FAIDA INVESTMENT BANK

KENYA MACROECONOMIC OUTLOOK: 1H2019

11th March 2019

ROBUST GROWTH HINGED ON POSITIVE INDICATORS

In 2019, we expect the economic growth momentum adopted from 4Q2017 to persist in 2019, supported by improved business confidence and stability in macroeconomic indicators. We believe growth will continue to be broad based and we opine that the key risk likely to weigh on GDP growth in 2019 will be limited credit access to the private sector.

In 1H2019, we expect we expect inflation to moderate within the CBK's lower target band (2.5% to 5.0%), supported by lower imported inflation (relatively stronger Kenya Shilling, lower global crude oil prices) and sufficient agricultural production

We expect a stable forex market in the 1H2019, supported by a narrower current account deficit on account of reduced imports, increased earnings from tourism coupled and improved agricultural exports as production improves due to favourable weather conditions. In 1H2019, we expect Dollar demand to remain muted predominantly due to an expected slower pace in interest rate hikes and concerns of growth tapering off in the US. The key risk to the stability of the foreign exchange market will most likely emanate from the repayment of interest payments and maturing debt on foreign currency loan.

In 1H2019, we expect the yields on Treasury bills to still maintain their downward trajectory, as the government continues to reject expensive bids and investor demand for Treasury securities persists.

Furthermore, we expect the shorter-to-medium end of the yield curve to shed at least 50 bps as (i) investor demand for these securities continues to persist (ii) the government continues to limit domestic borrowing rates as they ramp up borrowings to meet borrowing targets. With regards to the longer end of the yield curve, we expect it to remain relatively unchanged owing to sustained investor apathy.

Economic Overview

Global Economic Trends

Global growth slowed down to 3.7% in 2018 from 3.8% recorded in 2017, raising concerns that global growth may have peaked.

Despite the strong start in global growth at the onset of 2018 (buoyed by rising global manufacturing and trade output), global economic growth lost steam in 2H2018 largely due to the escalation of the trade tensions between the U.S. and China.

Despite the trade wars, the U.S. economy sustained its growth momentum rising by 2.9% in 2018 (2017: 2.2%) as tax cuts and increased spending enhanced demand. This led to a tighter monetary policy (partly aimed at curbing demand driven inflationary pressures) which resulted in strong Dollar appreciation relative to other countries, resulting in significant strains across some emerging markets (manifested as higher borrowing costs associated with servicing Dollar denominated debt).

Across Europe, growth was weak due to higher energy prices, slower export growth and political uncertainty (especially surrounding the Brexit deal). In Asia, the weak growth experienced in China (6.6% vs. 6.9% in 2017) was offset by rising momentum in India (7.3% from 6.7% in 2017). In Sub-Saharan Africa (SSA), elevated commodity prices supported growth in commodity exporters.

Crude oil prices maintained the rally adopted in 2017, rising in first three quarters of 2018 with the West Texas Intermediate (WTI) and the Murban ADNOC Crude Oil Prices rising by 13.2% and 18.8% to USD 73.25 and USD 78.75 per barrel in September 2018 respectively. This was attributable to improved oil demand amidst concerns of reduced global supply following sanctions against Iran.

From the last quarter of 2018, oil prices have trended downwards owing to waivers granted to eight countries (to continue importation Iranian oil) and rising oil supply (especially from U.S.), despite the OPEC+ decision to cut 1.2 million barrels per day.

In 2019, global growth is anticipated to taper, sustaining the weak growth patterns witnessed in 2H2018. The International Monetary Fund (IMF) in its latest World Economic Outlook (WEO) report, estimates global growth at 3.5% in 2019.

The deceleration in global economic growth in 2019 is expected to be influenced by trade policy uncertainty and economic slowdown in China.

The trade tensions between the U.S. and China persisted through most of 2H2018, negatively impacting global growth in 2018. While both countries are on the verge of a trade settlement, significant concerns on further trade escalations still exist, and this could further impede global growth.

In China, the economy is expected to slow down form 6.6% in 2018 to 6.2% in 2019 owing to the effects of financial regulatory tightening and the trade tensions with the U.S. The slowdown in China is also likely to cause slowdowns in other Asian countries. Thus growth in emerging and developing Asia is anticipated to decline to 6.3% (6.5% in 2018), but should be supported by rising growth in India which should reap the benefits of lower oil prices.

According to the WEO, growth in advanced economies is anticipated to weaken from an estimated 2.3% in 2018 to 2.0% in 2019. In the U.S., growth is projected to ease to 2.5% in 2019 principally owing to the fading effects of the fiscal stimulus. Consequently, the U.S. Federal Reserve is expected to adopt a slower pace in further rate hikes (compared to the four rate hikes undertaken in 2018).

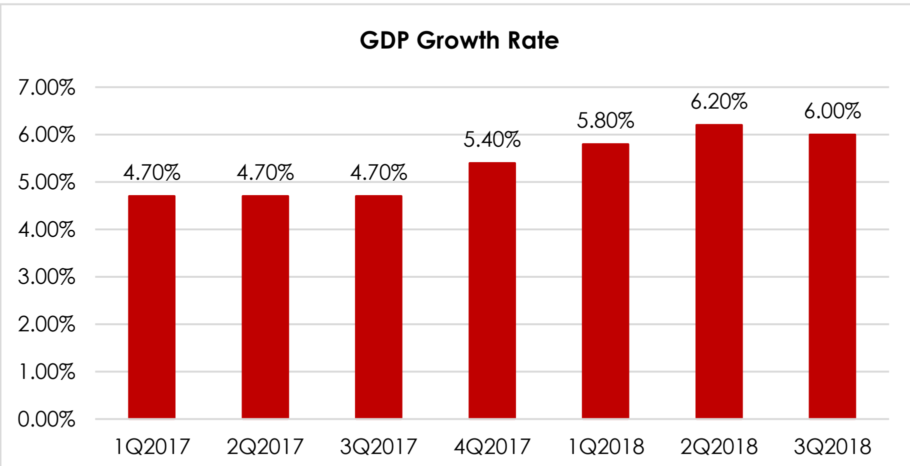
In Europe, growth is expected to come down to 1.6% (as compared to 1.8% in 2018), mainly weighed down by weaker growths in France (following the negative effects of industrial action) Germany (on the back of weak industrial output following new auto emission standards) and Italy (weighed down by weak domestic demand and higher borrowing costs). In the U.K., major uncertainty about the Brexit outcome, is expected to hamper growth. However, this impact should be offset by the anticipated impact of the fiscal stimulus introduced in the budget – leading to a growth forecast of 1.5%.

Across other emerging and frontier markets growth prospects remain relatively weak. In Turkey, policy tightening and restrictive financing terms are set further defer a recovery; Mexico's growth prospects remain dim due to lower private investment while in Argentina, weak domestic demand will curtail growth. In Brazil the recovery from the 2015-2016 recession is expected to continue albeit at a slower pace.

In contrast to 2018, the global crude oil prices are expected to come down in 2019, averaging USD 61.00 a barrel (Brent prices) compared with an average of USD 71.00 per barrel in 2018. The outlook is informed by expected higher inventory levels (especially U.S. inventories), despite the OPEC+ decision to cut oil supply by 1.2 million barrels per day amidst easing global demand (influenced by weaker global growth momentum).

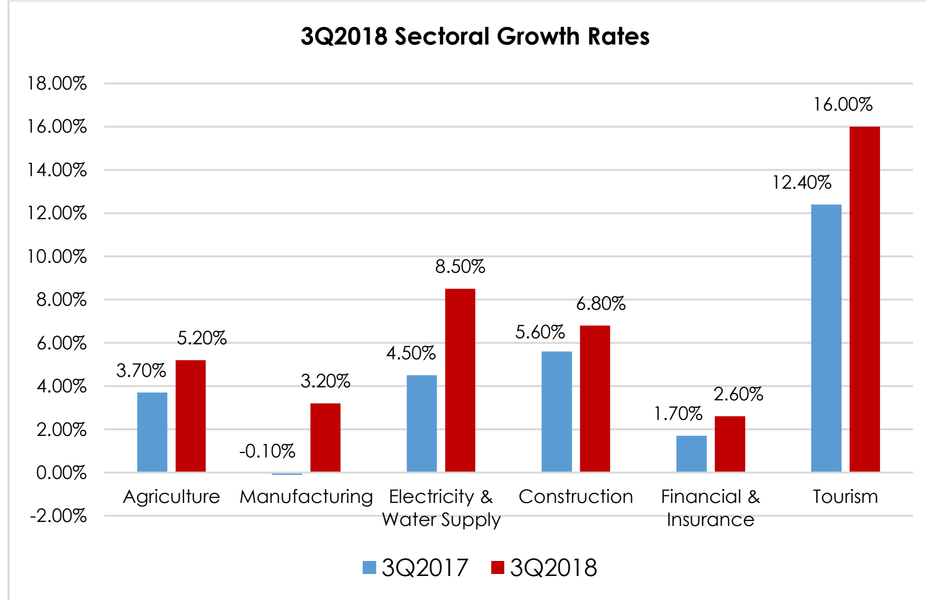
Kenyan GDP Growth

Economic growth accelerated to 6.0% in 3Q2018 from 4.7% recorded in 3Q2017 on the back of favourable weather conditions and a stable macroeconomic environment.



Source: KNBS

The robust growth was broad based, underpinned by a recovery in the agricultural, accommodation and food services, construction, electricity & water supply, finance and manufacturing sectors.



Source: KNBS

The improved performance of the agricultural sector was catalyzed by favourable weather conditions, which supported by increased production of important cash crops. The sector expanded by 5.2% in 3Q2018 compared to a growth of 3.7% in 3Q2017.

Improved performances recorded in both the food and non-food sub-sectors, supported the recovery witnessed in the manufacturing sector, which grew by 3.2% in 3Q2018 from a contraction of -0.1% in 3Q2017.

The tourism sector continued to post robust growth, rising by 16.0% in 3Q2018 (3Q2017: 12.4%). The tourism sector continued to be buoyed by improved security, political stability and sustained marketing efforts.

The financial services sector edged up by 2.6%, improving from the growth rate of 1.7% posted in 3Q2017. The sector continued to bear the effects of decelerated credit growth to the private sector.

In 2019, we anticipate economic growth to remain strong premised on the improved performance witnessed in 3Q2018. We anticipate growth to be buoyed by improved business confidence and stability in macroeconomic indicators.

We believe growth will continue to be broad based – supported by sustained growth recovery in the manufacturing, construction & mining sectors coupled with a robust services sector (especially tourism, communication, trade, and transport & storage).

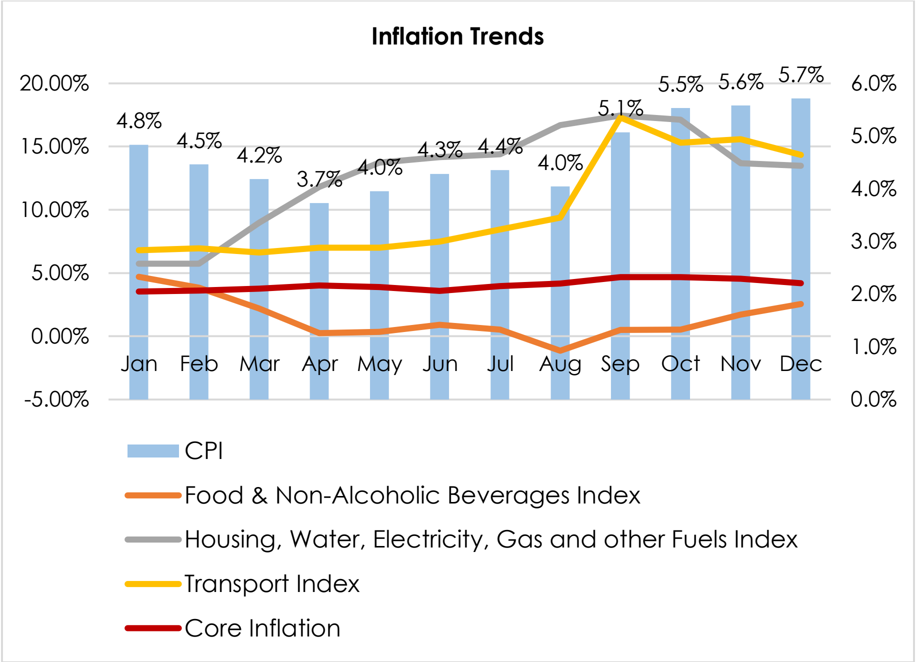
In the agricultural sector, we expect robust growth hinged on the expected near-normal to above-normal (enhanced) rainfall expected to during the long rain season (March-April-May).

We opine that the key risk likely to weigh on GDP growth in 2019 will be limited credit access to the private sector – particularly to micro, small and medium sized enterprises

Given the foregoing, our growth outlook for the economy ranges between 5.8% and 6.0% in 2019.

Inflation

In the 1H2018, the annual headline inflation generally adopted a downward bias (disinflation trend), declining from 4.8% in January to 3.7% in April (lowest rate achieved in 2018). This trajectory was principally underpinned by lower food prices, evidenced by a similar decline in the food & non-alcoholic beverages index which eased from 4.7% in January to 0.3% in April (owing to improved food production).



Source: KNBS

With the exception of August 2018 (which benefitted from negative growth in food inflation), inflation bucked the declining trend adopted in the first four months of the year, consistently rising each month to close at 5.7% in December 2018.

This trend was on the back of a persistent rise in the transport index (due to persistent rise in oil prices) and the housing, water, electricity, gas and other fuels index to peak highs in September.

The transport index rose from 7.0% in May to a high of 17.3% in September. This was due to a persistent rise in global oil prices (as measured by the Murban crude oil prices) edged up by 14.5% to 82.3 USD/barrel in October 2018 as well as the introduction of Value Added Tax on petroleum products in September.

During FY2018, the housing, water, electricity, gas and other fuels index also tilted towards a rising trend, edging up from 5.7% in January to a crest of 17.3% in September, on account of rising prices of kerosene and charcoal as well as a review in the tariff structure for electricity.

Between September and December, the rise in inflation was anchored by higher food prices (as the two other aforementioned indices adopted declining trends) as increases in the prices of some food stuffs offset decreases in others.

During the year, core inflation (non-food-non-fuel-inflation) continued to remain stable, below 5.0%, reflecting muted demand side inflationary pressures.

Since the beginning of 2019, headline inflation trended downwards-easing to 4.7% in January 2019 and 4.4% in February 2019. This was principally attributable to lower food prices given the improved agricultural production, despite the weak rainfall performance during the October-December 2018 season.

In 1H2019, we expect we expect inflation to moderate within the CBK's lower target band (2.5% to 5.0%), supported by lower imported inflation (relatively stronger Kenya Shilling, lower global crude oil prices) and sufficient agricultural production supported by the near-normal to above-normal (enhanced) rainfall expected to be witnessed during the long rain season (March-April-May).

Money Supply

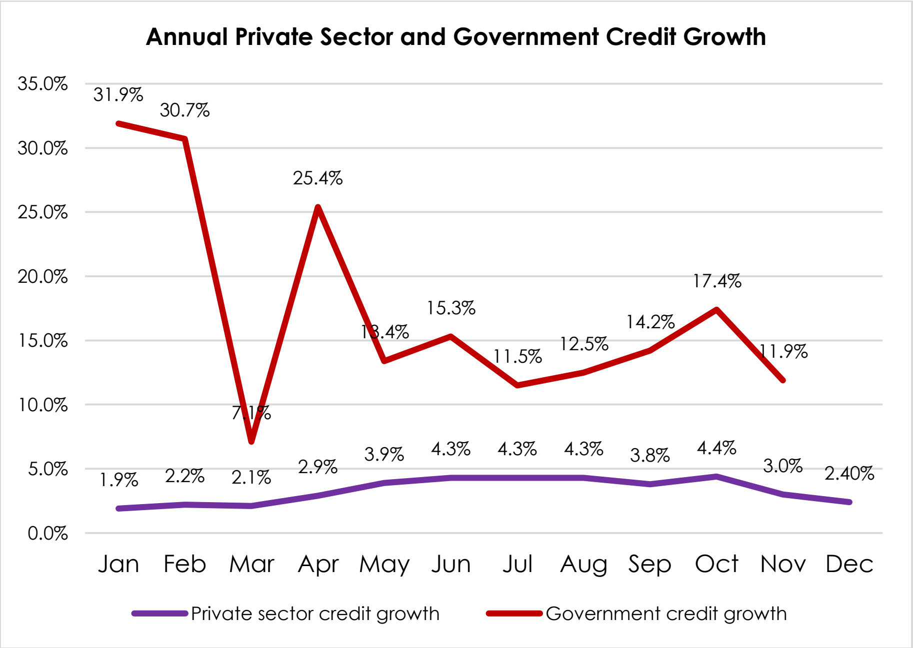
In 2018, broad money supply (M3) exhibited a rising trajectory in the 1H2018, followed by a plateau for the reminder of the year.

Money supply advanced by 7.8% from KES 3,026.1 billion in January to KES 3,262.60 billion in June, principally supported by 44.6% growth in net foreign assets to KES 756.9 billion owing to increased foreign financing.

During the 1H2018, domestic credit to the government eased by 3.5% to KES 745.1 billion in June while domestic credit to the private sector marginally rose by 1.2% to KES 2,380.4 billion (fairly supported by a an expansionary monetary policy adopted by the CBK).

In the 2H2018, money supply levels remained relatively stable, fluctuating around KES 3,300.0 billion, contrary to the rising inflation rates.

Overall, credit growth to the private sector continued to remain subdued in 2018, averaging 3.3%, slightly better than 2.4% registered in 2017. Government credit growth continued to significantly exceed private sector credit growth as shown in the graph below.



Source: CBK

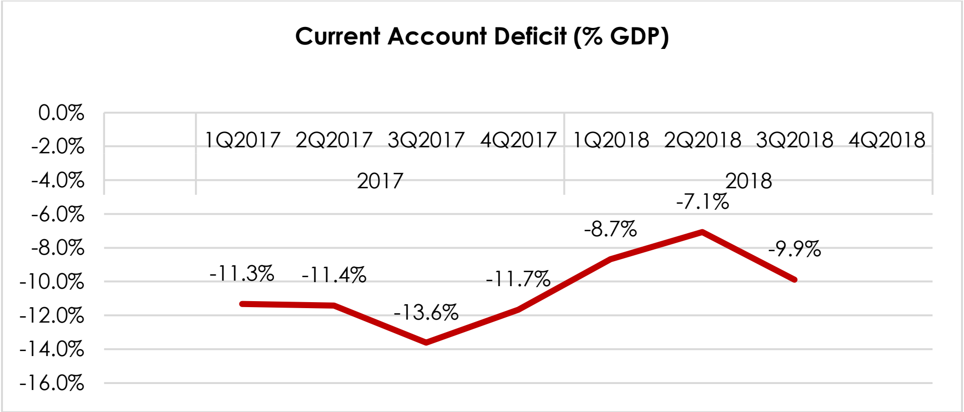
DISCLAIMER: The information contained herein is obtained from sources, which to the best of our knowledge are deemed reliable. As such, we are not responsible or liable for any factual errors arising thereof. Any opinions expressed herein are ours and are bound to change anytime at no notice.

In 2019, we do not expect the credit conditions in the private sector to significantly change predominantly owing to the existence of the interest rate regulations and heightened government borrowing. However, we believe that the improved business confidence could provide some uplift (modest) in private sector credit growth.

Current Account Deficit

The current account deficit narrowed by 23.1% y/y to KES 116.0 billion (9.9% GDP) as at 3Q2018 compared to KES 150.9 billion (13.6% GDP) in 3Q2017. In relative terms, according to the CBK, the current account deficit narrowed to 4.9% of GDP in 2018 (an 11 year low) from 6.3% in 2017. This was attributed to rising exports, subdued imports increased and diaspora remittances. Diaspora remittances grew by 26.2% y/y to KES 64.7 billion as at 3Q2018 (3Q2017: KES 51.5 billion).

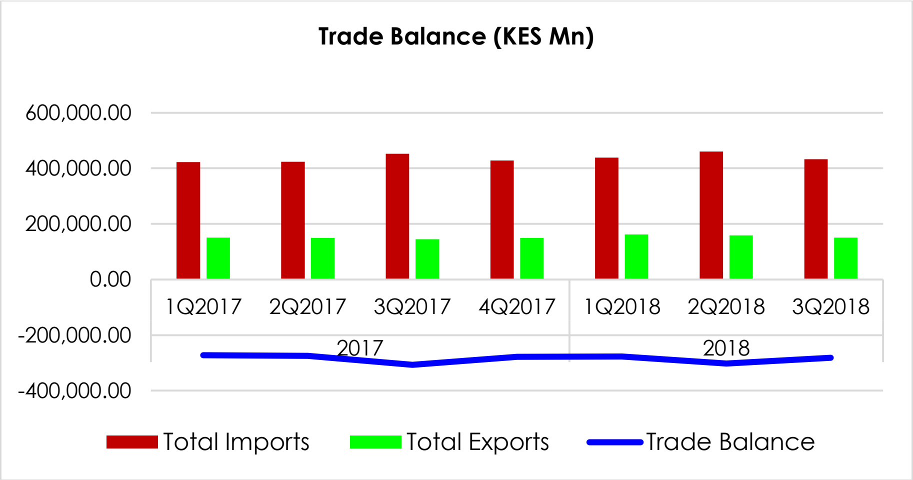
The value of exported goods grew by 3.9% y/y to KES 150.6 billion (3Q2017: KES 145.0 billion) on the back of increased domestic exports of titanium ores, horticulture, unroasted coffee and articles of apparel and clothing accessories. Tea exports experienced a notable decline (-10.1% y/y to KES 32.1 billion) influenced by a result of the decline in the unit price of black tea in the international market.



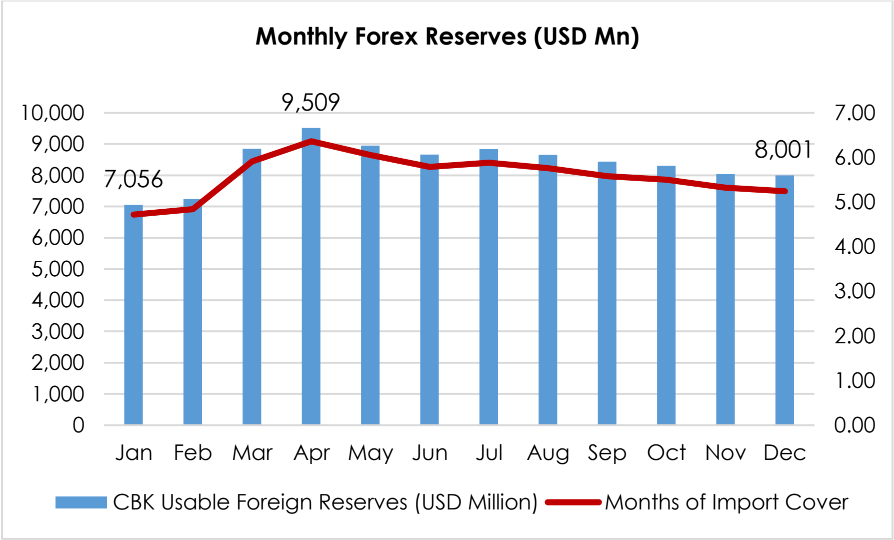
Source: KNBS

The value of imported goods eased by 4.3% y/y to KES 432.3 billion in 3Q2018 owing to lower food and heavy machinery imports and the decline in international oil prices.

Owing to the rise in the value of total exports combined with the effect of lower total imports, the trade balance eased by 8.2% y/y to KES 281.7 billion in 3Q2018.



Source: CBK



Source: CBK

We expect the current account deficit to further narrow in 2019 owing to reduced imports and increased earnings from tourism. We expect a decline in food imports and improved agricultural exports as production improves due to favourable weather conditions.

Forex Reserves

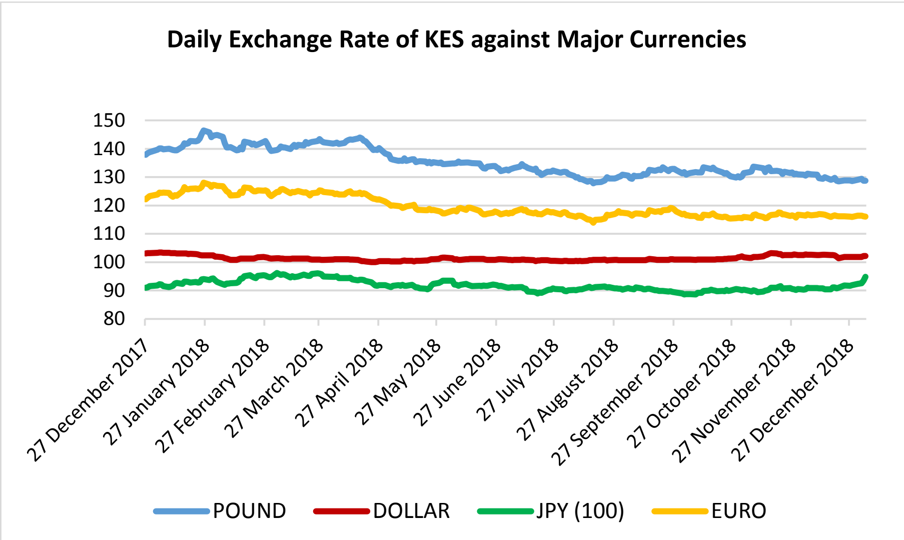
In the first four months of 2018, usable foreign exchange reserves grew by 34.8%, from USD 7.06 billion (4.72 months import cover) in January to USD 9.5 billion (6.36 months import cover) in April 2018. This was largely due to the inflow of Dollars from tourism and diaspora remittances. From April 2018, foreign exchange reserves adopted a declining trend, easing by 15.9% to USD 8.0 billion (5.24 months import cover) in December.

The beginning of 2019 was marked by a strengthening of foreign exchange reserves. The reserves closed at USD 8.20 billion (5.37 months of imports cover) as at the end of February, compared to USD 8.02 (5.26 months of imports cover) at the beginning of January. This was attributed to a strengthening Kenya Shilling supported by the aforementioned factors. Overall, we expect forex reserves to remain stable in 1H2019.

Exchange Rate

The Kenya Shilling exhibited varied performance against the major trading international currencies in 2018. The Kenya Shilling gained by 1.2% against the U.S. Dollar ,4.7% against the Euro and 6.5% against the Sterling Pound to close at 101.84 ,116.44 and 129.02 respectively (31/12/2018) but weakened by 1.5% against the Japanese Yen to close at 92.27.

The stability of the Kenyan shilling against the Dollar in 2018 was supported by hard currency inflows from diaspora remittances (which grew by 10.0% between 3Q2017 and 3Q2018), strong receipts from tourism and lower imports of food and Standard Gauge Railway related equipment relative to 2017. The Pound on the other hand suffered significantly in currency markets owing to a distinct lack of clarity over Brexit negotiations, which negatively impacted investor sentiment and economic activities in general.



Source: CBK

Since the turn of the year, the Kenya Shilling has adopted a strengthening bias, gaining by 1.7% y-t-d to close at 100.09 (as at 28th February 2019) against the Dollar.

The Shilling has been predominantly supported by robust Dollar inflows from diaspora remittances and investors targeting investments in Treasury securities, against subdued Dollar demand from importers (owing to slower growth in imports as a result of lower food and SGR–related equipment imports).

Furthermore, The Kenya Shilling has also benefitted from an unchanged federal funds rate at a range of 2.25% - 2.50%, and a dovish stance by the Federal Reserve's Open Market Committee – signaling a less aggressive interest rate hike in 2019.

In the short-term (1H2019), we believe that the aforementioned conditions in the forex market will remain relatively unchanged. The current account deficit is expected to narrow further in 2019, Dollar demand should remain muted predominantly due to an expected slower pace in interest rate hikes and concerns of growth tapering off in the US.

The key risk to the stability of the foreign exchange market will most likely emanate from the repayment of interest payments and maturing debt on foreign currency loans, (notably the USD 750.0 million sovereign bond which matures in June).

Since we expect the government to refinance this debt, providing short-term stability, this risk is more likely to be deferred to the medium to long-term.

Interest Rates

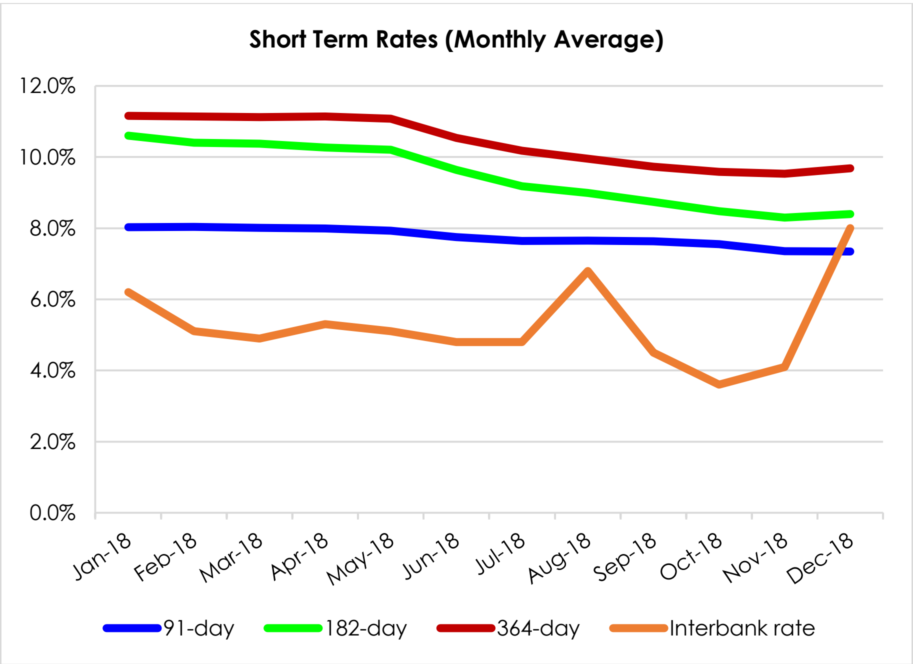
The Central Bank of Kenya's monetary policy was largely expansionary with two CBR rate cuts during the year; in March (from 10.0% to 9.5%) and in July (to 9.0%).

Short Term Rates

In 2018, short-term rates adopted a declining trend, as the 91-day, 182-day and 364-day Treasury bill yields shed by 76 bps, 165 bps and 120 bps respectively to 7.3%, 9.0% and 10.0% respectively.

The decreasing yields, mirrored the government's penchant for rejecting expensive bids (in line with the CBK's monetary policy direction) in an attempt to ease the cost of domestic debt.

The interbank rate followed a similar trend, declining by 458 bps from 7.4% in mid-January to 2.8% in mid-July 2018, occasioned by improving liquidity conditions in the money market.



Source: CBK

From mid-July 2018, the interbank rate shot to 8.7% (the second highest peak of 2018) owing to tight liquidity conditions on the back of low Government payments in the early weeks of the fiscal year 2018/2019. Thereafter, the rate declined to a low of 2.0% in October due to improved liquidity conditions occasioned by increased Government payments, before increasing to 11.3% in December (a 3 year high) due to tax payments and lenders' meeting of regulatory ratios.

Inflation and exchange rate trends and the need to spur private sector credit have left the CBK with some headroom for further cuts in the CBR. We therefore opine that there might at least one cut (25-50bps) in the CBR in the 1H2019.

In 1Q2019, the interbank rate has exhibited a down ward trend, declining to an 8-year low of 1.24% in February, attributable to high liquidity conditions in the money market – greatly supporting demand for Treasury securities (Tap sales for a 2-year and 15-year bond were oversubscribed by 418.3% and 136.7% respectively).

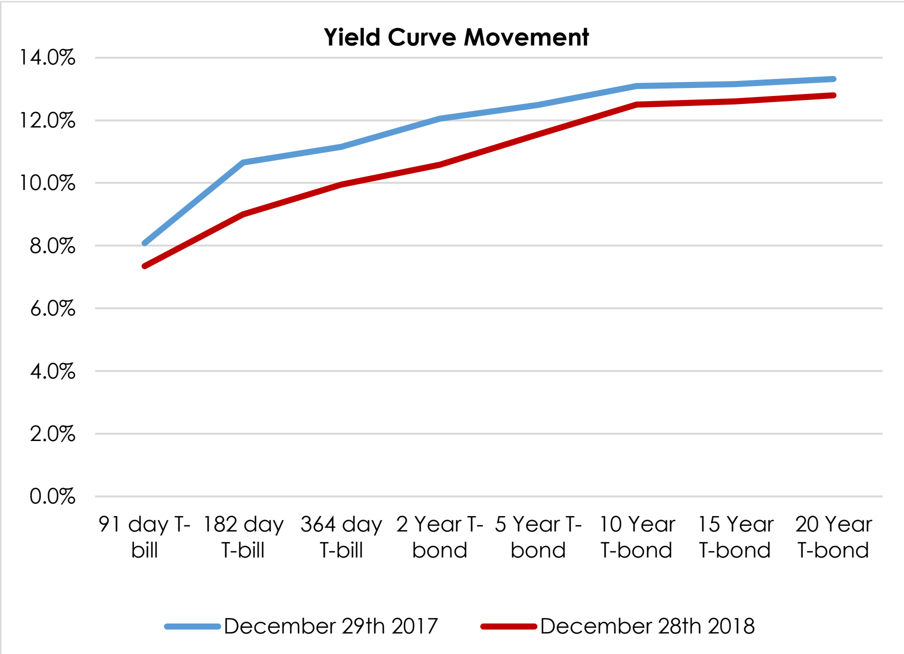
We expect the usual interplay of forces to continue to influence the movement in the interbank market (government payments, tax remittances…), giving rise to uncertainty as to the definite direction of the interbank rate.

In regards to Treasury bills, the yields on the 91-day, 182-day and 364-day papers continued their easing trend in 2019, shedding 38 bps, 63 bps and 46 bps respectively from the end of 2018 to 1st March 2019.

In 1H2019, we expect the yields on Treasury bills to still maintain their downward trajectory, as the government continues to reject expensive bids and investor demand for Treasury bills (particularly on the 364 day T-bill) persists.

Bonds

At the end of FY2018, the shape (steepness) of the NSE yield remained relatively unchanged, compared to the end of FY2017 as shown below.



Source: NSE

Increased demand for Treasury securities against the backdrop of a relatively liquid money market, coupled with the effects of a harmonious fiscal and monetary policy, pulled down the yield curve by 96 bps (on average across all maturities).

In comparison to the longer end of the yield curve, the short-to-medium end of the yield curve displayed a greater downward shift, plunging by 120 bps (on average across the 91-day T-Bill to 5-year T-bond) as compared to 55 bps for the longer end.

We opine this was principally influenced by an easing monetary policy(T-Bills), a scarcity of short-term debt issues - Treasury bonds (which heightened demand for the short-to-medium end of the yield curve) and investor preference for the shorter end of the yield curve (favorable returns and lower risk exposure associated with this end of the yield curve).

In the last two months of the year (January and February 2019), the government has shifted its strategy (previous strategy focused on issuing long-term bonds) within the fixed income market, preferring to issue both shorter dated bonds and longer dated bonds simultaneously – in an attempt to lengthen their maturity profile and improve subscription rates. Going by the last several 'joint' issues, investor preference still remains skewed towards shorter-dated securities as evidenced by the comparatively higher subscription rates.

The CBK issued the FXD1/2019/20 & the FXD1/2019/15 simultaneously and subsequently jointly re-opened them, before issuing the FXD1/2019/5 & the FXD1/2019/10 simultaneously.

We opine the shift in strategy has been influenced by tepid investor response to longer dated papers (in favor of shorter dated papers) coupled with the government's need to meet its borrowing targets and lengthen its maturity profile.

Bond	Subscription Rate	Yield
FXD/2019/2	192.26%	10.70%
FXD/2019/15	62.67%	12.86%
Re-open:		
FXD/2019/2	418.30%	10.70%
FXD/2019/15	136.72%	12.86%
FXD/2019/5	83.85%	11.30%
FXD/2019/10	72.66%	12.44%

Source: CBK

As seen above, investor preference still remains skewed towards shorter dated papers.

In the 1H2019, we expect the shorter-to-medium end of the yield curve to shed at least 50 bps as (i) investor demand for these securities continues to persist (ii) the government continues to reject aggressive bids.

With regards to the longer end of the yield curve, we expect it to remain relatively unchanged owing to sustained investor apathy.

However, we do expect the government to issue more IFBs in a bid to lengthen their maturity profile (which is already skewed towards short-term maturities). Furthermore, we believe this strategy will slightly help improve subscription rates in the long end as IFBs are more preferred to FXDs – owing to their tax savings offering.

Samuel Njihia	E-mail: samuel.njihia@fib.co.ke
Ivy Barongo	E-mail: ivy.barongo@fib.co.ke
John Jumwa	Email: john.jumwa@fib.co.ke

HEAD OFFICE:

Crawford Business Park,
Ground Floor
State House Road
Tel: 0207606026-37
P.O Box 45236-00100
Nairobi