STERLING CAPITAL
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Fixed Income Note

June 2023

"National Treasury set to miss 2022/23 funding target"

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Executive Summary

- Our June 2023 fixed income report is titled **"National Treasury set to miss 2022/23 funding target."**
- It is a coverage of the Central Bank of Kenya's (CBK) issuance of the second and third infrastructure bond in the 2023 and 2022/23 calendar and fiscal year respectively.
- The IFB with a weighted average term to maturity tenor of 5.5 years seeks to raise KES.60Bn.
- The issuance comes amid investor apathy for bonds given rising interest rates, inflationary pressure and increased concern over the country's debt position which will drive aggressive bidding.
- We expect oversubscription given its relatively short tenor and tax-free status with its relatively high liquidity and capital appreciation potential especially once interest rates start declining in the coming years.
- Our weighted average rate of investor bids prediction is as follows:

  IFB1/2023/7: 14.99% - 15.19%

- This report also covers primary auction outcomes, secondary market trading trends, short-term domestic debt interest rates, market liquidity and domestic debt maturities.
- The country's fiscal position is also discussed in brief in this report.
- We have done an analysis of the Nairobi Securities Exchange (NSE) yield curve and concluded the report with our inflation expectations as well as our views on the Monetary Policy Committee (MPC) meeting on 29th May 2023.

CBK issues third IFB in FY2022/2023 seeking to raise KES.60Bn

- The Central Bank of Kenya (CBK) invites bids for a 7-year amortized Infrastructure Bond **(IFB1/2023/7)**, with a market-determined coupon to raise KES.60Bn (Table.1).
- This is the second IFB issue in 2023 and third issue in 2022/23 fiscal year with the first and second issued in November 2022 and March 2023 respectively.
- Redemption will be in three tranches, with the first tranche of 20% redeemed in June 2026, second tranche of 30% redeemed in December 2027 and the remaining 50% at expiry in June 2030.
- An oversubscription is expected on account of the relatively attractive tenor, and tax-free status.
- IFBs are also highly liquid and offer trading opportunities thus an added incentive to investors.

Table.1: Infrastructure Bond issue summary

Issue Number	**IFB1/2023/7**
Total Amount Offered	KES.60Bn
Tenor (Years)	7
Effective Tenor (Years)	5.5
Coupon Rate (%)	Market Determined
Issue Price	Discounted/Premium/Par
Period of Sale	26th May 2023 to 13th June 2023
Auction Date	14th June 2023
Value Date	19th June 2023
Yield Curve (%) (Weighted Average tenor - 5.5 years) 2nd June 2023	**14.23**

Source: Central Bank of Kenya & Sterling Capital Research

IFB1/2023/7 amortized redemption structure

- **IFB1/2023/7** amortized redemption structure make its effective tenor 5.5 years (Table.2).

Table.2: Effective debt tenor is 5.5 years

Redemption Period	**% of principal**	**Tenor Calculation**	**Weighted Tenor**
3 Years (May 2023 - June 2026)	20%	20%*3 years	0.6 years
4.5 Years (May 2023 - Dec 2027)	30%	30%*4.5 years	1.35 years
7 Years (May 2023 - June 2030)	50%	50%*7 years	3.5 years
Effective tenor			0.6 + 1.35 + 3.5 = 5.45

Source: Central Bank of Kenya & Sterling Capital Research

Our market weighted average bid predictions

- We arrived at our market-weighted average bid predictions by analysing implied yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as at 2nd June 2023 and discussions with several fixed income traders (Table.3).

Table.3: Auction bid predictions

Rate	IFB1/2023/7
Market Weighted Average bid prediction (%)	14.99 – 15.19

Source: Sterling Capital Research

Historical debt issues guide our predicted rates

- We used implied yields of bonds of almost similar tenors to maturity on the NSE as at 2nd June 2023 as a guide for possible investor auction bid levels (Table.4).
- The best benchmark in relation to 5.5-year effective tenor is **FXD1/2023/3**; issued in May 2023 and had two successful tap sales, combined subscription of 117%.

Table.4: Benchmark issues to guide investor bids

Bond Issue	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years (Days)	Implied Yield to maturity (%)	Yield Curve at time of issue
FXD1/2023/3	15th May 2023	14.228	11th May 2026	(2.9) 1,074	14.228	14.2242

Source: Central Bank of Kenya

- We note overall high subscription rates for previous IFB issues (Table.5).
- The most recent IFB issues **IFB1/2023/17** and **IFB1/2022/14** recorded 119.5% and 153.1% subscription rates respectively.

Table.5: Historical IFB primary market auction performance

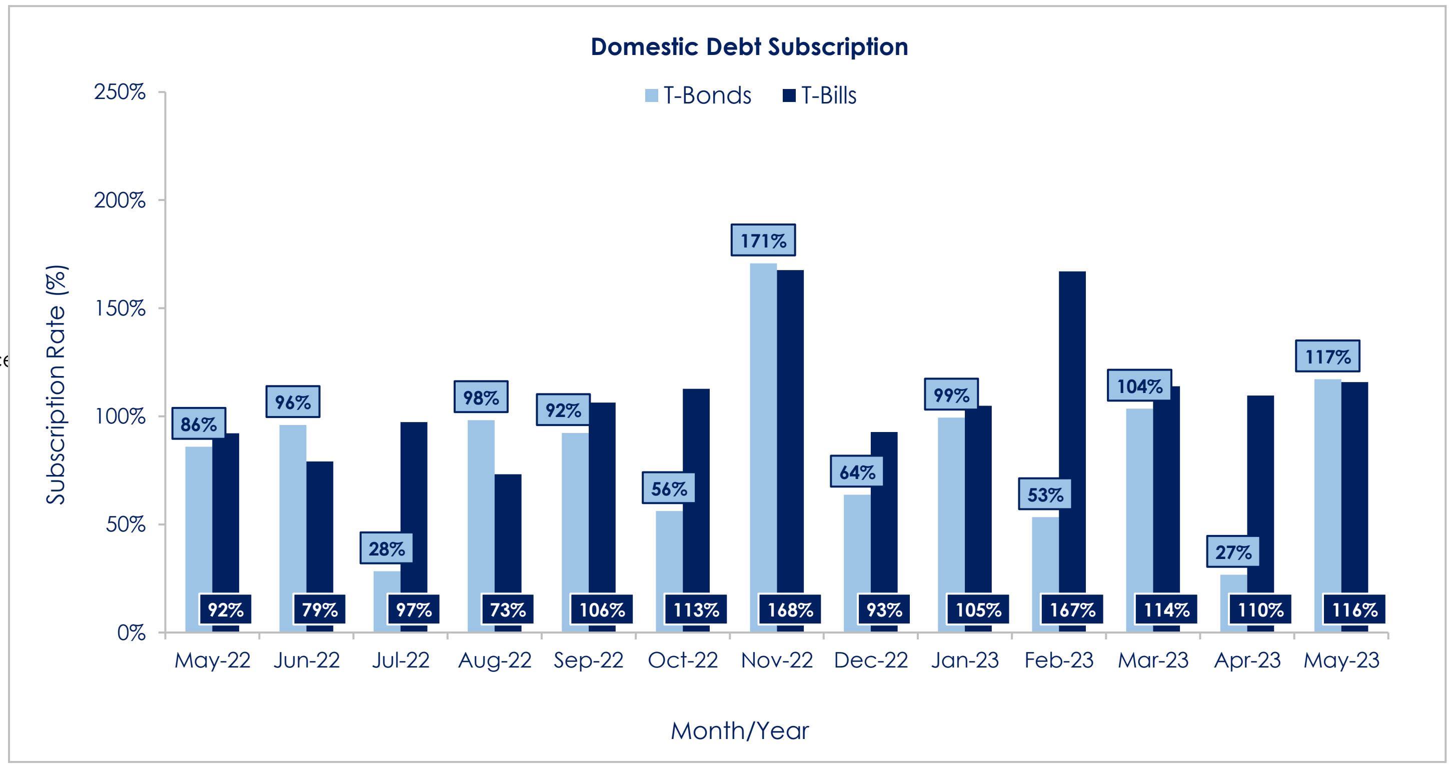
Issue	Issue Date	Offered (KES.Bn)	Bids Received (KES.Bn)	Amount Accepted (KES.Bn)	Performance Rate (%)	Coupon Rate (%)	Implied Yield (%)
IFB1/2014/12	Oct-2014	15	38.8	15.8	258.7	11.00	12.5500
IFB1/2015/12	Mar-2015	25	51.7	25.7	206.8	11.00	12.5750
IFB1/2015/12 (Tap)	Apr-2015	25	51.7	24	206.8	11.00	12.5750
IFB1/2015/9	Dec-2015	30	16.6	14	55.3	11.00	12.5000
IFB1/2016/9	May-2016	30	39.4	34.9	131.3	12.50	12.3000
IFB1/2016/15	Oct-2016	30	35.1	30.6	117	12.00	13.7500
IFB1/2017/12	Feb-2017	30	35.0	6	116.7	12.50	12.8070
IFB1/2017/12 (Tap)	Mar-2017	24	8	7.6	33.3	12.50	12.8070
IFB1/2017/7	Nov-2017	30	45.9	42.0	153	12.50	12.1250
IFB1/2018/15	Jan-2018	40	55.8	5	139.5	12.51	13.6875
IFB1/2018/15 (Tap)	Feb-2018	35	36.2	36.2	103.4	12.51	13.6875
IFB1/2018/20	Nov-2018	50	40.4	27.6	80.8	11.95	13.3250
IFB1/2018/20 Tap	Nov-2018	22.4	8.8	8.7	39.3	11.95	13.3250
IFB1/2019/25	Mar-2019	50	29.4	16.3	58.8	12.20	14.0050
IFB1/2019/16	Oct-2019	60	86.9	68.5	144.8	11.75	13.5485
IFB1/2020/9	Apr-2020	60	68.4	39	114	10.85	13.8807
IFB1/2020/9 (Tap)	Apr-2020	21	37.8	35.4	180	10.85	13.8807
IFB1/2020/6	Jun-2020	26	21.2	19.3	81.5	10.20	12.4000
IFB1/2020/11	Aug-2020	70	101.5	78.6	145	10.90	13.9250
IFB1/2021/16	Jan-2021	50	125.5	81.1	251	12.26	13.5000
IFB1/2021/18	Apr-2021	60	88.6	81.9	147.7	12.67	14.0797
IFB1/2021/21	Sep-2021	75	151.3	106.8	201.7	12.74	13.2000
IFB1/2022/19	Feb-2022	75	132.3	98.6	176.3	12.97	14.1953
IFB1/2022/18	Jun-2022	75	76.4	73.8	101.8	13.74	14.0250
IFB1/2022/18 (Tap)	Jul-2022	20	6.4	6.4	32.1	13.74	14.0250
IFB1/2022/14	Nov-2022	60	91.8	75.6	153.1	13.94	14.1125
IFB1/2022/14 (Tap)	Nov-2022	5	19.1	19.1	382	13.94	14.1125
IFB1/2022/6 (Tap)	Dec-2022	20	10.8	10.8	54	13.22	13.0833
IFB1/2023/17	Mar-2023	50	59.8	50.9	119.5	14.40	14.2344
IFB1/2023/17 (Tap)	Mar-2023	20	12.7	12.7	63.5	14.40	14.2344
IFB1/2023/17 (Tap)	Apr-2023	10	5.1	5.1	51	14.40	14.2344

Source: Central Bank of Kenya

T-Bond subscriptions bounce back temporarily as high T-Bill demand persists

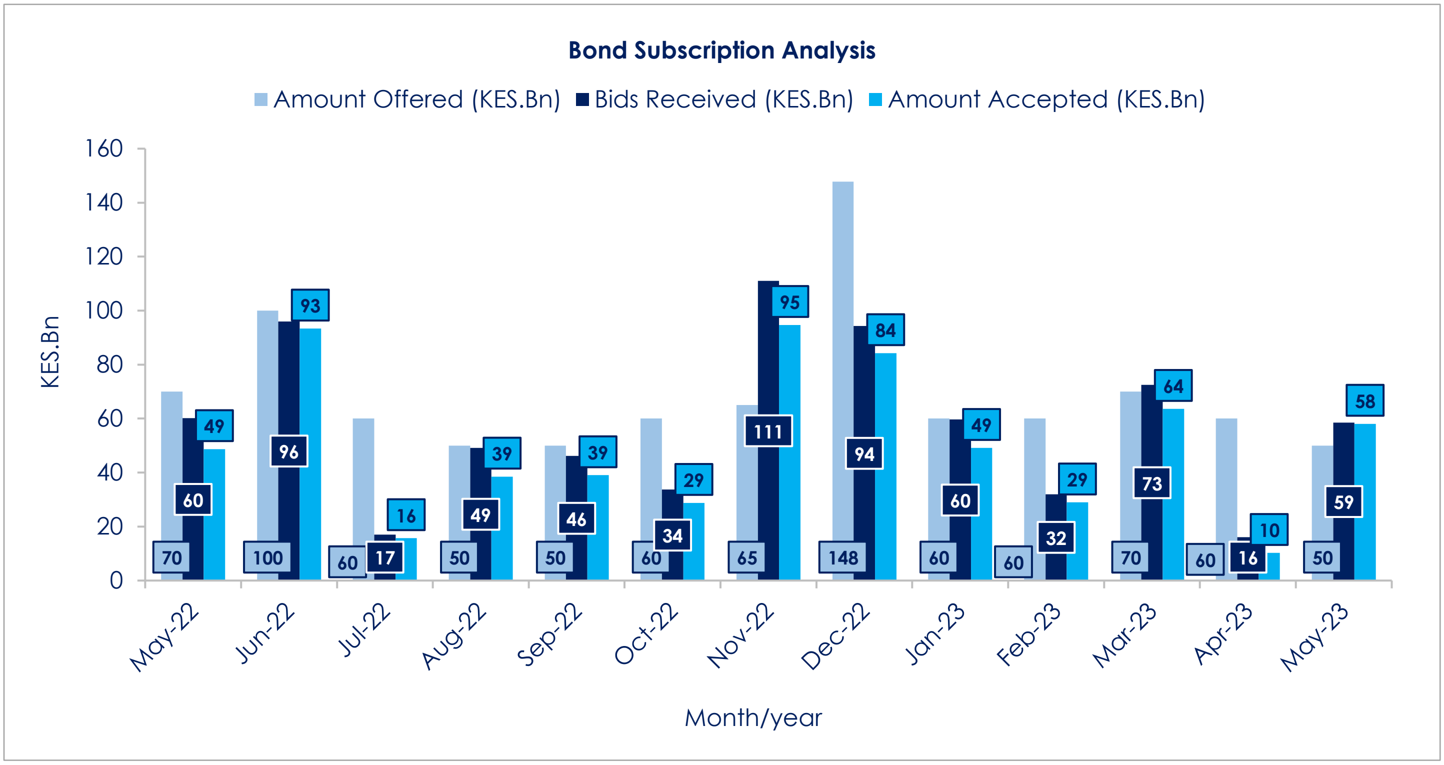
- T-Bill subscriptions increased to 115.8% in May 2023 from 109.6% a month earlier with KES.139Bn worth of bids received against KES.120Bn offered (Figure.1).
- This marked an increase from the KES.105.2Bn received against KES.96Bn offered in April 2023.
- The 91, 182 and 364-Day had subscription rates of 499.9%, 46.6% and 31.4% compared to 534.4%, 21.9% and 27.3% respectively in April.
- The high subscription for the 91-Day T-Bill illustrates the investors' strategy to counter duration risks.
- Over the same period, we observed a reversal in T-Bond demand with subscriptions increasing sharply to 117.1% from 26.7% in April with KES.58.6Bn received in bids against the KES.50Bn offered (Figure.1 & 2).
- This increase can be explained by the issuance of a short-term bond **FXD1/2023/3**.

Figure.1: T-Bond subscription in May 2023 highest Year to Date (YTD)



Source: Central Bank of Kenya

Figure.2: T-Bond amount accepted in May 2023 second highest Year to Date (YTD)

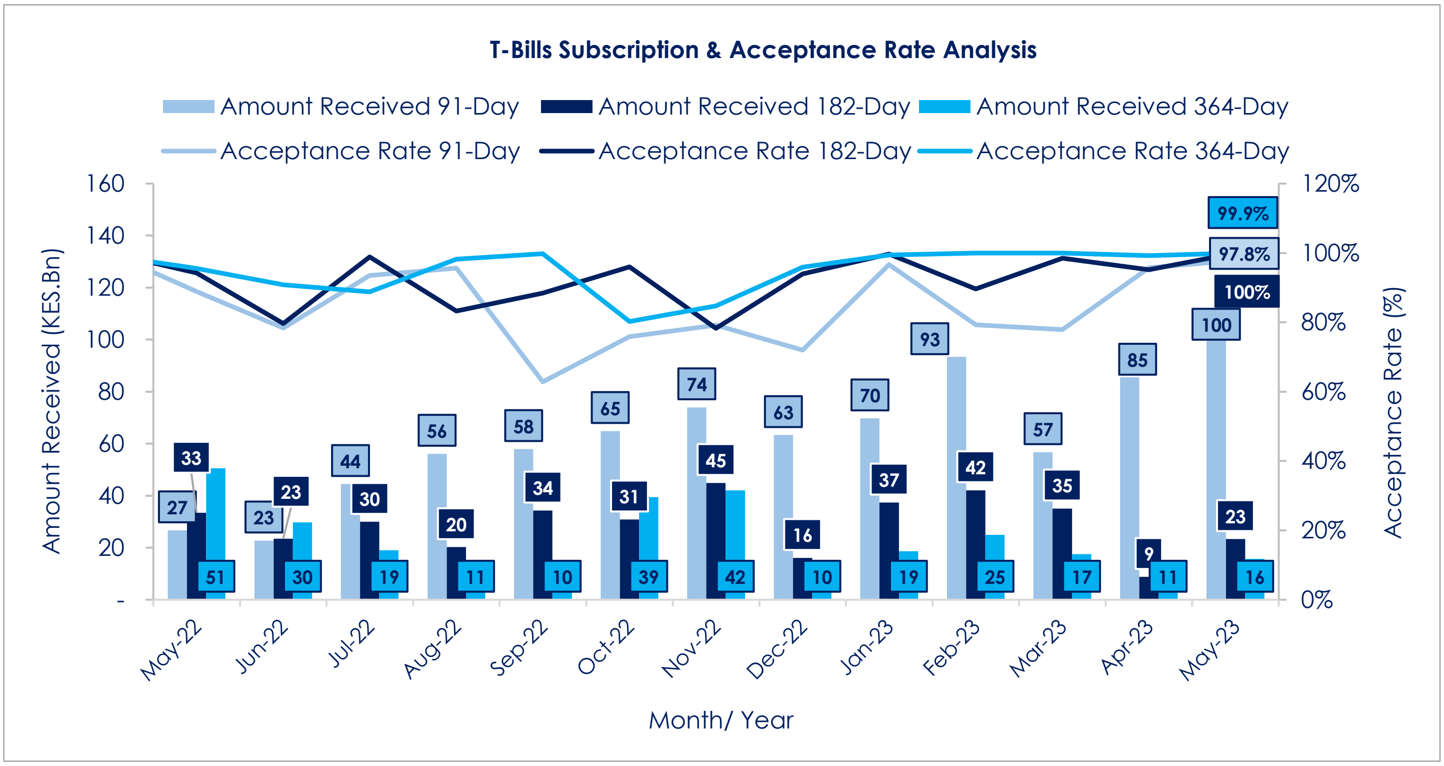


Source: Central Bank of Kenya

CBK's T-Bill acceptance rate rises in May 2023 in efforts to bridge budget deficit

- There was a general rise in the CBK's acceptance rate for T-Bills in May (98.4%) compared to April (96%).
- Acceptance rates for the 91-Day, 182-Day and 364-Day T-Bills stood at 97.8%, 100% and 99.9% in May 2023 compared to 95.7%, 95.2% and 99.2% in April 2023 (Figure.3).
- The National treasury is faced with the challenge of managing the cost of deficit financing at a favourable cost while increasing the Average Term to maturity of public debt.
- We expect demand for the 91-Day paper to remain high given the fiscal imbalance and rising interest rate environment.
- With investors focusing on **IFB1/2023/7**, we might see a decline in T-Bill subscriptions in June and then an increase in July.

Figure.3: 182 Day T-Bill acceptance rate in May 2023 at 100%

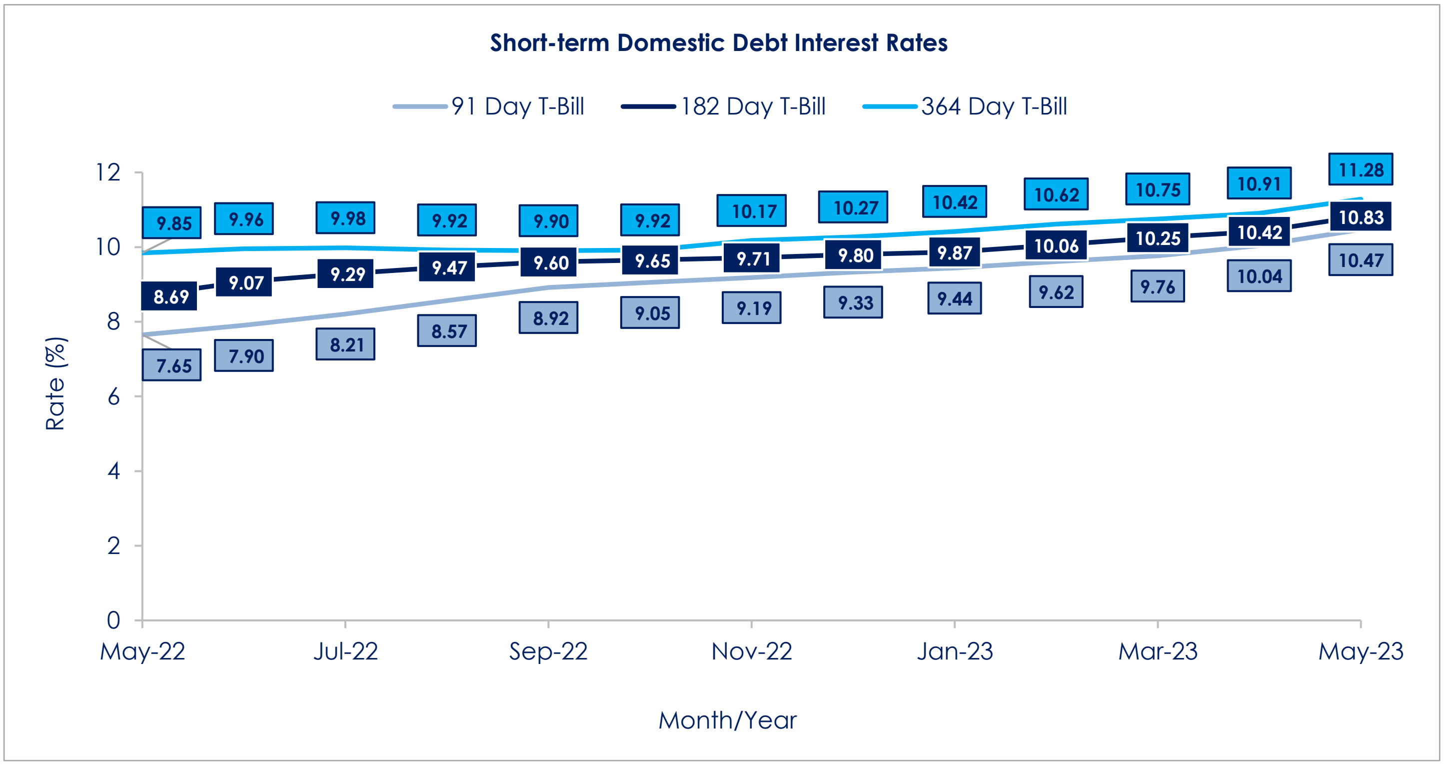


Source: Central Bank of Kenya

Average 364 Day T-Bill surpasses 11% in May 2023

- Average T-Bill rates continued on an upward trajectory with the 364 Day T-Bill rates surpassing 11% in May 2023 (Figure.4).
- The 91, 182 and 364-day average rates increased to 10.5%, 10.8% and 11.3% from 10%, 10.4% and 10.9% in April 2023 respectively.
- Over the last one year, average 91, 182 and 364-Day T-Bill rates have increased 281.8, 213.6 and 143.5 bps respectively showing the impact of CBR revisions, investor expectations, high inflation and increased fiscal deficit financing.
- The implementation of risk-based credit pricing by banks will in our opinion exert further pressure on domestic debt rates as banks lend to the private sector as an alternative to investing in Government debt.

Figure.4: T-Bill rates continue trending upwards in May 2023



Source: Central Bank of Kenya

Average inter-bank rates rise in May 2023

- Average inter-bank rate rose to 9.4% in May 2023 from 8.6% in April reflective of the general rise in interest rates (Figure.5).
- Trading volumes over the same period increased 16.1% to KES.474.4Bn from KES.408.7Bn.
- Over the same period, excess reserves (the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) increased 96.1% from KES.64.1Bn in April 2023 to KES.125.7Bn in May 2023 (Figure.6).

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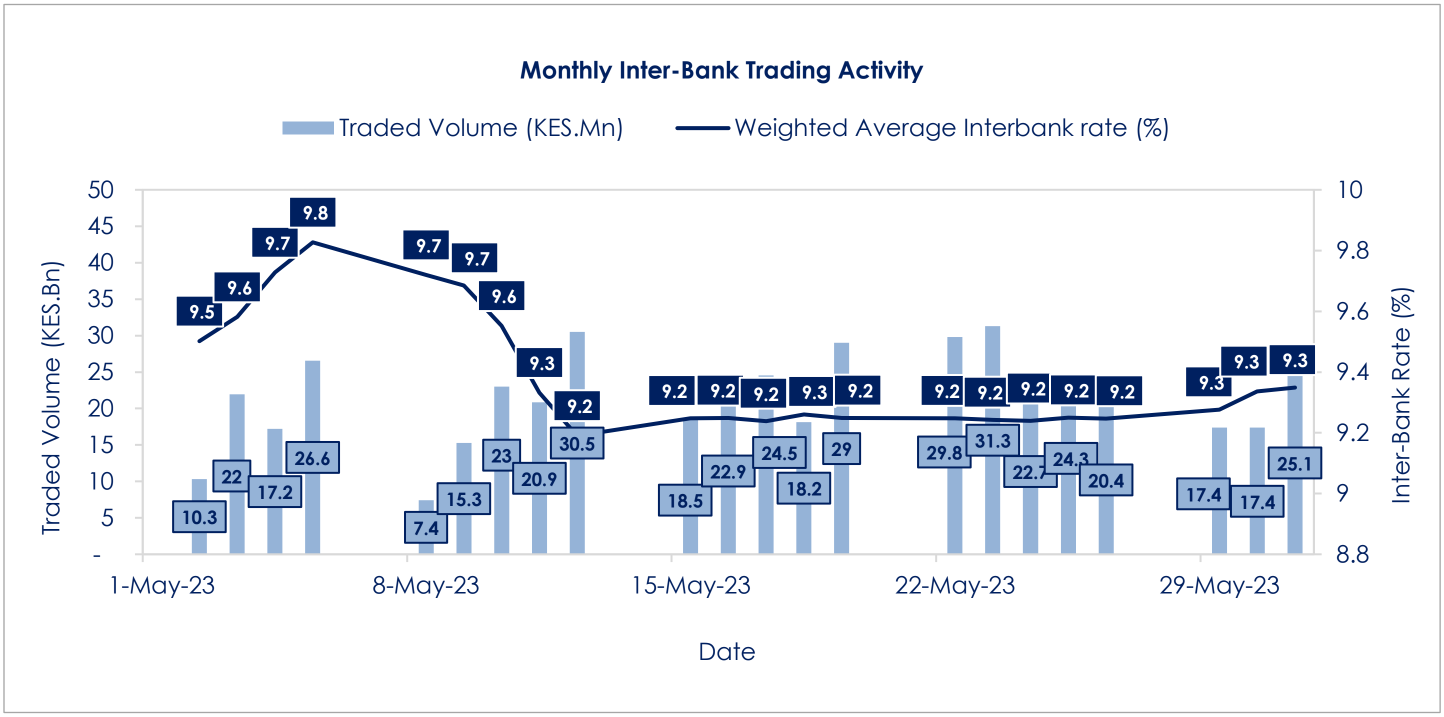
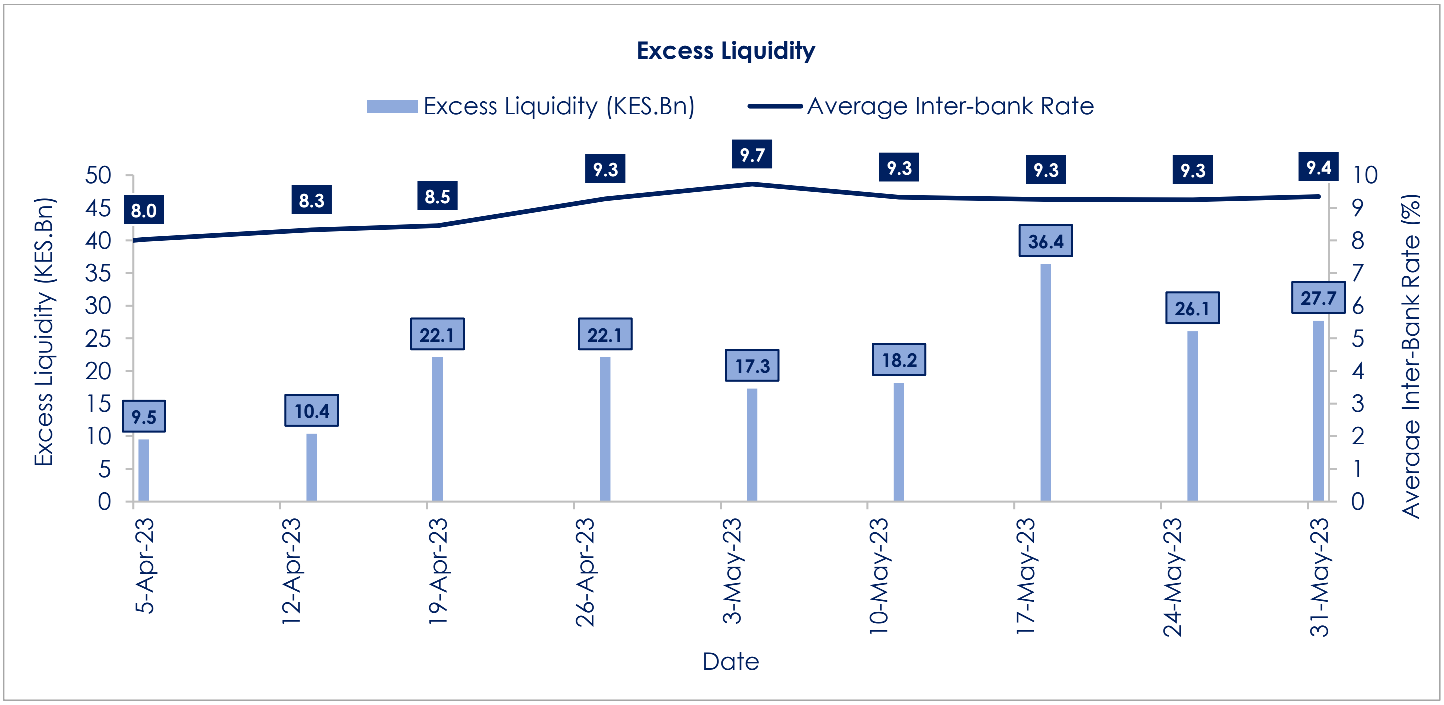
Figure.5: Uptick in average inter-bank lending rates in May 2023 due to tight market liquidity



Source: Central Bank of Kenya

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

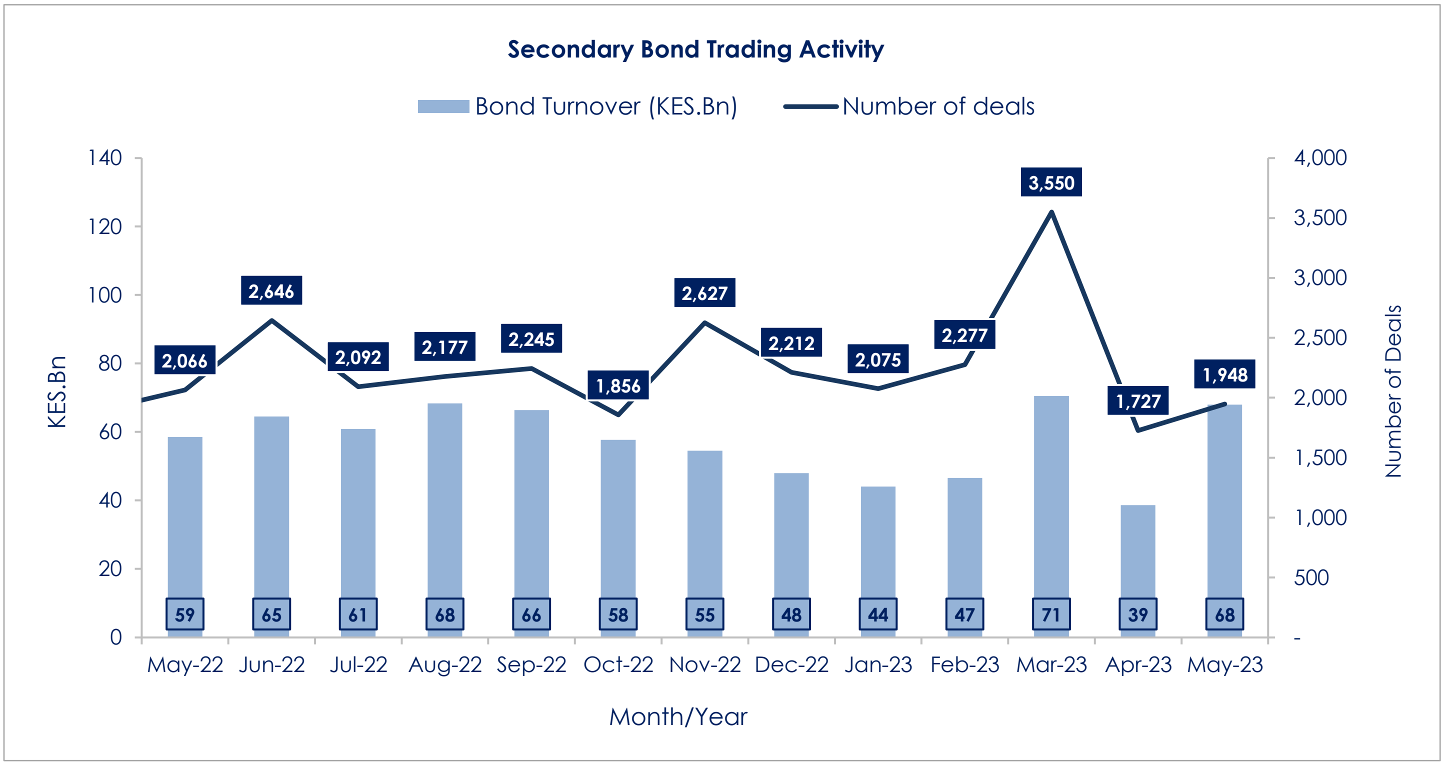


Source: Central Bank of Kenya

Secondary bond market turnover up 75.8% in May 2023

- Secondary bond market trading increased 75.8% to KES.68Bn from KES. 38.7Bn in April 2023 while the number of deals increased 12.8% to 1,948 from 1,727. (Figure. 7).
- We expect higher trading activity in June 2023 primarily due to high demand for **IFB1/2023/7**.

Figure.7: Secondary trading activity increased in May 2023

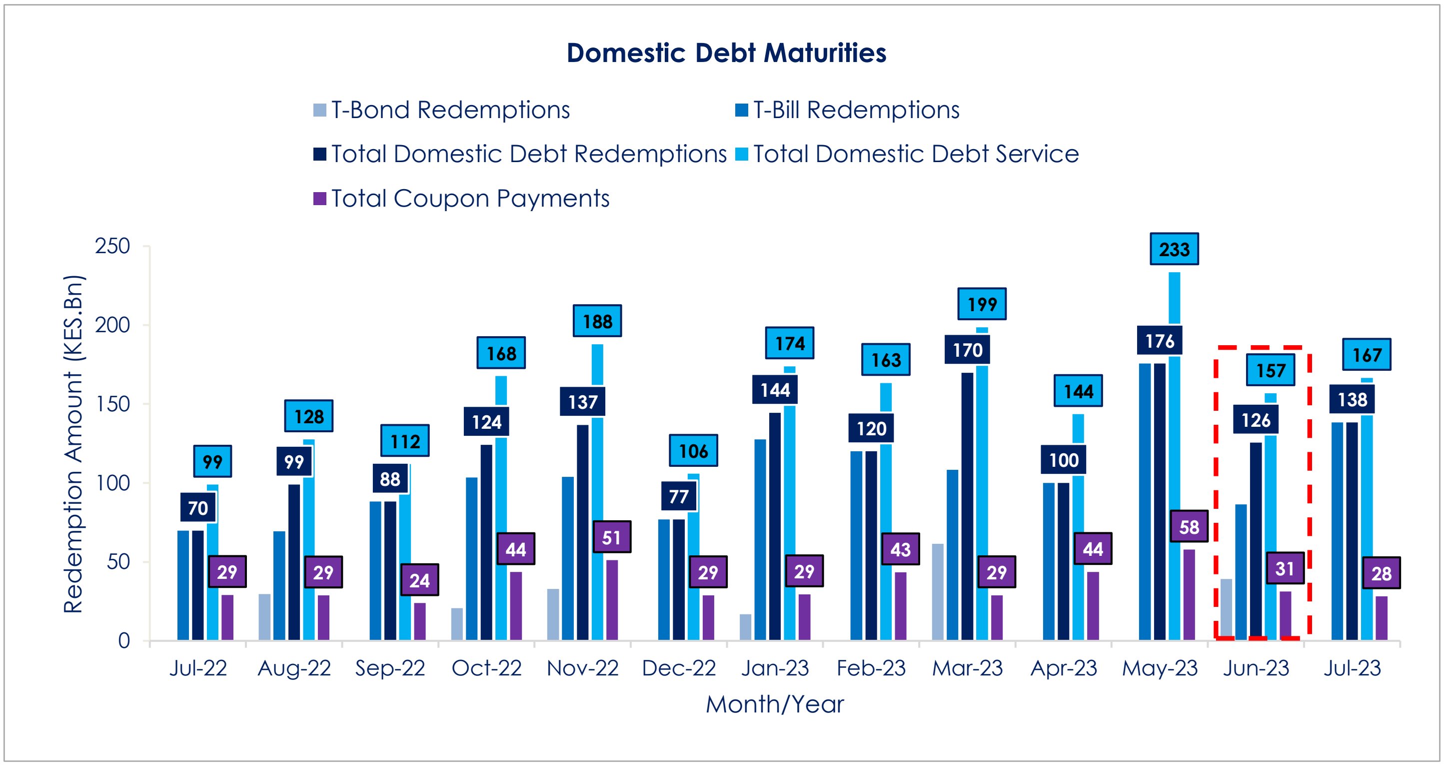


Source: Central Bank of Kenya

Domestic debt service in June 2023 at KES.156.9Bn

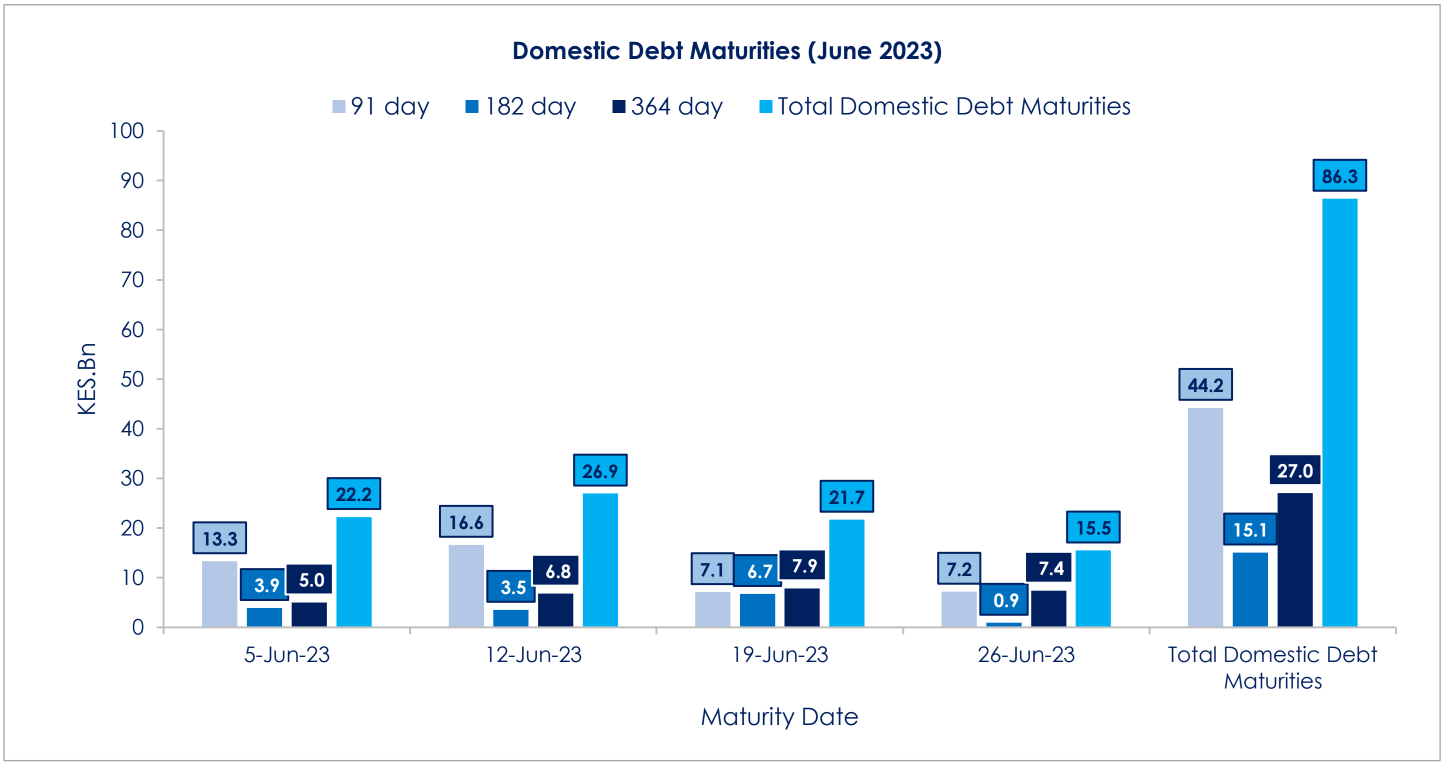
- Total domestic debt service is set to decline 32.8% in June 2023 to KES.156.9Bn from KES.233.5Bn in May 2023. (Figure.8).
- This comprises of KES.39.3Bn in T-Bond redemptions (Maturity of **FXD1/2013/10**), KES.86.3Bn in T-Bill redemptions and KES.31.3Bn in coupon payments.
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.44.2Bn, KES.15.1Bn and KES.27Bn respectively with the second week of the month having the highest redemptions at KES.26.9Bn (Figure.9).
- Debt service still remains high which combined with a wide budget deficit so close to the end of the fiscal year, point to the CBK's likely acceptance of aggressive investor bids in this auction.

Figure.8: Material decline in debt service in June 2023



Source: Central Bank of Kenya

Figure.9: Weekly debt maturities June 2023

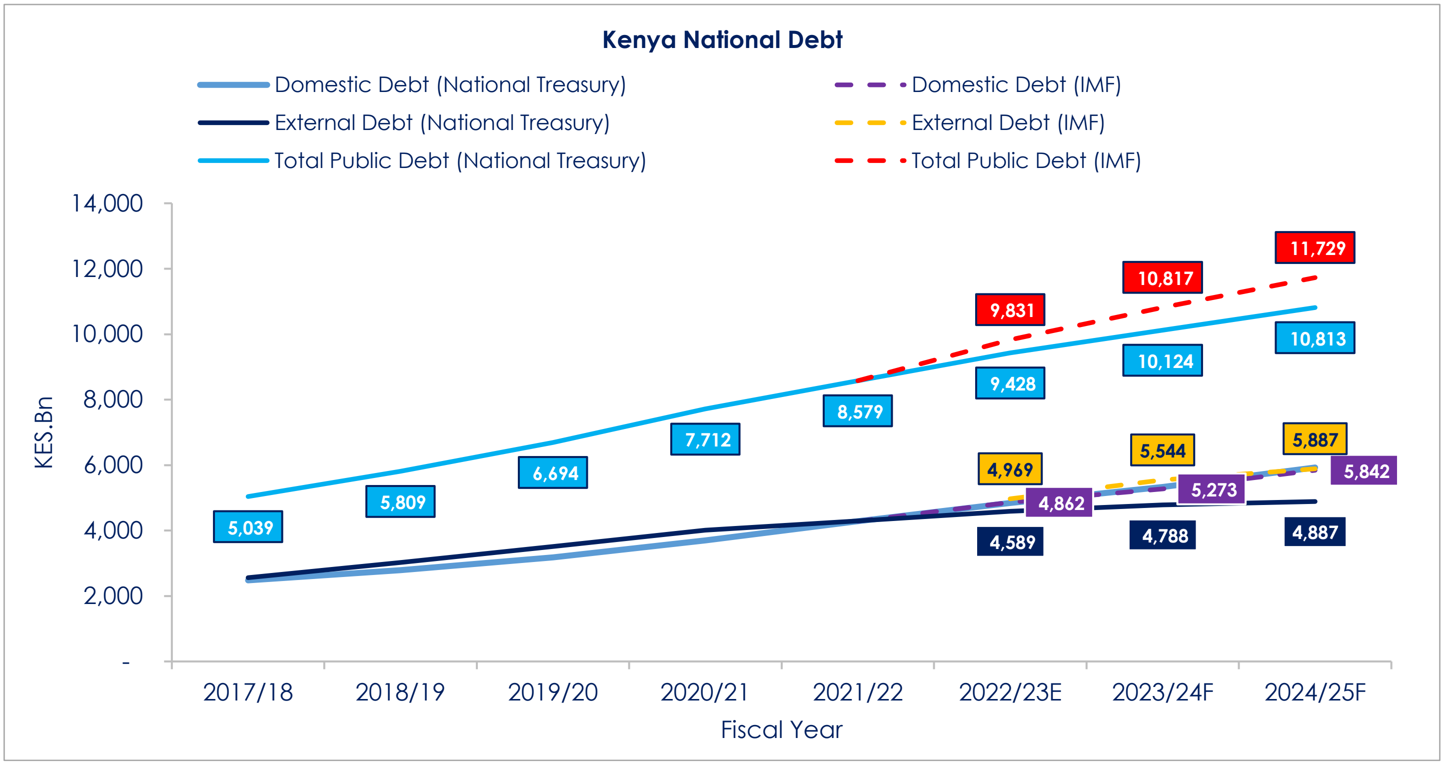


Source: Central Bank of Kenya

Kenya public debt analysis - Gross debt stock forecasts are underestimated

- Gross debt stock at the end of the 2022/23 fiscal year is estimated at KES.9.42Tn and KES.9.83Tn by the National Treasury and the IMF (December 2022 country report) respectively (Figure.10).
- The estimate by the National Treasury appears to be understated considering that the most recently available data at the end of March 2023 shows the country's total debt stock at KES.9.39Tn.
- On this run rate we see total public debt at between KES.9.6 - 9.7Tn in 2022/23 which is closer to the IMF estimates.

Figure.10: Kenya's total public debt expected to cross KES.10Tn in 2023/24



Source: National Treasury & International Monetary Fund (IMF)

- We further expect Government debt to increase at a faster pace in 2023/24 and 2024/25 with the IMF giving what we consider more realistic forecasts based on the following:

  1) Underperformance of tax revenues amid subdued economic activity translating to increased fiscal deficit financing.

  2) Refinancing of the US$.2Bn (KES.275Bn) Eurobond (**XS1028952403**) that matures in June 2024.

  3) Increased external debt stock through a combination of increased external financing (evident from the 2022/23 supplementary budget 1) following low domestic debt uptake and currency depreciation.

National Treasury increasingly likely to miss revised 2022/23 revenue targets

- With only two months to the end of the 2022/23 fiscal year, it is evident that the National Treasury will miss its overall revenue targets having raised KES.2.32Tn or 64.4% of its KES.3.61Tn total revenue target (Table.6 and Figure.11).
- Net domestic borrowing at KES.406.6Bn is equivalent to 45.9% of the revised KES.886.5Bn target with minimal movement from 44.7% at the end of March 2023.
- This is a reflection of the low investor appetite for Government debt in auctions.
- This would also have been equivalent to 39.1% of the original domestic borrowing target KES.1.04Tn.
- Another concern is the underperformance of tax revenue at KES.1.57Tn or 74.6% of the revised target.
- This is also short of our linear target of 83.3% after the first 10 months of the fiscal year.
- On the basis of above, we see increased reliance on external financing with the National Treasury expected to contract additional funding from the IMF, World Bank and bilateral lenders in the last two months of the fiscal year.

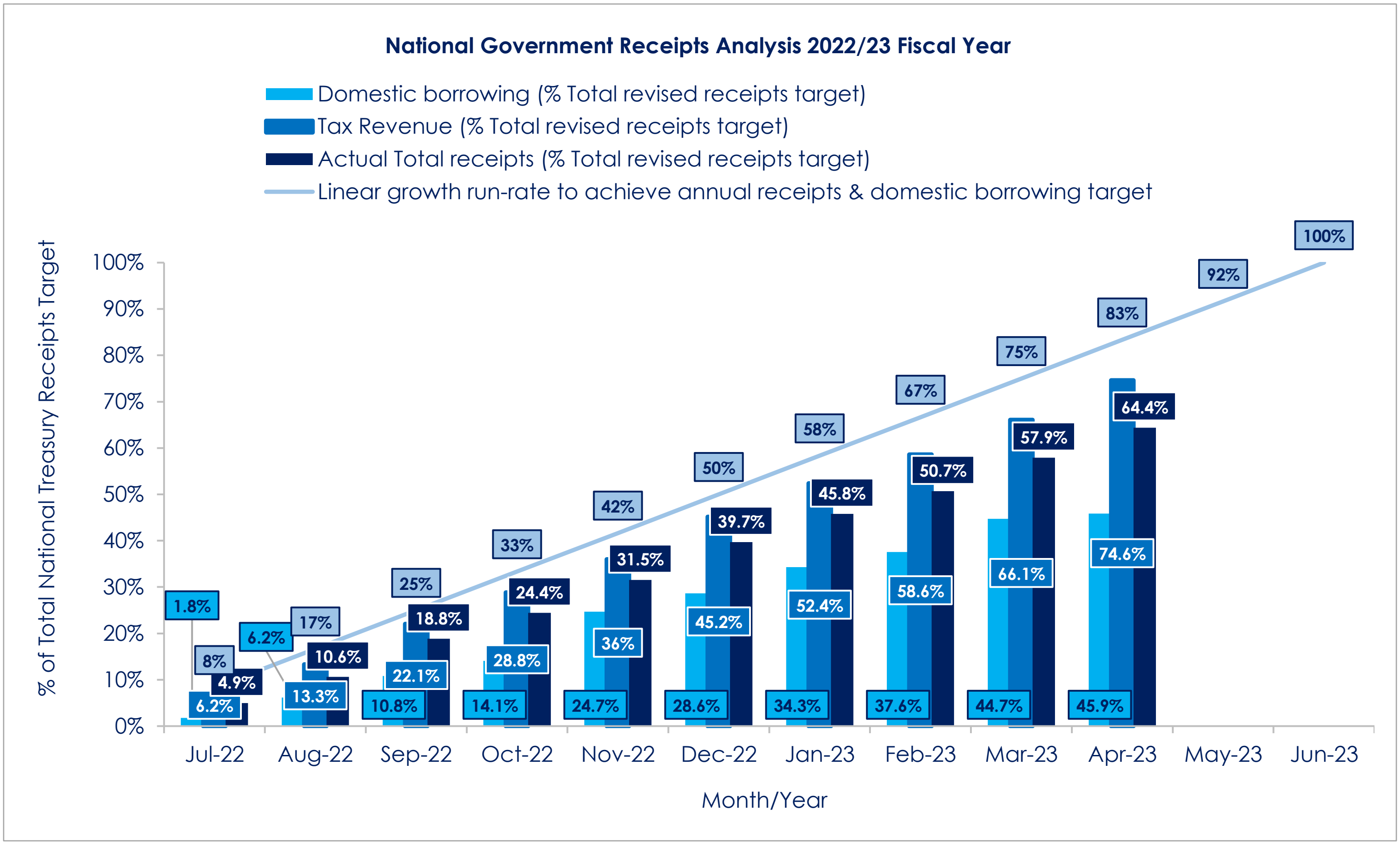
Table.6: All Government receipts below target with two months of the 2022/23 fiscal year left

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 April 2023	Proportion of Total Receipts 28th April 2023
Opening Balance (1st July)				616.5	
Tax Revenue	**2,071.9**	**2,108,3**	**1.8%**	**1,573.2**	**74.6%**
Non-Tax Income	69.7	83.7	20.1%	66	78.9%
Domestic Borrowing*	**1,040.5**	**886.5**	**-14.8%**	**406.6**	**45.9%**
External Loans & Grants	349.3	520.6	49%	264.4	50.8%
Other Domestic Financing	13.2	13.2	0	15.5	117.4%
Total Revenue	**3,544.6**	**3,612.3**	**1.9%**	**2,325.8**	**64.4%**
Linear Run Rate target (9 months of fiscal year 2022/23)					**83.3%**

* 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.11: Actual receipts remain well below our linear target run-rate

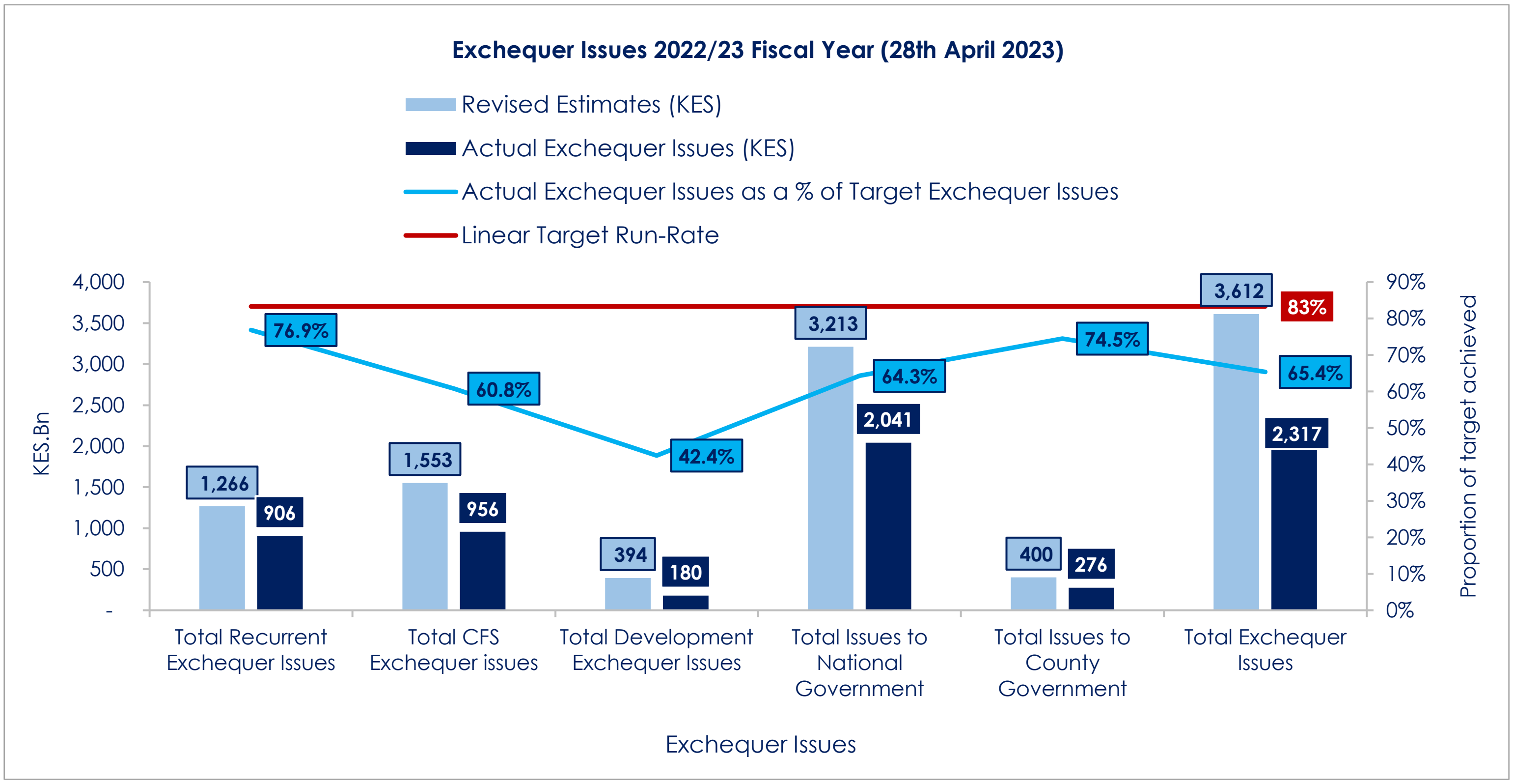


Source: The Kenya Gazette Vol. CXXV - No.86 14th April 2023

Government expenditure 2022/23 fiscal remains below target due to revenue shortfalls

- Our linear run rate with two months of the 2022/23 fiscal year remaining stands at 83.3% (Figure.12).
- All National Treasury exchequer issues at the end of April 2023 remain below this target due to the prevailing cash crunch.
- We however note that there was a marked increase (29.6%) in issues to the County Government in April to KES.275.7Bn equivalent to 74.5% of the 2022/23 fiscal year target.
- Development expenditure remains the hardest hit with KES.180.1Bn spent against a target of KES.393.8Bn this being equivalent to a paltry 42.4%.

Figure.12: Recurrent expenditure at 47% of total budget in H1 2022/23

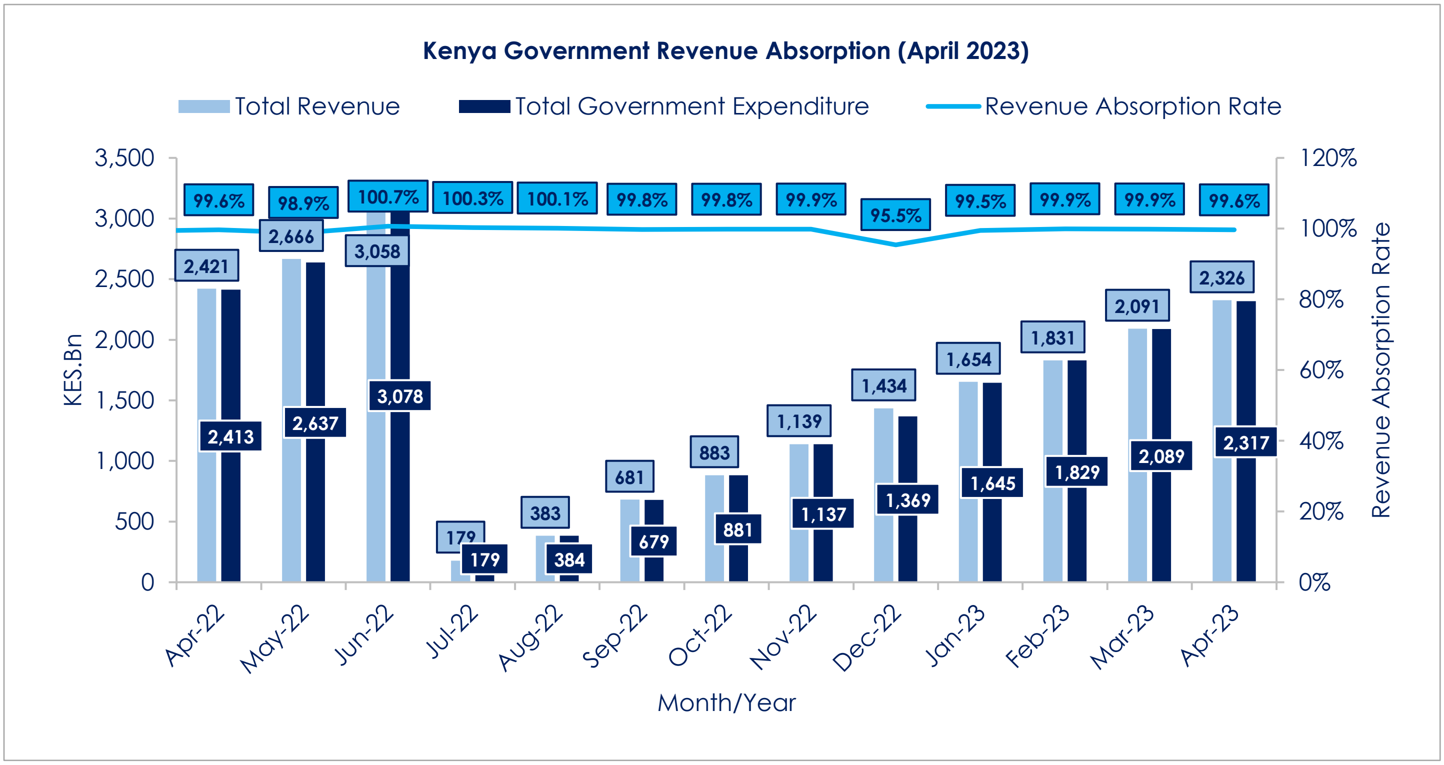


Source: The Kenya Gazette Vol. CXXV - No.86 14th April 2023

Government Revenue Absorption remains close to 100%

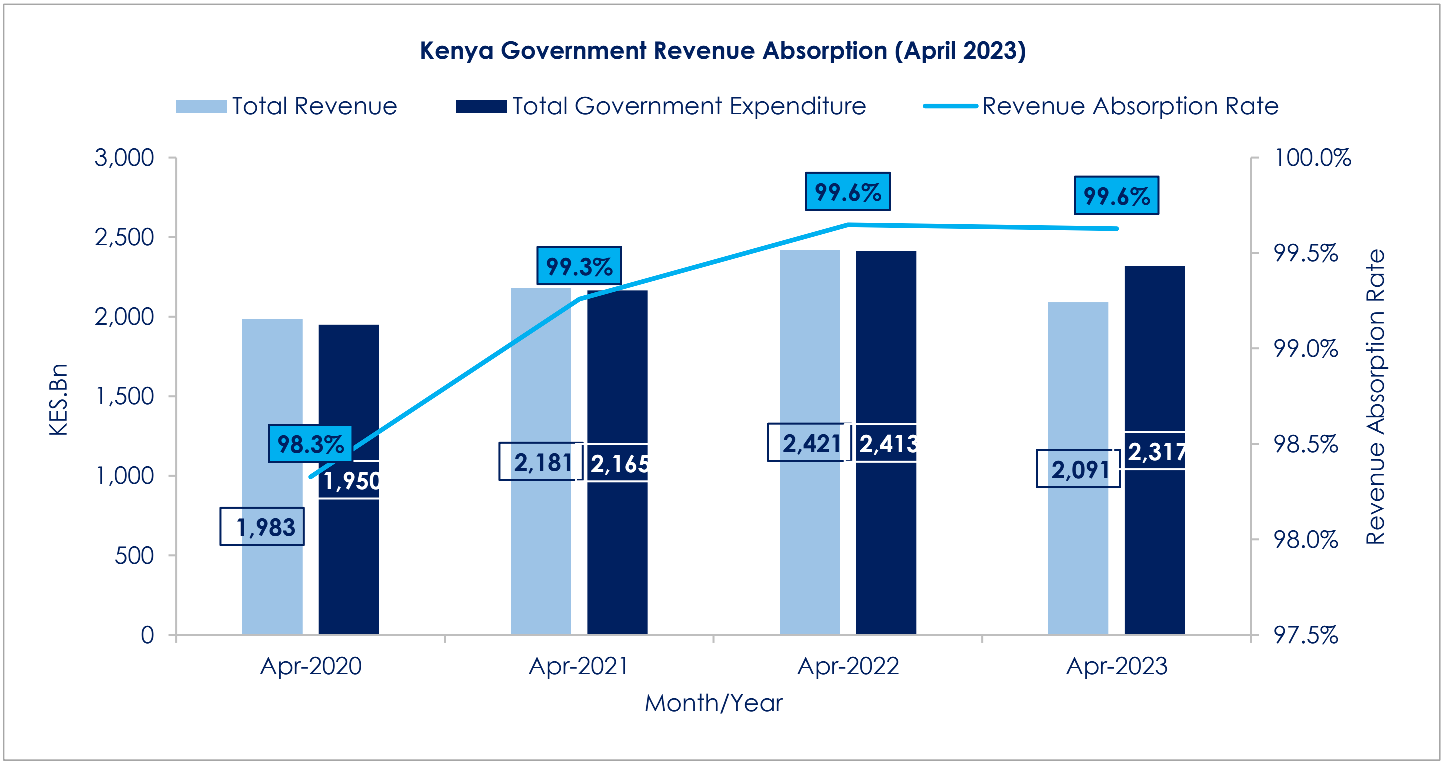
- Government Revenue Absorption Rate (RAR) is the proportion of Government receipts used to finance its expenditure.
- This remained close to full subscription in April 2023 as was the case the previous month showing the financing constraints faced by the Government in deficit financing (Figure.13).
- We however see a year decline in both Government revenue (-13.6%) and expenditure (-4%) in April 2023 indicative of an expected shortfall in revenue necessitating in expenditure cuts in the 2022/23 fiscal year.

Figure.13: Government revenue utilization remains at close to full utilization in March 2023



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

Figure.14: Revenue absorption highest in March 2023

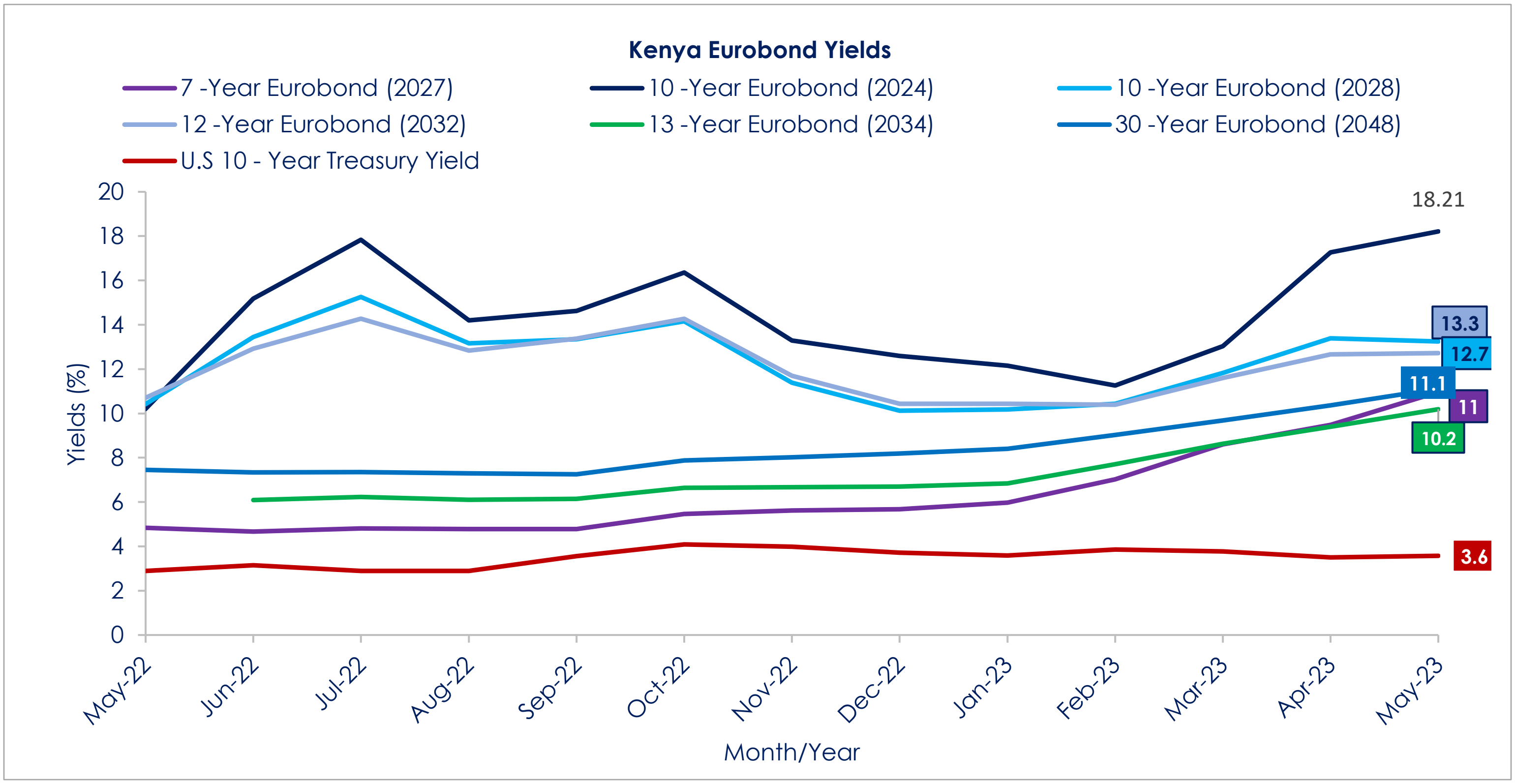


Source: The Kenya Gazette Vol. CXXV - No.86 14th April 2023

Average Kenya Eurobond yields decline in May 2023

- The average yield on Kenya Eurobonds rose 18 bps in April compared to the previous month largely because of the 95 bps and 23 bps increase in the average yields on 10 -Year Eurobond (2024) and 7 -Year Eurobond (2027) (Figure.15).
- The yields on 10 -Year Eurobond (2024) **XS1028952403** rose to as high as 20.9% on rising credit risk concerns on 2nd May before receding following financing commitments from the IMF and the World Bank.
- The US 10-year treasury yield declined 8 bps over the same period but remains well below the October 2022 peaks of +4%.
- Kenya Eurobond yields will remain volatile for the rest of the year due to the contrasting impacts of rising credit risk and commitments from lenders on the refinancing of bond nearing maturity.
- **XS1028952403** remains an attractive investment opportunity on the basis of the high yields and short term to maturity with investors likely to benefit from short-term price volatility.

Figure.15: 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 31st May 2023 against those as at 19th May 2023 (Issuance of **FXD1/2023/003**) and one year ago, shows an increase across the curve. (Table.7 and Figure.16).
- 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.

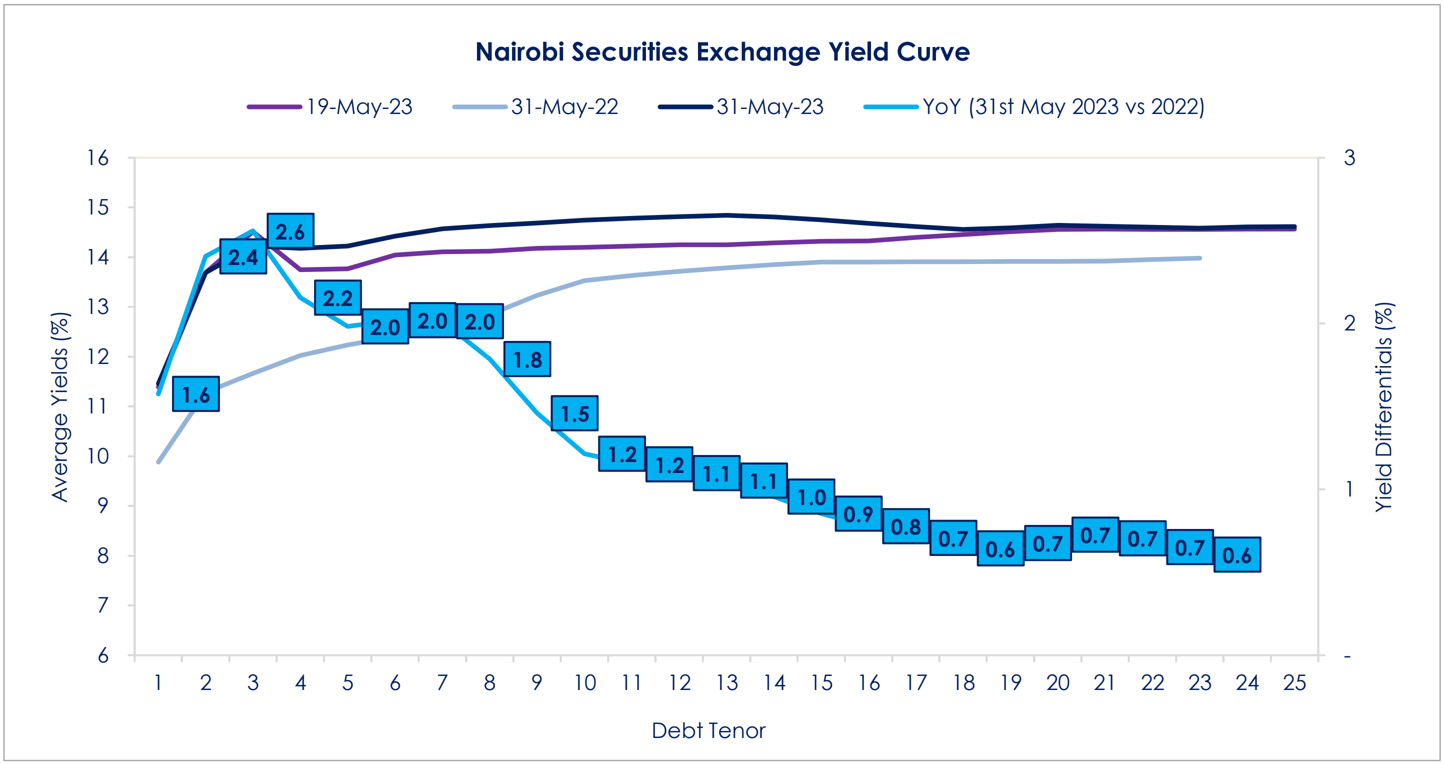
4) High inflation with investors bidding higher to maintain positive real return on capital invested.

Table.7: Yield curve has significantly shifted upward across all tenors

Tenor	Yields (19th May 2023)	Yields (31st May 2022)	Yields (31st May 2023)	∆ (31st May 2023 vs 19th May 2023) Bps	YoY ∆ (31st May 2023 vs 2022) Bps	Sterling Capital Yield Curve (June 2023)
1	11.3900	9.8810	11.4570	↑ 6.7	↑ 157.6	11.65
2	13.6872	11.2832	13.6883	↑ 0.1	↑ 240.5	13.75
5	13.7685	12.2397	14.2228	↑ 45.4	↑ 198.3	14.40
10	14.1966	13.5293	14.7442	↑ 54.8	↑ 121.5	14.90
15	14.3196	13.9005	14.7543	↑ 43.5	↑ 85.4	15.00
20	14.5610	13.9174	14.6444	↑ 8.3	↑ 72.7	15.00

Source: Nairobi Securities Exchange & Sterling Capital Research

Figure.16: Higher year on year differentials across all tenors



Source: Nairobi Securities Exchange

Trading ideas - Invest in Kenya Eurobonds

- Investors with a high-risk tolerance 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 short term trading opportunities arise (Table.8).
- **XS102895240** had a yield of 15.5% as at 1st June 2023 with the bond close to 12 months to maturity reducing the risk associated with longer dated bonds.
- The bond has seen a steep decline in yields in recent weeks from yields as high as 20.3% on the 24th of April 2023 as positive sentiment from the IMF and signs of steps to refinance the bond worked to calm investor nerves.

Table.8: Trading ideas - Consider Kenya Eurobonds

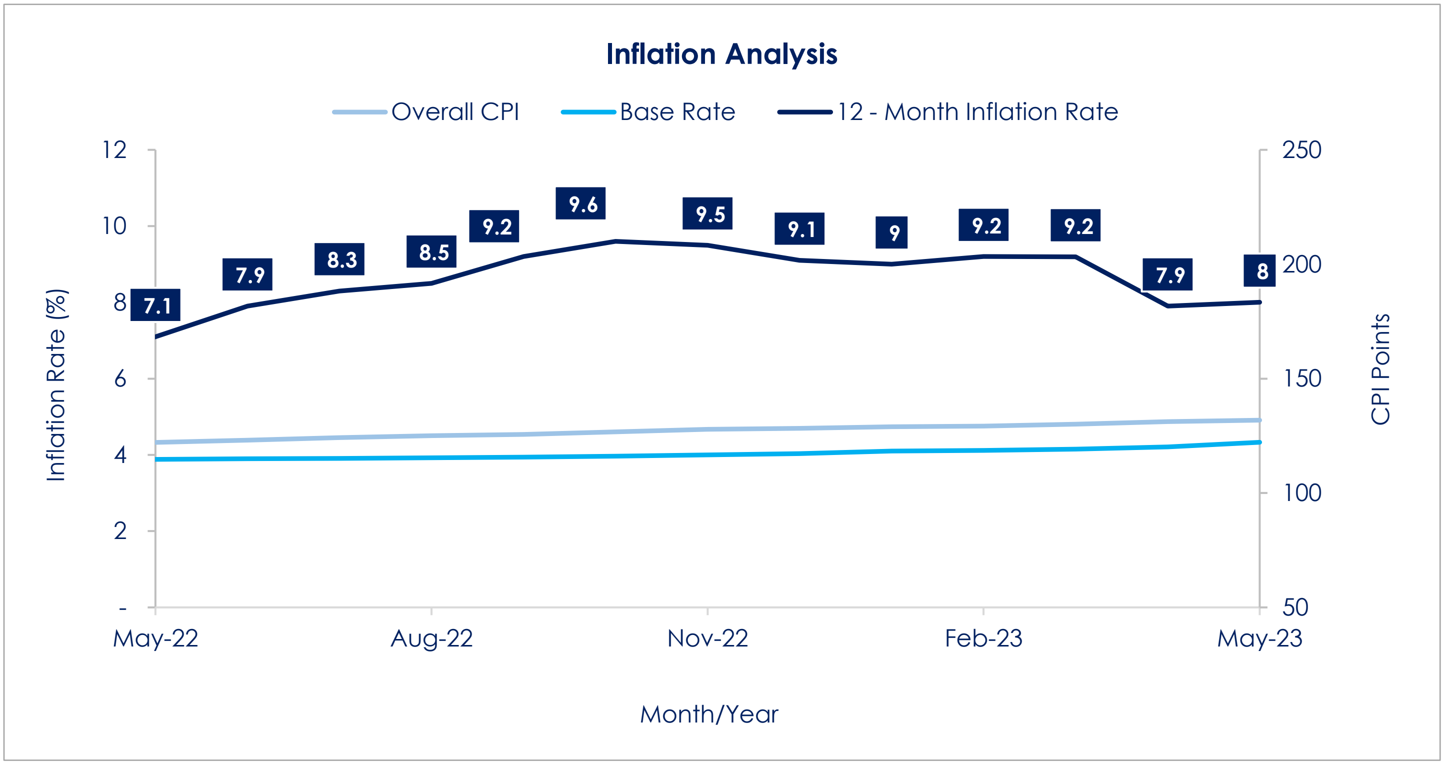
ISIN Code	Issue date	Tenor (Years)	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (1st June 2023)	Maturity
XS102895240	Jun-14	10	2	6.875%	15.52%	Jun-24
XS184343584	May-19	7	0.9	7%	12.96%	May-27
XS178171054	Feb-18	10	1	7.25%	11.94%	Feb-28

Source: Bloomberg & CBK

May 2023 Inflation ticked up slightly month on month to 8%

- May 2023 inflation ticked up slightly to 8% from 7.9% in April 2023 on account of an increase in electricity prices due to higher tariffs and the scaling down of the fuel subsidy (Figure.17).
- The rate was in line with our forecasted range of 7.7% - 8.2% for the month.
- Overall, there was marginal 1.4% month on month change in food and non-alcoholic beverages whose contribution to inflation is highest at 32.9%.
- Notably, year on year inflation rose from 7.1% in May 2022 due to an increase in prices of commodities under food and non-alcoholic beverages (10.2%), housing, water, electricity, gas and other fuels (9.7%) and transport (10.1%).
- We expect the long rains to continue moderating inflationary pressure with our June 2023 forecast at 7.6% - 8.1%.
- We are, however, cautious of the expected impact of higher taxes as proposed in the 2023 Finance Bill which are likely to act as a counterbalance to a reduction in inflation as producers push on higher costs to consumers.
- While we do note a decline in global fuel prices, we do not expect this to translate to lower pump prices locally due to currency depreciation.

Figure.17: June 2023 inflation forecast at 7.6% - 8.1%



Source: Kenya National Bureau of Statistics

MPC retains CBR at 9.5% during May meeting

- The Monetary Policy Committee (MPC) met 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.
- In line with our expectations, the MPC maintained the CBR at 9.5% informed by an increasingly stable inflationary environment.
- The committee had surprised investors and market players in March 2023 by raising the CBR by 0.75 Bps from 8.75% to 9.5% informed by rising inflationary pressures.
- Given the continuous increase in Non-Performing Loans (NPLs) which stood at 14.6% in April 2023, a rate reflective of the difficult macro environment and rising interest rates, we believe the MPC is likely to hold the rate unchanged in the short term.
- Other points of discussion included global economic developments, current account position, private sector credit performance, private sector and the sufficiency of our current foreign exchange levels, all of which can be read here.

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