STERLING CAPITAL LIMITED

ANALYSIS REPORT

18-Sep-2017

FIXED INCOME NOTE

Sustained Yields on reduced Government spending

Inflation has eased from its 5-yr high of 11.7% in May-17 to its current level of 8.04% by Aug-17. Pressure on food prices have leveled off in the past few months owing to delayed rains in various regions towards end of June. We anticipate inflation to remain above CBK's target owing to the recent increase in retail pump prices on petroleum (+ Ksh 2.22) and Kerosene. This was as a result of a 7.48% increase in the price of oil imports. Despite this, core inflation has remained below 5% throughout the year indicating low demand driven inflation. Private sector credit growth continues to record historically low figures (2% in July-17) affected by interest rate caps and slower economic growth (4.7%: Q1-17). We anticipate the MPC to maintain the CBR rate at 10.0% as demand driven inflation is expected to remain stable for the coming months.

On fiscal policy, the government's domestic borrowing target is at KES 268Bn an overall increase of 17% from the previous fiscal year. With increased demand for government papers by commercial banks resulting from interest rate caps, crowding out effects will sustain throughout the year. Revenue collection in the first half will be constrained with the impact of economic slowdown affecting company's profits and increased layoffs that will lower PAYE collections. This will exacerbate fiscal pressures on recurrent expenditure and in our view lag on development expenditure in FY17/18. Fiscal deficit stood at 8.3% in FY16/17 above the government's revised target of 6.9%, its projected target of 6.4% for the current fiscal year seems unattainable with increased wage pressures from and reduced revenue collection from the slowdown of the economy.

Government intends to borrow KES 30Bn in the upcoming auction by issuing both 2-YR and 10-YR papers. Yields across most maturities have remained stable and note the government's intent to reject higher bid yields. We anticipate bids for the the 2-yr between 11.75%-12.0% and the 10-yr at 12.80%-13.00%. Demand is expected to be high across both maturities with subscription levels of >100%. The view of stable interest rates is informed by the reduced government spending on development expenditure which has been slowed by the prolonged electioneering process

Eurobond tracker: Yields on the Kenya 5-yr and 10-yr have declined over the year in 2017 by 62bps and 148bps respectively to an average YTM of 6.189% and 3.999% respectively. This can be partially attributed to relatively stable economic environment however, political risk factors especially on the results of the upcoming presidential elections on October 17th 2017 could have an upward effect on the current yields.

Macro Statistics	
Inflation-Aug 17	8.04%
CBR: Current	10.00%
CBR: Forecast	10.00%
Interbank rate:	3.56%
Repo rate:	7.00%
91-day T-bill	8.13%
KES/USD	103.33
KES/USD %Δ Ytd	↓0.46%

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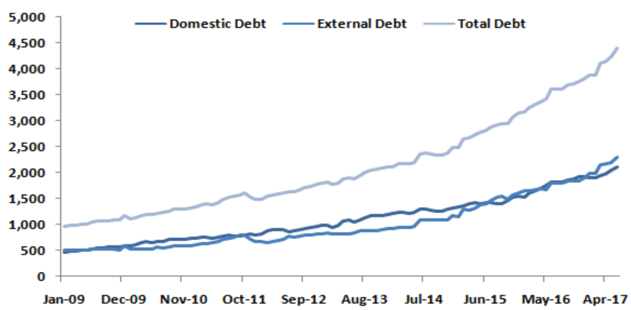
Government Fiscal policy

The governments continued need for domestic funds coupled with interest rate caps have led to crowding out effects on private sector credit which grew by 2% in Q2-17 relative to 9% in Q2-16. Revenue collection is expected to miss target in H1 of the fiscal year as a result of slower economic growth corporate profits which should place strain on the fiscal deficit which stood at 8.3% in FY16/17.

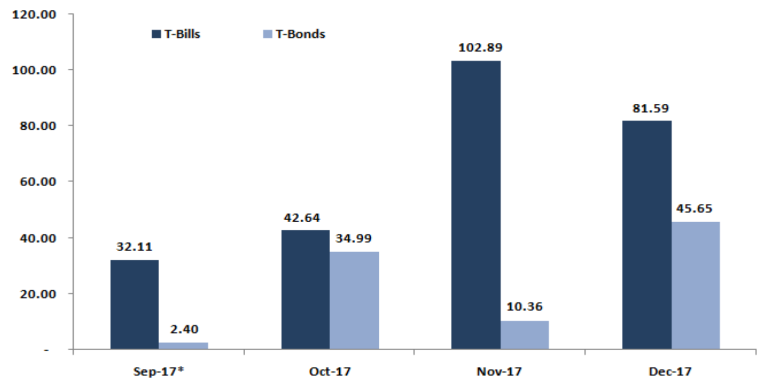
T-Bill redemptions are expected to be highest in November at approximately KES 102Bn. Preference for the 182-day has been high among investors with an average of 134.98% subscription level in the past 5-months (average bid-cover ratio 1.22) since it's suspension in Mar-17 for a period of two months bid-cover ratio of 1.22 which resulted . For the next 3 months, investors expect yields on short-term papers to remain stable as has been witnessed by the uptake of the 182-day paper. In addition, the government has been keen on lower maintain rates by rejecting higher bids across all maturities.

Fig 1: Kenya's Domestic Debt Level



Source: SCL Research & Bloomberg

Fig 2: Maturity Schedule FY17



**Remaining maturities in September 2017*

Flattening Yield curve

Over the year, yield curve has flattened and we attribute this on the back of two major factors: (i) economic slowdown in 2017, (ii) high demand for government papers by commercial banks. The view of stable interest rates across all maturities for the remainder of the year can be also informed by the reduced government spending on development expenditure which has been slowed by the prolonged electioneering process.

The current spread between the 10-yr and 2-yr yield stands at 114bps relative to its spread in Jan-17 at 185bps (5 yr average at 97.3bps) Our recommendation is for investors to keep maturities short as we expect the yield curve to remain flat for the remainder of the year.

Fig 3: Selected T-bond Yields vs. Annual inflation (%)

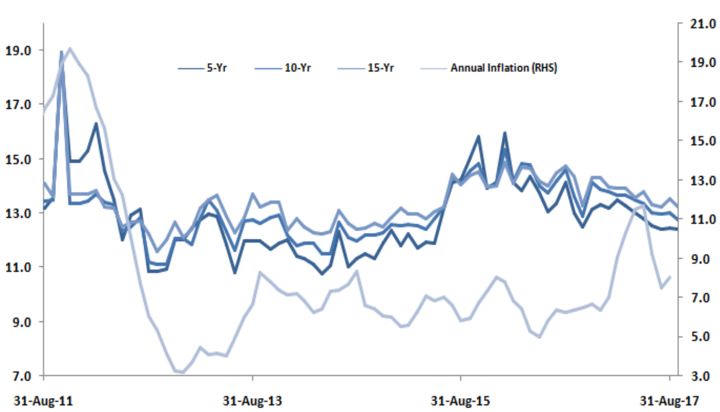
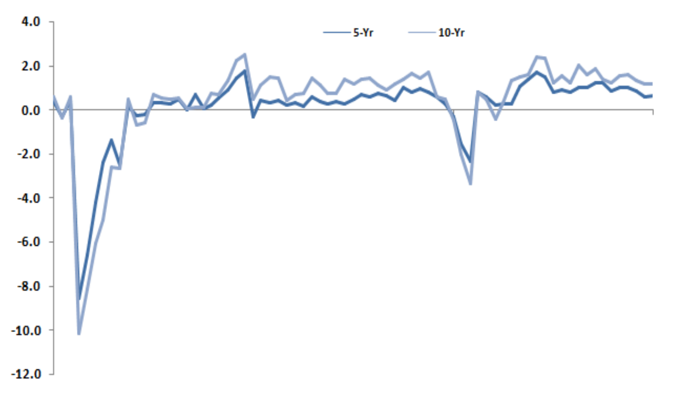


Fig 4: Yield Spread (10yr & 5 Yr Vs 2-yr) (%)



Source: SCL Research & Bloomberg

Eurobond Tracker

We note the slight downward trend in yields on both issues reflective of the relative stable macro and political factors in the first half of 2017 with average yields on both 5-yr and 10-yr issues at 6.189% and 3.966% respectively. With the upcoming presidential elections on 17th October 2017, we do expect yields to rise marginally on both papers to reflect pricing of political risk factors by investors.

Fig 5: Kenya's Eurobond Yields (%)

Source: SCL Research & Bloomberg

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Strong Buy: FV more than 30% above CSP

Buy: FV between 20% and 30% above CSP

Accumulate/Long-Term Buy: FV between 10% and 20% above CSP

Hold: FV between -10% and 10% around CSP

Lighten: FV between 10% and 20% below CSP

Sell: FV more than 20% below CSP

NB: The recommendation guide may change depending on the risk free rate.

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