Frontier Research

VIEWS UPDATED: ECONOMIC MONTHLY – JUNE' 20

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Are low rates the new normal?

Since April, Frontier has been highlighting its view of lower rates, strengthening this view since.

In April we said:

> *"In terms of interest rates, while it remains a difficult call, with plausible paths for both higher and lower rates, we're now slightly biased to lower rates for 2020, i.e at current levels or lower.A main reason is that we feel the government and Central Bank's actions signal a push for lower rates, with recent rate cuts and the lowering of the bank rate pointing towards this as well."*

And we strengthened this view further in May:

> *"Our emerging most likely scenario sees the 12 month T. Bill rate standing between 6% to 7.5% by end 2020 (Currently at 6.9%). This would lead rates to be very close to the historic lows experienced in 2014."*

The sudden cut in the Statutory Reserve Ratio (SRR) last week reaffirms our interest rate expectations and as such, we are now more aggressive about it. However, given that this policy change was a "surprise announcement" we don't think that future policy rate changes which are likely to be on the SLFR and SDFR could see a similar magnitude of a reaction in secondary market rates such as what was seen last week, where rates dropped around 60-70BPS within a day. We think that there is a likelihood of the SLFR and SDFR seeing up to a 100BPS fall in the second half of 2020.

Can low rates be sustained?

Overall, we think that this very low rate environment can be sustained till at least end-2020. As we have mentioned previously, the likely negative GDP growth for 2020 and worries of low growth next year as well would drive the CBSL and Government to take measures such as further monetary easing in order to provide some space for economic recovery. Moreover, given the lack of fiscal space to do so, monetary policy is likely to be the main tool for this.

At the moment, if there is to be a turn in the current trend of falling rates in 2020, the main drivers could be worries over our external balances and reserves amidst the US$1bn sovereign maturity in October and the easing of import restrictions - dependent on the pace of recovery , and/or unanticipated developments with the election in August and any political uncertainty arising from it.

Going forward, however, despite the excess liquidity and rates reductions, watching movements in private sector credit growth would be a good indicator on the pace of the recovery – and effectively how much monetary easing could be expected, as it relies on the willingness of private sector to borrow and conversely how much banks are willing to lend as well.

We have ended the lockdown on our probability-based views

In March, we suspended our views noting that:

> *"...given the extreme levels of risk and volatility we are facing, and with perspectives on the global economy changing rapidly, giving any kind of base case forward view in these circumstances seems a subjective choice between hope or fear. As such, we are suspending our interest rate and exchange rate views for 2020 and 2021."*

However, with somewhat more clarity on Covid and the data from lockdown periods beginning to trickle in, we formed biases on interest rates and exchange rates over the past 3 months. Now, taking into account the policy actions last week, we have updated our interest rate view from what we shared last month and also provided it within our scenario and probabilities framework.

- **Our most likely scenario (50% probability) expects the 12-month T. Bill to remain at the current levels or lower by end-2020, to between 5% to 7%. As at 24th June 2020, it stands at around 5.5% in the secondary market. We think there is also a possibility that in the near term secondary market rates can dip even below 5%.**

- **On the LKR, our most likely scenario (50% probability) expects it to stand between Rs. 185 and Rs. 200 (against the USD) by end-2020. As at 24th June 2020, it stands at Rs. 186.67 against the USD.**

We encourage you to take a look at the graphs on Pages 17 to 19 which visually expresses our views more clearly.

Quick rundown of a few key economic numbers and what they say about the impacts of Covid

- Reserves: Fell by US$716mn in May to US$6.5bn, owing to some SLDB maturities and sovereign bond coupon payments, with a majority of the fall possibly accounting for project payments. Data showed that reserves were not used to stabilize the exchange rate during the month.

- Remittances: In April, remittances saw a sharp drop of 30%. This is an area of worry not just for 2020 but also beyond due to its importance in foreign exchange inflows. While a sharp fall in remittances is very much taken into account in our BOP projections, the fact that it fell so much in April with job cuts in the main markets of foreign employment likely to keep playing out, it is a worrying factor of how much more it might fall from May onwards. Given poor global growth along with low oil prices, it is possible that going forward, remittances may be structurally lower than what we have experienced in the past few years.

- Exports: Earnings were hard-hit in March and April, however, early data from the EDB indicates that orders for PPE and rubber-products particularly have enabled them to capture US$606mn in May, compared to US$282mn in April - about a 37% drop in May compared to the 65% drop in April. If these orders are sustained and new market segments are captured, this could indicate better earnings than expected.

- Inflation: While there have been some concerns on the impact of excess liquidity on inflation, currently both headline and core inflation have remained in lower single digits of 4% and 2.9% respectively in May (CCPI). However, as transmission of the impacts of the liquidity injections and rates measure can take time to materialize, there could be a pickup in inflation later in the year. However, we do not think that it will rise to alarming levels.

- Private sector credit: On a YOY basis, credit to the private sector improved to 7.6% in April from 6.5% in March, however in absolute terms the monthly increase was only a marginal Rs. 13bn, compared to the sharp increase of Rs.120bn in March. As mentioned previously, credit growth could lend insights into the pace of recovery Sri Lanka sees and the impacts of the monetary measures taken.

- Global growth: Continues to be downgraded by several global analysts, with the most recent downgrade from the IMF expecting a 4.9% contraction from the 3.1% fall it projected in April, while also reducing its growth expectations for 2021 to 5.4% from 5.8% This comes on the back of worries over the impacts of second waves of Covid-19 along with worse than expected first half data.

But it's not just about economic numbers - Covid is still the number one factor to follow

While we do keep an eye on economic numbers, at this point, we think Covid-19 is *still* the most important factor to look at this year as it can influence your business, and the above indicators far more than any other economic story. Particularly given the threat and high likelihood of second waves in most of the West and China, how each country handles it this time will be quite different to the first wave – as such, the impacts of it on Sri Lanka could be different as well.

Beyond Covid, there are emerging risks which can also have notable impacts such as global politics, particularly in the lead up to the US Presidential election, with narratives around the protests and Covid as well, playing a large role in it. Additionally, continued developments on China's tensions with US on the trade war and border tensions with India are stories that could also become highly influential for the global economy this year.

In light of the varying stories on risks to follow, we leave you with this quote by Donald Rumsfeld, Secretary of Defense to George W. Bush which we have quoted before but could use a reminder of:

> *"As we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don't know we don't know."*

So, prepare not only for the "known unknowns" but also for the "unknown unknowns".

Focus: Yield curve flattening – A look at past changes

By: Trisha Peries

Given our view of a flattening yield curve in the coming months as rates dip, we looked back at past periods where the yield curve saw significant changes to see if they echo some of the conditions we see today.

2003: The 2002-2004 period saw a steady fall in interest rates. It was driven by varied factors including lower global interest rates, several policy rate cuts by the Central Bank and falling inflation along with perceptions of a more stable political situation at the time with the Ceasefire Agreement in place during the UNF Government. Data from primary auctions during the period revealed that the yield curve in fact saw an inversion towards end 2003, with rates on the longer end falling below the short end. [See Page 08] However, this was not sustained for a long period of time, with rates on the long end picking up in 2004.

2007/08: With a tightening of monetary policy in 2006 and the beginning of the GFC, this period did see an inversion in the yield curve. However, in contrast to 2003, this was in a time of rising interest rates, where rates on the shorter end rose above that of the mid-to-longer end. Interestingly, this lasted for around 2-years. Given that rates were close to 20% at the time, the demand for locking in high rates may have prevented longer end yields from rising further [See Page 09]. Of course, this is in stark contrast to the conditions of today.

2012/13: The Central Bank had resumed a loose monetary policy in December 2012 with several policy rate cuts in order to spur economic growth and increase credit growth, following the tightened conditions in 2011. This in turn saw yields fall rapidly, and effectively flattening the yield curve with the longer end seeing a greater fall. However, the spread widened within 6 months once again. [See Page 10]

What can we expect in 2020?

One thing is for sure – none of the conditions of today are similar to any one particular period in the past. The level and frequency of the emergency rate actions taken so far in 2020 are not close to anything we had experienced in any of the above periods, while the record lows expected on GDP growth and worries of private sector credit demand are harshly different as well.

Focus: Yield curve flattening – A look at past changes

By: Trisha Peries

With flatter yield curves in theory being an indicator of poor growth prospects, it could largely be expected that the spread between the short and longer end could reduce within this year. Particularly with the SRR reduction last week and the subsequent fall in interest rates, the spread has already seen a slight reduction [See Page 11]. This is likely to continue in the near term as expectations of possible further monetary easing moves rates towards new lows.

In 2003 the longer end fell more than the short-end leading to an inverted yield curve

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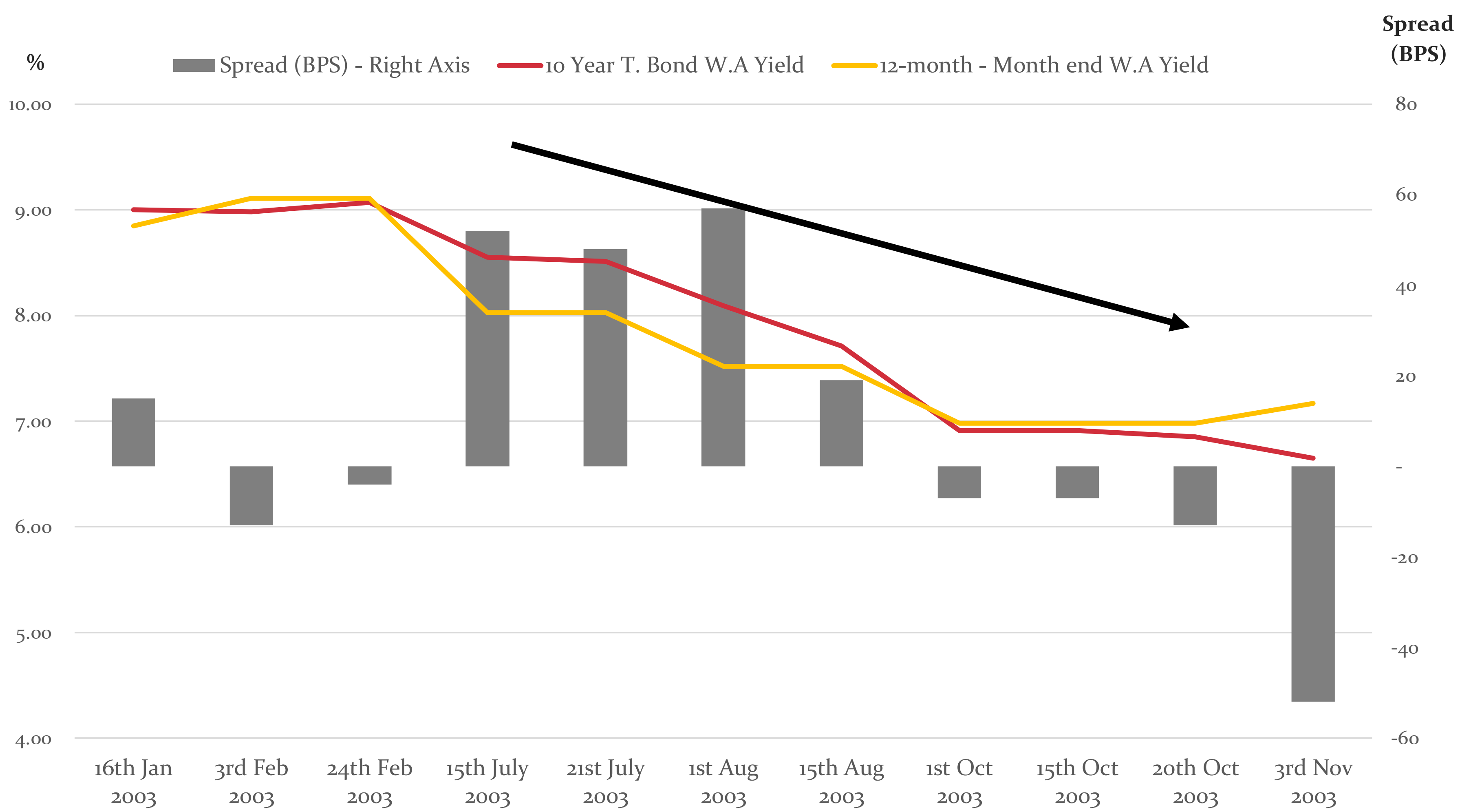

Source: CBSL

While yields were rising during GFC, the short-end rose above the 5-year

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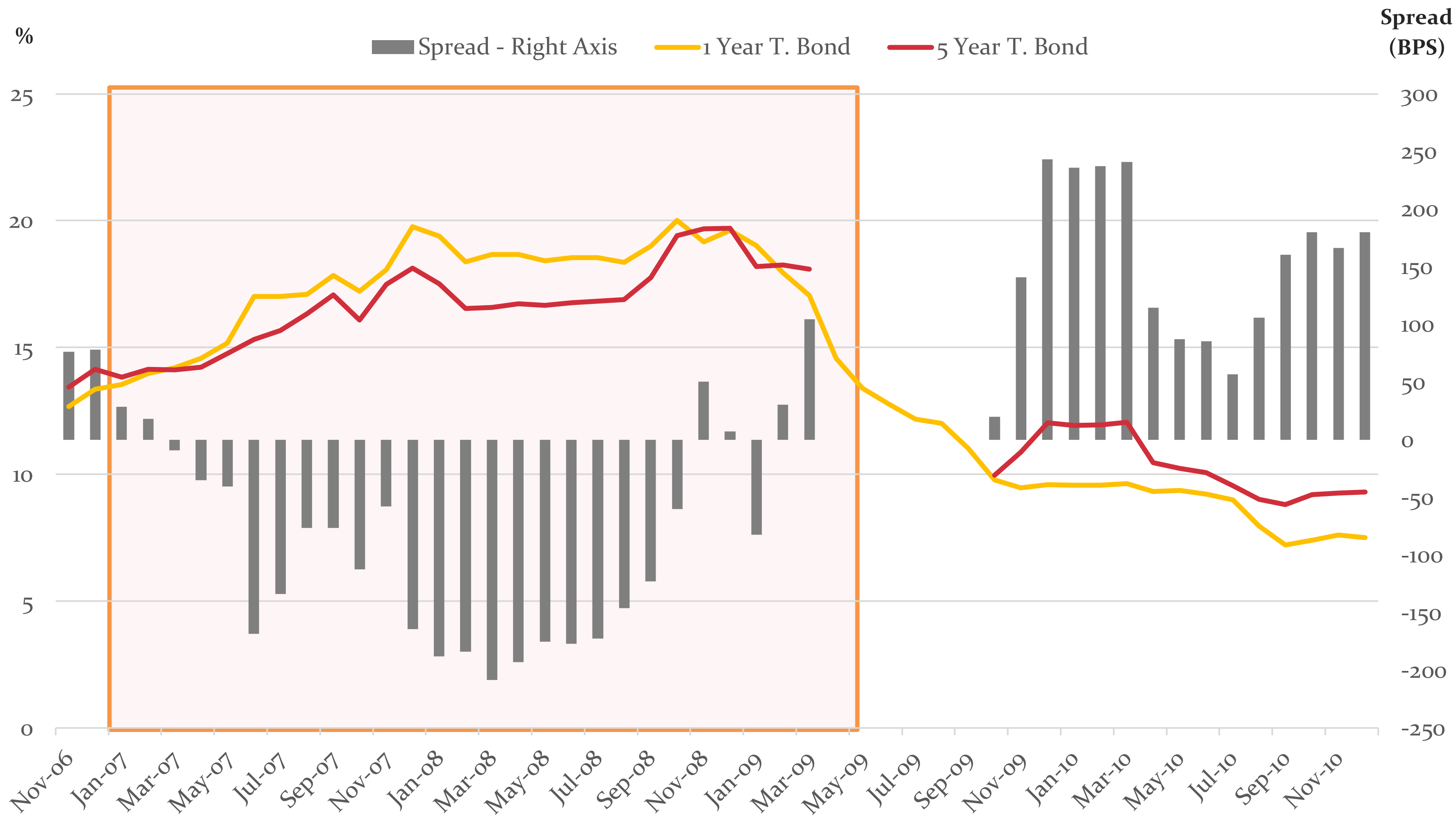

Source: Investing.com

The start of a loose monetary policy period in Dec 2012 saw yields and the spread reduce

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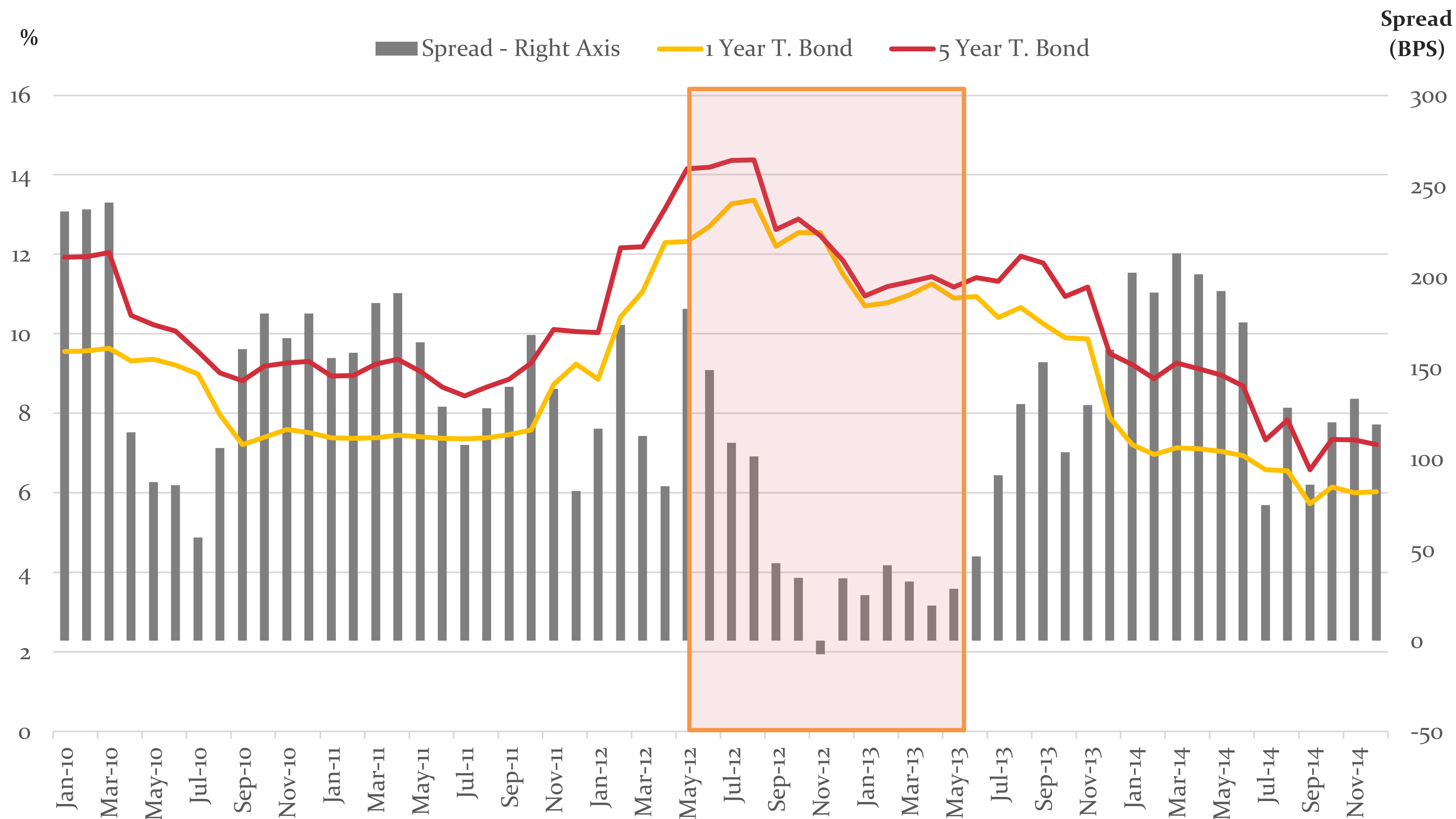

Source: Investing.com

Yield curve could flatten in 2020?

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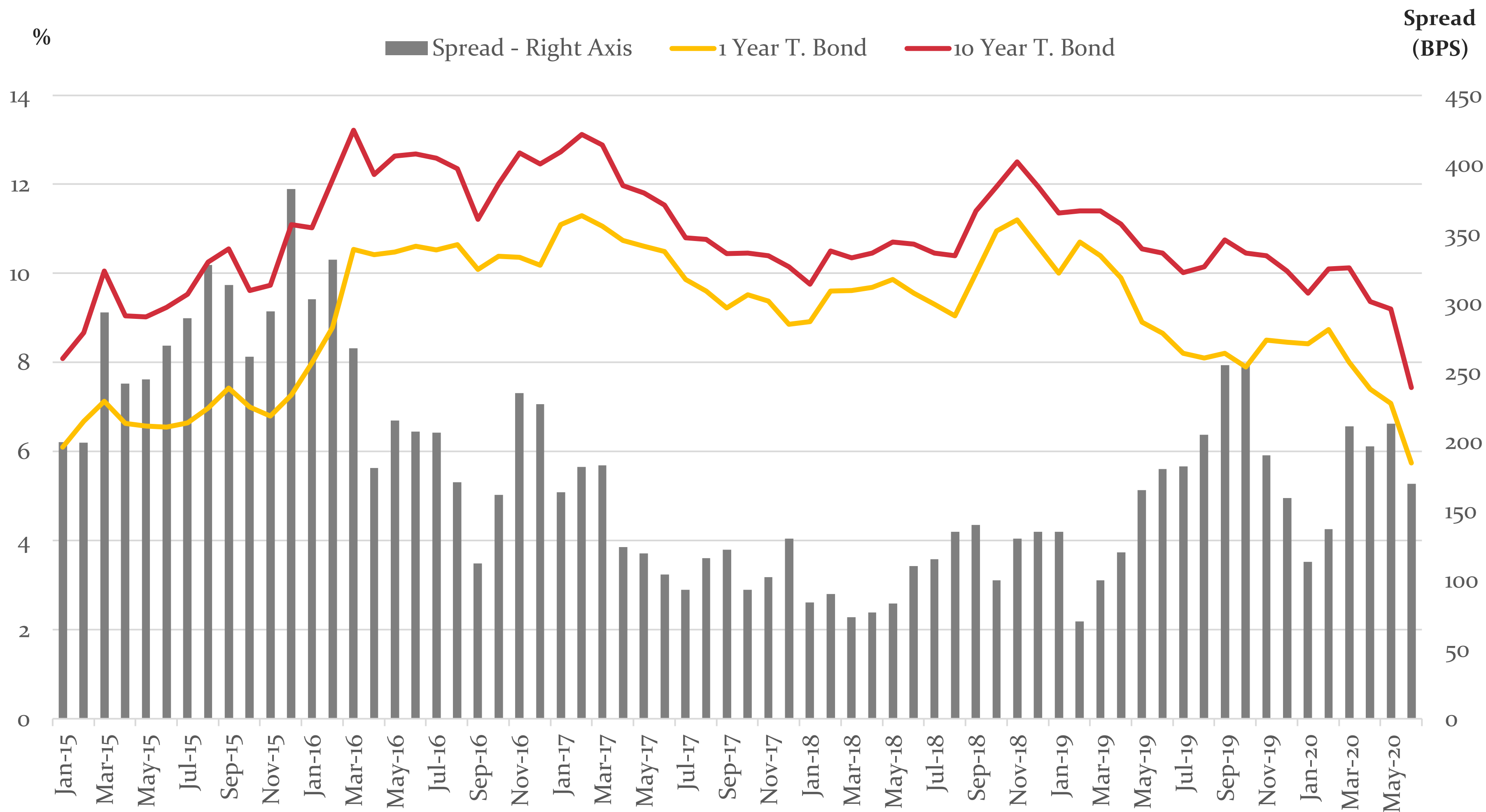

Source: Investing.com

Dashboard

Inflation	Month-on-Month April	Month-on-Month May	Year-on-Year April	Year-on-Year May
Headline Inflation (CCPI)	0.1%	**0.4%** ↑	5.2%	**4.0%** ↓
Core Inflation (CCPI)	0.2%	**0.7%** ↑	3.1%	**2.9%** ↓
Headline Inflation (NCPI)	-0.3%	**0.4%** ↑	5.9%	**5.2%** ↓
Core Inflation (NCPI)	0.7%	**0.7%** ↔	3.2%	**3.7%** ↑

Monetary Aggregates	March	April	March	April
Broad Money (M2B)	3.9%	**1.9%** ↓	11.6%	**13.2%** ↑
Credit to Public Corp.	4.3%	**7.6%** ↑	23.6%	**28.7%** ↑
Credit to Private Sector	2.1%	**0.2%** ↓	6.5%	**7.6%** ↑

External Sector	March	April	March	April
Exports	-33.6%	**-57.0%** ↓	-42.3%	**-64.6%** ↓
Imports	-22.9%	**-6.8%** ↑	-30.3%	**-29.6%** ↑
Trade Deficit	-4.4%	**53.0%** ↑	-7.3%	**5.4%** ↑

- The fall in YOY headline inflation was driven by base effects of higher inflation in 2019. This was also supported by a sharp fall in F&B inflation on a YOY basis.

- Private sector credit saw a marginal increase of Rs. 13.4bn in absolute terms during the month.
- Net credit to the government continued to increase in April, growing sharply by 26.2% YOY.

- Exports – declined in March and April with all major export sectors recording significant declines
- Imports – declined notably on a YOY basis in March and April 2020 led by the significant declines in intermediate and investment goods.
- Trade Deficit – increased to US$ 2.7 bn during the first four months of 2020, a 9.6% increase compared to the same period in 2019.

Source: CBSL, Dep. of Census and Statistics

Government Security Rates

SDFR(formerly Repo) 5.5%
SLFR(formerly Reverse Repo) 6.5%
SRR 2.0%

*Secondary market rates from Daily FT as at 24th June 2020

Key Interest Rates

- Latest month data is based on latest available CBSL weekly for the particular month (Source CBSL)

Currency Movements- against the LKR (as at 24th June 2020)

Depreciation against LKR

Appreciation against LKR

MTD (Month-To-Date)

Country	Rate
Thailand	6.04
Euro Zone	211.37
Singapore	134.52
Malaysia	43.65
UK	233.79
China	26.43
Japan	1.75
India	2.47
USA	186.67
Bangladesh	2.20
Vietnam	0.01
Pakistan	1.12

-5.0% -4.0% -3.0% -2.0% -1.0% 0.0% 1.0% 2.0% 3.0% 4.0%

* Indicative rate as at 24th June'20

YTD (Year-To-Date)

Japan
Euro Zone
Bangladesh
USA
Vietnam
China
Singapore
Thailand
Malaysia
UK
India
Pakistan

-6.0% -4.0% -2.0% 0.0% 2.0% 4.0% 6.0%

Source: CBSL

Key Forecasts for 2020

Indicator	2011	2012	2013	2014	2015	2016	2017	2018	2020F*
GDP(% 2010 base)	8.4%	9.1%	3.4%	5.0%	5.0%	4.5%	3.4%	3.2%	-3% to -8%
Inflation (CCPI Annual Average)	-	-	-	-	2.2%	4.0%	6.6%	4.3%	4.5% to 8%
Fiscal Deficit (% of GDP)	6.2%	5.6%	5.4%	5.7%	7.6%	5.4%	5.5%	5.3%	10% - 14%
Trade Deficit (USD 'Mn)	9,710	9,409	7,605	8,287	8,389	8,873	9,620	10,343	US$ 2.8 Bn to 4.6 Bn Deficit
Current Account Deficit (USD 'Mn)	4,615	3,982	2,541	1,988	1,883	1,742	2,309	2,814	Us$ 600 Mn surplus to Us$ 2.4 Bn deficit

*We have now resumed providing our forecasts after suspending them in March given the extreme levels of risk and volatility around the pandemic at the time and. However, there is still a considerable level of uncertainty with the developments around the pandemic, and as such, we are presenting our forecasts in the form of ranges in order to most realistically reflect this uncertainty. These forecasts will continue to be updated.

Source: CBSL, Dep. of Census and Statistics, Frontier estimates

Our Views

Our Preliminary Views on Rates

Currently in secondary market – 5.5%
(as at 24th June 2020)

** Remaining 5% incorporates other alternatives scenarios with different ranges for Rates and FX

Our Preliminary Views on Rates

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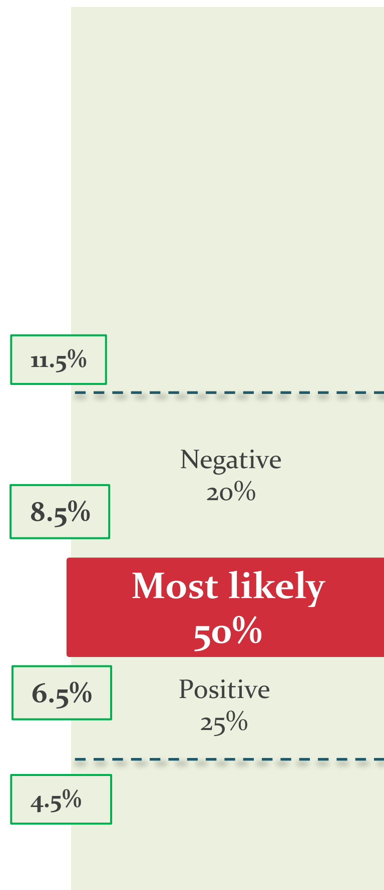
Currently in secondary market – 7.23%
(as at 24th June 2020)

Secondary Market - 10 year bond

18%
16%
14%
12%
10%
8%
6%
4%
2%

2-Jan-17 2-May-17 2-Sep-17 2-Jan-18 2-May-18 2-Sep-18 2-Jan-19 2-May-19 2-Sep-19 2-Jan-20 2-May-20



** Remaining 5% incorporates other alternatives scenarios with different ranges for Rates and FX

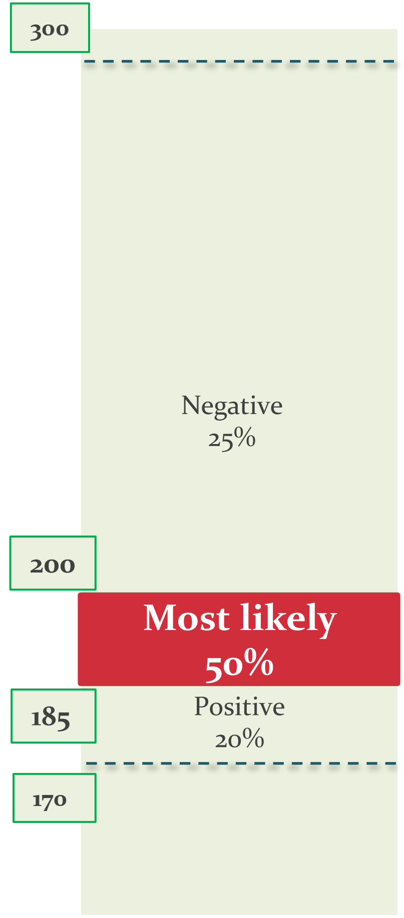
Our Preliminary Views on the LKR

Currently Rs. 186.67 per US dollar
(as at 24th June 2020)

USD/LKR

300
280
260
240
220
200
180
160
140

2-Jan-17 2-Jul-17 2-Jan-18 2-Jul-18 2-Jan-19 2-Jul-19 2-Jan-20



** Remaining 5% incorporates other alternatives scenarios with different ranges for Rates and FX

Economic Glossary

M2b: The sum of currency held by the public and all deposits held by the public with commercial banks (Source:CBSL)

Gross Official Reserves: consist of monetary gold, SDR holdings, reserve position in the IMF and foreign exchange, which comprises holdings of foreign currency, deposits with foreign banks and investment in foreign securities. (Source: IMF)

CCPI: The Colombo Consumer Price Index (2013=100) measures the general price level of consumer goods and services purchased in the Colombo urban areas. The consumer basket includes 392 items which represent the typical urban households' consumption expenditure. (Source: DCS)

NCPI: The National Consumer Price Index (2013=100) is compiled using prices collected for all of the nine provinces. The national consumer basket includes 407 items which represent the consumption expenditure of all households in Sri Lanka. (Source: DCS)

Core inflation: Considered a more accurate gauge of underlying inflation and compiled by subtracting out what is considered volatile elements of the overall index. In Sri Lanka, the core inflation index is compiled by excluding volatile food, energy, transport from the basket. (Source:CBSL)

YOY: Year-on Year: percentage change expressed compared to a value of a previous year

MOM: Month-on-Month: percentage change of a variable compared to a value of a previous month.

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