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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Update

FXD1/2023/05 & FXD1/2023/02

August 2023

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August 2023 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) re-opened **FXD1/2023/05** (4.9 years to maturity) and issued a new bond **FXD1/2023/2**, with a market-determined coupon to raise KES.40Bn;

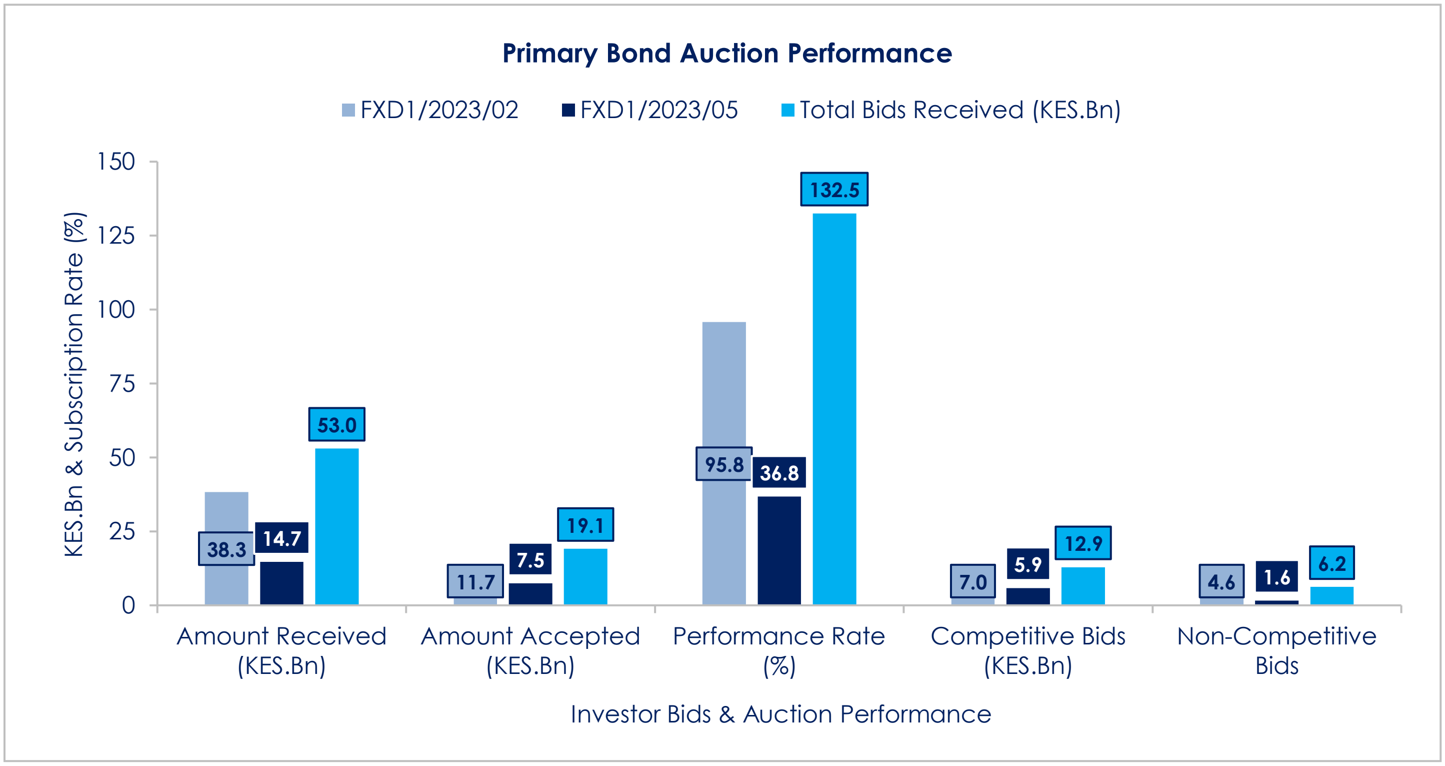
  FXD1/2023/05 (4.9*)
  FXD1/2023/02 (2*)
  ***Years to maturity**

- The period of sale was from 31st July to 16th August 2023.

Subscription Rates

- Both bonds were oversubscribed in line with our expectations in our August 2023 Fixed Income report "Will revised net borrowing target signal lower interest rates?" attributable to their relatively short tenors and low funding target (Figure.1).
- Given the Government's current fiscal position and the high interest rate environment, bidding was quite aggressive on both bonds.
- The CBK however, rejected aggressive bids with only 36.1% of total bids across both bonds being accepted.
- While this was unforeseen in consideration of the Government's fiscal budget funding needs, it appeared to be CBK's signal to investors that they it will not yield to investor pressure to accept expensive debt.
- We do not find this strategy tenable given the Government's fiscal deficit FY2023/24 (KES.718Bn) and foresee the CBK being more accommodative of higher investor bids in auctions in the near future.

Figure.1: Primary Bond Auction subscription



Source: Central Bank of Kenya

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Weighted Average Rates

- We have compared our predicted Weighted Average Rates (WAR) ranges as indicated in our August 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)
FXD1/2023/5	17.80 - 18.20	17.9538	-4.6
FXD1/2023/02	17.30 - 17.60	16.9723	-47.8

Source: Central Bank of Kenya

Our view

1) **Nairobi Securities Exchange (NSE) yield curve** - The yield curve inversion persists and this auction will result in a further inversion further given that the two bonds are benchmark issues.

   We note that the WAR of accepted bids for **FXD1/2023/5** (17.9538%) is higher than the 5-year NSE yield curve rate by 173.2 bps (16.2215%) while the WAR of accepted bids for **FXD1/2023/2** surpassed the 2-year NSE yield curve rate by 64 bps (16.3319%) as at 11th August 2023.

   As has been highlighted in previous reports, 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 bids.

2) **Market Liquidity** - The CBK has been issuing a mix of Term Auction Deposits (TADs) and reverse repos since the beginning of August 2023 in a bid to balance out liquidity in the market. The latest repo and reverse repo rates stood at 8.9% and 11.4% respectively as at 11th August 2023.

   The interbank rates hit material highs in August with the rate going as high as 19.5% on the 3rd and 4th of August prompted by the CBK's efforts to mop up liquidity from the market through repos.

As was highlighted in our August report, the CBK adopted an interest rate corridor around the CBR in a bid to better transmit monetary policy via the interbank rate. This new trend will see the interbank rate operate within 250bps of the CBR with higher rates being dissuaded by the CBK discount window which was adjusted to 400bps above the CBR.

In laymans terms, this means that the inter-bank rate cannot presently move above or below 13% and 8% respectively with the CBK acting as a lender of last resort through the discount window at 14.5%.

The combination of these factors has seen interbank liquidity improve to 10.2% as at the 16th of August 2023.

We continue to note that a bulk of investor capital continues to be directed to the 91-day T-Bill as shown in the latest auction dated 14th August 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.

      The 91 day T-Bill appears to be the most attractive investment options under the current interest environment with a yield of 13.1104 per annum which is 33 and 23 bps below the 182 and 364 day T-Bill rates as at the most recent auction (14th August 2023).

      The 91 day was 13 bps above the 182 and 42 bps below the 364 day T-Bill rates in the auction dated 7th August 2023.

      The comparatively high increases in subsequent auctions offers a good investment case for the 91 day.

   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 13.18% as at 10th August 2023.

4) **Secondary market trading** - We expect significant secondary market trading activity on **FXD1/2023/5** and **FXD1/2023/2** given their relatively short tenors and the high rejection rate on **FXD1/2023/02** should the CBK not issue a tap sale in the coming days.

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