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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Update

FXD1/2016/10 & FXD1/2023/5

July 2023

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July 2023 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) re-opened **FXD1/2016/10** (3.2 years to maturity) and issued a new bond **FXD1/2023/5**, with a market-determined coupon to raise KES.40Bn;

  FXD1/2016/10 (3.2*)
  FXD1/2023/5 (5*)

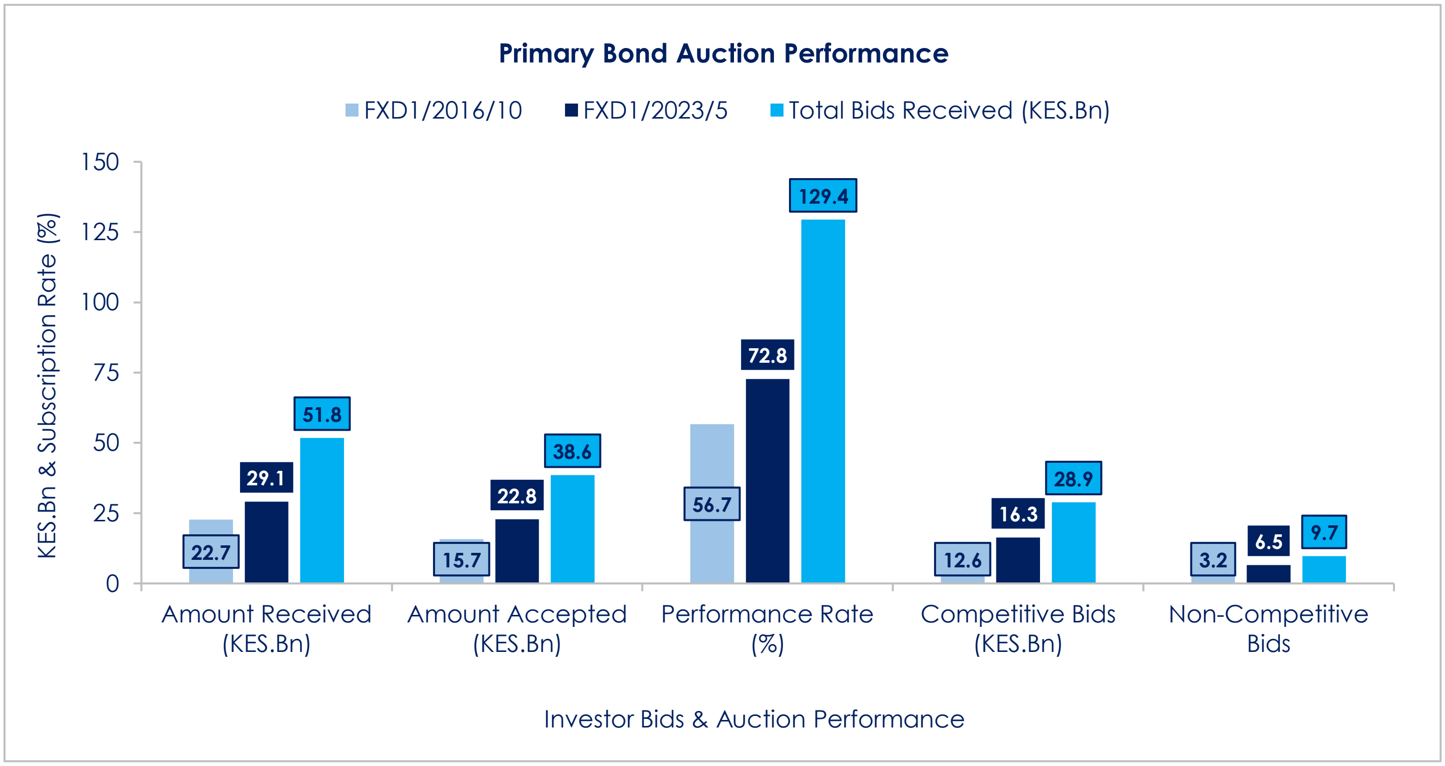
  ***Years to maturity**

- The period of sale was from 28th June to 11th July 2023.

Subscription Rates

- The bonds were oversubscribed in line with our expectations in our July 2023 Fixed Income report "Funding the KES.718Bn deficit" attributable to their relatively short tenors and low funding target (Figure.1).
- Also notable is that 74.9% (KES.28.9Bn) of total bids accepted (KES.38.6Bn) were competitive showing investors' awareness of current Government's fiscal position and interest rate environment.
- Investors were also guided by both the auction outcome of **IFB1/2023/7** (Where there was a significant increase in Weighted Average Rate (WAR) of accepted bids at 15.837%) and the recent CBR revision by 100bps to 10.5%.

Figure.1: Primary Bond Auction subscription



Source: Central Bank of Kenya

Weighted Average Rates

- We have compared our predicted Weighted Average Rates (WAR) ranges as indicated in our July 2023 Fixed Income Report with the CBK's accepted WAR and observe that our predictions in recent auctions have been conservative (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)
FXD1/2016/10	15.70 - 15.99	16.328	+48.3
FXD1/2023/5	15.99 - 16.20	16.844	+74.9

Source: Central Bank of Kenya

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - The yield curve continues to shift upwards on a weekly basis with WAR of accepted bids for **FXD1/2016/10** (16.328%) and **FXD1/2023/5** (16.844%) higher than the NSE yield curve rate by 207.9 bps and 248.2 bps respectively (14.2494% and 14.3621%) as at 7th July 2023.

   This is a direct result of the following:

   a) The CBR has been revised five times from 7% in March 2022 to 10.5% in June 2023.

   b) The huge disparity between government revenue and income resulting in a huge budget deficit combined with underperformance of borrowing from both domestic and external sources.

   c) Investors demanding a higher return for capital invested due to rising inflationary pressure.

- Higher yields on the secondary bond market will prompt investors to price future primary bond auctions upwards meaning rising rates in subsequent auctions in the short term (At least 1 year).
- The above trend combined with the need to finance the budget deficit will force the CBK to continue accepting aggressive investor.

2) **Market Liquidity** - The CBK has been issuing Term Auction Deposits (TADs) since the beginning of July 2023 in a bid to mop up excess liquidity from the market with the rate on 11th July at 9%.

   Further, the latest reverse repo (30th June 2023) was 10.7%.

   Consequently, the interbank rates have declined to 8.6% from 9.8% in the prior month indicative of improving liquidity.

   The bulk of investor capital has been been directed to the 91-day T-Bill as shown in the [latest auction] dated 10th July 2023.

3) **Investment Case** - We recommend the following fixed income investment strategies on account of rising interest rates:

   a) Invest in T-Bills and short-term bonds (below 3 years) to avoid locking capital for longer periods in a rising interest environment.

   b) Consider investing in high yielding new Infrastructure Bonds (IFB).

   c) Look out for bonds matching your maturity profile that are currently trading at huge discounts in the secondary market.

   d) Avoid revaluation losses (selling bonds at lower prices than their purchase prices) by holding on to your existing bond investment portfolio till maturity if possible.

   e) We advise active traders and investors with high risk tolerance and US$ liquidity to consider buying the US$ denominated Kenya Eurobonds and specifically **XS1028952403** maturing in June 2024 with a current yield of 13.33% as at 6th July 2023.

4) **Secondary market trading** - We expect minimal secondary market trading activity on **FXD1/2016/10** and **FXD1/2023/5** given rising interest rate environment as investors avoid mark to market losses.

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