Kenya Retail Sector Report 2018, & Cytonn Monthly – August 2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

During the month of August, T-bill auctions recorded an undersubscription, with the average subscription rate coming in at 85.1%, a decline from 157.4%, recorded in July. The average subscription rates for the 91-day, 182-day and 364-day papers came in at 57.9%, 59.7% and 121.3%, from 70.2%, 90.9% and 258.6%, in the previous month, respectively, with investors' participation remaining skewed towards longer dated papers. The yields on the 91-day paper remained unchanged at 7.6%, while yields on the 182-day and 364-day papers declined by 0.1% points and 0.2% points, to 9.0% and 9.9% from 9.1% and 10.1% the previous month, respectively. The average T-bills acceptance rate came in at 90.3% during the month, compared to 74.4% in July with the Kenyan government accepting a total of Kshs 73.8 bn of the Kshs 81.7 bn worth of bids received, indicating that bids were largely within ranges the Central Bank of Kenya (CBK) deemed acceptable.

During the week, T-bills were oversubscribed, with the overall subscription rate coming in at 176.1%, up from 120.4% recorded the previous week, due to improved liquidity in the money market. The yield on the 91-day increased by 0.1% points to 7.7% from 7.6%, the previous week, while yields on the 182-day and 364-day papers remained unchanged at 9.0% and 9.9%, respectively. The acceptance rate for T-bills declined to 77.8% from 79.3% the previous week with the government accepting Kshs 32.9 bn of the Kshs 42.3 bn worth of bids received. The subscription rate for the 91-day and 364-day papers improved to 289.6% and 216.9% from 48.4% and 175.4%, the previous week, respectively while the subscription rate for the 182-day paper declined to 90.0% from 94.1% the previous week, with investors' participation remaining skewed towards the longer dated paper attributed to the scarcity of newer short-term bonds in the primary market.

The 91-day T-bill is currently trading at 7.6%, which is below its 5-year average of 9.0%. 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%.

During the month, the Kenyan Government 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 issue was under-subscribed, with the overall subscription rate coming in at 74.6%, while the weighted average rate of accepted bids came in at 12.7%, in line with our expectations of 12.7% - 13.0%. We attributed the undersubscription of the bond to investors being cautious in lengthening their bond portfolio duration due to uncertainties in the interest rate environment as a result of the debate on the interest rate cap, which was still ongoing. With the National Assembly having voted to retain the interest rate cap, now awaiting presidential assent in order to become law, we expect improved performance going forward. The government accepted Kshs 19.4 bn out of the Kshs 29.8 bn worth of bids received, translating to an acceptance rate of 64.9%.

Secondary Bond Market:

The yields on government securities in the secondary market continued to decline in August 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 1.1% during the month, bringing the YTD performance to 10.3%.

Liquidity:

The average interbank rate declined to 5.8% at the end of August from 7.2% in July, pointing to improved liquidity during the month. The improved liquidity was attributed to overnight loans trading at lower interest rates in the interbank markets during the month as well as the pick-up in Government spending, which resulted in improved liquidity in the money market.

During the week, the average interbank rate declined to 5.8%, from 6.1% the previous week, while the average volumes traded in the interbank market increased by 25.6% to Kshs 22.5 bn from Kshs 17.9 bn the previous week, with the increased activity in the interbank market being attributed to a pickup in demand for funds to facilitate VAT remittances by corporates. The decline in the average interbank rate points to improved liquidity, which the Central Bank of Kenya partly attributed to overnight loans trading in the interbank markets at lower interest rates during the week.

Kenya Eurobonds:

According to Bloomberg, the yield on the 5-year and 10-Year Eurobonds issued in June 2014 both rose by 0.8% points to 4.9% and 7.2%, respectively, from 4.1% and 6.4% in July, attributable to adjustments of global yields to normalization of monetary policies in the advanced economies. During the week, the yields on the 5-year and 10-year Eurobonds issued in 2014 rose by 0.3% points and 0.1% points to 4.9% and 7.2% from 4.6% and 7.1%, respectively. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 3.9% points and 2.4% 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 rose by 0.8% and 0.7% points to 7.9% and 8.8% from 7.1% and 8.1% in July, respectively. During the week, the yields on the 10-year and 30-year Eurobonds both increased by 0.2% points, to 7.9% and 8.8% from 7.7% and 8.6% last week, respectively. Since the issue date, the yield on the 10-year Eurobond has increased by 0.6% points while the 30-year Eurobond has increased by 0.5% points.

The Kenya Shilling:

The Kenya Shilling depreciated by 0.2% against the US Dollar during the month of August to Kshs 100.6 from Kshs 100.4 at the end of July. This was driven by dollar demand from traders and oil importers coupled with subdued dollar inflows from exporters. During the week, the Kenya Shilling appreciated marginally against the US Dollar to close at Kshs 100.6 from Kshs 100.7, the previous week, which the CBK attributed to increased inflows from offshore banks. On a YTD basis, the shilling has gained by 2.5% against the US Dollar. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

?. 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 diaspora remittances as well as tourism receipts,

i. 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 increasing by 11.0%, 19.1% and 2.0% m/m, respectively,

ii. Improving diaspora remittances, which increased by 4.9% to USD 266.2 mn in June 2018, from USD 253.7 mn in May 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,

iii. Sufficient forex reserves, currently at USD 8.6 bn (equivalent to 5.7 months of import cover).

Inflation:

The Y/Y inflation rate for the month of August recorded a decline to 4.0% from 4.4% in July in line with our expectations of 4.0% - 4.4%, mainly due to a decline in food prices that constitute the food index, and the base effect. M/M inflation rate, however increased by 0.3% due to a 2.6% increase in the housing, water, electricity, gas and other fuels' index, which was driven by a significant increase in prices of electricity that rose by 52.8% and 6.6% for 50 and 200 KWh, respectively, coupled with an increase in the transport index on account of increased pump price of petrol which outweighed the decrease in price of diesel. Food and non-alcoholic Beverages index however declined by 0.7% due to decrease in prices of some foodstuff outweighing increases recorded in respect of others. This decrease was greatly contributed by a fall in prices of maize grains. Below is a summary of key changes in the Consumer Price Index (CPI) in August:

Major Inflation Changes in the Month of August 2018

Broad Commodity Group	Price change m/m (Aug-18/July-18)	Price change y/y (August-18/August-17)	Reason
Food & Non-Alcoholic Beverages	(0.7%)	(1.2%)	This was due to decrease in prices of some foodstuffs outweighing increases recorded in respect of others. This decrease was greatly contributed by fall in prices of maize grains
Transport Cost	0.9%	9.4%	This was on account of an increase in the pump price of petrol which outweighed the decrease in price of diesel
Housing, Water, Electricity, Gas and other Fuels	2.6%	16.7%	This was on account of a significant increase in prices of electricity which rose by 52.8% and 6.6% for 50 and 200 KWh, respectively

Major Inflation Changes in the Month of August 2018

Broad Commodity Group	Price change m/m (Aug-18/July-18)	Price change y/y (August-18/August-17)	Reason
Overall Inflation	**0.3%**	**4.0%**	**The m/m increase was due to a 2.6% rise in the Housing, Water, Electricity, Gas and other Fuels index which has a CPI weight of 18.3%**

Monthly Highlights:

During the month, the International Monetary Fund (IMF) concluded their visit to Kenya where they were holding discussions with the Kenyan Government on the second review under a precautionary Stand-By Arrangement (SBA), which was extended to Kenya on 14th March 2016. The existing program is set to expire on September 14th 2018 and it remains uncertain if Kenya's access to the facility will be extended as talks with the government were set to continue with the IMF team expected to submit a final report to the IMF Board by the end of August. Among the key pre-conditions set by the IMF to extend the facility was a substantial modification to the interest rate capping and the implementation of the 16.0% VAT on fuel in order to reduce the large deficits over the last few years. With the National assembly having voted to retain the status quo and keep the top ceiling capping loans at 4.0% above the Central Bank Rate, as well as pushing the implementation of VAT on fuels by another 2 years to September 2020 citing that its implementation would lead to a rise in inflation, it is unlikely that the IMF will renew the supplementary facility. We maintain our view that the facility would be essential to Kenya as it would enhance fiscal discipline due to the attached pre-conditions that the program comes with, which include, policy changes, such as the targeted inflation that the country must maintain, increased taxation in a bid to increase government revenues while minimizing dependency on debt, cutbacks of government spending and reduction of fiscal deficits. As such, this would reduce the risk perception of the country while improving investor sentiments as signing up to undertake the fiscal policy measures in order to be granted access to the facilities would provide reassurance to investors of expected improvements and stability in the macroeconomic conditions of the country.

During the month, the National Assembly voted on the Finance Bill, 2018. During the third reading and final stage of parliamentary debate, the National Assembly voted for the interest rate cap to be retained citing that there was no justification for the repeal, as there was no effort by banks to address the issue of high credit risk pricing. The National Assembly however voted to remove the 70.0% minimum limit on deposits, pegged on the Central Bank Rate (CBR) and instead, leave the decision of deposit pricing at the discretion of the banks and customers. The Bill now awaits the presidential assent in order to become law.

The National Assembly voted to scrap off the Robin Hood Tax, citing that it is punitive and the Kshs 500,000 set threshold was too low. This was despite the proposals by the Finance committee to make limited amendments.

The Members of the National Assembly also voted to scrap off the 2.0% tax increment on mobile transfers from 10.0% to 12.0%. The FY'2018/2019 budget had mainly focused on fiscal consolidation through strengthening of revenues which were projected to rise by 17.5% to Kshs 1.9 tn from Kshs 1.7 tn in the FY 2017/2018, with tax policy measures at the core of achieving the fiscal targets as well as a reduction in expenditure. With Parliament having rejected the tax proposals, there are expectations of a shortfall in Government revenues as there were expectations of a Kshs 86.0 bn rise in VAT collections, which may see it either reducing expenditures or increasing debt capital, which as per the budget was expected to decline by 8.6% to Kshs 271.9 bn from Kshs 297.6 bn in the

FY'2017/2018 budget; it remains to be seen how the National Treasury will respond to the outcome of the National Assembly actions.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids as it is currently 26.0% ahead of its pro-rated borrowing target for the current financial year, having borrowed Kshs 65.9 bn against a prorated target of Kshs 52.3 bn. The 2018/19 budget had given 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. With the rate cap still in place, and the national assembly having voted to retain it, now awaiting presidential assent to become law, 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.
