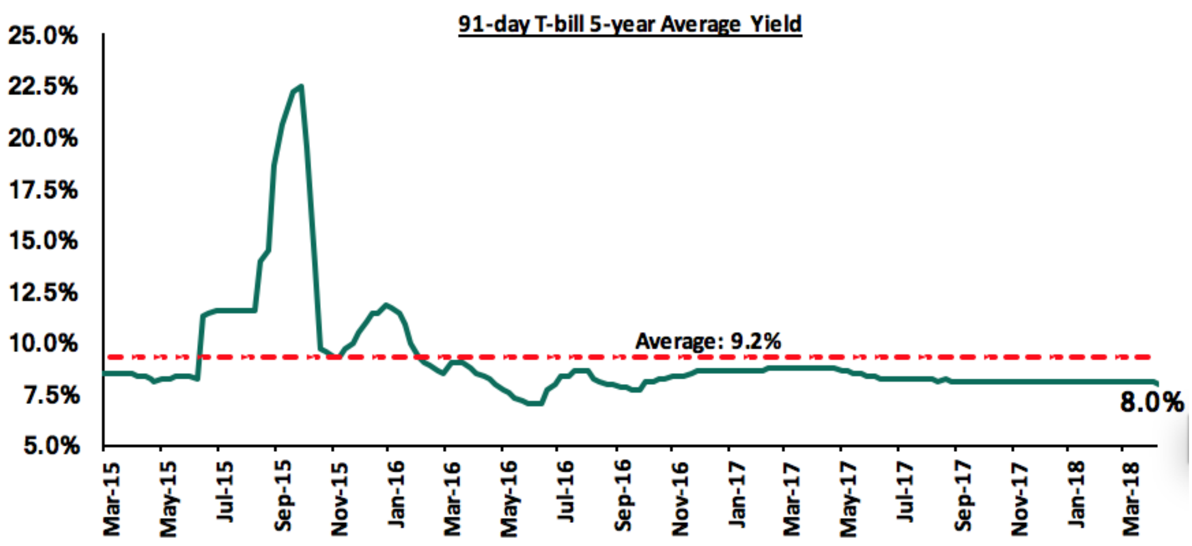
Cytonn Monthly - April 2018

Fixed Income

During the month of April, T-bill auctions recorded an oversubscription, with the average subscription rate coming in at 115.7%, a decline from 141.2% recorded in March. The subscription rates for the 91, 182 and 364-day papers came in at 68.5%, 109.1% and 141.1%, from 102.9%, 126.4% and 171.8%, the previous month, respectively. The yields on the 91 and 364-day papers remained flat at 8.0% and 11.1%, respectively, while the yield on the 182-day paper declined by 10 bps to 10.3% from 10.4% the previous month. The T-bills acceptance rate came in at 87.9% during the month, compared to 86.9% in March, with the Kenyan Government accepting a total of Kshs 97.6 bn of the Kshs 111.0 bn worth of bids received, indicating that bids were largely within ranges the Central Bank of Kenya (CBK) deemed acceptable. The government is currently ahead of its domestic borrowing target for the current fiscal year, having borrowed Kshs 324.1 bn, against a target of Kshs 251.8 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 297.6 bn).

This week, T-bills were oversubscribed with a subscription rate coming in at 136.8%, compared to 106.1% recorded the previous week. Yields on the 91, 182 and 364-day papers remained unchanged at 8.0%, 10.3% and 11.1%, respectively. The acceptance rate increased to 81.1%, from 76.7% the previous week, with the government accepting Kshs 26.6 bn of the Kshs 32.8 bn worth of bids received.

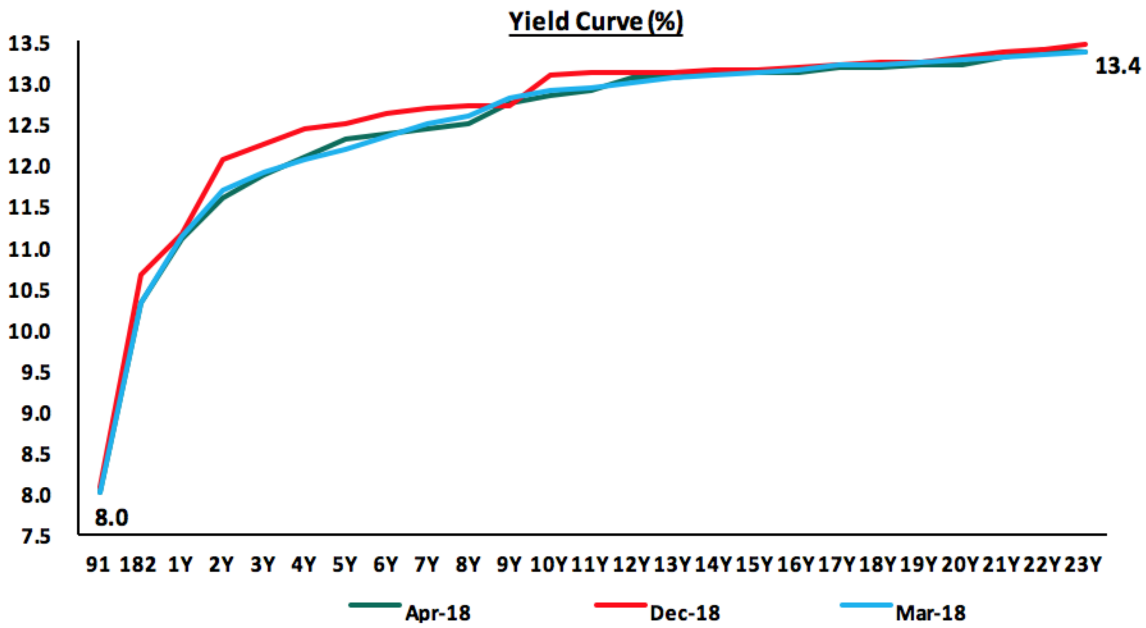
The 91-day T-bill is currently trading at 8.0%, which is below its 5-year average of 9.2%. The lower yield on the 91-day paper is mainly attributable to the low interest rate environment experienced since the passing of the law capping interest rates. We expect this to continue in the short-term, given (i) the discipline of the CBK in stabilizing interest rates in the auction market by rejecting aggressive bids that are priced above market, for both T-bills and T-bonds, and (ii) the government being under no pressure to borrow from the local market as it is currently ahead of its domestic borrowing target, and from the foreign markets where it has met approx. 86.1% of its prorated target.



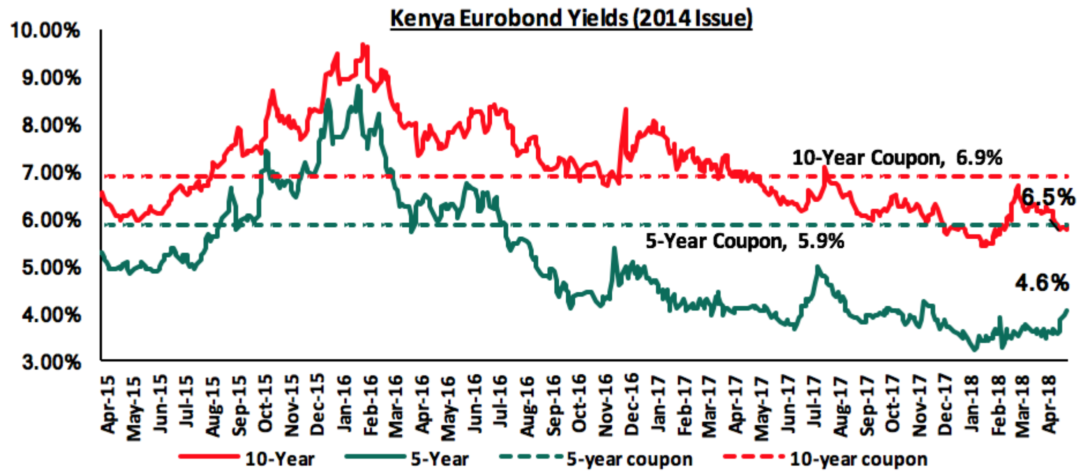
Liquidity levels declined in the money market as indicated by the increase in the average interbank rate to 4.84% from 4.75% recorded the previous week, following net payments for government securities and tax remittances by banks. There was an increase in the average volumes traded in the interbank market by 7.2% to Kshs 14.8 bn, from Kshs 13.8 bn the previous week.

During the month, the Kenyan Government re-opened two bonds, FXD 1/2008/15 and FXD 1/2018/20, with 4.9 years and 19.9 years to maturity, and coupons of 12.5% and 13.2%, respectively, in a bid to raise Kshs 40.0 bn for budgetary support. The overall subscription rate for the issue came in at 81.9%, with the market weighted average bid rates coming in at 12.3% and 13.3%, respectively, in line with our expectations. The government accepted only Kshs 26.9 bn of the Kshs 32.8 bn worth of bids received, translating to an acceptance rate of 82.2%. We do not expect the government to come under pressure to borrow for the current fiscal year given they are ahead of their domestic borrowing target and have also borrowed approximately 86.1% of their pro-rated foreign borrowing target.

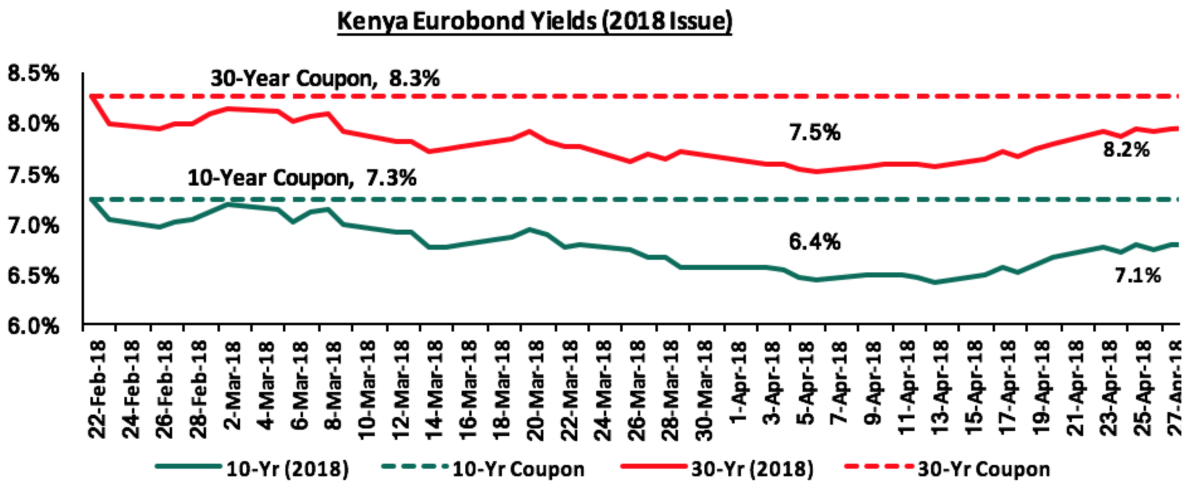
The yields on government securities in the secondary market remained relatively stable during the month as Central Bank continues to reject expensive bids in the primary market. According to the FTSE NSE Bond Index, Treasury bonds listed at the Nairobi Securities Exchange (NSE) gained 1.4% during the month, bringing the YTD performance to 4.0%.



According to Bloomberg, the yield on the 5-year Eurobond issued in June 2014 increased by 60 bps to 4.1% during the month of April from 3.5% in March, while the yield on the 10-year Eurobond (2014) increased by 20 bps to close at 6.1% from 5.9% during the same period. During the week, yield on the 5-year and 10- Year Eurobonds issued in 2014 rose by 50 bps and 40 bps to 4.6% and 6.5% from 4.1% and 6.1%, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.2% points and 3.2% points for the 5-year and 10-year Eurobonds, respectively, due to the relatively stable macroeconomic conditions in the country. Key to note is that yields on Kenya Eurobond have recently been increasing on account of varying market sentiments.

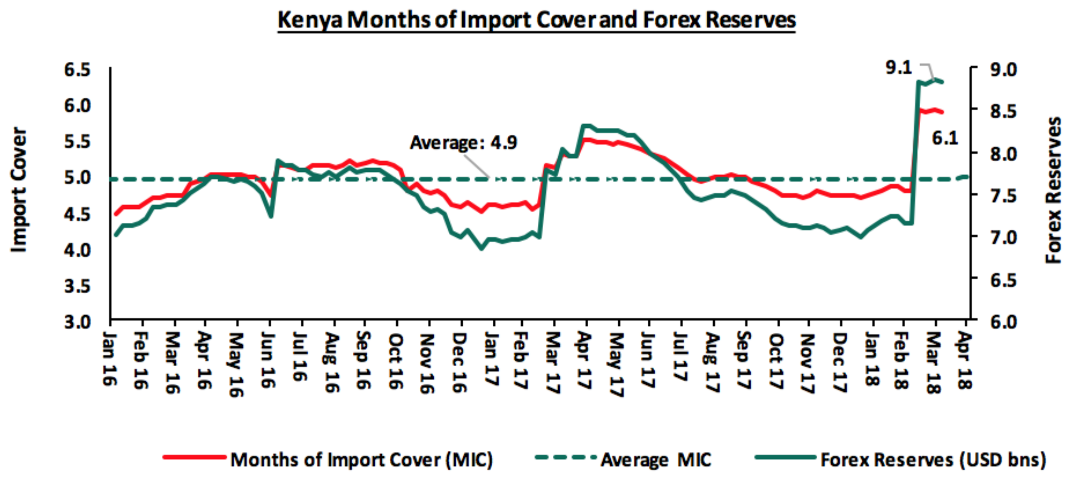


During the month, the yields on the 10-year and 30-Year Eurobond issued in February increased by 20 and 30 bps to 6.8% and 8.0% from 6.6% and 7.7% in March, respectively. During the week, the yields on the 10-year and 30-year Eurobonds increased by 30 bps and 20 bps to 7.1% and 8.2% from 6.8% and 7.9% last week, respectively. Since the issue date, yields on the 10-year and 30-year Eurobonds have declined by 0.1% points each indicating foreign investor confidence in Kenya’s macro-economic prospects.



The Kenya Shilling appreciated by 0.5% against the US Dollar during the month of April to Kshs 100.4, from Kshs 100.8 at the end of March, mainly as a result of increased offshore investor inflows, which stood at USD 222.2 mn in March 2018. During the week, the Shilling gained 0.1% against the USD to Kshs 100.2 from Kshs 100.3, the previous week, on the back of increased dollar supply from offshore investors. On a YTD basis, the shilling has gained 2.9% against the USD. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

i. Stronger horticulture export inflows driven by increasing production and improving global prices,
ii. Improving diaspora remittances, which increased by 47.5% to USD 210.4 mn in February 2018 from USD 142.7 mn in February 2017, and,
iii. High forex reserves, currently at USD 9.1 bn (equivalent to 6.1 months of import cover), and the USD 1.5 bn stand-by credit and precautionary facility by the IMF, still available until September 2018, after which a new facility will be discussed.



The year on year inflation rate for the month of April declined to 3.7%, from 4.2% in March, its lowest level since January 2013 driven by (i) Year on year food inflation declining to 0.3% from 2.2% in March on account of improved weather conditions, while the m/m inflation declined to 1.435% from 1.439% in March attributed to the transport index declining by 0.2%, as a result of reduction in petrol and diesel prices, (ii) Housing, Water, Electricity, Gas and Other Fuels' Index, increasing by 3.2% in April 2018 compared to 3.8% in March 2018 mainly attributed to significant increase in prices of cooking fuels with charcoal recording the highest increase of 16.9%. Below is a summary of key changes in the Consumer Price Index (CPI) in April;

Major Inflation Changes in the Month of February 2018

Broad Commodity Group	Price change m/m (April-18/ March-18)	Price change y/y (April -18/April 17)	Reason
Food & Non-Alcoholic Beverages	1.6%	0.3%	The increase to 1.6% from 1.5% in March was attributed to an increase in prices of some foodstuffs outweighing decreases recorded in respect of others.
Transport Cost	-0.2%	7.0%	The 0.2% decline in April was on account of reduction in pump prices of petrol and diesel.
Housing, Water, Electricity, Gas and Other Fuels	3.2%	11.8%	The 3.2% change in prices was mainly attributed to a significant increase in prices of cooking fuels with charcoal recording the highest increase of 16.9%.
Overall Inflation	1.4%	3.7%	The decline to 3.7% from 4.2% in March was due to a decline in y/y food inflation which has a CPI weight of 36.0%, to 0.3 from 2.1 in March

The World Bank released their World Economic Update, April 2018, during the month. As per the update, Kenya's GDP growth is expected to recover and grow at 5.5% in 2018 and steadily rise to 6.1% by 2020, driven by (i) improved agricultural output on account of better rains, (ii) the improved political climate after the prolonged electioneering period, and (iii) recovery in the global economy. The implementation of the government's big four agenda, (which focuses on agricultural and food security, real estate and affordable housing, manufacturing, and Universal Health Coverage) is expected to help Kenya advance towards becoming an upper middle-income economy with high standards of living. The growth is however expected to be impacted by the rise in oil prices currently at USD 67.7 per barrel up from USD 66.9 at the end of 2017, and the weak private sector credit growth that stood at 2.1% as at February 2018 following implementation of the rate cap in 2016.Going forward, we expect inflation to average 7.0% over the course of the year down from 8.0% in 2017, which is within the government target range of 2.5% - 7.5%. Upward pressure on the inflation rate is likely to come from fuel and transport prices as the Treasury plans on imposing 16.0% Value Added Tax (VAT) on petroleum products, effective September 2018, as per the deal made with the IMF to reduce the budget deficit.

During the week, Stanbic released their PMI index, which indicated that the private sector had the greatest significant improvement in April since January 2016 with output growth having risen at the fastest rate since the survey's inception in January 2014. The adjusted PMI rose to 56.4 in April from 55.7 in March driven by favorable macroeconomic conditions and greater inflows from new orders from both external and domestic markets attributed to a higher customer turnout and improved demand. Readings above 50.0 signal an improvement in business conditions on the previous month, while readings below 50.0 show a deterioration. The rate of job growth was solid and the strongest reported since the end of 2016 due to a rise in staffing levels

attributed to firms expanding their capacities in response to the rising output requirements during the month. The private sector however experienced higher input costs due to a general rise in cost of imported raw materials attributed to the strengthening of the US dollar with food and fuel prices also reportedly up since March. Going forward, output is expected to continue rising, driven by a recovery in agricultural produce, mainly horticulture, as the Eurozone, which is Kenya's main horticultural export destination, continues to recover thus boosting demand. Of concern however, the combination of rising demand with the continued rise in input costs and job growth have the potential to exert meaningful and durable upward pressures on inflation.

The Kenya National Bureau of Statistics (KNBS) released the Economic Survey 2018, with key take-outs from the report being:

i. Kenya's economy grew by 4.9% in 2017, compared to 5.9% in 2016 in line with our expectation of between 4.7% - 5.2%. The decline in performance was attributed to (a) adverse effects of weather conditions due to the widespread drought experienced in Q4'2016 and suppressed long rains in 2017 that led to a decline in agriculture sector growth, and (b) uncertainty associated with the prolonged election period that led to a deceleration of growth in the manufacturing sector. The growth in Q1, Q2 and Q3 came in at 4.7%, 5.0% and 4.4% from 5.9%, 6.2% and 5.7% in 2016, respectively. The first quarter of 2017 suffered from subdued growth in agriculture due to the effects of the 2016/17 drought, while the third quarter's growth suffered the negative effects of uncertainty in the political environment brought about by the prolonged election period. For more details, see our Kenya 2017 GDP Growth and Outlook Note,
ii. Exports increased by 2.8% to Kshs 594.1 bn in 2017 from Kshs 578.1 bn in 2016 with the major earners being tea and horticulture, collectively accounting for 49.1% of total domestic export earnings. Despite being the major earners, the total export volumes of tea and horticulture declined by 5.8% to 924,234 tons from 981,542 tons in 2016, on account of the adverse weather conditions experienced in the first half of 2017.
iii. Imports grew by 20.5% to Kshs 1.7 tn in 2017 from Kshs 1.4 tn in 2016, driven by an increase in importation of industrial machinery, petroleum products, motor vehicles, and iron & steel. Asia accounted for 64.2% of total imports in 2017 with China, India, United Arab Emirates and Saudi Arabia having the lion's share, accounting for 73.5% of the total Asian imports,
iv. Average deposit rates increased to 8.2% in December 2017 from 7.3% in December 2016, while commercial bank average lending rates remained unchanged at 13.6% in December 2017. Total domestic credit rose by 7.9% compared to 6.4% in 2016, primarily due to a 12.1% growth in credit to the national government, compared to the decline in private sector credit growth to 2.4% from 4.1% in 2016, indicating increased lending to the government. The slower growth in the financial & insurance sector is mainly attributed to effects of the interest rate cap, eroding interest income

earned by banks in 2017.

Below is a table showing that the Kenyan economy is expected to grow at an average of 5.5% in 2018 according to updated projections by the organizations that we track as at Q2’2018, updated with our own projection. We have since revised our GDP growth projection upwards to a range of 5.4% - 5.6%, from 5.3% - 5.5% previously, driven by a recovery in the agriculture and manufacturing sectors, and continued growth in tourism, real estate and construction sectors. We shall continue to update this table as these organizations release their updated 2018 projections:

Kenya 2018 Annual GDP Growth Outlook

No.	Organization	Q1'2018	Q2'2018
1	Central Bank of Kenya	6.2%	
2	Kenya National Treasury	5.8%	
3	Oxford Economics	5.7%	
4	African Development Bank (AfDB)	5.6%	
5	Stanbic Bank	5.6%	5.6%
6	Citibank	5.6%	
7	International Monetary Fund (IMF)	5.5%	
8	World Bank	5.5%	5.5%
9	Fitch Ratings	5.5%	
10	Barclays Africa Group Limited	5.5%	
11	Cytonn Investments Management Plc	5.4%	5.5%
12	Focus Economics	5.3%	
13	BMI Research	5.3%	5.2%
14	Standard Chartered	4.6%	
	Average	5.5%	5.5%

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 pro-rated domestic borrowing target by 28.7%, (ii) have met approx. 86.1% of their pro-rated foreign borrowing target, and (iii) the KRA is not significantly behind target in revenue collection, and therefore 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 to long-term fixed income instruments.