Kenya Listed Banks Q1’2018 Report, & Cytonn Weekly #24/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were oversubscribed during the week, with the subscription rate coming in at 259.5% up from 210.5%, the previous week. The subscription rates for the 91, 182 and 364-day papers came in at 137.9%, 221.6%, and 345.9% compared to 21.9%, 173.5%, and 322.9%, respectively, the previous week. Subscription picked up for the 91 and 182-day papers as investors keep short before the start of the next borrowing cycle where the government will once again be behind borrowing target. Yields on the 91- day, 182-day and 364-day papers declined by 10 bps, 30 bps and 20 bps to 7.8%, 9.8% and 10.7% from 7.9%, 10.1% and 10.9%, respectively, the previous week. The acceptance rate for T-bills declined to 29.5% from 40.5%, the previous week, with the government accepting a total of Kshs 18.3 bn of the Kshs 62.3 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 32.9% ahead of its pro-rated domestic borrowing target for the current fiscal year, having borrowed Kshs 380.2 bn, against a target of Kshs 286.2 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 issuance of the long tenor bond has been attributed to efforts by the Government to lengthen the maturity profile of local currency denominated debt as the average duration of total domestic government securities stood at 4.2 years as at April. Given that (i) the government is currently 32.9% ahead of its pro-rated domestic borrowing target for the current fiscal year, and has collected 79.1% of its total foreign borrowing target, we don’t expect the government to come under pressure to borrow. We also don’t expect upward pressure on interest rates during the same period due to the decision by the Monetary policy committee to retain the CBR at 9.5% in May 2018. As such, we expect the average yield for the new bond issue to come in between 13.4% and 13.7%.

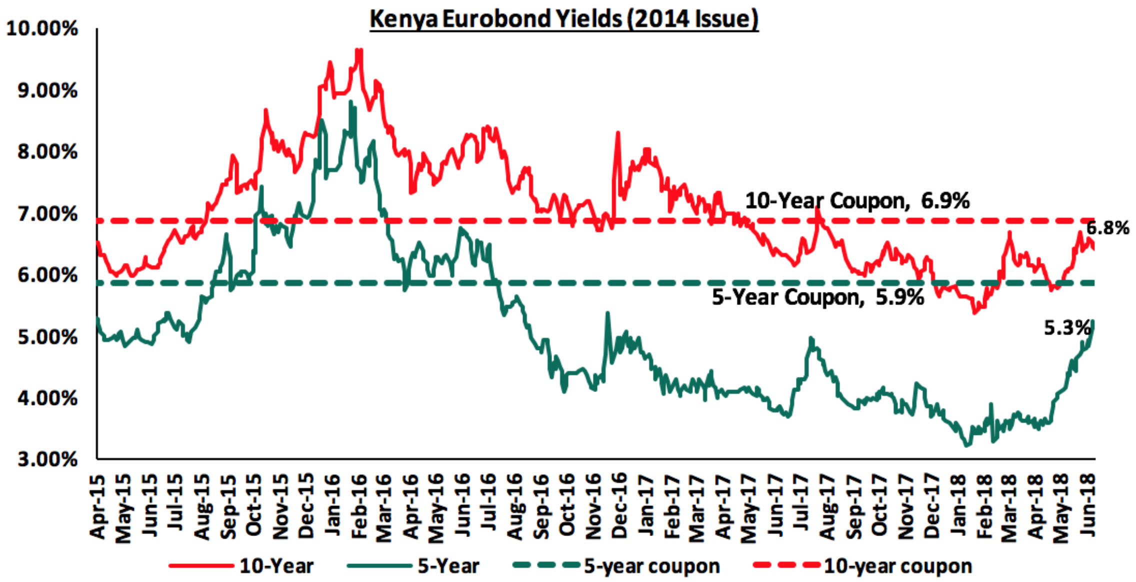
Liquidity:

The average interbank rate declined to 3.6% from 4.1%, the previous week, while the average volumes traded in the interbank market declined by 33.9% to Kshs 14.4 bn from Kshs 21.8 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 29.5% 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 before the start of the next fiscal year.

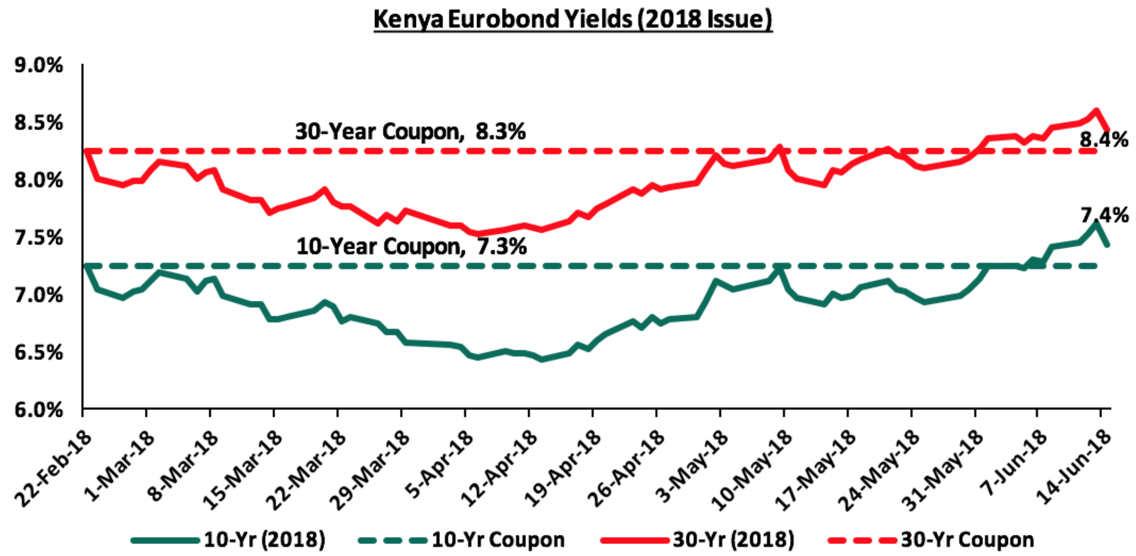
Kenya Eurobonds:

According to Bloomberg, the yield on the 5-year Eurobond issued in 2014 declined by 10 bps to 5.3%

from 5.4%, while the 10-year Eurobond remained unchanged at 6.8%, from the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 3.5% 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 remained unchanged at 7.4% and 8.4%, respectively. 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.

The Kenya Shilling:

During the week, the Kenya Shilling depreciated by 0.3% to close at Kshs 101.1 from Kshs 100.8, the previous week, due to a surge in dollar demand by oil importers. On a YTD basis, the shilling has gained 2.0% against the USD. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

i. The narrowing of the current account deficit which stood at 6.1% of GDP as at March 2018 from 6.4% in December 2017,
ii. Stronger inflows from principal exports which include coffee, tea and horticulture which

increased by 9.3% during the month of April to Kshs 21.9 bn from Kshs 20.0 bn in a similar period the previous year, with the exports from coffee, and horticulture increasing by 6.7%, and 25.0% y/y respectively, while tea exports have declined marginally by 1.6% y/y.

iii. Improving diaspora remittances, which increased by 56.6% to USD 217.1 mn in April 2018 from USD 138.6 mn in April 2017 with the bulk contribution coming from North America at USD 114.0 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,

iv. 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:

During the week, the National Treasury officially read the FY 2018/19 Budget on 14th June 2018. Below are some of the key highlights:

Amounts in Kshs tns unless stated otherwise

Comparison of 2017/18 and 2018/19 Fiscal Year Budgets

	2018/19	**% change 2017/18 to 2018/19**	**2017/18**	**% change 2016/17 to 2017/18**	**2016/17**
Revenue	**1.9**	**14.5%**	**1.7**	**9.6%**	**1.5**
Recurrent expenditure	1.5	7.7%	1.4	13.3%	1.2
Development expenditure	0.6	7.8%	0.6	(27.3%)	0.8
County governments	0.4	7.3%	0.4	16.4%	0.3
Total expenditure	**2.5**	**7.7%**	**2.3**	**(0.2%)**	**2.3**
Deficit as % of GDP	***(5.7%)***	***1.5%***	***(7.2%)***	***1.9%***	***(9.1%)***
Net foreign borrowing	0.3	(11.2%)	0.3	(30.3%)	0.5
Net domestic borrowing	0.3	(8.6%)	0.3	(14.7%)	0.3
Total borrowing	**0.6**	**(10.0%)**	**0.6**	**(23.6%)**	**0.8**

Key take-outs from the table:

i. Total expenditure in the fiscal year 2018/2019 is set to increase by 7.3%, to Kshs 2.5 tn from Kshs 2.3 tn in the fiscal year 2017/18,

ii. Development expenditure is set to increase at a slightly faster rate than recurrent expenditure; with recurrent increasing by 7.7% to Kshs 1.5 tn from Kshs 1.4 tn, while development will increase by 7.8% to Kshs 625.0 bn from Kshs 579.6 bn in FY 2017/18,

iii. The budget deficit is projected to decline to 5.7% of GDP from an estimated 7.2% of GDP in the FY 2017/18; in line with the International Monetary Fund's (IMF's) recommendation, in a bid to reduce Kenya’s public debt requirements,

iv. The total borrowing requirement to plug in the deficit is expected to decline to Kshs 558.9 bn from Kshs 620.8 bn, in a bid to reduce Kenya’s public debt burden which is estimated at 55.6% of GDP as at 2017 by the IMF, 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%, but well below the 74.0% mark considered a signal for debt unsustainability, and,
v. Debt financing of the 2018/19 budget is split 51:49 between foreign and domestic borrowing, with the foreign and domestic debt being estimated at Kshs 287.0 billion (equivalent to 3.0 percent of GDP) and Kshs 271.9 billion (equivalent to 2.8 percent of GDP), respectively.

Key to note is that the Treasury proposed a repeal of the interest rate cap, subject to passing by the National Assembly, stating that the rate cap had not achieved its intended purpose; this is after failing to mention it in the Draft Financial Markets Conduct Bill, 2018 – see our Focus Note on the Conduct Bill here. In terms of revenue collection, in addition to the expected implementation of the 16.0% VAT on petroleum products from September, the National Treasury has also proposed the widening of the tax base through, (i) the raising of excise duty fee on cellular money transfer services to 12.0% from 10.0%, previously, and (ii) introduction of a robin hood tax of 0.05% on any amount exceeding Kshs 500,000 transferred through financial institutions.

The US Federal Reserve Open Market Committee (FOMC) met during the week, on Wednesday 13th June, 2018 to assess the state of the US economy and agree on a path for the US Monetary Policy. The Fed decided to increase the federal funds rate to a band of 1.75% - 2.00%, from 1.5% - 1.75% previously, being the second hike in 2018. The decision by the Fed to hike rates was based on:

i. **Economic Growth:** economic growth in the US remained relatively stable, growing at 2.3% in Q1’2018, and expected to rise to 2.8% going forward,
ii. **Employment:** the US employment rate has improved over the last 12 months, with unemployment in May coming in at 3.8%, an 18- year low as compared to 5.0% which is considered full employment, indicating a strengthening labor market,
iii. **Inflation:** core inflation has been increasing, hitting 2.2% in May, a rise from 2.1% in April and a 15-month high since February 2017.

Given the stable economic growth expected in 2018, the Fed is now expected to further hike the federal funds rate two more times this year, up from only one additional hike before the FOMC meeting.

Rates in the fixed income market have remained stable, and even begun on a declining trend as the government rejects expensive bids with the government being 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 32.9%, (ii) they have met 79.1% of their total foreign borrowing target and 82.2% 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. As per the newly released 2018/19 budget, the domestic borrowing target is at Kshs 271.9 bn, 8.6% lower than the current fiscal year’s target, which may result in reduced pressure on domestic borrowing. The National Treasury has also proposed to repeal the interest rate cap, which if repealed can result in upward pressure on interest rates, as banks resume the rate of lending to the private sector who they will be able to price differently based on their risk profiles. However, with the cap still in place and the proposal subject to National Assembly passing, we maintain our expectation of stability in the interest rate environment. 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.