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Fixed Income Note

February 2020

"The big dilemma"

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Executive Summary

- Our February fixed income report titled **"The big dilemma"** provides a detailed investment analysis of two Central Bank of Kenya (CBK) Treasury Bond issues (T-Bonds) **FXD1/2020/15 (15Year) and FXD1/2018/25 (25Year Re-Opened with 23.3 years to maturity).**
- The "Big Dilemma" refers to the dilemma faced by the CBK and the Monetary Policy Committee (MPC) in funding a growing budget deficit while keeping domestic borrowing rates low and increasing private sector credit.
- CBK seeks to raise KES.50Bn from the long term issues for which investors are expected to bid aggressively in terms of rates especially for the 25 year paper as they demand a premium due to duration risk associated with such long-term papers.
- The issue is likely to achieve a combined subscription rate of between 67%-70% (KES.33.5-KES.35.0Bn).
- Our investor bid predictions on what we expect to be an undersubscribed issue as follows;

Weighted Average Rate (WAR) of bids 15 Year: 12.80%-13.00% / 25 Year: 13.35%-13.65%
Weighted average rate of accepted bids 15 Year: 12.80%-12.90% / 25 Year: 13.35%-13.50%

- The report shows our concern over growing public debt due to the growing mismatch between Government revenue and its expenditure as well as the rising cost of debt service.
- In terms on national accounts for the 2019/20 year, we see an increase in Government receipts in December where the National Treasury had achieved about 47% of its total receipts target including 50.2% of its domestic borrowing target.
- Secondary market activity picked up in January after the December slump with expectations of a further increase in February.
- New in our report is trading recommendations where we give trading ideas based on whether the investor is holding a trading or income portfolio further listing specific bonds with a buy or hold recommendation.
- We do not expect major deviations in the country's macro-economic variables with our inflation target remaining at 5.5-6% for February.
- On monetary policy we review the reasons behind the downward revisions of the Central Bank Rate (CBR) by the Monetary Policy Committee (MPC) with the view that the revisions have not had the desired impact on private sector credit.

CBK issues 15Year and 25Year bonds worth KES.50Bn

- Central Bank of Kenya (CBK) invites bids for two treasury bonds FXD1/2020/15 (15Year) and FXD1/2018/25 (25Year Re-Opened) for a total of KES.50Bn (Table.1).
- This move is largely aimed at increasing the maturity profile of public debt which currently stands at just over 4 years.
- Market liquidity remains high but most investor interest in primary auctions and secondary trading activity is on the short and medium-term papers.
- We predict an undersubscription for these issues - **67%-70% (KES.33.5Bn-KES.35Bn)** on account of the bonds' long tenors.

Table.1: Primary Bond issue summary

Issue Number	FXD1/2020/15	FXD1/2018/25
Total Amount Offered	KES.50Bn	
Tenor (Years)	15 Yrs	25 Yrs
Term to Maturity	15Yrs	23.33Yrs
Coupon Rate (%)	Market Determined	13.400
Issue Price	Discounted/Premium/Par	
Period of Sale	3rd Feb – 18th Feb 2020	
Auction Date	19th Feb 2020	
Value Date	24th Feb 2020	
Yield Curve (%) (Weighted average tenor 15Yrs and 25Yrs) 7th Feb 2020)	12.4905	-

Source: Central Bank of Kenya

- The initial auction for the 25Year bond received bids worth KES.10.1Bn, a performance rate of 25.3% with weighted rate of accepted bids at 13.451%.
- Yields on the 25 Year paper have fallen since then (June 2018) as all the bonds yields declined during the rate cap era (refer to table.4).

Investor bid predictions – Investors to bid higher due to duration risk

- We expect investors to bid aggressively for the two papers as they demand a duration risk premium.
- In an attempt to lengthen the average maturity profile of public debt, CBK is expected to cautiously accept most bids received.
- Our predicted Weighted Average Rate (WAR) of market and accepted bids are shown in Table 2.

Table.2: Auction bid predictions

Rate	FXD1/2020/15	FXD1/2018/25
Market Weighted Average Rate (%)	12.80 – 13.00	13.35 – 13.65
Weighted Average Rate of Accepted Bids (%)	12.80 – 12.90	13.35 – 13.50

Source: Sterling Capital Research

- Historically, there has been low investor demand for 15Yr and 25Yr issues especially from banks and retail investors (Table.3).
- Most of the subscription on the 25 Year bond will come from pension funds.

Table.3: Historical primary market auction performance

Issue Number	Issue Date	Amount Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield to Maturity
FXD1/2019/15	28th Jan, 2019	40	25.1	14.7	62.7	12.857	12.469
FXD2/2019/15	13th May, 2019	50	21.5	19.3	43.1	12.734	12.476
FXD1/2012/15 (Re-opened)	24th Sep, 2012	40	39.8	21.2	99.4	11.000	11.725
FXD1/2018/15 (Re-opened)	28th May, 2018		45.8	17.7	114.6	12.650	12.448
FXD3/2019/15	29th July, 2019	40	86.7	50.6	216.7	12.340	12.481
FXD1/2018/15 (Re-opened)	28th May, 2018	50	15.3	15.3	30.5	12.650	12.448
FXD2/2019/15 (Re-opened)	13th May, 2019		17.4	17.4	34.7	12.734	12.476
FXD1/2018/15 & FXD2/2019/15 – Tap Sale	28th May, 2018 13th May, 2019	30	9.4	9.4	31.2	12.650 & 12.734	12.448 & 12.476
FXD1/2018/25	25th June, 2018	40	10.1	5.2	25.3	13.400	13.056

Source: Central Bank of Kenya

- We have also used implied yields of bonds of almost similar terms to maturity from the Nairobi Securities Exchange (NSE) as at 7th February, 2020 yield curve to determine possible investor bids (Table.4).

Table.4: Benchmark issues to guide investor bids

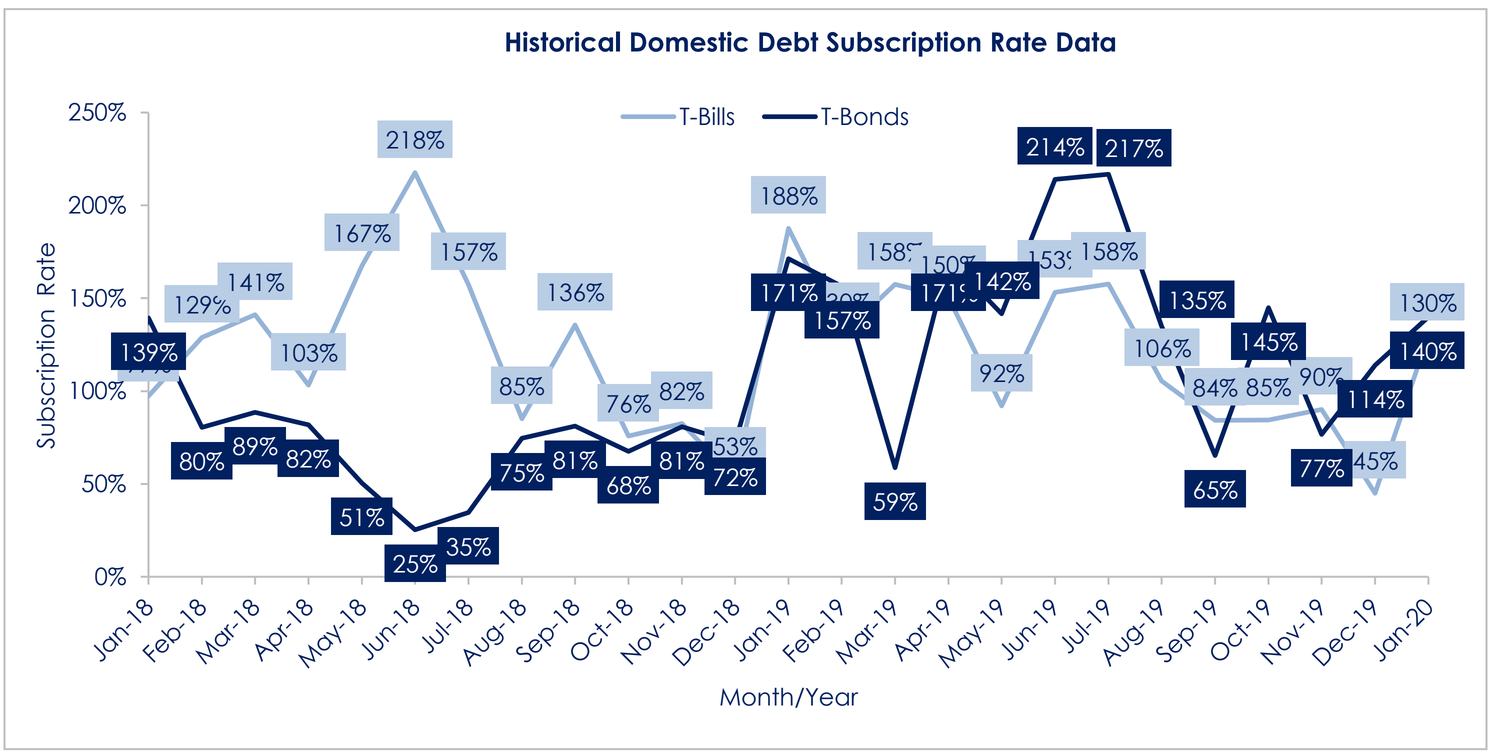
Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years	Last traded Yield (%)	Yield Curve at time of issue
FXD1/2018/25	25th June, 2018	13.40	25th May, 2043	23.37 (8508)	13.06	-
FXD1/2019/15	28th Jan, 2019	12.857	9th Jan, 2034	13.97 (5085)	12.47	12.61
FXD2/2019/15	13th May, 2019	12.734	24th Apr, 2034	14.26 (5190)	12.48	12.65
FXD3/2019/15	29th July, 2019	12.340	10th July, 2034	14.47 (5267)	12.48	12.36

Source: Central Bank of Kenya

Domestic debt subscription up in January 2020, expected to continue in February 2020

- CBK offered KES.50Bn in T-Bonds and KES.96Bn in T-Bills in January 2020.
- Both the T-bills and T-bonds were oversubscribed receiving bids worth KES.124.9Bn and KES.69.9Bn respectively.
- The subscription rate was 130.1% for the T-bills and 139.9% for the T-bonds.
- We attribute high subscription rates to high liquidity in the market and relatively attractive tenors of the T-bonds (4.13 and 9.13 years).
- In February, we expect high liquidity and increasing T-bill rates to continue driving subscription rate because they offer the best returns in respect of lower risk against good returns as opposed to investing in equities.

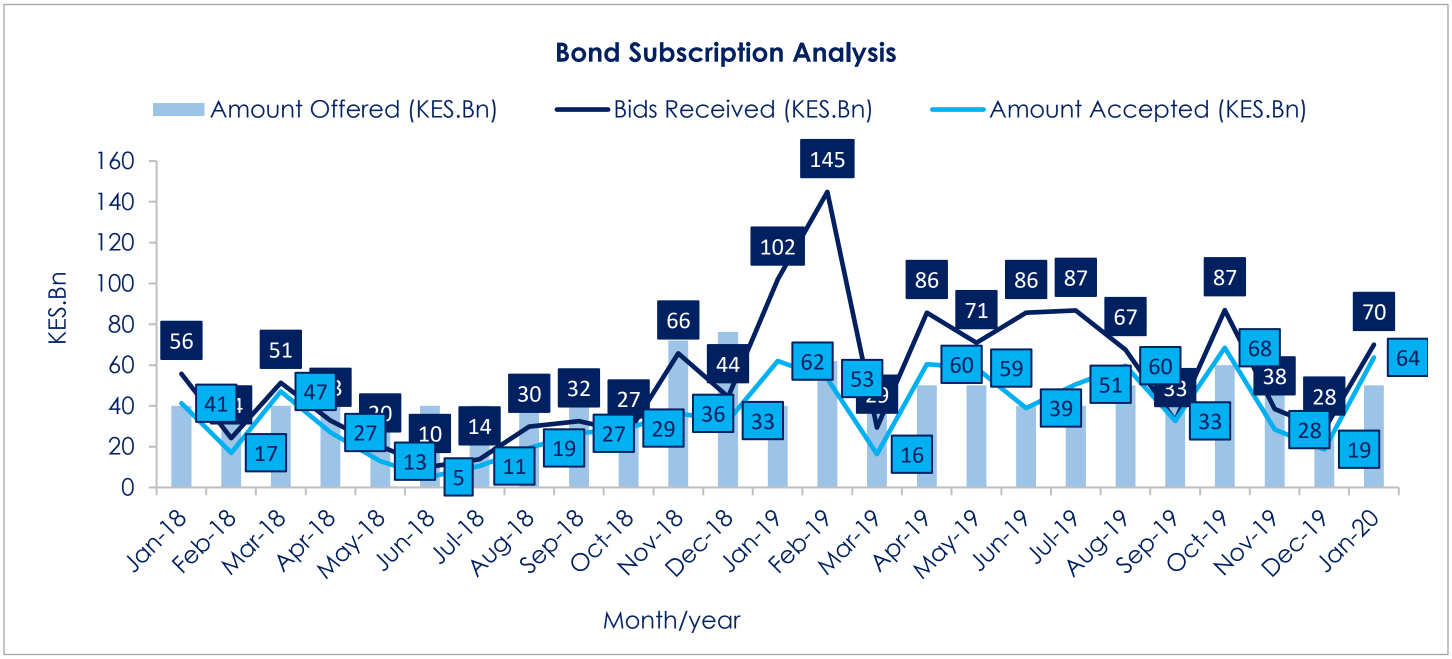
Fig.1: January Re-opened bonds oversubscribed



Source: Central Bank of Kenya

- The 5 and 10 year re-opened bonds (FXD1/2019/5 & FXD1//2019/10) issued in January 2020 received an aggregate KES.69.9Bn equivalent to a 139.9% subscription rate.
- The CBK accepted KES.44.5Bn and KES.19.3Bn at a rate of 11.499% and 12.430% for the 5 year and 10 year issues respectively.
- We attribute the high subscription to the term to maturities 4.13 and 9.13 years with the former attracting KES.44.5Bn and the latter KES.25.4Bn.

Fig.2: Uptick in T-bill demand with 364 day T-Bill in high demand

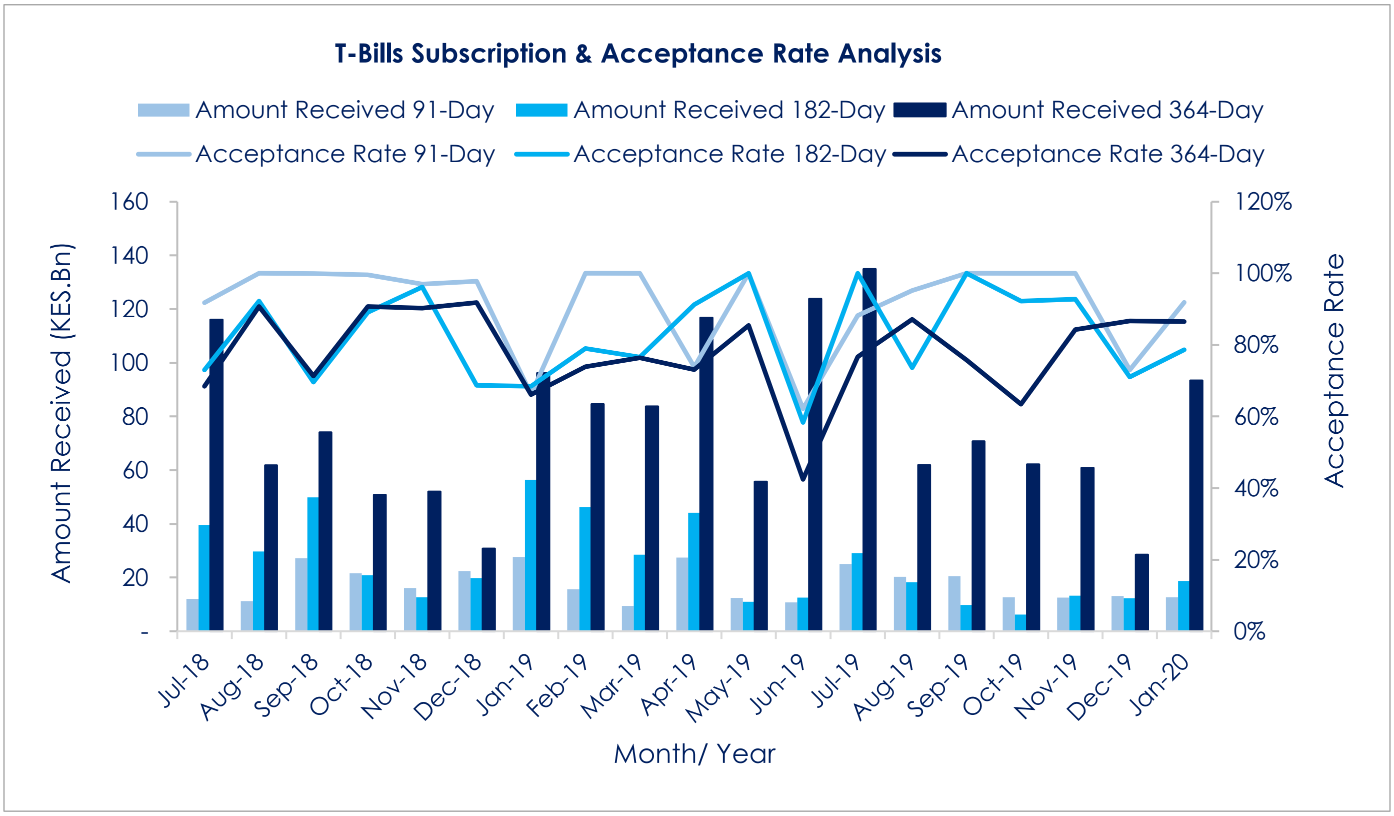


Source: Central Bank of Kenya

T-Bill auction demand increases in January 2020, expected to improve in February 2020

- The 364-day T-bill remains the most heavily subscribed T-Bill in January attracting KES.93.4Bn in subscriptions.
- The 91-day and 182-day T-Bills were undersubscribed with subscription rates of 79% and 47% respectively.
- KES.11.6Bn, KES.14.8Bn and KES.80.8Bn was accepted equivalent to acceptance rates of 92%, 79% and 87% for the 91-day, 182-day and 364 day papers respectively (Fig.3).
- Demand for all the papers improved from December auctions and we expect this improved investor auction participation to continue in February.
- We expect the 364 day T-bill to continue being heavily subscribed due to high liquidity in the market.

Fig.3: 364-day T-bill heavily over-subscribed in January

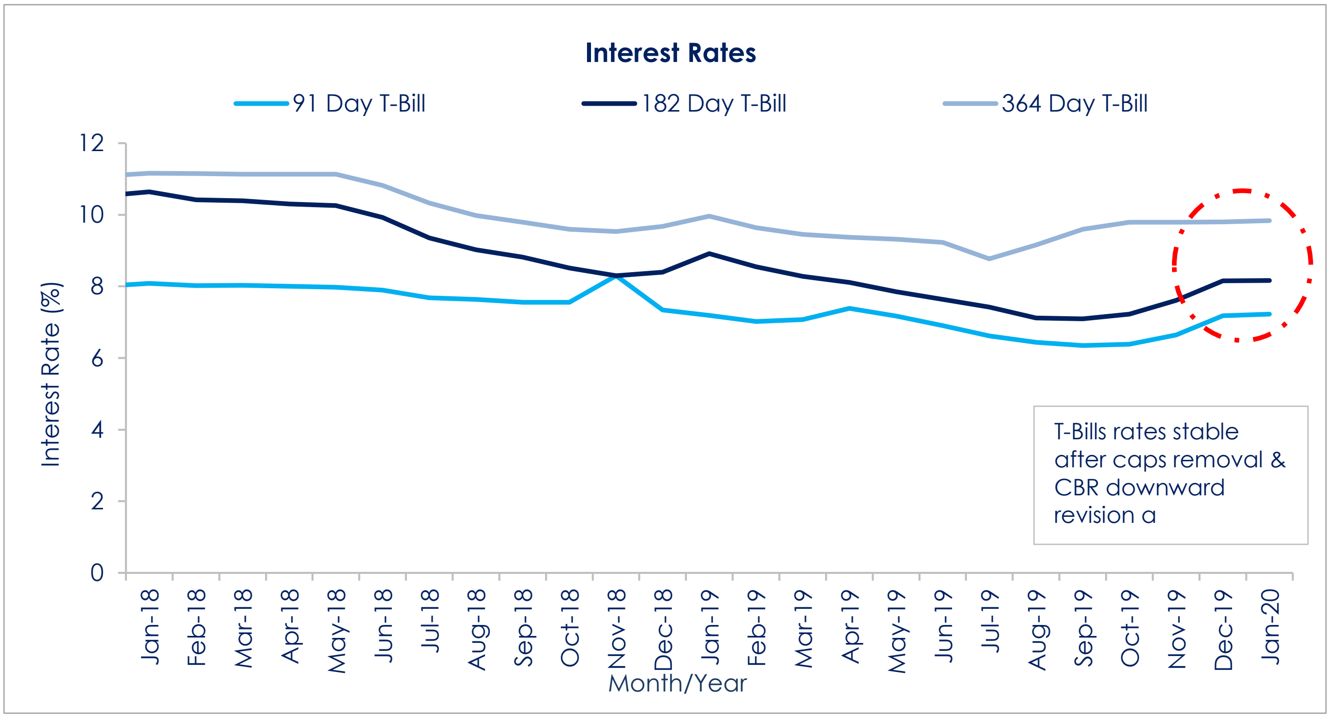


Source: Central Bank of Kenya

T-Bill yields rising gradually despite reduction of the Central Bank Rate (CBR)

- The average T-Bill rose marginally in January 2020 over the previous month in spite of the removal of interest rate caps in October 2019 and downward revision of the Central Bank Rate (CBR) in November 2019 and February 2020.
- Yields on the 91, 182 and 364 day T-Bills rose 5bps, 1bps and 4bps to 7.23%, 8.17% and 9.84% respectively in the month of January over the previous month. (Fig.4)
- T-Bills acceptance rate during the month was 85.9% (KES.107.3Bn) compared to 79.8% (KES.43.0Bn) in December 2019.
- We expect interest rates on short term domestic debt to remain relatively stable in the near and medium term

Fig.4: T-Bill rates remain stable

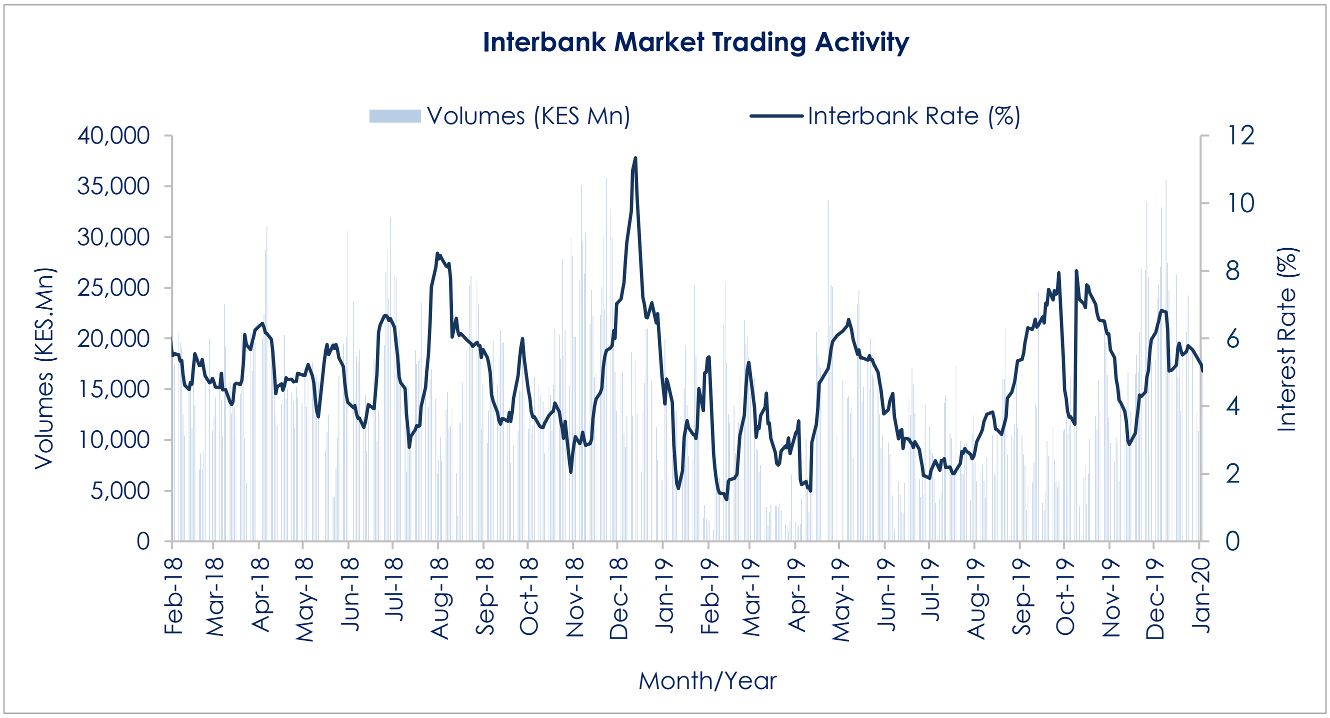


Source: Central Bank of Kenya

High market liquidity continues to suppress inter-bank lending activity and rates

- Average inter-bank lending rates declined to 4.3% in January 2020 from 5.9% the previous month with total traded volumes dropping 21.9% to from KES.325.9Bn Fig.5).
- The decline in the rate is mainly attributable to improved market liquidity.

Fig.5: Inter-bank rates remain low on high market liquidity, trend expected to continue in February 2020

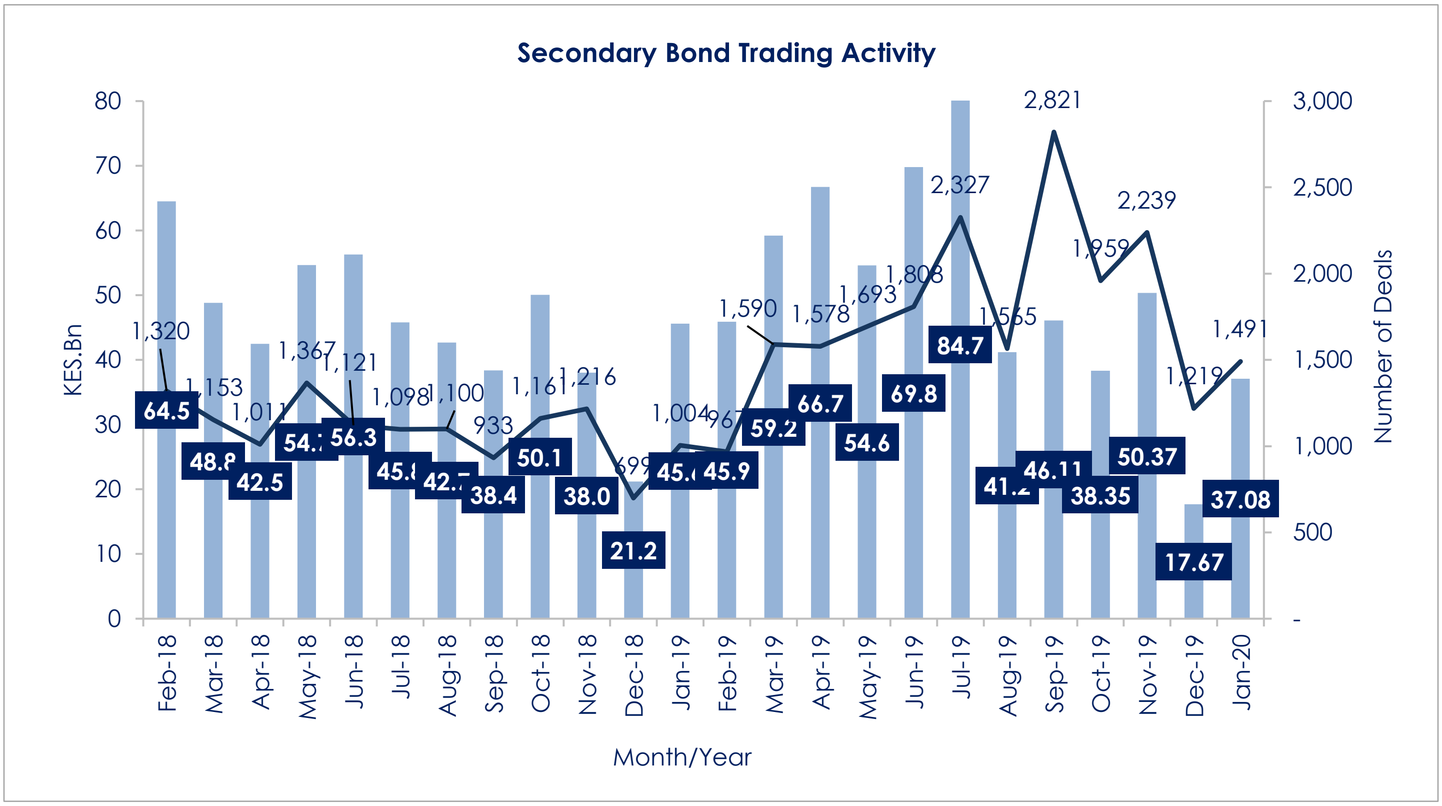


Source: Central Bank of Kenya

Secondary market trading activity recovers in January 2020 from festive season slump

- Turnover in the secondary market rose 109.8% to KES.37.1Bn in January 2020 with the number of deals up 22.3% to 1,491 (Fig.6).
- The improved trading activity is attributable to major market players opening up their trading books at the beginning of the year.
- Secondary market trading activity is expected to continue rising in the near term improving due to a combination of high market liquidity and active trading.

Fig.6: Uptick in Secondary Market Activity



Source: Central Bank of Kenya

Trading ideas - keep it short

- We recommend that investors with a trading portfolio to focus on the short end of the yield curve due to relatively high yields in consideration of the short period to maturity (Table.5).
- However, opportunities exist for bonds with high coupon rates in the long end of the yield curve, ideal for investors holding an income portfolio.

Table.5 - Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Yield to Maturity (%)	Current Yield** (%)	10-Year Historical Average Yield (Pre-Rate Cap)	Average Yield (Post-Rate Cap)
FXD1/2019/5	4.0	11.304	2.99	11.3836	10.76	11.8356	11.1315
FXD3/2019/5	4.9	11.492	3.56	11.4375	11.26	12.0236	11.3846
FXD2/2019/5	4.3	10.872	3.21	11.3997	10.76	11.8356	11.1315
FXD1/2019/2	1.0	10.701	0.88	9.8427	10.57	11.2689	9.8236
FXD1/2016/5	1.2	14.334	1.03	10.1667	13.15	11.2689	9.8236
FXD1/2016/10	6.5	15.039	4.02	11.6980	12.33	12.2080	11.4881

Source: Nairobi Securities Exchange & Sterling Research

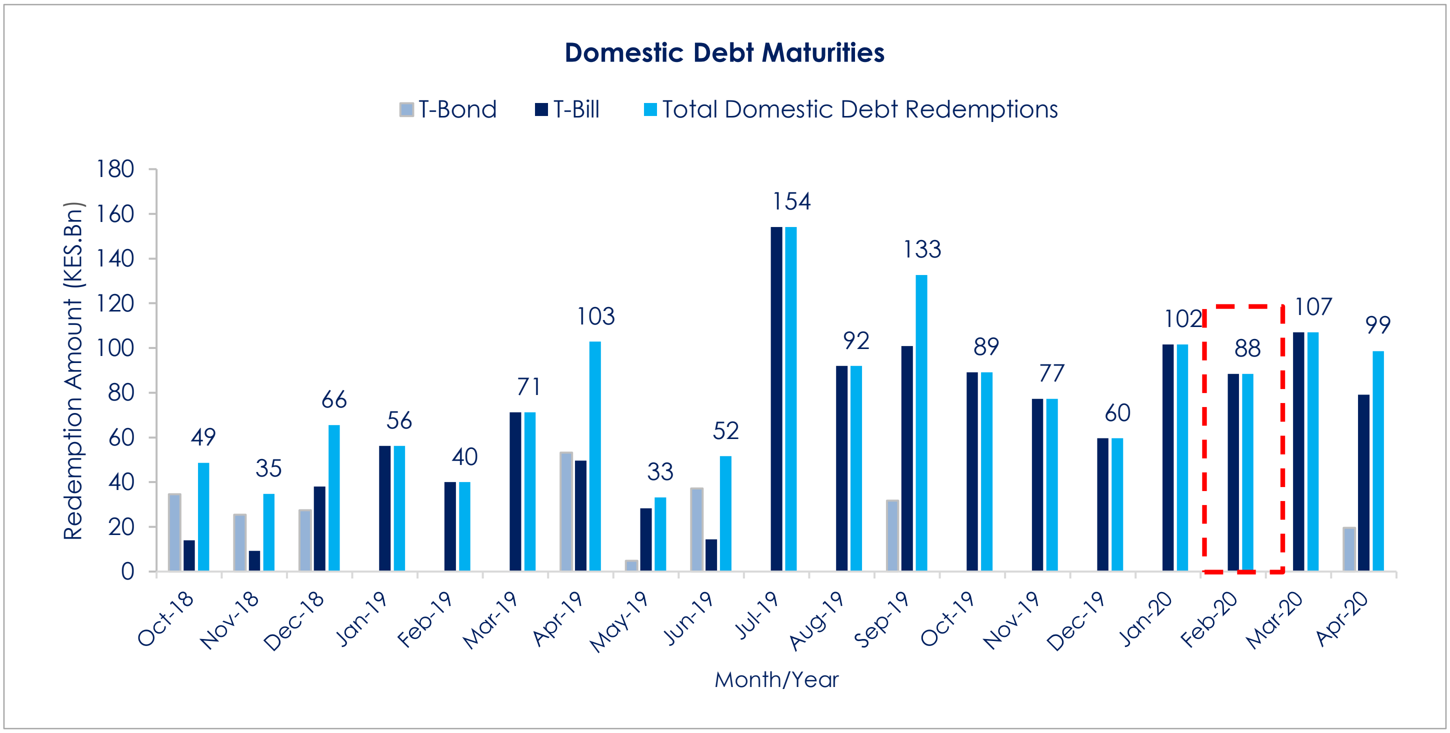
*Modified duration - Expresses the measurable change in the value of a security in response to a change in interest rates (for every 1% movement in interest rates, the bond would inversely move in price by the modified duration)
** Current Yield – Return on investment, for an investor holding a specific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

KES.88.5Bn in total domestic debt redemptions February 2020

No T-Bond redemptions in February 2020 - KES.88.5Bn in T-Bill redemptions

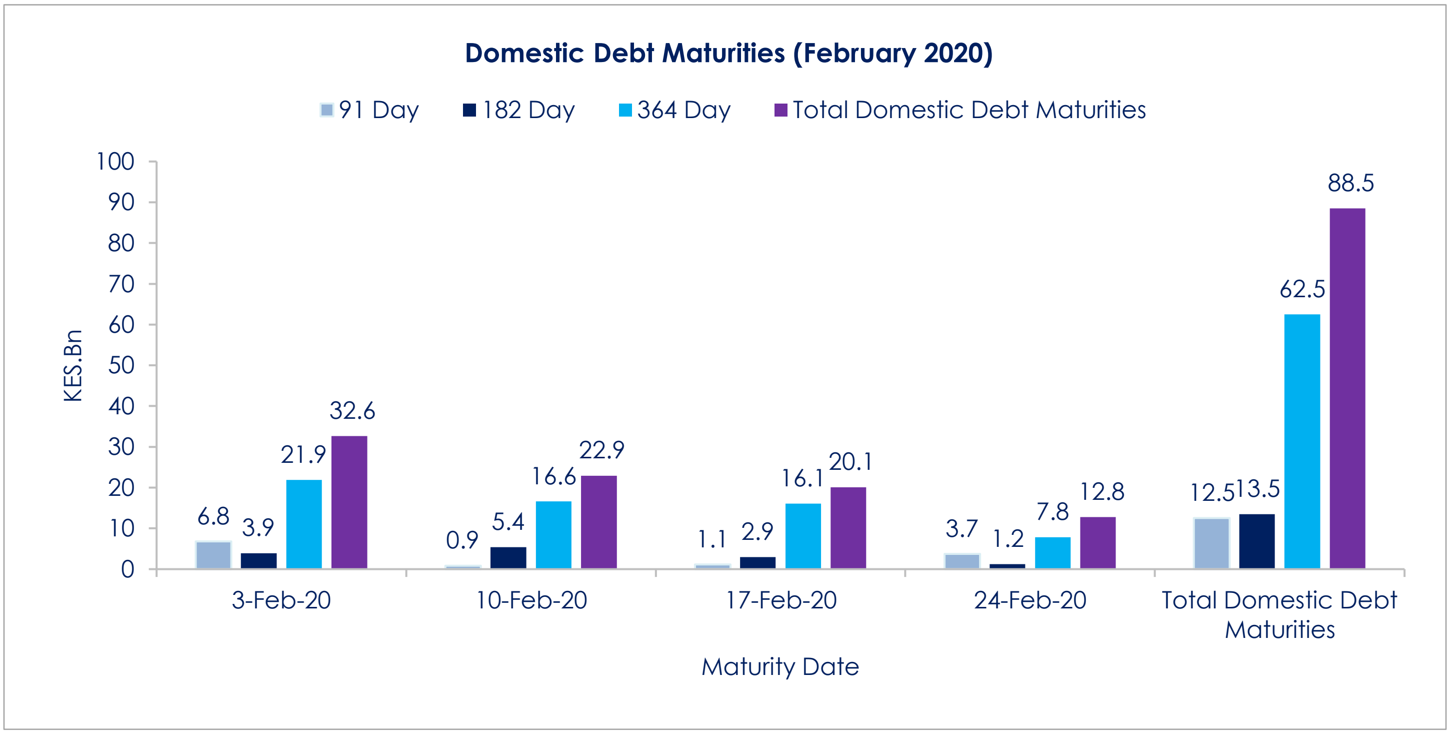
- A total of KES.88.46Bn in domestic debt is maturing in February 2020. T-Bills account for all the redemptions this month (Fig.7).
- The 91, 182 and 364 day T-Bills includes KES.12.5Bn, KES.13.5Bn and KES.62.5Bn in redemptions in February 2020 respectively.
- The first week of February will record the highest level of redemptions (KES.32.6). The amounts will decline gradually, with the final week of February recording the lowest amount (kes.12.8). (Fig.8)
- Domestic debt maturities are expected to edge up KES.107.1Bn in March. The first bond maturity for the year is expected to fall due in April 2020, indicating an increase in government appetite for domestic borrowing in the coming months to fund these redemptions.

Fig.7: Maturities decline to KES.88Bn in Feb 2020



Source: Central Bank of Kenya

Fig.8: Weekly debt maturities in February 2020



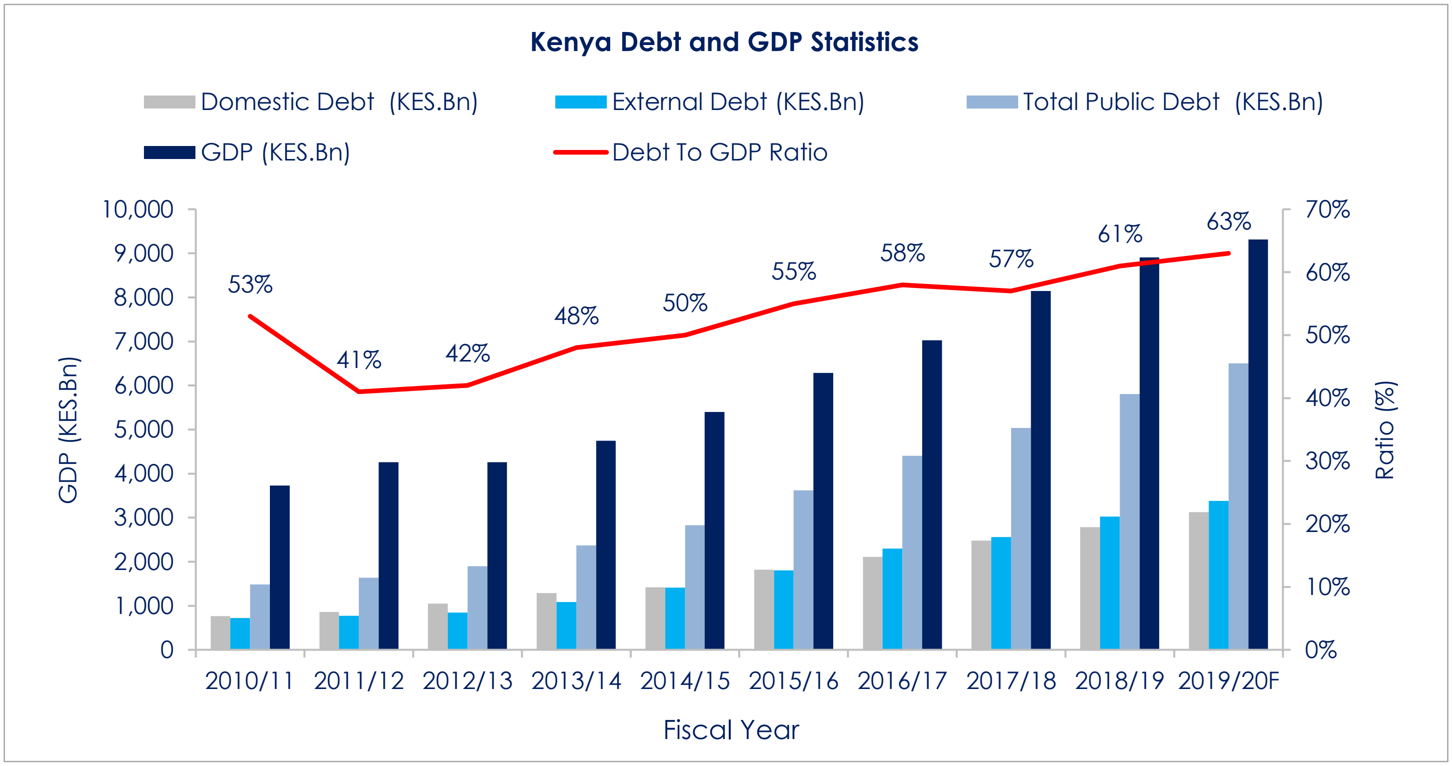
Source: Central Bank of Kenya

Growing concerns over Kenya's Public Debt and service levels

Rising debt levels indicate that Kenya's debt levels will reach 63% of GDP in the 2019/20 fiscal year

- Total public debt as at the end of December 2019 stood at KES.6Tn equivalent to 61% of the country's Gross Domestic Product (Fig.9).
- Forecasts show an increase in the proportion of the country's debt to economic productivity to 63% in the 2019/20 fiscal year.
- We also refer to the first supplementary budget that shows a fiscal deficit of KES, 146.3Bn with the National Treasury declaring that this deficit will be bridged through both domestic and external borrowing.

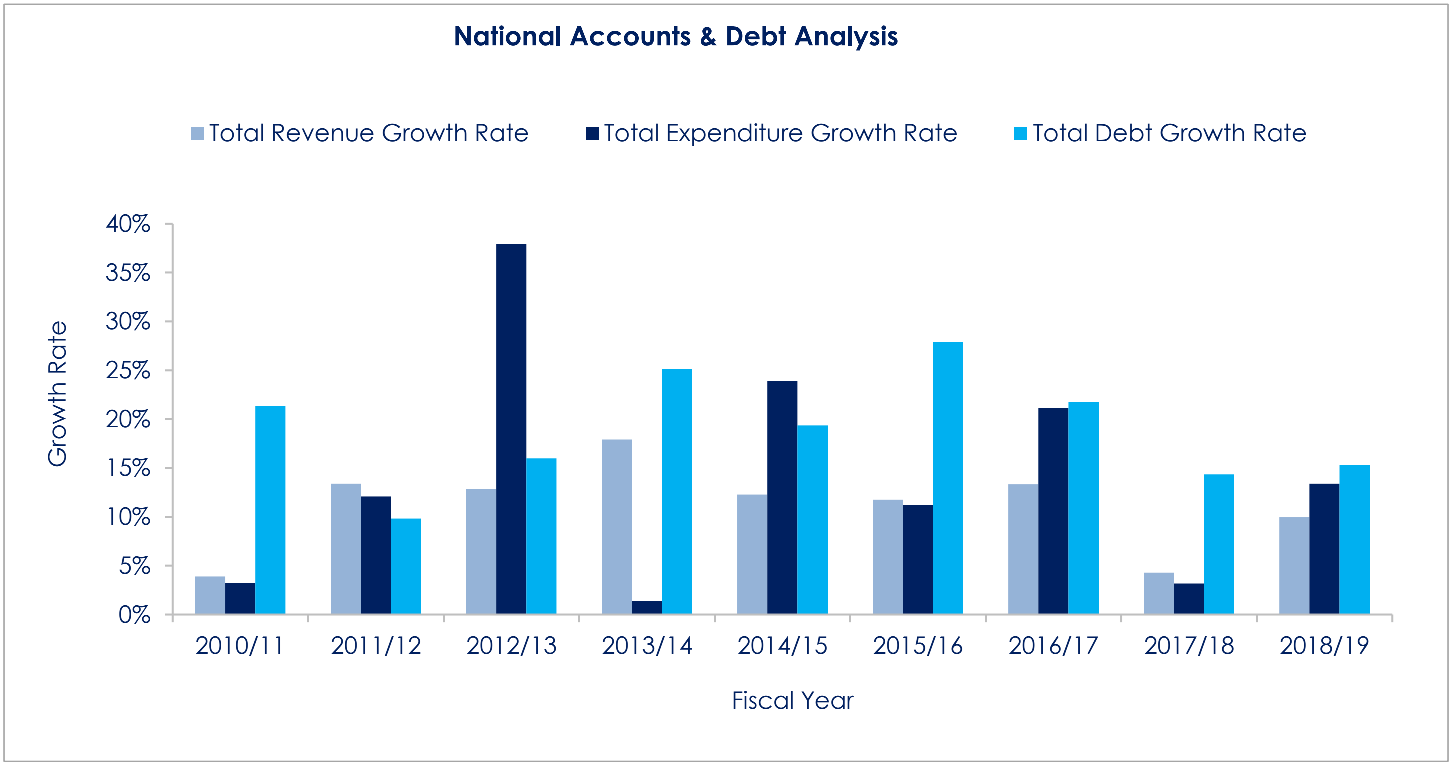
Fig.9: Kenya's total public debt as a proportion of its GDP in 2018/19 estimated at 61% and forecasted at 63% in 2019/20



Source: Kenya National Treasury, World Bank and Sterling Capital Research

- Of great concern is the pace at which the country's expenditure is growing. That is, it continues to grow at a faster pace than its revenues and thus the fast pace of growth in public debt (Fig.10).
- It is our view that additional taxation to bridge the fiscal gap will be counter effective and could even result in a decline in revenue collection. Instead the tax authorities should direct efforts towards enforcing tax compliance and deterring tax evasion.

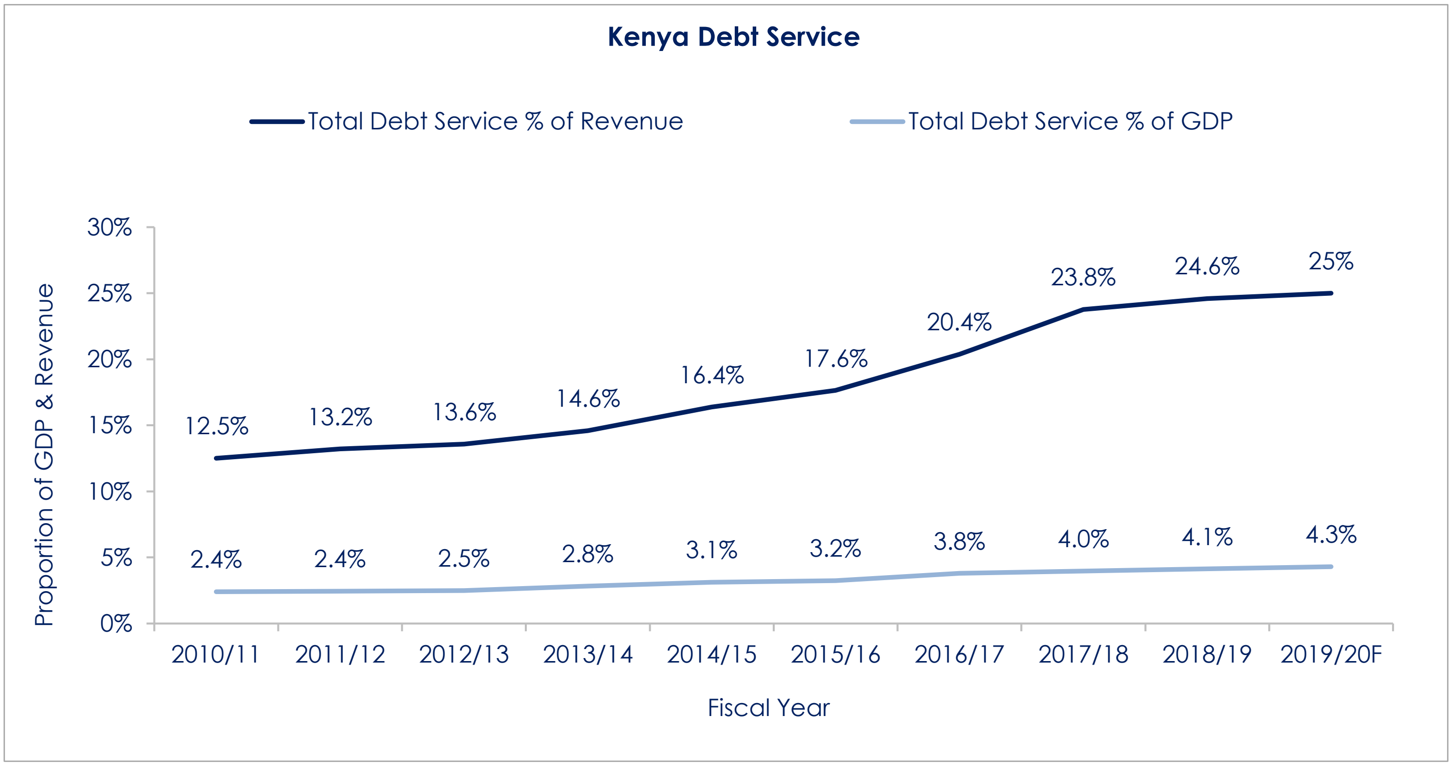
Fig.10: Total expenditure growing at a faster pace than Government revenue



Source: Kenya National Treasury, World Bank and Sterling Capital Research

- As is expected of rising debt levels, we also see an increase in debt service costs meaning that a larger portion of the country's income most of it raised through taxation is being used to service this debt (Fig.11).
- Our forecasts show an increase in debt service costs for the 2019/20 fiscal year as a result of increased borrowing and a gradual rise in domestic debt interest rates now that the interest rate capping law was repealed.

Fig.11: Kenya's debt service costs are increasing



Source: Kenya National Treasury, World Bank and Sterling Capital Research

H1 2019/20 - National Treasury domestic borrowing target at 47% of revised target

- The National Treasury had achieved 47% of its KES.1.2Tn revenue target by the end of the first half of its 2019/20 fiscal year (Table.6).
- Total Non-Tax income and domestic borrowing were above target at 56.6% and 50.2% respectively.
- Aggressive Government borrowing in the domestic market meant that it overcame its shortfall (38.6% against a run rate of 41.7%).
- CBK will continue its borrowing efforts in the second half of the year taking into account the first supplementary budget with a second expected in March 2020.

Table.6: CBK on course with its domestic borrowing target

Receipts	**2019/20 Original Estimates (KES.Bn)**	**2019/20 Revised Estimates (KES.Bn)**	**Actual Receipts (KES.Bn) 30th Nov 2019**	**Actual Receipts (KES.Bn) 31st Dec 2019**	**Proportion of Receipt Target Achieved 31st Dec 2019**
Opening Balance (1st July			98.9	98.9	
Total Tax Income	1,807.6	1,705	628.5	779.3	45.7%
Total Non-Tax Income	69.5	138.9	49.7	78.5	56.6%
Domestic Borrowing*	429.4	514.0	221.8	258.2	50.2%
Loans -Foreign Gov't & International Org	65.2	66.1	7.6	10.1	15.3%
Programme Loan-Budget	2.0	2.0	4.7	4.7	233.3%
Domestic Lending & on-lending	4.3	4.3	1.5	1.6	36.8%
Grant -Foreign Gov't &	14.5	17.7	5.9	6.5	36.5%
Grants from AMISON	5.0	4.0	1.9	1.9	48.5%
Commercial Loan	200.0	200.0	0.0	0.0	0.0%
Unspent Balances (Recoveries)			2.7	5.7	-
Total Revenue	**2,598**	**2,651.9**	**1,023.1**	**1,245.4**	**47.0%**

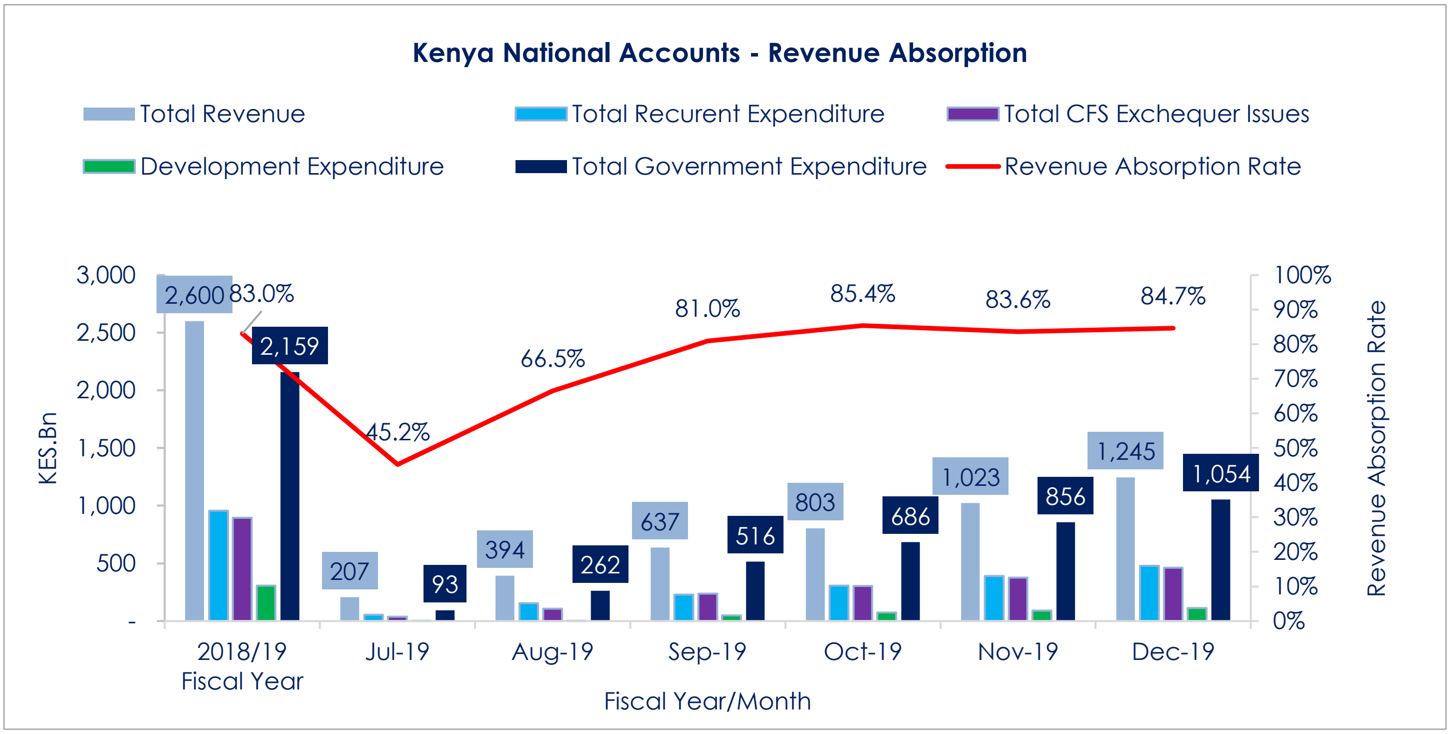
* Note 1: Domestic Borrowing of KES. 514.6 = Net Domestic borrowing KES.391.4 & Internal debt redemptions (Roll-overs) KES.122.6.

Source: The Kenya Gazette Vol. CXXII - No.16 24th January 2020

National Treasury revenue absorption remains high

- The rate at which the Government uses its revenue to finance its expenditure is what we refer to as the "revenue absorption rate" (Fig.12).
- The absorption rate at the end of December 2019 stood at 84.7% compared to 83.6% a month earlier meaning that the Government continues to finance its expenditure with a big proportion of its total receipts.
- This is also an indication that it will continue to tap into domestic and external sources to raise additional capital to finance its budget.

Fig.12: High revenue absorption rates puts pressure on deficit financing



Source: The Kenya Gazette Vol. CXXII - No.16 24th January 2020

Growing fiscal deficit, caps removal pushing domestic interest rates upwards

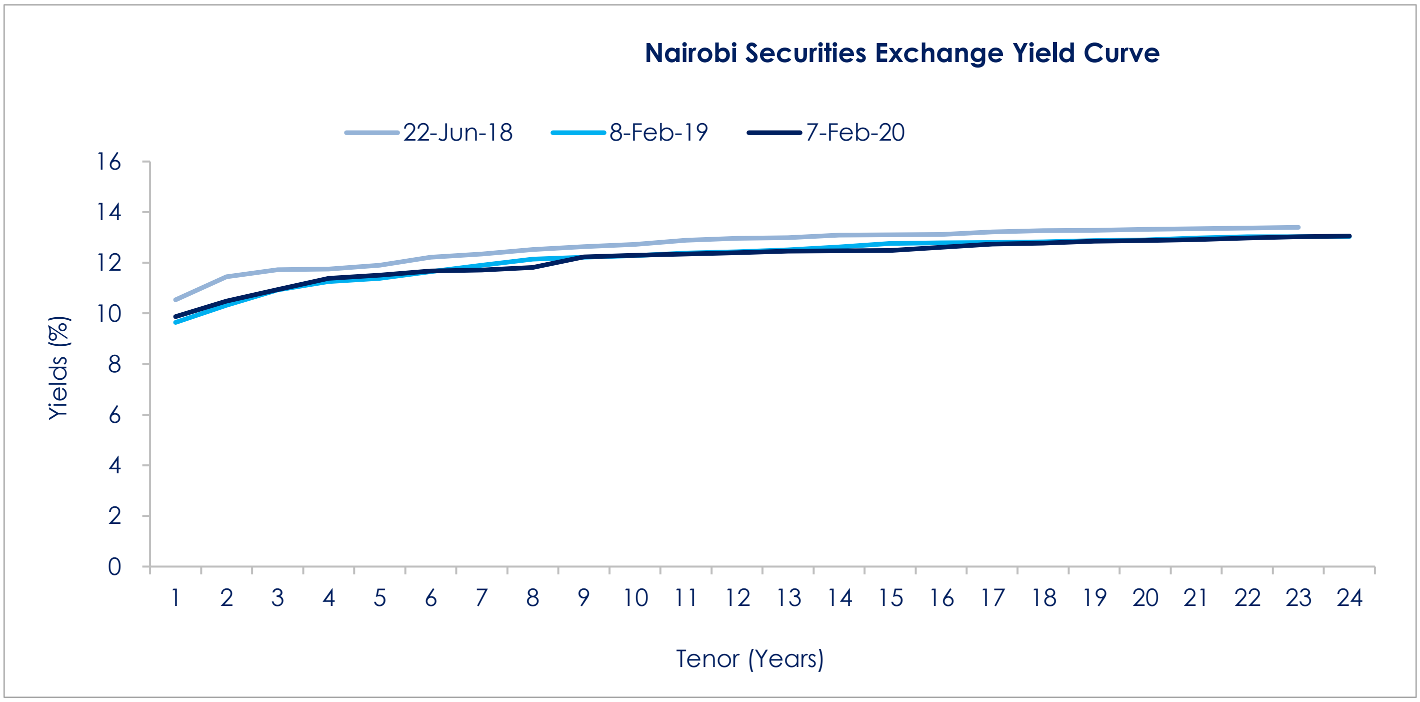
- Yields on short term papers have been rising while those on long term papers have been declining resulting in what appears to be a "flattening" yield curve (Table.6).
- This has been caused by an increase in the number of 5 and 10 years issues and trading activity in 2019 and less 20 and 25 year bonds.
- An inversion of the yield is highly unlikely as the CBK is keen on lengthening the maturity profile of domestic debt, and we expect to see increased issuance of long term papers in 2020.
- We believe that the simultaneous reopening of a 25-Year bond and issuance of a new 15-Year bond is not only an attempt to increase maturity but also one to restore a normal yield curve with higher longer term yields.
- We expect a gradual increase in interest rates as the widening fiscal deficit forces the government to continue borrowing from both domestic and external sources.
- Monetary policy measures such as lowering the CBR rate, inflation within the target range and rejection of aggressive bids by the CBK point towards efforts to maintain low yields on government securities.
- However, with the Kenya Revenue Authority (KRA) missing targets on tax collections, it results in an increasing the need for more government borrowing to cover the deficit. This is likely to gradually push yields further up.
- **We maintain our recommendation to BUY short and medium term bonds and HOLD long term papers.**

Table.6: Yields on all tenors dip compared to January 2019

Tenor	22nd Jun 2018	8th Feb 2019	Yield (7th Feb 2020)	Change June 2018 vs Feb 2020 (Bps)	Change Feb 2019 vs Feb 2020 (Bps)	Sterling Capital yield Curve(10th Jan 2020)
1	10.5370	9.6440	9.8730	↓66.4	↑22.9	9.87
2	11.4491	10.380	10.4868	↓96.2	↑10.7	10.45
5	11.8992	11.3875	11.5055	↓39.4	↑11.8	11.40
10	12.7190	12.2847	12.3004	↓41.9	↑1.6	12.35
15	13.1033	12.7680	12.4905	↓61.3	↓27.8	12.65
20	13.3209	12.9063	12.8813	↓44.0	↓2.5	12.90

Source: Nairobi Securities Exchange

Fig.13: Yields on short term papers increase compared to February 2019

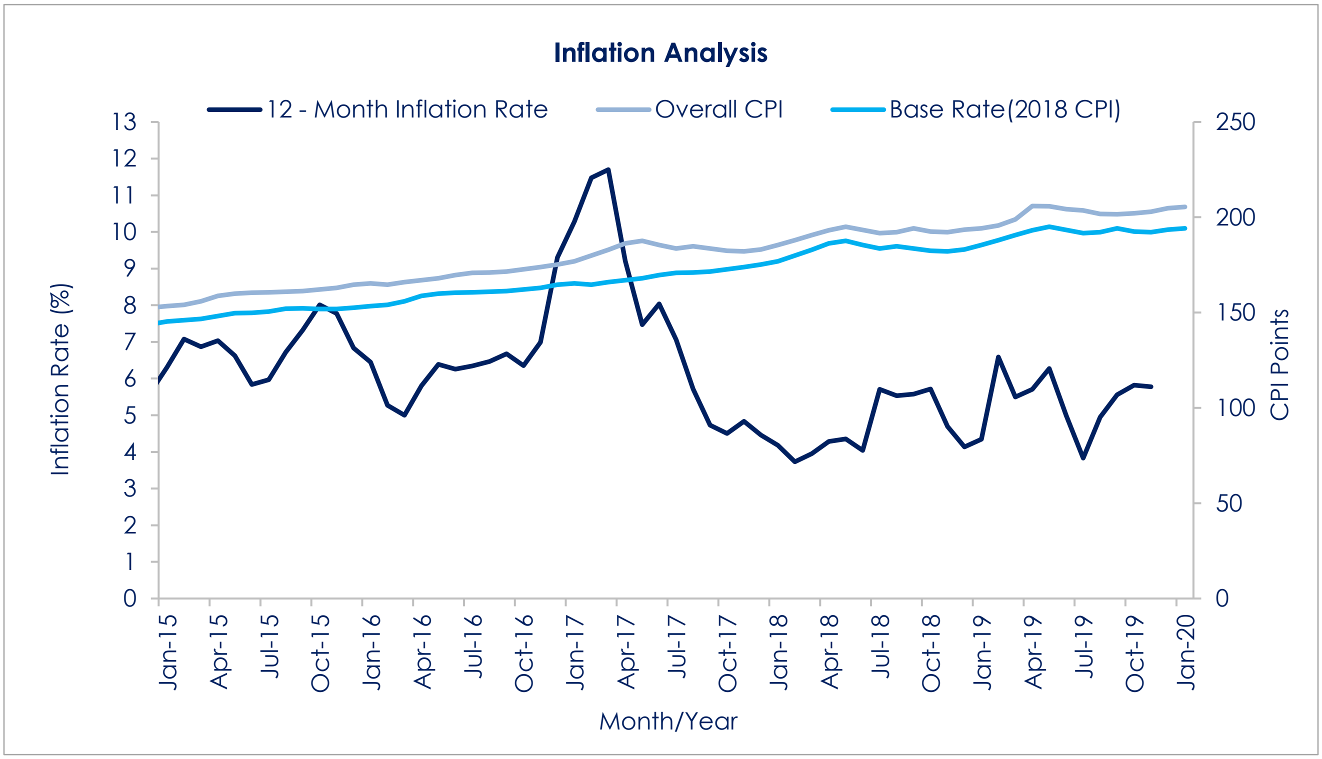


Source: Nairobi Securities Exchange

February 2020 inflation forecast - 5.5% - 6.0%

- Month on month inflation declined marginally to 5.78% in January 2020 from 5.82% in spite of an increase in all components of the Consumer Price Index (CPI) but for transport costs that declined 0.04%.
- Crude oil prices have trended downwards from the beginning of 2020 and we expect this to result in easing pressure on the inflation rate.
- **Our February 2020 inflation forecast is 5.5% - 6.0% based on expectations of minimal deviations in the biggest drivers of consumer prices; food, housing and electricity which combined account for 63% of the CPI.**

Fig.14: February 2020 inflation forecast 5.5% - 6.0%



Source: Kenya National Bureau of Statistics

Monetary Policy Committee likely to hold benchmark rate in next meeting

- The Monetary Policy Committee (MPC) revised the CBR downwards for the second successive meeting on 27th January 2020.
- As has been the case in the past, the MPC noted stable macro-economic conditions as a reason for the revision.
- Top most amongst considerations was private sector credit growth which in our view remains below the committee's expectations.
- That is, it was expected that the initial downward revision in November 2019 would yield a faster pace of private sector credit growth, which hasn't been the case yet.
- The initial revision was expected to serve as a signal to banks to reduce their lending rates, making it affordable for the public sector to access credit.
- All banks that have loan rates pegged to the CBR were forced to reduce their lending rates by 50 bps after the downward revision.
- We expect the further revision of the CBR to have a minimal impact on private sector credit growth as banks continue to purchase government securities.
- **The MPC's next meeting will be held in March, 2020 where we expect them to take stock of the impact of their last two revisions particularly on private sector credit, and it is for this reason that expect them to maintain the CBR at 8.25%.**

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