

15th May 2018

Rising oil prices to tee-up 2018 inflation expectations

Oil prices and inflation are known to have a positive correlation in Kenya. The cause-effect relationship is on two fronts; directly through higher pump prices and production costs and indirectly through the effect of US dollar pricing given petroleum imports account for nearly 15% of the country's import bill

The recent surge in global oil prices thus presents a significant upward risk to inflation. Brent crude oil prices have surged to \$78 a barrel, representing a 51.90% increase over the same period last year.

The surge in prices has been linked to continued supply rebalancing by OPEC which has significantly reduced the glut in the market. Prices have been further anchored by US' withdrawal from the Iran Nuclear Deal which has raised prospect of further reduction in global oil supply. Thus far, risks from the steady increase in supply from US shale and potential unwinding of OPEC production cuts seems tame, for now.

The latest pump price review by the Energy Regulatory Commission (ERC) underlines this emerging risk. A litre of petrol, diesel and kerosene will this month retail at an average of KES 109.17, KES 100.74 and KES 80.30 respectively. This represents an annualized price increase of 7.44%, 11.72% and 19.17% in the same order.

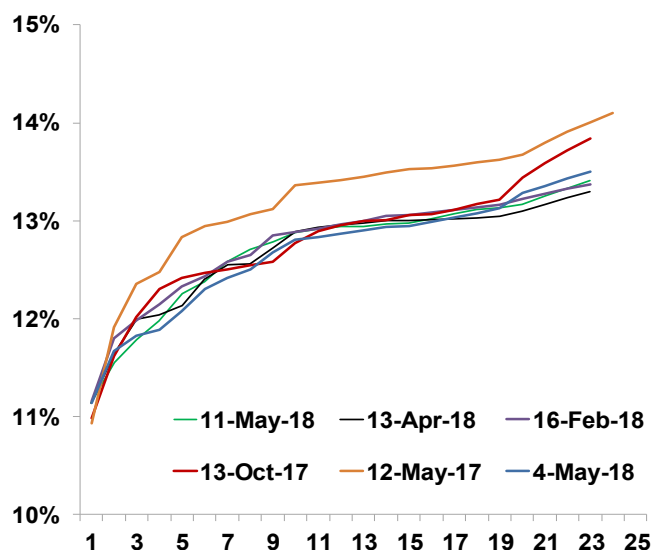
The surging oil prices will support higher inflation in the second half of the year. The pent-up inflation outlook is further supported by risks from a declining base and a relatively stronger US dollar. This could see inflation rise to the upper band of the inflation target band in the second half of the year with potential to overshoot the upper limit in the last quarter of the year.

The prospect of higher inflation could once again elicit interest in the potential policy response given the growing need to plug the current output gap. Given inflation remains the CBK's core objective, rising inflation expectations could limit scope for further easing.

| Indicative Rates | Previous | Current | Change bps |
|------------------|----------|---------|------------|
| Avg Overnight | 4.978% | 4.588% | -39.00 |
| 91-Day T-bill | 7.974% | 7.967% | -0.70 |
| 182-Day T-bill | 10.269% | 10.265% | -0.40 |
| 364-Day T-bill | 11.145% | 11.141% | -0.40 |
| Inflation | 4.18% | 3.73% | -45.00 |
| USD/KES | 100.29 | 100.43 | 0.14% |

Source: Central Bank of Kenya

NSE yield curve



Source: Nairobi Securities Exchange

Government maturities and coupon payments

| Month | KES (Bn) |
|---------------------------|----------|
| 14-May-18 | 17.94 |
| 21-May-18 | 60.47 |
| 28-May-18 | 21.64 |
| 18-Jun | 101.73 |
| New Cumulative Borrowing | 279.60 |
| Domestic Borrowing Target | 275.80 |

Source: Bloomberg

Financial News



While bond markets consider inflation expectations in pricing of the securities, the impact on the yield curve is likely to be limited. The atypical relationship reflects primarily the current heavy liquidity in the market amid thin investment options in the market. Preference for government securities has kept yields on government papers fairly low despite heavy government borrowing.

Government surpasses its 2017/18 domestic debt target

The government may once again this year exceed its local borrowing target as it seeks to plug the widening gap between expenditure and revenues. So far, Treasury has absorbed KES 279.60Bn from the market, KES 3.80Bn above this fiscal year's target.

That said, the recent appetite for local debt has been underscored by the need to redeem the upcoming heavy government debt maturities amounting to KES 183.85Bn to the end of this fiscal year. Last week, CBK absorbed KES 36.26Bn from the T-bill sale against a target of KES 24.00Bn.

Next week, Treasury will auction a 15 year bond (FXD/2018/15) for a total of KES 40.00Bn. This will partly re-finance KES 32.28Bn in bond maturities. Increased uptake could push borrowing towards KES 300Bn. The bond carries a coupon of 12.65%. In view of recent auction dynamics, the yield on the paper is unlikely to considerably deviate from the current implied yield of 12.98%. Even so, higher inflation expectations and the less attractive tenor could see investors demand a deeper discount on the issue.

Yields on T-bills were barely changed across the tenors. The 91, 182 and 364 day papers auctioned at 7.967% (Down 0.70bps), 10.265% (Down 0.40bps) and 11.141% (Down 0.40bps) for the respectively.

Weekly T-bill Auction Results

| | 91-Day | 182-Day | 364-Day |
|---------------------|--------|---------|---------|
| Yield | 7.967% | 10.265% | 11.141% |
| Change (Bps) | -0.7 | -0.4 | -0.4 |
| Amount Offered (Bn) | 4.00 | 10.00 | 10.00 |
| Bids Received (Bn) | 4.83 | 15.08 | 19.84 |
| Performance (%) | 120.79 | 150.80 | 198.43 |
| Amount Accepted | 4.75 | 12.49 | 19.02 |
| Bid Cover | 1.02 | 1.21 | 1.04 |
| Redemption (Bn) | 2.03 | 5.27 | 10.55 |
| New borrowing (Bn) | 2.71 | 7.23 | 8.47 |

Source: Central Bank of Kenya

Regional Equities Market

| | 04.05.18 | 11.05.18 | Wow (%) |
|----------|----------|----------|---------|
| NSE- 20 | 3,699.78 | 3,602.33 | -2.63% |
| NASI | 179.36 | 176.74 | -1.46% |
| NSE- 25 | 4,689.24 | 4,651.04 | -0.81% |
| USE ASI | 2,168.97 | 2,198.96 | -1.38% |
| DSEI | 2,428.30 | 2,421.84 | -0.27% |
| TSI | 4,149.13 | 4,160.32 | 0.27% |
| RSE ALSI | 133.30 | 133.07 | -0.17% |

Source: Regional Stock Exchanges

Equities stocks move lower on Safaricom profit taking

The equities market extended the recent downward trend weighed down by profit taking on Safaricom. All indices closed in the red with the NSE-20, NASI and NSE-25 declining by 2.63%, 1.46% and 0.81% lower, respectively.

Activity was however robust with turnover increasing to KES 5.47Bn from KES 3.61Bn in the previous week. Activity was equally distributed between foreign and local investors.

Foreign investors remained net sellers withdrawing USD 5.94Mn compared to the USD 13.68Mn in the previous week. Expectations of higher interest rates coupled with bullish equity markets in the US have seen increased sell off in emerging and frontier market equities.

Regional Market

| Period to (2018) | UGANDA | | TANZANIA | | RWANDA | |
|------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| | Apr 27 th | May 11 th | Apr 20 th | May 04 th | May 04 th | May 11 th |
| 91 Days T-Bill | 8.716% | 8.743% | 1.96% | 1.96% | 5.312% | 5.409% |
| 182 Days T-Bill | 9.306% | 9.405% | 2.96% | 2.67% | 6.095% | 6.633% |
| 364 Days T-Bill | 9.773% | 9.865% | 4.38% | 4.12% | 6.600% | 6.600% |
| Interbank O/N | 5.47% | 5.31% | 1.26% | 1.61% | 5.50% | 5.50% |
| CBR/CRR/ Key Repo Rate | 9.00% | 9.00% | 8.00% | 8.00% | 5.50% | 5.50% |

Source: Bank of Uganda, Bank of Tanzania, National Bank of Rwanda

Uganda

After pairing back some of its losses earlier in the week, the shilling was once again set on the back foot by renewed demand from the manufacturing sector later in the week. The shilling slipped to 3712/3722 at the end of the week from the opening levels of 3708/3718. At the same time, supply remained somewhat mute. The unit could remain somewhat fragile as demand picks up with increased government payments towards the end of the current fiscal cycle.

Meanwhile, heavy liquidity continued to place pressure on interbank rates with the overnight rate ending the week 142bps lower at 5.31%. The Central Bank mopped up UGX 853Bn in excess liquidity via repos and deposit auctions at an average rate of 9.00% and 9.39% respectively.

Relatedly, the week's Treasury bill auction was oversubscribed with the fiscal agent receiving UGX 299.16Bn in bids for the UGX 175Bn worth of papers. Despite the heavy liquidity, yields edged higher to 8.743% (Up 2.70bps), 9.405% (Up 9.90bps) and 9.865% (Up 9.20bps) for the 91, 182 and 364 day papers respectively. The pressure on yields is mostly attributed to increased borrowing by the government.

Tanzania

The Tanzania shilling was marooned in tight ranges with balanced activity on demand and supply counters. The shilling was quoted a shilling lower at 2276/2286 at the close of trading on Friday. The shilling is expected to remain relatively stable albeit with a weakening bias undermined by a widening current account deficit.

Interbank liquidity tightened somewhat during the week with overnight cost of funds edging 10bps higher to 1.62%. The Central Bank sought to mop up TZS 40.00Bn from the market but only received and accepted TZS 20.00Bn in bids via a 14-day repo at 2.50%.

Meanwhile, the oversubscribed 7-year Treasury bond auction attracted TZS 113.46Bn in bids against TZS 100.20Bn that was on offer and that was accepted. The yield on the bond declined to 12.226% (Down 73.21bps).

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Kenya Government Debt Maturities (KES Bn)

| | Issuer | Amount Outstanding | Principal | Interest |
|--------------------|--------------------------------------|--------------------|---------------|--------------|
| | 7-May-18 Treasury Bill | 18.81 | 18.81 | |
| | 14-May-18 Treasury Bill | 17.94 | 17.94 | |
| | 21-May-18 Treasury Bill | 23.91 | 23.91 | |
| | 21-May-18 FXD2/2016/2 | 58.64 | 58.64 | |
| | 28-May-18 Treasury Bill | 21.64 | 21.64 | |
| | Treasury Bond-Coupon Payments | | | 17.01 |
| MAY 2018 | | 140.94 | 140.94 | 17.01 |
| | 4-Jun-18 Treasury Bill | 21.46 | 21.46 | |
| | 11-Jun-18 Treasury Bill | 17.01 | 17.01 | |
| | 18-Jun-18 Treasury Bill | 15.88 | 15.88 | |
| | 25-Jun-18 Treasury Bill | 19.46 | 19.46 | |
| | 25-Jun-18 FXD2/2013/5 | 26.43 | 26.43 | |
| | Treasury Bond-Coupon Payments | | | 19.96 |
| JUNE 2018 | | 100.24 | 100.24 | 19.96 |
| | 2-Jul-18 Treasury Bill | 12.62 | 12.62 | |
| | 9-Jul-18 Treasury Bill | 15.63 | 15.63 | |
| | 16-Jul-18 Treasury Bill | 11.95 | 11.95 | |
| | 16-Jul-18 FXD2/2008/10 | 13.50 | 13.50 | |
| | 23-Jul-18 Treasury Bill | 8.47 | 8.47 | |
| | 30-Jul-18 Treasury Bill | 20.79 | 20.79 | |
| | Treasury Bond-Coupon Payments | | | 9.48 |
| JULY 2018 | | 100.25 | 100.25 | 9.48 |
| | 6-Aug-18 Treasury Bill | 14.00 | 14.00 | |
| | 13-Aug-18 Treasury Bill | 20.43 | 20.43 | |
| | 13-Aug-18 FXD1/2006/12 | 3.82 | 3.82 | |
| | 20-Aug-18 Treasury Bill | 22.83 | 22.83 | |
| | 27-Aug-18 Treasury Bill | 20.51 | 20.51 | |
| | Treasury Bond-Coupon Payments | | | 9.42 |
| August 2018 | | 81.60 | 81.60 | 9.42 |

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