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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Results Update Note

September 2022

Table of Contents

September 2022 Treasury Bond primary auction results update

- The Central Bank of Kenya (CBK) re-opened two bonds in September 2022, **FXD1/2022/10** and **FXD1/2022/15** seeking to raise KES.50Bn for budgetary support;

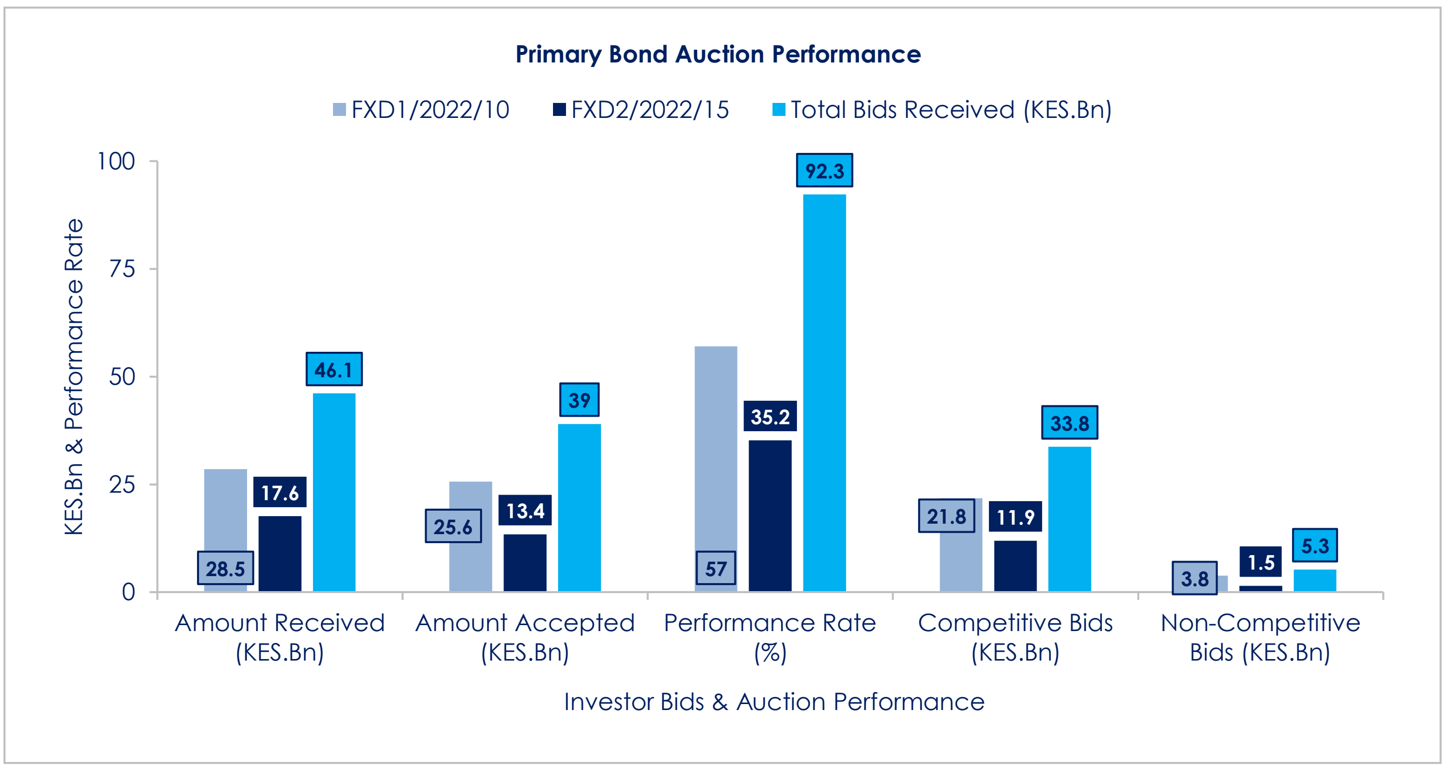
  - **FXD1/2022/10** (9.6*),
  - **FXD2/2022/15** (14.5*).

  ***Years to maturity**

Subscription Rates

- The debt issues were undersubscribed which was in line with our expectations as spelt out in our September fixed income report, **"Slow start to 2022/23."**
- Total bids received amounted to KES.46.1Bn against a target of KES.50Bn equivalent to a 92.3% subscription rate (Figure.1).
- We attribute the undersubscription to continued focus on short term government paper such as the 91-day T-bill as investors primarily prefer to hold short-term securities in an environment of rising interest rates.
- Trading investors also wish to avoid bond revaluation (mark to market losses) losses which are price declines below their purchase cost or original value resulting from rising interest rates.
- In line with our views, investor bidded aggressively beyond the 14% psychological level, particularly on the 15 year issue.
- These bids were however largely rejected by the CBK which is still keen on keeping rates below this level.

Figure.1: Primary Bond auction performance



Source: Central Bank of Kenya

Weighted Average Rates

- Our predicted Weighted Average Rates (WAR) ranges were in line with the CBK's accepted weighted average rates (Table.1).

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

Bond Issue	SCL Accepted Bids WAR Prediction (%)	CBK Accepted Bids WAR (%)	CBK Accepted Bids WAR vs SCL Predicted WAR Range Average (Bps)
FXD1/2022/10	13.85 - 13.95	13.949	+4.9
FXD2/2022/15	13.95 - 14.05	13.983	-1.7

Source: Central Bank of Kenya

Our view

1) **NSE yield curve** - As has been the case for most of the year, these auction results support our view of an upward shift in the yield curve given that the yields on the 10 and 15-year tenors as at the previous week (9th September 2022) were 13.69% and 13.91% respectively.

   Overall, the yield curve has been shifting upwards since the second quarter of 2021 with average yields expected to continue on an upward trend in the near term.

   While the CBK managed to ward off aggressive investor bids in this as well as previous auctions, the removal of Kenya's fuel subsidy will serve to increase inflation going forward which will prompt the CBK to accept higher bids to compensate investors for the lower real returns associated with investing in bonds going forward.

   Despite this, the efforts by the CBK thus far have worked to keep the long end of the yield curve relatively flat and as such, has prompted us to make slight revisions to our 2022 yield curve estimates. We expect the long-end of the yield curve (10 years and above) to increase 60 - 80 Bps in 2022, down from our previous estimate of 100 – 150 Bps.

   Our expectations on the short end of the yield curve remain unchanged with the short end (91 days – 3 years) expected to increase by an estimated 80 – 100 basis points (Bps), while the medium term (4 – 9 years) is set to increase by 100 – 150 Bps in 2022.

2) **Market Liquidity** - The repo, reverse repo and inter-bank rates as of 9th September 2022 were 7.1%, 9.3% and 4.2% compared to 7.1%, 9.1% and 5.6% during our last primary results update note on the 17th of August 2022. This trend points to an increasingly liquid market, most of which is being channeled toward the 91-day T-bill which commanded bids worth KES.20.2Bn against an offered amount of KES.4Bn (675.4% performance rate) as at the latest auction dated 12th September 2022.

   The CBK's initiative to focus on reverse repos since the 21st of July 2022 has worked to inject KES.158Bn worth of liquidity into the market as at the 9th of September 2022 when the latest reverse repo was done.

3) **Investment Case** – We recommend a **BUY** on medium and long-term papers for interest earning purposes as buying for active trading in the secondary market is likely to leave investors susceptible to losses in an environment of rising interest rates.

We advise active traders and investors with high risk tolerance to consider buying the US$ denominated Kenya Eurobonds to take advantage of current attractive yields.

This however, is suitable to high net-worth investors (considering the high minimum amount of US$200,000) with US$ holdings or those willing to incur the cost of currency conversion.

4) **Secondary market trading** - We do not expect a significant increase in demand on the two bonds in the secondary market as investors will pay a premium to purchase them. As has been the case for most of 2022, IFB's will remain more attractive due to their tax-free status and trading will be focused on them over FXD bonds.

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