Monday, 07 December 2020

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Fixed Income Note

December 2020

"Investors' appetite for yield"

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Executive Summary

- **"Investors' appetite for yield"** is the title of our last fixed income report in 2020 with the Central Bank of Kenya (CBK)raising KES.40Bn through two re-opened long-term bonds: **FXD1/2012/15 (6.82 years) and FXD2/2019/15 (13.48 years)**.
- We predict a combined subscription rate of with between 113%-138% (KES.45Bn-KES.55Bn) on account of growing investor interest for medium tenor bonds on account of comparatively higher yields.
- Our weighted average bid predictions are as follows:

Weighted Average Rate (WAR) of investor bids

- **FXD1/2012/15: 11.50%**
- **FXD2/2019/15: 13.00%**

WAR of accepted bids

- **FXD1/2012/15: 11.40%**
- **FXD2/2019/15: 12.90%**

- Our report highlights several past bond issues that we used as a "benchmark" to provide some guidance of potential investor bids for the bonds in issue this month.
- Also in the report is a summary of investor subscription in both the Treasury Bill (T-Bill) and Treasury Bond (T-Bond) primary auction market.
- Interest rates on short-term debt have been on a gradual the rise over the last few months and this is illustrated and explained in the report.
- Commercial bank liquidity and the impact on the secondary bond trading market in November as well as our expectations for December is covered in this report.
- We advocate for investment in Infrastructure Bonds in our trading ideas section based on attractive yield.
- The latter part of the report Kenya's national accounts, especially debt service and Government revenues and the potential impact on the national Treasury's borrowing strategy.
- As is the norm, yield curve movements and comparisons over time are graphically illustrated and explained in the report.
- Inflation and the Monetary Policy Committee (MPC) policy decision are explained in the final section of the report.

CBK taps into the domestic debt market to raise KES.40Bn

- The Central Bank of Kenya (CBK) invites bids for two re-opened Treasury Bonds (T-Bonds) FXD1/2012/15 (6.82 years) and FXD2/2019/15 (13.48 years) in a bid to raise KES.40Bn for budgetary support. (Table.1).
- These issues are consistent with the National Treasury's objective of lengthening maturity profile of domestic debt which currently stands at 5.7 years from 4.1 years two years ago.
- Faced with a widening fiscal deficit resulting from lower-than-expected tax revenues, we expect upward revisions to both domestic and external borrowing targets.

Table.1: Primary Bond issue summary

Issue Number	FXD1/2012/15 (Re-opened)	FXD1/2019/15 (Re-opened)
Total Amount Offered	KES.40Bn	
Tenor (Years)	6.82 Years	13.48 Years
Coupon Rate (%)	11.00	12.73
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	30th November 2020 - 8th December 2020	
Auction Date	9th December 2020	
Value Date	14th December 2020	
Yield Curve (%) (Weighted Average tenor - 6.82 Years, and 13.48 Years) 28th November, 2020	**10.73**	**12.15**

Source: Central Bank of Kenya

Our weighted average and accepted bids averages

- We have given our bid predations for the bond auctions by analyzing yields of similar tenor securities on the Nairobi Securities Exchange (NSE) as at 30th November 2020, as well as input from our fixed income trading team (Table.2).

Table.2: Auction bid predictions

Rate	FXD2/2012/15	FXD1/2019/15
Market Weighted Average Rate of investor bids (%)	11.50	13.00
Weighted Average Rate of Accepted Bids (%)	11.40	12.90

Source: Central Bank of Kenya

Benchmark bonds providing guidance to our predicted rates

- Implied yields of bonds of similar tenors on the NSE as at 30th November 2020 were used to predict 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
15-Year						
FXD2/2012/15	24th Sep 2012	11.00	6th Sep 2027	6.78 (2,471)	10.7293	N/A
FXD1/2019/15	13th May 2019	12.73	24th Apr 2034	13.44 (4,893)	12.1547	N/A

Source: Nairobi Securities Exchange & Sterling Capital

Comparatively higher yields for long term papers likely to drive subscription

- Investors have shown a preference for longer tenor debt driven by high yielding and low risk investment options.
- Given the tightening liquidity and government's high debt appetite, yields on these papers are likely to inch upwards.
- We anticipate a combined subscription of **KES.35 - KES.40Bn equivalent to an 88% to 100%**, reason being that there has been a lot supply from the CBK side through several re-opened issues with about the same tenors over the last few months.

Table.4: Historical primary market auction performance

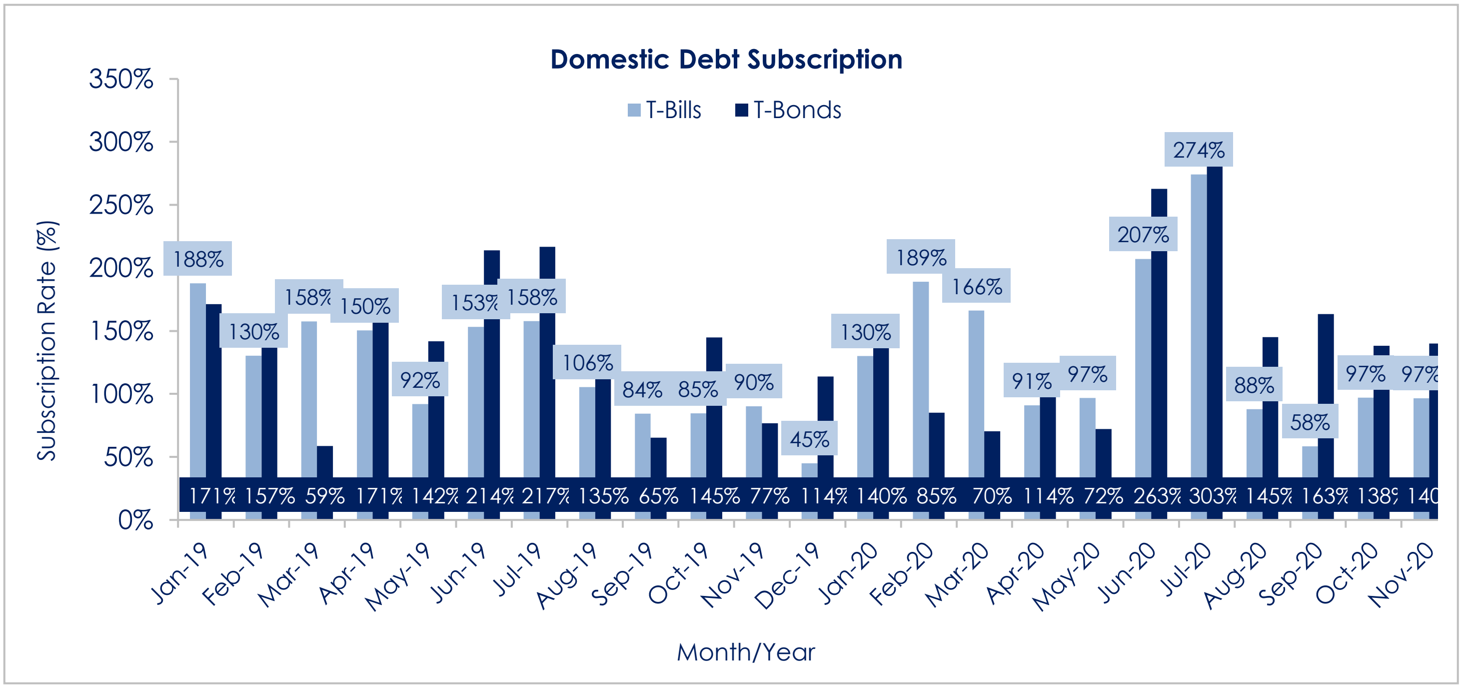
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
FXD1/2018/15	40	20.2	12.9	50.5	12.65	11.92
FXD2/2018/15	40	27.1	7.9	67.6	12.75	12.02
FXD1/2019/15	40	25.1	14.7	62.7	12.86	12.09
FXD2/2019/15	50	21.5	19.3	43.1	12.73	12.17
FXD3/2019/15	40	86.7	50.6	216.7	12.34	12.28
FXD1/2020/15	50	18.4	5.2	36.9	12.76	12.57

Source: Nairobi Securities Exchange & Sterling Capital

High demand for the 91-Day T-Bill and long-term T-Bonds to continue

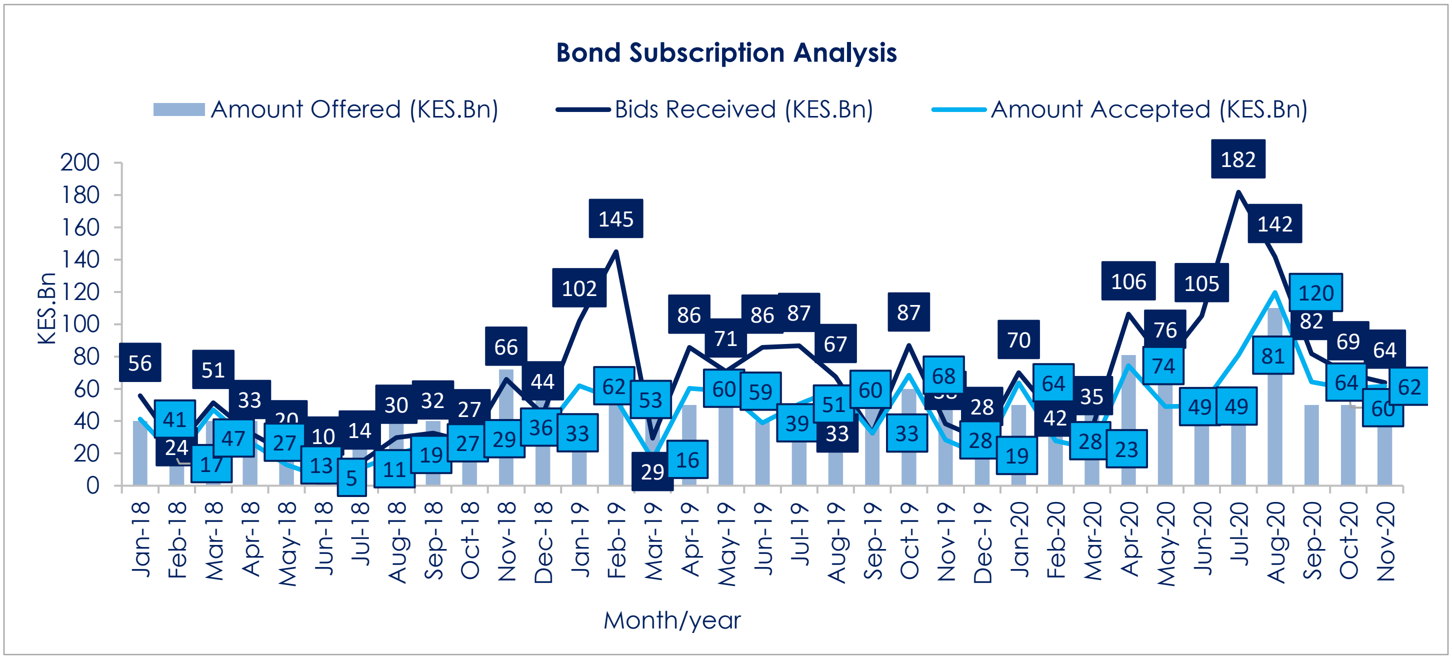
- The CBK received domestic debt bids worth KES.115.9Bn In November against KES.120Bn offered equivalent to a subscription rate of 96.6% (Figure.1 and Figure.2).
- The 364-day and 91-day T-Bills recorded subscription rates of 125.9% and 121.2% while the 182-day paper was undersubscribed at 57.5%.
- We observed a high acceptance rate of 92.8%, 98.3% and 96.2% for the 91-, 182- and 364-day debt issues respectively showing the urgent financing needs of Government (Figure.3).
- The two re-opened T-Bonds in November received bids worth KES.55.9Bn (139.9% subscription rate) with FXD1/2018/20 receiving recording a 51.6% subscription rate while FXD2/2013/15 received 48.4% of total subscriptions.
- Additionally, bonds offered included a KES.20Bn tap sale for FXD1/2018/25 which was undersubscribed at 39.8% (KES.7.9Bn) with CBK accepting 99.3% of the bids received.
- We expect demand for the T-Bonds to remain high compared to T-Bills as a result of higher interest rate spreads, thus providing high returns.

Figure.1: Domestic debt subscriptions up in November



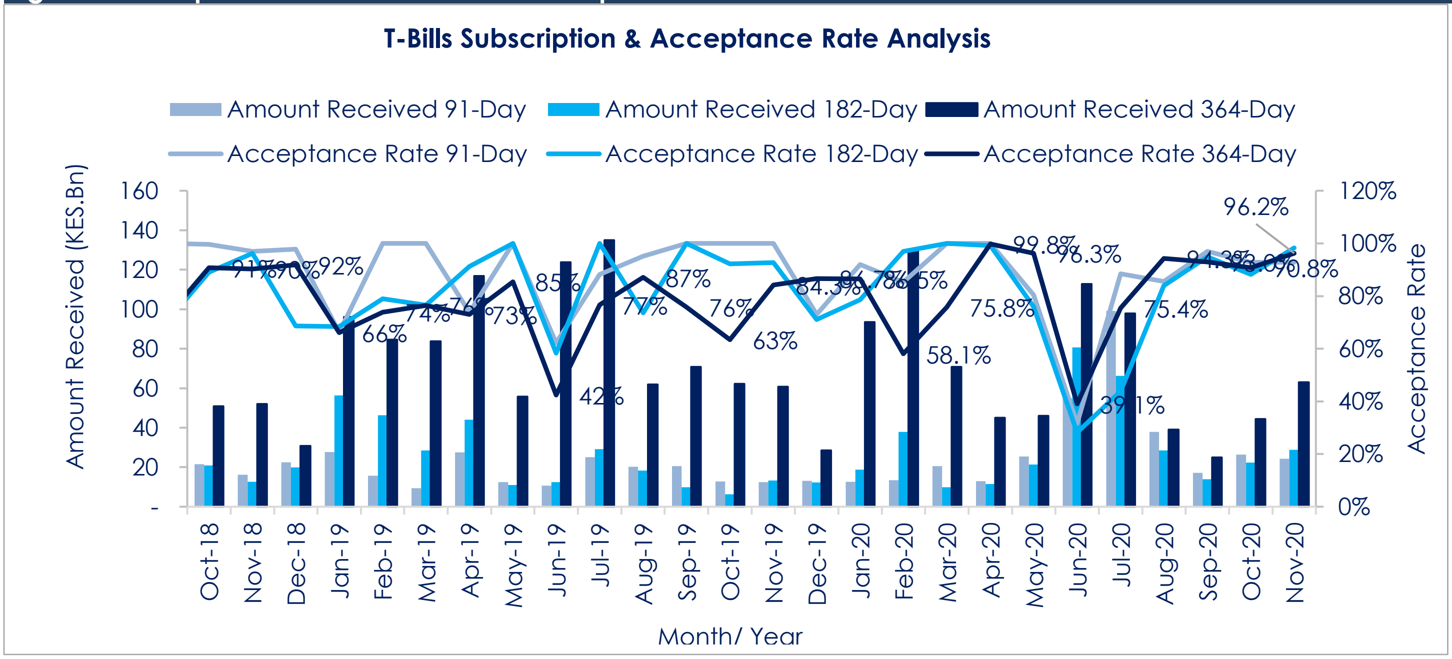
Source: Central Bank of Kenya

Figure.2: Investor auction bids received decline steadily



Source: Central Bank of Kenya

Figure.3: Acceptance rate for all T-Bill tenors up

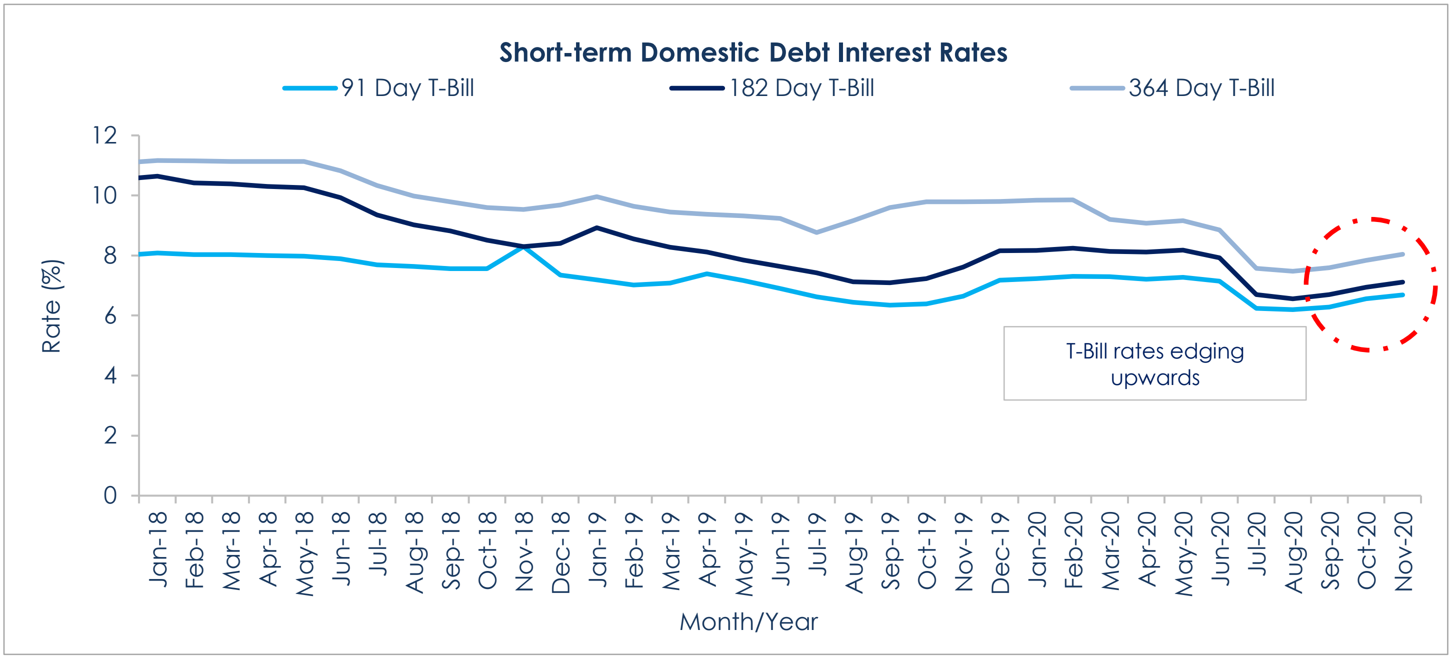


Source: Central Bank of Kenya

T-Bill rates continue to edge upwards

- Investor participation in T-Bill auctions increased in November with the 91-day and 364-day papers being oversubscribed due to comparatively higher yields.
- Average 91, 182- and 364-day papers rose 13bps, 17bps and 21bps to 6.7%, 7.1% and 8% respectively (Figure.4).
- We anticipate a gradual temporary rise in interest rate rates in upcoming auctions in an attempt to improve investor interest in the short-term debt.

Figure.4: Interest rates edge upwards as liquidity declines

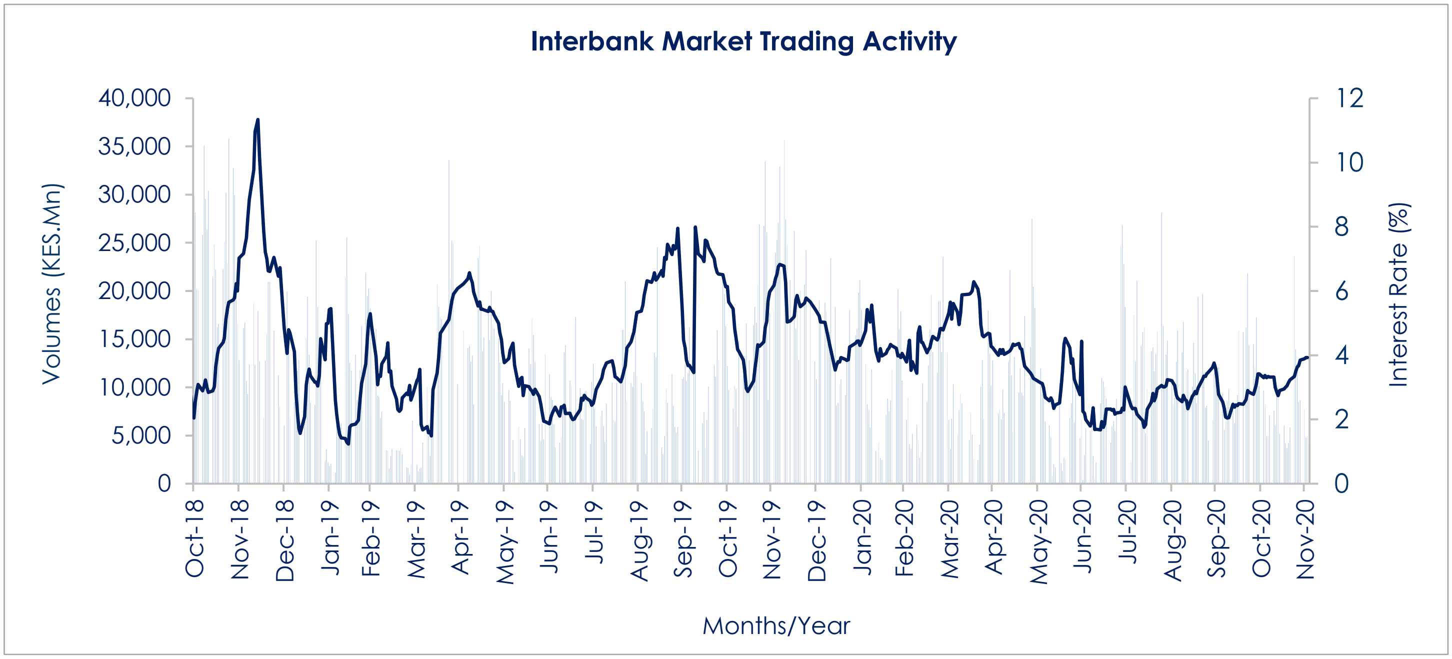


Source: Central Bank of Kenya

Commercial bank liquidity declines resulting in a rise in inter-bank rates

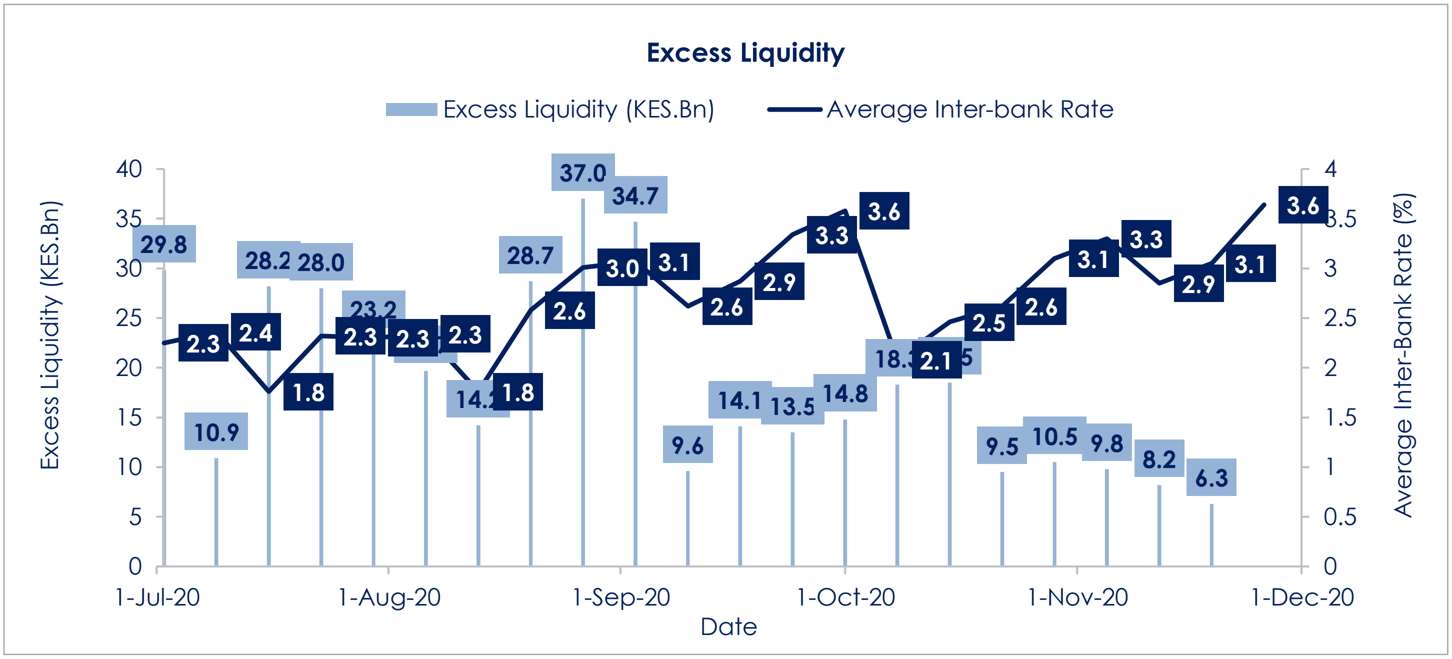
- Average weighted inter-bank lending rates rose to 3.3% in November from 2.8% in October with total traded volumes declining to KES.158.6Bn from KES.241.96Bn in October (Figure.5)
- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) decreased consecutively over the weeks in November from KES.10.5Bn at the beginning of the month to KES.6.3Bn as at 26th November 2020 (Figure.6).
- We expect average inter-bank rates to remain between 3% and 3.5% in December due to lower market liquidity.

Figure.5: Inter-bank rates rise marginally



Source: Central Bank of Kenya

Figure.6: Commercial excess reserves decline progressively in November

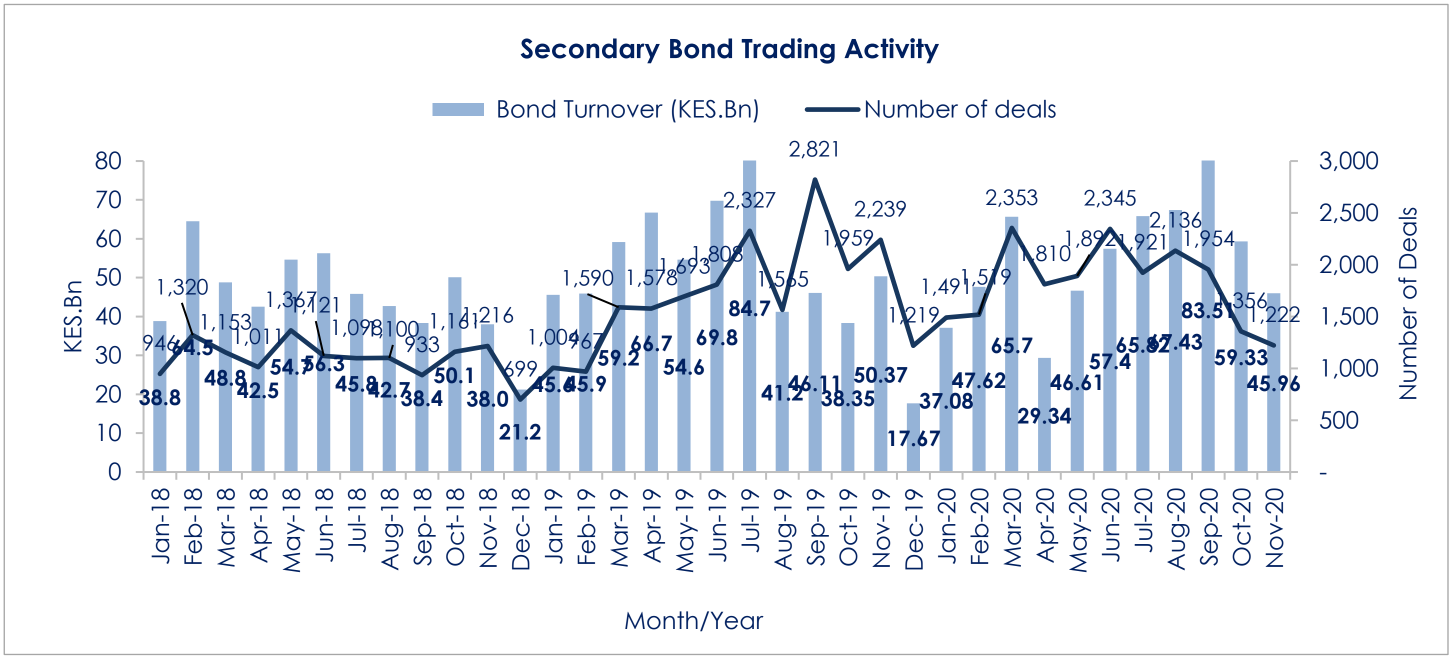


Source: Central Bank of Kenya

Secondary market trading activity declines in November 2020

- Secondary bond trading turnover declined 22.5% in November 2020 to KES.46Bn from KES.59.3Bn in October while the number of deals fell 9.9% to 1,222 from 1,356 (Figure.7).
- We attribute this to increased investor participation in the primary bond market.
- We expect trading to remain relatively subdued in December owing to lower market liquidity and the onset of the festive season.

Figure.7: Secondary trading activity declines in November



Source: Central Bank of Kenya

Trading ideas - Investors with trading portfolios should continue investing in IFBs

- We advise investors with trading portfolios to stick to Infrastructure Bonds (IFBs) for the following reasons:

{ Trading portfolios - Take positions in IFBs }

1) IFB's tend to have relatively faster price appreciation than the usual Kenya Fixed coupon Treasury bonds (FXD).

2) There is relatively too much concentration of primary FXD's issues on the 6 to 25 years which has muted price appreciation on these tenors.

- Specifically, we advise the purchase of the following bonds (Table.5):

Table.5: Trading ideas - Invest in IFBs

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2020/6	5.56	10.20	4.10	**10.00**	9.89
IFB1/2020/9	8.46	10.85	5.32	**10.55**	10.60
IFB1/2020/11	10.85	10.90	6.04	**10.75**	10.65

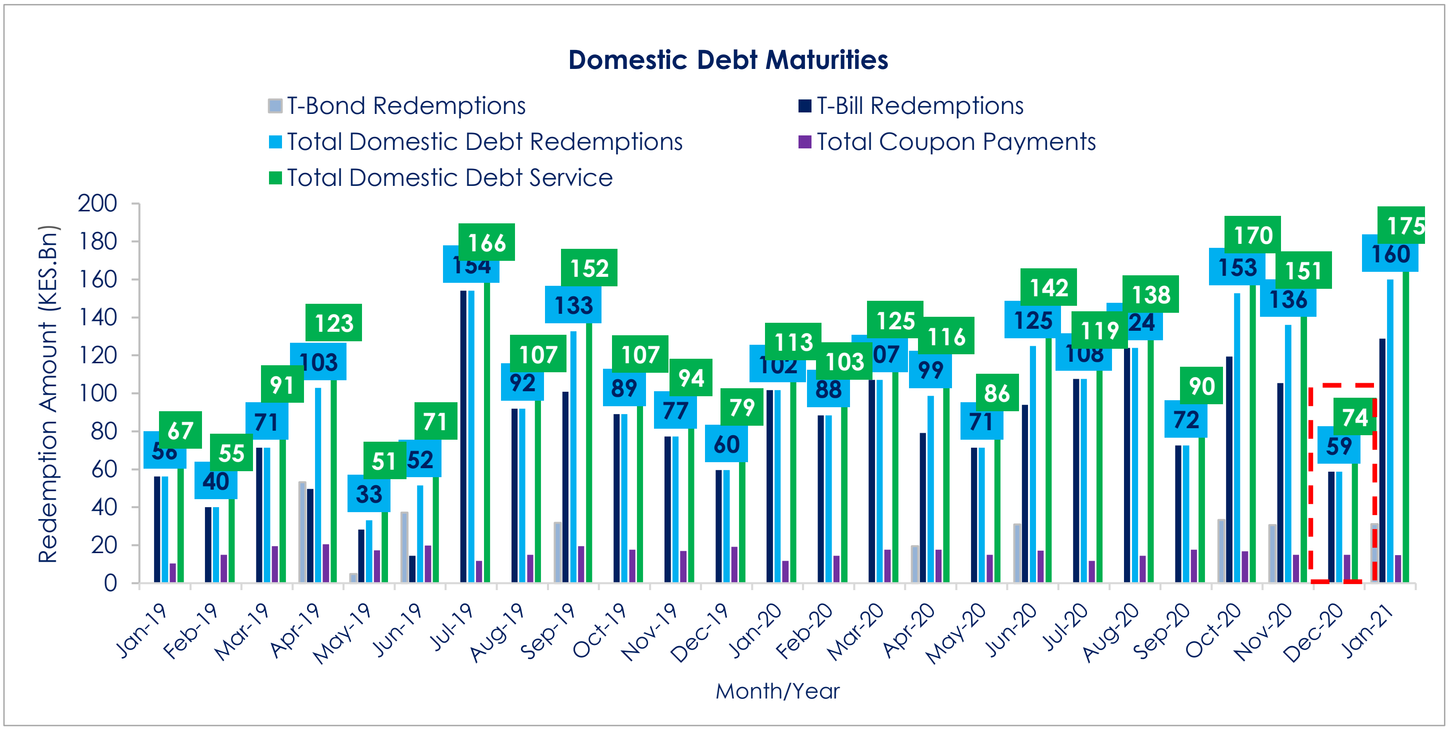
Source: Nairobi Securities Exchange & Sterling Research

*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 - Return on investment, for an investor holding a specific bond for 1 year

Domestic debt service to fall in December 2020

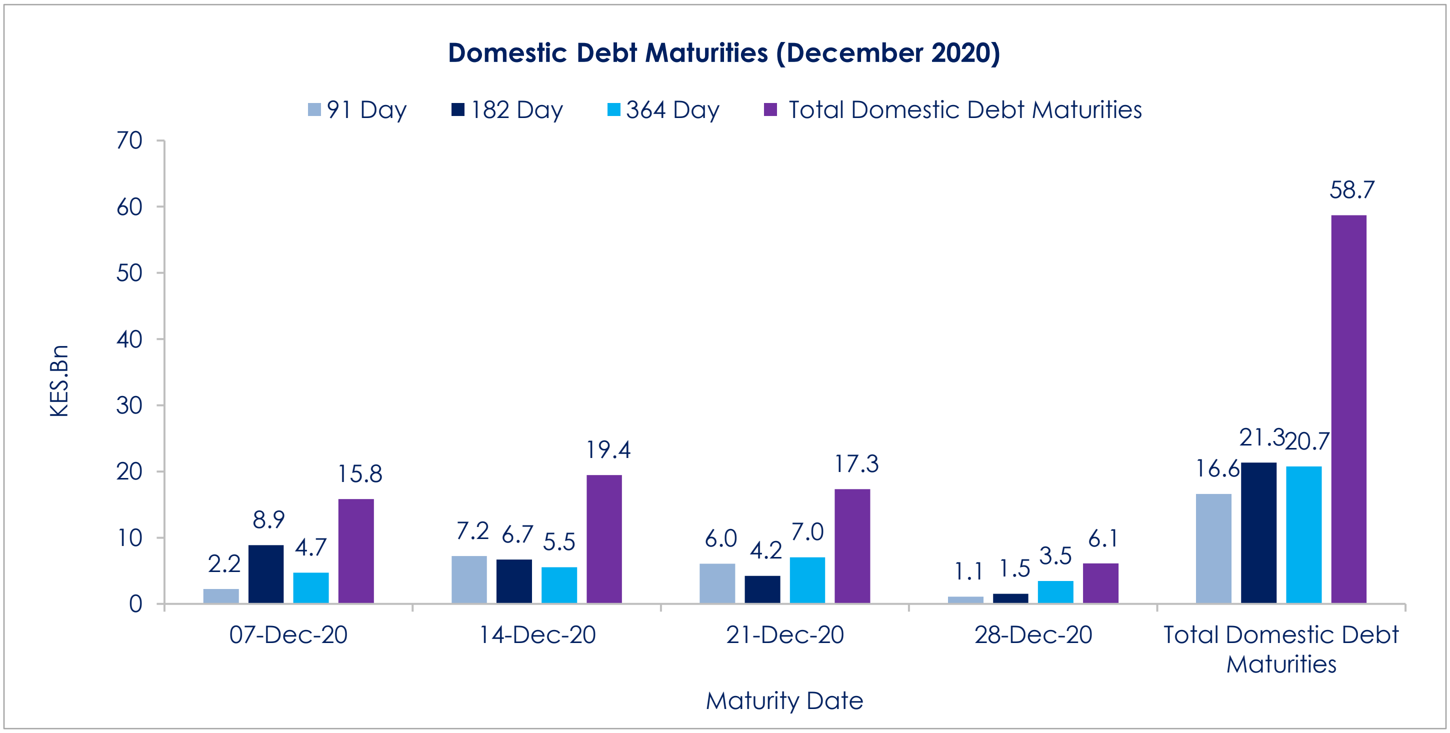
- With no T-Bond redemptions set for the month of December 2020, there will be a significant reduction in domestic debt service for the month at KES.73.6Bn compared to KES.151Bn in November 2020 (Figure.8).
- This is the lowest redemption amount in the 2020/21 fiscal year and comprises of KES.58.7Bn in T-Bill redemptions and KES.14.9Bn in coupon repayments.
- Redemptions for the 91, 182 and 364-day T-Bills are KES.16.6Bn, KES.21.3Bn and KES.20.7Bn respectively.
- The second week of the month will have the highest debt redemptions at KES.19.4Bn (Figure.9).
- The reduction in redemptions in December point towards a larger proportion of funds raised in debt auctions directed towards new borrowing.

Figure.8: December 2020 debt service at KES.74Bn, lowest in the 2020/21 fiscal year



Source: Central Bank of Kenya

Figure.9: November 2020 Weekly debt maturities



Source: Central Bank of Kenya

Government revenues remain below 2020/21 fiscal target

- Actual Government receipts after the first four months of the 2020/21 fiscal year (July - October 2020) remain below the annual target run rate according to data from the National Treasury (Table.6 & Figure.10).
- Total receipts at the end of October 2020 stood at KES.783.8Bn equivalent to 27.7% against our linear target run rate of 33.3%.
- However, domestic borrowing remains marginally above the linear run rate with the KES.264.8Bn equivalent to 33.7% of the annual target.
- The subdued economic performance has had a negative impact on tax revenue in particular with KES.426.4Bn or 27.2% of the total fiscal target (KES.1.6Tn) achieved.
- We therefore expect an upward revision of the domestic and external borrowing target while tax revenue is likely to be revised downwards.

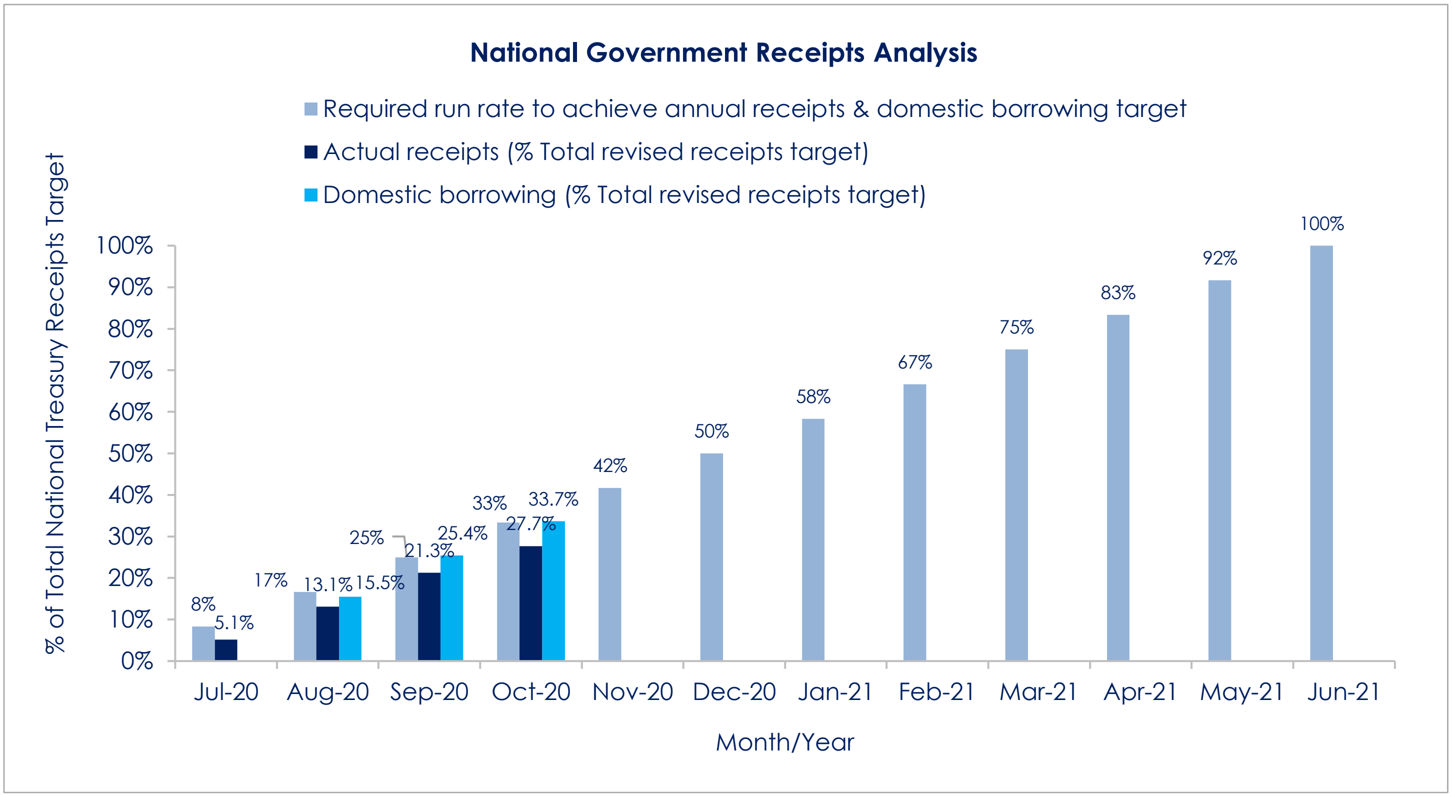
Table.6: Upward revision to domestic borrowing target

Receipts	Original Estimates (KES)	Revised Estimates (KES) 31st August 2020	Actual Receipts (KES) 30th September 2020	Actual Receipts (KES) 31st October 2020	Proportion of Receipt Target (KES) 31st October 2020
Opening Balance (1st July 2020)			48.0	48.0	-
Tax Revenue	**1,567.6**	**1,567.6**	317.7	426.4	27.2%
Non-Tax	66.1	66.1	24.9	31.9	48.3%
Domestic Borrowing	756.9	786.6	200.1	264.8	33.7%
External Loans & Grants	373.2	373.2	10.4	11.7	3.1%
Other Domestic Financing	36.8	36.9	0.9	0.9	2.5
Total Revenue	**2,800.7**		**602**	**783.8**	**27.7%**

* Note 1: Domestic Borrowing of KES.786.6Bn = Net Domestic borrowing KES.524.7Bn & Internal Debt Redemptions (Roll-overs) KES.262

Source: The Kenya Gazette Vol. CXXII - No.204 20th November 2020

Figure.10: Decline in debt service results in an increase in net borrowing in December 2020



Source: Central Bank of Kenya

Yield curve to steepen as short-end rates rise gradually

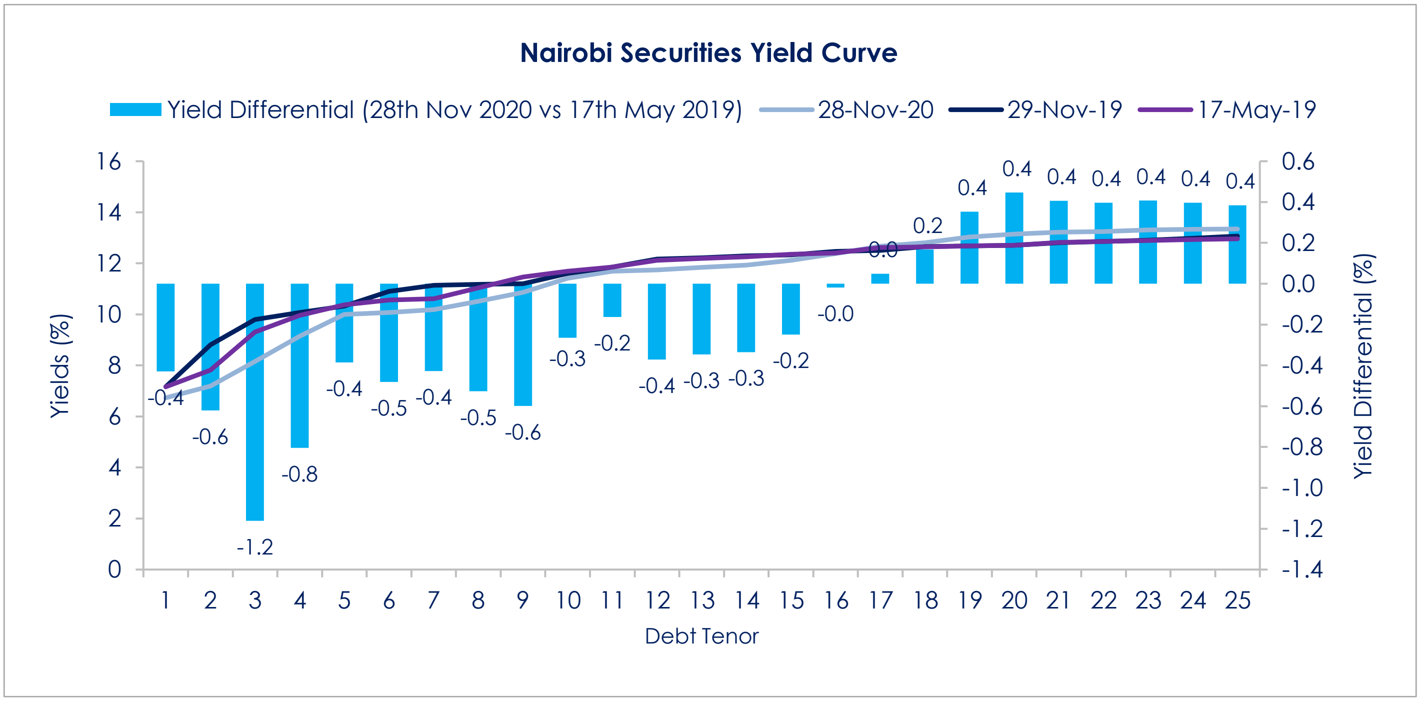
- Comparison of domestic debt yields on 28th November 2020, 29th November 2019 and 17th May 2019 (issue of FXD2/2019/15) show declines in yields in the short and medium tenors while those on the long end rose (Table.7 and Figure.11).
- The rise in yields on longer dated debt appears to be a deliberate strategy by the CBK to increase investor demand for these issues in a bid to lengthen the debt maturity profile.
- We forecast an increase in the interest rate spread leading to a steeper yield curve therefore **recommend investors to BUY short and medium-term bonds and HOLD long term papers.**

Table.7: Short-end of the yield curve declines significantly

Tenor	Yield (17th May 2019)	Yield (29th Nov 2019)	Yield (28th Nov 2020)	∆ 28th Nov 2020 vs 17th May 2019 (Bps)	YOY ∆ 28th Nov 2020 vs 29th Nov 2019 (Bps)	Sterling Capital yield Curve (29th Nov 2020)
1	9.3120	9.8000	8.1510	↓116.1	↓164.9	8.20
2	9.9546	10.0714	9.1500	↓80.5	↓92.1	9.25
5	10.6125	11.1375	10.1850	↓42.8	↓95.3	10.20
10	12.1100	12.1668	11.7391	↓37.1	↓42.8	11.80
15	12.6138	12.5063	12.6626	↑4.9	↑15.6	12,50
20	12.8532	12.8525	13.2500	↑39.7	↑39.8	13.10

Source: Nairobi Securities Exchange

Figure.11: Yields on the long-end rise gradually



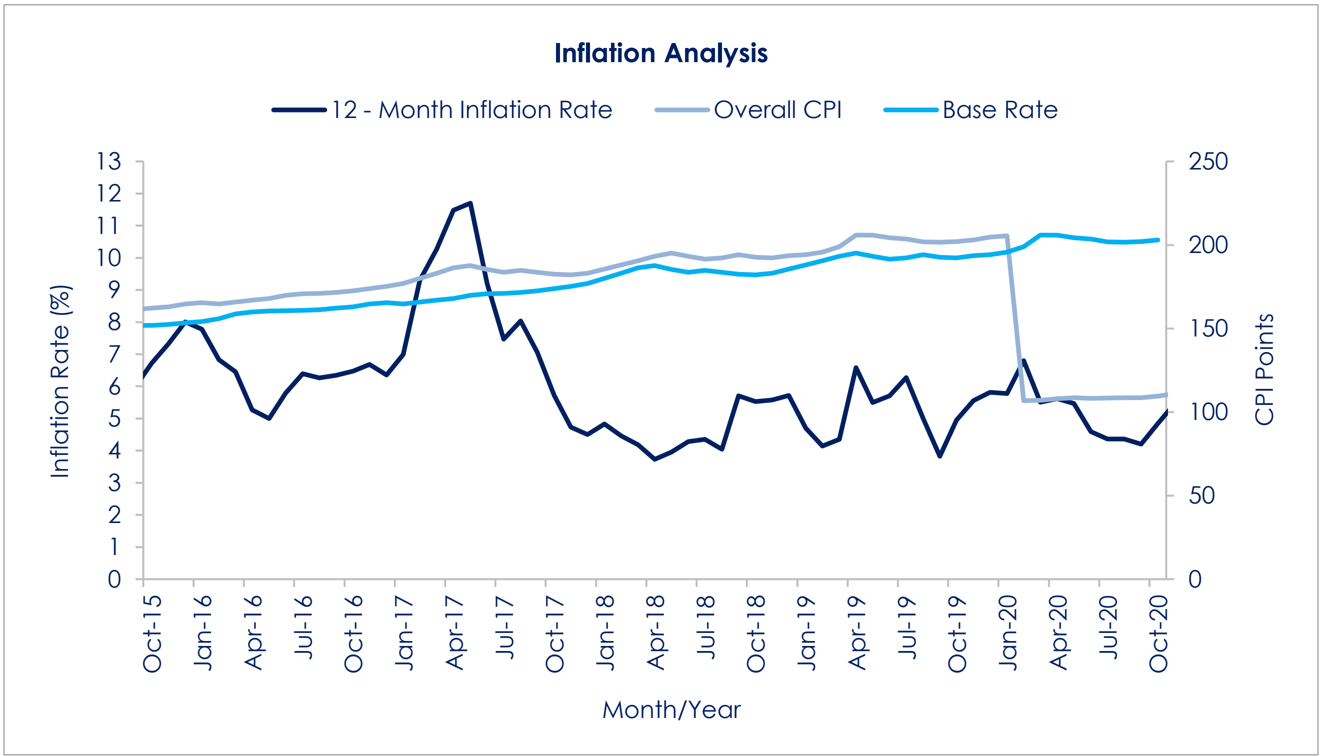
Source: Nairobi Securities Exchange

November inflation up but expected to remain stable in the short-term

Inflation to remain in the upper bound range in December 5% to 7.5%

- Inflation for the month of November 2020 rose to 5.46% from 4.84% a month earlier largely due to marked increases in the prices of transport (12.9%), food and non-alcoholic beverages (6.1%) as well as restaurants and accommodation services (5,2%). (Figure.12).
- In spite of this increase, we see inflation remaining within the medium and upper inflation bands of 5% to 7.5% in the short term.
- Consumer demand remains relatively low compared to the same time last year due to the impact of the Covid-19 pandemic on personal incomes.
- However, we expect an increase in transport and food pricing with the onset of new year festivities that is likely to result in inflation edging up.

Figure.12: Short term inflation likely to rise with the onset of end year festivities



Source: Kenya National Bureau of Statistics

No surprises as MPC retains CBR at 7% in November meeting

- The Monetary Policy Committee (MPC) met on Thursday, 26th November 2020 to review the impact of recent policy measures amid an economic downturn resulting from the ongoing pandemic.
- As expected, the MPC retained the Central Bank Rate (CBR) at 7% backed by optimism over the performance of the economy in the second half of the current fiscal year.

- With no concerns over banking liquidity and adequacy ratios even with a relatively high Non-Performing Loan (NPL) ratio of 13.6%, a stable inflation rate and a relatively healthy foreign currency reserve position being quoted as some of the reasons for the MPC's choice to retain the rate.
- We take note of emerging concerns over the Kenya Shilling (KES) which has depreciated 9.6% against the United States Dollar (US$) since the beginning of the year closing at KES.111.1 on 4th December 2020.
- We however do not see this as sufficient reason for the MPC to alter the CBR rate in their next meeting in January 2021.

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