

**Against All Odds,
The CBE Raised Policy Rates by 200 Basis Points**

May 22, 2017

In yesterday's meeting, the CBE's Monetary Policy Committee (MPC) decided to raise interest rate by 200 bps against the market consensus expectations to maintain policy rates unchanged. **While acknowledging the current disinflation path, in addition to tighter monetary conditions, the MPC stated that it remained insufficient to reach the inflation target of 13% YoY (+/-3%) by 4Q2018. The MPC statement also confirmed our view that an interest rate hike is meant to contain the demand-pull inflationary reaction that traditionally follows a cost-push inflation.**

Annual inflation to reach 14.2% in FY2018/19, and single digit by FY2021/22

Following yesterday's nominal interest rate hike, we project the annual inflation rate to reach 14.2% in FY2018/19. This is in line with the MPC's announced target range of 10-16% by 4Q2018. However, this remains above the International Monetary Fund (IMF) projection of 10.9% and 8.1% in FY2018/19 and FY2019/20, respectively.

Fiscal consolidation is next; to counter-effect the higher debt service in FY2017/18 budget

The recent 200 bps rate hike will cost the government budget's expenditure side c. EGP30-35 billion in additional interest payments per annum. Since there is only 40 days to go before the current fiscal year end, we believe that the negative impact on the budget deficit in FY2016/17 will be limited. However, we expect the government to undertake further fiscal consolidation measures (mainly fuel products price hike) early on, in order to maintain the budget deficit within the pre-announced target in FY2017/18.

Winners: Household savers, cash-rich companies and fixed income investors; Losers: Highly leveraged companies; debt providers, and equity investors

Given the fact that the private sector credit represents c.20% of GDP, such a low level of debt minimizes the negative effect of high nominal interest rates on the broad economy. Accordingly, cash-rich corporations will be key beneficiaries of the recent nominal interest rate hike, while highly leveraged corporations will continue to bear the brunt.

We note that the local currency credit maintained its upward trend following November's 300 bps nominal interest rate hike due to a favorable real interest rate. Having a positive real interest rate following yesterday's nominal interest rate hike, we expect the local currency credit to decline going forward.

We also expect the momentum of foreign fund inflows into Egypt's fixed income market to continue on the attractive nominal interest rate levels; and we should witness short-term pressure on the equity market. It is notable that we have been using a cost of equity of 24% for FY2017 (based on an after-tax risk free rate of 17%), that gradually levels off to 15% in 2021 (on RF rate of in all of our DCF models), and we do not believe that it should be reviewed upwards.



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