Nairobi Commercial Office Report, & Cytonn Weekly #10/2018

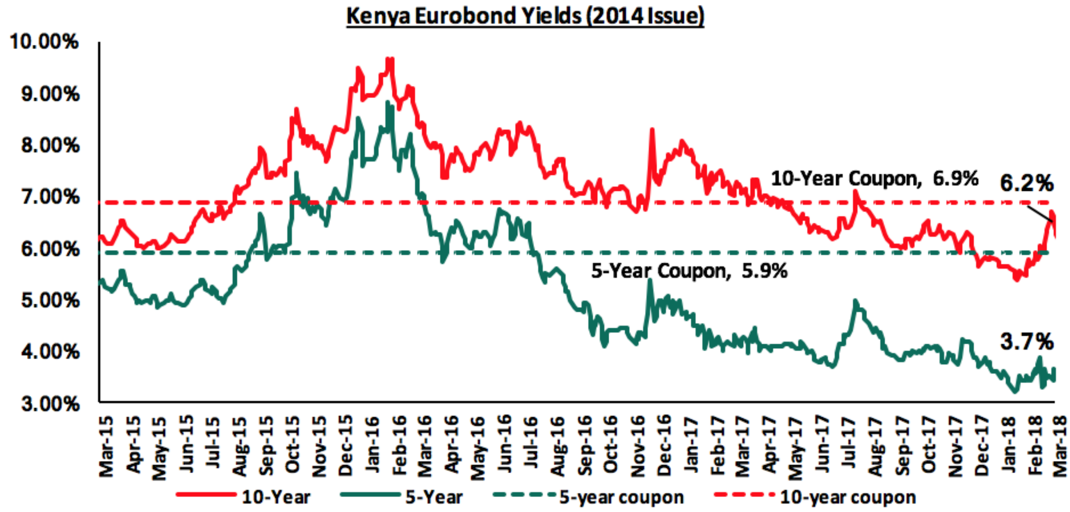
Fixed Income

Treasury bills were oversubscribed during the week, with the overall subscription rate at 155.0%, compared to 155.8% recorded the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 96.1%, 149.7%, and 183.8% compared to 192.3%, 163.3%, and 133.7%, respectively, the previous week. Yields on the 91, 182 and 364-day T-bills remained unchanged at 8.0%, 10.4%, and 11.1%, respectively. The overall acceptance rate increased to 87.8% compared to 81.9% the previous week, with the government accepting a total of Kshs 32.7 bn of the Kshs 37.2 bn worth of bids received, against the Kshs 24.0 bn on offer. The government is ahead of its domestic borrowing target for the current fiscal year, having borrowed Kshs 219.7 bn, against a target of Kshs 206.0 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 297.6 bn from the 2018 Budget Policy Statement (BPS)).

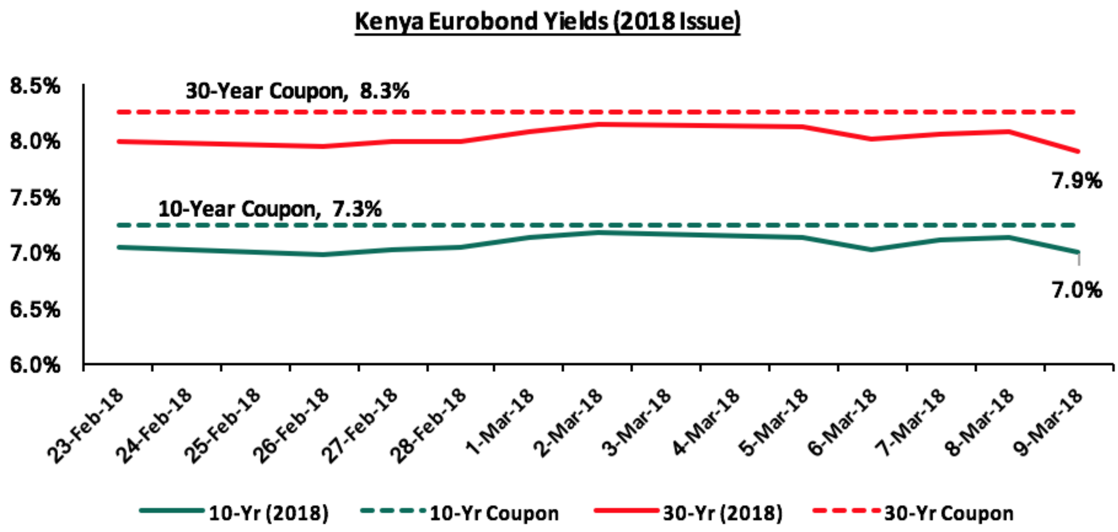
For the month of March 2018, the Kenyan Government has issued two new bonds, a 5-year (FXD 1/2018/5) and a 20-year (FXD 1/2018/20) with the 5-year coupon to be market-determined and the 20-year coupon set at 13.2%. The government will be seeking to raise Kshs 40.0 bn for budgetary support. We shall give our view on a bidding range in next week's report.

Liquidity levels remains stable in the market as indicated by the slight decline in the interbank rate to 4.7%, from 5.0% recorded the previous week, and also the decline in the average volumes traded in the interbank market by 2.5% to Kshs 13.5 bn from Kshs 13.8 bn the previous week, as larger banks dominated the market borrowing at low rates.

According to Bloomberg, the yield on the 5-year Eurobond issued in June 2014 remained unchanged at 3.7%, while the yield on the 10-year Eurobond (2014) increased by 10 bps to close at 6.2% from 6.3%, respectively, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 5.1% points and 3.4% points for the 5-year and 10-year Eurobonds, respectively, due to the relatively stable macroeconomic conditions in the country.



For the February 2018 issue, during the week, the yields on the 10-year and 30-year Eurobonds have decreased by 20 bps each to close the week at 7.0% and 7.9% from 7.2% and 8.1%, respectively. Since the issue date, the yield on the 10-year has remained unchanged while the yield on the 30-year Eurobond has declined by 0.1% points, indicating foreign investor confidence in Kenya's strong and relatively diversified economy.



The Kenya Shilling appreciated marginally by 0.1% against the US Dollar, during the week, to close at Kshs 101.2, from Kshs 101.3 the previous week, due to end month inflows from horticultural export earnings. On a YTD basis, the shilling has gained 1.9% against the USD. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

?. Weakening of the USD in the global markets as indicated by the US Dollar Index, which shed 9.9% in 2017, and has shed 2.3% YTD,
i. Improving diaspora remittances, which increased by 26.6% to USD 203.8 mn in December 2017 from USD 160.9 mn in December 2016, driven by a 39.2% and 30.9% increase in remittances from North America and Europe, respectively,
ii. CBK's intervention activities, as they have sufficient forex reserves, currently at USD 7.2 bn (equivalent to 4.8 months of import cover). Key to note is that an IMF team is still in Nairobi discussing a possible new program. Kenya has also requested for a 6-month extension on the USD 1.5 bn stand-by credit facility by the IMF to allow for completion of outstanding reviews of the program, a request which will be put to the board before expiry. Previously, the IMF had decided to withdraw the facility effective 13th March 2018 as conditions previously agreed upon for the facility to be extended had not been met, and,
iii. A possible increase in the forex reserves following the successful issuance of the Eurobond.

Stanbic Bank released their Monthly Purchasing Manager's Index (PMI) for February, which indicated that the business operating environment in the country improved, with the index coming in at 54.7 in February, up from 52.9 in January. The rise was driven by an increase in output and new orders, supported by increasing underlying demand and a rise in new business. The business environment has been improving since January as seen from the improving PMI index, above the 50.0 mark that signals improving conditions, increasing output and increased staffing by production firms as a result. This is expected to support economic growth and lead to stronger GDP growth this year. We maintain our outlook of 5.4% GDP growth in 2018, driven by growth in manufacturing, tourism, construction and real estate sectors, and recovery of the agriculture sector.

According to Africa Oil, one of the partner companies developing the country's first oilfield, construction of the oil export pipeline is supposed to start mid this year. It is estimated that oil will earn Kenya about a tenth of revenue once production is at its peak - as per the 2017/18 budget, this is about Kshs 164 bn. Production will start in 2021/22, starting with 210 mn barrels of oil (capacity is

560 mn). Daily production will start at 60,000 - 80,000 barrels per day (bpd), potentially increasing to 100,000 bpd, which is not as high as in other countries in SSA, which have production as follows: (i) Nigeria currently at 180,000 bpd and planning to increase this to 300,000 bpd in 2018 and 500,000 bpd by 2020, and (ii) Ghana with 123,000 bpd, expected to rise to 250,000 bpd in 2018. The first stage of production and construction of the pipeline are estimated at costs of USD 2.9 bn and USD 1.1 bn, respectively. In our view, this will further contribute to revenue collections in the fiscal year 2021/22 onwards and support the government's plan to reduce the budget deficit to 3.0% of GDP by then as per the 2018 BPS, if they manage to keep expenditure in check.

Given the changes in government borrowing that we have witnessed so far in 2018, we carried out a review of 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	2017 Experience	YTD Experience	Outlook Going Forward	Previous View	Current View
Government Borrowing	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 The government had met 39.2% of its H1'2017/18 foreign borrowing target	The domestic borrowing target was revised downwards to Kshs 297.6 bn from Kshs 410.2 bn, taking the government ahead of their domestic borrowing target, having borrowed Kshs 219.7 bn against a pro-rated target of Kshs 206.0 bn The government has met 69.9% of its total foreign borrowing target following issue of the Kshs 202.0 bn Eurobond	Government to be under no pressure to borrow as it is ahead of both domestic and foreign pro-rated borrowing targets for FY 2017/18, and KRA is not significantly behind its target Past June, at the start of the next fiscal year however, the government will once again begin a new borrowing cycle. However, with the petition by the Treasury to amend the Division of Revenue Act 2017 and reduce expenditure by counties and an expected improvement in revenue collections, the borrowing targets for the next fiscal year might be lower	Negative	Positive

Macro-Economic Indicators	2017 Experience	YTD Experience	Outlook Going Forward	Previous View	Current View
Revenue Collection	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. As per the Q1’2017/18 budget review, the KRA met 89.1% of its first quarter target	The KRA collected Kshs 709.4 bn, 91.2% of their target for H1’2017/18 and 86.3% of the pro-rated target for the same	KRA is unlikely to meet its collection target due to expected suppressed corporate earnings in 2017, which is half of the fiscal year. However, KRA is not expected to be significantly behind target, that can be easily plugged in from the local market borrowing Corporate earnings are expected to be better this year than last year, with earnings growth expected at 12.0% in 2018, higher than the expected 8.0% growth for 2017. This coupled with the VAT on petroleum products effective September 2018 is expected to boost revenue collections in the next fiscal year	Negative	Neutral
Monetary Policy	CBR has been maintained at 10.0% throughout 2017 The 91 Day T-Bill hit 8.0% from 8.8% recorded at the end of January 2017	In the January 2018 MPC meeting, the committee maintained the CBR at 10.0%	No upward pressure on interest rates, with the government ahead of its pro-rated borrowing targets for the fiscal year. Also, with the Banking (Amendment) Act, 2015, the MPC might be unable to do much with the CBR which has remained at 10.0% throughout 2017	Neutral	Neutral

Macro-Economic Indicators	2017 Experience	YTD Experience	Outlook Going Forward	Previous View	Current View
Inflation	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	Inflation in January and February 2018 came in at 4.8% and 4.5%, with y/y inflation remaining low mainly due to the base effect but m/m inflation rising due to increasing food, fuel, electricity and transport prices	Inflation to average 7.5% in 2018, which is at the upper limit of the 2.5% - 7.5% government target	Positive	Positive
Exchange Rate	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	The Shilling has appreciated by 1.9% against the USD YTD to Kshs 101.2 from Kshs 103.2 at the end of December 2017, hitting a high of Kshs 100.8 due to increased flower exports to the Eurozone in mid-February	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 7.2 bn - equivalent to 4.8 months of import cover) to support the shilling in the short term. However, a worsening current account deficit, which worsened to 7.0% of GDP in Q3’2017, as compared to 6.0% of GDP in a similar period last year, may have a negative effect	Neutral	Neutral
Investor Sentiments	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 2017, with a net outflow of USD 117.1 mn compared to net inflows of USD 88.8 mn recorded in 2016	The Kenya Eurobond was 7.0x oversubscribed partly showing the appetite for Kenyan securities by the foreign community, and investor confidence in Kenya’s stable and relatively diversified economy	Given (i) the now settling operating environment following the elections in Q3’2017, (ii) the expectation that long term investors will enter the market seeking to take advantage of the valuations which are still historically low, and (iii) expectations of a relatively stable shilling, we expect investor sentiment to improve in 2018	Positive	Positive

Macro-Economic Indicators	2017 Experience	YTD Experience	Outlook Going Forward	Previous View	Current View
Security	In January, the U.S. Department of State issued a travel warning regarding threats by Al-Shabaab on the Somalia border, coastal and north-eastern 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	The political climate in the country has eased, compared to Q3'2017 with security maintained and business picking up	We expect security to be maintained in 2018, especially given that the elections are now concluded and the government is settling into office	Positive	Positive

Fixed Income Conclusion:

Of the 7 indicators we track, previously, we were negative on government borrowing and revenue collection. Upon review, 4 are positive (government borrowing, inflation, investor sentiment and security) and 3 are neutral (revenue collection, monetary policy and currency). The outlook on government borrowing and revenue collection has changed from negative to positive and neutral, respectively. Rates in the fixed income market have remained stable as the government rejects expensive bids. With the government under no pressure to borrow for this fiscal year as (i) they are currently ahead of their domestic borrowing target by 14.3%, (ii) have met approx. 103.9% of their pro-rated foreign borrowing target, and (iii) the KRA is not significantly behind target in revenue collection, we expect interest rates to remain stable. With the expectation of a relatively stable interest rate environment, our view is that investors should be biased towards medium term fixed income instruments.

Note that we have changed our fixed income view from a short term bias to a medium term bias.