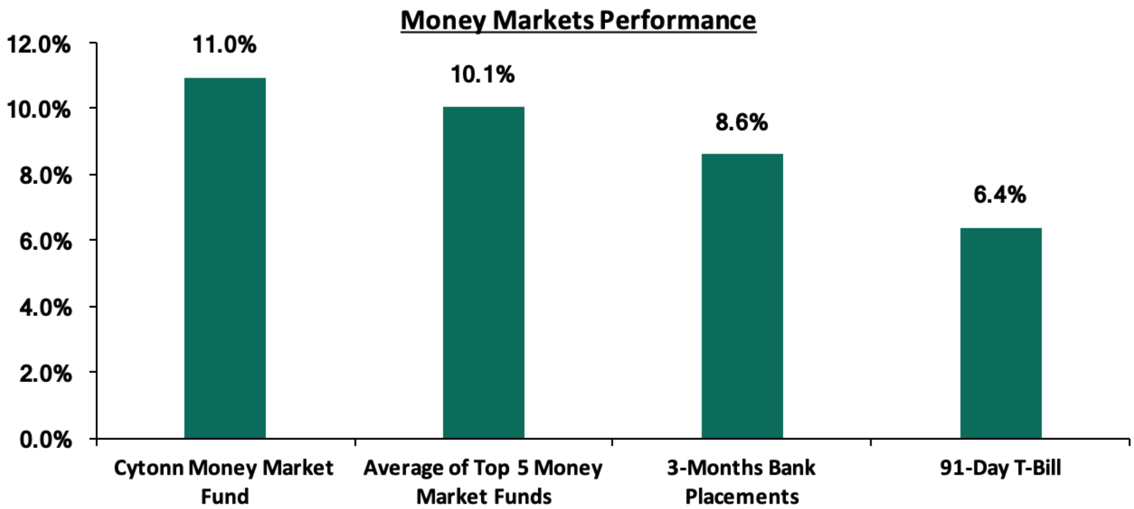
End of Interest Rate Caps?, & Cytonn Weekly #42/2019

Fixed Income

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

During the week, T-bills remained undersubscribed, with the subscription rate declining to 80.6%, from 98.3% recorded the previous week. The decline in the subscription rate is partly attributable to relatively tight liquidity conditions in the money market during the week; the relatively tight liquidity is attributable to the cyclical liquidity tightness due to the start of the new CRR cycle. The yield on the 91-day and 364-day papers remained unchanged at 6.4% and 9.8%, respectively, while the yield on the 182-day paper fell by 0.1% points to 7.2%, from 7.3% recorded the previous week. The acceptance rates decreased to 67.8%, from 71.7% recorded the previous week, with the government accepting Kshs 13.1 bn out of the Kshs 19.3 bn worth of bids received.

In the money markets, 3-month bank placements ended the week at 8.6% (based on what we have been offered by various banks), the 91-day T-bill came in at 6.4%, while the average of Top 5 Money Market Funds came in at 10.1%, higher than the 10.0% recorded the previous week, with the Cytonn Money Market Fund closing the week at 11.0%, from 10.9% recorded the previous week.

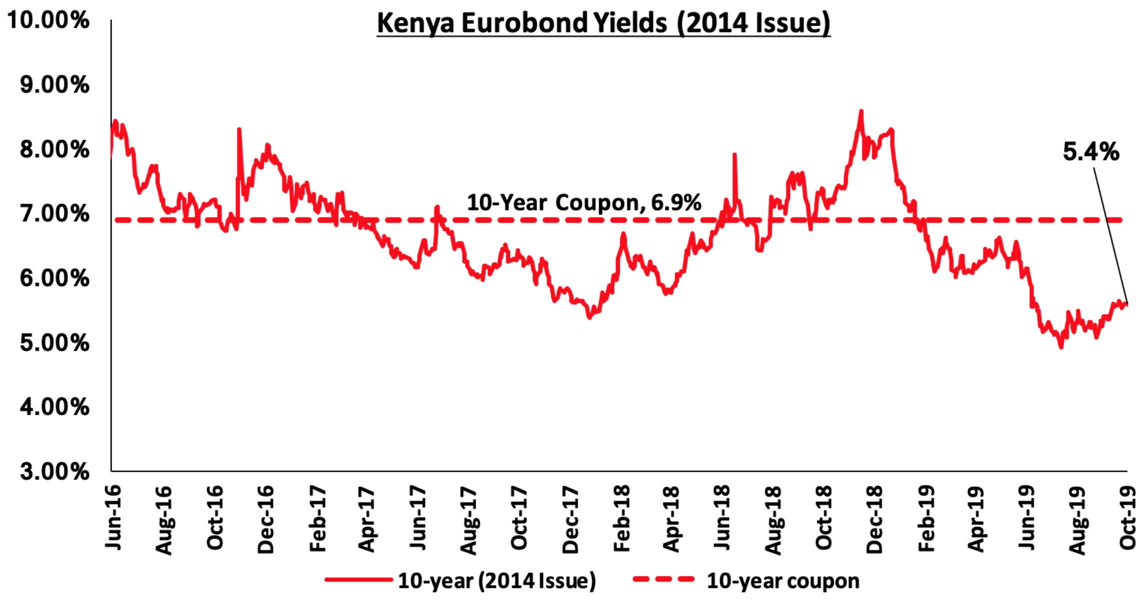


Liquidity:

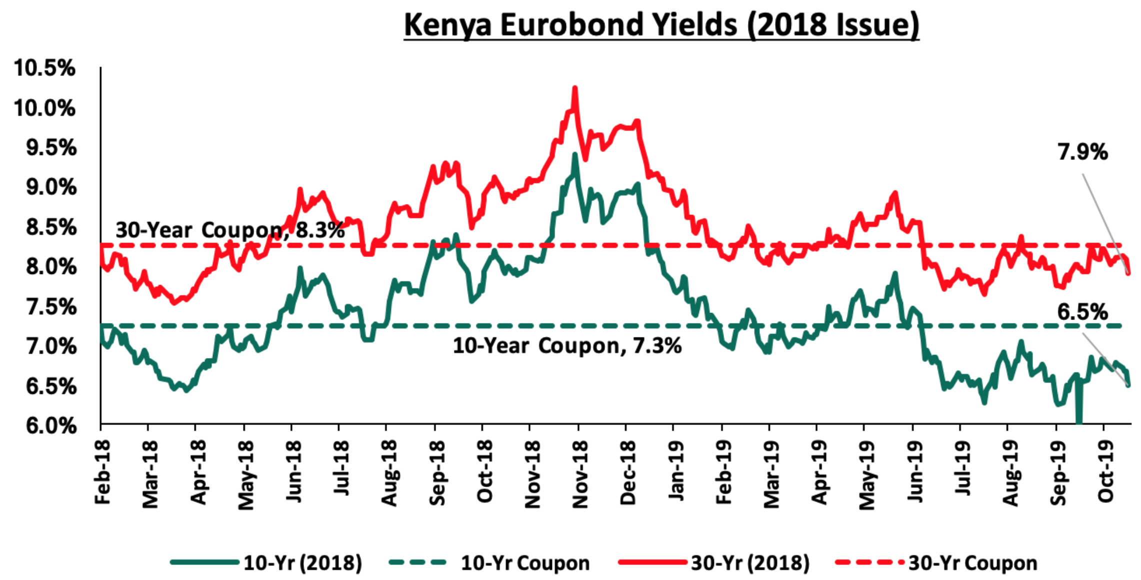
During the week, the average interbank rate increased by 0.2% points to 7.2% from 7.0% recorded the previous week, on the back of relatively tight liquidity conditions in the money market during the week, attributable to the cyclical liquidity tightness due to the start of the new CRR cycle. This saw the commercial banks' excess reserves come in at Kshs 16.4 bn, compared to 11.5 bn recorded last week, in relation to the monthly 5.25% cash reserve requirement. The average volumes traded in the interbank market increased by 13.0% to Kshs 6.0 bn, from Kshs 5.3 bn the previous week.

Kenya Eurobonds:

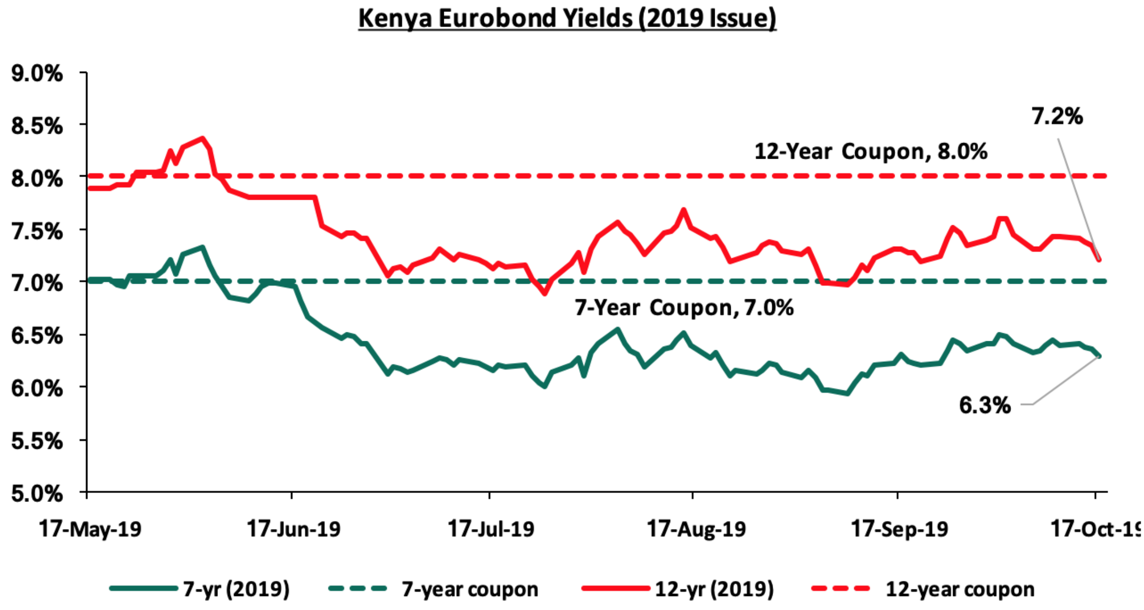
According to Reuters, the yield on the 10-year Eurobond issued in 2014 declined by 0.2% points to 5.4%, from 5.6% recorded the previous week. We attribute the decline across all the Kenya Eurobonds to easing risk concerns over the economy by investors following the news of a likelihood of the interest rate cap repeal, which is seen as likely to stimulate credit growth and the economy.



For the 2018 issues, the yields on the 10-year and 30-year Eurobonds both declined by 0.3% points and 0.2% points to 6.5% and 7.9%, from 6.8% and 8.1% recorded the previous week, respectively.



During the week, the yields on both the 7-year Eurobond and the 12-year Eurobond both declined by 0.1% points and 0.2% points to come in at 6.3% and 7.2% from 6.4% and 7.4% recorded the previous week, respectively.



Kenya Shilling:

During the week, the Kenya Shilling appreciated marginally by 0.1% against the US Dollar to close at Kshs 103.7, from 103.8 recorded the previous week, supported by inflows from diaspora remittances, easing dollar demand from merchandise importers. On a YTD basis, the shilling has depreciated by 1.9% against the dollar, in comparison to the 1.3% appreciation 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 preliminary data indicating that Kenya's current account deficit improved by 11.8% during Q2'2019, coming in at a deficit of Kshs 107.6 bn, from Kshs 122.0 bn in Q2'2018, equivalent to (6.2%) of GDP, from (7.6%) recorded in Q2'2018. This was mainly driven by the narrowing of the country's merchandise trade deficit by 1.7% and a rise in secondary income (transfers) balance by 5.1%,
ii. Improving diaspora remittances, which have increased cumulatively by 8.9% in the 12-months to August 2019 to USD 2.8 bn, from USD 2.6 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 8.9 bn (equivalent to 5.6-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 Highlight:

During the week, the IMF released its World Economic Outlook, October 2019, dubbed "Global Manufacturing Downturn, Rising Trade Barriers". According to the report, global growth is expected to be slower in 2019, with the IMF downgrading the growth rate to 3.0% from 3.3% projected as at the start of the year, with the 3.0% being the slowest pace since the global financial crisis. The decline in growth is attributable to trade tensions, which have resulted in significant tariff increases between the United States and China; this has hurt business sentiment and confidence globally. Kenya's economic growth for the year was also revised downwards to 5.6%, from their previous projection of 5.8%, released in April 2019.

In the second quarter of 2019, Kenya's economy grew by 5.6%, lower than the 6.4% growth seen during a similar period in 2018. Some of the highlights are;

- Growth was driven by; (i) a recovery in the Financial and Insurance Sector, which recorded a growth of 6.7% compared to the growth of 3.9% seen in Q2’2018, (ii) increased output in the Education, Transport and Storage and Construction sectors, which grew by 6.0%, 7.2% and 7.2%, compared to 4.5%, 6.0% and 5.2% seen last year, respectively, and (iii) Information and Communication sector, which recorded the highest growth of 11.6%, compared to 11.7% recorded in Q2’2018,
- However, growth was weighed down by; (i) the Agricultural sector, which recorded a slower growth of 4.1%, compared to 6.5% seen in Q2’2018, and (ii) the Professional, Admin and Support Services sector, which recorded a growth of 7.6%, compared to 15.2% seen in Q2’2018.
- Below is a table highlighting the contribution to growth by sector:

Sector	Contribution Q2'2018	Contribution Q2'2019	Q2'2018 Growth	Q2'2019 Growth	Weighted Growth Rate Q2'2018	Weighted Growth Rate Q2'2019	Variance
Agriculture and Forestry	23.4%	23.1%	6.5%	4.1%	1.5%	0.9%	(0.6%)
Taxes on Products	10.9%	10.8%	5.5%	4.5%	0.6%	0.5%	(0.1%)
Manufacturing	9.8%	9.7%	4.7%	4.2%	0.5%	0.4%	(0.1%)
Real estate	8.3%	8.2%	4.9%	5.4%	0.4%	0.4%	0.0%
Wholesale and retail trade	7.1%	7.1%	5.8%	5.8%	0.4%	0.4%	0.0%
Education	6.8%	6.8%	4.5%	6.0%	0.3%	0.4%	0.1%
Transport and Storage	6.8%	6.9%	6.0%	7.2%	0.4%	0.5%	0.1%
Financial & Insurance	5.9%	5.9%	3.9%	6.7%	0.2%	0.4%	0.2%
Construction	5.4%	5.5%	5.2%	7.2%	0.3%	0.4%	0.1%
Information and Communication	3.5%	3.6%	11.7%	11.6%	0.4%	0.4%	0.0%
Public administration	4.3%	4.3%	6.4%	6.0%	0.3%	0.3%	(0.0%)
Electricity and Water Supply	2.8%	2.8%	10.5%	5.6%	0.3%	0.2%	(0.1%)
Professional admin	2.4%	2.4%	15.2%	7.6%	0.4%	0.2%	(0.2%)
Health	1.8%	1.8%	2.5%	5.2%	0.0%	0.1%	0.0%
Accommodation & Food Services	1.0%	1.0%	15.4%	10.6%	0.1%	0.1%	(0.0%)
Other services	1.2%	1.2%	5.0%	2.3%	0.1%	0.0%	(0.0%)
Mining and quarrying	0.9%	0.9%	1.4%	5.7%	0.0%	0.1%	0.0%
Financial Services Indirectly Measured	(2.2%)	(2.1%)	(0.4%)	4.0%	0.0%	(0.1%)	(0.1%)
GDP at Market Prices	**100.0%**	**100.0%**	**6.4%**	**5.6%**	**6.4%**	**5.6%**	**(0.7%)**

- For a more detailed analysis, kindly see our analysis on Kenya’s Q2’2019 GDP Growth and 2019 Outlook.

Below is a table showing average projected GDP growth for Kenya in 2019 with a downward readjustment of the IMF and the National Treasury; noteworthy being that the highest projection is by the Central Bank of Kenya at 6.3%. We shall be updating this table should projections change and shall highlight who had the most accurate projection at the end of the year.

Kenya 2019 Annual GDP Growth Outlook

No.	Organization	Q1'2019	Q2'2019	Q3'2019
1.	Central Bank of Kenya	6.3%	6.3%	6.3%
2.	The National Treasury*	6.2%	6.2%	6.0%
3.	Citigroup Global Markets	6.1%	6.1%	6.1%
4.	African Development Bank (AfDB)	6.0%	6.0%	6.0%
5.	PNB Paribas	6.0%	6.0%	6.1%
6.	UK HSBC	6.0%	6.0%	6.0%
7.	Euromonitor International	5.9%	5.9%	6.3%
8.	International Monetary Fund (IMF)*	6.1%	5.8%	5.6%
9.	Cytonn Investments Management Plc	5.8%	5.8%	5.8%
10.	Focus Economics	5.8%	5.8%	5.6%
11.	World Bank	5.8%	5.7%	5.7%
12.	JPMorgan	5.7%	5.7%	5.6%
13.	Euler Hermes	5.7%	5.7%	5.7%
14.	Oxford Economics	5.6%	5.6%	5.6%
	Average	**5.9%**	**5.9%**	**5.9%**
****Revised Growth rates for Q3'2019***				

From the above table, the changes are:

1. International Monetary Fund revised its projection from 5.8% as at Q2'2019, to 5.6% in Q3'2019, and,
2. The National Treasury revised its projection from 6.2% as at Q2'2019, to 6.0% in Q3'2019

In our view, we expect the country's GDP growth to slow down to a range of 5.7% - 5.9% from 6.3% recorded in 2018, due to the delayed onset of the long rains in most parts of the country. This is expected to affect agricultural production and will consequently have an effect on the manufacturing sector, which is highly dependent on Agroprocessing.

During the week, the Energy and Petroleum Regulatory Authority released their monthly statement on the maximum retail fuel prices in Kenya effective from 15th October 2019 to 14th November 2019. Below are the key take-outs from the statement:

- Petrol prices have declined by 4.2% to Kshs 108.1 from Kshs 112.8 per litre previously, while diesel prices have declined by 1.1% to Kshs 102.0 from Kshs 103.0, previously, and,
- Kerosene prices however increased by 0.4% to Kshs 101.1 from Kshs 100.6 per litre.

The changes in prices are attributable to:

- A decrease in the average landing cost of imported super petrol by 7.7% to USD 459.3 per cubic meter in September 2019, from USD 497.4 per cubic meter in August 2019,
- A decrease in the average landing costs of imported diesel by 2.3% to USD 491.9 per cubic meter in September 2019, from USD 503.6 per cubic meter in August 2019, and Kerosene increasing by 0.5% to USD 486.6 per cubic meter in September 2019, from USD 484.3 per cubic meter in August 2019, and,

- The Free on Board (FOB) price of Murban crude oil lifted in September 2019 posted an increase by 3.4% to USD 64.4 from USD 62.3, per barrel in August 2019.

We expect a decline in the transport index, which carries a weighting of 8.7% in the total consumer price index (CPI), due to the decreased petrol and diesel pump prices. Consequently, the decline in the transport index will ease inflationary pressures since transport is a critical component in other sectors. It will thus result to lower input costs.

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. Putting into consideration the possible repeal of the interest rate cap, we expect improved private sector credit growth in the country, especially access to credit by MSMEs. This will lead to increased competition for bank funds from both the private and public sectors, thereby reducing liquidity in the money market, resulting in upward pressure on interest rates. Owing to this, we will be updating our Fixed Income House View.
