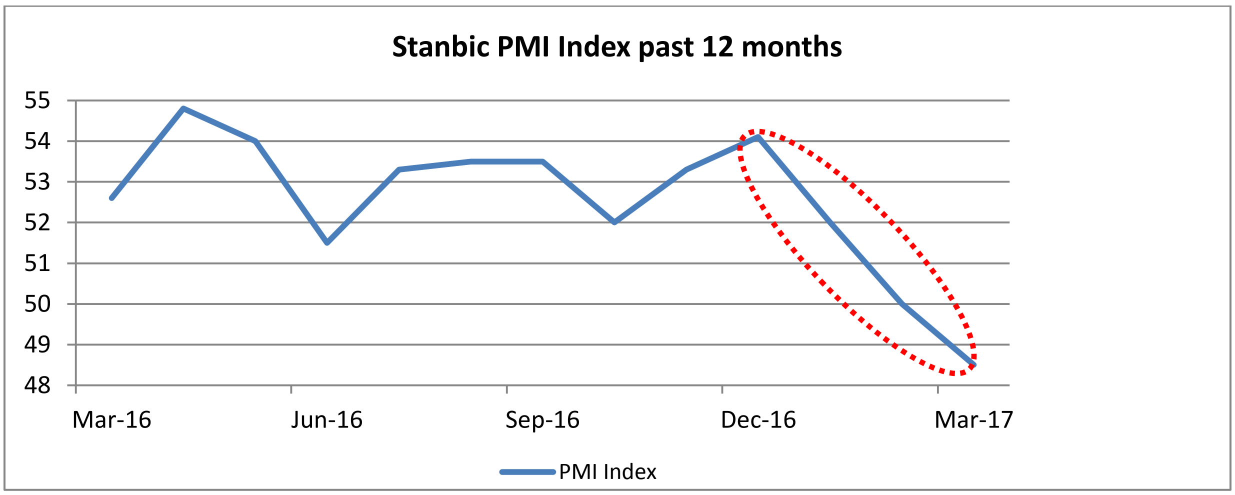
The Kenyan Economy

Business activity: Gradual slow down, eventually contracts

Private sector business activity is reported to have slowed throughout quarter one and eventually contracted in March. Stanbic bank Kenya's purchasing managers index (PMI) was reported to have slowed to 52.0 in January, 50.0 in February and 48.5 in March. The PMI index is an indicator of the economic health of the manufacturing sector, based on new orders, inventory levels, production, supplier deliveries and the employment environment. Readings above 50 signal improvements in business conditions from previous months, while readings below 50 show deterioration. The 48.5 reading as at March was the first time in the history of the index that PMI dropped below 50, signifying deterioration in the health of private sector. The circled part in the graph below represents the trend in Q1 2017.



As we had indicated in our previous macro report, the ongoing drought, declines in private sector credit growth and the build up to the general elections, would slow down business activity in 2017. (Click here to view report). The decline in the PMI Index is symptomatic of these risks that we flagged.

The Monetary policy committee also for the first time in conducting their market perception survey indicated that private sector respondents expected growth to decline in 2017. **See extract form MPC press release dated 30th March 2017.**

- The MPC Market Perception Survey conducted in March 2017 showed that private sector respondents expect a decline of growth in 2017, on account of the prevailing drought conditions and slowdown in private sector credit growth. However, the respondents expect the ongoing public investment in infrastructure to continue to be supportive growth.

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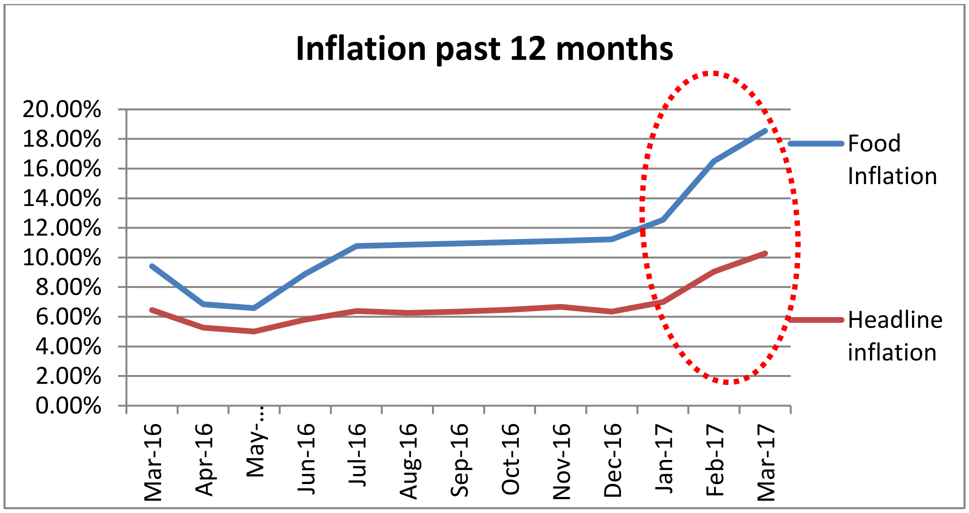
Going forward, the onset of the long rains will be crucial to recovery of the agricultural sector and in the event that the rains are insufficient (as the metrological department expects), we may experience further declines in business activity. Credit access to the private sector is also pivotal in the rebound of economic activity. The good news is we have started seeing politicians looking to resolve this, through relooking at how the interest rate cap law works. Stake holders are now in consultations on how to amend the law in a way that banks will have flexibility in allocating credit across all economic segments. It is however not known how long this process will take.

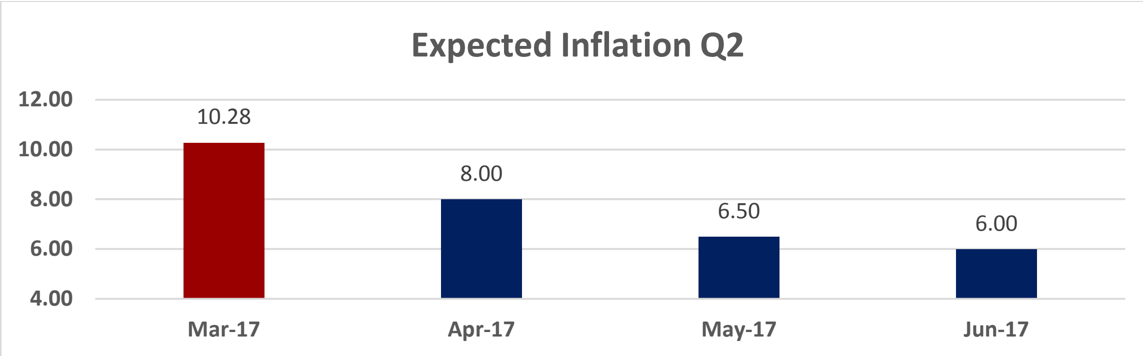
We maintain our 5.5% GDP growth forecast for 2017, a slowdown from 5.7% estimate for 2016. Despite the slowdown and signs of contraction in the private sector, we expect public expenditure to boost GDP in 2017. We also expect a gradual pick up of business activity after the elections.

Inflation: The Drought effect

Inflation averaged 8.8% during the quarter beating our 6.8% average for the quarter. This compares to an average of 6.5% in the previous quarter. While we expected inflation to increase during the quarter, the magnitude of the increases was larger than we expected. The sudden quarter on quarter increase was primarily driven by food inflation which increased to an average of 15.87% from 11.13% from the previous quarter.



Central bank noted that the non-food, non-fuel inflation remained relatively stable in the past 3 months, suggesting that demand pressures were muted. It is still expected that food inflation will remain elevated in the month of April due to the drought conditions, and ease thereafter. With the onset of the long rains, we expect food prices to reduce in the coming 3 months. Other baskets of the CPI index are expected to remain fairly stable. We thereby expect inflation to correct gradually to 6.0% in June 2017. Below is a chart showing our expectations on inflation rates.



Budget Deficit: Is treasury sincere this time?

As per the Budget statement 2017/2018, Treasury will be looking to reduce its budget deficit to 6% of GDP in the fiscal year 2017/2018 from 9.3% estimate for 2016/2017, a target we see as ambitious given the current economic environment. This is expected to be achieving through revenues collection amounting to Kes 1.76 in tax revenues up from Kes 1.57 trillion in 2016/2017 while at the same time maintaining expenditures at Kes 2.3 trillion. This will reduce the absolute deficit from 2016/2017 estimate of 690 Bn to 2017/2018 projection of Kes 525 Bn. The Deficit is expected to be financed equally between foreign and domestic borrowings.

It should be noted that the 2016/2017 fiscal year deficit is estimated at 9.3% of GDP compared to the target of 6.1%. Treasury noted that the variance was due to unforeseen expenditures related to the drought, the various strikes, security and preparations of the 2017 general elections. There were also additional expenditures for projects financed by development partners.

According to provisional data for the fiscal year 2016/2017, Treasury was able to meet its targeted revenues, at Kes 1.57 trillion against a target of Kes 1.5 trillion.

If the government implements the 2017/2018 budget as planned, and maintain its expenditure levels in check, we are likely to see reduced borrowing pressure from the local markets over the period. This will go a long way in reducing the market interest rates. With expected slowdown in business activity (see above discussions), it remains speculative whether the government will be able to raise the revenues it has targeted, given that its mostly dependent on economic expansion rather than increases in sources of revenue.

Interest rates: CBK's struggle

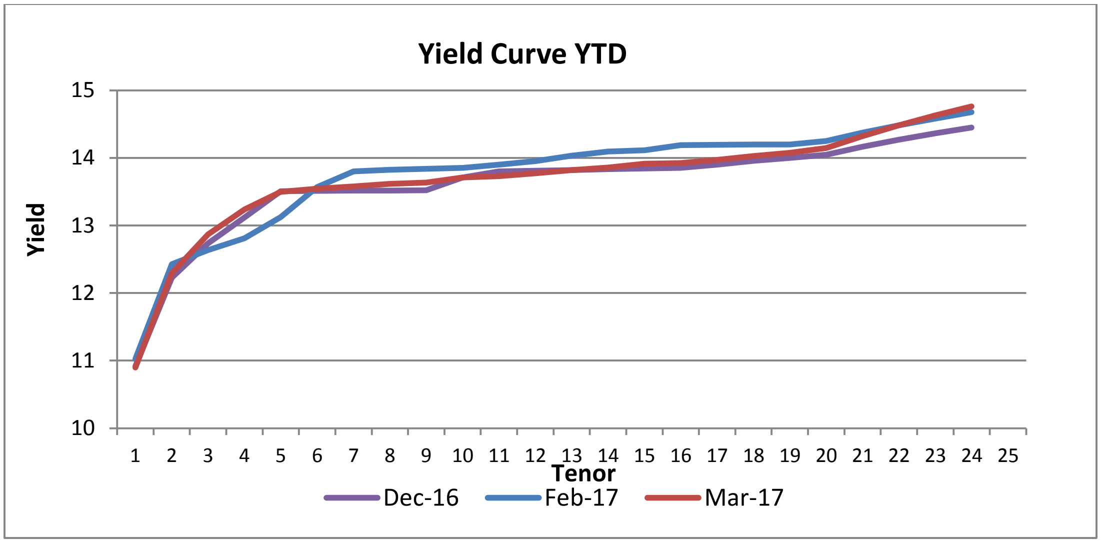
In line with our Quarter 1 expectations (see Q1 Macro report), short term interest rates were generally stable, with an upward bias. This is despite increases in expected inflation that should theoretically translate into increases in short term rates. The Quarter was characterized by demand /supply mismatches brought about by treasury's deliberate cherry picking strategy at the auctions, choosing to pick cheap money while dictating tenors. Several primary auctions were suspended during the quarter as central bank struggled to maintain the yield curve stable at rates below 14%.

The 91 day T-bill averaged at 8.7% (range of 22 basis points) compared to 8.1% in the previous quarter. The 364 day T-bill averaged at 10.9% (range of 13 basis points) compared to an average of 10.7% in Q4 2016. The 182 which was suspended in the last 4 auctions of the quarter averaged at 10.5% up from 10.4% in the previous quarter. Overall subscriptions remained high throughout the quarter, averaging 127%. This was despite an increase in the amounts offered from Kes 16 Bn a week to Kes 20 Bn a week in the month of March.

On the longer end of the yield curve, some volatility was witnessed in the medium term papers (2-12 years), where primary markets were most active. Below is a summary of quarter 1 bond primary auctions and performance.

Date of issue	Size	Tenure	Yield	Total Bids	Total accepted*
Jan-17**	Kes 30 Bn	5.3 years	N/A	N/A	N/A
Feb-17	Kes 30 Bn	12 Years	13.56%	35 Bn	14 Bn
March-17	Kes 30 Bn	2 year	12.4%	Kes 31 Bn	Kes 20 Bn
		1 year	11.8%	Kes 33 Bn	Kes 20 bn

includes tap sales ***** Issue was cancelled.***



The interbank rate increased to an average of 6.2% in Q1 from 5% in quarter 4 2016. The month of January and February saw episodes where the average interbank reached 9%, as liquidity distribution across the tier banks worsened. The interbank spread widened during the quarter to an average of 8% from 5.8% in Q416. Some interbank trades were happening at highs of 14% during the quarter, signifying further skewness in liquidity distribution in favor of large banks. Overall activity at the interbank declined 11% quarter on quarter to Kes 872 bn.

We expect short term interest rates to remain stable with a downward bias in quarter 2 on the back of improved liquidity in the money markets. Liquidity is expected to continue building up in the Money markets as banks continue to marginalize private sector borrowers in favor of governments.

The long term rates are expected to start declining in the second half of the year. Government's bid of maintaining 2017/2018 expenditures at similar levels to last year may see some reduced borrowing pressure beginning the next fiscal year which may lower interest rates at the longer end of the yield curve.

Monetary policy: formula change?

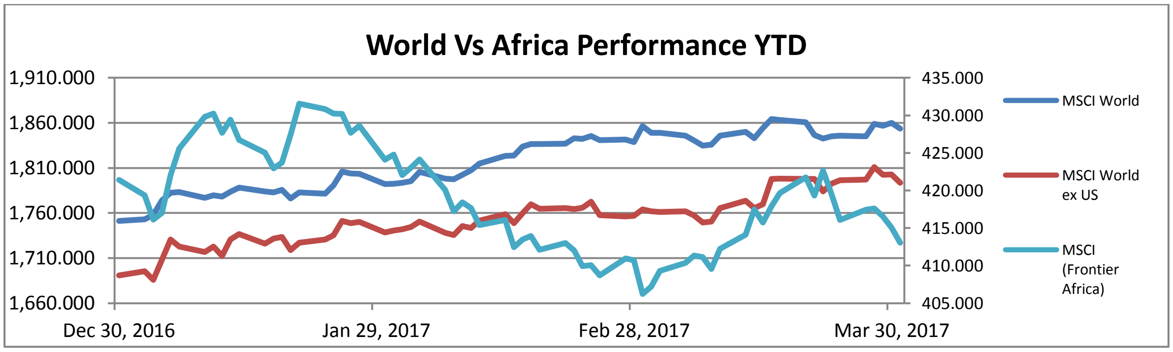
Monetary policy committee met twice during the quarter, both times overlooking the increase in inflationary pressure to retain the policy rate at 10%. In the Last meeting held on March 27th, credit growth and impacts of the interest rate cap took center stage of the discussion (91 words on the statement were used to explain the slowdown in credit growth while a further 168 words were used to describe the impact of interest rate cap).

The MPC for the first time since the rate cap law, attempted to break down some of the impacts of capping of the interest rates. Top on their list was the observation that banks were marginalizing business and personal borrowers in favor of the corporates. The tenure of loans was also observed to be declining with banks favoring short term loans. Lastly MPC noted that credit to SME's had declined in value terms, indicating reduced lending by the large and medium sized banks.

The language on their statement was generally observed as dovish, as the committee insisted that increase in inflation was not demand driven, and the slow credit growth was their main concern going forward. At this point **we cannot rule out a possible rate cut in the coming quarter**, as MPC is observed to be focusing more on growth rather than short term price movements. With inflation expected to decline in the coming few months, monetary policy easing will be on their cards in the coming meetings.

Equities Market: NSE Diverges from the rest

Global stock markets recovery continued well into Q1 2017 driven by bull runs in the developed markets and some select emerging markets. S&P 500 (US) went up 5.5% during the quarter; FTSE 100 (UK) went up 2.5% while MSCI china went up 13% over the same period.



In the US specifically, Positive economic numbers and hopes for a pro-growth change in U.S. economic policy, set the stage for rising bond yields and inflation expectations. These hopes fueled a Quarter 1 rally in U.S. stocks.

Unfortunately the same cannot be said for African frontier markets. The MSCI frontier markets Africa has declined 3% during the quarter, driven by bear runs in Nigeria and Kenya. This has mainly been driven by poor economic performance in commodity dependent countries as well as capital flights towards the high yielding assets in the developed markets.

Locally, the NASI lost 2.1% during the quarter, to close at 130.51 points as at 31st March 2017. At its trough in early March, the NASI index had lost 10% from beginning of the year. As the earnings season kicked off, the market started recovering, gaining 9% in the last 3 weeks of the quarter. The banking sector was the biggest gainer in the quarter, going up by 6.4% driven by KCB (21% gain), Equity (10% gain) and Standard chartered (14%). Gaining 6%, the Energy sector followed closely, driven by a 7% gain in Kengen and a 6% gain in Umeme. The agricultural sector gained 5.5% primarily driven by 35% gain in Sasini Tea.

The 3 week rally was largely driven by better than expected 2016 performance in the banking sector and higher dividend payments in the same sector. **There is also increased speculation that the capping of interest rate will be reviewed in the near future.** Statements from the President, the Central Bank Governor and various banks CEO's indicate amendment of the interest rate cap law is being strongly considered. It's still unclear what portion of the rally is attributed to a run up to dividend closure dates (as stocks rally towards their historical dividend yields) and what part is attributed to expectations of rate cap law amendments. We however still maintain our expectation of a sluggish first half of the year and a rebound in the second half.

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