Nakuru Real Estate Investment Opportunity, & Cytonn Weekly #30/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were undersubscribed during the week, with the overall subscription rate coming in at 57.4%, a decline from 60.4% recorded the previous week due to tight liquidity, which the Central Bank of Kenya (CBK) attributed to seasonal low government spending at the beginning of the fiscal year. Yields on the 91-day paper increased by 10 bps, to 7.7% from 7.6% the previous week, while yields on the 182-day paper declined by 10 bps to 9.0% from 9.1% the previous week. The yield on the 364-day paper remained unchanged at 10.0%. The acceptance rate for T-bills remained unchanged at 96.8%, with the government accepting Kshs 13.3 bn of the Kshs 13.8 bn worth of bids received. The subscription rate for the 91-day and 364-day papers improved to 15.1% and 111.1% from 14.2% and 87.9% the previous week, respectively, while the subscription rate for the 182-day paper declined to 20.5% from 51.5% the previous week. The 364-day paper continued to record the highest performance attributed to the scarcity of newer short-term primary bonds, as the government has been issuing longer tenor bonds in a bid to lengthen its debt maturity profile, leaving investors to settle for the 364-day paper.

For the month of August 2018, the Kenyan Government has issued a new 10-year Treasury bond (FXD 1/2018/10) with a market-determined coupon rate, in a bid to raise Kshs 40.0 bn for budgetary support. The government had been issuing longer-dated bonds in a bid to lengthen the debt maturity profile, which has been declining with the average term to maturity for all government securities hitting 4.4-years as at April 2018.The government has not achieved much in lengthening their liability profile mainly due to the poor performance of the longer dated bonds in the auction market. We attribute the low-performance rate to the relatively flat yield curve on the long-end, making it relatively unattractive to hold longer-term bonds considering the current uncertainties in the interest rate environment. The sale period for the 10-year bond ends on 21st August, and we shall give our view on a bidding range in next week's report.

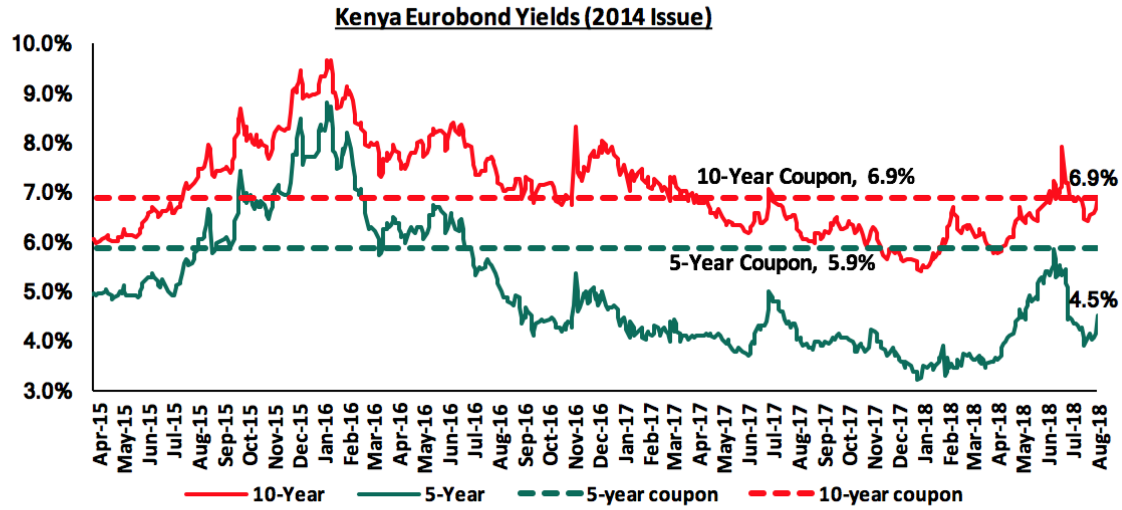
Liquidity:

The average interbank rate increased to 8.3%, from 7.2% the previous week, while the average volumes traded in the interbank market declined by 7.7% to Kshs 11.4 bn, from Kshs 12.4 bn the previous week. The increase in the average interbank rate points to the continued decline in liquidity, which the Central Bank of Kenya has attributed to seasonal low government spending at the beginning of the fiscal year.

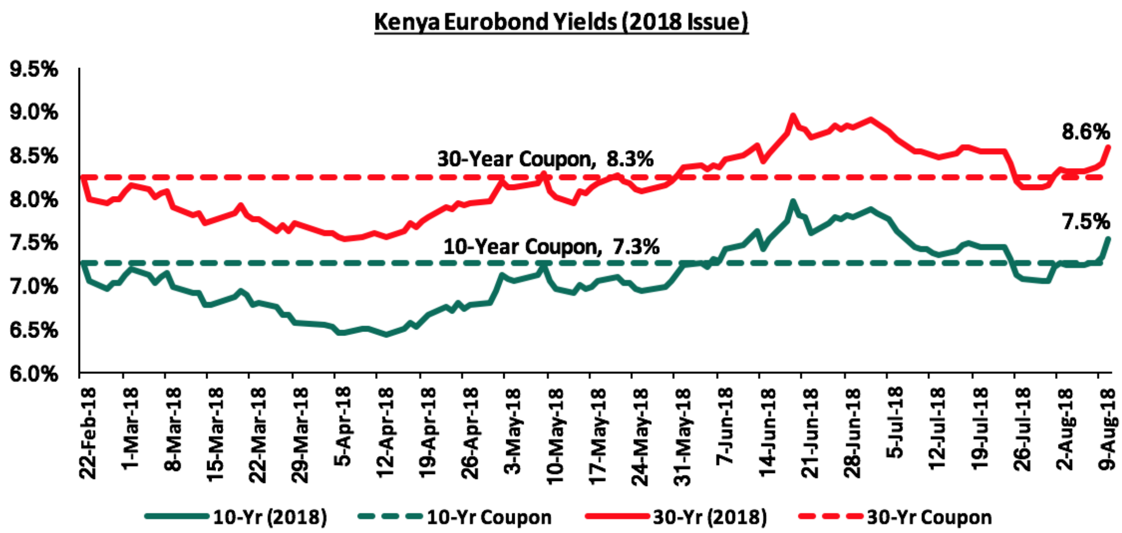
Kenya Eurobonds:

According to Bloomberg, the yield on the 5-Year and 10-year Eurobonds issued in 2014 increased by 0.5% points and 0.3% points to 4.5% and 6.9% from 4.0% and 6.6% the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.3% 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 both the 10-year and 30-year Eurobonds increased by 0.3% points each, to 7.5% and 8.6% from 7.2% and 8.3% the previous week, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have increased by 0.2% points and 0.3% points, respectively.



Key to note is that yields on all the Eurobond issues were on the rise this week, which the CBK attributed to the adjustments of global yields to normalisation of monetary policies in the advanced economies.

The Kenya Shilling:

During the week, the Kenya Shilling lost marginally to the US Dollar, to close at Kshs 100.4 from Kshs 100.3 the previous week, supported by inflows from offshore investors that matched the thin dollar demand by importers, amidst tightened liquidity in the money markets. The Kenyan Shilling has gained by 2.7% 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 5.8% in the 12-months to June 2018, from 6.3% in March 2018, attributed to improved agriculture exports, and lower capital goods imports following the completion of Phase I of the Standard Gauge Railway (SGR) project,
ii. Stronger inflows from principal exports, which include coffee, tea and horticulture, which increased by 10.8% during the month of May to Kshs 24.3 bn from Kshs 21.9 bn in April, with the

exports from coffee, tea and horticulture improving by 11.0%, 19.1% and 2.0% m/m, respectively,

iii. Improving diaspora remittances, which increased by 71.9% y/y to USD 266.2 mn from USD 154.9 mn in June 2017, and 4.9% m/m, from USD 253.7 mn in May 2018, with the largest contributor being North America at USD 130.1 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 8.7 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.

Highlights of the Week:

The International Monetary Fund (IMF) released a press statement on the recently completed review of Kenya with regards to the USD 1.5 bn stand-by credit and precautionary facility. The IMF stated that their mission to assess the Kenyan economy achieved significant progress, but it remains uncertain if Kenya's access to the standby facility will be extended as talks with the government are set to continue in the coming week with the IMF team expected to submit final report to the IMF Board by the end of August. This was the second review since the initial approval of the credit facilities on 14th March 2016. The reviews are normally conducted on an annual basis but the second and third review had been pending since the conclusion of the 1st review on 25th January 2017, since the fiscal balance, which is a performance criterion had not been met as at the end of December 2016 and June 2017. This was 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 a 6-months extension, which was granted on March 12th, 2018. In their press release with regards to the second review, the IMF noted that:

i. Kenya's economy had continued to perform well with the GDP having expanded by 5.7% in Q1'2018, up from 4.9% growth experienced in Q1'2017, with the growth being driven by strengthened investor confidence following the conclusion of the prolonged electioneering period, improved weather conditions in 2018 with the country having experienced a drought in 2017 and a recovery in tourism, which can be evidenced by an increase in the total number of visitors arriving through Jomo Kenyatta International Airport and Moi International Airports, that increased by 2.1% to 76,608 in June 2018 from 75,028 in May 2018, despite a 4.4% decline y/y from 80,121 in June 2017, as per data from Kenya National Bureau of statistics (KNBS),
ii. Inflation has remained within the 2.5% - 7.5% government set target since July 2017. We expect inflation to remain within target in 2018 despite the expectations of upward pressure in H2'2018, 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,
iii. Kenya had managed to meet the IMF's program fiscal target for the FY2017/2018, with the budget deficit for the 2017/2018 fiscal year coming in at Kshs 614.6 bn (equivalent to 7.0% of GDP), which is a significant narrowing from 9.0% of GDP previously,
iv. The current account deficit has started to adjust in 2018 after widening to 6.7% of GDP in 2017 from 5.2% in 2016, which was mainly driven by higher food imports and weaker agricultural exports due to the drought experienced during the year, coupled with higher fuel imports owing to rising global oil prices. The lower current account deficit so far in 2018, which narrowed to 5.8% in the 12 months to June 2018 from 6.3% in March 2018, has been attributed to improved agriculture exports, and lower capital goods imports following the completion of Phase I of the SGR project, and,
v. The Kenyan Shilling has remained resilient against major currencies, while foreign exchange

reserves have been relatively high currently standing at about USD 8.7 bn (equal to 5.8-months of projected imports for 2018).

The existing program is set to expire on September 14th 2018 and it remains uncertain if Kenya's access to the stand-by facility will be extended. Kenya has not tapped into the facility meant to cushion the country from unforeseen negative external shocks that could put pressure on Kenya's balance of payments since its initial approval as its external position has remained strong, supported by relatively high levels of foreign exchange reserves currently at USD 8.7 bn (equivalent to 5.8-months of import cover), coupled with improving diaspora remittances and exports.

The treasury is seeking to recruit debt management experts who will be tasked with providing guidance on determination of borrowing ceilings for national and county governments, as well as preparing proposals for debt restructuring and liaising with the Central Bank of Kenya (CBK) and other Treasury departments for effective debt management. The move is in response to the rising concerns over debt sustainability of the country as the government continues to embark on measures to improve debt management, with Kenya's public debt to GDP having hit 55.6% by the end of 2017, 5.6% above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, and the IMF threshold of 50.0%. Total domestic debt currently stands at Kshs 2.5 tn, while total external debt stood at Kshs 2.5 tn as at March 2018. The move is in line with the government's effort of reducing the debt to GDP ratio to below 50.0% under its fiscal consolidation plan which it projects to narrow the fiscal deficit to 5.7% of GDP in the FY'2018/19 from 7.2% of GDP in the FY'2017/18 and further to around 3.0% of GDP by FY'2021/22 by increasing revenue collection hence reducing the reliance on debt financing.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids as it is currently 54.8% ahead of its pro-rated borrowing target for the current financial year, having borrowed Kshs 56.7 bn against a prorated target of Kshs 36.6 bn. 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 an 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.
