Government Reopens 2 papers

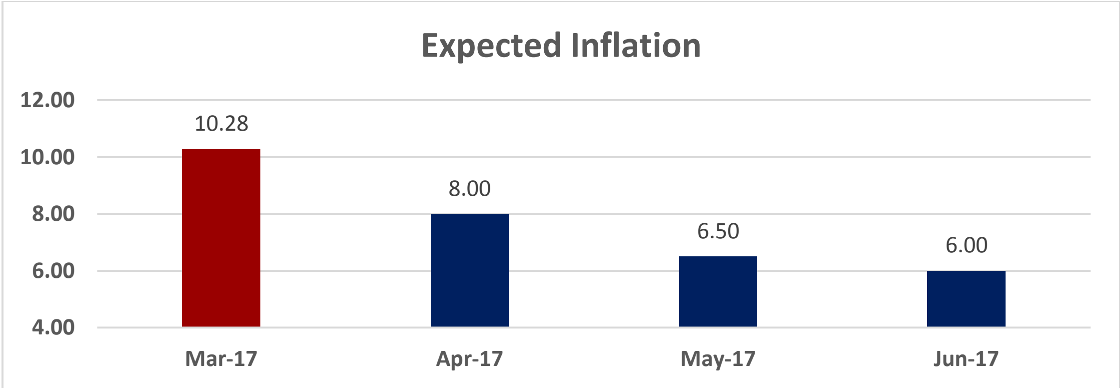
This month, the government is looking to raise 30 billion through the reopening of two ten year papers: FXD3/2008/10 (1.4 years) and FXD1/2009/10 (1.98 years), both with coupons of 10.75%. **We recommend investors to bid between 11.25% and 11.65% for the 1.4 year paper and between 11.8% and 12.25% for the 1.9 year paper.** Our bidding guides, which are below the market price for similar papers, is informed by our expectations of declining interest rates. Below we discuss our justifications for the expected low interest environment.

Inflation

Headline inflation is reported to have increased to 10.28% in the month of March, primarily driven by food inflation (36% of the index) which came in at 19% from 17% in February. The increases in food prices were mainly attributed to the drought conditions that have prevailed in the country for the last 4 months. Energy related products were also observed to have marginal increased on a year on year basis, with yoy change in the transport index (8.7% weight on the index) increasing to 4.9% from 0.9% at the beginning of the year. This has mainly been driven by increases in global oil prices, which have been on the rise following the move by OPEC members to reduce output starting February 2017. Crude oil averaged USD 49 per barrel in March 2017, compared to USD 41 per barrel in a similar period last year. The US/ Syria conflict has recently pushed the prices to USD 55 per barrel in the first 2 weeks of April.

Going forward, we expect inflationary pressure to reduce gradually back to historical levels. The onset of the long rains is expected to provide some reprieve to food prices in the coming few months. The rains are also expected to reduce electricity prices as water levels in Hydro plants improve. Government initiatives to ease certain food prices through changes in food taxation and direct intervention in food markets may also ease prices of food items.

This may partly offset by the base effect of fuel prices which are about 30% higher compared to Last year. Below is our inflation expectation for the next 3 months.



Public finance: 2017/2018

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.

Liquidity

Liquidity at the money markets remained high in the month of March evident by high subscription level. Aggregate subscription levels for all money market auctions stood at 155% (177% in February). This was despite an increase on amounts offered from Kes 16 Bn per week to Kes 20 Bn per week. The high liquidity in the money markets can be attributed to low private sector lending activity in the banking sector which is pushing banks to pack money in short term papers. Our expectation is that the liquidity situation will remain high in the month of April, due to the low lending activity by banks.
Upcoming Maturities are also expected to maintain liquidity high in the coming months. We calculate about Kes 250 Bn in maturities in the coming 3 months compared to Kes 236 in the past 3 months.

Upcoming Maturities Q2 2017			
	April	May	June
Treasury Bonds	-	30.13	18.38
Treasury Bills	73.70	76.12	51.03
Interest	0	1.79	1.16
Total	**73.70**	**108.04**	**70.57**

Conclusion

With inflation expected to decline in the coming 3 months and the fiscal deficit expected to narrow in the coming fiscal year, we are inclined to expect interest rate declines in the coming quarter. High liquidity is also expected to push investors to bid conservatively in both primary and secondary markets. Below is our bidding guide for the 2 papers on issue.

Isuue	Coupon	Tenor	Bidding Range
FXD3/2008/10 (reopen)	10.75%	1.4 Years	11.25%-11.65%
FXD1/2009/10 (reopen)	10.75%	1.98 Years	11.80%-12.25%

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