Cytonn INVESTMENTS

Cytonn Note on the Monetary Policy Committee (MPC) Meeting for November 2019

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The Monetary Policy Committee (MPC) is set to meet on Monday, 25th November 2019, to review the outcome of its previous policy decisions and recent economic developments, and to make a decision on the direction of the Central Bank Rate (CBR). In their previous meeting held on 23rd September 2019, the MPC maintained the CBR at 9.0%, citing that the economy was operating close to its potential and inflation expectations remained anchored within the target range. The Committee also noted the prospective tightening of fiscal policy which would provide scope for accommodative monetary policy in the near term, thus the prevailing monetary policy stance remained appropriate. This was in line with our expectations as per our MPC Note, informed by the country's macroeconomic fundamentals, which had remained stable as well as sustained optimism on the economic growth prospects, as evidenced by:

?. Inflation expectations, which had remained within the target range of 2.5% - 7.5%, coming in at 5.0% in August from 6.3% in July, mainly driven by a decline in food inflation to 6.9%, from 7.9% recorded in July, on the back of improved weather conditions, and

i. Increased private sector optimism as per the MPC Private Sector Market Perception Survey conducted in September 2019, which indicated that the private sector was optimistic about local economic prospects. The private sector expects stable economic growth in 2019, supported by improved macroeconomic environment, which led to increased economic activity in the private sector, implementation of the Big 4 agenda projects, improved weather conditions and political stability.

The Monetary Policy Committee also noted that the current account deficit had narrowed to 4.2% of GDP in the 12 months to July 2019 compared to 5.5% in July 2018, supported by strong growth in diaspora remittances and resilient performance of horticultural and manufactured exports. The decline was also partly attributable to higher receipts from the tourism and transport services as well as lower food imports and import of SGR-related equipment.

Below, we analyze the macro-economic indicators trend since the September 2019 MPC meeting, and how they are likely to affect the MPC decision on the direction of the CBR:

Indicators	Experience since the last MPC meeting in September 2019	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
Government Borrowing	· The Government is currently 30.8%, behind its prorated domestic borrowing target and has to borrow on average Kshs 115.2 bn on a monthly basis in the current financial year in order to meet its domestic borrowing target of Kshs 300.3 bn	· We remain neutral on domestic borrowing, due to the levels of domestic debt maturities in FY'2019/20 currently at Kshs 627.4 bn, coupled with the historical underperformance of ordinary revenues, with the Government having met 93.1% of its target as per the FY'2018/2019 budget outturn. Despite the underperformance, the Government raised its total revenue target by 14.2% to Kshs 2.1 tn for FY'2019/20 which we doubt it will meet, thus exert slight pressure on the domestic borrowing front to plug in the deficit	**Neutral**	**Neutral**
Inflation	· Inflation for the month of October increased to 5.0%, from 3.8% recorded in September. Y/Y inflation increased mainly driven by a 0.5% increase in the food and non-alcoholic drinks' index. M/M inflation also increased by 0.3% due to a 0.5% increase in the food and non-alcoholic drinks' index	· Inflationary pressure is expected to emanate from the effects of the increase in international oil prices. Despite this, inflation is still expected to remain within the 2.5%-7.5% government set target range	**Positive**	**Positive**

Indicators	Experience since the last MPC meeting in September 2019	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
Currency (USD/Kshs)	· The Shilling has appreciated against the US dollar by 1.7% to Kshs 102.1 from Kshs 103.8 during the last meeting, supported by improved inflows from diaspora remittances and portfolio investors buying government securities. Forex reserves have however declined to USD 8.9 bn (equivalent to 5.6 months of import cover) from USD 9.3 bn (equivalent to 5.8 months of import cover) since the last meeting. This however still meets the CBK's statutory requirement to endeavour to maintain at least 4 months of import cover and the EAC region's convergence criteria of 4.5 months of import cover, thus providing an adequate buffer for the Kenyan Shilling from external shocks	· We expect the Kenyan Shilling to remain relatively stable against the dollar, supported by; i. CBK's activities in the money market, such as repurchase agreements and selling of dollars, ii. High levels of forex reserves, currently at USD 8.9 bn (equivalent to 5.6-months of import cover) iii. The narrowing of the current account deficit, with preliminary data indicating that Kenya's current account deficit improved by 11.8% during Q2'2019, coming in at a deficit of Kshs 107.6 bn, from Kshs 122.0 bn in Q2'2018, equivalent to 6.2% of GDP, from 7.6% recorded in Q2'2018	**Neutral**	**Neutral**

Indicators	Experience since the last MPC meeting in September 2019	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
GDP Growth	· Kenya's economy expanded by 5.6% in Q2'2019, a decline from the 6.4% recorded in Q2'2018, which was due to: i. A slowdown in the Agricultural sector to 4.1% in Q2'2019 from 6.5% in Q2'2018 attributed to a delay in the long rains in most parts of the country which led to reduced agricultural production ii. A slowdown in the manufacturing sector to 4.2% in Q2'2019 compared to a growth of 4.7% in Q2'2018, largely attributed to the decline in agro-processing activities that were also subdued as a result of the delay in long rains	· GDP growth is projected to come in between 5.7% - 5.9% in 2019 above the 5-year average of 5.6%, driven by the continued growth in the tourism, real estate, construction and manufacturing sectors. The slowdown in growth however is expected to emanate from lower productivity in the agricultural sector following the late onset of long rains that is also expected to trickle down to the manufacturing sector due to a decline in agro-processing activities	**Positive**	**Positive**

Indicators	Experience since the last MPC meeting in September 2019	Going forward	Probable CBR Direction (September)	Probable CBR Direction (November)
Private Sector Credit Growth	· The latest data from CBK indicates that private sector credit growth recorded a drop in September 2019 to 11.4% from 11.5% recorded in July 2019 but below the 5-year average of 11.6%	· Private sector credit growth is expected to increase going forward with the interest rate cap repeal, which will make banks revise their credit risk assessment framework thus increasing lending to riskier borrowers	**Positive**	**Positive**
Liquidity	· Liquidity levels in the money markets have remained favourable in 2019, with the average interbank rate since the start of the year coming in at 3.5%, lower than the 5.2% recorded in 2018 driven by government payments and domestic debt maturities	· Liquidity is expected to remain high with the heavy maturities of domestic debt in 2019 that currently stand at Kshs 627.4 bn, as well as continued government spending through the various infrastructure investments. We also expect the amendment to regulate payment matters and the measure to have all suppliers to Government paid within 60 days to have a positive impact on the circulation of money in the economy	**Positive**	**Positive**

Conclusion

Of the six factors that we track, two are neutral and four are positive, with the change being on private sector credit growth from negative to positive since the last MPC meeting due to the recent repeal of the interest rate cap.

With the repeal of interest rate cap law, expectations are that the banks will have a bias in lending to the private sector, as they will be able to price for risk appropriately even for more risky borrowers thus stimulating private sector credit growth. As per comments from Central Bank Governor Patrick

Njoroge, there are expectations that the repeal of the interest rate cap will eventually unlock the stand-by credit facility with the International Monetary Fund (IMF), after the expiry of a previous program last year, since it was one of the conditions set, thus providing a buffer for the Kenyan Shilling. The Monetary Policy Committee through its assessment of the impact of the interest rate cap in the rate cap era, had also noted that it had weakened the transmission of monetary policy. With the repeal however, there is renewed clarity and certainty in the market's response to policy signals.

We expect the MPC to cut the Central Bank Rate (CBR) by 50 bps to 8.5% from the current 9.0%, with their decision mainly being supported by:

?. The need to stimulate growth, with GDP growth in 2019 having slowed down averaging 5.6% in H1'2019 lower than 6.4% in H1'2018 and below the CBK's estimated growth at 6.3%. With the plans of the continued fiscal consolidation by the Government, we believe that a further cut will be necessary to provide the required economic growth stimulus, further boosted by the repeal of the interest rate cap, which going forward is expected to provide more efficient transmission of monetary policy as opposed to the interest rate cap era,
i. Inflation has remained contained and within the Government set target of 2.5%-7.5%, amid slowed economic growth, thus providing room for moderate stimulus through expansionary monetary policy, and,
ii. A further reduction of the Central Bank Rate (CBR), coupled up with the interest rate cap repeal would provide the requisite stimulus to private sector credit growth which has remained below the 5 year average, having grown by 6.3% in the 12 months to August 2019, below the 5-year average of 11.0%.

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