The Role of the Capital Markets in Economic Development & Cytonn Weekly #12 2019

Fixed Income

T-Bills & T-Bonds Primary Auction:

T-bills recorded an oversubscription during the week, with the subscription rate rising to 198.9%, from 156.9% recorded the previous week. The oversubscription is partly attributable to improved liquidity conditions in the money market during the week as evidenced by the declining interbank rate that averaged 2.6% during the week, lower than the 3.8% recorded in the previous week. The yields on the 91-day papers rose by 86.0 bps to 7.7%, while those of 182-day and 364-day papers dropped by 4.4 bps and 3.0 bps to 8.2%, and 9.4%, respectively. The acceptance rate for T-bills rose to 73.3%, from 63.5% the previous week, with the government accepting Kshs 35.0 bn of the Kshs 47.7 bn worth of bids received. The subscription rate for the 91-day paper declined to 68.4%, from 76.7% recorded the previous week, while that of the 182-day and 364-day papers rose to 90.6% and 359.3% from 79.6% and 266.2%, recorded the previous week, respectively, with investors' participation remaining skewed towards the longer dated paper. The demand for the longer-dated paper is attributable to the scarcity of newer short-term bonds in the primary market.

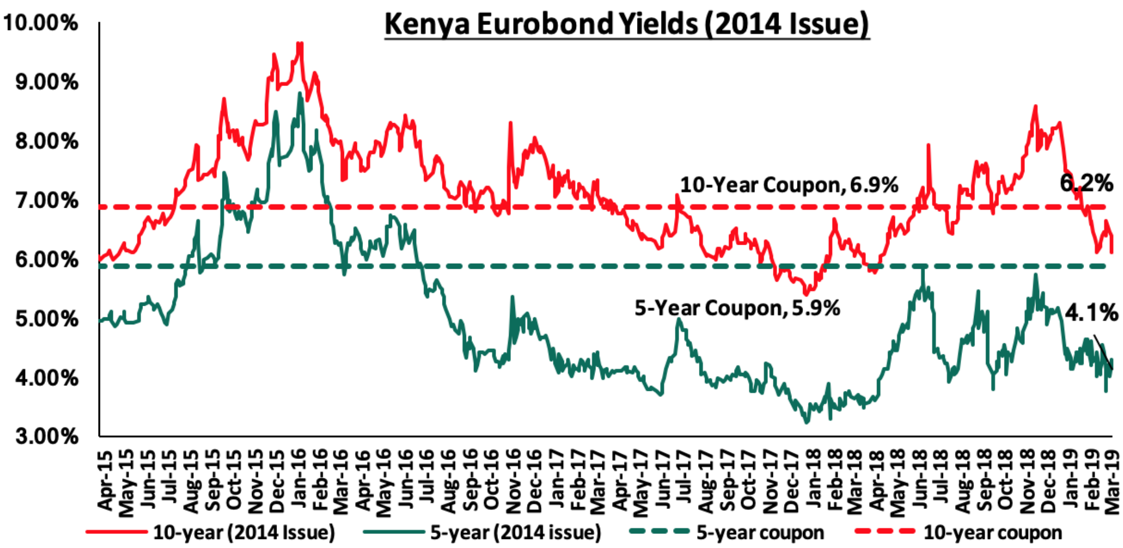
The newly issued 25-year (IFB1/2019/25) infrastructure bond for the month of March was undersubscribed at an overall subscription rate of 58.8%, attributable to the duration risk associated with long-term papers. The yield came in at 12.7%, in line with our expectations of 12.5% - 12.7%. The government accepted Kshs 16.3 bn out of the Kshs 29.4 bn worth of bids received, against Kshs 50.0 bn on offer, translating to an acceptance rate of 55.5%, indicating that bids were largely not within ranges the Central Bank of Kenya (CBK) deemed acceptable.

Liquidity:

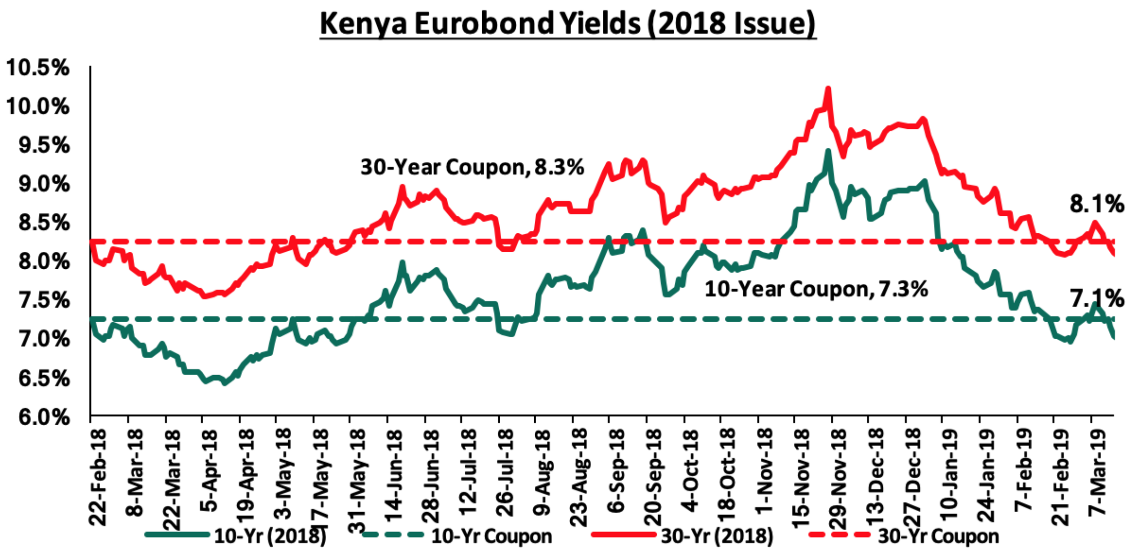
The average interbank rate declined to 2.6%, from 3.8% the previous week, while the average volumes traded in the interbank market rose by 17.7% to Kshs 3.5 bn, from Kshs 3.0 bn the previous week. This decline in the interbank rate points towards favorable liquidity conditions, driven partly by government payments, which offset tax remittances by banks.

Kenya Eurobonds:

According to Bloomberg, the yield on the 10-year Eurobonds issued in 2014 declined by 0.1% points to 6.2% from 6.3%, while that of the 5-year remained unchanged at 4.1%. Since the mid-January 2016 peak, yields on the Kenyan Eurobonds have declined by 4.7% points and 3.5% points for the 5-year and 10-year Eurobonds, respectively, an indication of the relatively stable macroeconomic conditions in the country. 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 10-year Eurobonds rose by 0.1% points to 7.1%, from 7.0% the previous week, while that of the 30-year Eurobond remained unchanged at 8.1%. Since the issue date, the yields on both the 10-year and 30-year Eurobond have both declined by 0.2% points.



The Kenya Shilling:

During the week, the Kenya Shilling edged down by 0.6% against the US Dollar to Kshs 100.8, from Kshs 100.2 the previous week. The Kenya Shilling has appreciated by 1.0% 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 with preliminary data on balance of payments indicating continued narrowing to 4.6% of GDP in the 12-months to January 2019, from 5.5% recorded in January 2018. The decline has been attributed to improved agriculture exports, increased diaspora remittances, strong receipts from tourism, and lower food and SGR-related equipment relative to 2017,

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 supportive 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, above the statutory requirement of maintaining at least 4-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover.

Monetary Policy:

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 27th March 2019, to review the prevailing macroeconomic conditions and decide on the direction of the Central Bank Rate (CBR). In their previous meeting held on 28th January 2019, the MPC maintained the CBR at 9.0%, citing that the economy was operating close to it's potential and inflation expectations remained anchored within the target range, thus the prevailing monetary policy stance remained appropriate. This was informed by the country's macroeconomic fundamentals, which remained stable as well as sustained optimism on the economic growth prospects, as evidenced by:

i. Inflation expectations, which have remained well anchored within the target range, declining to 4.7% in January 2019, from 5.7% recorded in December 2018, mainly driven by a 1.4% decline in the transport index attributable to a decline in pump prices of petrol and diesel, and,

ii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in January 2019, which indicated that the private sector was optimistic about local economic prospects. The private sector expects stronger economic growth in 2019, driven by a better investment climate, continued infrastructure development, expectations of increased agricultural production, the continued decline in international oil prices, and strong tourism performance.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 5.1% in the 12-months to November 2018, compared to 6.5% in November 2017, supported by strong growth of agricultural exports particularly tea and horticulture, improved diaspora remittances, and tourism receipts. The decline was also partly supported by higher tea and horticultural exports coupled with the slower growth in imports due to lower food and SGR–related equipment imports and declining international oil prices.

We believe that the MPC will maintain the current policy stance, given the macro-economic environment is relatively stable. ***We, therefore, expect the MPC to hold the CBR at 9.0% with their decision being supported by:***

i. Expectations of muted inflationary pressure in 2019, anchored by the declining food prices going forward with the expectations of long rains starting in late March as well as lower global fuel prices,

ii. The stability of the Kenyan Shilling, having already gained by 1.0% YTD in 2019 and recording a 4-year high of Kshs 99.7 against the dollar during the period under review, reflecting a more stable economic environment,

iii. Considering the government is currently behind its domestic borrowing schedule having borrowed Kshs 220.4 bn against a pro-rated target of Kshs 226.6 bn, we believe the MPC will maintain the CBR at the current rate with a bias to further easing in order to continue accessing domestic debt at cheaper rates. This, however, might have adverse effects of further crowding out of the private sector.

For more information on our expectation for the MPC meeting decision, see our March MPC note.

The Federal Reserve Bank (Fed) of the U.S, through its Federal Open Market Committee (FOMC), has maintained its benchmark policy rate within a band of 2.25% - 2.50% during its March meeting. The Fed also discarded earlier promises it had made on further gradual rate increases. The decision rides on the back of fears of an economic slowdown, highlighted by the Fed. This slowdown has been attributed to the growing uncertainty around trade relations between the US and China, further triggering falling factory output. In addition, the Fed also highlighted that beginning May it would slow down the monthly reduction of its Treasury bonds holdings to USD 15.0 bn, from the previous USD 30.0 bn, a move aimed at adjusting to the weaker global economic growth. We expect the Fed's decision not to hike the rates further to offer a reprieve for emerging markets, which would have had to contend with foreign investors repatriating their capital seeking more favorable terms in the US market and a strengthening US Dollar.

Inflation Projection:

We are projecting the y/y inflation rate for the month of March to come in within the range of 3.6% - 4.0%, a decline compared to 4.1% recorded in February. The m/m inflation for the month of February is however expected to rise due to the following factors:

i. A rise in the food and non-alcoholic beverages index, which has a weighting of 36.0%, mainly driven by the rise in food prices with a significant rise being recorded in tomato prices,
ii. A rise in the transport index, which has a weight of 8.7%, with petrol prices having increased by 1.3% to Kshs 101.4, from Kshs 100.1 per litre previously, while diesel recorded a 0.7% rise to Kshs 96.6 from Kshs 96.0 per litre, previously,
iii. A rise in the housing, water, electricity, gas and other fuels index, following the 3.1% rise in kerosene prices to Kshs 99.5 per litre from Kshs 96.5 per litre, previously.

Rates in the fixed income market have remained stable as the government rejects expensive bids, being currently 4.1% ahead of its domestic borrowing target for the current financial year, having borrowed Kshs 242.2 bn against a pro-rated target of Kshs 232.6 bn. 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 for 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.
