Cytonn INVESTMENTS

Cytonn Monthly – July 2018

Fixed Income

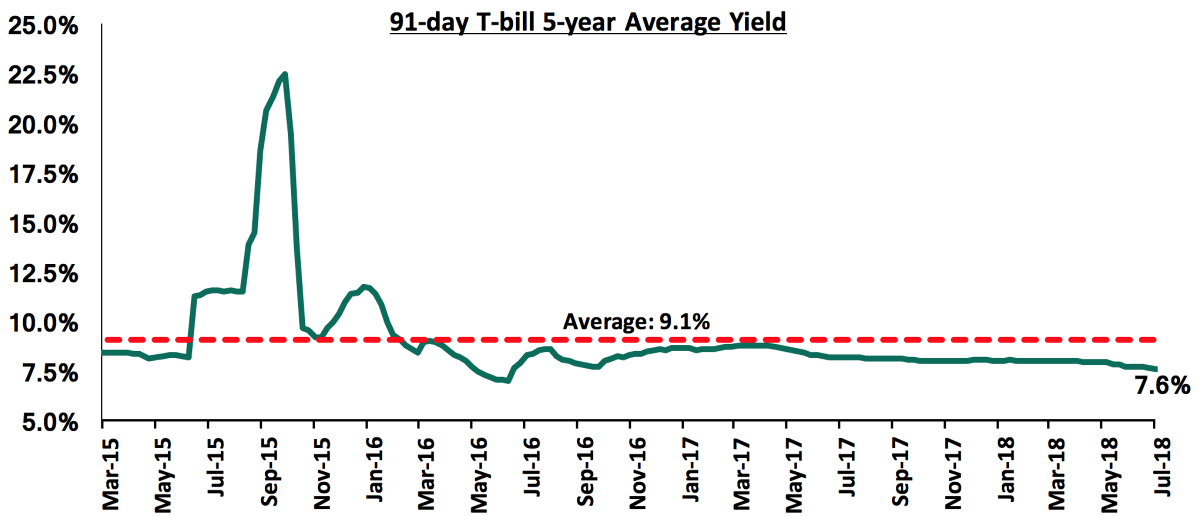
T-Bills & T-Bonds Primary Auction:

During the month of July, T-bill auctions recorded an oversubscription, with the average subscription rate coming in at 157.4%, a decline from 217.7%, recorded in June. The average subscription rates for the 91, 182 and 364-day papers came in at 70.2%, 90.9% and 258.6%, from 131.6%, 170.9% and 298.9%, the previous month, respectively, with investors' participation remaining skewed towards longer dated paper. The yields on the 91-day, 182-day and 364-day papers declined by 11.7 bps, 55.5 bps and 44.9 bps to 7.6%, 9.1% and 10.1%, respectively. The T-bills acceptance rate came in at 75.4% during the month, compared to 53.1% in June with the Kenyan government accepting a total of Kshs 140.4 bn of the Kshs 188.8 bn worth of bids received, indicating that bids were largely within ranges the Central Bank of Kenya (CBK) deemed acceptable.

This week, T-bills were undersubscribed, with the subscription rate coming in at 60.4% down from 88.2% the previous week, as a result of tight liquidity in the market attributed to slow government spending that usually characterises the beginning of the fiscal year. The subscription rates for the 91-day, 182-day and 364-day papers came in at 14.2%, 51.5%, and 87.9% compared to 50.6%, 58.6% and 133.0%, the previous week, respectively. Yields on the 91- day paper increased marginally by 0.3 bps to 7.6% while yields on the 182-day and 364-day papers declined by 2.8 bps and 8.0 bps to 9.1% and 10.0%, respectively. The acceptance rate for T-bills declined to 96.8% from 99.3%, the previous week, with the government accepting a total of Kshs 14.0 bn of the Kshs 14.5 bn worth of bids received, against the Kshs 24.0 bn on offer.

The 91-day T-bill is currently trading at 7.6%, which is below its 5-year average of 9.1%. The lower yield on the 91-day paper is mainly attributable to the low interest rate environment experienced since the passing of the law capping interest rates. We expect this to continue in the short-term, given:

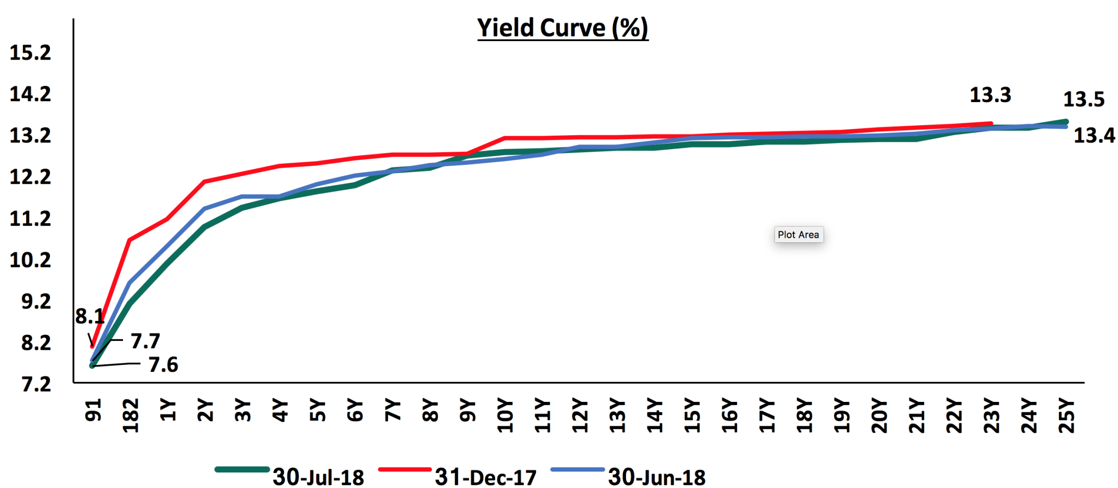
i. The discipline of the CBK in stabilizing interest rates in the auction market by rejecting aggressive bids that are priced above market, for both T-bills and T-bonds, and,
ii. The lowering of the Central Bank Rate by the Monetary Policy Committee in their July meeting to 9.0% from 9.5%, which will effectively reduce lending rates to 13.0% from 13.5%.



During the month, 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 uncertainty in the interest rate environment following the tabling of the Finance Bill 2018 that proposes the repeal of interest rate cap, which if passed, might result into upward pressure on interest rates.

Secondary Bond Market:

The yields on government securities in the secondary market continued to decline in July as the Central Bank of Kenya continued to reject expensive bids in the primary market. According to the FTSE NSE Bond Index, Treasury bonds listed at the Nairobi Securities Exchange (NSE) gained 1.0% during the month, bringing the YTD performance to 9.1%.



Liquidity:

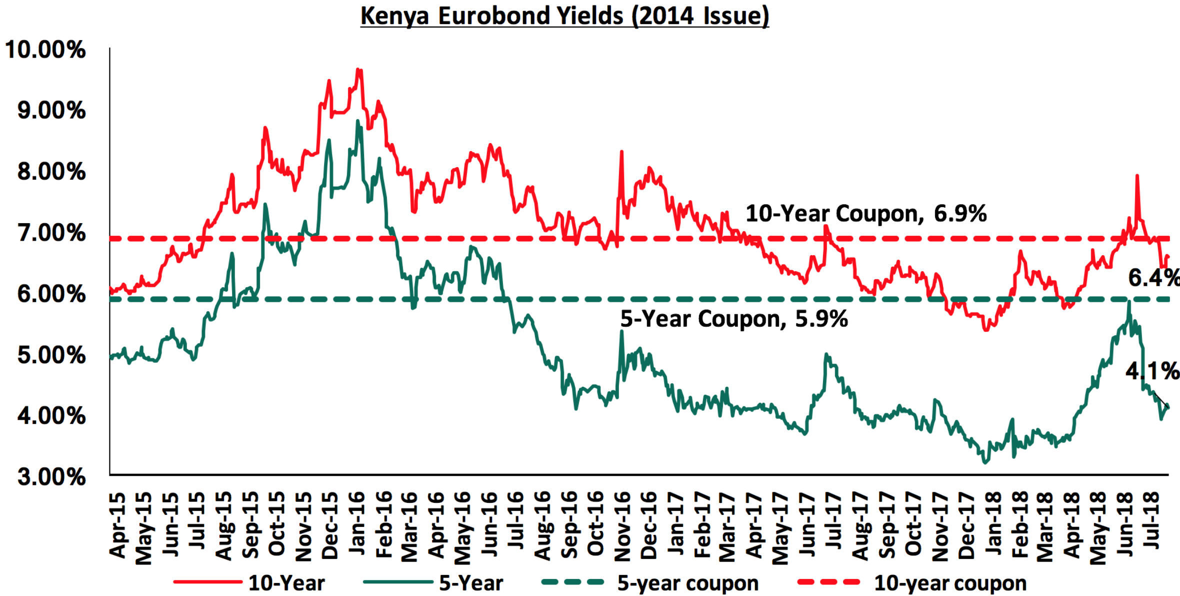
The average interbank rate increased to 6.4% at the end of July from 4.1% at the end of June, pointing to declined liquidity during the month, the increase was attributed to banks seeking funds for quarterly tax remittances.

During the week, the average interbank rate increased to 7.2% from 4.1% the previous week, while

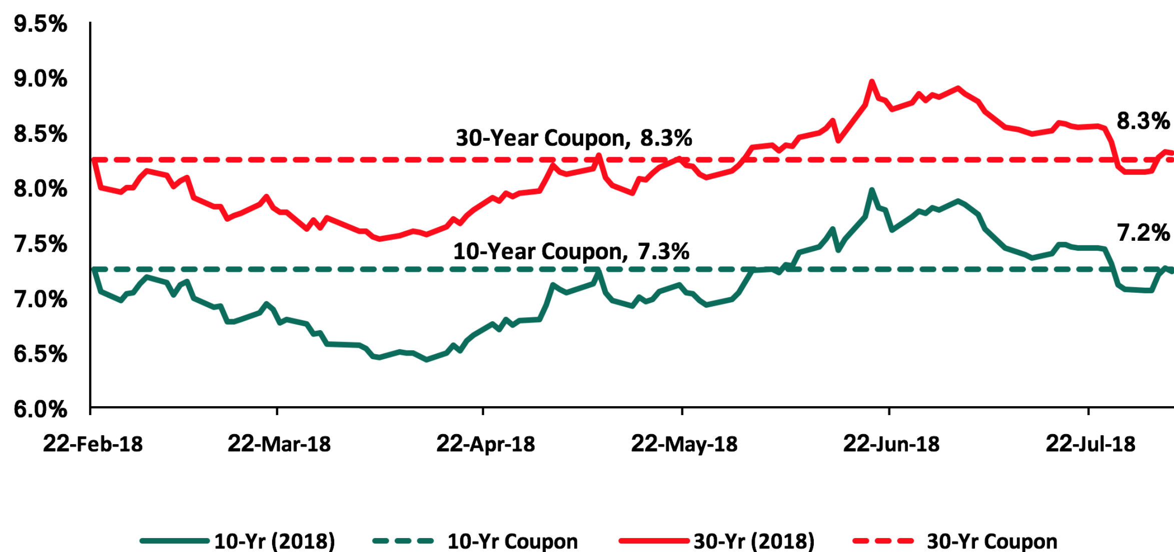
the average volumes traded in the interbank market declined by 26.8% to Kshs 12.4 bn from Kshs 16.9 bn the previous week. The increase in the average interbank rate points to declined liquidity, which the CBK attributed to low Government payments in the early weeks of the fiscal year 2018/2019.

Kenya Eurobonds:

According to Bloomberg, the yield on the 5-year and 10-Year Eurobonds issued in June 2014 declined by 1.2% points and 1.5% points to 4.1% and 6.4%, respectively from 5.3% and 7.9% in June. During the week, the yields on the 5-year and 10-year Eurobonds issued in 2014 both rose by 20 bps to 4.1% and 6.6% from 3.9% and 6.4%, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.7% points and 3.1% points for the 5-year and 10-year Eurobonds, respectively, due to the relatively stable macroeconomic conditions in the country.



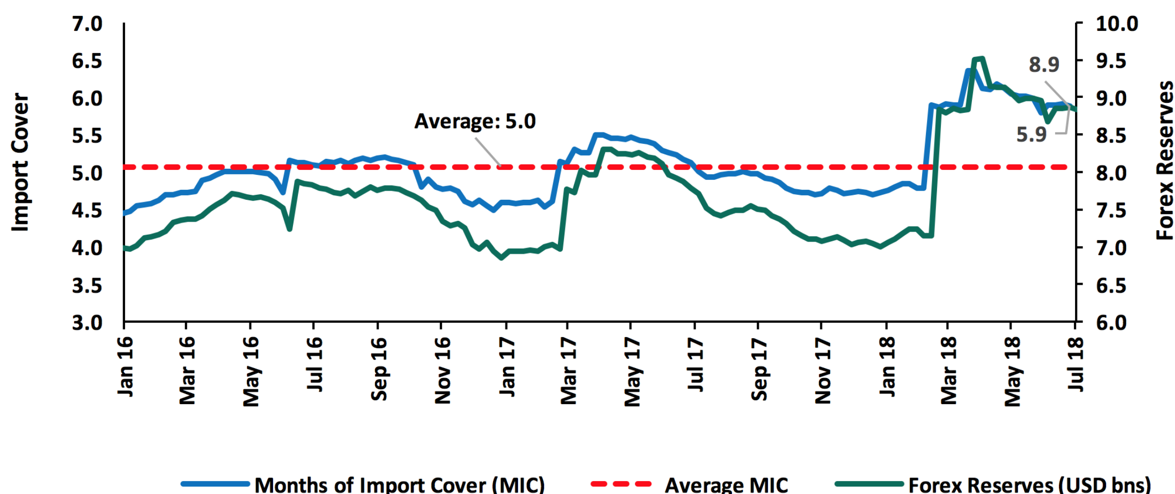
During the month, the yields on the 10-year and 30-year Eurobond issued in February 2018 declined by 70 bps to 7.1% and 8.1% from 7.8% and 8.8% in June, respectively as a result of improved liquidity in the global markets and lower risk perception as a result of improved investor sentiments based on the stable macroeconomic conditions. During the week, the yields on the 10-year and 30-year Eurobonds both increased by 10 bps and 20 bps respectively, to 7.2% and 8.3% from 7.1% and 8.1% last week, respectively. Since the issue date, the yield on the 10-year Eurobond has declined by 1 bps points while the 30-year Eurobond has increased by 10 bps.



The Kenya Shilling:

The Kenya Shilling appreciated by 0.6% against the US Dollar during the month of July to Kshs 100.4, from Kshs 101.1 at the end of June, supported by inflows from diaspora remittances. During the week, the Kenya Shilling appreciated by 0.1% against the US Dollar to close at Kshs 100.3 from Kshs 100.5, the previous week, supported by inflows from diaspora remittances. On a YTD basis, the shilling has gained 2.7% 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 to 5.8% in June from 6.3% in March, and is expected to narrow to 5.4% of GDP in 2018 driven by growth of agricultural exports, continued of diaspora remittances as well as tourism receipts,
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 bulk contribution coming from 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. Sufficient forex reserves, currently at USD 8.8 bn (equivalent to 5.8 months of import cover) and the USD 1.5 bn stand-by credit and precautionary facility by the IMF, still available until September 2018.



Inflation:

The inflation rate for the month of July recorded a marginal rise to 4.4% from 4.3% in June. The inflation rate declined by 0.9% m/m due to a 2.4% decline in the Food and Non-Alcoholic Drinks' Index, which was driven by a decrease in prices of some food basket items such as tomatoes, maize and beans outweighing increases in other constituents of the food basket. Housing, Water, Electricity, Gas and Other Fuels' Index increased by 0.1% in July 2018 compared to 0.5% recorded in June 2018. This was mainly attributed to an increase in prices of kerosene, electricity and cooking gas. The Transport Index also increased by 0.6% mainly on account of increase in the price of petrol which outweighed decrease in price of diesel. Below is a summary of key changes in the Consumer Price Index (CPI) in July:

Major Inflation Changes in the Month of July 2018			
Broad Commodity Group	**Price change m/m (July-18/June-18)**	**Price change y/y (July-18/July-17)**	**Reason**
Food & Non-Alcoholic Beverages	(2.4%)	0.5%	This was driven by a decrease in prices of some food basket items such as tomatoes, maize and beans outweighing increases in others
Transport Cost	0.6%	8.5%	This was on account of increase in the pump price of petrol which outweighed decrease in price of diesel
Housing, Water, Electricity, Gas and other Fuels	0.1%	14.4%	This was mainly attributed to an increase in prices of kerosene, electricity and cooking gas
Overall Inflation	**(0.9%)**	**4.4%**	**The m/m decline was due to a 2.4% decline in food prices which has a CPI weight of 36.0%**

We expect inflation in H2'2018 to experience upward pressure, partly due to the base effect, and the expected rise in fuel and transport prices with the introduction of 16.0% VAT on petroleum products as from September 2018 and other tax reforms proposed under the Finance Bill 2018. We however still expect inflation to remain within the government's set target of 2.5%-7.5% during the year.

Monetary Policy:

The Monetary Policy Committee (MPC) met on Monday 30th July, 2018 to review the prevailing macroeconomic conditions and give direction on the Central Bank Rate (CBR). The MPC reduced the CBR at 9.0% from 9.5%, which was not in line with our expectations as detailed in our MPC Note, citing that economic output was still below its potential despite improving economic growth prospects, as evidenced by:

i. Inflation expectations were well anchored within the target range despite rising to 4.3% in June from 4.0% in May. The MPC noted that the overall inflation is expected to remain within the government target range despite upward pressure from rising fuel prices due to a rise in global oil prices and the impact of excise tax on some of the CPI items. Expectations of declining food prices due to favorable weather conditions is expected to mitigate the upward inflationary pressure,
ii. Private sector credit growth, which grew by 4.3% in June up from 2.8% in April, with the highest growth in lending being recorded in the building and construction, manufacturing, and trade sectors at 13.5%, 12.3% and 8.6%, respectively, and
iii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in May 2018, which showed that the private sector was optimistic about local economic prospects in 2018. This was mainly attributed to a relatively stable macroeconomic environment, renewed business confidence, a rebound in agriculture due to improved weather conditions, continued infrastructure investment by the government, with the government's focus on the ***Big Four Agenda***.

The MPC however noted the risk of perverse outcomes from the lowering of the CBR stating that they will be closely monitoring its impact as well as other developments in the domestic and global economy ready to take any additional measures as necessary. See the CBK Release.

Monthly Highlights:

According to the Stanbic Bank's Monthly Purchasing Manager's Index (PMI), the business environment in the country continued to expand in July 2018 though at a moderate pace. The seasonally adjusted PMI declined to 53.6 in July from 55.0 in June. A PMI reading of above 50 indicates improvements in the business environment, while a reading below 50 indicates a worsening outlook. Firms reported growth in value of outputs due to the continued rise in new export orders, which rose at the fastest pace since March. This was despite high input costs attributed to an increase in fuel prices, leading to upward pressure on production costs, and consequently a rise in average selling prices with the cost burden being transferred to customers. In response to increased output requirements, firms also raised their staffing levels though at a slow and marginal pace. The private sector has remained resilient as the PMI is still above 50, we however expect the sector to experience increased input costs going forwards with the introduction of 16.0% VAT on petroleum products as from September 2018 and other tax reforms proposed under the Finance Bill 2018.

According to the quarterly Balance of payments report, released in July, Kenya's current account deficit improved during Q1'2018, coming in at Kshs 107.9 bn from Kshs 129.7 bn in Q1'2017, a decline of 16.8%, equivalent to 8.9% of GDP in Q1'2018, from 11.3% recorded in Q1'2017. The decline was attributed to export growth, which outpaced the growth in imports, growing at 7.1% to Kshs 162.9 bn from Kshs 152.1 bn in Q1'2017, compared to the 6.5% increase in imports to Kshs 432.1 bn from Kshs 406.4 bn in Q1'2017. In addition, there was a 28.0% increase in the services trade balance, coupled with the 26.9% increase in the secondary income (transfers) balance, whose increase could be attributed to the 46.1% increase in diaspora remittances. The current account deficit is expected to narrow further to 5.4% of GDP in 2018 from 6.2% in 2017, supported by

i. Continued growth of the primary agricultural exports particularly tea and horticulture,
ii. Continued improvement in diaspora remittances, and,

iii. Improved tourism receipts

Despite the expectations of an increase in the value of petroleum products due to higher global oil prices, lower imports of food as a result of improved weather conditions and the reduced importation of SGR-related equipment is expected to mitigate the impact on the current account.

According to the Kenya National Bureau of Statistics (KNBS) Q1’2018 Gross domestic product report also released in July, Kenya’s economy expanded by 5.7% in Q1’2018, higher than 4.8% in Q1’2017. This improved growth was attributed to:

i. Recovery in agriculture, which recorded a growth of 5.2% due to improved weather conditions,
ii. Improved business and consumer confidence, and
iii. Increased output in the real estate, manufacturing, and wholesale & retail trade sectors, which grew by 6.8%, 2.3% and 6.3%, respectively.

The year 2018 is set to be a better year in terms of the macroeconomic environment and economic growth, which resulted into stronger economic growth in the first quarter of the year, and we expect a similar trend going forward. During the week, the Central Bank of Kenya Governor maintained CBK’s 2018 GDP growth projection at 6.2%. With the country’s economy having grown by 5.7% in Q1’2018, and with the current freeze on new government projects and the low private sector credit growth remaining low at 4.3% in June, we maintain our 2018 GDP growth projection of between 5.4% and 5.6%. The strong economic growth will be supported by recovery in the agriculture and manufacturing sectors following improved weather conditions set to boost agricultural productivity, water supply and electricity that will in turn favour the manufacturing sector, and continued growth in tourism, real estate and construction sectors. Below is a table of Kenya’s 2018 GDP growth projections that we track released by 15 organizations, that comprises of research houses, global agencies, and government organizations. The average GDP growth expectations for 2018 is at 5.5%.

Kenya 2018 Annual GDP Growth Outlook				
No.	**Organization**	**Q1'2018**	**Q2'2018**	**Q3'2018**
1	Central Bank of Kenya	6.2%	6.2%	6.2%
2	Kenya National Treasury	5.8%	5.8%	5.8%
3	Oxford Economics	5.7%	5.7%	5.7%
4	African Development Bank (AfDB)	5.6%	5.6%	5.6%
5	Stanbic Bank	5.6%	5.6%	5.6%
6	Citibank	5.6%	5.6%	5.6%
7	International Monetary Fund (IMF)	5.5%	5.5%	5.5%
8	World Bank	5.5%	5.5%	5.5%
9	Fitch Ratings	5.5%	5.5%	5.5%
10	Barclays Africa Group Limited	5.5%	5.5%	5.5%
11	**Cytonn Investments Management Plc**	**5.4%**	**5.5%**	**5.5%**
12	Focus Economics	5.3%	5.3%	5.3%
13	BMI Research	5.3%	5.2%	5.2%
14	The Institute of Chartered Accountants in England and Wales		5.6%	5.6%
15	Standard Chartered	4.6%	4.6%	4.6%
	Average	**5.5%**	**5.5%**	**5.5%**

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids, as it is currently 118.2% 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 could 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.

Liason House, StateHouse Avenue
The Chancery, Valley Road
www.cytonn.com
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