The Fight Against Corruption in Kenya...Yet Another Chapter, & Cytonn Weekly #29/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were undersubscribed during the week, with the overall subscription rate coming in at 88.2%, a decline from 207.6% recorded the previous week due to reduced liquidity, which the Central Bank of Kenya (CBK) attributed to banks seeking funds for VAT remittances during the week. Yields on the 91-day, 182-day and 364-day papers declined by 4.8 bps, 8.3 bps, and 15.0 bps to 7.6%, 9.1%, and 10.1%, respectively, with Central Bank of Kenya (CBK) being cautious and not accepting aggressive bids from the market. The acceptance rate for T-bills improved to 99.3% from 71.8% the previous week, with the government accepting Kshs 21.0 bn of the Kshs 21.2 bn worth of bids received. The subscription rates for the 91-day, 182-day and 364-day papers declined to 50.6%, 58.6% and 133.0% from 105.9%, 137.9% and 318.1%, respectively, with the 364-day paper still recording the highest performance. Investors' participation remains skewed towards the longer-dated paper, which has been attributed to the lack of short term bond issuances in the primary market leading to the shift in focus to the 364-day paper.

The Kenyan Government 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 issue had a lacklustre performance, with the overall subscription rate coming in at 34.7% while the weighted average rate of accepted bids came in at 13.4%, in line with our expectations of 13.3% - 13.5%. The government accepted Kshs 10.5 bn out of the Kshs 13.9 bn worth of bids received, translating to an acceptance rate of 75.8%. Despite the government's effort to increase the local debt maturity profile by issuing longer dated bonds, there has been low appetite for the issues. We attribute this to the uncertainties in the interest rate environment due to the tabling of the Finance Bill 2018 that proposes the repeal of interest rate cap, which if passed, might result into an upward pressure on interest rates.

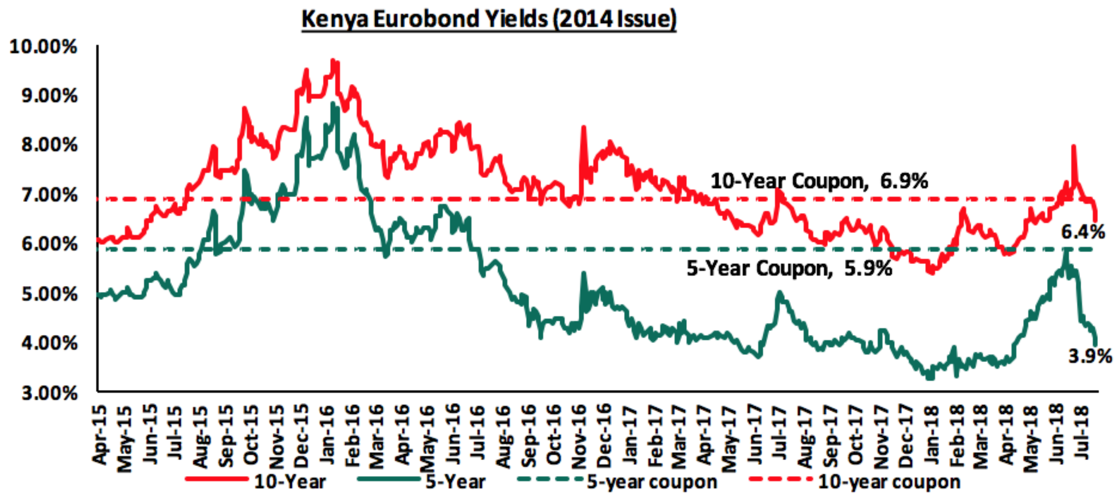
Liquidity:

The average interbank rate increased to 4.1%, from 3.2%, the previous week, while the average volumes traded in the interbank market increased by 13.0% to Kshs 16.9 bn from Kshs 15.0 bn the previous week. The increase in the average interbank rate points to declined liquidity, which the CBK attributed to banks seeking funds for VAT remittances during the week.

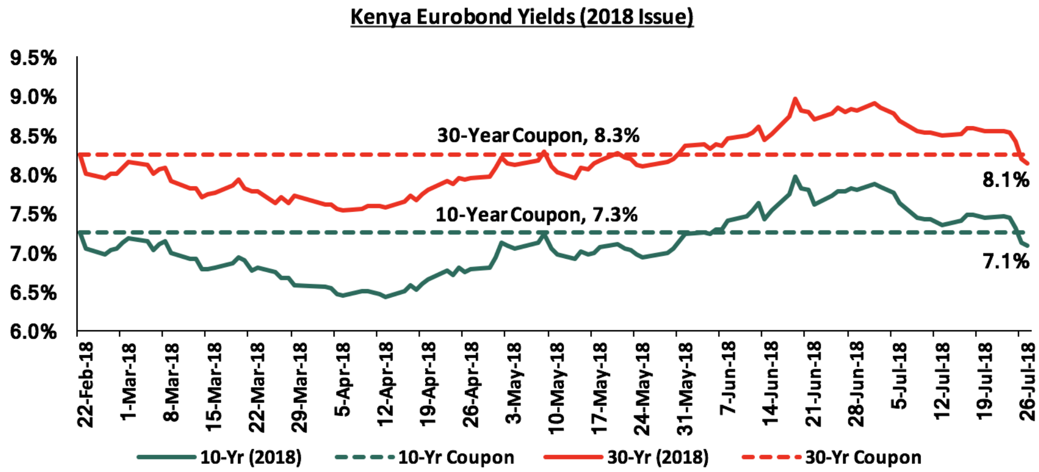
Kenya Eurobonds:

According to Bloomberg, the yield on the 5-Year and 10-year Eurobonds issued in 2014 declined by 0.3% points and 0.4% points to 3.9% and 6.4% from 4.2% and 6.8% the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.9% points and

3.2% 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 declined by 0.3% points and 0.4% points to 7.1% and 8.1% from 7.4% and 8.5% the previous week, respectively. Since the issue date, the yields on both the Eurobonds have declined by 0.2% points.



Yields on all the Kenyan Eurobond yields continued to decline during the week, 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. This is evidenced by 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 0.3% against the US dollar to close at Kshs 100.5, from Kshs 100.7 the previous week, supported by inflows from diaspora remittances amidst tightened liquidity in the money markets. The Kenyan shilling has gained by 2.6% year to date, and 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 imports 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 8.8 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:

The Monetary Policy Committee (MPC) is set to meet on Monday 30th July 2018 to review the prevailing macroeconomic conditions and give direction on the Central Bank Rate (CBR). Key factors to consider include:

i. Inflation has averaged 4.2% in the first 6-months of 2018 compared to 9.8% experienced in a similar period in 2017, and is expected to remain within the government target of 2.5% - 7.5%, despite the expectations of upwards inflationary pressure in H2'2018,
ii. The currency has appreciated by 0.4% since the last meeting on May 28th, 2018, and,
iii. The macroeconomic environment remains relatively stable despite the low private sector credit growth, which came in at 2.8% in April 2018.

We are of the view that the MPC will adopt a wait and see approach as they monitor the effects of the March rate cut to 9.5%, as well as await the National Assembly's decision on the interest rate cap from the proposed amendment of the Banking (Amendment) Act, 2016 by repealing Section 33B. We therefore expect the MPC to hold the CBR at 9.5%. For a comprehensive analysis, read our Cytonn Note on the MPC Meeting for July 2018.

According to data from the Kenya National Bureau of Statistics (KNBS), foreign currency deposits rose by 9.5% in the month of May 2018 to Kshs 514.9 bn, from Kshs 470.2 bn in April, and by 16.6% y/y from Kshs 441.6 bn in a similar period in 2017. This is a new high, being the first time the foreign currency deposits have crossed the Kshs 500 bn level, which has been attributed to increased inflows from abroad as individuals continued to take advantage of the tax amnesty granted on foreign income. The Tax Procedures Act had been amended in 2016 with the introduction of Section 37B, which granted amnesty on foreign income that had been earned on or before 31st December 2016 and was subject to taxation in Kenya. The section was later amended on 3rd April 2017, extending the deadline to allow full amnesty provided the foreign income was declared and funds realized were transferred to Kenya no later than 30th June 2018; failure to which they could be remitted within 5-years thereof but would be subjected to a 10% penalty. In the 2018/2019 financial year budget reading, the Cabinet Secretary for National Treasury proposed the extension of the amnesty to 30th June 2019 amidst concerns that it would lead to inflows of illicit cash including proceeds from corruption. The increase in foreign currency deposits has also been reflected in the increased diaspora remittances, which also increased by 57.1% year on year in the month of May to USD 253.7 mn from USD 161.5 mn in May 2017. The increased inflows have led to the strengthening of the Kenyan Shilling against the US Dollar, which has gained by 2.6% year to date as well as maintained the high forex reserves experienced during the year that are currently at USD 8.8 bn (equivalent to 5.9 months of import cover).

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids as it is currently 136.3% ahead of its pro-rated borrowing target for the current financial year. The 2018/19 budget gives a domestic borrowing target of Kshs 271.9 bn, 8.6% lower than the 2017/2018 fiscal year's budget of Kshs 297.6 bn which the government surpassed. The lower borrowing target 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.
