Sterling Capital Limited

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Fixed Income Note

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"National Treasury in a race against time"

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Executive Summary

- The Central Bank of Kenya (CBK) invites bids for two Treasury bond (T-Bond) issues FXD2/2019/10 (10 Years) and FXD1/2019/20 (20 Years).
- Like last month's issue **IFB1/2019/25 (25 years),** these two issues have a KES.50Bnfunding target.
- Once again we see the National Treasury under pressure to increase the debt maturity profile of domestic debt, a move that failed in the IFB March issue that received a paltry 58.5% with only KES.16.3Bn of the KES.29.4Bn received as bids accepted by CBK.
- Our title of this report **"National Treasury in a race against time"** is inspired by the clear mismatch between the current National Treasury receipts (KES.1.4Tn) against a fiscal receipt target of KES.2.58Tn.
- Also notable during the month of April is Treasury bond (T-Bond) maturities worth KES.53.2Bn, making it the single highest T-Bond maturity month between the 2018/19 and 2020/21 fiscal years.
- This in addition to the imminent issuance of a sovereign bond estimated at US.2.5Bn (KES.250Bn) points to growing financing needs.
- With only three months of the 2018/19 fiscal year left, we expect the Treasury to aggressively borrow from both the domestic and external debt market to bridge a deficit that currently appears difficult to bridge.
- We expect this issue to record a better performance than last month's 25 year IFB with the 10 year issue likely to receive a bulk of investor subscriptions.
- We predict the **weighted average rate of accepted bids at 12.35% and 12.85% respectively for the 10 and 20 year issues respectively.**
- There is little to report in terms of the macro-economic variables with the Kenya Shilling and inflation relatively stable and these were named as some of the reasons why the Monetary Policy Committee retained the Central Bank Rate (CBR) at 9% in their latest meeting.
- We are however concerned that we might see inflationary pressure in the medium term if weather conditions do not improve and international crude prices continue to rise.
- In terms of investment advice, we believe that the 10 Year Bond provides a good investment opportunity on the basis of current market yields and attractiveness of its tenor.
- Investors in the 20 Year issue would expect a premium rate for the length of the issue.

CBK's two debt issues aim to raise KES.50Bn

- The Central Bank of Kenya (CBK) issues a ten year (FXD 2/2019/10) and twenty year (FXD 1/2019/20) fixed coupon bonds for public subscription.
- The joint issue seeks to raise an aggregate of KES.50Bn as a budgetary support facility.
- We predict that the Weighted Average Rate (WAR) of accepted bids for the 10-yr bond issue to be around 12.50% and approximately 12.85% for the 20-yr issue. Refer to (Table. 2).
- The intermediate / long tenor of both bonds is a deliberate move by the CBK to lengthen the maturity profile of public debt since the current Average Term to Maturity (ATM) of domestic debt stands at 4 years 2 months as at June 2018.
- We forecast a subscription rate of about 65% - 75% for the 10-yr bond and approximately 50% - 55% for the 20-yr issue.

Table.1: Primary Bond issue summary

Issue Number	**FXD 2/2019/10 (10YR)**	**FXD 1/2019/20 (20Yr)**
Total Amount Offered	KES.50Bn	KES.50Bn
Tenor (Years)	10	20
Coupon Rate (%)	Market Determined	Market Determined
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	22nd March – 9th April 2019	22nd March – 9th April 2019
Auction Date	10th April 2019	10th April 2019
Value Date	15th April 2019	15th April 2019
Yield Curve 31st March 2019 (%)	**12.16**	**12.69**

Source: Central Bank of Kenya & Nairobi Securities Exchange

Table.2: Historical primary market auction performance

Issue Number	Amount Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Average Yield
FXD1/2018/20	40	13.74	8.49	34.35	13.20	13.336
FXD1/2018/20 Re-open	40	9.90	6.79	24.76	13.20	13.327
FXD 2/2018/20	40	13.86	10.51	34.65	13.20	13.371
FXD 1/2018/10	40	29.83	19.36	74.56	12.69	12.686
FXD2/2018/20 Re-open	40	10.33	5.31	25.82	13.20	12.931
IFB 1/2018/20	50	40.39	27.59	80.79	11.95	12.156
Tap Sale	22.41	8.84	8.73		11.95	12.28
FXD 2/2018/10	40	28.86	26.16	72.15	12.502	12.502
	13.84			47.83		
Tap Sale	**50**	**6.62**	**6.62**	**72.66**	**12.502**	**12.502**
FXD1/2019/10		**36.33**	**32.81**		**12.438**	**12.438**

Source: Central Bank of Kenya & Sterling Capital Research

Investors likely to bid at around 12.50% and 12.85% for the 10yr and 20-yr bonds

- We predict that investors are likely to bid for the 10-yr bond at around 12.50% with the weighted average of accepted bids expected to be approximately 12.35%.
- For the 20-yr issue, investors are likely to bid at around 12.90% with the weighted average of accepted bids likely to be 12.85% (Table.2).

Table.3: Auction bid prediction

Security	FXD2/2019/10 (10YR)	FXD1/2019/20 (20Yr)
Market Weighted Average Rate (%)	12.50%	12.90%
Weighted Average Rate of Accepted Bids (%)	12.35%	12.85%

Source: Central Bank of Kenya, Nairobi Securities Exchange & Sterling Capital Research

- We used implied yields for bonds traded on the Nairobi Securities Exchange as at 31st March 2019 as an indicator of possible investor bids.
- **Some caution should however be exercised as our benchmark bonds have slightly lower terms to maturity than the new issues and therefore have lower yields.**
- **For this reason we advise investors to add a premium rate to the rates shown on table 4.**

Table.4: Benchmark issues to guide investor bids

Current Bond Issue	Benchmark Bonds	Term to Maturity Years (Days)	Last traded Yield (%)	Last Trade Date
FXD2/2019/10 (10Yr)	FXD1/2019/10	9.91 (3,606)	12.16	31st Mar 2019
FXD1/2019/20 (20Yr)	FXD2/2018/20	19.33 (7,036)	12.69	31st Mar 2019

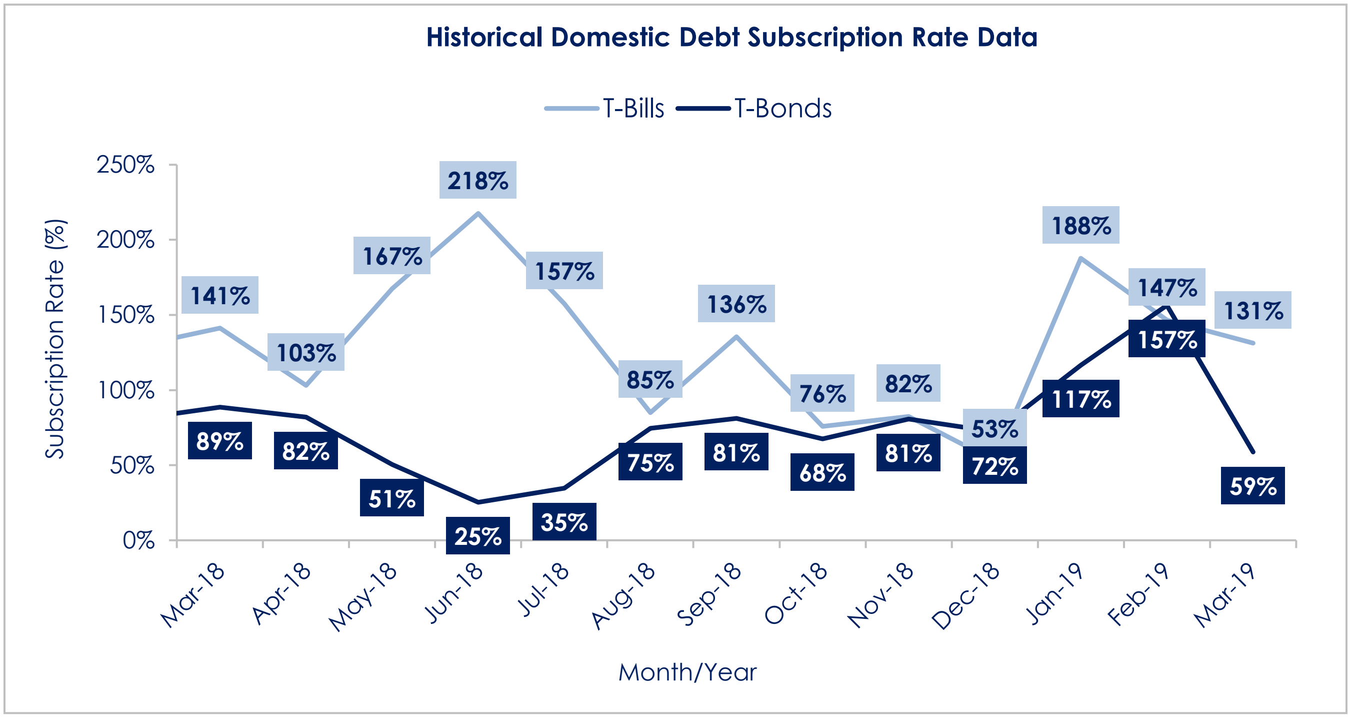
Source: Nairobi Securities Exchange

364 Day T-Bill popular with Kenya government debt investors

High investor interest in the 364-day T-Bill compared to the 91&182-day issues.

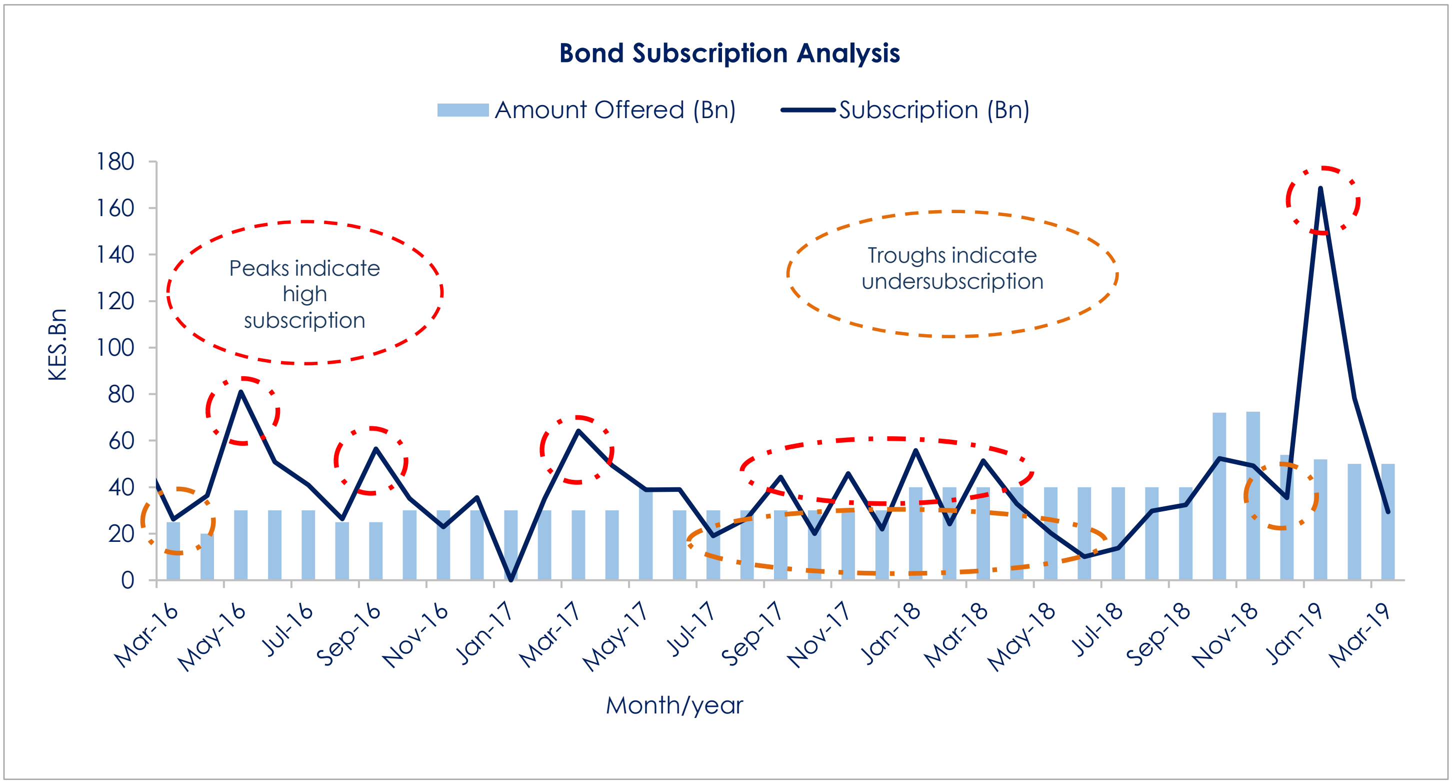
- Aggregate rate of subscription for the T-bill papers in March 2019 performed relatively well with the 91-day, 182-day and 364-day recording 58.8%, 77% and 174% (Fig.1).
- The 364-day Treasury bill (T-Bill) is particularly attractive to investors who wish to avoid re-investment risk on account of falling rates hence the over-subscription for the 364-day bills.
- The infrastructure bond issued within the month was under-subscribed with its performance rate standing at 58.8% (Fig.1 & Fig.2))
- This performance of the bonds relative to the bills reiterates the investor's preference for short term government securities.
- Market liquidity remained relatively high during the month with inter-bank rates touching lows of 2.31%.
- We expect T-Bill subscription rates to remain high in April in light of the high liquidity position of the market and subdued commercial bank lending.

Fig.1: Domestic debt demand falls in March 2019



Source: Central Bank of Kenya

Fig.2: Historical Treasury bond subscription analysis 2016-2019 - Low appetite for 25 Year IFB



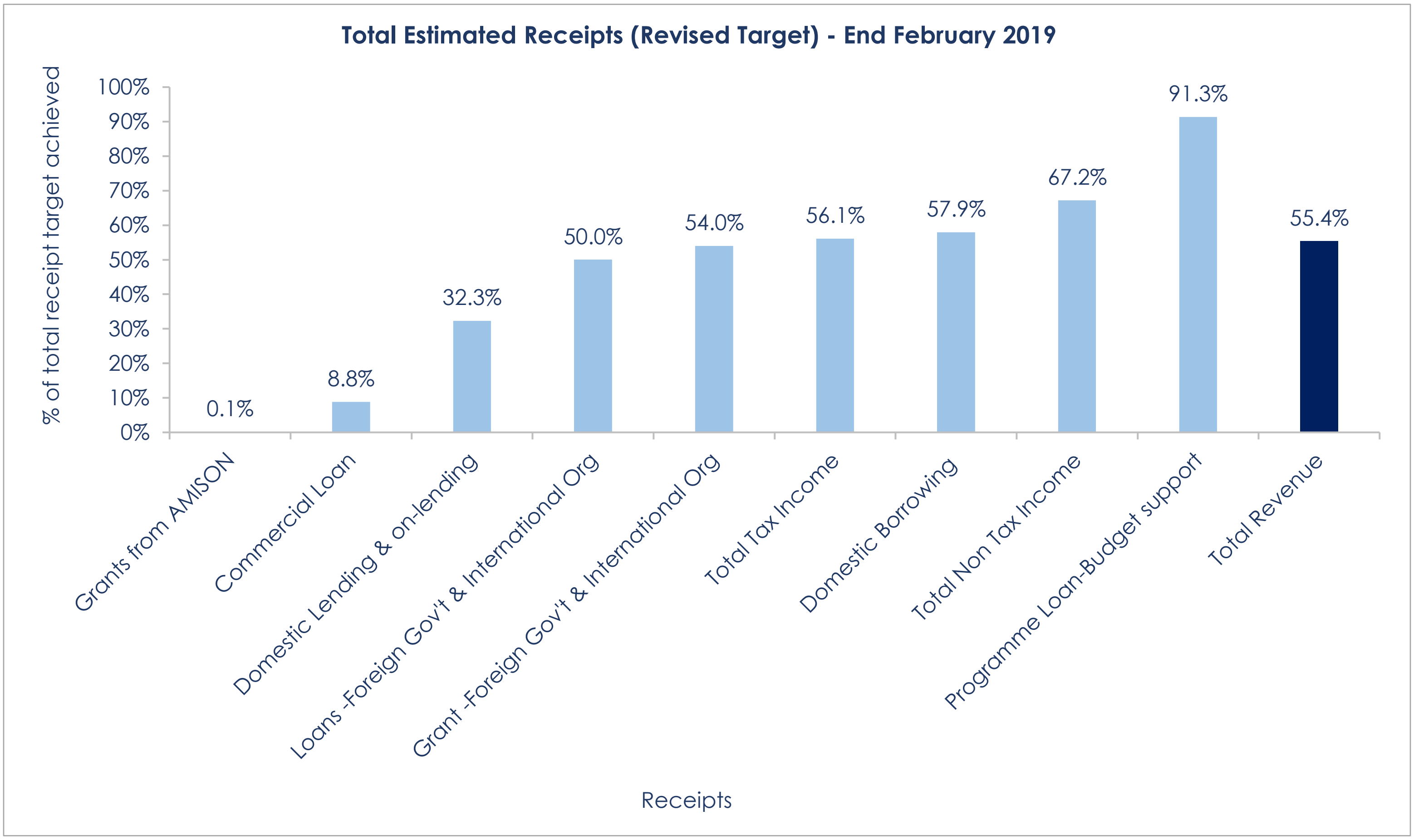
Source: Central Bank of Kenya

National Treasury will not meet fiscal year receipts target at the current run-rate

KES.1.4Tn in actual receipts equivalent to 55.4% of total fiscal target.

- Total receipts as at end of February 2019 stood at KES.1.4Tn equivalent to 55.4% of the KES.2.58 2018/19 fiscal target (Fig.3).
- With more than half of the fiscal year gone, only Non Tax and Programme loan support receipts are ahead of target based on a linear run rate at 67.2% and 91.3% of the total fiscal year receipts target.
- Total tax income the main revenue source for the government stands at KES.900.6Bn equivalent to 56.1% of the total estimated target.
- We expect the National treasury to aggressively tap into several funding lines such as foreign government and international organizations and commercial loans and primarily domestic borrowing.

Fig.3: Actual National treasury receipts at 55.4%, well below target

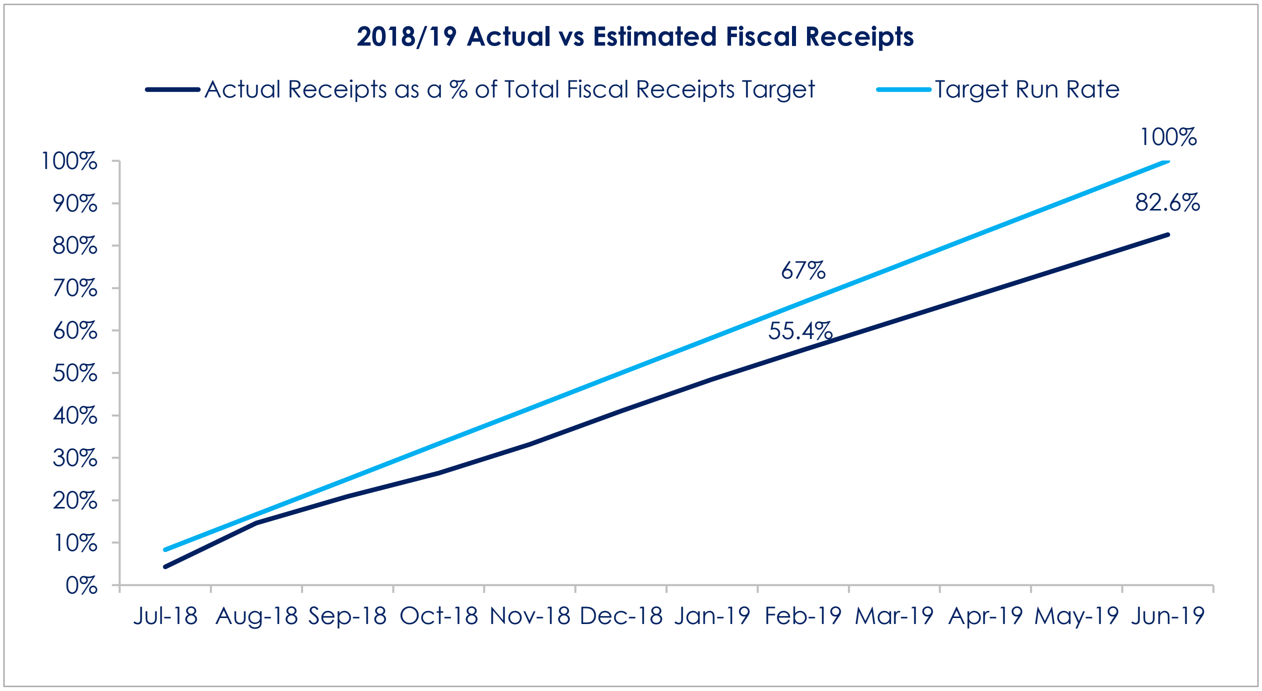


Source: The Kenya Gazette Vol. CXXI - No.34 22nd March 2019

2018/19 National Treasury receipts estimate at KES.2.1Tn at current run rate, equivalent to 82.6% of total revised target.

- On the current run-rate, we would expect Treasury to achieve 82.6% of its total fiscal year target equivalent to KES.2.1Tn (Fig.4).
- These shortfalls could possibly be a reason for another upward revision to the National Treasury's domestic borrowing target.
- In January 2019, the Treasury revised its domestic borrowing target upwards by 9.9% to KES.537.5Bn.
- The short fall in receipts is a concern for the Treasury in terms of the impact of rising public debt on overall debt management.
- For investors, rising demand for domestic debt translates to an increase in debt issues.
- To increase the success of subscription of new issues, Treasury might be forced to issue tenors that augur well with investor demands.
- This also explains why the CBK has issued a 5 and 10 year bond as well as Infrastructure Bonds (IFB) as they are more appealing to the main buyers of Government debt.

Fig.4: CBK receipt run rate points to missing its 2018/19 fiscal year target



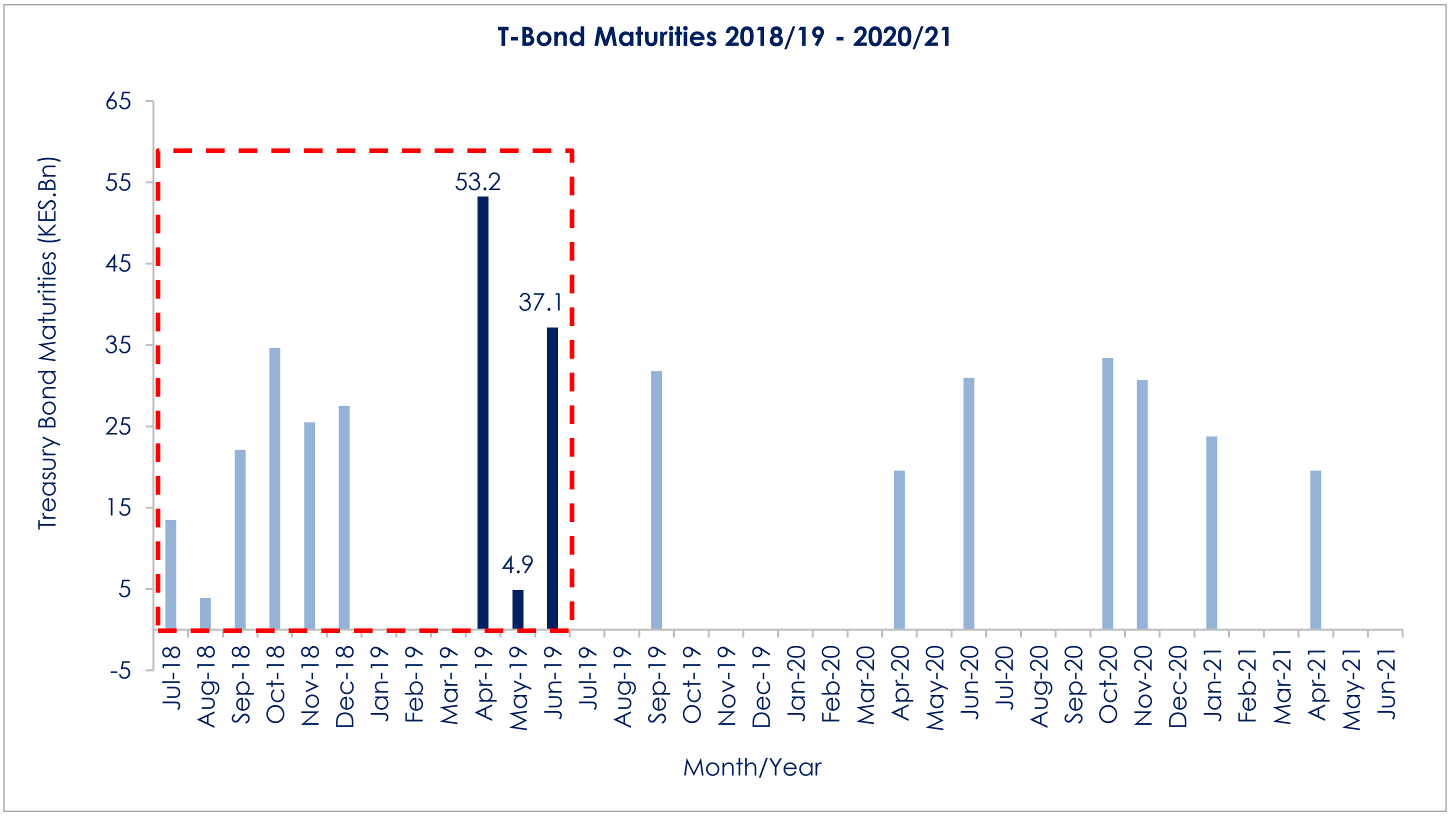
Source: The Kenya Gazette Vol. CXXI - No.34 22nd March 2019 & Sterling Capital Research Estimates

New debt maturities likely to drive National Treasury's demand for debt

- April 2019 has the biggest T-Bond maturities in the 2018/19 fiscal year (KES.53.2Bn).
- FXD1/2009/10 (KES.27.5Bn) and FXD1/2014/5 (KES.25.7Bn) will mature during the month (Fig.5).
- We expect another KES.42Bn in T-Bond maturities before the end of the 2018/19 fiscal year in addition to the US$750Mn (KES.75.8Bn) sovereign bond maturity in June 2019.
- For this reason, we expect heavy borrowing by the National Treasury in both the domestic and international (issue of US$.2.5Bn sovereign bond) debt markets for

the remainder of the fiscal year.

Fig.5: April T-Bond maturities the highest in the 2018/19 fiscal year

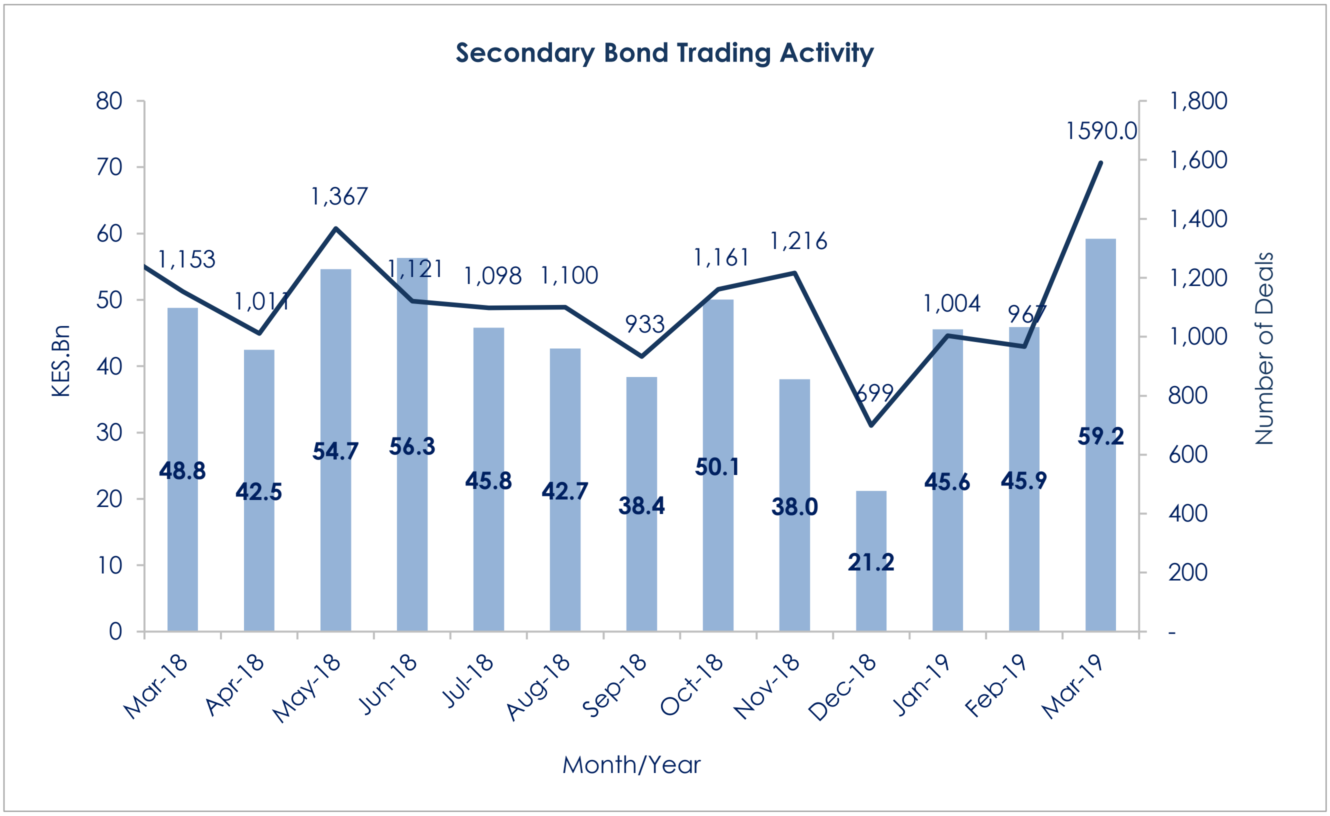


Source: Nairobi Securities Exchange

Secondary market trading activity up in March

- Bond turnover in the secondary market turnover significantly increased 28.9% in March 2019 from KES.45.9Bn to KES.59.2Bn in March 2019 (Fig.6).
- This was mainly attributable to the number of deals jumping by 64% to 1590 from 967 deals in February.
- The high trading activity is attributed to improved liquidity in the market.
- We expect the high liquidity to continue driving trading volumes in the secondary market in April.

Fig.6: Secondary trading activity increases significantly in March on high market liquidity



Source: Nairobi Securities Exchange

Yield curve continues to shift downwards

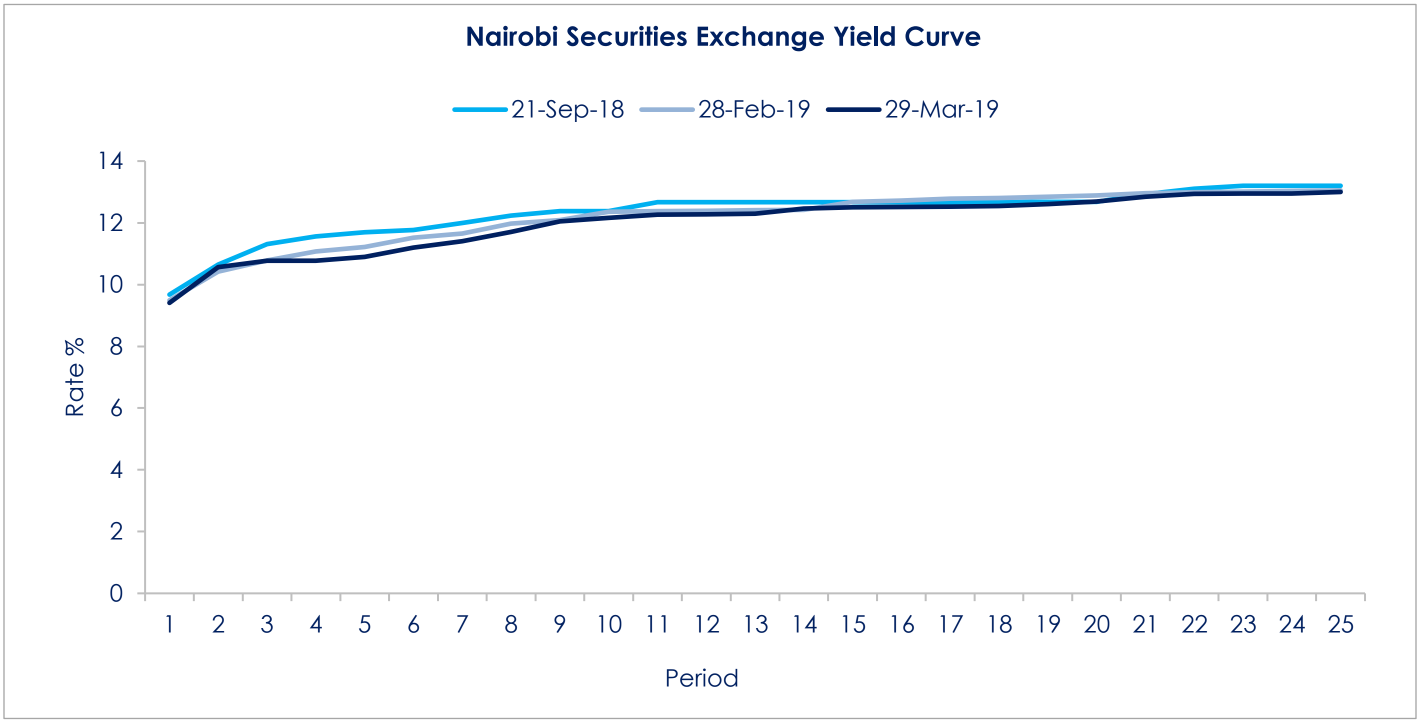
- The yield curve has shifted downwards since the most recent 20 year bond primary issue in September 2018 (Table.5 & Fig.7).
- The short end of the yield curve (2-5 years) shows the biggest downward shift during the period in consideration.
- This trend is explained by high subscription rates for the issues giving the CBK leeway to accept low bids and decline aggressive investor bids.
- The yield curve has also shifted marginally downwards over the last one month and we expect this trend to persist albeit gradually in the near term.
- Following recent trends in the domestic debt auction market, we do not expect major deviations in yields in the next one month with yields in the short end recording the biggest decline.
- The impact of the high court's ruling on the legality of the interest capping law could change our opinion on the shift of the yield curve in the medium term.
- We however, do not have clarity on recent developments on this front as several parties have appealed this decision.
- **We continue to emphasize on the need for investors to maintain a hold on long term bonds while buying short and medium term tenor issues.**

Table.5: Yield decreases for all benchmark tenors

Tenor	Yield (21st Sep 2018)	Yield (29th Mar 2019)	Change (Bps)
1	9.6760	9.4080	↓27
2	10.6496	10.5633	↓9
5	11.6993	10.9000	↓80
10	12.3798	12.1715	↓22
15	12.6713	12.1621	↓16
20	12.6750	12.6875	0
25	13.1997	13.0000	↓20

Source: Nairobi Securities Exchange

Fig.7: Yield curve has shifted downwards since the last 20 year primary bond issue in September 2018

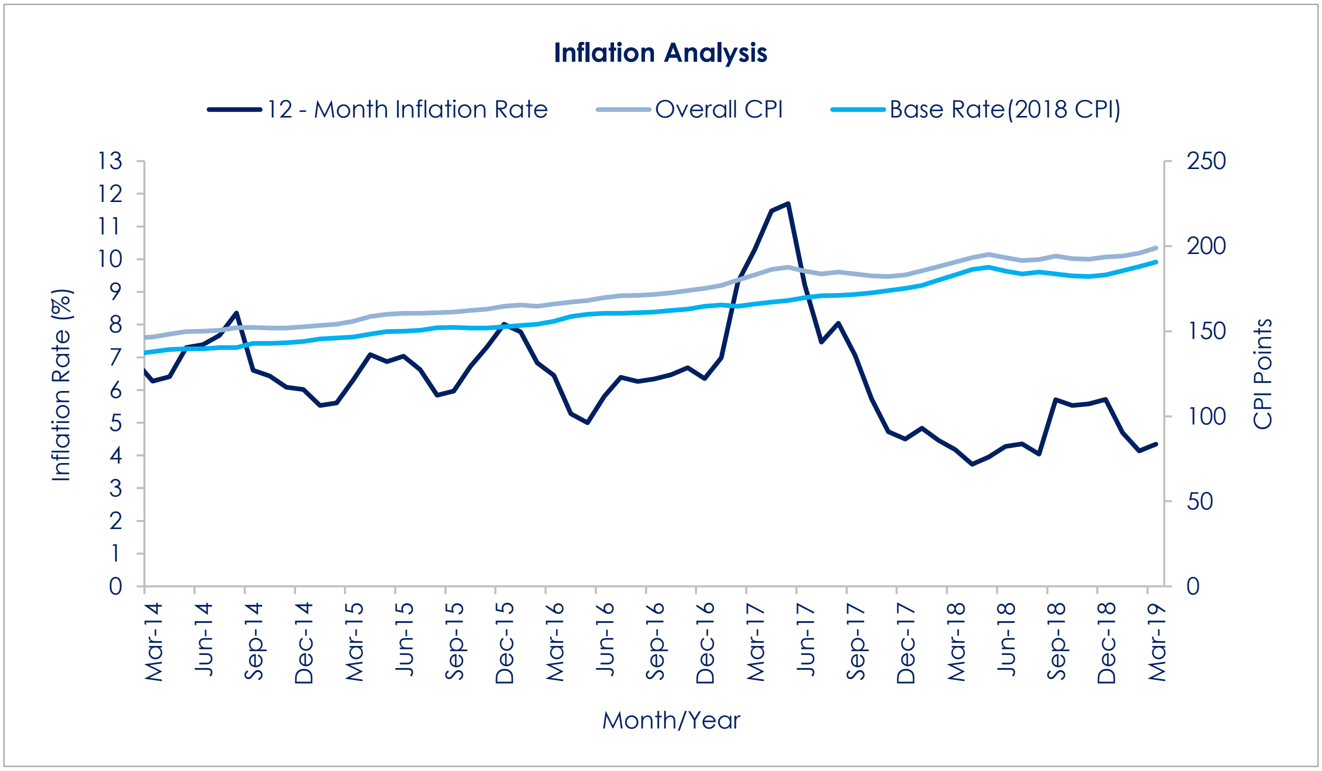


Source: Nairobi Securities Exchange

April inflation forecast - 4.3% to 4.5%

- Inflation edged up to 4.35% in March from 4.14% in February mainly attributable to an increase in prices of food due to the prevailing dry conditions in the country (Fig.8).
- Food and Non-Alcoholic beverages up 3.3% exhibited the biggest year on year increase amongst the twelve constituents of the Consumer Price Index (CPI).
- **We expect April inflation to edge upwards to 4.3%-4.5% due to a combination of the rise in international oil prices and dry weather conditions that will affect food prices.**

Fig.8: April inflation to remain well within CBK's target range



Source: Kenya National Bureau of Statistics

MPC maintains CBR in March meeting

- The Monetary Policy Committee (MPC) **maintained the Central Bank Rate (CBR) at 9.00%** citing a stable macroeconomic environment.
- This was in line with our prediction in our March fixed income report titled **"Longest IFB faces market test"**.
- At the time of the meeting (before the release of March 2019 inflation), Inflation was within CBK target range (2.5%-7.5%) declining to 4.1% in February from 4.7% in January due to stable food prices, lower electricity and fuel prices.

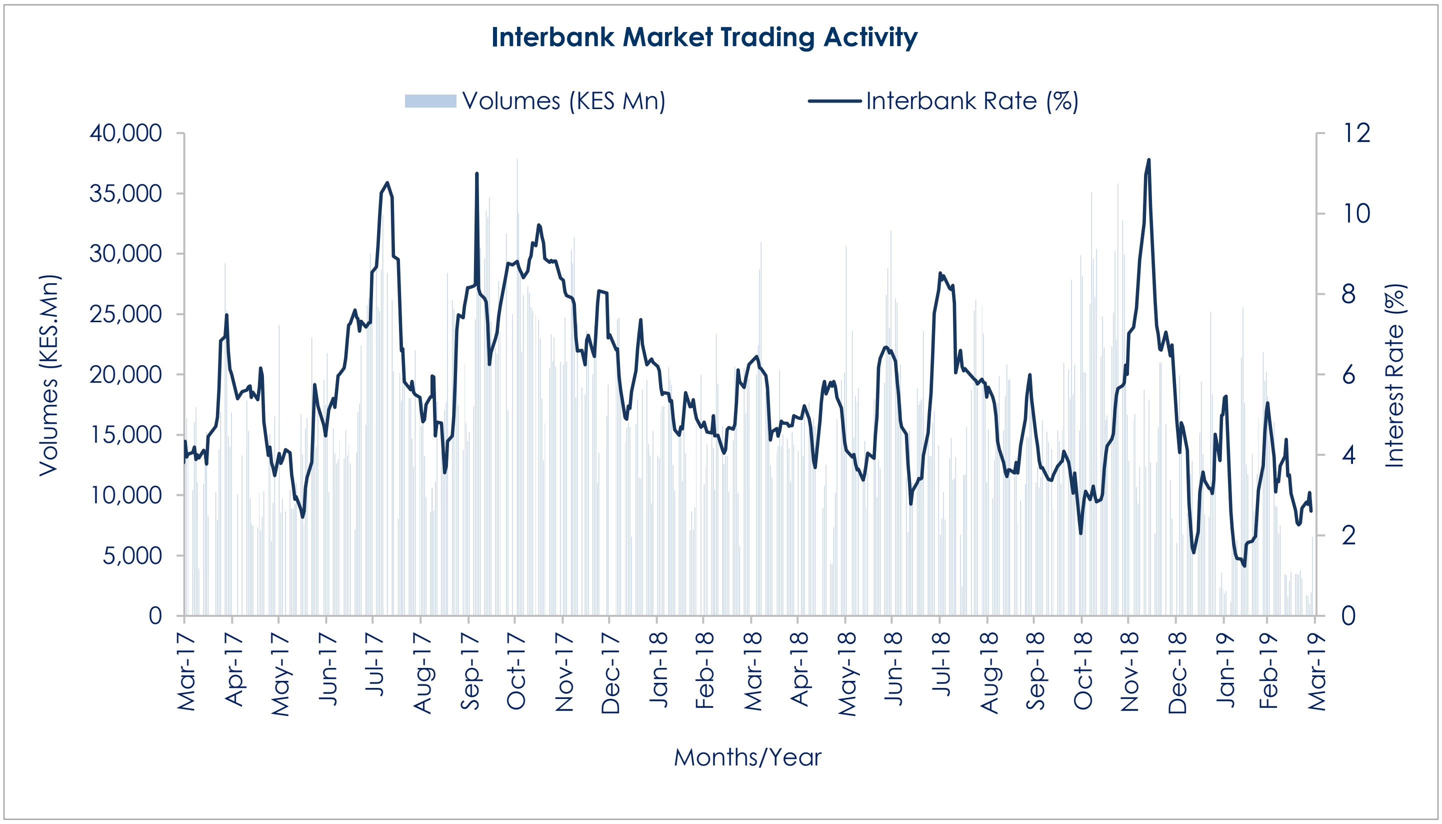
- The local currency was stable supported by;

  a) Increase in diaspora remittances.
  b) Narrowing of the current account deficit to 4.7% of GDP in the 12 months to February compared to 5.5% in February 2018.
  c) Higher receipts from tourism and strong growth in agricultural exports (tea and horticulture).
  d) Foreign exchange reserves currently at USD$8.3Mn (5.3 months of imports cover).

Average Interbank Rate to range between 3.0% - 3.5% in April

- The Average Interbank Rate rose to 3.31% in March compared to 2.64% in February (Fig.9).
- However, the average interbank volumes traded declined to KES.5.15Bn from KES.12.72Bn in February.
- The interbank rate hit a high of 5.29% on 1st March. Generally, there was high liquidity during the month supported by Government payments, which partly offset tax remittances.
- In the week ending 28th March, commercial banks' excess reserves stood at KES.24.5Bn in relation to the 5.25% cash reserves requirement (CRR) ~ CBK
- In April we forecast the average interbank rate to range between **3% and 3.5%** as a result of high market liquidity mainly attributable to large amounts of debt maturities (Including KES.53.2Bn T-Bond maturities).

Fig.9: Interbank rates remain low on high market liquidity



Source: Central Bank of Kenya

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