KINGDOM SECURITIES
A subsidiary of the Co-operative Bank of Kenya Limited

KENYA MACROECONOMIC OUTLOOK

QUARTERLY MACROECONOMICS NOTE - 2Q19

STABLE ECONOMIC OUTLOOK

Analyst

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EXECUTIVE SUMMARY:

Economic Growth: We estimate Kenya to grow at a real GDP of 5.80-6.00% this year driven by:

- The 'Big Four Plan': The government's resolve to get the private sector on board with its development plan, and the more focused nature of the agenda, bode well for growth going forward.
- Services momentum: tourism sector expected to remain vibrant supported by strong expansion in tourist arrivals.
- Favourable weather conditions through the year are expected to support the agricultural sector that accounts significantly for economic growth in Kenya.
- Growth will also be driven by both the public consumption (ongoing development in infrastructure) as well as private sector investment.

Inflation Trends: Headline inflation is expected to average between 5.0 - 6.5% this quarter. Power-tariff hikes in mid-2018 and tax rises imposed in September, including VAT on fuel at 8%, will maintain the upward pressure on energy costs, although declines in oil prices will provide some relief. Price pressures are expected to build towards the second quarter of the year, driven by the dissipation of favourable food price base effects and stronger demand-side pressures. On fuel inflation, we anticipate a gradual uptick mainly ensuing from sustained US sanctions on both Venezuela and Iran whose production plummeted 29.9% and 6.6%, respectively, in 2018, coupled with the ongoing OPEC+ 1.2Mn daily production cuts.. Generally, we expect inflation to remain within target range (2.5-7.5%) for the remaining part of the year.

Currencies Performance: We see the Kenya Shilling oscillating between 100.00-102.00 levels against its de facto anchor currency, the US dollar. The stability of KES will be pegged on healthy forex inflows; diaspora remittances, tourism earnings and inflows tied to the tax amnesty program ending on 30th June 2019, robust forex reserves and CBK interventions. Reserves remain high and will steady at current levels with Treasury on high gear to refinance the maturing 5-year Eurobond tranche at the international debt market. We anticipate FX reserves, currently at USD 8.12Bn, to be elevated by approximately USD 1Bn in 2Q19. This is on account of net external debt issuance attributable to the Eurobond. As such, we expect the growing FX reserves to further anchor KES at current levels. Eurobond III prospectus was to be ready from April. We do not expect the Treasury to borrow more than USD 2.0Bn through Eurobond 3.

Interest Rates Movement: At the end of last year, the MPC explicitly noted that interest rate caps – with lending rates limited to four ppts above the policy rate – have had a detrimental impact on the monetary policy transmission mechanism, something we have not seen in previous statements. It is no secret that the CBK wanted the interest rate regulation to be scrapped, but this is the second time the MPC acknowledges that its effectiveness is being hamstrung by these controls. Increasing the policy rate could inadvertently support credit extension by pricing in riskier borrowers, but elevated NPLs would make this strategy a bit too risky, while subdued price inflation renders contractionary policy largely unnecessary. Consequently, we expect the policy rate to remain unchanged for the foreseeable future.

Current Account Deficit: We forecast the current account deficit to GDP to remain largely stable between 4.8% - 5.0% this year. We have adjusted our current account forecasts to reflect slower-than-expected imports growth. A more enduring downturn in capital goods imports and a reduction in international oil prices during the final quarter of last year have contained the imports bill – a downward adjustment in our oil price forecasts over the medium term has also resulted in a lower fuel imports assumption.

Fixed Income Outlook: No significant change on the yield curve in 2Q19, marked with relative flatness on the long-end. The short-end of the yield curve has gradually shifted downwards, reflecting the bid discipline in the market by investors. The biggest game changer to a potential shift in the yield would be a return to the previous interest rate environment before the rate cap and with anticipated macro fundamentals holding up in the quarter (no significant changes expected), we maintain neutral stance on the yield curve.

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ECONOMIC GROWTH – Remains Strong and Steady

The latest data shows real GDP growth came in at 6.3% in 2018 compared to 4.9% growth rate a year earlier. Key growth drivers during the year included increased agricultural production (+6.4%, 2018 vs +1.9%, 2017), accelerated manufacturing activities (+4.2%, 2018 vs +0.5%, 2017), and sustained growth in transportation (+8.8%, 2018 vs +7.2%, 2017) and a vibrant services sector (+16.6%, 2018). Favourable weather conditions and a stable macroeconomic environment supported growth across the sectors. Looking ahead, we estimate Kenya to grow at a real GDP of 5.80-6.00% this year driven by:

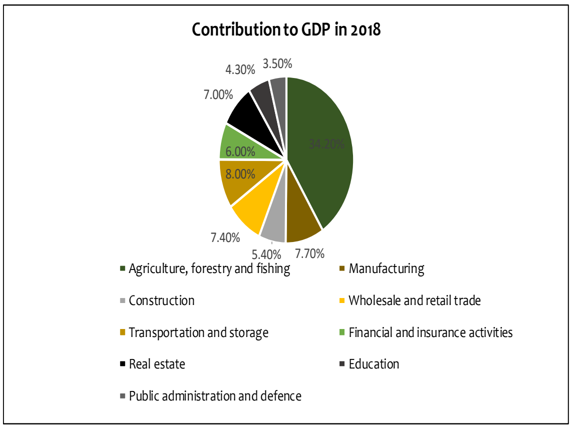
- The 'Big Four Plan': The government's resolve to get the private sector on board with its development plan, and the more focused nature of the agenda, bode well for growth going forward.
- Services momentum: tourism sector expected to remain vibrant supported by strong expansion in tourist arrivals.
- Favourable weather conditions through the year are expected to support the agricultural sector that accounts significantly for economic growth in Kenya.
- Growth will also be driven by both the public consumption (ongoing development in infrastructure) as well as private sector investment.

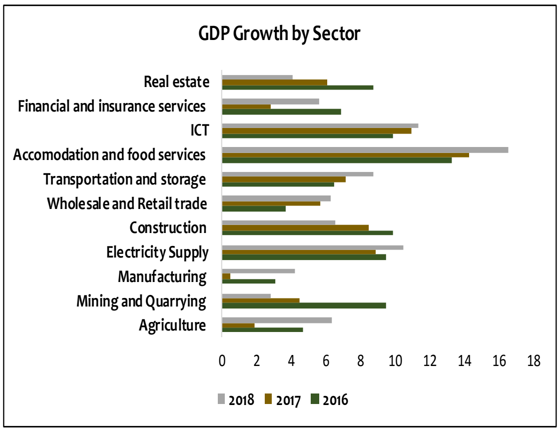
Real GDP growth reached an average of 6.3% in 2018 supported by a robust agricultural sector and accommodation and services sector.

Key risks:

- Pending interest rate cap ruling- The prevailing control on interest rate has curtailed extension of credit to the private sector, primarily to the SME segment.
- Low absorption of development funds
- Sub-par revenue collections by the governments and counties.
- The inability to pay government contractors will have negative spill over effects into the domestic financial sector through a deterioration in asset quality, and a reduction in spending on government services will curtail economic activity.
- Delay in the onset of the long rains expected in March-April and the looming food crisis; this could be detrimental to the first and second quarter growth trajectory.

Growth is expected to ease to 5.8% in the current year due to the throttling effect of weak private sector credit growth, which could be partly offset if the parliament lifts the interest rate control law within the 12 months it has been suspended or makes revisions on the same.





KENYA MACROECONOMIC OUTLOOK

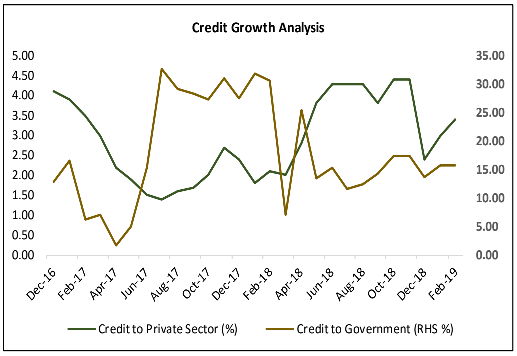
MONETARY POLICY- AUTOPILOT MODE

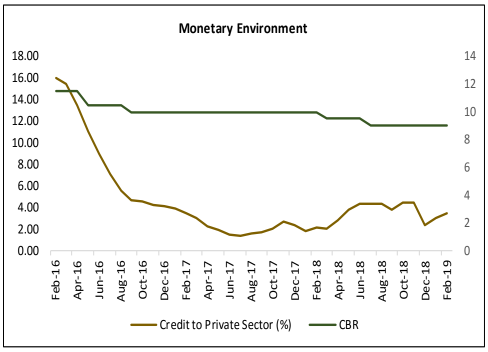
The Central Bank of Kenya (CBK) decided to maintain the country's benchmark interest rate at 9.0% following the Monetary Policy Committee (MPC) meeting on March 27. This was on the basis of; inflationary pressures remained well-anchored and within the target range; economic growth continues to gain traction while the Private Sector Market Perception Survey again confirmed increased optimism that economic activity will pick up in 2019; the foreign exchange market remains balanced; foreign reserves continue to provide adequate cover; and the banking sector remains stable and resilient. The fact that non-performing loans (NPLs) as a proportion of gross loans remain elevated at 12.0% spoiled the party to a certain extent, while the regular buzzkill of dismal private sector credit growth (estimated at 3.4% y-o-y in February) also tempered optimism. The MPC concluded that given the inflation outlook and the central bank's view that the economy is operating close to its potential, the current monetary stance remains appropriate.

Outlook:

No change on CBR anticipated in the near term

At the end of last year, the MPC explicitly noted that interest rate caps – with lending rates limited to four ppts above the policy rate – have had a detrimental impact on the monetary policy transmission mechanism, something we have not seen in previous statements. It is no secret that the CBK wanted the interest rate regulation to be scrapped, but this is the second time the MPC acknowledges that its effectiveness is being hamstrung by these controls. Increasing the policy rate could inadvertently support credit extension by pricing in riskier borrowers, but elevated NPLs would make this strategy a bit too risky, while subdued price inflation renders contractionary policy largely unnecessary. Consequently, we expect the policy rate to remain unchanged for the foreseeable future.





Source: CBK, KNBS

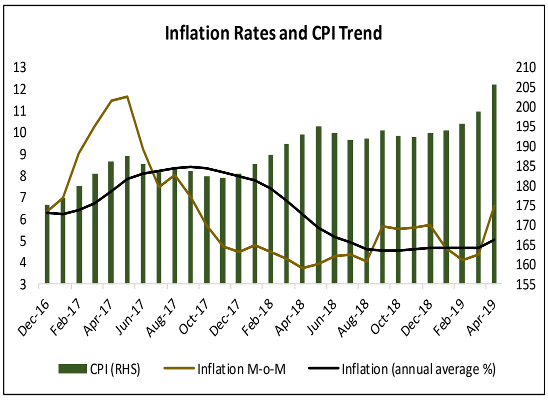
INFLATION- EXPECTED TO REMAIN BENIGN

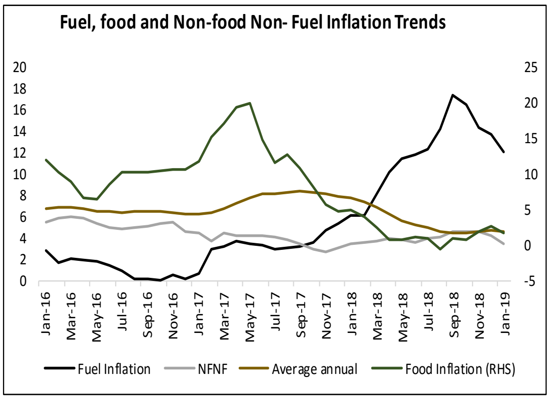
Headline inflation averaged 4.70% in 2018 compared to 8.0% in 2017, largely supported by declining food prices over the period following favorable weather conditions. Inflation for the month of April 2019 stood at 6.58% y-o-y and at an average of 4.40% in the first quarter of the year on account of rising food prices due to the prevailing drought conditions. Consequently, food inflation rose to 1.82% in 4Q18 from 0.41% in 3Q18. Fuel inflation also edged up to 14.87% in 4Q18 from 14.66% in 3Q18, owing to the rising domestic and international energy prices. The non-food non-fuel inflation increased to 4.48% in 4Q18 from 4.27% in 3Q18.

April inflation rises to 6.58%. Pressure on food prices expected to subside hence our inflation outlook falls within target range

Outlook:

Headline inflation is expected to average between 5.0 - 6.5% this year. Power-tariff hikes in mid-2018 and tax rises imposed in September, including VAT on fuel at 8%, will maintain the upward pressure on energy costs, although declines in oil prices will provide some relief. Price pressures are expected to build towards the second quarter of the year, driven by the dissipation of favourable food price base effects and stronger demand-side pressures. On fuel inflation, we anticipate a gradual uptick mainly ensuing from sustained US sanctions on both Venezuela and Iran whose production plummeted 29.9% and 6.6%, respectively, in 2018, coupled with the ongoing OPEC+ 1.2Mn daily production cuts.. Generally, we expect inflation to remain within target range (2.5-7.5%) for the remaining part of the year.





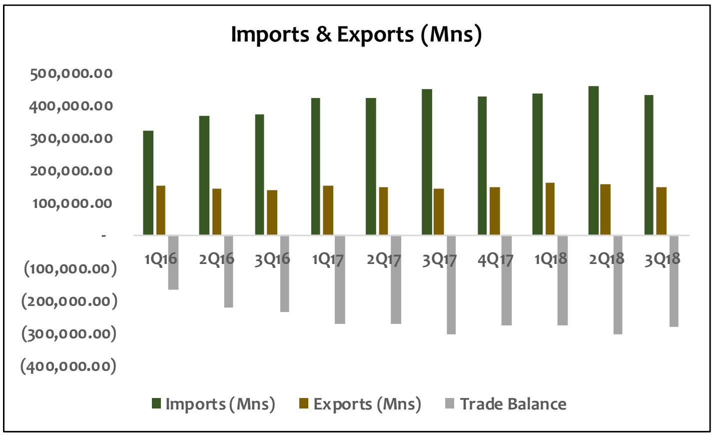
Current account deficit projected to remain largely stable between 4.8% - 5.0% on account of slower imports growth.

CURRENT ACCOUNT TO GDP DECLINES TO 4.7%

Imports grew by 3% in the 12 months to February 2019 while the horticulture, tea exports and diaspora remittances grew by 14%, 12.2% and 30% in 12 months to February 2019 respectively. Current account deficit to GDP stands at 4.7% as of February 2019, slightly lower compared to 4.9% in December 2018. Year- on-year the current account defit to GDP has declined from 6.3% in 2017 to 5.0% in 2018. The value of exports grew by 3.2% to KES 612.9Bn in 2018 on account of increased exports of horticulture, coffee, articles of apparel and titanium ores, collectively accounting for 62.0% of the total domestic export earnings .In turn, expenditure on imports rose by 2.0% y-o-y during the period under analysis, reaching KES 1,760.2Bn attributed to the increase in imports of beverages and tobacco, crude materials, manufactured goods and fertilizers. Import bill on petroleum products increased by 35.3% to KES 76.7Bn during the review period. Overall, Kenya recorded a trade deficit of KES 1,147.3Bn in 2018, an increase from KES 1,131.5Bn in 2017 following a faster increase in the imports than the exports.

Outlook

We forecast the current account deficit to GDP to remain largely stable between 4.8% - 5.0% this year. We have adjusted our current account forecasts to reflect slower-than-expected imports growth. A more enduring downturn in capital goods imports and a reduction in international oil prices during the final quarter of last year have contained the imports bill – a downward adjustment in our oil price forecasts over the medium term has also resulted in a lower fuel imports assumption.



KENYA MACROECONOMIC OUTLOOK

EXCHANGE RATE – STABILITY THE NEW NORM

The shilling started 2019 on the front foot, appreciating just over 1% against the US dollar by end of March, closing the month at KES 100.75/$. Gradually the local unit has lost ground by 0.4% as of end of April 2019. The shilling has been supported by some positive domestic data releases in the first quarter such as strong diaspora remittances, robust export and tourist earnings etc. A widespread downward adjustment in oil price forecasts would have also provided the shilling with some support given that Kenya is a net oil importer, and considering the large proportion of imports that is made up of fuel products. In addition to an improvement in the domestic economic outlook, external factors would have also supported the shilling given the relative liquid nature of Kenyan capital markets. More specifically, the US dollar weakened somewhat due to the negative effect that the government shutdown in the US could have on growth, and the fact that monetary tightening in the US is now expected to be more gradual/delayed.

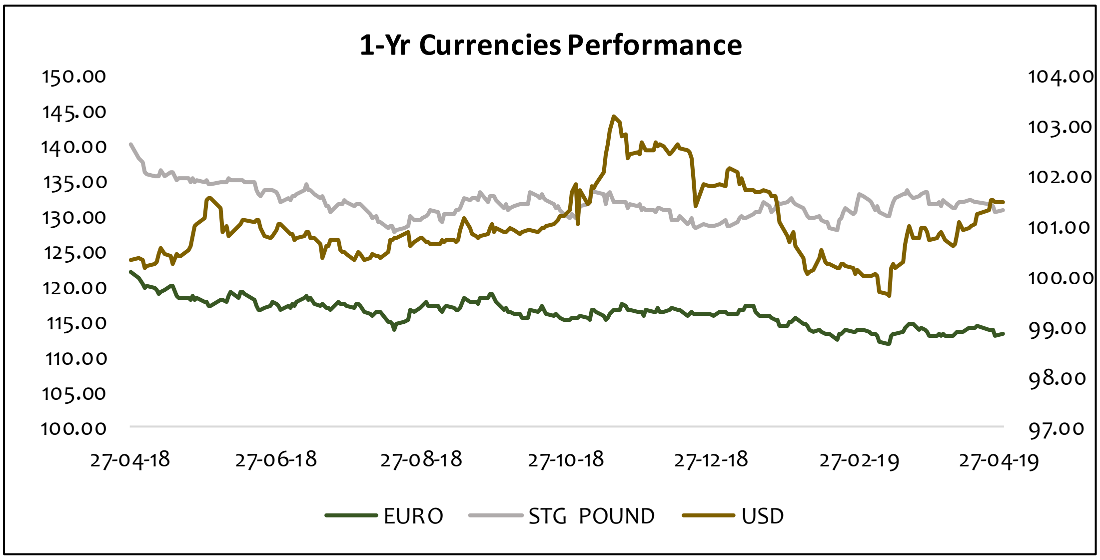
Outlook

Stable currency supported by robust diaspora remittances and strong export earnings.

We see the Kenya Shilling oscillating between 100.00-102.00 levels against its de facto anchor currency, the US dollar. The stability of KES will be pegged on healthy forex inflows; diaspora remittances, tourism earnings and inflows tied to the tax amnesty program ending on 30th June 2019, robust forex reserves and CBK interventions. Reserves remain high and will steady at current levels with Treasury on high gear to refinance the maturing 5-year Eurobond tranche at the international debt market. We anticipate FX reserves, currently at USD 8.12Bn, to be elevated by approximately USD 1Bn in 2Q19. This is on account of net external debt issuance attributable to the Eurobond. As such, we expect the growing FX reserves to further anchor KES at current levels. Eurobond III prospectus was to be ready from April. We do not expect the Treasury to borrow more than USD 2.0Bn through Eurobond 3.

Despite these positive developments, the shilling remains vulnerable to exogenous shocks.
These particularly relate to:

- **A probable sharp decline in FX reserves due to the absence of an IMF cushion.** This may however be mitigated by CBK as they would tighten the monetary policy if the shilling appeared vulnerable. Moreover, Kenya and the IMF are moving closer to agreeing a new stand-by arrangement.
- **Debt concerns:** Public debt concerns have been at the fore of Kenyan risk assessment for some time now, but the inability to put forward a resolute debt management plan would further erode investor confidence. Foreign currency debt maturities could also affect the shilling as demand for the hard currency rises.



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FISCAL POLICY:

Recent developments

Latest available data shows actual National Treasury fiscal receipts (March 2019) at KES.1.67Tn against a revised target of KES.2.58Tn, equivalent to 64.8% of the total fiscal year revenues target. Total non-tax and total tax income receipts stood at KES.44.3Bn and KES.1.02Tn equivalent to 66.1% and 63.5% respectively. Of particular interest to investors is the revised domestic borrowing target of KES 537.5Bn which includes KES 317.1Bn in net borrowing and KES 220.4Bn in redemptions (roll-overs). The data provided shows that 61.1% of the annual domestic borrowing target had been achieved as at the end of March 2019.

We estimate the fiscal deficit will decline to 6.0% of GDP at the end of FY2018/19, down from 7.2% at the end of FY2017/18. We do not expect the current revenue measures to boost collection in the final quarter, in light of the 15.2% underperformance as compared to pro-rated target (KES 945.6Bn – vs- KES 1.1Tn). However, absorption of funds has equally been off-tangent, with recurrent and development spending performing at 63.4% and 48.3%, respectively, against a possible 66.7% as at February.

The draft budget policy statement for FY 2019/20, released in February, notes that budget execution has been slow so far this fiscal year due to budget rationalization to align expenditure priorities to revenues after amendments to the Finance Bill 2018 that affected the reveenue yields. In addition, the exercise to clean up the development project portfolio also slowed down the uptake of development expenditure, although it picked up well in the second quarter of FY 2018/19.

The finance ministry made sure to point out that expenditure rationalisation aims to ensure a sustainable fiscal position over the medium term, and to reaffirm the government's commitment towards its fiscal consolidation plan and to prudent fiscal management in general.

Despite these developments containing fiscal expenditure, the government has again revised the projected 2018/19 fiscal deficit wider to incorporate a disappointing performance on the revenue side. The government attributes the latter, in turn, to amendments to the Finance Bill 2018 – including, among others, a reduction in the VAT on fuel from 16% to 8% – that significantly affected the expected revenue yields, while a lower-than-anticipated revenue yield in FY 2017/18 reduced the forecasting base. The fiscal deficit for the current fiscal year is now projected at 6.3% of GDP compared with an original budget projection of 5.8% of GDP, according to the latest official figures.

Outlook

The fiscal deficit is expected to narrow from an official estimate of 6.3% of GDP this fiscal year to 5.0% of GDP in FY 2019/20, before eventually narrowing to 3.0% of GDP by FY 2021/22. We however consider this to be too ambitious going by the current state of affairs. Remaining on this budgeted consolidation trajectory would quickly ease the fiscal concerns currently hanging over Kenya's economic outlook, but it is the country's track record of fiscal loopholes that sustains an air of scepticism when assessing these figures. We expect that recent revenue initiatives and more measured public investment will result in a fiscal deficit equivalent to 6.1% of GDP this fiscal year, which is slightly narrower than the official projection of 6.3% of GDP. However, sticky recurrent spending and a pick-up in public spending will hamper the government's consolidation efforts, and we expect the deficit to remain above 5% of GDP over the medium term.

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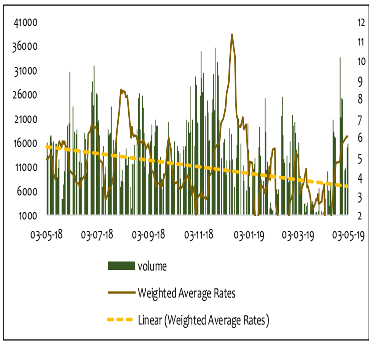


Source: CBK

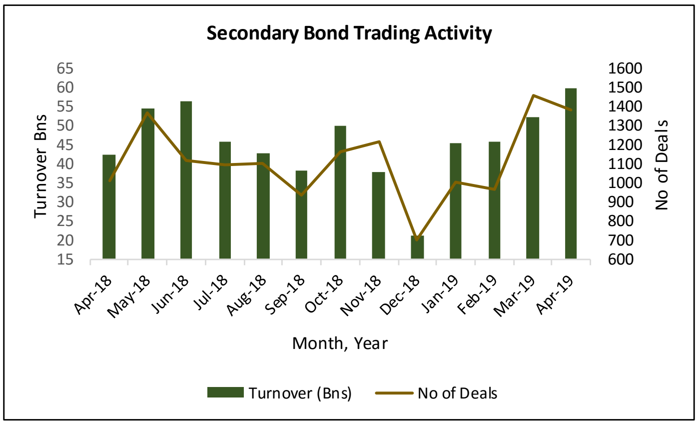
FIXED INCOME OUTLOOK

KES 169.95Bn and KES 132.81Bn in Domestic Debt Maturities in May & June 2019;

May has the biggest domestic debt maturity amount in the 2018/19 fiscal year amounting to KES 169.95Bn followed by June having maturities totalling to KES 132.81Bn . June has significant redemptions arising from maturities of FXD 2/2014/5Yr with an outstanding amount of KES 37.12Bn. Bond maturities for May (FXD 1/2007/12Yr) are totalling KES 5.18Bn while for T-bills are KES 148.9Bn. In consideration of these considerably high maturities, we expect heightened borrowing activity in the domestic debt market.

Bond Turnover Increases in April

April 2019 bond turnover rose 14.8% from the previous month to KES 59.87Bn, albeit on fewer trades – 1387 compared to 1,463 in the month of March. This was partially attributed to the end quarter fund manager reporting period that abnormally sees a decline in trading activity. High market liquidity is expected to have an impact in secondary market in May with turnover expected to increase.

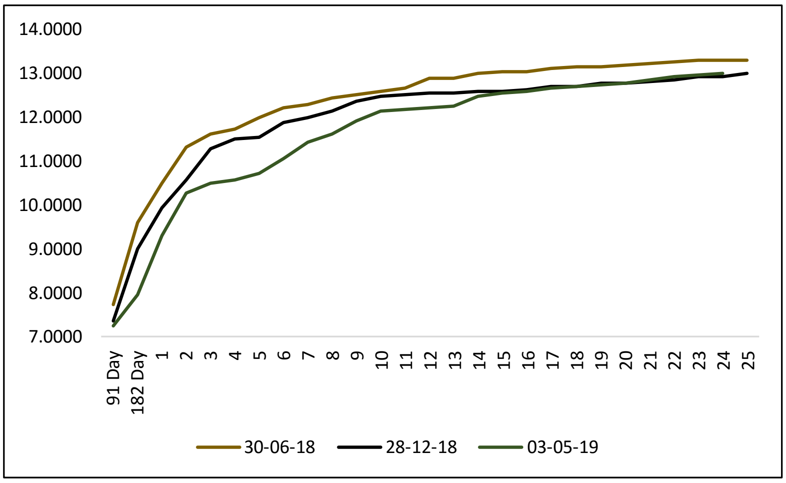


Source: NSE

Yield curve continues its downward shift

The yield curve has portrayed a downward shift since June 2018 to date . The biggest shift in the yield curve between June 2018 and May 2019 is on the short end with minor differences in yields on the long end between December 2018 and May 2019. This trend is illuminated by the CBK's action to accept lower bids in short tenor papers falling between 91-day T-bill and 10-year papers. Inflationary pressure and the expected fiscal financing needs are likely to put some upward pressure on short term yields in the near term. We are currently advising investors to go long on short and medium term tenor issues and hold on the long term bonds in their portfolios. This is inorder to reduce on portfolio duration and minimize on the downside risks.

Tenor	Yield (28th Dec 2018)	Yield (03rd May 2019)	Var (bps)
2	10.5849	10.2857	-30.0
5	11.5500	10.7333	-82.0
10	12.5000	12.1375	-36.0
15	12.6055	12.5675	-3.8
20	12.8000	12.775	-2.5
25	13.0000	13.0167	1.7



Source: NSE

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Expectations:

No significant change on the yield curve in 2Q19, marked with relative flatness on the long-end. The short-end of the yield curve has gradually shifted downwards, reflecting the bid discipline in the market by investors. The biggest game changer to a potential shift in the yield would be a return to the previous interest rate environment before the rate cap and with anticipated macro fundamentals holding up in the quarter (no significant changes expected), we maintain neutral stance on the yield curve.

We still expect instances of high liquidity environment over the course of 2Q19 mainly ensuing from the preference of banks to hold significant amounts of cash other than lending. We are not overly bullish that as we approach the tail-end of the budget cycle, government payments will spike up considering the hitherto low absorption of funds. Interbank rate improved in 1Q19 with the rate shaving 191bps q/q to 3.18% on lower volumes of KES 597.52Bn (-48.2% q/q), although it remains skewed against Tier III players. In this second quarter, the interbank rate has posted an average of 3.76% with May having seen the rate touch a high of 8.5%. We thus hold the view that the high liquidity will be supportive of T-Bill performance in the course of the second quarter, although there has been recorded underperformance of the Tbills over the last two weeks.

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