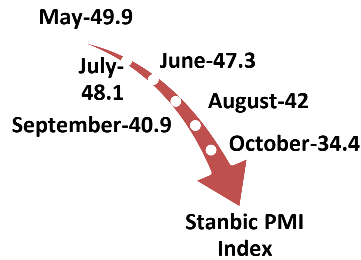
Government issues a 7 year paper

This month the government will be looking to raise Ksh 30 bn through a 7 year amortized bond to fund Infrastructure projects. The government paper will be tax free as is the case for all Kenyan Infrastructure bonds. We expect a moderate to high subscription for this paper owing to the appealing nature of the tax free Infrastructure bond. Investors are further expected to bid aggressively. Central bank may however choose to lower the acceptance level in a bid to keep the yield near the curve. We recommend investors to bid between 11.6% and 12.00%. The current market yield for an Infrastructure bond with a tenor to maturity of 7 years is at 11.60%.

Business Activity on the decline

The effects of Kenya's challenging political environment continue to be felt by the private sector. Private sector activity as measured by Stanbic Bank Kenya PMI, recorded the sharpest decline so far this year to a new low of 34.4. The survey recorded declines in manufacturing output, reduction in orders and also noted contraction in employment.



The panelist attributed the sharpest ever recorded decline in business activity to the ongoing political instability and poor economic conditions. Alongside the reduced domestic demand witnessed before, October saw the fastest decline in export orders in the survey's history.

Public Finance: Impact of Slow Business Activity

As we have previously highlighted on the September Primary Auction note, the two main contributors to actual ordinary revenue collected by government is the income tax and Value Added Tax (VAT). According to 2017 draft Budget Review and Outlook paper (BROP); the categories of VAT and Income tax contributed to Ksh 964.1 bn (or 73.8%) of the 1,305.8 bn of ordinary revenue collected in 2016/17.

The biggest driver of Value Added Tax is the demand for goods and services. The demand for goods and services is in turn driven by disposable incomes and access to credit. The current subdued consumer consumption may put downward pressure on government revenue collection.

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Income tax on the other is mainly driven by producer output and employment. With private activity slowing down since May of this year, we hold the opinion that government collection of ordinary revenue may further be hampered.

With government expenditure expected to remain sticky and target budget deficit moving to Ksh.750bn, we expect interest rates to go up in the near term driven by increased borrowing.

Interest rates

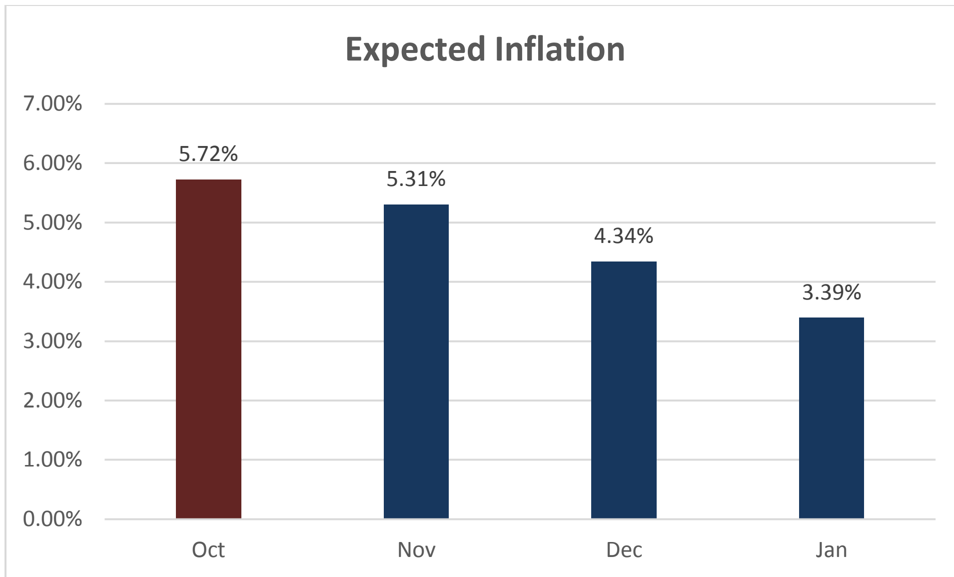
At the onset of Quarter 4 2017, we took the view that interest rates were expected to go up in the next 12 months. (See September & October Fixed income notes). This was primarily informed by developments in Fiscal policy where we saw government shelving initial fiscal consolidating plans. Through 2017 draft Budget Review and Outlook paper (BROP)Target fiscal deficit was revised from Ksh 530 Bn (6.2% of GDP) to Ksh 750 Bn (8.5% of GDP), primarily driven by lower revenues and increased recurrent expenditure. These developments in public finance saw Moody's (a rating agency) place the B1 long-term issuer rating of the government of Kenya on review for downgrade.

Another indicator of higher interest rates at the time was the reduced liquidity in the money markets. Low subscriptions at T-bill auctions were also indicators that interest rates were likely to go up.

The dollar strengthened against most currency in the months of September, October and November buoyed by expectations of a US Federal Reserve interest rate hike in December. This expectations were informed by strong US economic data and better than expected employment data. The months of November and October saw yield increases for both German sovereign bonds and US treasury bonds. The increase in these triple A sovereign bonds may push foreign investors to demand a higher yield to compensate them for both the opportunity costs and for currency risk.

Inflation

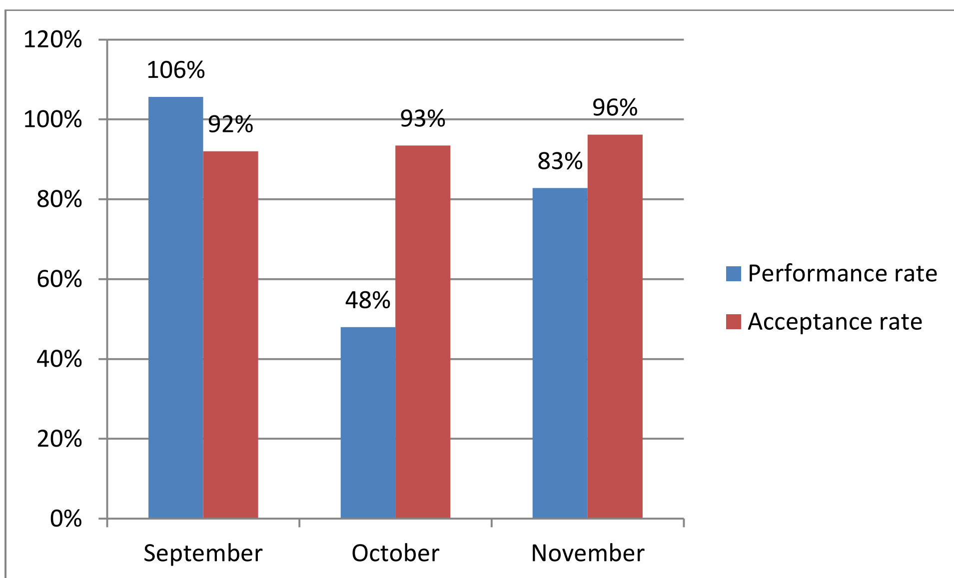
In line with our expectation, headline inflation continued on its downward trend in October. October inflation came in at 5.72% down from 7.06% witnessed in September. The actual Inflation recorded in October was 110 basis below our 6.8% October forecast .The decline in Headline inflation was mainly driven by the 1.78% decline in food inflation from last month. This meant that the year on year food inflation in October declined to at 8.47% from 11.50% in September. The decline in food inflation was mainly attributed to a drop in selected food prices occasioned by favourable weather conditions.
Going forward, the Metrological department expects most of the country to experience enhanced rainfall in the months of November and dry conditions for most of December. The enhanced rainfall during this important "short-rains" season, in our opinion will boost food supplies both in the short and medium terms.
We therefore still maintain our previous expectation of inflation trending downwards in the coming months. Food inflation will remain the key driver of the downward trend in headline inflation in the coming months. This is because we expect that most of the agriculturally productive counties in Kenya will continue to receive adequate rainfall. See below our expectation for inflation.



Liquidity Levels

The liquidity levels still remain tight despite the interbank market witnessing no CBK's window borrowings during the period between 12th October and 17th November. This was an improvement from the previous period between 13th September and 11th October where the banks accessed a total of Ksh. 515 Billion through the central bank borrowing window. The interbank spread also continued its slide from 4.5% to 3.5% over the same 35 day period, signaling improved liquidity distribution.

T-bill auction also witnessed improved subscription in the last three auctions, with under subscription improving to an average of 83% compared to 48% in the prior month. With the T-bill auctions still undersubscribed we still hold the opinion that liquidity levels are still tight. This 83% does not however compare to average performance rate of 106% witnessed in September.



The 91 day T-bill rates however reduced marginally to an average of 8.0% in November compared to 8.1% from the previous month. The 182 day T-bill rate increased marginally to 10.48% on 20th November from last month's 10.39%. The 364 day T-bill rate also marginally increased to 11% on the 20th of November.

Conclusion

Despite some improvement in liquidity levels and liquidity distribution, liquidity in our opinion remains tight. In our opinion the combination of increase of government domestic borrowing and the current tight liquidity levels in the money market will push interest rates up. With the increased domestic borrowing and widening fiscal deficit expected to increase Kenya's country risk premium, foreigners in our opinion are likely to put a premium on their required return.

For November's primary auction, we expect investors to bid aggressively as far as interest is concerned. Central bank may however choose to manage the market rate from deviating away from the current yield curve and instead make use of the tap sale option.

We see subscription levels coming in between 90% to 110%, owing to the appeal of the tax free Infrastructure bonds to foreign investors and individuals.

Factoring in these expectations, we recommend investors to bid between 11.6% and 12.0%. The current market yield for a 7 year is at 11.60%.

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