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Fixed Income Note

July 2019

"Kick-off 2019/20"

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Executive Summary

- Our July 2019 fixed income report **"Kick-off 2019/20"** is a comprehensive analysis of the Central Bank of Kenya's (CBK) first issue of the 2019/20 fiscal year a 15 year Treasury Bond **FXD3/2019/15** looking to raise KES.40Bn.
- We estimate the weighted average rate (WAR) of bids to be between **12.45% and 12.55%** and the weighted average rate of accepted bids which we expect to be between **12.40% and 12.50%.**
- With regards to investor demand, we expect the issue to be highly subscribed in contrast to the last two issues FXD1/2019/15 and FXD2/2019/15 that received subscription rates of 63% and 43% respectively.
- The report also highlights secondary trading market activity where bond turnover recorded a significant increase over the previous month due to high market liquidity.
- On the short term direction of domestic interest rates we discuss the impact of receipts from the third Eurobond issue as well as possible legislation on interest rate caps.
- As we settle into the first quarter of the FY19/20 inflation is expected to edge upwards to 5.8% an increase that will exert pressure on investor real returns.
- The Central Bank's MPC meeting will be held on 24th July and we expect the CBR to remain unchanged at 9% due to stable macro-economic indicators.

CBK taps into the domestic debt market to raise KES.40Bn

KES.283.5Bn - 2019/20 domestic debt borrowing target

- This is the first Treasury Bond (T-Bond) issue of 2019/2020 fiscal year seeking to raise KES.40Bn as part of the domestic debt borrowing target of KES.283.5Bn (Table.1).
- This issuance is part of the Government's debt management strategy that involves lengthening the maturity profile of public debt whilst reducing refinancing risk associated with issuance of short term debt.
- Government plans to further lengthen the maturity profile of its domestic debt by reducing the share of T-Bills in total net domestic financing.
- The National Treasury's target for the domestic debt mix is 30% T-Bills and 70% T-Bonds.
- This leads us to believe that the Government going forward will prefer issuing long term debt securities in order to reduce roll over risk.
- However, debt investors have shown a preference for short and medium term debt securities at times shunning long-term bond issuances.
- We therefore expect the Government to blend medium and long dated instruments.

Table.1: Primary Bond issue summary

Issue Number	**FXD 3/2019/15**
Total Amount Offered	KES.40Bn
Tenor (Yrs.)	15
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	2nd to 23rd July, 2019
Auction Date	Wednesday, 24th July 2019
Value Date	29th July 2019
Yield Curve (%) (Weighted Average tenor 15 Years)	12.32%

Source: Central Bank of Kenya

What are the likely domestic debt subscription patterns in the 2019/20 fiscal year?

High domestic debt subscription expected due to high market liquidity.

- We expect continued high demand for Government instruments in the medium term as low lending rates have discouraged lending to the private sector.
- This should lead to high subscriptions for Government securities in the medium term.
- Liquidity in the market has been rising with the start of the month of July 2019 recording one of the lowest average interbank rates of 1.86% since April 2019. This should also increase demand for Government securities.
- Interest rate capping has been favourable to the Government in terms of debt issuance and that coupled with stable inflation rates, we expect continued issuance in the medium term.

Investor bid predictions - 12.45%-12.55%

- In consideration of most recent similar dated tenors (Table.2), investor sentiment and current market yields on the Nairobi Securities Exchange (NSE), we predict investor bids for the FXD3/2019/15 at around 12.45% with the weighted average of accepted bids at 12.40%.

Table.2: Historical primary market auction performance

Issue Number	Issue Date	Amount Offered	Bids Received	Amount Accepted	Performance	Coupon Rate (%)	Implied Yield to Maturity
FXD1/2018/15	28th May 2018	40	20.22	12.86	50.54	12.65	12.13
FXD2/2018/15	22nd October 2018	40	27.05	7.85	67.61	12.75	12.13
FXD2/2018/15 (Re-open)	5th November 2018	32	25.38	21.26	79.30	12.75	12.13
FXD1/2019/15	28th January 2019	40	25.07	14.72	62.67	12.86	12.30
FXD2/2019/15	13th May 2019	50	21.54	19.32	43.08	12.73	12.32
FXD1/2012 /15 (Re-open)	17th June, 2019	40	39.77	21.21	99.42	11.00	11.29
FXD1/2018 /15 (Re-open)	17th June, 2019	40	45.85	17.73	114.62	12.65	12.13

Source: Central Bank of Kenya & Nairobi Securities Exchange

Table.3: Auction bid predictions

Security	**FXD3/2019/15**
Market Weighted Average Rate (%)	12.45-12.55
Weighted Average Rate Of Accepted Bids (%)	12.40-12.50

Source: Sterling Capital Research

- We also use implied yields for bonds with similar tenor to maturity currently trading on the Nairobi Securities Exchange (as at 5th July, 2019) to guide our investor bid predictions (Table.4).

Table.4: Benchmark issues to guide investor bids

Current Bond Issue	Coupon Rate (%)	Benchmark Bonds	Issue Date	Term to Maturity Years (Days)	Last traded Yield (%)	Trade Date
FXD3/2019/15	Market Determined	FXD2/2019/15	May 13th,2019	14.8 Yrs.(5,407days)	12.32	5th July, 2019
		FXD1/2019/15	January,28th 2019	14.5 Yrs.(5,302 days)	12.30	5th July, 2019

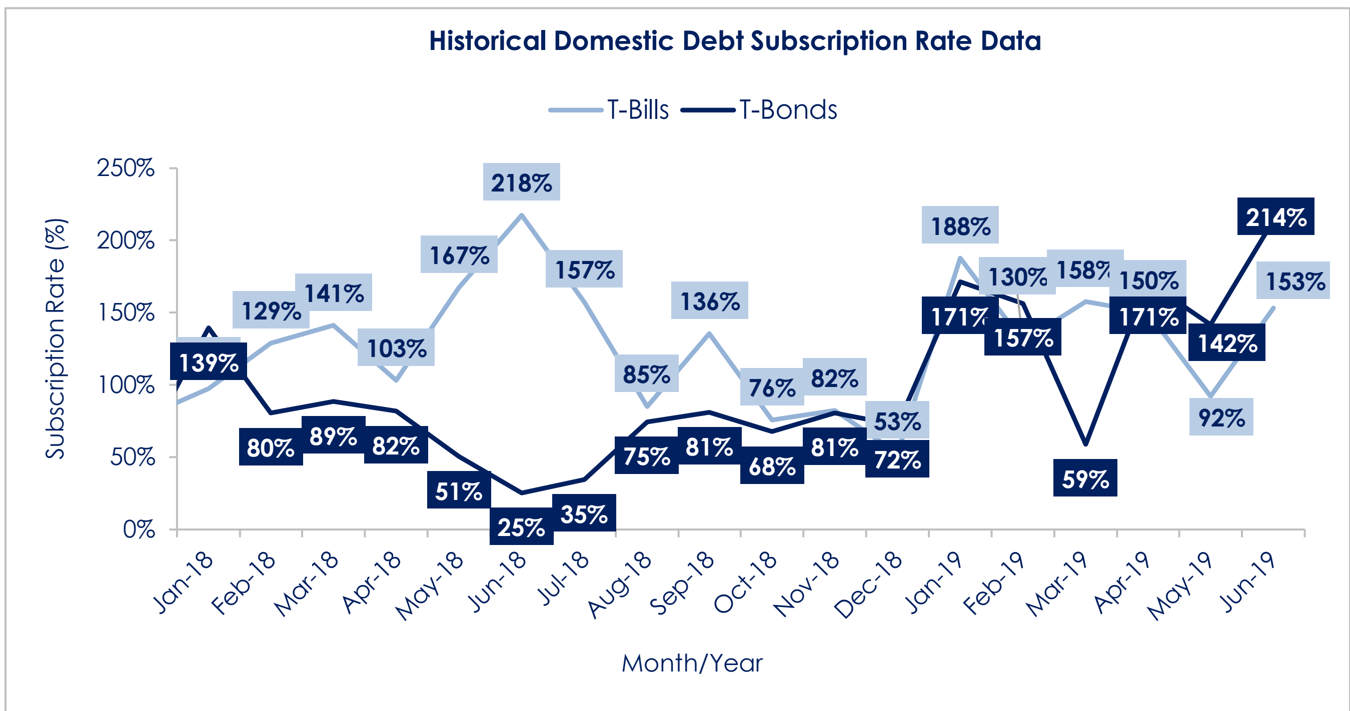
Source: Central Bank of Kenya

CBK's upper hand in debt issuance and acceptance

High investor demand for domestic debt.
CBK has been rejecting investor bids.

- Investor demand for domestic debt increased in June compared to May with KES.232.7Bn received in subscriptions (both T-Bills and T-Bonds) against the KES.136Bn that the CBK sought in auctions (Fig.1).
- KES.147Bn was received in T-Bill subscriptions equivalent to 153.2% of the total amount the CBK sought to raise (KES.96Bn) compared to KES.110.3Bn against a target of KES.120Bn in May 2019.
- Investor preference remained on the 364 day T-Bill which recorded a 309.4% subscription compared to 67.2% and 31.3% for the 91 and 182 Day T-Bill issues respectively.

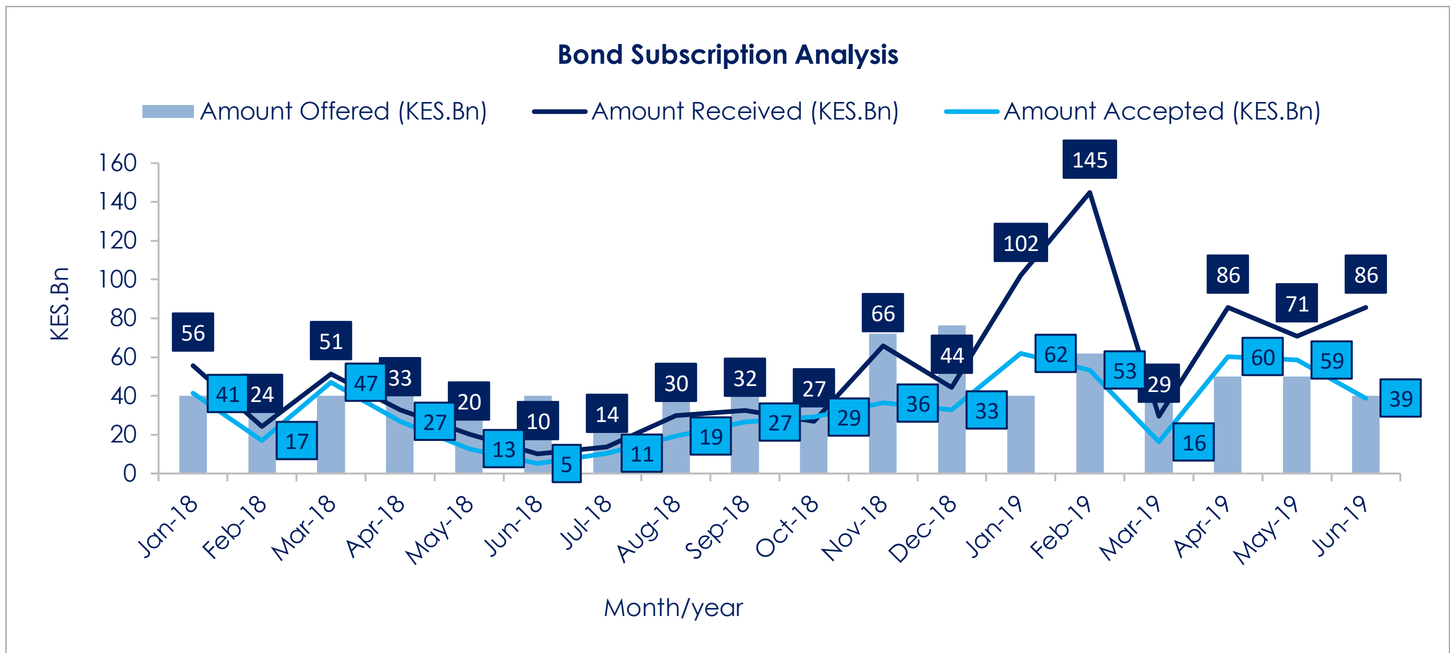
Fig.1: Investor demand for Government securities remains high in June 2019



Source: Central Bank of Kenya

- The May 2019 T-Bond issues (FXD1/2012/15 and FXD1/2018/15) recorded a 214% subscription rate with KES.85.6Bn received against a funding target of KES.40Bn (Fig.2).
- CBK rejected more investor auction bids in June (KES.46.7Bn) compared to the month of May (KES.12.3Bn) an increase of 279.1%.
- We attribute this to high market liquidity and possible Eurobond inflows that reduced the Government's demand for domestic debt.

Fig.2: CBK rejects KES.47Bn in June T-Bond auctions



Source: Central Bank of Kenya

Why domestic debt interest rates continue to fall and should investors expect this to continue?

> Capital outflows from the bear equities market towards the domestic debt market has resulted in high market liquidity.

- Decline in short term interest rates is driven by the rising liquidity in the market in turn largely a result of negative performance of the equities market.
- Banks, pension funds and insurance companies are the biggest buyers and holders of Government debt.
- Unlike banks, pension funds and insurance companies also invest in the equities market and in periods of double digit market draw-downs like 2019, they tend to move their capital to assets that offer more stable and predictable returns.
- This could explain the continuous fall in short term interest rates since Q1 after the rebound in the equities market came to a halt.
- The recent receipt of capital from the issuance of the Eurobond has also had a play in the decline in domestic debt interest rates.
- We expect this trend to continue in the second half of 2019 with interest rates remaining low and stable.

What if anything could trigger a rebound in domestic interest rates?

- This could be brought about by significant changes in inflation rates as is normally expected in the first quarter due to recurrent drought.
- High inflation rates reduce the expected real yield of a fixed income instrument and hence capital flight from the securities would cause their interest rates to rise.

- This has been minimized in the recent past due to the impact of interest rate caps and relatively stable inflation rates.
- Another factor could be a rebound in the equities market that tends to have, though not robust, an inverse correlation with the fixed income market.

What about interest rate caps? Should we expect a repeal or revision of the law?

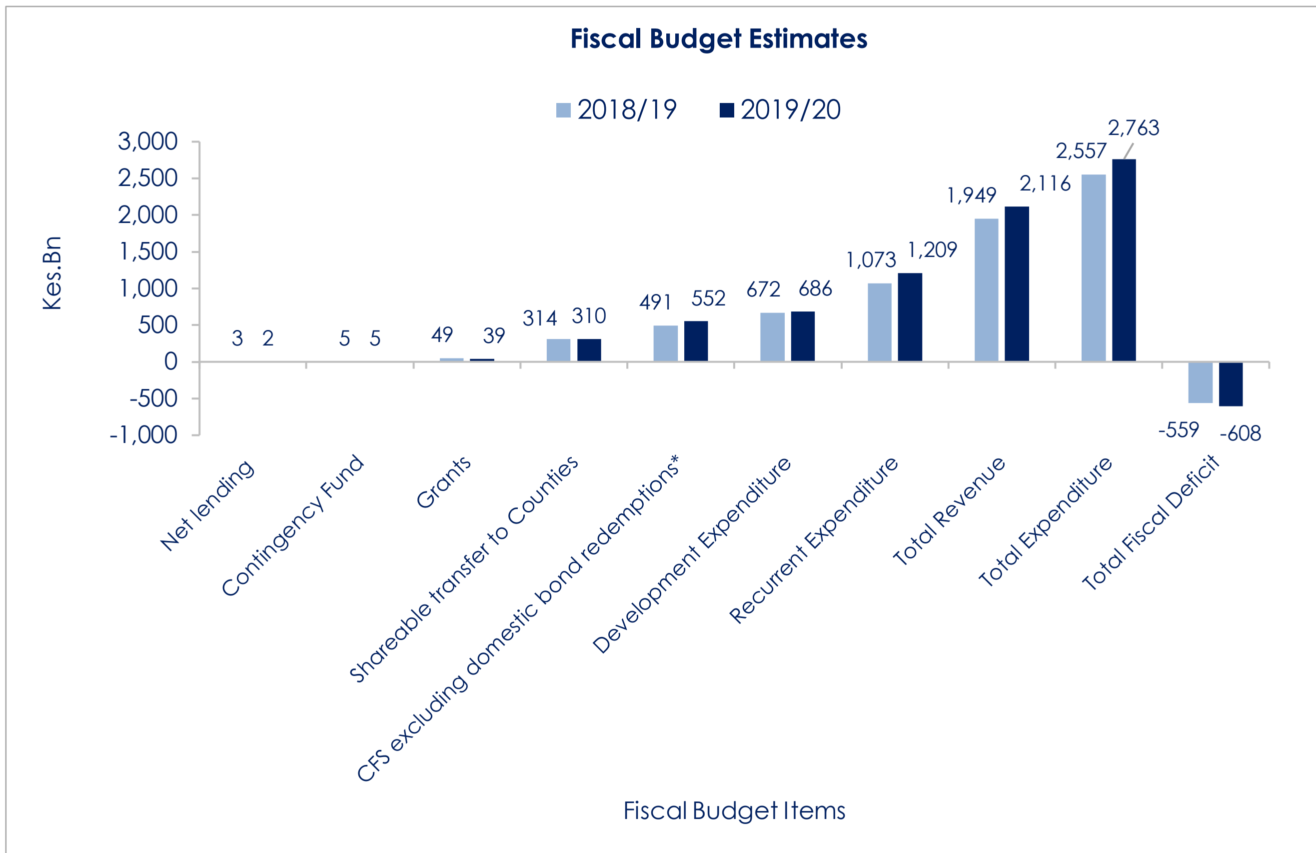
Low probability of interest rate capping law repeal, higher probability of revision to law.

- The cap on interest rates has resulted in reduced volatility in the short term interest rates with the headroom at 13%.
- However, the average rates of the different domestic debt papers have not been significantly affected since its introduction in September 2016.
- There has been high liquidity in the domestic market which has led to a decline in interest rates.
- A repeal of interest rate capping law will lead to a decline in liquidity and a rise in interest rates as the private sector will come into direct competition with Government for capital.
- In March 2019, the High Court declared the interest rate cap law unconstitutional but gave a 12-month grace period before the ruling is enforced.
- In the 2019/2020 Budget statement the cabinet secretary Henry Rotich proposed the repealing of interest rate cap law.
- The CBK governor has opposed the interest rate cap law since it was introduced because of its negative impact on private sector credit growth.
- However, the final say remains with the Members of Parliament (MPs).
- Domestic debt interest rates have been stable and we expect the same to continue for the second half of 2019.
- However, this might change if macroeconomic factors change significantly and CBK revises Central Bank Rate (CBR) upwards.
- We see a low probability of MPs repealing interest rate capping law.
- However, in consideration of the court ruling in January and the recommendation of the Treasury CS we see a higher probability of a revision of the law with a possible increase in the interest margin which currently stands at 4%.
- An increase in the interest margin to a level acceptable to banks as commensurate to their credit risk exposure would result in a gradual increase in credit to the private sector and a reduction in holdings in Government securities.
- This decline in demand to hold domestic debt securities would result in a steady increase in domestic debt interest rates.

How will the 2019/20 fiscal budget be financed?

- The 2019/20 fiscal budget (Fig.3) shows an 8.1% increase in Government expenditure with the biggest increase being recurrent expenditure 12.6% to KES.1.2Tn.
- This increase has a direct correlation to interest payments on both domestic and external debt due to the surge in debt financing.
- We draw attention to the total fiscal deficit of KES.608Bn an 8.8% increase over the previous fiscal year.

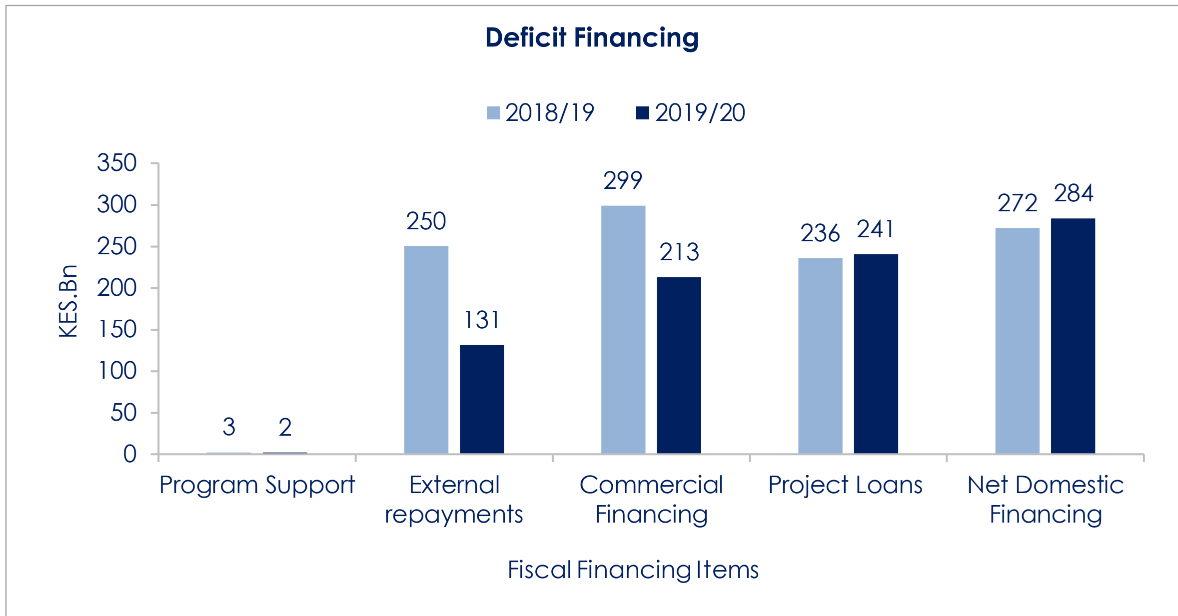
Fig.3: 2019/20 KES.2.8Tn fiscal budget & KES.608Bn fiscal deficit



Source: The National Treasury & Planning

- We further analyze fiscal debt financing (Fig.4) with the most notable financing items being external loan repayments and commercial financing declining 47.5% and 28.7% to KES.131.4Bn and KES.213.1 respectively.
- A 4.3% increase in net domestic financing to KES.283.5Bn suggests an increase in primary debt issuance.
- Current interest rate levels are also beneficial to the Government in financing this deficit.

Fig.4: 2019/20 fiscal budget financing shows an increase in net domestic financing



Source: The National Treasury & Planning

Like the last two issues, Eurobond 3 has resulted in a dip in domestic debt interest rates

Low probability of repeal of interest rate capping law, higher probability of revision to law.

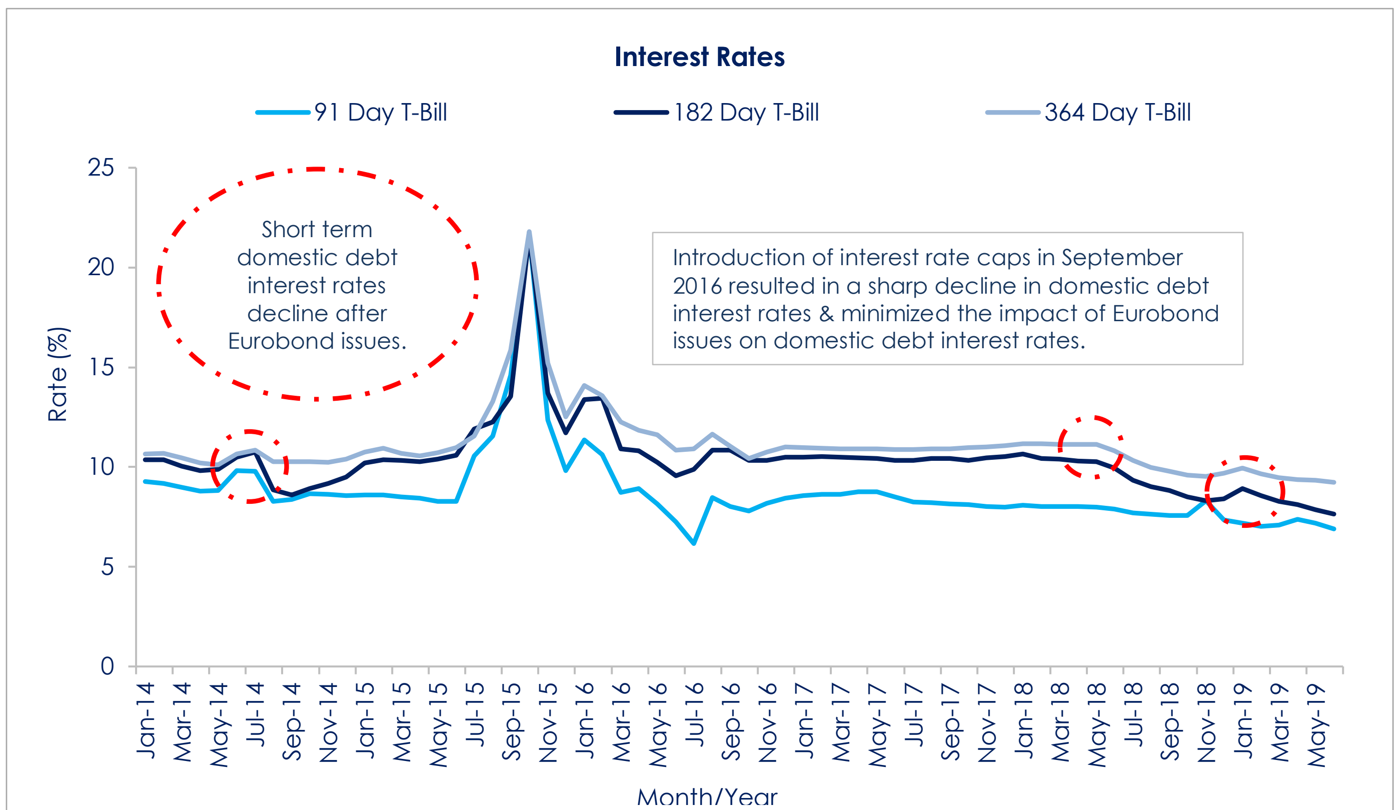
- Eurobond 3 has resulted in a steady but gradual decline in domestic debt interest rates as was the case of the first two debt issues in June 2014 and February 2018 (Table.5 & Fig.5).
- However, the current decline is not as sharp as was the case in June 2014 the time of the first issue due to the impact of interest rate caps that resulted in an almost immediate drop in both commercial and domestic debt interest rates.
- Our view is that this is a direct result of declining fiscal deficit financing pressure on the Government following the receipt of capital from the Eurobond issue.

Table.5: Domestic debt interest rates have been falling in recent auctions

Auction Date	Weighted Average Rate (%)		
	91 Day	182 Day	364 Day
13/05/2019*	7.196	7.897	9.316
20/05/2019*	7.160	7.814	9.312
27/05/2019	7.085	7.738	9.312
03/06/2019	6.995	7.651	9.311
10/06/2019	6.915	7.606	9.299
17/06/2019	6.895	7.723	9.263
24/06/2019	6.814	7.578	9.05
01/07/2019	6.738	7.487	8.759
08/07/2019	6.685	7.397	8.610
15/07/2019	6.600	7.469	8.646

Source: Central Bank of Kenya

Fig.5: Eurobond 3 to suppress domestic debt interest rates further?

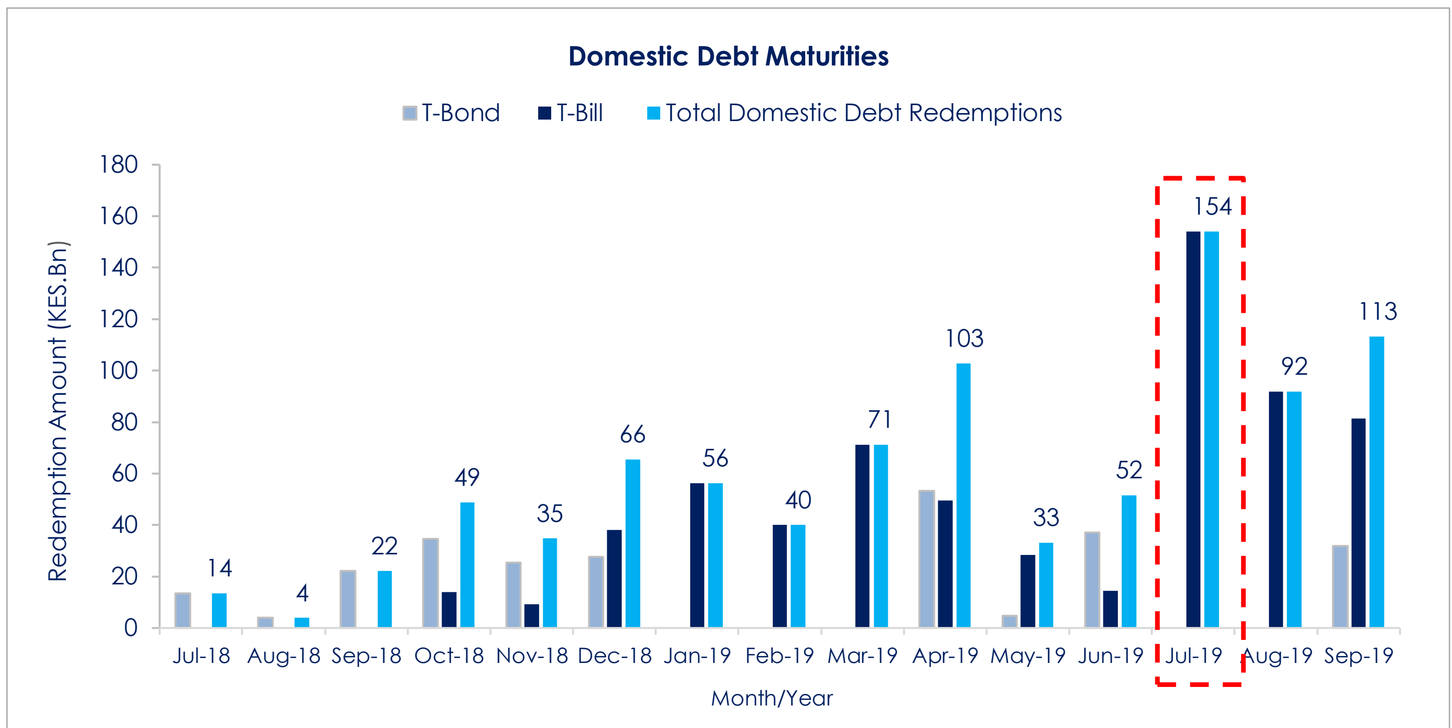


Source: Central Bank of Kenya

KES.154.10Bn in domestic debt maturities for July 2019

- KES.154.10Bn in domestic debt maturities for the first month of 2019/20 fiscal (Fig.6).
- Notable is there are no T-Bond maturities in the first two months of the 2019/20 fiscal year.
- Redemptions in July are significantly higher than June (KES.52Bn) and the highest year to date.
- These maturities are likely to impact the CBK's investor bids acceptance decision even with the current high market liquidity.
- A closer look at the results of the T-Bill auction on 11th July shows high appetite to take on debt with the CBK accepting all bids received KES.44.1Bn against a funding target of KES.24Bn.
- This means that the CBK is likely to accept more than the KES.40Bn they are looking to raise through the current bond issue.

Fig.6: July debt maturities at KES.154.1Bn



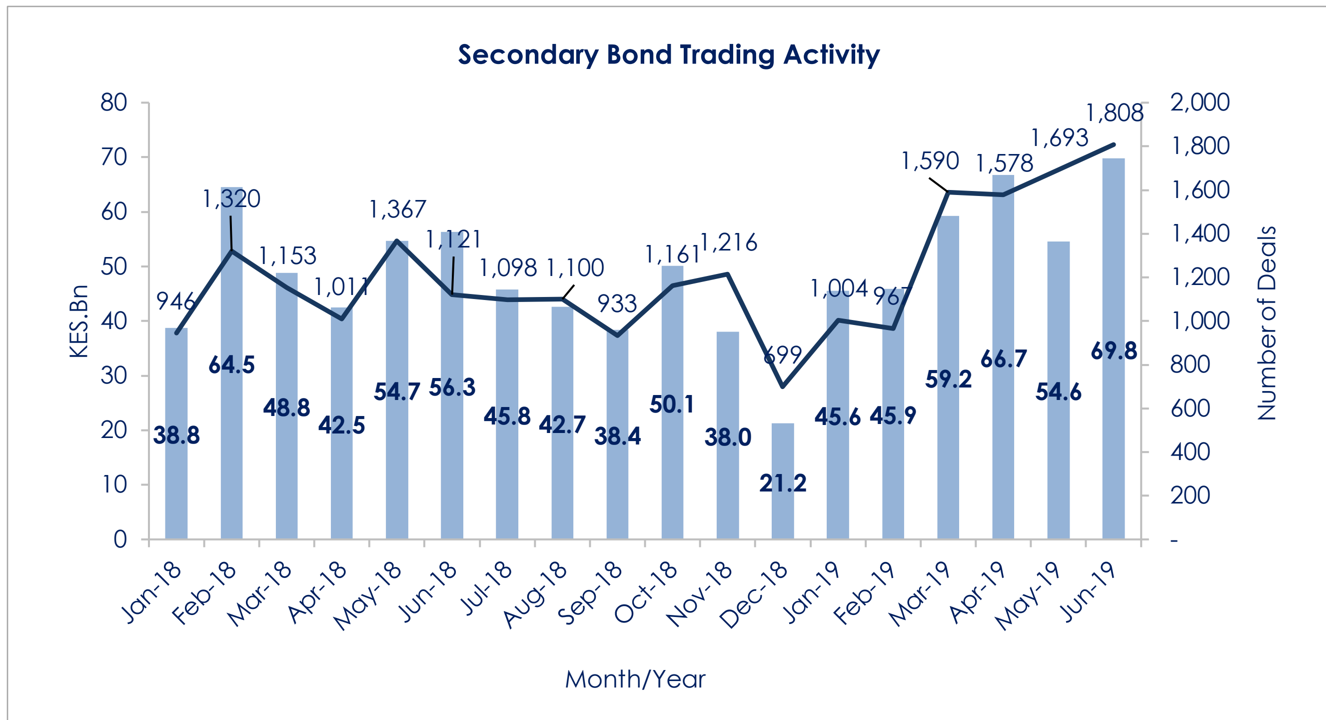
Source: Nairobi Securities Exchange

High liquidity results in higher bond trading volume in June

- Secondary market activity edged upwards (27.8%) in June over the previous month to KES69.8Bn attributable to increased liquidity from Government payments (Fig.7).
- Performance of the equities market is expected to have a significant impact on bonds trading FY2019/20. Investors have taken a "wait and see" approach in the equities market and we expect this to result in vibrant activity in the bonds market.

- Bonds turnover FY2019/20 is also highly dependent on the outcome of the interest rate cap debate, which has an impact on banks' liquidity.
- Bond trading activity would decline if the interest rate capping law is repealed or revised (interest margin increased), because banks would resume lending to the private sector and reduce their holdings of Government securities.
- We do not anticipate a repeal of the cap however, and would advise investors to hold long term papers and buy short and medium term bonds.

Fig.7: Bond turnover declines 18% in May due to tight market liquidity



Source: Nairobi Securities Exchange

Short-end of the yield curve exhibits the biggest shift in yields over the last one year

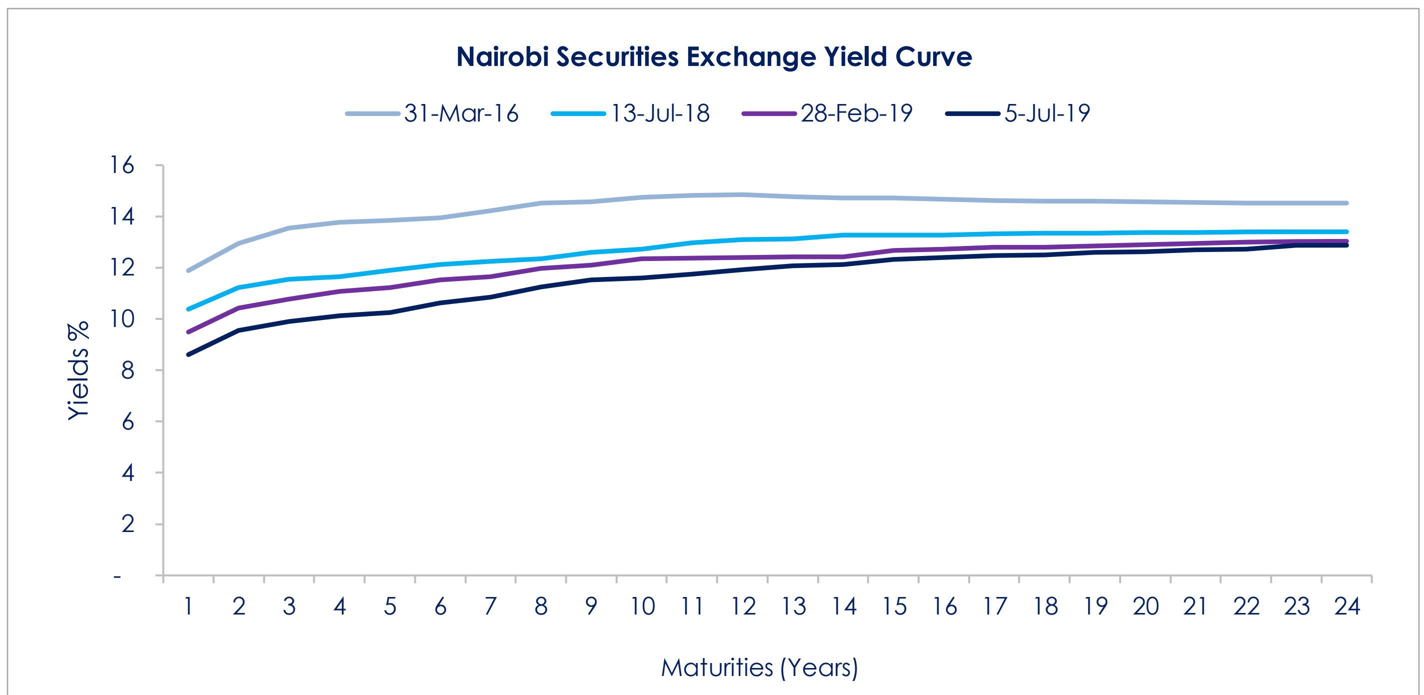
- All yields on Government securities have declined compared to the same period last year, with bigger shifts in the short end of the curve (Table.6).
- A repeal of the interest rate cap law would revert the yield curve back to the same interest rate levels as seen in March 2016, six months before the introduction of capping law (Fig.8).
- We do not expect any major shifts in the yield curve in the short and medium terms, as the interest rate cap regime prevails.
- The yield curve indicates a downward shift compared to the February 2019 15-Yr bond issue.
- **We maintain our recommendation to HOLD long term papers and BUY short and medium term bonds.**

Table.6: Yields decline for all debt maturities

Tenor	Yield (13th July 2018)	Yield (5th July 2019)	Change (Bps)
1	10.3810	8.6100	↓177
2	11.2304	9.5460	↓168
5	11.9000	10.2560	↓164
10	12.7275	11.6000	↓113
15	13.2719	12.3245	↓95
20	13.3750	12.6170	↓76
25	13.4000	12.8750	↓54

Source: Nairobi Securities Exchange

Fig.8: Yields on short term maturities exhibit larger declines compared to longer dated bonds



Source: Nairobi Securities Exchange

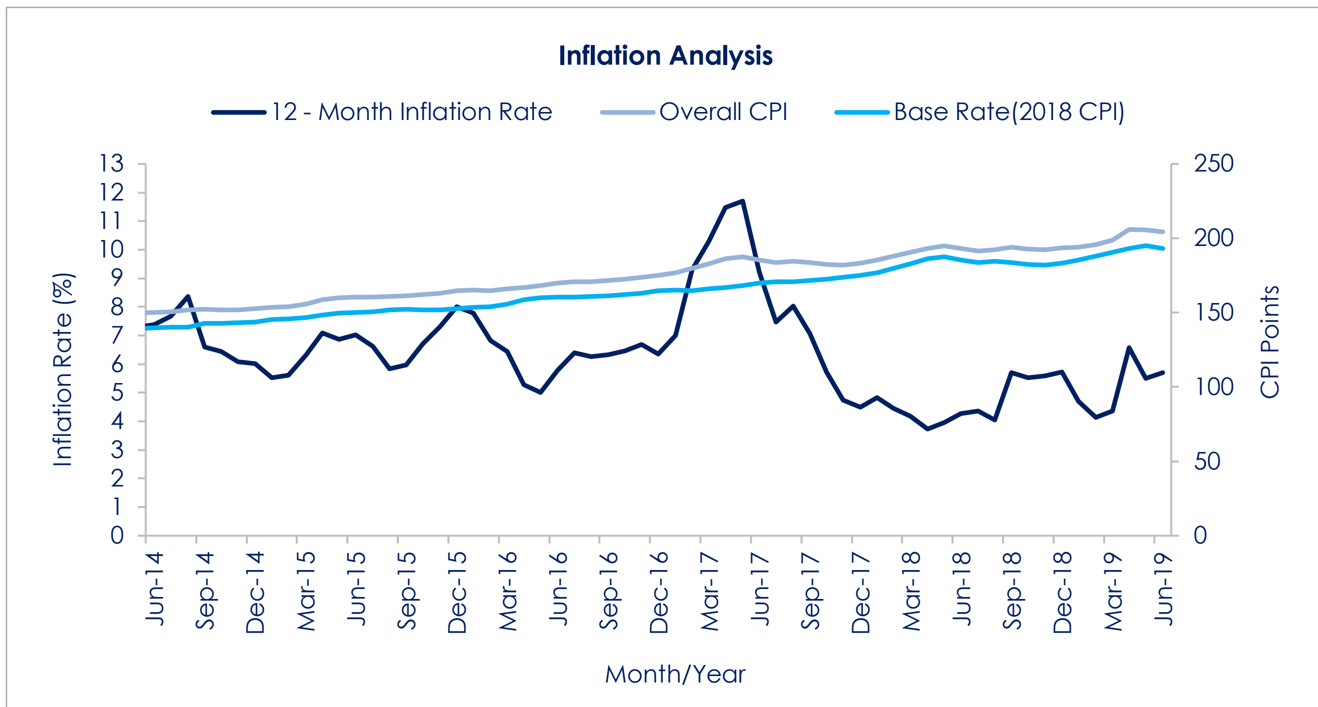
July inflation forecast - 5.8% - 6.0%

- The average inflation rate for the first half of 2019 stood at 4.94% compared to 6.52% the previous year, due to favoruoble food & non-alcoholic beverages indices performance.
- In the second half of the year we expect inflation to average 5.8% due to increased prices of fuel and food.
- Forecasted inflation rate for the June to September 2019 quarter is 5.8%

according to Trading Economics global macro models and analysts' expectations.

- Looking forward, they estimate Kenya's inflation rate in the next 12 months at 5.1%.
- Inflation is projected to trend around 6.40% in 2020, according to econometric models.
- A rise in inflation will reduce investors' a trend compounded by declining yields on Government securities.
- Our projections for July inflation is 5.8% - 6.0%.

Fig.9: July inflation forecast

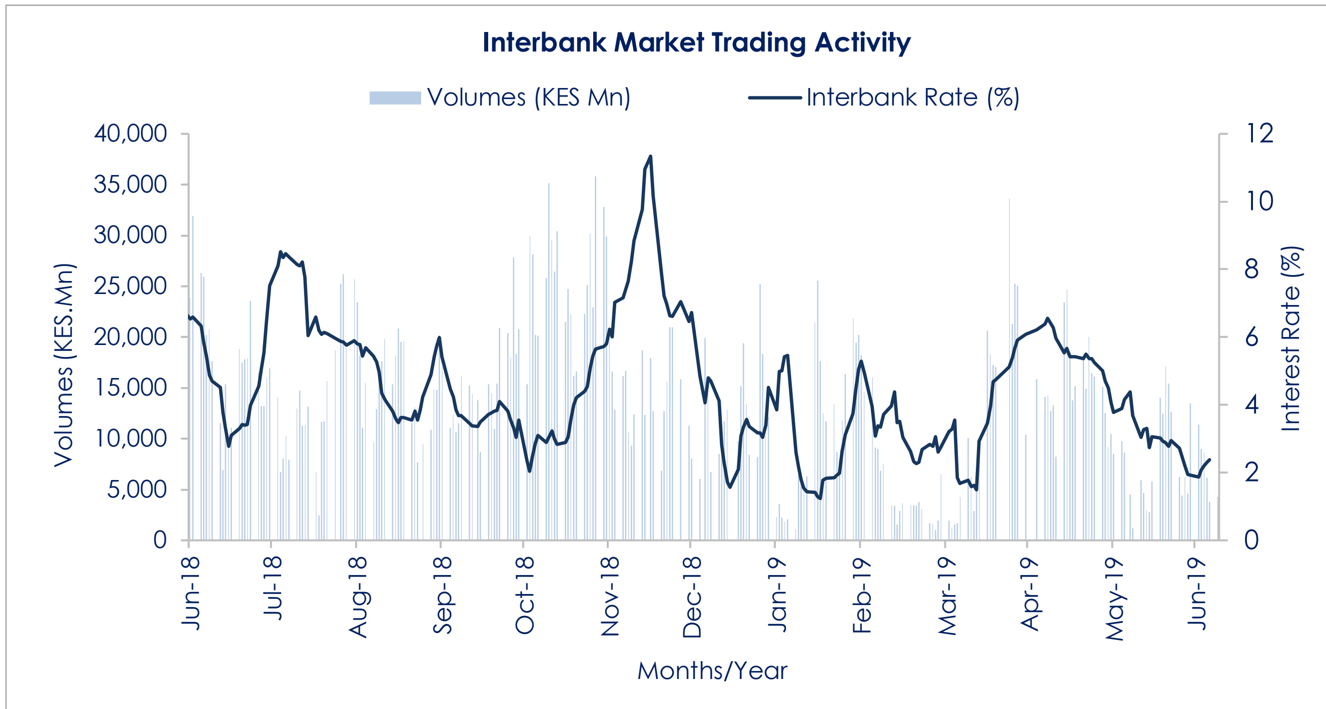


Source: Kenya National Bureau of Statistics

Interbank rates to remain low in H1 2019/2020

- Interbank rates reduced from 5.55% in May to 3.12% in June with volumes declining 51.5% to KES.152.7Bn in the period in focus (Fig.10).
- Liquidity increased as a result of Government payments reducing the interbank rate.

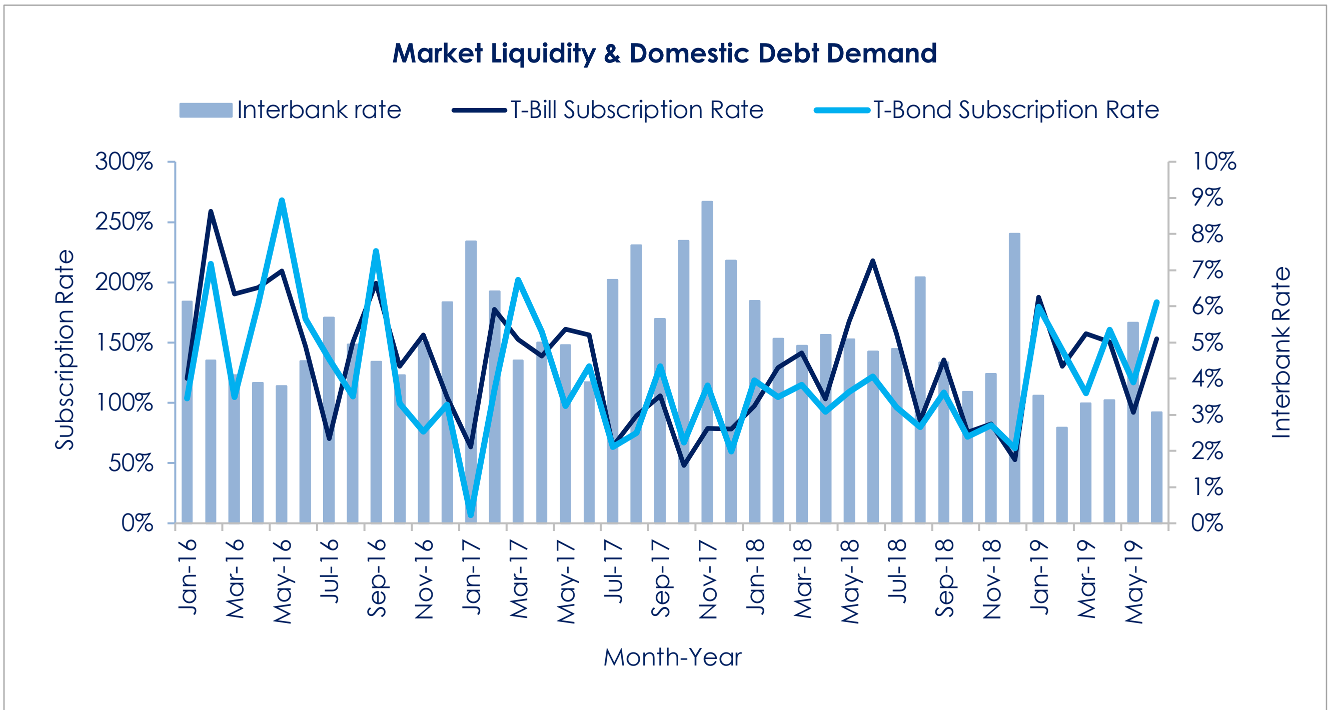
Fig.10: Inter-bank rates decline in June 2019



Source: Central Bank of Kenya

- We expect interbank rates this financial year to remain low due to high liquidity in the market.
- High market liquidity will be supportive of both secondary bond trading activity and primary bond demand.
- Generally, demand for domestic debt has been high as indicated by subscription rates in periods of high market liquidity (Fig.11).

Fig.11: High market liquidity translates to high domestic debt demand



Source: Central Bank of Kenya

Monetary Policy Committee meeting to be held on 24th July

- We expect the Monetary Policy Committee (MPC) to maintain the Central Bank Rate (CBR) at 9% when they meet on 24th July against a backdrop of macro-economic stability.
- The benchmark rate was maintained at 9% for the seventh consecutive meeting (Since revision in July 2018) with the committee noting that "inflation expectations remained well anchored within the target range, but there is need to remain vigilant on possible spillovers of recent food and fuel price increases."

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