STERLING CAPITAL LIMITED

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Fixed Income

Primary Auction Results Update Note I

(FXD1/2017/10 & FXD1/2020/15)

October 2022

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October 2022 Treasury Bond primary auction results update

- The Central Bank of Kenya (CBK) re-opened two Treasury Bond/s (T-Bonds); **FXD1/2017/10, FXD1/2020/15** and a new one **FXD1/2022/25** in October 2022 seeking to raise KES.40Bn and KES.20Bn for budgetary support respectively;
  - **FXD1/2017/10** (4.9*),
  - **FXD1/2020/15** (12.3*),
  - **FXD1/2022/25** (25*).

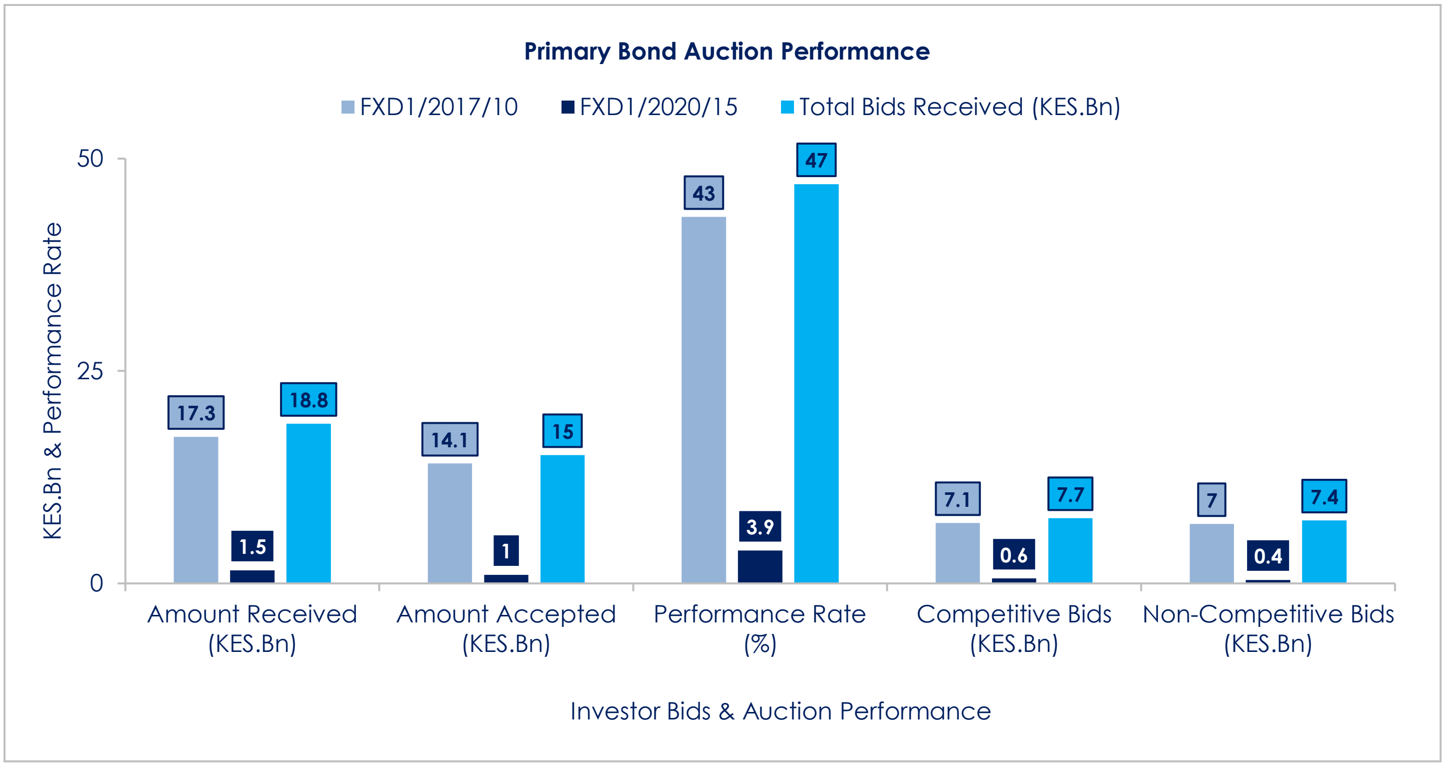
  ***Years to maturity**

- The bonds had different periods of sale with **FXD1/2017/10** and **FXD1/2020/15** (21st September - 4th October 2022) and **FXD1/2022/25** (21st September - 18th October 2022).
- This results update focuses on **FXD1/2017/10** and **FXD1/2020/15** auctioned on 5th October 2022, here.

Subscription Rates

- We observed a huge undersubscription which is in line with our expectations in the October fixed income report, "Revenue Drag" .
- Total bids received amounted to KES.18.8Bn against a target of KES.40Bn target equivalent to a 47% subscription rate (Figure.1).
- This was due to a combination of tight market liquidity which the CBK has been trying to address via reverse repos and expectations of rising interest rates which dissuades investors from holding medium to long-term bonds.
- In line with our views, investors bided aggressively beyond the 14% psychological level, particularly on **FXD1/2020/15**.
- These bids were however largely rejected by the CBK which maintained interest rates below this level.

Figure.1: Primary Bond auction performance



Source: Central Bank of Kenya

Weighted Average Rates

- Our predicted Weighted Average Rates (WAR) range for **FXD1/2020/15** was well within while **FXD1/2017/10** was slightly above the CBK's accepted weighted average rate (Table.1).

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

Domestic Debt Issue	SCL Accepted Bids WAR Prediction (%)	CBK Accepted Bids WAR (%)	CBK Accepted Bids WAR vs SCL Predicted WAR Range Average (Bps)
FXD1/2017/10	13.20 – 13.30	13.369	+11.9
FXD1/2020/15	13.95 – 14.05	13.970	-3

Source: Central Bank of Kenya

1) **Nairobi Securities Exchange (NSE) yield curve** - These auction results continue with the trend observed for the most part of the year where there has been an upward shift in the Nairobi Securities Exchange (NSE) yield curve.

   The implied yields on the bonds of similar tenors to maturity (4.9 years and 12.3 years) on 30th September 2022 were **12.6530%** and **13.8902%** equivalent to 716 and 8 basis points lower than the latest auctions 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 for the following reasons:

   1) Upward revision of the Central Bank Rate (CBR) from 7.5% to 8.25% on 29th September 2022.

   2) High inflationary pressure with September inflation at 9.2% meaning that investors will demand higher rates to compensate for the erosion in real return.

   3) Investor awareness that the Government is lagging behind its total annual receipts targets and will need to increase borrowing to bridge the funding gap.

      Total Government receipts as at the end of August 2022 stood at KES.383.4Bn which was 16.1% lower than the KES.457.1Bn at the end of the same period in 2021.

      Domestic borrowing over the same period stood at KES.54.8Bn or 72.6% lower than the KES.200.3Bn recorded in August 2021.

   In this regard, we expect the CBK to accept aggressive bids for the bond to be auctioned on 19th October - **FXD1/2022/25** thus breaching the 14% psychological ceiling.

   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 (91 days – 3 years) have also increased to 100 – 150 Bps from an estimated 80 – 100 basis points (Bps), while the medium term (4 – 9 years) remains unchanged at 100 – 150 Bps in 2022.

2) **Market Liquidity** - The repo, reverse repo and inter-bank rates as of 5th October 2022 were 7.1%, 9.9% and 5.2% compared to 7.1%, 9.3% and 4.2% during our last primary results update note on the 9th of September 2022. This trend points to an increasingly illiquid market, with a decline in the 91-day T-bill bids to KES.5.1Bn (128.2% performance rate) as at the latest auction dated 3rd October 2022 in comparison to commanded bids worth KES.20.2Bn against an offered amount of KES.4Bn (675.4% performance rate) as at 12th September 2022 (latest auction during our last primary results update).

3) **Investment Case** - We recommend the following investment strategies on account of rising interest rates:

   a) Invest in T-Bills and short-term debt to avoid locking capital for longer periods in a rising interest environment as you wait for high yielding new issues such as a new Infrastructure Bond (IFB).

   b) Look out for bonds matching your maturity profile trading at huge discounts in the secondary market due to rising interest rates.

   c) Avoid revaluation losses (selling bonds at lower prices than their purchase prices) by holding on to your existing bond investment portfolio.

   d) 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 expect minimal trading of the two bonds in the secondary market given low activity on the primary market.

   As has been the case for most of 2022, IFB's will remain more attractive than Fixed T-Bonds due to their tax-free status and trading will be focused on them.

   However, rising interest rates will mean that they will be trading at a discount especially when there are signs of a new IFB issue.

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