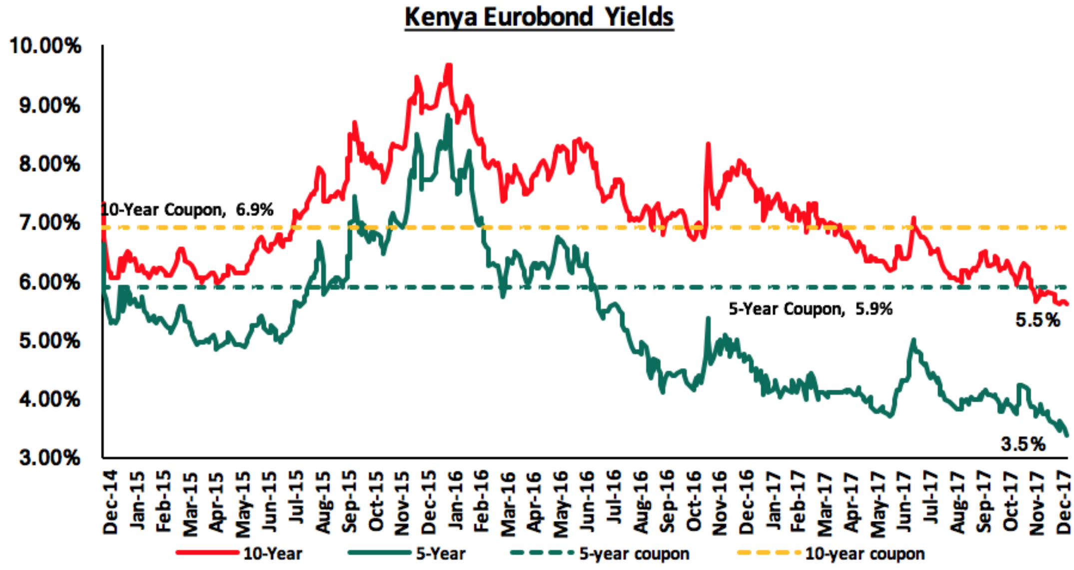
The Total Cost of Credit Post Rate Cap., & Cytonn Weekly #02/2018

Fixed Income

During the week, T-bills were oversubscribed, after 8-weeks of undersubscription, with the overall subscription rate coming in at 124.4%, from 85.3% recorded the previous week. The oversubscription can be attributed to improved liquidity in the market, as can be seen by the sudden decrease in the average interbank rate to 5.6% from 7.1% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 125.8%, 141.8%, and 106.6% compared to 89.6%, 97.5%, and 71.4%, respectively, the previous week. The yields on the 182 and 364-day papers remained unchanged at 10.7% and 11.2%, respectively, while the yield on the 91-day paper dropped to 8.0% from 8.1% the previous week. The overall acceptance rate declined to 85.0%, compared to 88.9% the previous week, with the government accepting a total of Kshs 25.4 bn of the Kshs 29.9 bn worth of bids received, against the Kshs 24.0 bn on offer. The government is still behind its domestic borrowing target for the current fiscal year, having borrowed Kshs 101.1 bn, against a target of Kshs 220.9 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)). The usage of the Central Bank overdraft facility remains high as it stands at Kshs 41.5 bn compared to a nil overdraft at the beginning of this fiscal year.

The average interbank rate declined to 5.6% from 7.1% recorded the previous week, while the average volumes traded in the interbank market decreased by 15.4% to Kshs 18.1 bn from Kshs 21.4 bn the previous week.

According to Bloomberg, yields on the 5-year and 10-year Eurobonds rose during the week by 30 bps and 20 bps, to close at 3.5% and 5.5%, from 3.2% and 5.3% the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 5.3% points and 4.2% points for the 5-year and 10-year Eurobonds, respectively, due to the relatively stable macroeconomic conditions in the country. The declining Eurobond yields and stable rating by Standard & Poor (S&P) are indications that Kenya's macro-economic environment remains stable and hence an attractive investment destination. However, concerns from Moody's and the International Monetary Fund (IMF) around Kenya's rising debt to GDP levels may see Kenya receive a downgraded sovereign credit rating if the issue is not addressed.



The Kenya Shilling appreciated by 0.2% against the US Dollar during the week to close at Kshs 103.1 from Kshs 103.3 the previous week, due to improved dollar inflows from diaspora remittances and horticultural exports. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by (i) expected calm in the political front as the government settles into office, (ii) the weakening of the USD in the global markets as indicated by the US Dollar Index, which shed 9.9% in 2017, and 0.7% YTD, and (iii) the CBK's intervention activities, as they have sufficient forex reserves, currently at USD 7.0 bn (equivalent to 4.7 months of import cover). Of note is that Reserves have been on a slight declining trend.

This week, the Energy Regulatory Commission (ERC) announced that it plans to eliminate a subsidy on the cost of electricity for the low-income households, starting April 2018. Currently, low-income households (consuming 50 units of electricity or less) pay Kshs 2.5 per kilowatt hour, middle-income households (consuming 51 to 1,500 units of electricity) pay Kshs 12.8 per kilowatt hour, while the high-end consumers (consuming above 1,500 units of electricity) pay Kshs 20.6 per kilowatt hour, where one unit is equivalent to one kilowatt hour. The regulator implemented the policy in a bid to keep the costs down for low-income households, but has recently noted that the framework is unsustainable, with consumers unable to track their power consumption and charges with ease, due to the distinct range of costs on consumption. The new policy will likely see the Last Mile initiative by the government, which seeks to ensure increased access of electricity to Kenyans, through the extension of low voltage network, take a hit, as the cost of electricity for low-income households rises. Despite this, the new tariff should see the uniform implementation of charges for domestic consumers, while also reducing the energy costs of high-end consumers, who have been shouldering the weight of the low-income households, and could go a long way into ultimately keeping the cost of goods low, thus improving the cost of living for Kenyans, as large manufacturers are relieved of higher production costs, with the benefits of lower cost production expected to be passed on to the consumer, consequently impacting the economy positively.

Rates in the fixed income market have remained stable, and we expect this to continue in the short-term as the government rejects expensive bids despite being behind their borrowing target. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rate environment as any additional borrowing in the domestic market to plug the deficit could lead to an upward pressure on interest rates. Consequently, our view is that investors should be biased towards short- term fixed income instruments to reduce duration risk.