Cytonn INVESTMENTS

The IMF Precautionary Credit Facility 2018, & Cytonn Weekly #35/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were oversubscribed during the week, with the overall subscription rate coming in at 181.1%, up from 148.7% recorded the previous week. Yield on the 91-day T-Bill remained unchanged at 7.6%, while the yields on the 182-day and 364-day papers declined by 0.1% points to 8.8% and 9.7%, from 8.9% and 9.8% recorded the previous week, respectively. The acceptance rate for T-bills declined to 59.8%, from 76.7% recorded the previous week, with the government accepting a total of Kshs 26.0 bn of the Kshs 43.5 bn worth of bids received. The subscription rate for the 91-day and 182-day papers improved to 182.9% and 170.9% from 64.0% and 126.2%, recorded the week, respectively, while the subscription on the 364-day paper declined to 181.1%, from 205.1% the previous week.

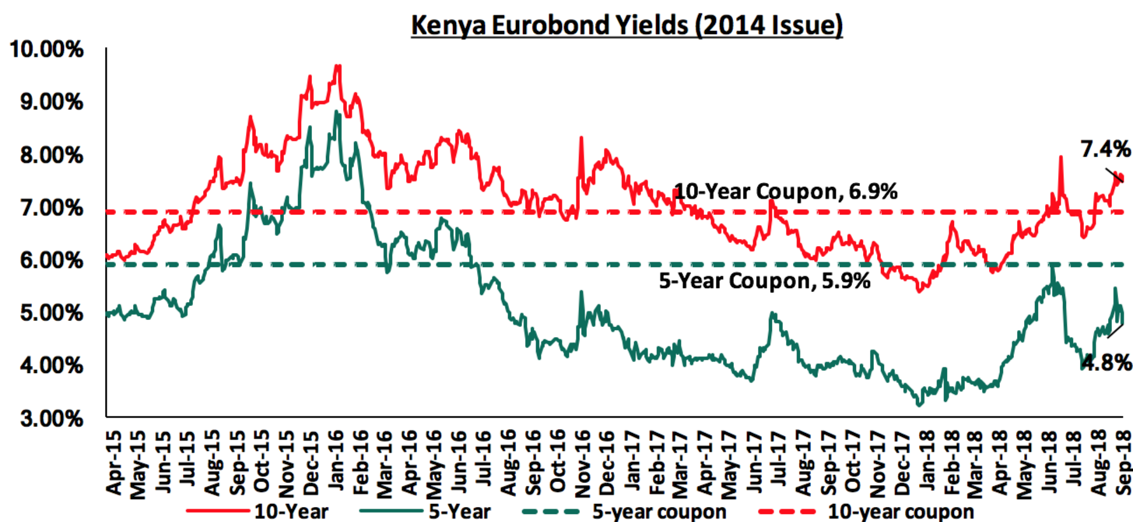
For the month of September, the Kenyan Government has re-opened 2 bonds, FXD 1/2018/10 and FXD 2/2018/20, with 10-years and 19.9-years to maturity, and coupon rates of 12.7% and 13.2%, respectively. The government will be seeking to raise Kshs 40.0 bn for budgetary support. We expect the 20-year tenor bond to have a lackluster performance compared to the 10-year bond due 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, with the 20-year bond having had a performance rate of 34.7% on its initial auction in July compared to the 74.6% subscription rate for the 10-year bond in August. These Treasury bonds are currently trading at yields of 12.5% and 12.8% in the secondary market, respectively. As such we see the average yield of the bonds coming in between 12.5% and 12.7% for the FXD 1/2018/10 and between 12.8% and 13.1% for the FXD 2/2018/20.

Liquidity:

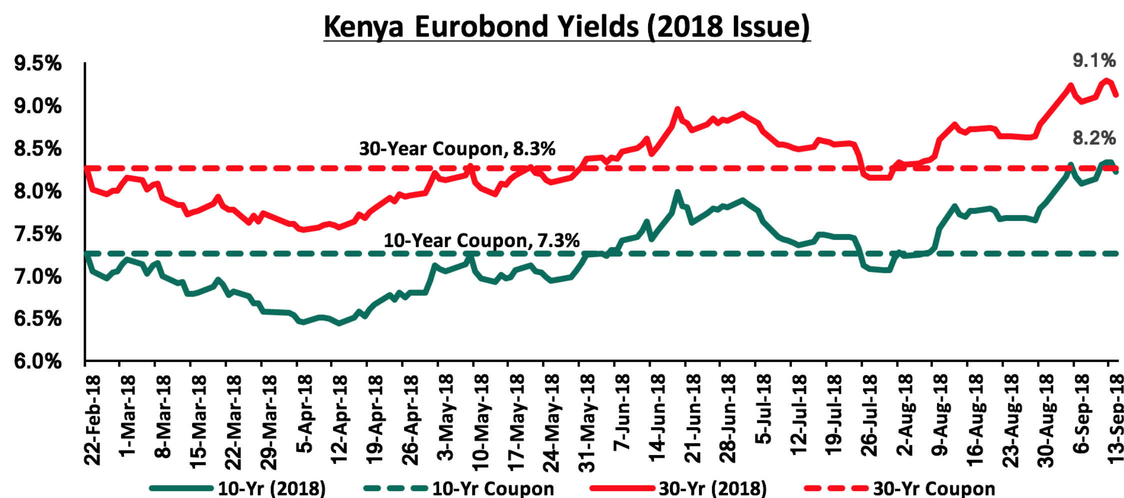
The average interbank rate declined to 4.2%, from 5.5% the previous week, while the average volumes traded in the interbank market increased by 40.4% to Kshs 18.4 bn, from Kshs 13.1 bn the previous week with the increased activity being partly attributed to the mobilization of funds for PAYE remittances. The decline in the average interbank rate points to improved liquidity, which the Central Bank of Kenya attributed to large banks trading at lower interest rates.

Kenya Eurobonds:

According to Bloomberg, the yield on the 10-Year and 5-year Eurobonds issued in 2014 remained unchanged at 7.4% and 4.8%, from the previous week. Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 4.0% points and 2.2% 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 0.8-years and 5.8-years to maturity for the 5-year and 10-year, respectively.



For the February 2018 Eurobond issue, during the week, the yields on both the 10-year and 30-year Eurobonds increased by 0.1% points to 8.2% and 9.1% from 8.1% and 9.0% the previous week, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have increased by 0.9% points and 0.8% points, respectively.



The Kenya Shilling:

During the week, the Kenya Shilling depreciated by 0.5% against the US Dollar to close at Kshs 101.2, from Kshs 100.7 the previous week, mainly driven by increased dollar demand from banks and importers over uncertainty regarding an IMF stand-by arrangement. The Kenya Shilling has appreciated by 1.9% year to date and in our view the shilling should remain relatively stable against the dollar in the short term despite the expiry of the IMF standby precautionary facility, 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 in June 2018 from USD 154.9 mn in June 2017 and by 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 8.5 bn, equivalent to 5.7 months of import cover.

Highlights of the Week:

During the week, the President received the Finance Bill 2018 from the Speaker of the National Assembly, which had amendments as voted by the National Assembly such as;

i. Postponing the imposition of VAT on fuel by another 2-years to September 2020, citing that its implementation would lead to a rise in inflation,
ii. Retaining of the interest rate cap citing that there was no justification for the repeal, as there were no concerted efforts by banks to address the issue of high credit risk pricing,
iii. Removal of the 70.0% minimum limit on deposits, pegged on the Central Bank Rate (CBR) instead, leaving the decision of the interest rate to be given on deposits at the discretion of the banks and customers
iv. Scrapping off the Robin Hood Tax, citing that it was punitive and the Kshs 500,000 set threshold was too low, and,
v. Scrapping off the 2.0% points tax increment on mobile transfers from 10.0% to 12.0%.

The President however did not assent to the Bill referring it back to the National Assembly for reconsideration due to the reservations he had concerning it he had, mainly on the postponement of VAT on fuel by another 2-years to September 2020 as voted by the National Assembly. A gazette notice dated 13th September stated that special parliamentary sittings shall be held on 18th September and 20th September to discuss budget supplementary estimates and the President's reservations against the Finance Bill. The President has proposed the VAT to be imposed on fuel to be cut by 50.0% to 8.0% from the initial 16.0% as well as other expenditure cuts and austerity measures across all arms of the government targeting the less essential spending such as expenditure on hospitality, travel, seminars and training. The ball is now on the National Assembly's court and according to the constitution, the legislators may accommodate the President's concerns following which the Bill would be resubmitted to the President for assent. However, Parliament may pass the Bill a second time without amendments by a vote supported by two thirds of the members of the National Assembly. If passed, the Speaker of the National Assembly would submit the Bill within 7-days to the President and the President would have 7-days to assent the Bill. If the President does not assent to the Bill after the 7-day expiry period, the Bill shall be taken to have been assented to on expiry. The proposal to reduce the VAT is a well-informed move as it would scale back the effects on the cost of living. We are however of the view that revenue generation ought to go hand in hand with management of government expenditure. Despite revenue generation improving over the years, there has been concerns over expenditure management as it does not reflect prudence and accountability. The continued rise in government expenditure with the target for FY'18/2019 increasing by 11.7% to Kshs 2.5 tn from Kshs 2.3 tn in the FY'17/2018 budget with the bulk of it being on recurrent expenditure, has continued to mount pressure on the Kenya Revenue Authority (KRA) due to the tax collection targets set to finance the budget. Going forward, it is essential for government institutions tasked with providing financial oversight to minimize poor management of public resources as well as ensure accountability to avoid fiscal leakages through corruption. With regards to this, the president has also proposed increased funding to bodies tasked with accountability of public funds e.g. the Judiciary and the Office of the Directorate of Criminal Investigations.

The International Monetary Fund's (IMF) precautionary stand-by facility granted to Kenya expired on 14th September 2018. The National Treasury was not keen on seeking to renew the facility noting that the macro-economic fundamentals of the country have continued to stabilize despite the country not drawing on the facility. This is as evidenced by inflation, which has remained within the

government's set target of 2.5% - 7.5% target averaging 4.2% in the 8 months to August 2018, the stable Kenyan Shilling, which has gained by 1.9% year to date and the country's GPD having grown by 5.7% in Q1'2018, up from 4.8% in Q1'2017. The Cabinet Secretary for Treasury further noted that Kenya should reduce its reliance on the facility as stand by facilities are meant to be short term with a maximum of 2-years after which the country should ideally graduate and get out of the program. The Treasury however insisted that the country can still engage and get access to the facilities in the future. Key to note, the country had not managed to meet the conditions set by the IMF for the renewal of the facility, which included:

i. Removal, or significant modification, of the interest rate controls by Parliament of which the National Assembly voted for the retaining of the interest rate cap with the only modification being the removal of the floor on deposit pegged at 70.0% of the Central Bank Rate (CBR), and,
ii. Fiscal consolidation in order to minimize the budget deficit and reduce public debt through rationalization of expenditure, supported by widening of the tax base by reducing exemptions in the VAT and income tax, as well as on-going improvements in revenue administration.

We believe that access to the facility would have been useful in cushioning the Kenyan Shilling from exogenous shocks as well as maintaining the country's fiscal discipline due to the preset conditions that come attached to it, which effectively reduces the risk perception of countries while improving investor sentiments. However, the country faces no immediate adverse risks as the country's external position is still strong, a view which the IMF has also affirmed through their local representative, as we have adequate forex reserves currently at USD 8.5 bn (equivalent to 5.7 months of import cover). There has however been misplaced fears on the state of the Eurobond issues in 2018 due to the clause under events of default on the prospectus dated 26th February 2018, which provided holders of at least 25.0% notes in aggregate principal amount of the relevant notes then outstanding maturing in 2028 and 2048 a leeway to declare such notes to be immediately due and payable at their principal amount together with accrued interest if the country ceases to be a member of the IMF or ceases to be able to use the general resources of the IMF. The country however does not face that risk as it is still a member of the IMF and is still eligible to use the general resources of the IMF thus lack of access to the standby facility does not constitute a default event.

According to the Energy Regulatory Commission (ERC), petrol prices have declined by 1.7% to Kshs 113.7 from Kshs 112.2 per litre previously, while diesel and kerosene prices have both increased by 0.3% to Kshs 115.5 and Kshs 97.7 per litre, respectively, effective 15th September – 14th October 2018. Key to note, the prices have changed from the recently revised prices as per the addendum released by the ERC that took effect from 1st September - 14th September 2018, taking into account the 16.0% VAT charge on fuel. The changes in prices have been attributed to the decline in average landing costs of imported super petrol by 2.3% to USD 743.9 per ton in August from USD 761.6 in July and Kerosene by 0.6% to USD 717.3 in August from USD 721.6 in July. Landing costs for diesel however increased by 0.4% to USD 686.0 in August from USD 683.3 in July. The means monthly USD to Kenyan Shilling exchange rate depreciated by 0.1% to Kshs 100.7 in August from Kshs 100.6 in July. Inflation for the month of September is expected to rise driven by the transport index and the housing, water, electricity, gas and other fuels due to the imposition of the 16.0 VAT charge on fuel as from 1st September 2018. We will release our inflation projection for the month of September 2018 in next week's report.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids as it is currently 37.3% ahead of its pro-rated borrowing target for the current financial year, having borrowed Kshs 86.2 bn against a pro-rated target of Kshs 62.7 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 in the finance bill despite the president referring it back to the National Assembly, 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.