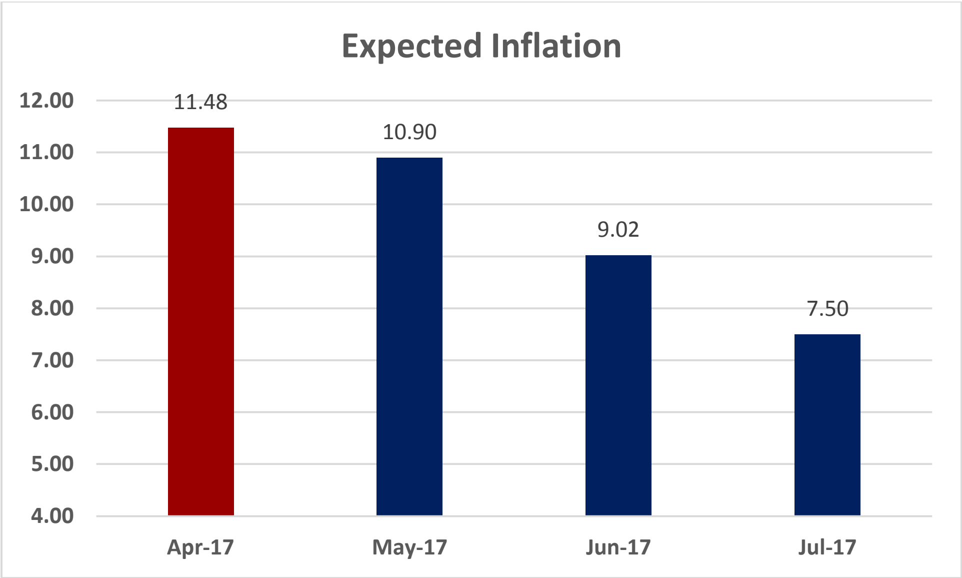
Government Reopens 2 papers

This month, the government is looking to raise 40 billion through the reopening of a 10-year paper, FXD2/2010/10 (3.42 years) and a 15-year paper, FXD1/2009/15 (7.40 years), for budgetary support. The coupon rates for the papers are 9.3% and 12.5% respectively. **We recommend investors to bid between 12.0% and 12.5% for the 3.42 tenure paper and between 12.8% and 13.4% for the 7.40 tenure paper.** Our bidding guides are informed by our expectations of slight oversubscription due to high liquidity and expected reduction in inflation. Below we discuss our justifications for the expected low interest rate environment.

Inflation

April headline inflation rose by 120 basis points to 11.48% from 10.28% in March, primarily driven by food inflation (36% of basket), which averaged 21.0% year-on-year as compared to 18.6% in March. This was mainly attributed to increases in prices of several food items including maize flour, Sukuma wiki, and milk, mainly driven by unfavourable weather conditions. The transport index (8.7% of basket) decreased by 0.22% in April compared to March, mainly on account of decreases in the pump prices of petrol and diesel in the month of March. Crude oil prices, as measured by WTI, closed lower for the month of April at $48 per barrel from March's close of $53, as the market reacts to increase US shale oil output. This should translate to lower local pump prices by the end of May.

Going forward, we expect inflationary pressure to reduce gradually back to single digit in the next few months. The onset of the long rains is expected to provide some reprieve to food prices and also to reduce electricity prices as water levels in hydro plants improve. This may partly offset by an expected increase in international crude oil prices after the OPEC meeting on the 25th of May, with OPEC and other large non-OPEC producers likely to extend supply cuts for the 2nd half of 2017. Below is our revised inflation expectation for the next 3 months.



CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 4

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 8.3% estimate for 2016/2017, a target we see as ambitious given the current economic environment. The FY18 budget accordingly aims to cut the deficit by reducing expenditures to approximately 26% of GDP, from an estimated 28% in FY17. The Treasury is looking to reduce the fiscal deficit and ensure the sustainability of Kenya's debt. The government forecasts the deficit falling to around 4% of GDP in FY20 with one-off expenditures seen in 2016/2017, such as the Kes 19.3 bn in election-related costs not expected to recur.

Fitch Ratings estimated the deficit for 2016/2017 at 7.1%, and explained that the 8.3% estimate was higher due to factors such increased in capital expenditures, higher-than-expected current expenditures ahead of the election, unfavourable weather conditions and lower-than-expected revenue growth.

Based on 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 maintains this trend for 2017/2018 as per the budget, and also 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.

Liquidity

Liquidity in the money markets remained high in the month of April evident by high subscription level. Aggregate subscription levels for T-bill auctions stood at 146% (159% in April). The subscriptions for the May T-bill auctions so far have averaged 162%, despite an increase in amounts offered from Kes 20 Bn per week to Kes 24 Bn per week, after re-introduction of the 182-day paper following its suspension in March. The high liquidity in the money markets can be attributed to low private sector lending activity and we expect this to continue in the month of May. Over the last one month, the high subscriptions have been largely biased towards 91-day and 182-day papers, which could either mean that investors are expecting yields to increase or that banks are anticipating an amendment in the interest rate capping law. The interbank rate averaged 4.5% and 5.0% in March and April respectively compared to 7.8% and 6.8% for January and February.

Upcoming maturities are also expected to keep liquidity high in the coming months. The maturities for the month of May are significantly higher at Kes 115 bn as compared to April's Kes 74 bn.

Upcoming Maturities Q2 2017			
	May	**June**	**July**
Treasury Bonds	30.13	18.38	-
Treasury Bills	83.42	72.96	67.42
Interest	1.79	1.16	-
Total	**115.34**	**92.50**	**67.42**

Conclusion

We expect pressure on interest rates to reduce based on our outlook for inflation, budget deficit and liquidity. For the current auction, we expect slight oversubscription due to increased liquidity in the market, with a bias toward the 3.42 paper due to its shorter tenure. We also expect investors to be slightly more aggressive than in previous auctions, given that the government has less than two months to the close of the current fiscal year and is likely to be more flexible with regards to acceptance of high rates, especially with expected high maturities for the month of May.

In recent auctions, the government has rejected expensive bids and opted for a tap sale. We expect a similar scenario if investors bid too high.

Issue	Coupon	Tenor	Bidding Range
FXD2/2010/10 (reopen)	10.75%	3.42 Years	12.00% - 12.50%
FXD1/2009/15 (reopen)	10.75%	7.40 Years	12.80% - 13.30%

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