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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Results Update

(FXD1/2008/20 & FXD1/2022/25)

December 2022

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December 2022 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) re-opened two bonds in December 2022, **FXD1/2008/20** and **FXD1/2022/25**, seeking to raise KES.40Bn;

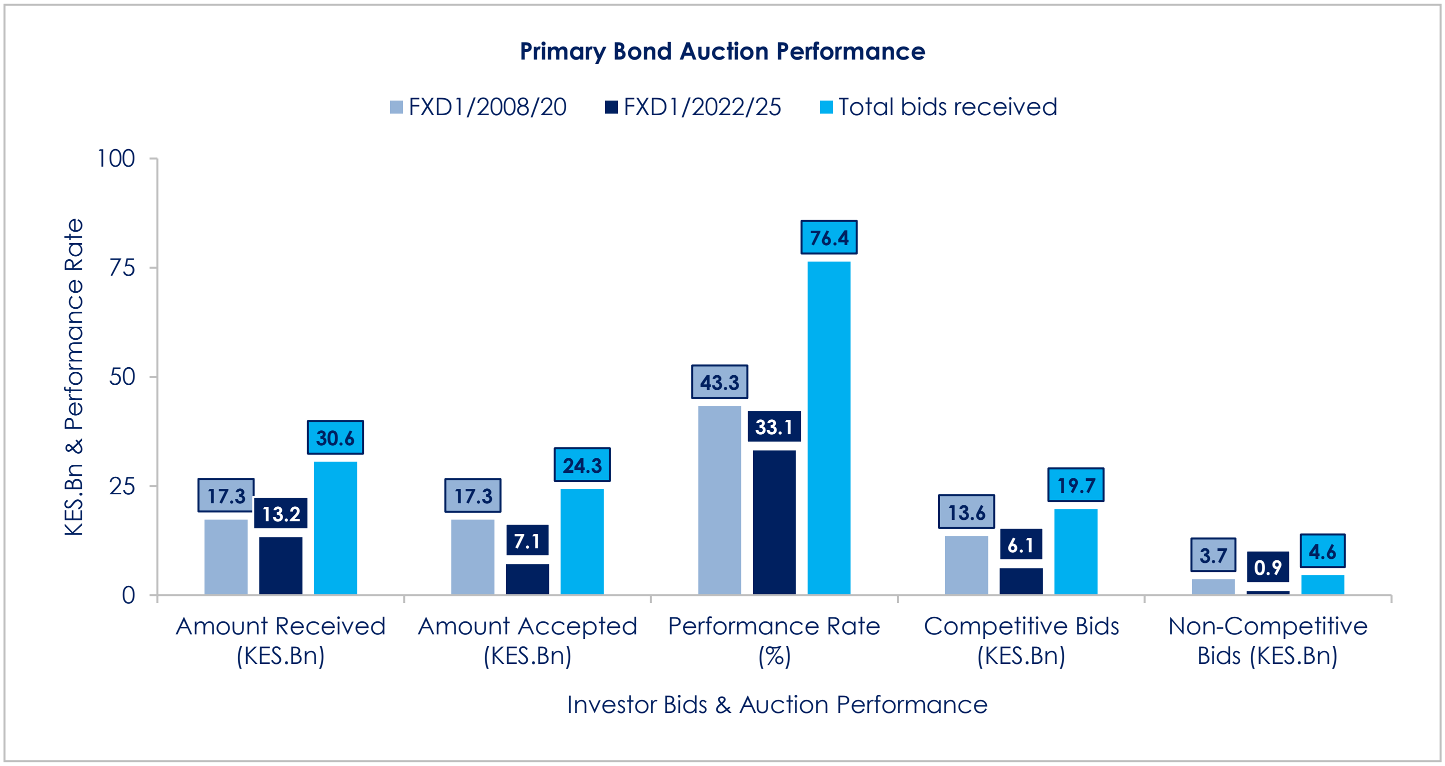
  FXD1/2008/20 (5.6*)
  FXD1/2022/25 (24.9*)
  **Years to maturity*

- The period of sale was between 22nd November and 6th December 2022 with the auction on 7th December 2022, results linked here.

Subscription Rates

- As per expectations in our December fixed income report dubbed, "Curtains fall on 2022 with KES.40Bn cash call," the issue was undersubscribed (Figure.1).
- We attribute this the unattractive tenors of the bonds especially in an environment of rising interest rates.
- We note that market bids were relatively high especially on **FXD1/2022/25** as the CBK gave into investor demands of a greater premium on yields for a long term debt issue.

Figure.1: Primary Bond auction performance



Source: Central Bank of Kenya

Weighted Average Rates

- The CBK's Weighted Average Rate (WAR) of accepted bids for both bonds was 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)
FXD1/2008/20	13.70 - 13.85	13.830	+5.5
FXD1/2022/25	14.35 - 14.50	14.439	+1.4

Source: Central Bank of Kenya

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** – The weighted average rates of accepted bids signalled a further upward shift in the yield curve as they fell above the bonds' coupon rates as well as the implied yields on similar tenured bonds.

   This has been the trend since the second quarter of 2021 and we expect a further increase for the following reasons:

   1) The Central Bank Rate (CBR) has been revised three times between May and November 2022 - 7% to 8.75% on account of inflationary pressure and currency depreciation thus signaling a general upward trend in interest rates.

   2) Bond investors bidding aggressively in domestic debt auctions to maintain positive real return following a spike in inflation.

      November inflation at 9.5% (October 2022 - 9.6%) 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 benchmark rates, the KES will continue to depreciate against these currencies.

   3) Government is lagging behind its receipts targets (includes tax collection, domestic and external funding) and will need to increase borrowing to bridge the funding gap.

      A) **Market Liquidity** - There has been no change in repo, reverse repo and inter-bank rates - 7.1%, 9.6% and 5.1% since our last fixed income results update on the switch bond and as of 7th December 2022.

As was highlighted in the note, the 91-day T-bill received bids worth KES.13.2Bn (330% performance rate) as at the latest auction dated 5th December 2022 an indication that available liquidity was channeled towards the short-term debt security and the recent IFB issue, **IFB1/2022/14**.

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

- Invest in T-Bills and short-term debt to avoid locking capital for longer periods in a rising interest environment as well as the higher yielding new Infrastructure Bonds (IFB).
- Look out for bonds matching your maturity profile trading at huge discounts in the secondary market.
- Avoid revaluation losses (selling bonds at lower prices than their purchase prices) by holding on to your existing bond investment portfolio.
- 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.

C) **Secondary market trading** - We do not expect high secondary trading activity on the two debt issues given their relatively long tenured nature.

Investors are increasingly allocating their capital on short-tenured paper such as the 91-day T-bill to hedge against duration risks in the current rising interest rate environment and this will likely continue in the short-run.

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