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Topical Note

August 2020

Domestic debt interest rates

"How low can they go?"

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Table of Contents

Executive Summary 3
Investors' concerned about direction and returns of Government debt 4
Slide in short-term domestic debt interest rates set to continue 4
Yield curve to shift downwards in response to steady decline in domestic debt interest rates 5
Commercial bank deposit rates to decline, lending rates to remain unchanged 7
How have selected banks responded to regulation of interest rates and short-term debt interest rate movements? 8
Private Sector Credit Growth to remain subdued FY2020 and FY2021 9
CBK benefitting from high market liquidity and using it to lower average borrowing costs 10
High investor subscription, low CBK acceptance for Government debt expected to continue 11
Sharp fall in domestic debt interest rates will erode returns from investment 12
Disclosures 15

Executive Summary

- Our topical note on domestic debt interest rates is titled "How low can they go?" is in reference to the sharp fall in domestic debt interest rates over the last few months.
- Investors in domestic debt have been concerned over the effect of the falling interest rates on real returns.
- We predict that the fall in interest rates will continue for the remainder of 2020 with the yield curve expected to shift downwards.
- We further analyze the impact of the decline on short term debt interest rates on commercial bank lending and deposit rates.
- Also covered in the report is an analysis of private sector credit where we see private sector lending being subdued in 2020 and possibly through to 2021.
- We also analyze the impact of falling interest rates on Government borrowing strategy.
- The report concludes with an analysis of real returns showing that investment in short-term investment Government debt outperforms other asset classes.

Investors' concerned about direction and returns of Government debt

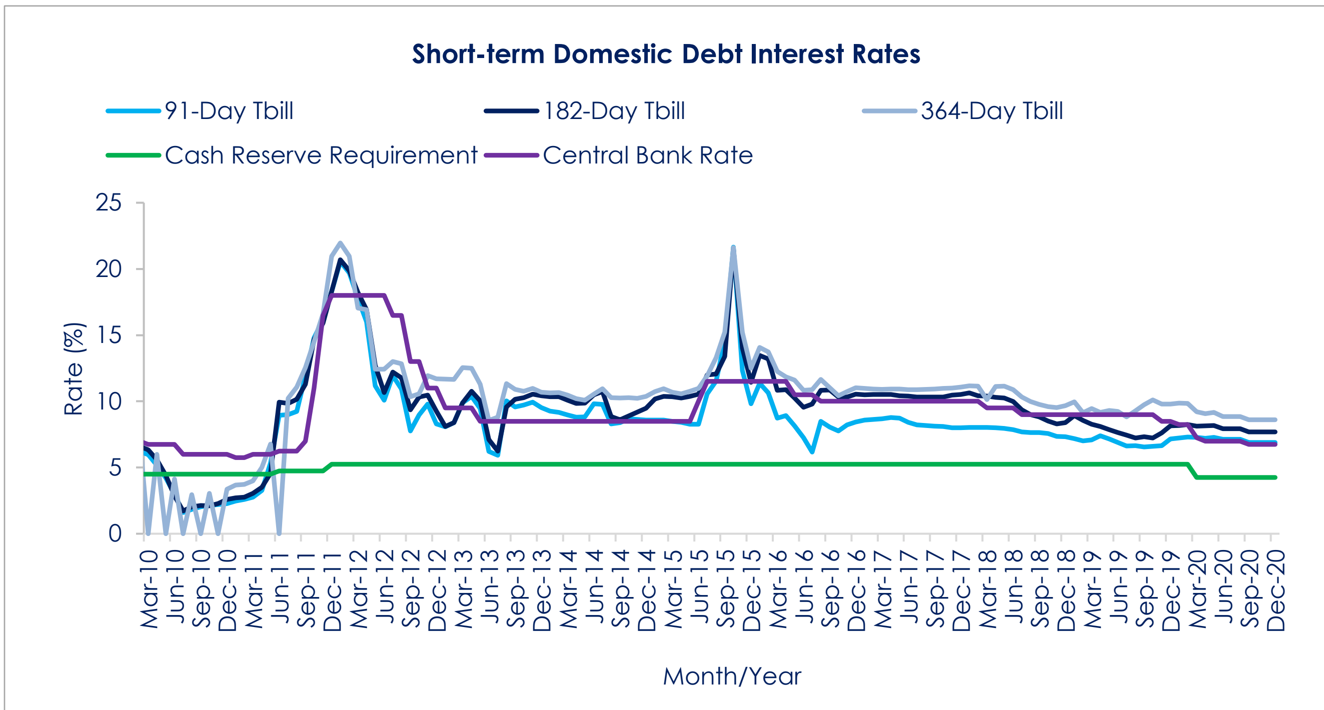
- Over the last few months, interest rates particularly on short term Government debt have fallen sharply with various reasons given for the trend including high market liquidity and resulting high demand, poor performance of the equity market and a risk averse investor universe.
- This report sets out to explain the reasons behind this trend as well as give the possible direction of domestic debt interest rates over the next few months.
- This we believe will assist investors adopt investment strategies matching their expected return, time horizon and risk appetite.
- We take note that while interest rates on short-term debt (Treasury Bills - T-Bills) have fallen steadily in weekly auctions, those on longer dated debt (Treasury Bonds - T-Bonds) have fallen gradually during the period in focus.

Slide in short-term domestic debt interest rates set to continue

Interest rates have fallen sharply in recent months over high market liquidity and monetary policy

- Interest rates on domestic debt fell sharply in the last three months of 2016 following the introduction of a law capping commercial bank lending and deposit rates and remained low and relatively stable even after the repeal of the law in October 2019 (Figure.1).
- Interest rates have declined steadily in recent months however, following the downward revision of the Central Bank Rate (CBR) and the Cash Reserve Ratio (CRR), resulting in high market liquidity that has pushed up subscription for government securities to record highs.
- The Central Bank of Kenya (CBK) has taken advantage of this trend to reduce its domestic borrowing costs and increase its debt maturity profile through a strategy of rejecting aggressive investor bids for shorter dated bonds while accepting aggressive bids for longer dated bonds.
- We expect the CBR to remain unchanged while T-Bill rates will remain subdued for the remainder of the year.

Figure.1: Interest rates stable since caps were introduced but trending downwards in recent weeks



Source: Central Bank of Kenya

Yield curve to shift downwards in response to steady decline in domestic debt interest rates

Yield curve continues to shift downwards with the biggest shift in the short-end of the yield curve.

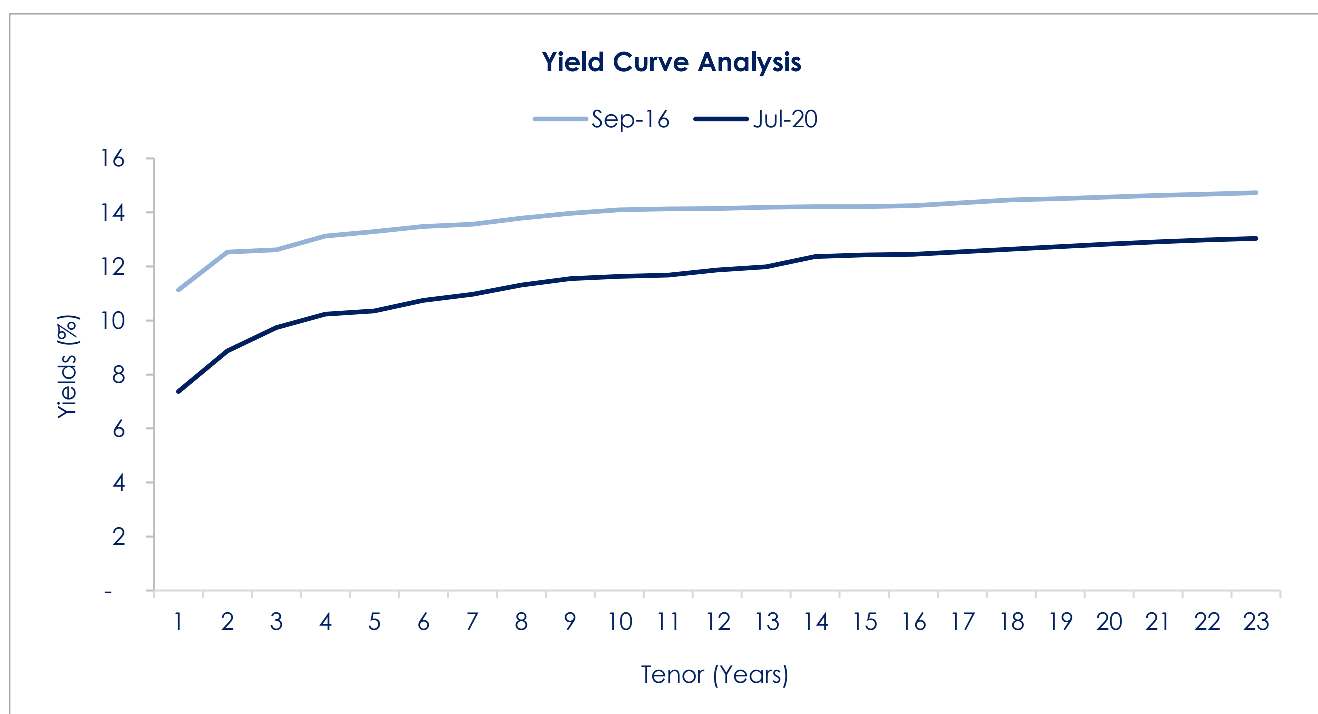
- Comparison of domestic debt yields on 24th July 2020 and 9th September (before interest rate caps were introduced) shows a significant dip in yields on all debt tenors. (Table.1 and Figure.2).
- The biggest declines are evident in the short and medium-term papers but remained almost unchanged for longer-dated government securities.
- We expect further downward shifts in the yield curve in the short term largely due to high market liquidity with short-term tenors exhibiting higher declines.
- Forecasted average interest rates in December 2020 for the 2, 5, 10 and 15- and 20-year T-Bonds are 7.501%, 9.432%, 11.176%, 12.613% and 13.165% respectively.
- With regards to primary debt auctions, the CBK is expected to continue issuing multiple tenor issues, accepting lower rates and accommodating fairly aggressive bids for longer dated papers in an attempt to lengthen the maturity profile of public debt.

Table.1: Yield curve has shifted downwards with the shorter-end exhibiting the biggest shift

Tenor	Yield (9th Sep 2016)	Yield (24th Jul 2020)	Change - July 2020 vs Sep 2016 2020 (Bps)
1	11.1290	7.370	↓375.9
2	12.5280	8.8736	↓365.4
5	13.2907	10.3494	↓294.1
10	14.1000	11.6383	↓246.2
15	14.2219	12.4290	↓179.3
20	14.5722	12.8309	↓174.1

Source: Nairobi Securities Exchange

Figure.2: Domestic debt yields on a decline



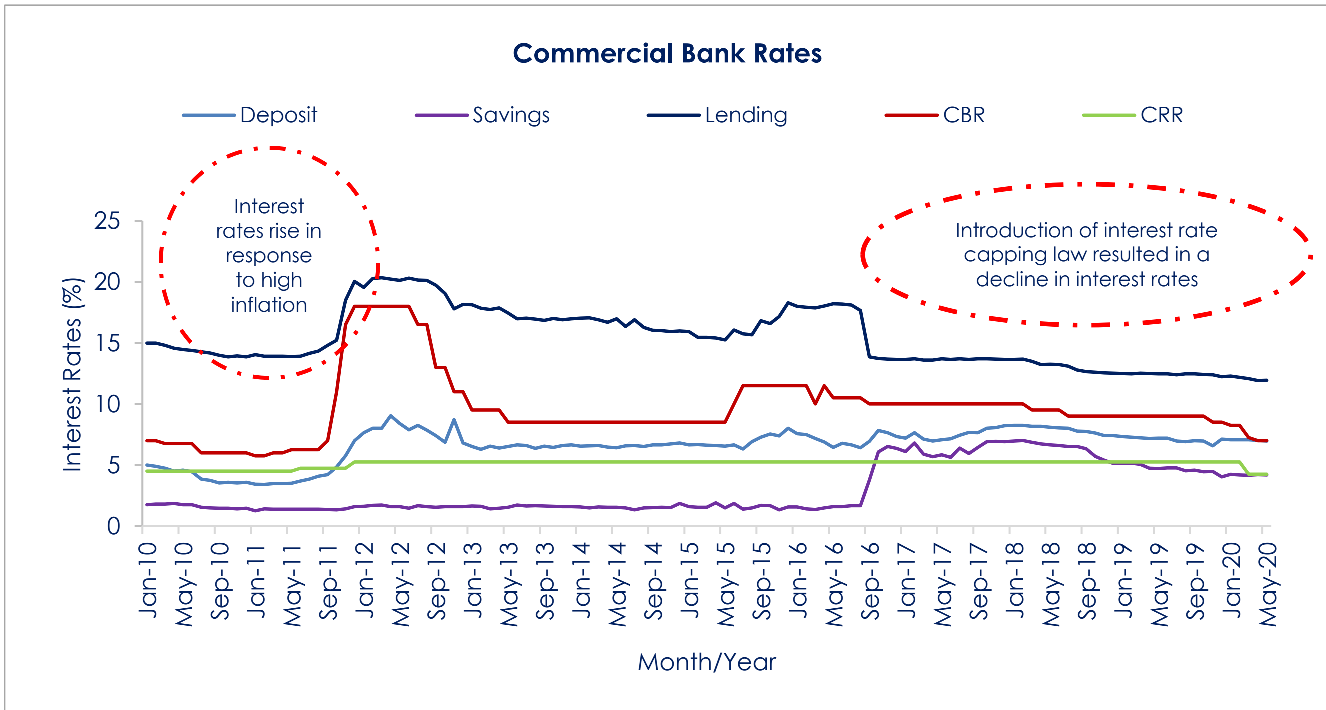
Source: Central Bank of Kenya

Commercial bank deposit rates to decline, lending rates to remain unchanged

Commercial bank deposit rates expected to decline while lending rates likely to remain stable.

- A sharp fall in commercial bank rates followed the introduction of the interest capping law in September 2016 (Figure.3)
- Interest rate caps on bank deposits were abolished In October 2018, resulting to a gradual improvement of commercial banks margins.
- In October 2019, the law capping interest rates on commercial bank loans was repealed but rates remained low due to monetary authorities' influence to keep interest rates low to avoid past controls and deteriorating asset quality resulting in increased preference for investment in government securities.
- The Covid-19 pandemic has severely affected both businesses and households with monetary policy measures mentioned earlier in this report implemented to stimulate liquidity in the economy.
- We expect the decline in deposit rates to continue for the remainder of 2020 due to the steady decline in domestic debt interest rates while lending rates will remain almost unchanged as slashing them would reduce banks profitability even further.

Figure.3: Deposit rates to decline further while lending rates likely to remain unchanged in 2020



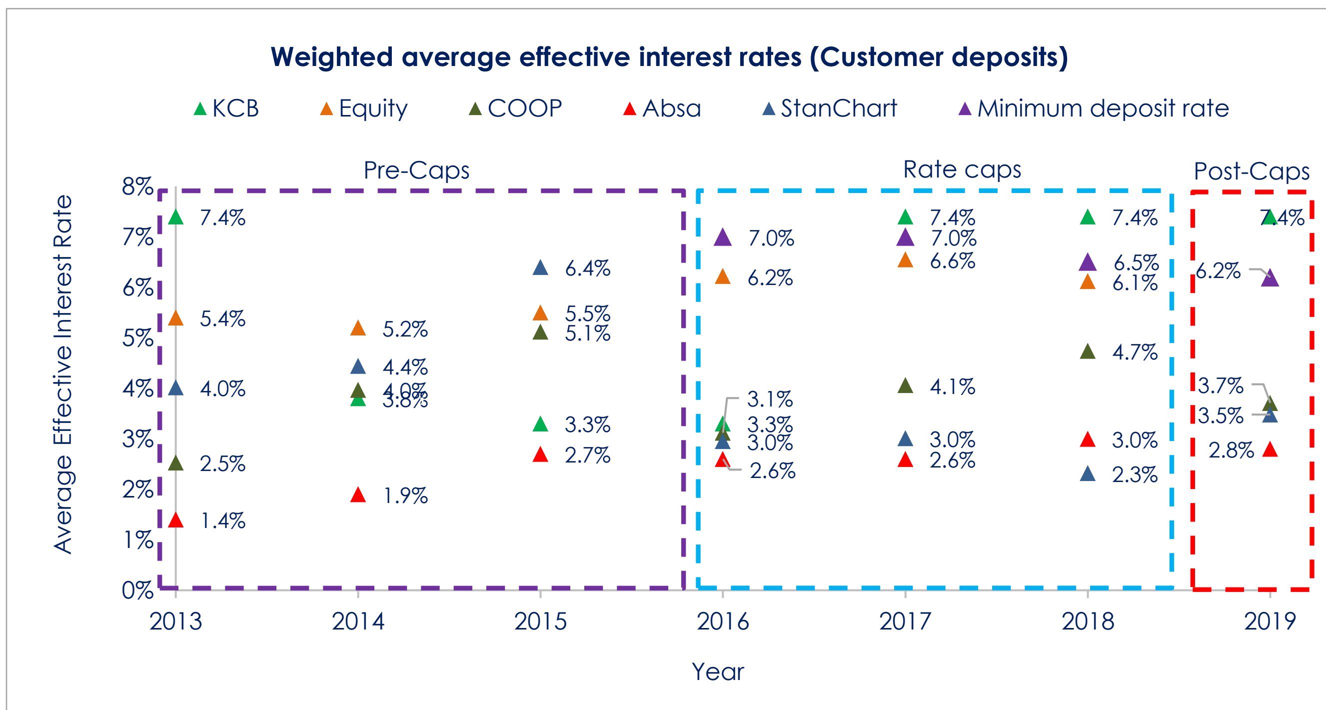
Source: Central Bank of Kenya

How have selected banks responded to regulation of interest rates and short-term debt interest rate movements?

Commercial bank revised their interest rates in response to both short term debt interest rates and regulation.

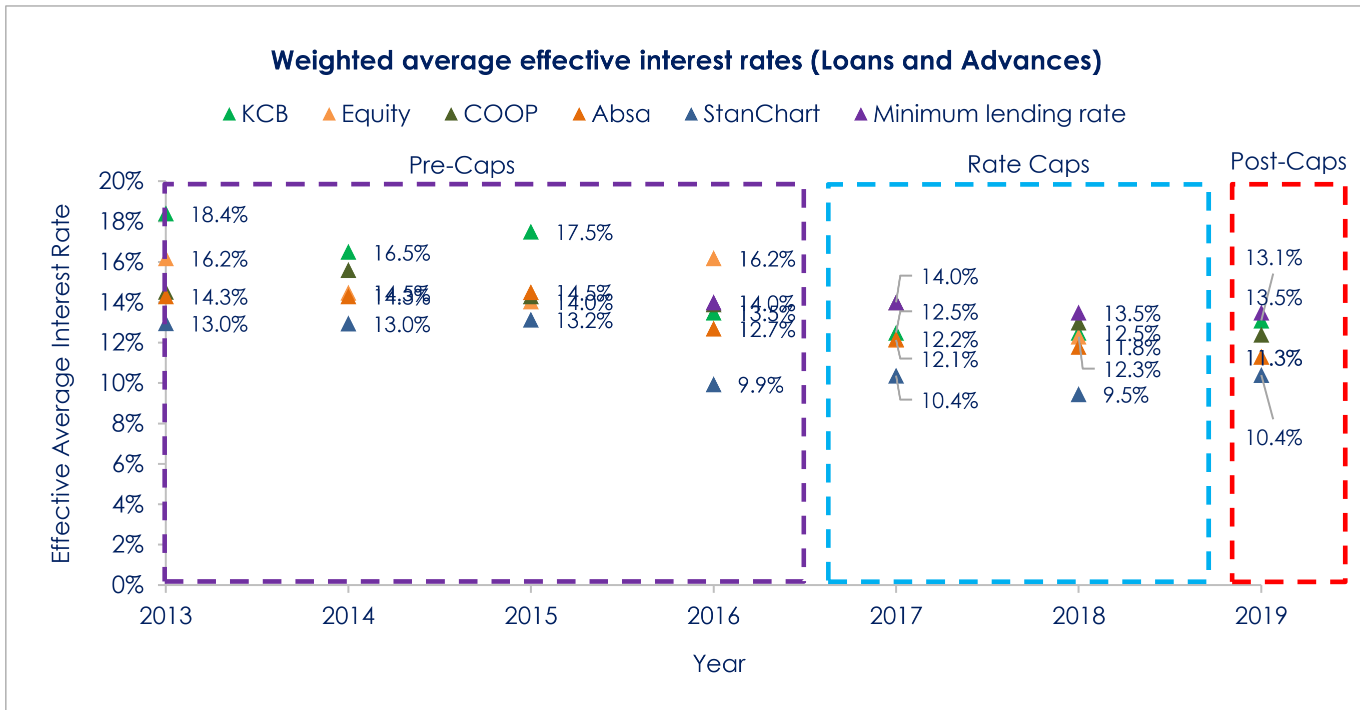
- Our analysis of effective lending and deposit rates since 2013 captures the full pre and post interest rate cap effect (Figure.4 and Figure.5).
- The interest rate capping law introduced in September 2016 placed a minimum deposit rate of 70% of the benchmark CBR rate which stood at 10% at the time (7%).
- We observe that most of the banks in focus revised their lending or deposit rates in response to regulatory or and monetary policy.
- For instance, the average effective interest rate on loans declined (below 14%) in 2016 for all banks after the maximum allowable lending rate was revised to 14%.
- We also note a significant drop in the effective lending rates for COOP bank, Absa Kenya and Equity Group in 2019, following the repeal of the interest rate caps.
- A lower CBR rate and falling T-Bill rates will also contribute to falling deposit rates as banks offer lower rates on deposits to maintain their interest rate spreads.
- We expect the effective interest rates on loans and advances to remain relatively unchanged during the pandemic.

Figure.4: Effective interest rates on customer deposits expected to decline FY2020



Source: Company Filings and Sterling Research

Figure.5: Effective interest rates on loans and advances expected to remain unchanged FY2020



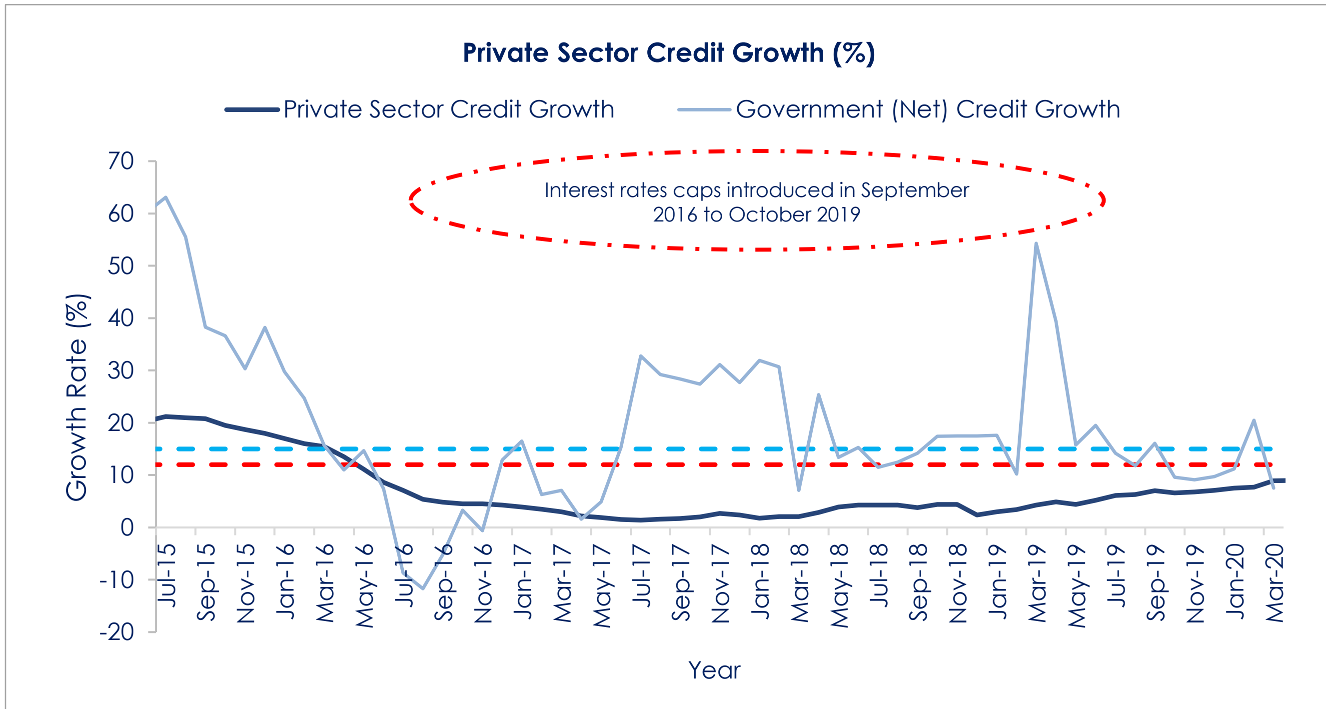
Source: Company Filings and Sterling Research

Private Sector Credit growth to remain subdued in 2020 and 2021

Private sector credit will remain subdued due to poor asset quality and low credit demand.

- Private Sector Credit (PSC) has been on a gradual increase from December 2018 and we attribute this to a decline in yields on domestic bonds and acceptable credit quality which resulted in banks engaging in selective lending during the interest rate cap era (Figure.6).
- The Covid-19 pandemic has slowed economic activity thus reducing credit demand and negatively impacting credit quality.
- The Monetary Policy Committee (MPC) revised the Cash Reserve Ratio (CRR) downwards from 5.25% to 4.25% in March 2020 releasing KES.32.5B to commercial banks for lending to the private sector.
- According to the Monetary Policy Committee (MPC) KES.30.8Bn of the funds (87.6%) had been used to support lending to sectors impacted by the pandemic at the end of June 2020.
- We see PSC remaining subdued below the CBK's preferred target range of 12% - 15% in the second half of 2020 as banks continue investing in government securities despite the low yields.
- This is a strategy of managing credit risk which has been on the rise due to effects of the Covid-19 pandemic.
- PSC should remain subdued in 2021 in line with low credit uptake as economic recovery is projected to begin in 2022.

Figure.6: Private Sector Credit Growth on a slow growth path but threatened by rising credit risks



Source: Central Bank of Kenya

CBK benefitting from high market liquidity and using it to lower average borrowing costs

Government benefitting from low domestic debt interest rates.

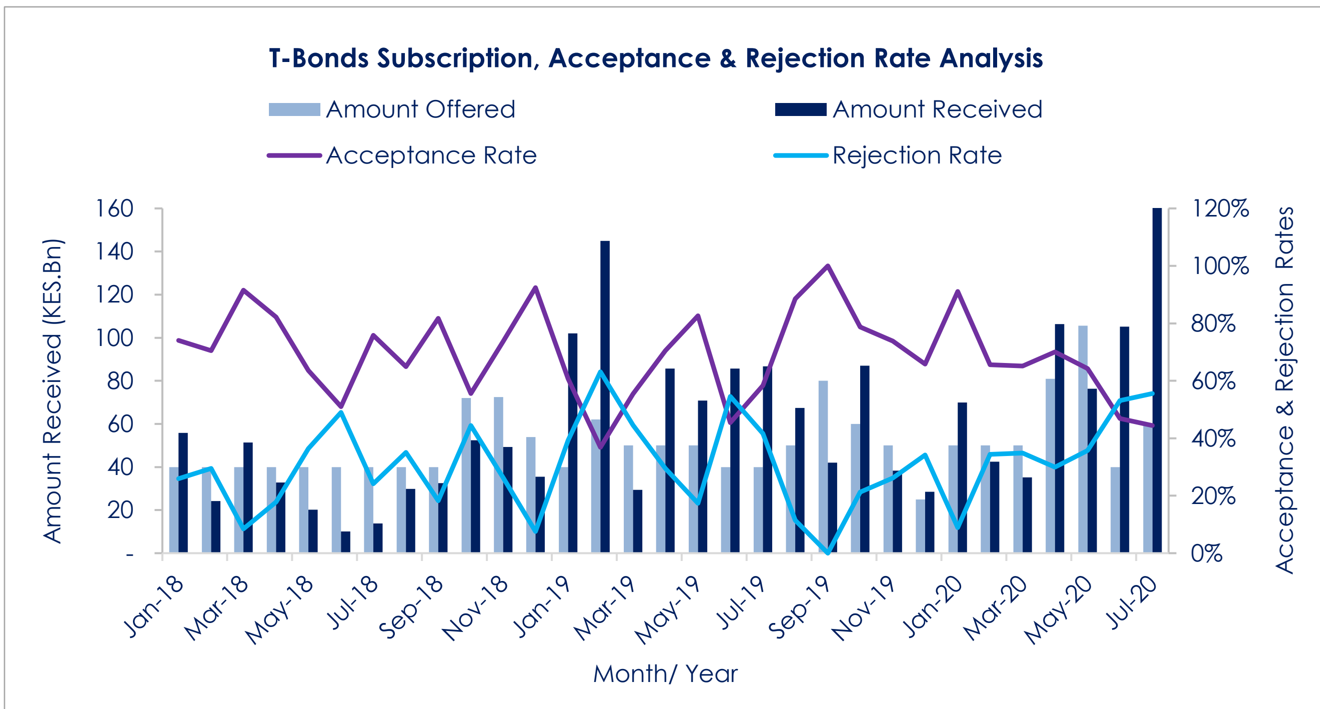
- Demand for Government debt has risen significantly in recent months due to a combination of high market liquidity and capital flight by risk averse investors from the underperforming equities market and other riskier asset classes.
- Increased liquidity is partially attributable to the reduction of the CRR in March, Government payments to suppliers and the implementation of the economic stimulus package.
- Commercial banks have slowed down on lending to the private sector in spite of increased liquidity due to heightened credit risk and increased their investment in Government securities.
- This increased demand has resulted in a steady fall in interest rates on short-term securities to a seven-year low.
- CBK has been taking advantage of the high demand by pushing rates downwards (rejecting aggressive investor bids in primary debt auctions) and increasing borrowing.
- The Kenya Revenue Authority (KRA) is expected to miss its 2020/21 fiscal year revenue target of KES.1.63Tn due to subdued economic activity and tax cuts by Government to cushion Kenyans from the effects of the pandemic.
- We therefore expect an increase in domestic borrowing above the KES.493Bn fiscal budget estimate and it is for this reason that we see the CBK intent to keep interest rates low for a better part of the current fiscal year.

High investor subscription, low CBK acceptance for Government debt expected to continue

High investor subscription and low CBK acceptance for domestic debt expected to continue.

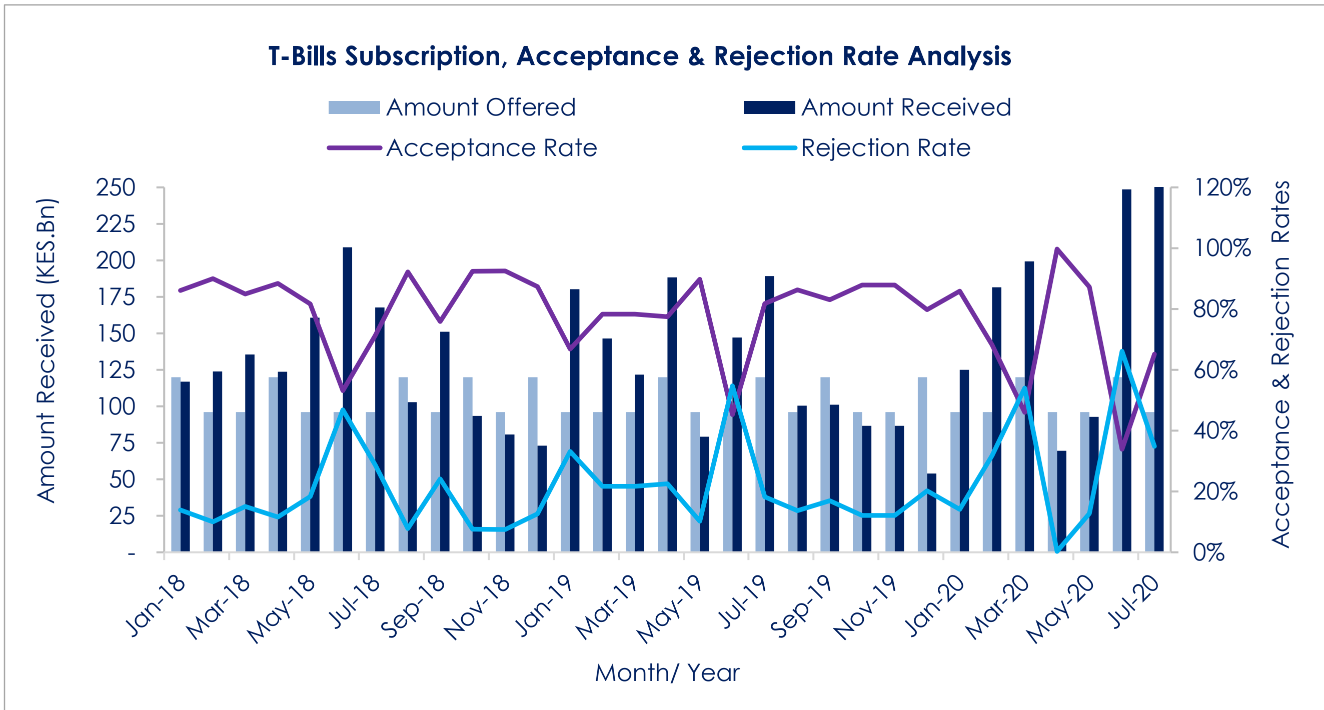
- Investor demand for domestic debt has risen sharply in recent months due to the reasons mentioned above while CBK acceptance levels have been low (Figure.7 and Figure.8).
- Aggregate subscription levels for T-Bills and T-Bonds between January and the third week of July 2020 stood at 141.3% and 163.9% compared to CBK accepted bids of 59.7% and 61.8% respectively.
- This is a trend we expect to continue as the CBK attempts to contain interest rates at their preferred levels.
- Most demand was reported on the 91-day and 364-day papers at 195% and 226.5% respectively while the 182-day paper was undersubscribed at 88.8% (Figure.8).
- Acceptance rates for 91-day, 182-day and 364-day T-Bills was 64.8%, 54.5% and 63.6% respectively.
- Demand for the 91-day T-Bill remains high as investors are unwilling to tie their capital for a longer period due to uncertainty over the direction of interest rates while some investors chose the 364 Day T-bill to lock in current rates with the expectation of further declines in interest rates.

Figure.7: CBK will continue rejecting aggressive investor bids to maintain interest rates at near current levels



Source: Central Bank of Kenya

Figure.8: Investors' preference for short-term domestic debt on uncertainty over interest rate direction



Source: Central Bank of Kenya

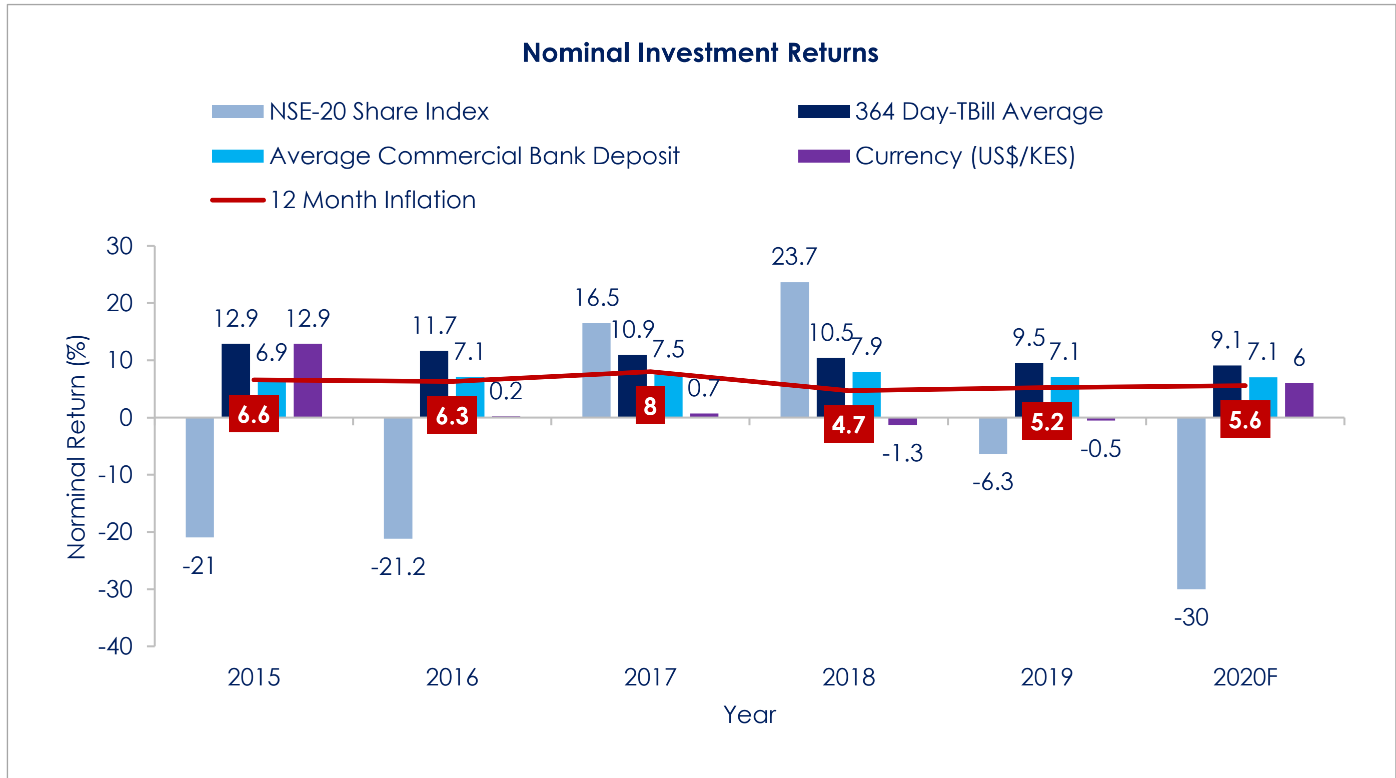
Sharp fall in domestic debt interest rates will erode returns from investment

Real returns from investment in domestic debt declining but still the best performing asset class.

- Our analysis of real returns from different asset classes shows the risks faced by investors for the remainder of 2020 and possibly 2021 assuming that annual inflation remains around our forecast levels of between 5 and 6% (Figure.9 and Figure.10).
- Although inflation has been relatively stable at an average of 5.2% over the last three years, the average 364-day T-Bill rate is at its lowest level in close to a decade at just below 9%.
- Investment in the short-term Government security has however consistently provided investors with positive real returns over our 5-year focus period.
- We expect the 364-day T-Bill rate to remain below 9% over the remainder of the year and into 2021 based on our analysis of market liquidity and Government borrowing patterns meaning that real return should range between 3% - 4% for the forecast period.
- It is likely that the 364-day T-Bill will outperform other asset classes in focus in spite of its single digit real return.
- Continued poor performance of the Nairobi Securities Exchange (NSE) partially explained by capital flow from the equities to the domestic debt market means negative return.
- Commercial bank deposit rates are often pegged on the short-term domestic interest rates and therefore we expect this to remain positive but still below the T-Bill rate.

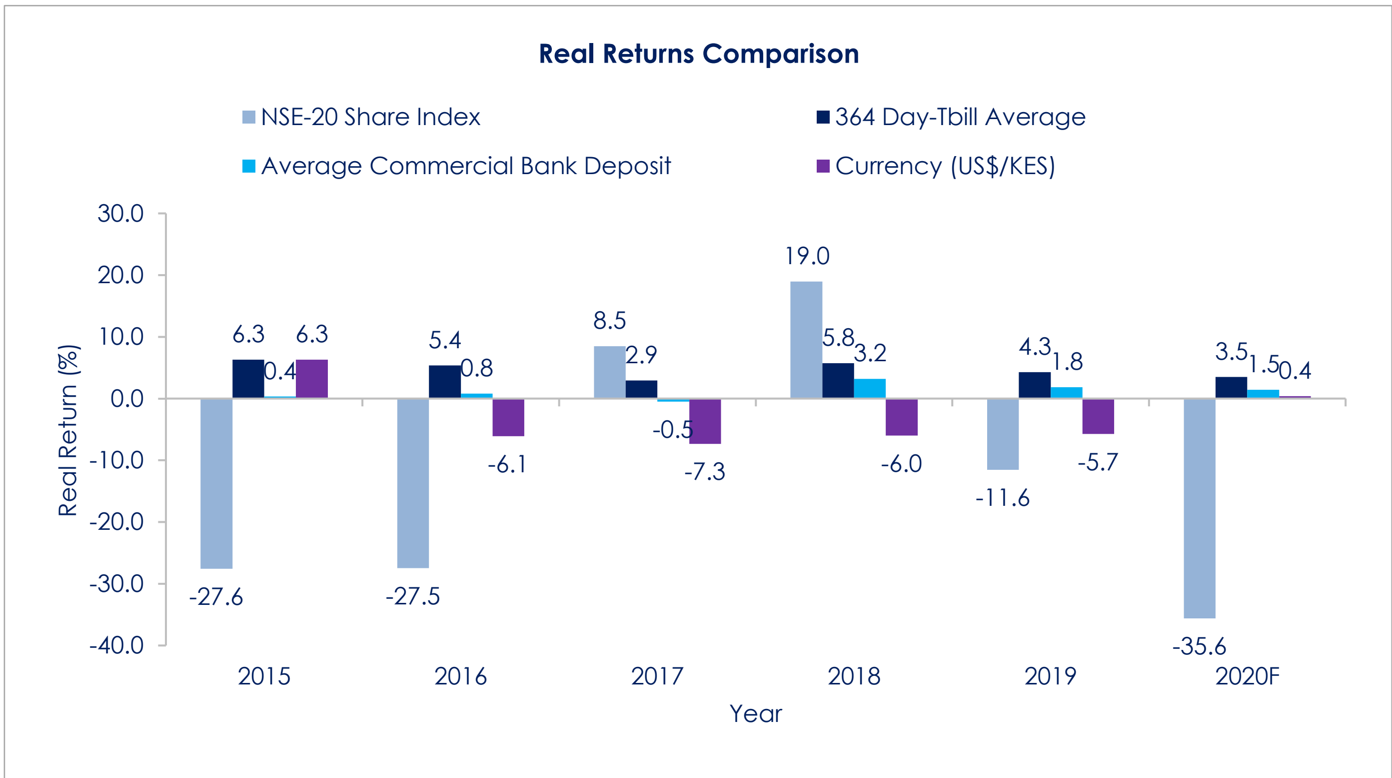
- The depreciation of the local currency particularly against the United States Dollar (US$) means that investment in the US$ will yield a positive return at least in 2020 before the exchange rate stabilizes in 2021.

Figure.9: Short-term Government debt securities to continue providing positive real return



Source: Central Bank of Kenya, Kenya National Bureau of Statistics & World Bank

Figure.10: Short-term Government debt securities to continue providing positive real return



Source: Central Bank of Kenya, Kenya National Bureau of Statistics & World Bank

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