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STERLING CAPITAL LIMITED

Fixed Income Note

August 2021

"Liquid despite mop-up"

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- Our fixed income report for the month of August 2021 titled **"Liquid despite mop-up"** is a detailed investment analysis of this month's re-opened ond issues, fixed income maket dynamics and the macro-economic environment.
- The Central Bank of Kenya seeks to raise KES.60Bn this month through three re-opened bonds; **FXD3/2019/10, FXD1/2018/20 and FXD1/2021/20**.
- Our weighted average bid predictions are as follows:

Weighted Average Rate (WAR) of investor bids

- **FXD3/2019/10: 12.15% - 12.20%**
- **FXD1/2018/20: 13.25% - 13.30%**
- **FXD1/2021/20: 13.45% - 13.50%**

WAR of accepted bids

- **FXD3/2019/10: 12.05% - 12.10%**
- **FXD1/2018/20: 13.15% - 13.20%**
- **FXD1/2021/20: 13.35% - 13.40%**

- The report examines domestic primary and secondary debt auction as well as inter-bank trading activity.
- Domestic Debt redemptions are also reviewed to give direction on expected debt service for the coming month which will impact CBK's borrowing strategy.
- Our fixed income portfolio allocation remains skewed to the IFB's as highlighted in the trading ideas section based on the current and expected yield curve movements.
- The yield curve section summarises the trends in domestic debt interest rates over the period in focus and gives a recommendation of the best tenor to invest in.
- We give our inflation review for July and expectations towards the end of the report which concludes with our view on the Monetary Policy Committee (MPC) decision in their latest meeting.

CBK issues re-opens three long-term debt issues to raise KES.60Bn

- The Central Bank of Kenya (CBK) invites bids for three re-opened treasury bonds **FXD3/2019/10, FXD1/2018/20** and **FXD1/2021/20** with a target amount of KES.60Bn (Table.1).
- The three debt issues have a term to maturity of 8.1, 16.7 and 20 years respectively.
- While FXD3/2019/10 and FXD1/2018/20 have fixed coupon rates of 11.517% and 13.2% respectively, FXD1/2021/20 will have a market determined rate.
- This month's issues are consistent with the CBK's strategy of lengthening the Average Term to Maturity (ATM) of public debt through issuance of long-term bonds
- We expect full subscription for the bonds because of high market liquidity.

Table.1: Primary Bond issue summary

Issue Number	FXD3/2019/10	FXD1/2018/20	FXD1/2021/20
Total Amount Offered		KES.60Bn	
Tenor (Years)	10 Years	20 Years	20 Years
Term to Maturity	8.1 Years	16.7 Years	20 Years
Coupon Rate (%)	11.517	13.20	Market Determined
Price Quote		Discounted/Premium/Par	
Period of Sale		26th July 2021 to 10th August 2021	
Auction Date		11th August 2021	
Value Date		16th August 2021	
Yield Curve (%) (Weighted average tenor - 30th July 2021)	**12.007**	**13.0878**	**13.2450**

Source: Central Bank of Kenya

Our weighted average bid estimates

- Analysis of yields of bonds of similar tenors on the Nairobi Securities Exchange (NSE) as at 30th July 2021 as well as discussions with fixed income traders resulted in the following bid predictions for the treasury bonds (Table.2).

Table.2: Auction bid predictions

Description	FXD3/2019/10	FXD1/2018/20	FXD1/2021/20
Market Weighted Average Rate (%)	12.15 - 12.20	13.25 - 13.30	13.45 - 13.50
Weighted Average Rate of Accepted Bids (%)	12.05 - 12.10	13.15 -13.20	13.35 -13.40

Source: Sterling Capital Research

Historical debt issues provide guidance

- We used implied yields of bonds of almost similar tenors to maturities on the Nairobi Securities Exchange (NSE) as at 30th July 2021 to determine possible investor bids (Table.3).

Table.3: Benchmark issues to guide investor bids

Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years (Days)	Implied Yield to maturity (%)	Yield Curve at time of issue
FXD3/2019/10						
FXD3/2019/10	19th Aug 2019	11.52%	6th Aug 2029	8.0 (2,928)	11.9859	11.45
FXD4/2019/10	25th Nov 2019	12.28%	12th Nov 2029	8.3 (3,026)	12.0000	11.71
FXD1/2018/20						
FXD1/2018/20	26th Mar 2018	13.20%	1st Mar 2038	16.6 (6,057)	13.0035	13.2728
FXD2/2018/20	30th Jul 2018	13.20%	5th Jul 2038	16.9 (6,183)	13.1427	13.30

Source: Central Bank of Kenya

Full Subscription expected with a bulk of bids on the 10-year issue

- A historical comparison of primary auction results for 10 and 20 year issues show higher investor appetite for the former (Table.4).
- This can be explained by the comparatively shorter tenor making it preferable for investors with a shorter investment horizon such as banks.
- For this reason, there has been higher price appreciation on the shorter tenor paper.
- High market liquidity in spite of CBK mop-up activity will drive demand for this month's debt issues and therefore we expect an oversubscription.
- FXD3/2019/10 would be the preferred bond in this auction and we see it receiving a bulk of investor bids.
- The CBK is likely to limit the acceptance rate for the shorter tenor issue to as part of its strategy to manage average term to maturity of domestic debt.

Table.4: Historical primary market auction performance

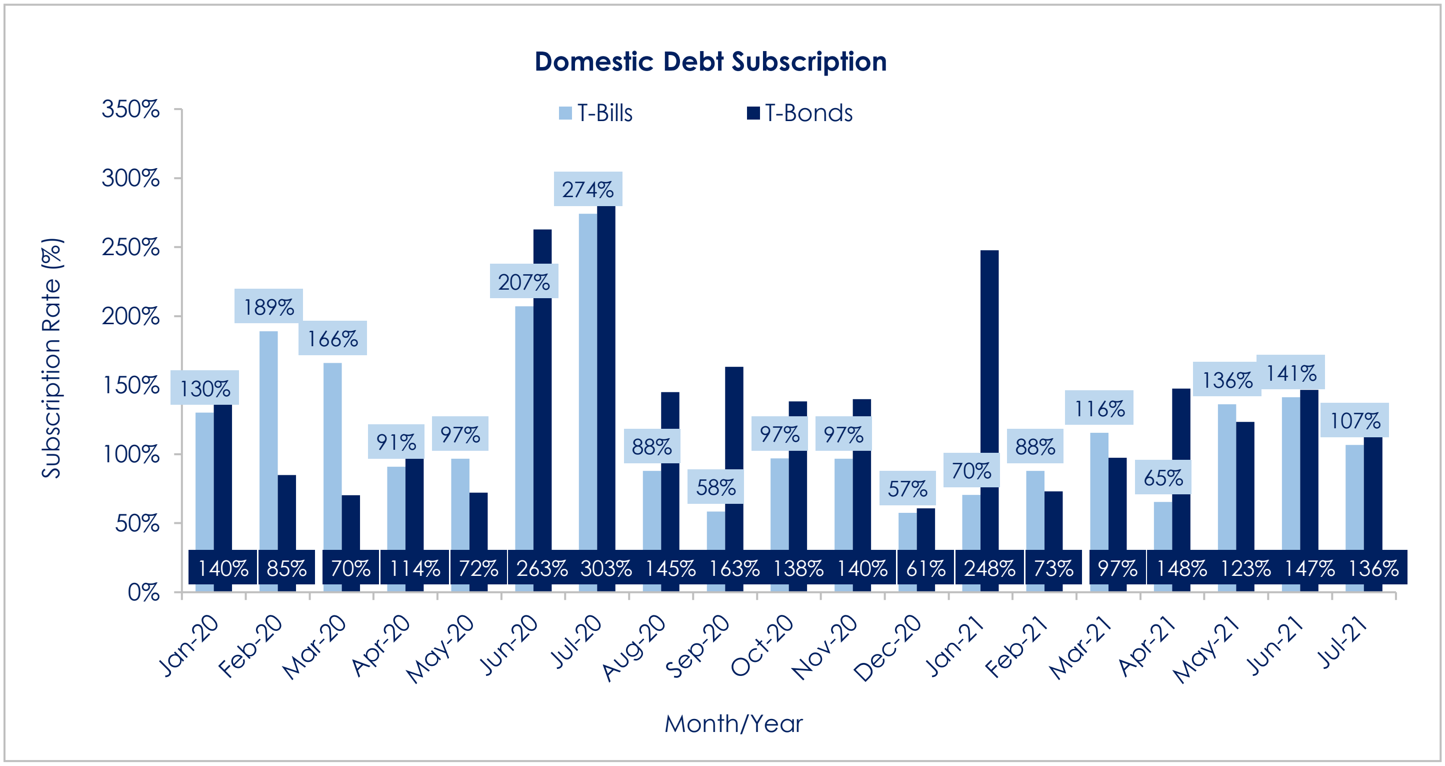
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yields (%)
10-Year						
FXD1/2016/10	25	26.3	18.3	105.2	15.0	11.0934
FXD1/2017/10 (Re-opened)	30	11.8	5.4	39.3	12.9	11.3688
FXD1/2018/10	40	29.8	19.4	74.6	12.7	11.8344
FXD1/2018/10 (Re-opened)	40	22.1	21.2	55.3	12.7	11.8344
FXD2/2018/10	40	28.9	26.2	72.15	12.5	11.9126
FXD1/2019/10 (Re-opened)	50	25.4	19.3	50.9	12.4	11.9583
FXD1/2019/10 (Re-opened)	50	15.9	15.5	31.8	12.4	11.9583
FXD2/2019/10	50	70.9	51.3	141.9	12.3	11.9664
FXD3/2019/10	50	52.8	45.0	105.5	11.5	11.9859
FXD4/2019/10	50	38.4	28.4	76.8	12.3	12.0000
FXD4/2019/10 (Re-opened)	40	44.2	32.8	110.6	12.3	12.0000
20-Year						
FXD1/2016/20	25	17.8	12.3	49.2	14.0	12.8824
FXD1/2018/20	40	13.7	8.5	34.3	13.2	13.0035
FXD1/2018/20 (Re-opened)	40	28.9	27.5	72.2	13.2	13.0035
FXD1/2018/20 (Re-opened)	50	19.8	8.3	39.6	13.2	13.0035
FXD2/2018/20 (Re-opened)	50	32.8	32.8	65.6	13.2	13.1427
FXD1/2019/20	50	14.7	9.0	29.36	12.9	13.1629
FXD1/2019/20(Re-opened)	30	41.0	13.4	136.8	12.9	13.1629
FXD1/2012/20(Re-opened)	30	23.9	6.3	79.6	12.0	12.3750

Source: Central Bank of Kenya

CBK liquidity mop-up affecting T-Bill demand

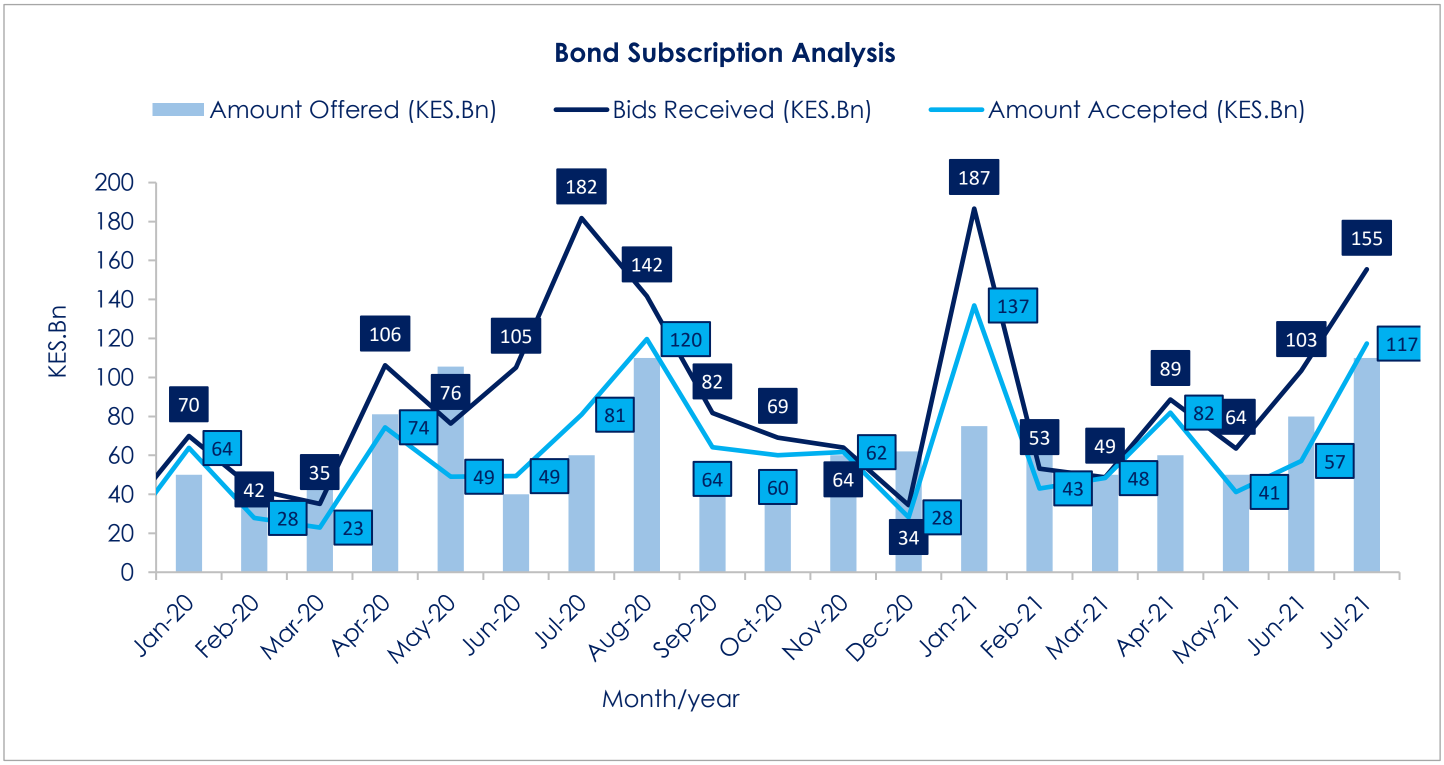
- A historical comparison of primary auction results for 10 and 20 year issues show higher investor appetite for the former (Table.4).
- This can be explained by the comparatively shorter tenor making it preferable for investors
- T-Bills subscription declined to 106.6% in July 2021 from (141.3%) in June with the CBK receiving T-Bills worth KES.102.4Bn against KES.96Bn offered (Figure.1).
- The 91-day and 182-day T-Bills received the highest subscription rates at 213.4% (KES.34.1Bn) and 119.7% (KES.47.9Bn) respectively while the 364-day paper was undersubscribed at 50.8% (KES.20.3Bn).
- The decline in T-Bill demand especially from banks was attributable to CBK's liquidity mop up activity with the average Term Auction Deposit (TAD) offering 5.450% compared to an average T-Bill rate of 6.486%.
- The technical aspects of the TAD particularly the flexibility in tenure (3 - 90 days) and liquidity appeals to commercial banks
- Bonds issued during the month recorded high subscription with FXD1/2012/15, FXD1/2018/15 and FXD1/2021/25 receiving an aggregate bid worth KES.116.9Bn against the KES.60Bn offered, equivalent to a subscription of 194.9%. (Figure.2).
- Demand for T-Bills in August is likely to decline if the CBK's liquidity mop-up activity persists.
- The 91-Day T-Bill will continue to receive a bulk of investor bids because of a comparatively favourable return (compared to the 182 and 364 day T-Bills) on a risk adjusted basis.

Figure.1: Demand for T-Bills declining as banks shifts preference for CBK's Term Auction Deposits



Source: Central Bank of Kenya

Figure.2: High demand for long-term domestic debt sustained

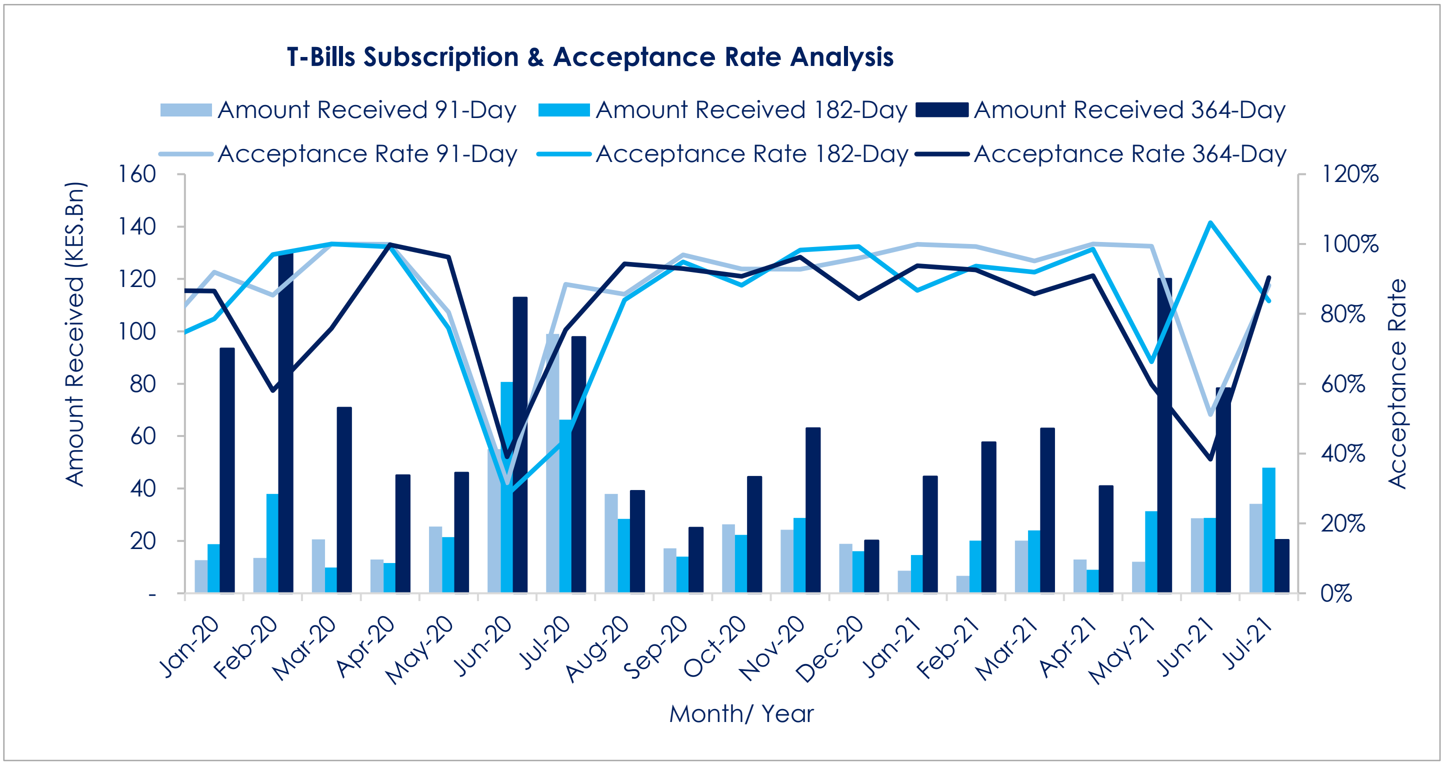


Source: Central Bank of Kenya

Have T-Bill rates bottomed out?

- As mentioned already in this report, CBK liquidity mop-up activity was the main reason for the decline in T-Bill demand during the month.
- July CBK acceptance rates for the 91, 182 and 364 day T-Bills were 88.2%, 83.7% and 90.4% against subscription rates of 213.4%, 119.7% and 50.8% respectively (Figure.3).
- We are beginning to see some signs of short-term rates bottoming out with rates on the 91 and 182 day papers rising in the last auction of the month while that of the 364 day dipped marginally.

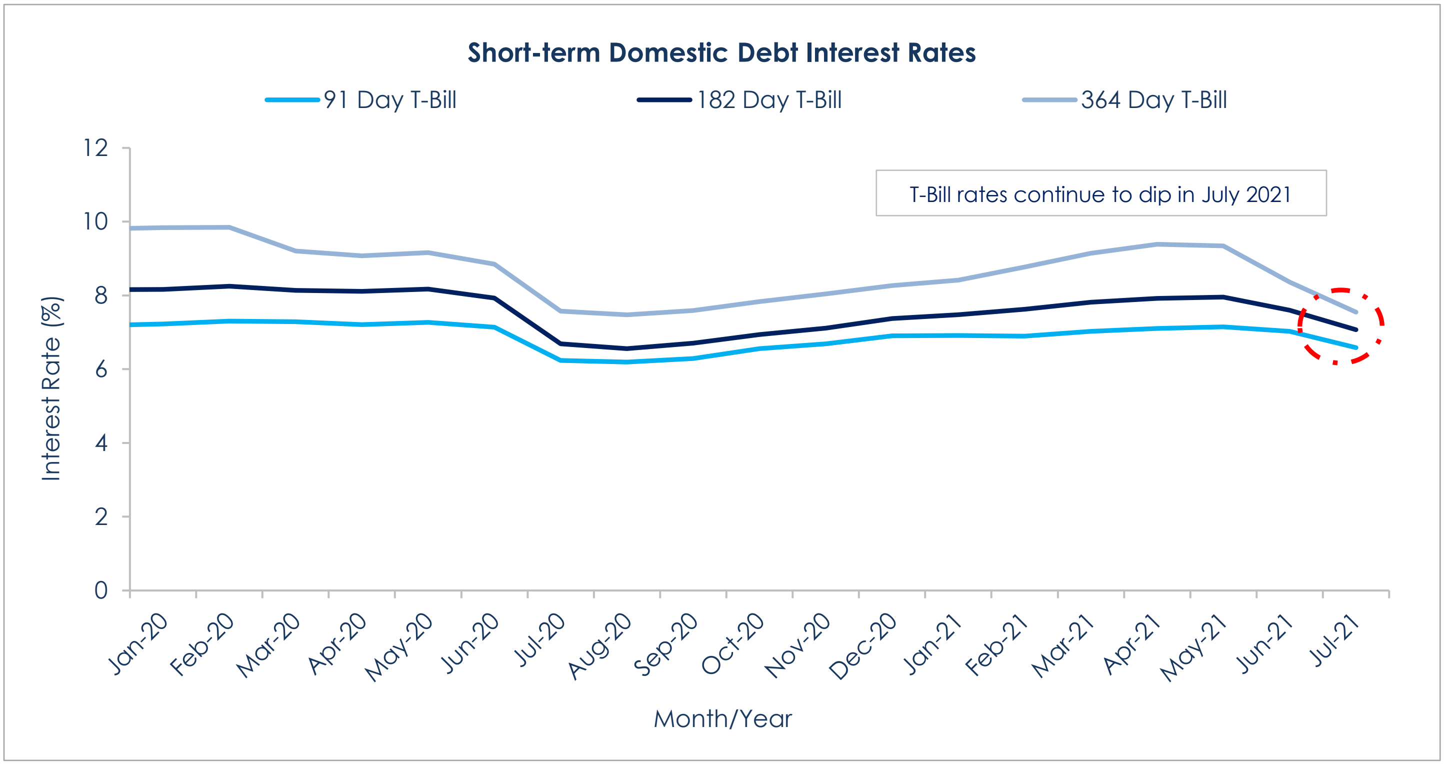
Figure.3: T-Bill demand declining as CBK mops up excess liquidity



Source: Central Bank of Kenya

- Average interest rates for the 91-day, 182-day and 364-day T-Bills in July 2021 declined to 6.6%, 7.1% and 7.5% compared to 7%, 7.6% and 8.4% in the previous month (Figure.4).
- This was attributable to high market liquidity during the month a scenario that prompted heightened CBK activity in the money market.
- The slowdown in the rate of decline in recent weeks could be the indication investors have been waiting for, that short-term rates are bottoming out.
- The likely effect of the above is increased demand for the shortest tenured T-Bill.

Figure.4: Short-term debt securities interest rates decline

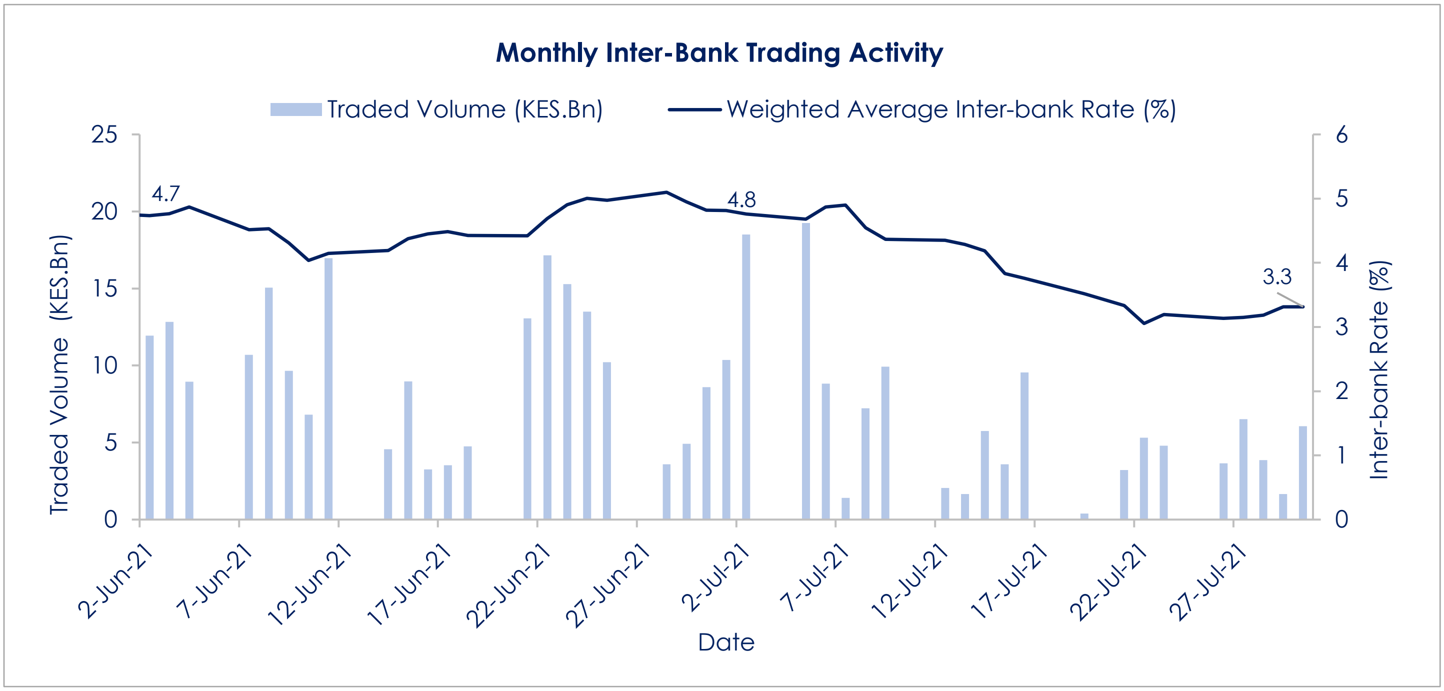


Source: Central Bank of Kenya

July 2021 average inter-bank rate at 3.9%

- The average inter-bank rate declined to 3.9% in July 2021 from 4.6% in June because of high market liquidity (Figure.5).
- During the period under review, total inter-bank trading volumes declined to KES.133.6Bn compared to KES.204.3Bn in June 2021.
- High market liquidity during the month was a result of Government cash releases to the county Governments and other payments, which partly offset tax receipts.
- Our forecasted average inter-bank rate range for August 2021 is 3.8% - 4.8%.

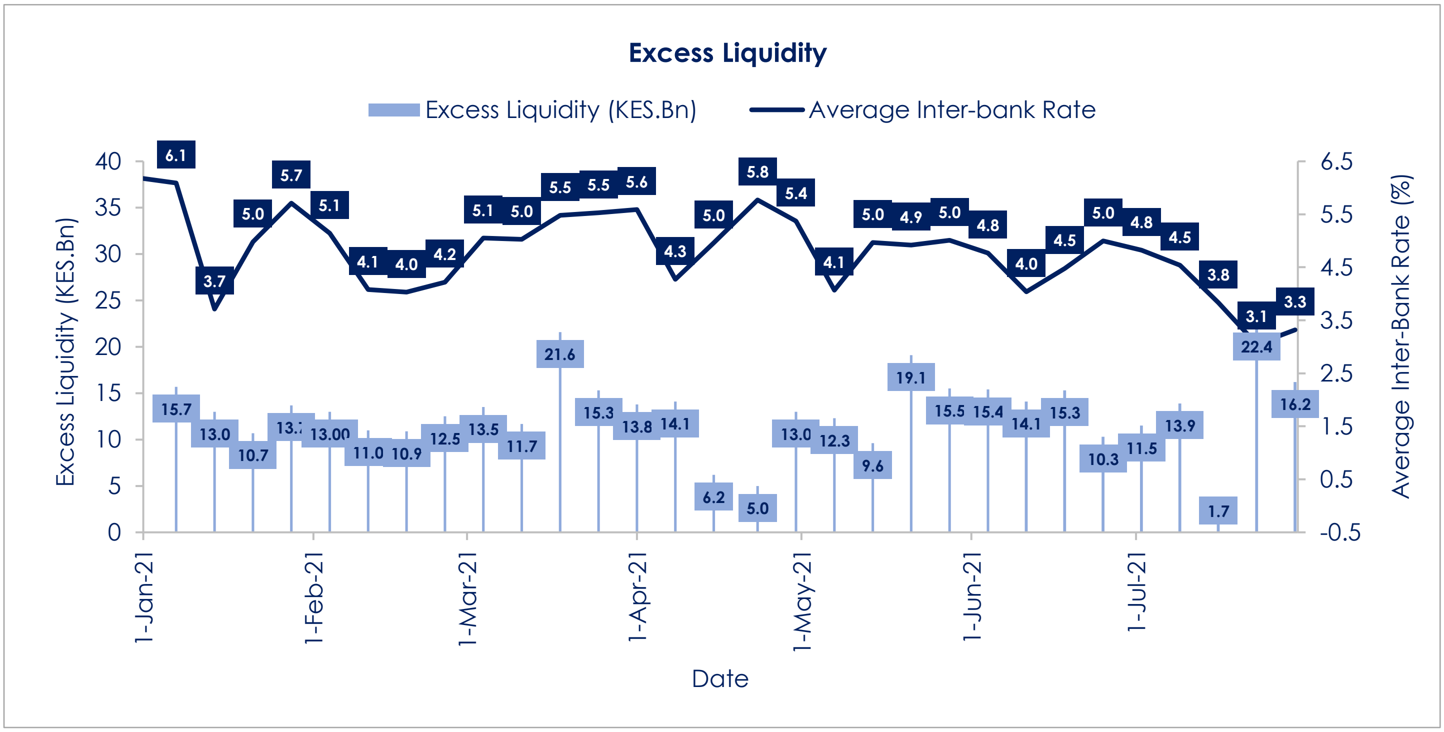
Figure.5: Inter-bank lending rates to range between 3.8% and 4.8% in August 2021



Source: Central Bank of Kenya

- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) over the same period increased to KES.65.7Bn, 19% above KES.55.1Bn a month earlier indicating the sharp increase in market liquidity (Figure.6).

Figure.6: Sharp increase in excess commercial bank liquidity in July 2021

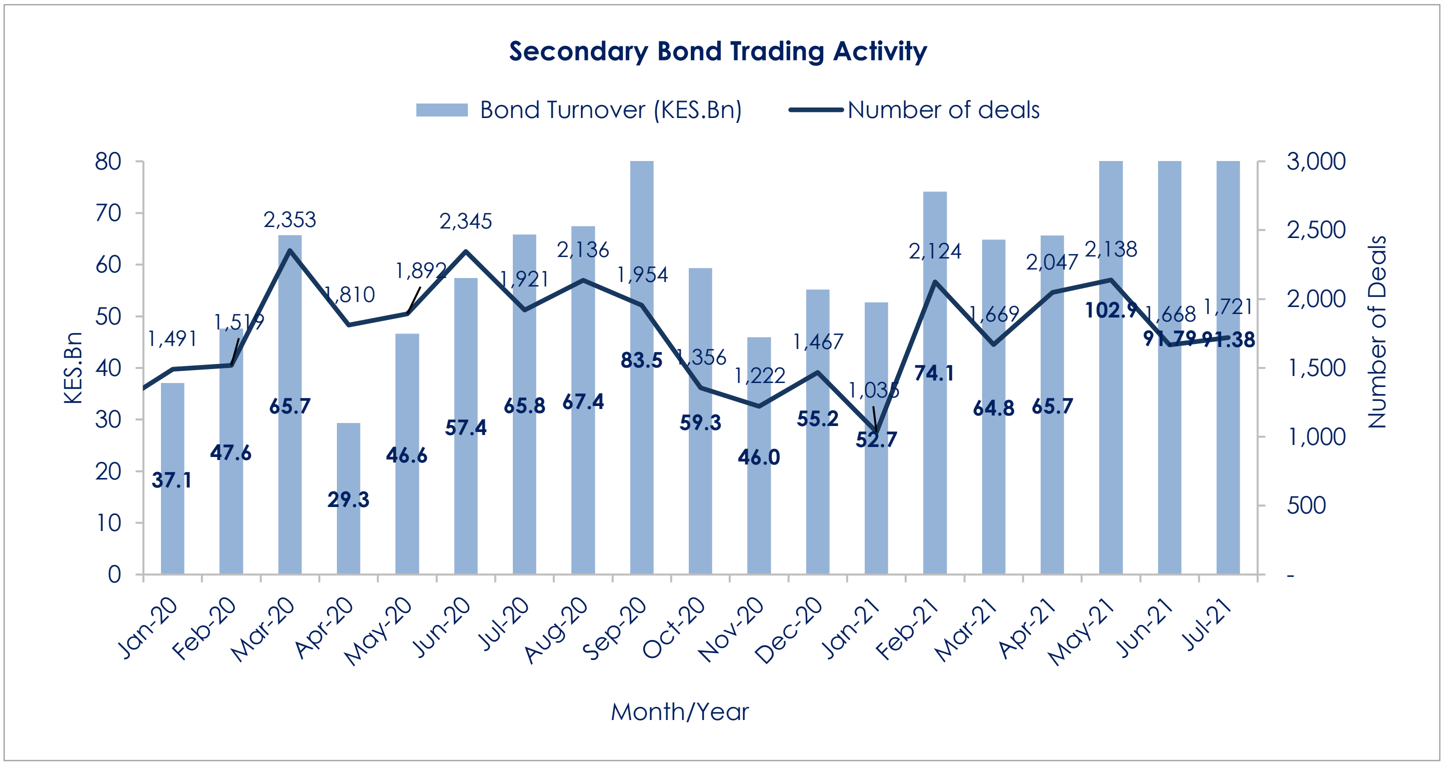


Source: Central Bank of Kenya

Secondary market bond turnover to increase in July 2021

- Total bond market trading turnover stood at KES.91.4Bn at the end of July, down from KES.91.8Bn the previous month with the number of deals over the same period at 1,721 compared to 1,668 in July (Figure.7).
- We attribute the comparatively low trading activity in the secondary market to capital diverted to re-opened bond issues.
- We have seen heightened liquidity mop-up and this could affect August secondary market trading activity.

Figure.7: Secondary trading activity declines in July 2021



Source: Central Bank of Kenya

Trading ideas - Investors buy IFB's and high yielding FXD

- Infrastructure Bonds (IFBs) have relatively high yields, favorable return in the secondary market and are tax exempt and we therefore recommend the following bonds for investors with a fixed income allocation portfolio.
- We single out IFB1/2020/09, IFB1/2020/11 and IFB1/2021/16 as suitable investment options (Table.5).
- We also view bonds with a six year tenor as favourable and with this in mind, we single out FXD1/2013/15 and FXD2/2013/15.

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2020/09	7.68	10.85	4.96	10.80	10.37
IFB1/2020/11	10.03	10.90	5.75	10.95	10.26
IFB1/2021/16	15.44	12.26	6.93	12.00	11.79
FXD1/2013/15	6.53	11.25	4.27	11.70	10.83
FXD2/2013/15	6.70	12.00	4.37	11.75	11.49

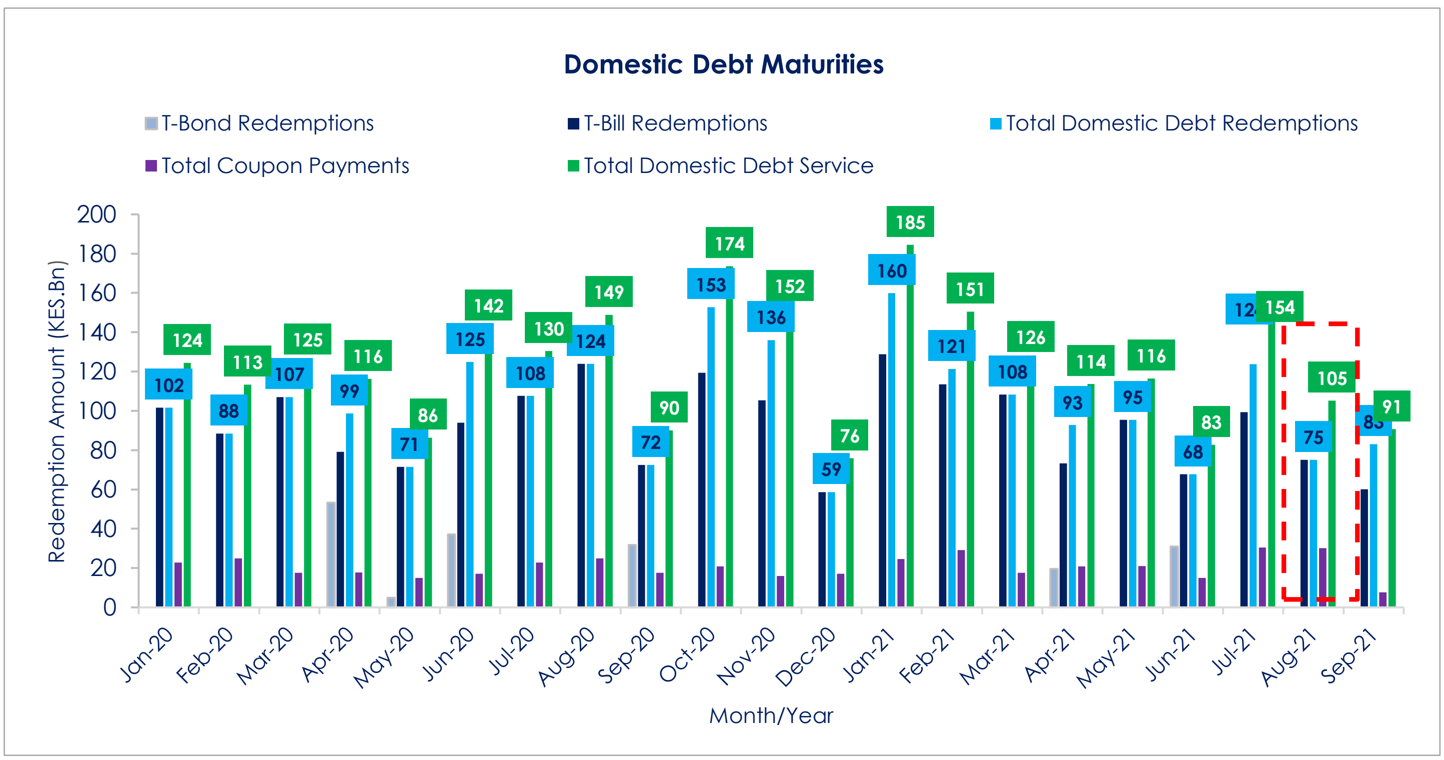
Source: Central Bank of Kenya

*Modified duration - Expresses the measurable change in the value of a security in response to a change in interest rates (for every 1% movement in interest rates, the bond would inversely move in price by the modified duration)
** Current Yield – Cash flows earned by an investor for holding a specific bond for 1 year

KES.105.2Bn domestic debt service in August 2021

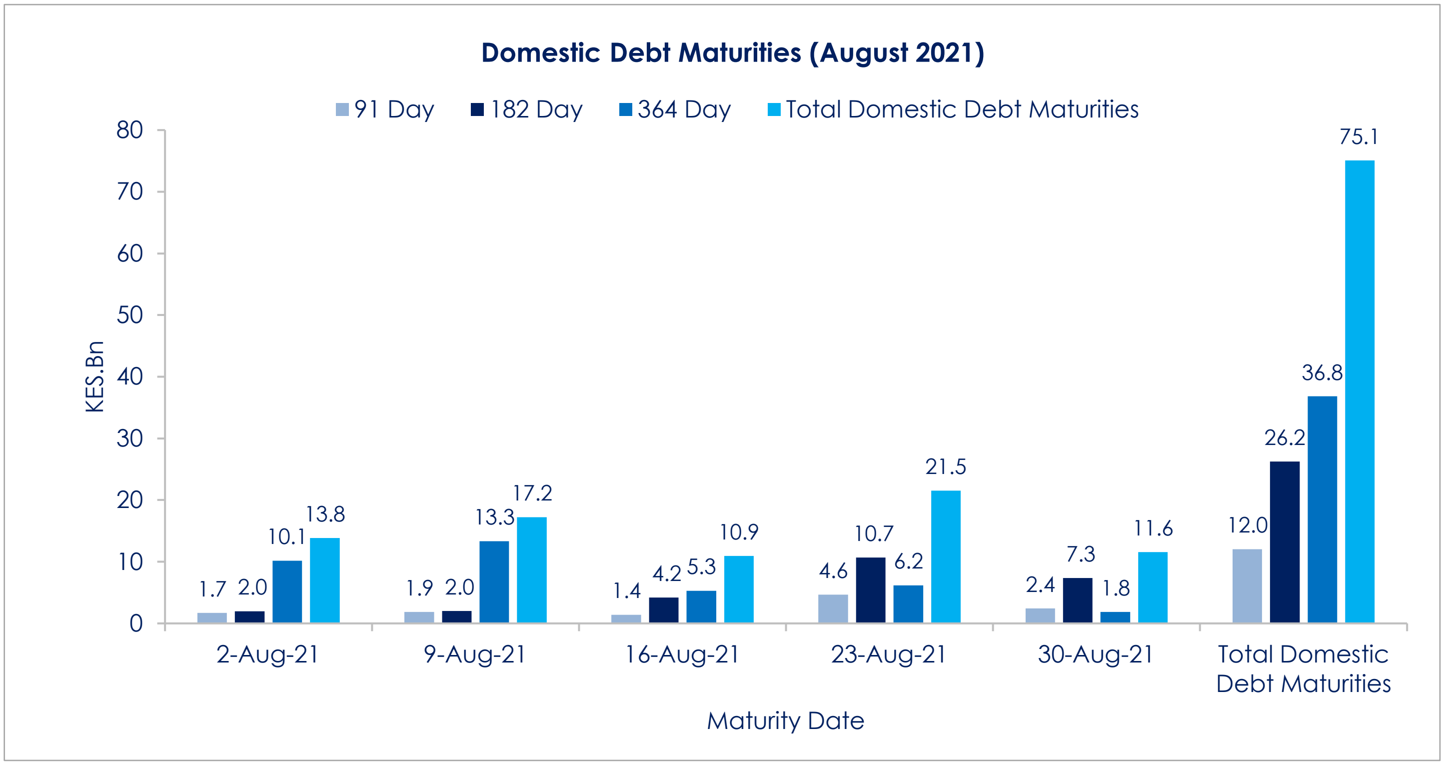
- Debt service for the month of August is KES.105.2Bn lower than KES.152.6Bn in July, and comprises of KES.75.1Bn and KES.30.1Bn in T-Bill and coupon payments respectively (Figure.8).
- Expected redemptions for the 91,182 and 364-day T-Bills during the month are KES.12Bn, KES26.2Bn, and 36.8Bn respectively with the fourth week of the month having the highest redemptions at KES.21.5Bn. (Figure.9).

Figure.8: August debt service KES.105Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities August 2021

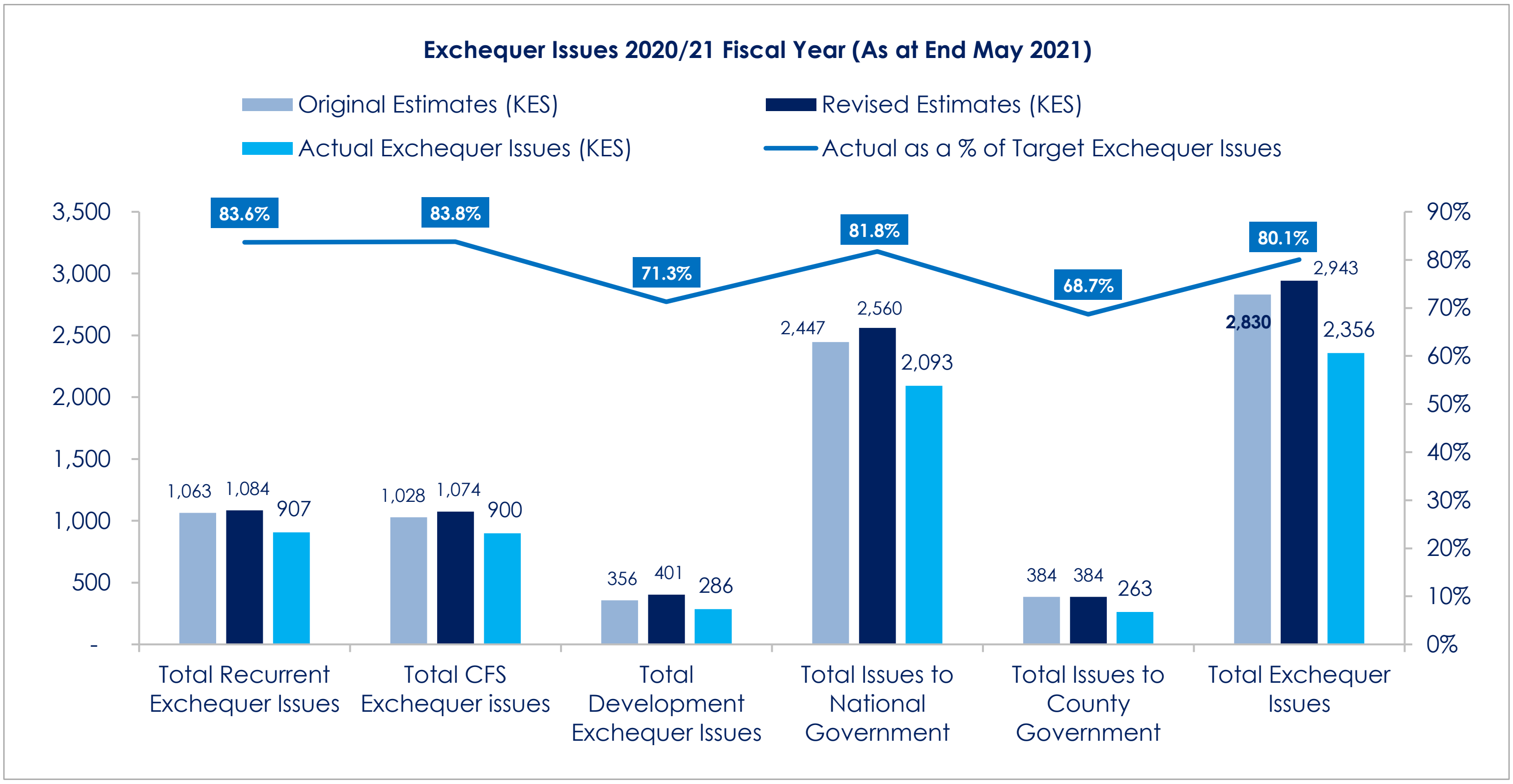


Source: Central Bank of Kenya

National Treasury's missed revenue and expenditure targets

- Data up to 31st May 2021 (end of June data yet to be released) shows the National Treasury way short of its revenue and expenditure targets, and based on a linear run-rate target of 91.7%, we believe the fiscal year targets were missed (Figure.10).
- This is an indication that Government continues to overestimate its revenues particularly tax receipts and underestimate its expenditure.
- Of great concern in terms of economic output at both the national and county Governments is development expenditure and issues to county Governments at 71.3% and 68.7% of revised targets.

Figure.10: Government's missed 2020/21 fiscal year revenue and expenditure targets

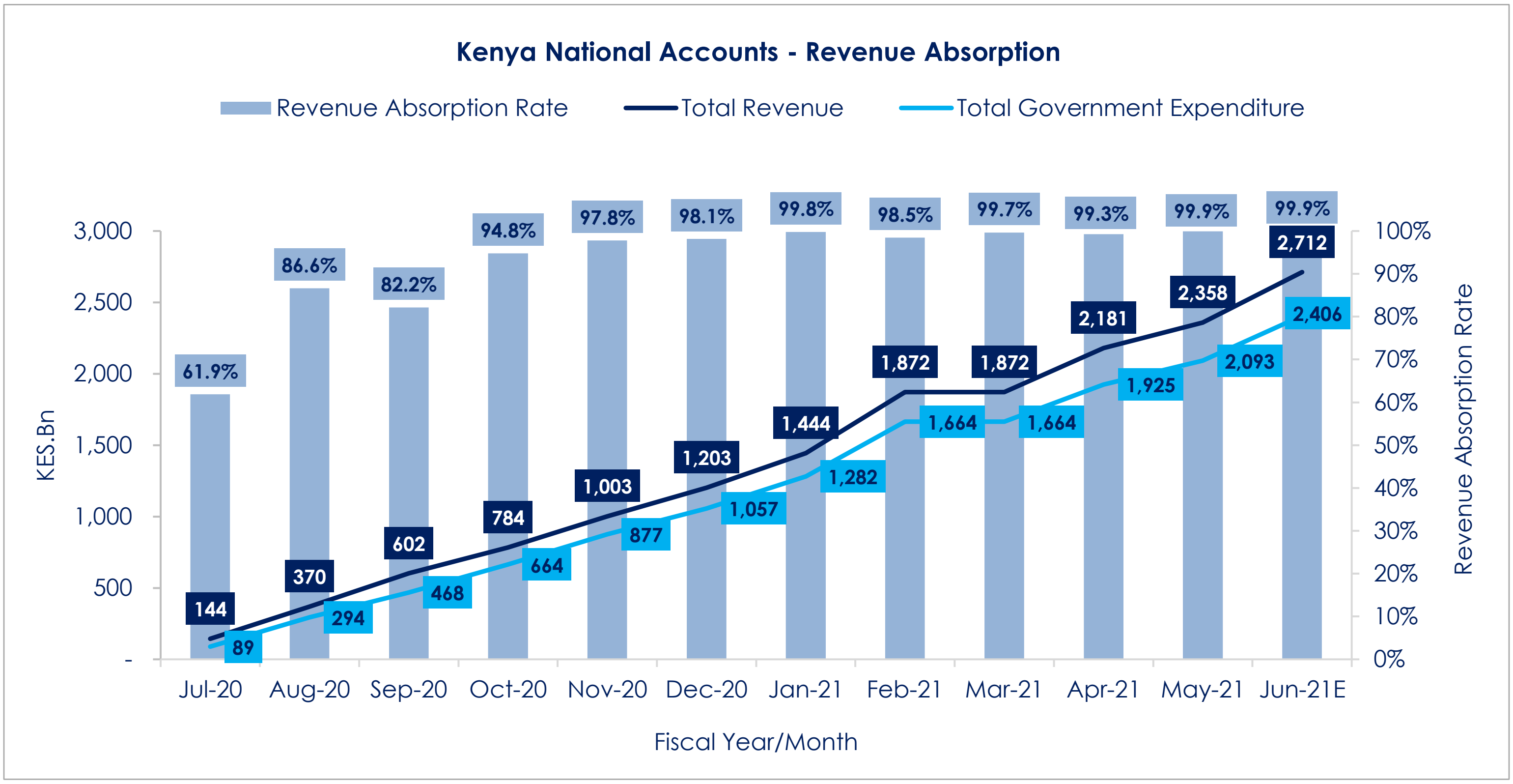


Source: The Kenya Gazette Vol. CXXIII - No.133 18th June 2021

Government revenue absorption low in July

- The "Revenue Absorption Rate" (RAA) in this context is the rate at which the National Treasury uses its receipts (revenue) to finance its expenditure.
- As is often the case at the beginning of every fiscal year Government revenue absorption is low and we do not expect this fiscal year to be any different (Table.6).
- RAA at the end of the first month (July) of the 2019/20 and 2020/21fiscal years stood at 45.2% and 61.9% well below the last 6 months (January to June) average of 98.1% and estimated 99.2% for the same fiscal years respectively.
- This means that Government funding needs are relatively low at the beginning of the year a trend partially explained by non-distribution of funds to county Governments in the first month of the fiscal year.
- The low funding needs could result in the CBK rejecting aggressive investor bids in debt auctions at the beginning of the fiscal year compared to the mid and tail end where they are more accommodative of aggressive bids as pressure to finance expenditure increases.
- This could also mean that interest rates will remain near current levels with high market liquidity also working in favour of the CBK's strategy to manage its cost of borrowing.

Figure.11: National Treasury unlikely to meet FY2020/21 receipts target



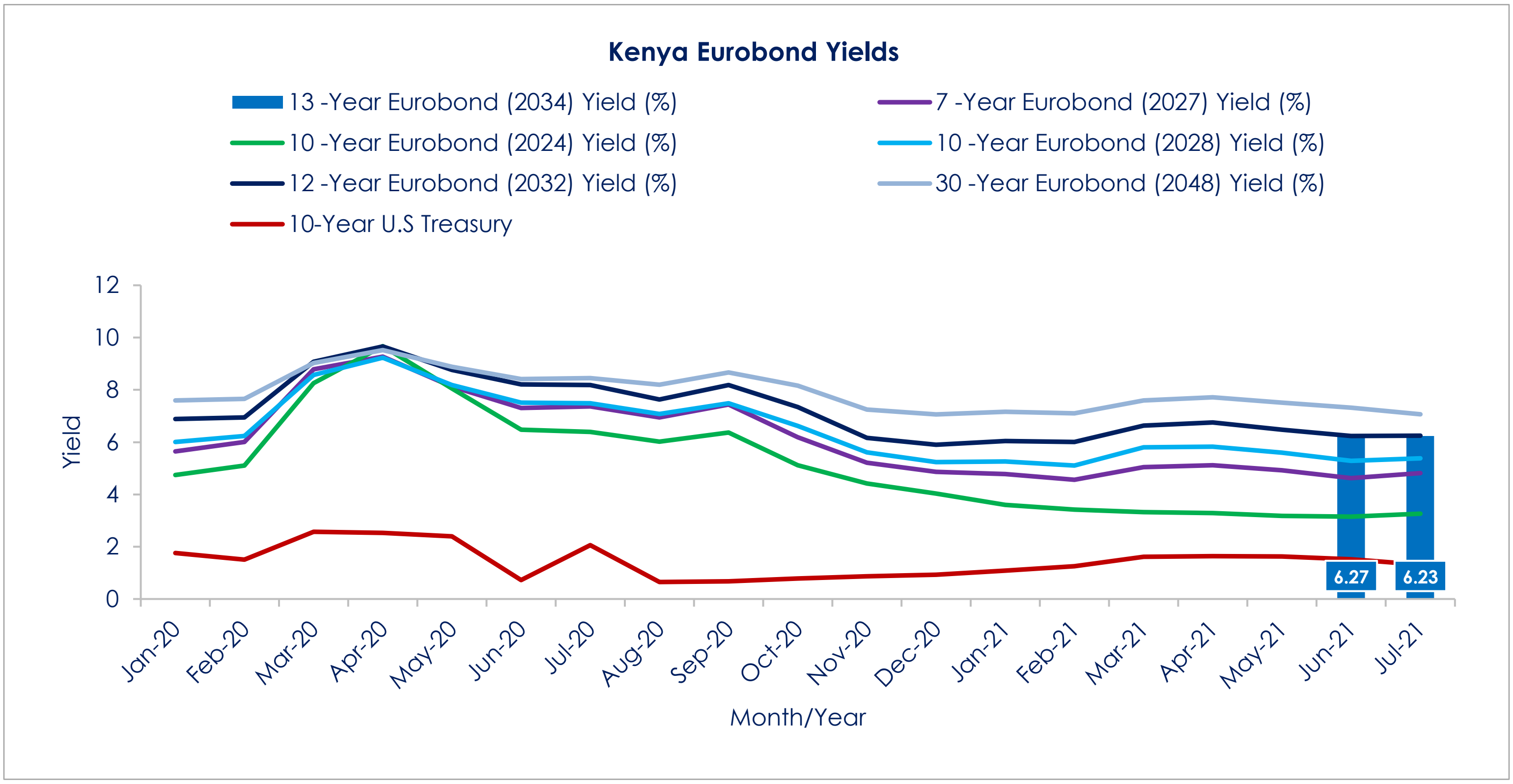
Data up to May 2021 from the National Treasury, June 2021 data Sterling Capital estimates

Source: The Kenya Gazette Vol. CXXIII - No.133 18th June 2021

Kenya Eurobond yields record mixed performance

- Average yields on Government of Kenya Eurobonds reported mixed performance in July compared to June (Figure.12).
- Yields of the 7, 10-year (2024) and 10 year (2028) rose while those of the 13 and 30 year declined.
- The United States (U.S) benchmark 10 year treasury continued its steady decline (20bps) during the month due to concerns over the impact of the new Covid-19 variant "Delta" and the impact of the prolonged pandemic on the pace of global economic recovery.

Figure.12: Kenya Eurobond yields decline on easing concerns over fiscal position and IMF support



Source: Central Bank of Kenya

Ghana, South Africa and Kenya Eurobond index returns positive

- The Kenya sovereign bond index returned 6.7% and 9.4% (USD return) year to date and over the 1-year period ending 5th August 2021 (Figure.13 and Table. 6).
- The Ghana and South African sovereign bond indices however outperformed the Kenyan one returning 12% and 8.1% year to date return.
- On a comparable basis the return from these sovereign bonds is outstanding considering that cash deposit for the U.S dollar have a 1 to 1.2% return

Figure.13: Africa sovereign bond indices continue to perform positively

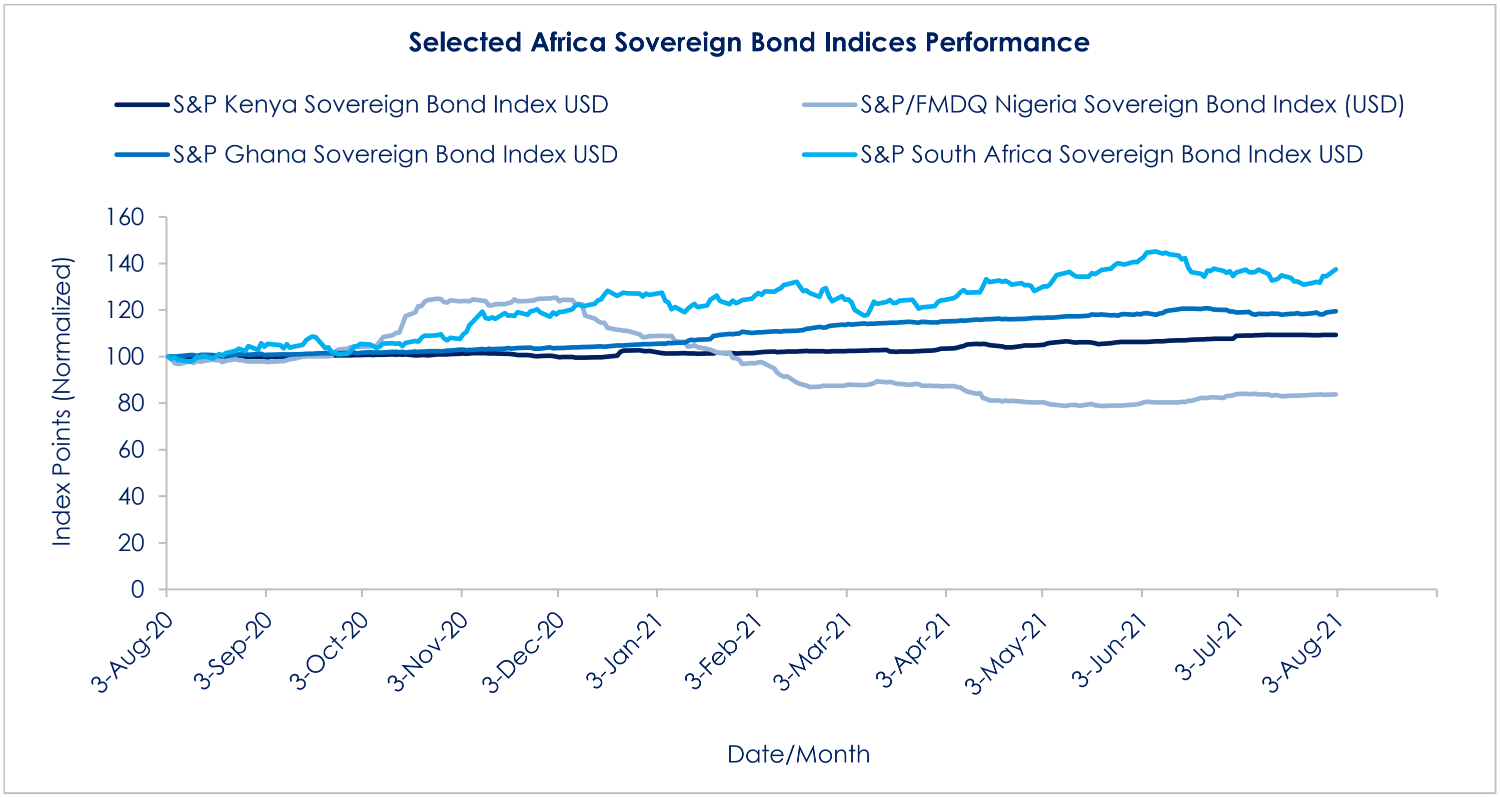


Table.6:

Index	YTD (%)	1-Year (%)	3-Year (%)	5-Year (%)
S&P Kenya Sovereign Bond Index USD	6.7	9.4	10.7	11.8
S&P/FMDQ Nigeria Sovereign Bond Index USD	-19.8	-10.2	14.9	16.7
S&P South Africa Sovereign Bond Index USD	8.1	38.3	5.9	7.6
S&P Ghana Sovereign Bond Index USD	12	17.8	12	12.2

Source: S&P Global

NSE yield curve has shifted upwards over the last one year

- A comparison of average yields in July 2021 against the same period in 2020 shows an increase all debt tenors (Table.7 and Figure.14).
- We however observe a decline in short and long-term yields when we compare current yields with those at the time of the primary issue of FXD1/2018/20 on 23rd March 2018.
- Current yields across the yield curve with the exception of the one year tenor are higher than those at the time of issue of FXD3/2019/10 (23rd August 2019).

- The increase in short, medium and long tenor debt over the last one year is a direct result of the following:

  1) CBK has been rejecting aggressive T-Bill primary auction investor bids.
  2) Most primary bond issues have been long term debt issues with the CBK intent on lengthening the Average Term to Maturity of domestic debt.
  3) CBK has been more accommodative of aggressive bids for long-term debt to encourage subscription.

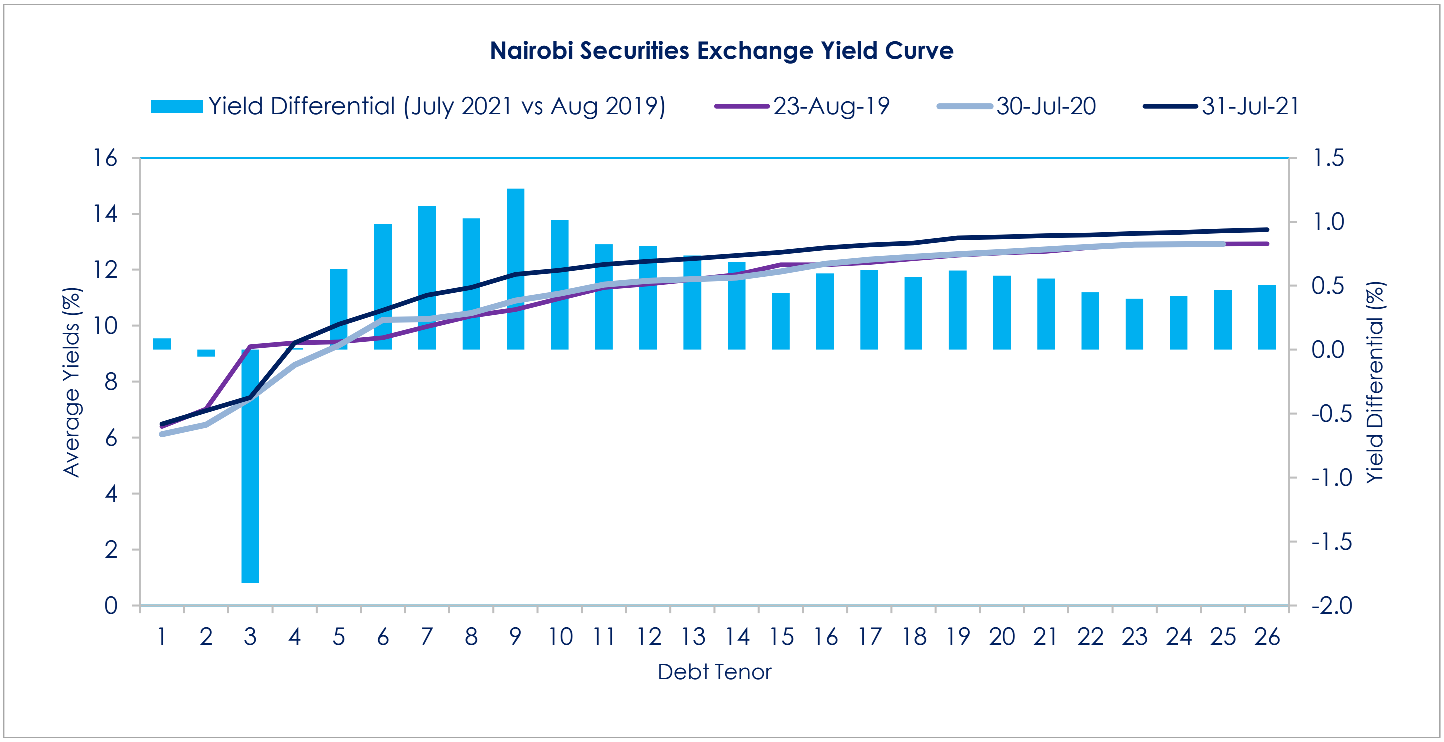
- We predict a gradual increase in long-term debt yields in response to the issuance of new and re-opened long-dated debt as the CBK maintains its strategy of lengthening the average term to maturity of domestic debt.
- **We maintain our recommendation of BUY short and HOLD medium- and long-term papers.**

Table.7: Yields curve has shifted upwards over the last one year

Tenor	Yields (23rd March 2018)	Yields (23rd August 2019)	Yields (30th July 2020)	Yields (31st July 2021)	∆ July 2021 vs March 2018) (bps)	∆ July 2021 vs August 2019) (bps)	YoY ∆ July 2021 vs July 2020 (Bps)	Sterling Capital yield Curve (July 2021)
1	11.1260	9.2480	7.3910	7.4260	↓370	↓182.2	↑3.5	7.50
2	11.6803	9.3816	8.6000	9.3916	↓228.9	↑1	↑79.2	9.45
5	12.3232	9.9683	10.2335	11.0934	↓123.0	↑112.5	↑86.0	11.10
10	12.8500	11.4875	11.6045	12.2981	↓55.2	↑81.1	↑69.4	12.35
15	13.0359	12.2612	12.3633	12.8824	↓15.4	↑62.12	↑51.9	12.90
20	13.2728	12.7967	12.8121	13.2450	↓2.8	↑44.83	↑43.3	13.35

Source: Nairobi Securities Exchange

Figure.14: The yield curve has shifted upwards over the last one year



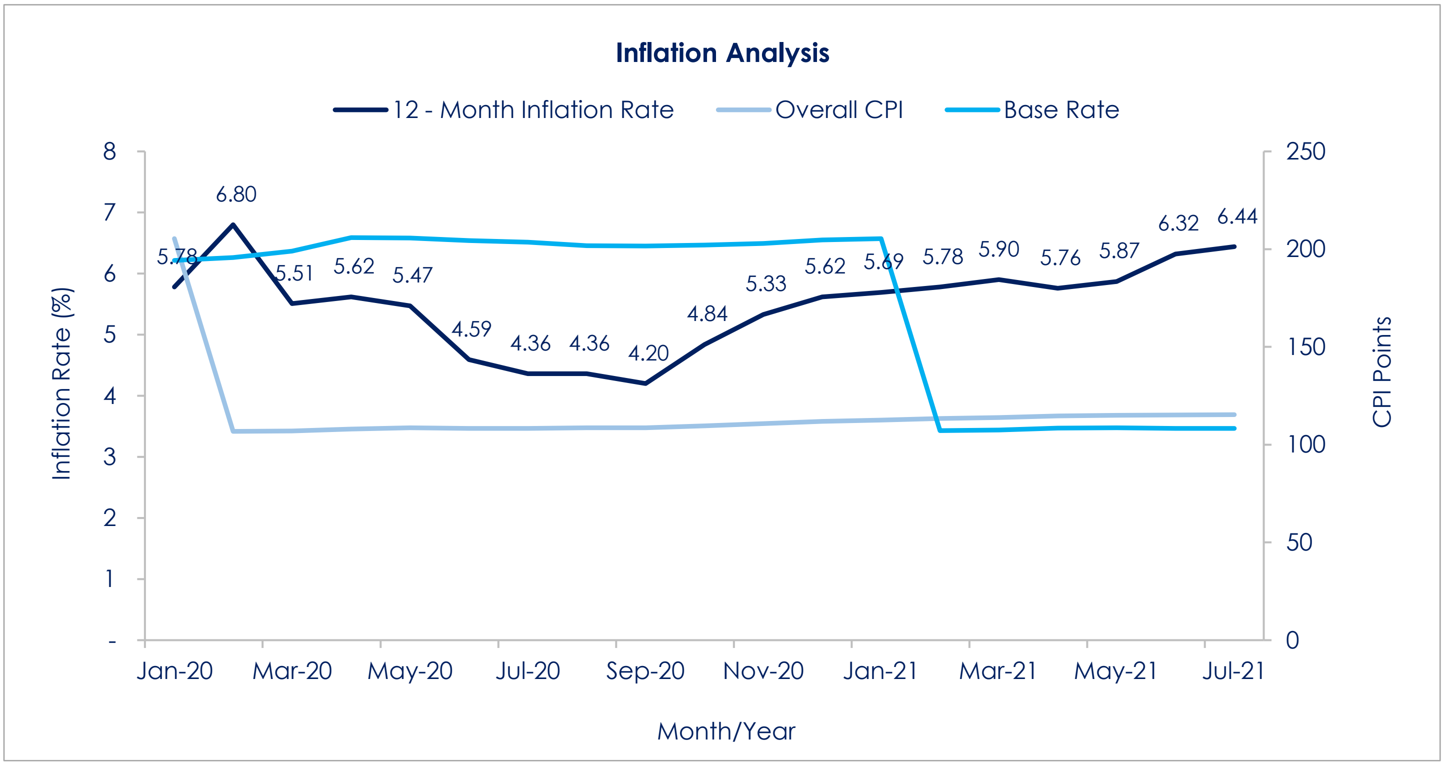
Source: Nairobi Securities Exchange

July inflation at 6.44% is at its highest level since March 2020 (6.8%)

August 2021 inflation to rise on higher transport and food prices

- Inflation for the month of July 2021 rose to 6.44%, the highest since March 2020 (6.8%) and higher than June 2021 (6.32%) (Figure.15).
- This was mainly driven by a rise in price of commodities under: food and non-alcoholic beverages (8.8%); housing, water, electricity, gas and other fuels (6.0%); and transport (10.3%).
- Consumer Price Index (CPI) increased by 0.2% from 115.1 in June 2021 to 115.3 in July.
- Housing, water, electricity, gas and other fuels' index rose 1.3% between June 2021 and July 2021, mainly attributed due to the increase in the price of cooking gas, which went up by 15.4%.
- Additionally, electricity prices went up by 0.8% and 1.1% for 200 Kilowatts and 50 Kilowatts, respectively.
- We predict August inflation to be in the range of 5.8% - 6.5%, which is still within the CBK's 2.5% - 7.5% target range, with food and transport indices the main drivers.

Figure.15: July 2021 inflation the highest since March 2020



Source: Kenya National Bureau of Statistics

MPC to hold monetary policy meeting in September 2021

- The MPC will meet again in September 2021 to review the impact of previous monetary policy measures.
- Following July's MPC meeting, we see the following as the main points of discussion for the monetary policy makers:

1) Rising inflationary pressure with July 2021 inflation at the highest level since March 2020.
2) The accelerated depreciation of the Kenya Shilling (KES) to the dollar, having depreciated in the month of July from KES.107.95 to KES.108.62.
3) Private sector credit increased to 7.7% in June 2021, from 6.8% in April. Strong credit growth was observed in; manufacturing (8.1%), transport and communications (11.8%), and consumer durables (23.4%).
4) Foreign exchange reserves negligible decline (0.3%) to US$.9.3Bn (5.7months of import cover) following debt repayments to China.
5) Commercial bank liquidity remains healthy with no immediate risks foreseeable.

MPC to maintain CBR and CRR at 7% and 4.25% respectively.

6) Improved revenue performance in FY2020/21 and a provisional fiscal deficit of 7.8% of GDP. Additionally, the rollout of the Economic Recovery Strategy, which is expected to support domestic demand.

- We feel that the above developments will not result in a revision to monetary policy and the CBR and Cash Reserve Ratio will remain at 7% and 4.25%.

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