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Macroeconomic outlook

Q3 2023

KEY THEMES

Agreement reached on Zambia’s Sovereign debt

The conclusion of an agreement to restructure c. USD 6.3 bil. of debt owed to Zambia’s official bilateral creditors bodes well for Zambia’s macroeconomic-outlook. Critically, the restructuring includes ZESCO’s debt (Zambia’s state-owned energy utility) which provides some visibility of ZESO’s bankability as an offtaker for Independent Power Projects (IPPs). The agreement will see loan tenors stretched by up to 12 years with concessional interest rates. This provides the Government with critical near-term flexibility. We expect fiscal policy to remain tight and capital spending to largely originate from FDI and other private sector sources.

Currency outlook only slightly bullish

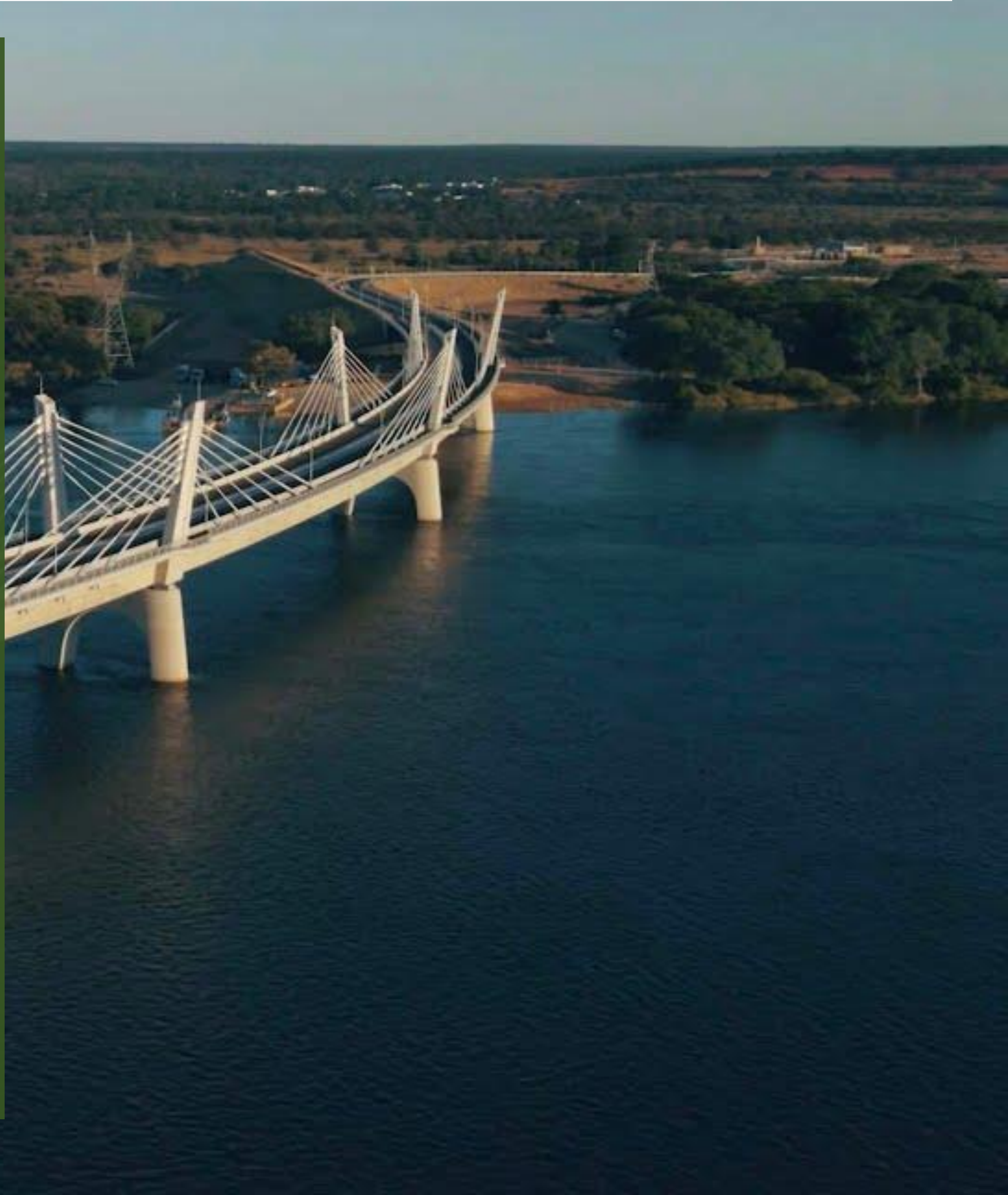
The forthcoming relief disbursements from IMF and World bank to Zambia, USD 188.8 and USD 75m, respectively, while significant do not by themselves warrant a sharp move upward for the Kwacha. This paired with a relatively narrow trade balance limits the upside prospects for the Zambian Kwacha. We believe sentiment factors will help to drive up Kwacha demand slightly post restructuring however the fundamental picture will still weigh on the exchange rate. We expect rates to remain stable at around ZMW 18 to the USD for Q3.

External factors likely to keep inflation elevated

Inflation is driven largely by external factors, especially the cost of fuels. Artificial oil supply reductions brought on by OPEC members threaten to keep energy prices high. Zambia has little immunity against these high prices due to Zambia’s total reliance on imported refined products and limited storage capacity. Lower local and global agricultural productivity will also contribute to elevated food prices.

Mining and energy to drive FX long term

Strengthening of Zambia’s international reserve position will be heavily dependent on increases in mining output and an increase in energy exports. With 3 significant interconnectors planned for the 2023 – 2026 window, grid integration between Zambia a number of its neighbours will be enhanced. However, these inflows will only be realised in the medium-long term. In the near term, growth in output at Mopani and KCM mines in particular and the sector in general will be drivers of additional inflows.



ZAMBIA DEBT RESTRUCTURING AGREEMENT SUMMARY

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Key features

Scope
The debt restructuring agreement covers approximately USD 6.3 billion of central government debt owed to external bilateral creditors and debt guaranteed by the government for ZESCO Limited. The agreement provides significant debt service savings, freeing up resources that can be directed towards developmental programs.

Private creditors not subject to agreement
The USD 6.8 billion owed to private creditors is not subject to the recently concluded agreement. Government has begun engaging with private creditors and these conversations are being supported by official creditors which will help to expedite the process.

Tenor extensions
The agreement includes significant debt relief, extending maturity by over 12 years until 2043, reducing interest rates to concessional levels, and will see principal repayments begin in 2026 at a fraction of the debt stock.

Repayment adjustment mechanism
It also features an adjustment mechanism based on future debt carrying capacity, allowing for reduced final maturity and slightly higher interest rates if the country's capacity improves.

Local debt excluded from restructuring
The official creditors have also agreed with the Government that domestic debt, which is local currency denominated debt such as Treasury Bills and Treasury Bonds, will be excluded from any treatment.

Implications of restructuring agreement

Debt Relief and Resource Allocation: With a reduction in debt obligations, the government will have more funds available for infrastructure projects, social services, and investment. In our view government capital spending will be constrained and Zambia will rely heavily on private sector financing for capital expenditure. This in part because Zambia’s new public debt management bill will make contracting new debt a more onerous task. Government has also demonstrated a conservative approach to fiscal affairs.

Improved Cash Flow and Financial Stability: The restructuring agreement postpones debt service payments and reduces the interest rates, resulting in lower debt servicing costs. Government expects US$5.8 billion in debt service savings over the period 2023 to 2031. Additionally, by stabilizing debt repayments and reducing uncertainty, the agreement will improve financial stability, and help restore confidence in the economy. However, government still has a substantial challenge in adjusting its consumption-oriented expenditure and reducing the high public sector wage bill which is the largest cost on its book.

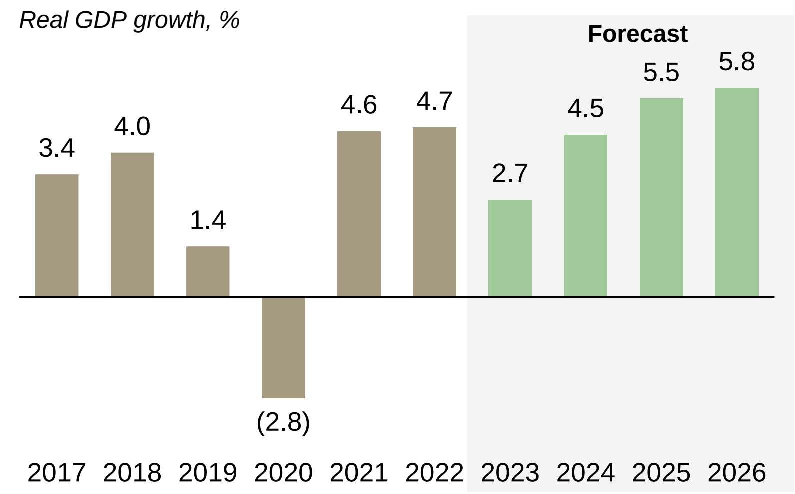
Exchange Rate Stability and Investment Climate: The agreement is expected to have a positive impact on the stability of the exchange rate by helping to plug the drain on international reserves. Renewed confidence will help reduce the risk of capital flight and other pressures on the Zambian kwacha. This stability creates a more favorable investment climate, making it easier to attract both domestic and foreign investments, which we expect to drive growth. The debt service relief provides Zambia with an opportunity to build up its international reserves which will strengthen the country’s credit position especially during the critical debt service holiday.

Enhanced Cooperation with Creditors and Cooperating Partners: The debt restructuring agreement signals to the market Zambia's commitment to resolving its debt crisis in a cooperative manner. It strengthens relationships with official bilateral creditors, paving the way for improved cooperation in the future. The agreement has also unlocked additional funds from cooperating partners like the IMF and World Bank, supporting Zambia's economic programs and reforms.

Pathway to Debt Sustainability and Economic Transformation: The agreement provides a roadmap for Zambia to achieve debt sustainability in the medium term. By extending debt maturity, reducing interest rates, and establishing mechanisms for monitoring debt carrying capacity, it allows the government to manage its debt burden effectively. This, in turn, contributes to an improved macroeconomic environment, which can foster economic transformation and attract long-term investment.

Sources: Bank of Zambia (BoZ), Ministry of Finance and National Planning (MoFNP), Kukula Capital Research (Kukula).

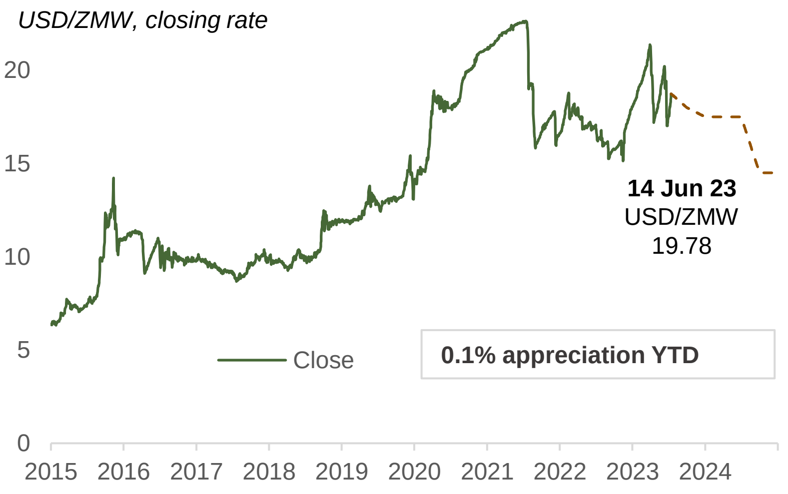
Real GDP growth rate (%)



Preliminary GDP data indicates GDP growth of 4.7% in 2022, which was driven largely by higher commodity prices. We have revised downward our end of year GDP target to 2.7% from 4% on the back of lower mining output. This will translate to lower FX earnings and consequently countering some of the Kwacha demand expected post restructuring announcement.

We expect relatively high commodity prices to be sustained but slightly behind the accelerated growth expected by the market. Prices of critical commodities such as petroleum and fertiliser drive higher input costs and thus limit growth of some sectors like agriculture. Promising future FDI inflows towards energy, mining and agriculture will more than likely raise the GDP outlook for 2024 onward. This combined with a strong global demand for copper and nickel and a shift to an increasingly business-friendly policy environment with restored access to international credit.

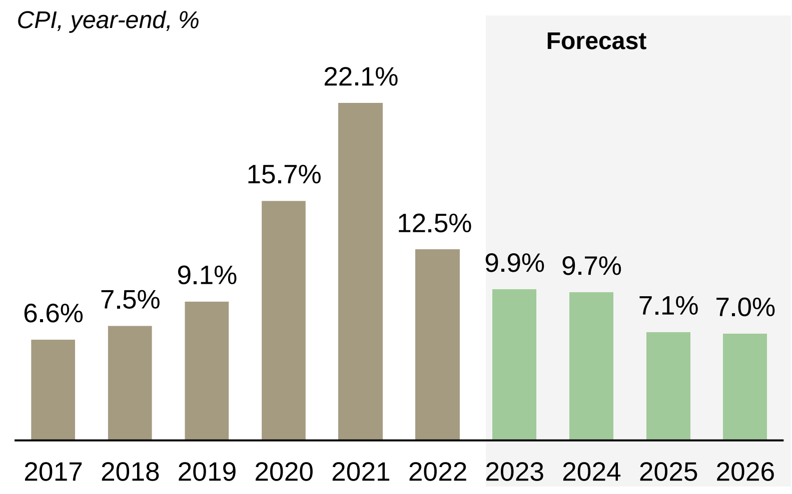
USD/ZMW exchange rate



The Kwacha YTD performance has been characterised by substantial volatility. A combination of sentiment linked to the conclusion of the debt agreement and BoZ intervention are in our view the main drivers.

The sharp appreciation anticipated post restructuring announcement was entirely absent suggesting that the expectation of an agreement was priced into the exchange rate. The prevailing negative/low trade balance, driven by increases in imports and weaker exports, in Q1 and Q2 suggests FX outflows from the market. We expect the Kwacha to remain stable around 18 USD for Q3 with slight appreciation expected to flow through into Q4. A normalisation of import levels and reductions in energy cost will be key driver for significant Kwacha appreciation in the short to medium term. We expect less volatility over Q4 given the additional clarity provided by recent debt restructuring and exclusion of local debts from restructuring.

Inflation rate (%)



The Zambian economy has seen a significant decrease in its annual inflation rate, from a peak of 22.1% in 2021 to 9.9% for May 2023 YoY. The YoY inflation rate of 9.9% for May is lower than the figure reported in April of 10.2%. We have revised downward our inflation outlook for 2023 year end to 9.9% from 11.1%.

With inflation still outside the 6-8% target band, The BoZ has increased the monetary policy rate by 25 basis points to 9.50% following its May meeting, as a precautionary measure against a potential economic slowdown. This 25-point increase was necessitated due to an up until now prolonged debt restructuring, a continued rise in prices of food and energy, a weaker Kwacha, higher electricity tariffs and reduced maize production - all of which have impacted the nation's currency stability and overall financial health. We believe improvements in export performance and renewed business confidence will help ease inflationary pressure.

Sources: Bank of Zambia (BoZ), Zambia Statistics Agency (ZamStats), Ministry of Finance and National Planning (MoFNP), Kukula Capital Research (Kukula).

COPPER DEMAND EXPECTED TO BE RESILIENT AS PRICE REMAINS ABOVE 10Y AVG.

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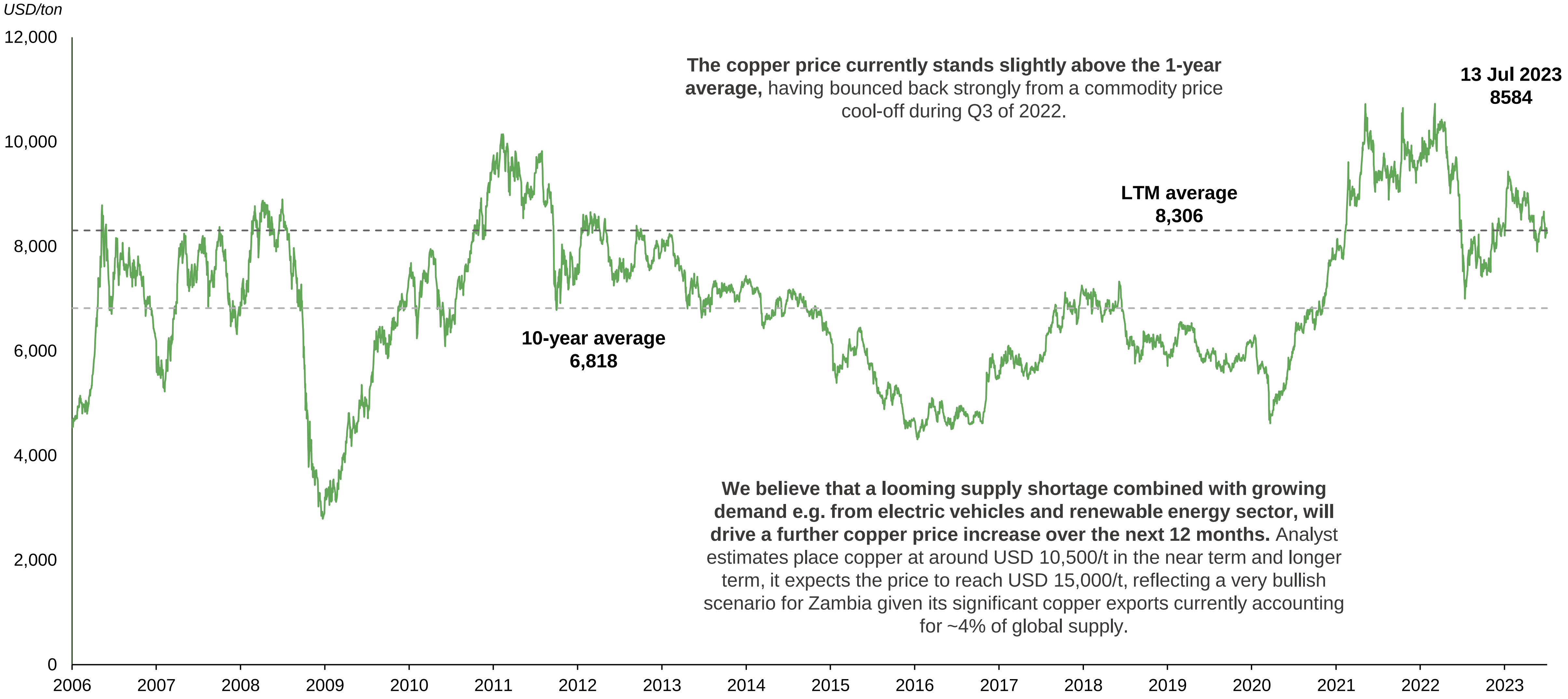

The copper price currently stands slightly above the 1-year average, having bounced back strongly from a commodity price cool-off during Q3 of 2022.

We believe that a looming supply shortage combined with growing demand e.g. from electric vehicles and renewable energy sector, will drive a further copper price increase over the next 12 months. Analyst estimates place copper at around USD 10,500/t in the near term and longer term, it expects the price to reach USD 15,000/t, reflecting a very bullish scenario for Zambia given its significant copper exports currently accounting for ~4% of global supply.

Source(s): BoZ, EIU, Bloomberg, S&P Global & London Metal Exchange.

HIGH COPPER PRICE EXPECTED TO BOOST KWACHA LONG TERM

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Copper/FX dynamics

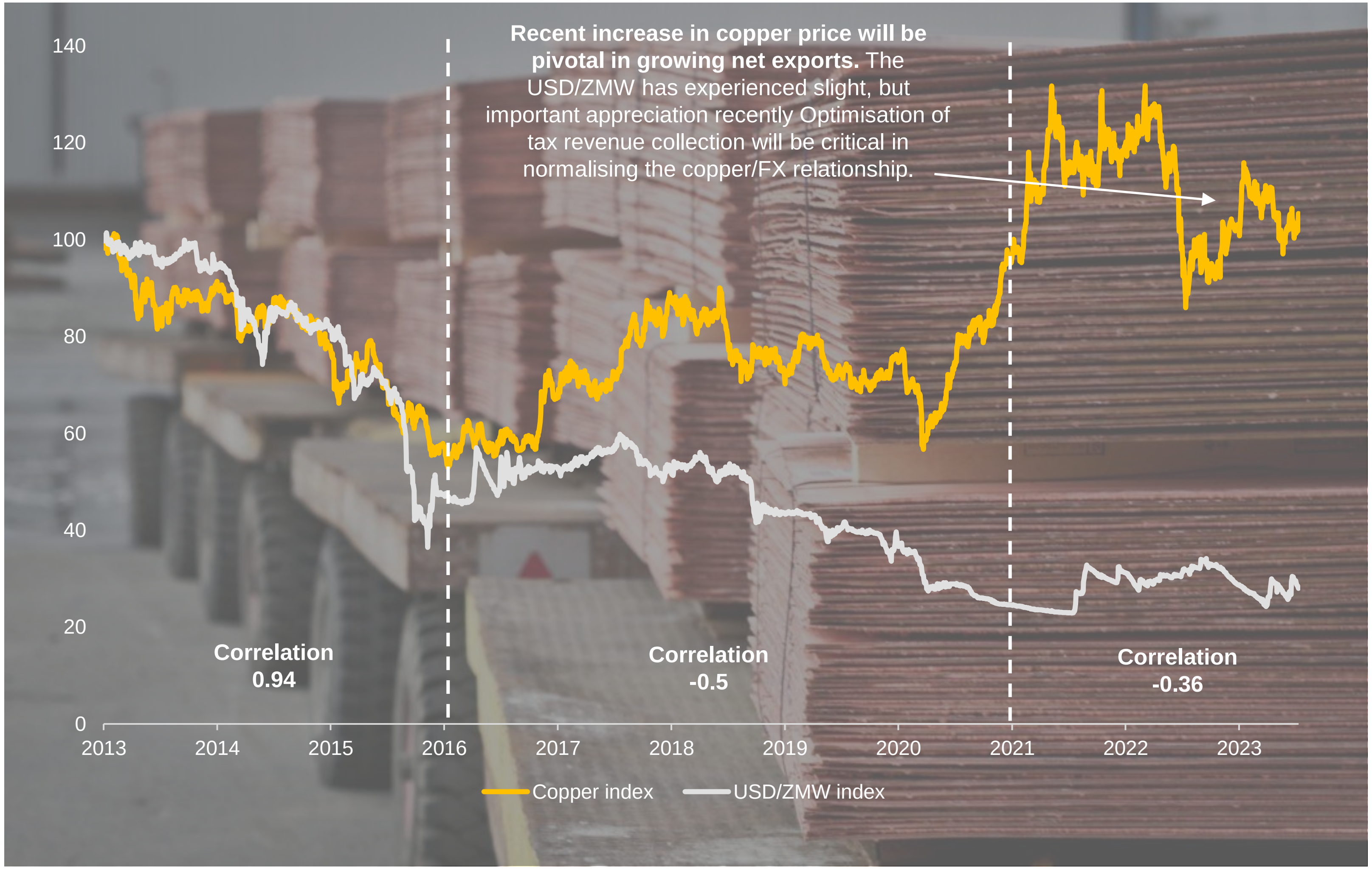
Copper price and FX seemingly detached

The historical relationship between the price of copper, the performance of the Zambian Kwacha, and the alignment of their movements has been characterized by a strong positive correlation. Given that copper is a significant export commodity for Zambia, fluctuations in its price have traditionally had a direct impact on the performance of the Kwacha. However, in recent years, this relationship has deviated from its usual pattern. Despite copper price moving upward, the performance of the Kwacha has not consistently followed suit. Nonetheless, going forward, it is anticipated that this relationship will normalize, and the Kwacha's performance will align more closely with copper price movements.

Improved tax policy to drive collections and reserve growth

The expected normalization of the relationship between copper prices and the performance of the Kwacha is attributed to several factors. Firstly, Enhancements in tax policy will improve revenue collection, which can contribute to squaring up its accounts. In addition, a higher copper price is anticipated to drive foreign exchange (FX) inflows into the Zambian economy. This, in turn, will help stabilize the country's reserve position and enhance its ability to meet external obligations. Policy improvements will help mitigate the impact of transfer pricing, which may have played a role in the misalignment between copper prices and the Kwacha performance. Overall, these factors are expected to reinstate the traditional relationship between the price of copper, the performance of the Kwacha, and promote a more balanced and stable economic environment in Zambia.

Copper price vs USD/ZMW index | 2013 - 2023



Reserves and FX stability

International reserves remain stable

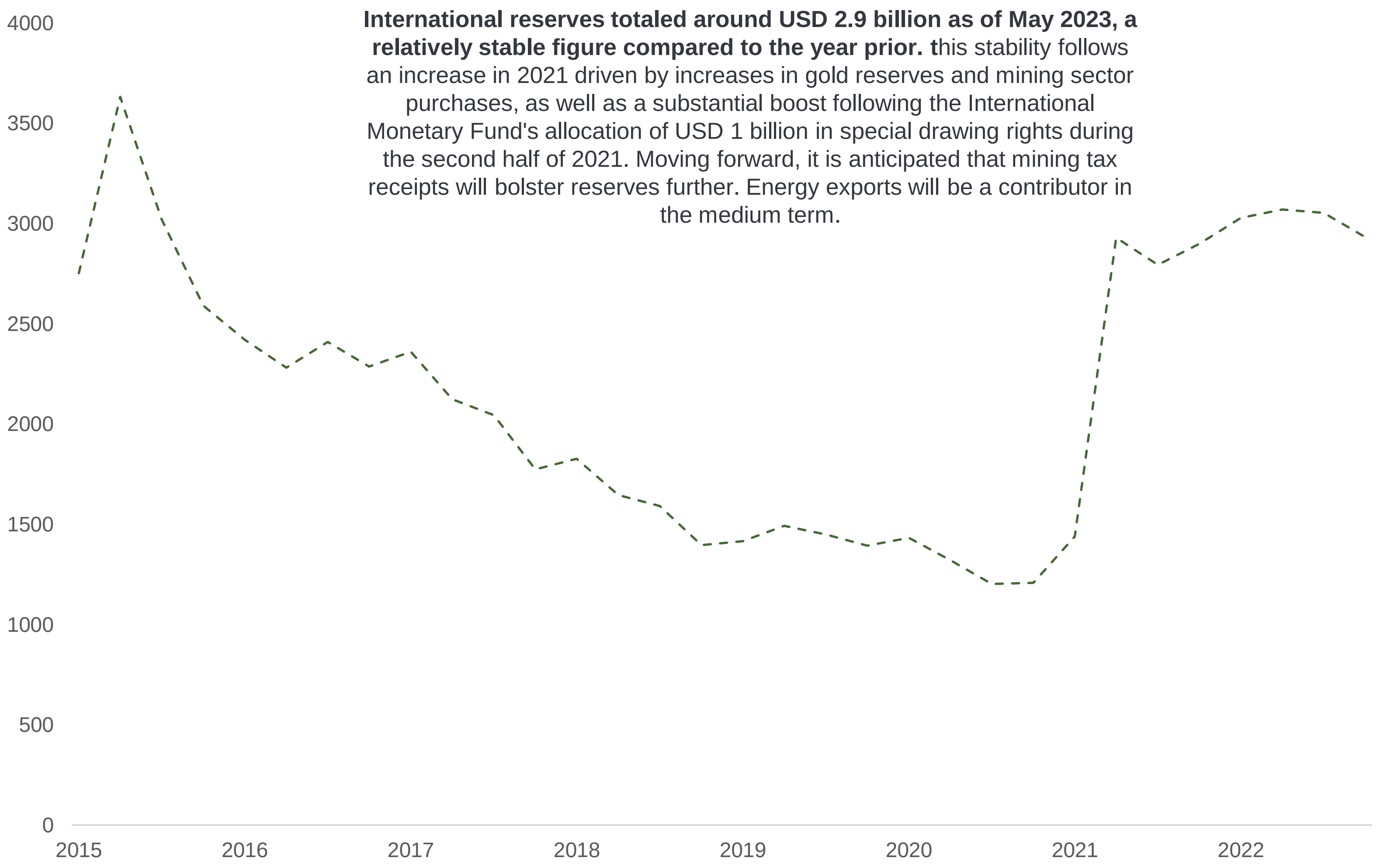
Zambia's international reserves have been relatively stable at around USD 3bil. Falling off slightly from the previous quarter due to open market transactions. negotiated a temporary suspension of debt payments with its creditors. is important to note that the overall economic outlook for Zambia remains cautiously optimistic. With the government implementing structural reforms and improving fiscal discipline, alongside active collaboration with the central bank concerning reserve bolstering and foreign direct investment attraction, long-term sustainable development is being pursued. A stronger reserve position will help stabilise FX rates and contribute to a reduction in Sovereign yields which could help reduce the crowding out effect high government yields have ha din the market.

Mining and energy to drive FX earnings

Government's two-pronged approach to improving FX inflows are increasing mining output and boosting energy exports. The "easy" win is the optimisation of production at existing mines. We expect that positive developments resulting from the reorganisation of existing mining assets will have a positive impact on the reserve position via enhanced tax collection. On the energy side, the completion of 3 major interconnectors in the medium term is the key turning point in FX medium-long term outlook.

Government will have difficulty incurring additional debt to finance capital projects. However, government has taken steps to enhance the framework for PPPs which is expected to create the right environment for private sector investment in infrastructure. In this regard FDI is critical to watch in terms of the outlook for infrastructure spending.

Gross international reserves (USDm) | 2013 - 2023



International reserves totaled around USD 2.9 billion as of May 2023, a relatively stable figure compared to the year prior. this stability follows an increase in 2021 driven by increases in gold reserves and mining sector purchases, as well as a substantial boost following the International Monetary Fund's allocation of USD 1 billion in special drawing rights during the second half of 2021. Moving forward, it is anticipated that mining tax receipts will bolster reserves further. Energy exports will be a contributor in the medium term.

Sources: Bank of Zambia (BoZ), Zambia Statistics Agency (ZamStats), Ministry of Finance and National Planning (MoFNP), Kukula Capital Research (Kukula).

LOWER EXPORTS AND HIGHER IMPORTS NARROW TRADE BALANCE

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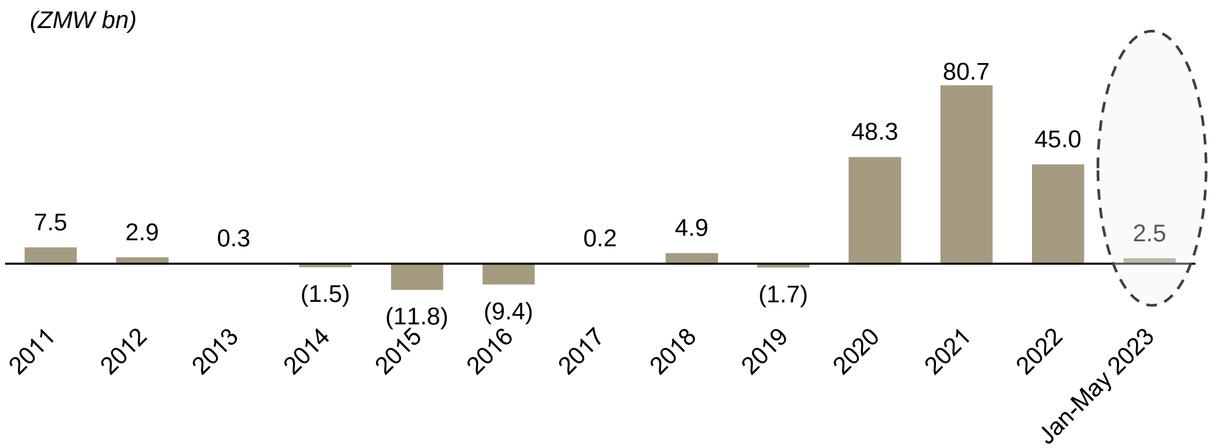
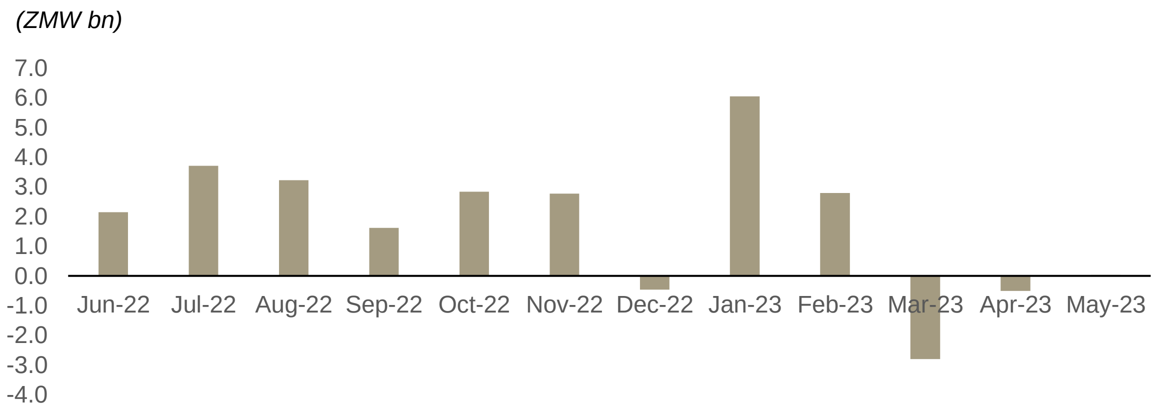
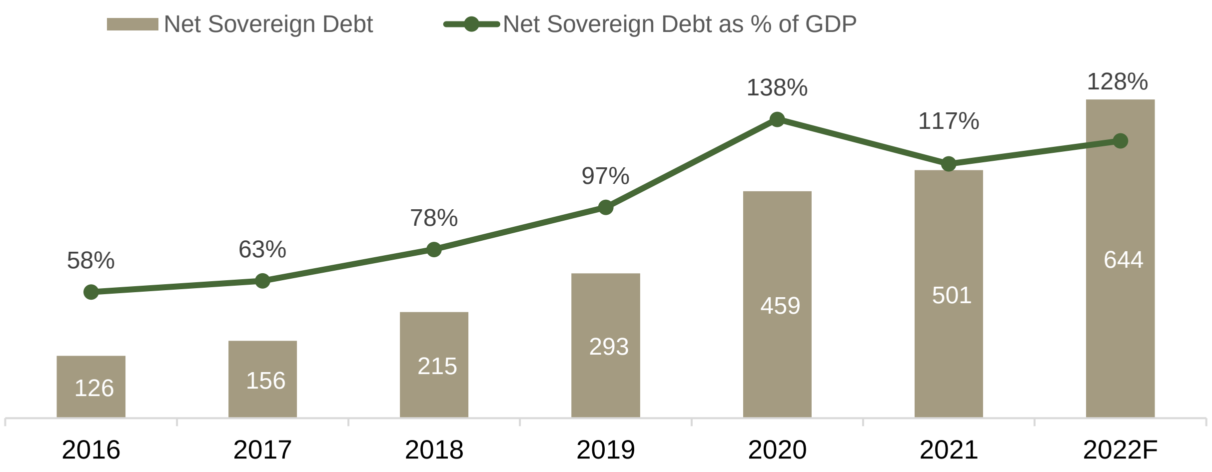
Historical annual aggregated trade balance



Monthly trade balance – LTM



Net sovereign debt (ZMW' bil)



Observations

Trade balance improves marginally but still low

Zambia just barely registered a positive trade balance in May of c. ZMW 40m. This follows the posting of a trade deficit of approximately ZMW 0.5 bil. in April. The narrowing of the trade balance since January is driven mostly by increased imports from South Africa and China and reduced copper export values. We believe import increases are attributable in part to relatively favorable ZMW/ZAR exchange rate and relative strength against the USD.

Negative/low trade balance suggest Kwacha weakness

A low/negative trade balance supports a short-term kwacha weakness thesis, but this is balanced out by positive developments. We expect the MPC rate to remain unchanged at 9.5% at the next MPC meeting. We expect BoZ to take a measured approach to the MPR and opt to wait and assess market performance following the recent restructuring developments. We have also seen a reduction in YoY inflation to 9.9% in May from 10.1% in April which provides support for keeping the rate unchanged. We believe Zambia is near the top of the rate hike cycle and we'll likely see rates remain flat for the remainder of 2023.

Sources: Bank of Zambia (BoZ), Zambia Statistics Agency (ZamStats), Ministry of Finance and National Planning (MoFNP), Kukula Capital Research (Kukula).

GOVERNMENT DEBT YIELDS EXPECTED TO HEAD LOWER ON IMPROVED OUTLOOK

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Government debt yields

Reversal in upwardly creeping yields

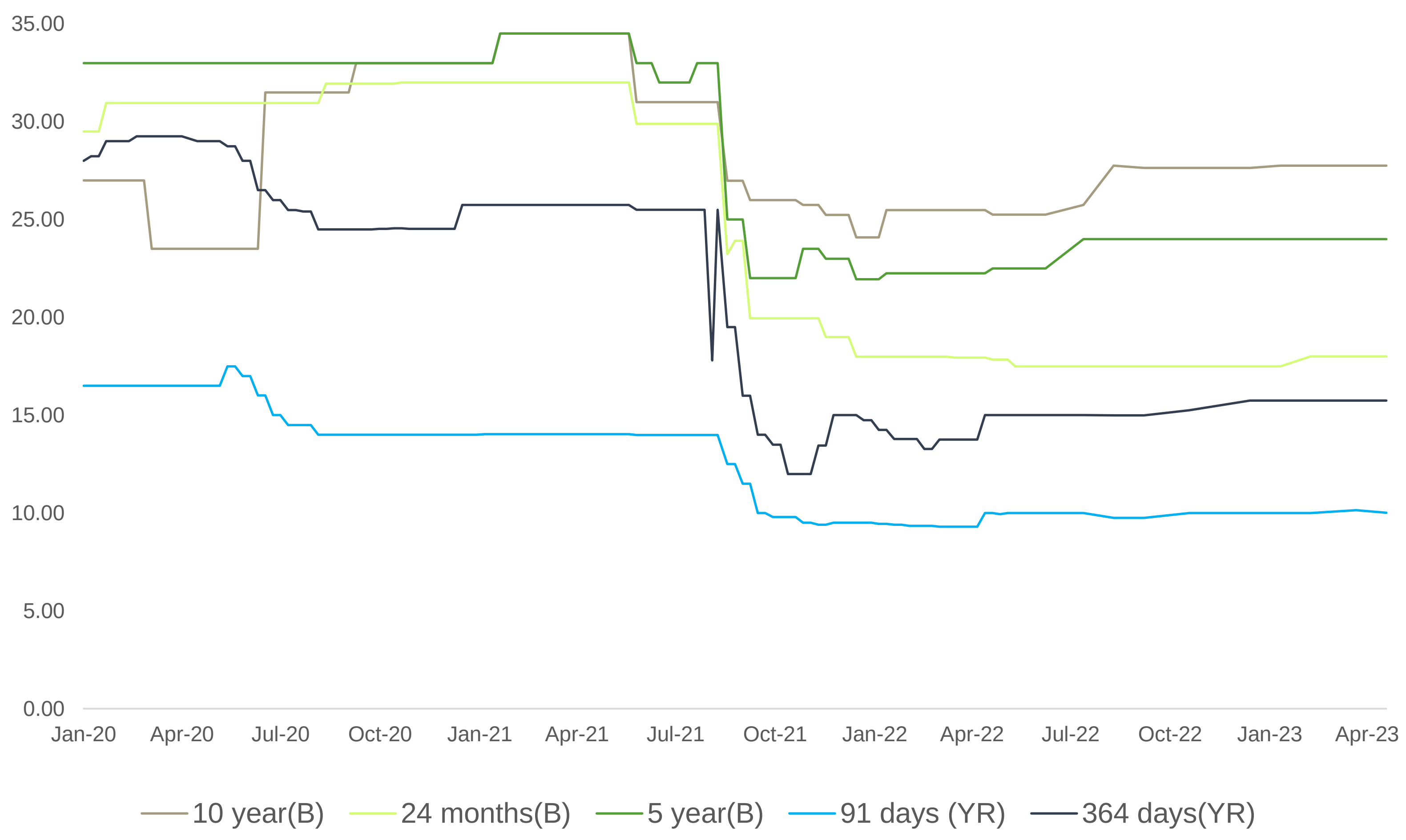
Over the past two years, Zambian bond yields have incrementally moved higher as various positive sentiment factors waned, and prolonged uncertainty regarding the anticipated sovereign debt restructuring took hold. This rise in bond yields reflected investor concerns about the potential risks associated with the restructuring process. However, with the recent clarity provided by the new restructuring agreement, we anticipate a decline in bond yields. The agreement has provided a more defined framework for debt management and instilled greater confidence in the market, mitigating some of the uncertainty that had previously influenced investor sentiment.

We believe the risk outlook for Zambia is lower. This is supported especially by the expectation of higher commodities prices which, under the right conditions, will help drive FX inflows. This should translate to lower borrowing costs for the government.

Higher demand to further drive down yields

Given the assurances in terms of the exclusion of local debt from restructuring, we expect an uptick in demand for local government paper. A sustained lower yield may also have medium term positive externalities. Chiefly, helping to persuade financial institutions to ramp up lending activity to SMEs as government yields become less attractive and alternative sources of absolute return are sought.

Historical Zambian Government debt yield spreads | 2020 - 2023



Sources: Bank of Zambia (BoZ), Zambia Statistics Agency (ZamStats), Ministry of Finance and National Planning (MoFNP), Kukula Capital Research (Kukula).

USD/ZMW EXCHANGE RATE OUTLOOK

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Historical/Forecast USD-ZMW exchange rate | 2015 – 2024

- *ZMW/USD*

Sources: Bank of Zambia (BoZ), Kukula Capital Research (Kukula).

MACRO ENVIRONMENT SUMMARY

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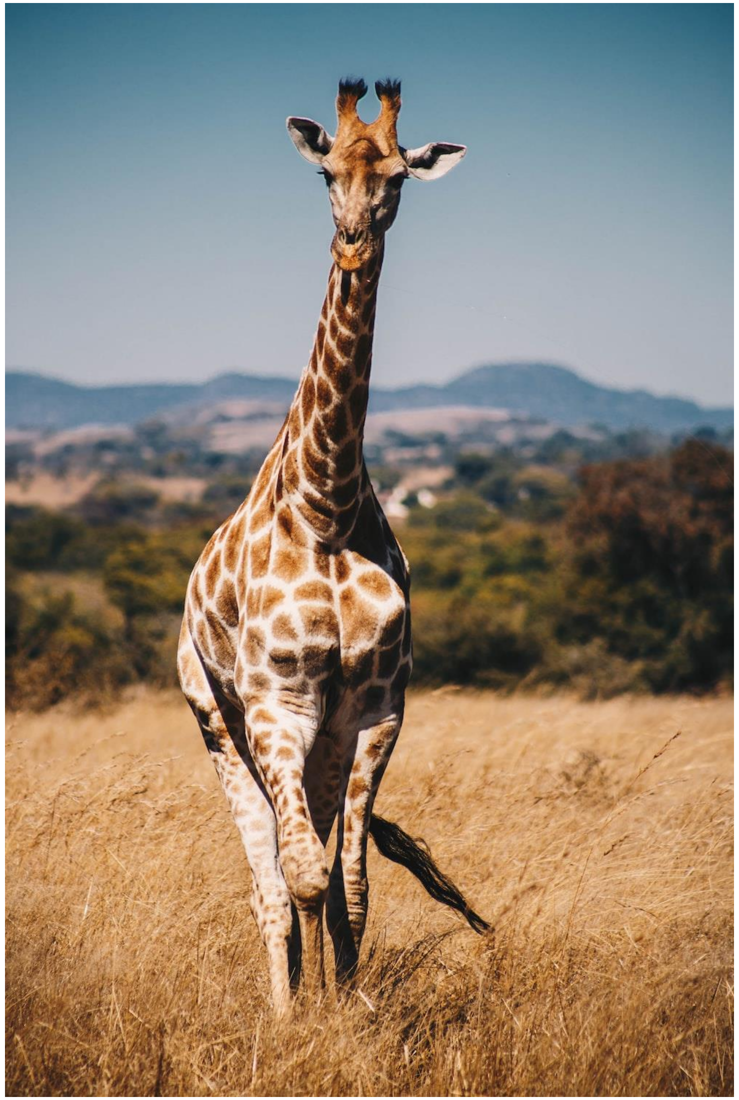
Theme	Outlook	Macroeconomic developments
Economic Growth		▪ **In the near-term, economic growth is expected to be below Zambia's long-term potential** as Zambia battles with limited fiscal flexibility. ▪ **Copper prices remain relatively high.** Copper demand is expected to remain resilient in the long term and a further **price increases are expected** in the short to medium term. However, short term, weaker output may skew trade balance negatively. ▪ **FDI directed at agriculture, copper and manufacturing, are expected to continue arriving.** This will have long term benefits in terms of boosting local production and import substitution which will help reduce reliance on imports.
Inflation		▪ **Inflation for the month of March registered at 9.9%, down from 10.2% the previous month,** bringing inflation down to single digits. ▪ **BoZ increased the monetary policy rate by 25 basis points to 9.50%** following its May meeting - primarily citing BoZ's updated inflation forecast, which projects inflation to increase over the short to medium term. ▪ **In line with BoZ's forecast, we expect inflation** to remain **above the BoZ's target rate of 6-8%** in the short to medium term driven by the weaker Kwacha, electricity tariffs being increased to cost reflective levels and a possible reduction in maize production. ▪ **The slight past weakening of the Kwacha is adding to the inflationary pressure**, but we expect the Kwacha to appreciate in the medium term, contributing to decreased inflationary pressure.
Exchange Rates		▪ **The Kwacha is expected to remain relatively stable until the end of Q3 2023** due the looming recession fears overcasting the positive debt restructuring, copper prices rising and prudent government spending**. Hereafter, we expect the Kwacha to slowly appreciate toward 2024** as investor sentiment improves, US rate hikes slow down. ▪ Serving as a cushion, international reserves will most likely increase through export income and support of sustainable foreign investment, protecting the economy from external pressures. ▪ New private and to a lesser extent government capital flows for copper production are expected to increase the strength of the Kwacha.
External Sector		▪ **We also forecast positive growth in trade balance as global commodity prices appear ready to rise.** ▪ **Exports are anticipated to rise in tandem with the increased economic activity**, which has bolstered demand for capital goods and raw materials. ▪ **The South African reserve bank revised upward its inflation guidance from 6% to 6.2% for 2023, which falls outside the 6% upper limit desired by the South African Reserve Bank.** There is empirical evidence to suggest that South Africa's inflation is likely to be imported into Zambia due to its significance as a major import origin, thus causing an increase in local prices for foodstuffs and non-food items alike. The likelihood of this happening increases as imports from South Africa increase.

Sources: Bank of Zambia (BoZ), Zambia Statistics Agency (ZamStats), Ministry of Finance and National Planning (MoFNP), Kukula Capital Research (Kukula).



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