Why Stock Indices Performance Differ; A Case Study of NASI vs NSE 20, & Cytonn Weekly 04/2018

Fixed Income

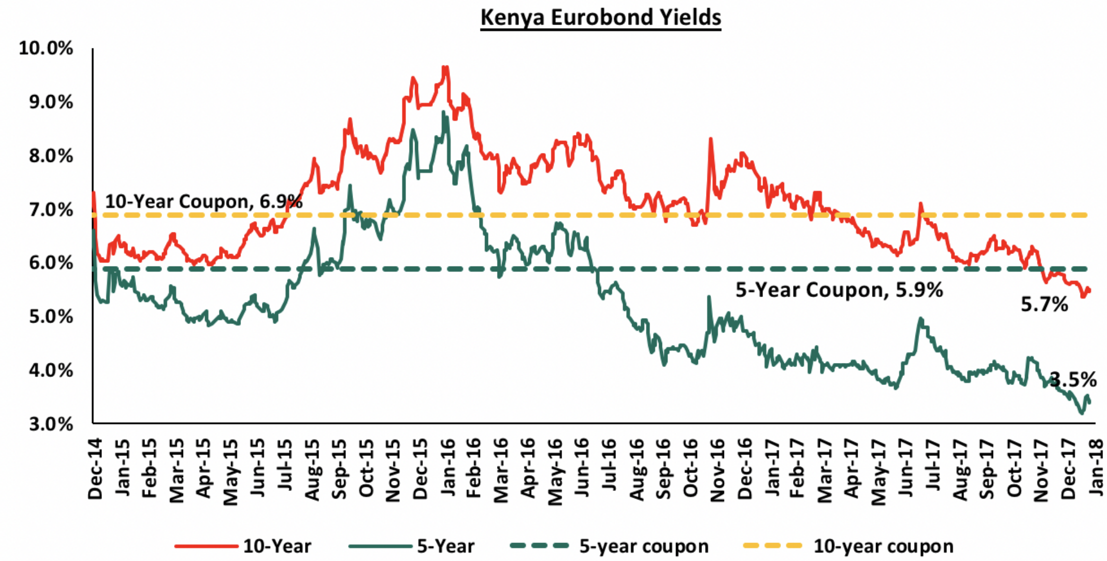
Treasury bills were oversubscribed during the week, with the overall subscription rate coming in at 116.8%, compared to 79.9% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 99.6%, 138.1%, and 102.4% compared to 42.4%, 99.4%, and 75.4%, respectively, the previous week. Yields on the 91 and 182-day papers remained unchanged at 8.0% and 10.6%, respectively, while the yield on the 364-day paper rose to 11.2% from 11.1%, the previous week. The overall acceptance rate rose to 91.5% compared to 84.9%, the previous week, with the government accepting a total of Kshs 25.6 bn of the Kshs 28.0 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 135.1 bn, against a target of Kshs 236.7 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 410.2 bn). If the domestic borrowing target is revised downwards to Kshs 293.8 bn as per the 2018 Budget Policy Statement (BPS), the pro-rated target comes in at Kshs 169.5 bn, meaning the government will still be behind on its borrowing target but marginally. The move to cut domestic borrowing could be aimed at reducing pressure on interest rates from investors in the domestic market who are bidding for higher yields, and instead increase borrowing from the foreign market. The usage of the Central Bank overdraft facility remains high as it stands at Kshs 47.0 bn compared to a nil overdraft at the beginning of this fiscal year.

The average interbank rate rose to 6.6% from 6.1% recorded the previous week, while the average volumes traded in the interbank market rose by 31.2% to Kshs 15.0 bn from Kshs 11.5 bn the previous week, indicating uneven distribution of liquidity in the market.

Last week, the Kenyan Government issued a 15-year amortized Infrastructure Bond (IFB 1/2018/15), with an effective tenor of 13.0 years, and a coupon of 12.5%, in a bid to raise Kshs 40.0 bn to fund infrastructural projects in the current fiscal year. The overall subscription rate for the bond issue came in at 139.4%, with the market average bid rate coming in at 13.0%, way above the average accepted rate of 12.5%. This indicates that the government continues to reject expensive bids in the auction market in order to maintain a low-levelled interest rate environment. The government accepted only Kshs 5.0 bn out of the Kshs 55.8 bn worth of bids received, translating to an acceptance rate of 9.0%. In our view, the rates have been kept artificially low by the government through their rejection of bids they deem expensive, despite pressure from investors who are demanding higher rates, and thus rates on government papers could be misleading in reflecting the accurate risk-free rate for the Kenyan economy.

According to Bloomberg, yield on the 5-year Eurobond remained unchanged while yield on the 10-year Eurobond rose by 20 bps to close at 5.7% from 5.5%, respectively, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 5.3% points and 4.1%

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 high debt levels persist.



The Kenya Shilling appreciated by 0.6% against the US Dollar during the week to a 1-year high of Kshs 102.3, from Kshs 102.9 the previous week, due to continued global weakening of the US Dollar. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

i. The calm political environment following the conclusion of the presidential elections,
ii. Weakening of the USD in the global markets as indicated by the US Dollar Index, which shed 9.9% in 2017, and has already lost 3.3% YTD thus hitting a 3-year low, and,
iii. 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 the forex reserves have been on a slight declining trend.

We are projecting the inflation rate for the month of January to rise to a range of between 4.9% - 5.2%, from 4.5% in December, mainly due to (i) an increase in food prices as government subsidy on maize flour ended in December 2017, (ii) an increase in fuel prices, which rose 3.7% m/m due to higher import prices for petroleum products, as global oil prices rose 5.5% to USD 70.5 per barrel during the month, and (iii) an increase in electricity prices, owing to an increase in the forex levy charge by 20.7% m/m in January. In addition, global oil prices are expected to rise due to a supply cap enforced by the Oil Producing and Export Countries (OPEC), which will lead to increased cost of transport and electricity production implying higher cost of living for Kenyan households. We expect inflation to average 7.5% over the course of the year down from 8.0% in 2017, which is within the government target range of 2.5% - 7.5%.

The Monetary Policy Committee (MPC) met this week, on Monday 22nd January 2018, to review the prevailing macroeconomic conditions and give direction on the Central Bank Rate (CBR). The MPC maintained the CBR at 10.0%, which was in line with our expectations as per our MPC Note. The Committee indicated that the decision was on the back of a relatively stable macroeconomic environment, given:

i. Decrease in inflation to 4.5% in December, from 4.7% in November, primarily due to reduced food prices, which offset the increases in fuel and electricity prices,

ii. The foreign exchange market remained relatively stable supported by resilient tea and horticultural exports, diaspora remittances, and strong recovery in tourism,
iii. Sufficient foreign reserves at USD 7.0 bn, translating to 4.7 months of import cover, with a standby facility of USD 1.5 bn from the IMF, which provides an adequate buffer for short term pressure on the shilling, and,
iv. A resilient banking sector, with the average commercial banks liquidity ratio and capital adequacy ratio at 43.7% and 18.5%, against statutory limits of 20.0% and 14.5%, respectively, as at December 2017, with the gross NPL ratio unchanged at 10.6% from October.

See the CBK release.

Key to note is that private sector credit growth improved marginally to 2.4% in December, from 2.0% in October; however, this remains way below the government set annual target of 18.3%.

The National Treasury released the 2018 Budget Policy Statement (BPS) for comments from the relevant stakeholders before presentation to the Cabinet and the Parliament. The BPS sets out the broad strategic priorities and policy goals that will guide the National Government and the County Governments in preparing their budgets both for the following financial year and over the medium term, while also highlighting some changes in the current fiscal year budget. Key take-outs from the BPS include:

i. The Treasury expects the current account deficit, which stood at 7.0% in Q3’2017 to narrow to 6.5% of the GDP by December 2017 as bulk of the Standard Gauge Railway (SGR) related imports are complete, while favourable weather conditions are expected to support food production and agricultural exports,
ii. Medium term economic growth is expected to come in at 7.0% supported by (i) increase in the share of manufacturing sector to GDP to 15.0% by 2022 from the current 8.9%, (ii) improvement in food security through enhanced agricultural production, (iii) expansion of universal health coverage, and (iv) delivery of at least 500,000 affordable housing units,
iii. Net foreign borrowing target is set to increase by 16.6% to Kshs 323.2 bn from Kshs 277.3 bn as per the budget, while net domestic borrowing is set to decrease by 28.4% to Kshs 293.8 bn from Kshs 410.2 bn that Cabinet approved in 2017. As indicated earlier, the move to cut domestic borrowing could be aimed at reducing pressure on interest rates from investors in the domestic market who are bidding for higher yields, and instead increase borrowing from the foreign market,
iv. The overall fiscal deficit is projected to decline from 8.9% of GDP in FY 2016/17 to 7.2% of GDP in FY 2017/18, 6.0% in FY 2018/19 and further to 3.0% of GDP by FY 2021/22 driven by the projected completion of key infrastructural projects being implemented by the Kenyan Government, enhanced revenue collection, and prudent public spending.

The BPS, if approved, will set a good step towards fiscal policy streamlining and ensuring that the budget is in line with the government goals for the fiscal year and thus supporting economic growth. The government needs to focus on fiscal discipline, as there is still a lot of criticism on the rising debt levels from the key global and regional institutions. The move to cut domestic borrowing is welcome, and could be aimed at reducing pressure on interest rates, however, the increase in foreign borrowing increases the country’s exposure to global risks. This comes as the Central Bank of Kenya (CBK) issued their economic growth projections for Kenya, underlining that they expect the economy to expand by 6.2% in 2018, on the back of positive fiscal policy, review of the interest cap legislation, strengthening of the banking sector, and an improvement in the ease of doing business. However, CBK has warned the National Treasury on the rising levels of debt as they are unsustainable and could have an adverse impact on economic growth. We shall be releasing our macroeconomic outlook report for Kenya highlighting our expectations for the year on 4th February, 2018.

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.

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