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Fixed Income Note

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"CBK in the market with two debt issues"

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Executive Summary

- The Central Bank of Kenya (CBK) invites bids for **FXD3/2019/10 (10 years) and FXD1/2019/20 (20 Years)** with a fund target of KES.50Bn.
- The 20 year bond was first issued in April 2019, attracting bids worth KES.14.68Bn.
- We estimate the weighted average rate (WAR) of bids to be between **12.70%** and **12.75%** for the **FXD1/2019/20 (20 Years)** and **11.45%** and **11.50%** for **FXD3/2019/10 (10 years).**
- We predict a combined subscription rate of between 150%-160% (KES.75-KES.80Bn)
- The report also highlights a gradual decline in interest rates. We note that the spread between the 182-day and the 364-day papers increased while it decreased between the 91-day and 182-day papers.
- We observe an increase in secondary market activity in July compared to the previous month attributable to increased liquidity.
- This report also highlights our projections for August inflation at (6.0%-6.3%) as a result of increasing food and fuel prices.
- Interbank rates remained low in July and we expect the same to remain low for the rest of year due to high market liquidity.

CBK issues 10Year and 20Year bonds worth KES.50Bn

KES.608Bn - 2019/20 fiscal deficit

- Central Bank of Kenya (CBK) invites bids for two treasury bonds FXD3/2019/10 (10Year) and FXD1/2019/20 (20Year Re-Opened) for a total of KES.50Bn (Table.1).
- CBK continues to reject expensive bids in security auctions thus investors have been making bids that are around or near yield curve levels.
- We believe CBK has blended the medium and long dated securities to give investors two options matching their different investment horizons with the hope of increasing the subscription rate.
- The 2019/20 fiscal deficit is about KES.608Bn and the treasury intends to fund it through domestic and external borrowing.
- Our view is that investors will be biased towards the shorter dated 10Year paper to reduce duration risk associated with long-term debt.
- We predict a combined subscription rate of between 150%-160% (KES.75-KES.80Bn)

Table.1: Primary Bond issue summary

Issue Number	**FXD3/2019/10**	**FXD1/2019/20 (Re-Opened)**
Total Amount Offered	KES.50Bn	
Tenor (Years)	10	19.65
Coupon Rate (%)	Market Determined	12.873
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	1st Aug -13th Aug 2019	
Auction Date	14th August 2019	14th August 2019
Value Date	19th August 2019	19th August 2019
Yield Curve 2nd August 2019 (%)	**11.45**	**12.62**

Source: Central Bank of Kenya

Investor bid predictions - FXD3/2019/10 (11.45%-11.50%) and FXD1/2019/20 (12.70%-12.75%)

- 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 FXD3/2019/10 at around 11.45% with the weighted average of accepted bids at 11.35%.
- For FXD1/2019/20, we predict bids at around 12.70% with the weighted average of accepted bids at 12.60%.

Table.2: Historical primary market auction performance

Issue Number	Issue Date	Amount Offered	Bids Received	Amount Accepted	Performance	Coupon Rate (%)	Implied Yield to Maturity
FXD1/2018/10	27th Aug 2018	40	29.83	19.36	74.56	12.69	11.29
FXD2/2018/10	17th Dec 2018	40	28.86	26.16	72.15	12.50	11.37
FXD1/2019/10	25th Feb 2019	50	36.33	32.81	72.66	12.44	11.42
FXD2/2019/10	15th Apr 2019	50	70.93	51.33	141.87	12.30	11.45
FXD1/2018/20	26th Mar 2018	40	13.74	8.49	21.23	13.20	12.56
FXD2/2018/20 (Re-opened)	30th Jul 2018	40	10.33	5.31	25.82	13.20	12.58
FXD1/2019/20	15th Apr 2019	50	14.68	9.02	29.36	12.87	12.62

Source: Central Bank of Kenya

Table.3: Auction bid predictions

Security	FXD3/2019/10	FXD1/2019/20
Market Weighted Average Rate	11.45-11.50	12.70-12.75
Weighted Average Rate Of	11.35-11.45	12.60-12.70

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 2nd August, 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
FXD3/2019/10	Market Determined	FXD1/2019/10	Feb 25th, 2019	9.57Yrs.(3,482 days)	11.42	2nd Aug, 2019
		FXD2/2019/10	April 15th, 2019	9.70Yrs.(3,531 days)	11.45	2nd Aug, 2019
FXD1/2019/20	12.873	FXD1/2018/20	March 26th, 2019	18.64Yrs.(6,786days)	12.56	2nd Aug, 2019
		FXD2/2018/20	July 30th, 2019	18.46Yrs.(6,719days)	12.58	2nd Aug, 2019

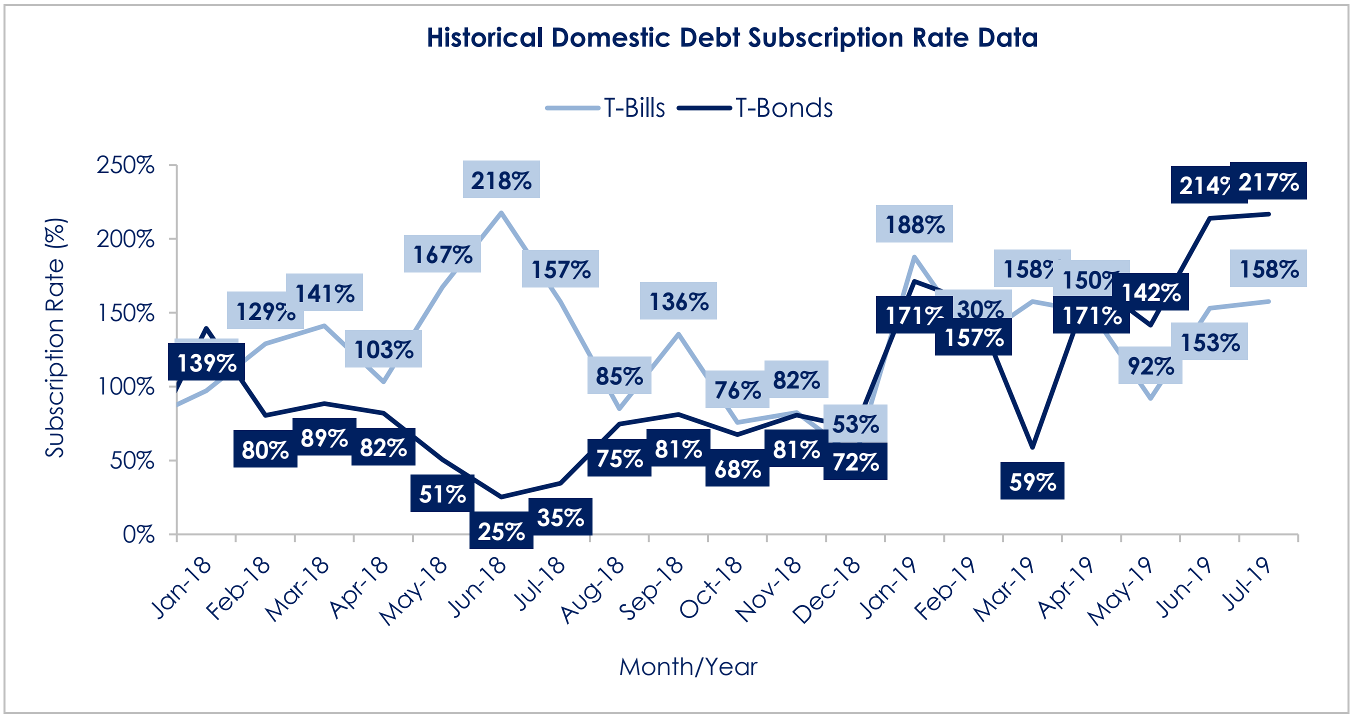
Source: Central Bank of Kenya & Nairobi Securities Exchange

Demand for Government Securities remains high

CBK has been rejecting aggressive bids that are priced above the market

- Government securities subscriptions (both T-Bills and T-Bonds) for July increased to KES.275.9Bn against the KES.160Bn that the CBK offered (Fig.1).
- T-Bill subscriptions increased from 153.2% (KES.147Bn) in June to 157.7% in July (KES.189.2Bn) against a target of KES.96Bn and KES.120Bn offered by CBK in the two months respectively.
- The 364 Day T-Bill was highly subscribed at 269.9% while the 91 and 182 Day T-Bill issues subscriptions stood at 125.6% and 58.3% respectively.

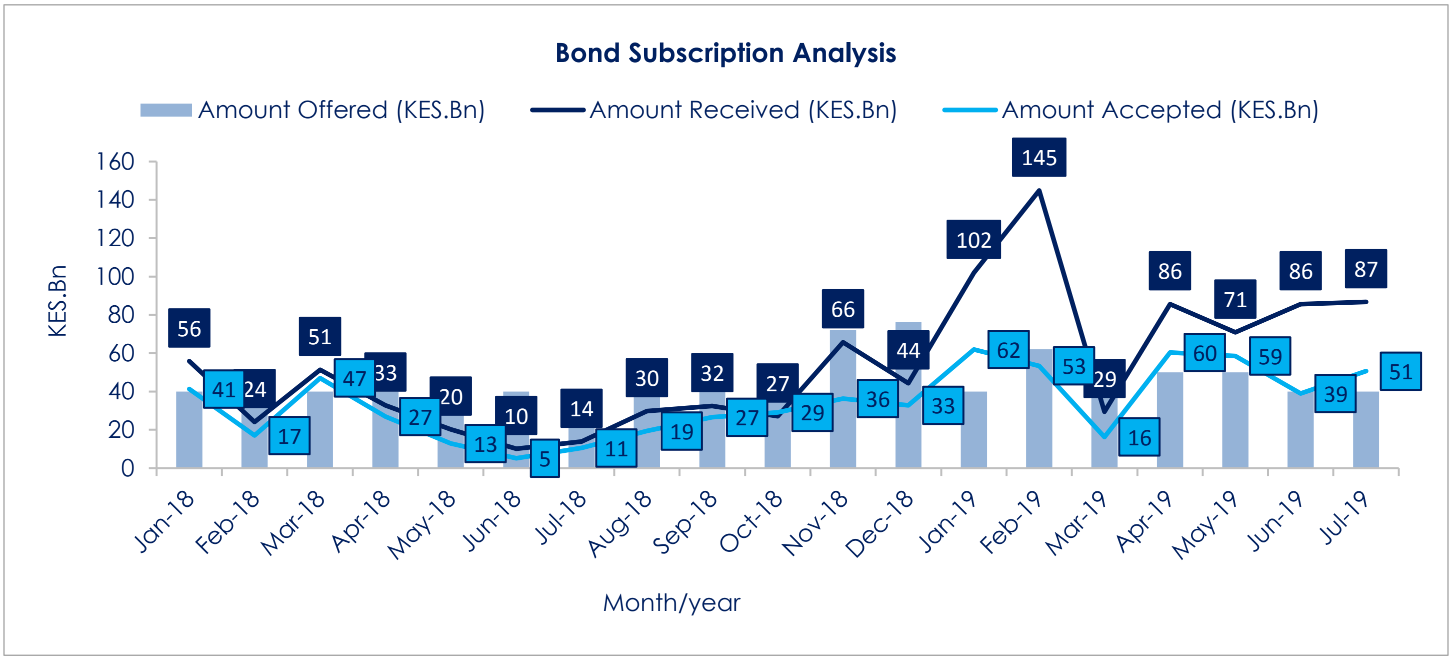
Fig.1: Investor demand for Government securities remains high in July 2019



Source: Central Bank of Kenya

- The 15-year (FXD3/2019/15) T-Bond issued in May was highly subscribed with a performance rate of 216.7% (KES.86.7Bn) against KES.40Bn offered by CBK (Fig.2).
- CBK accepted KES.50.6Bn in July compared to KES.38.9Bn in June attributable to high market liquidity.

Fig.2: CBK accepts KES.87Bn in July T-Bond auctions

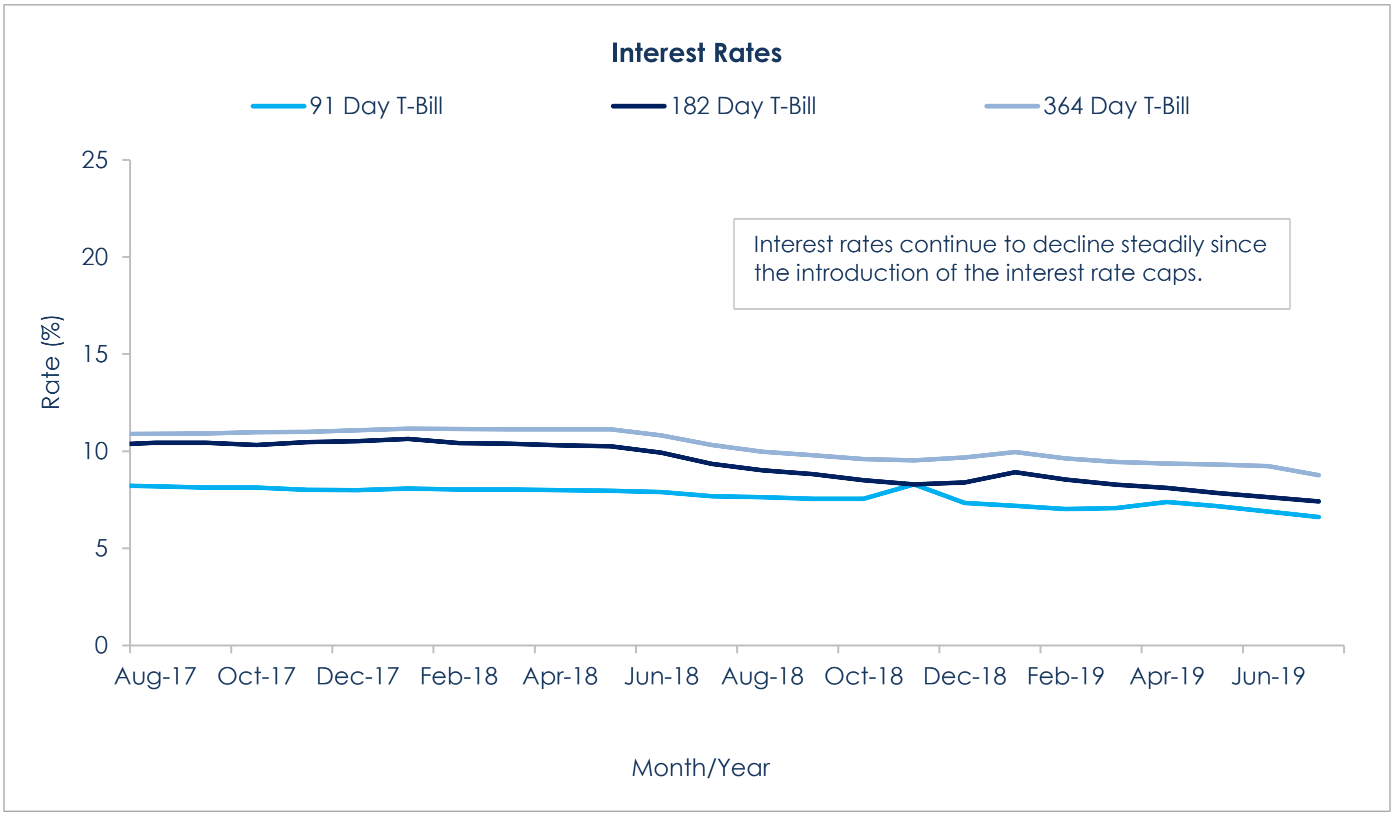


Source: Central Bank of Kenya

Domestic debt interest rates decline

- The interest rate cap has caused steady but gradual decline in domestic debt interest rates as indicated by Fig.8 below. At the last auction the T-bill rates stood at 6.62%, 7.42% and 8.77% for the 91,182 and 364 day T-Bills a decline from 6.9%, 7.64% and 9.32% respectively.
- We observe that the spread between the 182-day and the 364-day papers increased while it decreased between the 91-day and 182-day papers.
- **We advise investors to concentrate on the 364-day paper which is 168bps higher than the 182-day paper.**
- We expect the rates to continue declining on account of the interest rate cap which has provided the market with high liquidity and external debt(Eurobond) that has eased pressure off government financing of the fiscal deficit.
- In the international market, yields on Kenya's 7-year, 10- year (2024), 10-year (2028), 12-year and 30-year Eurobonds increased by 34.10, 35.60, 44.30, 20.90 and 35.90 basis points, respectively.

Fig.3: Interest rates continue declining

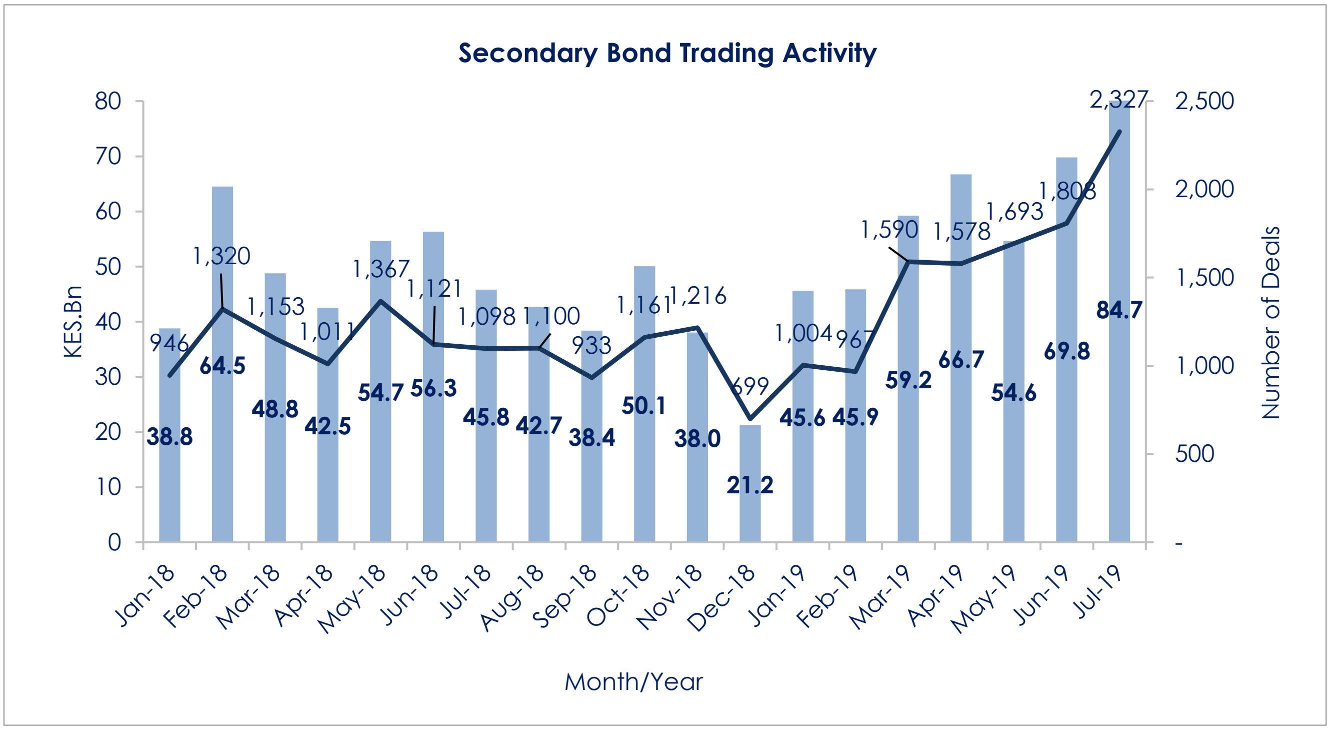


Source: Central Bank of Kenya

High liquidity continues to drive high trading volumes

- Secondary market activity increased by 21.3% in July over the previous month to KES.84.7Bn attributable to increased liquidity (Fig.4).
- 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.
- A total of 2327 deals were made a 28.7% increase from the 1808 deals made in June 2019.
- On week 1 of August, the most traded bonds were the infrastructure and 15-year bonds.

Fig.4: Bond deals increase by 28.7% in July



Source: Nairobi Securities Exchange

Medium term bonds exhibit the biggest shift in yields year on year

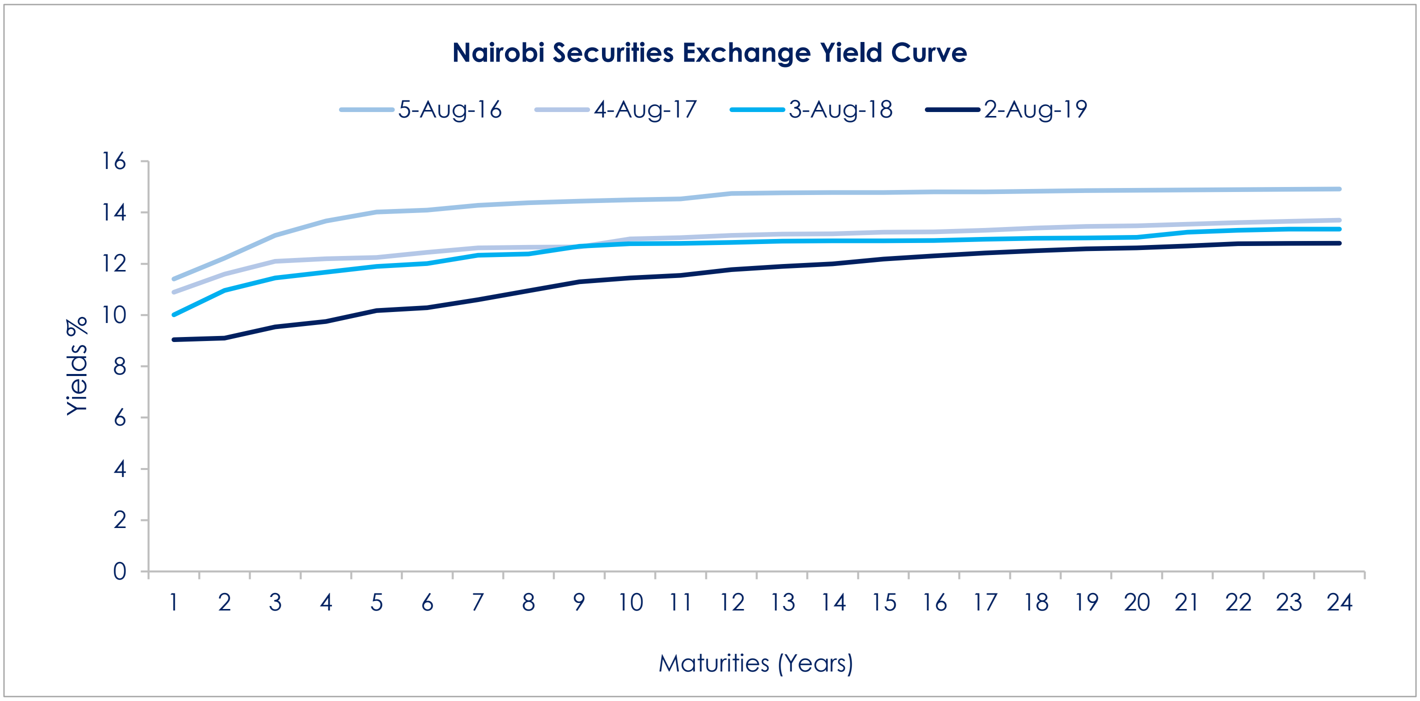
- All yields on Government securities have declined compared to the same period last year, with bigger shifts on the medium term papers (Table.5).
- We expect the yield curve, to continue declining as the interest rate cap regime prevails.
- **We maintain our recommendation to HOLD long term papers and BUY short and medium term bonds.**

Table.5: Yields decline for all debt maturities

Tenor	Yield (3rd Aug 2018)	Yield (2nd Aug 2019)	Change (Bps)
1	10.0080	9.0380	↓97.00
2	10.9583	9.0952	↓186.31
5	11.8938	10.1750	↓171.88
10	12.7769	11.4500	↓132.69
15	12.8964	12.1783	↓71.81
20	13.0250	12.6167	↓40.83

Source: Nairobi Securities Exchange

Fig.5: Yields on long term maturities have marginal decline compared to longer dated bonds

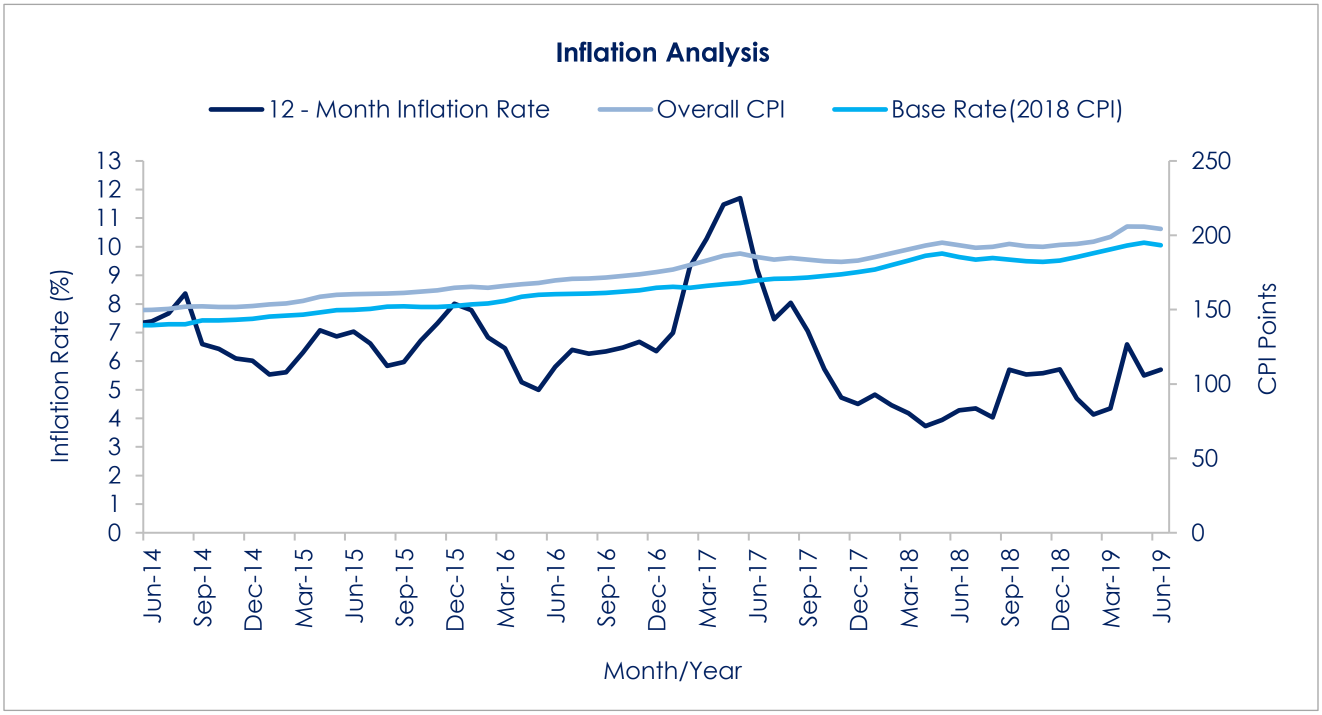


Source: Nairobi Securities Exchange

August inflation forecast – 6.0% - 6.3%

- Inflation in July increased to 6.27% from 5.70% in June on the back of an increase in the Housing, Water, Electricity, Gas and Other Fuels' Index (+0.14%), and the Transport Index (+0.22%).
- The Alcoholic Beverages, Tobacco and Narcotics Index increased by 0.82% mainly due to increase in price of cigarettes.
- The food and nonalcoholic beverages index however declined by 1.04% as a result of an increase in prices of some food items.
- In the second half of the year we expect inflation to average 5.8% due to increased prices of fuel and food.
- Our projections for August inflation is 6.0%-6.3% as a result of increasing fuel prices, and food prices.

Fig.6: July inflation forecast

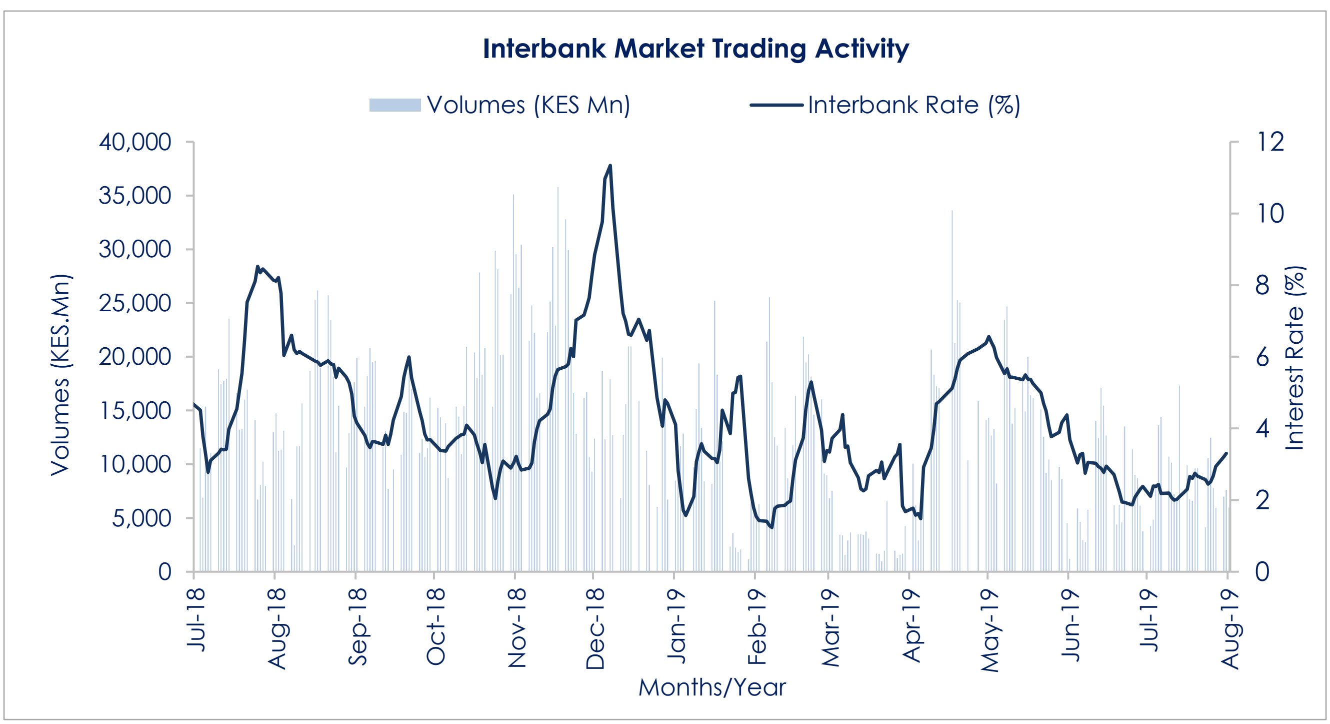


Source: Kenya National Bureau of Statistics

Interbank rates to remain low in H1 2019/2020

- The money market remained liquid in July as the interbank rates trended downwards from an average of 3.12% in June to 2.29% in July.
- Volumes increased by 34.59% to KES.205.52Bn in July compared to KES.152.7Bn in June (Fig.7).

Fig.7: Inter-bank rates decline in June 2019

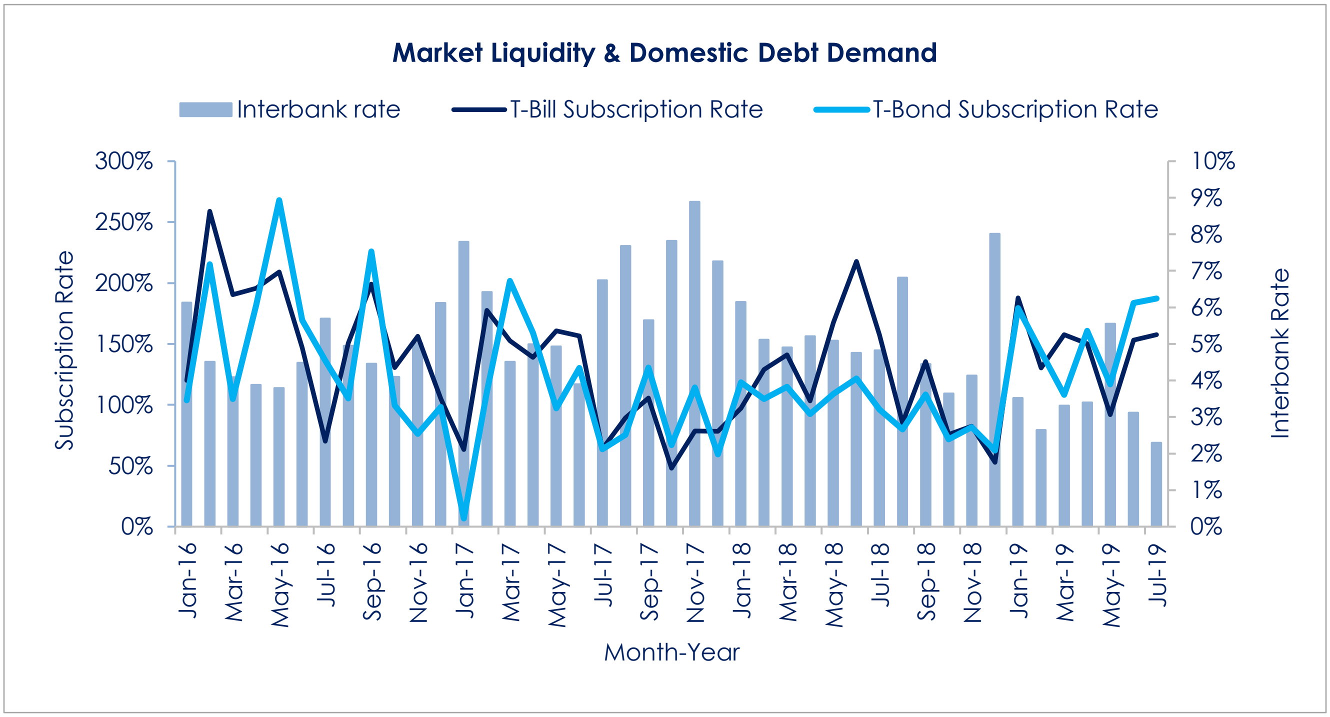


- We expect interbank rates to remain low for the rest of year due to high liquidity in the market.

Source: Central Bank of Kenya

- 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.8).

Fig.8: High market liquidity translates to high domestic debt demand



Source: Central Bank of Kenya

Monetary Policy Committee maintains the CBR at 9%

- The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 9.00 percent during its Meeting on July 24.
- The Committee noted that inflation expectations remained well anchored within the target range, and that the economy was operating close to its potential.
- However, they cited need to be vigilant on the possible effects of the recent increases in fuel prices, the ongoing demonetization, and the increased uncertainties in the external environment.

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