Cytonn Q1’2018 Markets Review

Kenya Macroeconomic Review

During the quarter, we tracked Kenya GDP growth projections for 2018 released by 13 organizations, that comprised of research houses, global agencies, and government organizations. The average, including our projection of 5.4%, came to 5.5%. The common view was that GDP growth would improve in 2018, from a Treasury estimate of 4.8% in 2017, generally due to (i) recovery in the agriculture sector on the back of improved weather conditions, and (ii) recovery in the business environment following easing of political risk caused by the prolonged political impasse over the 2017 presidential elections.

The rise of the Stanbic Bank Monthly Purchasing Manager’s Index (PMI) to 54.7 in February, up from 52.9 in January and 53.0 in December 2017, indicates that the business operating environment in the country improved during the quarter. Below is a table showing average projected GDP growth for Kenya in 2018; noteworthy being that the highest projection is by the CBK at 6.2%, followed by the National Treasury at 5.8%. We shall be updating this table should projections change and shall highlight who had the most accurate projection at the end of the year.

Kenya 2018 GDP Growth Outlook

No.	Organization	Q1'2018
1.	Central Bank of Kenya	6.2%
2.	Kenya National Treasury	5.8%
3.	Oxford Economics	5.7%
4.	African Development Bank (AfDB)	5.6%
5.	Stanbic Bank	5.6%
6.	Citibank	5.6%
7.	International Monetary Fund (IMF)	5.5%
8.	World Bank	5.5%
9.	Fitch Ratings	5.5%
10.	Barclays Africa Group Limited	5.5%
11.	**Cytonn Investments Management Plc**	**5.4%**
12.	Focus Economics	5.3%
13.	BMI Research	5.3%
14.	Standard Chartered	4.6%
	Average	**5.5%**

The 2018 Budget Policy Statement (BPS) was passed in February, with key changes to the budget from the 2017 Budget Review and Outlook Paper (BROP) for the fiscal year 2017/18 as follows:

?. The government's domestic borrowing target was reduced by 27.5% to Kshs 297.6 bn from Kshs 410.2 bn as per the 2017 BROP, which effectively took the government ahead of their target, currently having borrowed Kshs 267.4 bn against a pro-rated target of Kshs 223.2 bn, and
i. The downward adjustment of the domestic borrowing target was most likely made to accommodate plans of a Kshs 202.0 bn Eurobond issue by the government as the foreign borrowing target increased by 16.6% to Kshs 323.2 bn from Kshs 277.3 bn as per the 2017 BROP. The government has currently borrowed 72.9% of its foreign borrowing target, following the signing of the Kshs 9.5 bn loan from the Japan International Cooperation Agency (JICA) for the rehabilitation of the Olkaria 1, 2 and 3 Geothermal Power Projects last week. On a pro-rated basis however, they are behind target, having borrowed 97.2% of their pro-rated foreign borrowing target.

The National Treasury released the Quarterly Economic and Budgetary Review for the first half of the fiscal year 2017/18, during the quarter. Key highlights from the report included:

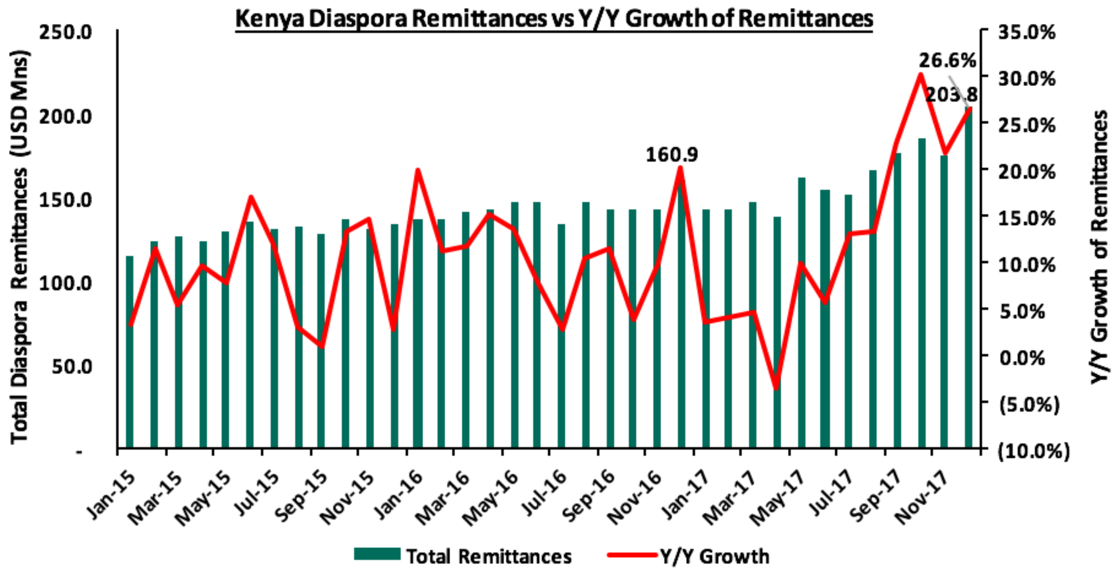
?. The KRA met 91.2% of their half year target, having collected Kshs 709.4 bn against a target of Kshs 777.7 bn. Overall revenue and grants were at 89.3% of the target. This figure differs slightly with KRA's H1'2017/18 Performance Review and Prospects, also released during the quarter, according to which the government had collected Kshs 712.2 bn during the same period, 92.0% of their target and 87.0% of the pro-rated target,
i. Recurrent expenditure was above target at 105.0% while development expenditure was below target at 67.3%. Of recurrent expenditure, Kshs 154.8 bn was foreign and domestic interest payments, which comes to 21.8% of revenue. Total budget absorption was at 88.5% of the target,
ii. The government collected 39.2% of the net foreign borrowing target and 112.3% of the domestic borrowing target, having collected Kshs 24.1 bn and Kshs 183.6 bn from the foreign and domestic markets, respectively,
iii. In December 2017, Kenya's external debt was composed of 33.3% bilateral, 35.8% multilateral and 30.1% commercial debt, as compared to 33.8%, 41.2% and 24.2% in December 2016, respectively. As stated in our recent focus note on Kenya's Public Debt, multilateral debt is mostly concessional hence cheaper, accounting for 16.0% of external debt service, while commercial loans are largely non-concessional and more expensive, accounting for 50.0% of external debt service,
iv. China remains the largest bilateral lender to Kenya at USD 5.2 bn as at December 2017, followed by Japan at USD 824.8 mn and France at USD 622.5 mn,
v. Money Supply (M3) growth was at 8.4% in November 2017, up from 6.2% in November 2016. This is however still below the 5-year historical average of 12.7% growth, and
vi. Kenya's BOP position improved to a surplus of 1.2% of GDP in November 2017 from a deficit of 1.3% of GDP in November 2016 supported by a capital & financial account balance surplus of 8.2% of GDP, despite a current account deficit of 7.0% of GDP.

In our view, the report pointed to a more positive outlook on government borrowing, with the government now on track towards meeting both their domestic and foreign borrowing target, though concerns still remain around the rising non-concessional debt burden.

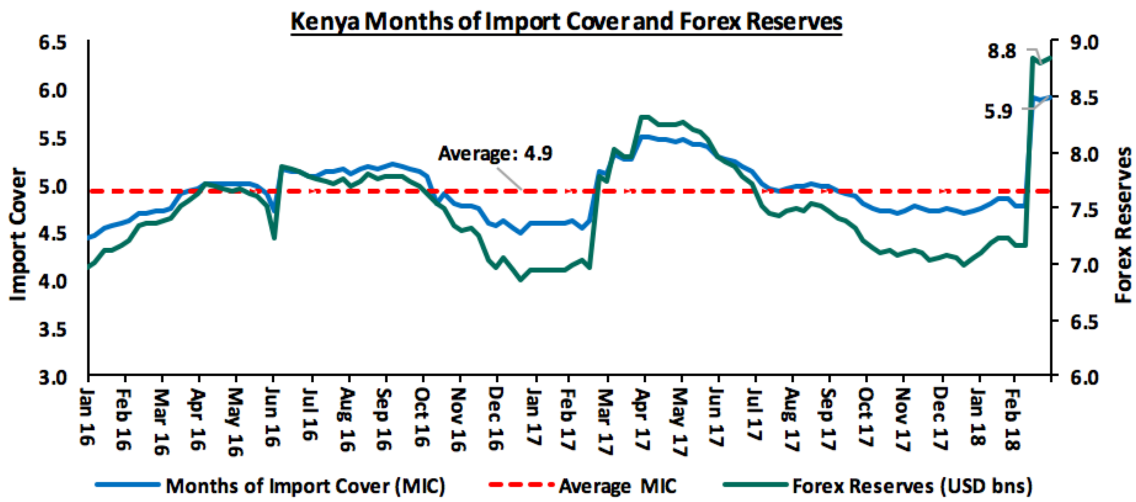
The Kenya Shilling appreciated by 2.3% against the US Dollar, during the quarter, to close at Kshs 100.8, from Kshs 103.2 as at the end of December 2017, mainly driven by positive sentiments strengthened by receding political risk and increased hard currency inflows. During the week, the Shilling appreciated by 0.1% from Kshs 101.0, the previous week, due to a weak demand for dollars coupled with healthy inflows from investors. In our view, the shilling should remain relatively stable against the dollar in the short term, supported by:

?. Weakening of the USD in the global markets as indicated by the US Dollar Index, which shed 9.9% in 2017, and has shed 2.2% YTD, as the Euro and the Sterling Pound continue to strengthen against the USD with the continued recovery of the Eurozone,

i. Improving diaspora remittances, which increased by 26.6% to USD 203.8 mn in December 2017 from USD 160.9 mn in December 2016, driven by a 39.2% and 30.9% increase in remittances from North America and Europe, respectively, and,



iii. CBK's intervention activities, as they have sufficient forex reserves, currently at USD 8.8 bn (equivalent to 5.9 months of import cover), an increase from USD 7.1 bn at the end of December 2017, following the receipt of proceeds from the recently issued Eurobonds, and the USD 1.5 bn (equivalent to approx. 1 month of import cover) stand-by credit and precautionary facility by the IMF, still available until September 2018, after which a new facility will be discussed. This facility had been withdrawn during the quarter, but following a request to extend by the government, the IMF agreed to an extension.



The average inflation rate for Q1'2018 decreased to 4.5% from 5.0% in Q4'2017, with March inflation having declined to 4.2% from 4.5% in December 2017. This was in line with our projections of between 4.1% - 4.3% for the month of March. Y/Y inflation declined mainly due to the base effect given an average inflation rate of 8.8% in Q1'2017, above the government upper limit target of 7.5%. However, m/m inflation increased by 1.4% in March due to (i) a 3.8% rise in the housing, water, electricity, gas and other fuels index, driven by a rise in prices of cooking fuels and electricity, and (ii) a 1.5% increase in the food & non-alcoholic beverages index, driven by a rise in prices of select food basket items. We expect relatively lower inflation during the first half of the year, mainly due to the base effect, with rising prices only beginning to reflect well on the inflation rate in the second half of the year, hence, going forward, we expect inflation to average 7.0% in 2018, down from our previous projection of 7.5%, compared to 8.0% in 2017, which is within the government target range of 2.5% - 7.5%.

The Monetary Policy Committee (MPC) met twice during the quarter; on 22nd January and 19th March. In their second meeting, they reduced the Central Bank Rate (CBR) by 50 basis point to 9.5% from 10.0% noting that there was room for monetary policy easing to further support economic activity, as evidenced by easing inflation and increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in March. This decision was not in line with our expectation to maintain the rate at 10.0% as we believed that the MPC would have adopted a wait and see approach given (i) the stability in the macroeconomic environment, and (ii) the fact that lowering the CBR would effectively lower lending rates, thus making credit access by the private sector even harder due to the interest rate cap, given the further decline in private sector credit growth to 2.1% in February 2018 from 2.4% in December 2017.

Macroeconomic Indicators Table

The table below summarizes the 7 macroeconomic indicators that we track, the expectation at the beginning of 2017, the actual 2017 experience YTD, and the impact of the same, and our expectations going forward:

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
Government Borrowing	Government to come under pressure to borrow as it is well behind both domestic and foreign borrowing targets for FY 2017/18, and KRA is unlikely to meet its collection target due to expected suppressed corporate earnings in 2017	The domestic borrowing target was revised downwards to Kshs 297.6 bn from Kshs 410.2 bn, taking the government ahead of their domestic borrowing target, having borrowed Kshs 267.4 bn against a pro-rated target of Kshs 223.2 bn The government has met 72.9% of its total foreign borrowing target following issue of the Kshs 202.0 bn Eurobond and a Kshs 9.5 bn loan from Japan International Corporation Agency (JICA) for the rehabilitation of the Olkaria 1, 2 and 3 Geothermal Power Projects	The Government to be under no pressure to borrow as it is ahead of its domestic target, has borrowed 72.9% of its full year foreign borrowing target of Kshs 323.2 bn, However, with the petition by the Treasury to amend the Division of Revenue Act 2017 and reduce expenditure by counties and an expected improvement in revenue collections, the borrowing targets for the next fiscal year might be lower	**Negative**	**Positive**

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
Exchange Rate	Currency projected to range between Kshs 102.0 and Kshs 107.0 against the USD in 2018. With the possible widening of the current account deficit being a possible point of concern, we expect the CBK to continue to support the Shilling in the short term through its sufficient reserves of USD 7.1 bn (equivalent to 4.7 months of import cover)	The Shilling has appreciated by 2.3% against the USD YTD to Kshs 100.8 from Kshs 103.2 at the end of December 2017, hitting a high of Kshs 100.8 due to increased flower exports to the Eurozone in mid-February. Forex reserves hit a high of Kshs 8.8 bn (equivalent to 5.9 months of import cover) upon receipt of proceeds from the March Eurobond issue. The IMF extended the USD 1.5 bn standby and precautionary facility by 6 months to September 2018	We expect the currency to remain relatively stable against the dollar due to a weaker USD in the global markets, ranging between Kshs 100.0 and Kshs 107.0 to the USD. We expect the CBK to continue supporting the shilling given the level of reserves and the IMF standby facility. However, a worsening current account deficit, which worsened to 7.0% of GDP in Q3’2017, as compared to 6.0% of GDP in a similar period last year, may have a negative effect	**Neutral**	**Neutral**
Interest Rates	Upward pressure expected on interest rates, especially in the first half of the year, as the government falls behind its borrowing targets for the fiscal year. However, with the Banking (Amendment) Act, 2015, the MPC might be unable to do much with the CBR which has remained at 10.0% throughout 2017	The MPC met on 19th March 2018 and decided to reduce the CBR to 9.5% from 10.0%, for the first time since July 2016, noting that there was room for monetary policy easing to further support economic activity. Interest rates have remained stable, with the yields on the T-bills remaining unchanged since the end of the previous quarter	No upward pressure on interest rates, with the government ahead of its pro-rated borrowing targets for the fiscal year. However, with calls to repeal or revise the Banking (Amendment) Act, 2015, the CBK might not be able to maintain low interest rates by rejecting bids deemed expensive in primary bond auctions, during the second half of the year and the beginning of a new borrowing cycle by the government	**Neutral**	**Neutral**
Inflation	Inflation expected to average 7.5% compared to 8.0% last year	Inflation in January, February and March 2018 came in at 4.8%, 4.5% and 4.2% with y/y inflation remaining low mainly due to the base effect but m/m inflation rising due to increasing food, fuel, electricity and transport prices	Inflation to average 7.0% in 2018, down from 8.0% in 2017 and within the government target range of 2.5% - 7.5%	**Positive**	**Positive**

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
GDP	GDP growth projected to come in at between 5.3% - 5.5%	Various research houses, global agencies, and government organizations released their Kenya 2018 GDP projections, with the average coming to 5.5%, inclusive of our projection. The common view was that GDP growth would improve in 2018, from a Treasury estimate of 4.8% in 2017, generally due to (i) recovery in the agriculture sector after the end of the drought, and (ii) recovery in the business environment following easing of political risk arising from the prolonged political impasse over the 2017 presidential elections	We maintain our GDP growth projection for 2018 at between 5.3% - 5.5%, higher than the expected growth rate of 4.7% in 2017, and in line with the 5-year historical average of 5.4%	**Positive**	**Positive**
Investor Sentiment	Investor sentiment expected to improve in 2018 given the now settling operating environment after conclusion of the 2017 elections	The Kenya Eurobond was 7.0x oversubscribed partly showing the appetite for Kenyan securities by the foreign community, and investor confidence in Kenya's stable and relatively diversified economy	Given (i) the now settling operating environment following the elections in Q3'2017, (ii) the expectation that long term investors will enter the market seeking to take advantage of the valuations which are still historically low, and (iii) expectations of a relatively stable shilling, we still expect investor sentiment to improve in 2018	**Positive**	**Positive**
Security	Security expected to be maintained in 2018, especially given that the elections were concluded and the USA lifted its travel warning for Kenya, placing it in the 2nd highest tier of its new 4-level advisory program, indicating positive sentiments on security from the international community	The political climate in the country has eased, compared to Q3'2017 with security maintained and business picking up. Kenya now has direct flights to and from the USA, a possible signal of improving security in the country	We expect security to be maintained in 2018, especially given that the elections are now concluded, the government has settling into office, and the country's two principals are discussing working towards growing the economy	**Positive**	**Positive**

Of the 7 indicators we track, 5 are positive and 2 are neutral, with government borrowing being the only indicator whose outlook has changed, to positive from negative. This is a positive change from the last quarter where we had 4 positives, 1 negative and 3 neutrals. From this, we maintain our positive outlook on the 2018 macroeconomic environment.

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