The Draft Financial Markets Conduct Bill, 2018, & Cytonn Weekly #23/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were oversubscribed during the week, with the subscription rate coming in at 210.5% up from 186.1%, the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 21.9%, 173.5%, and 322.9% compared to 230.0%, 117.1%, and 237.6%, respectively, the previous week. 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, at 322.9% from 237.6% the previous week, as investors seek to lengthen duration. Yields on the 91- day paper remained unchanged at 7.9% while yields on the 182 and 364-day papers declined to 10.1% and 10.9% from 10.2% and 11.1%, the previous week. The acceptance rate for T-bills declined to 40.5% from 47.7%, the previous week, with the government accepting a total of Kshs 20.5 bn of the Kshs 50.5 bn worth of bids received, against the Kshs 24.0 bn on offer. The acceptance rate continued to decline due to the government cutting down on local borrowing since it is currently 34.7% ahead of its pro-rated domestic borrowing target for the current fiscal year, having borrowed Kshs 377.6 bn, against a target of Kshs 280.4 bn (assuming a pro-rated borrowing target throughout the financial year of Kshs 297.6 bn).

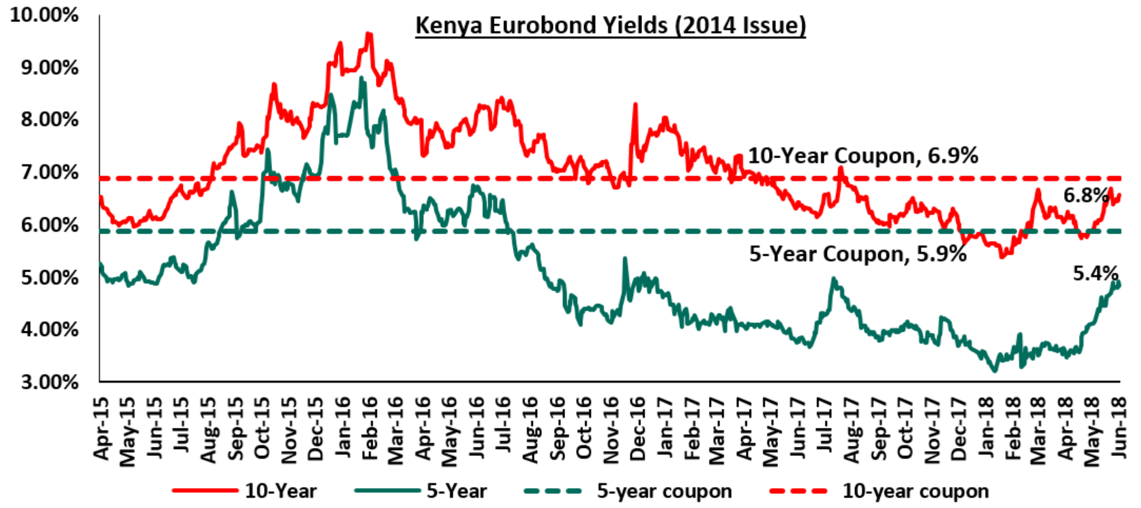
For the month of June 2018, the Kenyan Government has issued a new 25-year Treasury bond (FXD 1/2018/25) with the coupon set at 13.4%, in a bid to raise Kshs 40.0 bn for budgetary support. The sale period ends on 19th June, and we shall give our view on a bidding range in next week's report.

Liquidity:

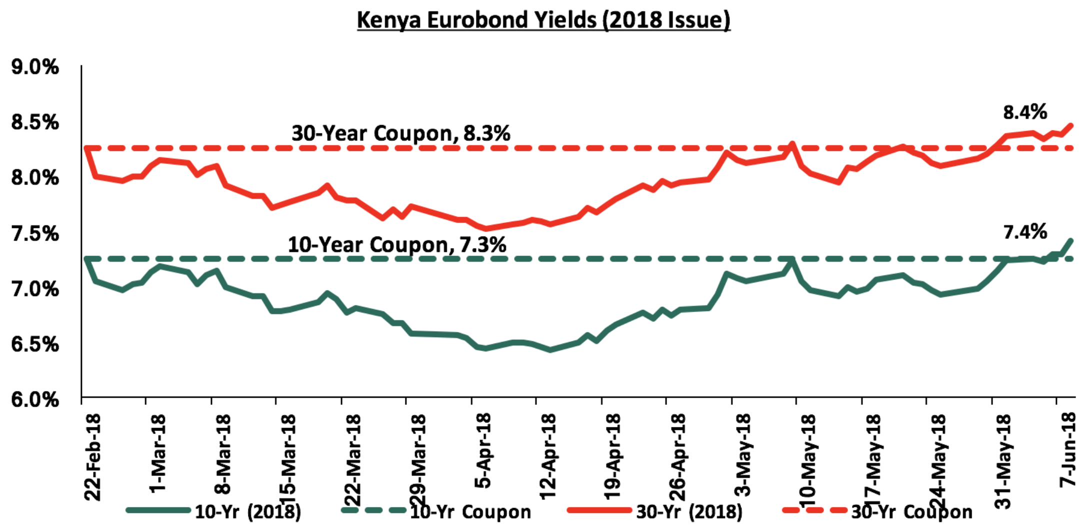
The average interbank rate declined to 4.1% from 5.4%, the previous week, attributed to increased participation by large banks trading at lower rates, while the average volumes traded in the interbank market increased by 34.6% to Kshs 21.8 bn from Kshs 16.2 bn, the previous week. The decline in the average interbank rate also points to improved liquidity, which can be attributed to the government's reduced borrowing appetite as evidenced by the 40.5% acceptance rate in the T-bill auction this week. The government's reduced borrowing appetite has resulted in banks holding excess cash, which is likely to trickle down to the private sector.

Kenya Eurobonds:

According to Bloomberg, the yields on both the 5-year and 10-year Eurobonds issued in June 2014 rose by 20 bps each to 5.4% and 6.8% from 5.2% and 6.6%, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 3.4% points and 2.9% points for the 5-year and 10-year Eurobonds, respectively, an indication of relatively stable macroeconomic conditions in the country.



For the February 2018 Eurobond issue, during the week, the yields on the 10-year and 30-year Eurobonds increased by 30 bps and 10 bps to 7.4% and 8.4% from 7.1% and 8.3%, respectively, the previous week. Since the issue date, yields on the 10-year and 30-year Eurobonds have both increased by 0.1% points respectively.



We have noted the recent rise in Kenya Eurobond yields and this may be attributed to the current corruption scandals erupting in the country that seem to have led to varying sentiments across the market. Of interest is also the fact that bond yields have been on the rise globally attributed to:

i. The end of the US Federal Reserve's expansionary policy measures, which has seen a rise in the US Treasury yields against a backdrop of tighter monetary policy, rising interest rates, and inflation expected to rise in the coming months having edged up to 2.5% in April from 2.4% in March. This has resulted in corrections in global markets to the tune of US Treasury yields, as investors move to the relatively less risky USA securities, and,
ii. The current political crisis in Italy, which has had an effect on global bond yields. Italy is the third-largest economy in the Eurozone, and some investors have been exiting their positions in other markets to invest in the high Italian yields. The Italian bonds have been seen as an attractive investment as the country's turmoil poses more of a political risk than economic. The economy is still growing above trend with GDP growth in 2017 coming in at 1.5%, a 7-year high and above a 5-year average of 0.04% coupled with low default rates thus providing a feasible investment opportunity.

The Kenya Shilling:

During the week, the Kenya Shilling appreciated by 0.7% against the US Dollar to close at Kshs 100.8 from Kshs 101.6, the previous week, due to increased diaspora remittances. On a YTD basis, the shilling has gained 2.3% 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,
ii. Improving diaspora remittances, which increased by 56.6% to USD 217.1 mn in April 2018 from USD 138.6 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, and,
iii. High forex reserves, currently at USD 9.0 bn (equivalent to 6.0 months of import cover) and the USD 1.5 bn stand-by credit and precautionary facility by the IMF, still available until September 2018.

Weekly Highlights:

According to the Stanbic Bank's Monthly Purchasing Manager's Index (PMI), the business environment in the country continued to improve in May 2018, but at a slower pace compared to April, mainly driven by favorable economic conditions and continued strong demand from international markets. The PMI declined to 55.4 in May from 56.4 in April. A PMI reading of above 50 indicates improvements in the business environment, while a reading below 50 indicates a worsening outlook. Firms reported growth in value of outputs midway through the second quarter, while new orders increased attributed to the continued rise in new export orders. This was despite high input costs due to a limited supply of resources experienced during the month as well as a modest rise in wages and staffing levels, leading to upward pressure on production costs, and consequently a rise in average selling prices for the sixth consecutive month. We expect output to continue rising, driven by a recovery in agricultural produce, mainly horticulture, as the Eurozone (Kenya's main horticultural export destination) continues to recover and boost demand with the main focus currently being on the 2018/2019 budget and the outcome of the draft financial markets conduct bill, 2018 and its effects on the extension of credit to the private sector. We maintain our view that GDP is expected to grow at 5.4% in 2018 supported by growth in the manufacturing, agriculture, real estate, construction, and tourism sectors.

Kenya's National Budget for the fiscal year 2018/19, projected at Kshs 2.5 tn, is set to be read on June 14th 2018. This will be a 9.1% increase from the current fiscal year's budget of Kshs 2.3 tn. KRA is expected to raise Kshs 1.7 tn, a 9.1% rise from Kshs 1.3 tn previously, with the extra amount expected to be raised from recent initiatives by the Treasury such as the imposition of fuel VAT beginning September 2018, in line with the deal that Kenya made with the International Monetary fund (IMF) in March 2018. The fiscal deficit to GDP is expected to narrow to 6.0% from a projected 7.2% in the 2017/18 financial year, which is in line with the International Monetary Fund's (IMF) recommendation in March as it pointed out that the initial targeted deficit of about 8.0-9.0% was not sustainable. The National treasury has budgeted a total of Kshs 97.7 bn, inclusive of Kshs 19.4 bn in interest payments, to finance the USD 750 mn, 5-year Eurobond issued in 2014 that is set to mature in the year ending June 2019. Including interest payments from the USD 2.0 bn 2018 issue, external debt financing in the 2018/19 fiscal year is estimated to increase by 51.9% to Kshs 364.7 bn from Kshs 240.1 bn in 2017/18, which will be 21.0% of budgeted revenues. Debt sustainability continues to be a key concern, with the public debt to GDP estimated to have hit 55.6% by the end of 2017, 5.6% above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, and the IMF threshold of 50.0%. Following the recent recommendation by the CBK governor, that the country should shift its focus to other non-debt financing arrangements such as public private partnership to fund infrastructural projects, we expect increased measures to improve debt management going forward. We don't expect the budget to significantly differ from the estimates provided in the 2018 BPS and shall provide a detailed breakdown in next week's report, once the budget is officially released.

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 34.7%, (ii) they have met 79.1% of their total foreign borrowing target and 83.9% 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, our view is that investors should be biased towards medium to long-term fixed income instruments.