Sri Lanka has much to expect from the unexpected. From political powers in disarray to the light at the end of our economic woes not even close to being in sight, many find themselves dishearteningly planning to make ends meet. While the share market experienced some vital signs after a blood bath, even debt markets are buzzing with business. Mobius Capital Partners Founder Mark Mobius has expressed that Sri Lanka is in a time of great potential with bonds and equity trading at steep discounts. Dollar-denominated bonds too are trading at 40 cents to the dollar, indicating risk as well as to the seasoned investor – an opportunity.

This week the Central Bank issued 87.5 billion worth of Treasury bills and 35 billion of Treasury bonds. The three month bill was accepted in full of the offered volume as it garnered the most interest in bids. This resulted in a yield of 23.53%, subsequently, a 32 basis points increase from last week according to the state debt office reports. Primary dealers and other market participants confirmed the strong interest in Treasury bill purchases from clients as money is starting to flow into debt markets from the system. The interest in T-bills outstrips that of the T-bond auction with the three year and seven year paper issued yielding 22% in comparison.

The yield on a bond or bill is essentially the return that an investor will receive if they purchase the paper and hold it until it matures or expires. Generally, one might expect a yield curve, that is, the full range of issued bonds and bills returns across time, to be upward sloping because investors require higher returns for longer-dated bonds. The theory holds that this is to compensate buyers for the additional risk of holding an asset for a longer time, with inflation and the lower liquidity involved with committing funds for longer.

However, this relationship does not always hold and has been seen to flip. Known as an inversion, this ‘inverted yield curve’ means that the buyers have more return potential in the short term, simply because there is more uncertainty in the short term that will wane with time. This has been considered a predictor of worsening economic situations and was first coined as a recession indicator by financial economist Campbell Harvey of Duke University in 1986. Having successfully predicted many economic recessions since then, it has also been a false bellwether in many instances.

Sri Lanka’s economy and currency have been badly hit by two years of excessive money printing while running twin deficits, as outflows exceeded imports on the foreign front, and reserves were used up to entice new money to maintain currency regimes. A currency float brought about in March to rebalance fund flows by ending sterilised interventions has failed due to letting go of interest that was required to make it a peg and depress the currency in the first place, according to analysts. Therefore, with 5,880 million dollars of foreign currency-denominated debt payments lined up to be restructured this year 2022, as we make outflows for import purchases, the currency is unlikely to stabilise under these conditions in the short term.

The Central Bank is now under a new manager who is confident to keep a monetary policy tightening stance with limited impact on treasury market volatility. This has been expressed to banks and primary dealers alike meaning that while the very short-term rates peak it is likely to be the target of a correction, for the yield curve and currency to adjust. The real economy may suffer the short-term brunt of the fallout.