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STERLING CAPITAL LIMITED

Fixed Income Note
May 2021

"FY2020/21 fiscal financing target now KES.1.3Trillion"

Analysts:

Renaldo D'Souza
+254 (20) 2222651
Renaldo.DSouza@sterlingib.com

Susan Makena
+254 (20) 2222651
Susan.Makena@sterlingib.com

Elizabeth Njenga, CFA
+254 (20) 2222651
Elizabeth.Njenga@sterlingib.com

Justina Vuku
+254 (20) 2222651
Justina.Vuku@sterlingib.com

Email: research@sterlingib.com

Bond Dealing: +254 (20) 2213914, 3315414; 2244077
+254 723153219, +254 734219146
Email: invest@sterlingib.com

Website www.sterlingib.com
Bloomberg Code: SCLK <GO>

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Executive Summary

- Our fixed income report for the month of May 2021 is titled **"Fiscal deficit financing target now KES.1.3Trillion"** in response to the National Treasury's downward and upward revision of the country's tax revenues and borrowing target respectively.
- As has become the norm, the Central Bank of Kenya (CBK) has re-opened **FXD2/2019/15** but added a new issue **FXD1/2021/25** with a KES.30Bn financing target.
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids

  - **FXD2/2019/15: 12.95% - 13.05%**
  - **FXD1/2021/25: 14.00% - 14.10%**

  WAR of accepted bids

  - **FXD2/2019/15: 12.85% - 12.95%**
  - **FXD1/2021/25: 13.80% - 13.90%**

- The report examines domestic debt auction subscription rates, secondary market activity and interbank rates.
- 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.
- 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 May debt issues target KES.30Bn

- The Central Bank of Kenya (CBK) invites bids for two treasury bonds re-opened **FXD2/2019/15 and a new issue FXD1/2021/25** seeking to raise KES.30Bn (Table.1).
- The two bonds have a term to maturity of 13 years and 25 years respectively.
- FXD1/2021/25 bond will have a market determined coupon while FXD2/2019/15 has a coupon of 12.734%, lower than the yield curve at 12.8087%.
- We believe CBK has issued the 25-Year bond to enable the Government bridge its fiscal deficit and lengthen debt maturity amid falling revenues.
- We are cautiously optimistic that the issue will be fully subscribed due to the relatively small amount offered dampened by the long tenor of the new issue FXD1/2021/25.

Table.1: Primary Bond issue summary

Issue Number	FXD2/2019/15	FXD1/2021/25
Total Amount Offered	KES.30Bn	
Tenor (Years)	15 Years	25 Years
Term to Maturity	13 Years	25 Years
Coupon Rate (%)	12.734	Market Determined
Price Quote	Discounted/Premium/Par	
Period of Sale	23rd April 2021 to 04th May 2021	
Auction Date	05th May 2021	
Value Date	10th May 2021	
Yield Curve (%) (Weighted Average tenor –23rd April 2021	**12.8087**	**13.3765**

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 23rd April 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	FXD2/2019/15	FXD1/2021/25
Market Weighted Average Rate	12.95 – 13.05	14.00 – 14.10
Weighted Average Rate of Accepted Bids (%)	12.85 – 12.95	13.80 – 13.90

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 23rd April 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						
FXD1/2019/15	28th Jan 2019	12.86	9th Jan 2034	12.8 (4,644)	12.8078	12.6145
FXD3/2019/15	29th July 2019	12.34	10th July 2034	13.3 (4,826)	12.8094	12.2160
25-Year						
FXD1/2018/25	25th June 2018	13.40	25th May 2043	22.2(8067)	13.3587	13.4497

Source: Central Bank of Kenya

Cautiously optimistic that the issue will be fully subscribed

- A historical comparison of primary auction results for 15 and 25-year issues shows low investor demand due to the long term to maturity (Table 4).
- We expect a full subscription of the two bonds, with more bids received on FXD2/2019/15 as a result of short term to maturity.
- We anticipate the CBK to limit subscriptions to manage the cost of borrowing and subsequently tap and re-open the issue as has been the trend recently.

Table.4: Historical primary market auction performance

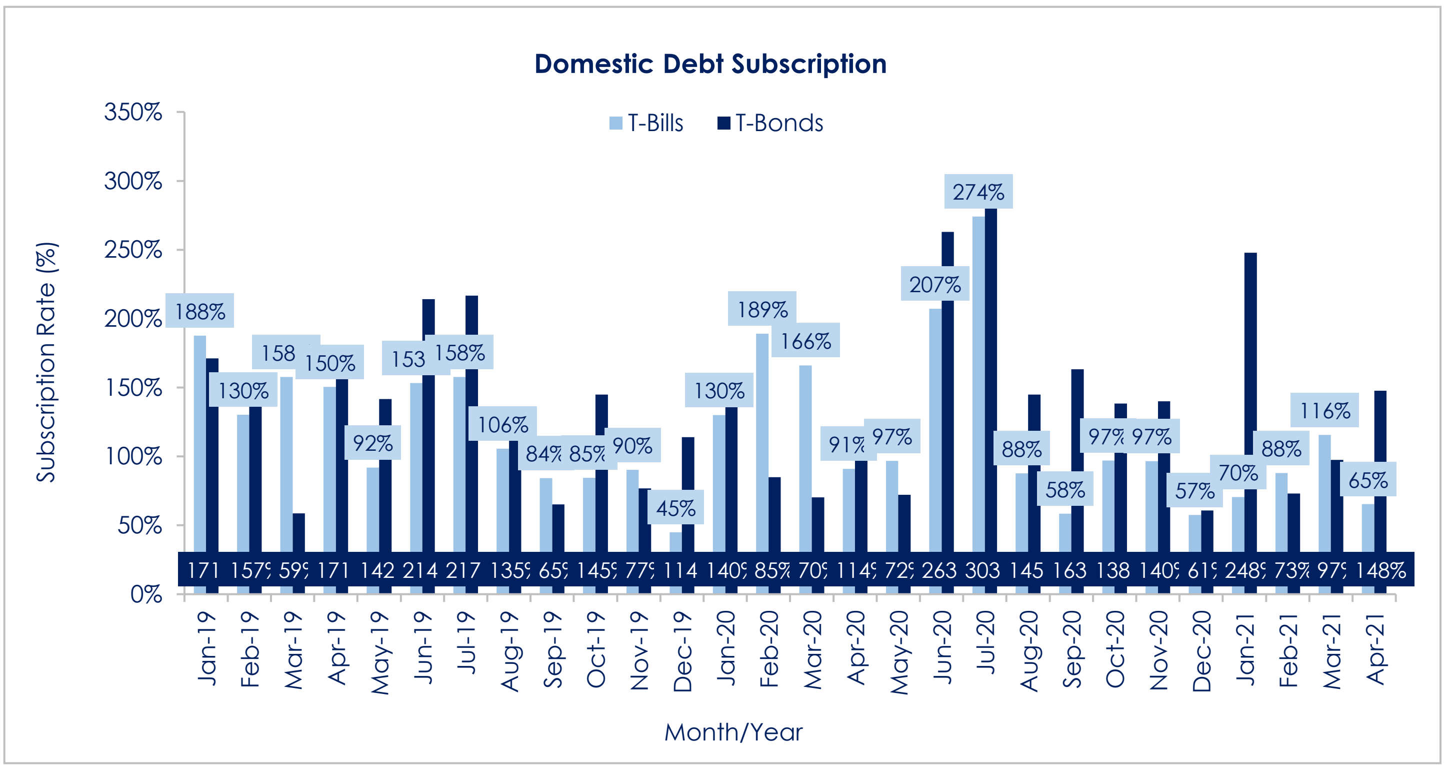
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yields (%)
15-Year						
FXD1/2018/15	40	20.2	12.9	50.5	12.65	12.6169
FXD2/2018/15	40	27.1	7.9	67.6	12.75	12.6238
FXD1/2019/15	40	25.1	14.7	62.7	12.86	12.8078
FXD2/2019/15	50	21.5	19.3	43.1	12.73	12.8087
FXD3/2019/15	40	86.7	50.6	216.7	12.34	12.8094
FXD1/2020/15	50	18.4	5.2	36.9	12.76	12.8111
25-Year						
FXD1/2010/25	7.5	27.1	7.5	361.0	11.25	12.8120
FXD1/2018/25	40	10.1	5.2	25.3	13.40	13.3587

Source: Central Bank of Kenya

T-bill's subscriptions dip in April 2021

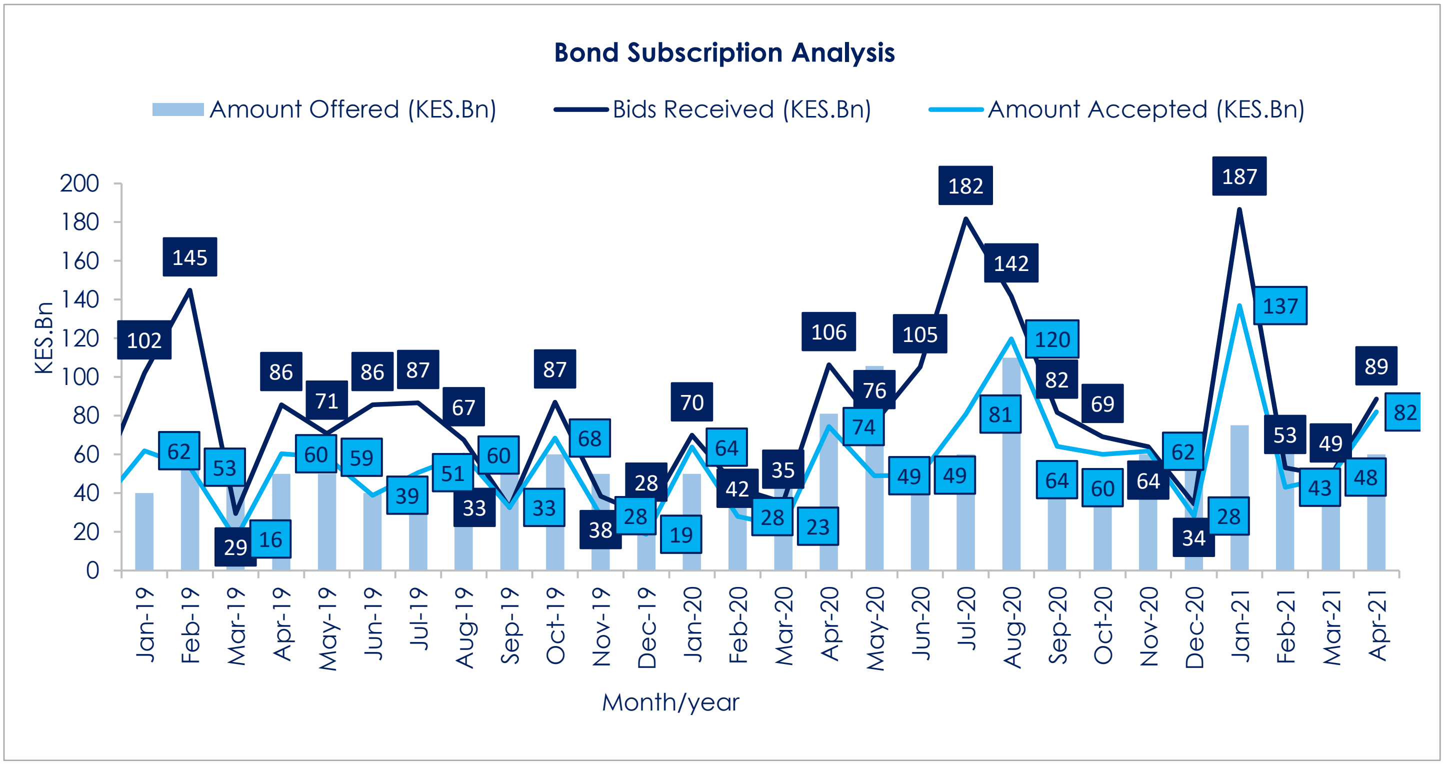
- Subscription rate for T-Bills declined to 65.4% in April 2021 from 115.6% in March with the CBK receiving T-Bills worth KES.62.7Bn against KES.96Bn offered (Figure.1).
- The 364-day T-Bill recorded the highest subscription at 102% (KES.40.8Bn) while the 91-day and 182-day papers were undersubscribed at 80.8% (KES.12.9Bn) and 22.5% (KES.9Bn) respectively.
- The acceptance for the T-Bills remained high at 100%, 98.5% and 90.9% respectively for the 91-day, 182-day and 364-day papers.
- The newly issued Infrastructure Bond IFB1/2021/18 received bids worth KES.88.6Bn against the KES.60Bn offered, a subscription of 147.6%. (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.

Figure.1: T-bond subscription for April 2021 at 65.4%



Source: Central Bank of Kenya

Figure.2: April IFB oversubscribed at 148%

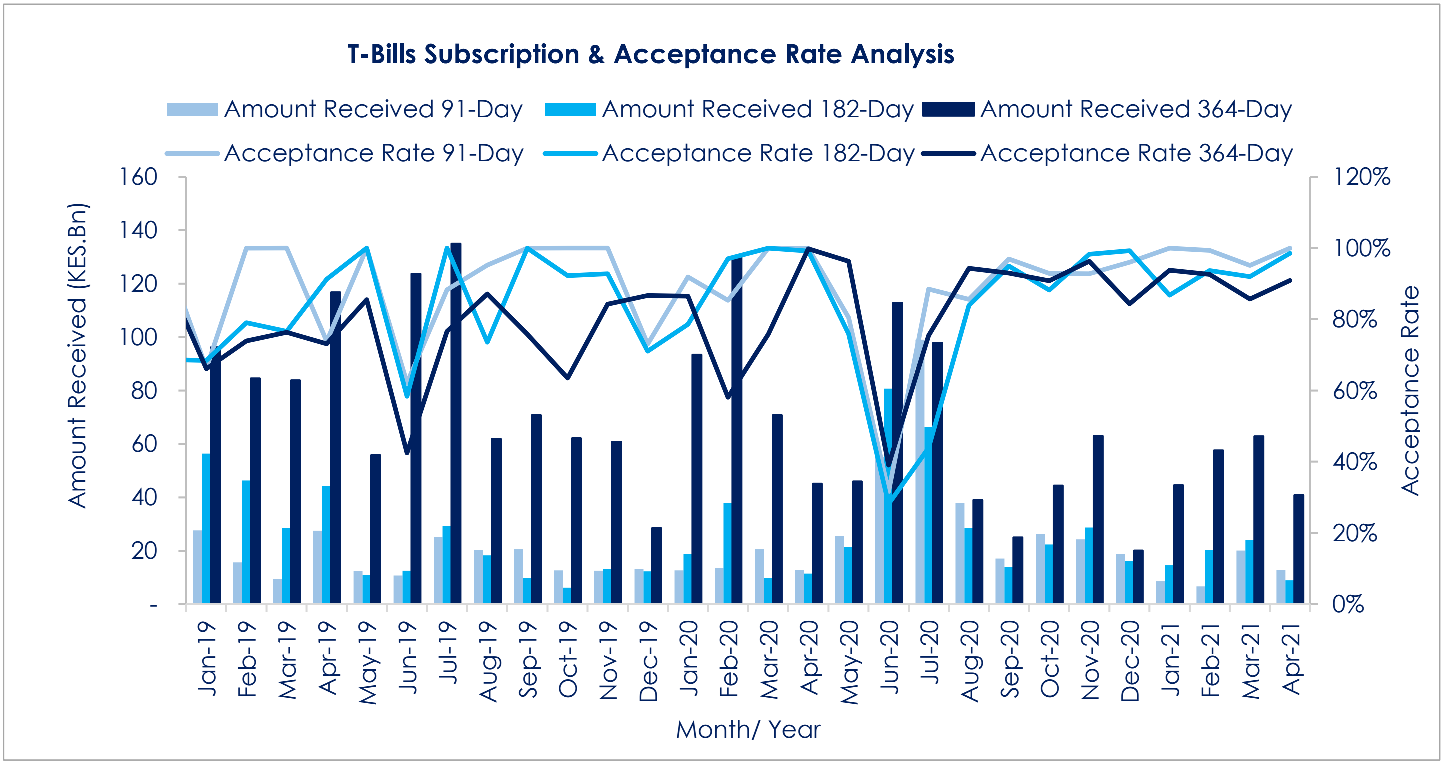


Source: Central Bank of Kenya

T-Bill rates edge upwards as CBK accommodates higher investor bids

- Interest rates on short-term debt have been rising steadily since August 2020 due to fiscal financing pressure amid falling tax revenues (Figure.4).
- This also explains the high acceptance rate in April 2021 (93.9%) compared to 88.9% in March (Figure.3).

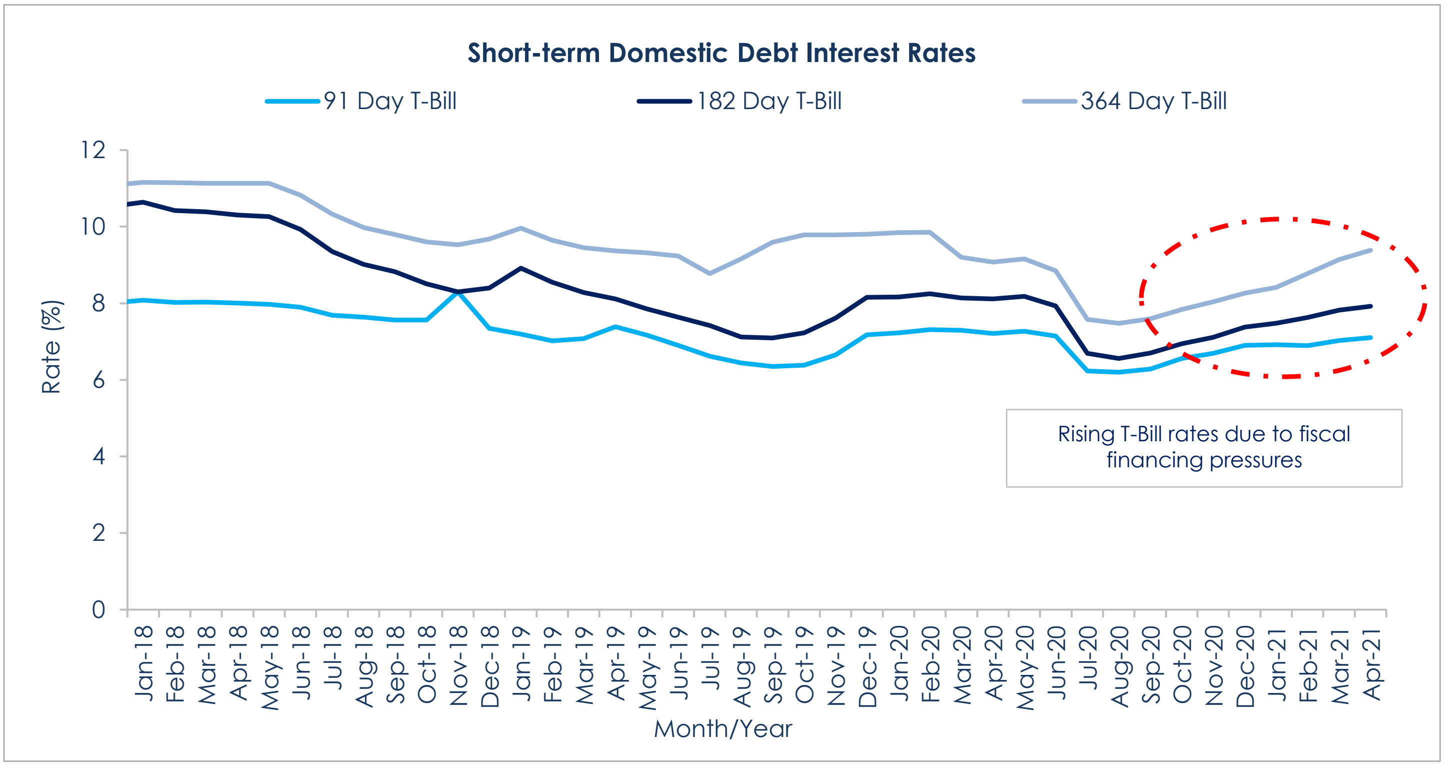
Figure.3: Interest rates on short term debt continues to rise due to budget financing pressure



Source: Central Bank of Kenya

- Average interest rates for the 91, 182 and 364-day debt issues rose in April to 7.1%, 7.9% and 9.4% from 7%, 7.8% and 9.1% respectively (Figure.4).
- The upward pressure on the short-end of the yield curve is expected to continue due to the reasons mentioned above.

Figure.4: Short-term debt securities interest rates continue to rise

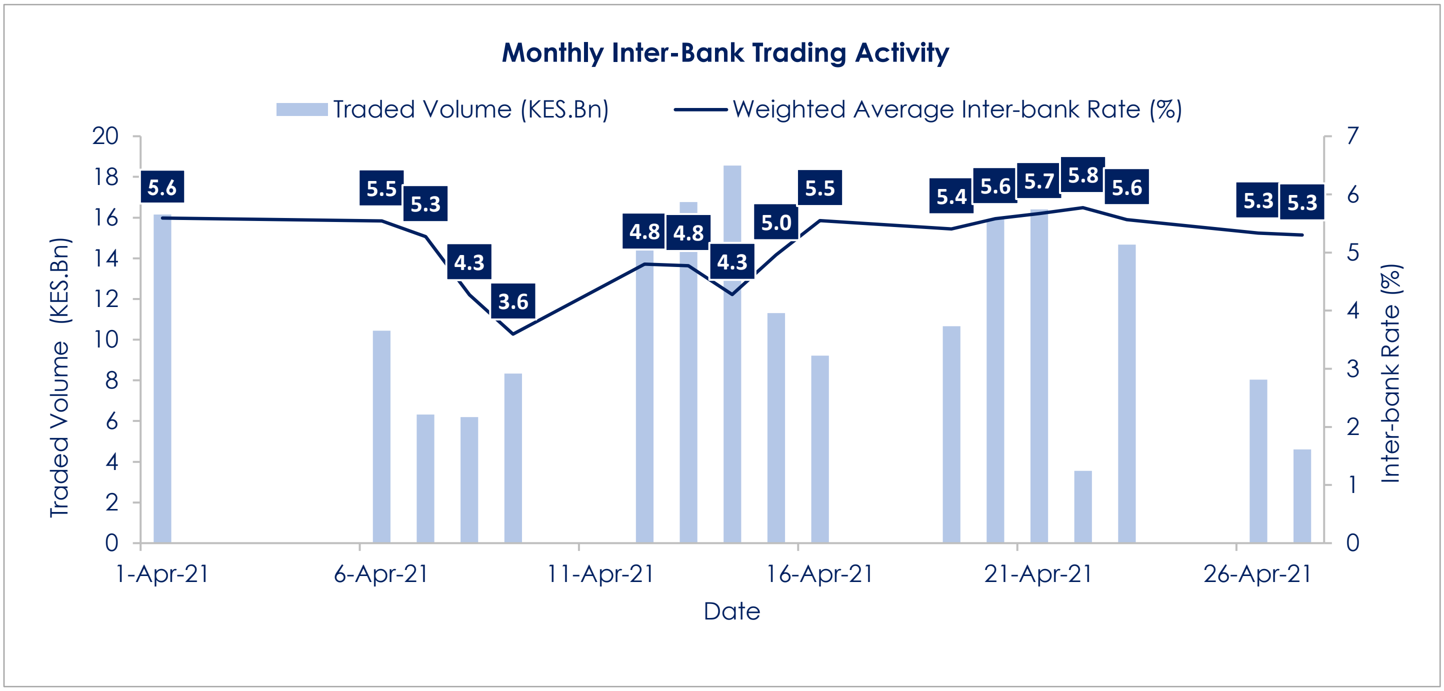


Source: Central Bank of Kenya

Average inter-bank rate stable

- The average inter-bank rate declined marginally to 5.1% in April (data until 27th April 202) from 5.2% in March as a result of tight market liquidity (Figure.5).
- During the period under review, total inter-bank trading volumes stood at KES.191.9Bn compared to KES.294.3Bn transacted in March.
- Tightening liquidity during the month resulted from tax remittances which offset Government payments.
- Our forecasted average inter-bank rate for May 2021 is 5% - 5.5%.

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

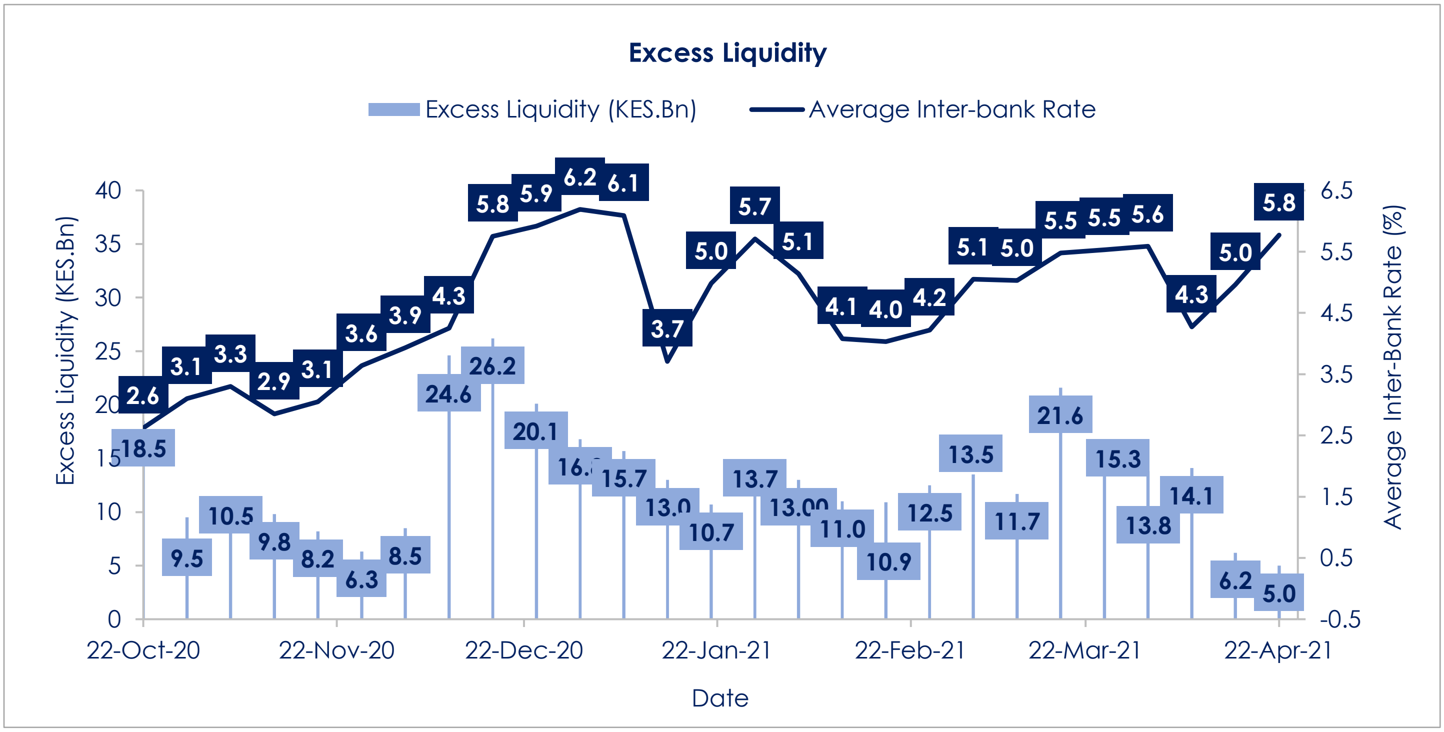


*Figures up to 27th April

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.39.1Bn a 37% decline from KES.62.1Bn attributable to a tight market liquidity (Figure.6).

Figure.6: Excess commercial bank reserves decline in April 2021

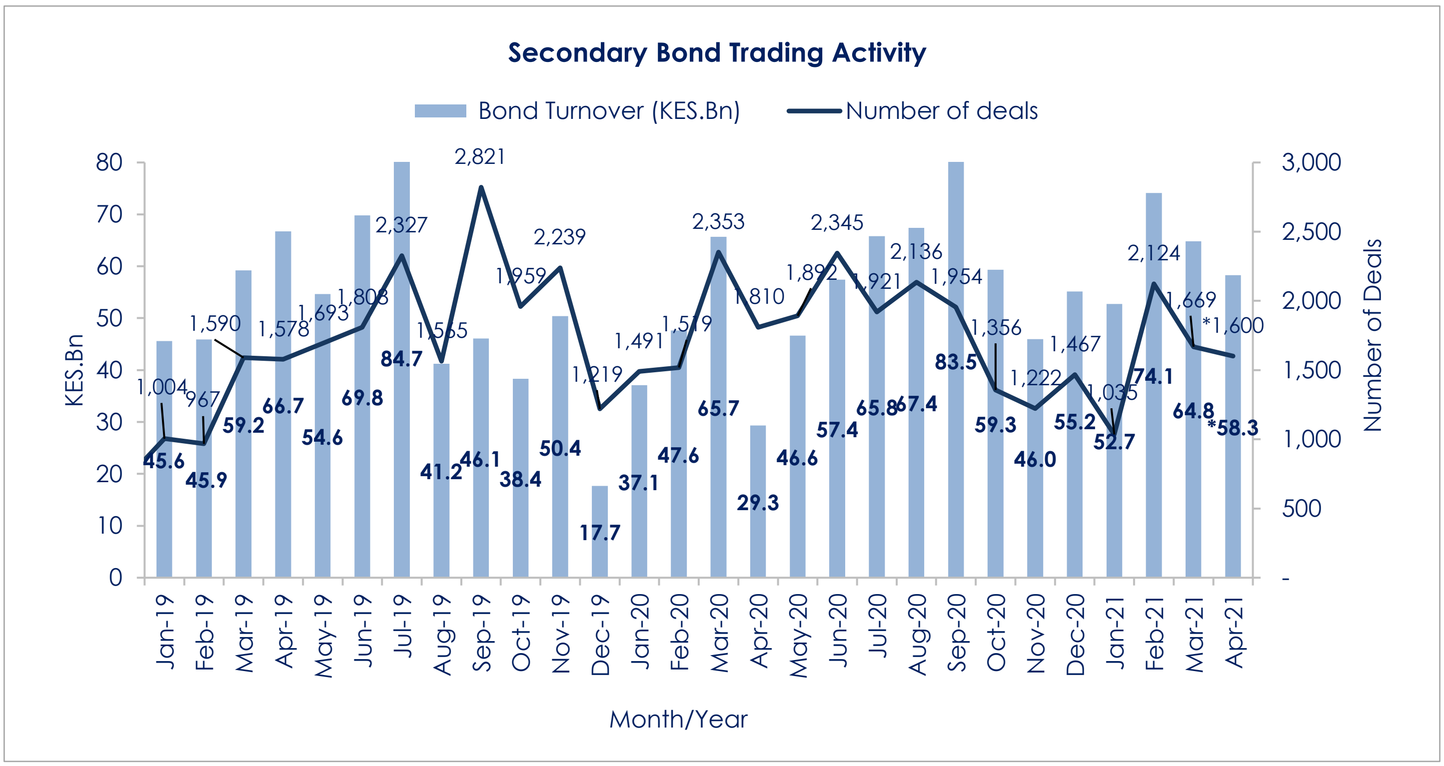


Source: Central Bank of Kenya

Secondary market bond turnover to increase in May 2021

- Secondary market trading activity stood at KES.58.3Bn as at 28th April, down from KES.64.8Bn the previous month with the number of deals over the same period at 1,600 from 1,669 in March (Figure.7).
- We attribute the low trading activity during the month to investors high interest in the IFB issued during the month which was oversubscribed at 147.6%.
- We expect higher secondary market turnover in May on account of an "unattractive primary bond issue" as well as flow of capital from investors who missed out on the IFB.

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



*Figures up to 28th April

Source: Central Bank of Kenya

Trading ideas - Buy IFB's

- IFBs have a history of significant price appreciation in the secondary market and we therefore recommend them for investors with a fixed income allocation.
- We single out IFB1/2021/18 and IFB/2021/16 as suitable investment options (Table.5)

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2021/18	18.0	12.313	7.08	12.40	12.24
IFB1/2021/16	15.7	12.260	6.72	12.00	11.69

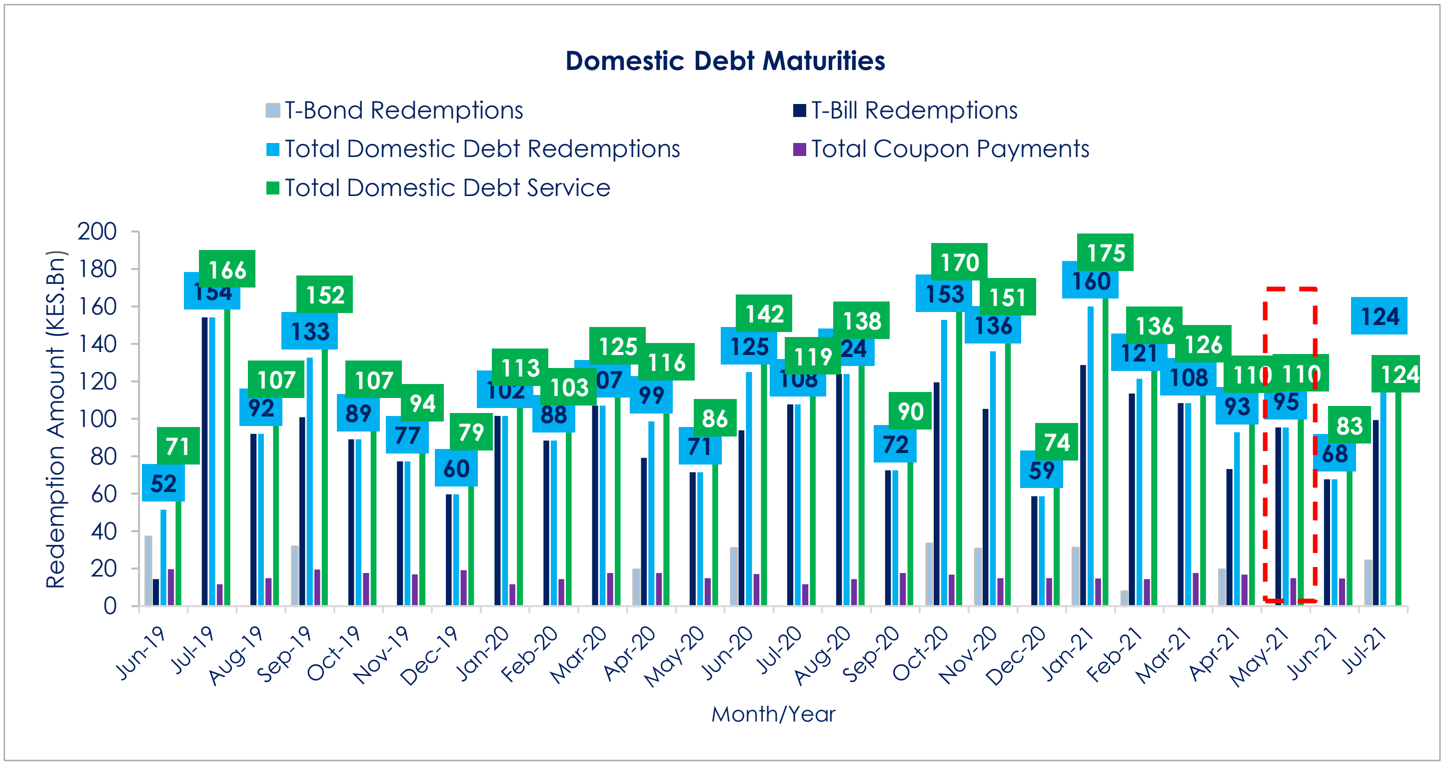
Source: Central Bank of Kenya

*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

May 2021 domestic debt service at KES.110Bn

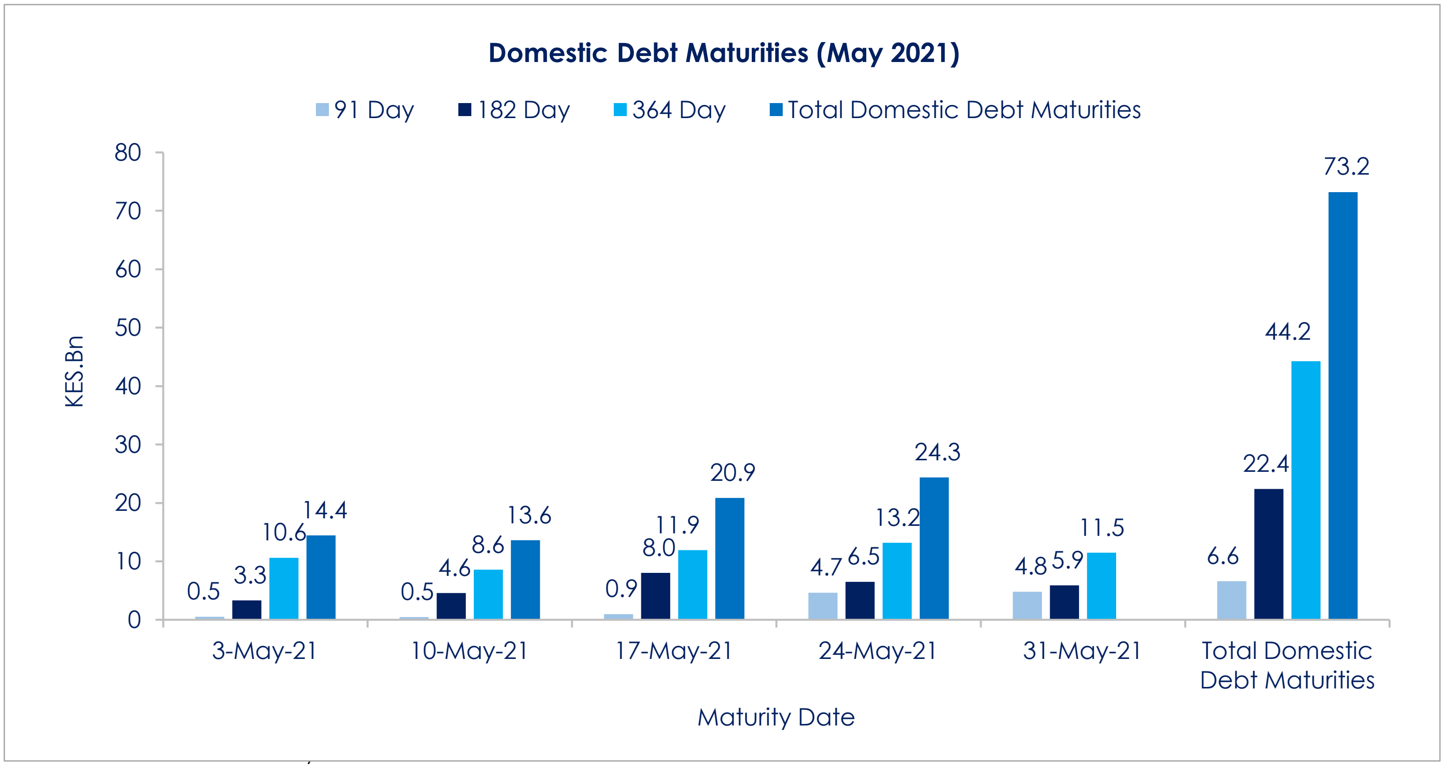
- Debt service for the month of May is KES.110.3Bn comprising of KES.95.4Bn in T-Bills and KES.14.9Bn in coupon payments with no T-Bond maturities (Figure.8).
- Expected redemptions for the 91, 182 and 364-day T-Bills during the month are KES.6.6Bn, KES.22.4 Bn and KES.44.2Bn respectively with the third week of the month expected to have the highest total redemptions at KES.24.3Bn. (Figure.9).
- The total amount KES.143.4Bn raised in domestic debt auctions (KES.48.3Bn in T-Bonds and KES.95.1Bn in T-Bills), KES.115.5Bn has been used as redemptions equivalent to 94.8% of total amount raised by the CBK.
- T-Bill redemptions are expected to fall to KES.67.7Bn, while coupon payments decline to KES.14.9Bn, bringing the total debt service cost to KES.82.7Bn in June 2021.

Figure.8: May 2021 domestic debt service stands at KES.110Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities May 2021



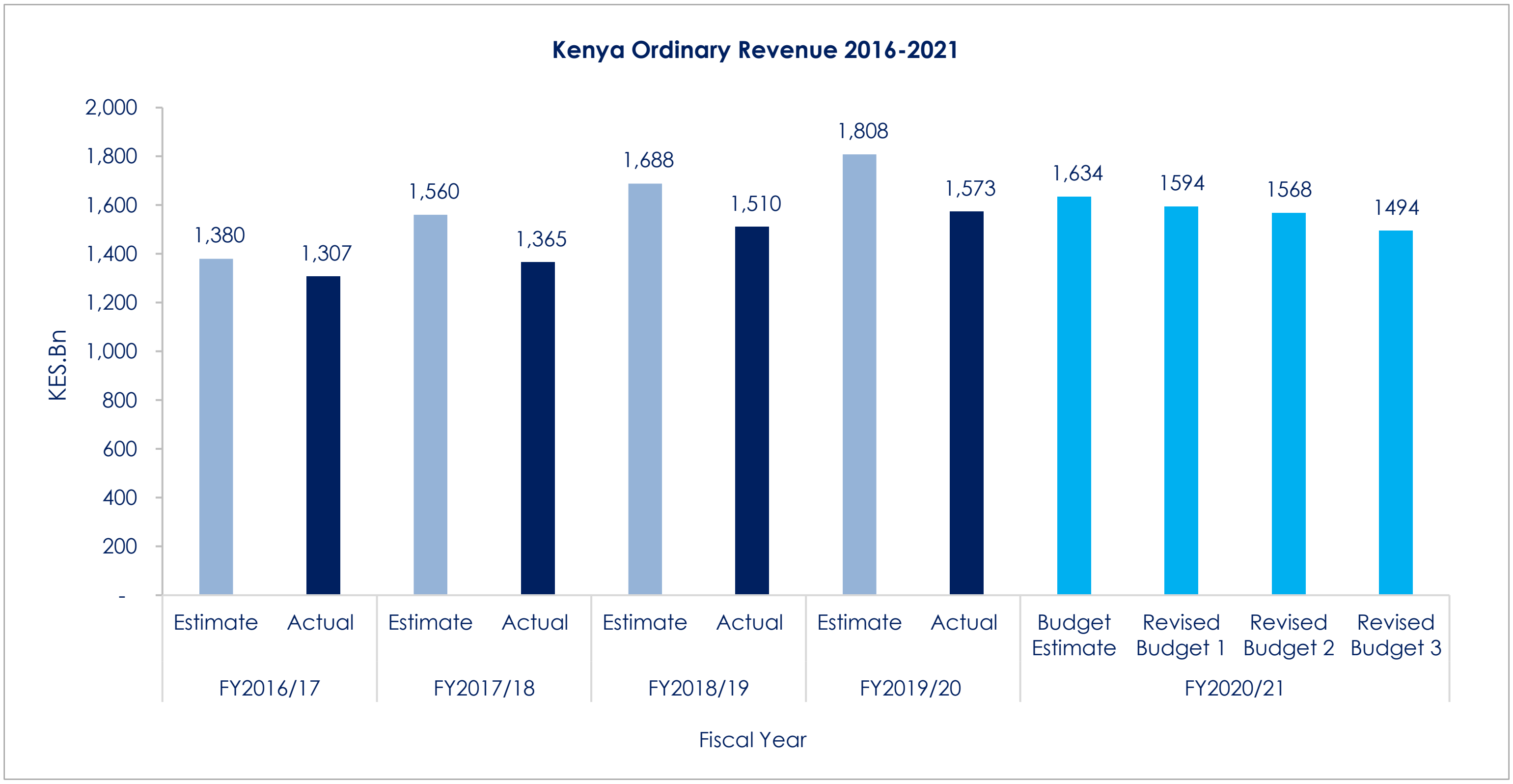
Source: Central Bank of Kenya

Kenya's tax revenue target revised downwards to KES.1.494Trillion

Kenya ordinary (tax revenues) have fallen to levels last seen in the 2018/19 fiscal year.

- The March 2021 National Treasury receipts revision puts ordinary revenue estimate at KES.1.49Tn, near 2018/19 actual revenues - KES.1.51Tn. (Figure.10)
- This clearly shows the impact of measures implemented by the Government to contain the spread of the Covid-19 pandemic on the economy.
- With the economy operating below its capacity and additional containment measures being introduced, we see tax collection falling even below the revised figure.
- We are concerned that the resulting increase in borrowing will have a negative impact on public debt levels and debt servicing which consumed 34% of total tax revenue in 2019/20 and we estimate to take up 43% FY2020/21.

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



Source: Kenya National Treasury

2020/21 National Treasury makes major revisions to budgetary targets

Total tax revenue revised to KES.1.47Tn, borrowing target up 9.7% to KES.1.3Tn.

- The National Treasury has made significant revisions to its 2020/21 fiscal year budgetary targets with the most visible being downward and upward revisions to tax revenue, domestic and external borrowing. (Table.6 and Figure.11).
- This is consistent with our expectations as mentioned in our March 2021 fixed income report titled **"New restrictions, new risks to public finances"** where we singled out underperformance of tax revenues as the key reason behind the upward revision of borrowing targets.
- Domestic and external borrowing targets have been increased 8.5% and 12.3% following a 6.2% decline in the tax revenue target.
- Overall, the National Treasury expects total receipts to increase 4% to KES.2.94Tn and almost doubling of Non-Tax revenue to KES.124.3Bn.
- We are pessimistic about the National Treasury's ability to meet its KES.1Tn receipt deficit with just one financial quarter remaining having raised KES.1.9Tn in the first three quarters.
- With regards to domestic borrowing, the CBK needs to raise KES205.8Bn in net borrowing in Q4, a scenario we see as achievable considering that at 75.9% is within our estimated target linear run-rate.
- Any shortfalls in domestic borrowing could be supplemented by external borrowing most from the International Monetary Fund (IMF) which has so far disbursed approximately KES.200Bn.
- Increased domestic borrowing will exert pressure on domestic interest rates while yields on Government of Kenya Eurobonds are likely to rise.

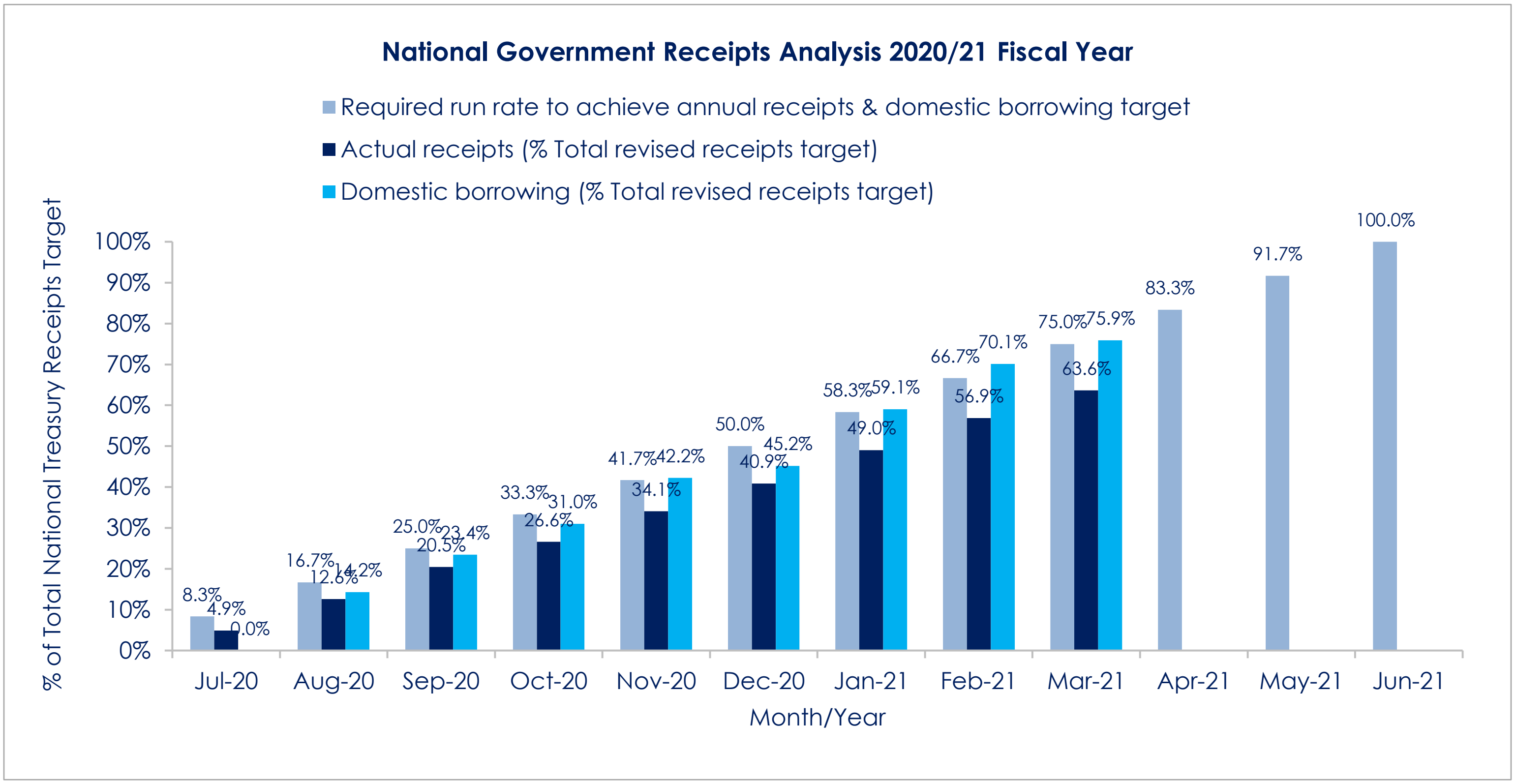
Table.6: 2020/21 fiscal year revenues remain below target run-rate

Receipts	Estimates (KES) Aug 2020	Revised Estimates (KES) Mar 2021	Actual Receipts (KES) 26th February 2021	Actual Receipts (KES) 31st March 2021	Proportion of Receipt Target (KES) 31st March 2021
Opening Balance (1st July 2020)		48.0	48.0	48.0	-
Tax Revenue	**1,567.6**	**1,469.7**	784.9	1,037.2	70.6%
Non-Tax Income	66.1	124.3	55.1	69.7	56.1%
Domestic Borrowing	786.6	853.8	504.3	648	75.9%
External Loans & Grants	373.2	419	48.3	65.8	15.7%
Other Domestic Financing	36.8	28.5	3.0	3.7	12.9
Total Revenue	**2,830.4**	**2,943.2**	**1,203.1**	**1,872.4**	**63.6%**

* 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.75 16th April 2021

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

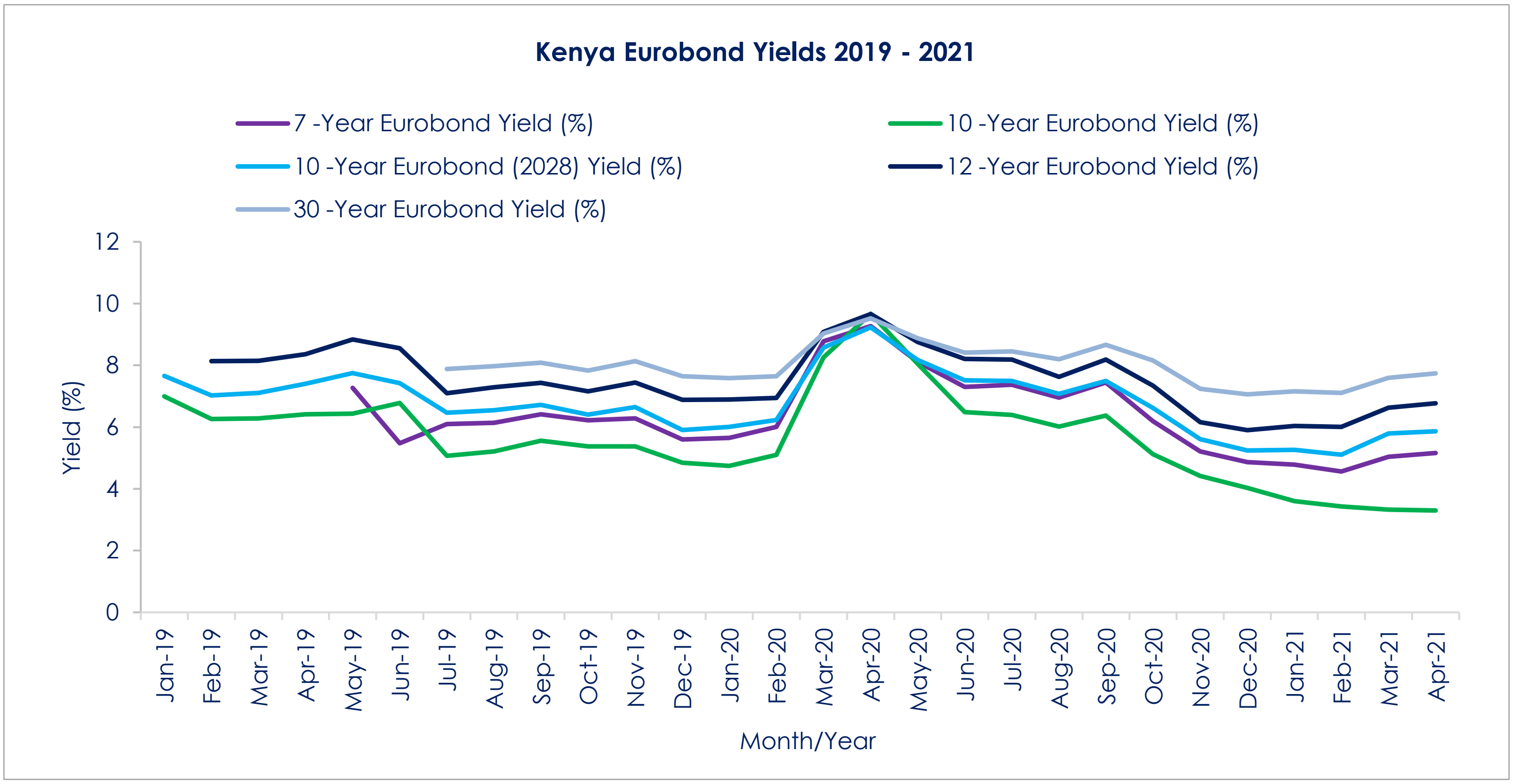


Source: The Kenya Gazette Vol. CXXIII - No.75 16th April 2021

Kenya Eurobond yields rise on concerns over economic prospects and fiscal position

- Yields on Government of Kenya Eurobonds rose in April (week ending 22nd April) compared to average yields in February and March 2021 (Figure.12).
- We attribute this to negative investor sentiment on the economic prospects of the country following the introduction of new Covid-19 containment measures by the Government at the end of March.
- We observed a similar trend albeit a sharp increase in yields in March 2020 after the country announced its first positive Covid-19 case which was followed by the announcement of curfews, travel restrictions and reduced operating hours for some businesses amongst others.
- Concerns over the country's fiscal position especially rising public debt arising from a widening fiscal deficit could have impacted Eurobond yields.

Figure.12: Kenya Eurobond yields rise on concern over economic prospects and fiscal position



Source: Central Bank of Kenya

Yields expected to rise on account of fiscal budgetary pressure

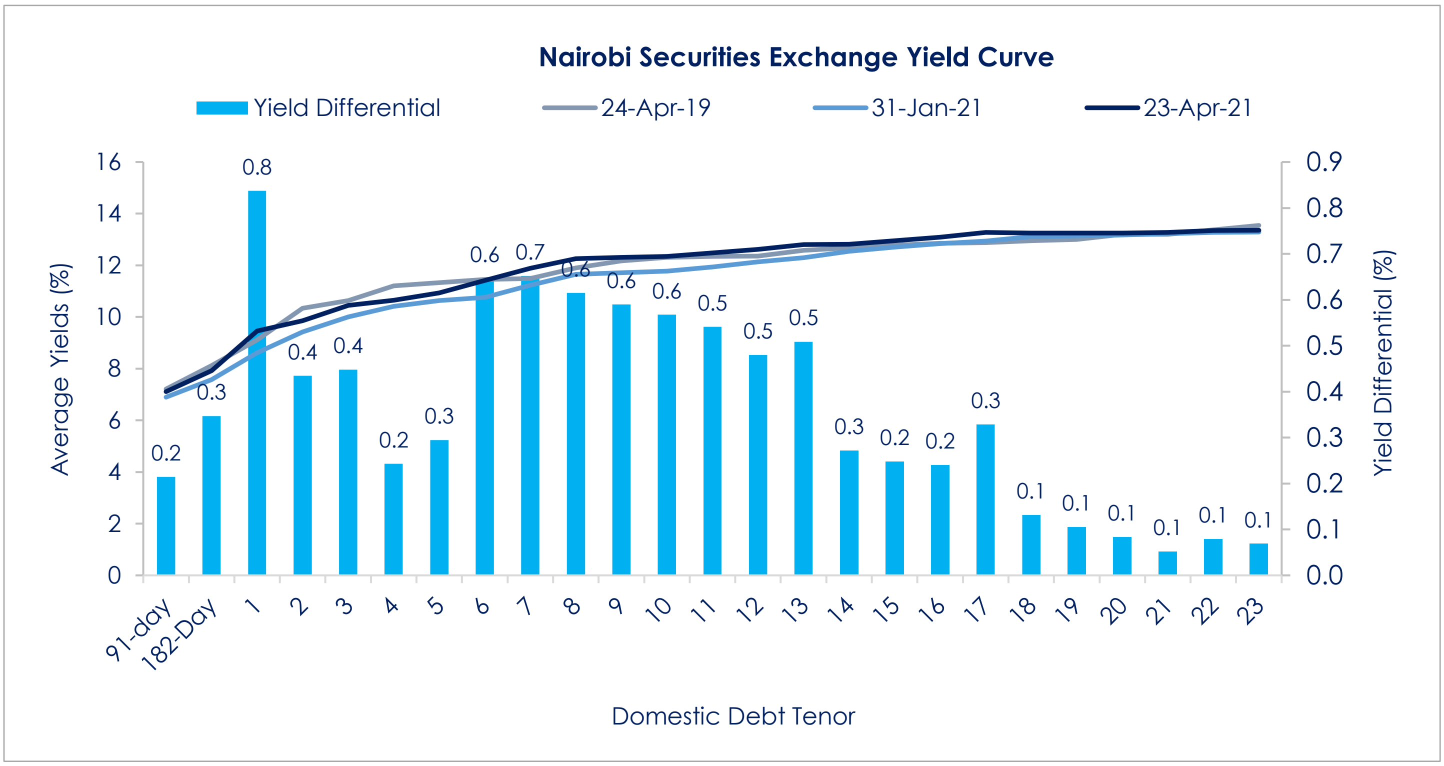
- We observe an overall decline in yields on different tenor instruments on 23rd April compared to 31st January this year (Table.7 and Figure.12).
- We attribute this mainly to increased demand for Government debt brought about flight of capital towards fixed income assets.
- A comparison of yields on 23rd April 2021 and 24th April 2020, however, shows a dip in 2-Year and 5-Year yields while those on the 1-Year and long end rose.
- CBK has been accepting higher investor bids for longer dated debt securities in a bid to lengthen the debt maturity profile, pushing the long end of the curve upwards.
- We maintain our recommendation of **BUY short and HOLD medium and long term papers.**

Table.7: Yields on the short end and medium-term debt issues decline

Tenor	Yield (24th Apr 2020)	Yield (31st Jan 2021)	Yield (23rd Apr 2021)	YoY ∆ 23rd Apr 2021 vs 24th Apr 2020 (Bps)	YoY ∆ 23rd Apr 2021 vs 31st Jan 2021(Bps)	Sterling Capital yield Curve (30th March 2021)
1	9.1100	8.6230	9.4600	↑35.0	↑83.7	9.50%
2	10.3433	9.4234	9.8578	↓48.6	↑43.4	10.00%
5	11.3303	10.6331	10.9275	↓40.3	↑29.4	11.00%
10	12.3038	11.7813	12.3486	↑4.5	↑56.7	12.45%
15	12.7833	12.7016	12.9491	↑16.6	↑24.8	13.00%
20	13.1958	13.1720	13.2556	↑6.0	↑8.4	13.35%

Source: Nairobi Securities Exchange

Figure.12: Gradual rise in long term yields

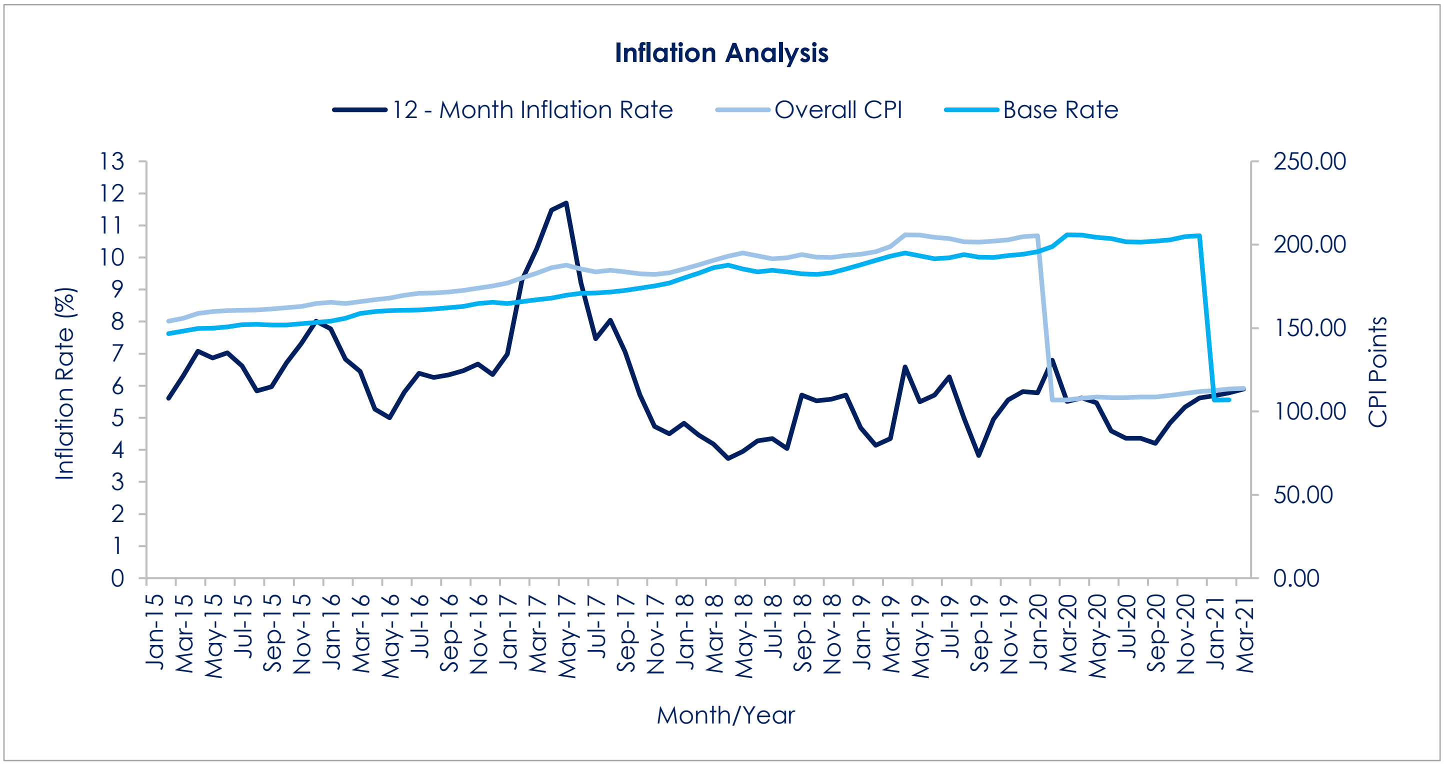


Source: Nairobi Securities Exchange

April 2021 inflation to rise on higher transport and food prices

- Inflation for the month of March 2021 rose to 5.9% from 5.78% in February 2021, a 11-month high. (Figure.13)
- Consumer Price Index (CPI) rose 0.4% to 113.81 from 113.37 the previous month.
- The rise in inflation is attributable to higher costs of food & non-alcoholic beverages, transport, fuel, health, restaurants & hotels and housing & utilities.
- We predict inflation for April 2021 in the range of 5.8% - 6%, which is still within the CBK's 2.5% - 7.5% target range.

Figure.13: Short term inflation forecast 5.5% - 6%



Source: Kenya National Bureau of Statistics

MPC expected to retain CBR at 7% in the short term

- The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 7% in the last meeting on 29th March citing gradual economic recovery in the last two quarters.
- Strong performance of agriculture, construction, real estate, finance and insurance, and the wholesale and retail trade were the key drivers of the recovery.
- Inflation is expected to remain within the target range in the near term in spite of upward pressure on higher in fuel prices.
- The next MPC meeting is set for May 26th 2021. We expect the MPC to retain the CBR at 7% in the short-term.

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