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STERLING CAPITAL LIMITED

Fixed Income Note

July 2021

"Filling the Trillion Shilling Deficit"

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Executive Summary

- Our fixed income report for the month of July 2021 is titled **"Filling the Trillion Shilling Deficit"** in reference to the biggest budget deficit the country has experienced in its history.
- The Central Bank of Kenya seeks to raise KES.60Bn this month through three re-opened bonds FXD1/2012/15, FXD1/2018/15, and FXD1/2021/25.
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids

  - **FXD1/2012/15: 11.65% - 11.75%**
  - **FXD1/2018/15: 12.55 - 12.65%**
  - **FXD1/2021/25: 13.70 - 13.80%**

  WAR of accepted bids

  - **FXD1/2012/15: 11.55% - 11.65%**
  - **FXD1/2018/15: 12.45% - 12.55%**
  - **FXD1/2021/25: 13.55% - 13.65%**

- 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.
- Investment recommendations are highlighted in the trading ideas section based on the current and expected yield curve movements. The yield curve section is an analysis of the trends in domestic debt interest rates over the period in focus.
- We give our inflation expectations towards the end of the report which concludes with our view on the Monetary Policy Committee (MPC) decision in their meeting at the end of the month.

CBK's July debt issues target KES.60Bn

- The Central Bank of Kenya (CBK) invites bids for three re-opened treasury bonds **FXD1/2012/15**, **FXD1/2018/15** and **FXD1/2021/25** seeking to raise KES.60Bn (Table.1).
- The three bonds have a term to maturity of 6.2 years, 11.9 years and 24.9 years respectively.
- All the bonds have fixed coupon rates with the FXD1/2012/15 bond having a coupon of 11.000%, FXD1/2018/15 has a coupon of 12.650%, and the FXD1/2021/25 having a coupon of 13.924%.
- We believe CBK has issued the bonds to enable the Government to bridge its fiscal deficit and lengthen debt maturity amid stagnant revenues.
- We are cautiously optimistic that all the bonds will be oversubscribed due to the relatively low amount on offer and the large amount of liquidity present in the market.

Table.1: Primary Bond issue summary

Issue Number	FXD1/2012/15	FXD1/2018/15	FXD1/2021/25
Total Amount Offered	KES.60Bn		
Tenor (Years)	15 Years	15 Years	25 Years
Term to Maturity	6.2 Years	11.9 Years	24.9 Years
Coupon Rate (%)	11.000	12.650	13.924
Price Quote	Discounted/Premium/Par		
Period of Sale	28th June 2021 to 13th July 2021		
Auction Date	14th July 2021		
Value Date	19th July 2021		
Yield Curve (%) (Weighted average tenor - 2nd July 2021)	**12.8841**	**12.8841**	**13.5316**

Source: Central Bank of Kenya

Our weighted and accepted bids averages

- Analysis of yields of bonds of similar tenors on the Nairobi Securities Exchange (NSE) as at 6th 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

Rate	FXD1/2012/15	FXD1/2018/15	FXD1/2021/25
Market Weighted Average Rate (%)	11.65 - 11.75	12.55 - 12.65	13.70 - 13.80
Weighted Average Rate of Accepted Bids (%)	11.55 - 11.65	12.45 - 12.55	13.55 - 13.65

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 2nd 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
15-Year						
FXD1/2012/15	24th Sept 2012	11.00	6th Sept 2027	6.2 (2,257)	11.6537	N/A
FXD1/2018/15	28th May 2018	12.65	9th May 2033	11.9 (4,329)	12.5161	12.9820
25-Year						
FXD1/2021/25	10th May 2021	13.92	9th April 2046	24.9 (9.047)	13.5316	13.9240

Source: Central Bank of Kenya

Optimistic on full subscription

- A historical comparison of primary auction results for previous 15-year issues show low investor demand especially for the bond issued in 2012. This due to relatively low coupon rates (Table 4) at least on a historical basis.
- However, current high market liquidity suggests that both 15-year issues will be oversubscribed with a general preference for the FXD1/2012/15, due to the shorter tenure.
- During its primary auction, the 25-year issue saw an oversubscription due to the relatively high coupon rate at the time of issue as well as significant market liquidity evident in the current low interest rate environment.
- In light of the foregoing factors and the relatively low targeted amount, we expect a full subscription on all three bonds.
- We also anticipate the CBK to limit subscriptions to manage the cost of borrowing.

Table.4: Historical primary market auction performance

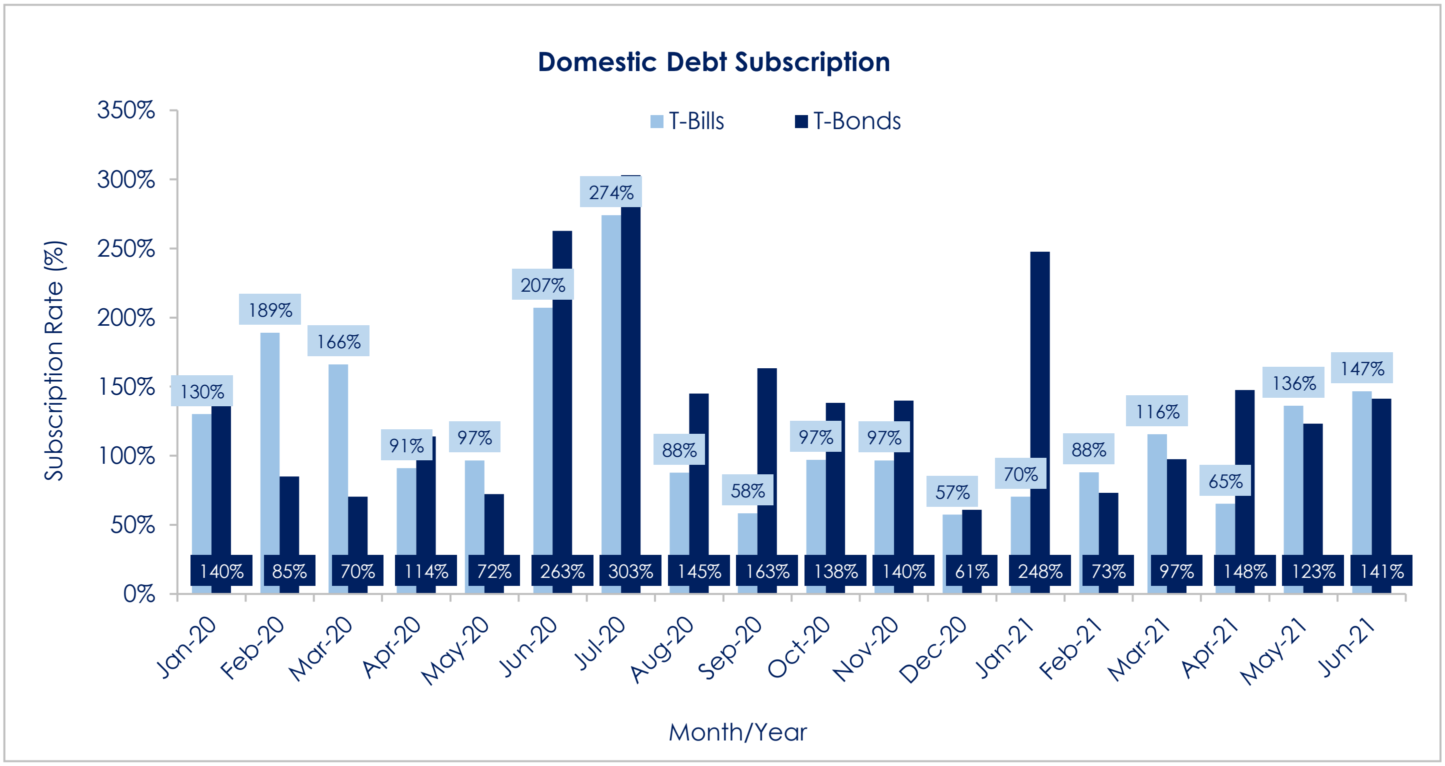
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yields (%)
15-Year						
FXD1/2012/15	40	9.3	8.5	23.2	11.000	12.8841
FXD1/2018/15	40	20.2	12.9	50.5	12.650	12.5385
FXD1/2019/15	40	25.1	14.7	62.7	12.857	12.6085
FXD2/2019/15	30	11.6	6.0	38.6	12.734	12.6802
25-Year						
FXD1/2021/25	30	31.0	14.3	103.4	13.92	13.5316

Source: Central Bank of Kenya

High market liquidity continues to drive T-Bill demand

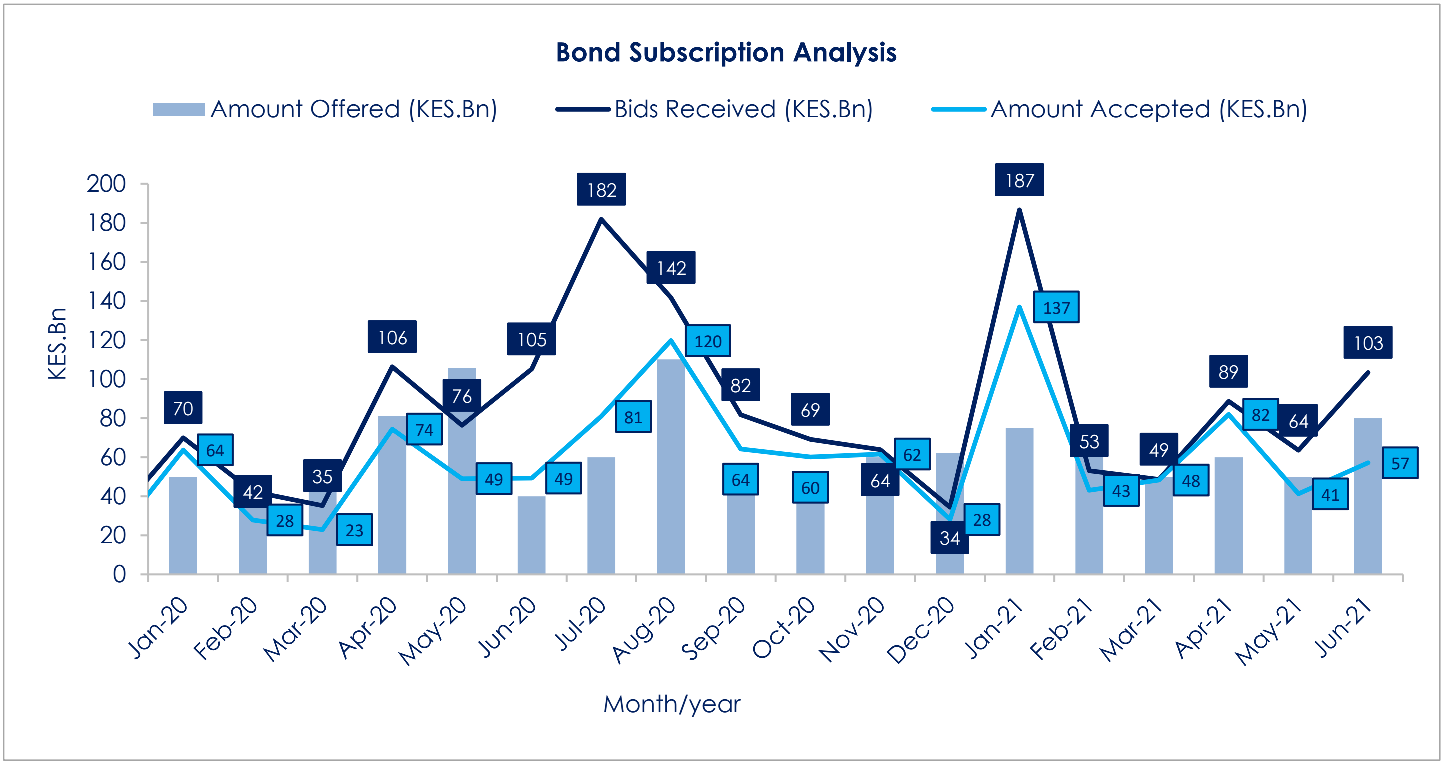
- T-Bills subscription rose for the third month running in June 2021 (146.7%) from 136.2% in May with the CBK receiving T-Bills worth KES.135.7Bn against KES.96Bn offered (Figure.1).
- The 364-day and 182-day T-Bills recorded the highest subscription rates at 195.5% (KES.78.2Bn) and 179.2% (KES.28.7Bn) respectively while the 91-day paper was undersubscribed at 72% (KES.28.8Bn).
- The Bond issue and tap sale for FXD1/2019/20 and FXD1/2012/20 received bids worth KES.80Bn against the KES.103.4Bn offered, a subscription of 146.7%. (Figure.2).
- We expect the demand for the T-Bills to remain high on account of high market liquidity this being the driving factor behind declining T-Bill rates in recent months.

Figure.1: Investor demand for 182-day and 364-day T-Bill soars



Source: Central Bank of Kenya

Figure.2: High demand for Government debt persists in June 2021

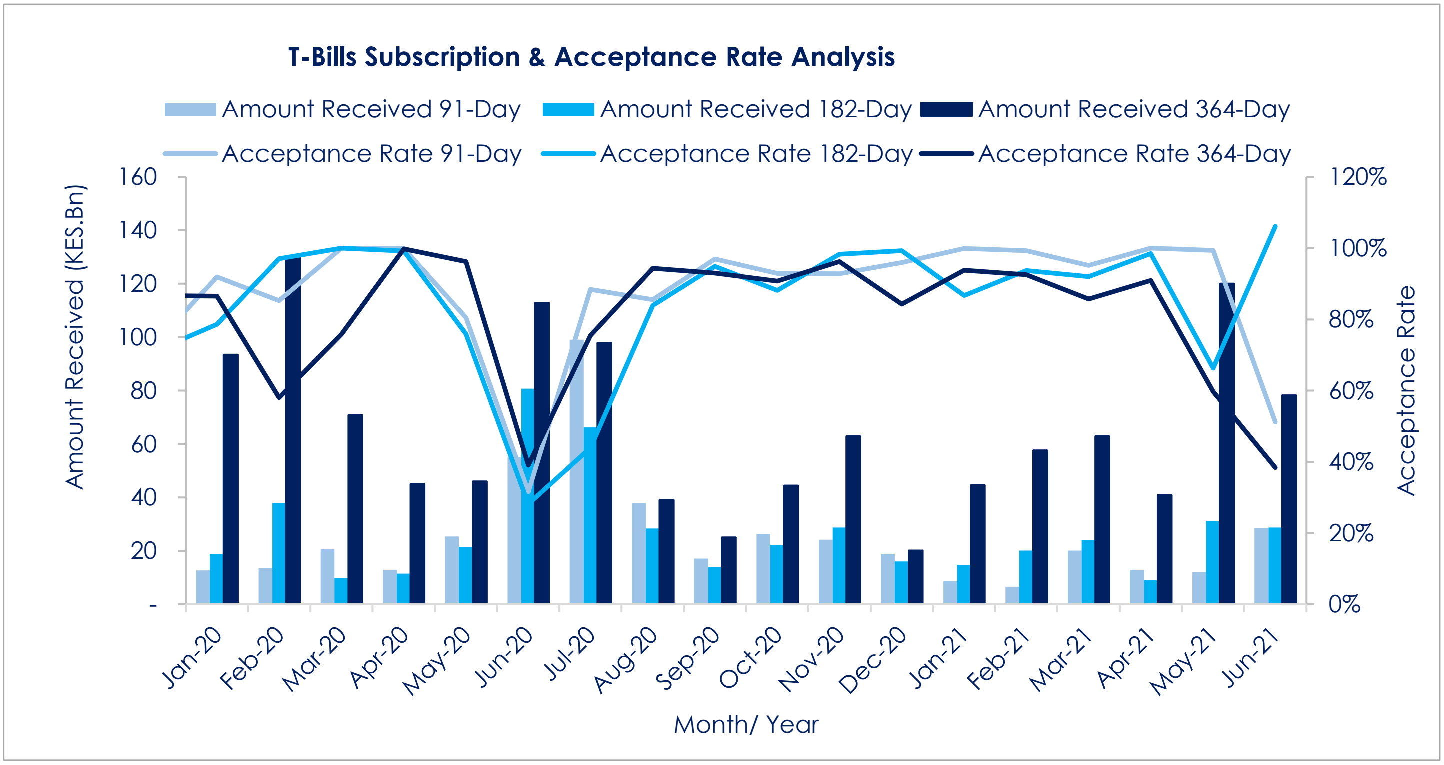


Source: Central Bank of Kenya

T-Bill rates continue on a downward trend

- Acceptance rate for the 91-day and 364-day papers dipped on account of high subscription rates while the 182-day paper acceptance rate rose on lower demand during the month (Figure.3).
- June 2021 acceptance rates for 91-, 182- and 364-day T-bills were 51.2%, 106.1% and 38.4% against subscription rates of 179.2%, 72% and 195.5% respectively.
- We expect high demand for the T-bills specifically the 364-day paper to continue pushing interest rates lower.

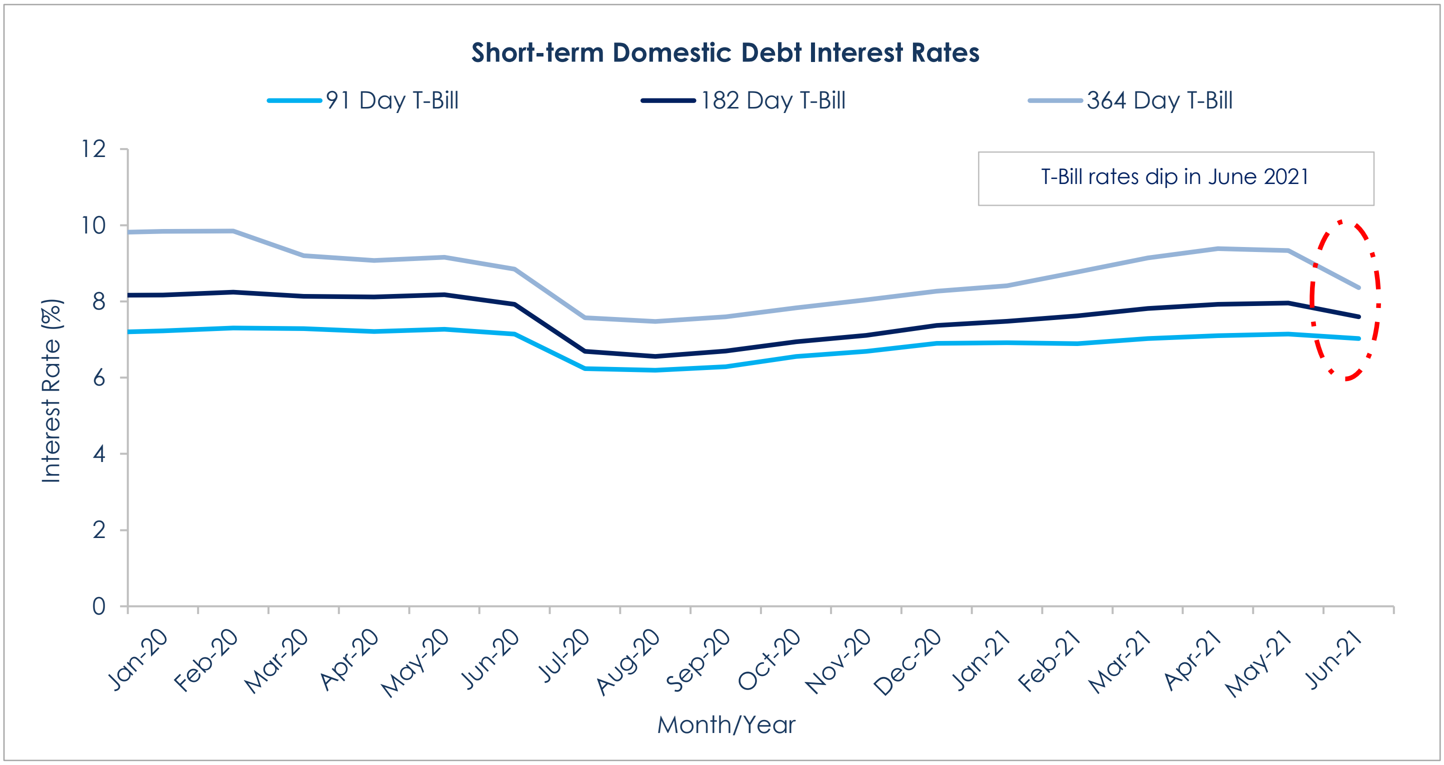
Figure.3: Acceptance rate for 91-day and 364-day papers dip while 182-day acceptance rate goes up



Source: Central Bank of Kenya

- Average interest rates for the 91-day, 182 day and 364-day T-Bills declined to 7%, 7.6% and 8.4% compared to 7.2%, 8% and 9.3% in May 2020 respectively (Figure.4).
- We observe a gradual decline in T-Bill rates beginning in mid-May which we attribute to lower demand by the government who achieved the net domestic borrowing target for FY2020/21 borrowing KES.521.7Bn.
- Despite the decline in T-Bill rates in recent auctions, we expect an upward shift of the yield curve in the new fiscal year as the government tries to complete some infrastructure projects before the end of their term in 2022.

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

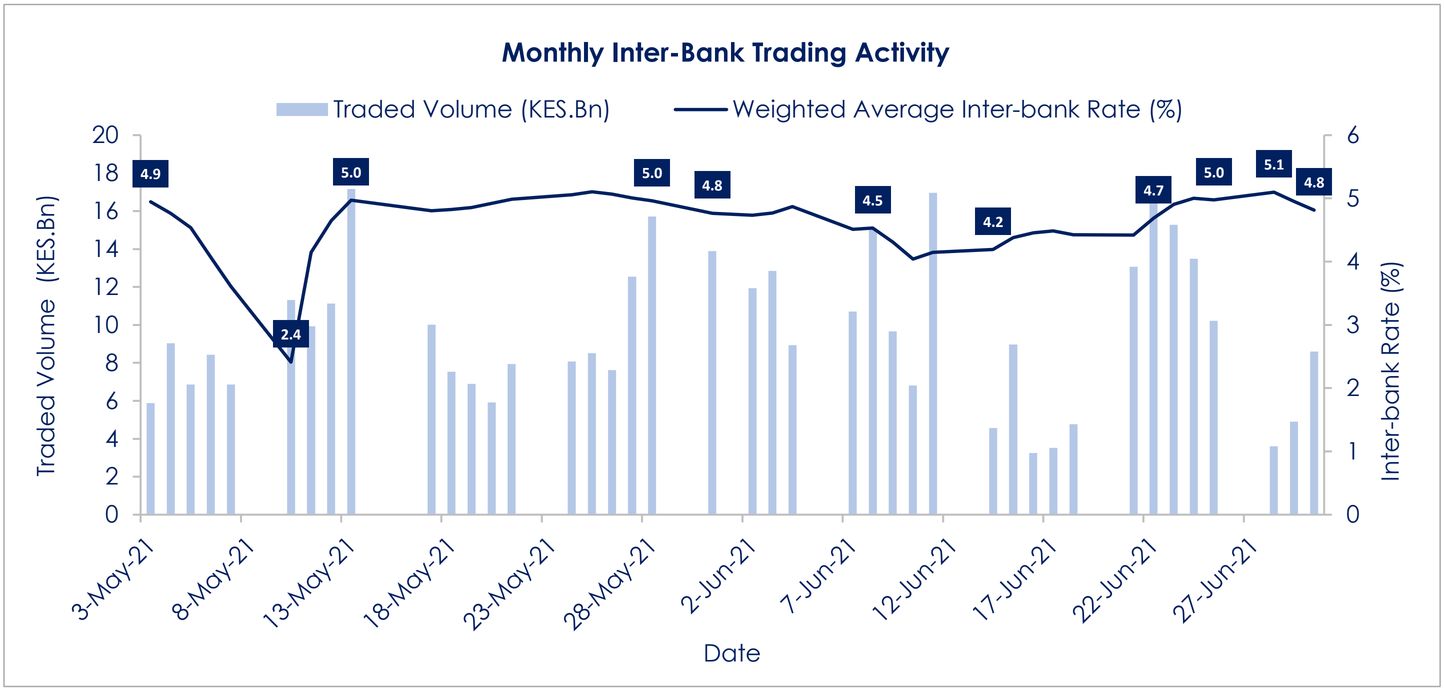


Source: Central Bank of Kenya

Average inter-bank rate at 4.6% in June 2021

- The average inter-bank rate stood at 4.6% in June 2021 similar to May 2021 as a result of a stable market liquidity (Figure.5).
- During the period under review, total inter-bank trading volumes increased to KES.204.3Bn compared to KES.191.2Bn in May.
- The higher market liquidity during the month is attributable to government cash releases to the county Governments and other Government payments which partly offset tax remittances
- Our forecasted average inter-bank rate for July 2021 is 4.5% - 5.5%.

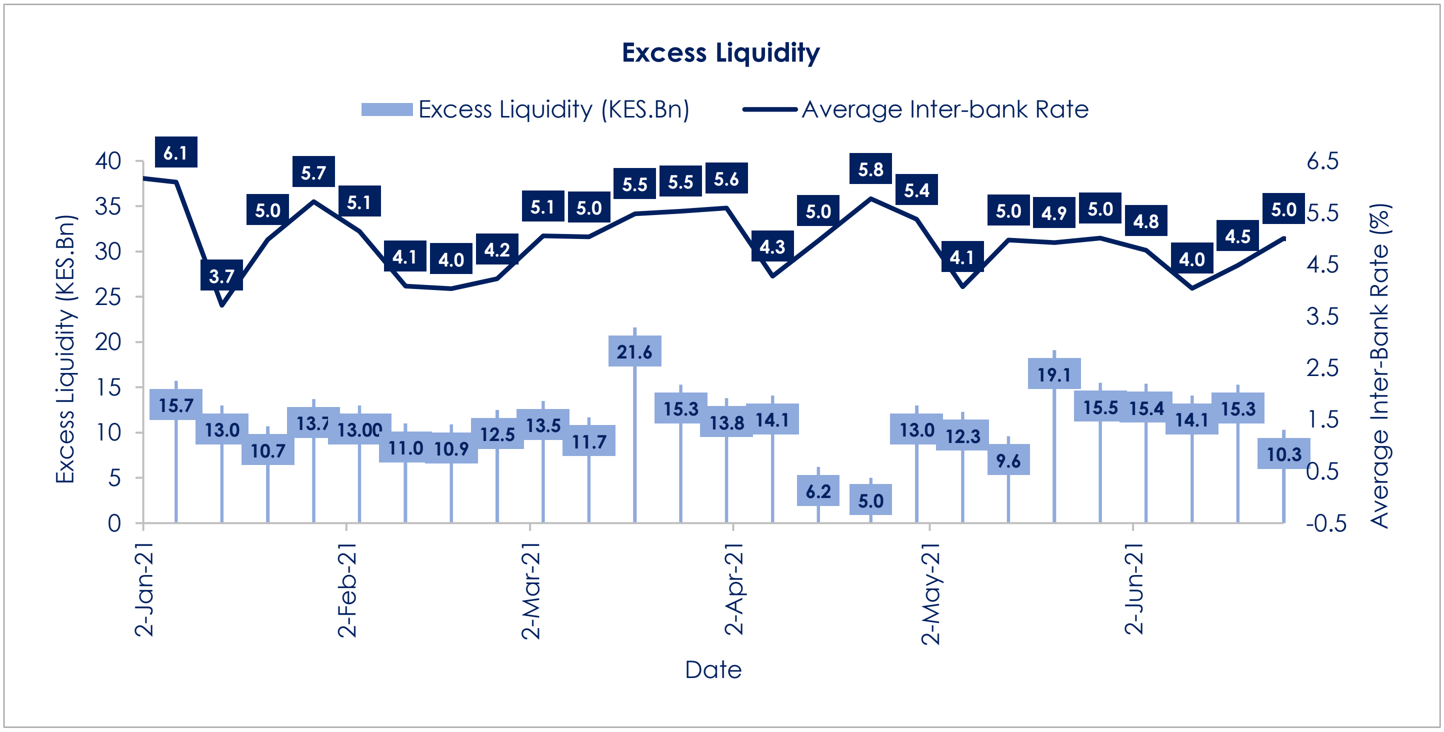
Figure.5: Inter-bank lending rates to range between 4.5% and 5.5% in July 2021



Source: Central Bank of Kenya

- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) over the same period declined to KES.55.1Bn, 2.5% below KES.56.5Bn a month earlier (Figure.6).

Figure.6: Excess commercial bank reserves decline 3% in June 2021

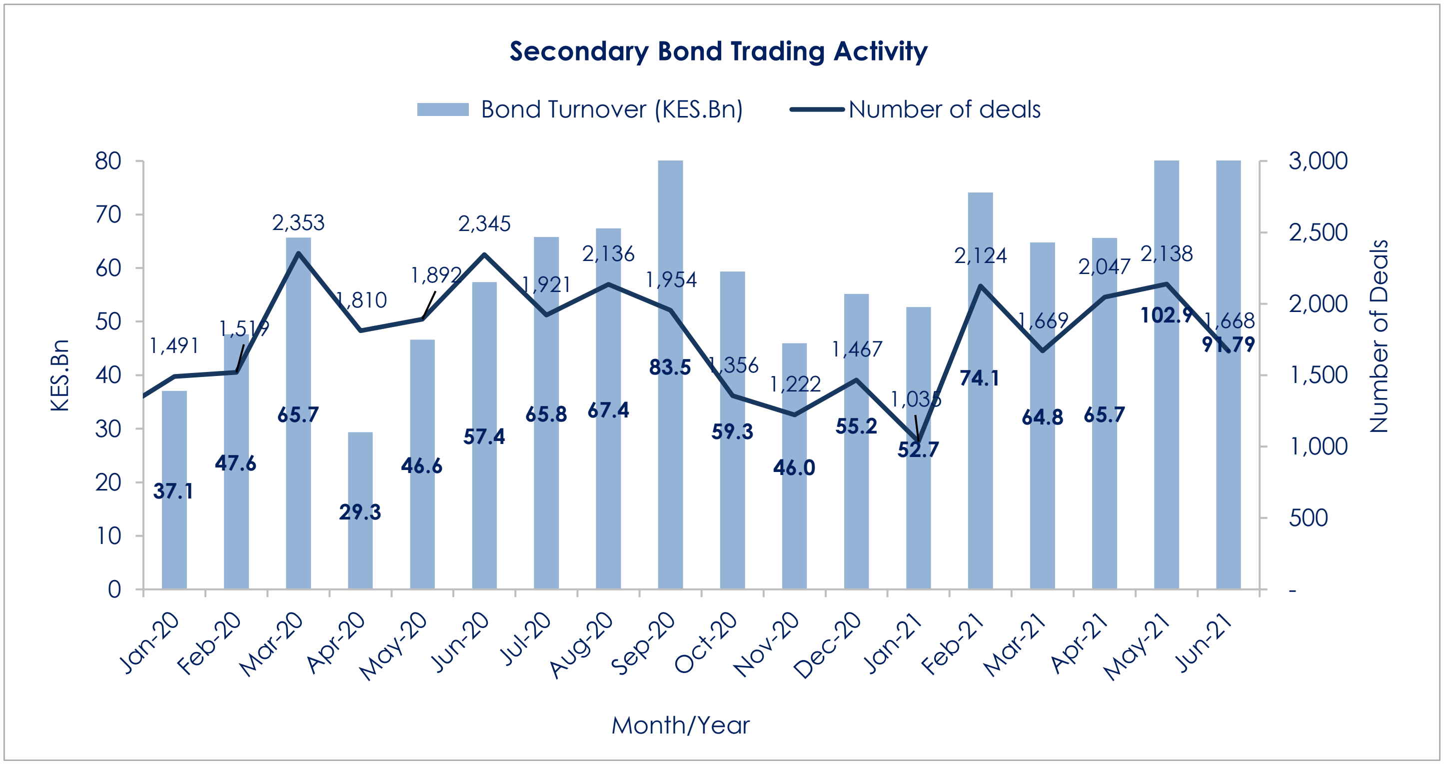


Source: Central Bank of Kenya

Secondary market bond turnover to increase in July 2021

- Secondary market trading activity stood at KES.91.8Bn at the end of June, down from KES.102.9Bn the previous month with the number of deals over the same period at 1,668 compared to 2,138 in May (Figure.7).
- We attribute the decline in secondary market trading activity during the month to higher primary auction activity compared to the previous month.
- Secondary market activity in July will depend will on investor activity in the primary issues and market liquidity.

Figure.7: Secondary trading activity declines in June 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 IFB1/2021/11, IFB1/2021/16 and IFB1/2021/18 as suitable investment options (Table.5).

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2020/11	7.63	10.90	5.82	10.75	10.63
IFB1/2021/16	12.05	12.26	6.97	11.95	11.85
IFB1/2021/18	13.24	12.67	6.96	12.10	12.03

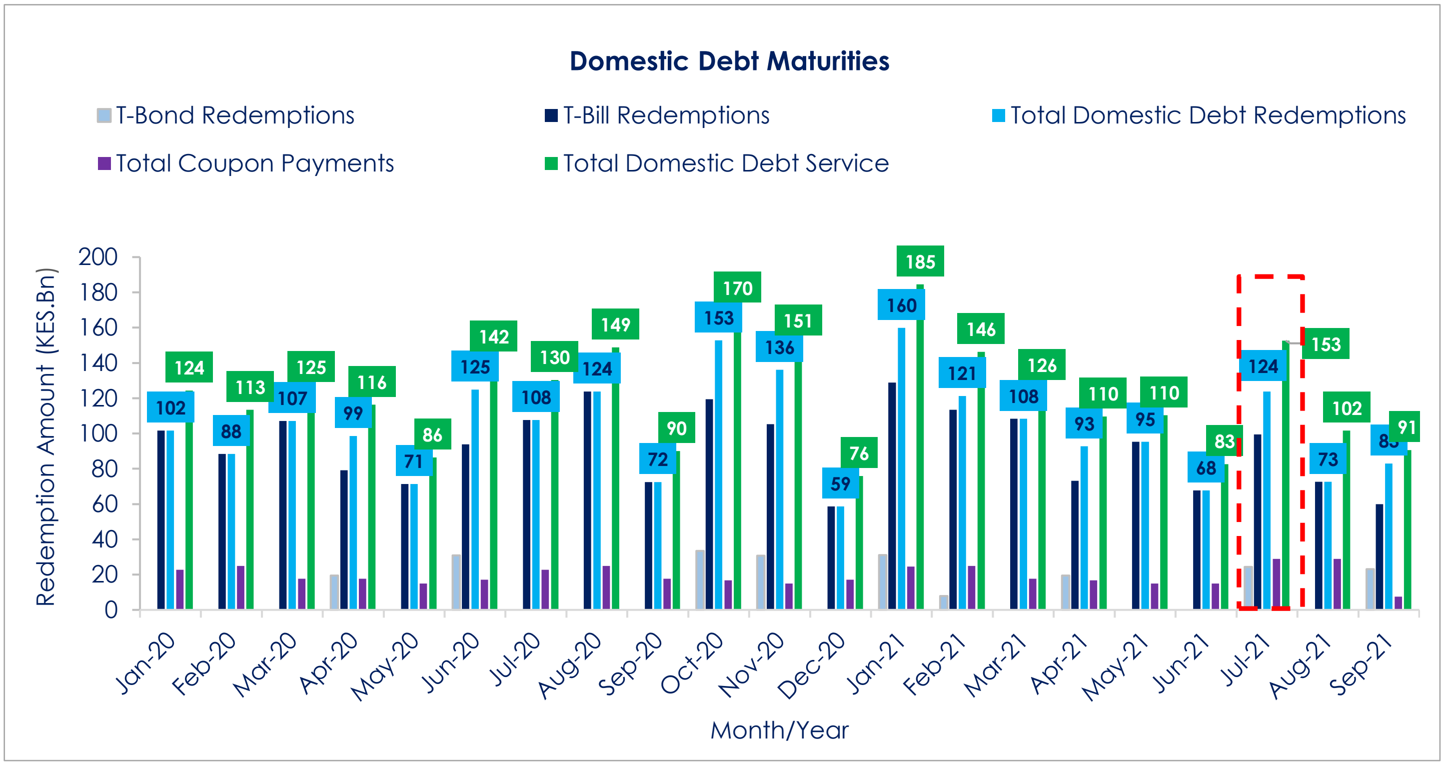
Source: Central Bank of Kenya

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

KES.153Bn domestic debt service in July 2021

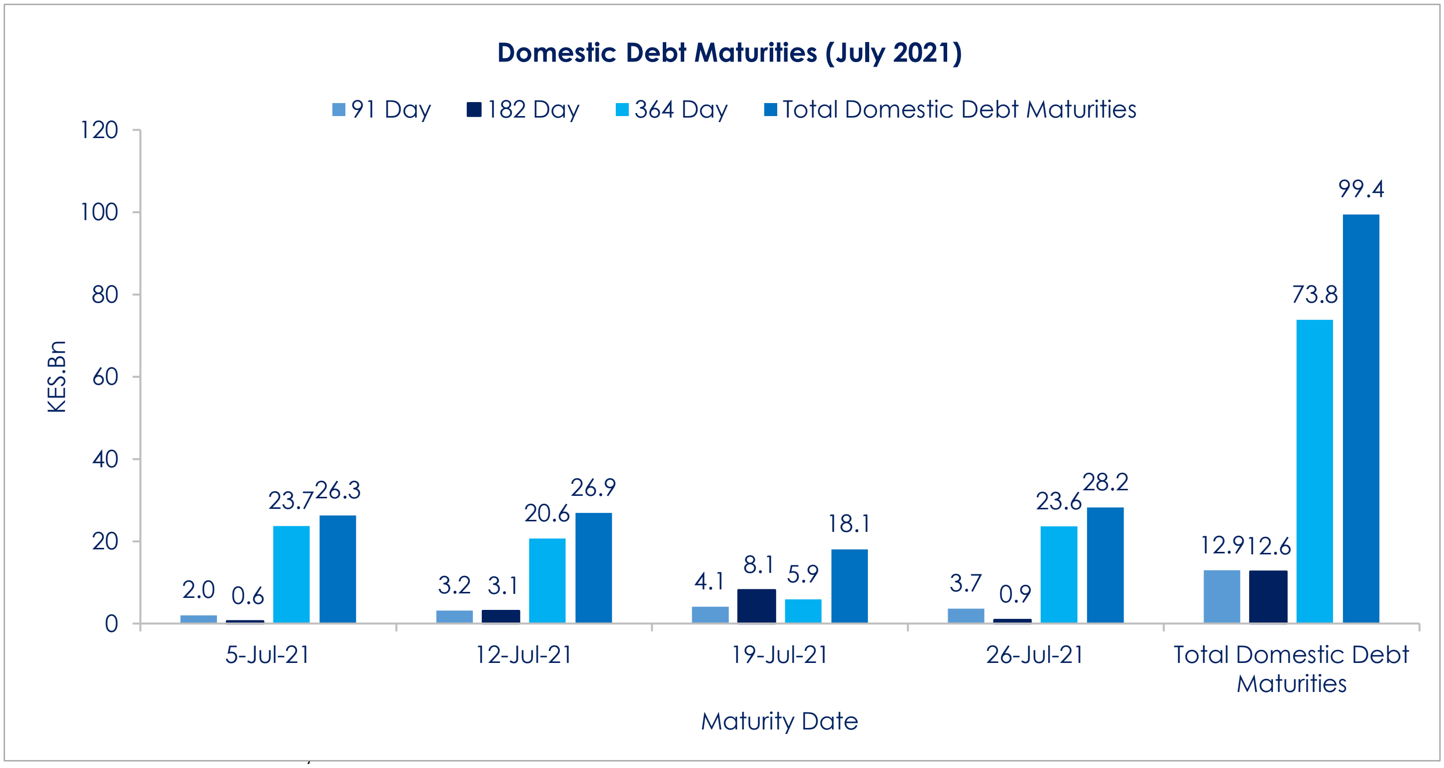
- Debt service for the month of July is KES.152.6Bn and comprises of KES.99.4Bn, KES.24.4Bn and KES.28.8Bn in T-Bills, T-Bonds and coupon payments respectively (Figure.8).
- Expected redemptions for the 91,182 and 364-dat T-Bills during the month are KES.12.9Bn, KES12.6Bn, and 73.8Bn respectively with the fourth week of the month having the highest redemptions at KES.28.2Bn. (Figure.9).
- Total debt service for August 2021 will decline to KES.101.6Bn with KES.72.7Bn in T-Bill redemptions and KES.28.9Bn in coupon payments.

Figure.8: July 2021 domestic debt rises to KES.153Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities July 2021



Source: Central Bank of Kenya

Kenya's 2021/22 fiscal budget points towards higher deficit financing

2021/22 fiscal year deficit likely to exceed KES.1Tn on account of shortfalls in Government revenue.

- The National Treasury and Planning Cabinet Secretary read the 2021/22 fiscal budget on 10th June 2021.
- Notable in the budget is an increase in total expenditure to KES.3.6Tn which includes KES.608.9Bn in debt redemptions, a 10.3% increase in total Government revenues to KES.2Tn and a cut in foreign financing to KES.271.2Bn (Table.6).
- While we see efforts to cut recurrent expenditure with FY2021/22 estimates at KES1.3Tn nearly the same as FY2020/21, we are concerned about the optimistic revenue target.
- A more realistic revenue target in our opinion would be near the target in 2020/21 KES.1.8Tn factoring in the fact that the economy is still operating below its optimal capacity even if we include new taxes most of which come into effect in July 2021 and assume the success of efforts aimed to halt evasion.
- This would push the fiscal deficit way above the KES.930Bn estimate and in the region of KES.1.1-1.2Tn.
- Such a scenario would increase net domestic borrowing to KES.800 - 900Bn assuming that foreign financing remains unchanged at the estimated level.
- A sharp increase in the fiscal deficit would present a huge challenge for the Government which will also want to manage the cost of borrowing with investors expecting a premium for capital invested in Government debt pushing interest rates upwards especially on the short-end of the yield curve.
- In light of this growing fiscal deficit, we see a continuation of the CBK's long dated tenor debt issuance strategy.

Table.6: 2021/22 Fiscal budget revenue estimates appear optimistic

Budgetary Item	FY2019/20 Actual (KES.Bn)	FY2020/21 Revised Budget (KES.Bn)	FY2021/22 Budget Estimates (KES.Bn)	Change (FY2021/22 vs FY2020/21)
TOTAL EXPENDITURE	**2,850**	**3,362**	**3,639.2***	**8.2%**
Recurrent Expenditure	1,111	1,275	1,272	-0.2%
Development Expenditure	614	697	670	-3.9%
County Allocation	317	317	370	16.7%
CFS	808	1,074	1,327	23.6%
TOTAL REVENUES	**1,734**	**1,849**	**2,039**	**10.3%**
Ordinary Revenue	1,573	1,594	1,776	11.4%
Ministerial Appropriation in Aid	160	255	263	3.1%
GRANTS	20	49	62	26.5%
DEFICIT (INCLUDING GRANTS)	**(812)**	**(977)**	**(930)**	**-4.8%**
FINANCING				
Foreign Repayments	**(101.6)**	**(427.1)**	**(271.2)**	**-36.5%**
Domestic Financing	**450.4**	**543.9**	**658.5**	**21.1%**

Source: Kenya National Treasury

National treasury to fall short of 2021/22 fiscal year targets

- Data as at the end of May 2021 shows tax revenue, domestic borrowing and total revenue at 89.3%, 90.2% and 80.1% of the revised 2020/21fiscal receipts estimate against a linear run-rate target of 91.7% (Table.7 and Figure.10).
- This compares fairly well with April 2021, where actual tax revenue, domestic borrowing and total revenue stood at 81%, 85.4% and 74.1% of their respective revised targets against a linear run-rate of 83.3%.
- We however expect that National Treasury to fall below these targets with a month to go to the end of the fiscal year.

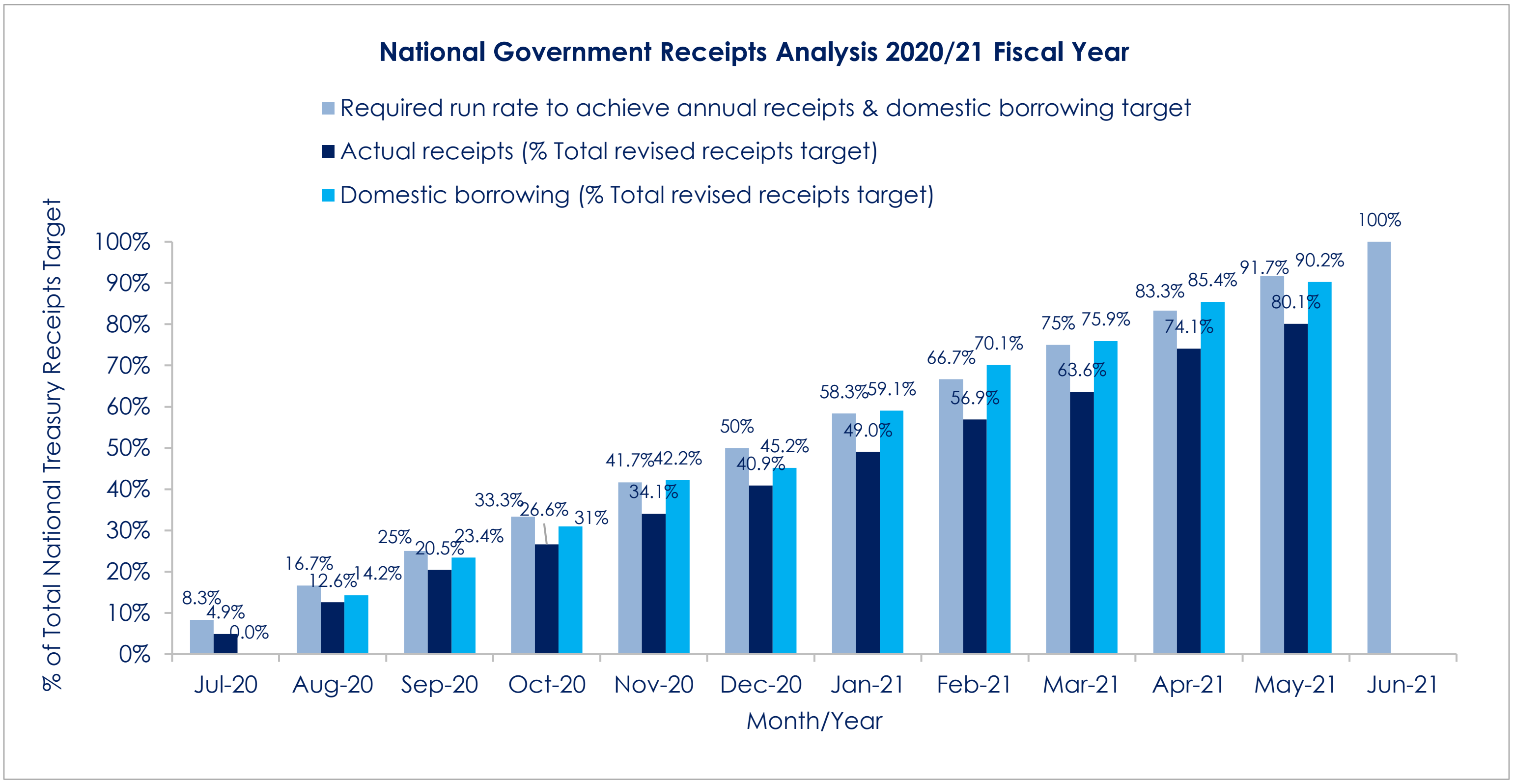
Table.7: 2020/21 fiscal year domestic borrowing above target run-rate

Receipts	Estimates (KES) Aug 2020 (KES.Bn)	Revised Estimates (KES) Mar 2021 (KES.Bn)	Actual Receipts (KES) 30th April 2021 (KES.Bn)	Actual Receipts (KES) 31st May 2021 (KES.Bn)	Proportion of Receipts Target (KES) 31st May 2021 (%)
Opening Balance (1st July 2020)		48	48	48	-
Tax Revenue	**1,567.6**	**1,469.7**	**1,190.6**	**1,313.1**	**89.3**
Non-Tax Income	66.1	124.3	81	80.6	64.8
Domestic Borrowing	786.6	853.8	729.6	770.6	90.2
External Loans & Grants	373.2	419	112.5	124.4	29.7
Other Domestic Financing	36.8	28.5	19.6	21.8	76.4
Total Revenue	**2,830.4**	**2,943.2**	**2,181.3**	**2,358.5**	**80.1**

* Note 1: Domestic Borrowing of KES.853.8Bn = Net Domestic borrowing KES.491.9Bn & Internal Debt Redemptions (Roll-overs) KES.362

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

Figure.10: 2020/21 Government unlikely to meet FY2020/21 receipts target



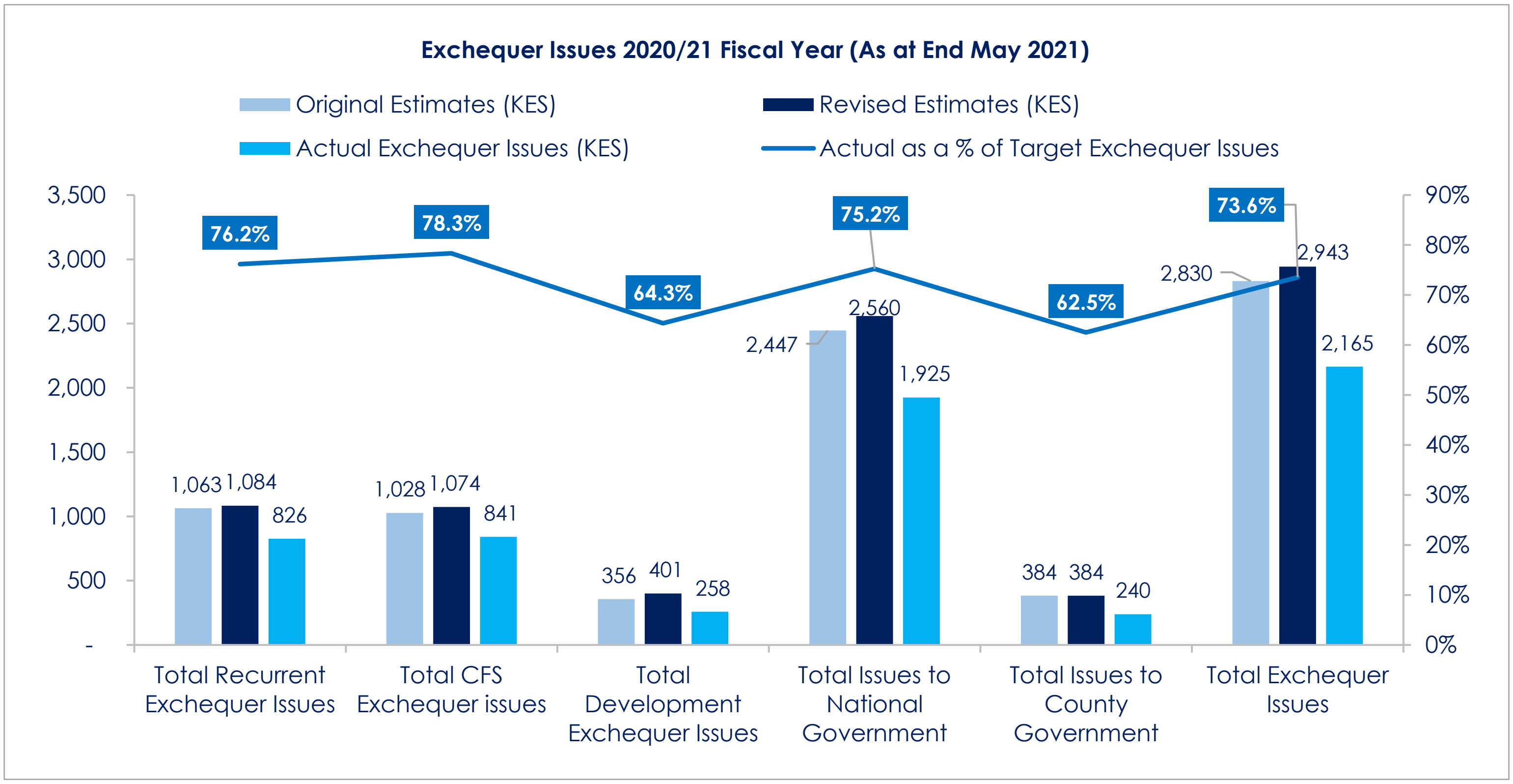
Source: The Kenya Gazette Vol. CXXIII - No.133 18th June 2021

National Treasury likely to fall below 2020/21 fiscal year expenditure targets

National Treasury falling below revised expenditure targets points to liquidity challenge.

- The National Treasury fell way below its expenditure targets going by exchequer issue data at the end of May 2021 (Figure.11).
- Notable is KES.240Bn and KES.258.2Bn in county expenditure and total development expenditure against the KES.384Bn and a KES.401Bn revised targets.
- This underspending suggests liquidity challenges brought about by underperformance of revenues.
- It also points to increased pressure to borrow from both domestic and external funding sources.

Figure.11: Kenya ordinary estimate declines to 2018/19 level

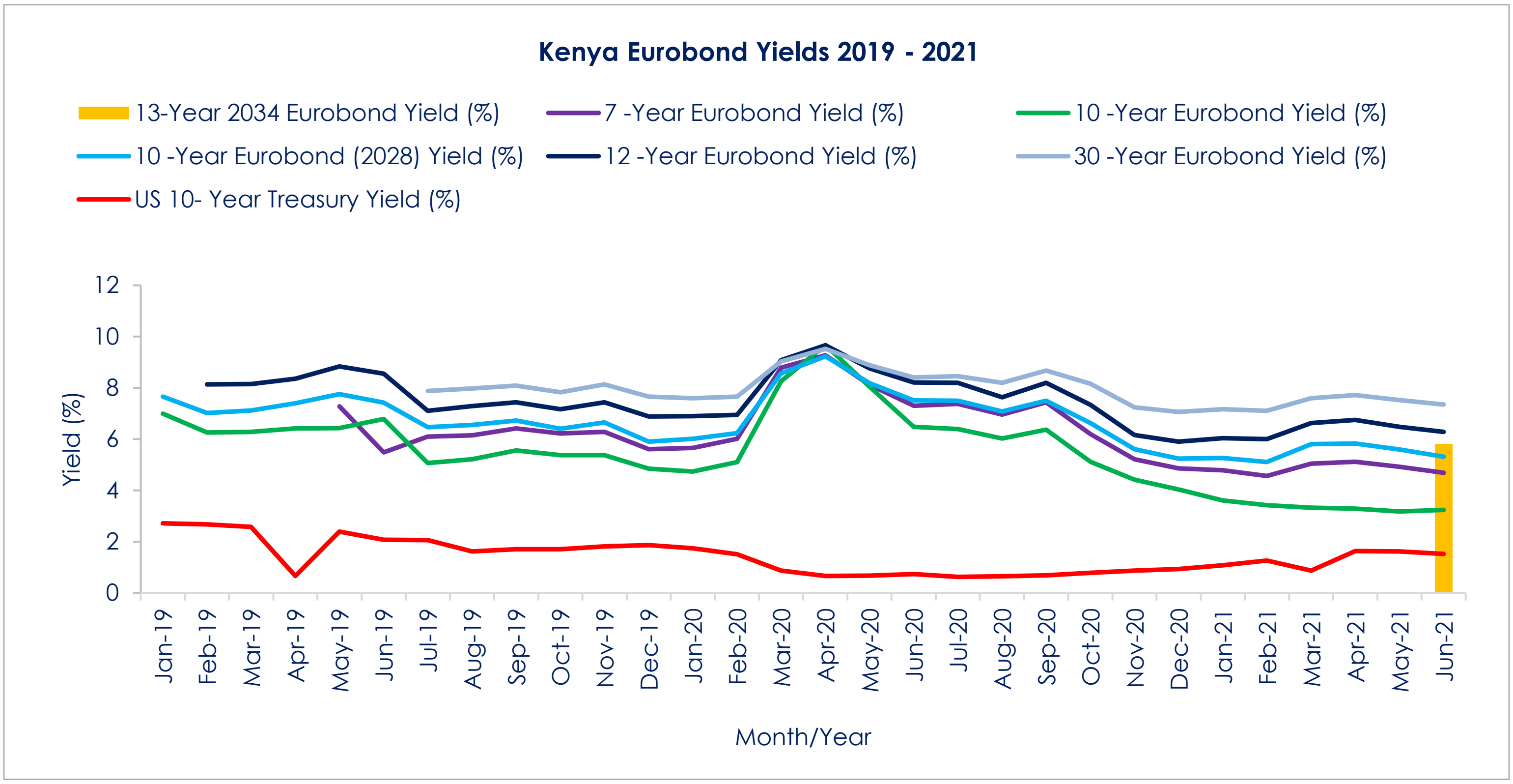


Source: Kenya National Treasury

Kenya Eurobond yields decline in June 2021 on positive investor sentiment

- Average yields on Government of Kenya Eurobonds with (the exception of the increased 13-year bond issued in June 2021) continued the gradual decline with yields in June 2021 lower than the previous month (Figure.12).
- We attribute this trend that began in April 2021 to easing Covid-19 restrictions and financial support from the International Monetary Fund (IMF) and several bilateral lenders who have extended the country's debt relief period to the end of 2021.
- The yield on the newly issued 13-year bond rose 94 bps in the week ending 1st July 2021 compared to the previous week (24th June 2021) an indication of high demand for the high yielding bond (coupon - 6.3 %)
- While we see yields on the new issue to rise in the near term, we expect yields on previous issues to decline gradually unless there is significant market moving negative news or economic influences that could reverse the trend.

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



Source: Central Bank of Kenya

Kenya Eurobond index return double digit one year growth

- The Kenya sovereign bond index returned 10.8% (USD return) over the 1-year period ending 5th July 2021 (Figure.13 and Table. 8).
- It however underperformed relatively to our comparable; S&P South Africa Sovereign Bond Index USD (37.7%) and S&P Ghana Sovereign Bond Index USD (21.2%).
- This is a fairly good return taking into account other USD investment options like cash USD/KES (1.2%).
- Following the issuance of the 13-year bond, we expect an improvement in price performance in the near to medium term assuming all macro-economic factors remain stable.

Figure.13: Kenya Eurobond yields decline on easing concerns over fiscal position and IMF support

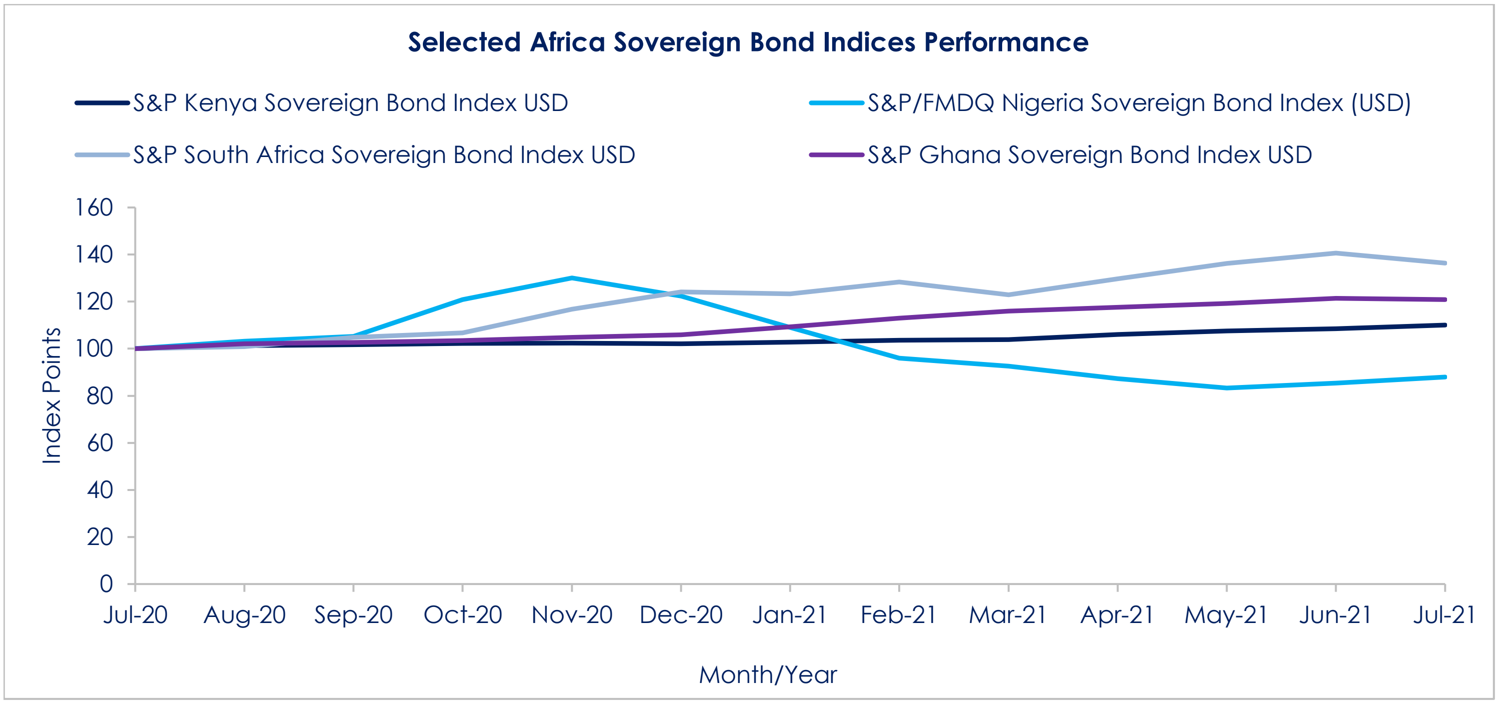


Table.8:

Index	Index Level	MTD (%)	YTD (%)	1-Year (%)	3-Year (%)	5-Year (%)
S&P Kenya Sovereign Bond Index USD	272.03	1.3	6.4	10.8	11.1	13.1
S&P Nigeria Sovereign Bond Index USD	167.11	0.9	-22.8	-11.5	10.4	7.4
S&P South Africa Sovereign Bond Index USD	353.72	0.5	8.6	37.7	7.1	9.9
S&P Ghana Sovereign Bond Index USD	304.68	-0.2	13.1	21.2	12.9	12.6

Source: S&P Global

Yields on the long-end rise steadily as pressure mounts on the CBK to finance the widening budget deficit

National Treasury falling below revised expenditure targets points to liquidity challenge.

- A comparison of average yields in July 2021 against the same period in 2020 shows a significant dip in the short (1 and 2 years) while those on the medium tenors (5 years) and long-end (10 - 20 years) rose (Table.9 and Figure.14).
- We also observe a decline in short and long-term yields when we compare current yields with those at the time of the primary issue of FXD1/2021/25 in 13th May 2021.
- Current yields across the yield curve with the exception of the 20-year tenor are lower than those at the time of issue of **FXD1/2018/15** (28th May 2018).
- The dip in short and rise in 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.

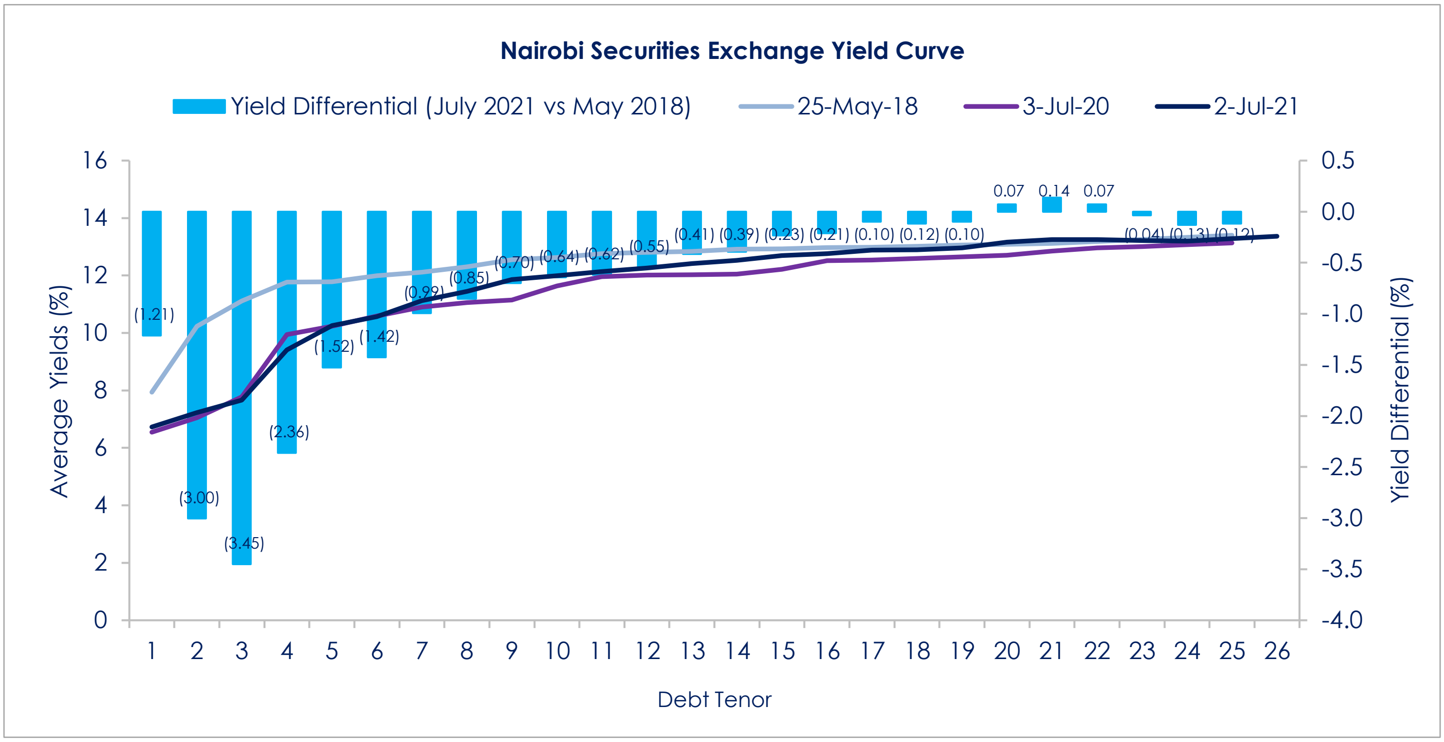
- We predict continued increase in yields on long term debt in 2021 as the CBK faces the challenge of financing the widening fiscal deficit.
- We maintain our recommendation of **BUY short and HOLD medium- and long-term papers.**

Table.9: Yields on the short end of the yield curve have declined over the last one year

Tenor	Yields (25th May 2018)	Yields (13th May 2021)	Yields (3rd July 2020)	Yields (2nd July 2021)	∆ July 2021 vs May 2018) (bps)	∆ July 2021 vs May 2021) (bps)	YoY ∆ July 2021 vs July 2020 (Bps)	Sterling Capital yield Curve (July 2021)
1	11.1110	9.3650	7.7690	7.6610	↓345	↓170.4	↓10.8	7.70
2	11.7713	10.0177	9.9500	9.4102	↓236	↓60.8	↓53.9	9.40
5	12.1172	10.9871	10.9058	11.1231	↓99	↑13.6	↑21.7	11.15
10	12.8090	12.3465	12.0166	12.2628	↓54.6	↓8.4	↑24.6	12.25
15	12.9820	13.0873	12.5417	12.8841	↓9.8	↓20.3	↑34.2	12.90
20	13.1793	13.3300	12.9574	13.2514	↑7.2	↓7.9	↑29.4	13.25

Source: Nairobi Securities Exchange

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



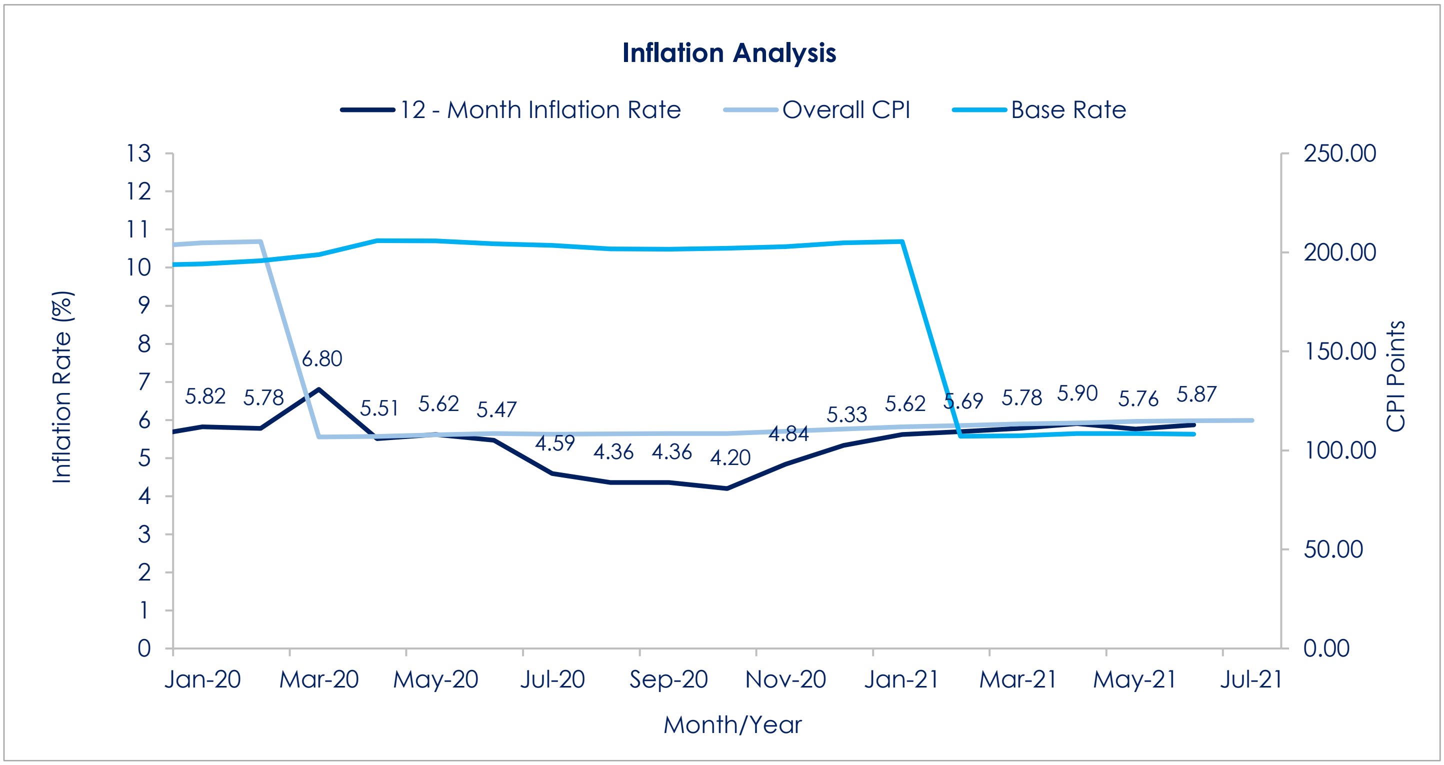
Source: Nairobi Securities Exchange

July 2021 inflation to rise on higher transport and food prices

June inflation at 6.32% is at its highest level since March 2020 (6.8%)

- Inflation for the month of June 2021 rose to 6.32% the highest since March 2020 (6.8%) and higher than May 2021 (5.87%).
- This was a direct result of higher transport (0.3%) and Food and Non-Alcoholic drink prices (0.1%). (Figure.15)
- Consumer Price Index (CPI) increased by 0.1% to 115.1 in June 2021 from 114.9 the previous month.
- The Transport Index rose 0.3% attributed due to higher petrol prices (0.6%) between May 2021 and June 2021.
- We predict June 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.
- We do not see an immediate reaction from the Monetary Policy Committee (MPC) in terms of monetary policy with the CBR to remain at 7% in the near term.

Figure.14: Short term inflation forecast 5.5% - 6.5%



Source: Kenya National Bureau of Statistics

MPC to hold monetary policy steady in July 2021 meeting

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

- The MPC meets on Wednesday 28th July to review the impact of previous monetary policy measures.
- We see the following as the main points of discussion for the monetary policy makers:

1) Rising inflationary pressure with June 2021 inflation at the highest level since March 2021.
2) The Kenya Shilling (KES) has been stable and traded within a tight range over the last two month KES.107.59 - KES.107.90).
3) Private sector credit remains lower than the preferred target of between 12% and 15% with asset quality remaining relatively poor at about 14.2%-14.5%.
   However, progress has been noted in selected economic sectors and there exist signs of slow but gradual economic recovery.
4) Foreign exchange reserves have increased 26.9% to US$.9.5Bn (5.8months of import cover) since the last MPC meeting at the end of May (US$7.5Bn – 4.6 months) following the receipt of funds from the Eurobond issue and IMF as well as World Bank donor support.
5) Commercial bank liquidity remains healthy with no immediate risks foreseeable.

6) The 2021/2022 budget set aside KES.23.1Bn as part of the Economic Stimulus Package (ESP) which will improve business and personal liquidity and drive spending.

- We however 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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