Cytonn INVESTMENTS

Kenya's Attractiveness as an Investment Destination, & Cytonn Weekly #49/2018

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills subscription rate improved during the week, with the overall subscription coming in at 93.9%, up from 23.8% recorded the previous week, partly attributed to improved liquidity in the money market as evidenced by the decline in the average interbank rate to 8.1%, from 10.2% recorded the previous week. Despite the improvement in T-bill subscription this week, T-bills remained under-subscribed for the 7th week in a row, due to the relatively tight liquidity in the money market. The subscription rate for the 91-day, 182-day and 364-day papers rose to 70.1%, 70.3% and 126.9%, from 23.3%, 16.1% and 31.7%, recorded the previous week, respectively. The yields on the 91-day T-bill remained unchanged at 7.3% while the yields on the 182-day and 364-day papers increased by 0.1% points to 8.3% and 9.7%, from 8.2% and 9.6% recorded the previous week, respectively. The acceptance rate declined to 87.3%, from 95.0% recorded the previous week, with the government accepting Kshs 19.7 bn of the Kshs 22.5 bn worth of bids received.

This week, the Kenyan Government went back to the primary market with a tap sale for the 10-year Treasury bond issue No. FXD 2/2018/10, with similar features as the initial issue floated the previous week in a bid to raise Kshs 13.8 bn. The coupon and yield are set at 12.5%. Last week, the government accepted Kshs 26.2 bn compared to a target of Kshs 40.0 bn at an average yield of 12.5%. The tap sale period is 9-days, from 18th December 2018, to 27th December 2018, or upon attainment of quantum, whichever comes first.

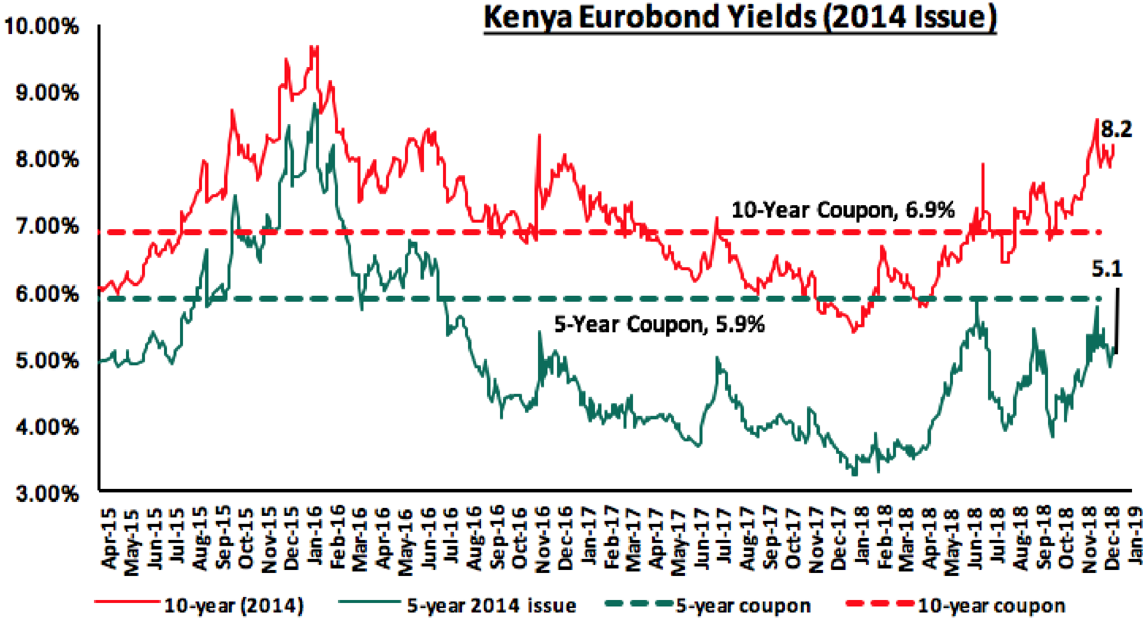
Liquidity:

The average interbank rate declined to 7.8%, from 10.2% recorded the previous week, while the average volumes traded in the interbank market remained unchanged at Kshs 15.4 bn. The lower interbank rate points to improved liquidity in the money market, mainly attributed to the end of the monthly Cash Reserve Requirement (CRR) cycle, on the 14th of December. The CRR is the percentage of deposits that commercial banks are required to keep with the Central Bank of Kenya. It is a mandatory requirement, and Kenya’s CRR currently stands at 5.25% of deposits held by a commercial bank. All commercial banks are required to maintain a CRR of 5.25% of their deposits for a month, ending on the 14th of every month, but can let the ratio get to a low of 3.0% during the month, as long as the average for the month gets to 5.25%. Towards the end of a cycle, banks are always under pressure to meet the requirement if they had not met it earlier on in the cycle, but after one cycle ends and another begins, the pressure on liquidity for banks reduces.

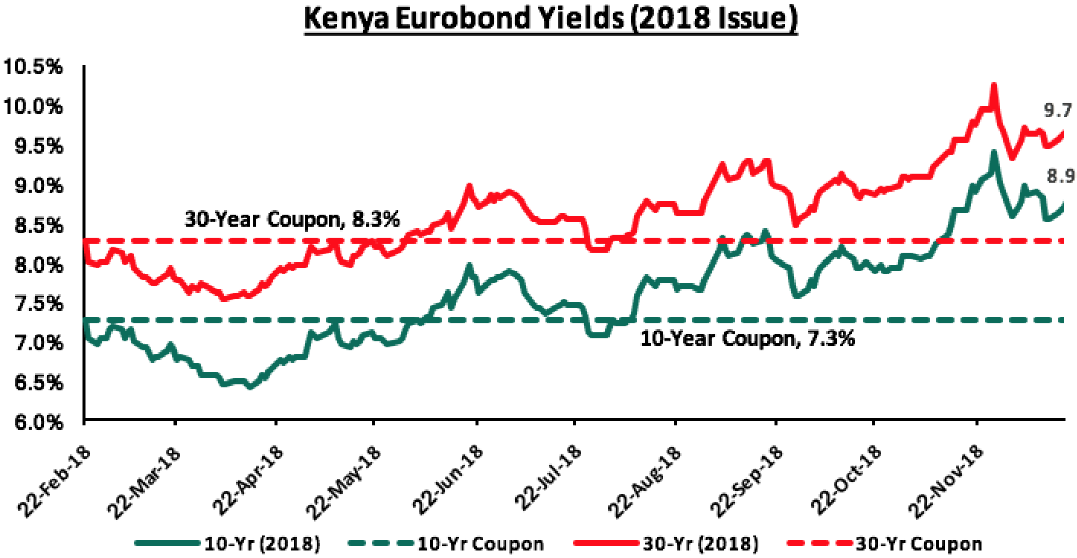
Kenya Eurobonds:

According to Bloomberg, the yields on the 5-year and 10-year Eurobonds issued in 2014 increased by 0.2% points and 0.3% points to 5.1% and 8.2%, from 4.9% and 7.9% recorded the previous week, respectively. Since the mid-January 2016 peak, yields on the Kenyan Eurobonds have declined by

1.5% points and 3.7% 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 0.5-years and 5.5-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 0.4% and 0.2% points, to 8.9% and 9.7%, from 8.5% and 9.5%, respectively. Since the issue date, the yields on the 10-year and 30-year Eurobonds have both increased by 1.6% points and 1.5% points, respectively.



Key to note however, yields in Eurobonds issued in the Sub-Saharan Region have been on the rise on a year to date basis, signalling higher risk perception by investors. This has partly been attributed to the increment in the Federal Funds Rate for the fourth time this year, currently at 2.25% - 2.50%, which has led to market correction in Eurobond yields in the emerging markets in the wake of rising US Treasury yields and a stronger US Dollar.

Kenya Shilling:

During the week, the Kenya Shilling gained by 1.1% against the US Dollar to close at Kshs 101.4, from Kshs 102.6 recorded the previous week, due to thin dollar demand from oil importers amidst the continued tight liquidity. The Kenya Shilling has appreciated against the US Dollar by 1.8% year to date, and in our view the shilling should remain relatively stable to the dollar in the short term,

supported by:

?. The narrowing of the current account deficit to 5.3% in the 12-months to September 2018, from 6.5% in September 2017, attributed to improved agriculture exports, increased diaspora remittances, strong receipts from tourism, and lower food and SGR-related equipment relative to 2017,
i. Improving diaspora remittances, which increased by 6.9% m/m growth in diaspora remittances in the month of October 2018 to USD 219.2 mn from USD 205.1 mn recorded in September. The y/y growth came in at 18.2% from USD 185.5 mn recorded in October 2017. Cumulatively, total diaspora remittances rose by 39.5% in the 12 months to October 2018, to USD 2.6 bn, from USD 1.9 bn recorded in a similar period in 2017. This has been 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. For more analysis on this see our October Diaspora Remittances Note,
ii. CBK's activities in the money market, such as repurchase agreements and selling of dollars, and,
iii. High levels of forex reserves, currently at USD 8.0 bn, equivalent to 5.2-months of import cover, compared to the one-year average of 5.1-months and above the EAC region's convergence criteria of 4.5-months of imports cover.

Inflation Projection:

We are projecting the inflation rate for the month of December to come in within the range of 5.3% - 5.7% compared to 5.6% recorded in November. We expect the m/m inflation for the month of December to rise mainly due to:

?. The increase in Transport cost in the month of December as per historical data mainly due to higher bus fares associated with Christmas festivities, despite petrol prices declining by 3.9% to Kshs 113.5 from Kshs 118.1 per litre previously, while diesel prices have declined by 0.5% to Kshs 112.3 from Kshs 112.8, effective 15th December- 14th January 2018. The changes in prices have been attributed to the decline in average landing costs of imported super petrol by 8.5% to USD 694.2 per ton in November from USD 758.3 per ton in October. Landing costs for diesel declined by 2.6% to USD 722.2 per ton in November from USD 741.3 per ton in October, and,
i. We expect the food and non-alcoholic index to rise marginally for the month of December due to a rise in prices of several food items, which outweighed the decline in others. For instance, maize flour prices have risen by 8.1% to Kshs 93.0 per 2 Kg bag from Kshs 86.0 in November. Wheat flour prices have risen by 8.9% to Kshs 122.0 from Kshs 112.0 for a two-kilo packet in August 2018.

The m/m rise in inflation for the month of December is however expected to be mitigated by a decline in housing, water, electricity, gas and other fuels index, as kerosene prices declined by 5.9% to Kshs 105.2 in December, from Kshs 111.8 in November. We also expect the effects of the lower costs in prices of electricity as from November, which saw the cost of consumption of 50 KWh of electricity declining by 31.4% to Kshs 758 from Kshs 1,105 in October 2018. Key to note, inflation for 2018 is expected to be within the government set target of 2.5%-7.5% having already averaged 4.6% for the 11-months to November, down from 8.3% in a similar period in 2017. The decline has mainly been attributed to a decline in food prices due to improved weather conditions, which has mitigated the increased fuel prices due to implementation of the 8.0% VAT on Fuel, as well as various tax amendments as per the Finance Bill 2018.

Rates in the fixed income market have been on a declining trend, as the government continues to reject expensive bids, as it is currently 28.9% behind its pro-rated domestic borrowing target for the current financial year, having borrowed Kshs 96.6 bn against a pro-rated target of Kshs 136.0 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.