Cytonn INVESTMENTS

Kisumu Real Estate Investment Opportunity, & Cytonn Weekly #28/2018

Fixed Income

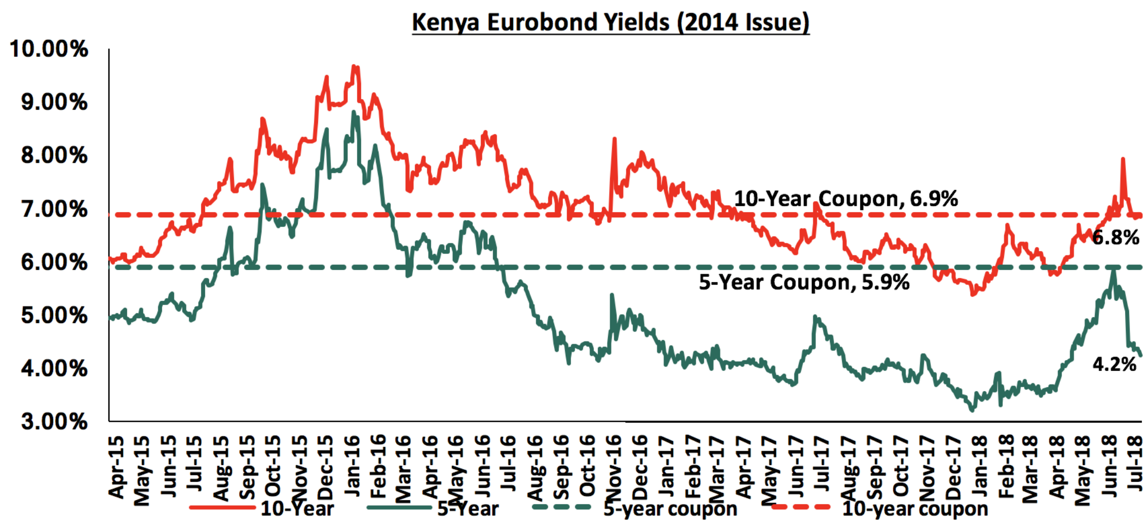
T-Bills & T-Bonds Primary Auction:

T-bills were oversubscribed during the week with the overall subscription rate coming in at 207.6%, a decline from 218.9%, recorded the previous week. Yields on the 91-day, 182-day and 364-day papers declined by 4.5 bps, 12.8 bps, and 14.3 bps to 7.7%, 9.2%, and 10.2%, 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 improved to 71.8% from 61.0% the previous week, with the government accepting Kshs 35.8 bn of the Kshs 49.8 bn worth of bids received. The subscription rates for the 91-day and 182-day papers increased to 105.9% and 137.9% compared to 61.1% and 123.6%, respectively the previous week while the subscription rate for the 364-day paper declined to 318.1% from 377.3% the previous week, but still recorded the highest performance as investors' participation remains skewed towards the longer-dated papers.

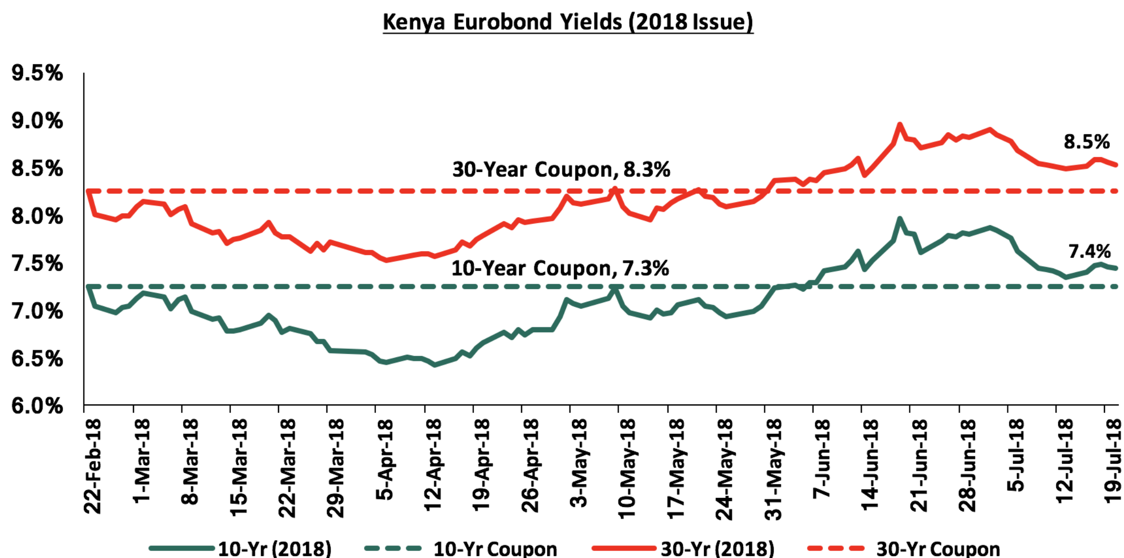
For the month of July 2018, the Kenyan Government has issued a new 20-year Treasury bond (FXD 2/2018/20) with the coupon rate set at 13.2%, in a bid to raise Kshs 40.0 bn for budgetary support. The government has been issuing longer-dated bonds in a bid to increase its local debt maturity profile since 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. The performance of longer-dated bonds has been on the decline with the 25-year bond issued in June attracting a subscription of 25.3%, which has been attributed to the uncertainties in the interest rate environment due to the tabling of the Finance Bill 2018, which proposes the repeal of interest rate cap, which might result into an upward pressure on interest rates. As such, we expect the current issue to also have a lacklustre performance. Given that the treasury bonds with the same tenor to maturity are currently trading at a yield of 13.3%, we expect bids to come in at between 13.3% and 13.5%.

Kenya Eurobonds:

According to Bloomberg, the yield on the 10-year Eurobond issued in 2014 remained unchanged at 6.8% from the previous week, while the 5-year Eurobond declined by 20 bps to 4.2%, from 4.4% the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.6% points and 2.8% 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 and 30-year Eurobonds remained unchanged at 7.4% and 8.5% from the previous week. Since the issue date, the 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 gained by 0.1% against the US dollar to close at Kshs 100.7 from Kshs 100.8 the previous week supported by inflows from offshore investors amid high liquidity in the money 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 the faster growth of exports at 7.1%, compared to import growth of 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.

Key to note, The International Monetary Fund (IMF) recently completed the review of the USD 1.5 bn stand-by credit and precautionary facility. It, however, did not disclose the results of the review and their recommendations, stating that it had submitted the report to the government, which needed more time to consider its publication. The Executive Board of the International Monetary Fund (IMF) had approved Kenyan government's request for a 6-month extension of the Stand-By Arrangement (SBA) on 12th March 2018, to allow more time for the completion of the outstanding reviews. Since the initial approval of the credit facilities on 14th March 2016, only the 1st review had been completed on 25th January 2017 while the 2nd and 3rd reviews were still pending as the balance of payments which is a performance criterion had not been met as at the end of December 2016 and June 2017 attributed to the shortfall in revenues and pressure on government spending which was partly due to the challenging operating environment. An understanding could not be reached on corrective measures the Government was to undertake to tackle the problems on account of the prolonged electioneering period thus the request for an extension. In a letter to the IMF dated 6t March 2018, signed by the National Treasury Cabinet secretary and the Governor of the Central Bank of Kenya that sought the extension of the stand-by arrangement to September 14, 2018, the Kenyan government highlighted that it was aiming at:

i. Narrowing the fiscal deficit to 5.7% of GDP in the 2018/2019 financial year,
ii. Strengthening the monetary policy framework in the country which would include the introduction of an interest rate corridor, and
iii. Modifying interest rate controls to resolve the negative impact of the interest rate cap to private sector credit growth as well as enhance the effectiveness of monetary policy.

To resolve the fiscal deficit problem, the government highlighted its intention to reduce the expenditure as well as increase revenues through the introduction of the finance bill which would have several tax reforms. The finance bill has already been tabled in the National Assembly awaiting debate and approval.

Weekly Highlights:

The Kenya Revenue Authority (KRA) is set to increase excise duty charged on a variety of goods including water, beer, cigarettes, wines, and spirits among others by up to 5.0% effective August 2018. In the new tax system, excise duty will be rising in tandem with inflation thus reflecting the current economic reality as well as ensure that excise rates charged do not erode the public's purchasing power during periods of inflation. The move is in accordance with the Excise Act that was passed in 2015 but has not been implemented since then, due to fears of price instability as it would lead to a rise in prices of basic commodities in the country and a net effect of inflationary pressure. The new tax system is set to be a boost to the government's effort of increasing revenue in the 2018/2019 financial year by 17.5% to Kshs 1.9 tn, from the Kshs 1.7 tn target in the 2017/2018 financial year, by widening of the tax base through various tax reforms as outlined in the Finance Bill tabled in parliament, as the excise duty increments will be automatic and will not require any additional approval from Parliament. Excise duty on petroleum products was however not adjusted with the expected introduction of 16.0% VAT tax from September, as it would further escalate fuel prices in the country, which are already expected to rise.

We are projecting the inflation rate for the month of July to come in between 4.9% - 5.3%, from 4.3%

in June. The y/y inflation rate is expected to increase as a result of a base effect while m/m inflation is expected to rise mainly due to:

i. A rise in electricity costs due to an increase in forex and inflation charges to Kshs 1.2 per kilowatt hour (kWh) and Kshs 0.5 per unit from Kshs 1.1 and Kshs 0.4 in the previous month, respectively. Fuel levy linked to power produced by diesel generators has continued to drop, though marginally in July by Kshs 0.2 to Kshs 4.6 attributed to increased HEP generation due to the heavy rains experienced in the 1st half of the year reducing reliance on diesel-generated electricity. The decline, however, is marginal and thus not sufficient to counter the rise in forex and inflation charge, and
ii. An increase in the price of petrol by 3.1% due to an increase in super petrol landing cost by 5.5%, which will result in a rise in the transport index. Prices of diesel and Kerosene, however, have decreased by 0.3% and 1.8% brought about by a decline in landing costs for diesel and kerosene by 1.1% and 1.9%, respectively. Charcoal prices are also expected to rise attributed to the enforcement of the anti-logging.

There has been a decline in prices of some items in the food basket such as tomatoes and a rise in others such as vegetables. But prices of a majority of items in the food basket have remained stable. We still expect the inflation to average 7.5% over the course of the year down from 8.0% in 2017, which is within the government target range of 2.5% -7.5%.

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 experience. 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-term fixed-income instruments.