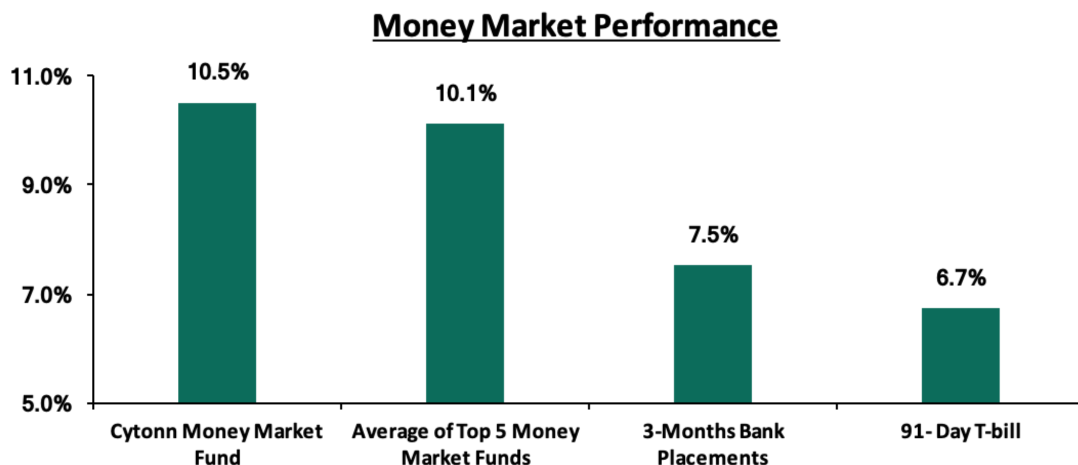
Understanding Exchange Regimes, & Cytonn Weekly #48/2020

Fixed Income

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

During the week, T-bills were undersubscribed, with the overall subscription rate coming in at 64.3%, down from 104.2% the previous week. The highest subscription rate was in the 91-day paper, which came in at 114.5%, down from 139.6% recorded the previous week. The subscription for the 182-day paper declined to 63.7% from 65.0%, while that of the 365-day paper dropped to 44.7% from 129.3% recorded the previous week. The yields on the 91-day, 182-day and 364-day increased marginally by 2.4 bps, 4.1 bps and 5.7 bps to 6.7%, 7.2% and 8.2%, respectively. The government continued to reject expensive bids with the acceptance rate declining to 87.2%, from 96.6% recorded the previous week, accepting bids worth Kshs 13.4 bn out of the Kshs 15.4 bn worth of bids received.

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 increased marginally by 2.4 bps to close at 6.7%. The average yield of the Top 5 Money Market Funds increased by 0.1% points to 10.1% from 10.0% recorded the previous week. The yield on the Cytonn Money Market Fund remained unchanged at 10.5%, similar to what was recorded the previous week.

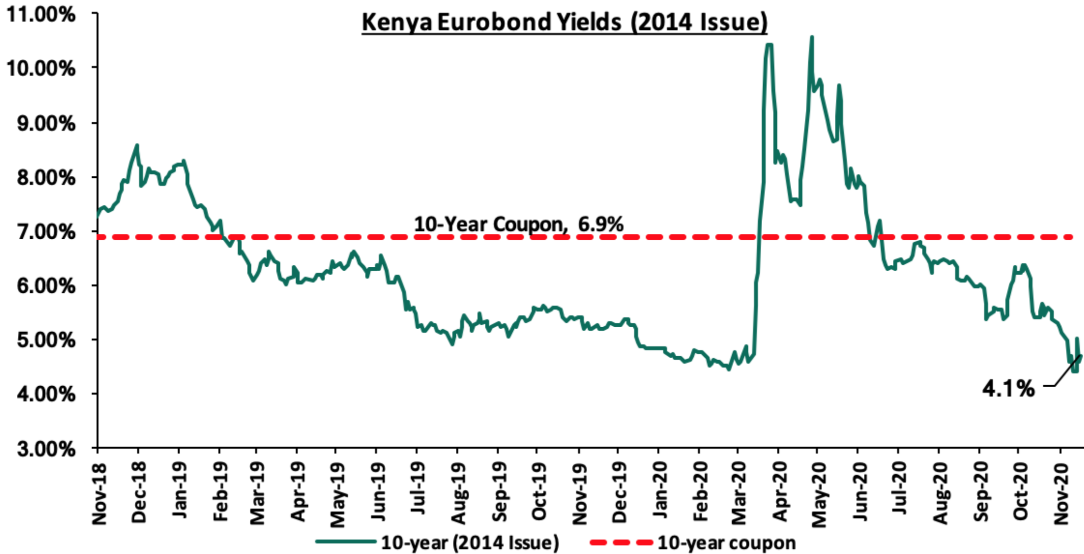


Liquidity:

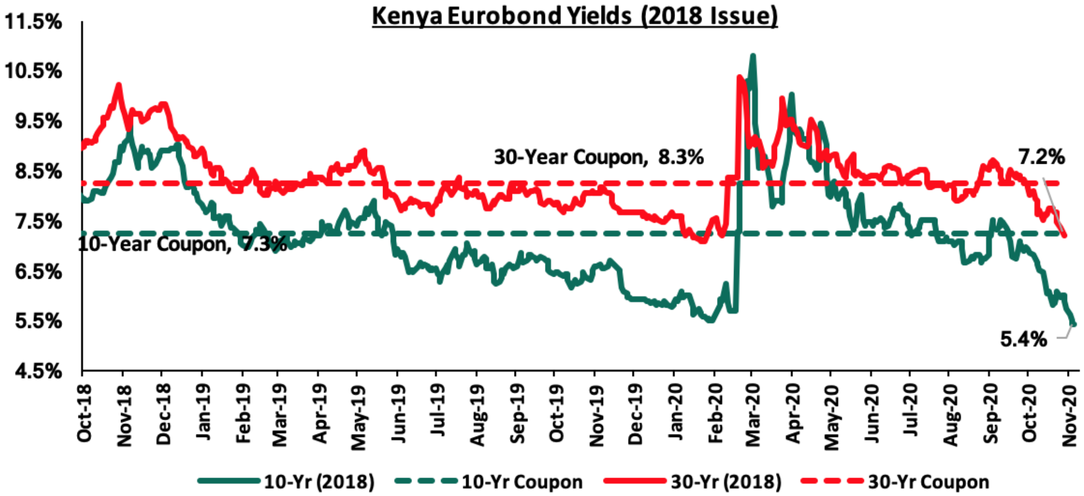
The money markets remained liquid during the week, with the average interbank rate increasing marginally by 0.5% points to 3.5%, from the 2.9% recorded the previous week. This was supported by government payments, which partly offset tax receipts. The average interbank volumes also increased by 173.2% to Kshs 12.8 bn from Kshs 4.7 bn, recorded the previous week. According to the Central Bank of Kenya's weekly bulletin released on 27th November 2020, commercial banks' excess reserves stood at Kshs 6.3 bn in relation to the 4.25% cash reserves requirement (CRR).

Kenya Eurobonds:

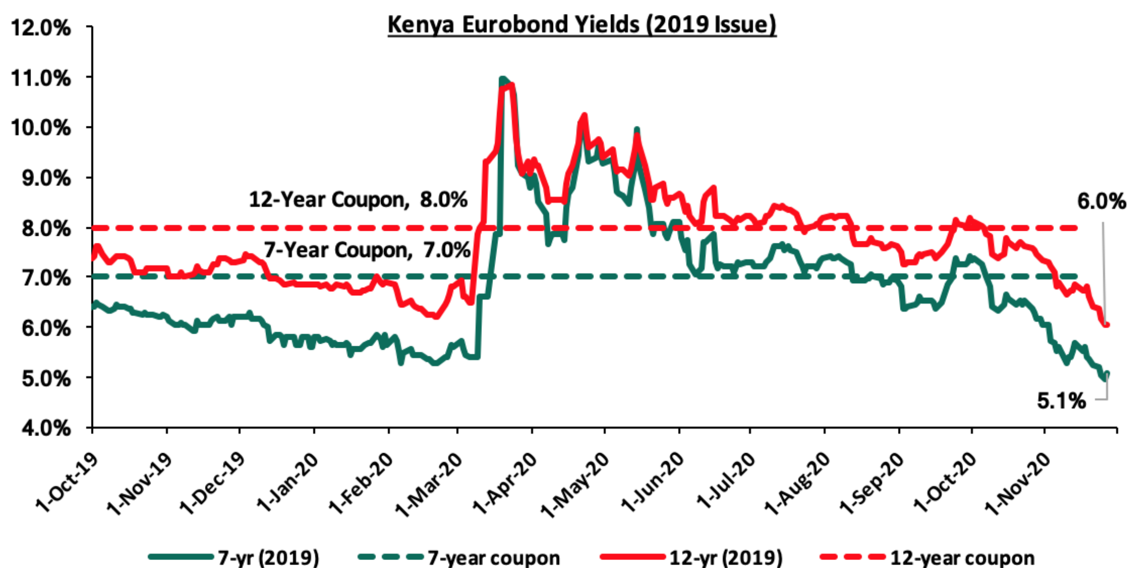
During the week, the yields on all Eurobond yields declined pointing to improved foreign investor sentiments. This was following the announcement of a USD 2.3 bn IMF drawdown facility to help mitigate Covid-19 related economic shocks and the news of Kenya's intention to join the Paris club - Debt Service Suspension Initiative (DSSI) that will aid in debt sustainability. According to Reuters, the yield on the 10-year Eurobond issued in June 2014 declined by 0.6% points to 4.1% from 4.7%, as was recorded the previous week.



During the week, the yields on the 10-year and 30-year Eurobonds issued in 2018, on the other hand, declined by 0.5% points and 0.4% points to 5.4% and 7.2%, respectively, from 5.9% and 7.6% recorded previous week



During the week, the yields on the 2019 dual-tranche Eurobonds also declined, with the 7-year Eurobond and the 12-year Eurobond declining by 0.3% points and 0.6% points to 5.1% and 6.0%, from 5.4% and 6.6% recorded last week.



Kenya Shilling:

During the week, the Kenyan shilling depreciated against the US dollar by 0.4% to Kshs 109.9 from Kshs 109.4, mainly attributable to the persistent dollar demand from general importers as they meet their end of month obligations, as well as low inflows from sectors like horticulture and tourism. On a YTD basis, the shilling has depreciated by 8.4% against the dollar, in comparison to the 0.5% appreciation in 2019. We expect continued pressures on the Kenyan shilling due to:

i. Demand from merchandise and energy sector importers as they beef up their hard currency positions amid a slowdown in foreign dollar currency inflows, and,
ii. Continued uncertainty globally making people prefer holding dollars and other hard currencies.

However, in the short term, the shilling is expected to be supported by:

i. The Forex reserves which are currently at USD 8.0 bn (equivalent to 4.9-months of import cover), which is 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. The improving current account position which narrowed to 4.9% of GDP in the 12 months to October 2020 compared to 5.3% of GDP during a similar period in 2019, and,
iii. Improving diaspora remittances evidenced by a 17.3% y/y increase to USD 263.1 mn in October 2020, from USD 224.3 mn recorded over the same period in 2019, has cushioned the shilling against further depreciation.

Weekly Highlight:

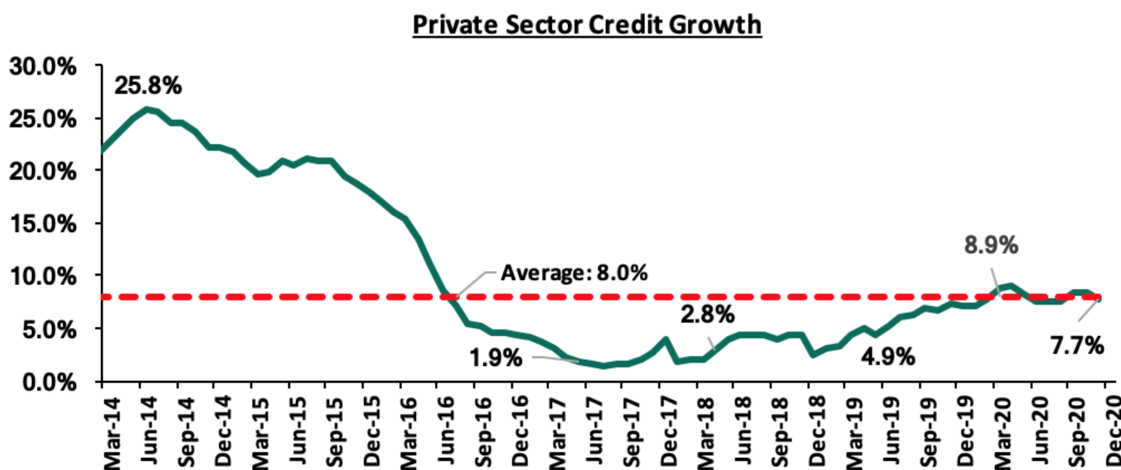
During the week, the World Bank released the 22nd edition of the Kenya economic outlook – Navigating the pandemic. The report highlighted that Kenya's economic outlook remains highly uncertain, as the COVID-19 pandemic has severely affected the country, with the GDP contracting by 5.7% as discussed in our Q2'2020 GDP Note. Some of the key take-outs include:

I. **Economic Growth**: The report noted that the economy contracted sharply, by 5.7% year on year in H1'2020. Tourism and education sectors were the worst hit sectors contracting by 83.3% and 56.2% respectively, due to the Covid-19 containment measures put in place. There has been a couple of response measures by the government that are now starting to help with the economic recovery in the second half. Some of the measures include gradual reopening of the economy and also implementation of accommodative fiscal and monetary policies. The report's baseline assumption is that normal weather will support agricultural production and its strong linkage to industrial and services output will stimulate a faster recovery,

II. **Fiscal and monetary Measures undertaken to support the economy**: The government's fiscal policy counter measures against the COVID-19 pandemic in Q4 of FY2019/20, coupled with the weaker economy, reversed the fiscal consolidation efforts
Tax revenue underperformed by Kshs 41.7 bn (0.4% of GDP) to close at Kshs 342.5 bn (3.0% of GDP), below the target of Kshs 384.3bn, for Q1 of FY2020/21. The revenue under-collection arose from shortfalls due to tax relief granted to mitigate the impact of COVID-19 and low economic activity. On the other hand, Monetary policy has been accommodative to mitigate the impact of the pandemic with the Central Bank reducing the policy rate to 7.0% in April from the previous 8.25% at the beginning of the year and the cash requirement ratio to 4.25% from 5.25% in March and maintaining them up to now,

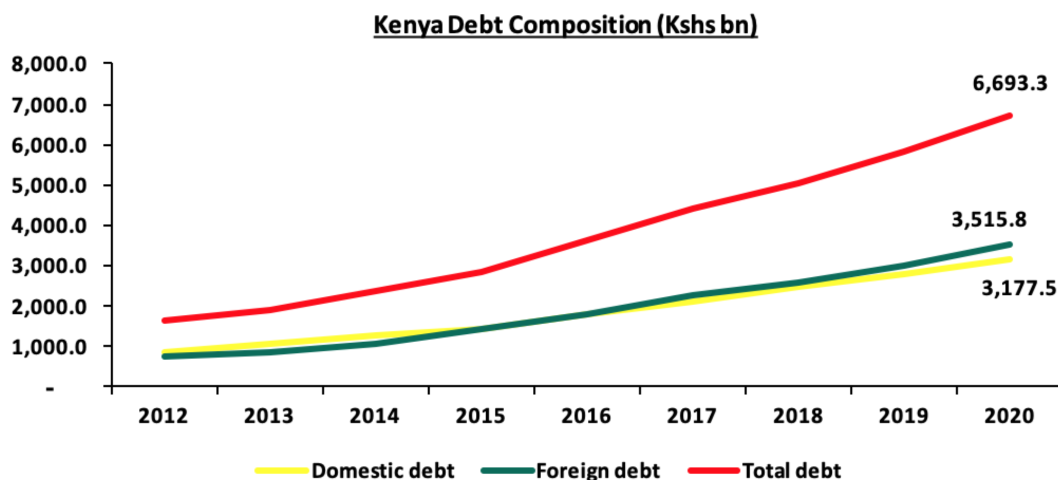
III. **Private Sector Credit Growth:** Private sector credit growth has remained moderate in 2020, since despite the lower Central Bank Rate the banks have remained cautious to lending due to increased risk and also since government papers have remained attractive. According to the latest data from the MPC release growth in private sector lending stood at 7.7% in the 12 months to October, 2020. There was strong growth in lending to sectors like: manufacturing (7.8%), transport and communications (21.1%), real estate (7.6%) and consumer durables (15.7%). The imminent operationalization of the Credit Guarantee Scheme for the vulnerable Micro Small and Medium sized Enterprises (MSMEs), will de-risk lending by commercial banks, as is aimed at increasing credit to this sector.

The chart below indicates the growth in private credit growth over the last few years:



IV. **Public Debt**: The fiscal measures have led to revenue underperformance as the government tries to find a balance between Covid - 19 containment and providing tax relief. In order to finance the revenue shortfall the government has resulted in borrowing where public debt rose to 65.6% of GDP in June 2020 from 62.4% of GDP in June 2019. The increase in debt has been driven by widening fiscal deficit due to revenue underperformance. Following the significant slowdown in GDP growth and nominal exchange rate depreciation, debt vulnerabilities have risen and interest payments will continue to add to the burden. The report also noted that; the composition of Kenya's debt remains balanced between external and domestic sources and the share of multilateral debt in external debt remains substantial.

The figure below shows Kenya's debt composition as of June 2020 with 55.2% of the total debt being foreign borrowing:



As at June 2020, external debt composition comprised of multilateral, bilateral and commercial debt at 37.8%, 30.7% and 31.5% of the total external debt, respectively. Below is a breakdown of Kenya's external debt:

	Jun-18		Jun-19		Jun-20	
	USD mn		USD mn		USD mn	
Multilateral debt	8,031.40	33.5%	8,938.50	30.2%	12,407.10	37.8%
Bilateral debt	7,533.40	31.5%	9,736.80	32.9%	10,084.80	30.7%
Commercial debt	8,219.70	34.3%	10,711.40	36.2%	10,340.00	31.5%
Export Credit	165.5	0.7%	165.5	0.6%	0	0.0%
Total	**23,950.00**		**29,552.20**		**32,831.90**	

V. **Balance of Payments:** Kenya's external trade position has been supported by import compression and resilient remittances. The current account deficit fell to 4.5 % of GDP in the 12-month to August 2020, from 5.2 % of GDP over the same period 2019, driven by resilient diaspora remittance inflows, and lower imports of goods and services which more than outweighed a decline in exports of goods and services. Following containment measures in Kenya and its trading partners, both merchandise exports and imports contracted sharply year to date. The current account deficit is financed through borrowings and private investments, these has led to the capital and financial account balance declining to 3.8% of GDP in the year to August 2020 compared to 6.7% of GDP in the year to August 2019. The external financing pressures has increased with the continued depreciation of the shilling against the dollar.

In conclusion, the report takes a baseline assumption that Kenya's economic output is projected to contract by 1.0 % in 2020, and rebound in 2021 to grow by 6.9%. The base case projections assume that the economic effects of COVID-19 are expected to fade by early to mid-2021, as vaccines and additional treatments become available. Even with the economy set for recovery, as shown by an improvement in the leading economic indicators; We are of the view that the 6.9% growth in 2021 is quite ambitious given that we are already in the last quarter of 2020 and there has been a recent spike in the number of Covid infection, not only in Kenya but globally.

MPC November 2020 Meeting

The Monetary Policy Committee (MPC) met on 26th November 2020 to review the prevailing macroeconomic conditions and decide on the direction of the Central Bank Rate (CBR). The MPC retained the CBR at 7.0% which is in line with our expectations MPC November 2020 Note. This is the fifth straight time that the committee is retaining the rate at 7.0% following the rate cut in April 2020, indicating that it was having its intended outcome. The key highlights from the meeting:

I. **Inflation remains well anchored**. Month-on-month overall inflation stood at 4.8% in October compared to 4.2% in September, and is expected to remain within the target range in the near term, supported by lower food prices and muted demand pressures.
II. **The banking sector remains stable and resilient**, with strong liquidity and capital adequacy ratios. The ratio of gross non-performing loans (NPLs) to gross loans remained stable at 13.6% in October and August. NPL increases were noted in the transport and communication, energy and water, tourism, restaurant and hotels and real estate sectors, mainly due to the disruption of businesses.
III. Total loans amounting to Kshs 1.38 tn have been restructured 46.5% of the total banking sector loan book of Kshs 2.97 tn by the end of October, in line with the emergency measures announced by CBK on March 18 to provide relief to borrowers. For other sectors, a total of Kshs 1,076.9 billion had been restructured mainly to trade (18.7%), manufacturing (22.7%), real estate (14.5%) and agriculture (12.8%).
IV. Following the lowering of the Cash Reserve Ratio (CRR) in March, Kshs 32.6 bn of the Kshs 35.2 bn, representing 92.7%, has been used to support lending, especially to the tourism, trade and transport and communication, real estate, manufacturing and agriculture sectors.
V. Current account deficit is projected at about 5.1% of GDP in 2020 from 5.8% in 2019. Exports of goods have strengthened from the disruptions of COVID-19, growing by 2.8% in the period January to October 2020 compared to a similar period in 2019. Receipts from tea exports rose by 13.2% during this period, largely reflecting increased output. Horticulture and flower exports have rebounded, reflecting the normalization of demand in the international market, and the availability of adequate cargo space.

The MPC concluded that the current accommodative monetary policies together with the fiscal measures are still being transmitted to support the economy, and therefore decided to retain the Central Bank Rate (CBR) at 7.0%. The Committee will meet again in January 2021, but remains ready to re-convene earlier if necessary.

Rates in the fixed income market have remained relatively stable due to the high liquidity in the money markets, coupled with the discipline by the Central Bank as they reject expensive bids. The government is 48.7% ahead of its prorated borrowing target of Kshs 196.4 bn having borrowed Kshs 291.9 bn. In our view, due to the current subdued economic performance brought about by the effects of the COVID-19 pandemic, the government will record a shortfall in revenue collection with the target having been set at Kshs 1.9 tn for FY'2020/2021 thus leading to a larger budget deficit than the projected 7.5% of GDP, ultimately creating uncertainty in the interest rate environment as additional borrowing from the domestic market may be required to plug the deficit. Owing to this uncertain environment, our view is that investors should be biased towards short-term to medium-term fixed income securities to reduce duration risk.