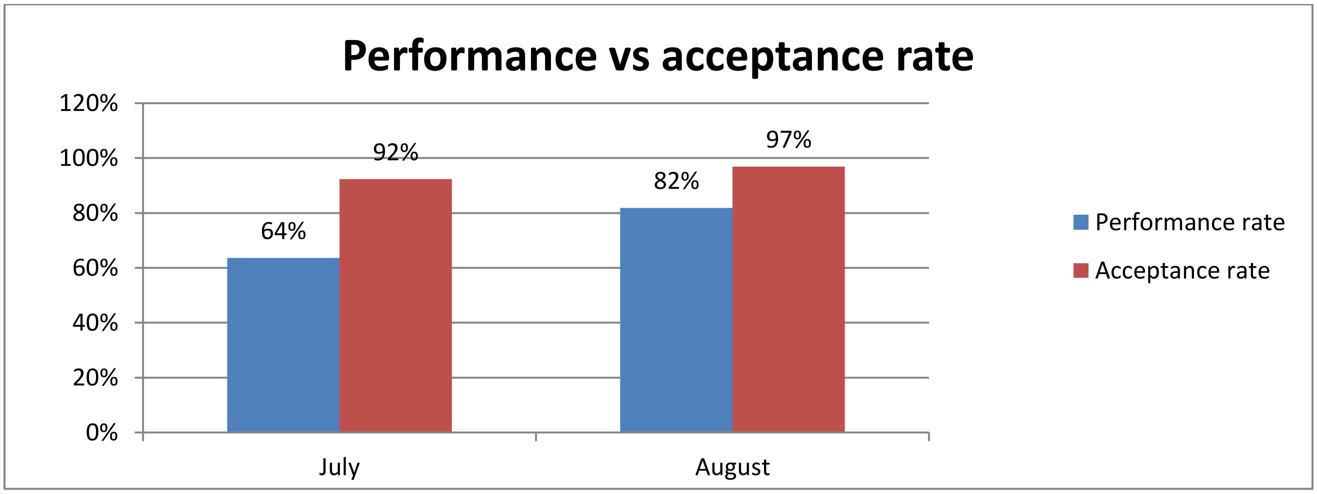
Government issues two papers to raise Kes 30 Bn

In a bid to accommodate all investor preference as far as bond tenures are concerned, GOK has issued a new 5 year paper and reopened last month's primary paper (10 years). As expected in our July bidding guide, the 10 year paper was undersubscribed owing to tight liquidity of Kenya shillings at the market at the time and low preference by the local banks due to long tenure. We believe this to be the reason for reopening this paper and subsequently issuing a new 5 year. The offer amount for both papers is Kes 30 Bn and both are subject to withholding tax; 15% for the 5 year and 10% for the 10 year.

We recommend investors to bid between 12.85% and 13.05% for the 10 year paper and 12.2% to 12.5% for the 5 year paper.

Liquidity Levels

Improved government payments, coupled with T-bill maturities helped improve liquidity in the month of August compared to July. Subscriptions rates for T-bill auctions improved to 82% from 64% in July. T bill maturities increased to Kes 93 Bn from Kes 53 Bn in the previous month. However, due to uneven distribution of liquidity the Central Bank was on both sides of the market. It withdrew excess liquidity from segments of the market with surpluses and used reverse repos to support segments facing temporary liquidity shortages (CBK).



We further hypothesize that capital flows towards the equities market may be contributing to the tight money markets. Market capitalization has increased by 14% since mid-May to stand at Kes 2.43 trillion as at 18th August.

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 3 & 4

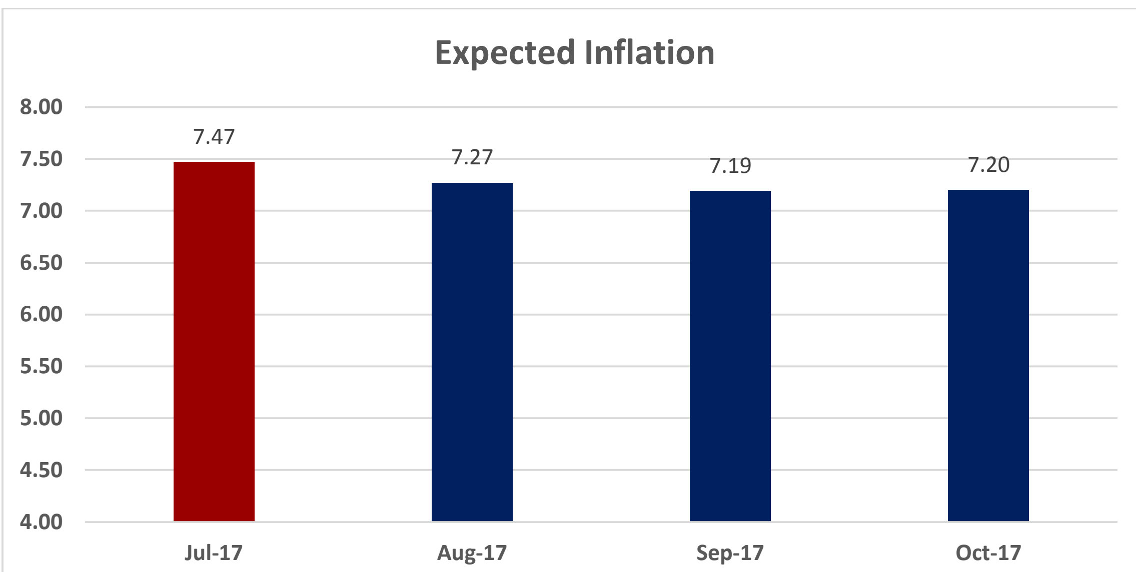
Inflation

Inflation further decreased by 96 bps to 7.47% in July, largely driven by continued decline on Food and Non-Alcoholic beverages index, dropping by 205 bps to 12.19% in July. We expected a much gradual decline in inflation. Government interventions coupled with improved weather conditions continue to be the main drivers of the decline in food prices.

We believe that inflation may stabilize at current levels owing to base effects of food and fuel prices. While the food and petroleum prices have declined on a quarter by quarter basis, they still remain high compared to a similar period last year. As noted in our Q2 Macro report (**click to view**) on the outlook for the agricultural sector, Kenya Metrological reported most parts of the country had below normal rainfall in April, May and June long rain season. Rainfall distribution over the same period was also poor. This is expected to result in low food production in the second half of 2017.

International crude prices have remained relatively stable on a month on month basis, averaging USD 48 per barrel in August up from USD 46 in July. Consensus estimates indicate expectations of stability in the crude oil market for the remainder part of the year.

We therefore expect inflation to remain stable with a down ward bias, at least in the coming 3 months. See below our



Public finance

We still expect this new financial year to be a turnaround year as far as fiscal expenditure is concerned. Our expectation of a lower fiscal deficit in the current 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. News of State officer's salaries and allowances being reduced by the Salaries and remunerations commission (SRC) may serve as an indication of the direction the government is seeking to undertake. Kenya revenue authority also reported that revenue collections were up 13.8% to Kes 1.365 trillion in the fiscal year 2016/2017. This was marginally below their revised target of Kes 13.76 trillion.

Fiscal indiscipline still remains a key risk to this expectation. This risk informed Fitch ratings in projecting a higher deficit of 7.1% compared to treasury's 6%. This view further supports our expectation of lower and stable interest rates across the curve.

Conclusion

We remain convinced that interest rates across the curve will remain sticky at current levels in H2. This is mainly informed by the expectation of fiscal consolidation in the current fiscal year, lower inflation expectation and potential capital flows favoring equity markets at the expense of the bonds market.

We expect moderate to subdued subscription on the ten year issue at the current yields. We do not expect the banking industry to go heavy on this paper due to the long term nature. As for the 5 year paper, we expect a lot of interest from the banking sector due to its short term paper.

We thereby recommend investors to bid between 12.8% and 13.1% for the ten year paper, and 12.2% to 12.5% for the 5 year paper. The current market yield for 10 year is at 12.966% and 12.25% for the 5 year papers

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