Cytonn INVESTMENTS

Cytonn Weekly #20/2018

Fixed Income

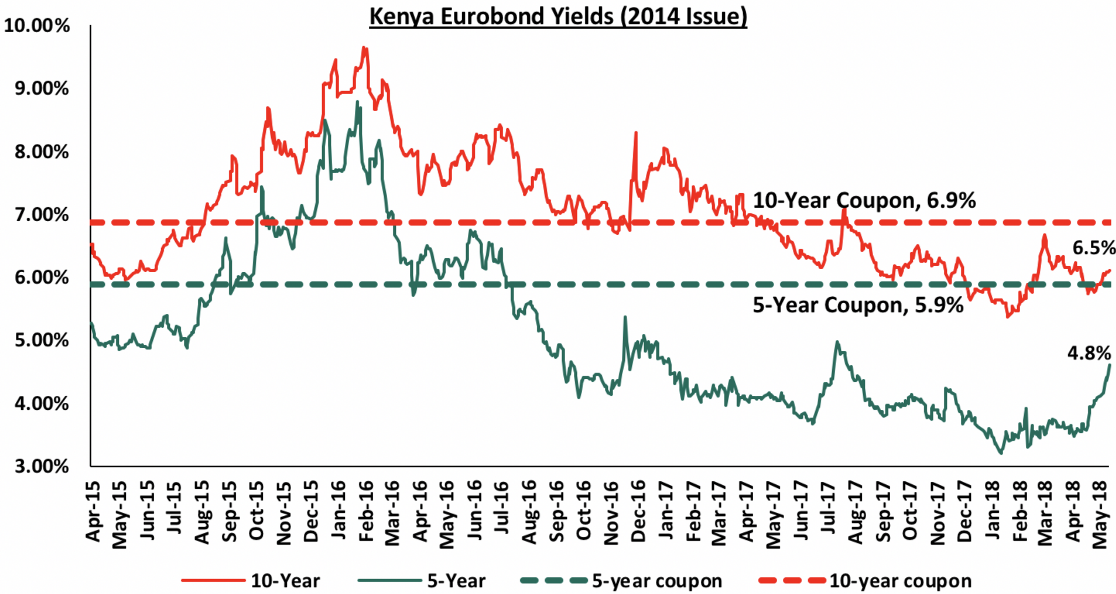
T-bills were oversubscribed during the week, with the subscription rate coming in at 183.1%, up from 165.7% the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 82.7%, 78.6%, and 327.8% compared to 120.8%, 150.8%, and 198.4%, respectively, the previous week. Yields on the 91, 182 and 364-day papers remained unchanged at 8.0%, 10.3% and 11.1%, respectively. We note that the 364-day paper continued to receive the most interest from investors, having recorded the highest subscription rate of the 3 papers this week of 327.8%, from 198.4% the previous week, as investors seek to lengthen duration. The acceptance rate for T-bills declined to 69.7%, from 91.2% the previous week, with the government accepting a total of Kshs 30.6 bn of the Kshs 43.9 bn worth of bids received, against the Kshs 24.0 bn on offer. The government is currently 31.0% ahead of its pro-rated domestic borrowing target for the current fiscal year, having borrowed Kshs 345.0 bn, against a target of Kshs 263.3 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 297.6 bn).

For the month of May 2018, the Kenyan Government has issued a new 15-year Treasury bond (FXD 1/2018/15) with the coupon set at 12.7%, in a bid to raise Kshs 40.0 bn for budgetary support. Given that (i) the government is currently 31.0% ahead of its pro-rated domestic borrowing target, and has collected 72.9% of its total foreign borrowing target, and (ii) the KRA is not significantly behind target, having collected 91.2% of its half year 2017/18 target, we don't expect the government to come under pressure to borrow during the current fiscal year, neither do we expect upward pressure on interest rates during the same period. Treasury bonds with the same tenor are currently trading in the secondary market at a yield of 13.0%. As such, we expect the average yield to come in between 13.0% and 13.3%.

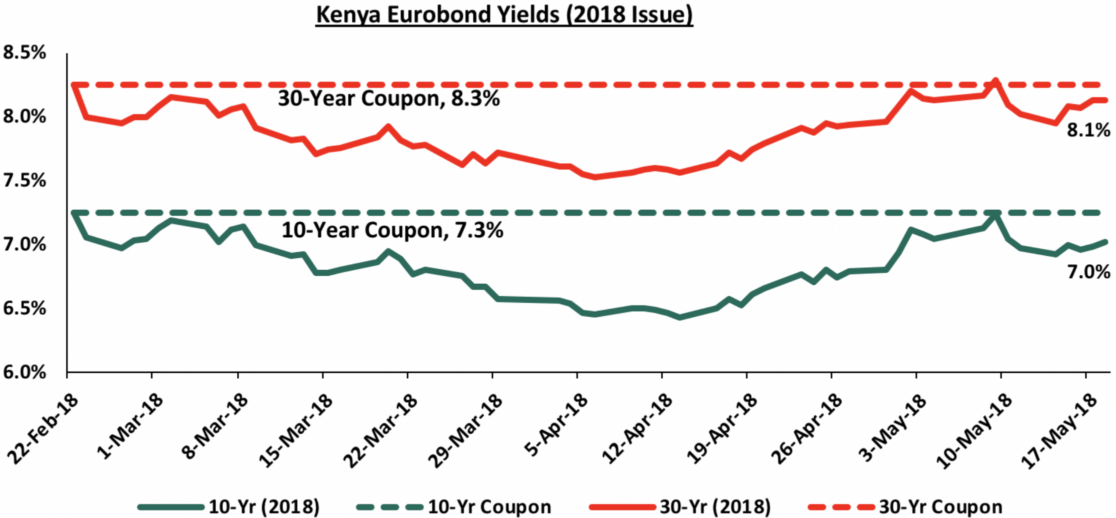
Liquidity levels improved in the money market as indicated by the decline in the average interbank rate to 4.4%, from 5.0% recorded the previous week, and the reduction in the average volumes traded in the interbank market by 18.1% to Kshs 12.7 bn, from Kshs 15.5 bn the previous week. The reduced pressure on liquidity can be attributed to the end of the monthly Cash Reserve Requirement (CRR) cycle for the month of May, which ended on the 14th. The CRR is the percentage of deposits that commercial banks are required to keep with the Central Bank of Kenya. It is a mandatory requirement, and Kenya's CRR currently stands at 5.25% of deposits held by a commercial bank. How the CRR cycle works is that, all commercial banks are required to maintain a CRR of 5.25% of their deposits for a month, ending on the 14th of every month, but can let the ratio get to a low of 3.0% during the month, as long as the average for the month gets to 5.25%. Towards the end of a cycle, banks are always under pressure to meet the requirement if they had not met it earlier on in the cycle, but after one cycle ends and another begins, the pressure on liquidity for banks reduces.

According to Bloomberg, the yield on the 5-year Eurobond issued in June 2014 increased by 30 bps to 4.8% from 4.5%, the previous week, while the yield on the 10-year Eurobond increased by 10 bps to 6.5% from 6.4% the previous week. The increase during the week can be attributed to varying market sentiments from foreign investors. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.0% points and 3.2% points for the 5-year and 10-year Eurobonds,

respectively, due to the relatively stable macroeconomic conditions in the country.



For the February 2018 Eurobond issue, during the week, the yield on the 10-year Eurobond remained unchanged at 7.0%, while the yield on the 30-year Eurobond increased by 10 bps to 8.1%, from 8.0% the previous week. Since the issue date, yields on the 10-year and 30-year Eurobonds have both declined by 0.3% points and 0.2% points for the 10-year and 30-year Eurobonds, respectively, indicating foreign investor confidence in Kenya's macroeconomic prospects.



During the week, the Kenya Shilling remained stable, closing at Kshs 100.4 to the US Dollar, as dollar inflows from diaspora and portfolio investors matched demand from oil importers. On a YTD basis, the shilling has gained 2.7% 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 50.6% to USD 222.2 mn in March 2018 from USD 147.5 mn in March 2017, attributed to (a) recovery of the global economy, (b) increased uptake of financial products by the diaspora due to financial services firms, particularly banks, targeting the diaspora, and (c) new partnerships between international money remittance providers and local commercial banks making the process more convenient. Key to note is that in 2017, diaspora remittances became the largest foreign exchange earner at Kshs 202.9 bn, exceeding tea exports and tourism receipts, which earned Kshs 119.9 bn and Kshs 147.2 bn, respectively, and,
iii. High forex reserves, currently at USD 9.1 bn (equivalent to 6.2 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.

During the week, South Africa raised USD 2.0 bn through the issue of 12-year and 30-year Eurobonds at yields of 5.9% and 6.3%, respectively. The issue was 1.7x oversubscribed, as the increase in investor appetite for the African bonds continues. The issue came a month after Moody's Investor Service confirmed South Africa's sovereign long-term issuer and senior unsecured ratings of "***Baa3***", and changed the outlook to "***positive***" from "***negative***" citing the potential of economic recovery with the recent change in leadership of the country. This was the second Eurobond issue in Africa in the 2nd quarter of 2018 after Ghana managed to raise a similar amount a week earlier through the issuance of 10-year and 30-year Eurobonds at yields of 7.6% and 8.6%, respectively. Ghana's issue was also oversubscribed at 4.0x the targeted amount, higher than South Africa, which we attribute to their relatively higher yields. Moody's Investor Service affirmed Ghana's sovereign long-term issuer and senior unsecured bond ratings at "***B3***" maintaining the outlook at "***stable***". Ghana's economy has continued to improve, recording GDP growth of 8.5% in 2017, up from 3.7% in 2016. The country however still grapples with increasing public debt, with the International Monetary Fund (IMF) estimating their public debt-to-GDP at 70.5% in 2017, 20.5% points above the 50.0% recommended threshold, but with the country implementing the IMF credit-facility program, the budget deficit has since narrowed to 6.3% of GDP in 2017 from 9.3% in 2016. From the Eurobond issuances that have taken place so far this year, we note that governments have begun issuing more long-term Eurobonds, 30-years on average, to increase their liability tenures, a commendable debt management move.

Following the March 2018 IMF visit to Kenya, the Treasury has been seeking ways to increase revenue collected going forward, in a bid to reduce the budget deficit and Kenya's public debt burden. With respect to this, the following changes have been tabled in parliament through various tax bills, including the Income Tax Bill, 2018 and the Tax Laws (Amendment) Bill, 2018:

i. 35.0% tax on individuals earning Kshs 750,000 per month and above as well as large corporations with a monthly taxable income of more than Kshs 500 mn, and,
ii. Amendments to the VAT Act that include changing the status of various products such as milk and cream, maize (corn) flour, bread and wheat among others from zero-rated to exempt, meaning that producers of these products cannot claim Value Added Tax (VAT) on inputs from the government, thus increasing their retail prices.

These changes as well as the expected 16.0% VAT on petroleum products as from September 2018 is aimed at increasing revenue collections by the KRA and reducing the budget deficit to 6.0% of GDP in the fiscal year 2018/19, and further to 3.0% of GDP by 2021/22, from 7.2% in this fiscal year. Prices of basic goods, however, will take a hit as suppliers will pass on the additional tax cost burden to the final consumers, thus leading to a rise in food inflation in the period of implementation. As we continue to see significant changes to taxes, we are of the view that this should be accompanied by equally significant reduction efforts in recurrent expenditure, as only this joint effort will lead to a substantial decline in the budget deficit and in turn the public debt burden.

On inflation for the month of May;

i. Electricity prices are set to fall in May for the first time this year attributed to (a) a 7.5% decline in the fuel levy to Kshs 5.0 from Kshs 5.4 per Kilowatt Hour (KwH) previously, due to reduced reliance on the more expensive thermal electricity powered by diesel generators, as generation of the cheaper Hydroelectric Power (HEP) increases now that dams are filling up thanks to the heavy rainfall experienced recently, and (b) a decline in the forex levy by 15.3% to Kshs 1.2, from Kshs 1.4 per KwH previously in May, due to continued appreciation of the Kenya Shilling, and,
ii. According to the Energy Regulatory Commission (ERC), petrol, diesel and kerosene prices have increased by 0.3%, 0.8% and 2.0% to Kshs 107.2, Kshs 98.6 and Kshs 78.2 per liter, respectively,

effective 15th May to 15th June, driven by increased global fuel prices, which edged closer to USD 70.0 per barrel, from USD 66.1 per barrel previously.

The rise in fuel prices is expected to push the transport and fuel indices up, hence reflecting in the rise in m/m inflation. This however is expected to be offset by the decline in electricity prices. We will release our inflation projection for the month of May 2018 in next week’s report.

Given the current fiscal year is nearly coming to a close, 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. Notably, there is no change in any of the indicators going forward, and the outlook remains very similar to our Q1’2018 view:

Macro-Economic Indicators	2017 Experience	YTD Experience	Outlook Going Forward	Previous View	Current View
Government Borrowing	Government had been behind its target on its domestic borrowing schedule since the fiscal year 2017/18 begun, having borrowed Kshs 61.0 bn against a pro-rated target of Kshs 140 bn as at the end of the year 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 The government is currently 31.0% ahead of its pro-rated domestic borrowing target for the current fiscal year, and has borrowed 72.9% of its total foreign borrowing target	Government to be under no pressure to borrow as it is ahead of both domestic and not far off from meeting its foreign borrowing target 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, and will likely be behind target as per historical data. Despite this, with the interest rate cap still in place, we don’t expect this to result in upward pressure on interest rates, like we saw at the start of the current fiscal year. Should the cap be repealed, we expect this to result in upward pressure on interest rates in the next borrowing cycle, as the government will be behind target and will no longer have an easy time collecting funds from the domestic market. However, with National Assembly against a complete repeal and the National Treasury working on a Bill to amend the law, we still remain positive on government borrowing until we have a feel of how the Bill will seek to amend the cap and how this in turn will affect borrowing by the government and the interest rate environment Also, with the Treasury’s efforts to increase revenue collections and reduce expenditure as per directive by the IMF, the borrowing targets for the next fiscal year might be lower	Positive	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 period	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, and the deficit 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	**Neutral**	**Neutral**
Monetary Policy	CBR was maintained at 10.0% throughout 2017 The Government remained disciplined in the auction market rejecting expensive bids. The 91 Day T-Bill hit 8.0% from 8.8% recorded at the end of January 2017	In the March 2018 MPC meeting, the committee reduced the CBR to 9.5%	No upward pressure on interest rates, with the government ahead of its pro-rated borrowing targets for the fiscal year. Also, with the interest rate cap still in place, we still maintain that the effectiveness of monetary policy has been weakened	**Neutral**	**Neutral**
Inflation	Kenya's Inflation rate averaged 8.0% for the year 2017 up from 6.3% in 2016, mainly due to a rise in prices for Food and Non-alcoholic beverages by 8.0% y/y. 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	Inflation has averaged 4.3% in the first 4 months of 2018. The year on year inflation rate for the month of April declined to 3.7%, its lowest level since January 2013 driven by food inflation declining to 0.3% from 2.2% in March on account of improved weather conditions	We expect Inflation to average 7.0% in 2018 down from 8.0% in 2017 and within the government target range of 2.5% - 7.5%. Inflation in H1'2018 is expected to remain low mainly due to the base effect. Inflation in H2'2018 however is expected to experience upward pressure, partly due to the base effect, and the expected rise in fuel and transport prices with the introduction of 16.0% VAT on petroleum products as from September 2018 and also a rise in items in the food basket due to the proposed change of various products from zero-rated to tax-exempt status	**Positive**	**Positive**

Macro-Economic Indicators	2017 Experience	YTD Experience	Outlook Going Forward	Previous View	Current View
Exchange Rate	The shilling depreciated by 0.7% against the dollar in 2017, 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 2.7% against the USD YTD to Kshs 100.4 from Kshs 103.2 at the end of December 2017, hitting a high of Kshs 100.0 due to increased inflows from horticulture exports and diaspora remittances Forex reserves are currently at USD 9.1 bn, equivalent to 6.2 months of import cover	We expect the currency to remain relatively stable against the dollar supported by (i) stronger horticulture export inflows driven by increasing production and improving global prices, (ii) improving diaspora remittances, and (iii) the ample reserves with the IMF having extended the standby credit facility of USD 1.5 bn (approx. 1-month import cover) by 6-months, to allow for review	**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**
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 has settled into office	**positive**	**Positive**

Of the 7 indicators we track, 4 are positive (government borrowing, inflation, investor sentiment and security) and 3 are neutral (revenue collection, monetary policy and currency). Rates in the fixed income market have remained stable as the government rejects expensive bids. The government is under no pressure to borrow for the remaining part of the current fiscal year as: (i) they are currently ahead of their domestic borrowing target by 31.0%, (ii) they have met 72.9% of their total foreign borrowing target and 82.4%

of their pro-rated target for the current fiscal year, and (iii) the KRA is not significantly behind target in revenue collection. Come the next fiscal year, the government is likely to remain behind target for the better part of the first half as per historical data, but we do not expect this to result in a rise in interest rates with the interest rate cap still in place. Therefore, we expect interest rates to remain stable. With the expectation of a relatively stable interest rate environment, we maintain our view that investors should be biased towards medium to long-term fixed income instruments.

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