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Fixed Income Note

November 2020

"Trend in long-term debt issuance continues"

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Executive Summary

- **"Trend in long-term debt issuance continues"** is the title of our November 2020 fixed income report where the Central Bank of Kenya (CBK) is looking to raise KES.40Bn in the two re-opened long-term bonds: FXD2/2013/15 (7.52 Years) and FXD1/2018/20 (17.4 Years).
- The issue is likely to achieve a combined subscription rate of between 113%-138% (KES.45Bn-KES.55Bn).
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids

  - **FXD2/2013/15: 11.40%**
  - **FXD1/2018/20: 13.10%**

  WAR of accepted bids

  - **FXD2/2013/15: 11.30%**
  - **FXD1/2018/20: 13.00%**

- The report highlights both Treasury bills and bonds primary auction activity in October whilst giving our expectations for the near term based on market liquidity and investor expectations.
- We have also analysed historical secondary bond trading activity in the report which we expect to remain subdued in November as a result of reduced market liquidity.
- Domestic debt maturities have a huge impact on CBK's borrowing strategy and this debt service for the next three months is analysed in the report.
- We also give trading recommendations in our 'trading ideas' section for investors showing a preference for Infrastructure Bonds (IFB) on account of potential price appreciation.
- Also discussed in this report is the country's national accounts position.
- The report includes an analysis of the yield curve over selected periods 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 taps into the domestic market to raise KES.40Bn

- Central Bank of Kenya (CBK) is inviting bids for the re-opened two Treasury Bonds FXD2/2013/15 (7.52 Years) and FXD1/2018/20 (17.4 Years), as it seeks to raise KES.40Bn (Table.1).
- The move to issue the longer dated papers is in continuation of a recent trend which is meant to lengthen the maturity of domestic debt which currently stands at 5.7 years from 4.1 years two years ago.
- We believe continued issuance of multiple tenors with higher acceptance rate for longer dated papers will lengthen the maturity profile further and reduce refinancing risk.
- In addition, issuance of two different tenors is intended to cater for investors with different investment horizons.

Table.1: Primary Bond issue summary

Issue Number	FXD2/2013/15 (Re-opened)	FXD1/2018/20 (Re-opened)
Total Amount Offered	KES.40Bn	
Tenor (Years)	7.52 Years	17.4 Years
Coupon Rate (%)	12.00	13.20
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	4th November 2020– 17th November 2020	
Auction Date	18th November 2020	
Value Date	23rd November 2020	
Yield Curve (%) (Weighted Average tenor – 7.52 Years, and 17.4 Years) 6th November, 2020	**11.14**	**12.68**

Source: Central Bank of Kenya

Our weighted average and accepted bids averages

- We have given our bid predations for the bond auctions by analyzing yields of similar tenor securities on the Nairobi Securities Exchange (NSE) as at 6th November 2020, as well as input from our fixed income trading team (Table.2).

Table.2: Auction bid predictions

Rate	FXD2/2013/15	FXD1/2018/20
Market Weighted Average Rate (%)	11.40	13.10
Weighted Average Rate of Accepted Bids (%)	11.30	13.00

Source: Sterling Capital Research

Existing listed bond issues provided guidance to our predicted rates

- Implied yields of bonds of similar tenors on the NSE as at 6th November 2020 were used to predict 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						
FXD1/2013/15	25th Feb 2013	11.25	7th Feb 2028	7.28 (2,649)	10.9350	N/A
20-Year						
FXD2/2018/20	30th Jul 2018	13.20	5th Jul 2038	17.72 (6,450)	12.8087	N/A

Source: Nairobi Securities Exchange & Sterling Capital

Maturing bond and higher yields for long term papers likely to drive subscription

- In recent months investors have shown preference for long-term debt securities due to higher returns and limited viable alternative low risk investments.
- We anticipate a combined oversubscription rate of **113% - 138% (KES.45Bn – KES.55Bn)**, cushioned by liquidity from bond maturity (FXD2/2015/5, KES.30.7Bn) and interest payments on the value date 23rd November, 2020.

Table.4: Historical primary market auction performance

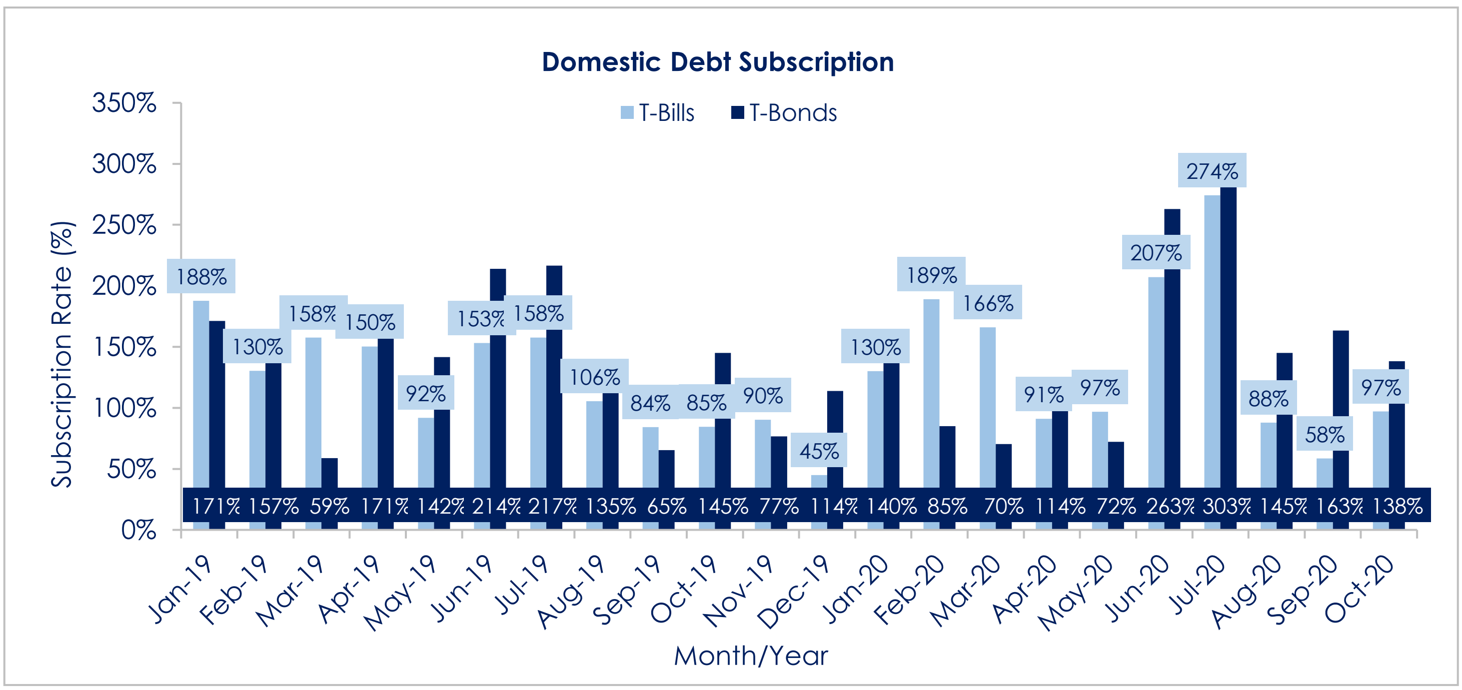
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
15-Year						
FXD1/2018/15	40	20.22	12.86	50.54	12.65	11.9222
FXD2/2018/15	40	27.05	7.85	67.61	12.75	12.0153
FXD1/2019/15	40	25.07	14.72	62.67	12.86	12.0901
FXD2/2019/15	50	21.54	19.32	43.08	12.73	12.1669
FXD3/2019/15	40	86.67	50.58	216.69	12.34	12.2784
FXD1/2020/15	50	18.44	5.19	36.87	12.76	12.5664
20-Year						
FXD1/2018/20	40	13.74	8.49	34.35	13.20	12.7113
FXD2/2018/20	40	13.86	10.51	34.65	13.20	12.8087
FXD1/2019/20	40	25.07	14.72	62.67	12.86	12.8827

Source: Nairobi Securities Exchange & Sterling Capital

Demand for the 91-Day T-Bill and long-term T-Bonds to remain high

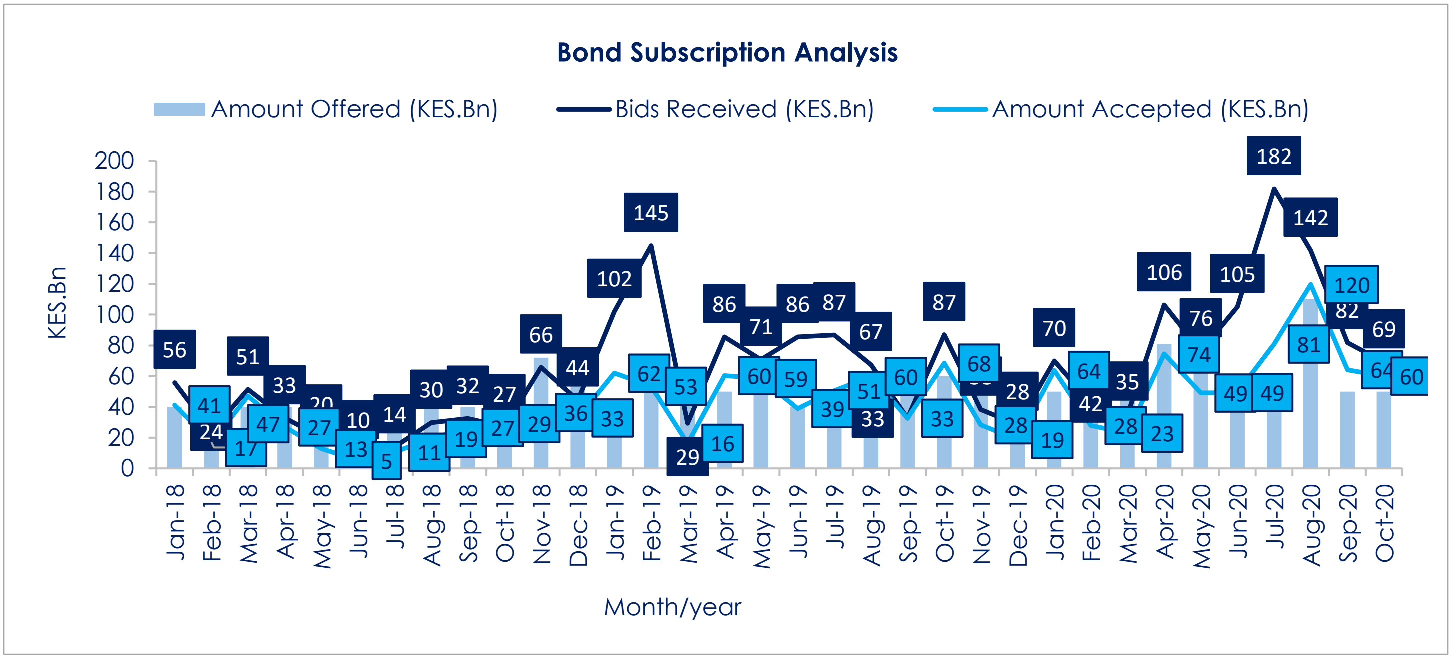
- The CBK received domestic debt bids worth KES.93.1Bn against KES.96Bn offered in October, a subscription rate of 97% (Figure.1).
- The 91-day T-Bill remained the most popular debt issue during the month, with a subscription rate of 164.8%, attributable to an expected gradual increase in short-term interest rates.
- The 182-day paper received a subscription rate of 55.8% while the 364-day paper was oversubscribed at 111%.
- The two re-opened T-Bonds in October received bids worth KES.69.1Bn (138.3% subscription rate) with FXD1/2018/25 (22.7 Years) receiving a higher subscription rate (92%) compared to 46.3% received for FXD/2011/20 (10.6 Years).
- We expect demand for the T-Bonds to remain high compared to T-Bills as a result of higher interest rate spreads, thus providing high returns.

Figure.1: Domestic debt subscriptions up in October



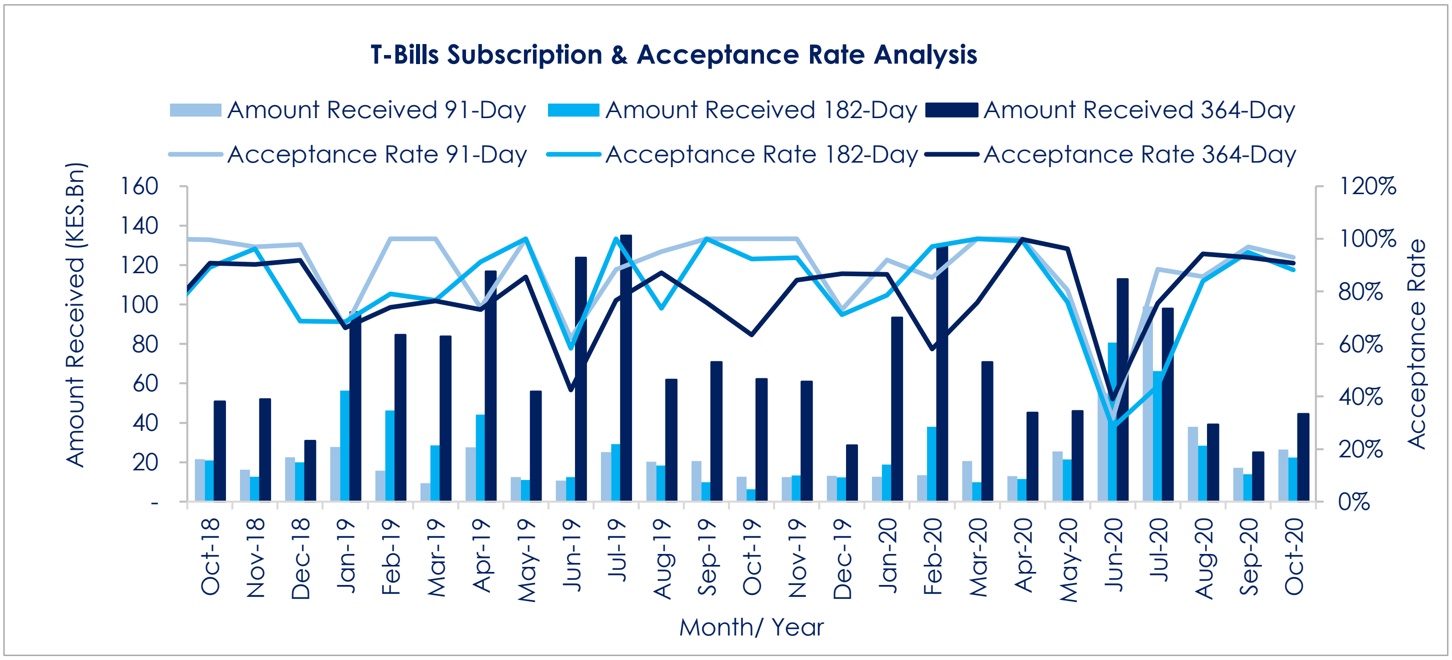
Source: Central Bank of Kenya

Figure.2: Investor auction bids received decline steadily



Source: Central Bank of Kenya

Figure.3: Acceptance rate for all T-Bill tenors declines

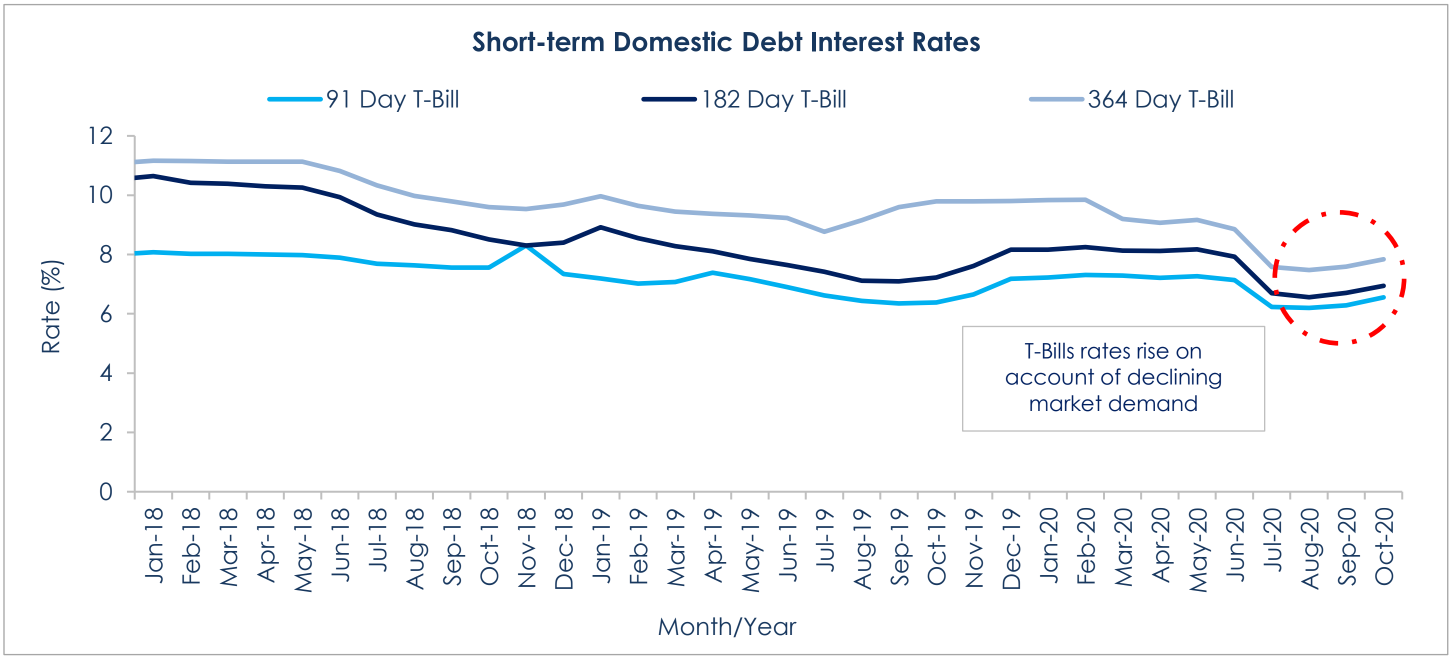


Source: Central Bank of Kenya

T-Bill rates continue to edge upwards

- Average T-Bill yields rose marginally in October with the 91, 182- and 364-day papers recording a rise of 27bps, 24bps and 24bps to 6.6%, 6.9% and 7.8% respectively (Figure.4).
- Investor participation in T-Bill auctions increased in October with the 91-day and 364-day papers being oversubscribed, reversing the overall undersubscription noted in the previous two months
- We anticipate a continued rise in interest rate rates in upcoming auctions in a bid to maintain investor interest in the short-term papers.

Figure.4: Interest rates edge upwards as liquidity declines

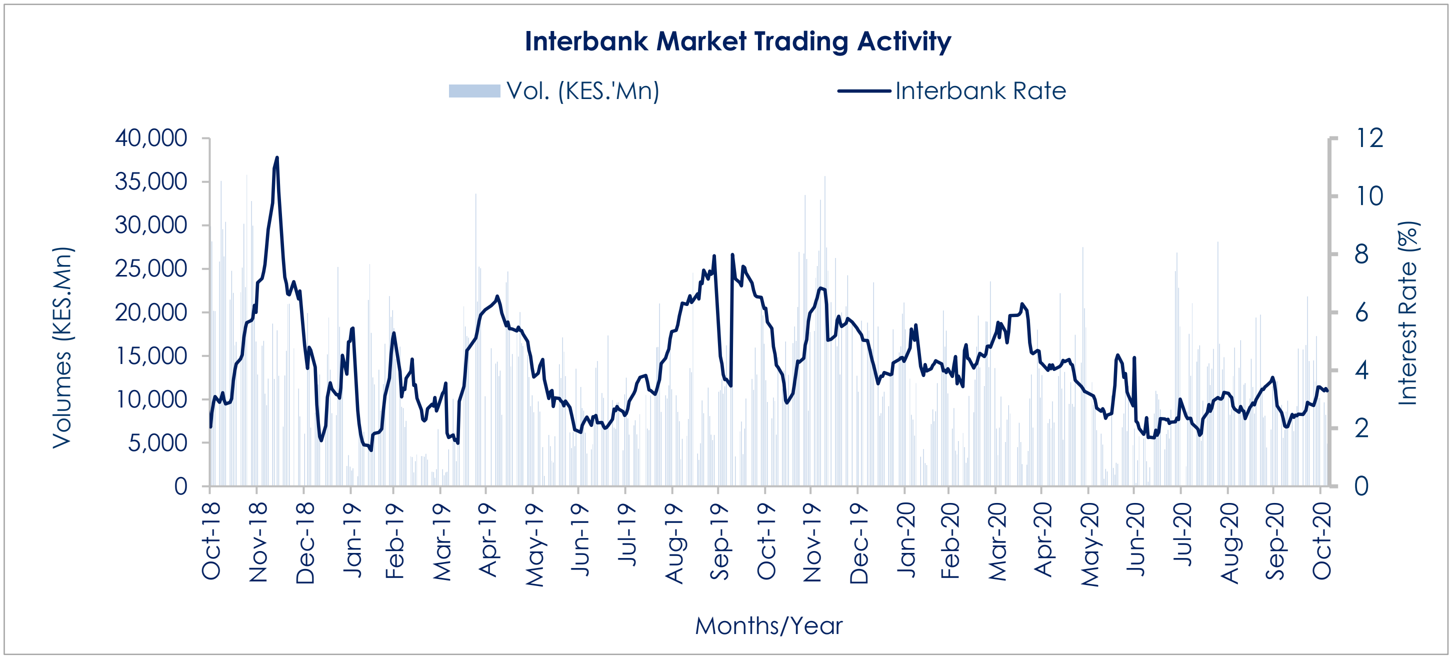


Source: Central Bank of Kenya

Inter-bank rates rise as commercial banking liquidity declines

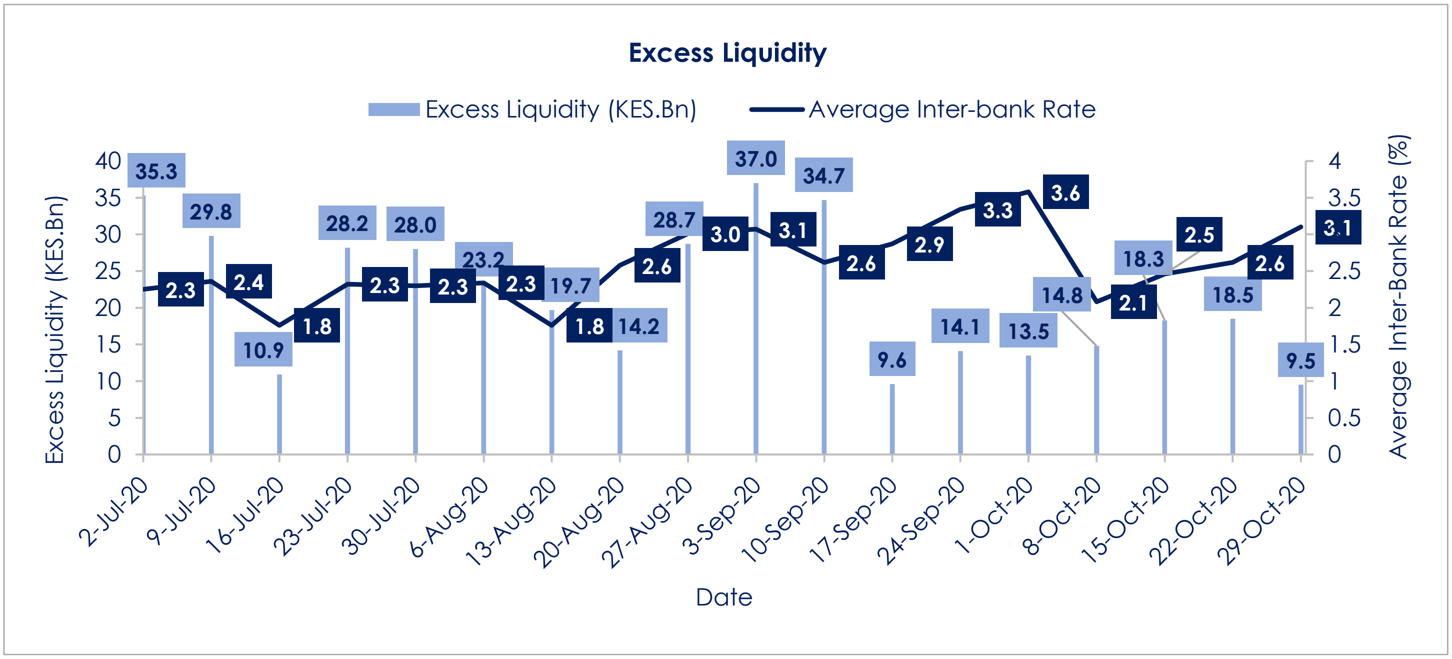
- Average weighted inter-bank lending in October stood at 2.8%, a decline compared to 3% in September while total traded volumes declined from KES.253.6Bn in September to KES.241.96Bn in October (Figure.5).
- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) increased significantly in the first 3 weeks of October from 13.5% to 18.5% attributable to increased government payments. The reserves dipped to 9.5% 29th October and we expect them to remain around this level in November (Figure.6).
- We expect average inter-bank rates to remain between 3% and 3.5% in November attributable to comparatively lower market liquidity.

Figure.5: Inter-bank rates expected to rise marginally



Source: Central Bank of Kenya

Figure.6: Commercial excess reserves decline in October sparking rise in inter-bank rates

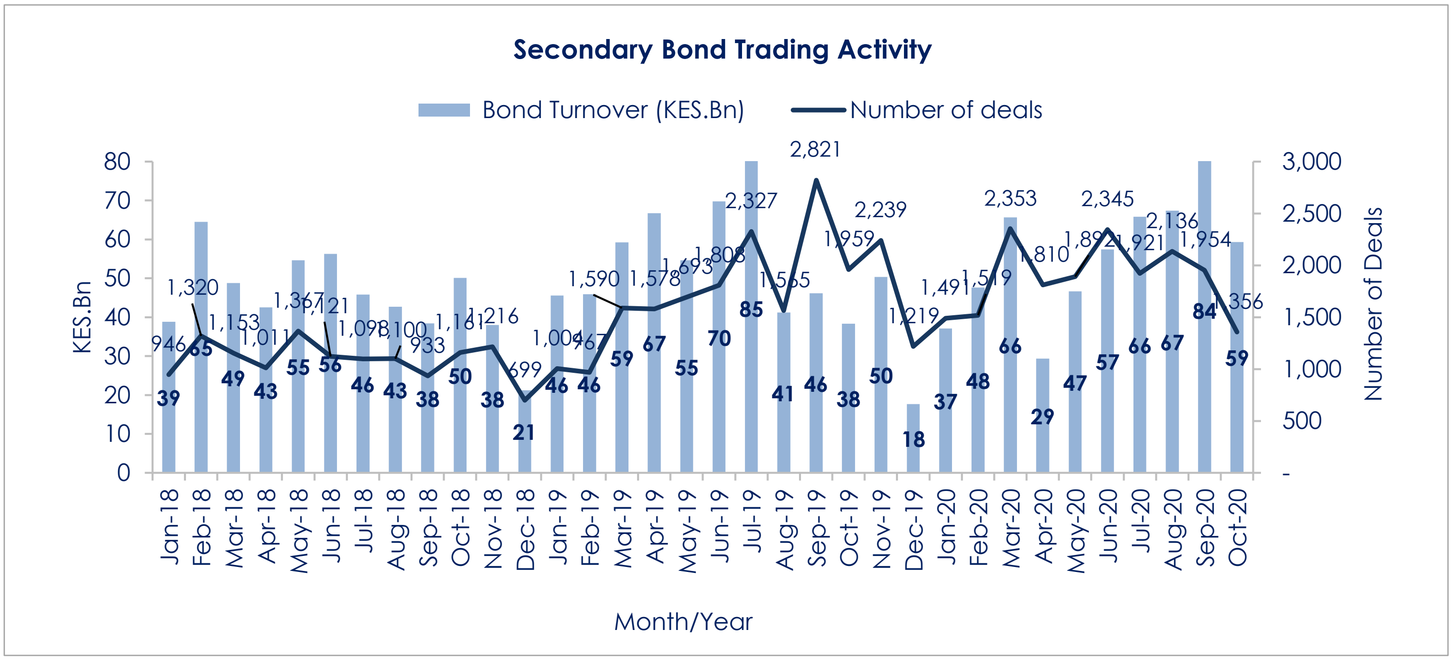


Source: Central Bank of Kenya

Secondary market trading activity set to remain subdued in November 2020

- Secondary bond trading turnover fell 29% in October 2020 to KES.59.3Bn from KES.83.5Bn in September while the number of deals recorded a significant drop (30.6%) to 1,356 (Figure.7).
- We attribute this to increased investor participation in the primary bond market.
- We expect trading to remain subdued in November as a result of lower market liquidity.

Figure.7: Secondary trading activity declines in October



Source: Central Bank of Kenya

Trading ideas - Take trading positions in the IFBs

Take trading positions in the IFBs due to higher price appreciation

- In reference to the poor performance of the NSE's equities market, we recommend investment in Government securities, specifically the Infrastructure Bonds (IFB) on the basis of lower risk and favourable return.
- IFBs offer higher price appreciation potential hence presenting better capital gain opportunities.
- **We single out IFB1/2020/6, IFB1/2020/9 and IFB1/2020/11 as offering a good investment opportunity** (Table.5.)

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
IFB1/2020/06	5.56	10.20	3.99	9.85	9.61
IFB1/2020/09	8.42	10.85	5.40	10.45	10.55
IFB1/2020/11	10.79	10.90	6.11	10.80	10.58

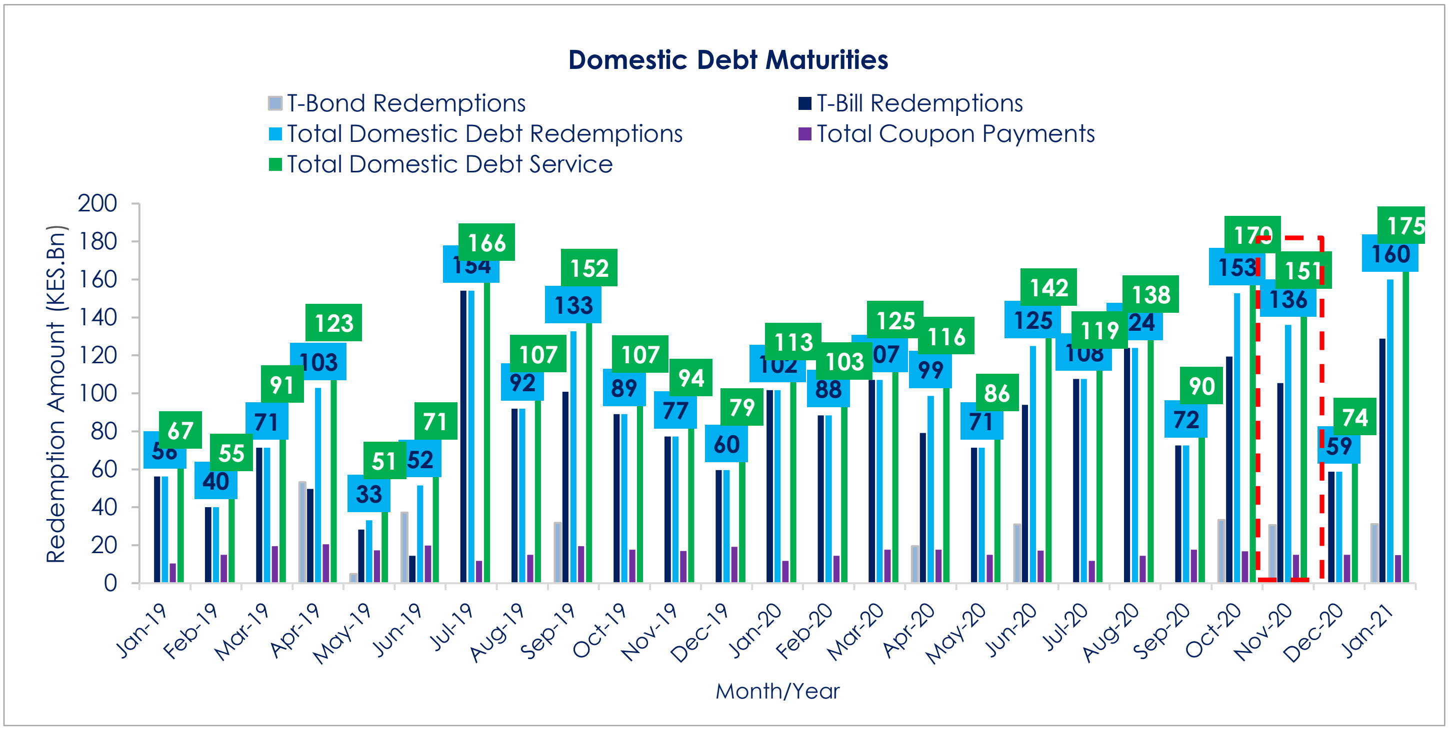
Source: Nairobi Securities Exchange & Sterling Research

*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

Domestic debt service at KES.151Bn in November

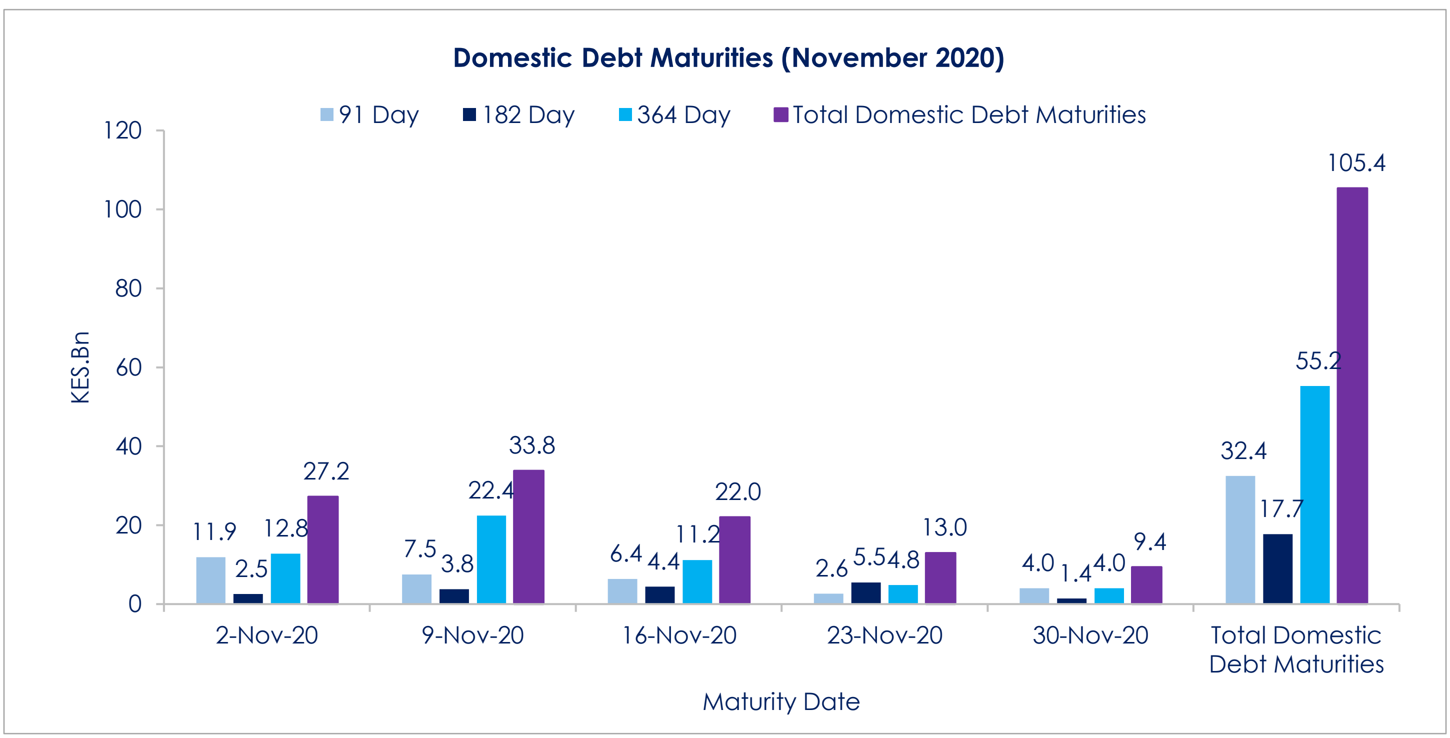
- Total domestic debt service for November 2020 is KES.151Bn, a 11% decline from KES.169.6Bn in October (Figure.8).
- T-Bond redemptions for the month will be KES.30.7Bn with T-Bill and coupon payments at KES.105.4Bn and KES.14.9Bn respectively.
- Redemptions for the 91, 182 and 364-day T-Bills includes KES.32.4Bn, KES.17.7Bn and KES.55.2Bn respectively.
- The first (KES.27.2Bn) and the second week (KES.33.8Bn) of November will have the highest debt redemptions (Figure.9).
- Total redemptions will decline significantly to KES.73.6Bn (-51.2%) in December to KES.73.6Bn with no bond redemptions, KES.58.7Bn and KES.14.9Bn in T-Bills and coupon payments respectively.
- A significant portion of funds raised in November will be directed towards redemptions rather than new borrowing to fund the fiscal budget.
- December will have the lowest domestic debt service in 2020, an indication that most funds raised during the month will to Bn (budget financing rather than debt service.

Figure.8: November 2020 debt service KES.151Bn



Source: Central Bank of Kenya

Figure.9: November 2020 Weekly debt maturities



Source: Central Bank of Kenya

Revision to domestic borrowing receipts target in August 2020

- Domestic borrowing in the first quarter of the 2020/21 fiscal year (July-September 2020) is on course with the fiscal year target (Table.6).
- According to the data, KES.200.1Bn had been borrowed at the end of September equivalent to 25.4% of the KES.786.6Bn target.
- Tax revenue at KES.317.7Bn (20.3% of total fiscal year target) however falls short of our 1st quarter linear run rate estimate of KES.391.9Bn.
- This is a direct result of subdued economic activity caused by the COVID-19 pandemic.
- We therefore expect an upward revision to both domestic and external borrowing targets in the 2020/21 fiscal year supplementary budgets.

Table.6: Upward revision to domestic borrowing target

Receipts	Original Estimates (KES)	Revised Estimates (KES) 31st August	Actual Receipts (KES) 31st August	Actual Receipts (KES) 30th September	Proportion of Receipt Target (KES) 30th September
Opening Balance (1st July 2020)			48.0	48.0	-
Tax Revenue	**1,567.6**	**1,567.6**	188.1	317.7	20.2%
Non-Tax	66.1	66.1	1.7	24.9	37.7%
Domestic Borrowing	756.9	786.6	121.7	200.1	25.4%
External Loans & Grants	373.2	373.2	10.6	10.4	2.8%
Other Domestic Financing	36.8	36.9	-	0.9	2.5
Total Revenue	**2,800.7**		**322.1**	**602**	**21.3%**

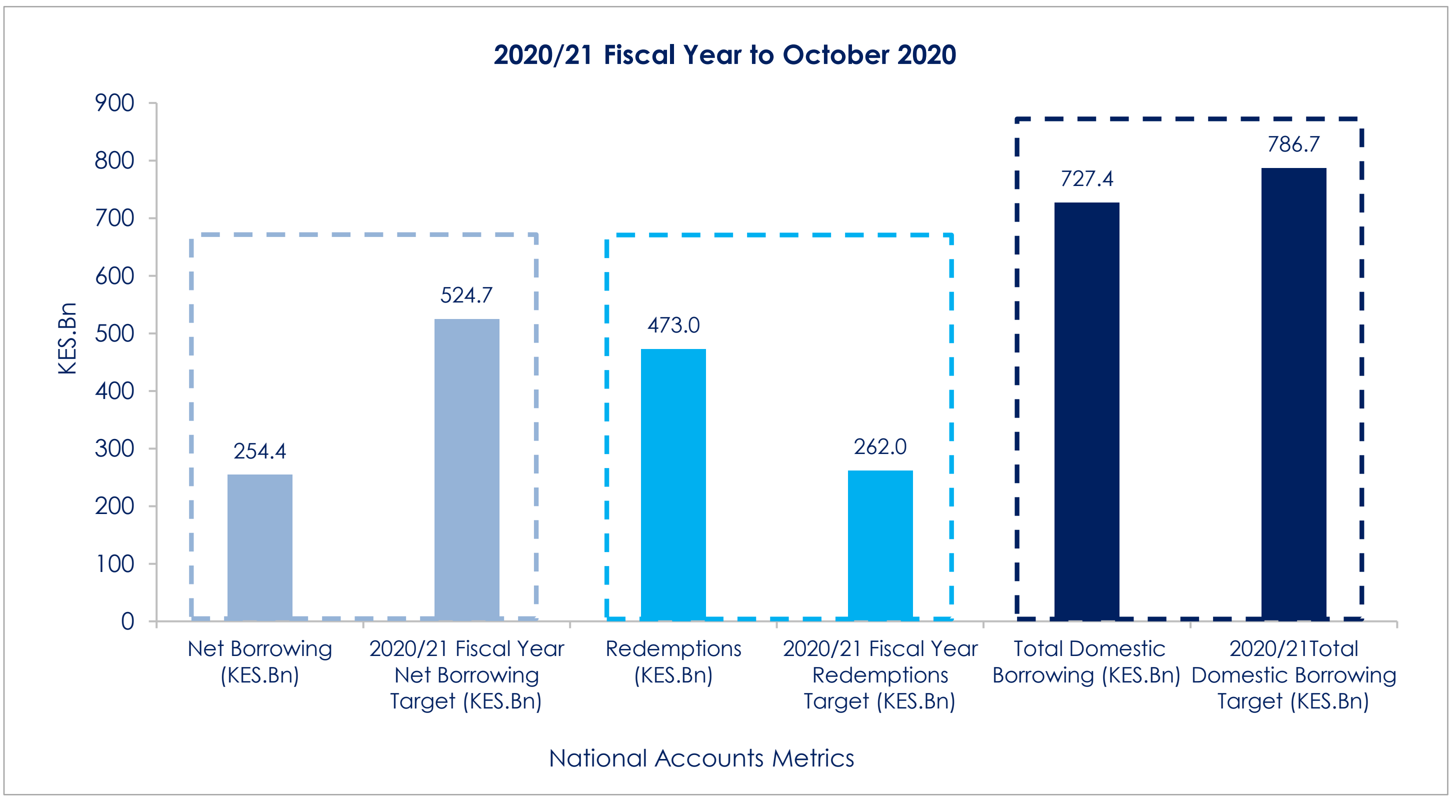
* Note 1: Domestic Borrowing of KES.786.6Bn = Net Domestic borrowing KES.524.7Bn & Internal Debt Redemptions (Roll-overs) KES.262

Source: The Kenya Gazette Vol. CXXII - No.187 16th October 2020

Net domestic borrowing declines following sharp fall in T-Bill demand

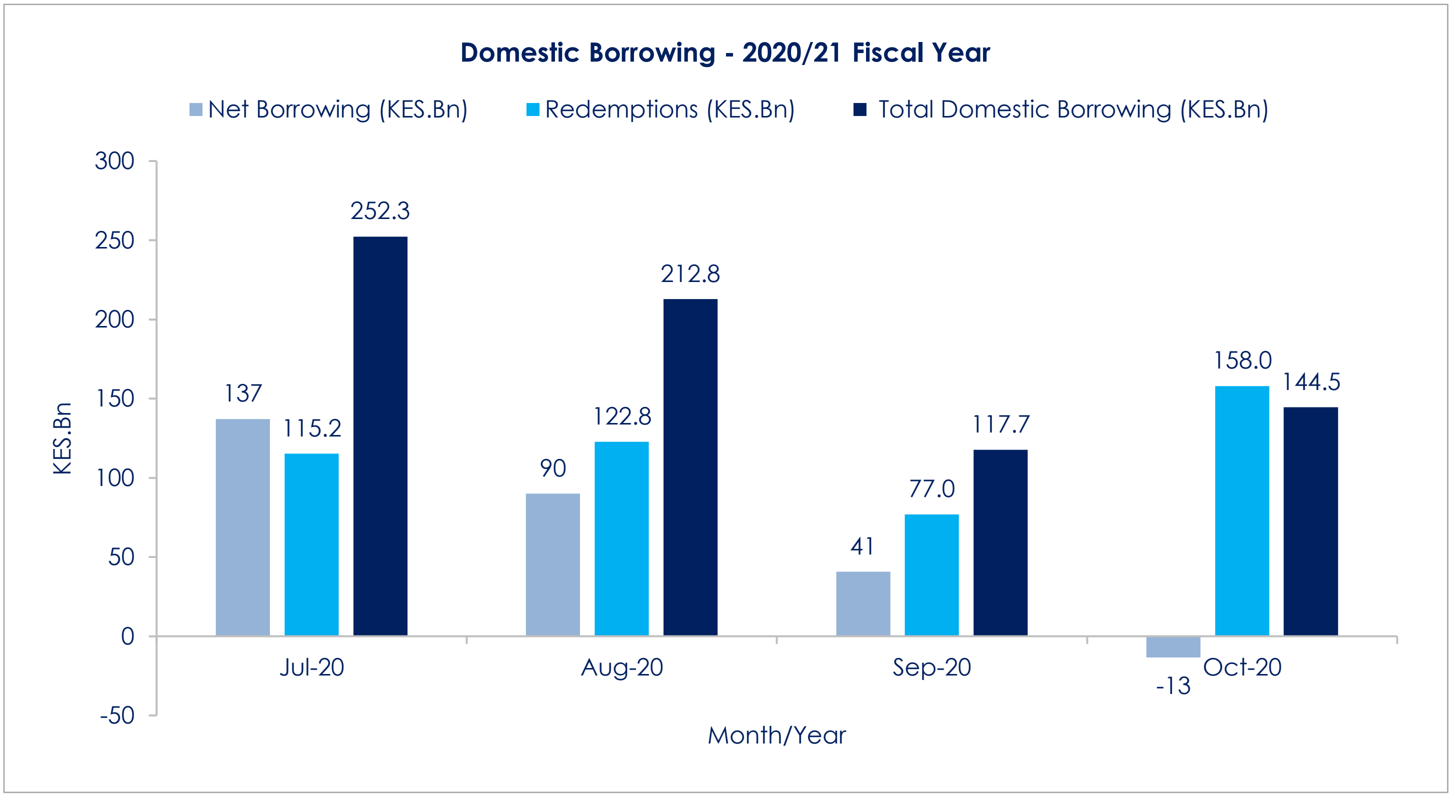
- The CBK has so far borrowed aggressively with total domestic borrowing (T-Bills and T-Bonds) for the period July to September 2020 at KES.727.4Bn according to our computation of data provided by the CBK (Figure.10).
- This comprises of KES.254.4Bn in net borrowing and KES.473Bn in redemptions.
- We attribute the decline in net borrowing level to the decline in T-Bill demand in the months of September and October as investors shifted their preference to the higher yielding T-Bonds.
- October in particular saw net borrowing deficit of KES.13.5Bn with redemptions (KES.158Bn) exceeding total domestic borrowing (KES.144,5Bn) Figure.11.
- We are concerned that a significant portion of new borrowing is being directed to debt service rather than new borrowing but expect this to decline in December as domestic debt maturity falls to around KES.74Bn from KES.170Bn and KES,151Bn in November and December.

Figure.10: Decline in T-Bill subscription over the last three months resulted in a decline in net borrowing



Source: Central Bank of Kenya

Figure.11: Net borrowing deficit in October 2020 as redemptions exceed total domestic borrowing

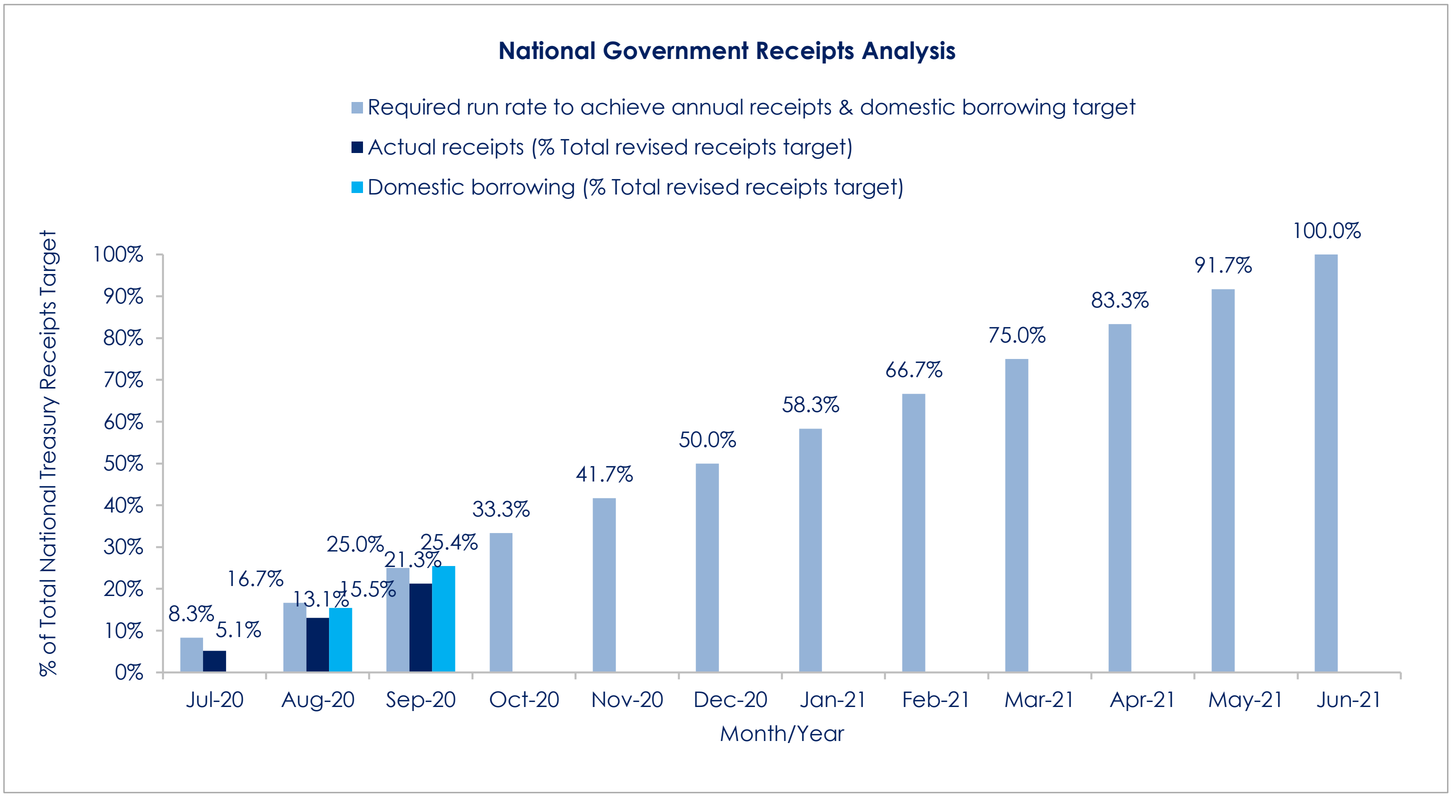


Source: Central Bank of Kenya

Government remains behind 2020/21 revised fiscal revenue target

- According to data provided by the National Treasury, the national Government remains below our linear run-rate target of 25% after Q1, with actual total receipts amounting to KES.602Bn, equivalent to 21.3% of the KES.2.8Tn target (Figure.12).
- This is in spite of it being on course with its domestic debt target – KES.200Bn or 25.4% of the 2020/21 target.
- The reason for this is largely shortfalls in tax revenue collection and as mentioned earlier, we see this as the reason for an expected upward revision in the domestic borrowing target.
- We see a high likelihood of tax revenue targets being revised downwards in the first supplementary budget as the National Treasury provides a more realistic estimate of its revenue expectations.

Figure.12: Government remains behind 2020/21 fiscal year target



Source: Central Bank of Kenya

Yield curve to steepen as short-end rates rise gradually

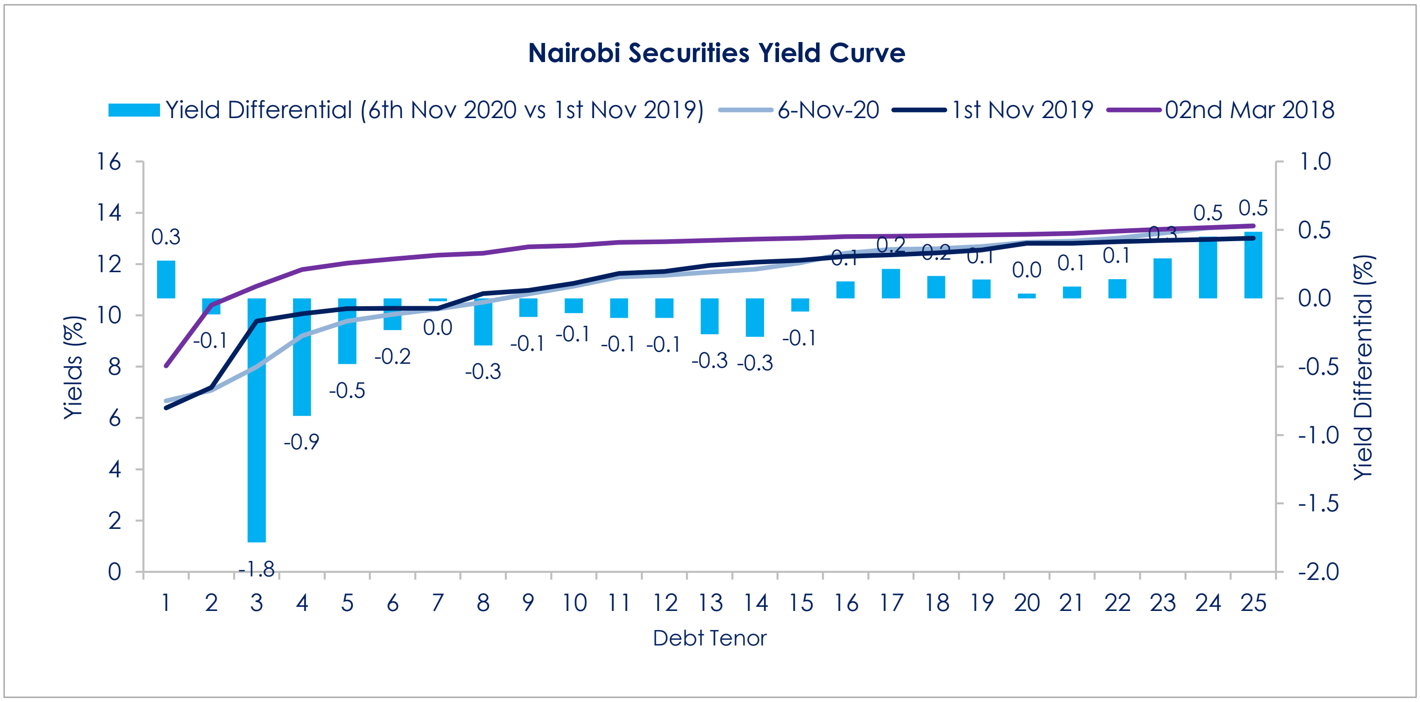
- Comparison of domestic debt yields on 6th Nov 2020 and 2nd March 2018 (when the FXD1/2018/20 was issued) shows a significant decline in yield across all tenors (Table.7 and Figure.13).
- The biggest decrease was in the short and medium-term papers.
- However, a comparison of yields year on year, 6th November 2020 and 1st November 2019 shows a dip in short term yields while yields on the long end rose.
- This is explained by high demand for short term papers due to the uncertainty over the direction of interest rates and investors unwilling to tie their capital for the long-term.
- We expect the CBK to continue issuing multiple tenors with higher acceptance rate for longer dated papers in an attempt to lengthen the debt maturity profile.
- We forecast an increase in the interest rate spread leading to a steeper yield curve, as a result we expect the market to shorten duration and dispersion of their bond holdings focusing on shorter- and medium-term maturities.
- **Our outlook supports this strategy and we recommend our investors to BUY short and medium-term bonds and HOLD long term papers.**

Table.7: Short-end of the yield curve declines significantly

Tenor	Yield (02nd March 2018)	Yield (01st Nov 2019)	Yield (06th Nov 2020)	Δ 06th Nov 2020 vs 02nd March 2018(Bps)	YOY Δ 06th Nov 2020 vs 01st Nov 2019 (Bps)	Sterling Capital yield Curve (9th Nov 2020)
1	11.1350	9.7800	7.9940	↓314.1	↓178.6	7.90
2	11.7816	10.0625	9.2033	↓257.8	↓85.9	9.40
5	12.3500	10.2750	10.2530	↓209.7	↓2.2	10.20
10	12.8742	11.7083	11.5644	↓131.0	↓14.3	11.70
15	13.0789	12.3583	12.5736	↓50.5	↑21.5	12.65
20	13.2788	12.8678	13.0074	↓27.1	↑14.0	13.00

Source: Nairobi Securities Exchange

Figure.13: Yield Curve continues to steepen



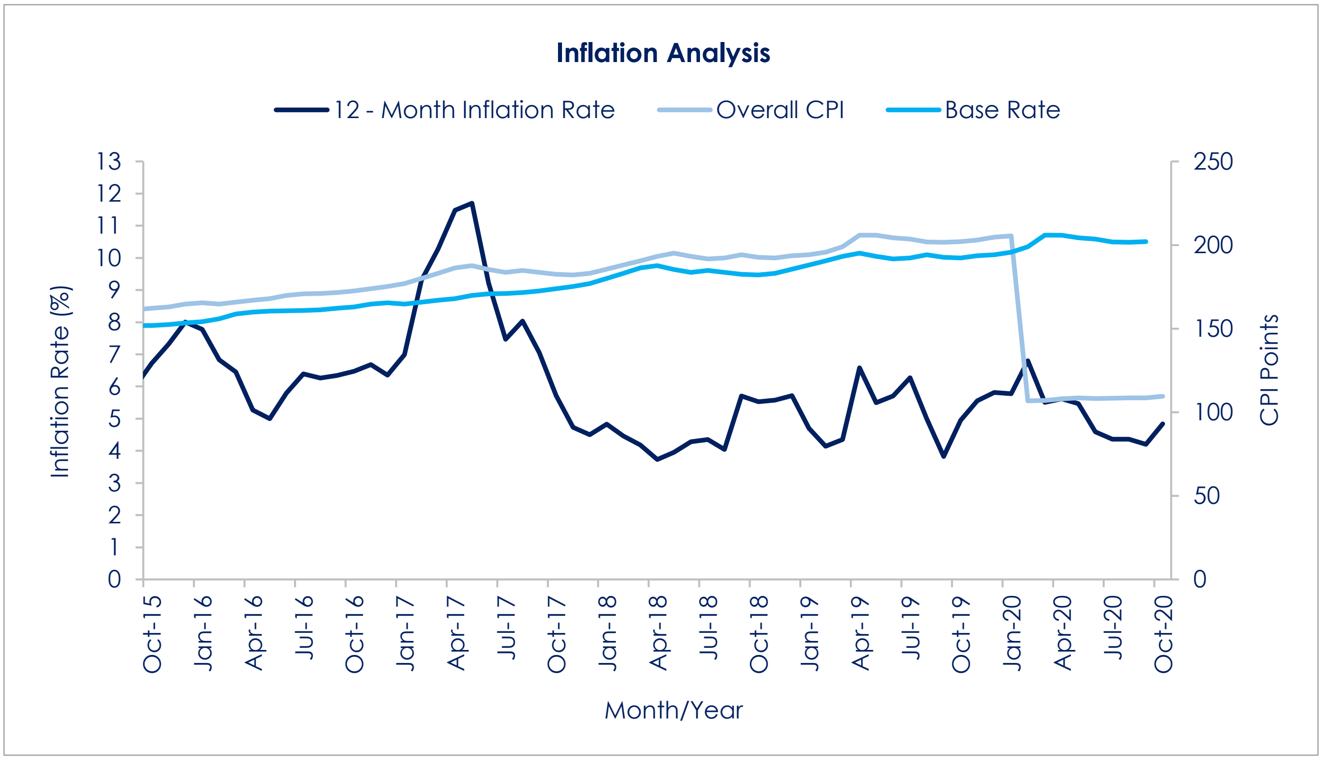
Source: Nairobi Securities Exchange

October inflation up but expected to remain stable in the short-term

Inflation to range between 4.5% and 5% in November 2020.

- Inflation for the month of October rose to 4.84% from 4.2% in September attributable to an uptick in the food, housing, water, electricity, gas and other fuels and transport indices. (Figure.14).
- Food and Non-Alcoholic Drinks' Index rose by 1.1%, as a result of increase in prices of carrots, mutton and wheat flour among other food stuffs.
- During the month Housing, Water, Electricity, Gas and Other Fuels' Index went up by 0.9% due to an increase in the cost of cooking fuels.
- The Transport Index expanded 0.6% as petrol prices rose 1.7% and diesel declined 1.7%.
- We expect demand for goods and services to remain low due to a surge in coronavirus cases that saw the president enforce stricter rules to control the spread of the virus
- We expect inflationary pressure to remain within CBK target range of 2.5%-7.5% and range between 4.5% - 5.0% in the short term.

Figure.14: Short term inflation forecast 4.5% - 5.0%



Source: Kenya National Bureau of Statistics

MPC expected to retain CBR at 7% in November meeting

- The Monetary Policy Committee (MPC) is set to meet on Thursday, 26th November 2020, 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).
- The MPC chose to retain the CBR at 7% in their last meeting in September citing that the accommodative policy stance adopted earlier in the year had been effective.
- We expect the MPC to take a wait and see approach to monitor economic developments as reported COVID-19 cases escalate.
- A policy rate cut is unlikely at this point in time and might be ineffective in increasing private sector credit due to poor asset quality.
- We therefore expect a retention of the CBR at 7%.

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