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Analysts:

Renaldo D'Souza
Renaldo.DSouza@sterlingib.com

Davis Gathinji
Davis.Gathinji@sterlingib.com

Isabel Chakairu
Isabel.Chakairu@sterlingib.com

Email: research@sterlingib.com

Bond Dealing: +254 (20) 2213914/0723 153 219

Email: invest@sterlingib.com

Office Address: Delta Corner Annex, 5th Floor, Ring Road Westlands.

Website www.sterlingib.com

Bloomberg Code: SCLK <GO>

STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Results Update Note

July 2022

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July 2022 Treasury Bond primary auction results update

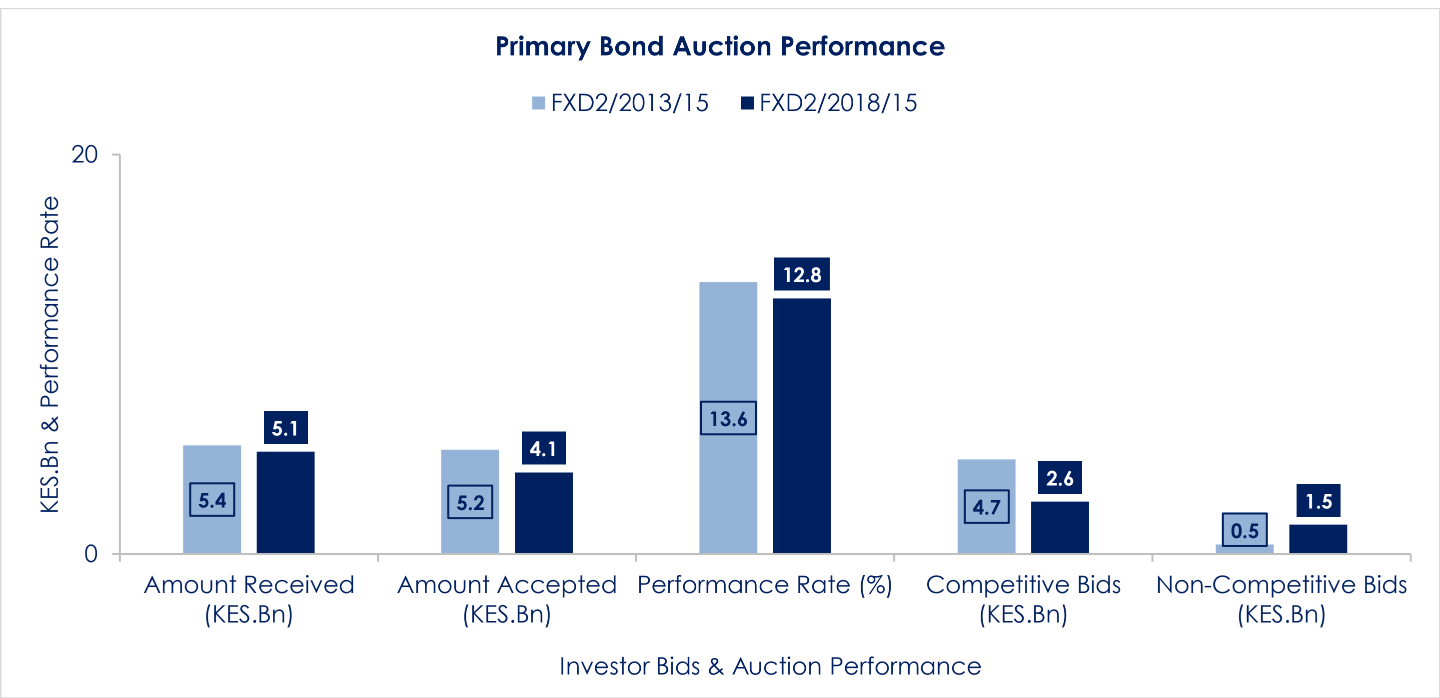
- The Central Bank of Kenya (CBK) re-opened two bonds in July 2022; **FXD2/2013/15** and **FXD2/2018/15**, seeking to raise KES.40Bn to cater to the Government's fiscal deficit and budgetary needs.
  - **FXD2/2013/15** (5.8*)
  - **FXD2/2018/15** (11.3*)

  **Years to maturity*
- The period of sale for both bonds was between 28th June - 19th July 2022 with the auction date on 20th July 2022, results linked **here**.

Subscription Rates

- We had stated in our July fixed income report **"2022/23 begins with a KES.40Bn cash call"** that the issues would be undersubscribed given that both bonds were trading at a significant discount within the secondary market.
- The logic herein was that since investors can enjoy higher yields to maturity on the same bonds if bought in the secondary market, it would negate any purchase on the primary and therefore contribute to vast undersubscription.
- Total bids received amounted to KES.10.5Bn against the KES.40Bn target equivalent to a 26.4% subscription rate (Figure.1).

Figure.1: Primary Bond auction performance



Source: Central Bank of Kenya

Weighted Average Rates

- Our predicted market Weighted Average Rates (WAR) ranges for investor bids for **FXD2/2013/15** was slightly higher than the WAR of investor bids with our prediction being informed by the historical undersubscription of 15-year bond issuances and the upward revision of the Central Bank Rate (CBR) on 30th May 2022 which signals a further rise in interest rates going forward. (Table.1).

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

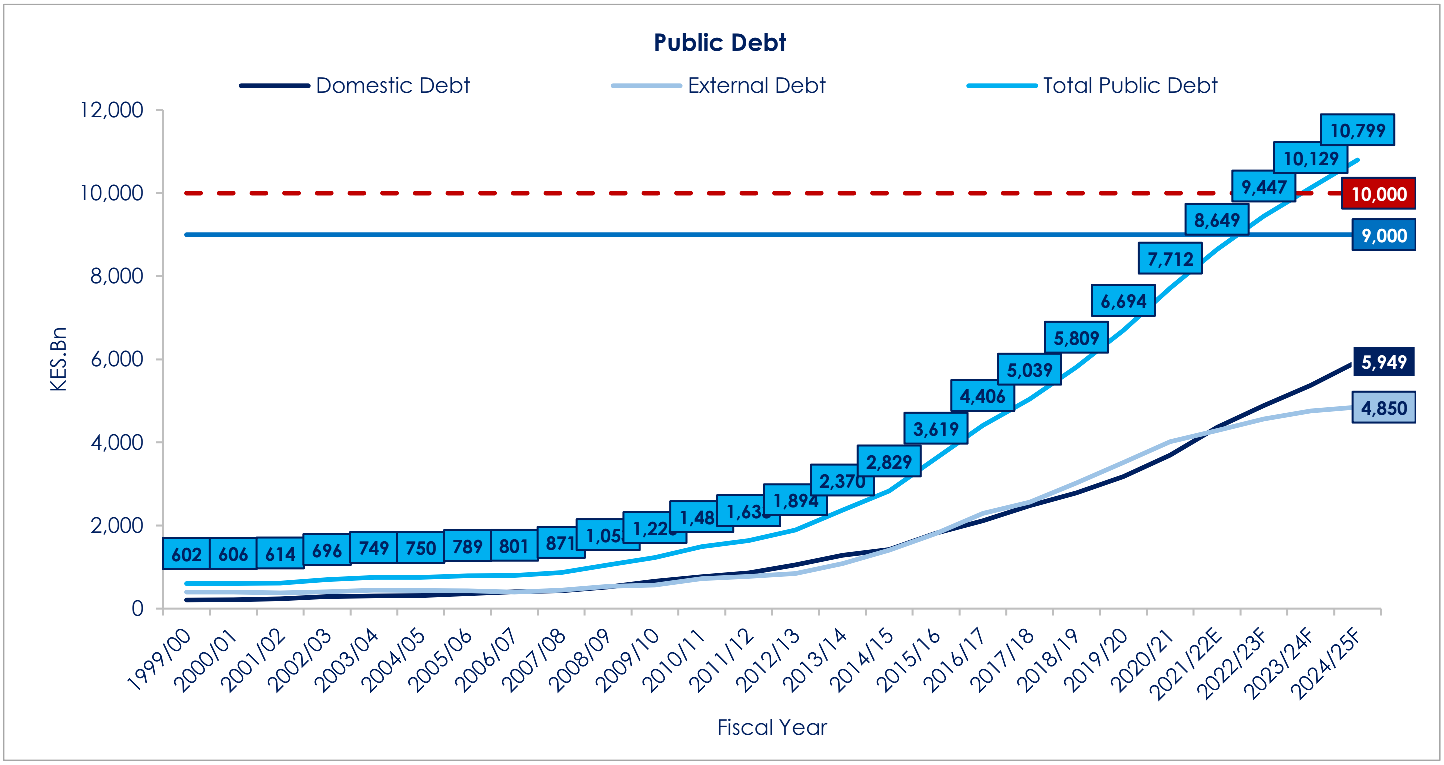
Domestic Debt Issue	SCL Market Weighted Average Rate (WAR) of Investor Bids Prediction (%)	CBK Market Weighted Average Rate (WAR) of Investor Bids (%)	CBK Investor Bids WAR vs SCL Predicted WAR Range Average (Bps)
FXD2/2013/15	12.99 – 13.14	13.214	14.9
FXD2/2018/15	13.89 – 13.99	13.888	5.2

Source: Central Bank of Kenya

Kenya's domestic debt - Up and up it goes

- In the first part of our Public Debt Series dubbed, "**Beyond the ceiling**" we highlighted the fact that domestic debt makes up 49.9% of Kenya's public debt with Treasury bonds accounting for 84% of total domestic debt.
- While the National Treasury estimates that domestic debt will grow from KES.4.9Tn in FY2022/23 to KES.6.5Tn in FY2025/26 (Fig.2), we view this as unrealistic given that the political regime change in the August 2022 general election is likely to come with a rise in overall borrowing.
- This, coupled with the ever growing fiscal defict will translate into increased deficit financing which will exert further pressure on domestic debt interest rates.
- The incoming Government will find itself in a difficult situation where expenditures will continuously outpace revenues, forcing them to increase borrowing at increasingly higher rates.

Figure.1: Kenya's public debt has grown at a rapid pace over the last 10 years



Source: Central Bank of Kenya

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 14 basis points (bps) as at 15th of July 2022.

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

   We expect the CBK to continue its efforts to lengethen the Average Term to maturity of public debt, however, doing so will eventually force it to begin accepting investor bids above 14%.

   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 20th July 2022 were 7.1%, 8.6% and 5.4% pointing to tight liquidity in the market.

   We note that increased trading on **IFB/2022/18** served to increase inter-bank rates to +5%.

Given the underperformance of the issues, we expect liquidity to increase going forward as the CBK makes attempts to rectify the situation through reverse repos.

3) **Investment Case** – We have revised our investment case from BUY short and HOLD medium-term and long term papers to BUY medium and long-term papers for interest income given the prevailing interest rate trend.

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.

We advise against an active trading strategy since this 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.

Investors with a high risk tolerance should consider buying the US$ denominated Kenya Eurobonds to take advantage of current attractive yields with an option of holding till maturity or disposing when trading opportunities arise.

4) **Secondary market trading** - 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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