Payden & Rygel's sovereign analysts regularly visit regions we invest in to research economic fundamentals and local markets. As we make investment and portfolio allocation decisions, on the ground research provides our team with first-hand knowledge of local economic and political trends.

Payden&Rygel

TRIP NOTES

SRI LANKA

NOVEMBER 2026

A Snapshot of Sri Lanka

Sri Lanka faced a remarkably challenging set of circumstances starting just before the COVID pandemic. The troubles began with the Easter terrorist attacks in April 2019, followed by the election of President Gotabaya Rajapaksa in November of the same year. The new government pursued tax cuts for growth, right as the pandemic hit. Sri Lanka handled the pandemic incredibly well, notwithstanding the revenue shortages. Nevertheless, Russia's invasion of Ukraine in 2022 caused food and fuel prices to surge, savaged tourism, and made a balance of payments crisis and debt default unavoidable. In April of that year, Sri Lanka suspended all debt payments. By July, in the face of import shortages including most medicines, the presidential palace was stormed by protestors and the president fled the country and resigned.

Tea train crossing Nine Arch Bridge, Ella, Sri Lanka



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Between July 2022 and September 2024 Sri Lanka gradually recovered. An interim government negotiated a funded International Monetary Fund (IMF) reform program, began reaccumulating foreign exchange reserves and import shortages eased. Sri Lanka's voters spoke in September 2024, rejecting all of the establishment politicians and bringing a president from a communist party to power for the first time. The parliamentary election a month later gave the President's coalition a supermajority. There were near-universal fears that this would herald an end to the IMF program, the repudiation of the debt and a return to crisis. Instead, the economy has recovered strongly, and the government pursued almost exactly the opposite of the policies that most observers feared.

Recovering and Resilient

Sri Lanka's paddy rice can sit under water for as long as 12 days without lasting damage. When Cyclone Ditwah struck in late 2025, causing US$3.4 billion of damage, equal to 3.1% of gross domestic product (GDP), only about a fifth of the crop was lost. The fiscal deficit remained stable as funds were reallocated for recovery, and growth outperformed on reconstruction. The experience is a fitting allegory for the post-2022 turnaround, especially under the new government. Barely a year after the cyclone, the conflict in Iran has become the largest external shock since 2022, as the region supplies about half of Sri Lanka's petroleum imports and 40% of its remittances. Once again, the economy has bent rather than broken.

We came away more positive than we went in. Forecasters have underestimated Sri Lanka on growth and the fiscal balance for three years running, the Iran shock has shown up in prices but not activity, and nothing in our meetings or the data suggests that 2027 requires heroic assumptions to outperform expectations again; the politics reinforce that view.

Expectations Were Too Low in 2025

Going into 2025, forecasters expected a fragile recovery. Instead, Sri Lanka beat consensus on almost every front. Growth came in at 5.0%, far above the 3.7% consensus at year-end 2024, and a surge in remittances and tourism pushed the current account into the highest surplus in memory at 1% of GDP. The fiscal surprise was the largest of all: at year-end 2024 consensus looked for a deficit of 5.4% of GDP, but the 2025 outturn was 2.3%, and the primary surplus was more than double the IMF program target. Foreign reserves were the one area where the outcome fell short of hopes.

Before our trip, we were concerned that the fiscal results owed more to luck than policy. This was true in part. Vehicle import taxes, boosted by pent-up demand for cars, contributed about 2.8% of GDP in revenue, and capital spending ran well below plans. Neither is repeatable, but our meetings convinced us that the improvement goes deeper. Vehicle revenue is expected to fall back toward 2% of GDP in 2026 as demand fades, but the expectation in Colombo is that tax compliance, which has roughly doubled from 20% to 40%, will fill most of the gap. In the context of growth outperformance, this is a setup for classic broad-based revenue mobilization, and both the government and private sector emphasized this point.

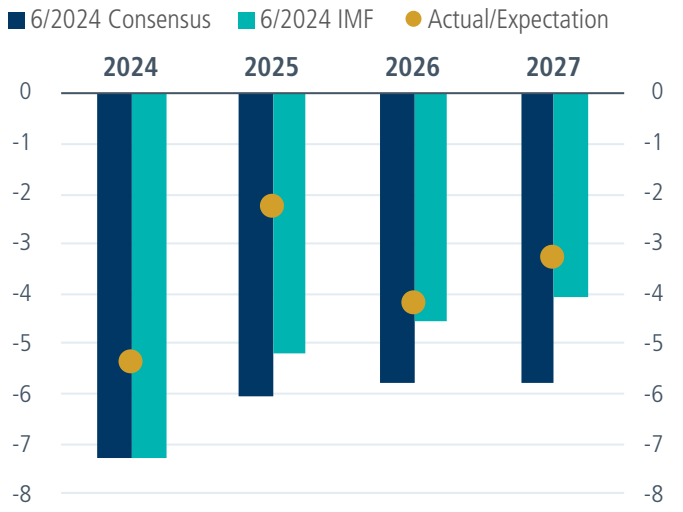
2026: The Shock Has Landed in Prices, Not in Activity

The conflict in Iran hit just as the recovery was gathering pace. Before, consensus GDP growth expectations were 5% in every quarter of 2026, with the IMF more conservative at 4% for the year. The IMF's May review cut its forecast to 3%, assuming a three-month conflict and oil near US$98. The external factors ended up even worse: the conflict is now into eight months, and Brent was approaching US$120 before the US elections; and yet, the economy has held up far better than those assumptions implied. Growth slowed only to 4.2% in the second quarter, and the central bank expects about 4% in the second half. The IMF's own October World Economic Outlook is back up at 4.0% for 2026, along with market consensus.

The fiscal accounts tell the same story more forcefully. The IMF and consensus both expect a full-year deficit of around 5% of GDP, yet the four-quarter deficit through June is only about 1% and still improving. Part of the gap is timing: fiscal data are published with a full quarter's lag, so the IMF's May review contained no 2026 data at all, and capital spending tends to be back-loaded. Even so, private sector estimates put this year's primary surplus at roughly double the program's post-cyclone target, and we think the full-year deficit has ample room to outperform. A possible risk is the fiscal response to the Iran conflict. A smaller additional fiscal relief package has replaced the original one, which was due to end in September, and keeping it well targeted and properly costed is an IMF priority.

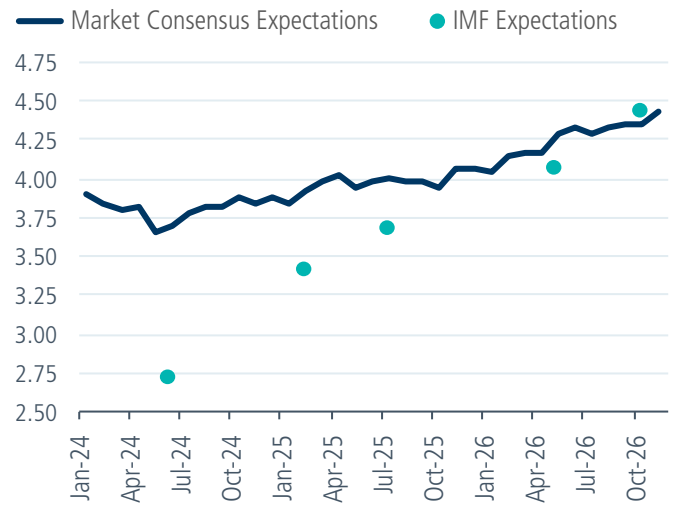
Where the Iran shock has bitten is in prices and the external accounts. Apart from the clear fuel price shock, the government aligned both electricity and fuel price regulation with costs, which kept the fiscal impact contained

Figure 1: Fiscal Deficit % of GDP



Sources: IMF, Focus Economics

Figure 2: Annualized Real GDP % Growth 2024-2027



Sources: IMF, Focus Economics

but led the consumer price index (CPI) to surge. Consumers bore the impact, with consensus inflation for 2026 rising by 1.7% to 5.4% since the conflict began, and the current account is now expected to post a small deficit. The central bank responded early, raising its policy rate by 100 basis points to 8.75% in May. Together with tighter loan-to-value rules, the hike lifted lending rates by around 300 basis points and cooled credit, imports and dollar demand. The central bank expects inflation to stay stable until Q1 2027 before heading toward the 5% target, and the private sector views inflation as close to peak, if oil is stable or lower. Physical shortages rather than rising prices are the main risk to Sri Lanka's growth; apart from short-term isolated issues with bitumen, physical shortages have not materialized and seem unlikely to.

2027: Reasonable Expectations and Larger Buffers

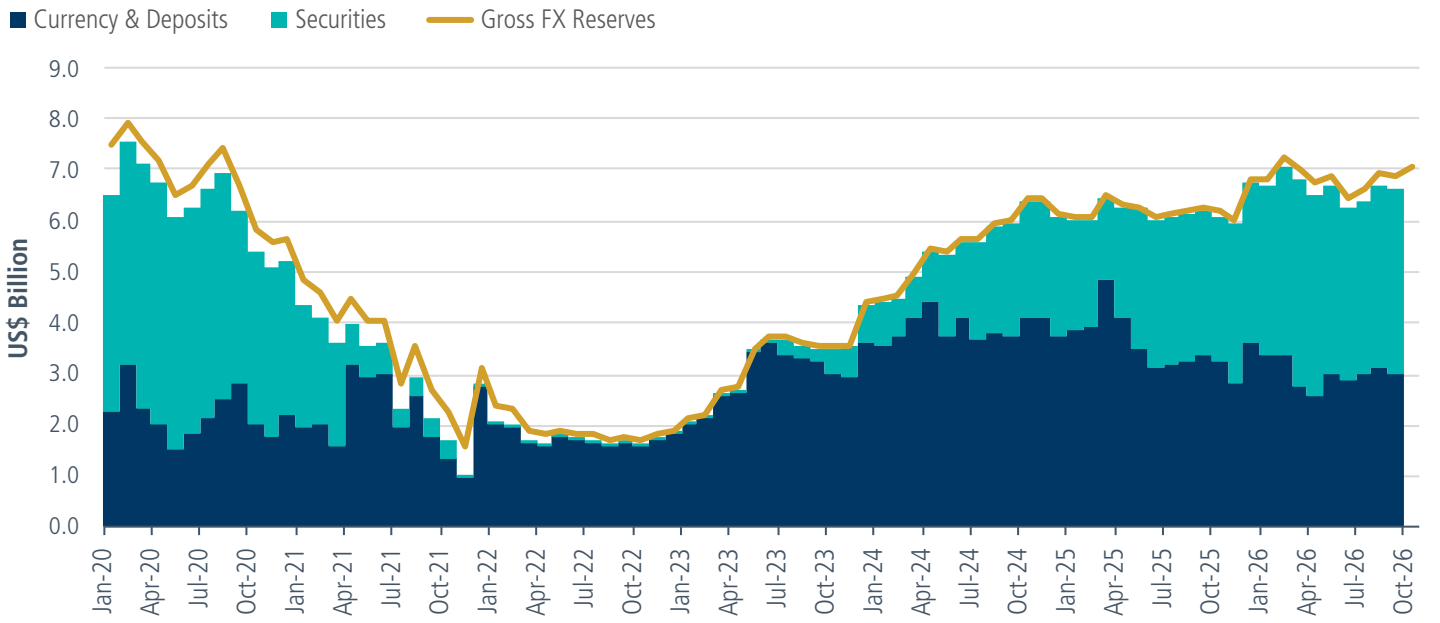
Consensus for 2027 looks reasonable to us: growth of 3.8%, inflation back at the 5% target, a fiscal deficit just under 4% of GDP, a near-balanced current account, and public debt falling below 91% of GDP. If anything, the tone of our meetings points to modest upside. Corporate capacity utilization had only recovered to around 2018 levels by 2025, and private sector participants expect firms to begin investing again to expand capacity next year. Fitch upgraded the rating to B- despite the conflict, and the IMF has reached a staff-level agreement on the latest review, after the government completed a prior action on fuel and electricity pricing tied to the 2027 budget.

The bigger question is what replaces the IMF program when it ends in March 2027. The Deputy Finance Minister told Parliament on October 8 that discussions are underway on options beyond the current program, describing "a shift from crisis-driven support towards a more sustainable, long-term growth-targeted engagement model." We expect a follow-on arrangement rather than a cliff. The key test is whether fiscal discipline holds once the program is no longer there as an external anchor, and the government's record so far gives us confidence that it will.

The quality of policymaking supports this view. Fuel and electricity pricing has been returned to cost recovery. The debt office now publishes a medium-term strategy and runs weekly domestic auctions, the Sri Lankan Airlines debt exchange is complete, and only US$300 million of the US$28 billion of external sovereign debt remains to be restructured. The unresolved debt is held by Hamilton Reserve Bank, believed to be involved with the former President Gotabaya Rajapaksa's family. Capital spending is the weak spot: of roughly US$500 million budgeted for cyclone reconstruction, only around US$40 million has been approved. We see this as a capacity problem rather than a lack of intent. Many infrastructure projects are a decade old and have to be re-costed, and a rigorous anti-corruption drive has slowed procurement even as it has cleaned up tenders. The upside is that capital spending has room to increase without damaging the fiscal result.

The buffers are also much larger than in 2022 when Sri Lanka defaulted. Public debt has fallen by about 30 percentage points since the crisis, to 91% of GDP as of

Figure 3: Foreign Exchange Reserves



Source: Central Bank of Sri Lanka

Q2 2026, gross financing needs have nearly halved, and interest now absorbs less than half of revenue rather than 80%. Favorably, reserves in hard currency securities rose from zero in the crisis to US$3.5 billion by the beginning of 2025, staying stable through today. Less favorably, gross reserves rose only modestly to US$6.8 billion, and much of the accumulation so far has relied on concessional inflows. Several drains are coming within the next year that lower external debt service will only partly offset. Our meetings suggested that the IMF's reserve and Eurobond issuance assumptions are too optimistic, and we would not be surprised to see unchanged reserves through 2027.

The other risks are outside of Sri Lanka's control. Oil above US$100 next year would pressure both the current account and reserves. Tourism is exposed to any escalation that disrupts winter travel, although September arrivals ran ahead of 2025, even with the conflict ongoing. Remittances are more diversified than the headline Middle East share suggests, with flows from Europe rising through formal channels. El Niño could bring drought in Q1 2027, but rice stocks provide a buffer of around three and a half months, and the current harvest should add to it. Rapid solar expansion with full reservoirs for hydropower limit the risk to power generation. Barring an extended escalation in the Iran conflict, we see minimal impact on growth from these risks and a manageable impact on prices.

The longer-term constraint is potential growth. Much of the 2024-26 rebound was catch-up and post-cyclone rebuilding, and the shared view in Colombo is that the economy can sustain about 4% real GDP growth without major reform. Going beyond that requires foreign direct investment, and Sri Lanka remains a relatively closed economy, with high energy costs, significant regulatory barriers and few privatizations over the last twenty years. The success of the Port of Colombo, which handles some 12 million containers a year, shows what is possible, and trade facilitation, including a single-window customs system, now in live testing, is a step in the right direction. These constraints do not threaten the 2027 outlook but do hamper the upside beyond it.

A Government That Has to Perform

The politics reinforce the economics. In the November 2024 parliamentary election, the National People's Power (NPP) coalition won 61.6% of the vote, up from 3.8% four years earlier. We estimate its core base at around 5% of voters, i.e. the original Janatha Vimukthi Peramuna (JVP) party, the largest in the NPP coalition. The important point is that fewer than one in ten 2024 NPP voters were party loyalists. The rest voted for change and competence

Temple of the Tooth, Kandy, Sri Lanka



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after the 2022 crisis, and for a President whose personal credibility goes well beyond his party's. In our view, this is the most important political fact about the country. The government's mandate is to outperform its predecessors, not to implement the JVP's political philosophy, and its leadership appears acutely aware that its support depends on delivery.

This helps explain what we saw in Colombo. The business community has more access than anyone expected from a government of this political orientation, and a former chair of the chamber of commerce serves as the President's chief economic adviser. The ruling party has deferred to the central bank rather than pressing for more control over it, and the bulk of the reform agenda inherited under the IMF program has been carried forward rather than reversed. Some in the private sector see the IMF as having provided valuable cover against populist pressure, which is one reason the commitment to continued engagement matters. With elections scheduled for September and November 2029, there is a reasonable runway before election-related fiscal pressure becomes a risk.

Looking Forward

Sri Lanka continues to beat expectations on growth and the fiscal balance, the policy approach is credible, and the buffers against risks are healthy. The Iran shock has tested that resilience, and so far the economy has been slightly bent, not broken. We see the main risks as oil prices, reserve accumulation, tourism and the shape of the IMF engagement that follows the current program, but they do not seem likely to derail the positives. We remain of the opinion that consensus continues to set expectations too low. Our view underpins overweight positions in both hard and local currency sovereign bonds.

Payden&Rygel

LOS ANGELES | BOSTON | LONDON | MILAN

Los Angeles

333 South Grand Ave.
Los Angeles,
CA 90071
USA
Tel +1 213 625 1900

Boston

265 Franklin Street
Boston,
MA 02110
USA
Tel +1 617 807 1990

London

1 Bartholomew Lane
London
EC2N 2AX
UK
Tel +44 20 7621 3000

Milan

Corso Matteotti,
1 20121
Milan
Italy
Tel +39 02 7606 7111

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