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Fixed Income

Primary Auction Update

FXD1/2020/5 and FXD1/2022/15

January 2023

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January 2023 Treasury Bond primary auction results update

- The Central Bank of Kenya (CBK) re-opened two bonds in January 2023, FXD1/2008/20 and FXD1/2022/25 seeking to raise KES.50Bn for budgetary support;

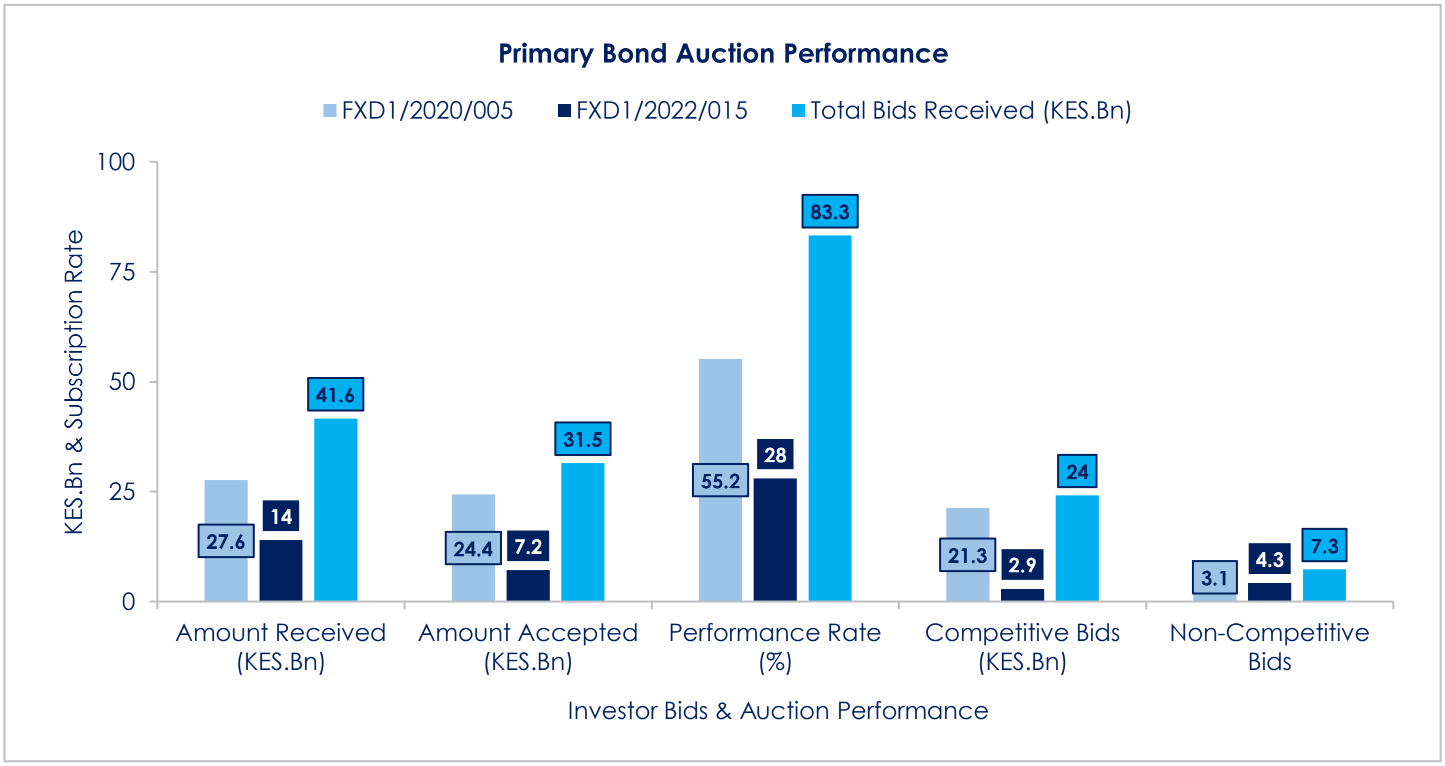
  FXD1/2020/005 (2.4*),
  FXD1/2022/015 (14.3*).
  ***Years to maturity**

- The bonds had a period of sale between 14th December 2022 and 10th January 2023.

Subscription Rates

- As per expectations highlighted in our January 2023 fixed income report - New year, more financing, the issues were undersubscribed. (Figure.1).
- Undersubscription is attributable to
  1) Liquidity largely being allocated toward 91-day T-bills given the rising interest rate environment which dissuades investors for locking up their capital for long periods of time
  2) The bonds already having significant amounts outstanding (KES.65.7Bn for FXD1/2020/005 and KES.43.6Bn for FXD1/2022/015).
  3) The bonds being issued during the festive season when market demand is historically low.

Figure.1: Primary Bond Auction subscription



Source: Central Bank of Kenya

Weighted Average Rates

- An analysis of our predicted Weighted Average Rates (WAR) ranges as indicated in our January 2023 Fixed Income report compared to accepted WARs by the CBK are shown below. (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)
FXD1/2020/005	12.60 - 12.70	12.879	+22.9
FXD1/2022/015	14.20 - 14.30	14.186	-6.4

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) was revised three times between May and November 2022 - 7% to 8.75% on account of inflationary pressure and currency depreciation.

      We expect further upward revisions in subsequent meetings this year in a bid to tame inflation.

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

      December inflation at 9.1%, which while lower than November's rate of 9.5%, it's still way above the CBK's upper band target of 7.5% and contributes significantly to real return erosion.

      This means that investors to will demand higher rates to compensate them for the trend above.

   3) The Government is lagging behind its receipts targets needs to increase borrowing to bridge the funding gap.

      A) **Market Liquidity** - There has been minimal change in repo, reverse repo and inter-bank rates – 7.1%, 9.9% and 5.3% from 7.1%, 9.6% and 5.1% respectively in December.

         We also note that large swaths of liquidity continue to be allocated to the 91-day T-bill received bids worth KES.19.3Bn (482.9% performance rate) as at the latest auction dated 9th January 2023.

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 large outstanding amounts.

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

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