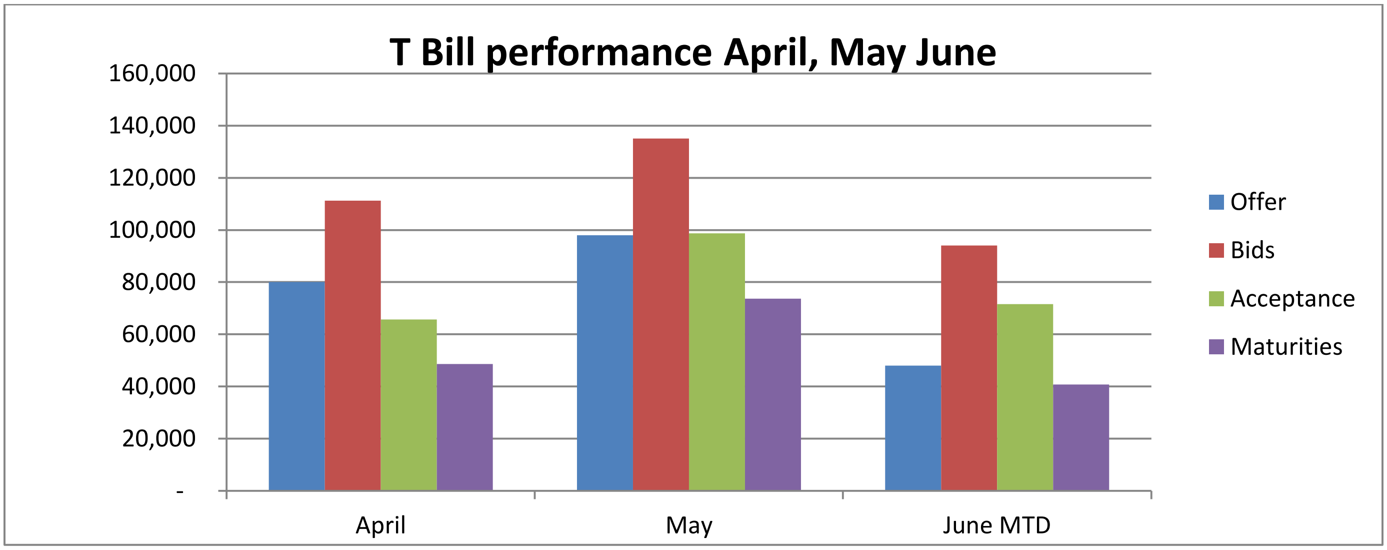
Treasury reopens 15 year paper

Treasury will be looking to raise Kes 30 Bn this month, through the reopening of a 15 year paper with an effective maturity of 5 years. Withholding tax for the paper is 10%. **We recommend investors to Bid between 12.3% and 12.6%.** Similar papers are currently trading at 12.4%. We do not expect the weighted average rate for the paper to deviate far from the market rates, due to the high liquidity environment as well as Central banks cautionary behavior in the auctions.

Liquidity remains high

The last 3 months have seen increased inflows into the money markets as banks seek to pack their high liquidity. April and May saw aggregate subscription rates in the money markets come in at 139% and 138% respectively. June to date has seen subscriptions increase to 196%, driven by lower offer amounts by treasury as well as increased bids. We are still operating under the hypothesis that banks are rationing credit to the private sector, due to the rate cap, and are thus trying to pack the extra liquidity in government papers. CBK acceptance rates have however remained below the bids, with acceptance rate of 59% and 73% in April and May respectively. Thus far June has seen acceptance rates increase slightly to 76%.



The heavy liquidity in the money markets, combined with the high inflationary environment, seem to have had a balancing effect on yields, as short term interest rates literary remained unchanged in April and May. June auctions have however seen Interest rates decline, as liquidity increased and inflation expectations seem to have declined.

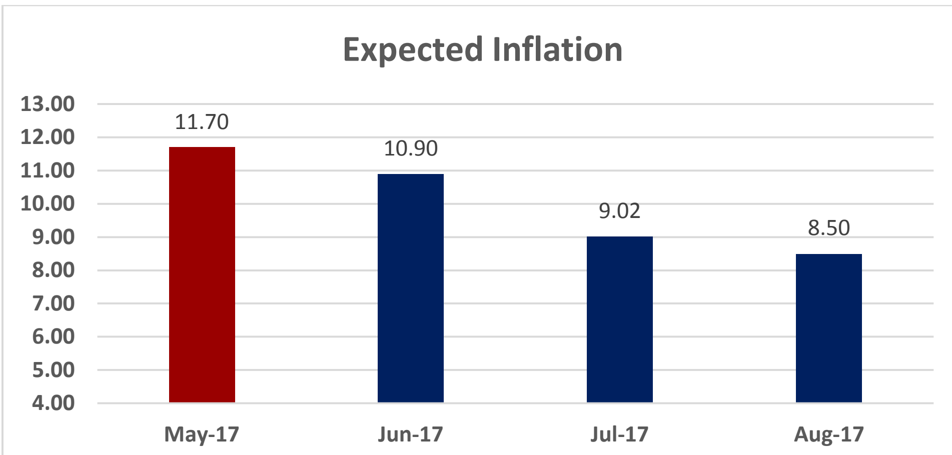
We still expect to see liquidity remain high and government acceptance remaining below the bids.

In our last two bidding guidelines we have been expecting declines in interest rates across the yield curve owing to increased liquidity and an expectation of fiscal consolidation in the coming fiscal year. We still expect this to continue for the rest of the year.

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 3

Inflation

At 11.7% inflation remained elevated in May (11.48% in April), against our expectation of gradual decline. Food category continued to register high price increases. Food inflation comes in at 21.52% compared to 20.98% in April. Inflation in all other categories remained stable on month on month and year of year basis. As the MPC has demonstrated in their recent decision to hold the policy rate at 10%, it is highly unlikely that they are going to intervene to correct inflation downwards. They view the inflationary pressure transitionary and that it will self-correct as the effect of the drought wade off. Fiscal interventions are however underway, in a response to public outcry over food prices.
We still expect inflation to decline gradually in the coming months, and finally revert back to around 6% by year end. See below our expectations for inflation In the coming months.



Public finance

Our expectation of a lower fiscal deficit in the coming new fiscal year still holds at this point. Based on the Budget estimates for FY 2017/2018, the fiscal deficit is expected to decline to 6% from 8.3% estimated for the current year. Fitch ratings also noted that the recent budget statement pointed to a shift in policy stance by treasury from expansionary to more of fiscal consolidation. (click here to view statement). They however projected a higher deficit of 7.1% compared to treasury's 6%, due to high capital expenditures. This view further supports our expectation of lower and stable interest rates across the curve.

Conclusion

We expect pressure on interest rates to reduce based on our outlook for inflation, budget deficit and liquidity. Investors are expected to be conservative in their bidding in this primary auction, as they seek to lock in the current market yield with the paper. While banks are observed to prefer shorter money market instruments, as they position themselves for a better credit environment in H2, this paper still remains attractive to them.

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.

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Research Disclosure

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