Thursday, 30 December 2021

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STERLING CAPITAL LIMITED

Fixed Income Note

January 2022

"On to H2 of the 2022/23 fiscal year"

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Executive Summary

- Our fixed income report for the month of January 2022 is titled **"On to H2 of the 2022/23 fiscal year"** in reference to the issuance of the first Treasury Bond issues of the second half of the 2022/23 fiscal year.
- These are also the first debt issues in the 2022 calendar year where the Central Bank of Kenya (CBK) intends to raise KES.60Bn through three re-opened bonds; **FXD1/2020/5 (3.4 years), FXD2/2018/10 (7 years) and FXD1/2021/20 (19.7 years)**.
- Our weighted average bid predictions are as follows:

  Weighted Average Rate (WAR) of investor bids
  FXD1/2020/5: 10.90% - 11.10%
  FXD2/2018/10: *
  FXD1/2021/20: *

  WAR of accepted bids
  FXD1/2020/05: 10.85% - 10.95%
  FXD2/2018/10: *
  FXD1/2021/20: *

  *We will send our estimates for **FXD2/2018** and **FXD1/2021/20** closer to toward the end of their periods of sale.

- The report summarizes the details of the bonds issued, examines historic primary auction results and gives our subscription level and weighted average predictions.
- Also analyzed in the report is T-Bill and T-Bond subscription patterns, T-Bill and inter-bank rates and secondary bond trading activity.
- Investment recommendations are highlighted in the trading ideas section based on the current and expected yield curve movements.
- Under national accounts we analyze the latest Government revenue and expenditure data.
- Under the yield curve section we analyze trends in domestic debt interest rates of different tenors in the period under focus.
- The report concludes with an analysis of both inflation and the outcome of the Monetary Policy Committee (MPC) meeting at the end of January 2022.

CBK's January debt issues target KES.60Bn

- The Central Bank of Kenya (CBK) invites bids for three re-opened treasury bonds; **FXD1/2020/5, FXD2/2018/10 and FXD1/2021/20** in a bid to raise KES.60Bn for budgetary support (Table.1).
- The three bonds have remaining terms to maturity of 3.4, 7 and 19.7 years respectively.
- FXD1/2020/5, FXD2/2018/10 and FXD1/2021/20 have coupon rates of 11.667%, 12.502% and 13.444% respectively.
- We see an increasing likelihood of FXD1/2020/5 being oversubscribed on account of its short tenure particularly due to the expectation that interest rates will continue rising come 2022.
- We are not convinced that the other bonds will be fully subscribed considering that there is an oversupply of bonds of similar tenors trading on the Nairobi Securities Exchange (NSE).

Table.1: Primary Bond issue summary

Issue Number	FXD1/2020/05	FXD2/2018/10	FXD1/2018/20
Total Amount Offered	KES.60Bn		
Tenor	5 Years	10 Years	20 Years
Term to Maturity	3.4 Years	7 Years	19.7 Years
Coupon Rate (%)	11.667	12.502	13.444
Price Quote	Discounted/Premium/Par		
Period of Sale	20th Dec 2021 – 4th Jan	20th Dec 2021 – 18th Jan 2022	
Auction Date	5th January 2022	19th January 2022	
Value Date	10th January 2022	24th January 2022	
Yield Curve (%) (Weighted average tenor - 24th December	**10.7939**	**12.1993**	**13.1800**

Source: Central Bank of Kenya

Weighted and accepted bids average estimates

- Our analysis of yields of bonds of similar tenors on the Nairobi Securities Exchange (NSE) as at 24th December as well as discussions with fixed income traders resulted in the following bid predictions for the treasury bonds (Table.2).
- **Note that we will disclose our auction bid predictions closer to the auction date for FXD2/2018/10 and FXD1/2018/20.**

Table.2: Auction bid predictions

Rate	FXD1/2020/5	FXD2/2018/10*	FXD1/2018/20*
Market Weighted Average Rate (%)	10.90 - 11.10		
Weighted Average Rate of Accepted Bids	10.85 - 10.95		

*Action bid predictions to be disclosed closer to end of period of sale

Source: Sterling Capital Research

Historical debt issues provide guidance

- We used implied yields of bonds of similar tenors to maturity on the Nairobi Securities Exchange (NSE) as at 24th December 2021 to estimate 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
5-Year						
FXD1/2020/5	11th May 2020	11.67	5th May 2025	3.4 (1,235)	10.7939	11.6670
10-Year						
FXD2/2018/10	17th Dec 2018	12.50	1st Mar 2038	16.4 (5,939)	12.1993	12.5000
20-Year						
FXD1/2021/20	16th Aug 2021	13.44	22nd July 2041	19.7 (7,157)	13.1800	13.3688

Source: Central Bank of Kenya

5-Year debt issue to receive the bulk of demand

- A historical comparison of primary auction results for 5, 10 and 20 year debt issues shows investors' preference for bonds with shorter tenors (Table.4).
- This trend coupled with rising interest rates leads us to believe that **FXD1/2020/5** will have the highest demand among all the three issues.

Table.4: Historical primary market auction performance

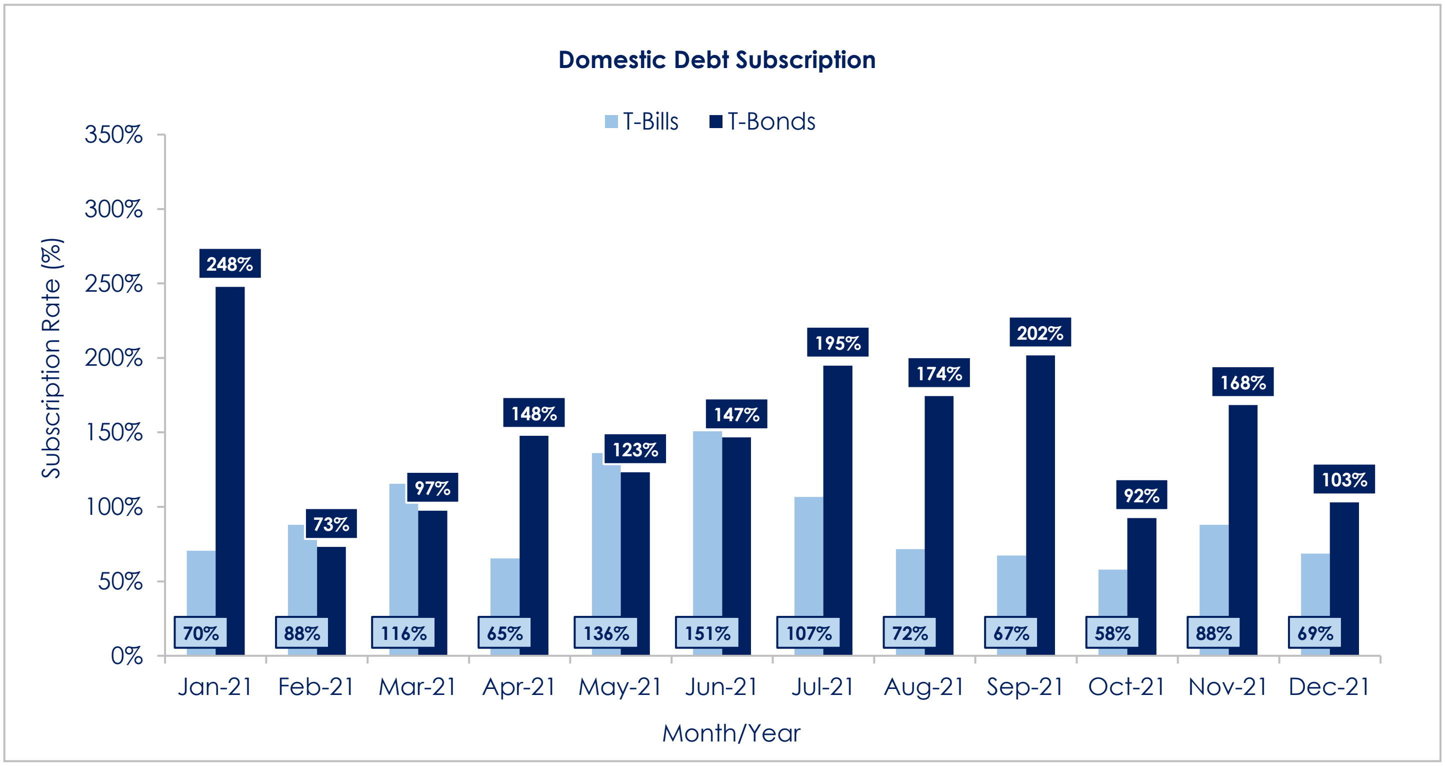
Issue	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yields (%)
5-Year						
FXD1/2019/5	50	41.9	20.6	83.9	11.304	10.5500
FXD2/2019/5	50	49.3	39.2	98.6	10.872	10.6334
FXD1/2020/5	50	34.5	20.8	69.1	11.667	10.7939
FXD1/2021/5	50	66.6	53.7	133.2	11.280	11.2770
10-Year						
FXD1/2019/10	50	36.3	32.8	72.7	12.444	12.2486
FXD2/2019/10	50	70.9	51.3	141.9	12.300	12.2837
FXD3/2019/10	50	52.8	45.0	105.5	11.517	12.3683
FXD4/2019/10	50	38.4	28.4	76.8	12.280	12.4290
20-Year						
FXD2/2018/20	40	13.9	10.5	34.7	13.200	13.2665
FXD1/2019/20	50	14.7	9.0	29.4	12.873	13.2754
FXD1/2021/20	60	43.5	39.5	72.5	13.444	13.3035

Source: Central Bank of Kenya

Lower domestic debt subscription recorded in December 2021

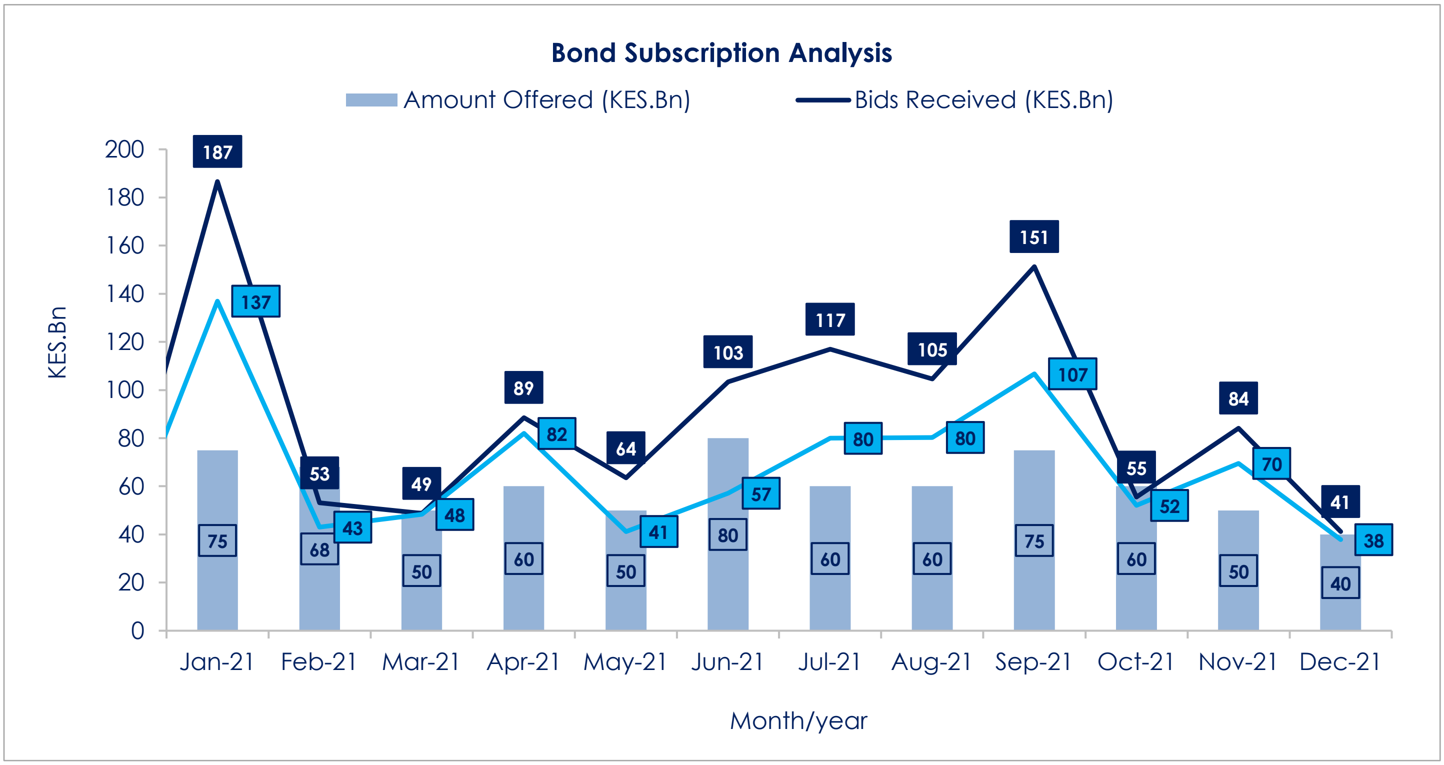
- Treasury Bill (T-Bill) demand dropped in December with the CBK receiving bids worth KES.66Bn against an offer amount of KES.96Bn, equivalent to a 68.7% subscription rate which is lower than the 87.9% in November 2021. (Figure.1).
- Subscription rates for the 91, 182 and 364 day T-Bills stood at 124.3%, 57% and 58.2% respectively.
- The two re-opened Bonds, FXD4/2019/10 and new issue FXD1/2018/20 received aggregate bids worth KES.41.2Bn against KES.40Bn offered, equivalent to a 102.9% subscription rate (Figure.2).
- The high subscription was largely attributable to the comparatively low target amount with recent debt issues looking to raise KES.50 - 60Bn.

Figure.1: Both T-Bill and T-bond subscriptions decrease in December 2021



Source: Central Bank of Kenya

Figure.2: Bond subscriptions above expectation in December 2021

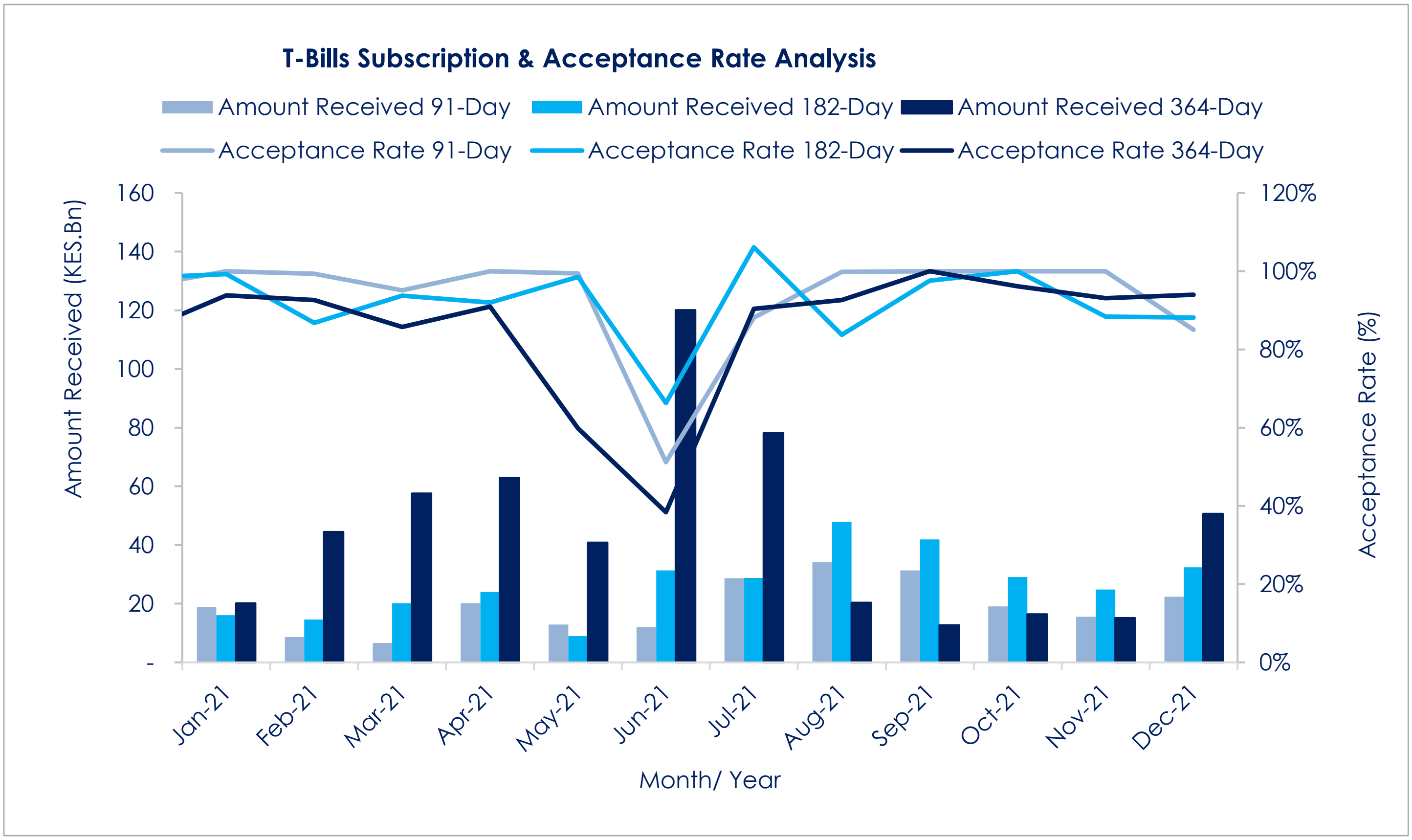


Source: Central Bank of Kenya

T-Bill acceptance rates drop in December 2021

- CBK's acceptance rates for 91, 182 and 364-Day T-bills were 85%, 74.5% and 94% respectively which were relatively lower compared than November's 100%, 88.1% and 93.1% save for the 364-Day issue (Figure.3).
- Acceptance rates still remain relatively high due to the high deficit financing pressure faced by the National Treasury.

Figure.3: T-Bill acceptance rates remain relatively high in December

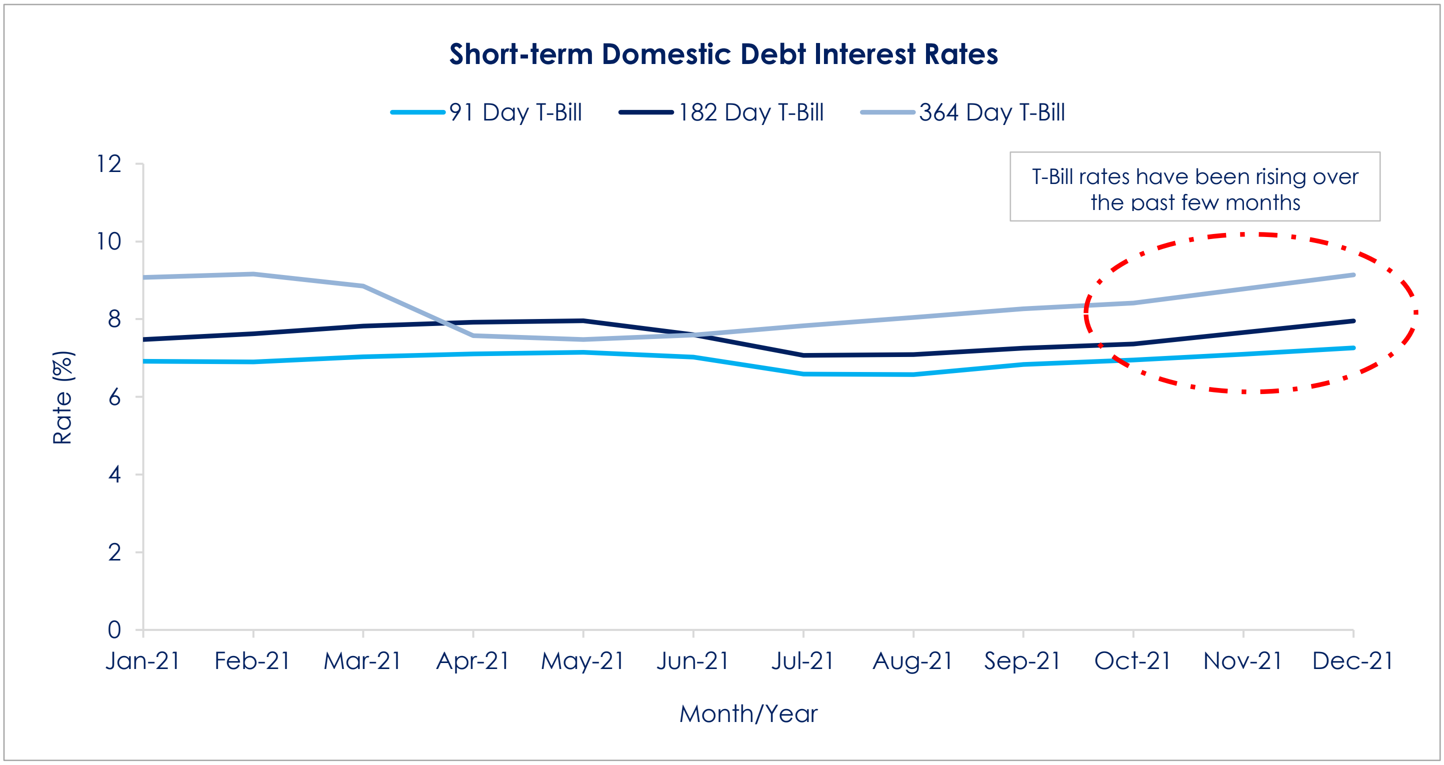


Source: Central Bank of Kenya

T-Bill rates continue heading North with the 364 Day at +9%

- T-Bill rates continue on an upward trajectory with average rates for the 91, 182 and 364-day debt issues at 7.3%, 8% and 9.1% in December 2021 from 7.1%, 7.7% and 8.7% in November 2021 respectively (Figure.4).
- The biggest rise was 40 bps reported on the 364 day T-Bill a trend which is attributable to the CBK being more accommodative of higher investor bids to encourage subscription and reduce the refinancing risk.
- A sustained increase in T-Bill rates is expected in the near term as deficit financing pressure persists.

Figure.4: Sustained rise in short-term debt securities interest rates

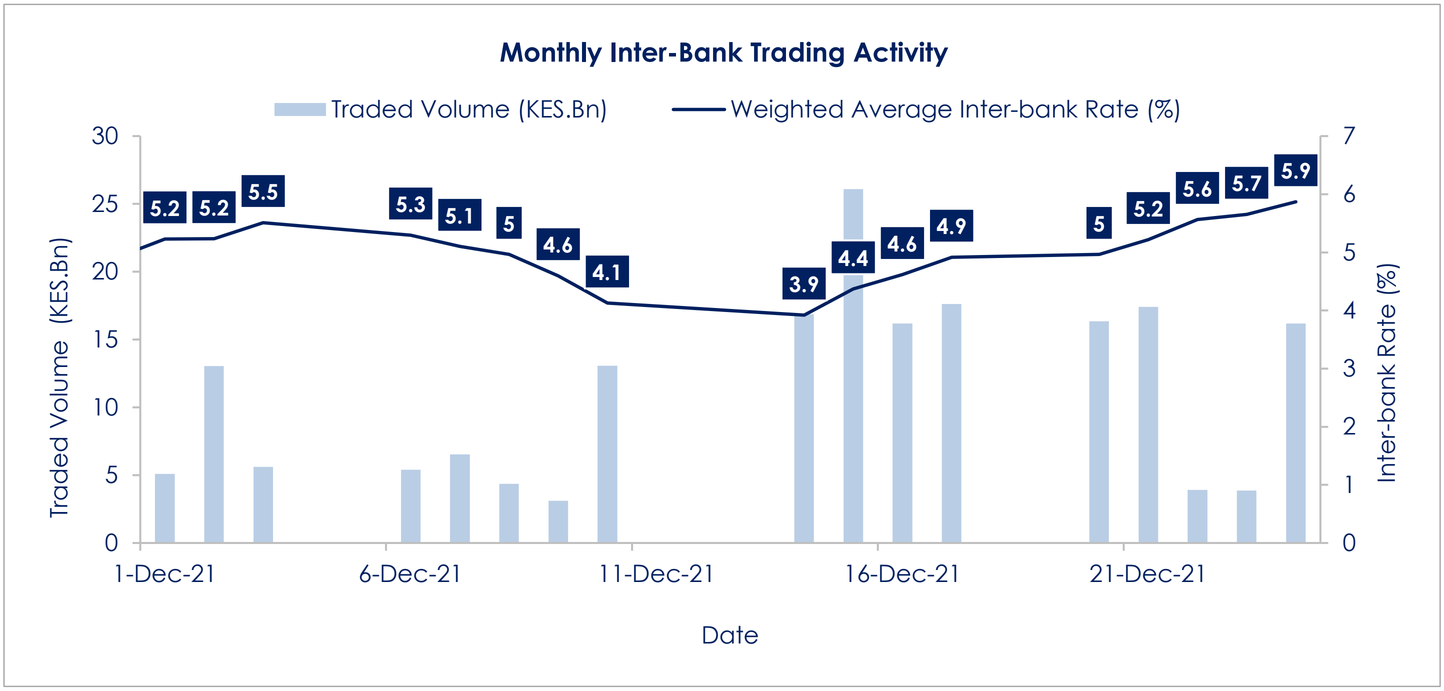


Source: Central Bank of Kenya

Average inter-bank rates remain flat in December 2021

- Average inter-bank rate for December 2021 remained flat at 5% similar to November while total inter-bank trading volumes over the same period increased negligibly by 1.3% to KES.190.7Bn. (Figure.5).
- Our forecasted average inter-bank rate range for January 2021 is 4.5% - 5.5%.

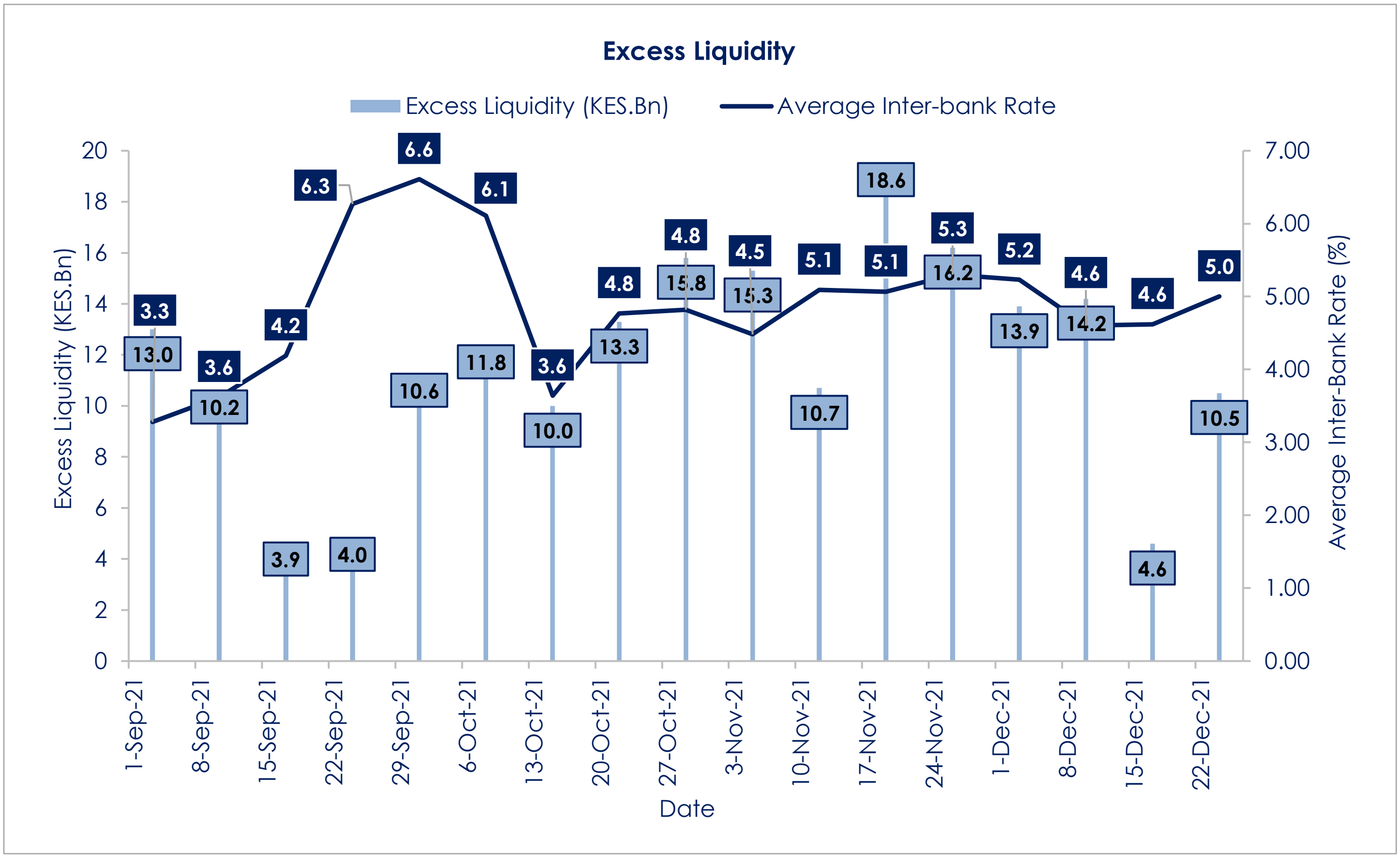
Figure.5: Inter-bank lending rates to hover around 5% in January 2022



Source: Central Bank of Kenya

- Excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) over the same period continued its month-on-month declined to KES.43.2Bn, compared to KES.60.8Bn in November and KES.61.5Bn in October (Figure.6).

Figure.6: Excess commercial bank reserves decrease further in December 2021

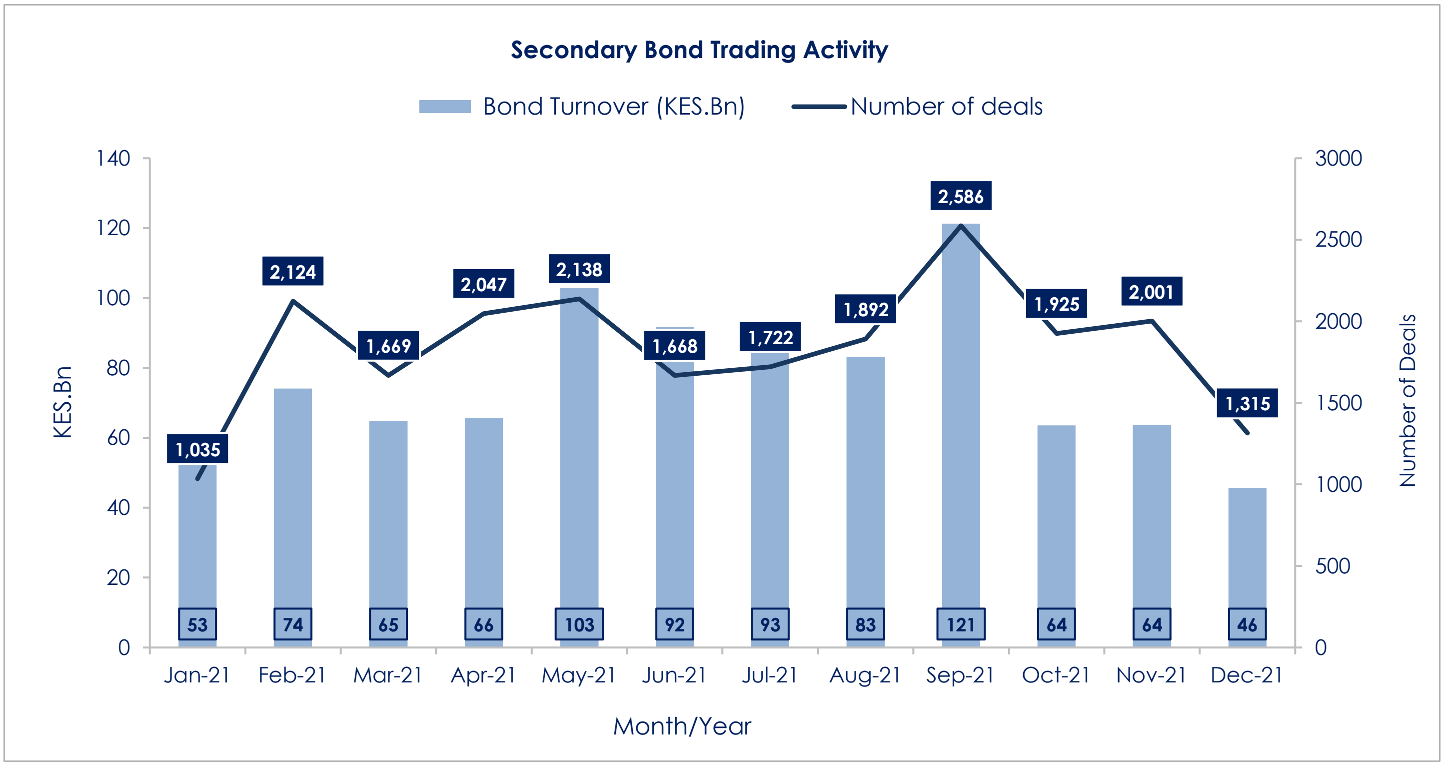


Source: Central Bank of Kenya

Secondary market bond turnover to pick up in January 2022

- Secondary market trading activity stood at KES.45.7Bn as at 24th December 2021, down from KES.63.8Bn in November with the number of deals over the same period decreasing 34.3% to 1,315 (Figure.7).
- As per our expectations, trading turnover declined due to the onset of the festive season which has reduced trading days. Further, tightening liquidity in the market has also contributed to lower turnover.
- We expect trading turnover to pick up in January 2022 following the end of the festive season, liquidity increases as the CBK initiates further reverse repos.
- We also expect increased trading activity on the FXD1/2020/5 due to high investor demand.

Figure.7: Secondary trading activity decreases in December 2021



Source: Central Bank of Kenya

Trading ideas - Investors buy IFB's and high yielding FXD

- We identify Infrastructure Bonds **IFB1/2021/21** as **FXD1/2021/5** a short-tenor T-Bond as suitable investment options for fixed income investors (Table.5).
- IFBs have attractive yields (due to tax exemption), favorable capital appreciation and are highly liquid.
- The 5 year issue is attractive largely because of its relatively short tenor and has been trading heavily since its issuance in October 2021.

Table.5: Trading ideas

Bond	Tenor (Years)	Coupon (%)	Modified Duration* (%)	Sterling Capital Yield to Maturity (%)	Current Yield** (%)
FXD1/2021/5	4.9	11.28	3.61	11.40	11.13
IFB1/2021/21	20.7	12.74	7.01	12.50	12.10

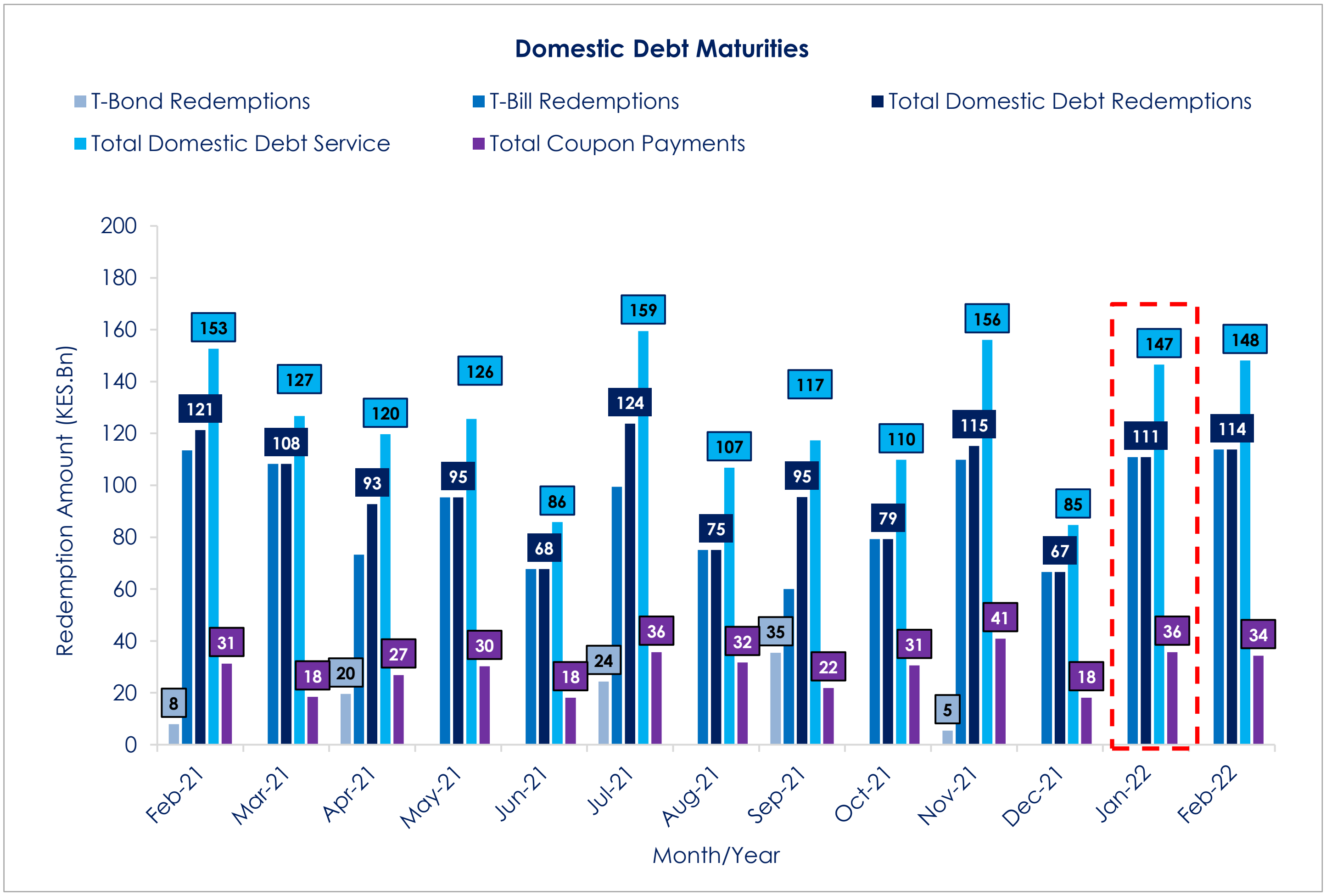
*Modified duration - Expresses the measurable change in the value of a security in response to a change in interest rates (for every 1% movement in interest rates, the bond would inversely move in price by the modified duration)
** Current Yield - Return on investment, for an investor holding a specific bond for 1 year

Source: Central Bank of Kenya

Total domestic debt service set to rise in January 2022

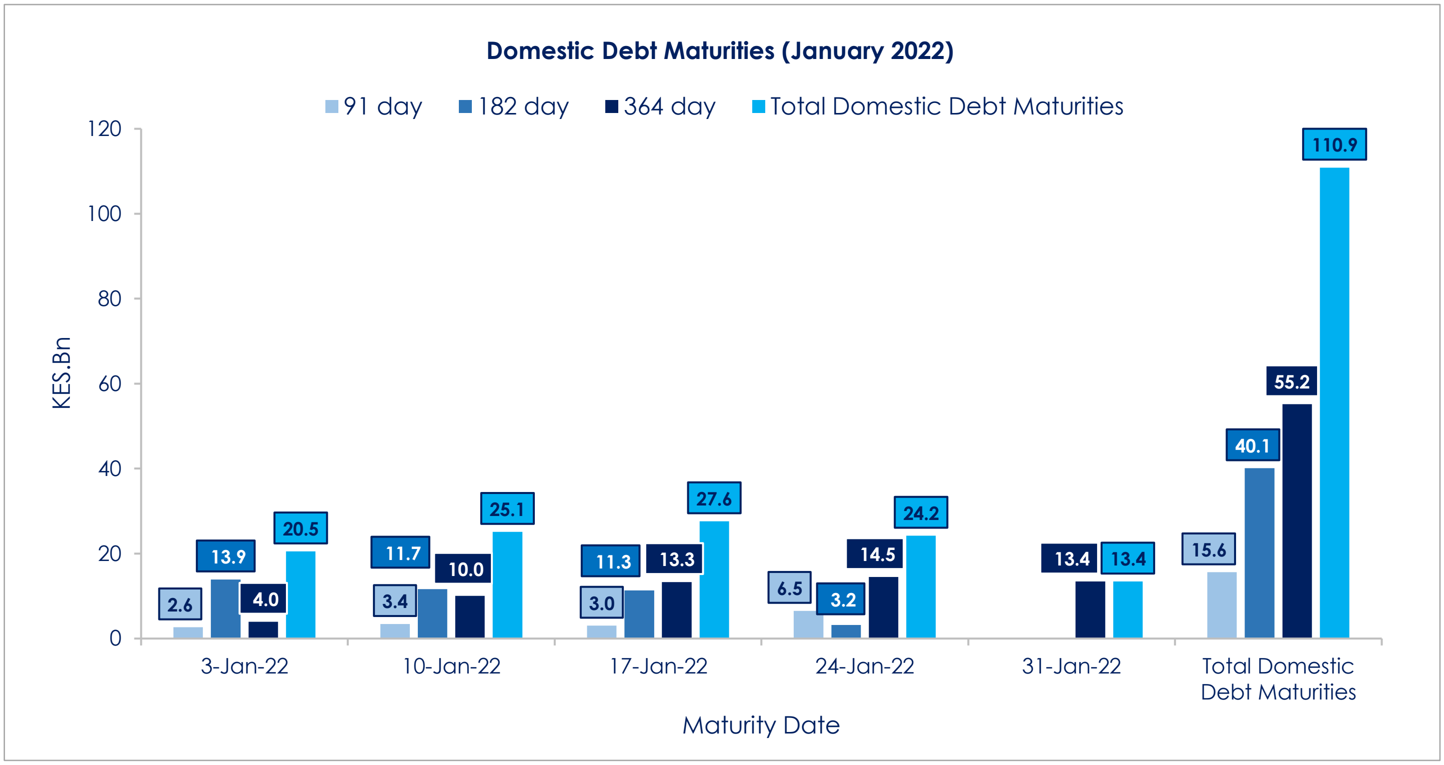
- Total domestic debt service for the month of January 2022 is KES.146.5Bn comprising of KES.110.9Bn and KES.35.7Bn in T-Bills and coupon payments respectively (Figure.8).
- Redemptions for the 91, 182 and 364-day T-Bills during the month are KES.15.6Bn, KES.40.1Bn and KES.55.2Bn respectively with the third week of the month having the highest redemptions at KES.27.6Bn (Figure.9).
- Total debt service will rise to KES.147.6Bn in February 2022 made up of KES.113.8Bn in T-Bill redemptions and KES.33.9Bn in coupon payments.

Figure.8: January 2022 domestic debt service rises to KES.146.5Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities January 2022



Source: Central Bank of Kenya

Domestic borrowing remains above 2021/22 fiscal year target

- The National Treasury remained below our linear target run rate of 41.7% on both tax (40.3%) and total revenue (37.1%) as at the end of November 2021 which is five months into the 2021/222 fiscal year (Table.6 and Figure.10).
- Note that our linear target run-rate assumes a flat monthly target and therefore differs from that of the Kenya Revenue Authority (KRA) which has reported that it is ahead of its revenue target.
- As has been the case this fiscal year, the National Treasury remains ahead of its domestic borrowing target having raised KES.430.1Bn equivalent to 42.6% of the fiscal year's total domestic borrowing target.
- The National Treasury is yet to revise its revenue, expenditure and borrowing targets through a supplementary budget which we see likely in early 2022 with a likely revision of the domestic borrowing target upwards.

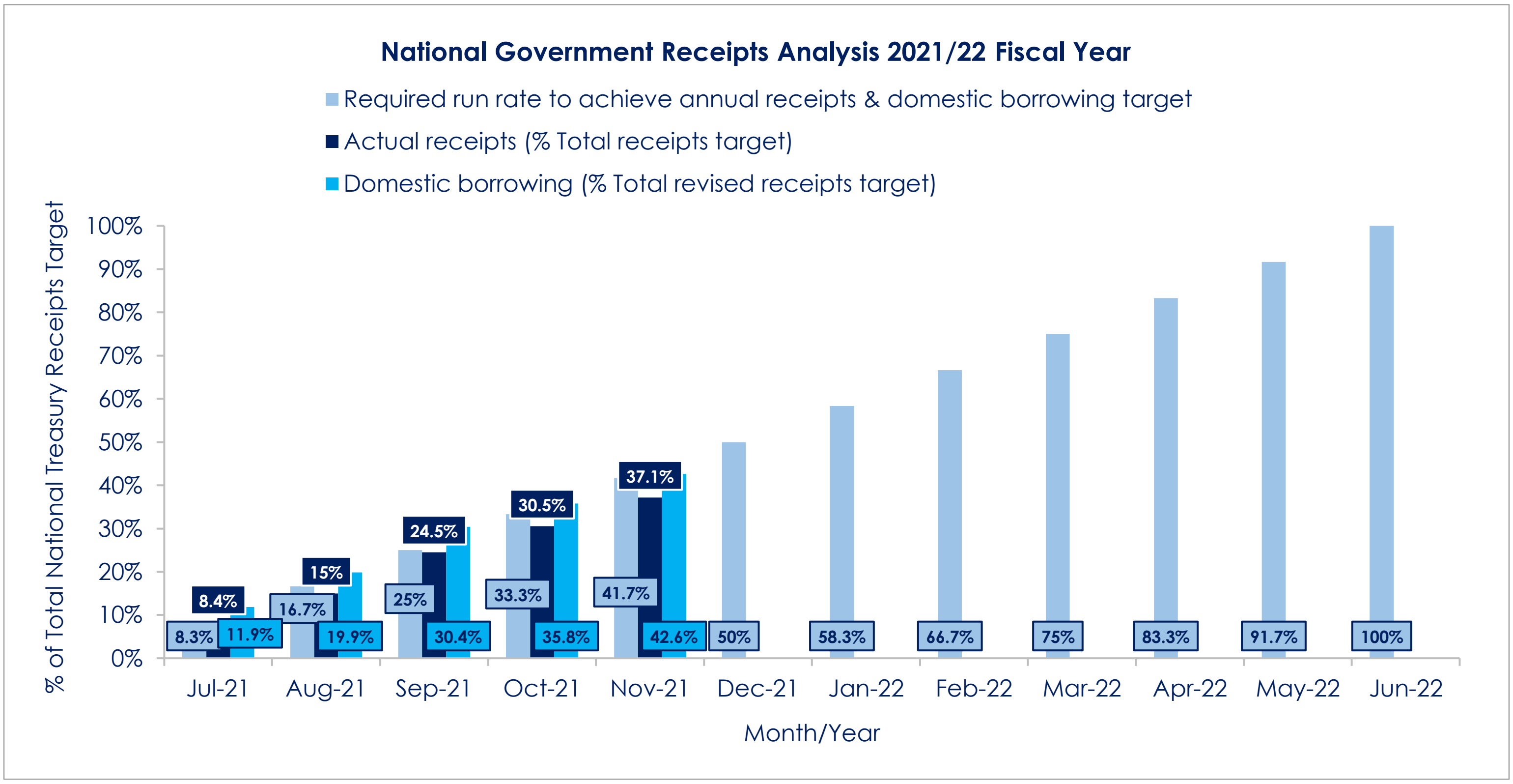
Table.6: 2020/21 fiscal year domestic borrowing above target run-rate

Receipts	Original Estimates July 2021 (KES.Bn)	Actual Receipts 31st Oct 2021 (KES.Bn)	Actual Receipts 30th Nov 2021 (KES.Bn)	Proportion of Total Receipts as at 30th Nov 2021 (%)
Opening Balance (1st July 2021)		21.3	21.3	-
Tax Revenue	**1,707.4**	**548.4**	**688.1**	**40.3**
Non-Tax Income	68.2	28.9	30.7	45
Domestic Borrowing*	**1,008.4**	**360.8**	**430.1**	**42.6**
External Loans & Grants	379.7	10.8	11.8	3.1
Other Domestic Financing	29.3	4.2	4.2	14.2
Total Revenue	**3,193**	**974.3**	**1,164.8**	**37.1**
Linear Run Rate target (5 months of fiscal year)				**41.7**

* Note 1: Domestic Borrowing of KES.1, 008.4Bn = Net Domestic borrowing KES.661.6Bn & Internal Debt Redemptions (Roll-overs) KES.346.8

Source: The Kenya Gazette Vol. CXXIII - No.253 10th December 2021

Figure.10: National Treasury at 43% of 2021/22 fiscal year domestic borrowing target

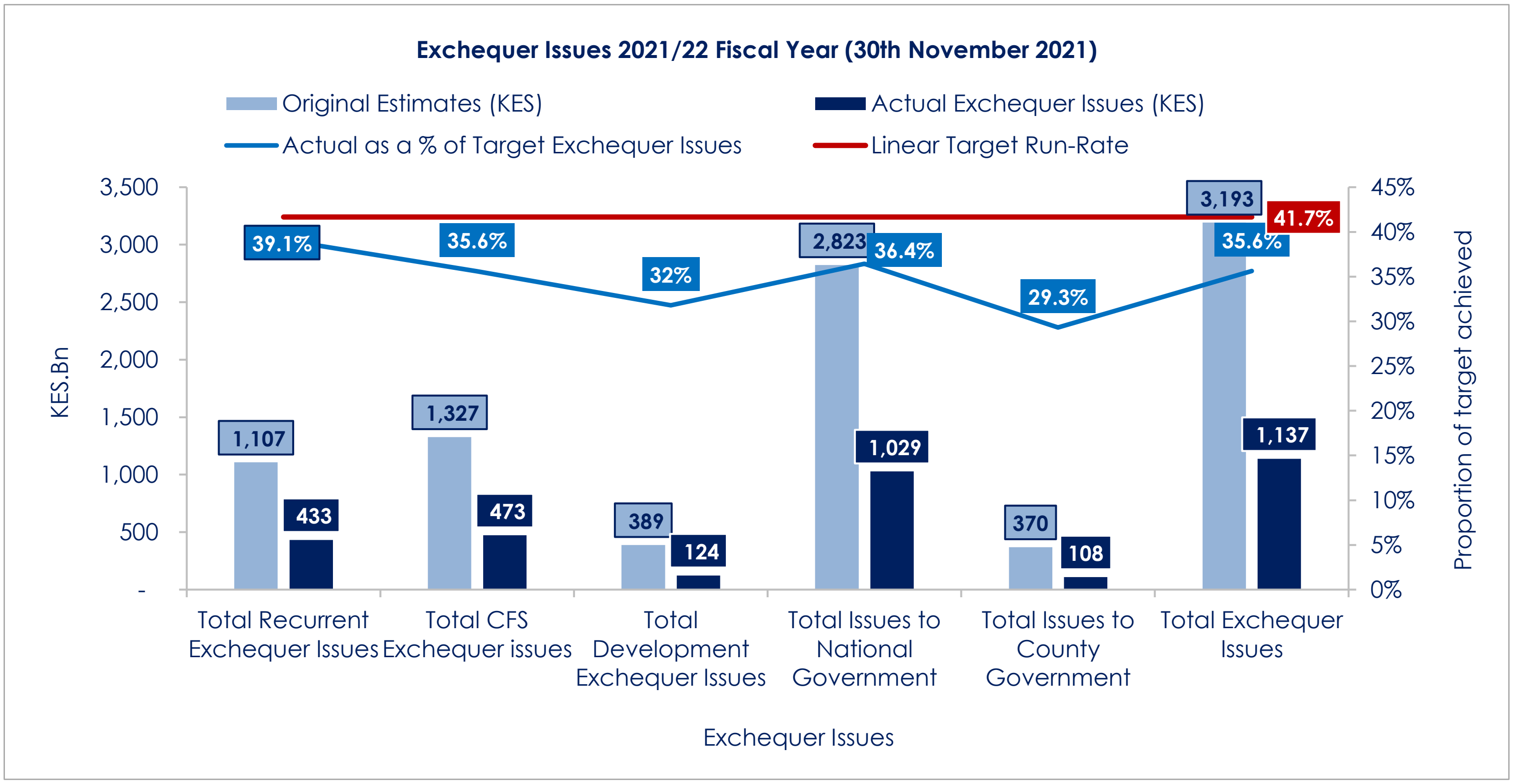


Source: The Kenya Gazette Vol. CXXIII - No.253 10th December 2021

Government expenditure remains below 2021/22 fiscal year expenditure run-rate targets

- Our linear target run rate after the first five months of the 2021/22 fiscal year (ending November 2021) is 41.7% which remains well above all actual exchequer issues (Figure.11).
- Actual Total Government expenditure stood at KES.1.14Tn equivalent to 35.6% of the total fiscal year target of KES.3.19Tn.
- Notable is the underperformance of total issues to the county Governments which stood at KES.108Bn or 29.3% of the total fiscal year target.
- Revenue absorption remains low based on the illustration below which suggests that the National Treasury continues to face a financing challenge even with a sharp improvement in revenue collection following the uptick of economic activity in the current fiscal year.
- Relatively low spending therefore is a capital preservation strategy at this point in time although we expect this to improve in the second half of the fiscal year especially in distinct expenditure items such as recurrent spending and county transfers.

Figure.11: Government expenditure remains below target run-rate estimates

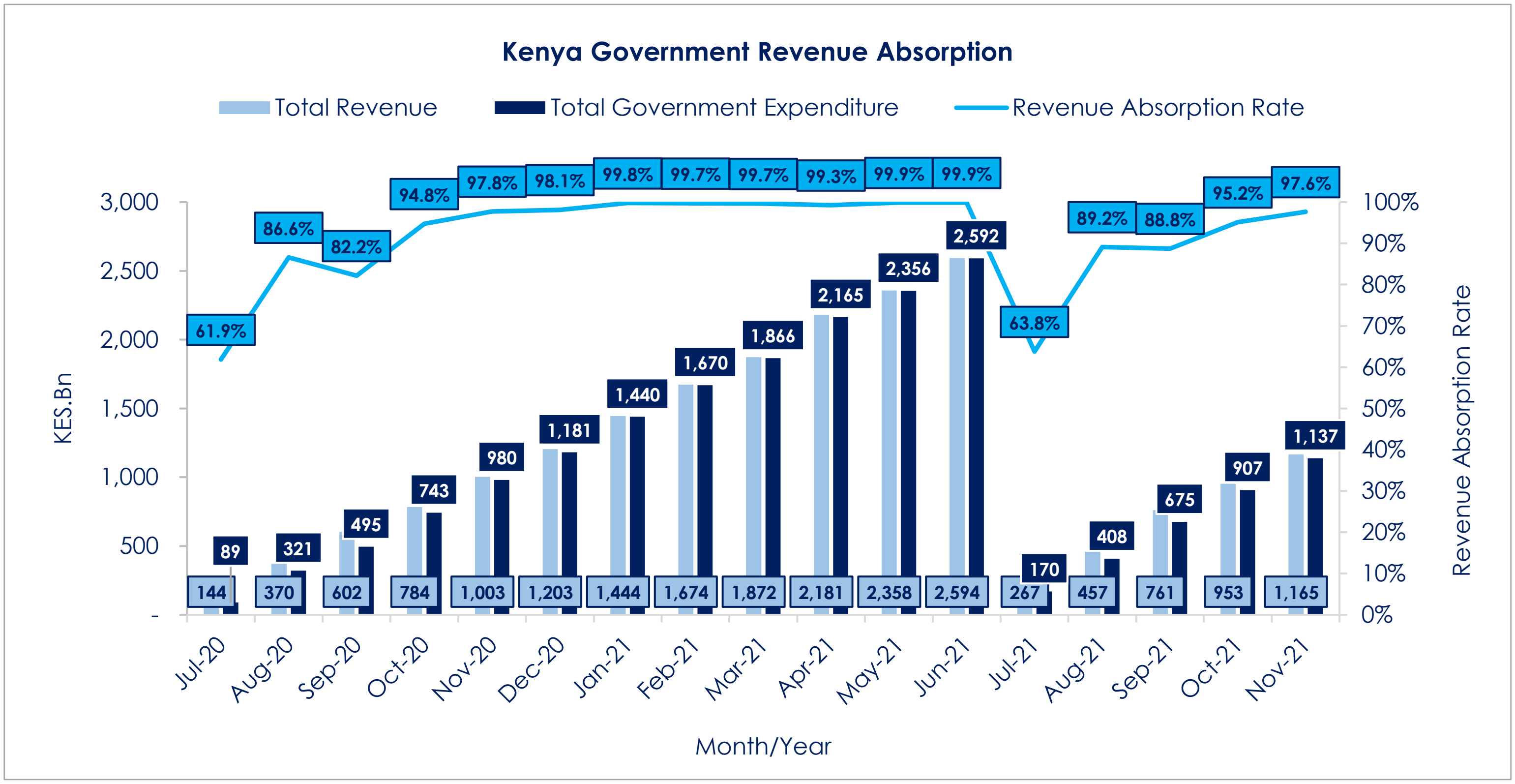


Source: The Kenya Gazette Vol. CXXIII - No.253 10th December 2021

Government Revenue Absorption inches towards full utilization

- Revenue Absorption Rate (RAA) which is the proportion of Government receipts used to finance expenditure stood at 97.6% in November 2021 almost unchanged from the same period in 2020 (97.8%) (Figure.12).
- This is also an increase from October where the RAA was 95.2%.
- RAA moves closer towards full utilization towards the end of the year and into the new year.
- This also means that the revenue authorities and the CBK will also come under pressure to raise revenue and capital to finance Government expenditure

Figure.12: Kenya ordinary estimate declines to 2018/19 level

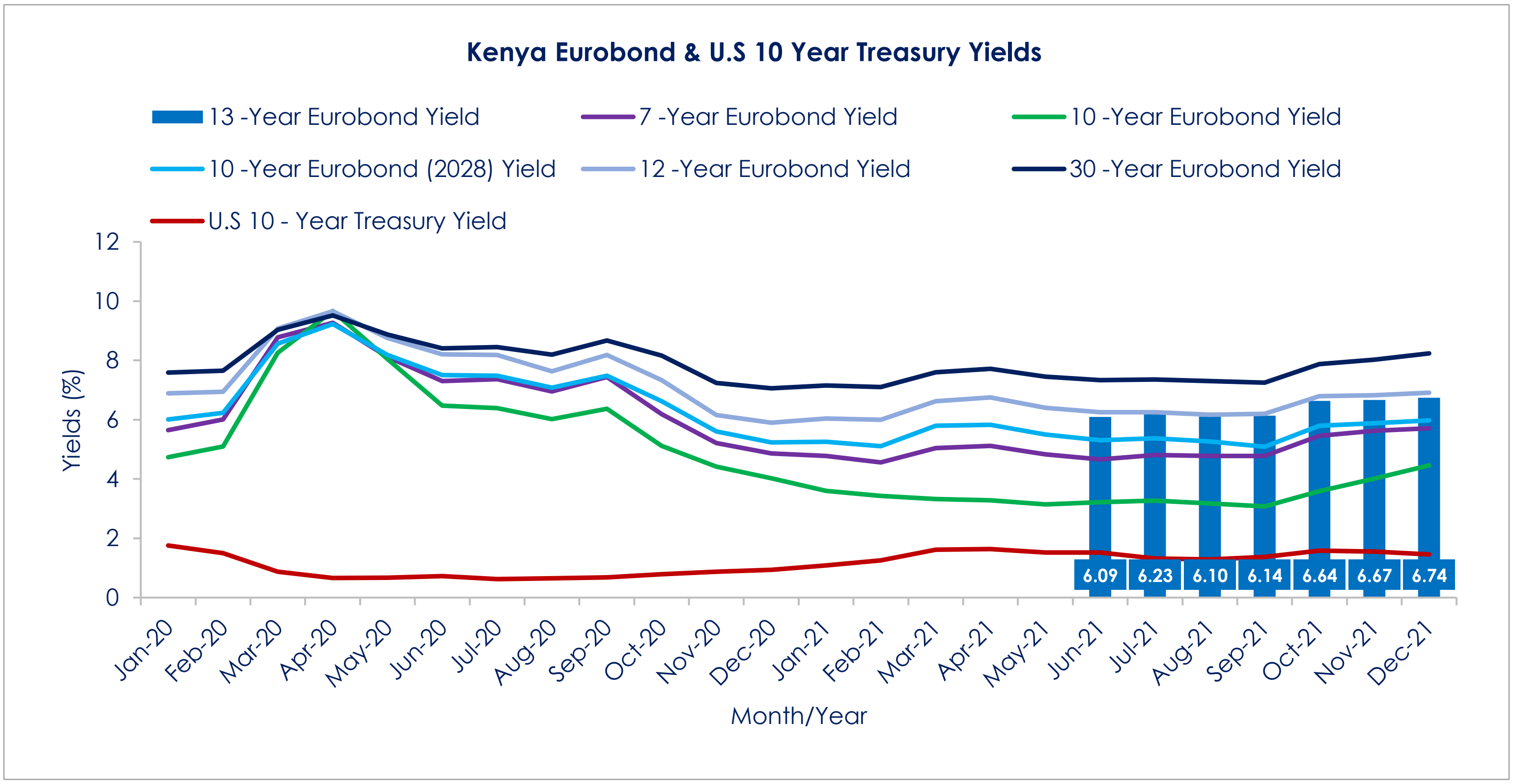


Source: The Kenya Gazette Vol. CXXIII – No.230 12th November 2021

Kenya Eurobond yields rise in December 2021

- Average Government of Kenya Eurobond yields rose in November compared to November 2021 with the largest increase being on the 10 Year Bond (Figure.13).
- We attribute this increase to investor concerns over rising public debt service costs especially with the depreciation of the KES against the U.S$.
- The National Treasury has indicated that it intends to issue at least to sovereign debt issues before the end of the current fiscal year.

Figure.13: Kenya Eurobond yields rise in December 2021

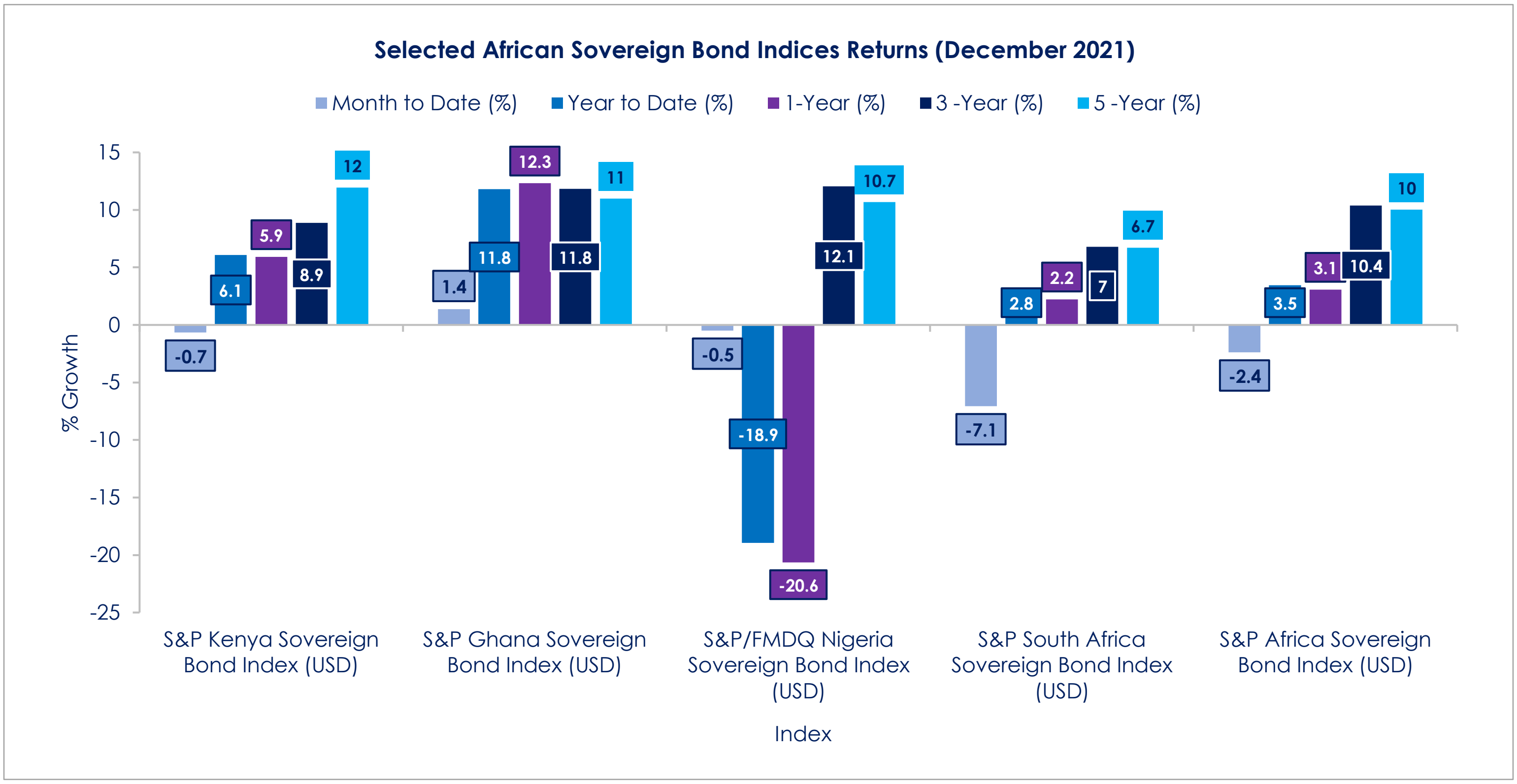


Source: Central Bank of Kenya

Kenya sovereign bond index returns positive in December 2021

- The S&P Kenya Sovereign Bond index recovered in the Month of December posting a return of 0.2% compared to a negative return of 0.7% in November (Figure.14).
- The S&P South African Bond Index was the top performer during the month with a return of 6.2%.
- Over the last one year, the Kenya bond index has returned 5.9% but lagged behind the S&P Ghana Sovereign Bond Index which is the top performing index amongst our comparables with a return of 12.3%.

Figure.14: S&P Kenya Sovereign bond returns to positive territory in December 2021



Source: S&P Global

NSE yield curve has shifted upwards over the last one year

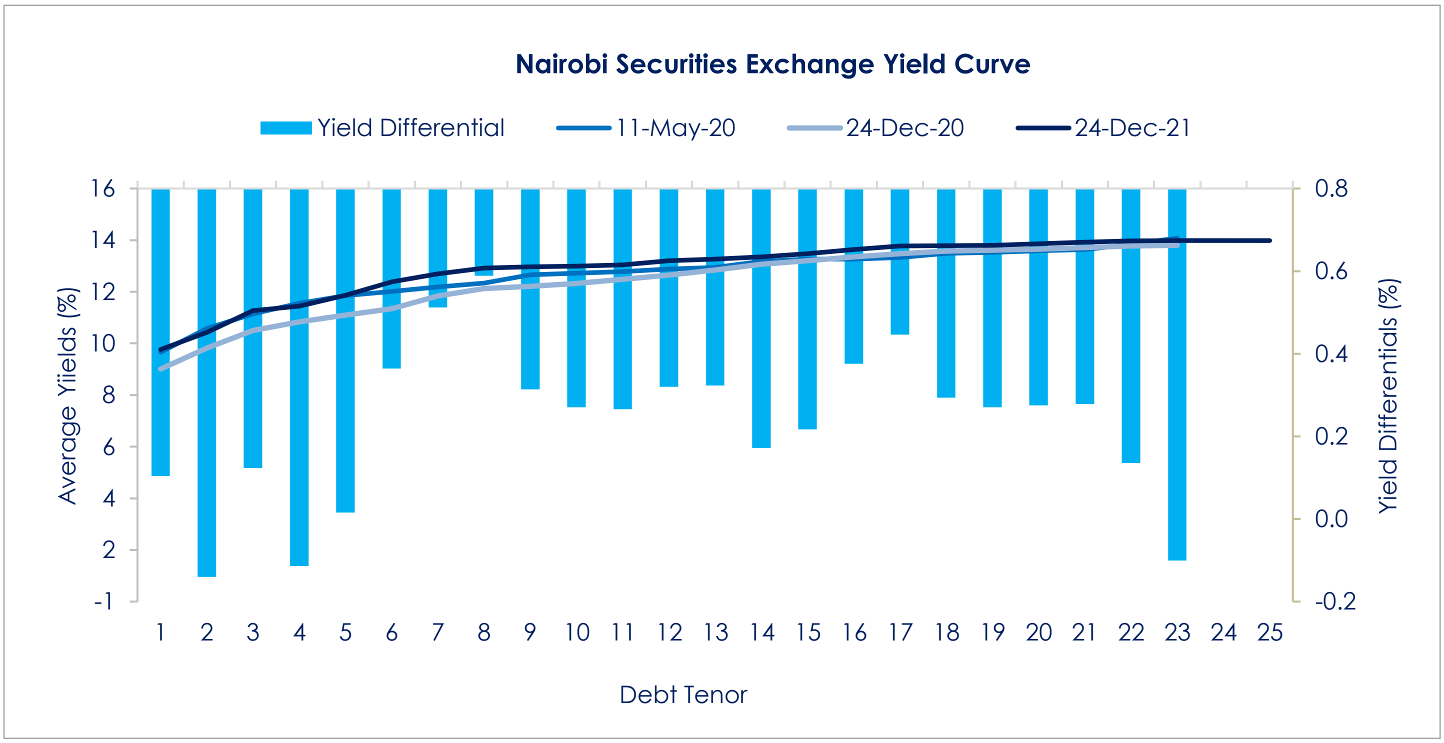
- A comparison of average bond yields in the NSE on 11th May 2020 (issuance FXD1/2020/5) and 24th December 2021 shows an increase in the long-term debt tenors while yields on short-term and medium debt tenors showed mixed trends particularly on the two and ten-year tenors. (Table.7 and Figure.15).
- However, a comparison of average yields in December 2021 compared to the same month in 2020 shows an increase in yields on all debt tenors.
- The upward shift in the yield curve over the last one year is a direct result of the CBK being accommodative of more aggressive investor bids to encourage subscription for Government debt.
- We predict gradual increases in yields on all debt tenors over the next few months due to the persistent fiscal budget deficit financing.
- Due to the prospect of rising interest rates, we expect to see higher demand of short-term debt with some investors preferring to invest in T-Bills particular the 91 and 182 Day T-Bills.

Table.7: Yields on the short, medium and long-end of the yield curve have increased over the last one year

Tenor	Yields (11th May 2020)	Yields (24th December 2020)	Yields (24th December 2021)	YoY ∆ 24th December 2021 vs 2020 (Bps)	∆ 24th December 2021 vs 11th May 2020 (Bps)	Sterling Capital yield Curve (December 2021)
1	9.1610	8.5080	9.2650	75.7	10.4	9.3
2	10.0703	9.3167	9.9298	61.3	-14.0	10.0
5	11.3528	10.6000	11.3684	77.1	12.3	11.4
10	12.2224	11.8223	12.4925	60.9	-11.4	12.5
15	12.7633	12.7091	12.9803	76.8	1.6	13.0
20	13.0821	13.1529	13.3571	103.9	36.4	13.4

Source: Nairobi Securities Exchange & Sterling Capital Research

Figure.15: The yield curve has shifted upwards over the last one year

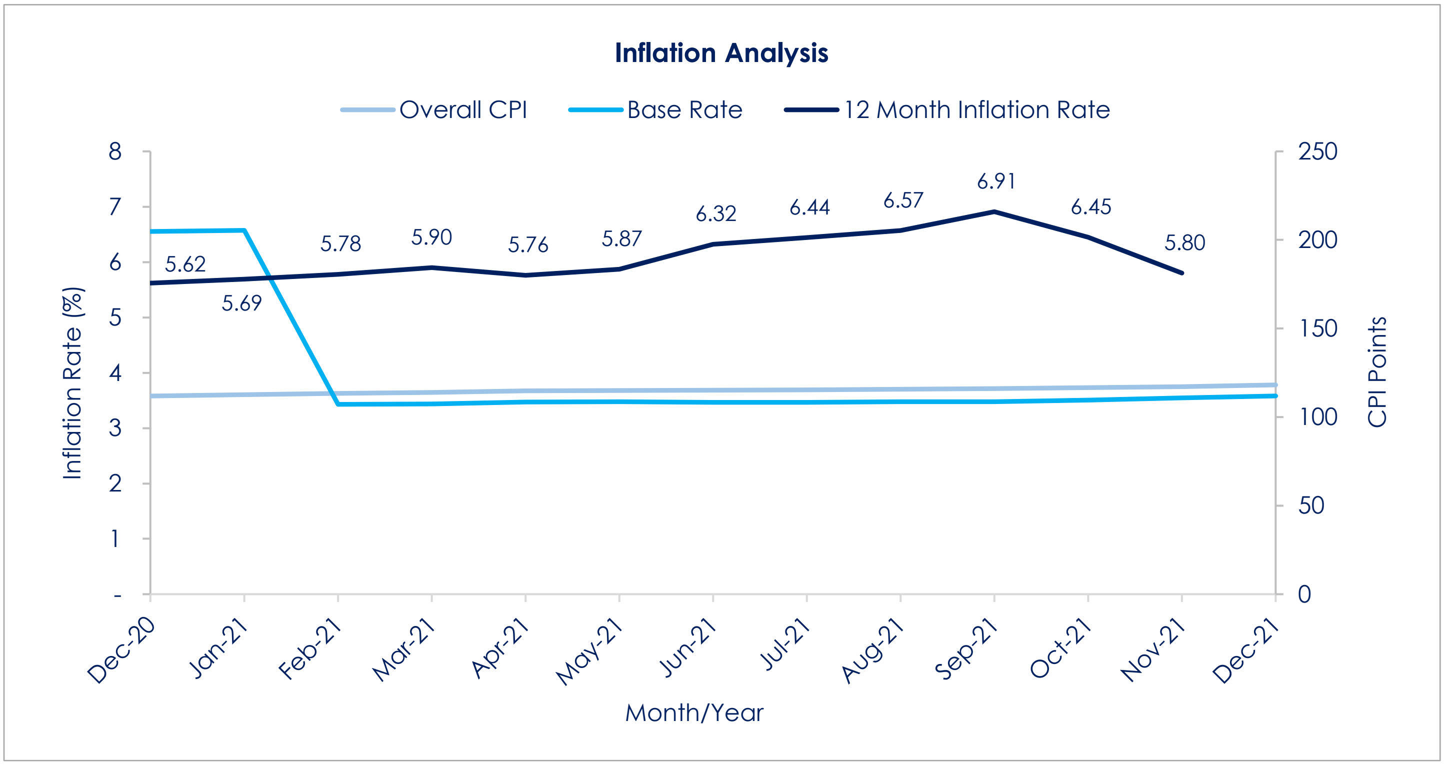


Source: Nairobi Securities Exchange

December 2021 inflation to rise on higher transport and food prices

- Inflation for the month of November 2021 declined to 5.8% from 6.5% in October 2021 (Figure.16).
- This was however significantly higher than the inflation rate for November 2020 (5.3%) but the lowest inflation rate since May 2021 (5.87%).
- The year on year increase was mainly attributable to an increase in prices of commodities under; food, and non-alcoholic beverages (9.9%), transport (8.1%) and housing, water, electricity, gas and other fuels (6.2%).
- We predict December inflation to be in the range of 6% - 7%, which is still within the CBK's 2.5% - 7.5% target range, with food and transport indices the main drivers.

Figure.16: Short-term inflation forecast 5.5% - 6.5%



Source: Kenya National Bureau of Statistics

Monetary Policy Committee to meet at the end of January 2022

- The Monetary Policy Committee meets at the end of January 2022 with the main focus being inflation levels and the depreciating Kenya Shilling (KES) which has been trading at KES.113 to the United States Dollar (U.S$) over the last week.
- That said, we do not expect a revision in the Central Bank Rate (CBR) and Cash Reserve Ratio (CRR) at 7% and 4.25% respectively.

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