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Fixed Income Note

September 2023

"Era of short tenor domestic debt"

Table of Contents

Executive Summary

- Our September 2023 fixed income report is titled **"Era of short tenor domestic debt"** in reference to the move by the National Treasury to issue more short term domestic debt in a bid to attract investor capital.
- The Treasury has consistently issued relatively short-term debt with tenors of less than 5 years since April 2023.
- This month's domestic debt issuances are no different with the Central Bank of Kenya (CBK) re-opening **FXD1/2023/2** (1.9 years) and **FXD1/2016/10** (2.9 years) looking to raise KES.35Bn for budgetary support.
- Our weighted average bid predictions are as follows:

  FXD1/2023/2: 17.40% - 17.60%
  FXD1/2016/10: 17.89% - 18.09%

- This report also covers primary auction outcomes, secondary market trading activity, short-term domestic debt interest rates and market liquidity.
- Domestic debt service for September is also covered in this report.
- Government revenue, expenditure and fiscal deficit as well as the country's its borrowing is covered in detail in the later part of the report.
- We also analyse the Nairobi Securities Exchange yield curve to compare domestic debt interest rates at different periods.
- Further to this, we compare the Nairobi Securities Exchange yield curve and the Kenya Government bonds yield curve from the World Government bonds index to show the disparity between the two.
- The report concludes with our inflation expectations as well as our expectations of the MPC meeting in October 2023.

CBK's seeks to raise KES.35Bn from re-opened debt issues

- The Central Bank of Kenya (CBK) intends to raise KES.35Bn through two re-opened Treasury Bonds (T-Bonds); **FXD1/2023/2** and **FXD1/2016/10** (Table.1).
- This continues the trend of re-opening bonds with short tenors to maturity due the high cost of debt in the face of rising environment of rising interest rates.
- We expect investors to bid aggressively in this auction in a bid to hedge against the issuance of more shorter duration papers going forward which would expose their present holdings to capital losses as interest rates continue to rise.
- We expect an oversubscription on the 2-year paper with CBK's acceptance rate determined by the aggressiveness of the bids as has been the case with recent bond primary auctions.

Table.1: Primary Bond summary

Issue Number	FXD1/2023/2	FXD1/2016/10
Total Amount Offered	KES.35Bn	
Tenor	1.9 Years	2.9 Years
Coupon Rate (%)	16.9723	15.0390
Price Quote	Discounted/Premium/Par	
Period of Sale	**01/09/2023 to 13/09/2023**	
Auction Date	13/09/2023	
Value Date	18/09/2023	
Yield Curve (%) (Weighted average tenor – 25th Aug 2023)	**16.9723**	**17.2709**

Source: Central Bank of Kenya & Sterling Capital Research

Our market weighted average bid predictions

- Market-weighted average bid predictions have been arrived at by analyzing implied yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as of 25th August 2023 as well as discussions with fixed income traders (Table.2).

Table.2: Auction bid predictions

Rate	FXD1/2023/2	FXD1/2016/10
Weighted Average bid predictions	17.40% - 17.60%	17.89% - 18.09%

Source: Sterling Capital Research

Our predicted rates are guided by recent debt auction outcomes and not historical issues

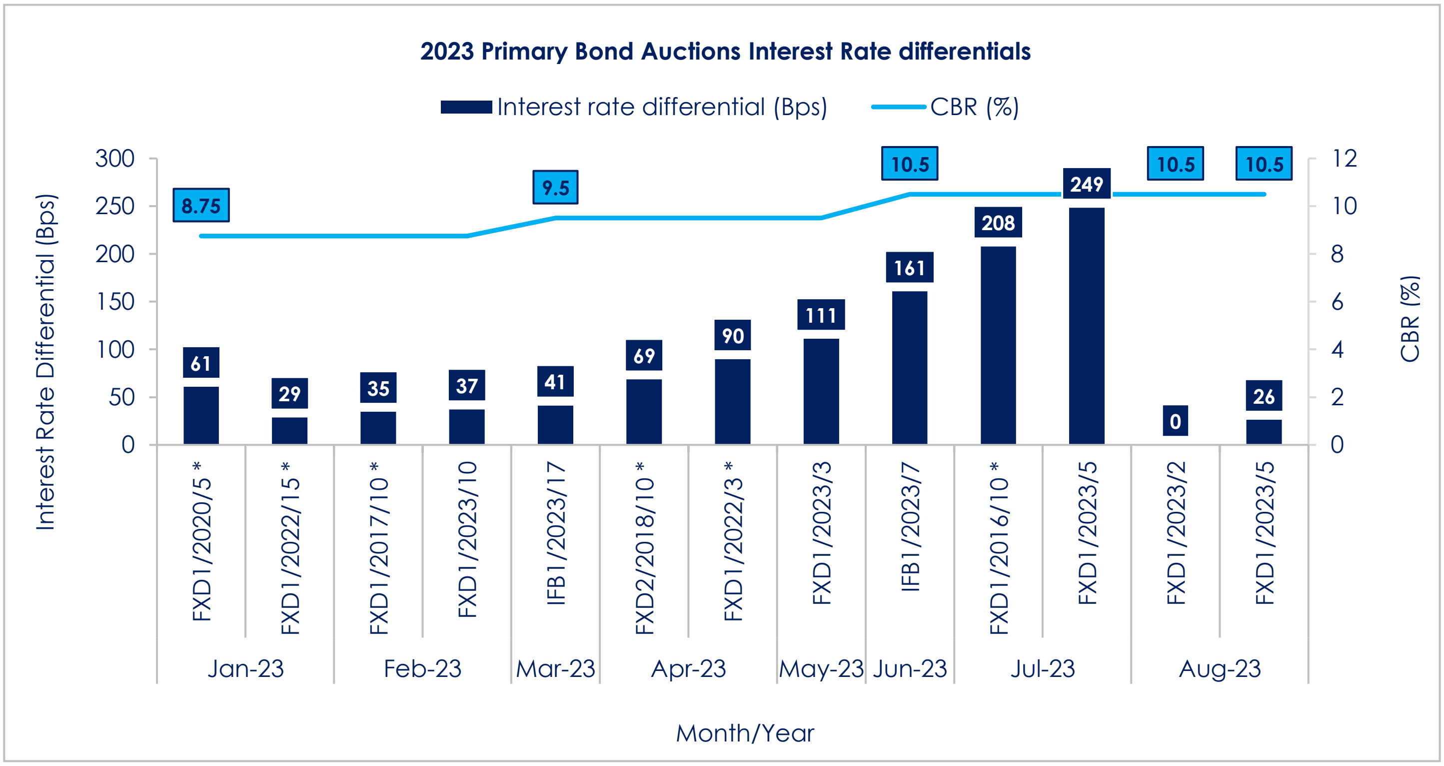
- We looked at the primary auction results for the two re-opened issues and note the huge disparity between investor auction bid levels and the NSE's implied yields at the time of issue (Table 3).
- This means that investors are placing a huge premium on their bids on account of the rising interest environment.

Table.3: Benchmark issues to guide investor bids

Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Years (Days)	Implied Yield to maturity (%)	Yield Curve at time of issue
FXD1/2023/2	21st Aug 2023	16.9723	5th May 2025	724 (1.9 years)	16.9723	16.9589
FXD1/2016/10	29th Aug 2016	15.0390	17th Aug 2026	1,088 (2.9 Years)	17.2709	14.6002

Source: Central Bank of Kenya

Figure.1: The outcome of recent bond auctions suggests a further spike in weighted average rates

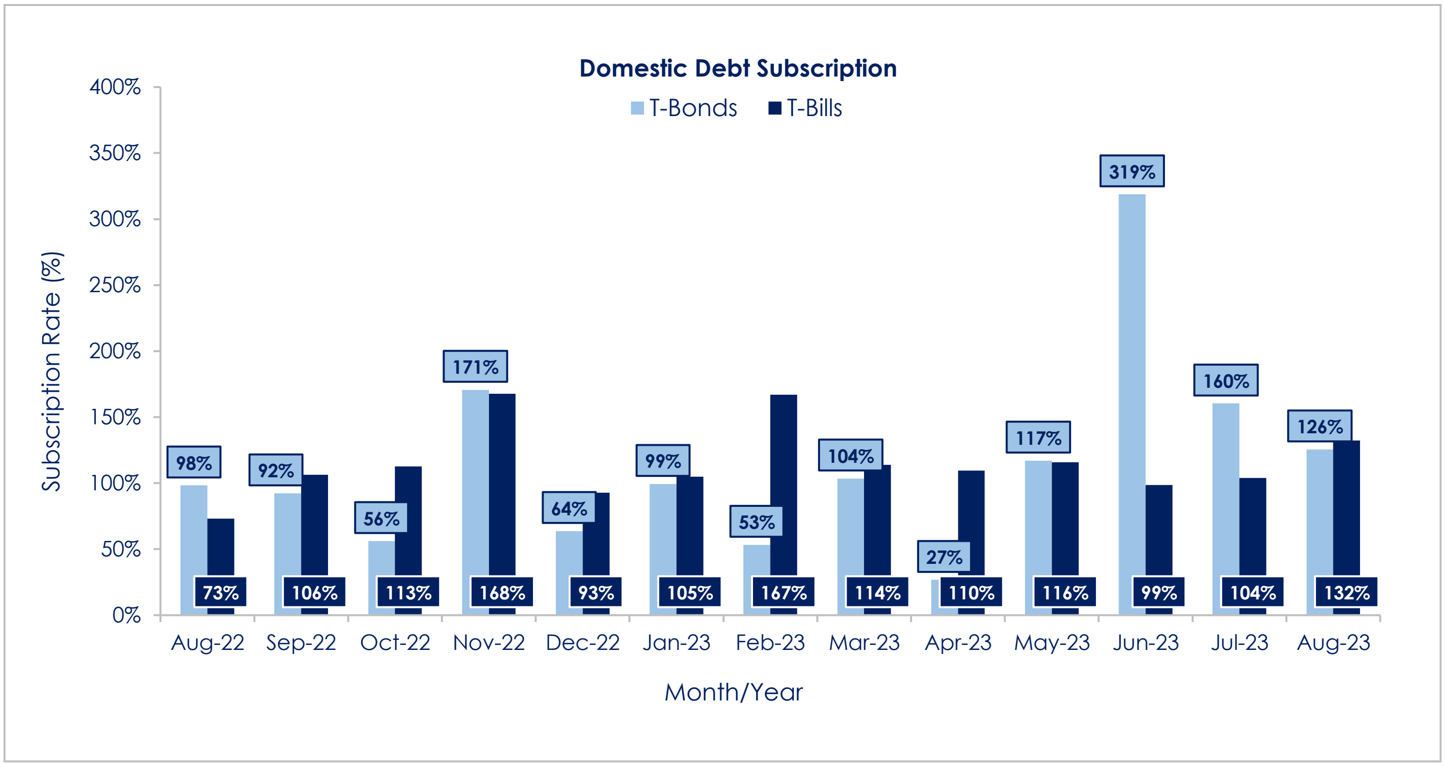


Source: Central Bank of Kenya

T-Bill demand ticks up in August 2023

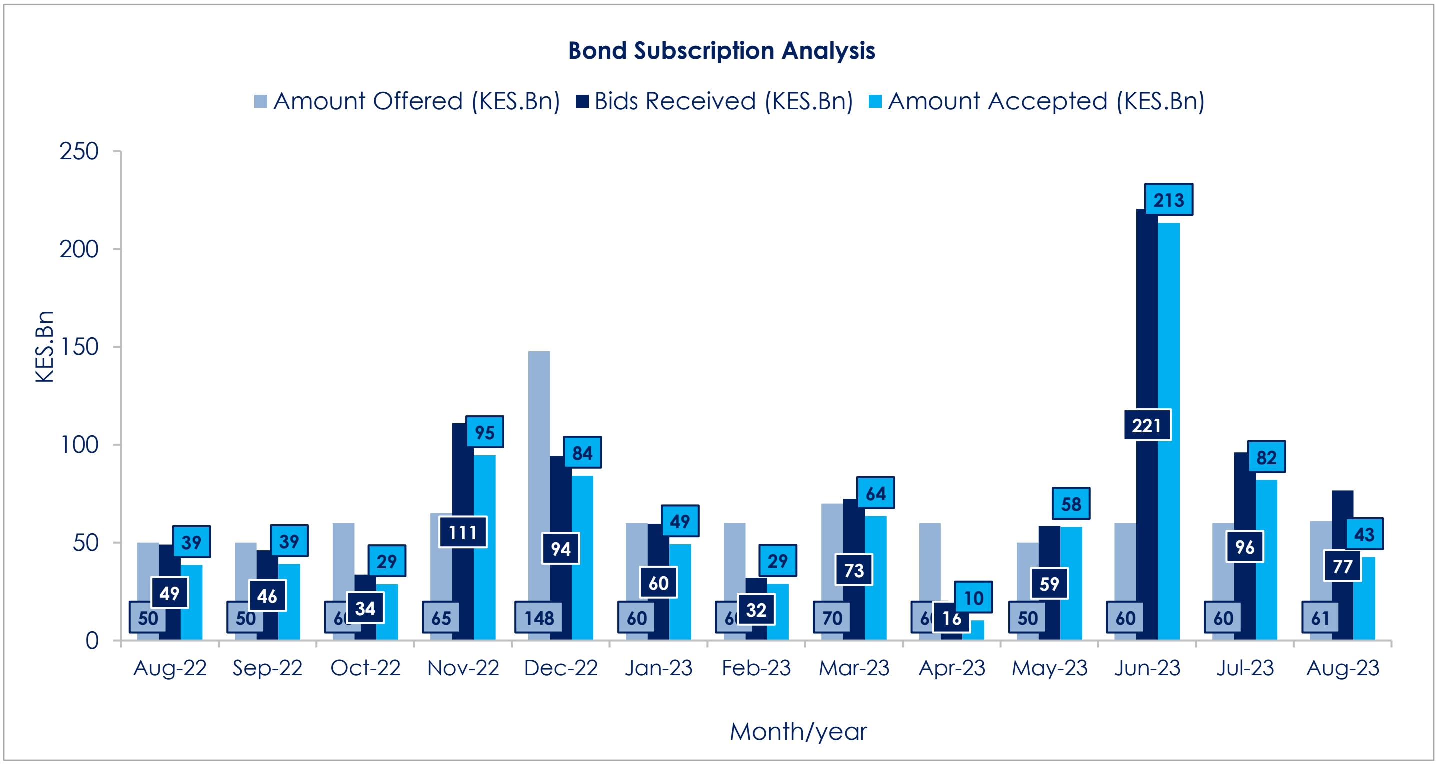
- T-Bill subscription rose to 132.2% from 103.9% a month earlier with KES.126.9Bn worth of bids received against KES.96Bn offered (Figure.2).
- The 91, 182 and 364-Day T-Bills recorded a 655.8%, 40.1% and 14.9% subscription rate this August compared to 506.7%, 29.4% and 17.3% in July 20223 respectively.
- T-Bond demand declined to 125.6% from 160% in July with KES.53Bn received in bids against the KES.40Bn offered (Figure.3).

Figure.2: T-Bond subscription declines slightly in August 2023



Source: Central Bank of Kenya

Figure.3: Bond subscriptions in August 2023

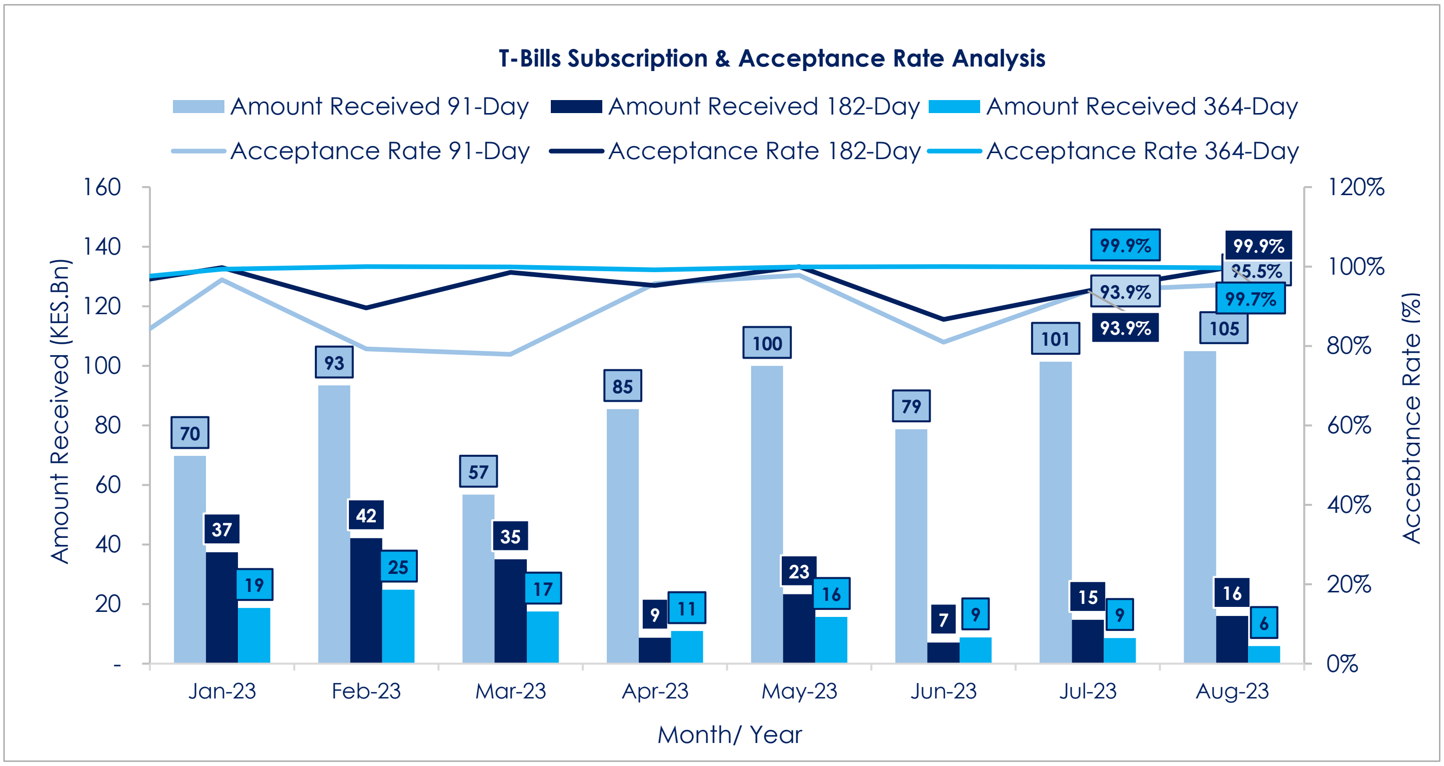


Source: Central Bank of Kenya

CBK's acceptance rate rises in August compared to July 2023

- CBK's acceptance rate for the 91, 182-Day and 364-Day T-Bills stood at 95.5%, 99.9% and 99.7% in August 2023 compared to 93.9%, 93.9% and 99.9% in July 2023 (Figure.4).
- The relatively low month-on-month acceptance rate for the 91-Day paper can be attributed to the CBK's strategy of rejecting aggressive bids to manage the level of interest rates and instead accepting more aggressive bids for the longer dated T-Bills.

Figure.4: 182-Day T-Bill acceptance rate ticks up in August 2023

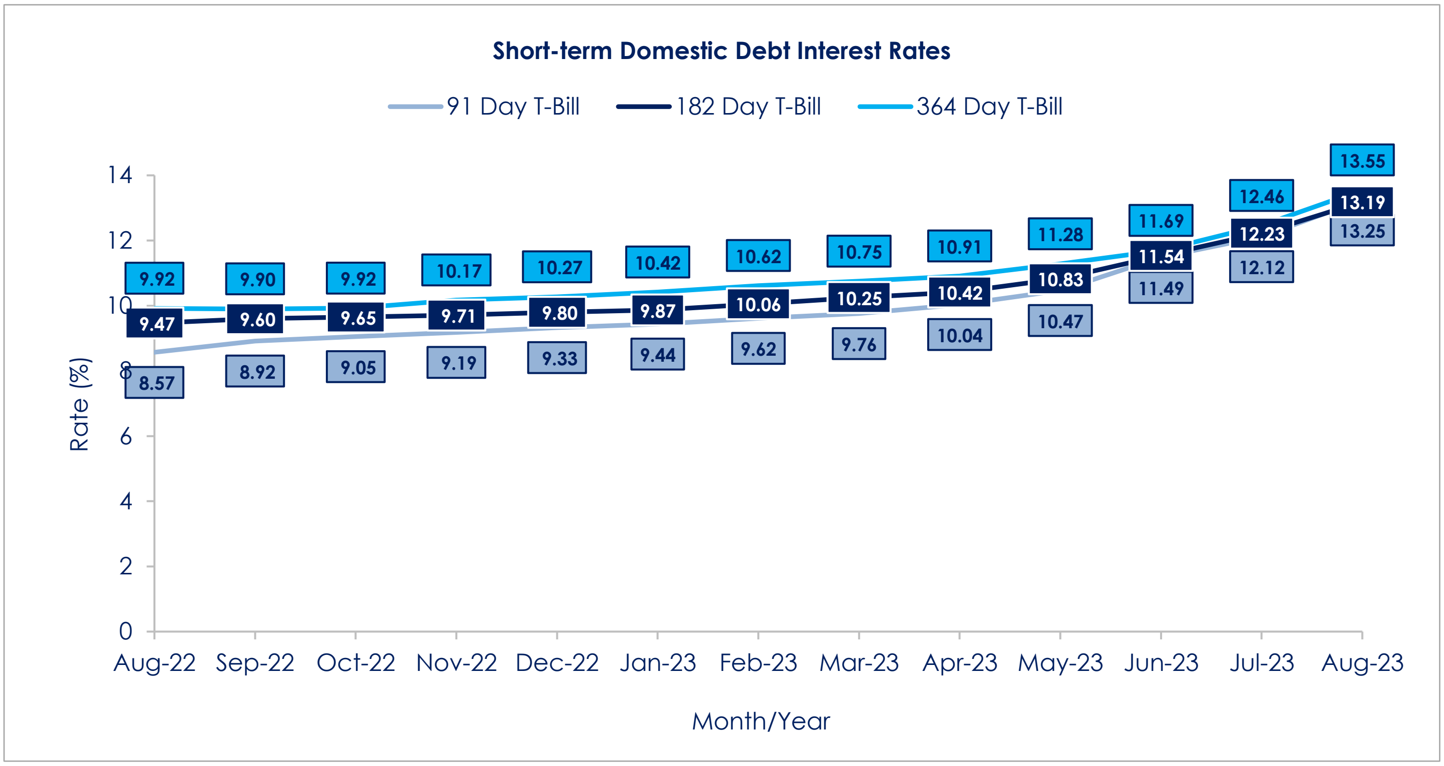


Source: Central Bank of Kenya

T-Bill rates edge closer to 14% in August 2023

- The rise in average T-Bill rates continued in August 2023 with the average 91, 182 and 364-day rates increasing to 13.3%, 13.2% and 13.6% from 12.1%, 12.2% and 12.5% in July 2023 respectively (Figure.5).
- This we continue to attribute to a combination of CBR revisions, high inflation as well as investor expectations that interest rates will continue rising in the short to medium term.
- Thee 91-day T-bill yield (13.73%) surpassed the 182-day one (13.49%) in one auction and subsequently surpassed the 364-day T-bill yield in September (13.99% vs. 13.77%).
- We expect T-bill yields to remain above 14% in September with an increasing likelihood of testing 15% in October if not sooner.

Figure.5: T-Bill rates continue upward trajectory in August 2023

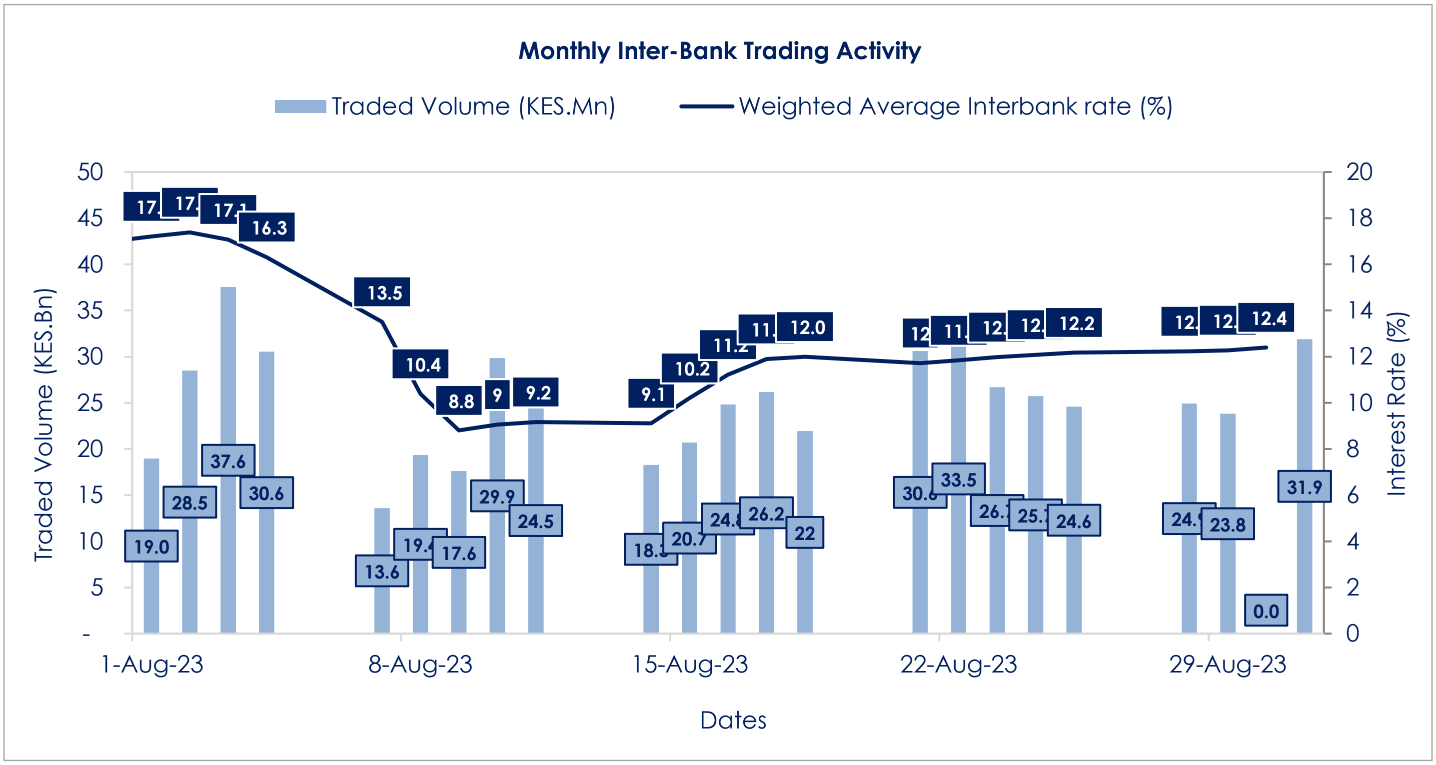


Source: Central Bank of Kenya

Market liquidity tightens further in August 2023

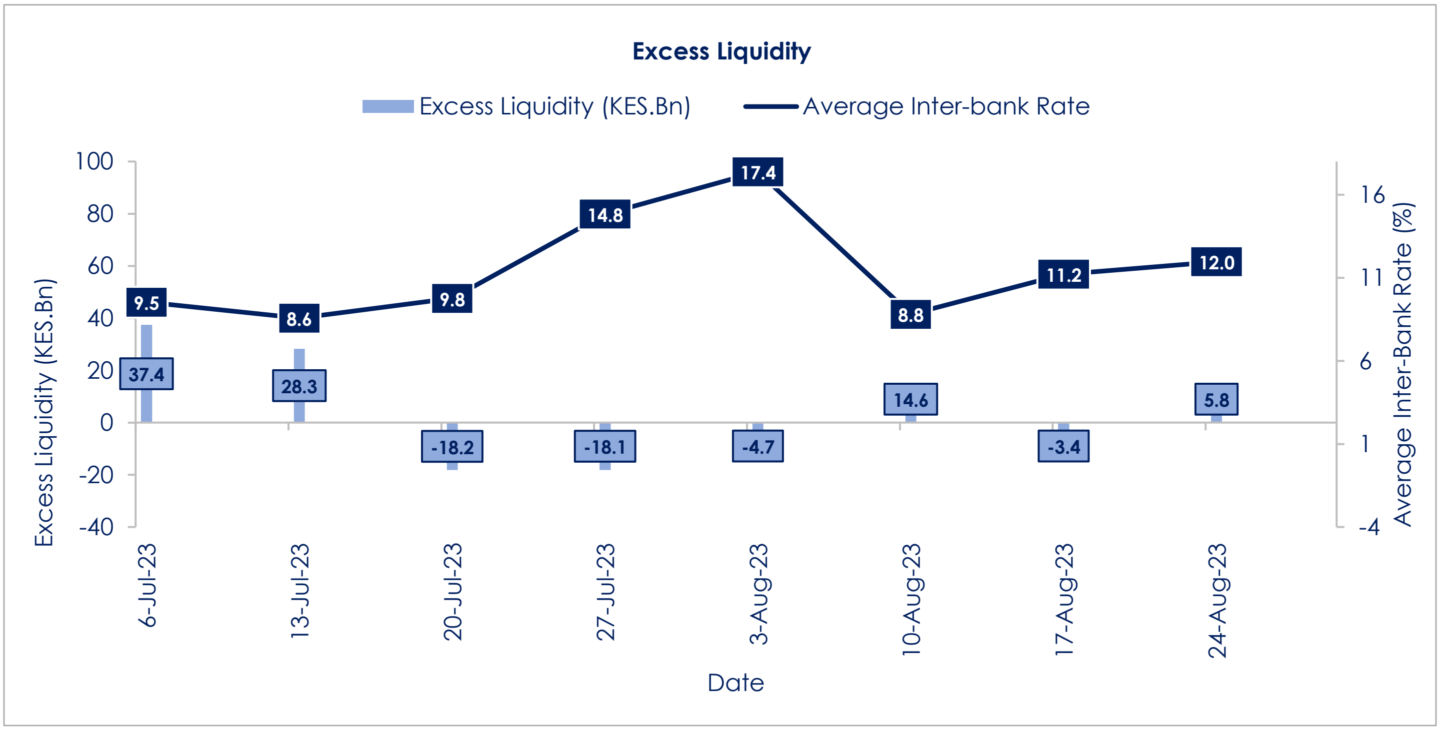
- Average inter-bank rates rose to 12.5% in August compared to 10.7% in July as a result of tight market liquidity (Figure.6).
- Trading volumes in August increased 73.7% to KES.554.1Bn from KES.319.1Bn in July.
- Over the same period, excess reserves which is the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR)) declined 58.2% to KES.12.3Bn (Figure.7).
- We also note that excess reserves showed a shortfall (were negative) for two out of the four weeks in August.
- We, however, would like to highlight a general improvement in the monthly interbank market rates since the CBK enacted an interest rate corridor pegged to the CBR.

Figure.6: Uptick in average inter-bank lending rates in August 2023



Source: Central Bank of Kenya

Figure.7: Excess commercial bank reserves declines in August 2023

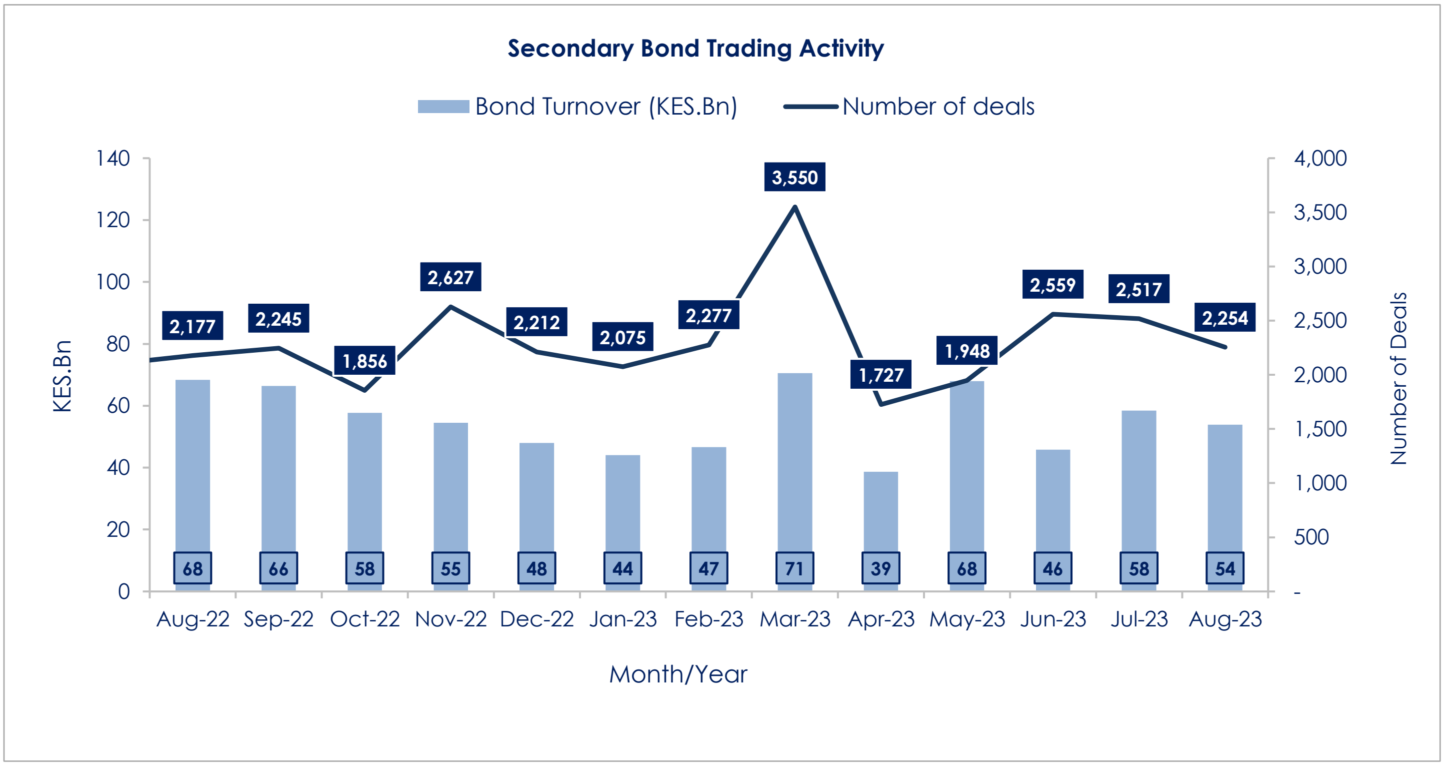


Source: Central Bank of Kenya

Bond turnover declines 7.8% in August 2023

- Secondary bond market trading decreased 7.8% to KES.53.9Bn in August 2023 from KES.58.5Bn the previous month. The number of deals for the month also declined 11.7% to 2,517 from 2,254 (Figure.8).
- Secondary market activity will remain relatively low in the near term as investors avoid selling their holdings at lower prices due to rising interest rates.
- Further, we expect the CBK to continue its attempts to reject relatively aggressive bids and issuing tap sales soon thereafter to meet their targets which will further skew investor capital to the primary market.

Figure.8: Secondary trading activity decreases in August 2023

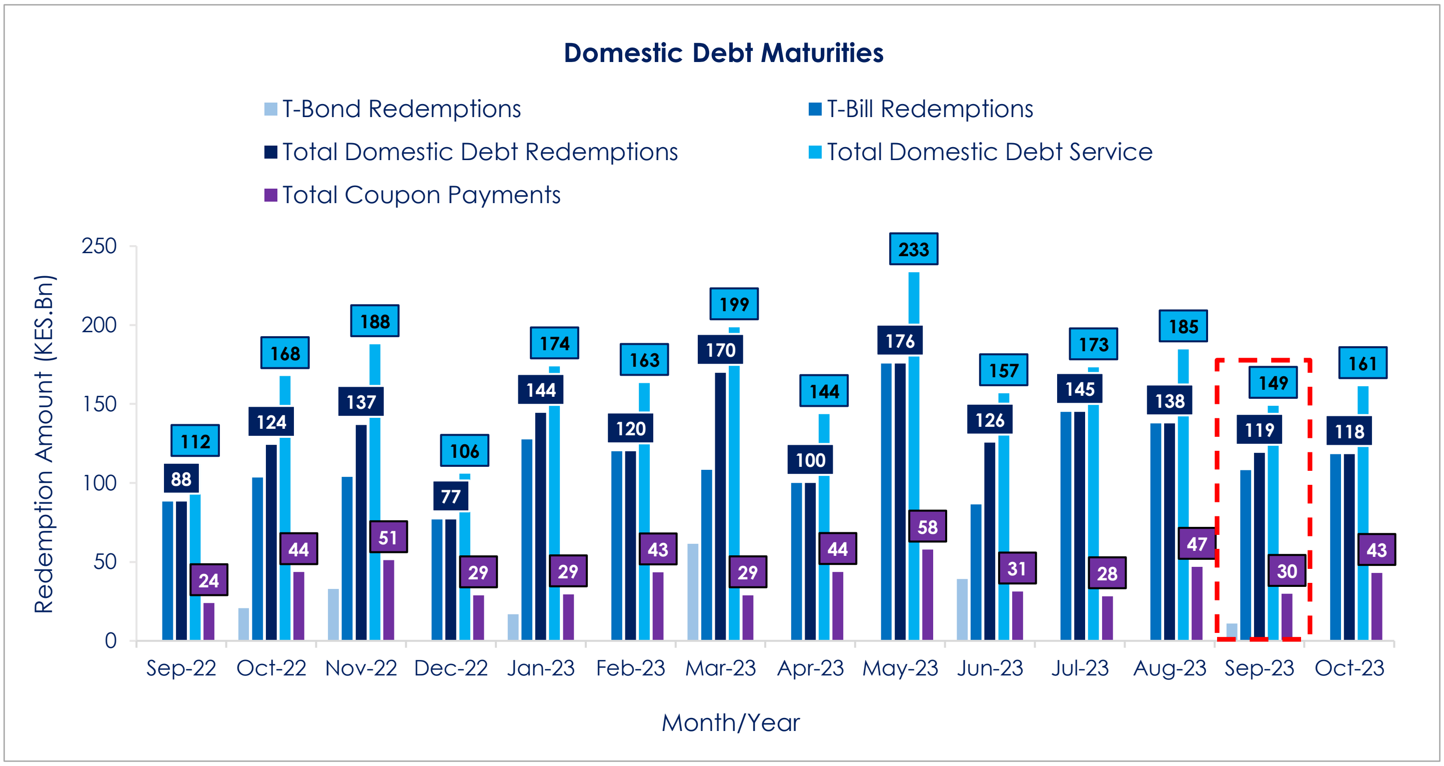


Source: Central Bank of Kenya

Domestic debt service set to dip in September 2023

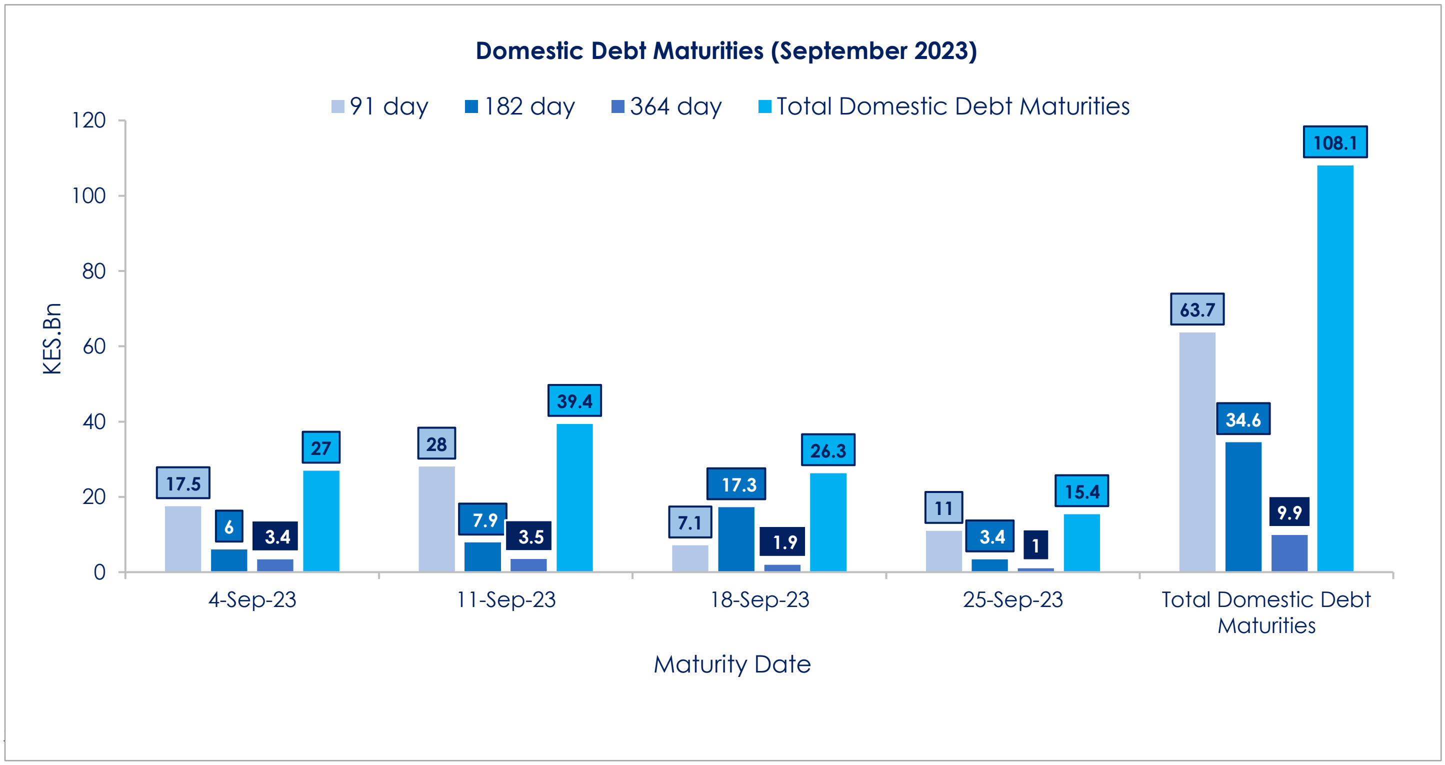
- Total domestic debt service is set to decrease 19.4% in September 2023 to KES.148.9Bn from KES.184.6Bn in August 2023. (Figure.9).
- This includes KES.11Bn, KES.108.1Bn and KES.29.8Bn in T-Bond redemption (**IFB1/2011/12**), T-Bill redemptions and coupon payments respectively.
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.63.7Bn, KES.34.6Bn and KES.9.9Bn respectively with the second week of the month having the highest redemptions at KES.39.4Bn (Figure.10).

Figure.9: Decline in debt service given drop in coupon payments and T-Bill redemptions in September 2023



Source: Central Bank of Kenya

Figure.10: Second week of September 2023 with highest T-Bill redemption at KES.39.4Bn

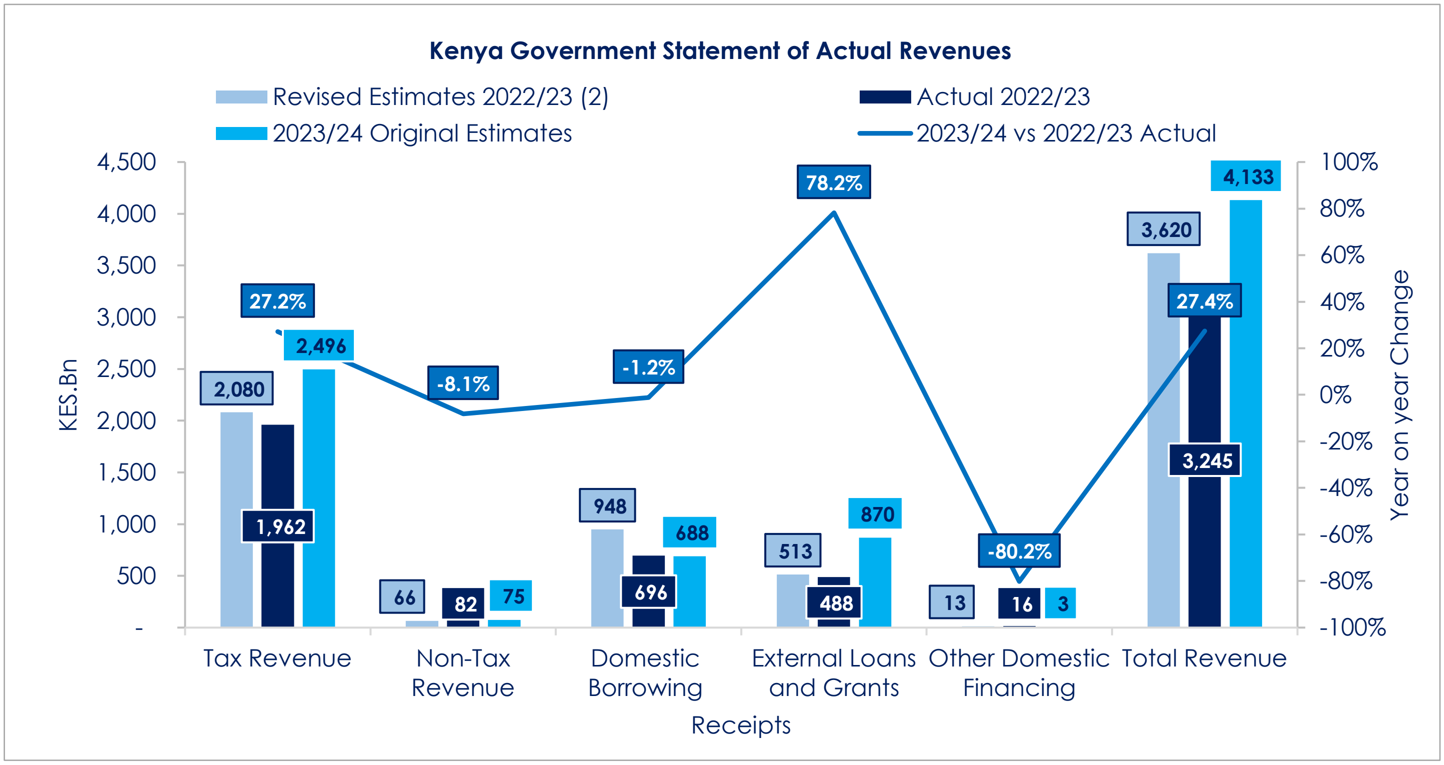


Source: Central Bank of Kenya

National Treasury's 2023/24 tax revenue and borrowing estimates are unrealistic

- Data from the National Treasury as at the end of July 2023 shows a significant disparity between estimates for the current fiscal year (2023/24) against the revised 2022/23 and actual receipts for the same year (Figure.11).
- Most notable in our view is the 27.2% increase in tax revenue compared to actual 2022/23 tax revenue and 20% higher than the 2022/23 supplementary budget 3 estimated receipts.
- This sharp increase in our view is overly optimistic under the current economic environment.
- Also optimistic is the domestic borrowing estimate considering that it is partially pegged on the achievement of the aggressive tax revenue targets and sharp increase in external borrowing.
- A combination of the above means that we expect to see significant adjustments in supplementary budget in this year with our view being an increase in domestic borrowing to make up for shortfalls in tax revenue.

Figure.11: 2022/23 Government receipts and expenditure fall below revised targets



Source: National Treasury

Domestic borrowing falls way short of 2022/23 revised target

- After one month of the 2023/24 fiscal year, we see most receipts are below our linear target run rate of 8.3% (Table.4 & Figure.12).
- Most notably is external borrowing, tax revenue and overall revenue at 4.9%, 6.2% and 6.9% of the original 2023/24 fiscal year target.
- We however note that domestic borrowing at 12.1% of the year's target is well above the target run rate.
- Considering what we see is highly likely shortfalls in tax revenue targets later in the year, we see domestic borrowing targets being revised upwards which will change this run rate.

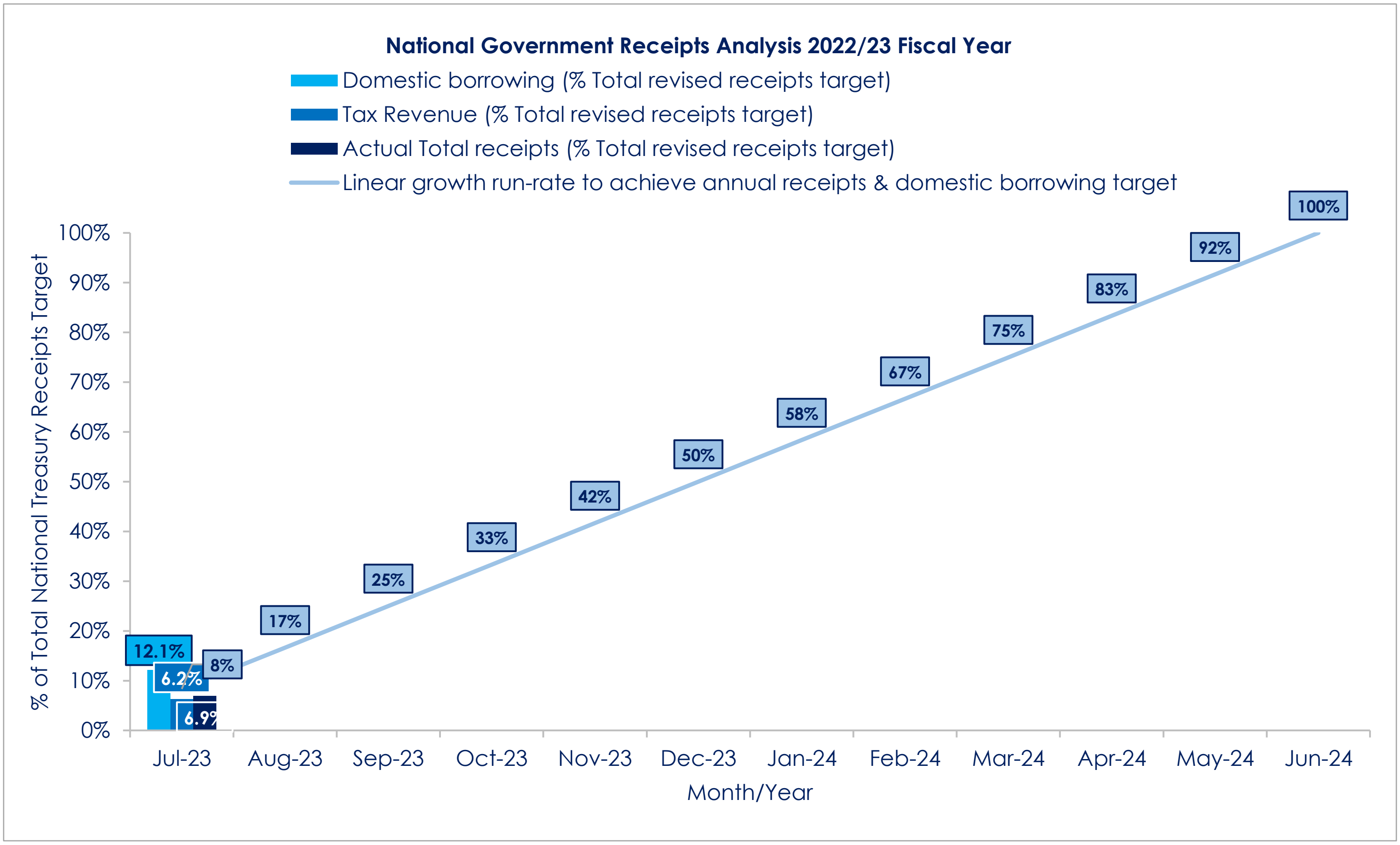
Table.4: Domestic borrowing above linear target run rate after first month of 2023/24 fiscal year

Receipts	Actual Receipts 2022/23 (KES.Mn)	Original Estimates 2023/24 (KES.Mn)	Variation 2023/24 vs Actual 2022/23	Actual Receipts (KES.Mn) 31st July 2023	Proportion of Total Receipts 31st July 2023
Opening Balance (1st July)	616.5	2,617.4		2.6	
Tax Revenue	**1,962**	2,495.8	**27.2%**	155.1	**6.2%**
Non-Tax Income	82	75,3	**-8.2%**	1.9	**2.5%**
Domestic Borrowing*	**696.4**	**688.2**	**-1.2%**	**83.6**	**12.1%**
External Loans & Grants	488.3	870.2	**78.2%**	43.1	**4.9%**
Other Domestic Financing	16.1	3.2	**-80.1%**	0.9	**27.5%**
Total Revenue	**3,244.8**	**4,132,7**	**27.4%**	**284.5**	**6.9%**
Linear Run Rate target 2022/23					**8.33%**

* Note 1: Domestic Borrowing of KES.688.2Bn = Net Domestic borrowing KES.313.7Bn & Internal Debt Redemptions (Roll-overs) KES.374.5Bn

Source: The Kenya Gazette Vol. CXXV - No.184 18th August 2023

Figure.12: Domestic borrowing at 12.1% of 2023/24 estimated target

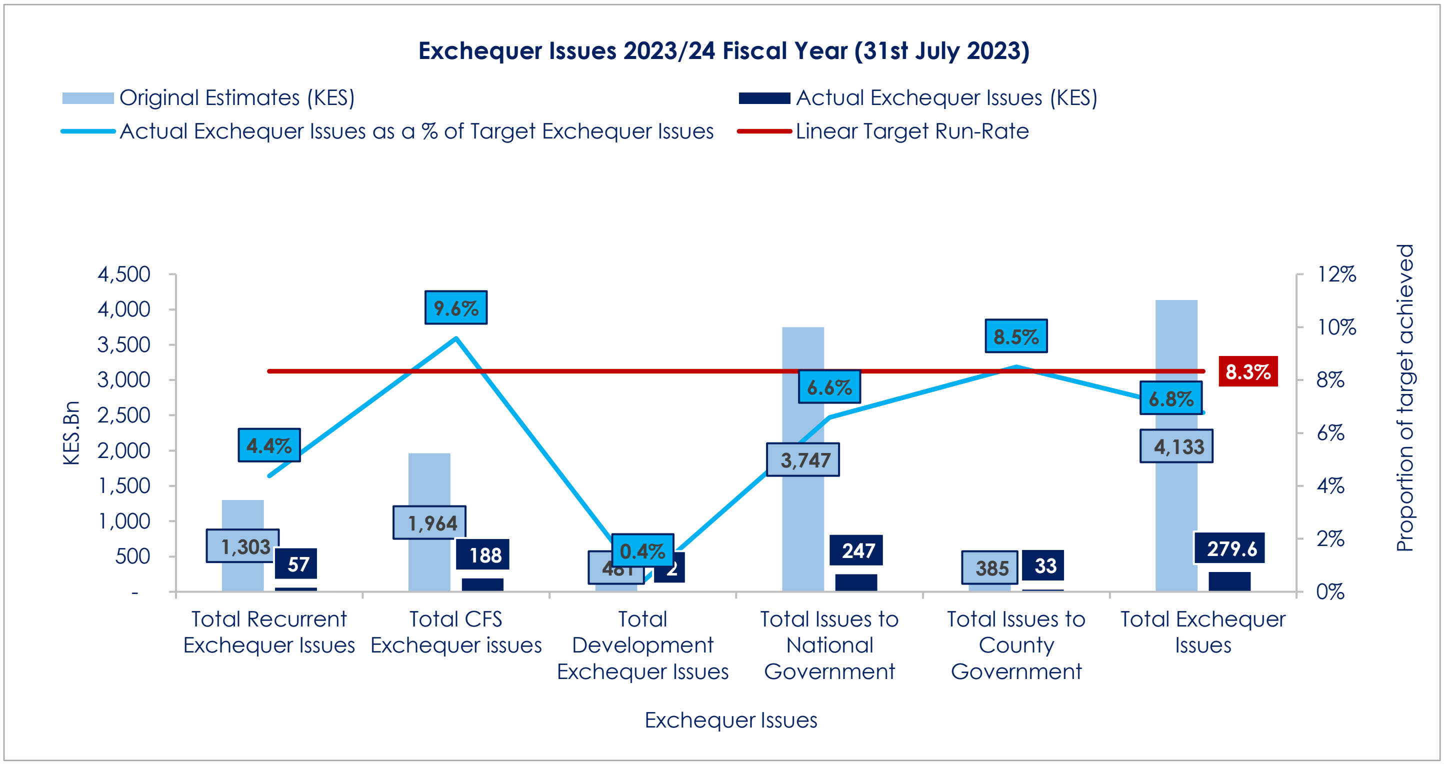


Source: The Kenya Gazette Vol. CXXV - No.184 18th August 2023

2023/24 exchequer issues fell below revised targets

- All exchequer issues with the exception of total cfs exchequer issues remain below our linear target after one month of the 2023/24 fiscal year (Figure.13).
- The beginning of any fiscal year is traditionally slow in terms of expenditure and we expect this to change in the next few months.

Figure.13: Total 2023/24 exchequer issues below target

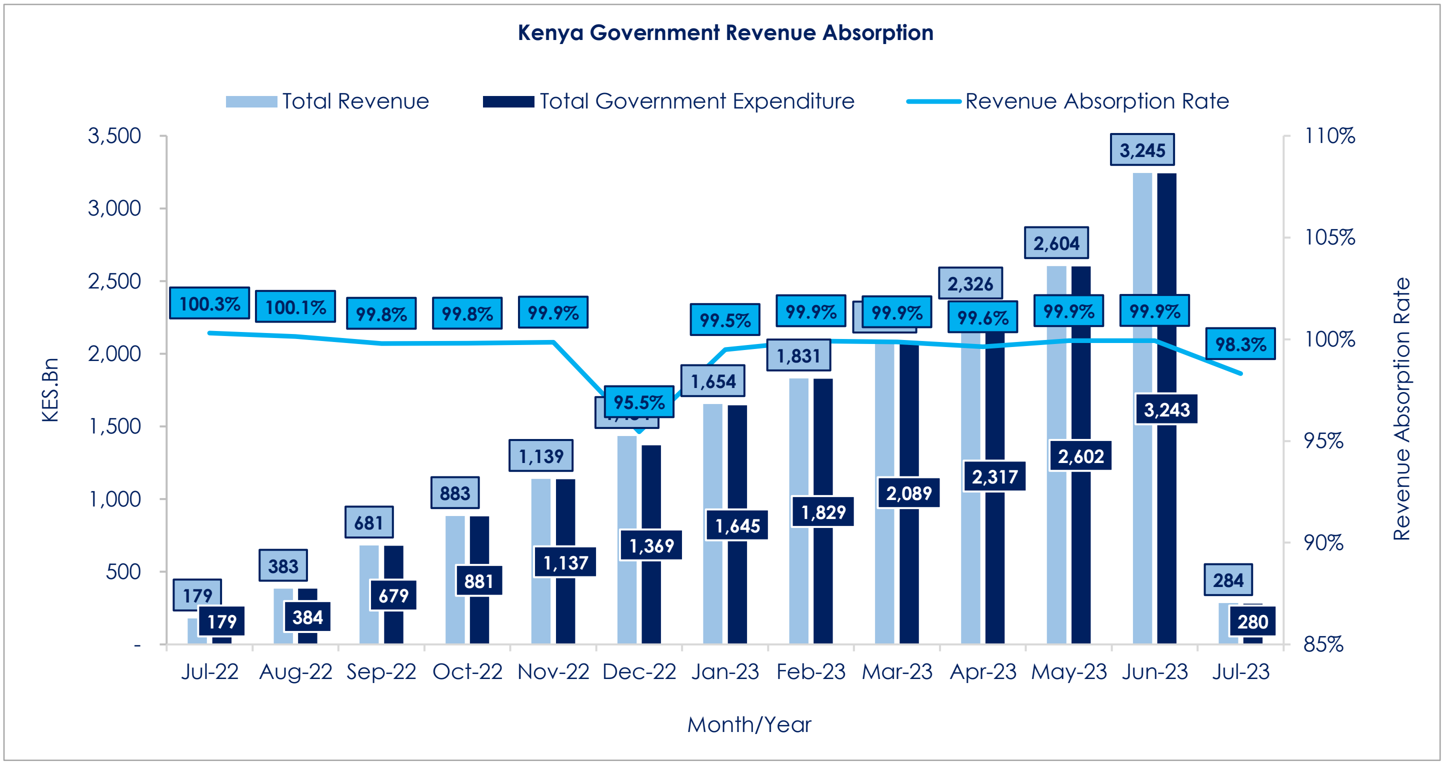


Source: The Kenya Gazette Vol. CXXV - No.184 18th August 2023

Full Government Revenue Absorption for 2022/23 fiscal year

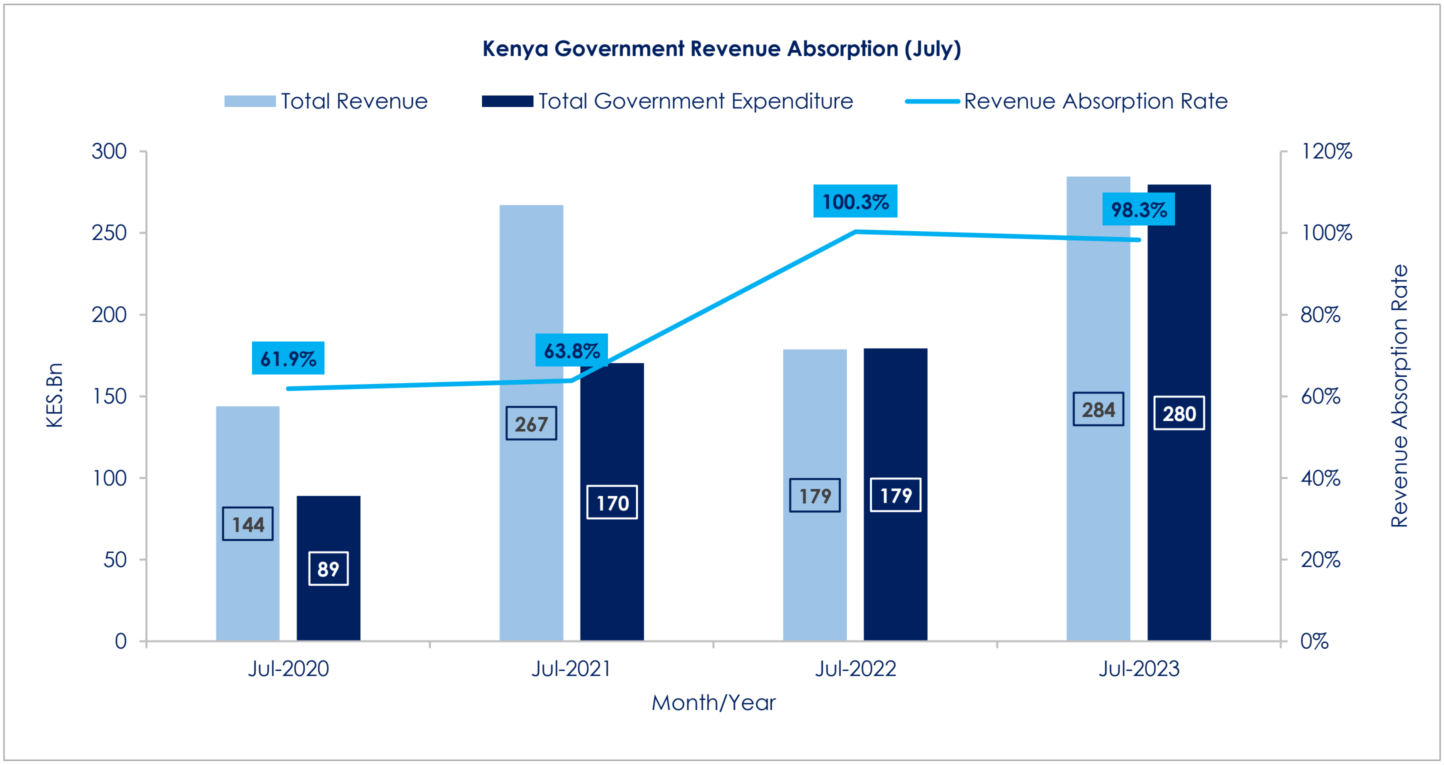
- Revenue Absorption Rate (RAR) which is the proportion of Government receipts used to finance its expenditure remained is relatively high at 98.3% considering it's the first month of the 2023/24 fiscal year (Figure.14).
- This points to high financing needs amid revenue shortfalls a scenario we expect to be the trend for most of the year.
- When we review historical data, we notice that revenue absorption at the beginning of the fiscal year is low with July 2023 being an exception (Figure.15).
- This analysis shows a 6.1% and 5.3% growth in year on year revenue and expenditure in 2023 significantly lower than 17.95% and 18.8% in 2021/22.

Figure.14: Government's revenue remained high throughout the fiscal year due to revenue shortfalls



Source: The Kenya Gazette Vol. CXXV - No.184 18th August 2023

Figure.15: 2022/23 fiscal year closes with high revenue absorption

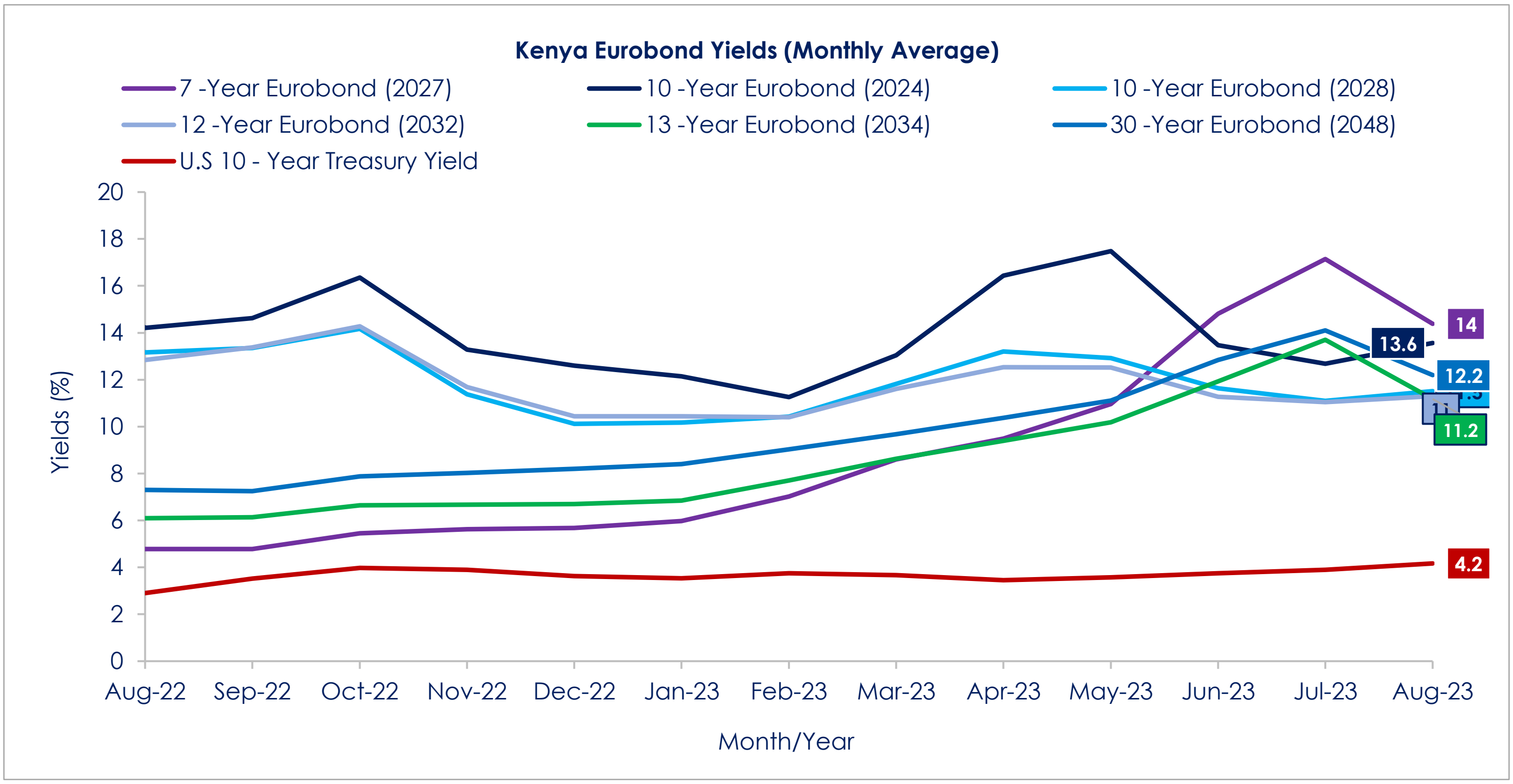


Source: The Kenya Gazette Vol. CXXV - No.184 18th August 2023

Kenya Eurobond yields rise in July as US treasuries close higher

- Average yields on Kenya Eurobonds rose 39 bps on average above the than the previous month (Figure.16).
- During the same period, the US 10-year treasury yield rose 27 bps to 4.17%.
- The yield on the 10-year treasury was the highest since October 2022 and attributed to investors' expectations of a Fed rate hike later in the year to counter inflation.
- The Federal Reserve has set an inflation target of 2% and the current rate of 3.2% suggests further tightening in coming months.
- In the case of Kenya Eurobonds, concerns over the country's fiscal position and other economic risks tend to have a bearing on investor sentiment thus explaining the fluctuations in Eurobond yields.

Figure.16: Kenya Eurobond yields up in August 2023



Source: Central Bank of Kenya

NSE Yield curve inversion continues as rates continue to head north

- A comparison of average debt security NSE yields as at 1st September 2023 against those as at 19th August 2016 (Close to issuance of **FXD1/2016/10**) and 2nd September 2022 shows a sharp in interest rates increase across the curve. (Table.5 and Figure.17).
- Yields as at 18th August 2023 (Close to issuance of **FXD1/2023/2**) which is less than a month ago also shows a slight increase in yields on select tenors.
- The upward shift in the yield curve has resulted from the following:

1) Upward adjustments of the CBR, with five revisions between May 2022 and June 2023 - 350Bps to 10.5%.

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 in primary debt auctions to encourage subscription following a decline in investor demand for debt instruments.

4) High inflation and KES depreciation more so against the US$ with investors bidding higher to maintain positive real return on capital invested.

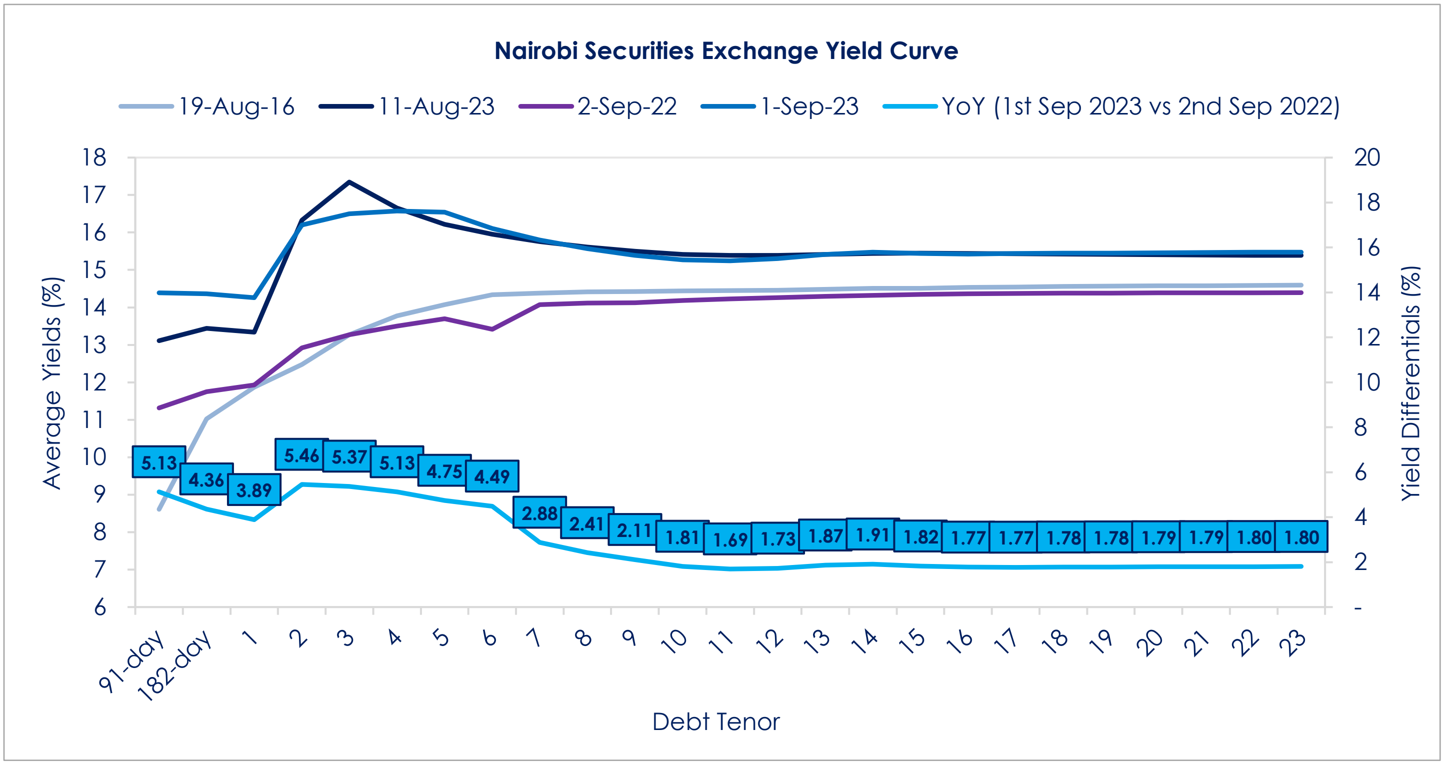
Table.5: Yield curve has significantly shifted upward across all tenors

Tenor	Yields (19th Aug 2016)	Yields (11th Aug 2023)	Yields (2nd Sep 2022)	Yields (1st Sep 2023)	∆ 1st Sep 2023 vs 19th Aug 2016) Bps	∆ 1st Sep 2023 vs 11th Aug 2023) Bps	YoY ∆ (1st Sep 2023 vs 2nd Sep 2022) Bps
1	11.8650	13.3402	9.8760	13.7650	↑ 190	↑ 42	↑ 389
2	12.4741	16.3319	11.5388	16.9956	↑ 452	↑ 66	↑ 546
5	14.0750	16.2215	12.8308	17.5764	↑ 350	↑ 135	↑ 475
10	14.4385	15.4169	13.6443	15.4544	↑ 102	↑ 4	↑ 181
15	14.5097	15.4487	13.9108	15.7327	↑ 122	↑ 28	↑ 182
20	14.5732	15.4035	13.9753	15.7640	↑ 119	↑ 36	↑ 179

Source: Nairobi Securities Exchange

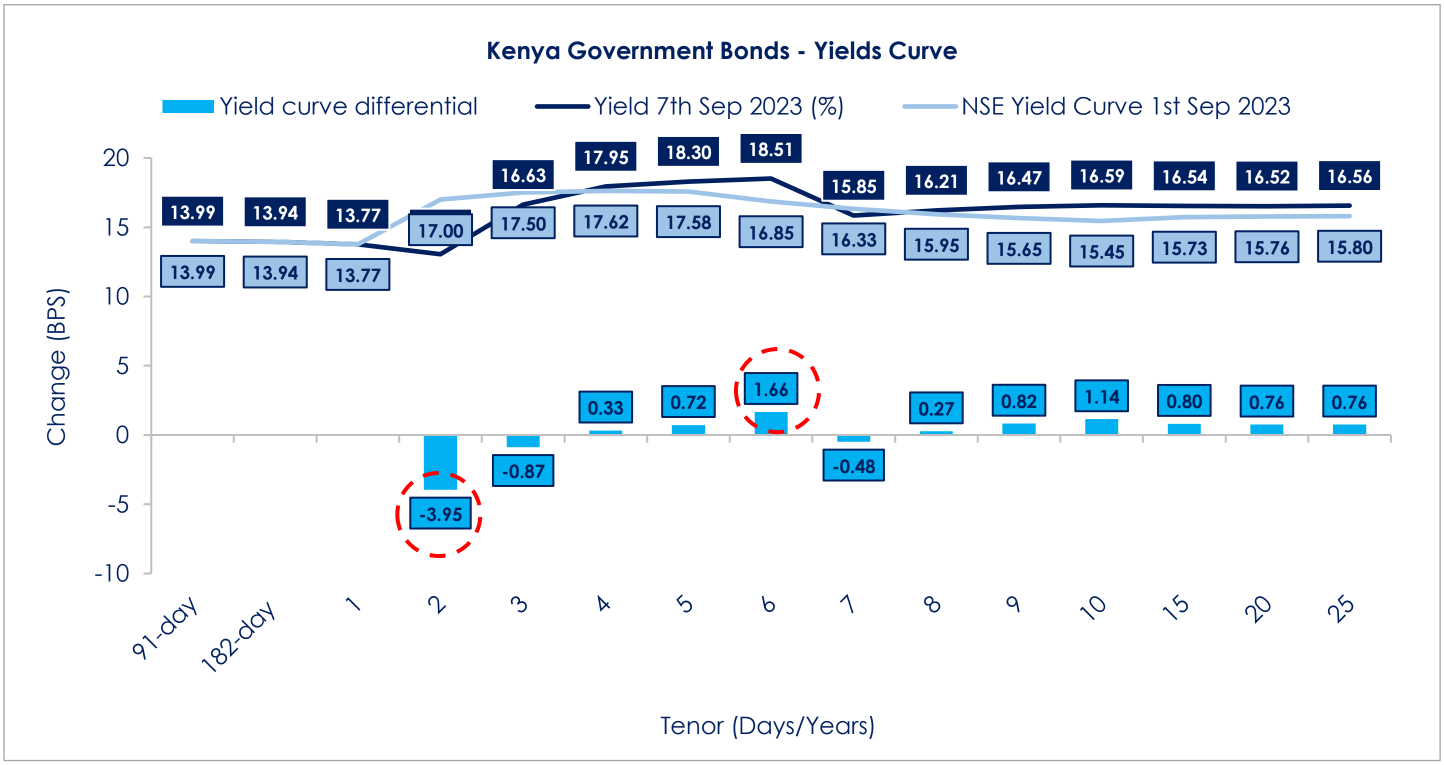
- The Kenya Government bonds yield curve (source: World Government bonds) can also be used to determine possible investor bidding levels (Figure.18).
- We notice disparities in yields in medium and long end of the curve.
- This curve puts the 2-year yield at 13.05% which is 394.6Bps below the current NSE yield curve and 18.51% for the 6-year bond which is 166.5Bps above the same yield curve.
- Investors bidding for the newly debt issues could therefore use both these yield curves as a basis for bidding in the upcoming auctions with a fairly aggressive bidding strategy recommended.

Figure.17: Higher year on year differentials across all tenors



Source: Nairobi Securities Exchange

Figure.18: Notable disparities in Kenya Government bond yield curves



Source: World Government bonds

Trading ideas - Invest in Kenya Eurobonds & high yielding short-term debt

- We continue to suggest that investors with a high tolerance for risk and those with US$ exposure should consider investing in Kenya Eurobonds and in particular, **XS1028952403** maturing in June 2024.
- Here they will take advantage of current high yields with an option of holding till maturity or disposing in the event short term trading opportunities arise (Table.6).
- The bond has a yield of 15.15% as at 8th September with about 9 months until maturity.
- The bond has seen a steep decline in yields in recent weeks from yields as high as 20.3% on 24th April 2023 as reassurance from the IMF and increased effort to refinance the bond calmed investors.
- Investors looking for higher yields could also consider disposing their current bond holdings in favour of new short term bonds but will have to be wary of actualizing losses due to current low prices.
- These higher coupons of the new bonds combined with coupons already received could minimize their losses or even put them in break-even range.

Table.6: Trading ideas - Consider Kenya Eurobonds

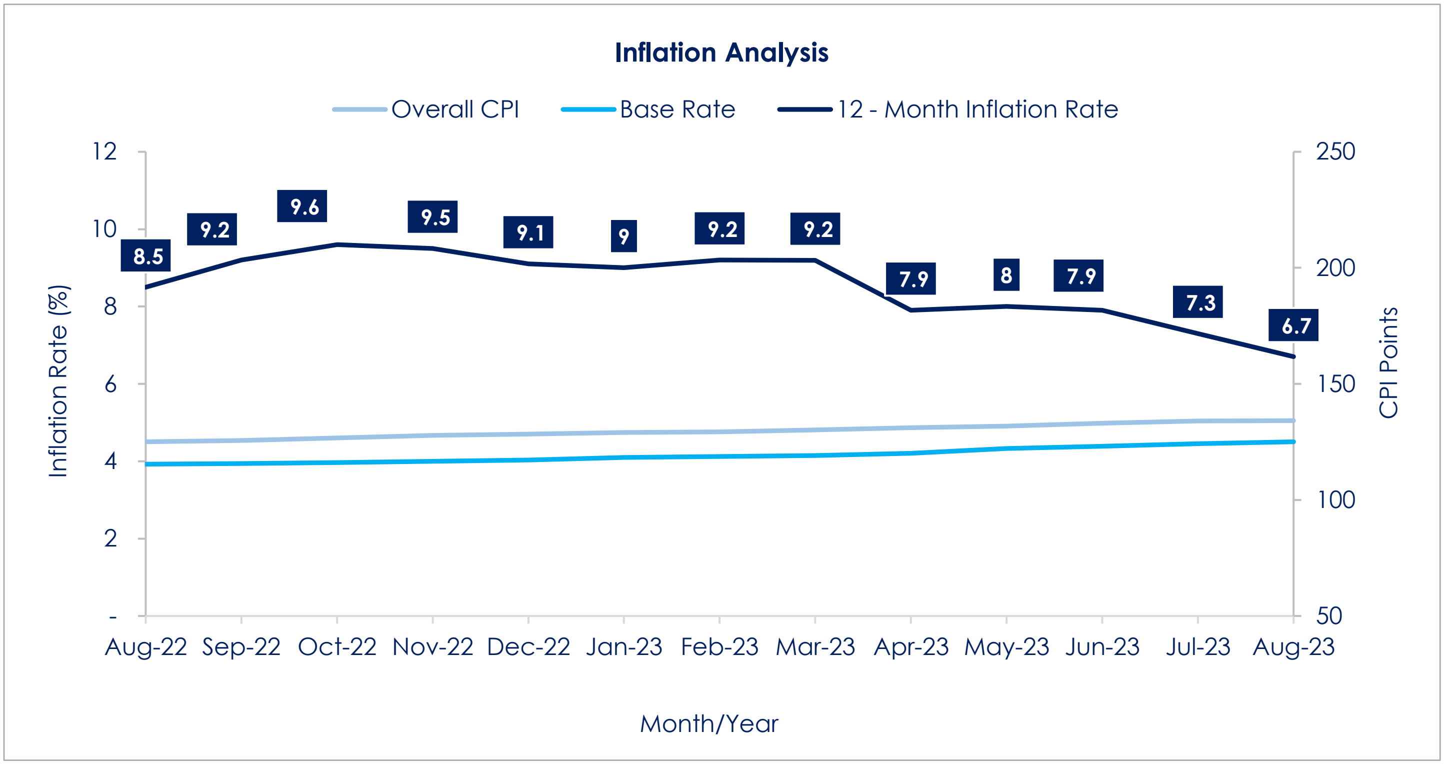
ISIN Code	Issue date	Tenor (Years)	Maturity	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (31st Aug 2023)
XS1028952403	Jun -14	10	Jun-24	2	6.875%	13.977%
XS1843435840	May -19	7	May-27	0.9	7%	12.092%
XS1781710543	Feb -18	10	Feb-28	1	7.25%	11.761 %

Source: Bloomberg & Central Bank of Kenya

August 2023 inflation eases to 6.7% on low food prices

- August 2023 inflation declined materially to 6.7% from 7.3% in July on account of lower food prices (Figure.19).
- This was outside our forecasted range of 7.5% - 8% for the month.
- We expected inflation to trend upwards following the court of appeal's lifted orders barring the implementation of the Finance Bill 2023.
- Despite the overall month-on-month decline, transport; food and non-alcoholic beverages; housing, water, electricity, gas and other fuels increased 13.1%, 7.5% and 7.5% respectively accounting for over 57% of overall inflation.
- While global fuel prices have declined, we do not expect this to translate to lower pump prices locally further due to currency depreciation and the increase of Value added Tax from 8% to 16%.

Figure.19: September 2023 inflation forecast at 6% - 6.3%



Source: Kenya National Bureau of Statistics

MPC's likely to maintain CBR at 10.5% in October 2023 meeting

- The Monetary Policy Committee (MPC) is set to meet in October 2023 (date yet to be announced) to review the impact of previous monetary policy measures on the economy.
- In its last meeting on the 9th August 2023, the MPC retained the CBR at 10.5% informed by the following reasons:

  a) Overall inflation was within the CBK's target band of 5% (+/-) 250bps in July (7.3%) with food inflation expected to come down further due to the upcoming harvest season and global food prices easing.

  b) Non-food non-fuel inflation has declined from 4.1% in June to 3.8% in July.

  c) The impact of tightening monetary policy in June 2023 is still being transmitted into the economy.

- With inflation easing further in August 2023 we believe the MPC is likely to hold the rate unchanged.

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