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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Results Update Note

June 2022

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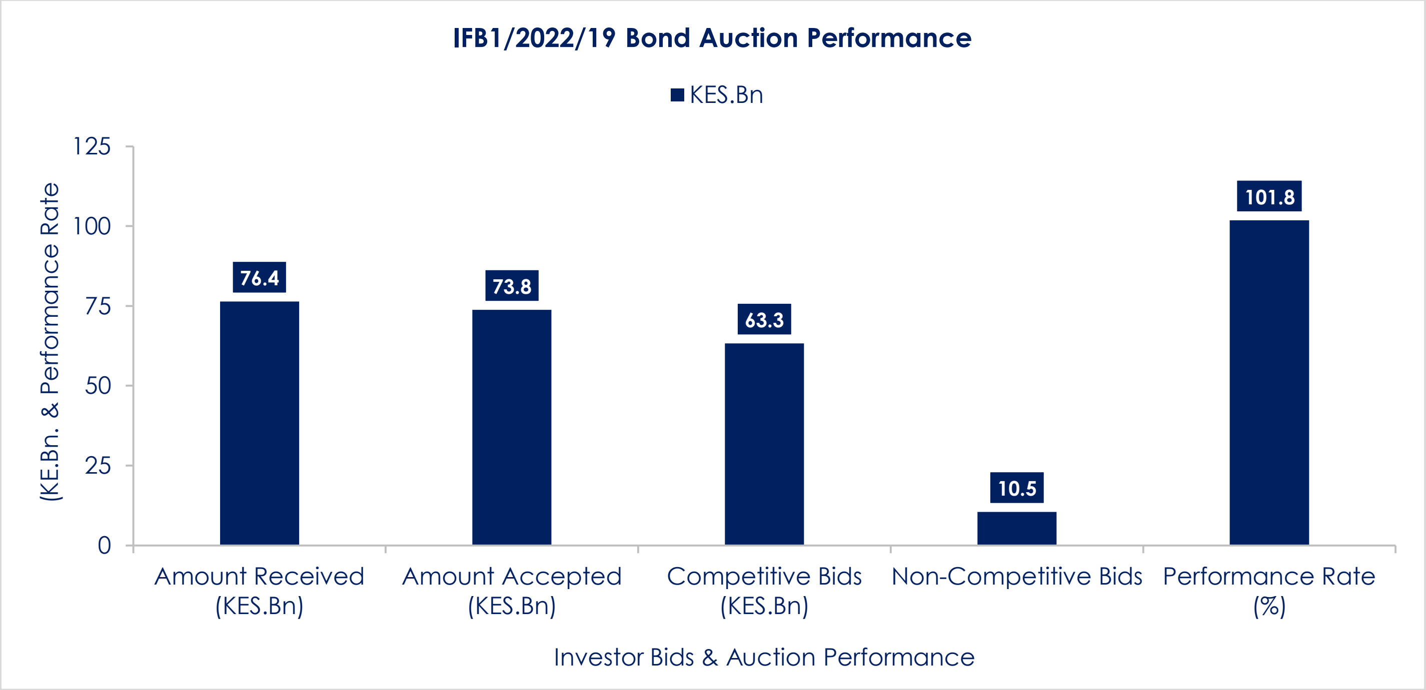
June 2022 Treasury Bond primary auction results update

- The Central Bank of Kenya (CBK) issued an infrastructure bond in June 2022, **IFB1/2022/18**, seeking to raise KES.75Bn for infrastructural projects in the FY2021/22 budget estimates;
    - **IFB1/2022/18** (18*)
      **Years to maturity*
- The period of sale for both bonds was between 23rd May - 7th June 2022 with the auction date on 8th June 2022, results linked here.

Subscription Rates

- We had stated in our June fixed income report **"Bridging the funding gap with an IFB"** that the issue would be oversubscribed given its tax-free status as well as its capital gains potential.
- Notably, the CBK has in recent auctions been trying to manage th cost of borrowing by keeping interest rates below the 14% phychological barrier and rejecting aggressive investor bids.
- However, given the magnitude of the Government's fiscal financing needs, the CBK accepted aggressive bids during this particular auction as illustrated by the results.
- The coupon rate of **13.742%** is above those of **IFB1/2022/19** (12.965%) and **IFB1/2021/21** (12.737%) despite both bonds having comparatively longer tenors.
- Total bids received amounted to KES.76.4Bn against the KES.75Bn target equivalent to a 101.8% subscription rate (Figure.1).

Figure.1: IFB Primary Bond auction performance



Source: Central Bank of Kenya

Weighted Average Rates

- Our predicted market Weighted Average Rates (WAR) ranges for investor bids for IFB1/2022/18 were higher than the WAR of investor bids with our prediction being informed by the upward revision of the Central Bank Rate (CBR) on 30th May 2022, rising inflationary pressure and depreciating Kenya Shilling (Table.1).
- Discussions with our fixed income traders reveal that the CBK accepted investor bids as high as 13.9%, highlighting the fiscal financing pressures faced by Government.

Table.1: Predicted and actual Weighted Average Rates (WAR)

Domestic Debt Issue	SCL Market Weighted Average Rate (WAR) of Investor Bids Prediction (%)	CBK Market Weighted Average Rate (WAR) of Investor Bids (%)	CBK Investor Bids WAR vs SCL Predicted WAR Range Average (Bps)
IFB1/2022/18	13.80 - 13.99	13.761	-13.4

Source: Central Bank of Kenya

National Accounts - Fiscal financing target revised upwards

- Our attention is drawn to the May 2022 budgetary report from the Parliamentary budget office that indicates an upward revision of the budget estimates.
- We take note of the revision in the budget estimates and particulary an upward revision of the fiscal deficit estimate from KES.846.1Bn to kes.862.5Bn equivalent to a 1.9% increase (Table.2).
- With this revision is an upward revision of both net domestic and net foreign financing estimates.
- Increased deficit financing will exert further pressure on domestic debt interest rates.

Table.2: 2022/23 Fiscal budget estimates revised upwards

Budgetary Item	2021/22 Approved Revised	2022/23 BPS	2022/23 Budget Estimate	Deviation (KES)	Deviation (%)
Fiscal Balance (inclusive of grants)	-1,024.3	-846.1	-862.5	-16.4	1.9%
Total Financing	1,024.3	-846.1	-862.5	-16.4	1.9%
Net Foreign Financing	360	275.9	280.7	4.8	1.7%
Net domestic Financing	664.4	570.2	581.7	11.5	2%

Source: Parliamentary Budget office

Our view

1) **NSE yield curve** - The auction results are consistent with our view of a continued upward shift in the yield curve.

   Notably, we continue to observe a flat curve particularly on the long end with the difference between the 15-year and the 23-year being only 12 basis points (bps).

   This means that investors would prefer to bid or purchase bonds of shoter term to maturities on a risk versus return basis considering that interest rates are rising.

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This could mean that if the CBK intends to maintain its strategy of lengethening the Average Term to maturity of public debt, it will face pressure to begin accepting investor bids above 14%.

Alternatively, the CBK could issue new or re-open bonds with tenors till maturity of between 10 and 15 years.

The general trend in the yield curve movement will remain upwards at least in the short-term driven by rising inflatonary pressure and increased budget financing pressure.

Our estimated average yields for 2022 on the short end (91 days - 2 years) will increase by 10 - 20 basis points (bps) while for medium (3 - 9 years) and long tenors (10 years and above) will increase by 20 and 30 bps.

2) **Market Liquidity** - The repo, reverse repo and inter-bank rates as of 6th June 2022 were 6.4%, 7.8% and 4.9% pointing to tight liquidity in the market.

   We expect liquidity to decline significantly in the near term after the issue of **IFB1/2022/18** which will result in a further increase in inter-bank rates to +5%.

   We observed a similar scenario following the September 2021 issue of **IFB1/2021/21** where the CBK accepted KES.106.8Bn of the KES.151.3Bn received as investor bids, well above the KES.75Bn offer amount.

   While we do not expect a liquidity crunch of similar proportions, we still see the CBK injecting liquidity into the market through reverse repos in June, adding to the KES.65Bn injected in May 2022.

3) **Investment Case** - Government debt remains an attractive investment option for both "Buy and hold" and active investment strategies considering current bear equity market, rising inflationary pressure and limited low risk high yielding investment options available in the market.

   An active trading strategy would likely leave investors nursing significant losses as is evidenced by the large swath of bond issues currently trading at a discount as investors price in rising interest rates into present bond prices.

   We have seen evidence of this within the banking sector as banks report significant mark-to-market losses on account of discounted bond prices.

   For investors looking at a buy an hold strategy, a number of investment opportunities are emerging in the market with high yielding bonds including IFBs trading at a discount with some investors looking to exit for liquidity purposes.

4) **Secondary market trading** - We expect significant trading activity on this bond considering its very attractive coupon rate which is above both the **IFB1/2022/19** and **IFB1/2021/21** yields.

   However, we expect secondary market activity to remain suppressed as bonds continue to trade at discounted prices, causing investors to hold their bonds to maturity rather than sell at a loss.

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