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FUNDAMENTALS

WHACK-A-MOLE HEADACHE

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IN BRIEF

- Last Friday, President Dr. William Samoei Ruto made a statement to the effect that local rates will have a ceiling of 10.0%. We view this statement drives the final nail in the coffin, a doubling down to last month's statement by the new National Treasury Cabinet Secretary (CS) Prof. Njuguna Ndung'u to the effect that domestic bonds will be refinanced with concessional loans.

- We see heightened risk of fiscal dominance, teeing up the odds of a neutral policy stance in next week's MPC meeting (CBR currently at 8.25%) despite rising inflationary pressures.

- Could it be that we are missing the forest for the trees? Trying to make sense of the President's off-script remarks, it seems like the government wants its affordable housing and roads projects financed partly by pension money.

- We explore a number of issues that may play out in the maelstrom of the President's comments. First, this could lead to primary auctions featuring new bonds with coupon rates less than 10.0%.

- Secondly, liability management operation for KENINT 2024 should be given top priority. A capped tender offer and new issue is the best route but bearing in mind that other African sovereigns are thinking alike, Kenya should explore Samurai bond issuance. This kills two birds with one stone; low interest rates and diversifying the external currency risk.

- Lastly, and most importantly, the government may consider upping its game with its communication. Less of the open mouth operations for now, please. The President, or the CS, should probably stick to the script, in both the literal and figurative sense. Amidst the current cloud of uncertainty, investors should hide in the comfort of 91-day and 182-day T-bills, currently trading at sub-10.0% levels.

Unpacking Ruto's statement

Kenya's President Dr. William Samoei Ruto's statement last Friday to the effect that rates will be capped at 10.0% needs further probing. We view this statement drives the final nail in the coffin, a doubling down to last month's statement by the new National Treasury Cabinet Secretary (CS) Prof. Njuguna Ndung'u to the effect that domestic bonds will be refinanced with concessional loans.

So, what exactly did Dr. Ruto say?

"I have also given instruction to the Ministry of Finance (The National Treasury) that yes, we will go to the market and if we find that in the market, we cannot find money at 10%, we will go back and relook at other sources. It is not possible for us to borrow at beyond 10%, anything 12, the last borrowing that we did was at 14%, that is unacceptable. That is the trajectory that we are going. I don't know whether it is good news for you"

For a start, we think the President was referring to domestic market, and not external market. Last week, the new 14-year infrastructure bond[1] flew off the shelf, posting the best uptake (153.1% against an average 69.8% in the preceding months) in the current fiscal year. The paper printed 13.938% average yield of the accepted bids, giving investors' confidence that the new regime is walking the talk to let markets price freely. Prof Ndung'u hammered home this point in his statement last week following the latest IMF staff level agreement…" **have noted turnaround in domestic liquidity for government securities in the recent auction. The Government will continue correcting for market failures and protect competitiveness to enhance the performance of the domestic financial market."**

We are not in the business of playing a sitting President with his appointed CS, but the former's statement seems to be diametrically opposed to what the latter intends to achieve, at least on face value. Domestic borrowing is behind the curve at an estimated KES 205.6bn (excl. of CBK overdraft) – representing a run rate of 90.1% for the current FY23[2] - and the uncertainty around ceiling on local rates will weigh on overall outturn. The only consolation is that the President statement is clouded with uncertainty. Is the 10.0% ceiling, tax-free or taxable? Within what timeframe will the proposal be in effect? Will the proposal affect current stock of local domestic debt – restructuring of local debt – or applied prospectively? We thus see increasingly bricks of worry on the market, unless we get some clarity in the coming days/weeks. Furthermore, this drumbeat of concern should also extend to money markets and fixed deposits, quasi-savings instruments, which are moored to the government securities. This point ushers in the 'whack-a-mole' theme that runs throughout this note.

We see heightened risk of fiscal dominance, teeing up the odds of a neutral policy stance in next week's MPC meeting (CBR currently at 8.25%) despite rising inflationary pressures. The Central Bank of Kenya is caught in a bind. How does it independently conduct its monetary policy and yet the government has a Sisyphean task of borrowing at sub-10.0% levels. But a neutral policy accommodation is the least of the market's worries. The elephant in the room is that there is a higher risk of deficit monetizing (increased reliance of CBK overdraft facilities) in the event domestic market dries up amidst the sub-10.0% borrowing uncertainty. At the moment, this is a tail risk but could become easily morph into the base case. Additionally, although baby steps are being made to prop up vibrancy in the market, specifically with reforms around the Central Securities Depository (CSD) system, to improve horizontal repo[3] market, a giant backward leap will arise in the event of a near shutdown of the government securities' primary market. As such, we see increased activity mainly in the (vertical) repo market, the heightened liquidity finding reversing the prevalent reverse repo (current rate: 9.738%) activity that has been prevalent lately.

Missing the forest for the trees?

It will be remiss of us not to mention the context in which the President was speaking; launch of Sanduku Investment Initiative platform organized by the Association of Pension Trustees and Administrators of Kenya (APTAK). The President's audience was largely the pensions sector with a KES 1.5trn AUM as at end FY22, and holders of local government securities to the tune of KES 690.0bn[4] . Sanduku Investment Initiative, a partnership between the government and private sector players, is an initiative to fundraise for target government projects with private players, majorly pensions, providing the fundraising. It targets to raise a staggering KES 500bn in FY23, and progressively reach KES 1.0tn by FY27.

The President ignored his prepared speech and spoke off-script. So, what exactly did the President dangle to a majority-pension audience?

[1] Infrastructure bonds are tax-free government bonds towards funding of infrastructural projects. Finance Act 2021 amended the Income Act to define infrastructure bonds as "issued by the Government for the financing of a strategic public infrastructure facility including a road, hospital, port, sporting facility, water and sewerage system, a communication network or energy project.

[2] FY23 means Fiscal Year 2022/2023. Kenya's fiscal year runs from July 1st to June 30th.

[3] Horizontal repo allows banks to borrow amongst themselves with the comfort of government securities deposited as collateral. This will greatly improve liquidity in the banking sector which hitherto relies on the uncollateralized overnight interbank market.

[4] Estimates using data in the CBK weekly reports puts this figure higher at KES 1.4tn. The figures in the report are from the Retirements Regulatory Authority.

"We will make affordable housing ready for you, either to sell to your members or invest in for those who want mortgages for long-term, we will give you a ready product. You participate with us in our housing program. I am offering an investment grade product"

"I have available every year from the Kenya Roads Board about KES 40bn that I can pay you. Ring-fenced. I want to agree with you how I can pay you this KES 40bn every year, if you give me the money to be able to finish the infrastructure which your people will use. Si (Isn't) this a win-win?"

Trying to make sense of the President off-script remarks, it seems like the government wants its affordable housing and roads projects to be financed partly by pension money. We understand that for the former, there is an I-REIT (Income Real Estate Investment Trust) product in the pipeline while for the latter, we believe will be through a securitized roads bond. We thus think in the context of **"…and if we find that in the market, we cannot find money at 10%, we will go back and relook at other sources"**, the government is keen on project-based financing with investable low-return instruments to the pensions' players. This is laudable, considering the thread-bare information around infrastructure bonds' use of proceeds. On the demand side, we believe that the proposal will not result in material re-allocation of the current pensions' asset holdings but that the funding will come through rollover of pensions' government securities (at least KES 53.0bn[5] in 2H of FY23), new member contributions and inflows as the government settles the outstanding pension arrears. We estimate pension arrears outstanding at KES 50.0bn[6].

From our conservative estimates, the government can scour c. KES 110bn from pensions' industry leaving close to KES 400bn to be sourced from other financial sector players and developed markets' pensions. This, now, leads us to examine another emerging school of thought; that probably the President was training his guns at the Eurobond market where yields have elevated for the better part of this year. We think this perspective is weak and lacks merit. A sovereign is either in the market (can tap the international markets at favourable yields) or is shut off the international market. No amount of jawboning, even from the President talking yields down, can bend the market backward on this fact.

A lesser argument is that potentially external concessional borrowing will be the only game in town. But we also think this argument is weak. Look here folks, there's only much you can wring out of bilateral debt financing in any given fiscal year (KES 286.5bn in FY23), which are mainly loans tied to development projects. Additionally, there are programme loans totalling KES 129.7bn (FY23) from multilateral lenders, mainly the IMF and the World Bank. Granted, we expect additional financing from the IMF – via Resilience and Sustainability Trust that may potentially unlock additional USD 400mn in FY23 once the fourth and fifth reviews are completed and approved by the IMF Board – and an additional USD 350mn from the World Bank DPO5[7]. However, these hardly move the needle if the outlier goal of refinancing the entire stock of domestic debt (USD 35.2bn) is to be pursued.

Way Forward

Uncertain as it is, we explore a number of issues that may play out in the maelstrom of the President's comments.

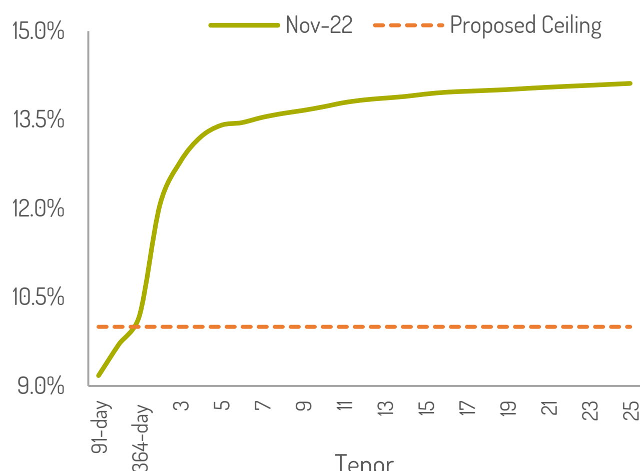
First, this could lead to primary auctions featuring new bonds with coupon rates less than 10.0%. We think the sub-10.0% environment will best apply prospectively, and not result in coupon hair losses to existing local bond holders. From our Africa coverage, Tanzania stands out as the country whose tax-free coupons are preset, notably having slashed the coupon rates by an average of 165bps across the benchmark tenors (an average cut of 329bps for the longer 20 and 25-year tenors) effective April 2022. Notwithstanding, in an environment of higher yields, these bonds (sub-10.0% bonds) will be trading at steep discounts compared to levels traded by current bonds. Overall, we shall be sticking our heads in the sand if we allow the government to get away scot-free. As it takes two to tango, the government needs to work on the economy to justify the sub-10.0% rates in the market. With inflation currently at 9.6% (October 2022), investors will be in deep negative real returns in a sub-10.0% regime. We understand that there is no quick fix to the economy, but that hardly justifies short-circuiting the rates market. We think credible economic structural reforms first, will be more convincing to the market. In the meantime, the new government needs to tamper more of the talk.

[5] KES 53.0bn assumes current pensions holdings of government securities (33.0% of total holdings) multiplied by maturities of KES 160.7b.

[6] As at end FY22, domestic arrears stood at KES 504.7bn, of which 65.5% of the amount was owed to contractors and suppliers. We have assumed 10.0% of the domestic arrears as outstanding pension arrears.

[7] Kenya has been tapping World Bank's Development Policy Operation (DPO) financing each fiscal year since FY19. From the pipeline, seems World Bank is committing USD 750mn for the fifth DPO to be concluded in FY23, but the authorities had projected USD 400mn in the FY23 budget.

KENYA CURRENT LOCAL RATES YIELD CURVE



SOURCE: NAIROBI SECURITIES EXCHANGE (NSE), ICAMMU

Secondly, liability management operation for KENINT 2024 should be given top priority. As at end of last week, yields had erased 645bps off their mid-July peak, with KENINT 2024 having slashed 1036bps to close at 11.310%. Pretty impressive, but the yields are still elevated (+698bps YTD). We understand that syndicated loans are also on the cards as the sovereign lines up its ammunition of servicing the upcoming USD 2bn maturity. The downside with syndicated loan is that it will be short-term (to sidestep the higher rates of longer issuance) and, nevertheless, still costly as US Secured Overnight Financing Rate (SOFR), the benchmark, dials up in lockstep with the US Federal Funds Rate.

Should Eurobond yields continue their downward trend, this will make capped tender offer and new issue - tried and tested in Ghana before - as the best liability management operation that Kenya can pursue. Therein Kenya can offer, say, a capped USD 1.5bn to existing KENINT 2024 bond holders. Subsequently, it can issue a new dual-tranche or three-tranche longer-tenors USD 2.0bn, each tranche having amortizing features, to the existing bondholders (investors who would have participated in the USD 1.5bn capped tender offer) and to raise USD 500mn via Eurobond in FY23. But Kenya may not be the only African sovereign thinking along those lines. We note that there is an outstanding USD 9.1bn[8] (excluding Ethiopia and Zambia who are engaging under the Common Framework) in upcoming maturities above USD 200mn in calendar years 2023 and 2024 spread across four countries (Egypt, Kenya, Nigeria and South Africa). Bar South Africa, the rest of the countries are single B rated (Fitch Ratings), which cycles us back to the credit risk premium investors would demand. Going out on a limb, we are of the view that Kenya should explore Samurai bonds (JPY-denominated Eurobond) as we singularly pick on Egypt[9] as the only African sovereign that has tapped it. A Samurai bond will kill two birds with one stone; its low interest rate makes it quasi-concessional and also diversifies external currency risk away from USD.

Lastly, and most importantly, the government may consider upping its game with its communication. As we write this note, it is less clear as where the National Treasury stands amidst the President's remarks. Ben Bernanke famously stated that monetary policy is 98% talk and 2% action. At this point, the market would want the reverse from the new administration. Less of the open mouth operations for now, please. The President, or the CS, should probably stick to the script, in both the literal and figurative sense. Otherwise, the market gets a litany of less-thought of ideas thrown at it. This means that the sequencing of communication and engagements should not be left to chance. Amidst the current cloud of uncertainty, investors should hide in the comfort of 91-day and 182-day T-bills, currently trading at sub-10.0% levels.

EVOLUTION OF EGYPT 2027 (JPY-DENOMINATED) 0.85%

SOURCE: BLOOMBERG

[8] We considered the set of USD-denominated Eurobonds only.

[9] Egypt issued a JPY 60bn (USD 500mn equivalent) Samurai bond in March 2022 with a coupon rate of 0.85%.

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