Cytonn Monthly November 2019

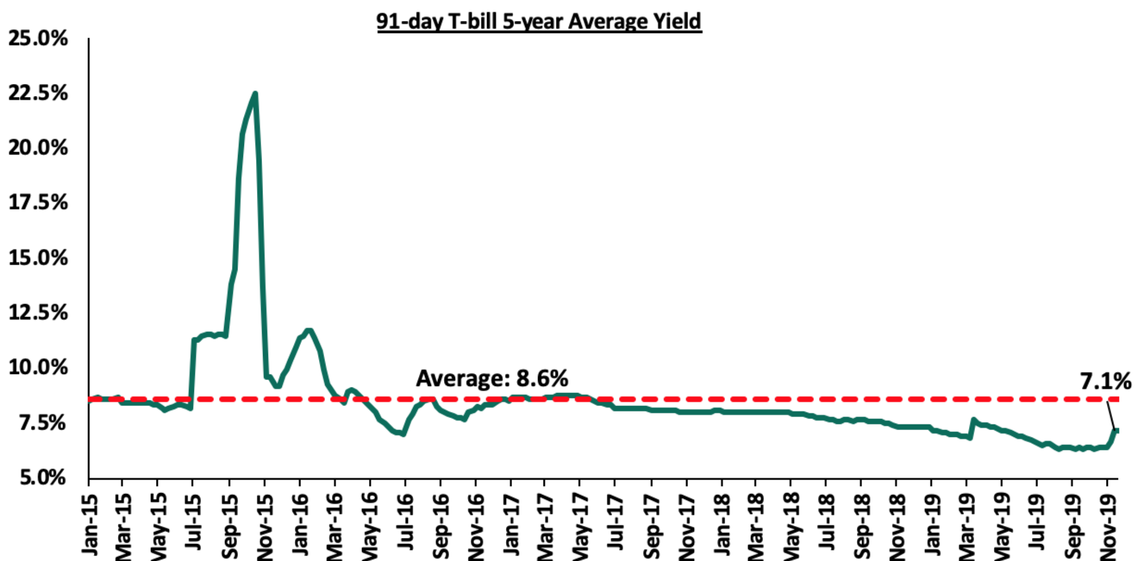
Fixed Income

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

During the month of November, T-bills remained undersubscribed, with the overall subscription rate coming in at 90.2%, compared to 84.5% recorded in the month of October 2019. The continued undersubscription has partly been attributed to investors holding back in anticipation of a potential increase in the risk premium for government securities following the repeal of the interest rate cap, which is expected to result in an increase in interest rates. This has seen the bond turnover declining by 2.2% to Kshs 35.0 bn in November from Kshs 35.8 bn in October. The subscription rates for the 91-day and the 364–day came in at 78.3% and 152.1%, a decline from 79.4% and 155.5% recorded in October, respectively. The subscription rates for the 182-day T-bill however increased to 33.1%, from 15.6% recorded in October. The yields on the 91-day and 182-day T bills increased by 0.7% points and 1.0% points to 7.1% and 8.2%, from 6.4% and 7.2%, respectively. The yield on 364-day paper however remained unchanged at 9.8%. The Central Bank remained disciplined in rejecting expensive bids in order to ensure the stability of interest rates.

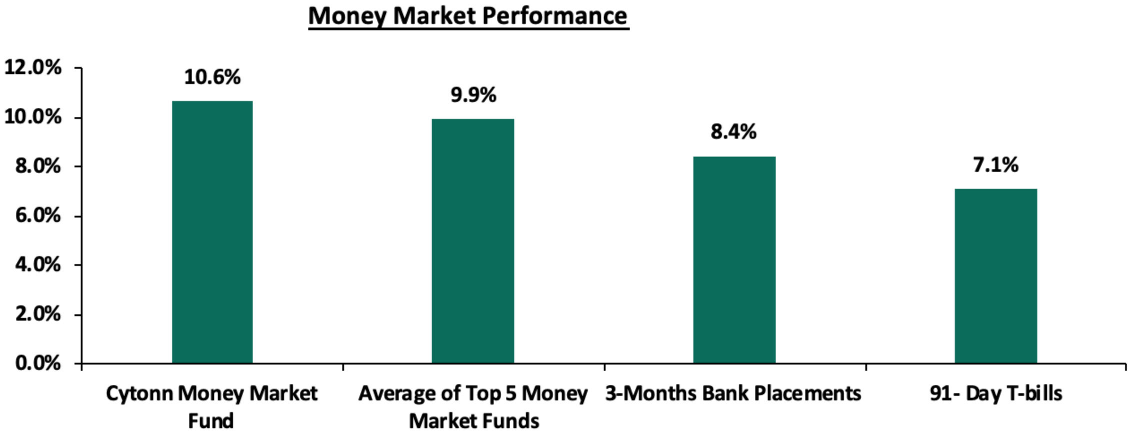
During the week, T-bills continued to be undersubscribed, with the subscription rate coming in at 34.8%, down from 56.2% the previous week. The yield on the 91-day, 182-day, and 364-day papers remained unchanged at 7.1%, 8.2% and 9.8%, respectively. The acceptance rate dropped to 59.7%, from 88.4% recorded the previous week, with the government accepting Kshs 5.0 bn of the Kshs 8.4 bn bids received.

The 91-day T-bill is currently trading at a yield of 7.1%, which is below its 5-year average of 8.6%. The increasing yield on the 91-day paper is mainly attributable to the repeal of interest rate caps.



During the week, the National Treasury issued a Kshs 21.7 bn tap sale for FXD 4/2019/10, with a coupon rate of 12.3% for budgetary support, following the low reception in the initial issue, which was undersubscribed with the subscription rate coming in at 76.8%, which saw the Kenyan

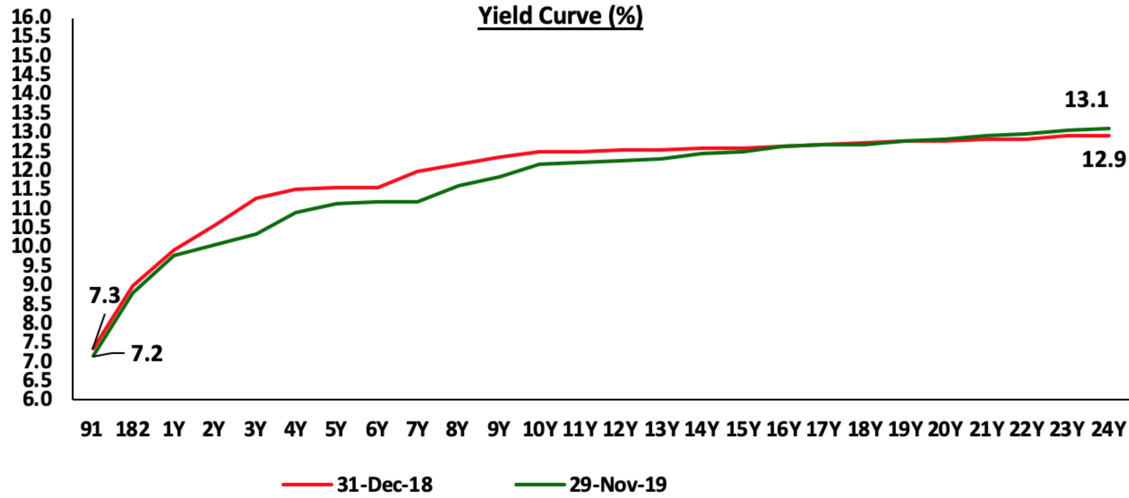
Government only managing to raise Kshs 28.4 bn, lower than Kshs 50.0 bn issued. The tap sale was undersubscribed, with the subscription rate coming in at 37.5%, on the back of an expected increase in private sector credit with banks now looking to lend to the private sector, due to the interest rate cap repeal. The acceptance rate on the bond was 100.0%, with the government accepting Kshs 8.1 bn of the Kshs 8.1 bn bids received.



In the money markets, 3-month bank placements ended the week at 8.4% (based on what we have been offered by various banks), the 91-day T-bill came in at 7.1%, while the average of Top 5 Money Market Funds came in at 9.9%, unchanged from the previous week. The Cytonn Money Market Fund closed the week at 10.6%, unchanged from the previous week.

Secondary Bond Market:

The yields on government securities in the secondary market remained relatively stable during the month of November, as the Central Bank of Kenya continued to reject expensive bids in the primary market. On an YTD basis, government securities on the secondary market have gained with yields declining across the board except for the 20-year and 23-year securities.

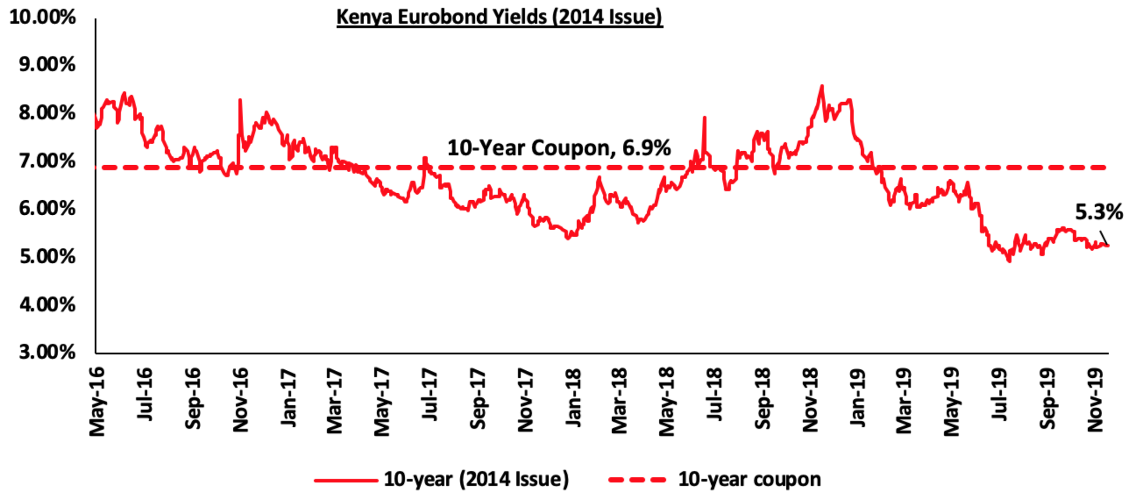


Liquidity:

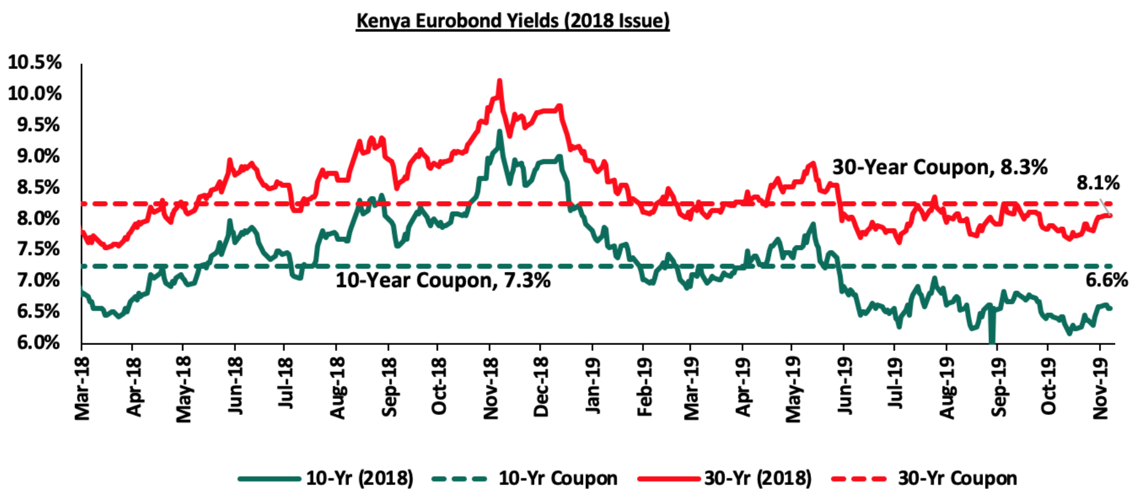
Liquidity in the money markets improved during the month of November with the average interbank rate declining to 4.1%, from 7.0% recorded in October, supported by government open market activities such as selling the dollar to increase dollar liquidity, which offset tax payments. During the week, the average interbank rate increased to 4.7%, from 3.4% recorded the previous week, pointing to tightening of liquidity in the money markets attributed to the aggressive mobilization of revenue and cutting down by the government and cutting down on spending. The average interbank volumes rose by 31.7% to Kshs 23.8 bn, from Kshs 18.0 bn recorded the previous week.

Kenya Eurobonds:

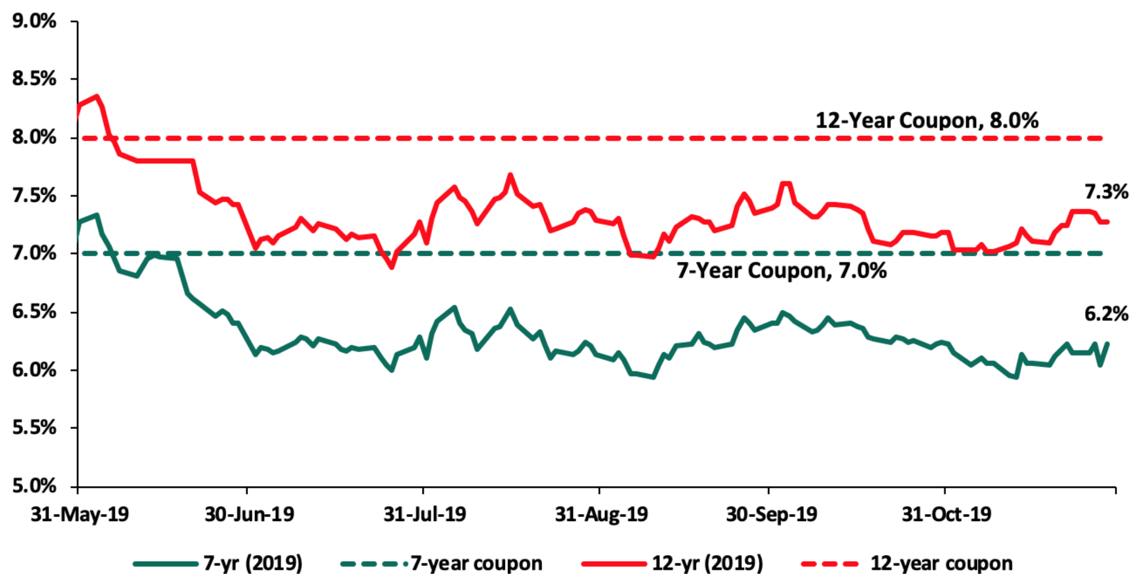
According to Reuters, the yield on the 10-year Eurobond issued in June 2014 decreased by 0.1% points to 5.3% in November, from 5.4% in October 2019. During the week, the yield on the 10-year Eurobond remained stable at 5.3%, similar to the previous week.



During the month, the yields on the 10-year and 30-year Eurobond issued in February 2018 both increased by 0.2% points and 0.3% points to close at 6.6% from 6.4% in October and at 8.1% from 7.8% in October, respectively. During the week, the yield on the 10-year remained unchanged at 6.6% while the 30-year Eurobond, increased by 0.1% points to 8.1%, from 8.0% previously.



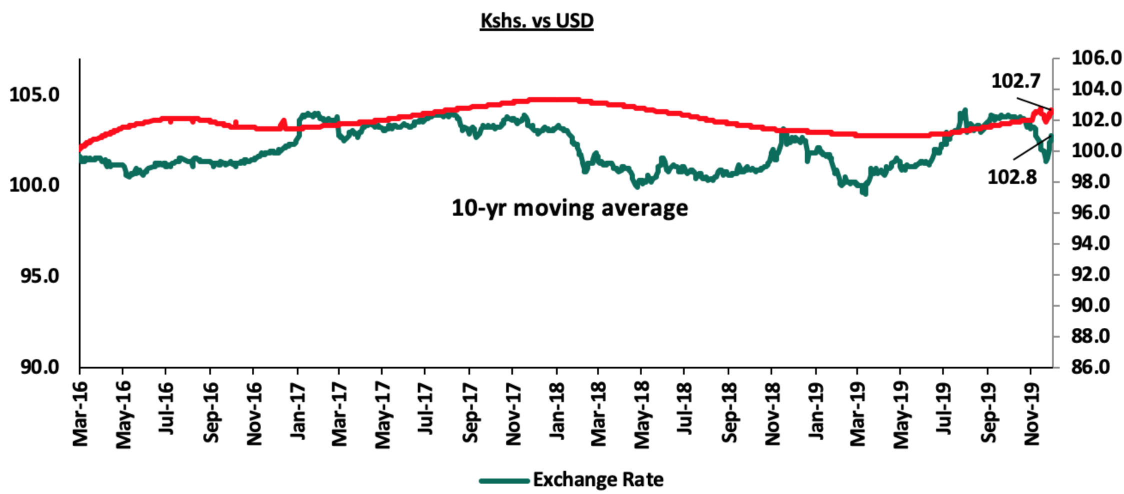
During the month, the yields on the newly issued dual-tranche Eurobond with 7-years remained unchanged at 6.2% from the previous month. The 12-year Eurobond however increased by 0.1% points to 7.3% from 7.2% recorded in October 2019. During the week, the yields on the 7-year Eurobond increased by 0.1% points to 6.2% from 6.1% the previous week, while the 12-year Eurobond decreased by 0.1% points to 7.3%, from 7.4% previously.



Kenya Shilling:

The Kenya Shilling appreciated by 0.4% against the US Dollar during the month of November to Kshs 102.8, from Kshs 103.2 at the end of October, supported by inflows from diaspora remittances and portfolio investors buying government debt. During the week, the Kenya Shilling depreciated by 1.4% against the dollar to close at Kshs 102.8, owing to a surge in end month dollar demand from merchant importers and the energy sector. On a YTD basis, the shilling has depreciated by 0.9% 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 7.0% in the 12-months to October 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. Foreign capital inflows, with investors looking to participate in the equities market,
iv. CBK's supportive activities in the money market, such as repurchase agreements and selling of dollars, and,
v. High levels of forex reserves, currently at USD 8.7 bn (equivalent to 5.4-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 November 2019

Broad Commodity Group	Price change m/m (November-19/October-19)	Price change y/y (November-19/November-18)	Reason
Food & Non-Alcoholic Beverages	0.6%	9.6%	The m/m increase was due to an increase in prices of some foodstuffs such as Irish potatoes, maize flour- sifted and tomatoes
Transport Cost	0.3%	2.0%	The m/m increase was mainly on account of the increase in pump prices of diesel and petrol by 2.2% and 2.0%, respectively.
Housing, Water, Electricity, Gas and other Fuels	0.3%	2.5%	The m/m increase was mainly as a result of an increase in cost of house rent and cooking fuel, following the 2.5% increase in Kerosene prices
Overall Inflation	**0.4%**	**5.56%**	**The m/m increase was due to a 0.6% increase in the food index which has a CPI weight of 36.0%**

The y/y inflation for the month of November increased to 5.6%, from 4.95% recorded in October, which exceeded our projections of an increase to 5.2% - 5.4% with the variance mainly due to the 0.6% rise in the food and non-alcoholic drinks' index, which exceeded our expectations of a 0.2% rise. Month-on-month inflation also increased by 0.4%, which was attributable to:

i. A 0.6% increase in the food and non-alcoholic drinks' index, due to an increase in prices of significant food items including maize flour-sifted and tomatoes, which increased by 4.3% and 6.1%, respectively,
ii. A 0.3% 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 2.5%, and,
iii. A 0.3% increase in the transport index on account of the increase in pump prices of diesel and petrol by 2.2% and 2.0%, respectively.

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

Monthly Highlights:

The Monetary Policy Committee (MPC) met on 25th November 2019 to review the prevailing macroeconomic conditions and decide on the direction of the Central Bank Rate (CBR). The MPC lowered the Central Bank Rate (CBR) by 50 bps to 8.5% from 9.0%, in line with our expectations, citing that inflation expectations remained well anchored within the target range and that the economy was operating below its potential level, as evidenced by:

i. Month on month inflation remained within the 2.5% - 7.5% target range, largely driven by stable food prices and lower cost of energy. Inflation stood at 4.9% in October an increase from 3.8% recorded in September, due to temporary effects of increase in prices of maize grain,
ii. Stability in the foreign exchange market supported by the narrowing of the current account deficit to 4.1% of GDP in the 12-months to September 2019, from 5.1% in September 2018, driven by strong receipts from transport and tourism services, resilient diaspora remittances and lower imports of food and SGR related equipment. The foreign exchange market has also been supported by adequate forex reserves currently at USD 8.8 bn (equivalent to 5.5-months of import cover), that continue to provide adequate cover and a buffer against short-term shocks in the foreign exchange market, and,
iii. Improving private sector credit growth, despite being below historical averages, coming in at 6.6% in the 12-months to October. Strong growth in credit to the private sector was being observed in the consumer durables (28.6%), private households (6.9%) and trade (8.5%).

As such, the MPC concluded that due to the tightening of fiscal policy, there was room for accommodative monetary policy to support economic activity. The committee also pointed out that there was a need to remain vigilant on possible effects of the increased uncertainties in the external environment. In the short and medium-term, we expect the Central Bank Rate to remain stable.

During the week, rating agency Moody’s released its rankings. In the rankings Moody’s maintained Kenya’s sovereign credit rating at B2 and described the outlook as stable reflecting its expectations of a relatively strong economic growth, neutralized by large fiscal deficits and debt. Kenya’s rank was maintained at B2, owing to the high levels of public debt driven by high fiscal deficits, as well as weak institutions.

According to Moody’s Kenya’s debt to GDP ratio increased to 62.0% at the end of 2019 from 49.0% in 2015. The institution however, noted that Kenya has a diversified economy with multiple growth sources, favorable prospects and resilience to shocks. The agency also noted the deep capital markets and a mature financial services sector relative to regional peers as some of the strengths. Factoring the current debt levels and the risks abound in the medium term, we are of the view that in order to reduce our debt levels, in line with the IMF sustainable levels of 50.0%, the government should consider achieving:

i. Enhanced tax revenue collection growth,
ii. Involve the private sector in development through Public-Private Partnerships (PPP’s),
iii. Continue with the fiscal consolidation efforts aimed at reducing recurrent expenditure and improve on development budget absorption rates,
iv. Enhancing the capacity of the Public Debt Management Office and ensure the implementation of the Medium-Term Debt Management Strategies as outlined every financial year, and
v. Ensure an enabling environment that promotes Macro-economic stability as it is a critical component for debt sustainability.

For more information see our debt sustainability note (here)

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. The government is 5.9% behind its domestic borrowing target, having borrowed Kshs 119.5 bn against a pro-rated target of Kshs 127.1 bn. We expect an improvement in private sector credit growth considering the repeal of the interest rate cap. This will result in increased competition for bank funds from both the private and public sectors, resulting in upward pressure on interest rates. Owing to this, our view is that investors should be biased towards short-term fixed-income securities to reduce duration risk.