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Fixed Income Note

May 2020

"CBK's quick KES.50Bn cash call"

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Executive Summary

- "**CBK's quick KES.50Bn cash call**" is the title of our May fixed income report where the Central Bank of Kenya (CBK) is looking to raise KES.50Bn in a five-year Treasury Bond (T-Bond) **FXD1/2020/5.**
- This is the first 5-year bond of the 2020 calendar year and the first since January 2020 FXD1/2019/5 a bond that was reopened alongside a 10-year bond FXD1/2019/10.
- Our investor and CBK accepted bid predictions are:

Weighted Average Rate (WAR) of bids: 11.80%-11.95%
Weighted average rate of accepted bids: 11.50%-11.65%

- As is often the case, we expect high subscription for FXD1/2020/5, and this is evident from historical bond auction results for similar dated debt issues in the report.
- Our report also highlights both Treasury Bills (T-Bills) and bond primary auction activity in April whilst giving our expectations for the near term based on market liquidity and investor expectations.
- Also covered in the report is short -term domestic debt interest rates movements with recent monetary policy actions appearing to result in a gradual decline on the rates.
- Historical secondary bond trading activity is also analysed in the report as volumes and turnover is dependent on market liquidity, both of which could impact the results of the current bond on sale.
- The high cost of debt service and the challenges of financing a growing fiscal deficit are included in the report under our national accounts analysis.
- Our yield curve analysis section shows an increase in yields on the short-end of the curve with expectations of a downward shift of the curve due to recent monetary policy actions.
- We analyse April 2020 inflation and give our expectations in the near term towards the end of the report which concludes with a review of the effectiveness of recent Monetary Policy Committee (MPC) measures also giving a prediction of any rate reviews we expect in the next meeting in May 2020.

CBK taps into the domestic debt market to raise KES.50Bn

- Central Bank of Kenya (CBK) invites bids from investors for the 5-Year T-Bond (FXD1/2020/5) to raise KES.50Bn (Table.1).
- We take note of a change in the CBK's borrowing strategy with a bias towards issuance of short- and medium-term debt following the successful issuance of the 9Yr infrastructure bond (IFB1/2020/9) in April 2020.
- We believe this move is aimed at raising capital increasing subscription for domestic debt in the face of a widening fiscal deficit worsened by the negative impact of the COVID-19 pandemic.
- We expect the bond to be oversubscribed due to its tenor and investors' flight to safety from equity investments to risk free government securities.

Table.1: Primary Bond issue summary

Issue Number	**FXD1/2020/5**
Total Amount Offered	KES.50Bn
Tenor (Years)	5 Years
Coupon Rate (%)	Market determined
Issue Price	Discounted/Premium/Par
Period of Sale	29th Apr – 05th May 2020
Auction Date	6th May 2020
Value Date	11th May 2020
Yield Curve (%) (Weighted Average tenor - 5 years) 30th Apr 2020	**11.23**

Source: Central Bank of Kenya

Our weighted average and accepted bids averages

- Investors are likely to bid at 11.80% - 11.95% for FXD1/2020/5 with the weighted average of accepted bids at approximately 11.50% - 11.65%.

Table.2: Auction bid predictions

Rate	**FXD1/2020/5**
Market Weighted Average Rate (%)	11.80% - 11.95%
Weighted Average Rate of Accepted Bids (%)	11.50% - 11.65%

Source: Sterling Capital Research

Investors love the taste of short-term Government debt

Bond issue likely to be oversubscribed because of its short tenor.

- High subscription is expected for this bond issue as is often the case with similar dated Government paper also considering that it is the sole issue this month (Table.3).
- This is also increasingly likely given the current economic conditions in the country where the Government is faced with the challenge of a rising financing deficit amid falling receipts and therefore concerns over long-term debt sustainability could be drawn into question.
- All but one 5-year bond (FXD3/2019/5 issued in 2019) have been issued with a different tenor bond since 2018 with the bulk of bids going to the 5-year security.

Table.3: Historical primary market auction performance

Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Average Yield
FXD1/2018/5	40	37.6	23.1	94.1	12.30	10.53
FXD1/2018/5 (Tap)	10	7.7	7.7	-	12.30	10.53
FXD1/2019/5	50	41.9	20.6	83.9	11.30	11.10
FXD2/2019/5	50	49.3	39.2	98.6	10.87	11.12
FXD3/2019/5	25	28.5	18.7	113.9	11.49	11.18
FXD3/2019/5 (Tap)	9.7	9.8	9.8	-	11.49	11.18
FXD1/2019/5 (Re-opened)	50	44.5	44.5	89.0	11.304	11.10

Source: Central Bank of Kenya

- Implied yields of bonds of almost similar tenor to maturities on the Nairobi Securities Exchange (NSE) as at 30th April, 2020 were also used to determine possible investor bids (Table.4).

Table.4: Benchmark issues to guide investor bids

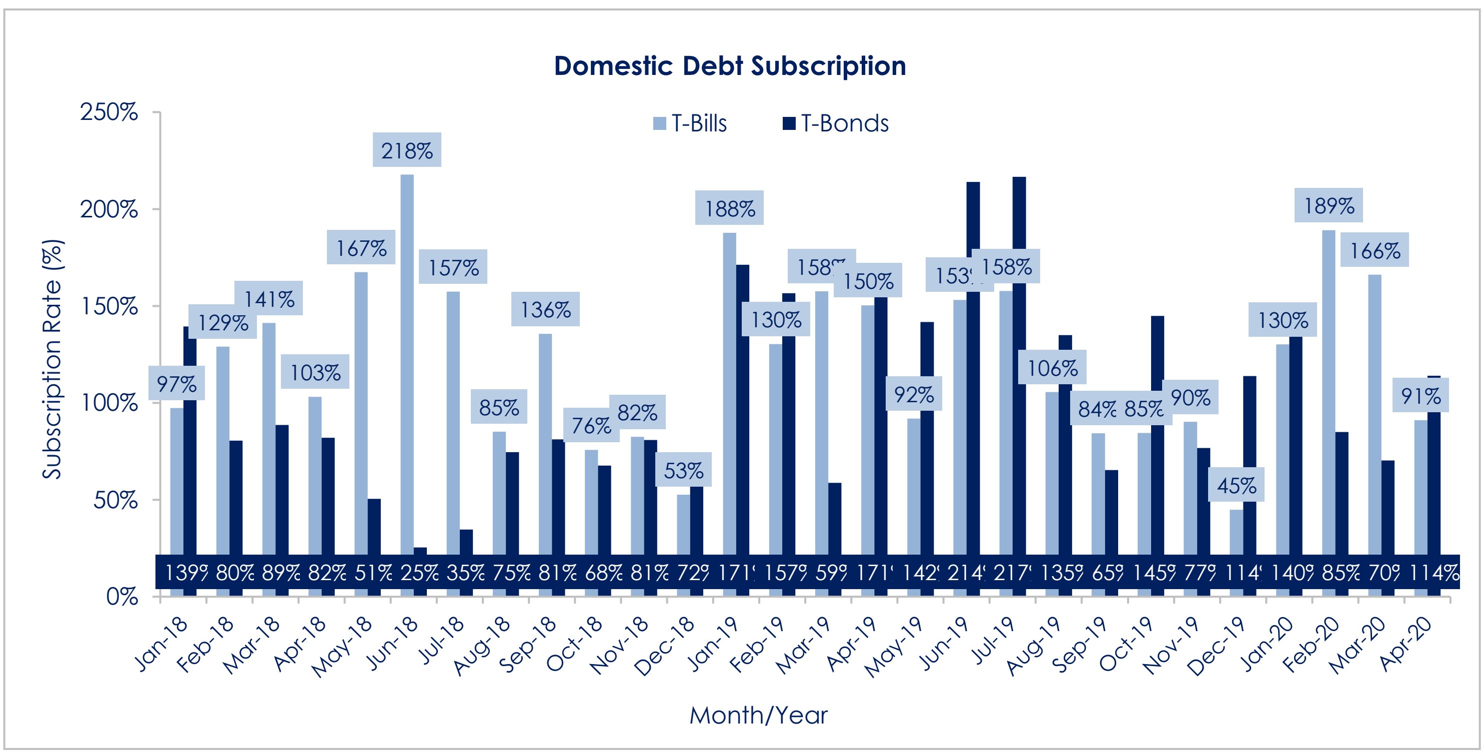
Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years (Days)	Last traded Yield (%)	Yield Curve at time of issue
FXD1/2019/5	25th Feb 2019	11.30	19th Feb 2024	3.8 (1390)	11.10	11.3125
FXD2/2019/5	13th May 2019	10.87	6th May 2024	4.0 (1467)	11.12	10.6750
FXD3/2019/5	16th Dec 2019	11.49	9th Dec 2024	4.6 (1684)	11.18	11.4920

Source: Central Bank of Kenya

High domestic debt investor participation expected in May 2020

- CBK received bids worth KES.68.4Bn against KES.60Bn offered in the first Infrastructure Bonds (IFB) issue for the month of April 2020 (Figure.1).
- This was equivalent to a subscription rate of 114% attributable to the medium tenor and tax-free status of the bond.
- A total of KES.87.4Bn was received in T-Bill auctions against KES.96Bn on offer, representing a subscription rate of 91%.
- The 91 day,182 day, and 364-day papers received subscription rates of 108.5% 35.5% and 139.6% respectively.
- We observe a significant increase in the demand for the 91-day T-Bill in recent auctions a trend we believe is supported by investors' unwilling to tie up their capital in a period of high market volatility.
- High subscription for the 364-day paper continues from investors willing to take a longer investment view in the face of the ongoing global economic slowdown.
- Bids accepted by the CBK amounted to KES. 39Bn for the bond issue and KES.84.9Bn in T-Bills.
- We believe the high rejection rate in the bond auction was the result of aggressive bidding and CBK's decision to lower the average cost of debt.
- The tap sale for the IFB later in the month sought to raise KES.21Bn with KES.37.8Bn received in bids and KES.35.4Bn accepted.

Figure.1: High IFB subscription in April negatively impacts T-Bill demand

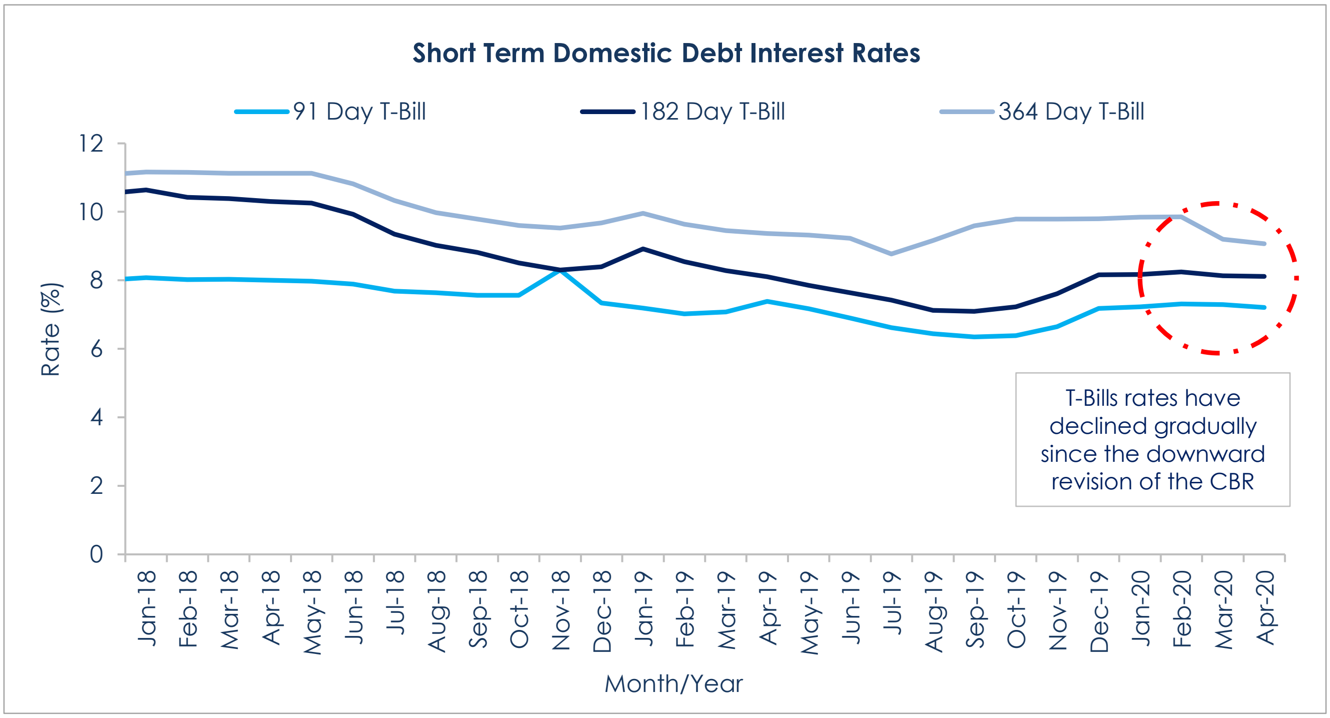


Source: Central Bank of Kenya

T-Bill yields decline marginally in response to monetary policy easing

- Average T-Bill yields declined marginally in April 2020 compared to the previous month by 8bps, 2bps and 13bps to 7.2%, 8.1% and 9.1% for the 91, 182- and 364-day papers respectively. (Figure.2)
- The decline in yields is due to high investor demand for short term government securities in the face of uncertain economic environment.
- We expect high liquidity and high demand to result in a minimal decline in yields in May.
- Reduction of the Central Bank Rate (CBR) is expected to result in increased demand for government securities in the near to medium term.

Figure.2: T-Bill interest rates have edged lower after monetary policy easing

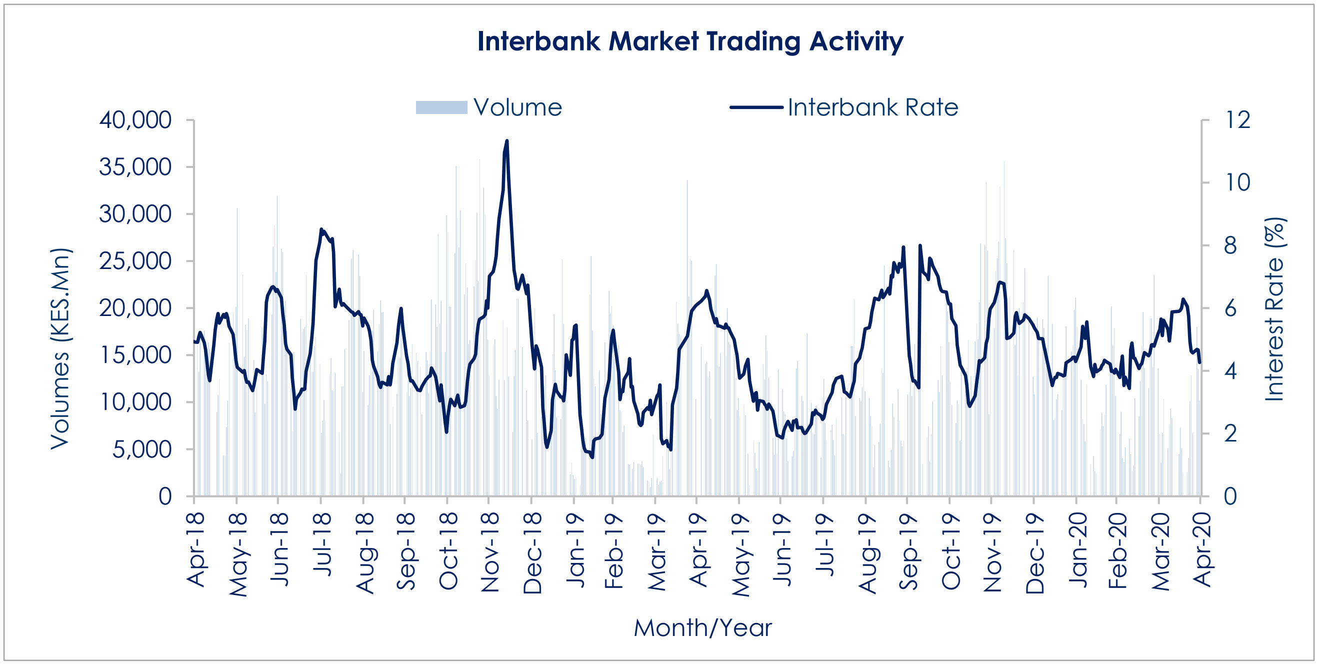


Source: Central Bank of Kenya

High market liquidity to keep inter-bank lending rates low in May 2020

- The weighted average interbank rate for April was 5.3% an increase from 4.4% attributable to the low market liquidity during the month.
- Total volumes traded in the review period decreased 30.6% to KES.161.3Bn from KES.232.5Bn in March.
- Daily inter-bank rates however rose in the first three weeks then declined in the last week of the month.
- We expect interbank rates to remain low on account of high market liquidity.

Figure.3: High Market liquidity to subdue rates in May 2020

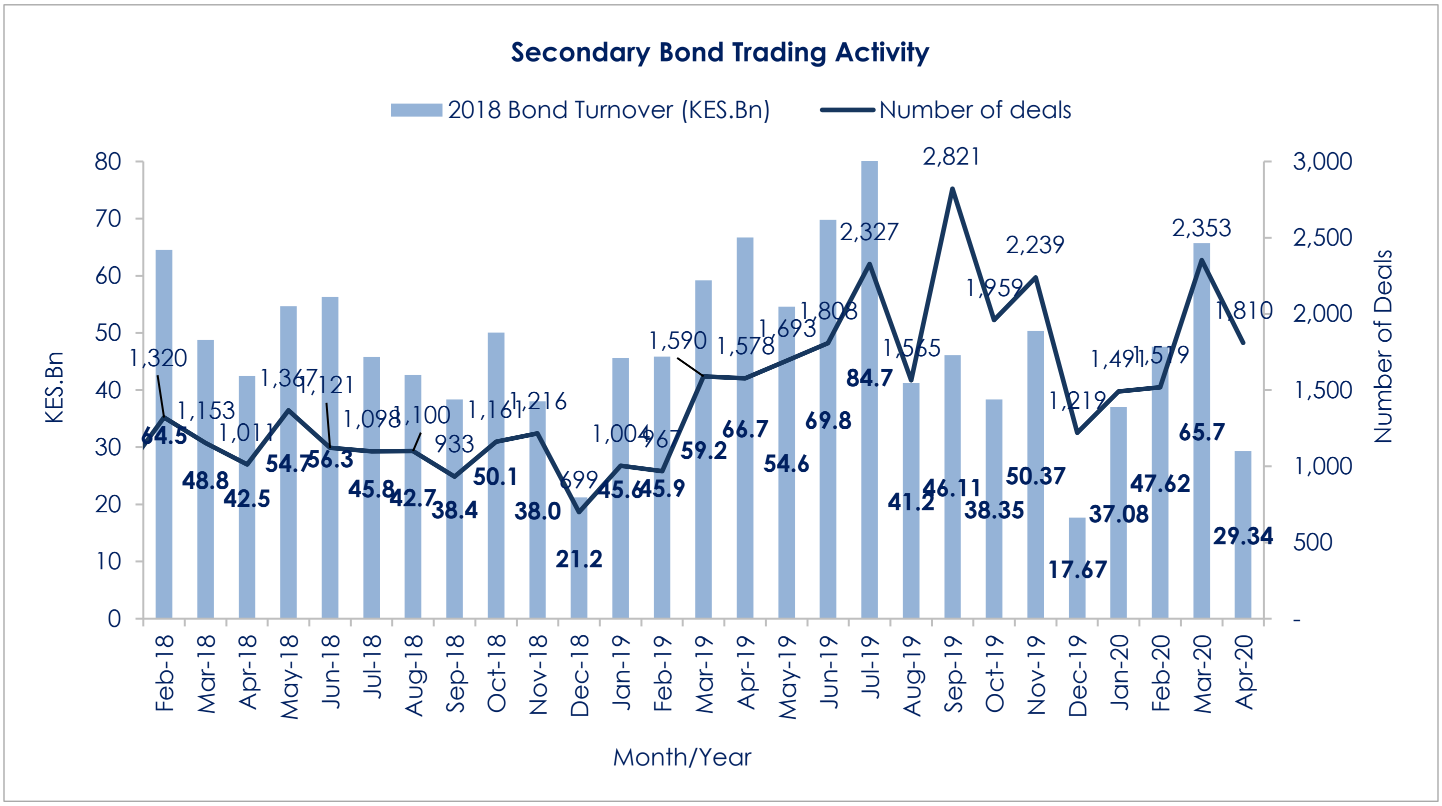


Source: Central Bank of Kenya

Secondary trading activity to pick up in May 2020 after subdued trading in April

- April 2020 bond trading turnover declined 55.3% to KES.29.3Bn with the number of deals falling 23.1% to 1,810(Figure.4).
- This was largely attributable to diversion of funds to IFB1/2020/9 in both the primary auction and the tap sale.
- Secondary market trading activity in May is expected to increase on account of the short period of sale of this month's primary issue.
- Investors whose bids are rejected are likely to direct liquidity to the secondary market especially due to the high risk of the equity market.

Figure.4: Subdued secondary market trading activity in April



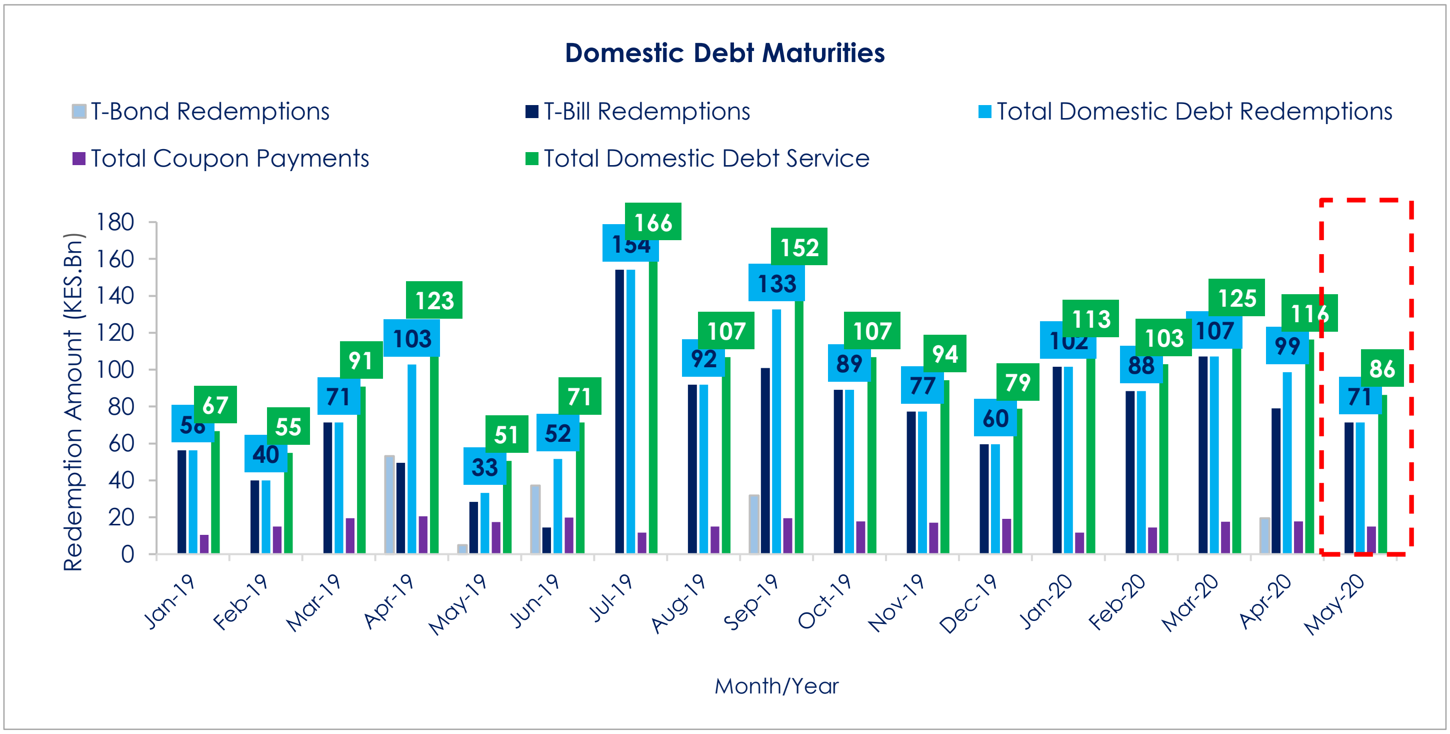
Source: Central Bank of Kenya

Government to feel the strain of KES.86Bn debt service in May 2020

May 2020 - Total domestic debt service KES.86Bn

- Government continues to feel the strain of meeting its debt service obligations with total domestic debt service for May at KES.86Bn (Figure 5.).
- This is made up of KES.71Bn in domestic debt redemptions (entire amount in T-Bills) and KES.15Bn in coupon payments.
- This however is a decline from KES.116Bn in April 2020 comprising of KES.98.6Bn in domestic debt redemptions (T-Bonds KES.19.5Bn and T-Bills KES.79.1Bn) and KES.17Bn in bond coupon payments.
- We take note of high T-Bill redemptions as a signal of the high re-financing risk faced by the National Treasury which we see as a risk to public debt sustainability in the medium term.

Figure.5: Government continues to feel the weight of debt service - Total debt redemptions for May 2020 at KES.86Bn



Source: Central Bank of Kenya

Supplementary budget 2 shows a wider fiscal budget deficit financing gap

- The supplementary budget 2 released in April 2020 shows notable revisions in the total and ordinary revenue, total financing and financing gap estimates (Table.5).
- Revisions to the budget are largely influenced by the negative impact of the COVID-19 pandemic on economic activity and in turn tax collection.
- Downward revisions of tax rates are also expected to have a negative impact on tax collections.
- Total and ordinary revenue estimates have been revised 9.1% and 10.9% lower to KES.1.9Tn and KES.1.6Tn respectively.
- The supplementary budget shows a KES.129.1Bn financing gap in spite of a 6.8% increase in net domestic financing to KES.321.1Bn which offsets a 6,1% decline in net foreign financing to KES.455Bn.
- This means that we should expect an increase in domestic borrowing in the last two months of the 2019/20 fiscal year, a scenario that will impact CBK and investor behaviour in domestic debt auctions.

Table.5: Major revisions to 2020/21 fiscal budget estimates expected

Budgetary Item	Printed Estimates	Supplementary Estimates 1 (November 2019)	Supplementary Estimates 2 (April 2020)
Total Revenue	**2,115.8**	**2,084.2**	**1,893.9**
Ordinary Revenue	1,877.1	1,843.8	1,643.4
Expenditure	**2,796.0**	**2,874.2**	**2,774.4**
CFS (Interest Pensions etc.)	550.00	550.00	524.67
Recurrent Ministerial	1,224.6	1,224.3	1,248.62
Development Ministerial	704.2	782.7	684.0
County Transfers	316.5	316.5	316.5
Net Lending	0.6	0.6	0.6
Equalization Fund	5.8	5.8	0
Fiscal Balance	**(680.2)**	**(789.9)**	**(880.5)**
Grants	38.8	41.8	44.6
Fiscal Balance (Grants)	**(641.4)**	**(748.1)**	**(835.9)**
Total Financing	**641.3**	**657.4**	**706.8**
Foreign Financing	462.7	484.8	455.0
Debt Repayment	(131.4)	(131.4)	(121.5)
Net Domestic Financing	306.8	300.7	321.1
Other Domestic Financing	3.2	3.2	152
Provision for T-Bills	0	0	(100)
Financing Gap*	**0.0**	**(90.7)**	**(129.1)**

*During Supplementary 1 Cash Adjustment of KES.90Bn

Source: Parliamentary Budget Office

National Treasury still behind 2019/20 fiscal year receipts target

- We had correctly predicted a revision of the 2019/20 receipts estimates in our April 2020 fixed income report **"Government to the rescue"** on account of the disruptive impact of the pandemic on economic activity.
- Total Government revenue as at the end of March 2020 stood at KES.1.8Tn equivalent to 67% of the KES.2.7Tn revised annual fiscal target (Table.6 and Figure.6).
- Actual tax revenue at KES.1.1Tn is also equivalent to 68.2% of the supplementary estimates 2 (KES.1.6Tn) short of our 75% liner target run rate.
- We expect an increase in domestic funding in the next two months on account of the shortfalls in receipts.

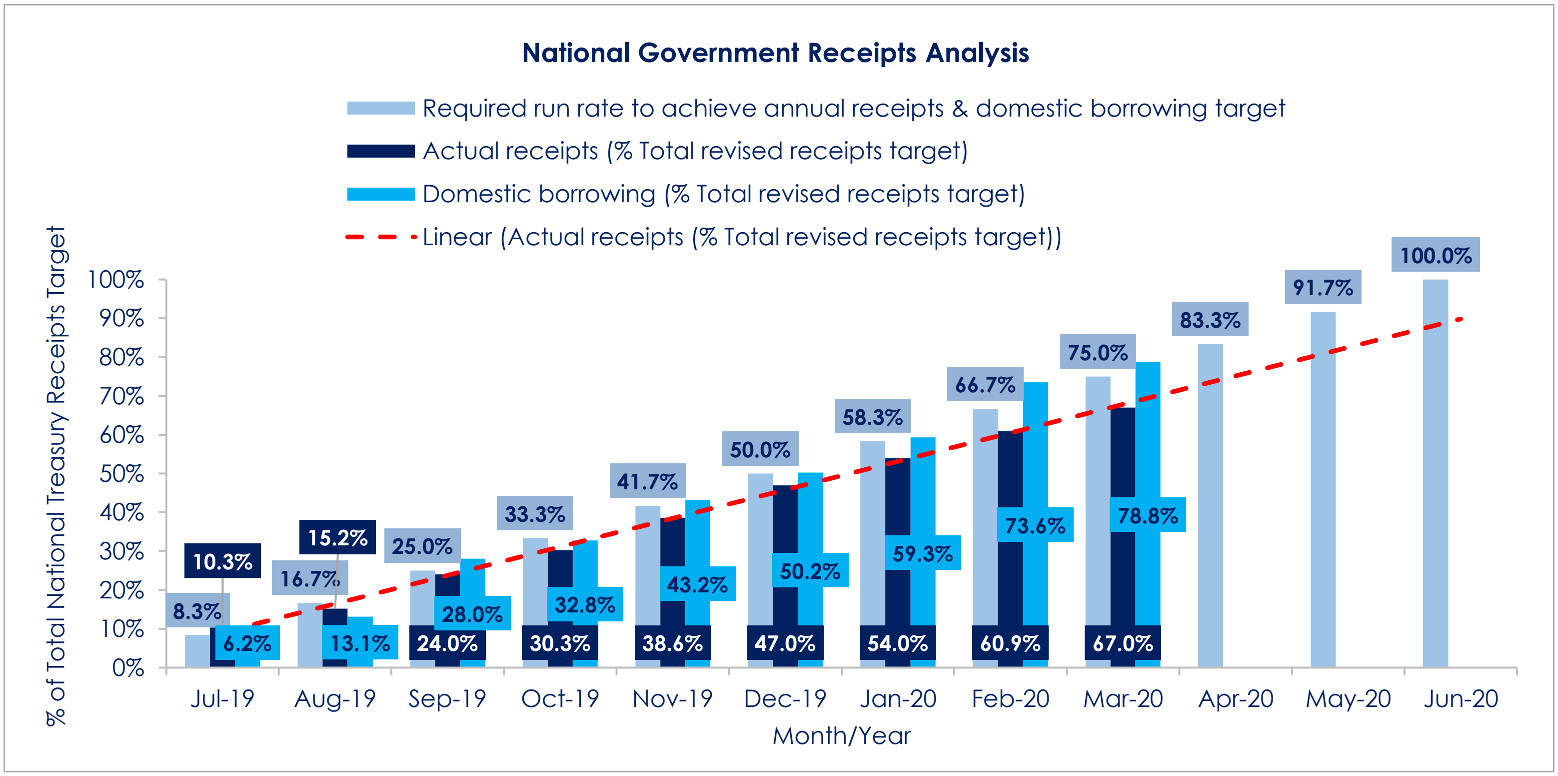
Table.6: CBK behind 2019/20 fiscal year total revenue target but on course with its domestic borrowing target

Receipts	2019/20 Original Estimates (KES.Bn)	2019/20 Revised Estimates (KES.Bn)	Actual Receipts (KES.Bn) 29th Feb 2020	Actual Receipts (KES.Bn) 31st Mar 2020	Proportion of Receipt Target Achieved 31st Mar 2020
Opening Balance (1st July 2019)			98.9	98.9	
Total Tax Income	1,807.6	1,705	995.4	1,120	65,7
Total Non-Tax Income	69.5	138.9	89.7	95.8	69.0
Domestic Borrowing*	429.4	514.0	378.4	405.1	78.8
Loans -Foreign Gov't &	65.2	66.1	21.4	24.3	36.7
Programme Loan-Budget	2.0	2.0	11.8	11.8	588.5
Domestic Lending & on-lending	4.3	4.3	2.2	2.2	49.8
Grant -Foreign Gov't &	14.5	17.7	9.0	10.0	56.5
Grants from AMISON	5.0	4.0	2.9	2.9	72.5
Commercial Loan	200.0	200.0	0.0	0.0	0.0
Unspent Balances (Recoveries)			5.7	5.7	-
Total Revenue	**2,598**	**2,651.9**	**1,615.3**	**1,776.6**	**67.0%**

* 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.75 24th April 2020

Figure.6: CBK still short of 2019/20 fiscal target with two months left



Source: The Kenya Gazette Vol. CXXII - No.75 24th April 2020

Short end of the yield curve shows biggest shift in yields

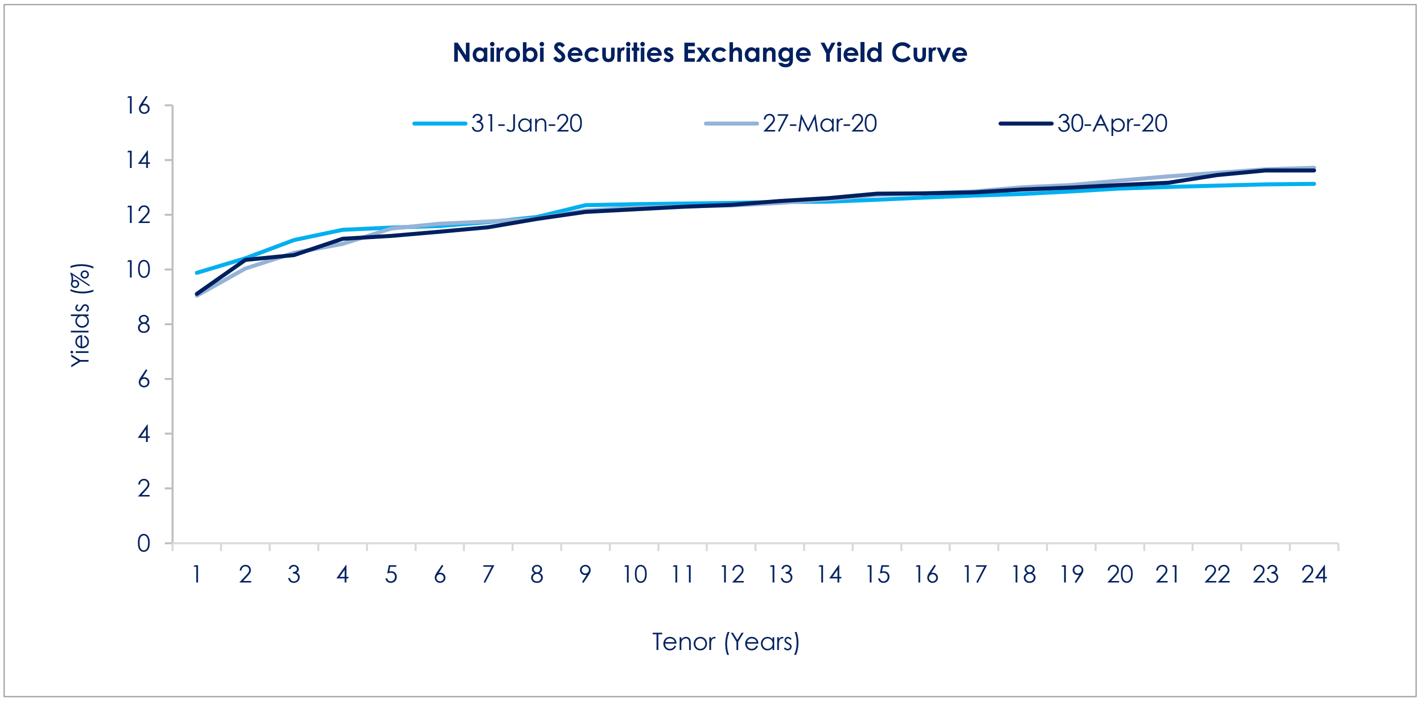
- We compared domestic debt yields as at 30th April 2020 and 31st January 2020 (time of issue of FXD1/2019/5) as well as 27th March 2020 (previous month) Table 7 and Figure 7.
- Compared to March 2020, we note a slight increase in yields on the short and long ends of the curve, while yields on the 5Yr and 10Yr papers declined.
- The 10Yr and 15Yr yields recorded a significant increase in yields as at 27th April 2020 compared to January 2020.
- Overall, we expect a downward shift in the curve due to increased domestic debt demand as investors redirect their money towards risk free investments.
- **Our recommendation still stands; BUY short- and medium-term bonds and HOLD long term papers.**

Table.7: Short-term bond yields down while those on the long end rise

Tenor	Yield (31st Jan 2020)	Yield (27th Mar 2020)	Yield (30th Apr 2020)	Change Jan 2020 vs Apr 2020 (Bps)	Change Mar 2020 vs Apr 2020 (Bps)	Sterling Capital yield Curve (4th May 2020)
1	9.8790	9.0450	9.1100	↓76.9	↑6.5	9.08
2	10.4094	10.0375	10.3500	↓5.9	↑31.3	10.25
5	11.5364	11.5001	11.2296	↓30.7	↓27.1	11.30
10	12.3856	12.2532	12.1949	↓19.1	↓5.8	12.23
15	12.5524	12.7196	12.7733	↑22.1	↑5.4	12.78
20	12.9621	13.2452	13.0829	↑12.1	↓16.2	13.08

Source: Nairobi Securities Exchange

Fig.7: Decline in short end yields resulting in a normal yield curve

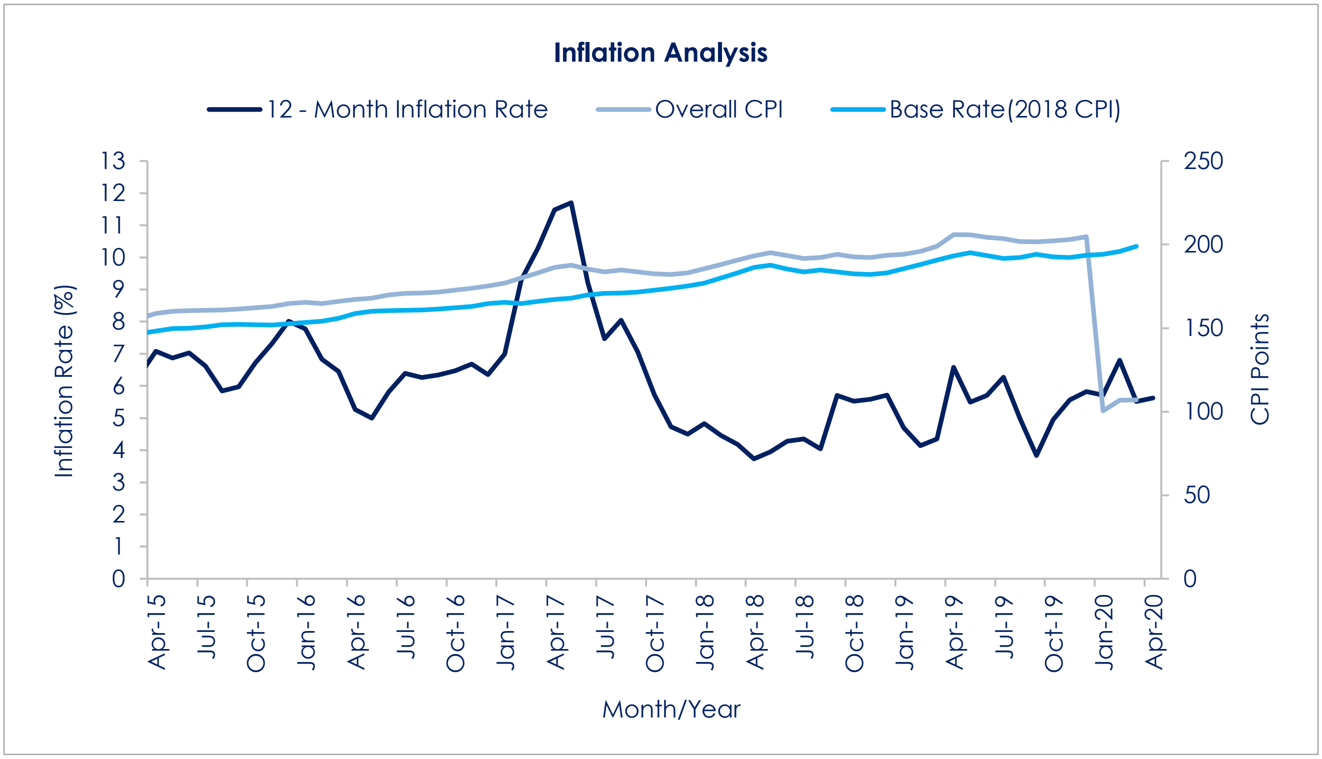


Source: Nairobi Securities Exchange

May 2020 inflation forecast 5.5-6%

- Overall year on year inflation for the month of April 2020 stood at 5.62% from 5.51% (rebased CPI) in the previous month this is attributable to a 1.8% and 1.3% increase in the Food and Non-Alcoholic Drinks as well as transport indices respectively (Figure.8).
- Our May inflation forecast range is 5.5% - 6.0% based on our expectations of improved food prices as a result of the ongoing rains and falling global oil prices.
- Risks to this call include flooding in some areas around the country as well as disruptions to the supply chain due to the partial curfew.
- We expect the low prices of petrol, diesel and kerosene to persist (Murban Crude: $21.97) due to slumping global demand for oil and U.S.-China trade tensions that could restrict an economic recovery.
- We expect inflation to remain within the upper band of the target range 5%-7.5% in the short term due to the disruptive effect of the COVID-19 Pandemic on the economy.

Fig.8: May 2020 inflation forecast 6.0% - 6.5%



Source: Kenya National Bureau of Statistics

Another downward revision by the Monetary Policy Committee

MPC lowers CBR to 7% in April meeting further monetary easing possible in next meeting.

- Monetary Policy Committee held a meeting on the 29th of April and further lowered the Central Bank Rate (CBR) from 7.25% to 7.00%.
- The decision was based on the continuing adverse economic outlook caused by the global COVID-19 pandemic, which saw the economic growth forecast reduced further from 3.4% to 2.3%.
- Noted by the committee was an increase in private sector credit to 8.9% in March 2020 over the previous year a trend it attributed to the revision of the CBR and CRR during the month.
- We anticipate another downward revision given the subdued impact of monetary policy easing over the last few months.

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