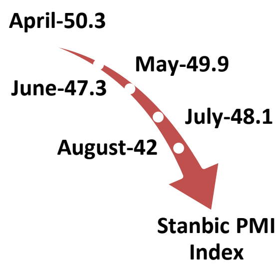
Government issues two papers to raise Kes 30 Bn

Similar to last month, treasury has issued two papers, so as to accommodate investor preference. A new 2 year paper which is observed to be targeted to the banks and reopening of a ten year paper (9.85 years), which is being reopened for the second time. We expect a lot of appetite for the new two year paper, relative to the 10 year reopening. The offer amount for both papers is Kes 30 Bn and both are subject to withholding tax; 15% for the 2 year and 10% for the 10 year.

In this issue we argue that expected slowdown in economic activity, and the current high inflationary environment, is expected to exert pressure on interest rates in the near future.

We thereby recommend investors to bid between 12.8% and 13.1% for the ten year paper, and 11.6% to 12.0% for the 2 year paper.

Business Activity on the decline



Recent events in Kenya's political environment are expected to exert pressure on government expenditure, and put a strain on revenue collection. The political climate is being cited as a big impediment to economic output as investors are holding back on investments, and also reducing their pay roll numbers. In its latest purchasing managers index (PMI), Stanbic bank reported the lowest level of the index in the surveys history. At 42 points for the month of August, the private sector activity is said to be contracting at very high rates (see trend above). The index is designed to provide an overview of activity in the economy. A reading of the PMI below 50 points indicates that economic activity is generally on the decline from the previous period. This has been the case for Kenya since April 2017. Low money circulation, coupled with weak demand conditions were the reasons cited by the panelist as the key drivers to this decline in business activity.

Impact on Public finance

The two main revenue contributors for the government are the income tax and the value added tax (VAT). Income tax is mainly dependent on growth in personal incomes and company output. VAT is dependent on expenditure patterns which are dependent on income and access to credit.

As stated above, business activity and employment in general are on the decline. This will come as a big challenge to treasury since it's expected to put a strain on revenue collections going forward. Banking sector is reported to have reduced its tax remittance by 13% in the first half of 2017 (Business daily). On the other hand, government expenditure is expected to remain sticky with an upward bias, due to the longer than expected electioneering period, as well as the political transitions which will cost treasury in terms of sendoff packages.

Going by these current developments in the economy, we are now inclined to revise our earlier assumption of expected decline in the fiscal deficit. Current deficit is expected at Kes 524 Bn which will be funded equally through domestic and foreign sources. Economists at CITI bank have also identified this large deficit as the key risk to our economy.

Consequently, we now expect interest rates to go up in the near term, due to an increase in country risk, and expected heavy borrowing in a tight environment.

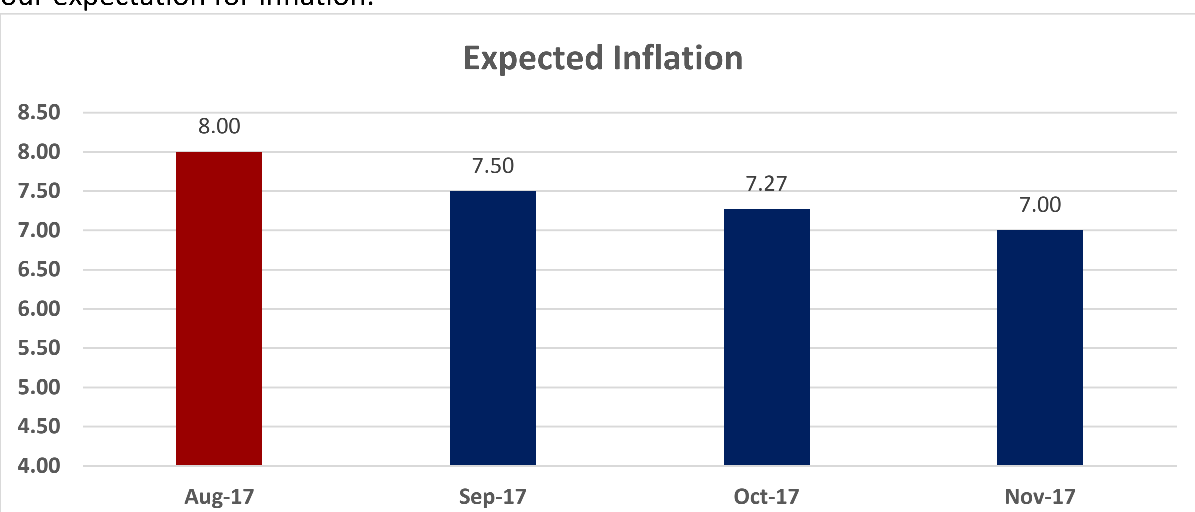
Inflation

Against our expectation, overall inflation increased to 8.0 % in August 2017 from 7.5 % in July 2017, largely reflecting increases in prices of selected food items. The increase was mainly attributed to depressed supply of key food items in the second week of August 2017 that coincided with the general elections. We understand some key subsidies were withdrawn during the month, causing prices of staple foods to increase. Consequently, food inflation increased to 12.8 % in August 2017 from 11.6 % in July 2017.

Fuel inflation increased marginally to 3.1% in August 2017 from 2.9% in July 2017, due to a slight increase in energy prices, particularly electricity, petrol, and kerosene in August 2017 compared to July 2017. However, Non-Food-Non-Fuel (NFNF) inflation declined to 3.9% in August 2017 from 4.1 percent in July 2017, reflecting minimal demand pressures.

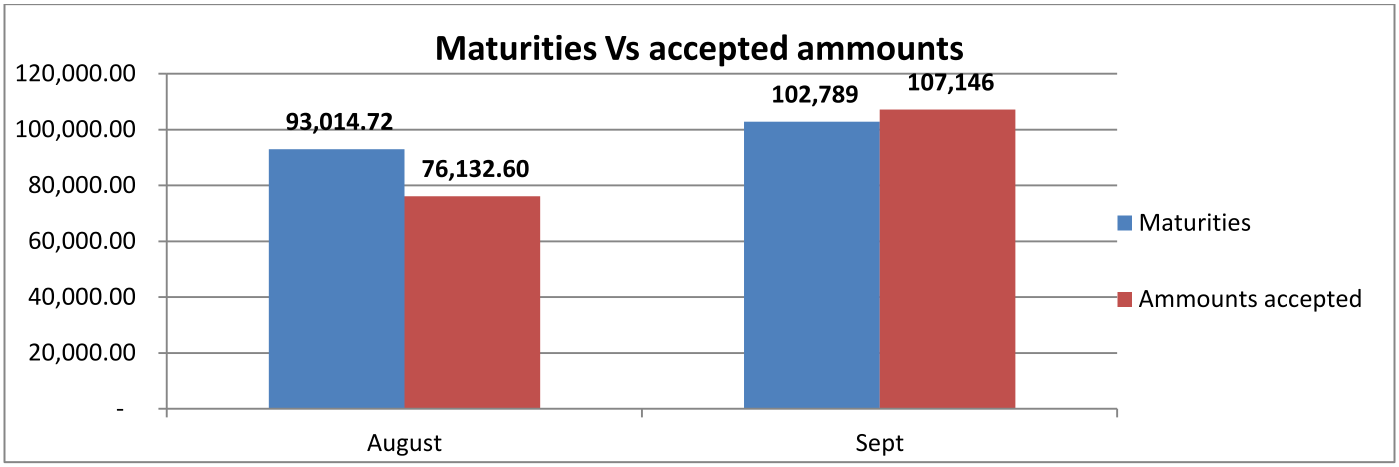
Going forward, the Metrological department expects most of the country to experience enhanced rainfall. It should be noted that this is the first time since Q4 2015 that they have given a positive outlook with regards to rainfall. This is expected to really boost food supplies both in the short and medium terms.

We therefore still expect inflation to trend downwards in the coming months. Food inflation is expected to normalize in the coming months as the country begins to get adequate rainfall. See below our expectation for inflation.



Liquidity Levels

Liquidity levels have remained flat in the past 4 auctions. Maturities have uniformly matched accepted amounts in the T-bill markets, as government payments have generally netted out with tax payments. Repo market has remained mute over the period, signifying improved liquidity distribution in the banking sector.



Conclusion

Recent evidence on deteriorating economic activities and recent political events has significantly increased our country risk. At this point we are inclined to revise our outlook for interest rates from low and stable, to upward trending, in the near term.

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 2 year paper, we expect aggressive bidding both in price and issue amount.

We thereby recommend investors to bid between 12.8% and 13.1% for the ten year paper, and 11.6% to 12.0% for the 2 year paper. The current market yield for 10 year is at 12.75% and 11.6% for the 2 year papers.

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