Thursday, 10 August 2023

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Fixed Income Note

August 2023

"Will revised net domestic borrowing target signal lower interest rates?"

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Executive Summary

- Our August 2023 fixed income report is titled **"Will revised net domestic borrowing target signal lower interest rates?"** in reference to the move by the National Treasury to reduce the net domestic borrowing target by 46% to KES.386Bn as mentioned in the lasted Monetary Policy Committee (MPC) statement.
- The report gives insights to the second and third debt issues of the 2023/24 fiscal year.
- The Central Bank of Kenya (CBK) re-opens **FXD1/2023/5** and issues a new **FXD1/2023/2** looking to raise KES.40Bn target for budgetary support.
- Our weighted average bid predictions are as follows:

  FXD1/2023/5 (Re-opened): 17.80% - 18.20%
  FXD1/2023/2: 17.30% - 17.60%

- This report also covers primary auction outcomes, secondary market trading activity, short-term domestic debt interest rates and market liquidity.
- Domestic debt service is also covered in this report.
- Government revenue, expenditure and fiscal deficit as well as the country's its borrowing is covered in detail in the later part of the report.
- We also analyse the Nairobi Securities Exchange yield curve to compare domestic debt interest rates at different periods.
- The report concludes with our inflation expectations as well as an analysis of the outcome of the MPC meeting on Wednesday, 9th August 2023.

CBK in KES.40Bn cash call through two short term domestic debt issues

- The Central Bank of Kenya (CBK) has invited bids to raise KES.40Bn through two bonds **FXD1/2023/5** (re-opened) and a new bond issue **FXD1/2023/2** (Table.1).
- This continues its strategy of short tenor debt issues in consideration of the current high interest environment and subdued investor demand for medium and long-term debt.

Table.1: Primary Bond issues' summary

Issue Number	**FXD1/2023/5 (Re-opened)**	**FXD1/2023/2**
Total Amount Offered	KES.40Bn	
Tenor (Years)	4.9	2
Coupon Rate (%)	16.844%	Market Determined
Price Quote	Discounted/Premium/Par	
Period of Sale	**31/07/2023 to 16/08/2023**	
Auction Date	16/08/2023	
Value Date	21/08/2023	
Yield Curve (%) (Weighted average tenor - 31st July 2023)	**16.625**	**14.9966**

Source: Central Bank of Kenya & Sterling Capital Research

Why is the CBK issuing a 2-year bond?

- The issue of a 2-Year bond by the CBK has been a rarity particularly in recent years where its focus has been on increasing the average term to maturity of public debt.
- Data from the CBK shows that the first issuance of a 2 Year T-Bond issue was in September 2009 (**FXD3/2009/2**) when it was issued alongside a 5-year bond **FXD1/2009/5**.
- At this time inflation, the CBR and average 91,182 and 364-day T-Bills were at 7.75%, 7.3%, 8.1% and 8.7% respectively.
- The issuance of 2-year debt issues in 2011 and 2012 were prompted by high inflation and interest rates signaled by CBR rates as high as 18%.
- We also observe 2-year debt issues in 2016 when the CBR was at 11.5% before declining to 10% following the introduction of interest rate caps in September 2016.
- The most recent 2 Year debt issues were in January 2019 (**FXD1/2019/2**) also reopened a month later and January 2021 (**FXD1/2021/2**).
- We observe that the general level of interest rates is the biggest driving factor behind the issuance of the short tenured paper with the CBK willing to borrow at a relatively high cost but for the short-term rather than increase its exposure to expensive debt for longer tenors.
- This is a strategy it continues to employ in recent auctions through new short term and re-opened debt issues.
- We note that these short-term debt issues will attract high subscription from investors.

Our market weighted average bid predictions

- Following the steady rises in the general level of interest rates, we caution investors from using the Nairobi Securities Exchange (NSE) implied yields as a guide for possible investor auction bid levels.
- We instead prefer to use the outcome of recent primary bond auction results as estimates of bid levels gathered from consulting fixed income traders (Table.2).
- Recent primary bond auctions suggest that investors will bid aggressively and we will see a further distortion of the yield curve on short-term tenors.

Table.2: Auction bid predictions

Rate	FXD1/2023/5 (Re-opened)	FXD1/2023/2
Weighted Average bid predictions (%)	17.80 - 18.20	17.30 - 17.60

Source: Sterling Capital Research

Our predicted rates are guided by recent debt auction outcomes and not historical issues

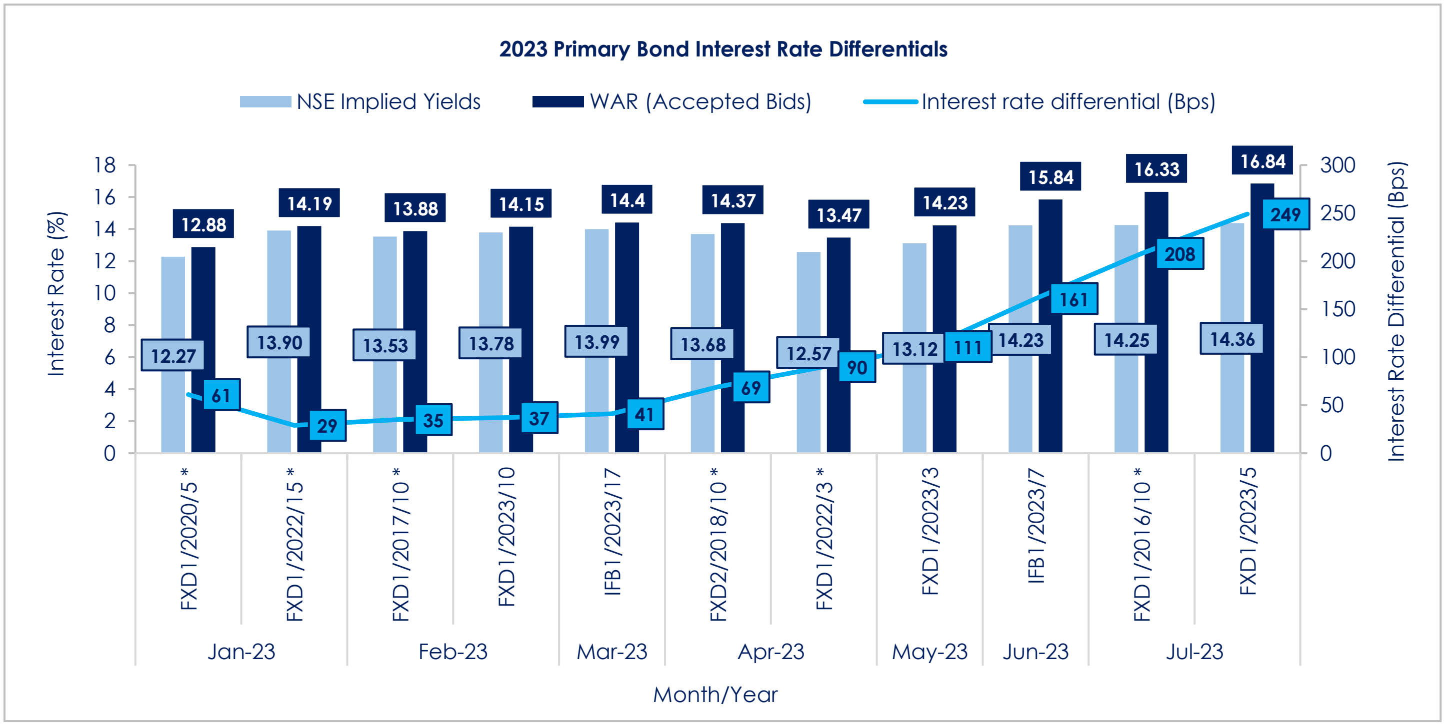
- By looking at historical auction results, one can clearly see the growing disparity between the NSE's implied yields and investor auction bid levels (Table 3 and Figure.1).
- The Weighted Average Rate (WAR) of accepted bids for the July debt issues - **FXD1/2023/5** and **FXD1/2016/10** for instance were 16.844% and 16.328%, 249 and 208 bps above the NSE yield curve levels respectively.
- The WAR of accepted bids has been on average 182 bps above the NSE yield curve over the last two months (Since May 2023) and we could see +200 – 250 bps in the upcoming debt auctions.
- Such disparities suggest that we could see a further spike in yields on this month's debt auctions.
- Aggressive investor bidding has been guided by expectations of higher interest rates following the recent CBR revision and deficit financing challenges.
- Market liquidity is tight as exhibited by current interbank rates but we do not expect this to have a significant impact on subscription for these debt issues.
- This is because of the expected liquidity injection by CBK through Reverse Repos.
- We also expect the bulk of available liquidity to be channeled towards **FXD1/2023/2** more so given expectation of CBK accepting aggressive bids.

Table.3: Historical 5 and 2-year debt issues

Treasury Bond	Value Date	Coupon Rate (%)	Maturity Date	Term to Maturity (Days/Years)	Implied Yield to maturity (%) (31st July 2023)	Yield Curve at time of issue
5 Year						
FXD1/2023/5	17th July 2023	16.8440	10th July 2028	1,806 (4.9Yrs)	16.6250	14.3621
2 Year						
FXD1/2020/5	11th May 2020	11.6670	5th May 2025	647 (1.8Yrs)	14.4880	11.3528

Source: Nairobi Securities Exchange

Figure.1: The outcome of recent bond auctions suggests a further spike in weighted average rates

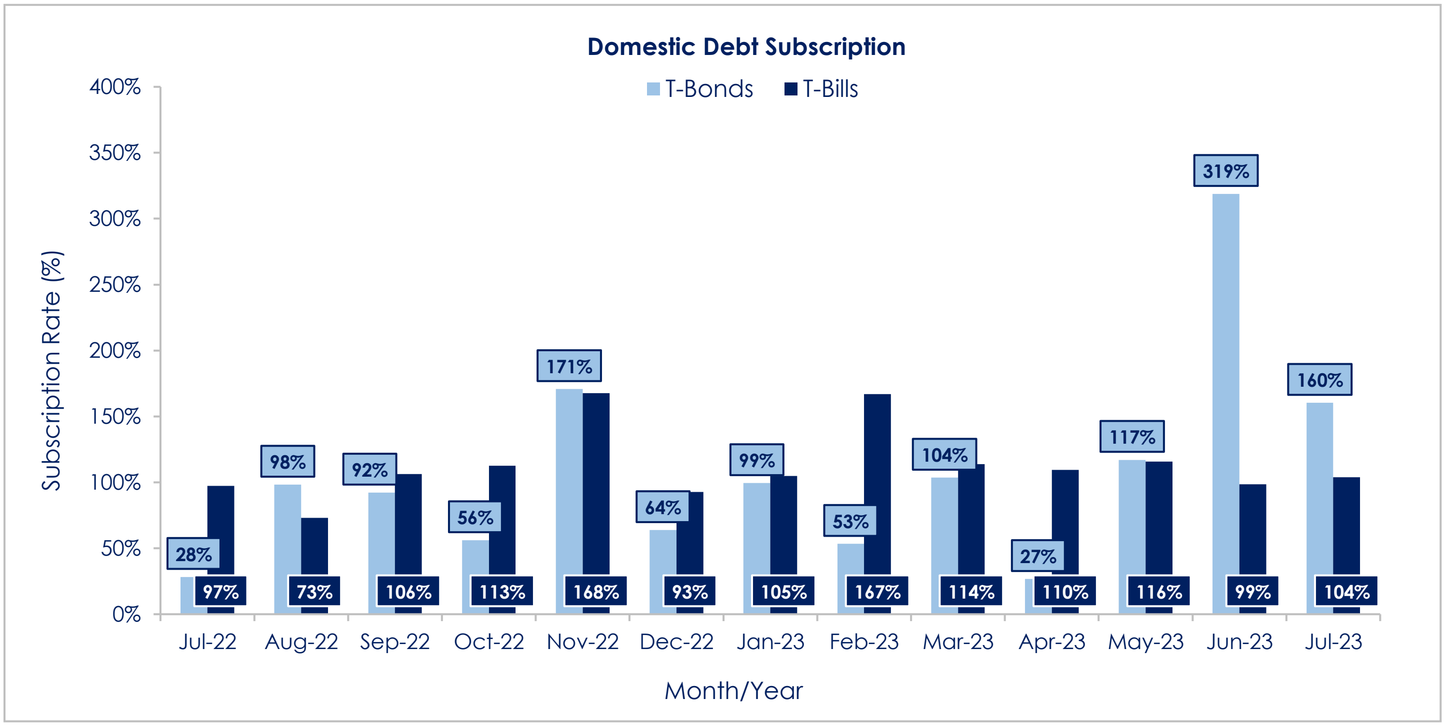


*: Re-Opened
Source: Central Bank of Kenya

T-Bill subscription rises and T-Bond's decline in July 2023

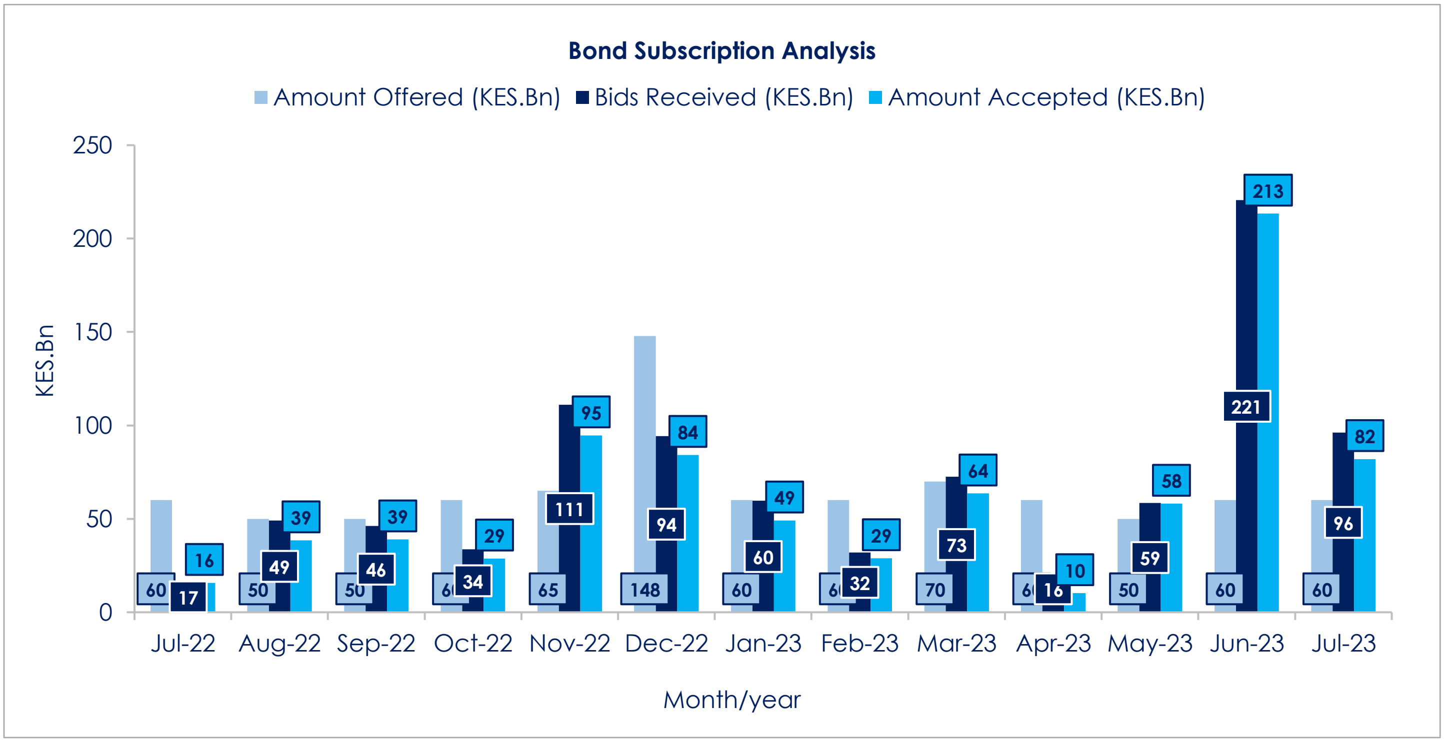
- T-Bill subscriptions rose to 103.9% from 98.6% a month earlier with KES.124.7Bn worth of bids received against KES.120Bn offered (Figure.2).
- The 91, 182 and 364-Day had subscription rates of 506.7%, 29.4% and 17.3% compared to 491.8%, 17.7% and 22.1% respectively in June 2023.
- Subscription rates for the 91-Day T-Bill remains high with investors looking to manage re-investment risks in the current rising interest rate environment.
- T-Bond demand declined to 160.3% from 318.8% in June with KES.96.2Bn received in bids against the KES.60Bn offered (Figure.3).
- This is however an increase from 117.1% subscription recorded in May 2023.
- This was primarily on account of the issuance of **IFB1/2023/7** which had a subscription rate of 367.5% a record for a T-Bond issuance.

Figure.2: T-Bond subscription third highest over the last one year



Source: Central Bank of Kenya

Figure.3: T-Bond acceptance in July 2023, second highest year to date (YTD)

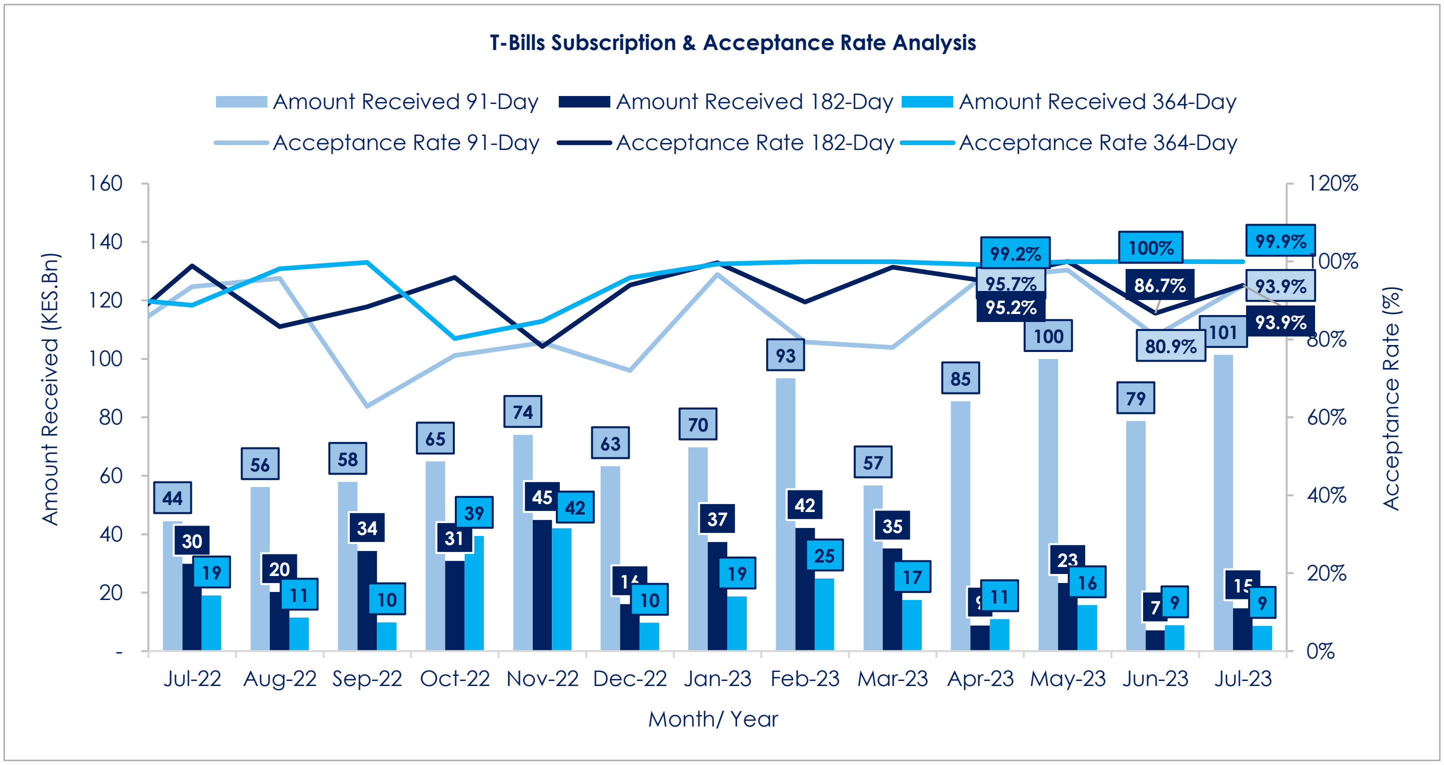


Source: Central Bank of Kenya

T-Bill acceptance increases in July 2023 in efforts to bridge funding gap

- CBK's acceptance rate for T-Bills increased to 94.3% in July 2023 compared to 83.1% a month earlier (Figure.4).
- Acceptance rates for the 91-Day, 182-Day and 364-Day T-Bills stood at 93.9%, 93.9% and 99.9% in July 2023 compared to 80.9%, 86.7% and 100% in June 2023.
- Continued investor interest in short tenor debts has reduced the average term to maturity of domestic debt to 8.7 months in June 2023 compared to 9.1 years in June 2022.

Figure.4: T-Bill acceptance rates increase in July 2023 due to decline in T-Bond subscription



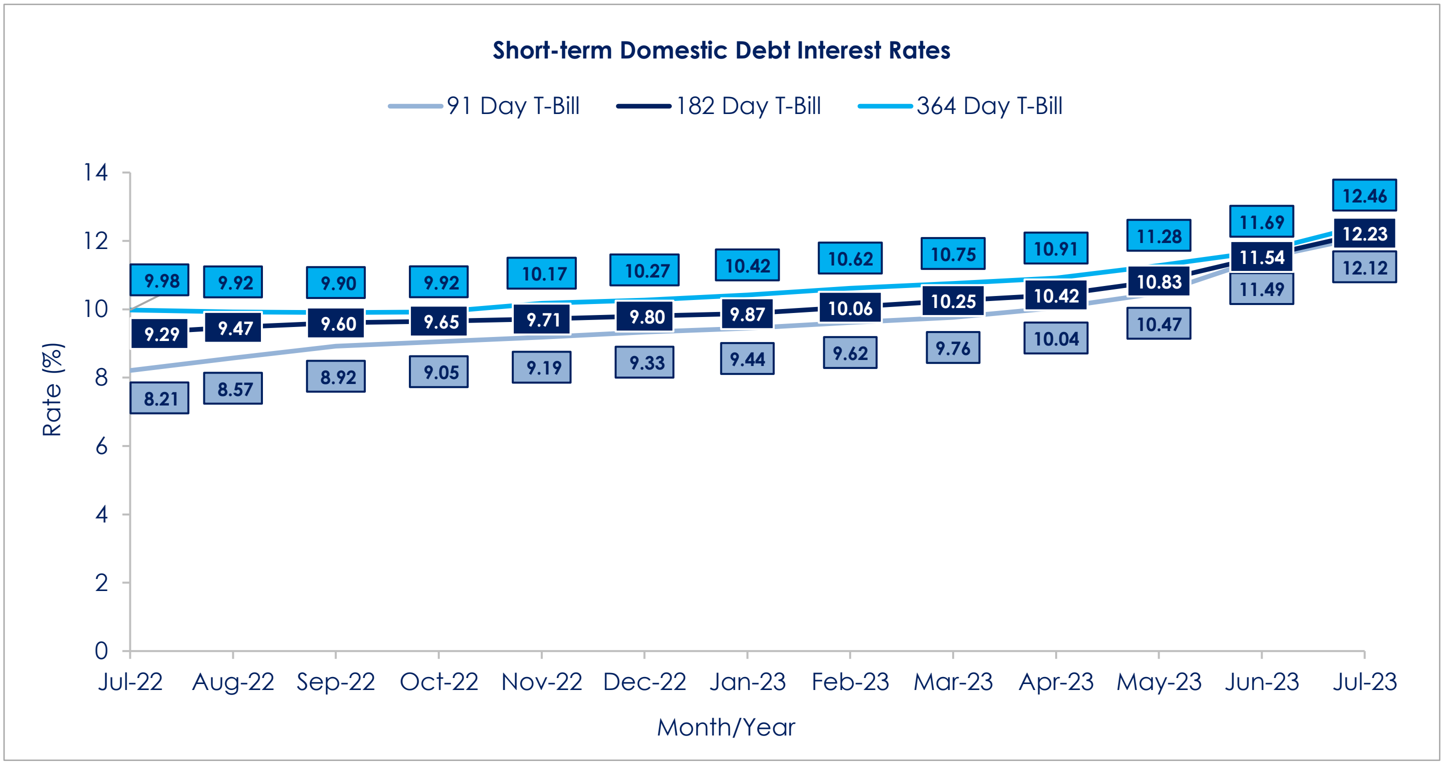
Source: Central Bank of Kenya

T-Bill rates above 12% in July 2023

- Average T-Bill rates continued on an upward trajectory in July 2023 (Figure.5).
- Average 91, 182 and 364-day rates increased to 12.1%, 12.2% and 12.5% from 11.5%, 11.5% and 11.7% in June 2023 respectively (Figure.5).
- Over the past month alone, average 91, 182 and 364-Day T-Bill rates have increased 64, 68 and 77 bps respectively showing the impact of upward CBR revisions, investor expectations, high inflation and increased deficit financing.
- While we feel that the MPC's decision to raise the CBR from 9.5% to 10.5% will drive T-Bill rates further upwards as investors place a premium on the capital invested in Government debt, the MPC feels that the National Treasury's decision to reduce net domestic borrowing for 2023/24 to KES.316Bn from KES.586.5Bn (2023/24 budget) will have an opposite effect.
- We feel that revenue targets remain ambitious and domestic borrowing will

be revised upwards in subsequent budgets and therefore it's still premature to forecast lower domestic interest rates.

Figure.5: T-Bill rates continue trending upwards in July 2023



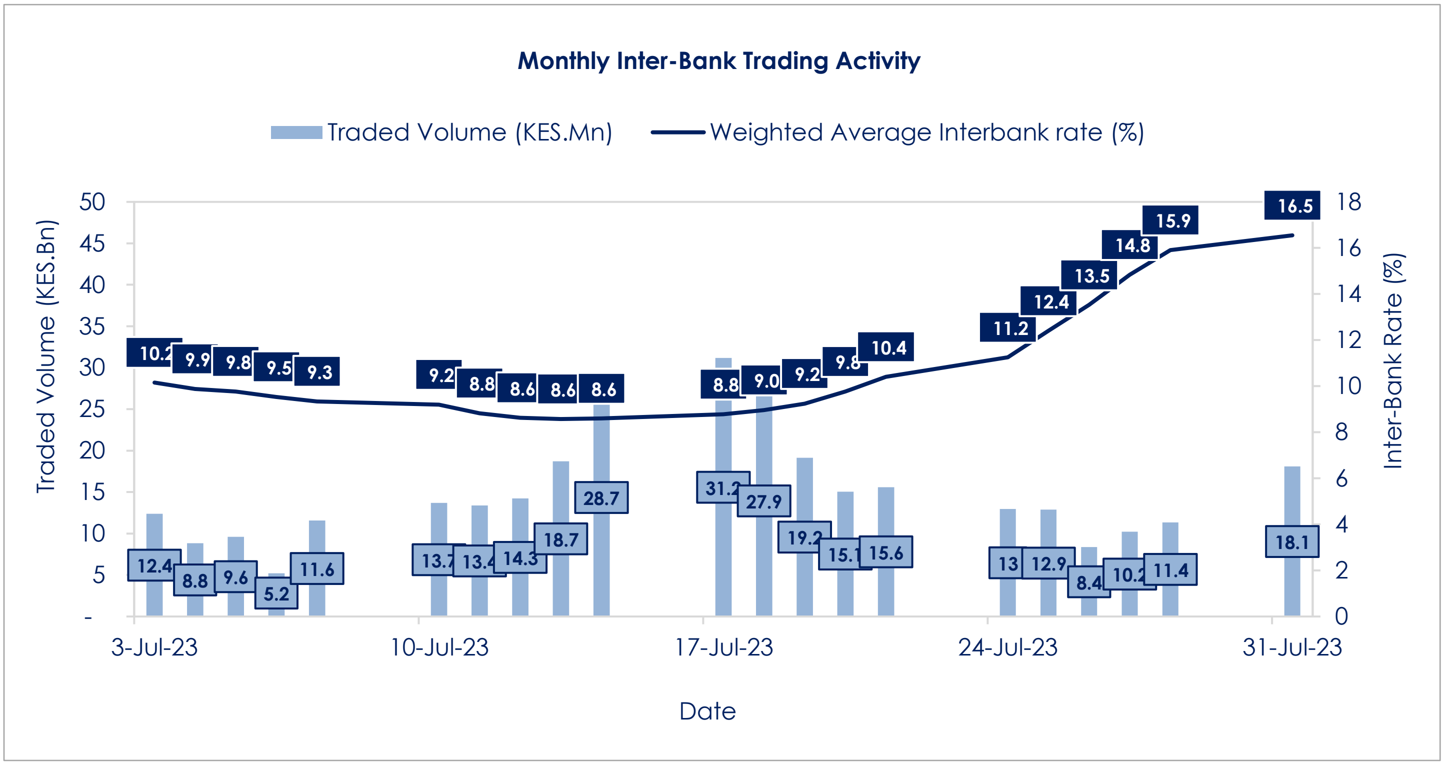
Source: Central Bank of Kenya

Average inter-bank rates rise further in July 2023

- As we had predicted, average inter-bank rates rose in July following the upward revision of the CBR and tight market liquidity (Figure.6).
- Average inter-bank rates rose to 10.7% in July 2023 from 9.6% in June.
- Notably, when the CBK consecutively raised the CBR from 8.5% in May 2015 to 10% in June 2015 and 11.5% in July 2015, interbank rates rose from 10.4% to a high of 25.8% in September 2015.
- These revisions were meant to ease inflationary pressure, currency depreciation and volatility mostly against the US Dollar with depreciation at 5.5% to USD/KES.96.39 in May 2015 from USD/KES.91.36 in January 2015.
- Further, inflation had increased from 5.5% to 6.9% over the same period.
- Trading volumes in July 2023 declined 12.4% to KES.319.1Bn from KES.364.1Bn.
- Over the same period, excess reserves (the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) declined 88% from KES.245.5Bn in June 2023 to KES.29.4Bn in July 2023 (Figure.7).
- Shortfalls recorded in the last two weeks of the month was indicative of tight market liquidity.
- The decline is reflective of the CBK's open market operations consisting of Term Auction Deposits (TADs) which mopped up KES.95.1Bn in July 2023 coupled with high liquidity channeled to the Government via the recent IFB auction.

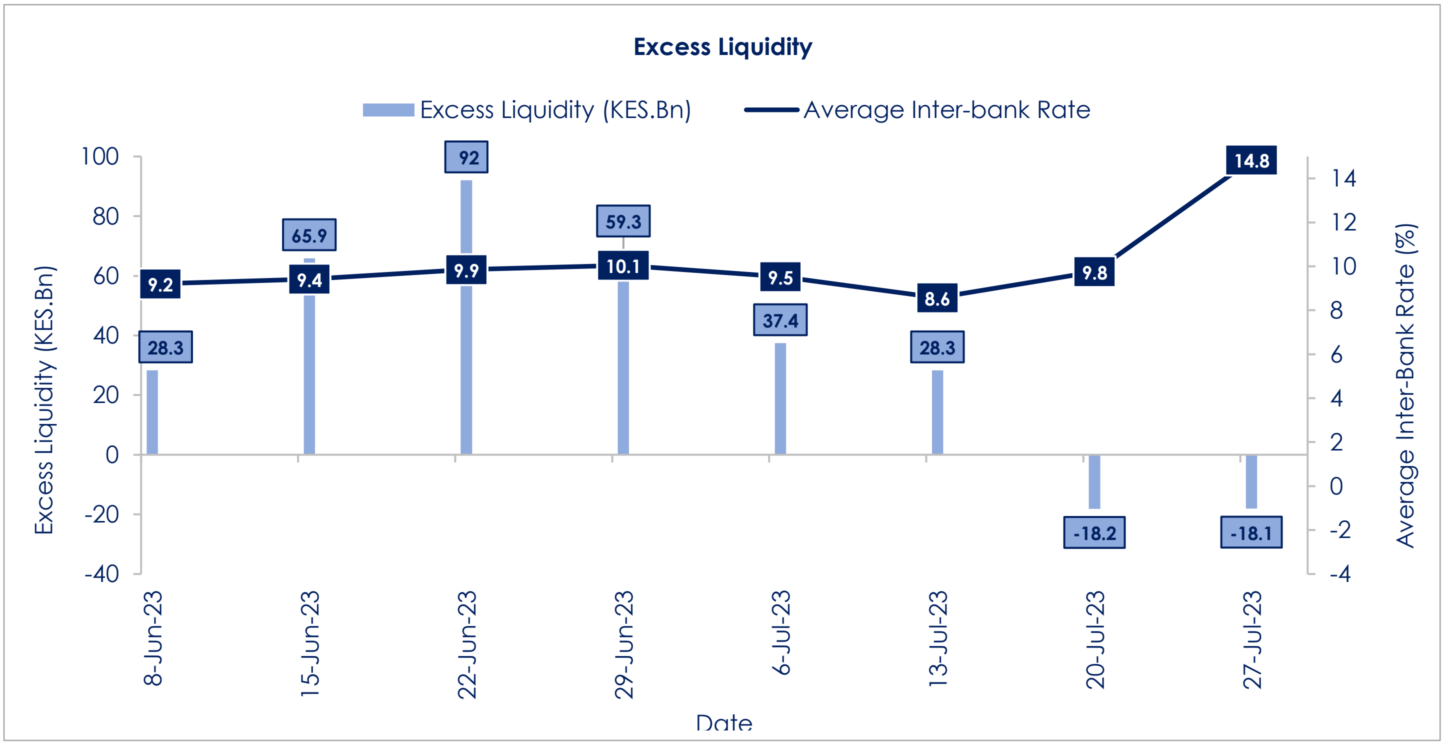
- We expect the CBK to inject liquidity within August bond's period of sale through issue of Reverse Repos to support subscription.

Figure.6: Uptick in average inter-bank lending rates in July 2023 as tight market liquidity persists



Source: Central Bank of Kenya

Figure.7: Excess commercial bank reserves decline in July 2023

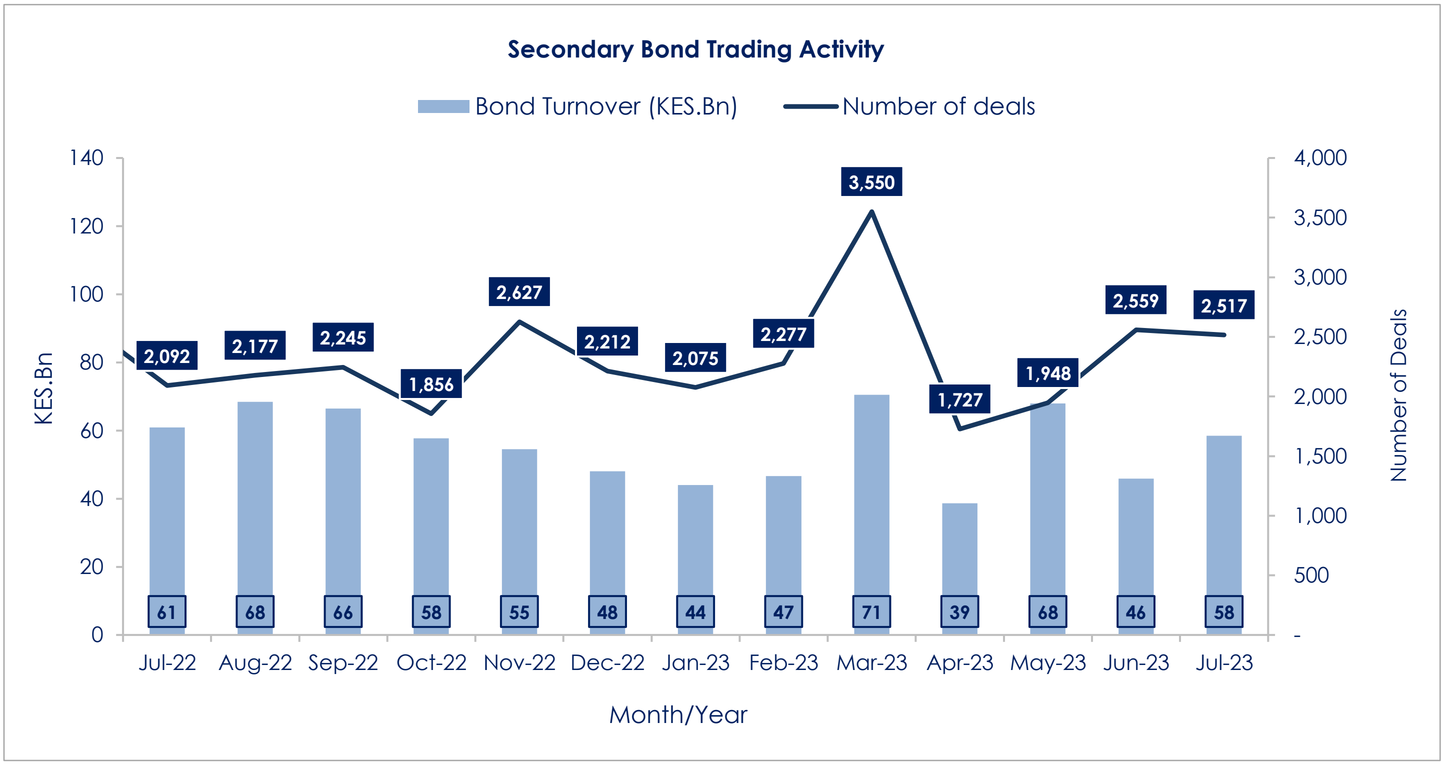


Source: Central Bank of Kenya

Secondary bond market turnover up 27.5% in July 2023

- Secondary bond market trading increased 27.5% to KES.58.5Bn from KES.45.8Bn in July 2023 while the number of deals declined 1.6% to 2,517 from 2,559 (Figure.8).
- The increase in turnover can be attributed to high trading activity on **IFB1/2023/7,** which began trading on the 20th June 2023.
- The CBK's new central securities depository, known as CBK DhowCS went live on Monday, 31st July 2023.
- With stockbrokers racing to register their clients, only one trade of KES.37.1Mn involving **IFB1/2023/7** was concluded compared to 120 trades the previous day further explaining the overall decline in number of deals.
- The Government's objective of the system is to improve efficiency, boost savings, increase access by retail investors and reduce cost of domestic debt.
- Given the above reasons and current interest rate environment, we expect August secondary trading activity to be in on-the-run papers including **IFB1/2023/7**, the new **FXD1/2023/2** and re-opened **FXD1/2023/5**.

Figure.8: Secondary bond market turnover increased in July 2023

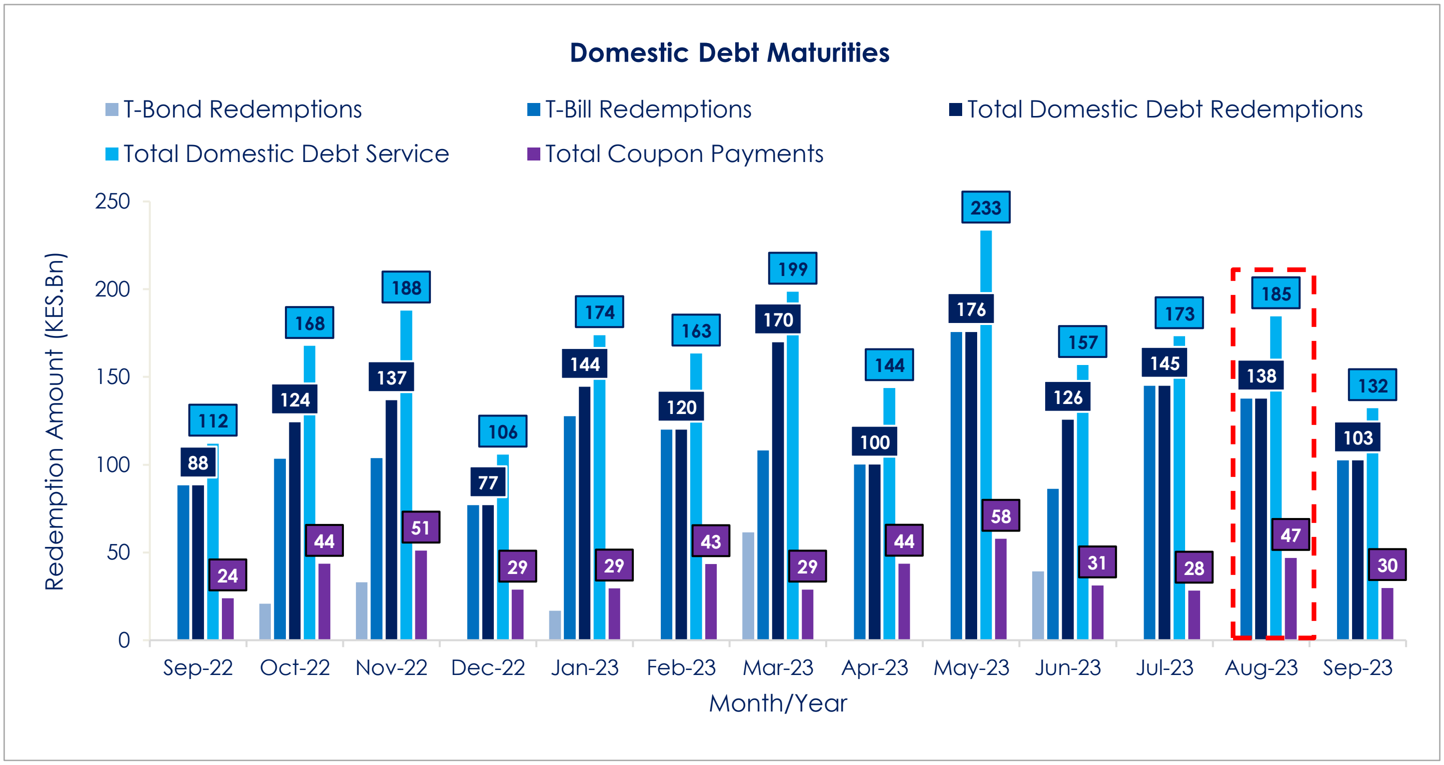


Source: Central Bank of Kenya

Domestic debt service set to increase in August 2023

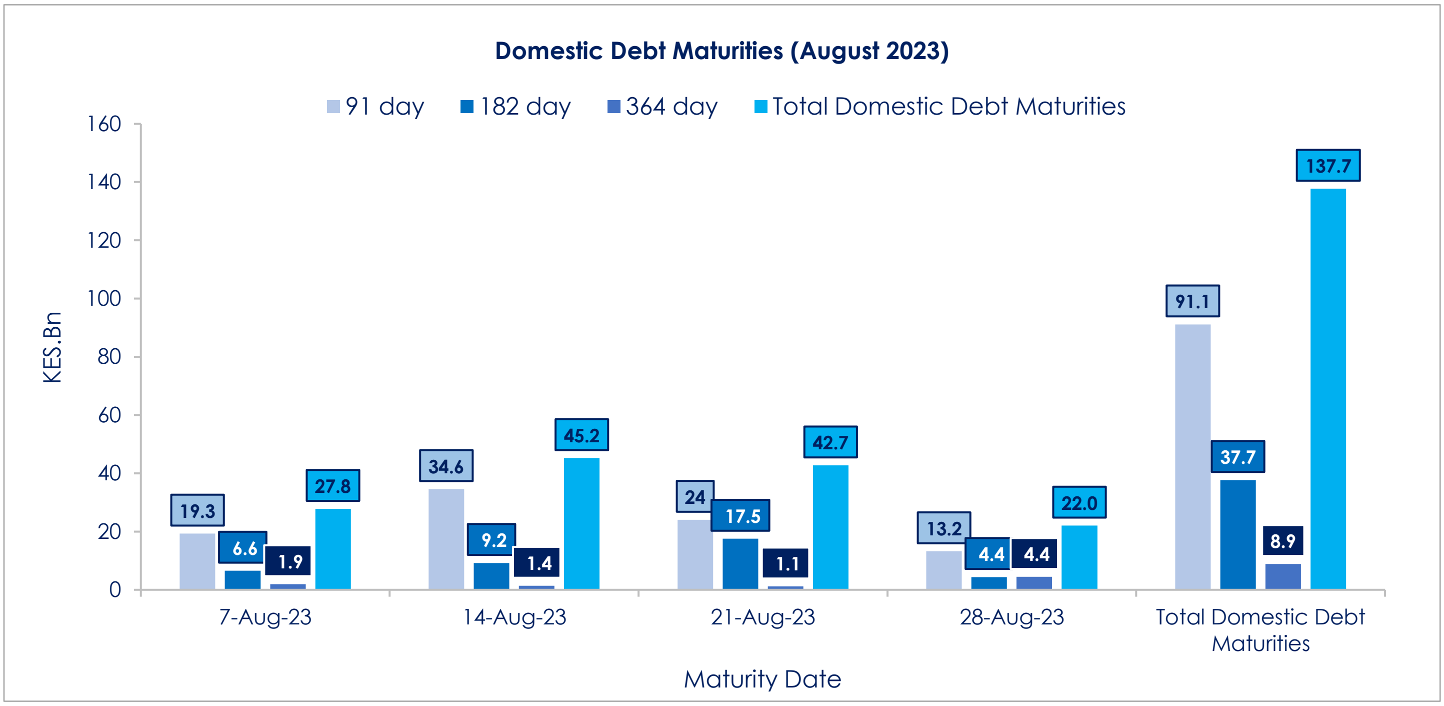
- Total domestic debt service is set to increase 6.6% in August 2023 to KES.184.6Bn from KES.173.3Bn in July 2023. (Figure.9).
- This includes KES.137.7Bn and KES.46.9Bn in T-Bill redemptions and coupon payments respectively.
- Just like in July, there will be no T-Bond redemptions during the month.
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.91.1Bn, KES.37.7Bn and KES.8.9Bn respectively with the second week of the month having the highest redemptions at KES.45.2Bn (Figure.10).

Figure.9: Slight increase in debt service driven by higher coupon payments in August 2023



Source: Central Bank of Kenya

Figure.10: Second week of August 2023 with highest T-Bill redemption at KES.45.2Bn



Source: Central Bank of Kenya

National Treasury fails to meet 2022/23 revenue and expenditure targets

- Data from the National Treasury as at the end of June 2023 which is also the end of the 2022/23 fiscal year shows shortfalls in both revenue and expenditures against revised estimates (Figure.11a & Figure.11b).
- Tax income stood at KES.1.96Tn equivalent to 94.3% of the KES.2.08Tn revised target and can be attributed to a slowdown in economic activity.
- Also notable was domestic borrowing at KES.696.4Bn or 73.5% of the KES.948.1Bn target, this in our view is attributable to subdued demand for domestic debt and particularly treasury bonds.

Figure.11: 2022/23 Government receipts and expenditure fall below revised targets

Figure.11a

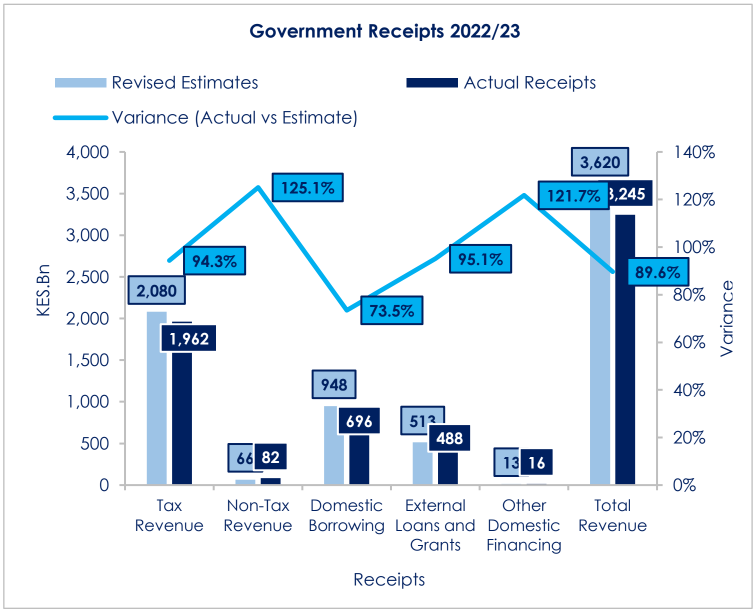
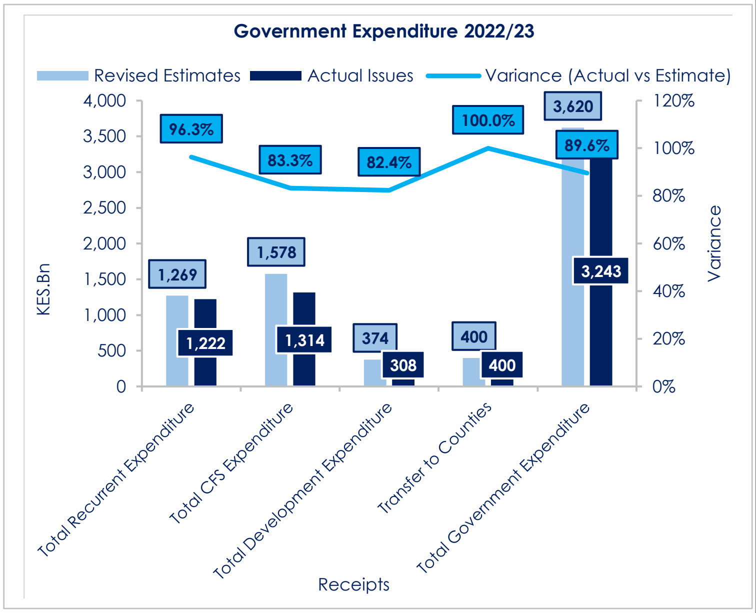


Figure.11b



Source: National Treasury

Domestic borrowing falls way short of 2022/23 revised target

- As we had predicted, the National Treasury closed the 2022/23 fiscal year behind its revenue target having collected KES.3.24Tn against a revised target of KES.3.62Tn (Table.4 & Figure.12).
- This was largely a result of the underperformance of domestic borrowing with both tax revenue and external borrowing near the revised targets.
- Our attention is drawn to the most recent MPC statement released on 9th August indicating a downward revision of net domestic borrowing.
- ***"The Committee noted that as a result of the identified new external financing, the projected net domestic borrowing by the Government had been reduced from Ksh.586.5Bn to Ksh.316Bn... The revised borrowing requirements should exert downward pressure on domestic interest rates…"***
- This reduction is equivalent to a 46% cut in net domestic borrowing.
- This takes us back to the projected tax revenues for the current 2023/24 fiscal year (KES.2.57Tn) which is 31% above the actual 2022/23 tax revenue (KES.1.96Bn).
- In our opinion, this growth is overly ambitious meaning that the actual fiscal deficit would be significantly higher than the KES.718Bn and probably closer to KES.1Tn.
- With this in mind the National Treasury will have to adjust both domestic and external borrowing upwards and this will have a similar impact on interest rates.

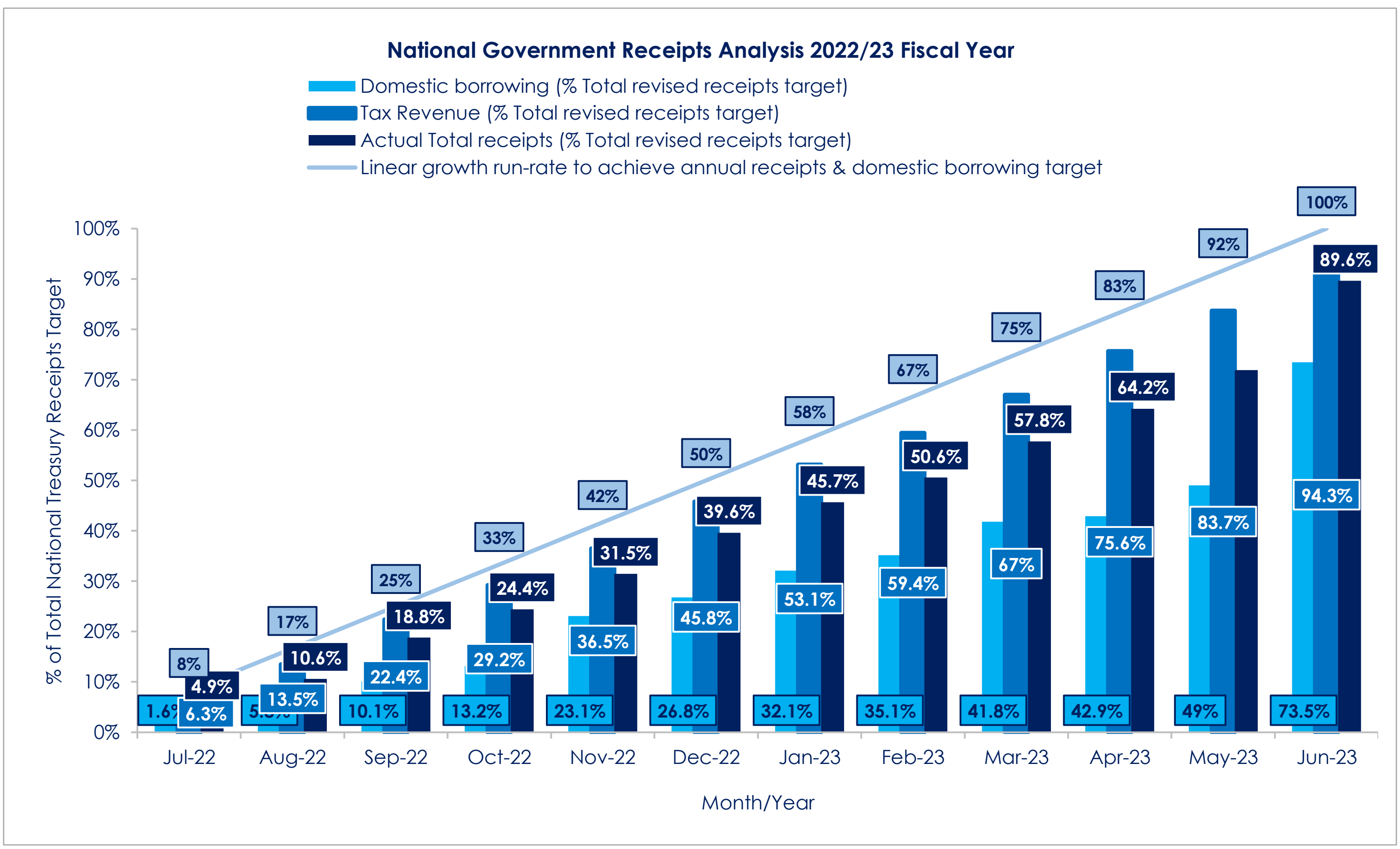
Table.4: National Treasury fails to meet revised 2022/23 revenue target

Receipts	Original Estimates 2022/23 (KES.Mn)	Revised Estimates 2022/23 (KES.Mn)	Variation Revised vs Original 2022/23 Estimates	Actual Receipts (KES.Mn) 31st May 2023	Proportion of Total Receipts 31st May 2023
Opening Balance (1st July)				616.5	
Tax Revenue	**2,071.9**	**2,079.8**	**0.4%**	**1,962**	**94.3%**
Non-Tax Income	69.7	65.6	**-5.9%**	82	**125.0%**
Domestic Borrowing*	**1,040.5**	**948.1**	**-8.9%**	**696.4**	**73.5%**
External Loans & Grants	349.3	513.4	**47%**	488.3	**95.1%**
Other Domestic Financing	13.2	13.2	**-**	16.1	**122.0%**
Total Revenue	**3,544.6**	**3,620.2**	**2.1%**	**3,244.8**	**89.6%**
Linear Run Rate target 2022/23					**100%**

* Note 1: Domestic Borrowing of KES.948.1Bn = Net Domestic borrowing KES.480.4Bn & Internal Debt Redemptions (Roll-overs) KES.467.7Bn

Source: The Kenya Gazette Vol. CXXV - No.168 21st July 2023

Figure.12: Actual receipts, tax revenue and domestic borrowing close 2022/23 fiscal year below revised target

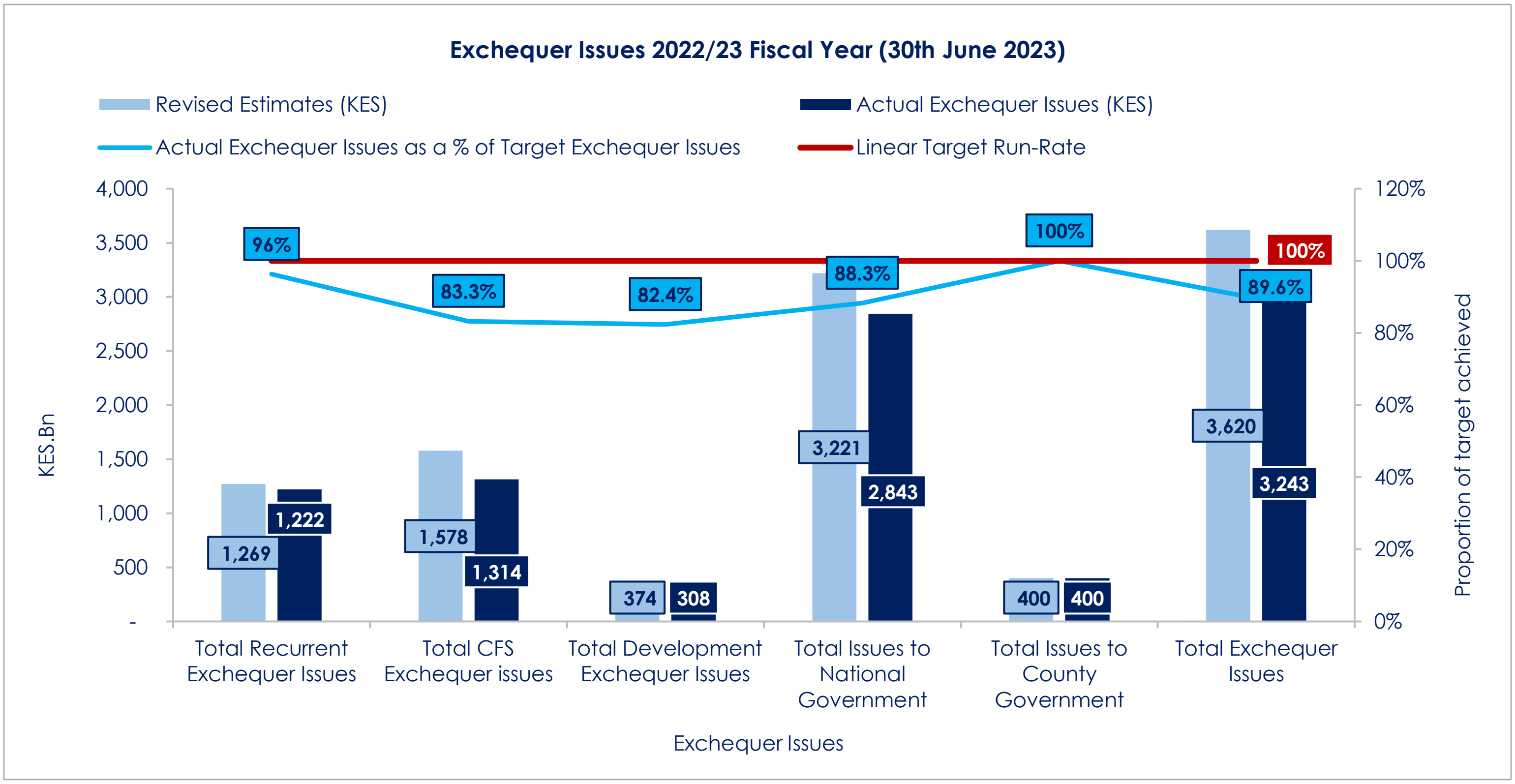


Source: The Kenya Gazette Vol. CXXV - No.168 21st July 2023

2022/23 exchequer issues fell below revised targets

- Only transfers to the county closed the 2022/23 fiscal year on target with the rest of the exchequer issues below the revised targets (Figure.13).
- This as explained in the report can be attributed to challenges in revenue generation through taxation and funding particularly from domestic borrowing.

Figure.13: Total 2022/23 exchequer issues below target

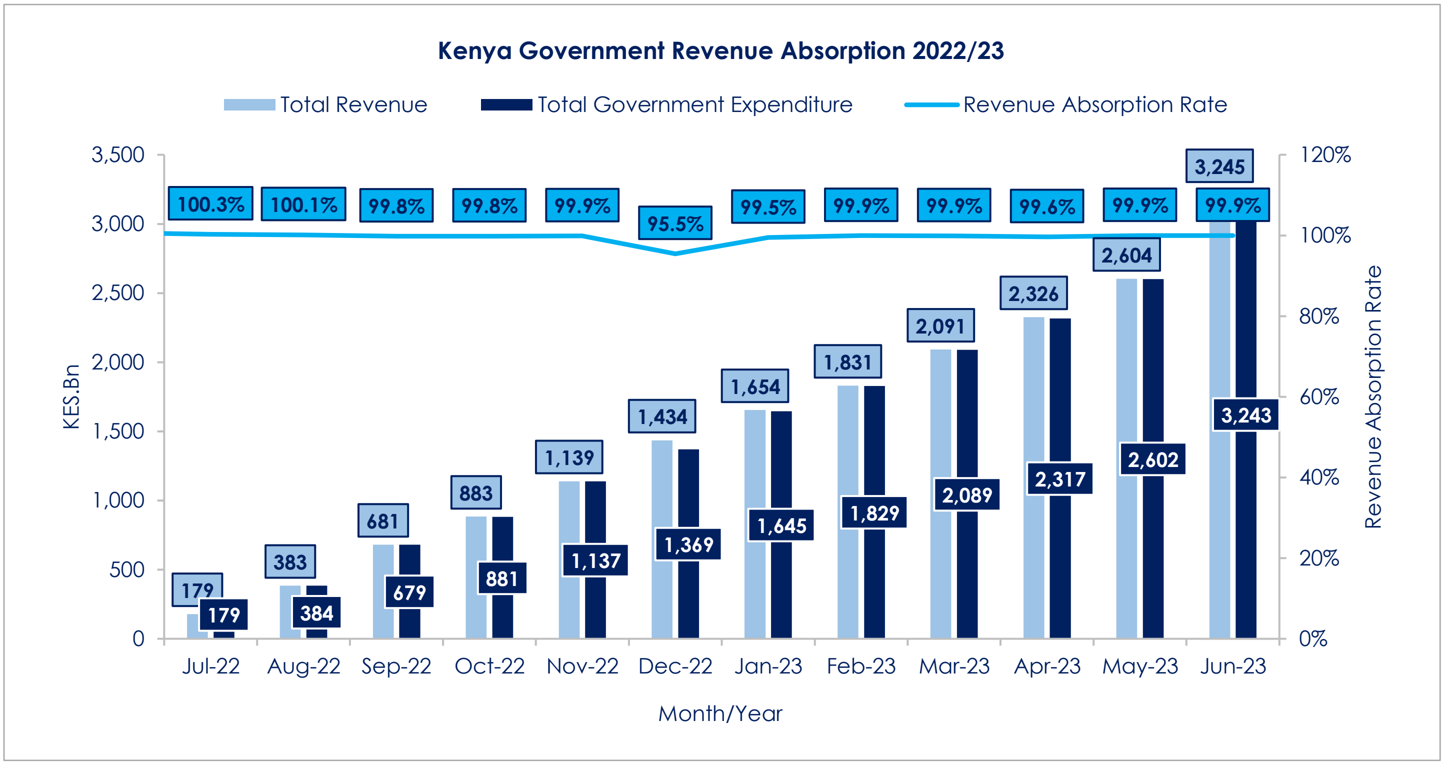


Source: The Kenya Gazette Vol. CXXV - No.168 21st July 2023

Full Government Revenue Absorption for 2022/23 fiscal year

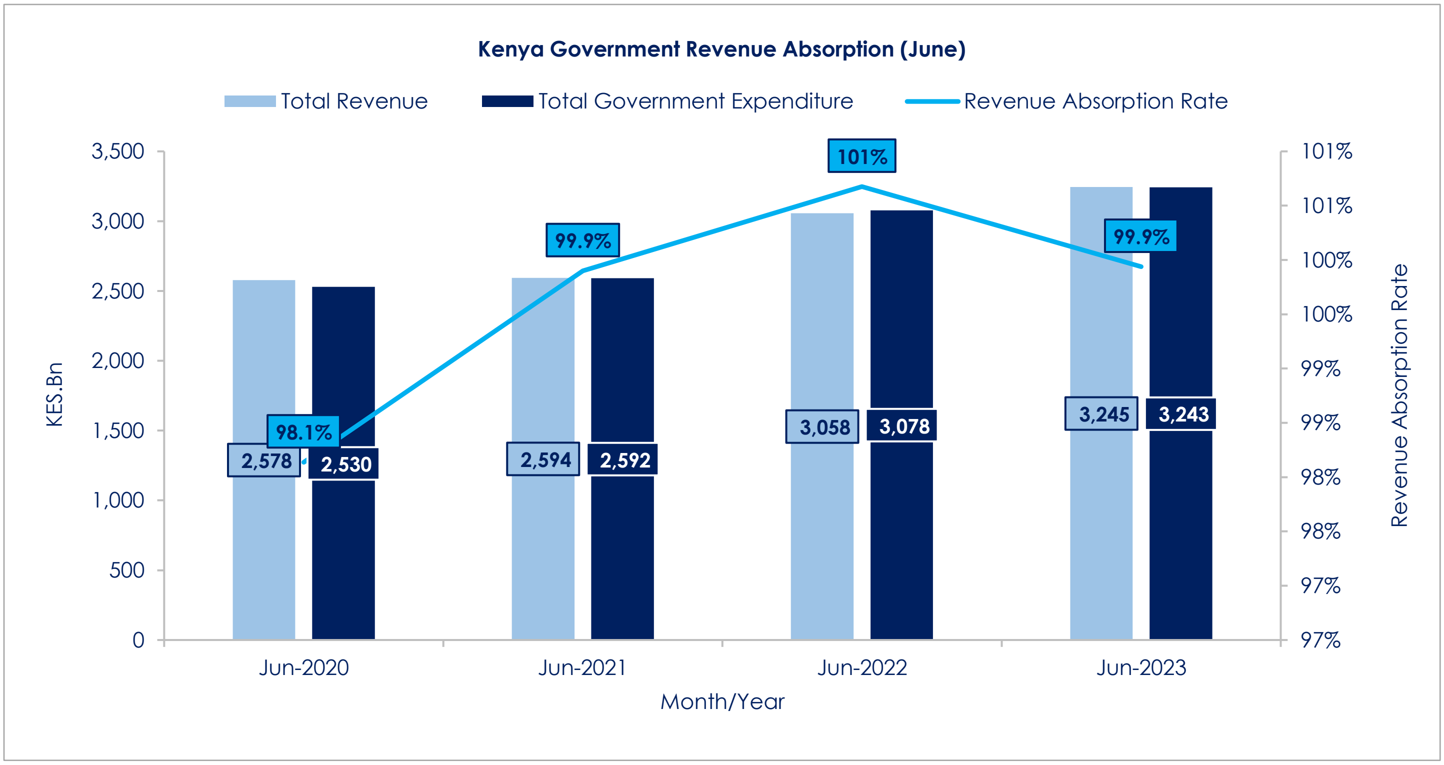
- Government Revenue Absorption Rate (RAR) which is the proportion of Government receipts used to finance its expenditure remained unchanged in June 2023 at 99.9% (Figure.14).
- Overall, the RAR for the 2022/23 fiscal year was 99.9% with KES.3.242Tn in expenditure against KES.3.245Tn leaving a difference of KES.2Bn.
- This means that almost the entire Government revenue was allocated to its expenditure thus also explaining trends in debt auctions.
- Further historical analysis shows that high RAR was reported in the last month of the fiscal year (Figure.15).
- This analysis shows a 6.1% and 5.3% growth in year on year revenue and expenditure in 2023 significantly lower than 17.95% and 18.8% in 2021/22.

Figure.14: Government's revenue remained high throughout the fiscal year due to revenue shortfalls



Source: The Kenya Gazette Vol. CXXV - No.168 21st July 2023

Figure.15: 2022/23 fiscal year closes with high revenue absorption

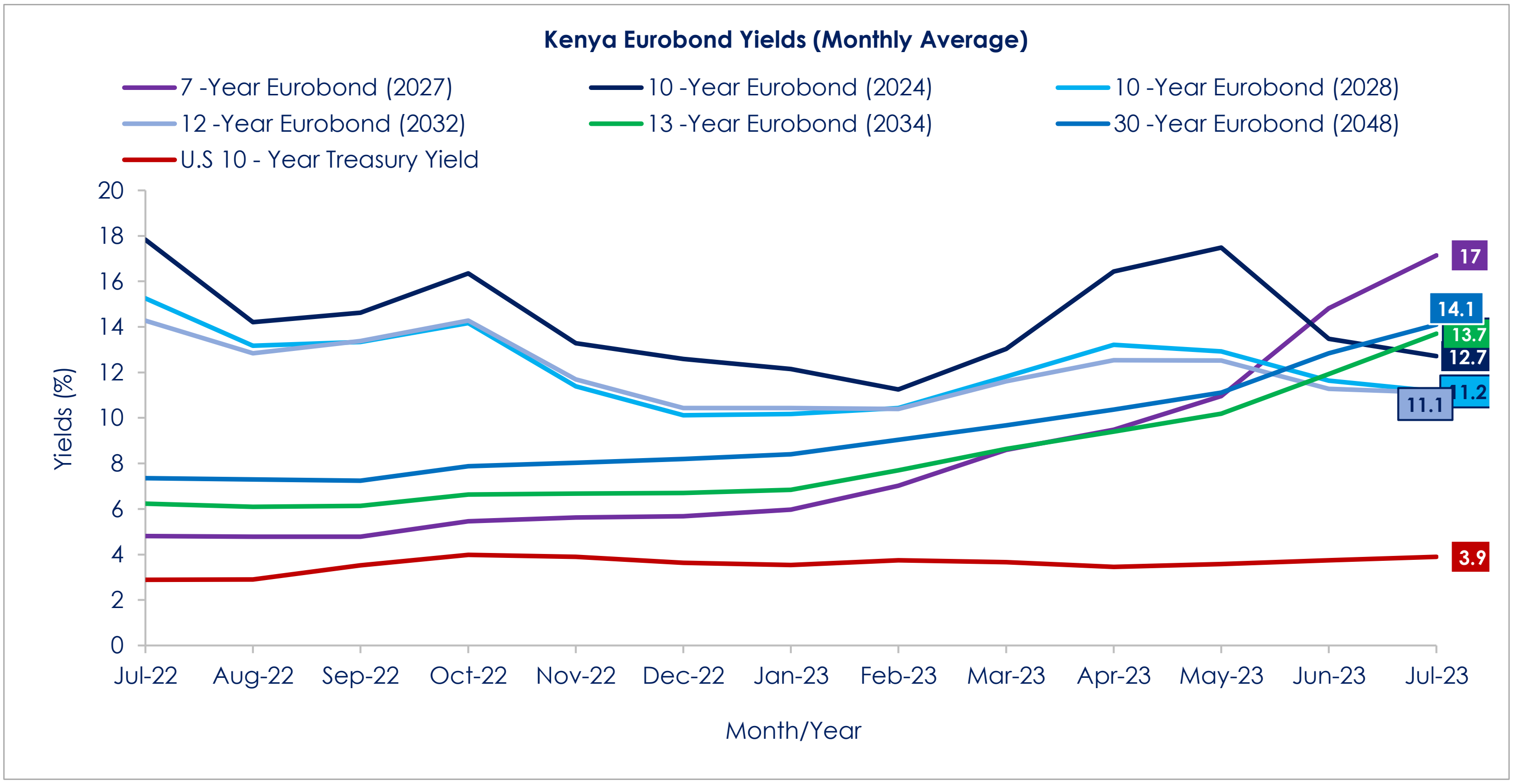


Source: The Kenya Gazette Vol. CXXV - No.168 21st July 2023

Kenya Eurobond yields decline in June 2023 following IMF reassurance

- Average yields on Kenya Eurobonds declined by a smaller margin (34 bps) than the previous month (180 bps) with the yields on 10-Year (2024) and 7-Year (2027) declining 79 and 55 bps respectively below the June averages (Figure.16).
- The yields on 10 -Year Eurobond (2024) **XS1028952403** declined by the biggest margin.
- During the same period, the US 10-year treasury yield rose 27 bps this being a result of the upward revision of the Fed rate by 25 bps during the month to 5.5% the highest level in twenty-two years.
- Economic data including GDP remains positive with a better than expected increase in jobs created and lower than expected inflation.
- This however suggests further upward rate hikes in coming months with this expected to push the 10 year yield further upwards.

Figure.16: Kenya Eurobond yields decline in June 2023



Source: Central Bank of Kenya

Yield curve continues to shift upwards

- A comparison of average debt security NSE yields as at 4th August 2023 against those as at 14th July 2023 (Close to issuance of **FXD1/2023/5**) and 5th August 2022 shows a sharp increase across the curve. (Table.5 and Figure.17).
- As has been mentioned in previous reports, the upward shift in the yield curve has resulted from the following:

  1) Upward adjustments of the CBR, with five revisions between May 2022 and June 2023 - 350Bps to 10.5%.

  2) Increased budgetary financing pressure resulting from revenue shortfalls with the CBK borrowing aggressively in the domestic debt market.

  3) CBK has accommodated more aggressive investor bids in primary debt auctions to encourage subscription following a decline in investor demand for debt instruments.

  4) High inflation with investors bidding higher to maintain positive real return on capital invested.

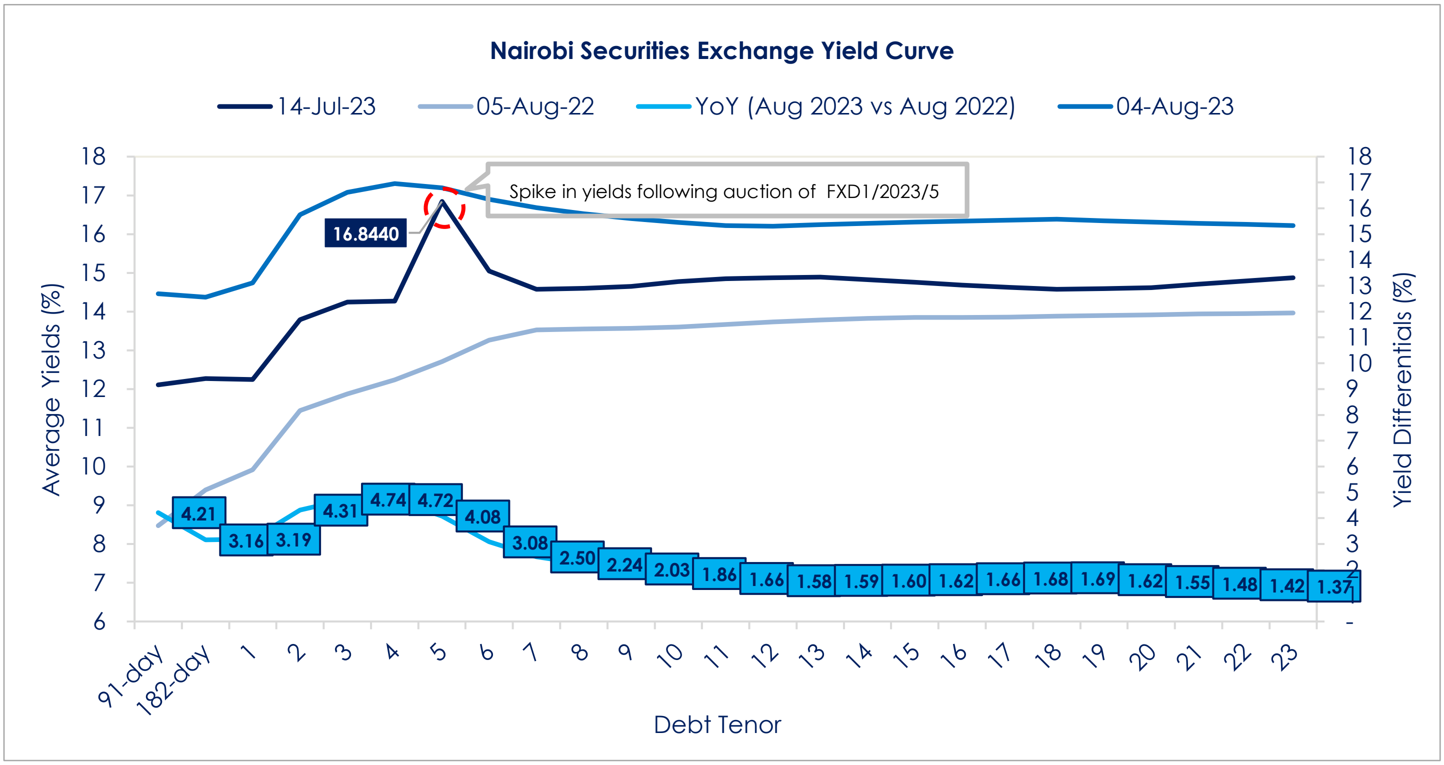
Table.5: Yield curve has significantly shifted upward across all tenors

Tenor	Yields (5th Aug 2022)	Yields (14th Jul 2023)	Yields (4th Aug 2023)	∆ (4th Aug 2023 vs 14th Jul 2023) Bps	YoY ∆ (4th Aug 2023 vs 5th Aug 2022) Bps
1	9.9200	12.2500	13.1072	↑ 86	↑ 319
2	11.4417	13.7887	15.7527	↑ 196	↑ 431
5	12.7125	16.8440	16.7962	↓ 5	↑ 408
10	13.6009	14.7745	14.4570	↑ 68	↑ 186
15	13.8497	14.7556	14.4684	↑ 71	↑ 162
20	13.9183	14.6165	14.4656	↑ 85	↑ 155

Source: Nairobi Securities Exchange

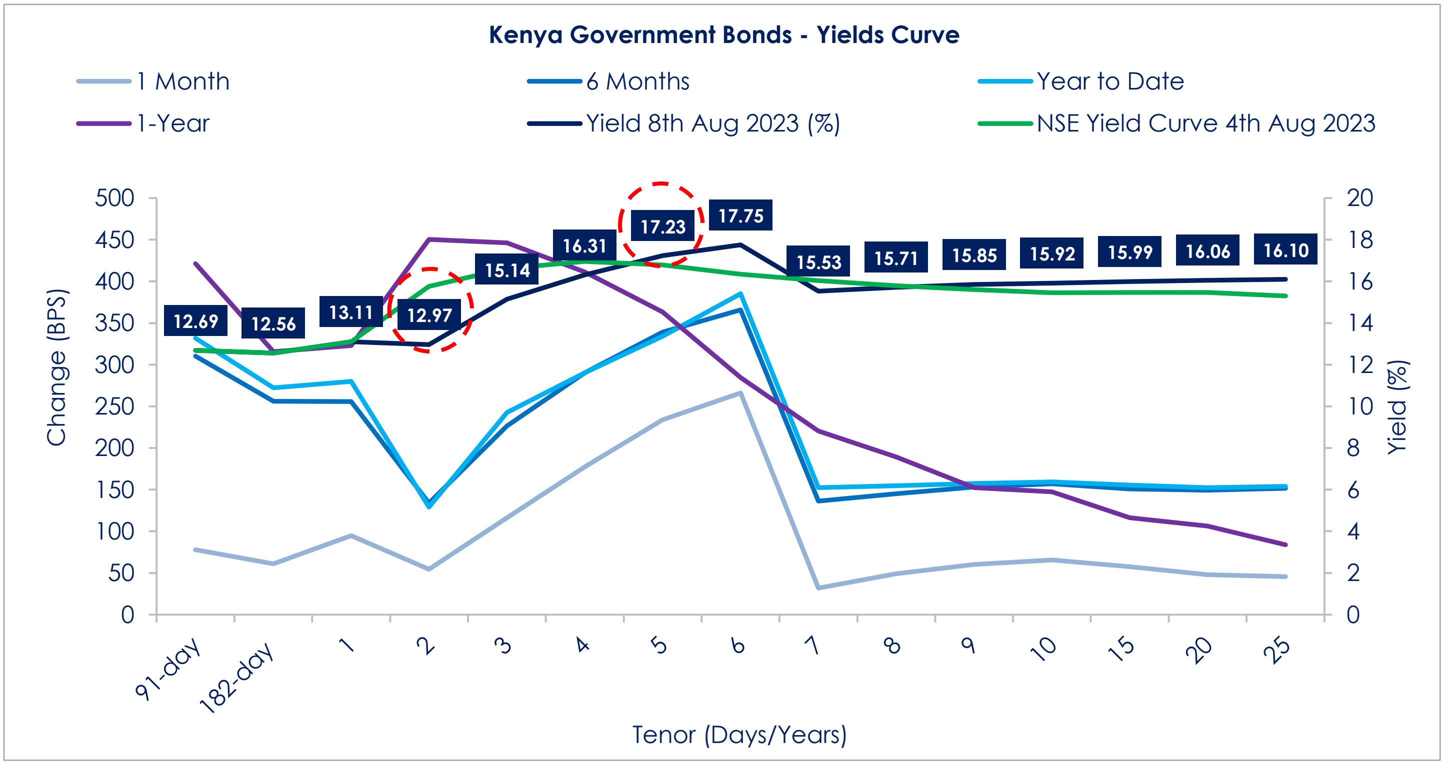
- We also reviewed an alternative Kenya Government bonds yield curve (source: World Government bonds) to determine possible investor bidding levels for the bonds in issue and notice disparities in yields in medium and long end of the curve (Figure.18).
- This curve puts the 2-year yield at 12.97% which is 278bps below the most recent NSE yield curve level and 17.23% for the 5-year bond which is 44 bps above the same yield curve.
- Investors bidding for the newly debt issues could therefore use both these yield curves as a basis for bidding in the upcoming auctions with a fairly aggressive bidding strategy recommended.

Figure.17: Higher year on year differentials across all tenors



Source: Nairobi Securities Exchange

Figure.18: Kenya Government Bonds yield curve shows disparities with NSE yield curve



Source: World Government bonds

Trading ideas - Invest in Kenya Eurobonds & high yielding short-term debt

- Investors with a high-risk tolerance should consider buying Kenya Eurobonds and in particular, **XS1028952403** maturing in June 2024 to take advantage of current high yields with an option of holding till maturity or disposing in the event short term trading opportunities arise (Table.6).
- **XS1028952403** had a yield of 12.60% as at 27th July 2023 with less than twelve months to maturity reducing the risk associated with longer dated bonds.
- The bond has seen a steep decline in yields in recent weeks from yields as high as 20.3% on 24th April 2023 as reassurance from the IMF and increased effort to refinance the bond calmed investors.
- Investors looking for higher yields could also consider disposing their current bond holdings in favour of new short term bonds.
- We however advise caution on this strategy considering that investors would be actualizing losses due to current low prices.
- The attractive coupons of new issues alongside coupons already received from current holdings could mean that investors adopting this trading strategy remain above or within break even range.

Table.6: Trading ideas - Consider Kenya Eurobonds

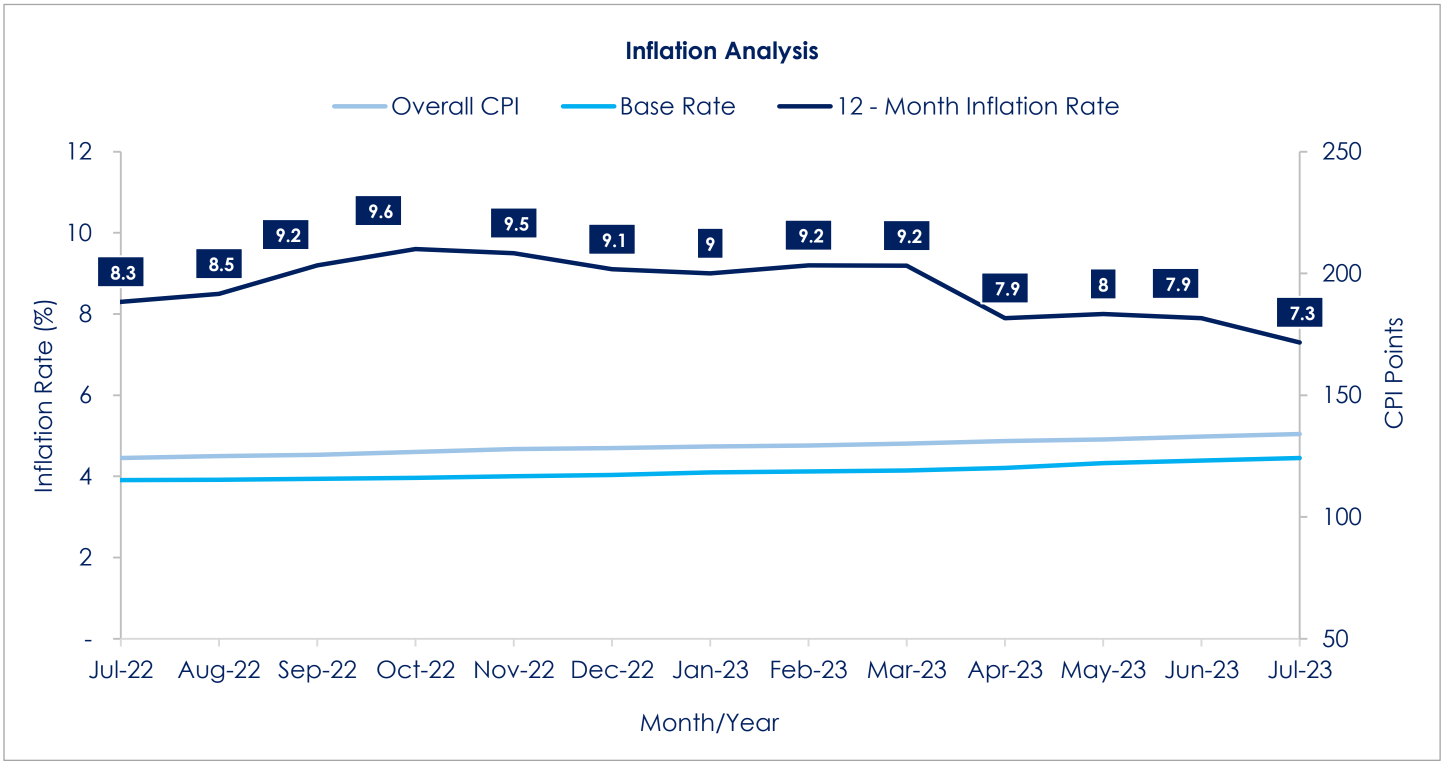
ISIN Code	Issue date	Tenor (Years)	Maturity	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (27th July 2023)
XS1028952403	Jun -14	10	Jun-24	2	6.875%	12.60%
XS1843435840	May -19	7	May-27	0.9	7%	11.40%
XS1781710543	Feb -18	10	Feb-28	1	7.25%	10.93%

Source: Bloomberg & Central Bank of Kenya

July 2023 inflation eases to 7.3% on low food prices

- July 2023 inflation declined materially to 7.3% from 7.9% in June on account of lower food prices (Figure.19).
- This was outside our forecasted range of 7.6% - 8.1% for the month.
- Despite the overall month-on-month decline, transport; food and non-alcoholic beverages; housing, water, electricity, gas and other fuels increased 13%, 8.6% and 7.8% respectively accounting for over 57% of overall inflation.
- Given the court of appeal lifted orders barring the implementation of the Finance Bill 2023, we expect inflation to trend upwards and this informs our August 2023 inflation forecast of 7.5% - 8%.
- While global fuel prices have declined, we do not expect this to translate to lower pump prices locally further due to currency depreciation and the increase of Value added Tax from 8% to 16%.

Figure.19: August 2023 inflation forecast at 7.5% - 8%



Source: Kenya National Bureau of Statistics

MPC's keeps CBR flat in August meeting

- The Monetary Policy Committee (MPC) retained the CBR at 10.5% in the August meeting.
- The committee highlighted the following reasons as to why they opted to keep the rate unchanged:

  a) Overall inflation came in within the CBK's target band of 5% (+/-) 250bps in July (7.3%) with food inflation expected to come down further due to the upcoming harvest season and global food prices easing.

  b) Non-food non-fuel inflation has eased from 4.1% in June to 3.8% in July.

  c) The impact of tightening monetary policy in June 2023 is still being transmitted into the economy.

- Similar to previous reports, the MPC discussed the global growth outlook, import and export figures, forex reserves, private sector credit and the banking sector NPLs.
- The MPC welcomed efforts by the National Treasury to source new external financing for the Budget which has worked to reduce net domestic borrowing from KES.586.5Bn to KES.316Bn – A reality that, in the CBK's opinion, should reduce pressure on interest rates over time assuming revenue targets are met.

- Finally, in line with the CBK's White paper on the Modernisation of the monetary policy framework and operations, the CBK highlighted its adoption of an inflation targeting regime whereby an interest rate corridor will be set around the Central Bank Rate (CBR).
- The policy will be aimed at ensuring that the inter-bank rate operates at (+/-) 250bps of the CBR.
- According to the white paper, "**the new framework will ensure effective transmission of monetary policy changes by coordinating medium to long term rates with a view of changing the behavior of economic agents in response to the desired monetary policy stance**."
- In simple terms, the new regime aims to ensure that the interbank rate runs efficiently to better transmit monetary policy signals thereby having a greater bearing on inflation.
- We view these developments as positive and will continue to monitor its impact over the coming weeks and months.

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