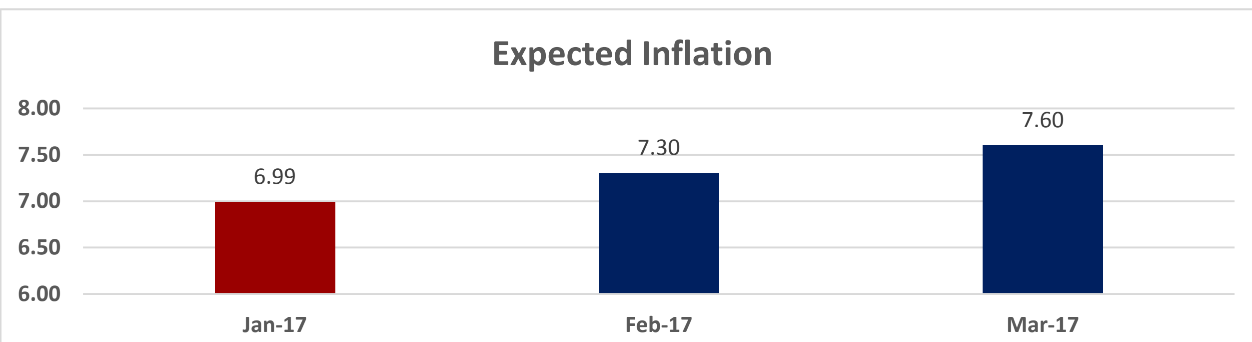
Government issues a 12 year Infrastructure Bond

This month, the government is looking to raise 30 billion through the issuing of a 12 year infrastructure bond. The paper has a coupon rate of 12.5%. The Bond will be tax free as is the case for all Infrastructure Bonds. The proceeds have been ear marked for partial funding of infrastructure projects in Roads, Energy and Water sectors. **We recommend investors to bid between 13.50% and 13.99%.** The last bond primary auction held a month ago saw Central Bank cancel the whole issue. Central bank later in response to our enquiries said that bids were too high for Treasury. It is not clear though on the participations rate, but we also suspect that it was lower than their projections owing to tight liquidity at the time. For this auction we still expect investors to bid **aggressively** as far as yield is concerned. Inflationary expectations are still on the rise, Shilling is expected to depreciate further in the near term and fiscal deficit is expected to widen further in the coming financial year.

Consumer prices continue to rally

Headline inflation in January came in at 6.99% up from 6.35% recorded in December beating our projection by 400 bps. This was mainly on account of steep increase in food prices. Food inflation came in at 12.5% year-on-year compared to 11.2% in December 2016. The ongoing drought is expected to put more pressure on food items and energy costs. Fuel Pump prices are also on the rise in line with international crude prices. Crude oil prices are expected to remain elevated following supply cuts by major producers. We thereby revise our inflation expectation for February and March to 7.3% and 7.6% respectively. With high inflation, it is expected that investors will bid aggressively in order to maintain their real return. See chart below for our inflation projection for the quarter.



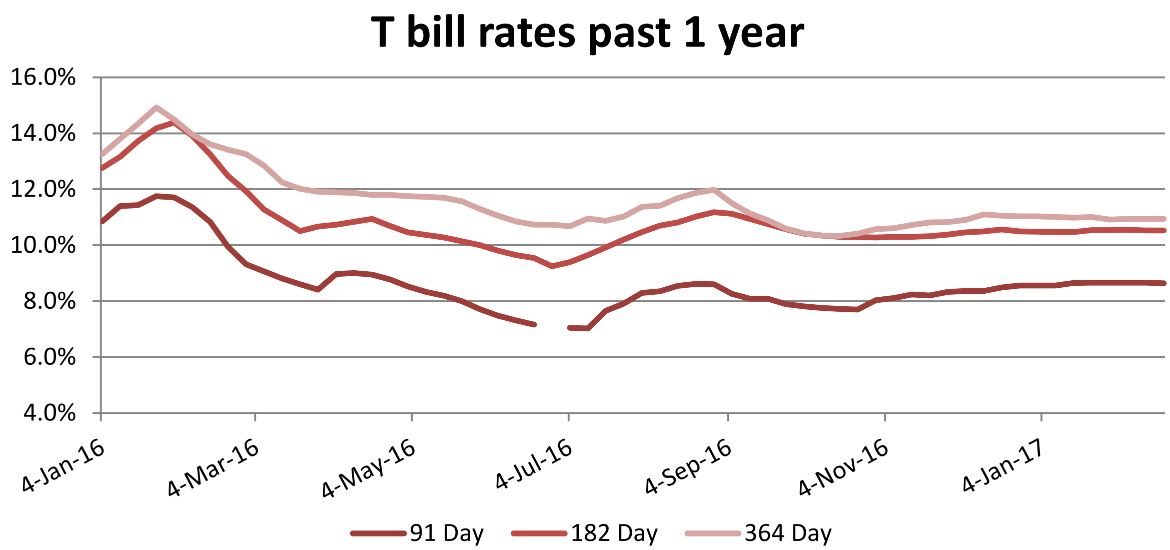
Public finance: Expected wider fiscal deficit

During the cabinet meeting held on 9th Feb 2017, the Cabinet approved a budget of Kes 2.62 trillion. The government is expecting to raise Kes 1.72 trillion from taxes implying a deficit of Kes 900 billion. The National Treasury, through the 2017/2018 budget policy statement had earlier estimated that Kenya would spend Kes 2.275 trillion in the financial year 2017/2018. Tax revenues were then estimated at Kes 1.6 trillion. This move by cabinet, if approved by the parliament will see the fiscal deficit increase from Kes 515.8 Bn (7.4% of GDP) to Kes 900 bn (12% of GDP). This move is expected to push interest rates upwards as government increases the level of local borrowing

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 3

Rates remain stable despite liquidity fluctuations

Short-term interest rates have remained fairly unchanged in 2017 despite some liquidity fluctuation in the money markets. Subscriptions the T-bill auctions have improved significantly in February with a bias towards the 182 and 364 papers. Theoretically this should imply investor expectation of interest rates falling in the near term. The interbank rate declined to an average of 6.8% for the first 3 weeks of February compared to 7.8% in January.



Conclusion

In our last fixed income note we expected aggressive bidding as far as interest rates are concerned at the primary bond market owing to some changes in economic fundamentals. We think the environment will remain the same in the coming few months. High inflation, a strengthening dollar and a fairly tight interbank market are expected to drive interest rates higher.

- We believe the paper is attractive to foreigners due to the high liquidity nature of IFBs, attractive yield and the tax free nature of IFBs.
- With a possible fiscal deficit widening in the future, interest rate outlook in the medium term remain elevated.
- The cancellation of the previous Primary auction due to aggressive bidding is seen as a signal of the unwillingness of treasury paying high interest rates. We however believe economic fundamentals will remain the key drivers to interest rate directions.
- Current 12 year papers are trading at 13.8%.
- **We recommend that investors bid between 13.50% and 13.99% for the paper.**

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Research Disclosure

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