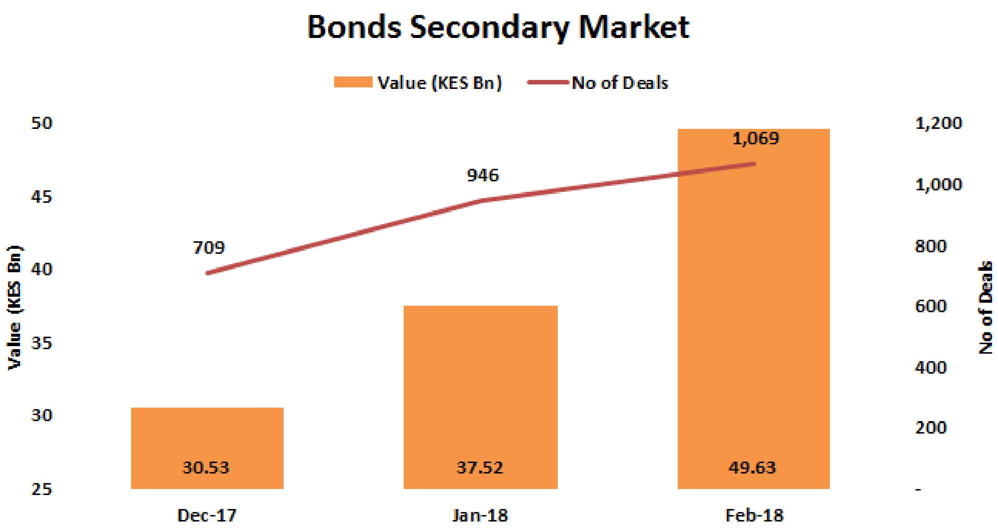
Auction Results for the Reopened Fifteen-Year Fixed Coupon Treasury Bond

The CBK received a subscription of **KES 24.14Bn (USD 238.32Mn) (60.4% subscription)** from an offer of **KES 40Bn (USD 394.88Mn)** on the reopened fifteen-year bonds, A total of **KES 13.2Bn (USD 130.4Mn),** a **54.7%** acceptance rate with **FXD1/2010/15** (**7.06 years**) receiving **KES 7.97Bn (USD 78.6Mn)** with the government accepting **KES 4.44Bn (USD 43.9Mn)** while **FXD2/2013/15 (10.15 years)** attracted **KES 16.18Bn (USD 159.7Mn)** with **KES 8.76Bn (USD 86.5Mn)** accepted. The weighted average rate (WAR) for stood at **12.676%** and **12.906%** compared to our prediction of **12.5%-12.75%** and **12.80%-13.1%** for the two bonds respectively.

With the low acceptance rate, we foresee the government opening a Tap sale for **KES 26Bn (USD 256.3Mn)** with rates set at **FXD2/2013/15 (10.15 years) 12.676%** and **FXD2/2013/15 (10.15 years) 12.906%.** Subscriptions will be lower compared to the primary issue.

Secondary Market: The Secondary market witnessed an increase in activity. As of the third week, the market had transacted **KES 49.63 (USD 490Mn)** compared to **KES 37.5Bn (USD 371.4Mn)** for the whole of January 2018. The on the run **IFB/2018/15Yr** was the most traded bond moving **KES 12.3Bn (USD 121.3Mn)** on **71** deals. The market is set to normalize in March.

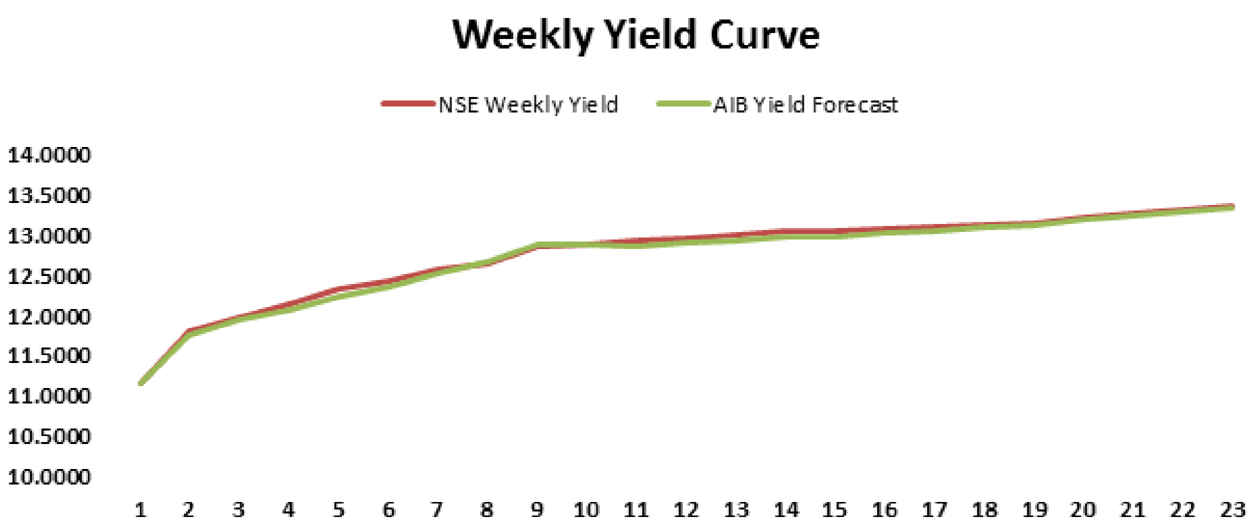
Figure 1: Secondary Bonds Market



Source: CBK, AIB

NSE Yield Curve (5 Week Yield Curve): As of Friday 16th, the Yield Curve saw mid-term yields rise **(10Yr +11.0bps)** while the **5yr, 15 Yr and 20 Yr** were down **10.1bps, 7.2bps and 2.5bps** down respectively. The yield curve has remained stable since the implementation of the interest rate cap laws. As per our prediction on figure 2, we anticipate very little movement on the weekly yield curve. The mid-term rates to shift up by an average of 2bps while short and long term key rates to remain put.

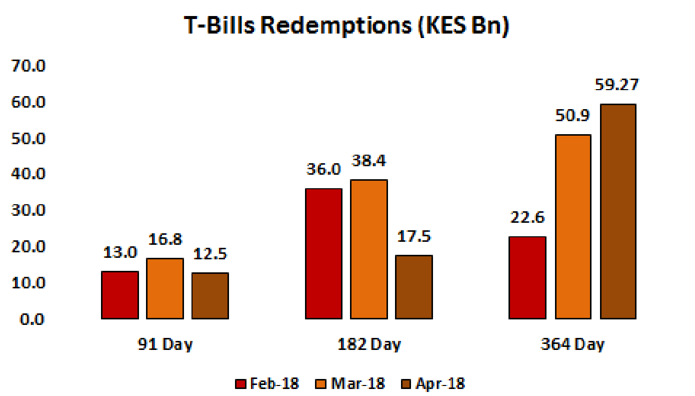
Figure 2

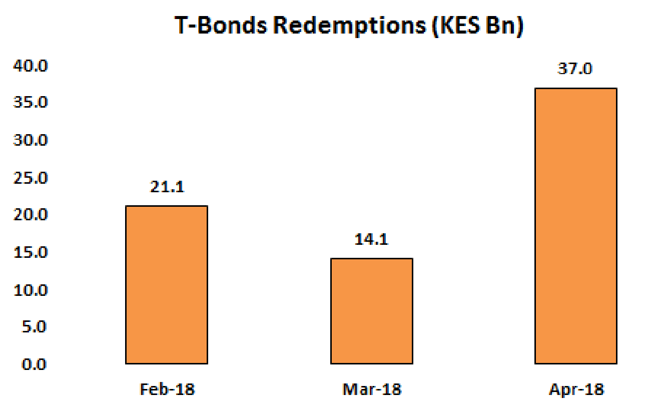


Source: NSE, AIB

T-Bills: Government will borrow **KES 96Bn (USD 950.2Mn)** in short-term papers. The market has seen a high liquidity with T-Bills oversubscribed with past four auctions **averaging 131.6%** with a mean acceptance of **89.5%.** The subscription was skewed towards the 364-day paper which has seen rates gaining marginally. The government has shown preference towards the 182-day paper due to heavy redemptions on the particular term. We anticipate subscriptions to remain **>100%** with **acceptance >95%** as rates remain stable at **8.0%, 10.4% and 11.2% for the 91 day, 182 day and 364-day** papers respectively.

Figure 3 T-Bills and T-Bonds Redemptions



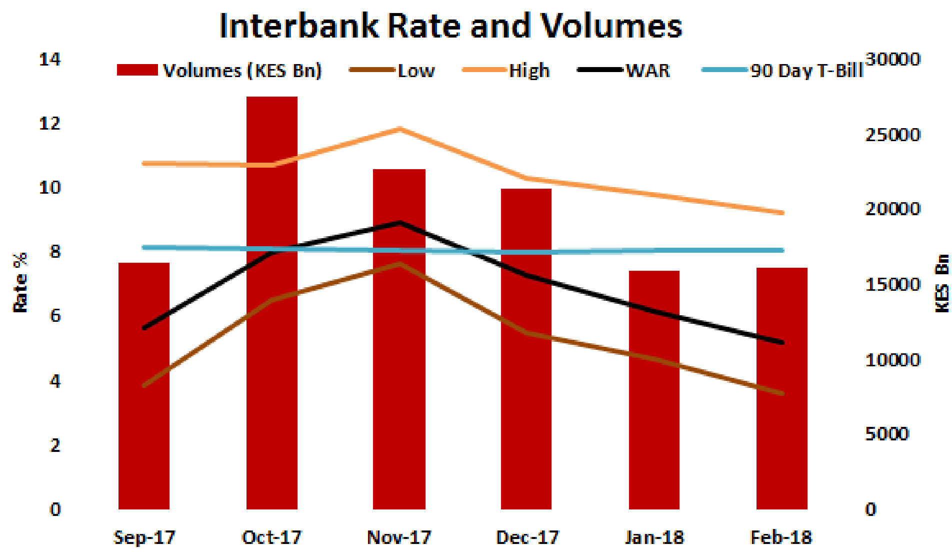


Source: CBK, AIB

Interbank: Interbank rate stood at 5.502% with a three week average of **5.156%** and **KES 14.19Bn (USD 139.2Mn)** for the month to date compared to **6.058%** and **KES 16.8Bn (USD 165.7Mn)** over the same period in January. The demand remained low on easing pressure on the interbank rate.

Despite the high liquidity in the market, we expect the rate to marginally increase due to pressure from tax payment by banks.

Figure 4: Interbank Rate, Volumes and 90 Day T-Bill

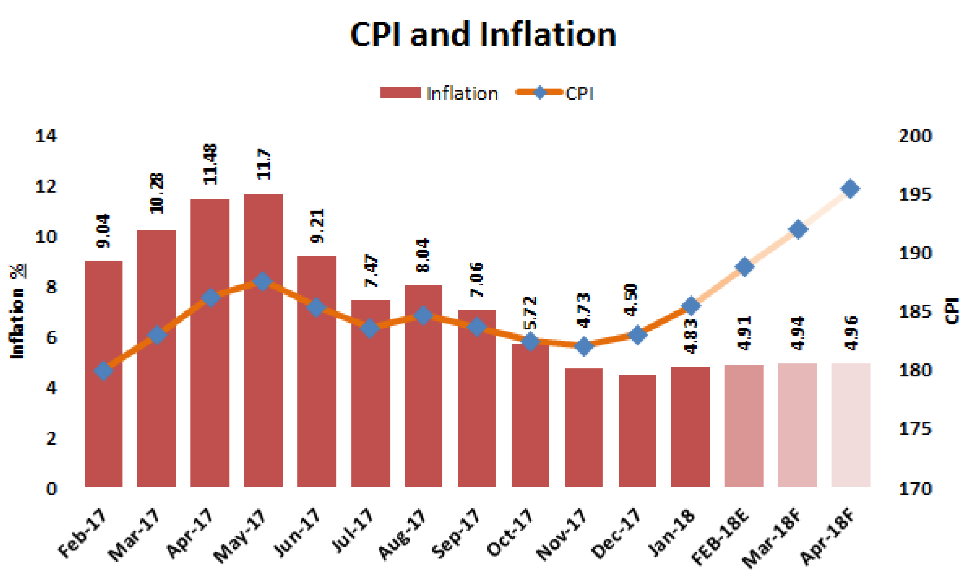


Source: CBK, AIB

February Inflation: We project February inflation to range **4.6% to 4.91% with CPI up 1.6%-1.8% to 188.25-188.81.** This be driven marginal increase in pump prices on higher international prices in (December average USD 63.33pb and dollar KES 103.1 versus 62.31pb and KES 103.57 average in November), increase in electricity bills and increased food prices.

Onset of long rains in March and April will help ease food inflation and electricity inflation on the use of cheaper hydropower and less of the more expensive thermal energy.

Figure 5: CPI and Inflation



Source: KNBS, AIB

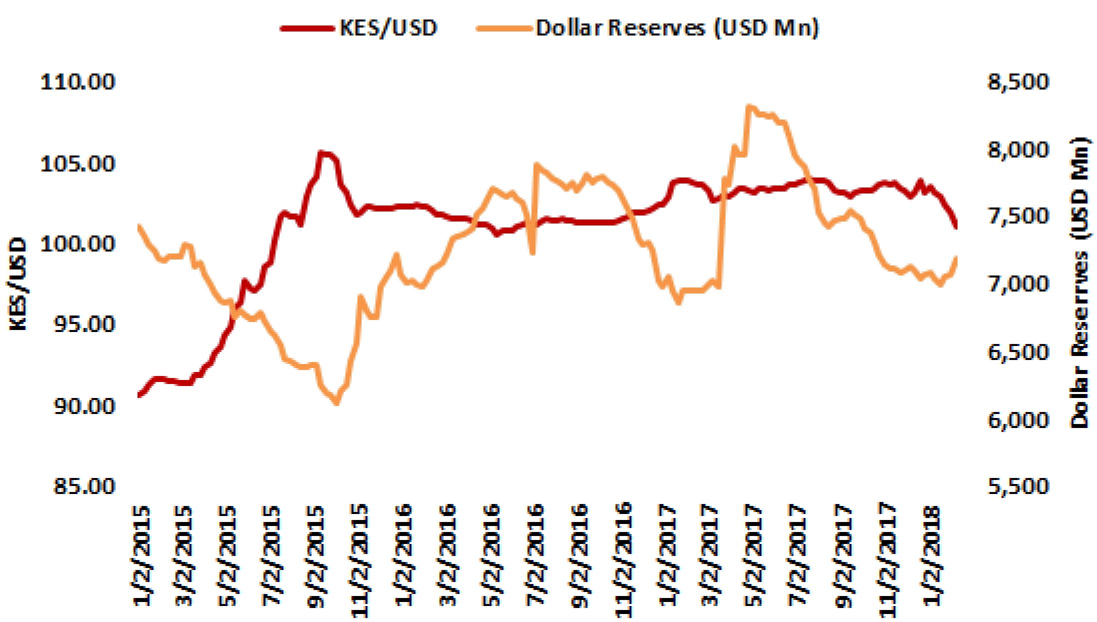
Currency and Currency Reserves: The Kenyan shilling reversed its gains on the USD to end at **KES 101.4683**, a **0.25%** decline compared to **KES 101.2167** last week. The local currency has been weakening continuously since hitting a low of **KES 100.7956** to the USD on February 8th, 2018. The KES has gained by **1.77%** year to date (y-t-d)**,** from **KES 103.23** compared to a depreciation of **0.7%** Full Year (FY) 2017. The movement also represents a **2.0%** gain year on year(Y/Y).

The current downward slip against the dollar was due to low borrowing rates in the money markets which triggered the increased demand for dollars among banks so that they can meet the liquidity threshold. The shilling will continue to ease against the dollar, reverting to back to the KES 103/USD levels. The strengthening of the shilling in January was caused by inflows from foreign investor looking for a piece of the infrastructure bond issued.

The strengthening of the currency, as per figure 6, helped boost dollar reserves to a high of **USD 7,240Mn** or **4.84** months of import cover, a 0.82**%** improvement compared to **USD 7,181Mn** or **4.8** months of import cover. Dollar demand will continue to claw on the dollar reserves.

Meanwhile, in the international market, the US dollar fought back to recover ground against major currencies in the beginning of February. The U.S. Dollar Index (**DXY**), which measures the value of the **USD** against a basket of major currencies, was down **1.7%** year to date, from **91.57** to **90.03**.

Figure 6: Dollar Reserves and Currency Movement



Source: CBK, AIB

Public Finance: Draft 2018 Budget Policy Statement

The Treasury has just released the draft Budget Policy Statement that lays out the government's medium-term priorities and policy goals that will guide the preparation of budgets for both the national and county government. The draft Budget Policy statement reflects the razor-sharp line that the treasury must walk to actualize the government's big four agenda in the medium term but still achieve its fiscal consolidation targets.

The Budget Policy Statement indicates that the government intends to implement an accommodative Fiscal policy stance in the medium term to reinforce economic growth. On top of the expansionary fiscal policy stance, the government plans to follow a consolidation path in the medium term in order to achieve the East African Community Monetary Union Protocol's fiscal deficit ceiling (including grants) of **3%** or a fiscal deficit ceiling (excluding grants) of **6%** by FY 21/22.

Total Revenue is projected by Treasury to grow by **96.2%** or at a CAGR of **18.3%** from the **KES 1,400.6 Billion** penned in FY16/17 to **KES 2,747.6 Billion** by FY21/22**.** They envision the growth in total revenue in the medium term to be mainly driven by a growth in ordinary revenue collections. Income tax revenue and Value Added Tax revenue, that currently form at least **70%** of ordinary revenue, is expected to continue playing an integral part in growing ordinary tax revenue in the medium-term. The government plans to double income tax revenue from **KES 625.1 Billion** recorded in FY 16/17 to KES **1,259.6 Billion** by FY21/22**.** Medium-term Revenue mobilization plans communicated in the BPS 2018 strategy will also see the government target a substantial increase in Value Added Tax (VAT) from **KES 339.0 Billion** collected in FY 16/17 to **KES 665.5 Billion** by FY 21/22.

Table 1: Government Fiscal Operations

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
	Actual	Prel. Act	BPS'18	BPS'18	BPS'18	BPS'18	BPS'18
	KES Billion	**KES Billion**	**KES Billion**	**KES Billion**	**KES Billion**	**KES Billion**	**KES Billion**
TOTAL REVENUE	1,232.6	1,400.6	1,643.1	1,849.4	2,105.6	2,417.8	2,747.6
Total Revenue as a % of GDP	***18.4%***	***18.3%***	***19.0%***	***18.9%***	***19.0%***	***19.2%***	***19.1%***
YoY Growth		***13.6%***	***17.3%***	***12.6%***	***13.9%***	***14.8%***	***13.6%***
EXPENDITURE AND NET LENDING	1,781.9	2,110.0	2,323.1	2,488.4	2,639.8	2,897.5	3,239.4
Expenditure & Net Lending as a % of GDP	***26.6%***	***27.6%***	***26.8%***	***25.4%***	***23.8%***	***23.0%***	***22.6%***
YoY Growth		***18.4%***	***10.1%***	***7.1%***	***6.1%***	***9.8%***	***11.8%***
Fiscal Balance *(commitment basis excl. grants)*	-549.3	-709.4	-680.0	-639.0	-534.3	-479.7	-491.8
Fiscal Balance as a % of GDP	***-8.2%***	***-9.3%***	***-7.9%***	***-6.5%***	***-4.8%***	***-3.8%***	***-3.4%***
YoY Growth		***29.1%***	***-4.1%***	***-6.0%***	***-16.4%***	***-10.2%***	***2.5%***
Public Debt	3,210.8	3,972.5	4,589.6	5,173.9	5,662.2	6,090.6	6,282.1
Fiscal Balance as a % of GDP	47.9%	51.9%	53.0%	52.8%	51.0%	48.3%	43.7%
Primary budget balance	-282.0	-411.9	-316.7	-217.7	-98.8	4.1	53.7
Nominal GDP	**6,709.7**	**7,658.1**	**8,654.6**	**9,790.8**	**11,100.8**	**12,620.8**	**14,363.9**
Nominal GDP Growth (YoY)		14.1%	13.0%	13.1%	13.4%	13.7%	13.8%
GDP Deflator(Inflation)	8.80%	8.40%	7.30%	6.80%	6.60%	6.40%	6.40%
Real GDP growth (%)	5.80%	5.30%	5.30%	5.90%	6.30%	6.80%	6.90%

Sources: AIB, the National Treasury

Expenditure and Net Lending is projected to grow by **53.5%** from **KES 2,110.0 Billion** registered in FY 16/17 to **KES 3,239.4 Billion** by FY 21/22. As has been the case in the past, the BPS envisions recurrent expenditure continuing to play a dominant role in the medium term expenditure spending. The recurrent expenditure is projected to increase from **55.9%** of expenditure and net lending in FY16/17 to approximately form **60%** of expenditure and net-lending for the rest of the medium term.

Fiscal Deficit and Public debt are projected to stabilise as a percentage of GDP and eventually decline over the medium term. The government expects deficits to stabilise on an absolute basis but decline as a percentage of GDP to reach its consolidation targets of **6%** (excluding grants) by FY19/20. Treasury also hopes to achieve a primary budget surplus by FY20/21. Public debt as a percentage of GDP is expected to stabilise around **50%** in the medium term and finally decline to **43.7%** of GDP by the end of FY 21/22.

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