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Fixed Income Note

April 2023

"National Treasury cuts domestic debt target in Supplementary Budget"

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Executive Summary

- Our April 2023 fixed income report is titled **"National Treasury cuts domestic debt target in Supplementary Budget"** in reference to the Central Bank of Kenya's (CBK) re-opening of **FXD2/2018/10, FXD1/2022/03** and **FXD1/2019/15.**
- **FXD2/2018/10** has a funding target of KES.20Bn while **FXD1/2022/03** and **FXD1/2019/15** have a funding target of KES.30Bn.
- We see a high likelihood of an undersubscription with interested investors expected to bid aggressively due to rising interest rates, inflationary pressure and knowledge of the fiscal budget financing challenges.
- Liquidity is likely to be concentrated on **FXD1/2022/03** whose short remaining tenure of 2 years is more attractive to investors given the current rising interest rate environment which dissuades investors from locking up their capital over an extended period.
- Our weighted average bid predictions are as follows:

  FXD2/2018/10: 13.95 - 14.05
  FXD1/2022/03: 12.89 - 12.99
  FXD1/2019/15: 14.39 - 14.49

- The report covers primary auction outcomes, secondary market trading trends, short-term domestic debt interest rates and market liquidity.
- Domestic maturities have a huge impact on CBK's borrowing strategy and this debt service is analyzed in the report.
- Also covered in the report is the country's current fiscal position including Government revenue, expenditure and fiscal deficit as well as its borrowing needs.
- We also include an analysis of the yield curve over selected periods showing trends in yields of different tenors.
- Our report concludes with our inflation expectations as well as analysis of the Monetary Policy Committee's (MPC) decision in its Wednesday 29th March 2023 meeting.

CBK seeks to raise KES.50Bn in April 2023 in three re-opened debt issues

- The Central Bank of Kenya (CBK) invites bids to raise KES.50Bn through three re-opened debt issues; **FXD2/2018/10**, **FXD1/2022/03** and **FXD1/2019/15** (Table.1).
- We notice a slight change in its budget funding strategy with a mix of short and medium-term bonds in contrast to issuing longer-dated bonds to lengthen the average yield to maturity.
- This we believe is intentional to appeal to investors who have shied away from longer dated debt securities in an environment of rising interest rates.
- There is a high likelihood of an overall undersubscription with interested investors expected to bid aggressively due to rising interest rates, inflationary pressure and knowledge of the fiscal budget financing challenges.

Table.1: Primary Bond issues' summary

Issue Number	**FXD2/2018/10**	**FXD1/2022/03**	**FXD1/2019/15**
Total Amount Offered	KES.20Bn	KES.30Bn	
Tenor	5.8 Years	2.1 Years	10.9 Years
Coupon Rate (%)	12.502	11.766	12.857
Price Quote	Discounted/Premium/Par		
Period of Sale	**16/03/2023 to 04/04/2023**	**16/03/2023 to 18/04/2023**	
Auction Date	05/04/2023	19/04/2023	
Value Date	10/04/2023	24/04/2023	
Yield Curve (%) (Weighted average tenor - 24th Mar 2023)	**13.6809**	**12.5741**	**13.9467**

Source: Central Bank of Kenya & Sterling Capital Research

Our market weighted average bid predictions

- We used implied yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as of 24th March 2023 as well as discussions with fixed income traders (Table.2) to determine our Market-weighted average bid predictions.

Table.2: Auction bid predictions

Rate	**FXD2/2018/10**	**FXD1/2022/03**	**FXD1/2019/15**
Weighted Average bid predictions (%)	13.95 - 14.05	12.89 - 12.99	14.39 - 14.49

Source: Sterling Capital Research

Our predicted rates are guided by historical debt issues

- We used implied yields of bonds of similar tenors to maturity on the NSE as of 24th March 2023 as a guide for possible investor auction bid levels (Table.3).

Table.3: Benchmark issues to guide investor bids

Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity (Days)	Implied Yield to maturity (%)	Yield Curve at time of issue
FXD2/2018/10	17th Dec, 2018	12.502	4th Dec, 2028	2,082	13.6809	12.5000
FXD1/2022/3	11th Apr, 2022	11.766	7th Apr, 2025	745	12.5741	11.3193
FXD1/2019/15	28th Jan, 2019	12.857	9th Jan 2034	3,944	13.9467	12.6145

Source: Central Bank of Kenya

- Recent auctions of the 10 and 15-year debt issues illustrate low subscription rates with investors discouraged from investing in longer-dated debt issues due to higher duration risk (Table.4).
- We see banks on an asset-liability matching strategy as the biggest buyers of these debt issues with most institutional buyers avoiding mark-to-market losses if they are bought and held for trading or for sale in the current interest rate environment.
- As has been the case over previous months, we expect investors to center their capital on T-Bills as the market waits to see how high interest rates are set to go.

Table.4: Historical primary market auction performance

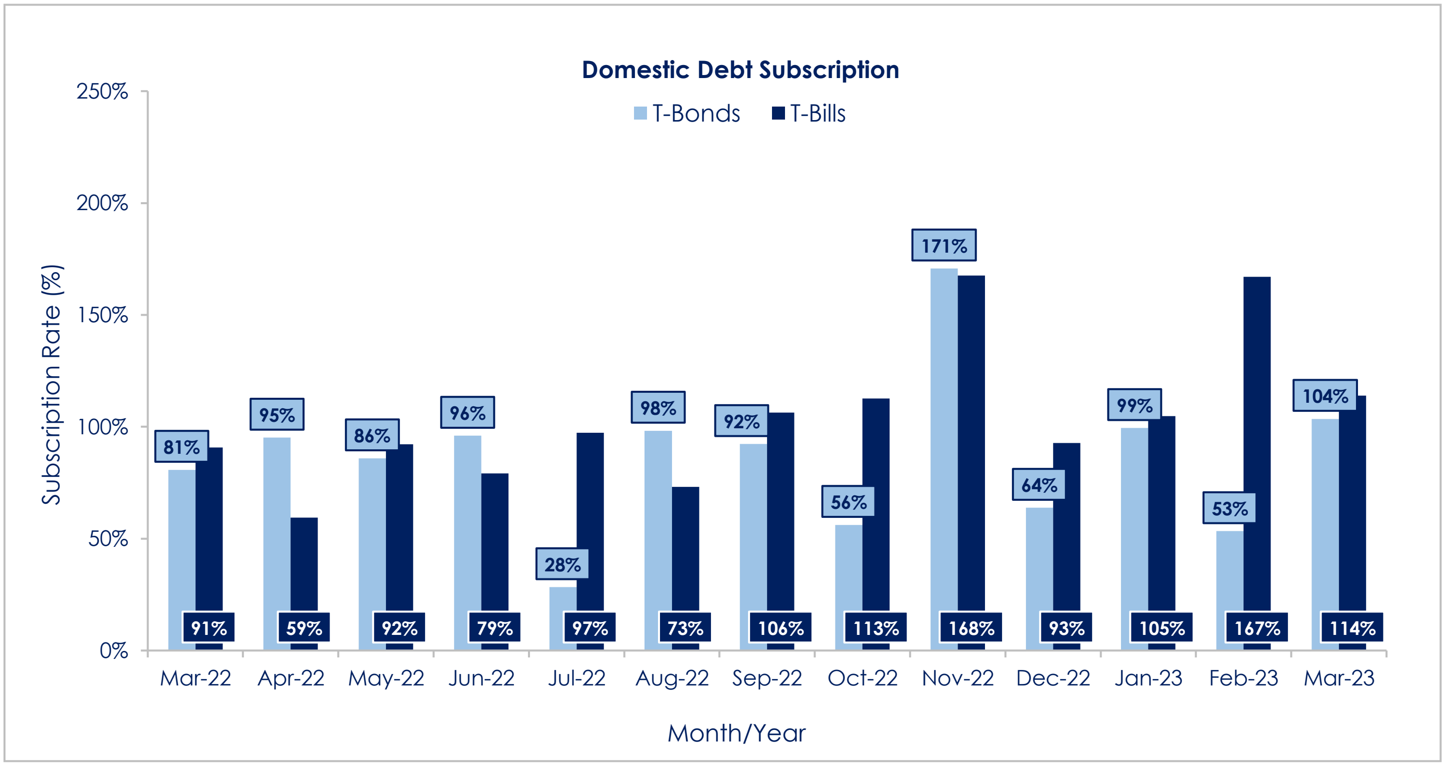
Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
3-Year							
FXD1/2022/03	11th Apr, 2022	40	34	33.1	85.1	11.7660	12.5741
10-Year							
FXD1/2018/10	27th Aug 2018	40	29.8	19.4	74.6	12.686	13.6419
FXD2/2018/10	17th Dec 2018	40	28.8	26.2	72.0	12.502	13.6809
FXD1/2019/10	25th Feb 2019	50	36.3	32.8	72.6	12.438	13.7032
FXD2/2019/10	15th Apr 2019	50	70.9	51.3	141.8	12.300	13.7180
FXD3/2019/10	19th Aug 2019	50	52.8	45.0	105.6	11.517	13.7532
FXD4/2019/10	25th Nov 2019	50	38.4	28.4	76.8	12.280	13.800
FXD1/2022/10	16th May 2022	60	43.2	31.7	72.0	13.490	14.1639
15-Year							
FXD1/2018/15	28th May 2018	40	20.2	12.9	50.5	12.650	13.9153
FXD1/2019/15	28th Jan 2019	40	25.1	14.7	62.7	12.857	13.9467
FXD2/2019/15	13th May 2019	50	21.5	19.3	43.1	12.734	13.9590
FXD1/2020/15	24th Feb 2020	50	18.4	5.2	36.9	12.760	13.9895

Source: Central Bank of Kenya

T-Bond subscriptions in March 2023 second highest over the last one year

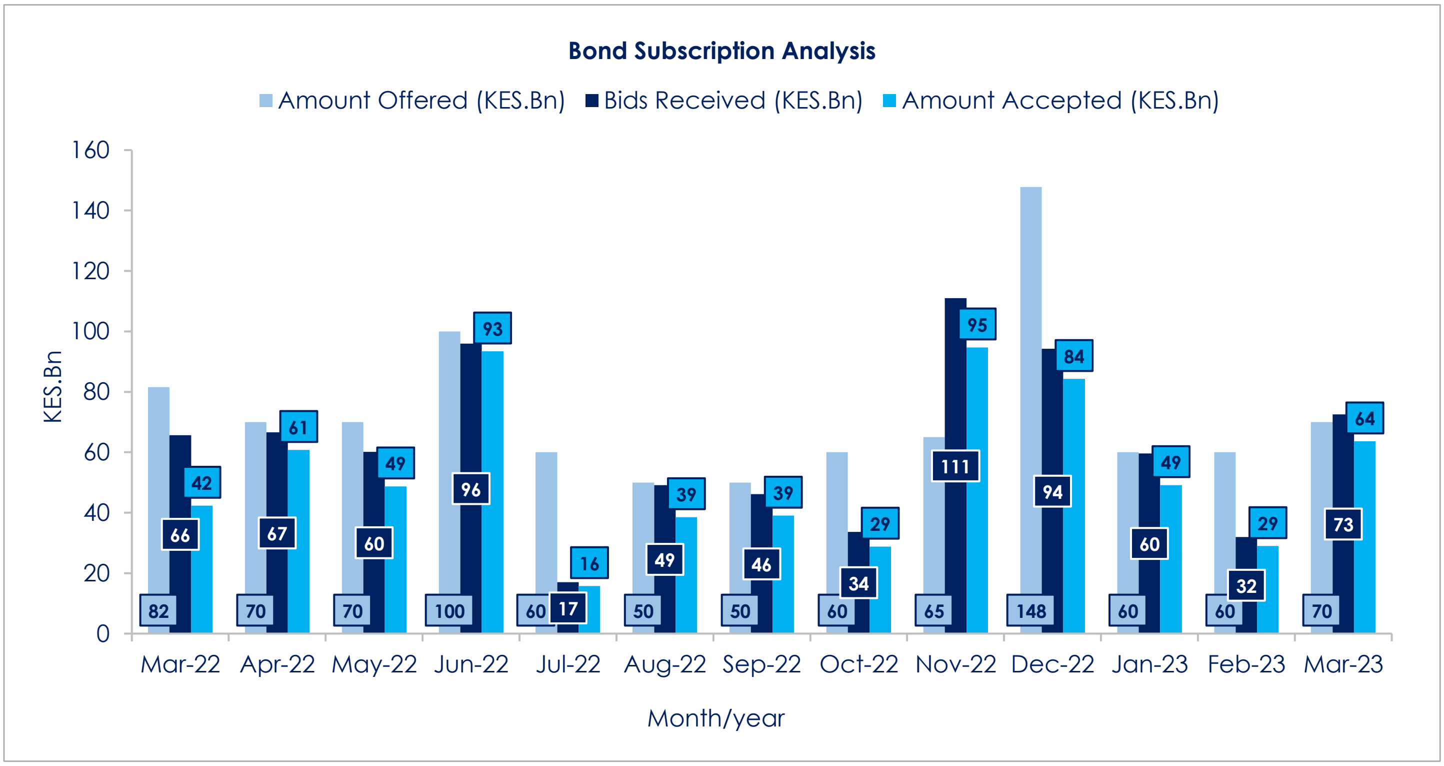
- T-Bill subscription rate declined to 113.9% in March 2023 with KES.109.3Bn bids received against KES.96Bn offered compared to February's 167.1% subscription rate which was also the highest recorded over the last one year (Figure.1).
- The 91, 182 and 364-Day T-Bills recorded subscription rates of 354.6%, 87.7% and 43.7% in March compared to 583.7%, 105.3% and 62.2% respectively in February.
- We attribute the decline in subscription to investors' preference for the **IFB1/2023/17** primary issue and tap sale in March.
- This decline does not negate the high preference for the shortest dated debt security given rising interest rates.
- T-Bond subscription at 103.5% was the second highest over the last one year with the highest (170.7%) recorded in November 2022 due to the issuance of **IFB1/2022/14** and its subsequent tap sale (Figure.2).

Figure.1: T-Bill subscription declined in March 2023 but still relatively high



Source: Central Bank of Kenya

Figure.2: IFB drives up T-Bond subscription in March 2023

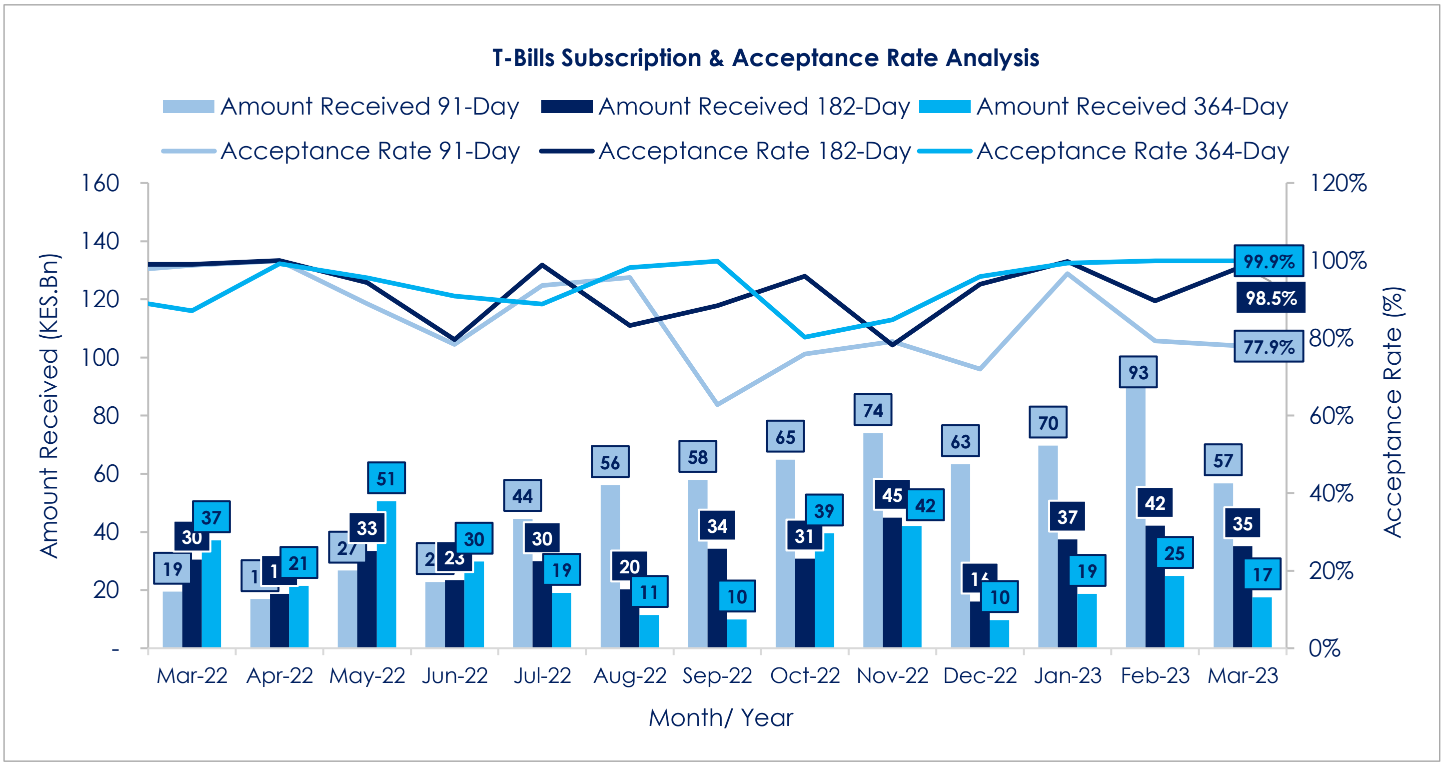


Source: Central Bank of Kenya

CBK's acceptance rate rises in March amid low subscription and high debt service

- There was a general rise in the CBK's acceptance rate for T-Bills in March (88.1%) compared to February (85.2%) due to the relatively lower subscription rates and the high debt service of KES.198.6Bn for the month (Figure.3).
- Acceptance rates for the 91-Day, 182-Day and 364-Day T-Bills stood at 77.9%, 98.5% and 99.9% in March 2023 compared to 79.3%, 89.6% and 99.9% in February.
- The challenge for the National treasury is to find a balance between financing the Government's fiscal deficit whilst managing the Average Term to maturity and cost of public debt.
- The higher acceptance rate for the 182 and 364-Day T-Bills is evidence of the CBK's attempts to reduce liquidity pressure largely experienced from accepting very short duration paper such as the 91-Day T-Bill.

Figure.3: Further decline in 91 Day T-Bill acceptance rate in March 2023 due to aggressive bidding

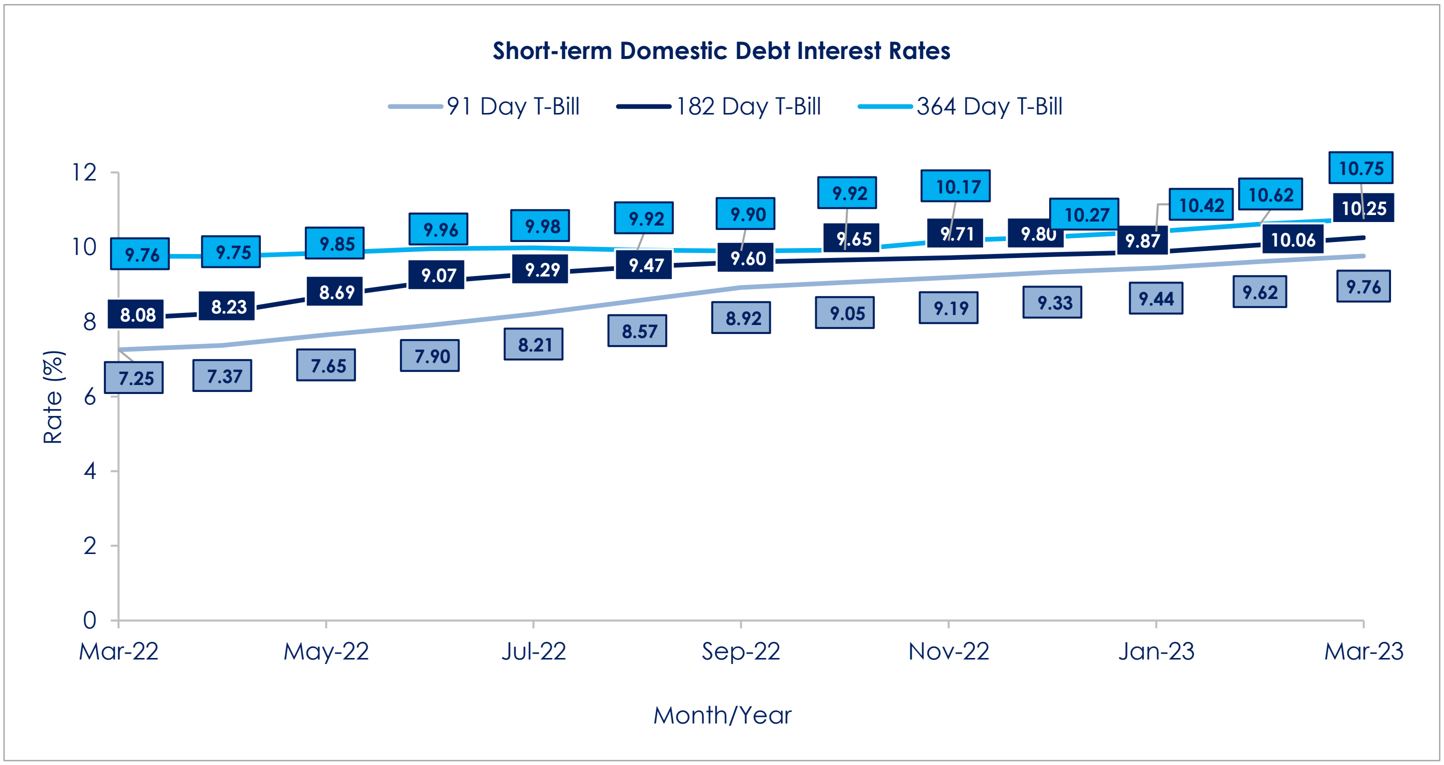


Source: Central Bank of Kenya

91 Day T-Bill inches closer and closer towards 10%

- Average T-Bill rates continued on an upward trajectory with the 91 Day T-Bill rates noticeably approaching 10% (Figure.4).
- The 91, 182 and 364 day average rates increased to 9.8%, 10.3% and 10.8% from 9.6%, 10.1% and 10.6% in February respectively.
- Over the last one year, average 91, 182- and 364-Day T-Bill rates have increased 251.1, 217.2 and 98.8Bps respectively showing the lasting impact of CBR revisions, high inflation and increased fiscal deficit financing.
- Given the CBK's recent 75bps rate hike in March which brought the CBR to 9.5%, we expect the 91-day T-bill to surpass 10% in the coming weeks.
- In addition to the factors mentioned above, we feel that the continued approval and implementation of risk-based credit pricing models by banks will exert further pressure on both short and long tenor domestic debt rates as banks look at private sector lending as an attractive option to investing in Government debt.

Figure.4: T-Bill rates continue upward trajectory in March 2023

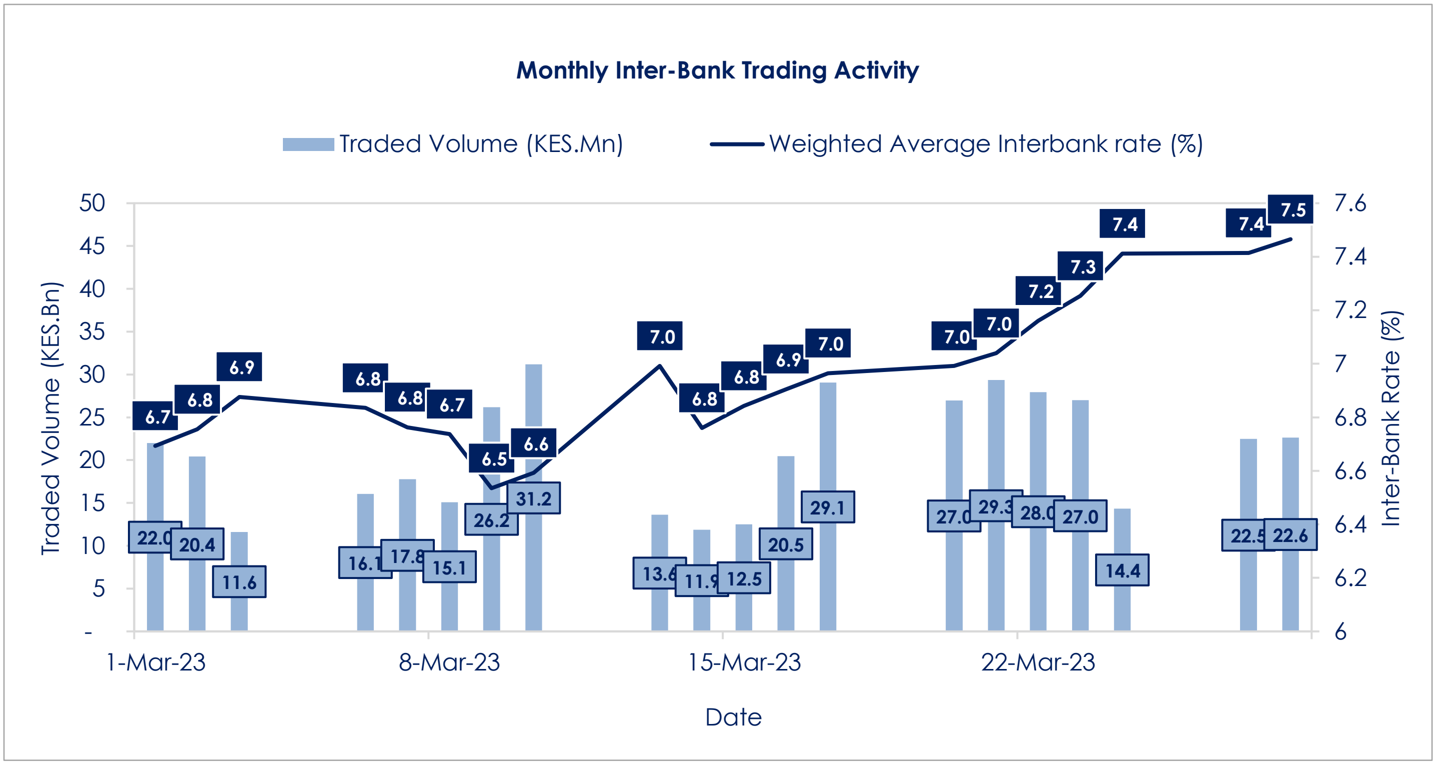


Source: Central Bank of Kenya

Average inter-bank rates tick up in March 2023

- Average inter-bank rate increased while trading volumes declined in March 2023 compared to the previous month (Figure.5).
- The average inter-bank rate increased to 6.9% from 6.4% pointing to relatively low market liquidity.
- Trading volumes declined to KES.418.5Bn (as at 28th March 2023) from KES.491.6Bn over the period in focus.
- We expect this month on month decline to persist given the increasingly tight liquidity environment.
- Over the same period, excess reserves (the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) declined 15.8% from KES.55.7Bn in February 2023 to KES.46.9Bn in March 2023 (Figure.6).

Figure.5: Uptick in average inter-bank lending rates in March due to tightening market liquidity



Source: Central Bank of Kenya

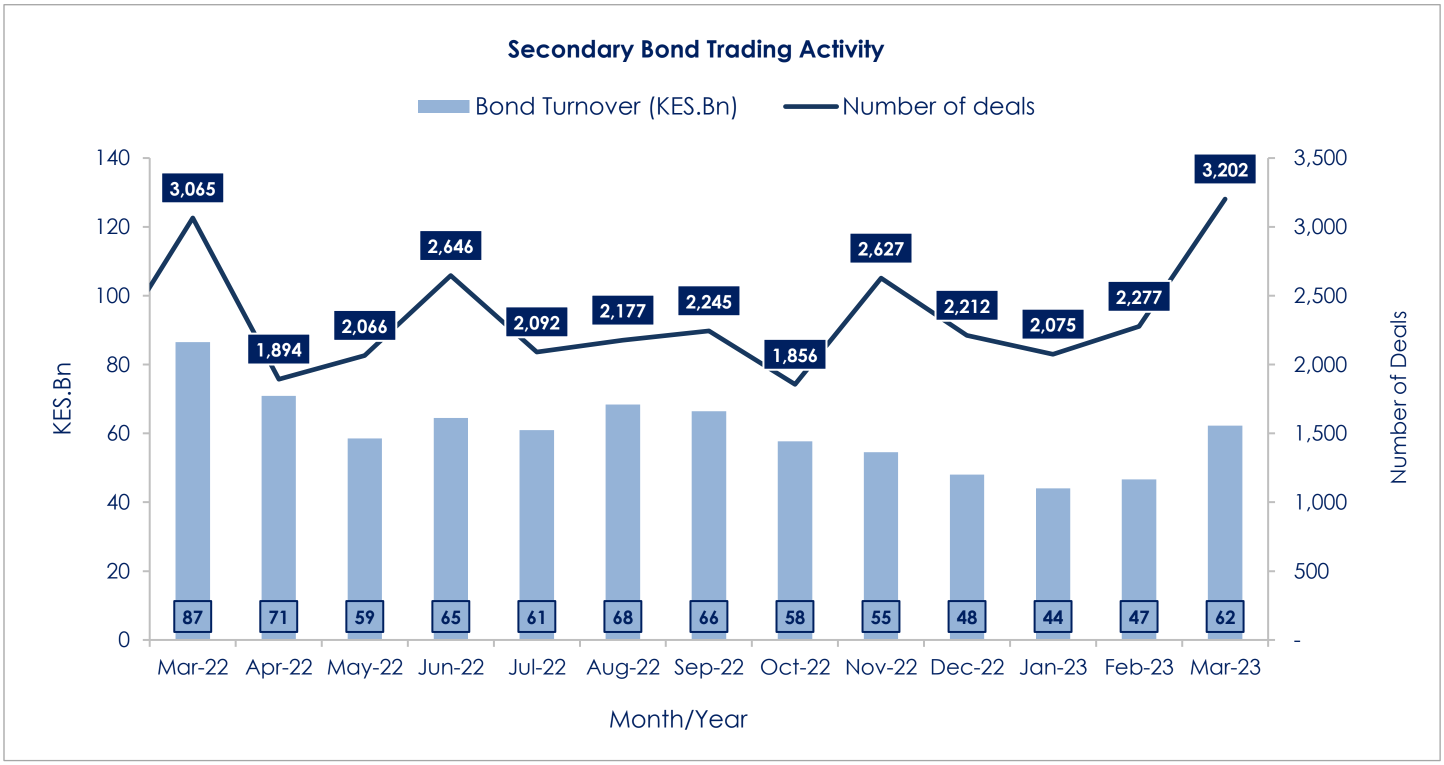
Figure.6: Excess commercial bank reserves decline in March 2023

Source: Central Bank of Kenya

Secondary market trading up 33.5% in March 2023 on IFB issue

- Secondary bond market trading increased 33.5% to KES.62.2Bn as at 29th March 2023 from KES.46.6Bn in February while the number of deals increased 40.6% to 3,202 from 2,277 (Figure. 7).
- **IFB1/2023/17** issue and tap sale contributed to the increase in trading given its tax free status and capital appreciation potential.

Figure.7: Secondary trading activity rises in March 2023

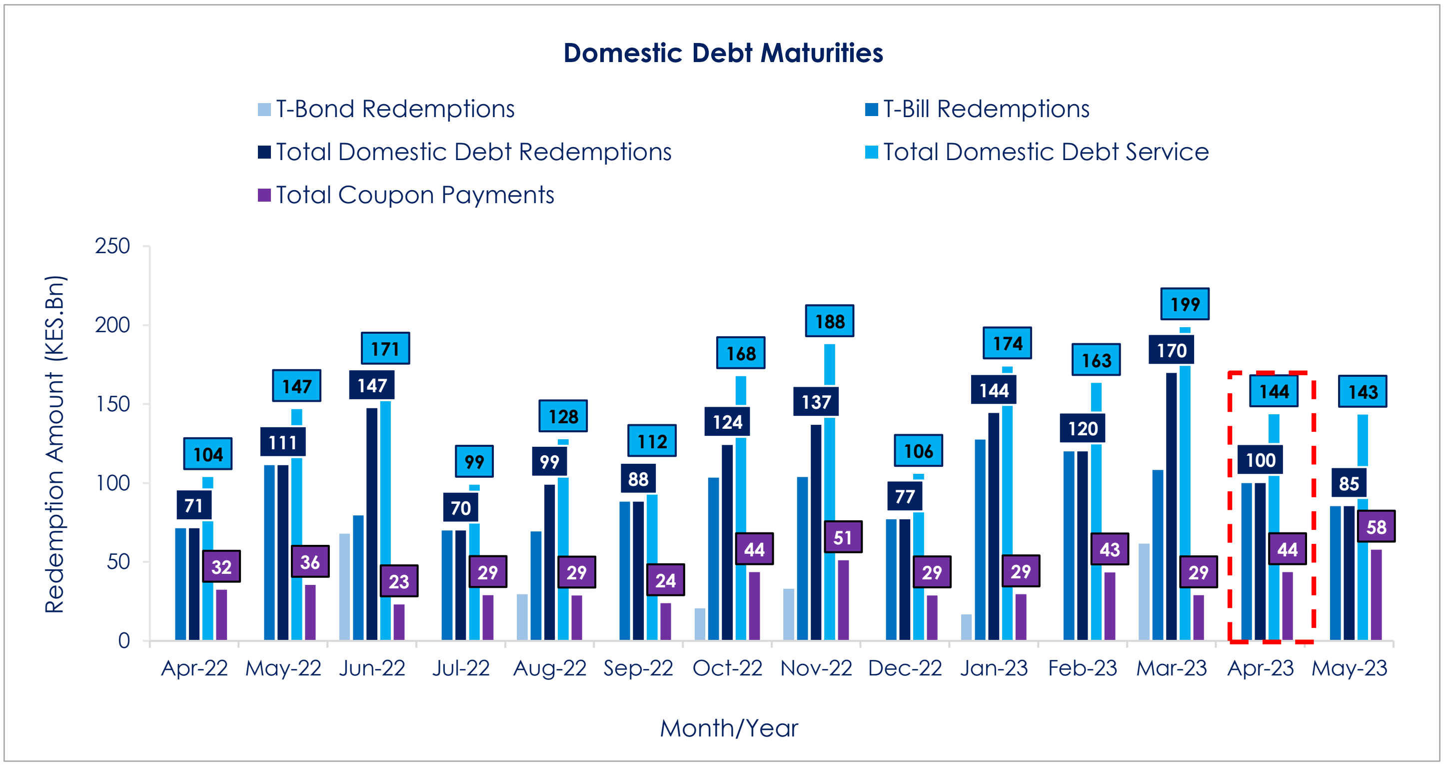


Source: Central Bank of Kenya

Domestic debt service in April 2023 at KES.143.6Bn

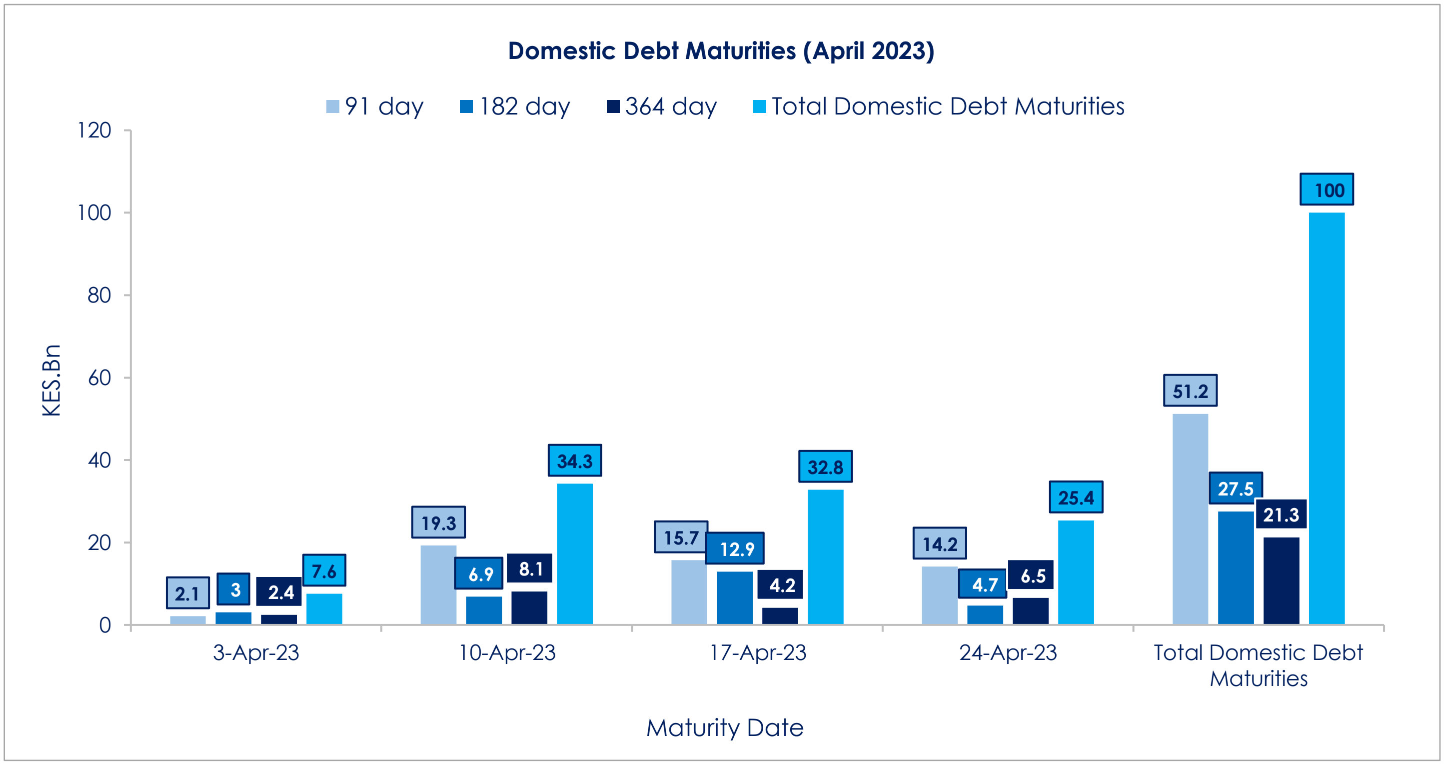
- Total domestic debt service declines 27.7% in April 2023 to KES.143.6Bn from KES.198.6Bn in March 2023 (Figure.8).
- This comprises of KES.100Bn in T-Bill redemptions and KES.43.5Bn in coupon payments.
- There will be no T-Bond redemptions both in April and May 2023.
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.51.2Bn, KES.27.5Bn and KES.21.3Bn respectively with the second week of the month having the highest redemptions at KES.34.3Bn (Figure.9).

Figure.8: April debt service declines to KES.143.6Bn



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities April 2023

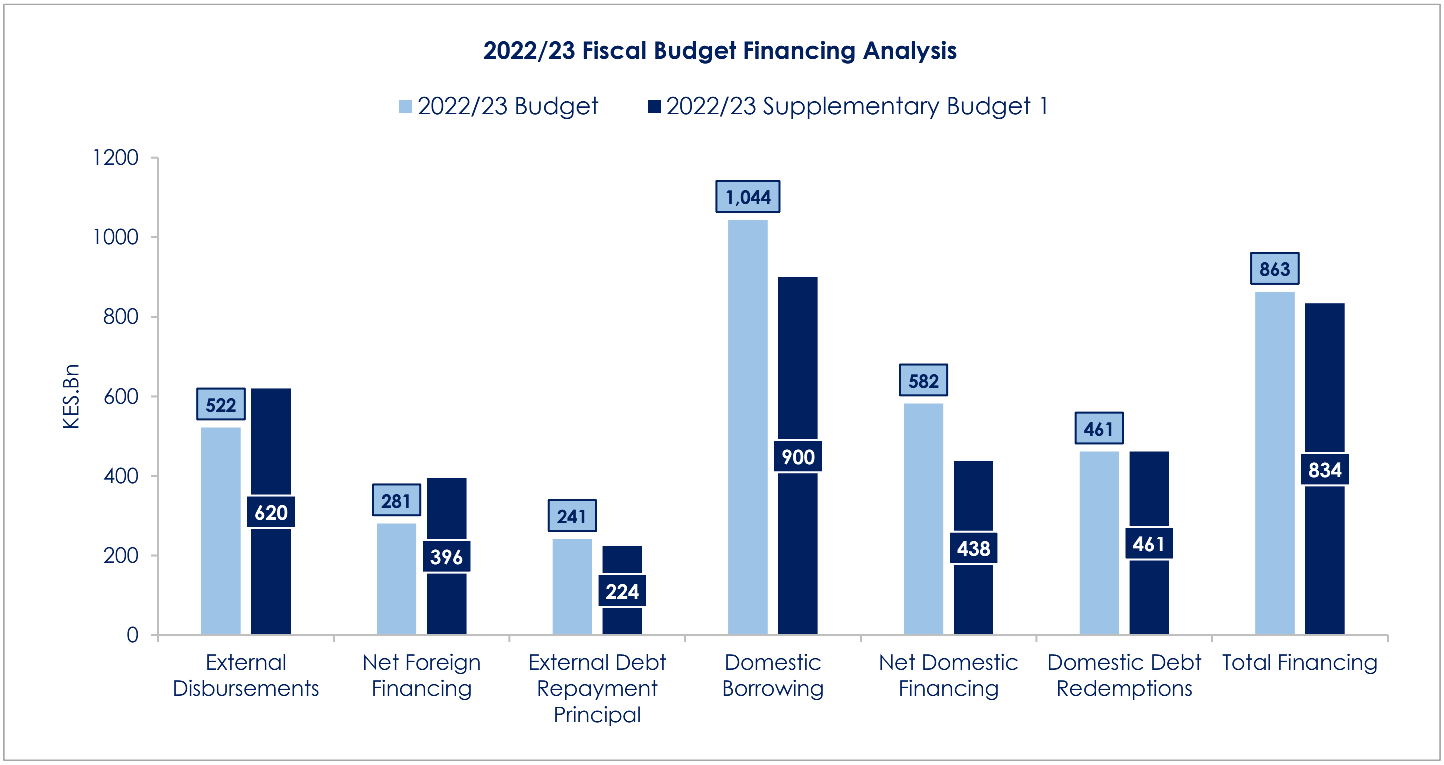


Source: Central Bank of Kenya

2022/23 supplementary budget shows spike in external debt financing

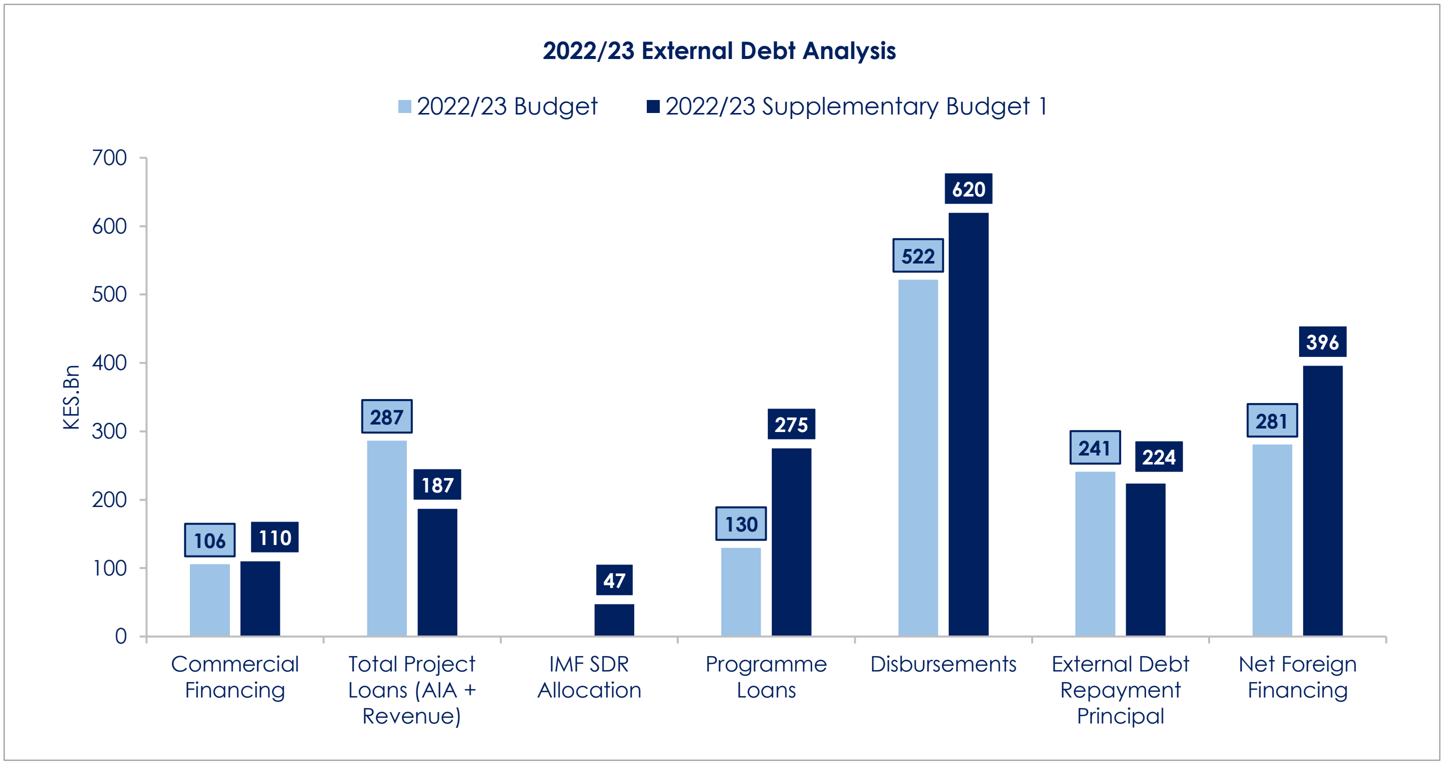
- The 2022/23 supplementary budget 1 shows a 41% increase in external financing to KES.395.7Bn compared with a 24.8% decline in net domestic financing to KES.438.1Bn (Figure.10).
- We delved deeper into each external financing item to explain the reason for the sharp contrast in the two budgets and gathered interesting insights (Figure.11).
- Most noticeable is the 112.3% increase in Programme Loans which offset the 34.8% decline in Total Project Loans.
- We also note the KES.47.3Bn IMF SDR loan disbursed in December 2022 as budgetary support in the revised budget.
- The significant increase in external debt estimates could also be a result of the recent and expected depreciation of the KES particularly against the US$.
- The overall impact of the increase in external debt is a decline in domestic financing.

Figure.10: Sharp increase in external debt financing in 2022/23 supplementary budget



Source: National Treasury & International Monetary Fund (IMF)

Figure.11: Increase in programme loans and IMF support explains sharp increase in external financing



Source: National Treasury & International Monetary Fund (IMF)

National Treasury revises its 2022/23 fiscal budget estimates

- The National Treasury has revised its 2022/23 fiscal budget estimates through its first supplementary budget.
- Worth pointing out is the 49% increase in its external loans and grants estimate to KES.520.6Bn and the 14.8% reduction in net domestic borrowing to KES.886.5Bn (Table.5 and Figure.12).
- Net domestic borrowing has declined 26.6% to KES.425.1Bn from KES.579.1Bn with roll overs (redemptions) remaining unchanged at KES.461.4Bn.
- Government currently is well below our receipts linear target run rates but assuming that it is able to achieve them, we would expect a decline in domestic financing.
- This could also be a strategy employed by the Government to reduce the pressure on domestic interest rates and lower the overall cost of new domestic debt contracted.

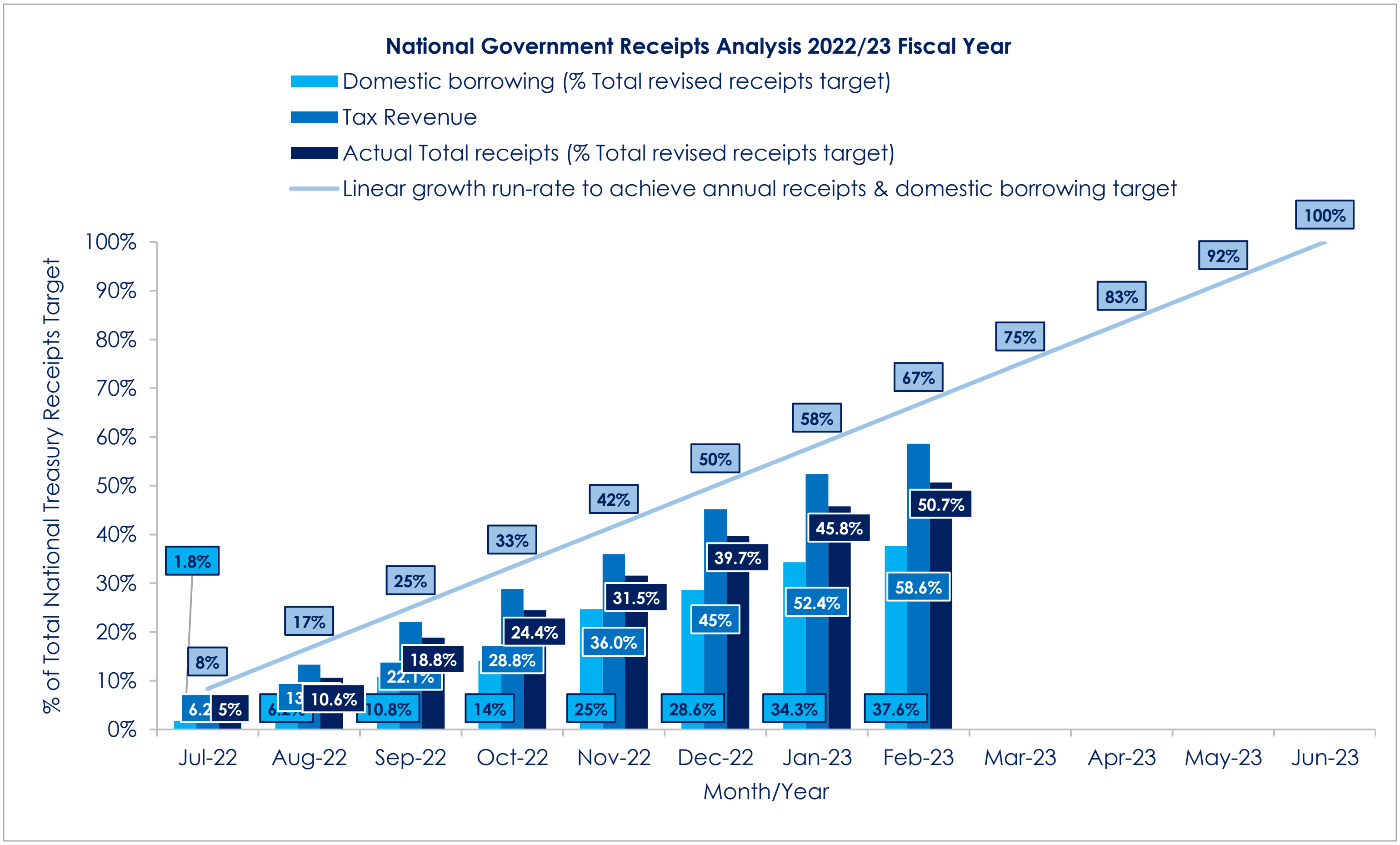
Table.5: Total Government receipts underperforming after H1 2022/23

Receipts	Original Estimates 2022/23 (KES.Mn)	Original Estimates 2022/23 (KES.Mn)	Variation Original vs Revised 2022/23 Estimates	Actual Receipts (KES.Mn) 28th February 2023	Proportion of Total Receipts 28th February 2023
Opening Balance (1st July)				616.5	
Tax Revenue	**2,071.9**	**2,108,3**	**1.8%**	**1,236.1**	**58.6%**
Non-Tax Income	69.7	83.7	20.1%	44.5	53.2%
Domestic Borrowing*	**1,040.5**	**886.5**	**-14.8%**	**333.3**	**37.6%**
External Loans & Grants	349.3	520.6	49%	201	38.6%
Other Domestic Financing	13.2	13.2	0	15.5	117.4%
Total Revenue	**3,544.6**	**3,612.3**	**1.9%**	**1,830.5**	**50.7%**
Linear Run Rate target (8 months of fiscal year 2022/23)					**66.7%**

* Note 1: Domestic Borrowing of KES.886.5Bn = Net Domestic borrowing KES.425.1Bn & Internal Debt Redemptions (Roll-overs) KES.461.4

Source: The Kenya Gazette Vol. CXXV - No.65 17th March 2023

Figure.12: Actual receipts remain well below our linear target run-rate

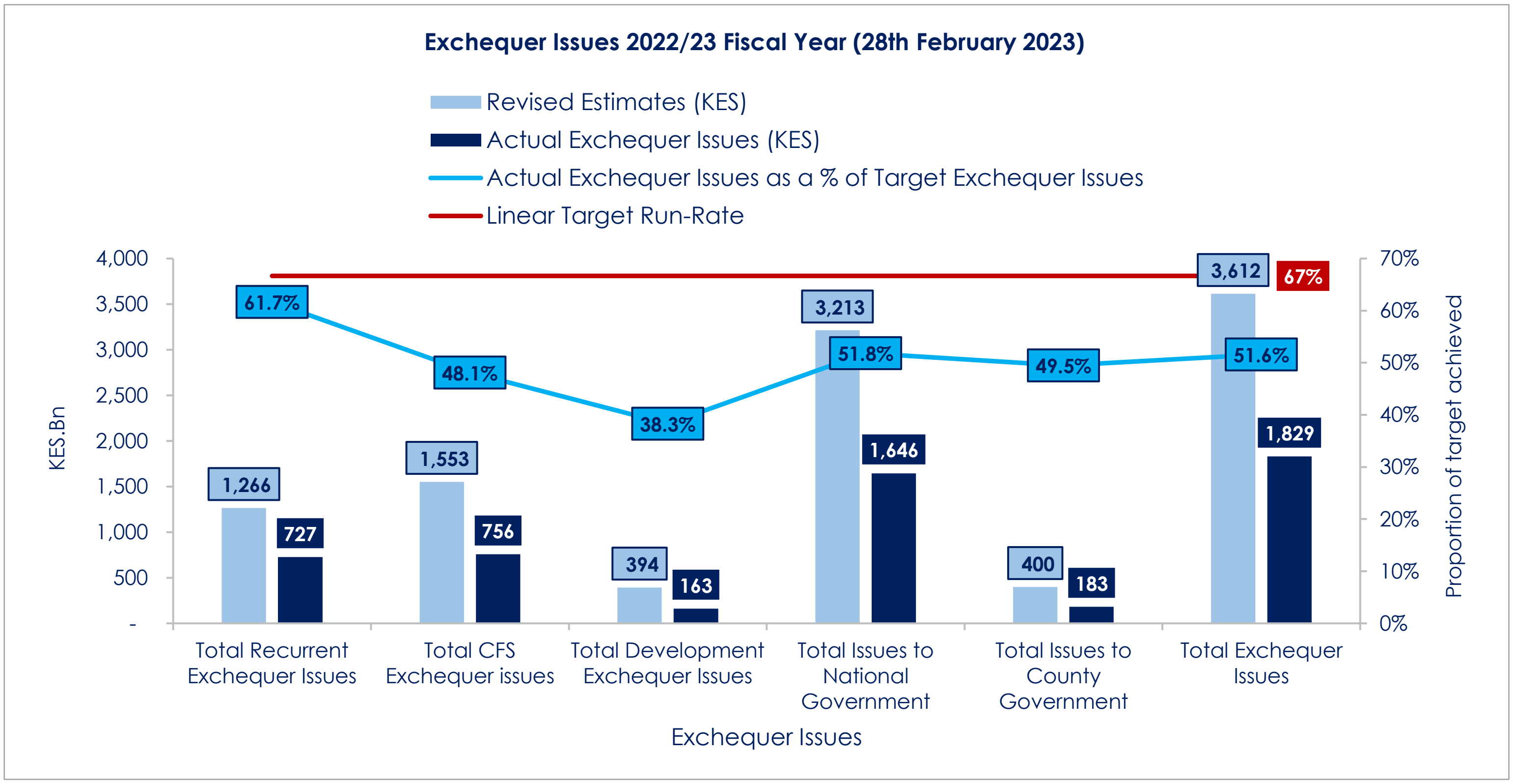


Source: The Kenya Gazette Vol. CXXV - No.65 17th March 2023

Government expenditure below our 2022/23 fiscal year linear run-rate

- Government remains below our linear target run rate of 67% on all its exchequer items after eight months of the fiscal year (Figure.13).

Figure.13: Recurrent expenditure at 47% of total budget in H1 2022/23

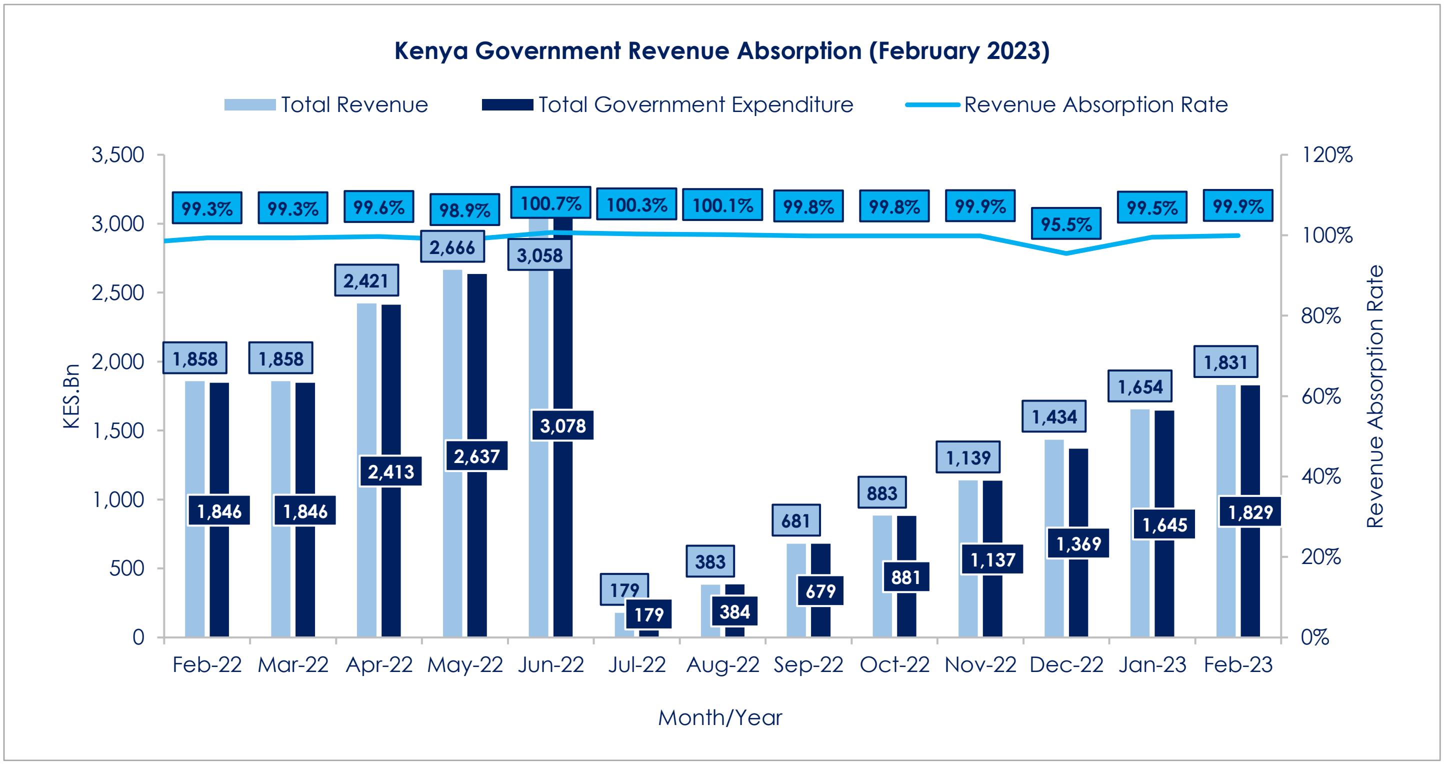


Source: The Kenya Gazette Vol. CXXV - No.65 17th March 2023

Government Revenue Absorption almost 100% in February 2023

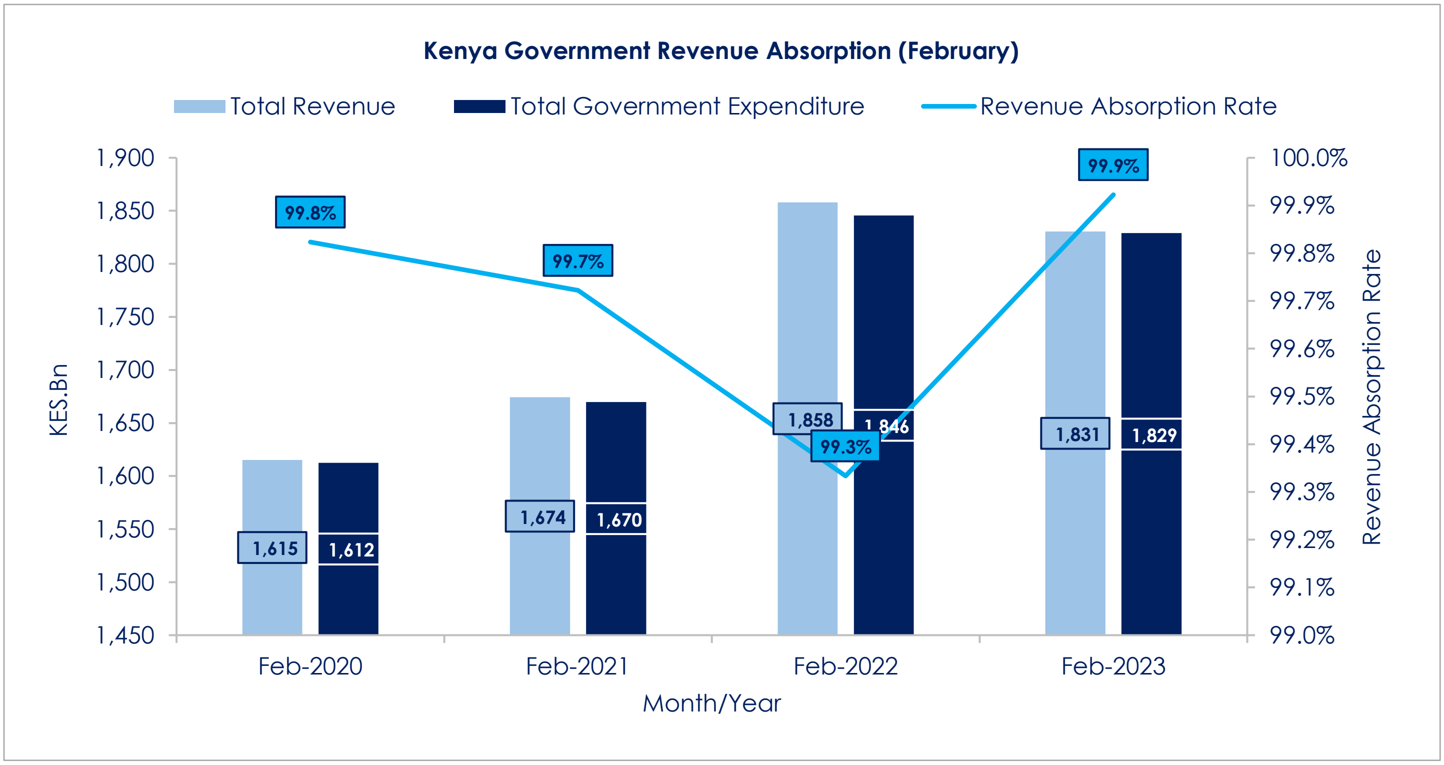
- Government Revenue Absorption Rate (RAR) which is the proportion of Government receipts used to finance expenditure rose to close to full subscription in February 2023. This was also slightly above the same period in 2022 (Figure.14).
- With regards to year on year comparison, we see a decline in both total revenue (-1.5%) and total expenditure (-0.9%) in 2022 compared to 2021 (Figure.15).
- This illustrates the challenge faced by Government in its bid to increase its revenues.

Figure.14: Government revenue utilization almost 100% in February 2023



Source: The Kenya Gazette Vol. CXXV - No.65 17th March 2023

Figure.15: Revenue absorption improves in February 2023

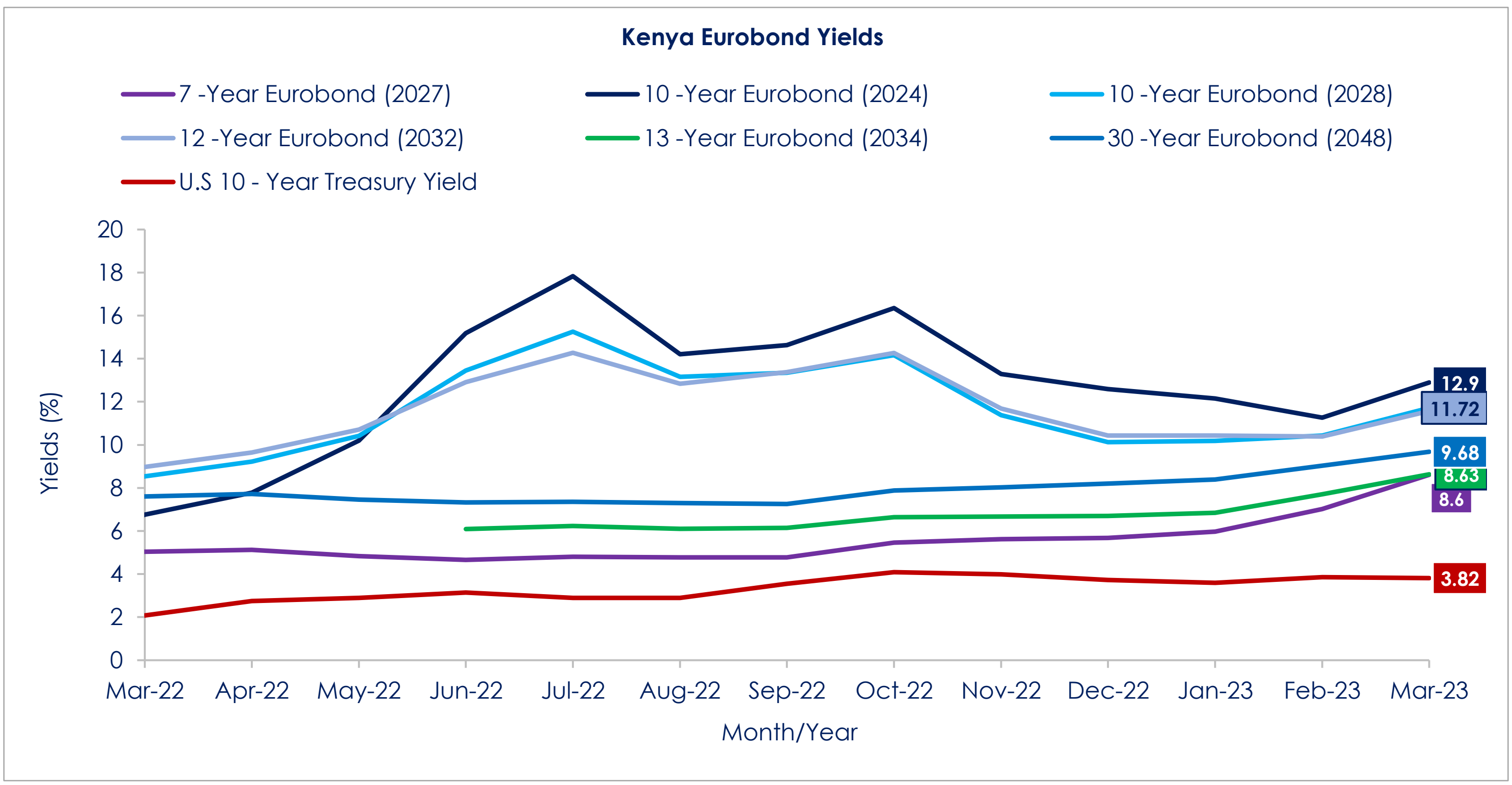


Source: The Kenya Gazette Vol. CXXV - No.65 17th March 2023

Kenya Eurobond yields trend upwards in March 2023

- Kenya Eurobond yields rose 125 bps on average in March compared to the previous month while the US 10 year treasury yield remained relatively flat (Figure.16).
- The average yield on the 10-Year Eurobond maturing 2024 exhibited the biggest increase (164Bps) during the time under consideration.
- The increase in yields could be explained by investor uncertainty over the country's fiscal position ahead of the maturity of the bond as well as the impact of the December 2022 Fitch downgrade.
- With regards to US treasuries, the Federal Reserve (Fed) raised interest rates by 25Bps bringing the benchmark funds rate to 5% from 4.75% the highest since September 2007.
- The Fed is expected to hike the rate to the range of 5% - 5.25% before year end thus suggesting that rate hikes are nearing an end.
- In spite of the increase in Eurobond yields, we still feel that the 10-year US$.2Bn Eurobond maturing in June 2024 (**ISIN - XS1028952403)** remains an attractive investment opportunity on the basis of the short term to maturity and expected U.S$ appreciation.

Figure.16: Kenya Eurobond yields rise in March 2023



Source: Central Bank of Kenya

Yield curve continues to shift upwards

- A comparison of latest average yields on the NSE as at 24th March 2023 with average yields on 31st December 2018 (close to issue date of **FXD2/2018/10** on 17th December 2018), 25th January 2019 (close to issue date of **FXD1/2019/15** on 28th January 2019) and 8th April 2022 (close to issue date of **FXD1/2022/3** on 11th April 2022) shows an increase in yields across the curve. (Table.6 and Figure.17).
- The upward shift in the yield curve over the last one year is a direct result of the following:

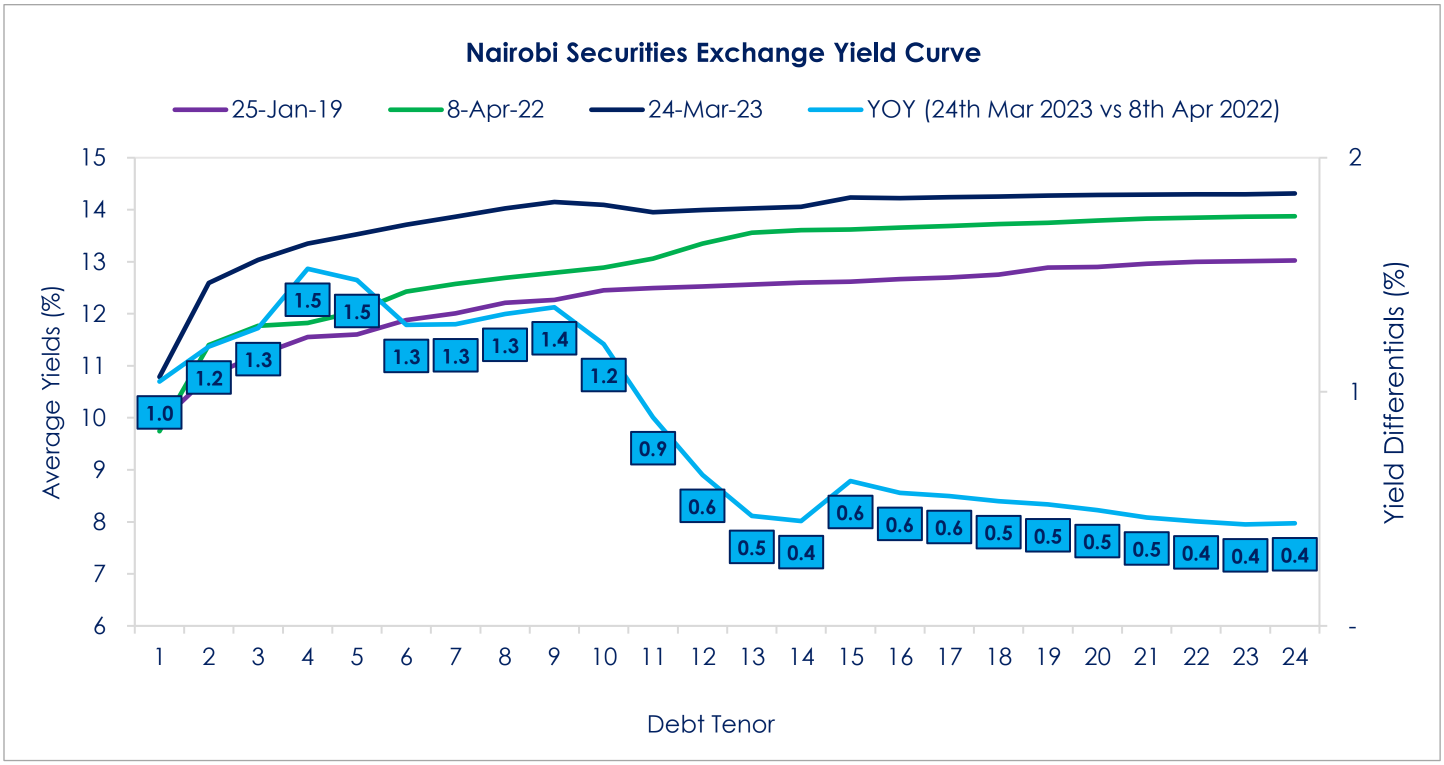
1) Upward adjustments of the CBR, with four revisions between May 2022 and March 2023 - 250Bps to 9.5%.
2) Increased budgetary financing pressure resulting from revenue shortfalls with the CBK borrowing aggressively in the domestic debt market.
3) CBK has accommodated more aggressive investor bids to encourage subscription following a decline in investor demand for short-term debt instruments.
4) Rising inflation with investors bidding higher to maintain positive real return on capital invested.

Table.6: Yield curve has significantly shifted upward across all tenors

Tenor	Yields (31st Dec 2018)	Yields (25th Jan 2019)	Yields (8th Apr 2022)	Yields (24th Mar 2023)	∆ (24th Mar 2023 vs 31st Dec 2018) Bps	∆ (24th Mar 2023 vs 25th Jan 2019) Bps	YOY ∆ (24th Mar 2023 vs 8th Apr 2022) Bps	Sterling Capital Yield Curve (Apr 2023)
1	9.9520	9.9050	9.7430	10.7870	↑ 83.50	↑ 88.20	↑ 104.40	10.95
2	10.5849	10.8000	11.3962	12.5896	↑ 200.47	↑ 178.96	↑ 119.34	12.60
5	11.5500	11.6000	12.0478	13.5252	↑ 197.52	↑ 192.52	↑ 147.74	13.60
10	12.5000	12.4500	12.8875	14.0913	↑ 159.13	↑ 164.13	↑ 120.38	14.10
15	12.6055	12.6145	13.6187	14.2374	↑ 163.19	↑ 162.29	↑ 61.87	14.25
20	12.8000	12.9027	13.7893	14.2837	↑ 148.37	↑ 138.10	↑ 49.44	14.30

Source: Nairobi Securities Exchange & Sterling Capital Research

Figure.17: Higher year on year differentials across short-term and medium-term tenors



Source: Nairobi Securities Exchange

Trading ideas - Invest in Kenya Eurobonds

- Investors with a high-risk tolerance should consider buying the US. $ denominated Kenya Eurobonds to take advantage of current attractive yields with an option of holding till maturity or disposing when trading opportunities arise (Table.7).

Table.7: Trading ideas - Consider Kenya Eurobonds

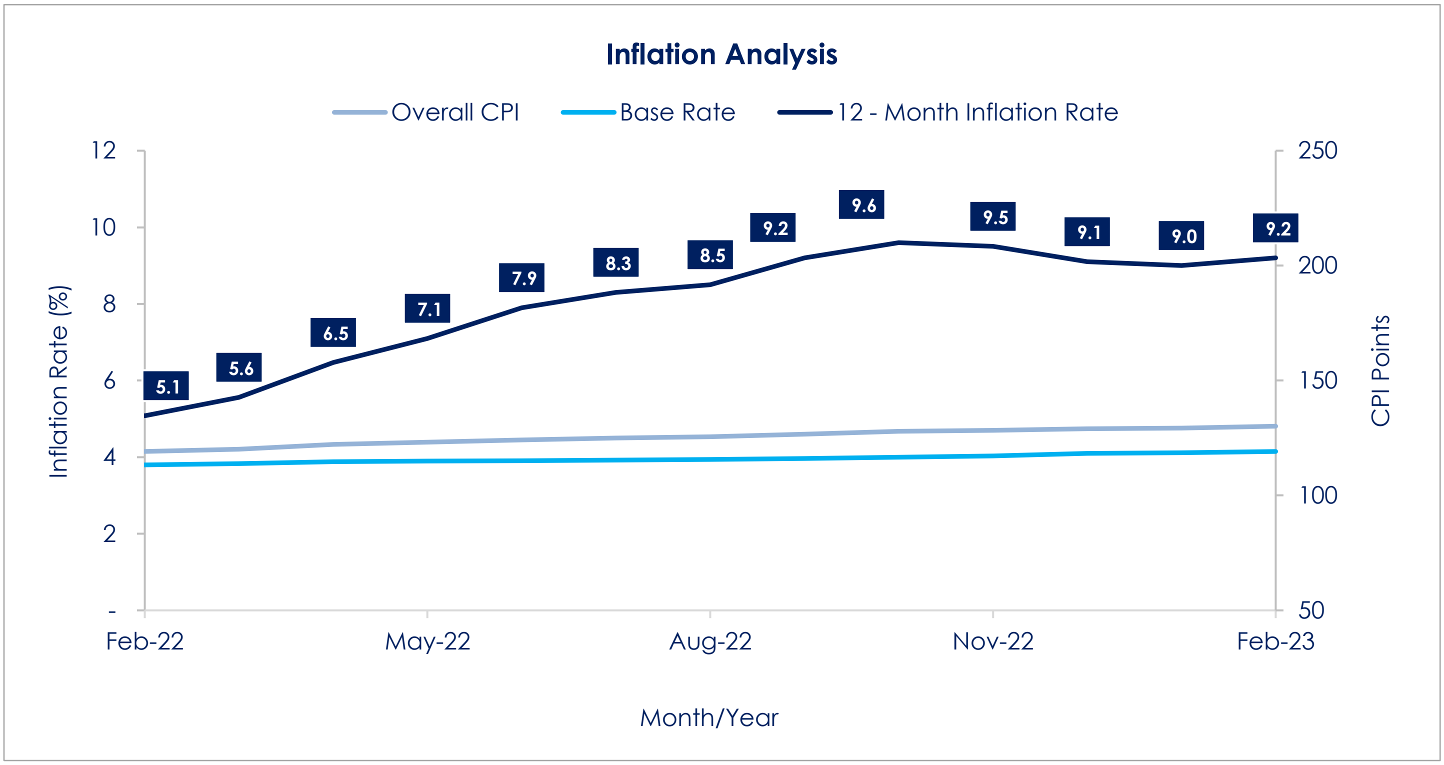
ISIN Code	Issue date	Tenor (Years)	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (23rd March 2023)	Maturity
XS102895240	Jun-14	10	2	6.875%	14.217	Jun-24
XS184343584	May-19	7	0.9	7%	13.74	May-27
XS178171054	Feb-18	10	1	7.25%	12.817	Feb-28

Source: Bloomberg

March 2023 Inflation forecast at 9% - 9.5%

- February 2023 [inflation rose to 9.2%]() from 9% in January, bringing to a halt the decline in inflation since November (Figure.18).
- We expect further hike driven by the currency depreciation and risen food prices with our March 2023 forecast at 9% - 9.5%.
- However, the long rains will work to moderate inflationary pressure in the medium to long term.
- We further note a decline in global fuel prices which will help offset some pressure on the rising bread basket.

Figure.18: March 2023 inflation forecast 9% - 9.5%



Source: Kenya National Bureau of Statistics

MPC raise CBR by 75Bps to 9.5% in March meeting

- The Monetary Policy Committee (MPC) met on 29th March 2023 to review the impact of previous monetary policy measures on the economy.
- In its last meeting on the 30th January 2023, the MPC retained the CBR at 8.75% informed by expectations of a decline in overall inflation and an improved macro-economic outlook.
- The recent inflationary pressures and elevated global risks given their potential impact on our economy are some of the reasons that informed the CBR hike by MPC to 9.5% in March meeting.
- Other points of discussion during the meeting included;

  1) The ongoing geopolitical tensions particularly the war between Ukraine and Russia and the pace of monetary policy tightening in the advanced economies.
  2) Economic performance in 2023 expected to be supported by service sector and anticipated recovery in the agricultural sector.
  3) Gross Non-Performing Loans (NPLs) which rose to 14% in February 2023 from 13.3% in December 2022.

     Increases in NPLs were noted in the trade, personal and household, manufacturing and building and construction sectors.

     Further, Private sector credit growth at 11.7% in February 2023 declining from 12.7% in December 2022.

  4) The adequacy of the CBK's foreign exchange reserves which fell below 4 months of import cover in February 2023.

- We maintain that the upward revision in the CBR will have a minimal impact in managing inflation and currency depreciation, as the current inflationary pressure is a direct effect of supply side and not demand effects that cannot be controlled by a revision of the policy rate.
- Given the difficult macro-economic environment, currency depreciation and further expectations of asset quality deterioration, the current rate hike is likely to constrain private sector credit growth.
- We project a decline in inflation to be driven by a softening of global commodity prices and an improved weather conditions.

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