Karen Investment Opportunity, & Cytonn Weekly #04/2019

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills were over-subscribed during the week, with the overall subscription rate coming in at 170.2%, an increase from 161.4% recorded the previous week. The over-subscription in all the auctions since the beginning of the year has partly been attributed to the improved liquidity in the market, driven by debt maturities as well as government payments. There was mixed performance in subscription rates across the board with the 91-day and 182-day papers falling to 123.8% and 107.3% from 180.8% and 138.8% recorded the previous week, respectively, while the 364-day paper subscription rates improved to 251.7% from 176.2% recorded the previous week. The yields on the 91-day paper remained unchanged from the previous week at 7.1%, while yields on the 182-day and 364-day papers declined to 8.8% and 9.9% from 8.9% and 10.0% recorded the previous week, respectively. The acceptance rate declined to 65.0%, from 73.6% recorded the previous week, with the government accepting Kshs 26.5 bn of the Kshs 40.8 bn worth of bids received.

This week, the Kenyan Government issued two bonds; issue number FXD 1/2019/2 and issue number FXD 1/2019/15, with tenors of 2.0-years and 15.0-years, both with market determined coupon rates. The government was seeking to raise Kshs 40.0 bn from the two bonds for budgetary support. The two bond issues were over-subscribed with an overall subscription rate of 254.9% with bids worth Kshs 102.0 bn received against the Kshs 40.0 bn on offer. The 2-year bond had a better performance with total bids of Kshs 76.9 bn compared to Kshs 25.1 bn worth of bids for the 15-year bond, an indication of the high demand in the shorter-term papers. The government accepted Kshs 38.5 bn out of the Kshs 102.0 bn worth of bids received against Kshs 40.0 bn on offer, translating to an acceptance rate of 37.7%, indicating that bids were largely not within ranges the Central Bank of Kenya (CBK) deemed acceptable. The average accepted yield for the 2-years and 15-years issue came in at 10.7% and 12.9%, respectively. This was within target of our expectation of between 10.7% - 10.9% and 12.6% - 12.9% for the 2-year and 15-year bonds, respectively.

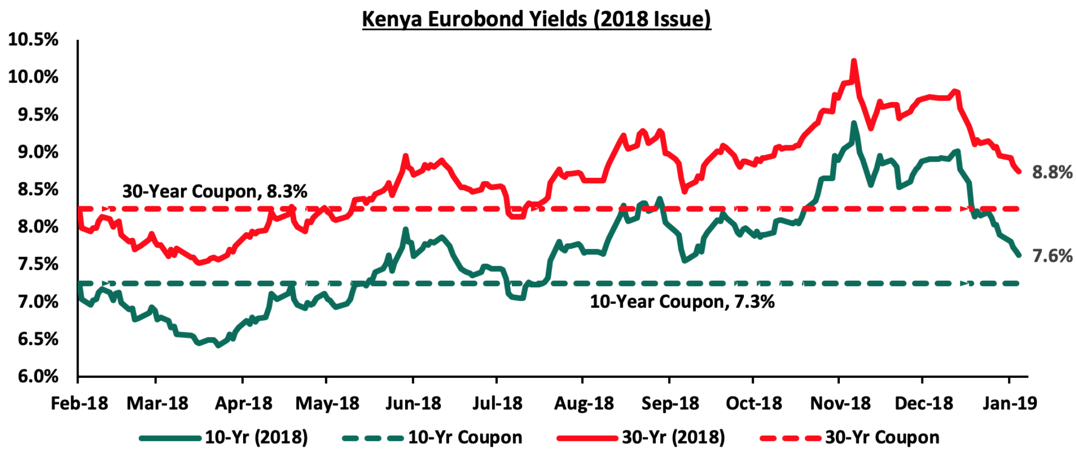
We are of the view that the continued issuance of medium to long-term domestic securities is well guided as lengthening the average maturity will reduce the potential rollover risks in the medium term. The issuance of medium to long-term securities have however been having a lacklustre performance, which 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:

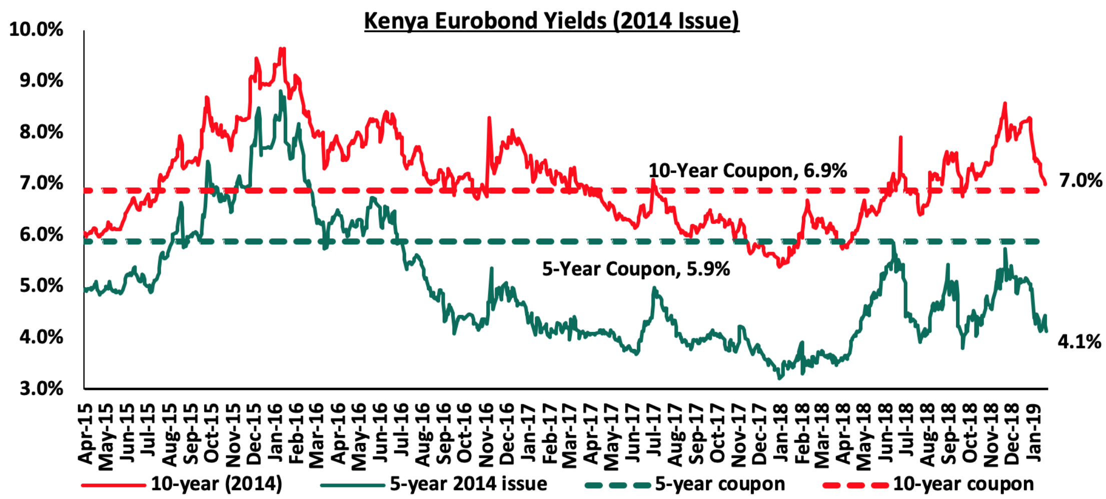
The average interbank rate rose to 3.2%, from 2.7% the previous week, while the average volumes traded in the interbank market rose by 12.2% to Kshs 14.8 bn, from Kshs 13.2 bn the previous week. The higher interbank rate points to tightening liquidity conditions experienced during the start of the week as the market recovered from tax payments due on 20th of every month. Despite the rise in the interbank rate, the money market remained relatively liquid with commercial banks recording excess reserves of Kshs 21.9 bn in relation to the 5.25% cash reserves requirements (CRR) supported by government payments and debt redemptions.

Kenya Eurobonds:

According to Bloomberg, the yields on the 5-year Eurobond issued in 2014 remained unchanged at 4.1% while the 10-year Eurobond declined by 0.3% points to 7.0% from 7.3% the previous week. Since the mid-January 2016 peak, yields on the Kenyan Eurobonds have declined by 2.6% points and 4.7% 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 0.4-years and 5.4-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 declined by 0.3% points and 0.2% points to 7.6% and 8.8% from 7.9% and 9.0% the previous week, respectively. Since the issue date, the yield on the 10-year Eurobond has increased by 0.4% points while that of the 30-year Eurobonds has increased by 0.5% points.



Kenya Shilling:

During the week, the Kenya Shilling appreciated by 0.6% against the US Dollar, to close at Kshs 101.1, from Kshs 101.7 recorded the previous week, which was attributed to inflows from diaspora remittances, which subdued the thin oil importer demand. The Kenya Shilling has appreciated against the US Dollar 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. 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 and strong receipts from tourism,

ii. Improving diaspora remittances, which increased by 38.6% in 2018 to USD 2.7 bn, from USD 1.9 bn recorded in 2017. The rise is due to; (a) increased uptake of financial products by the diaspora due to financial services firms, particularly banks, targeting the diaspora, and (b) new partnerships between international money remittance providers and local commercial banks making the process more convenient,
iii. CBK's activities in the money market, such as repurchase agreements and selling of dollars, and,
iv. 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 5.1-months and above the EAC Region's convergence criteria of 4.5-months of imports cover.

Monetary Policy Committee Meeting:

The Monetary Policy Committee (MPC) is set to meet on Monday, 28th January 2019, to review the prevailing macro-economic 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 4.7% in 2018 compared to 8.0% experienced in 2017, and is expected to remain within the government target of 2.5%-7.5%, anchored by lower food prices, reflecting favorable weather conditions, the decline in international oil prices, and the downward revision in electricity tariffs,
ii. The currency that gained by 1.3% since the last meeting on 27th November 2018 to Kshs 101.1 from Kshs 102.5, supported by improved diaspora remittances coupled with thin dollar demand from oil importers, and,
iii. The macroeconomic environment that has remained relatively stable despite the low private sector credit growth, which recorded a recovery in 2018, rising to an average of 3.4% in the 10 months to October from an average of 2.3% recorded in a similar period in 2017. This pointing to a recovery albeit slow and still way below the 5-year average of 12.4%.

We are of the view that the MPC will adopt a wait and see stance 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 supported by:

i. Inflationary pressure expected to be muted in 2019, anchored by the declining food prices due to the improved weather conditions as well as a decline in fuel prices due to lower global prices with Petrol, Diesel and Kerosene prices having already declined by 8.2%, 8.9% and 3.3%, respectively for the period effective 15th January- 14th February, 2019,
ii. The stability of the Kenyan Shilling, being among the best performing currencies in 2018, having gained by 1.8% against the dollar which saw the IMF reclassifying it, from a floating arrangement to stabilized arrangement. The Kenyan Shilling is expected to remain stable having gained by 0.7% YTD in 2019 reflecting a more stable economic environment,
iii. The Government is currently behind its domestic borrowing schedule having borrowed Kshs 113.0 bn against its pro-rated target of Kshs 173.0 bn. As such, we believe the MPC will maintain the CBR at the current rate with a bias to further easing in order to access domestic debt at cheaper rates. This however might have adverse effects of further crowding out of the private sector, and,
iv. Private sector credit growth has recorded a recovery, rising to an average of 3.4% in the 10 months to October from an average of 2.3% recorded in a similar period in 2017, with growth coming in at 4.4% in October 2018 from 3.9% recorded in September, but still remains below the 5-year average of 12.4%.

The key concern however remains the effectiveness of monetary policy with the interest rate cap still in place. The Monetary Policy Committee through its assessment of the impacts of the interest rate cap noted that it has weakened the transmission of monetary policy decisions. In particular, the transmission of changes in the CBR to growth and inflation takes longer compared to the period before implementation of the interest rate cap.

For a comprehensive analysis, read our MPC Note

Inflation Projection:

We are projecting the inflation rate for the month of January to range between 3.8% - 4.2% from 5.7% recorded in December. We expect the y/y inflation to decline mainly driven by:

i. The 8.2% decline in petrol prices to Kshs 104.2 from Kshs 113.5 per litre, while diesel prices declined by 8.9% to Kshs 102.2 from Kshs 112.3 per litre from the previous month. The changes in prices have been attributed to the decrease in average landing costs of imported super petrol by 14.9% to USD 590.9 per ton in December from USD 694.2 per ton in November. Landing costs for diesel also decreased by 14.7% to USD 616.0 per ton in December from USD 722.2 per ton in November,
ii. A marginal decline in the food and non-alcoholic index for the month of January due to a decline in prices of several food items, which outweighed the increase in others, and,
iii. A decline in housing, water, electricity, gas and other fuels index, as kerosene prices declined by 3.3% to Kshs 101.7 in January, from Kshs 105.2 in December. Also the effects of the lower costs in prices of electricity as from November 2018, 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.

Rates in the fixed income market have remained stable as the government rejects expensive bids despite being 11.5% behind its domestic borrowing target for the current financial year, having borrowed Kshs 158.2 bn against a pro-rated target of Kshs 178.7 bn. However, a budget deficit that is likely to result from depressed revenue collection creates uncertainty in the interest rate environment as any additional borrowing from the domestic market goes to plug the deficit. Despite this, we do not expect upward pressure on interest rates due to increased demand on government securities, driven by improved liquidity in the market owing to the relatively high debt maturities. Our view is that investors should be biased towards medium-term fixed income instruments to reduce duration risk associated with long-term debt, coupled with the relatively flat yield curve on the long-end due to saturation of long-term bonds.
