Cytonn Monthly - October 2017

Fixed Income

T-bills auctions recorded an undersubscription during the month of October, with the average subscription level coming in at 48.0%, compared to 105.7% recorded in September, due to tight liquidity in the market. The subscription rates for the 91, 182 and 364-day papers came in at 68.1%, 35.6% and 52.3% from 84.5%, 125.7% and 169.0% the previous month, respectively. The yield on the 91-day paper declined to 8.0% from 8.1% at the end of September, whereas the yield on the 182-day paper increased to 10.4% from 10.3%, and the yield on the 364-day paper remained unchanged at 11.0%. The T-bills acceptance rate came in at 93.5% during the month, compared to 92.1% in September, with the government accepting Kshs 53.8 bn of the Kshs 57.6 bn worth of bids received, indicating that bids were largely within ranges the CBK deemed acceptable. The government is still behind its domestic borrowing target for the current fiscal year, having borrowed Kshs 61.0 bn, against a target of Kshs 142.0 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 410.2 bn budgeted for the full financial year as per the Cabinet-approved 2017 Budget Review and Outlook Paper (“**BROP”**)).

For this week, T-bills were undersubscribed with the overall subscription coming in at 69.7%, compared to 34.2% recorded the previous week. Subscription rate for the 91, 182, and 364-day papers came in at 109.4%, 42.1%, and 81.4% from 12.7%, 13.7%, and 63.3%, the previous week, respectively. The drastic increase in the 91-day paper subscription rate can be attributed to the uncertainty in the market with the investors opting to keep short. Yields on the 91, 182 and 364-day T-bills remained unchanged during the week at 8.0%, 10.4%, and 11.0%, respectively.

The 91-day T-bill is currently trading below its 5-year average of 9.2%. The lower yield on the 91-day paper is mainly attributable to the low interest rates environment we have been experiencing since the beginning of the year. We expect this to continue in the short-term, given the discipline of the Central Bank of Kenya (CBK) in stabilizing interest rates in the auction market by rejecting aggressive bids that are priced above market, both on T-bills and T-bonds.

During the month, the Kenyan Government issued a new 5-year bond (FXD 2/2017/5), in a bid to raise Kshs 30.0 bn for budgetary support. The bond was undersubscribed, with the overall subscription rate at 66.9%, with Kshs 20.1 bn worth of bids received compared to the Kshs 30.0 bn on offer. The average market bid rates came in at 12.6% while the average yields of the accepted bids came in at 12.5%. The acceptance rate for the bids received came in at 67.3%, which was higher than the average acceptance rate of 59.5%, from previous auctions during the year. The government accepted Kshs 13.5 bn out of the Kshs 20.1 bn worth of bids received. The government consequently issued a tap sale on the bond at the accepted weighted average yield of 12.5% to raise Kshs 16.5 bn, but received only Kshs 7.3 bn, a 44.2% subscription rate. Going forward, pressure could mount on the government, given (i) the tight liquidity levels currently being experienced in the market, (ii) the government being behind its domestic borrowing target, and (iii) the expected low revenue collections by the Kenya Revenue Authority (KRA).

During the month, the average interbank rate closed at 6.9%, compared to 8.2% at the end of September, despite tight liquidity in the market, with a net liquidity withdrawal of Kshs 16.4 bn compared to a net liquidity injection of Kshs 13.0 in September. A significant amount of the liquidity withdrawal came from Reverse Repo Maturities and Transfer of Taxes from Banks of Kshs 94.5 bn and Kshs 81.7 bn, respectively, which offset liquidity injection from Government Payments and Reverse Repo Purchases of Kshs 88.2 bn and Kshs 78.7 bn, respectively, as the CBK looked to counter the tight liquidity.

Below is a summary of the money market activity during the month:

all values in Kshs bn, unless stated otherwise

October Monthly Liquidity Position – Kenya			
Liquidity Injection		**Liquidity Reduction**	
Government Payments	88.2	T-bonds sales	13.5
T-bonds Redemptions	31.3	Transfer from Banks - Taxes	81.7
T-bills Redemptions	28.7	T-bills (Primary issues)	46.6
T-bonds Interest	4.8	Reverse Repo Maturities	94.5
Reverse Repo Purchases	78.7	OMO Tap Sales	11.8
Total Liquidity Injection	**231.7**	**Total Liquidity Withdrawal**	**248.1**
Net Liquidity Injection			**(16.4)**

The yields on government securities in the secondary market have declined since the beginning of the year, as highlighted in the yield curve below. According to the FTSE NSE Bond Index, Treasury bonds listed at the Nairobi Securities Exchange (NSE) gained 0.9% during the month bringing the YTD performance to 12.6%.

According to Bloomberg, yields on the 5-year and 10-year Eurobonds, with 1.6-years and 6.6-years to maturity, declined by 30 bps during the month, to close at 3.8% and 6.1% from 4.1% and 6.4%, respectively, at the end of September, despite the uncertainty surrounding the repeat presidential elections conducted during the month. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 5.0% points and 3.6% points for the 5-year and 10-year Eurobonds, respectively, due to stable macroeconomic conditions in the country. The declining Eurobond yields and stable rating by Standard & Poor (S&P), in spite of the political uncertainty around the presidential poll re-run, are indications that Kenya's macro-economic environment remains stable and hence an attractive investment destination. However, concerns from Moody's around Kenya's rising debt to GDP levels may see Kenya receive a downgraded sovereign credit rating.

The Kenya Shilling depreciated by 0.5% against the USD during the month of October to close at Kshs 103.8, from Kshs 103.2 in September. This was primarily due to importers accumulating dollar holdings due to increased political uncertainty surrounding the presidential election held during the month. On a year to date basis, the shilling has depreciated against the dollar by 1.2%. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by (i) the weakening of the USD in the global markets, and (ii) the CBK's activity, as they have sufficient forex reserves, currently at USD 7.1 bn (equivalent to 4.7 months of import cover), as indicated in the graph below. The key factor to watch is the current account deficit that worsened to 6.2% of GDP in Q2'2017, as compared to 5.3% of GDP in a similar period last year.

The inflation rate for the month of October declined by 1.4% points to a 17-month low of 5.7%, from 7.1% in September. The decline was primarily driven by a drop in food prices, which dropped by 1.9% m/m, due to improved weather conditions in most parts of the country. This was despite, (i) a rise of 0.5% m/m in housing, water, electricity, gas and other fuels, brought about by increased cost of electricity and house rents, and (ii) an increase of 0.9% in the cost of fuel, following increased pump prices of petrol and diesel. Below is a summary of key changes on the Consumer Price Index (CPI) in October;

Key Changes on the Consumer Price Index (CPI) during the month of October

Broad Commodity Group	Price change m/m	Price change y/y (Oct 2015/ Oct 2016)	Price change y/y (Oct 2016/Oct 2017)	Reason
Food & Non-Alcoholic Beverages	(1.9%)	11.0%	8.5%	This was due to fall in the cost of some food items, which was mainly attributed to favorable weather conditions
Transport Cost	0.9%	0.4%	3.8%	This was on account of an increase in pump prices of petrol and diesel
Housing, Water, Electricity, Gas and other Fuels	0.5%	(0.04%)	3.6%	This was mainly due to notable increases in the cost of house rents and electricity, due to increased foreign exchange charge adjustment
Overall Inflation	**(0.6%)**	**6.5%**	**5.7%**	**The decline was mainly driven by the decrease in food & non-alcoholic beverages, which has a CPI weight of 36.0%**

On a year-to-date basis, inflation has averaged 8.7%. Going forward, we expect inflationary pressures to remain subdued given food prices are expected to stabilize on account of the ongoing rains. We expect inflationary pressure to ease in the last two months of 2017, but average 8.2% over the course of the year, which is above the upper bound of the government target range of 2.5% - 7.5%.

Following the Supreme Court's decision that annulled the August 8th 2017 Kenyan Presidential poll, the Independent Electoral and Boundaries Commission (IEBC) organized a fresh presidential election as per the Kenyan Constitution. With all eight presidential candidates on the ballot, elections were held on 26th October. This move was met with mixed reactions across the country as voters turned up in polling stations in some parts of the country, while in other areas, protests prevailed as the opposition party held up its announcement to boycott the repeat presidential poll, citing non-implementation of reforms that were proposed to the IEBC that would ensure a free, fair and credible election. Consequently, political uncertainty continues to prevail resulting in subdued activity in the market. Uhuru Kenyatta emerged the winner of the repeat presidential election and is awaiting swearing in, should the opposition or any other party fail to challenge the election at the Supreme Court within seven days from the date of the results announcement. We maintain the view that the market should normalize after the election, as post-election fears and uncertainty dissipates, the president elect is sworn in, and the government takes charge, with the Kenya growth fundamentals remaining strong and intact.

During the month, the World Bank released the 2018 Ease of Doing Business Report, which highlighted that Kenya improved on the Ease of Doing Business Ranking, rising 12 places to position 80 from position 92 in 2017, out of 190 countries, indicating a positive impact of reforms in business regulations put in place over the last one year. Kenya ranked third in Africa, behind Mauritius and Morocco, which came in at position 25 and position 69, respectively. A summary of the ease of doing business indicators and Kenya's ranking is as shown below;

Ease of Doing Business in Kenya

Indicators	**2008 Rank**	**2017 Rank**	**2018 Rank**	**Direction**
Starting a Business	112	116	117	**Neutral**
Dealing with Construction Permits	9	152	124	**Positive**
Getting Electricity	-	106	71	**Positive**
Registering Property	114	121	125	**Neutral**
Getting Credit	13	32	29	**Neutral**
Protecting Minority Investors	83	87	62	**Positive**
Paying Taxes	154	125	92	**Positive**
Trading Across Borders	148	105	106	**Neutral**
Enforcing Contracts	107	87	90	**Neutral**
Resolving Insolvency	76	92	95	**Neutral**
Overall	**72**	**92**	**80**	
****Neutral if the rise or drop in position is not more than 5 places, else positive or negative, respectively***				

As seen from the table above, Kenya has improved its overall ranking from last year; however, the country still has a lot to do in order to reclaim its 2008 position. Four areas stand out as needing significant improvement: starting a business, construction permitting, property registration and cross boarder trading. Improvement in these areas will require a clear plan, especially around real estate, which seems to have significant bureaucratic inefficiencies.

Given the change in the operating environment that we have witnessed so far in 2017, we carried out an analysis on the seven indicators of interest rates that we track in order to re-evaluate our view. The table below highlights the different economic drivers, and their effects on interest rates:

Macro-Economic Indicators	**Expectations at the Start of the Year**	**2017 YTD Experience**	**Going Forward**	**Effect on Interest Rates (June 2017)**	**Effect on Interest Rates (October 2017)**

Government Borrowing	The government will have to borrow Kshs 126.9 bn locally on a monthly basis to meet both its domestic borrowing target of Kshs 410.2 bn and maturity obligations worth Kshs 688.3 bn	Government has been behind its target on its domestic borrowing schedule since the fiscal year 2017/18 begun, currently having borrowed Kshs 61.0 bn against a pro-rated target of Kshs 140 bn	Following the enactment of the Banking (Amendment) Act, 2016, we expect that banks will have a preference lending to the government hence we do not expect pressure on domestic borrowing going forward. However, the government having borrowed only 6.8% of their foreign borrowing target remains a concern	**Neutral**	**Neutral**
Revenue Collection	KRA would miss their revenue collection target for 2016/2017 FY	The KRA missed their collection target for the 2016/2017 FY having collected Kshs 1.4 tn against a target of Kshs 1.5 tn. The 2017/2018 FY target was set at Kshs 1.7 tn	We expect the government to miss their revenue collections target due to (i) expected depressed corporate earnings due to the interest rate cap eating into banking sector earnings, and (ii) economic slowdown amid extended political uncertainty	**Negative**	**Negative**
Monetary Policy	Upward pressure on interest rates in 2017	(i) CBR has been maintained at 10.0% throughout 2017 (ii) The 91 Day T-Bill hit 8.0% from 8.8% recorded at the end of January 2017	We expect the Monetary Policy Committee to maintain the CBR while monitoring keenly inflation and currency movements	**Neutral**	**Neutral**
Inflation	Expected to average above the 2.5% - 7.5% government target	Inflation declined to 5.7% in October from 7.1% in September, on account of improved weather conditions. The inflation rate hit a high of 11.7 % in May, driven by an increase in basic food prices, and was at 7.0% in January. The YTD average inflation rate is 8.7%, compared to 6.3% in the same period last year	We expect the inflation rate to stabilize going forward due to falling food prices, but average above the 7.5% upper bound government target in 2017 since YTD average is at 8.7%; driven by expected increases in international oil prices affecting the local cost of transport	**Neutral**	**Neutral**

Exchange Rates	Shilling to depreciate against major currencies	The shilling has depreciated by 1.2% against the dollar YTD, having remained relatively stable for the better part of the year, with volatility only witnessed during the election period following the August 8th election and the repeat presidential poll on 26th October. Volatility was mainly driven by speculation in the forex market and demand from oil importers	We expect the currency to remain relatively stable against the dollar due to a weaker USD in the global markets and It is also important to note that the CBK has sufficient reserves (USD 7.1 bn - equivalent to 4.7 months of import cover) to support the shilling in the short term. However, a worsening current account deficit, which worsened to 6.2% of GDP in Q2’2017, as compared to 5.3% of GDP in a similar period last year, may have a negative effect.	**Negative**	**Neutral**
Investor Sentiments	Foreign investors to demand higher premiums due to political risks posed by elections and economic risk due to the planned rate hikes by the US Fed	Investor sentiment has been high, with foreign investors entering the market in search of attractive valuations, amid a relatively peaceful election period. However, Foreign investors were net sellers in Q3’2017 with net outflow of USD 106.3 mn compared to net inflows of USD 57.5mn recorded in Q3’2016.	Political and economic risks on frontier markets still remains a risk and foreign investors are still adopting a “wait-and-see” approach due to this. However, we expect long term investors to enter the market seeking to take advantage of the attractive valuations	**Neutral**	**Neutral**
Politics and Security	Expect the government to put initiatives in place to ensure improved security. However, the 2017 election remains a challenge	In January, the U.S. Department of State issued a travel warning regarding threats by Al-Shabaab on the Somalia border, coastal and northeastern counties. In March, the U.K government issued a warning due to security concerns in parts of Laikipia County. As the election date approached, security was beefed up across the country	Security has been tight during and after the election period, despite reports of protests that turned violent in some parts of the country following the repeat presidential poll on October 26th, with the government expected to keep this in check. Security is still expected to be tight as political uncertainty continues to prevail.	**Neutral**	**Neutral**

Fixed Income Conclusion:

Of the 7 indicators of direction of interest rates, 1 has improved (Exchange Rate has changed from negative to neutral) since our last review in June, while the other 6 have remained unchanged. 6 of the 7 indicators are neutral pointing towards a stable outlook, hence our view that investors should be biased towards short-to medium term fixed income instruments to reduce duration risk. Rates in the fixed income market have remained stable, and we expect this to continue in the short-term. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rates environment as any additional borrowing in the domestic market to plug the deficit could lead to upward pressures on interest rates.
