Two- year fixed coupon Treasury bond issue

The government is looking to raise 30 billion through a 2 year bond. The paper is subject to a 15% withholding tax. **We recommend investors to bid between 12.5% and 13.0%**. In this note we argue that current fiscal developments are expected to increase government's appetite for local debt. Inflationary pressures coupled with increasing yields in the US markets will make investors to go aggressive on the auction.

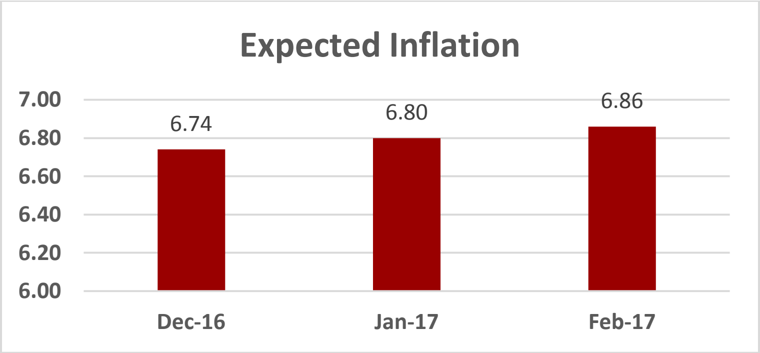
New Fiscal Developments: Reverse Gear

The draft budget policy statement for 2017/2018 fiscal year indicates that treasury intends to reduce the fiscal deficit for the current fiscal year from Kes 702.3 Bn to Kes 546.5 bn. This will be achieved through reducing development expenditure by Kes 217 Bn. Recurrent expenditure estimates were however revised upwards by Kes 16 bn. Revenue collection was revised downwards slightly by Kes 5 bn, on account of expected poor performance of Import duty and Income tax. Government is expecting to raise Kes 255 Bn (47% of the fiscal deficit) from local debt markets while the rest will be raised externally. This was a downward revision of about Kes 40 bn from the September estimate.

Going by this policy statement, we see the government putting efforts to expand its fiscal space which had narrowed in the last 4 years. Part of the commitments Kenya made when IMF extended a USD 1.5 Bn precautionary facility was to reduce its deficit by 3% over 3 years. This gesture may go a long way in stabilizing key economic metrics Interest rates included.

Inflation trending upwards

In line with market expectations, Inflation continued to trend upwards for the fourth consecutive month. Headline inflation for the month of November came in at 6.68% up from 6.47% in October. Price pressure came in on food items with energy and fuel prices remaining fairly flat. Food and non-alcoholic beverages (36% of the basket) went up 11.1% year on year (1.2% month on month). In its decision to hold on the policy rate at 10%, the MPC indicated that "inflationary pressures were mild and expected to remain within government range" This was a shift from its usual statement that "demand pressures are expected to remain moderate." This may indicate that they expect further uptick in the coming months. We also further expect inflation to trend upwards on account of higher food prices and recovery in fuel prices.



Interest rates continue to trend upwards

In light of the fiscal developments in the past 3 months, and continued inflationary pressure, investors have been demanding higher yields in the market. While the extent of foreign participation in the fixed income markets is not clear, we suspect the increase in US dollar yields may be further pushing foreign participants to bid at high yields in both the primary and secondary markets due to the increase in their opportunity cost. We expect rates to remain stable at current levels with an upward bias. Despite the fiscal consolidation gesture that government has shown, it is still expected to remain cash hungry for the rest of the year owing to high yields in international markets as well as expected revenue underperformance. On the supply side, we expect liquidity to be fairly high on the back of upcoming maturities (Kes 83 Bn in December only).

	14-Nov	21-Nov	28-Nov	5-Dec
91-day	8.20	8.30	8.36	8.36
182-day	10.30	10.40	10.50	10.50
364-day	10.70	10.80	10.90	11.09
Inter Bank	4.63	5.05	5.63	6.34
5 year	12.65	12.82	13.16	-
10 year	13.10	13.37	14.12	-
20 year	13.96	14.24	14.35	-

The two year paper expected to be attractive to Banks

At the current interest rates, government papers seem attractive on a risk adjusted basis compared to lending to private sector. Banking amendment act has forced banks to lend at no more than 400 basis points above the CBR. Looking at the five tier 1 banks that have released their Q3 earnings results so far, banks seem to be shifting their asset allocation in favor of government securities. Tier 1 banks' liquidity is also significantly high relative to the 20% minimum requirement. The Table below shows government securities as a % of assets for the five banks and how it has shifted between Sept last year to date. We also see the short tenure to augur well with their books.

	Q3 2016	Q3 2015	Liquidity
Equity	17.6%	7.2%	43%
KCB	15.6%	11.0%	38%
Coop	18.7%	12.7%	38%
Barclays	25.1%	20.2%	35%
DTB	23.6%	9.7%	49%

Bidding guide

- We expect robust demand on this paper from local banks.
- The current and expected high liquidity in the money markets serves as an indicator of expected oversubscription to this specific paper.
- Given that the government is currently slightly behind its borrowing timetable, and the decreasing maturity profile of its debt portfolio, we foresee a high acceptance rate to this paper.
- Current 2 year papers are trading at 12.14%
- **We recommend that investors bid at between 12.5% and 13.0% for 2 year paper.**

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