Cytonn INVESTMENTS

National Housing Development Fund (NHDF), & Cytonn Weekly #21/2019

Fixed Income

T-Bills & T-Bonds Primary Auction:

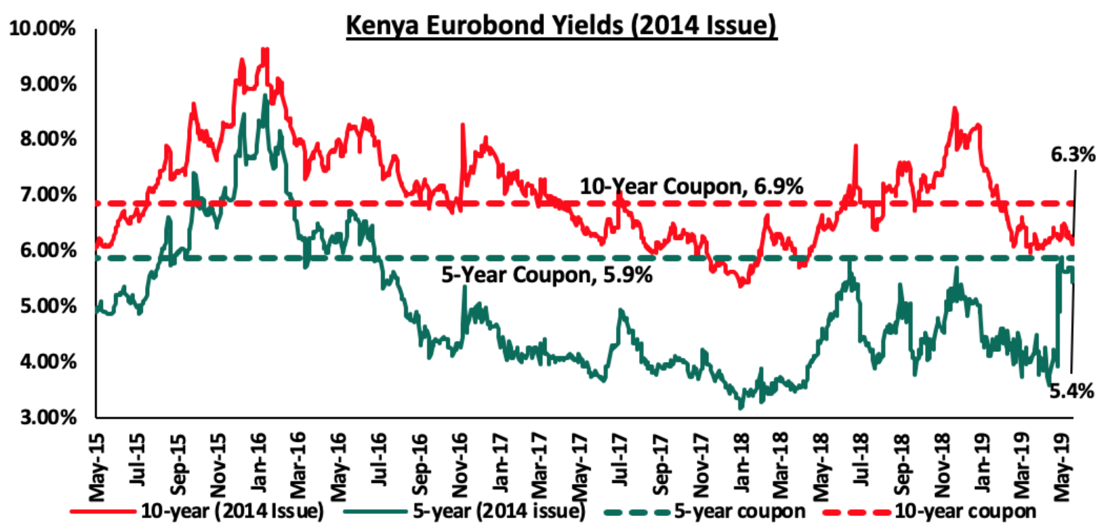
T-bills were oversubscribed during the week, with the overall subscription rate increasing to 131.4%, from 92.3% recorded the previous week. The improved subscription was attributable to improved liquidity in the market supported by government payments. The yields on the 91-day and 182-day papers declined by 7.5 bps and 7.6 bps to 7.1% and 7.7%, from 7.2% and 7.8%, respectively, while the yield on the 364-day paper remained unchanged at 9.3%. The acceptance rate rose to 91.9%, from 75.0% recorded the previous week, with the government accepting a total of Kshs 29.0 bn of the Kshs 31.5 bn worth of bids received, higher than the weekly quantum of Kshs 24.0 bn. Investors' participation remained skewed towards the longer dated paper, with the 364-day recording improved subscription to 210.5%, from 193.0% the previous week, while the subscription rates for the 91-day and 182-day papers rose to 146.1% and 46.4%, from 49.8% and 8.0% recorded the previous week, respectively.

Liquidity:

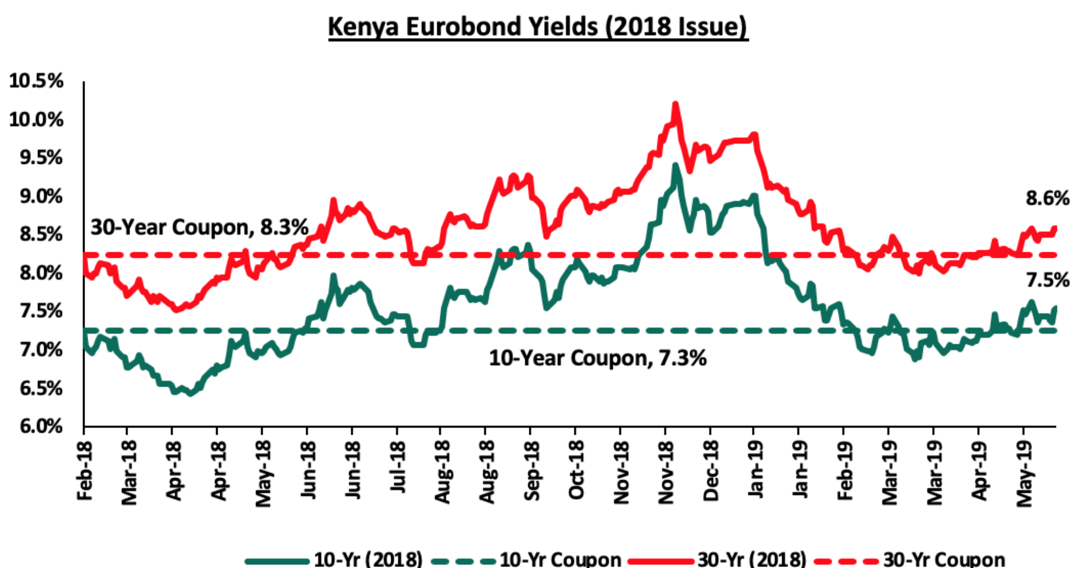
During the week, the average interbank rate declined to 5.4%, from 5.7% recorded the previous week, pointing to improved liquidity conditions in the money market, supported by government payments. The average volumes traded in the interbank market declined by 14.6% to Kshs 17.0 bn, from Kshs 20.0 bn the previous week.

Kenya Eurobonds:

According to Reuters, the yield on the 10-year Eurobond issued in 2014 declined by 0.1% points to 6.3%, from 6.4% the previous week, while that of the 5-year declined by 0.3% points to 5.4%, from 5.7% the previous week. Key to note is that these bonds have 1.0-month and 5.1-years to maturity for the 5-year and 10-year, respectively.



For the February 2018 Eurobond issue, yields on the 10-year Eurobond remained unchanged at 7.5%, while the yield on the 30-year Eurobond rose by 0.1% points to 8.6% from 8.5% the previous week. Since the issue date, the yields on both the 10-year Eurobond has increased by 0.1% points while the yields on the 30-year Eurobond has increased by 0.2% points.



The newly issued dual-tranche Eurobond with 7-Years and 12-years tenor, priced at 7.0% for the 7-year tenor and 8.0% for the 12-year tenor, respectively, started trading on 17th May 2019. The yield on the 7- year bond and 12-year bonds have risen by 0.1% point and 0.2% points to 7.1% and 8.1%, from 7.0% and 7.9%, respectively, as at the close of 17th May 2019.

The Kenya Shilling:

During the week, the Kenyan Shilling depreciated by 0.1% against the US Dollar to close at Kshs 101.2, from Kshs 101.1 the previous week, due to increased dollar demand from merchandise and oil importers buying dollars to meet their end-month obligations. The Kenya Shilling has appreciated by 0.6% year to date in addition to the 1.3% appreciation in 2018, 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 4.7% of GDP in the 12-months to February 2019, from 5.5% recorded in February 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 have increased cumulatively by 3.8% in the Q1'2019 to USD 665.6 mn, from USD 641.5 mn recorded in a similar period of review in 2018. 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 8.0 bn (equivalent to 5.2-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.

Highlights of the Week

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

i. Inflation expectations, which had remained well anchored, within the target range, declining to 4.1% in February 2019, from 4.7% recorded in January 2019, mainly driven by a 0.5% m/m 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 March 2019, which indicated that the private sector was optimistic about local economic prospects. The private sector expects stronger economic growth in 2019, continued infrastructure development, expectations of adequate agricultural production despite the delayed onset of the long rains in most parts of the country and a stable macroeconomic environment.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.7% in the 12-months to February 2019 compared to 5.5% in February 2018, supported by strong growth of agricultural exports particularly tea and horticulture, improved diaspora remittances, and tourism receipts. The decline was also partly supported by the slower growth in imports due to lower imports of food and machinery.

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

i. Expectations of easing of the recent inflationary pressures, which had mainly been driven by food supply shocks specifically grain prices with maize recording a 26.1% rise m/m leading to a 29.8% rise in the prices of maize flour. The surge in prices is however expected to be mitigated by the current measures being undertaken by the Kenyan Government, key of which being the release of 3 million bags of maize from the strategic food reserves that has eased the grains shortage curbing rising flour prices,
ii. The stability of the Kenyan Shilling having already gained by 0.7% YTD in 2019 and recording a 4-year high of Kshs 99.7 against the dollar during the year, reflecting a more stable economic environment, and,
iii. Considering the heavy domestic debt maturities, which currently stand at Kshs 1.0 tn for 2019, we believe the MPC will maintain the CBR at the current rate, in order for the government to

continue accessing domestic debt at cheaper rates. This however might have adverse effects of further crowding out of the private sector.

The key concern continues to be the weak private sector credit growth, which was at 3.4% y/y in February 2019, lower than the 5-year average of 11.9%, with the highest growth in lending being recorded in consumer durables at 16.2%, finance and insurance at 13.1%, manufacturing at 7.7%, and trade at 6.4%. This was a decline from 3.0% recorded in November, and below the 3.3% average recorded in 2018. Despite the 100-bps cut of the policy rate in 2018, no significant change has been recorded in private sector credit growth which remains anaemic due to the effects of the interest rate cap. On this front we have seen various measures being put in place to address the low private sector credit growth with the recent initiative being the launch of Stawi, a mobile loan product led by five commercial Banks targeting micro, small and medium scale enterprises. As a result, the Central Bank of Kenya has continued to express concern over 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. 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 our detailed MPC analysis, please see our MPC Note for the 27th May, 2019, meeting here.

Inflation projections

We are projecting the y/y inflation rate for the month of May to come in within the range of 5.8% - 6.2%, compared to 6.6% recorded in April. The inflation for the month of May is expected to remain elevated due to the following factors:

I. A rise in the transport index, which has a weight of 8.7%, with petrol prices having increased by 5.1% to Kshs 112.0, from Kshs 106.6 per litre previously, while diesel recorded a 2.2% rise to Kshs 104.4, from Kshs 102.1 per litre previously, and,
II. A rise in the housing, water, electricity, gas and other fuels index, following the 2.3% rise in kerosene prices to Kshs 104.6 per litre, from Kshs 102.2 per litre previously.

Inflation is however expected to be mitigated by a marginal decline in the food and non-alcoholic beverages index, which has a weighting of 36.0%, mainly driven by a decline in food prices such as tomatoes and maize flour following the release of 3 million bags of maize from the strategic food reserves that has eased the grains shortage, hence curbing rising flour prices.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids as they are currently 15.5% ahead of its domestic borrowing target for the current financial year, having borrowed Kshs 330.6 bn against a pro-rated target of Kshs 286.2 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.