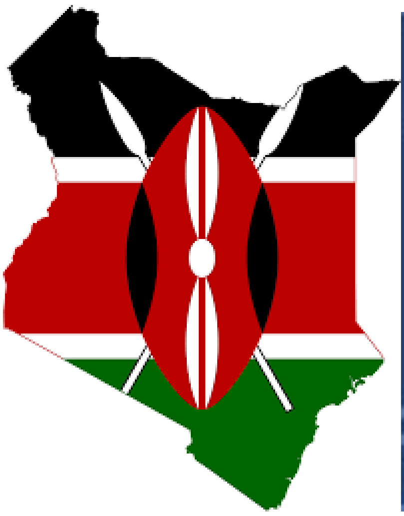
Economic Outlook
Q3 - 2023

Kingdom Securities Limited

Kenya Macroeconomic Outlook



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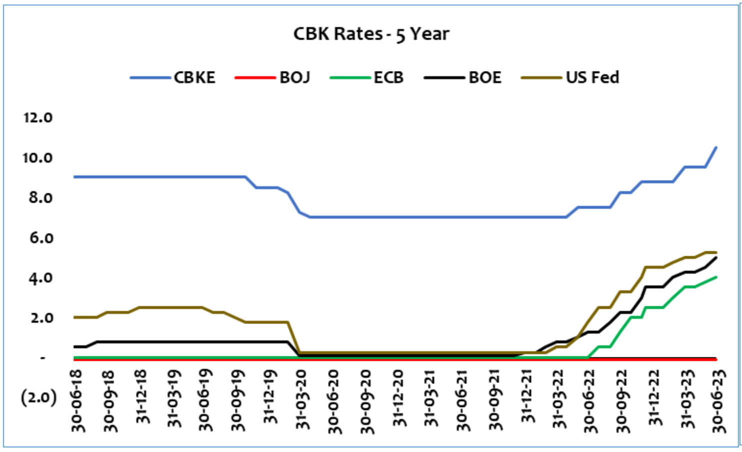
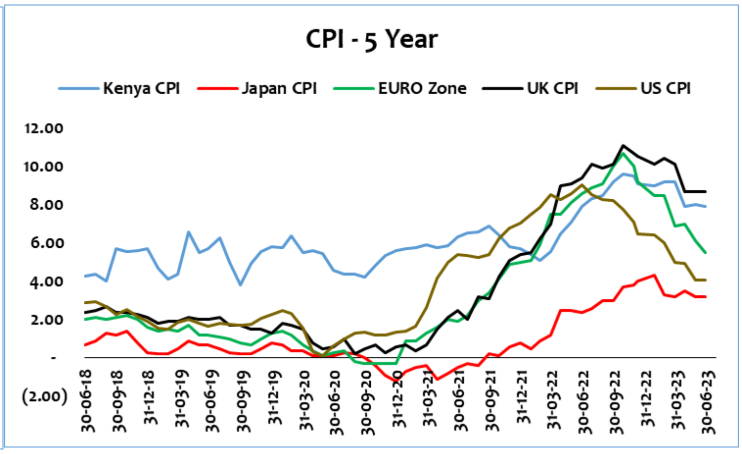
Global Economy Forecast to Grow by 2.8%

The globally, economies had mix performance with US and China growing by 1.3% and 4.5% in Q1-23 compared to Q1-22 supported by growing consumption and private inventory investment. Euro and EU area grew by 1.3% and 1.2%. The UK saw an estimated growth of 0.1% with March GDP declining by 0.3%. The UK growth was primarily driven by higher price pressures for household consumption. However, significant challenges remain against the backdrop of slow global economic growth and tight financial conditions.

The World Bank's Global Economic Prospect Report forecast the Global Economy to grow by 2.1%, down from 3.4% in 2022 on monetary policy tightening to tame inflation, banking sector instability and the ongoing Russia invasion of Ukraine. The report project Sub Sahara Africa growth to decline to 3.6% amid slowdown in activities due to credit squeeze, high inflation projected at 14.0% and tight policies.





Global inflation is seen to taper downwards albeit remaining above respective economic targets. This is supported by a strong economic recovery and monetary tightening.

Kenyan Economy Expanded by 5.3% in Q1-2023

The government projects a GDP growth of 5.5% for the fiscal year 2023/24 with inflation forecast at 7.8%, above the government target of 5±2.5%. The Kenyan GDP expanded by 5.3% in Q1-23 compared to a growth of 6.2% in Q1-22 but better than 3.7% in Q4-22. The quarter's performance was supported by a 5.8% y-y growth in the agriculture sector after the sector saw a contraction of 1.7% in Q1-22 and 0.9% in Q4-22. The sector contribution to GDP remained flat at 18.5% with improved production on much improved rainfall during the period.

In June, the government read a budget with a KES 3,680.0Bn budget for the fiscal year 2023-24 representing 22.6% of Kenya's GDP. The government expects to raise KES 2,919.8Bn in revenues or 17.9% of GDP. The government intends to reduce fiscal deficit from 5.8% in 2022/2023 to 4.4% in 2023/2024.

Kenya remains on the global cross hair with regards to payment of the USD 2.0Bn Eurobond that matures in June 2024. In May 2023, Moody's agency downgraded Kenya's sovereign rating from B2 to B3, High Risk, citing liquidity risk and deteriorating domestic funding conditions.

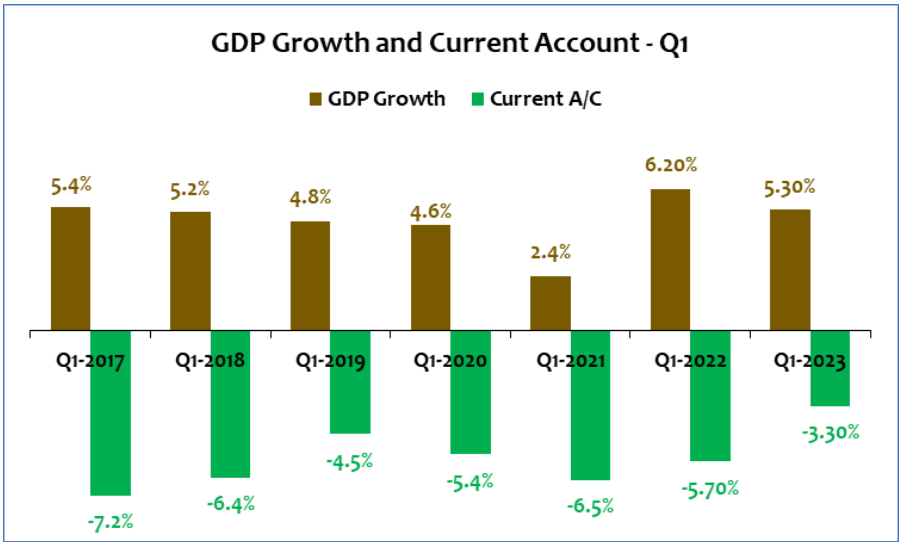
Kenya Q1-2023

GDP Growth

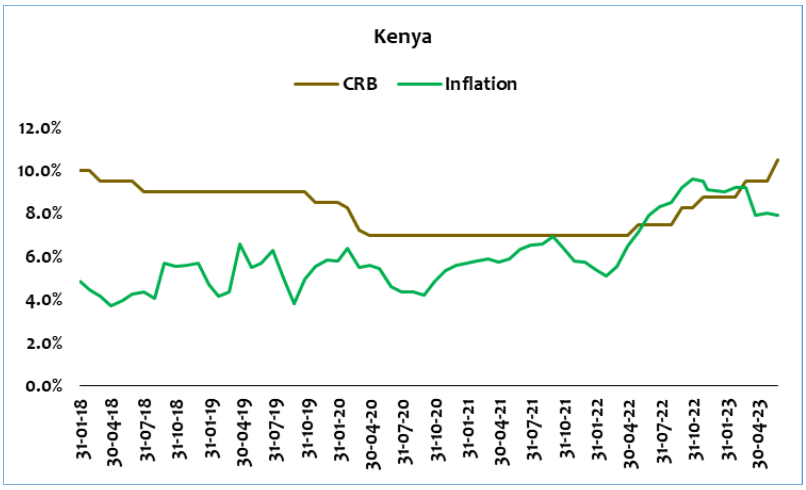
5.3%

Current A/C

3.3%



The Central Bank of Kenya Monetary Policy Committee hiked the Central Bank Rate to 10.5% from 9.5%. The hike which was meant to tame inflation came at a time when Q2-2023 inflation averaged 7.93% lower compared to Q1-23 average of 9.13% when the CBR rate was 9.0%. We view this was a hike necessitated by the international influence as UK and EURO Zone has a rate hike midst declining inflation while US and Japan held their rates flat as inflation eased but remaining above government target.



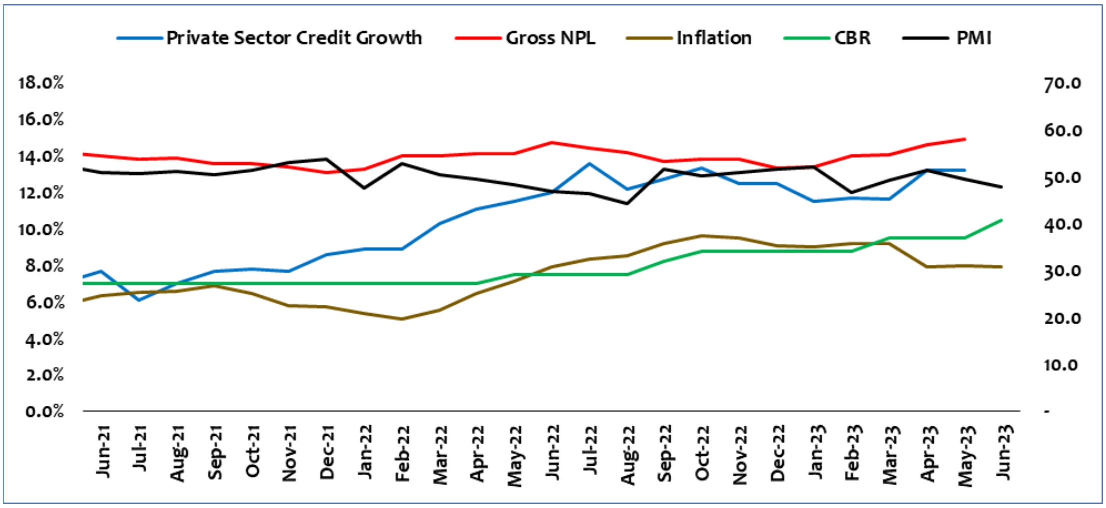
Current Account

The current account deficit declined to 3.3% in Q1-23 from 5.7% in Q1-23and 4.9% in Q4-23. The quarter had improved export earnings which grew by 9.4% on payment from tea, iron and steel, titanium ores and concentrates while imports decelerated on drop of import of industrial machineries. The value of imported petroleum products increased by 16.5% y-y to constitute 22.1% of total import bill.

Global economic slowdown as indicated by the growth performance has had a ripple effect in the Kenyan economy. This is reflected on:

- Flat growth in private sector credit growth of 12.2% of the first five months compared to an average of 10.1% same period in 2022.
- Growing levels of gross bank non-performing loans to an average of 14.2% in the first 5 months and a high of 14.9% compared to an average of 13.9% and a high of 14.1% in 2022.
- Slowdown in manufacturing levels with PMI of 49.4 in H1-23 against 49.3 in the first six months of 2022. This is due to weakening Kenya shilling, low consumer purchasing power, due to high inflation and cash shortage leading to weak order flows while there was in increase in inventories.
- The Central Bank Rate (CRB) hike to 10.5% in June from 8.75% has led to a rise in yields on government securities and cost of credit from banks forcing high cost of financing for both the public and private sectors.
- The changes in tax structure as detained in the Finance Bill 2023 further worsened the manufacturers activities due to payment that would affect their expenses including increase of VAT to 16.0% from 8.0%, introduction of a 1.5% housing levy and changes in duties for raw materials.

The current account levels have been suppressed due to the low demand of producers supplies while the customs changes on consolidated cargo curtail imports by MSME. We expect this to change after the introduction of new taxes and stimulation of the local economy.

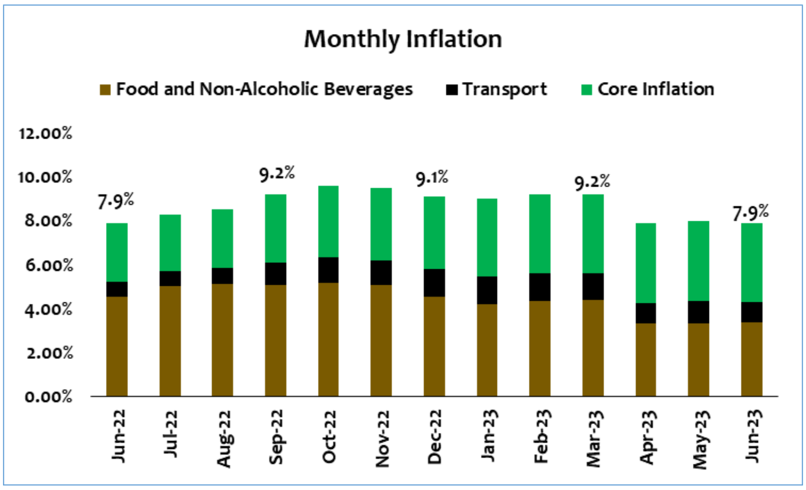


We review the PMI to stay below 50.0 as manufacturers grapple with the high cost of production. Pressure to remain on gross non-performing loans on low economic performance despite government attempt to clear pending bills especially on the infrastructure front which remain a thorn in the flesh for banks. Private sector credit growth to be hindered by increase in cost of credit due to rate hike as banks align with the new CBR levels.

Inflation

The metrological department forecasted that the key country bread baskets to receive above average rainfall between June and August. This will aid by improving food production leading to lower food prices cutting inflation levels.

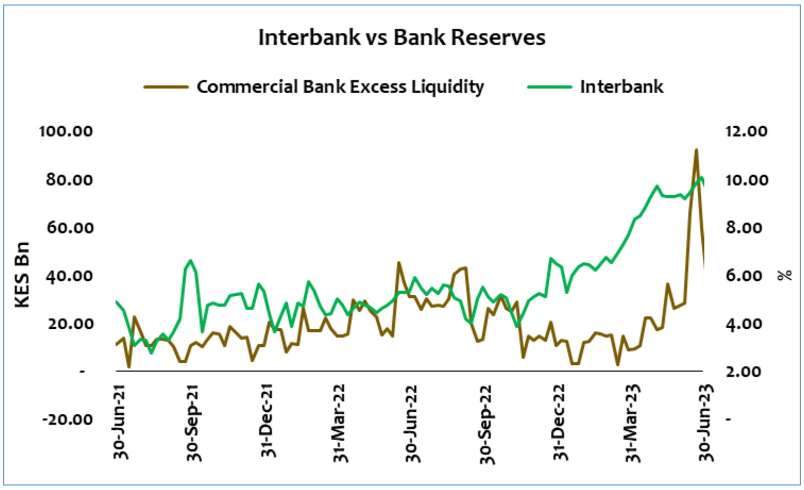
The pressure in food production prices, both agriculture and manufacturing, will come from an increase in pump prices for diesel and petrol after the adjustment in VAT from 8% to 16%. The market has seen adjustment of prices with transport association, Matatu Owners Association (MOA) announcing adjustment of prices with bread manufacturers increasing prices of bread.



We expect the Kenyan inflation to remain above the government target of 7.5% influenced by high cost of petroleum, high food cost due to increase in production cost.

Interbank Rate

The interbank rate has remained tight to average 7.81% in H1-23 compared to 4.70% in H1-22. The rate was tight in Q2-23 at 9.23% from a 6.50% in Q1-23 highly as investors anticipated a tough operating environment. The CBK has remained a key player with repo offers to manage the rate. However, the rising short-term yields and hiked CBR leaves the interbank rate at a pickle position.



Commercial bank excess reserve ratio averaged KES 22.21Bn in H1-23 against KES 20.74Bn in H1-22. The second part of the half year saw an average of KES 33.46Bn against KES 10.95Bn in Q1-23 as banks conserved liquidity towards the end of the fiscal year and the expectation of rate hike to enable them offer higher yields on advances and loans and expected rise in government yields.

The widening gap on the rate and reserves indicated a market that was awaiting policy direction on both the fiscal front with regards to budget reading and monetary policy on change of guards with the retiring of the CBK governor on June 15th, 2023.

We forecast the rate to stay above the 9.0% level in Q3-23 as investors remain skeptical about government plans as weak economic growth. High cost of lending will give a reprieve on the rate as banks will slowdown lending to the private sector on weak economic performance and opt for short-term government papers.

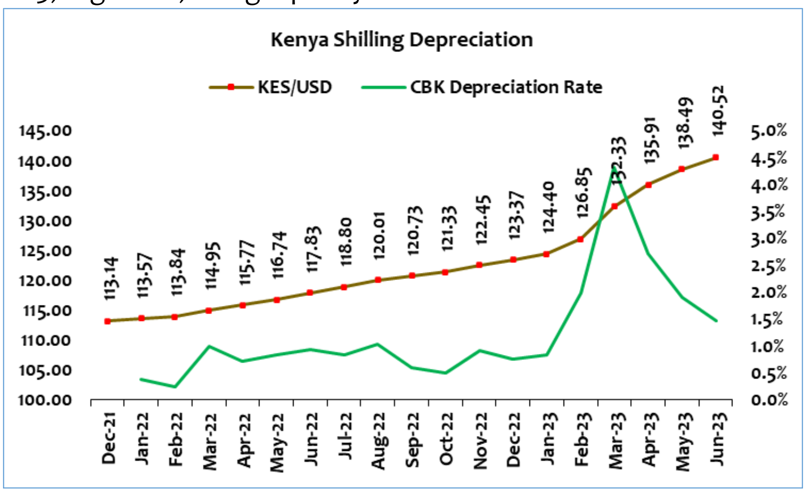
Currency

Kenya shilling has been on a downward spiral shedding 13.9% as end of H1-23 while done 19.3% y-y as of close of June 2023. The depreciation was due to different factors that include.

- Global strengthening of the dollar due to demand of the green buck which was up 0.6% in H1-23,
- Country's low forex reserves with support by receipts from concessionary borrowing while demand towards external debt puts pressure. In the first 5 months, diaspora remittance declined by 1.8% y-y with low receipts from North America (-4.5%) and Europe (-3.5%). The 2022 remittance was USD 4.03Bn representing 4.8% of GDP,
- Import demand especially for energy demand, merchandisers, and raw materials,
- Reprieve come from strong export remittance from tea, horticulture and with Q1-23 exports value growing by 17.0% y-y.

The local currency has been shedding with m-m highest levels reached in March 2023 (4.3% m-m) with lowest levels in June 2023 of 1.3% m-m. The graph indicates there has been a slowdown in depreciation rates as since the start of interbank forex trading in March.

Commercial banks have been exchanging with a premium of 3.9% on the USD, a level that has reduced from a high of 9.2% in March 2023. The rate was at a low of 2.3% after improved liquidity in May after market defying the panic created by the Moody's report that cut Kenya's sovereign rating from B2 to B3, High Risk, citing liquidity risk.



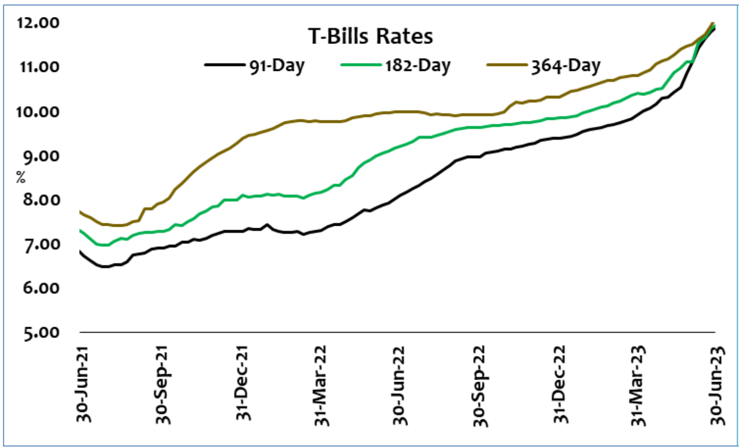
Simulation on the depreciation, we price the CBK level of KES/USD at 150.66<KES <161.42 on a depreciation range of 1.0% - 2.0% as at end of 2023.

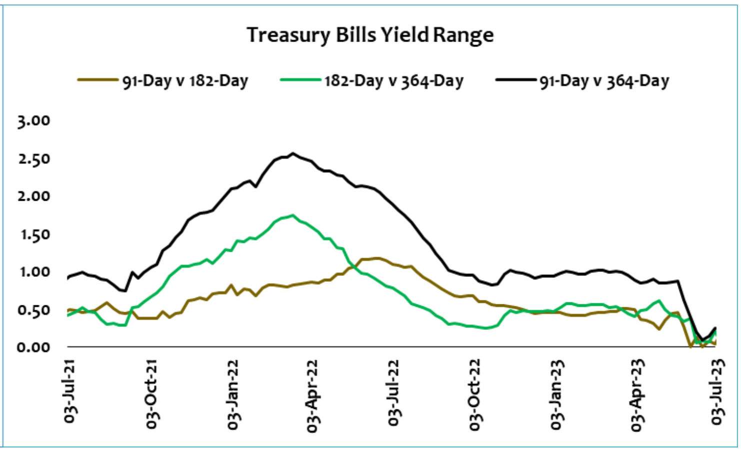
Treasury Bills

Treasury bills rates have been on an upward momentum due to government appetite for funds which has led to aggressive bidding. In Q2-23, maturity stood at KES 379.97Bn, 21.8% higher compared to demand of KES 312.00Bn for the quarter. The high demand should have eased the rates; however, government demand has created a large percentage of competitive bid elevating short-term yields.

Quarter on quarter, the yields have increased by 195.6bps, 151.9bps and 114.7bpss on the 91-day, 182-day, and 364-day respectively and 377.2bps, 270.0bps and 196.0bps on y-y.

Concentration and aggressive bidding on the 91-day paper has pushed the rate high, to narrow the ranges between its rate and the other tenure. Investors continue to give distrust signal to the unknown government strategy as they are unable to decipher the policies directives from the executive.





The quarter expects a maturity of KES 406.53Bn, 30.3% above the government demand of KES 312.00Bn. The need to cover for the maturities will force government to accept aggressive rates.

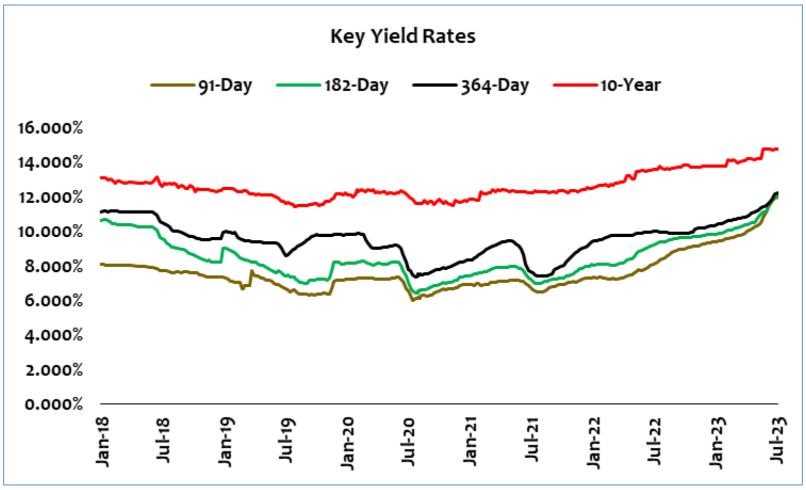
The change of government and CBK governor seat has shown acceptance of tighter monetary policy against the previous regime which had more control on rates.

Yields Movement

The Kenyan yields have surged above pre-covid levels with 10-year yields closing June at 14.768% compared to 12.260% on March 2020. The market continues to face challenges with government forced to offer better results to attract investors.

The current witnessed yields are equivalent to yields witnessed in the tight liquidity regime in 2015 where short-term returns touched 22.492% while the 10-year bond was at 14.8296% and interbank were at a high of 13.3178%. The environment remains tight forcing investors to focus on near hand investment. If the government insist on long-tenure papers, they will not be able to meet the fiscal year net domestic borrowing target of KES 586.50Bn.

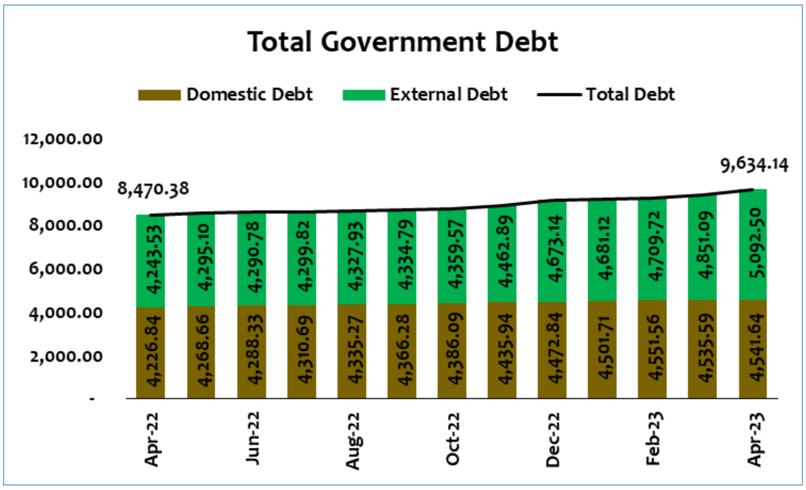
The rising yields have forced investors to change holding timelines moving most of their book to held to maturity category.



Kenya Public Debt

Kenya public debt increased by 13.7% y-y on the close of April 2023. The level surged due to a 20.0% increase in external debt to KES 5,092.50Bn while domestic debt increased by 7.4% y-y during the period. The ration of external debt to domestic debt stood at 52.9%:47.1%.

The surge in foreign debt was due to an increase in concessionary debt from the World Bank and IMF with March 2023 figures showing multilateral debt increased by 23.5% y-y. financing from the Brentwood Institution went towards budgetary support, debt management, and currency support.



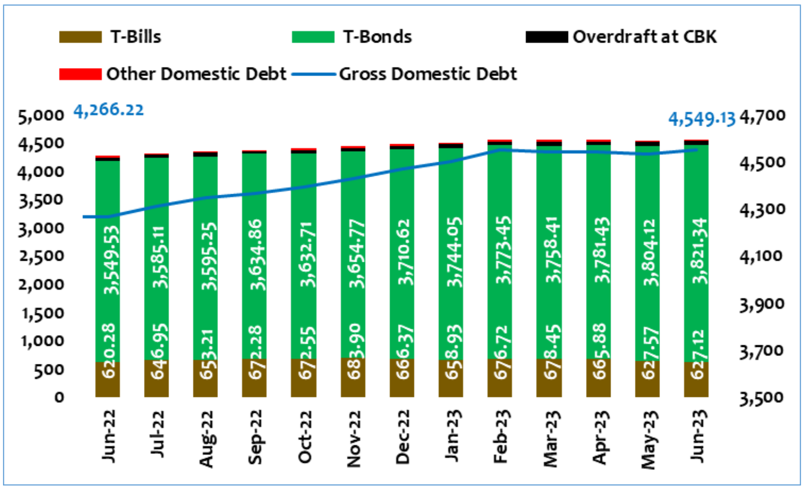
We expect the external debt levels to increase in July after the IMF management approval and consideration by the Executive Board, which will give Kenya immediate access to about USD USD410.0Mn.

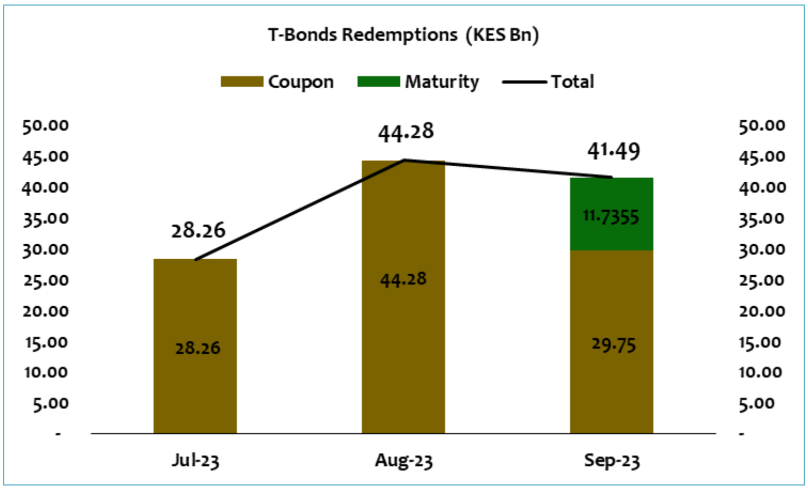
Kenya Domestic Debt

Kenya's net domestic debt increased by 6.6% y-y as of end of H1-23. The drive was due to a 7.7% net growth in Treasury Bonds while T-Bills increased by 1.1%. The T-Bonds holdings increased to 84.0% while T-Bills holdings declined to 13.8%. Total payout in Q2-23 stood at KES 172.00Bn (coupon KES 132.75Bn, maturity KES 39.25Bn).

The CBK overdraft facility increased by 14.0% y-y on cash crunch. This credit facility is limited to 5.0% of the most recent audited accounts as it creates potential inflationary risk as it is equated to printing of money. The current Treasury Cabinet Secretary, while he was the CBK Governor, stated in the Kenya Financial Sector Stability 2012: ***"Accelerated borrowing from the CBK is inflationary as it is equated to the printing of money and therefore leads to macroeconomic instability through inflationary pressures."***

The government of focus on long-term bonds to lengthen the tenure came into a headwind with investors shying away from long tenures. Government's high demand forced a change in strategy during the April 2023 auctions with the cancellation of FXD1/2019/15. The CBK has issued bonds ranging from 3-7 years in Q2-23. On the short-term papers, focus increased on the 91-day paper rather than the 364-day paper.



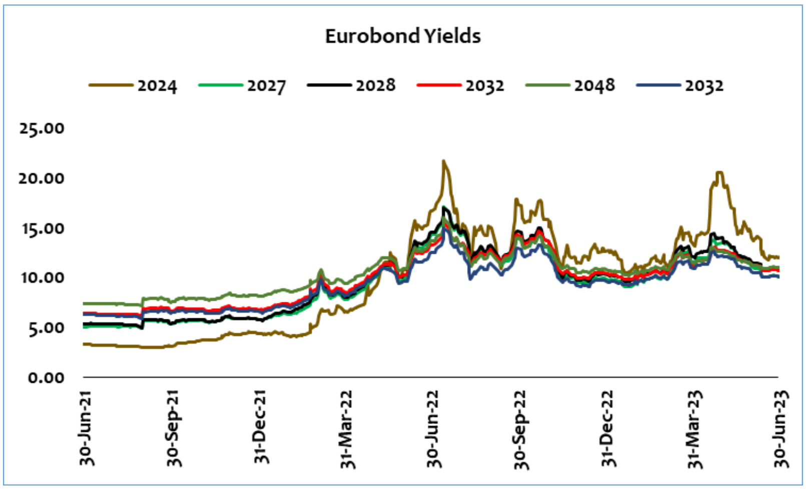


The second half of the year is bound to see lesser activity on maturity and coupon payment (KES 266.65Bn) compared to H1-23 (KES 404.34Bn). The third quarter expects a payout of KES 114.03Bn, (coupon KES 102.30Bn, maturity KES 11.74Bn). We forecast the government to continue to issue short term bonds, ranging 5-7 years with a focus of trapping liquidity leading to aggressive bidding pushing yields further up. The slower second have will lead to accelerated portfolio on domestic debt due to government taking advantage of the low payout.

Eurobond

Debate continues to rage on strategies mulled towards payment of the USD 2.0Bn maturing on June 22nd, 2024. The mild comfort presented by the government with receipts from IMF and World Bank saw the yield ease with the 2024 Eurobond moving 168.4bps by end of Q2-23 lower compared to end of Q1-23.

The continent has shown confidence on payments with Nigeria redeeming USD 1.0Mn 10-year Eurobond. In May, Rwanda managed to redeem USD 400.0Mn 10-year Eurobond. Rwanda was supported by drawdown facilities availed by the IMF for economic stability.



We reflect the yields on the 10-Year 2024 Eurobond will remain elevated above the 12.0% levels until the Kenyan government show substantive payment plan. In the 2023/2024 fiscal year, the government allocated KES 270.0Bn in external commercial financing which is intended to be used in the payment of the 10-Year 2024 Eurobond.

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