Thursday, 10 June 2021

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Fixed Income Note

June 2021

"It's budget day"

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Executive Summary

- Our fixed income report for the month of May 2021 is titled **"It's budget day"** in reference to the 2021/22 fiscal budget to be read on Thursday 10th June 2021.
- This month, the Central Bank of Kenya seeks to raise KES.30Bn through two re-opened bonds FXD1/2012/20 and FXD1/2019/20.
- Our weighted average bid predictions are as follows:

Weighted Average Rate (WAR) of investor bids

- **FXD1/2012/20: 12.75% - 12.85%**
- **FXD1/2019/20: 13.40% - 13.50%**

WAR of accepted bids

- **FXD1/2012/20: 12.65% - 12.75%**
- **FXD1/2019/20: 13.30% - 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.
- 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 also analyse the country's fiscal position; revenue, expenditure, financing deficit and borrowing needs with specific mention of the draft 2021/22 fiscal budget.
- We give our inflation expectations towards the end of the report which concludes with our view on the Monetary Policy Committee (MPC) decision in the short term.

CBK's June debt issues target KES.30Bn

- The Central Bank of Kenya (CBK) invites bids for two treasury bonds re-opened **FXD1/2012/20 and FXD1/2019/20** seeking to raise KES.30Bn (Table.1).
- The two bonds have a term to maturity of 11 years and 18 years respectively.
- Both bonds have fixed coupon rates with the FXD1/2019/20 bond having a coupon of 12.873%, while FXD1/2012/20 has a coupon of 12%, lower than the yield curve at 13.2649%.
- We believe CBK has issued the 20-Year bonds to enable the Government bridge its fiscal deficit and lengthen debt maturity amid falling revenues.
- We are fairly optimistic that the issue will be fully subscribed due to the relatively small amount offered.

Table.1: Primary Bond issue summary

Issue Number	**FXD1/2019/20**	**FXD1/2012/20**
Total Amount Offered	KES.30Bn	
Tenor (Years)	20 Years	20 Years
Term to Maturity	18 Years	11 Years
Coupon Rate (%)	12.873	12.000
Price Quote	Discounted/Premium/Par	
Period of Sale	2nd June 2021 to 15th June 2021	
Auction Date	16th June 2021	
Value Date	21st June 2021	
Yield Curve (%) (Weighted Average tenor - 7th June 2021	**13.2649**	**13.2649**

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 7th June 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	**FXD1/2012/20**	**FXD1/2019/20**
Market Weighted Average Rate	12.75 – 12.85	13.40– 13.50
Weighted Average Rate of Accepted Bids (%)	12.65 – 12.75	13.30 – 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 7th June 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
20-Year						
FXD1/2012/20	26th Nov 2012	12.00	1st Nov 2032	11.4 (4,168)	12.5115	14.8200
FXD1/2019/20	15th April 2019	12.87	21st Mar 2039	17.8 (6,499)	13.1784	12.8136

Source: Central Bank of Kenya

Optimistic that the issue will be fully subscribed

- A historical comparison of primary auction results for 20-year issues shows low investor demand due to the long term to maturity (Table 4).
- We expect a full subscription of the two bonds on account of the low target amount (KES.30Bn) and high market liquidity.
- FXD1/2012/20 is likely to receive a bulk of subscriptions due to its a shorter term to maturity which eclipses its slightly lower yield.
- We anticipate the CBK to limit subscriptions to manage the cost of borrowing.

Table.4: Historical primary market auction performance

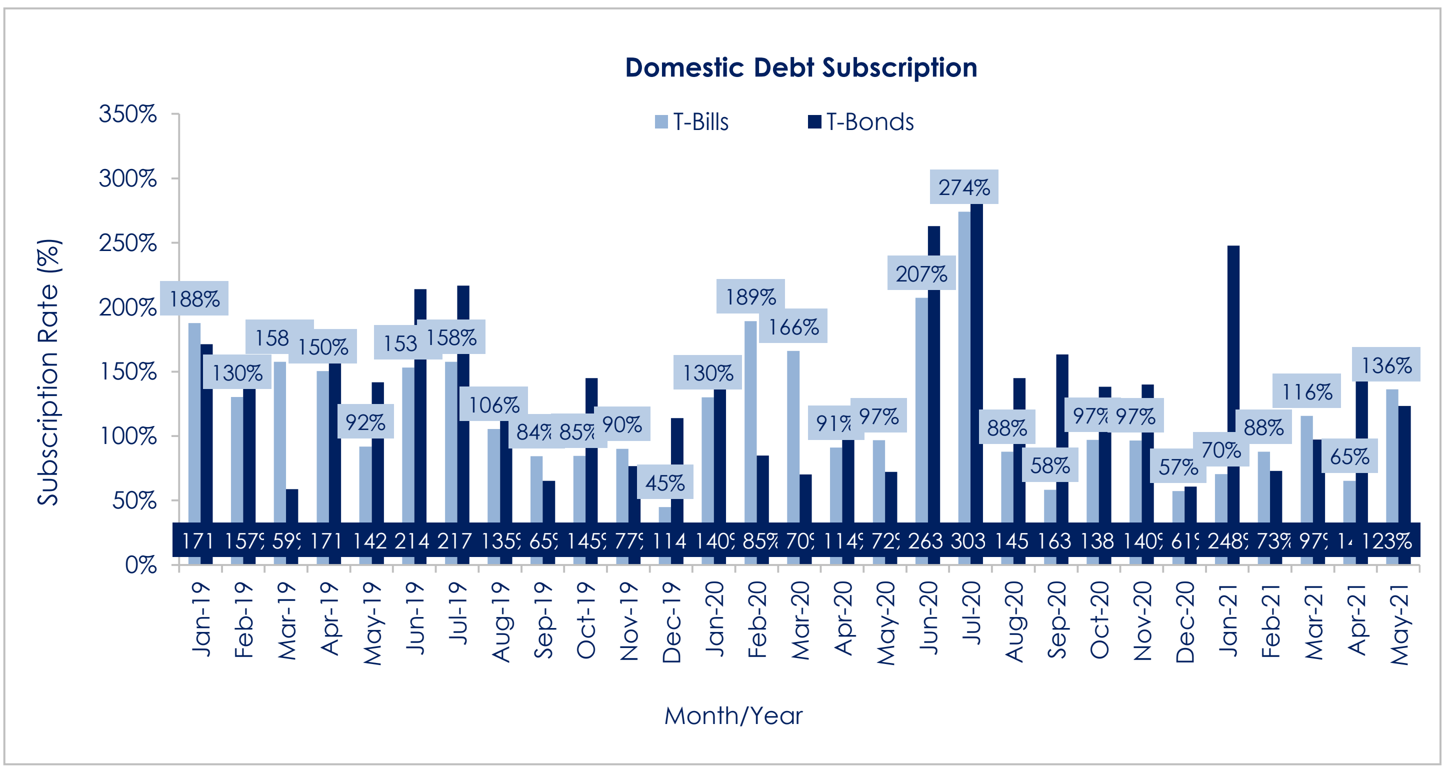
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yields (%)
20-Year						
FXD1/2016/20	25	17.8	12.3	78.3	14.00	13.0061
FXD1/2018/20	40	28.9	27.5	72.2	13.20	13.1697
FXD2/2018/20	50	32.8	32.8	65.6	13.20	13.1918
FXD1/2019/20	50	14.7	9.0	29.4	12.87	13.1784

Source: Central Bank of Kenya

T-bills over-subscribed in May 2021

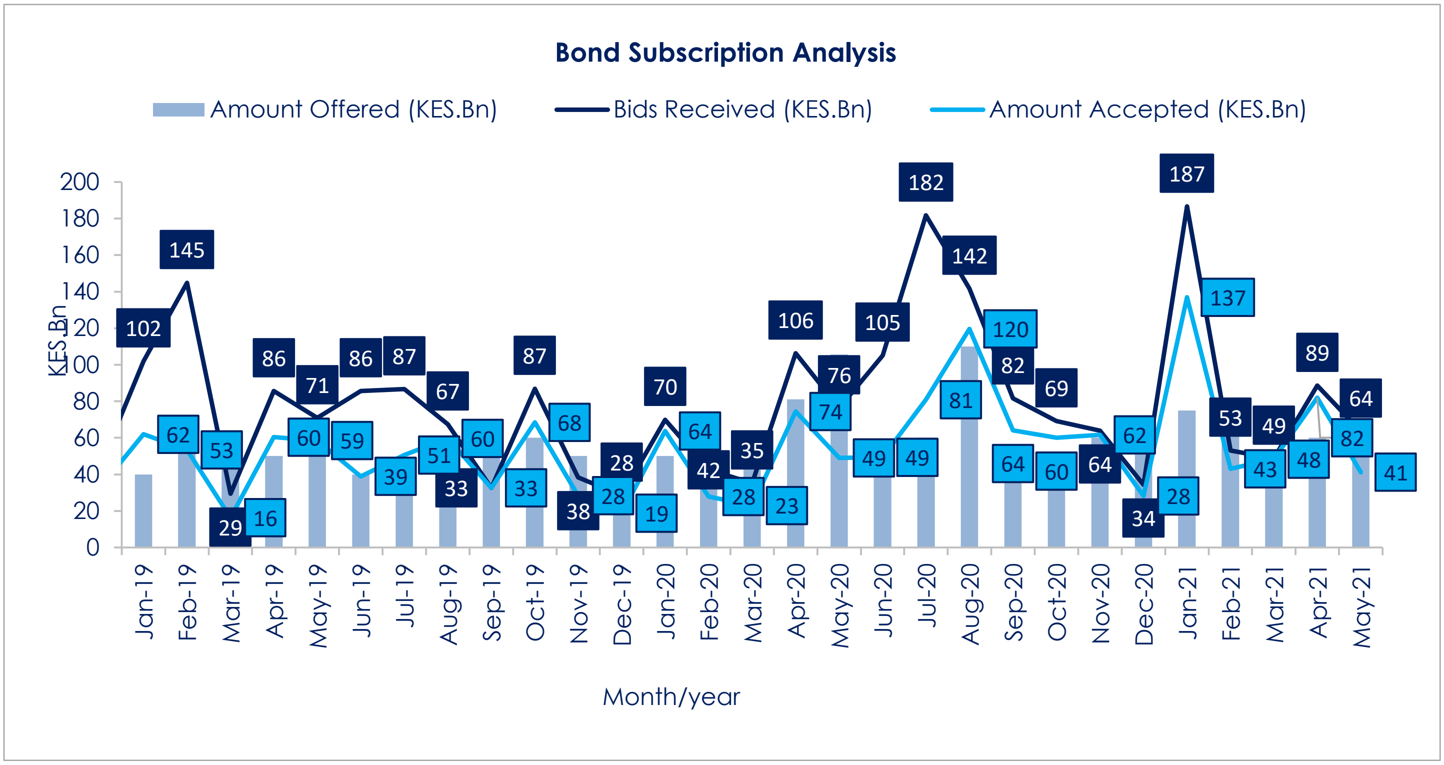
- Aggregate subscription rate for T-Bills rose to 136.2% in May 2021 from 65.4% in April with the CBK receiving T-Bills worth KES.163.5Bn against KES.120Bn offered (Figure.1).
- The 364-day T-Bill recorded the highest subscription rate at 240.1% (KES.120.1Bn) while the 91-day and 182-day papers were undersubscribed at 60.4% (KES.12.1Bn) and 62.6% (KES.31.3Bn) respectively.
- April's Bond issue and tap sale for FXD2/2019/15 and FXD1/2021/25 received bids worth KES.63.5Bn against the KES.50Bn offered, a subscription of 123.3%. (Figure.2).
- We expect the demand for the 364-day T-Bill to remain high compared to the 91-day and 182-day T-Bills as investors lock-in the higher rate of return.
- This high demand however has been the driving factor behind the lower acceptance rate and the drop in 364 Day t-Bill rate during the month.

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



Source: Central Bank of Kenya

Figure.2: Bonds subscription continues to exceed amount offered by the CBK

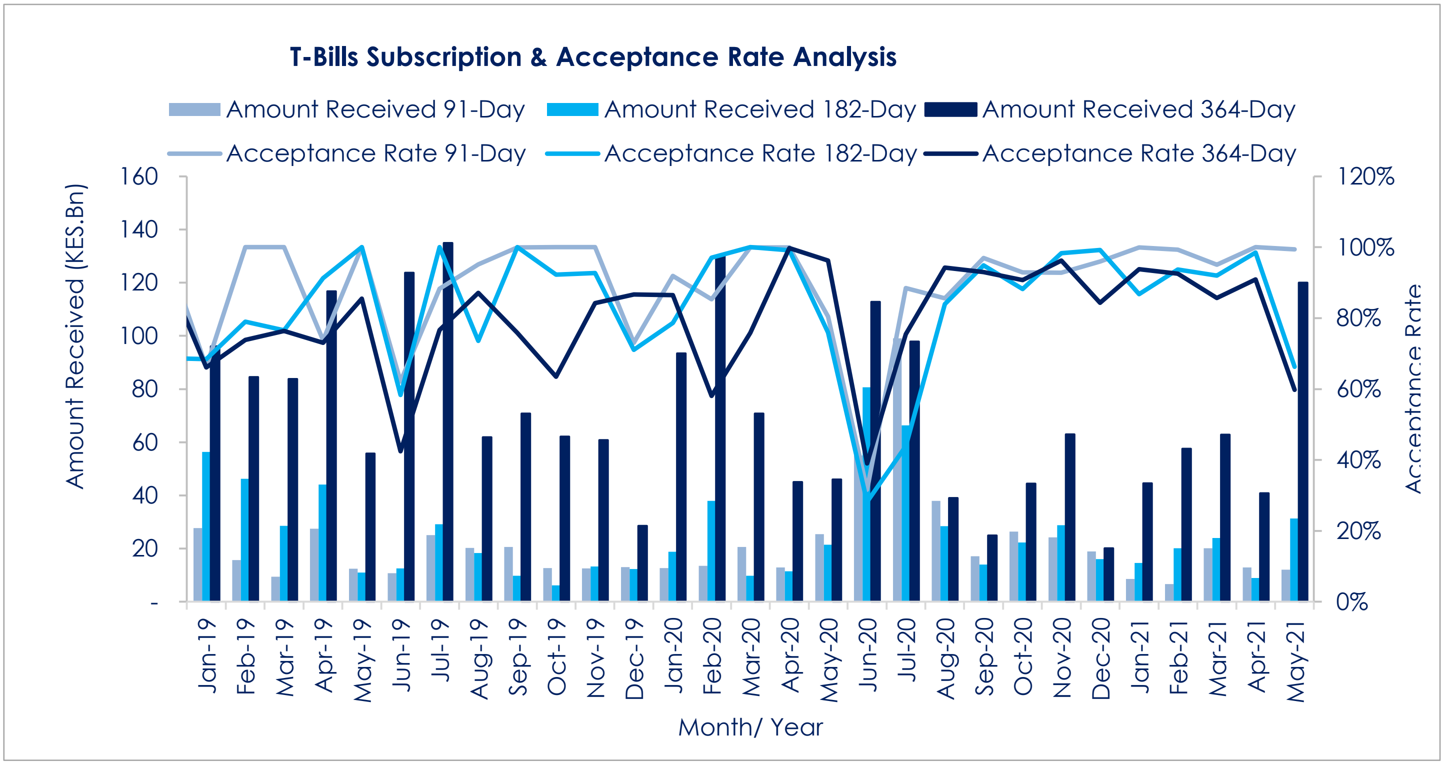


Source: Central Bank of Kenya

Average T-Bill rates up in May 2021 despite dip towards the end of the month

- The rising budget deficit has increased pressure on the CBK to accept higher investor bids in T-Bill auctions, resulting in a gradual rise in short term domestic debt interest rates since August 2020 (Figure.3).
- The May 2021 acceptance rate for the 91, 182 and 364 day T-bills were 99.4%, 66.3% and 59.8% respectively.
- We see the low acceptance rate for the 364 day-Tbill as the CBK's strategy to discourage aggressive investor bids and thius push down rates which has been the case in recent auctions.

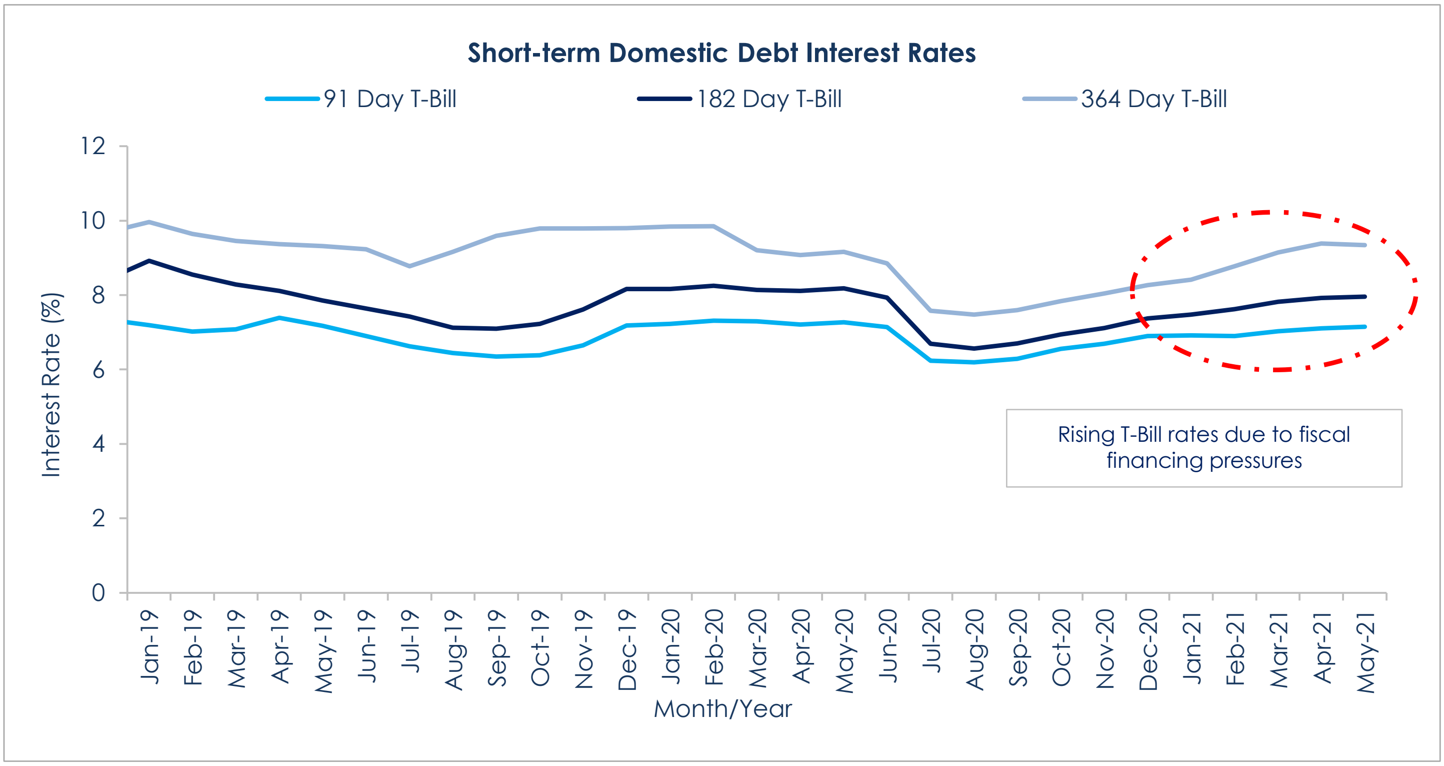
Figure.3: Acceptance rate for 91-day paper goes up in May 2021



Source: Central Bank of Kenya

- Average interest rates for the 91 and 182 day T-Bills rose to 7.2% and 8% compared to 7.1% and 7.9% in April 2020 respectively (Figure.4).
- Average rate for the 364 Day T-Bill however declined to 9.3% compared to 9.4% in April.
- We observe a gradual decline in T-Bill rates beginning the 2nd week of May (13th May 2021) which we attribute to a decline in acceptance rates by the CBK.
- Despite the slight decline in T-Bill rates in recent auctions, we expect a slight upward shift on the short-end of the yield curve due to the reasons mentioned above.

Figure.4: Short-term debt securities interest rates appear to have stabilized

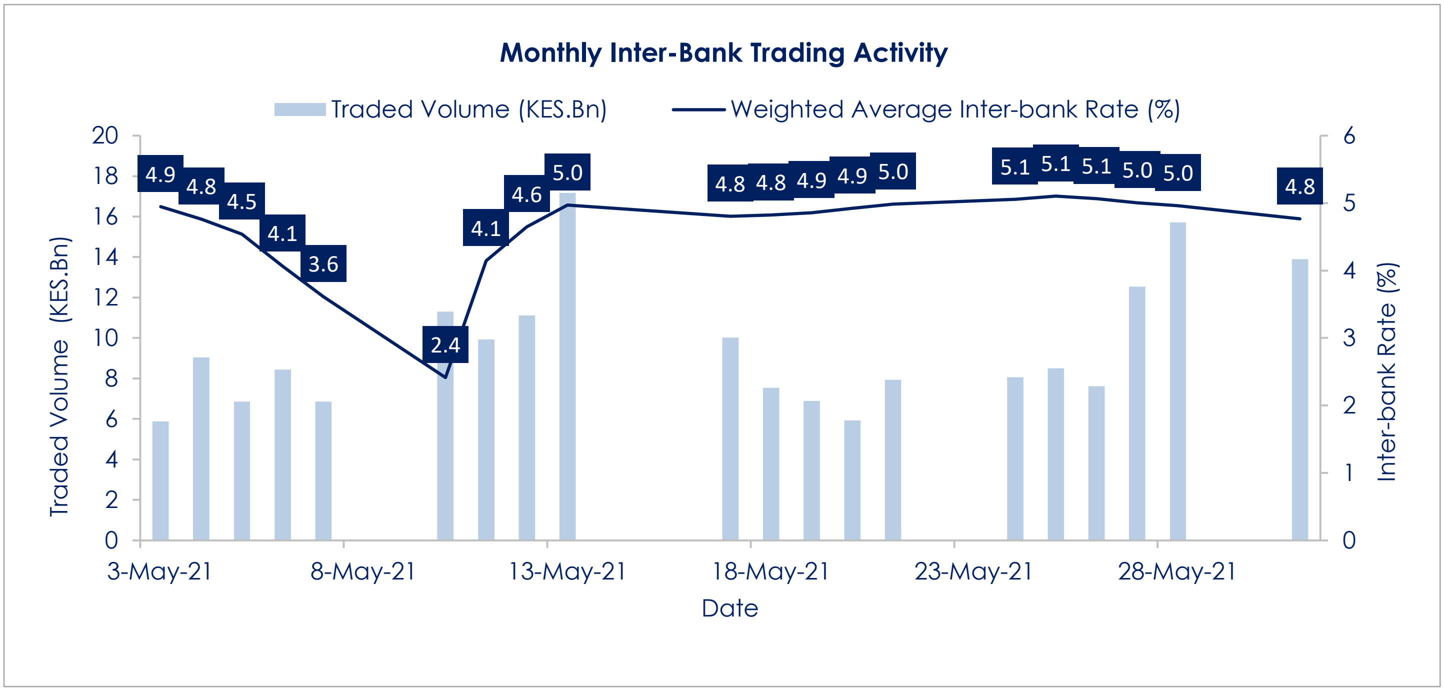


Source: Central Bank of Kenya

Average inter-bank rate declines further in May

- The average inter-bank rate declined to 4.6% in May 2021 from 5.1% in April as a result of comparatively higher market liquidity (Figure.5).
- During the period under review, total inter-bank trading volumes stood at KES.191.2Bn compared to KES.191.9Bn transacted in April.
- Increased liquidity during the month was supported by government payments which partly offset tax remittances
- Our forecasted average inter-bank rate for June 2021 is 4.5% - 5.5%.

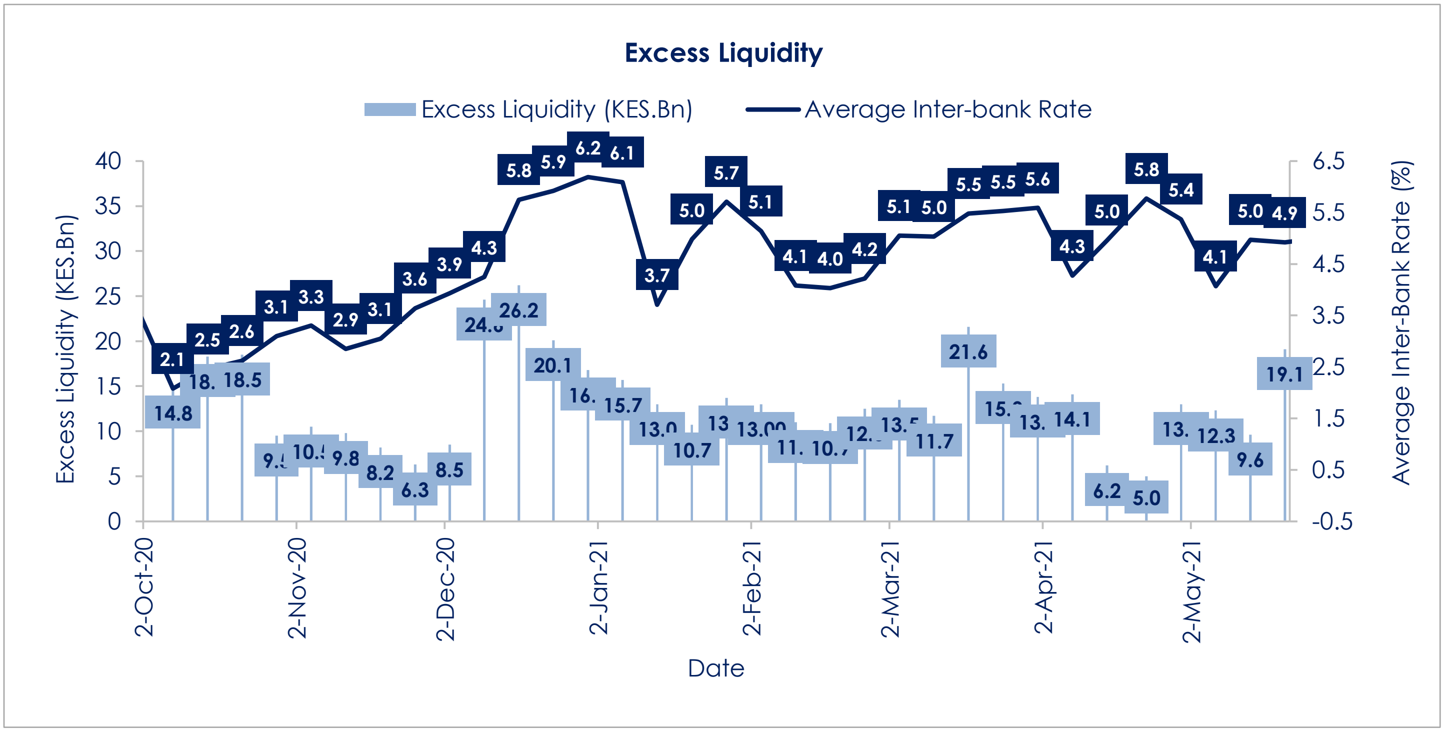
Figure.5: Inter-bank lending rates to range between 4.5% and 5.5% in June 2021



Source: Central Bank of Kenya

- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) over the same period grew to KES.56.5Bn, 8.4% above KES.52.1Bn attributable to higher market liquidity (Figure.6).

Figure.6: Excess commercial bank reserves rise 8% in May 2021

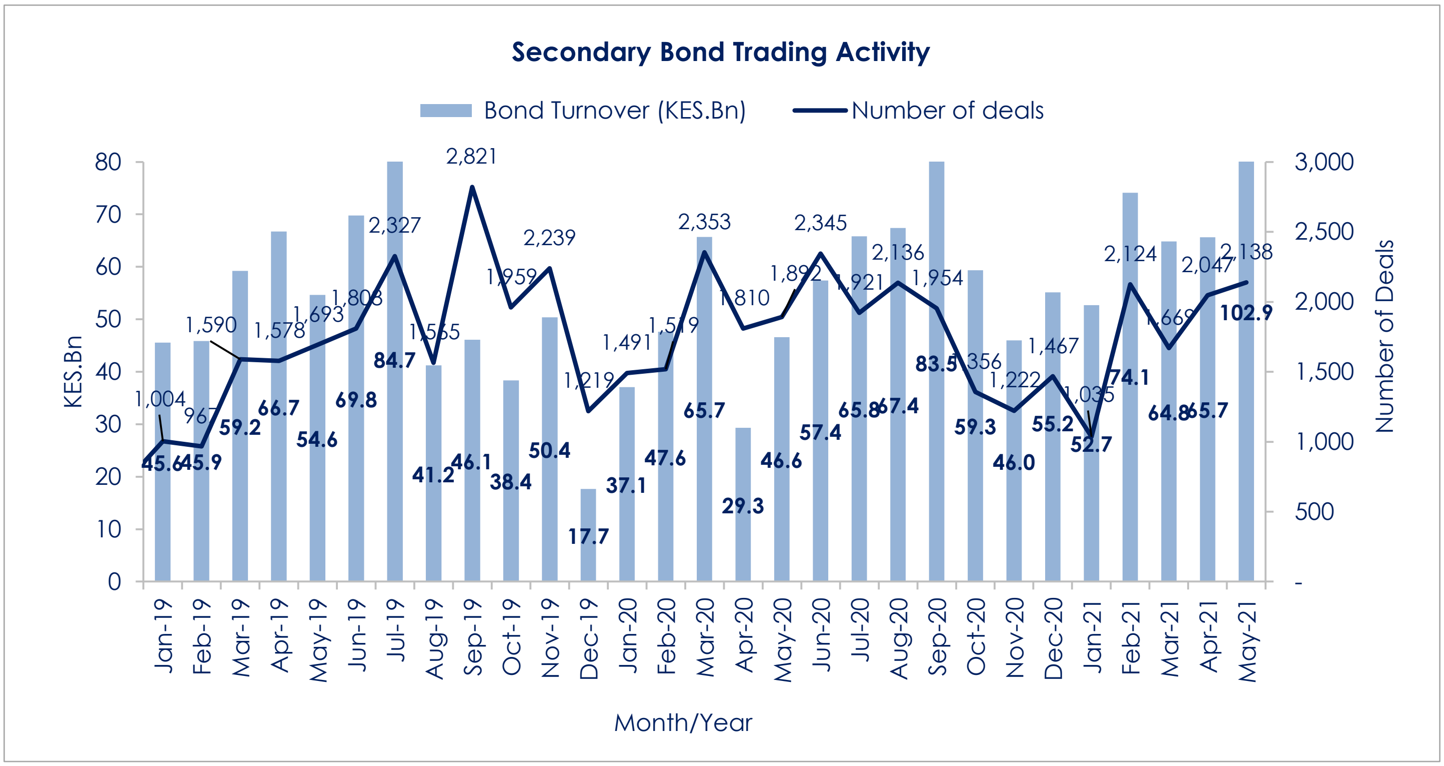


Source: Central Bank of Kenya

Secondary market bond turnover to increase in June 2021

- Secondary market trading activity stood at KES.102.9Bn at the end of May, up from KES.65.7Bn the previous month with the number of deals over the same period at 2,138 from 2,047 in April (Figure.7).
- We attribute the high trading activity during the month to high market liquidity compared to the previous month.
- We expect higher secondary market turnover in June on account of high market liquidity boosted by government payments.

Figure.7: Secondary trading activity set to increase in May 2021



Source: Central Bank of Kenya

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

- Infrastructure Bonds (IFBs) have relatively high yields, favourable return in the secondary market and are tax exempt and we therefore recommend the following bonds for investors with a fixed income allocation portfolio (Table.5):
- We also recommend FXD1/2021/025 due to its comparatively high coupon.

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2021/18	17.81	12.67	6.98	12.15	12.19
IFB1/2021/16	15.6	12.26	6.63	12.00	11.92
IFB1/2020/11	10.19	10.90	3.77	11.10	10.95
FXD1/2021/25	24.86	13.92	6.91	13.65	13.59

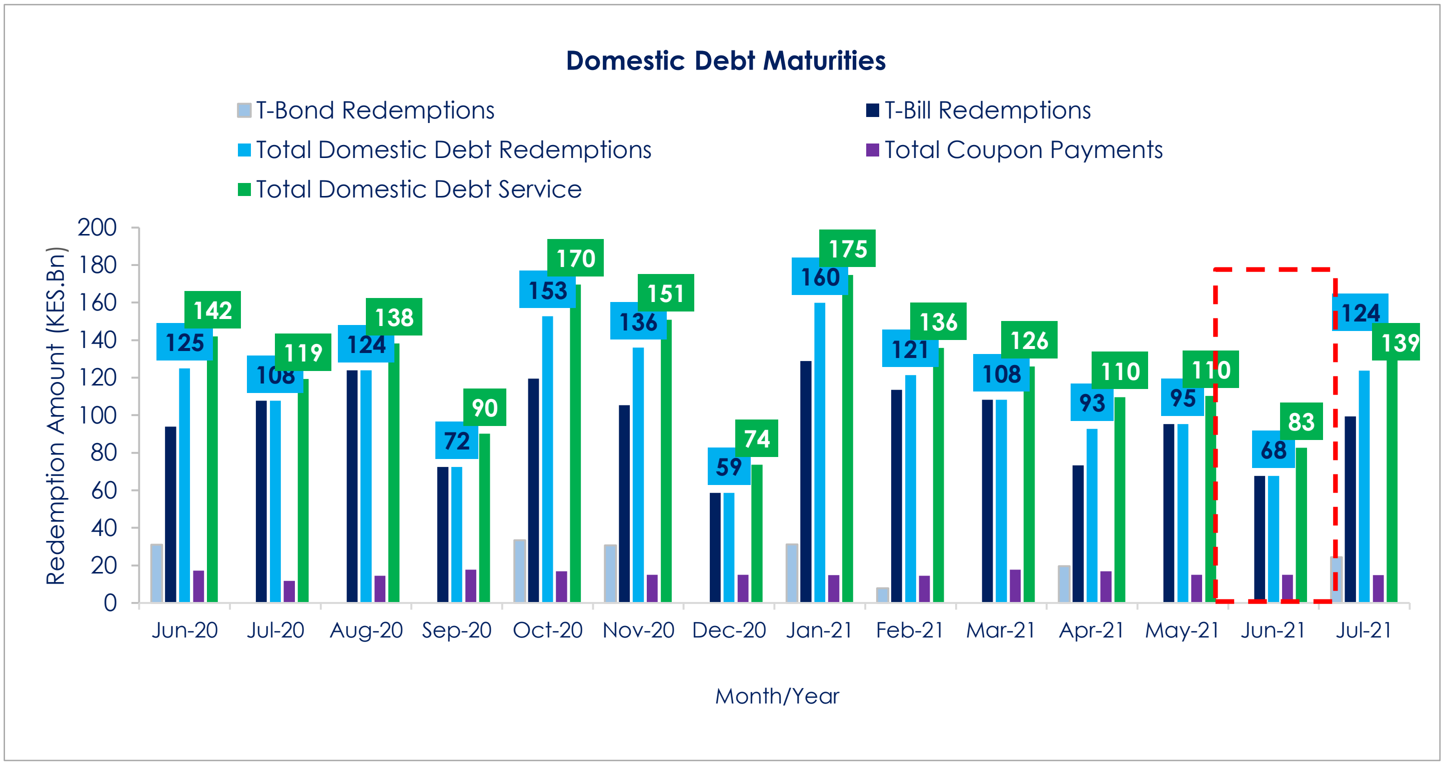
Source: Central Bank of Kenya

*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

June 2021 domestic debt service at KES.83Bn

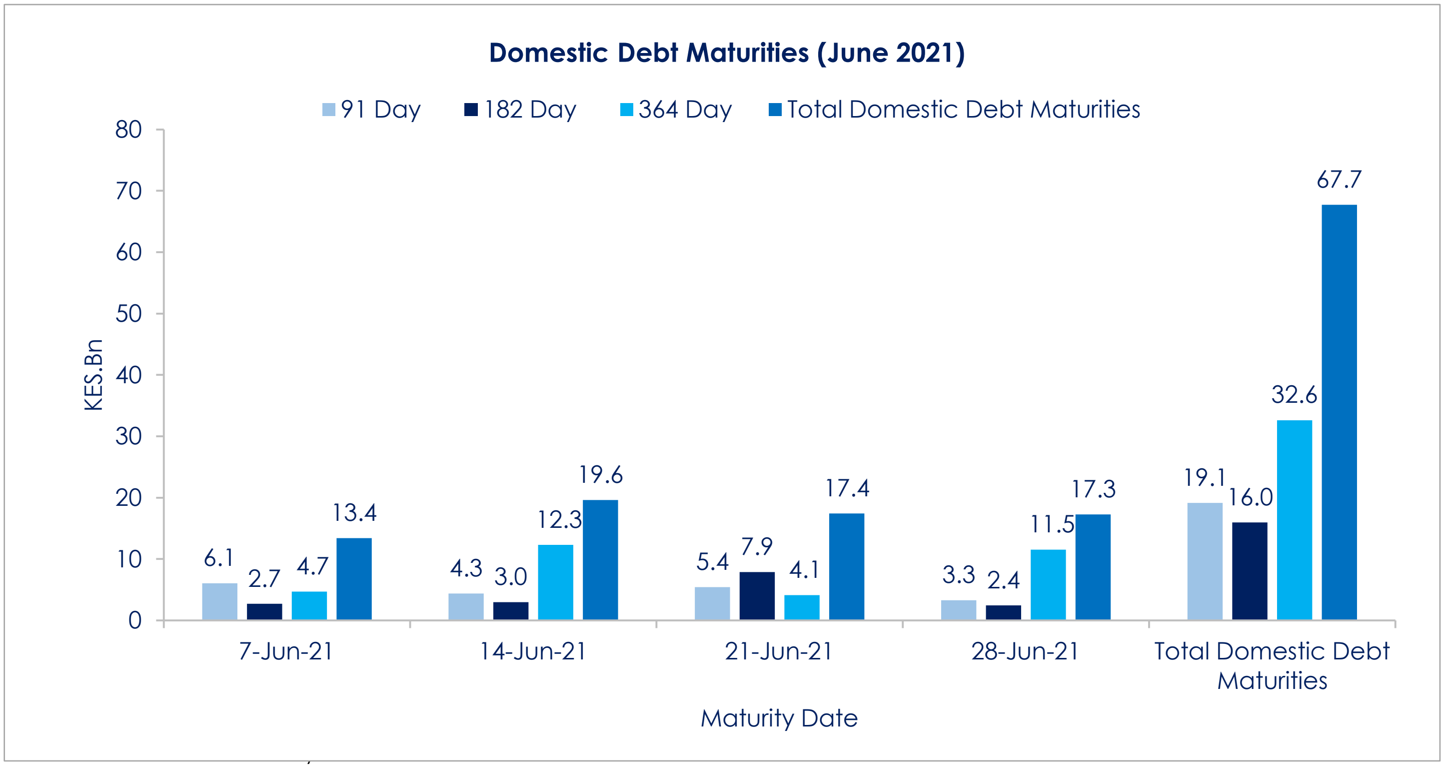
- There will be a further reduction in domestic debt service for the month of June with to KES.82.7Bn with no bond maturities compared to KES.110.3Bn in May 2021 (Figure.8).
- Expected redemptions for the 91, 182 and 364-day T-Bills during the month are KES.19.1Bn, KES.16Bn and KES.32.6Bn respectively with the second week of the month having the highest total redemptions at KES.19.6Bn. (Figure.9).
- T-Bond redemptions, T-Bill redemptions and coupon payments are expected to be KES.24.4Bn, KES.99.4Bn and KES.14.8Bn respectively in July, bringing the total debt service cost for that month to KES.138.6Bn.

Figure.8: June 2021 domestic debt service dips to KES.83Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities May 2021



Source: Central Bank of Kenya

National Treasury to unveil Kenya's KES.3.7 Trillion Budget

Kenya total expenditure FY2021/22 projected at KES.3.7Tn

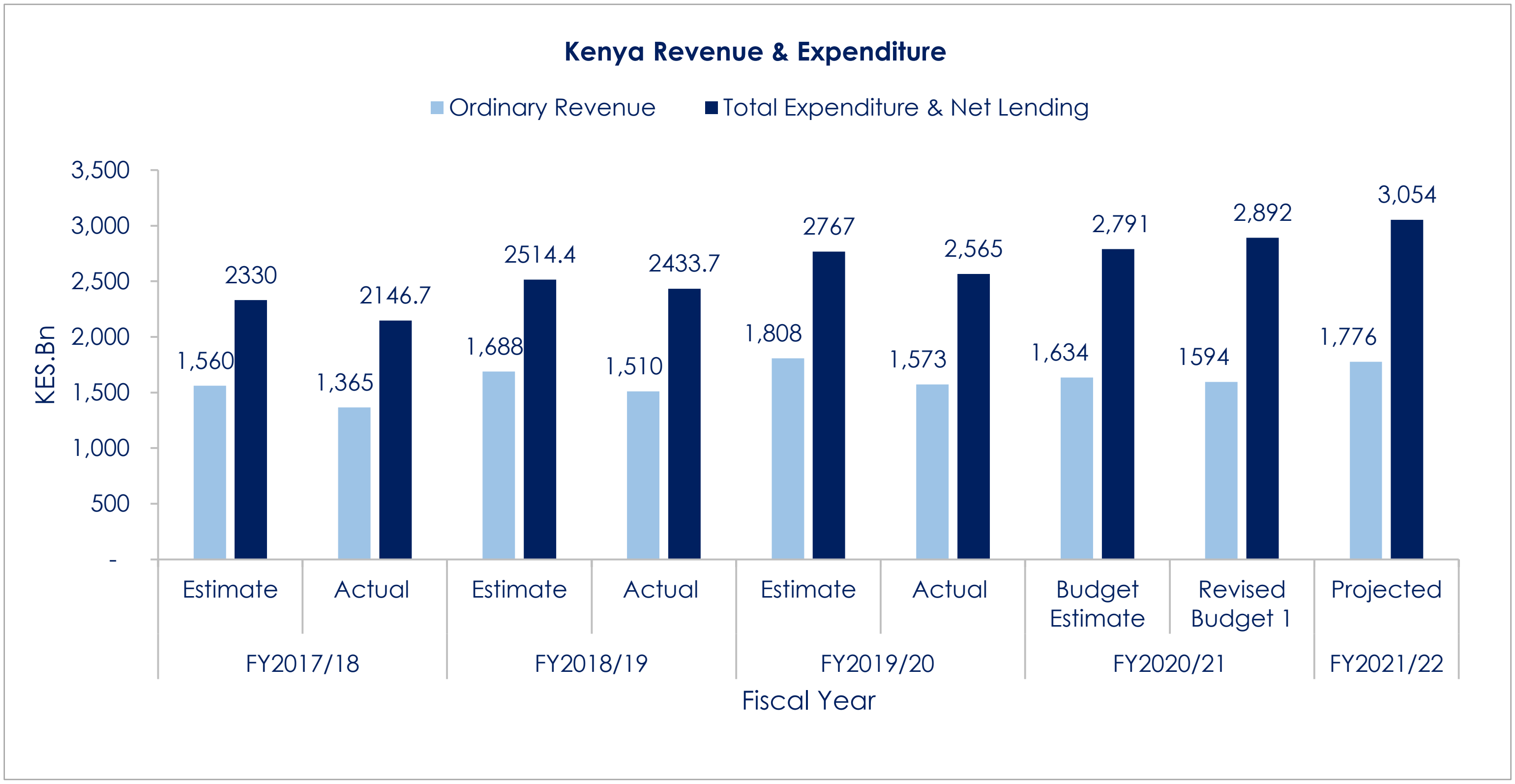
- The National Treasury and Planning Cabinet Secretary will on 10th June unveil the country's first KES.3Tn plus budget (KES.3.7Tn).
- Recurrent and development expenditure will amount to KES.1.3Tn and KES.666.5Bn.
- Increase in expenditure FY2021/22 over the previous year is 8.8% against a total revenue increase of 10.3% to KES.2Tn which we believe is overly optimistic under the current economic environment.
- The economic slowdown exacerbated by the Covid-19 pandemic means that tax revenue will remain subdued and growth if any in 2021/22 will be modest.
- For this reason we see a significant increase in the fiscal deficit and an upward revision in borrowing targets during the year particularly domestic financing.

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 FY2019/20)
TOTAL EXPENDITURE	**2,850**	**3,362**	**3,657**	**8.8%**
Recurrent Expenditure	1,111	1,275	1,293	1.4%
Development Expenditure	614	697	667	-4.3%
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)**	**(970)**	**(952)**	**-1.9%**
FINANCING				
Foreign Repayments	**(101.6)**	**(427.1)**	**(291.3)**	**-31.8%**
Domestic Financing	**450.4**	**543.9**	**642.1**	**18.1%**

Source: Kenya National Treasury

Figure.10: Kenya ordinary estimate declines to 2018/19 level



Source: Kenya National Treasury

National treasury below fiscal receipts target with two months to the end of the 2020/21 fiscal year

- Data as at the end of April 2021 shows total revenue and domestic borrowing at 74.1% and 85.4% of the revised fiscal receipts estimate (Table.7 and Figure.11).
- Total revenue falls below while domestic borrowing is above our estimated linear run rate target (83%).
- The National Treasury has made several revisions to its 2020/21 fiscal year budgetary targets due to expected shortfalls in tax collections against an increase in Government expenditure.
- With two months to go to the end of the 2020/21 fiscal year, it is unlikely that the treasury will meet its revised tax collection targets and we expect this shortfall to be met through both domestic and external borrowing.

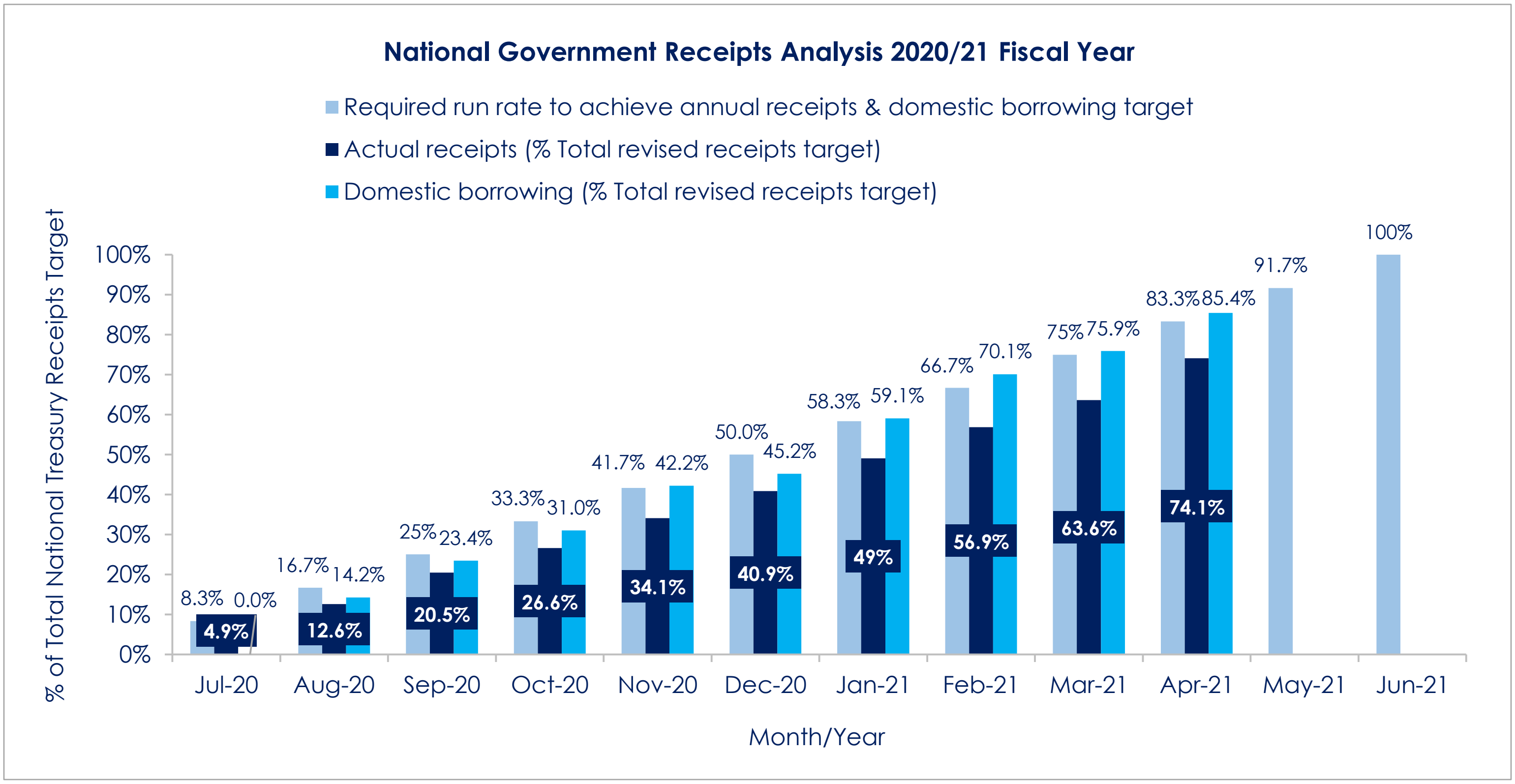
Table.7: 2020/21 fiscal year domestic borrowing above target run-rate

Receipts	Estimates (KES) Aug 2020 (KES.Bn)	Revised Estimates (KES) Mar 2021 (KES.Bn)	Actual Receipts (KES) 31st March 2021 (KES.Bn)	Actual Receipts (KES) 30th April 2021 (KES.Bn)	Proportion of Receipts Target (KES) 30th April 2021 (%)
Opening Balance (1st July 2020)		48	48	48	-
Tax Revenue	**1,567.6**	**1,469.7**	1,037.2	1,190.6	81
Non-Tax Income	66.1	124.3	69.7	81	65.2
Domestic Borrowing	786.6	853.8	648	729.6	85.4
External Loans & Grants	373.2	419	65.8	112.5	26.9
Other Domestic Financing	36.8	28.5	3.7	19.6	68.7
Total Revenue	**2,830.4**	**2,943.2**	**1,872.4**	**2,181.3**	**74.1**

* 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.113 21st May 2021

Figure.11: 2020/21 Government unlikely to meet FY2020/21 receipts target

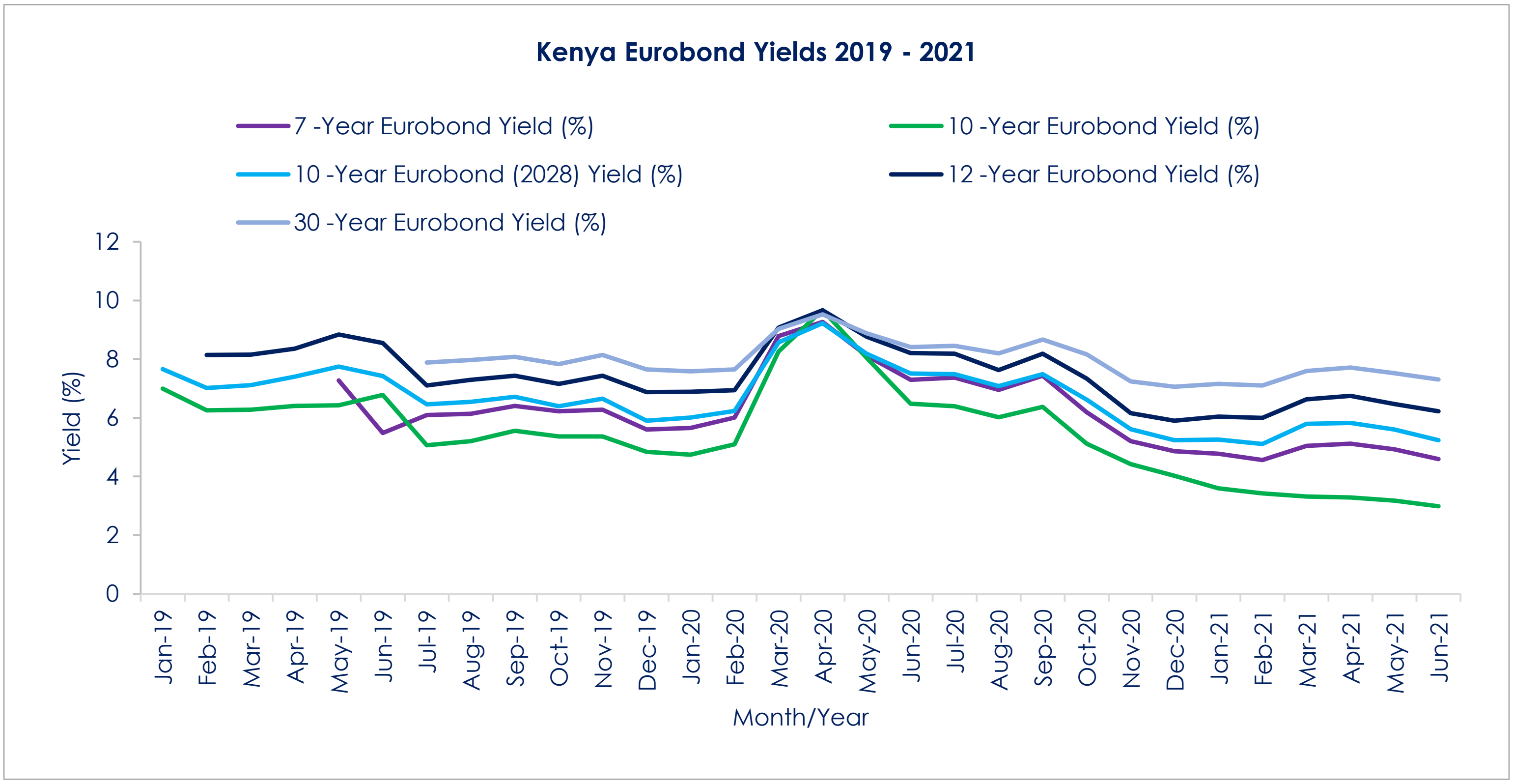


Source: The Kenya Gazette Vol. CXXIII - No.113 21st May 2021

Kenya Eurobond yields rise on easing concerns over Kenya's fiscal position

- Average yields on Government of Kenya Eurobonds declined in May 2021 compared to April (Figure.12).
- We attribute this to improved investor sentiment of on the economic prospects of the country following the easing of Covid-19 containment measures by the Government in May as well as financial aid from the International Monetary Fund.
- Kenya Euro bond yields will remain volatile on account of fast changing investor sentiment driven largely by news on Kenya's fiscal position and economic prospects.

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



Source: Central Bank of Kenya

Yields on long-end expected to rise on account of higher fiscal financing pressure

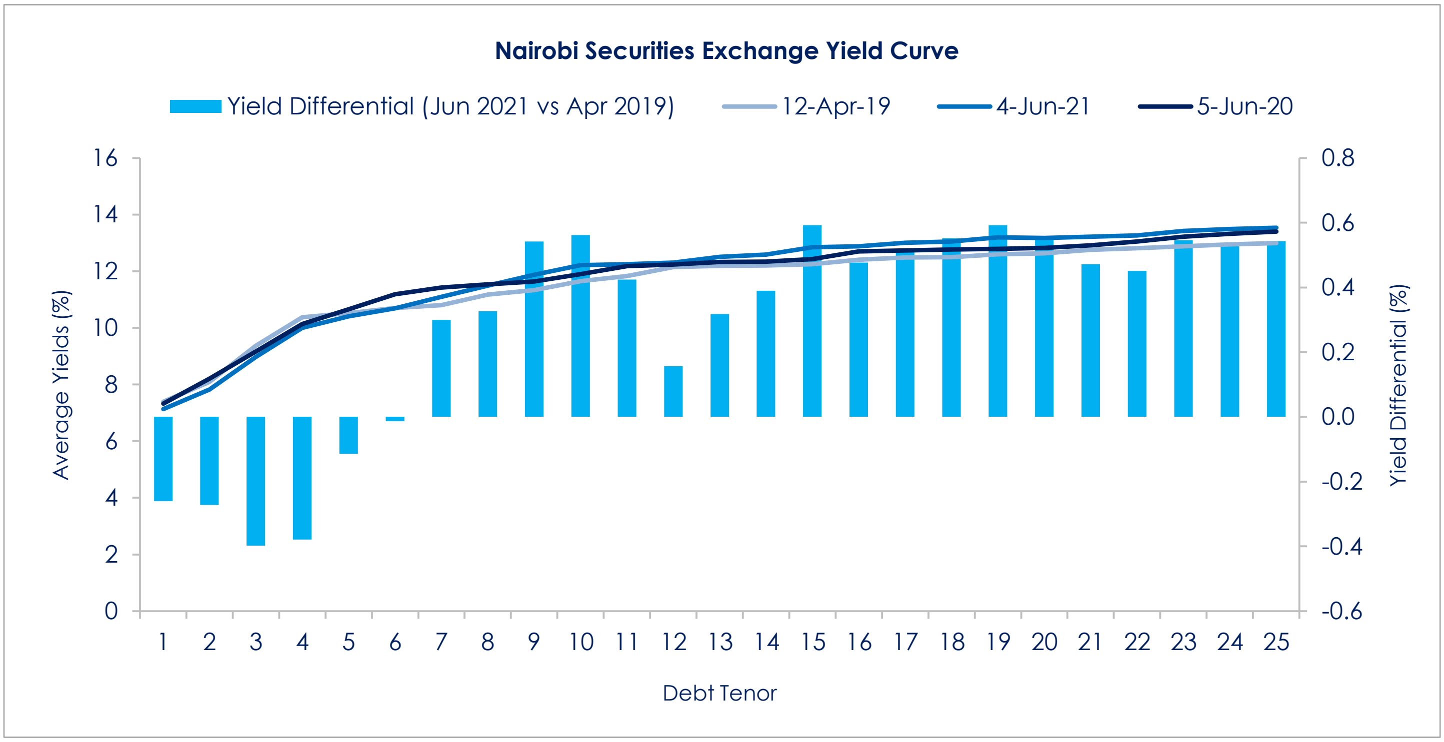
- A comparison of yields on in June 2021 and the same time in 2020 shows a significant dip in the short (1 and 2 years) and medium tenors (5 years) while those on the long-end (10-20 years) rose (Table.8 and Figure.13).
- We also observe a decline in short term yields when we compare yields at the time of the primary issue of **FXD1/2019/20** (15th April 2019) and 4th June 2021 while those in medium and long tenors rose.
- 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 predict continued increase in yields on long term papers in 2021 due to with 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.8: Yields on the short end and medium-term debt issues have decline over the last one year

Tenor	Yield (12th Apr 2019)	Yield (5th Jun 2020)	Yield (4th Jun 2021)	Δ (4th Jun 2021 vs 12th Apr 2019 (bps)	YoY Δ Jun 2021 vs Jun 2020 (Bps)	Sterling Capital yield Curve (4th Jun 2021)
1	9.3710	9.1650	8.9730	↓39.8	↓19.2	9.00
2	10.3750	10.1408	9.9959	↓37.9	↓14.5	10.00
5	10.8000	11.4251	11.0997	↑29.9	↓32.5	10.95
10	12.1500	12.2309	12.3067	↑15.7	↑7.6	12.45
15	12.7900	12.7294	13.0061	↑21.6	↑27.7	13.10
20	13.0500	13.0438	13.2649	↑21.5	↑22.1	13.35

Source: Nairobi Securities Exchange

Figure.13: Short and medium tenor yields have risen since the primary issuance of FXD1/2019/20



Source: Nairobi Securities Exchange

June 2021 inflation to rise on higher transport and food prices

- Inflation for the month of May 2021 rose to 5.87% from 5.76% in April on account of higher transport (0.7%) and Food and Non-Alcoholic drink prices (0.3%). (Figure.14)
- Consumer Price Index (CPI) rose 0.2% to 115 in May 2021 from 114.8 the previous month.
- The increase in transport indices was mainly due to increase in pump prices of petrol by 2.9% between April 2021 and May 2021.
- We predict June inflation to be in the range of 5.8% - 6%, which is still within the CBK's 2.5% - 7.5% target range.

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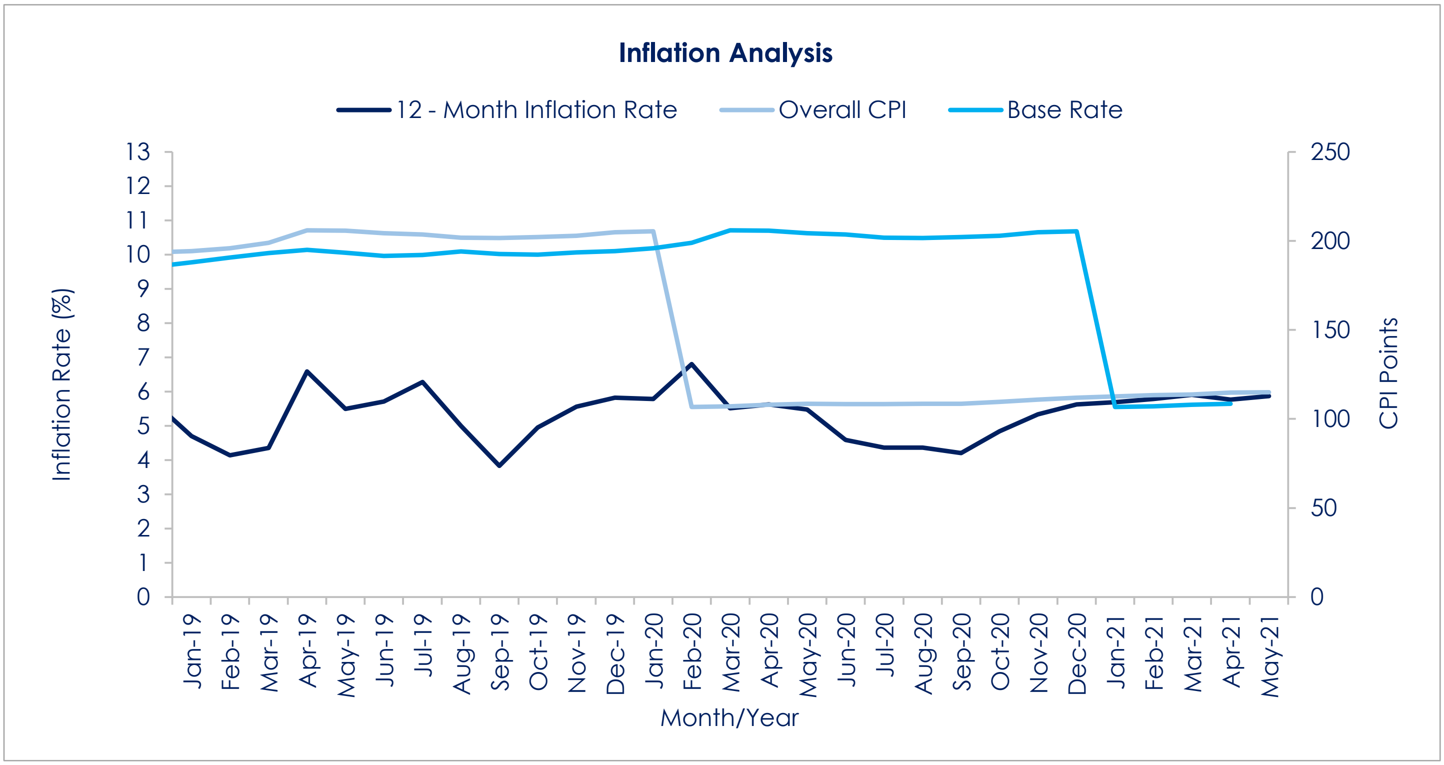
Figure.14: Short term inflation forecast 5.5% - 6%



Source: Kenya National Bureau of Statistics

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