STERLING CAPITAL LIMITED

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Fixed Income Note
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"Market liquidity reigns supreme"

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Executive Summary

- The Central Bank of Kenya (CBK) has re-opened two fifteen year bonds **FXD1/2018/15 and FXD2/2019/15 targeting** KES.50Bn for budgetary support.
- This is the third bond issuance in the 2019/20 fiscal year with the previous two issues receiving KES.154.1Bn against a KES.90Bn target testimony of high demand for Government debt.
- Our report titled **"Market liquidity reigns supreme"** illustrates the impact of high market liquidity as shown by low inter-bank rates, high commercial bank liquidity and low private sector credit.
- The recently released commercial bank results show relatively high demand for Government securities as has been the trend since the introduction of interest rate caps with modest loan book growths recorded.
- **In terms of expected yields on the issues, we predict the Weighted Average Rate (WAR) of bids at between 12.30 and 12.50% for FXD1/2018/15 and a weighted average rate of accepted bids at 12.40%. For FXD2/2019/15 we expect bidding at between 12.50% to 12.60%, with the weighted average of accepted bids at around 12.50%.**
- On demand for the issues, we expect a combined subscription rate of 60% (KES.30Bn) on account of temporary tightening liquidity.
- We review National Treasury accounts for both the 2018/19 and 2019/20 fiscal years. The 2018/19 accounts show that the Government revised its domestic borrowing target upwards after revising Total tax income target downwards, a likely scenario in 2019/20.
- The report further highlights secondary trading activity which declined significantly in August. We expect an increase in trading activity as market liquidity eases towards the end of the month courtesy of Central government allocations to the counties.
- On Macro-economics, we forecast an inflation rate of 4.5-5%% in September a decline from August.
- On monetary policy, the Monetary Policy Committee (MPC) meets on 23rd September where we expect no revision to the Central Bank Rate (CBR).

CBK re-opens two 15Yr bonds seeking KES.50Bn

Bonds issue likely to be undersubscribed on account of long tenor and tightening market liquidity.

- The Central Bank of Kenya (CBK) invites investor bids to raise KES.50Bn through two Treasury bond issues: **FXD1/2018/15** (13.67 Years) and **FXD2/2019/15** (14.63 Years) - (Table.1).
- Issuance of longer dated papers is purposed towards lengthening the maturity profile of Kenya's domestic debt, which stood at 4.4years (52 months) in April 2019.
- Total domestic debt redemptions in September amounts to KES.113Bn, considerably high and we expect the government demand for capital to rise to settle these redemptions.
- We expect an undersubscription for the combined issues at around 60% (KES.30Bn) given temporary tightening market liquidity and the tenor of the issues that make it less attractive especially for commercial banks.

Table.1: Primary Bond issue summary

Issue Number	**FXD1/2018/15**	**FXD2/2019/15**
Total Amount Offered	KES.50Bn	
Tenor (Years)	13.67 Yrs	14.6 Yrs
Coupon Rate (%)	12.650%	12.734%
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	22nd Aug -17th Sep 2019	
Auction Date	18th September 2019	
Value Date	23rd September 2019	
Yield Curve 6th September 2019	**12.275**	

Source: Central Bank of Kenya

Investor bid predictions - FXD1/2018/15 (12.30%-12.50%) and FXD2/2019/15 (12.50%-12.60%)

- Given the recent rise in the 364 day T-Bill and the performance of T-Bill auctions, we expect yields on T-Bonds to also edge upwards.
- **For FXD1/2018/15, we predict bids at around 12.30-12.50% with the weighted average of accepted bids at 12.40% while FXD2/2019/15 will receive bids around 12.50% to 12.60%, with accepted weighted average of accepted bids at around 12.50%** (Table. 2).
- However, it is possible that most investor bids will be at the almost similar levels for both issues (12.50%)

Table.2: Auction bid predictions

Security	**FXD1/2018/15**	**FXD2/2019/15**
Market Weighted Average Rate	12.30-12.50	12.50-12.60
Weighted Average Rate of Accepted Bids (%)	12.40	12.50

Source: Sterling Capital Research

- We have also reviewed historic T-Bond auction results showing contrasting demand for 15 year issues with the most recent issue FXD3/2019/15 issued in July heavily oversubscribed (Table.3).

Table.3: Historical primary market auction performance

Issue Number	Issue Date	Amount Offered	Bids Received	Amount Accepted	Performance Rate (%)	Coupon Rate (%)	Implied Yield to Maturity
FXD3/2019/15	29th Jul 2019	50	86.67	50.58	216.69	12.34	12.28
FXD1/2012/15	17th Jun 2019	40	39.77	21.21	99.42	11.00	11.07
FXD1/2018/15	17th Jun 2019	40	45.85	17.73	114.62	12.65	11.90
FXD2/2019/15	18th May 2019	50	21.54	19.32	43.08	12.73	12.28
FXD1/2019/15	28th Jan 2019	40	25.07	14.72	62.67	12.86	12.16
FXD2/2018/15 (Re-opened)	05th Nov 2018	32	25.38	21.26	79.30	12.75	12.05
FXD2/2018/15	22nd Oct 2018	40	27.05	7.85	67.61	12.75	12.05

Source: Central Bank of Kenya

- Our yield predictions are also based on an analysis of implied yields of benchmark bonds (bonds of almost similar terms to maturity) currently trading on the NSE (31st August 2019) (Table.4).

Table.4: Benchmark issues to guide investor bids

Treasury Bond	Issue Date	Coupon Rate (%)	Issue Date	Term to Maturity Years (Days)	Last traded Yield (%)	Yield Curve at time of issue	Trade Date
FXD1/2018/15*	28th May, 2019	12.650	28th May, 2019	13.67 (5,008)	11.8981	12.9820	31th Aug, 2019
FXD2/2018/15**	22nd Oct, 2019	12.750	22nd Oct, 2019	14.14 (5,147)	11.9993	12.5752	30th Aug, 2019
FXD2/2019/15*	13th May, 2019	12.734	13th May, 2019	14.63 (5,325)	12.1083	12.6500	30th Aug, 2019
FXD3/2019/15**	July 30th, 2019	12.340	July 30th, 2019	14.91.(5,427) days)	12.2750	12.3637	30th Aug, 2019

*Bond in issue **Benchmark bond

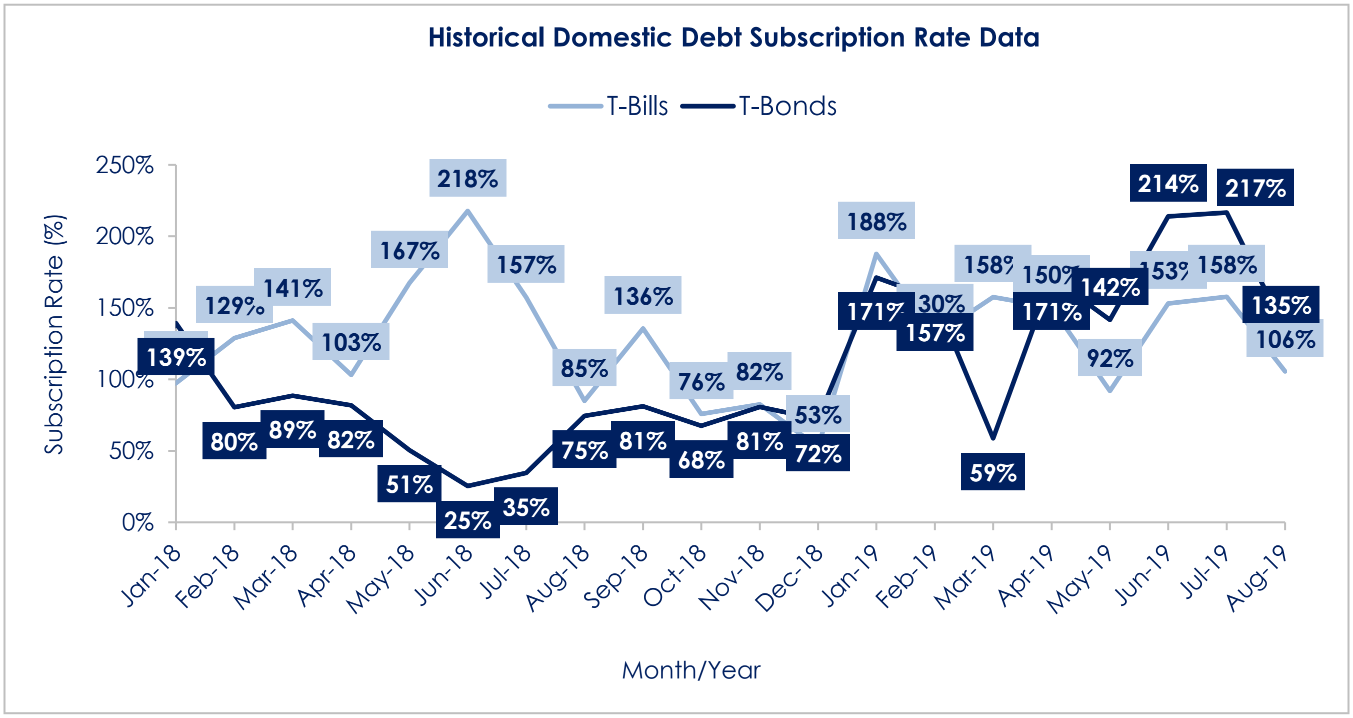
Domestic debt auction results illustrate high demand

CBK well positioned to reject High investor debt auction bids due to high demand

- A total of KES.168.7Bn was received as in domestic debt subscriptions (T-Bills and T-Bonds) in the month of August against KES.146Bn offered by CBK equivalent to a 115.6% oversubscription rate (Fig.1).
- T-Bill subscriptions declined from 157.7% in July (KES.189.2Bn) to 105.5% (KES.101.3Bn) in August against a target of KES.120Bn and KES.96Bn offered in the two months respectively.

- 91, 182 and 364-Day T-Bills subscription rates were 126.8% (KES.20.3Bn), 45.8% (KES.18.3Bn) and 156.7% (KES.62.7Bn) respectively.
- The high subscription for the 91-Day T-Bill can be explained by some banks preferring to invest in the short-term paper which is more liquid compared to 182 and 364-day T-Bills so that they can easily redeem the funds when an investment opportunity with higher return comes up.
- There is also high demand for the 364-Day T-Bill as some investors prefer to lock in the rate as they anticipate a further decline in yields for the short term papers.

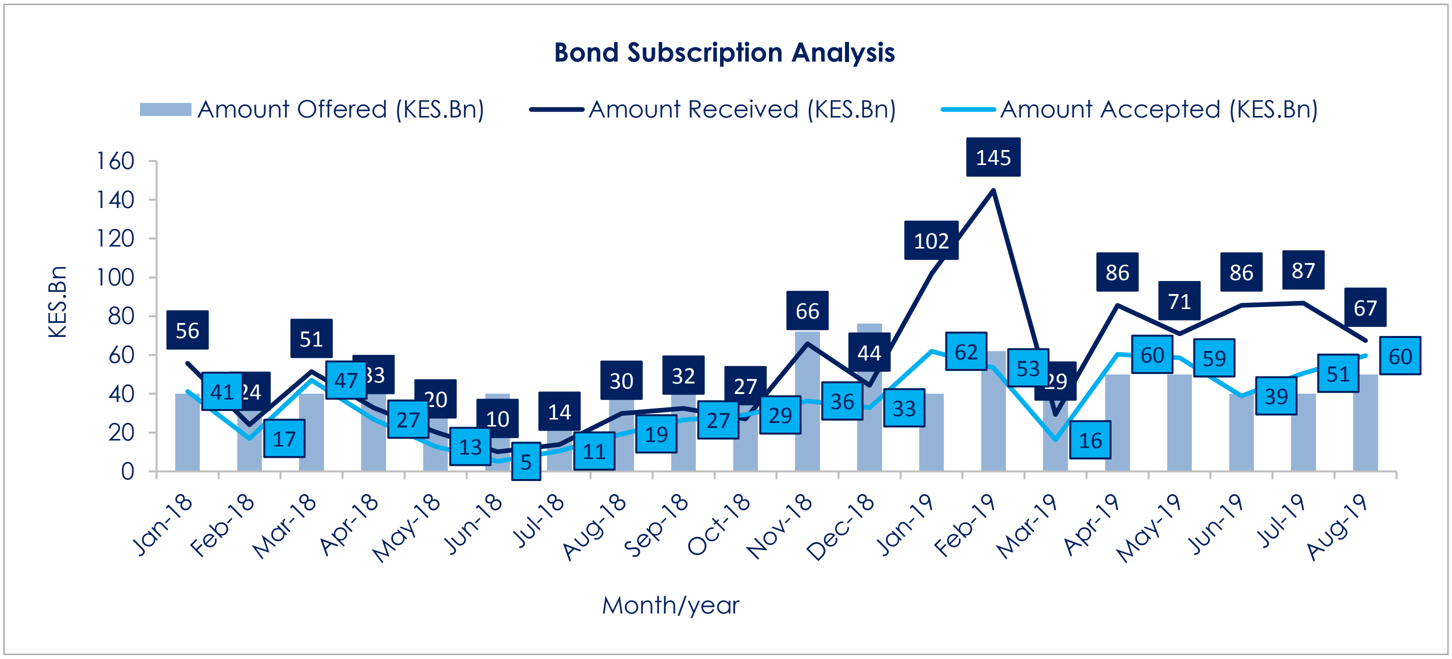
Fig.1: Government debt subscriptions receive full subscription in August 2019



Source: Central Bank of Kenya

- The 10-year (FXD3/2019/10) T-Bond issued in August was highly subscribed with a performance rate of 105.5% (KES.52.8Bn) while the 20-Year (FXD1/2019/20) was undersubscribed with a performance rate of 14.7% (KES.29.3Bn) against KES.40Bn offered by CBK (Fig.2).
- Total T-Bond subscriptions stood at 134.9% (KES.67.4Bn) in August compared to 216.7% (KES.86.7Bn) in July, this attributable to high market liquidity with the CBK accepting KES.59.7Bn compared to KES.50.6Bn in the previous month.
- On the basis of recent subscription trends in long term bond auctions, we expect the bonds to be undersubscribed.

Fig.2: CBK accepts KES.60Bn of the KES.67.4Bn received in August T-Bond auctions

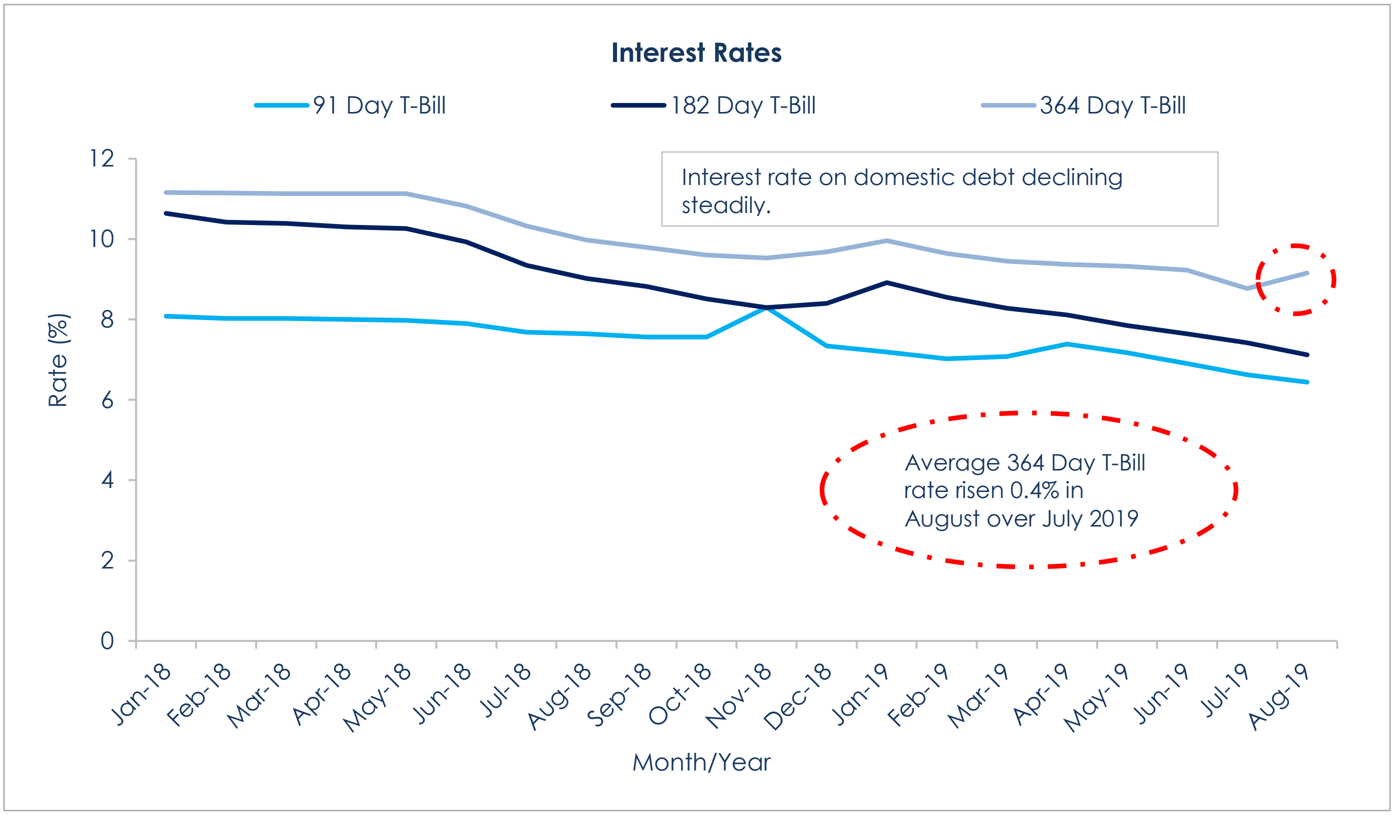


Source: Central Bank of Kenya

Short-term domestic debt yields declining

- Yields on government securities have continued to decline since the introduction of interest rate cap law.
- During the month, the average yield for 91-day and 182-day papers declined by 0.2% and 0.3% to 6.4% and 7.1% respectively while that of the 364-day T-Bill increased 0.4% to 9.2% (Fig.3).
- We believe that this increase was due to high demand for 364-day T-Bill as investors lock in the yields since they anticipate a decline in re-investment rates.
- T-Bills acceptance rate in the month of August stood at 85.6% (KES.86.7Bn) compared to 95.6% in July.
- We expect the decline in yields to continue as CBK continues rejecting high bids in the primary market auction.

Fig.3: Short-term domestic debt interest rates continue declining

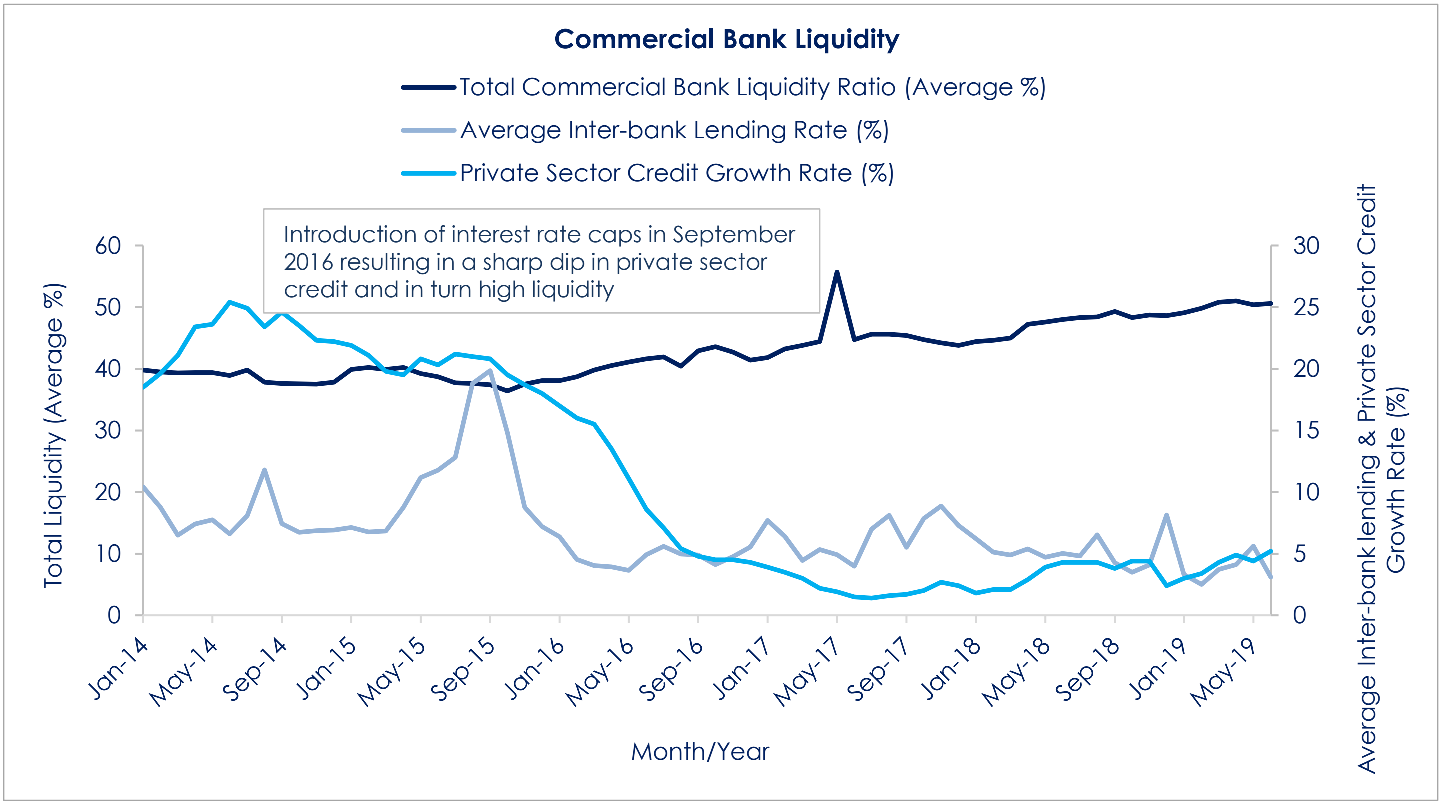


Source: Central Bank of Kenya

Commercial bank liquidity at record highs

- Data from the CBK shows a significant increase in average commercial bank liquidity since the introduction of interest rates caps in September 2016 (Fig.4).
- Average liquidity in the first half of 2019 stands at 50.3% compared to 46.1% over a similar period in 2018.
- High liquidity is evident in the domestic debt auction results that show high subscription rates for domestic debt.
- At the same time, private sector credit growth remains low at an average of 4.2% in the first half of 2019 and 5.2% in June in spite of gradual growth.
- Inter-bank lending rates often used measure of market liquidity have remained relatively low at an average of 3.7% in H1 2019 compared to 5.2% in H1 2018. This rate has however been on the rise in recent weeks.
- We expect bank liquidity to remain relatively high in the second half of 2019 and possibly see a gradual increase in private sector credit growth as banks lend due to a combination of high liquidity and significantly low rates on domestic debt.

Fig.4: High commercial bank liquidity impact on inter-bank lending and private sector credit

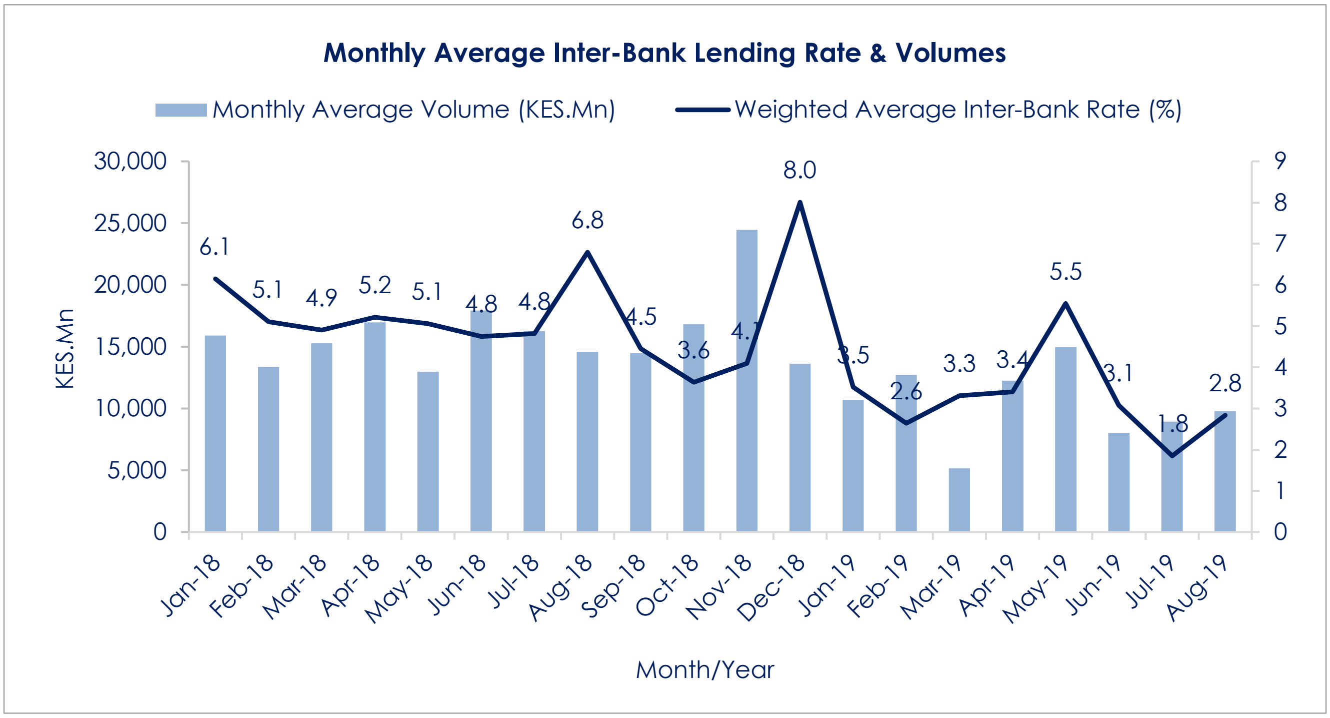


Source: Central Bank of Kenya

Low Inter-bank lending rates point to high market liquidity

- Inter-bank lending rates declined in the month of August 2019 to an average of 2.8% a slight increase from 1.9% in July while average traded volumes rose 9.6% to KES.9.8Bn (Fig10).
- This supports our view on high market liquidity which we also expect to have an impact on both primary domestic debt auctions and secondary trading activity.
- We expect inter-bank lending rates to remain low for most part of the remainder of 2019 on account of high market liquidity.

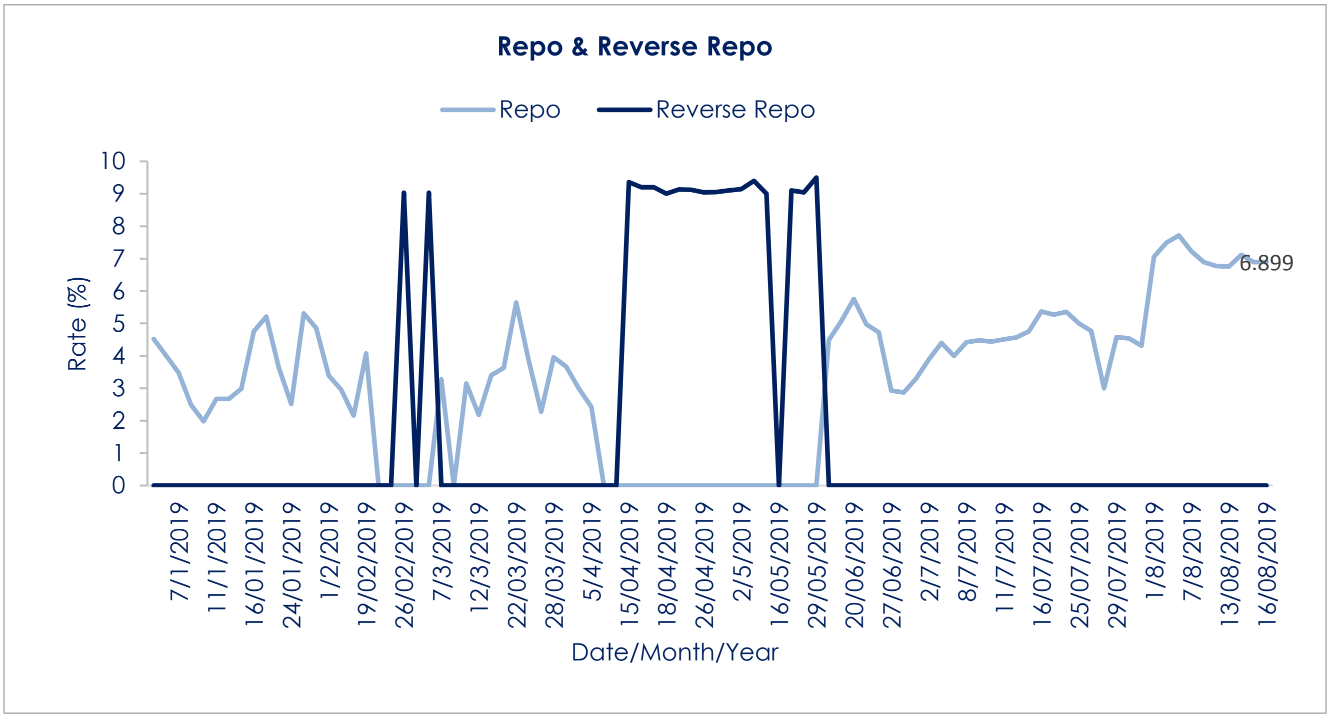
Fig.5: Inter-bank lending rates expected to remains low in H2 2019 as high market liquidity persists



Source: Central Bank of Kenya

- Our analysis of the repo (repurchase) market rate (rate at which the CBK lends short-term money to the banks against securities - CBK) has been on a rise while the reverse repo rate (rate at which the banks park surplus funds with reserve banks) has been at 0 since August, thus indicating short term tightening liquidity (Fig.6).

Fig.6: Repo rates have been on the rise on tightening liquidity

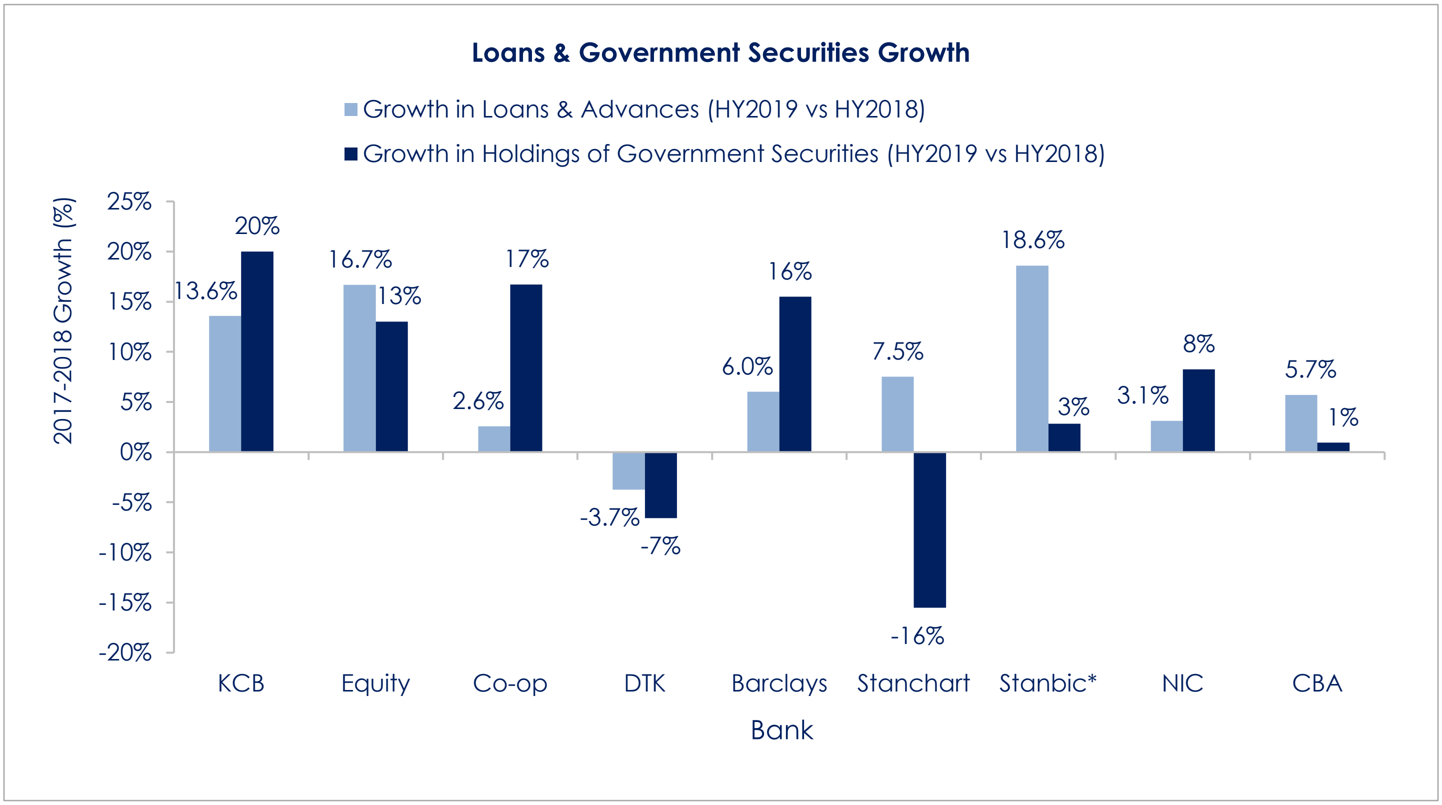


Source: Central Bank of Kenya

Banks' contrasting investment strategies - Appetite for debt securities remains high for most banks

- Commercial Banks recently released their financial results for the six months period ending June 2019 (Fig.7 & Fig.8).
- We observe contrasting capital deployment strategies amongst our focus banks with only Diamond Trust Bank (DTB) recording a loan book decline.
- KCB, Co-op, Barclays and NIC recorded bigger growth in holdings of Government securities than they did in loans and advances.
- Only DTB and Stanbic recorded a decline in holdings of Government securities with the latter showing a clear preference for lending.
- We do not expect major shifts in banking strategy for the remainder of 2019 as demand for Government securities by banks will remain high in the face of growing risks over asset quality (Non-Performing Loans sector average 12.7%).

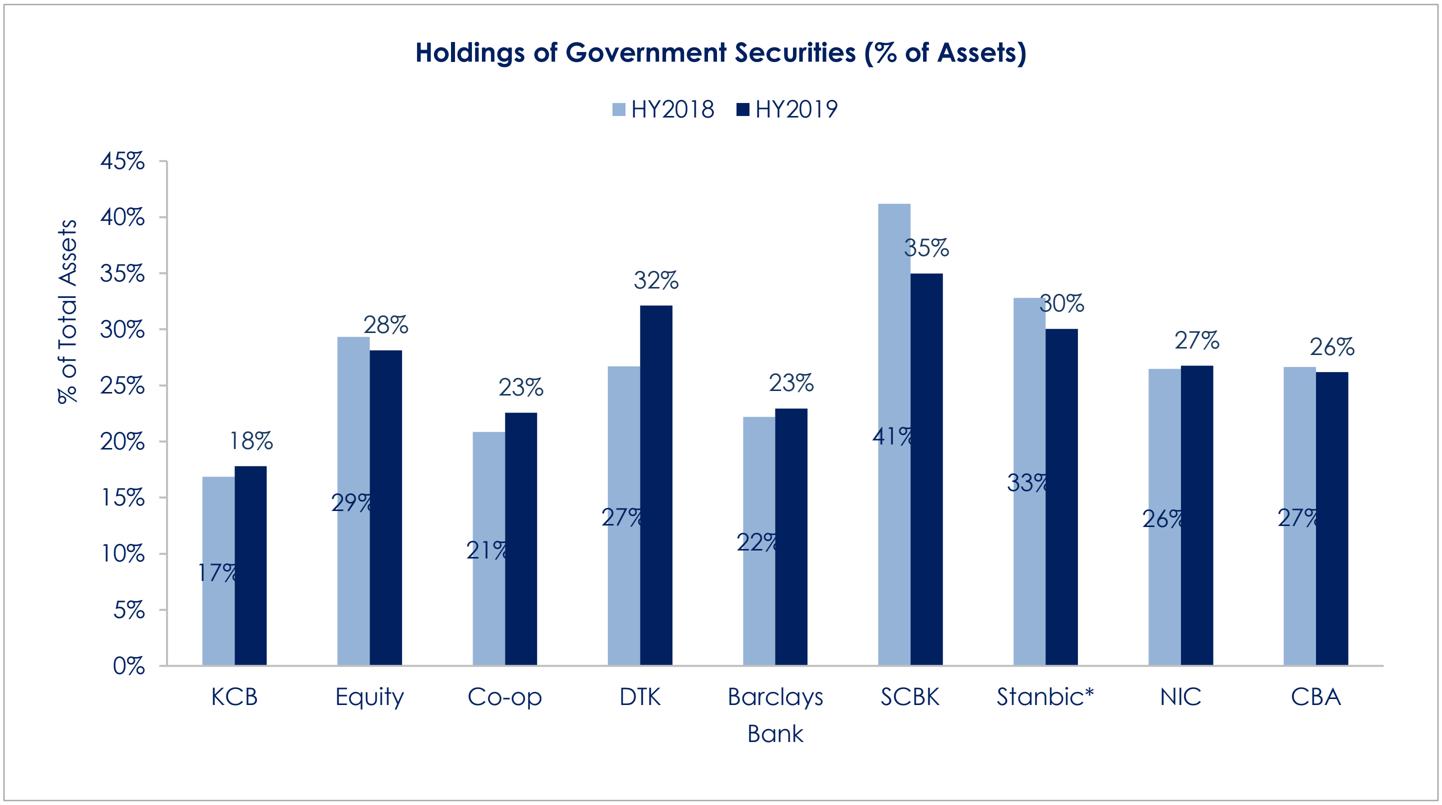
Fig.7: Banks' contrasting investment strategies



Source: Central Bank of Kenya

- KCB, Co-op, DTB, Barclays and NIC increased their holdings of Government securities as a proportion of total assets HY2019 compared to the same period in 2018.
- This shows the continued preference by banks for "risk-free" securities especially with the continuous deterioration in asset quality (Non-Performing Loans sector average 12.7% compared to 12% HY2018).

Fig.8: Most of our focus banks have increased their holdings of Government securities

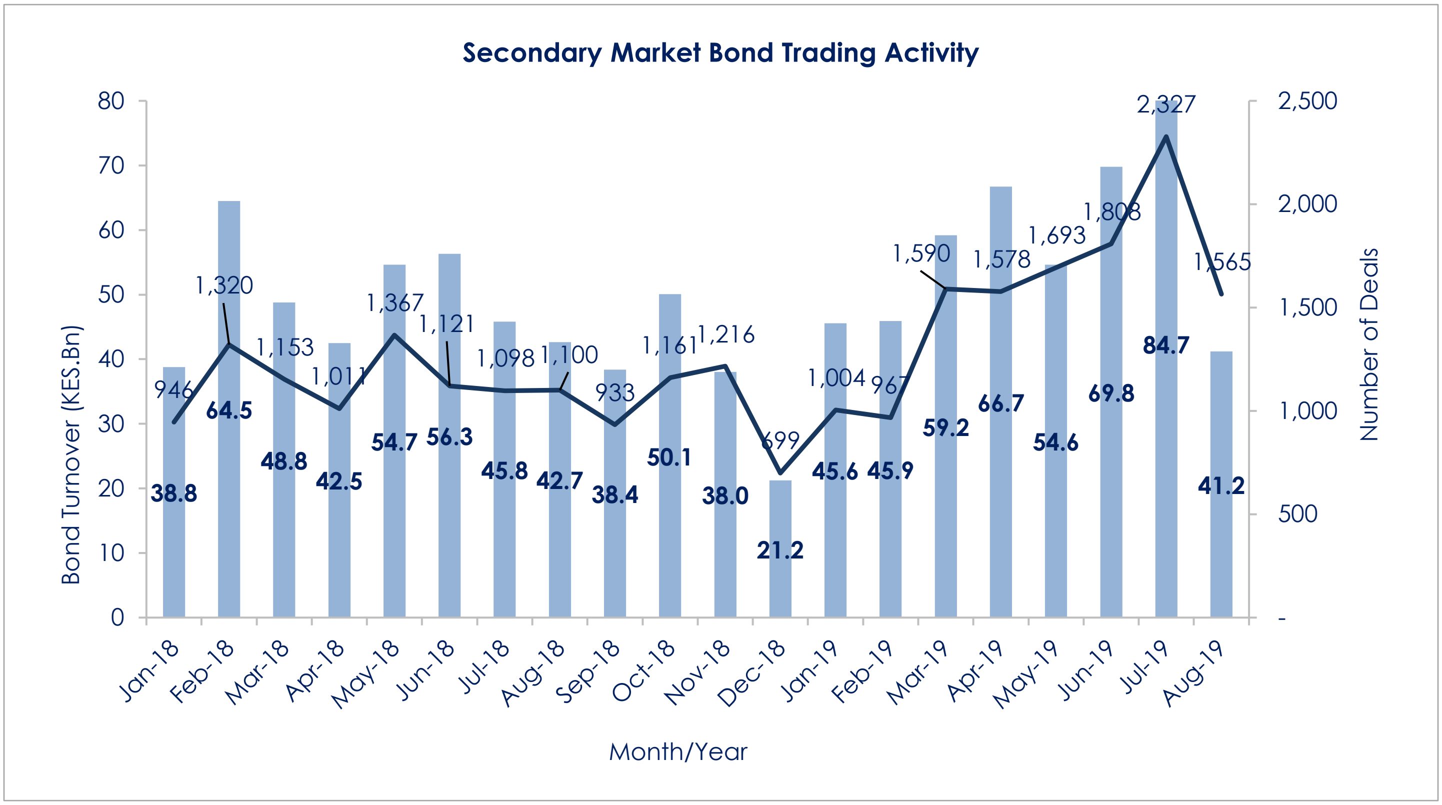


Source: Central Bank of Kenya

Secondary market trading activity 51% lower in August

- Secondary market bond trading turnover declined significantly (51.4%) in August 2019 to KES.41.2Bn with the number of deals declining 32.7% to 1,565 (Fig.9).
- The low trading activity is attributed to comparatively tight market liquidity due to low government spending.
- We expect a slight improvement in secondary market activity in September as a result of improved liquidity in turn supported by the Central government's KES.316Bn cash allocation to the counties flowing through the banking system.

Fig.9: Secondary trading activity declines 51% in August, growth expected in September

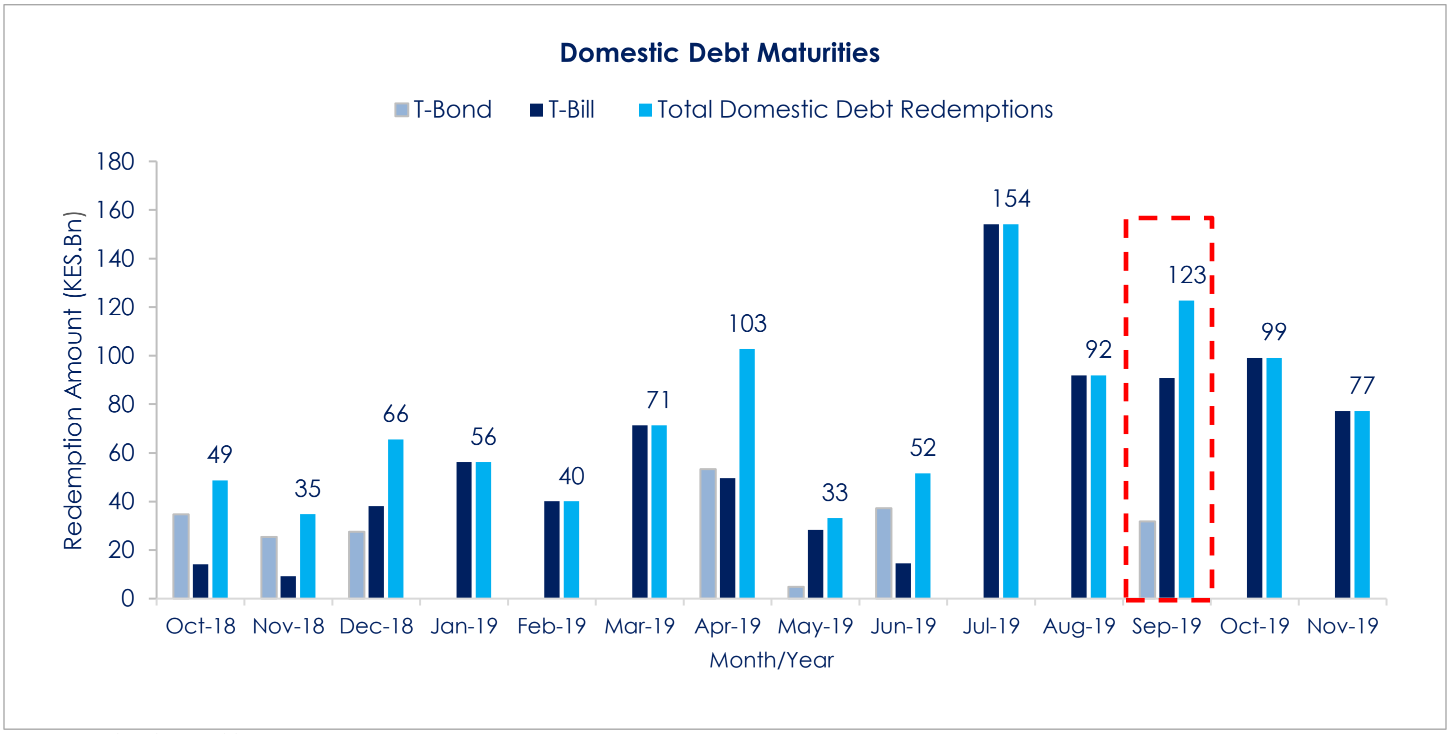


Source: Central Bank of Kenya

KES.123Bn in domestic debt maturities for September 2019

- Total domestic debt redemptions for September stands at KES.123Bn compared to KES.92Bn in August (Fig.10).
- The first T-Bond (FXD1/2017/002) maturing in the 2019/20 fiscal year amounts to KES.31.8Bn with the rest KES.90.86Bn being T-Bill redemptions.
- A closer look at the results of 9th September T-Bill auction shows high appetite for domestic debt with CBK accepting KES.15.01Bn of the KES.15.02Bn bids received.
- This means that CBK will most likely accept most of the bids received (estimated KES.30Bn) for the two re-opened bond issues in a bid to meet their target of KES.50Bn offered.

Fig.10: September debt maturities at KES.123Bn



Source: Nairobi Securities Exchange

National Government receipt data estimates shows a decline in domestic borrowing in the 2019/20 fiscal year

2019/20 Fiscal receipt data shows a 16.5% decline in domestic borrowing and 19.5% increase in total tax income.

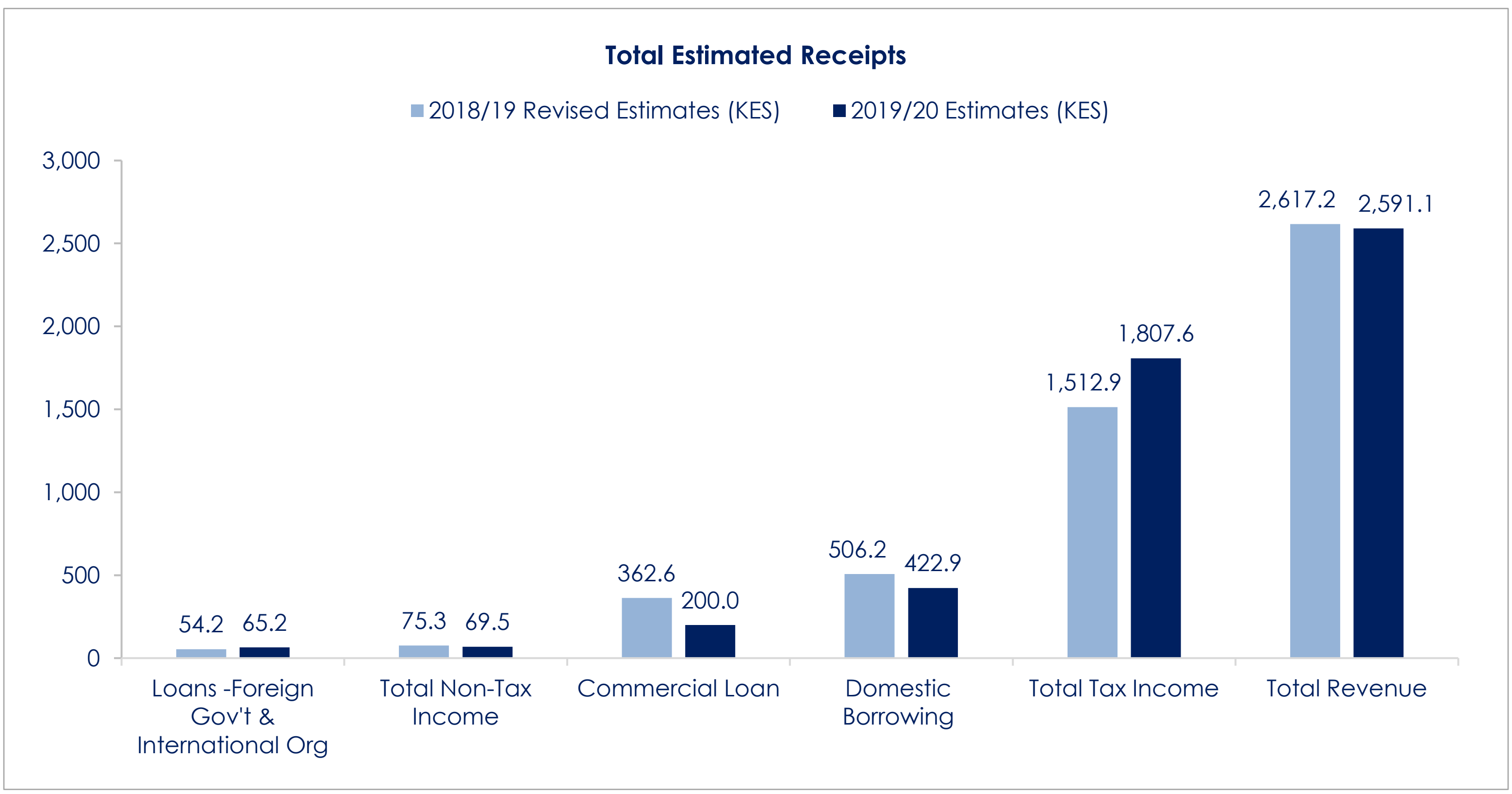
- Data released by the National Treasury as at the end of July 2019 for the 2019/20 fiscal year shows a 16.5% decline in the National Government's domestic borrowing target over 2018/19 to KES.422.9Bn (Table.5 & Fig.11).
- This is in contrast with a 19.5% increase in total tax income to KES.1.8Tn over the period in consideration.
- Actual receipt estimates for the 2018/19 period shows that the Government achieved 96.2% (KES.486.8) of its total revised budget for the period.
- It is important to note that the domestic borrowing target for the 2018/19 year had been revised 3.5% upwards from KES.489Bn to KES.506.2Bn possibly to compensate for an envisaged decline in total tax income which was revised 10.5% downwards from KES.1.7Tn to KES.1.5Tn.
- Even then, the Government achieved 99.5% and 85.2% of the revised domestic borrowing and total tax income targets.
- We predict a similar scenario in 2019/20 with domestic borrowing targets likely to be revised upwards due to shortfall in tax revenue.

Table.5: National Treasury Data shows a 17% decline in domestic borrowing target

Receipts	2018/19 Revised Estimates (KES)	2018/19 Actual (KES)	% Achieved	2019/20 Estimates (KES)	Actual Receipts (KES)	Estimate 2018/19 vs 2019/20
Opening Balance (1st July 2019)		10.28			9.89	
Total Tax Income	1,512.9	1,440.2	95.2%	1,807.6	107.45	19.5%
Total Non-Tax Income	75.3	58.2	77.3%	69.5	0.31	-7.6%
Domestic Borrowing	506.2	486.8	96.2%	422.9		-16.5%
Loans -Foreign Gov't & International Org	54.2	41.7	76.9%	65.2		20.3%
Programme Loan-Budget support	82.1	84.8	103.2%	2.0		-97.6%
Domestic Lending & on-lending	3.9	2.9	73.3%	4.3		10.1%
Grant -Foreign Gov't & International Org	13.4	8.4	62.7%	14.5		7.6%
Grants from AMISON	6.5	4.3	66.4%	5.0		-23.1%
Commercial Loan	362.6	362.6	100.0%	200.0		-44.8%
Unspent Balances (Recoveries)		7.8				
Total Revenue	**2,617.2**	**2,507.9**	**95.8%**	**259.1**	**266.5**	-1.0%

Source: The Kenya Gazette Vol. CXXI - No.105 16th August 2019

Fig.11: Actual National Treasury receipts at 64.8% of total 2018/19 fiscal year



Source: The Kenya Gazette Vol. CXXI - No.105 16th August 2019

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

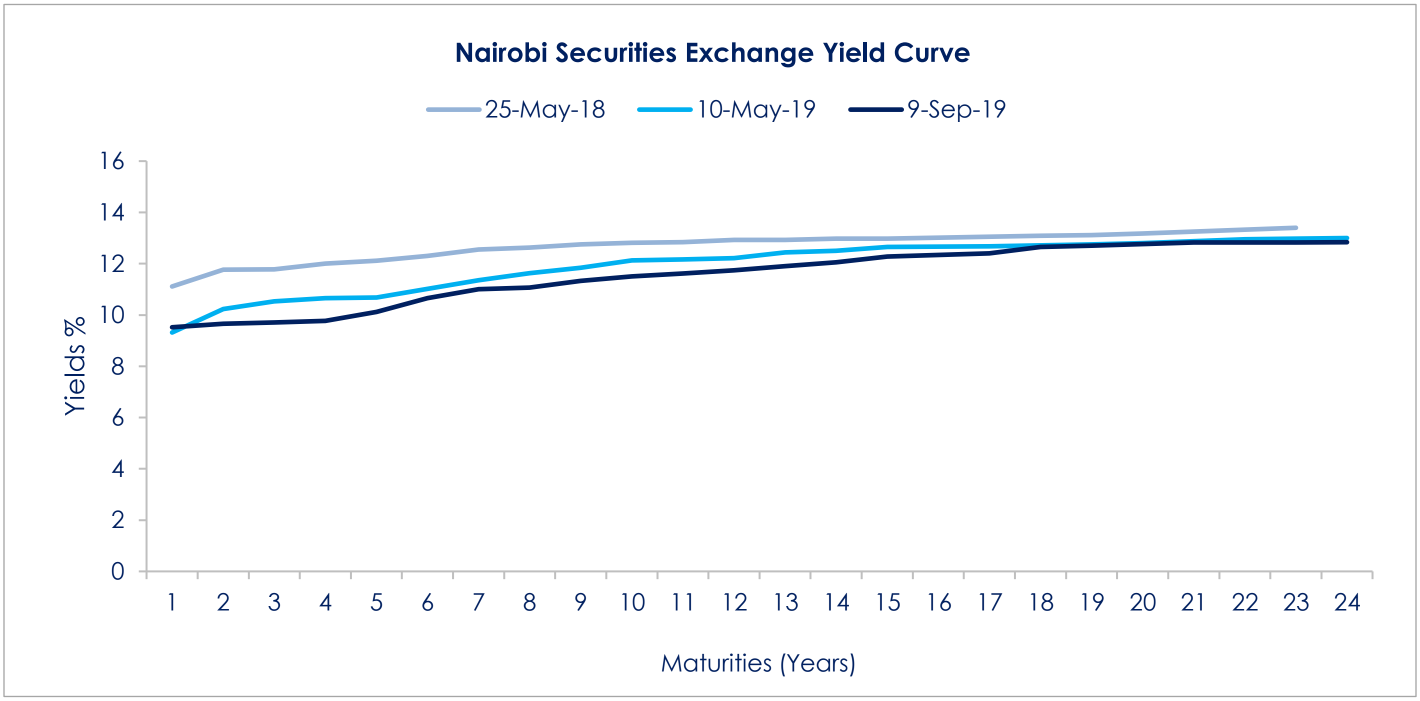
- All yields on Government securities have declined compared to the same period last year, with bigger shifts on the medium term papers (Table.6 and Fig.12).
- We expect the yield curve, to continue declining as the interest rate cap regime prevails.
- **We maintain our recommendation to HOLD long term papers and BUY short and medium term bonds.**

Table.6: Yields decline for all debt maturities

Tenor	Yield (24th Aug 2018)	Yield 31st Aug 2019)	Change (Bps)
1	9.9410	9.3920	↓54.90
2	10.9046	9.4977	↓140.69
5	11.7408	9.8683	↓187.25
10	12.6860	11.4973	↓118.87
15	12.8964	12.2750	↓62.14
20	13.0250	12.6500	↓37.50

Source: Nairobi Securities Exchange

Fig.12: Yields on long-term maturities have declined compared to medium-term bonds

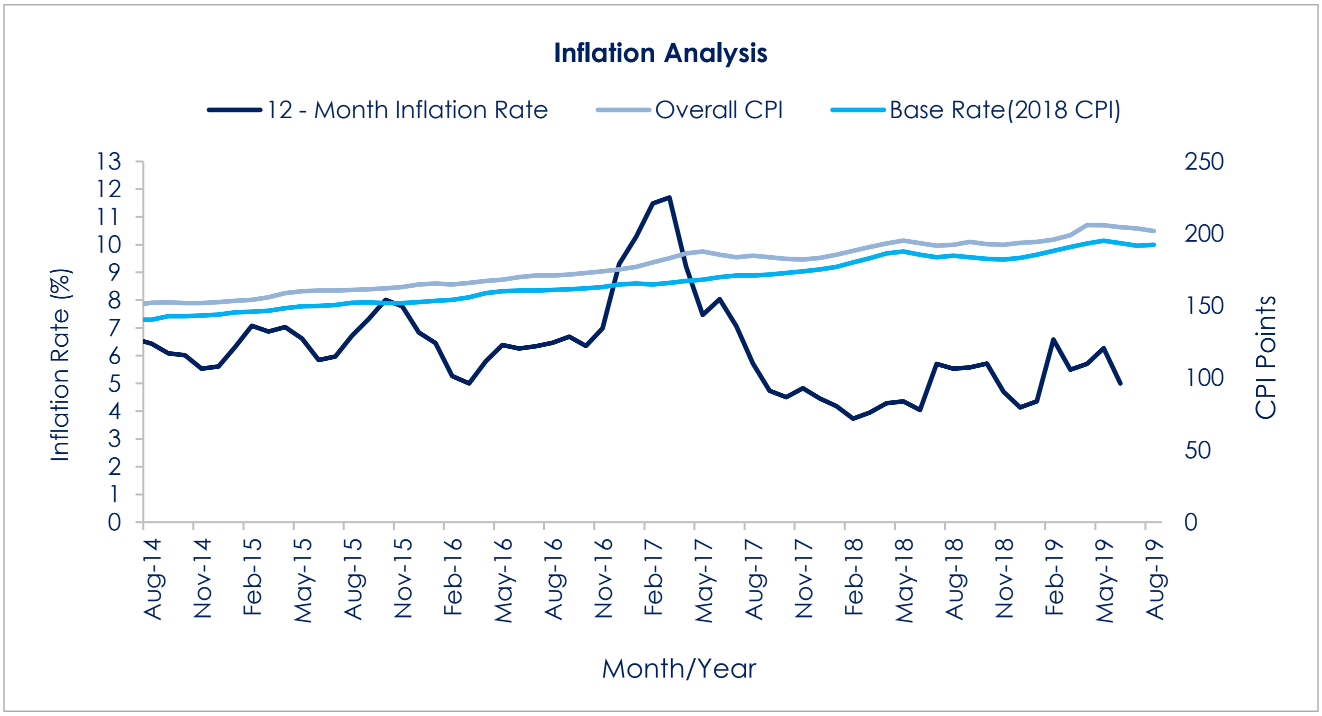


Source: Nairobi Securities Exchange

August Inflation rate lowest since May 2019

- The rate of inflation in Kenya declined sharply to 5% in August, 2019 from 6.27% recorded in July, 2019 (Fig.12).
- This is the lowest rate witnessed since May when the rate was 5.5%.
- The month-on-month fall in inflation is largely attributable to favorable weather conditions a trend witnessed over the past 5 months which, in turn, has led to a decline in prices of majority of food staples consumed by Kenyans.
- Food and Beverages which holds the greatest weight in the basket of goods and services used to calculate the CPI (Consumer Price Index) witnessed a decline of 1.89% in prices from the previous month.
- Alcoholic beverages, tobacco, and narcotics, on the other hand, experienced the largest increase in prices 0.27% from July, 2019.
- The fall in inflation rate will boost the real rate of return on long term fixed income investments.
- The rate of inflation is likely to decline further this month to the tune of **4.5% to 5.0%** owing to higher than expected rainfall forecasted by the Kenya Meteorological Department. This will have a favorable impact on food staples prices.
- Crude oil prices are expected to average US$64 in the second half of the year, the same price observed in June and July, respectively. Thus, the price of petrol and diesel is unlikely to fall significantly.

Fig.12: August inflation forecast 4.5-5%



Source: Kenya National Bureau of Statistics

Monetary Policy Committee to maintain the CBR at 9%

- The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 9.00% during the meeting held on 24th July.
- We do not expect a revision on the benchmark rate in the next MPC meeting on 23rd September, 2019.

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