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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Update II

FXD1/2022/3

April 2023

Analysts:

Renaldo D'Souza
+254 (20) 2222651
Renaldo.DSouza@sterlingib.com

Davis Gathinji
+254 (20) 2222651
Davis.Gathinji@sterlingib.com

Isabel Chakairu
+254 (20) 2222651
Isabel.Chakairu@sterlingib.com

Email: research@sterlingib.com

Bond Dealing: +254 (20) 2213914, 3315414; 2244077
+254 723153219, +254 734219146

Email: invest@sterlingib.com

Website www.sterlingib.com

Bloomberg Code: SCLK <GO>

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April 2023 Treasury Bond Primary Auction Results Update II

- The Central Bank of Kenya (CBK) reopened three Treasury Bond/s (T-Bonds); **FXD1/2022/3, FXD1/2019/15** and **FXD2/2018/10** in April 2023 seeking to raise KES.30Bn and KES.20Bn for budgetary support respectively;

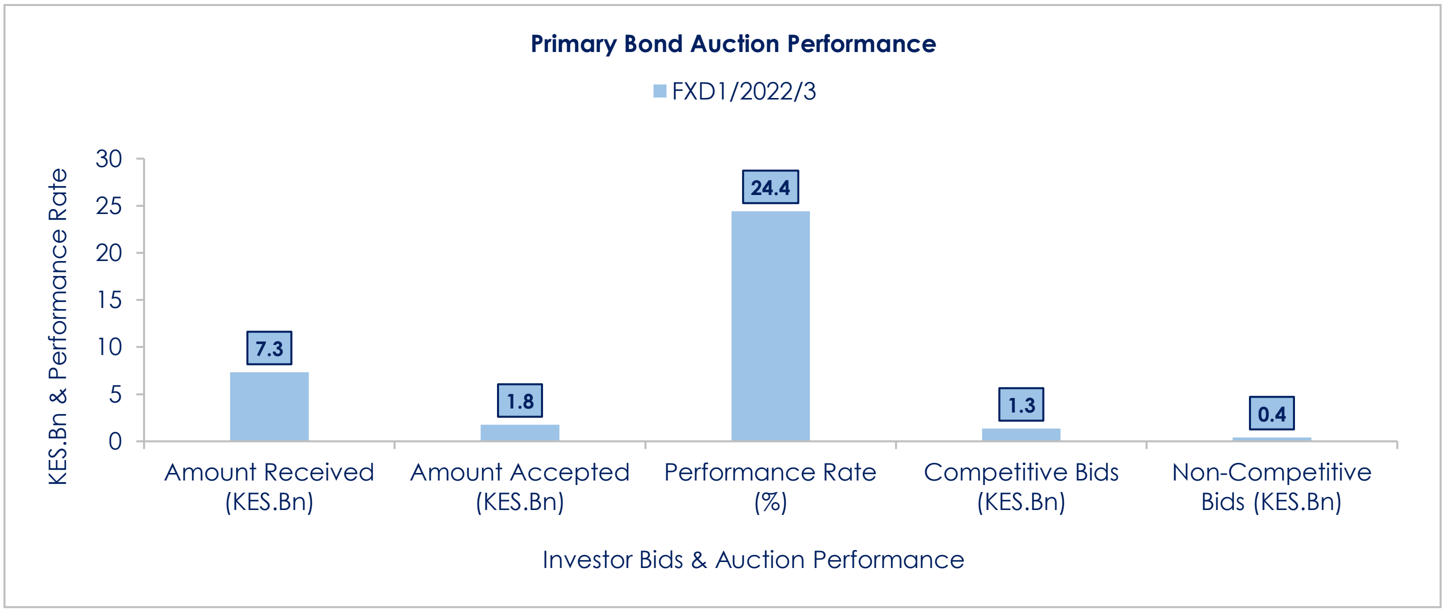
FXD1/2022/03 (2.1*)
FXD1/2019/15 (10.9*)
FXD2/2018/10 (5.8*)

***Years to maturity**

- The bonds had different periods of sale with **FXD1/2022/03** and **FXD1/2019/15** (16th March - 18th April 2023) and **FXD2/2018/10** (16th March - 4th April 2023).
- We issued a results update on **FXD2/2018/10** whose auction was 5th April 2023, here.
- This results update focuses on **FXD1/2022/3** whose auction was 19th April 2023, here.
- In line with our expectations 'Fixed Income Report - April 2023 - National Treasury cuts domestic debt target in Supplementary Budget,' the issue was undersubscribed (Figure.1).
- We attribute the undersubscription to lack of investor interest and need to preserve capital given an environment of rising interest rates with most liquidity directed towards the 91-day T-Bill.
- Those who subscribed to the debt issue bid aggressively for the reason above together with high fiscal financing needs of the Government.
- The auction for **FXD1/2019/15** was cancelled.
- We believe it is due to aggressive investor bids, a cost the CBK was not willing to absorb.

Subscription Rates

Figure.1: Primary Bond Auction subscription



Source: Central Bank of Kenya

Weighted Average Rates

- An analysis of our revised predicted Weighted Average Rates (WAR) ranges compared to that accepted 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)
FXD1/2022/3	13.49 - 13.69	13.47	-12

Source: Central Bank of Kenya & Sterling Capital Research

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - There has been a significant upward shift in the yield curve with average yields up 92Bps year on year and 17Bps year to date across the yield curve.

The latest bond auction's WAR of accepted bids is higher than the implied yields on similar tenured bonds.

The upward shift has resulted from the following:

a) Upward revisions of the CBR from 7% to 9.5% between May and March 2023.

b) Increased budgetary financing pressure resulting from modest growth in revenues with the CBK borrowing aggressively in the domestic debt market.

c) CBK continues to accommodate more aggressive investor bids to encourage subscription for long-term debt instruments.

d) Rising inflation with investors looking for positive real return on capital invested.

FXD1/2022/3 yield is 32.5Bps higher than the implied yields as at 14th April 2023 (13.1454%).

We also note that the yield curve is inverted on the 11 - 14 and 16 - 23-year tenors.

Data from the NSE indicates that the 11 - 14-year implied yields as at 14th April 2023 stood between 14.0669% and 14.1028% while the 10-year yield stood at 14.1975%.

Further, the 16 - 23-year implied yields stood between 14.0416% and 14.2457% while the 15-year stood at 14.2469%.

This trend will continue to force the CBK to accept aggressive investor bids as they seek to normalize the curve and subsequently raise rates further.

Notably, we believe the option of canceling auctions given prevailing fiscal deficit needs is unsustainable.

2) **Market Liquidity** - There has been no change in repo rate since our March results' update (7.1%). However, the reverse repo and inter-bank rates increased to 10.9% and 8.7% from 10.8% and 8% respectively signaling tight market liquidity.

A bulk of liquidity has been directed to the 91-day T-Bill as shown in the latest auction dated 17th April 2023.

3) **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 and US$ liquidity to consider buying the US$ denominated Kenya Eurobonds to take advantage of current attractive yields.

4) **Secondary market trading** - We expect minimal secondary market trading activity on **FXD1/2022/3** given low activity in the primary market.

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