Kenya Economic Review 2018, & Cytonn Weekly #45/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were under-subscribed during the week, with the overall subscription rate coming in at 48.8%, down from 93.8% recorded the previous week. The under-subscription is partly attributable to the tight liquidity in the inter-bank markets evidenced by the rise in the average inter-bank rate to 4.7% from 3.3% recorded the previous week. The tightened liquidity is mainly due to the statutory tax payments that were due this week, coupled with the beginning of a new cash reserve ratio (CRR) cycle. The subscription rate for the 91-day, 182-day and 364-day paper decreased to 43.5%, 19.3% and 80.4% from 182.1%, 24.4% and 127.9% recorded the previous week, respectively. The yields on the 91-day remained unchanged at 7.3% while the yields on the 182-day paper declined to 8.2% from 8.3%. The yields on the 364-day paper however increased to 9.6% from 9.5% recorded the previous week. The acceptance rate for T-bills declined to 76.2% from 96.0% the previous week, with the government accepting Kshs 8.9 bn of the Kshs 11.7 bn worth of bids received.

This week, the Kenyan Government went back in the primary market with a tap sale for the 20-year infrastructure bond, issue No. IFBI/2018/20 with similar features as the initial issue, the previous week in a bid to raise Kshs 22.4 bn. The coupon is set at 11.95% while the average yield is set at 12.2%. Last week, the Government accepted Kshs 27.6 bn compared to a target of Kshs 50.0 bn at an average yield of 12.2%. The funds received from the IFB Sale mainly went to the redemption of Kshs 34.6 bn 5-Year bond issue no: FXD3/2013/5 that was due for payment on Monday. The proceeds will be used for funding infrastructure projects in the road, water and energy sectors. The period of sale in the tap sale has however been lengthened to 6 days from, 21st November 2018 to 27th November 2018 or upon attainment of quantum, whichever comes first.

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 potential rollover risks in the medium term. The issuance of medium to long-term securities have however been having a lacklustre performance, which we attribute to the saturation of long-end offers, leading to a relatively flat yield curve on the long-end and the government will need to offer more incentive for the long-term bonds by increasing the yields to attract investors.

Liquidity:

The average interbank rate increased to 4.7% from 3.3% the previous week, while the average volumes traded in the interbank market increased by 34.6% to Kshs 27.3 bn, from Kshs 20.3 bn the previous week. The higher interbank rate points to tightened liquidity conditions attributed to the statutory tax payments that were due, coupled with the beginning of a new cash reserve ratio (CRR).

Kenya Eurobonds:

According to Bloomberg, the yields on the 5-year and 10-year Eurobonds issued in 2014 both increased by 0.5% and 0.3% points to 5.8% and 8.2%, from 5.3% and 7.9% recorded the previous

week, respectively. Since the mid-January 2016 peak, yields on the Kenyan Eurobonds have declined by 1.4% points and 3.0% 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 0.6-years and 5.6-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 rose by 0.4% and 0.3% points to 9.1% and 9.9% from 8.7% and 9.6% the previous week, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have both increased by 1.8% and 1.6% points, respectively.

Key to note, the yields on all the Eurobonds have been on the rise in recent weeks. The rising yield on all the Eurobonds signals higher country risk perception by investors, partly attributed to International Monetary Fund (IMF) raising the risk of Kenya's debt distress from low to moderate in October, resulting in investors demanding a higher return for the risk. In November, the yields on the 5-year and 10-year 2014 issues have both increased by 1.0% points and 0.8% points, respectively while the yields on the 10-year and 30-year 2018 issues have increased by 1.0% points and 0.8% points, respectively. The increment in the Federal Rate twice this year, currently at 2.0% - 2.25% has also led to market correction in Eurobond yields in the emerging markets with the 2014 Eurobond issues having increased by 2.4% points and 2.6% points for the 5-year and 10-year 2014 Eurobond issues, respectively.

Kenya Shilling:

During the week, the Kenya Shilling gained by 0.7% against the US Dollar to close at Kshs 102.4 from Kshs 103.2, recorded the previous week. This was partly attributed to tightened liquidity, as well as support from inflows from horticulture exports and diaspora remittances that helped to meet increased dollar demand from merchandise importers shipping goods ahead of the festive season. The Kenya Shilling has appreciated by 0.7% year to date, and in our view the shilling should remain relatively stable to the dollar in the short term, supported by:

i. CBK's activities in the money market, such as repurchase agreements and selling of dollars,
ii. High levels of forex reserves, currently at USD 8.1 bn, equivalent to 5.3-months of import cover, compared to the one-year average of 5.5-months, which is above the IMF threshold for emerging markets, which is 3-months, and,
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.

Monetary Policy Committee Meeting:

The Monetary Policy Committee (MPC) is set to meet on Tuesday, 27th November 2018, on their last meeting in 2018, to review the prevailing macroeconomic conditions and make a decision on the direction of the Central Bank Rate (CBR). Key factors that will shape MPC's decision include:

i. Inflation that has averaged 4.5% in the first 10-months of 2018 compared to 8.7% experienced in a similar period in 2017, and is expected to remain within the government target of 2.5% - 7.5%, despite the expectations of upwards inflationary pressure in H2'2018 due to the imposition of the 8.0% VAT charge on fuel as well as other tax measures as introduced in the Finance Bill,
ii. The currency that has lost by 1.4% since the last meeting on 25th September 2018 to Kshs 102.4

from Kshs 101.0, and,

iii. The macroeconomic environment that has remained relatively stable despite the low private sector credit growth, which has remained unchanged at 4.3% since July to September 2018. This has been the highest growth rate since December 2016, pointing to a recovery albeit slow and still way below the 5-year average of 13.0%.

We are of the view that the MPC will adopt a wait and see approach given the macroeconomic environment is relatively stable. We expect the MPC to hold the Central Bank Rate (CBR) at 9.0% with their decision being on the back of:

i. Despite expectations of inflationary pressure in the remainder of the year as the effects of the various tax policy measures introduced through the Finance Bill 2018 continue to be felt, we do not believe that the pressure is high enough to warrant a policy shift. Inflationary pressure has further been mitigated by the declining food prices due to the improved weather conditions and as such, inflation is expected to be within the government set target of 2.5%-7.5%,
ii. Despite the recent depreciation of the Kenyan Shilling against the US dollar, it has remained relatively stable, reflecting a more stable economic environment, which saw the IMF reclassifying Kenya, from a floating arrangement to stabilized arrangement, in their Annual Report on Exchange Arrangements and Exchange Restrictions released on 30th April 2018. The classification of the arrangement, is primarily based on the degree to which the exchange rate is determined by the market, rather than by official action. For a country to be classified as a stabilized arrangement, the market exchange rate should remain within a margin of 2.0% for 6 months or more with respect to a single currency or a basket of currencies, thus showing the stability of the Kenyan shilling. Volatility of the Kenyan shilling has however mainly been cushioned by Central Bank's activities, which has seen the forex reserves decline by 4.4% to USD 8.1 bn, equivalent to 5.3 months of import cover, from USD 8.4 bn, since the last MPC meeting but still remain high and above the optimal level of reserves for Kenya as per the IMF set at 3.5 months of imports. The ongoing prospects of the Treasury issuing another Eurobond could also eliminate the need for tightening the monetary policy, as it will enhance the forex reserves thus cushioning the shilling, and,
iii. Private sector credit growth has remained unchanged at 4.3% for the 3 months to September, since the lowering of the CBR to 9.0% in July, higher than the 3.3% average for the 9 months to September 2018 as well as the 2017 average of 2.5% but is still below the 5-year average of 12.6%.

For a comprehensive analysis, read our MPC Note

Inflation Projection:

We are projecting the inflation rate for the month of November to range between 5.7% - 6.1% from 5.5% recorded in September. We expect inflation to rise mainly due to the base effect as well as:

i. The 2.1% increase in petrol prices to Kshs 118.1 from Kshs 115.7 per litre, while diesel prices increased by 2.8% to Kshs 112.8 from Kshs 109.7 per litre from the previous month. The changes in prices have been attributed to the increase in average landing costs of imported super petrol by 4.0% to USD 758.3 per ton in October from USD 729.0 per ton in September. Landing costs for diesel also increased by 5.8% to USD 741.3 per ton in October from USD 700.4 per ton in September. The price increase will directly affect transport costs and indirectly affect food prices in November, and,
ii. On the housing, water, electricity, gas and other fuels index, kerosene prices increased by 2.7% to Kshs 111.8 from Kshs 108.8 recorded the previous month. The increase in the prices of Kerosene can be attributed to the increase in landing costs of imported Kerosene by 5.8% to USD 763.5 per ton in October from USD 721.6 per ton in September. Electricity costs are however expected to mitigate the rise in kerosene prices due to the reduction of electricity bills as per the released

reviewed electricity tariffs by the Energy Regulatory Commission (ERC). Electricity prices for households and businesses consuming a maximum of 100 units of power declined by 31.6% to Kshs 1,517 in November from Kshs 2,219 in October, after factoring in variable pass-through charges such as 16% VAT, fuel cost charge, forex levy and inflation charge.

The increase in Inflation is expected to be mitigated by a decline in the food and non- alcoholic beverages index, which has a weight of 36.0%. This is due to declined food prices mainly driven by a decline in grain products with the maize harvest having increased by 20.0% to 40.9 mn bags from 34.0 mn bags last year. These has effectively reduced the prices of maize flour. Key to note, according to Kenya National Bureau of Statistics (KNBS), we expect inflation in H2'2018 to experience upward pressure but at a lower rate following the reduction in the rate of VAT charge on fuel to 8.0% from 16.0%, affirming the expectations of inflation for the year averaging within the government's set target of 2.5%-7.5%.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids, as it is currently 18.2% ahead of its pro-rated domestic borrowing target for the current financial year, having borrowed Kshs 136.0 bn against a pro-rated target of Kshs 109.8 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, 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.