Navigating Rough Tides Ahead

Preview to Monetary Policy H1'FY2024

June 16, 2023

What's inside

Executive Summary

- **Global Outlook:** Central banks globally are nearing the end of their tightening cycles, with the Federal Reserve signaling two additional rate hikes before reaching the cycle's conclusion. The economic slowdown and a banking crisis in the US have diminished the urgency for further sharp rate hikes. As a result, the likelihood of the Dollar index strengthening is low, alleviating pressure on global currencies, including the Bangladeshi taka.

- **Recap of policy measures in Bangladesh and its impact on the economy:** In the past year, a contrast emerged between major advanced economies adopting tight monetary policies with substantial interest rate hikes, while Bangladesh pursued a macroeconomic strategy aimed at achieving low inflation, exchange rate stability, and stimulating economic growth through low-interest rates. This pursuit of the "impossible trinity" resulted in macroeconomic imbalances, including high inflation, currency depreciation, and a shortage of US dollars.

- **Macroeconomic Outlook H1'FY2024:** Considering external factors and involvement in an IMF program, the central bank of Bangladesh is scheduled to announce its monetary policy on 18th June. The central bank finds itself in a challenging situation without any favorable options. Two policy paths lie before the central bank- an aggressive stance would help stabilize the macroeconomic situation but potentially lead to slower growth and an increase in non-performing loans within the banking system. Conversely, opting for a progressive stance would support growth but may result in higher inflation, and further depreciation of the currency.

  a) **Aggressive Response:** Under the Aggressive Response, the policy measures will be aimed at tackling inflation and currency depreciation through tighter monetary policies. Based on the policy measures, CAL expects interest rates for 364-day T-bills to be around 10.6% to 11%, c.7% depreciation of the taka against the dollar, and sustained elevated inflation of approximately 8.2% to 8.5%.

  b) **Progressive Response:** Under the Progressive Response scenario, the policy measures will be aimed at prioritizing policies that promote growth over cautious approaches. Based on the policy measures, CAL expects interest rates for 364-day T-bills to be around 8.3% to 8.6%, c.15% depreciation of the taka against the dollar, and an increase in inflation to 10.5% to 11.0%.

- **Investment Strategy:** In the event of a potentially aggressive stance, we recommend a shift towards short-term fixed-income securities to capture yield opportunities. In contrast, if a progressive approach is chosen, we recommend increasing exposure to equities and real estate assets due to potential opportunities from debt monetization.

- Consistent with our usual practice, we will **publish an updated forecast** in our monetary policy review for H1'FY2024 based on the adopted policy changes in the upcoming monetary policy statement by Bangladesh Bank.

Towards Turning the Corner

Global Outlook: Tightening cycles nearing the end

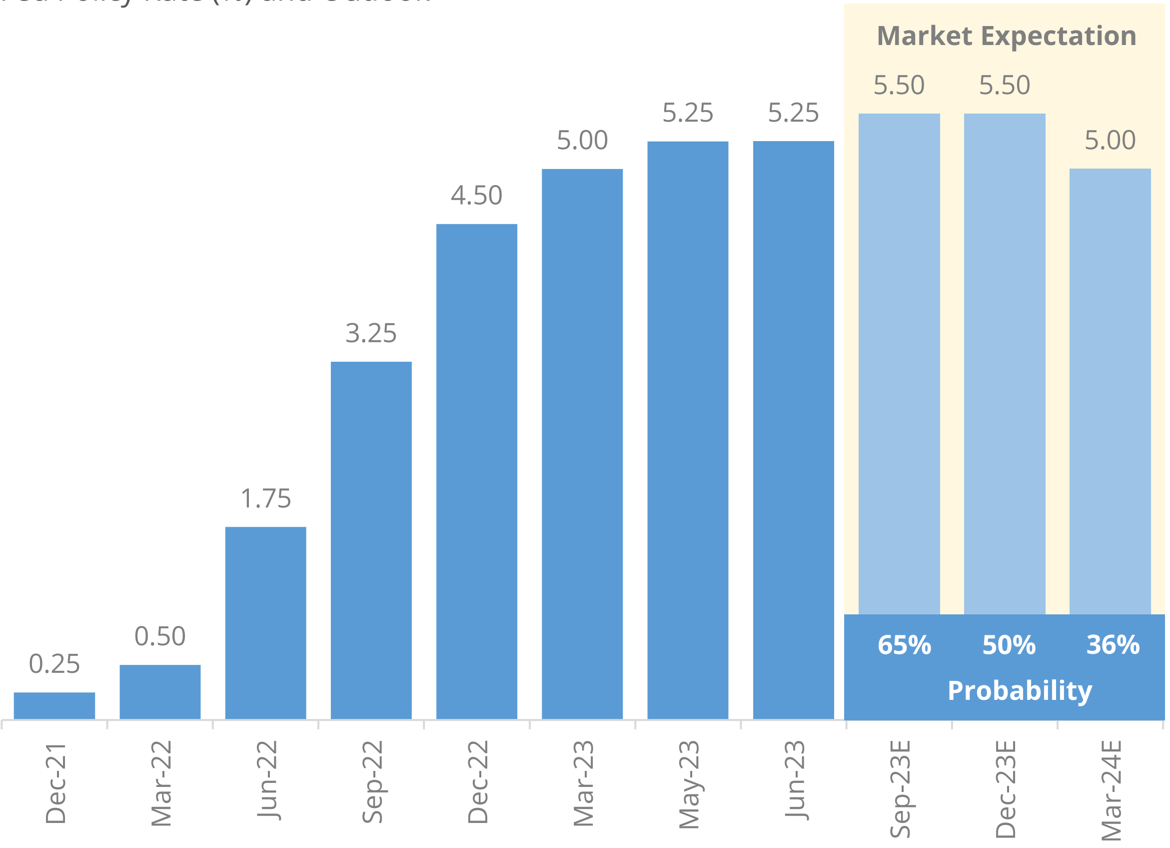
Globally, central banks are nearing the end of their tightening cycles, with the Fed projecting two more rate hikes before the cycle ends. The recent banking crisis in the US, a slowdown in economic growth, and declining inflation have reduced the need for sharp rate increases. Amid the economic slowdown and the nearing end of tightening cycles by year-end, the likelihood of further strengthening in the Dollar index is low, alleviating pressure on global currencies. A deteriorating banking crisis in the US could deepen the economic woes, necessitating a more expeditious easing of the tightening cycle. However, elevated inflation and tighter credit conditions in developed markets may impede growth and adversely impact imports in major economies.

Globally policy rates are expected to stay at elevated levels. However, central banks are approaching the tail end of tightening cycles.

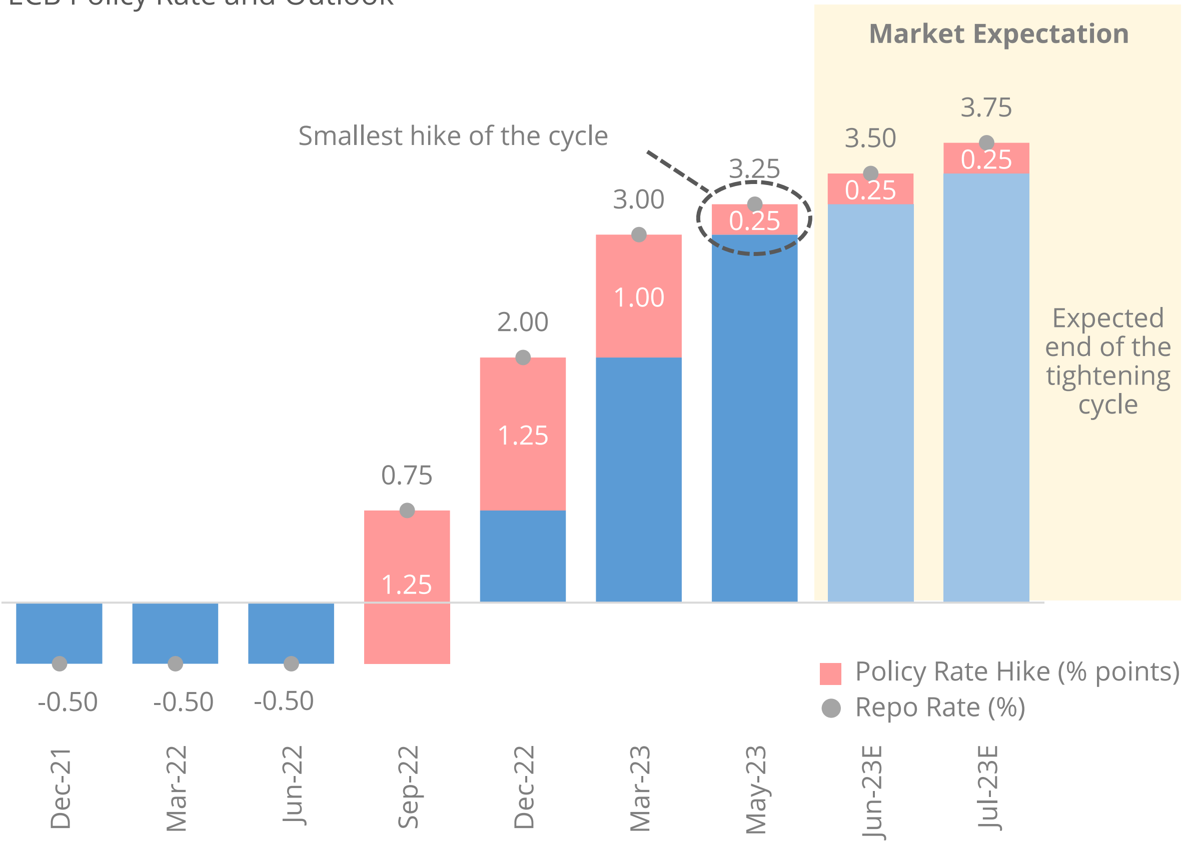
In June, the Fed kept interest rates unchanged after 10 straight increases but indicated two more hikes this year, aiming to push the rates to or above the median range of 5.5% to 5.75%. According to the CME Fed Watch tracker of prices in the Fed funds futures market, traders anticipate one additional hike in the policy rate, projecting it to reach a peak of 5.5% before the tightening cycle concludes.

European Central Bank (ECB) has slowed the pace of its interest rate increases in its last policy decision. However, it conveyed a message of further tightening with the possibility of two further 25 bps rate hikes, in June and July which the market anticipates to be the final stage of its fight against inflation.

Fed Policy Rate (%) and Outlook

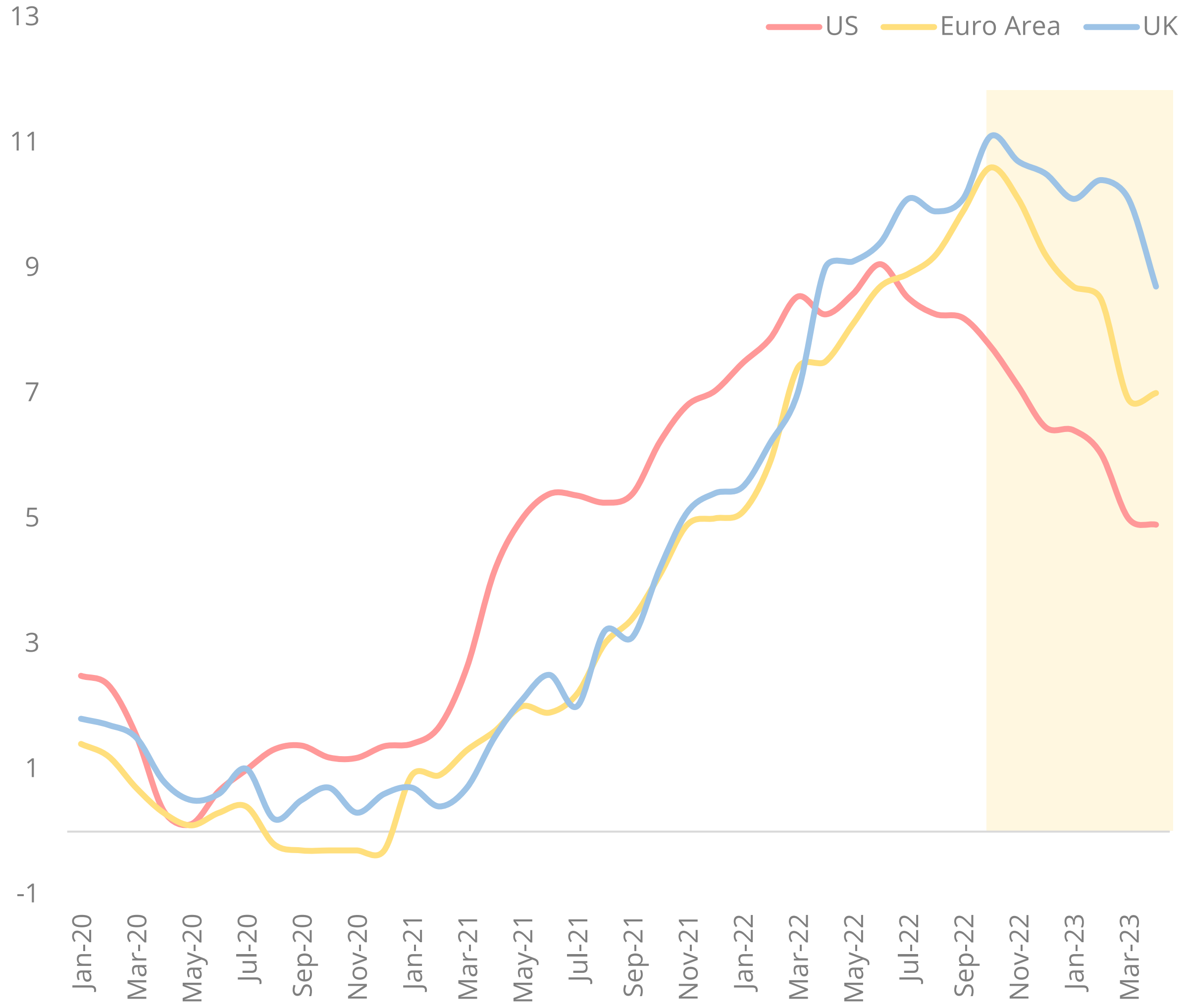


ECB Policy Rate and Outlook

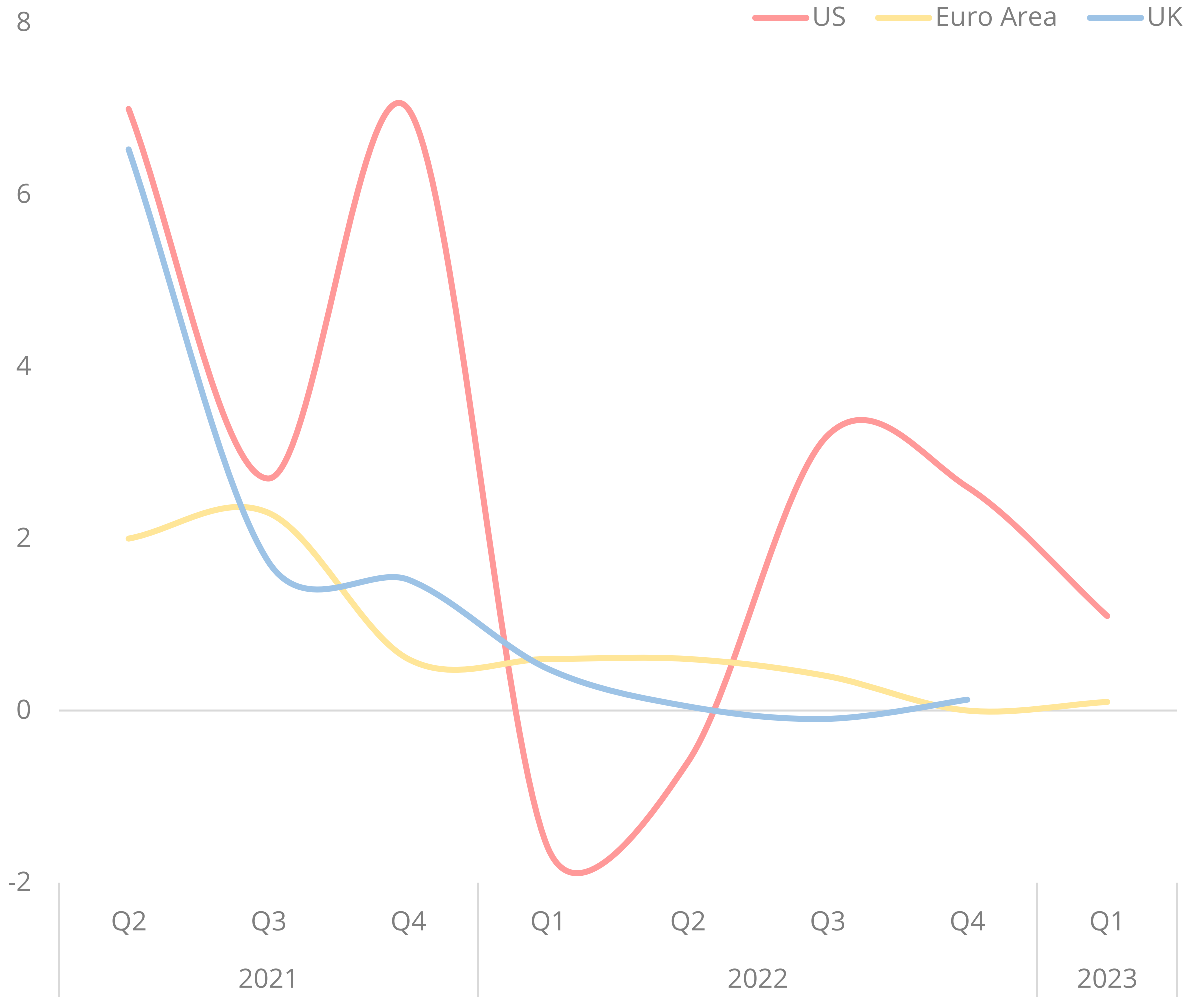


Initiative to tame inflation through steep interest rate increases has resulted in a slowdown in economic growth…

Inflation (%)



Real GDP Growth _ QoQ (%)



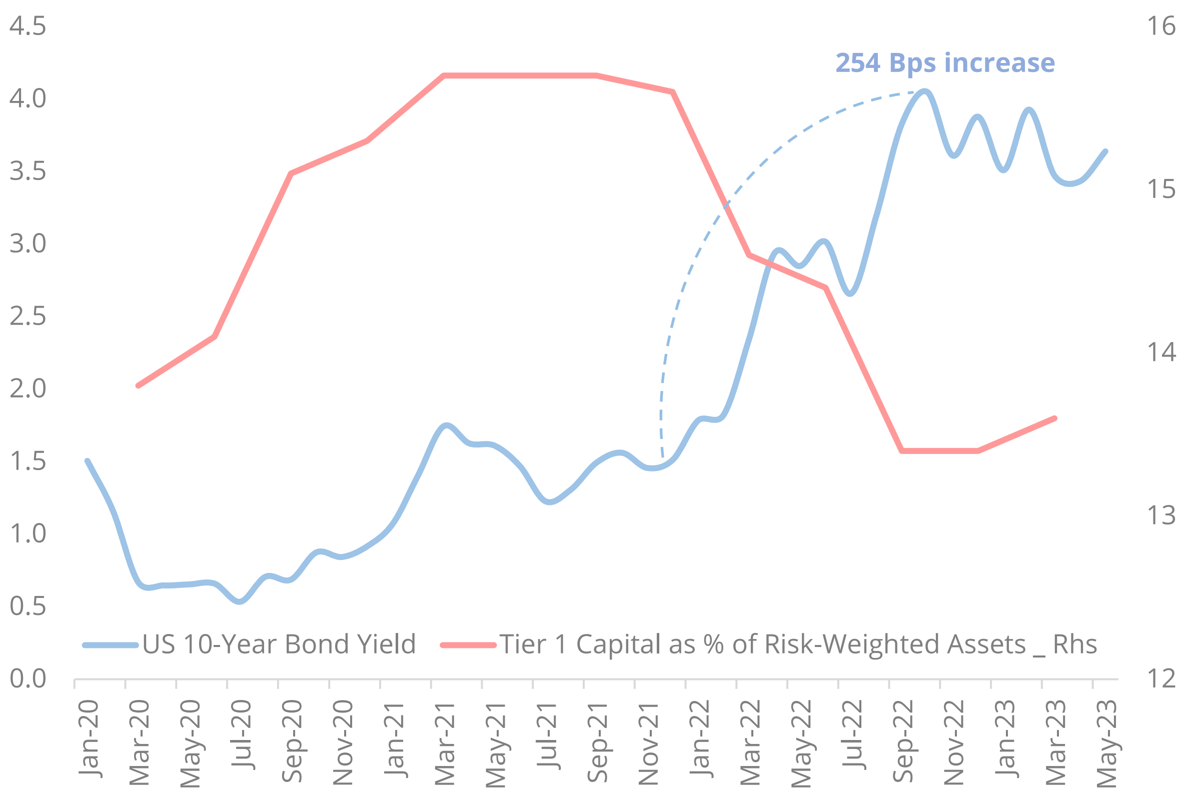
Source: Fed, ECB, Office for National Statistics-UK

… coupled with the recent banking crisis in the US, resulting in a decreased need for significant rate hikes.

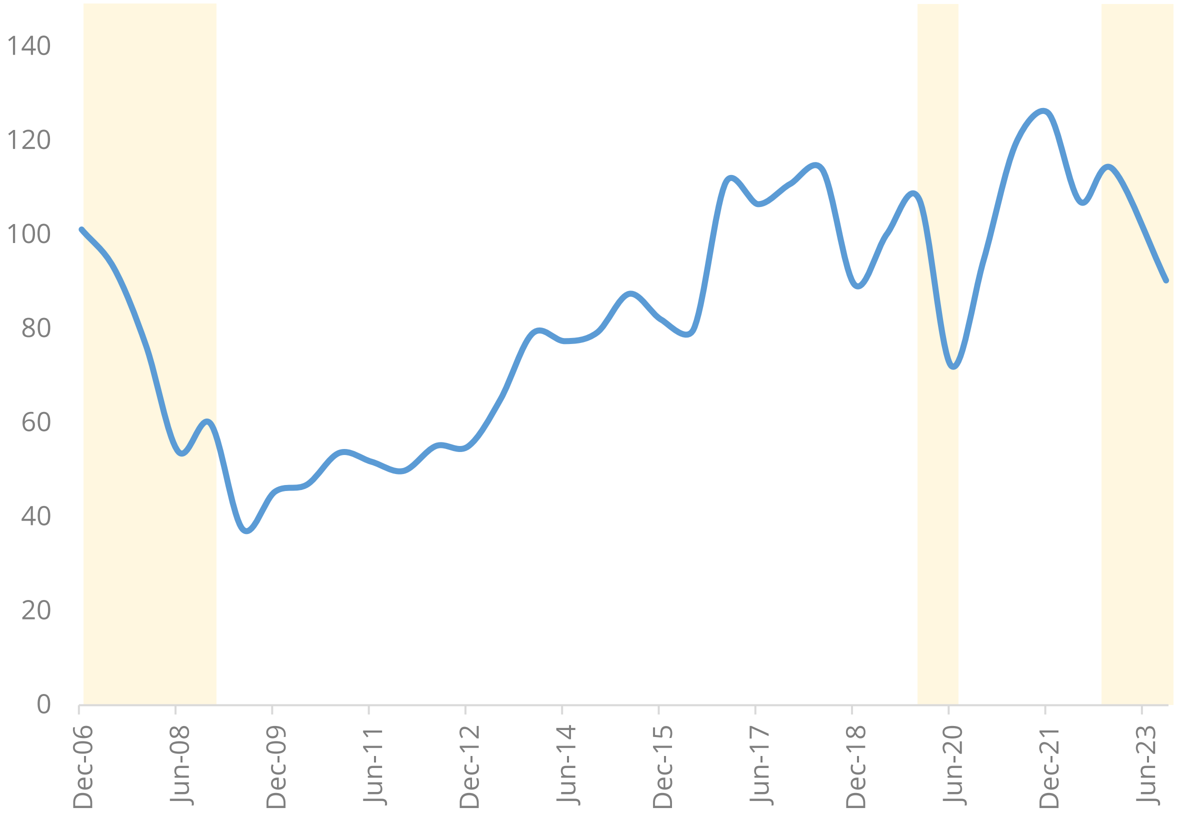
In a rising interest rate environment, some US banks have encountered difficulties due to their holdings of low-interest bonds. As the bond prices decreased, the market value of their capital reserves also decreased, resulting in some banks incurring unrealized losses.

Since March, three regional banks, namely Silicon Valley Bank, Signature, and First Republic, have failed, raising concerns among investors about the financial health of other regional banks. The continuing decline of the US regional bank stocks has weighed down the Regional Banking Index, indicating a potential systemic issue in the sector.

US 10-year Bond Yield (%) and Tier 1 Capital Ratio (%)



Regional Banking Index

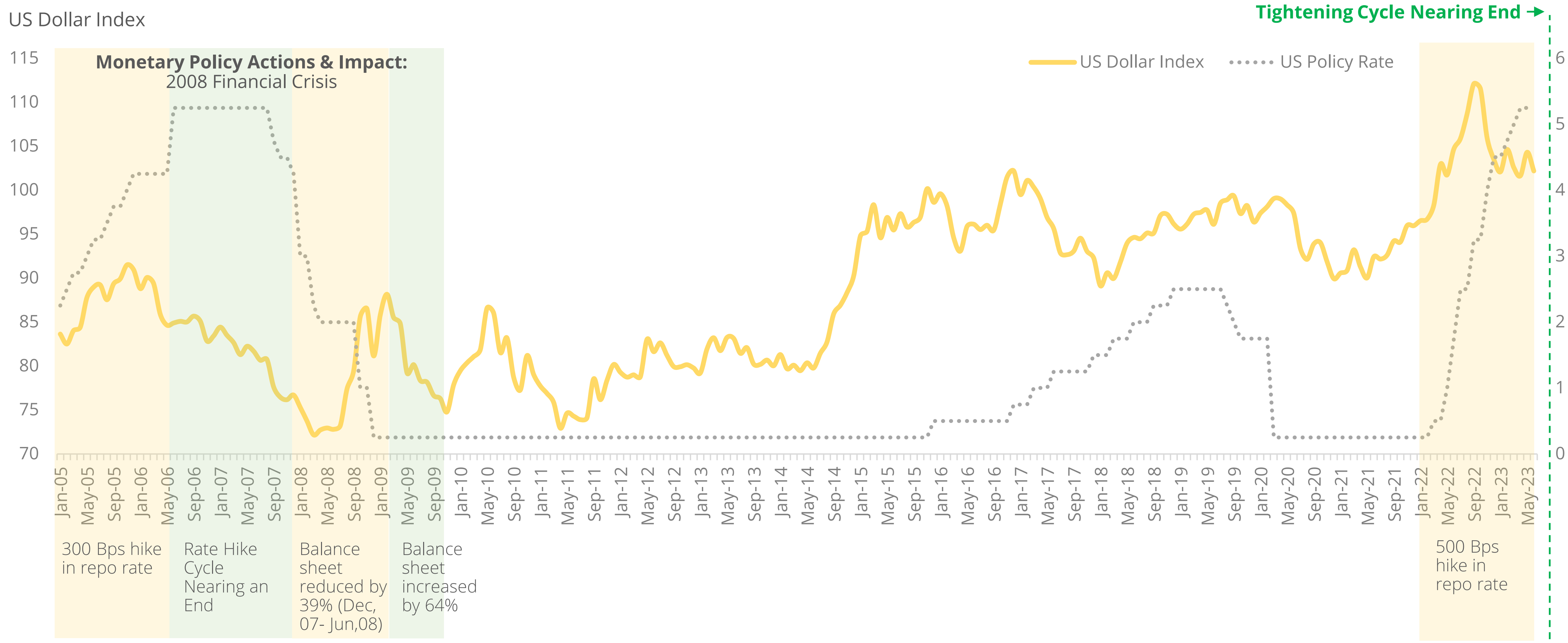


Source: Fed, Investing.com

Pressure on global currencies is expected to ease as the likelihood of further strengthening in the Dollar index is low with the US nearing the end of rate hikes by the end of the year.

After a long period of strengthening of the U.S. dollar, attaining a 20-year peak in September last year, the U.S. dollar index experienced an approximate 9.6% decline till April 2023. The factors that drove the dollar's appreciation in the previous year are now expected to recede gradually, indicating the possibility of further softening in the dollar index.

US Dollar Index

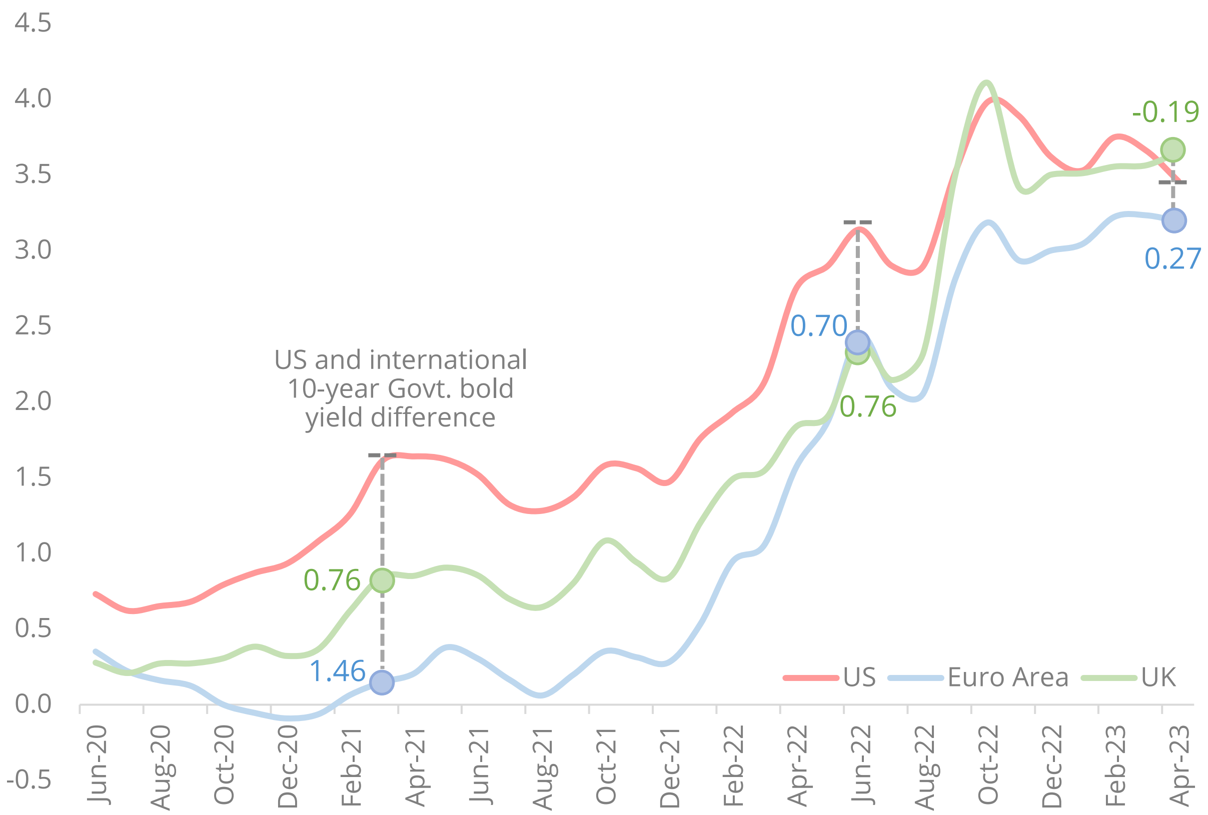


The combination of squeezed interest rate differentials and increased negative trade balance will exert further pressure on the dollar.

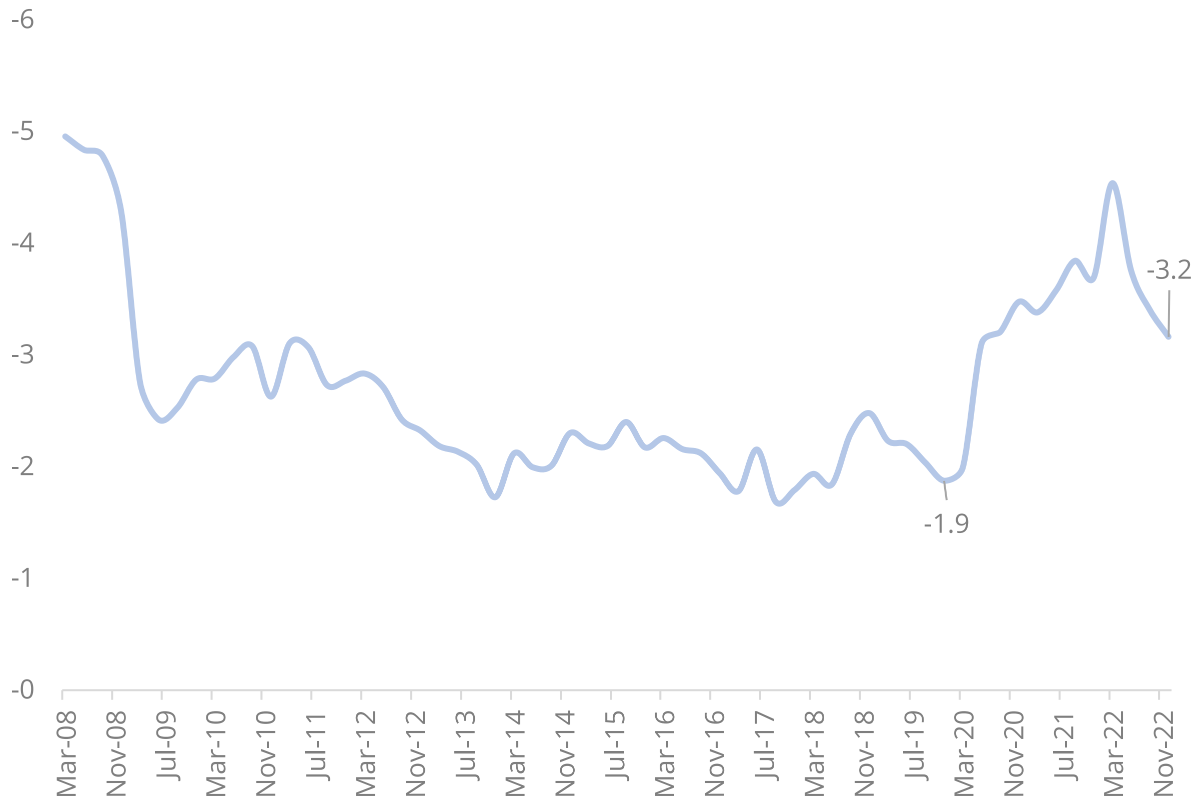
Fed's pause in tightening before other developed economy central banks may lead to a narrowing in interest rate differentials between the US and other developed markets which is likely to weigh on the dollar.

The current U.S. trade deficit standing at 3.2% of GDP, reflects the adverse impact of a strong dollar on the competitiveness of U.S. manufacturing. Conversely, a persistent high negative current account can exert downward pressure on the dollar index, spurring greater demand for overseas goods and services.

Developed Market Interest Rate Differentials (% points)



US Current Account Balance as % of GDP

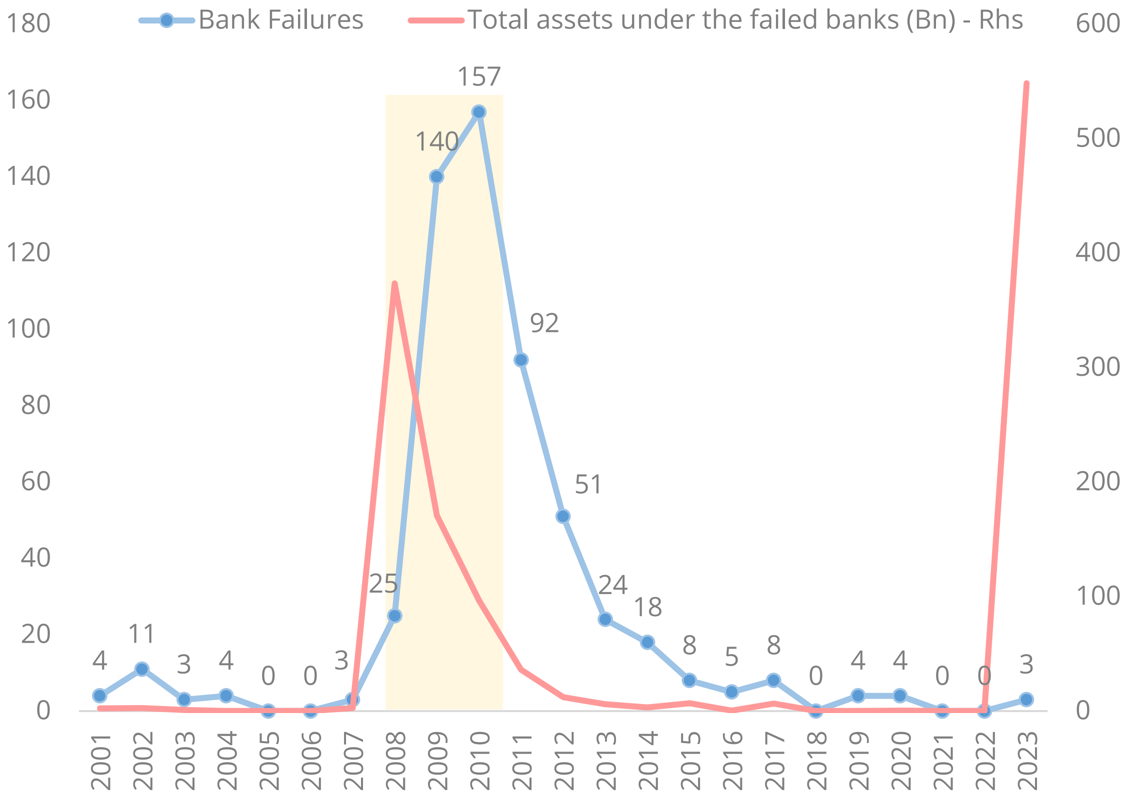


Under the scenario of a deteriorating banking crisis in the US, the economy could be pushed into a recession necessitating a swifter easing of the tightening cycle.

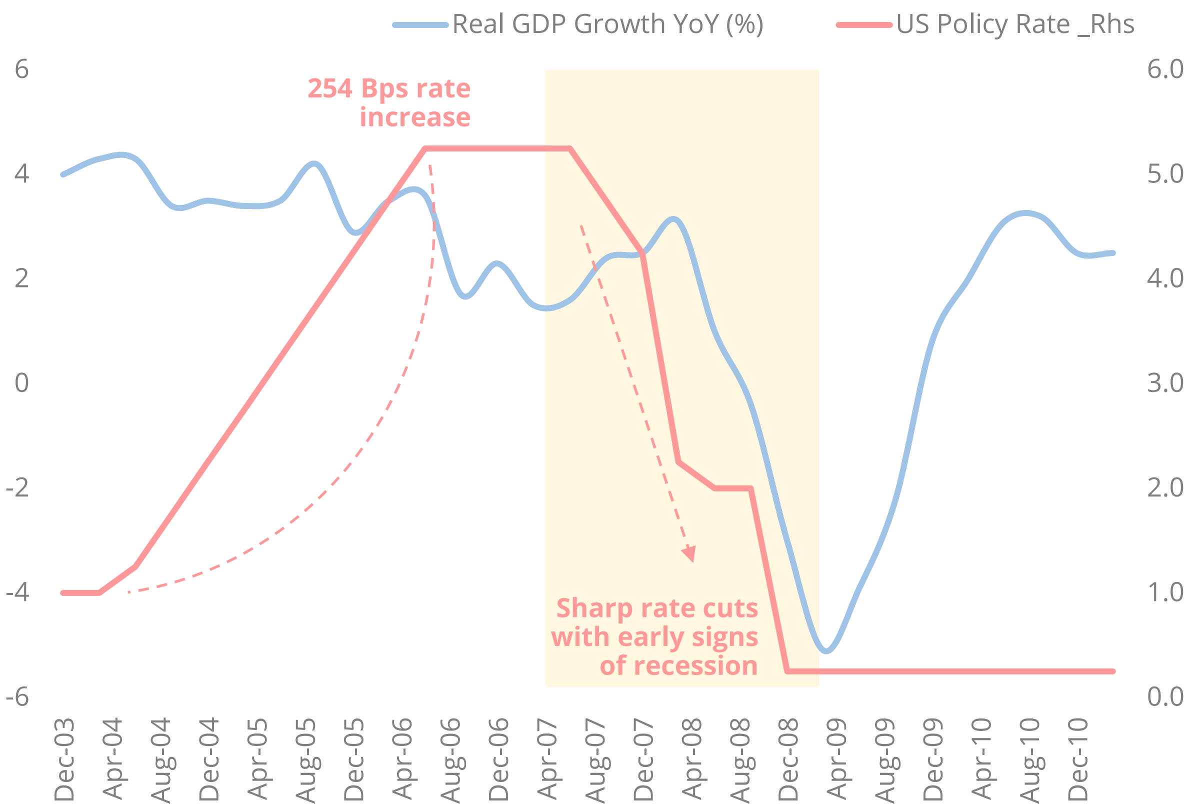
The recent turmoil in regional banks has created new headwinds for the US economy, heightening the risk of a recession later this year. Consequently, there is an anticipated tightening of bank lending conditions as banks are expected to prioritize enhancing the quality of their balance sheets over pursuing growth, potentially impeding overall economic expansion.

As the Fed raised the policy rate 17 times from 1.0% to 5.25% between 2004 and 2006 leading to a burst in the housing bubble resulting in 157 bank failures. The financial crisis sent the economy into a deep recession with –a 5.1% decline in real GDP. (Currently, rate hikes have impacted the regional banks only and any worsening banking crisis may send the economy into recession raising the need to easing of the tightening cycle.)

Bank Failures

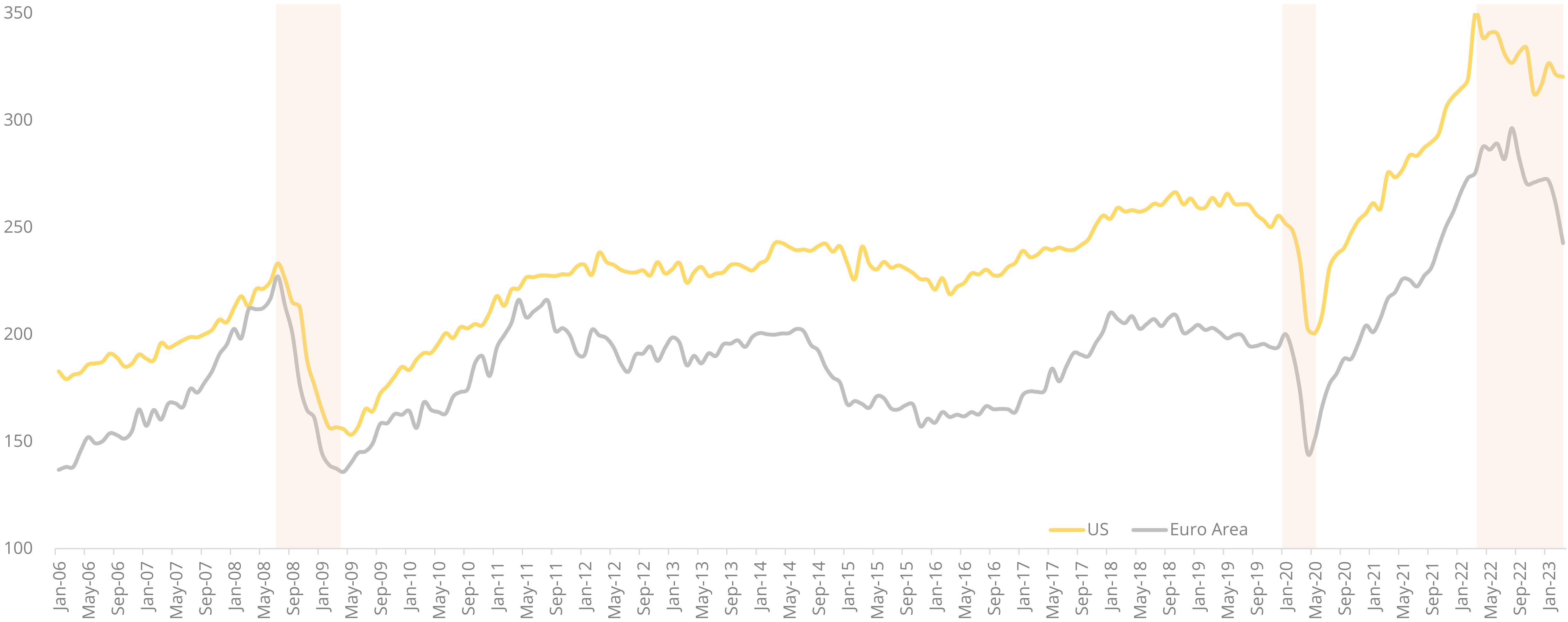


US Real GDP Growth YoY (%)



High inflation, elevated interest rates, and tighter credit conditions in developed markets is expected to weaken growth, impacting imports in the major markets.

Import Scenario (USD Bn)



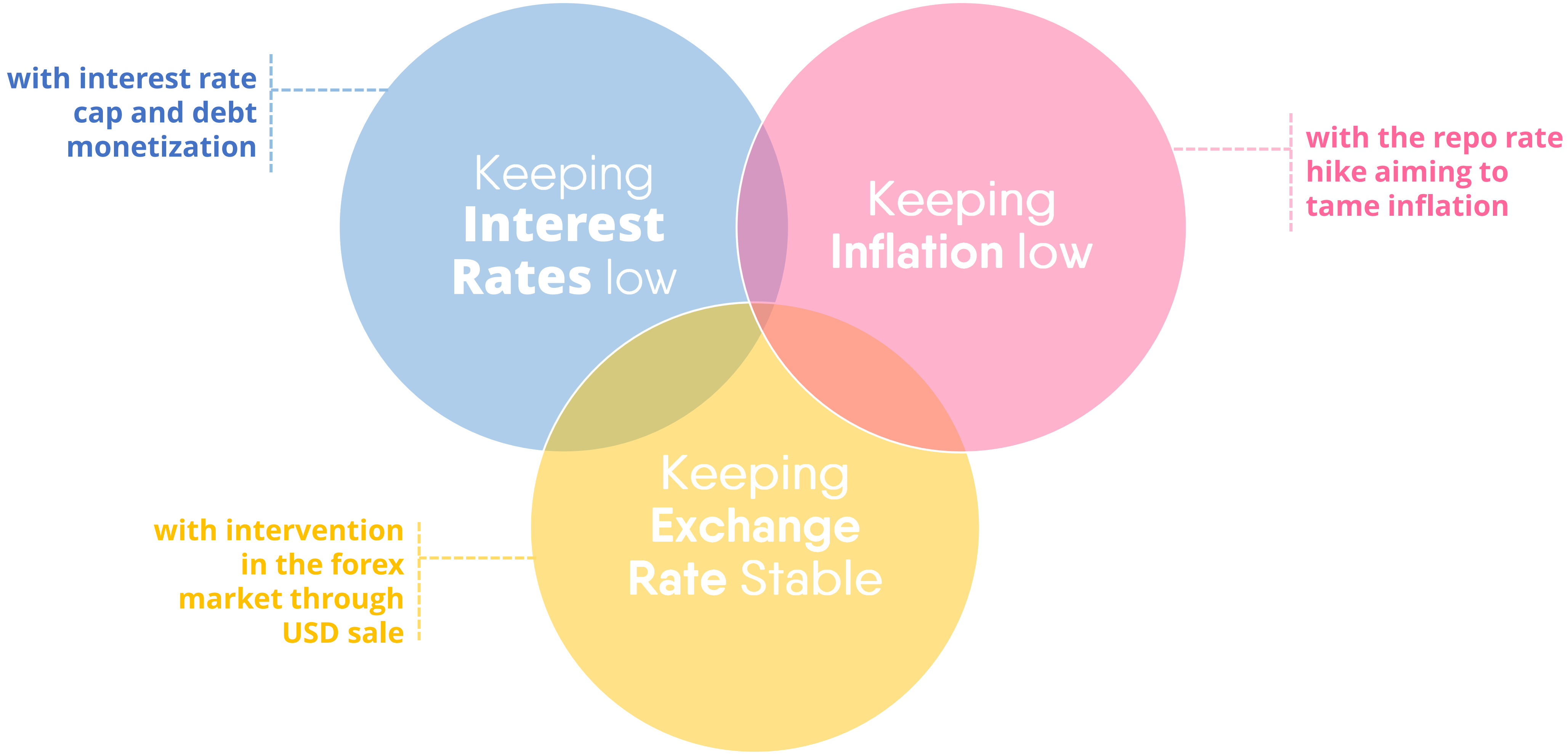
Source: Fed

In Deep Water

A Recap: Policy Measures in Bangladesh and its Impact on the Economy

In the past year, a contrast emerged between major advanced economies adopting tight monetary policies with substantial interest rate hikes, while Bangladesh pursued a macroeconomic strategy aimed at achieving low inflation, exchange rate stability, and stimulating economic growth through low-interest rates. This pursuit of the "impossible trinity" resulted in macroeconomic imbalances, including high inflation, currency depreciation, and a shortage of US dollars. The effectiveness of policies was hindered by lending rate caps, while lower deposit rates spurred a liquidity shortage in the banking system.

What were the key policy measures driving the response in Bangladesh?"



What were the key policy measures driving our response?

The policy rate has been raised by **100 basis points** to **6.00%**, while the **lending cap** for banks (except for consumer loans and credit cards) has been maintained at **9%.**

To keep currency on stable footing, **forex intervention** involved the sale of **USD 11.7 billion** over a period of 10 months from July to April '23.

Higher bank borrowing targets to finance the budget deficit resulted in debt monetization of c. BDT 770 Bn by BB in the first eleven months of this fiscal year.

Imposed import restrictions: including a ban on luxury imports and increased LC margins based on the nature of the goods

What were the outcomes based on the implemented policy measures?

- Inflation in **May** soared to a decade-high of **9.94%.**
- The Bangladeshi Taka (BDT) experienced a **14% depreciation** against the dollar
- The Central Bank has been employing **moral suasion** to maintain the exchange rate.
- **Shortage of USD** at the **current exchange rate**
- Macroeconomic imbalances and the depletion of Foreign Exchange Reserves prompted Bangladesh to **enroll in an IMF program**.

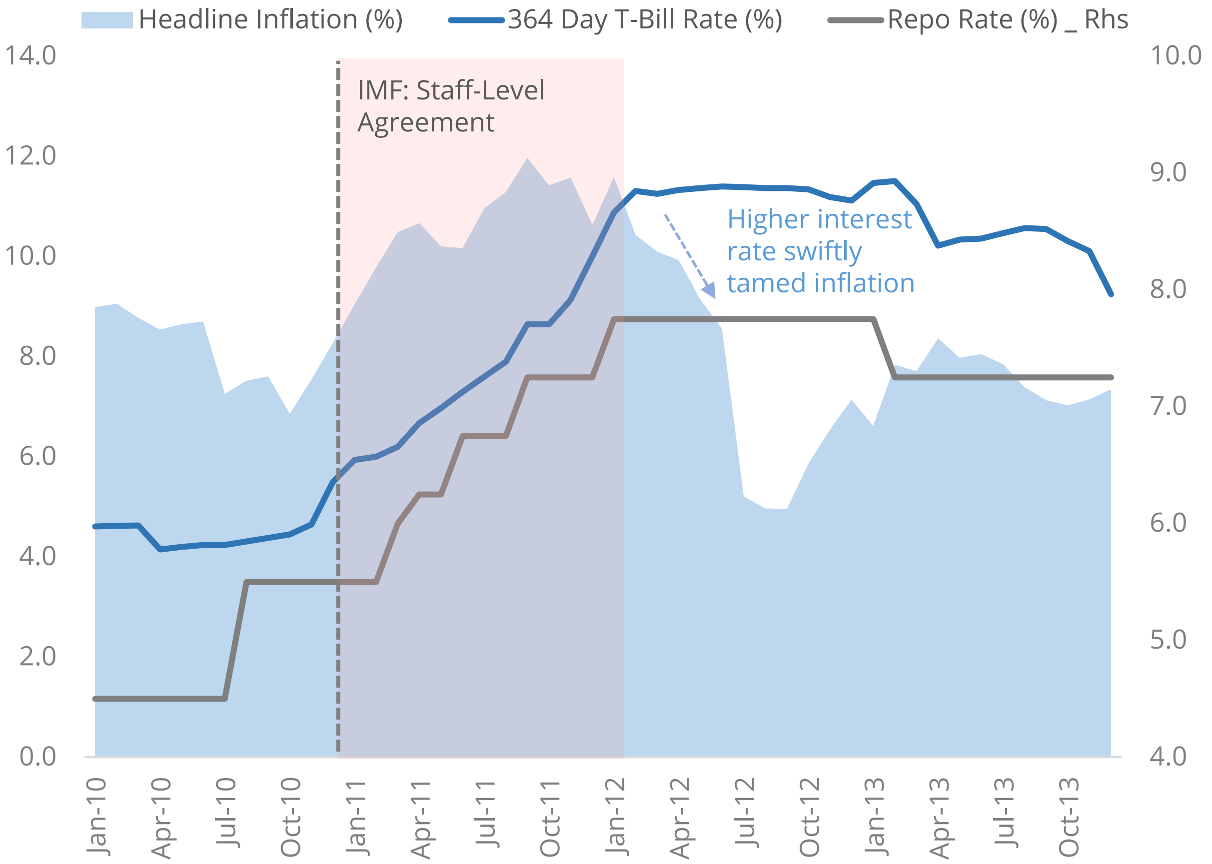
Source: Bangladesh Bank

A case study: The current policy response differs from those in the previous IMF program.

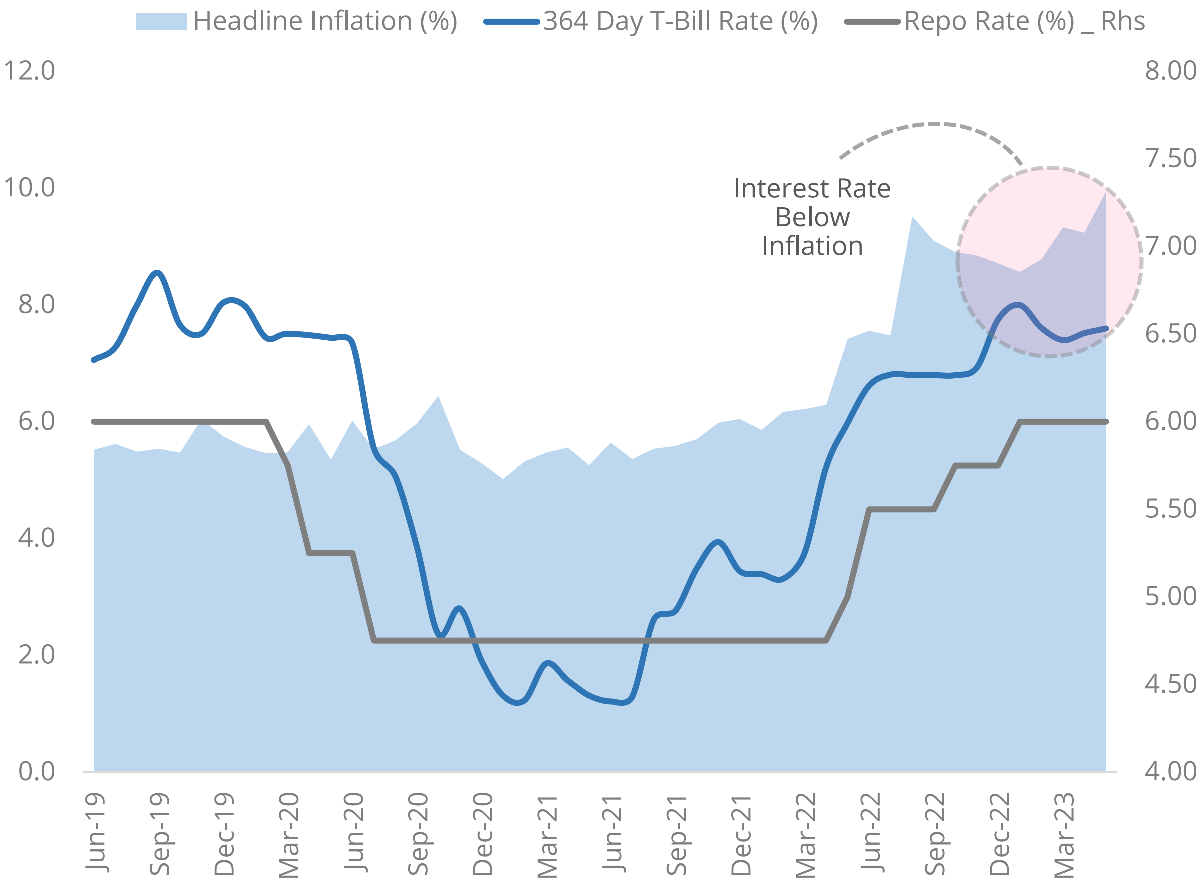
The significant increase in the policy rate, combined with the removal of rate caps, facilitated the effective transmission of monetary policy across the economy during 2010-2011, resulting in the successful containment of inflation within a brief timeframe.

With a low-interest-rate policy in place, inflation has remained at elevated levels, unlike the previous IMF program.

Inflation and Interest Rate Scenario During 2011-12



Current Inflation and Interest Rate Scenario

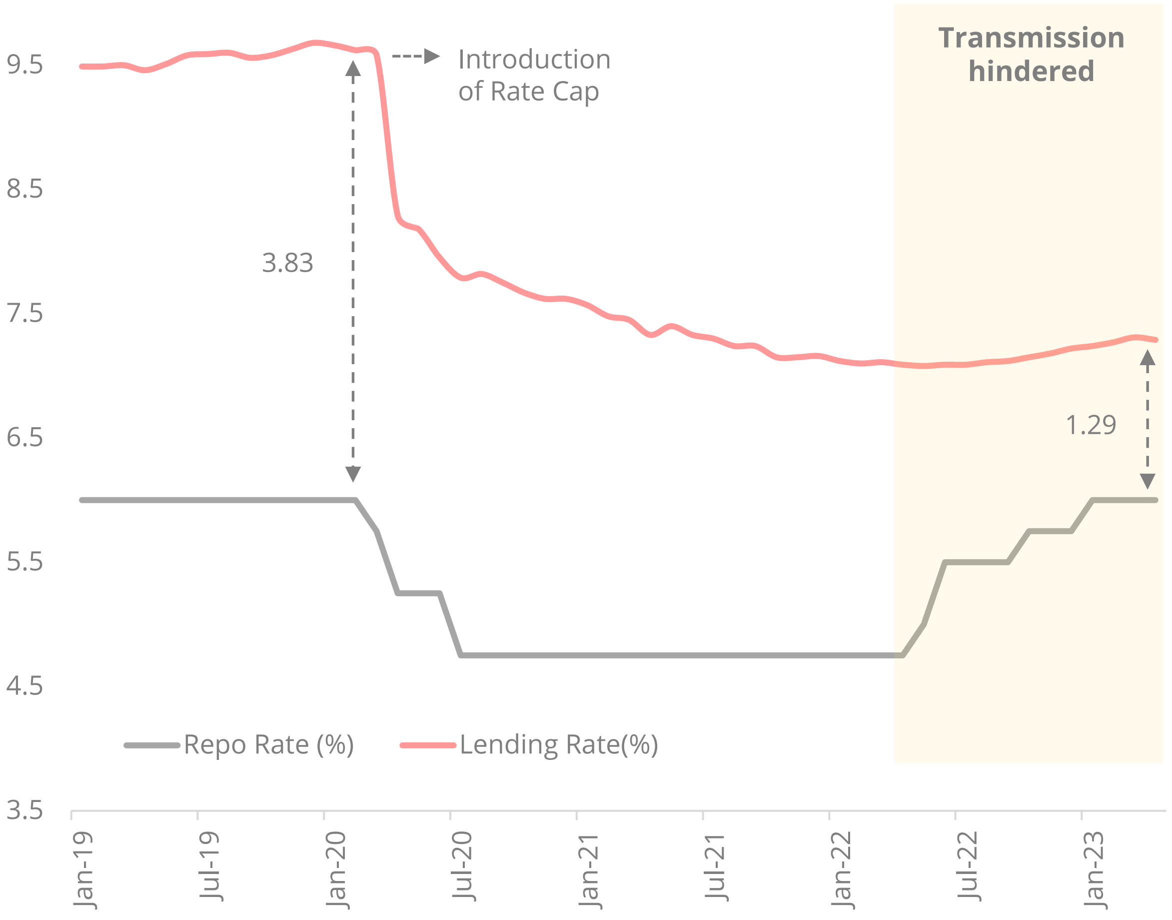


The policy direction has been oriented towards utilizing debt monetization as a tool to maintain interest rates at a lower level...

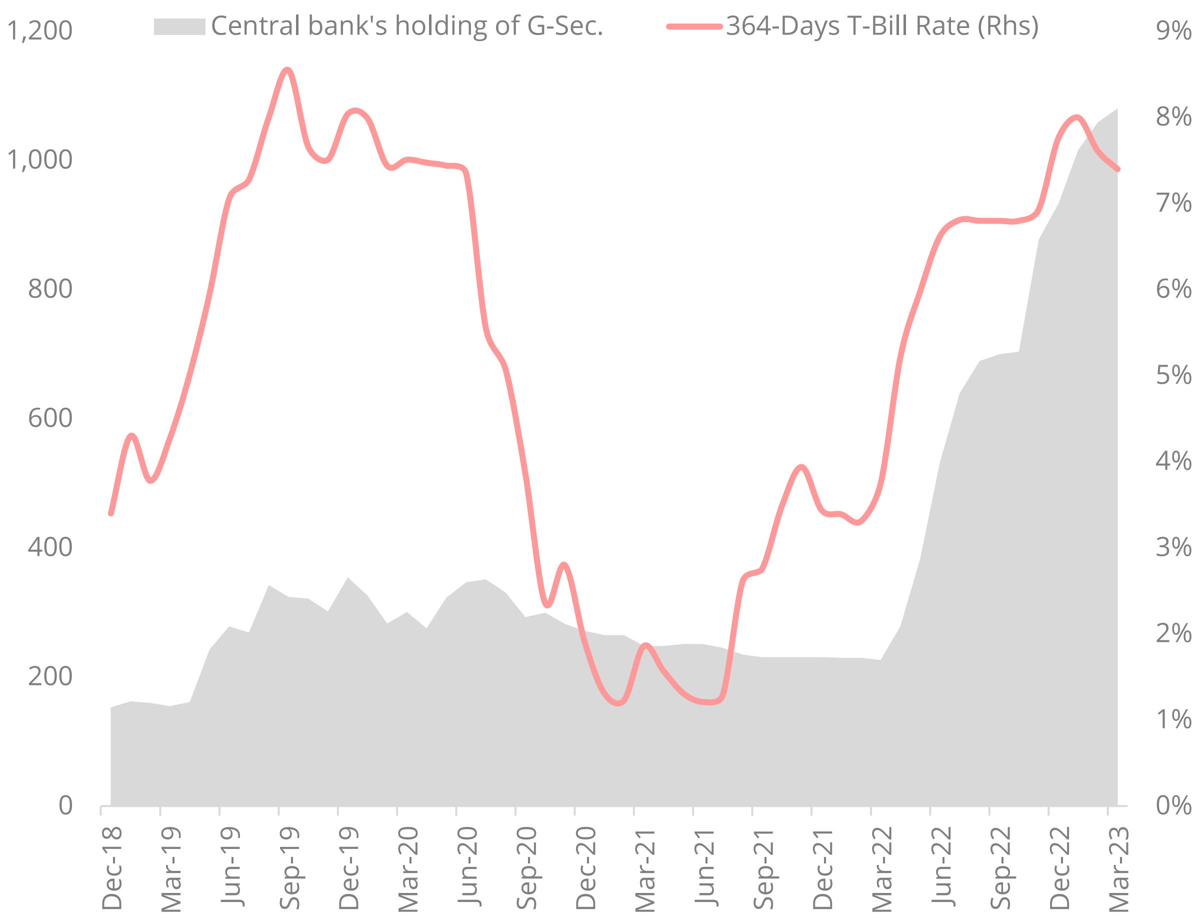
The impact of the policy rate hike has been limited by the current interest rate cap, as the gap between the policy rate and lending rate has reached a historically low level.

From June to March of FY-23, the BB injected substantial liquidity into the economy by purchasing treasury assets worth BDT 549 bn, thereby keeping interest rates lower.

Repo Rate (%) vs Lending Rate (%)



Interest Rate (%) Vs BB's Asset Purchase (BDT Bn)

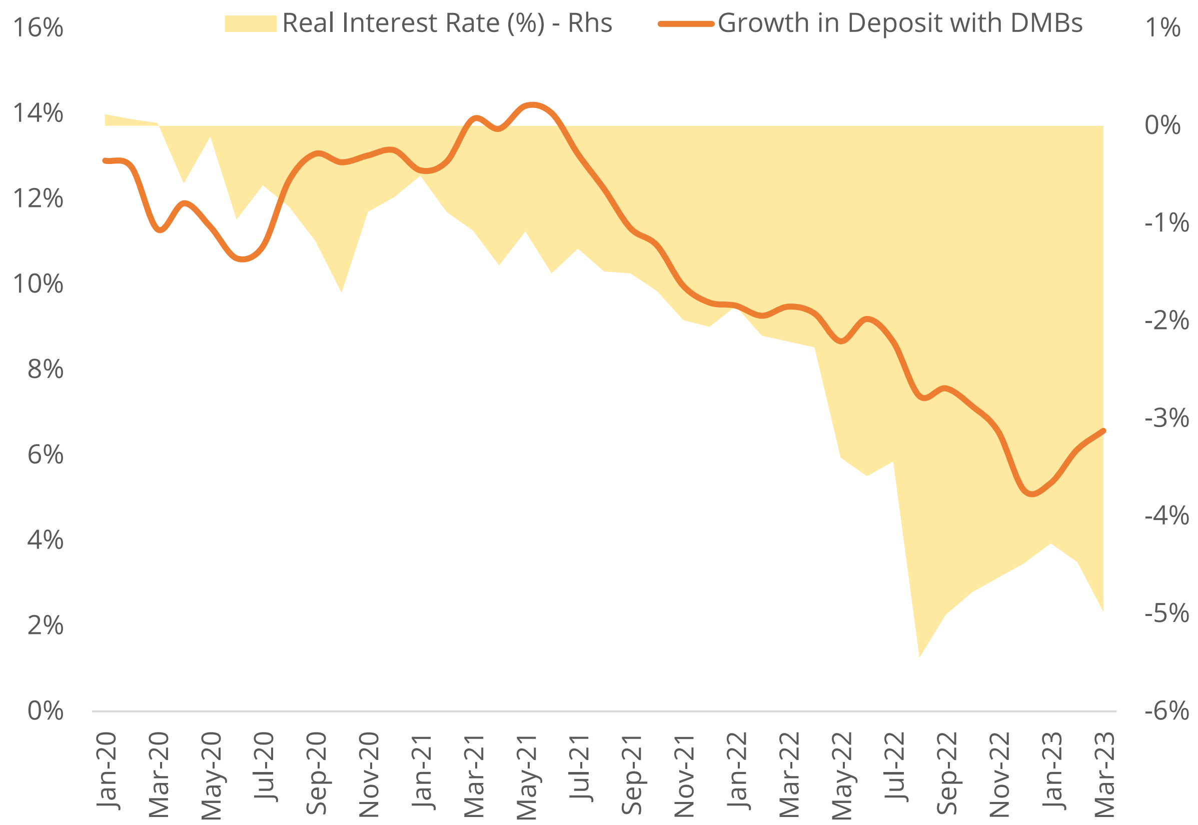


…while the prevailing negative real deposit rates have contributed to a liquidity shortage in the market, prompting the central bank to extend support through the repo market.

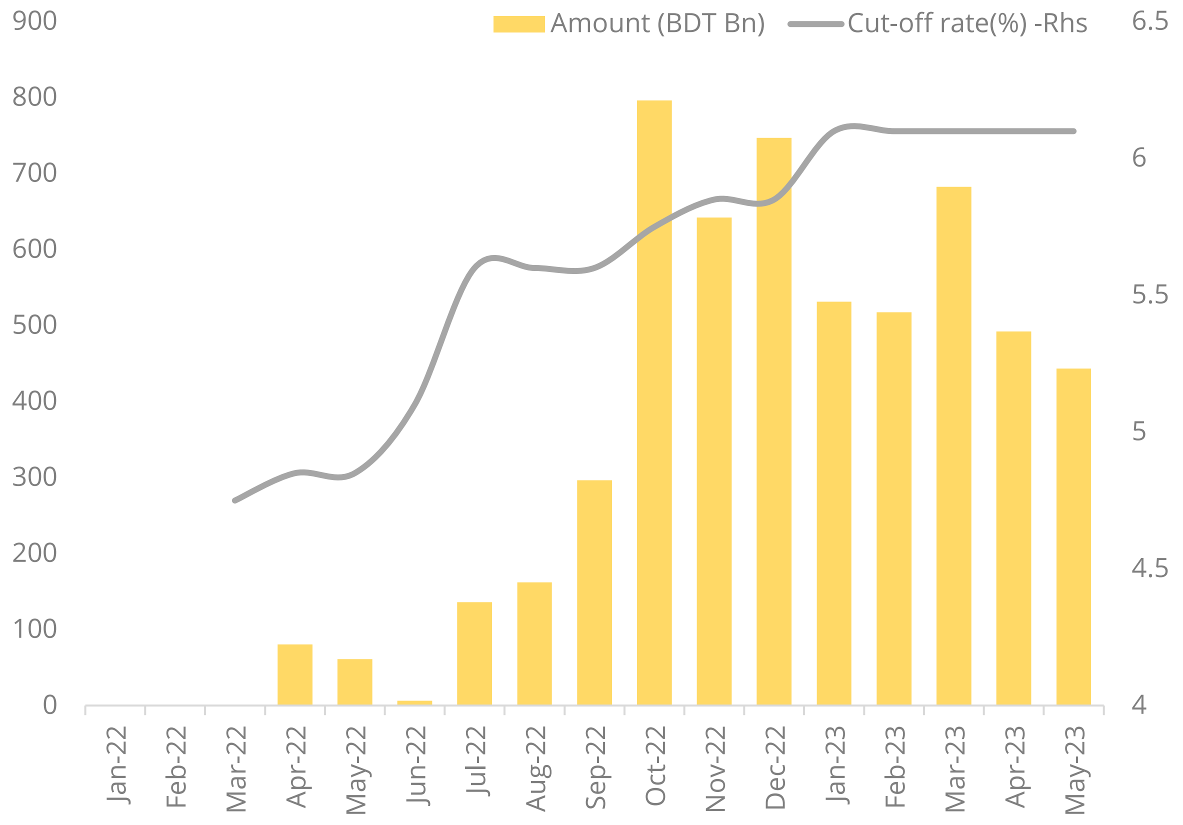
Due to negative real interest rates, deposit growth in the banking system has sharply declined, leading to a liquidity shortage in the banking system.

In response to the existing liquidity shortage in the banking sector, the central bank has been offering support through the repo market.

Deposit Growth vs Real Interest Rate (%)



Repo with Bangladesh Bank



Between the Devil and the Deep Blue Sea

Macroeconomic Outlook: H1’FY2024

Considering external factors and involvement in an IMF program, the central bank of Bangladesh is scheduled to announce its monetary policy on June 18th. The central bank finds itself in a challenging situation without any favorable options. Two policy paths lie before the central bank- an aggressive stance focused on controlling inflation and ensuring currency stability or a progressive approach prioritizing growth. The macroeconomic outlook hinges on the central bank's response to IMF recommendations and choice between prudence and fostering growth.

The adoption of IMF's recommendations can act as a catalyst in rectifying macroeconomic imbalances through policy adjustments.

Bangladesh's post-pandemic economic recovery was disrupted by Russia's conflict in Ukraine, resulting in a significant current account deficit, Taka depreciation, and declining foreign exchange reserves. Consequently, Bangladesh sought a $4.7 billion IMF loan under the ECF/EFF and RSF arrangements. Under the program, IMF recommended reform aiming at restoring macroeconomic stability, easing financing constraints, rebuilding reserves, and modernizing the monetary policy framework will play a vital role in guiding Bangladesh's monetary decisions this year.

A summary is given below highlighting which IMF reform recommendation will impact the three key macro variables; Interest rate, exchange rate, and inflation.

Interest Rate

Interest rate corridor:
Adopt an interest rate corridor system with automatic standing lending and deposit facilities. (Jul-23)

Monetary policy framework: Move away from reserve money to the interest rate as an operational target. (Program Period)

Cap Removal:
Remove all interest rate caps. (Program Period)

Reduce NSC issuance (Program Period)

Ceiling on reserve money*

Exchange Rate

Floor on net international reserves (Jun-23 onwards)

Unified Exchange Rate:
market-determined exchange rate for all official FX transactions (Jun-23)

Reserve Calculation:
Reporting the official Gross International Reserves (GIR) as per BPM6. (Jun-23)

Easing import restrictions:
Reverse the temporary increases in margins for opening letters of credit on nonessential imports.

Inflation

Subsidies Rationalization:
Adopt a periodic formula-based price adjustment mechanism for petroleum Products (Dec-23)

* Indicative target

Scenario 1: Aggressive policy stance to restore macroeconomic stability

The upcoming Monetary Policy Statement (MPS) to be announced in June will depict how the Bangladesh Bank (BB) responds to IMF recommendations to address the macroeconomic challenges in the first half of FY-2024. The outcome of this policy decision will have a significant impact on the economic landscape in the months ahead. Here is a summary of the policy actions and the outlook under the first scenario “Aggressive Response”.

Aggressive Response

Due to declining foreign exchange reserves and higher inflation, BB has the option to implement a policy focused on curbing inflation and controlling currency depreciation. In line with IMF recommendations, the central bank is expected to use interest rates as an operational tool for monetary policy to address inflation and adopt market-determined exchange rates for official foreign exchange transactions. This necessitates the adoption of a tighter monetary policy approach. However, the aggressive tightening might dent economic growth while increasing NPL in the banking system.

CAL’s View:

Policy actions under the “Aggressive Response” scenario:

- Increase the policy rate by 175 to 200 bps
- Move away from money printing to fund Budget deficit and fund mainly through commercial banks at market-determined rates
- Removal of the lending rate cap
- Floating the currency and Gradual removal of restrictions on imports

How will these policy measures translate into the Macro Variables?

Interest Rate (364 days T-bills)	10.6% - 11.0%
Exchange Rate	6% - 8% depreciation of the taka against the USD
Inflation Rate	8.2% - 8.5%

Scenario 2: Progressive policy stance prioritizing growth over caution

If the central bank aims for a progressive approach prioritizing growth here is a summary of the policy actions and the outlook under the second scenario "Progressive Response".

Progressive Response

In the "Progressive Response" scenario, prioritizing policies that do not significantly impede growth will be favored over caution. As a result, the increase in the policy rate might be less than the required level. Additionally, devolvement from the central bank may persist, limiting the extent of the interest rate increase, which would lead to higher inflation and a larger depreciation of the currency.

CAL's View:

Policy actions under the "Progressive Response" scenario:

- Increase in the policy rate by 25 to 50 bps
- Continue to fund Budget deficit through debt monetization
- Stricter restrictions on imports
- Will float the currency but will continue to employ moral suasion to influence exchange rates

How will these policy measures translate into the Macro Variables?

Interest Rate (364 days T-bills)	8.3% - 8.6%
Exchange Rate	14%-16% depreciation of the taka against the USD
Inflation Rate	10.5% - 11.0%

How our outlook for Q1'2023 and the actual numbers compare?

Macro Indicator	Actual (Jan'23)	Forecast	Actual (Mar'23)	Comment
Inflation Rate	8.71%	9.0%	9.33%	Actual inflation was in line with our expectations.
Policy Rate	6%	6.25%	6%	The central bank maintained an accommodative stance during the period with a debt monetization of BDT 63 Bn
Exchange Rate	104.0	114.6	106.7	From January to March 2023, BB intervened in the forex market with a sale of USD 3.12 Bn limiting the currency depreciation at a cost of reserve depletion.

Source: Bangladesh Bank, BBS, CAL Research

CAL BANGLADESH

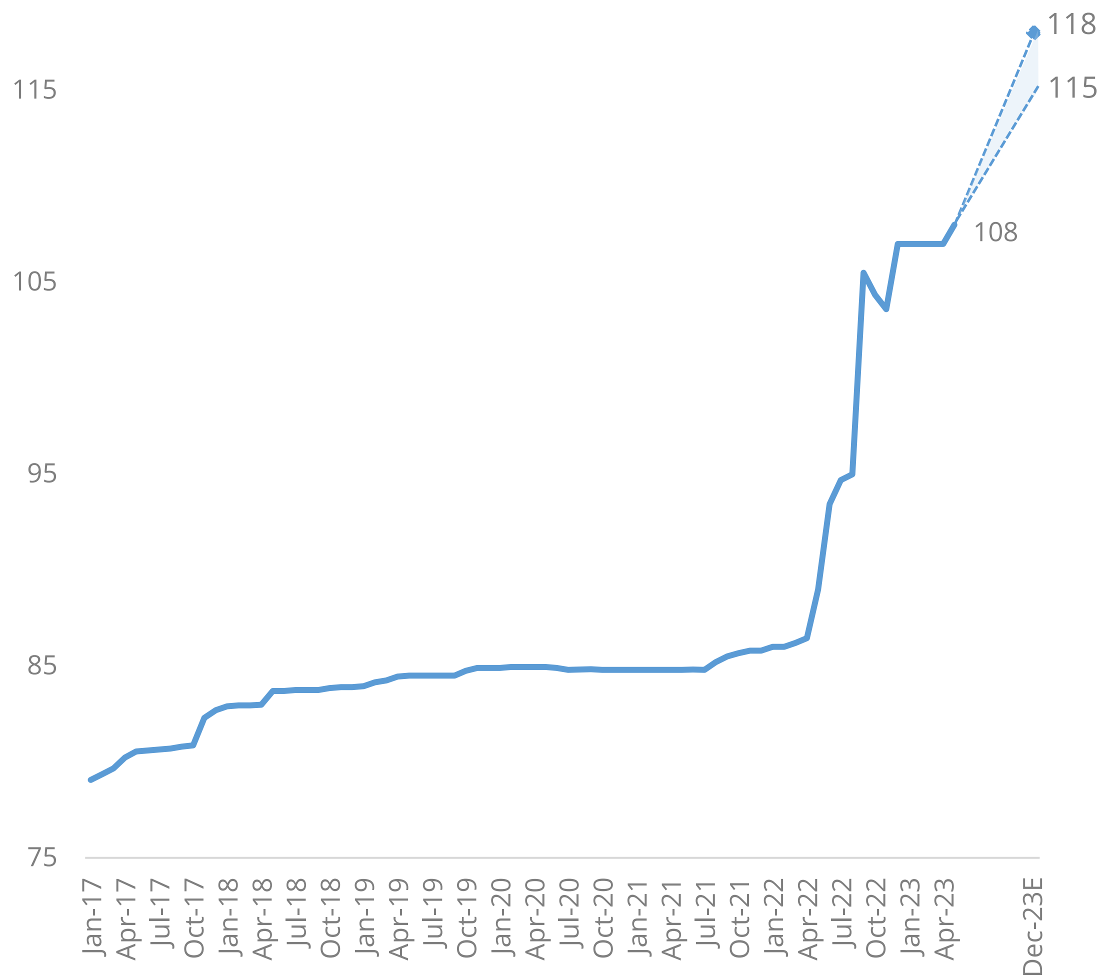
Stemming the Tide

Scenario 1: Aggressive Response

Under the Aggressive Response, the policy measures will be aimed at tackling inflation and currency depreciation through tighter monetary policies. This involves increasing the policy rate, reducing reliance on debt monetization, eliminating lending rate caps, and allowing the currency to float. Based on the policy measures, CAL expects interest rates for 364-day T-bills to be around 10.6% to 11%, c.7% depreciation of the taka against the dollar, and sustained elevated inflation of approximately 8.2% to 8.5%.

CAL expects BDT to depreciate by 6%-8% by the end of 2023E, but any immediate shocks resulting from adopting a market-determined exchange rate are likely to be minimized.

Exchange Rate (BDT/USD)



What factors will influence the exchange rate?

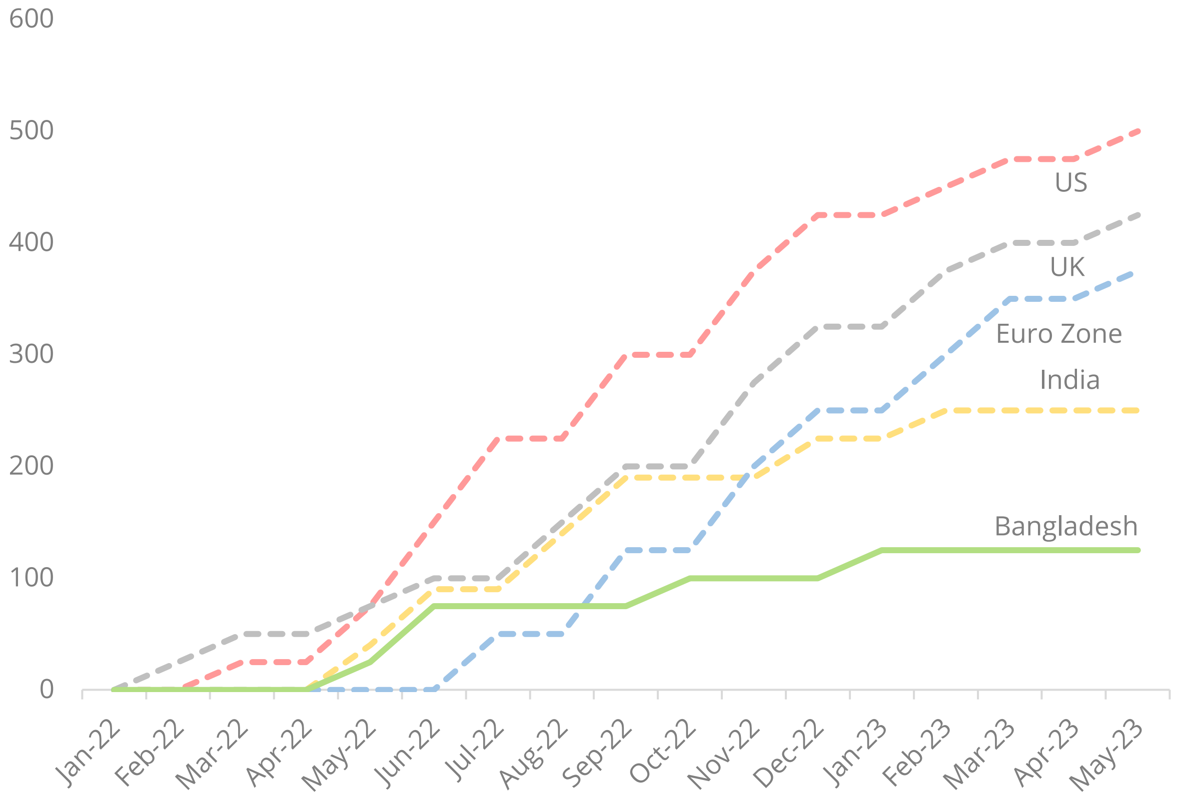
Depreciation Drivers	Easing Factors
BOP Pressure	Global Monetary Easing
Interest Rate Differentials	Commodity Cooling
Reduced Forex Intervention	
Dollar Shortage	

Relief is in sight for BDT from the expected easing of external depreciation pressure with major central banks nearing the end of their tightening cycle or slowing the pace of tightening...

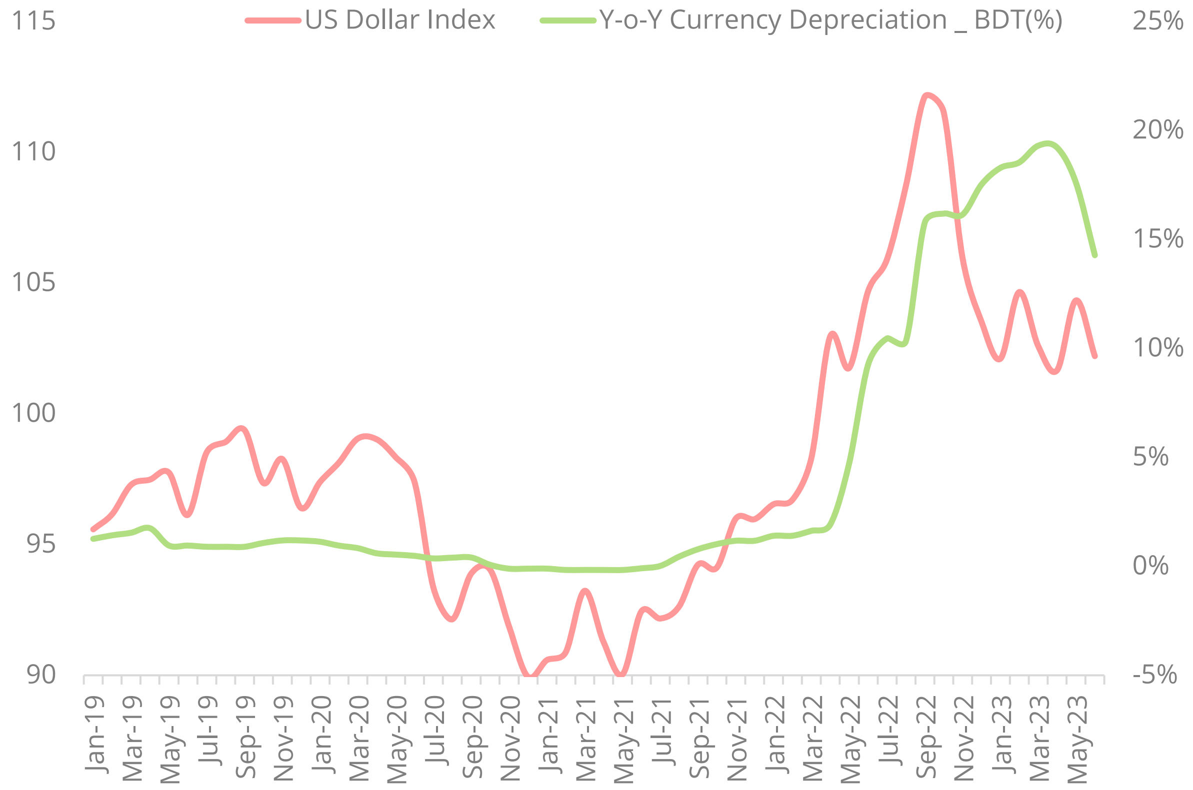
The European Central Bank (ECB) has reduced the speed at which it was raising interest rates while the US is also nearing the end of significant rate hikes aimed at mitigating inflation.

The strengthening of the US dollar followed by the series of steep rate hikes has significantly impacted the performances of the global currencies. From Jan-Sep 2022, the Dollar Index rose by 16.8%, causing a 15.5% depreciation in BDT. As the Fed's tightening cycle nears its end, the likelihood of the Dollar index strengthening reduces, alleviating external pressure on BDT.

Policy Rate Hikes by Central Banks (bps)



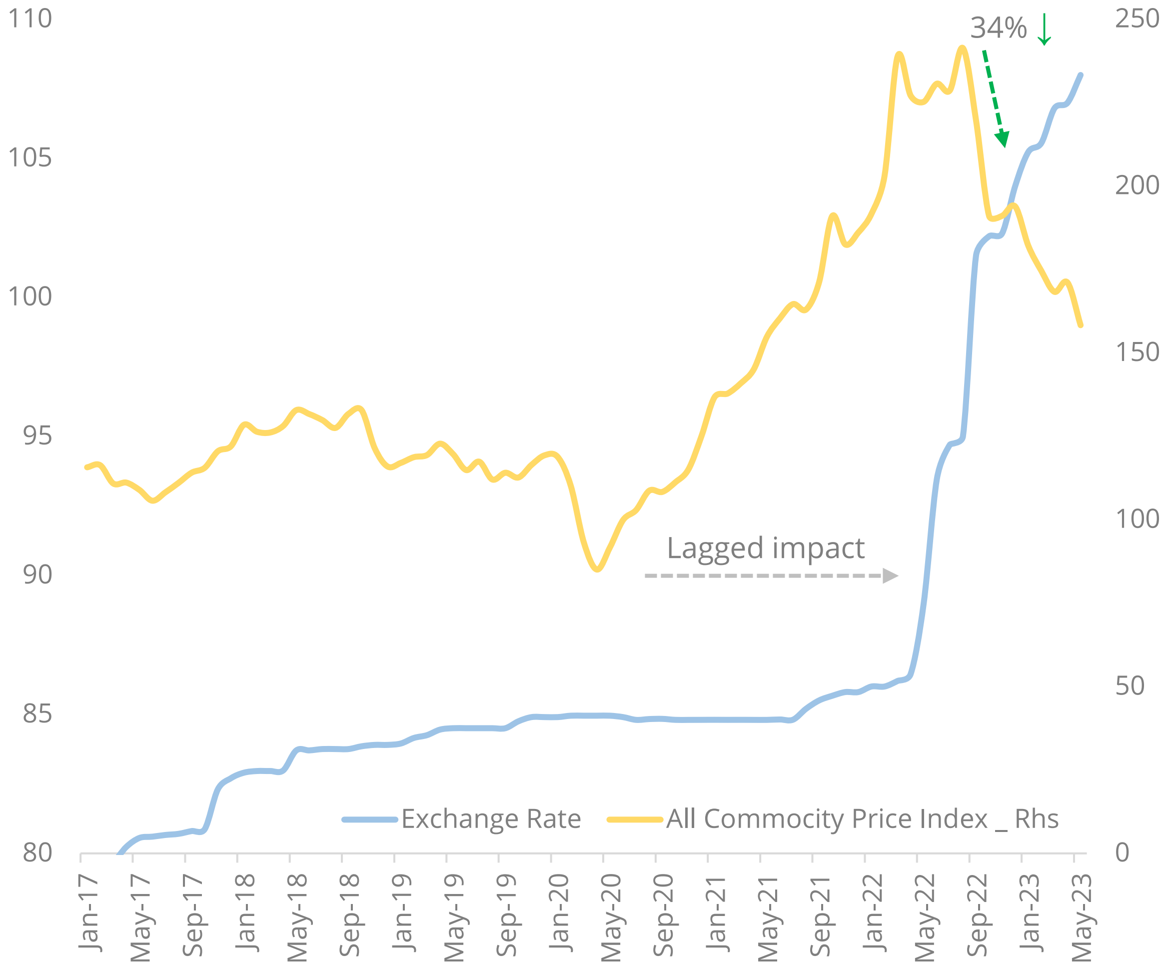
US Dollar Index and Currency Depreciation



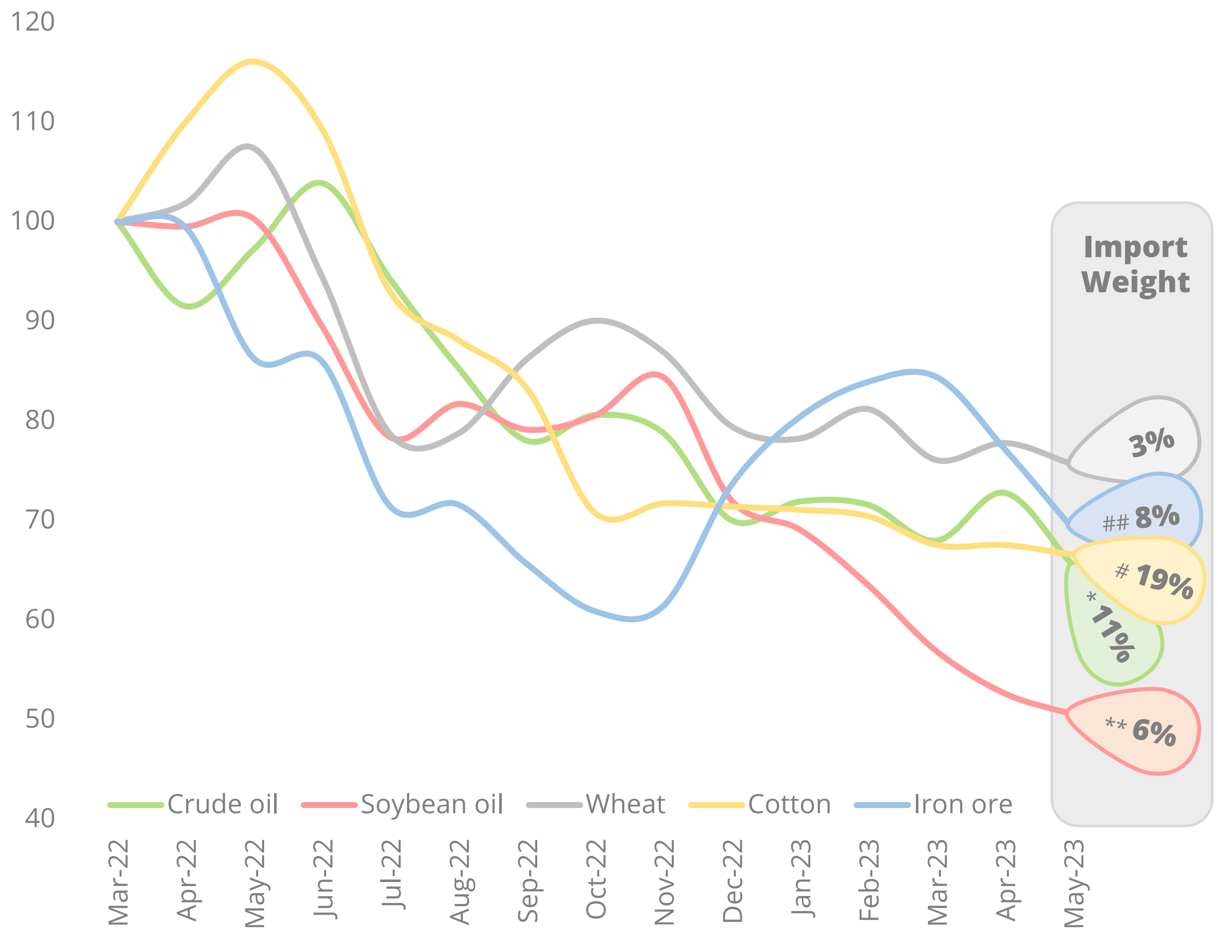
Source: Fed, ECB, BOE, Bangladesh Bank, RBI, investing.com

...while the downward trajectory of the commodity price cycle is anticipated to further alleviate pressures.

Commodity Price Index and Exchange Rate



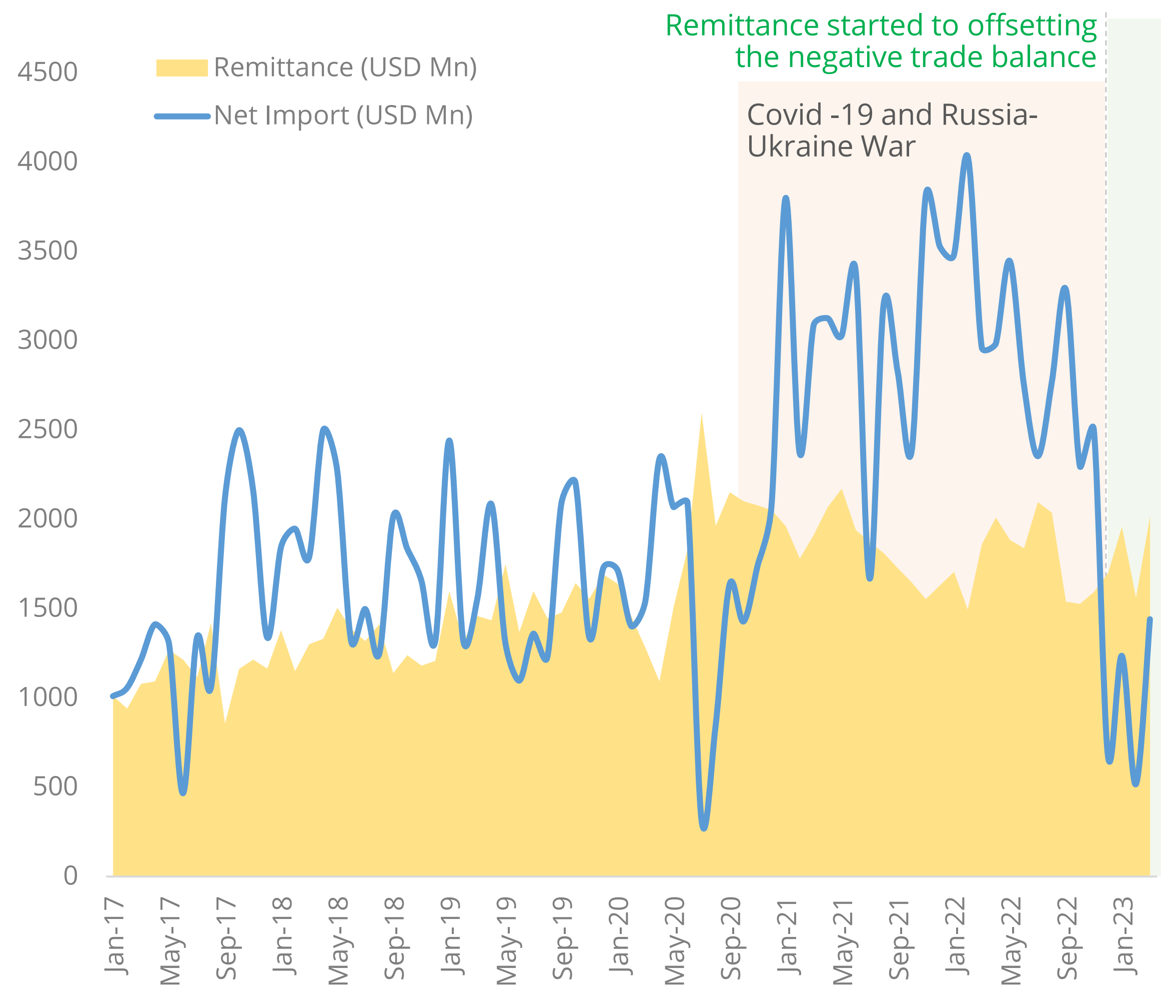
Rebased Price of the Major Import Items of Bangladesh



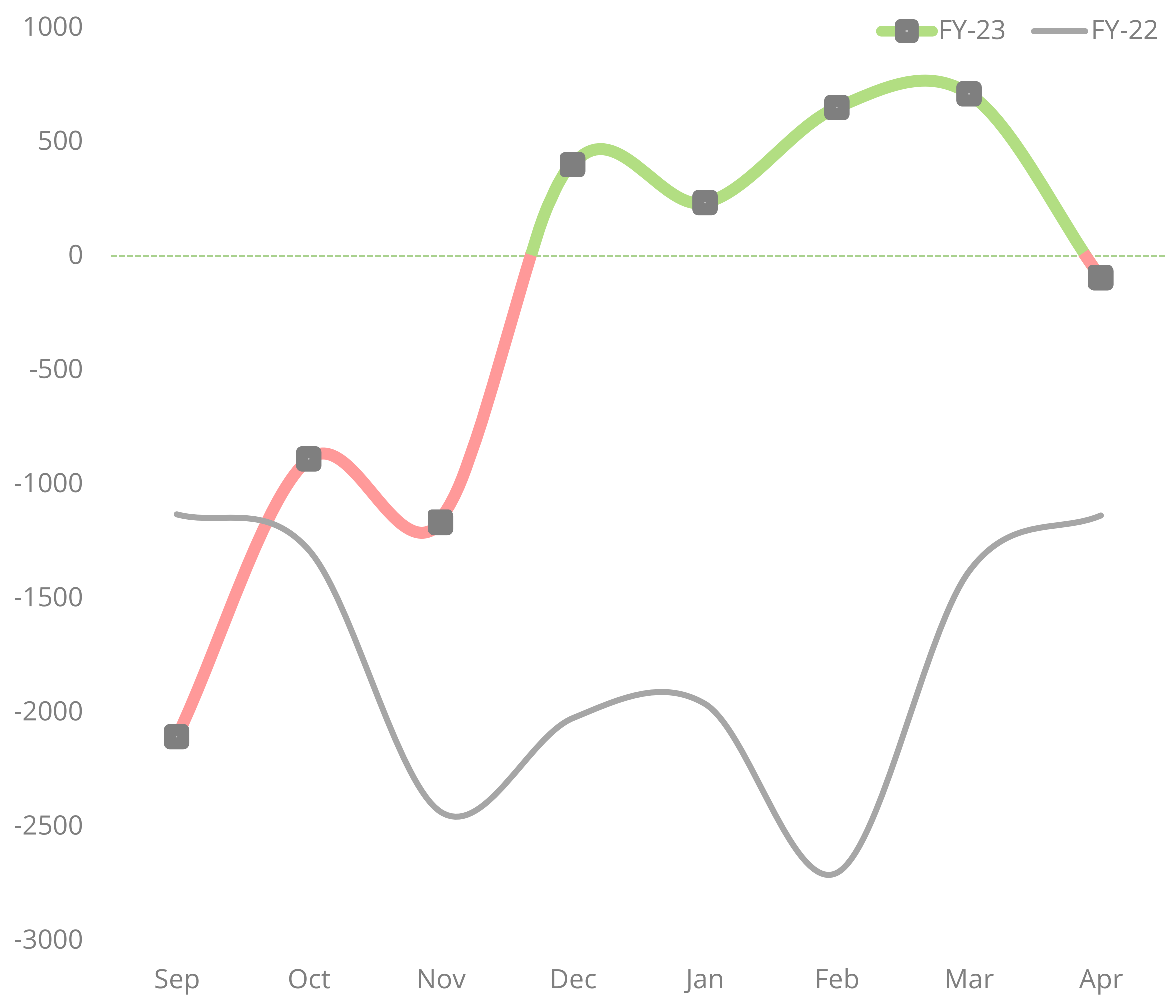
* Crude Petroleum & Petroleum Products ** Oil seeds & edible oil # Cotton, yarn, fiber & textile articles
Iron & Steel

Ease in the external factors has minimized the trade gap, while stable remittances have improved the current account balance.

Trade Gap and Remittance (USD Mn)



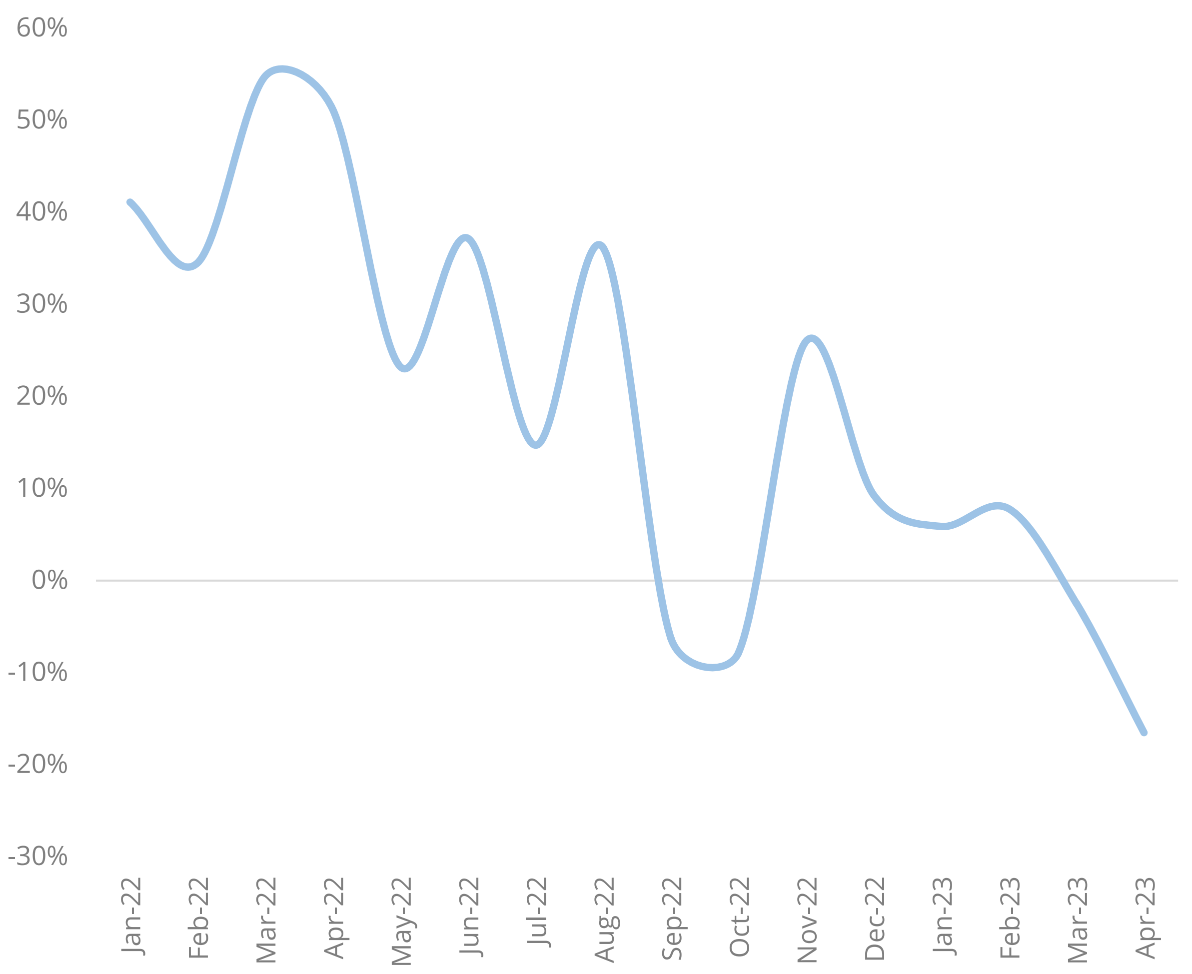
Current Account Balance (USD Mn)



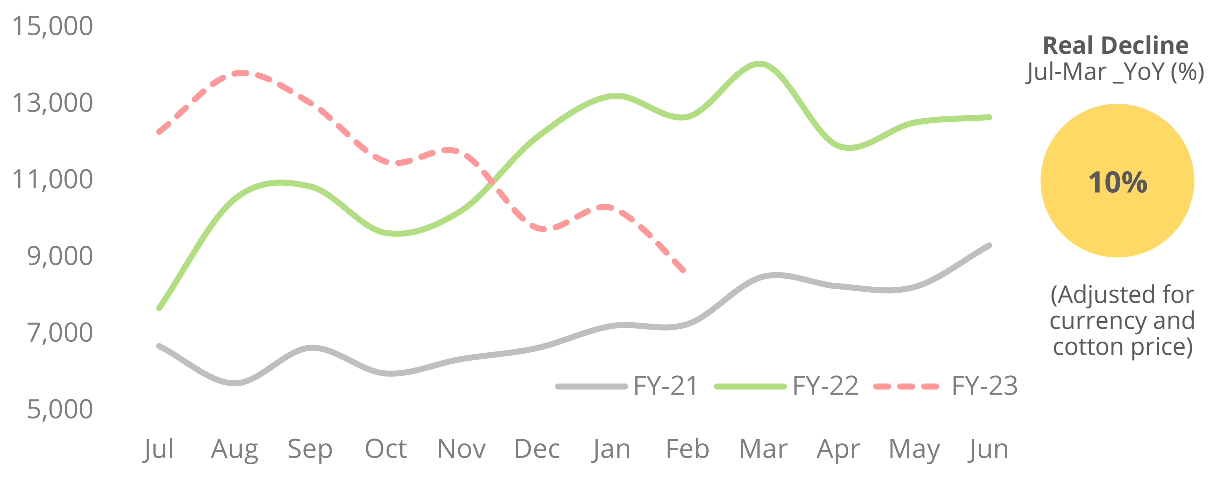
Source: Bangladesh Bank

However, export is expected to slow down as signaled by declining apparel raw material imports owing to depressed consumer sentiment in the major apparel markets.

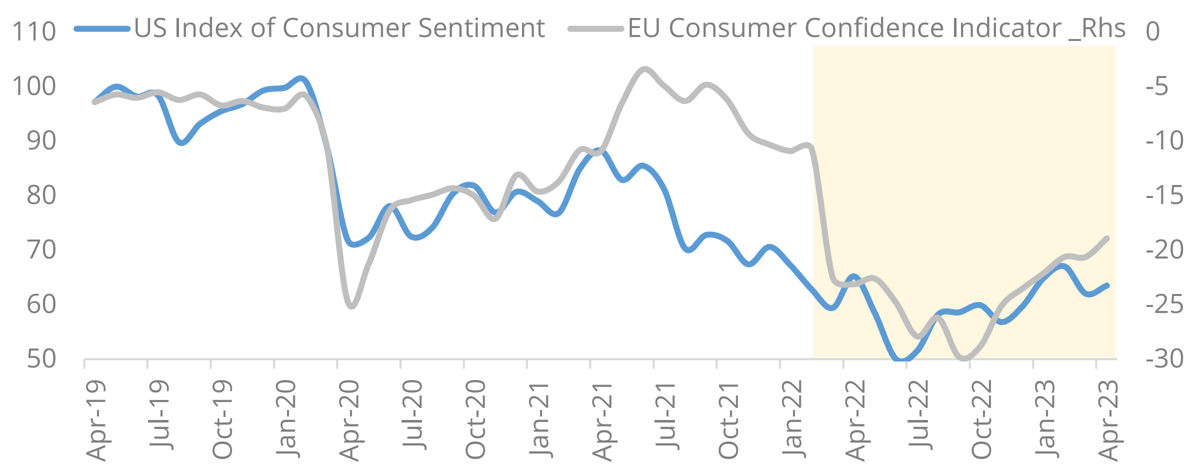
Export Growth _YoY (%)



Raw Material Import for RMG (BDT Cr.)



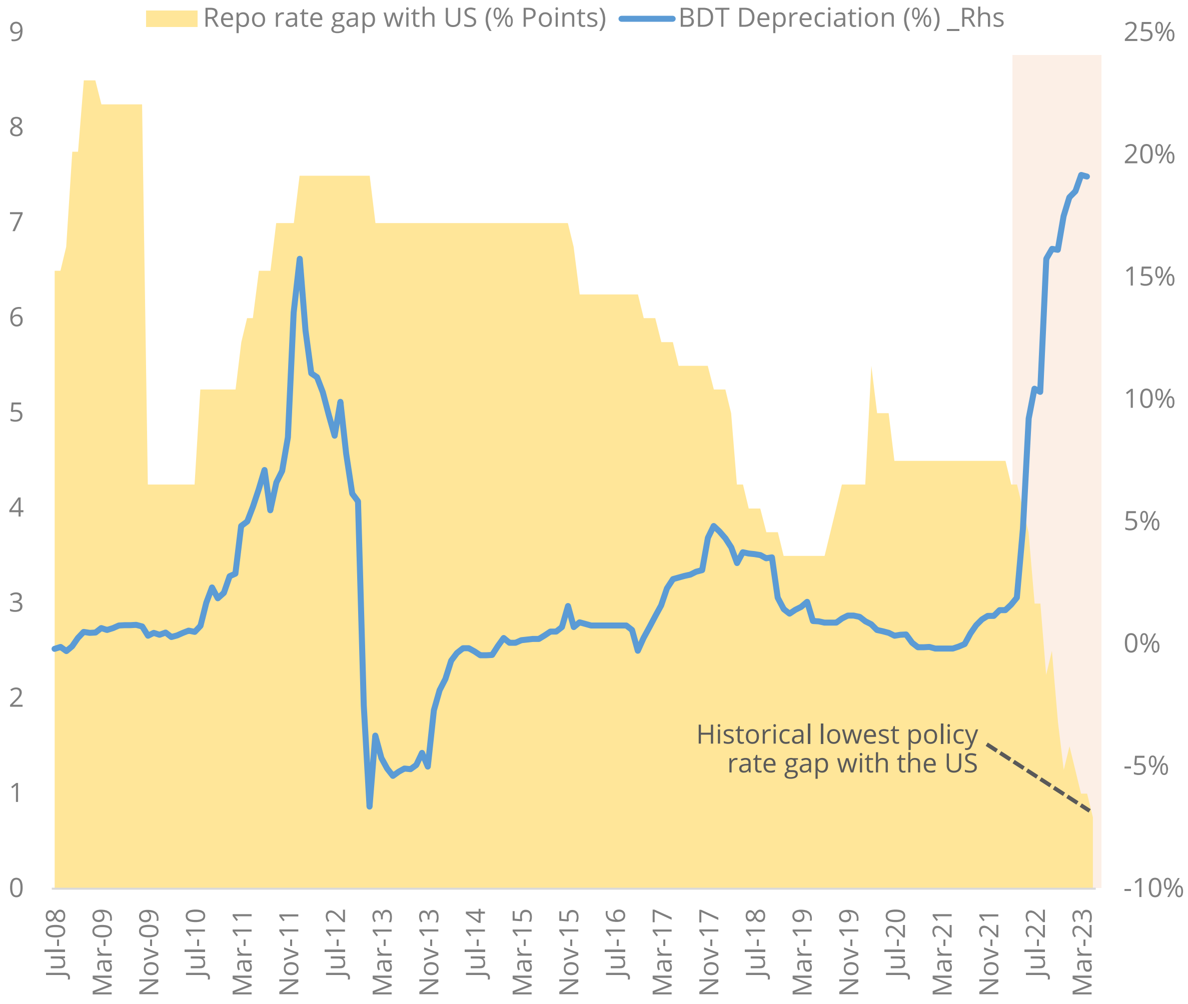
Consumer Confidence in the Major Apparel Markets



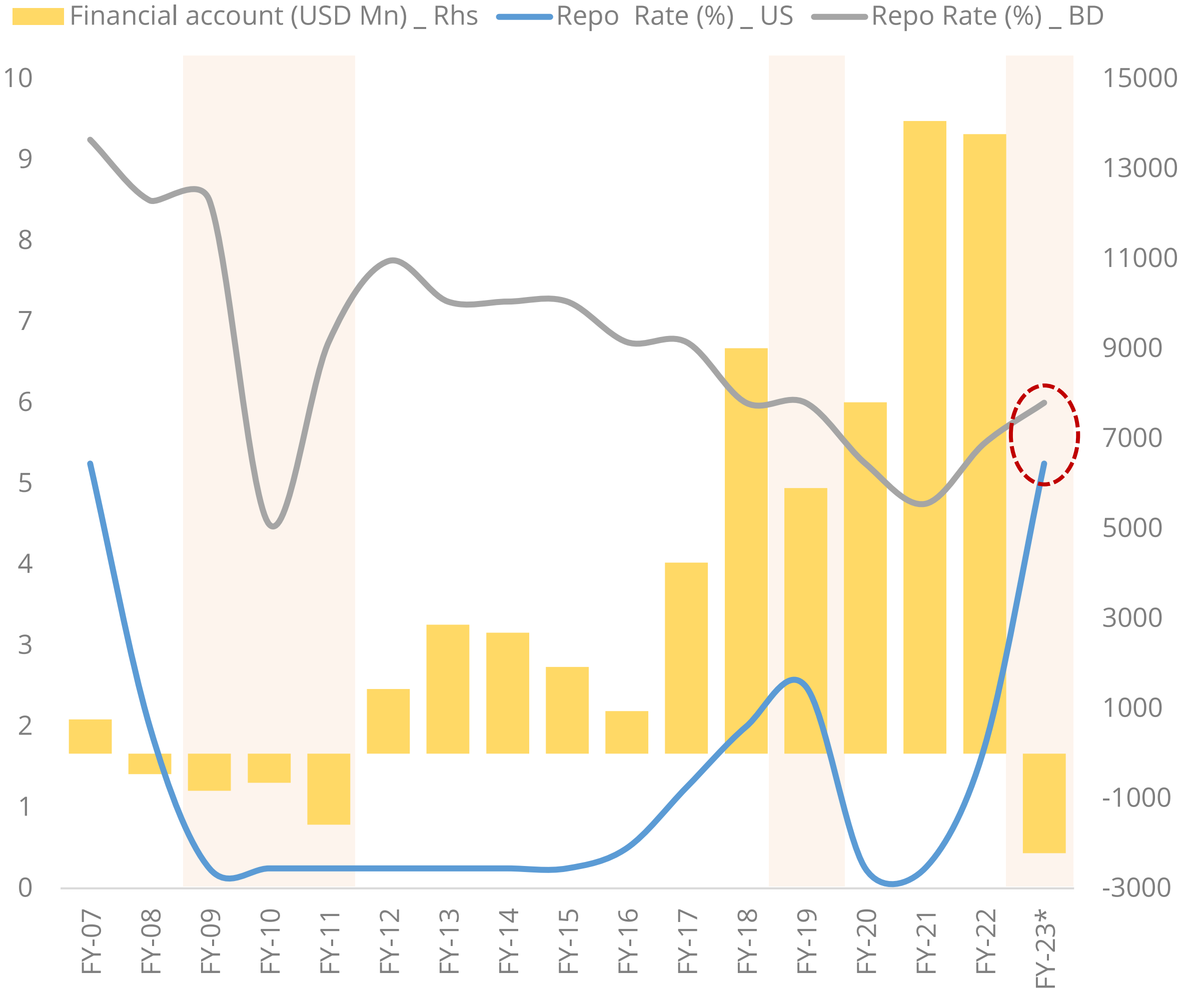
Source: Bangladesh Bank, University of Michigan, European Commission

Lower rate hikes in Bangladesh compared to the US have narrowed interest rate differentials, negatively impacted the financial account, and stressed the balance of payments.

Policy Rate Difference and Currency Depreciation

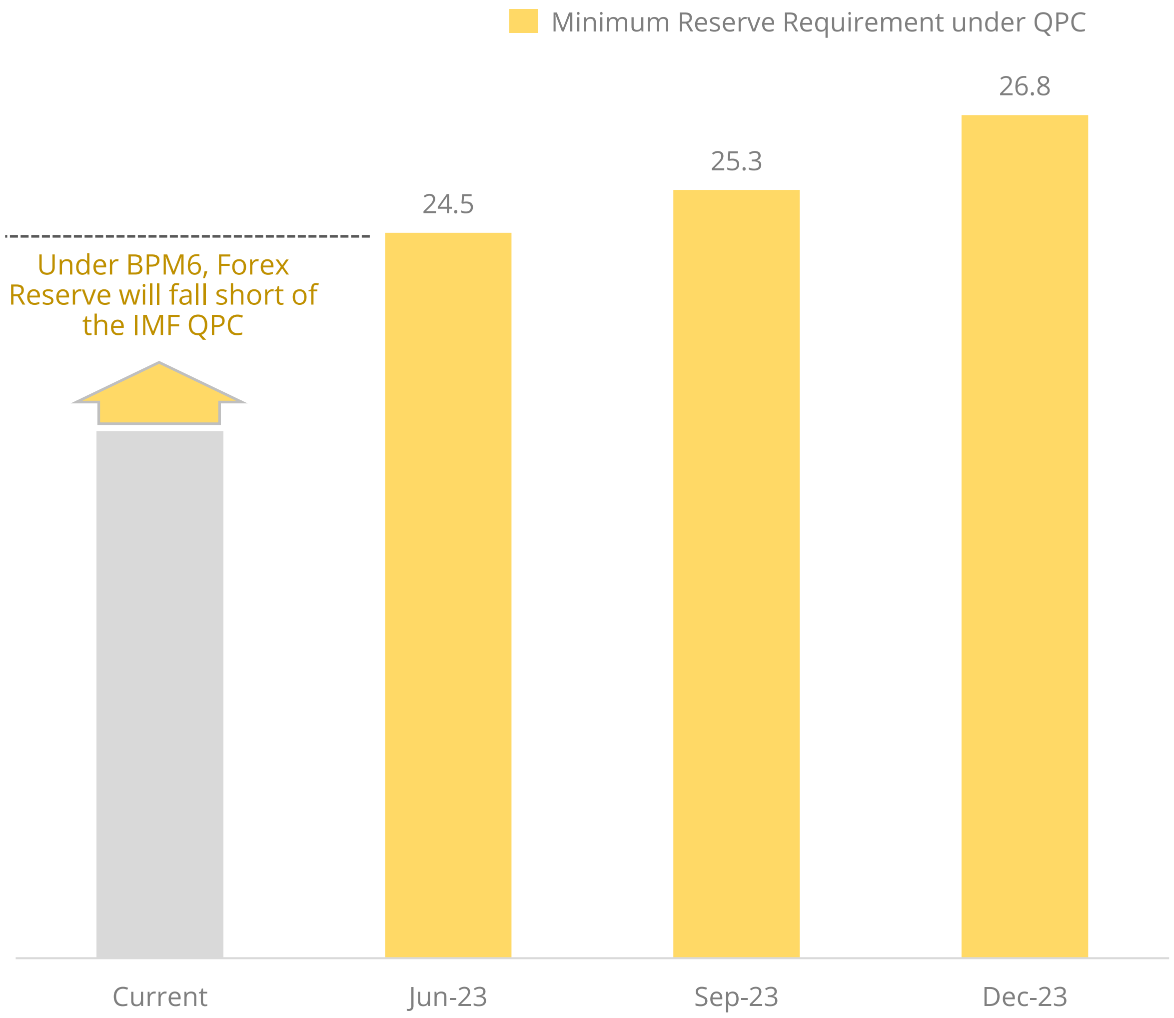


Financial Account (USD Mn)

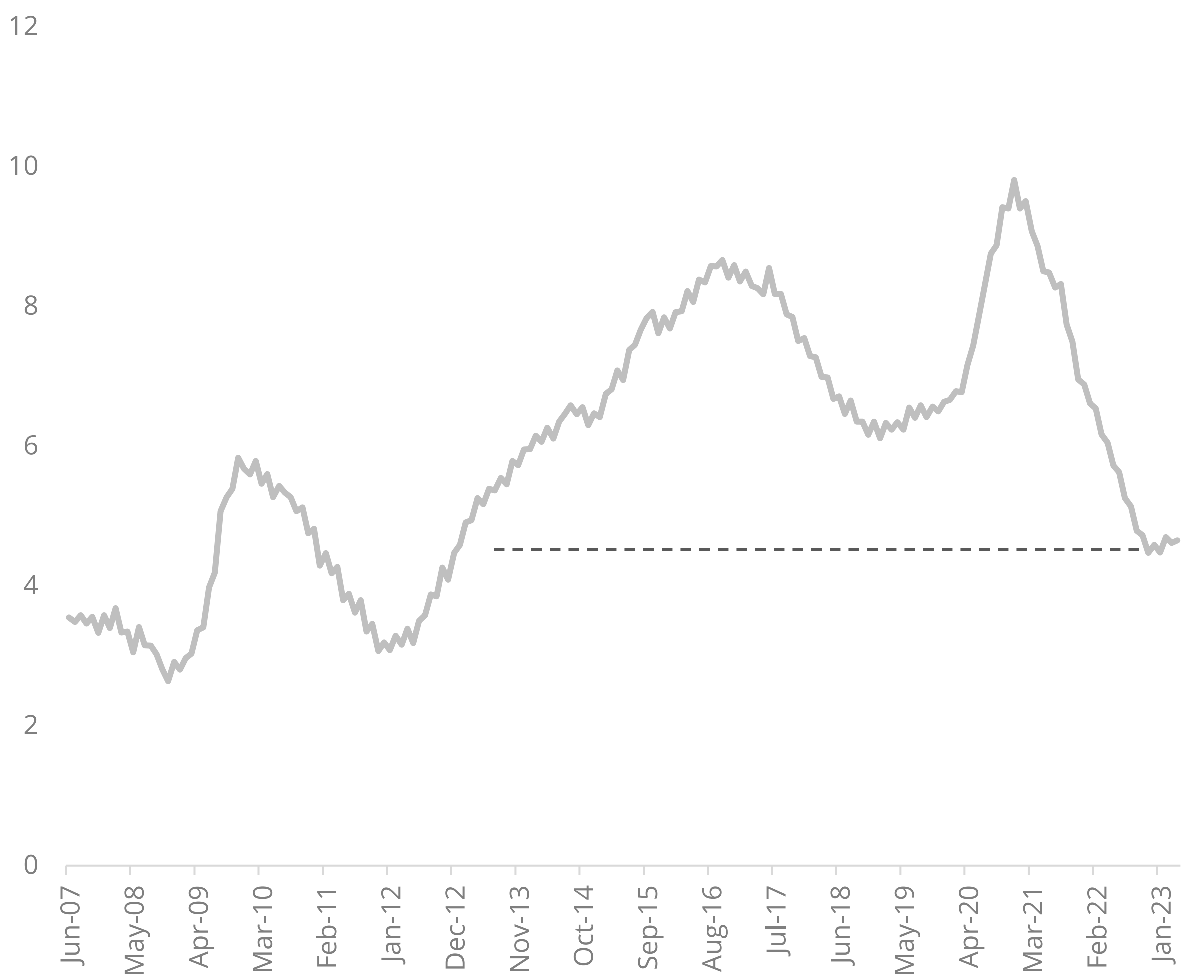


IMF's QPC requirements will limit the central bank's ability to sell USD while the reserve coverage dipping down ten-year low is raising the need for reserve accumulation.

FX Reserve and QPC (Quantitative Performance Criteria) by IMF (USD Bn)



Reserve Coverage (Months of Import)



Source: Bangladesh Bank, IMF

It is evident that at the current exchange rate, there is not a required supply of dollars causing an uptick in deferred payments which has already squeezed the supply of imported items.

Any disruption in production owing to load-shedding and reduced capital machinery imports might deteriorate the domestic supply pushing the import requirements even higher.

S&P Global
Commodity Insights

OIL | SHIPPING — 19 May 2023 | 06:53 UTC

Fuel suppliers threaten to stop shipments to Bangladesh amid payment delays: BPC

HIGHLIGHTS

Bangladesh Petroleum owes around $297.49 million to oil product suppliers

BPC struggling to pay dues in US dollars due to plunging forex reserves

THE BUSINESS STANDARD

ENERGY

Eyamin Sajid
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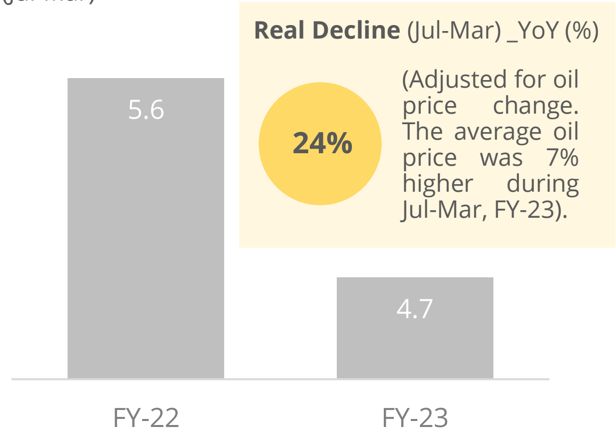
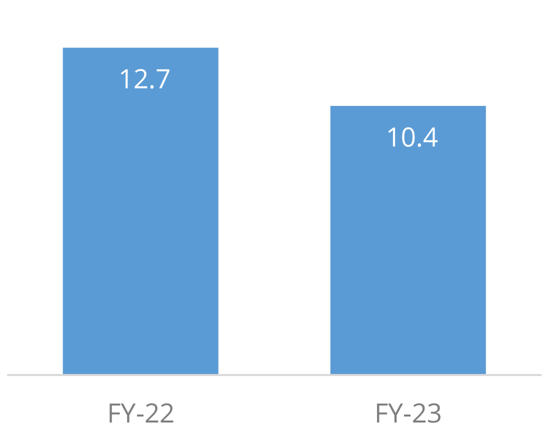
Coal power plants' operation under threat over dollar crisis

After the Rampal power plant halted its operations for coal shortage on 14 January, the Payra power plant is also facing closure owing to the same problem stemming from the crisis of dollars needed to pay coal import bills.

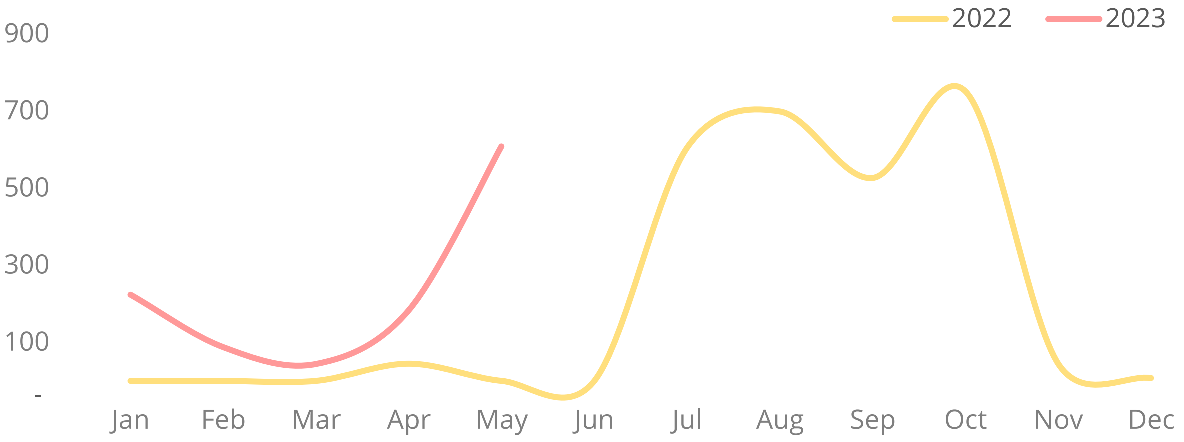
Import of Petroleum Goods (USD Bn)
(Jul-Mar)



Import of Capital Goods (USD Bn)
(Jul-Mar)

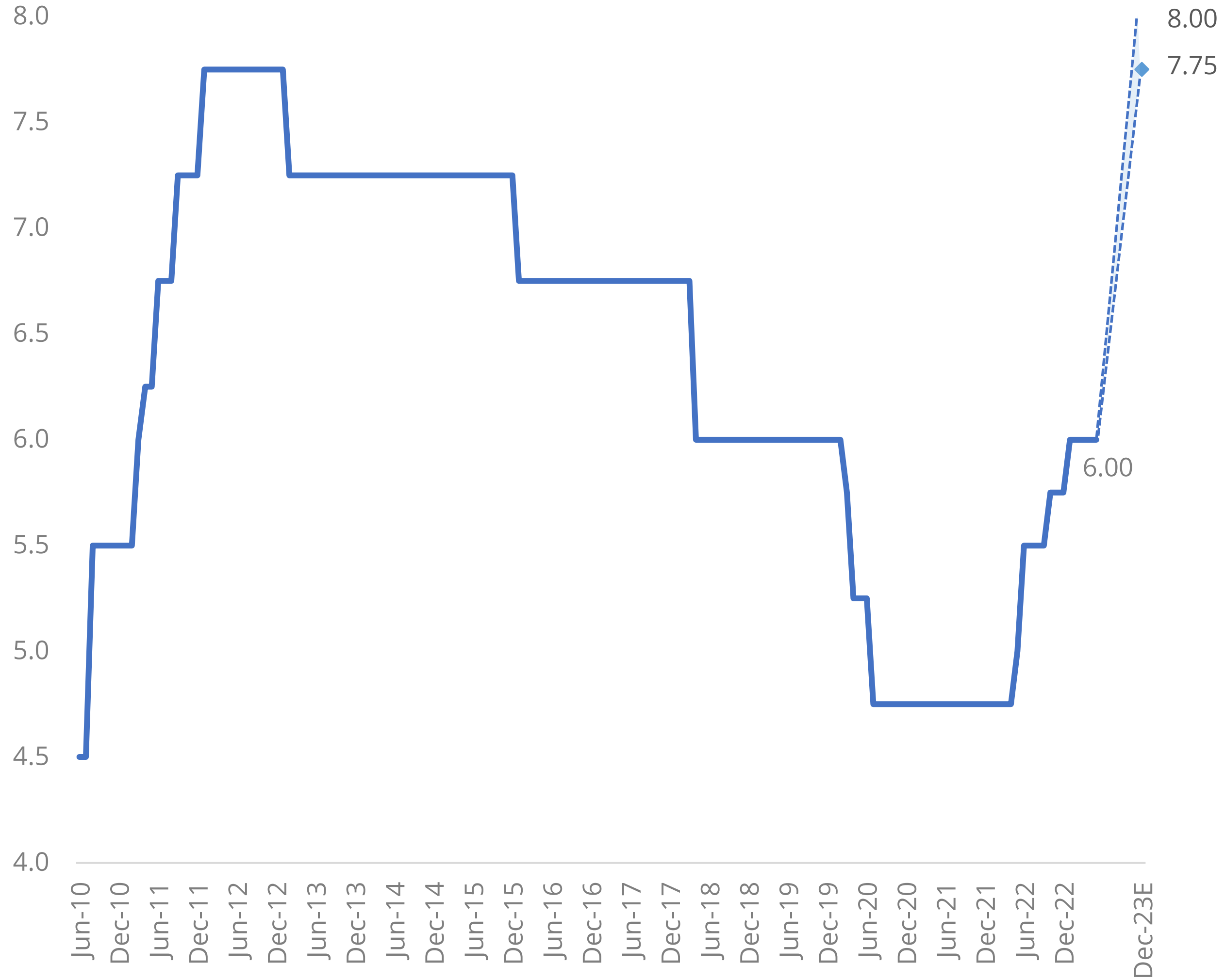


Daily Average Loadshedding (MW)



CAL expects the policy rate to increase by 175-200 basis points by the end of 2023E to address inflationary pressure.

Policy Rate (%)



What factors will influence interest rate?

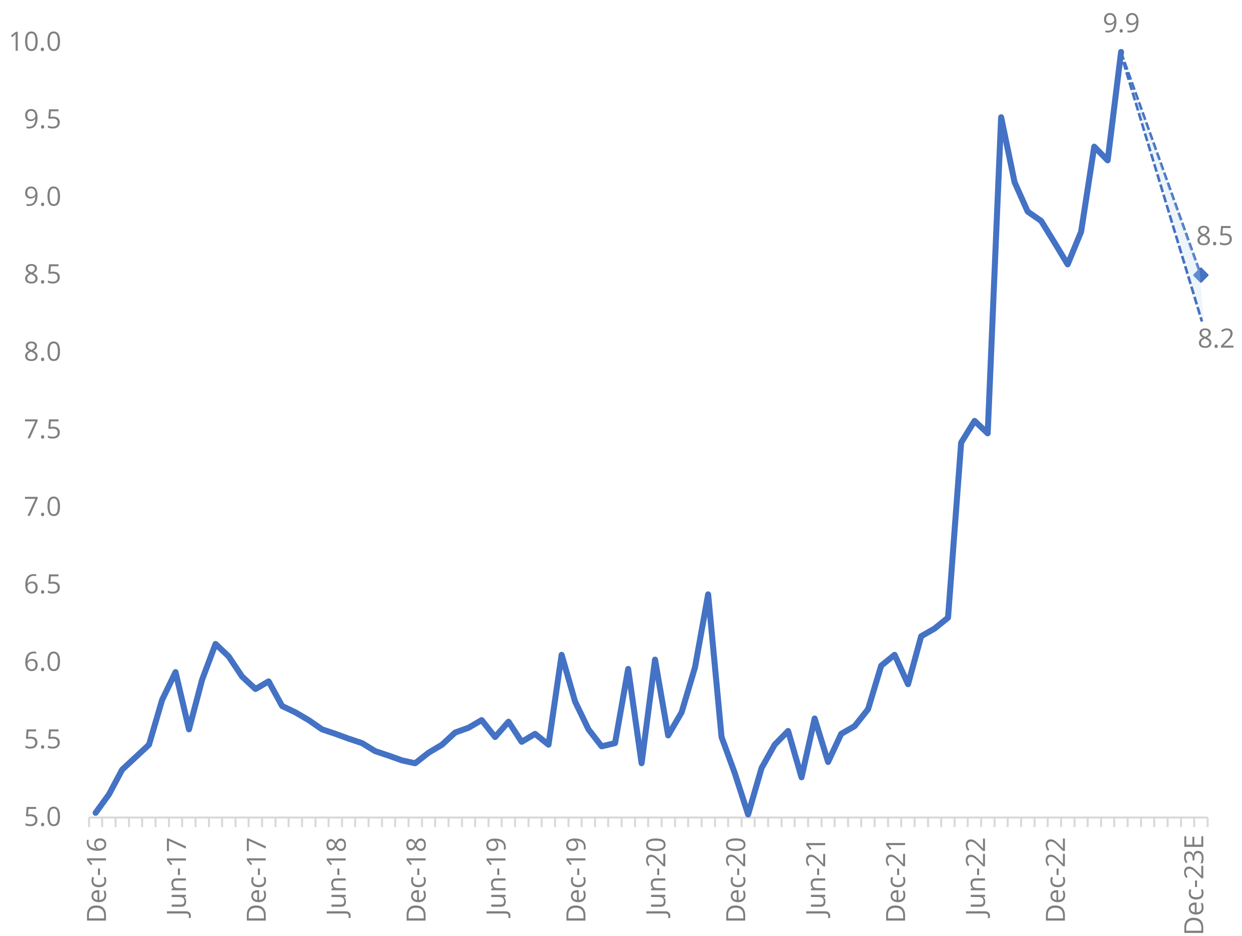
- **Inflation**
- **Currency Stability**
- **Lagged Transmission**

Source: Bangladesh Bank, CAL Research Estimates

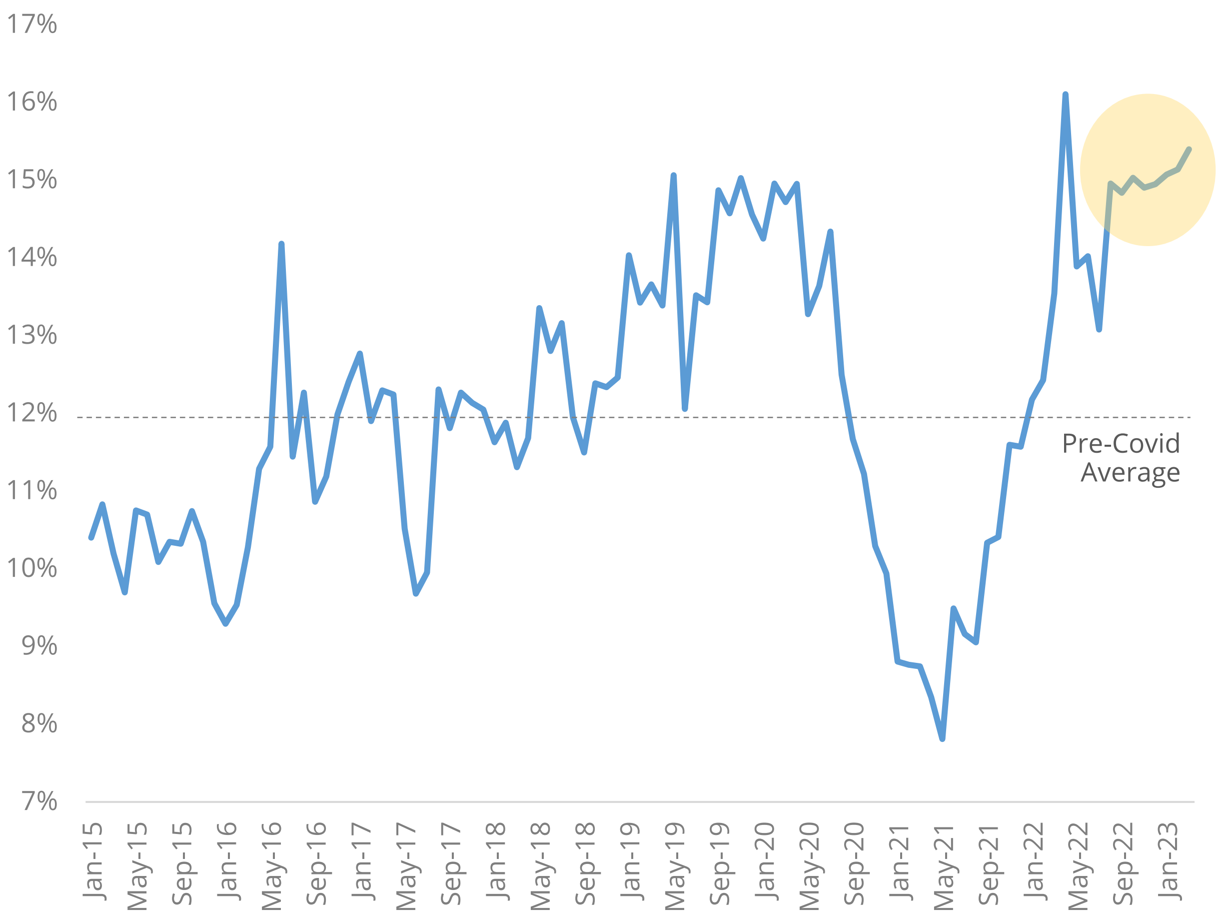
CAL expects inflation to stay elevated at around 8.5% by the end of 2023E.

The tightening of the policy stance is likely to lead to a decline in inflation from its current levels. However, the current accommodative monetary stance, characterized by a 15.4% growth in domestic assets, indicates that the injection of new money into the economy will likely keep inflation at elevated levels.

Headline Inflation (%)

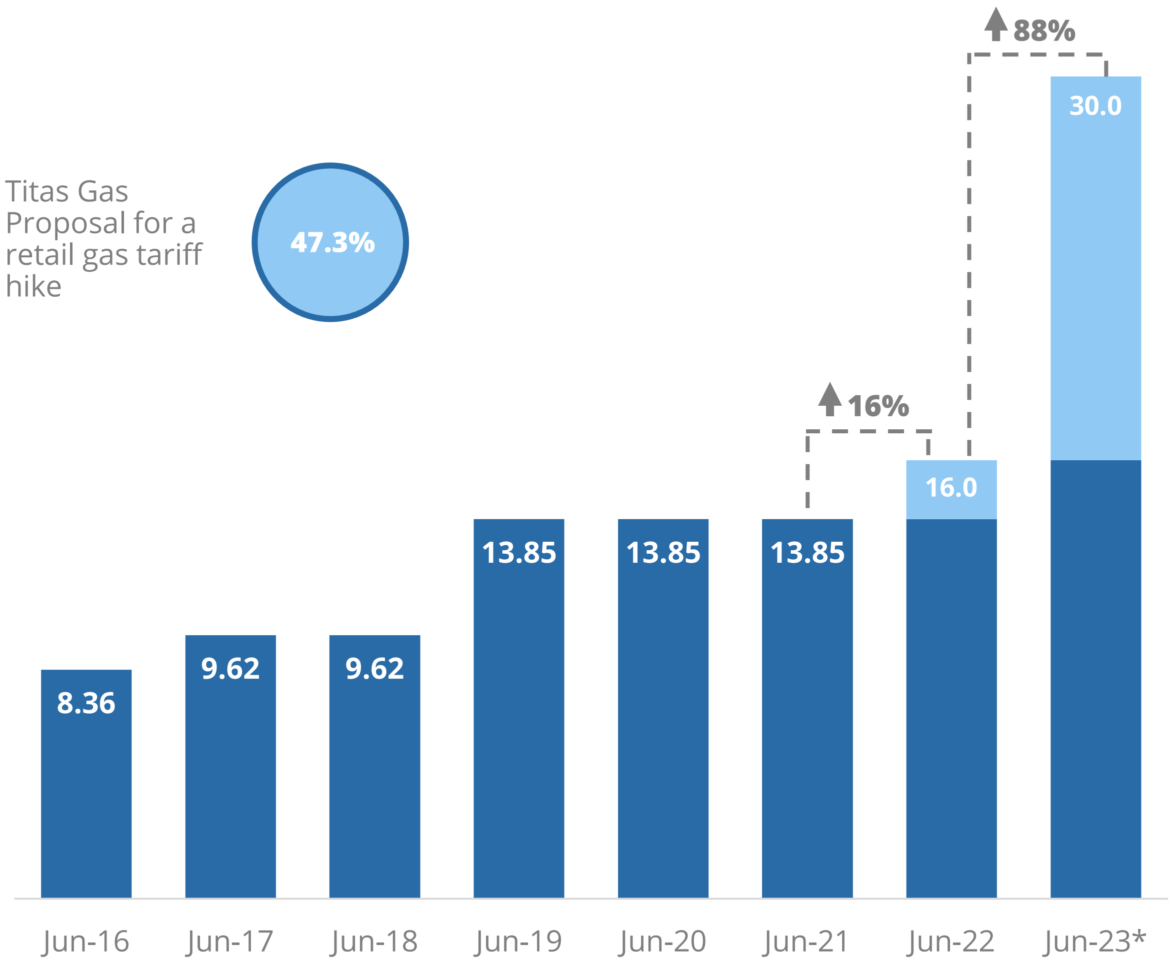


Domestic Asset Growth (%)

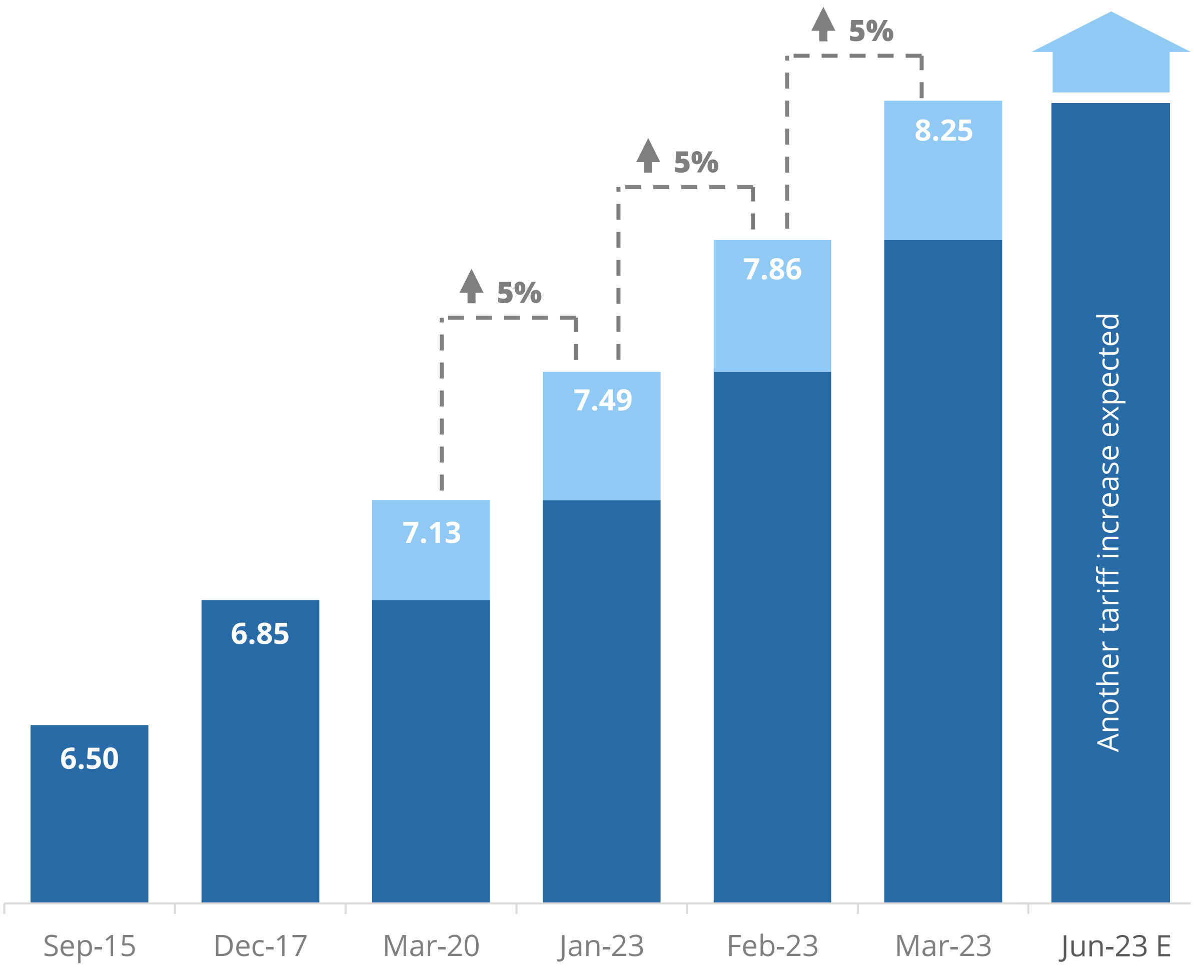


Expected tariff hikes and full transmission of current tariff hikes will keep inflation elevated.

Gas Tariffs for Captive Power (BDT/M3)



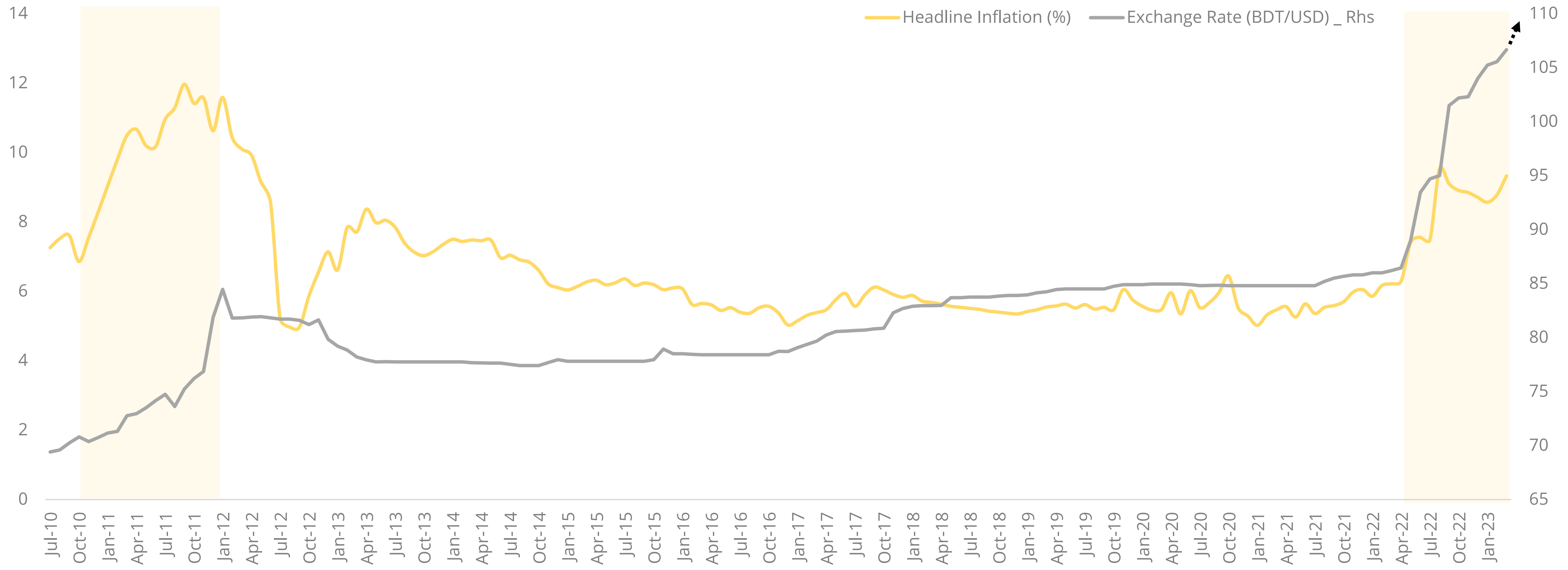
Retail Electricity Tariff (BDT/KWH)



The expected depreciation of the currency is likely to trigger inflationary pressures from imported goods.

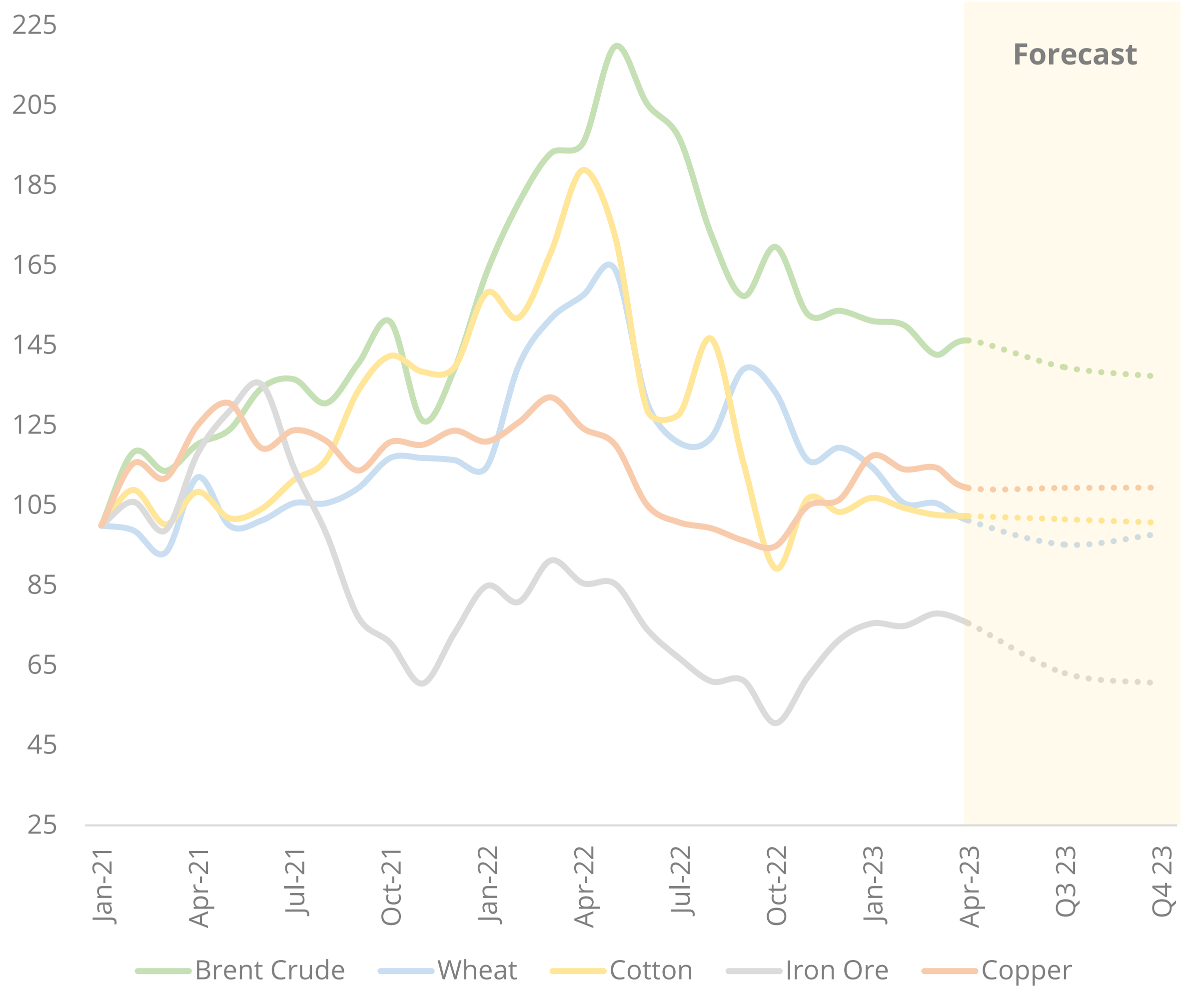
During the 2010-11 period, a significant currency depreciation contributed to inflationary pressures, which were already rising due to increasing commodity prices. Since the beginning of 2022, substantial currency depreciation has already driven inflation to higher levels. Anticipated currency depreciation in 2023E is expected to keep inflation at elevated levels.

Exchange Rate and Inflation

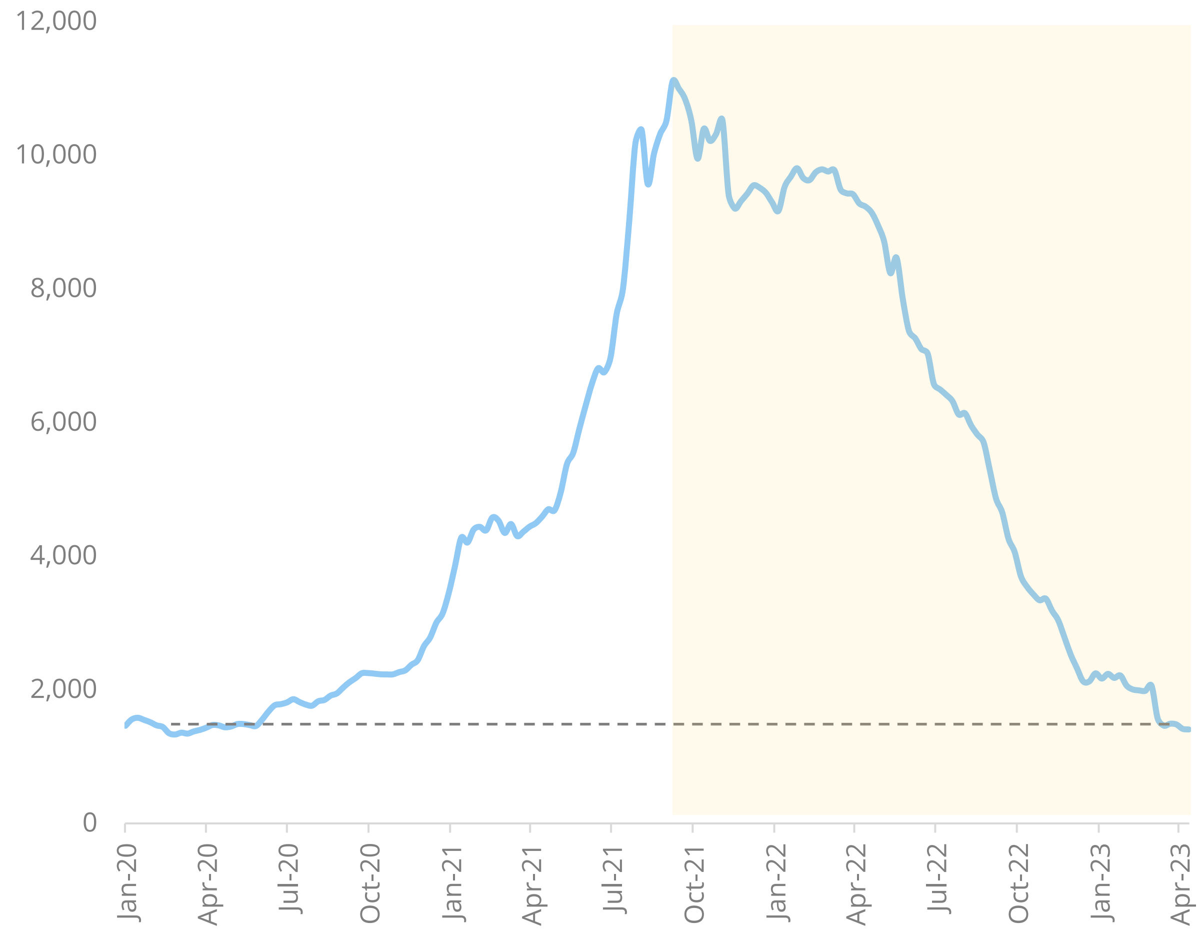


Amidst the challenging domestic factors, the cooling of commodity prices and lower freight costs on the global front will help ease some pressure on inflation.

Rebased Commodity Price (January 2021 = 100)



Freight rate Index (FBX)

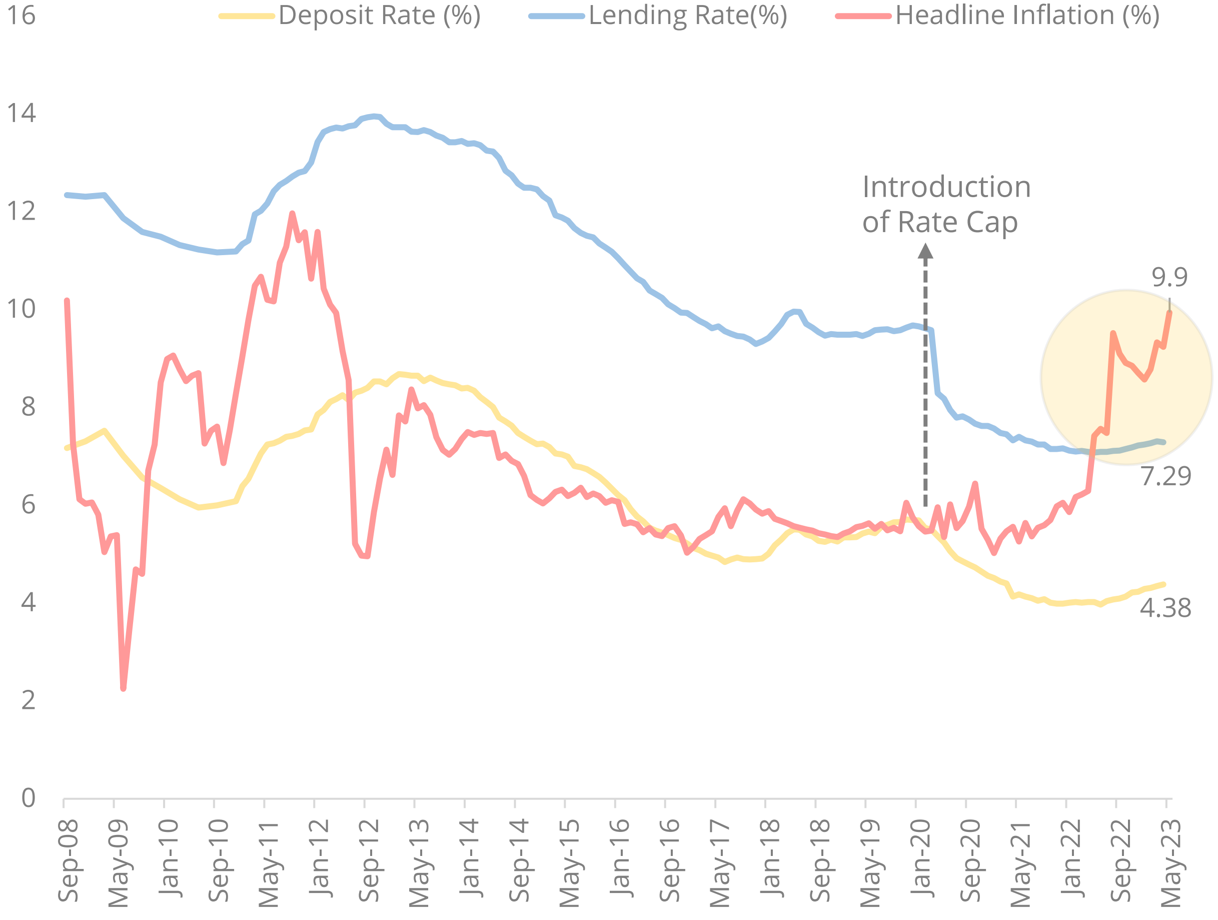


CAL expects the 364-Days T-Bill yield to increase by 270-310 bps by the end of 2023E as the BB adopts interest rate as an operational target to combat inflation, in line with IMF recommendation.

Following the implementation of the lending rate cap, inflation has surpassed the deposit rate, resulting in a negative real return, and it has even surpassed the lending rate, leading to a cheaper borrowing environment. The low borrowing rates have contributed to further inflation. However, CAL expects as monetary policy stances from June 2023 will be guided by inflation, the pace of devolvement from the central bank will slow down allowing effective transmission of the policy rate hikes.

364-Day's T-bill Rate (%)

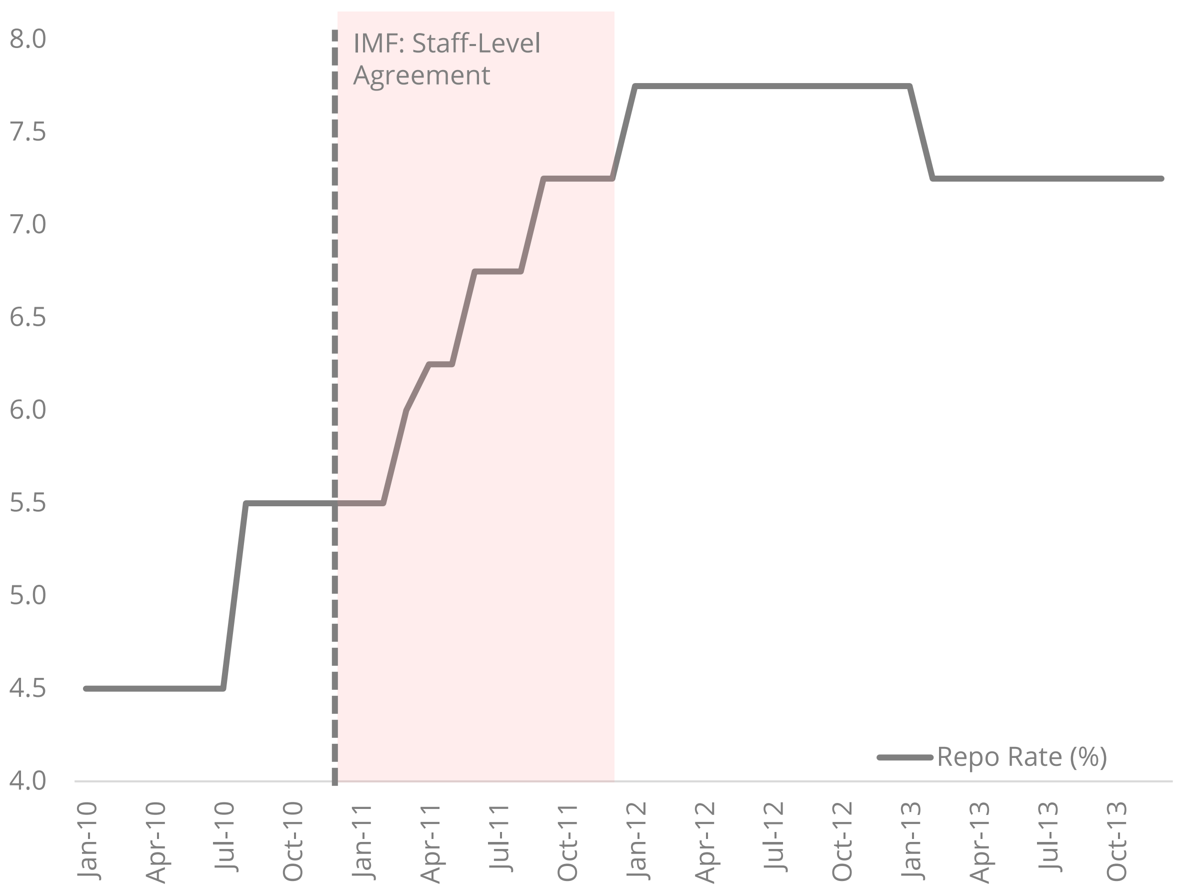
Headline Inflation Vs Interest Rates (%)



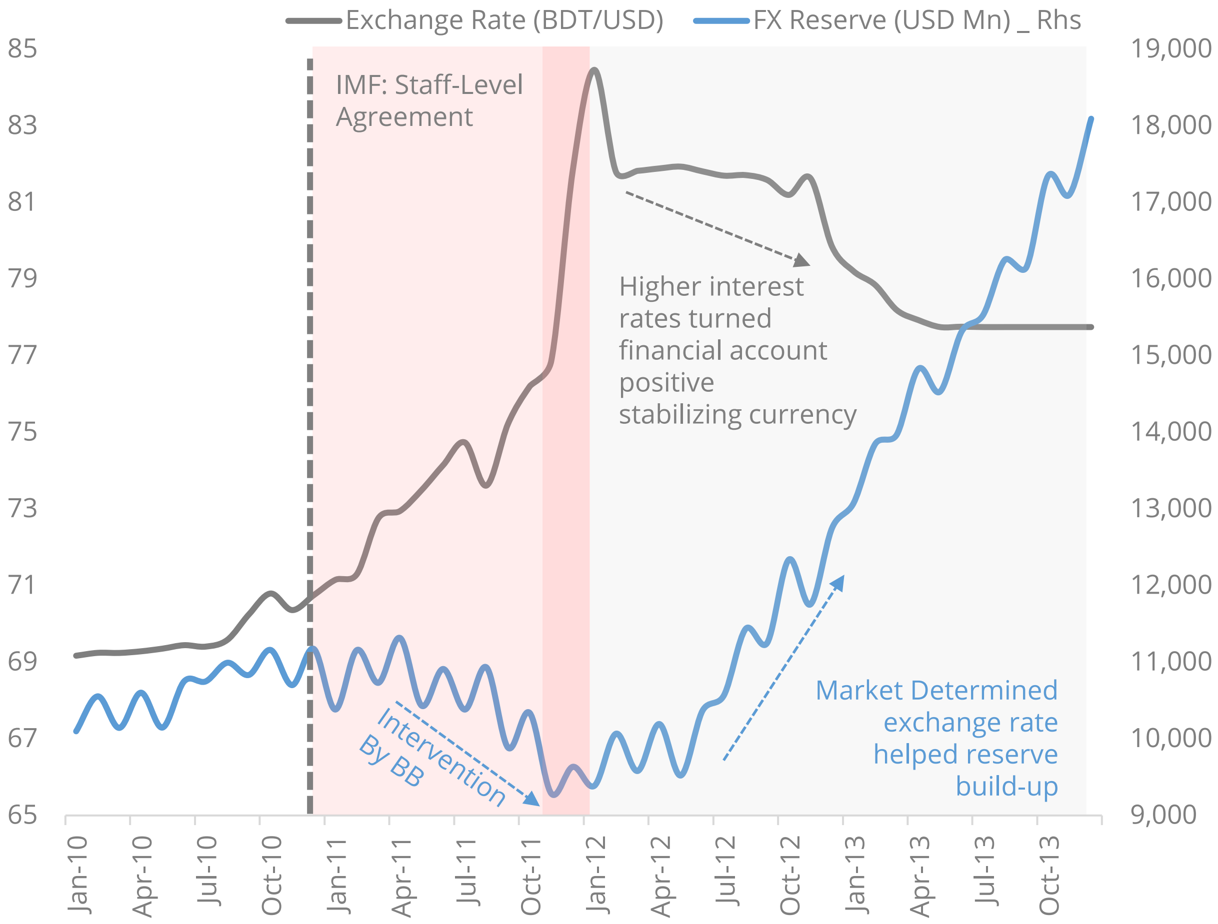
Adaptation of a market-determined exchange rate will necessitate a policy rate hike to stabilize the currency mirroring the approach taken in the previous IMF Program.

In the previous IMF program, the central bank notably raised the policy rate prior to transitioning to a market-determined exchange rate. As a result, in the subsequent market-determined regime, after an initial shock, the exchange rate stabilized and began to appreciate.

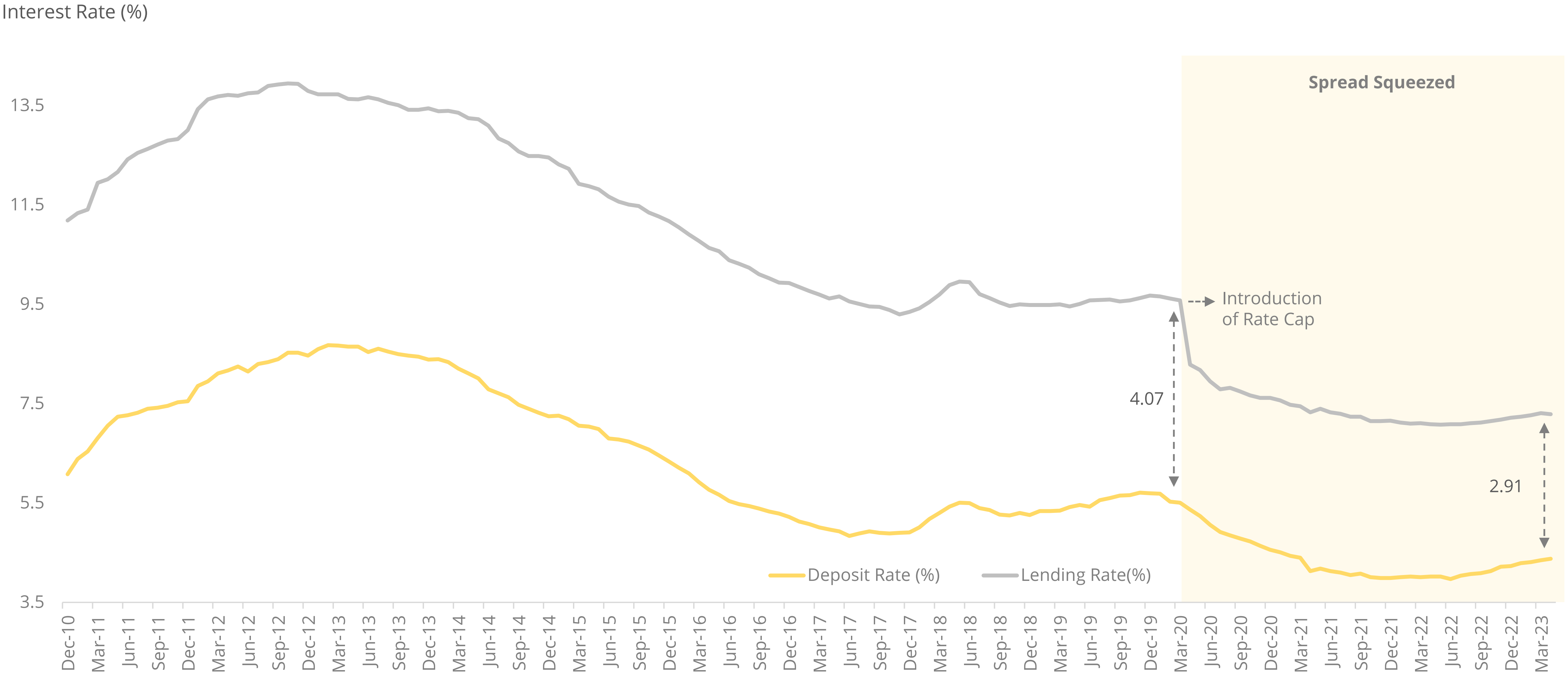
Repo Rate (%)



Exchange Rate and Central Bank Intervention

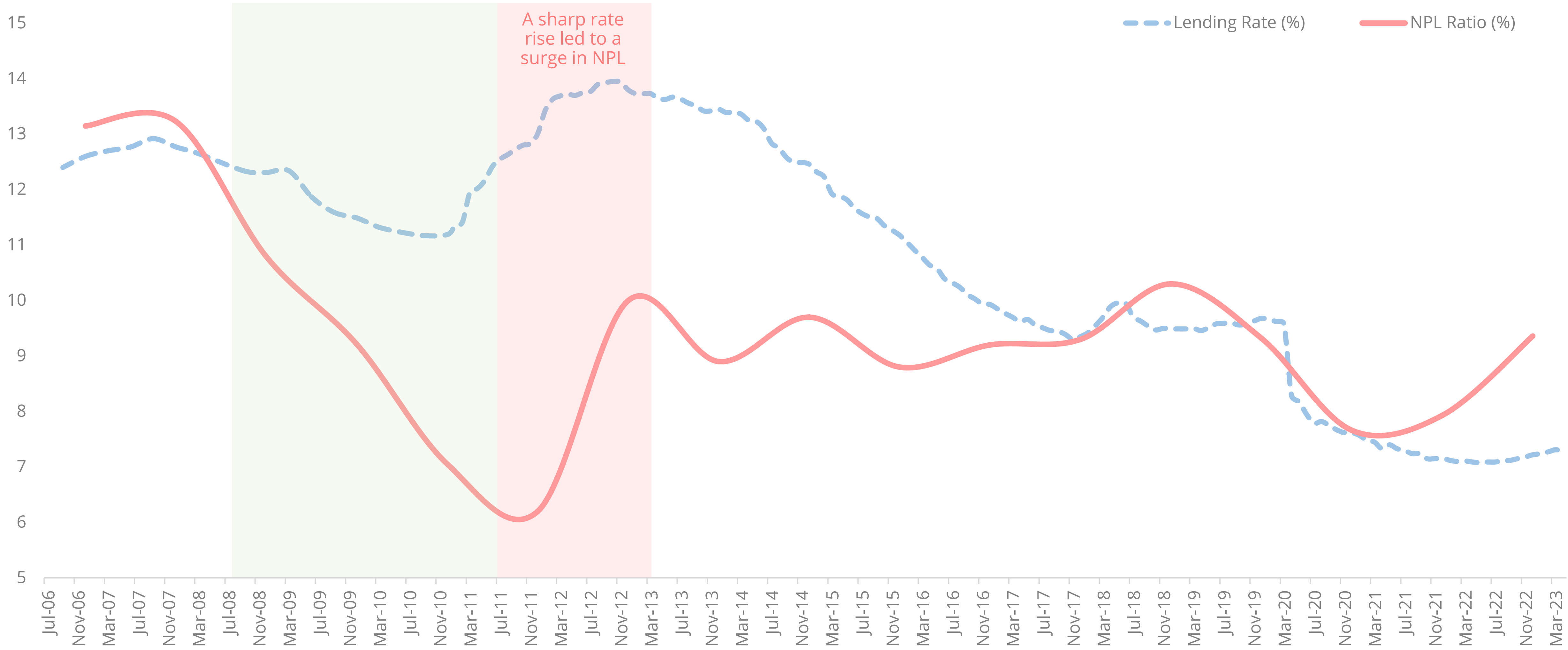


Lending rates will increase to double digits after the adaptation of a benchmark lending rate system owing to the lagged transmission of the mounted policy pressures.



Based on historical precedents, a significant increase in interest rates has the potential to lead to a buildup of non-performing loans (NPLs) in the banking sector.

Interest Rate Vs. NPL (non-performing loan) Ratio (%)



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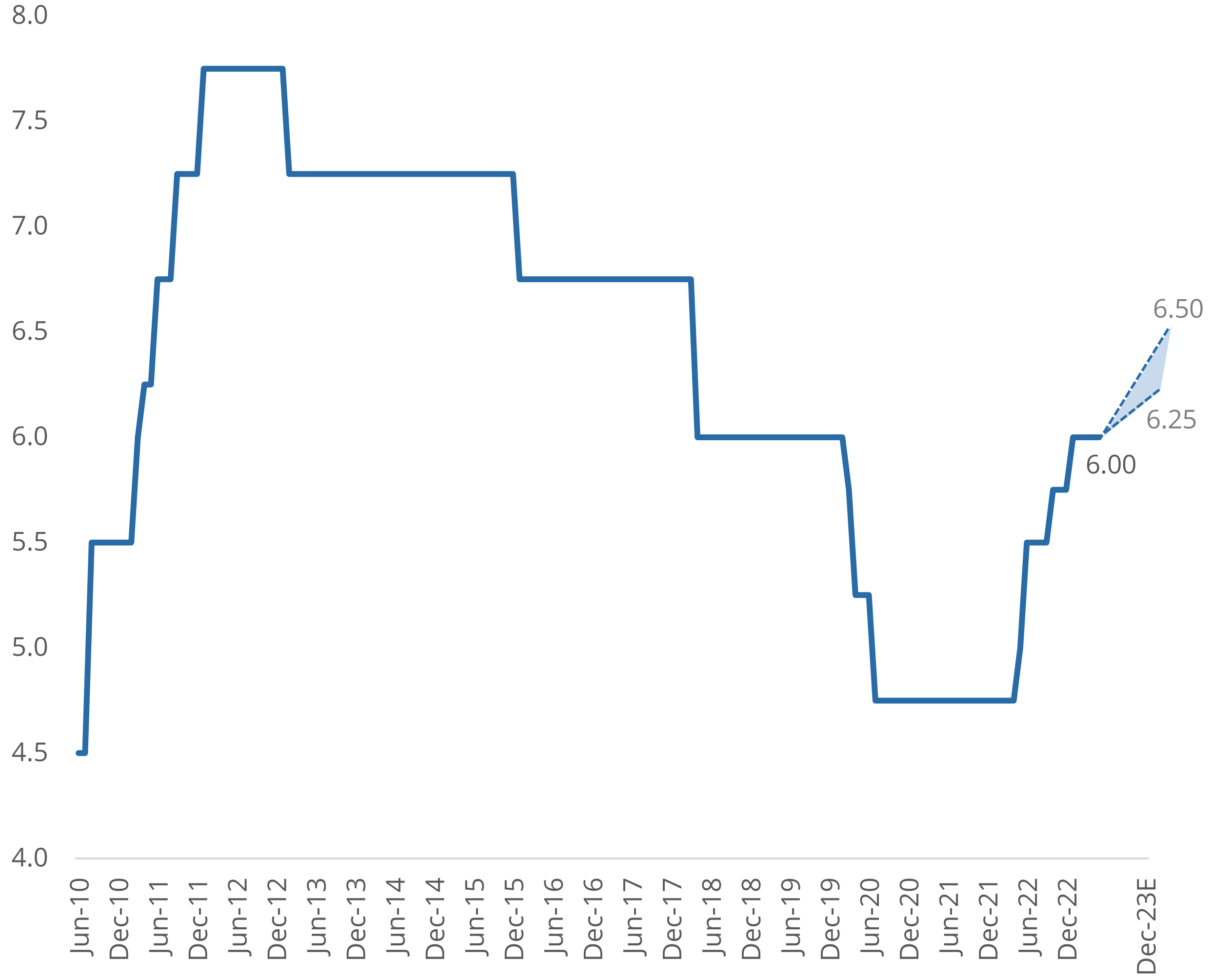
An Even Keel

Scenario 2: Progressive Response

Under the Progressive Response scenario, the policy measures will be aimed at prioritizing policies that promote growth over cautious approaches. Consequently, the policy rate may see a lower increase than necessary. Additionally, debt monetization and stricter import restrictions are expected to continue. Although the currency may be allowed to float, the policy measures will continue to exert influence through moral suasion to manage exchange rates resulting in continued dollar shortages. Based on the policy measures, CAL expects interest rates for 364-day T-bills to be around 8.3% to 8.6%, c.15% depreciation of the taka against the dollar, and an increase in inflation to 10.5% to 11.0%.

If BB prioritizes growth over caution keeping a cheaper borrowing environment, CAL expects the policy rate to increase by 25-50 bps and 364-Days T-Bill yield by 40-70 bps by the end of 2023E.

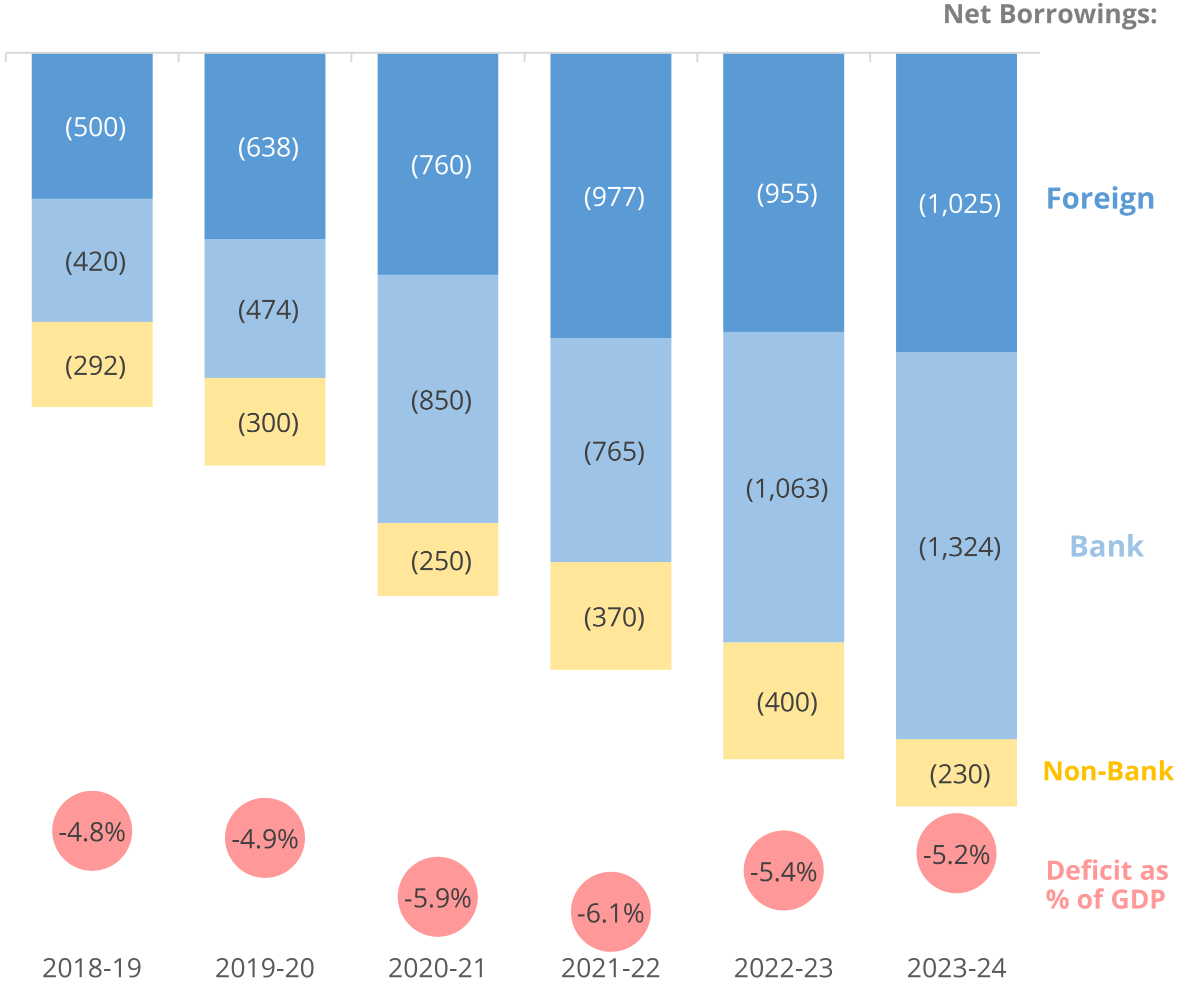
Policy Rate (%)



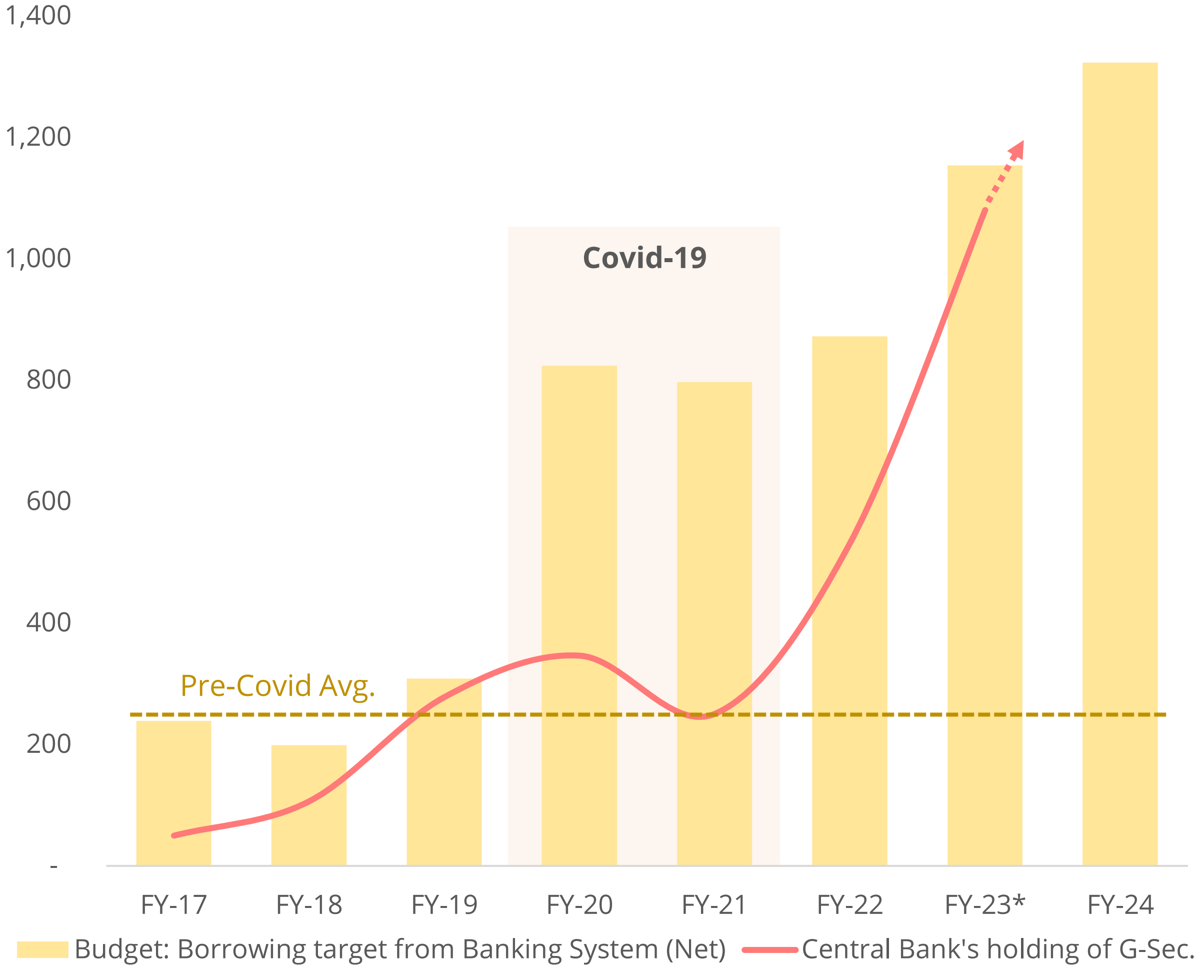
364-Day's T-bill Rate (%)

Heavy reliance on borrowing from the banking system for budget deficit financing is expected to be financed through debt monetization.

Budget Deficit & Deficit Financing (BDT Bn)



Government's Bank Borrowing Target Vs BB's Asset Purchase (BDT Bn)

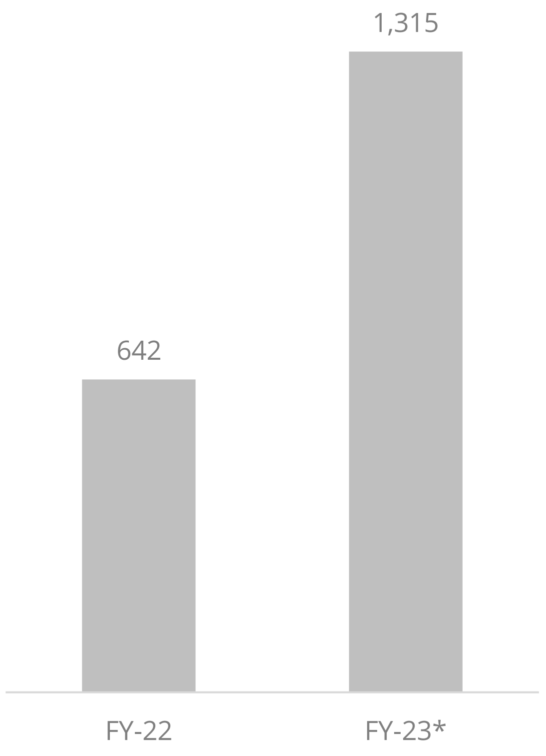


*Asset Purchase data till March-23

With the depletion of Forex reserves, reduced sales of dollars will no longer be able to adequately counter the necessary debt monetization, leading to an expansion in the money supply. Under progressive response, CAL expects BDT to depreciate by 14%-16% by the end of 2023E.

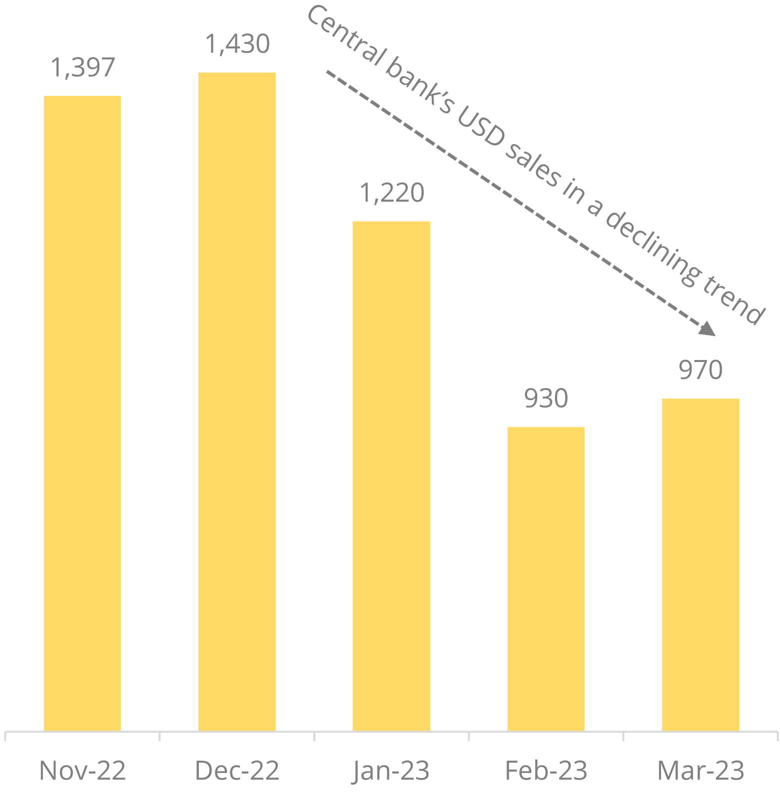
Up until May of FY23, the central bank intervened in the foreign exchange market with a net sale of USD 12.62 Bn and absorbed nearly BDT 1.3 Tn from the economy. These substantial USD sales offset the significant debt monetization by the central bank. Nevertheless, a sharp decline in USD sales is anticipated to hinder liquidity management operations. As a result, an increased supply of domestic assets amid declining foreign assets would lead to steeper currency depreciation.

Liquidity Mop up through USD Sales (BDT Bn)

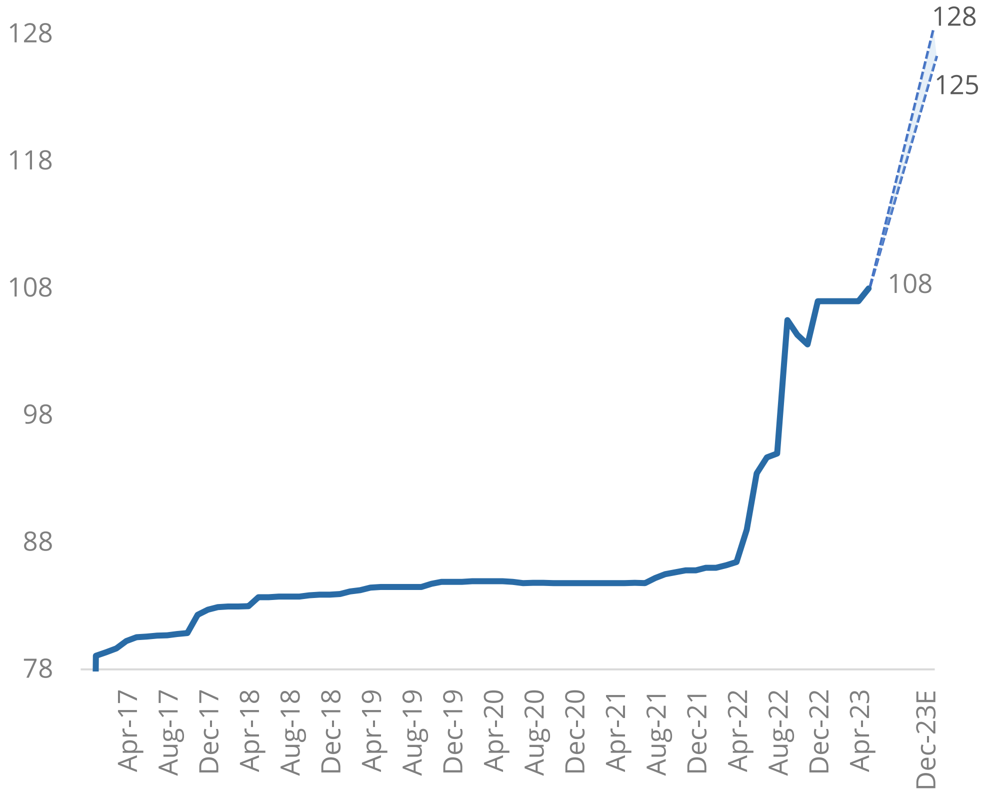


* Up to May
(Calculated using period average exchange rate)

Central Bank's USD Sales (USD Mn)



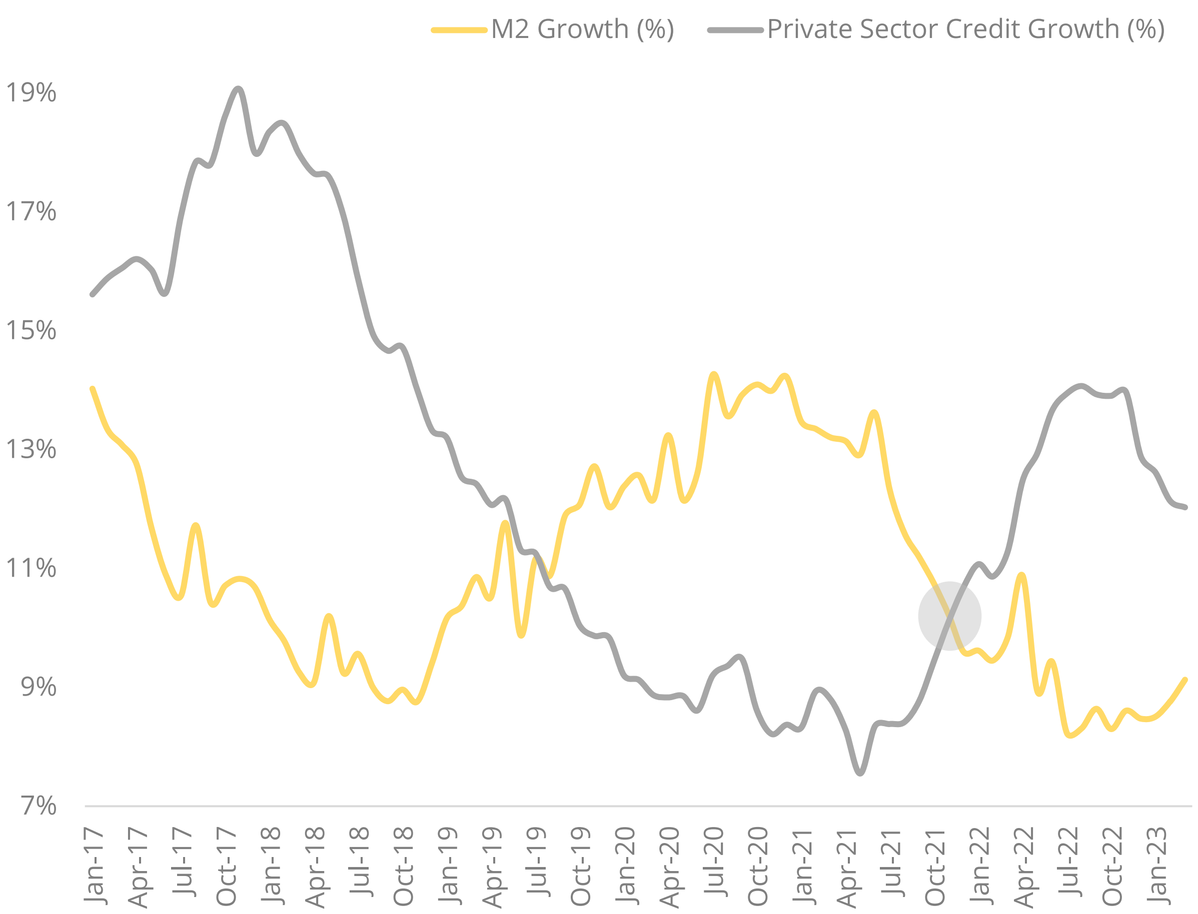
Exchange Rate Forecast (BDT/USD)



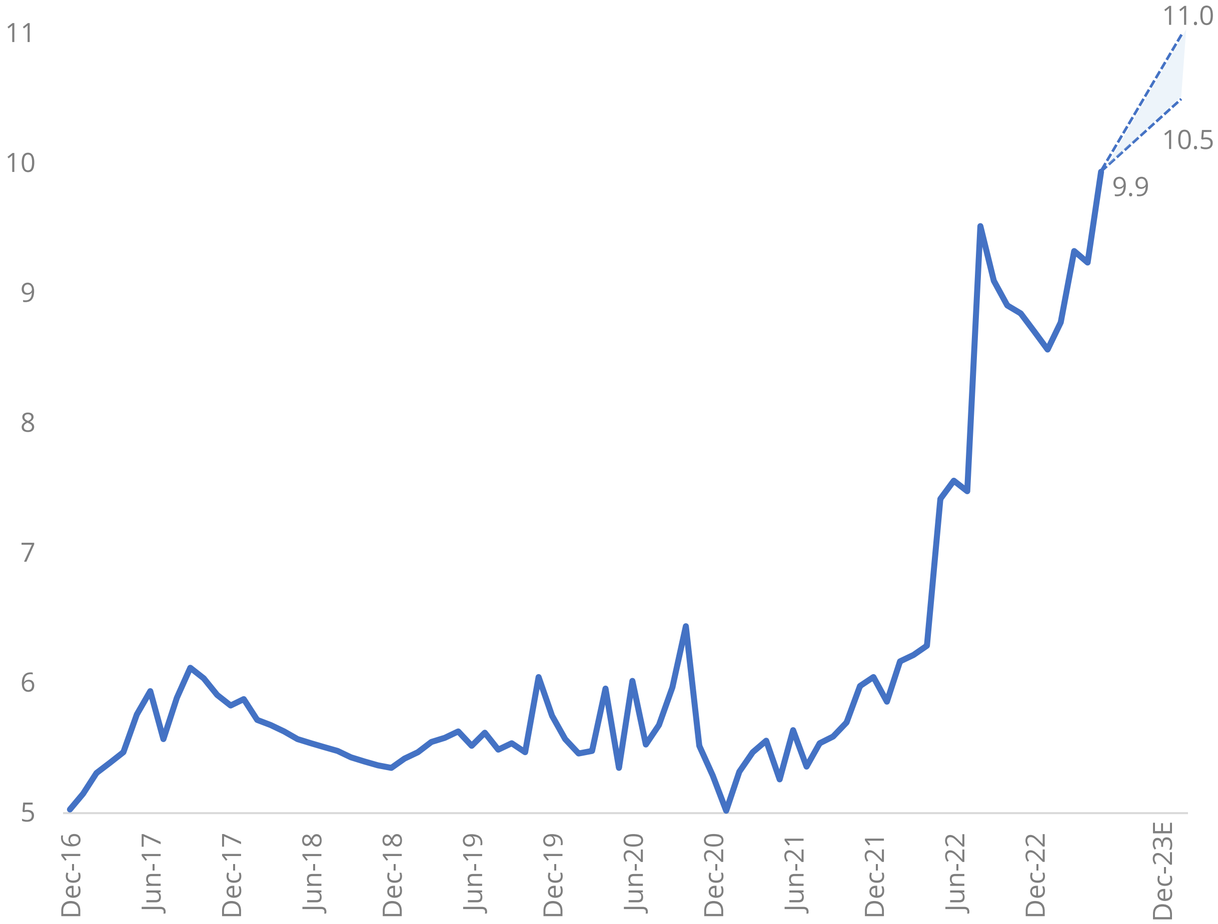
CAL expects in a scenario of slowing real growth, an increase in broad money supply can reignite credit growth to non-productive sectors pushing inflation to reach 10.5% to 11.0%.

The current declining credit trend suggests reduced demand for funds for business expansionary activities. Increasing the money supply in this situation could reignite credit growth, leading to funds being allocated towards unproductive activities, thereby exacerbating inflation.

Money Supply and Credit Growth (%)



Headline Inflation (%)



Source: Bangladesh Bank, CAL Research Estimates

Steering Through Policy Wave

Investment Strategy

In case of the adoption of an aggressive stance by the central bank, CAL recommends a strategic repositioning towards an increased allocation in short-term fixed-income securities. This tactical move is driven by our outlook for a significant surge in interest rates. By proactively adjusting investment portfolios to capture the potential yield opportunities, investors can aim to enhance risk-adjusted returns in this dynamic market environment. However, if the central bank opts for a progressive approach, we recommend increasing exposure to equities and real estate assets.

CAL's view on different asset classes in H1'FY2024

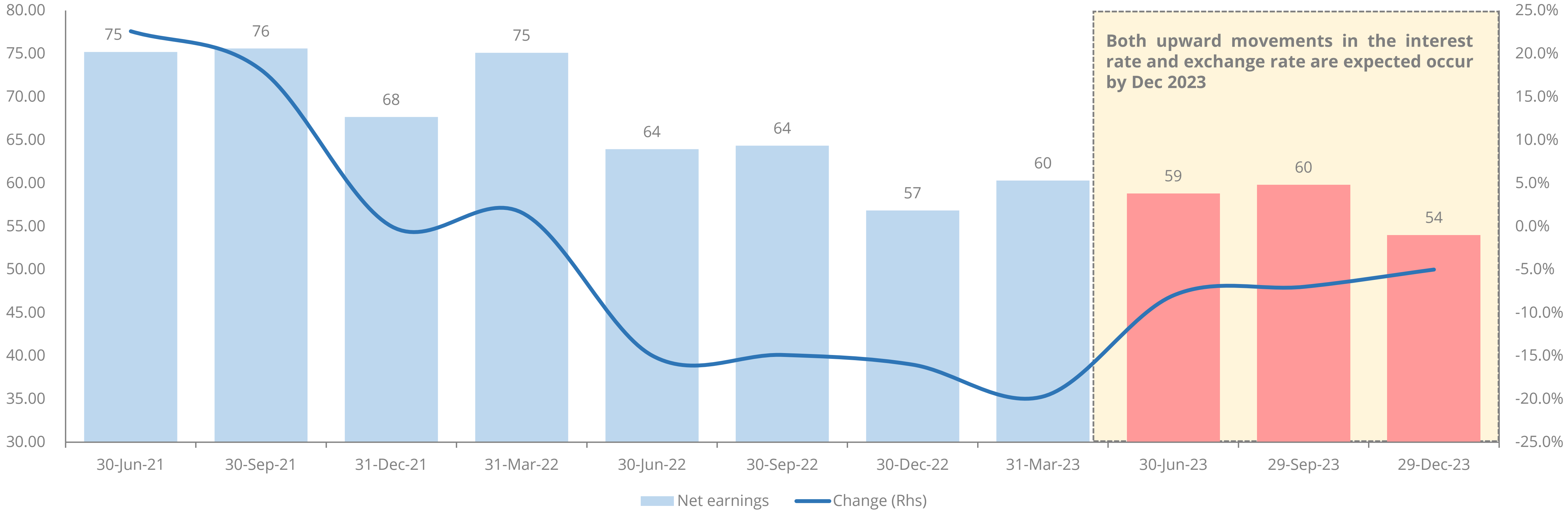
Asset Class	View	Tightening	Status Quo
Equities	We are underweight on equities if the central bank opts for hiking interest rates as investors are likely to move towards fixed income-generating assets. However, status quo will increase broad money growth, leading investment funds to flow into risky assets in search of higher returns.		
Short Term Fixed Income Securities	We are overweight on short-term fixed-income securities under both scenarios due to expected interest rate increases in 2023 and a flat yield curve, making long-term bonds less attractive.		
Long Term Fixed Income Securities	For the status quo scenario, we maintain an underweight position in long-term fixed-income securities due to anticipated future interest rate hikes. Conversely, in a tightening scenario, we would advise locking in rates promptly if interest rates begin to reach their peak.		

Underweight | Neutral | Overweight

Double whammy: CAL expects corporate earnings to record a 5% YoY degrowth by Dec 2023E…

Corporate earnings are likely to get worse before getting better on the back of tightened business environment. With elevated inflation levels forecasted for 2023E, we anticipate a decline in consumer demand, which will negatively impact corporate earnings.

Corporate Earnings (BDT Bn)



**Earnings have been calculated based on selected 250 companies, excluding mutual funds, Life insurance companies*

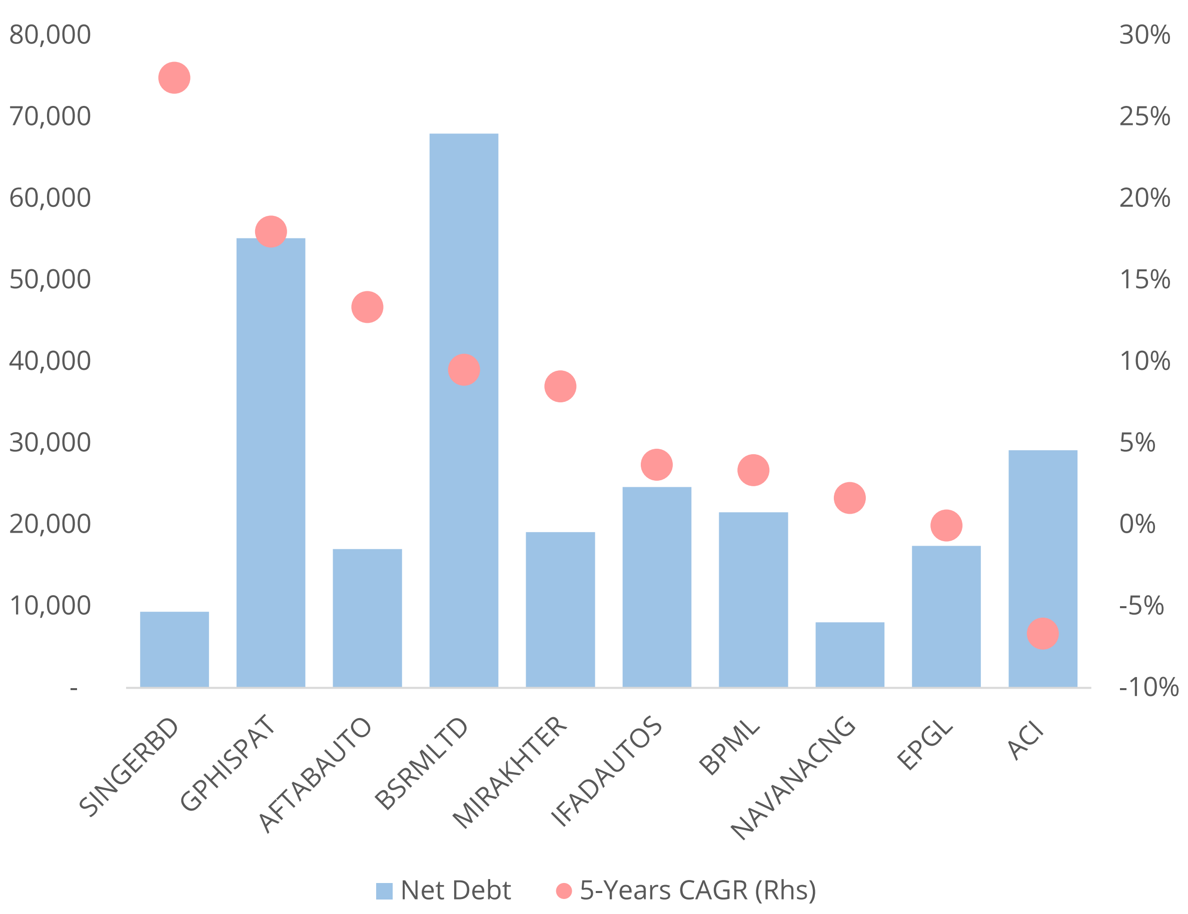
**NBL has been removed due to extraordinary loss incurred by the company in Dec'2022 quarter*

Source: Company quarterly reports, CAL research estimates

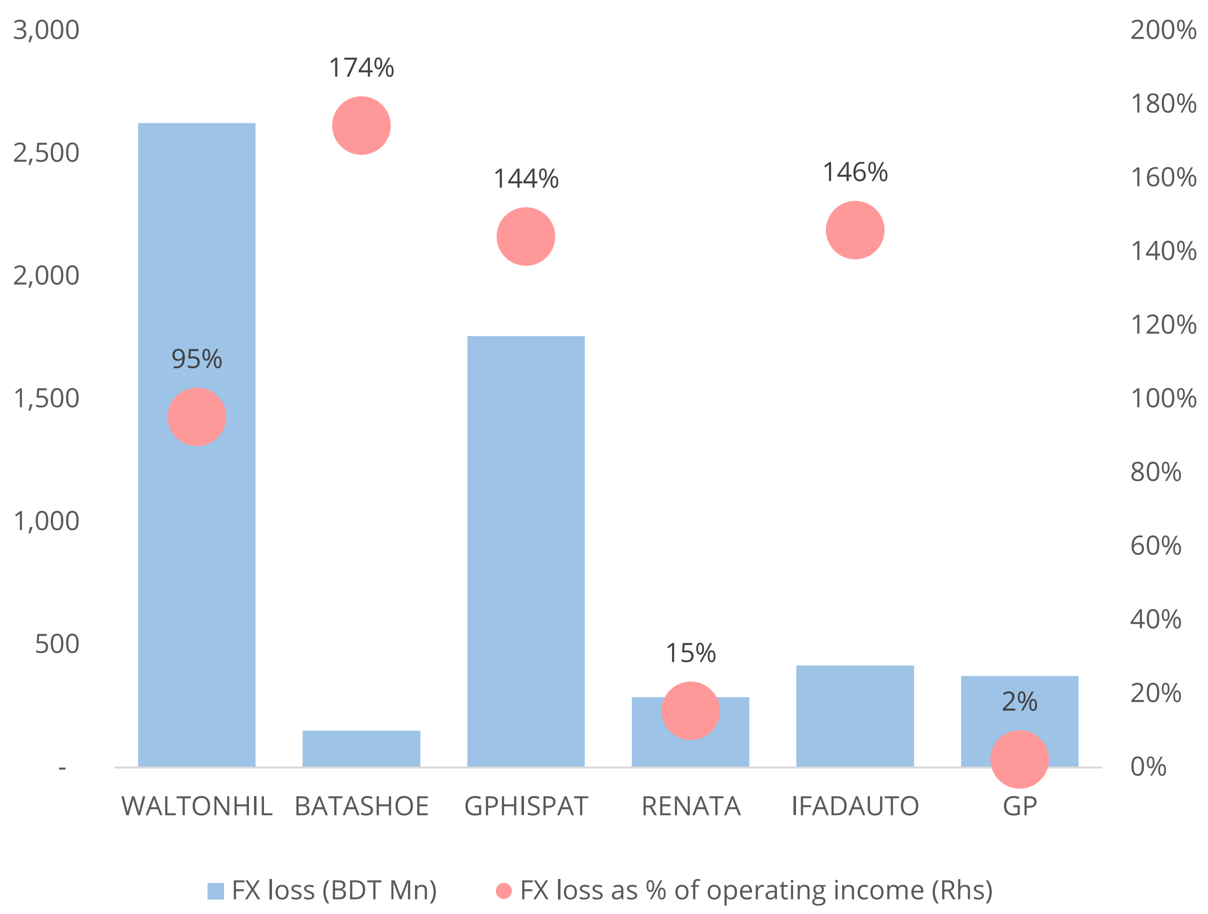
…stemming from the adverse impact of a weaker local currency, and increased interest expenses.

In the September 2022 quarter, listed companies saw a 10% YoY decrease in their bottom line due to increased finance expenses from currency exchange loss and interest rate expenses. We expect a continuation of this trend in 2023E.

Net Debt (BDT Mn)



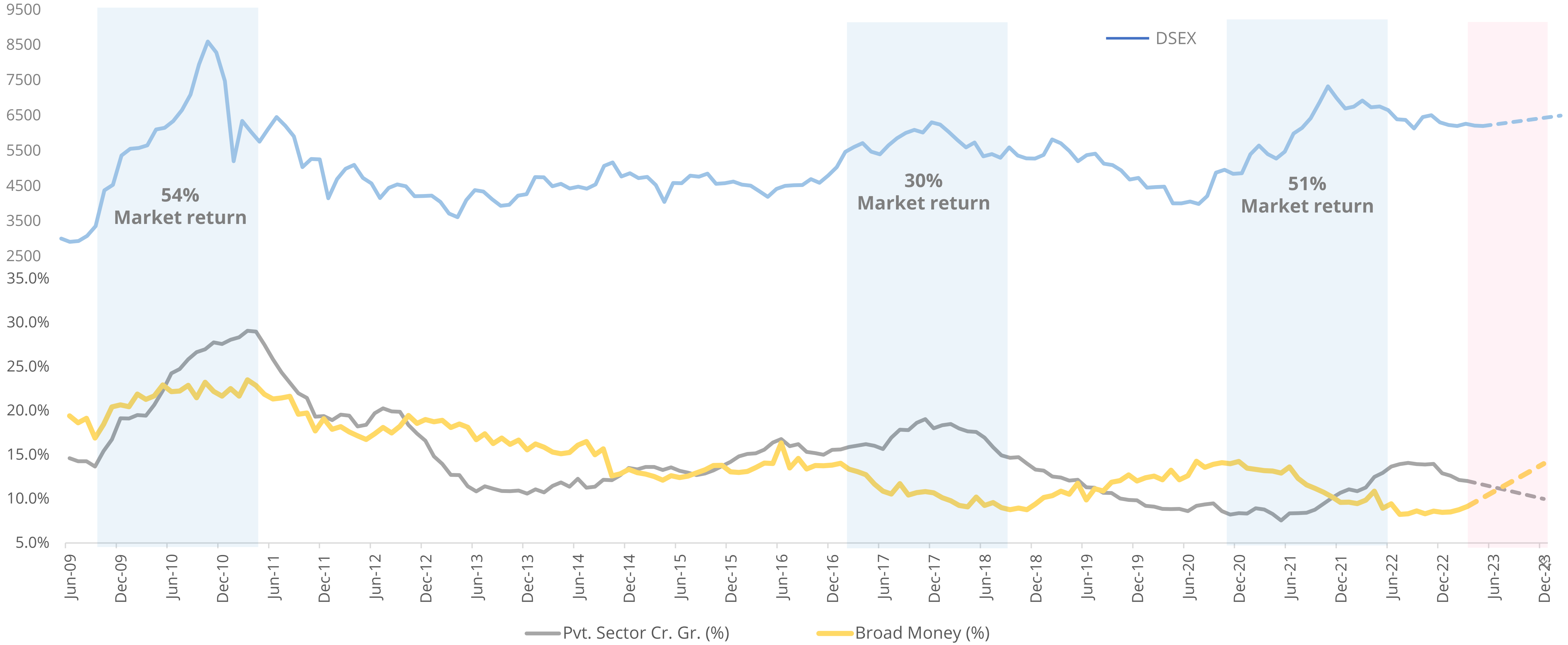
Foreign Exchange Loss (BDT Mn)



Source: Company annual and quarterly reports

In the progressive scenario, increased broad money growth will lead investment funds to flow into risky assets in search of higher returns.

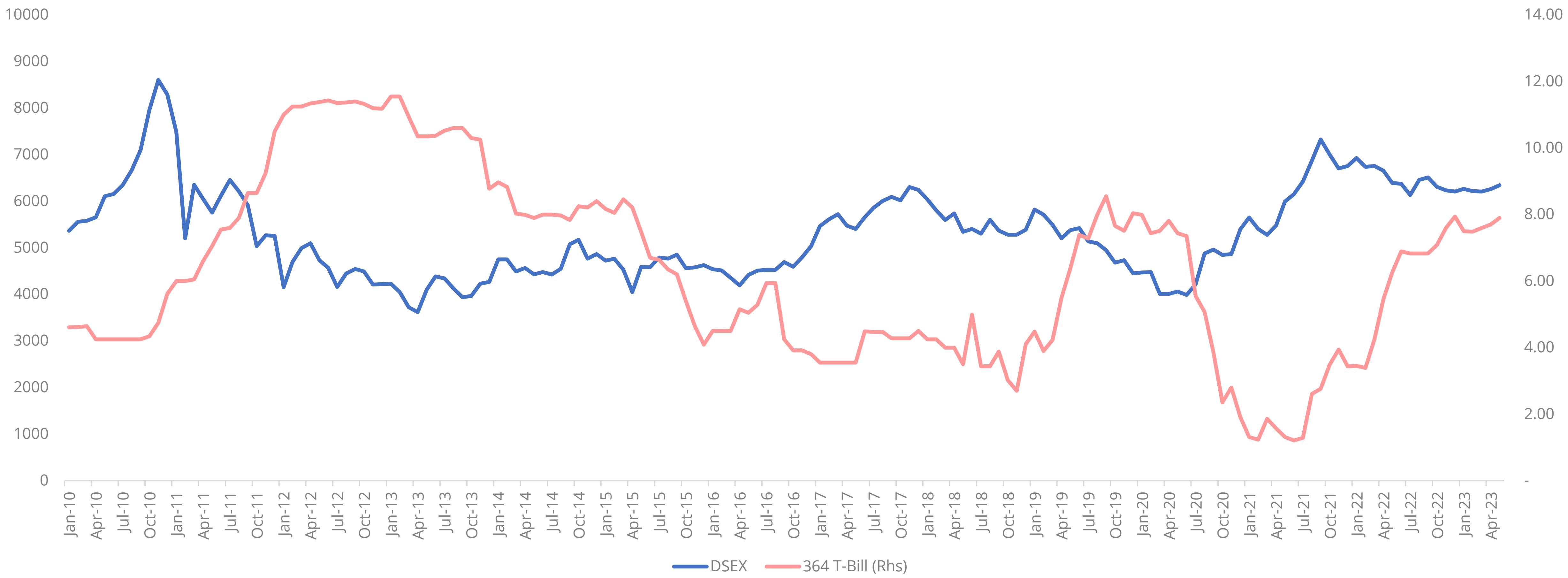
DSEX vs Broad Money and Private Sector Credit Growth



Source: Bangladesh Bank, Dhaka stock exchange

However, based on aggressive scenario, with tighter monetary policy, investor funds will likely flow into safer bets toward fixed-income-generating asset classes, creating the need for portfolio rebalancing

DSEX (Points) vs. 364 Days T-Bill Rate (%)



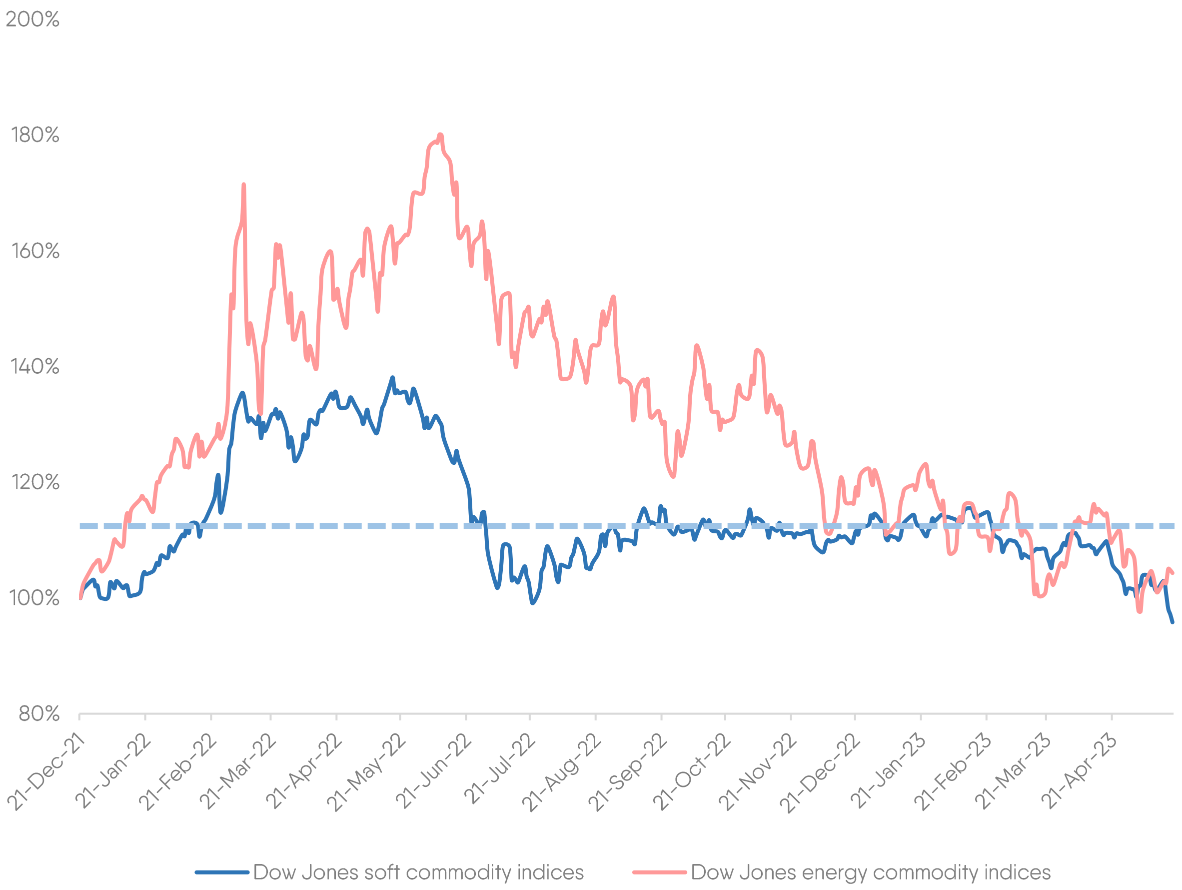
Source: Bangladesh Bank, Dhaka stock exchange

Investment themes to consider under the MPS scenarios in 2023E

Scenario	Key theme	Investment theme	Top Picks
Aggressive	Margin Expansion	**Companies with higher pricing power will enjoy a higher margin expansion on a downward commodity cycle;** Globally commodity prices have reverted toward the pre-Russia-Ukraine war level in a downward commodity cycle, and listed companies that have significantly raised their product prices are likely to book higher margin expansion	OLYMPIC, BATASHOE, BERGERPBL
Aggressive	Interest Income	**Companies with high cash balances will benefit from a rise in interest rates:** Banks with higher CASA and companies with high cash balances benefit from upward interest rates and revision of rate caps.	BRACBANK, DUTCHBANGL, MPETROLEUM, PADMAOIL
Progressive	Currency depreciation	**Companies with dollarized revenue are likely to be the main beneficiaries of further Taka depreciation:** Companies that have dollar-linked revenue, high-value addition and high operating leverage due to low variable costs are likely to enjoy higher profitability driven by Taka deprecation.	Listed export-oriented apparel companies, BSC, UNIQUEHRL
Aggressive + Progressive	Market Share Consolidation	**Companies with leading market shares and strong balance sheets will consolidate their market share:** We believe market leaders with dollarized earnings sources or strong balance sheets will consolidate their market share as smaller companies struggle under restrictive import and tight macroeconomic scenarios.	SQURPHARMA, OLYMPIC, BATBC, BERGERPBL, BATASHOE
Aggressive + Progressive	CAPEX Cycle	**Companies with real estate exposure or major CAPEX completion will benefit in the high inflationary scenario:** Global commodity price hikes and taka depreciation has led to higher construction and materials costs increasing the replacement cost of existing assets.	GP, MARICO, BXPHARMA, WALTONHIL

Margin expansion: Globally commodity prices are decreasing to the pre-war level, companies that have significantly raised their product prices will see higher margin expansion.

Dow jones Commodity Index

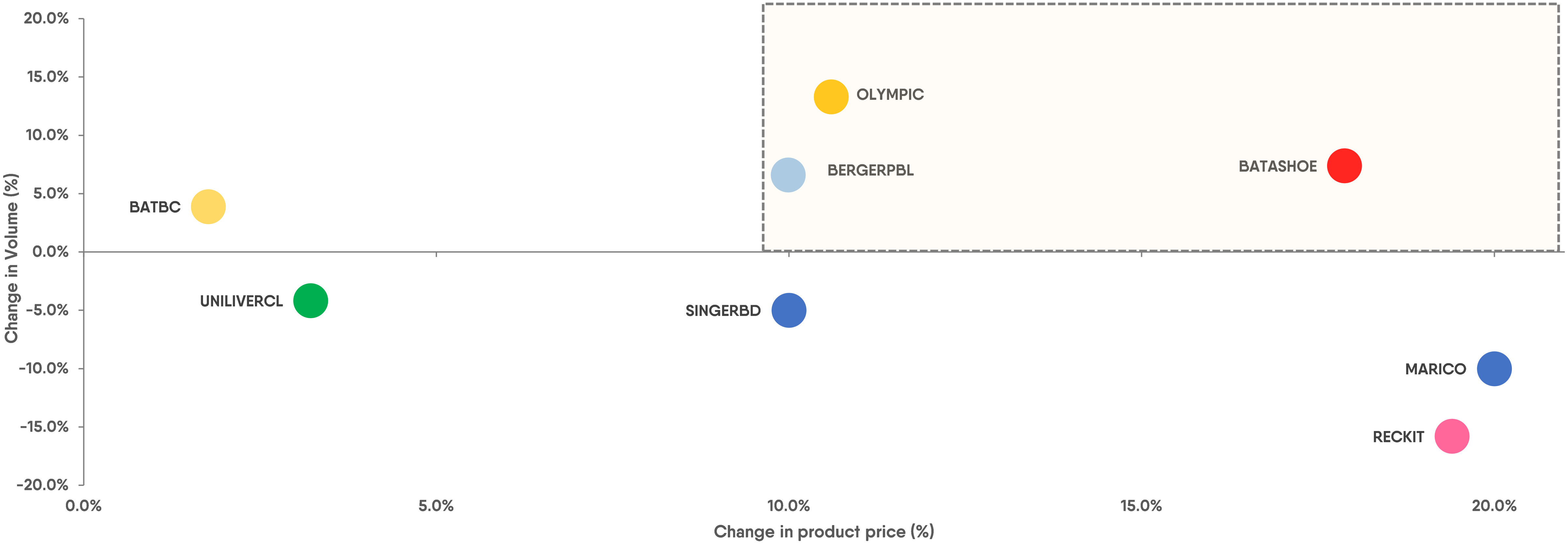


Change in the retail price of products

Company ticker	Popular products	Change in retail price since 2022
MARICO	Parachute Coconut oil	37%
RECKITTBEN	Harpic	36%
OLYMPIC	Energy plus biscuits	30%
BERGERPBL	Radiance Paints	26%
BATASHOE	Power shoes	20%
SINGERBD	Singer Fridge	15%

Companies with higher pricing power will see faster margin expansion in a downward commodity cycle due to higher customer retention.

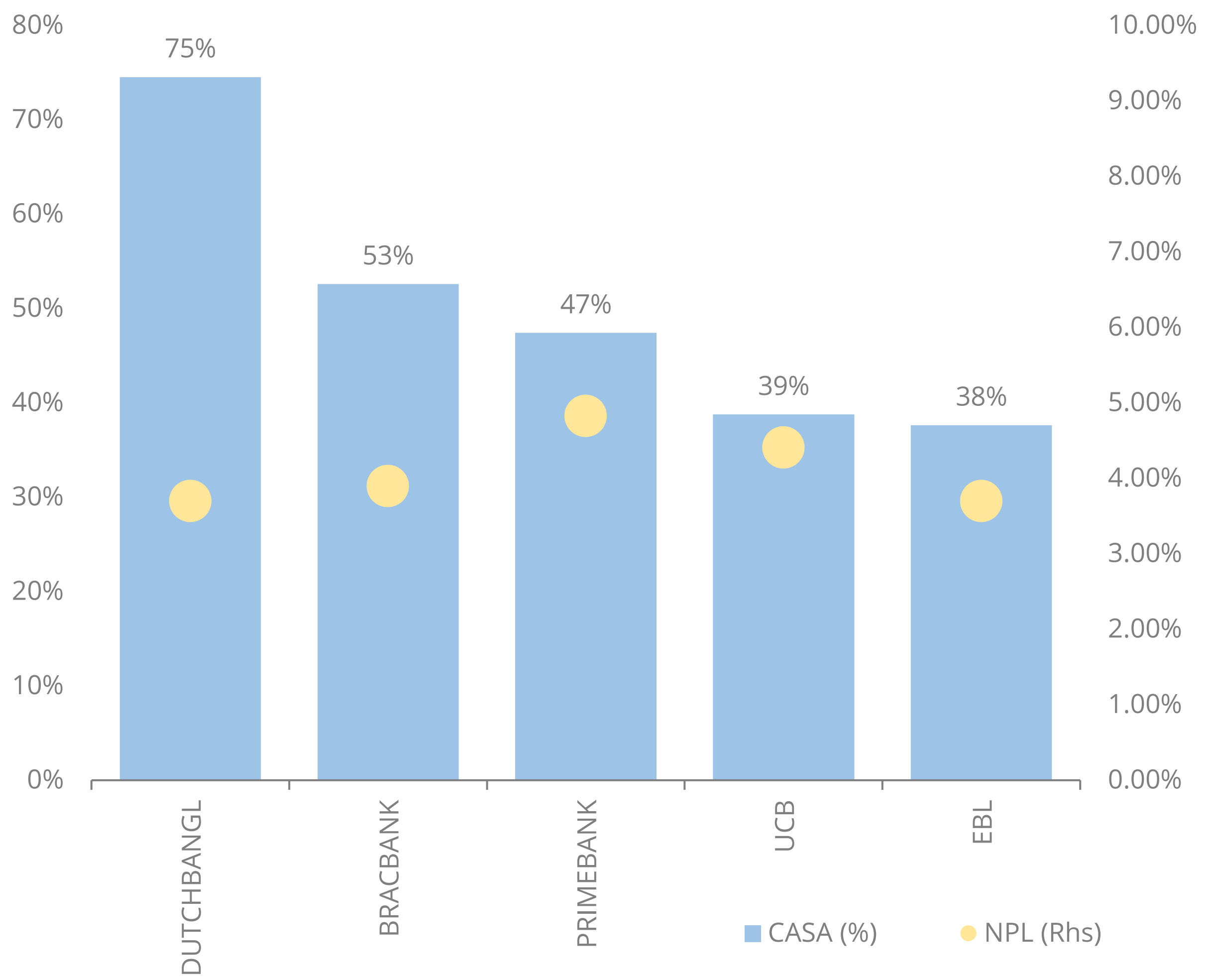
Comparison Between Change in Price and Change in Volume of Sales (%)



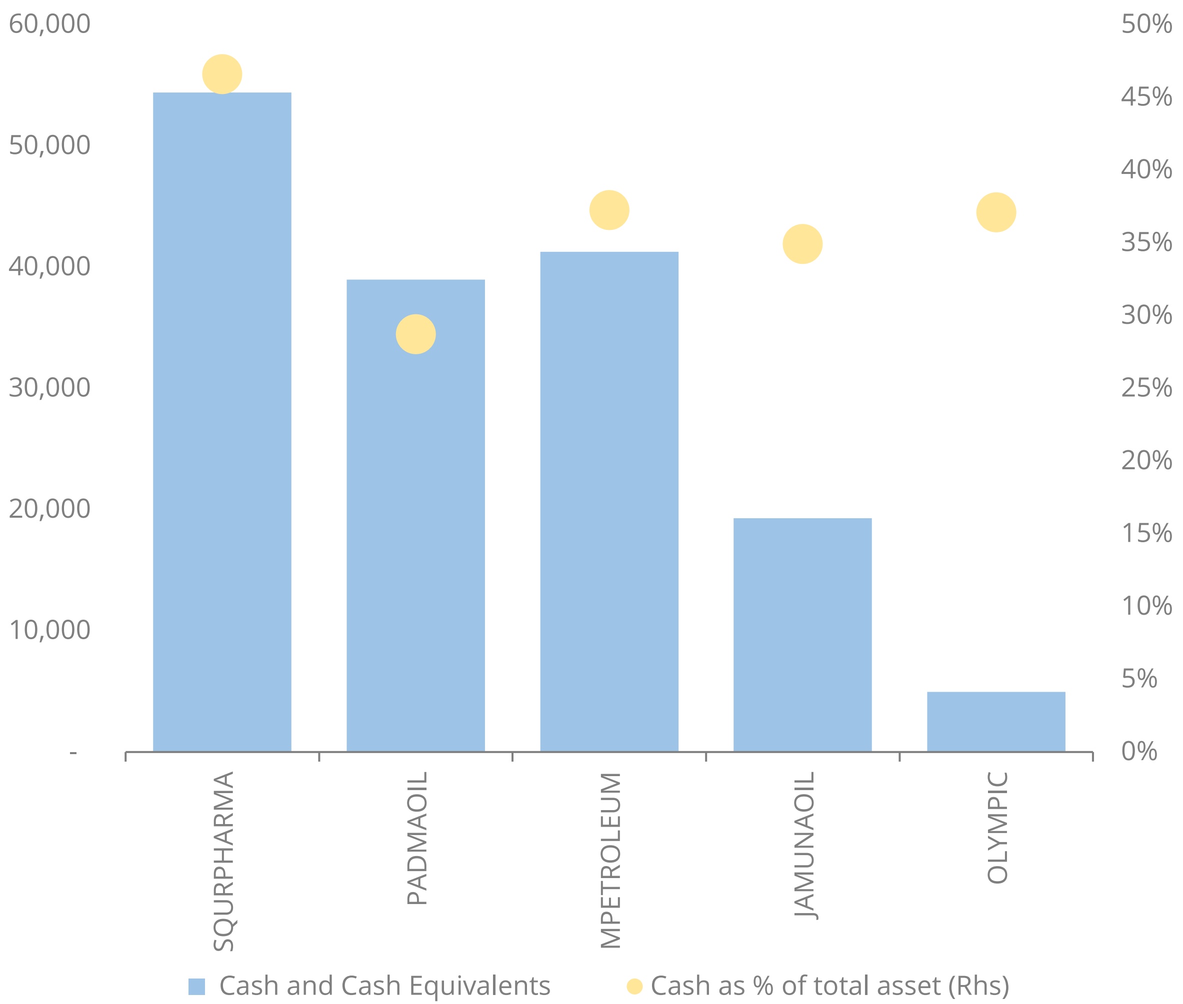
Note: Due to the reporting standard of listed companies, we have only taken a handful of companies that report the amount of sales volume or change in sales volume. However, the theme extends to all the companies that have increased their product prices and have retained sales volume, for example, the pharmaceuticals sector.

Interest income: Banks with higher CASA and companies with high cash balances will benefit from upward interest rates and revision of rate caps

Banks with Higher CASA Deposits



Companies with High Cash & Cash Equivalent Holdings (BDT Mn)

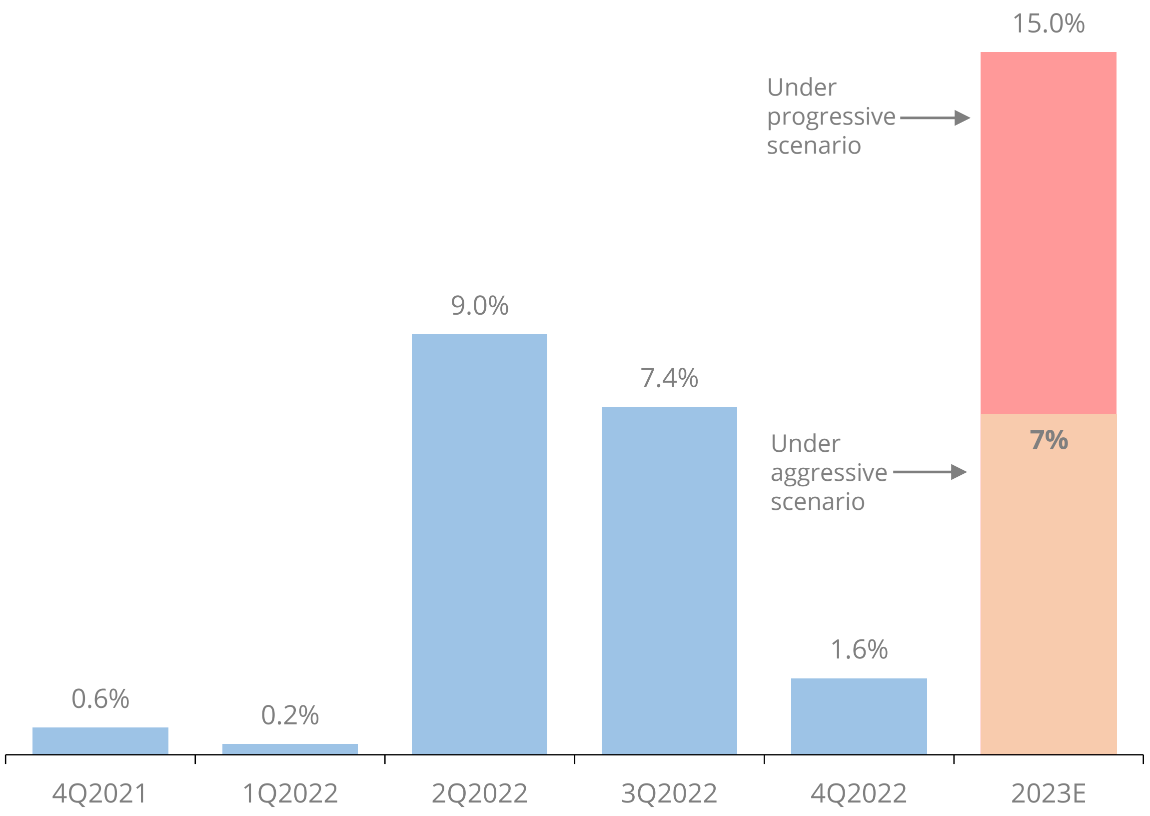


Source: Company annual report

Dollar Bets: Companies with dollarized revenue and high operating leverage are likely to be the main beneficiaries of further taka depreciation

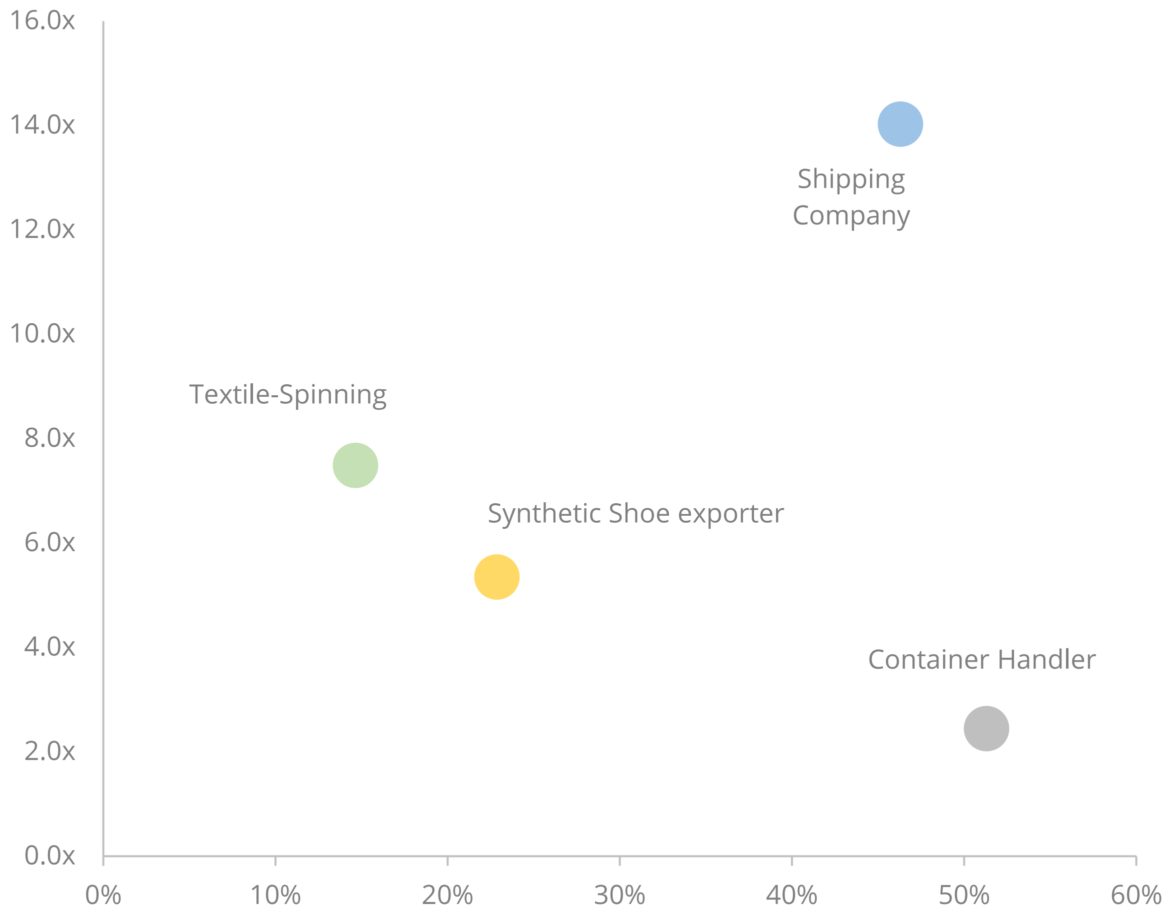
Companies that have dollar-linked revenue, high-value addition, and high operating leverage due to low variable costs are likely to enjoy higher profitability driven by taka deprecation.

Currency deprecation (%)



*For 2023E, Full year currency depreciation has been taken in account from Jan-Dec

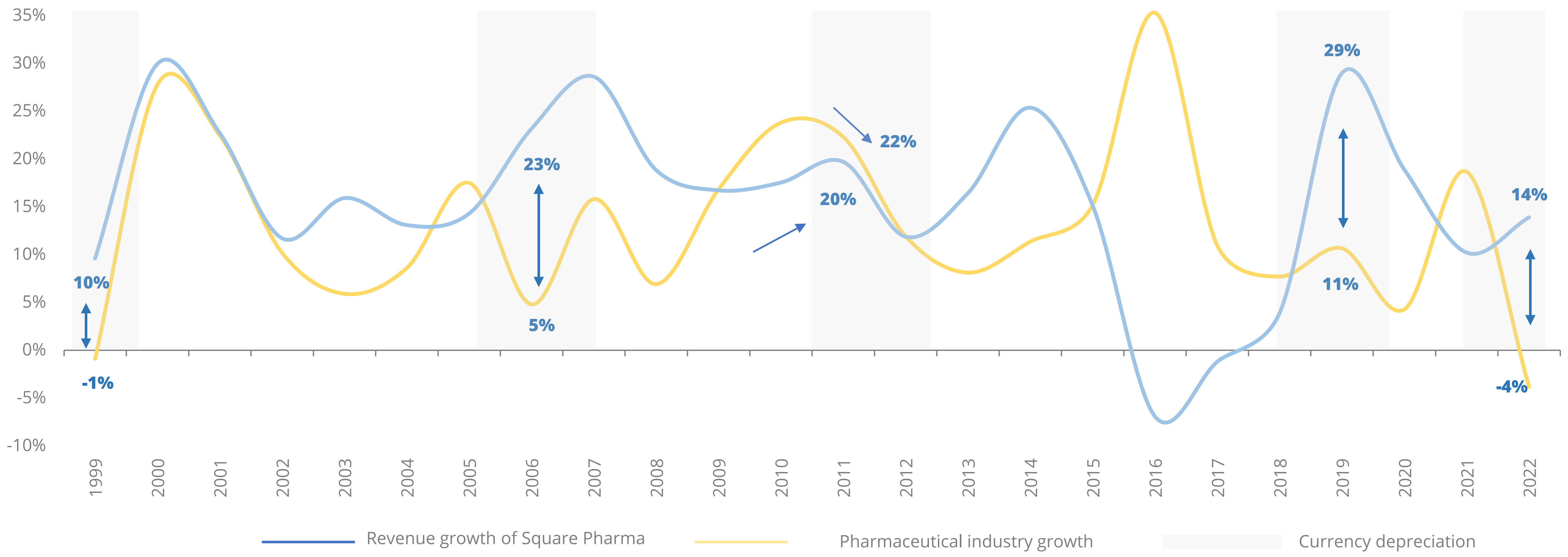
Value addition vs operating leverage of selected sectors



Source: Bangladesh Bank, Respective company's annual and quarterly reports, CAL Research estimates

Market Share Consolidation: Companies with leading market share and strong balance sheets will consolidate market share against the backdrop of the tightened economic scenario

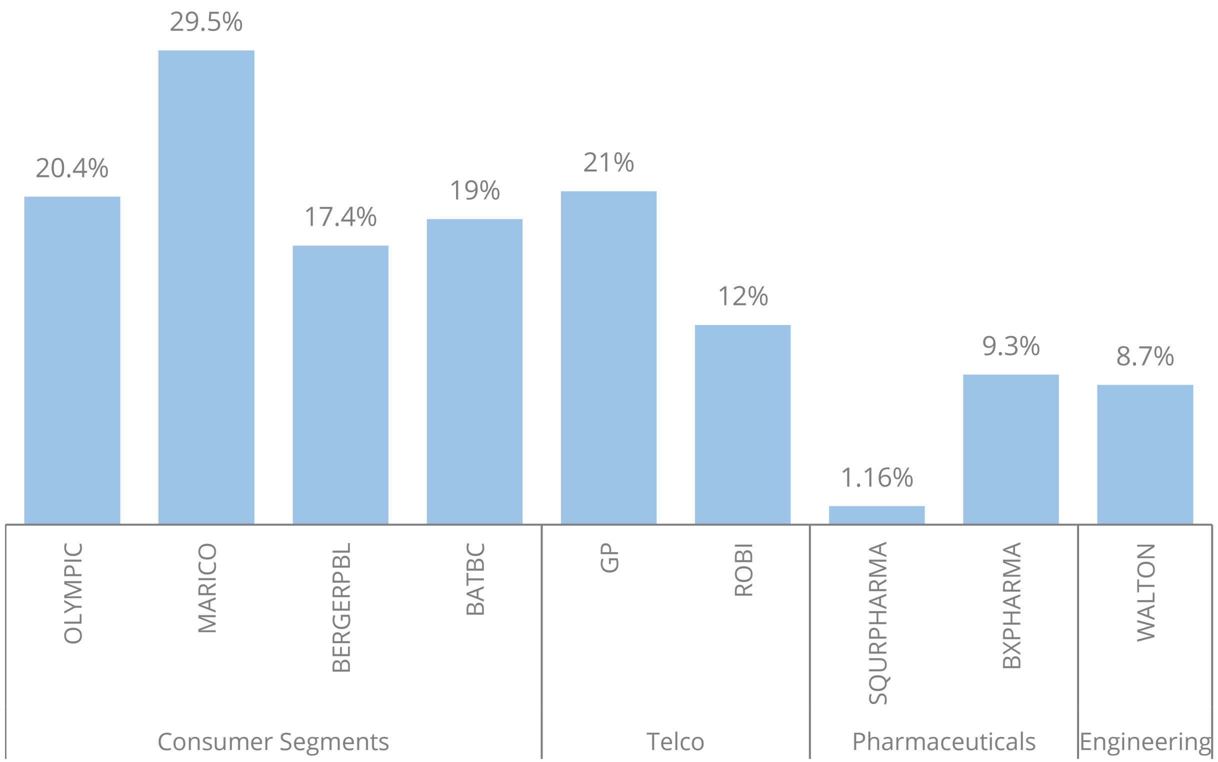
We believe market leaders with dollarized earnings sources or strong balance sheets will consolidate their market share as smaller companies will continue to struggle under restrictive import and tight macroeconomic scenarios. Square Pharma serves as a prime example of market share consolidation by major market players. Historically, in the five instances of the tightened economic situation, Square Pharmaceutical's revenue grew significantly compared to the industry.



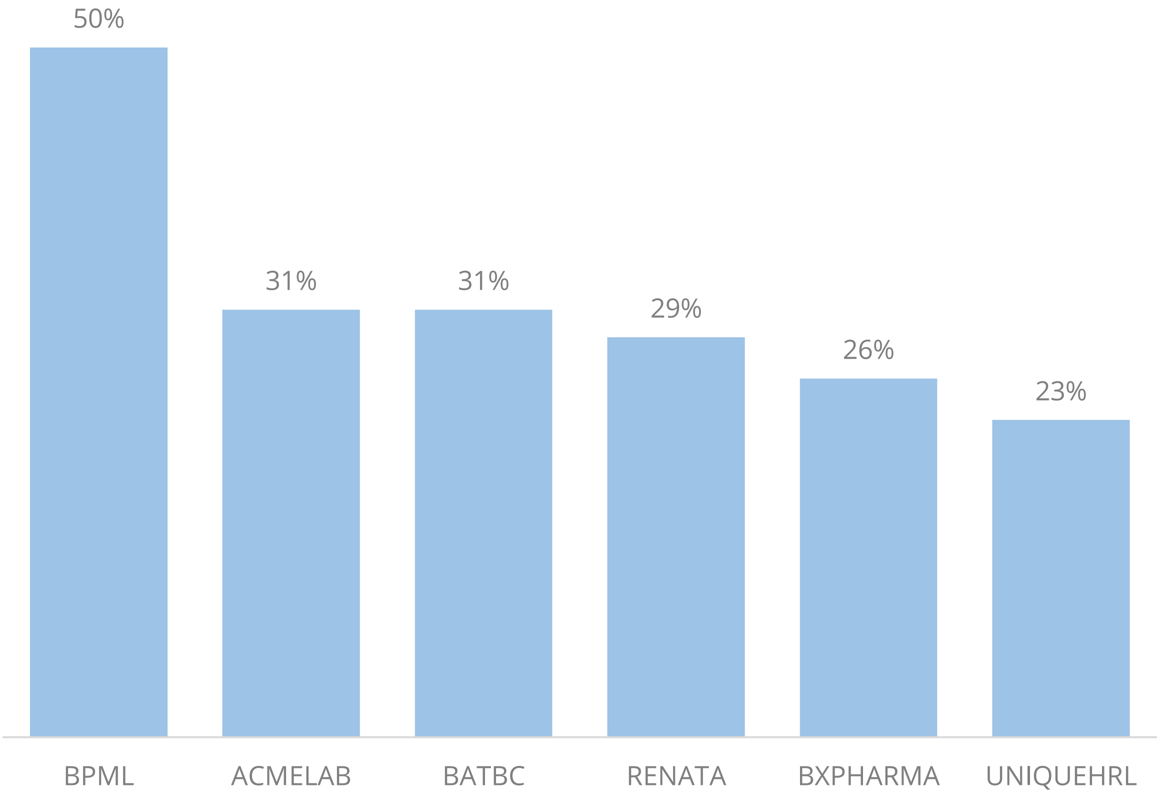
CAPEX Cycle: Companies with major CAPEX completion will benefit from rising construction costs.

Taka depreciation and import restrictions have led to higher construction and materials costs increasing the replacement cost of existing assets. As a result, companies that have already completed their Capex investment will have a higher margin compared to the companies that will make a new investment.

Capacity Expansion (%)



5-year Capital Expenditure as % of Total Assets



Source: Company annual report

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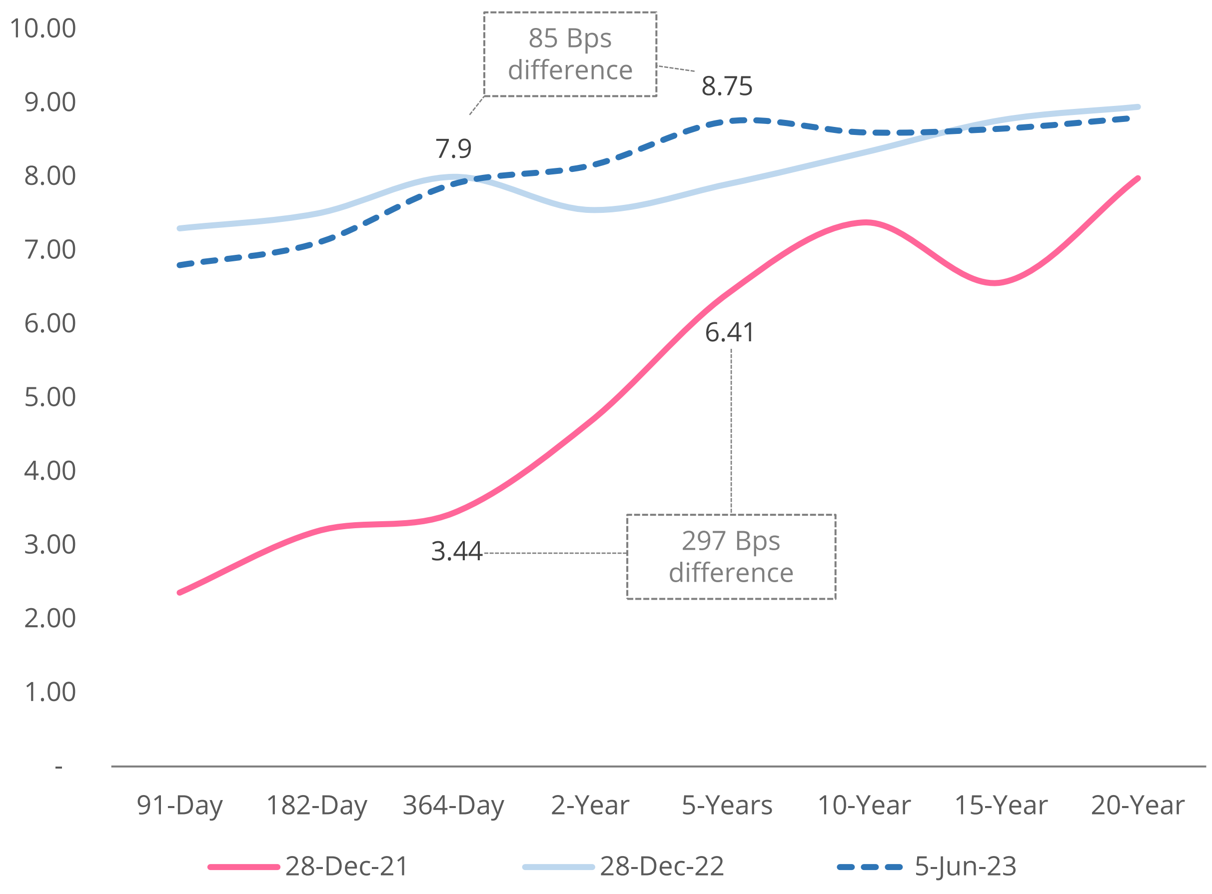
What Does This Mean for Fixed Income Investments?

Preferring short-term maturities for fixed-income securities

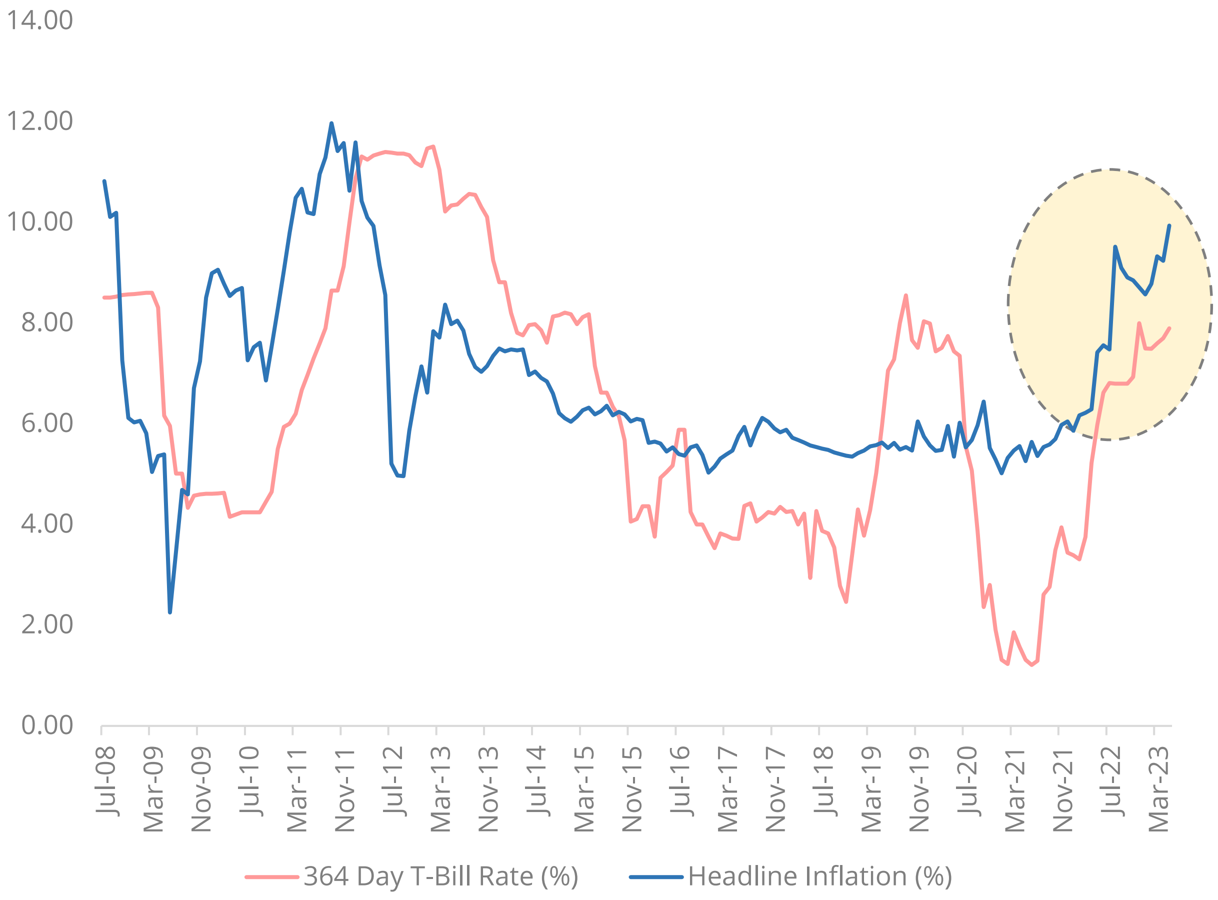
Exposure to fixed-income securities with shorter maturities will provide the opportunity to reprice as the interest rate rises.

The spread between 364-days T-Bill and 5-Years T-bond has narrowed to 85bps, indicating shorter tenure T-Bills are providing better yields compared to longer tenure bonds. As the central bank opts for a flexible interest regime, staying in shorter tenure T-bills will provide a better opportunity to reprice once T-bond rates start to increase significantly.

Yield Curve (%)



Inflation (%) vs 1-Year T-bill Rate (%)



Source: Bangladesh Bank

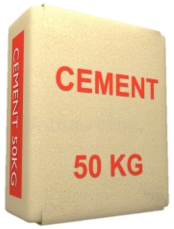
What Does This Mean for Real Estate Investment?

An inflation hedge

Higher construction and materials costs will increase the replacement cost of existing real estate assets providing a hedge against inflation.

The cost of building materials has risen by 29% on average, owing to Taka deprecation and global commodity price hikes.

June 2022-June 2023



Cement
14.80% YoY

Bricks
50% YoY

Steel/Rods
35% YoY

Land prices in Dhaka have increased 27 (x) times over the last two decades.

Land prices in Dhaka city increased at a
CAGR of 17%
in the Last 20 Years.

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