Nairobi Metropolitan Area Infrastructure Report 2018, & Cytonn Weekly #41/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were under-subscribed during the week, with the overall subscription rate coming in at 66.8%, an increase from 51.5% recorded the previous week. The subdued performance is partly attributable to tighter liquidity in the interbank market, as evidenced by the increase in the interbank rate to 4.1% as at 22nd October from 3.8% at the close of the previous week. However, liquidity improved throughout the week, with inter-bank rate recording 3.0% as at the close of the week. The subscription rate for the 364-day paper increased to 105.6% from 49.6% the previous week, while the subscription rate for the 91-day and 182-day papers declined to 61.0% and 30.3% from 95.8% and 35.8%, recorded the previous week, respectively. The yields on the 91-day paper remained unchanged at 7.5%, while the yields on the 182-day and 364-day papers declined to 8.4% and 9.5%, from 8.5% and 9.6%, the previous week. The acceptance rate for T-bills improved to 100.0% from 97.4% recorded the previous week, with the government accepting Kshs 16.0 bn.

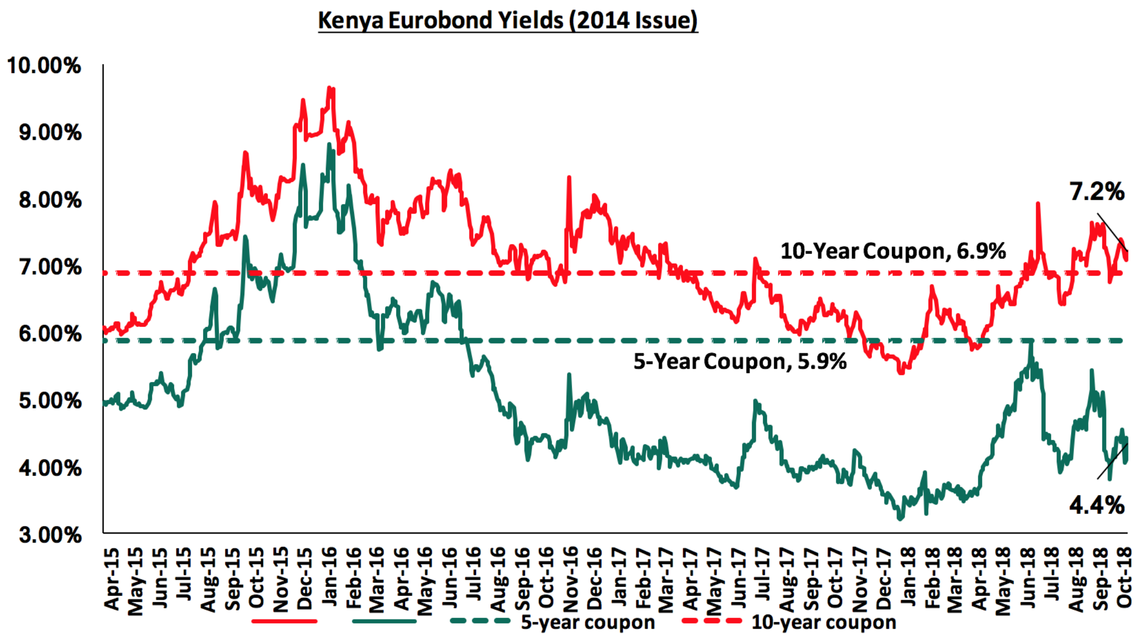
The Kenyan Government has re-opened the 15-year Treasury bond, issue No. FXD 2/2018/15, that closed last week with a coupon rate of 12.75% with the period of sale ending on 30th October 2018. The government seeks to raise Kshs 32.0 bn for budgetary support. The issuing of longer-term bonds is in a bid to lengthen the average time to maturity for the Kenyan Government's debt portfolio. The Central Bank of Kenya (CBK), in their Financial Sector Stability Report 2017, identified the continued shortening of debt maturities as posing potential rollover risks in the medium term if the trend is not reversed, having reduced to 4.1 years as at the end of 2017, from 4.5 years at the end of 2016, and highs of 8.9 years as at 2010. We are of the view that the continued issuance of medium to long-term domestic securities is well guided as lengthening the average maturity will reduce the pressures on the domestic debt market. Given that the Treasury bonds with the same tenor as FXD2/2018/15 are currently trading at a yield of 12.6%, we expect bids to come in at between 12.6% and 12.8%.

Liquidity:

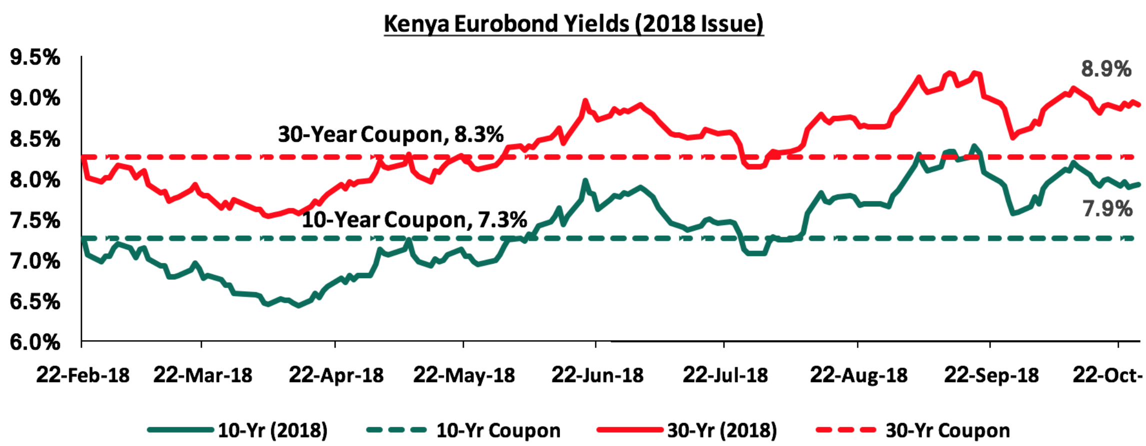
The average interbank rate declined marginally to 3.6%, from 3.7% the previous week, while the average volumes traded in the interbank market rose by 36.7% to Kshs 21.1 bn from Kshs 15.4 bn the previous week, reflecting banks' mobilization of funds for tax remittances. The lower interbank rate points to improved liquidity conditions, attributed to large banks trading at lower interest rates.

Kenya Eurobonds:

According to Bloomberg, the yield on the 5-year Eurobond issued in 2014 increased by 0.1% points to 4.4% from 4.3% the previous week, while the yield on the 10-year Eurobond issued in 2014 was constant from the previous week at 7.2%. Since the mid-January 2016 peak, yields on the Kenyan Eurobonds have declined by 2.5% points and 4.4% points for the 10-year and 5-year Eurobonds, respectively, an indication of the relatively stable macroeconomic conditions in the country. Key to note is that these bonds have 0.7 years and 5.7 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 Eurobond declined by 0.1% points to 7.9% from 8.0% the previous week, while the yield on the 30-year Eurobond remained constant at 8.9%. Since the issue date, the yields on the 10-year and 30-year Eurobonds have both increased by 0.6% points.



Kenya Shilling:

During the week, the Kenya Shilling depreciated by 0.2% against the US Dollar to close at Kshs 101.2 from Kshs 101.0, recorded the previous week, attributed to end-month dollar demand from oil and merchant importers. The Kenya Shilling has appreciated by 1.9% year to date, and in our view the shilling should remain relatively stable to 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 1.7% during the month of July to Kshs 24.7 bn, from Kshs 24.3 bn in June, with the exports from horticulture improving by 9.1%,

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 levels of forex reserves, currently at USD 8.4 bn, equivalent to 5.6-months of import cover, compared to the one-year average of 5.4-months.

Highlight of the Week:

During the week, the International Monetary Fund (IMF) released a report based on bilateral discussions held with the Kenyan Government on the country's economic developments and policies. The economic and financial information collected was used to establish the Performance Criteria for the second review under the precautionary Stand-By Arrangement (SBA), amounting to USD 985.9 mn (Kshs 99.0 bn), extended to Kenya on 14th March 2016. The program expired on 14th September 2018 after being extended from 14th March 2018, and the Treasury announced that it was not keen on renewing the precautionary credit facility with the IMF, despite having requested an extension of the same in March 2018, arguing that the country had kept macroeconomic fundamentals stable despite the country not drawing on the facility. For more information, see our focus on The IMF Precautionary Credit Facility 2018. The key take outs from the IMF report were:

i. **Kenya's risk of debt distress has increased from low to moderate:** The IMF noted that Kenya's debt and debt servicing has increased because of the government's public investment drive and revenue shortfalls in recent years. Public debt is projected to rise to 63.2% of GDP in end 2018 from 58.0% in 2017 and 53.2% in 2016 due to increased infrastructural projects. The higher level of debt, coupled with rising reliance on non-concessional borrowing, has raised fiscal vulnerabilities and increased interest payments on public debt to nearly 20.0% of revenue, placing Kenya in the top quartile among its peers,
ii. **The interest rate cap, introduced in September 2016, weakened economic performance:** Interest rate controls have reduced the profitability of commercial banks, which have been forced to adjust their deposit and lending facilities with the controls, significantly reducing their net interest income. The IMF also noted that the interest rate cap had led to lower credit growth, reduced financial inclusion, weaker tax revenues, and higher financial stability risks. The estimated decline in growth due to the interest rate controls in 2017 is estimated at 0.25% - 0.75% points. Key to note, the recent removal of the floor rate on deposit due to the assent of the Finance Bill 2018 could increase banks profitability without necessarily increasing lending to SMEs, as it would lead to reduced cost of funding. Whether the amendment will translate to higher lending will be dependent on the "risk free" rate of government securities. If yields on government securities remain high, banks will continue to be incentivized to lend to the government rather than customers perceived to be riskier, and with lower cost of funds for the banks, return on equity could be higher. However, were yields on government securities to decline, the combination of greater spreads from the lower funding costs and diminished attractiveness of government securities could reignite lending to the private sector,
iii. **The interest rate controls and interbank market volatility have hampered monetary policy effectiveness:** The report stated that the Central Bank Rate (CBR) has lost its signaling role as interest rate controls have weakened the link between the CBR and bank lending and deposit rates. Prior to introduction of interest rate controls, the CBK had been changing the CBR with respect to developments in inflation and growth. However, since the implementation of the rate cap, the impact of the CBR cuts has not been clear. The weighted average interest rate in the interbank market has ranged between 3.0% and 10.0% during 2017 and early 2018. The wide range has entailed significant day-to-day volatility, which has had adverse effects on bank lending

rates, incentivizing banks to retain excess liquidity, and weakened the monetary policy transmission mechanism,

iv. **Additional measures would be needed for FY'2018/19 to meet the deficit target:** The IMF noted that the weak performance of income generation and mobilization of tax revenue by the government are likely to persist, partially offsetting the effects of the revenue boosting measures as outlined in the FY'2018/2019 budget whose main focus was on fiscal consolidation. These measures include (i) the increment in excise duty of bank transaction, data and voice calls to 15.0% from 10.0% (ii) removal of the VAT exemption on petroleum imports and (iii) removing various VAT and Corporate Income Tax (CIT) exemptions. The measures are expected to yield to 1.1% of GDP in additional revenue. However, in order for the government to achieve its fiscal deficit target of 5.7% of GDP in FY'2018/19 down from 6.8% for the 2017/2018 fiscal year, the IMF projects that measures of an additional 0.6% of GDP will be needed. In line with this, the government has begun implementing austerity measures. The National Assembly passed an expenditure reduction of Kshs 37.6 bn, which is to be achieved through a reduction in recurrent expenditure and capital expenditure for FY'2018/2019 by Kshs 9.1 bn and Kshs 28.5 bn, respectively coupled with a reinstatement of Kshs 1.5 bn to the judiciary,

v. **The Kenyan shilling is over-valued by approximately 17.5%:** The IMF's assessment of Kenya's current account deficit suggested an overvaluation of the real exchange rate by approximately 17.5%. This was attributed partly to CBK engaging in periodic foreign exchange interventions, reflecting limited movement of the shilling relative to the US dollar. CBK underscored their adherence to a flexible exchange rate policy and that their interventions were undertaken to avoid excessive exchange rate volatility, which they view as important for achieving macroeconomic and financial stability. In response to the IMF report, CBK stated that their calculations support the view that there is no fundamental misalignment reflected in the exchange rate and reiterates that the Kenya shilling reflects the currency's fundamental value.

Kenya's medium-term outlook remains favorable and we expect the GDP growth to average 5.4% - 5.6% in 2018. However, this positive outlook hinges on the implementation of reforms that will maintain macroeconomic and financial stability within the country. The government should continue with its efforts to work on a fiscal consolidation plan aimed at narrowing the fiscal deficit to 5.7% of GDP from 6.8% of GDP in the FY 2017/18 and further to around 3.0% of GDP by FY 2021/22. This can be achieved through revenue enhancement measures, which will in turn lead to reduced dependency on debt in a bid to reduce Kenya's public debt burden. Abolishing or significantly modifying interest rate controls is also key for improving the subdued private sector credit growth, which has remained below the 5-year average of 13.0%, despite improving to 4.3% in August 2018. The government should also embark on aggressive privatization of state corporations, through listing, in order to diversify sources of funding for funding the budget effectively reducing the fiscal deficit as well as reduce a portion of the recurrent expenditure in running these corporations. CBK has emphasized its commitment to further strengthening macroeconomic stability and enhancing the resilience of the economy. They will also continue to sustain efforts towards maintaining low and stable inflation, further strengthening financial sector supervision and regulation, and deepening structural reforms.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids, as it is currently 46.8% ahead of its pro-rated borrowing target for the current financial year, having borrowed Kshs 130.5 bn against a pro-rated target of Kshs 88.9 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, with the president having assented to the Finance Bill 2018, 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 instrument.