Fintech Impact on Kenya's Financial Services Industry, & Cytonn Weekly #07/2019

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills remained over-subscribed during the week, with the overall subscription rate coming in at 140.3%, a decline from 198.3% recorded the previous week. The continued over-subscription in the primary auctions in 2019 has been attributed to improved liquidity in the market, driven by debt maturities as well as government payments. There was mixed performance, with the 91-day paper recording an increase in its subscription rates to 121.5%, from 83.4% recorded the previous week, while the 182-day and 364-day papers recorded declines in subscription to 117.1% and 170.9%, from 149.3% and 293.2%, recorded the previous week, respectively.

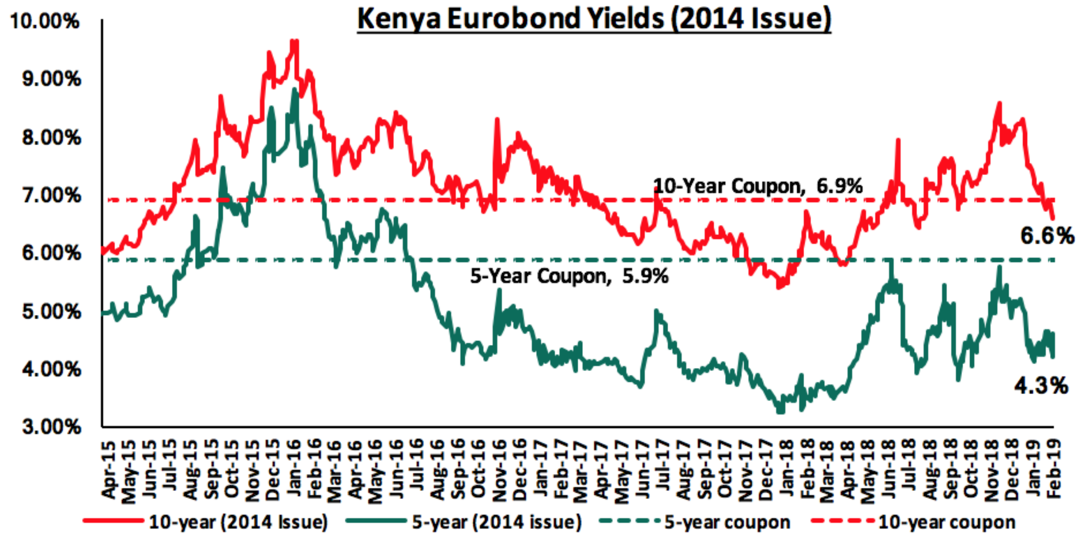
The yields on the 91-day, 182-day, and 364-day papers declined by 2.4 bps, 8.4 bps and 9.3 bps to 7.0%, 8.5% and 9.6%, respectively. The acceptance rate improved to 90.9% from 60.8%, recorded the previous week, with the government accepting Kshs 30.6 bn of the Kshs 33.7 bn worth of bids received.

Liquidity:

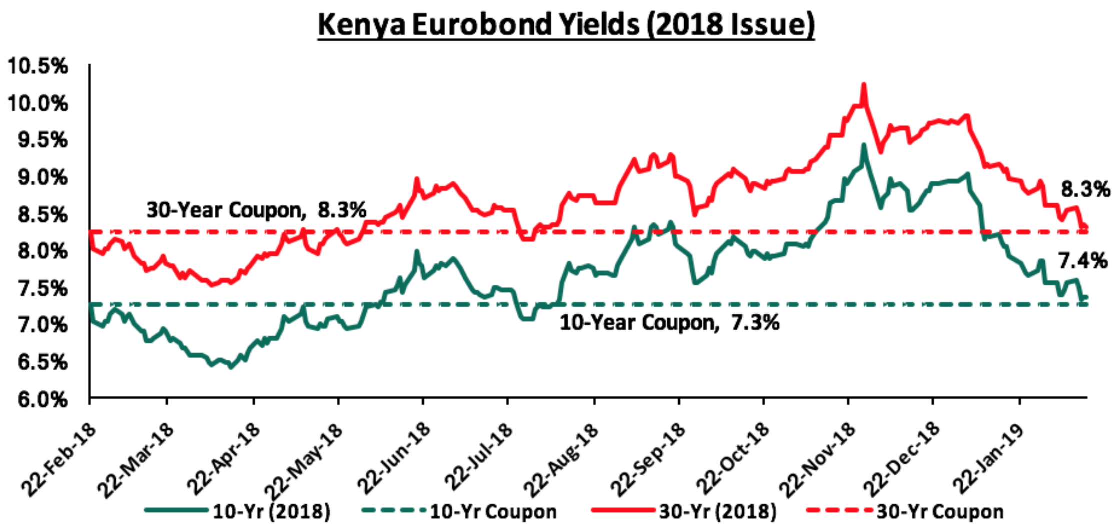
The average interbank rate declined to 1.4%, from 2.7% the previous week, while the average volumes traded in the interbank market rose by 246.4% to Kshs 17.8 bn, from Kshs 5.1 bn the previous week. Commercial banks' excess reserves stood at Kshs 20.8 bn in relation to the 5.25% cash reserves requirement (CRR). The lower interbank rate points to improved liquidity conditions, with the rate declining to an 8-year low of 1.2% as at 14th February 2019 partly attributed to government payments and net redemption of government securities.

Kenya Eurobonds:

According to Bloomberg, the yields on the 5-year and 10-Year Eurobonds issued in 2014 declined by 0.3% points to 4.3% and 6.6% from 4.6% and 6.9%, the previous week. The continued decline in yields signals improving country risk perception by investors, which is partly attributed to bullish expectations of improved economic growth in 2019 as well as increased Eurobond demand in emerging markets with a similar trend observed in other Sub-Saharan African Eurobonds, driving the prices up and effectively the yields down. Key to note is that these bonds have 0.3-years and 5.3-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 0.2% points to 7.4% and 8.3% from 7.6% and 8.5%, respectively. Since the issue date, the yields on the 10-year Eurobond has increased by 0.1% points while the 30-year Eurobonds has remained unchanged at 8.3%.



Kenya Shilling:

During the week, the Kenya Shilling remained stable depreciating marginally by 0.1% to close at Kshs 100.2, from Kshs 100.1 recorded the previous week, supported by inflows from horticulture exports and Diaspora remittances, which offset the dollar demand from manufacturers and oil importers. The Kenya Shilling has appreciated against the US Dollar by 1.6% year to date, in addition to the 1.4% appreciation in 2018, 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 5.1% in the 12-months to November 2018, from 6.5% in November 2017, attributed to improved agriculture exports, increased diaspora remittances, strong receipts from tourism and slower growth in imports due to lower food and SGR–related equipment imports and the decline in international oil prices,

i. 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,

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 8.1 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.

Weekly Highlights:

During the week, the Kenya National Bureau of Statistics (KNBS) released the Gross County Product (GCP), which includes a geographic breakdown of Kenya's Gross Domestic Product (GDP), giving an estimate of the size and structure of county economies. According to the report, the average contribution per county to gross value added over the period 2013-2017 was approximately 2.1%, with Nairobi having the highest contribution at 21.7%, followed by Nakuru and Kiambu at 6.1% and 5.5%, respectively. Isiolo had the lowest contribution coming in at 0.2%, for the same period under review. Key to note however, is that counties with a low contribution to GDP recorded higher growth mainly attributable to a lower base with Elgeiyo Marakwet, which had a 1.7% contribution to GDP being the only county that recorded a double-digit growth at 10.0%, above the 5.6% average, with 28 counties recording growth below the average. The report also noted that more than a half of the national county economic activity is driven by the services sector, which accounts for 54.6%, followed by the agriculture sector at 24.0%, and the industry sector at 21.4%. Nairobi Metropolitan Area, made up of Nairobi, Kajiado, Kiambu, Machakos, and Murang'a counties, has a total contribution of 34.2% to the country's GDP. The report is expected to help shape the contentious revenue sharing debate as well as aid in promoting evidence-based economic planning and policymaking in the county levels in order to reduce the economic disparity among the different counties.

During the week, the National Treasury released the Draft Kenya Sovereign Wealth Fund Bill, 2019 aimed at providing institutional arrangements for effective administration and efficient management of minerals and petroleum revenues. The Bill is set to establish a clear framework to guide the usage of proceeds from natural resources on the backdrop of the discovery of mineral and petroleum deposits considering that natural resources are exhaustible.

The bill proposes the establishment of a Fund, which shall comprise of three distinct components namely:

?. **The Stabilization Component** whose main objectives will be:

?. To insulate expenditures under the budget estimates of the national government from fluctuations in resource revenues; and
a. Management of shocks, which may affect macroeconomic stability

?. **The Infrastructure Development Component** whose main objective will be to provide funding for public sector infrastructure development priorities that are aligned to the national or county development plan to foster a stronger and more inclusive growth and development, and
I. **The Urithi Component** whose main objective is to build a savings base for future generations by:

?. Providing a facility to support development for future generations, when the revenues from minerals and petroleum are depleted
a. Generating an alternative stream of income to support expenditure on capital projects as a result of revenue downturn caused by depletion of minerals and petroleum; and
b. Distributing wealth across generations.

The proceeds will be held in an account known as the holding account, which shall be maintained by the Central Bank of Kenya (CBK). Deposits into the account are set to be transferred into the three components of the fund in the following proportions:

?. At least 15.0% to the stabilization component,
i. At least 60.0% percent to the infrastructure development component and
ii. At least 10.0% to the Urithi component.

In the event of depletion of petroleum and mineral resources, all the funds will be collapsed into a single account where withdrawals will be limited to earnings from assets and dividends for infrastructure development. The sovereign wealth fund has been established in a number of resource rich countries such as the Norway Sovereign Fund, which has about USD 1.0 tn investments globally. In Africa, Angola, Nigeria, Botswana, Senegal, Libya, Algeria, and Ghana are some of the countries that have also established similar funds. We believe that the introduction of the bill is a well-guided move, which would enable the effective management of revenues generated from extraction of resources and aid the country in rational utilization of the funds.

The Treasury released the draft 2019 Budget Policy Statement, which outlines the current performance of the Kenyan economy, as well as give the medium term outlook. The Budget Policy Statement (BPS) is a Government policy document that sets out the broad strategic priorities, policy goals, together with a summary of the Government's spending plans, as a basis of preparing the FY 2019/20 budget.

Below is a summary of the major changes as per the BPS 2019 from the revised FY'2018/2019 budget

Comparison of 2018/19 and 2017/18 Fiscal Year Budgets as per The 2018 Budget Policy Statement

	FY'2017/2018 Budget Outturn	**FY'2018/2019 Revised Budget**	**FY'2019/2020 BPS**	**% change 2018/19 to 2019/20**
Total revenue	1,487.2	1,852.6	2,080.9	12.3%
External grants	26.3	48.5	51.6	6.4%
Total revenue & external grants	**1,513.5**	**1,901.1**	**2,132.5**	**12.2%**
Recurrent expenditure	1,319.6	1,541.0	1657.3	7.5%
Development expenditure & Net Lending	485.7	595.7	670.9	12.6%
County governments + contingencies	306.2	372.4	376.5	1.1%
Total expenditure	2,111.5	2,509.1	2704.7	7.8%
Fiscal deficit excluding grants	**(597.9)**	**(608.0)**	**(572.2)**	(5.9%)
Deficit as % of GDP	6.8%	6.1%	5.0%	
Net foreign borrowing	331.6	287.0	306.5	6.8%
Net domestic borrowing	273.7	317.1	271.4	(14.4%)
Other domestic financing	2.6	3.9	-5.7	
Total borrowing	608.0	608.0	572.2	(5.9%)
GDP Estimate	8,845.9	9,990.0	11,346.5	13.6%

Key take-outs from the table include:

?. The 2019 BPS points to a 7.8% increase of the budget, to Kshs 2.7 tn from Kshs 2.5 tn in the FY' 2018/19 revised budget,
i. Recurrent expenditure is set to increase at a slower rate than development expenditure; with recurrent increasing by 7.5% to Kshs 1.7 tn from Kshs 1.5 tn as per the revised budget, while development expenditure is projected to increase by 12.6% to Kshs 670.9 bn from Kshs 595.7 as per the revised FY'2018/2019 budget,
ii. The budget deficit is projected to decline to Kshs 572.2 bn (5.0% of GDP) from the projected Kshs 608.0 bn (6.1% of GDP) in the FY 2018/19; in line with the International Monetary Fund's (IMF's) recommendation, in a bid to reduce Kenya's public debt requirements,
iii. Revenue is projected to increase by 12.3% to Kshs 2.1 tn from the projected Kshs 1.8 tn in the revised FY 2018/19 budget, with measures already in place to work towards increasing the amount of revenue collected in the next fiscal year.
iv. The total borrowing requirement is expected to decline by 5.9% to Kshs 572.2 bn from Kshs 608.0 bn, in a bid to reduce Kenya's public debt burden which is estimated at 57.0% of GDP as at the end of the FY'2017/2018 above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, and the IMF threshold of 50.0%, and,
v. Debt financing of the 2018/19 budget is estimated to consist of 53% foreign debt and 47% domestic debt, unlike 47% foreign and 53% domestic as projected in the revised FY' 2018/19 budget which presents a risk of increased exposure to external shocks.

For more analysis on this, see our Draft 2019 Budget Policy Statement Note,

The Energy Regulatory Commission (ERC) released their monthly statement on the Maximum Retail Prices in Kenya for the period 15th February 2019 to 14th March 2019. Below are the key take-outs from the statement:

?. Petrol prices have declined by 4.0% to Kshs 100.1 from Kshs 104.2 per litre previously, while diesel and kerosene prices have declined by 6.1% and 5.1% to Kshs 96.0 and 96.5 per litre, respectively, from Kshs 102.2 and 101.7 per litre, previously
i. The changes in prices has been attributed to the decline in average landing cost of imported super petrol by 7.2% to USD 548.2 per ton in January, from USD 590.9 per ton in December. Landing costs for diesel and kerosene declined by 11.3% and 3.9% to USD 546.4 per ton and USD 595.8 per ton in January, respectively, from USD 661.0 per ton and USD 620.1 per ton in December

We expect a decline in the transport index, which carries a weighting of 8.7% in the total consumer price index (CPI), due to the decline in petrol and diesel prices. We will release our inflation projection for the month of February 2019 in next week's report.

Rates in the fixed income market have remained stable as the government rejects expensive bids, as it is currently 1.4% ahead of its domestic borrowing target for the current financial year, having borrowed Kshs 198.7 bn against a pro-rated target of Kshs 196.0 bn. However, a budget deficit is likely to result from depressed revenue collection creating uncertainty in the interest rate environment as 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.