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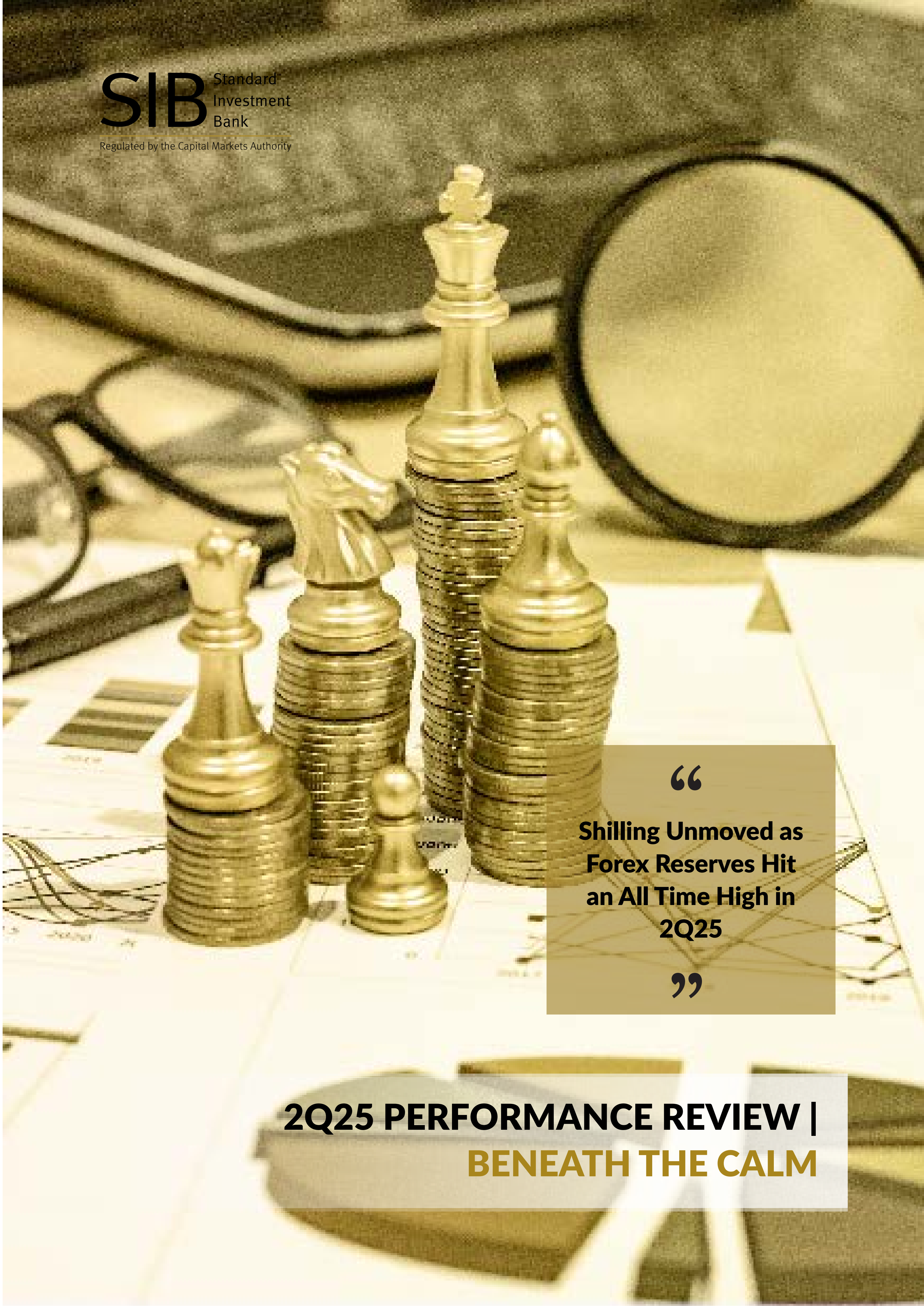


"Shilling Unmoved as Forex Reserves Hit an All Time High in 2Q25"

2Q25 PERFORMANCE REVIEW | BENEATH THE CALM

TOP NEWS THIS QUARTER

MACRO VIEW: SWEET NOTHING

We have observed with growing concern the persistent misalignment of economic stability with economic prosperity. Businesses thrive in predictable environments and abhor volatility. While stability is valuable and a key ingredient for growth, it alone is not a driver for prosperity. Further, while indicators have been coming through positively, the prosperity component seems to be lagging behind.

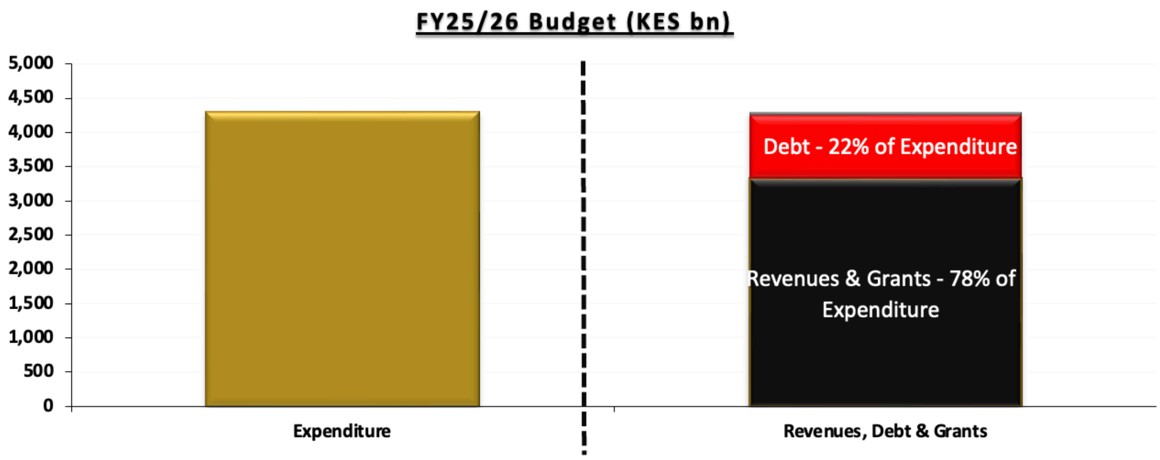
The second quarter of every year is particularly crucial in shaping the economic outlook, as it often sets the tone for fiscal and monetary direction over the subsequent four quarters. This is typically when new tax measures, administrative procedures, and incentive structures are introduced. It is also the period when public expenditure priorities become more apparent, often going beyond the routine.

Last year, this period was marked by historic unrest when bottom-up policies led to nationwide economic protests. While a full year has passed—offering ample time to course-correct, refine engagement, and temper expectations—2Q25 once again experienced disruptions. This time, however, the Finance Bill was not at the center of the unrest. Rather, it reflected a broader shift to deeper public participation in economic and governance discourse.

In the sections that follow, we distil the key takeaways across five critical areas: fiscal space, monetary policy, the business environment, the foreign exchange market, and the overall economic landscape over the review period;

FY2025/26 Budget: Navigating Fiscal Policy in the Absence of IMF and Aid

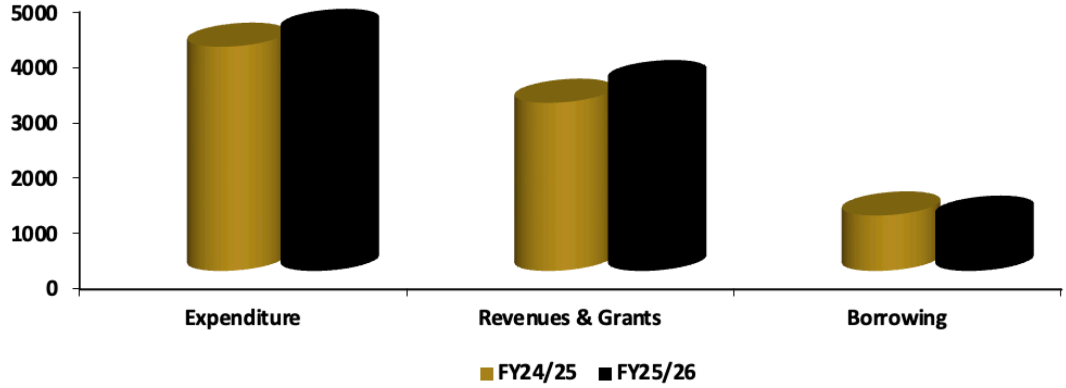
The FY2025/26 budget marks a significant milestone as the first post-COVID-19 fiscal plan formulated without support from the International Monetary Fund (IMF) and amid reduced foreign aid, following policy shifts under the new U.S. administration. The budget is estimated at KES 4.29tn, excluding debt redemptions. It is expected to be financed through KES 3.37tn in revenues and grants, alongside KES 923.24bn in domestic and external borrowing. See the chart below;



Source: Treasury, Chart: SIB

Juxtaposing FY25/26 budget against the FY24/25 numbers show that expenditure rose by 6.2% from KES 4.04tn under the supplementary budget III. Meanwhile, revenues and grants grew even faster, climbing 11.1% from the FY24/25 estimates of KES 3.03tn. on the contrary, the fiscal deficit dropped by 7.7% from KES 999.9bn in FY24/25. See the chart below;

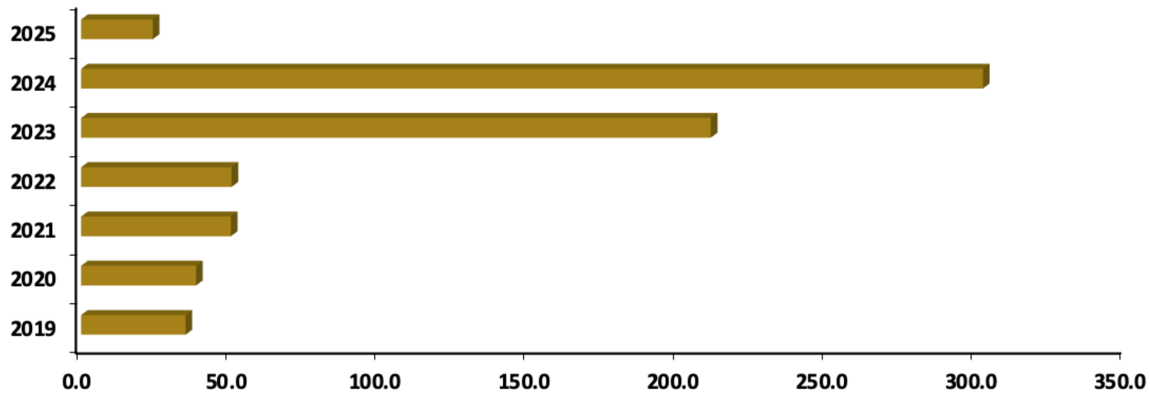
FY25/26 vs. FY24/25 Budget (KES bn)



Source: Treasury, Chart: SIB

Of the KES 336.0bn absolute increase in revenue and grants, only KES 24.0bn is projected to be raised through the Finance Bill 2025. This is in stark contrast to the Finance Bill 2024, which had aimed to generate KES 302.25bn, before its withdrawal—clearly indicating a significant slowdown in the tax expansion drive, likely as a response to growing public discontent. From our assessment, income tax and VAT have the highest projected increases with the likelihood that the government is banking on ramping up existent measures;

Revenue Projections from Respective Finance Bills (KES bn)



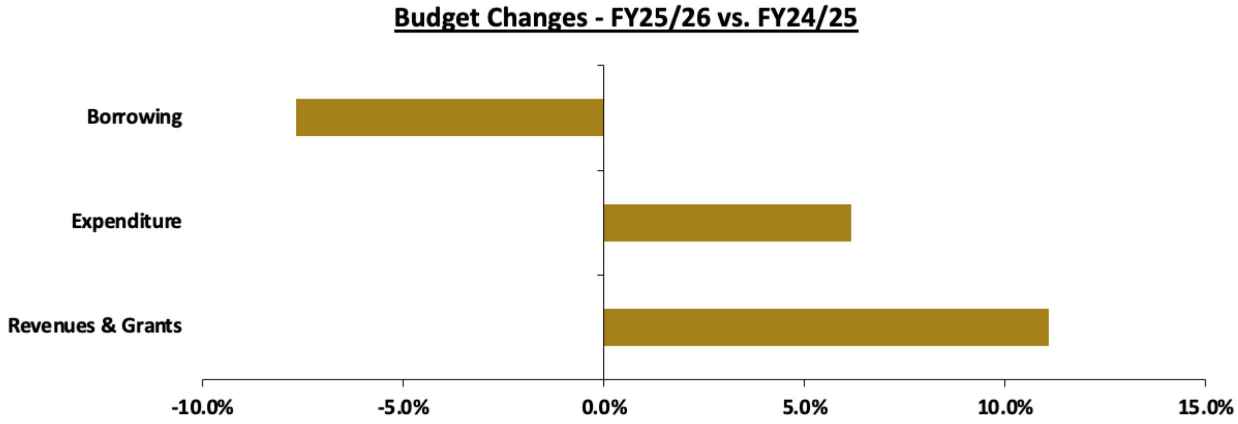
Source: Parliament | Chart: SIB

Borrowing Falls – Sweetest Thing, Don't Let Me Down

The fiscal deficit is expected to be financed through KES 624.75bn from domestic capital markets issuance of government securities, KES 287.70bn from external markets, and KES 10.80bn from other domestic sources. Notably, net domestic borrowing is projected to decline by 24.1% compared to the KES 823.05bn estimated in FY2024/25 under supplementary budget III.

While this downward shift in borrowing may seem encouraging at first glance, we remain cautious. The government has, in the past, revised its borrowing targets upwards in subsequent supplementary budgets—of which we expect at least two in the current fiscal year. Furthermore, the continued and significant reliance on the domestic market—especially in the absence of an active IMF program—raises concerns about the crowding-out effect on private sector credit.

See the chart below for a visual presentation:



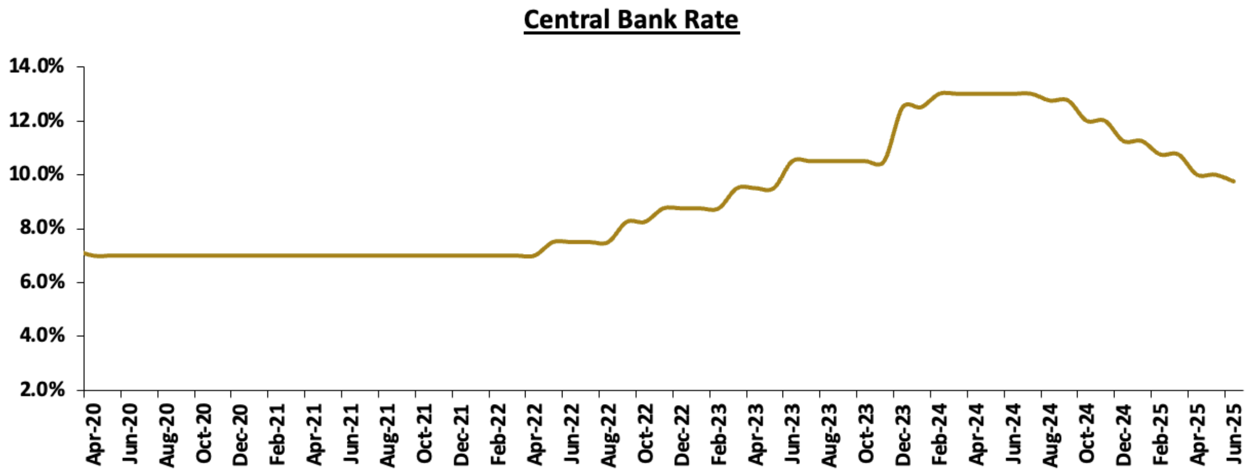
Source: Parliament | Chart: SIB

Between the lines, the budget reflects a series of additions and reductions across sectors, with notable disparities. For instance, the health sector received only a marginal increment, despite the cessation of aid from the United States—a situation that, in our view, warranted a more substantial boost in allocation. Stay tuned for a detailed breakdown of the budget in our forthcoming report.

Meanwhile, the Central Bank has maintained a strong presence in the market throughout the quarter, actively working to moderate interest rates on both government securities and private sector lending.

2Q25 Marks Return to Single-Digit Benchmark Rate After Two Years

In 2Q25, the Central Bank's Monetary Policy Committee (MPC) met twice, and decided to lower the Central Bank Rate (CBR), by 100bps to 9.75%, from 10.75% at the beginning of the quarter – this marked the first single digit policy rate since May 2023. The committee also narrowed the interest rates window from ± 150bps against the CBR to ±75bps. See the chart below;



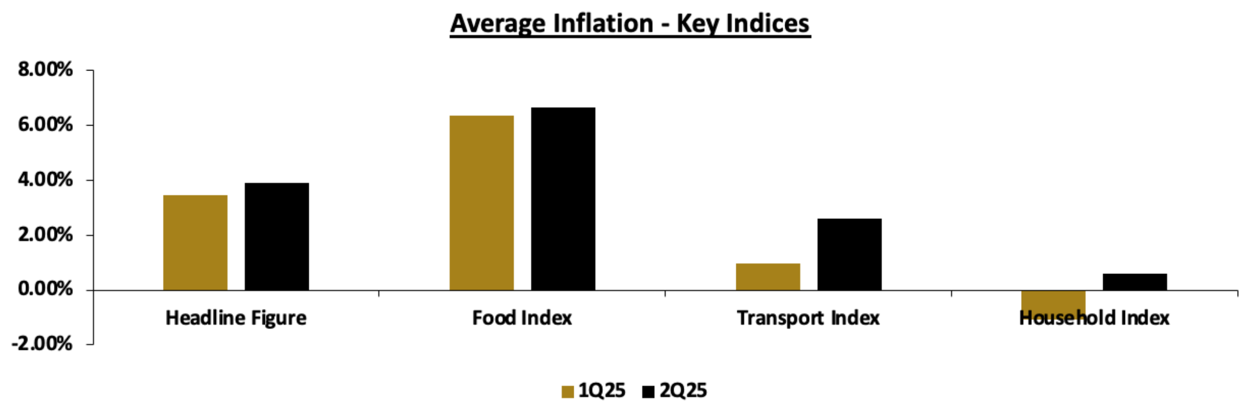
Source: CBK, Chart: SIB

The reduction was largely underpinned by stable inflation, which has remained well below the midpoint of the Central Bank of Kenya's target range of 2.5% to 7.5%. During the quarter, headline inflation averaged 3.89%, with core inflation remaining steady between 2.5% and 3.0%. In contrast, non-core inflation remained volatile, as is typically expected due to its sensitivity to external and seasonal shocks.

Food inflation continued to exert the greatest upward pressure on the overall consumer basket, driven by its higher weighting relative to other indices. The transport index also recorded an uptick compared to the first quarter, largely reflecting the short-lived increase in fuel prices at the start of the period and the subsequent upward adjustment of the Current Retail

Selling Price (CRSP) by the Kenya Revenue Authority (KRA) which raised the prices of personal cars.

Overall, while the pace of price growth has moderated, we emphasize that the cost of goods and services continues to rise—albeit at a more stable and predictable rate. See the chart below for further illustration;

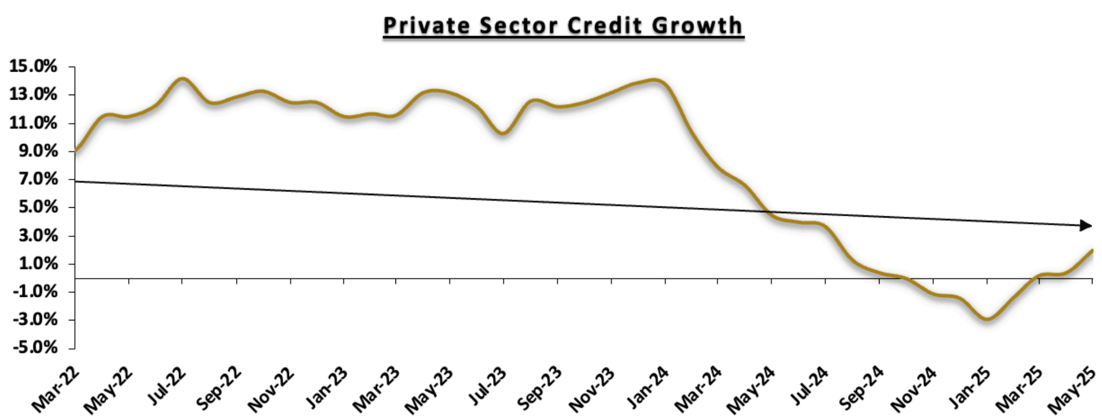


Source: KNBS| Chart: SIB

Meanwhile, private sector credit growth saw a rebound during the quarter as the currency effects dissipated and several banks slightly lowered their lending rates. 2Q25 also ushered in the beginning of the recovery from a low base

In particular, credit to the private sector grew by 2.0% and 0.4% in April and May, respectively compared to the 1.3% average decline recorded in 1Q25.

See a summary of the rates;



Source: KNBS| Chart: SIB

All the same, lending to the private sector remains subdued partly due to:

i. The persistent borrower risks, which then feeds into the Risk-Based Credit Pricing Model (RBCPM), and,
ii. Increased borrowing needs by the government

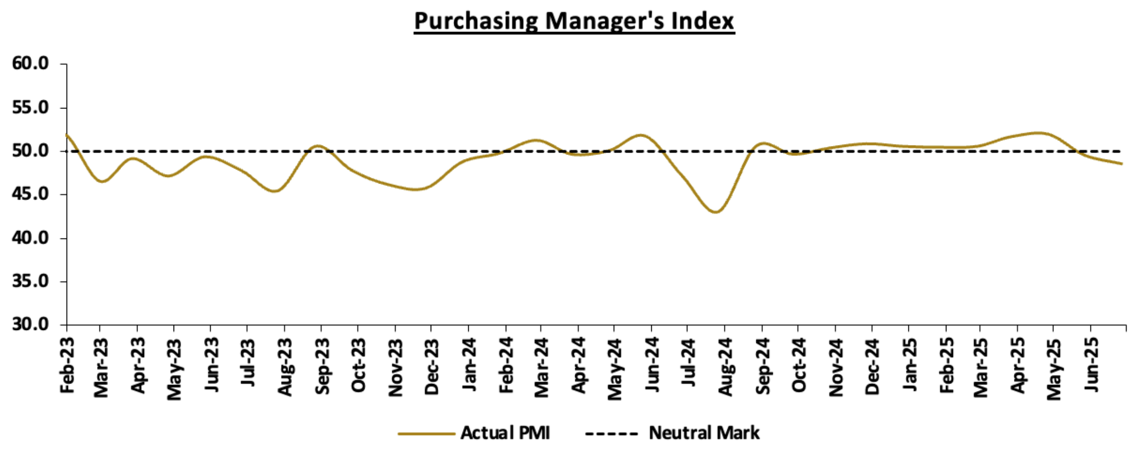
The period under review marked what could be the beginning of a new era in the pricing of lending rates, following the Central Bank of Kenya's (CBK) release of a Consultative Paper on the Review of the (RBCPM). This move was prompted by persistent concerns surrounding the availability, quality, and fairness of credit scoring data underpinning the model, as well as the inconsistent application of the RBCPM across commercial banks.

CBR Proposed as New Reference Rate for Borrowing. In the proposed framework, the CBK recommends the adoption of the Central Bank Rate (CBR) as the common reference rate, augmented by a premium ("K"). This premium would reflect a combination of the bank's operational costs related to lending, a return to shareholders, and the borrower's risk profile. While public comments are still under review, the Kenya Bankers Association has notably advocated for the interbank rate to be considered as the base rate for setting lending rates across the sector.

Our Take: The proposed model offers a more responsive mechanism, as policy rate changes would be transmitted more directly and immediately to lending rates. However, our primary concern lies in the composition and variability of the premium ("K"), which would need to be reviewed and approved by the CBK. The variability in the premium—especially as it accounts for differing funding costs and borrower risk levels—could introduce volatility and delays in pricing, particularly during periods of sharp interest rate movements. Additionally, in a business environment where borrower risk profiles are highly sensitive to macroeconomic conditions, the model could unintentionally amplify credit risk pricing. We therefore emphasize the need for joined effort to stimulate economic growth.

Business Metrics Falter Under Economic Headwinds

Private sector business conditions experienced a brief expansion in the second quarter, which was swiftly reversed by reduced consumer spending and disruptions linked to protests. The Purchasing Managers' Index (PMI) averaged 50.1 in 2Q25, with April contributing most significantly to the quarterly performance. See the chart below illustrating PMI trends over the years;



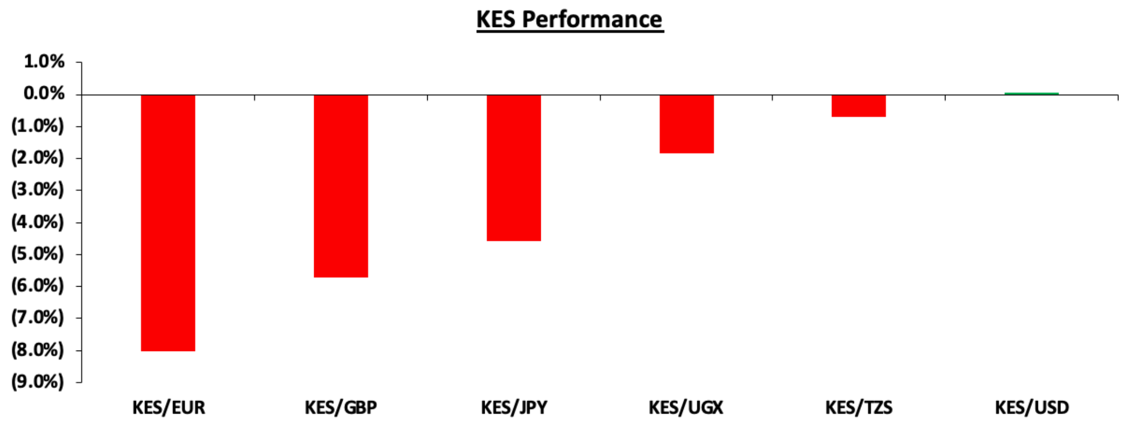
Source: Stanbic, S&P Global, Chart: SIB

The developments during the period under review reinforce our view that the private sector operating environment remains fragile—burdened by underlying structural challenges linked to fiscal constraints and prevailing policy frameworks. In this new era, governance issues have emerged as a persistent and systemic risk, with the path to private sector growth and expansion increasingly disrupted. Businesses that depend heavily on consumer spending remain especially vulnerable, knowing that a single adverse event could rapidly revert them to survival mode.

Amid these challenges, we continue to underscore the importance of decentralizing economic activity beyond the capital. A more regionally diversified economy would provide greater resilience—ensuring that when disruptions occur in one part of the country, business activity can continue elsewhere. This approach holds strong potential to offset losses and support a more inclusive and balanced economic landscape. The removal of the clause in the Finance Bill 2025 that had proposed scrapping capital investment deduction allowances for investments in major cities outside Nairobi is certainly a welcome move.

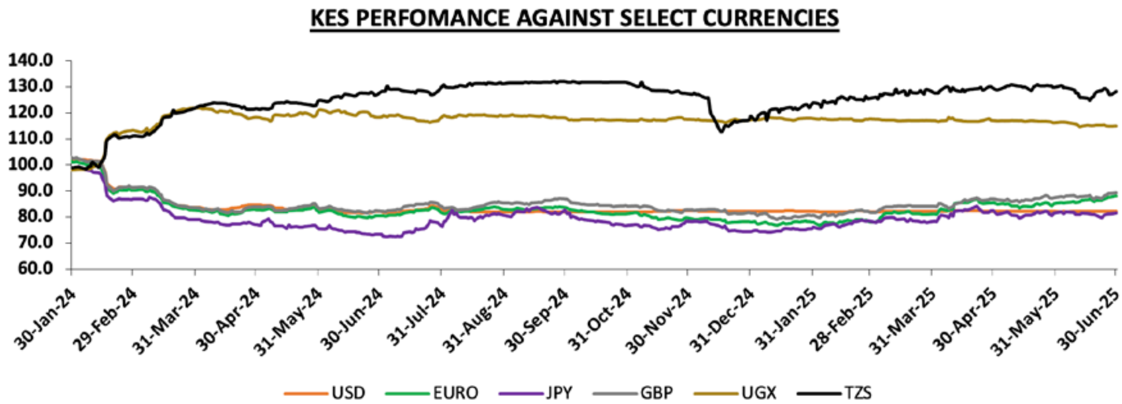
The International Scene: Shilling Unmoved as Forex Reserves Hit an All Time High

The shilling closed the quarter weaker against most of the currencies we track, though it remained relatively stable against the U.S. dollar. The sharpest depreciation was recorded against the Euro, while regional currencies registered only minor fluctuations. See the chart below for illustration;



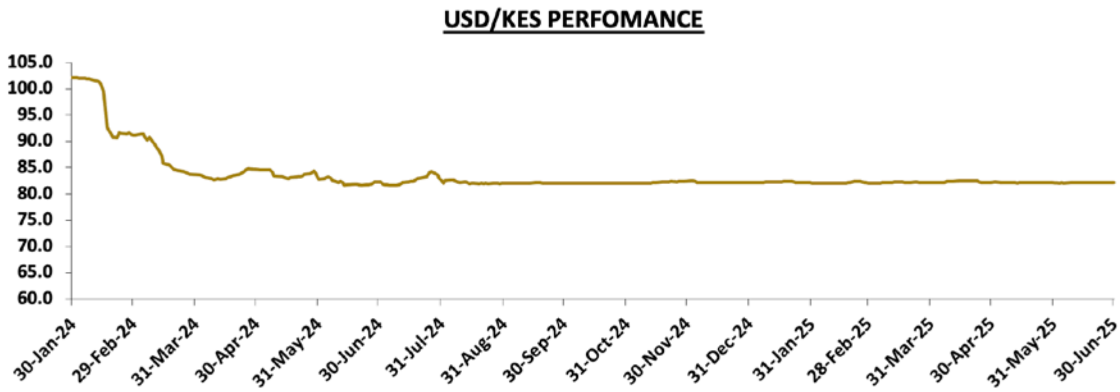
Source: CBK. Chart: SIB

Over the review period, all tracked currency pairs exhibited typical fluctuations—except for the USD/KES pair, which remained relatively unchanged, as illustrated below;



Source: CBK, SIB Estimates, Chart: SIB

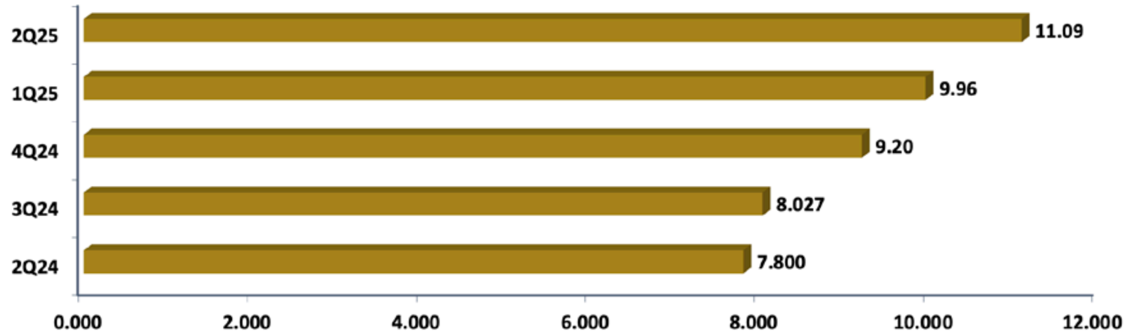
For nearly a year, the USD/KES exchange rate has remained anchored around the resistance level of 128–129. This sustained stability is largely attributed to reduced dollar demand and a strong foreign exchange reserves position, which affords the Central Bank the flexibility to intervene in the market when necessary. See the illustration below;



Source: CBK, SIB Estimates, Chart: SIB

That said, 2Q25 saw foreign exchange reserves climb to an all-time high of USD 11.09bn, bolstered by inflows from a private debt placement in the United Arab Emirates, which followed the Eurobond settlement in 1Q25. This boost is a welcome development, as it provides a buffer ahead of the expected drawdowns in July related to upcoming debt repayments. See the chart below;

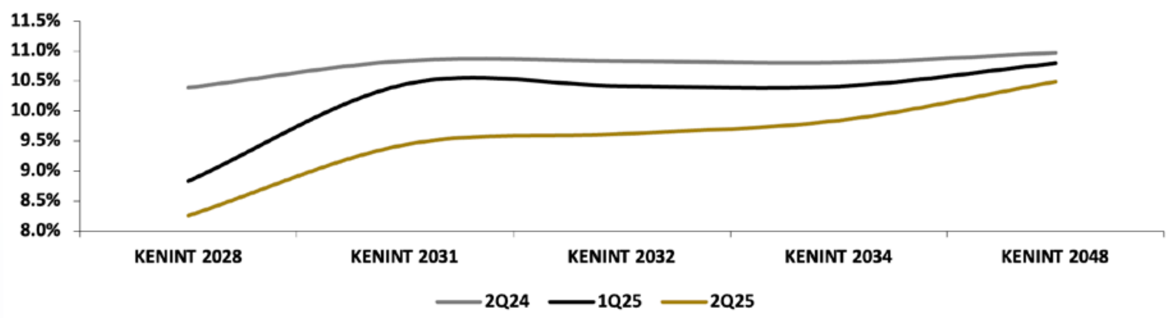
Evolution of Forex Reserves (USD bn)



Source: CBK | Chart: SIB

In other news, the Eurobond market remained relatively stable, although yields declined notably between the first and second quarters. The fluctuations observed during the quarter were largely driven by global developments—particularly during the announcement of U.S. tariffs under the Trump administration. See the chart below;

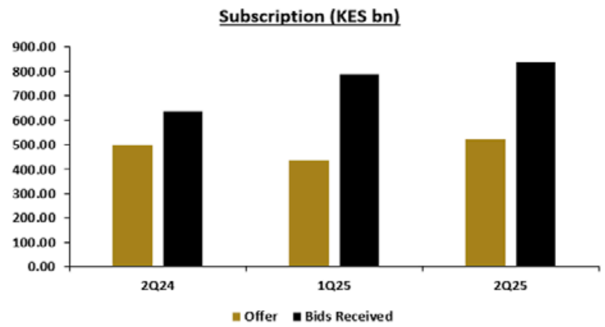
Kenyan Eurobond Yields

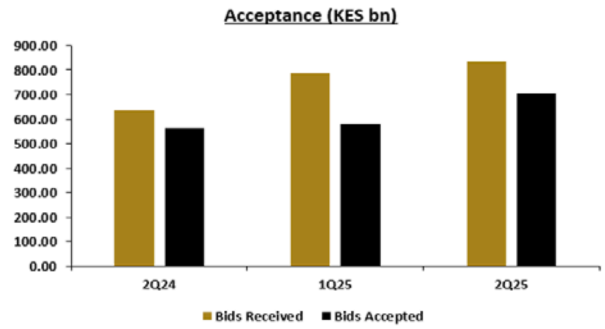


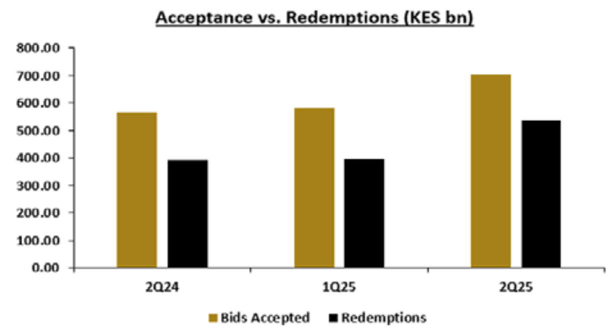
Source: CBK, SIB Estimates, Chart: SIB

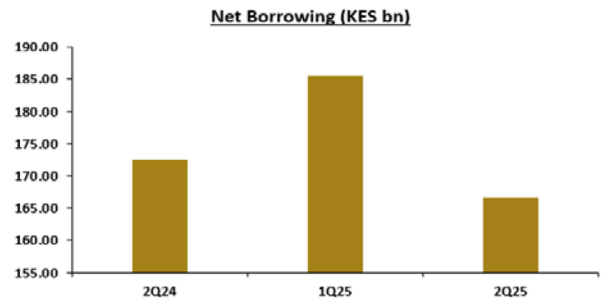
FIXED INCOME MARKETS: PRIMARY OFFERINGS RECEIVE 160% OVER-ALL SUBSCRIPTION RATE

In the primary market, demand for government securities remained robust, with an overall subscription rate of 160.4%—slightly lower than the 180.1% recorded in 1Q25, despite a higher offering volume. The fiscal agent floated a total of KES 522.0bn in T-bonds and T-bills, attracting bids worth KES 837.24bn and accepting 84.3% of the total bids received. Over the quarter, repayments amounted to KES 539.20bn, resulting in a net domestic borrowing of KES 166.73bn for 2Q25. See a summary of the offering below;









Source: CBK, Chart: SIB

Traditionally, the government issues an infrastructure bond in the second quarter as part of its efforts to close out the fiscal year. However, this trend has shifted over the last two fiscal years, with the government opting to absorb more from such issuances in the first quarter instead. Notably, the only existing Savings Development Bond made a return to the market in 2Q25 after more than a decade of absence, though it attracted limited investor interest.

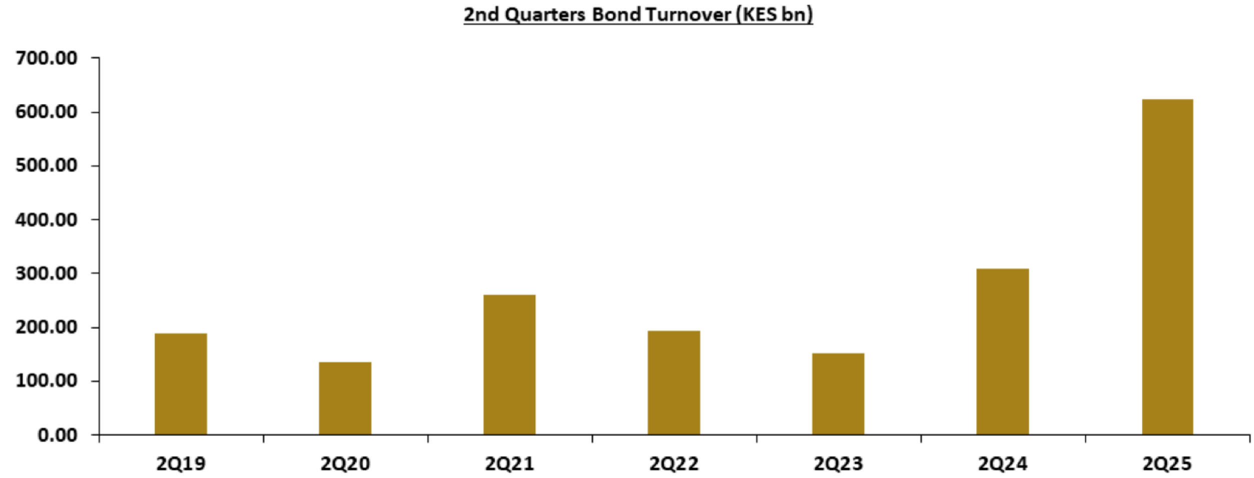
In addition, the average tenor of securities issued in 2Q25 declined slightly to 13.75 years, down from 15.03 years in 1Q25—reflecting alignment with the government's borrowing strategy for FY2024/25.

Bond Market Activity; Turnover declines 6.8% q/q, up 101.6%y/y

In 1Q25, the secondary bond market recorded a 101.6% y/y increase to approximately KES 622.69bn, up from KES 308.88bn in 2Q24. On a Q/q basis however, turnover dropped by 6.8% from KES 667.79bn an indication that market activity is gradually stabilizing, following a period of expansion from a relatively low base.

Notably, the secondary bond market has remained consistently active in terms of volumes since February 2024.

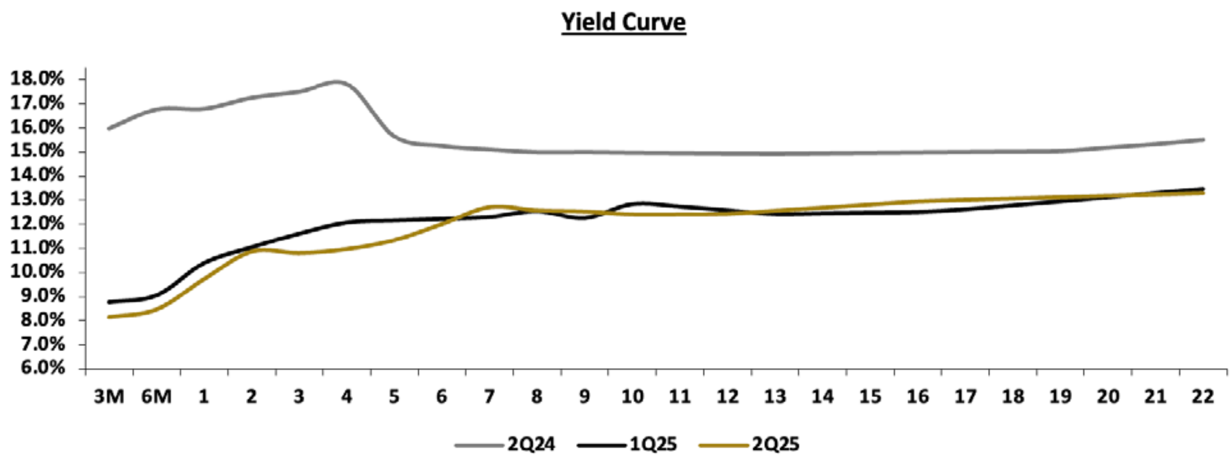
See the chart below for details;



Source: NSE, Chart: SIB

Government's Cost of Borrowing Eases as T-Bill Rates Fall to Mid 2022 Levels

Overall, yields on government securities exhibited mixed performance during the quarter, with short-term securities notably declining across the board—falling to single-digit levels within the review period. See the chart below;



Source: NSE, Chart: SIB

We maintain that the decline is largely influenced by;

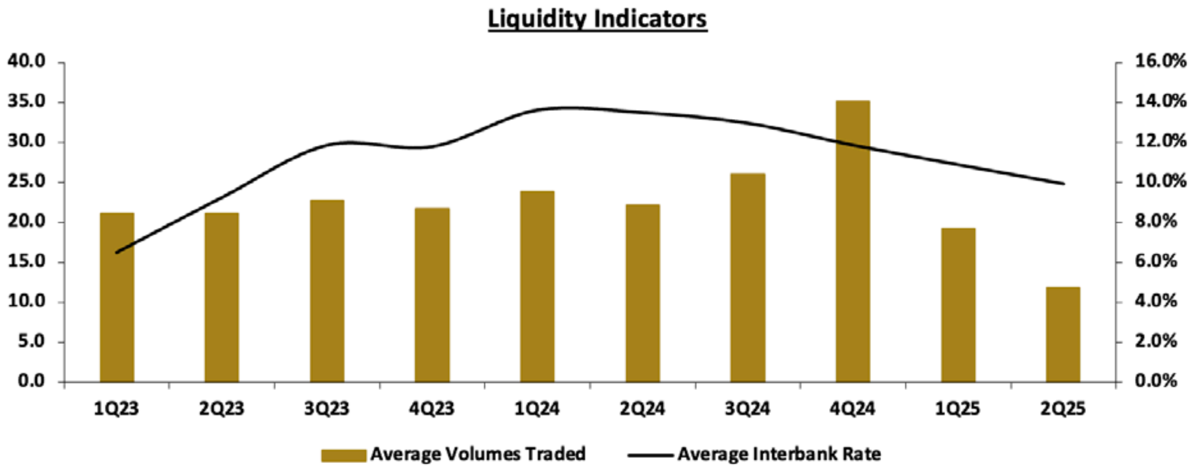
i. **Lower Benchmark Rates** - The cumulative cuts in the Central Bank Rate (CBR) created a ripple effect across the yield spectrum, and,

ii. **Moral Suasion & Stability** - A relatively stable short-term economic outlook, coupled with effective moral suasion by the monetary authority, encouraged market participants to align with the lower rate environment and to favor non-competitive bidding.

Money Market: OMO Drifts Through 2Q25 - Fast & Steady

In the interbank market, average traded volumes declined by 38.4% q/q and 46.4% y/y to KES 11.83bn, from KES 19.21bn and KES 22.07bn, respectively. Conversely, the average interbank lending rate eased to 9.92%, down from 10.88%, in 1Q25 in line with the downward adjustment of the CBR and consequently the interbank corridor.

See the chart below;

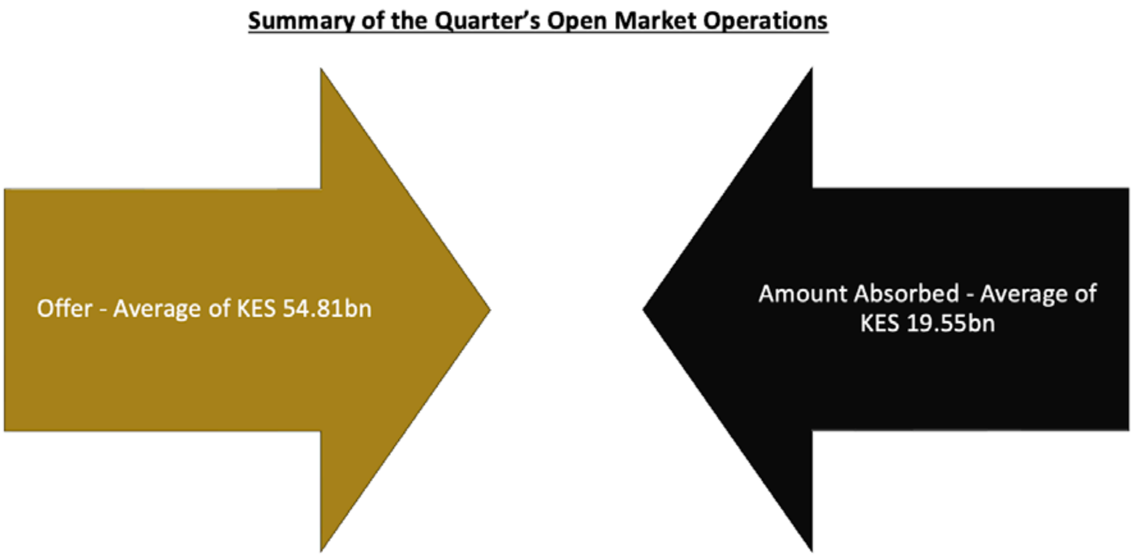


Source: CBK, Chart: SIB

The decline in traded volumes may be attributed to heightened activity in Open Market Operations (OMO), which were primarily aimed at stabilizing interbank rates within the policy corridor. Specifically, we observe the following;

i. A total of KES 14.50bn was accessed through the discount window during the quarter, more than double the KES 7.0bn recorded in 1Q25, and,

ii. Open Market Operations were consistently active throughout 2Q25, with a focus on liquidity absorption. On average, KES 54.81bn was offered daily, while KES 9.55bn was successfully absorbed from the interbank market, as shown below;



Source: CBK, Chart: SIB

All through, the CBK has maintained that these interventions align with policy frameworks designed to ensure the interbank rate closely tracks the CBR.

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