FUNDAMENTALS

KENYA MPC UPDATE: PAUSE… THEN MIC DROP

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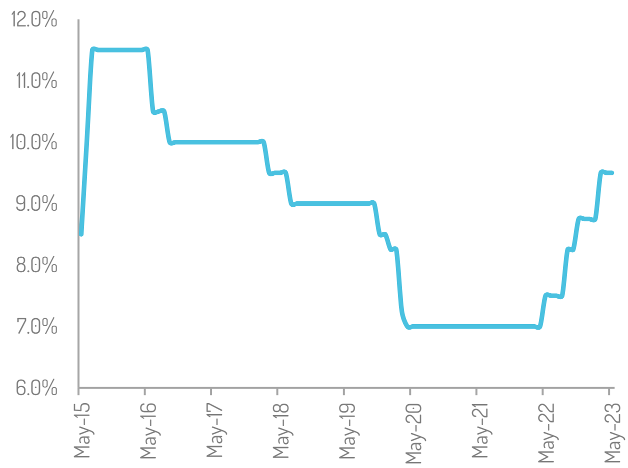
IN BRIEF

- As expected, the Central Bank of Kenya maintained the benchmark policy rate at 9.5% in its May 2023 MPC meeting. Amidst an expectation of inflation trending higher on the back of removal of fuel subsidies, the Committee was bullish on the positive offsetting factors.
- With private sector sentiment somewhat going off the boil in 1Q2023, the Committee baked in a weaker 5.1% growth in the quarter (1Q2022: 6.3%). The Composite Purchasing Managers Index (PMI) averaged 49.3 points in the first quarter of 2023, signaling some contraction in private sector activity.
- All in all, the Committee's tone was ambivalent on the growth outlook. Two Committee surveys ahead of its policy meeting pointed to some optimistic outlook but this sentiment was moderated by "*concerns about the proposed increase in taxation, rise in electricity and fuel prices, and the weakening of KES*".
- Amidst the continued weakness of KES, we applaud the impact of restoration of FX interbank market that has resulted in a narrowing of quoted FX spreads between the official and retail rates. Nevertheless, we expect that FX pressure will rear its ugly head in August - September 2023 as the authorities honour the USD-settlement leg of the recently implemented government-to-government oil importation deal.
- Notwithstanding the expected external financing from multilateral institutions, the domestic financing outturn has not been satisfactory. Domestic borrowing outturn is at KES 251.4bn; 59.1% of the target with one month remaining in the current fiscal year.
- There is a Pavlovian expectation embedded following the twin TAP Sales that accompanied this month's 3-year primary bond sale. We think the authorities will not follow through with a TAP Sale(s) in next month's primary bond sale. We expect outsized appetite for the 7-year infrastructure bond that the authorities will mop up.

Dr. Patrick Njoroge: Con te partiro

As expected, the Central Bank of Kenya maintained the benchmark policy rate at 9.5% in its May 2023 MPC meeting. Amidst an expectation of inflation trending higher on the back of removal of fuel subsidies, the Committee was bullish on the positive offsetting factors. Furthermore, the Committee maintained the policy rate as the lagged effect of the previous 250bps filters through the economy. The May 2023 MPC was the final policy meeting chaired by Governor Dr. Patrick Njoroge. We expect Dr. Kamau Thugge to be named the new Governor in mid-June 2023, following his vetting and approval by the National Assembly.

POLICY RATE UNDER DR. NJOROGE'S TENURE



SOURCE: CENTRAL BANK OF KENYA

Removal of fuel subsidy to lift inflation outlook although food and subdued global fuel price should give moderating effect

May 2023 inflation report is due to be released later today and was not in consideration ex-post at the policy meeting deliberations. April 2023 inflation backpedaled to 7.9%, majorly on retreating food inflation (32.9% weighting in the CPI basket). Nevertheless, the complete removal of the fuel subsidy may give inflation some upside risks. The monthly fuel price review as regulated by the Energy & Petroleum Regulatory Authority lifted the subsidy on diesel and kerosene, in line with the authorities' commitment in the current IMF programme. Although not the policy metric, we majorly see upside risk on Nairobi low-income inflation as the biggest price increment following the removal of subsidy affected Kerosene, hitherto subsidized by Petrol.

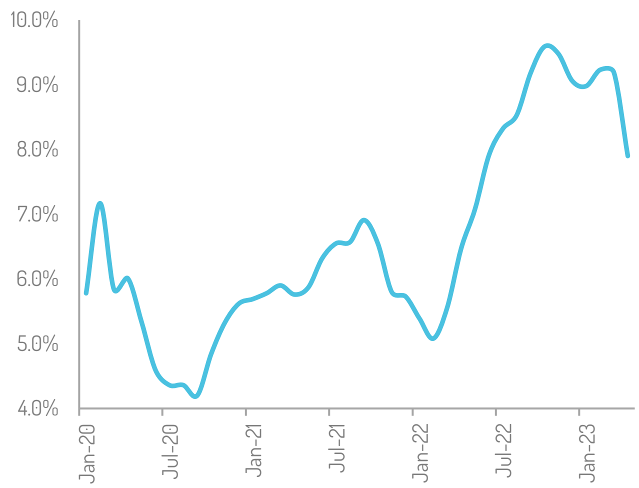
The proposed doubling in the fuel VAT to 16.0% as contained in the Finance Bill 2023, if adopted by the National Assembly, may lift off inflation outlook and expectations. This notwithstanding, the Committee expects the ongoing long rains to boost food harvest and contain food inflation while lower global energy prices will offset potential inflationary pressures in the economy. Fiscal support to boost supplies of key commodities through duty-free window is also expected to put a lid on food inflation. We believe the deceleration in core inflation to 4.1% in April 2023 convinced the Committee that the previous rate hikes are cooling the economy.

Softening private sector sentiment to weigh down growth outturn

With private sector sentiment somewhat going off the boil in 1Q2023, the Committee baked in a weaker 5.1% growth in the quarter (1Q2022: 6.3%). The Composite Purchasing Managers Index (PMI) averaged 49.3 points in the first quarter of 2023, compared with 50.9 points in 4Q2022, signaling some contraction in private sector activity. Although we take a cautious view of PMI's predictability prowess on growth, gleaning from the released data gives us the gut feel that 1Q2023 growth will indeed surprise to the downside. While VAT revenue outturn grew by 5.7% in the first quarter of 2023, adjusting by the average 9.1% inflation suggests anemic private sector consumption.

All in all, the Committee's tone was ambivalent on the growth outlook. Two Committee surveys ahead of its policy meeting painted a bullish outlook with findings that "*revealed improved optimism about business activity and economic growth prospects for the next 12 months*". The uptick in private sector credit growth to a 6-month high of 13.2% reinforces this view. Nevertheless, this positive tone was softened by "*concerns about the proposed increase in taxation, rise in electricity and fuel prices, and the weakening of KES*". We would like to incline towards the glass-is-half-empty as we believe the negative offsetting factors will shift sentiment lower. As such, we expect 2Q2023 growth of 4.5% - 5.0%, compared with 5.2% print in 2Q2022.

INFLATION

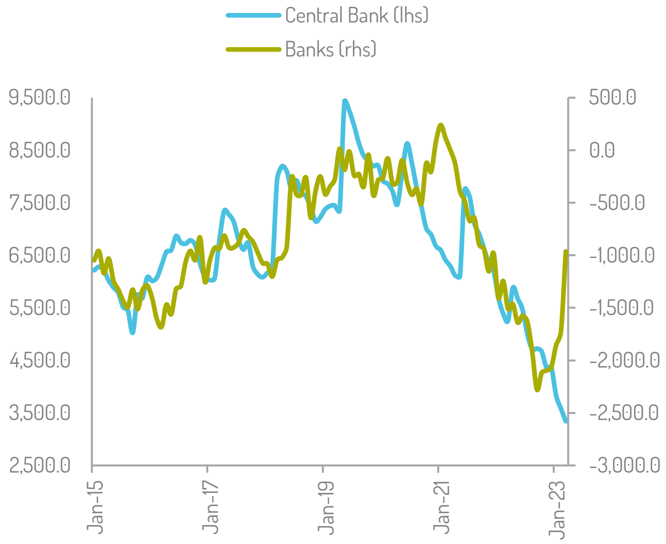


SOURCE: KENYA NATIONAL BUREAU OF STATISTICS

External financing flows to boost FX Reserves

We expect pressure on the Kenya Shilling (KES), which has shed off 10.9% YTD. Net foreign liability position in the banking sector improved from USD 2.1bn in December 2022 to USD 962.4mn in March 2023. However, this reflects the impact of the restoration of the FX interbank market. KES weakened 4.3% QTD, implying a widening of the net foreign liability position in the banking sector in May 2023. Amidst the continued weakness of KES, we applaud the impact of restoration of FX interbank market that has resulted in a narrowing of quoted FX spreads between the official and retail rates. Nevertheless, we expect that FX pressure will rear its ugly head in August - September 2023 as the authorities honour the USD-settlement leg of the recently implemented government-to-government oil importation deal. Although the Committee struck a positive note about the narrowing of the current account deficit, the signal in the noise implies some demand compression impact. Normalization of the demand, more so with the upcoming USD settlement of the oil importation deal, may dial upwards KES pressure at the tail end of the year.

NET FOREIGN ASSETS, USD MN'S



SOURCE: CENTRAL BANK OF KENYA, ICAMMU CALCULATIONS

FX reserves outlook is promising from the current depressed levels, boosted by the incoming external financing this fiscal year. The World Bank approved the USD 1.0bn Development Policy Operation (DPO) facility back on the heels of the USD 300.0mn Afreximbank syndicated loan. The disbursement of these external finances should lift FX reserves to c. USD 7.5bn and above the 4-month import cover threshold. Against our expectation, the IMF disbursement of c. USD 300.0mn will be disbursed in July 2023, rather than June 2023. Nevertheless, the Staff Level Agreement penciled in an augmented access of USD 544.3mn, in addition to a planned new Resilience and Sustainability Facility that could unlock up to USD 1.0bn additional financing until April 2025.

Cloudy domestic financing; flatter yield curve

Notwithstanding the expected external financing from multilateral institutions, the domestic financing outturn has not been satisfactory. Domestic borrowing outturn is at KES 251.4bn; 59.1% of the target with one month remaining in the current fiscal year. The domestic financing outturn tees up the odds of a further Moody's downgrade as they flagged off domestic financing constraints. Tax revenue outturn in the first ten months has also underwhelmed at a run rate of 89.5%. Nevertheless, we maintain the view that a contractionary Supplementary FY23 budget will be introduced this coming month to deflate the domestic funding gap pressures.

The fiscal risk has seen a lowering in duration in the local rates market. The bid-to-cover ratio of 1.0x for the 91-day T-bills belies the massive 5.0x demand by investors for the shorter-duration discounted securities. From a supply perspective, the fiscal agent has opted to issue a new-year 7-year infrastructure bond in its last issuance this fiscal year. Infrastructure bonds are preferred by investors due to their tax-free appeal and we believe the KES 60.0bn target will be met. There is a Pavlovian expectation embedded following the twin TAP Sales that accompanied this month's 3-year primary bond sale. We think the authorities will not follow through with a TAP Sale(s) on this primary bond sale as we expect outsized appetite for the 7-year infrastructure bond that the authorities will mop up.

The news flow has telegraphed an outsized level of pushback to some of the proposals contained in the Finance Bill 2023, exerting pressure on FY24 revenue mobilization. MPs allied to the ruling Kenya Kwanza government, with a slight majority in Parliament, have shown a firm commitment to push through the Finance Bill despite the misgivings in the public participation phase. The Finance Committee is expected to table its recommendations on the Bill in the coming week upon resumption from the month-long recess.

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