Developing Technical Education Institutions with a Focus on Vision 2030, & Cytonn Weekly #27/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were oversubscribed during the week with the overall subscription rate coming in at 218.9% up from 146.0%, recorded the previous week. Yields on the 91-day, 182 and 364-day papers declined by 2 bps, 20 bps and 4 bps to 7.7%, 9.3% and 10.4%, respectively. T-bill yields have continued to decline as a result of increased demand evidenced by the high subscription rates, attributable to improved liquidity, which saw the interbank rate decline to an average of 5.2% in H1'2018 compared to 7.2% recorded in H2'2017. The acceptance rate for T-bills declined to 61.0% from 70.8%, the previous week, with the government accepting Kshs 32.0 bn of the Kshs 52.5 bn worth of bids received. The subscription rates for the 91, 182 and 364-day papers increased to 61.1%, 123.6%, and 377.3%, compared to 18.7%, 77.1%, and 265.9%, respectively, the previous week as investors' participation remain skewed towards the longer dated papers.

For the month of July 2018, the Kenyan Government has issued a new 20-year Treasury bond (FXD 2/2018/20) with the coupon set at 13.2%, in a bid to raise Kshs 40.0 bn for budgetary support. The government has been trying to increase its local debt maturity profile, having issued a 25-year bond in June, the longest tenor since 2014. The average term to maturity for all government securities has been on the decline, hitting 4.4 years as at April 2018 from an average of 6.2 years in 2009 as stated in the Medium Term Debt Management Strategy for 2018 to 2021, which can expose the government to refinancing risks due to the high maturities of short term debt expected in the 2018/2019 Financial Year. The sale period for the bond ends on 24th July, and we shall give our view on a bidding range in next week's report.

Liquidity:

The average interbank rate declined to 4.7%, from 6.4%, the previous week, while the average volumes traded in the interbank market decreased by 43.8% to Kshs 14.4 bn, from Kshs 25.6 bn the previous week. The decline in the average interbank rate points to improved liquidity, which the Central Bank of Kenya attributed to support from Government payments that took place during the week.

Kenya Eurobonds:

According to Bloomberg, the yield on the 10-year Eurobond issued in 2014 declined by 30 bps to 6.8% from 7.1% the previous week, while the 5-year Eurobond declined by 20 bps to 4.4%, from 4.6% the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.4% points and 2.9% points for the 5-year and 10-year Eurobonds, respectively, an indication of the relatively stable macroeconomic conditions in the country. Key to note is that these bonds have 1 year and 6 years to maturity.

For the February 2018 Eurobond issue, during the week, the yields on the 10-year Eurobond declined by 30 bps to 7.3% from 7.6% the previous week, while the 30-year Eurobonds declined by 20 bps to 8.5%, from 8.7% the previous week. Since the issue date, yield on the 10-year Eurobond has declined marginally by 0.1% points while the yields on the 30-year Eurobond has increased by 0.2% points.

We have noted the Kenyan Eurobond yields have been on the decline in the recent weeks, which has been attributed to improved liquidity in the global markets and lower risk perception as a result of improved investor sentiments based on the stable macroeconomic conditions evidenced by the strong economic growth of 5.7% in Q1'2018, compared to 4.8% in Q1'2017.

The Kenya Shilling:

During the week, the Kenya Shilling remained stable against the US dollar, remaining unchanged at Kshs 100.8 from the previous week. CBK attributed this to an even match in the demand for and supply of the US dollar in the forex market. 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, to 8.9% of GDP in Q1'2018 compared to 11.3% in Q1'2017 on account of faster growth of exports at 7.1%, compared to import growth at 6.5%,
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 16.9% to USD 253.7 mn in May 2018, from USD 217.1 mn in April 2018, with the largest contributor being North America at USD 122.8 mn 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 8.9 bn (equivalent to 5.9 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 African Union Commission released their first annual economic report in collaboration with the OECD Development Centre dubbed 'Africa's Development Dynamics 2018'. These are some of the key take-outs:

i. Africa has been experiencing strong economic growth averaging 4.6% over the last 17 years, with the recent growth being attributed to:
   a. Improved commodity prices,
   b. Formulation of diversification strategies that have focused on increasing the growth drivers, which reduce dependency on commodity driven economic growth, and
   c. Improved macroeconomic management.
ii. Volatility in growth continues to be a concern as most economies are reliant on commodities affected by global prices, which saw the GDP growth in resource-rich countries decline to 1.5% in 2016 after the sharp 58.0% decline in fuel prices, and 37.0% decline in metals and mineral prices. Volatility in different countries in the region varies based on the type of exports, with the resource-rich countries enjoying stronger terms of trade in the recent years due to the improved

commodity prices as well as higher economic growth averaging 6.0% since 2000, higher than the 4.0% in non-resource-rich countries. Growth has also remained inconsistent in the continent with only 3 out of the 55 countries being projected to reach the 7.0% annual growth target by 2020, set by the African Union in the Agenda 2063.

iii. African regional markets are expected to grow driven by,
    a. The increasing contribution of private consumption to economic growth largely attributed to increased literacy levels and higher purchasing power by Africa's growing middle class (those spending USD 5-20 per day). This has been viewed as an opportunity that can be tapped by the domestic market, but it also raises the risk of worsening balance of payments due to increased demand for imported goods should the local markets not match competing products from developed markets,
    b. Improved ease of doing business due to simplified administrative procedures and reduced operational costs, and
    c. Higher foreign direct investments with total inflows in the region reaching 8.8% of GDP in 2016. The expected growth in regional markets is set to boost Small and Medium Enterprises due to their proximity as well as understanding of the local markets.

iv. East Africa's annual economic growth has been more resilient compared to other regions, exceeding 4.0% since 1990, on the back of the service sector, which represents almost 60.0% of GDP. Despite the service sector being the largest contributor to GDP, Agriculture with a contribution to GDP of 20.0% employs 60.0% of the labor force, though the share has been marginally declining with some of the labor force being absorbed in the expanding services sector.

Key to note, the report emphasized on the need for local firms to upgrade their processes as well as technology in order to be able to meet the expected surge in domestic demand due to the new continental free trade area, which was signed on 21st March 2018 in Kigali, that aimed at creating a single continental market and improving intra-regional trade. Africa's intra-regional trade stands at only 4.1% of GDP compared to 16.6% in Europe and 24.2% in Asia. The African Union also noted that the region is already open to the global economy but the problems lie in the lack of diversification in exports, as the bulk of them are unprocessed commodities, which are cheaper than the processed imports leading to an unfavourable trade balance.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids due to increased demand evidenced by the high subscription rates, attributable to improved liquidity, which saw the interbank rate decline to an average of 5.2% in H1'2018 compared to 7.2% recorded in H2'2017. 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 2018/19 budget gives a domestic borrowing target of Kshs 271.9 bn, 8.6% lower than the 2017/2018 fiscal year's target of Kshs 297.6 bn, 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.