KENYA | MACROECONOMIC UPDATE | MONETARY POLICY | INSIGHTS

FUNDAMENTALS

KENYA MPC UPDATE: LITMUS TEST TO THE POLICY CUT

Economist
Churchill Ogutu
+254 711 796 739
churchill.ogutu@ic.africa

IN BRIEF

- The Central Bank of Kenya (CBK) lowered the Central Bank Rate (CBR) by 25bps to 12.75% in its August 2024 MPC meeting and in line with our overall cut expectation. With inflation having trended to comfort levels and a stable exchange rate, the downward calibration of the policy rate is more than welcome.

- Inflation is expected to remain anchored below the mid-point target of 4.5% in the short-term horizon. The July 2024 headline inflation extended the disinflation trend that has played its course this year. Going forward, stability of the exchange rate, improved food supply and lower fuel prices will act as anchors to a low and steady inflation environment.

- The CBK emphasized that there has been no intervention to support KES against the US dollar, with the stability in FX reserves. This notwithstanding, it is of importance to note that FX interbank trading volumes has normalized post the outsized levels witnessed in February-March 2024 period.

- Noticeably, there has been a preference to fund banks' liquidity position via reverse repo by the CBK, as opposed to horizontal repo transactions between banks even with the introduction of the Central Securities Depository. This year, the average 7-day reverse repo daily volume has been KES 34.2bn against KES 1.5bn in horizontal repo transactions. We opine that this should reverse gradually as the CBK implements rate cuts in this easing cycle.

- With domestic financing outturn in FY24 at KES 589.6bn, our expectations are that rates will chart a downtrend this FY25 with a much lower domestic borrowing target of KES 412.8bn. The authorities expect the rate cut, and subsequent easing, to bring domestic yields lower. Higher concessional financing, from bilateral and/or multilateral sources, should it come to fruition will also reduce FY25 domestic borrowing target and sustain the interest rate decline.

First cut since April 2020 MPC meeting

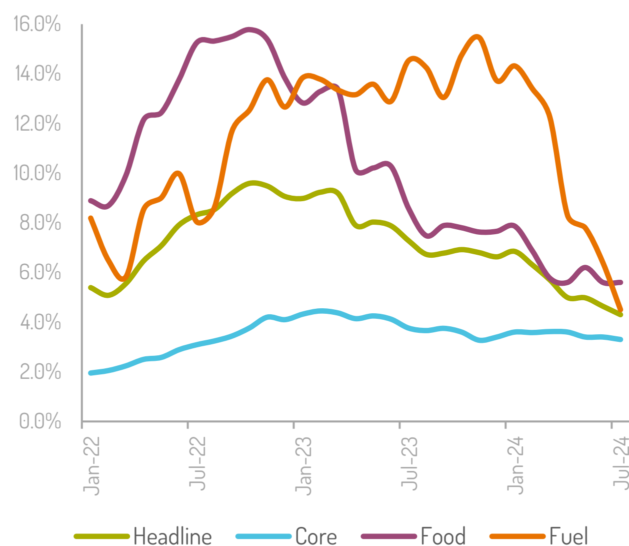
The Central Bank of Kenya (CBK) lowered the Central Bank Rate (CBR) by 25bps to 12.75% in its August 2024 MPC meeting and in line with our overall cut expectation. This was the first cut decision since the lowering of the policy rate at the start of the COVID-19 era. With inflation having trended to comfort levels and a stable exchange rate, the downward calibration of the policy rate is more than welcome. Furthermore, with the US Federal Open Market Committee (FOMC) expected to cut rate in its September 2024 meeting, this gave the policymakers the much-needed resolve to act decisively in the MPC meeting. Nevertheless, the policymakers see an upside risk from geopolitical conflict, more so the ongoing Middle East tension. From our assessment of the post-MPC briefing, the MPC largely expects an orderly transmission of the lower policy rates to lending and rates environment, the latter further supported by the lower domestic financing requirements in FY25. The MPC was silent on the succession of the four external members in the nine-member Committee whose term is coming to an end next month. A longstanding issue from Kenya's MPC architecture that bar the Governor and Deputy Governor, there has been a loud silence by the other Committee members regarding monetary policy formulation. As such, this leaves us agnostic on the eventual successor MPC members' picks.

Favourable inflation outlook in the near-term horizon

Inflation is expected to remain anchored below the mid-point target of 4.5% in the short-term horizon. The July 2024 headline inflation extended the disinflation trend that has played its course this year. Going forward, stability of the exchange rate, improved food supply and lower fuel prices will act as anchors to a low and steady inflation environment. A disaggregation of the July 2024 inflation shows that core print remained subdued at 3.3%, and down from a recent peak of 4.5% in February 2023. Downward adjustments in pump prices and electricity prices, together with lower transportation costs impacted positively on fuel inflation. Refreshingly, although the authorities implemented a 39.0% hike in the Road Maintenance Levy, charged on consumption of petrol and diesel fuel products, the lower landed cost cushioned consumers positively.

Vegetable inflation (6.1% CPI weighting) more than offset the decline in the non-vegetable inflation (26.8% CPI weighting), resulting in food inflation remaining steady at 5.6% y/y in July 2024. Supply of key vegetables was negatively impacted by the excessive rains and floods experienced in April and May 2024 period, but we trim the negative impact from this disruption going forward. Non-vegetable inflation has decelerated markedly from 3.1% y/y in July 2023 to -1.1% y/y in last month's print, driven down by lower commodity prices for maize, wheat, milk and edible oils. Improved sugar supply from India and Thailand has resulted in the commodity's price outturn, from a peak of 63.6% y/y in July 2023 to -22.3% y/y in July 2024.

INFLATION TREND



SOURCE: KENYA NATIONAL BUREAU OF STATISTICS, CENTRAL BANK OF KENYA

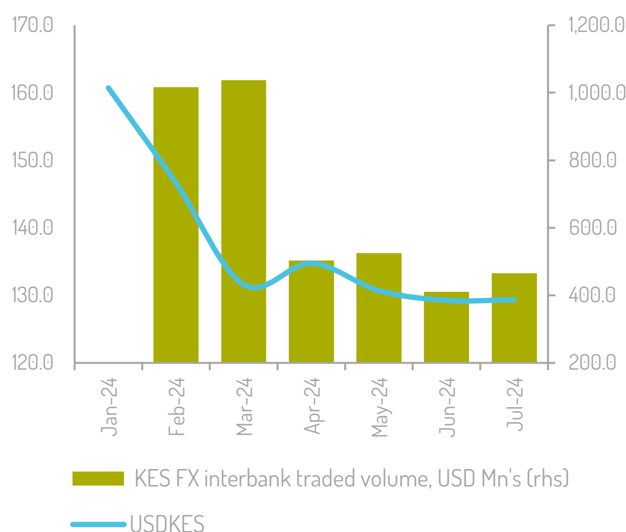
Low FX liquidity in the interbank market belies KES stability

Notwithstanding the improved export growth and higher remittance flows in the first 6months this year, the stronger KES that has appreciated 21.5% YTD should see a pickup in imports and widen current account deficit from the monetary authorities' expectation of 4.0% at year-end. FX reserves remain perched at USD 7.3bn, or 3.8months of import cover, supported by the multilateral inflows at the tail end of FY24 budget. We expect a cumulative USD 2.6bn disbursement from the World Bank and the IMF in FY25, although the actual disbursement following the approval of the imminent IMF seventh review later this month remains uncertain. The monetary authorities are nonetheless optimistic that Kenya will complete the remainder of the IMF programme, unlocking USD 1.4bn, although the successor programme is yet to be discussed at this point.

The CBK emphasized that there has been no intervention to support KES against the US dollar, with the stability in FX reserves. This notwithstanding, it is of importance to note that FX interbank trading volumes has normalized post the outsized levels witnessed in February-March 2024 period. Put differently, unless we see outsized FX interbank trading volumes, we expect stability in USDKES at 129 – 131/USD levels as has been the case from May 2024-to-date. With volumes traded at the FX interbank at USD 282.3mn in the July 25 to-date period, coinciding with this month's sale of the two re-opened infrastructure bonds, this does not suggest to us a possibility of a repeat of further KES appreciation past current level, as was the case in February 2024

amidst a backdrop of the 8.5year infrastructure bond issuance. Furthermore, sentiment has shifted negatively on the back of the Finance Bill 2024 withdrawal and the subsequent downgrades by Moody's and Fitch Ratings.

KES SPOT AND FX INTERBANK TRADED VOLUME



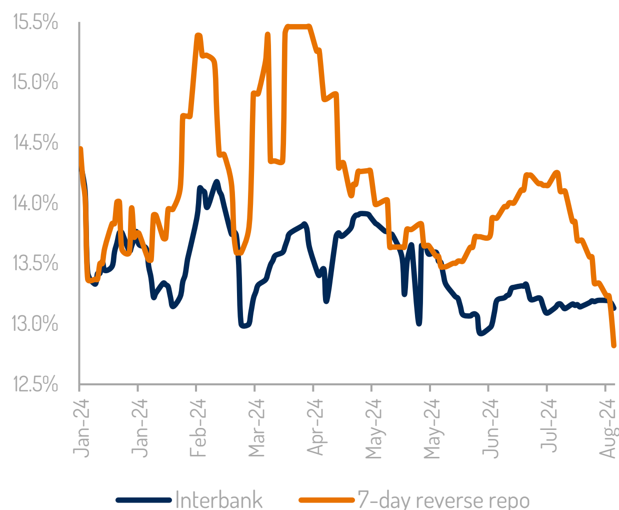
SOURCE: BLOOMBERG

Adjustments of key metrics and reverse repo usage reveals KES liquidity strains

Prior tightening of the monetary policy between December 2023 through February 2024 constrained growth in M3 money supply and private sector credit to 6.0% and 4.0%, respectively, in June 2024. For private sector credit, the CBK noted that LCY loans grew by 10.2% y/y whereas the stock of KES-equivalent FCY loans declined by 13.3% y/y in June 2024, largely on KES appreciation effect. Adjusted for exchange rate impact on FCY deposits and FCY loans, M3 money supply and private sector credit grew by 7.5% and 6.6%, respectively.

Noticeably, there has been a preference to fund banks' liquidity position via reverse repo by the CBK, as opposed to horizontal repo transactions between banks even with the introduction of the Central Securities Depository. This year, the average 7-day reverse repo daily volume has been KES 34.2bn against KES 1.5bn in horizontal repo transactions. We understand that the aversion towards horizontal repo uptake has been due to the lack of actual transfer of beneficial ownership of the underlying securities for purposes of such transactions, leaving sell-buy back transactions as a viable alternative. Thus, reverse repo transactions with the apex bank remain the preferred choice of liquidity interventions in the banking system amidst higher deposit rates. We opine that this should reverse gradually as the CBK implements rate cuts in this easing cycle.

INTERBANK AND 7-DAY REVERSE REPO RATES



SOURCE: CENTRAL BANK OF KENYA, BLOOMBERG

Lower domestic financing target in FY25 justifies lower rate environment but secondary market trading of the August 2024 re-opened bonds offers some cautionary tale

With domestic financing outturn in FY24 at KES 589.6bn, our expectation is that rates will chart a downtrend this FY25 with a much lower domestic borrowing target of KES 412.8bn. The authorities expect the rate cut, and subsequent easing, to bring domestic yields lower. Higher concessional financing, from bilateral and/or multilateral sources, should it come to fruition will also reduce FY25 domestic borrowing target.

The CBK downplayed concerns of low subscriptions hitherto in this fiscal year. However, the Pavlovian conditioning of re-opening of two infrastructure bonds – KENIB 17.9327% 2030 and KENIB 14.3990% 2039 – suggests an inclination to meet the financing quota amidst the revenue strains following the withdrawal of the Finance Bill 2024 and the recent Court of Appeal decision nullifying Finance Act 2023. These two papers have registered yields of 19.35% and 19.25%, respectively, at the secondary market during the ongoing sale, although it can be argued that these elevated yields have been witnessed on odd lots that trade below KES 50.0mn. If anything, these two papers have been illiquid, unlike liquidity for the on-the-run KENIB 18.4607% 2032, cementing expectation of some discounted pricing during next week's auction. Amidst the MPC's rate cut, we opine that this month's primary auction will provide a key litmus test as to whether the market is persuaded by the latest monetary policy decision.

For more information contact your IC representative

Business Development & Client

Derrick Mensah
Head, Business Development
+233 24 415 5765
derrick.mensah@ic.africa

Kelvin Quartey
Analyst, Business Development
+233 57 604 2802
kelvin.quartey@@ic.africa

Dora Youri
Head, Wealth Management
+233 23 355 5366
dora.youri@ic.africa

Corporate Access

Joanita Hotor
Corporate Access
+233 50 137 6100
joanita.hotor@ic.africa

Insights

Courage Kingsley Martey
Head, Insights
+233 240 970 832
courage.martey@@ic.africa

Churchill Ogutu
Economist
+254 711 796 739
churchill.ogutu@ic.africa

Emmanuel Dadzoe
Analyst, FMCG, OMC, Telecoms
+233 30 825 0051
emmanuel.dadzoe@ic.africa

Investing

Isaac Adomako Boamah
Chief Investment Officer
030 225 2623
isaac.boamah@ic.africa

Obed Odenteh
Portfolio Manager, Fixed Income
+233 54 707 3464
obed.odenteh@ic.africa

Timothy Schandorf
Portfolio Manager, Risk Assets
+233 24 292 2154
timothy.schandorf@ic.africa

Herbert Dankyi
Portfolio Manager
+233 55 710 6971
herbert.dankyi@ic.africa

Clevert Boateng
Analyst, Risk Assets.
+233 24 789 0452
clevert.boateng@ic.africa

Operations

Nana Amoa Ofori
Chief Operating Officer
+233 24 220 6265
nanaamoa.ofori@ic.africa

Emmanuel Amoah
Fund Administrator
+233 20 847 2245
emmanuel.amoah@ic.africa

Kelly Addai
Fund Accountant
+233 20 812 0994
kelly.addai@ic.africa

Trading

Randy Ackah-Mensah
Head, Global Markets
+233 24 220 6265
randy.mensah@ic.africa

Allen Anang
Trader, Equities
+233 54 084 8441
allen.anang@ic.africa

Daniel Asante
Trader, Fixed Income
+233 55 285 7164
daniel.asante@ic.africa

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