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STERLING CAPITAL LIMITED

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Fixed Income Note

March 2021

"Public debt likely to hit KES.1Tn"

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Table of Contents

Executive Summary

- **"Public debt likely to hit KES.1Tn"** is the title of our March 2021 fixed income report.
- As has become the norm, the Central Bank of Kenya (CBK) is re-opening two bonds with a KES.50Bn financing target.
- We anticipate an under subscription for the issue based on low liquidity in the market and relatively short period of sale.
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids

  - **FXD1/2019/10: 12.30% - 12.35%**
  - **FXD2/2018/20: 13.30% - 13.35%**

  WAR of accepted bids

  - **FXD1/2019/10: 12.20% - 12.25%**
  - **FXD2/2018/20: 13.20% - 13.25%**

- We analyze domestic debt auction activity in terms of subscription, trading activity and interest rates.
- The country's fiscal position; revenue, expenditure, financing deficit and borrowing needs are also covered in this report.
- The yield curve section is an analysis of the trends in domestic debt interest rates over the period in focus.
- Inflation and monetary policy are discussed at the end of the report.

CBK returns to the primary market to raise KES.50Bn

- The Central Bank of Kenya (CBK) invites bids for two re-opened treasury bonds **FXD1/2019/10 and FXD2/2018/20** seeking to raise KES.50Bn (Table.1).
- The two bonds have a term to maturity of 8 and 17.4 years respectively.
- We expect the issue to be undersubscribed due to the long tenor of FX2/2018/20 and oversupply of bonds with a similar tenor as FXD1/2019/10 which has resulted in limited price appreciation opportunities.

Table.1: Primary Bond issue summary

Issue Number	FXD1/2019/10	FXD2/2018/20
Total Amount Offered	KES.50Bn	
Tenor (Years)	10 Years	20 Years
Term to Maturity	8 Years	17.4 Years
Coupon Rate (%)	12.438	13.200
Price Quote	Discounted/Premium/Par	
Period of Sale	01st March 2021 to 9th March 2021	
Auction Date	10th March 2021	
Value Date	15th March 2021	
Yield Curve (%) (Weighted Average tenor – 26th February 2021	**11.9876**	**12.9615**

Source: Central Bank of Kenya

Our weighted and accepted bids averages

- Analysis of yields of bonds of similar tenors on the NSE as at 26th February 2021 as well as discussions with fixed income traders resulted in the following bid predictions for the reopened bonds (Table.2).

Table.2: Auction bid predictions

Rate	FXD1/2019/10	FXD2/2018/20
Market Weighted Average Rate	12.30 -12.35	13.30 -13.35
Weighted Average Rate of Accepted Bids (%)	12.20 -12.25	13.20 -13.25

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 26th February 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
10-Year						
FXD1/2019/10	25th Feb 2019	12.00	12th Feb 2029	8 (2,906)	11.9876	N/A
FXD2/2019/10	15th April 2019	12.30	2nd April 2029	8.1(2955)	12.005	N/A
20-Year						
FXD1/2018/20	26th Mar 2018	13.20	1st Mar 2038	17.1(6210)	12.9000	N/A
FXD2/2018/20	30th July 2018	13.20	05th July 2038	17.4 (6,336)	13.1091	N/A

Source: Central Bank of Kenya

Debt issues are likely to be undersubscribed

- A comparison of primary auction results for 10 and 20-year issues shows a general preference for the shorter tenured issues (Table 4).
- We expect an undersubscription of the two bonds, with more bids received on FXD2/2018/20 as a result of higher yields on the long end of the yield curve as well as an oversupply of medium-term bonds that have left little room for capital appreciation.
- We also anticipate the CBK to issue a tap sale on the issue as has been the trend recently.

Table.4: Historical primary market auction performance

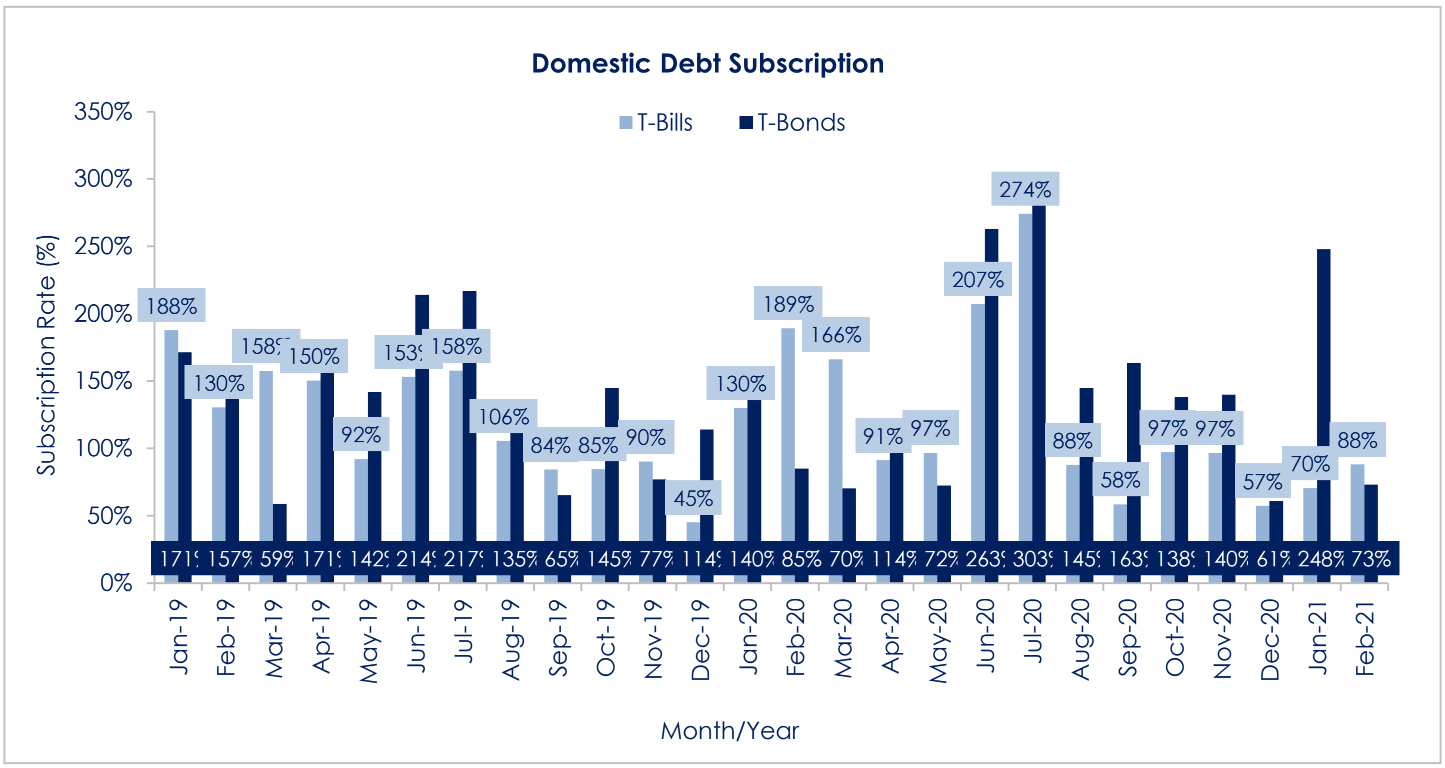
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
10-Year						
FXD2/2018/10	60	55.5	21.3	92.4	12.50	11.9460
FXD1/2019/10	50	25.4	19.3	50.9	12.44	11.9876
FXD2/2019/10	50	70.9	51.3	141.9	12.30	12.0005
FXD3/2019/10	50	52.8	45.0	105.5	11.52	12.0318
FXD4/2019/10	40	44.2	32.8	110.6	12.28	12.0544
20-Year						
FXD1/2018/20	40	13.7	8.5	34.4	13.20	12.7113
FXD2/2018/20	40	13.9	10.5	34.7	13.20	12.8087
FXD1/2019/20	40	25.1	14.7	62.7	12.86	12.8827

Source: Central Bank of Kenya

T-bills subscriptions increase by 18% in February

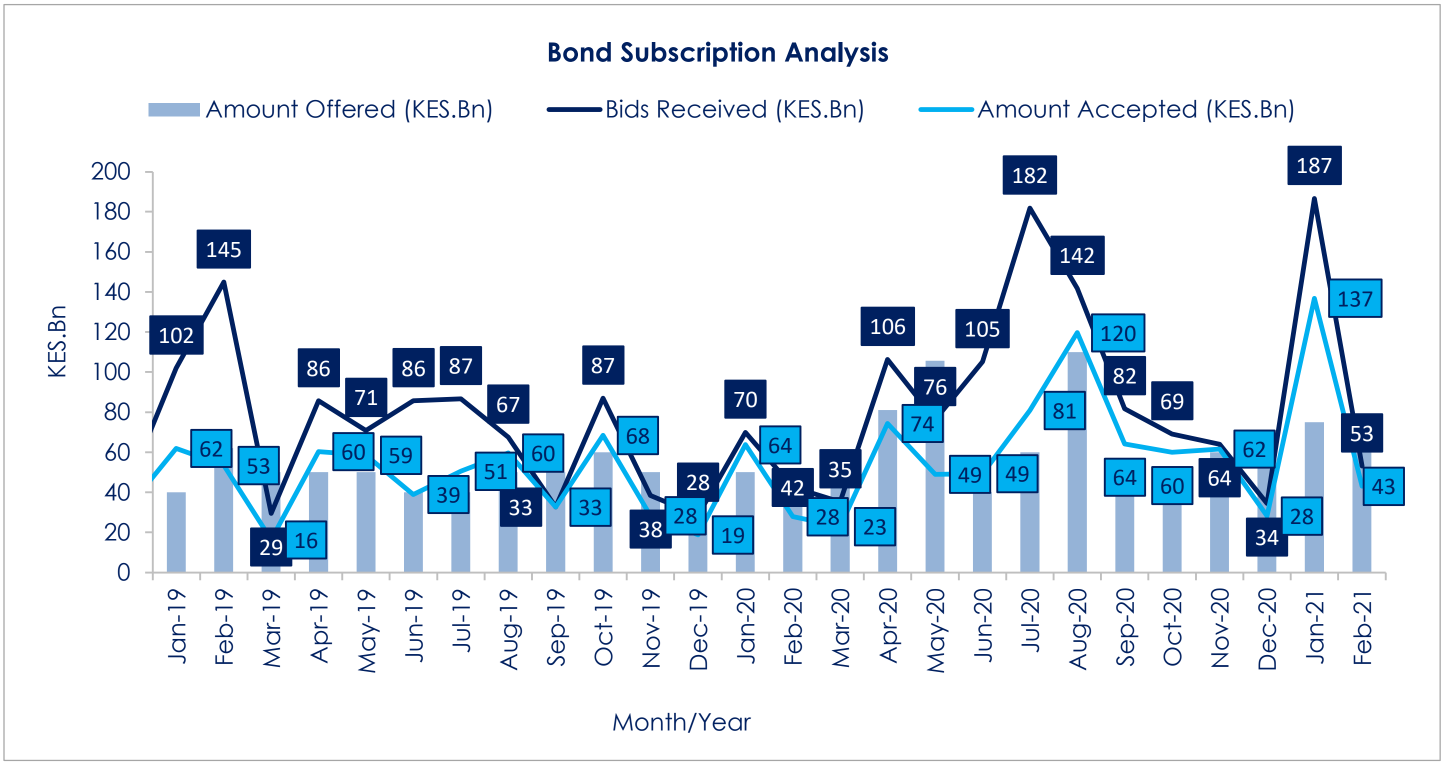
- The CBK received T-bills bids worth KES.84.4Bn against KES.96Bn offered in February 2021, translating to a subscription rate of 88% compared to 70% in January (Figure.1).
- The 364-day T-Bill was the most popular debt issue during the month, with a subscription rate of 144%, attributable to the gradual rise in interest rates.
- The 91-day and 182 -day papers were undersubscribed at 41.5% and 50.4% respectively.
- The re-opened T-Bonds (FXD1/2013/15 & FXD1/2012/20) received bids worth KES.41.9Bn against KES.50Bn offered (83.8% subscription rate) while the Tap sale (KES.18Bn offered) received bids worth KES.11.2Bn, 62.2% subscription rate.

Figure.1: T-bond subscriptions decline in February 2021



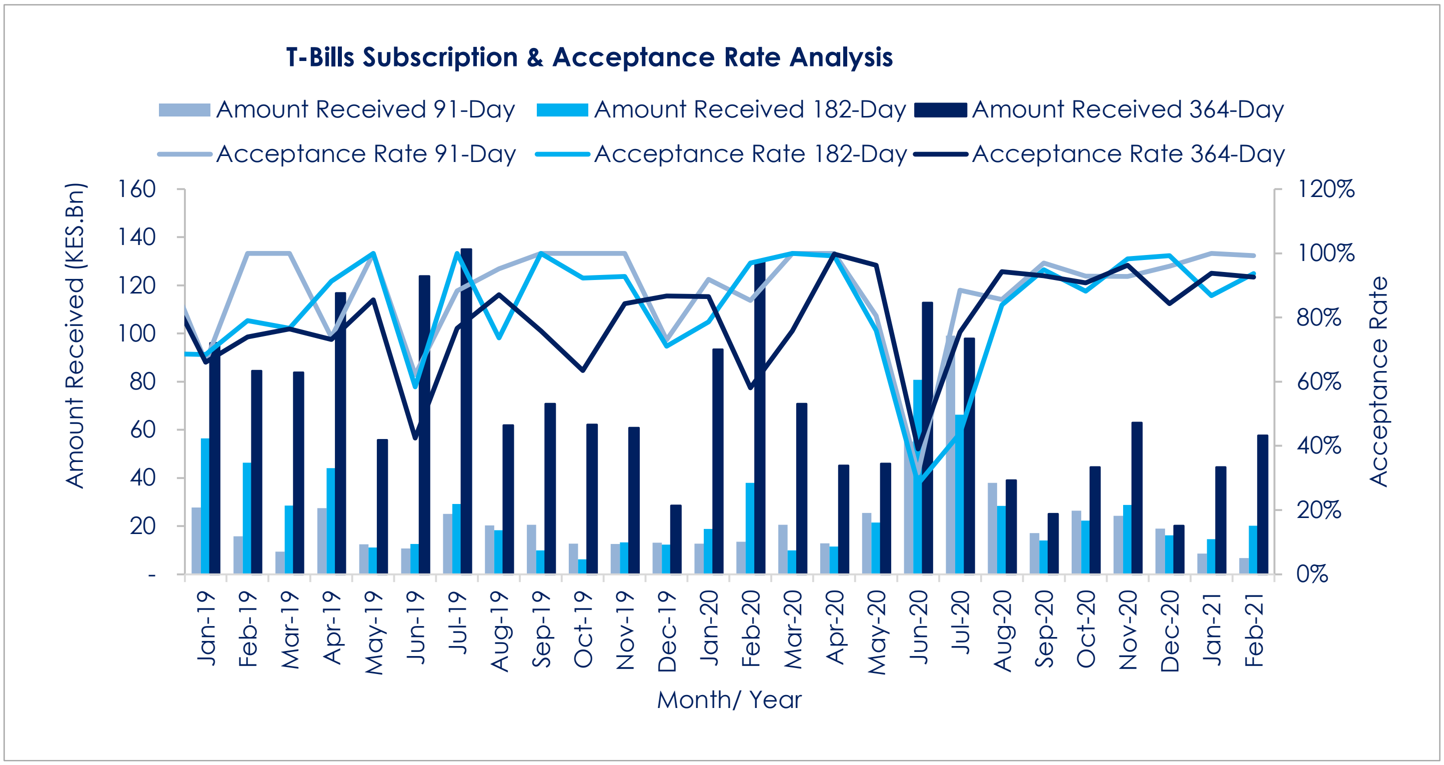
Source: Central Bank of Kenya

Figure.2: Bond subscriptions fell sharply in February 2021



Source: Central Bank of Kenya

Figure.3: Acceptance rate remains high

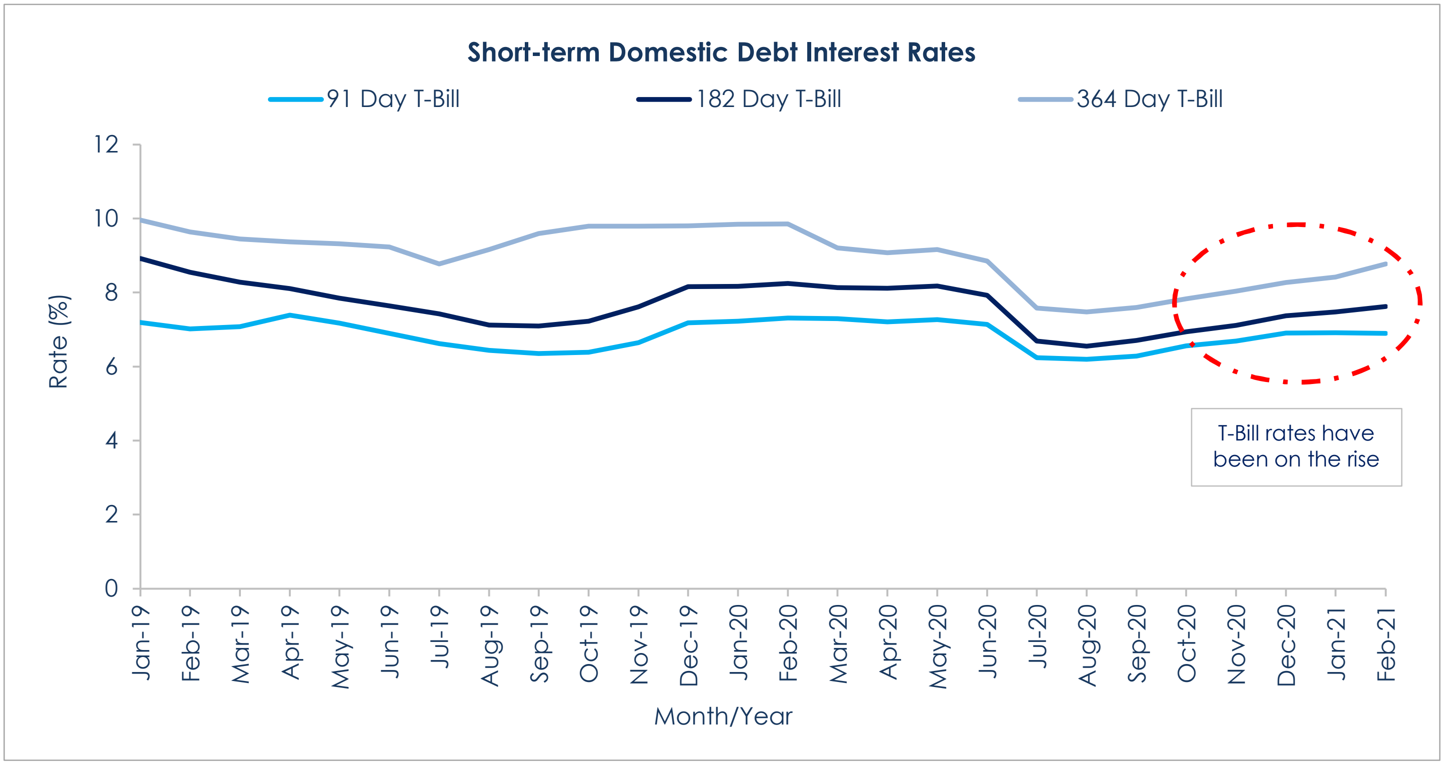


Source: Central Bank of Kenya

Average T-Bill rates up in February 2021

- Fiscal financing pressures has resulted in an increase in T-Bill rates in recent months. This also explains the rising T-Bill demand (Figure.4).
- The pressure to finance the growing deficit also explains the high acceptance rates during the period under review 95.2% compared to 93.5% in January.
- Average interest rates for the 91, 182 and 364-day debt issues in January stood at 6.9%, 7.5% and 8.4% respectively and slightly increased to 6.9%, 7.6% and 8.8% respectively.
- We expect the upward pressure on the short-end of the yield curve to continue in upcoming auctions due to the reasons mentioned above.

Figure.4: Interest rates on short-term debt securities edge upwards

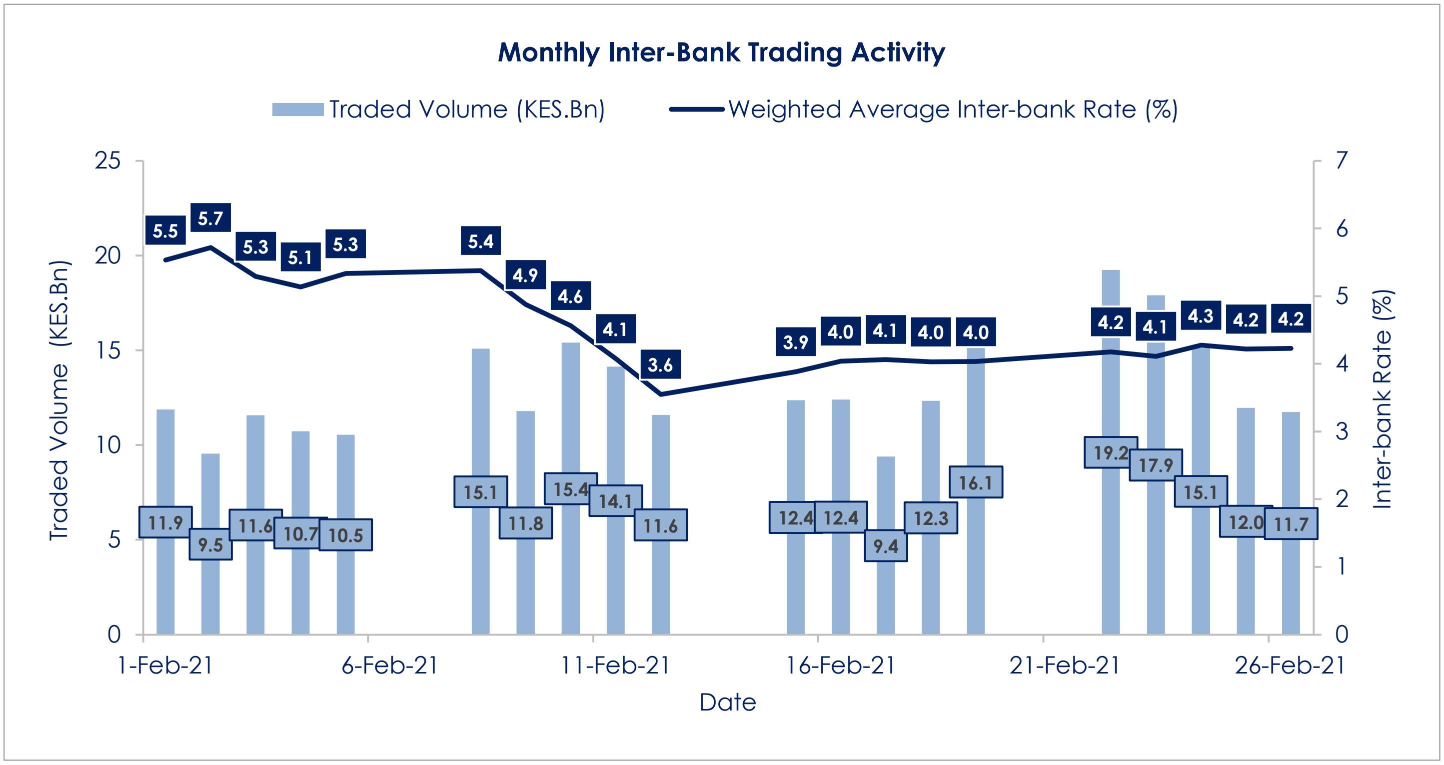


Source: Central Bank of Kenya

Average inter-bank rate falls in February 2021

- The average inter-bank rate declined in February 2021 to 4.5% compared to 5.2% in January (Figure.5).
- Total inter-bank trading volumes increased 38% to KES.260.8Bn during the period under review.
- Our forecasted inter-bank rate for March 2021 is 4% - 4.5%.

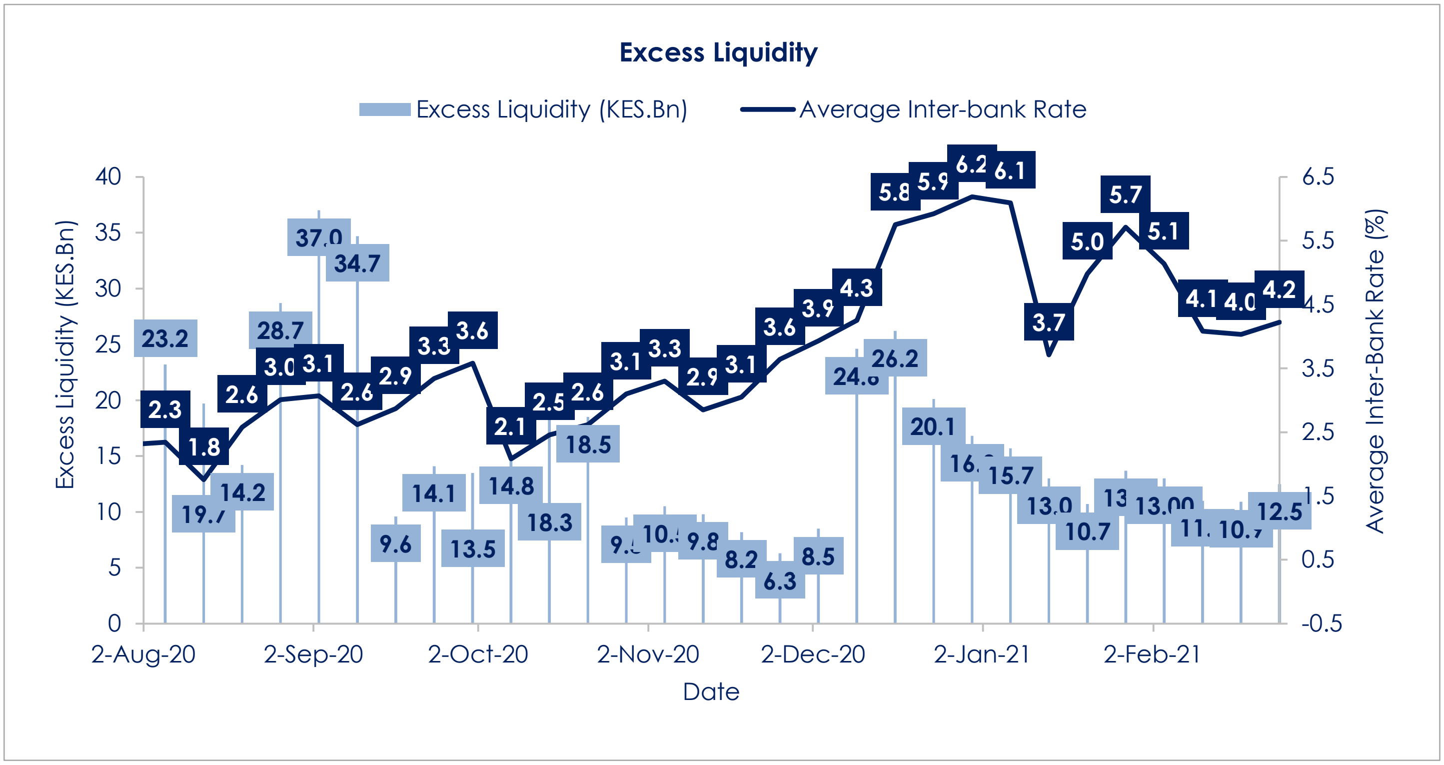
Figure.5: Inter-bank rates to range between 4% and 4.5% in March 2021



Source: Central Bank of Kenya

- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) over the same period stood at KES.47.4Bn a decline from KES.53.1Bn pointing to relatively high market liquidity supported by government payments which offset tax remittances (Figure.6).

Figure.6: Excess commercial bank reserves declined in February 2021

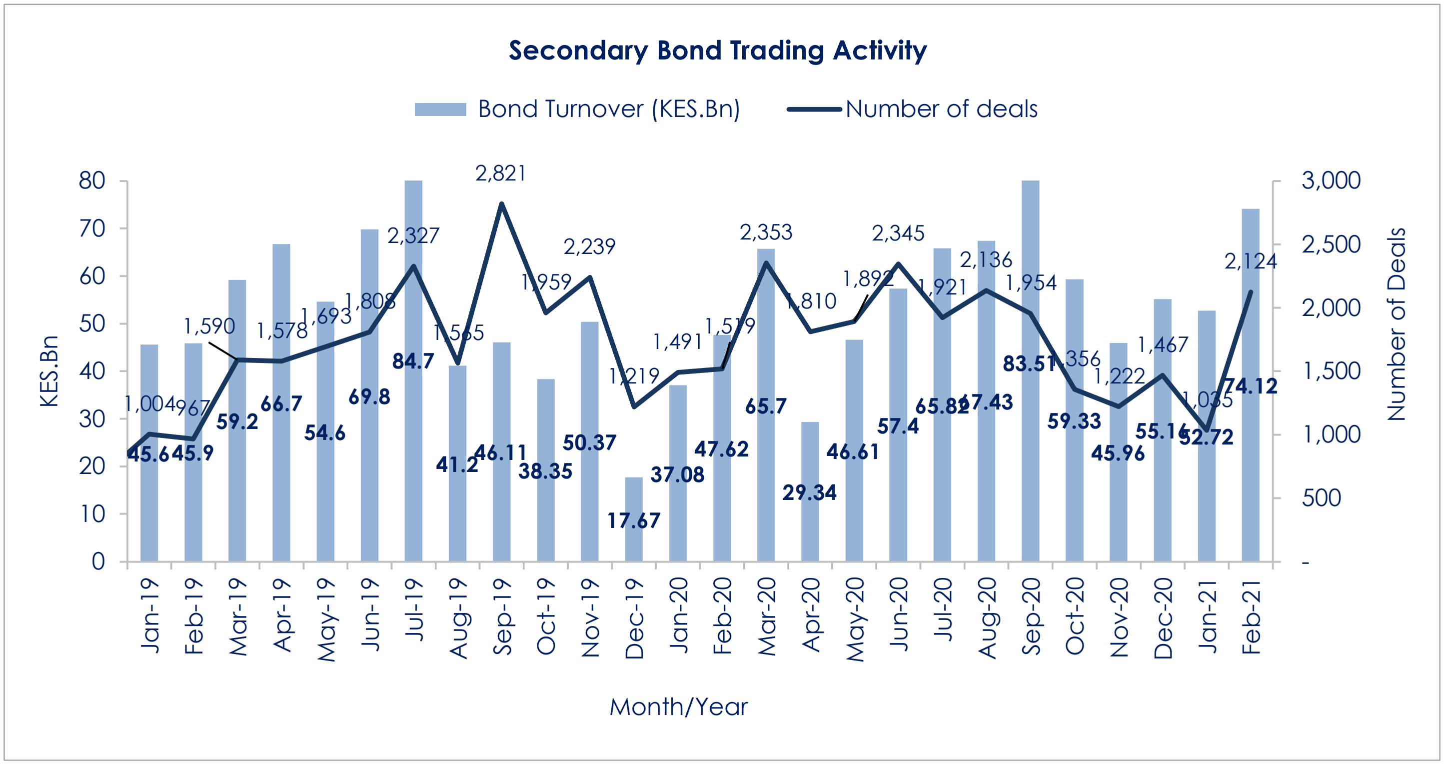


Source: Central Bank of Kenya

Secondary market trading Activity to decline in March 2021

- Secondary trading activity increased 40.6% in February 2021 compared to the previous month to KES.74.1Bn with the number of deals over the same period increasing 105.2% to 2,124 (Figure.7).
- We attribute this to the high market appetite for the Infrastructure Bond (IFB) issued in January and short term bonds.
- We expect to see a decline in turnover In March for the month compared to February due to a favourable tenor in the primary issue (8-year and 17.4-Year).

Figure.7: Secondary trading activity set to decline in March 2021



Source: Nairobi Securities Exchange & Sterling Research

Trading portfolio - short end / Income portfolio - long end.

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

- Government securities remain a favourable investment option during the Covid-19 pandemic with most investors looking for predictable and less risky returns on capital invested.
- Our investment recommendation for investors with a trading portfolio is to focus on bonds with a tenor of between 1 and 5 years (FXD1/2019/05 and FXD1/2020/05).
- We have noted that Infrastructure bonds (IFBs) show significant price appreciation in the market, and we recommend IFB1/2020/09, IFB1/2020/11 and IFB/2021/16 (Table.5).

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
FXD1/2019/05	2.97	11.30	2.47	10.35	10.95
FXD1/2020/05	4.18	11.67	3.15	10.60	10.85
IFB1/2020/09	8.11	10.85	5.07	10.95	10.38
IFB1/2020/11	10.47	10.90	6.11	11.05	10.87
IFB1/2021/16	15.90	12.26	6.98	11.70	11.56

Source: Central Bank of Kenya

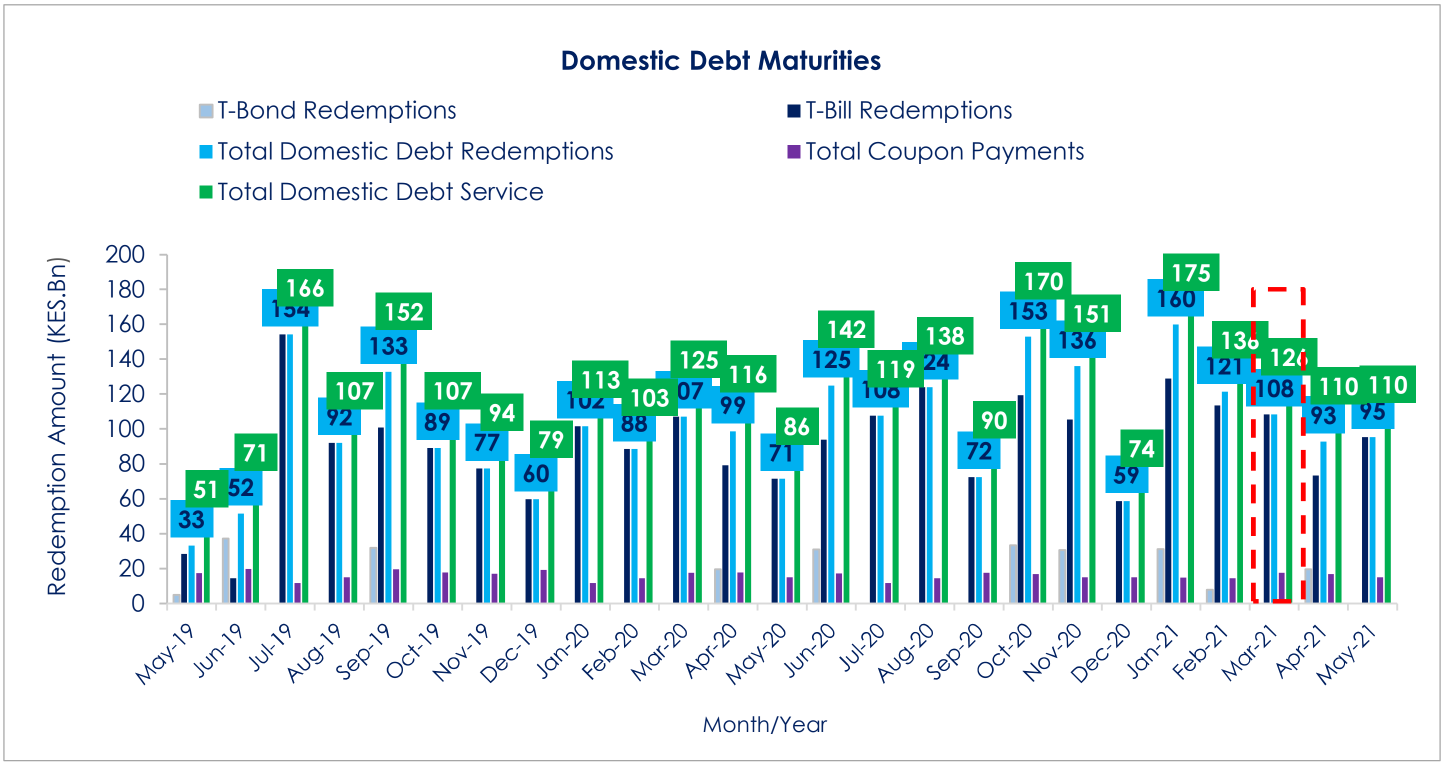
*Modified duration - Expresses the measurable change in the value of a security in response to a change in interest rates (for every 1% movement in interest rates, the bond would inversely move in price by the modified duration)
** Current Yield - Return on investment, for an investor holding a specific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

Domestic debt service to fall in March 2021

KES.121.9Bn raised in February with KES.121.3Bn directed towards debt redemptions and KES.14.5Bn in coupon payments.

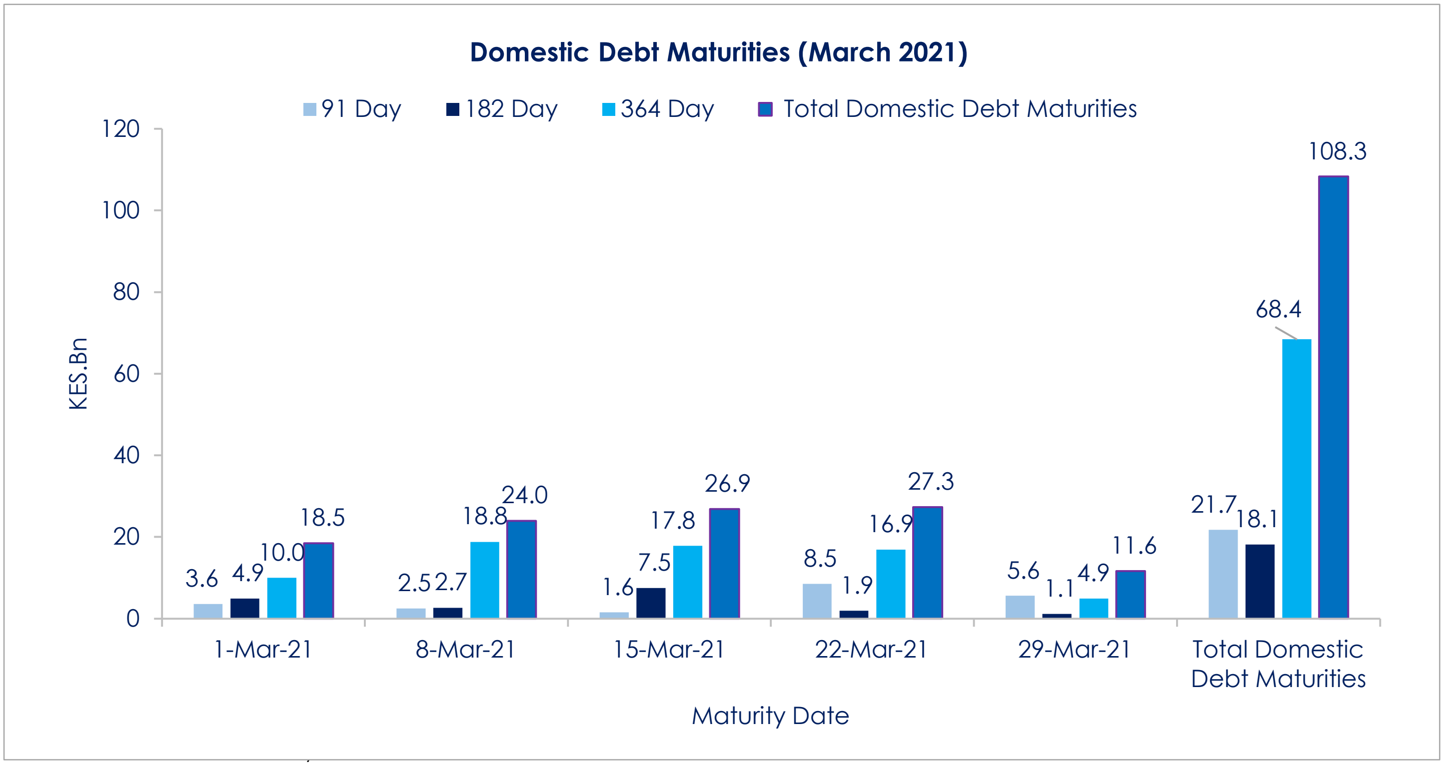
- With no T-Bond redemptions set for the month of March 2021, there will be a reduction in domestic debt service for the month at KES.126Bn compared to KES.135.8Bn in February 2021 (Figure.8).
- This comprises of KES.108.3Bn in T-Bill redemptions and KES.17.7Bn in coupon repayments.
- Redemptions for the 91, 182 and 364-day T-Bills during the month are KES.21.7Bn, KES.18.1Bn and KES.68.4Bn respectively.
- The fourth week of the month will have the highest total redemptions at KES.27.3Bn (Figure.9).
- We observe that of the KES.121.9Bn raised in domestic debt auctions in February (KES.43.0Bn in T-Bonds and KES.78.8Bn in T-Bills), the total amount was directed towards debt redemptions (KES.121.3Bn) with no amount left for new borrowing as coupon payments for the month stood at KES.14.5Bn.
- T-Bond redemptions are expected to increase to KES.19.5Bn while T-Bill and coupon payments will fall to KES.92.8Bn and KES.16.8Bn respectively, bringing the total debt service cost to KES.109.6Bn in April 2021.

Figure.8: March 2021 debt service declines to KES.126Bn



Source: Central Bank of Kenya

Figure.9: March 2021 Weekly debt maturities



Source: Central Bank of Kenya

Fiscal deficit likely to reach KES.1Tn

Shortfalls in tax revenues FY2020/21 could result in an increase in Government borrowing to KES.1Tn.

- As we expected and stated in our January Fixed Income report titled **"Flurry of domestic debt issues continues"**, the National Treasury released its first revision to the 2020/21 fiscal budget (Table.6).
- Notable in the revised budget is a 0.6% and 0.4% downward revision in total and ordinary revenue respectively as well as a 0.4% decline in estimated expenditure and net lending.
- Although the revised revenue and expenditure estimates translate to a 3.5% decline in total financing to KES.967Bn, we see further downward revisions especially in tax revenues will result in a fiscal deficit in excess of KES.1Tn.
- We predict the issuance of sovereign debt (Eurobond) and possibly a sovereign Green Bond with a combined issuance amount of about KES.2Bn to add to the already disbursed KES.2.4Bn International Monetary Fund (IMF) loan thus exceeding the external borrowing target.

Table.6: Kenya National Accounts - Fiscal deficit likely to reach KES.1Tn

Fiscal Budget Item	2019/20 Actual	2020/21 BROP* Target	2020/21 Revised Budget 1	Change
Total Revenue	**1,734**	**1,860**	**1,849**	**-0.6%**
Ordinary Revenue	**1,573**	**1,601**	**1,594**	**-0.4%**
Appropriation in Aid**	160	259	255	-1.5%
Expenditure and Net-Lending*	**2,565**	**2,919**	**2,864**	**-0.4%**
Recurrent	**1,645**	**1,844**	**1,838**	**-1.5%**
Development and Net Lending	595	675	639	-5.3%
County Allocation	325	395	383	-3.0%
Fiscal Balance (Excluding Grants)	**-832**	**-1,059**	**-1,015**	**-4.2%**
Grants	20	57	57	0.0%
Fiscal Balance (Including Grants)	-812	-1,002	-967	-3.5%
Total Financing	**791**	**1,002**	**967**	**-3.5%**
Net Foreign Financing	340	402	426	6.0%
Net Domestic Financing	**450**	**600**	**540**	**-10.0%**

Source: The National Treasury & Planning

2020/21 Domestic borrowing ahead of our target run rate

Total tax revenue continues to underperform

- According to data released by the National Treasury as at the end of January 2021, total domestic borrowing and total revenue stand at KES.504.2Bn and KES.784.9Bn respectively (Table.7).
- This is equivalent to 64.1% and 50.1% of the total domestic and tax revenue targets for the 2020/21 fiscal year against our linear target run-rate of 58.3% (Figure.10).
- This is a clear indication of the challenges faced by the Government in raising tax revenue with the economy severely affected by the Covid-19 pandemic.

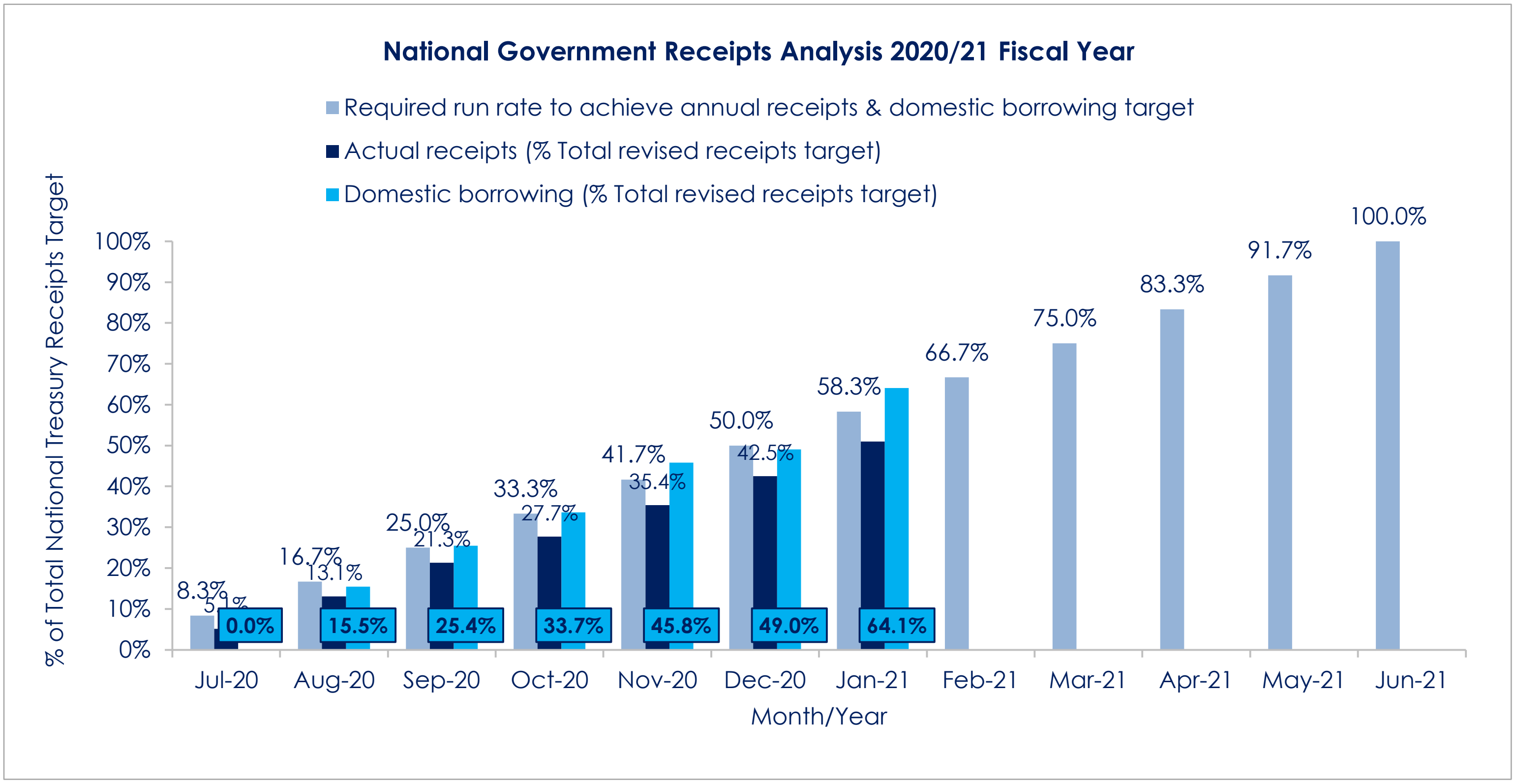
Table.7: 2020/21 fiscal year revenues remain below target run-rate

Receipts	Original Estimates (KES)	Revised Estimates (KES) 31st August 2020	Actual Receipts (KES) 31st December 2020	Actual Receipts (KES) 31st January 2021	Proportion of Receipt Target (KES) 31st January 2021
Opening Balance (1st July 2020)			48.0	48.0	-
Tax Revenue	**1,567.6**	**1,567.6**	673.6	784.9	50.1%
Non-Tax Income	66.1	66.1	52.9	55.1	83.2%
Domestic Borrowing	756.9	786.6	385.8	504.3	64.1%
External Loans & Grants	373.2	373.2	39.8	48.3	12.9%
Other Domestic Financing	36.8	36.9	3.0	3.0	8.3
Total Revenue	**2,800.7**		**1,203.1**	**1,203.1**	**51.0%**

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

Source: The Kenya Gazette Vol. CXXIII - No.33 19th February 2021

Figure.10: 2020/21 Total revenue underperforming



Source: The Kenya Gazette Vol. CXXIII - No.33 19th February 2021

Yield curve expected to steepen due to increased fiscal budgetary pressure

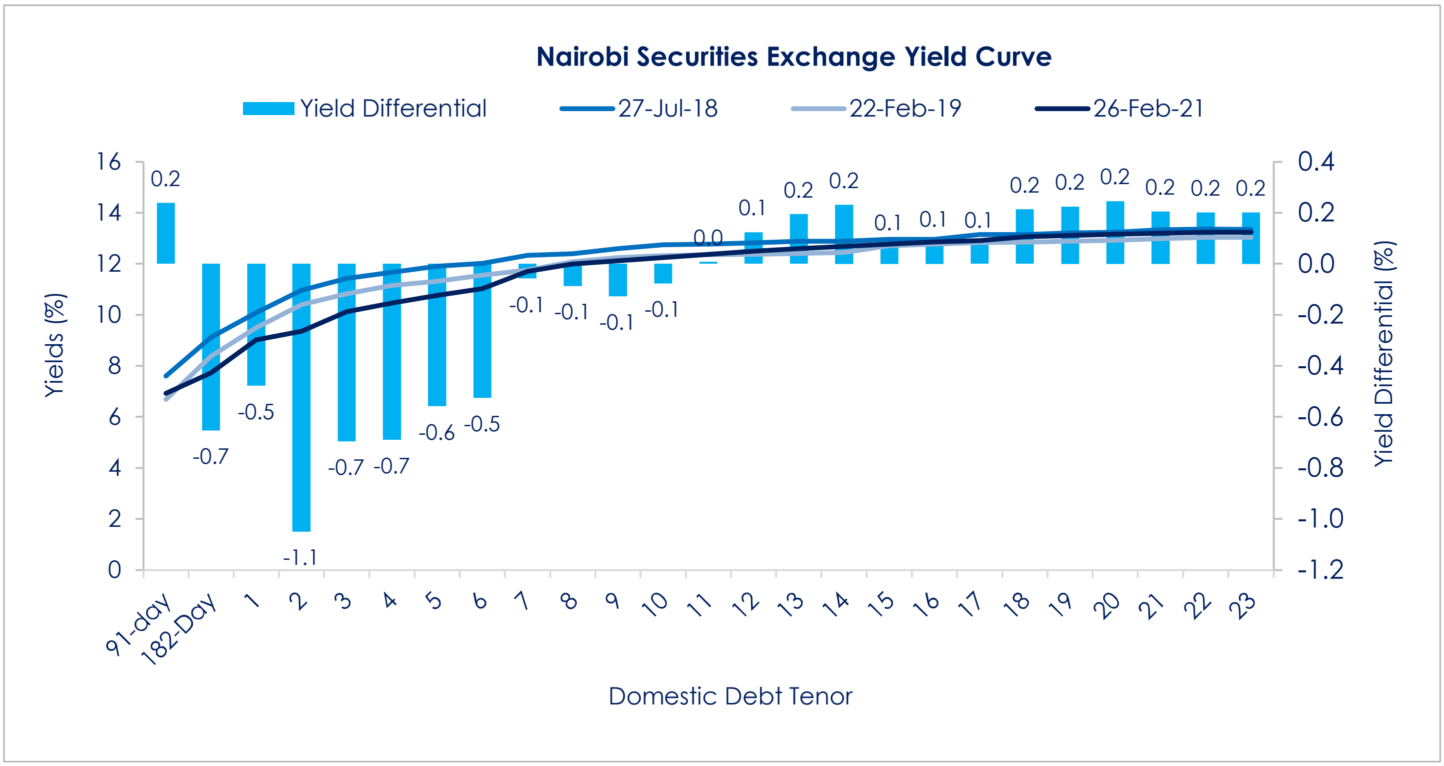
- A comparison of the NSE yield curve on 26th February 2021 and 27th July 2018 (when the FXD2/2018/20 was issued) shows a significant decline in yields across all tenors and particularly on the short and medium tenors (Table.8 and Figure.11).
- However, a comparison of yields on 26th February 2021 and 22nd February 2019 (when the FXD1/2019/10 was issued) shows a dip in short- and medium-term yields while those on the long end 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 an increase in yields on domestic debt in 2021 due to increased domestic debt financing.
- We maintain our recommendation of **BUY short and medium-term bonds and HOLD long term papers.**

Table.8: Yields on the short end and medium terms decline

Tenor	Yield (27th Jul 2018)	Yield (22nd Feb 2019)	Yield (26th Feb 2021)	YoY ∆ 26th Feb 2021 vs 27th Jul 2018 (Bps)	YoY ∆ 26th Feb 2021 vs 22nd Feb 2019 (Bps)	Sterling Capital yield Curve (4th March 2021)
1	10.0880	9.4920	9.0140	↓107.4	↓47.8	9.05
2	10.9583	10.4000	9.3500	↓160.8	↓105.0	9.50
5	11.9070	11.3125	10.7539	↓115.3	↓55.9	10.70
10	12.7417	12.3172	12.2399	↓50.2	↓7.7	12.25
15	12.9500	12.7000	12.7652	↓18.5	↑6.5	12.80
20	13.2333	12.9125	13.1580	↓7.5	↑24.6	13.20

Source: Nairobi Securities Exchange

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



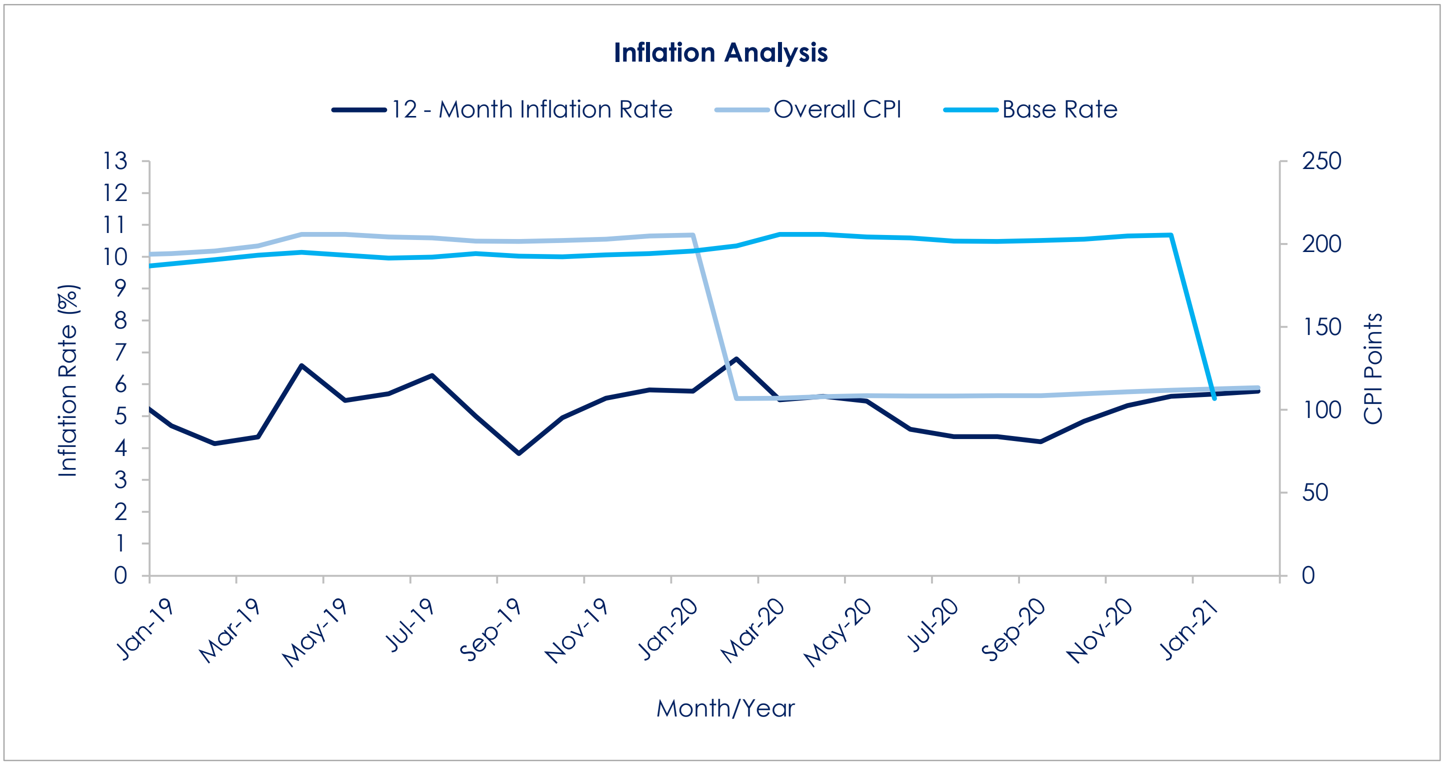
Source: Nairobi Securities Exchange

February 2021 inflation rises to nine months high

Inflation to range between 5.5% and 6% in the short term.

- Inflation for the month of February rose to 5.78% from 5.69% in January attributable to an uptick in the food, housing, water, electricity, gas and other fuels and transport indices. (Figure.12).
- During the month, Food and Non-Alcoholic Drinks and housing, water, electricity, gas and other Fuels' Index rose 1% and 0.4% respectively.
- The Transport Index expanded 2.3% as prices of diesel and petrol rose 5.7% and 7.6% respectively.
- The volatility of the Kenya Shilling (KES) that depreciated 7.7% against the US Dollar in 2020 will continue to exert pressure on inflation through the prices of imports.
- We expect global fuel prices to fluctuate in the short term attributable to rebounding international crude prices along with a weakening shilling.
- The cost of Murban from which Kenya derives its fuel imports has increased and is now trading at US$61.70 from US$51.52 at the beginning of the year. This upward trend will drive the inflation rate upwards.
- We however expect inflation to remain within the CBK's 2.5% - 7.5% target range to oscillate between 5.5% - 6.0% in the short term.

Figure.12: Short term inflation forecast 5.5% - 6.0%



Source: Kenya National Bureau of Statistics

MPC expected to retain CBR at 7% in March meeting

MPC to retain CBR at 7% in March meeting.

- The Monetary Policy Committee (MPC) is set to meet in March to review the outcome of its previous policy decisions, recent economic developments, and to make a decision on the direction of the Central Bank Rate (CBR).
- Monetary policy measures adopted in 2020 have been fairly effective in supporting macro-economic stability.
- We are fairly optimistic on the economic prospects in 2021 owing to gradual improvement of economic activity and the roll out of the Covid-19 vaccine and expect the MPC to retain the CBR at 7% at least in the short-term.

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