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Fixed Income Note
October 2020

"Domestic debt profile to lengthen further"

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Executive Summary

- Our fixed income report for the month of October is titled **"Domestic debt profile to lengthen further"** in reference to the re-opening of two long term debt issues: **FXD1/2011/20 (10.6 years)** and FXD**1/2018/25 (22.7 years)**.
- The CBK is looking to raise KES.50Bn through the re-opened issues for budgetary support.
- Our weighted average bid predictions are as follows:

Weighted Average Rate (WAR) of investor bids

- **FXD1/2011/20: 11.90% -12.00%**
- **FXD1/2018/25: 13.40% - 13.50%**

WAR of accepted bids

- **FXD1/2011/20: 11.75% -11.85%**
- **FXD1/2018/25: 13.20% - 13.30%**

- The report highlights both primary market auction and secondary market trading activity for September and gives our expectations of investor behaviour on both the primary auction and secondary bond trading market for the month of October and going forward.
- We also give trading recommendations for investors showing a preference for Infrastructure Bonds (IFB) on account of potential price appreciation.
- Also covered in the report is the country's national accounts which shows the Government's current revenue and expenditure position while exposing its growing fiscal deficit and borrowing needs.
- Also analysed in the report is the Nairobi securities yield curve which shows an average decline in yields of most domestic debt tenors. The report includes an analysis of the yield curve over the last six months and one year.
- We give our inflation and monetary policy expectations at the end of the report where we do not see significant deviations over the current variables.

CBK re-opens two long-term debt issues

- Central Bank of Kenya (CBK) has re-opened two long-term Treasury Bond (T-Bonds) FXD2/2011/20 (10.6 years) and FXD1/2018/25 (22.7 years), seeking to raise KES.50Bn.
- Once again we see this as a deliberate strategy by the CBK to lengthen the maturity profile of domestic debt further.
- We take note of changes in the composition and Average Term to Maturity (ATM) of total public and domestic debt over the last year.
- The proportion of T-Bonds in total domestic debt has increased to 71.8% as at 25th September 2020 compared to 64.5% in September 2019.
- The ATM for total public debt according to the Kenya Medium-Term Debt Management Strategy (MTDMS) 2020 released in February 2020 is 8.8 years compared to 8.7 years at the end of December 2019.
- The ATM of domestic debt is 5.8 years compared to 5.7 at the end of 2019.
- We attribute the increase in the ATMs to increased issuance of long-term bonds in the current fiscal year.
- While the differences might not appear as significant, these increases point to reduced re-financing risks a positive trend in the face of rising indebtedness.

Table.1: Primary Bond issue summary

Issue Number	FXD1/2011/20 (Re-opened)	FXD1/2018/25 (Re-opened)
Total Amount Offered	KES.50Bn	
Tenor (Years)	10.6 Years	22.7 Years
Coupon Rate (%)	10.0	13.40
Issue Price	Discounted/Premium/Par	Discounted/Premium/Par
Period of Sale	28th September 2020– 13th October 2020	
Auction Date	14th October 2020	
Value Date	19th October 2020	
Yield Curve (%) (Weighted Average tenor - 10.6 Years, and 22.7Yrs) 02nd October , 2020	**11.67**	**12.97**

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 2nd October 2020, as well as discussions with our fixed income trading team (Table.2).
- We anticipate an oversubscription of the two re-opened bonds at 120% (KES.60Bn), attributable to significantly higher yields in long term papers compared to short term bonds.

Table.2: Auction bid predictions

Rate	FXD1/2011/20	FXD1/2018/25
Market Weighted Average Rate (%)	12.00	13.50
Weighted Average Rate of Accepted Bids (%)	11.85	13.30

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 2nd October 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
20-Year						
FXD1/2012/20	26th Nov 2012	12.00	1st Nov 2032	12.12 (4,413)	12.0500	N/A
25-Year						
FXD1/2010/25	28th June 2010	11.250	28th May 2035	14.78 (5,379)	12.3872	N/A

Source: Nairobi Securities Exchange & Sterling Capital

Comparatively higher yields for longer dated debt likely to drive subscription

- Investors have in recent months shown a growing prefence for longer tenor bonds in a bid to yield higher investment returns.
- This, coupled with limited low risk investment options is likely to result in high subscription levels for the re-opened bonds.

Table.4: Historical primary market auction performance

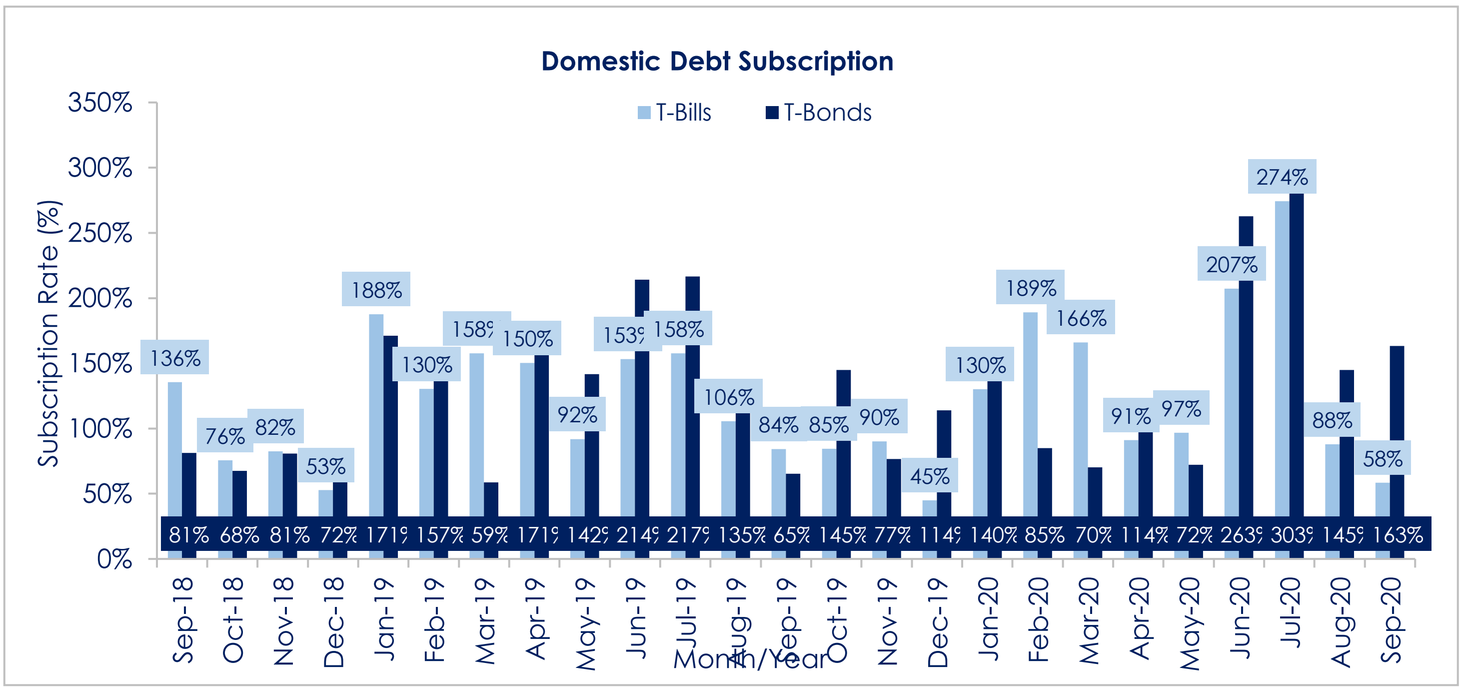
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
20-Year						
FXD1/2018/20	40	13.74	8.49	34.34	13.20	12.6090
FXD2/2018/20	40	13.86	10.51	34.65	13.20	12.6560
FXD1/2019/20	50	14.67	14.67	29.34	12.87	12.7851
25-Year						
FXD1/2010/25	7.5	27.07	7.5	360.96	11.25	12.3872
FXD1/2018/25	40	10.13	5.17	25.33	13.400	12.9799

Source: Nairobi Securities Exchange & Sterling Capital

High demand for the 91-Day T-Bill and long-term T-Bonds to continue

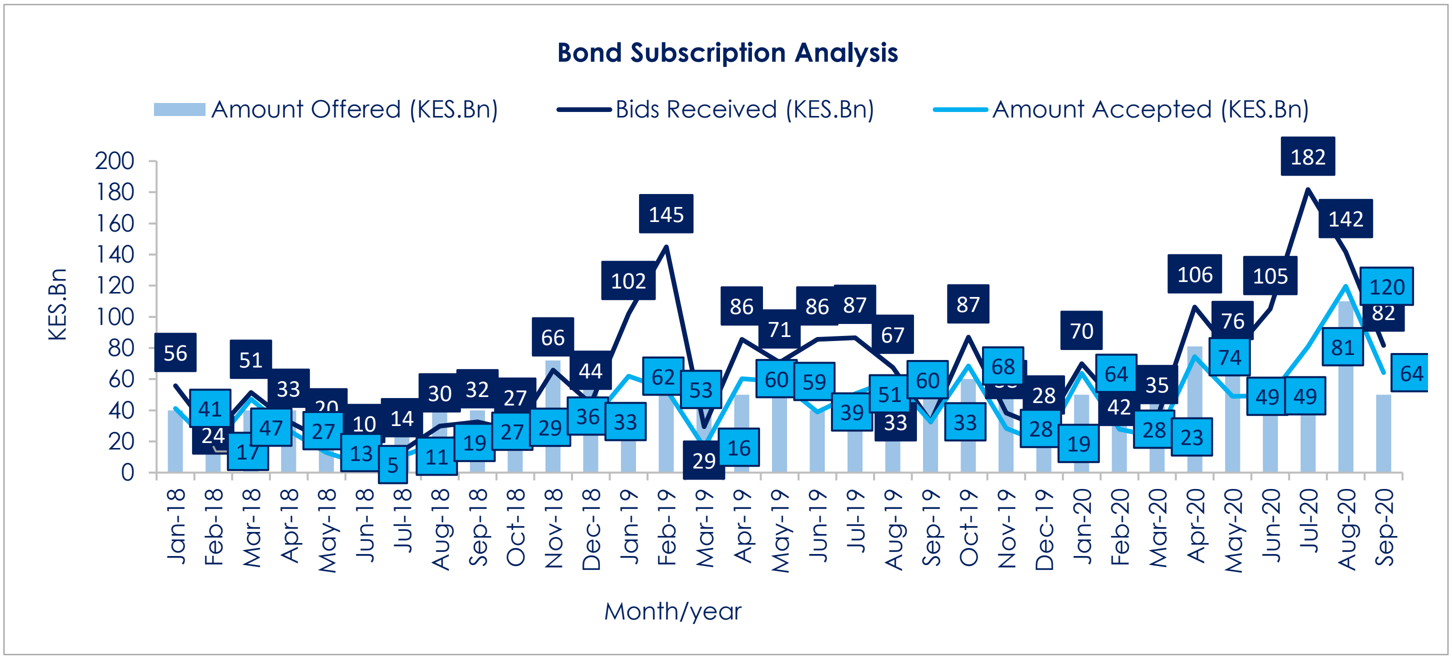
- The CBK offered KES.96Bn in T-Bills in the month of September receiving KES.56.1Bn in subscriptions equivalent to a 58% subscription rate (Figure.1).
- We attribute this to investors directing their capital to higher yielding bonds.
- The 91-day (107%) remained the most popular debt issue during the month due to the expected gradual increase in short-term debt interest rates
- Bids worth KES.81.7Bn (163% subscription rate) were received for the three re-opened bonds auctioned in September (FXD2/2010/15(5.3 years), FXD1/2011/20 (10.7 years) and FXD1/2020/15 (14.5 years) (Figure.1 and Figure.2).
- Acceptance rates for the papers was however relatively high at 96.9%, 94.9% and 93.0% respectively showing the urgent financing needs of Government (Figure.3).
- 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: T-Bill subscriptions decline further



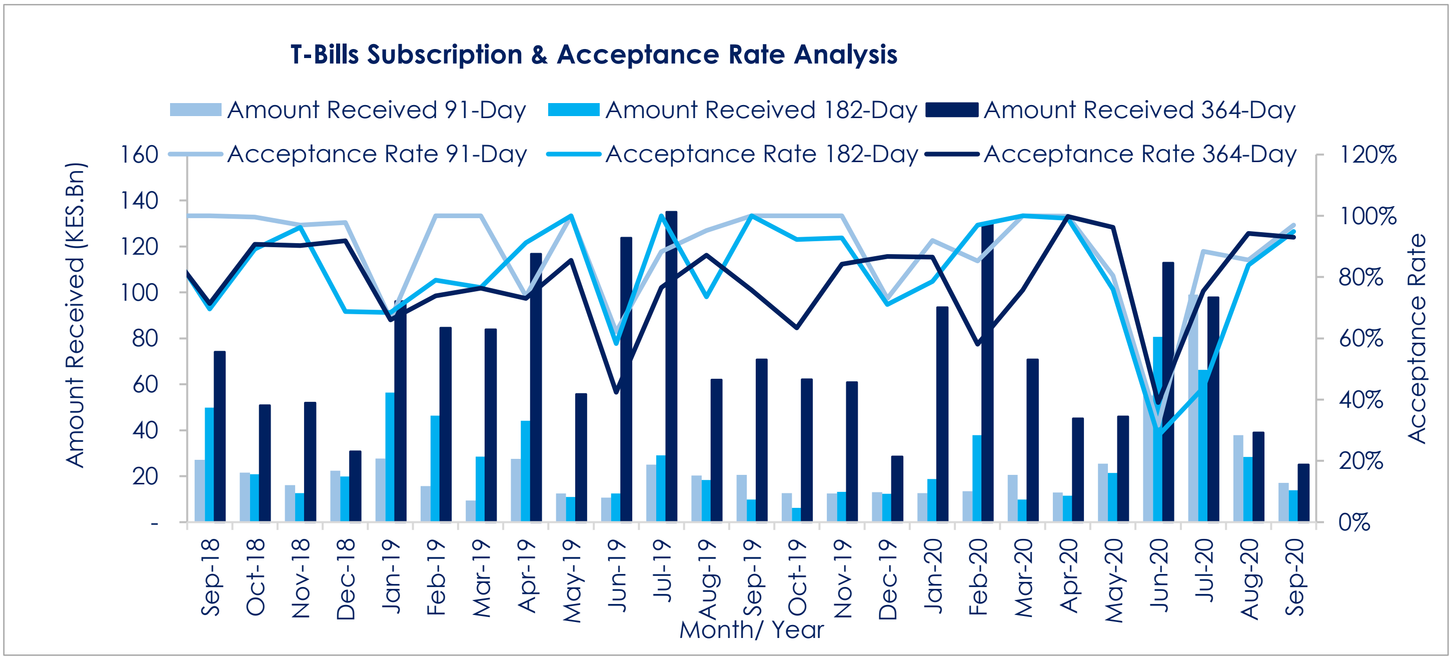
Source: Central Bank of Kenya

Figure.2: Bids received decline steadily



Source: Central Bank of Kenya

Figure.3: Acceptance rate for the 364-day T-Bill declines

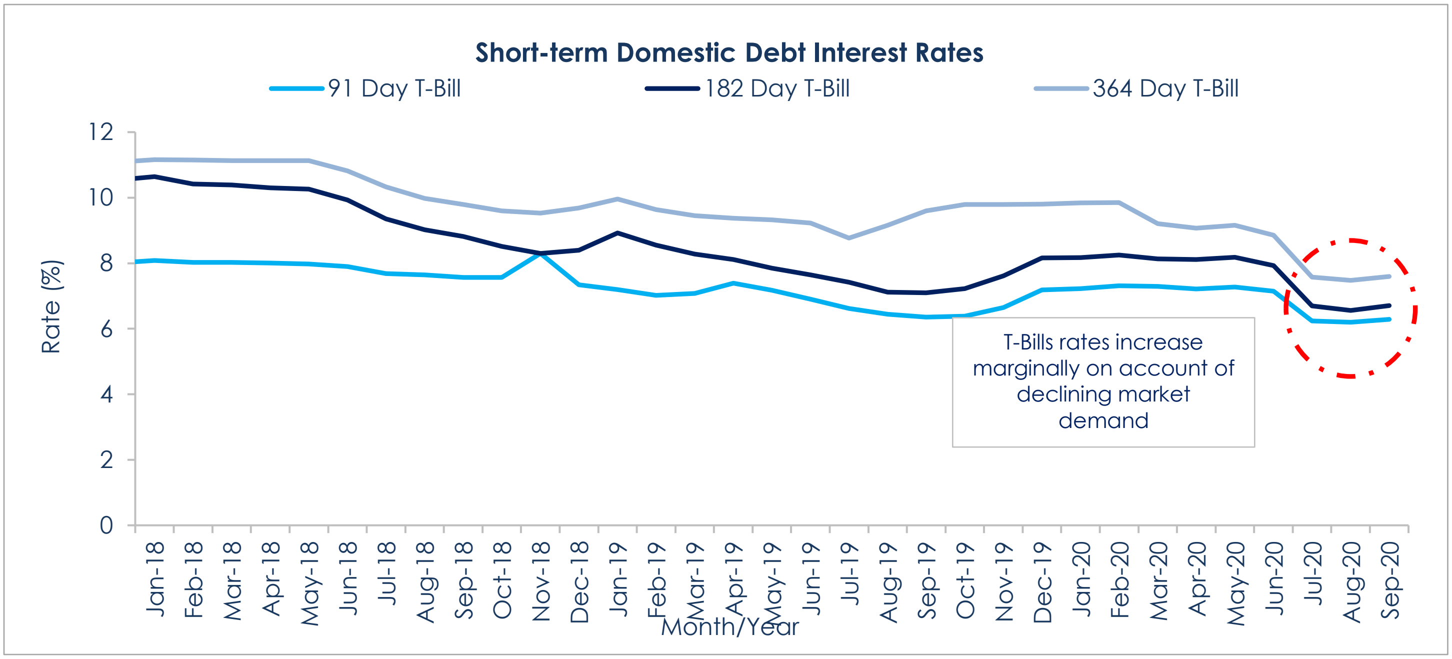


Source: Central Bank of Kenya

Average T-Bill rates rise marginally in September

- Average T-Bill yields rose marginally in September with the 91, 182 and 364 day papers recording a rise of 9bps, 14bps and 12bps to 6.3%, 6.7% and 7.6% respectively (Figure.4).
- The short-term debt instruments have been undersubscribed for the last eight weeks to the week ending 2nd October, 2020 with investors looking at the bond market for higher returns.
- We anticipate a gradual rise in interest rate rates in upcoming auctions as the CBK looks to entice investors.

Figure.4: Interest rates edge upwards as liquidity declines

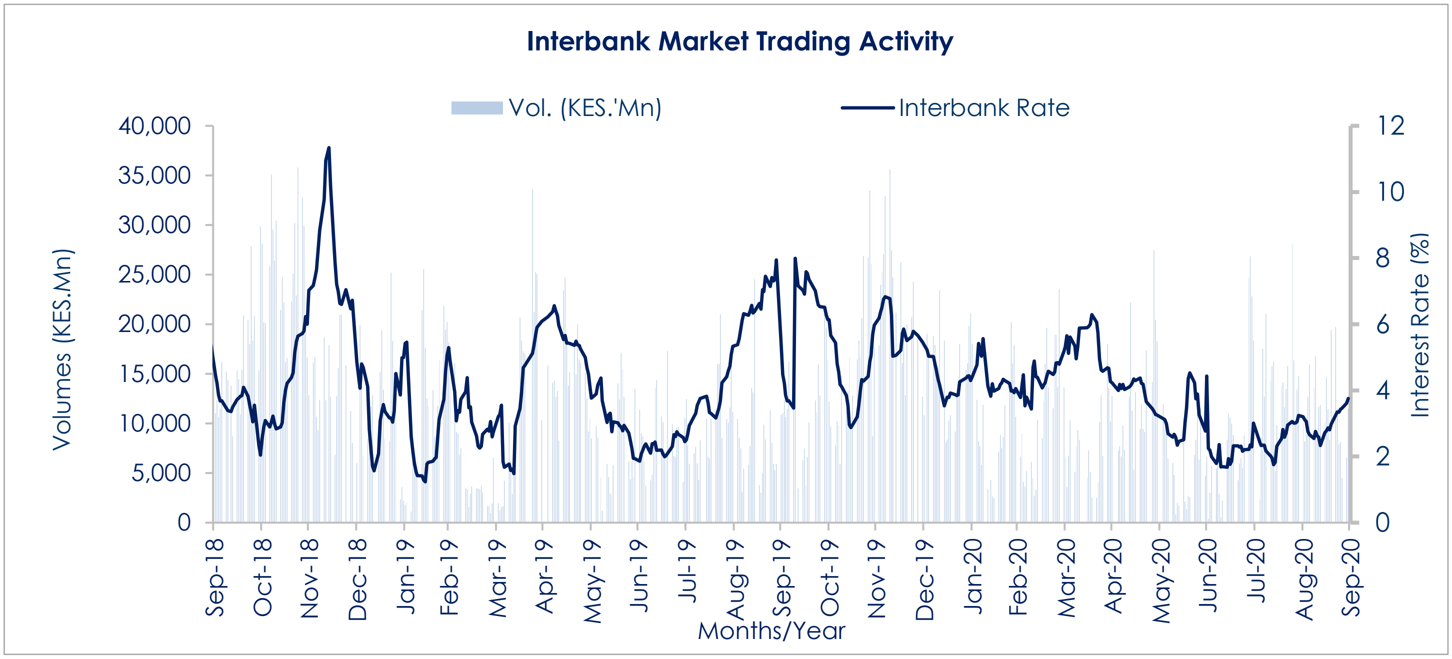


Source: Central Bank of Kenya

Government payments driving commercial bank liquidity

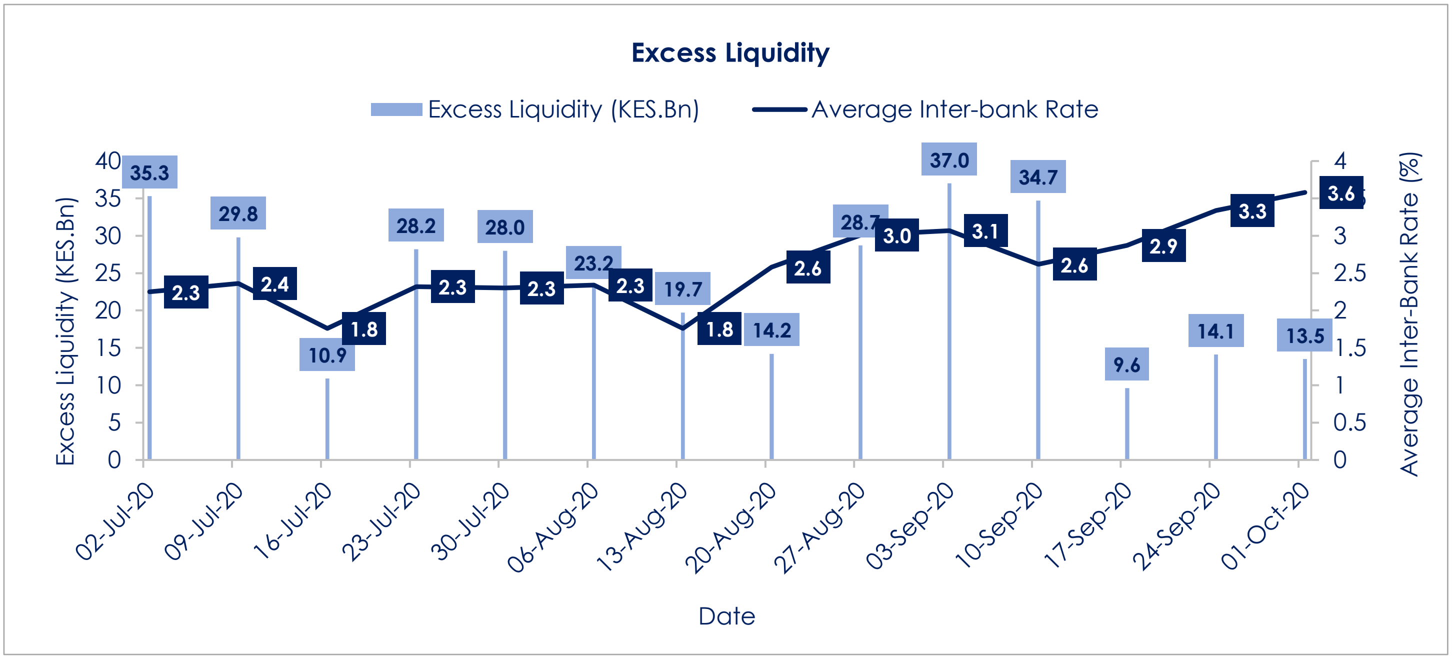
- Average weighted inter-bank lending rose to 3% in September compared to 2.6% in August with total volumes traded declining 11.1% to KES.253.6Bn from KES.285.3Bn in August (Figure.5).
- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) rose 11.2% from KES.85.8Bn to KES.95.4Bn in September supported by government payments (Figure.6).
- We expect average inter-bank rates to remain between 3% and 3.5% in October attributable to comparatively lower market liquidity.

Figure.5: Inter-bank rates expected to rise



Source: Central Bank of Kenya

Figure.6: Commercial excess reserves lower in September

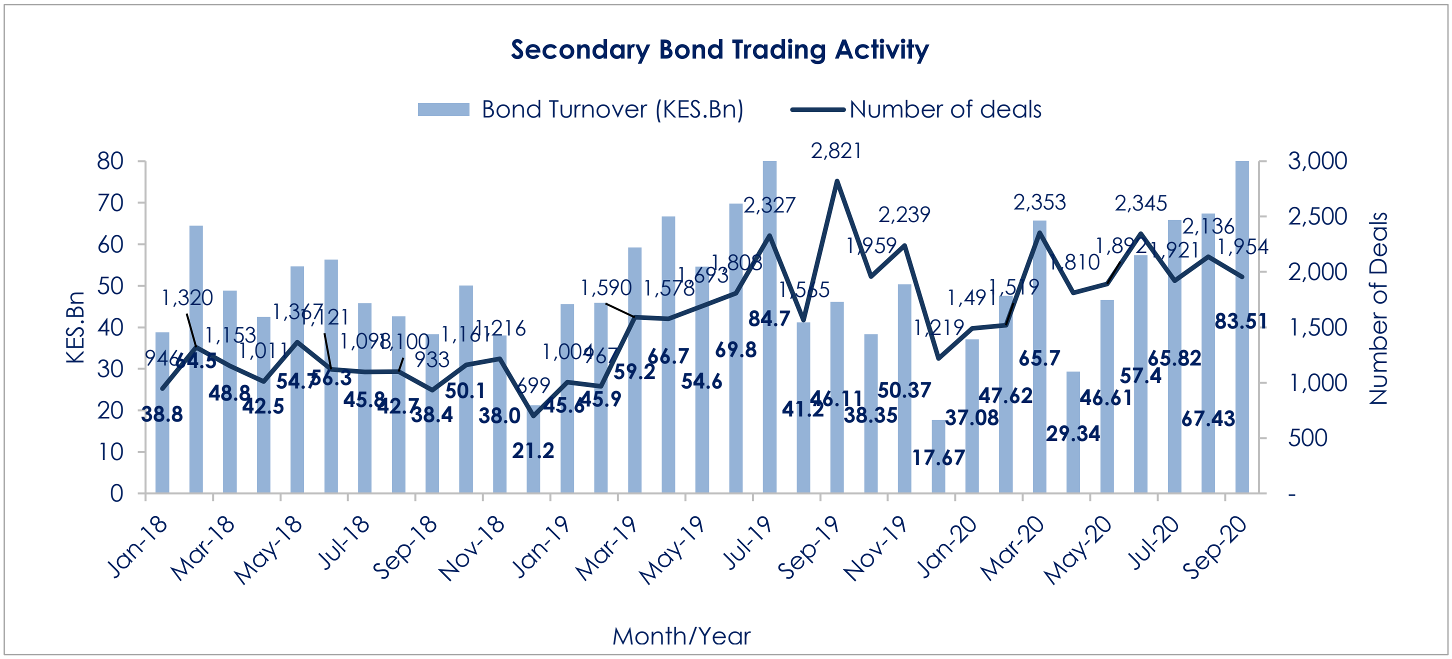


Source: Central Bank of Kenya

Secondary market trading activity set to remain high in October 2020

- Secondary bond trading turnover rose 23.8% in September 2020 to KES.83.5Bn from KES.67.4Bn in August while the number of deals declined 8.5% to 1,954 (Figure.7).
- This can be attributed to higher trading turnover per deal and increased investor interest particularly on Infrastructure Bonds (IFB bonds) which have high capital appreciation.
- We expect trading to remain high in October on account of the Infrastructure safety offered by Government debt and the expectation of positive real returns over a 12-month period.

Figure.7: Secondary trading activity increases for the 5th month running



Source: Central Bank of Kenya

Trading ideas – Take positions in the IFBs

Take positions in the IFBs due to higher price appreciation

- In reference to the poor performance of the equities market and subdued trading activity, we recommend Government securities as a good investment option on the basis of low risk and favourable return.
- **Our investment recommendation is to invest in IFBs due to comparatively higher price appreciation 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	5.65	10.20	4.07	10.00	9.77
IFB1/2020/09	8.52	10.85	5.48	10.60	10.18
IFB1/2020/11	10.88	10.90	6.17	11.00	10.77

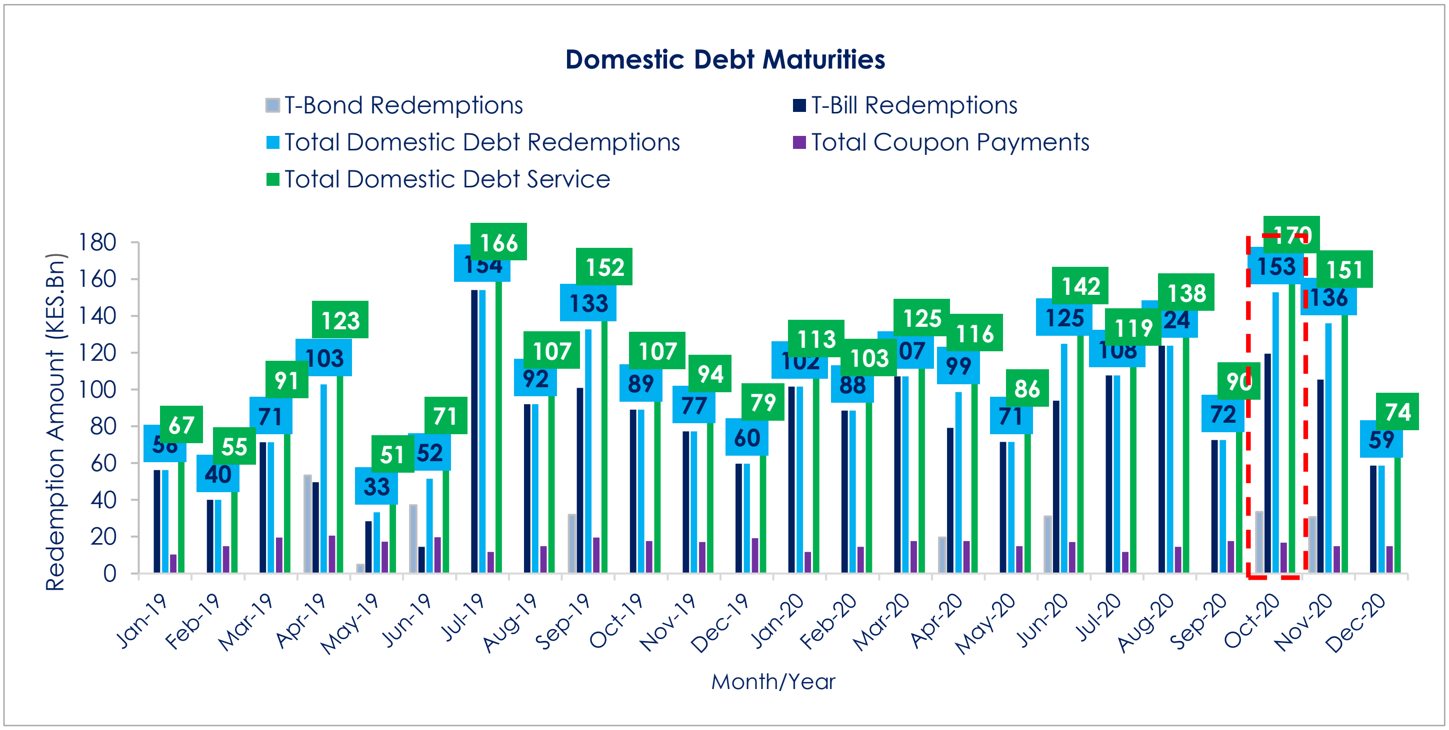
Source: Nairobi Securities Exchange & Sterling Research

*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

Highest domestic debt service in FY2020 at KES.170Bn in October

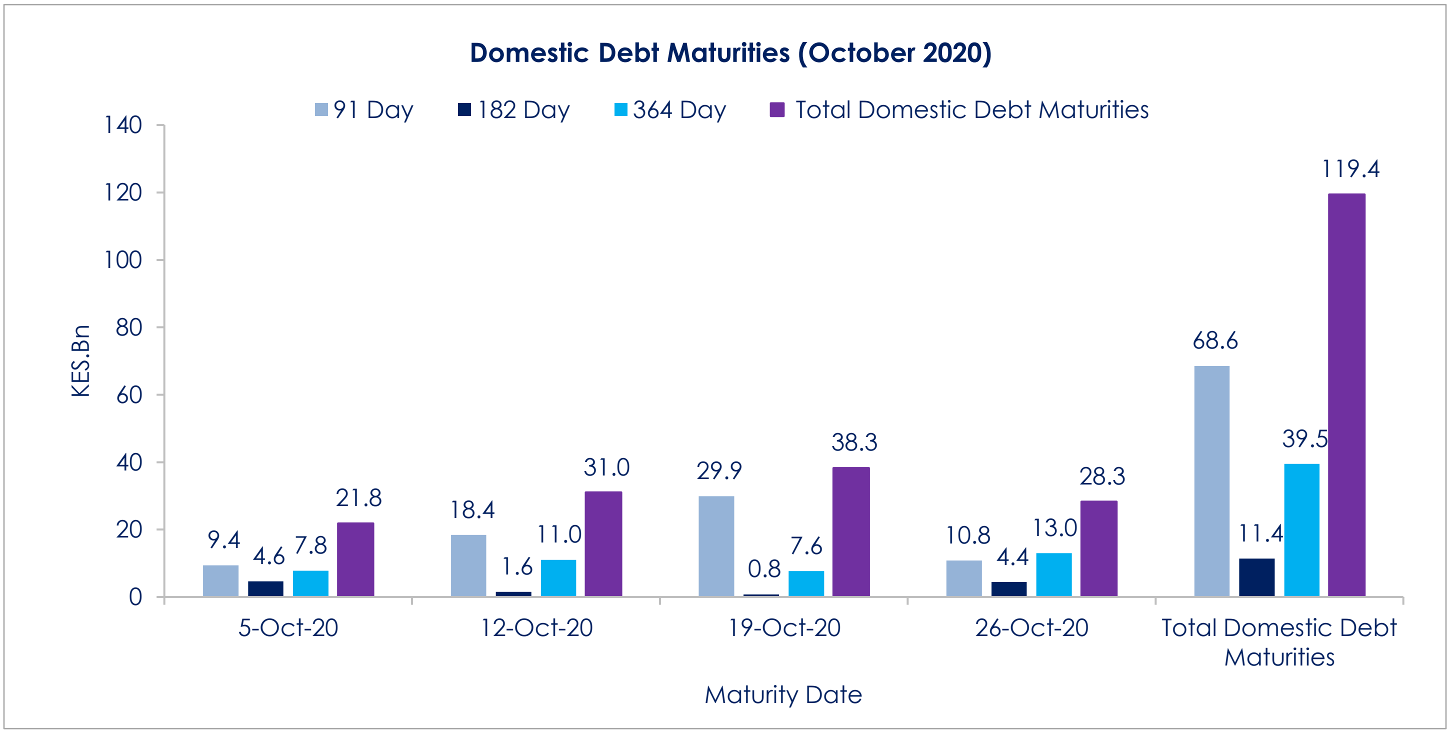
- Total domestic debt service for the month of October is the highest this calendar year at KES.169.6Bn, an 88.2% increase from debt service in September (Figure.8).
- T-Bond redemptions for the month stands at KES.33.4Bn with T-Bill and coupon payments at KES.119.4Bn and KES.16.8Bn respectively.
- Redemptions for the 91, 182 and 364-day T-Bills includes KES.68.6Bn, KES.11.4Bn and KES.39.5Bn respectively.
- The second (KES.31Bn) and the third (KES.38.3Bn) of October show the highest debt redemptions.
- Total redemptions will are expected to decline 11% in November to KES.151Bn with KES.30.7Bn, KES.105.4Bn and KES.14.9Bn in T-Bonds, T-Bills and coupon payments respectively.
- High domestic debt maturities in October and November implies that a significant portion of funds raised in both these months will be directed towards redemptions rather than new borrowing.
- In addition, the high redemptions and declining market liquidity could result in the CBK accommodating higher investor bids in domestic debt auctions.

Figure.8: October 2020 debt service KES.170Bn



Source: Central Bank of Kenya

Figure.9: October 2020 Weekly debt maturities



Source: Central Bank of Kenya

Revision to domestic borrowing receipts target in August 2020

- We notice a KES.30Bn upward revision in the domestic borrowing target as at the end of August (KES.786.6Bn) compared to the previous month (KES.756.9Bn) (Table.6).
- This we see as evidence of the revenue collection constraints faced by the Government amid the Covid-19 pandemic that negatively impacted economic activity and particularly tax revenue collection.

Table.6: Upward revision to domestic borrowing target

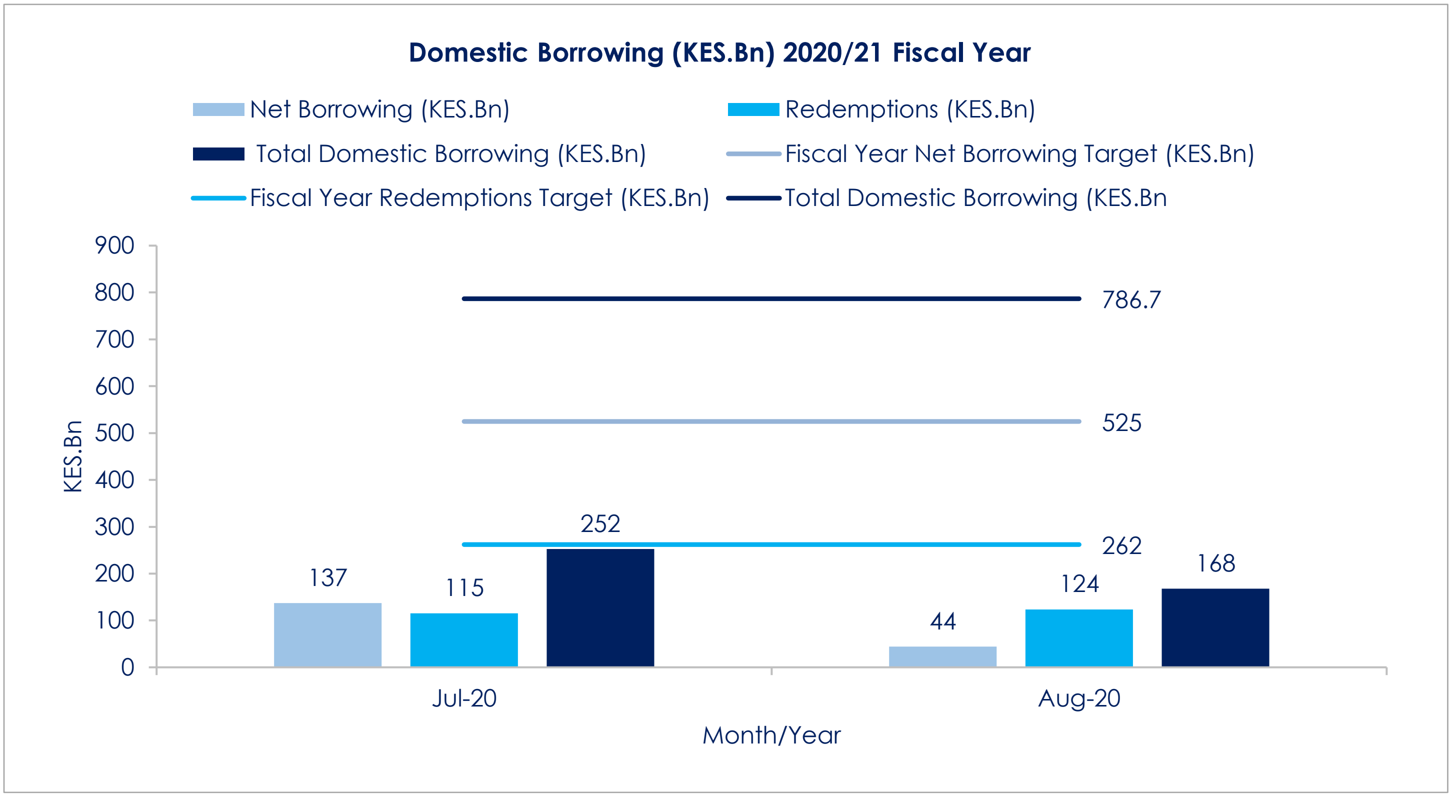
Receipts	Original Estimates (KES)	Actual Receipts (KES) 31st July 2020	Revised Estimates (KES) 31st August	Actual Receipts (KES) 31st August	Proportion of Receipt Target (KES) 31st August
Opening Balance (1st July 2020)		48.0	48.0		-
Tax Revenue	**1,567.6**	**94.5**	**1,567.6**	188.1	12%
Non-Tax	66.1	1.4	66.1	1.7	2.6%
Domestic Borrowing	756.9	-	786.6	121.7	15.5%
External Loans & Grants	373.2	-	373.2	10.6	2.8%
Other Domestic Financing	36.8	-	36.9	-	-
Total Revenue	**2,800.7**	**144**		**322.1**	**11.4%**

* Note 1: Domestic Borrowing of KES.786.6Bn = Net Domestic borrowing KES.524.7Bn & Internal

Source: The Kenya Gazette Vol. CXXII - No.169 18th September 2020

- We notice differences in the domestic debt data provided by the National Treasury in the Kenya Gazette Vol. CXXII - No.169 18th September 2020 which puts actual cumulative net domestic borrowing at the end of August 2020 (inclusive of redemptions/roll-overs) at KES.121.7Bn while data provided by the CBK shows actual total domestic borrowing at KES.420.3Bn (KES.181.3Bn in net borrowing and KES.239Bn in redemptions) Figure.10

Figure.10: Kenya Public Debt 2019/20 estimate KES.6.6Tn, 63.1% of GDP



Source: Central Bank of Kenya & National Treasury

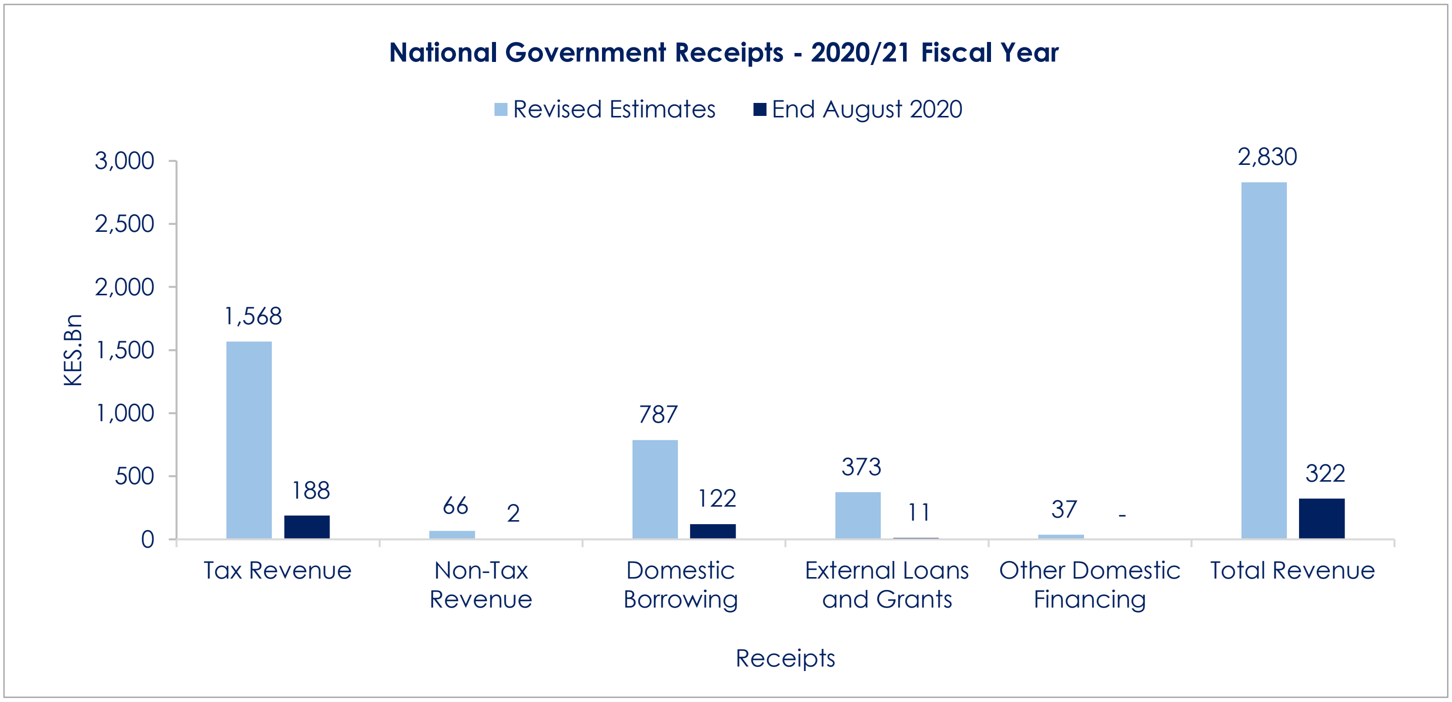
BROP shows revisions in revenue and borrowing estimates

Net domestic borrowing estimate revised to KES.55Bn in the budget review (KES.494Bn in 2020/21 fiscal budget)

- The 2020 Budget Review and Outlook Paper (BROP) released on 9th September 2020 shows some revisions to the fiscal budget revenue and borrowing estimates (Figure.11).
- All revenue estimates including total revenues, tax and non-tax revenues which are estimated to decline 5.9%, 6% and 16% respectively.
- We see as a prudent move by the National Treasury in realization that subdued economic activity (which has affected disposable incomes and consumption) will have a major impact on its revenues and this will also impact its deficit financing.
- The decline in tax revenue is also attributable to income tax cuts such as revision of Value Added Tax (VAT) from 16% to 14% and income tax from 30% to 25% or no tax for lower income.
- Government expenditure however, does not change in line with the Government's strategy to manage its expenses.
- This however, still means that budget deficit will increase from KES.898Bn and cross over the KES.1Tn mark for the first time in history.
- Net foreign and domestic borrowing financing estimates increased 14.4% and 12.3% to KES.397Bn and KES.555 respectively.

- This essentially means that investors should expect an increase in debt issuance during the fiscal year.
- In addition, we might see the CBK being more accommodative of aggressive investor bids should they see the need for additional deficit financing especially in periods of low market liquidity.

Figure.11: Total National Government receipts now at KES.322Bn



Source: Central Bank of Kenya

Yield curve to steepen as short-end rates rise gradually

- Comparison of domestic debt yields on 2nd October 2020 and 22nd June 2018 (when the FXD1/2018/25 was issued) shows a significant dip in yields on all debt tenors (Table.7 and Figure.12).
- The biggest declines are evident in the short and medium-term papers while yields on longer dated papers have dipped marginally.
- However, a comparison of current yields (2nd October 2020) with those around the same period last year (30th September 2019) shows a significant decline in short term yields while yields on 5Yr and 20Yr have risen (Table.7 and Figure.12).
- This is attributable to high demand for short term papers due to the uncertainty over the direction of interest rates and investors unwilling to tie their capital for long period during the COVID-19 pandemic.
- We expect the Government to focus on issuance of multiple tenors with higher acceptance rate for longer dated papers in an attempt to lengthen the public debt maturity profile.
- Liquidity has dried up over the last two months but with the national

Government expected to release funds to counties we expect a slight improvement.

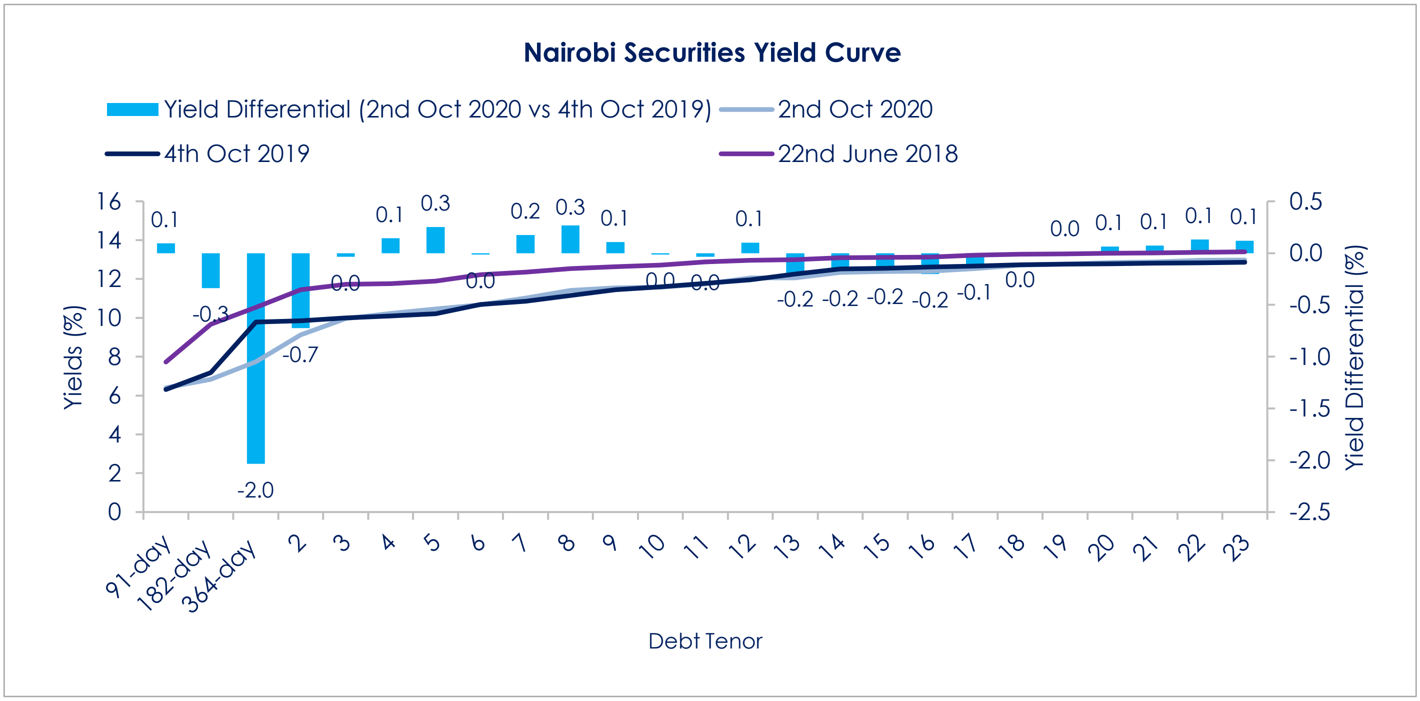
- We expect the yield curve to steepen in the coming weeks due to a gradual increase in the short-end rates.
- **Our recommendation still stands; BUY short and medium-term bonds and HOLD long term papers.**

Table.7: Short-end rates have fallen sharply over the last one year

Tenor	Yield (22nd June 2018)	Yield (30th Sep 2019)	Yield (2nd Oct 2020)	Δ 2nd Oct 2020 vs 22nd June 2020 (Bps)	YOY Δ 2nd Oct 2020 vs 30th Sep 2019 (Bps)	Sterling Capital yield Curve (6th Oct 2020)
1	10.5370	9.7770	7.7440	↓279.3	↓203.3	7.80
2	11.4491	9.8500	9.1254	↓232.4	↓72.5	9.00
5	11.8992	10.2131	10.4659	↓143.3	↑25.3	10.45
10	12.7190	11.5913	11.5781	↓114.1	↓1.3	11.75
15	13.1033	12.5583	12.3921	↓71.1	↓16.6	12.45
20	13.3209	12.7871	12.8517	↓46.9	↑6.5	12.75

Source: Nairobi Securities Exchange

Figure.12: Short end of the yield curve shows biggest shift on lower yields



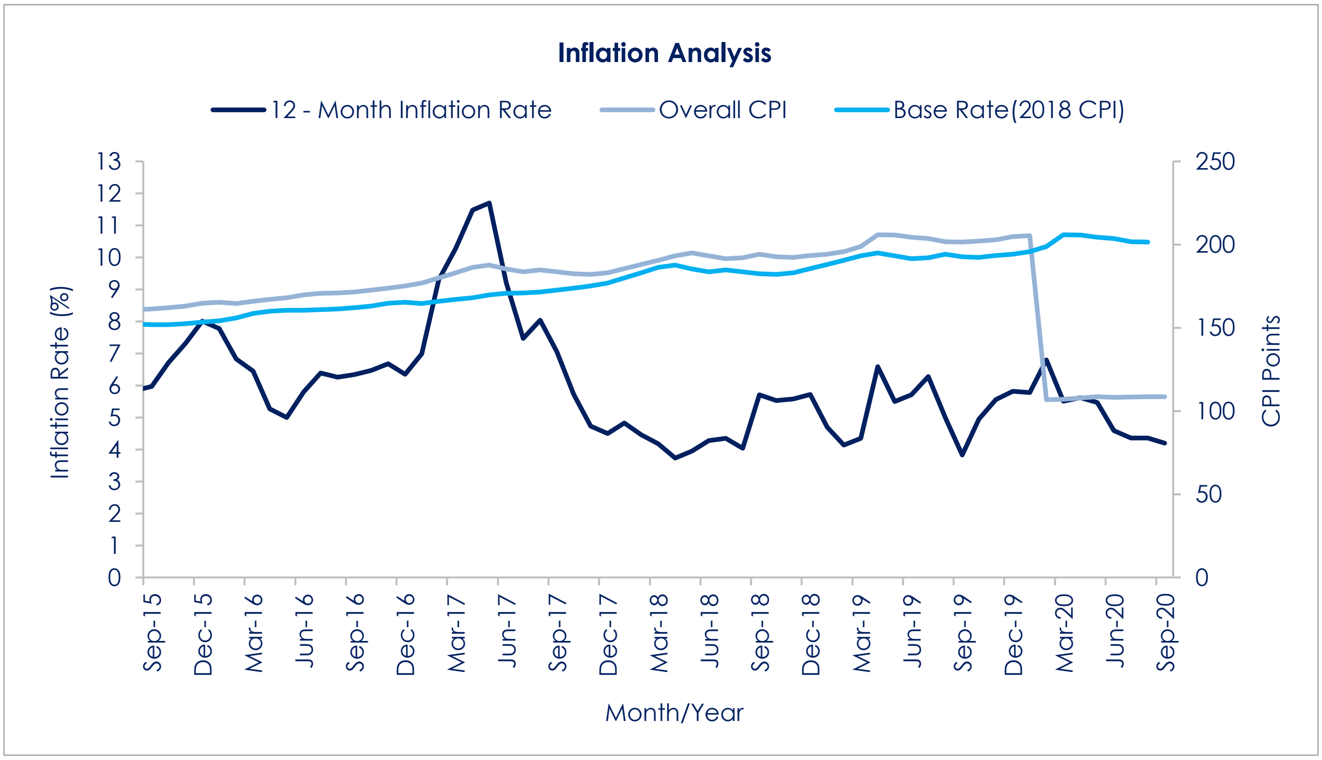
Source: Nairobi Securities Exchange

Inflation slows to 12-month low in September, expected to range between 4.2%-5.0% in the short-term

Inflation to range between 4.2% and 5.0%.

- September inflation declined marginally to 4.2% from 4.4% in August attributable to a drop in the price of vegetables, maize floor, beans, kerosene and cooking gas (Figure.13).
- Food and Non-Alcoholic Drinks' Index rose by 0.2%, as a result of increase in prices of peas, oranges, Irish potatoes and cabbages among other food stuffs.
- During the month Housing, Water, Electricity, Gas and Other Fuels' Index dropped by 0.1% mainly attributed to a drop in cost of cooking gas and kerosene, by 1.3% and 0.6% respectively. On the other hand, the price of electricity for 200 KWh, increased by 0.7%.
- The Transport Index decreased by 0.01% mainly due to a drop in the pump prices of diesel which outweighed the 1.4% increase in petrol prices.
- The ease in inflation is beneficial to investors as it enhances real returns which we expect to range between 3% - 4% over a one year horizon, based on liquidity and government borrowing patterns.
- Inflation remains well anchored within CBK target range of 2.5%-7.5% on the back of lower food prices, reduction in value-added tax and weak consumer demand.
- We expect inflationary pressure to range between 4.2% - 5.0% in the short term.

Figure.13: Short term inflation forecast 4.2% - 5.0%



Source: Kenya National Bureau of Statistics

MPC retains CBR at 7% on account of macro-economic stability

MPC to retain CBR at 7% in October meeting.

- In the last meeting on 29th September 2020, the Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 7% in line with our expectations as stated in our September 2020 fixed income report titled "CBK's three debt issues".
- The MPC has been content that previous monetary measures have been effective in managing their main macro-economic variables of inflation and foreign exchange as well as private sector credit growth.
- The committee noted that the exports of goods have remained robust despite the corona virus pandemic growing 0.8% in the period January to August compared to a similar period in 2019.
- According to the MPC, of the KES.35.2Bn released by the downward revision of the Cash Reserve Ratio (CRR) in March, KES.32.4Bn (92%) has been lent out.
- Private sector credit grew by 8.3% in the 12 months to August 2020 with strong growth in manufacturing (13.1%), transport and communications (19%), trade (8.1%) and consumer durables (13.7%).
- We expect the continued phased re-opening of the economy to have a positive impact on the economic activity.
- On the basis of the above-mentioned variables, we expect a retention of the CBR at 7% in the meeting scheduled for end of October 2020.

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