Cytonn INVESTMENTS

Cytonn Monthly - May 2019

Fixed Income

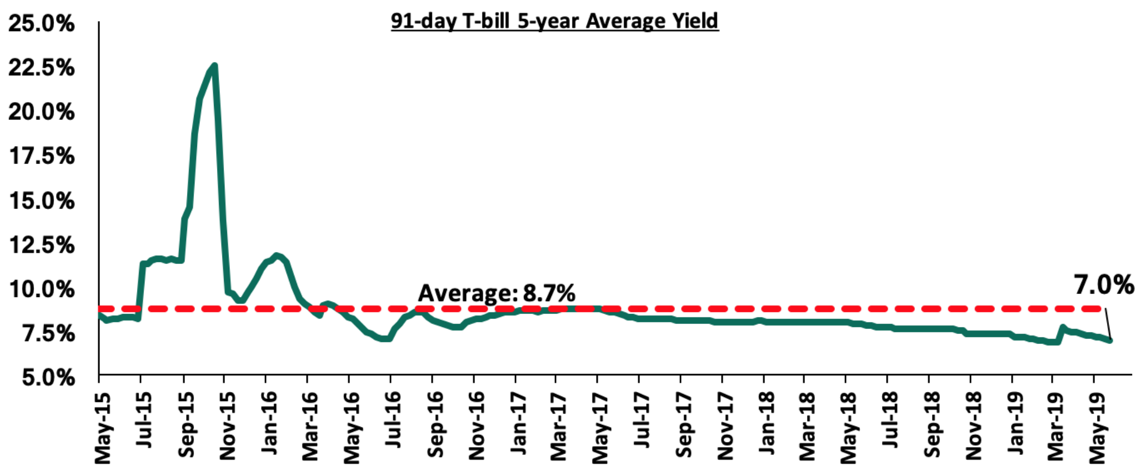
T-Bills & T-Bonds Primary Auction:

During the month of May, T-bill auctions recorded an undersubscription, with the overall subscription rate coming in at 82.6%, a decline from 157.0% recorded in the month of April 2019, attributable to tightened liquidity in the market, as evidenced by the rise in the average interbank rate to 5.5% in May, from 3.4% in April. The subscription rates for the 91-day, 182-day and 364-day papers came in at 77.9%, 27.6% and 139.4%, lower than the 137.5%, 88.2% and 233.6% registered in the previous month, respectively. The yields on the 91-day and 182-day papers declined by 0.2% points and 0.3% points, respectively, to 7.1% and 7.7%, while the yield on the 364-day paper remained unchanged at 9.3% from the previous month. T-bills acceptance rate came in at 89.8% during the month, compared to 77.4% recorded in April, with the government accepting a total of Kshs 71.1 bn of the Kshs 79.3 bn worth of bids received. The Central Bank of Kenya (CBK) remained disciplined in rejecting expensive bids in order to ensure stability of interest rates.

During the week, T-bills recorded an oversubscription, with the subscription rate coming in at 129.4%, down from 131.4% the previous week. The oversubscription rate is partly attributable to favorable liquidity in the money market during the week supported by government payments. The yield on the 91-day declined by 0.1% points to 7.0%, from 7.1%, recorded the previous week, while yields on the 182-day and 364-day papers remained unchanged at 7.7% and 9.3%, respectively. The acceptance rate declined to 91.1% from 91.9%, recorded the previous week, with the government accepting Kshs 28.3 bn of the Kshs 31.1 bn bids received.

The 91-day T-bill is currently trading at a yield of 7.0%, which is below its 5-year average of 8.7%. The lower yield on the 91-day paper is mainly attributable to the low interest rate environment that has persisted since the passing of the law capping interest rates. We expect this to continue in the short-term, given:

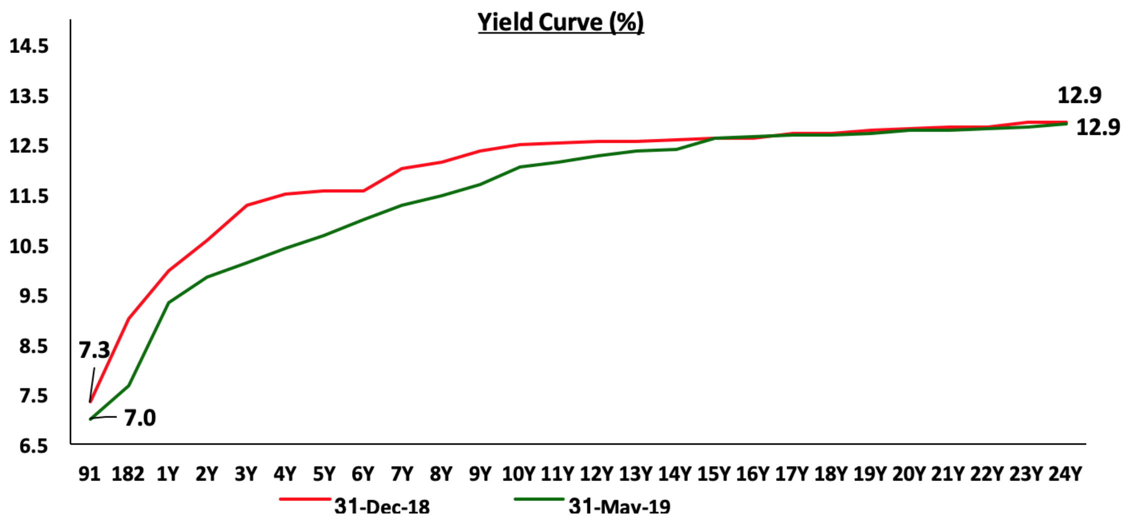
i. The discipline of the CBK in stabilizing interest rates in the auction market by rejecting aggressive bids that are priced above market, for both T-bills and T-bonds, and,
ii. The maintaining of the Central Bank Rate at 9.0% by the Monetary Policy Committee in their May 2019 meeting.



During the month of May, the government issued two bonds with issue numbers (FXD 2/2019/5) and (FXD 2/2019/15) with 5-year and 15-year tenors. The issue was oversubscribed, with the performance rate coming in at 141.7%. The market maintained a bias towards the 5-year bond that generated total bids of Kshs 39.2 bn as investors continue to avoid the longer-tenor bond driven by the perception that risks may not be adequately priced on the longer end of the yield curve, which is relatively flat due to saturation of long-term bonds, coupled with the duration risk associated with longer-term papers. The accepted yields for the 5-year and 15-year bonds came in at 10.9% and 12.7% in line with our expectations of 10.8% - 11.0% and 12.5% - 12.7% for the 5-year and 15-year bonds, respectively.

Secondary Bond Market:

The yields on government securities in the secondary market remained relatively stable during the month of May as the Central Bank of Kenya continued to reject expensive bids in the primary market.



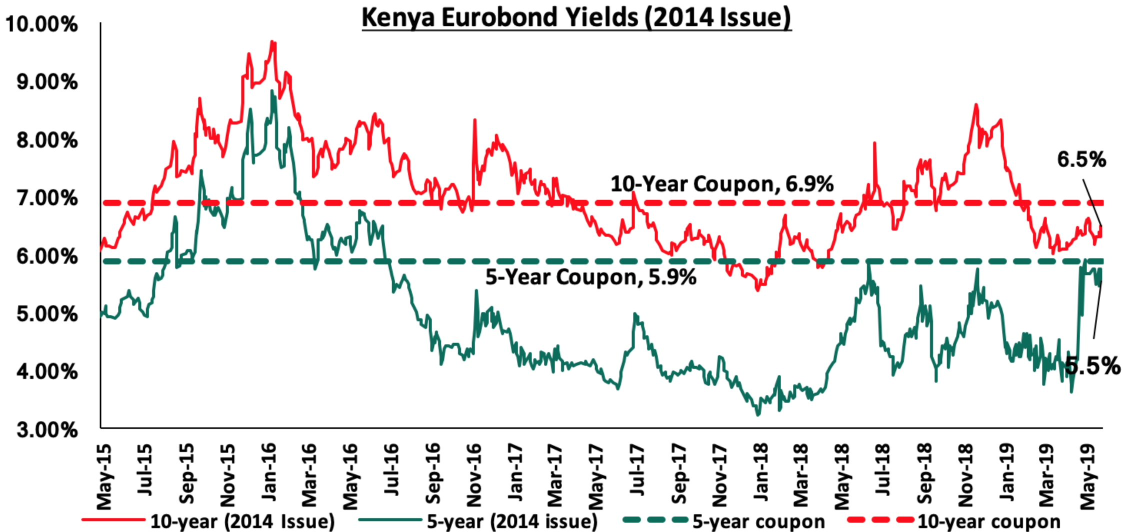
Liquidity:

The average interbank rate rose to 5.5% during the month of May from 3.4% in April, pointing to tightening liquidity conditions in the money market. During the week, the average interbank rate declined to 4.7%, from 5.4% the previous week. The decline in the interbank rate points to improved liquidity conditions in the money market, which the Central Bank of Kenya (CBK) attributed to support from government payments, which partly offset tax remittances.

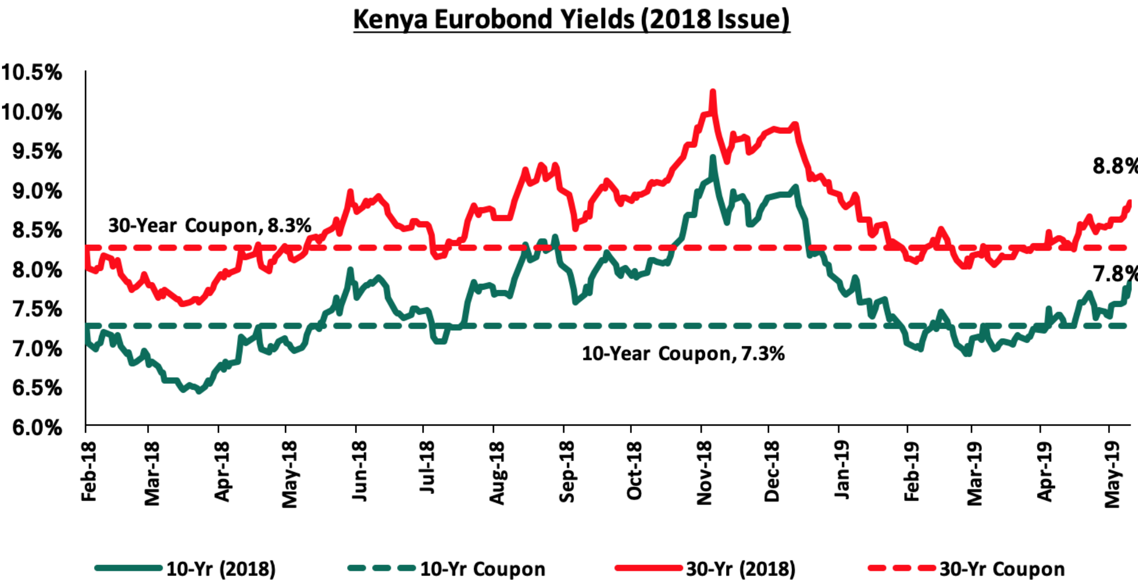
Kenya Eurobonds:

According to Reuters, the yield on the 5-year Eurobond issued in June 2014 declined by 0.3% points to 5.5% in May, from 5.8% in April 2019, while those of the 10-year Eurobonds issued in the same year rose by 0.1% points to 6.5% in May, from 6.4% in April 2019. During the week, the yield on the

5-year Eurobond issued in 2014 rose by 0.1% points to 5.5%, from 5.4% the previous week, while that of the 10-year Eurobond issued in the same year rose by 0.2% points to 6.5%, from 6.3% the previous week.



During the month, the yields on the 10-year and 30-year Eurobond issued in February 2018 rose by 0.4% points for both issuances to close at 7.8% and 8.8%, from 7.4% and 8.4% in April 2019, respectively, attributable to increased risk perception due to the downgrading of Kenya's 2019 growth prospects following delayed onset of the long rains this year. During the week, the yield on the 10-year Eurobond rose by 0.3% points to 7.8% from 7.5% recorded the previous week while those of the 30-year Eurobond rose by 0.2% points to 8.8%, from 8.6% the previous week.



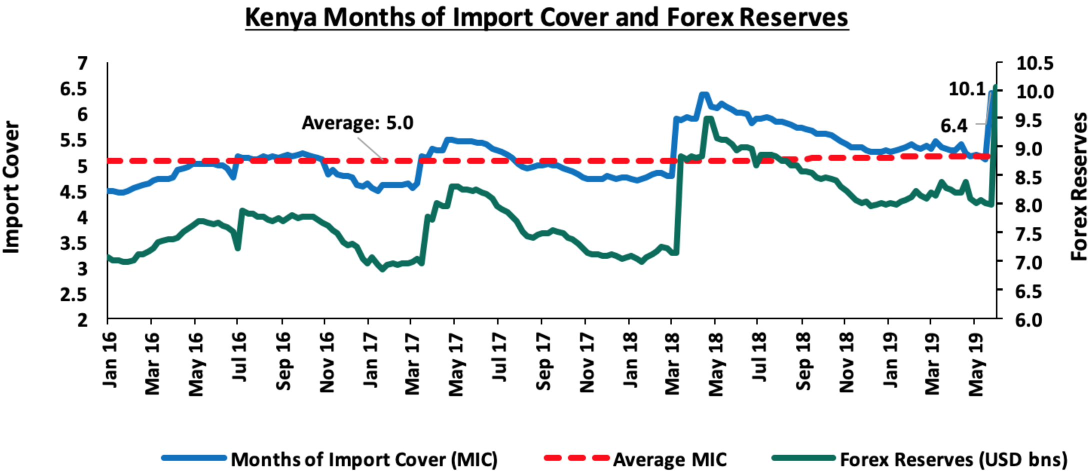
The newly issued dual-tranche Eurobond with 7-years and 12-years tenor, priced at 7.0% for the 7-year tenor and 8.0% for the 12-year tenor, respectively, started trading on 17th May 2019. The yield on the 7-year bond and 12-year bonds have risen by 0.3% points and 0.4% points to 7.3% and 8.3%, from 7.0% and 7.9%, respectively, as at the close of 17th May 2019.

The Kenya Shilling:

The Kenya Shilling remained stable against the US Dollar during the month of May, closing at Kshs 101.4, unchanged from the previous month with inflows from diaspora remittances and offshore investors offsetting end month dollar demand from oil and merchandise importers. During the week, the Kenya Shilling depreciated by 0.1% against the US Dollar to close at Kshs 101.4, from Kshs 101.2 in the previous week, driven by increased dollar demand from merchandise and oil importers buying dollars to meet their end-month obligations. On an YTD basis, the shilling has appreciated by

0.5% against the US Dollar in addition to 1.3% in 2018. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

i. The narrowing of the current account deficit with data on balance of payments indicating continued narrowing to 4.5% of GDP in the 12-months to April 2019, from 5.5% recorded in April 2018. The decline has been attributed to resilient performance of exports particularly horticulture and coffee, strong diaspora remittances, and higher receipts from tourism and transport services. Growth of imports also slowed mainly due to lower imports of food,
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 an all-time high of USD 10.1 bn (equivalent to 6.4-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.



Inflation:

The Y/Y inflation rate for the month of May declined to 5.5%, from 6.6% recorded in April, lower than our expectations of a decline to 5.8% - 6.2%, with the variance being as a result of a 0.4% m/m decline in the food and non-alcoholic beverages index against our expectations of a 0.2% decline. Month-on-month 0.1% deflation was attributed to;

i. A 0.4% decline in the food and non-alcoholic drinks' Index, due to favorable weather conditions, which led to lower prices for some commodities with the prices of spinach, sukuma wiki (kale) and tomatoes recording declines of 10.7%, 9.4%, and 6.8%.

A 0.3% rise was however recorded in the Transport index due to a rise in the pump prices of petrol and diesel, and a 0.6% rise in the housing, water, electricity, gas and other fuels' index due to higher cost of house rents and some cooking fuels. Partly contributing to this, were prices of domestic consumption of electricity that increased by 7.8% for consumption of 50 KWh increasing from Kshs 778.7 in April 2019 to Kshs 839.8 in May 2019 due to increase in fuel adjustment costs. Below is a summary of key changes in the Consumer Price Index (CPI) in May;

Major Inflation Changes in the Month of May 2019

Broad Commodity Group	Price change m/m (May-19/April-19)	Price change y/y (May-19/May-18)	Reason
Food & Non-Alcoholic Beverages	(0.4%)	6.3%	The m/m decline was due to favourable weather conditions which led to lower prices for some commodities
Transport	0.3%	11.1%	The m/m rise was mainly on account of increase in pump prices of petrol and diesel
Housing, Water, Electricity, Gas and other Fuels	0.6%	4.6%	The m/m rise was as a result of higher costs of house rents, electricity and cooking fuels
Overall Inflation	(0.1%)	5.5%	The m/m decline was due to a 0.4% decline in the food index which has a CPI weight of 36.0%

Monetary Policy:

The Monetary Policy Committee (MPC) met on 27th May 2019 to review the prevailing macroeconomic conditions and decide on the direction of the Central Bank Rate (CBR). The MPC retained the prevailing monetary policy stance leaving the Central Bank Rate (CBR) unchanged at 9.0%, which was in line with our expectations citing that inflation expectations remained well anchored within the target range and that the economy was operating close to its potential as evidenced by:

i. Month on month inflation remained within the 2.5% - 7.5%, target range despite rising to 6.6% in April, from 4.4% in March, largely driven by a rise in in food prices attributable to depressed supply of vegetables and other fast-growing food crops following the delayed onset of the long rains,
ii. Stability in the foreign exchange market supported by the narrowing of the current account deficit to 4.5% of GDP in the 12-months to April, from 5.5% in April 2018, driven by resilient performance of exports particularly horticulture, and higher diaspora remittances, and receipts from tourism and transport services, and,
iii. Improving private sector credit growth despite being below historical averages coming in at 4.9% in the 12-months to April, compared to 4.3% in the 12-months to March with strong growth being observed in the manufacturing sector (7.9%); trade (8.4%); finance and insurance (13.3%); and consumer durables (16.4%).

As such, the MPC concluded that the current policy stance was still appropriate, but noted that there was a need to remain vigilant on possible spill overs of recent food and fuel price increases. We expect monetary policy to remain relatively stable in 2019, as the CBK monitors Kenya's inflation rate and the currency.

Monthly Highlights:

During the month, Kenya issued its 3rd Eurobond, raising USD 2.1bn (Kshs 210.0 bn) through a dual-tranche Eurobond of 7-year and 12-year tenors, value dated 15th May 2019. A longer-term issuance would have been more preferable, though it comes at a trade-off on the yields as investors would demand a higher risk premium to compensate for the risk in tandem with the repayment period of the loan. The Eurobond will be listed on the London Stock Exchange (LSE). The issue was 4.5x oversubscribed attracting orders worth USD 9.5 bn. The Eurobond was priced at 7.0% for the 7-year tenor and 8.0% for the 12-year tenor with the proceeds expected to go towards:

i. Refinancing the obligations outstanding from the USD 750.0 mn Eurobond issued in 2014, which is due on 24th June, 2019, and,
ii. Financing development infrastructure projects as well as the general budgetary expenditure.

The additional funds obtained from the Eurobond will add to the public debt burden, which stood at Kshs 5.4 tn as at March 2019, according to the latest data released by the CBK. As at the end of 2018, the debt to GDP ratio stood at 57.5%. We expect the new issue to drive the debt to GDP ratio to “around” 60.0%, which continues to raise concern mainly driven by the inability of KRA to meet the set revenue collection targets. As at the end of March, ordinary revenue hit Kshs 1.1 tn against a target of Kshs 1.4 tn. The performance of the issue was commendable considering the current market conditions, with the International Monetary Fund (IMF) having withdrawn their stand-by credit facility in 2018, coupled with the downgrading of Kenya’s growth prospects by both the IMF and the World Bank. Key to note is that, unlike the previous issues, with expected bullet payments on the maturity date, both the 7-year and the 12-year tenors are sinkable, which means that the repayment of the principal will be amortized equally, at USD 300 mn and USD 400 mn, respectively, per year in the last three-years to maturity, as opposed to a full repayment of the principal on redemption. For more information, see our Cytonn Weekly #20/2019.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids as they are currently 17.1% ahead of its domestic borrowing target for the current financial year, having borrowed Kshs 310.1 bn against a pro-rated target of Kshs 292.2 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.