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Fixed Income Note

June 2020

"Focus shifts to 2020/21"

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Executive Summary

- The title of our June 2020 fixed income report is **“Focus shifts to 2020-21”.**
- It is an analysis of two re-opened bond issues FXD3/2019/5 and FXD4/2019/10 seeking to raise KES.40Bn.
- Our investor bid predictions on what we expect to be a fully subscribed issue as follows:

Weighted Average Rate (WAR) of bids 5 Year: 11.55% - 11.65% / 10 Year: 12.40% -12.60%
Weighted average rate of accepted bids 5 Year: 11.50%-11.60% / 10 Year: 12.40%-12.45%

- The report analyses investor primary auction preferences, short-term domestic debt interest rates, secondary market trading activity and market liquidity.
- We also give trading ideas based on current and expected yield curve movements.
- Also discussed in this report is the country’s debt service for the next three months and national accounts position which is of great interest to investors in the wake of the negative impact of the Covid-19 pandemic on the economy.
- Also covered in this report is an analysis of the yield curve focusing on interest rate movements in different areas of the yield curve.
- We give our expectations of inflation in our macro-economic analysis section.
- The report concludes with our expectations of the Monetary Policy Committee (MPC) decision when they meet later this month.

CBK's penultimate bond issues in the 2019/20 fiscal year

- Central Bank of Kenya (CBK) invites investor bids for two bond issues FXD3/2019/5 (4.48 years) and FXD4/2019/10 with (9.42 years) aiming to raise KES.40Bn (Table.1).
- This is the third month running that the CBK has issued short and medium-term debt in what we see as an attempt to ensure full subscription in the face of the widening fiscal deficit and conclusion of the fiscal year.
- We expect this issue to be fully subscribed on account of the bond's short tenor and current high market liquidity.

Table.1: Primary Bond issue summary

Issue Number	**FXD3/2019/5**	**FXD4/2019/10**
Total Amount Offered	KES.40Bn	
Tenor (Years)	5 Years (4.48 Years)	10 Years (9.42 Years)
Coupon Rate (%)	11.492	12.280
Issue Price	Discounted/Premium/Par	
Period of Sale	04th June – 16th June 2020	
Auction Date	17th June 2020	
Value Date	22nd June 2020	
Yield Curve (%) (Weighted Average tenor - 4.48Yrs and 9.42Yrs) 05th June, 2020	**11.30**	**12.20**

Source: Central Bank of Kenya

- Bids worth KES.28.5Bn equivalent to a subscription rate of 113.9% was received for the initial primary auction for FXD3/2019/5 in December 2019 with a Weighted Accepted Rate (WAR) of 11.492%.
- FXD4/2019/10 reissued in November 2019 received bids worth KES.38.4Bn, a performance rate of 76.8% with an accepted rate of 12.280%.
- Yields on 5- and 10-year issues have increased since these two issues (refer to Table.8).

Our weighted average and accepted bids averages

- From an analysis of current and historic market yields, discussions with fixed income traders and investors' sentiment, we have arrived at the following as our predicted auction and accepted bid levels:

Table.2: Auction bid predictions

Rate	**FXD3/2019/5**	**FXD4/2019/10**
Market Weighted Average Rate (%)	11.55% - 11.65%	12.40%-12.60%
Weighted Average Rate of Accepted Bids (%)	11.50% - 11.60%	12.40%-12.45%

Source: Sterling Capital Research

Investors continue to favour short and medium tenor issues

- High subscription is expected for as is customary with similar tenor debt issues (Table.3).
- In addition, investors particularly banks are currently faced with few low risk investment options and would prefer to take advantage of the Government's debt appetite.

Table.3: Historical primary market auction performance

Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield
5-Year						
FXD1/2018/5	40	37.6	23.1	94.1	12.30	10.5271
FXD1/2018/5 (Tap)	10	7.7	7.7	-	12.30	10.5271
FXD1/2019/5	50	41.9	20.6	83.9	11.30	11.1417
FXD2/2019/5	50	49.3	39.2	98.6	10.87	11.1847
FXD3/2019/5	25	28.5	18.7	113.9	11.49	11.3100
FXD3/2019/5 (Tap)	9.7	9.8	9.8	-	11.49	11.3100
FXD1/2019/5 (Re-opened)	50	44.5	44.5	89.0	11.304	11.3100
FXD1/2020/5	50	34.5	20.8	69.1	11.667	11.4167
FXD1/2020/5 (Re-opened)	30	20.6	8.9	68.6	11.667	11.4167
10-Year						
FXD2/2018/10	40	28.86	26.16	72.15	12.502	12.0645
FXD1/2019/10	50	36.33	32.81	72.66	12.438	12.1320
FXD2/2019/10	50	70.93	51.33	141.87	12.300	12.1775
FXD3/2019/10	50	52.77	45.01	105.54	11.517	12.1857
FXD4/2019/10	50	38.4	28.4	76.75	12.28	12.1917
FXD1/2019/10 (Re-opened)	50	25.43	19.26	50.85	12.438	12.1320

Source: Central Bank of Kenya

- In our determination of possible investor's bids, we also used implied yields of bonds of similar tenors to maturities on the Nairobi Securities Exchange (NSE) as at 05th June, 2020 (Table.4).

Table.4: 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
5-Year						
FXD3/2019/05	16th Dec	11.49	9th Dec 2024	4.52 (1648)	11.3100	11.4920
10-Year						
FXD4/2019/10	25th Nov	12.28	12th Nov 2029	9.5 (3447)	12.1917	11.9417

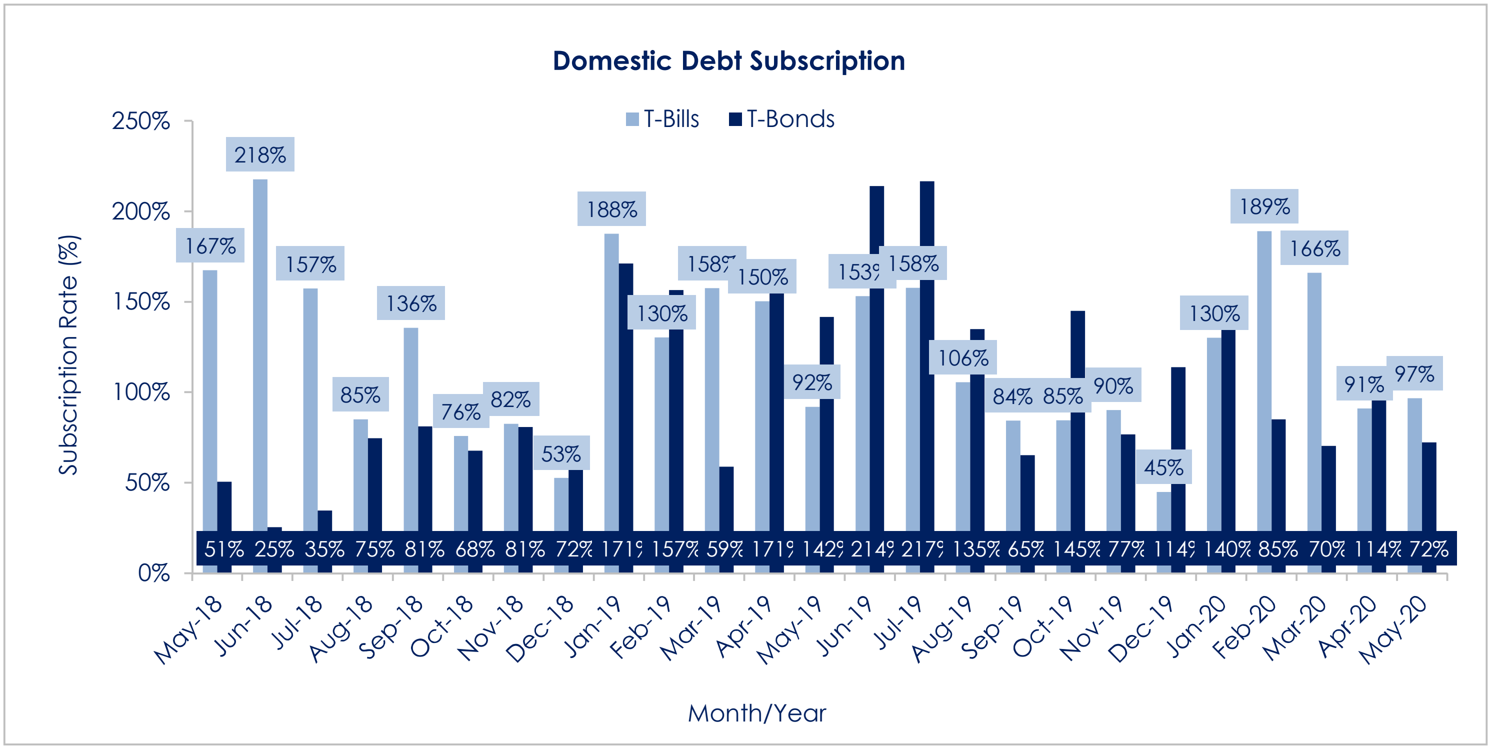
Source: Central Bank of Kenya

T-Bill subscriptions on the rise as investors play short

High subscription rates on T-Bills particularly 91 and 364 Day

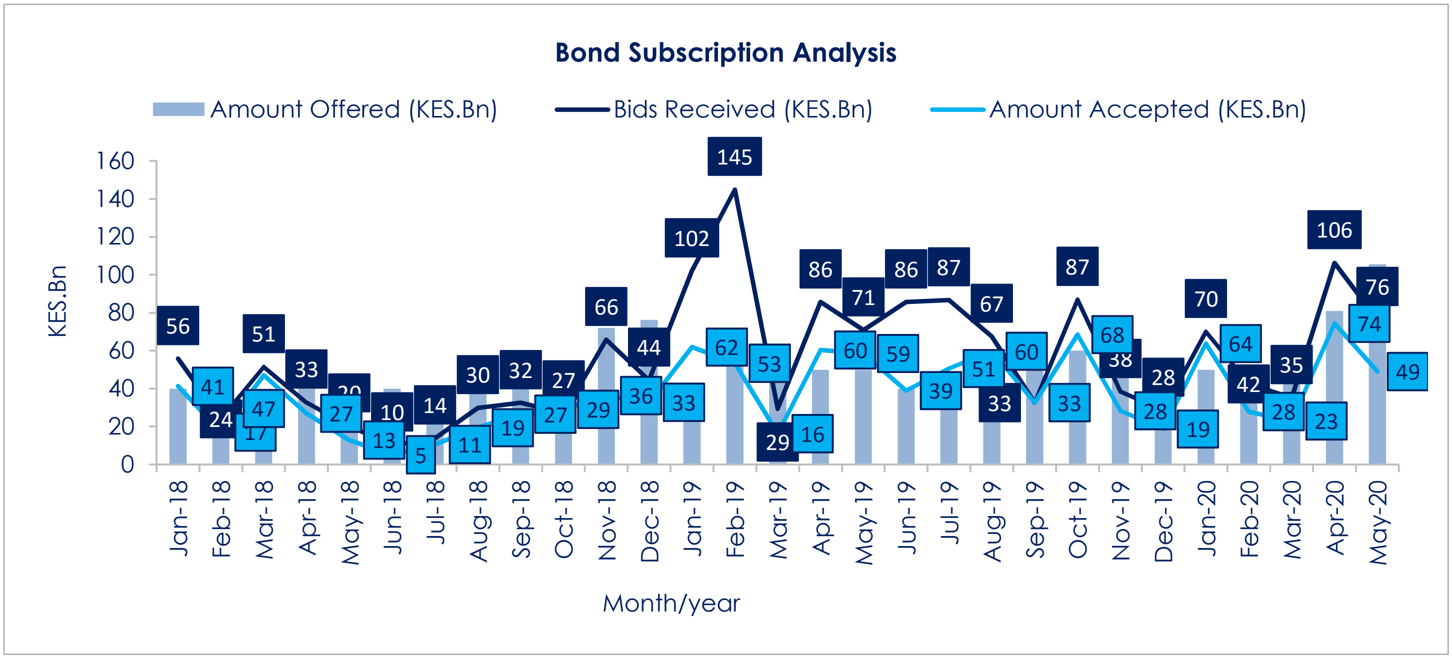
- CBK offered KES.105.6Bn in three T-Bond issues and KES.96Bn in T-Bills in May 2020 with KES.76.3Bn (72.2%) and KES.92.8Bn (96.7%) received in subscriptions respectively (Figure.1).
- Bids accepted amounted to KES.49Bn and KES.81Bn for the T-Bonds and T-Bill issues respectively a trend we attribute to CBK's strategy to contain interest rates at their preferred levels resulting in high bid rejections (Figure.2).
- FXD1/2020/5 received a marginally higher subscription, 69.1% (KES.34.5Bn) in its initial issuance (also affected by the short period of sale) compared to its re-opening in May 2020 with subscription at 68.6% (KES.20.6Bn).
- The acceptance rates for the original issue and re-opening stood at 60.2% (KES.20.8Bn) and 43.5% (KES.8.9Bn) respectively.
- IFB1/2020/6 which was a switch security and eligibility only limited to investors with holdings in T-Bill Issue No. 2236/364 was undersubscribed at 82.7% (KES.21.2Bn) with performance rate at 91.1% (KES.19.3Bn).
- The 91 day and 364-day papers were oversubscribed at 158.9% and 114.9% while the 182-day paper was undersubscribed at 53.6% (Figure.3).
- Acceptance rate for the 91-day, 182-day and 364-day papers stood at 80.5%, 75.9% and 96.3% respectively.
- Demand for the 91-day T-Bill remains high as investors are unwilling to tie their capital for a longer period due to uncertainty over the direction of interest rates and to a less extent the Government's fiscal position.
- T-Bill demand is likely to remain high in June with high subscription on the 91-day T-Bill.
- We also expect demand for short-term Government debt to remain high due to the poor performance of the Nairobi Securities Exchange.

Figure.1: T-Bill subscriptions remain high as investors take a short-term investment view



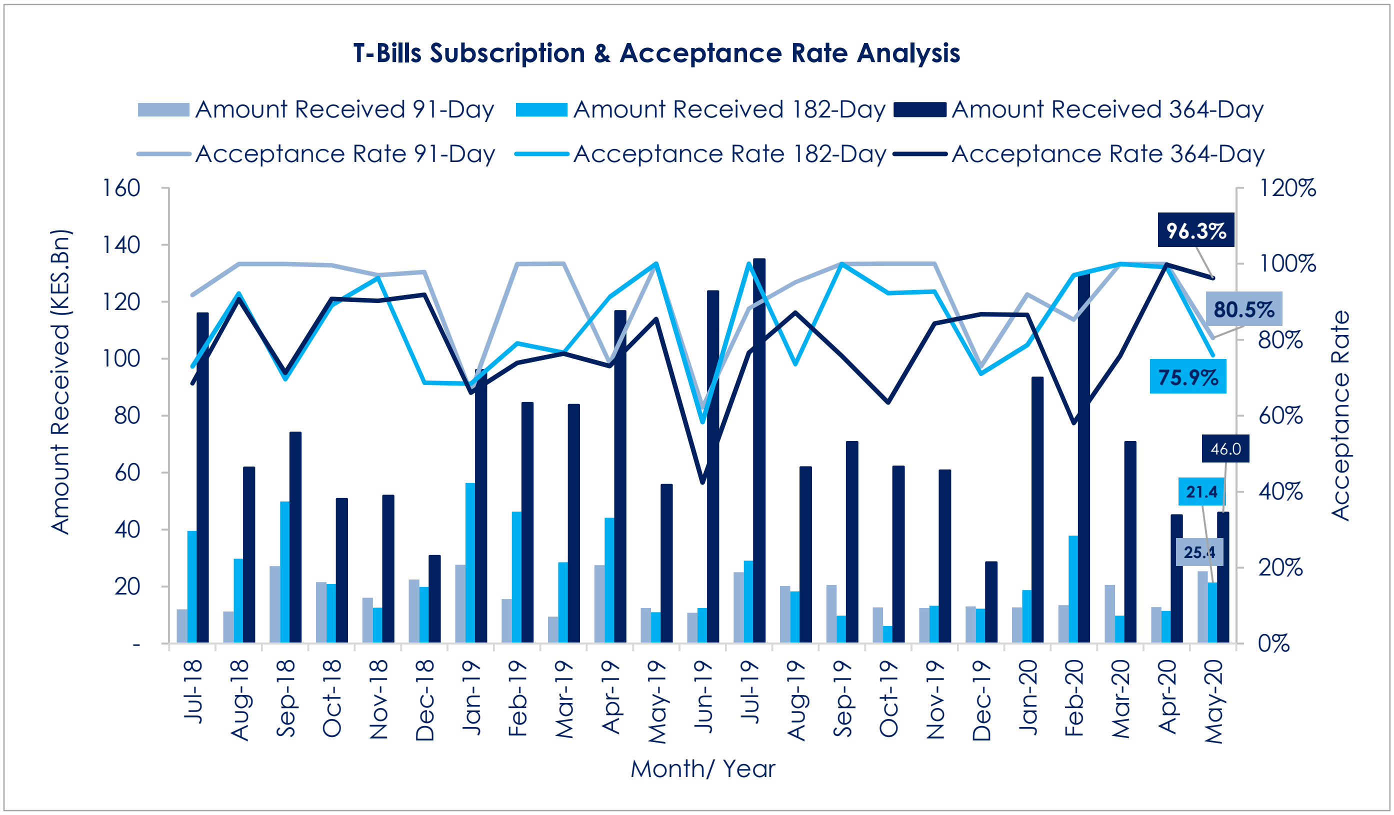
Source: Central Bank of Kenya

Figure.2: CBK continues to reject aggressive investor bids to maintain interest rates at near current levels



Source: Central Bank of Kenya

Figure.3: 364-day and 91-day T-bills heavily over-subscribed in May

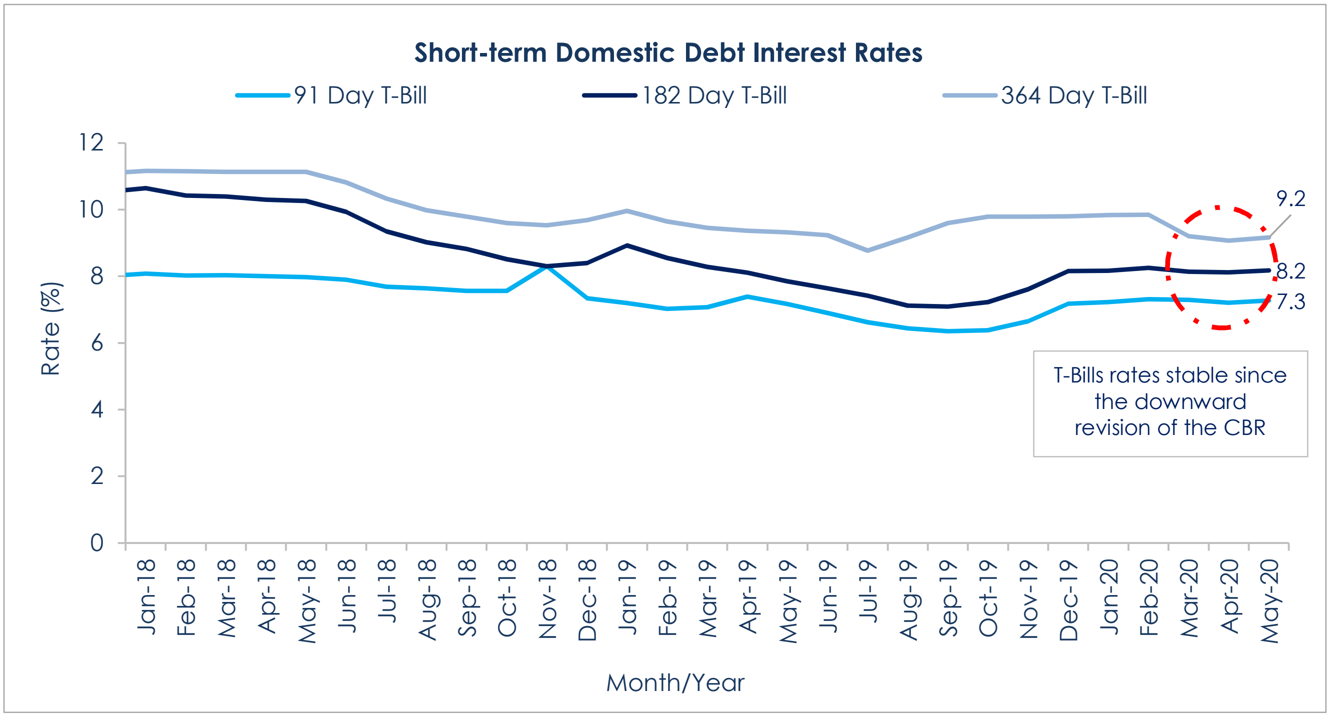


Source: Central Bank of Kenya

T-Bill rates to remain stable on high demand and market liquidity

- Average T-Bill yields for the 91, 182 and 364-day papers increased marginally by 6bps, 6bps and 9bps to 7.3%, 8.2% and 9.2% respectively in the month of May 2020 (Figure.4).
- We attribute the increase to investors' aggressive bidding as they believe that the Government is facing financing pressure due to rising expenditure and falling income and would take slightly higher investor bids.
- We expect interest rates on short term debt securities to remain relatively stable owing to high market demand and liquidity.
- The high demand is supported by commercial banks risk aversion strategy as they slow down on lending to prevent further asset deterioration in the current economic environment.

Figure.4: T-Bill interest rates remain relatively stable after CBR cut

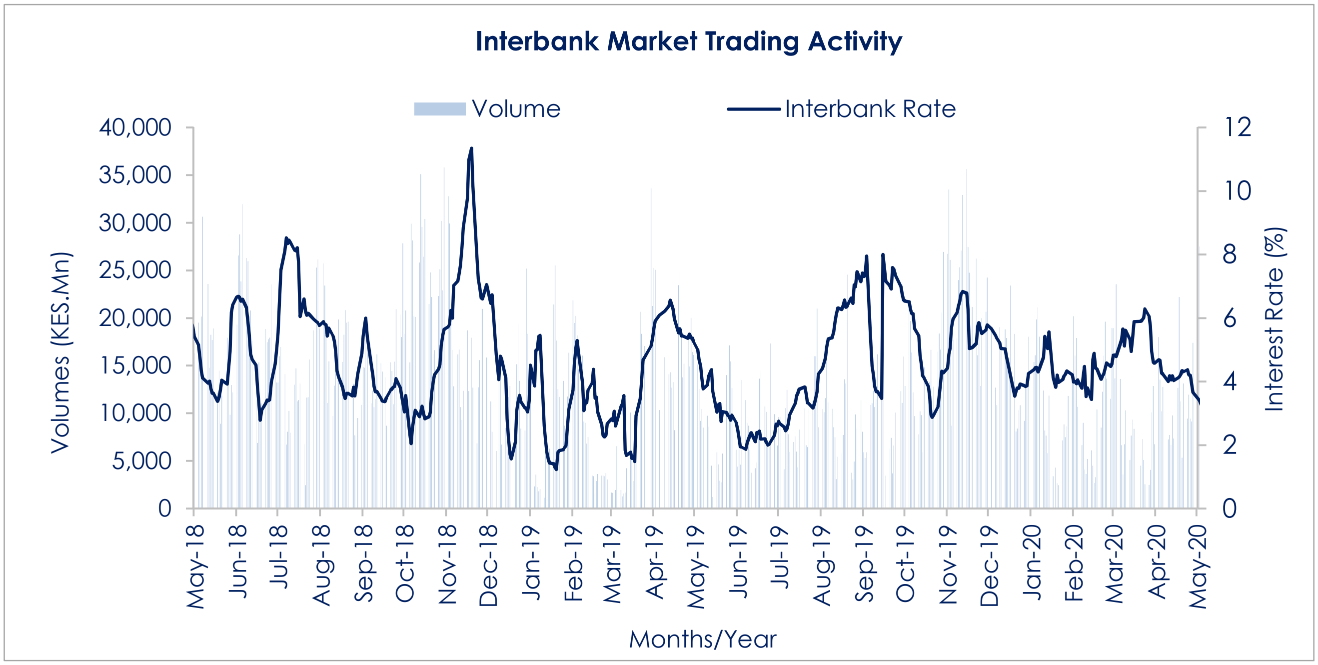


Source: Central Bank of Kenya

High market liquidity continues to suppress Inter-bank lending rates

- Average weighted inter-bank lending rate declined to 4% in May 2020 from 5.3% in April owing to high market liquidity (Figure.5).
- During the period total volumes traded rose 49.6% to KES.241.2Bn compared to KES.161.3Bn in April.
- Daily inter-bank rates have been on a steady decline recorded at 2.7% on 9th June attributed to Government payments to suppliers, economic stimulus package and the Cash Reserve Ratio (CRR) reduction.
- We expect interbank rates to remain near current levels in June owing to high market liquidity.

Figure.5: Inter-bank rates decline on high market liquidity, rates to remain low in June 2020

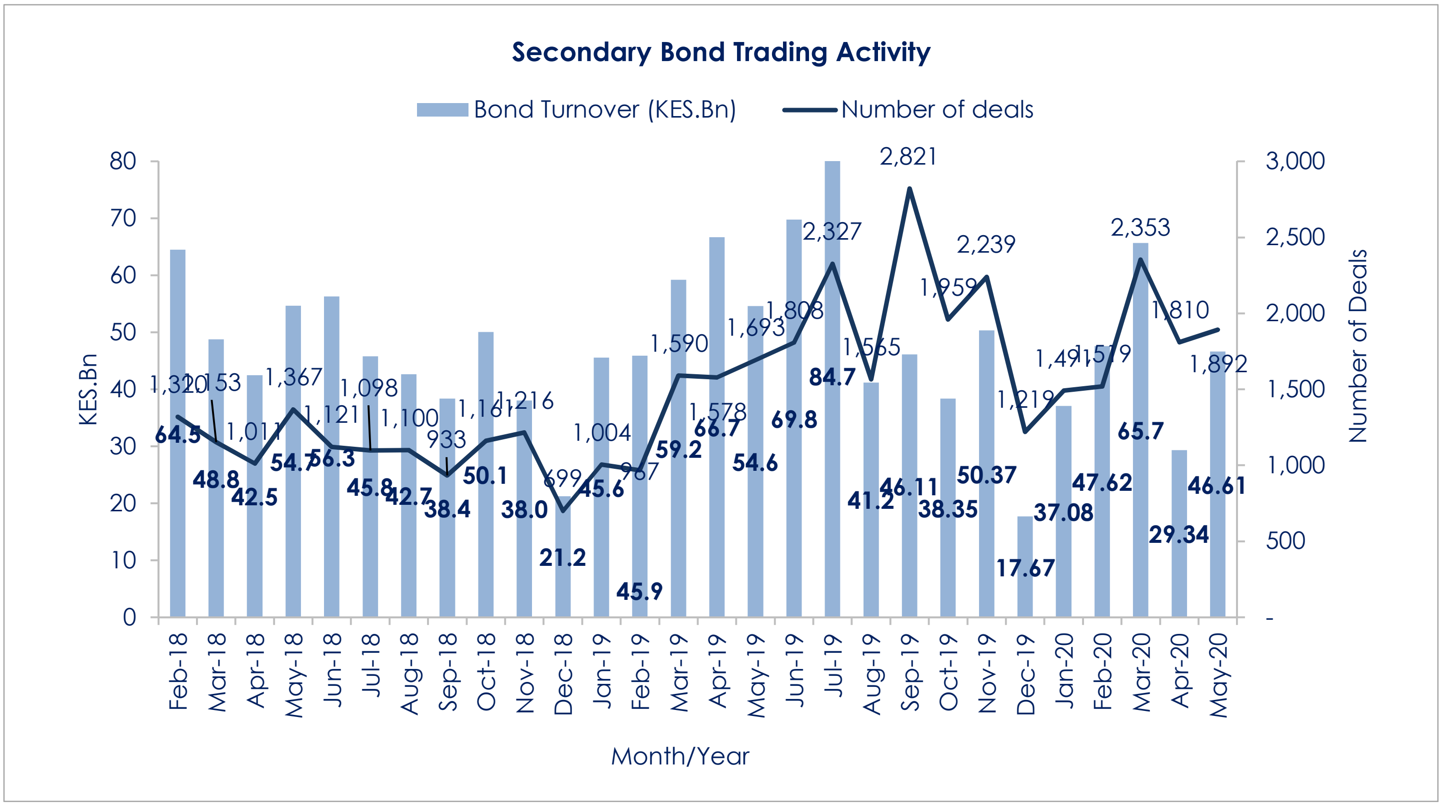


Source: Central Bank of Kenya

High market liquidity to support secondary trading activity in June

- May 2020 bond trading turnover increased 58.9% to KES.46.6Bn with the number of deals rising 4.5% to 1,892 (Figure.6).
- This activity can be attributed to the three bonds issued in the primary market and rejection of high investor bids for the re-opened bond FXD1/2020/5.
- Flight to safety from the equities market also continues to support secondary bond trading activity.
- Trading activity in June is expected to increase on account of high liquidity with those investors who miss out in the primary auction tapping into it.

Figure.6: Secondary trading activity on the rise due to high market liquidity



Source: Central Bank of Kenya

Trading ideas - Trading portfolio buy short, income portfolio go long

- Investment in Government securities remain a favourable investment option in the current economic environment.
- Our recommendations remain unchanged:
- Investors with a trading portfolio to focus on the short end of the yield curve where most investor interest and trading activity is concentrated.
- Market liquidity remains high but most investor interest in primary auctions and secondary trading activity is on the short and medium-term papers.
- Investors with income portfolio should consider investing in long term papers to take advantage of high coupon rates.

Table.5 - Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
FXD1/2019/5	3.7	11.30	2.86	11.150	10.89
FXD1/2020/5	4.9	11.67	3.63	11.650	11.46
FXD1/2019/10	8.7	12.44	5.05	12.400	11.82
FXD1/2018/20	17.8	13.20	6.69	13.000	12.50
FXD1/2018/25	23.03	13.40	7.08	13.500	12.54

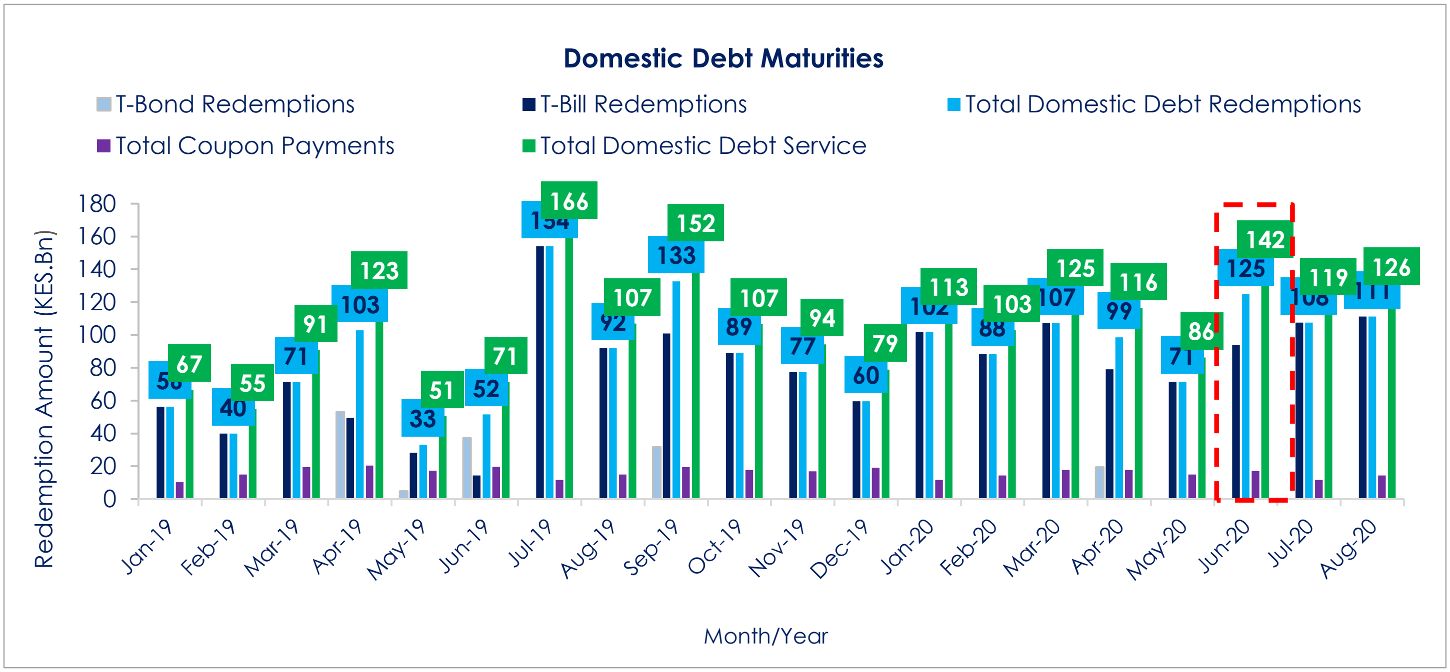
Source: Nairobi Securities Exchange & Sterling Research

*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.142Bn in Total Domestic Debt Service for June 2020

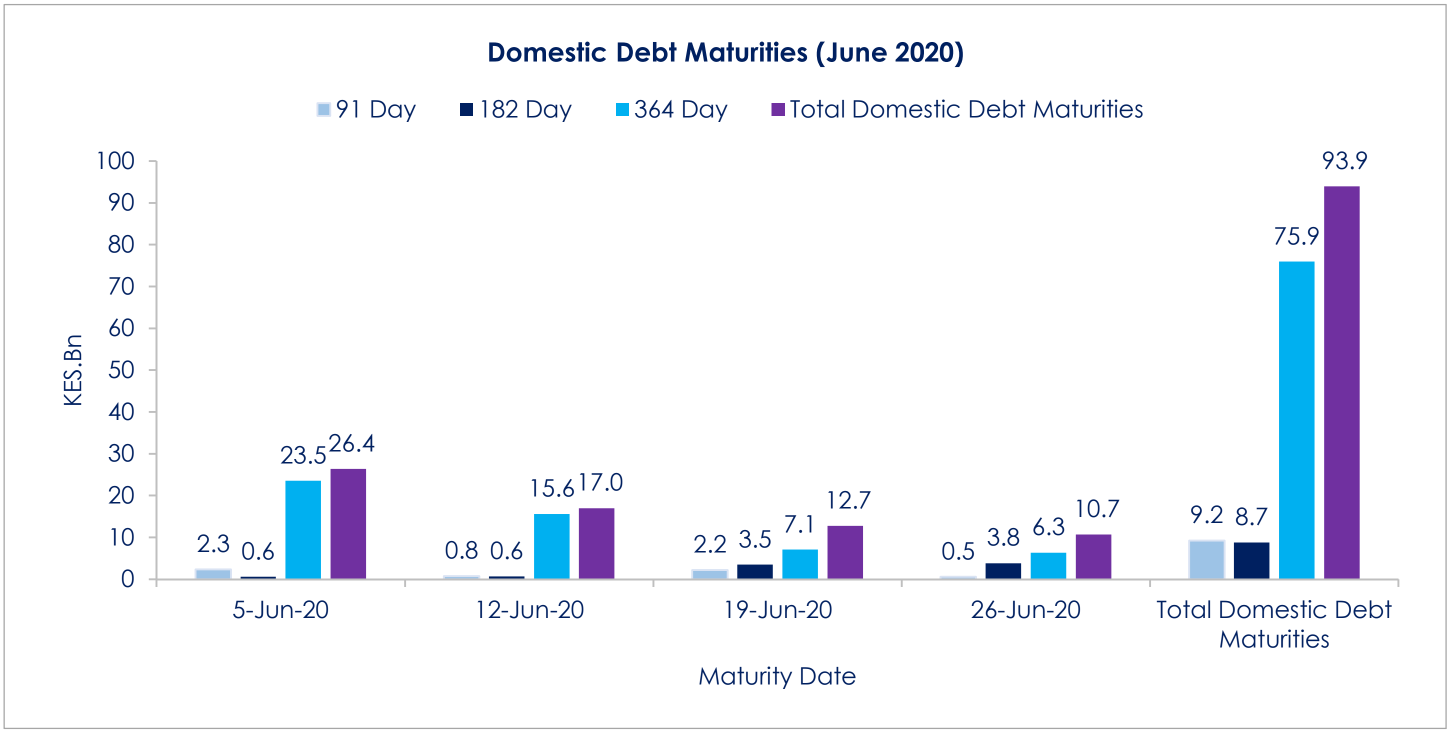
- Total domestic debt service for the month of June 2020 amounts to KES.142Bn, a 64.5% increase from KES.86.4Bn in the previous month (Figure.7).
- T-Bills, T-Bonds and coupon payments account for KES.93.9Bn, KES.31Bn and KES.17.2Bn respectively.
- Total redemptions for the 91, 182- and 364-day T-Bills includes KES.9.2Bn, KES.8.7Bn and KES.75.9Bn respectively (Figure.8).
- This suggests that a significant portion of funds raised in the month will be directed towards redemptions rather than new borrowing.

Figure.7: June 2020 debt service KES.142Bn



Source: Central Bank of Kenya

Figure.8: June 2020 Weekly debt maturities



Source: Central Bank of Kenya

National Treasury above 2019/20 domestic borrowing but unlikely to meet total receipts target

- The National Treasury projects to close total tax revenues for the 2019/20 fiscal year at KES.1.4Tn below its initial revised KES.1.5Tn estimate.
- Total tax receipts at the end of April 2020 stood at KES.1.2Tn equivalent to 83.2% of the KES.1.5Tn revised target and 88.7% of a KES.1.4Tn target (Table 6 Figure.9 and Figure 10).
- An underperformance in revenue collection for 2020/21 is also expected with initial projections at between KES.1.5Tn and KES.1.6Tn if the pandemic persists.
- Total domestic borrowing at KES.476.9Bn or 85% is above our 83.3% linear target with two months of the 2019/20 fiscal year left.
- We see a possibility of the CBK exceeding this borrowing target following a flurry of debt issues in May and increased debt subscription in the months of May and the beginning of June.

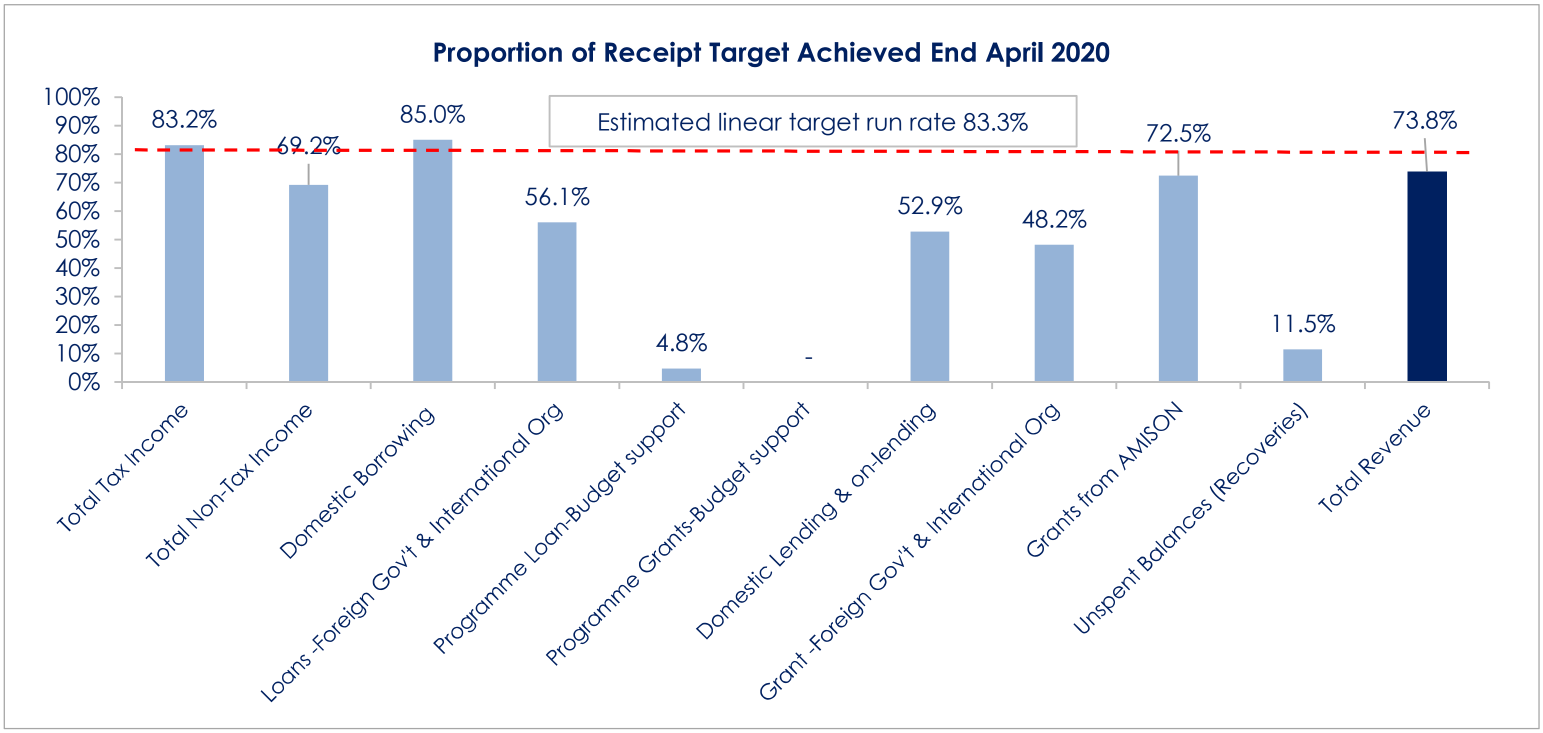
Table.6: National Treasury above domestic borrowing target run rate

Receipts	2019/20 Revised Estimates (KES) 2	Actual Receipts (KES) 30th Apr 2020	Proportion of Receipt Target Achieved 30th Apr 2020
Opening Balance (1st July 2019)	98.9	98.9	
Total Tax Income	**1,490.2**	**1,240.1**	83.2%
Total Non-Tax Income	153.2	106.0	69.2%
Domestic Borrowing	561.0	476.9	85.0%
Loans -Foreign Gov't & International Org	55.9	31.4	56.1%
Programme Loan-Budget support	246.2	11.8	4.8%
Programme Grants-Budget support	7.7	-	-
Domestic Lending & on-lending	4.3	2.3	52.9%
Grant -Foreign Gov't & International Org	14.7	7.1	48.2%
Grants from AMISON	4.0	2.9	72.5%
Unspent Balances (Recoveries)	50.0	5.7	11.5%
Total Revenue	**2,686.1**	**1,983.1**	**73.8%**

* Note 1: Domestic Borrowing of KES. 561 = Net Domestic borrowing KES.338.4 & Internal debt redemptions (Roll-overs) KES.222.6.

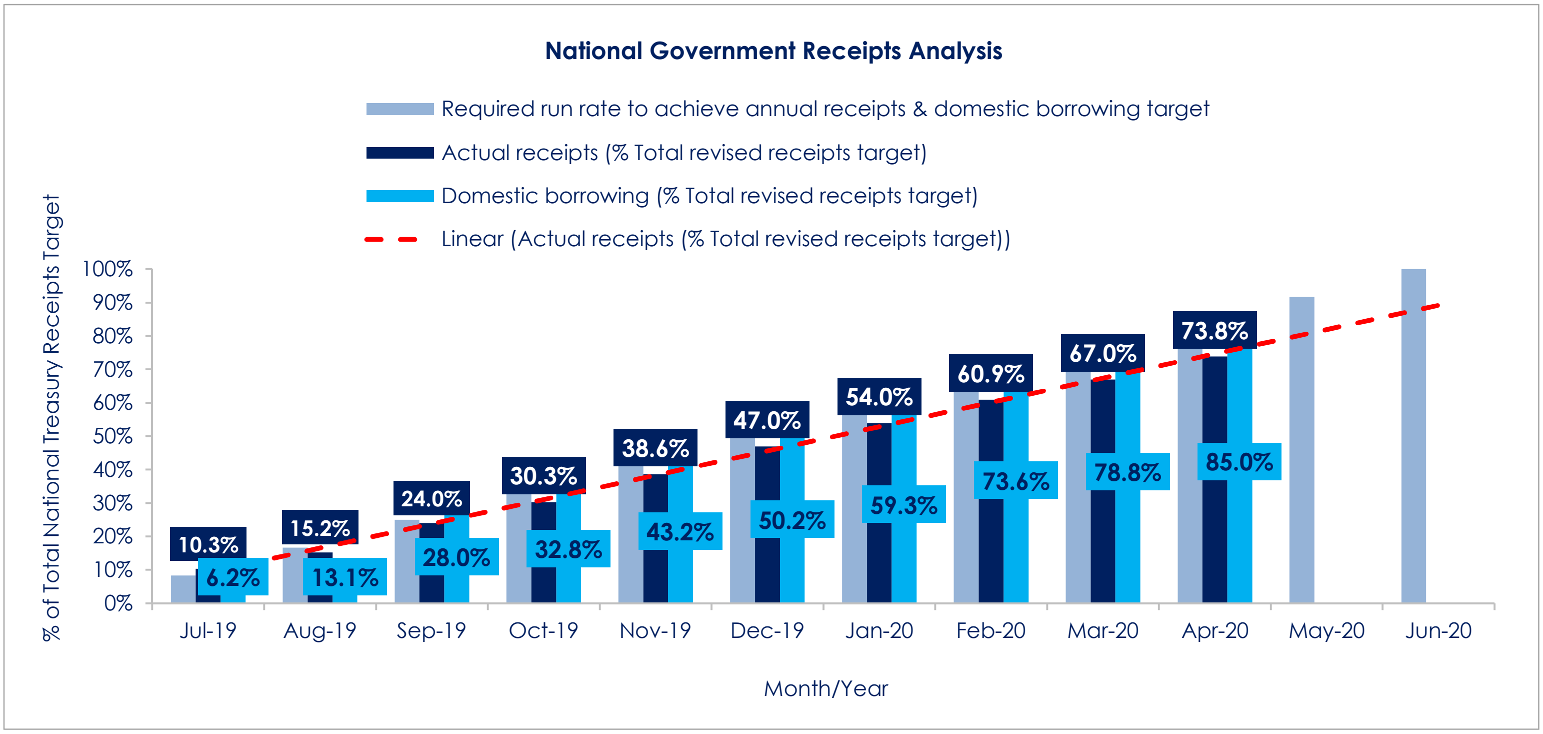
Source: The Kenya Gazette Vol. CXXII - No.94 22nd May 2020

Figure.9: Supplementary budget shows KES.129.1 fiscal budget deficit



Source: The Kenya Gazette Vol. CXXII - No.94 22nd May 2020

Figure.10: Supplementary budget shows KES.129.1 fiscal budget deficit

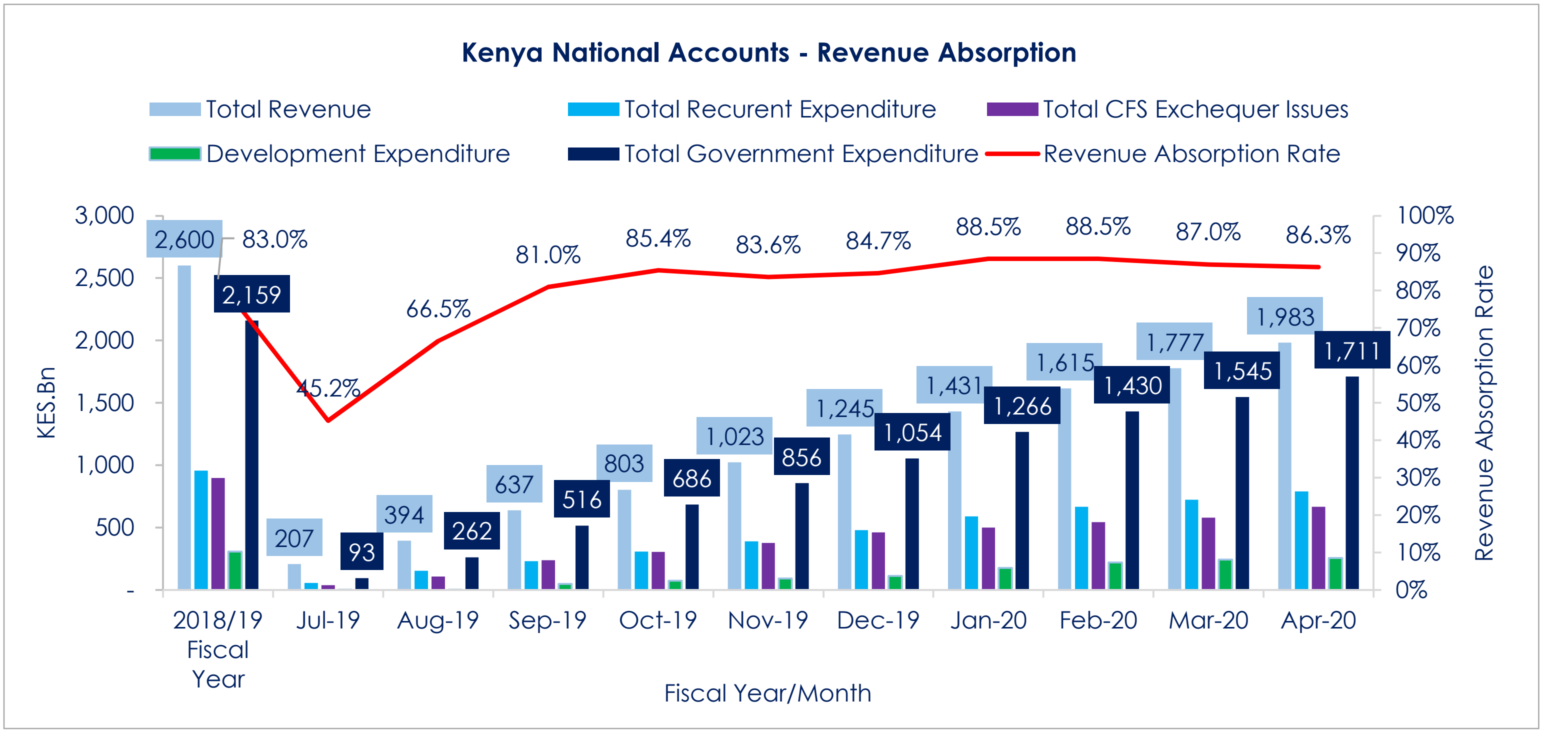


Source: The Kenya Gazette Vol. CXXII - No.94 22nd May 2020

National Treasury revenue absorption rate at 86.3%

- National Treasury absorption levels for the 2020/21 fiscal year have remained high at an average of 86.4% over the last six months to April 2020 (Figure.11).
- April revenue absorption rate stood at 86.3% a signal that a big proportion of Government income is being used to finance its expenditure Treasury.
- It also means that the Government has huge fiscal budget financing needs and explains why it has been actively borrowing in the domestic debt market.

Figure.11: Revenue absorption has been high in the 2019/20 fiscal year



Source: The Kenya Gazette 2020

National Treasury admits to growing public debt distress

2020/21 fiscal deficit estimated at 7.3% of GDP above the 4.9% target

- As a result of depressed Government revenue and increased Government expenditure (due to the impact of Covid-19 pandemic on economic activity), fiscal deficit excluding grants for the 2020/21 year is projected to increase 7.3% of the country's Gross Domestic Product (GDP) well above the National Treasury's initial 4.9% target (Table.7).
- A prolonged pandemic means that the National Treasury will fail to meet its revenue targets while increased expenditure on health and the economic impact mitigation measures is expected to increase the fiscal budget.
- It is also estimated that income tax and Value Added Tax (VAT) revenue will decline from 7.2% of GDP to between 5.8% to 6% and 4% to 3.8% respectively.
- Other than an introduction of a digital tax and the removal of some tax exemptions, no new measures to increase tax revenue are expected in the budget thus increasing the pressure on deficit financing.
- According to the 2020/21 fiscal budget, public debt service is estimated at KES.904.7Bn equivalent to 87% of total Consolidated Fund Services (CFS) - CFS includes public debt service, pensions and salaries.
- Interest payments are expected to make up for 51% of total debt service a significant cost to the exchequer.
- As a result of the increased fiscal deficit we expect a significant increase in borrowing a bulk of which will be sourced from the domestic debt market.

- This is in sharp contrast with estimates published in the Budget Review and Outlook paper in February 2020.
- The increase in borrowing according to the National Treasury goes against its debt management strategy: "This trend is contrary to the previous undertaking by the National Treasury to ensure that there is reduced domestic borrowing as well as targeting cheaper financing from multilateral and bilateral source."

Table.7: 2020/21 fiscal budget estimates adjusted upwards to account for impact of Covid-19

Budgetary Item	2020/21 Estimate
Total Revenue	**2,133.5**
Ordinary Revenue	1,621.4
Total Expenditure & Net Lending	**2,733**
Recurrent Expenditure	1,805.2
Development Expenditure (including foreign financed projects & conditional transfers to County Governments)	584.9
Economic Stimulus Programme	53.7
Net Foreign Financing	349.7
Net Domestic Financing	473.6

CFS – Expenses related to public debt, pensions and salaries of constitutional offices

Source: Budget & appropriations committee report

Yields on the short-end decline while those on the long-end rise

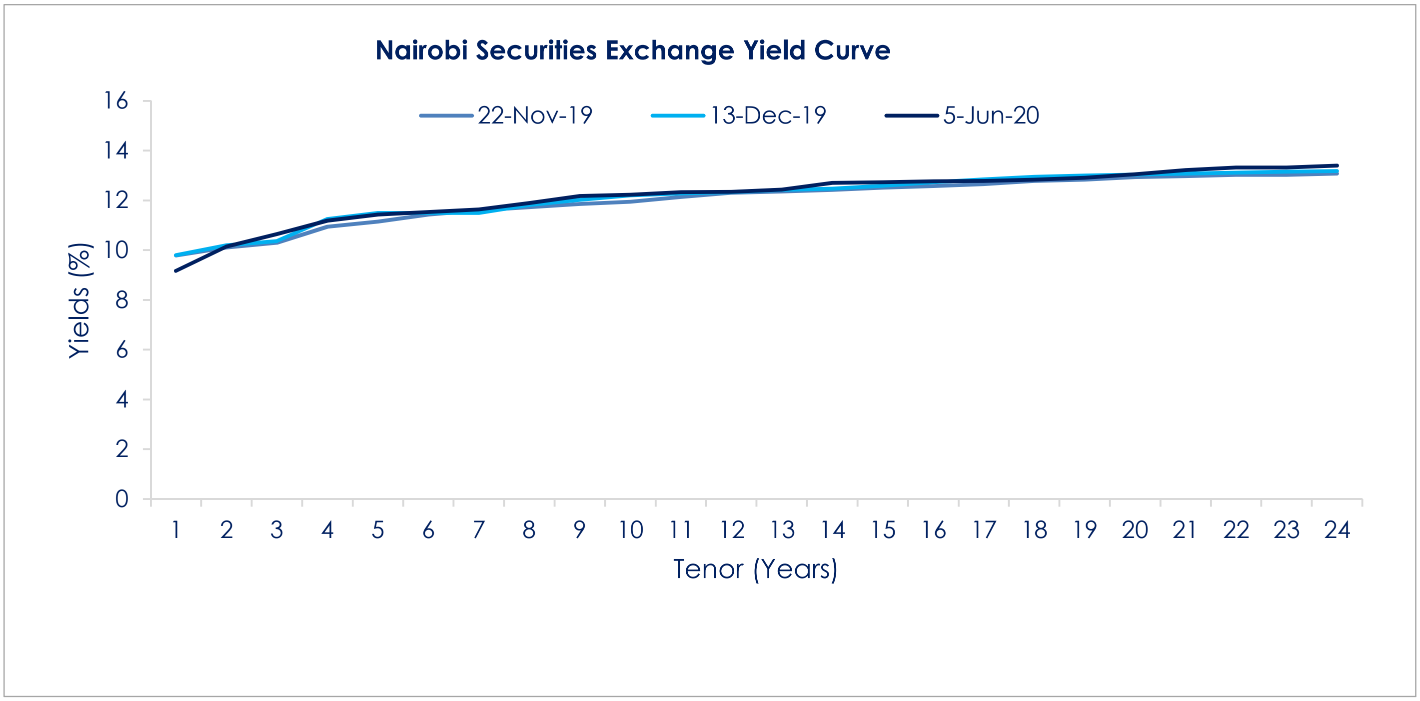
- Comparison of yields as at 5th June 2020 and 22nd November 2019 (time of issue of FXD4/2019/10) shows a significant dip in short- and medium-term yields, and a rise in yields on long term papers. (Table.8 and Figure, 12).
- We anticipate minimal change in the yield curve over the next month due to high market liquidity.
- In addition, we expect the government to focus on short- and medium-term debt issues as investors remain averse to long term commitment during the COVID-19 pandemic.
- **Our recommendation still stands; BUY short- and medium-term bonds and HOLD long term papers.**

Table.8: Short-end yields dip, long-end yields rise

Tenor	Yield (22nd Nov 2019)	Yield (13th Dec 2019)	Yield (5th Jun 2020)	Change Nov 2019 vs Jun 2020 (Bps)	Change Dec 2019 vs Jun 2020 (Bps)	Sterling Capital yield Curve (9th June 2020)
1	9.7870	9.7980	9.165	↓63.3	↓62.2	9.150
2	10.1044	10.1910	10.1408	↓5.0	↑3.6	10.100
5	11.1500	11.4920	11.4251	↓6.7	↑27.5	11.525
10	11.9417	12.2000	12.2309	↑3.1	↑28.9	12.400
15	12.5100	12.5905	12.7294	↑13.9	↑21.9	12.700
20	12.9292	13.0374	13.0438	↑0.6	↑11.5	12.875

Source: Nairobi Securities Exchange

Figure.12: Yields on the short-end down, long-end up

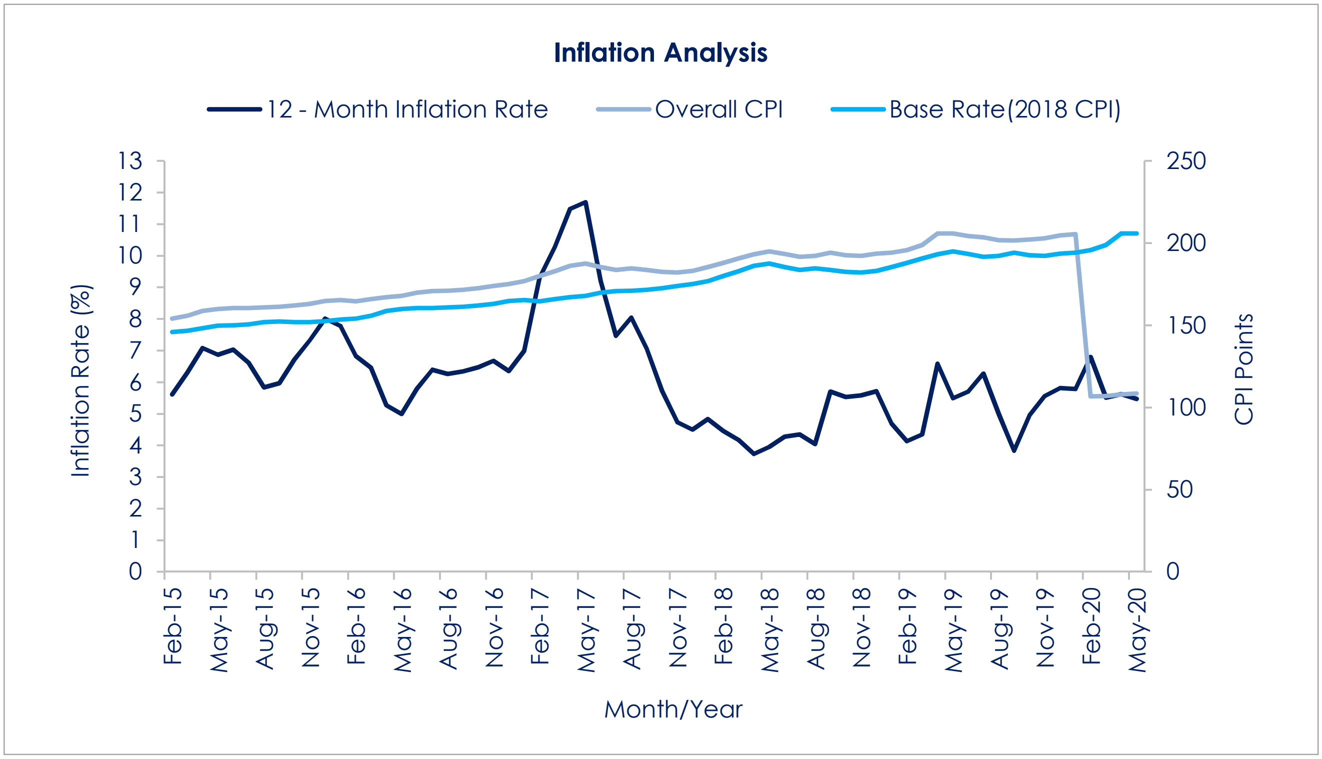


Source: Nairobi Securities Exchange

June 2020 inflation forecast 5.5-6.0%

- Overall year on year inflation for the month of May 2020 stood at 5.5% from 5.6% in April 2020 (Figure.13).
- Food and Non-Alcoholic Drinks' Index increased by 0.9% while food inflation stood at 10.6%.
- During the same period, Housing, Water, Electricity, Gas and Other Fuels' Index, increased 0.8% mainly attributed to a 3.2% increase in the cost of kerosene.
- Transport Index increased by 0.02% despite the decline in prices of petrol and diesel by 9.8% and 19.1% respectively.
- Our June 2020 inflation forecast is 5.5 - 6.0% based on expectations of increased fuel and food prices.
- We expect the inflationary pressure to be sustained within the upper band of the target range 2.5%-7.5% in the short term during the period of COVID 19 Pandemic.

Figure.13: June 2020 inflation forecast 5.5% - 6.0%



Source: Kenya National Bureau of Statistics

Monetary Policy Committee likely to retain CBR at 7% in June meeting

MPC to retain CBR at 7% in June meeting

- As predicted in our third fixed income report in May 2020 titled "CBK's Unusual Offer", the Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 7%.
- This followed a review of the impact of previous monetary policy action which included a reduction in the Cash Reserve Ratio (CRR) rate from 5.25% to 4.25%.
- The decision shows that the MPC believes that recent monetary policy actions have been effective with a positive impact on inflation, currency stability and private sector credit growth.
- The Committee noted that 82.6% of the funds released by CRR revision had been directed towards private sector lending as illustrated by the 9% year on year private sector credit growth in April 2020.
- It also expects the Economic Stimulus Programme announced by the Government to cushion households and businesses from the negative impact of the pandemic.
- We also anticipate the recent cessation of restrictions in key destination markets and increased cargo capacity to result in increased volumes of horticultural exports and in turn support for the Kenya Shilling (KES).
- Extension of the national dusk to dawn curfew is expected to result in improved economic activity.
- The MPC is set to meet again on 30th June 2020 where we see a retention of the CBR as economy continues to absorb the effects of the previous measures put in place.

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