Sterling Capital Limited

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Fixed Income Note

May 2019

"CBK's quest for debt to continue"

Analysts:

Renaldo D'Souza
+254 (20) 2222651
Renaldo.DSouza@sterlingib.com

Susan Makena
+254 (20) 2222651
Susan.Makena@sterlingib.com

Elizabeth Njenga
+254 (20) 2222651
Elizabeth.Njenga@sterlingib.com

Justina Vuku
+254 (20) 2222651
Justina.Vuku@sterlingib.com

For queries call: +254 (20) 315414; 2244077 or
Email: research@sterlingib.com
Website www.sterlingib.com
Bloomberg Code: SCLK <GO>

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Executive Summary

- Our May fixed income report titled **"CBK's quest for debt continues"** provides a detailed investment analysis of the FXD2/2019/5 (5Years) and FXD2/2019/15 (15 Years) primary Treasury Bonds (T-Bonds).
- The Central Bank of Kenya (CBK) wishes to raise KES.50Bn from the two issues.
- We forecast the **weighted average rate (WAR) of accepted bids to be 11.15% and 12.75% for the 5 and 15 year papers respectively.**
- Our analysis of Treasury Bill (T-Bill) and Treasury Bond (T-Bond) auction results show a **high preference for short dated securities.**
- We further analyse the latest data available on Government receipts and expenditures in the 2018/19 fiscal year where we observe a **high absorption rate of receipts (98.8%) suggesting high financing demand.**
- This we expect to have on the CBK's borrowing strategy in subsequent months.
- The month of April 2019 had the second biggest domestic debt maturity amount this fiscal year amounting to **KES.102.8Bn with another KES.33.2Bn to be redeemed in May**.
- On the macro economic front, we focus on **rising inflationary pressure in April and our expectations for May where we expect inflation to ease to between 5.0%-6.0% on improved weather conditions.**
- **Market liquidity** is key in determining domestic debt demand and we expect it to remain supportive for the CBK in its quest to raise capital in May

CBK taps into the domestic debt market to raise another KES.50Bn

- Two debt issues FXD2/2019/5 (5Year) and FXD2/2019/15 (15Year) are on auction this month aiming to raise KES.50Bn (Table.1).
- Our Weighted Average Rate (WAR) of bid predictions are 11.15% and 12.75% for the 5 and 15 year issues respectively. (Table. 2).
- The National Treasury continues with its strategy of issuing two contrasting tenor issues to improve subscription rates this time short and medium term tenors.
- Higher interest in the 5 Year issue should see an oversubscription with the 15 year receiving at least a 50% subscription rate.

Table.1: Primary Bond issue summary

Issue Number	**FXD 2/2019/5 (5YR)**	**FXD 2/2019/15 (15Yr)**
Total Amount Offered	KES.50Bn	KES.50Bn
Tenor (Years)	5	15
Coupon Rate (%)	Market Determined	Market Determined
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	17th April – 7th May 2019	17th April – 7th May 2019
Auction Date	8th May 2019	8th May 2019
Value Date	13th May 2019	13th May 2019
Yield Curve 19th April 2019 (%)	**10.76**	**12.45**

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
FXD1/2018/5	40	37.65	23.07	-	12.299	12.299
FXD1/2018/5 (Tap Sale)	10	7.74	7.74	-	12.299	12.299
FXD1/2019/5	50	41.93	20.59	83.85	11.304	11.304
FXD1/2018/15	40	20.22	12.86	50.54	12.650	13.078
FXD2/2018/15	40	27.05	7.85	67.61	12.750	12.746
FXD2/2018/15 (Re-open)	32	25.38	21.26	79.30	12.750	12.734
FXD1/2015/15	40	25.07	14.72	62.67	12.857	12.857
FXD1/2019/15 (Re-open)	12	16.41	15.96	136.72	12.857	12.768

Source: Central Bank of Kenya & Sterling Capital Research

Bid predictions - 11.15% (5Year) and 12.75% (15Year)

- Investors are likely to bid at 11.15% for the 5-yr bond with the weighted average of accepted bids at approximately 11.10%.
- For the 15-yr issue, investors are likely to bid at around 12.75% with the weighted average of accepted bids likely at 12.65% (Table.2).

Table.3: Auction bid prediction

Security	FXD2/2019/5 (5YR)	FXD2/2019/15 (15Yr)
Market Weighted Average Rate (%)	11.15%	12.75%
Weighted Average Rate of Accepted Bids (%)	11.10%	12.65%

Source: Nairobi Securities Exchange & Sterling Capital Research

- We used implied yields for bonds traded on the Nairobi Securities Exchange as at 26th April 2019 as an indicator of possible investor bids (Table.4).
- **We urge investors to take caution as our comparable bonds have slightly lower terms to maturity than the new issues and therefore have comparatively lower yields.**
- **For this reason we advise investors to add a premium rate to the traded yields.**

Table.4: Benchmark issues to guide investor bids

Current Bond Issue	Benchmark Bonds	Issue Date	Term to Maturity Years (Days)	Last traded Yield (%)	Last Trade Date
FXD2/2019/5 (5YR)	FXD1/2019/ 5 (5YR)	25th Feb - 2019	4.84 (1,756)	10.79	26th Apr 2019
FXD2/2019/15 (15Yr)	FXD1/2019/ 15 (15yr)	28th –Jan - 2018	14.76 (5,368)	12.54	26th Apr 2019

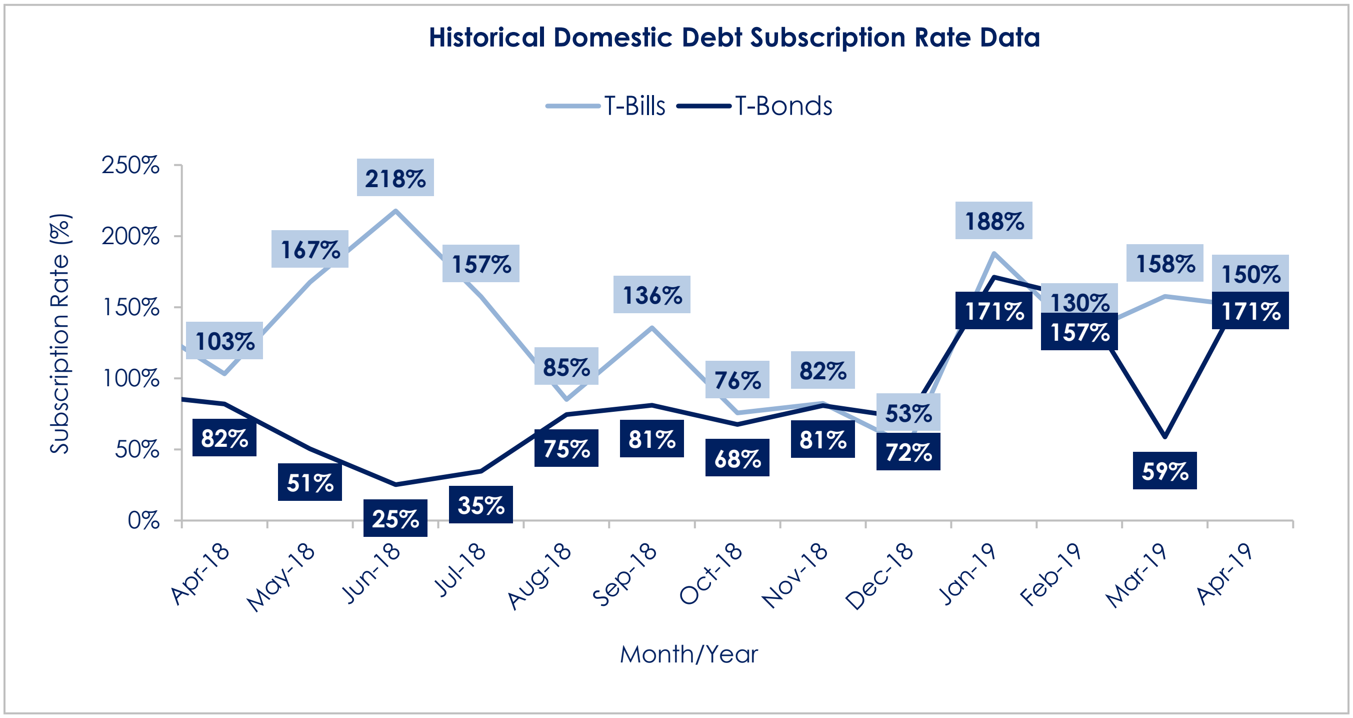
Source: Nairobi Securities Exchange

Investor preference for the longest dated (364 Day) T-Bill

364 day T-Bill recorded the highest subscription rate in April 2019 (216.9%)

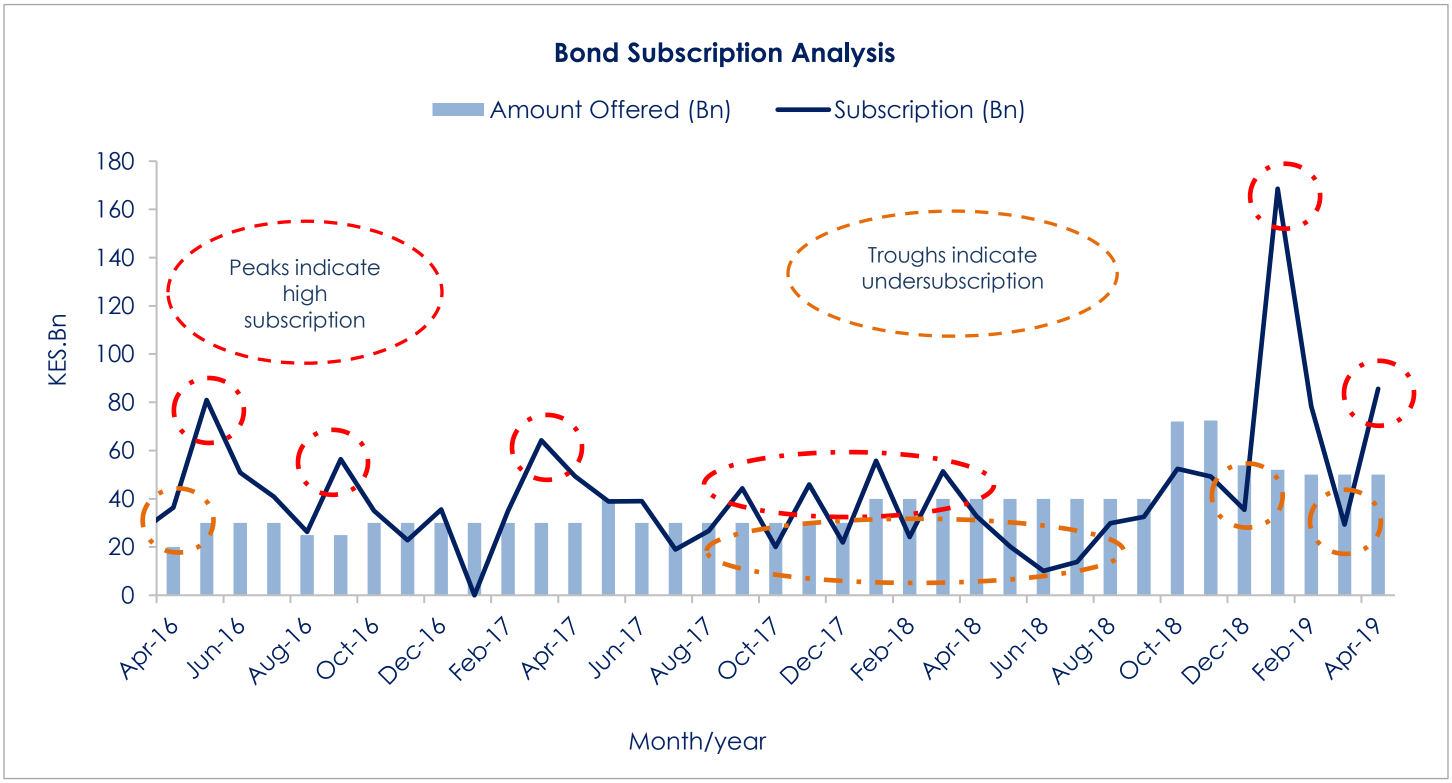
- Aggregate rate of subscription for T-Bills in April 2019 was 150.5% with a total of KES.144.3Bn received against KES.96Bn offered.
- Market liquidity is still relatively high with the biggest buyers of domestic debt securities having few alternative investible options.
- The 364-day Treasury bill (T-Bill) received the highest subscription rate (216.9%) followed by the 91 day and 182 day T-Bills with 130.1% and 92% subscription rates respectively.
- Two bonds were auctioned in April 2019 with the FXD2/2019/10 (10 Year) receiving the bulk of subscriptions at KES.70.9Bn equivalent to a 141.9% subscription rate (Fig.1 & Fig.2).
- FXD1/2019/20 (20 year) was less popular with investors due to its long tenor receiving KES.14.7Bn (29.4%) subscription).
- CBK accepted KES.51.3Bn and KES.9Bn for the 10 and 20 year bonds respectively.
- The preference for short dated issues will likewise dictate subscription for this month's 5 and 15 year issues with the shorter dated issue expected to receive the bulk of subscriptions.

Fig.1: High demand for both T-Bills and T-Bonds in April 2019



Source: Central Bank of Kenya

Fig.2: Historical Treasury bond subscription analysis 2016-2019 – High appetite for joint bond issues in April 2019



Source: Central Bank of Kenya

National Government receipt and expenditure data shows high appetite for domestic debt financing

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

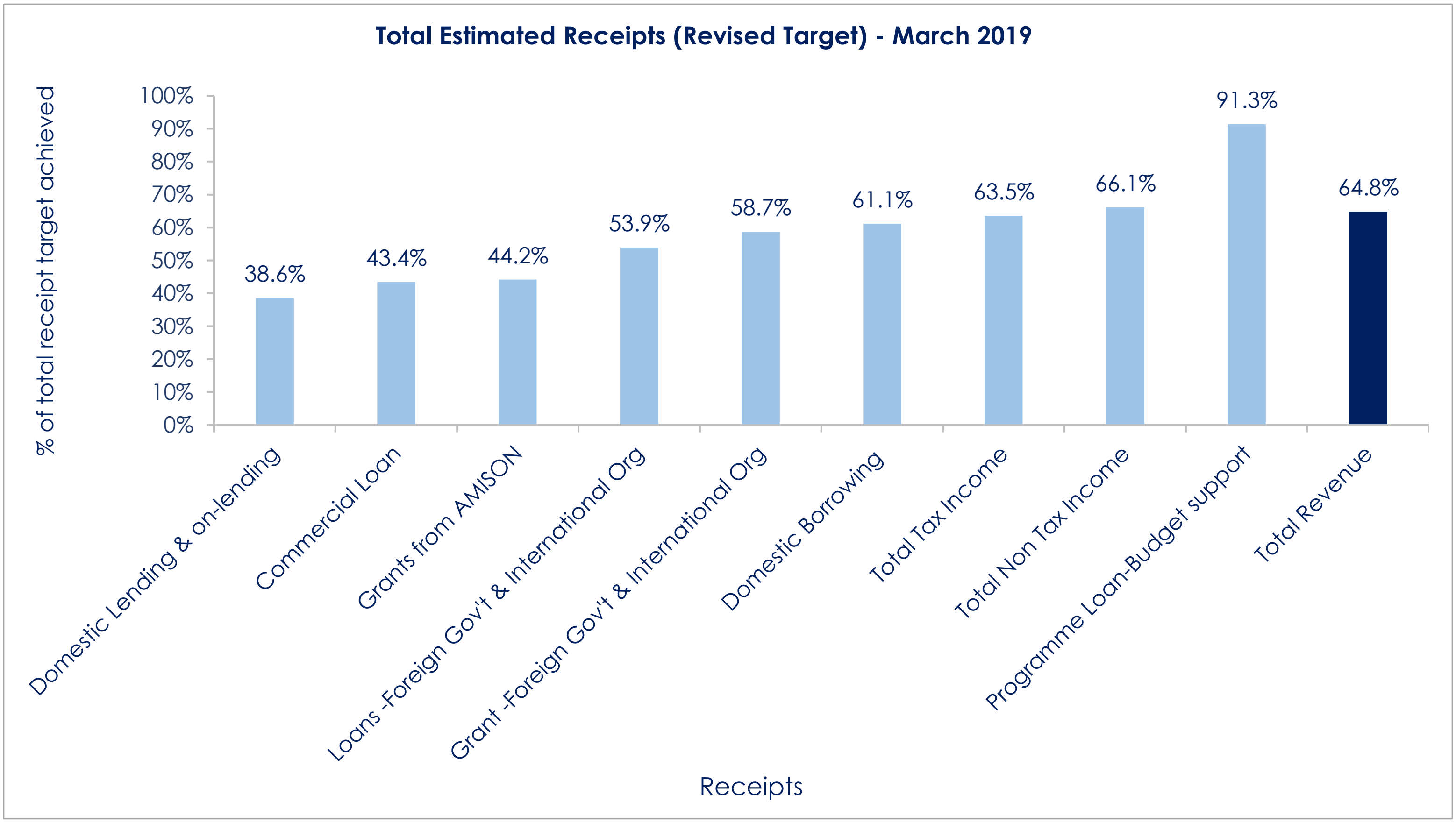
- Latest available data shows actual National Treasury fiscal receipts (March 2019) at KES.1.67Tn against a revised target of KES.2.58Tn (Table.5) and Fig.5), equivalent to 64.8% of the total fiscal year receipts target.
- Programme loan budget appears to be the only receipts targets ahead of the annual budget at 91.3% against our estimate run rate target of 75%.
- Total Non-Tax and Total Tax income receipts stand at KES.44.3Bn and KES.1.Tn equivalent to 66.1% and 63.5% respectively.
- Of particular interest to investors is the revised domestic borrowing target of KES.537.5Bn which includes KES.317.1Bn in net borrowing and kes.220.4Bn in redemptions (roll-overs).
- The data provided shows that 61.1% of the annual fiscal target has been achieved as at the end of March 2019 with only one financial quarter to the end of the fiscal year left.
- This together with the high revenue absorption rates shown in table 5 shows a rising financing need and increased activity in the domestic debt market.

Table.5: National Government receipts for the 2018/19 fiscal year falling below target

Receipts	Original Estimates (KES.Bn)	Revised Estimates (KES.Bn)	Actual Receipts (KES.Bn) End March 2019	Proportion of Total Revised Target
Opening Balance (1st July 2018)	0	0	102.79	
Domestic Lending & on-lending	3.93	3.93	1.51	38.6%
Commercial Loan	287.95	287.95	125.05	43.4%
Grants from AMISON	8.50	8.50	3.76	44.2%
Loans -Foreign Gov't & International Org	55.29	56.79	30.62	53.9%
Grant -Foreign Gov't & International Org	12.92	12.92	7.59	58.7%
Domestic Borrowing	**489.01**	**537.47**	**328.44**	**61.1%**
Total Tax Income	1,690.29	1,605.59	1,020.31	63.5%
Total Non-Tax Income	78.94	67.04	44.34	66.1%
Programme Loan-Budget support	2.50	2.50	2.28	91.3%
Unspent Balances (Recoveries)	-	-	6.83	-
Total Revenue	**2,629.33**	**2,582.69**	**1,673.53**	64.8%

Source: The Kenya Gazette Vol. CXXI - No.47 18th April 2019

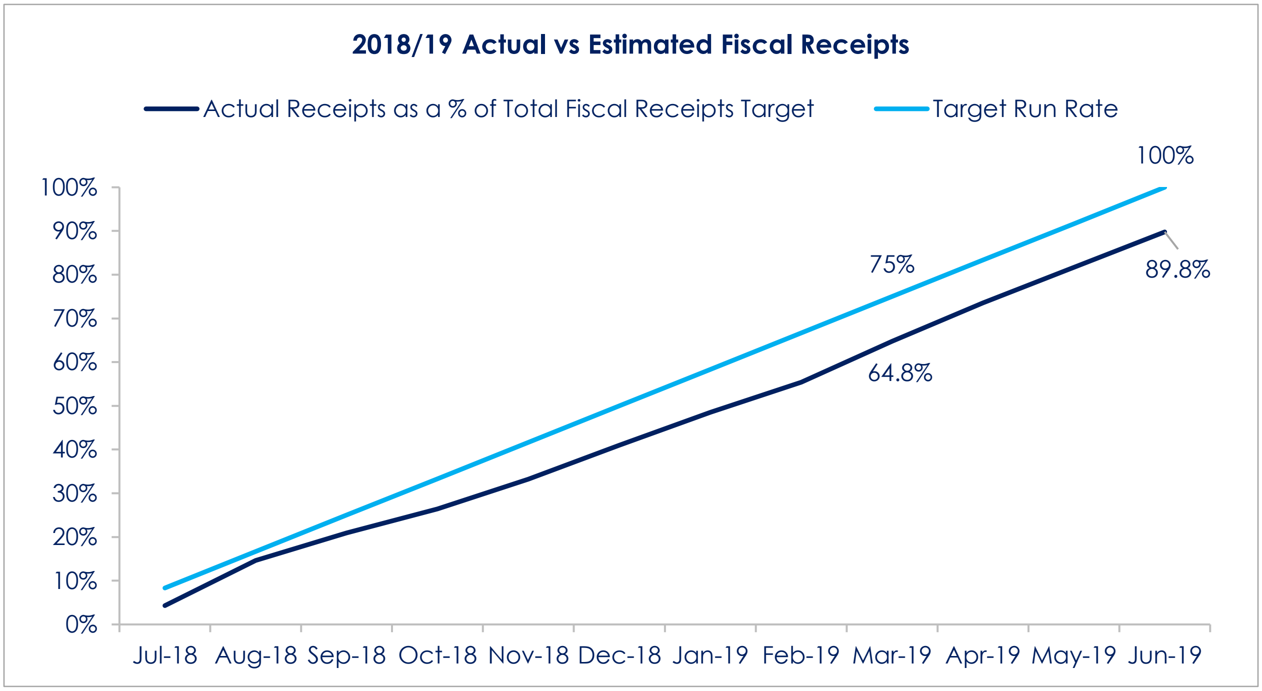
Fig.3: Actual National Treasury receipts at 64.8% of total 2018/19 fiscal year



Source: The Kenya Gazette Vol. CXXI - No.47 18th April 2019

- We observe an improvement in the fiscal receipt run rate following aggressive domestic borrowing in the month of March 2019 and estimate that the National Treasury will achieve KES.2.3Tn or 89.8% of its revised receipts target (Fig.4) at the end of the fiscal year.

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



Source: The Kenya Gazette Vol. CXXI - No.47 18th April 2019 & Sterling Capital Research Estimates

High absorption rates of government revenue suggests growing fiscal financing needs

- In consideration of the high absorption rate (uptake of funds for both recurrent and development expenditure) of 98.8% (Table.6) we can effectively conclude that there is a significant funding gap yet to be realized by the National Treasury.
- This we expect to influence their domestic borrowing strategy between now and the end of the fiscal year.
- There is a high chance of the CBK yielding ground to investor's demands for shorter dated issues (as is the case with the current 5 and 15 year bonds) and acceptance of more aggressive investor bids to encourage subscription for domestic debt.

Table.6: High revenue absorption rates suggest high fiscal financing needs

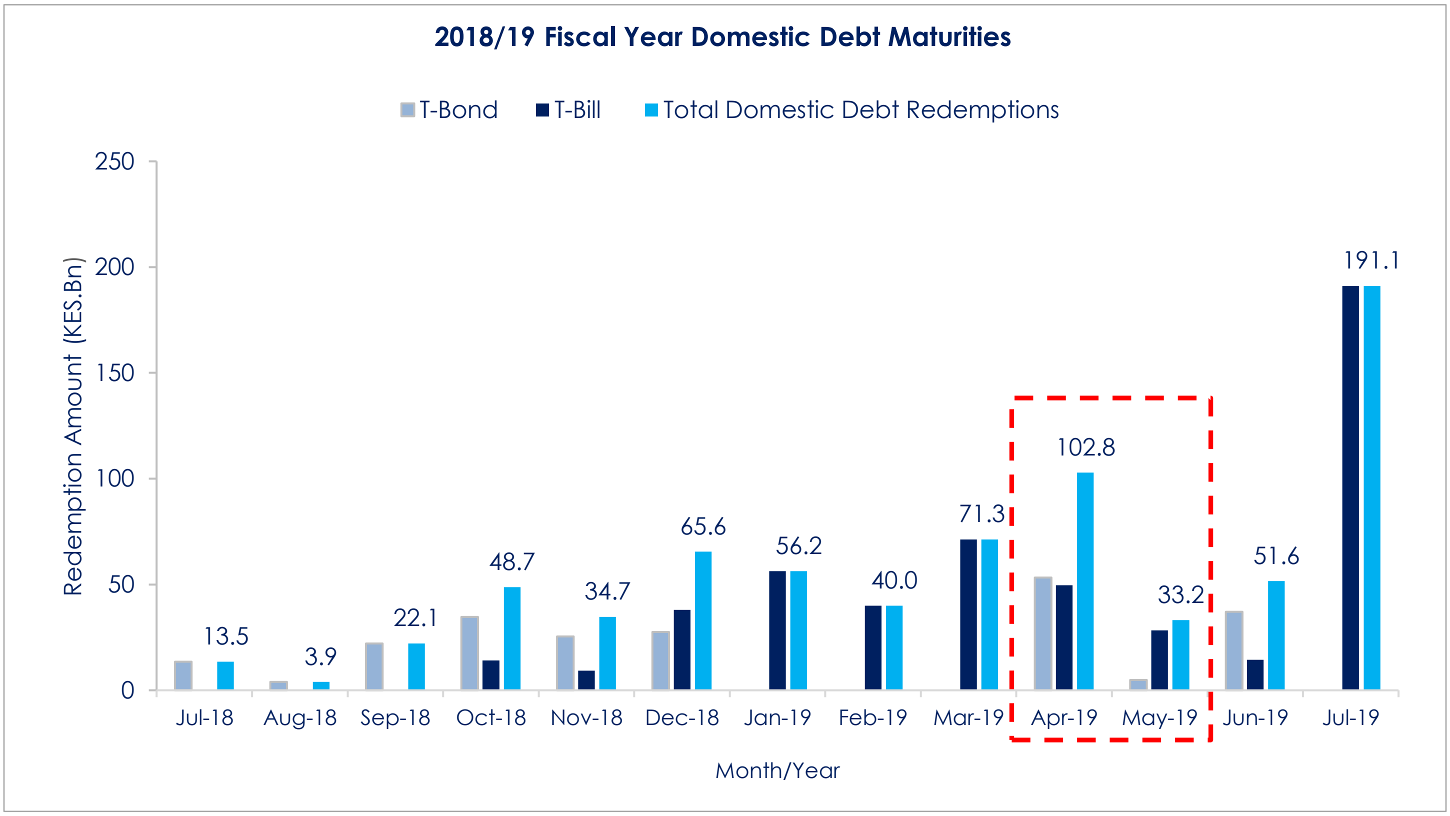
Exchequer Issue	**Revised Estimate (KES)**	**Actual (KES)**
Total Government Revenue (Actual) KES.(A)	2,582.7	1,673.5
Total National Government Expenditure	2,253.3	1,448.0
Total Expenditure (County Governments) (C)	329.3	205.6
Grand Total (B+C)	2,582.7	1,653.6
Exchequer Balance (A-B-C)	-	19.9
Absorption Rate (B+C)/A	**-**	**98.8%**

Source: The Kenya Gazette Vol. CXXI - No.47 18th April 2019& Sterling Capital Research Estimates

KES.136Bn in domestic debt maturities in April & May 2019

- April 2019 has the second biggest domestic debt maturity amount in the 2018/19 fiscal year amounting to KES.102.8Bn (Fig.5).
- This comprises KES.49.6Bn and KES.53.3Bn in T-Bills and T-Bonds respectively.
- The month of May has KES.28.3Bn and KES.4.9Bn in debt maturities (Fig.5).
- In consideration of these considerably high maturities, we expect heightened borrowing activity in the domestic debt market.

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

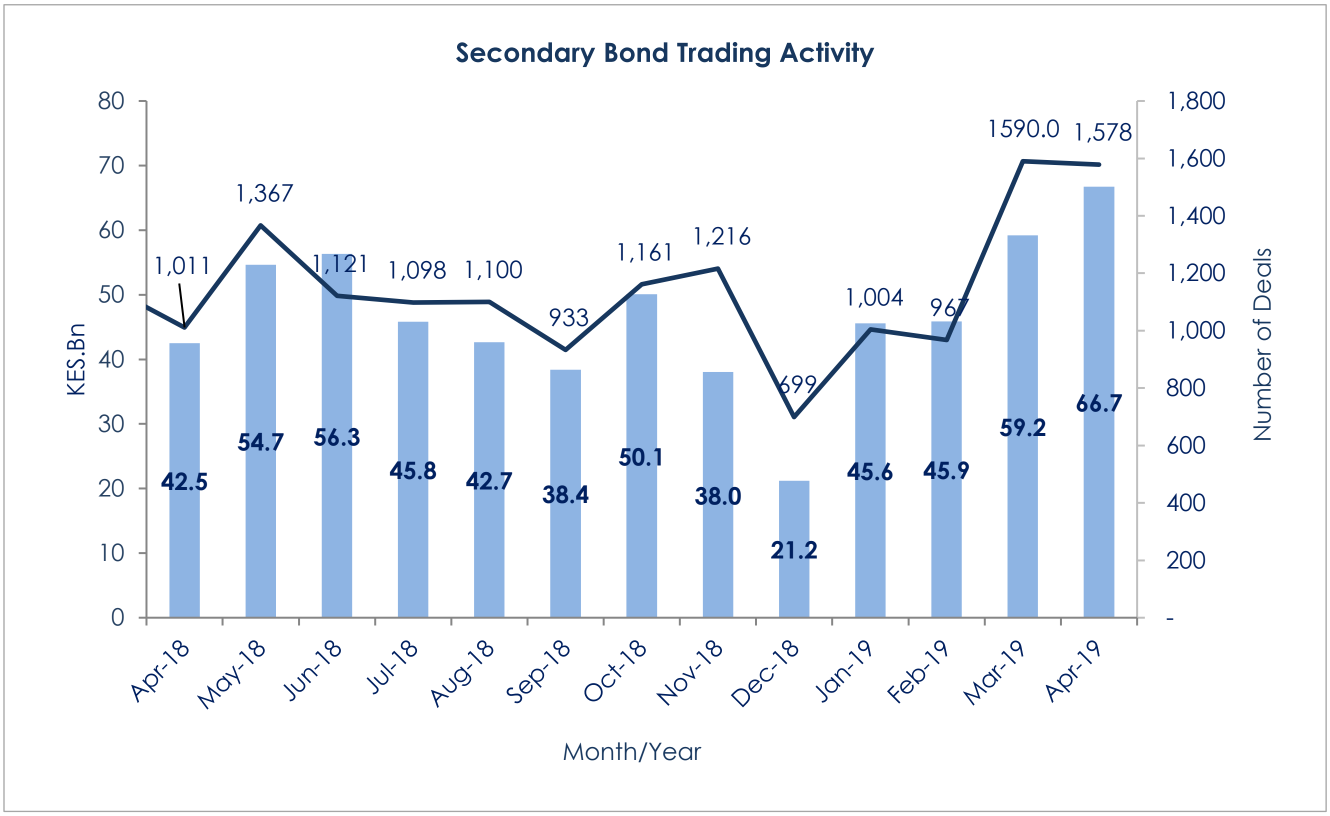


Source: Nairobi Securities Exchange

Bond turnover increases in April

- April 2019 bond turnover rose 12.7% over the previous month to KES.66.7Bn (Fig.6), albeit on fewer trades 1,578 compared to 1,590 in the previous month.
- This was partially attributed to the end quarter fund manager reporting period that abnormally sees a decline in trading activity.
- Market liquidity should have a bearing in secondary market in May with turnover expected to increase.

Fig.6: Secondary bond trading turnover 13% higher in April over the previous month trading activity increases significantly in March on high market liquidity



Source: Nairobi Securities Exchange

Yield curve continues to shift downwards

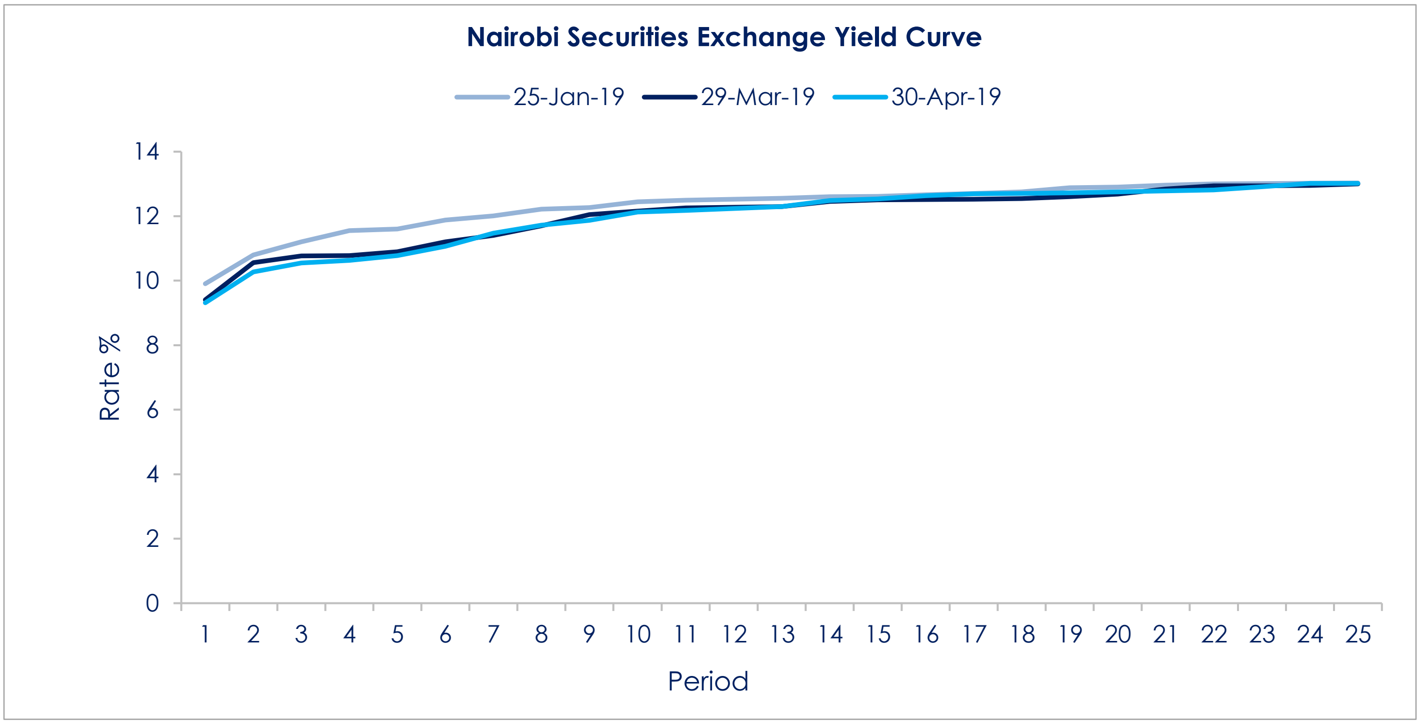
- We observe a downward shift in the yield curve between January 2019 when the last 15 year bond was issued, end of March and April 2019 (Table 5 & Fig 4).
- The biggest shift in the yield curve between January and April is on the short end with minor differences in yields on the long end.
- The trend in the yield curve is explained by the CBK's action to accept lower bids in shorter dated security auctions.
- Inflationary pressure and the expected fiscal financing needs are likely to put some upward pressure on short term yields in the near term.
- **Our fixed income investing strategy remains unchanged as we continue to advise investors to HOLD long term bonds and BUY short and medium term tenor issues.**

Table.7: Yield decreases for short and medium tenors

Tenor	Yield (21st Sep 2018)	Yield (30th April 2019)	Change (Bps)
1	9.6760	9.3150	↓59
2	10.6496	10.2713	↓53
5	11.6993	10.7782	↓82
10	12.3798	12.1250	↓32
15	12.6713	12.5400	↓1
20	12.6750	12.7563	↓1
25	13.1997	13.0167	↓1

Source: Nairobi Securities Exchange

Fig.7: Yield curve shifts further down for the short term maturities

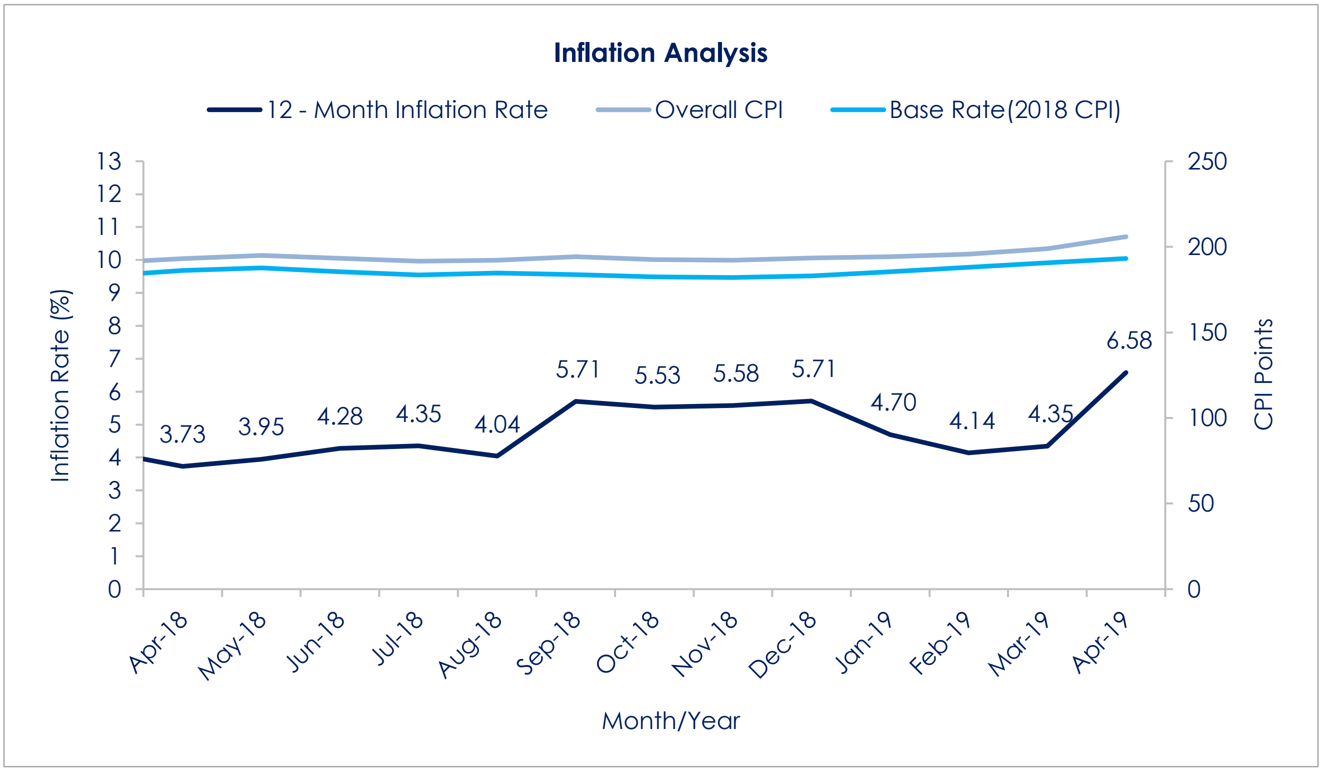


Source: Nairobi Securities Exchange

April inflation forecast - 5.0% to 6.0%

- Kenya National Bureau of Statistics (KNBS) released monthly Consumer Price Indices (CPI) and rates of inflation, for April 2019 indicating an inflation rate of 6.58% (Fig.8).
- This was an increase from 4.35% in March and 4.14% in February.
- The rise in inflation is due to a year on year increase in all components of the CPI.
- Transport as well as food and non-alcoholic beverages index recorded the biggest rises - 10.8% and 8.2% respectively.
- We expect inflationary pressure to ease in May **to 5.0%-6.0% levels largely due to improved weather conditions that will see food prices declining.**

Fig.8: May Inflation rate to be above CBK's mid-point target

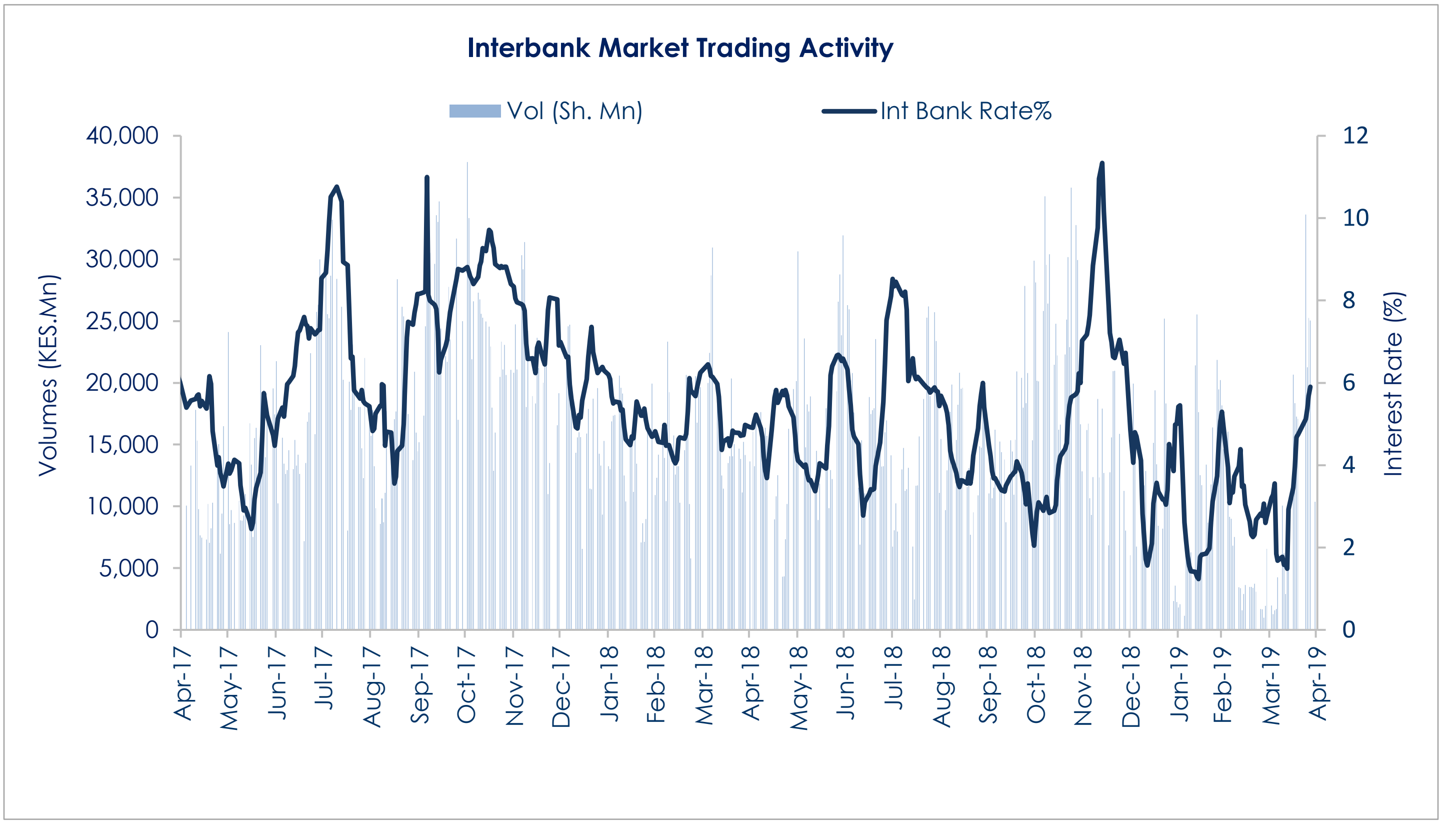


Source: Kenya National Bureau of Statistics

Weighted Average Interbank Rate to remain between 3.0% - 3.5% in May

- The Average Interbank Rate rose to 3.4% in April from 3.3% in March (Fig.9).
- Volumes traded over the same period rose to KES.12.3Bn from KES.5.2Bn.
- During the month there was high liquidity with rates going as low as 1.6% (mid-month).
- The rate started rising at the end of the month closing at 5.91% on 29th April.
- **We forecast the average interbank rate for the month of May to range between 3% and 3.5%.**

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



Source: Central Bank of Kenya

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