STERLING CAPITAL LIMITED

Thursday, 05 December 2019

Fixed Income Note

December 2019

“CBK strikes the sweet spot”

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>

Table of Contents

Executive Summary

- The Central Bank of Kenya (CBK) invites bids for the third 5 year Treasury Bond (T-Bond) issue **FXD3/2019/5**
- In this report titled **"CBK strikes the sweet spot"** we review the expected interest rate movements following the removal of interest rate caps.
- **We predict the weighted average rate (WAR) of bids between 11.45% and 11.65%, weighted average rate of accepted bids at 11.40% and 11.60%.**
- With the bond tenor being on the short end of the yield curve, and the amount offered being lower than previous issues, we expect this issue to be fully subscribed.
- Average inter-bank lending rates declined in November compared to the previous month, and we attribute it to high market liquidity supported by government open market activities such as selling the dollar to increase dollar liquidity, which offset tax payments.
- We continue to use a linear growth rate as a basis of monitoring the performance of the national Government in terms of its receipts and we there is a 2.4% shortfall by end of October for FY2019/20.
- Our analysis of the yield curve over the last one year shows a **downward shift in the middle of the curve.** However, we expect a gradual upward shift in the yield curve following the removal of the rate caps.
- December inflation rate to range between 5.5-6.0% due to temporary effects of increase in food prices and the festive season.
- The Monetary Policy Committee (MPC) will be meeting on 27th January 2020 and we expect the CBR to be maintained at 8.5% as the committee takes time to observe the effect that this month's rate cut has on the economy.

CBK issues 5Yr Treasury Bond

Bond issue likely to be fully subscribed because of increased yields and a shorter tenor.

- For the month of December 2019, the Central Bank of Kenya (CBK) is inviting bids for a **5-Year T-Bond (FXD3/2019/5)** seeking to raise KES.25Bn (Table.1).
- This is the shortest bond issue for the 2019/20 fiscal year so far.
- Following the removal of interest rate caps, investors have adopted a wait and see approach in anticipation for higher yields and we believe this informed the decision by the CBK to issue a shorter-dated bond.
- We expect full subscription for the bond on account of its shorter tenor and higher yields.

Table.1: Primary Bond issue summary

Issue Number	FXD3/2019/5
Total Amount Offered	KES.25Bn
Tenor (Years)	5 Yrs.
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	1st Dec -10th Dec 2019
Auction Date	11th Dec 2019
Value Date	16th Dec 2019
Yield Curve (%) (Weighted average tenor 5 years) 29th November 2019	11.1375

Source: Central Bank of Kenya

CBK mapping out new yield curve after interest rate cap repeal

The CBK is in the process of mapping out new yield curve after rate cap repeal

- The 10-year bond issued last month received bids worth KES.38.4Bn, a performance rate of 76.75% as investors do not want to lock their money in long term papers, in anticipation for higher yields.
- Following the 10-year bond issue, yields on the 10 year paper have shifted upwards by 58 bps compared to the levels at the beginning of October 2019.
- Investors have shown a preference for short term bonds and we expect this issue's tenor to attract high investor participation.
- The yields on 5 year papers are expected to shift upwards and we believe the CBK has issued a 5-year bond to serve as a benchmark for the new yield curve after the removal of interest rate caps.

Investor bid predictions – FXD3/2019/5 (11.45%-11.65%)

- Given the short tenor of this bond issue, we expect high investor participation in the primary auction.
- Following the removal of interest rate caps, we also anticipate investors to bid aggressively on the yields.
- However, the government is only seeking KES.25Bn, an indication that they are not pressed for funds and this could result in the CBK rejecting bids that are too aggressive.

- **We predict bids at around 11.40-11.70% with the weighted average of accepted bids at 11.40% - 11.60%** (Table.2).

Table.2: Auction bid & Coupon predictions

Security	FXD3/2019/5
Market Weighted Average Rate	11.45% -11.65%
Weighted Average Rate of Accepted Bids (%)	11.40%-11.60%

Source: Sterling Capital Research

- We have also reviewed T-Bond auction results for past 5-year issues, showing high subscription levels for all issues (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
FXD1/2018/5	26th Mar, 2018	40	37.65	23.07	94.11	12.299	10.5335
FXD1/2018/5 (Tap Sale)	2nd Apr, 2018	10	7.74	7.74	77.39	12.299	10.5335
FXD1/2019/5	25th Feb, 2019	50	41.93	20.59	83.85	11.304	10.9295
FXD2/2019/5	13th May, 2019	50	49.30	39.21	98.60	10.872	11.0000

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 (29th November 2019) (Table.4).

Table.4: Benchmark issues to guide investor bids

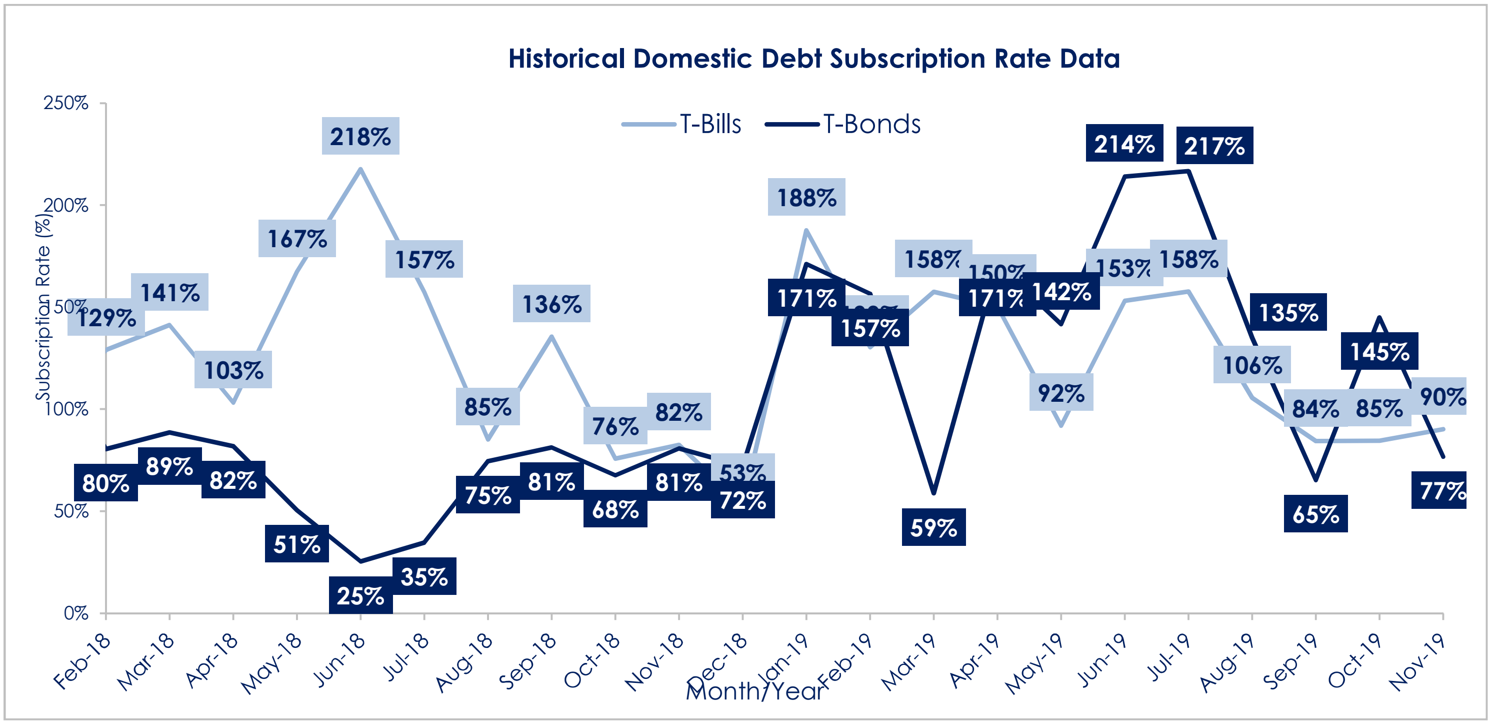
Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years (Days)	Last traded Yield (%)	Yield Curve at time of issue	Trade Date
FXD1/2019/5	25th Feb, 2019	11.30	19th Feb, 2024	4.22 (1,542)	10.93	11.22	29th Nov, 2019
FXD2/2019/5	13th May, 2019	10.87	6th May, 2024	4.44 (1,619)	11.00	10.68	29th Nov, 2019

Source: Central Bank of Kenya

Domestic debt subscription rate declines in November 2019

- In November the CBK received a total of KES.133.1Bn in bids (T-Bills and T-Bonds) against KES.167.7Bn offered, equivalent to a 79.4% subscription rate (Fig.1).
- This was a decline from 107.7% (KES.168.1Bn) subscription rate for October against KES.156Bn offered by CBK.
- T-Bonds subscription slumped from 144.9% in October to 76.8% in November.
- On the other hand, T-Bill subscriptions increased from 84.5% (KES.81.1Bn) in October to 90.2% (KES.86.6Bn) against a target of KES.96Bn offered in the two months.
- The subscription rates for 91, 182 and 364-Day T-Bills stood at 78.3% (KES.12.5), 33.1% (KES.13.2Bn and 152.1% (KES.60.8Bn) respectively

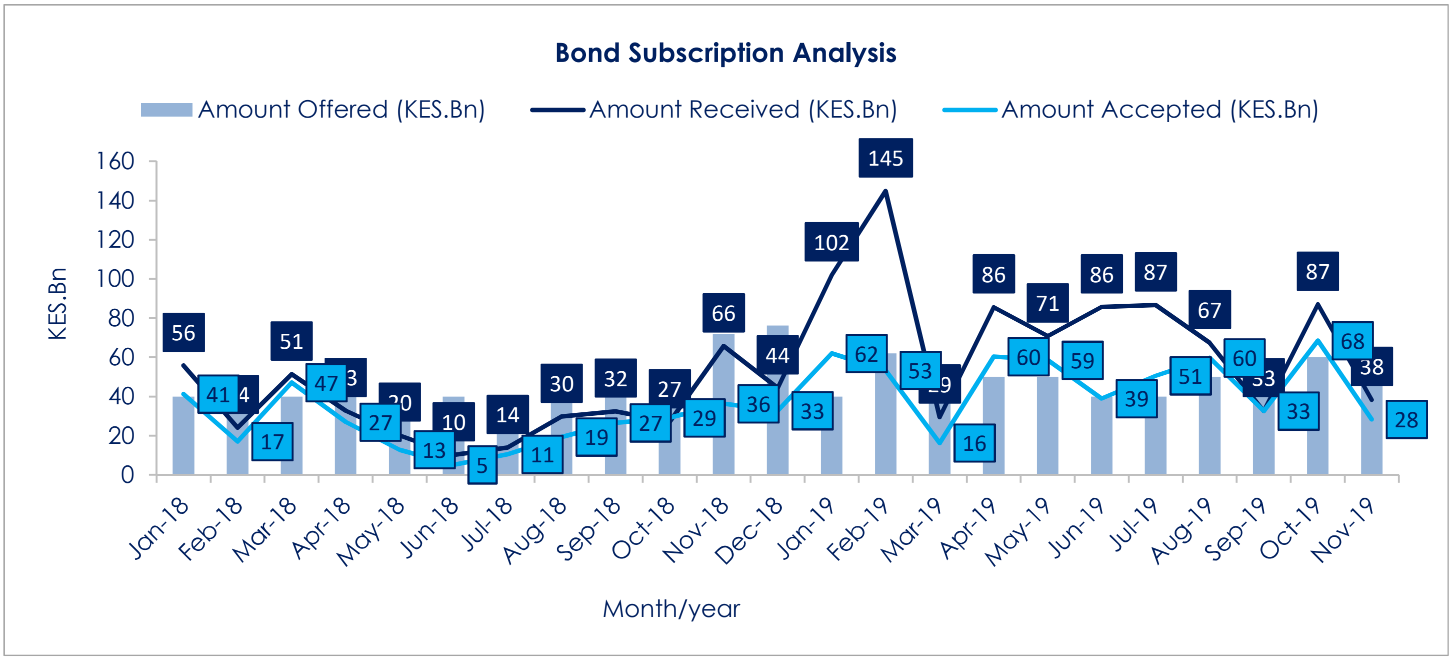
Fig.1: November 10-Year Bond undersubscribed



Source: Central Bank of Kenya

- In November CBK offered a 10-Year (FXD4/2019/10) which was undersubscribed with a performance of 76.8% (KES.38.4Bn) against a target of KES.50Bn (Fig.2).
- CBK offered a tap Sale for the same bond with a subscription rate of 37.5% (KES.8.1Bn) against KES.21.7Bn offered.
- We believe the undersubscription was partly attributed to investors adopting a wait and see approach in anticipation for a potential increase in interest rates after the repeal of the rate cap law.

Fig.2: CBK accepts KES.28Bn in November for the 10-Year issue

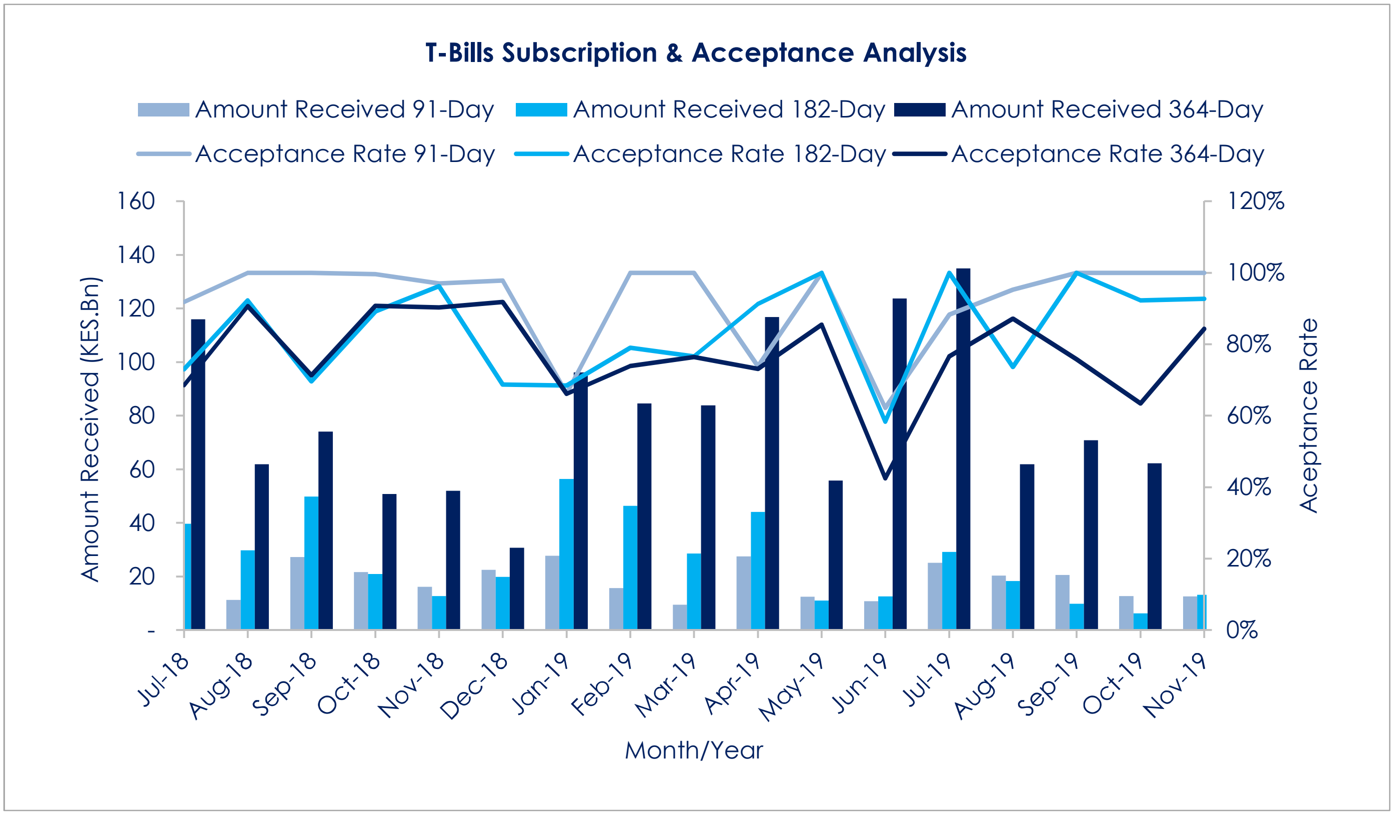


Source: Central Bank of Kenya

Demand for the 364-Day paper remains high

- In November the 364-day paper was highly subscribed at 152.1% while the 91-day and 182-day T-Bills were undersubscribed at 78.3% and 33.1% respectively.
- During the month, acceptance rates for the 91-day, 182-day and 364-day papers stood at 100%, 92.7% and 84.3% respectively (Fig.3).
- Demand was high for the 364-Day paper but CBK remained disciplined in rejecting expensive bids in order to ensure the stability of interest rates.

Fig.3: High demand for 364-day T-Bill with 100% acceptance rate for the 91-day T-Bill

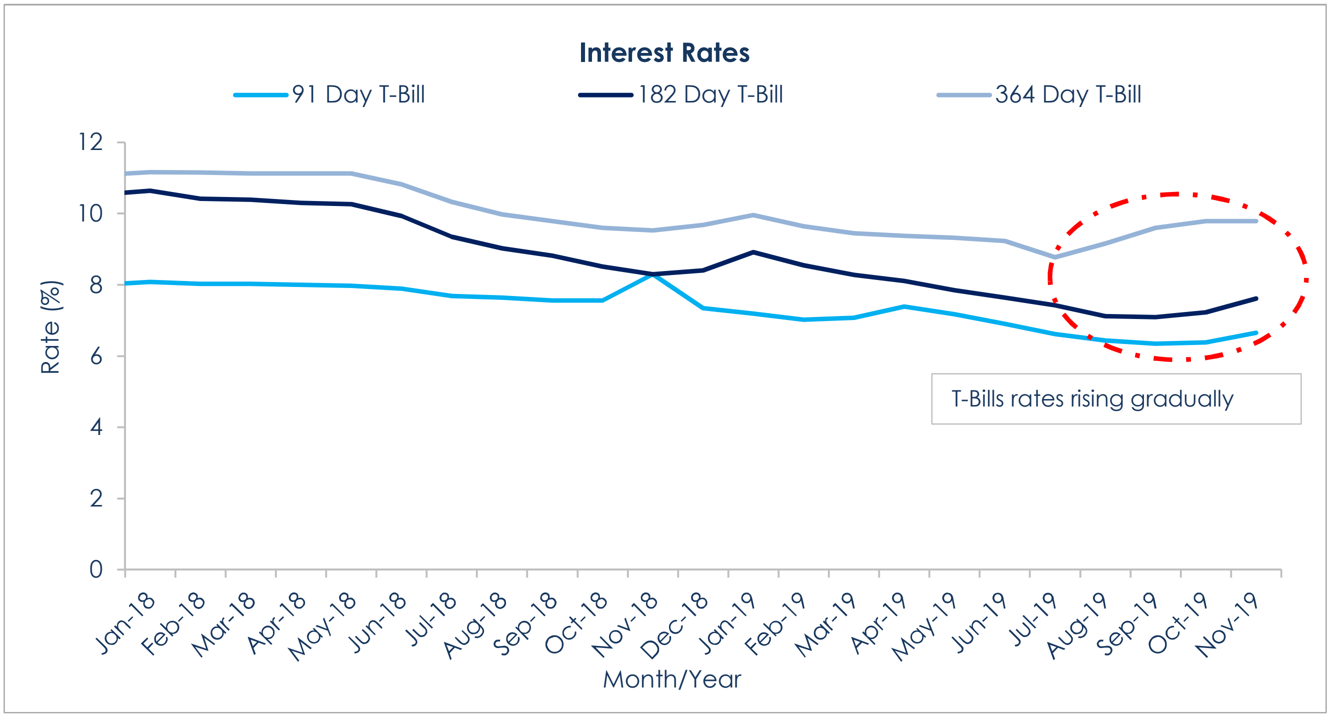


Source: Central Bank of Kenya

T-Bill yields rising gradually after the rate cap removal

- In November, the average yields for the 91-day and 182-day papers rose by 0.3% and 0.4% to 6.7% and 7.6% respectively while the 364-day paper remained flat at 9.8% (Fig.4).
- During the month the T-Bills acceptance rate rose to 87.8% (KES.76.0Bn) compared to 71.4% (KES.57.9Bn).
- Following the removal of the interest rate caps we expect the rate to increase further but gradually.

Fig.4: Short-term domestic debt interest rates rising gradually

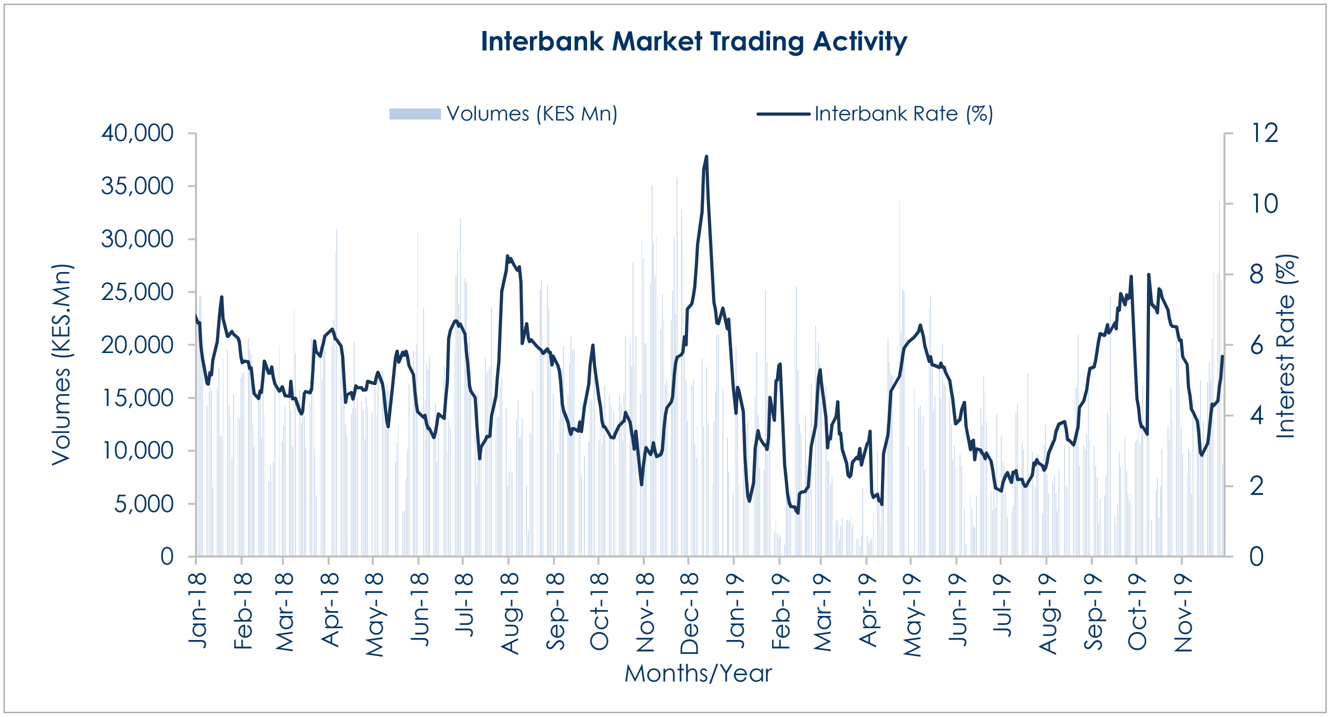


Source: Central Bank of Kenya

Inter-bank lending rates declines in November due to high market liquidity

- Average inter-bank lending rates declined to 4.3% in November from 6.0% the previous month (Fig.5).
- However, total volumes traded went up 33.0% to KES.333.6Bn from KES.250.9Bn in October.
- This is attributed to high market liquidity supported by government open market activities such as selling the dollar to increase dollar liquidity, which offset tax payments.
- In December, we expect inter-bank rates to increase owing to tight market liquidity due to annual financial reporting by financial institutions which normally leads to lower trading activity.

Fig.5: Inter-bank lending rates expected to increase in December

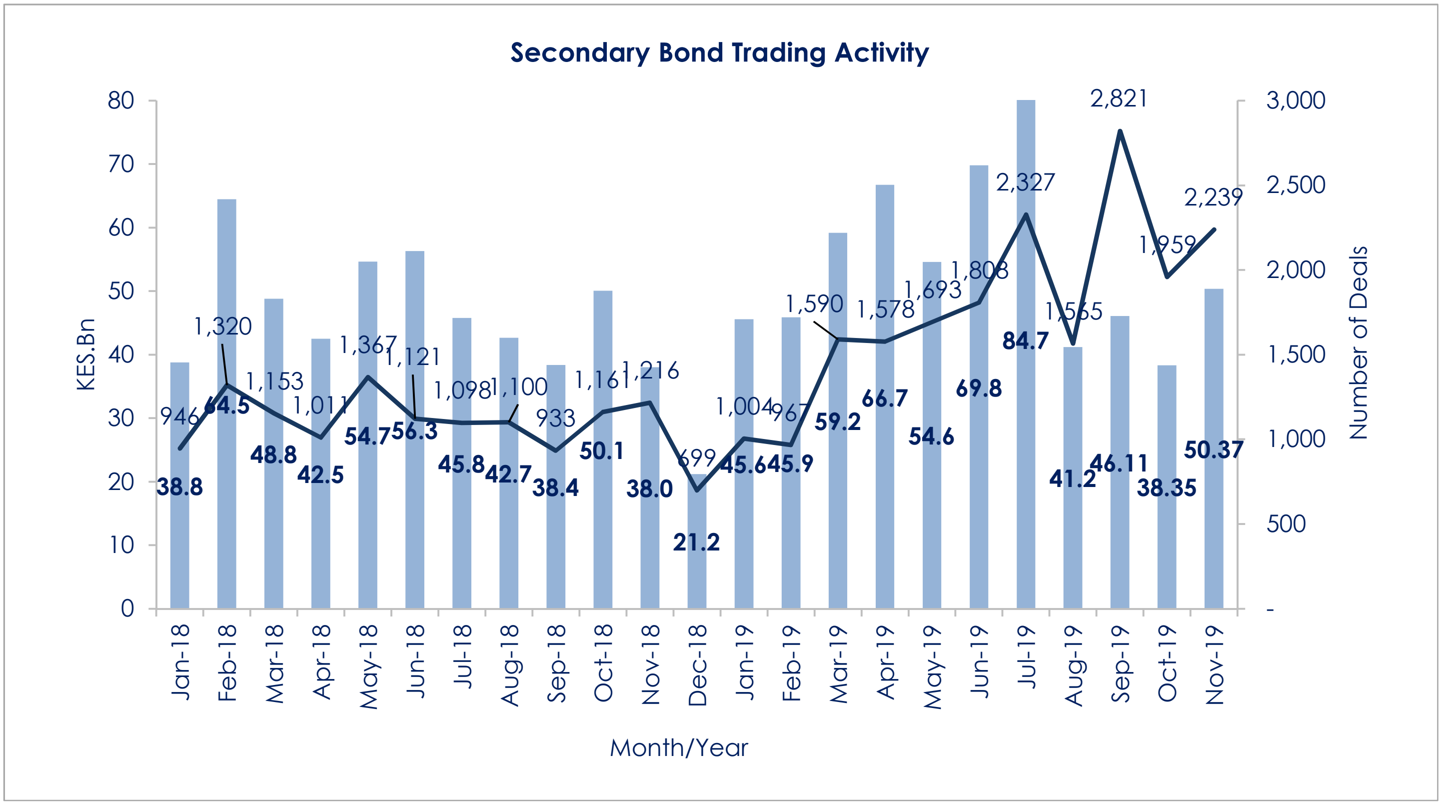


Source: Central Bank of Kenya

31.3% increase in Secondary market trading activity

- Activity in the secondary market rose 31.3% in November to KES.50.4Bn while the number of deals increased 14.3% to 2,239 (Fig.6).
- We attribute the high secondary market trading activity to demand for IFB1/2019/16 which was the highest issue ever as CBK offered KES.60Bn and received KES.86.9Bn (144.9% subscription rate).
- In December we expect the secondary market activity to decline owing the festive season and uncertainty in the market in-terms of the direction of interest rates.

Fig.6: High Secondary trading activity as turnover rises 31.3%

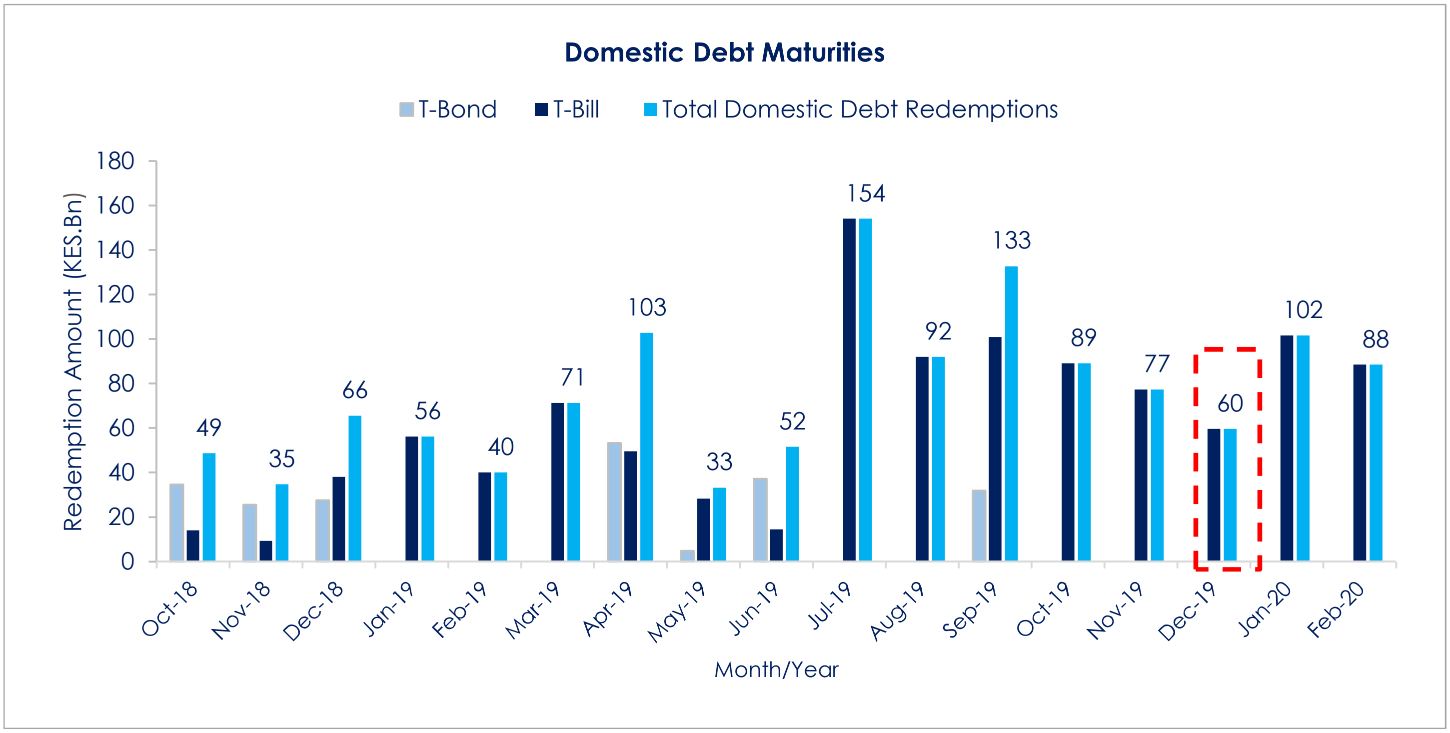


Source: Central Bank of Kenya

December T-bill redemptions at KES.60Bn

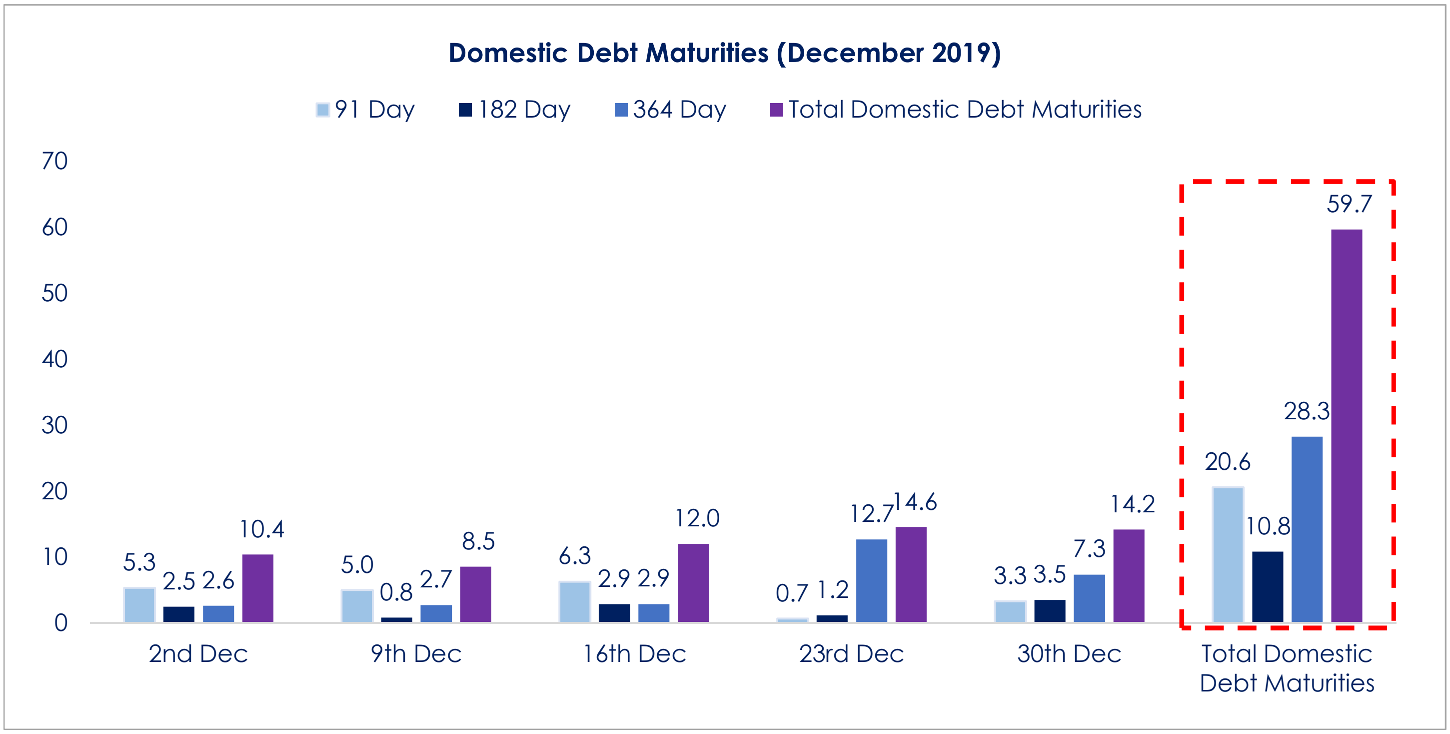
- Total domestic debt redemptions for December are KES.60Bn a decline from KES.77.3Bn for the previous month (Fig.7).
- Majority of the redemptions are 364 and 91 day T-bills which are KES.28.3Bn and KES.20.6Bn respectively. 182-day redemptions account for 18% of the total redemptions at KES.10.8Bn.
- There are no bond maturities outstanding for the month and coming months till April 2020.
- The steady decline in debt redemptions to the end of the calendar year means that most debt issue proceeds for December will be directed to financing the budget rather than rollovers.

Fig.7: December debt maturities at KES.60Bn



Source: Central Bank of Kenya

Fig.8: Weekly debt maturities in December 2019



Source: Central Bank of Kenya

National Treasury receipts at 31% of total FY2019/20 target

Domestic borrowing above target 39.3% compared to 33.3% in the first four months

- Total National Government receipts at the end of October 2019/20 (stood at KES.803.1Bn or 30.9% of the total revised receipt target amount (KES.2.6Tn) (Table.5).
- We particularly draw attention to total tax income and domestic borrowing which were at 27.6% and 39.3% respectively.
- Total tax income collected is below target as at end of October. On the basis of a linear run rate it should be at 33.3% (fig.9) equivalent to KES.601.9 in the first 4 months.
- However only KES.493.3Bn has been achieved presenting a shortfall of KES.108.6Bn.
- Domestic borrowing however is above the target at 39.3% a move aimed at countering the shortfall in revenues.
- KES.168.6Bn was raised from the domestic debt market of the total target in the period under focus.

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

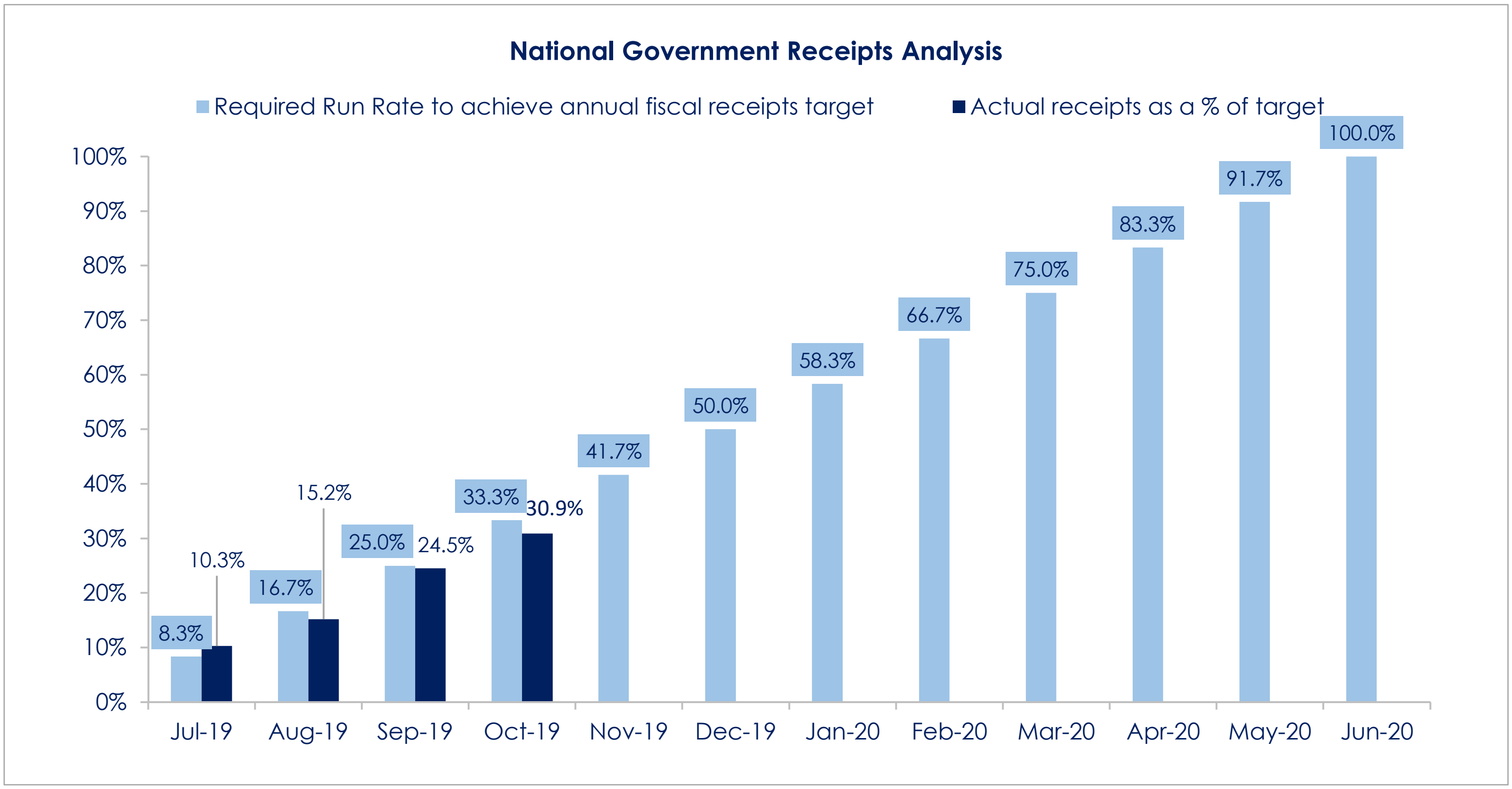
Receipts	2019/20 Original Estimates (KES)	Actual Receipts (KES) 30th Sep 2019	Actual Receipts (KES) 31st Oct 2019	Proportion of Receipt Target Achieved End Oct
Opening Balance (1st July 2019)		98.9	98.9	
Total Tax Income	1,807.6	372.3	493.3	27.6%
Total Non-Tax Income	69.5	12.0	15.6	22.5%
Domestic Borrowing*	429.4	144.1	168.6	39.3%
Loans -Foreign Gov't & International Org	65.2	3.3	6.3	9.7%
Programme Loan-Budget support	2.0	2.5	4.7	233.3%
Domestic Lending & on-lending	4.3	1.2	1.5	33.8%
Grant -Foreign Gov't & International Org	14.5	1.0	5.1	35.4%
Grants from AMISON	5.0	0.0	1.9	38.8%
Commercial Loan	200.0	0.0	0.0	0.0%
Unspent Balances (Recoveries)		2.1	2.2	-
Total Revenue	**2,598**	**637.4**	**803.1**	**30.9%**

Source: The Kenya Gazette Vol. CXXI - No.156 15th November 2019

* Note 1: Domestic Borrowing of KES. 429.4 = Net Domestic borrowing KES.306.8 & Internal debt redemptions (Roll-overs) KES.122.6.

- We continue to use a linear growth rate as a basis of monitoring the performance of the national Government in terms of its receipts and we see there is a 2.4% shortfall by end of October for FY2019/20 (Fig.9).
- We expect this to be the case the remaining part of the year on the back of missed revenue targets.

Fig.9: 31% fiscal receipt target achieved in the first 4 months 2019/20



Source: The Kenya Gazette Vol. CXXI - No.156 15th November 2019

Domestic debt yields on the short end of the curve decline year on year

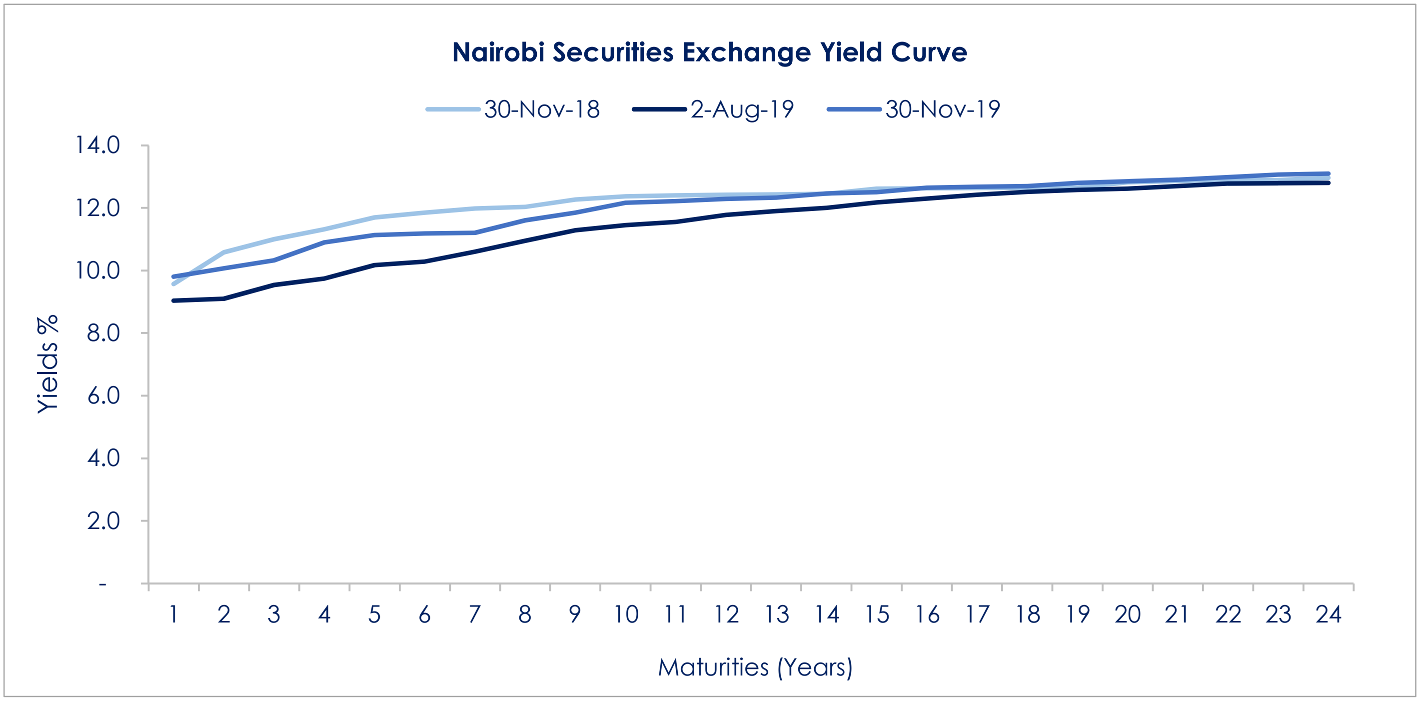
- A comparison of yields this month and one year ago show an increase in yields on the 1 year paper and long term papers above 15 years.
- All the other tenors dipped in yields, with the medium term bonds showing the biggest decline.
- We expect to see a gradual upward shift in the yield curve, following 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 the 1Yr and 20Yr paper increase while medium term rates dip

Tenor	Yield (30th Nov 2018)	Yield 30th Nov 2019)	Change (Bps)	Sterling Capital yield Curve (4th Dec 2019)
1	9.5640	9.8000	↑23.6	9.9
2	10.5815	10.0714	↓51.0	10.3
5	11.6975	11.1375	↓56.0	11.35
10	12.3680	12.1668	↓20.12	12.18
15	12.6126	12.5063	↓10.63	12.73
20	12.8167	12.8525	↑3.58	12.85

Source: Nairobi Securities Exchange

Fig.10: Long term Yields edge upwards year on year

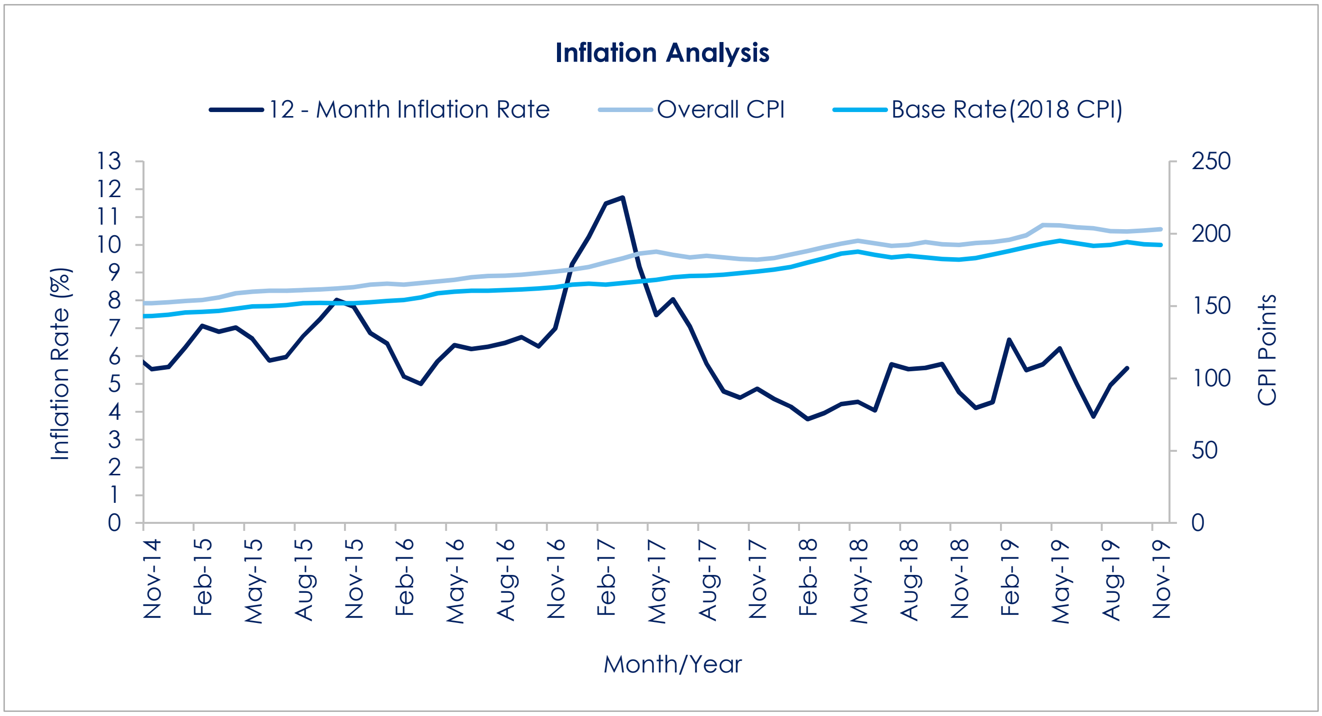


Source: Nairobi Securities Exchange

November inflation rises to 5.56%, an increase in December expected

- Inflation rate rose to 5.6% in November inflation from 4.95% in October mainly due to a 0.6% increase in the food and non-alcoholic drinks' index to 9.6%.
- During the period, prices of potatoes (Irish), tomatoes, maize flour-sifted, green grams and mineral waters increased by 7.0%, 6.1%, 4.3%, 3.9% and 2.4% respectively.
- During the month the prices of other essential services increased. Transport Index went up 0.3% owing to the increase in pump prices of diesel and petrol by 2.2% and 2.0% respectively.
- Housing, Water, Electricity, Gas and Other Fuels' Index, rose 0.3% mainly as a result of an increase in cost of house rent and cooking fuel, following the 2.5% increase in Kerosene prices.
- Annual average inflation remained flat at 5.2% in November as in October.
- **We expect December inflation rate to range between 5.5-6.0% due to temporary effects of increase in food prices and the festive season.**
- Following the favorable rainfalls in November, we expect the prices of foodstuffs to decline in the first quarter of 2020 which in turn will ease the pressure of inflation.
- The rise in inflation is still within the Central Bank of Kenya's (CBK) target range of 2.5% - 7.5%.
- However, for investors high inflation erodes real return from investments.
- Therefore, CBK will have to offer investors an even higher rate of return for investing in government securities in order to offset the decline in returns owing to a higher rate of inflation.

Fig.12: December inflation forecast 5.5%-6.0%



Source: Kenya National Bureau of Statistics

Monetary Policy Committee reduces the CBR to 8.5%

- The Monetary Policy Committee (MPC) met on 25th November, 2019, to review the outcome of its previous policy decisions and recent economic developments.
- The meeting was held against a backdrop of domestic macroeconomic stability, the recent repeal of interest rate caps, and heightened global uncertainties and volatility in international markets.
- The MPC noted that inflation expectations remained well anchored within the target range, and assessed that the economy was operating below its potential level.
- Furthermore, the Committee noted the ongoing tightening of fiscal policy and concluded there was room for accommodative monetary policy to support economic activity.
- The MPC, therefore, decided to lower the Central Bank Rate (CBR) to 8.50% from 9.00%.
- **The committee's decision to reduce the benchmark rate in our opinion is driven by the need for economic stimulus through private sector lending.**
- **However we do not expect this to have a significant impact on private sector credit growth due to the repeal of the interest rate capping law on lending.**
- The rationale behind our prediction is that the repeal of the rate cap has given banks the leeway to lend at rates they deem fit. We expect them to maintain lending rates at 13% in the short run.
- This will therefore not offer reprieve for borrowers who with rate caps would have borrowed at 12.5% in the interest rate capping regime.
- Similar to central banks in major advanced economies CBK has implemented a more accommodative monetary policy to support growth and financial stability.
- The CBK's decision comes amidst statistics released which show that private sector credit growth stood at 6.6% in October from 7.0% growth in September.
- Private sector credit growth is still below the CBK's target rate of 12-15% which they deem to be sufficient to enhance economic growth.
- The next meeting will be held on Monday, 27th January 2020 and we expect the rate to be maintained as the committee observes the effect of the decline on the economy.

Disclosures

Ownership and material conflicts of interest:
The authors or a member of their household, of this report do not hold a financial interest in the securities of this company. The authors or a member of their household, of this report do not know of the existence of any conflicts of interest that might bias the content or publication of this report.

Position as an officer or director: The authors or a member of their household, do not serve as an officer, director or advisory board member of the subject company.

Research analyst certification:
The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that all of the views expressed herein accurately reflect their personal views. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the view(s) expressed by that research analyst in this research report.

Additional Disclosures:
This research report is for distribution only under such circumstances as may be permitted by applicable law. This research report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient, even if sent only to a single recipient. This research report is not guaranteed to be a complete statement or summary of any securities, markets, reports or developments referred to in this research report. Neither SCL nor any of its directors, officers, employees or agents shall have any liability, however arising, for any error, inaccuracy or incompleteness of fact or opinion in this research report or lack of care in this research reports preparation or publication, or any losses or damages which may arise from the use of this research report.

Disclaimer:
This research report was prepared under the supervision of the Research Department of Sterling Capital Limited (SCL), a company authorized to engage in securities activities in Kenya, and with partnerships in Uganda, Rwanda, Zimbabwe, and Tanzania. Data used in this report was gathered from reliable sources, but the analyst(s) and the publishers of this report do not hold themselves responsible for the accuracy or completeness of data used. The report provides the opinions, analyses and conclusions of the Research division only and is provided without any warranties of any kind.

This report does not constitute an offer, or the solicitation of an offer, for the sale or purchase of any security. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. Whilst every care has been taken in preparing this report, no representation, warranty or undertaking (express or implied) is given and no responsibility or liability is accepted by SCL or any employee of SCL as to the accuracy, timeliness, completeness merchantability or fitness for any particular purpose of any such recommendation or information contained and opinions expressed herein. SCL do not accept any liability for any direct or remote loss or damage arising out of the use of all or any part of the information contained in this report.

This report is published for information purposes only and is not an offer to solicit, buy or sell any security of any kind. This report does not provide customized investment advice. It has been prepared without regard to the individual financial circumstances and risk and return objectives of individuals who receive it. The appropriateness of a particular investment will depend on an investor's individual circumstances, risk tolerance and return objectives. The investments securities referred to in this document may not be suitable for all or certain categories of investors. The Research Division and SCL have implemented Chinese walls procedures to prevent any conflict of interest. Other additional information may be available at SCL.

Further disclosure regarding SCL policy on potential conflicts of interest in the context of investment research and SCL policy on disclosure and conflicts in general are available on request. The opinions presented in this note may be changed without prior notice or cannot be depended upon if used in the place of the investor's independent judgment. The historical performance of a security is not representative of the security's future returns. Investment in securities can be highly risky as security prices may go down in value as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may adversely affect the value, price or income of that investment. In case of illiquid investments for which there is no organized market it may be difficult for investors to exit investment positions or to obtain reliable information about its value or the extent of the risk to which it is exposed. The information contained in this report is confidential and is solely for use to those persons to whom it is addressed and may not be reproduced, further distributed to any other person or published, in whole or in part, for any purpose.