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STERLING CAPITAL LIMITED

Fixed Income

Primary Auction Update

FXD1/2023/2 & FXD1/2016/10

September 2023

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Table of Contents

September 2023 Treasury Bond Primary Auction Results Update

- The Central Bank of Kenya (CBK) re-opened two bonds, **FXD1/2023/2** and **FXD1/2016/10**, with a market-determined coupon to raise KES.35Bn;

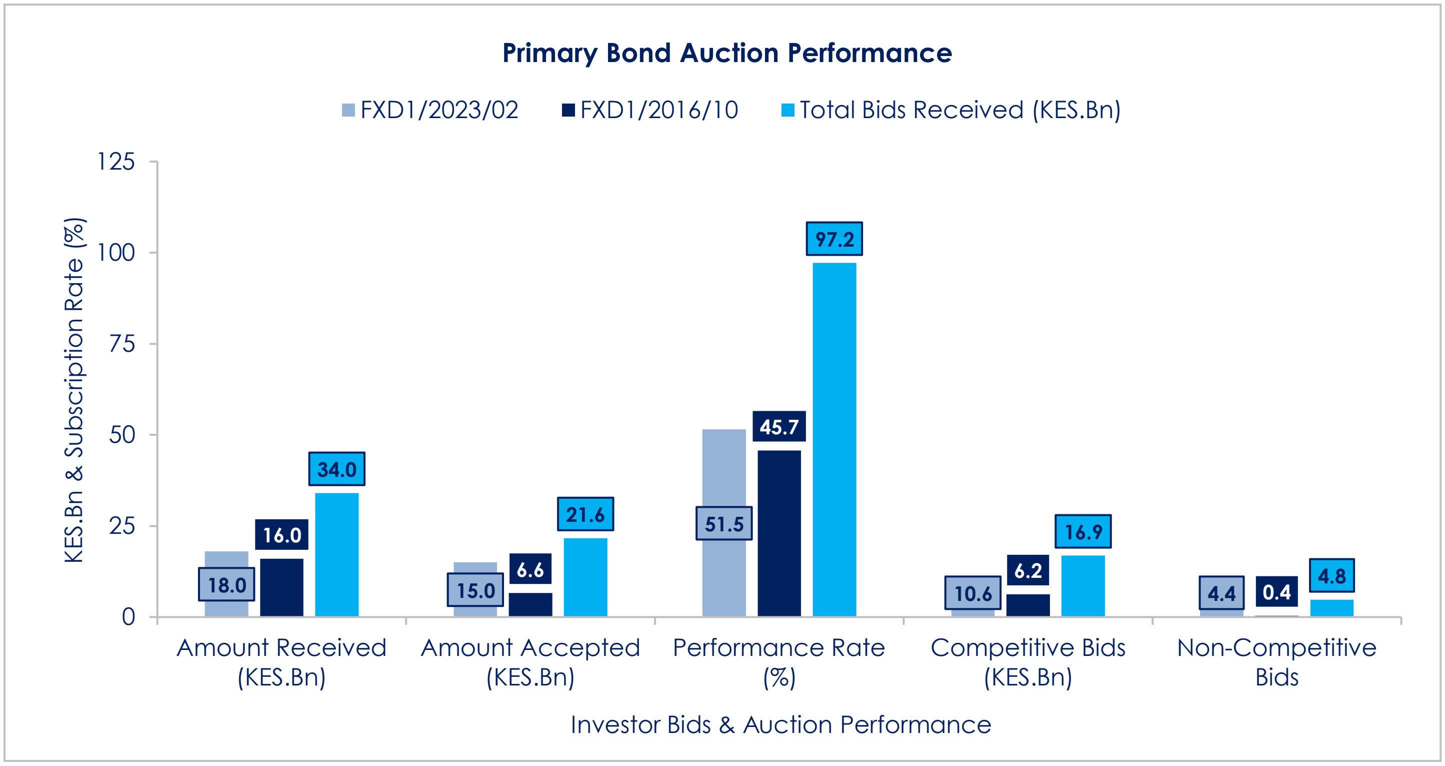
  FXD1/2023/2 (1.9*)
  FXD1/2016/10 (2.9*)
  Years to maturity

- The period of sale was from 1st September to 13th September 2023.

Subscription Rates

- The auction was slightly undersubscribed a performance rate of 97.2%, contrary to our prediction in our [September fixed income report] (Figure.1).
- As expected, investors priced in the Government's current fiscal deficit and the ensuing high interest rate environment which led to aggressive bidding on both bonds.
- To this effect, we would like to highlight that the WAR market rates were 17.58% and 18.49% for **FXD1/2023/2** and **FXD1/2016/10** respectively.
- This is 33.9bps and 113bps above each respective bond's yield to maturity as at 8th September 2023 (16.9723% and 17.3604%).
- The CBK rejected aggressive bids by accepting 63.6% of total bids across both bonds.
- While this maintains the CBK's signal to investors that it will not yield to investor pressure to accept expensive debt, the rates being accepted at each subsequent auction still signal's the opposite.
- We refer to the August 2023 MPC press release where the National Treasury projected net domestic borrowing at KES.316Bn a reduction from KES.586.5Bn which suggested a decline in domestic borrowing a scenario that would drive interest rates lower.
- We however see this as untenable considering that this is pegged on a 27% increase in tax revenue in the current fiscal year over the previous one and a significant increase in external borrowing.
- In view of the above we foresee the CBK being more accommodative of higher investor bids in debt auctions at least in the near future.

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 September 2023 Fixed Income Report with the CBK's accepted WAR and observe that our predictions were in line with the outcome of the auction (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)
FXD1/2023/02	17.40 - 17.60	17.4537	-4.6
FXD1/2016/10	17.89 - 18.09	17.9266	2.7

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 given that **FXD1/2023/02** is a benchmark issue.

   We note that the WAR of accepted bids for **FXD1/2023/02** (17.4537%) is higher than the 2-year NSE yield curve rate by 45.3bps (17.0006%) while the WAR of accepted bids for **FXD1/2016/10** (17.9266%) surpassed the 3-year NSE yield curve rate by 55.4 bps (17.3729%) as at 8th September 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 solely been issuing reverse repos since the beginning of September 2023 in a bid to boost out liquidity in the market. The latest repo and reverse repo rates stood at 8.9% and 14% respectively as at 12th September 2023.

   We note that the adopted interest rate corridor that pegs the interbank rate within 250bps of the CBR continues to be effective with the highest interbank rate hitting 14% thus far in September. Higher rates continue to be dissuaded by the CBK's discount window which currently sits at 400bps above the CBR (14.5%).

   In layman's 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%.

   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 11th September 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 14.2337 per annum which is 13.5 and 62.7 bps below the 182 and 364-day T-Bill rates as at the most recent auction (11th September 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 14.669% as at 8th September 2023.

4) Secondary market trading - We do not expect significant secondary market trading activity on **FXD1/2023/02** and **FXD1/2016/10** given the rising interest rate environment which will cause the bonds to trade at larger discounts to their par values.

In our assessment, current holders of the two bonds are unlikely to sell given that they would realize their mark to market losses as interest rates rise while potential investors in the bonds are currently parking their capital in 91-day issuances as they await more attractive issuances in the near future.

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