December Primary Auction Note

Date: 7th December 2018

Recommendation:
Bid within the range of **12.42%** to **12.52%** for **FXD 2/2018/10**

Sovereign Credit Rating (outlook):
Moody's: *B2 (stable)*
Fitch: *B+ (stable)*
S&P: *B+ (stable)*

CPI: (2009=100)
192.25

November Inflation:
5.58%

Interbank rate (6th Nov-18):
7.65%

C.B.R (As set in Nov-18):
9.00%

91-Day T-Bill (29th Nov-18):
7.34%

182-Day T-Bill (29th Nov-18):
8.24%

364-Day T-Bill (29th Nov-18):
9.638%

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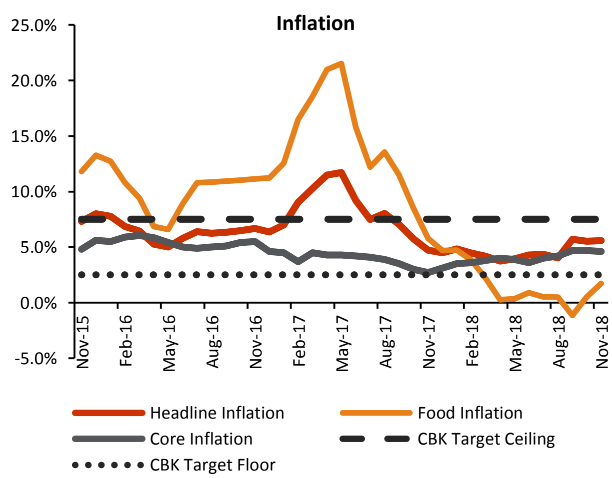
In December, the CBK is auctioning a **10 year bond**, FXD 2/2018/10, in a bid to raise **KES 40 billion** (USD 396.5 million) for budgetary support. The coupon will be market determined. The medium term paper is likely to be attractive to the market. We expect subscription rates to be elevated thus advise investors to bid within a **12.42%** to **12.52%** range.

Interest rates have been on a downward trend supported by high money market liquidity. Treasury has announced that it seeks to raise it domestic borrowing target by KES 100 billion to KES 317 billion this could exert upward pressure on interest rates in 1H19.

This year CBK has been auctioning long term bonds thus a medium term paper is likely to be well received by the market. Liquidity, however, remains tight as CBK has recently withdrawn liquidity as it seeks to support the shilling.

Secondary Bond Market: In November, activity in the secondary market in remained muted performance as investors preferred to participate in the primary auctions. Turnover was down 24% to KES 38.03 billion (USD 370.6 million) from KES 54.4 billion (USD 530.2 million) recorded in October.

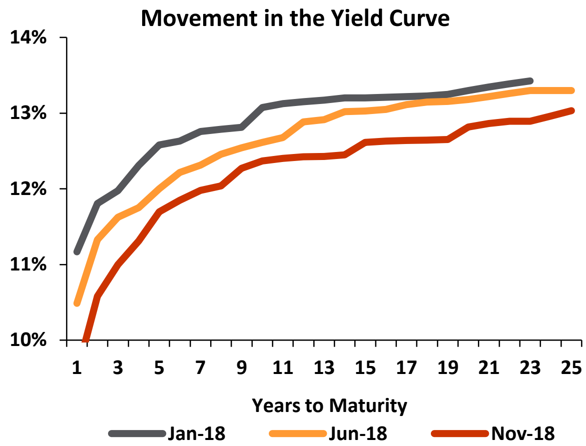
October Inflation: Headline inflation is expected to remain subdued in 1Q19 on the back of lower food and fuel inflation. According to the Kenya Meteorological Department, the country is likely to receive favourable rainfall during the short rain season. This is expected to keep food prices subdued during 1Q19. Meanwhile, concerns over a supply glut may keep oil prices depressed.



Interbank: Money market liquidity has been relatively tight as CBK has been withdrawing liquidity in a bid to support the shilling. The interbank rate increased from a low of 2.05% at the end of October to 7.40% on 6th December.

T-Bills: During the month of November, T-bill auctions recorded an undersubscription, with the average subscription rate coming in at 84.1%, an increase from 77.8%, recorded in October. Uncertainty over the direction of interest rates led to high 91day T-bill subscription rates (101% subscription rate), while other investors wanted to lock in high rates thus subscription rates on the 364 day T-bill stood at 129%. Due to the uncertainty surrounding interest rates, we advise our clients to buy the short-term papers as rates could increase in 1H19.

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 3



NSE Yield Curve: The current yield curve, (30/11/2018), continued to exhibit a downward shift in the short and long-term key rates. Investors should consider going long on bonds with longer duration papers to benefit from increased portfolio sensitivity to the possible flattening of the yield curve. The bond yields could continue flattening as a consequence of Kenya's monetary policy shift, with a possible upward pressure from government borrowing. Active managers should consider increasing their bond portfolio duration by investing mainly in long term bonds to outperform.

Currency: The shilling came under pressure during the month due to a report published by the IMF stating that the shilling was overvalued by 17%. The shilling depreciated to a low of 103.2 but later stabilized as CBK reduced liquidity in the money market.

CBK's intervention in the forex market led to a decrease in forex reserves which stood at USD 8.03 billion at the end of November from USD 8.30 billion at the end of the previous month representing a reduction to 5.32 months of import cover from 5.50 months of import cover.

The stability of the shilling in 2019 will be determined by the government's ability to refinance existing debt. A syndicated loan and a 5-year Eurobond are maturing in 2019. The repayment of this debt could decrease CBK's reserves which were very useful in maintaining the shillings stability in 2018. The government is currently in talks with TDB (formerly PTA Bank) to extend the tenor of the syndicated loan to either 7 or 10 years. If successful, this could lengthen the maturity of foreign debt and reduce pressure on government's repayment schedule. The inflow of fund could also help shore up the reserves. However, if the government is unable to raise the fund, CBK's reserves may decrease when it repays the debt, thereby reducing the Bank's ability to support the shilling in the event of a shock.

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