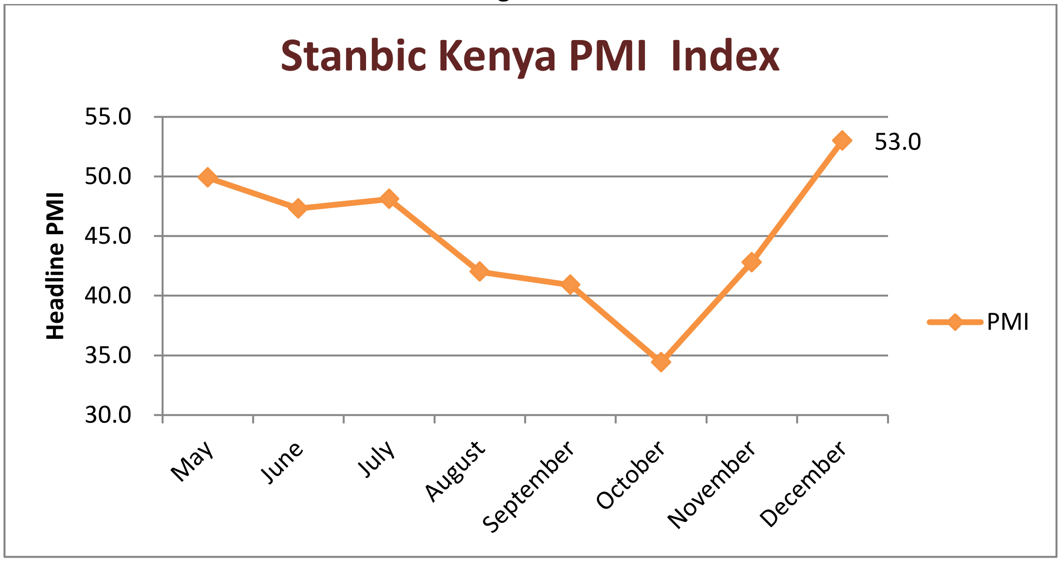
Government issues a fifteen-year infrastructure bond

This month the government will be looking to raise KES 40 billion to fund infrastructure projects by issuing a fifteen year, fixed **12.500%** coupon amortized treasury bond: **IFB 1/2018/15** (**15 years**). The amortized bond will attract no tax as is the case of all infrastructure bonds. We expect a moderate to high subscription for this paper owing to the tax-free appeal of the bond and also as a consequence of the bond's appeal to foreign investors. We recommend investors to bid between **12.200%** and **12.700%** for the **15-year** bond. The current market yield of an infrastructure bond with the longest tenor of **13.74-years** (**IFB1/2016/15**) and a coupon of 12.00% is **11.800%.**

The last Treasury Bond auction held in mid-December was moderately subscribed with the value of bids received at 72.97% of the KES 30 billion on offer. The auction received KES 21.9 billion worth of bids, which was in line with our moderate to high subscription expectation in our **December note** but lower than the 90% subscription we foresaw. The government made a choice to accept KES 4.7 billion of the bids for the **FXD1/2008/15 (5.25 years) bond** at the weighted average rate of **12.58%,** well within our recommended bid range of **12.35%** and **12.75%** and in confluence with the then prevailing market yield of **12.57%.** For the second bond, **FXD1/2017/10 (9.62 years)** the government elected to accept KES 5.4 billion of the bids at the weighted average rate of **13.087%,** within our expected range of 12.75% and 13.15%**.**

Business Activity intensifies in December

A combination of an upsurge in demand and the dissipation of political uncertainty during the month of December boosted business activity, the continuation of a trend that began in November last year. Business activity, as measured by the Stanbic Purchase Manager Index, showed the sharpest rise in output since September 2016. The Stanbic Bank PMI for December accelerated to 53 from the 42.8 recorded in November. The growth of business activity in during December was driven: by rising output, a surge in new orders, a boost in employment numbers and an increase business confidence. The momentum of growth in the private sector will continue to rise supported by a recovery in the agricultural sector, increased tourism and the resurgence of government spending. Private sector growth and growth of employment will eventually enhance government revenue collected from direct taxes during 2018.



Source: Markit Stanbic PMI, AIB

Public Finance: Conditions are perfect for Eurobond Issuance in Q1 2018

The Government of Kenya has been mulling over the issuance of a Eurobond since May of last year tempted by the favourable global funding conditions that currently pervade. The initial logic for the issuance in May was to pay off the $ 800 million syndicated loan from four international lenders that was set to mature in April of 2017 but the government chose to wait for a more congenial time. The government instead secured $ 107 million from Trade and Development Bank which were partially used to settle the syndicated debt and requested an extended payment of the rest of loan to April 2018. With political tension resolved and a new government in place, G.O.K is on track to issue the Eurobond this year to fund spending requirements in FY17/18. We believe that the government is very close to issuing the Eurobond in the first quarter of 2018 after Treasury requested proposals from banks to help structure the loan back in November last year.

Interest rates

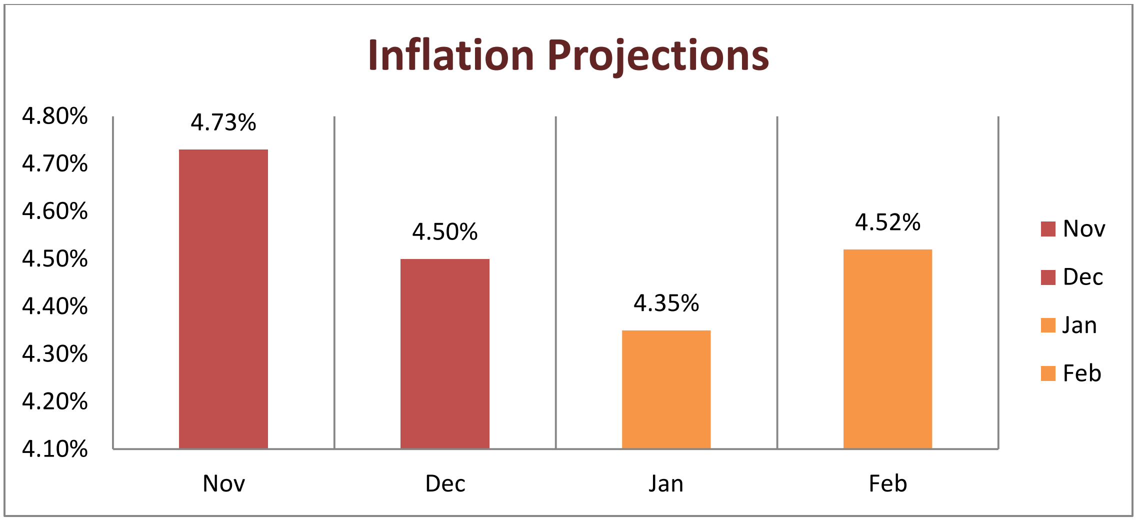
Interest rates have been relatively stable since our last note in December. The yields on the Treasury Bills have slightly risen since the release of our December Note on the 11th of December. The 91-day T-Bill has risen by 4 basis points from 8.011% to 8.059% in the last six auctions. The 182-day and the 364-day T-Bills have also risen marginally from 10.522% and 11.076% on the 11th of December to 10.661% and 11.170% respectively. Reverse Repo rates remained flat at around 10% during the months of December and January. The Central Bank Rate remained 10% after the MPC elected to hold the benchmark lending rate in their last meeting in November.

Our outlook for 2018 is that interest rates will go up in the short term, informed by several reasons that we have previously highlighted in our September & October Fixed income notes. Our view then was informed partially by Kenya's public finance: we expect the government persistent fiscal deficit to drive government borrowing, GOK's challenges in reigning in recurrent expenditure and challenges in revenue mobilization that still plague the government. We also envision that interest rates are still under threat from impending headwinds in 2018 that would increase the required returns demanded by investors. The headwinds that could cause investors to demand more compensation in return for investing in Kenya' debt markets include: increase in inflation driven by food and global crude prices; the imminent downgrade of Kenya's B1 sovereign rating and the weakening of the shilling against the resurgent dollar.

Inflation

In accord with our outlook for the month, December registered a drop in headline inflation. Inflation in recorded in December was, however, 101 basis points above our forecast for December. Headline inflation, measured on a Year on Year **(YOY)** basis declined to **4.50%** in December from the **4.73%** recorded in November. The decline was in contrast to headline inflation measured on a month on month basis which increased slightly by **54 basis points**. The fall in headline inflation on a year on year (**YOY)** basis inflation was mainly driven by the slower growth of the Food and Non-Alcoholic Beverages index in December 2017 compared to December 2016. The Food and Non-Alcoholic Beverages index grew only **4.68% YOY** in December 2017 compared to the 11.22% **YOY** recorded in 2016**.**

The Metrological department is currently projecting a dry and sunny January over most parts of Kenya. Their new outlook for the January projects an occasional to light rainfall in a few parts of Western Kenya, the Central Rift and the Central Region, that includes Nairobi. A sunny and Dry January and general poor distribution of rainfall over most agricultural areas will most likely depress agricultural production and reduced water levels in the Seven Folks Hydroelectric power generating Dams in the short term. We maintain our previous inflation expectations to reflect the change in climate outlook. We continue to iterate our previous expectation that inflation will trend slightly upwards in the coming months mainly driven by rising cost of food.

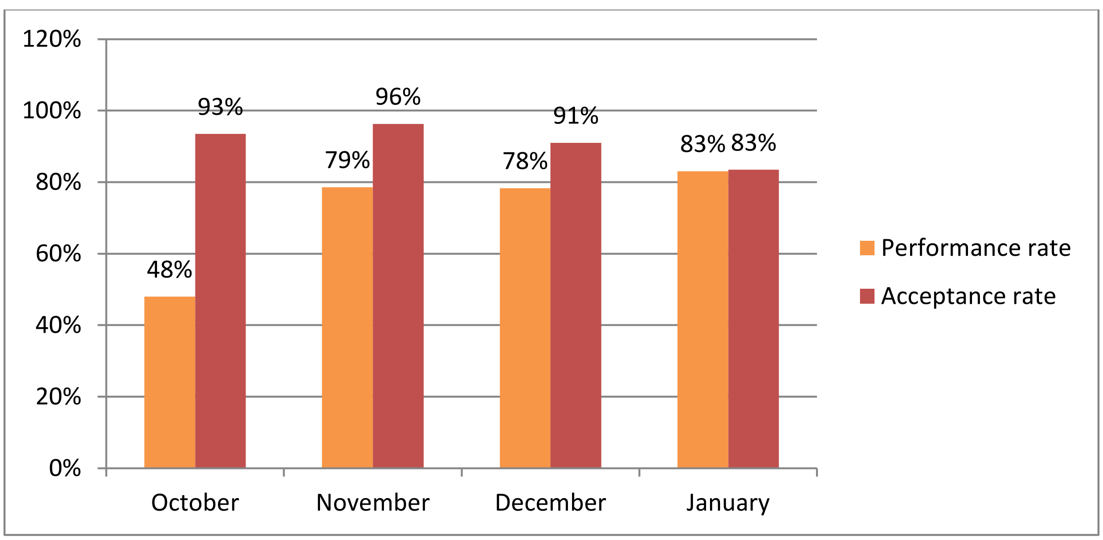


Sources: AIB

Liquidity Levels

The liquidity in the last four weeks has been tight with Reverse Repos maturities offsetting government payments. The interbank witnessed increased activity in January. In the first week in January the interbank market recorded an increase in volume to KES 21.39 billion traded compared to the KES 13.70 billion traded the previous week. The interbank spread, the difference between the highest interbank rate and the lowest interbank rate, also widened from the 3.50% registered on the 28th of December to 6.00% recorded on the 11th of January, indicating poor liquidity distribution during the period.

T-bill auctions recorded flat subscriptions in the month of December. T-bill average performance rate for the month of December was registered as 78%, which was largely unchanged from the 79% average performance rate witnessed in October. The first two T-bill auctions in January, however, recorded a slight improvement in subscriptions with the average performance rate currently standing at 83%



Source: CBK, AIB

Conclusion

Liquidity levels and liquidity distribution in the market is currently tight in our opinion. For January's primary auction we expect investors to bid competitively as far as interest is concerned. We see subscription levels coming in between 80% to 110%, owing to the appealing nature of the bond to institutional investors and foreign investors. Factoring in these expectations, we recommend investors to bid between **12.200%** and **12.700%** for the **15-year** infrastructure bond. The current market yield of an infrastructure bond with the longest tenor of **13.74-years**, (**IFB1/2016/15**), with a coupon of **12.00%** is **11.800%.**

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