# Cytonn Monthly October 2019

## Fixed Income

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

During the month of October, T-bill auctions recorded an undersubscription, with the overall rate coming in at 84.5%, compared to 105.4% recorded in the month of September 2019. The subscription rates for the 91-day came in at 122.0%, which was lower than the 128.6% recorded in September. The subscription rates for the 182-day and 364-day came in at 27.1% and 195.5%, higher than the 23.5% and 127.3%, recorded in September, respectively. The yields on the 91-day increased by 0.1% points to 6.4%, from 6.3%, while the yield on the 182-day paper and 364-day paper, recorded no change in the yields remaining stable at 7.2% and 9.8%, respectively in October. The T-bills acceptance rate came in at 71.4% during the month, compared to 67.9% recorded in September, with the government accepting a total of Kshs 57.9 bn of the Kshs 81.1 bn worth of bids received.

The Central Bank remained disciplined in rejecting expensive bids in order to ensure the stability of interest rates.

During the week, T-bills were oversubscribed, with the subscription rate coming in at 114.3%, up from 72.8% the previous week. The oversubscription is partly attributable to favourable liquidity in the money market during the week. The yield on the 91-day, 182-day, and 364-day papers remained unchanged at 6.4%, 7.2% and 9.8%. The acceptance rate dropped to 86.5% from 94.3%, recorded the previous week, with the government accepting Kshs 23.7 bn of the Kshs 27.4 bn bids received.

The 91-day T-bill is currently trading at a yield of 6.4%, which is below its 5-year average of 8.6%. 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.

For the month of October, the National Treasury issued a tax-exempt 16-year Kshs 60.0 bn infrastructure bond (IFB1/2019/16) with market-determined coupon rates for the purpose of financing the infrastructure projects in the FY 2019/20 budget estimates. The bond was oversubscribed as per our expectations due to its tax-free incentive that translates to higher returns, receiving bids totaling Kshs 86.9 bn of the Kshs 60.0 bn on offer, translating to a subscription rate of 144.9%. The weighted average rate of accepted bids was at 12.4% in line with our expectations of 12.3% - 12.5%.

In the money markets, 3-month bank placements ended the week at 8.5% (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 10.2%, which was a 0.1% increase from 10.1% recorded in the previous week. The Cytonn Money Market Fund closed the week at 11.0%, from 10.9% recorded the previous week.

**Secondary Bond Market:**

The yields on government securities in the secondary market remained relatively stable during the month of October, as the Central Bank of Kenya continued to reject expensive bids in the primary market. On a YTD basis, government securities on the secondary market have gained with yields declining across the board, which has, in turn, led to price appreciation.

**Liquidity:**

Liquidity in the money markets remained favourable during the month of October despite the average interbank rate rising to 7.0%, from 6.5% recorded in September, supported by Government open market activities, which offset tax payments. During the week, the average interbank rate dropped to 6.4% from 6.9% recorded the previous week, pointing to increasing liquidity in the money markets. The average interbank volumes rose by 33.5% to Kshs 17.4 bn, from Kshs 13.1 bn recorded the previous week.

**Kenya Eurobonds:**

According to Reuters, the yield on the 10-year Eurobond issued in June 2014 decreased by 0.2% points to 5.4% in October, from 5.6% in September 2019. During the week, the yield on the 10-year Eurobond remained stable at 5.4% similar to the previous week.

During the month, the yields on the 10-year and 30-year Eurobond issued in February 2018 both declined by 0.3% points to close at 6.4% from 6.7% in September and at 7.8% from 8.1% in September, respectively. During the week, the yield on the 10-year and 30-year Eurobond remained unchanged at 6.4 and 7.8%, respectively.

During the month, the yields on the newly issued dual-tranche Eurobond with 7-years declined by 0.2% points to 6.2% from 6.4% in September 2019. The 12-year Eurobond also declined by 0.2% points to 7.2% from 7.4% recorded in September 2019. During the week, the yields on the 7-year Eurobond declined by 0.2% points to 6.1% from 6.3% the previous week, while the 12-year Eurobond remained unchanged at 7.2%.

**Kenya Shilling:**

The Kenya Shilling appreciated by 0.7% against the US Dollar during the month of October to Kshs 103.2 from Kshs 103.9 at the end of September, supported by inflows from diaspora remittances and portfolio investors buying government debt. During the week, the Kenya Shilling remained stable against the US Dollar to close at Kshs 103.3, which was similar to the value recorded in the previous week. On a YTD basis, the shilling has depreciated by 1.4% against the US 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:

?. 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%,

i. Improving diaspora remittances, which have increased cumulatively by 8.0% in the 12-months to September 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:
   ?. Increased uptake of financial products by the diaspora due to financial services firms, particularly banks, targeting the diaspora, and,
   a. New partnerships between international money remittance providers and local commercial banks making the process more convenient,

ii. CBK's supportive activities in the money market, such as repurchase agreements and selling of dollars, and,

iii. High levels of forex reserves, currently at USD 9.0 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.

**Inflation:**

**Major Inflation Changes in the Month of October 2019**

| Broad Commodity Group | Price change m/m (October-19/August-19) | Price change y/y (October-19/October-18) | Reason |
|---|---|---|---|
| Food & Non-Alcoholic Beverages | 0.5% | 8.7% | The m/m increase was due to an increase in prices of commodities such as maize flour-sifted and tomatoes |
| Transport Cost | (0.3%) | 2.5% | The m/m decline was mainly on account of the reduction in pump prices of diesel and petrol by 1.0% and 4.2%, respectively. |
| Housing, Water, Electricity, Gas and other Fuels | 0.1% | 0.9% | The m/m increase was mainly as a result of an increase in prices of some cooking fuels following the 0.4% increase in kerosene prices |
| **Overall Inflation** | **0.3%** | **4.95%** | **The m/m increase was due to a 0.5% increase in the food index which has a CPI weight of 36.0%** |

The y/y inflation for the month of October increased to 4.95%, from 3.8% recorded in September, which exceeded our projections of an increase to 4.4%-4.8%. Month-on-month inflation also increased by 0.3%, which was attributable to:

?. A 0.5% increase in the food and non-alcoholic drinks' index, due to an increase in prices of significant food items including maize grain-loose, maize flour-sifted and tomatoes which increased by 5.8%, 4.6% and 4.4 %, respectively

i. A 0.1% increase in the housing, water, electricity, gas and other fuels index, as a result of an increase in prices of some cooking fuels such as kerosene which increased by 0.4%, and

ii. A 0.3% decline in the transport index on account of the reduction in pump prices of diesel and petrol by 1.0% and 4.2%, respectively.

**Monthly Highlight:**

During the week, World Bank Group released the Kenya Economic Update October 2019. Below are the key take-outs from the report:

1. **Economic Growth:** Kenya's economic growth is estimated to be 5.8% in 2019 supported by a pickup of the economy in H2'2019, evidenced by (i) the nascent recovery in private sector credit, which grew by 6.3% in August, (ii) positive business sentiment, and (iii) the improved weather conditions expected to boost agricultural activities. However, risks of fiscal slippage and incidences of drought are expected to negatively affect the economy going forward. Externally, spill over effects from ongoing global slowdown could affect the demand.

Below is a table showing average projected GDP growth for Kenya in 2019 with an upward readjustment of the World Bank; 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 | Q4'2019 |
|---|---|---|---|---|---|
| **1.** | Central Bank of Kenya | 6.3% | 6.3% | 6.3% | 6.3% |
| **2.** | Euromonitor International | 5.9% | 5.9% | 6.3% | 6.3% |
| **3.** | Citigroup Global Markets | 6.1% | 6.1% | 6.1% | 6.1% |
| **4.** | PNB Paribas | 6.0% | 6.0% | 6.1% | 6.1% |
| **5.** | The National Treasury | 6.2% | 6.2% | 6.0% | 6.0% |
| **6.** | African Development Bank (AfDB) | 6.0% | 6.0% | 6.0% | 6.0% |
| **7.** | UK HSBC | 6.0% | 6.0% | 6.0% | 6.0% |
| **8.** | Cytonn Investments Management Plc | 5.8% | 5.8% | 5.8% | 5.8% |
| **9.** | World Bank* | 5.8% | 5.7% | 5.7% | 5.8% |
| **10.** | Euler Hermes | 5.7% | 5.7% | 5.7% | 5.7% |
| **11.** | International Monetary Fund (IMF) | 6.1% | 5.8% | 5.6% | 5.6% |

**Kenya 2019 Annual GDP Growth Outlook**

| No. | Organization | Q1'2019 | Q2'2019 | Q3’2019 | Q4’2019 |
|---|---|---|---|---|---|
| **12.** | Focus Economics | 5.8% | 5.8% | 5.6% | 5.6% |
| **13.** | JPMorgan | 5.7% | 5.7% | 5.6% | 5.6% |
| **14.** | Oxford Economics | 5.6% | 5.6% | 5.6% | 5.6% |
| | **Average** | **5.9%** | **5.9%** | **5.9%** | **5.9%** |

***Revised Growth rates for Q4’2019**

2. **Inflation and Monetary Policy:** Headline inflation averaged 5.2% as a result of low energy prices, which offset the food inflation in H1’2019. Core inflation decreased in September due to subdued demand pressures. The low inflation levels have been supported by a stable currency,
3. **Current Account:** Current account deficit narrowed to 4.0% of GDP in the year to August, supported by lower imports, diaspora remittance inflows and improved tourism. The current account deficit continues to be financed by borrowings and an increase in foreign reserves,
4. **Government Debt:** The country’s total debt stock rose by 16.0% to Kshs 5.8 tn in June 2019 from Kshs 5.0 tn in the year to June 2018, with the domestic debt accounting for 48.0% of the total debt (2.8 tn) while foreign debt amounted to 52.0% (Kshs 3.0 tn). The country continues to access international markets to refinance its external debt. Some of the activities included a Eurobond issuance of USD 2.1 bn to refinance the payments from the first Eurobond of USD 750.0 mn, with the balance going to budgetary support. Domestic interest payments to tax revenue has increased to 18.2% from 16.3% recorded last year. With 43.0% of the domestic debt expected to mature within a year, the government is expected to face challenges in the rollover of the bonds as a result of low subscription rates, and if the repeal of the interest rate cap is approved, operating in a country with no interest rate caps would reduce lending to the government. The country’s total debt at Kshs 5.8 tn, is 62.3% of GDP, which is above the 50.0% debt to GDP threshold, but below the 70.0% debt to GDP level that signifies a country in debt distress. External debt currently accounts for 52.0% of the total debt stock. Going forward, we expect the debt service obligations to continue to impose fiscal pressures on the country with the need to repay the debt obligations both domestically and externally. The raising of the borrowing ceiling to Kshs 9 tn would drive the country into debt distress levels owing to the country’s current debt position, as highlighted in our Debt Sustainability note.

In conclusion, the macroeconomic environment in Kenya remains stable with low inflation and a manageable current account deficit. However, interest rate caps have reduced the effectiveness of the monetary policy transmission and constrained the operating environment for the banking sector. If the interest rate cap is removed, the potency of the monetary policy will be restored. Despite a reduction in the fiscal deficit from 9.1% of GDP in FY 2016/17 to 7.4% of GDP in FY 2017/18, the fiscal deficit expanded to 7.7% in FY 2018/19 compared to a target deficit of 6.8% of GDP. The fiscal deficit at 0.9% points above the target is due to revenue shortfalls and expenditure pressures.

***Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. Despite the rise in net revenue collections in Q1’2019 by 13.1% to Kshs 372.3 bn from Kshs 329.2 bn recorded in a similar period last year, we still don’t expect the government to meet the Kshs 2.1 tn revenue target for FY’2019/2020, 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.***

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