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ZAMBIA RESEARCH NOTE (REVISED)

Deteriorating fundamentals signal further spread-widening ahead

1) At a press conference on Thurs. 25th, the director of the national statistics office gave a **preliminary estimate[1] of 22.88% for February's inflation[2] rate** (y/y). Price pressure was evident in both food items (impacted by the region-wide drought) and non-food items (reflecting the rise in utility prices as well as the pass-through effect of the Kwacha's depreciation on imported products).

2) If confirmed, the inflation statistic would mean that **retail prices have surged by 17.45% over the last 6 months alone, equivalent to an annual rate of almost 35%**.

No wonder demand has been so weak at the front end of the local curve. At the Feb. 18 auction, the Treasury was only able to sell ZMK 8 bn out of ZKM 45 bn in 3-month bills and ZMK 29 bn out of ZMK 105 bn in 6-month paper, at yields of 22.001% and 24.005%, respectively.

3) Appearing before the National Assembly earlier this month, finance minister Alex Chikwanda (a.k.a. ABC), had delivered some bad news of his own:

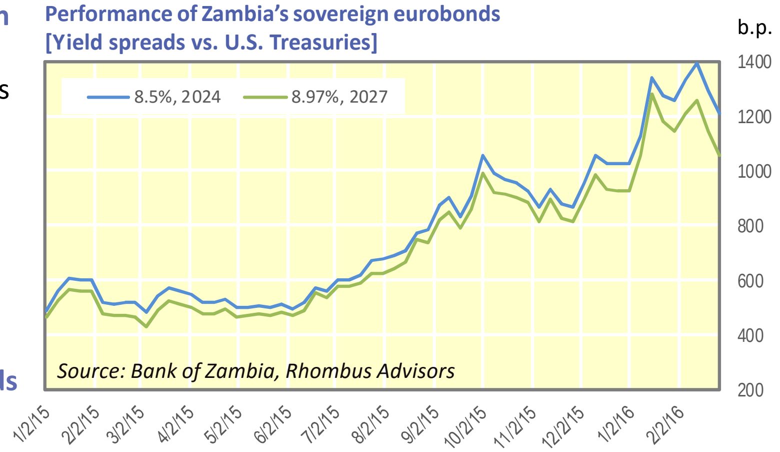
- First, he estimated the **fiscal deficit for 2015 at 8.1%**, a sharp deterioration from the revised target of 6.1%[3] he had presented last October, while introducing the 2016 Budget[4].
- Then, he sought and obtained **approval to raise the debt ceiling** - from K60 billion to K160 billion for external loans payable in a period of more than one year, and from K13 billion to K30 billion for domestic loans payable over a period of not more than one year[5].
- Finally, ABC informed parliament, the **Cabinet had authorized his ministry to approach the IMF for an economic support package**.

4) Clearly, the last item amounts to **little more than a 'Hail Mary'**, less than a month having elapsed since the Fund's deputy director for Africa, David Owen, concluded two days of frank consultations with government officials and key stakeholders.

According to participants quoted (anonymously) in the local press, Owen advised that ***"any package to help restore the economy could only be put in place after the general elections."***[6]

[1] The official release is due at the end of next week.
[2] i.e. more than 100 b.p. north of the already vertiginous 21.78% rate recorded a month earlier.
[3] The original target, spelled out in the 2015 budget, had been 4.6% of GDP.
[4] The deficit target for 2016 is set at a clearly implausible 3.9% of GDP.
[5] It is unclear how much external demand there is for Zambia's paper in this fraught election year marked by the collapse in copper prices, an acute power deficit further hobbling economic growth and the highest inflation rate on the Continent. Nevertheless, the 5:1 ratio between the respective ceilings for foreign and domestic financing echoes the minister's memorable declaration, during his 2016 Budget statement, that "*Government will, therefore, significantly limit domestic borrowing and focus on accessing external financing with lower interest rates and longer repayment periods.*"
[6] It was further reported that, *"Mr Owen said the biggest challenge Zambia is facing at the moment is the level of fiscal indiscipline and credibility of the level of expenditure management. So yes, he said the country was constrained in its revenues but the government equally is not willing to apply any fiscal restraint."* [See Zambia Watchdog, Jan. 20, 2016]

5) In the light of the foregoing, **we regard Zambian assets as highly vulnerable**, even though a rising tide is currently lifting all boats emerging-markets (among other risk sectors).

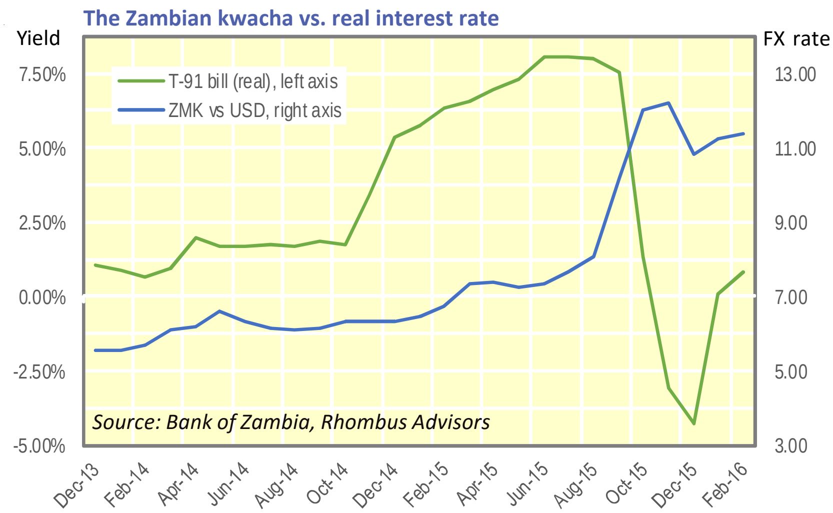


⇨ On sentiment alone, the credit spreads on Zambia's on-the-run eurobonds[7] have tightened from their mid-month levels by 187 b.p. and 205 b.p., respectively.

As the market takes stock of the deteriorating economic fundamentals[8], we **expect these spreads re-test their earlier highs of 1,394 b.p. and 1,258, respectively**.

⇨ The risk-reward profile of Zambia's treasury bills is even more adversely skewed, despite their offering the highest nominal yields[9] available in the frontier markets.

The real interest rate[10] is a barely positive 0.81% which offers no support to the Kwacha. And, as illustrated in the chart alongside, **this rate has declined by 672 b.p.** over the last five months – **while the local currency has depreciated by a mere 10.45%**. A significant adjustment is almost certainly on the cards.



In a nutshell, ***caveat emptor***.

[7] i.e. the 8.5% due 2024 and the 8.97% due 2027.
[8] Not to mention the growing incidence of political violence as the ruling Patriotic Front party seeks to retain its grip on power in the elections to be held this August.
[9] The most recent auction, held on Feb. 18th, produced yields of 20.001% and 24.005% for the 91- and 182-day bills, respectively.
[10] i.e. the annualized yield on the 91-day bill, deflated by the CPI.