FUNDAMENTALS

UGANDA MPC UPDATE: RECEDING INFLATION RISK NUDGES RATE PAUSE

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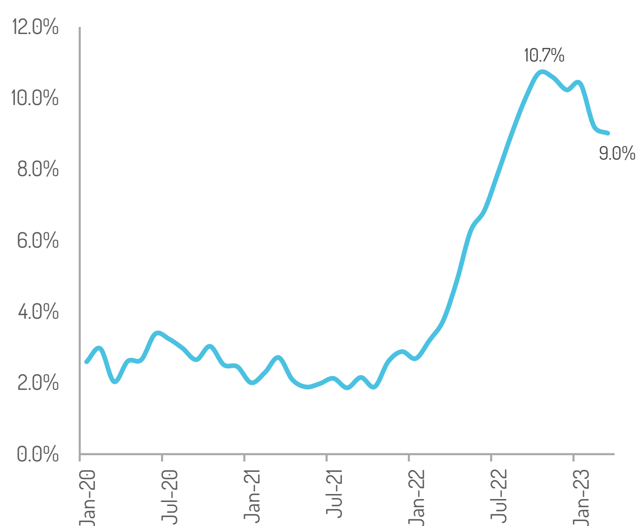
IN BRIEF

- The Bank of Uganda (BoU) maintained the Central Bank Rate (CBR) at 10.0% at its April MPC meeting. This was the third consecutive neutral policy stance after the apex bank front-loaded 350bps hike between July and October 2022.
- We have the sense that with a myriad of uncertainties clouding the inflation outlook, the policymakers opted not to include an explicit inflation guidance but a more general statement, "...inflation will continue decelerating and converge to the 5% target by the end of 2023". Not to lose the forest for the trees, the policymakers' reaction function suggests that inflation may have peaked.
- Compared with an expansion of 9.2% y/y in 3Q2022, real GDP growth moderated to 4.4% y/y in 4Q2022 on account of a decline in industrial output and deceleration in services output growth. The policymakers expect growth to be rangebound between 5.5% - 6.0% band until FY26, before reverting to its long-term trend of 7.0%.
- The Ugandan Shilling (UGX) has been stable (-0.7% YTD) with volatility easing compared to 2022 performance. FX reserves have remained steady at USD 3.6bn; down from USD 4.5bn in April 2022. Increased external debt servicing costs and a reversal of foreign portfolio flows have stifled build-up of the FX buffers.
- The FY23 supplementary budget is expected to be passed in Parliament later this week. With a continued shortfall in revenue outturn, the proposed UGX 3.0tn additional expenditure will result in a widening of the fiscal deficit from the base case.
- Yields have jumped 24bps YTD, on average, across the yield curve, more pronounced at the tail end. We anticipate yields to remain rangebound following the neutral policy rate decision and the reversal in the rally that played out between late 2022 into mid-Feb 2023. The expected passage of FY23 Supplementary budget with an upward tilt suggests investors will pencil in higher real rates in the remainder of the fiscal year, whereas disinflation outlook implies lower premium.

Rate pause largely expected

The Bank of Uganda (BoU) maintained the Central Bank Rate (CBR) at 10.0% at its April MPC meeting. This was the third consecutive neutral policy stance after the apex bank front-loaded 350bps hike between July and October 2022. With inflation on a downward trend YTD, the neutral rate decision did not come as a surprise. The March 2023 headline inflation printed at 9.0% y/y (Jan 2023: 10.4% y/y) with March core inflation also trending lower at 7.6% y/y. We have the sense that with a myriad of uncertainties clouding the inflation outlook, the policymakers opted not to include an explicit inflation guidance but a more general statement, "...inflation will continue decelerating and converge to the 5% target by the end of 2023". Not to lose the forest for the trees, the policymakers' reaction function suggests that inflation may have peaked.

INFLATION



SOURCE: UGANDA BUREAU OF STATISTICS, BANK OF UGANDA

Below-trend growth to be buoyed by oil projects

Real GDP growth came in at 4.4% y/y in 4Q2022, bringing 2022 real GDP growth at 6.3% y/y (2021: 5.6%). Compared with an expansion of 9.2% in 3Q2022, real GDP growth moderated in the final quarter of 2022 on account of a decline in industrial output and deceleration in services output growth. The policymakers expect growth to be rangebound between 5.5% - 6.0% band until FY26, before reverting to its long-term trend of 7.0%. Oil production, expected to come online from 2025, will anchor growth back to its long-term trend. Ugandan fiscal authorities are optimistic that following the resolution of the teething problems with the East African Crude Oil Project (EACOP) refinery site, the midstream segment of the project will be on track. In the interim, the cooling of political tensions in neighbouring Kenya gives Uganda some level of comfort on its trade sector. Nevertheless, Ugandan authorities have taken steps to hedge the spillover effect of Kenya's political risk by increased diversification of trade with Tanzania.

Steady FX, although we flag some fragile points

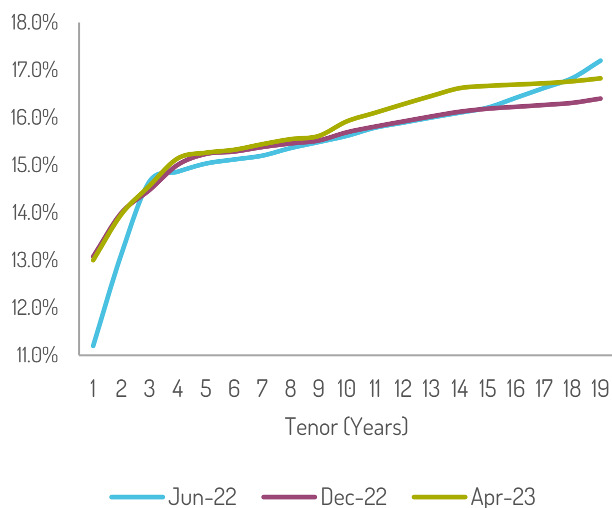
The Ugandan Shilling (UGX) has been stable (-0.7% YTD) with volatility easing compared to 2022 performance. FX reserves have remained steady at USD 3.6bn; down from USD 4.5bn in April 2022. External debt servicing costs have climbed from USD 500mn in FY22 to USD 900mn in the current FY23, denting FX reserve build-up. The silver lining has been the semi-annual disbursements from the IMF, with the next tranche disbursement of USD 122.0mn expected at end 2Q2023. With global central banks on a tightening cycle, this has, in turn, dampened the appetite of foreign portfolio flows to Ugandan rates market, and constrained the BoU's efforts to build up its external buffers. Currently, the risk-off sentiment has seen a pullback in foreign investors' holdings of local bonds from a peak of 15.0% to c. 8.0%. Furthermore, although Uganda has a better FX convertibility profile than some of its African peers, it is yet to tap the Eurobond market.

Nonetheless, Fitch Ratings flagged the dalliance towards external syndicated loan financing in FY23 may be constrained against the backdrop of tighter global financial conditions. The pivot towards external syndicated loan route – EUR 455mn from Standard Chartered Bank-led syndicate – was precipitated by the lower-than-expected domestic financing outturn in the first quarter of the current fiscal year. We believe recourse to external commercial funding will feature predominantly in future fiscal years, and as penciled in the FY24 proposed budget. As per our calculations, the current account deficit stood at 10.3% of GDP at the end of last year. Although the authorities are optimistic this will decline to an average of 7.4% in the next three years, the increased capex requirements for the oil projects coupled with OPEC+ decision to reduce oil supply implies additional pressure on the merchandize import bill.

FY23 Supplementary budget with an upward bias; Achilles heel

Fiscal deficit outturn in the first eight months of the fiscal year was better-than-targeted (UGX 6.0tn against UGX 6.8tn target). Revenue collection in the period missed its target by UGX 352.3bn; dragged down by the lower indirect domestic tax collections of excise duty and value-added tax. This suggests that the erosion of purchasing power that was prevalent in the first half of the fiscal year weighed down on these tax streams. In aggregate, revenues and grants fell short of its target by UGX 1.1tn. However, a lower-than-targeted expenditure by UGX 1.9tn resulted in a narrow fiscal deficit in the period. With yields in the rates market edging higher in tandem with BoU tightening, this had a negative spillover on the higher-than-expected domestic interest payments (UGX 2.9tn -vs- UGX 2.1tn target). The FY23 supplementary budget is expected to be passed in Parliament later this week. With a continued shortfall in revenue outturn, the proposed UGX 3.0tn additional expenditure will result in a widening of the fiscal deficit from the base case.

UGANDA YIELD CURVE



SOURCE: BANK OF UGANDA

Base case: rangebound trading in rates

The rates market has continued pricing concerns around the fiscal trajectory. Yields have jumped 24bps YTD, on average, across the yield curve, more pronounced at the tail end. The Bank of Uganda announced two consecutive bond switch auctions for the upcoming maturity of UGANGB 11.000% 2024 with an outstanding face value amount of UGX 1.7tn. Following the bond switch, the outstanding face value amount declined to UGX 1.0tn. We applaud these liability management steps taken by the central bank, but therein lies the underbelly. Notably, there has been a yield pickup in the subsequent tenors following the bond switch auctions; +109bps and +70bps on UGANGB 16.000% 2037 and UGANGB 18.500% 2042, respectively. That said, we anticipate yields to remain rangebound following the neutral policy rate decision and the reversal in the rally that played out between late 2022 into mid-Feb 2023. The expected passage of FY23 Supplementary budget with an upward tilt suggests investors will pencil in higher real rates in the remainder of the fiscal year, whereas disinflation outlook implies lower premium.

The Ministry of Finance published a framework around issuance and trading of infrastructure bonds. The broad features of the infrastructure bonds include tax exemption on interest income, a tenor of at least 25 years, and the bond proceeds will be applied towards viable infrastructure projects. The first infrastructure bond is expected to be issued in FY25. We believe that this specific instrument will rope back offshore investors who typically participate at the primary auctions and the tax-exempt status will juicy up their carry trade strategies. Secondary market turnover has declined from a daily average of USD 70.4mn in Dec 2022 to USD 34.3mn in March 2023. With c. 50.0% of the market activity driven by repo trades, we believe the neutral policy stance in the last three MPC meetings has slowed repo demand amongst primary dealers.

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