STERLING CAPITAL LIMITED

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Fixed Income Note

November 2019

"Out with interest rate caps"

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Executive Summary

- Our report is titled **"Out with interest rate caps"** following the **repeal of the interest rate capping law** a major factor in the country's fiscal and monetary policy.
- The report introduces the second 10 year bond issue in the fiscal year 2019/20 with the previous issue in August oversubscribed.
- **We predict the weighted average rate (WAR) of bids between 12.40% and 12.50%, weighted average rate of accepted bids at 12.30% and 12.40% and the coupon rate at 11.50% and 11.60% (in the event that the CBK decides to issue it at a discount).**
- High investor demand is expected on this bond on account of its tenor and current market liquidity levels with a **120% subscription rate**.
- The report also covers domestic debt **primary auction performance in terms of subscription, CBK acceptance levels as well as yields** over the last 2 years.
- Also covered in the report is **historical and forecasted secondary bond market trading activity**.
- **Domestic Bond maturities** have a huge impact on CBK's borrowing and we analyse this in the report with **KES.77Bn in redemptions in the month of November.**
- We also do an analysis of the country's **national accounts** to determine whether the Government is on course to achieve its 2019/20 fiscal year receipts target.
- The report includes an analysis of the yield curve over the last one year showing a **downward shift in the middle and long end of the curve.**
- Macro-economic variables and in particular **inflation** is expected to decline in November where we have forecasted a rate between **4.1%-4.5%**.
- Finally, we give our expectations of the **Monetary Policy Committee (MPC)** meeting on 25th November where we give a **60% chance of the Central Bank Rate (CBR) being retained at current levels (9%)** on a backdrop of macro-economic stability.

CBK issues 10Yr Treasury Bond

Bond issue likely to be oversubscribed because of the favorable tenor and current market liquidity levels.

- The Central Bank of Kenya (CBK) issues a **10-Year T-Bond (FXD4/2019/10)** in November 2019 to raise KES.50Bn (Table.1).
- 2019/20 fiscal budget deficit estimate is KES.607.8Bn according to the National Treasury's fiscal budget.
- The budget deficit will be financed through a combination of domestic and foreign (project loans, commercial debt and foreign payments).
- The Government has revised its FY2019/20 domestic borrowing target upwards by KES.6.5Bn to KES.429.4Bn and this could have an impact on acceptance levels in debt auctions.
- We expect an oversubscription for the bond at around 120% (KES.60Bn) on account of its medium tenor and high market liquidity.

Table.1: Primary Bond issue summary

Issue Number	FXD4/2019/10
Total Amount Offered	KES.50Bn
Tenor (Years)	10 Yrs.
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	6th Nov -19th Nov 2019
Auction Date	20th Nov 2019
Value Date	25th Nov 2019
Yield Curve (%) (Weighted average tenor 10 years) 8th November 2019	11.71

Source: Central Bank of Kenya

CBK surprises investors by issuing IFB at a discount and a lower than expected coupon

CBK surprised bond investors with a lower coupon rate (11.75%) than the weighted average of accepted bids (12.394%).

- Similar to some of the previous issues, the CBK has stated that the coupon for this bond will be market determined, whereby the CBK used the Weighted Average Rate of accepted bids as the coupon.
- In October the CBK issued the Infrastructure Bond - **IFB1/2019/16** indicating that the bond's coupon will be market determined.
- In instances where coupon is market determined it is equal to the weighted average rate of accepted bids.
- However, during the IFB's auction the coupon rate settled on is 11.75% instead of the weighted average rate of accepted bids of 12.394%.
- Therefore, in as much as we expected the average rate of accepted bids to be between **12.30 - 12.40%,** we are also open to the possibility that the bond's coupon could be between **11.50 - 11.60%**.
- We believe that the CBK's move was aimed at managing the cost of borrowing at a time that the President had rejected the Finance Bill 2019 asking for a total repeal of the interest rate capping law.

- It is thought that investors placed higher bids in that auction in anticipation of a rise in interest rates following the repeal.
- We believe interest rates are likely to increase gradually in the medium to long-term.

Investor bid predictions – FXD4/2019/10 (12.40%-12.50%)

- Given the repeal of the interest rate cap law, we expect investors to bid aggressively for this issue.
- The government is pushing universities and quasi-government institutions to invest deposits lying in banks and idle cash in government securities.
- This might help maintain the rates at current levels as the KES.20Mn limit for non-competitive bids does not apply to these institutions
- **We predict bids at around 12.40-12.50% with the weighted average of accepted bids at 12.30% - 12.40%** (Table.2).

Table.2: Auction bid & Coupon predictions

Security	FXD4/2019/10
Market Weighted Average Rate	12.40 – 12.50
Weighted Average Rate of Accepted Bids (%)	12.30 – 12.40
Coupon*	11.50 - 11.60

Source: Sterling Capital Research

* Note 1: Predicted coupon in case the CBK issues FXD4/2019/10 at a discount

- We have also reviewed T-Bond auction results for past 10-year issues with the most recent issue FXD3/2019/10 issued in August 2019 oversubscribed (Table.3).

Table.3: Historical primary market auction performance

Issue Number	Issue Date	Amount Offered (Bn)	Bids Received	Amount Accepted	Performance Rate (%)	Coupon Rate (%)	Implied Yield to Maturity
FXD1/2018/10	27th Aug, 2018	40	29.83	19.36	74.56	12.686	11.4497
FXD1/2018/10 RE-OPEN	24th Sep, 2018	40	22.14	21.24	55.34	12.686	11.4497
FXD2/2018/10 (TAP SALE)	31st Dec, 2018	13.84	6.62	6.62	47.83	12.502	11.5503
FXD2/2018/10	17th Dec, 2018	40	28.86	26.16	72.15	12.502	11.5503
FXD1/2019/10	25th Feb, 2019	50	36.33	32.81	72.66	12.438	11.5503
FXD2/2019/10	15th April, 2019	50	70.93	51.33	141.87	12.300	11.6500
FXD3/2019/10	19th Aug, 2019	50	52.77	45.01	105.54	11.517	11.5170

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 (8th November 2019) (Table.4).

Table.4: Benchmark issues to guide investor bids

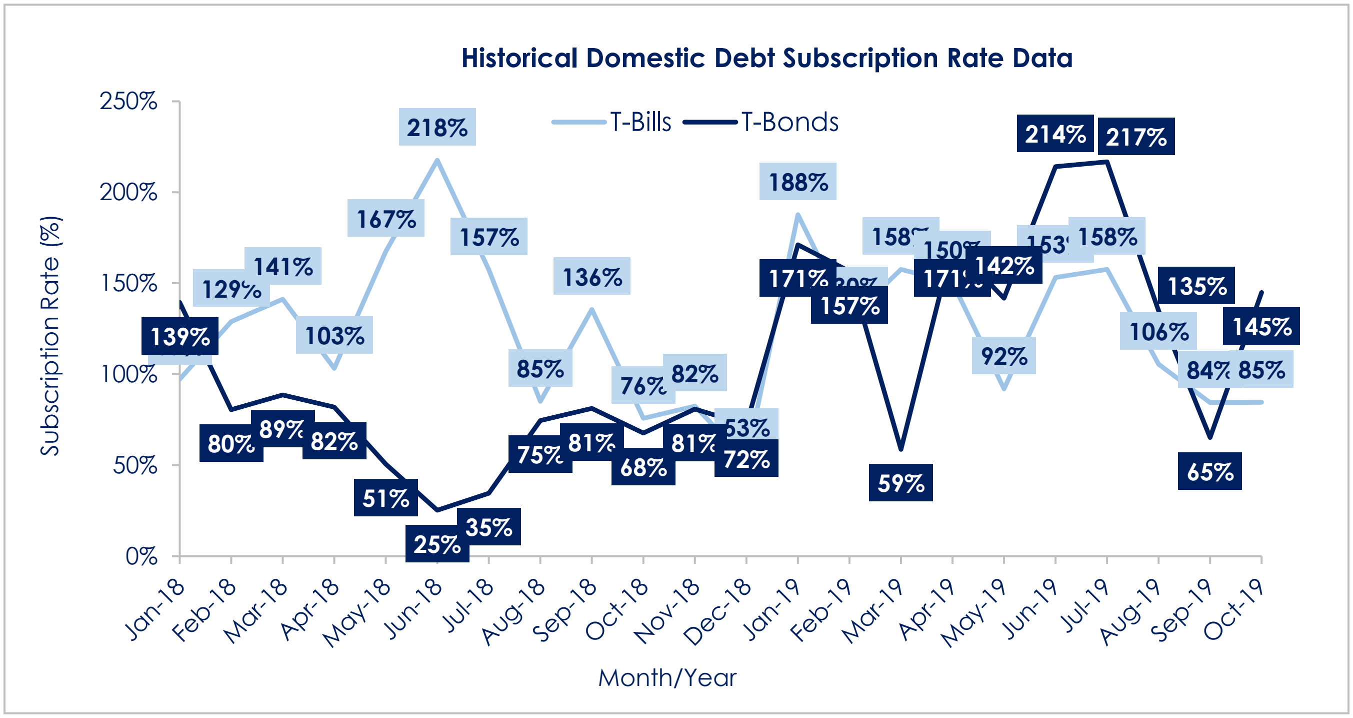
Treasury Bond	Issue Date	Coupon Rate (%)	Issue Date	Term to Maturity Years (Days)	Last traded Yield (%)	Yield Curve at time of issue	Trade Date
FXD3/2019/10	19th Aug, 2019	11.52	6th Aug, 2029	9.78(3,559)	11.52	11.50	8th Nov, 2019
FXD2/2019/10	15th April, 2019	12.30	2nd April, 2029	9.43(3,433)	11.65	12.15	8th Nov, 2019
FXD1/2019/10	25th Feb, 2019	12.44	12th Feb, 2029	9.30(3,384)	11.55	12.32	8th Nov, 2019

Source: Central Bank of Kenya

High subscription for domestic debt in October 2019

- A total of KES.168.1Bn was received in bids in October T-Bills and T-Bonds auctions against KES.156Bn offered by CBK equivalent to a 107.7% subscription rate (Fig.1).
- T-Bill subscriptions increased marginally from 84.3% in September (KES.101.2Bn) to 84.5% (KES.81.1Bn) in October 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 79.4% (KES.12.7Bn), 15.6% (KES.6.2Bn) and 155.5% (KES.62.2Bn) respectively.
- The high subscription for the 364-Day T-Bill can be explained by an uptick in the 364-day yields for the second month running.

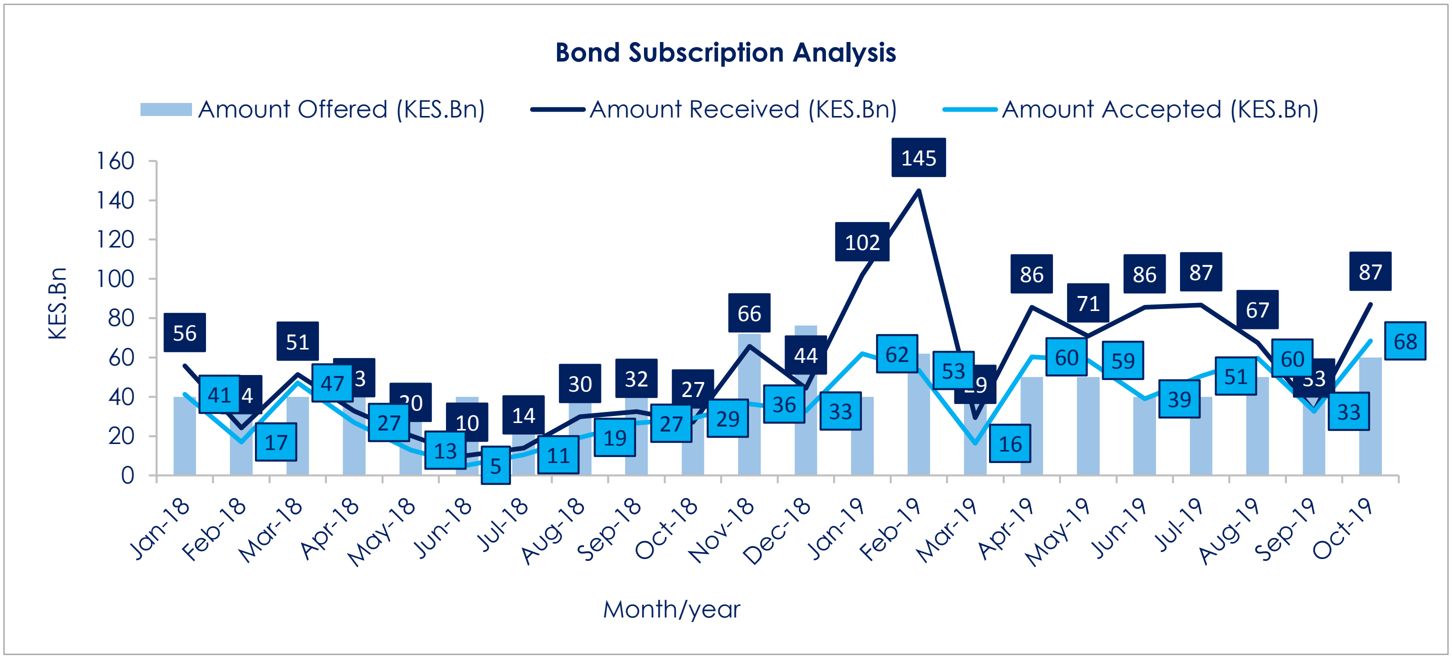
Fig.1: October Infrastructure Bond oversubscribed



Source: Central Bank of Kenya

- The 16-year (IFB1/2019/16) Bond issued in October was oversubscribed with a performance rate of 144.91% (KES.86.9Bn) against KES.60Bn offered by CBK (Fig.2).
- This subscription was on account of the relatively short term to maturity and the tax benefit of the infrastructure bond.

Fig.2: CBK accepts KES.68Bn in October IFB issue

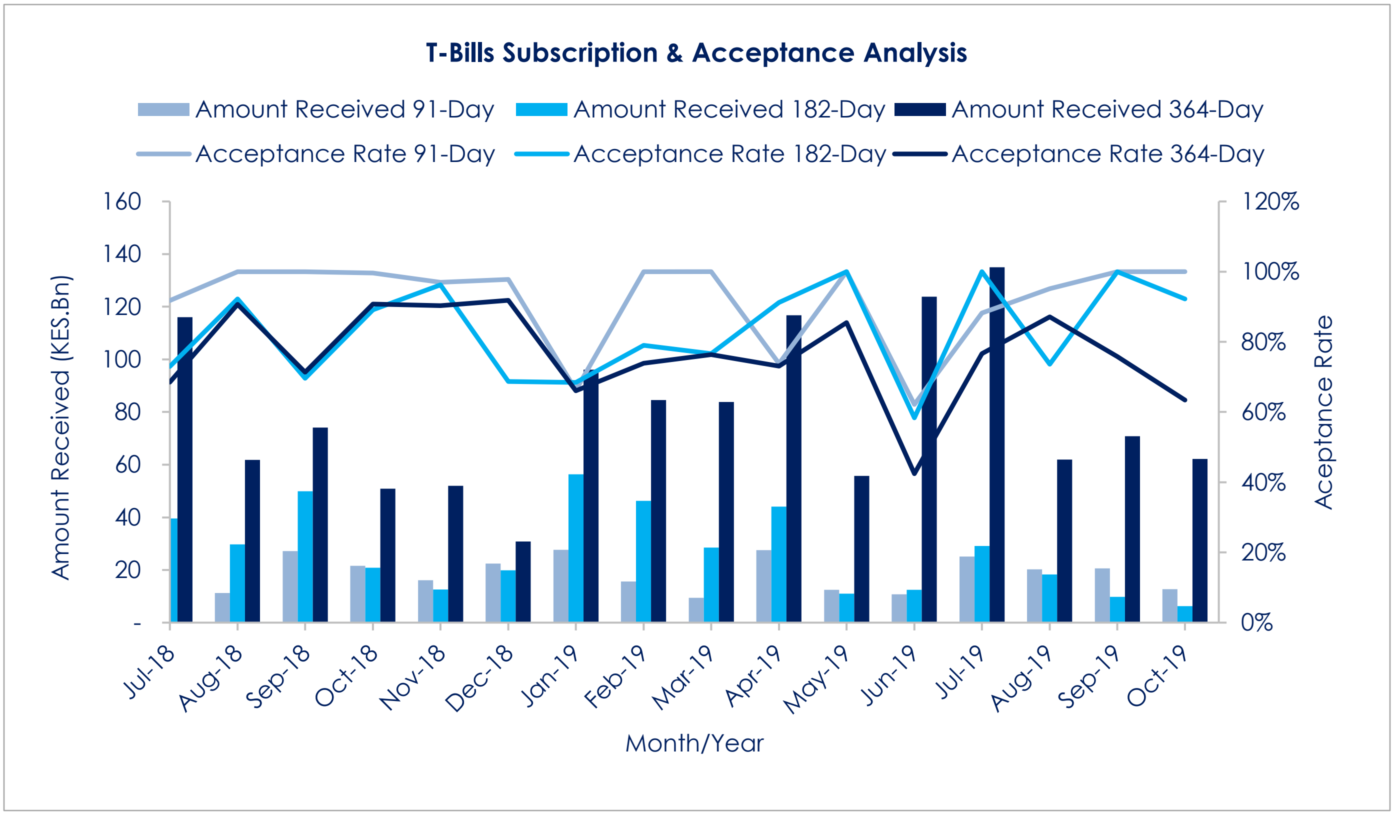


Source: Central Bank of Kenya

Long tenor T-Bill in high demand

- In October the 364 day paper received KES.62.2Bn a subscription rate of 155.5% compared to 79.4% and 15.6% for the 91-day and 182-day papers.
- Acceptance rates for the 91-day, 182-day and 364-day stood at 100%, 92% and 63% respectively (Fig.3).
- The 364 day T-Bill seems to have the lowest acceptance rate despite the high demand due to relatively high investor bids.

Fig.3: 100% acceptance rate for the 91 day T-Bill on comparatively low yields

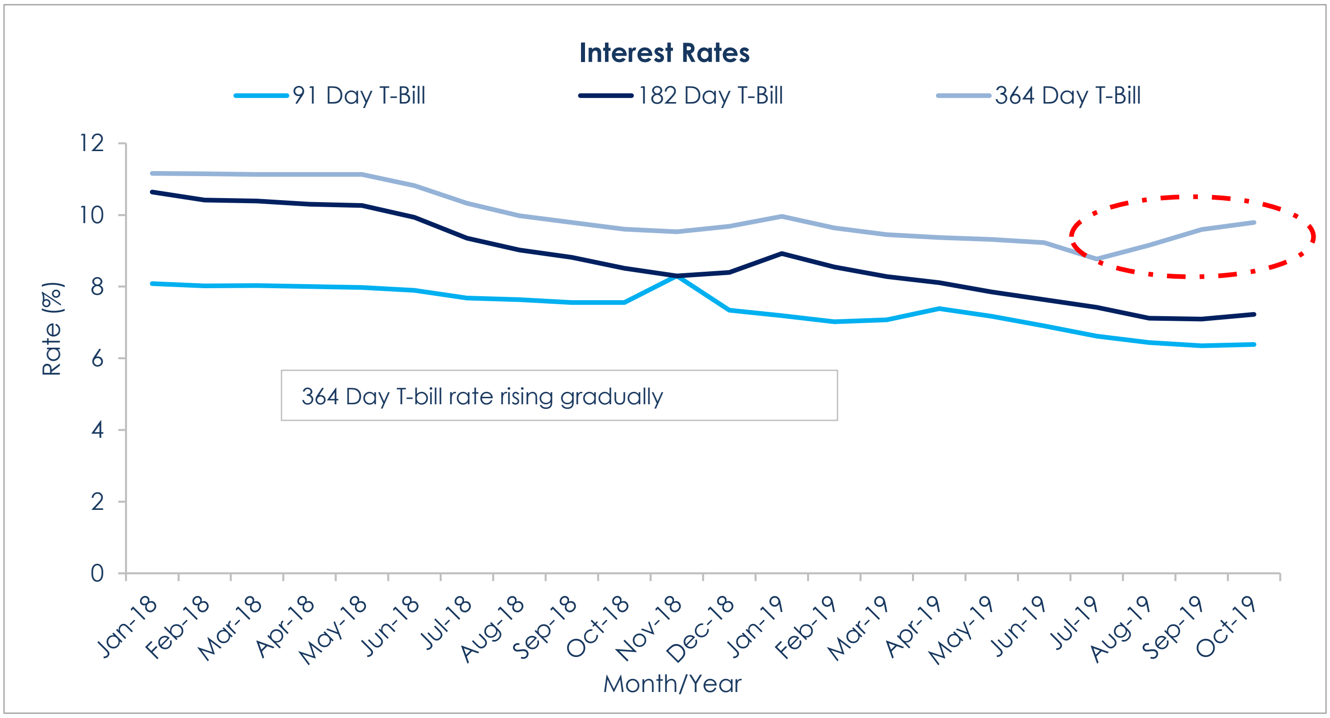


Source: Central Bank of Kenya

T-bill yields rise marginally in October, set to increase gradually following interest rate cap repeal

- During the month, the average yields for 91-day, 182-day and 364-day papers went up by 3bps, 13bps and 19bps to 6.4%, 7.2% and 9.8% respectively (Fig.4).
- We believe that this increase was attributable to the removal of interest rate cap.
- T-Bills acceptance rate in the month under review stood at 71.4% (KES.57.9Bn) compared to 83.1% (KES.84.1Bn) in September.
- We expect the yields to increase gradually following the removal of the interest rate caps.

Fig.4: Short-term domestic debt interest rates continue declining

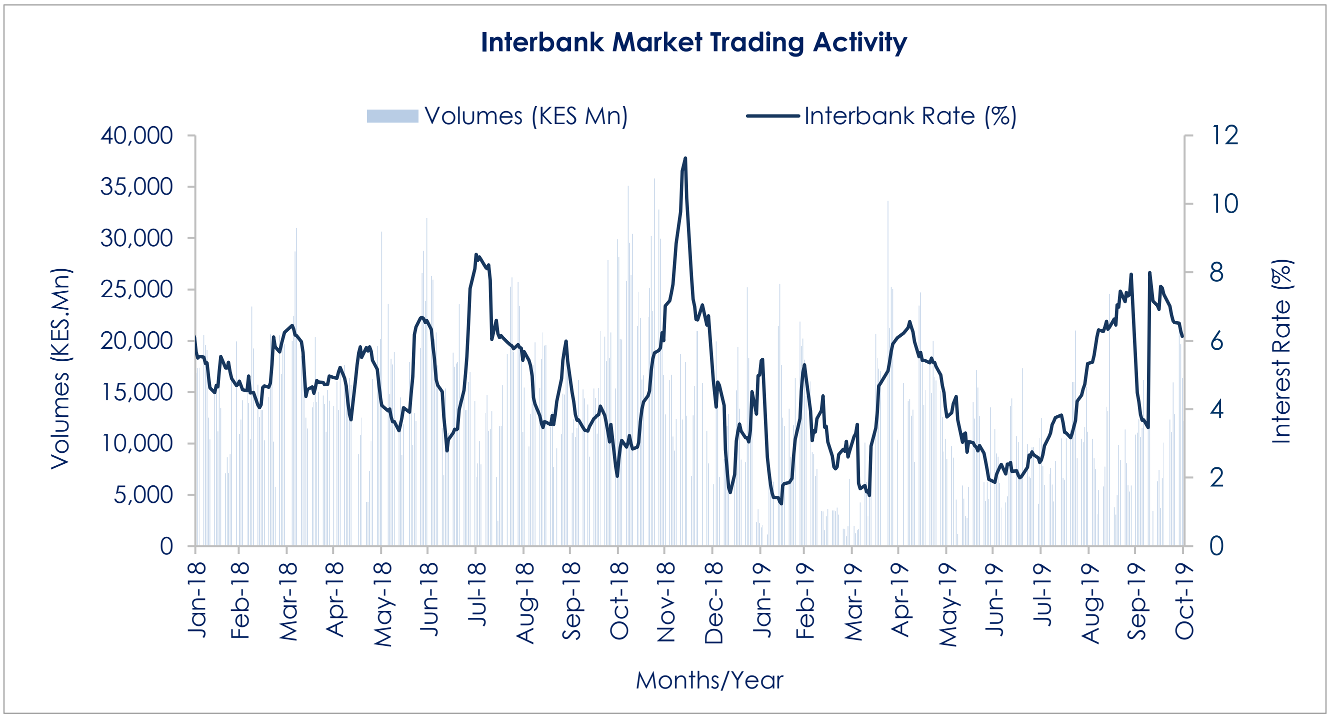


Source: Central Bank of Kenya

Inter-bank lending rates dip marginally in October, expected to rise towards year end

- Inter-bank lending rates declined in October 2019 to an average of 6.0% from 6.58% in September while total traded volumes rose 41.5% to KES.250.9Mn from KES.177.3mn in the previous month (Fig.5).
- This was due to high market liquidity in the month which we expect to have an impact on both primary domestic debt auctions and secondary trading activity.
- We expect inter-bank lending rates to rise marginally in November and December on account of low market liquidity due to the annual financial reporting period whereby most funds and banks consolidate their books and trade less and removal of interest rate caps.

Fig.5: Inter-bank lending rates expected to increase as the year nears the end

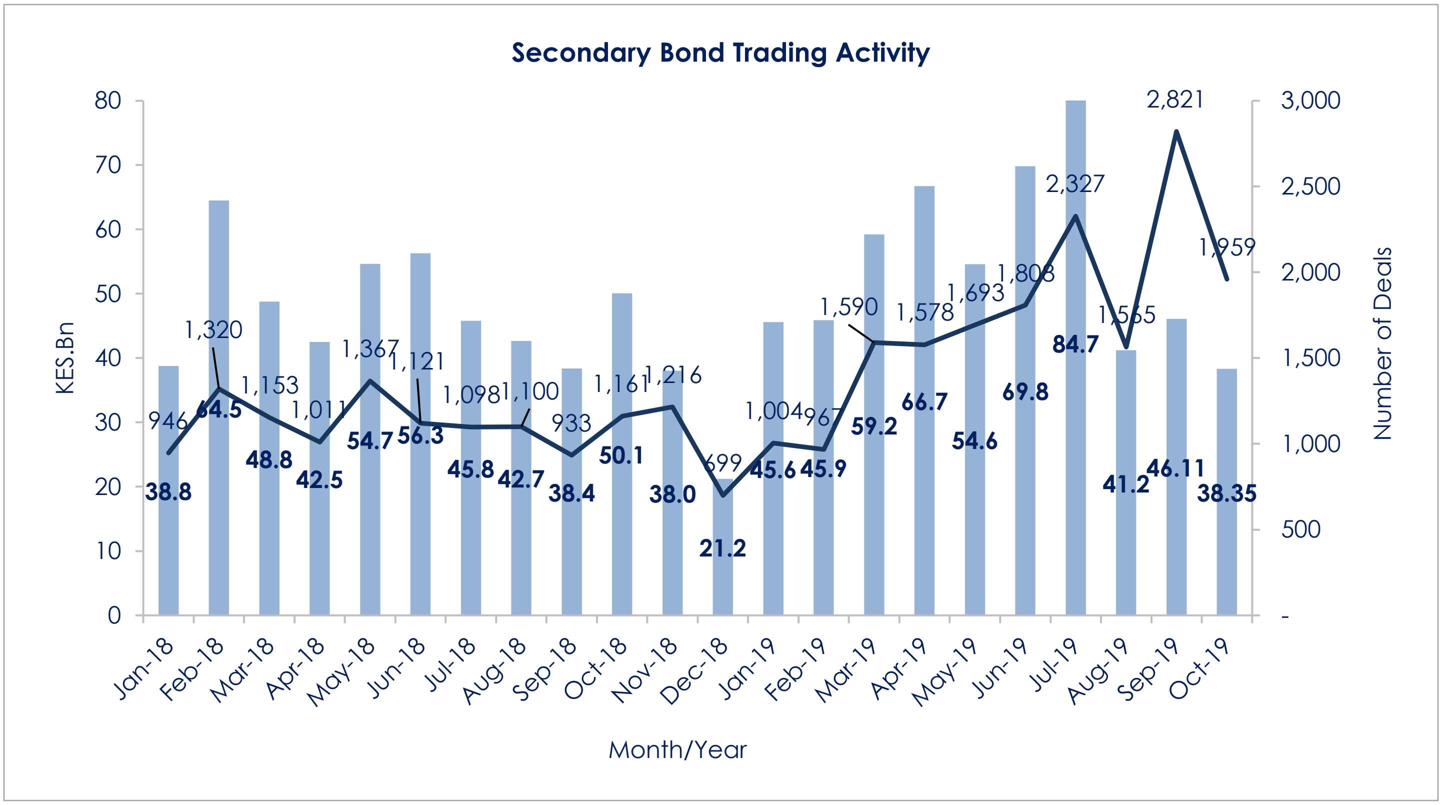


Source: Central Bank of Kenya

Secondary market trading activity declines by 16.8%

- Secondary market bond trading turnover declined by (16.8%) in October 2019 to KES.38.35Bn with the number of deals declining 30.6% to 1,959(Fig.6).
- The low trading activity is attributed to most focus being on the IFB issued in October and also due to rate cap removal whereby most people have adopted a wait and see approach.
- We don't expect an improvement in secondary market activity in November and December because of the end year when most banks and funds don't trade.

Fig.6: Secondary trading activity down 16%

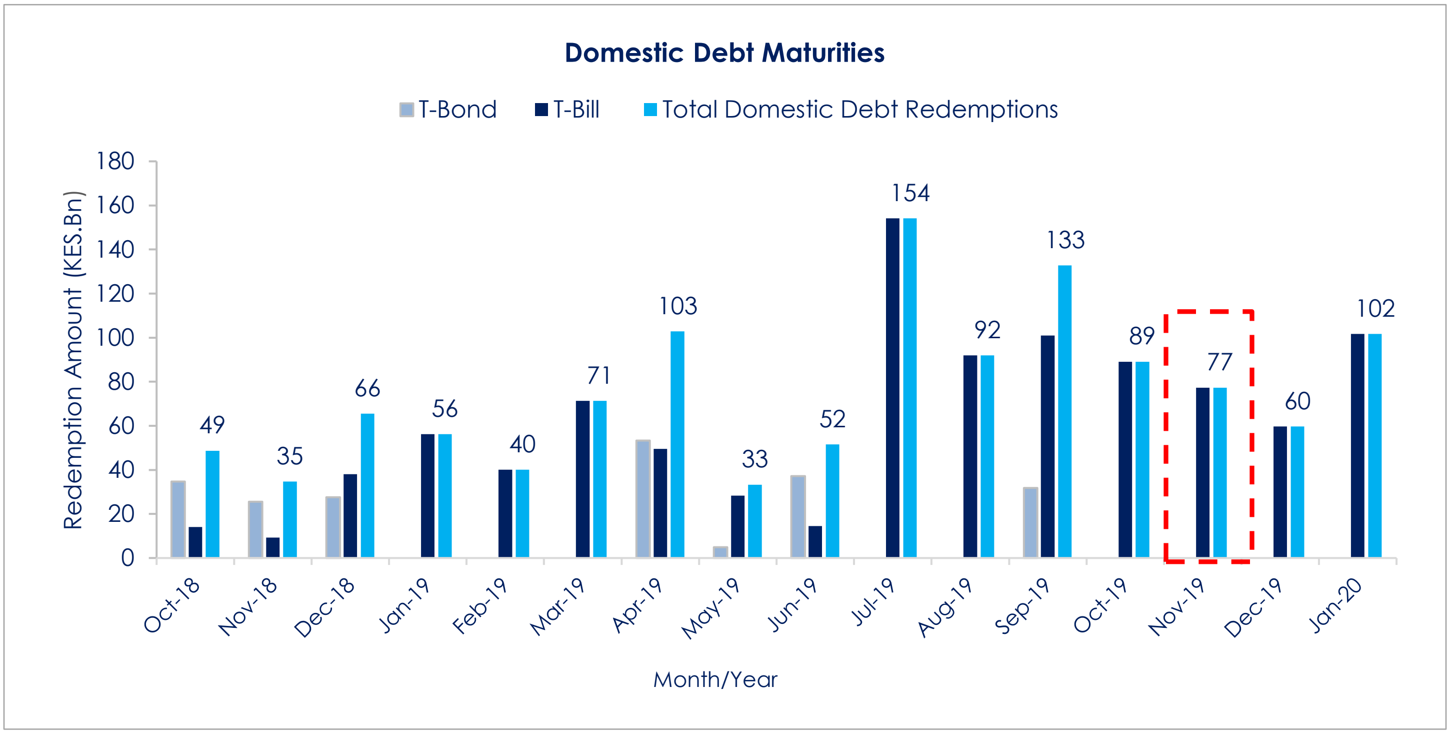


Source: Central Bank of Kenya

November 2019 - KES.77Bn in T-Bill redemptions, no bond redemptions

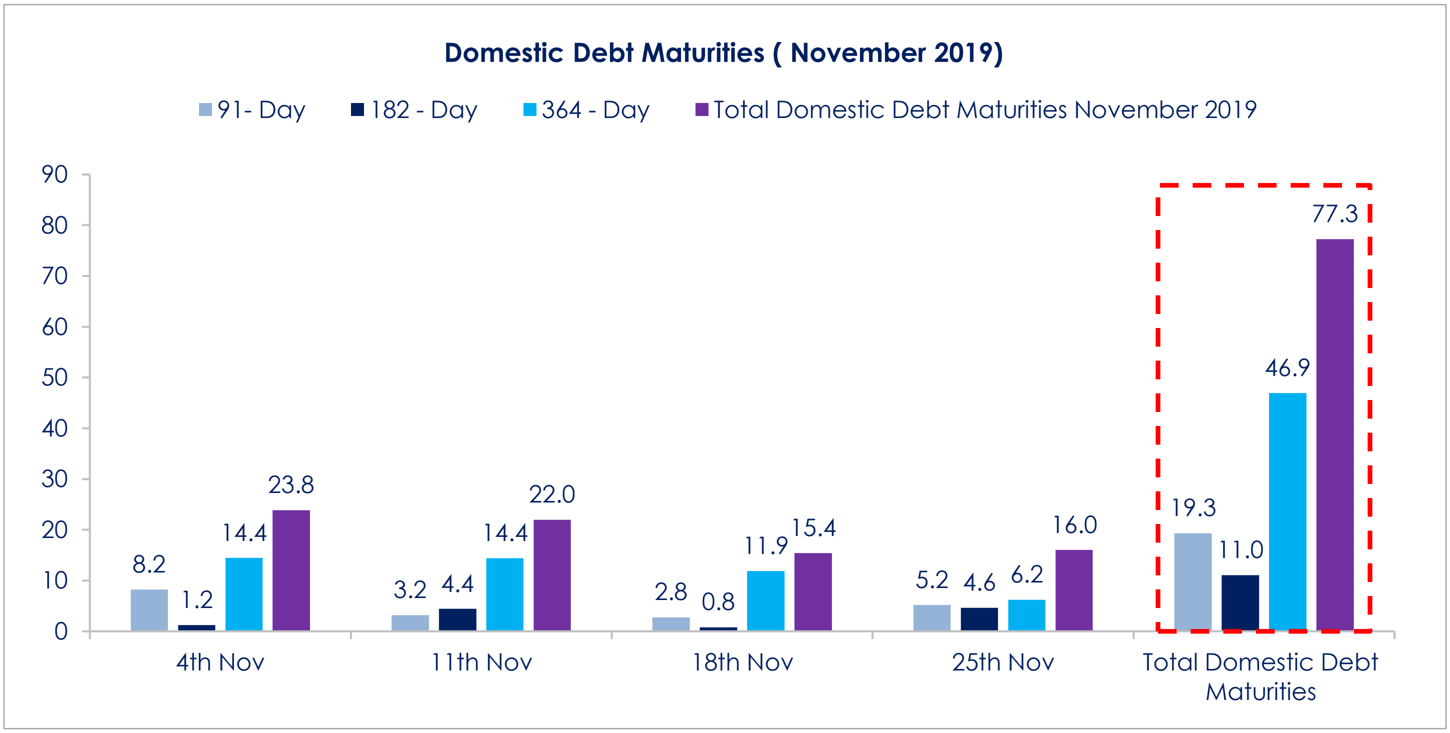
- KES.77.3Bn in total domestic debt redemptions (T-Bills only) in November down from KES.89.1Bn in October (Fig.7).
- This is still considerably high in consideration of the month's KES.96Bn T-Bill target.
- Weekly T-Bill redemptions data indicate a slowdown in debt redemptions as the month progresses (Fig.8) with most redemptions done in the first week of the month.
- The steady decline in debt redemptions towards the end of the calendar year means that most debt issue proceeds will be directed to new borrowing.

Fig.7: November debt maturities at KES.77Bn



Source: Central Bank of Kenya

Fig.8: Weekly debt maturities in November 2019



Source: Source: Central Bank of Kenya

National Treasury revises its 2019/20 fiscal year domestic borrowing target upwards

KES.6.5Bn increase in the domestic borrowing target to KES.429.4Bn

- Total National Government receipts at the end of Q1 2019/20 (30th September 2019) stood at KES.637.4Bn or 24.5% of the total revised receipt target amount (KES.2.6Tn) (Table.5).
- We draw attention to a KES.6.5Bn increase in the annual domestic borrowing target to KES.429.4Bn.
- This is possibly a move aimed at countering the expected shortfall in revenues for the fiscal year or looking to take advantage of the prevailing low interest rate environment.
- KES.144.1Bn was raised from the domestic debt market in the period under focus equivalent to 33.6% of the total target (above the 25% linear run rate).
- This supports our view of a high chance of a revision of this receipt target.

Table.5: Total National Government receipts at 25% of 2019/20 fiscal year target

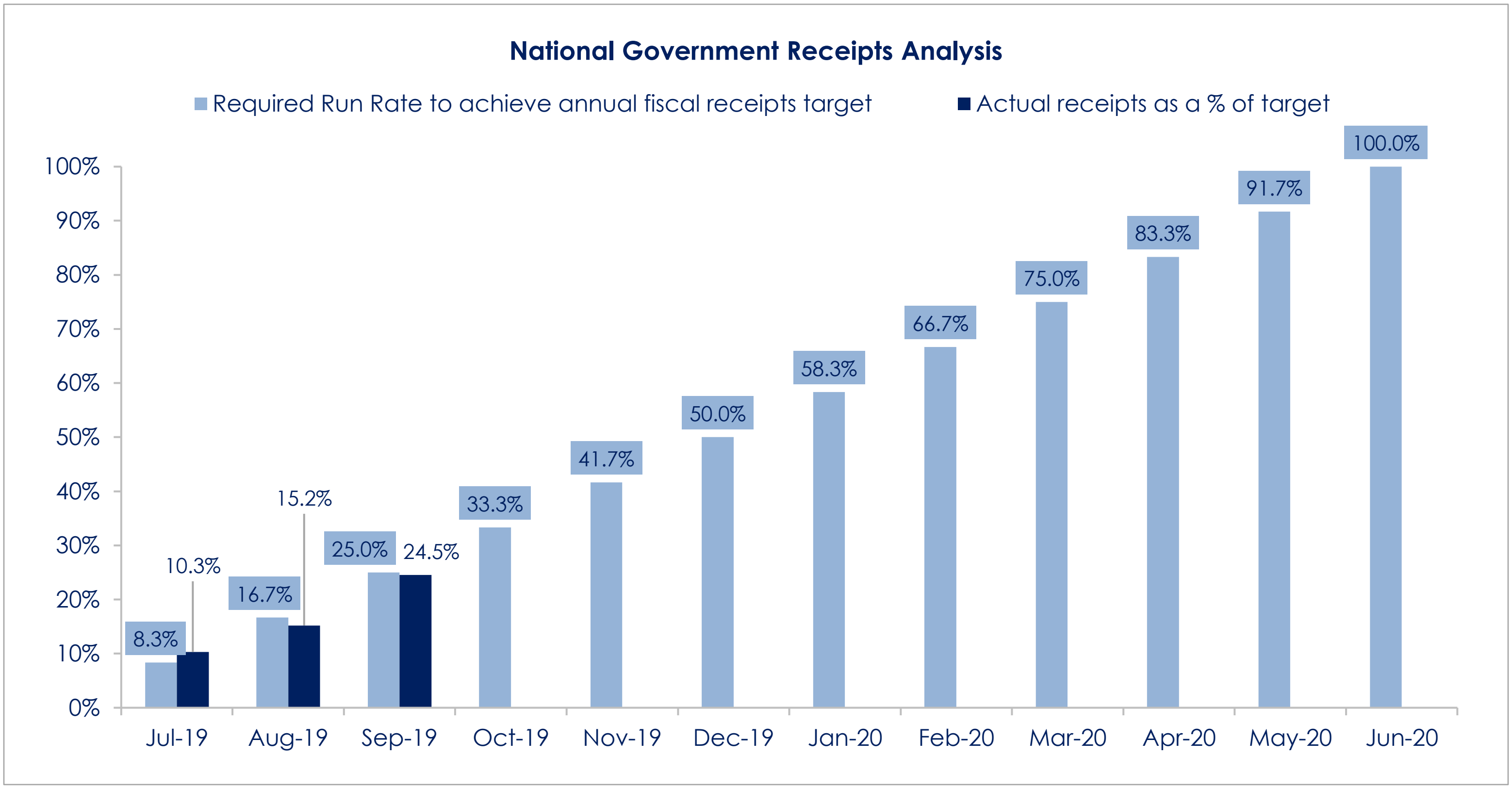
Receipts	2019/20 Original Estimates (KES)	2019/20 Revised Estimates (KES) End Sep	Actual Receipts (KES) End Sep 2019	Proportion of Receipt Target Achieved End Sep
Opening Balance (1st July 2019)			98.9	
Total Tax Income	1,807.6	1,807.6	372.3	20.6%
Total Non-Tax Income	69.5	69.5	12.0	17.3%
Domestic Borrowing*	422.9	429.4**	144.1	33.6%***
Loans -Foreign Gov't & International Org	65.2	65.2	3.3	5.0%
Programme Loan-Budget support	2.0	2.0	2.5	125.7%
Domestic Lending & on-lending	4.3	4.3	1.2	28.7%
Grant -Foreign Gov't & International Org	14.5	14.5	1.0	7.0%
Grants from AMISON	5.0	5.0	0.0	0.0%
Commercial Loan	200.0	200.0	0.0	0.0%
Unspent Balances (Recoveries)			2.1	-
Total Revenue	**2,591**	**2,598**	**637.4**	**24.5%**

Source: Source: The Kenya Gazette Vol. CXXI - No.140 30th September 2019

* Note 1: Domestic Borrowing of KES. 429.4 = Net Domestic borrowing KES.306.8 & Internal debt redemptions (Roll-overs) KES.122.6.
** Note 2: Domestic borrowing target revised upwards from KES.422.9 to KES.429.4Bn
*** Note 3: Proportion of receipts target achieved of revised estimate (KES.429.4Bn)

- We continue to use a linear growth rate as a basis of keeping monitoring the performance of the national Government in terms of its receipts and we see its at par in Q1 2019/20 (Fig.9).
- This however could be tested in coming months especially if revenue collections decline.

Fig.9: 25% fiscal receipt target achieved in Q1 2019/20



Source: Source: The Kenya Gazette Vol. CXXI - No.125 20th September 2019

Domestic debt yields on the short and long end of the curve rise year on year

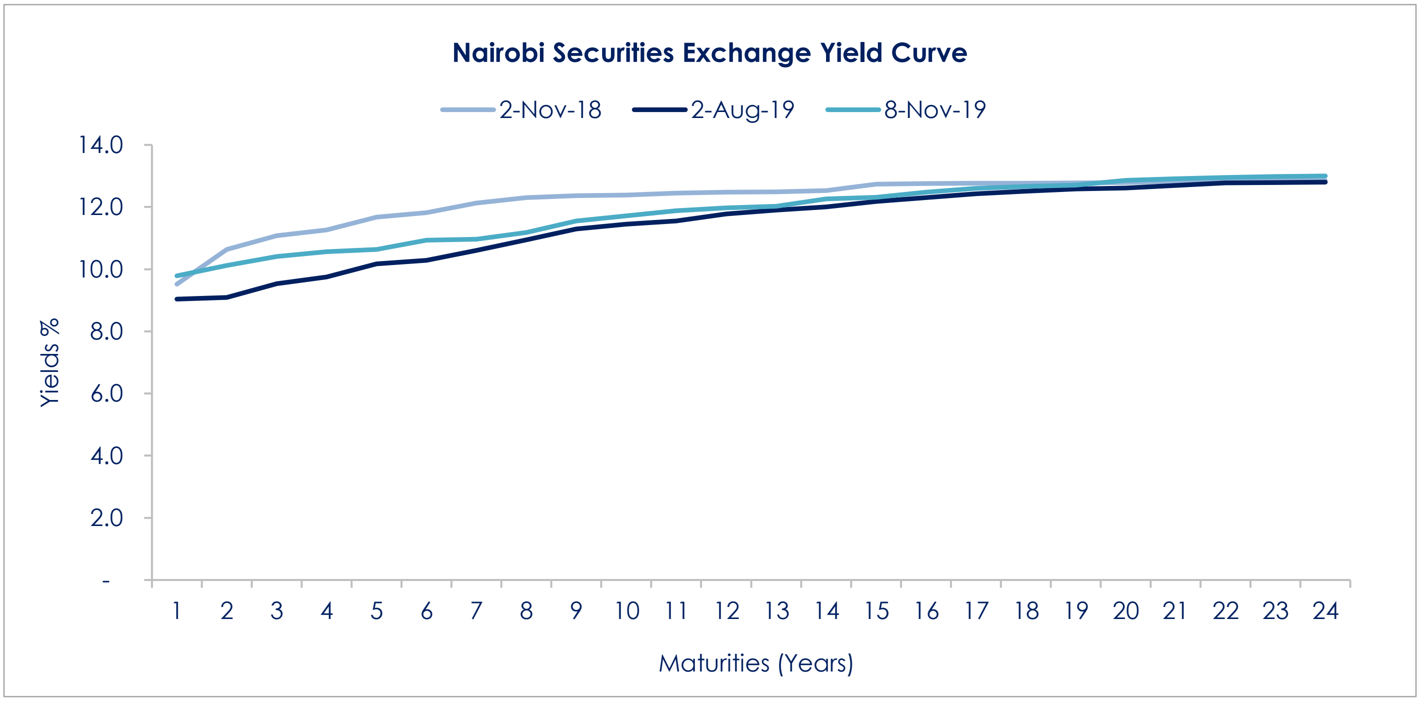
- A comparison of yields this month and one year ago show an increase in yields on the 1 year paper.
- All other tenors have dipped in yields, with the 5-Yr and 10-Yr bonds showing the biggest decline.
- We expect to see an upward shift in the yield curve, following the interest rate cap removal.
- **We maintain our recommendation to HOLD long term papers and BUY short and medium term bonds.**

Table.6: Yields on 364-day paper increase while yields for all maturities dip

Tenor	Yield (2nd Nov 2018)	Yield 8th Nov 2019)	Change (Bps)	Sterling Capital yield Curve (14th Nov 2019)
1	9.5190	9.7870	↑26.80	9.800
2	10.6396	10.1167	↓52.29	10.275
5	11.6800	10.6375	↓104.25	10.725
10	12.3896	11.7132	↓67.64	11.800
15	12.7340	12.3125	↓42.15	12.375
20	12.7851	12.8563	↓07.12	12.900

Source: Nairobi Securities Exchange

Fig.10: Yields on short-term edge upwards while yields on medium and long term bonds decline YoY



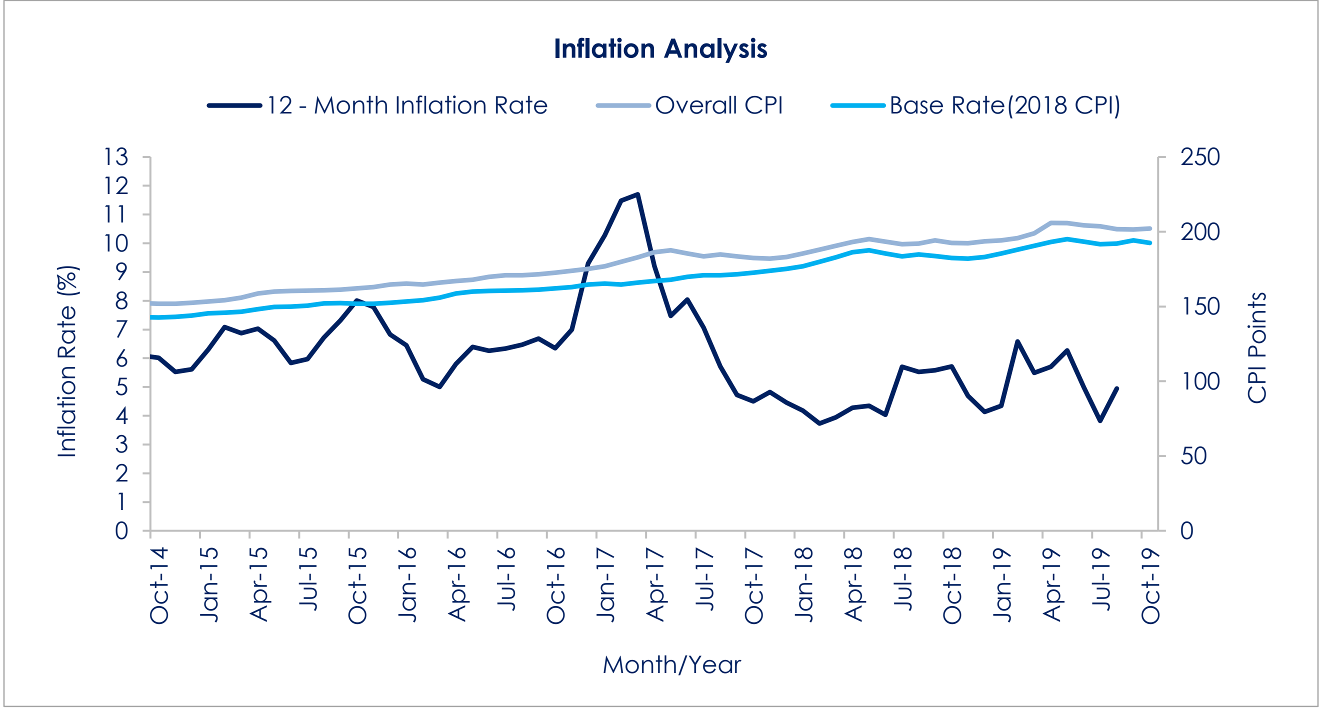
Source: Nairobi Securities Exchange

October inflation rises to 4.95%, a decline in November inflation forecasted

- The rate of inflation in Kenya rose sharply from 3.83% in September, 2019 to 4.95% recorded in October, 2019. (Fig.12)
- This arrested the two-month consecutive decline in the inflation rate from July 2019 with inflation falling to an 18-month low of 3.83% in September.
- The month-on-month fall in inflation is largely attributable to a rise in the prices of majority of food staples coupled with an increase in the price of cigarettes following the implementation of a new excise duty.

- Food and Beverages index which holds the greatest weight in the basket of goods and services used to calculate the CPI (Consumer Price Index) – witnessed an increase of 0.5% in prices from the September.
- Alcoholic beverages, tobacco, and narcotics, on the other hand, experienced the largest increase in prices - 2% from September.
- The inflation rate in October is below the upper (7.5%) and medium range (5%) set by the CBK.
- The Treasury is likely to gradually start paying higher rates on government securities after the president signed into law the Finance Bill 2019 which will lead to an increase in interest rates on loans offered by commercial banks (who are the largest investors in treasury securities).
- The prices of food are likely to come down in the following months following the onset of the short rains which in turn will ease the pressure of inflation to a rate of about **4.1% - 4.3%**.

Fig.12: November inflation forecast 4.1%-4.5%



Source: Kenya National Bureau of Statistics

Monetary Policy Committee likely to retain the CBR at 9%

- The Monetary Policy Committee (MPC) is set to meet on Monday 25th November 2019.
- On the basis of our own sentiments, that of several macro-economic analysts and economists as well as bank treasury persons, we anticipate a 60% probability of the CBR being retained (Table.7).
- We also take note of a growing sentiment of a downward revision with some holding out for a 25-50 basis points change.

Table.7: Higher probability of CBR being retained in this month's MPC meeting

MPC Decision	Unchanged	Revised Downwards (8.25%-8.5%)
Reasons	- Macro-economic variables particularly inflation, domestic interest rates and foreign exchange rates remain stable. - Too soon to make any abrupt monetary policy decisions and the policy makers might want to monitor developments following the repeal of the interest rate capping law e.g. Bank positions on private sector lending. - Banks are unlikely to respond to the repeal with a sharp increase in lending rates. Many have issued statements saying rates remain unchanged in the near term	- The CBK taking the lead to signal the rate at which banks ought to be lending. - KES and inflation have remained relatively stable and a downward revision of the CBR does not pose a near term threat to macro-economic stability. - Signal of monetary policy easing to improve money supply and drive private sector credit growth
Probability	**60%**	**40%**

Source: Kenya National Bureau of Statistics

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