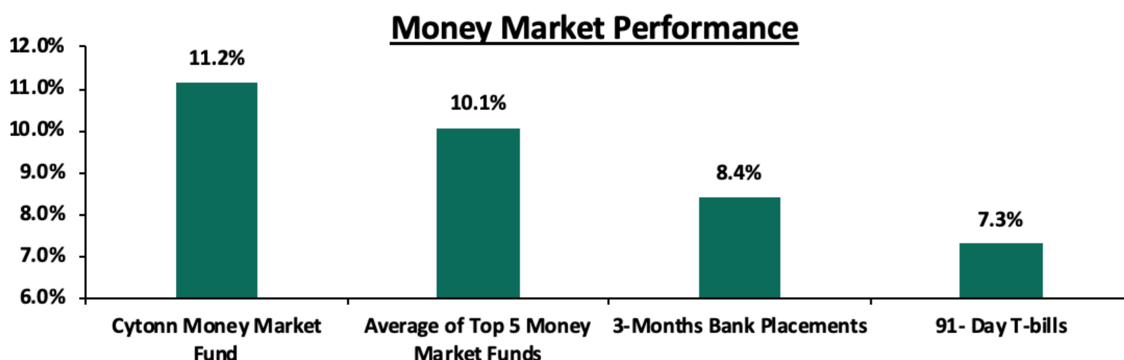
Is There a Real Estate Bubble in Kenya? & Cytonn Weekly #04/2020

Fixed Income

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

During the week, T-bills remained oversubscribed, with the subscription rate coming in at 145.9%, up from 118.1% recorded the previous week, and higher than the YTD average of 111.2%. The oversubscription is attributable to improved liquidity in the market during the week, supported mainly by government payments, which partly offset tax remittances. We note that the 364-day paper continued to receive the most interest from investors, having recorded the highest subscription rate of the 3 papers, at 217.1%. This is attributable to the market currently pricing that the government will be under pressure to meet its domestic borrowing target, and as such a bias to shorter-dated papers in order to avoid duration risk, which has seen most investors still keen on the primary fixed income market, finding the 364-day T-bill more attractive on a risk-adjusted return basis, compared to a two year bond with a yield of 10.4%. The yields on the 91-day, 182-day and 364-day papers increased by 4.7 bps, 4.5 bps and 1.7 bps to 7.3%, 8.2%, and 9.9%, respectively. The acceptance rate declined to 77.0%, from 80.1% recorded the previous week, with the government accepting Kshs 26.9 bn of the Kshs 35.0 bn worth of bids received.

During the month of January, the government reopened two bonds, FXD1/2019/5 and FXD1/2019/10, in a bid to raise Kshs 50.0 bn for budgetary support. The FXD1/2019/5 and FXD1/2019/10 had an effective tenor of 4.1-years and 9.1-years, and coupon rates of 11.3% and 12.4%, respectively, with the overall subscription rate coming in at 139.9%. Further to this, we note that there was pent up demand on the FXD1/2019/5, which received bids worth Kshs 44.5 bn of the Kshs 69.9 bn worth of bids received for both bonds, in line with our expectations that investors will be attracted to the shorter-term paper due to its relatively shorter tenor, thus, reduced duration risk, coupled with the high liquidity in the market. The yields came in at 11.5% and 12.5% for the 5-year and 10-year bonds, respectively, with the government accepting Kshs 63.7 bn out of the Kshs 69.9 bn worth of bids received, translating to an acceptance rate of 91.1%. We note that this was higher than the quantum of Kshs 50.0 bn for the issue, emphasizing the government's aggressiveness in accepting money in an effort to meet its domestic borrowing target.



In the money markets, 3-month bank placements ended the week at 8.4% (based on what we have

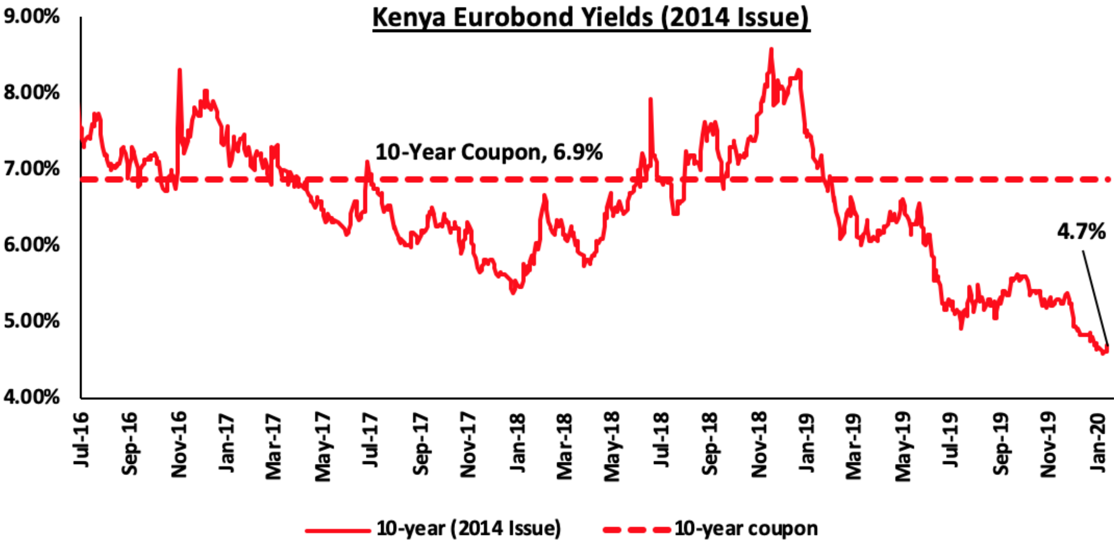
been offered by various banks), the 91-day T-bill came in at 7.3%, while the average of Top 5 Money Market Funds came in at 10.1%, unchanged from the previous week. The yield on the Cytonn Money Market increased marginally by 0.1% points to close at 11.2%, from the 11.1% recorded the previous week.

Liquidity:

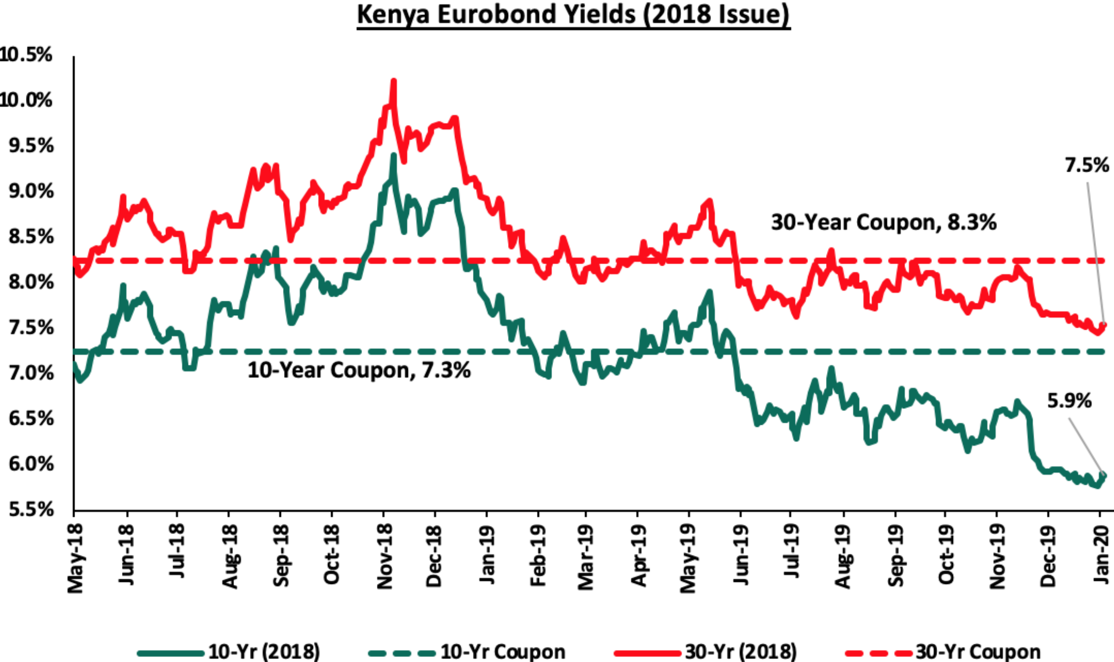
During the week, the average interbank rate increased marginally to 3.9%, from 3.8% recorded the previous week. The average interbank rate is way below the 2019 average of 4.3%, an indication of the improved liquidity position in the money markets, supported by government payments and debt maturities, with commercial banks' excess reserves coming in at Kshs 28.2 bn in relation to the 5.25% cash reserves requirement (CRR). The average interbank volumes increased by 17.6% to Kshs 13.2 bn, from Kshs 11.2 bn recorded the previous week.

Kenya Eurobonds:

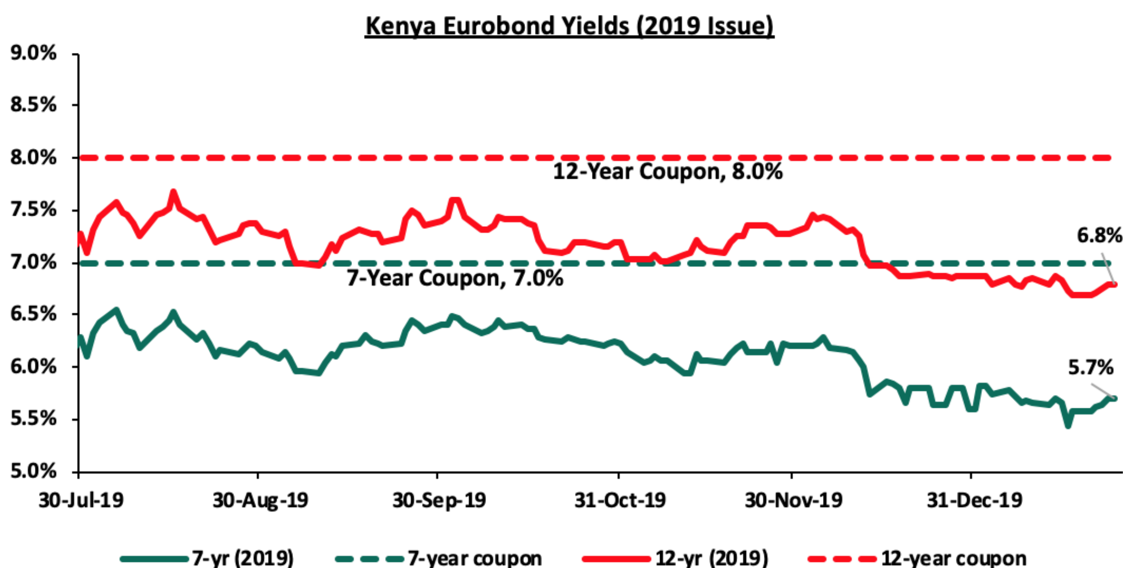
According to Reuters, the yield on the 10-year Eurobond issued in June 2014 increased marginally by 0.1% points to 4.7%, from 4.6% recorded the previous week.



During the week, the yields on the 10-year Eurobond increased marginally to 5.9%, from 5.8% seen the previous week, while that of the 30-year Eurobond remained unchanged at 7.5%.



During the week, the yield on the 7-year Eurobond increased by 0.1% points to 5.7%, from 5.6% recorded the previous week. The yield on the 12-year Eurobond also increased by 0.1% points to 6.8%, from 6.7% recorded the previous week.



Kenya Shilling:

During the week, the Kenya Shilling appreciated marginally by 0.1% against the US Dollar to close at Kshs 100.9, from 101.0 recorded the previous week, mostly supported by dollar inflows from horticulture exports and offshore investors buying government debt. On an YTD basis, the shilling has appreciated by 0.4% against the dollar, in comparison to the 0.5% appreciation in 2019. In our view, the shilling should remain relatively stable against the dollar in the short term, with a bias to a 2.4% depreciation by the end of 2020, supported by:

i. The narrowing of the current account deficit, with preliminary data indicating that Kenya's current account deficit in Q3'2019 was equivalent to 8.2% of GDP, from 9.3% recorded in Q3'2018. This was mainly driven by the narrowing of the country's merchandise trade deficit balance (a scenario where imports are greater than exports) by 6.7%, and a rise in secondary income transfers (transfers recorded in the balance of payments whenever an economy provides or receives goods, services, income or financial items) by 4.3%,
ii. Foreign capital inflows, with investors looking to participate in the domestic equities market, and,
iii. CBK's supportive activities in the money market, such as repurchase agreements and selling of dollars.

We, however, expect pressure on the Kenyan shilling to arise from:

i. Increased oil imports bill, as a result of the U.S - Iran diplomatic row, which has seen average crude oil prices increase by 9.9% to an eight-month high to USD 72.0 a barrel in Jan 2020, from USD 65.5 a barrel in December 2019, and,
ii. Subdued diaspora remittances growth following the close of the 10.0% tax amnesty window in July, which has seen cumulative diaspora remittances increase by a 3.7% in the 12-months to December 2019 to USD 2.8 bn, from USD 2.7 bn in 2018.

Monetary Policy:

The Monetary Policy Committee (MPC) is set to meet on Monday, 27th January 2020, to review the prevailing macro-economic conditions and decide on the direction of the Central Bank Rate (CBR). In their previous meeting held on 25th November 2019, the MPC lowered the CBR by 50 bps to 8.5% from 9.0%, citing that the economy was operating below its potential level concluding that there was room for accommodative monetary policy to support economic activity. This was in line with our

expectations as per our MPC Note, with our view being informed by:

1. The need to stimulate growth, with GDP growth in 2019 having slowed down averaging 5.6% in H1'2019 lower than 6.4% in H1'2018 and below the CBK's estimated growth at 6.3%. With the plans of the continued fiscal consolidation by the Government, we believed that a further cut would be necessary to provide the required economic growth stimulus, further boosted by the repeal of the interest rate cap, which going forward was expected to provide more efficient transmission of monetary policy as opposed to the interest rate cap era,
2. Inflation had remained contained and within the Government set target of 2.5%-7.5%, amid slowed economic growth, thus providing room for moderate stimulus through expansionary monetary policy, and,
3. A further reduction of the Central Bank Rate (CBR), coupled up with the interest rate cap repeal would provide the requisite stimulus to private sector credit growth which had remained below the 5-year average, having grown by 6.3% in the 12 months to August 2019, below the 5-year average of 11.0%.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.1% of GDP in the 12-months to September 2019 compared to 5.1% in September 2018, supported by strong growth in diaspora remittances. The decline was also partly attributable to higher receipts from the tourism and transport services as well as lower food and SGR-related equipment imports.

We expect the MPC to hold the CBR at 8.5%, with their decision being supported by:

1. Inflation has remained contained and within the Government set target of 2.5%-7.5%, with inflationary pressure gradually easing off, due to improved agricultural production thus causing a decline in food prices which has a weight of 36.0% in the Consumer Price Index following favourable weather conditions,
2. We foresee the Central Bank taking a wait and see approach as it observes the effects of the 50 bps rate cut done in the November 2019 meeting as there remains some opacity in terms of response from the banks and consumers. From the last MPC briefing, the Central Bank of Kenya (CBK) Governor indicated that following the interest rate cap repeal, re-learning by banks and consumers was essential so that the market can react appropriately to any monetary policy. The CBK Governor also indicated that they were re-calibrating their models so as to determine the effect of changes in the CBR on the other macro-economic indicators such as GDP and inflation over a certain period.

Based on this, we believe the MPC will hold the rates steady as they continue monitoring the market reactions of the previous cut.

For our detailed MPC analysis, please see our MPC Note for the 27th January 2020 meeting here.

Weekly Highlight:

During the week, the Treasury released the Draft 2020 Budget Policy Statement, which highlights the current performance of the country's economy and gives a medium-term outlook, in preparation for the FY2020/21 Budget for comments from the general public. The Budget Policy Statement (BPS) is a government policy document that sets out the strategic priorities, policy targets as well as a summary of the government's spending plans in preparation for the FY 2020/21 Budget. It is prepared by the National Treasury and submitted to the Cabinet for approval. Upon approval, the BPS is submitted for deliberations in Parliament where a resolution will be passed to adopt it, with or without amendments. The Cabinet Secretary will then take into account the resolutions passed by parliament in finalizing the budget for that Fiscal Year.

Below is a comparison of the FY'2019/20 budget and the projected FY'2020/21 budget as per the Draft 2020 BPS;

(All values in billions)

A Comparison of the FY'2019/20 Budget with the Projected FY'2020/21 Budget

	FY'2018/2019 Budget Outturn	FY'2019/2020 Supplementary 2019	FY'2020/2021 BPS	% Change 2019/20 to 2020/21
Total Revenue	1,698.8	2,084.2	2,133.5	2.4%
External Grants	19.7	41.8	43.1	3.0%
Total Revenue & External Grants	**1,718.5**	**2,126.1**	**2,176.5**	**2.4%**
Recurrent Expenditure	1,531.1	1,760.0	1,786.9	1.5%
Development Expenditure & Net Lending	541.9	730.8	576.0	(21.2%)
County Governments + Contingencies	360.7	383.4	381.0	(0.6%)
Total Expenditure	2,433.7	2,874.2	2,743.8	(4.5%)
Fiscal Deficit Excluding Grants	**(734.9)**	**(789.9)**	**(610.3)**	**(22.7%)**
Fiscal Deficit Including Grants	**(715.2)**	**(748.1)**	**(567.3)**	**(24.2%)**
Deficit as % of GDP;				
Excluding Grants	7.9%	7.6%	5.2%	
Including Grants	7.7%	7.2%	4.9%	
Net Foreign Borrowing	414.5	353.5	247.3	(30.0%)
Net Domestic Borrowing	303.7	300.7	318.9	6.0%
Other Domestic Financing	2.9	3.2	3.2	
Total Borrowing	721.1	657.4	569.4	(13.4%)
GDP Estimate	9,348.3	10,355.4	11,633.4	12.3%

Source: The National Treasury

Key take-outs from the table include:

i. The 2020 BPS points to a 4.5% decrease in Total Expenditure to Kshs 2.7 tn, from Kshs 2.9 tn in the FY'2019/2020 Supplementary Budget. This will mainly be driven by a 21.2% reduction in Development Expenditure & Net Lending, outlining the government's efforts towards fiscal consolidation,

ii. Recurrent Expenditure is set to increase marginally by 1.5% to Kshs 1.79 tn, from Kshs 1.76 tn previously. This performance is expected as a result of the current fiscal pressure from the increasing debt & debt service obligations, but will be mitigated by the digitization of government services, which will help reduce public expenditure,

iii. Revenue is projected to increase slightly by 2.4% to Kshs 2.13 tn from Kshs 2.08 tn in FY 2019/20, compared to the 12.3% projected increase seen in the 2019 BPS. This is a more conservative approach from the previous years' ambitious targets, with the performance being expected to be driven by revenue enhancement initiatives by the KRA such as the development of a mobile app to

aid in collection of turnover tax,

iv. The budget deficit is projected to decline to Kshs 567.3 bn (4.9% of GDP) from the projected Kshs 748.1 bn (7.2% of GDP) in the FY'2019/20 supplementary budget, which will in effect reduce the country's public debt requirements with the total borrowing requirement expected to decline by 24.2% to Kshs 567.3 bn from Kshs 748.1 bn, and,
v. Debt financing for the FY'2020/21 budget is estimated to consist of 43% foreign debt, 56% domestic debt and 1% other domestic financing, compared to the 54% foreign debt and 46% domestic debt recorded in the FY 2019/20 Supplementary Budget.

In conclusion, the government has taken a keen focus on fiscal consolidation where we can see the significant reduction in the expenditure towards development, and the more realistic revenue targets that they have set. This will allow them to get a clear picture of the current fiscal framework, which will ultimately help make policies more effective. Similarly, the proposed debt restructuring will contribute significantly to reducing the fiscal deficit through the restructuring of expensive commercial loans to cheaper multi and bilateral loans. We, however, remain concerned about the country's debt levels and are pessimistic about their ability to meet its revenue collection targets due to the levels of domestic debt maturities in FY'2019/20, currently at Kshs 493.0 bn, coupled with the historical underperformance of ordinary revenues, with the government having met 93.1% of its target as per the FY'2018/2019 budget outturn. There is more to be done in terms of revenue collection such as:

i. The use of third party data to identify non-compliant taxpayers and their inclusion in the tax base, and,
ii. Detection of non-compliance, through the i-tax system by enhancement of investigations and intelligence capacity.

Inflation Projections:

We are projecting the Y/Y inflation rate for the month of January to come in within the range of 5.7% - 6.1%, compared to 5.8% recorded in December. The Y/Y inflation for the month of January is expected to rise due to the base effect. The M/M inflation is also expected to rise driven by:

i. An increase in the food and non-alcoholic beverages index, which has a weighting of 36.0%, mainly driven by the higher food prices especially vegetables where a sack of kale now goes for Kshs 8,500, up from Kshs 2,500 in 2019, as well as tomato prices which have doubled from Kshs 4,500 in 2019 to Kshs 9,000,
ii. We also expect an increase in the transport index following the 1.6% and 0.6% increase in petrol and diesel prices, respectively, during the month, and,
iii. An increase in the housing, water, electricity, gas, and other fuels index following the 0.5% increase in kerosene prices to Kshs 102.3, from Kshs 101.8 in December 2019.

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. The government is 33.2% ahead of its domestic borrowing target, having borrowed Kshs 238.5 bn against a pro-rated target of Kshs 179.0 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.