Recovery Amidst Easing Inflation

During Q3'23 the ongoing economic recovery faced persistent challenges exacerbated by spill-over effects from 2022 which led to slower global growth and increasing domestic interest rates. Globally, inflation in advanced economies continued to ease during the year driven by a decline in commodity prices and easing supply chain costs. The continued strengthening of the dollar and reduced dollar inflows have contributed to further weakening of the shilling against the dollar creating a challenging business environment. We anticipate local economic growth will remain hampered by elevated interest rates, inflationary pressures and continued depreciation of the shilling.

- **Inflation Eases:** Headline inflation during the quarter decreased to an average of 6.93% from 8.67% in Q3'22 primarily driven by the decrease in food inflation. The food inflation index decreased to an average of 8.00% compared to 15.37% over a similar period in 2022, attributable to favorable weather conditions and ongoing harvests which has led to a decline in prices of key food items. We expect inflation to remain under pressure but within CBK's target range of 2.50%-7.50% in the short term. We expect the increasing local pump prices to continue exerting upward pressure on headline inflation. We anticipate that global inflationary pressures will continue to ease due to effects of monetary tightening and recovery of supply chains.

- **Fixed Income Market:** We expect investors to continue bidding aggressively in the primary market in light of persistent macroeconomic challenges pushing them to demand a premium in an effort to protect their real rate of return. However, the anticipated surge in tap sale issuances is expected to be a drawback in the secondary market. We expect investors to continue to be torn between their expectations of higher future yields in the fixed income sector and the currently subdued valuations in the equities market. The government will persist in experiencing challenges related to the redemption of Eurobonds due to constraints in its fiscal capacity which adds complexity to the available options.

- **Equity Market:** Activity in Q3'23 improved compared to the preceding quarter with the banking sector releasing positive financial performance in HY'23 results. However, the ongoing capital flight by foreign investors driven by interest rate hikes continued to impact the equity market. We anticipate that this trend will persist, albeit at a slower rate due to sustained negative investor sentiment toward emerging and frontier markets alongside pessimistic outlook for the local currency. The ongoing hiking of benchmark rates in developed markets has made returns more appealing which is likely to encourage further foreign exits. Stocks whose values were driven down as a result of the capital flight present an attractive entry point for investors.

27th October 2023

Sovereign Credit Rating:

Moody's: B3 (Negative)

Fitch: B (Negative)

S&P: B (Negative)

GDP Est. (2023): 5.50%

Inflation: (Sept) 6.80%

Interbank Rate (Ave): 11.85%

CBR (June 2023): 10.50%

Analyst

Stacy Makau
+254 114842208
smakau@aib-axysafrica.com

Global Outlook

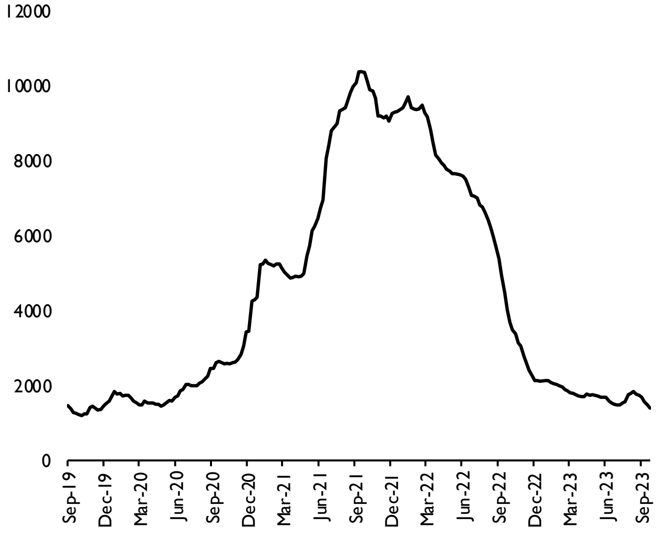
We continue to see global economy facing three major threats in the coming quarter:

a) **Inflation to Remain a Persistent Concern for Policy Makers:** We anticipate inflationary pressure to remain sticky in the coming quarter as central banks continue to maintain or hike their monetary policies to control stubborn inflation. High inflationary pressure will be primarily driven by increasing oil prices. We anticipate that monetary tightening measures will extend till the end of Q4'23 with probable shift towards reducing benchmark interest rates to begin in Q1'24.

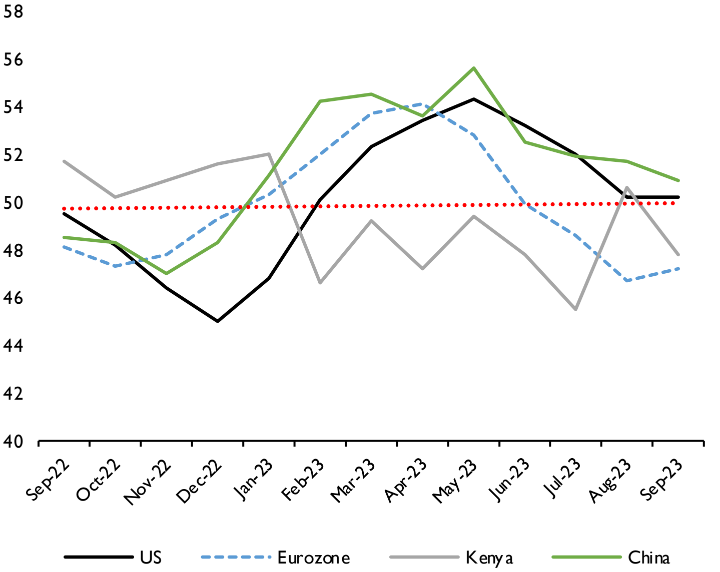
b) **Geo-Political Stability to Influence Economic Policies:** Rising energy and commodity prices due to geopolitical events in Middle East are likely to disrupt global supply chains and lead to elevated inflationary pressures across the world in the coming quarter. Monetary policy makers will closely monitor events in the region to respond effectively and mitigate inflationary pressures. BRICS led activities to shift trade away from the petrodollar is likely to persist, potentially causing numerous countries to clash with the US. Additionally, the upcoming 2024 US election is likely to start playing out during the quarter.

c) **Recession Fears Linger:** The global average composite PMI experienced a decline in the quarter but remained above the 50.00 threshold. Manufacturing PMI, impacted by elevated factory input expenses, decreased new orders, and reduced factory output, has remained restricted. We anticipate sluggish growth in the United States, Europe, China, and other emerging markets. Exports are likely to suffer and with the strengthening of the dollar this will be difficult for economies that rely heavily on exports.

Graph 1: USD Cost of Transporting a 40Ft Container Has Been Declining



Graph 2: Global Composite PMI Declined in Q3'23



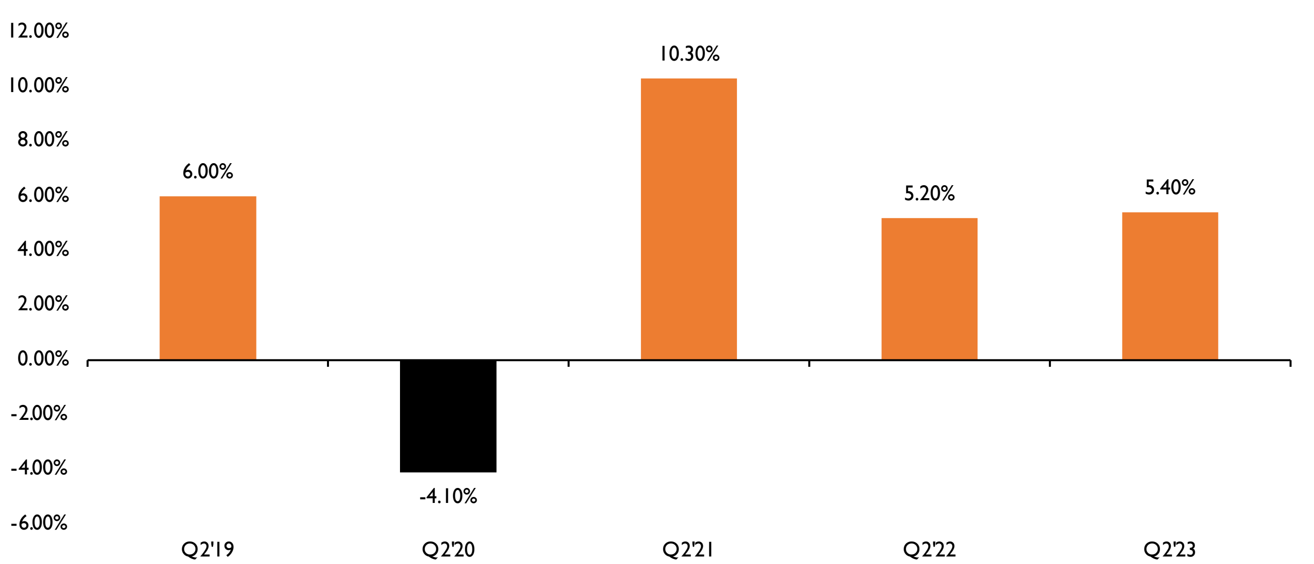
Local Economic Performance

- **Local Economic Activity Improves:** In Q2'23 the economy expanded by 5.40% surpassing the 5.20% recorded in Q2'22. Growth during the quarter was driven primarily by recovery of the agricultural sector and growth in financial and insurance services but hampered by a decline in manufacturing and construction sectors. Similarly, growth in Q3'23 is expected to marginally outpace that of the preceding year. However, we foresee local economic growth to continue being constrained by elevated interest rates, inflationary pressures, continued depreciation of the shilling, rising global uncertainties, and high commodity prices. Additionally, high debt servicing costs, elevated fuel prices and sustained foreign capital flight continue to slow down GDP projections.

- **Agriculture to Remain Dominant with Encouraging Growth:** During Q2'23, the agricultural sector expanded by 7.70% from 2.40% in Q2'22 on account of favorable weather conditions increasing agricultural production. We anticipate that agriculture will maintain its role as a substantial contributor to the local economy (+20% contribution) in the coming quarters resulting from the onset of the rainy season. However, we remain concerned with the high cost of agricultural inputs increasing the cost of production in the sector. We foresee similar factors continuing to be the driving force behind the deceleration observed in the manufacturing sector.

- **Growth to be Driven by Pandemic Stricken Sectors:** We anticipate growth to be driven by the rebound of sectors that were worst affected by the pandemic such as tourism, accommodation and food service. Additionally, we expect the foreign exchange difficulties to continue favoring export driven sectors such as mining and agriculture.

Graph 3: Kenya's Five Year Historical Q2 GDP Growth

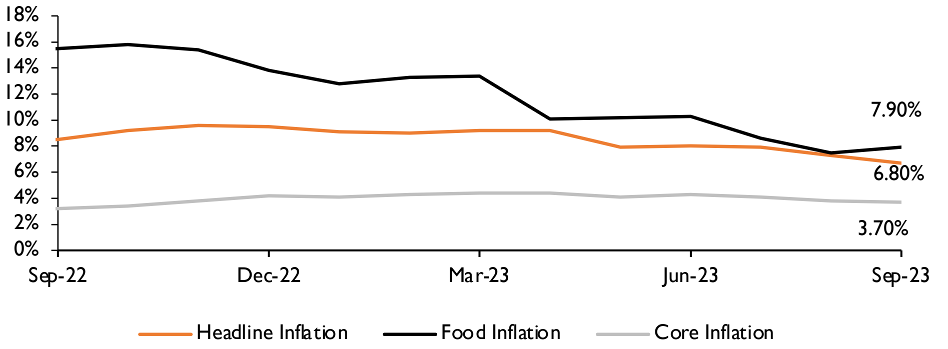


Source: KNBS, AIB-AXYS Research

Inflation

➢ **Year-on-Year Inflation Declines:** Headline inflation during the quarter decreased to an average of **6.93%** from **8.67%** in Q3'22 and **7.93%** in Q2'23. The September inflation print increased to **6.80%** from **6.70%** in August which was a decrease from **7.30%** in July. Headline Inflation during the quarter remained within the CBK's target range of 2.50% -7.50%. The food inflation index decreased to an average of **8.00%** compared to **15.37%** over a similar period in 2022, attributable to favorable weather conditions and ongoing harvests which has led to a decline in prices of key food items. The core inflation (Non-Food Non-Fuel) marginally increased to an average of **3.73%** from **3.17%** in Q3'22, a decrease from **4.17%** in Q2'23. We believe that the stickiness of core inflation is resultant of the spillover effects of increasing fuel inflation.

Graph 4: Headline Inflation Drops and Remains Within CBK's Upper Target



Source: KNBS, AIB-AXYS Africa Research

➢ We anticipate the onset of the short rains to positively impact food production leading the the continuous easing of key food prices. We expect the increasing local pump prices to continue exerting upward pressure on headline inflation. We foresee that headline inflation will remain under pressure but within the CBK's upper target in Q4'23. **In Q4'23, we anticipate that global inflationary pressures will continue to ease due to effects of monetary tightening and recovery of supply chains. Commodity and food prices are anticipated to continue declining during the period as central banks are anticipated to maintain or further tighten their policies in an effort to mitigate inflation expectations.**

Table 1: Inflation Has Had Mixed Trends Across Markets Globally

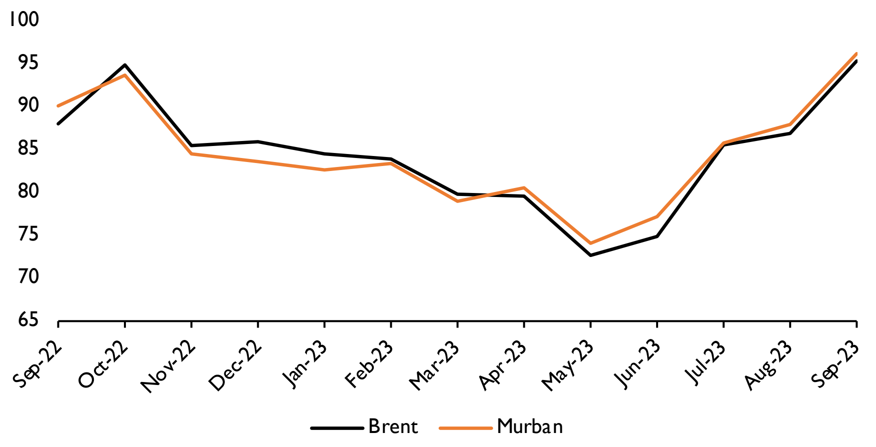
	Country	Inflation Rate			Base Lending Rate	
		July'23	August'23	September'23	Decision	Current Rate
1.	USA	3.20%	3.70%	3.70%	25bps Hike	5.25%
2.	UK	6.80%	6.70%	6.70%	125bps Hike	5.25%
3.	Ghana	43.10%	40.10%	38.10%	50bps Hike	30.00%
4.	Rwanda	17.30%	17.40%	18.40%	50bps Hike	7.50%
5.	South Africa	4.70%	4.80%	5.40%	No Change	8.25%
6.	Kenya	7.30%	6.70%	6.80%	No Change	10.50%
7.	Uganda	3.90%	3.50%	2.70%	50bps Cut	9.50%
8.	Tanzania	3.30%	3.30%	3.30%	No Change	5.00%

Source: National Statistics, AIB-AXYS Africa Research

Inflation – Effect from Oil Prices

- **Crude Prices Surge:** Global crude oil prices increased during the quarter as OPEC+ members made the decision to extend the production cuts of 1.16Mn barrels/day to December 2023, thereby reducing global supply of crude oil and causing prices to increase. The ongoing sanctions against Russia despite their recovery in supply is expected to continue affecting their oil exports, consequently affecting the global supply and causing prices to remain elevated. Crude oil prices are expected to increase in Q4'23 resulting from continuous constraint on oil supply.

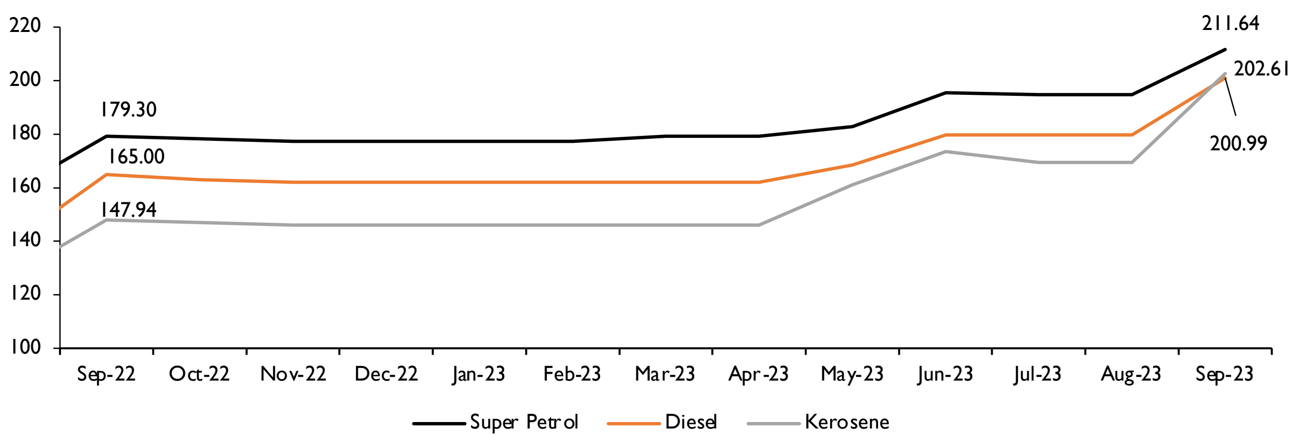
Graph 5: Global Crude Oil Prices to be Affected by Production Cuts



Source: Nasdaq, Bloomberg, AIB-AXYS Africa Research

- **Local Pump Prices to Remain Under Pressure:** Local pump prices were on the rise in Q3'23 in line with the increase in global oil prices and the VAT hike on fuel products consequently increasing pressure on the cost of living. **We expect the Reduction of levies (Railway Development Levy and the Import Declaration Levy) to have minimal positive effects on local pump prices. We uphold our earlier expectation that the G-to-G oil import model is unlikely to provide consumers with any significant additional cost advantages.**

Graph 6: Local Pump Prices to Continue Edging Up



Source: EPRA, AIB-AXYS Africa Research

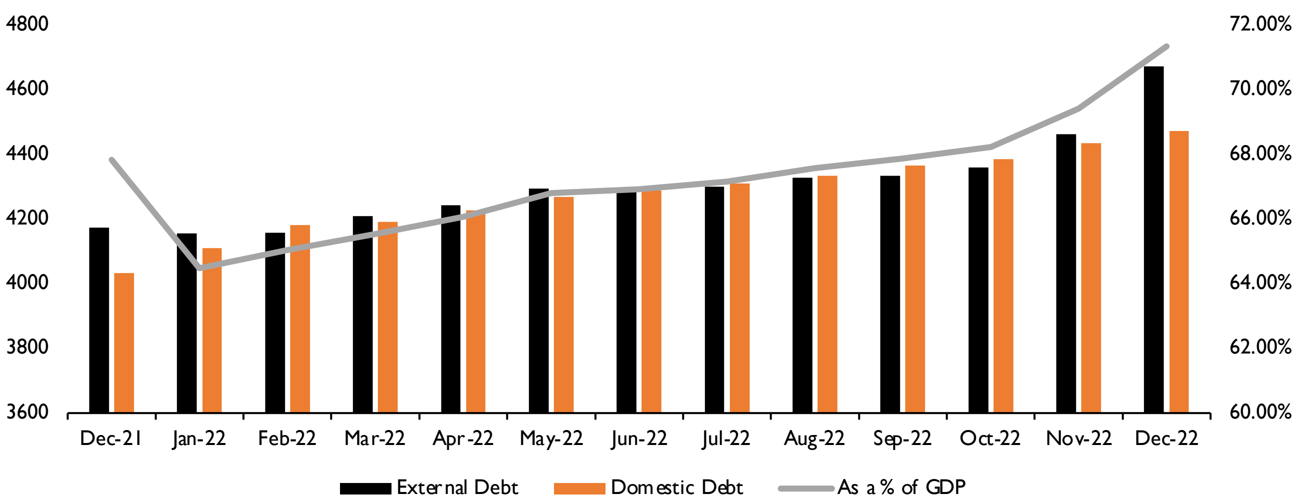
Fiscal Policy

- **Revenue Collection:** Total revenue collection in the three months of FY23/24 stood at **72.14%** which is **KES 745.36Bn** of the prorated target of **KES 1,033.19Bn.** Tax revenue collection stood at **82.42%** which is **KES 514.26Bn** of the prorated estimate **KES 623.96Bn** attributable to decreased economic activity and heightened inflation which have negatively impacted consumers purchasing power and tax collection efforts. The primary drivers of tax collection are income tax and VAT. Despite increased efforts and tax policy reforms by the KRA, revenue collection continues to fall short of the targets. We anticipate that the new taxes and levies implemented in the Finance Act 2023 will expand the tax base and positively impact tax collections. However, economic challenges are expected to persist, keeping tax revenues below the prorated targets. Additionally, the high interest environment in the local market may drive the government to increase external borrowing to bolster dollar inflows and address the upcoming 2024 Eurobond maturity.

- **Expenditure:** In the three months of FY23/24 diminished government expenditure corresponded with the underperformance of revenue collection. Recurrent expenditure, which constitutes the largest share of total government expenditure stood at **82.31%** which was **KES 268.10Bn** of the prorated estimate **KES 325.70Bn**. The ongoing depreciation of the shilling has led to the notable increase in foreign and domestic interest payments, substantially driving up recurrent expenditure. Development expenditure remained significantly low at **26.33%** which was **KES 31.65Bn** of the prorated estimate **KES 120.20Bn.** We anticipate reduced performance in development expenditure as a consequence of the difficult economic environment.

- **Fiscal Deficit:** Domestic borrowing stood at **KES 147.16Bn** which is **85.53%** of the prorated estimate of **KES 172.05Bn**. With the ongoing depreciation of the shilling against foreign currencies, debt servicing costs have increased. To plug the budgetary deficit, borrowing by the government is anticipated to increase in the coming quarter with concerns of high debt distress as a result. Total outstanding public debt increased to **KES 10.19Tn** as at the end of FY22/23.

Graph 7: Debt-to-GDP has remained Above IMFs recommended levels

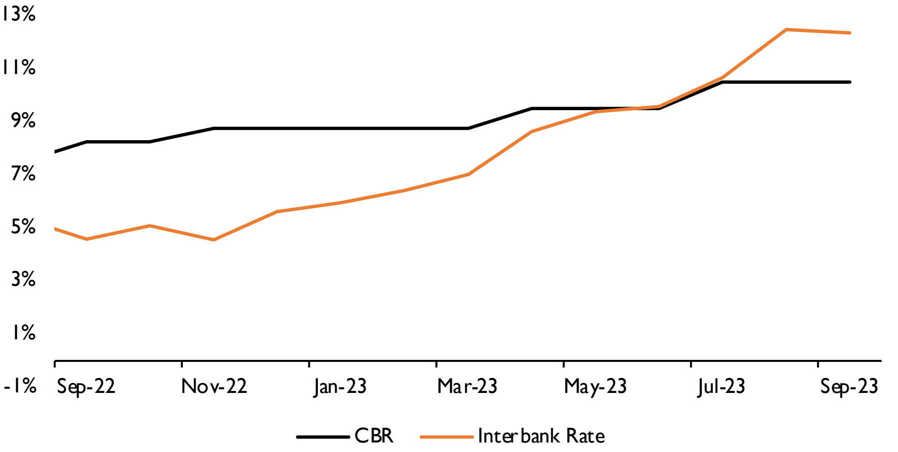


Source: CBK, AIB-AXYS Africa Research

Monetary Policy

- **Aggressive Stance Upheld:** In Q3'23, the Monetary Policy Committee (MPC) maintained its aggressive monetary stance by retaining the CBR at **10.50%.** Central banks globally have continued to aggressively hike their base rates in reaction to persistent inflationary pressures amid global uncertainties. In maintaining the CBR, the MPC hopes to let the effects of previous hikes to be transmitted across the economy thereby further mitigating inflationary pressures and promoting economic stability. **We expect the CBR will be maintained in the short-term for effects of the previous hike to be transmitted across the economy.**

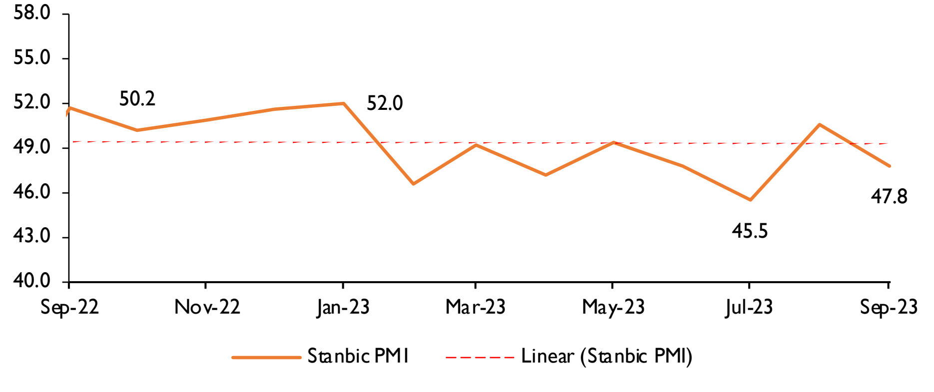
Graph 8: Central Bank Rate (CBR) and Interbank Rate (IBR)



Source: CBK, AIB-AXYS Africa Research

- **Business Environment Remains Challenged:** Following the decline in business conditions in 2023, we observed business activity remaining challenged as evidenced by the Stanbic Kenya Purchasing Managers Index (PMI) that averaged 47.97 in Q3'23 from 47.40 in Q3'22 and a decline from 48.10 in Q2'23. We expect the PMI to remain below the 50-point threshold in the short-term on the back of high input costs, depreciation of the shilling and ongoing inflationary pressures. **We foresee a gradual improvement of business activity in the long term driven by enhanced private sector credit growth and positive effects of monetary tightening measures.**

Graph 9: Stanbic Kenya PMI



Source: Stanbic PMI, AIB-AXYS Africa Research

Currency

- **Shilling To Continue Decline Further Against The USD:** During the quarter, the shilling depreciated by 5.39% to close at **KES 148.10** from **KES 140.52** at the end of the preceding quarter. Depreciation against the dollar is mainly attributed to strengthening of the dollar against emerging market currencies and increased demand for the greenback due to rise in global commodity prices.

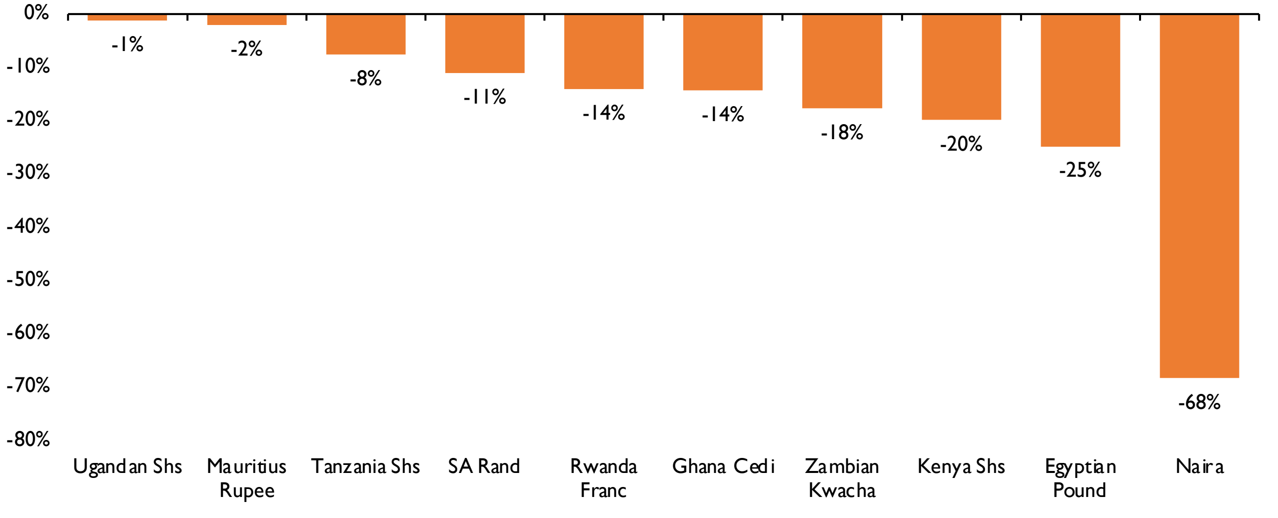
Table 2: KES Performance

	USD	EUR	GBP	RAND/KES	KES/UGX	KES/TZS
4Q22	-2.19%	-12.06%	-13.62%	-7.22%	5.82%	2.06%
1Q23	-7.26%	-9.98%	-10.24%	-1.89%	5.14%	6.53%
2Q23	-6.19%	-5.97%	-8.31%	-3.46%	8.69%	2.81%
3Q23	-5.39%	-1.98%	-1.85%	-2.73%	2.79%	1.58%

Source: CBK, AIB-AXYS Africa Research

- Foreign exchange reserves increased in Q3'23 averaging USD 7,264 equivalent to 3.96 months of import cover which is below CBK's statutory requirement of at least 4 months of import cover. **We anticipate that the shilling will continue to weaken against the dollar having lost 20.04% at the end of Q3'23 surpassing the 9.04% decline in 2022. The ongoing strengthening of the dollar against frontier currencies coupled with foreign denominated debt repayments is expected to exert additional pressure on the foreign exchange reserves. We anticipate that dollar inflows through foreign direct investments, diaspora remittances and other capital sources will serve as significant supplier of dollars which should support the KES resilience. The IMF is expected to disburse additional funds through the EFF/EFC arrangement which will help replenish the diminishing foreign reserves.**

Graph 10: Performance of select African Currencies vs USD



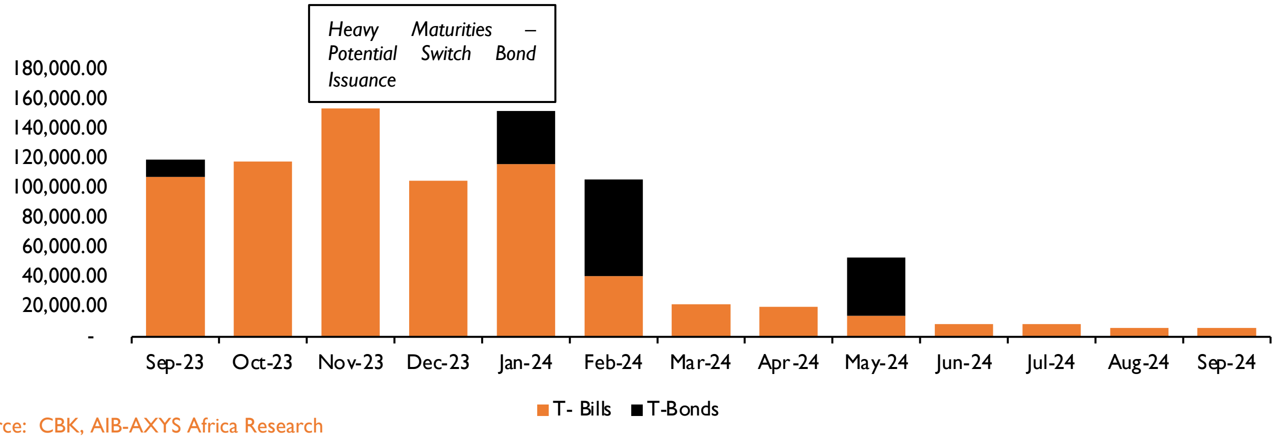
Source: Bloomberg

Interest Rates Outlook

- **Decreased Appetite for Fixed Income:** Activity in the Fixed Income market decreased in Q3'23 with the government raising **KES 486.09Bn** compared to **KES 616.29Bn** in the preceding quarter as investors displayed caution to the higher yield on short-term government papers and higher risk adjusted returns. Treasury bond issuances were generally undersubscribed at an average rate of **69.36%**. Treasury bills were oversubscribed with investors continuing to see short term risks in the market and favoring their risk adjusted returns. During the quarter, we observed a yield uptick on all papers to firmly above the 14.00% level.

- In the secondary market, bond turnover increased in Q3'23 by **36.66%** to **KES 208.46Bn** from **KES 152.53Bn** in Q2'23 driven by investors who missed out in the primary market auctions. We anticipate increased activity in the fixed income secondary market as investors continue to chase after papers they missed out on in the primary market.

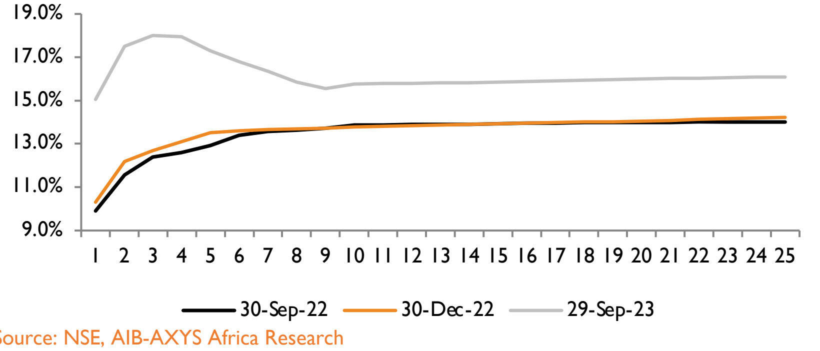
Graph 11: Upcoming Maturities for the Next 12 Months



Source: CBK, AIB-AXYS Africa Research

- **Yield Curve Inverts in the Short-End:** During the quarter, we observed an inversion in the yield curve in the short end with the potential for this inversion to extend across the curve, depending on the maturity profile of upcoming primary issues. In line with our earlier outlook, investors have persisted in testing the governments resolve by pushing T-Bill rates above 14.00% and T-Bond rates higher than 17.00%. The three-year paper gained the most by 3.76x in Q3'23 driven by investors demand for higher returns in response to rising global and domestic instability. **We expect investors to persist in pushing for a 18.00% bond likely in Q4'23 as compensation for taking up additional risks and protection for their real rate of return.**

Graph 10: NSE Yield Curve Inverts in the Short End



Source: NSE, AIB-AXYS Africa Research

Kenya Eurobond Performance

- **GOK Fiscal Position Concerns Linger:** The debt to GDP ratio remained near the 70.00% level in Q1'23 surpassing the IMF's suggested threshold of 50.00% for a B rated country. During the quarter, Fitch's rating agency downgraded Kenya's B rating outlook to Negative from Stable. The rating agency further stated that the downward revision of the outlook was influenced by declining foreign reserves, increasing external financing costs and uncertainty concerning the country's fiscal trajectory. The rating agency estimated that the government/debt ratio increased to 71.00% in FY22/23 reflecting increased currency risk as the shilling continues to depreciate.

Table 3: Kenya Eurobond Performance (Q3'23)

Kenya Eurobond	Q3'23 Change (bps)
KENINT 2024	+583 bps
KENINT 2027	+214 bps
KENINT 2028	+223 bps
KENINT 2032	+156 bps
KENINT 2034	+194 bps
KENINT 2048	+138 bps

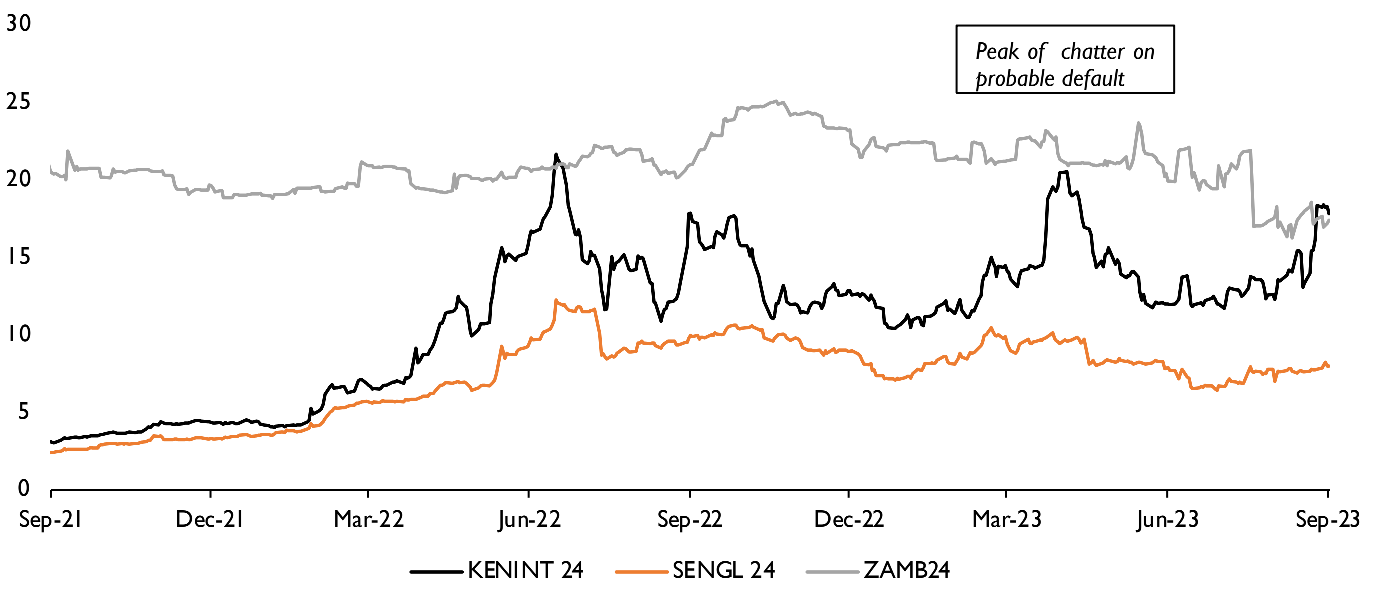
Source: Bloomberg

- **External Eurobond Issuance Ruled Out:** Yields on all KENINT Eurobonds surged 2.0x in 2022 driven by heightened risk perception of emerging markets and credit incidents in frontier markers such as Ghana which have eroded investor confidence. In light of the challenging credit market conditions, the possibility of issuing a fresh Eurobond to repay the maturing KENINT 24 was dismissed by the government.

- In Q3'23 yields on all KENINT Eurobonds recorded an upward performance (see table), more so in the month of September, driven by ongoing worries regarding Kenya's ability to manage its debt effectively. The World Bank cautioned that escalating borrowing expenses and challenging economic conditions might make it difficult for the government to refinance its forthcoming maturing debt. The persistent concerns about debt sustainability have the potential to undermine investor confidence and cast a negative outlook on Kenya's overall economic prospects, possibly resulting in higher KENINT yields. For the upcoming Eurobond maturity, the government is actively pursuing credit from multilateral development banks such as World Bank, IMF as well as bilateral and regional banks.

- **We foresee yields on KENINT Eurobonds will increase in Q4'23 primarily driven by mounting uncertainties surrounding GOK's debt sustainability which continues to drive negative investor sentiment.**

Graph 12: Kenya Eurobond Performance Against Select SSA Sovereigns (10 Year paper Maturing in 2024)



Source: Bloomberg

Equity Market

- **Market Activity Improves:** Activity in the equities market in Q3'23 improved with the equity turnover increasing **19.60%** to **KES 17.21Bn** from **KES 14.39Bn** in the preceding quarter. Benchmark indices recorded losses with the NASI and NSE-20 declining **11.01%** and **4.20%** to close at **KES 95.22** and **KES 1,508.75** respectively. The YTD loss for the NSE-20 stood at **(9.98%)** and NASI stood at **(25.30%)**. The bourses market capitalization declined by **11.01%** to **KES 1.49Tn** from **KES 1.67Tn** in Q2'23 indicating decrease in overall value of listed companies. We believe that the improved market activity was brought about by local investors taking positions in the banking sector despite continued foreign investor outflow.

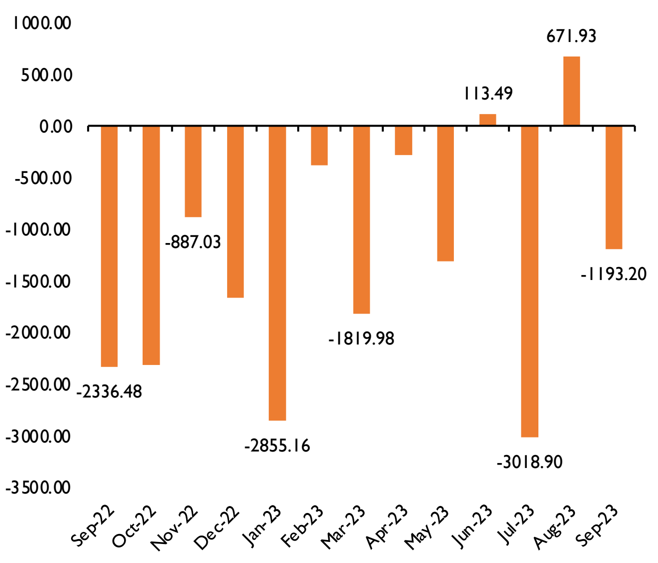
Table 4: NSE Indices YTD Performance

	Q4'22	Q1'23	Q2'23	Q3'23
NSE 20	-11.90%	-3.22%	-6.04%	-9.98%
NASI	-23.42%	-11.54%	-16.06%	-25.30%

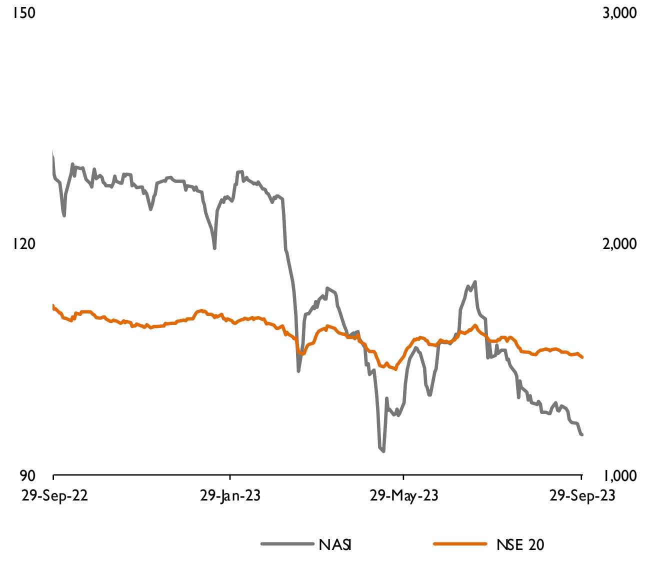
Source: NSE, AIB-AXYS Africa Research

- We anticipate further foreign investor selloffs in Q4'23, although at a slower pace, driven by continued negative investor sentiment on emerging and frontier markets as well as a negative shilling outlook. The ongoing hiking of benchmark rates in developed markets has rendered returns more attractive, which is likely to drive further foreign exits. Given the scarcity of the US dollar and the relatively low returns compared to other asset classes, we expect the market's performance to be sluggish. The upcoming settlement of dividend payments is expected to cause little to no action on the respective counters.

Graph 13: NSE Net Foreign Activity



Graph 14: NSE Indices Performance



Sources: NSE, AIB-AXYS Africa research

CONTACTS:

Research Desk

Stacy Makau

Email: research@aib-axysafrica.com

Equities Dealing

Bernard Kung'u

Benard Gichuru

Anthony Muringi

Nina Goswami

Samuel Githinji

Sheema Shah

Samuel Wachira

Email: trading@aib-axysafrica.com

Bond Dealing

Crispus Otieno

Titus Marenye

Email: trading@aib-axysafrica.com