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Fixed Income Note

May 2023

"Will a 3-year debt issue excite investors"

Table of Contents

Executive Summary

- Our May 2023 fixed income report is titled **"Will a 3-year debt issue excite investors"** in reference to the Central Bank of Kenya's (CBK) issuance of a 3-year bond - **FXD1/2023/3** to raise KES.20Bn.
- The issuance comes amid investor apathy for bonds given rising interest rates and increased concern over the country's debt position.
- We expect increased subscription given the low funding target of KES.20Bn and the short tenure of the issuance.
- Investors will bid aggressively due to rising interest rates, inflationary pressure and knowledge of the fiscal budget financing challenges.
- Our weighted average bid prediction is as follows:

  FXD1/2023/3: 13.89% - 14.09%

- This report also 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.
- The report concludes with our inflation expectations as well as predictions of the Monetary Policy Committee's (MPC) decision in its Monday 29th May 2023 meeting.

CBK seeks to raise KES.20Bn in May 2023 through a three-year debt issue

- The Central Bank of Kenya (CBK) invites bids to raise KES.20Bn through a new three-year bond issue; **FXD1/2023/3** (Table.1).
- As was mentioned in our April fixed income report, we notice a slight change in the Government's 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 oversubscription with interested investors expected to bid aggressively due to knowledge of the government's tight fiscal situation.

Table.1: Primary Bond issues' summary

Issue Number	**FXD1/2023/3**
Total Amount Offered	KES.20Bn
Tenor	3 Years
Coupon Rate (%)	Market determined
Price Quote	Discounted/Premium/Par
Period of Sale	**26/04/2023 to 09/05/2023**
Auction Date	10/05/2023
Value Date	15/05/2023
Yield Curve (%) (Weighted average tenor - 30th April 2023)	**13.1168**

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 30th April 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	**FXD1/2023/3**
Weighted Average bid predictions (%)	13.89 - 14.09

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 30th April 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
FXD1/2022/3	11th April 2022	11.7660	7th April 2025	708	12.5902	11.3193

Source: Central Bank of Kenya

- The CBK issued its first 3-year bond in April 2022 seeking KES.40Bn for budgetary support.
- The auction was undersubscribed with subscription coming in at 85.1% due to tight market liquidity at the time (Table.4).
- Last month, CBK signaled that it would not yield to high investor bids by cancelling one bond auction due to aggressive investor bids.
- However, given the current fiscal deficit, CBK is likely to increasingly yield to investor pressure and we are likely to see evidence of the same on the current bond issuance.
- This informs our view that the issuance is likely to be oversubscribed as high investor bids are accepted by the CBK.

Table.4: Historical primary market auction performance

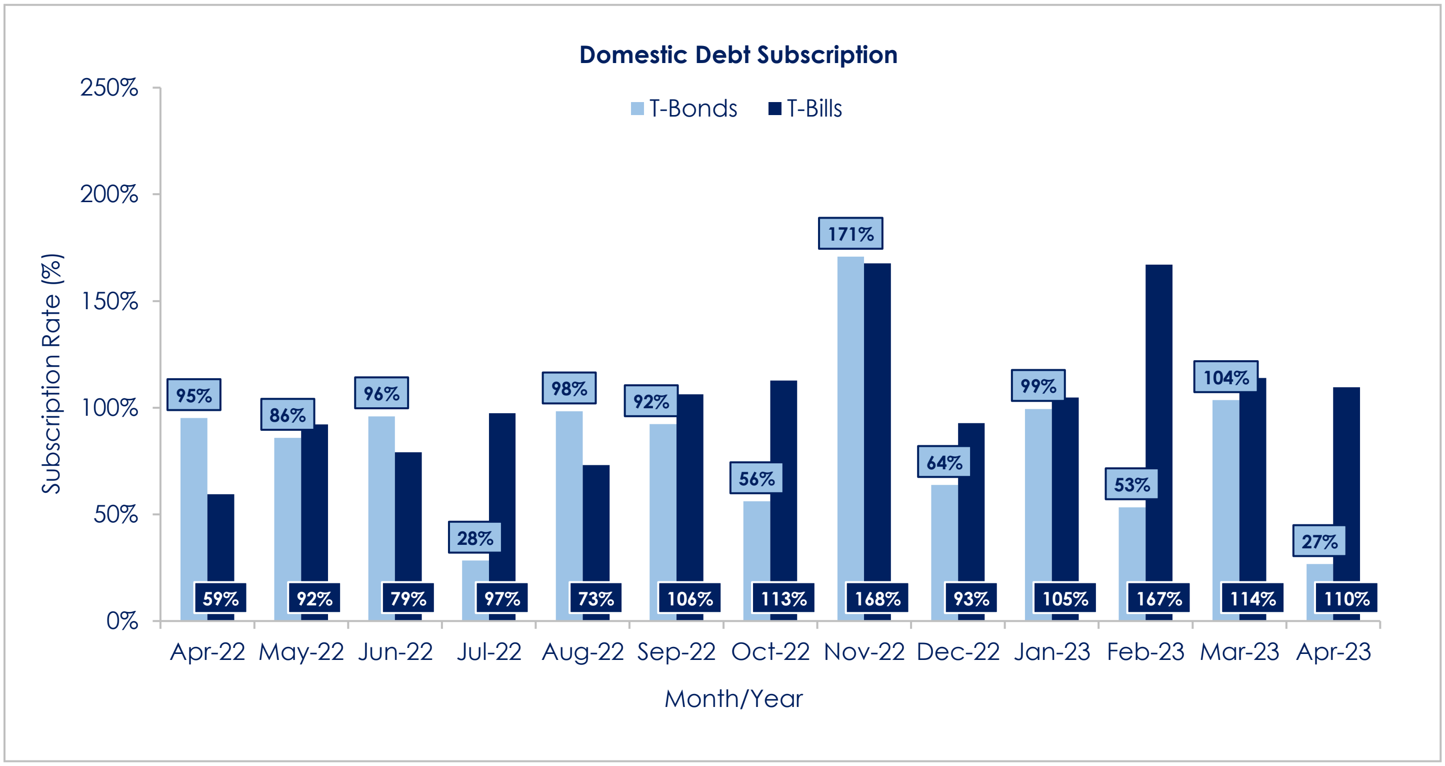
Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
3-Year							
FXD1/2022/03	11th April 2022	40	34	33.1	85.1	11.7660	12.5741

Source: Central Bank of Kenya

T-Bond subscriptions hit new lows amid high T-Bill demand

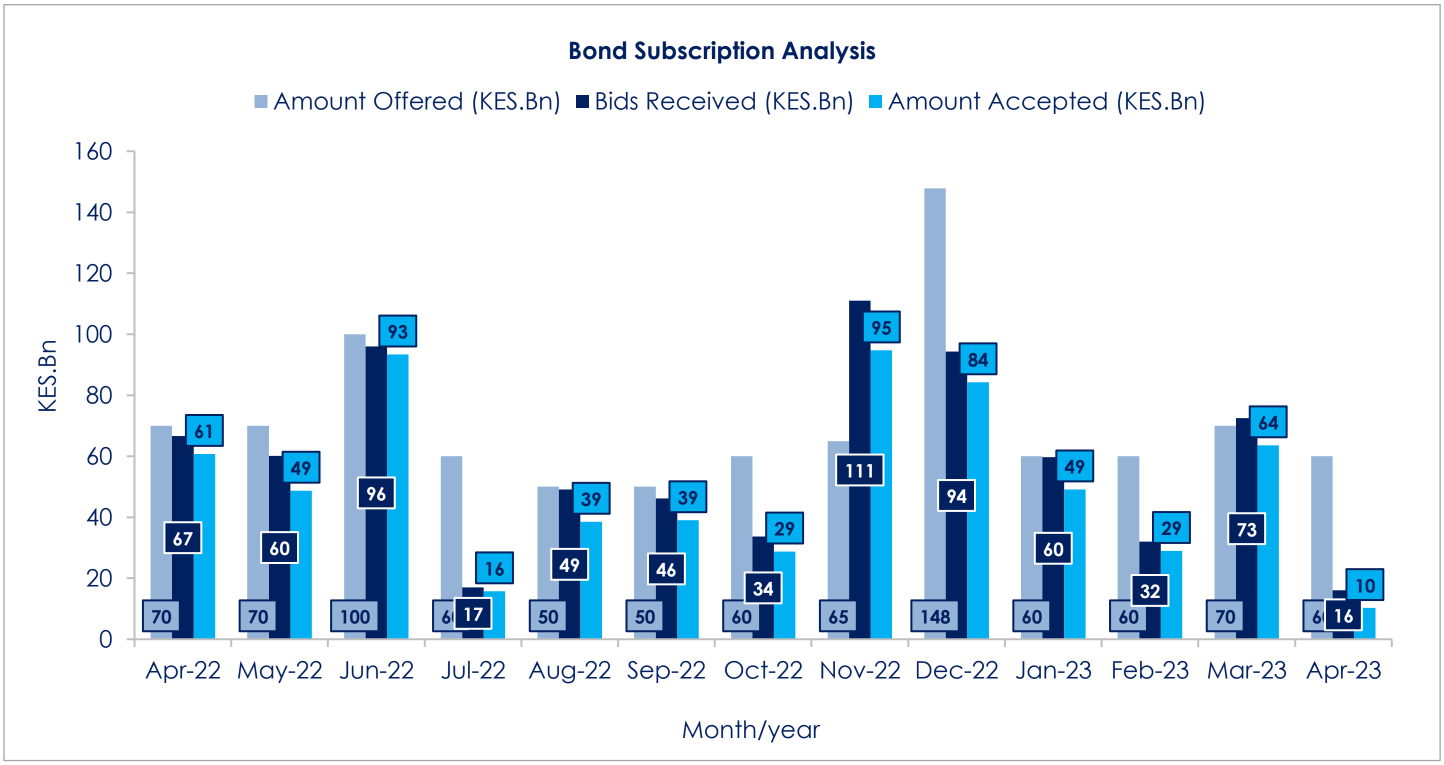
- The April 2023 T-Bill subscription rate declined 109.6% from 113.9% in March with KES.105.2Bn worth of bids received against KES.96Bn offered (Figure.1).
- This marked a slight reduction from the KES.109.3Bn received against KES.96Bn offered in March 2023.
- The 91, 182 and 364-Day had subscription rates of 534.4%, 21.9% and 27.3% compared to 354.6%, 87.7% and 43.7% respectively in March.
- The high subscription for the 91-Day T-Bill illustrate the investors' strategy to counter duration risks.
- The foregoing translated in a decline in T-Bond subscriptions to 26.7% from 103.5% in March with KES.16Bn received in bids against the KES.60Bn offered (Figure.1 & 2).
- Most notable was the cancellation of the **FXD1/2019/15** auction as the CBK shied away from accepting aggressive investor bids.

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



Source: Central Bank of Kenya

Figure.2: T-Bond subscription in April 2023 falls to significant lows

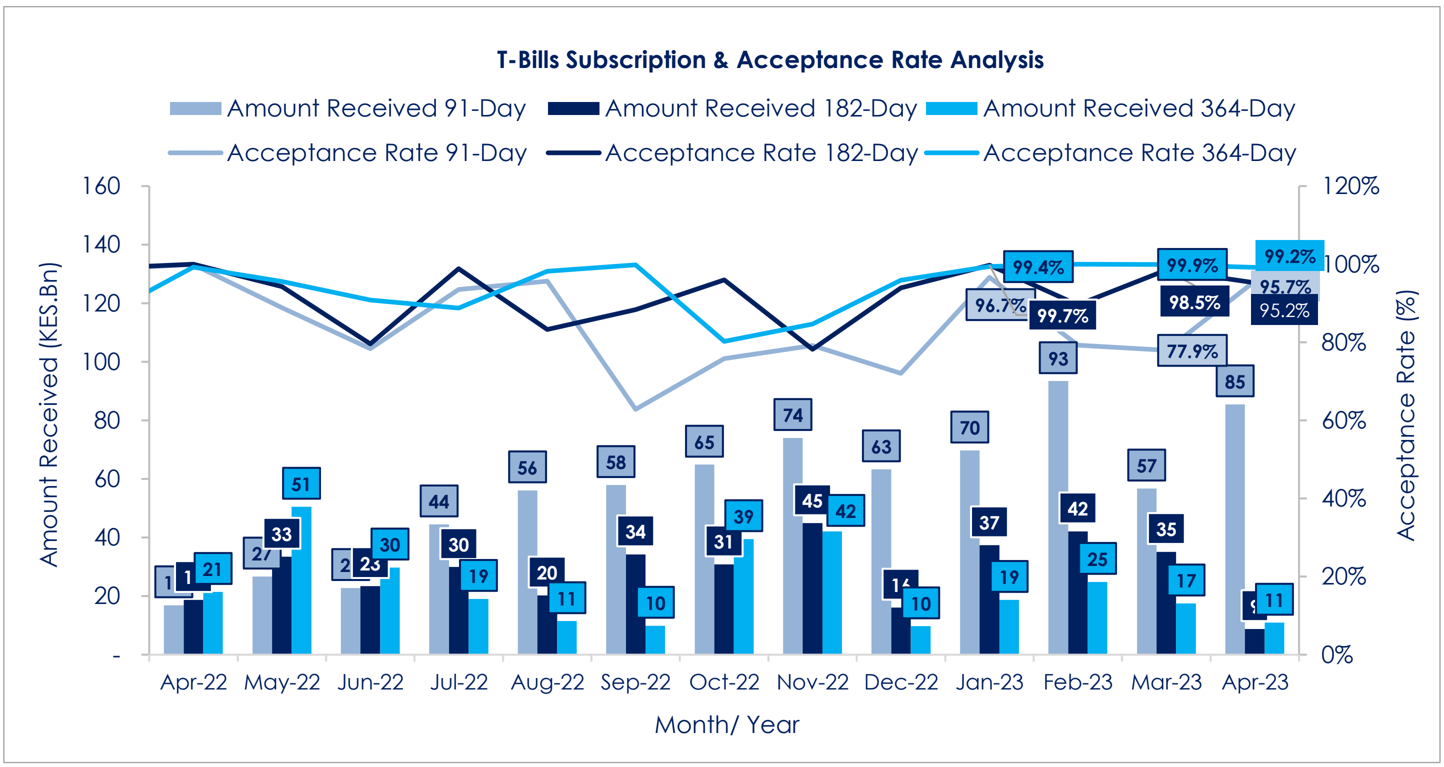


Source: Central Bank of Kenya

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 April (96%) compared to March (88.1%) due to the relatively high demand for short-term debt.
- Acceptance rates for the 91-Day, 182-Day and 364-Day T-Bills stood at 95.7%, 95.2% and 99.2% in April 2023 compared to 77.9%, 98.5% and 99.9% in March 2023 (Figure.3).
- 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 high acceptance rates amid low demand for T-Bonds is evidence of the difficulties being faced by the CBK to attract capital toward the long end of the yield curve.
- We expect demand for the 91-Day paper to continue being elevated given the fiscal imbalance and rising interest rate environment which investors are striving to hedge against through short-term government paper uptake.

Figure.3: Material increase in 91 Day T-Bill acceptance rate in April 2023 due to liquidity constraints

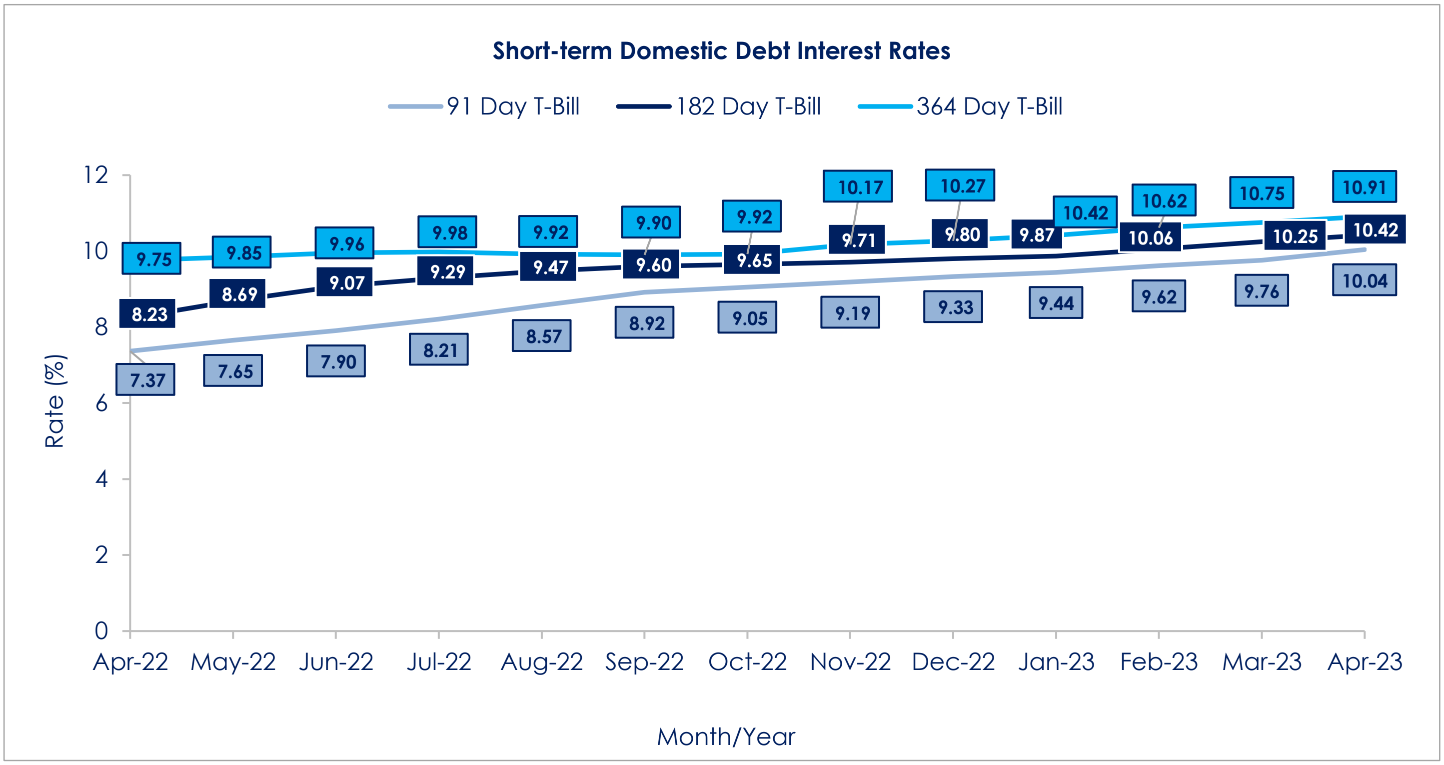


Source: Central Bank of Kenya

Average 91 Day T-Bill surpasses 10% psychological level

- Average T-Bill rates continued on an upward trajectory with the 91 Day T-Bill rates surpassing the 10% psychological level (Figure.4).
- The 91, 182 and 364 day average rates increased to 10%, 10.4% and 10.9% from 9.8%, 10.4% and 10.9% in March 2023 respectively.
- Over the last one year, average 91, 182 and 364-Day T-Bill rates have increased 267.2, 218.7 and 116Bps respectively showing the lasting impact of CBR revisions, high inflation and increased fiscal deficit financing.
- 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.
- While we do expect the CBK to pause on rate hikes given a reduction in inflation, we are of the opinion that investors will continue demanding a premium for funds given the current macro-environment and therefore expect that interest rates on the short-end will continue to remain elevated for the rest of the year.

Figure.4: T-Bill rates continue trending upwards with average 91-Day T-Bill surpassing 10% in April 2023

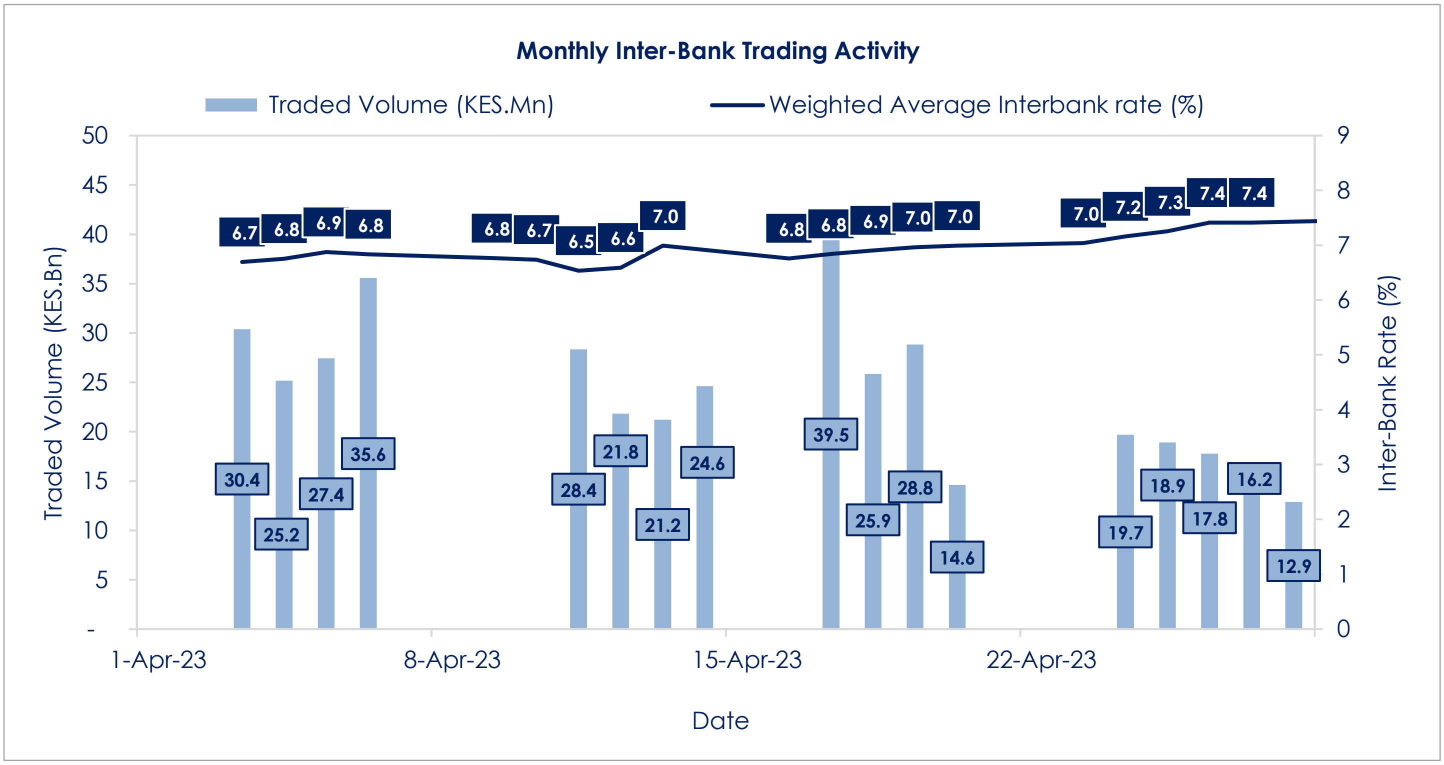


Source: Central Bank of Kenya

Average inter-bank rates tick up in April 2023

- Average inter-bank rate continued trending upward while trading volumes declined in April 2023 compared to the previous month (Figure.5).
- The average inter-bank rate increased 158.5Bps from 7% to 8.6% indicative of relatively low market liquidity.
- Trading volumes declined to KES.408.7Bn in April 2023 from KES.483.2Bn in March.
- 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)) increased 14.9% from KES.55.8Bn in March 2023 to KES.64.1Bn in April 2023 (Figure.6).

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



Source: Central Bank of Kenya

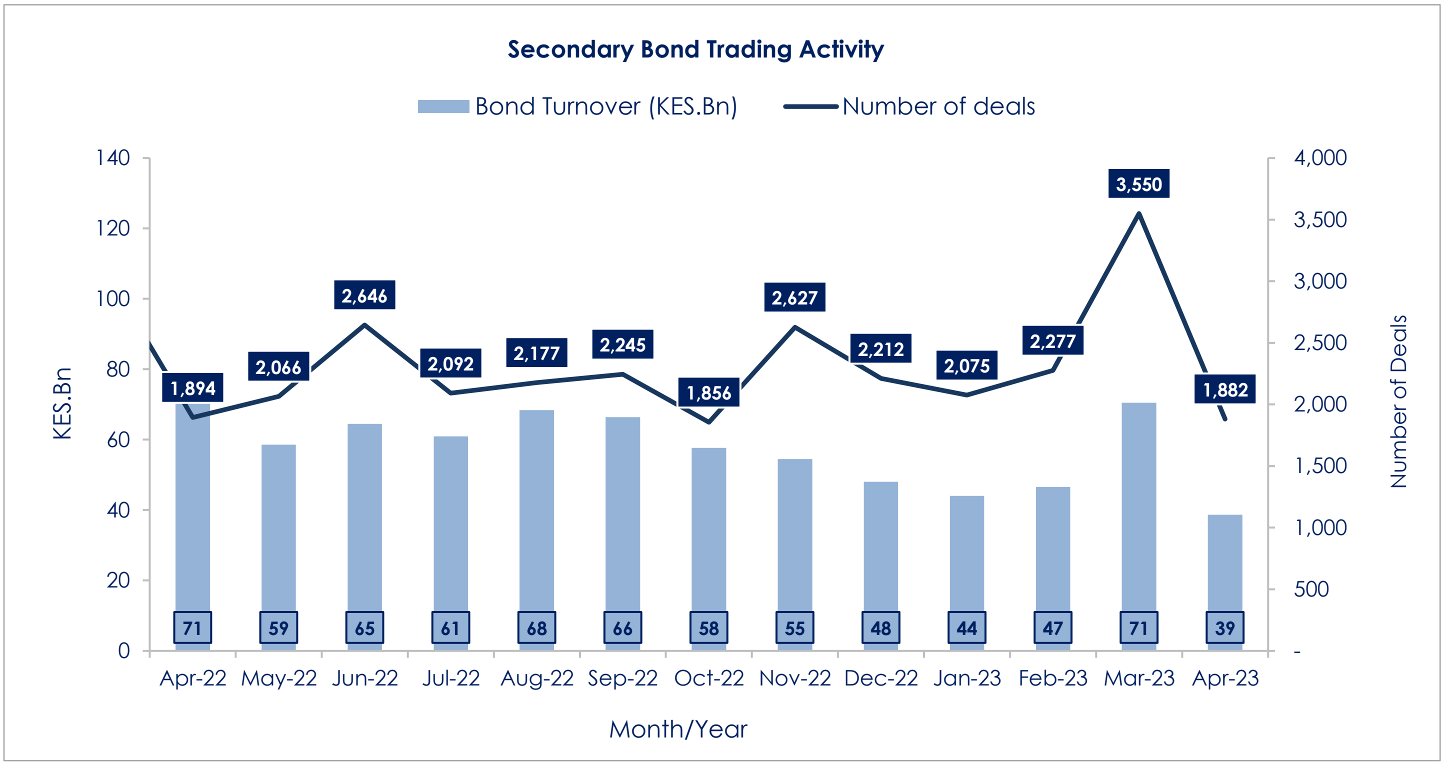
Figure.6: Excess commercial bank reserves increase in April 2023

Source: Central Bank of Kenya

Secondary market trading down 45.1% in April 2023

- Secondary bond market trading declined 45.1% to KES.38.7Bn from KES.70.5Bn in March 2023 while the number of deals declined 47% to 1,882 from 3,550 (Figure. 7).
- The relatively high trading activity in March was due to **IFB1/2023/17** issue and tap sale which contributed to the increase in trading given its tax free status and capital appreciation potential.
- The unattractive bond valuations resulting from the general rise in interest rates also discouraged trading.

Figure.7: Secondary trading activity declines in April 2023

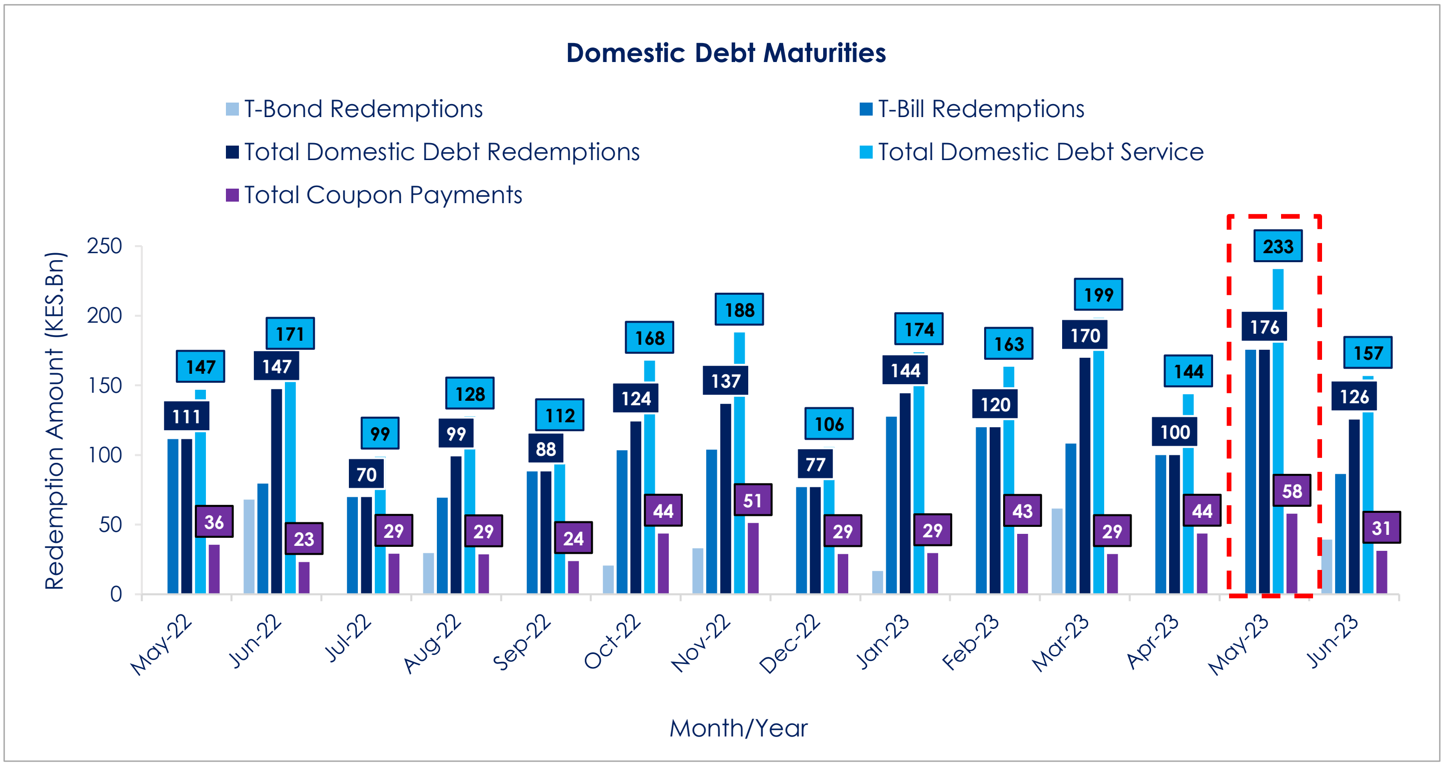


Source: Central Bank of Kenya

Domestic debt service in May 2023 at KES.233.5Bn

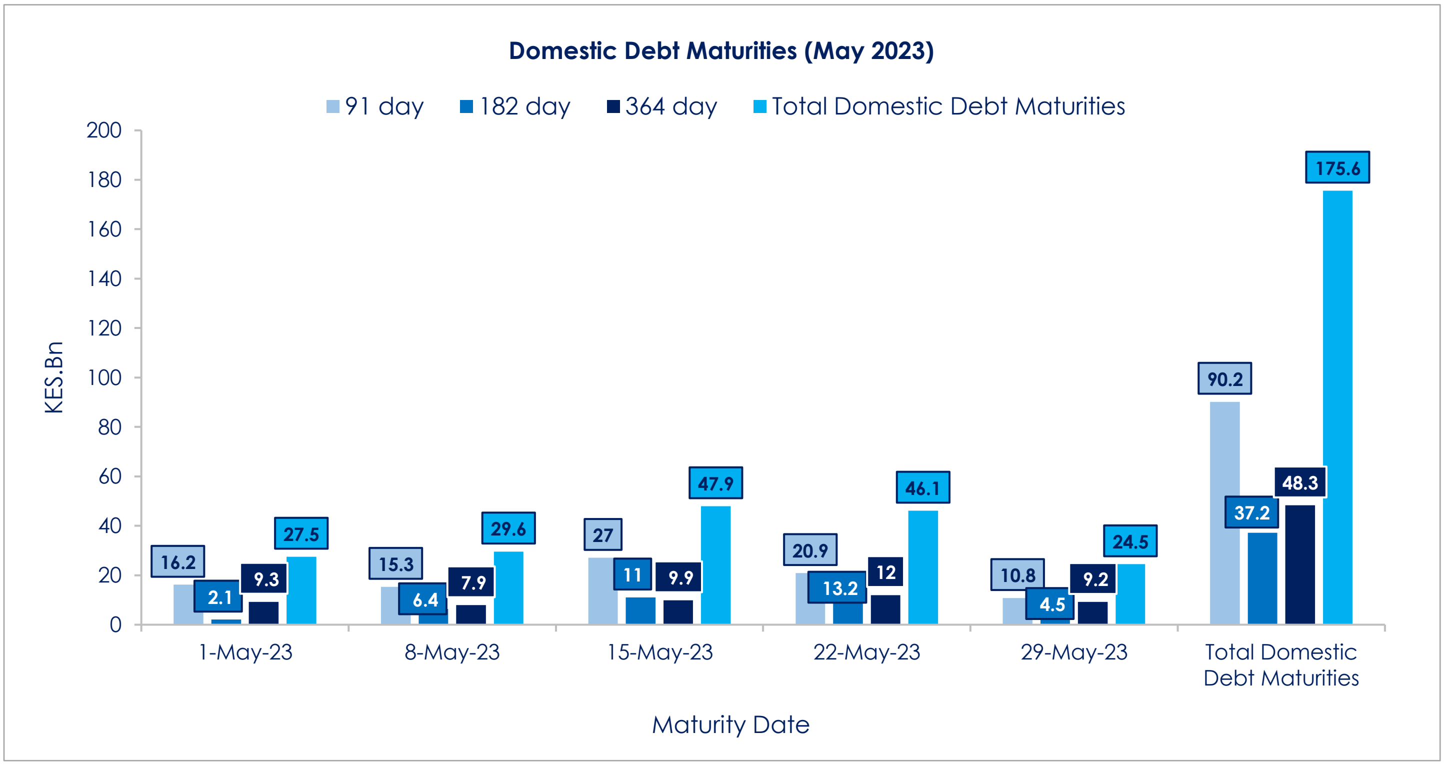
- Total domestic debt service increased to KES.233.5Bn in May 2023 equivalent to an increase of 62.6% from KES.143.6Bn in April 2023 (Figure.8).
- This comprises of KES.175.6Bn in T-Bill redemptions and KES.57.8Bn in coupon payments while there will be no T-Bond redemptions.
- **FXD1/2013/10** will mature in June 2023 with a redemption value of KES.39.2Bn.
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.90.2Bn, KES.37.2Bn and KES.48.3Bn respectively with the third week of the month having the highest redemptions at KES.47.9Bn (Figure.9).

Figure.8: May 2023 debt service highest over the last one year



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities May 2023



Source: Central Bank of Kenya

National Treasury falling way short of revised 2022/23 fiscal budget estimates

- The National Treasury continues to fall way short of its 2022/23 fiscal budget supplementary budget estimates (Table.5 and Figure.10).
- Net domestic borrowing in particular is a great concern at 44.7% of the KES.886.5Bn as has been evident in weekly and monthly T-Bill and T-Bond auctions.
- This is the reason why the CBK is issuing a 3 year bond with the hope that it generates sufficient demand from investors who are unwilling to commit to long-term debt in an environment of rising interest rates.
- This underperformance also partially explains why the external borrowing target was revised upwards in the Supplementary budget. This too continues to underperform.
- While tax revenue is the best performing metric amongst the government receipts, it also falls below our linear target run rate of 75% after nine months of the fiscal year.

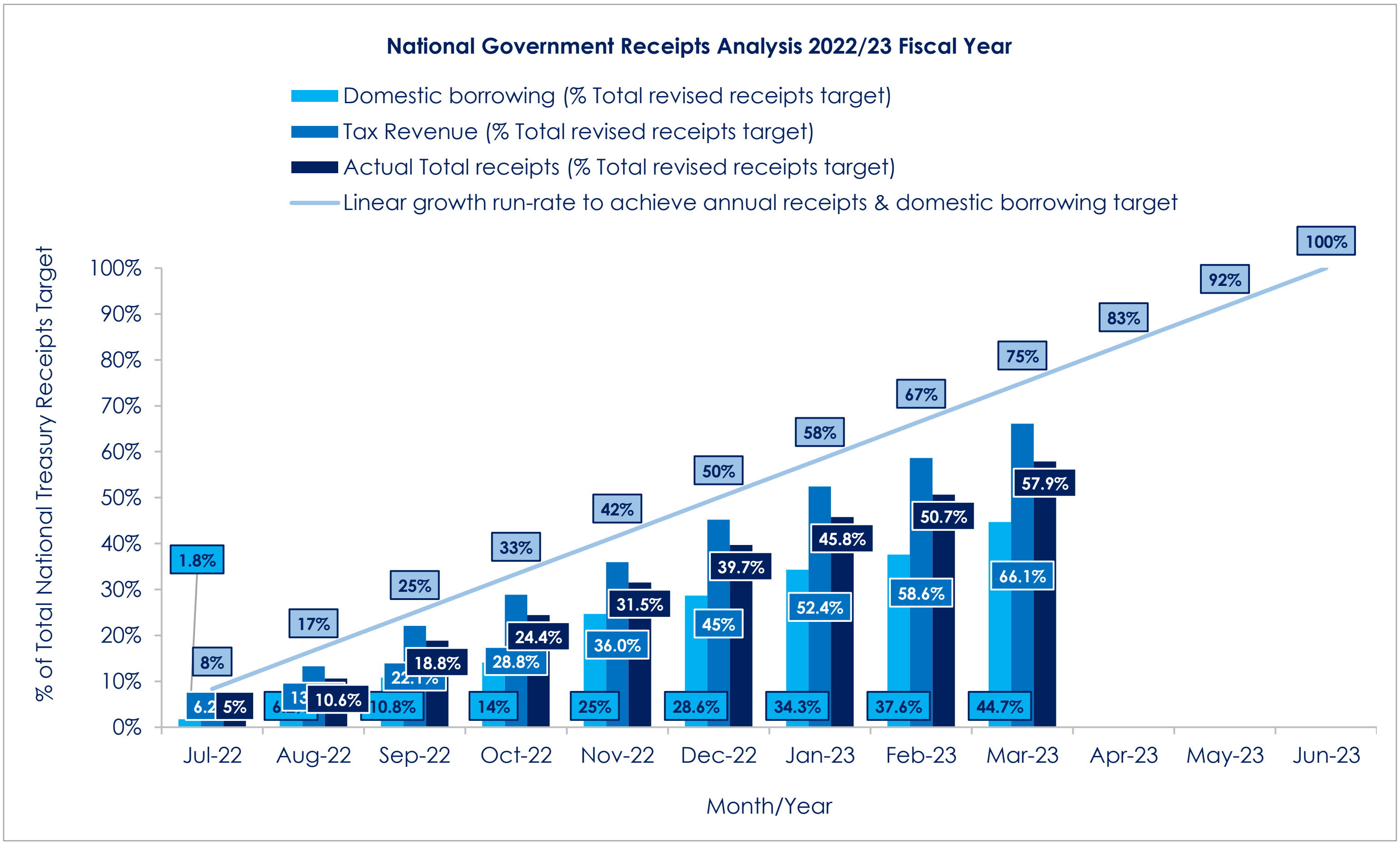
Table.5: Total Government receipts underperforming after H1 2022/23

Receipts	Original Estimates 2022/23 (KES.Mn)	Original Estimates 2022/23 (KES.Mn)	Variation Original vs Revised 2022/23 Estimates	Actual Receipts (KES.Mn) 31st March 2023	Proportion of Total Receipts 31st March 2023 (%)
Opening Balance (1st July)				616.5	
Tax Revenue	**2,071.9**	**2,108,3**	**1.8%**	**1,393.4**	**66.1**
Non-Tax Income	69.7	83.7	20.1%	50.7	60.6
Domestic Borrowing*	**1,040.5**	**886.5**	**-14.8%**	**396.3**	**44.7**
External Loans & Grants	349.3	520.6	49%	235.5	45.2
Other Domestic Financing	13.2	13.2	0	15.5	117.4%
Total Revenue	**3,544.6**	**3,612.3**	**1.9%**	**2,091.4**	**57.9**
Linear Run Rate target (9 months of fiscal year 2022/23)					**75%**

* 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.86 14th April 2023

Figure.10: Actual receipts remain well below our linear target run-rate

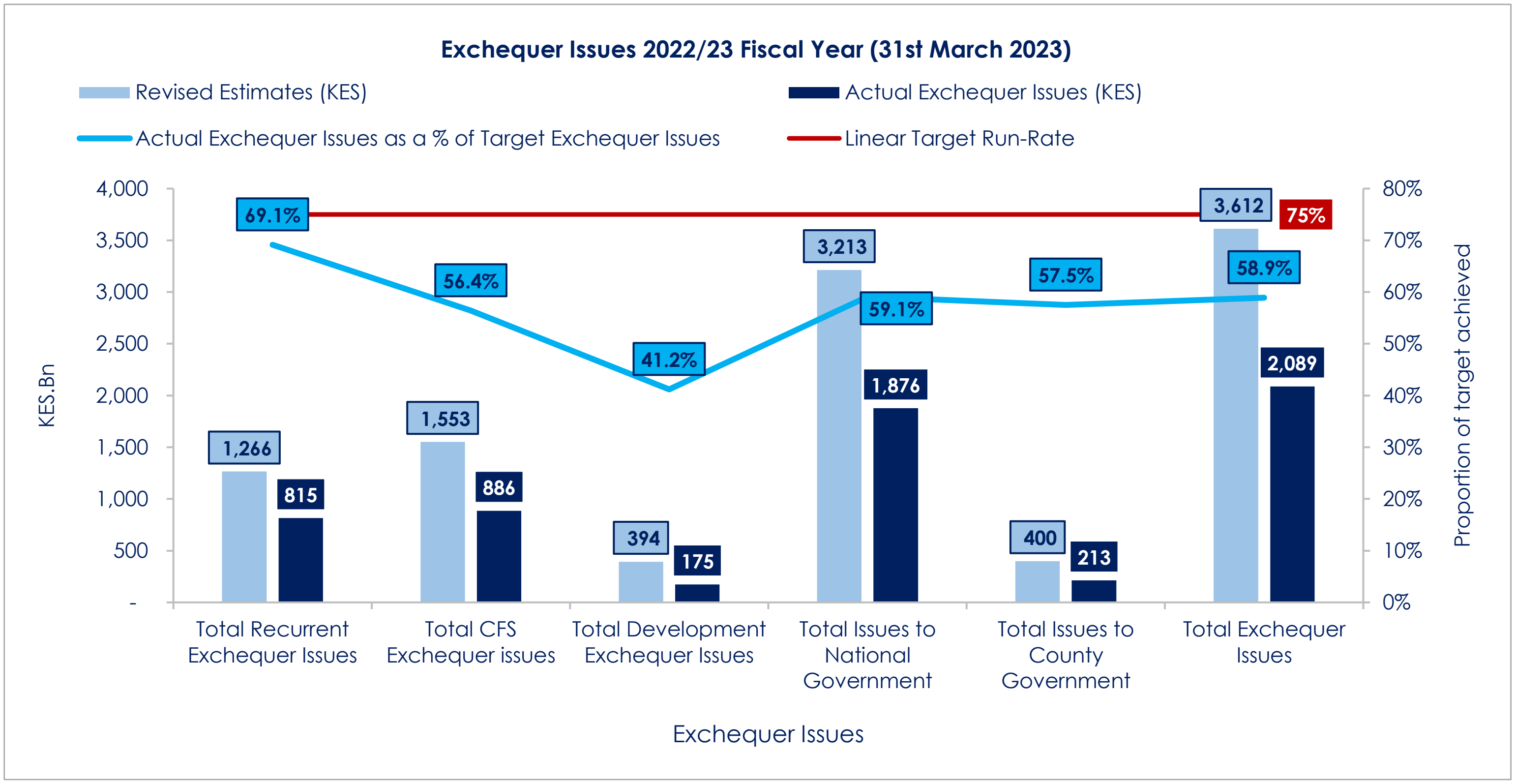


Source: The Kenya Gazette Vol. CXXV - No.86 14th April 2023

Government expenditure remains below our 2022/23 fiscal year linear run-rate due to cash crunch

- The existing cash crunch experienced by the National Treasury is evident as observed in our analysis of exchequer issues at the end of March.
- All exchequer issues fall below our linear target run rate of 75% with recurrent expenditure the highest after nine months of the fiscal year (Figure.11).

Figure.11: Recurrent expenditure at 47% of total budget in H1 2022/23

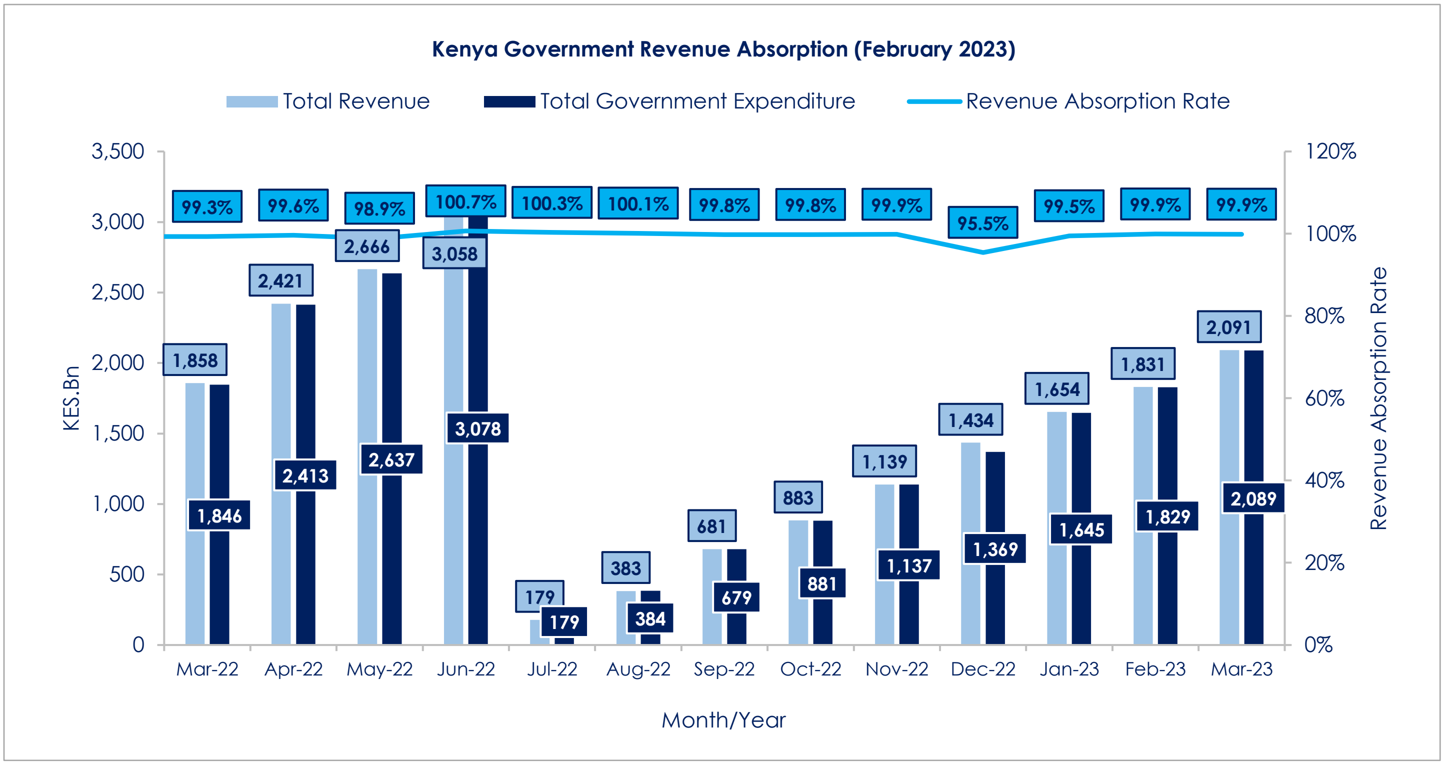


Source: The Kenya Gazette Vol. CXXV - No.86 14th April 2023

Government Revenue Absorption at close to full absorption

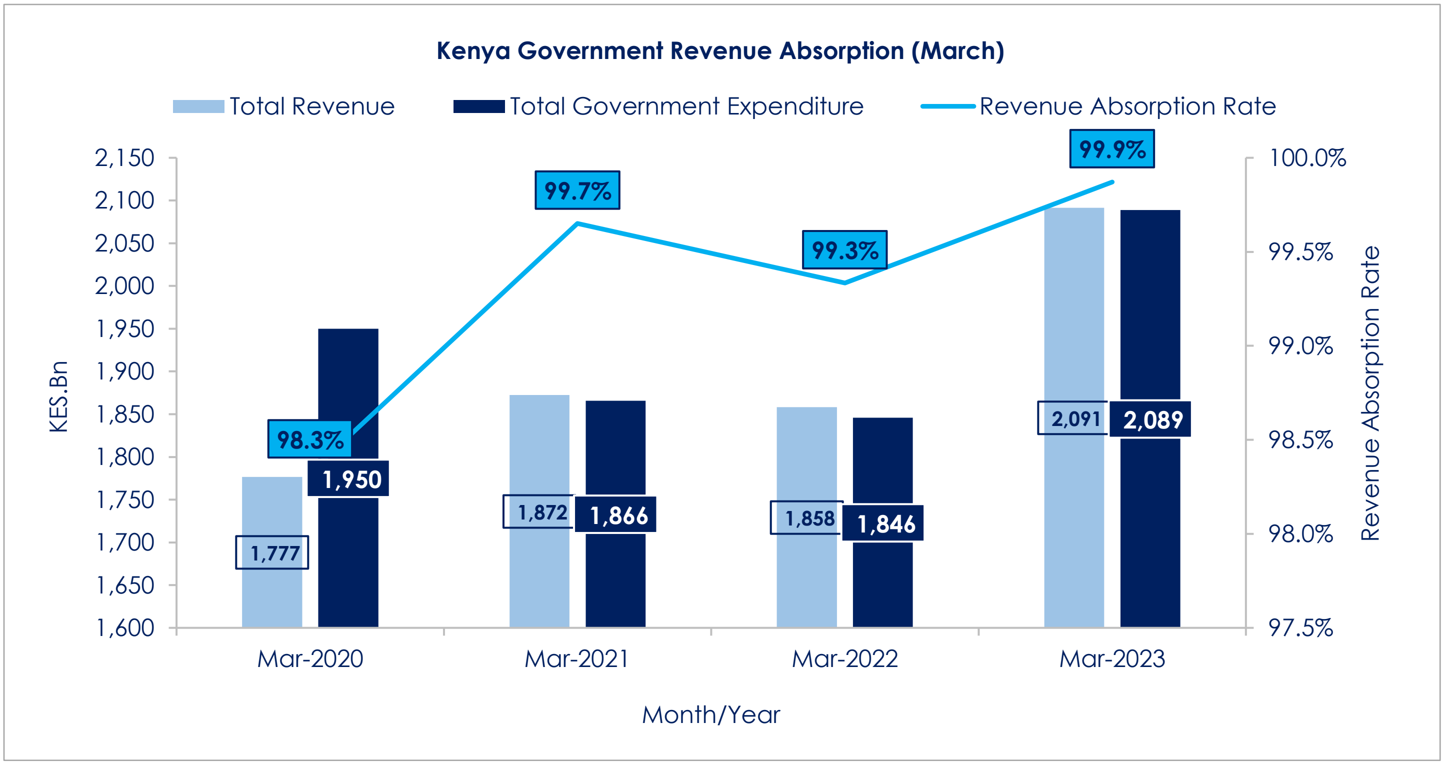
- Government Revenue Absorption Rate (RAR) which is the proportion of Government receipts used to finance expenditure rose to close to full subscription in March 2023 emphasizing the challenges faced by the government in financing its budget (Figure.12).
- This is also the case when we do a year on year comparison where we see a 12.6% increase in revenue to KES.2.091Tn against a 13.2% increase in expenditure to KES2.089Tn (Figure.13).
- We expect RAR to remain high for the rest of the fiscal year.

Figure.12: Government revenue utilization remains at close to full utilization in March 2023



Source: The Kenya Gazette Vol. CXXV - No.86 14th April 2023

Figure.13: Revenue absorption highest in March 2023

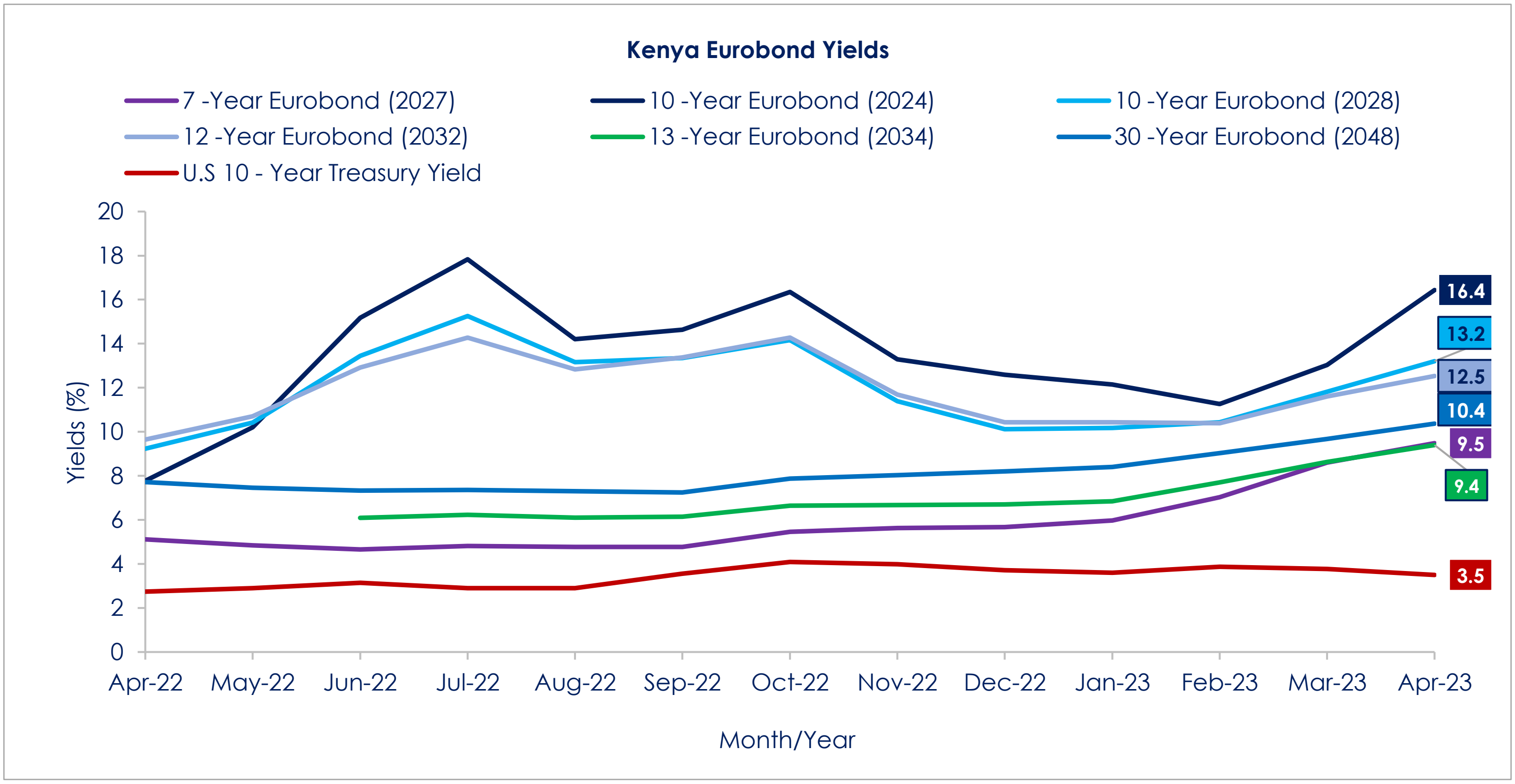


Source: The Kenya Gazette Vol. CXXV - No.86 14th April 2023

Kenya Eurobond yields trend upwards in April 2023

- We observed a sharp spike in average yields on Kenya Eurobonds in April with average yields for the US$.2Bn 10 year bond maturing in 2024 (**ISIN - XS1028952403)** up 340Bps on average in April compared to March 2024 (Figure.14).
- Yields on the debt issue highest on 24th April (20.345%).
- Kenya Eurobond yields rose 125Bps on concerns over debt distress and rising probability of default.
- During the same week, the Government of Kenya issued an expression of interest to raise funds through issuance of a new Eurobond which is expected to refinance the one maturing in June 2024.
- The US 10 year treasury yield declined 26Bps over the same period.
- We still feel that **XS1028952403** remains an attractive investment opportunity on the basis of the short term to maturity.

Figure.14: Kenya Eurobond yields rise in March 2023



Source: Central Bank of Kenya

Yield curve continues to shift upwards

- A comparison of average debt security NSE yields as at 30th April 2023 against those a year ago and two years ago, shows an increase across the curve. (Table.6 and Figure.15).
- The upward shift in the yield curve is a result of the following:

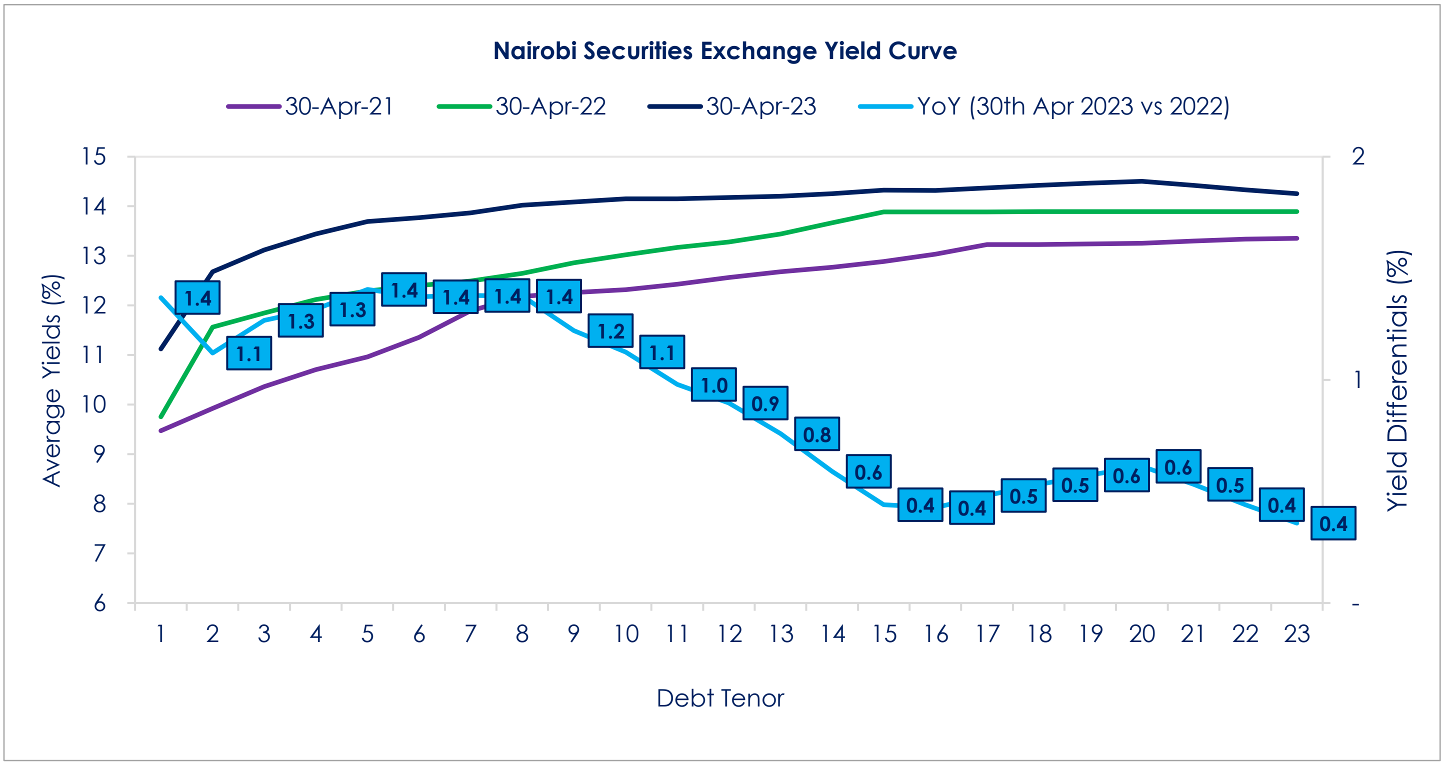
1) Upward adjustments of the CBR, with four revisions between May 2022 and March 2023 - 250Bps to 9.5%.
2) Increased budgetary financing pressure resulting from revenue shortfalls with the CBK borrowing aggressively in the domestic debt market.
3) CBK has accommodated more aggressive investor bids to encourage subscription following a decline in investor demand for short-term debt instruments.
4) High 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 (30th April 2021)	Yields (30th April 2022)	Yields (30th April 2023)	∆ (30th April 2023 vs 2021) Bps	YoY ∆ (30th April 2023 vs 2022) Bps	Sterling Capital Yield Curve (May 2023)
1	9.4740	9.7550	11.1240	↑ 165.00	↑ 136.90	11.15
2	9.9226	11.5620	12.6820	↑ 275.94	↑ 112.00	12.70
5	10.9646	12.2910	13.6963	↑ 273.17	↑ 140.53	13.75
10	12.3197	13.0240	14.1491	↑ 182.94	↑ 112.51	14.20
15	12.8893	13.8878	14.3284	↑ 143.91	↑ 44.06	14.40
20	13.2570	13.8919	14.5045	↑ 124.75	↑ 61.26	14.45

Source: Nairobi Securities Exchange & Sterling Capital Research

Figure.15: 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 (considering concerns over high debt distress, and challenges of re-financing) should consider buying Kenya Eurobonds and in particular, **XS102895240** maturing in June 2024 to take advantage of high yields with an option of holding till maturity or disposing in the event trading opportunities arise (Table.7).
- **XS102895240** had a yield just short of 20% as at 27th April 2023 with the bond close to 12 months to maturity reducing the risk associated with longer dated bonds.

Table.7: Trading ideas - Consider Kenya Eurobonds

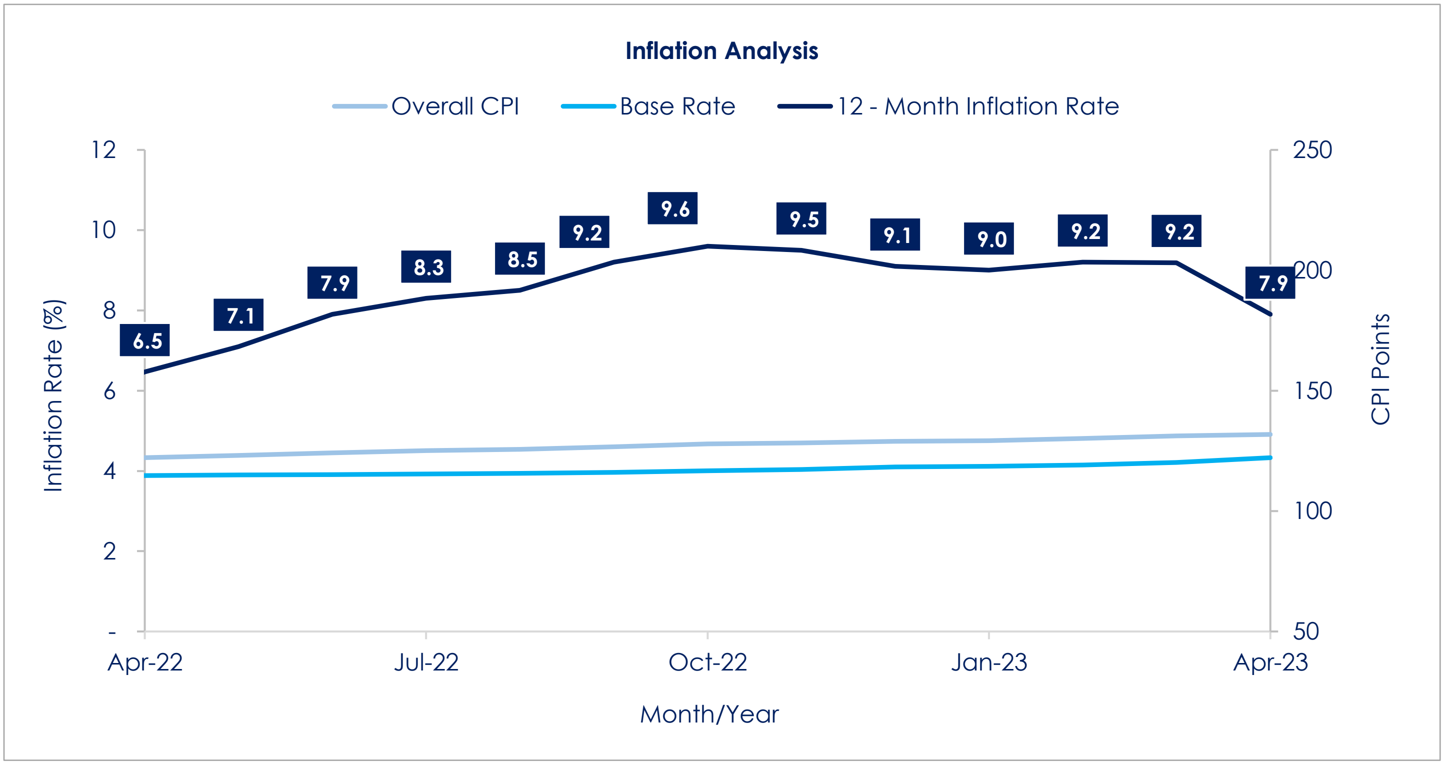
ISIN Code	Issue date	Tenor (Years)	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (27th April 2023)	Maturity
XS102895240	Jun-14	10	2	6.875%	19.98%	Jun-24
XS184343584	May-19	7	0.9	7%	15.39%	May-27
XS178171054	Feb-18	10	1	7.25%	14.08%	Feb-28

Source: Bloomberg

April 2023 Inflation declined month on month to 7.9% on account of heavy rains

- April 2023 inflation declined to 7.9% from 9.2% in March 2023 on account of a general decline in food prices (Figure.16).
- Overall, there was marginal 0.1% month on month change in food and non-alcoholic beverages whose contribution to inflation is highest at 32.9%.
- However, year on year inflation rose from 6.5% in April 2022 due to increase in prices of commodities under food and non-alcoholic beverages (10.1%), housing, water, electricity, gas and other fuels (9.6%) and transport (9.8%).
- We expect the long rains to continue moderating inflationary pressure with our May 2023 forecast at 7.7% - 8.2%.
- We further note a decline in global fuel prices which may not translate to lower pump prices locally due to currency depreciation.

Figure.16: May 2023 inflation forecast at 7.7% - 8.2%



Source: Kenya National Bureau of Statistics

MPC likely to maintain CBR at 9.5% in May 2023 meeting

- The Monetary Policy Committee (MPC) is set to meet on Monday, 29th May 2023 to review the impact of the revision of the CBR in its last meeting on 29th March on the economy.
- The MPC surprised investors and market players by raising the CBR by 0.75 Bps from 8.75% to 9.5% mainly informed by inflationary pressure.
- With inflation easing in April 2023 (Figure.16), we believe the MPC is likely to hold the rate unchanged.
- Other points of discussion would be the global economic developments, current account position, private sector credit performance, banking sector Non-Performing Loans (NPLs) and the sufficiency of our current foreign exchange levels.

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