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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Results Update

(IFB1/2022/14)

November 2022

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November 2022 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) issued an infrastructure bond in November 2022, **IFB1/2022/14**, seeking to raise KES.60Bn;

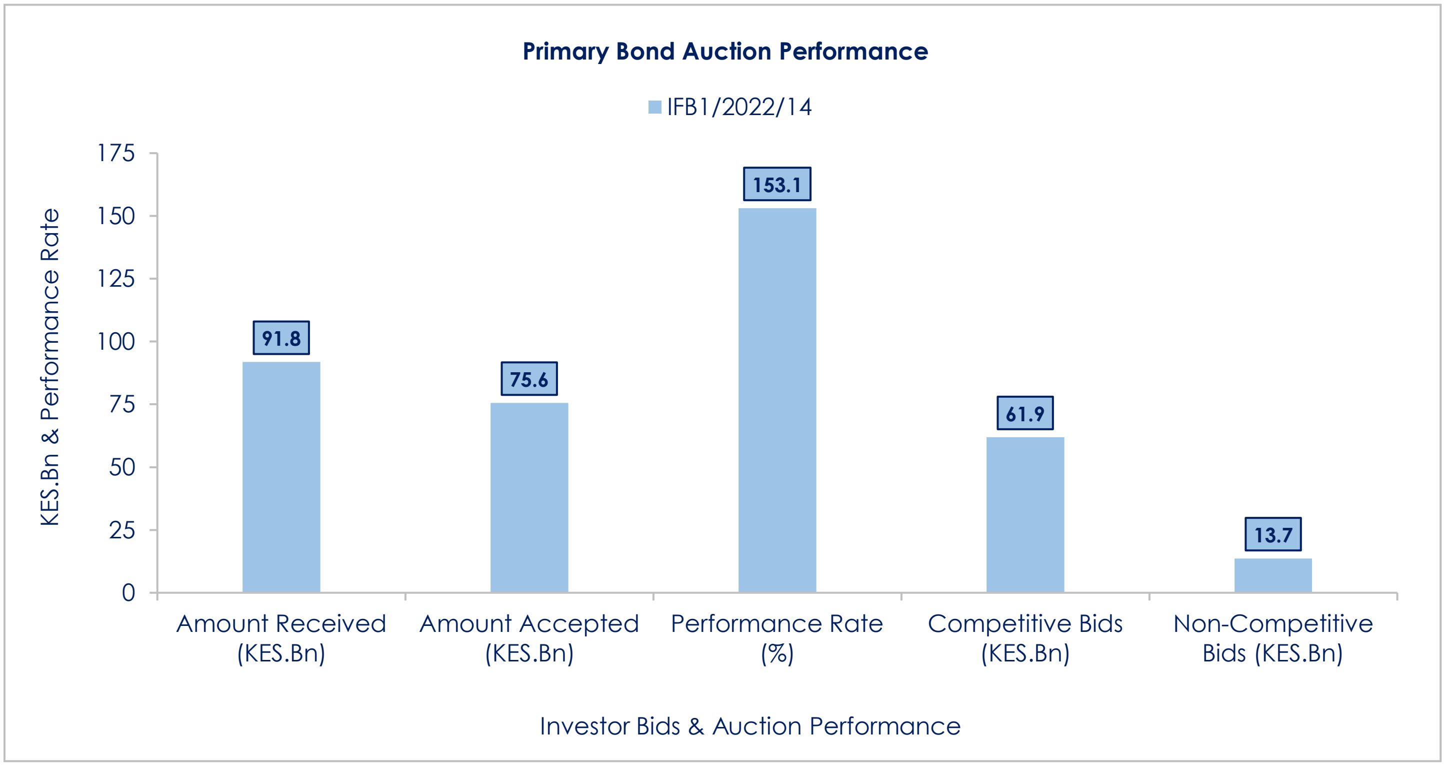
  IFB1/2022/14 (14*)
  **Years to maturity*

- The period of sale was between 26th October - 8th November 2022 with the auction date on 9th November 2022, results linked here.

Subscription Rates

- The debt issue was oversubscribed as is often the case with IFBs and in line with our expectations as outlined in our November fixed income report, "CBK issues 2022/23's first IFB ".
- Redemptions including; KES.33Bn - FXD3/2007/15 redemption, KES.30.4Bn - T-Bill first week redemptions and KES.27.2Bn - T-Bill second week redemptions, coupled with Reverse-Repos issued by the CBK since FXD1/2022/25 results amounting to KES.42.3Bn further explain the oversubscription.
- Total bids received amounted to KES.91.8Bn against a target of KES.60Bn equivalent to a 153.1% subscription rate (Figure.1).
- Additionally, investors bidded aggressively beyond the 14% psychological level (14.008%), with the CBK accommodating Weighted Average Rate (WAR) of accepted bids at 13.938%.
- This suggests aggressive investor bidding in subsequent long-term FXD bond auctions.
- The high acceptance rate of KES.75.6Bn was expected given October bonds undersubscription and the ever-growing budget deficit financing pressure.

Figure.1: Primary Bond auction performance



Source: Central Bank of Kenya

Weighted Average Rates

- The CBK's Weighted Average Rate (WAR) of accepted bids was well within our predicted range (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)
IFB1/2022/14	13.80 - 13.94	13.938	+6.8

Source: Central Bank of Kenya

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - The latest yield curve (4th November 2022) shows the 14-year debt tenor yield at 13.9030%.

   IFB1/2022/14 yield of 13.938% speaks to the impact of fiscal deficit pressures, high inflation and the CBR revisions on interest rates. With every new debt issue we witness a further upward shift in the yield curve.

   The yields differentials on medium and longer dated bonds have narrowed in recent months and this auction points towards gradual normalization of yield curve.

   We forsee the CBK accepting even more aggressive bids close to 14.5% in subsequent long-tenured auctions.

   The yield curve has been shifting upwards since the second quarter of 2021 with average yields expected to rise 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 October inflation at 9.6% (September 2022 - 9.2%) meaning that investors will demand higher rates to compensate for the real return erosion.

      Important to note is that despite revisions of the CBR in May and September inflation has breached the CBK's medium term upper band limit of 7.5% showing the ineffectiveness of the monetary measure at least in the short-term.

      Notably, as some global economies such like the United States continue to increase their benchmarke rates, the KES will continue to depreciate against these currencies.

   3) Government is lagging behind its revenue targets and will need to increase borrowing to bridge the funding gap.

      Total Government receipts as at the end of September 2022 stood at KES.680.7Bn which was 13% lower than the KES.782.2Bn at the end of the same period in 2021.

      Domestic borrowing over the same period stood at KES.95.7Bn or 68.8% lower than the KES.306.8Bn recorded in September 2021.

Notably, the CBK has breached the 10% psychological mark on the recent 364-day T-bill (as at 7th November 2022) in line with our expectations.

1) **Market Liquidity** - The repo, reverse repo and inter-bank rates as of 8th November 2022 were 7.1%, 9.8% and 4.5% compared to 7.1%, 9.7% and 5.2% during our last results update note on the 21st October 2022 pointing to improvement in liquidity within the market further explaining **IFB1/2022/14**'s 153.1% oversubscription.

   Notably, the 91-day T-bill received bids worth KES.18.6Bn (463.8% performance rate) as at the latest auction dated 7th November 2022 an indication that available liquidity was channeled towards the short-term debt security and the IFB issue.

2) **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 and high yielding new Infrastructure Bonds (IFB).

   b) Look out for bonds matching your maturity profile trading at huge discounts in the secondary market.

   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.

3) **Secondary market trading** - We expect active trading on **IFB1/2022/14** in the secondary market given high investor appetite and the attractive yield.

   At 13.938% **IFB1/2022/14** will be highest yielding IFB. The recently issued **IFB1/2022/18** and **IFB1/2022/19** have yield to maturity of 13.5215% and 13.4588% respectively.

   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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