Understanding the Derivatives Market and Cytonn Weekly #27/2019

Fixed Income

Money Markets, T-Bills & T-Bonds Primary Auction:

T-bills remained oversubscribed during the week, however, the overall subscription rate decreased to 133.3%, from 249.2% recorded the previous week. The continued oversubscription is attributable to favorable liquidity in the market supported by government payments. The yields on the 91-day paper remained unchanged at 6.7%, while that of the 182-day and 364-day papers declined by 0.1% points and 0.2% points to 7.4% and 8.6%, respectively, from 7.5% and 8.8% recorded the previous week. The acceptance rate increased to 94.2%, from 52.0% recorded the previous week, with the government accepting a total of Kshs 30.1 bn of the Kshs 32.0 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 continued demand being attributable to the scarcity of newer short-term bonds in the primary market. The 182-day registered improved subscription to 48.2%, from 35.2% the previous week. The subscription rates for the 91-day and 364-day papers decreased to 53.8% and 250.2% from 103.6% and 521.6% recorded the previous week, respectively.

During the week, the Kenyan Government issued its first T-Bond for the 2019/2020 fiscal year with a tenor of 15-years, issue number FXD 3/2019/15. The bond has a market-determined coupon rate and the value date set on 29th July 2019. The period of sale is from 2nd July to 23rd July 2019. We shall provide the bidding recommendation for this bond issue in our next report.

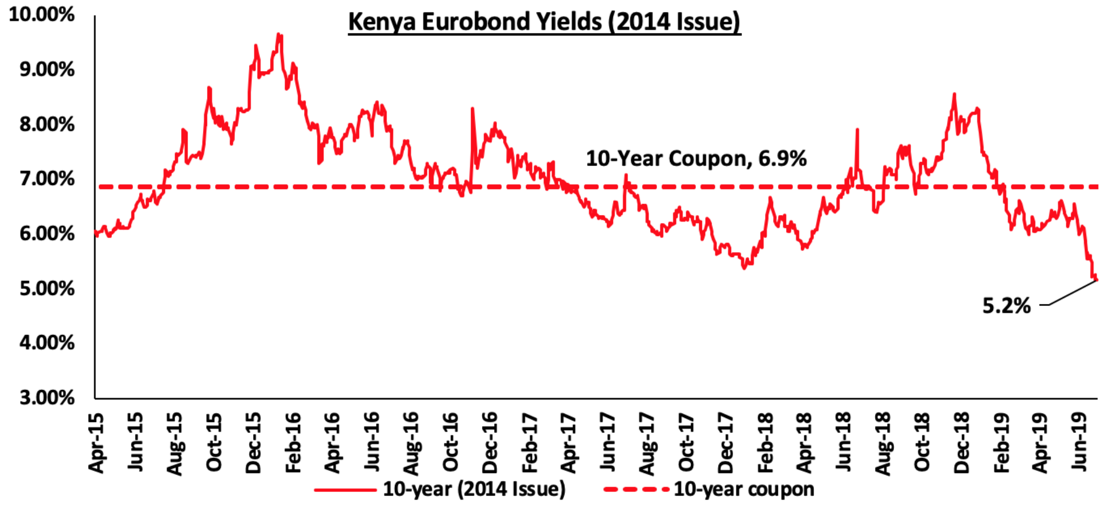
In the money markets, 3-month bank placements ended the week at 8.8% (based on what we have been offered by various banks), 91-day T-bill at 6.7%, an average of Top 10 Money Market Funds at 8.7%, with the Cytonn Money Market Fund closing the week at 11.0%.

Liquidity:

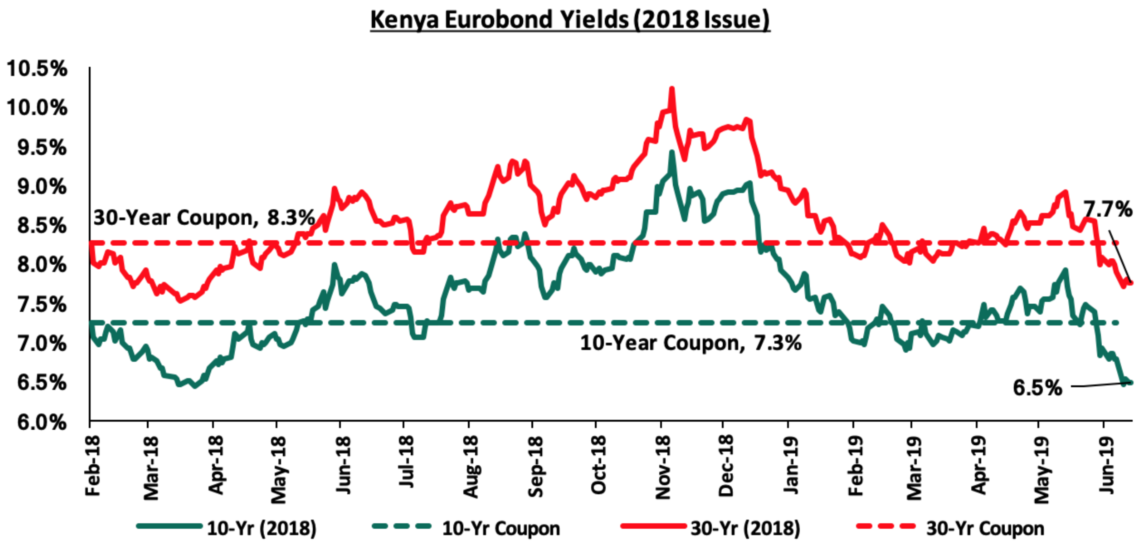
During the week, the average interbank rate declined to 2.0%, from 2.6% recorded the previous week, pointing to improved liquidity conditions in the money market supported by government payments, which offset tax remittances during the week. This saw commercial banks' excess reserves coming in at Kshs 16.4 bn in relation to the 5.25% cash reserves requirement (CRR). The average volumes traded in the interbank market gained by 81.1% to Kshs 9.7 bn, from Kshs 5.4 bn the previous week.

Kenya Eurobonds:

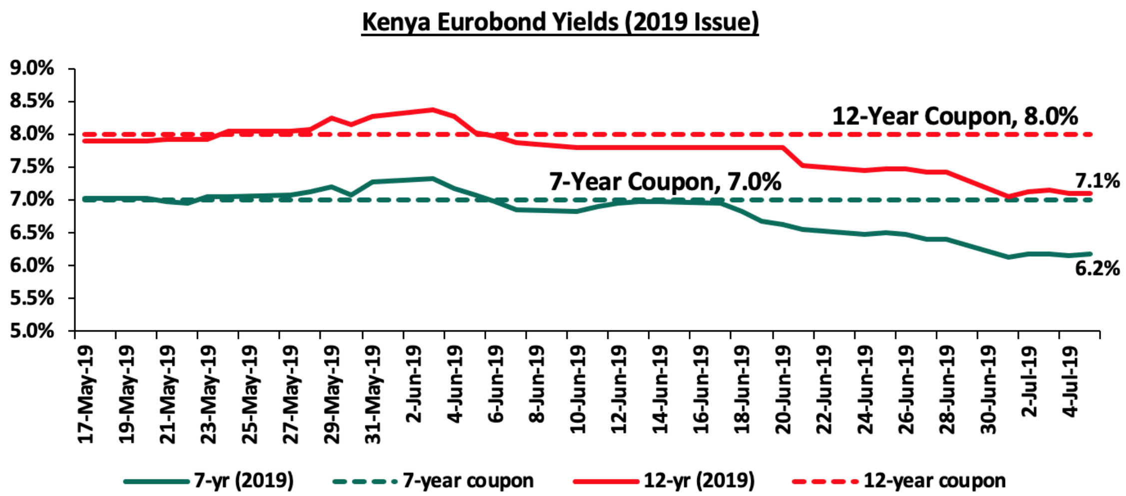
The yield on the 10-year Eurobond issued in 2014 declined by 0.3% points to 5.2%, from 5.5% recorded the previous week. The decline in yields has been attributed to increased demand for emerging market fixed-income securities following the pause by the US Fed in raising the benchmark interest rate.



For the February 2018 Eurobond issue, yields on the 10-year and 30-year Eurobond both declined by 0.3% points and 0.2% points to 6.5% and 7.7%, respectively, from 6.8% and 7.9% recorded the previous week.



For 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, the yields on the 7-year and 12-year bond declined by 0.2% points and 0.3% points to 6.2% and 7.1%, respectively, from 6.4% and 7.4% recorded the previous week.



The Kenya Shilling:

During the week, the Kenya Shilling depreciated by 0.3% against the US Dollar to close at Kshs

102.6, from Kshs 102.3 the previous week, this was due to excess local currency liquidity in the money markets. The Kenya Shilling has appreciated by 0.5% 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 data on balance of payments indicating continued narrowing to 3.2% of GDP in the 12-months to April 2019, from 8.9% recorded in April 2018. The decline has been attributed to the 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 3.8% in May 2019 to USD 1.2 bn, from USD 1.1 bn 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 9.0 bn (equivalent to 5.7-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

GDP Growth Q1’2019

According to Kenya National Bureau of Statistics (KNBS) Q1’2019 Gross Domestic Product (GDP) report, the country’s economic activity experienced relatively slower growth, expanding by 5.6%, compared to the 6.5% growth recorded in Q1’2018, but in line with the 5-year average growth rate of 5.6%. The table below shows differences in y/y growth of major sectors of the economy, as we seek to look at sectoral performance in Q1’2019:

Sector	Contribution Q1'2018	Contribution Q1'2019	Q1'2018 Growth	Q1'2019 Growth	Weighted Growth Rate Q1' 2018	Weighted Growth Rate Q1'2019	Variance of Growth (% Points)
Agriculture and Forestry	26.1%	26.3%	7.5%	5.3%	2.0%	1.4%	(2.2%)
Taxes on Products	10.3%	10.2%	5.7%	5.3%	0.6%	0.5%	(0.4%)
Manufacturing	9.9%	9.7%	3.8%	3.2%	0.4%	0.3%	(0.6%)
Real Estate	8.2%	8.1%	5.3%	4.2%	0.4%	0.3%	(1.1%)
Wholesale and Retail Trade	6.8%	6.7%	5.9%	5.3%	0.4%	0.4%	(0.6%)
Education	6.8%	6.7%	4.9%	5.4%	0.3%	0.4%	0.4%
Transport and Storage	6.1%	6.2%	8.5%	6.7%	0.5%	0.4%	(1.8%)
Financial & Insurance	5.9%	5.9%	5.2%	5.0%	0.3%	0.3%	(0.2%)
Construction	5.0%	5.0%	6.6%	5.6%	0.3%	0.3%	(1.0%)
Information and Communication	4.0%	4.2%	12.5%	10.5%	0.5%	0.4%	(2.1%)
Public Administration	3.6%	3.6%	6.2%	6.5%	0.2%	0.2%	0.3%
Electricity and Water Supply	2.5%	2.5%	6.5%	6.1%	0.2%	0.2%	(0.5%)
Professional Administration	2.1%	2.0%	4.0%	4.8%	0.1%	0.1%	0.8%
Health	1.5%	1.5%	4.6%	4.0%	0.1%	0.1%	(0.6%)

a. Slowdown in Agricultural Activities - Growth in the agricultural sector declined to 5.3% in Q1’2019, from 7.5% in Q1’2018. The slower growth in agriculture was attributed to a delay in the long rains in most parts of the country, which led to reduced agricultural production in the country,
b. Slowdown in the Manufacturing Sector - The manufacturing sector recorded declines in both growth and contribution to GDP in Q1’2019. The sector recorded a growth of 3.2% in Q1’2019, compared to a growth of 3.8% in Q1’2018. The slowdown in growth was largely attributed to the decline in agro-processing activities that were subdued as a result of the delay in long rains in most parts of the country, which led to reduced agricultural production in the country, and,
c. Slowdown in Real Estate Sector - The real estate sector’s performance declined to record a growth of 4.2% in Q1’2019, from a growth of 5.3% in Q1’2018. The decline in performance is a result of constrained access to financing, despite private sector credit growth rising slightly to 3.4% in February 2019 from 2.0% in February 2018, but still below the 5-year average of 11.8%.

We expect the 2019 GDP growth to slow down to a range of 5.7% - 5.9% from 6.3% in 2018, due to the delayed long rains with most parts of the country expected to experience depressed rainfall that is set to lead to a decline in agricultural production. Consequently, this will have an adverse effect on the manufacturing sector, as the major growth driver in the sector is agro-processing. For a more comprehensive analysis see the Q1’2019 Quarterly GDP Review and Outlook Note.

Balance of Payments & Current Account Q1’2019

Kenya’s current account deficit improved by 32.7% during Q1’2019, coming in at Kshs 78.8 bn, from Kshs 117.1 bn in Q1’2018, equivalent to 3.2% of GDP, from 5.2% recorded in Q1’2018. This was mainly driven by:

i. The 89.6% increase in the services trade balance to Kshs 60.7 bn, from Kshs 32.0 bn,
ii. A 3.8% decline in the merchandise trade deficit to Kshs 239.0 bn, from Kshs 248.3 bn in Q1’2018, and,
iii. The 14.6% rise in the secondary income (transfers) balance, to Kshs 128.5 bn, from Kshs 112.2 bn in Q1’2018.

The table below shows the breakdown of the various current account components, comparing Q1’2018 and Q1’2019:

all figures in Kshs bns unless stated otherwise

Q1’2019 Current Account Balance

Item	Q1'2018	Q1'2019	% Change
Merchandise Trade Balance	(248.3)	(239.0)	(3.8%)
Services Trade Balance	32.0	60.7	89.6%
Primary Income Balance	(13.0)	(29.1)	124.3%
Secondary Income (Transfers) Balance	112.2	128.5	14.6%
Current Account Balance	(117.1)	(78.8)	(32.7%)
GDP at Current Prices (Q1’2019 Quarterly GDP Report by KNBS)	2,239.0	2,489.3	11.2%
Current Account Balance as a % of GDP	*(5.2%)*	*(3.2%)*	*(2.1%)*

Key take-outs from the table include:

i. The secondary income/transfers surplus increased by 14.6% to Kshs 128.5 bn, from Kshs 112.2 bn in Q1’2018, driven by various factors such as diaspora remittances, which recorded a 2.9% increase to Kshs 67.9 bn, from Kshs 65.9 bn recorded in Q1’2018,

ii. The merchandise trade deficit contracted by 3.8% to Kshs 239.0 bn, from Kshs 248.3 bn in Q1'2018, driven by a 3.4% decline in merchandise imports to Kshs 397.1 bn, from Kshs 411.3 bn in Q1'2018. This improvement was however impeded by a 2.9% decline in merchandise exports to Kshs 158.2 bn from Kshs 162.9 bn recorded in a similar period in 2018. The decline in the merchandise imports was mainly on account of declines in the value of maize, iron and steel imports by 82.4% and 15.8% to Kshs 1.1 bn and Kshs 22.4 bn, respectively,
iii. In terms of exports by region, Africa remained the largest merchandise export destination with 34.1% of the total exports valued at Kshs 53.4 bn, a 1.1% decline from Q1'2018 total exports of Kshs 54.0 bn. The European region accounted for 25.6% of total exports, valued at Kshs 40.1 bn, a 6.6% increase from the Kshs 37.6 bn recorded in Q1'2018. Similarly, exports to the United States of America rose by 31.9% to Kshs 12.2 bn, from Kshs 9.3 bn in Q1'2018,
iv. In terms of imports by region, the European Union accounted for 15.7% of total imports in Q1'2019, valued at Kshs 66.0 bn, a 27.4% increase from the Kshs 51.8 bn recorded in Q1'2018. Asia was the largest merchandise import source, accounting for 61.2%, with the value of imports decreasing by 3.9% to Kshs 421.2 bn, from Kshs 438.5 bn recorded in Q1'2018. The decline was attributed to a decrease in imports from Malaysia (25.1%), India (22.9%), China (12.4%) and Japan (11.1%). Commodities that recorded marked reductions in import values from China included railway wagons and light emitting diodes, and,
v. As a result of the decline in the merchandise trade deficit, the increase in the services trade balance, and the increase in the secondary income balance, the current account deficit improved faster than the growth in GDP at current prices, resulting in the current account deficit improving to 3.2% of GDP, down from 5.2% recorded in Q1'2018.

For a more comprehensive analysis see the Q1'2019 Quarterly Balance of Payments Note

Purchasing Manager's Index

According to Stanbic Bank's Monthly Purchasing Manager's Index (PMI), released earlier during the week, the business environment in the country improved significantly during the month of June. The seasonally adjusted PMI came in at 54.3 in June, an improvement from 51.3 in May, and a 10-month high. A PMI reading of above 50 indicates improvements in the business environment, while a reading below 50 indicates a worsening outlook. Firms showed sharp increases in new orders during the month from both domestic and external markets. Some attributed the growth to easing of cash-flow issues, leading to sales growing at the fastest rate in the year so far. Output levels expanded during the month to a five-month high that consequentially leads to an increase in staff numbers. The increased growth through the month led companies to raise input purchases. This placed extra pressure on suppliers resulting in shortened delivery times. Purchasing costs rose significantly as a result of inflationary effects such as higher taxes, increased input demand, and fuel hikes. Overall, input costs continued to rise steeply forcing some companies to raise output charges in an effort to maintain profit levels. In line with our expectations, the PMI index reflects the upbeat sentiment from businesses as the government continues to settle its arrears, resulting in improved cash-flows. We expect the trend to continue considering the Kenyan President's directive to ensure consignments are cleared faster at the port going forward, accompanied with the proposal in the 2019/2020 Budget that all government suppliers should be paid within 60-days.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. A budget deficit is likely to result from depressed revenue collection with the revenue target for FY'2019/2020 at Kshs 2.1 tn, 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.*