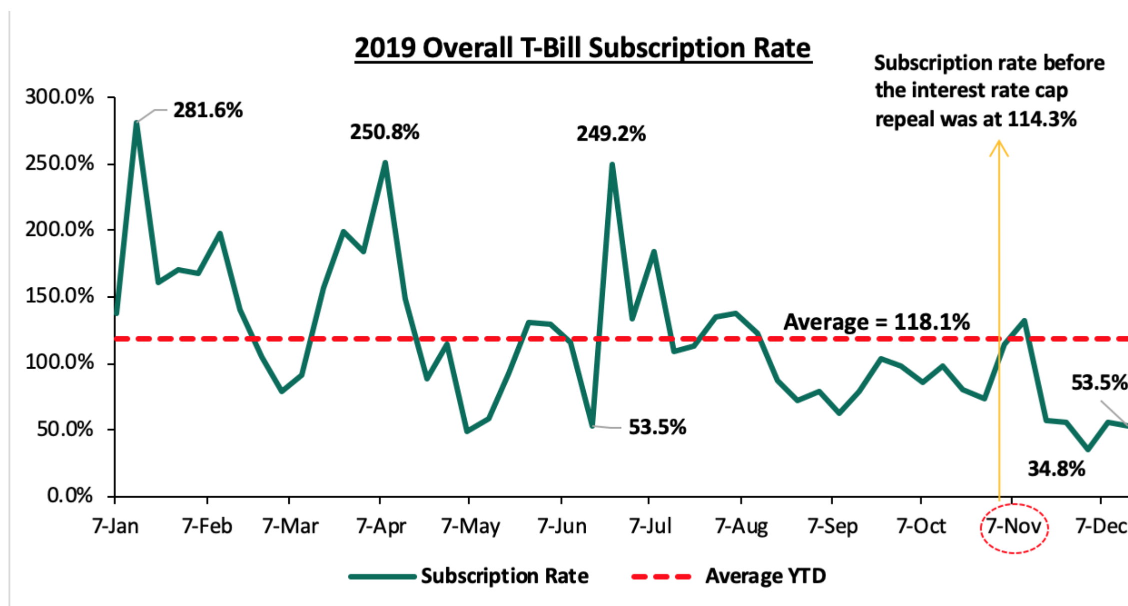
Market Post Interest Rate Cap & Cytonn Weekly #50/2019

Fixed Income

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

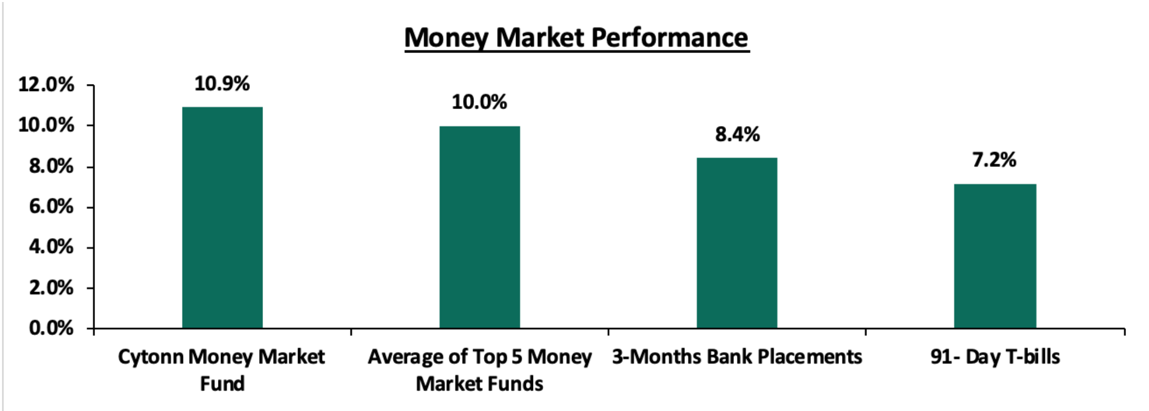
During the week, T-bills remained undersubscribed, with the subscription rate coming in at 53.5%, down from 55.3% the previous week. The undersubscription is attributable to reduced participation by banks who are now looking to lend to the private sector following the repeal of the rate cap legislation. The yield on the 91-day and 364-day paper remained unchanged at 7.2% and 9.8%, respectively, while that of the 182-day paper declined by 0.1% points to 8.1%, from 8.2% recorded last week. The acceptance rate increased to 99.2%, from 44.7% recorded the previous week, with the government accepting Kshs 12.7 bn of the Kshs 12.8 bn worth of bids received.

It is important to note that only a month after the repeal of the Interest Rate cap (7th Nov), the overall subscription rate has declined to lows of 34.8%, which is 83.3% points lower than the YTD average of 118.1%. We attribute this to reduced demand for government paper from the banking sector following the repeal of the interest rate cap. Below is a chart highlighting the performance through the year:



For the month of December, the National Treasury issued a 5-year bond of Kshs 25.0 bn (FXD 3/2019/5) with a coupon rate of 11.5%. The bond was oversubscribed, with the subscription rate coming in at 113.9%. The continued high demand for short tenor bonds has been attributable to the negative bias by investors on longer-tenor bonds due to the relatively flat yield curve on the long-end brought about by the saturation of long-term bonds, coupled with the duration risk associated with long-term papers, thus making the short tenor bonds more attractive. The bond yield for the issue

came in at 11.6%, while the acceptance rate on the bond was 65.8%, with the government accepting Kshs 18.7 bn of the Kshs 28.5 bn worth of bids received.



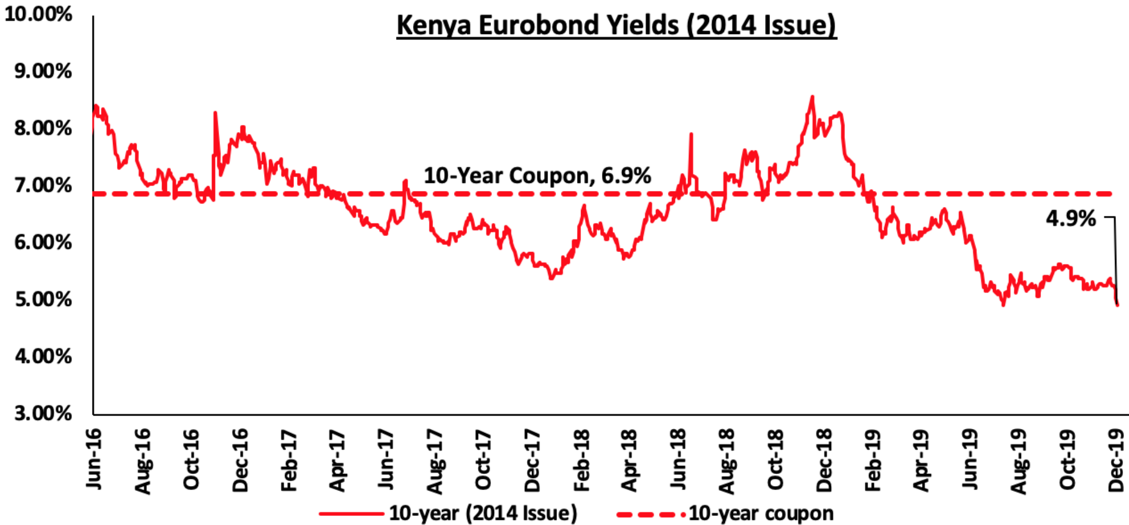
In the money markets, 3-month bank placements ended the week at 8.4% (based on what we have been offered by various banks), the 91-day T-bill came in at 7.2%, while the average of Top 5 Money Market Funds came in at 10.0% from 9.9% recorded the previous week. The Cytonn Money Market Fund, increased by 0.2% points to close the week at 10.9%, from 10.7% recorded in the previous week.

Liquidity:

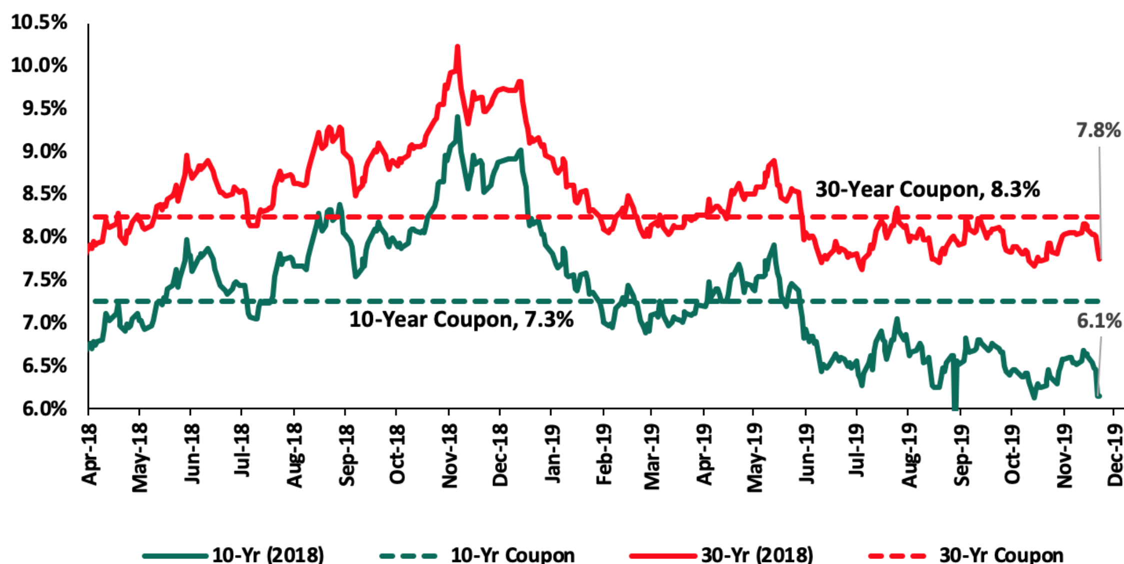
During the week, the average interbank rate increased to 6.6%, from 6.3% recorded the previous week, pointing to tightened liquidity in the money markets; this performance was mainly driven by banks trading cautiously in the interbank market in order to meet their CRR cycle requirements for the period ending December 15th 2019. This saw commercial banks excess reserves come in at Kshs 13.1 bn in relation to the 5.25% cash reserves requirement (CRR). The average interbank volumes increased by 24.3% to Kshs 29.3 bn, from Kshs 23.6 bn recorded the previous week.

Kenya Eurobonds:

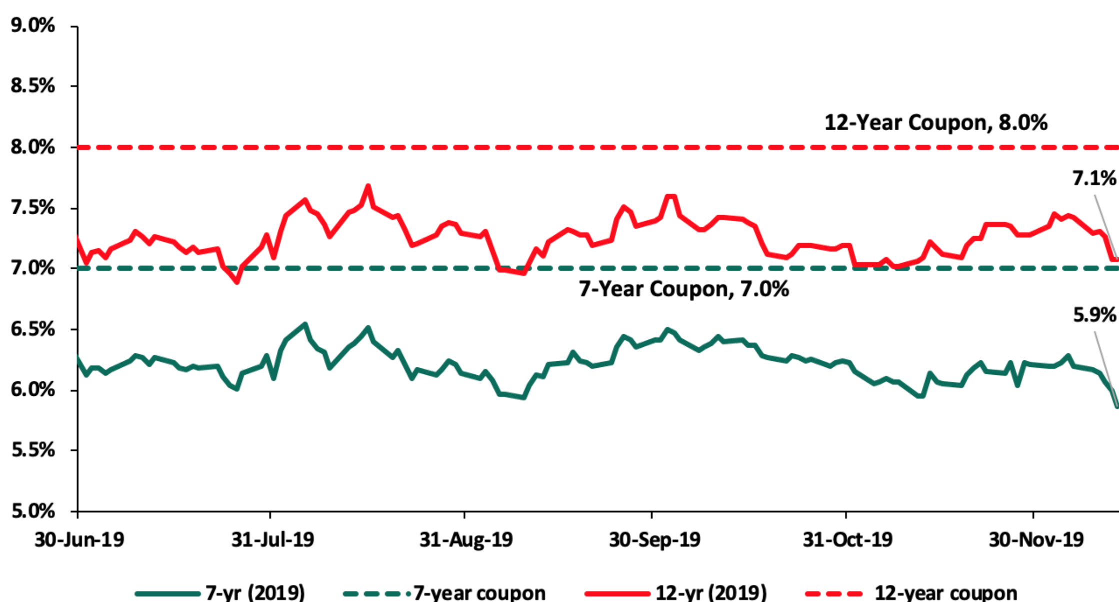
According to Reuters, the yield on the 10-year Eurobond issued in June 2014, decreased by 0.4% points to 4.9%, from 5.3%, as recorded in the previous week. Eurobond yields were on the decline as a result of the Fitch’s credit Rating released earlier during the week, affirming that Kenya’s Long-Term Foreign-Currency Issuer Default Rating was at B+ with a stable outlook.



During the week, the yields on the 10-year Eurobond and the 30-year Eurobond both decreased by 0.5% points and 0.3% points, to 6.1% and 7.8%, from 6.6% and 8.1%, respectively.



During the week, the yield on the 7-year Eurobond decreased by 0.4% points to 5.9%, from 6.3% recorded the previous week, while the yield on the 12-year Eurobond decreased by 0.3% points to 7.1%, from 7.4% recorded the previous week.



Kenya Shilling:

During the week, the Kenya Shilling appreciated marginally against the US Dollar to close at Kshs 101.7, from Kshs 101.8 recorded the previous week, mostly attributable to diaspora remittances which helped to meet increased dollar demand from merchandise importers. On an YTD basis, the shilling has appreciated by 0.1% 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,

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 8.8 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.

Weekly Highlights

During the week, Fitch Ratings, an American credit rating agency, affirmed through a press release that Kenya's Long-Term Foreign-Currency Issuer Default Rating was at B+ with a stable outlook. This rating is informed by the country's high levels of debt, both domestic and external, against a strong and stable growth outlook. Some of the weaknesses highlighted in the report include administrative issues such as weak tax compliance and expansion of tax exemptions that have hindered revenue growth. These issues have caused the government's revenue collection to fall to an estimated 17.5% of GDP in the fiscal year ending June 2019, from highs of 19.0% seen in 2015. To curb this the government has, in the Finance Bill 2019;

i. Increased capital gains tax,
ii. Introduced a new excise tax, and
iii. A widening of withholding tax.

In FY'2019, Kenya's fiscal deficit expanded to 7.8%, higher than the 7.0% recorded in 2018. The slowdown in the large infrastructure development projects has lowered the capital expenditure costs, with capex falling below 6.0% of GDP from an average of 8.1% in FY'2015 to FY'2017. Fitch assumes in their release that the general government Debt-to-GDP ratio will continue increasing through FY'2022 to 64.8%, before easing very gradually to 60.5% by 2028.

In November 2019, Kenya's Parliament approved a change to the existing debt limit, moving it to a nominal limit of Kshs 9 tn, from 50.0% of GDP in net present value terms. The new debt limit is in line with the forecasts in the National Treasury's most recent Budget Review and Outlook Paper, which sees debt rising to just below the Kshs 9 tn ceiling by FY'2024. Fitch have forecasted a slower GDP growth to 5.6% in 2019, from 6.3% in 2018. This is informed by the slowdown in the economy, experienced in H1'2019 as drought impacted agricultural output, although growth in the services sector picked up.

The country has experienced an increase in inward Foreign Direct Investments (FDI), which rose to USD1.6 bn in 2018 after having fallen to USD400 mn in 2016. The inability to increase FDI has over the years increased Kenya's reliance on public external debt to finance the Current Account Deficit. Similarly, private sector credit growth has recovered to 7.0% as of September 2019, from 2.5% recorded in 2018. This recovery has been supported by the removal of the interest rate cap during the last quarter of the year. In our view, Kenya's relatively favourable macro-economic conditions have had a significant impact on the country's rating, despite the high levels of debt we are currently experiencing. This is good for the country since It builds the confidence in both local and foreign investors.

During the week, the Energy and Petroleum Regulatory Authority released their monthly statement on the maximum retail fuel prices in Kenya effective from 15th December 2019 to 14th January 2020. Below are the key take-outs from the statement:

- Petrol prices have declined marginally by 1.0% to Kshs 109.5 per litre, from Kshs 110.6 per litre previously, while diesel prices have declined by 2.7% to Kshs 101.8 per litre, from Kshs 104.6 per litre previously,
- Kerosene prices decreased by 1.7% to Kshs 102.3 per litre, from Kshs 104.1 per litre.

The changes in prices are attributable to:

- A decrease in the average landing cost of imported super petrol by 0.5% to USD 460.8 per cubic meter in November 2019, from USD 463.2 per cubic meter in October 2019,
- A decrease in the average landing costs of imported diesel by 3.4% to USD 485.3 per cubic meter in November 2019, from USD 502.2 per cubic meter in October 2019, and Kerosene decreasing by 3.8% to USD 481.1 per cubic meter in November 2019, from USD 499.9 per cubic meter in October 2019, and,
- The Free on Board (FOB) price of Murban crude oil lifted in November 2019 increased by 4.7% to USD 66.6 from USD 63.6, per barrel in October 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.

Rates in the fixed income market have remained relatively stable as the government rejects expensive bids. The government is 16.7 % ahead its domestic borrowing target, having borrowed Kshs 148.2 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.