Cytonn Monthly - July 2020

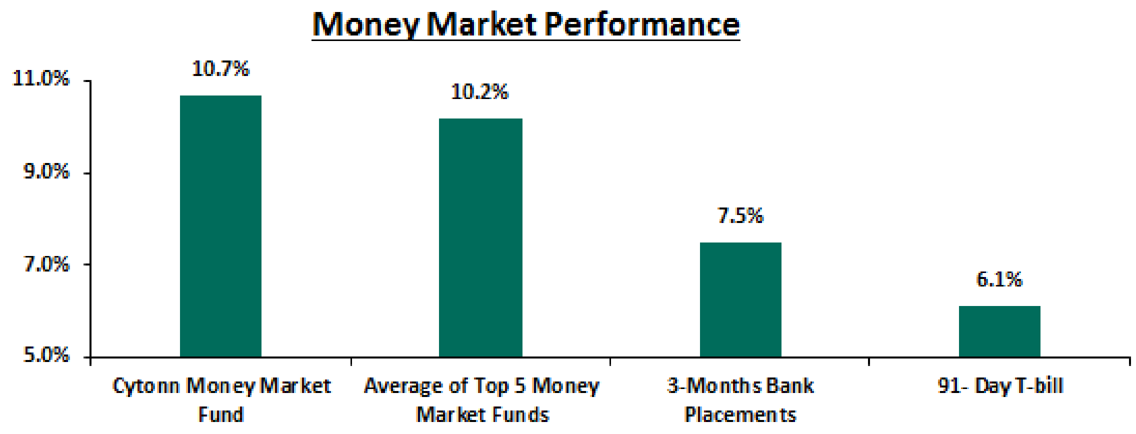
Fixed Income

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

During the month of July, T-bill auctions recorded an oversubscription, with the overall subscription rate coming in at 243.1%, compared to 233.4% recorded in the month of June. The oversubscription is partly attributable to increased liquidity in the money market with the average interbank rate coming in at 2.2% for the month of July coupled with banks' preference for government securities as opposed to lending with their holdings in government securities rising to 54.9% from 54.3% at the beginning of the year. The subscription rates for the 91-day paper rose to 574.7%, from 324.0% recorded in June. The subscription rates for the 182-day and 364-day papers, on the other hand, declined, coming in at 137.5% and 216.0%, lower than the 187.2% and 243.3% recorded in June, respectively. We note that the 91-day paper continued to receive the most interest from investors, having recorded the highest subscription rate of 574.7% as investors preferred holding the shorter-dated paper due to the uncertainty in the market, coupled with the significant declines in yield for the 182-day and 364-day papers which has declined by 1.7% points and 2.4% points, respectively. The Central Bank remained disciplined in rejecting expensive bids in order to ensure the stability of interest rates as evidenced by the decline in yields on the 91-day, 182-day and 364-day paper to 6.2%, 6.6% and 7.5%, respectively, from 7.1%, 7.8% and 8.8% recorded in June. The T-bills acceptance rate came in at 66.9% during the month, compared to 30.9% recorded in June, with the government accepting a total of Kshs 195.0 bn of the Kshs 291.7 bn worth of bids received.

During the week, T-bills remained oversubscribed, with the subscription rate coming in at 118.7%, down from 149.6% the previous week. The subscription rate for the 91-day and 182-day papers increased to 396.5% and 24.7%, respectively, from 270.4% and 13.9% recorded the previous week, respectively. The subscription rate for the 364-day paper, however, fell to 101.5%, from 236.9% recorded the previous week. The yields on the 91-day and 364-day papers remained unchanged at 6.1% and 7.4%, respectively, similar to what was recorded the previous week, while that of the 182-day paper increased marginally to close at 6.5%, from the 6.4% recorded the previous week. The acceptance rate declined to 82.8%, from 99.8% recorded the previous week, with the government accepting Kshs 23.6 bn of the Kshs 28.5 bn bids received.

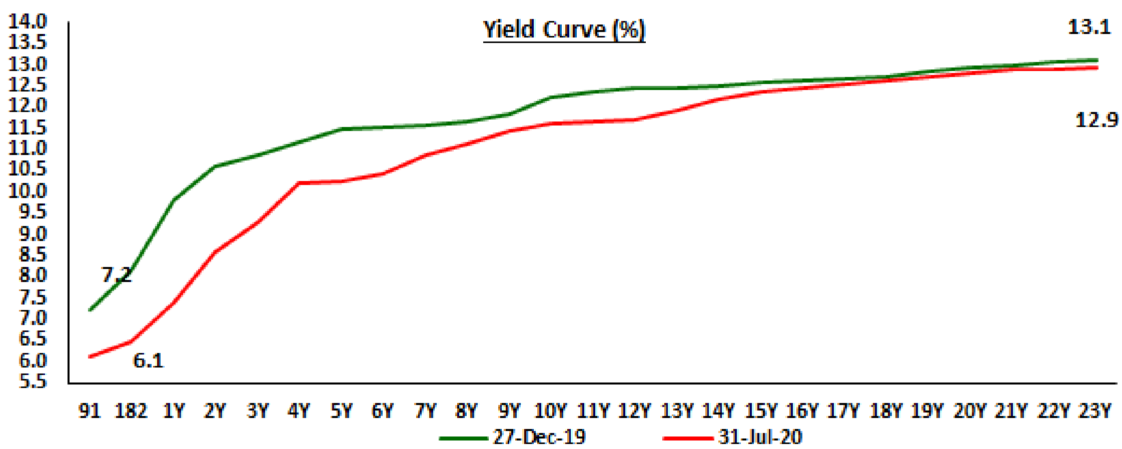
For the month of July, the Kenyan government reopened 3 fixed coupon Treasury bonds, FXD1/2020/05, FXD2/2018/10 and FXD1/2019/15 with effective tenors of 5 years, 8 years and 14 years respectively, for budgetary support purposes. The issue was oversubscribed with the average subscription rate coming in at 303.0%, as the government received bids worth Kshs 181.8 bn, higher than the Kshs 60.0 bn offered, mainly attributable to the high liquidity in the money markets. Yields on the bonds came in at 10.6%, 11.7% and 12.4%, respectively, for the five, ten and fifteen-year papers, which was in-line with our expectations. The government rejected expensive bids only accepting Kshs 80.9 bn out of the Kshs 181.8 bn worth of bids received, translating to an acceptance rate of 44.5%.



In the money markets, 3-month bank placements ended the week at 7.5% (*based on what we have been offered by various banks*), while the yield on the 91-day T-bill remained unchanged at 6.1%, similar to what was recorded the previous week. The average yield of Top 5 Money Market Funds increased to 10.2% from 9.9% recorded the previous week. The yield on the Cytonn Money Market remained unchanged at 10.7%, similar to what was recorded the previous week.

Secondary Bond Market:

The yields on government securities in the secondary market remained relatively stable during the month of July. The Central Bank of Kenya was keen to ensure that rates remained low and therefore continued to reject expensive bids given the investors' increased appetite for government papers, evidenced by the higher subscription rates in both T-bills and T-bonds. Consequently, this led to a decline in the yields on the yield curve, which saw the FTSE NSE bond index gain by 1.1% during the month of July bringing the YTD gain to 0.1%. The chart below is the yield curve movement during the period.



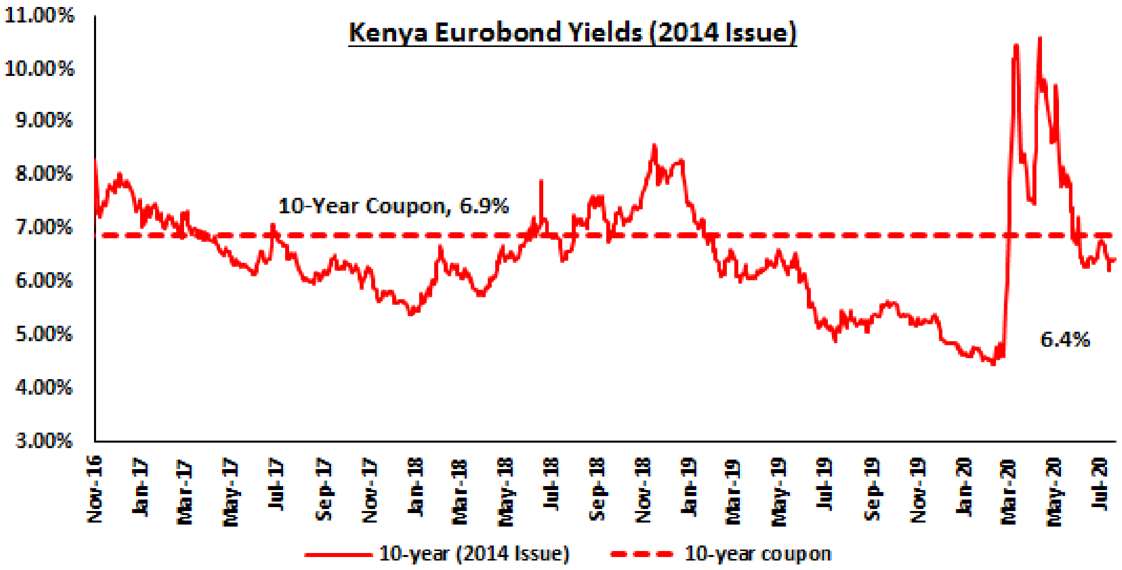
Liquidity:

Liquidity in the money markets eased in July with the average interbank rate declining to 2.3%, from 2.8% recorded in June. Liquidity was supported by government payments and maturing TADS of Kshs 162.2 mn. (TADs are used when the securities held by the CBK for Repo purposes are exhausted or when CBK considers it desirable to offer longer tenor options). During the week, the average interbank rate increased marginally to 2.3% from 2.2% recorded the previous week. The average interbank volumes rose by 316.8% to Kshs 23.2 bn, from Kshs 5.6 bn recorded the previous week.

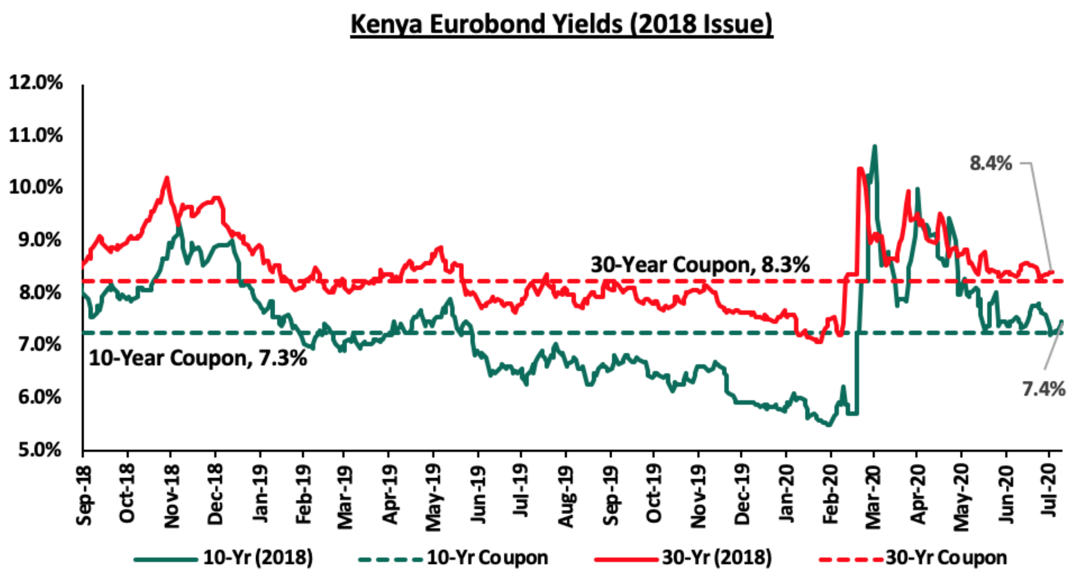
Kenya Eurobonds:

According to Reuters, the yield on the 10-year Eurobond issued in June 2014 decreased marginally by 0.1% points to 6.4% in July, from 6.5% in June. During the week, the yield on the 10-year

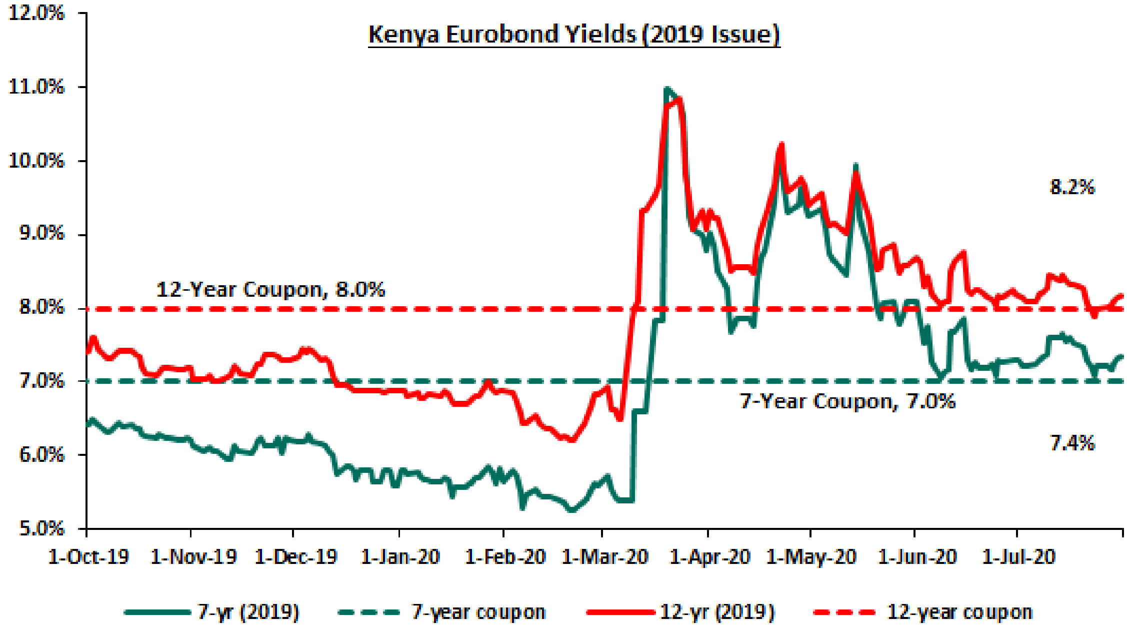
Eurobond remained unchanged at 6.4%, similar to what was recorded the previous week.



During the month, the yields on the 10 year Eurobonds issued in February 2018 decreased marginally by 0.1% points to close at 7.4% in July, from the 7.5% recorded in June. The 30 year Eurobond, on the other hand, remained unchanged at 8.4% in July, similar to what was recorded in June. During the week, the yield on the 10-year Eurobond increased by 0.2% points to close at 7.4% from 7.2% recorded the previous week. The 30-year Eurobond increased marginally by 0.1% point to 8.4%, from 8.3% recorded the previous week.



During the month, the yields on the newly issued dual-tranche Eurobond with 7-years increased marginally by 0.1% points to 7.4% in July, from 7.3% in June. The 12-year Eurobond remained unchanged at 8.2% similar to what was recorded in June. During the week, the yields on both the 7-year and 12-year Eurobonds increased by 0.2% points to 7.4% and 8.2%, respectively, from 7.2% and 8.0% recorded the previous week.



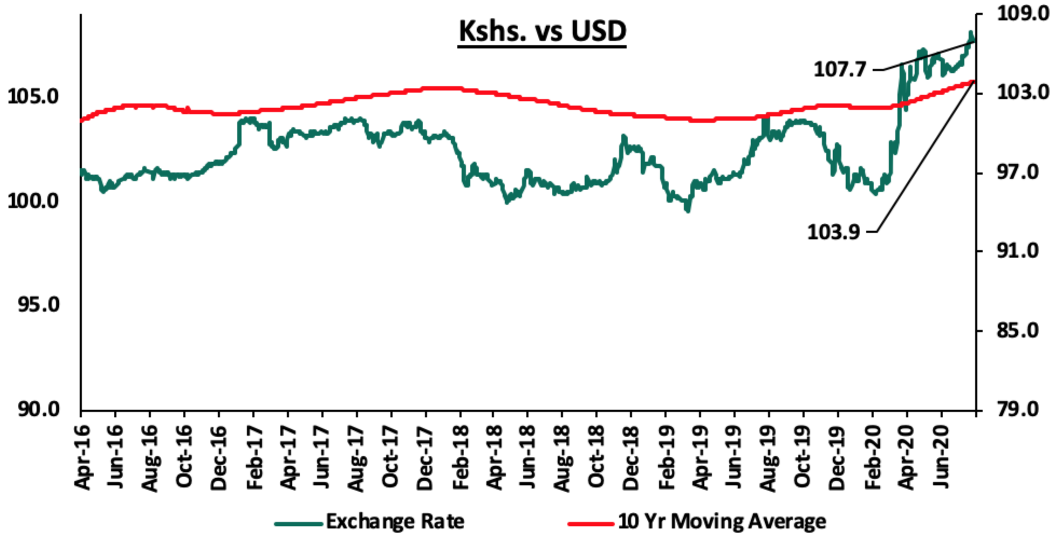
Kenya Shilling:

During the month, the Kenya Shilling depreciated by 1.1% against the US Dollar to close at Kshs 107.7, from Kshs 106.5 recorded at the end of June, due to increased dollar demand by both banks and merchandise importers. During the week, the Kenya Shilling appreciated marginally by 0.3% against the US Dollar to close at Kshs 107.7, from Kshs 108.0 recorded the previous week, attributable to subdued dollar demand from merchandise importers and players in the energy sector. On a YTD basis, the shilling has depreciated by 6.3% against the dollar, in comparison to the 0.5% appreciation in 2019. We expect continued pressure on the shilling due to:

i. Demand from merchandise and energy sector importers as they beef up their hard currency positions,
ii. A deteriorating current account position, with the current account deficit deteriorating by 10.2% during Q1'2020, to Kshs 110.9 bn, from Kshs 100.6 bn recorded in Q1'2019 attributable to;
iii. 0% decline in the secondary income (transfers recorded in the balance of payments whenever an economy provides or receives goods, services, income or financial items) balance, to Kshs 124.1 bn, from Kshs 128.0 bn in Q1'2019, and,
iv. A 67.0% decline in the services trade balance (the difference between the imports and exports of services) to Kshs 20.4 bn, from Kshs 61.9 bn.

The shilling is however expected to be supported by:

i. High levels of forex reserves, currently at USD 9.4 mn (equivalent to 5.7-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, and,
ii. Improving diaspora remittances evidenced by the 24.0% increase to USD 258.2 mn in May 2020, from USD 208.2 seen the previous month. In terms of y/y performance, diaspora remittances increased by 6.2% to USD 258.2 mn in May 2020, from USD 243.2 mn recorded in May 2019.



Weekly Highlight:

Inflation

The y/y inflation for the month of July declined to 4.4%, from the 4.7% recorded in June 2020. Month-on-month inflation came in at 0.9%, which was attributable to:

i. A 0.8% decline in the food and non-alcoholic drinks' index, due to a decline in prices of significant food items such as tomatoes, Irish potatoes, spinach, onions and kales which declined by 5.5%, 4.1%, 3.2%, 3.1% and 2.6%, respectively,
ii. A 0.4% decline in the housing, water, electricity, gas and other fuels index, as a result of the lower cost of water vendor services, house maintenance and some house rents. Despite the above, the effects were muted due to,
iii. A 4.0% increase in the transport index on account of an increase in the pump prices of diesel and petrol by 22.3% and 12.2%, respectively.

Major Inflation Changes – July 2020

Broad Commodity Group	Price change m/m (July-20/June-20)	Price change y/y (July-20/July-19)	Reason
Food & Non-Alcoholic Beverages	(0.8%)	6.6%	The m/m decline was due to a decline in prices of some food items such as tomatoes, Irish potatoes, spinach, onions and kales
Transport Cost	4.0%	11.1 %	The m/m increase was mainly on account of increases in the pump prices
Housing, Water, Electricity, Gas and other Fuels	(0.4%)	1.1%	The m/m marginal decline was as a result of the lower cost of water vendor services, house maintenance and some rents
Overall Inflation	**0.1%**	**4.4%**	**The m/m increase was due to a 4.0% increase in the transport cost, mainly driven by the increase in fuel prices which was mitigated by the decline of 0.8% in the Food and non-alcoholic foods index**

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.

Monetary Policy

The Monetary Policy Committee (MPC) met on 29th July 2020 to review the prevailing macroeconomic conditions and decide on the direction of the Central Bank Rate (CBR). The MPC retained the CBR at 7.00%, which was in line with our expectations; MPC July 2020 Note. The MPC indicated that the previous cuts in the CBR rate in March and April 2020 to the current 7.0%, was having the intended outcome. The key highlights from the meeting:

i. The economy remained resilient during the first quarter of 2020 where real GDP grew by 4.9% compared to Q1'2019, mainly supported by agricultural production. Leading economic indicators for the second quarter point towards continued strong performance in agriculture due to favourable weather conditions and the lifting of restrictions in key export markets. However, against a backdrop of major disruptions due to COVID-19 containment measures, the services sector remained subdued, particularly hotels, restaurants and the education sector,
ii. Inflation is expected to remain within the government's 2.5% - 7.5% target range, largely supported by lower food prices, the impact of the reduction of VAT and muted demand pressures,
iii. The banking sector remained resilient with strong liquidity and capital adequacy ratios. The ratio of gross non-performing loans to gross loans stood at 13.1% in June compared to 13.0% in May. Increased in NPLs were noted in the manufacturing, trade and personal sectors due to the subdued business environment,
iv. Total loans amounting to Kshs 844.4 bn (29.0%of the total banking sector loan book) has been restructured by the end of June, of which personal/ household loans amounted to Kshs 240.0 bn 30%, while the other sectors amounted to Kshs 604.4 bn; Trade (22.9%), Real Estate (19.5%), Transport and communication (16.3%) and Manufacturing (14.0%),
v. The imminent operationalization of the Credit Guarantee Scheme for the vulnerable MSMEs which is expected to reduce the risk banks will take on by lending, and ultimately boost credit growth,
vi. Private sector credit growth came in at 7.6% in the 12-months to June 2020, below the 5-Year historical average, of 8.2%. Strong credit growth was observed in the Manufacturing sector (12.3%), trade (8.4%), transport and communication (14.9%) and consumer durables (15.2%), and
vii. Export of goods rebounded, growing at 1.7% during the first half of the year, compared to a similar period in 2019. Receipts from tea exports increased by 18.4% while horticulture exports declined by 14.2% as a result of the contraction of flower exports in April 2020.

The committee noted that the policy measures put in since March were having the intended effect on the economy and would be augmented by the implementation of the measures in the FY2020/21 budget. The MPC concluded that the current accommodative policy stance remains appropriate and they will continue to closely monitor the policy measure implemented so far, as well as developments in the global and domestic economy. The committee will meet again in September 2020, but remains ready to re-convene earlier if necessary.

Monthly Highlights

1. The Kenya National Bureau of Statistics (KNBS) in conjunction with the Ministry of Treasury and National Planning released wave 2 of the Survey on Socio-Economic Impact of COVID-19 on Household Report. The Government of Kenya established a National Coordination Committee on the Response to the Corona Virus Pandemic (NCCRCP) to respond to the crisis and help cushion Kenyans against the adverse effects of the Coronavirus pandemic. For more information, see our, Cytonn Weekly #28/2020.

2. S&P Global lowered Kenya's Credit rating outlook from stable to negative and affirmed the B+ long term and B short-term credit rating. Key to note, Moody's credit rating agency changed Kenya's sovereign credit outlook to "negative", from a previous outlook of "stable" and affirmed the B2 credit rating. The agency pointed out that the negative outlook was as a result of rising financial risks brought about by the country's high debt and interest burden. Below is a summary of the credit rating and outlook revisions on Kenya so far;

Rating Agency	Rating as at January 2020	Outlook as at January 2020	Current Rating	Current Outlook
Moody's	B2	Stable	B2	Negative
S&P Global	B+ 'short term', B 'Long Term'	Stable	B+ 'short term', B 'Long Term'	Negative
Fitch Ratings	B+	Stable	B+	Negative

For more information, see our, Cytonn Weekly #29/2020.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. As a result of depressed revenue collection with the revenue target for FY'2020/2021 at Kshs 1.9 tn, we expect a higher budget deficit, which the Treasury estimates at 7.5% of GDP, creating uncertainty in the interest rate environment as additional borrowing from the domestic market will be required to plug in 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