Fundamentals

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Macroeconomic update | Strategy | Monetary policy analysis | Kenya

Follow through to allay FOMO fears

IN BRIEF

- The CBK delivered a surprise rate hike – the first in seven years – but there is a school of thought that the policy decision reflects FOMO. Whereas Kenya delivered a modest 50bps hike, the median hike by the central banks in our African coverage has been 100bps in their maiden hike decision.
- But the apex bank would like the market to believe that it erred on caution and to arrest the inflation genie before it gets out of the bottle.
- The market would like the CBK to fortify its credibility by addressing three key issues.
- First, the market thinks the CBK has no informational advantage as to the inflation outlook. CBK needs to issue 2022 inflation projection, as it fully pivots into inflation targeting regime.
- Secondly, although the rate hike is to signal tighter financial conditions, credit to the private sector has gathered momentum and is expected to continue. The operationalization of the Central Securities Depository should anchor interbank market with the policy rate and ensure effective transmission of the monetary policy via the credit channel.
- Third, and the elephant in the room, is the FX shortage that has gained currency. Failure to address the FX concerns risks pass-through effect into headline inflation, unmooring inflationary expectations.
- We thus see a 6month long USD/KES Non-Deliverable Forward (NDF) trade quite attractive, unless the CBK addresses FX supply concerns. We think the upcoming 18-year infrastructure bond (auction date Wednesday 8 June 2022) will be priced at 13.5% levels, baking in the rate hike, but the on-the-run papers should adjust gradually in the medium term.

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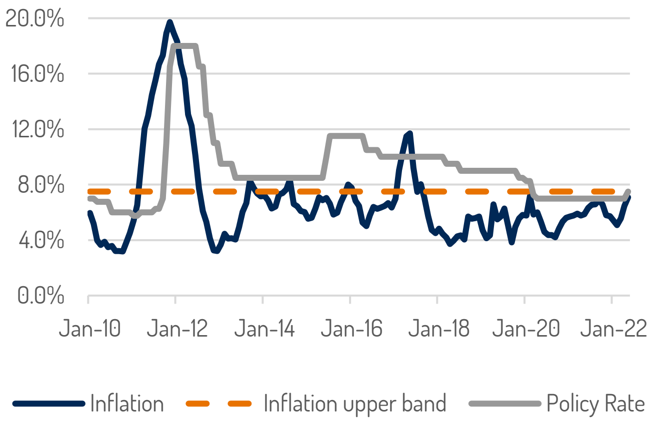
Modest hike suggests FOMO on CBK's part

The Central Bank of Kenya (CBK) delivered a surprise rate hike – the first in seven years. We opine that two schools of thought have emerged in reaction.

The first one is that the apex bank's action is telegraphing its fear of missing out, FOMO. The 50bps hike, is below the median 100bps delivered by the central banks in our Africa coverage universe during their maiden hike decision, in the course of this year. Inflation has run hot in a number of African economies, more so post Russia-Ukraine war, which necessitated aggressive hikes. Not so with Kenya, with inflation (May: 7.1%) within the 2.5% - 7.5% band and pretty much with cost-push flavour, knock-on effect of fuel and food inflation.

This camp thinks that inflationary pressures may cool off in the near-term, as the shocks ebb away. As such, the rate hike is interpreted to give the apex bank policy ammunition in the context that recessionary fears materialise. The current round of global rate tightening, is expected to tighten financial conditions, cooling off growth momentum. Thus, the Kenya decision, is not only joining the rate hike bandwagon but to give the central bank some wiggle room for the day of reckoning.

Kenya's inflation trend

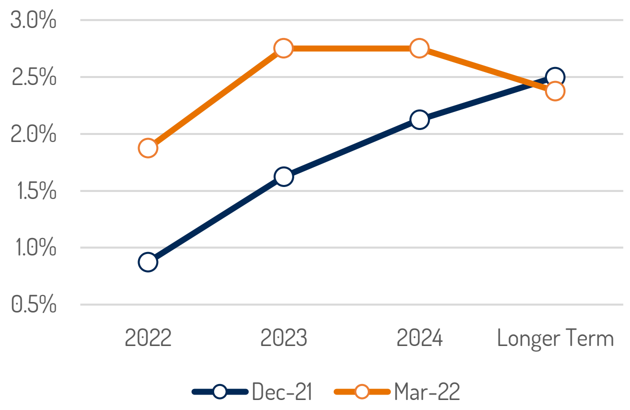


Source: Central Bank of Kenya (CBK), Kenya National Bureau of Statistics (KNBS)

The central bank does not entertain such thoughts, bringing us to the second school of thought. The central bank would like to err on the side of caution, pretty much to avoid the "Type II error" (error of omission). With inflation within the target band, the rate hike is to signal its intent of arresting the inflation genie before it gets out of the bottle. In recent history, the 2011 inflationary period comes to mind with a peak of 19.7%. History usually does not repeat itself, but it does rhyme.

Then, the policy action was staggered and lagged at the front-end of the inflationary shock and had to hike aggressively in the final quarter of the year. This is the exact history that the central bank wants to avoid repeating. Although inflation was in an upward flare in electioneering year 2017, it was broadly idiosyncratic cost-push, due to drought situation and thus the monetary policy was muted. The 2011 inflationary shock was a combined cost-push from external pressure (KES weakness from Eurozone debt concerns) and demand-pull (higher demand in the economy).

US Federal Reserve dot plot median projections



Source: Bloomberg

The inflation outlook may not be dire negative for the latter part of the year. For one, demand pressure as proxied by core inflation is expected to remain subdued with the ongoing election risk event. We expect a broad-based wait-and-see approach and recent Purchasing Managers Index (PMI) prints have signalled bearish sentiment from the private sector.

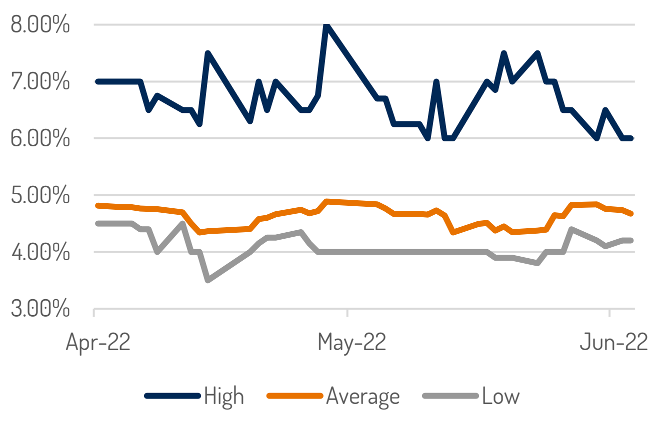
Food inflation is expected to trend lower as weather improves with the subsidy program, on the fiscal side, offering the Sisyphean task of holding fuel inflation from de-anchoring precariously. Thus, we do not expect further rate hikes by the CBK. Needless to say, the CBK needs to fortify its credibility following the rate hike. To be sure, apart from the front end of Kenyan credits (international) and rates (local), the markets' price action has been fairly quiet.

Three key issues need to be remedied by the central bank

First, the apex bank needs to go out on a limb with its inflation projections for end-2022.The market thinks the central bank has no informational advantage as to the inflation outlook in the near-term, and that's dangerous for a central bank that is pivoting fully into an inflation targeting regime. In the absence of the Bank's well-articulated inflation projection, the market is groping in the dark as to the future glide path of Kenya's tightening cycle. Thus, CBK really needs to stick its neck out, with this key metric, to sort of give forward guidance to its reaction function.

Secondly, the credit channel to ensure effective transmission of the monetary policy needs to be firmed up. Granted that growth to private sector has picked up momentum in a significant manner (April: 11.5%, a 71-month high), we think the momentum may continue as credit mediation is on cruise course in spite of tightened banking sector credit standards. To put into context, the current interbank regime has clearly separated winners and losers, what with the spread differential at an average 260bps (quarter-to-date) in the interbank market. The apex bank needs to operationalise the Central Securities Depository, to ensure a narrowing of interbank spreads and anchor the transmission channel of the monetary policy to the credit channels. Otherwise, the signalling effect (to cool off demand pressure by tighter financial conditions) is blunt.

Interbank market rates



Source: Central Bank of Kenya (CBK), Kenya National Bureau of Statistics (KNBS)

This brings us to the third issue, the elephant in the room: FX shortage. Anecdotal evidence, via news flow, is that the manufacturing sector is constrained to meet its FX demand needs with commercial banks rationing customer requests. Nonetheless, the apex bank chose the path of least resistance; the CBK governor tiptoeing around FX questions in the post-MPC briefing. The apex bank stated that FX monthly needs totals c. USD 2bn per month, but the rising import bill on account of runaway global commodity prices implies higher FX needs. Thus, failure to address the FX concerns may exacerbate the pass-through of imported inflation into the headline print. This should make 6month long USDKES NDF trade quite attractive, up until the point CBK addresses FX supply concerns.

Market action to take firm cues with CBK follow-up measures

The CBK needs to follow through its rate hike to enhance its credibility, otherwise we expect continued sideways trading in the local rates market. Despite the new 18-year infrastructure bond (auction held auction) averaging at 13.7%, clearly reflecting the rate hike, we expect a gradual adjustment on the current on-the-run papers.

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