Cytonn H1’2018 Markets Review

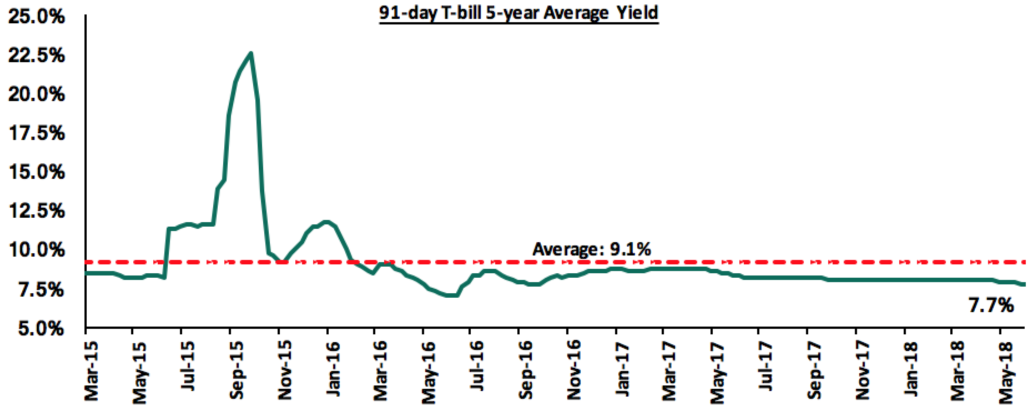
D. Fixed Income

T-Bills & T-Bonds Primary Auction:

During the first half of 2018, T-bills auctions recorded an oversubscription, with the average subscription rate coming in at 142.6% compared to 263.2% in H1’2017. Overall average subscription rates for the 91, 182, and 364-day papers in H1’2018 came in at 105.6%, 122.3% and 177.7%, respectively, from 154.0%, 184.5% and 131.2%, in a similar period in 2017. Yields on T-bills declined by 40 bps, 90 bps and 70 bps in H1’2017, closing at 7.7%, 9.7%, and 10.5%, from 8.1%, 10.6%, and 11.2% for the 91, 182, and 364-day papers, respectively, at the end of 2017, mainly due to the Central Bank of Kenya’s (CBK’s) efforts to keep rates low by rejecting expensive bids in the auction market.

During the week, T-bills were oversubscribed at a subscription rate of 126.0%, down from 214.7% recorded the previous week. Yields on the 91- day and 364- day papers remained unchanged at 7.7% and 10.5%, respectively while yields on the 182-day paper declined to 9.6% from 9.7%, the previous week, as T-bill yields continue to decline. The acceptance rate declined to 88.5% from 98.8%, the previous week, with the government accepting Kshs 26.8 bn of the Kshs 30.2 bn worth of bids received.

The yield on the 91-day T-bill is currently at 7.7%, below its 5-year average of 9.1%. The lower yield on the 91-day paper is mainly attributed to the low interest rate environment we have been experiencing, and we expect this to continue in the short-term because (i) the rate cap is still in place which will make it easier for the government to borrow from the domestic market, as institutions will continue channeling funds more actively towards government securities deemed less risky, since the pricing of loans to the private sector is based on the Central Bank Rate as opposed to their risk profiles, and (ii) the government domestic borrowing requirement for the 2018/19 financial year has been reduced by 8.6%, with revenues expected to increase by 14.5% from the previous fiscal year.



Should the rate cap be repealed as per the recommendation by the National Treasury as well as the International monetary fund (IMF), it would result in upward pressure on interest rates, as banks would resume pricing of loans to the private sector based on their risk profiles thus banks would revert to channeling funds to loans as opposed to government securities.

During H1’2018, the Kenyan Government issued 6 Treasury Bonds on a monthly basis, with details in the table below:

No.	Date	Bond Auctioned	Effective Tenor to Maturity (Years)	Coupon	Amount to be Raised (Kshs bn)	Actual Amount Raised (Kshs bn)	Average Accepted Yield	Average Subscription Rate	Average Acceptance Rate
1	16/01/18	IFB 1/2018/15	15.0	12.5%	40.0	5.0	12.5%	139.4%	9.0%
	30/01/18	IFB 1/2018/15 (tap sale)			35.0	36.2	12.5%	103.5%	99.9%
2	12/02/18	FXD/1/2010/15(re-open)	7.1	10.3%	40.0	4.4	12.7%	60.4%	54.7%
		FXD2/2013/15(re-open)	10.2	12.0%		8.8	12.9%		
	27/02/18	FXD1/2010/15 (tap sale)	7.1	10.3%	27.0	0.3	12.7%	14.1%	100.0%
		FXD2/2013/15(tap sale)	10.2	12.0%		3.5	12.9%		
3	9/03/18	FXD 1/2018/5	5.0	12.3%	40.0	23.1	12.3%	128.5%	61.4%
		FXD 1/2018/20	20.0	13.2%		8.5	13.3%		
	27/03/18	FXD 1/2018/5(tap sale)	5.0	12.3%	8.5	15.5	12.3%	182.5%	100.0%
		FXD 1/2018/20(tap sale)	20.0	13.0%			13.3%		
4	30/04/18	FXD1/2008/15 (Re-open)	15.0	12.5%	40.0	20.15	12.3%	81.9%	82.0%
		FXD1/2018/20 (Re-open)	20.0	13.2%		8.5	13.3%		
5	25/06/18	FXD1/2018/15	15.0	12.7%	40.0	12.9	13.1%	50.5%	63.6%
6	25/06/18	FXD1/2018/25	25.0	13.4%		5.2	13.5%	25.3%	51.1%

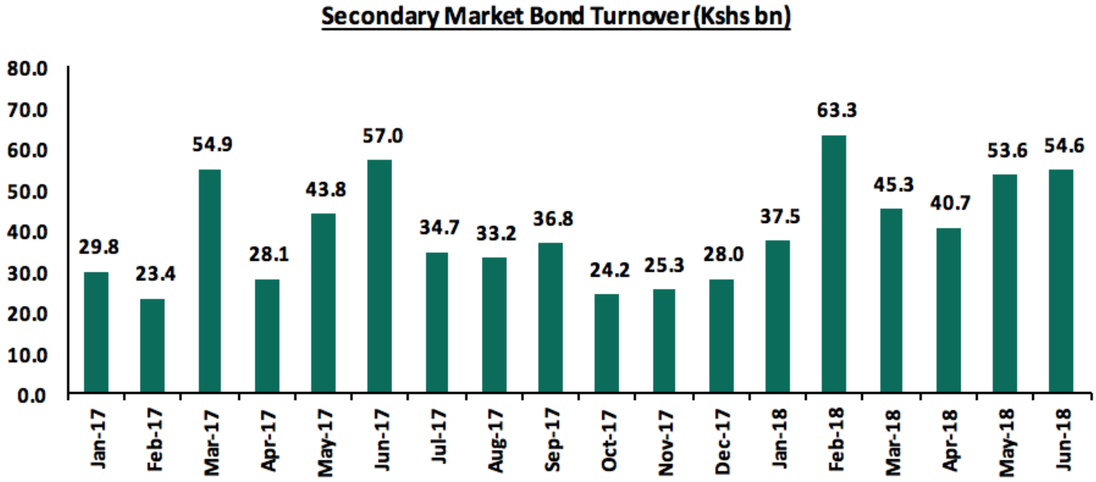
Performance in the Primary T-bond auctions in H1’2018 was varied between the various issues, with the subscription rate averaging 87.3% (an undersubscription). The average acceptance rate for the first half of the year came in at 65.2%, as the CBK continued to reject bids deemed expensive in order to maintain the rates at low levels, with tap sales still being used as a tool to plug in any deficits from primary auction bids.

Liquidity:

Liquidity levels remained stable and well distributed in the market as indicated by the 25.7% decline in the average volumes traded in the interbank market to Kshs 15.5 bn from Kshs 20.8 bn, recorded in H2’2017, and the subsequent decline in the interbank rate to 5.2% from 7.2% at the end of 2017. During the week, liquidity tightened with the average interbank rate rising to 6.2% from 4.1% recorded the previous week attributed to remittances of Value Added Tax (VAT) and quarterly corporate taxes through commercial banks. There was an increase in the average volumes traded in the interbank market by 41.1% to Kshs 19.9 bn, from Kshs 14.1 bn the previous week.

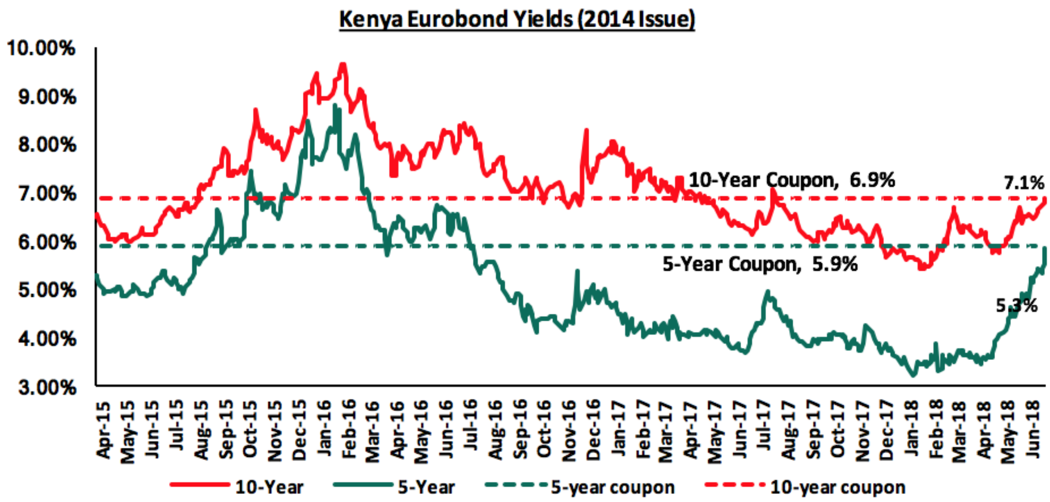
Secondary Bond Market Activity:

The NSE FTSE Bond Index gained 4.7% during H1’18 while the secondary bonds market recorded reduced activity, with turnover decreasing by 8.9% to Kshs 215.8 bn from 236.9 bn recorded in H1’2017.

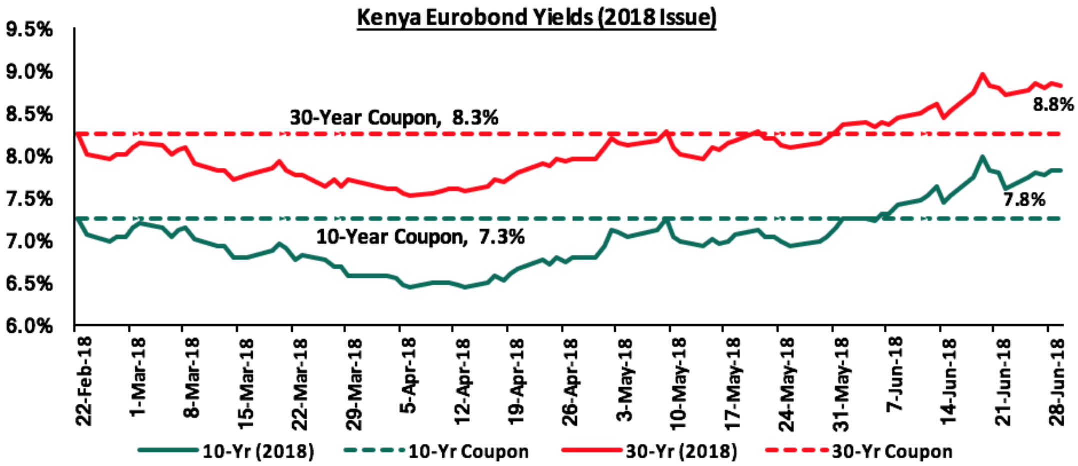


Kenya Eurobonds:

According to Bloomberg, the yields on the 5-year and 10-Year Eurobonds issued in 2014 have increased by 1.9% points and 1.5% points respectively in H1'2018. During the week the yields on the 5-year Eurobond remained unchanged at 5.3%, while the 10-year Eurobond increased by 20 bps to 7.1% from 6.9%, the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 3.5% points and 2.6% 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, since the issue date, yields on the 10-year and 30-year Eurobonds have both increased by 0.5% points. During the week, the yields on the 10-year Eurobond increased by 20 bps to 7.8% from 7.6% the previous week while the 30-year Eurobonds increased by 10 bps to 8.8% from 8.7% the previous week.



Rates in the fixed income market have remained stable, and had been on a declining trend towards the tail end of the fiscal year 2017/18, as the government rejected expensive bids given it had been under no pressure to borrow. The government is however likely to remain behind its borrowing target for the better part of the first half of the 2018/19 financial year as per historical data. The newly released 2018/19 budget gives a domestic borrowing target of Kshs 271.9 bn, 8.6% lower than the current fiscal year's target, which may result in reduced pressure on domestic borrowing. However, the National Treasury has proposed to repeal the interest rate cap, which if repealed can result in upward pressure on interest rates, as banks would resume pricing of loans to the private sector based on their risk profiles. With the cap still in place, 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.