Thursday, 11 May 2023

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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Update

FXD1/2023/3

May 2023

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May 2023 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) invited bids to raise KES.20Bn through a new three-year bond issue; **FXD1/2023/3**.

  FXD1/2023/3 (3*)

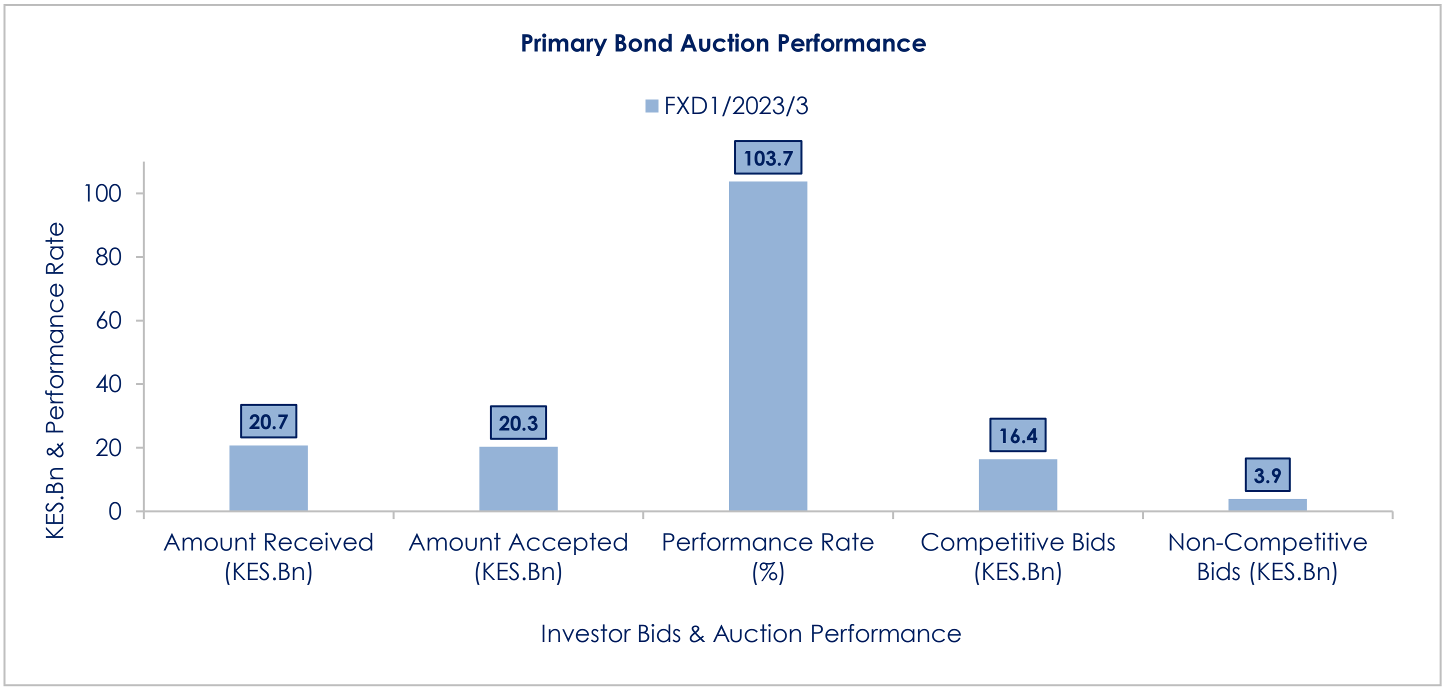
  ***Years to maturity**

- The bond's period of sale was between 26th April and 9th May 2023, auction results here.

Subscription Rates

- The debt issue was oversubscribed in line with our expectation in our May 2023 fixed income report "Will a 3-year debt issue excite investors" with investors bidding aggressively due to a combination of the Government high fiscal financing needs and rising interest rates influenced by the upward revisions of the Central Bank Rate (CBR) (Figure.1).

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 May 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)
FXD1/2023/3	13.89 - 14.09	14.228	+23.8

Source: Central Bank of Kenya & Sterling Capital Research

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - The yield curve continues to shift upwards with the weighted average rates of accepted bids for **FXD1/2023/3** higher than the current 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 March 2022 and March 2023.

   b) Increased budgetary financing pressure resulting from shortfalls in revenue collection with latest available Government revenue estimates (As at 31st March 2023) showing Government revenues at KES.1.39Tn against a revised target (Supplementary budget 1) of KES.2.11Tn or 66% of the revised target with less than two months of the 2022/23 fiscal year remaining.

   c) Investors' apathy for medium and long-term bonds with the CBK forced to accommodate aggressive investor bids to encourage debt subscription.

   d) Relatively high inflation with investors demanding higher return on capital invested.

   FXD1/2023/3 yield is similar to a 10-year tenor's which currently stands at 14.2283% as at 5th May 2023.

   We also note that the yield curve is inverted on the 13, 16 and 21 - 25-year tenors.

   Data from the NSE indicates that the 21 - 25-year implied yields as at 5th May 2023 ranged between 14.2508% - 14.4597% compared to the 20-year yield which stood at 14.5590%.

   Further, the 13 and 16-year implied yields stood at 14.2543% and 14.3188% compared to the 12 and 15-year yields at 14.2643% and 14.3282% respectively.

   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.

2) **Market Liquidity** - There has been no material change in repo rates since our March results' update (7.1%).

However, the reverse repo and inter-bank rates increased to 11% and 9.6% 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 8th May 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.

Investors with a high-risk tolerance (considering concerns over high debt distress, and challenges of re-financing) to consider buying Kenya Eurobonds and in particular **XS102895240** maturing in June 2024 to take advantage of the high yield with an option of holding till maturity or disposing in the event trading opportunities arise.

4) **Secondary market trading** - We expect minimal secondary market trading activity on **FXD1/2023/3** given rising interest rate environment as investors avoid mark to market losses.

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