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STERLING CAPITAL LIMITED

Fixed Income Note

September 2020

"CBK's three debt issues"

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Executive Summary

- Our fixed income report for the month of September 2020 titled **“CBK’s three debt issues”** is an analysis of the three re-opened bond issues FXD2/2010/15, FXD1/2011/20 and FXD1/2020/15
- CBK seeks to raise KES.50Bn from the bonds that have a remaining term to maturity of 5.3 years, 10.7 years and 14.5 years respectively.
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids

  - **FXD2/2010/15: 10.30% -10.40%**
  - **FXD1/2011/20: 11.95% - 12.05%**
  - **FXD1/2020/15: 12.55% - 12.65%**

  WAR of accepted bids

  - **FXD2/2010/15: 10.25% -10.35%**
  - **FXD1/2011/20: 11.85% - 11.95%**
  - **FXD1/2020/15: 12.40% - 12.50%**

- The report highlights both primary market auction and secondary market trading activity for August while giving our view on what to look out for in the short term.
- Trading recommendations for investors with both income and trading portfolios are highlighted in our ‘trading ideas’ section.
- We also look at the government borrowing for the current fiscal year and the impact of government payments on market liquidity and the interbank rates.
- The report includes an analysis of the yield curve over the last six months and one year.
- We give our inflation expectations towards the end of the report which concludes with our view on the monetary Policy Committee (MPC) meeting later this month.

CBK re-opens three debt issues to raise KES.50Bn

- Central Bank of Kenya (CBK) is inviting investor bids for three re-opened bond issues FXD2/2010/15(5.3 years), FXD1/2011/20 (10.7 years) and FXD1/2020/15 (14.5 years) in a bid to raise KES. 50Bn (Table.1).
- Issuance of three different tenors is intended to cater for investors with different investment horizons.

Table.1: Primary Bond issue summary

Issue Number	FXD2/2010/15 (re-opened)	FXD1/2011/20 (re-opened)	FXD1/2020/15 (re-opened)
Total Amount Offered	KES.50Bn		
Tenor (Years)	5 .3 Years	10.7 Years	14.5 Years
Coupon Rate (%)	9.0	10.0	12.756
Issue Price	Discounted/Premium/Par		
Period of Sale	31st August 2020– 15th September 2020		
Auction Date	16th September 2020		
Value Date	21st September 2020		
Yield Curve (%) (Weighted Average tenor – 5.3 Years, 14.5 Years and 10.7Yrs) 04th Sep, 2020	**10.42**	**11.81**	**12.28**

Source: Central Bank of Kenya

Our weighted average and accepted bids averages

- We used implied yields provided by the Nairobi Securities Exchange (NSE) as at 4th September 2020, discussions with our fixed income traders and other market players as a guide for our investor and CBK accepted bid predictions (Table.2).

Table.2: Auction bid predictions

Rate	FXD2/2010/15	FXD1/2011/20	FXD1/2020/15
Market Weighted Average Rate	10.30 – 10.40	11.95 – 12.05	12.55 -12.65
Weighted Average Rate of Accepted Bids (%)	10.25 – 10.35	11.85 – 11.95	12.40 – 12.50

Source: Sterling Capital Research

Existing listed bond issues provided guidance to our predicted rates

- NSE implied yields as at 4th September 2020 of bonds of similar tenors were used to determine 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
5-Year						
FXD1/2020/05	11th May 2020	11.6670	5th May 2025	4.68 (1704)	10.3237	11.3528
25-Year						
FXD1/2010/25	28th June 2010	11.250	28th May 2035	14.78 (5379)	12.3233	N/A
10-Year						
FXD2/2019/15	25th Nov 2019	12.280	12th Nov 2029	9.22 (3356)	11.7833	12.5100

Source: Sterling Capital Research

Investors shift focus to long term issues

- In our determination of possible investors' bids, we also used implied yields of bonds of similar tenors to maturities on the Nairobi Securities Exchange (NSE) as at 4th September, 2020 (Table.4).

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
5-Year						
FXD1/2018/5	40	37.6	23.1	94.1	12.30	9.4417
FXD1/2018/5 (Tap)	10	7.7	7.7	-	12.30	9.4417
FXD1/2019/5	50	41.9	20.6	83.9	11.30	10.1400
FXD2/2019/5	50	49.3	39.2	98.6	10.87	10.2000
FXD3/2019/5	25	28.5	18.7	113.9	11.49	10.2710
FXD3/2019/5 (Tap)	9.7	9.8	9.8	-	11.49	10.2710
FXD1/2019/5 (Re-opened)	50	44.5	44.5	89.0	11.304	10.1400
FXD1/2020/5	50	34.5	20.8	69.1	11.667	10.3237
FXD1/2020/5 (Re-opened)	30	20.6	8.9	68.6	11.667	10.3237
10-Year						
FXD2/2018/10	40	28.86	26.16	72.15	12.502	11.4700
FXD1/2019/10	50	36.33	32.81	72.66	12.438	11.6000
FXD2/2019/10	50	70.93	51.33	141.87	12.300	11.6352
FXD3/2019/10	50	52.77	45.01	105.54	11.517	11.7210
FXD4/2019/10	50	38.4	28.4	76.75	12.28	11.7833
FXD1/2019/10 (Re-opened)	50	25.43	19.26	50.85	12.438	11.6000
15-Year						
FXD1/2019/15	40	25.07	14.72	62.67	12.857	12.0983
FXD2/2019/15	50	17.37	17.37	34.74	12.734	12.1798
FXD3/2019/15	40	86.67	50.58	216.69	12.340	12.2375
FXD1/2020/15	50	18.44	5.19	36.87	12.756	12.2946

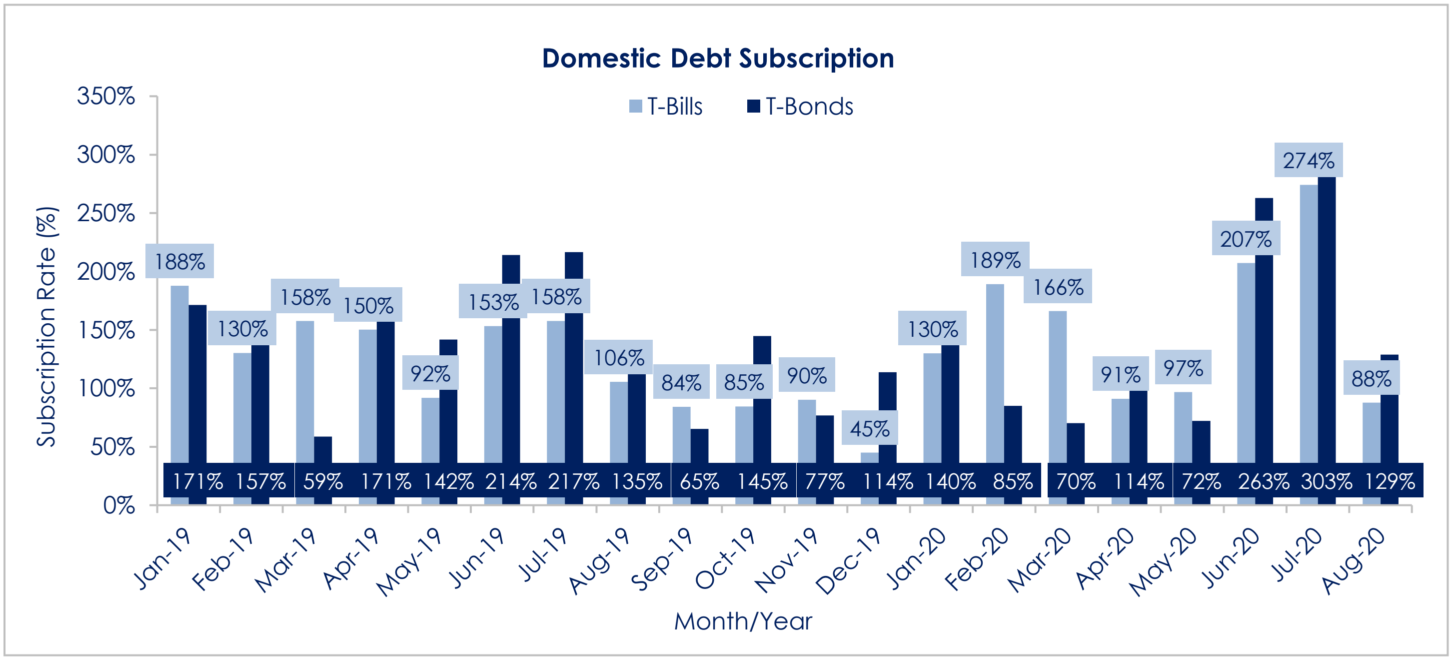
Source: Central Bank of Kenya

High demand for the 91-day T-Bill, to continue in September 2020

IFB issue in August soaks up most market liquidity.

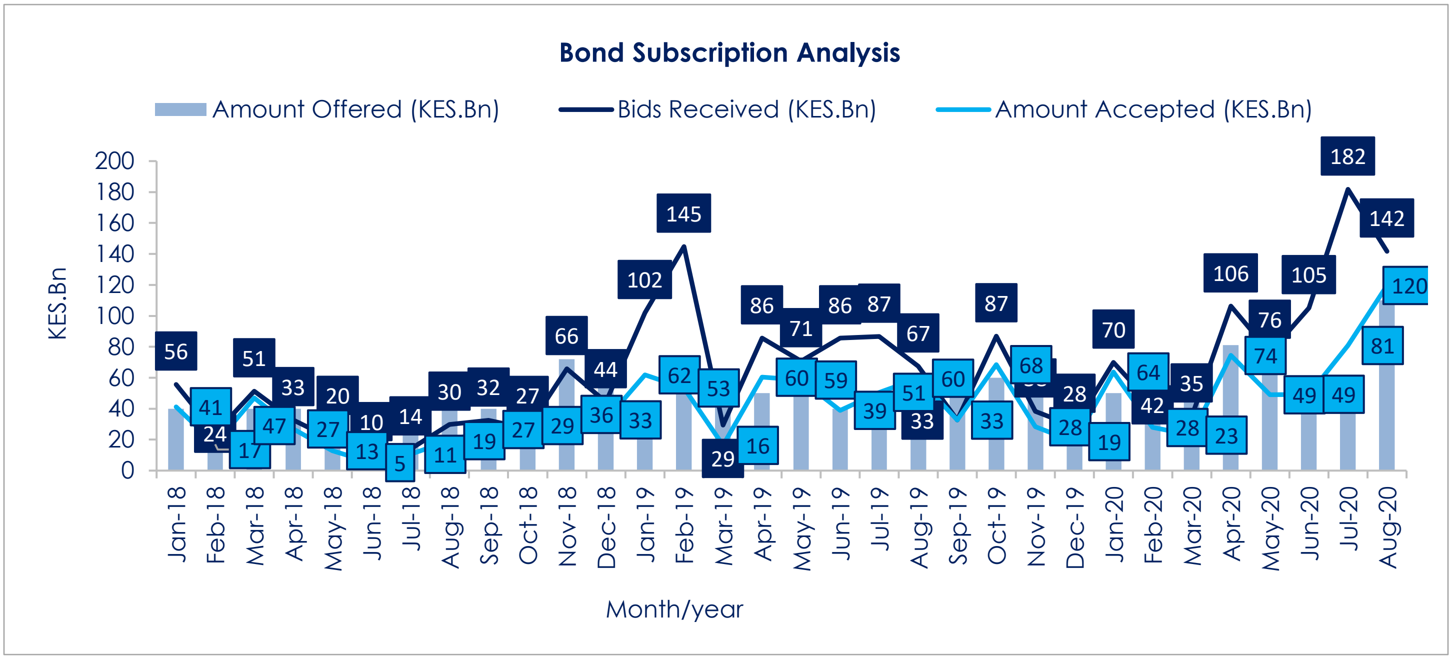
- The CBK offered KES.110Bn in T-Bonds and KES.120Bn in T-Bills with KES.141.7Bn and KES.105.4Bn received in subscriptions respectively (Figure.1).
- This was equivalent to 128.9% and 87.8% in T-Bond and T-Bill subscriptions respectively.
- Bids accepted for the T-Bonds and T-Bills amounted to KES.119.7Bn (84.4%) and KES.93.1Bn (88.4%) respectively, a trend we attribute to CBK's strategy to contain interest rates at their preferred levels resulting in high bid rejections (Figure.2 and Figure.3).
- The bonds issued included a KES.70Bn infrastructure bond, IFB1/2020/11 which received a 145% (KES.101.5Bn) subscription with CBK accepting bids worth KES.78.6Bn or 77.5% of bids received.
- Additionally, CBK offered a KES.40Bn tap sale for FXD2/2018/20 which was also oversubscribed at 100.7% (KES.40.3Bn) with the whole amount accepted.
- The 91-day was oversubscribed at 189.5% while the 182-day and 364-day papers were undersubscribed at 56.9% and 78.1% respectively. Acceptance rates for the papers stood at 85.6%, 83.9% and 94.3% respectively (Figure.3).
- We attribute the T-Bill undersubscription during the month to investors directing their capital to the higher yielding IFB.
- During the month demand for the 91-day T-Bill remained high as investors are unwilling to tie their capital for a longer period due to uncertainty over the performance of the economy and direction of interest rates.
- Demand for the 91-day T-Bill is likely to remain high in September due to the reasons mentioned above.

Figure.1: T-Bill undersubscribed in August as investors opt for the 91-day paper



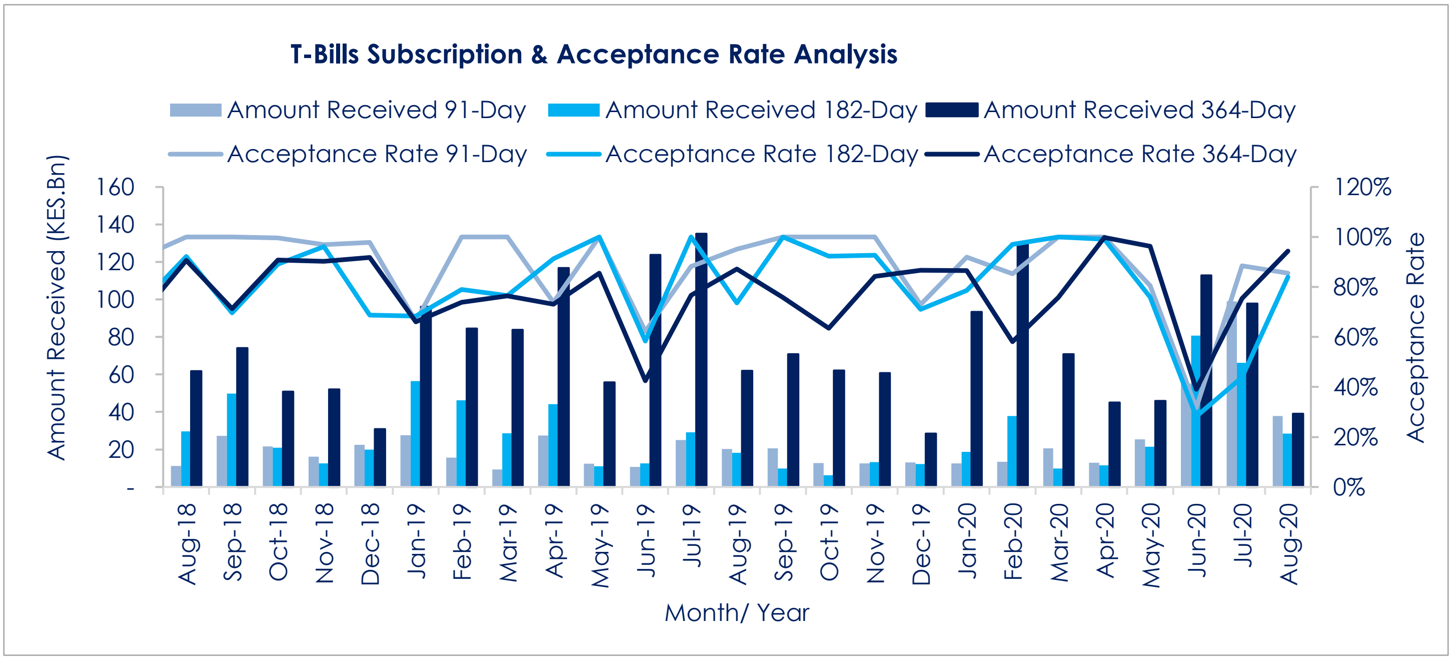
Source: Central Bank of Kenya

Figure.2: CBK continues to reject aggressive invesor bids to manage its domestic borrowing costs



Source: Central Bank of Kenya

Figure.3: Heavy subscription for the 91-day T-Bill continues

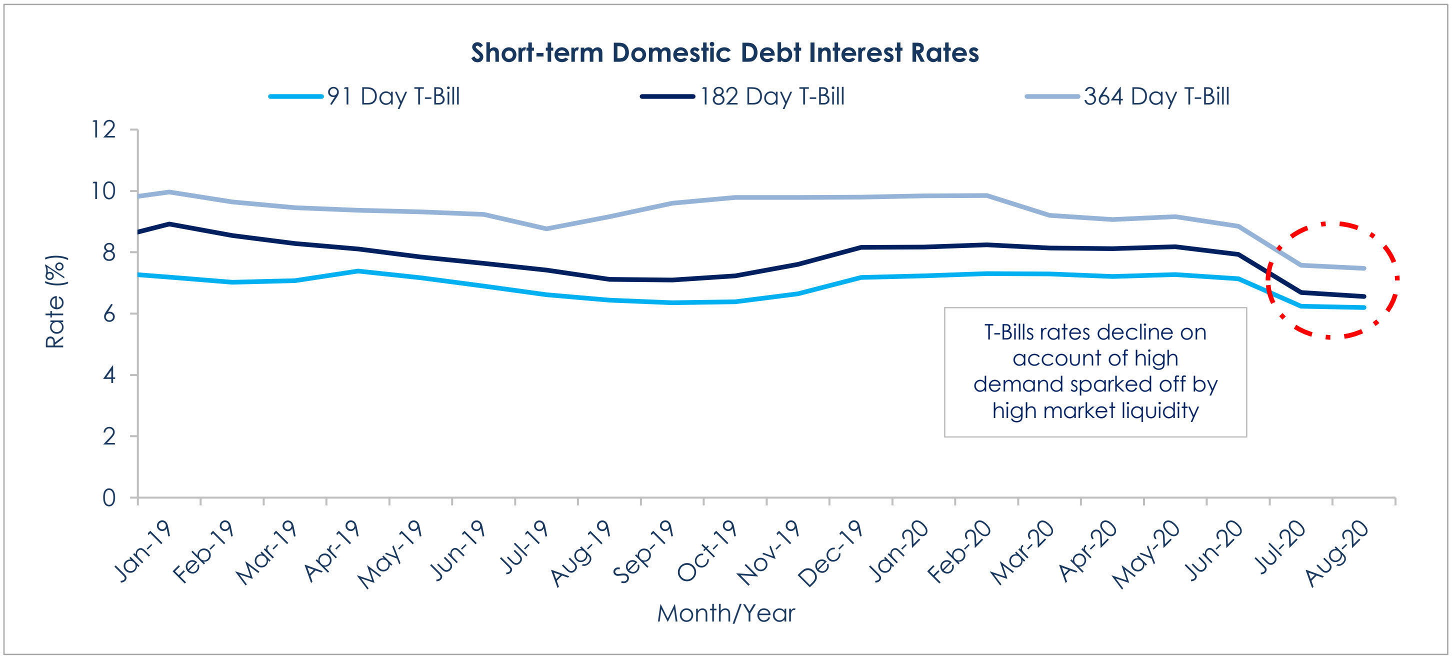


Source: Central Bank of Kenya

T-Bill rates remain low but upward pressure on the short-end of the yield curve expected

- In the month of August, average T-Bill yields for the 91, 182 and 364-day papers declined marginally by 4bps, 13bps and 10bps to 6.2%, 6.6% and 7.5% respectively (Figure.4).
- The CBK has been rejecting aggressive bids in debt auctions to maintain interest rates at near current levels.
- T-Bills issues have been undersubscribed for the last four weeks to the week ending 4th September, 2020 as investors showed a preference for last months IFB issue and higher yielding T-Bonds.
- We anticipate upward pressure on the short-end of the yield curve in upcoming auctions Due to the falling demand for the short-term papers.

Figure.4: Interest rates on short-term papers remains low as CBK rejects aggressive bids

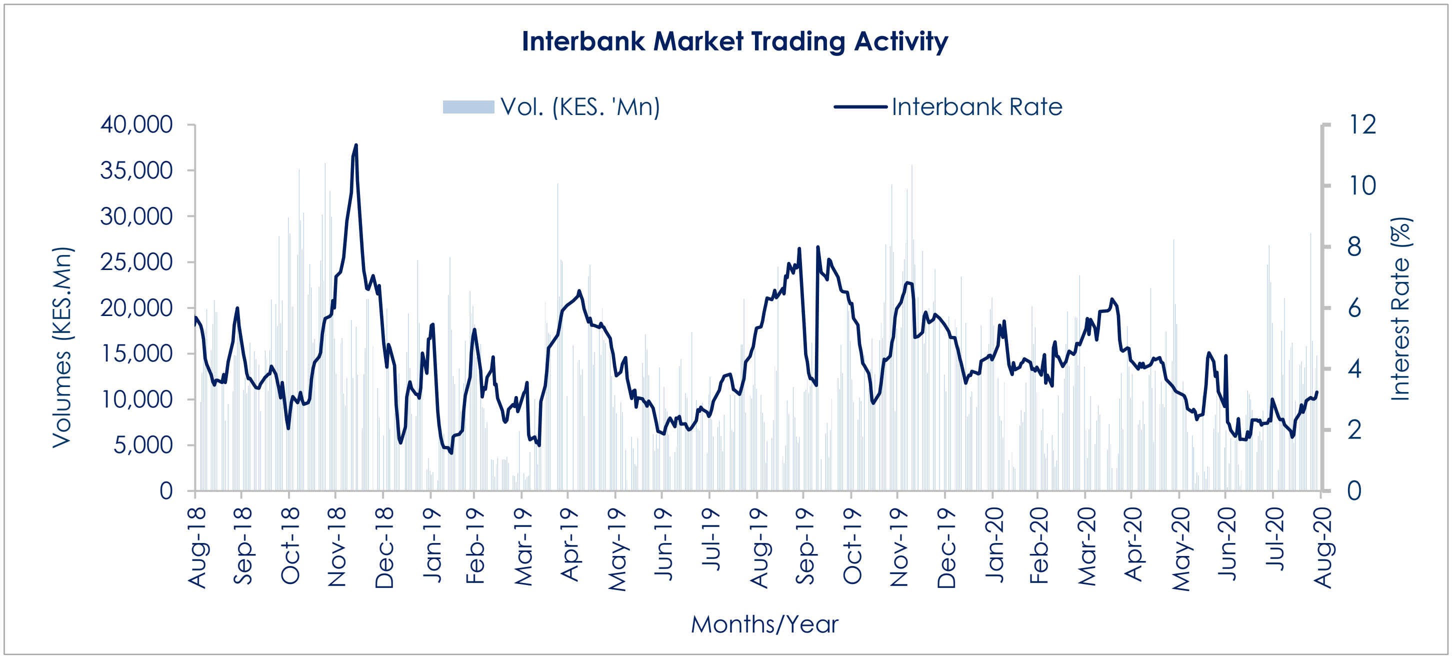


Source: Central Bank of Kenya

Government payments to continue driving up commercial bank liquidity

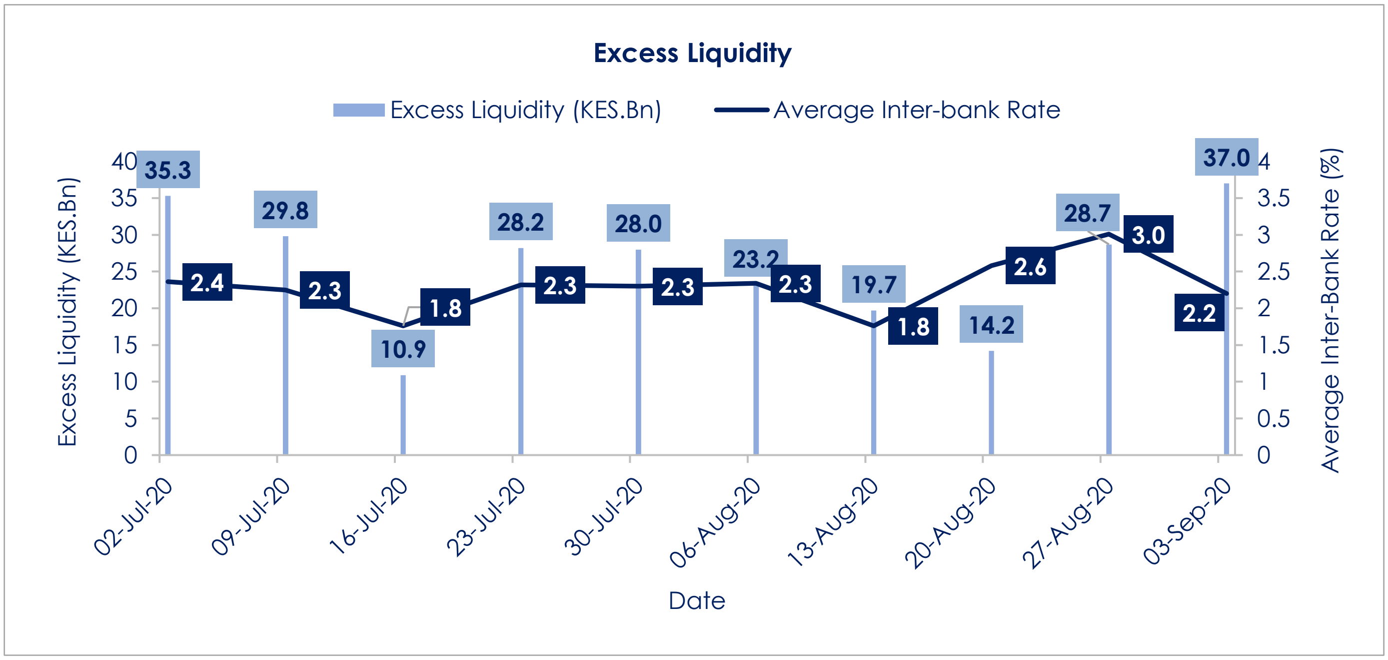
- Average weighted inter-bank lending rate rose to 2.6% in August from 2.2% in July with total volumes traded increasing 42.1% to KES.285.3Bn from KES.200.8Bn in July (Figure.5).
- Government payments explain the high market liquidity in recent weeks with commercial banks excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) at KES.37Bn as at 3rd September 2020 (Figure.6).
- We expect interbank rates to remain near current levels in September partially supported by the high market liquidity.

Figure.5: Inter-bank rates expected to remain low in September on high market liquidity



Source: Central Bank of Kenya

Figure.6: Commercial excess reserves at a two month high of KES.37Bn showing high liquidity

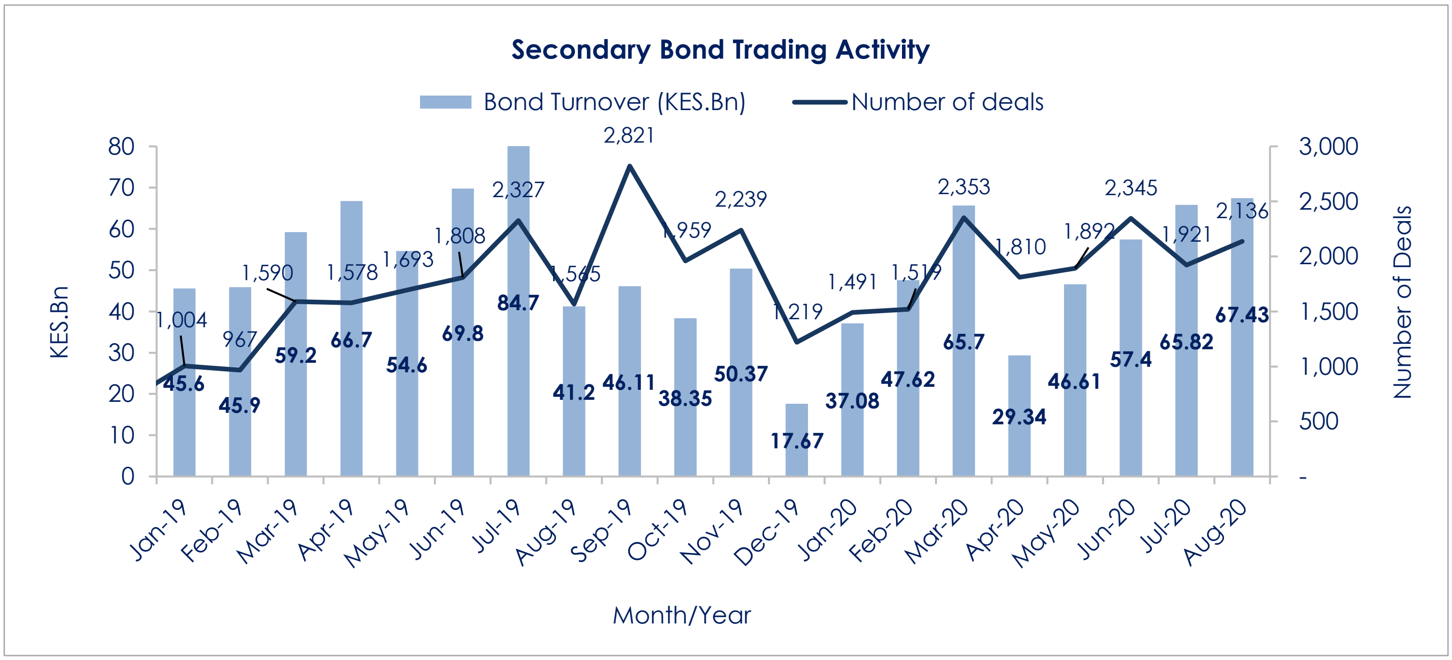


Source: Central Bank of Kenya & National Treasury

Secondary trading activity rises, demand to continue in September

- Secondary bond trading turnover increased 2.4% in September 2020 to KES.67.4Bn from KES.65.8Bn in July while the number of deals rose 11.2% to 2,136 (Figure.7).
- The increased activity can be attributed to the high market liquidity and the CBK's rejection of aggressive investor bids for IFB1/2020/11 with some investors who missed out in the primary auction tapping into it.
- High liquidity and fight to safety from the NSE continues to support bond trading activity which is expected to remain high in September.

Figure.7: Secondary trading activity to remain high in September 2020



Source: Central Bank of Kenya

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

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

- 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 (FXD1/2019/005).**
- **We have noted that Infrastructure bonds (IFBs) show significant price appreciation in the market, and we recommend IFB1/2020/06 and IFB/2020/11**(Table.6).
- We anticipate increasing yields on short term papers as a result of decreased demand as invetsors shift interest to longer dated bonds with higher coupons.

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
FXD1/2019/5	3.47	11.304	2.80	10.20	10.89
IFB1/2020/6	5.74	10.200	4.14	10.10	9.85
IFB1/2020/11	10.97	10.900	6.22	11.10	10.94

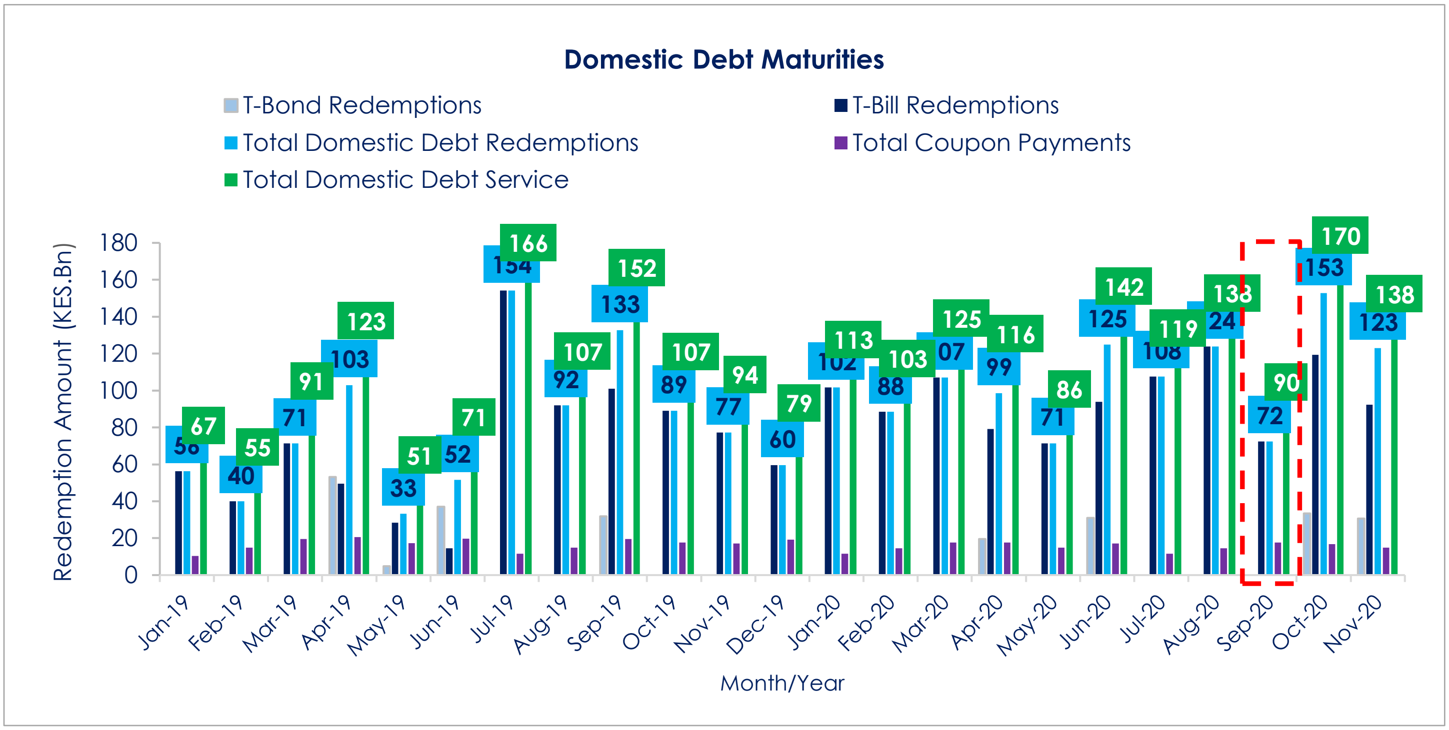
Source: Nairobi Securities Exchange & Sterling Research

*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

Total domestic debt service for September 2020 down KES.48.2Bn to KES.90Bn

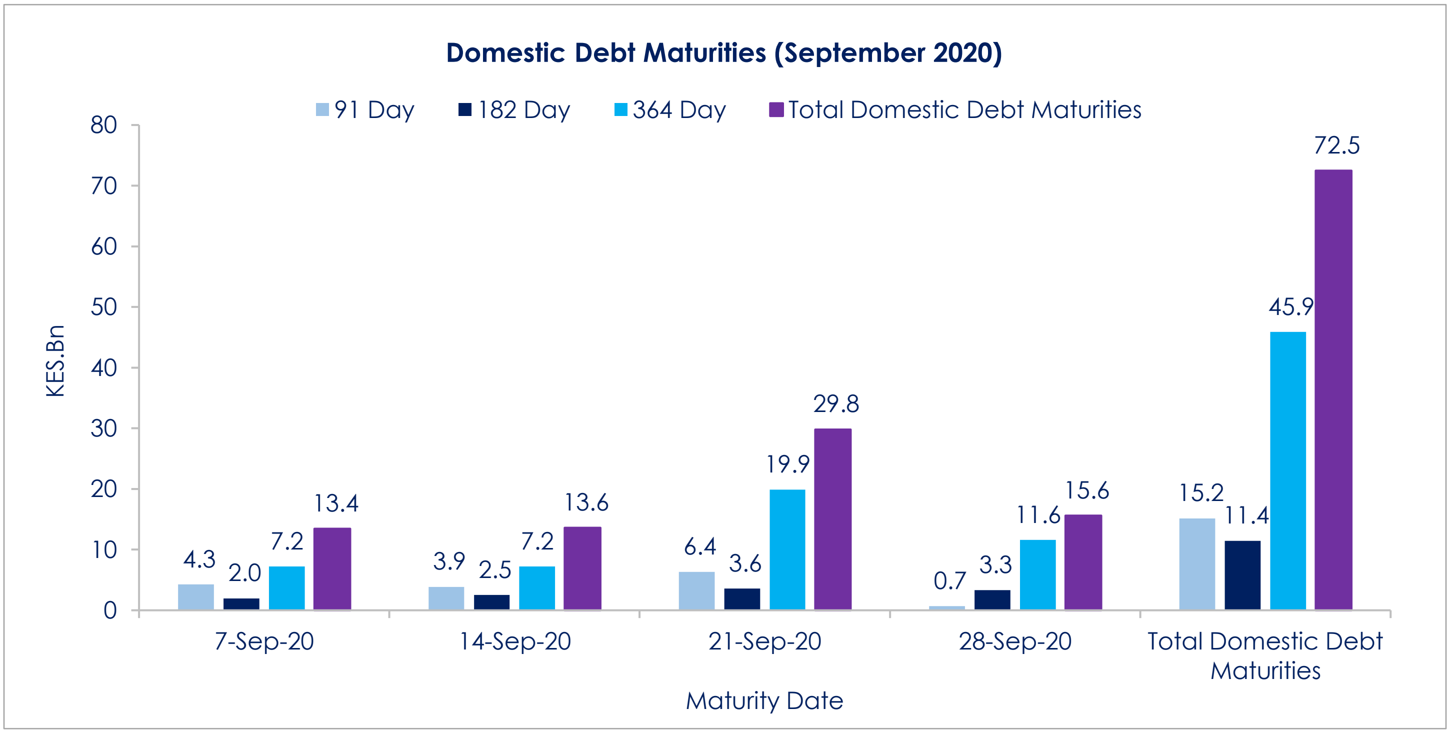
- September 2020 debt service amounts KES.90Bn, a 34.8% decline over debt service in August 2020 (Figure.8).
- T-bill redemptions fell 41.4% over the previous month to KES.72.5Bn, while coupon payments increased 22.1% to KES.17.7Bn.
- There are no T-Bond redemptions for the month of September 2020.
- The 364 day T-Bill will record the highest redemption in September 2020.
- October redemptions will increase 88.2% over September to KES.169.6Bn driven by KES.30.7Bn and KES.119.4Bn in T-bond and T-bill redemptions respectively, as well as KES.16.8Bn in coupon payments.

Figure.8: September 2020 debt service KES.90Bn



Source: Central Bank of Kenya

Figure.9: September 2020 Weekly debt maturities

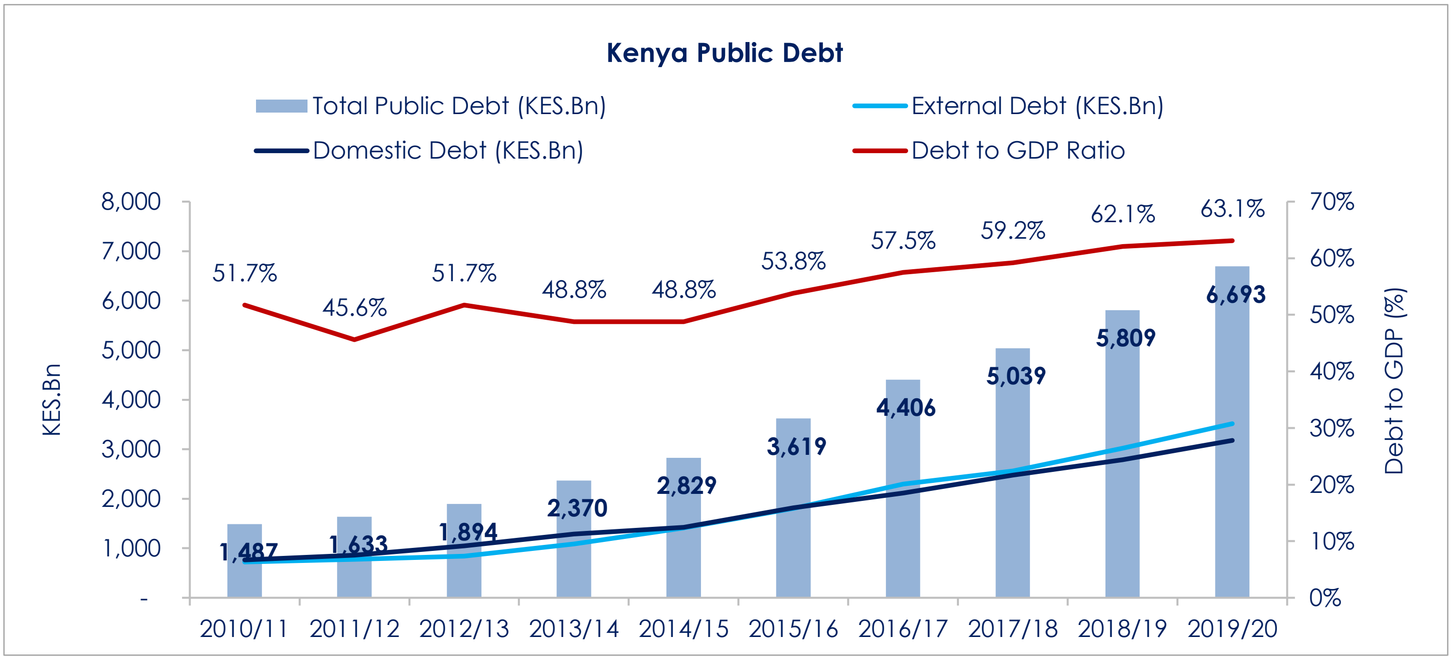


Source: Central Bank of Kenya

Public debt to rise on increased fiscal deficit and Government borrowing

- The Government is likely to face a challenge of financing the 2019/20 fiscal budget with ordinary tax revenue expected to fall below estimates (Figure.10).
- We expect an increase in both domestic and external borrowing domestic borrowing to finance the increasing budget deficit.
- Sluggish economic growth and tax breaks are both responsible for the declining tax revenue while Government efforts to contain the impact of the Covid-19 will work against its efforts to manage its expenditures.
- Debt service is still a concern and unless there is some concession or the Government is able to restructiure some of its external debt , a huge proportion of its revenues will be directed to meeting its debt obligations.

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



Source: Central Bank of Kenya & National Treasury

Government borrowing spikes in first month of the 2020/21 fiscal year

Government receipts to be adversely impacted by Covid 19 pandemic.

- Latest available data from the National Treasury shows KES.144Bn in total receipts at the end of the first month of the 2020/21 fiscal year (Figure.11).
- This however excludes domestic borrowing which we estimate at KES.252.3Bn inclusive of KES.137.1Bn as net borrowing and KES.115.2Bn as redemptions.
- External loans and grants as well as other domestic financing are not indicated in the latest available data.

- It is a concern but remains our position that tax revenue collection is set to fall below the original estimate due to sluggish economic activity even with the easing of some restrictions associated with the prevailing Covid-19 pandemic.
- This essentially means that there is a high likelihood of an increase in both external and domestic funding.
- This increase would be evident from an inreaese in debt issues or acceptance of more aggressive investor bids.
- This would also depend on the ability of the Government to access external funding that would reduce the pressure on the domestic debt market. We observe aggressive borrowing by Government in the first months of the fiscal year as it took advantage of high market liquidity (see page xxx

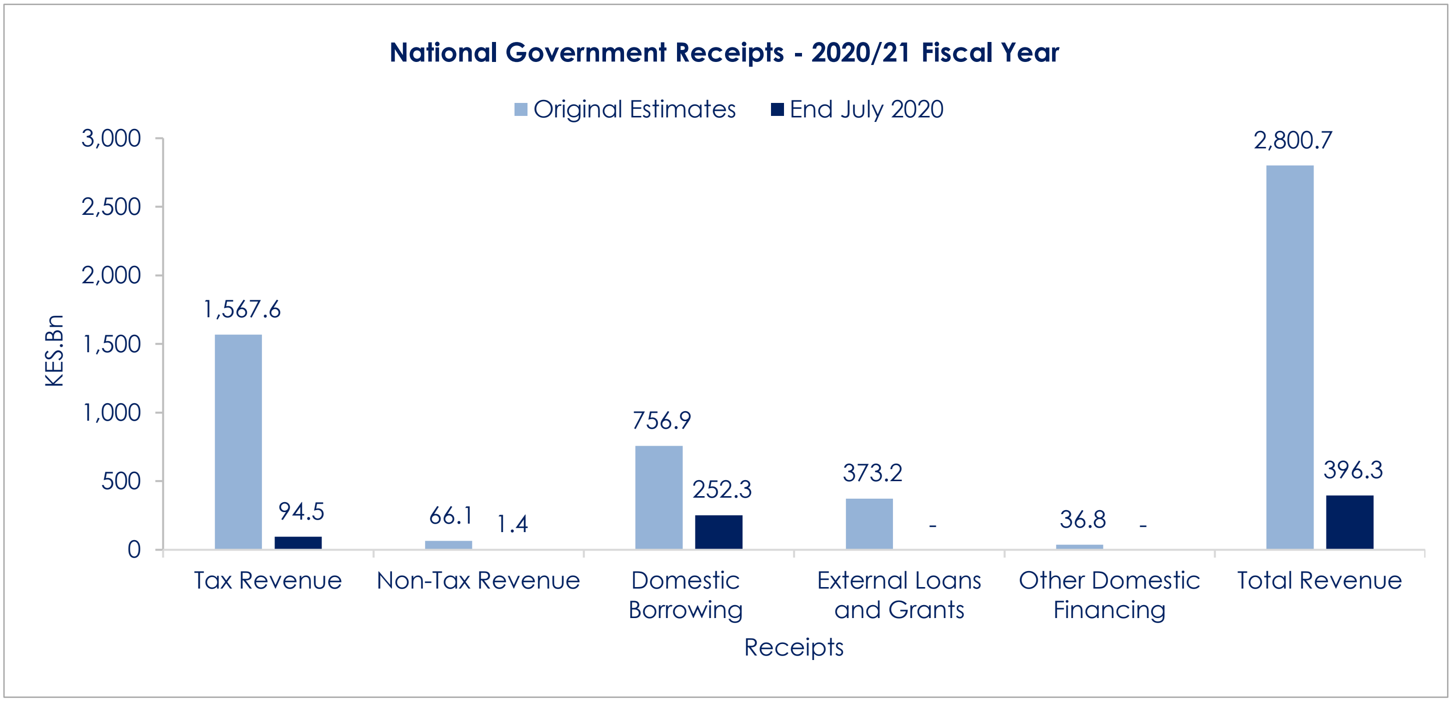
Table.6: National Treasury off to a slow start in revenue collection

Receipts	**Original Estimates (KES)**	**Actual Receipts (KES) 31st July 2020**	**Proportion of Receipt Target Achieved 31st July 2020**
Opening Balance (1st July 2020)		48.0	-
Tax Revenue	**1,567.6**	**94.5**	6.0%
Non-Tax Income	66.1	1.4	2.1%
Domestic Borrowing	756.9	252.3	33.3%
External Loans & Grants	373.2	-	-
Other Domestic Financing	36.8	-	-
Total Revenue	**2,800.7**	**396.3**	**14.1%**

* Note 1: Domestic Borrowing of KES.756.9Bn = Net Domestic borrowing KES.495Bn & Internal debt redemptions (Roll-overs) KES.262Bn.

Source: The Kenya Gazette Vol. CXXII - No.155 21st August 2020

Figure.11: August 2020 Weekly debt maturities



Source: Central Bank of Kenya

Yields on the short-end rise gradually but remain comparatively lower than 2019

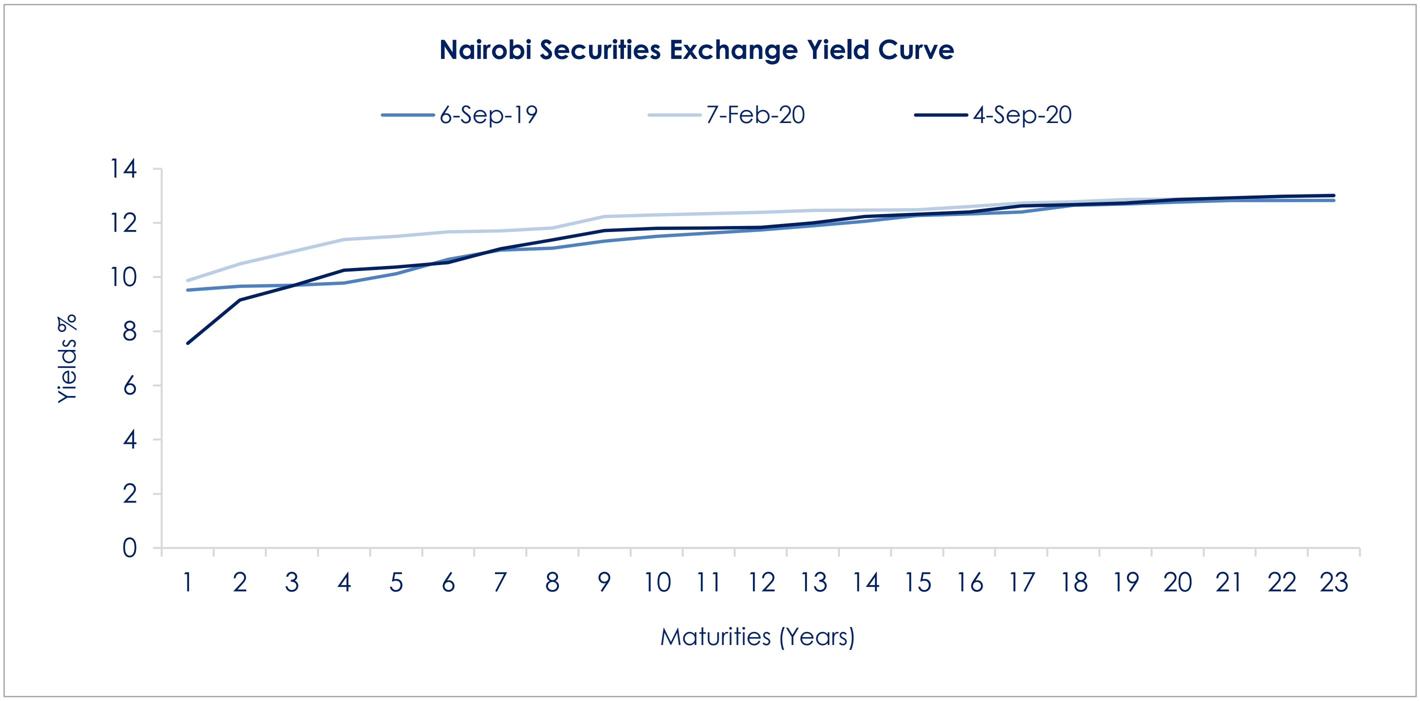
- We observe an overall decline in yields on different tenor instruments on 4th September compared to 7th February this year.
- We attribute this mainly to increased demand for Government debt brought about by high commercial bank liquidity and flight of capital towards fixed income assets.
- When we compare current yields with those around the same period last year (6th September 2019) we see declines in yields on the short-end of the yield curve, while those on the medium and long end of the curve rose. (Table.7 and Figure.9).
- We attribute this trend to increased demand for the short dated security following fuelled by uncertainty over the direction of interest rates and investors unwilling to commit to longer dated investments.
- We expect the CBK to be more accommodative of aggressive investor bids for long-term debt in its attempts to lengthen the maturity profile of public debt.
- Overall, we anticipate high subscription for the bonds on offer as investors shun risky investment instruments as well as limited higher yielding investments options.
- **Our recommendation still stands; BUY short and medium-term bonds and HOLD long term papers.**

Table.7: Interest rates on the short-end have fallen sharply over the last one year

Tenor	Yield (06th Sep 2019)	Yield (7th Feb 2020)	Yield (04th Sep 2020)	YOY ∆ 4th Sep 2020 vs 6th Sep 2019 (Bps)	4th Sep 2020 vs 7th Feb 2020 (Bps)	Sterling Capital yield Curve (4th Sep 2020)
1	9.5200	9.8730	7.5540	↓196.6	↓231.9	7.60
2	9.6630	10.4868	9.1500	↓51.3	↓133.5	9.20
5	10.1204	11.5055	10.3694	↑24.9	↓13.6	10.28
10	11.5000	12.3004	11.8022	↑30.2	↓36.4	11.78
15	12.2750	12.4905	12.3233	↑4.8	↓49.8	12.38
20	12.7680	12.8813	12.8617	↑9.4	↓2.0	12.63

Source: Nairobi Securities Exchange

Figure.12: 1Yr and 2Yr rates in a steady decline



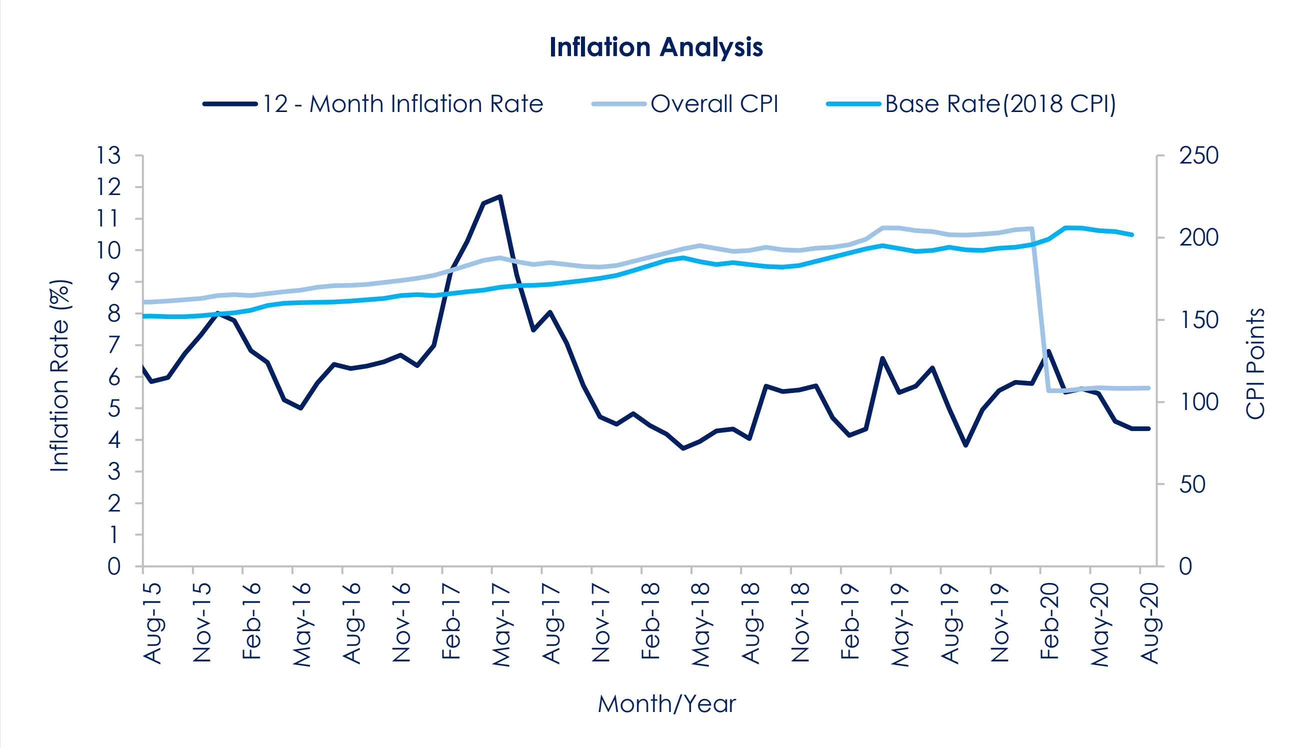
Source: Nairobi Securities Exchange

Inflation rate to range between 4.5-5.5% for the remaining months of 2020

Inflation to range between 4.5% and 5.5%.

- Inflation for the month of August 2020 remained unchanged over the July at 4.36%.
- The 2.1% increase in transport cost was neutralized by a 1% decline in food and non-alcoholic drinks costs.
- The Housing, Water, Electricity, Gas and Other Fuels' Index, rose 1.2%, largely due to the increase in the cost of electricity (0.5%) and kerosense (27.4%).
- Pump prices of diesel and petrol increased by 3% and 3.4%, respectively resulting in a 2.1% increase in the Transport Index.
- Rising international oil prices due to the increase in global demand following easing of pandemic containment measures is likely to result in increased inflationary pressure.
- We expect lower food prices, the impact of the reduction of Value Added Tax (VAT) and muted demand pressures to keep inflation well anchored within the CBK target range of 2.5% - 7.5%.
- In the short term, we predict an inflation rate between 4.5% anfd 5.5%.

Figure.13: Short term Inflation forecast 4.5% - 5.5%



Source: Kenya National Bureau of Statistics

MPC to retain CBR at 7% in September 2020

MPC to retain CBR at 7%.

- The Monetary Policy Committee (MPC) retained the Central Bank Rate (CBR) at 7% in the last meeting on 29th July 2020 citing resilient economic performance.
- The MPC noted that the package of policy measures implemented since March have been effective and supported their decision.
- The MPC expects the operationalisation of the Credit Guarantee Scheme for the vulnerable Micro Small and Medium sized Enterprises (MSMEs) to reduce credit risk faced by commercial banks thus increasing private sector credit which grew by 7.6% in the 12 months to June 2020.
- Exports of goods by 1.7% in the first half of 2020 compared to a similar period in 2019, while remittances remained strong in June, rising to USD288.5Mn from USD258.2Mn in May.
- CBK foreign exchange reserves position remains favourable at US$9.3Bn (5.67 months of import cover).
- The Monetary Policy Committee is set to meet on 29th September and we expect the CBR to be retained at 7%.

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