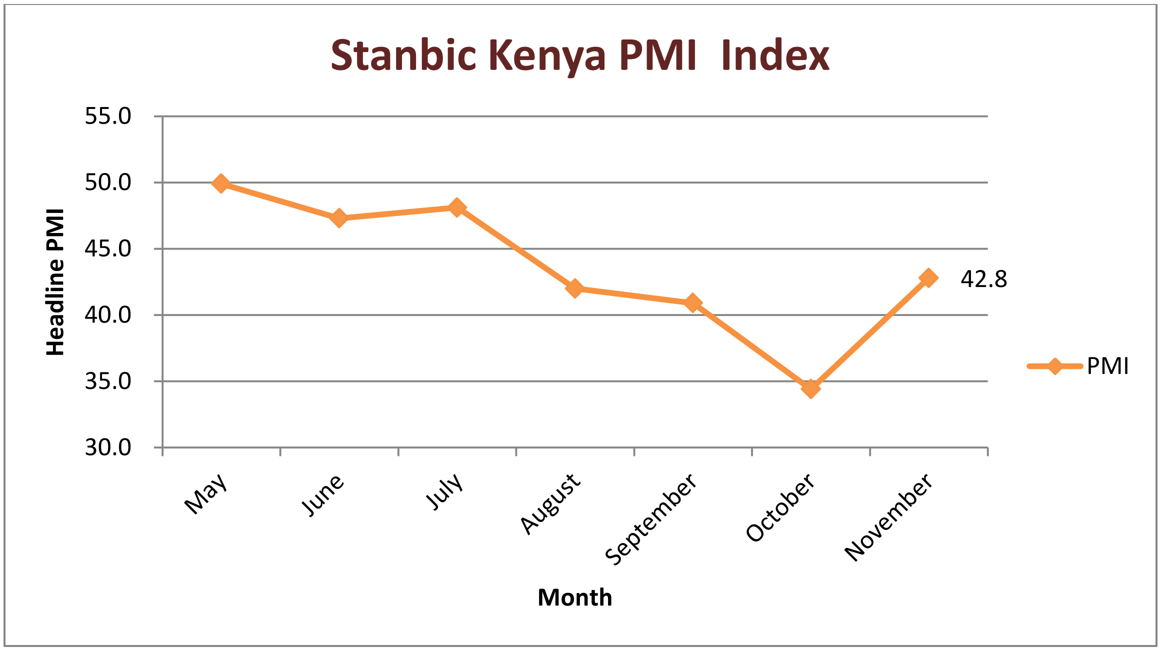
Government reopens two paper

This month the government will be looking to raise KES 30 bn for budgetary support by reopening a ten year fixed 12.966% coupon treasury bond and a fifteen year fixed 12.50% coupon treasury bond: that is FXD1/2017/10 (**9.62 years**) and FXD1/2008/15 (**5.25 years**) respectively. The two fixed coupon bonds will both attract a withholding tax of 10% on the interest/discount. We expect a moderate to high subscription for this paper owing to the short-term nature of both the bonds. We recommend investors to bid between 12.35% and 12.75% for the **5.25-year** bond and to bid between 12.75% and 13.15% for the **9.62-year** paper. The current market yield of the **5.25-year** bond (FXD1/2008/15) is 12.57% and the current market yield of the **9.62-year** bond (FXD1/2017/10) is 12.80%.

The last Treasury Bond auction held at the end of November was oversubscribed with the value of bids received at 153.4% of the of the KES 30 bn on offer. The auction received KES 45.9 bn worth of bids which was KES 12.9 bn more valuable than the KES 33bn we had anticipated in our November note. The government made a choice to accept KES 42 bn of the bids at the weighted average rate of 12.23%, 43 basis points above our 11.8% expectation and 63 basis points above the then prevailing market yield of 11.6%. The decision to increase acceptance levels above the market rates contrary to previous auctions indicates to us of an increase government appetite for borrowing.

Business Activity declines at a slower pace

The heightened political uncertainty during the month of November environment led to the seventh straight decline of private sector activity. Business activity as measured by Stanbic Bank Kenya Purchase Manager Index showed that the slide in private sector activity slowed down in November. Stanbic Bank Kenya PMI headline figure improved in November to 42.8 from the record low of 34.4 witnessed in October. Despite the marginal improvement, headline PMI is still less than 50, indicating private sector activity is still in free fall. Firms in the private sector survey noted subdued demand conditions, low customer turnout, declining orders and increased cost pressures during the month of November.

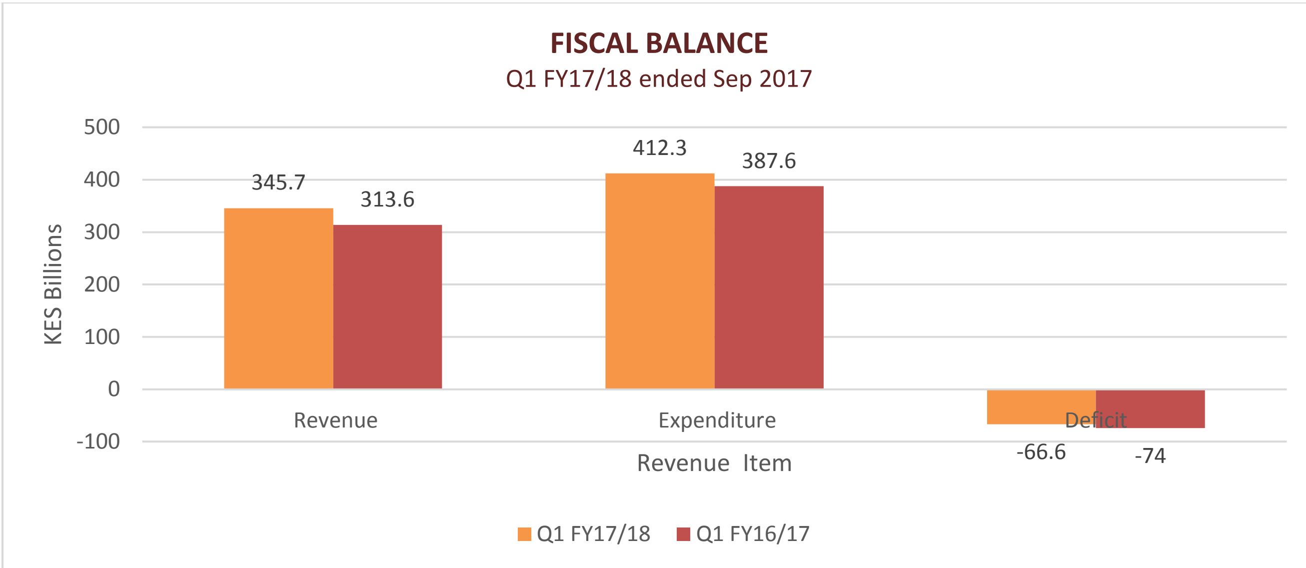


Source: Markit Stanbic PMI, AIB

Public Finance: Quarterly Economic & Budgetary Review

Total Revenue collection in the first quarter of the financial year 2017/18, for the period ended September 2017, saw the government collect a cumulative of KES 345.6 bn against their cumulative quarter target of KES 388 bn. Data from the latest Quarterly Economic and Budgetary Review released this November by Treasury showed that government revenue collections underperformed by KES 42.5 bn. This total revenue underperformance was blamed on shortfalls in Income Tax, Excise duty and Appropriation in Aid (AIA). Revenue showed some growth in Q1 despite the government failing to achieve its revenue targets for the quarter. Total Revenues and External Grants (TREG) rose 10.2% from KES 315.1 bn reported in the same period last year to 347.2 bn in Q1 FY 17/18.

Total expenditure and net lending for the first quarter of the financial year grew 6.4% compared to the same period last year mainly driven by the growth of recurrent expenditures. Total government expenditure and net lending for the Q1 of FY17/18 was KES 412.3 bn compared to the KES 387.6 bn spent in the same period last year. GOK's Q1 recurrent expenditure rose by 28% to KES 294.7 bn from KES 230.2 bn recorded during the same period last year. Q1 development expenditure, in contrast, fell by 4.1% to KES 90.7 bn in Q1 FY17/16 from KES 94.6 bn in Q1 FY16/17. The growth of expenditure was slower than previously anticipated because of lower than expected absorption of funds by National and County government.



Sources: Treasury, AIB

Public debt increased during the one year period between September 2016 and September 2017, propelled by the growth of external debt. Net public debt increased by 23.6% from KES 3276.7 bn at the end of September 2016 to KES 4,049.0 bn by the end of September 2017. The growth of external debt was mainly driven by the disbursement of external debts and unfavourable exchange rate fluctuations.

Interest rates

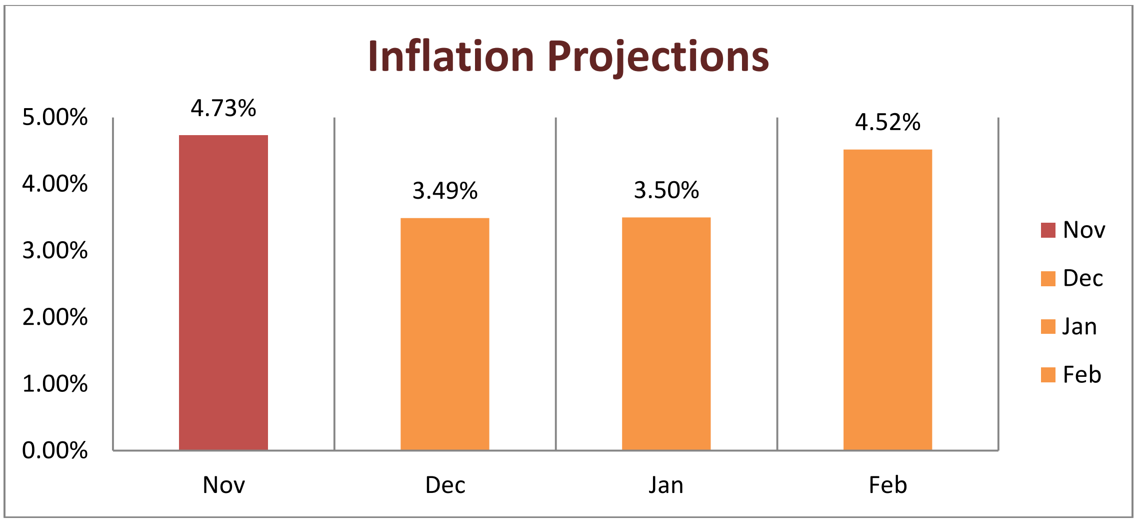
At the beginning of September this year, we took the view that interest rates will go up in the next one year in our September & October Fixed income notes. Our view then was informed by the: persistent primary fiscal deficit, increasing government borrowing, sticky recurrent expenditure and reduced revenue collection due to declining economic activity. We still hold to the view but update our outlook to include the rise in inflation caused by the cessation of rainfall in December and the rising global oil prices. We now expect that the current stable interest rates to be pushed upwards by a combination of rising inflation and increased government borrowing. Interest rates, in our opinion, could also be pushed upwards by the depreciation of the Kenyan shilling caused by increased dollar demand by oil and food importers in the coming months.

Inflation

Headline inflation, in line with our previous expectations, continued on its downward descent in November. November inflation was 4.73%, down from the 5.72% inflation recorded in October. Actual inflation recorded in November was 58 basis points below our 5.31% inflation forecast for November. The decline in headline inflation was mainly driven by the 1.33% decline in food inflation from last month. On a year on year (YoY) basis, food inflation in November declined to 5.77% from 8.47%

reported in October. Favourable weather in November over most agriculturally rich areas can be credited with the fall in food inflation.

The Metrological department updated their monthly projections at the end of November to reflect changing Sea Surface Temperatures. The new outlook for the next month projects the cessation of rainfall during the month of December. Depressed rainfall and general poor distribution of rainfall over most agricultural areas during the month of December will most likely depress agricultural production in the short to medium term. We update our previous inflation expectations to reflect the change in climate outlook. We now expect inflation to trend upward in the coming months mainly driven by depressed agricultural output.

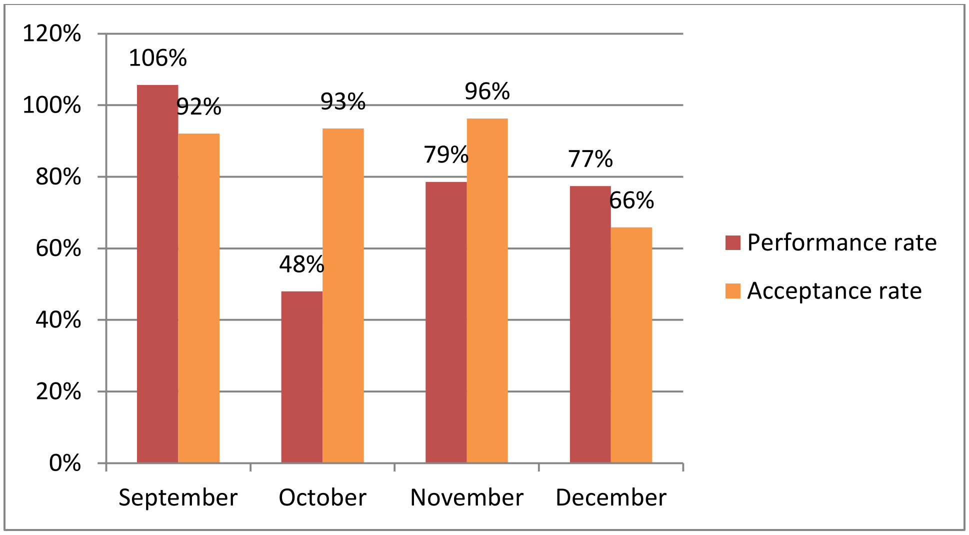


Sources: AIB

Liquidity Levels

The interbank market in November remained mute mirroring the previous month's inactivity. There were no CBK window borrowings during the month of November, a contrast to September and October. November also witnessed the narrowing of the interbank spread from 5.0% to 3.5%, signalling improved liquidity distribution.

November T-bill auctions also witnessed improved subscriptions with a bias towards the 91 and 364-day paper. Liquidity in the market remains tight with the month's average performance rate shy of 100%. The only exception to the rule was the 91 day T-bill that was oversubscribed in all but one auction. The T-bill average performance rate for the month of November jumped to 79% from an average of 48% in October.



Source: CBK, AIB

Conclusion

Despite some improvement in liquidity levels and liquidity distribution, liquidity in our opinion remains low. For December's primary auction we expect investors to bid competitively as far as interest is concerned. We see subscription levels coming in between 90% to 110%, owing to the appealing nature of the tenors to institutional investors and individuals. Factoring in these expectations, we recommend investors to bid between 12.35% and 12.75% for the **5.25-year** bond and to bid between 12.7% and 13.1% for the **9.62-year** paper. The current market yield of the **5.25-year** bond (FXD1/2008/15) is 12.57% and the current market yield of the **9.62-year** bond (FXD1/2017/10) is 12.80%.

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