We expect decline of rates in tenge and recommend buying bonds of the Ministry of Finance with a maturity of 3-5 years

July 7 2020

Due to the improvement of the external economic situation and stabilization of the situation in the money market, in recent months there has been a steady downward trend in rates in tenge. We believe that as a result of the slowdown in inflation and inflationary expectations in the second half of this year, decline in rates will continue. We expect a decrease in the base rate of the National Bank to 9% by the end of this year and recommend buying tenge bonds of the Ministry of Finance with a maturity of 3-5 years.

Lower inflationary expectations allows the National Bank to soften monetary policy

As a result of the return of oil prices to above $ 40 per barrel, the tenge has significantly strengthened and is consolidating at the level of 405-410 tenge per 1 dollar. Strengthening the tenge significantly reduces pressure on inflation and stabilizes inflation expectations. After rising in April to 0.9% mom inflation sharply slowed down to 0.5% mom in May, and in June it weakened even more – to 0.4% mom. In early June, the NBK left the base rate unchanged at 9.5%, but announced a decrease in inflation expectations from 9-11% to 8%-8.5%.

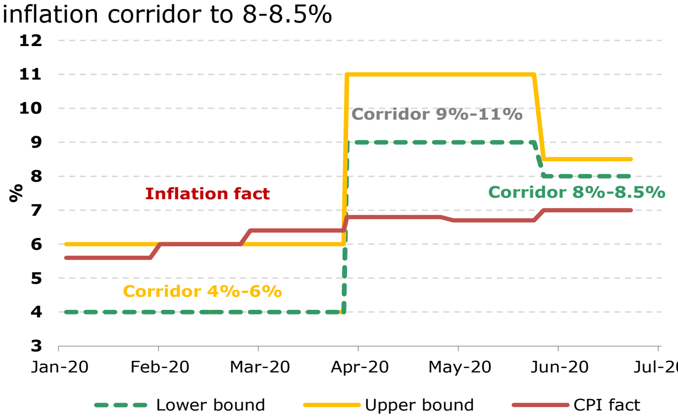
We believe that in the second half of this year, the tenge will gradually weaken against the dollar, which may increase pressure on inflation. However, the effect on inflation will be restrained due to the ongoing economic downturn. The appreciable stabilizing effect on inflation will be provided by a tenge appreciation against the ruble by about 5% since the beginning of this year, which partially offset the weakening of the tenge against the dollar. Given that imports from the Russian Federation account for more than 30% of Kazakhstan's total imports, this has a significant stabilizing effect on prices.

The recession that began in the second quarter in the domestic economy, according to our expectations, will continue in the second half of the year. A significant decrease in export revenues as a result of falling hydrocarbon prices and a forced reduction in oil production together with a contraction in business and investment activity in the country will lead to lower consumer incomes and dampen aggregate demand, which will significantly limit inflationary pressures.

In the structure of inflation, we expect a significant increase in prices only for food products, while prices for non-food products and the cost of services will grow weakly due to suppressed demand and a savings model of consumer behavior. Distribution of the remote work format will reduce the demand for rent, transportation services and many other types of services. In our opinion, in the second half of the year, average monthly inflation will be within 0.5% with the prospect of a decrease in 2021. According to the results of the current year, we expect inflation at 7.3%, which is below the 8-8.5% forecasted by the National Bank.

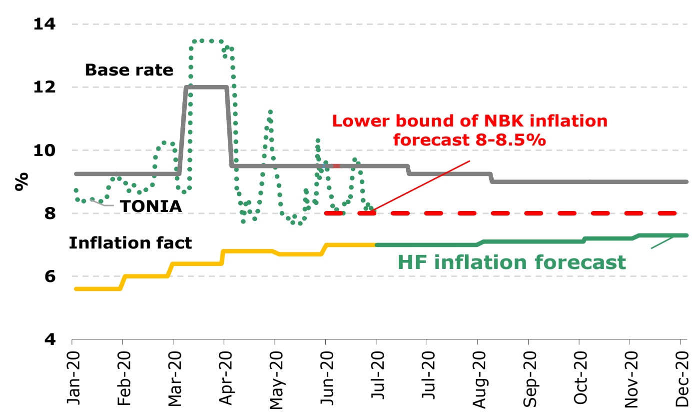
A more restrained change in inflation, the temporary nature of its acceleration, as well as the need to stimulate the economy through a monetary channel, in our opinion, will prompt the National Bank to gradually reduce the base rate. As a result, we expect the base rate to be cut to 9% by the end of this year.

Figure 1. In June NBK lowered and narrowed forecasted inflation corridor to 8-8.5%



Source: NBK, KASE, CS MNE, Halyk Finance

Figure 2. HF inflation forecast: 7.3% in 2020



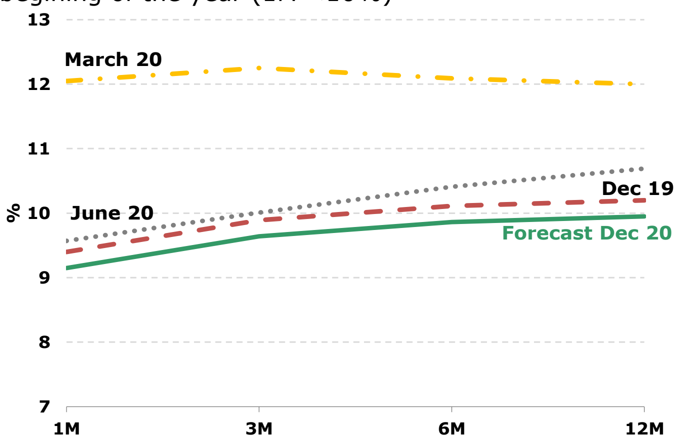
Source: NBK, KASE, CS MNE, Halyk Finance

Rates on government securities – a comparison of the notes of the National Bank and bonds of the Ministry of Finance

An important benchmark in the Kazakhstani money market is the notes of the National Bank, which are used by the NBK to implement its decisions in the field of monetary policy. The most representative are 1-month notes with a maturity of 28 days, auctions for which are held once a week. The rates on these notes have been dropping quite quickly lately after the rise in March, which followed the increase in the base rate. For example, in March, the rates for monthly notes were at the level of 12.1%, but already in early April they fell to 10.6%, and at the end of June they approached 9.6%. Rates on longer notes of the National Bank also decreased, although less significantly. Thus, rates for 6-month notes decreased from 12.1% to 10.4%, and for 12-month notes – from 12% to 10.7%. As a result, the spread between 1M notes and 12M notes widened from 0.2pp. earlier this year to the current 1.1pp.

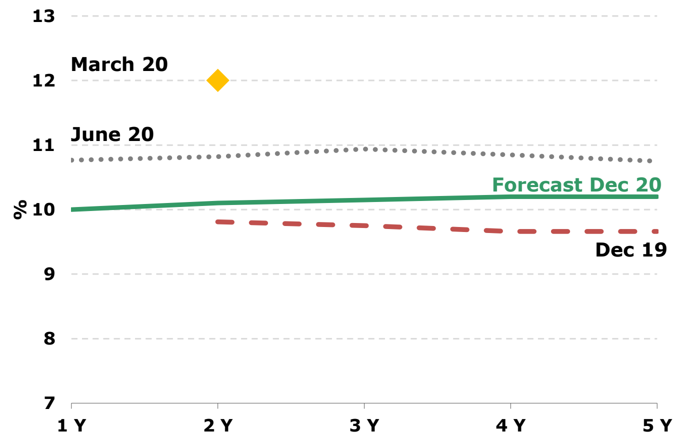
Yields on bonds of the Ministry of Finance also reacted to changes in rates in the money market, although with some lag to shorter NBK notes. In particular, the yield on 2-year bonds of the Ministry of Finance when placed in March was 12%, in April was at 11%, but already in June, the yield on placement for securities with identical maturity decreased to 10.8%.

Figure 3. Yield curve of NBK notes moved toward the begining of the year (1M <10%)



Source: NBK, KASE (Yield curve at placement)

Figure 4. Yield curve of Minfin bonds react with lag to NBK notes



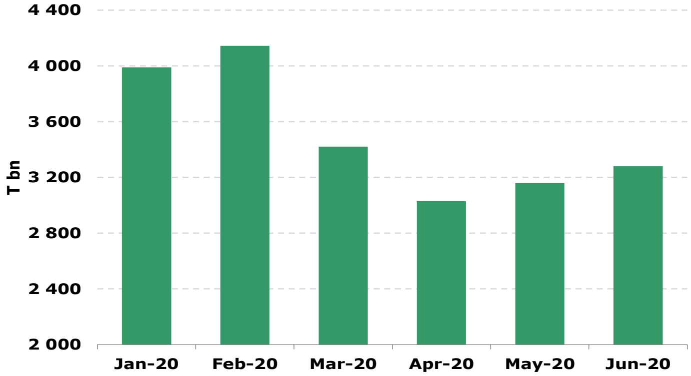
*Source: KASE (Yield curve at placement) * in March 2Y bonds, no deals on the secondary market with 1Y-5Y maturities*

Volumes of notes of the National Bank in circulation are decreasing, and bonds of the Ministry of Finance – are increasing

For 6 months of this year, the total volume of notes of the National Bank in circulation decreased from T4 trillion to T3.3 trillion. This is due to the fact that the volume of notes issued by the National Bank declined by more than 40% compared to the same period in 2019. However, there was an increase in the volume of bonds issued by the Ministry of Finance.

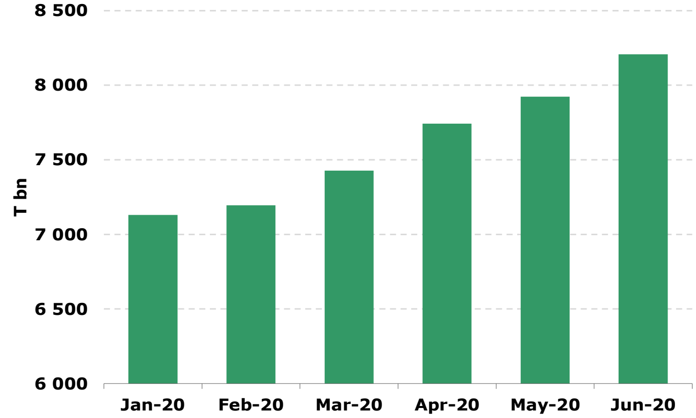
The volume of obligations of the Ministry of Finance in circulation increased from T7.1 trillion at the beginning of the year to T8.2 trillion at the beginning of July. Thus, there was a certain rebalancing of the issuance of government securities from the National Bank notes towards the bonds of the Ministry of Finance. The growth in the obligations of the Ministry of Finance this year seems logical and is due to an increase in the state budget deficit from T1.3 trillion in 2019 to T2.4 trillion this year. At the same time, a shift in demand from the National Bank notes in favor of the Ministry of Finance bonds offering a higher yield is obvious.

Figure 5. Short term NBK notes in circulation are decreasing …



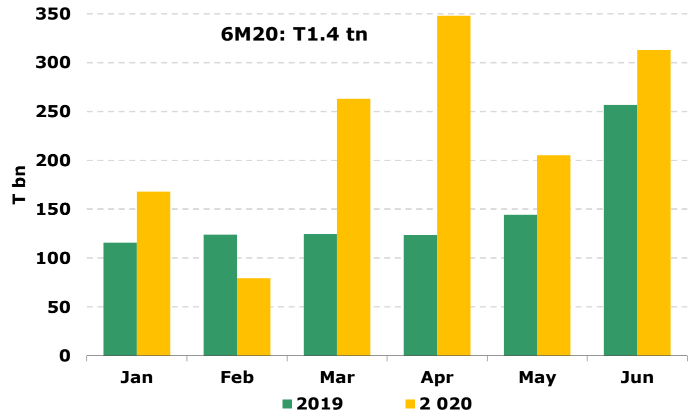
*Source: NBK, KASE *June – HF estimate*

Figure 6. … Minfin bonds in circulation are increasing



*Source: NBK, KASE *June – HF estimate*

Figure 7. The issuance of Minfin obligations increased



*Source: NBK, KASE *June – HF estimate*

As a result of the increased need for financing, for the first half of 2020 the placement of the Ministry of Finance bonds increased by 55% compared to the same period of 2019. In January-June, the Ministry of Finance raised approximately T1.4 trillion in the market through bonds. At the beginning of the year, the volumes of fundraising were quite small, but already in March they exceeded T250 billion, in April they approached T350 billion, and in May their volume decreased to T205 billion. According to our estimation, in June the Ministry of Finance raised T313 billion. The placement of the Ministry of Finance obligations in the first 6 months of this year could have been much higher, but the large attraction of transfers from the National Fund, the size of which in the 5M2020 reached T2.5 trillion, smoothed the financing needs.

In its June releases, the National Bank did not exclude consideration of easing monetary conditions, but de facto we already see a gradual decrease in short rates, which in June were only 0.7pp higher than the level recorded at the beginning of the year. The unfolding recession and falling purchasing power of the population have already reduced demand in the economy, while recovery will be slow, which creates the prerequisites for the emergence of sustainable disinflation factors. According to our expectations, a decrease in the base rate to 9% by the end of this year will lead to a decrease in interest rates on NBK notes in the second half of the year by 0.4pp-0.7pp from current values. Accordingly, a decrease in short-term rates will entail a drop in rates on the Ministry of Finance securities along the entire yield curve.

The structure of notes issued by the National Bank is largely represented by longer issues – 6-month and 12-month notes in the total volume approach 85%. Moreover, more than half the volume of all notes in circulation have a period of 12 months. But already in July this year, the National Bank stopped to issue 12-month notes, thus encouraging investors to purchase bonds of the Ministry of Finance, which plans to significantly increase the supply on the securities market with a circulation period of 1 to 3 years.

We recommend buying bonds of the Ministry of Finance with a maturity of 3-5 years

Despite a slight decrease, we believe that rates on government securities remain attractive for investment, especially on bonds of the Ministry of Finance. The most interesting paper seems to us with a maturity of 3-5 years. Rates on bonds of the Ministry of Finance on this segment of the curve are at the highest level (10.8-10.9%), while liquidity in the secondary market for these bonds is quite high – slightly lower than for shorter instruments (1-2 years), but significantly higher than for long instruments (7-15 years).

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