STERLING CAPITAL LIMITED

Fixed Income Note

May 2022

"CBK's last lap"

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Executive Summary

- Our fixed income report for the month of May 2022 is titled **“CBK’s last lap”** in reference to the Central Bank of Kenya’s (CBK) new ten year and re-opened twenty-five year fixed coupon treasury bonds.
- The apex bank seeks to raise KES.60Bn through the ten year issue **FXD1/2022/10** and twenty-five year issue **FXD1/2021/25.**
- While we are optimistic that **FXD1/2022/10** will be oversubscribed, **FXD1/2021/25** is likely to be undersubscribed.
- Our weighted average bid predictions are as follows:

- Weighted Average Rate (WAR) of accepted bids:
  FXD1/2022/10: 13.29% - 13.44%
  FXD1/2021/25: 13.99% - 14.14%

- 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.
- Also covered in the report is the country’s current fiscal position including Government revenue, expenditure and fiscal deficit as well as its borrowing needs.
- We also analyse the yield curve over selected periods showing trends in yields of different tenors.
- We finally give our inflation expectations towards the end of the report, which concludes, with our expectations of the upcoming Monetary Policy Committee (MPC) meeting later this month.

CBK's May debt issues to raise KES.60Bn

- The Central Bank of Kenya (CBK) invites bids for two Treasury Bonds (T-Bonds); **FXD1/2022/10** and **FXD1/2021/25** to raise KES.60Bn for budgetary support (Table.1).
- Subscription of the debt issues will highly depend on current market liquidity levels.
- The CBK also seems intent on keeping rates at below 14% as observed in recent medium and long-term debt auctions where it rejected bids above this rate.
- If this remains the case, they will pick more bids for the 10-year issue and reject aggressive bids for the 25-year issue.
- 10-year issue likely to receive the bulk of investor demand particularly from banks which prefer shorter investment horizons given the prevailing duration risk.
- Demand for the 25-year issue will most likely from local institutional buyers as they look for stable long-term returns.

Table.1: Primary Bond issues' summary

Issue Number	**FXD1/2022/10**	**FXD1/2021/25 (Re-opened)**
Total Amount Offered	KES.60Bn	
Tenor	10 Years	24.1 Years
Coupon Rate (%)	Market Determined	13.924%
Price Quote	Discounted/Premium/Par	
Period of Sale	28th April 2022 - 10th May 2022	
Auction Date	11th May 2022	
Value Date	16th May 2022	
Yield Curve (%) (Weighted average tenor - 30th April 2022)	**13.0240**	**13.8940**

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 implied yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as at 30th April 2022, together with discussions with several fixed income traders (Table.2).

Table.2: Auction bid predictions

Rate	**FXD1/2022/10**	**FXD1/2021/25**
Weighted Average Rate of Accepted Bids (%)	13.29 - 13.44	13.99 - 14.14

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 30th April 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
FXD1/2012/20	26th Nov 2012	12	1st Nov 2032	3,838	13.1021	13
FXD1/2021/25	10th May 2021	13.92	9th Apr 2046	8,745	13.8940	13.924

Source: Central Bank of Kenya

Investor interest higher in shorter tenor Government debt.

- Reviews of historical auction results show higher investor interest in short tenured debt issues which supports our expectations of higher demand for **FXD1/2022/10** (Table 4).
- We expect aggressive bidding for the 25-year given investor expectations of rising interest rates, higher inflation and the fact that Government is behind its domestic debt financing target FY2021/22.
- It is likely that the CBK will accept in excess of KES.50Bn due to its fiscal deficit financing needs.

Table.4: Historical primary market auction performance

Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
10-Year							
FXD1/2019/10	25th Feb 2019	50	36.3	32.8	72.6	12.44	12.4803
FXD2/2019/10	15th April 2019	50	70.9	51.3	141.8	12.30	12.4914
FXD3/2019/10	19th Aug 2019	50	52.8	45.0	105.6	11.52	12.5183
FXD4/2019/10	25th Nov 2019	50	38.4	28.4	76.8	12.28	12.5375
25-Year							
FXD1/2010/25	28th Jun 2010	15	15.8	15.0	105.3	11.25	13.4424
FXD1/2018/25	25th Jun 2018	40	10.1	5.2	25.3	13.40	13.8926
FXD1/2021/25	10th May 2021	30	31.0	14.2	103.3	13.92	13.8940

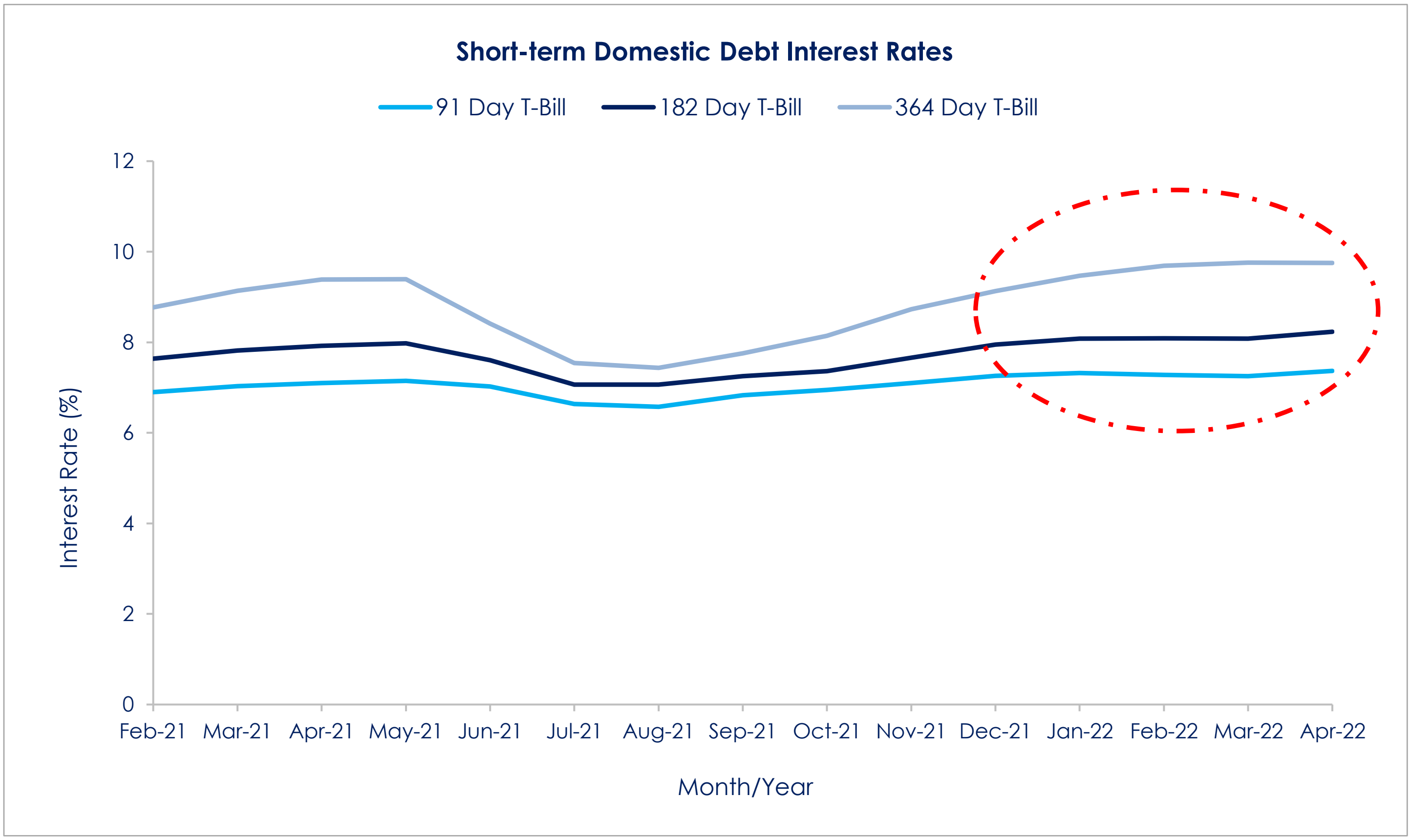
Source: Central Bank of Kenya

Short-term domestic interest rates tick upwards in April 2022

Average 91 & 182 day T-Bill rates rise as 364- day remains flat in April 2022.

- Average short-term interest rates rose in April 2022, with the exception of the 364-day paper that remained relatively flat.
- Interest rates have generally been on an upward trajectory since Q3 2021 before stabilizing in February 2022 particularly with regards to the 91 and 182 day papers (Figure.1).
- However, the gradual rise continued in April and we expect the trend to continue in May.
- The average 91-day and 182-day T-Bill rate rose to 7.37%, 8.23% in April from 7.25% and 8.08% in March respectively while the 364-day T-Bills rate dipped slightly from 9.76% to 9.75% over the same period.
- Overall, we expect short-term interest rates to maintain an upward trend in the short-term due to budget deficit financing pressure and give an average YoY rise of 80 - 100 basis points (bps) for the first half of 2022 across all three short term domestic tenures.

Figure.1: Short-term debt securities interest rates maintain the steady rise



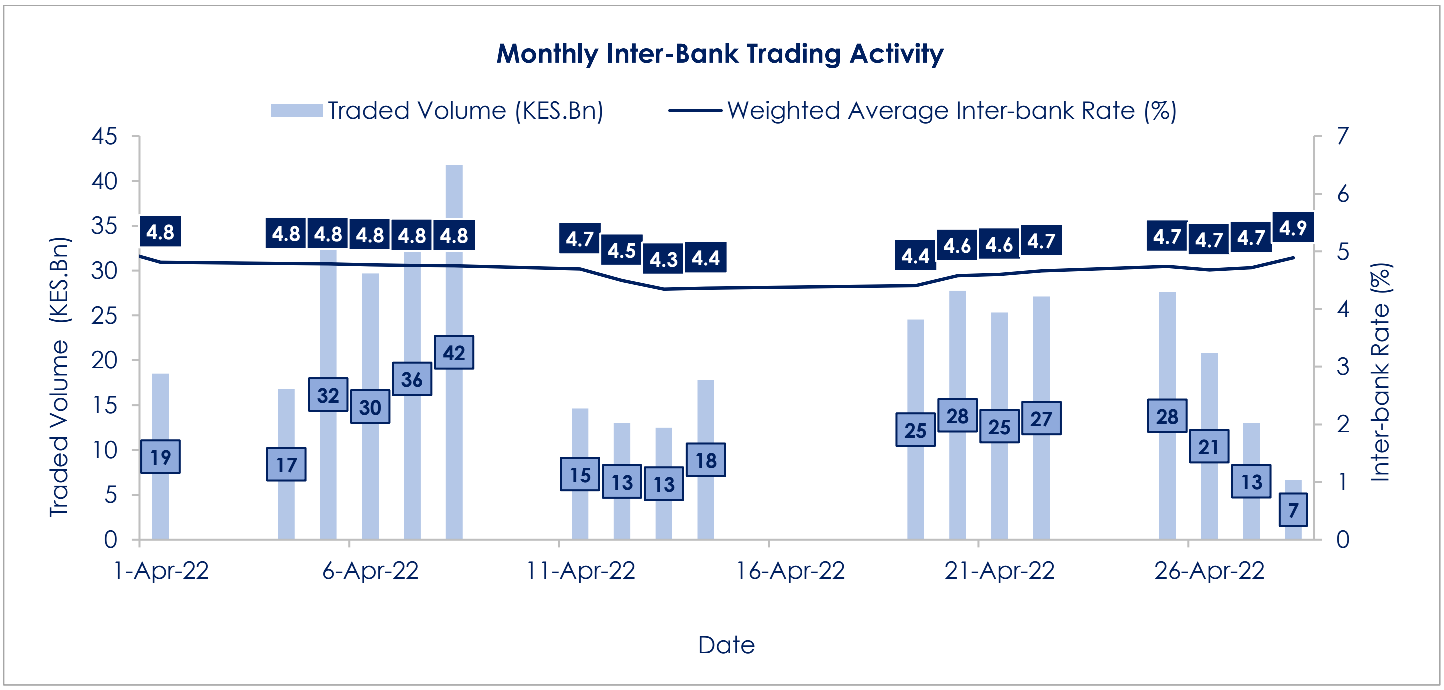
Source: Central Bank of Kenya

Slight decline in April 2022 average inter-bank lending rates

Market liquidity remains tight with average inter-bank rate at 4.6% in April 2022

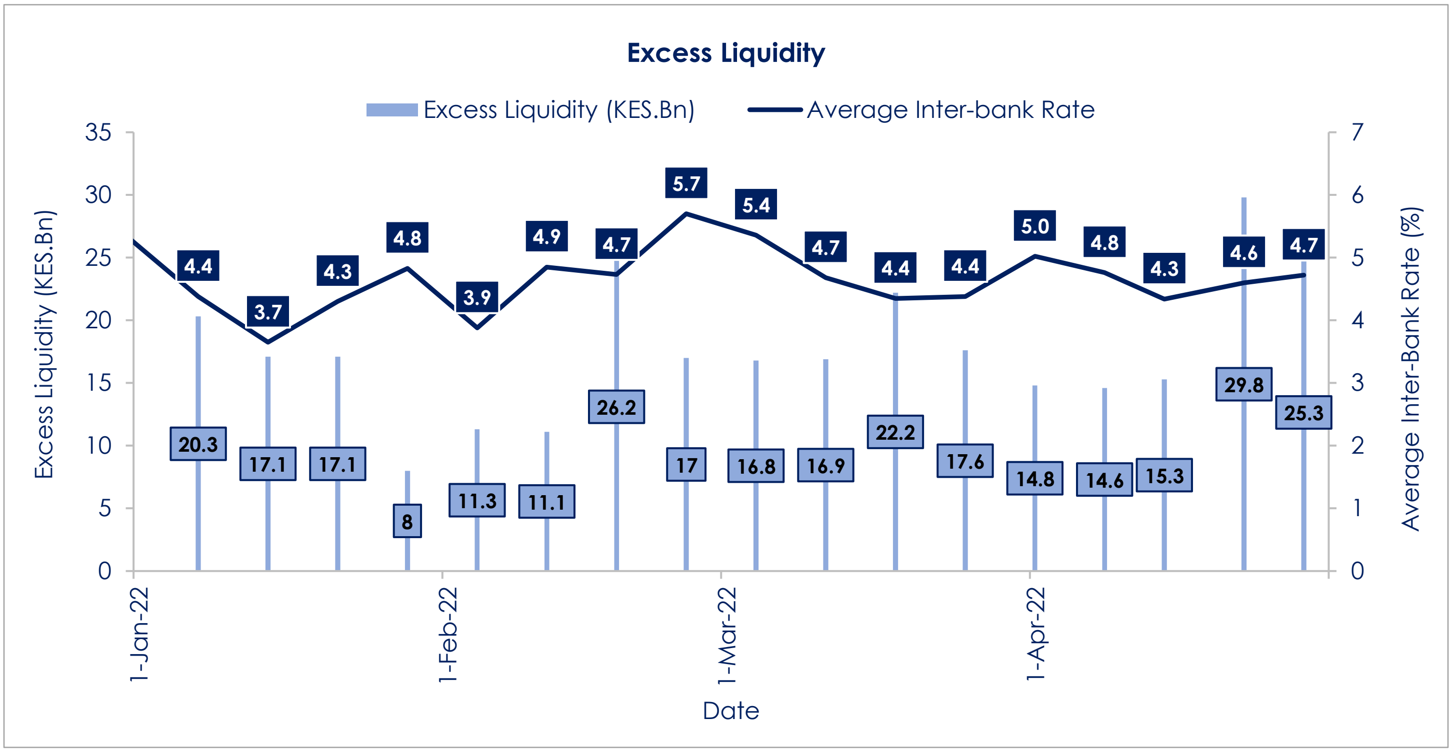
- Average inter-bank rates declined slightly to 4.6% in April 2022 compared to the 4.7% in March while total inter-bank trading volumes for the same period rose to KES.405.9Bn from KES.259Bn in March 2022 (Figure.2).
- This is an indication that market liquidity remained tight but on higher volumes.
- Total excess reserves (additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) was KES.99.8Bn compared to KES.73.5Bn in March (Figure.3).
- Our forecasted average inter-bank rate for May 2022 is between 4.5% - 5.5% as market liquidity continues to improve.

Figure.2: Inter-bank lending rates to range between 4.5% and 5.5% in May2022



Source: Central Bank of Kenya

Figure.3: Excess commercial bank reserves borders KES.100Bn in April 2022



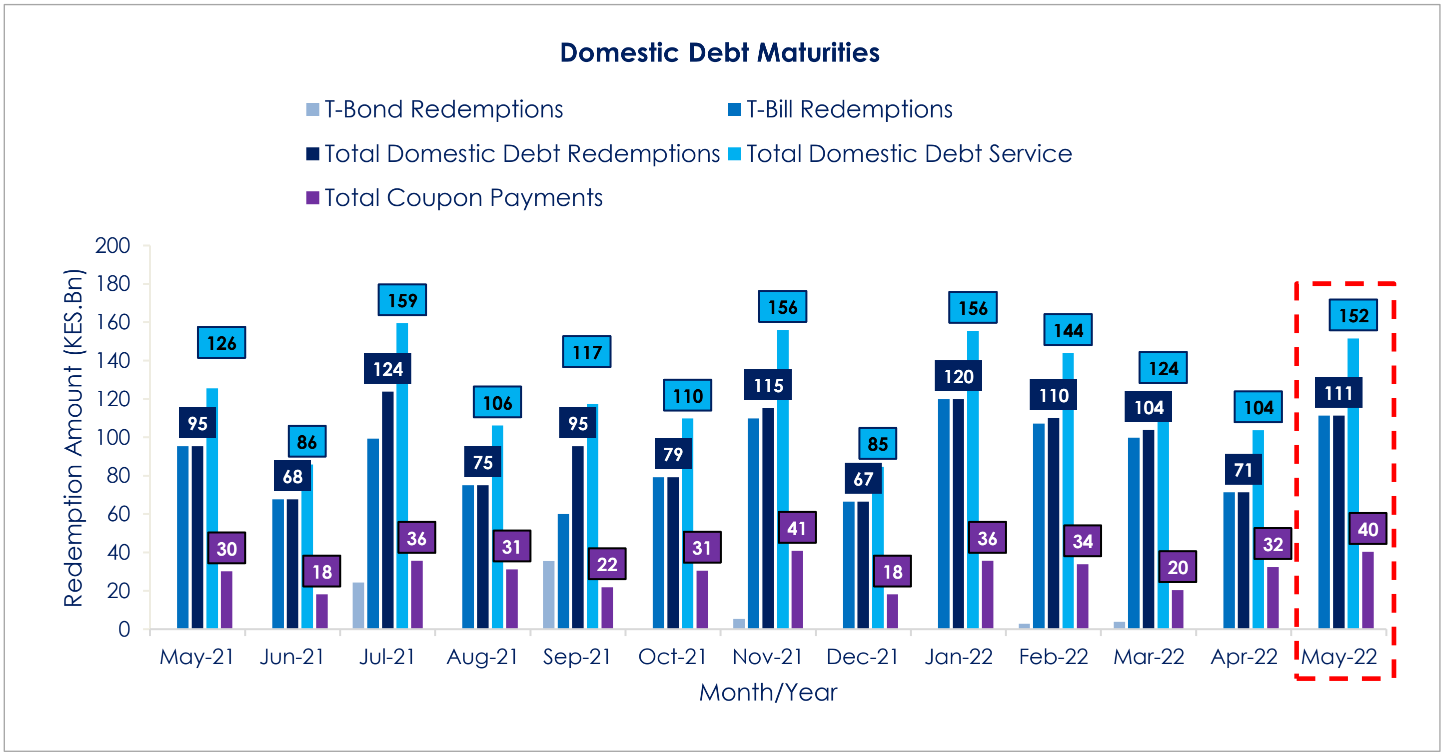
Source: Central Bank of Kenya

Domestic debt service for May 2022 rises to KES.152Bn

Domestic debt service rises 46.2% in May 2022 over the previous month to KES.152Bn

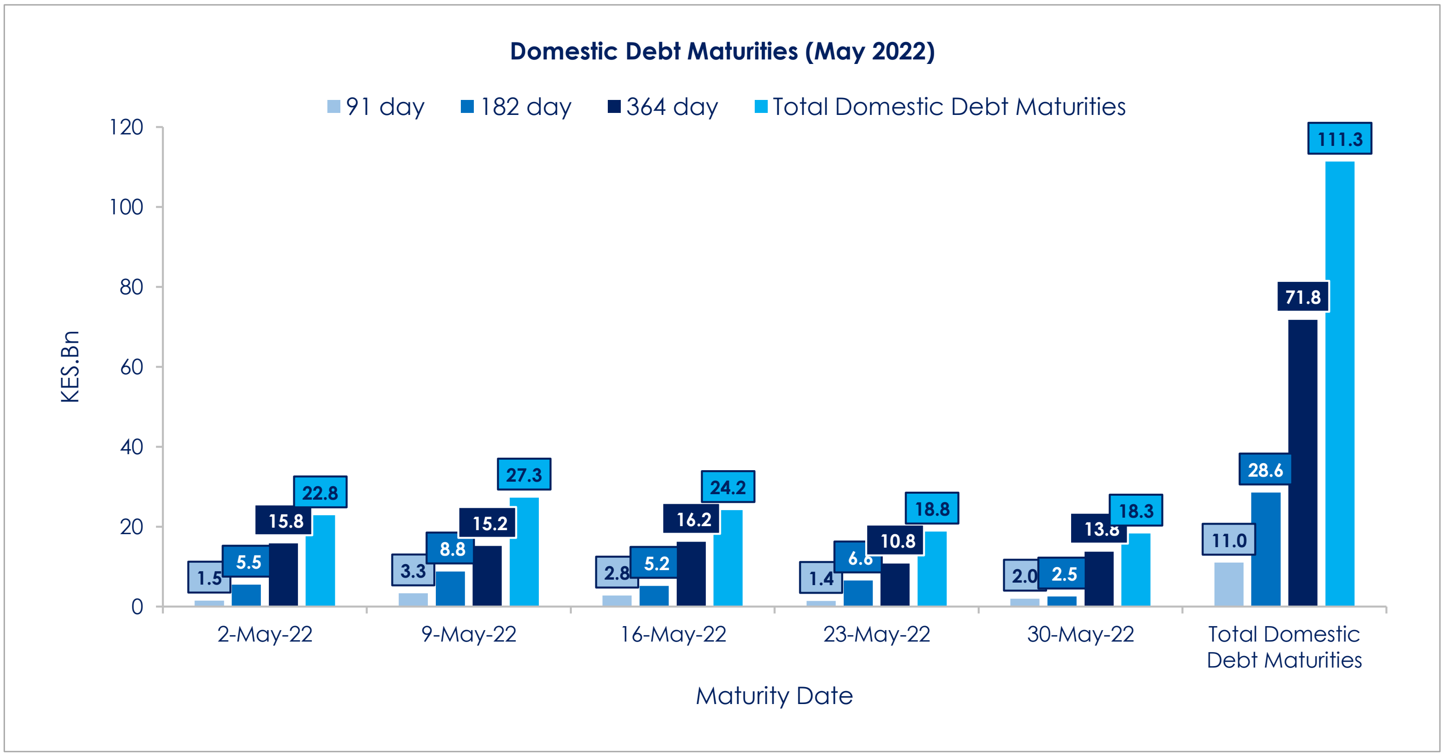
- Debt service for May 2022 amounts to KES.152Bn, 46.2% higher than KES.104Bn in April (Figure.4).
- This comprises of KES.111Bn and KES.40.3Bn in T-Bill redemptions and bond coupon payments respectively.
- Total redemptions for the 182 and 364-day T-Bills will increase in May to KES.28.6Bn and KES.71.8Bn compared to KES.22Bn and 37.1Bn in April respectively.
- On the contrary, total redemptions for the 91-day T-Bills will decline slightly to KES.11Bn from KES.12.2Bn month on month.
- The second week of May will have the highest redemptions at KES.27.3Bn (Figure.5).

Figure.4: May 2022 debt service KES.152Bn



Source: Central Bank of Kenya

Figure.5: May 2022 weekly T-Bill redemptions



Source: Central Bank of Kenya

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Tax revenues fall below 2021/22 fiscal budget run-rate target

Tax receipts and domestic debt fall short of linear target run-rate signaling increase in domestic borrowing.

- Total tax receipts stood at KES.1.13Tn equivalent to 66% of total estimated tax receipts for the 2021/22 fiscal year - KES.1.7Tn as per the latest data available - end of February 2022. (Table.5 and Figure.6).
- This however is a slight decline below the linear target run rate after eight months of the 2021/22 fiscal year - 66.7%.
- Tax receipts were above the target run rate in the months of December 2021 and January 2022 showing the positive impact of the lifting of several Covid-19 containment measures in October 2021 on economic activity.
- Domestic borrowing stood at KES.631.1Bn (62.6%) of the fiscal year target still short of our linear target run rate.
- It is on the basis of this trend that we see an increase in CBK bond issuance and acceptance rates in primary debt auctions towards the end of the fiscal year.
- External borrowing stood at KES.50Bn or 13.2% of the fiscal year target, this being before the approval of a KES.750$Mn (KES.85.9Bn) Development Policy Operation (DPO) loan from the World Bank approved mid-March 2022.
- The issuance of a U.S$.1- U.S$.1.1Bn Eurobond (KES.114.5Bn - KES.126Bn) will further boost external debt receipts for the current fiscal year.

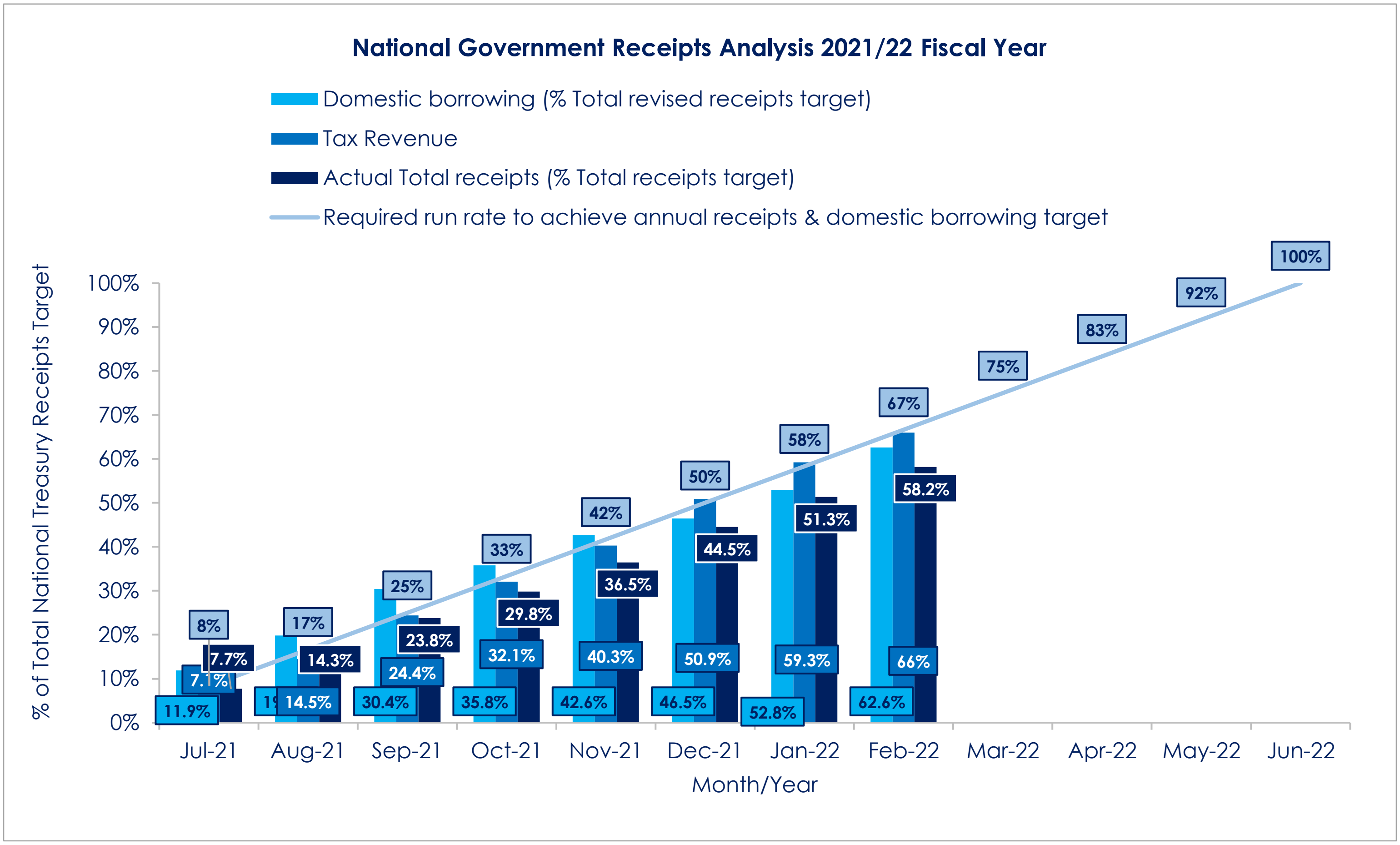
Table.5: 2020/21 tax receipts slip below linear target run-rate

Receipts	Original Estimates July 2021 (KES.Bn)	Actual Receipts 31st Jan 2022 (KES.Bn)	Actual Receipts 28th Feb 2022 (KES.Bn)	Proportion of Total Receipts 28th Feb 2022 (KES.Bn
Opening Balance (1st July 2021)		21.3	21.3	-
Tax Revenue	**1,707.4**	**1,011.7**	**1,126.4**	**66**
Non-Tax Income	68.2	42.3	45.1	66.1
Domestic Borrowing*	**1,008.4**	**532.9**	**631.1**	**62.6**
External Loans & Grants	379.7	47.3	50	13.2
Other Domestic Financing	29.3	5.3	5.3	18.1
Total Revenue	**3,193**	**1,660.8**	**1,857.9**	**58.2**
Linear Run Rate target (8 months of fiscal year)				**66.7**

* 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. CXXIV - No.44 11th March 2022

Figure.6: National Treasury at 43% of 2021/22 fiscal year domestic borrowing target



Source: The Kenya Gazette Vol. CXXIV - No.44 11th March 2022

Yield curve has shifted upwards on all debt tenors over our review period

NSE yield curve on all debt tenors shifts upwards since the issuance of FXD4/2019/10 and FXD1/2021/25

- We compare average domestic debt yields during different periods to assist in our prediction of future medium and long-tenor yield movements (Table.6 and Figure.7).
- The following NSE yield curves were selected with reasons highlighted below:

  1) Current yield curve as at 30th April 2022 - Current market interest rate levels.

  2) Yield curve as at 22nd November 2019 - Issue date of the most recent 10 - year debt issue **FXD4/2019/10** (25th November 2019).

  3) Yield curve as at 7th May 2021 - To show differences in yields over the last 1 year which also represents yields at the time of the first issuance of **FXD1/2021/25** (value date - 10th May 2021).

- We observe higher yields across all debt tenors in April 2022 compared to the other two periods under review with the exception of the 1 year tenor.

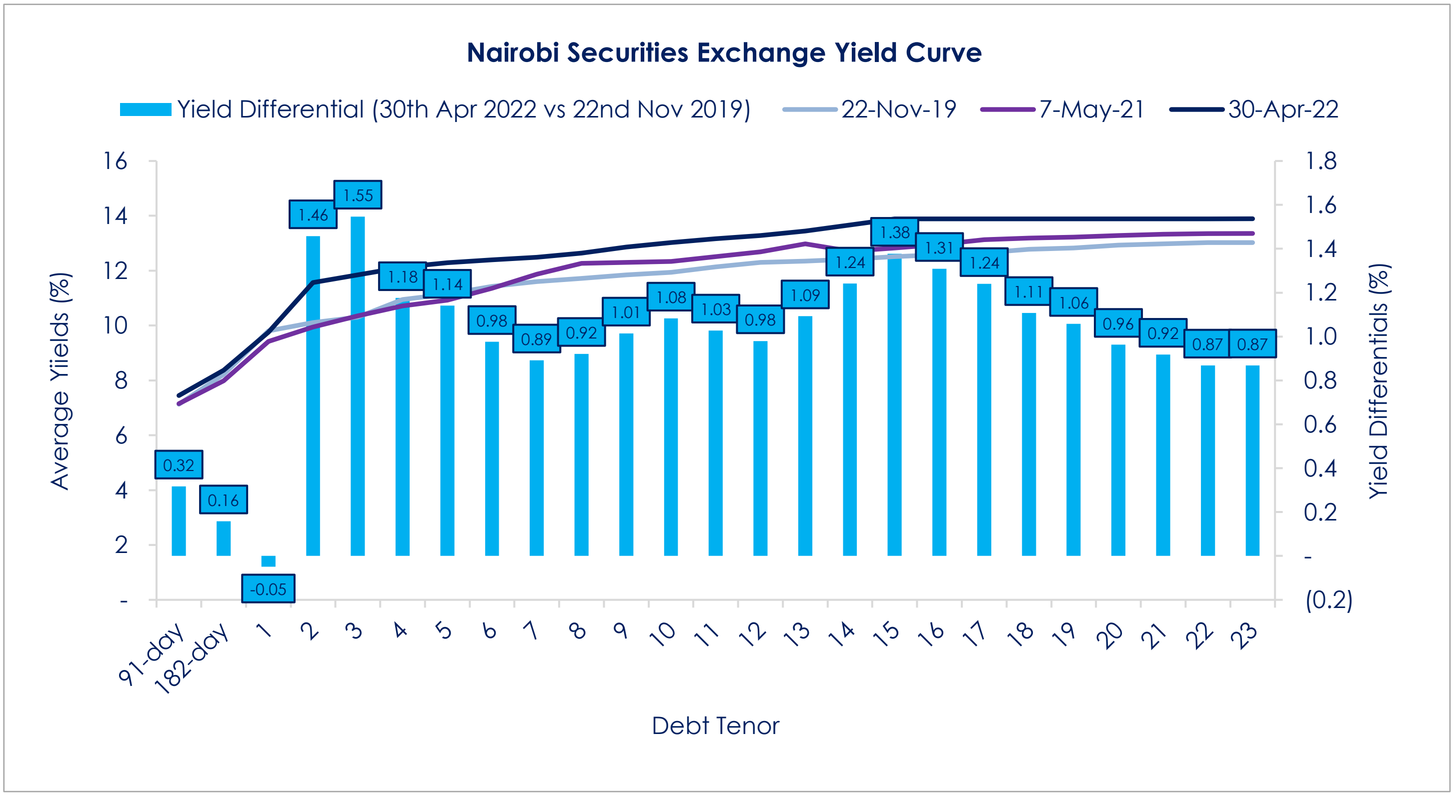
- There has been a general increase in interest rates during the review period as the CBK looks to fill the ever rising fiscal financing gap.
- The bigger increase in the medium and longer tenor debt can be explained by the CBK's efforts to lengthen the Average Tenor to Maturity (ATM) of public debt by accepting higher investor bids in debt auctions.
- We anticipate a further gradual increase in interest rates across the yield curve in first half of 2022 due to increased domestic debt financing which will result in another upward shift in the curve
- We maintain our recommendation of **BUY short and HOLD medium and long term papers.**

Table.6: Yield curve has shifted upwards Year on year (Yoy)

Tenor	Yields (22nd Nov 2019)	Yields (7th May 2021)	Yields (30th Apr 2022)	∆ (30th Apr 2022 vs 22nd Nov 2019) Bps	YOY ∆ (30th Apr 2022 vs 7th May 2021) Bps	Sterling Capital Yield Curve (May 2022)
1	9.8040	9.4240	9.7550	↓ 5	↑ 33	10.00
2	10.1044	9.9410	11.5620	↑ 146	↑ 162	11.80
5	11.1500	10.9290	12.2910	↑ 114	↑ 136	12.50
10	11.9417	12.3358	13.0240	↑ 108	↑ 69	13.40
15	12.5100	12.8220	13.8878	↑ 138	↑ 107	13.90
20	12.9292	13.2872	13.8919	↑ 96	↑ 60	13.95

Source: Nairobi Securities Exchange

Figure.7: Short, medium and long-term tenors rise Year on year (Yoy)



Source: Nairobi Securities Exchange

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Central Bank Rate will remain unchanged in May monetary policy meeting

- The Monetary Policy Committee (MPC) will meet on Monday, 30th May 2022 to review the impact of previous monetary policy measures on the economy.
- We see the following as the main points of discussion:

MPC to hold CBR at 7% in consideration of current macro-economic conditions

1) The increase in overall inflation (6.47% as at April 2022, highest since September 2021 at 6.91%) which is a direct result of the impact of Russia's military action with Ukraine on international commodity and particularly oil prices.

   This has resulted in fuel inflation which increased 8.5% on 28th April 2022 from 5.8% in March 2022.

   Food inflation increased 12.1% on 28th April 2022 from 9.9% in March 2022 on account of seasonal factors and global supply chain disruptions.

2) Foreign exchange reserve position.

   The usable foreign exchange reserves have remained adequate at U.S$.8.4Bn (5 months of import cover) but risks exist especially with regards to rising external debt service, a widening current account and depreciating shilling.

3) General liquidity in the market despite tax remittances.

   The repo, reverse repo and inter-bank rates as of 28th April 2022 were at 4.9%, 8.9% and 4.7% pointing to a relatively liquid environment.

   The CBK has been issuing reverse repos over the last three months amounting to approximately KES.277Bn in what we suspect is a bid to inject liquidity into the market.

4) The depreciation of Kenya Shilling (KES) exchange rate against the United States Dollar (U.S$) with a range of KES.113.84 - KES.115.81 over the last two months.

   The decline is primarily attributable to higher import costs and a sudden significant rise in oil prices.

   We anticipate the shilling to depreciate further to levels of KES.115 - 117 as a result of deteriorating fiscal position caused by capital outflows, higher inflationary pressure due to geopolitical tensions and a widening trade deficit.

   We expect the inflows from the Eurobonds to provide a slight temporary reprieve nonetheless, they're likely to be ineffective in shifting the trend.

5) 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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