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STERLING CAPITAL
Inspired Financial Solutions

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Fixed Income Note

July 2022

"2022/23 begins with a KES.40Bn cash call"

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Executive Summary

- Our fixed income report for the month of July 2022 is titled **"2022/23 begins with a KES.40Bn cash call"** in reference to the Central Bank of Kenya's (CBK) two re-opened fifteen-year fixed coupon treasury bonds.
- The apex bank seeks to raise KES.40Bn through both issues, **FXD2/2013/15** and **FXD2/2018/15.**
- Given the fact that both bonds are trading at a significant discount within the secondary market, we hold that both bonds will be undersubscribed since investors can enjoy higher yields on the same bonds if bought in the secondary market.
- Our weighted average bid predictions are as follows:
- Weighted Average Rate (WAR) of accepted bids:

  FXD2/2013/15: 12.99% - 13.14%
  FXD2/2018/15: 13.89% - 13.99%

- 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.

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CBK's re-opens debt issues to raise KES.40Bn in July 2022

- The Central Bank of Kenya (CBK) invites bids for two re-opened Treasury Bonds (T-Bonds), the first of the 2022/23 fiscal year; **FXD2/2013/15** and **FXD2/2018/15** to raise KES.40Bn (Table.1).
- We expect relatively low subscription given that the current Yield to Maturity (YTM) of **FXD2/2013/15** (12.6579%) and **FXD2/2018/15** (13.7081%) is above the coupon rates of 12% and 12.75% respectively.
- The CBK is intent on keeping rates at below 14% as observed in recent medium and long-term debt auctions where it rejected investor bids above this rate.
- In light of this, we expect this and subsequent bonds, save for IFB's, to have relatively low subscription rates with investors waiting for CBK to begin accepting bids above 14%.

Table.1: Primary Bond issues' summary

Issue Number	FXD2/2013/15	FXD2/2018/15
Total Amount Offered	KES.40Bn	
Tenor	5.8 Years	11.3 Years
Coupon Rate (%)	12.000%	12.750%
Price Quote	Discounted/Premium/Par	
Period of Sale	28th June 2022 - 19th July 2022	
Auction Date	20th July 2022	
Value Date	25th July 2022	
Yield Curve (%) (Weighted average tenor - 1st July 2022)	**12.6579**	**13.7081**

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 1st July 2022, together with discussions with several fixed income traders (Table.2).

Table.2: Auction bid predictions

Rate	FXD2/2013/15	FXD2/2018/15
Weighted Average Rate of Accepted Bids (%)	12.99 – 13.14	13.89 – 13.99

Source: Sterling Capital Research

Our predicted rates are guided by historical debt issues

- We used implied yields of bonds of similar tenors to maturity on the NSE as at 1st July 2022 as a guide for possible investor auction bid levels (Table.3).

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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
FXD2/2013/15	29th April 2013	12	10th April 2028	2,110	12.6579	13.6610
FXD2/2018/15	22nd Oct 2018	12.75	3rd Oct 2033	4,112	13.7081	12.5752

Source: Central Bank of Kenya

- Our review of auction results of 15-year debt issues since 2018 shows an undersubscription with only **FXD1/2020/15** issued in September 2020 close to full subscription.
- This trend can be explained by the following;

  1) Yields offered on the select 15 year tenors were below their corresponding yield curve weighted average tenor rates - **FXD1/2018/15**.
  2) Relatively large target amount in a single debt issuance - **FXD2/2018/15**.
  3) Relatively low liquidity environment - **FXD2/2019/15**.

- The historic trend contributes to our assertions that these re-opened issues will also be undersubscribed (Table.4).

Table.4: Historical primary market auction performance

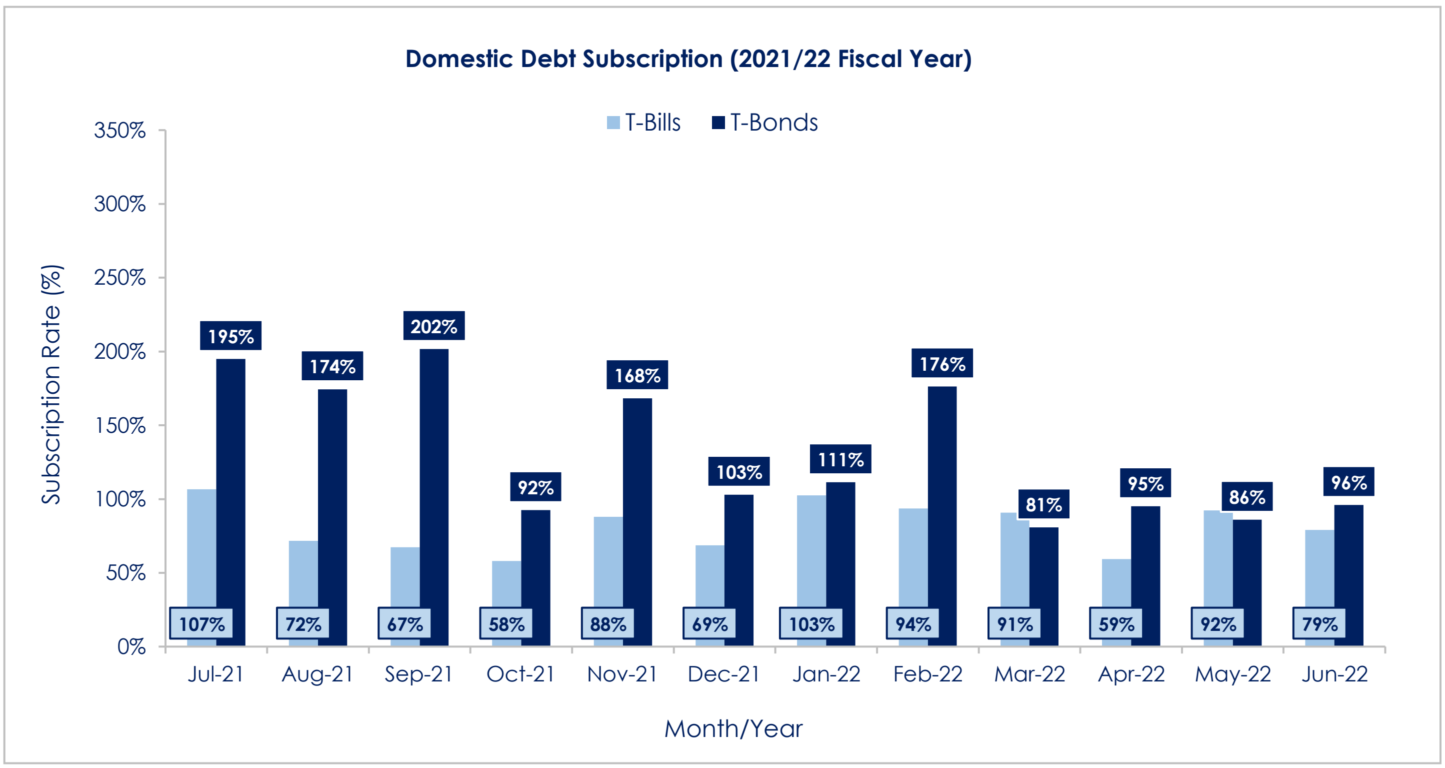
Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
15-Year							
FXD1/2018/15	28th May 2018	40	20.2	12.9	50.5	12.65	13.6736
FXD2/2018/15	22nd Oct 2018	40	27	7.9	67.6	12.75	13.7081
FXD1/2019/15	28th Jan 2019	40	25.1	14.7	62.7	12.86	13.7298
FXD2/2019/15	13th May 2019	50	21.5	19.3	43.1	12.73	13.7498
FXD1/2020/15	21st Sept 2020	50	49.8	45.7	99.6	12.76	13.8000
FXD1/2022/15	27th June 2022	25	16	16	64	13.94	13.8701

Source: Central Bank of Kenya

T-Bond subscription spikes in June 2022 due to IFB issue

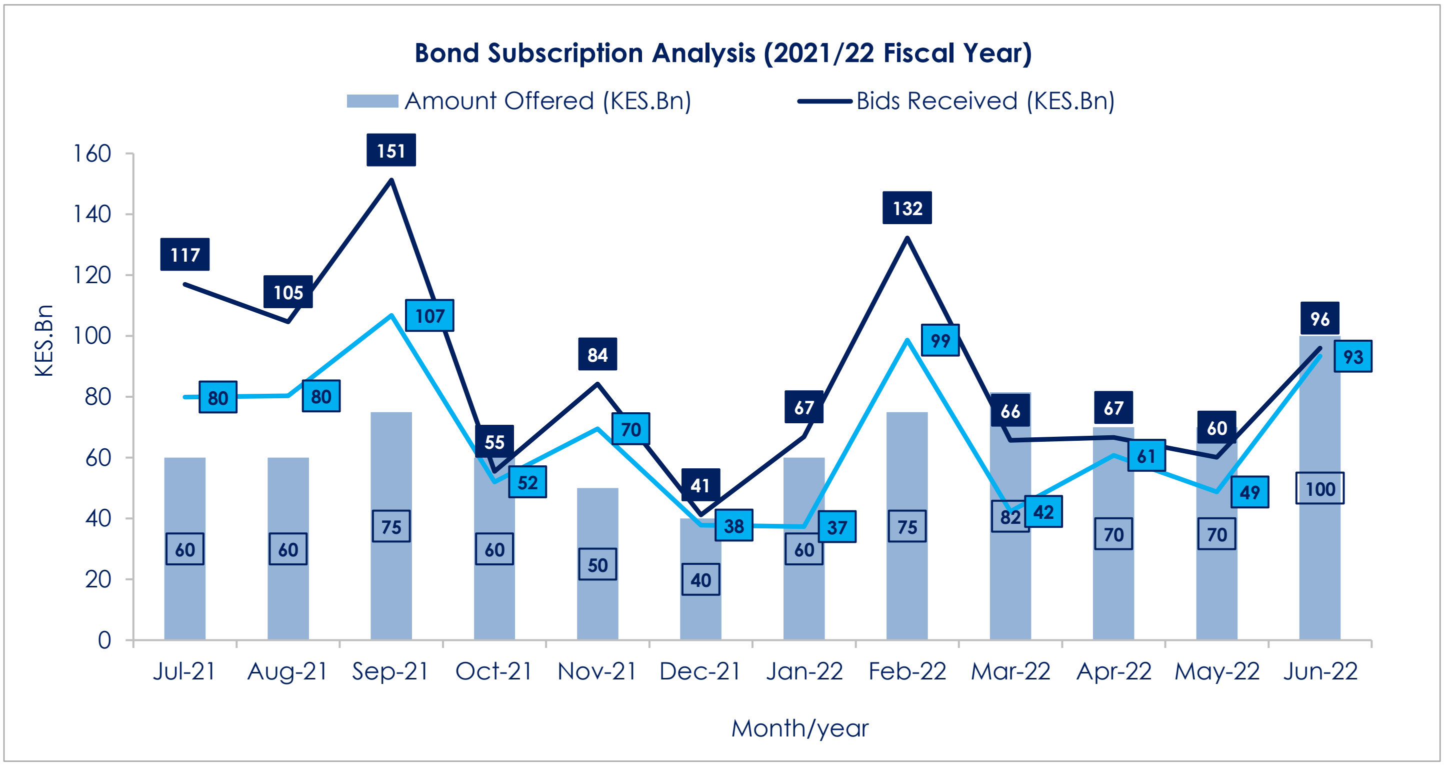
- The CBK issued an Infrastructure bond - **IFB1/2022/18** (primary issue) and two tap sales - **FXD1/2022/03** and **FXDI/2022/15** in June thus explaining the rise in T-Bond subscriptions compared to the previous month (Figure.1 & Figure.2).
- A total of KES.76.4Bn of the KES.75Bn (101.8% subscription rate) was received in the IFB issue and KES.19.6Bn of the KES.25Bn (78.4% subscription rate) received on the tap sale of fixed coupon bonds.
- With regards to T-Bills, aggregate investor subscription fell in June 2022 with KES.76Bn in bids received against KES.96Bn offered equivalent to a 79.2% subscription rate which was lower than 92.2% in May.
- The 91 T-Bills was oversubscribed at 142.3% and 364 Day T-Bill reporting a subscription rate of 58.6% and 74.4% respectfully.
- It is likely that investors unwilling to lock in their capital for a longer period in an environment of rising interest rates invested in the 91-Day T-Bill.

Figure.1: T-Bond subscriptions rise while T-Bill subscriptions remain relatively low in June 2022



Source: Central Bank of Kenya

Figure.2: Bond subscriptions slightly increased in June 2022

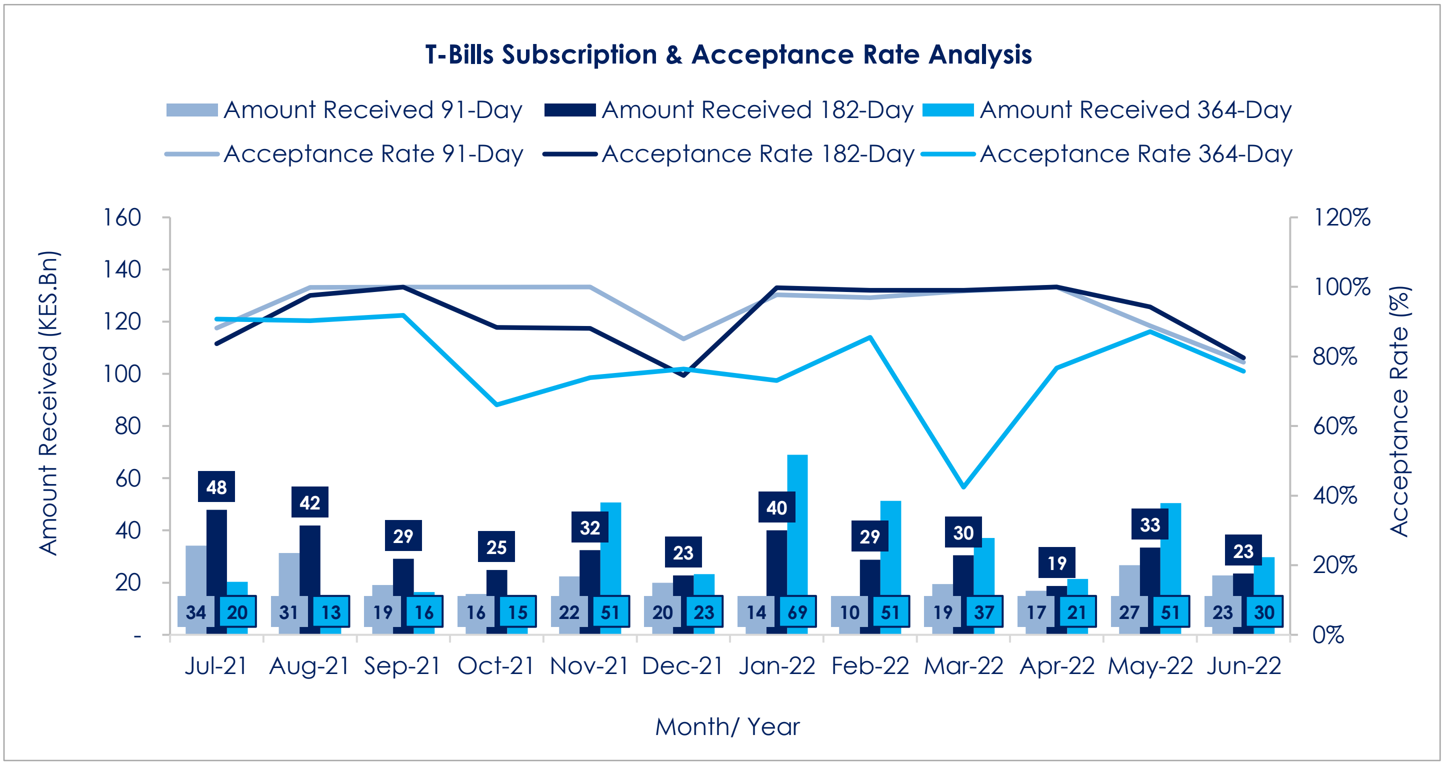


Source: Central Bank of Kenya

CBK continues to reject aggressive investor bids in T-Bill auctions

- The CBK continues to manage the short-term domestic borrowing costs by rejecting aggressive investor bids in debt auctions.
- CBK acceptance rates for the 91, 182 and 364-Day T-bills in June 2022 declined to 78.4%, 79.6% and 90.8% respectively compared to 88.8%, 94.3% and 95.5% respectively in May (Figure.3).

Figure.3: CBK's T-Bill acceptance rate declines in June 2022

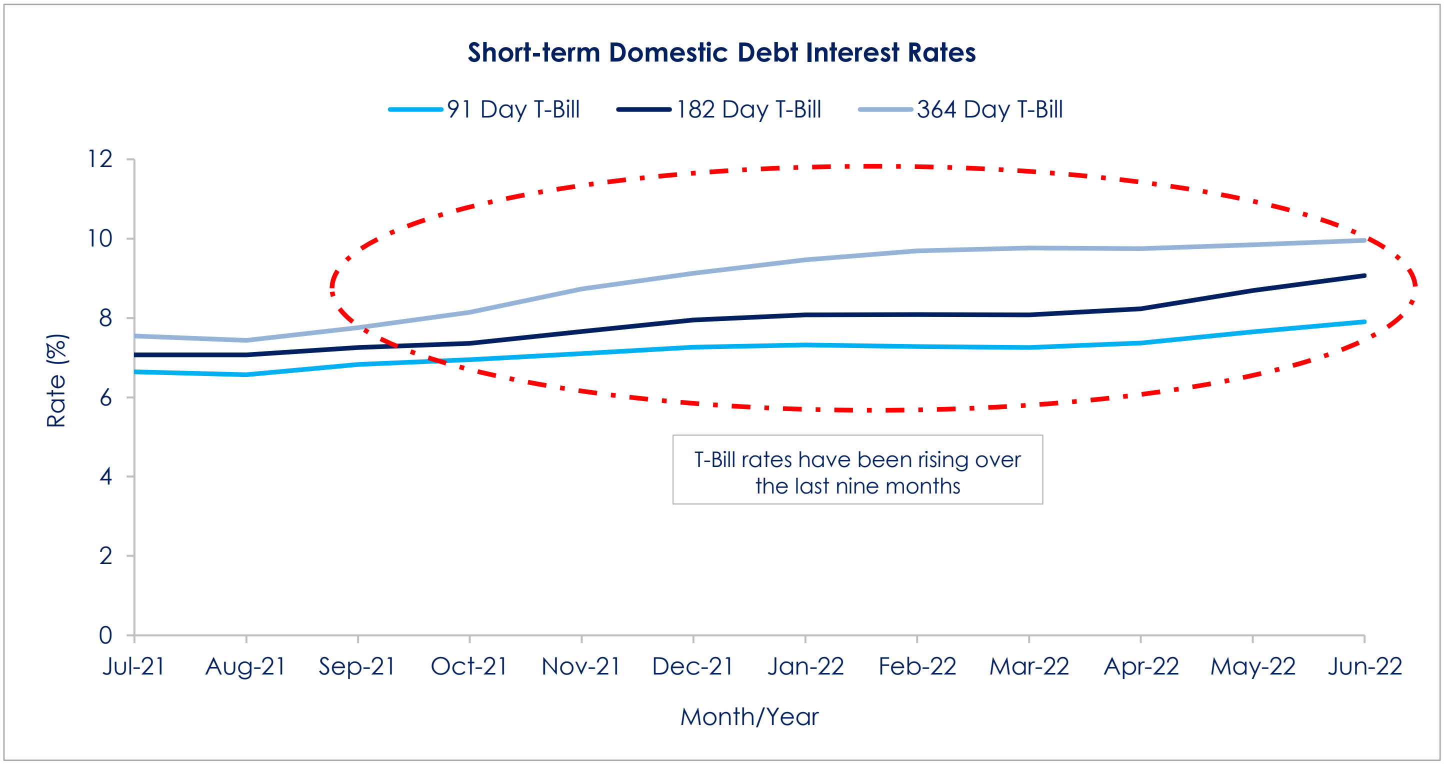


Source: Central Bank of Kenya

Short-term interest rates rise further in June 2022

- Average 91, 182 and 364-day T-Bill rates rose to 7.9%, 9.1% and 10% in June 2022 up from 7.7%, 8.7% and 9.9% in May 2022 respectively (Figure.4).
- We attribute the above to a combination of investor awareness of the Government's high deficit financing pressure, rising inflation and investor expectations of a general rise in the level of interest rates following the upward adjustment of the Central Bank Rate to 7.5% from 7%.
- We expect short-term interest rates to maintain this upward trend in the short term for the reasons mentioned above.

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

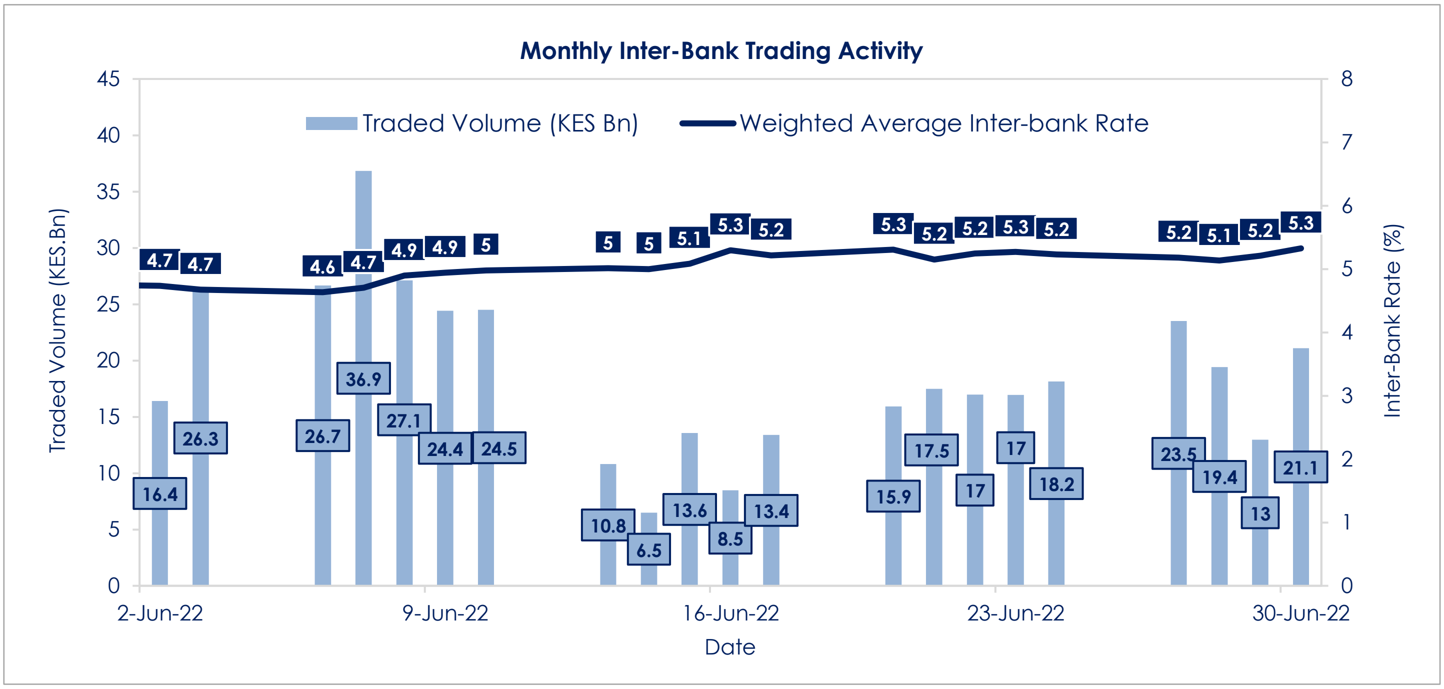


Source: Central Bank of Kenya

Average inter-bank lending rates rise in June 2022

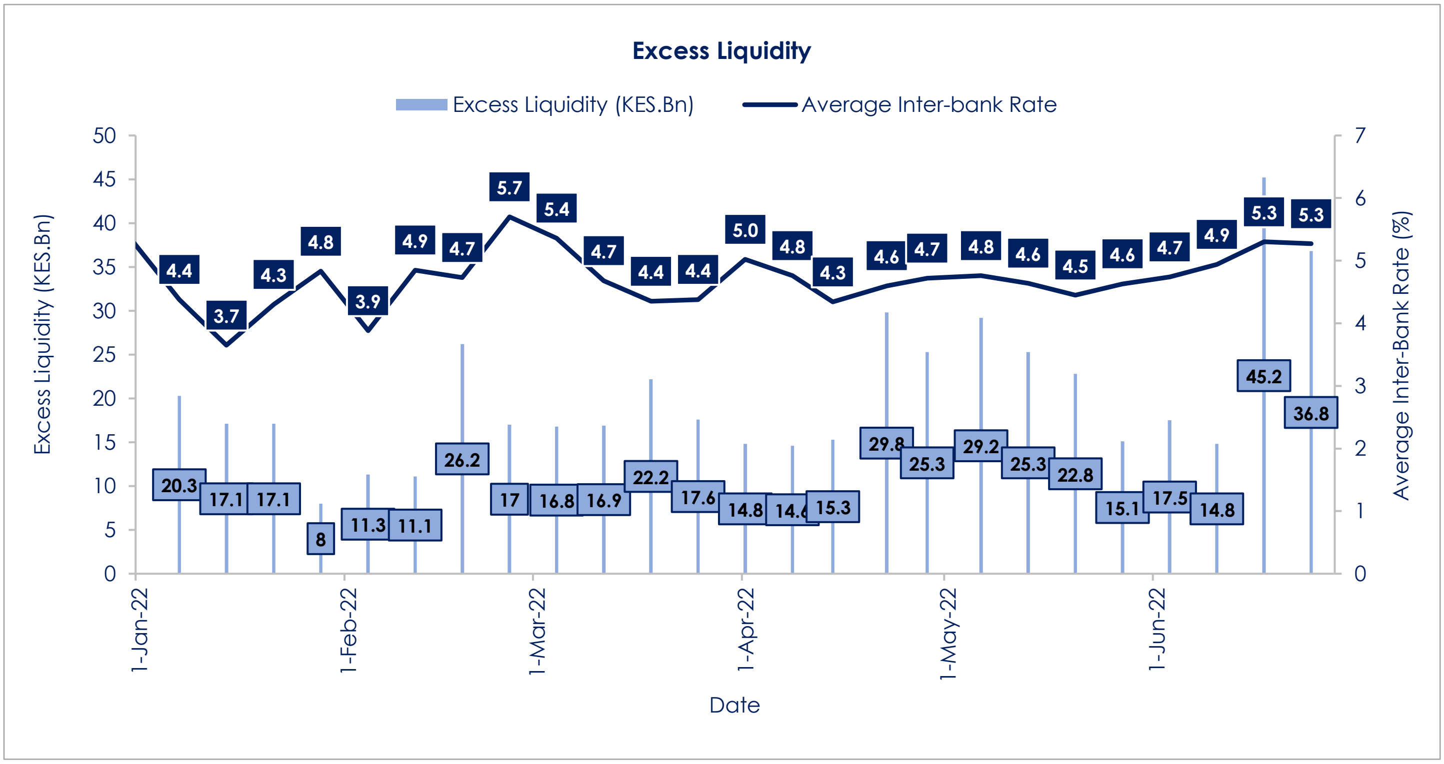
- Average inter-bank rates rose to 5.1% in June 2022 compared to 4.6% in May 2022 while total inter-bank trading volumes over the same period increased 23% to KES.397.5Bn from KES.323Bn the previous month. (Figure.5).
- Over the same period, excess reserves which is the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) rose 23.7% to KES114.3Bn, compared to KES. 92.4Bn in May (Figure.6).
- We do not expect significant changes to market liquidity levels in June and forecast average inter-bank rates at 4.7% - 5.3%.

Figure.5: Inter-bank lending rates to range between 4.7% and 5.3% in July 2022



Source: Central Bank of Kenya

Figure.6: Excess commercial bank reserves increases in June 2022

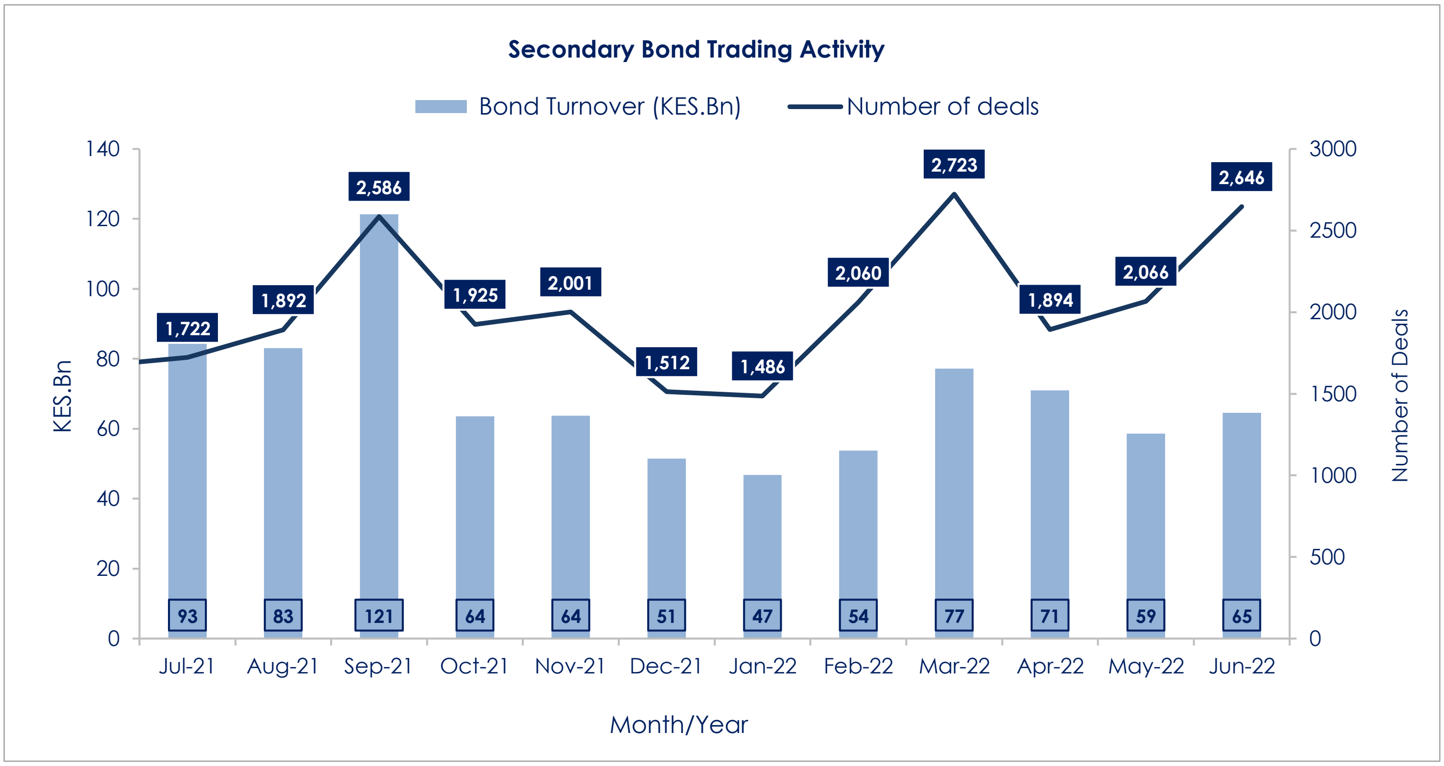


Source: Central Bank of Kenya

Secondary market bonds up 10% in June 2022

- Secondary market trading activity rose 10.2% in June 2022 to KES.64.5Bn from KES.58.6Bn in May 2022 with the number of deals over the same period increasing 28.1% to 2,646 from 2,066 (Figure.7).
- This increase was largely attributed to heightened trading activity on IFBs including **IFB1/2021/18**, **IFB1/2021/21** and **IFB1/2022/19** which are currently trading at a discount and thus offering attractive yields.
- As has been mentioned, **FXD2/2013/15** with a coupon of 12% and **FXD2/2018/15** with a coupon of 12.75% are currently trading at a discount.
- **IFB1/2022/18** whose tap sale closed on 7th July has a YTM of 13.74% and is trading at a premium.

Figure.7: IFB sales boost June secondary trading activity

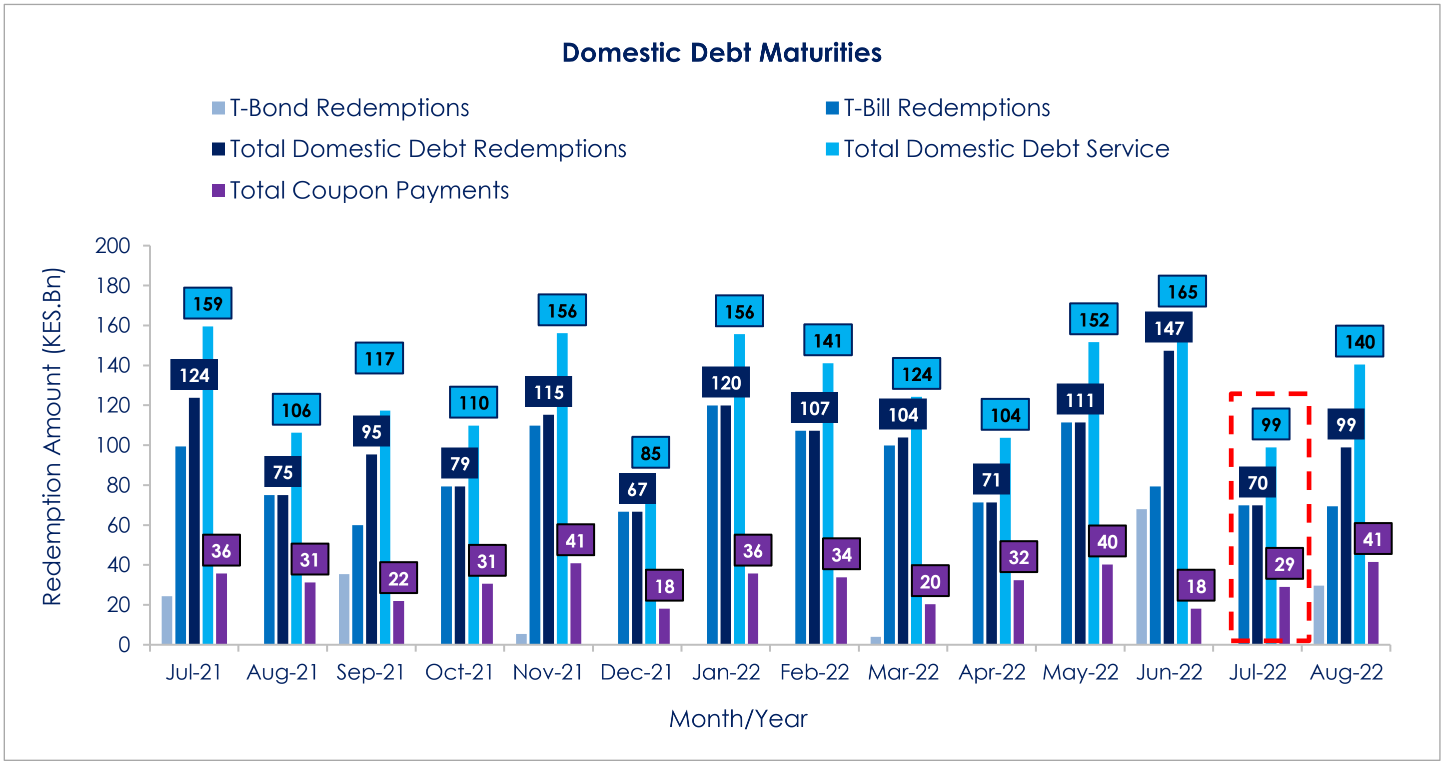


Source: Central Bank of Kenya

KES.99Bn in total domestic debt service for July 2022

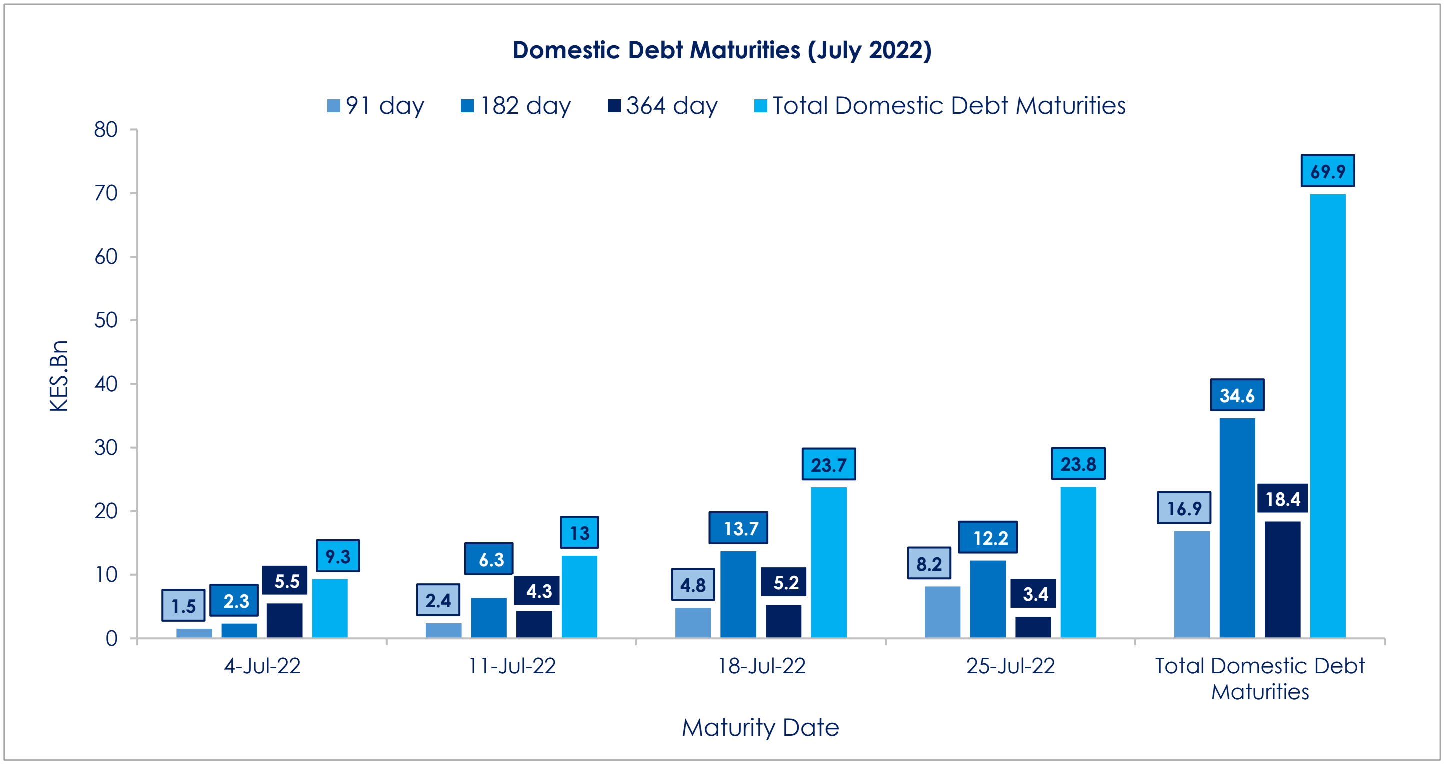
- Total domestic debt service for July is KES.99Bn, 40% lower than June's KES.165.5Bn on account of a 12% decline in T-Bill redemptions and no T-Bond maturities (Figure.8).
- This comprises of KES.69.9Bn and KES.29Bn in T-Bill redemptions and coupon payments respectively.
- Redemptions for the 91,182 and 364-day T-Bills during the month are KES.16.9Bn, KES.34.6Bn and KES.18.4Bn respectively with the fourth week of the month having the highest redemptions at KES.23.8Bn (Figure.9).

Figure.8: July debt service to decline to KES.99Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities July 2022

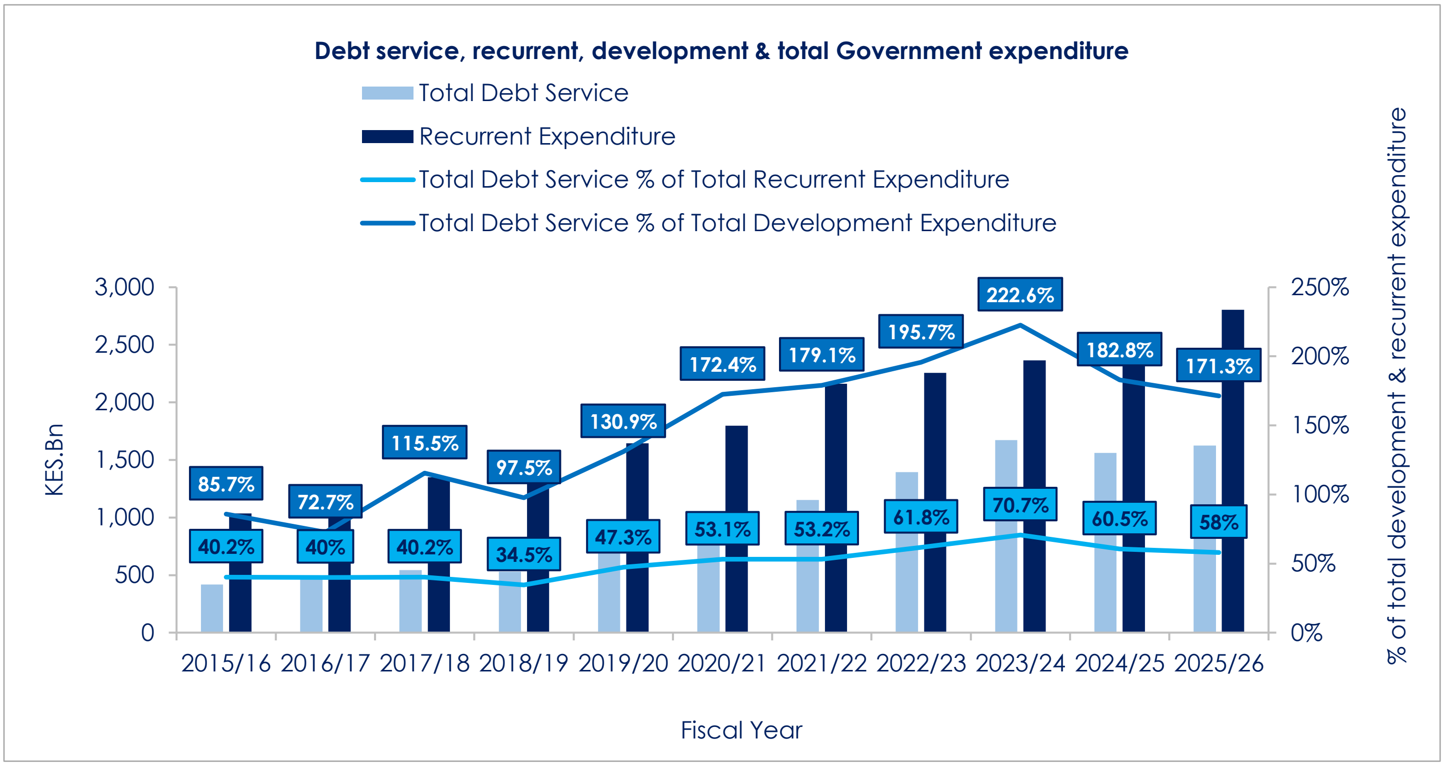


Source: Central Bank of Kenya

Huge proportion of Government revenue used to service public debt

- Data released by the National Treasury in May 2022 shows that an increasing proportion of Government revenue is being used to meet its debt service obligations (Figure.10).
- This is also a great concern considering that debt service is also higher than development expenditure.
- This is unsustainable in the long run also considering the sustained pressure on both domestic and external interest rates.
- This means that the Government will be hard pressed to cut its fiscal deficit which include both increasing taxes and managing its expenditure.

Figure.10: Huge proportion of Government revenue used to finance public debt service



Source: The National Treasury

Government tax revenue collection above our linear target run-rate estimate

- Data from the National Treasury at the end of May 2022 shows KES.1.64Tn in tax collection against a revised target of KES.1.74Tn (Table.5 and Figure.11).
- This is equivalent to 94.1% of the revised target which is comfortably above our linear target run-rate of 91.7% after eleven months of the 2021/22 fiscal year.
- We however note that domestic borrowing remained below our linear target run-rate thus creating a challenge of financing the fiscal deficit for the same fiscal year.
- Also notable is the huge shortfall in external loans and grants which we attribute to the decision of the National Treasury to shelve the issuance of the US$1Bn (KES.118Bn) Eurobond.
- This means that we should expect an increase in domestic borrowing to compensate for this shortfall.

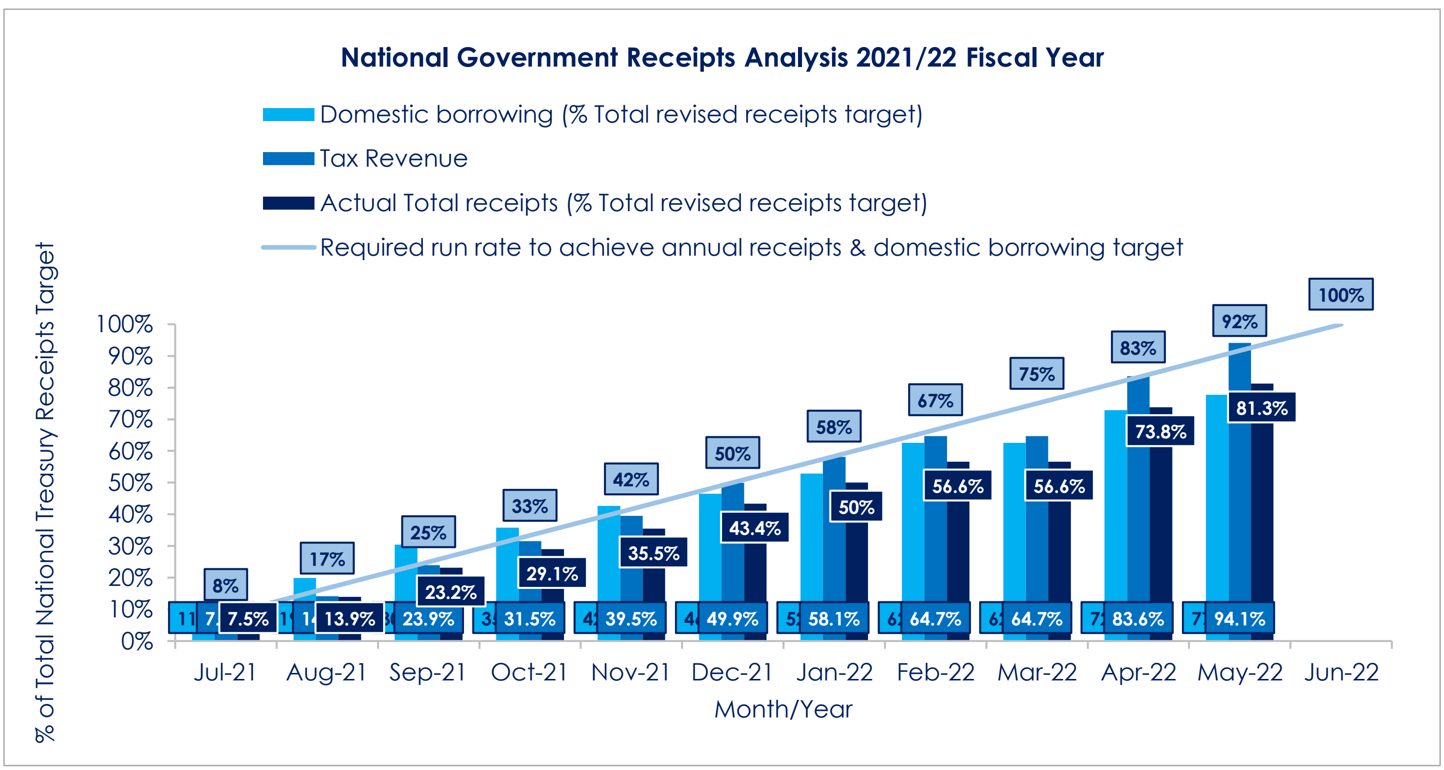
Table.5: 2021/22 Tax receipts above linear target run-rate

Receipts	Original Estimates July 2021 (KES.Bn)	Revised Estimates Mar 2022 (KES.Bn)	Actual Receipts 28th Apr 2022 (KES.Bn)	Actual Receipts 31st May 2022 (KES.Bn)	Proportion of Total Receipts 31st May 2022
Opening Balance (1st July 2021)		21.3	21.3	21.3	
Tax Revenue	**1,707.4**	**1,741.1**	**1,456.2**	**1,637.9**	**94.1%**
Non-Tax Income	68.2	67.1	59.3	59.6	88.6%
Domestic Borrowing*	**1,008.4**	**1,008**	**735**	**783.5**	**77.7%**
External Loans & Grants	379.7	433.2	162.5	172.2	39.7%
Other Domestic Financing	29.3	30.4	8	13.2	43.6%
Total Revenue	**3,193**	**3,279.8**	**2,421.1**	**2,666.3**	**81.3%**
Linear Run Rate target (11 months of fiscal year)					**91.7%**

* Note 1: Domestic Borrowing of KES.1, 008.4Bn = Net Domestic borrowing KES.664Bn & Internal Debt Redemptions (Roll-overs) KES.343.9

Source: The Kenya Gazette Vol. CXXIV - No.112 17th June 2022

Figure.11: National Treasury at 43% of 2021/22 fiscal year domestic borrowing target

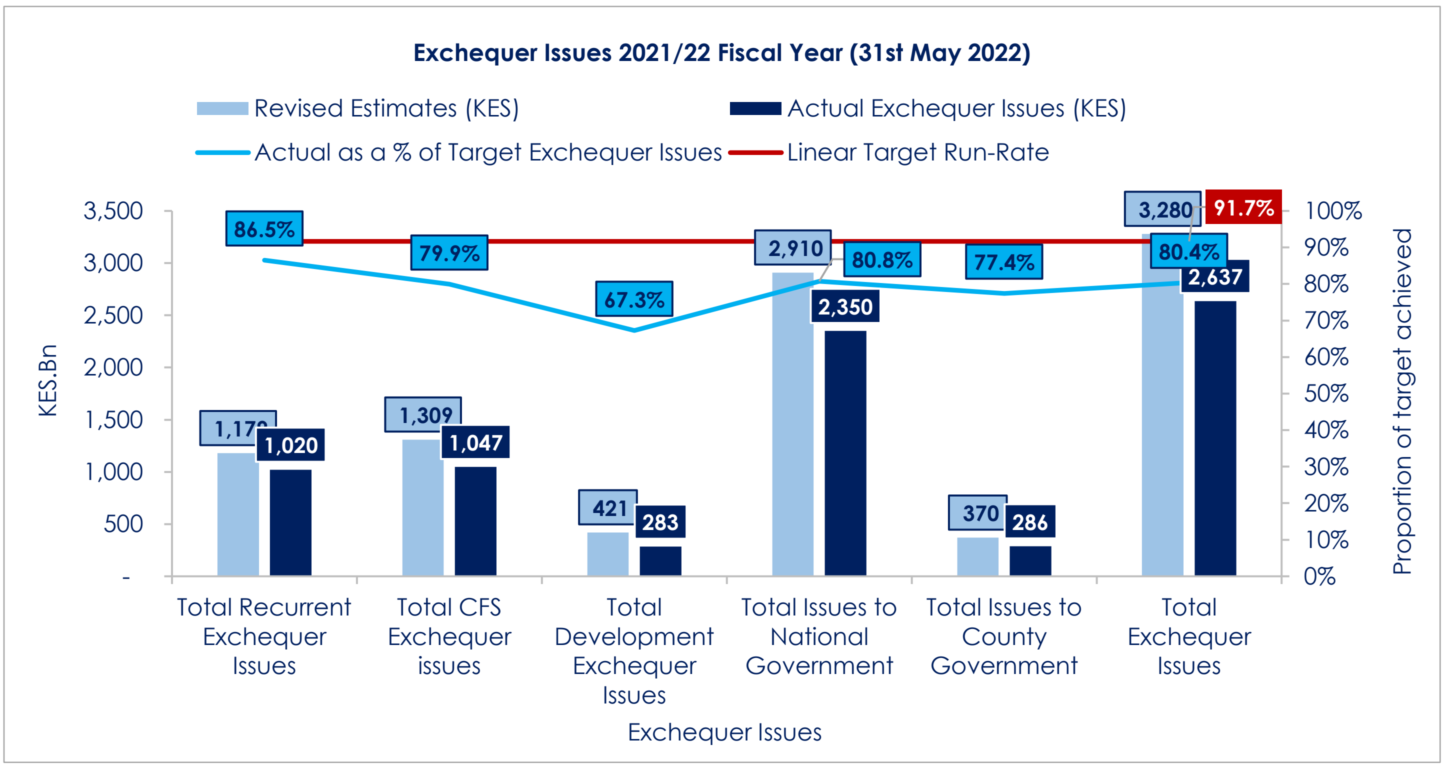


Source: The Kenya Gazette Vol. CXXIV - No.112 17th June 2022

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

- Actual total Government expenditure stood at KES.2.64Tn equivalent to 80.4% of the total fiscal year target of KES.3.28Tn (Figure.12) but below our linear target run-rate of 91.7% for the eleven months of the 2021/22 fiscal year.
- Total recurrent expenditure stood at KES1.02Tn equivalent to 86.5% also below our linear target run-rate
- The persistent underperformance of development expenditure and transfers to county Government remains at 67.3% and 77.4%.
- The above points to challenges faced by the Government to raise sufficient capital to finance its budget.
- This also means that we expect the CBK to actively issue new and re-open debt issues to raise funds.

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

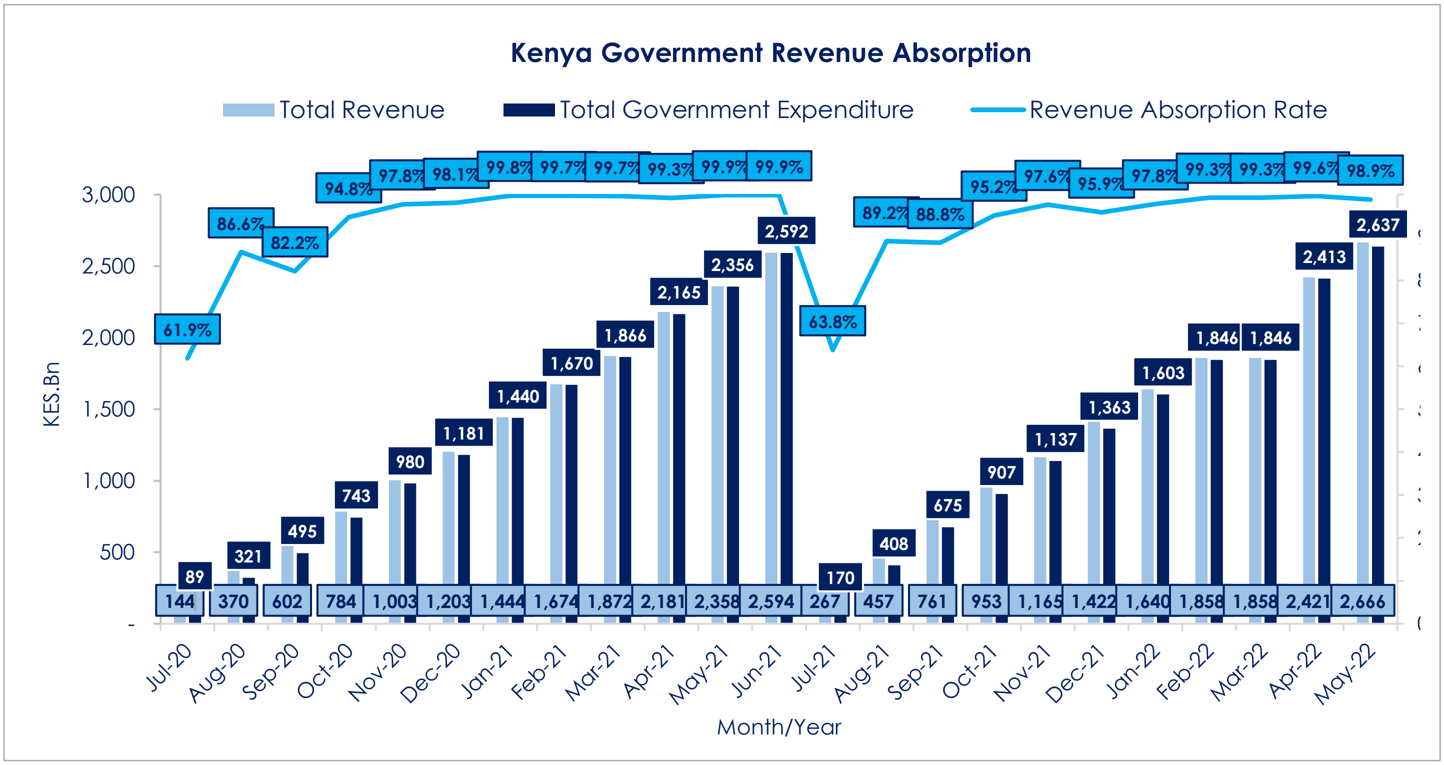


Source: The Kenya Gazette Vol. CXXIV - No.112 17th June 2022

Slight dip in Government Revenue Absorption in May 2022

- The proportion of Government receipts used to finance expenditure also known as the Revenue Absorption Rate (RAA) declined to 98.9% compared to 99.6% and 99% in April 2022 and May 2021 respectively (Figure.13).
- Despite the slight decline, the RAA remains high illustrating the high budget financing needs as almost the entire Government revenue is being used to finance its expenditure.

Figure.13: Revenue absorption is high showing close to full utilization

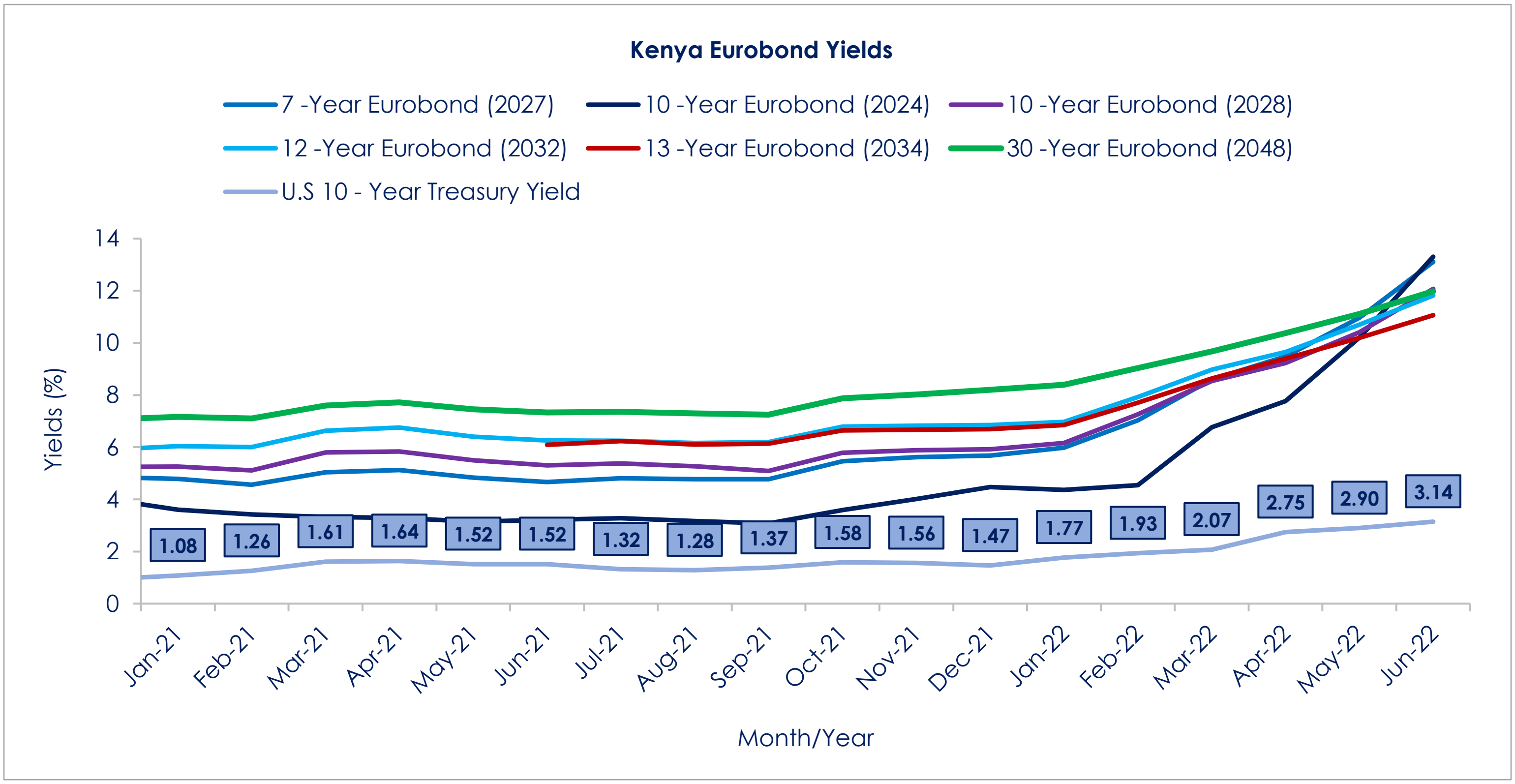


Source: The Kenya Gazette Vol. CXXIV - No.112 17th June 2022

Spike in Kenya Eurobond yields as global economic uncertainty and interest rates rise

- Average Kenya Eurobond yields have risen 592 and 168 bps since the end of 2021 and May 2022 respectively (Figure.14).
- This is a reflection of global economic uncertainty following the Russia-Ukraine crisis and the resulting inflationary pressure that evoked three upward revisions of the Federal Reserve rate (Fed Rate) and in turn U.S treasury yields.
- This is not unique to Kenya but has also been the case with other African sovereign bonds.
- Average yields on the U.S 10-Year Treasury have increased 168 bps over the same period with 25 basis points increase between May and June 2022.
- A further hike in the Fed rate is expected (75 bps) in July 2022 as indications of sustained inflationary pressure remain meaning a further surge in US treasury yields.
- This combined with global economic uncertainty and concerns over the fiscal condition of the country will result in a further hike in Kenya Eurobond yields.

Figure.14: Kenya Eurobond yields have spiked since the turn of the year

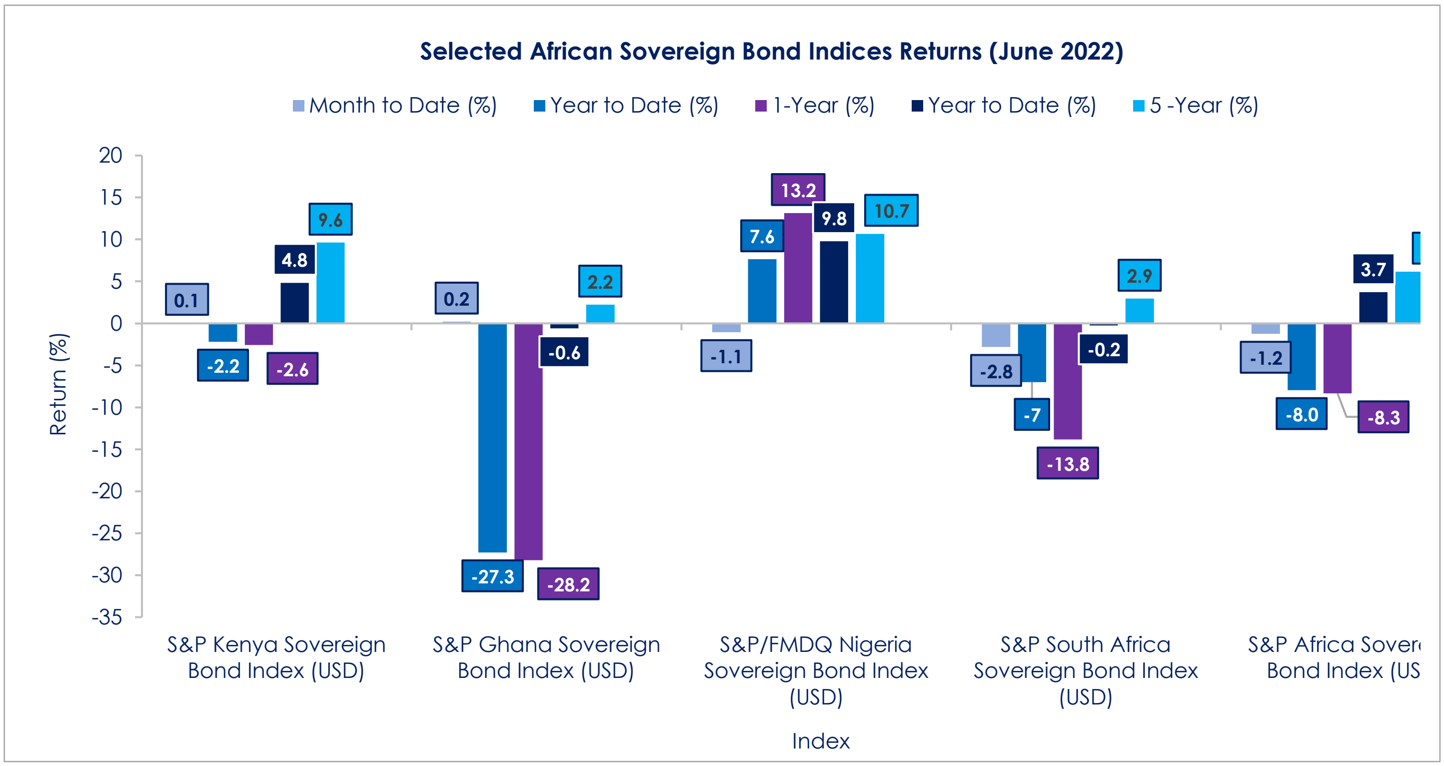


Source: Central Bank of Kenya

Ghana sovereign bond index tops month and annual performance

- The S&P/FMDQ Nigeria Sovereign Bond Index remains the best performing sovereign bond index amongst our comparables year to date and over the 1 to 5-year period under (Figure.15).
- The Kenya Eurobond has performed dismally during the period only returning a positive price performance month to date and over 3 and 5 year periods.
- Uncertainty over the fiscal positions of the African sovereign debt issuers and currency depreciation explains the relatively low return in the month to date and over the last one year.
- We expect this to remain the case at least in the short-term.

Figure.15: S&P Nigeria bond index outperforms our comparable sovereign bond indices in the 5-year period



Source: S&P Global

Yield curve shifts further northwards

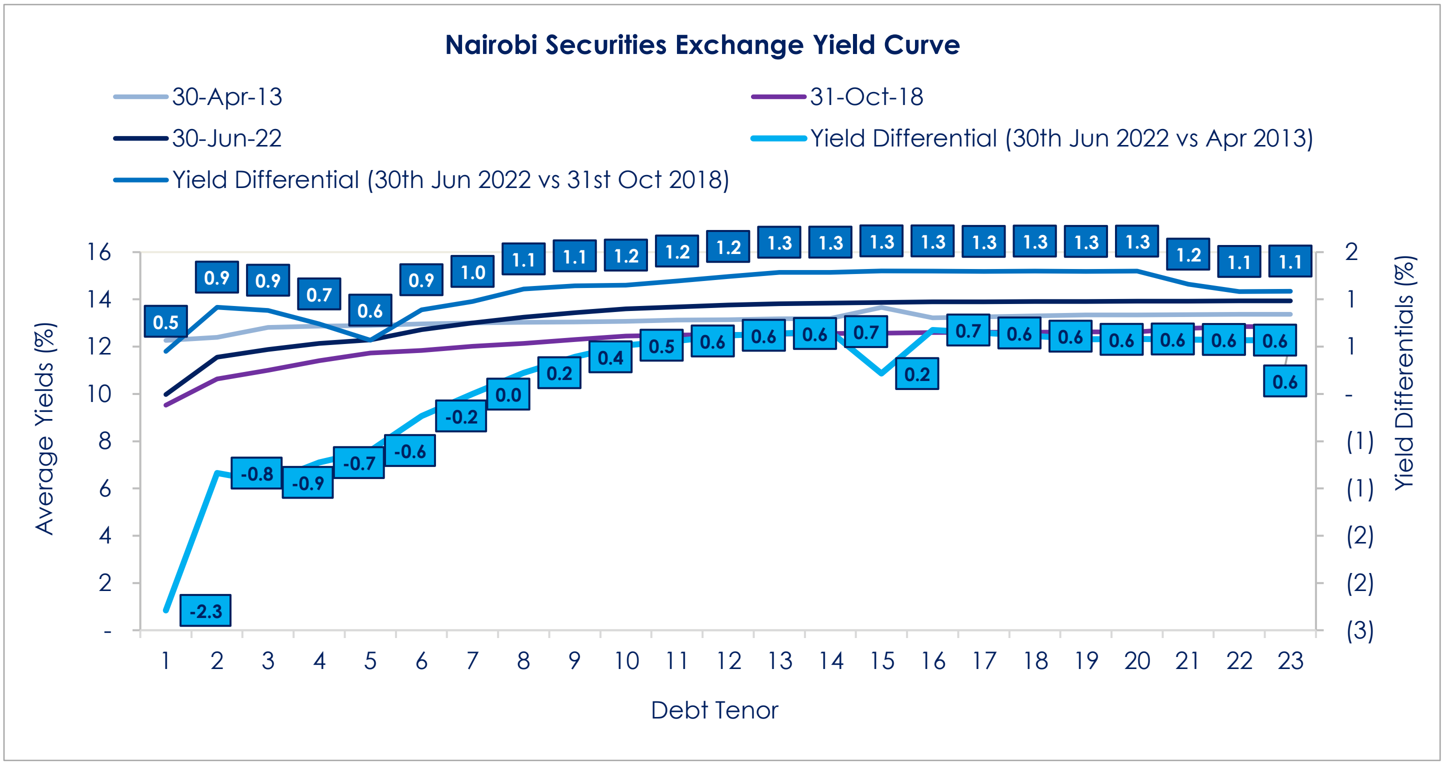
- A comparison of average yields on the NSE on 31st October 2018 (issuance of **FXD2/2018/15)** and the most recent 30th June 2022 shows an increase in yields across the curve. (Table.6 and Figure.16).
- This is also the case when we compare current yields with those of the same time last year.
- However, current average yields on short and medium-tenors have declined when compared to average yields on 30th April 2013 (issuance of **FXD2/2013/15**).
- Our expectations of a gradual increase in interest rates across the yield curve throughout 2022 due to an increased domestic debt financing demand pressure, increasing inflation and the revision of CBR to 7.5% remain unchanged.
- 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 (Table.7).
- This however is suitable to high net-worth investors (considering the high minimum amount) with US$ holdings or those willing to incur the cost of currency conversion.
- The attractive coupon rates compare favourably to returns available locally for US$ denominated investment assets.
- We revise our recommendation from BUY short and HOLD medium-term and long term papers to BUY medium and long-term papers for interest income play given prevailing rates.
- IFBs are generally attractive due to their tax free component.

Table.6: Yield curve has shifted upwards over the last three years across all tenors

Tenor	Yields (30th Apr 2013)	Yields (31st Oct 2018)	Yields (30th Jun 2021)	Yields (30th Jun 2022)	∆ 30th Jun 2022 vs Apr 2013) (Bps)	∆ 30th Jun 2022 vs 31st Oct 2018) (Bps)	YoY ∆ 30th Jun 2022 vs 2021 (Bps)	Sterling Capital Yield Curve (July 2022)
1	12.2640	9.5240	7.7290	9.9740	↓ 229	↑ 45	↑ 224.5	10.0000
2	12.3943	10.6399	9.4260	11.5572	↓ 83.7	↑ 91.7	↑ 213.1	11.6000
5	12.8920	11.7253	11.1231	12.2933	↓ 59.9	↑ 56.8	↑ 117	12.3500
10	13.0787	12.4438	12.2628	13.5941	↑ 51.5	↑ 115	↑ 133.1	13.6000
15	13.6610	12.5752	12.8841	13.8762	↑ 21.5	↑ 130.1	↑ 99.2	13.8500
20	13.3420	12.6250	13.2736	13.9231	↑ 58.1	↑ 129.8	↑ 65	13.9500

Source: Nairobi Securities Exchange

Figure.16: 2013 Short-term tenors higher compared to 2018 and 2022



Source: Nairobi Securities Exchange

Table.7: Trading ideas - Consider Kenya Eurobonds

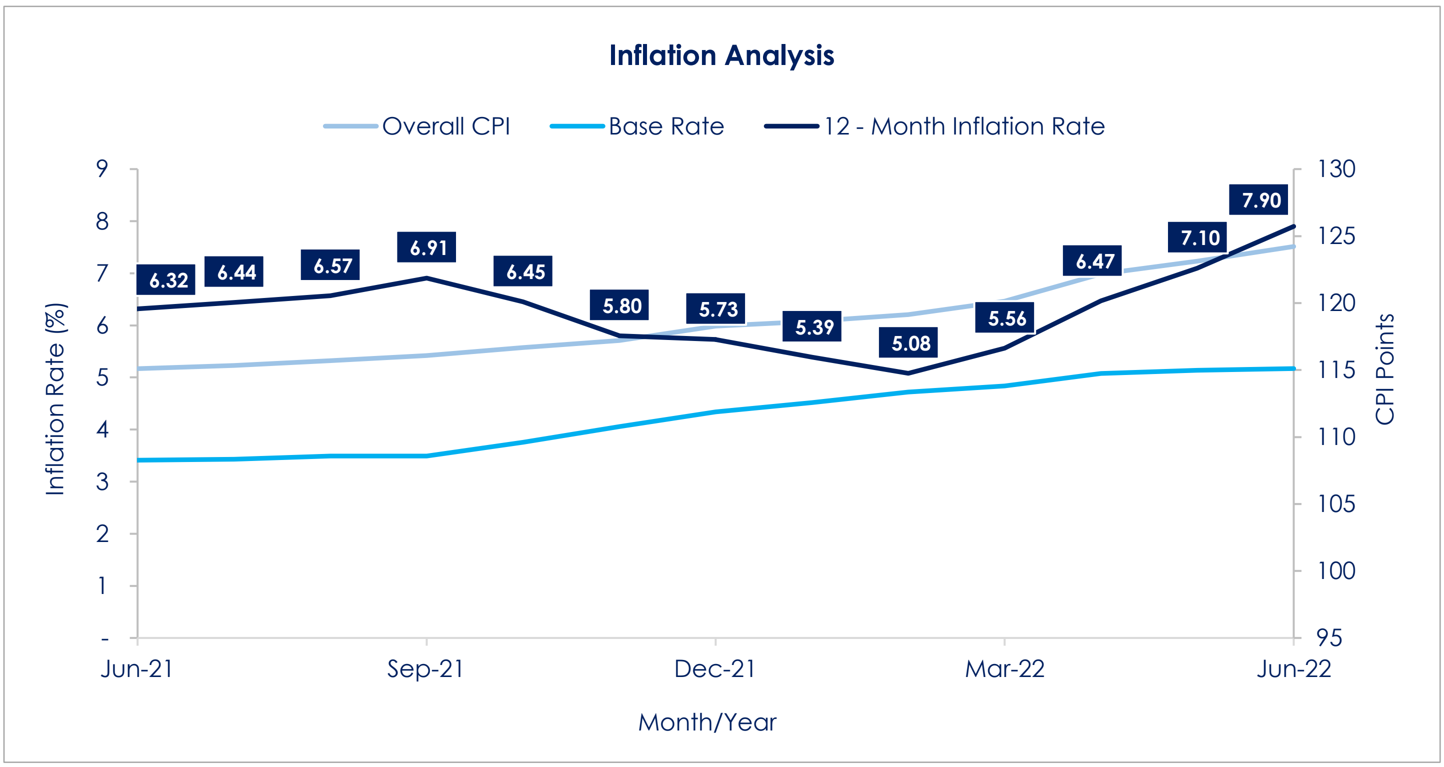
ISIN Code	Issue date	Tenor (Years)	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (7th July 2022)	Maturity
XS102895240	Jun-14	10	2	6.875%	16.852	Jun-24
XS184343584	May-19	8	0.9	7%	14.426	May-27
XS178171054	Feb-18	10	1	7.25%	14.716	Feb-28

Source: Bloomberg

July 2022 inflation to rise further on supply-side pressures

- Inflation for the month of June 2022 stood at 7.9%, up from 7.1% a month earlier largely due to an increase in the prices of commodities (Figure.17).
- This is the first time the inflation rate has crossed above the CBK's medium term upper band range of 7.5%.
- The marked increase in the prices was a result of an increase in food and non-alcoholic beverages (13.8%), household maintenance (9.2%), transport (7.1%) and housing, water, electricity, gas and other fuels (6.8%) between June 2021 and June 2022 (Figure.18).
- Our short-term (July and August) inflation forecast is 8% - 9% on account of continued supply-side pressures such as elevated global fuel and food import prices, supply-chain constraints.
- The depreciation of the Kenya shilling keep inflation elevated throughout 2022.
- To this effect, we see inflation above 7% through 2022.

Figure.18: Short-term inflation forecast 8% - 9%



Source: Kenya National Bureau of Statistics

MPC to revise the CBR to rein in inflation and KES depreciation

- The Monetary Policy Committee (MPC) meets on 27th July 2022 to review the impact of previous monetary policy measures on the economy.
- In its last meeting in May 2022, the MPC revised the Central Bank Rate (CBR) by 50 basis points from 7% to 7.5%.
- We expect another by 50 bps to 8% on account of the following:

    1) June inflation at 7.9% exceeding its upper band medium term range of 7.5%.

    2) Depreciation of Kenya Shilling (KES) with the local currency trading at KES.118.03 against the U. S$ (as at 7th July 2022), representing a 4.3% depreciation since the beginning of the year.

- Other points of discussion during the meeting will most likely include the status of the Russia-Ukraine conflict and its impact on the global commodity prices, the Q1'2022 GDP growth, Private Sector Credit (PSC), banking sector liquidity and asset quality, foreign currency reserves and status of the country's international trade data.
- Our view is that any upward revision will largely be ineffective in the short-term, as the current inflationary pressure is a direct effect of supply side and not demand effects that can be controlled by a revision of the policy rate.

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