Potential Effects COVID-19 Might Have on Money Market Funds, & Cytonn Weekly #12/2020

Focus of the Week

Introduction

The novel Coronavirus, better known as COVID-19 in the medical community, is a group of viruses that causes respiratory tract illnesses. COVID-19 was first reported on 31st December 2019 in the city of Wuhan, China and currently, the disease has spread to over 104 countries with major economies such as Italy, Japan, South Korea, France, Spain, Australia, and the US reporting thousands of cases of the virus within their borders, and deaths related to the virus. The first case of Coronavirus infection within Kenya's borders was reported on the 13th of March 2019, and so far, Kenya has reported seven confirmed cases. The impact felt in the local financial market mirrors what has equally been witnessed in the global setting. The uncertainty brought about by the disease, more so with World Health Organization (WHO) declaring it a pandemic, has seen investors selling-off risky assets such as equities in favor of safe havens such as gold and US Treasuries.

Last week, we discussed the Impact of Coronavirus to the Kenyan Economy, covering how the pandemic started, the current state of affairs, noting that despite the virus spreading, emotional contagion also played a significant role in amplifying the effects of the pandemic on the global economy. We analyzed the effects the pandemic has had on the global economy weighing in on how the virus has negatively impacted international trade, the financial & commodity markets, and the global macroeconomic environment. Closer home, we focused on the effects experienced so far in the Kenyan economy where we had already witnessed, with the major ones being:

I. **Equities Sell Offs** – We have witnessed massive sell-offs in the equities market as investors divest away from risky assets, which saw the Nairobi All Share Index (NASI) drop by 0.5% between 13th March 2020 and 20th March 2020 and 20.1% on a year-to-date basis, and the resultant heightened demand for fixed income instruments as investors sought safe havens,

II. **Currency Volatility** - The Kenyan Shilling has experienced a lot of volatility**,** due to persistent concerns about the impact of the Coronavirus and heightened worries about the potential drop of hard currency inflows. This has seen the Kenyan Shilling depreciating by 3.7% against the US Dollar YTD, to close at a 4.5-year low of Kshs 105.1 this week, and,

III. **Disrupted Supply Chains**- The spread of the virus has also disrupted the global supply chain and Kenya has not been spared either. Imports from China account for approximately 21.0% of Kenya's total imports and with the current lockdown, activities within the manufacturing sector are likely to be disrupted.

Following last week's Focus Note, several of our readers requested us to focus on the effect on Money Market Funds. Consequently, this week, we revisit the topic, with our focus being on the possible effects the Coronavirus might have on Money Market Funds. Under this, we shall be discussing the following;

i. Current Situation of the Kenyan Macroeconomic Environment,
ii. Current Situation of the Fixed Income Market in Kenya:
    a. Interest Rates,
    b. Bond Yields, and
    c. Bank Deposits.
iii. Constituents of Money Market Funds & Impact of Coronavirus on Each Asset Class, and
iv. Conclusion – Overall Impact on Money Market Funds.

Section I: Current Situation of the Kenyan Macroeconomic Environment

In the Cytonn 2020 Markets Outlook, we projected Kenya's 2020 GDP growth to come within the range of 5.6% - 5.8%, supported by expected improvements in private sector growth, coupled with anticipation for stable growth of the agricultural sector and public infrastructural investments to be driven by budgetary allocations in infrastructural projects. However, since the outbreak of the virus coupled with the invasion of locust in the country, key sectors such as the Agricultural sector have already taken a bad hit, and has resulted in severe implications for macroeconomic indicators in the country as highlighted below:

Indicators	Impact	Effect
GDP Growth	· The key sectors of the economy affected by the Coronavirus pandemic include the Tourism, Agricultural, and Manufacturing sectors which were hit the hardest hit due to shutdowns in major markets and the disruption of the global supply chain. Combined, the 3 sectors account for 43.8% of Kenya's GDP in 2018. · Based on the impacts witnessed so far, we believe that Coronavirus may have a 10.0% to 25.0% impact on GDP growth for the year 2020. The 10.0% impact is an optimistic case in the event the outbreak is contained, and a 25.0% impact in the event it is not contained. As such, the coronavirus could reduce Kenya's GDP growth to a range of 4.3% to 5.2% for the year 2020 depending on the severity of the outbreak and economic implications for Kenya.	**Negative**
Inflation	· There are expectations of inflationary pressure emanating from the effects of the world Pandemic-Coronavirus, driven by supply-side shortages owing to lockdowns across the globe which have disrupted supply chains, further heightening cost-push inflation.	**Neutral**
Currency	· The Kenyan Shilling has experienced a lot of volatility, due to persistent concerns about the impact of the coronavirus and heightened worries about the potential drop of hard currency inflows. This saw the Shilling depreciating by 4.2% against the US Dollar during the week to close at Kshs 105.1, from Kshs 102.4 recorded last week, making it a 4.5-years low, prompting Central Bank of Kenya to sell dollars to limit the losses. · Going forward, the global uncertainty surrounding the outbreak of the virus is likely to continue exerting pressure on the shilling due to the supply chain disruptions, and subdued diaspora remittances growth.	**Negative**
Fiscal Position	· As per the Budget Policy Statement, the fiscal deficit for FY2019/20 was estimated at 6.3% of GDP and although the government continues to pursue the fiscal consolidation policy, risks abound from possible reallocation of funds in a bid to contain the spread of the Coronavirus. This is expected to further widen the fiscal deficit away from the projected decline to 4.9% of GDP in FY 2020/21. · On this front, the Central Bank of Kenya (CBK), this week under Sections 9 and 51 of the CBK Act and following approval by the Board, announced that it had transferred Kshs 7.4 bn from its General Reserve Fund to the Government Consolidated Fund in support of the fight against Coronavirus.	**Negative**
Private Sector Credit Growth	· This week, Kenya Bankers Association (KBA) announced that commercial banks will provide relief with the loan repayment tenor extended by a period up to 12-months for all personal loans that were current on 2nd March 2020 and a possible loan restructuring for SMEs and corporate borrowers, a further indication of the defaults expectations. · The effects of the coronavirus pandemic are expected to negatively affect the financial sector. We expect to see increased caution on lending especially to businesses that rely on imports hence inhibiting private credit sector growth due to the high risk of credit default, with the possibility of heightened Non Performing Loans if the pandemic is to continue.	**Negative**

Section II: Current Situation of the Fixed Income Market in Kenya

Fixed Income markets are markets where securities such as certificates of deposits, corporate &

government bonds and other money market instruments. In light of the Coronavirus pandemic, we weigh in on the current situation of the Fixed Income Market in Kenya;

a. **Interest Rates -** Around the globe, we have seen several central banks ease monetary policies to support the economy amid the negative macroeconomic effects emanating from the Coronavirus pandemic. The table below shows how Central Banks of major global economies have moved to cut interest so far;

No.	Country	Central Bank	Reduction Margin	Current Rate
1	USA	Federal Reserve	1.00% Point	0%-0.25%
2	Australia	Reserve Bank of Australia	0.25% Points	0.50%
3	China	People's Bank of China	0.10% Points	4.10%
4	Malaysia	Central Bank of Malaysia	0.25% Points	2.75%
5	England	Bank of England	0.50% Points	0.25%

Locally, the Monetary Policy Committee (MPC) is set to meet on 23rd March 2020 to review the outcome of its previous policy decisions and recent economic developments. Similar to the actions of other Central Banks, we expect the MPC to maintain the status quo and reduce the Central Bank Rate (CBR) by up to 100 basis points to 7.25% from 8.25% in a bid to boost the economy amid the uncertainty and supply chain shortages caused by the Coronavirus.

However, we do not expect this to pass on to bank rates. The enactment of the Banking (Amendment) Act 2015 in September 2016, introducing interest rate controls, reduced the effectiveness of the monetary policy and made it difficult for the CBK to adjust the monetary policy rates in response to economic developments. Following the repeal of Section 33B of the Banking Act, the implementation of expansionary monetary policy continues to be difficult because with the tough and uncertain economic environment, banks find it even more difficult to price for risk at lower interest rates. In such an event, banks will also not increase their deposit rates.

On this premise, we believe that a big part of the solution to broken supply chains, and the sharp fall in demand in industries acutely affected by the virus, is fiscal, and as such monetary policy might not be effective in injecting the requisite liquidity to the economy, owing to the fact that Banks are expected to take a cautious stance in lending due to the heightened likelihood of defaults and as such **we do not foresee a decline in lending interest rates, and also do not expect an increase in deposit rates at banks**. Consequently, we believe this is the main reason that has driven the Kenyan Government to take a rather unconventional type of quantitative easing by transferring Kshs 7.4 bn obtained from the demonetization exercise of the older series Kshs 1,000 notes from its General Reserve Fund to the Government Consolidated Fund in a bid to inject new money into the money supply,

b. **Bond Yields -** Over the last two weeks, the bond market recorded reduced activity with bonds worth Kshs 30.1 bn transacted, 13.8% lower compared to Kshs 34.9 bn registered in the last two weeks before the first case of Coronavirus was recorded in the country. We attribute dampened activity to large players such as commercial banks preferring to hold excess liquidity in the current uncertain environment. This week, only the 1-year, 5-Year and 11-Year yields recorded price gains as their yields decline with the other bonds recording price losses as yields rose across the board. **We expect the yields on government securities to remain stable despite the expected cut on the CBR, with a bias to an upward readjustment in the yield curve.** We believe that in the absence of credit risk, the main feature associated with Government-issued securities, the value of the cash flows accrued to such investors becomes a function of their required return based on inflation expectations, which presents a risk of effectively eroding the purchasing power of such securities future cash flows. With the expectations of heightened inflationary pressures, we believe that investors will continue demanding higher yields to compensate for the inflation risk, which will possibly lead to higher yields, and,

c. **Bank Deposits –** Despite the corona pandemic, liquidity in the money market has remained relatively favorable with the interbank rate averaging 4.2%, below the 4.3% average for the entire year so far. We believe favorable liquidity conditions will persist in the money markets, following the drive by the Government as well as the industry players to discourage cash transactions in the economy in favor of mobile money transactions, card payments, and internet banking to reduce the risk of transmission of Covid-19 via hard currency. This directive has also seen financial industry players waive costs associated with the transfer of money between their mobile wallets and bank accounts. However, given the prevailing environment and movement of funds away from the equities market, towards investor perceived safe havens such as bank deposits, government instruments and gold, **we do not expect any changes in deposit rates, given that supply of funds towards the banking sector will not be affected.**

Section III: Constituents of Money Market Funds & Impact of Coronavirus on Each Asset Class

Money Market Funds are conservative funds designed to serve the needs of investors whose primary goal is capital preservation, and who are willing to accept a modest return on their investment portfolio in return for more safety and liquidity. Therefore, to achieve this objective, Money Market Funds primarily invest in securities with short maturities and pose minimal investment risks such as fixed deposits, Government-issued securities, and commercial paper. As at 31st December 2019, the Money Market industry's exposure to Cash and Fixed Deposit and Securities Issued by the Government of Kenya stood at 31.2% and 55.7%, respectively, bringing the combined exposure to 86.8%. The table below highlights the Capital Markets Authority's provisions for the above-mentioned asset classes, their investment limits, actual exposure as at 31st December 2019 and our expectations on the effects potent to them from the current ongoing pandemic:

Money Market Funds Investment Instruments

Asset Class	Impact	Effect	*Investment Limits	**Actual Exposure
Cash, Demand Deposits and Fixed Deposits	· Owing to the continued favorable conditions in the money markets and the continued drive by the Banking industry players as well as the Government to push for cashless transactions which have seen Banks waive costs associated with the transfer of money between their mobile wallets and bank accounts, we believe Banks will not be facing liquidity crunches. However, given the prevailing environment and movement of funds away from the equities market, towards investor perceived safe havens such as bank deposits, government instruments and gold, we do not expect any changes in deposit rates, given that supply of funds towards the banking sector will not be affected. · With reduced monetary policy effectiveness, we do not foresee any cut in the Central Bank Rate (CBR) affecting bank deposit and lending rates.	**Neutral**	100.0%	31.2%
Securities Issued by the GoK (Government T-Bills and Bonds)	· We expect the yields on government securities to remain stable despite the expected cut on the CBR, with a bias to an upward readjustment in the yield curve. We believe that in the absence of credit risk, the main feature associated with Government-issued securities, the value of the cash flows accrued to such investors becomes a function of their required return based on inflation expectations which presents a risk of effectively eroding the purchasing power of such securities future cash flows. With the expectations of heightened inflationary pressures, we believe that investors will continue demanding higher yields to compensate for the inflation risk	**Positive**	80.0%	55.7%

Money Market Funds Investment Instruments

Asset Class	Impact	Effect	*Investment Limits	**Actual Exposure
Securities Listed on NSE Excluding GoK & Any Other Unlisted Securities & Other Collective Investment Schemes	· Investments away from the bank deposits and government securities ie. securities listed in the NSE excluding GoK, any other unlisted securities and other collective investment schemes exposes money market funds to higher returns while providing diversification. During this period of uncertainties, investment managers and investors may look for a slight premium on such investments; however we foresee little to no additional allocation away from bank deposits and government securities.	**Neutral**	25.0% for Each	13.1%

Investment Limits are the maximum allowable limits for Money Market Funds as per the Capital Markets Regulations.
***** Source: CMA, Q4'2019 Collective Investment Schemes Report***

Based on the above-mentioned factors, we expect the yields on Money Market Funds to remain stable, with a likelihood of going higher. The table below highlights the yields of Money Market Funds in the market as published on 21st March 2020;

Fund Managers' Money Market Fund Yields as Published on 21/03/2020

Rank	Fund Manager	Daily Yield	Effective Annual Rate
1	Cytonn Money Market Fund	10.41%	10.96%
2	Zimele Money Market Fund	9.56%	9.91%
3	Nabo Africa Money Market Fund	9.46%	9.89%
4	Alphafrica Kaisha Money Market Fund	9.19%	9.81%
5	CIC Money Market Fund	9.40%	9.75%
6	Sanlam Money Market Fund	9.23%	9.67%
7	Madison Money Market Fund	9.11%	9.54%
8	Dry Associates Money Market Fund	8.66%	9.02%
9	Co-op Money Market Fund	8.51%	8.85%
10	Apollo Money Market Fund	9.31%	8.72%
11	GenCapHela Imara Money Market Fund	8.20%	8.52%
12	NCBA Money Market Fund	8.18%	8.49%
13	British-American Money Market Fund	8.02%	8.32%
14	Amana Money Market Fund	8.00%	8.20%
15	ICEA Lion Money Market Fund	7.87%	8.19%
16	AA Kenya Shillings Fund	7.21%	7.45%
17	STANLIB Money Market Fund	6.15%	6.32%
18	Old Mutual Money Market Fund	4.91%	4.80%
	Average	**8.41%**	**8.69%**

Source: Daily Newspaper Publishing for Money Market Fund Yields

Money Market industry's exposure to Securities Issued by the Government of Kenya continues to be the highest coming in at 55.6%, as at the end of 2019. The expectations of stability in yields on government securities will provide an adequate buffer on the Money Market Funds effective annual yields. In the event that interest rates from Cash, Demand Deposits and Fixed Deposits decline, we expect to see a readjustment in the Money Market Funds Portfolios to skew towards increased exposure in Government securities to abate any reinvestment risks (the possibility that an investor will be unable to reinvest cash flows at a rate comparable to their current rate of return).

Conclusion

In conclusion, we believe that for Money Market Funds;

i. **Returns for Money Market Funds will remain stable with a bias to a slight increase upwards should rates on government securities increase, and,**
ii. **They will remain the most liquid of all mutual funds providing a short-term parking bay that earns higher income yields compared to deposits and savings accounts.**

Further, with increased digitization and automation, liquidity is enhanced and an investor should receive their funds within 3 to 5 working days if they are withdrawing to their bank accounts, and immediate access to funds when withdrawing via M-Pesa. Also, as investors are fleeing to the Fixed Income market in light of current economic conditions, we believe that due to economies of scale, small investors are unable to do so. Money Market Funds allow such investors to re-align their investments with their risk appetites by pooling money together and invest in safe havens. Also noting that historically markets have shown an ability to bounce back from events that sparked volatility, we are of the view that the coronavirus pandemic will be no exception. Thus, it is important that investors remain calm even in the face of uncertainty.

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