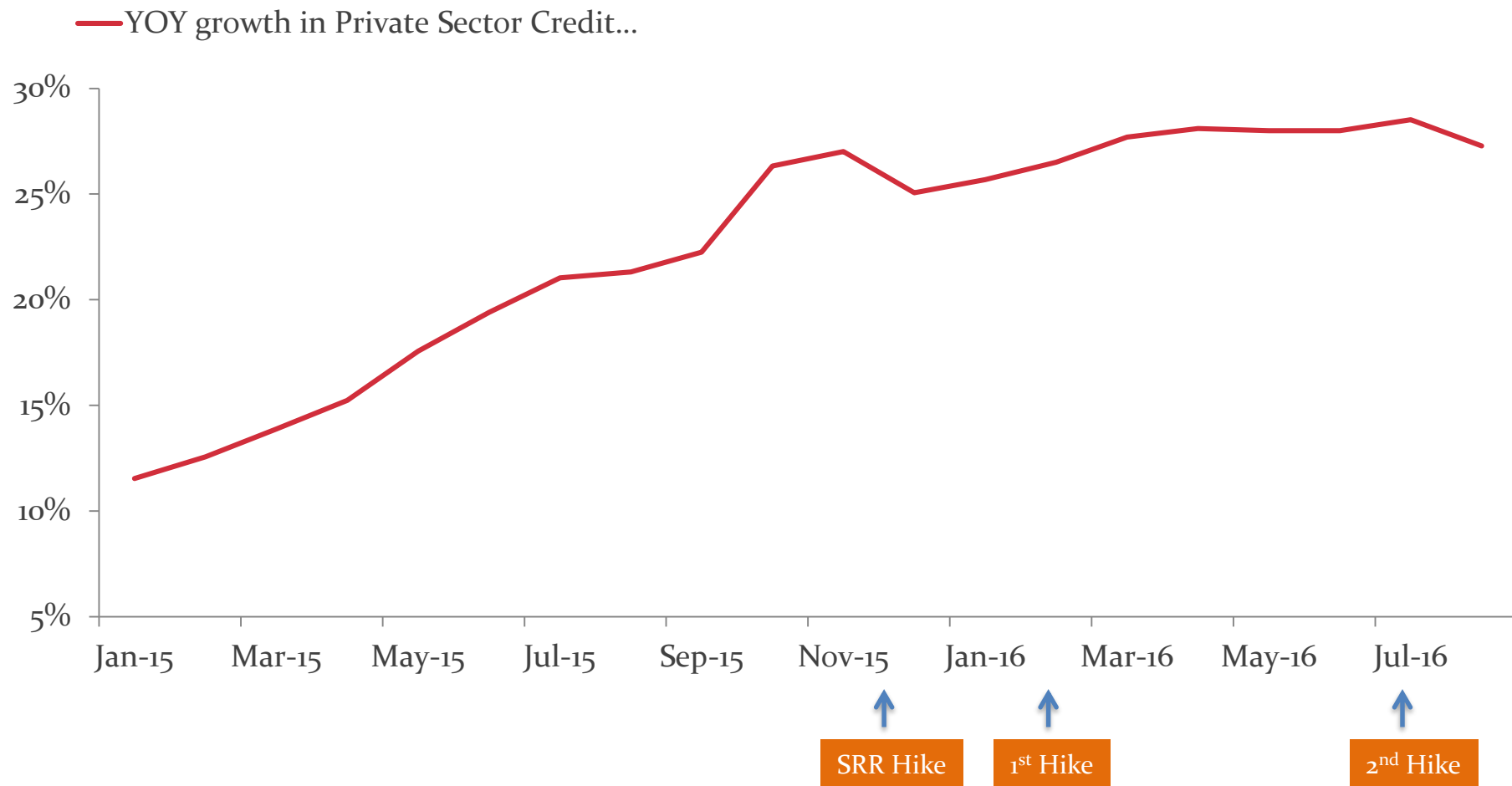
Expected budget deficit if achieved will be the lowest seen in recent years



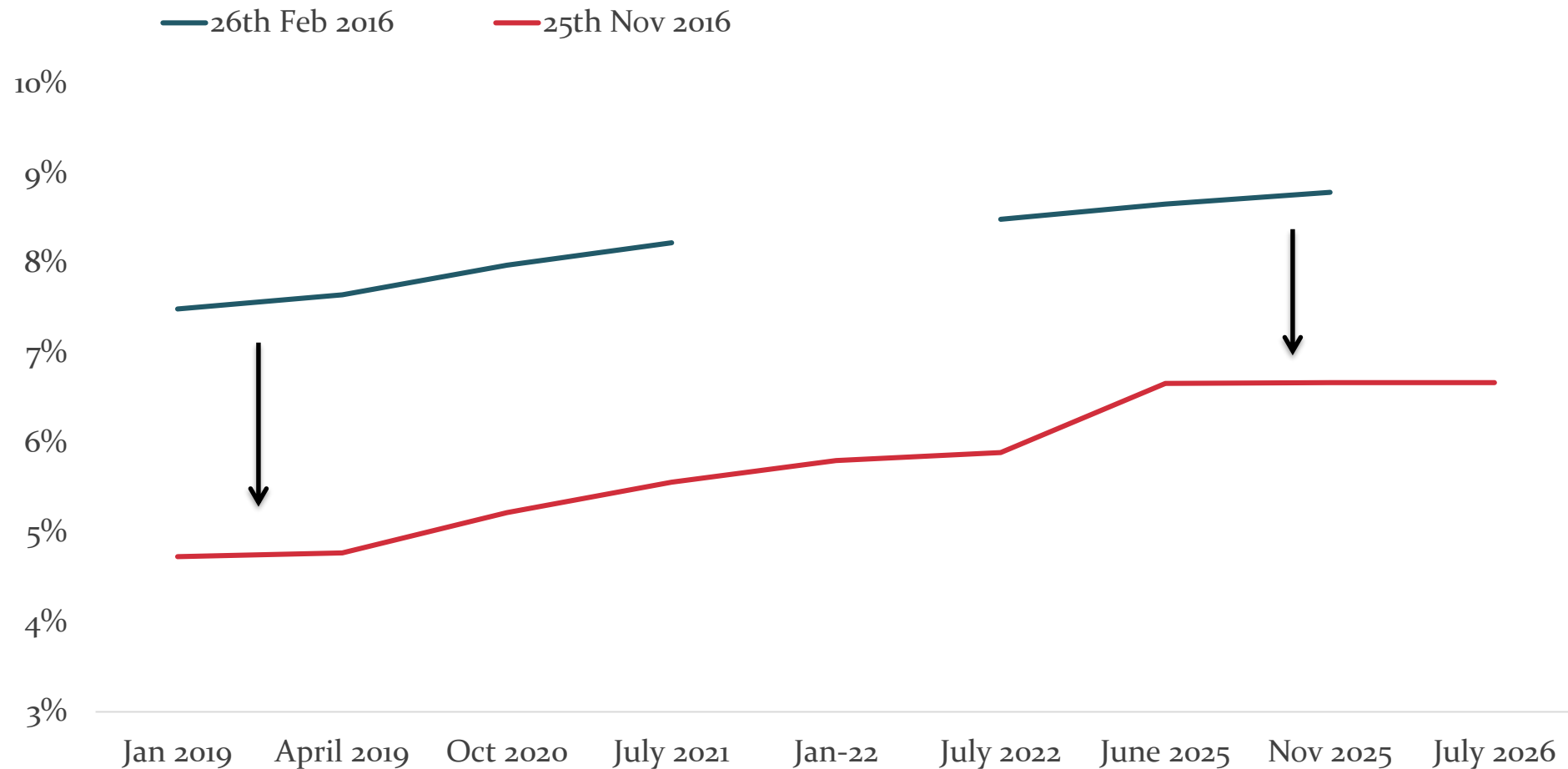


"We do not think there are quick fixes. I think trying to create sugar highs by artificially trying to boost asset markets or growth or anything else is not possible."

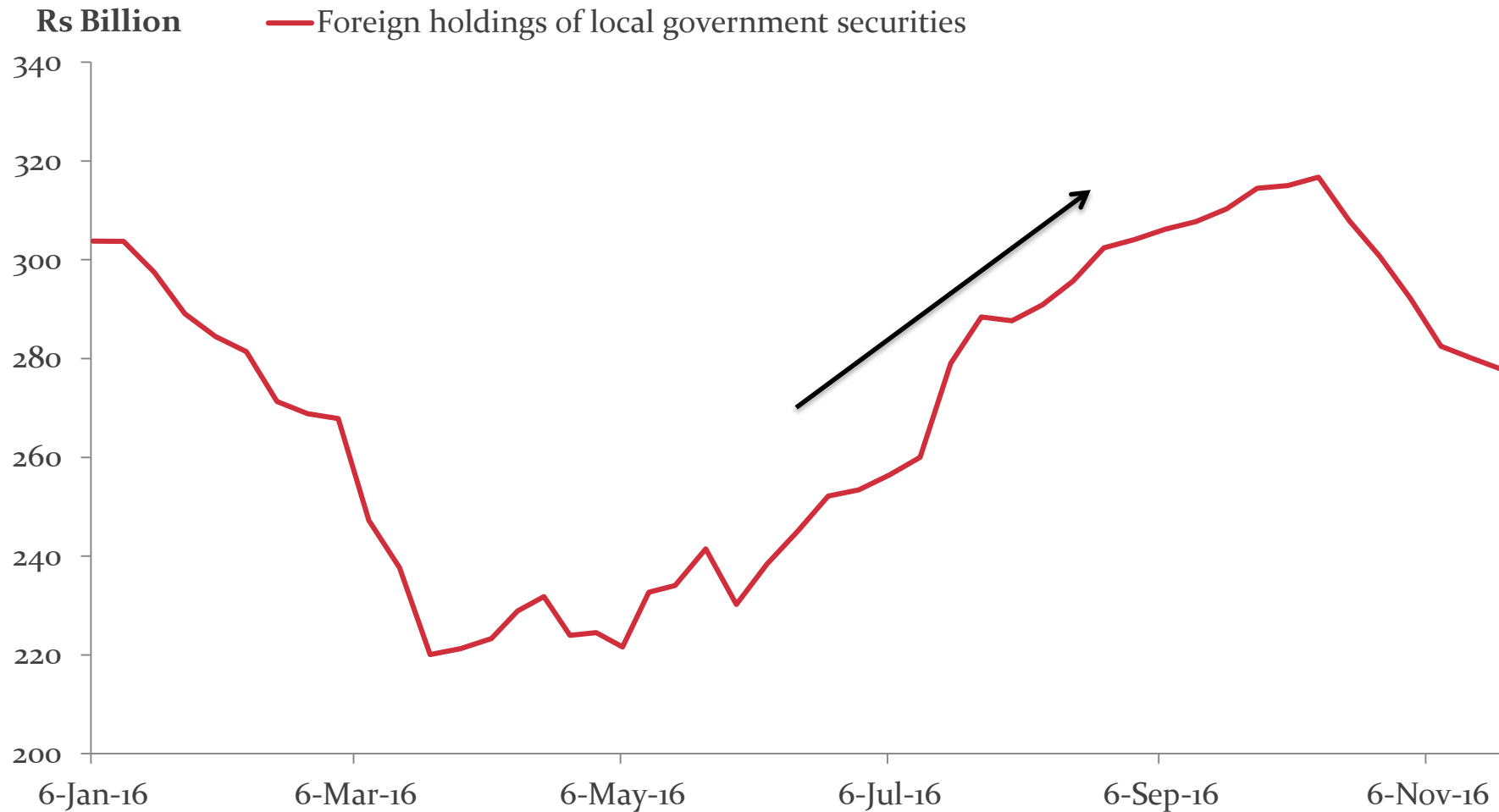
Private sector credit growth still high but expected to moderate



Sovereign yields have seen a decline across maturities



Local government securities expected to see net foreign inflows next year



Why we are vigilant

A shock is the most likely scenario now

April 8th 2015

Frontier
— Research — FRONTIER SPECIAL REPORT

April 2015: *We now believe there is a 50% probability that interest rates will rise at least 250 basis points (BPS) and the rupee will depreciate more than 8% within the next 12 months.*

2017 – from ‘shock’ to positivity



"THE WEDNESDAY MORNING MEETING OF THE ECONOMIC OPTIMIST CLUB
WILL NOW COME TO ORDER."

**From Shock to Positivity, Rates bulls in our 12-24
month base view**

6th April 2016

Frontier
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April 2016: *We have a positive long-term expectation on interest rates at present. Our base view is that financial stability will return to the economy within a 12 to 24 month horizon where rates across the board will be lower.*

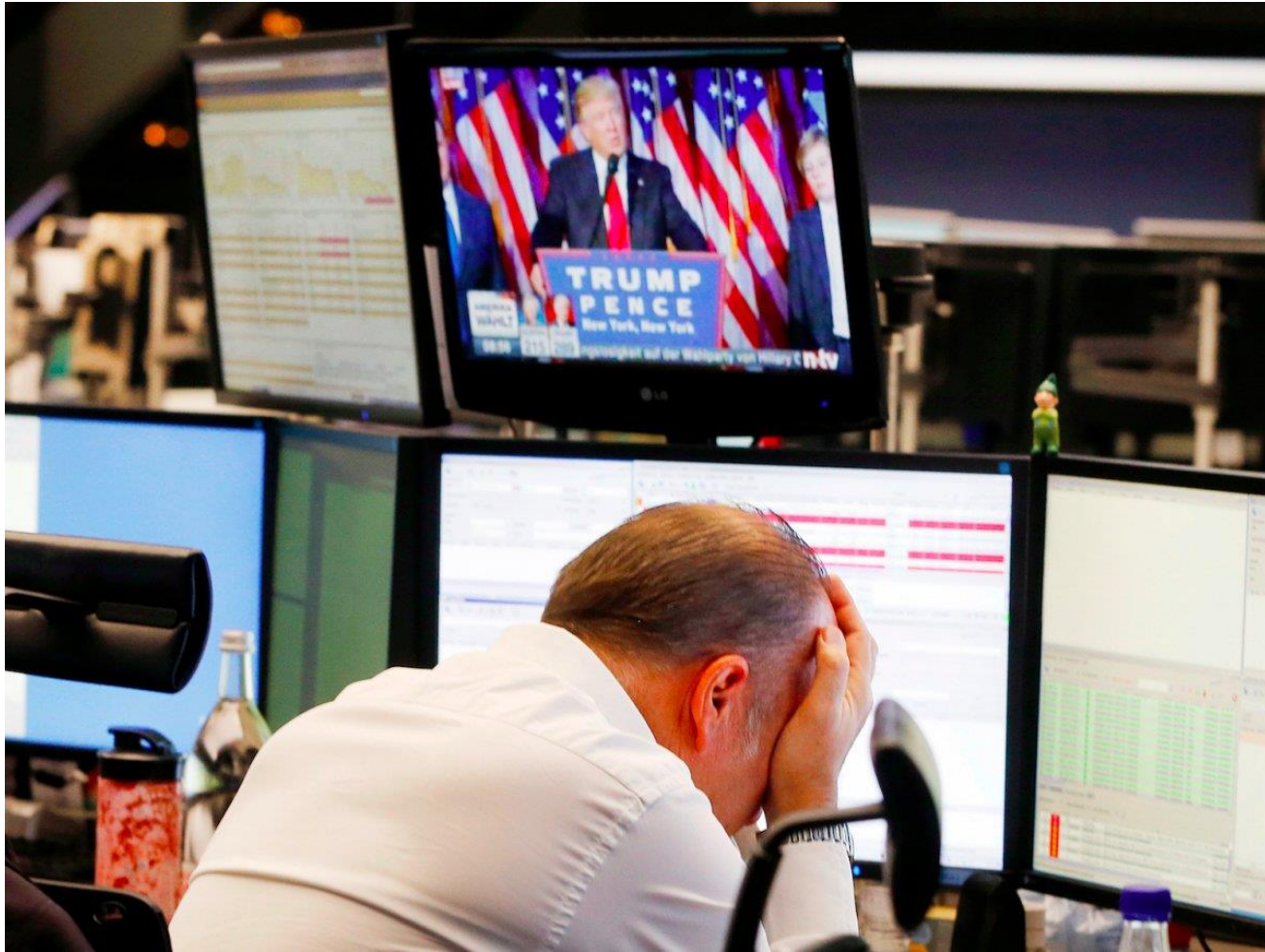
September 2016: *Similar to our view given in April, we continue to have a positive view on rates for 2017. We expect to see a decline in interest rates and a largely stable LKR (against the USD) with just a bit more room for further depreciation by the end of 2017.*

Before election



After election

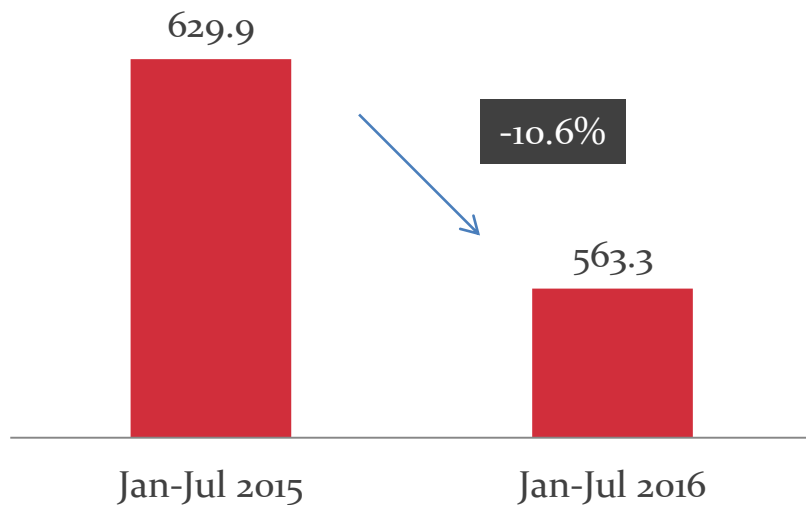




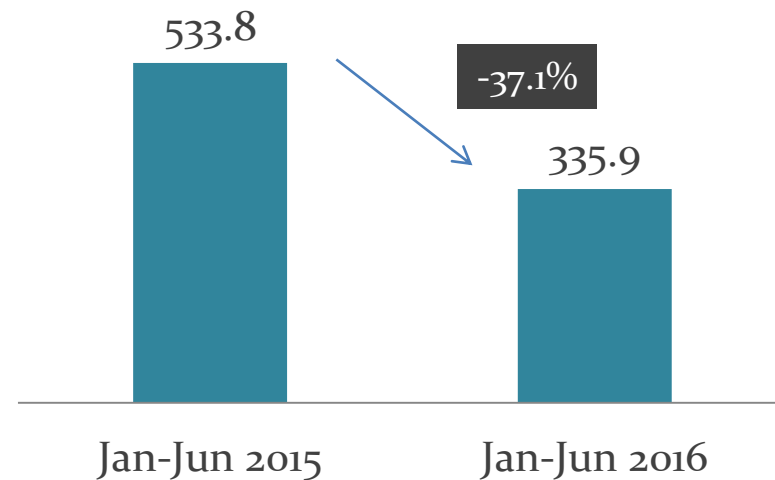
Why do external developments matter?

Weak foreign financing

■ Loan inflows to Government (L/T) USD Mn



■ FDI USD Mn





International Finance Requirements higher than during 2011-12 despite lower absolute CAD

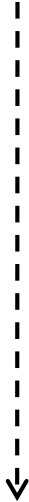
Current Account Deficit

Debt Repayments

2011

\$4615_{mn}

\$1092_{mn}



2015

\$2009_{mn}

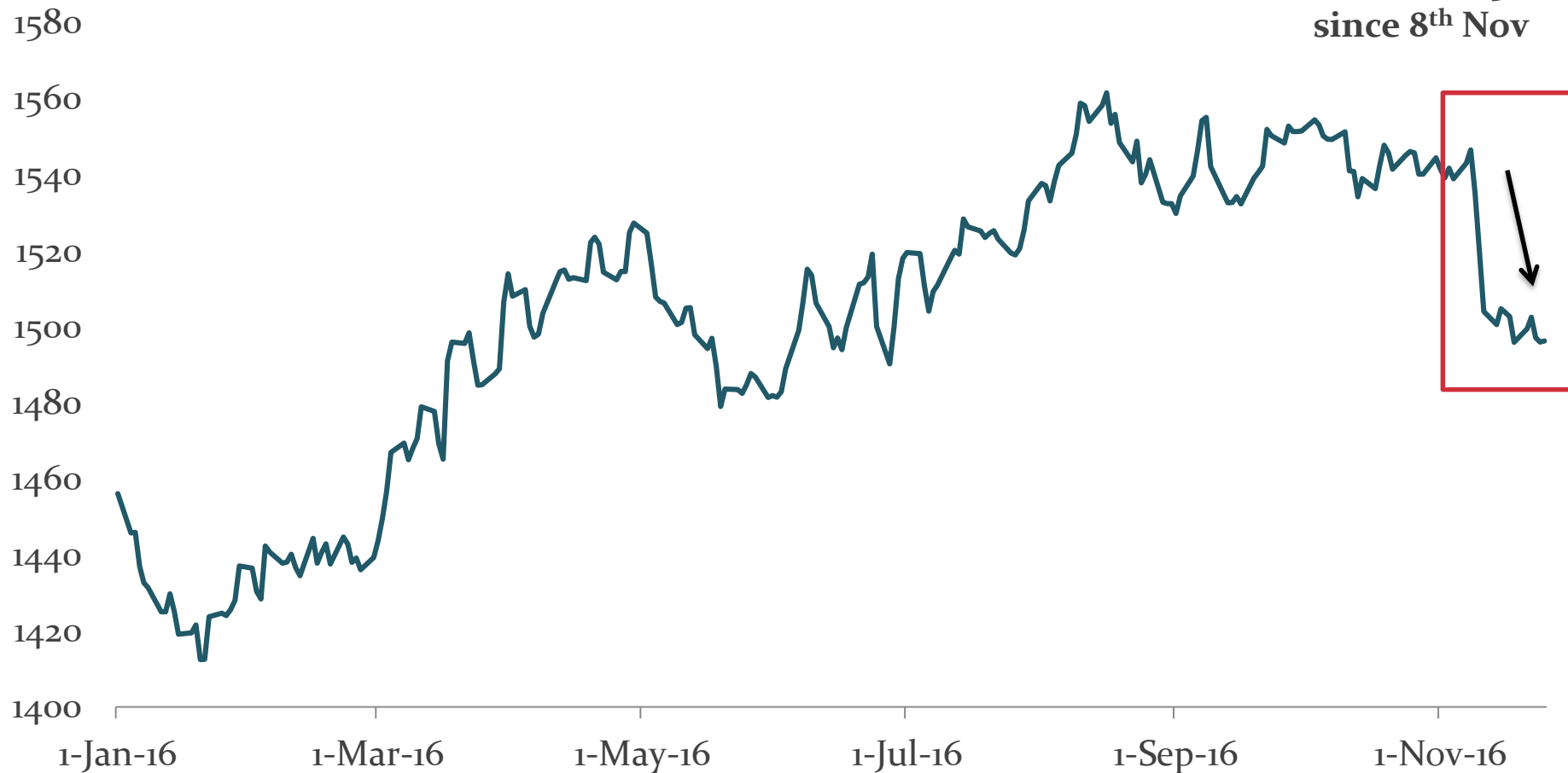
\$4660_{mn}

The risks of being Trump-ed!



EM currencies weakening against the US dollar post-election

MSCI Emerging Market Currency Index



How Trump can be bad for Emerging Markets

Debt outflows



A re-acceleration of capital outflows
Higher cost of capital for EM

Trade wars



"The upshot is that there is now a significant risk that the world enters a period of **rising trade barriers and tit-for-tat trade wars**"

Oxford Economics, [Business Insider](#)

Market volatility



but if interest rates go up, I think you could see a **25%-plus fall in equity and/or bond and real-estate prices**, and that would be quite serious.

Jerry Haworth, 36 South Capital Advisors, [Business Insider](#)

How Trump could be good for Lanka - Possible Scenarios

Good for everyone



End to Grid Lock in Washington, a Pro Business Agenda, Less unilateral US intervention and joined action by US-Russia on global terror threats – Causes a much better business environment globally benefitting all economies/ markets

Bad for US, but
good for other
countries



Consensus view builds that a Trump Presidency is very negative, investor's re-evaluate the US economy/politics and reallocate investments to other markets – particularly into Emerging economies

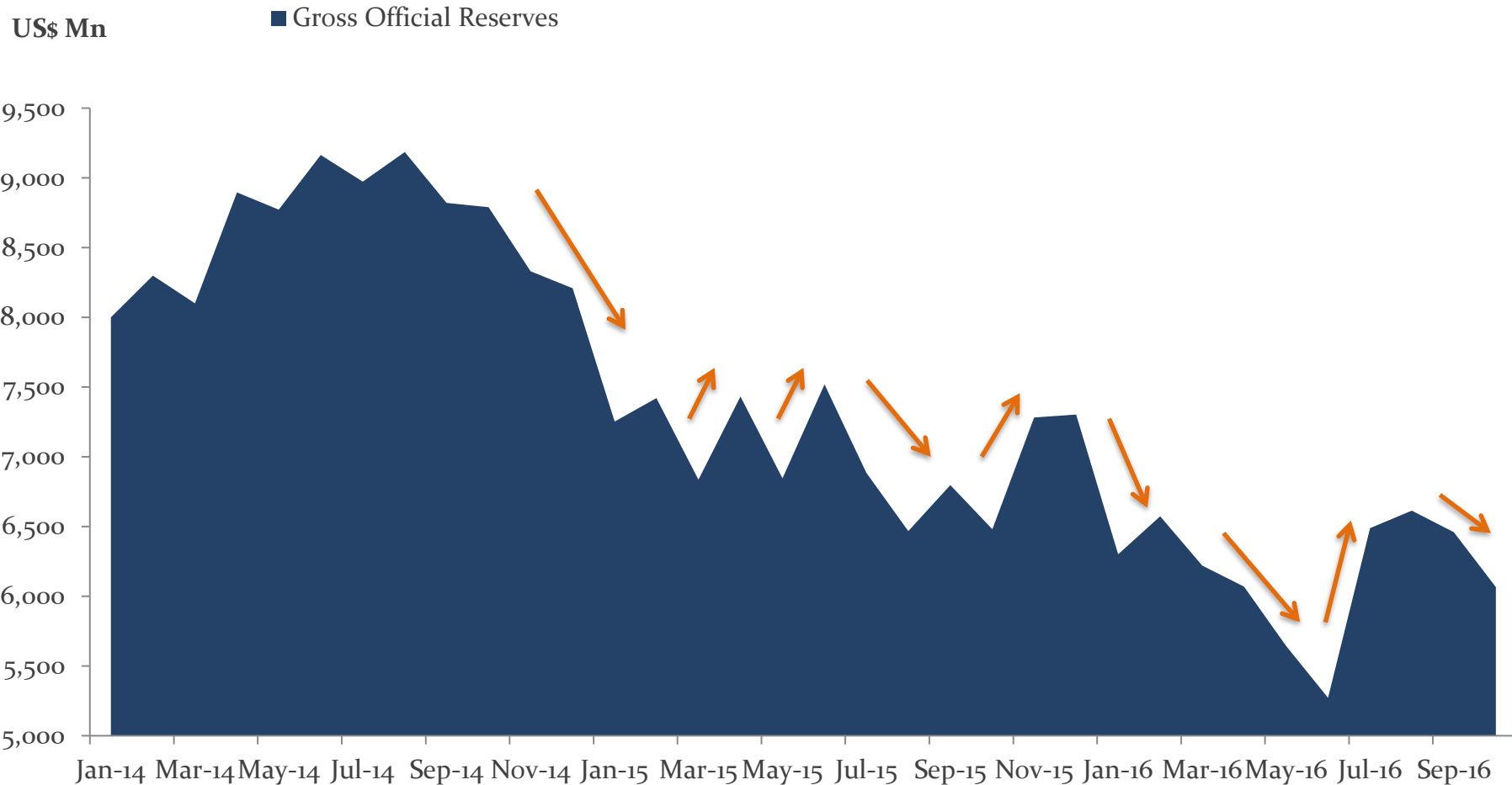
Bad for
China/Mexico,
but good for
others



Tariff on China/Mexico but nothing on us! Makes us a great place to export to US from

Reset to India – benefits us.

Volatility in Foreign Reserves



What does this mean to you?

Stay vigilant –

Positive base case maintained, but be prepared for outlier risks

(16th November 2016)

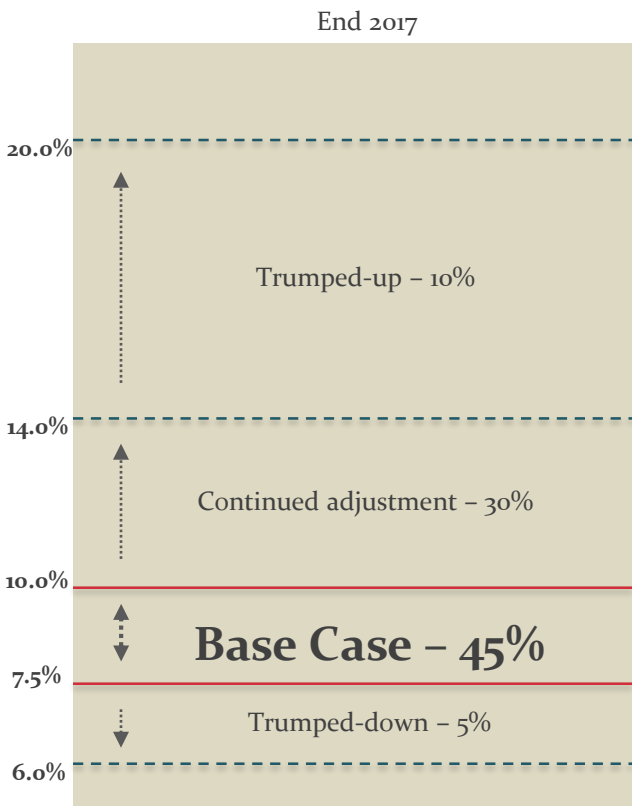
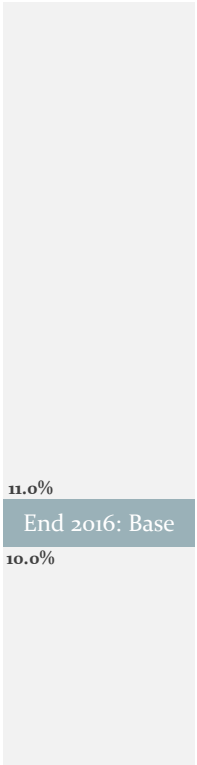
Updated End 2017 Views

(16th November 2016)

Base Case

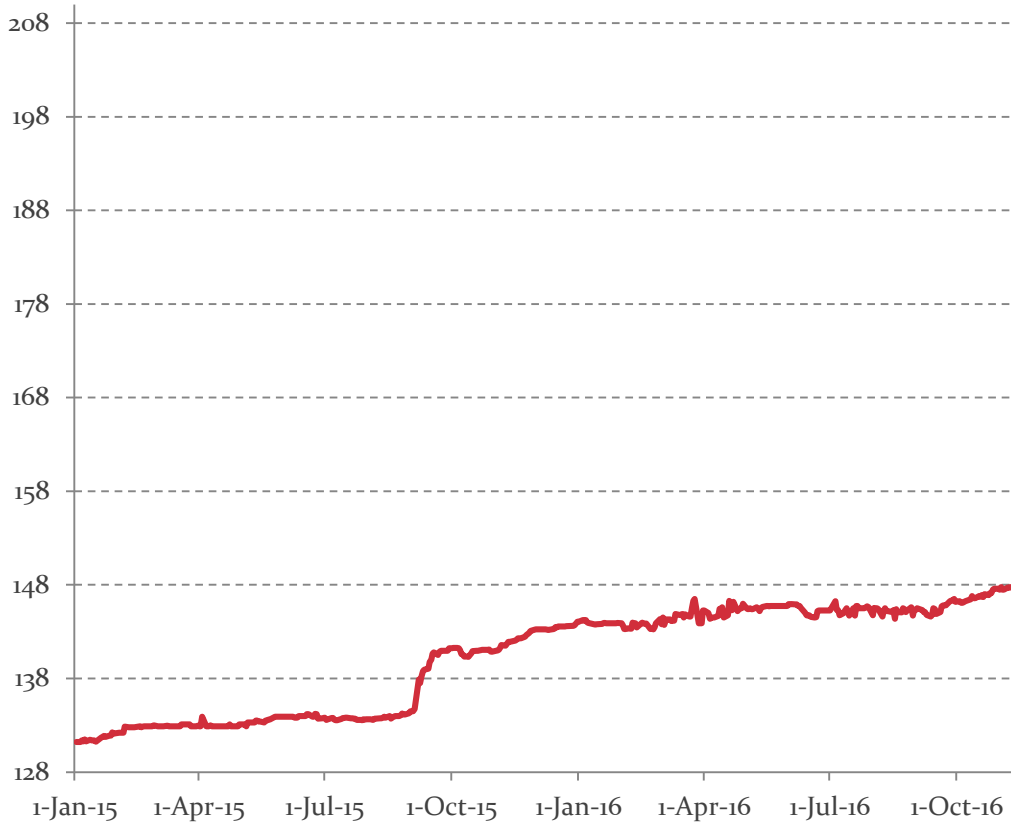
- Continued adjustment
- Trumped-up
- Trumped-down

	10 year yield	
Probability	Lower Bound	Upper Bound
45%	10.0%	12.0%
30%	12.0%	16.0%
10%	16.0%	22.0%
5%	8.0%	10.0%



** Remaining 10% incorporates other alternatives scenarios with different ranges for Rates and FX

— LKR/USD



160

End 2016
Base

148

End 2017

200

Trumped-up – 10%

170

Continued adjustment – 30%

158

Base Case – 45%

148

Trumped-down – 5%

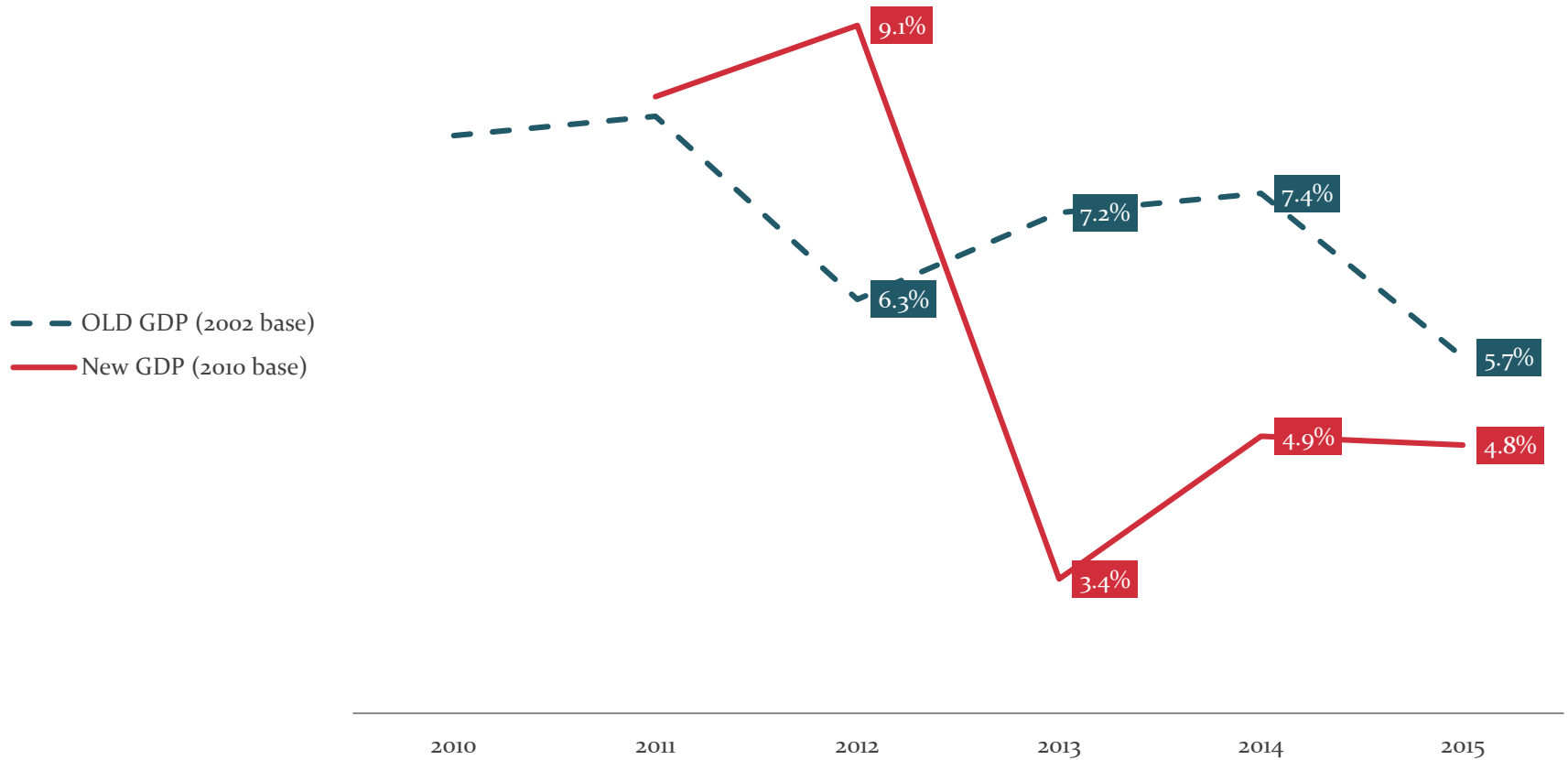
135

** Remaining 10% incorporates other alternatives scenarios with different ranges for Rates and FX

Why we don't give a GDP view



Significant change in trend of GDP following the rebasing



GDP estimate revisions – “numbers can mislead”

	First release July 2015		Revised Sep 2015
GDP growth 1 st quarter 2015	6%	→	4.4%
Agriculture	2.9%	→	1.6%
Industry	(1.9%)	→	0.7%
Services	10.1%	→	6.2%

Is **Strong** Growth? Over 7.2%

Is **Good** Growth? Over 3.4% to 7.2%

Weak Growth? Below 3.4%



Rather than GDP – We use broad concept of
“Domestic Demand Conditions”

Domestic Demand Conditions to worsen with a very high probability (in almost all scenarios) in 1H, possible recovery from that towards end 2017.

What do you do with all these Scenarios on Rates/LKR?

**Depends on how you feel and
deal with Risk**

"In prospect theory, **loss aversion** refers to the tendency for people to strongly prefer avoiding **losses** than acquiring gains. Some studies suggest that **losses** are as much as twice as psychologically powerful as gains."

Loss aversion was first convincingly demonstrated by Amos Tversky and Daniel Kahneman.

Takeaways

Focus on the Trumped-Up & Trumped-Down scenarios and not the BASE

- ✓ In Financial Markets, very much tilted to heavily being in Cash rather than Equity.
- ✓ Get ready for worse consumer demand conditions.
- ✓ While your base financial planning on rates/LKR would be on the positive base, spend as much time making sure risk mitigation strategies are in place for outlier risks.
- ✓ Because if Global markets turn, the scenario could change from our base to Trumped Up/Down easily, and if it happens you may not have time to prepare for it.

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