Cytonn Monthly - May 2020

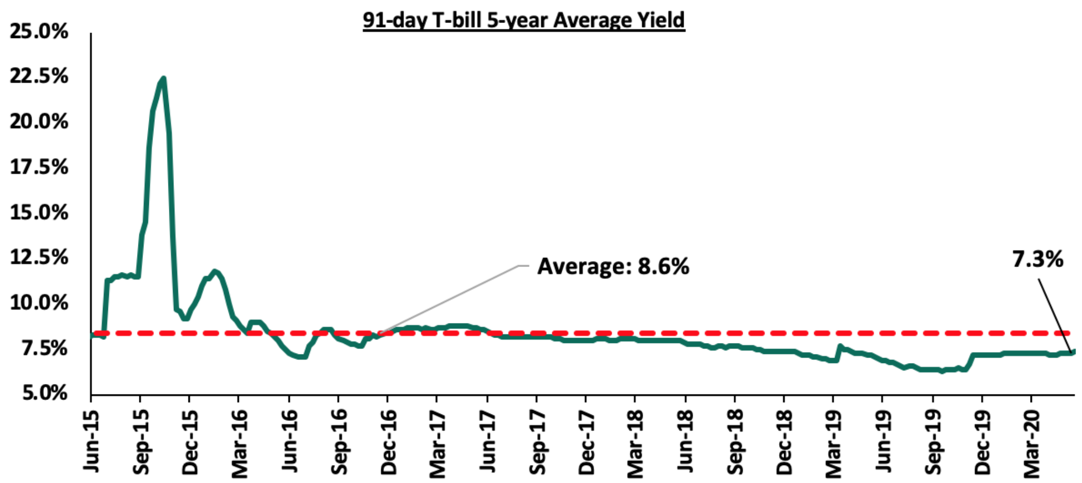
Fixed Income

Money Markets, T-Bills & T-Bonds Primary Auction:

During the month of May, T-bill auctions recorded an oversubscription, with the overall subscription rate coming in at 103.7%, compared to 72.8% recorded in the month of April. The oversubscription is attributable to high liquidity in the money markets during the month supported by government payments. The subscription rates for the 91-day, 182-day and 364-day paper rose to 151.3%, 61.5% and 126.8%, respectively, from the 86.8%, 28.4% and 111.7% recorded in April. The Central Bank remained disciplined in rejecting expensive bids in order to ensure the stability of interest rates as evidenced by them rejecting expensive bids and therefore leading to a marginal increase of 0.1% points to 7.3%, 8.2% and 9.2%, respectively across the various tenors 91-day, 182-day and 364-day papers. The T-bills acceptance rate came in at 80.1% during the month, compared to 97.2% recorded in April, with the government accepting a total of Kshs 79.7 bn of the Kshs 99.5 bn worth of bids received.

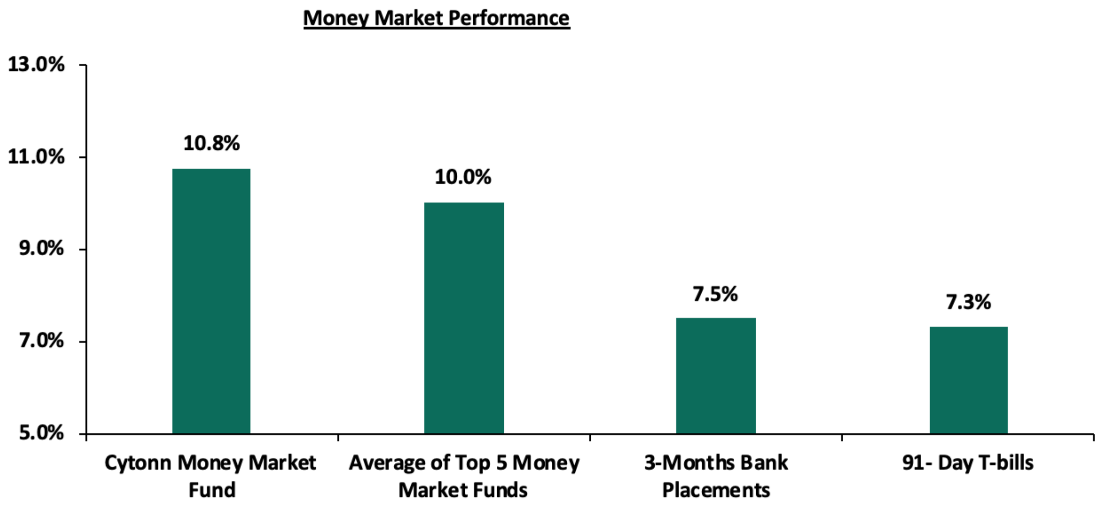
During the week, T-bills were oversubscribed, with the subscription rate coming in at 102.5%, down from 149.3% the previous week. The subscription rate of the 91-day and 182-day papers declined to 81.3% and 58.4%, respectively, from 271.0% and 104.9% recorded the previous week, respectively. The subscription rate for the 364-day paper however improved to 155.0%, from 145.0% recorded the previous week. The yields on the 91-day, 182-day and 364-day papers remained unchanged at 7.3%, 8.2% and 9.2%, respectively. The acceptance rate declined to 58.5%, from 74.1% recorded the previous week, with the government accepting Kshs 14.4 bn of the Kshs 24.6 bn bids received.

The 91-day T-bill is currently trading at a yield of 7.3%, which is below its 5-year average of 8.6%. The yield has, however, increased surpassing the 2019 average of 6.9% mainly attributable to the repeal of interest rate cap, which has seen increased lending to the private sector, forcing the government to accept expensive bids in order to secure funds from investors to meet their domestic borrowing target.



For the month of May and away from the norm of issuing a bond once in a month the government initially issued a Five-year bond and later re-opened the same bond; FXD1/2020/5 with a coupon of 11.7% which was market-determined. The initial amount they sought to raise was Kshs 50 bn and the subsequent amount was Kshs 30bn. The bond was undersubscribed in both the issues receiving subscriptions of 69.1% and 68.6% during the initial issue and the reopen, respectively. The under subscription was partly attributable to investors' uncertainty and increased risk perception as the country was downgraded by Moody's and the expectation of high rates due to increased need by the government to borrow more in line with the budget for 2019/2020. The yield on the 5-year bond came in at 11.8% and 11.7% respectively for the issue and re-open, with the government accepting Kshs 20.8 bn out of the Kshs 34.5 bn worth of bids received, translating to an acceptance rate of 60.2%, and Kshs 8.9 bn out of the Kshs 20.6 bn worth of bids received, translating to an acceptance rate of 43.5%, respectively.

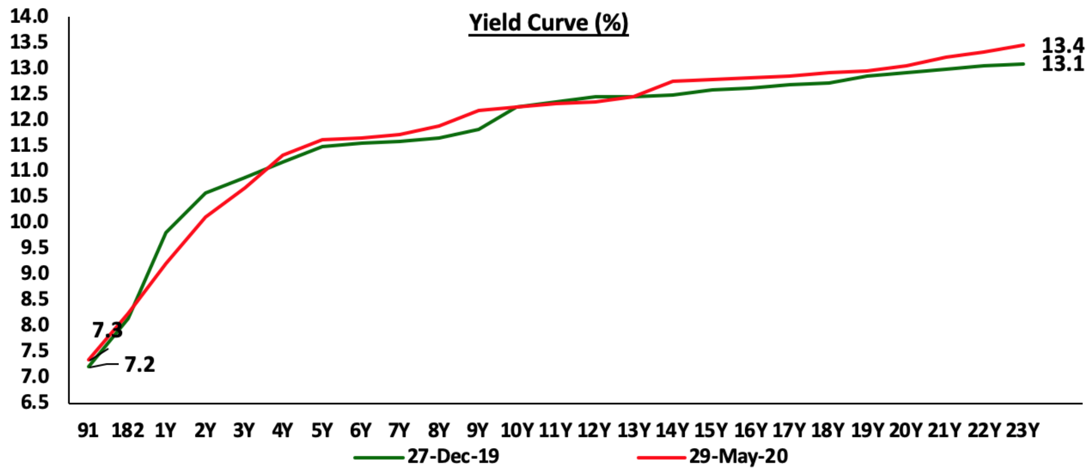
The government also issued an infrastructure bond, IFB1/2020/6 with an effective tenor of 6.0 years and a coupon rate of 10.2% in a bid to raise Kshs 25.6 bn for funding of infrastructure projects in the FY'2019/20 budget estimates. The bond was undersubscribed with the subscription rate coming in at 82.7%, with the government receiving bids worth Kshs 21.2 bn out of the Kshs 25.6 bn offered. The yield came in at 11.6% with the government accepting Kshs 19.3 bn worth of bids received, translating to an acceptance rate of 91.1%.



In the money markets, yields on the short term papers remained unchanged at 7.3% and 10.0% for the 91-day T-bill and the average yield of top 5 money market funds, while the yield on 3-month bank placements declined to 7.5% from 7.9% recorded the previous week. The yield on the Cytonn Money Market Fund increased marginally by 0.1% points to close the week at 10.8% from 10.7% recorded the previous week.

Secondary Bond Market:

According to the FTSE NSE Kenya Government Bond Index, the secondary market lost by 0.2% during the month closing the month at 96.5 from 96.7, recorded in April, with most papers having declined YTD as yields readjust upwards with the exception of the 1 – 3 year papers and 11 – 13 year papers.

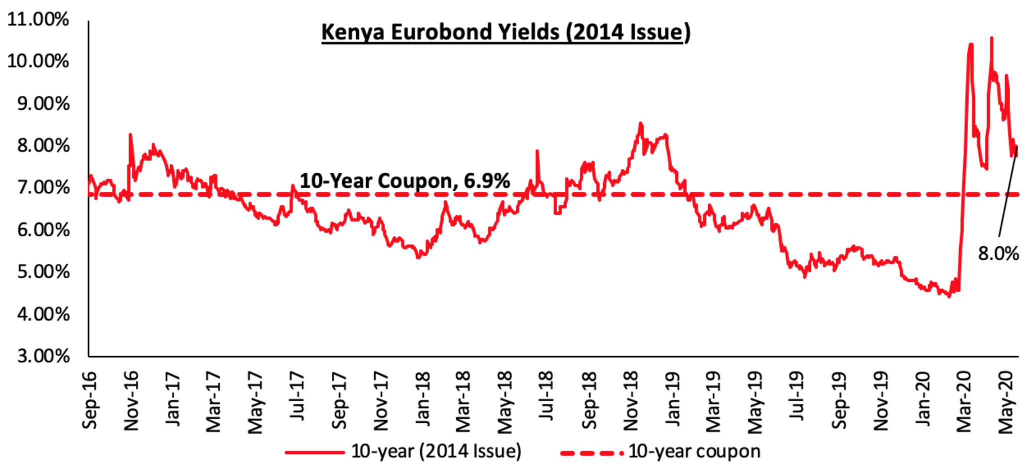


Liquidity:

Liquidity in the money markets eased during the month of May with the average interbank rate declining to 4.1%, from 5.3% recorded in April mainly supported government payments and tax refunds done during the month, and the reduction of the Cash Reserve Ratio (CRR) to 4.25%, from 5.25% previously, by the Monetary Policy Committee (MPC) during its March 2020 sitting. The reduction in (CRR) freed up Kshs 35.2 bn to provide additional liquidity to commercial banks for onward lending to distressed borrowers during the COVID-19 pandemic. During the week, the average interbank rate declined to 3.5% from 4.2% recorded the previous week, due to increased liquidity in the money markets due to pending bill payments and tax refunds. The average interbank volumes rose by 80.4% to Kshs 20.7 bn, from Kshs 11.5 bn recorded the previous week.

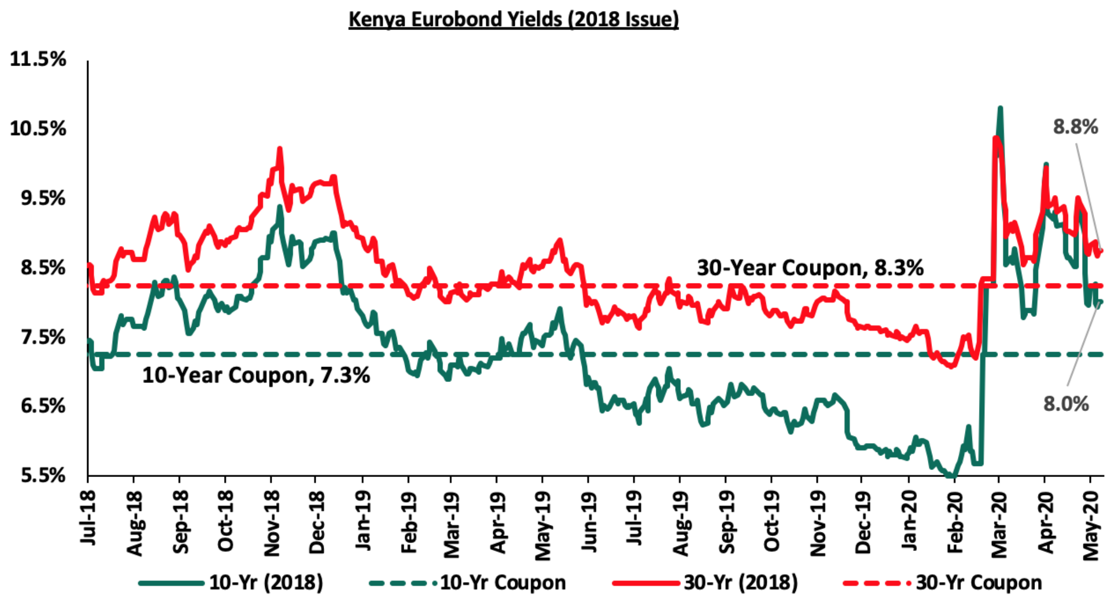
Kenya Eurobonds:

According to Reuters, the yield on the 10-year Eurobond issued in June 2014 declined by 1.5% points to 8.0% in May, from 9.5% in April. During the week, the yield on the 10-year Eurobond remained unchanged at 8.0%, similar to what was recorded the previous week. Notably, all the Eurobonds yields declined significantly in May. The performance was mainly driven by improved investor sentiments as the market reacted to the news by the World Bank that they had approved USD 1.0 bn funding to support the economy as well as the Rapid Credit Facility (RCF) which reaffirmed investors' confidence despite the recent downgrade by Moody's where Kenya's sovereign credit outlook was changed to negative from stable.

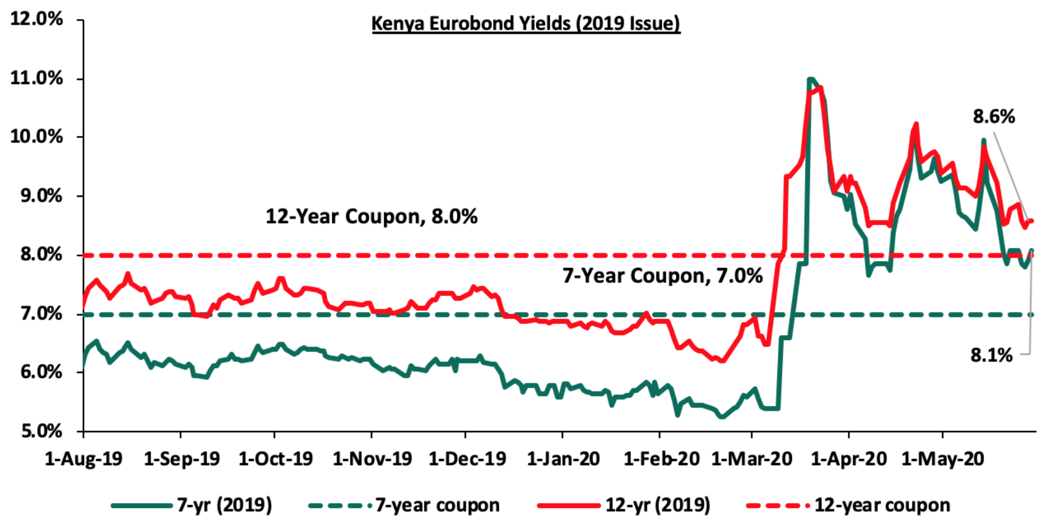


During the month, the yields on the 10 and 30 year Eurobonds issued in February 2018 declined by 1.1% points and 0.5% points to close at 8.0% and 8.8%, respectively, from 9.1% and 9.3% in April. During the week, the yield on the 10-year Eurobond declined by 0.2% points to close at 8.0% from

8.2% recorded the previous week. The 30-year Eurobond remained unchanged at 8.8% similar to what was recorded the previous week.



During the month, the yields on the newly issued dual-tranche Eurobond with 7-years declined by 1.2% points to 8.1% from 9.3% in April. The 12-year Eurobond decreased by 0.8% points to 8.6% from 9.4% in April. During the week, the yields on the 7-year remained unchanged at 8.1% while that of the 12-year Eurobond declined by 0.2% points to 8.6% from 8.8% recorded the previous week.



Kenya Shilling:

During the month, the Kenya Shilling appreciated by 0.3% against the US Dollar to close at Kshs 106.9, from Kshs 107.3 recorded at the end of April, mostly attributable to the increased forex reserves which rose to a four-month high USD 8.5 bn as the Central bank received the USD 750.0 mn from the International Monetary Fund for economic support cushioning the shilling from the hard currency dollar demand. During the week, the Kenya Shilling remained unchanged against the US Dollar to close the week at Kshs 106.9 similar to what was recorded the previous week. The shilling was supported by some USD flows from USD amidst reduced demand from merchandise importers. On an YTD basis, the shilling has depreciated by 5.5% against the dollar, in comparison to the 0.5% appreciation in 2019. We expect continued pressure on the shilling due to:

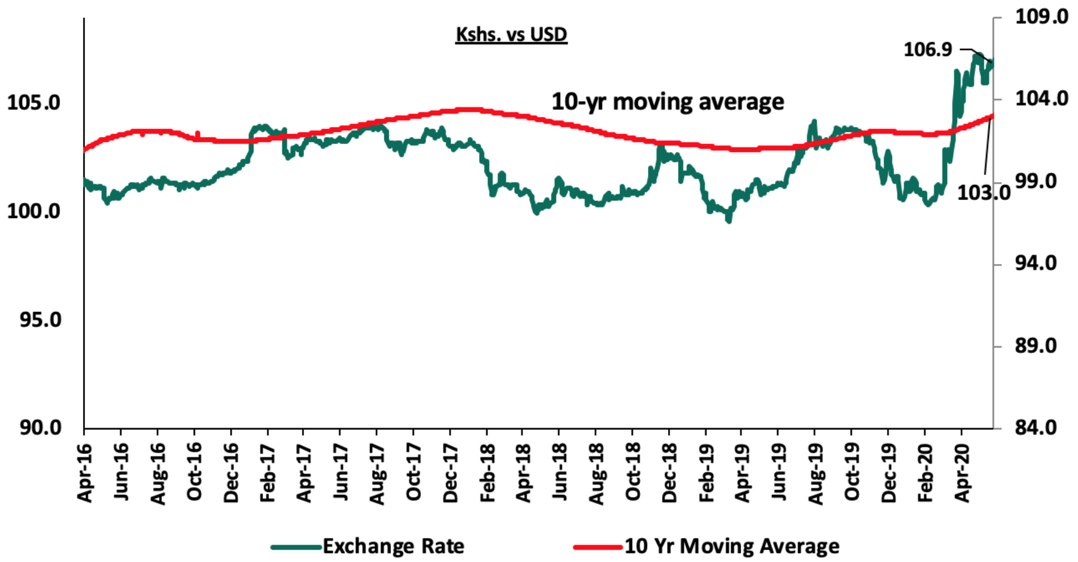
i. High dollar demand from foreigners exiting the market as they direct their funds to safer havens,
ii. Increased demand as merchandise and energy sector importers beef up their hard currency

positions amid a slowdown in foreign dollar currency inflows, and,

iii. Subdued diaspora remittances evidenced by the 9.0% decline to USD 208.2 mn in April 2020, from USD 228.8 seen the previous month, mainly due to the decline in economic activities globally, coupled with increased prices of household items leading to lower disposable income. The CBK expects a 12.0% decline in remittances in 2020.

The shilling is however expected to be supported by:

i. High levels of forex reserves, currently at USD 8.5 mn (equivalent to 5.1-months of import cover), above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover. As a result of inflows from the IMF Rapid Credit Facility (RCF) approved during the week reserves rose by 8.7% to USD 8.4 mn from USD 7.8 mn,



Monetary Policy

The Monetary Policy Committee (MPC) met on 27th May 2020 to review the prevailing macroeconomic conditions and decide on the direction of the Central Bank Rate (CBR). The MPC maintained the CBR at 7.00%, which in line with our expectations in our MPC May 2020 Note. The MPC indicated that the previous cut in CBR rate in their 29th April 2020 meeting, from 7.25% to the current 7.00%, was having the intended outcome but they noted that the Coronavirus pandemic had continued to affect economic growth and as such, there would be a need further cushion the economy. After their sitting on Wednesday, the committee highlighted that;

i. Inflation is expected to remain within the Government's 2.5% - 7.5% target range, largely supported by the improving food supply due to favourable weather conditions, lower international oil prices, the impact of the reduction of VAT and muted demand pressures,

ii. Taking into consideration the impact of COVID-19, the current account deficit is expected to remain at 5.8% of GDP in 2020, with the lower oil imports more than offsetting the projected reduction in remittances. However, horticulture exports and receipts from transport and tourism services are expected to decline due to the impact of COVID-19, and,

iii. There was an Improvement in private sector credit growth, coming in at 9.0% in the 12-months to April 2020, above the 5-Year historical average, of 8.0%. Strong credit growth was observed in the Manufacturing sector (20.1%), trade (10.3%) and transport and communication (9.1%).

The committee noted that the policy measures put in place in March and April were having the intended effect on the economy and are still being transmitted. They concluded that the current accommodative stance is appropriate. We maintain our view that monetary policy stimulus measures may not be highly effective in combating the effects emanating from the COVID-19 pandemic especially in some sectors such as the tourism sector which have been hit by demand-side issues. We believe what businesses and the economy as a whole needs is financial relief as highlighted in our report on COVID-19 Economic Containment Policies in order to ensure survival during this period of uncertainties.

Inflation

The y/y inflation for the month of May declined marginally to 5.5%, from 5.6% recorded in April 2020 (based on the new CPI base period, February 2019), which was in line with our projections of 5.5% - 5.7%. The decrease was due to a high base effect and despite slight increases in some major components the inflation decreases: Month-on-month inflation came in at 0.6%, and the key things to note:

i. There was 0.9% increase in the food and non-alcoholic drinks' index, due to an increase in prices of significant food items such as onions, carrots, oranges, spinach and Sukuma wiki which increased by 4.5%, 3.3%, 2.6%, 2.2% and 2.0%, respectively,
ii. A 0.8% increase in the housing, water, electricity, gas and other fuels index, as a result the 3.2% increase in the price of kerosene, and,
iii. A 0.02% increase in the transport index on account of increases in the prices of matatu and taxi fares despite the decline in petrol and diesel prices by 9.8% and 19.1%, respectively.

Major Inflation Changes – May 2020

Broad Commodity Group	Price change m/m (May-20/April-20)	Price change y/y (May-20/May-19)	Reason
Food & Non-Alcoholic Beverages	0.9%	10.6%	The m/m increase was due to an increase in prices of significant food items such as onions, carrots, oranges, spinach and Sukuma wiki
Transport Cost	0.0%	5.2%	The m/m change was mainly on account that the benefits from a decrease in pump prices was largely wiped out by the increase in the prices of matatu and taxi fares due to the Covid-19 containment measures
Housing, Water, Electricity, Gas and other Fuels	0.8%	2.6%	The m/m increase was as a result the 3.2% increase in the price of kerosene
Overall Inflation	**0.6%**	**5.5%**	**The m/m increase was due to a 0.9% increase in the food index which has a revised CPI weight of 32.9% and a 0.8% increase in housing, water, electricity, gas and other fuels.**

Going forward, we expect the inflation rate to remain within the government set range of 2.5% - 7.5%. We expect inflation to remain stable despite supply side disruption due to COVID-19 as low demand for commodities compensates for the cost-push inflation, coupled with the low oil prices in the international markets.

Monthly Highlights

1. Global credit rating agency, Moody's released its rating outlook where it changed Kenya's sovereign credit outlook to "negative", from a previous outlook of "stable", and also affirmed the B2 credit rating. The agency pointed out that the negative outlook was a result of rising financial risks brought about by the country's large borrowing requirements especially during this time where the fiscal outlook is deteriorating given the erosion of the revenue base and the high debt and interest burden. For more information, see our Cytonn Weekly #19/2020,
2. The International Monetary Fund (IMF) Executive Board approved a USD 739.0 mn (Kshs 78.7 bn) disbursement to Kenya to be drawn under the Rapid Credit Facility (RCF) to help the country address the impact of COVID-19. In the press release, the IMF highlighted that the Coronavirus pandemic is slowly but surely taking a toll on the Kenyan economy by significantly reducing its growth prospects as well as widening the fiscal and financial needs of the country. For more information, see our Cytonn Weekly #19/2020,
3. The Committee on Finance and Planning tabled their proposals in the National Assembly during the first reading of the Finance Bill, 2020. The amendment was necessitated by the need to legalize the measures announced by the president in March to help cushion the economy against the Coronavirus pandemic. For more information, see our Cytonn Weekly #19/2020,
4. Moody's changed Acorn Group's Kshs 5.0 bn green bond outlook from 'B1 stable' to 'B1 negative'. The bond had a rating of B1 stable when it was issued in 2019 higher than Kenya's sovereign rating of B2 stable at the time. The initial higher rating was informed by a partial guarantee to investors through GuarantCo which assured investors of recovery of up to 50.0% of principal and interest in the case of a default. For more information, see our Cytonn Weekly #20/2020,
5. The International Monetary Fund (IMF) raised Kenya's risk of distress to "High" from "Moderate" due to the effects of the Coronavirus pandemic which has worsened the existing vulnerabilities within the Kenyan economy. Some of the key issues raised include the increased budget deficit and debt vulnerability. For more information, see our Cytonn Weekly #20/2020, and,
6. The World Bank approved US Dollar 1.0 bn financing for Kenya to address the COVID-19 financing gap and support the economy through this period. This is the second-ever such lending from the World Bank after the first in May 2019 where the government received USD 750.0 mn for budgetary support. The country undertook policy reforms to secure the financing and ultimately, directly benefit low-income households in the country. Through this policy, small scale farmers will benefit from better targeting of subsidized agricultural inputs through electronic vouchers. For more information, see our Cytonn Weekly #21/2020.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. The government is 16.1% behind of its current domestic borrowing target of 404.4bn, having borrowed Kshs 300.0 bn against a prorated target of Kshs 357.7 bn. The government had also borrowed 98.4 bn (42.3%) of the 232.8 bn foreign borrowing target, as at 31st March 2020. The uncertainty brought about by the novel Coronavirus will make it harder for the government to access foreign debt due to uncertainty affecting the global markets which might see investors attaching a high-risk premium on the country. A budget deficit is likely to result from the depressed revenue collection with the revenue target for FY'2019/2020 at Kshs 2.1 tn, creating uncertainty in the interest rate environment as additional borrowing from the domestic market goes to plug the deficit. Owing to this uncertain environment, our view is that investors should be biased towards short-term fixed income securities to reduce duration risk.