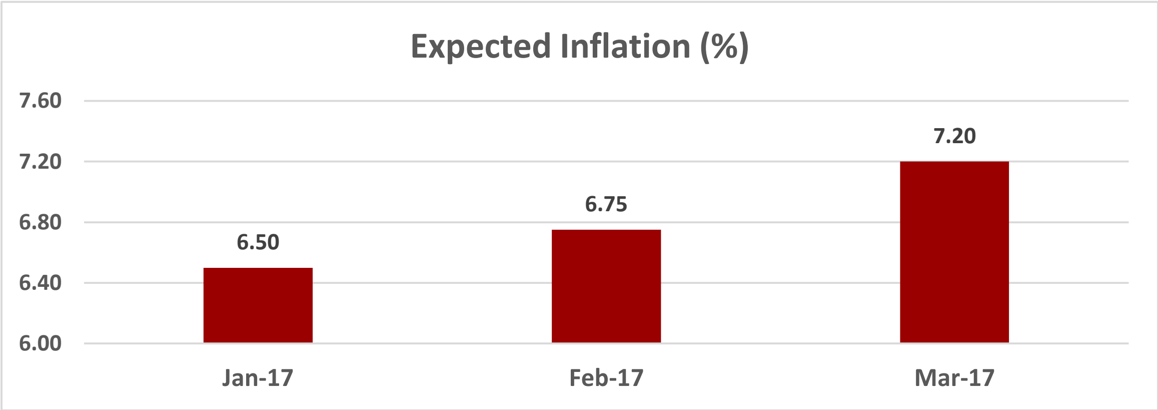
Reopening of 15 year Treasury Bond Issue

The government is looking to raise 30 billion through the reopening a 15 year bond (5.37 years to maturity). The paper has a coupon rate of 13.5% and is subject to a 10% withholding tax on interest. **We recommend investors to bid between 13.50% and 13.99%.** Similar to the last primary auction, we expect investors to bid aggressively as far as yield is concerned. Inflationary expectations are on the rise, Government borrowing still behind schedule and the dollar continues to strengthen against the Kenyan shilling.

Inflation expected to go up

Headline inflation in December came in at 6.35% down from 6.68% recorded in November. This was mainly on account of fairly stable food prices. We expect inflation to increase to 7.2% in March 2017. This is on account of higher food prices, increase in electricity and fuel costs and imported inflation following the strengthening of the dollar in the past 2 months. In line with these expectations, yields are expected to increase. See below our inflation expectation for this quarter.



Government borrowing still behind target

As at 6th January, the government had borrowed Kes 126.9 bn against their full year target of Kes 294.6 Bn. This represents 43% of the borrowing target. During the week, Bloomberg reported that Treasury had mandated four international banks to arrange for a USD 800 million (Kes 83 Bn) syndicated loan. This loan is expected sometime in February. This loan might just give treasury some breathing space given they are behind schedule on borrowings. Looking at the Tbill auction in the last couple of weeks and the last primary bond auction, the trend in acceptance signifies that treasury is willing to keep interest rates low at the expense of reduced borrowings.

Rates remain stable as liquidity tightens

The Month of December and January has seen short term interest rates remain fairly stable although with an upward bias. 91 day Treasury bill averaged 8.58% in the first 3 auctions of 2017, compared to 8.44% average in December. 182 & 364 day papers have remained unchanged at 10.5 and 11.0% over the same period. Subscriptions at the auctions have however declined substantially following tightening conditions at the interbank market. Interbank rates have rallied in January. The rate has averaged 7.9% in January compared to 6% in December. Currently the interbank is trading at 9.2%. Central bank data shows some activity on the CBK borrowing window signifying the liquidity tightness in the banks.

Conclusion

We expect the tight liquidity conditions in the interbank market to remain, as CBK tries to prop up the shilling. CBK's new dilemma will be to maintain inflation within target and still maintain liquidity in the banking system. Given that the government is behind schedule on borrowing we expect acceptance rates to be high. We however expect subscription to be below the 30 Bn that treasury is targeting to rise. This scenario increases the possibility of a Tap sale.

Bidding guide

- We expect modest demand on this paper from local banks.
- The current and expected low liquidity in the money markets serves as an indicator of expected undersubscription.
- 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.
- In the last primary auction (2 year bond), the government rejected Kes 26 Bn out of Kes 35 Bn in subscriptions. It opted to do a tap sale where it raised Kes 15Bn. This scenario is also likely in this auction, given government's plan to raise a syndicated loan which might reduce local borrowing pressure.
- Current 5 year papers are trading at 13.6%.
- **We recommend that investors bid between 13.5% and 13.99% for the paper.**

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