Cytonn Annual Markets Review - 2018

Fixed Income

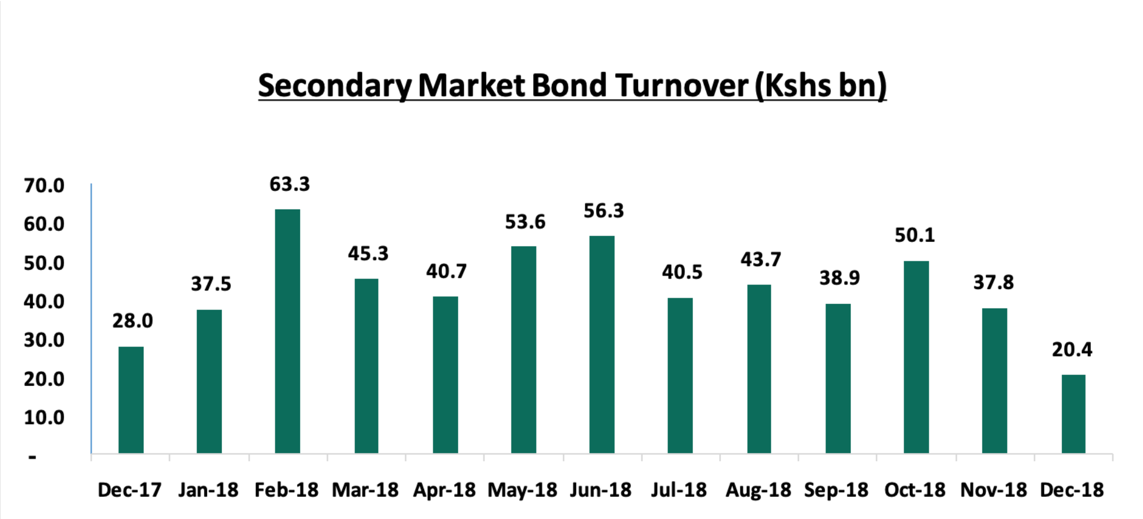
T-Bills & T-Bonds Primary Auction:

During the year 2018, T-bills auction recorded an oversubscription with the average subscription rate coming in at 123.2% compared to an average of 110.5% in 2017. The yield on the 91-day, 182-day and 364-day T-bills declined by 80 bps, 160 bps and 120 bps to close at 7.3%, 9.0% and 10.0% in 2018 from 8.1%, 10.6% and 11.2% at the end of 2017, respectively. This is mainly attributed to the Central Bank of Kenya’s (CBK’s) efforts to keep rates low by rejecting expensive bids. Following the enactment of the Banking (Amendment) Act, 2015, banks have preferred to lend to the less risky government as opposed to the riskier private sector.

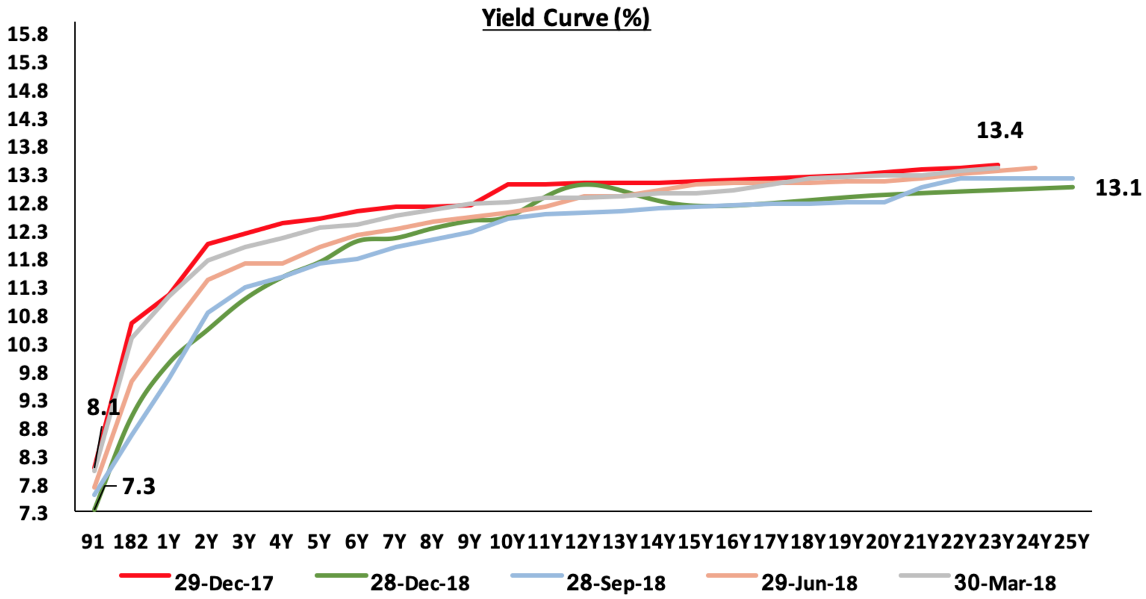
Primary T-bond auctions in 2018 were undersubscribed with the subscription rate averaging 75.8% lower than the average subscription rate for 2017, which came in at 100.2%. This was mainly attributed to efforts by the government to raise its debt maturity profile to reduce the potential rollover risks in the medium term, by issuing longer-dated papers, which recorded lackluster performance due to uncertainties in the interest rates environment with the proposal of repealing the interest rate cap having been tabled in parliament through the Finance Bill 2018. The continued issuing of longer-term papers also led to saturation of long-end offers, leading to a relatively flat yield curve on the long-end. The average acceptance rate for 2018 came in at 73.0%, as the market adjusted to the efforts of the CBK to maintain the rates at low levels, with tap sales being a common method used by the CBK throughout the year to tame expensive bids and keep interest rates at low levels.

Secondary Bond Market Activity:

The NSE FTSE bond index recorded a 2.7% gain in 2018 with the secondary bond market recording increased activity with the turnover having increased by 26.1% to Kshs 528.2 bn from Kshs 419.0 bn in 2017, as the local institutional investors increased their allocation to treasury bonds as a result of poor performance of the equities market, which declined by 18.0%.



The graph below shows the evolution of the yield curve during the year, with yields declining, given that the government was only accepting reasonable bids in the auction market resulting into a downward pressure on yields in the secondary market.



Liquidity:

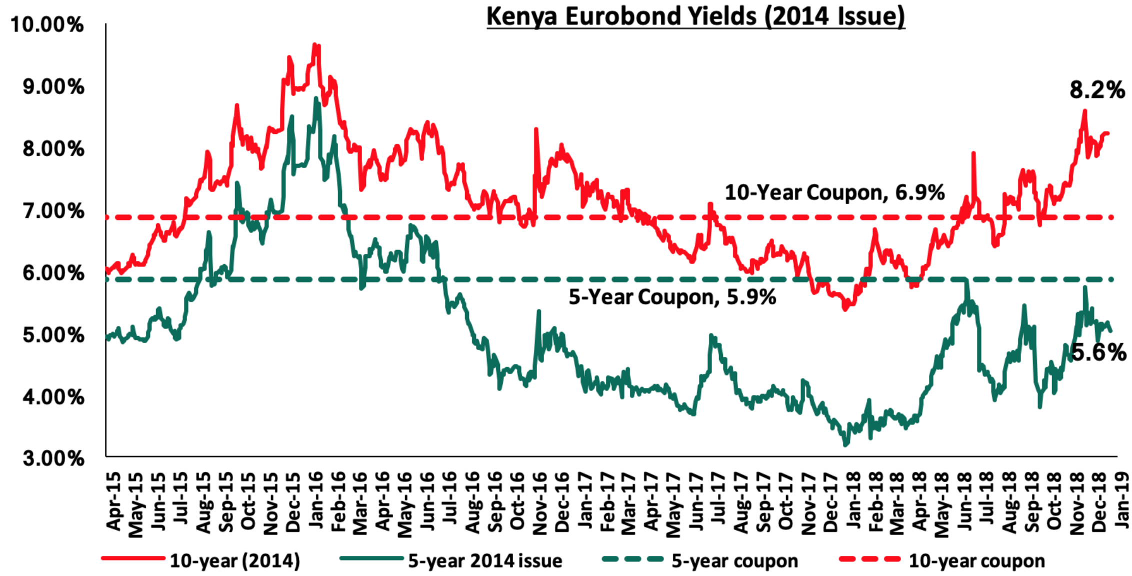
During the year, liquidity levels remained stable and well distributed in the market as indicated by the decline in the average interbank rate to 5.2% in 2018 from 6.4% in 2017, coupled with the 5.5% decline in the average volumes traded in the interbank market to Kshs 16.1 bn in 2018 from Kshs 17.0 bn recorded in 2017.

Kenya Eurobonds:

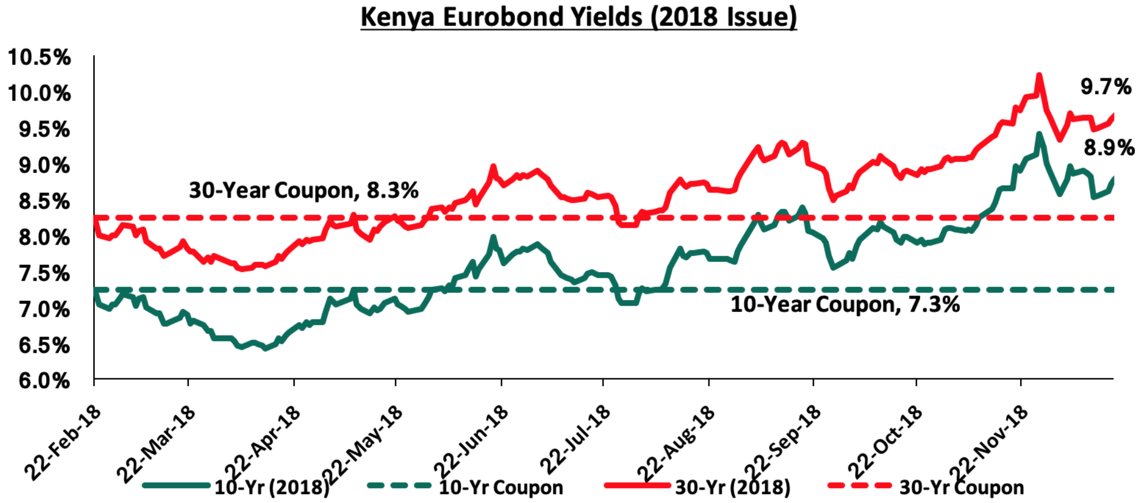
According to Bloomberg, yields on the 5-year and the 10-year Eurobond issued in 2014 increased by 2.2% points and 3.2% points to close at 5.6% and 8.2% at the end of 2018, from 3.4% and 5.0% at the end of 2017, respectively; the significant increase in yields during the year was due to;

i. A higher country risk perception by investors, partly attributed to the International Monetary Fund (IMF) raising the risk of Kenya's debt distress from low to moderate on October, resulting in investors demanding a higher return for the risk, and,
ii. The aggressive tightening monetary policy regime adopted by the U.S Federal reserve, that saw the Federal reserve raise the benchmark interest rate 4 times during the year, exacerbated the rise in yields as most foreign investors began pulling out their capital in the wake of rising US treasury yields and a strong dollar.

Since the mid-January 2016 peak, yields on the Kenya Eurobonds have declined by 3.8% points and 1.4% points for the 5-year and 10-year Eurobonds, respectively, due to the relatively stable macroeconomic conditions in the country. Key to note is that these bonds have 6-months and 5.5-years to maturity for the 5-year and 10-year, respectively.



For the February 2018 Eurobond issue, the yields on the 10-year Eurobond and the 30-year Eurobond have increased by 1.7% points and 1.5% points to close the year at 8.9% and 9.7% from a yield of 7.3% and 8.3% when they were issued in February 2018, respectively.



Rates in the fixed income market have remained relatively stable despite the government being 30.3% behind its pro-rated domestic borrowing target for the current financial year, having borrowed Kshs 91.1 bn against a pro-rated target of Kshs 130.7 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, 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