Cytonn INVESTMENTS

# Impact of Proposed Budget Changes to Pensions Industry, & Cytonn Weekly #29/2019

## Fixed Income

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

T-bills remained oversubscribed during the week, however the overall subscription rate decreased to 108.4%, from 183.9% 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 and the 182-day paper fell by 0.1% points to 6.5% and 7.4%, from 6.6% and 7.5% recorded the previous week, respectively. The yields on the 365-day paper, however, rose by 0.2% points to 8.8%, from 8.6% recorded the previous week. The acceptance rate for all T-bills bid declined to 96.4%, from 100.0% the previous week, with the government accepting Kshs 25.1 bn of the Kshs 26.0 bn worth of bids received, higher than the weekly quantum of Kshs 24.0 bn. The 91-day paper registered improved subscription to 187.6%, from 81.1% recorded the previous week, while the 182-day and 365-day papers recorded a downturn in subscription to 69.7% and 115.6%, from 111.1% and 297.7% recorded the previous week, respectively.

For the month of July, the Kenyan Government has issued a 15-year bond issue number FXD 3/2019/15, which is set to be the first T-Bond for the 2019/2020 fiscal year and the third 15-year tenor bond in 2019, in a bid to raise Kshs 40.0 bn for budgetary support. The bond has a market-determined coupon rate and the value date set on 29th July 2019. In the market, bonds with 15-year maturity are currently trading at a yield of 12.2%. We expect bids for the FXD 3/2019/15 to come in at 12.2% - 12.4%, as well as at a significantly high subscription rate, driven by the current high liquidity in the money markets attributable to the government payments as well as effects emanating from the ongoing demonetization process.

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 6.5%, the average of Top 5 Money Market Funds at 9.9%, with the Cytonn Money Market Fund closing the week at an average yield of 10.8% p.a.

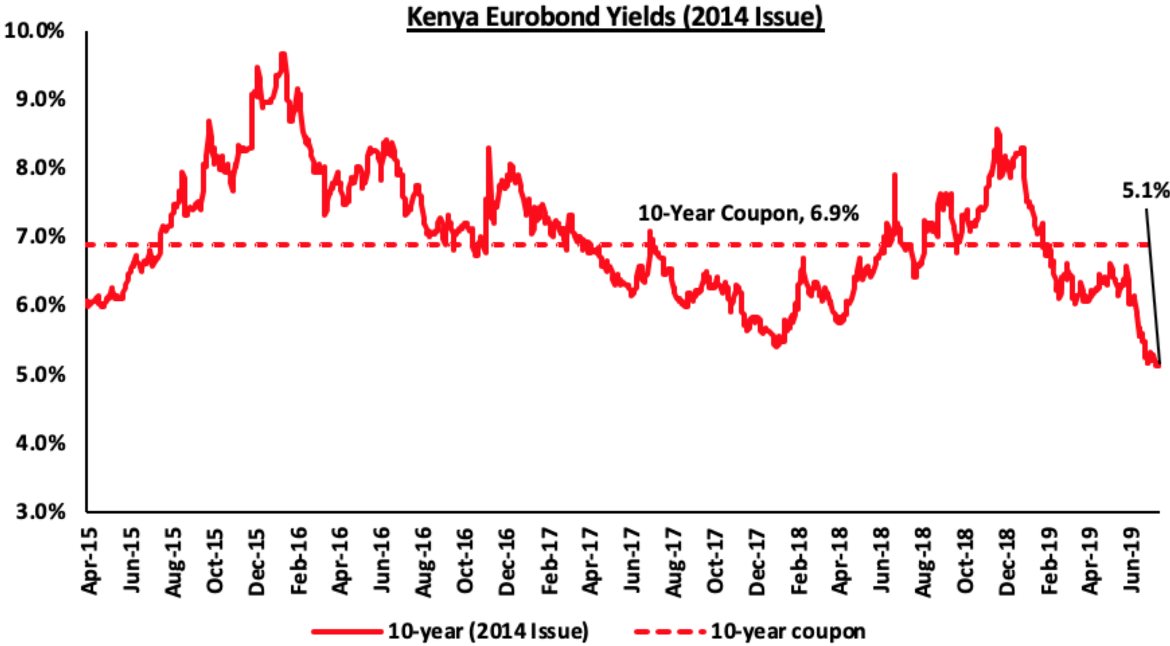
**Liquidity:**

Liquidity in the market remained favorable during the week, with the interbank rate falling slightly to 2.1%, from 2.3% recorded the previous week. Commercial banks' excess reserves stood at Kshs 9.0 bn in relation to the 5.25% cash reserves requirement (CRR). The average volumes traded in the interbank market declined by 3.7% to Kshs 8.7 bn, from Kshs 9.0 bn the previous week.

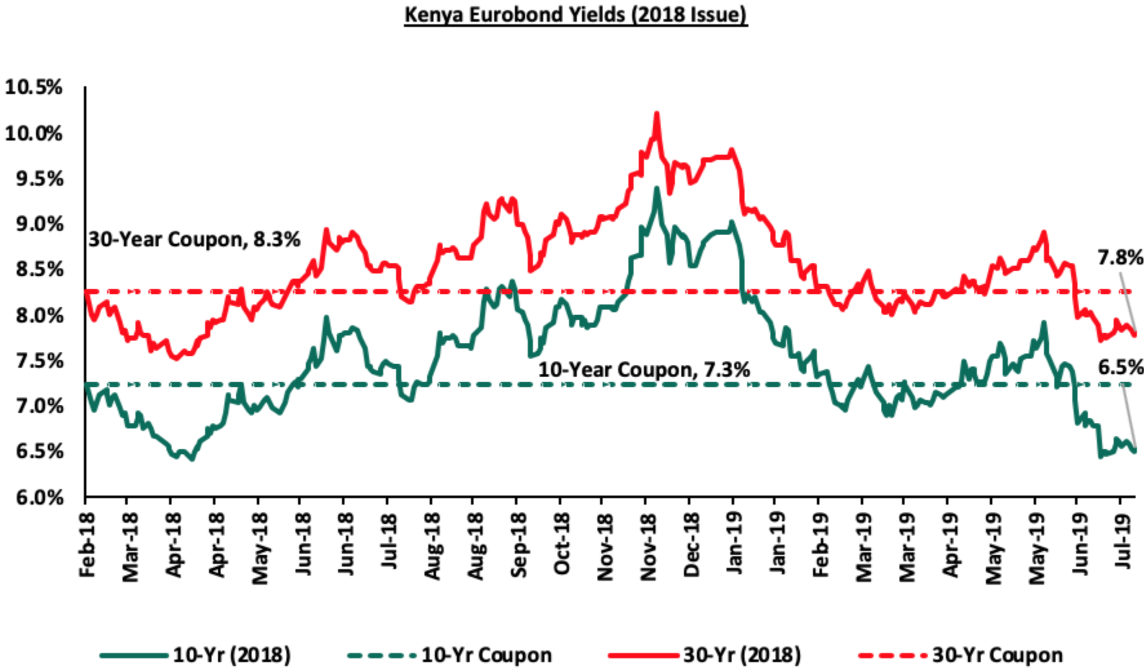
**Kenya Eurobonds:**

The yield on the 10-year Eurobond issued in 2014 dropped by 0.2% points to 5.1%, from 5.3% 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

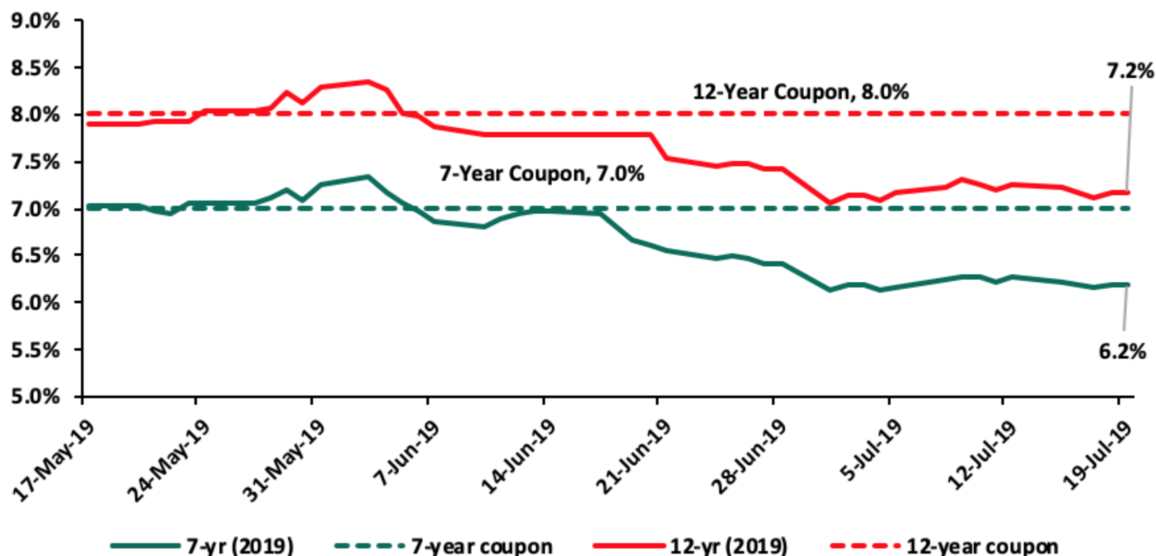
benchmark interest rate.




For the February 2018 Eurobond issue, yields on both the 10-year and 30-year Eurobonds dropped by 0.1% points to 6.5% and 7.8%, from 6.6% and 7.9% recorded the previous week, respectively.




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 bond and the 12-year bond dropped by 0.1% points to 6.2% and 7.2%, from 6.3% and 7.3% recorded the previous week, respectively.




**The Kenya Shilling:**

During the week, the Kenya Shilling depreciated by 0.3% against the US Dollar to close at Kshs 103.1, from Kshs 102.9 the previous week, driven by a relatively liquid money market largely supported by government payments, which more than offset tax remittances during the week. The Kenya Shilling has depreciated by 1.2% year to date, in comparison 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 indicating that the current account deficit narrowed to 4.2% of GDP in the 12-months to May 2019, from 5.8% recorded in May 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 cumulatively by 13.6% in the 12 months to June 2019 to USD 2.8 bn, from USD 2.4 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 9.7 bn (equivalent to 6.2-months of import cover), above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover.

**Weekly Highlights**

The Monetary Policy Committee (MPC) is set to meet on Wednesday, 24th July 2019, to review the prevailing macroeconomic conditions and decide on the direction of the Central Bank Rate (CBR). In their previous meeting held on 27th May 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, despite the possible spill-overs of the food and fuel price increases, 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 within the target range of 2.5% - 7.5%, despite rising to a high of 6.6% in April from 4.4% in March, mainly driven by a flare in food inflation following the late onset of long rains coupled with a rise in fuel prices, and,
ii. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in May 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, growth in the tourism sector, a stable macroeconomic environment and investor confidence in the economy.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.5% in the 12-months to April 2019, compared to 5.5% in April 2018, supported by strong growth of agricultural exports, particularly coffee 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.

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

i. Considering the heavy domestic debt maturities, which currently stand at Kshs 949.2 bn for FY'2019/20, we believe the MPC will maintain the CBR at the current rate, in order for the Kenyan Government to continue accessing domestic debt at cheaper rates. This, however, might have adverse effects of further crowding out of the private sector, which is evidenced by private sector credit growth which as at April 2019 stood at 4.9%, below the 5-year average of 11.6%, and,
ii. Expectations of inflationary pressures remaining within the government set range of 2.5% - 7.5%. Risks are however present in the short term, due to the expectations of food supply shocks, specifically in grain, which is expected to lead to a surge in prices, with the Agriculture Ministry's push for duty-free maize importation from the month of July to plug the grain deficit being blocked by the National Assembly's Agriculture Committee.

We maintain our view that the key concern still lies in the weak private sector credit growth, despite improving to a 31-month high of 4.9% in the month of April 2019, from 4.2% recorded in March and higher than the 3.3% average in 2018. 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, with the loans having a repayment period of between 1 and 12-months and an interest rate of 9.0% per annum. Small business owners, youth and women are also expected to access loans from the state under the new Biashara Kenya Fund from rates of 6.0% on a monthly reducing balance as per the regulations tabled by the Treasury in parliament for approval.

The Cabinet Secretary, National Treasury and Planning, Mr. Henry Rotich during the Budget reading also proposed a repeal of the interest rate cap should be adopted in order to unlock credit, which would in effect boost the performance of the economy, and consequentially boost taxable income available. The Central Bank of Kenya has also 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. Read our latest Interest Rate cap Topical here.

***For our detailed MPC analysis, please see our MPC Note for the 24th July 2019 meeting here.***

**Inflation Projections:**

We are projecting the Y/Y inflation rate for the month of July to come in within the range of 6.2% - 6.6%, compared to 5.7% recorded in June. The Y/Y inflation for the month of June is expected to rise due to the base effect as well as:

i. A rise in the food and non-alcoholic beverages index, which has a weighting of 36.0%, mainly driven by a rise in food prices especially grain prices, with a 2 kg bag of maize currently retailing at Kshs 120 - Kshs 125,
ii. We also expect a marginal rise in the transport index following the 0.3% rise in petrol prices during the month, despite a 0.8% decline in diesel prices due to the higher 16.0% weighting of petrol in the CPI items under the transport index as compared to 1.9% diesel weighting.

Going forward, we expect the inflation rate to remain within the Government set range of 2.5% - 7.5%.

***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.***

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