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STERLING CAPITAL LIMITED

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# Fixed Income Note

## March 2022

## "Three bonds for the third month"

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## Executive Summary

- Our fixed income report for the month of March 2022 titled **"Three bonds for the third month"** is our analysis of the Central Bank of Kenya's (CBK) three re-opened bond issues for the month of March 2022 **FXD1/2021/5 (4.7 years)**, **FXD1/2020/15 (12.9 years)** and **FXD1/2021/25 (24.2 years)**.
- The CBK is seeking to raise KES.50Bn through these issues of which we are cautiously optimistic that the issues will be oversubscribed with our weighted average bid predictions as follows:

  **Weighted Average Rate of accepted bids:**
  **FXD1/2021/5: 11.75% - 11.85%**
  **FXD1/2020/15: 13.15% - 13.25%**
  **FXD1/2021/25: 13.85% - 13.95%**

- The report covers primary auction outcomes, secondary market trading trends, short-term domestic debt interest rates and market liquidity.
- Domestic maturities have a huge impact on CBK's borrowing strategy and this debt service is analysed in the report.
- This month's fixed income report also covers the country's fiscal position including Government revenue, expenditure and fiscal deficit as well as its borrowing needs.
- The report includes an analysis of the yield curve over selected periods showing trends in yields of different tenors.
- 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 re-opens three bonds in March 2022

- The Central Bank of Kenya (CBK) invites bids for three re-opened Treasury Bonds (T-Bonds); **FXD1/2021/5**, **FXD1/2020/15** and **FXD1/2021/25** to raise KES.50Bn for budgetary support (Table.1).
- The three bonds have remaining terms to maturity of 4.7, 12.9 and 24.2 years respectively.
- **FXD1/2021/5**, **FXD1/2020/15** and **FXD1/2021/25** have coupon rates of 11.28%, 12.76% and 13.92%.
- We are cautiously optimistic that the debt issue will be oversubscribed with our estimates at KES.50Bn - KES.60Bn.
- We expect the 5-year issue to receive the bulk of demand as banks and retail investors prefer short investment horizons.
- We also expect relatively high demand for the 25-year issue from local institutional buyers as they look for stable long-term interest income source.

**Table.1: Primary Bond issue summary**

| **Issue Number** | **FXD1/2021/5** | **FXD1/2020/15** | **FXD1/2021/25** |
|---|---|---|---|
| Total Amount Offered | KES.50Bn | | |
| Tenor | 5 Years | 15 Years | 25 Years |
| Term to Maturity | 4.7 Years | 12.9 Years | 24.2 Years |
| Coupon Rate (%) | 11.28 | 12.76 | 13.92 |
| Price Quote | Discounted/Premium/Par | | |
| Period of Sale | 24th Feb 2022 - 8th March 2022 | | |
| Auction Date | 9th March 2022 | | |
| Value Date | 14th March 2022 | | |
| Yield Curve (%) (Weighted average tenor - 25th Feb 2022) | **11.6050** | **13.0476** | **13.6500** |

Source: Central Bank of Kenya & Sterling Capital Research

## Our weighted average and accepted bids averages

- We arrived at our market weighted and the CBK's accepted bids average estimates by analysing yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as at 25th February 2022 and discussions with fixed income traders (Table.2).

**Table.2: Auction bid predictions**

| **Rate** | **FXD1/2021/5** | **FXD1/2020/15** | **FXD1/2021/25** |
|---|---|---|---|
| Weighted Average Rate of Accepted Bids (%) | 11.75 - 11.85 | 13.15 - 13.25 | 13.85 - 13.95 |

Source: Sterling Capital Research

## Our predicted rates are guided by historical debt issues

- We used implied yields of bonds of almost similar tenors to maturity on the NSE as at 25th February 2022 as a guide for possible investor auction bid levels (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 |
|---|---|---|---|---|---|---|
| FXD1/2021/5 | 15th Nov 21 | 11.28 | 9th Nov 2026 | 1,718 | 11.6050 | 10.8986 |
| FXD1/2020/15 | 24th Feb 20 | 12.76 | 5th Feb 2035 | 4,728 | 13.0476 | 12.6000 |
| FXD1/2021/25 | 10th May 21 | 13.92 | 9th April 2045 | 8.809 | 13.6500 | 13.9240 |

Source: Central Bank of Kenya

- Reviews of historical auction results show higher investor interest in issues with shorter tenors which reinforces our assertions of higher demand for that **FXD1/2021/5** in this auction (Table 4).
- We also note the oversubscription of the 25-year issue with the CBK accepting lower bids.
- We expect aggressive bidding for the 25-year given it is trading below its coupon rate and the Government's significant fiscal needs.
- It is likely that the CBK will likely accept in excess of KES.50Bn due to high financing needs brought about by shortfall in revenue collection targets for the current fiscal year.

**Table.4: Historical IFB primary market auction performance**

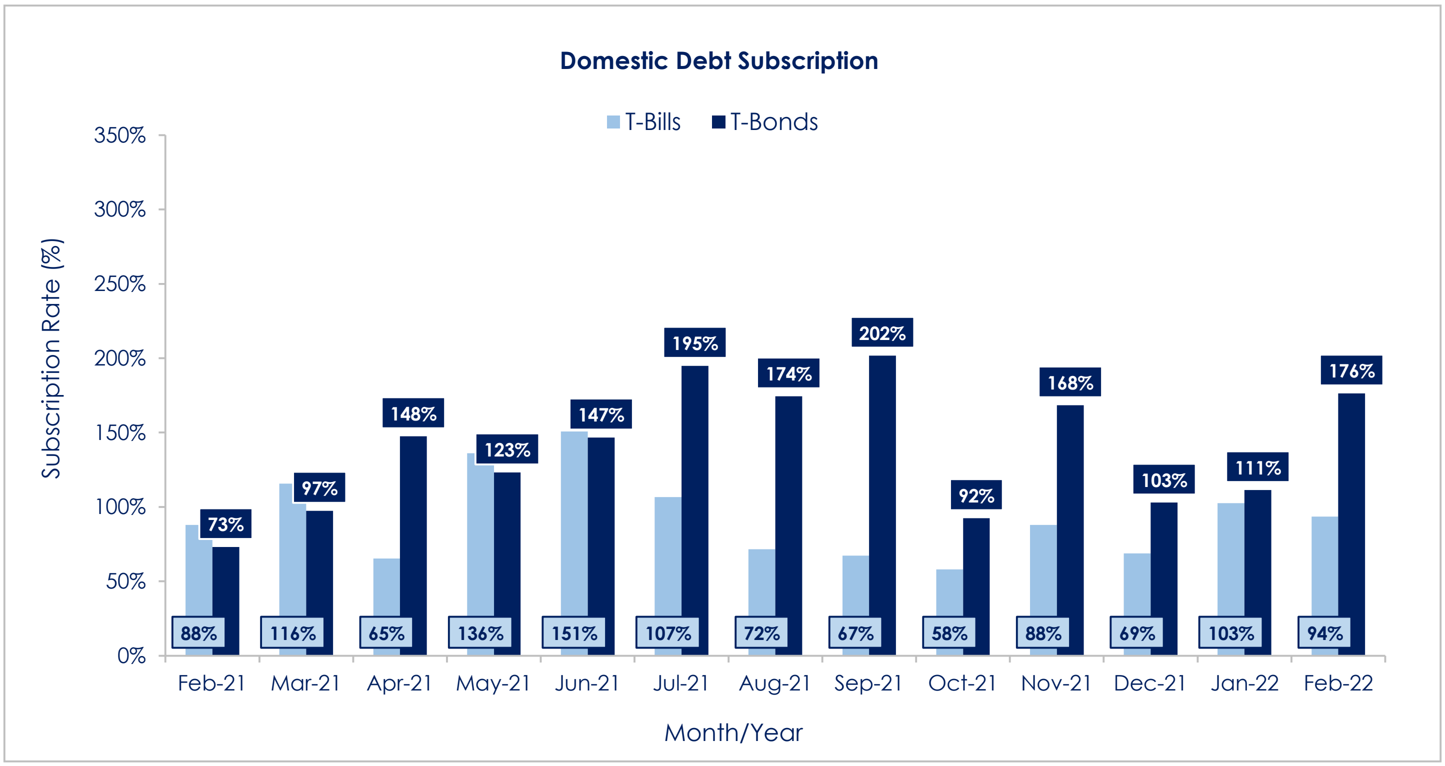
| Issue | Issue Date | Offered (KES.Bn) | Bids Received (KES.Bn) | Amount Accepted (KES.Bn) | Performance Rate (%) | Coupon Rate (%) | Implied Yield (%) |
|---|---|---|---|---|---|---|---|
| **5-Year** | | | | | | | |
| FXD1/2019/5 | 25th Feb 2019 | 50 | 41.9 | 20.6 | 83.9 | 11.304 | 10.4500 |
| FXD2/2019/5 | 13th May 2019 | 50 | 49.3 | 39.2 | 98.6 | 10.872 | 10.6316 |
| FXD1/2020/5 | 11th May 2020 | 50 | 34.5 | 20.8 | 69.1 | 11.667 | 11.1670 |
| FXD1/2021/5 | 15th Nov 2021 | 50 | 66.6 | 53.7 | 133.2 | 11.280 | 11.6050 |
| **15-Year** | | | | | | | |
| FXD1/2018/15 | 28th May 2018 | 40 | 20.2 | 12.9 | 50.5 | 12.650 | 12.8171 |
| FXD1/2019/15 | 28th Jan 2019 | 40 | 25.1 | 14.7 | 62.7 | 12.857 | 12.8958 |
| FXD2/2019/15 | 13th May 2019 | 50 | 21.5 | 19.3 | 43.1 | 12.734 | 12.9269 |
| FXD1/2020/15 | 24th Feb 2020 | 50 | 18.4 | 5.2 | 36.9 | 12.760 | 12.6000 |
| **25-Year** | | | | | | | |
| FXD1/2021/25 | 10th May 2021 | 30.0 | 31 | 14.2 | 103.4 | 13.920 | 13.6500 |

Source: Central Bank of Kenya

## T-Bonds oversubscribed as investors gravitate towards IFBs

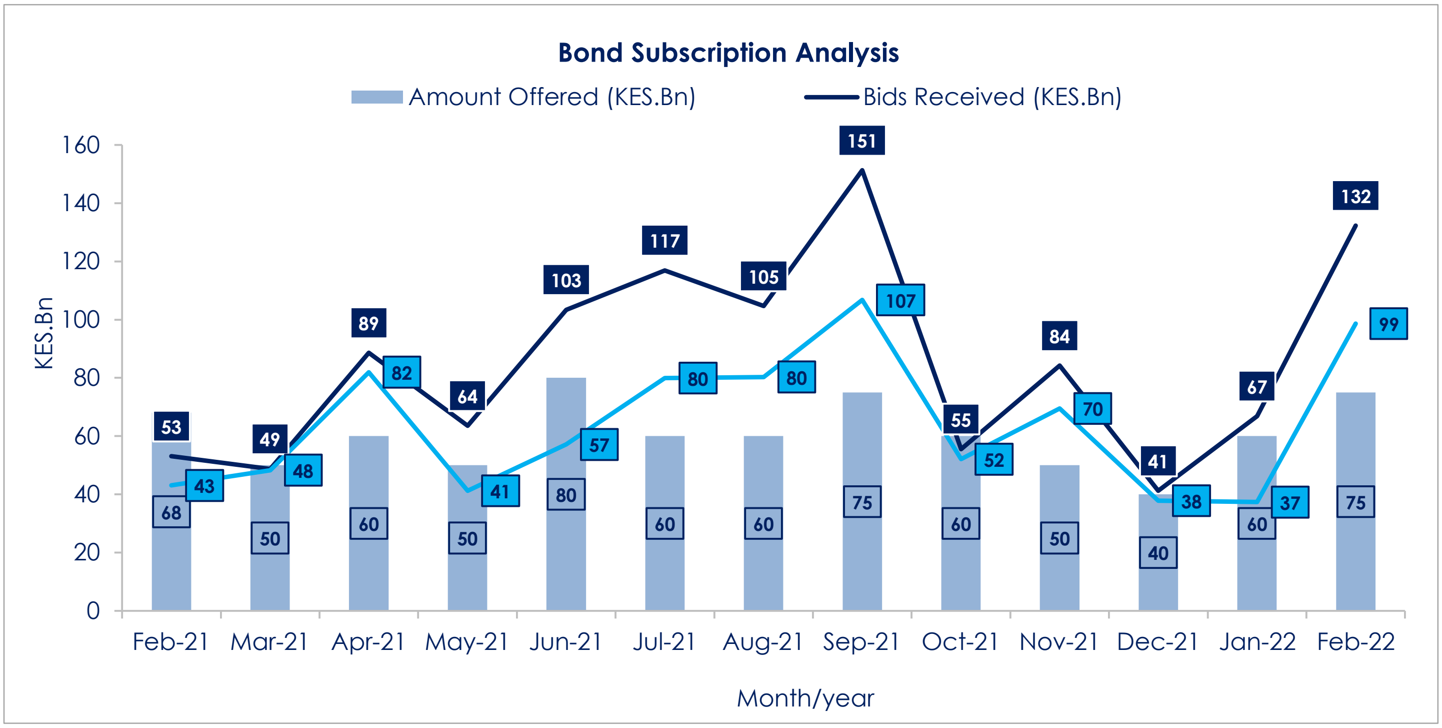
- Investor subscription rates for February rose to 176% due to the issuance of **IFB1/2022/19** from 111% in January 2022 (Figure 1).
- Subscription rates for the bond increased due to its attractive tax free coupon - 12.965% with the CBK accepting KES.98.6Bn of the KES.132.3Bn received (Figure.2).
- There was however a slight drop in the T-Bill subscription rate to 94% from 103% due to tightening liquidity.
- Subscription rates for the 91,182 and 384 day T-bill stood at to the 61.1%, 72.1% and 128.2% respectively, a significant drop from the 70.3%, 80.1% and 138% recorded in January.
- Increased T-Bill interest rate as well as the shift in demand to the IFB mentioned above recently issued IFB greatly attributed to the drop in subscription rates for T-bills.

**Figure.1: T-Bond subscription rise, T-Bill's drop in February 2022**




Source: Central Bank of Kenya

**Figure 2: T-bond subscriptions surge in February 2022**

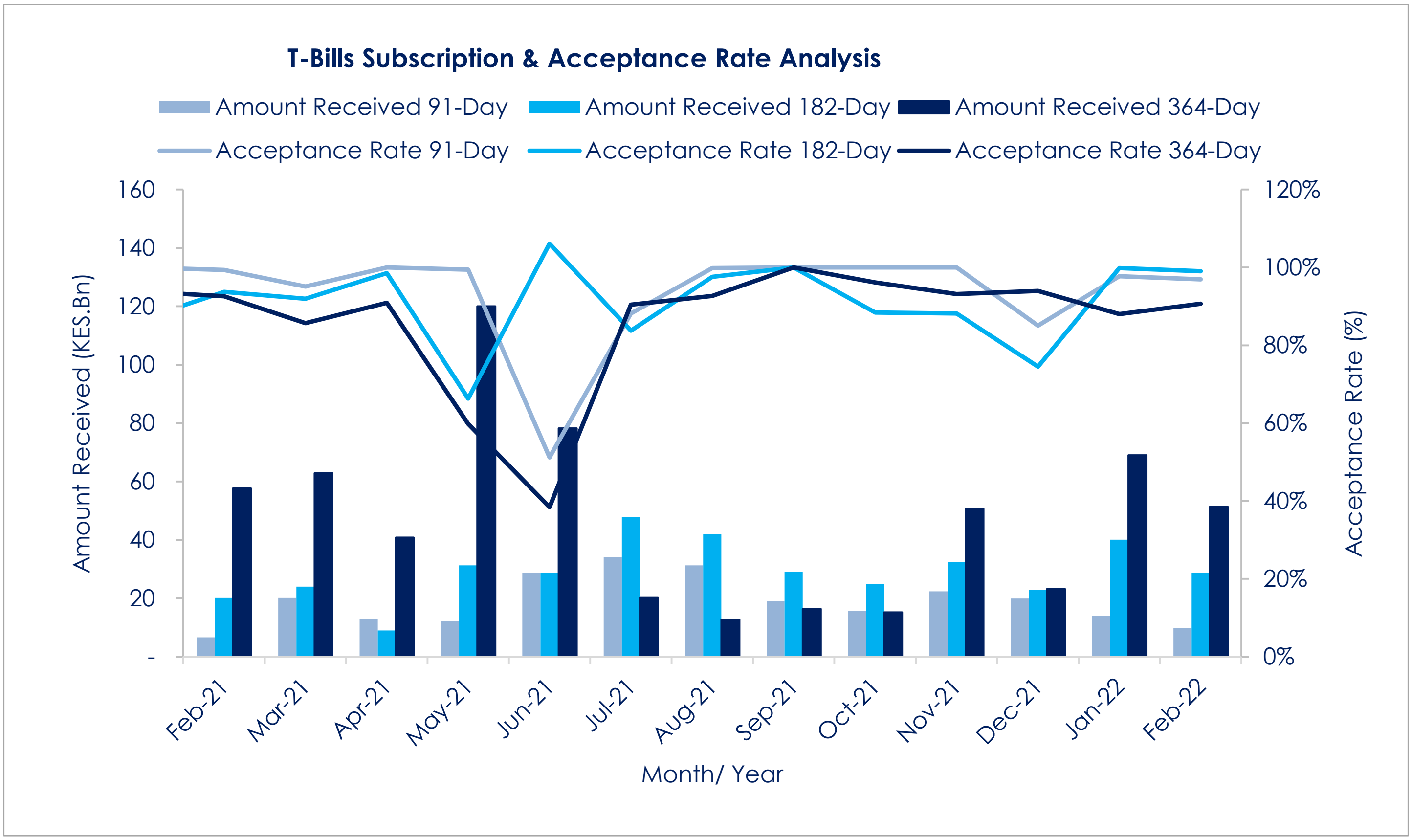



Source: Central Bank of Kenya

## T-Bill acceptance rates close to full high as subscription

- CBK acceptance rates for the 91, 182 and 364-Day T-bills were relatively high at 97%, 99% and 90.6% respectively a trend we attribute to high deficit financing pressures (Figure.3).

**Figure.3: Slight increase in 364 Day T-Bill acceptance rate in February 2022**

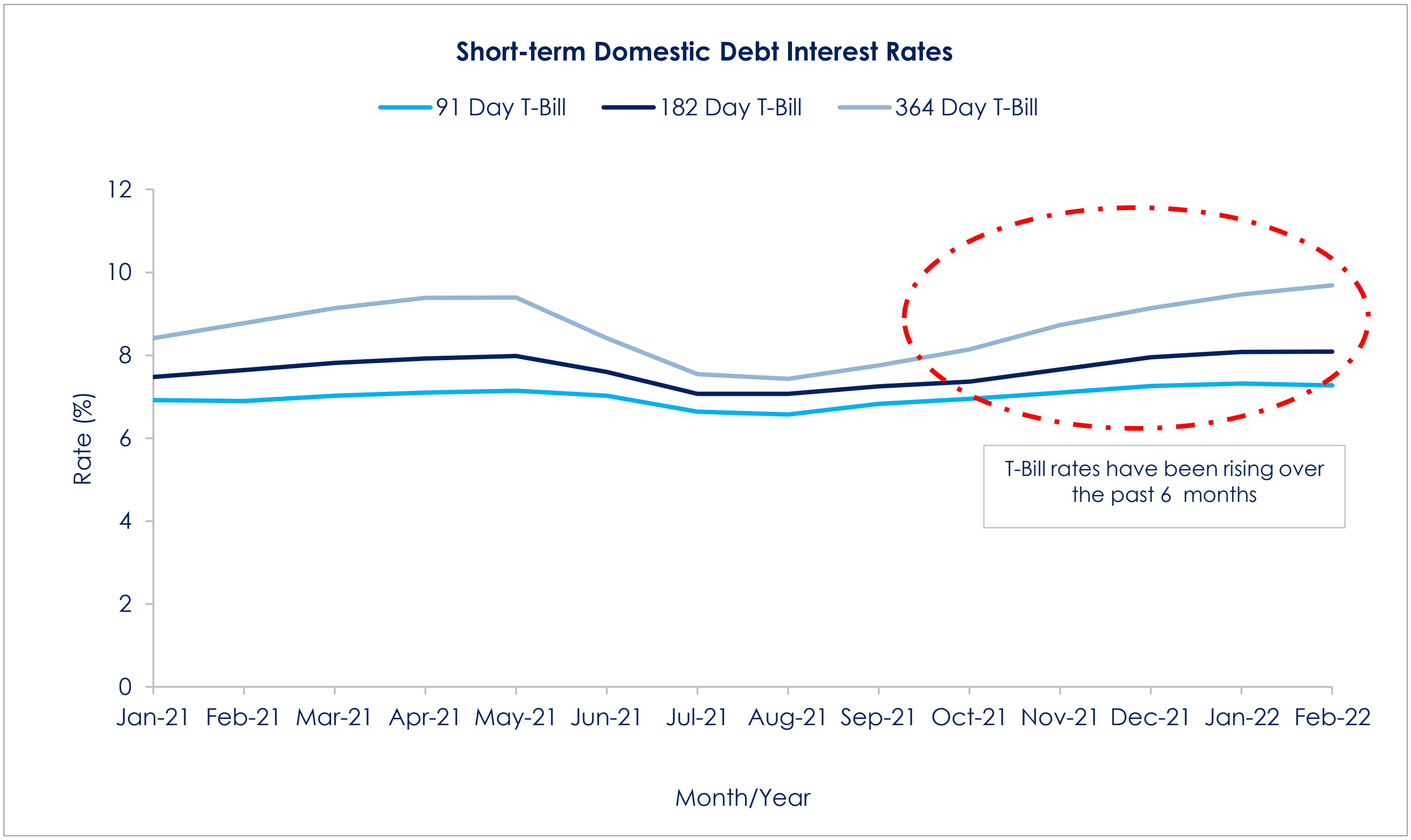



Source: Central Bank of Kenya

## Short-term interest rates maintain the positive trend in February 2022

- Average short-term interest rates in February 2022 maintained the upward trajectory that started in the third quarter of 2021 (Figure.4).
- The 91-day T-bill rate declined to 7.28% from 7.32% in January while the 182 and 364-day T-Bills rates rose to 8.09% and 9.69% from 8.08% and 9.47% in January respectively.
- The 364 day has risen by the biggest margin with average interest rates up 22 bps over the previous month showing the CBK's intention to reduce refinancing risks.
- Overall, we expect short-term interest rates to maintain this trend in the short-term due to budget deficit financing pressure.

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

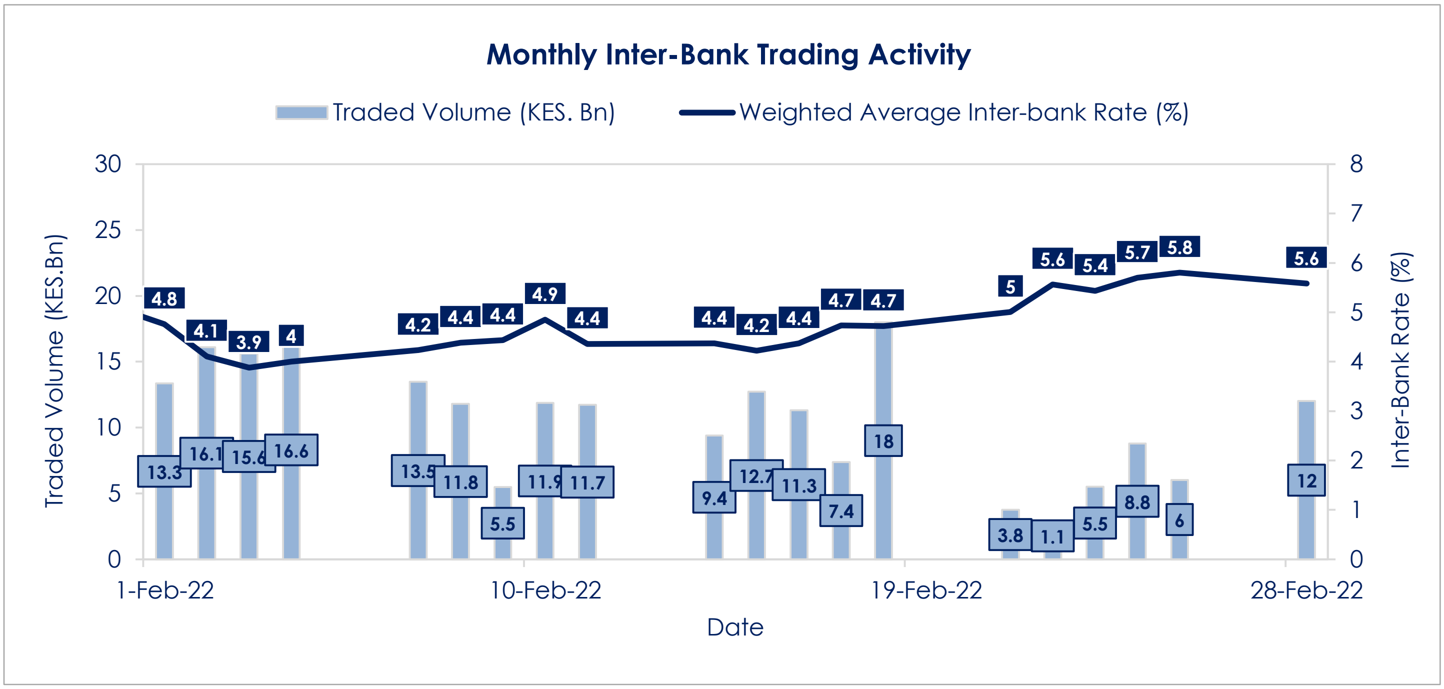



Source: Central Bank of Kenya

## Average inter-bank lending rates up in February 2022 on tighter liquidity

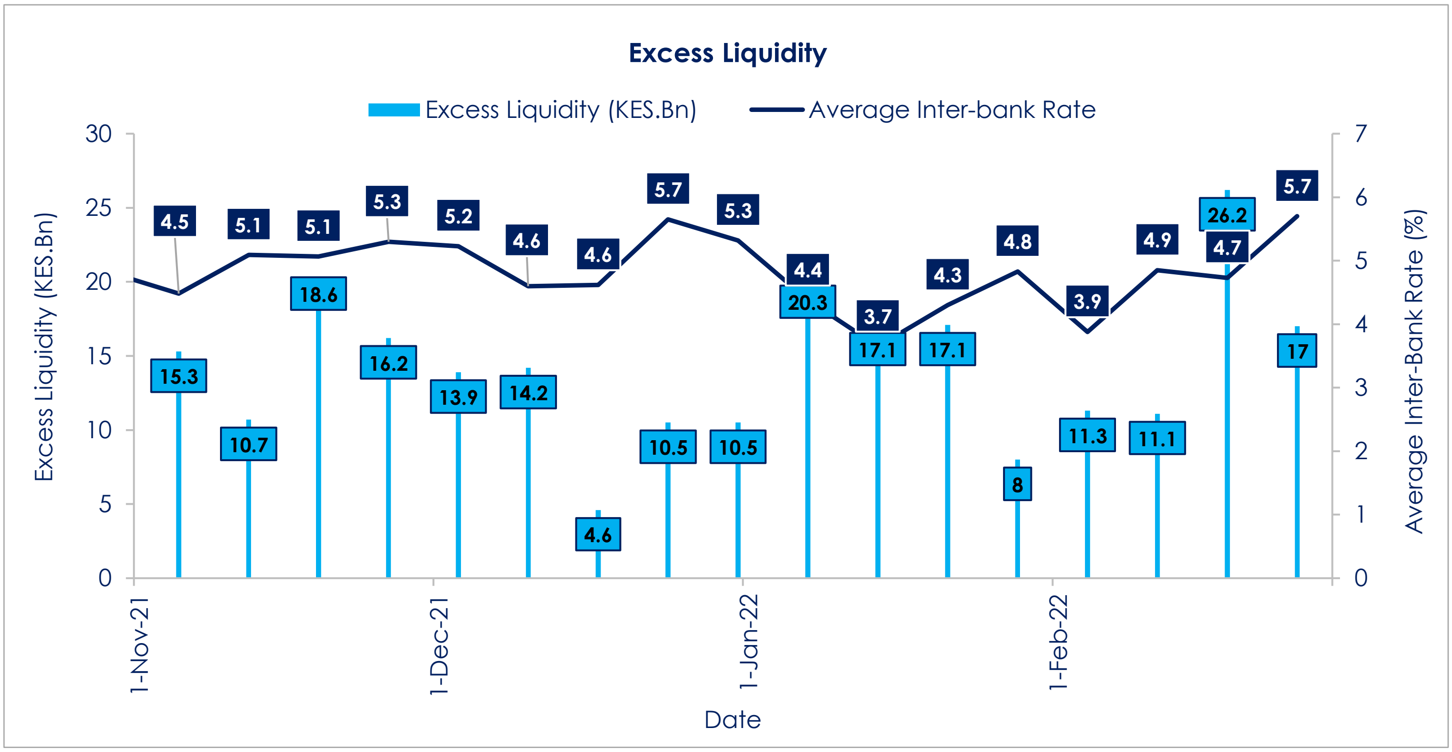
- Average inter-bank rates rose to 4.7% in February 2022 compared to the 4.5% in January while total inter-bank trading volumes for the same period dropped to KES.212.1Bn from the KES.301.7Bn recorded in January 2022 (Figure.5).
- This is an indication of a decline in liquidity partly caused by the high investor interest in **IFB1/2022/19**.
- However, total excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) for the same period increased slightly to KES.65.6Bn, compared to KES.62.5Bn in the previous month (Figure.6).
- Our forecasted average inter-bank rate for March 2022 is between 4% - 5%.

**Figure.5: Inter-bank lending rates to range between 4% and 5.5% in March 2022**




Source: Central Bank of Kenya

**Figure.6: Excess commercial bank reserves increase in February 2022**

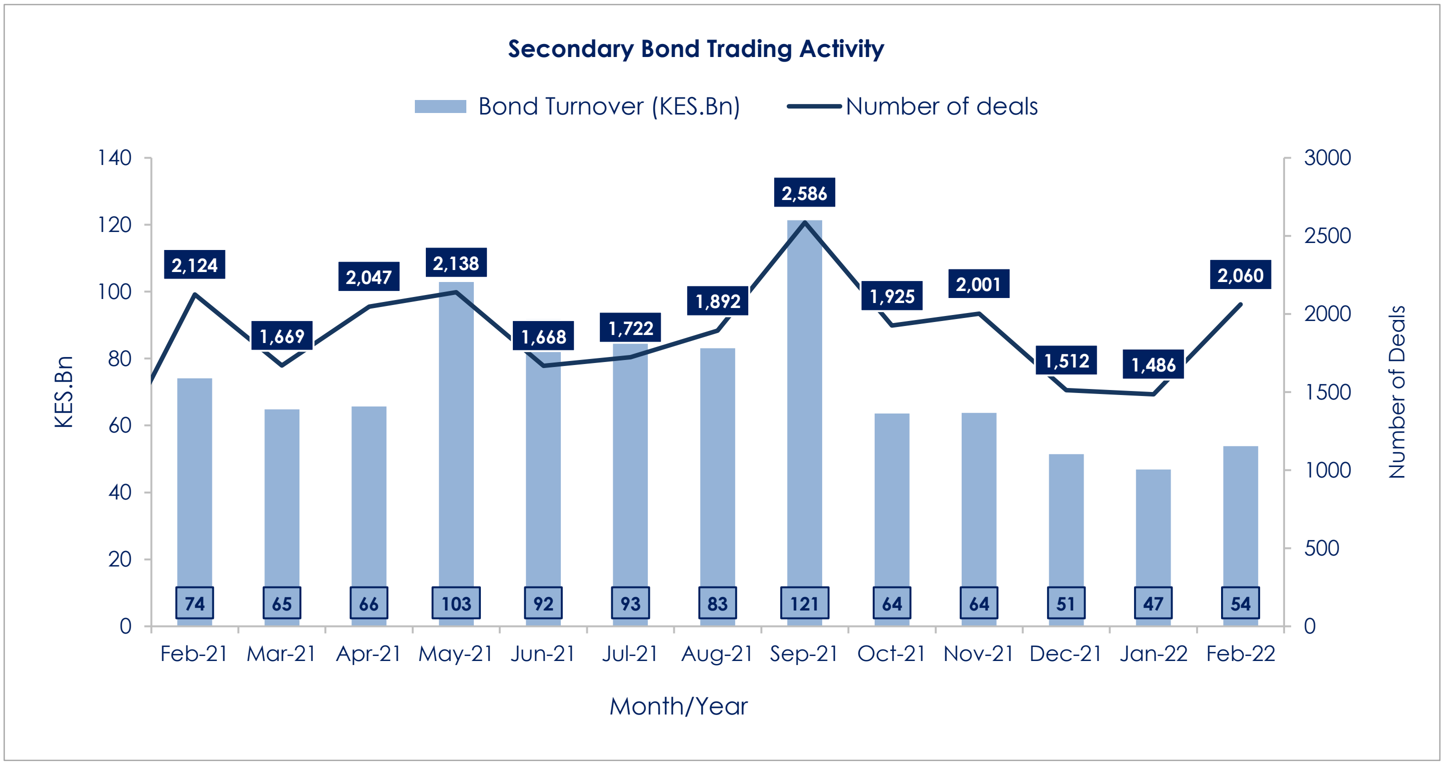



Source: Central Bank of Kenya

## Secondary market bond turnover to increase in February 2022

- In line with our January prediction, secondary market trading activity rose in February with the number of deals increasing from 1,486 in January to 2,060 in February and turnover from KES.47Bn to KES.54Bn.
- The expected increase was generally due to trading of **IFB1/2022/19**.
- We expect secondary market activity to remain elevated with most trading activity concentrated on recent IFB issues.

**Figure.7: Secondary trading activity rises in February 2022**

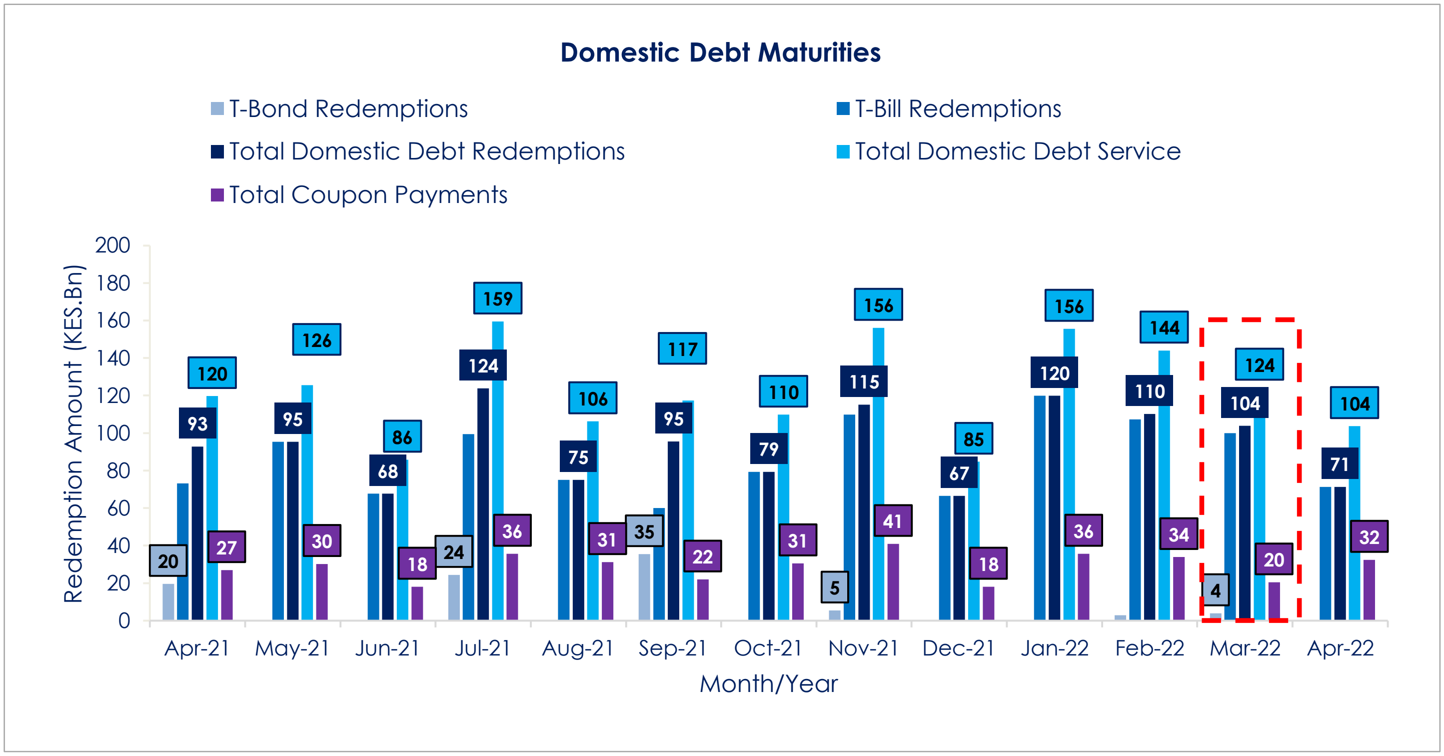



Source: Central Bank of Kenya

## Domestic debt service for March 2022 at KES.124Bn

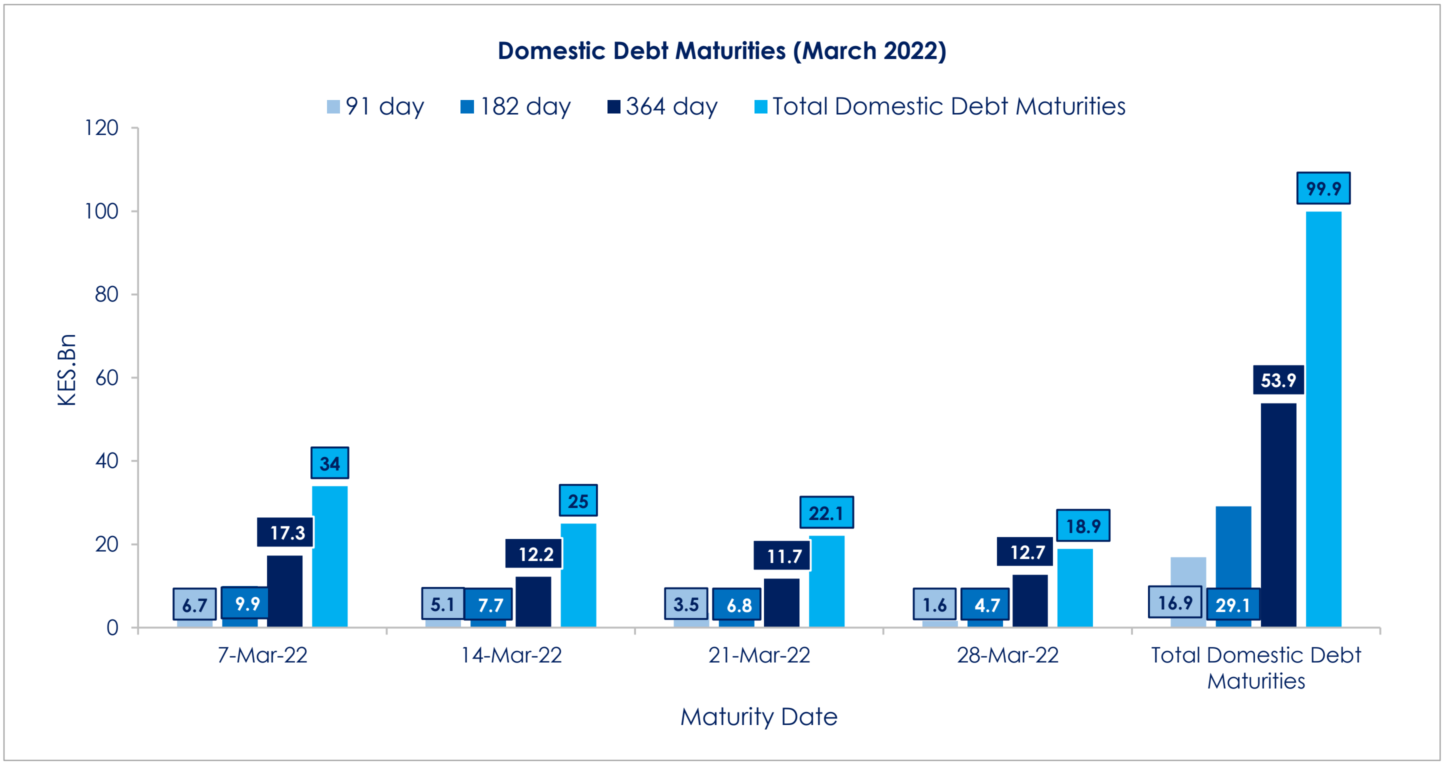
- Debt service for March 2022 is KES.124.2Bn, equivalent to 13.8% lower than the KES.144Bn in February (Figure.8).
- This comprises of KES.99.9Bn and KES.20.4Bn in T-Bill and coupon payments respectively as well as KES.3.9Bn as full redemption of **FXD1/2007/15**.
- Expected redemptions for the 91,182 and 364-day T-Bills during the month are KES.16.9Bn, KES.29.1Bn and 53.9Bn respectively with the first week of the month having the highest redemptions at KES.34Bn (Figure.9).

**Figure.8: March debt service KES.124Bn**




Source: Central Bank of Kenya

## Figure.9: Weekly debt maturities March 2022




Source: Central Bank of Kenya

### Tax revenues comfortably above 2021/22 fiscal year budgetary target

- Actual total tax revenue receipts for the 2021/22 fiscal year stood at KES.1.01Tn at the end of January 2022 (seven months of the fiscal year) above our linear target estimate of KES.995.4Bn (assumes 58.3% of the KES.1.71Tn) (Table.7 and Figure.10).
- This is in line with the Kenya Revenue Authority (KRA) which reported in January 2022 that it had surpassed its Q1 2021/22 (July-September 2022) target.
- Domestic borrowing at KES.532.9Bn (52.8%) remained short of our linear target run rate of 58.3% which translates to heighten domestic borrowing in the second half of year.
- External borrowing stood at 12.5% of the fiscal year target (KES47.3Bn) a scenario we see changing significantly following the issuance of sovereign debt estimated at U.S$KES.2.2Bn (KES.249.3Bn) in the second half of the year.
- We note however that the 0.6% increase in tax receipts falls well below the 6.5% increase (KES.126.3Bn) in Government expenditure estimates (excludes consolidated fund services and county allocation) for the current fiscal year.
- This means that the fiscal deficit has actually expanded and we do not expect a major shift in Government borrowing.

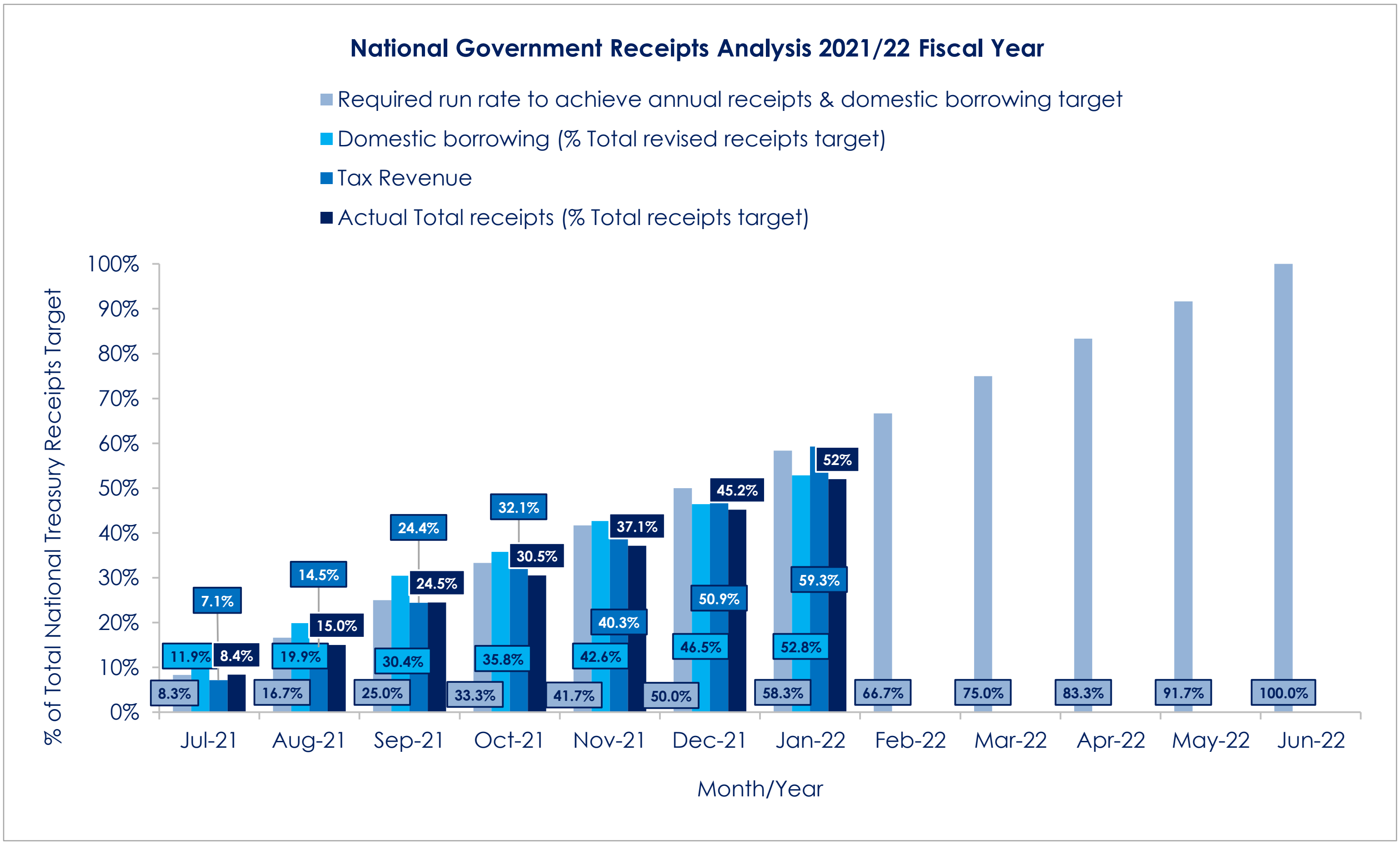
## Table.7: 2020/21 fiscal year domestic borrowing above target run-rate

| Receipts | Original Estimates July 2021 (KES.Bn) | Actual Receipts 31st Dec 2021 (KES.Bn) | Actual Receipts 31st Jan 2022 (KES.Bn) | Proportion of Total Receipts 31st Jan 2022 (KES.Bn) |
|---|---|---|---|---|
| Opening Balance (1st July 2021) | | 21.3 | 21.3 | - |
| **Tax Revenue** | **1,707.4** | **868.8** | **1,011.7** | **59.3** |
| Non-Tax Income | 68.2 | 36.2 | 42.3 | 62 |
| **Domestic Borrowing*** | **1,008.4** | **468.5** | **532.9** | **52.8** |
| External Loans & Grants | 379.7 | 44.3 | 47.3 | 12.5 |
| Other Domestic Financing | 29.3 | 4.2 | 5.3 | 18.1 |
| **Total Revenue** | **3,193** | **1,422** | **1,660.8** | **52** |
| **Linear Run Rate target (7 months of fiscal year)** | | | | **58.3** |

* 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. CXXIV - No.31 18th February 2022

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

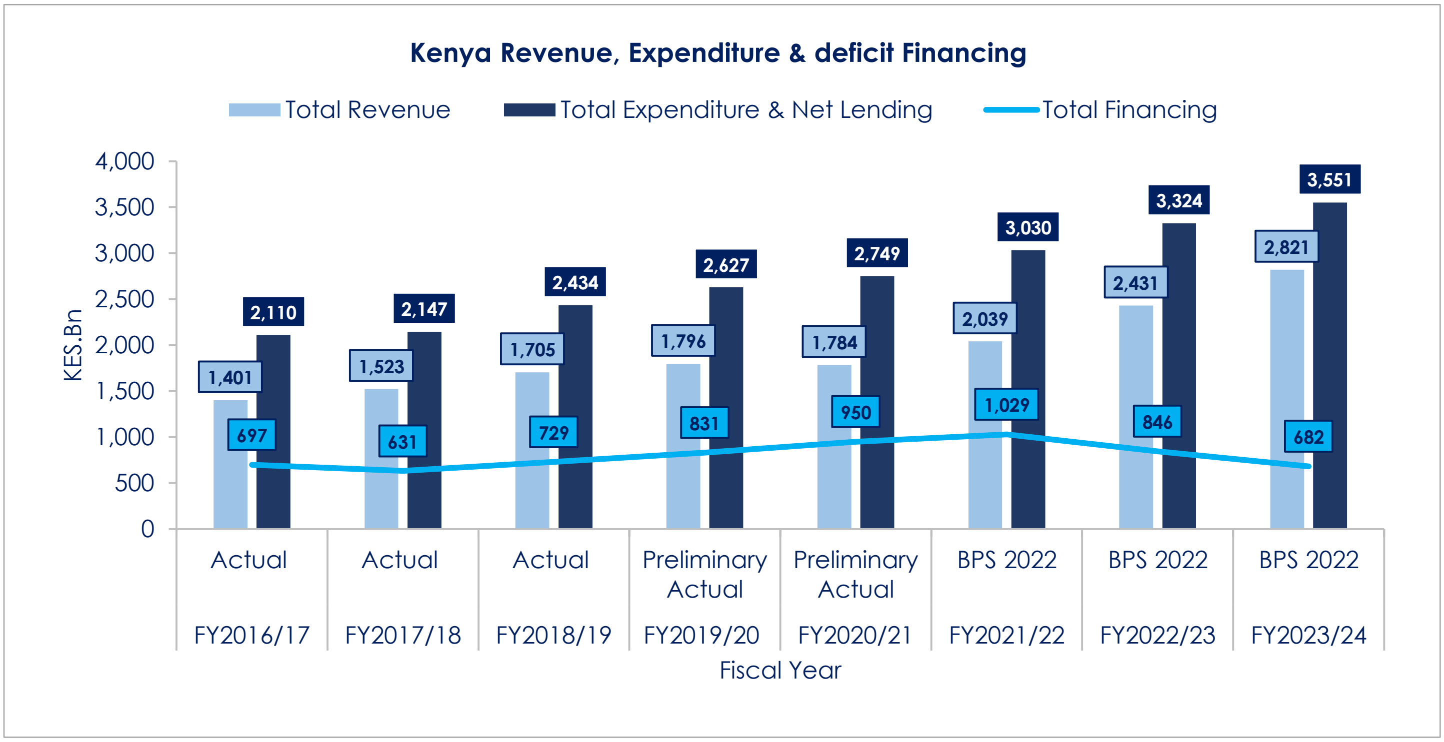



Source: The Kenya Gazette Vol. CXXIV - No.31 18th February 2022

## National Treasury financing target of KES.846Bn is optimistic

- The National Treasury estimates a fiscal deficit financing target of KES.846.1Bn for the 2022/23 fiscal year, 17.8% lower than the 2021/22 budget estimate (KES.1.03Tn) and 11% lower than the 2020/21 Budget Review and Outlook Paper (BROP) KES.950.2Bn estimate (Figure.11).
- As mentioned in our **2021 Kenya Economy Review & Outlook 2022 "2022 - Will politics overshadow economics?"** we feel that this fiscal deficit estimate is low on account of expected increase in 2022 General election, Covid-19 and drought alleviation expenditures.
- We see the fiscal deficit and financing target near the KES.1Tn estimate for the 2021/22 fiscal year.

**Figure.11: Kenya Revenue, expenditure and deficit financing**



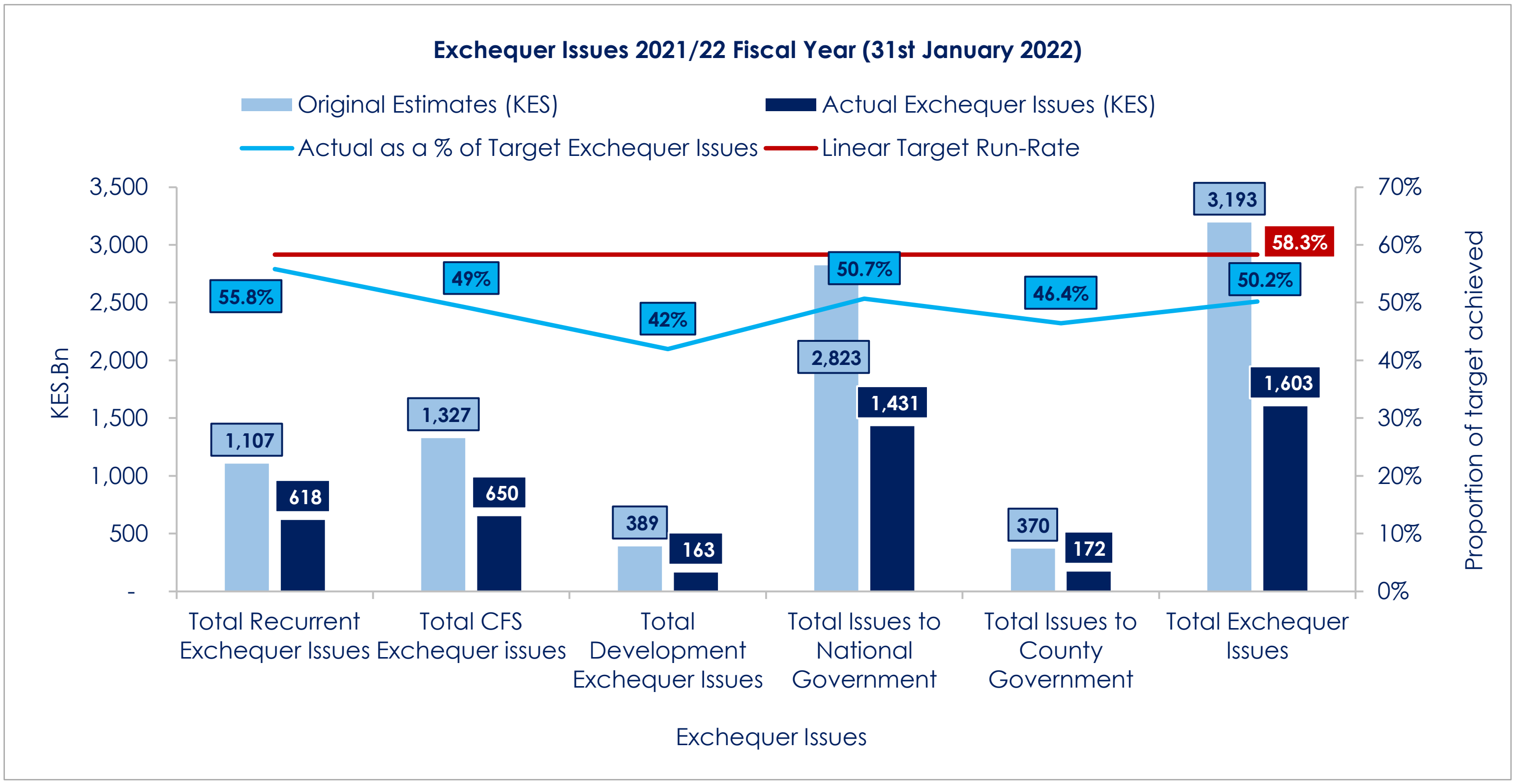

Source: National Treasury & Planning

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

- Actual Total Government expenditure as at the end of January 2022 stood at KES.1.6Tn equivalent to 50.2% of the total fiscal year target of KES.3.19Tn (Figure.12) and below our 58.3% linear target run-rate for the seven months of the 2021/22 fiscal year (Figure.12).
- We however take note of an improvement in transfers to county Government which stood at KES.171.8Bn or 46.4% of the KES.370Bn target compared to KES.144Bn (37%) of the estimated total target.

- We attribute the underperformance to financing constraints even with improved tax revenue collection, but expect an uptick following improved tax revenue collections in the current fiscal year as well as increased borrowing in the second half of the current fiscal year.

**Figure.12: Government expenditure remains below target run-rate estimates**

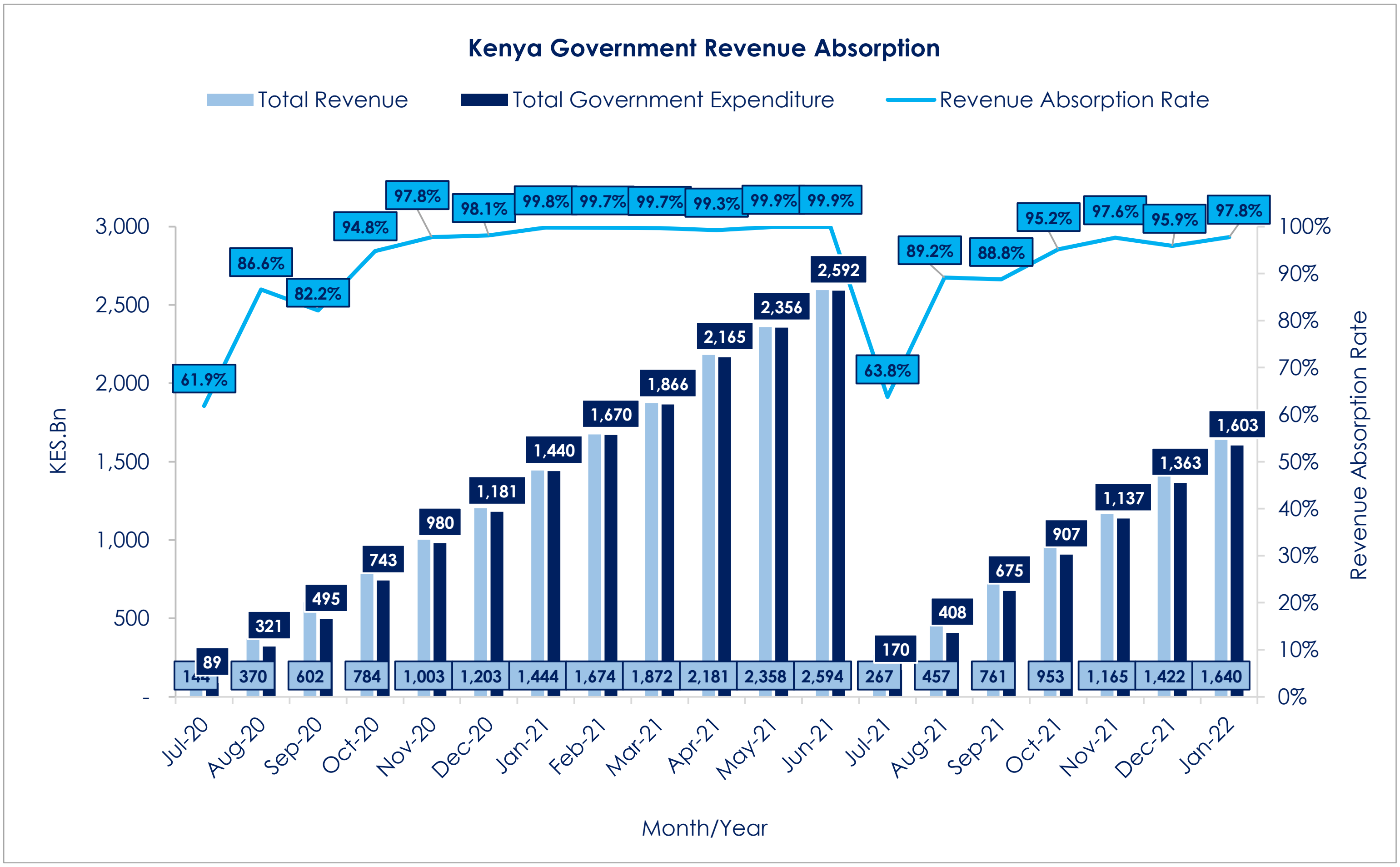



Source: The Kenya Gazette Vol. CXXIV - No.31 18th February 2022

## Revenue Absorption improves in January 2022 but still below January 2021

- The proportion of Government receipts used to finance expenditure, the Revenue Absorption Rate (RAA) increased to 97.8% in January 2022 compared to 95.9% in December 2021 (Figure.13).
- This however was still lower than close to full absorption (99.8%) in January 2020.
- We expect the RAA to fluctuate within a narrow range of 97.5% and 98.7% for the rest of the fiscal year.

**Figure.13: Revenue absorption dips in December 2021**

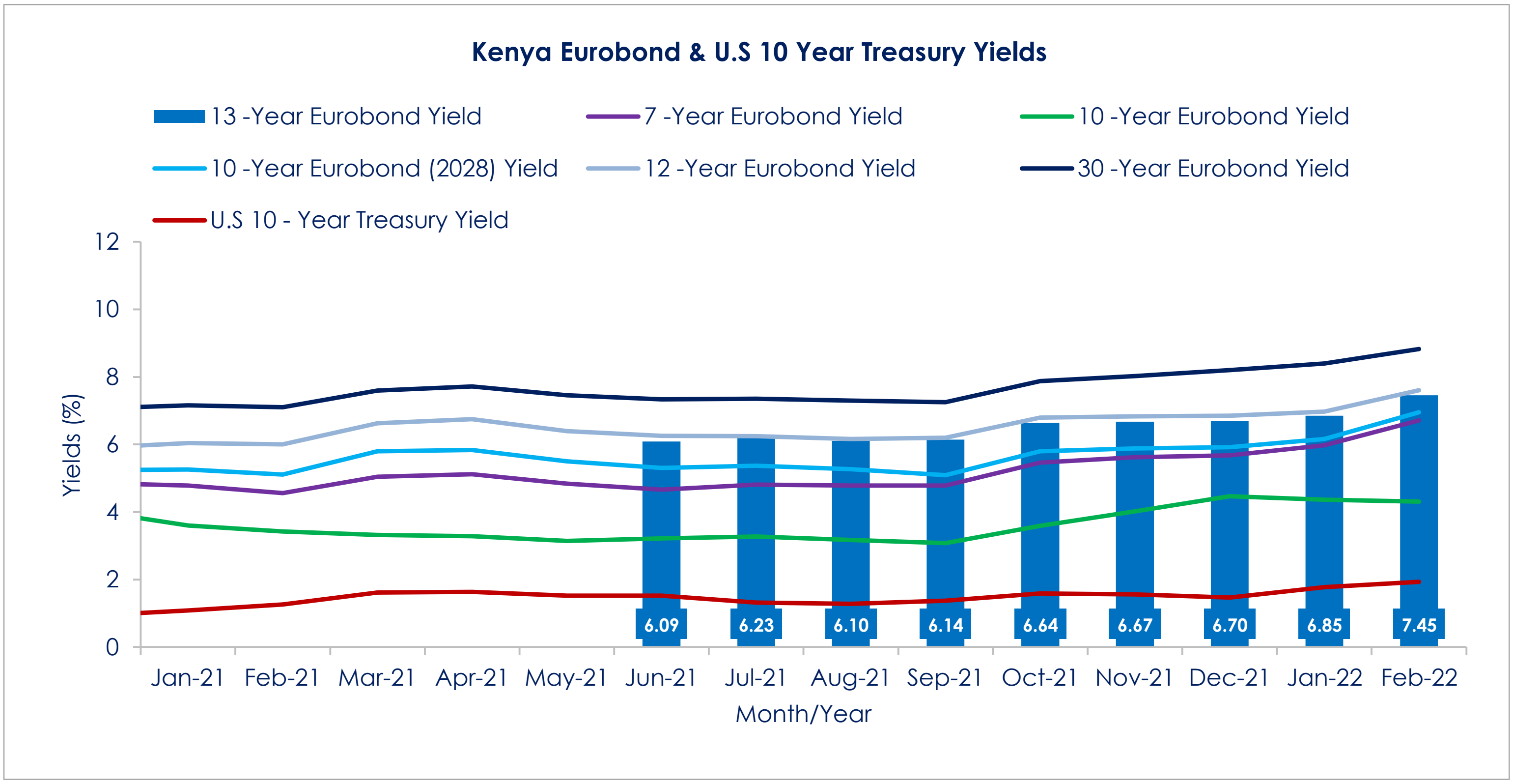



Source: The Kenya Gazette Vol. CXXIV - No.31 18th February 2022

## Kenya Eurobond yields spike on Ukraine-Russia crisis

- Average yields for all Government of Kenya Eurobond yields with the exception of the 10 -Year Eurobond maturing in December 2024 rose in February 2022 compared to January 2022 (Figure.14).
- Average yields on the U.S 10-Year Treasury over the same period rose 16bps a trend we are likely to see as investors prepare for the upward revision of the Fed rate.
- Kenya Eurobond bond yields will continue to rise due to the upward movement of interest rates and the impact of the Ukraine-Russia war that has resulted in negative investor sentiment and a flight from "safe haven" bonds.

**Figure.14: Kenya Eurobond yields rise in February 2022**

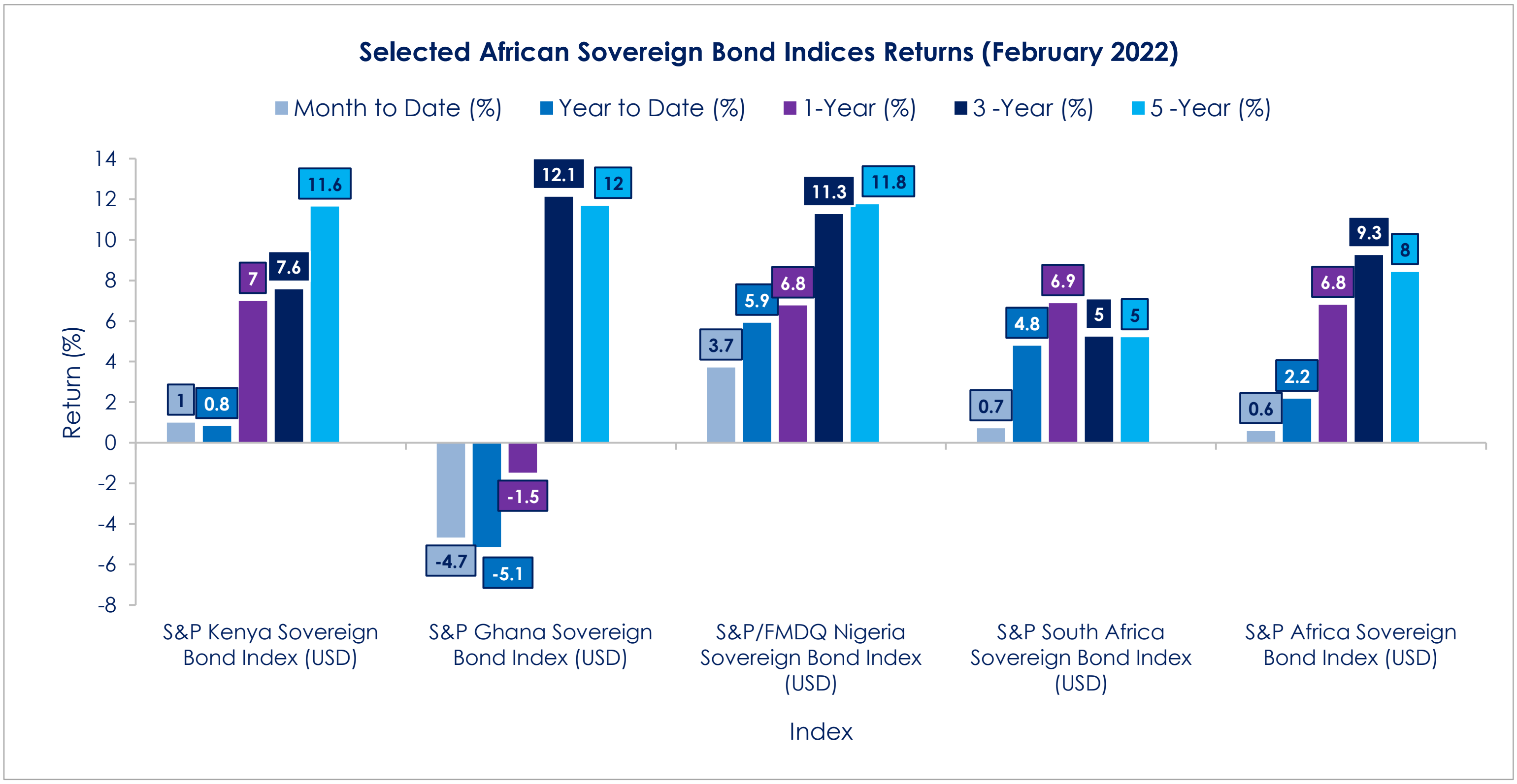



Source: Central Bank of Kenya

## Nigerian sovereign bond index tops month and annual performance

- The S&P Kenya sovereign bond index is the best performing sovereign bond index amongst our comparables over the last 1 year with a return of 7% 9Figure.15).
- The Ghanaian index narrowly outperforms the Nigerian index on a 3-year and 5-year basis however it offers negative returns on a 1 year, Year-to-Date (YTD) and Month-to-Date (MTD) basis.
- The reasons behind the poor return this year so far could be a combination of investors' expectations of new sovereign debt issues at higher yields and expectations of rising benchmark yields both of which would have a negative

**Figure.15: S&P Kenya bond index top performer over the last 1 year**




Source: S&P Global

## Treasury Bills maintain upward trend in February 2022

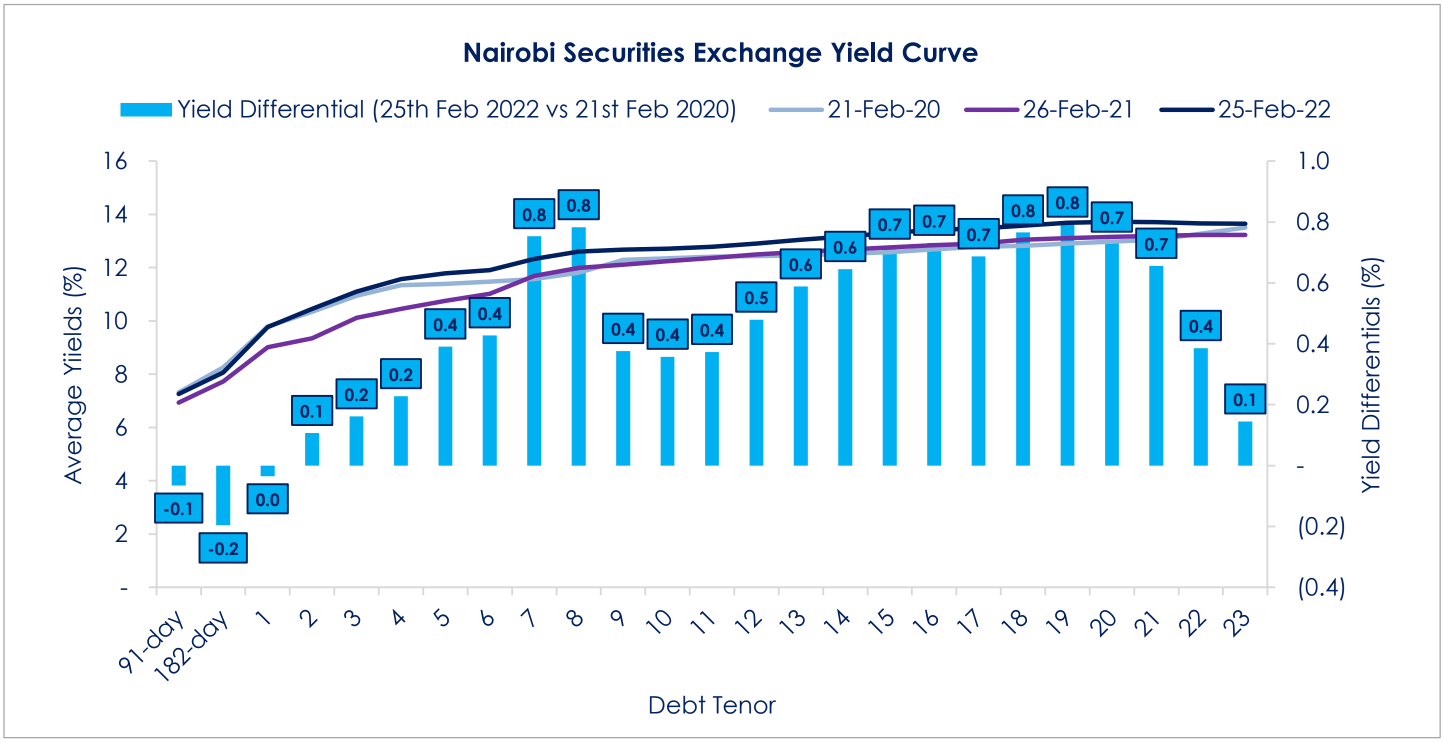
- A comparison of average yields on the NSE on 21st February 2020 (closest to issuance date of **FXD1/2020/15**) and 25th February 2022 shows an uptick across the short, medium and long tenors with the exception of the 1 year tenor which declined by 3.5Bps (Table.8 and Figure.16).
- Further, a comparison of yields during in February 2021 shows an increase across all tenors along the yield curve.
- The CBK has been driving demand for longer dated debt by accepting higher investor bids in debt auctions as its strategy to lengthen the Average Tenor to Maturity (ATM) of public debt.
- We predict a gradual increase in rates across the yield curve in 2022 due to an increased domestic debt financing demand.
- On the basis of the above, we expect a higher yield on **FXD1/2021/25** and **FXD1/2020/15** compared to **FXD1/2021/5** with its comparatively shorter tenor.
- Notably, these March issues have been well spread out to capture a wider target market with short, medium and long term tenors.
- We maintain our recommendation of **BUY short and HOLD medium-term and long term papers.**

## Table.8: Yield curve has shifted upwards Year on year (Yoy)

| Tenor | Yields (21st Feb 2020) | Yields (26th Feb 2021) | Yields (12th Nov 2021) | Yields (25th Feb 2022) | Δ Feb 2022 vs Feb 2020) (Bps) | YoY Δ Feb 2022 vs Feb 2021 (Bps) | Sterling Capital Yield Curve (March 2022) |
|---|---|---|---|---|---|---|---|
| 1 | 9.7990 | 9.0140 | 8.7450 | 9.7640 | ↓ 3.5 | ↑ 75 | 10.00 |
| 2 | 10.3435 | 9.3500 | 9.7015 | 10.4500 | ↑ 10.7 | ↑ 110 | 10.45 |
| 5 | 11.3965 | 10.7539 | 11.2442 | 11.7877 | ↑ 39.1 | ↑ 103.4 | 11.80 |
| 10 | 12.3542 | 12.2399 | 12.3481 | 12.7117 | ↑ 35.8 | ↑ 47.2 | 12.75 |
| 15 | 12.5782 | 12.7652 | 12.8859 | 13.2973 | ↑ 71.9 | ↑ 53.2 | 13.30 |
| 20 | 12.9750 | 13.1580 | 13.3993 | 13.7173 | ↑ 74.2 | ↑ 55.9 | 13.75 |

Source: Nairobi Securities Exchange

## Figure.16: Short, medium and long-term tenors rise Year on year (Yoy)

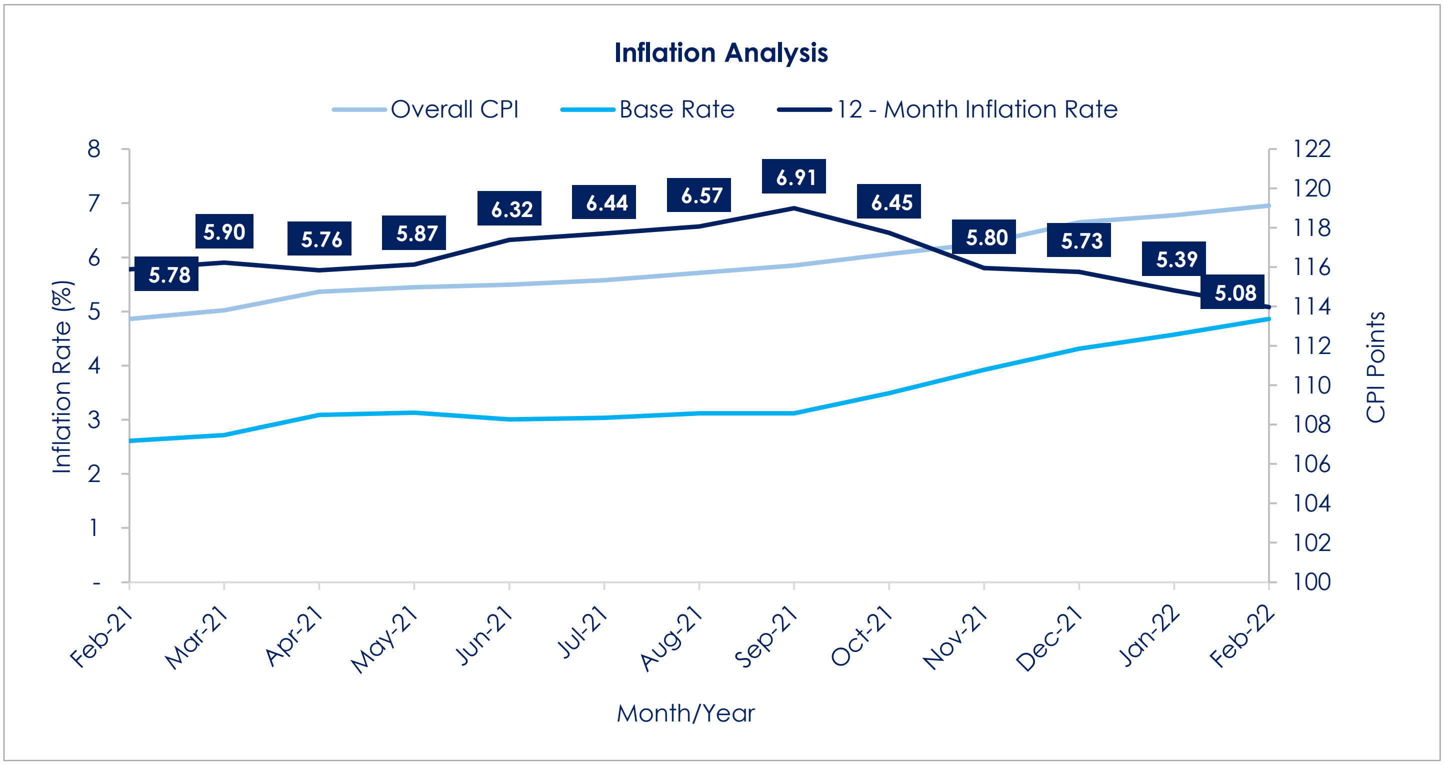



Source: Nairobi Securities Exchange

## February 2022 inflation declines on lower month on month prices

- Inflation for February 2022 declined to a 16 month low of 5.08% and lower than 5.39% in January (Figure.17).
- This was largely due to muted increases in prices of food and non-alcoholic beverages (8.7%) compared to 8.9% in January 2022 (Figure 18).
- There was a marked month on month decline in the prices of transport 4.5% from 6.8% and housing, water, electricity, gas and other fuels 4.8% from 5.1%).
- Our short term forecast for the last month of the quarter is 5% - 6% while we see it remaining within the medium and upper inflation bands of 5% to 7.5% through 2022.

**Figure.17: Short-term inflation forecast 5% - 6%**




Source: Kenya National Bureau of Statistics

## MPC to hold monetary policy steady in March meeting

- The Monetary Policy Committee (MPC) will met on Tuesday, 29th March 2022 to review the impact of previous monetary policy measures on the economy.
- We see the following as the main points of discussion:

1) The decline in overall inflation in Q1 which will be reflective of the impact of improved rainfall and decrease in water, electricity, gas and other fuel prices.

2) The ramifications of increased geopolitical tensions as a result of Russia's military action with Ukraine on the Kenyan economy.

   If the conflict is prolonged we expect to see increased capital flight away from the NSE equity market more so by foreign investors.

   Expected increase in Brent crude prices will drive Kenya's pump prices upwards and overwhelm the current state-backed subsidy that has kept pump prices unchanged for the fourth month in a row.

MPC to maintain CBR and CRR at 7% and 4.25% respectively.

   Further, with Russia and Ukraine as major sources of wheat imports to Kenya, the conflict could also soar wheat prices which risk a rise in cost of bread and other wheat products which comprise the basket of consumer goods and services.

3) Foreign exchange reserve position.

   The usable foreign exchange reserves have remained adequate over the last two months at U.S$.8.3Bn (5.1 months of import cover) and U.S$.8.1Bn (5 months of import cover) as at 26th January 2022 and 24th February 2022 respectively.

   Both periods have maintained at least 4 months and 4.5 months of import cover in accordance to CBK's statutory requirement and EAC region's convergence criteria respectively.

   These have provided adequate cover and buffer against short-term shocks in the foreign exchange market but will come under pressure due to a rise in import costs and subdued inflows.

4) Increased liquidity in the market that saw oversubscription of IFB1/2022/19 at 176.3%.

   The repo, reverse repo and inter-bank rates as of 25th February 2022 were at 4.9%, 8.1% and 5.8% pointing to a relatively liquid environment.

The CBK had largely issued reverse repos during the month of January and February amounting to approximately KES.194.3Bn in what we see was a bid to inject liquidity to support subscription of the IFB.

5) The depreciation of Kenya Shilling (KES) exchange rate against the United States Dollar (U.S$) with a range of KES.113.14 - KES.113.84 over the last two months.

   We expect the KES to stabilize at levels of KES.114-115 against the U.S$ in Q1 2022 largely driven by the widening current account deficit with inflows from Tourism, diaspora remittances, tea and coffee exports being inadequate to prevent further depreciation.

6) Developments in Private Sector Credit (PSC), banking sector credit quality, public debt, exports and imports.

- We feel that the above developments will not be sufficient for a revision to the Central Bank Rate (CBR) and Cash Reserve Ratio (CRR) which will remain at 7% and 4.25% respectively.

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