Recovery Under Inflationary Pressure

28th April 2023

Sovereign Credit Rating:

Moody's: B2 (Negative)

Fitch: B (Stable)

S&P: B (Negative)

GDP Est. (2023):	5.10%
Inflation: (March)	9.20%
Interbank Rate (Ave):	**6.49%**
CBR (March 2023):	9.50%

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During Q1'23, economic recovery remained challenged with downsides from 2022 creating spill-over effects that further dampened macro factors leading to a slower global growth, rising domestic interest rates and more geopolitical tensions. Global increase in the price of commodities has exacerbated the local inflation and has continued hurting the local currency. Reduced dollar inflows and higher import bill have contributed to further weakening of the shilling against the dollar creating a challenging business environment. Central Bank has continued to tighten its monetary stance to anchor inflationary pressures in an attempt to drive improvement in business activity. Going forward, we expect the economic growth to remain subdued due to persistent inflationary pressures, high commodity prices, global shocks and a heightened risk of debt distress.

- **Hiked Inflation:** Headline inflation during the quarter increased to an average of **9.13%** from **5.34%** in Q1'2022 although this was a decrease from **9.40%** in Q4'2022. The significant increase was as a result of the drought causing an increase in food prices, global supply chain crisis which has elevated energy costs resulting from the Russia-Ukraine war and the depreciation of the shilling.The food inflation index rose to an average of **13.17%** compared to **9.17%,** over a similar period in 2022, attributable to unfavourable weather condition, effects of the Ukraine war and the increase in production input costs. We expect inflation to remain above the CBK's target range of 2.5%—7.5%, in the short-term in part due to continued increase in energy prices. We expect food inflation to ease slightly due to the onset of the short rains.

- **Tightened Monetary Policy:** During the quarter, the Central Bank of Kenya (CBK) increased the Central Bank Rate (CBR) to **9.50%** a **75bps** increase from **8.75%** in a move to control rising inflation while the Cash Reserve Ratio (CRR) was maintained at **4.25%,** indicating the effect of global inflationary pressures and global risks on the local economy. Central banks globally have been tightening their monetary stance in an effort to combat surging inflation and bring it back to their targets.

- **Equity Market:** Activity in Q1'2023 slowed down compared to Q1'22 with companies releasing mixed FY'22 results with the banking sector posting positive financial performance. Effects of the capital flight by foreign investors on the back of heightened global risks and interest rate hikes are still being experienced by the equity market. We expect that this trend will slow down and potentially reverse. Stocks whose values were driven down as a result of the capital flight provide an attractive entry point for foreign investors.

Economic Performance

Global Economic Activity: In Q1'23, the global economy was projected to remain subdued despite the boost in activity following the global recovery from the pandemic. Global economic growth was predicted to be **1.70%** in 2023 by the World Bank with yearly inflation expected to be above the central bank targets. Headline inflation was anticipated to peak during the quarter and drop throughout the rest of 2023.

The slow economic growth was attributed to;

- **Recessionary Fears** – Towards the end of 2022, analyst consensus across various markets was a general expectation of mild to acute recessionary concerns in developed markets – both the US and the euro zone and slowed growth in China and other emerging markets. While recessionary fears have dwindled, they have not gone away. Fears exists of that the world economy could enter a recession as a result of more negative shocks like increased inflation, tighter monetary policy, financial stress, further weakening in major economies, or Geo-political plays - escalating geopolitical tensions.

- **Monetary Policy Actions** – In our 2023 markets outlook, we had expected the US Fed and other developed markets MPCs to go easy on one of the most aggressive tightening campaigns in decades. However, we have continued to see MPC remain committed to tighter monetary policies to control inflation. In Q1'23, the US Fed increased the benchmark rate by 50 bps making it nine consecutive hiking cycles and the highest post 2008 financial crisis. The recent banking crisis in the US and Europe is likely to slow down the tightening cycle, as central banks and other regulators try to control a potentially systemic calamity.

- **Geopolitical Plays** – In our 2023 markets outlook, we expected that, geopolitical plays, as witnessed by the effects of the Russia-Ukraine war, will continue to be key drivers of global economic growth. The Russia-Ukraine war is likely it will continue for the foreseeable future meaning further strained relations between Russia and the Eurozone translating to further energy crisis likely to have an upward pressure on global fuel prices. We also expected US –China relations to remain stiff as battle for world dominance continues. In Q1'23, we have seen major economic moves by members of BRICS (Brazil, India, Russia, China and South Africa) which included trade agreements to be settled in their own currencies. The BRICS members have been on the forefront of leading the de-dollarization war.

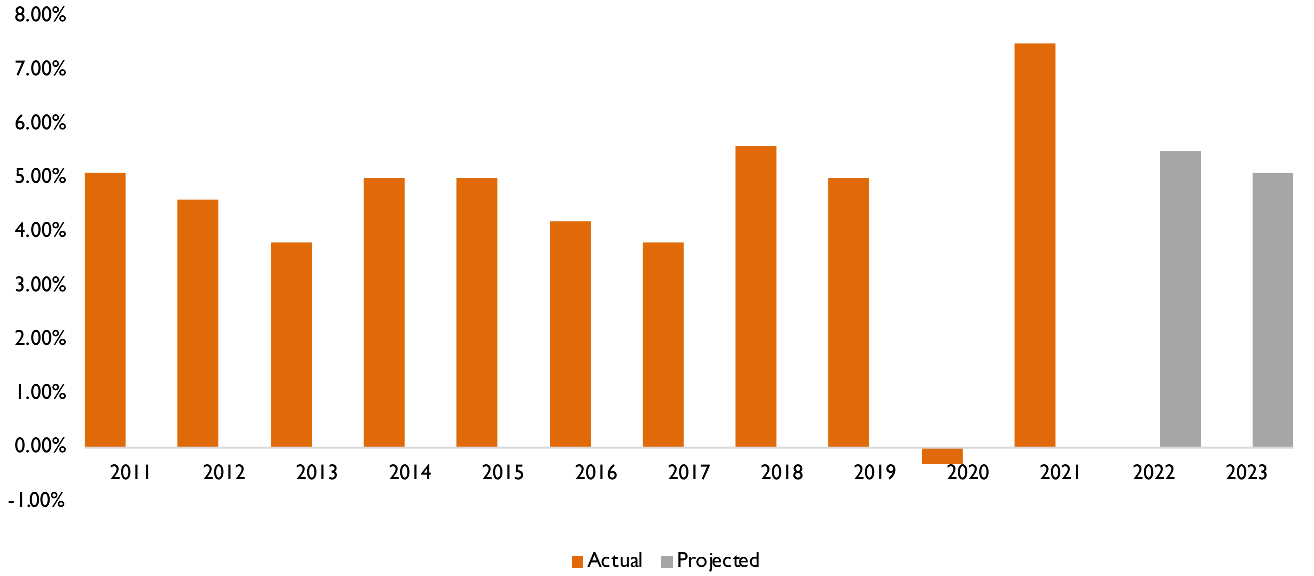
Economic Performance

- **Local Economic Activity:** As per IMF estimates, the economy expanded **5.3%** in 2022 and is projected to grow by **5.1%** in 2023.These estimates are however being impacted by heightened global uncertainties, slowing global growth, increasing commodity prices, hiking of interest rates and a strengthening of the U.S dollar, subduing the growth of the local economy. Furthermore, high fuel prices, high debt servicing costs, low agricultural production resulting from the drought and foreign capital flight continue to slow down GDP projections.

- **Agriculture to Remain Dominant but Decline is Worrying:** We Expect agriculture to remain as a key contributor to the local economy with the contribution to GDP remaining above 20.00%. For 2022 and Q1'23, we are likely to see marginal drop in Agriculture's contribution to GDP. The decline will be driven by unfavourable weather conditions that have seen lower food production. Many parts of the country experienced drought that reduced crop production, killed animals and lowered the quality of animal products. Additionally, the increase in the cost of farm inputs; Seeds, fertilizer, farm machinery, animal feeds among others have also increased the sector's cost of production. We also foresee almost similar factors contributing to the decline in the manufacturing sector.

- **Growth Will Come from Pandemic Stricken Sectors:** We expect growth to come from sectors such as; Education, healthcare and hospitality which were the worst affected by the pandemic. Additionally, the foreign currency woes have favoured export driven sectors such as mining.

Graph 1: Kenya Historical GDP Growth



Source: KNBS, AIB-AXYS Research

Global Outlook

- **Triple Threats:** We continue to see global economy facing three major threats in the coming quarter;

  a) Inflation : High inflation globally has caused a cost-of-living crisis putting millions in difficult financial situations. Monetary tightening has been aggressive as a result of rising inflation that is affecting developed and developing nations. Given the rising wage pressures, inflation may continue being high necessitating tighter monetary policies and in tandem a greater downturn in economic growth.

  b) Geo-political stability : We expect that the BRICS led activities around moving trade away from the petrodollar is also likely to put many countries on a collision path with the US. Lastly, the US election in 2024 is likely to start playing out later this year as we expect Donald Trump to make a comeback in the path to dethrone President Biden.

  c) Recessionary Fears to Cool Off: We expect global analyst consensus to remain that majority of the developed global economies will potentially enter a mild recession as a result of surging inflation and continued hike in interest rates by the central banks. We expect slow growth in US, 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.

Table:1 Global GDP Growth Projections

	Organization	2022 Estimates	2023 Projections
1	International Monetary Fund	3.40%	2.90%
2	OECD	3.20%	2.60%
3	S&P Global	3.00%	2.00%
4	World Bank	2.90%	1.70%
	Average	**3.13%**	**2.30%**

Local Outlook

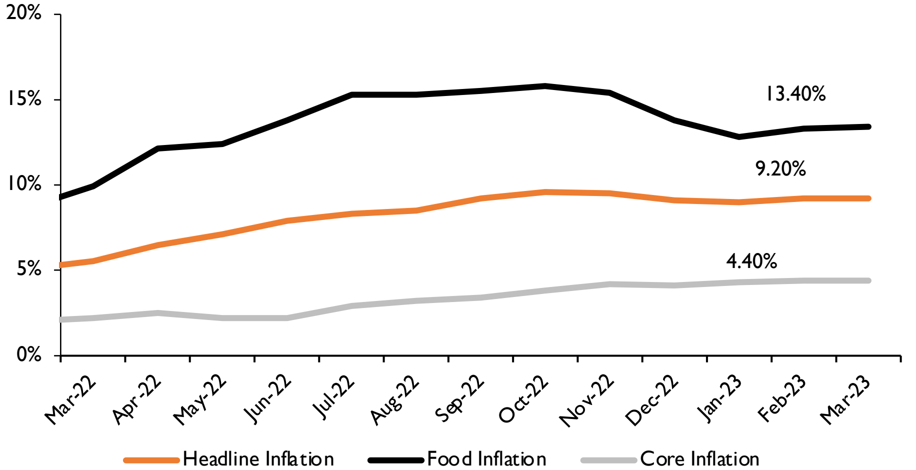
National Budget: Kenya's budget for 2023/2024 is set to be released in Q2 with expectations that the budget will increase to KES 3.60Tn as the country struggles to strike a balance between promoting economic growth and servicing debt. Expanding the tax base and raising foreign exchange earnings are key focus areas in the upcoming budget. The government wishes to finance the deficit mostly by domestic borrowing which will be met with difficulties of a depreciating shilling, declining foreign reserves and inflationary pressures.

We expect the country to continue facing a state of deteriorating liquidity resulting from increasing debt servicing costs which are putting the country at a risk of debt distress. We expect the foreign reserves that have been depleting slowly to remain under pressure with increasing demand for dollars by importers. We expect an easing in food prices as a result of short rains increasing agricultural production and the duty-free grains imports.

Inflation

- **Year-on-Year Inflation Soars:** Headline inflation, during the quarter, increased to an average of **9.13%** from **5.34%** in Q1'2022, and declined from **9.40%** in Q4'2022.The significant increase was as a result of the drought causing an increase in food prices, global supply chain crisis which has elevated energy costs resulting from the Russia-Ukraine war and the depreciation of the shilling. The food inflation index rose to an average of **13.17%** compared to **9.17%,** over a similar period in 2022, attributable to unfavorable weather conditions and an increase in production input costs limiting the food production. Core inflation (Non-food, Non-fuel inflation) more than doubled to an average of **4.37%** from **2.07%** in the preceding quarter, reflecting the ripple effects of consistently increasing input prices.

Graph 2: Inflation Rates Have Remained Above CBK's Upper Target



Source: KNBS, AIB-AXYS Africa Research

- **Inflation Outlook – Difficult Decisions:** In Q2'23, we anticipate that global inflationary pressures will begin to ease as a result of the effects of monetary tightening and supply chain recovery. Commodity, food, and gasoline prices are anticipated to start declining in Q2. Central banks are expected to continue tightening their policies or maintain them to mitigate inflation expectations. We see move to raise interest rates in order to anchor inflation being modified by policy makers to foster economic growth. Even though these rates will remain in place to anchor surging inflation before they are eased. We expect headline inflation to decelerate in most developed and emerging markets by the end of Q3'23.

Table 2: Inflation Outlook

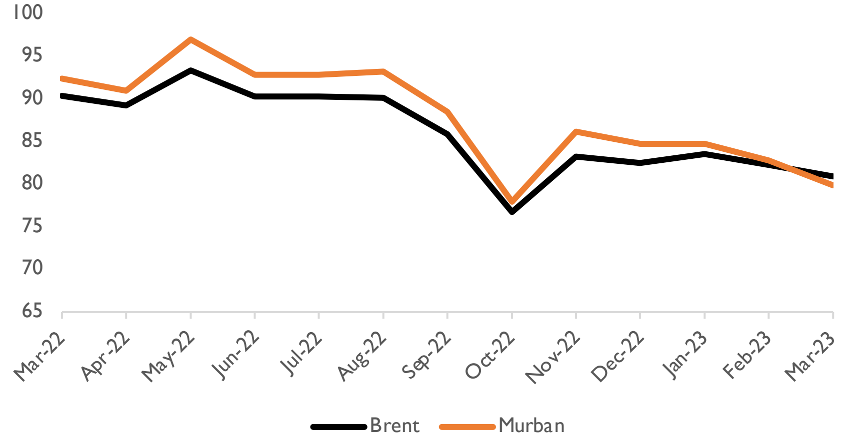
	Country	Inflation Rate			Base Lending Rate	
		Jan 23	Feb 23	Mar 23	Decision	Current Rate
1.	USA	6.40%	6.00%	5.00%	25bps Hike	5.00%
2.	UK	10.10%	10.40%	10.10%	25bps Hike	4.25%
3.	Ghana	53.60%	52.80%	45.00%	150bps Hike	29.50%
4.	Rwanda	31.10%	30.30%	31.00%	50bps Hike	7.00%
5.	South Africa	6.90%	7.00%	7.10%	50bps Hike	7.75%
6.	Kenya	9.00%	9.20%	9.20%	75bps Hike	9.50%
7.	Uganda	10.40%	9.20%	9.00%	100bps Hike	10.00%
8.	Tanzania	4.90%	4.80%	4.70%	No Change	5.00%

Source: National Statistics, AIB-AXYS Africa Research

Inflation – Effect from Oil Prices

- **Crude Prices to Remain Steady:** Global crude oil prices fell during the quarter amid the rise in demand in China and worries on recession. Western Economic sanctions against Russia will continue to affect their oil exports affecting the global supply and elevating prices. Global oil prices are likely to be elevated as pre-covid demand resumes and the OPEC+ members continue reducing output. In March 2023, OPEC+ members announced a further 1.16Mn barrels/day reduction in output supply. Lower supply will likely lead to higher prices in the global space. An emerging trend of countries using their own currencies to purchase oil will likely increased affordability and negotiating opportunities for buyers.

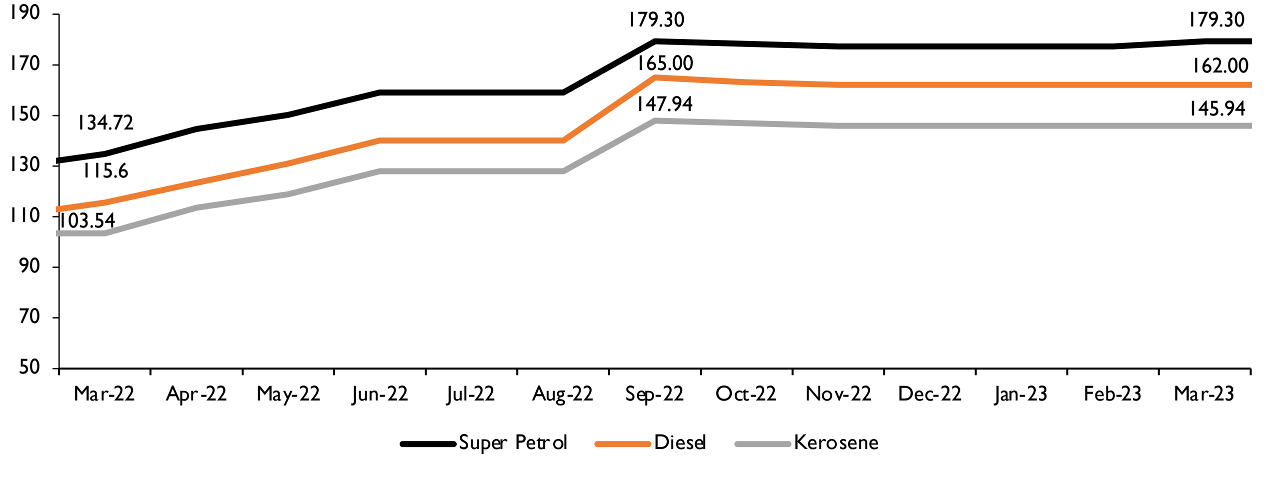
Graph 3: Global Crude Oil Prices to be Affected by Production Cuts



Source: Nasdaq, Bloomberg, AIB-AXYS Africa Research

- **G-to-G is Likely to Cause Little Pricing Benefits:** The government partially withdrew the fuel subsidy in Q4'22 and has been using cross-subsidization where the fuel product with lower pricing has been used to subsidize the much expensive product. During Q1'23, the government announced the government-to-government oil imports from the middle east with a six months credit line. We are not likely to see pricing benefits for consumers in the new oil import model as the settlement currency remains the dollar. As such, we see the challenges the oil importers had been facing resuming in Q4'23 when settlement becomes due.

Graph 4: Local Pump Prices



Source: EPRA, AIB-AXYS Africa Research

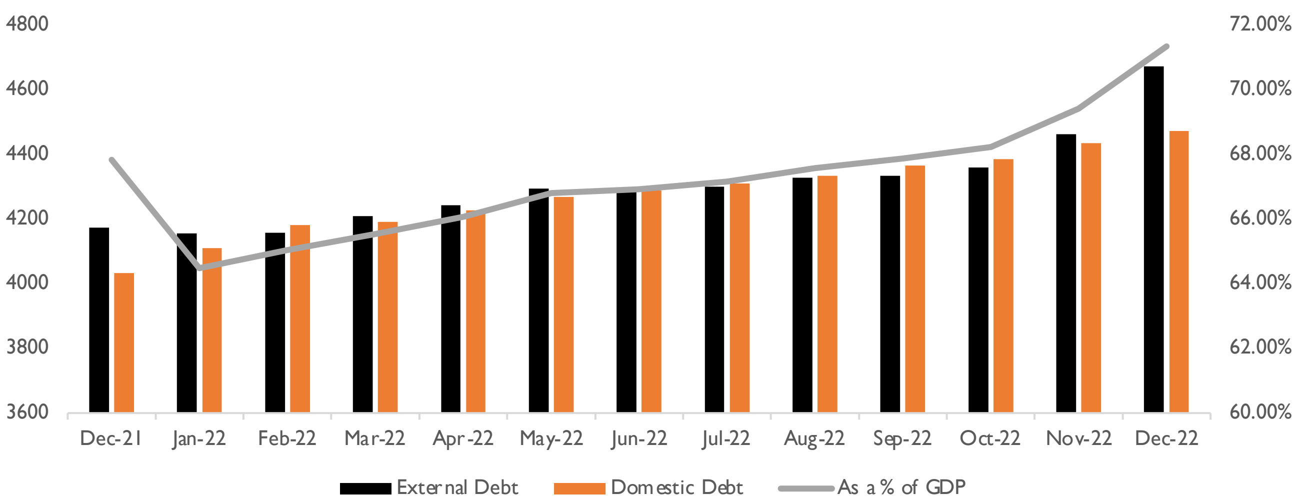
Fiscal Policy

- **Revenue Collection:** Total revenue collection in nine months of FY22/23 stood at **65.88%** which is **1,44.09Bn** of the estimated **1643.99Bn** indicating the possibility of missing revenue collection targets. Tax revenue collection at **88.12%** which is **1,393.35Bn** of the prorated estimate of **1581.24Bn** is attributable to decreased economic activities and elevated inflation which has a detrimental effect on consumers purchasing power and tax collection efforts. The drivers of tax revenue collection are income tax and VAT. Revenue collection continues to fall short of the targets despite increased efforts by the KRA and tax policy reforms. Factoring in the payment of installment tax between April and June, we expect KRA to achieve a collection in the regions of 95% of the estimated target. We expect KRA to continue coming under pressure to meet tax collection targets. We anticipate that the ongoing tax improvements in tax policy and revenue administration to expand the tax base will result in improved collections.

- **Expenditure:** In nine months of FY22/23, diminished government expenditure corresponded to the low performance in revenue collection. Recurrent expenditure, which holds the largest share of total government expenditure stood at **85.81%** which was **KES 814.71Bn** of the estimated **KES 949.48Bn.** The depreciation of the shilling lead to increased domestic and foreign interest payments significantly increasing recurrent expenditure as a result. Development expenditure has remained low standing at KES **174.79Bn** which was **59.18%** of the prorated estimate of **KES 295.36Bn**. We expect a diminished performance in development expenditure resulting from the difficult economic environment.

- **Fiscal Deficit:** Domestic borrowing stood at **KES 396.32Bn** which is **59.61%** of the prorated estimate of **KES 664.89Bn**. With the shilling depreciating against foreign currencies, debt servicing costs have increased. To plug the budgetary deficit, borrowing by the government is set to increase in the coming quarter with concerns of high dent distress as a result. Total outstanding public debt increased to **9.15Tn** as at the end of H2 of FY22/23.

Graph 5: Debt-to-GDP has remained Above IMFs recommended levels

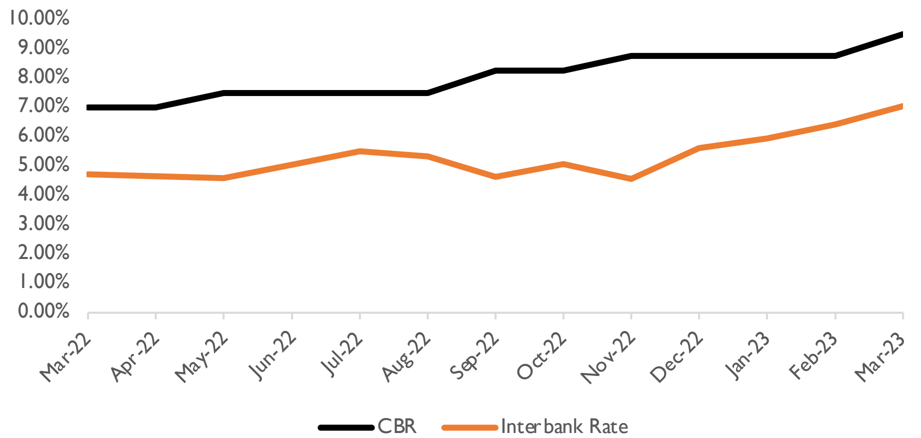


Source: CBK, AIB-AXYS Africa Research

Monetary Policy

- **Aggressive Stance:** In Q1'23, the Monetary Policy Committee (MPC) tightened the monetary stance by increasing the CBR by 75bps to **9.50%** from **8.75%** marking the fourth hike from Q1'22. Globally, central banks have been aggressively hiking their base rates in response to elevated inflation brought about by the ongoing global crises. In raising the CBR, the MPC hopes to tame rising inflation and steady the economy against shocks from rising global prices and supply chain issues. We anticipate that the CBR will be maintained in the next quarter as the economy fully absorbs the effects of the hike.

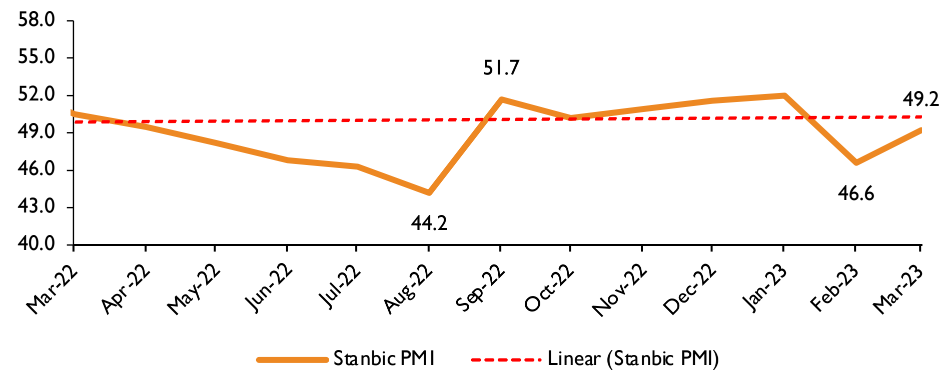
Graph 6: Central Bank Rate (CBR) and Interbank Rate (IBR)



Source: CBK, AIB-AXYS Africa Research

- **Purchasing Managers Index (PMI):** The Stanbic Kenya PMI dropped to an average of **49.3%** in Q1'23 compared to **50.9%** in Q4'22, indicating a decline in business environment resulting from increasing input costs. The PMI index closed the quarter at **49.2%** from **52.0%** in January 2023. We anticipate that the operating environment outlook in the private sector in the coming quarter will continue to be strained by high input prices and inflationary pressures. However, maintain our earlier outlook of the PMI reading remaining in and around the 50 points levels. Opening of the interbank forex market has eased the dollar access challenges easing raw material imports pressure and thus lowering waiting times and production costs.

Graph 7: Stanbic Kenya PMI



Source: Stanbic PMI, AIB-AXYS Africa Research

Currency

- **Shilling To Decline Further Against The USD:** During the quarter, the shilling depreciated by 7.26% against the US Dollar to close at **KES 132.33** from **KES 123.37** at the end of the preceding quarter. Depreciation against the dollar is mainly attributed to increased dollar demand from importers.

Table 3: KES Performance

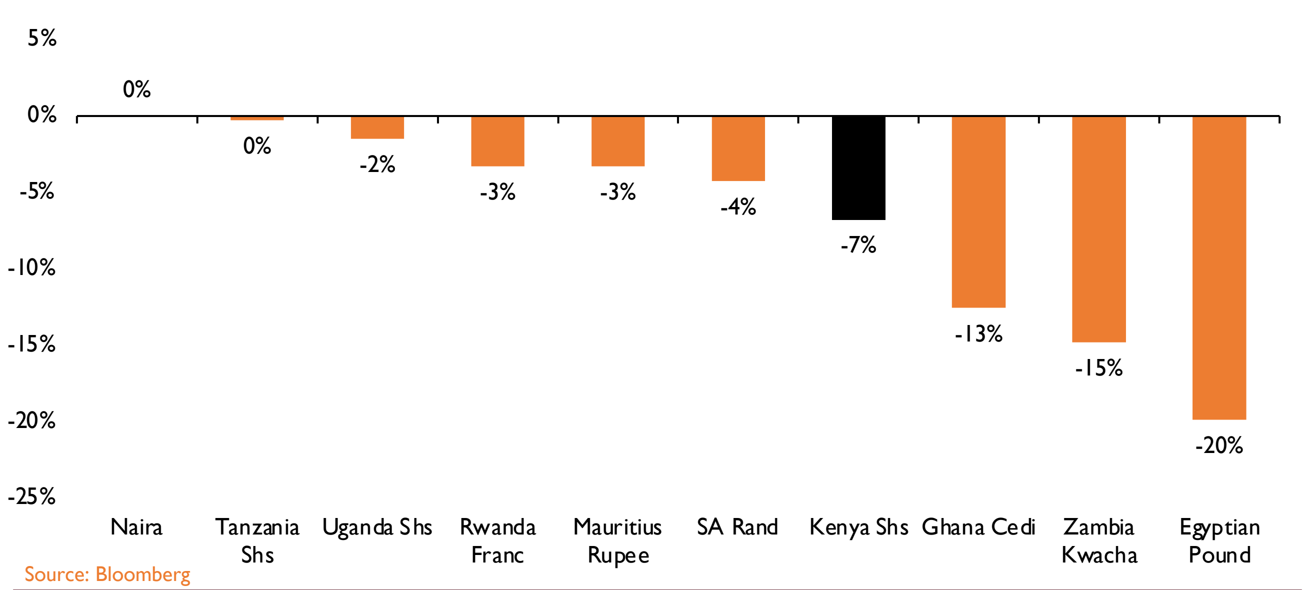
	USD	EUR	GBP	RAND/KES	KES/UGX	KES/TZS
2Q22	-2.45%	3.05%	5.17%	8.42%	-2.13%	1.98%
3Q22	2.46%	-5.55%	-9.07%	-8.08%	0.19%	-2.40%
4Q22	2.19%	12.06%	13.62%	7.22%	-5.82%	-2.06%
1Q23	7.26%	9.98%	10.24%	1.89%	-5.14%	-6.53%

Source: CBK, AIB-AXYS Africa Research

We expect the shilling to remain under pressure due to increasing dollar demand from fuel importers resulting from high global oil prices and a decreasing dollar inflow from export earnings. The continuous depreciation of the shilling is anticipated to continue increasing the cost of living in the country. We expect the shilling to remain under pressure as the US dollars value strengthens against emerging and frontier currencies on the back of increased interest rates to combat inflation by the Federal Reserve further driving depreciation. Kenya's current account deficit is significantly wide due to high crude oil prices and increasing costs of servicing external debt leading to foreign currency shortages further eroding the shilling's performance.

However, we anticipate that increased tea export earnings and diaspora remittances will boost the foreign exchange account. The depreciation of the shilling may be at a slower rate with IMF expected to increase the country's quota allocation allowing the country to increase depleting foreign reserves.

Graph 8: Performance of select African Currencies vs USD



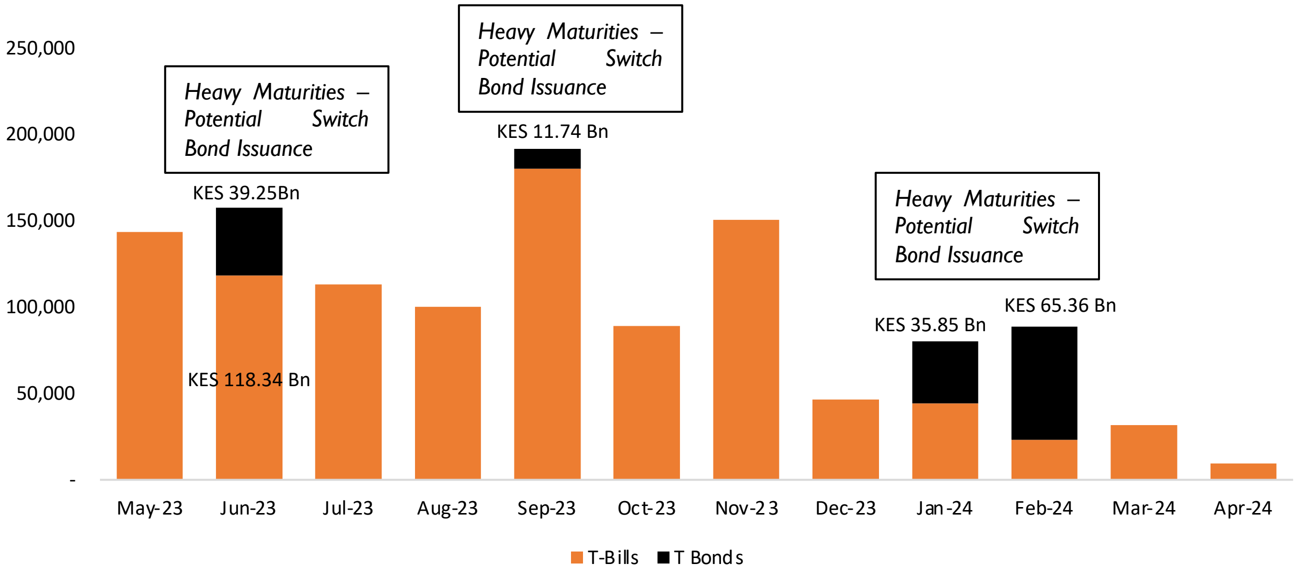
Source: Bloomberg

Interest Rates Outlook

- **Appetite for Fixed Income:** Activity in the Fixed Income market increased as investors preferred the higher yield on short-term government papers and higher risk adjusted returns. Treasury bond issuances were generally undersubscribed at an average rate of **67.14%.**Treasury bills were oversubscribed with investor's seeing short term risks in the market and favoring their risk-adjusted returns. The Government's appetite for debt remained high and was **13.66%** behind of its prorated at the end of the quarter with a net borrowing at **KES 343.20Bn** against a prorated target of **KES 397.50Bn**.

- In the secondary market, bond turnover decreased by **1.41%** to **KES 178.98Bn** from **KES 181.53Bn** in the preceding quarter as investors place bids in the primary market due to increased short term risks. We anticipate increased activity in the fixed income market as investors continue to favor their high risk adjusted returns.

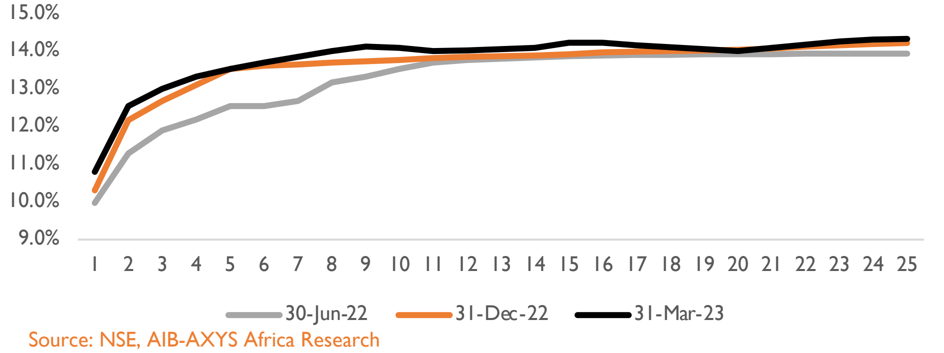
Graph 9: Upcoming Maturities for the Next 12 Months



Source: CBK, AIB-AXYS Africa Research

- **Yield curve steepening continues:** In line with our earlier outlook, investors have continued to test government's resolve by pushing T Bill rates to above 10.00% and T Bond rates to higher than 14.50%. We expect investors to continue pushing for a 15% bond likely in Q3'22. The one-year paper gained the most, by **49bps**, in Q1'23, driven by investors demand for higher returns in response to rising local and domestic economic instability.

Graph 10: NSE Yield Curve Has Continued to Steepen



Source: NSE, AIB-AXYS Africa Research

Kenya Eurobond Performance

Table 4: Kenya Eurobond Performance (Q1'2023)

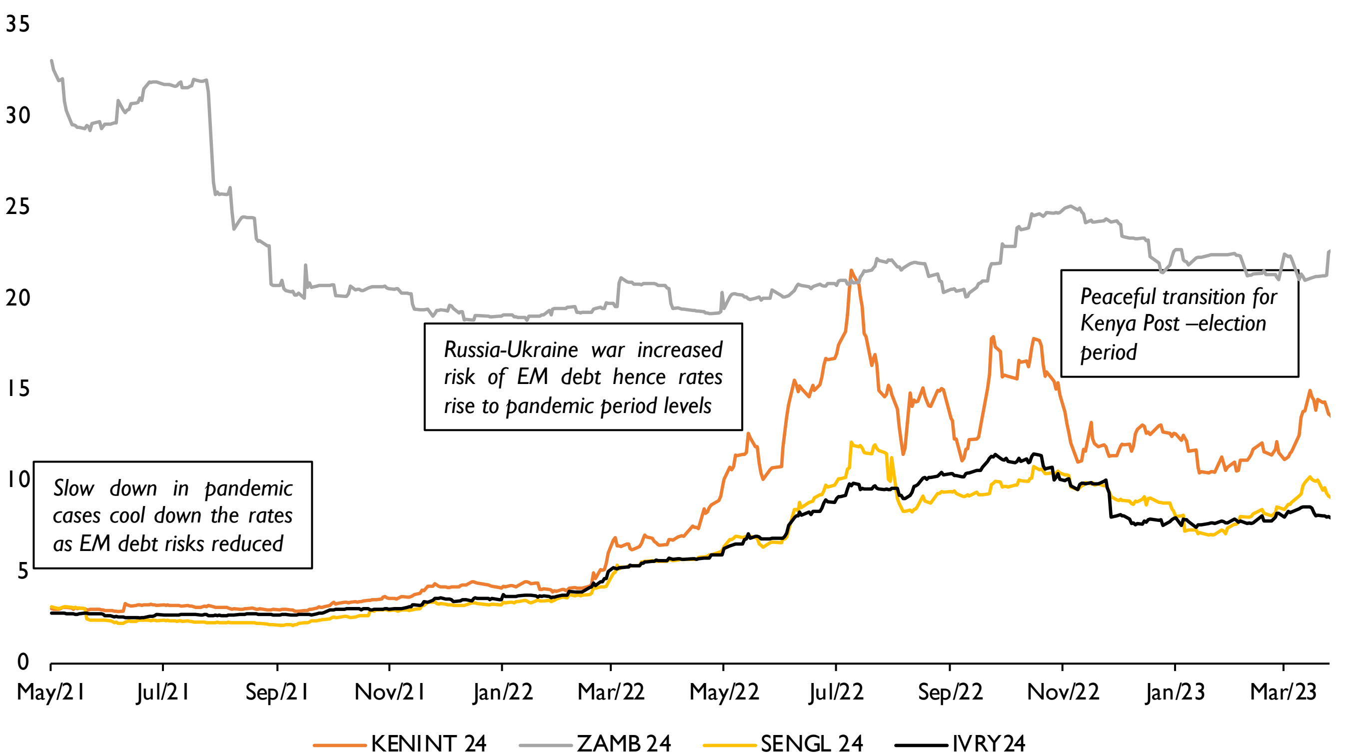
Kenya Eurobond	Q1'23 Change (bps)
KENINT 2024	+637 bps
KENINT 2027	+386 bps
KENINT 2028	+410 bps
KENINT 2032	+250 bps
KENINT 2034	+288 bps
KENINT 2048	+205 bps

Source: Bloomberg

- **GOK Fiscal Position Questions Persist** – The debt to GDP ratio remained near the 70.00% level in 2022 higher than the IMF recommended level of 50.00% for a 'B' rated country. In the recent months we have seen two ratings downgrades from Fitch ratings and S & P Ratings. During the downgrade, (B from B+ with a stable Outlook) Fitch Ratings observed that Kenyan external debt service will rise to 24.80% of current external receipts in 2024 from 16.60% in 2023. Additionally, the public debt –to- GDP will remain above 60.00% mark even as the government seeks fiscal consolidation and weaker foreign reserves will add pressure on external interest servicing.

- **External Eurobond Issuance Will be an Expensive Affair** – Yields on all the KENINT Eurobonds rose 2.0x in 2022 driven by increased risk perception on frontier markets, more so, Sub Saharan countries, election related fears and credit events in other frontier markets such as Ghana and Sri Lanka that eroded investor confidence.
- In Q1'23, yields on all KENINT Eurobonds were on an upward trend (See table), more so in the month of March. The bi-weekly political protest by members of the opposition coupled with chatters on the government of Kenya's debt sustainability have eroded investors confidence and created a negative outlook on Kenya's macro prospects. We suspect that the advertisement for a transaction advisor for another Eurobond could have unnerved investors leading the KENINT 24 yields to a high of 19.6% , earlier this week.
- As such, the Eurobond issuance environment will be hostile for any new issuances as the current high yields would mean more expensive debt for issuers. We expect the yields to continue rising in 2023 driven by GOK's debt sustainability questions. We do not foresee KENINT yields declining fast enough to allow Kenya issue a paper at a single digit rate and thus might be forced to issue the next Eurobond at above 10.00%.

Graph 11: Kenya Eurobond Performance Against Select SSA Sovereigns (10 Year paper Maturing in 2024)



Source: Bloomberg

** EM – Emerging Markets

Equity Market

- **Market Opened the Year in the Red:** The benchmark indices were on a downward trend as the **NSE 20** and **NASI** lost 3.22% and 11.54% to close at **KES 1,622.05** and **KES 112.76** from **KES 1676.10** and **KES 127.47** respectively. The YTD loss for the NSE 20 and NASI stood at **(3.11%)** and **(11.54%)** respectively. Equity turnover increased by 31.30% to **KES 22.05Bn** from **KES 16.80Bn** in the preceding quarter. The bourse's capitalization increased by 1.99% to **KES 1.22Tn** from **KES 1.19Tn** in Q4'2022. We believe that this slight increase was brought about by investors taking positions in the banking sector despite continued foreign investor outflow brought about by the effects of the Russia war that has seen increased capital flight.

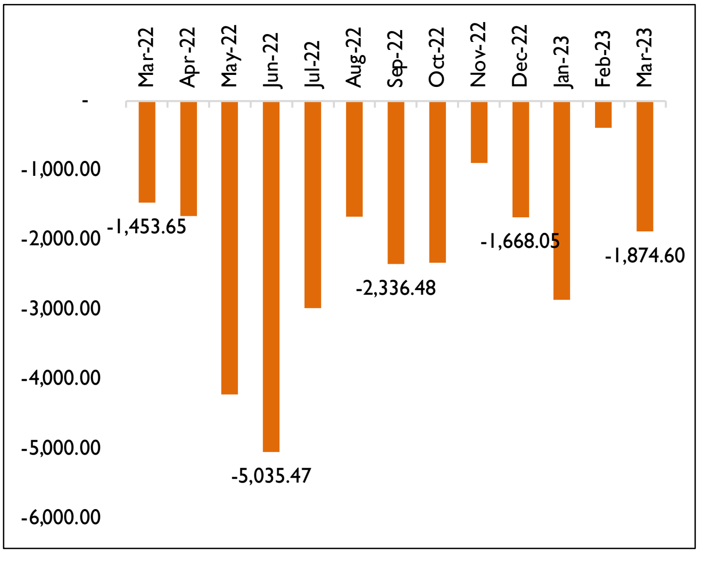
Table 5: NSE Indices Performance

	Q2'22	Q3'22	Q4'22	Q1'23
NSE 20	-15.23%	-9.72%	-11.90%	-3.22%
NASI	-25.23%	-22.86%	-23.42%	-11.54%

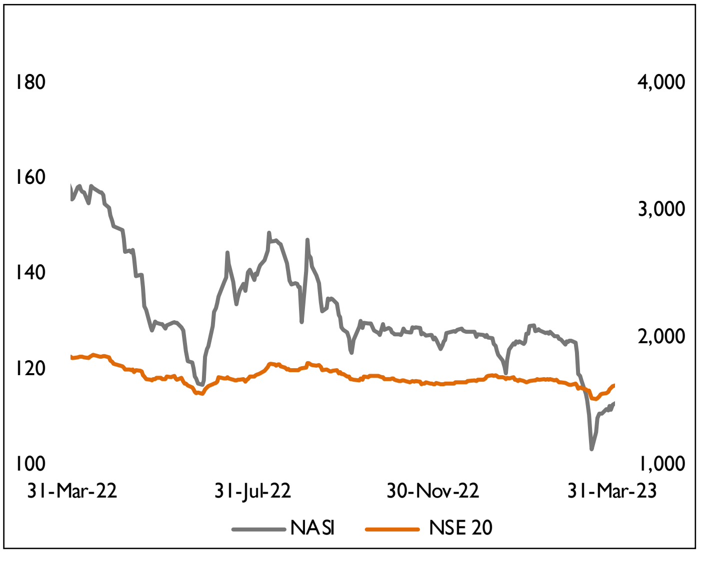
Source: NSE, AIB-AXYS Africa Research

- **Q2'23 Outlook:** The second quarter of the year is likely to see continued foreign investor outflow due to the negative shilling outlook, presenting a lucrative entry point for local investors. With scarcity of the dollar and low returns relative to other asset classes, performance is expected to be slow. With the book closure of several counters upcoming in Q2, we anticipate the net selling position to increase in tandem. Upcoming settlement of dividend payments is expected to cause little to no action on the corresponding counters.

Graph 12: NSE Net Foreign Activity



Graph 13: NSE Indices Performance



Sources: NSE, AIB-AXYS Africa research

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