Thursday, 12 October 2023

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Fixed Income Note

October 2023

"It's the 2 and 5-year debt issues once again"

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Executive Summary

- Our October 2023 fixed income report is titled **"It's the 2 and 5-year debt issues once again"** in reference to the re-opening of **FXD1/2023/2** (1.9 years) and **FXD1/2023/5** (4.8 years) for the second time to raise KES.35Bn earmarked for budgetary support.
- These issues are consistent with our expectations of the strategy of the CBK to manage the cost of borrowing under the high interest rate environment.
- Our weighted average bid predictions are as follows:

  FXD1/2023/2: 17.84% - 17.99%
  FXD1/2023/5: 18.79% - 18.94%

- This report also covers primary auction outcomes, secondary market trading activity, short-term domestic debt interest rates and market liquidity.
- Domestic debt service for October is also covered in this report.
- In the middle section of the report we discuss Government finances with focus on revenue, expenditure and fiscal deficit.
- Kenya's Eurobond yields are also covered towards the end of the report as is the case with Nairobi Securities Exchange yield curve.
- The report concludes with our inflation expectations as well as an analysis of the outcome of the MPC meeting on Tuesday, 3rd October 2023.

CBK's re-opens 2 and 5 Year debt to raise KES.35Bn

- The Central Bank of Kenya (CBK) intends to raise KES.35Bn through two re-opened Treasury Bonds (T-Bonds); **FXD1/2023/2** and **FXD1/2023/5** (Table.1).
- **FXD1/2023/5** and **FXD1/2023/2** were first issued in July and August this year respectively with both bonds receiving high subscriptions in the first auction as well as the tap sales and re-opening.
- These re-opened issues are consistent with the National Treasury's strategy to manage the cost of domestic debt in the current high interest rates environment.
- The Treasury has consistently issued relatively short-term debt with tenors of less than 5 years since April 2023.
- We have been accustomed to aggressive investor bids in recent months as investors take into consideration the following:

  1) Lag time between the upward revision of the CBR and the rise in interest rates on investment instruments.

  2) Government's high budget financing requirements translating to it being accommodative of aggressive investor bids in the face of slow growth in tax revenues.

  3) Relatively high inflation eroding real returns from invested capital.

  4) General market sentiment that interest rates will continue to rise in the near to medium term.

- We expect oversubscription on both papers 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**	**FXD1/2023/5**
Total Amount Offered	KES.55Bn	
Tenor	1.9 Years	4.8 Years
Coupon Rate (%)	16.9723	16.844
Price Quote	Discounted/Premium/Par	
Period of Sale	2nd to 11th Oct 2023	
Auction Date	11th Oct 2023	
Value Date	16th Oct 2023	
Yield Curve (%) (Weighted average tenor - 30th Sep 2023)	**17.3581**	**17.4073**

Source: Sterling Capital Research

Market weighted average bid predictions

- Market-Weighted Average (WAR) bid predictions have been arrived at by analyzing implied yields of securities of similar tenors on the Nairobi Securities Exchange (NSE) as of 30th September 2023 as well as discussions with fixed income traders (Table.2).

Table.2: Auction bid predictions

Rate	FXD1/2023/2	FXD1/2023/5
Weighted Average bid predictions	17.84% - 17.99%	18.79% - 19.94%

Source: Central Bank of Kenya & Sterling Capital Research

Our predicted rates are also guided by current implied yields

- We choose to use the implied yields of the same issues as at 30th September 2023 as a guide for possible investor auction bid levels (Table.3).

Table.3: Benchmark issues to guide investor bids

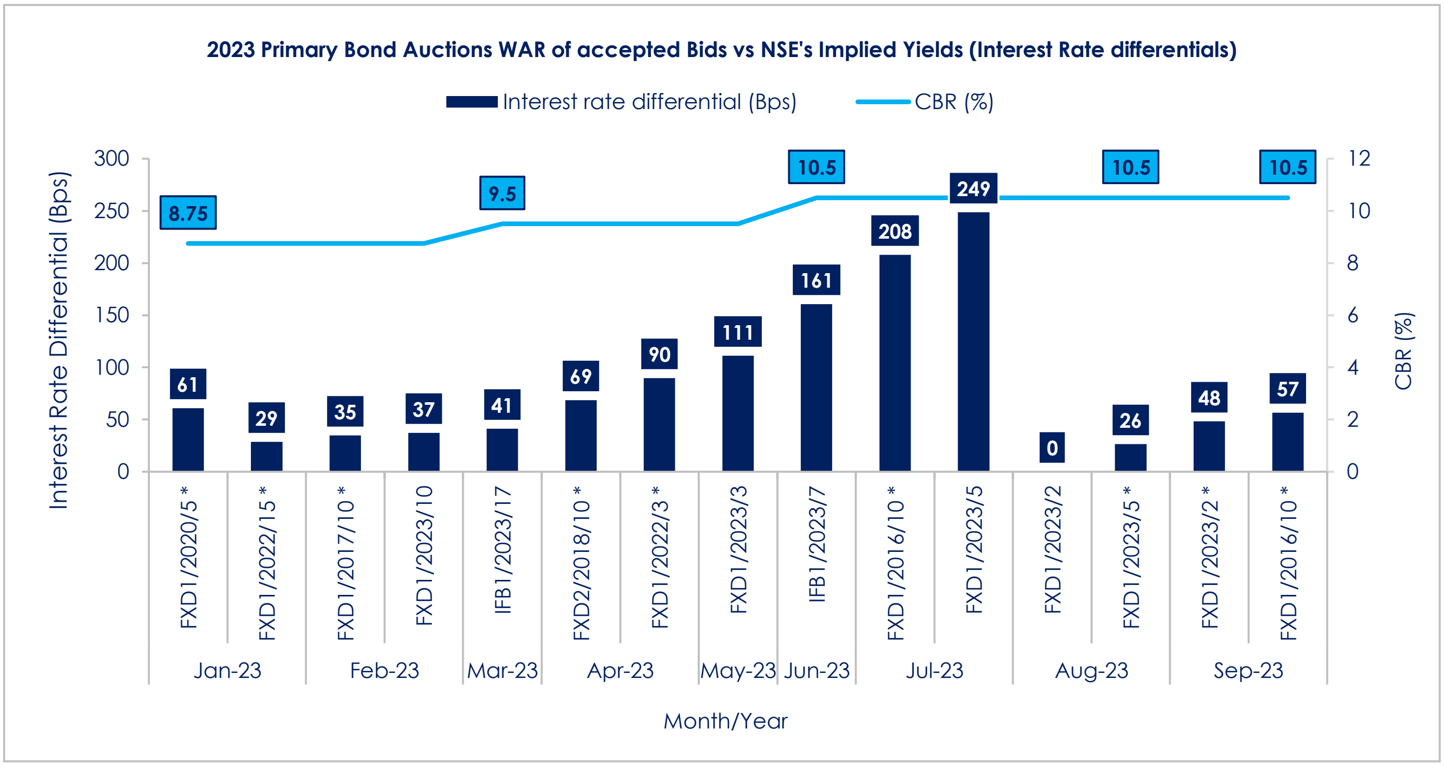
Treasury Bond	Issue Date	Coupon Rate (%)	Maturity Date	Term to Maturity Days (Years)	Implied Yield to maturity (%)	Yield Curve at time of issue (%)
FXD1/2023/2	16th Aug 2023	16.9723	18th Aug 2025	688 (1.9)	17.3581	16.3319
FXD1/2023/5	12th Jul 2023	16.844	10th Jul 2028	1,745 (4.8)	17.4073	14.8548

Source: Central Bank of Kenya

Primary bond auction differentials have narrowed in recent auctions

- We note that there has been a general decline in the difference between the WAR of accepted bids and the NSE's implied yields in recent months (Figure.1).
- This indicates some degree of stability in the rise in interest rates also taking into consideration that most auctions have been for re-opened debt issues with a more or less pre-determined yields leaving less room for speculative bidding.

Figure.1: The difference between WAR of accepted bids and NSE's implied yields have declined

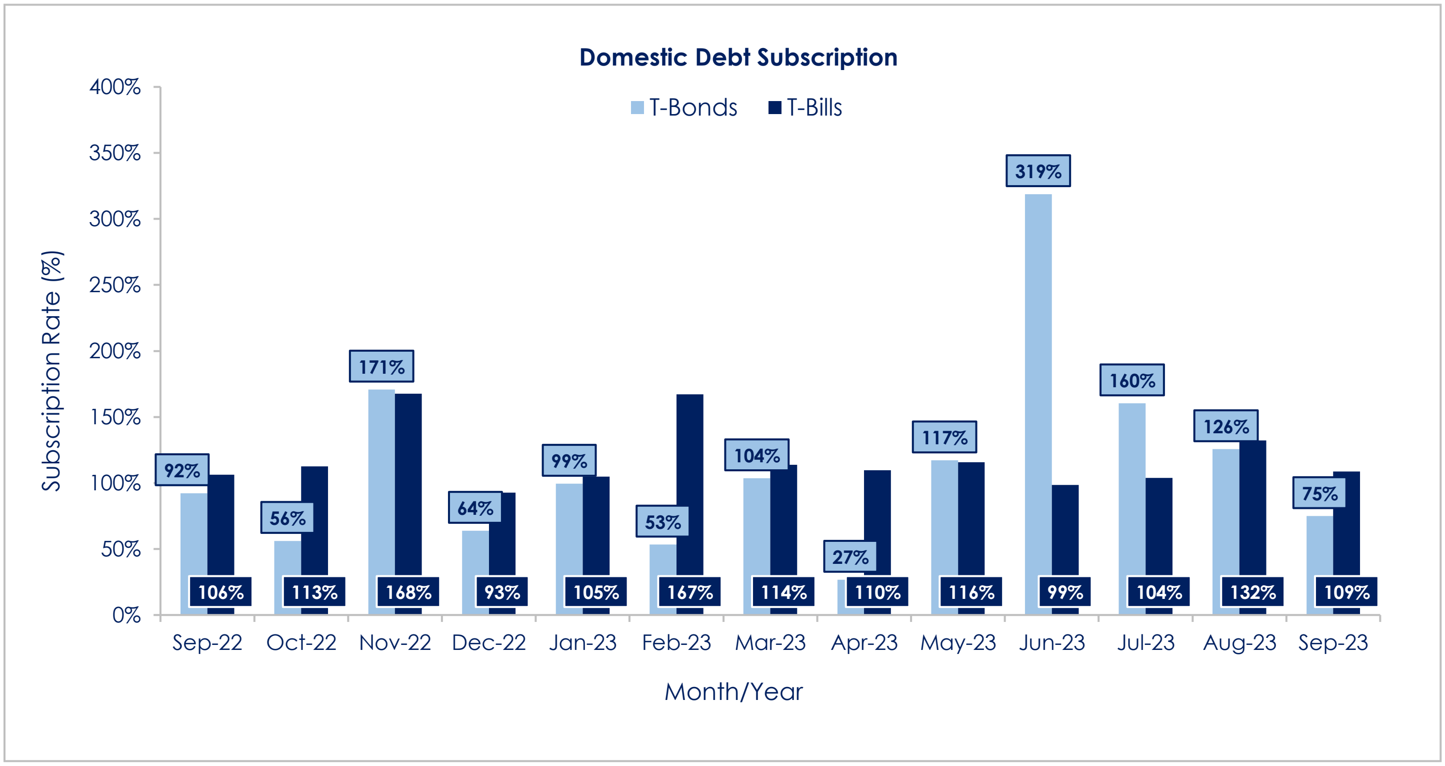


Source: Central Bank of Kenya

Demand for domestic debt issues declines in September 2023

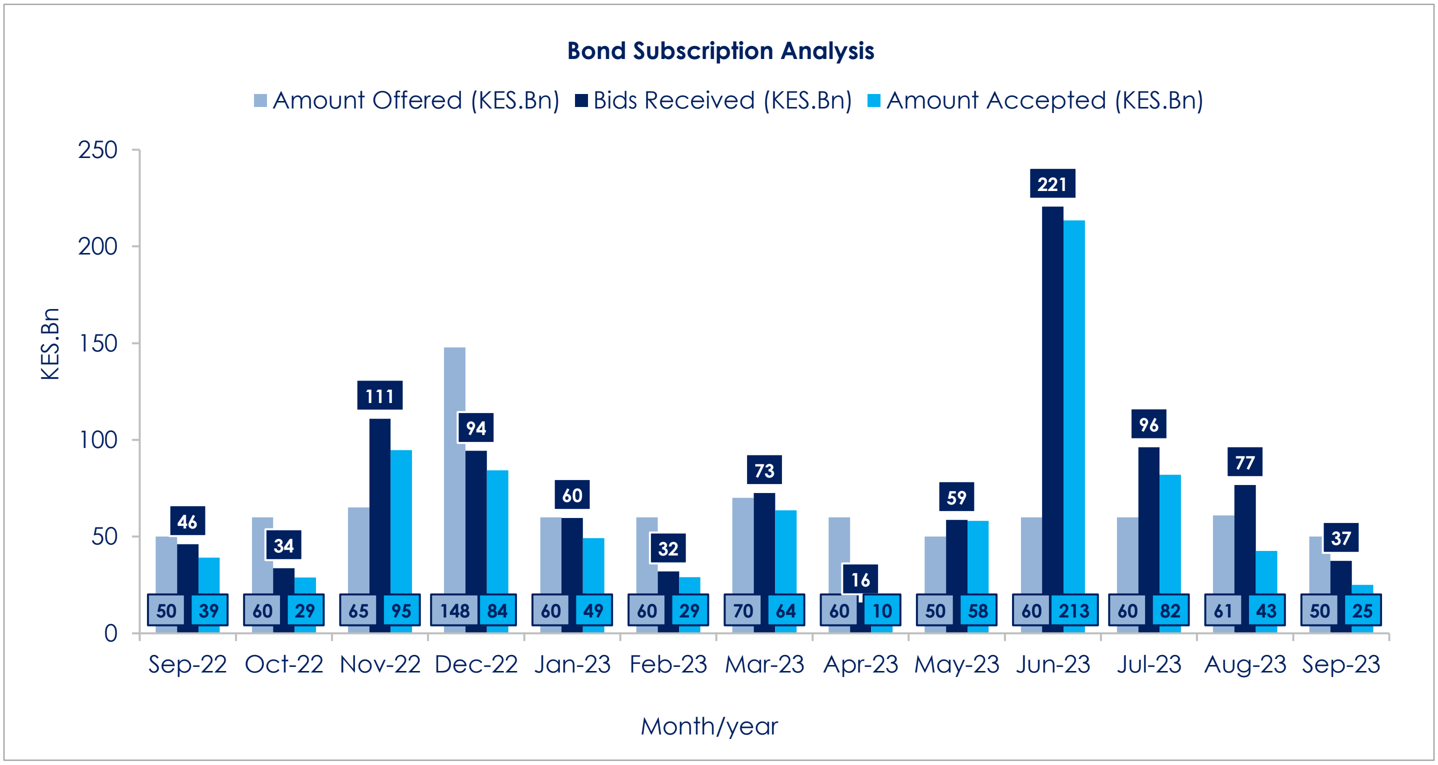
- T-Bill subscription declined in September to 108.6% from 132.2% in August with KES.104.3Bn worth of bids received against KES.96Bn offered (Figure.2).
- The 91, 182 and 364-Day T-Bills recorded 565.6%, 11.2% and 23.3% in subscription rates for the month compared to 655.8%, 40.1% and 14.9% in August 2023 respectively.
- We attribute this to relatively tight liquidity in the market as evidenced by the active Reverse Repurchase Agreement (Repo) market.
- The CBK received bids worth KES.306.3Bn against the KES.215Bn offered with an average rate of 13.6% for the month.
- The CBK accepted KES249Bn (116% acceptance rate).
- This compared to KES.192.4Bn accepted of the KES.155Bn offered in August with KES.147.1Bn accepted at an average rate of 14.1%.
- Notably, T-Bond demand also declined to 74.9% from 125.6% in August with KES.34Bn received in bids against the KES.35Bn offered (Figure.3).

Figure.2: T-Bond subscription declines further in September 2023



Source: Central Bank of Kenya

Figure.3: T-Bond subscriptions dip in September 2023

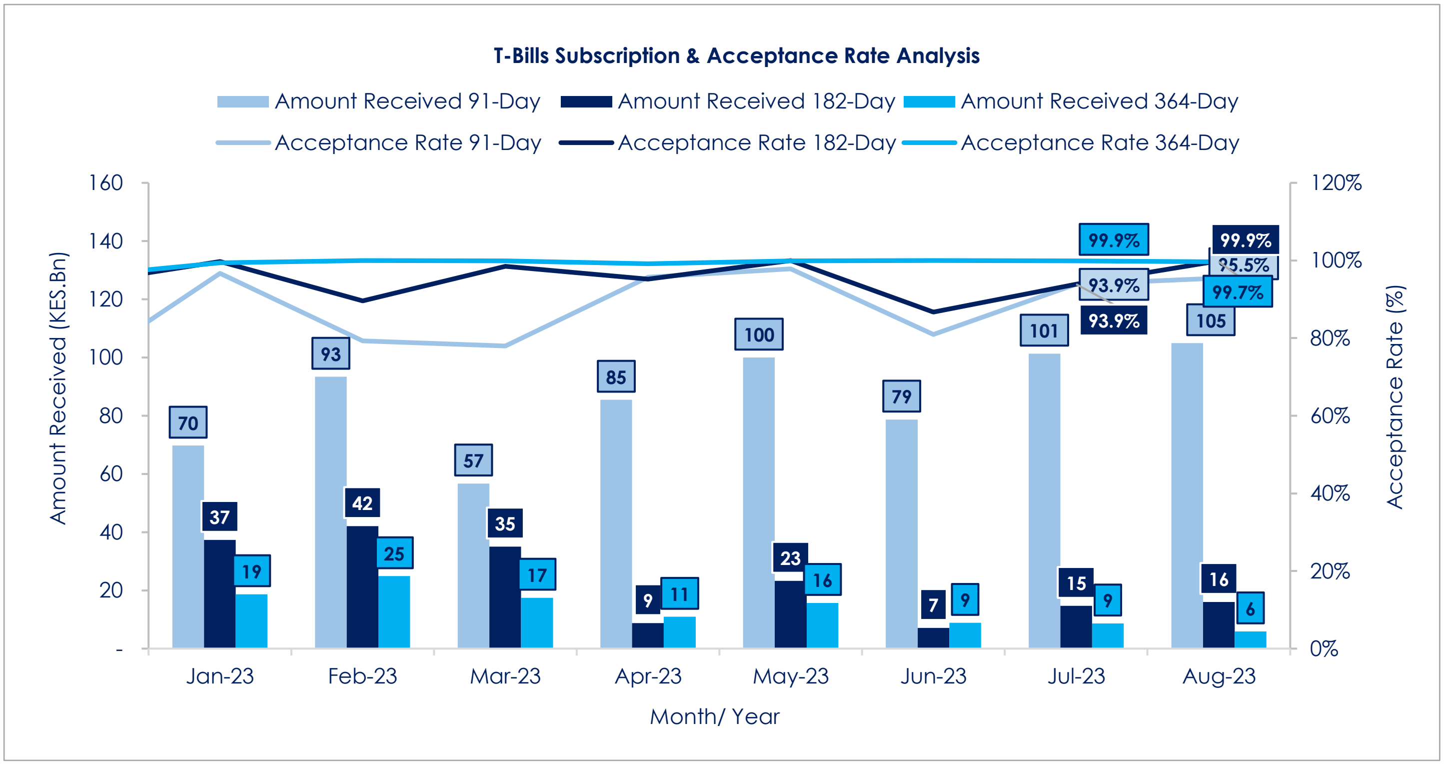


Source: Central Bank of Kenya

Notable decline in the CBK's acceptance rate for the 364 Day T-Bill

- The CBK's acceptance rate for the 91, 182-Day and 364-Day T-Bills stood at 99.2%, 99.8% and 63.4% (Figure.4).
- While we note minimal differences in the month on month acceptance rates in September over August (95.9% and 99.9% for the 91 and 182-day T-Bill), we note a huge disparity in the acceptance rates for the 364-day T-Bill which had a near full acceptance rate of 99.7% in August 2023.
- We attribute this to the CBK's strategy of rejecting aggressive bids to control the rise in interest rates.
- In this regard, the yield for the 364-Day T-Bill in the last auction of the month declined 17 bps having risen 49 bps in the previous auction.

Figure.4: 364-Day T-Bill acceptance rate dips sharply in September 2023

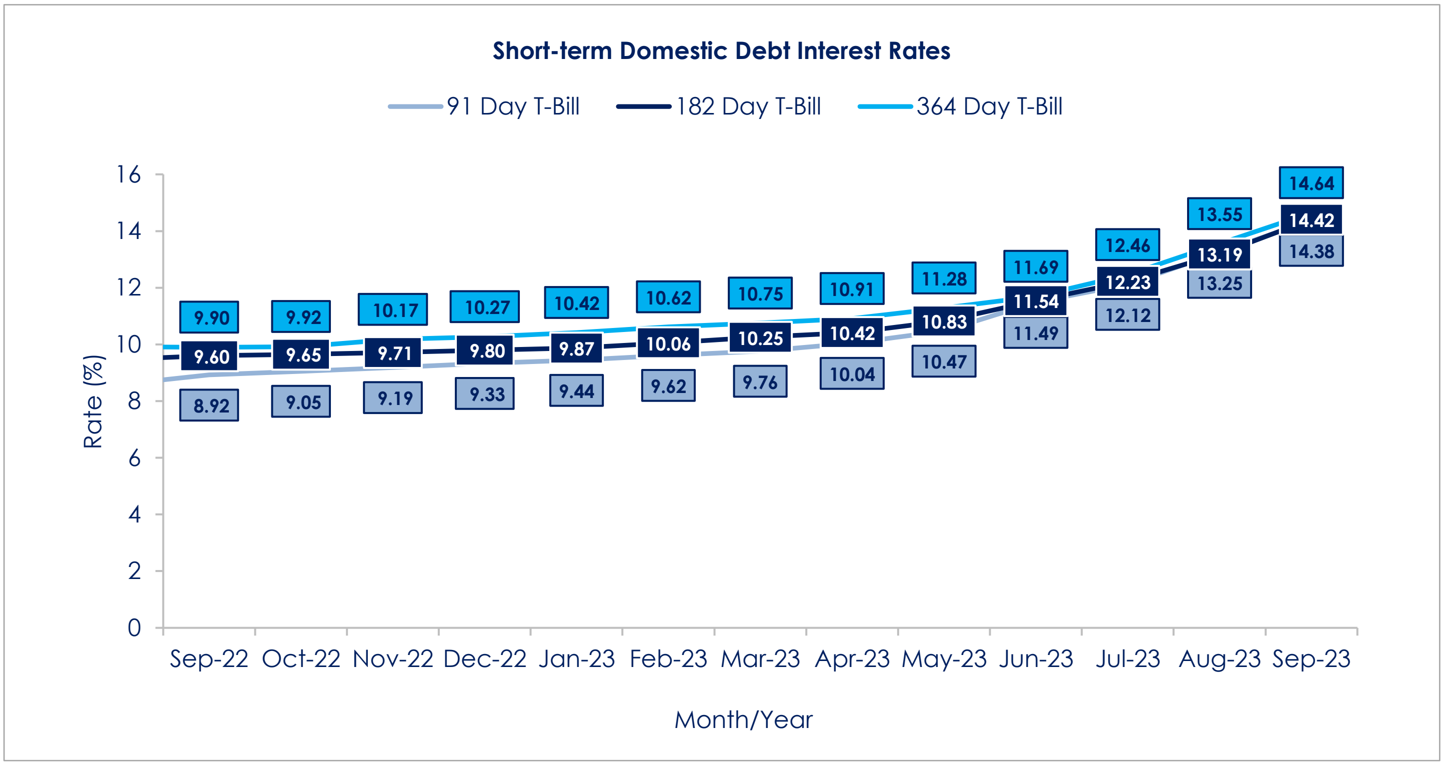


Source: Central Bank of Kenya

T-Bill rates edge closer to 15% in September 2023

- T-Bill rates continued in an upward trajectory in September 2023 with the average 91, 182 and 364-day rates up to 14.3%, 14.4% and 14.6% from 13.3%, 13.2% and 13.6% in August 2023 respectively (Figure.5).
- This as mentioned earlier is attributable to upward CBR revisions, high budget financing needs, relatively high inflation as well as investor expectations.
- We expect average T-bill yields to rise cross over 15% in October.

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

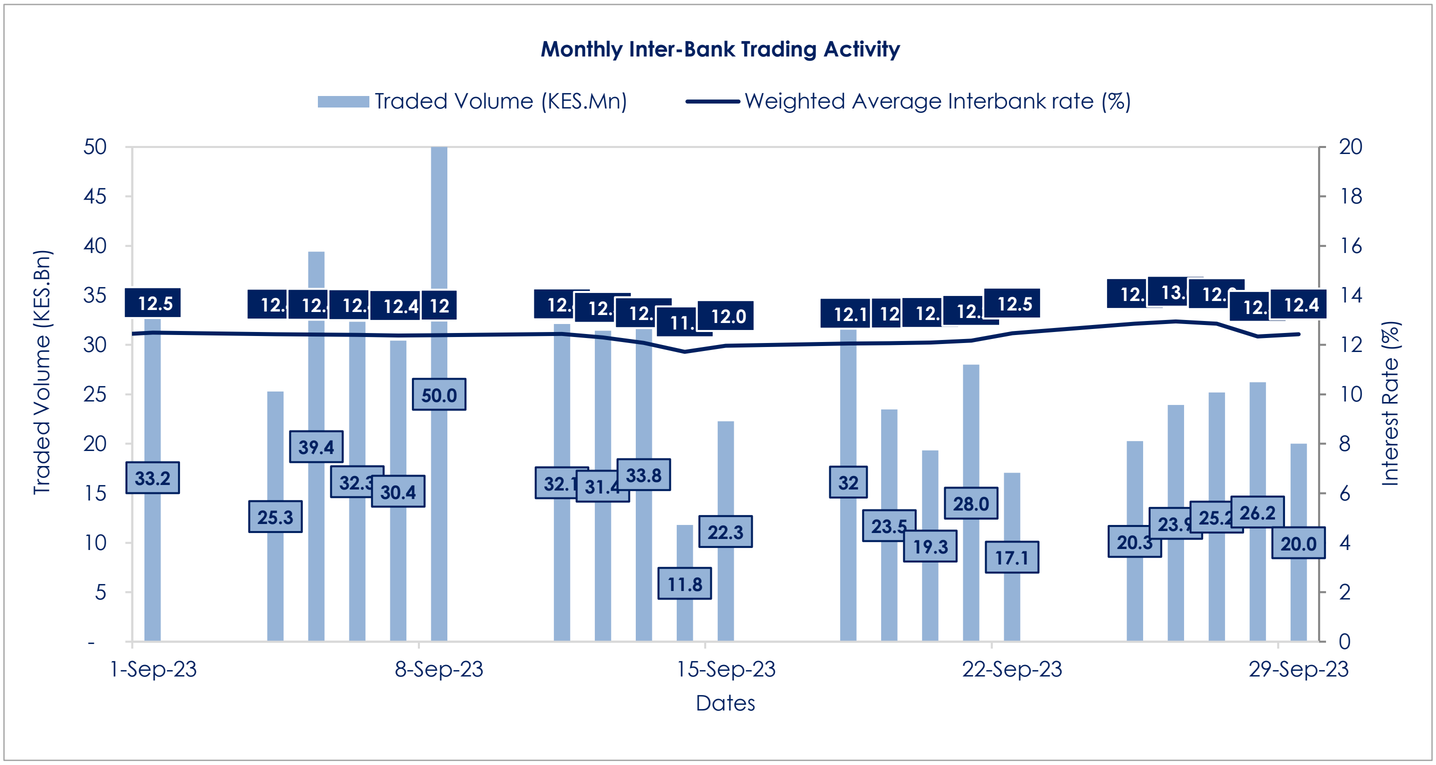


Source: Central Bank of Kenya

Average interbank rates decline in September 2023

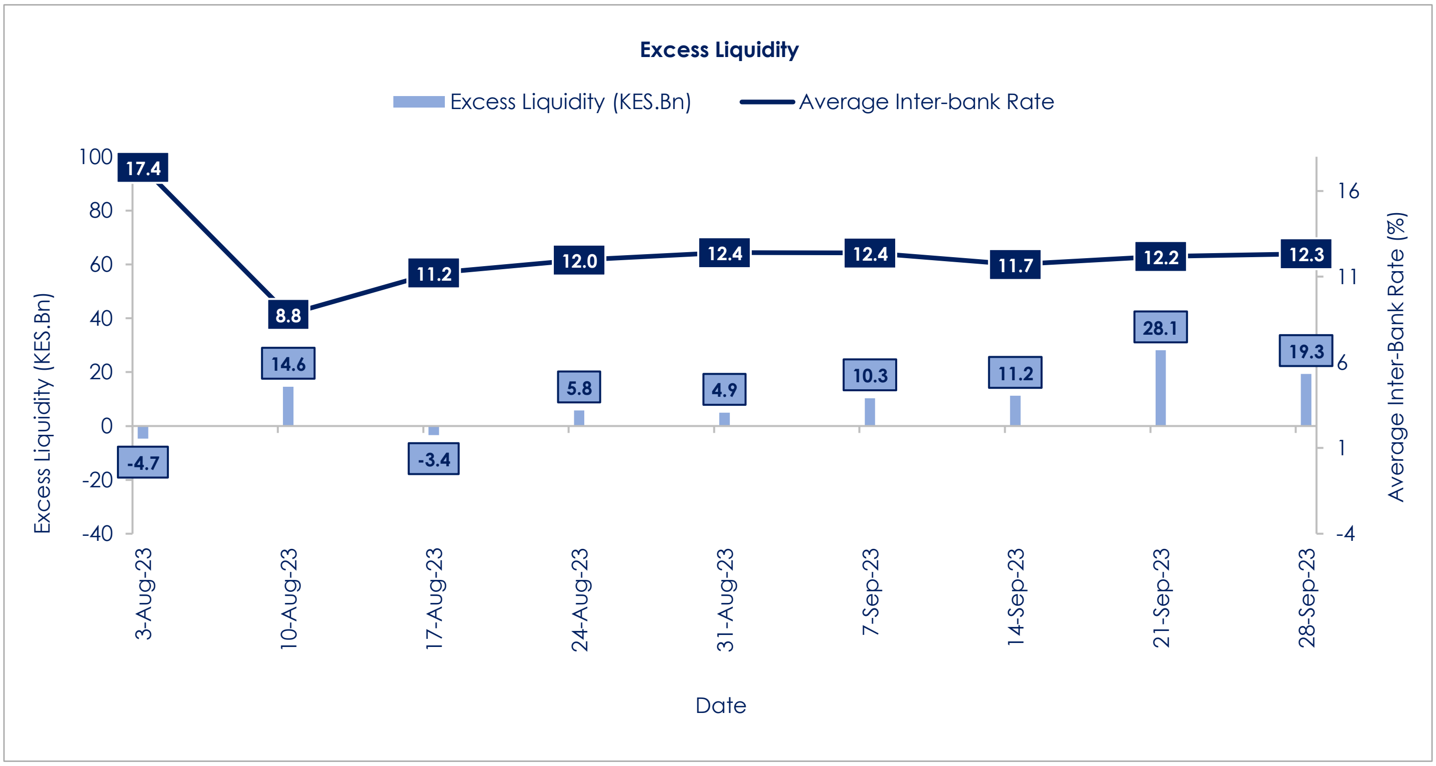
- Average inter-bank rates declined slightly to 12.3% in September compared to 12.5% in August (Figure.6).
- Trading volumes however increased 4.3% to KES.577.7Bn over the same period (KES.554.1Bn in August).
- Over the same period, excess reserves which is the additional liquidity above the minimum 4.25% Cash Reserve Ratio (CRR) rose 300.6% to KES.68.9Bn (Figure.7).

Figure.6: Average inter-bank lending rates decline in September 2023



Source: Central Bank of Kenya

Figure.7: Excess commercial bank reserves ticks up in September 2023

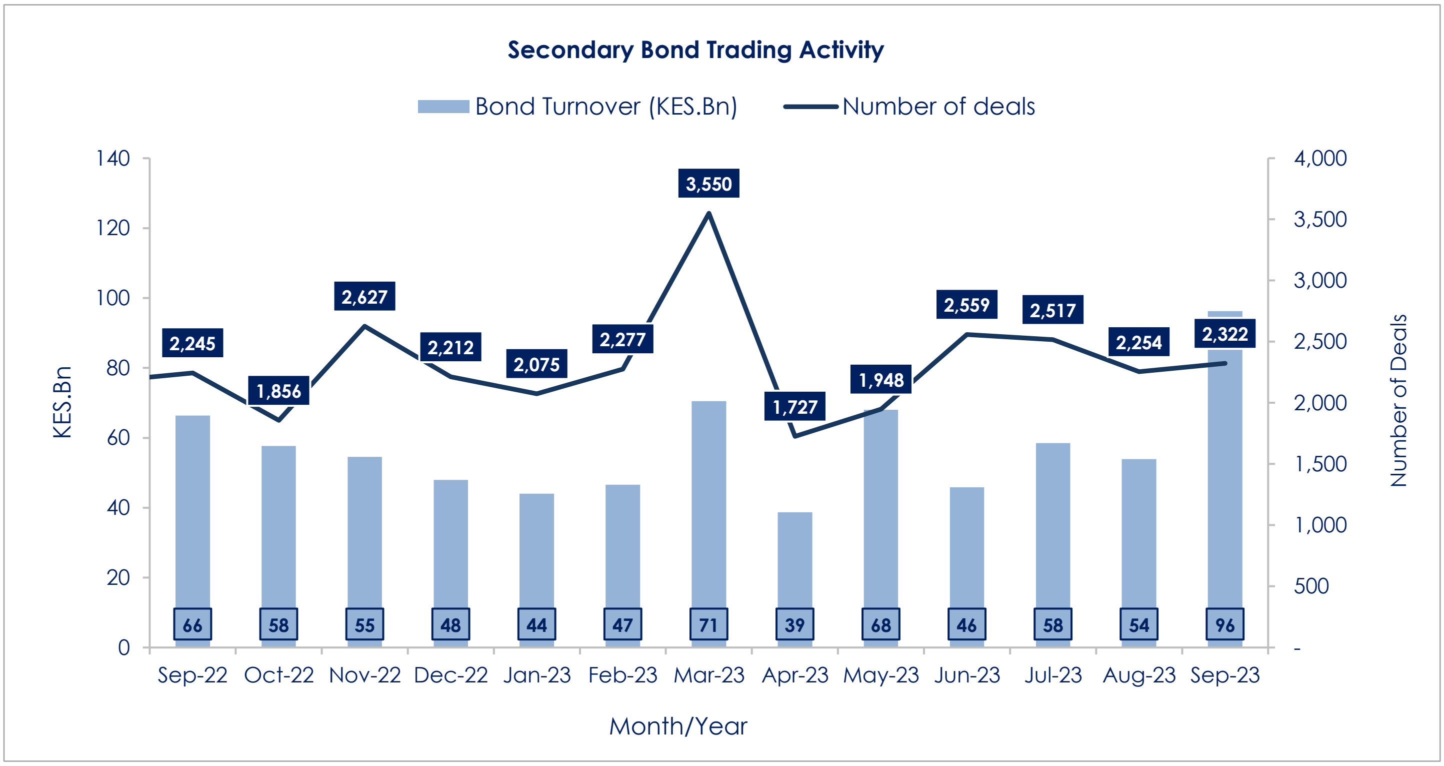


Source: Central Bank of Kenya

Bond turnover rises sharply in September 2023

- Secondary bond market trading increased 78.6% to KES.96.2Bn in September 2023 from KES.53.9Bn the previous month. The number of deals for the month rose but marginally (3%) to 2,322 from 2,254 (Figure.8).
- The increase in turnover can be attributed to the high trading activity of the recent re-opened short term debt issues by the Central Bank of Kenya (CBK).

Figure.8: Secondary trading activity rises 78% in September 2023

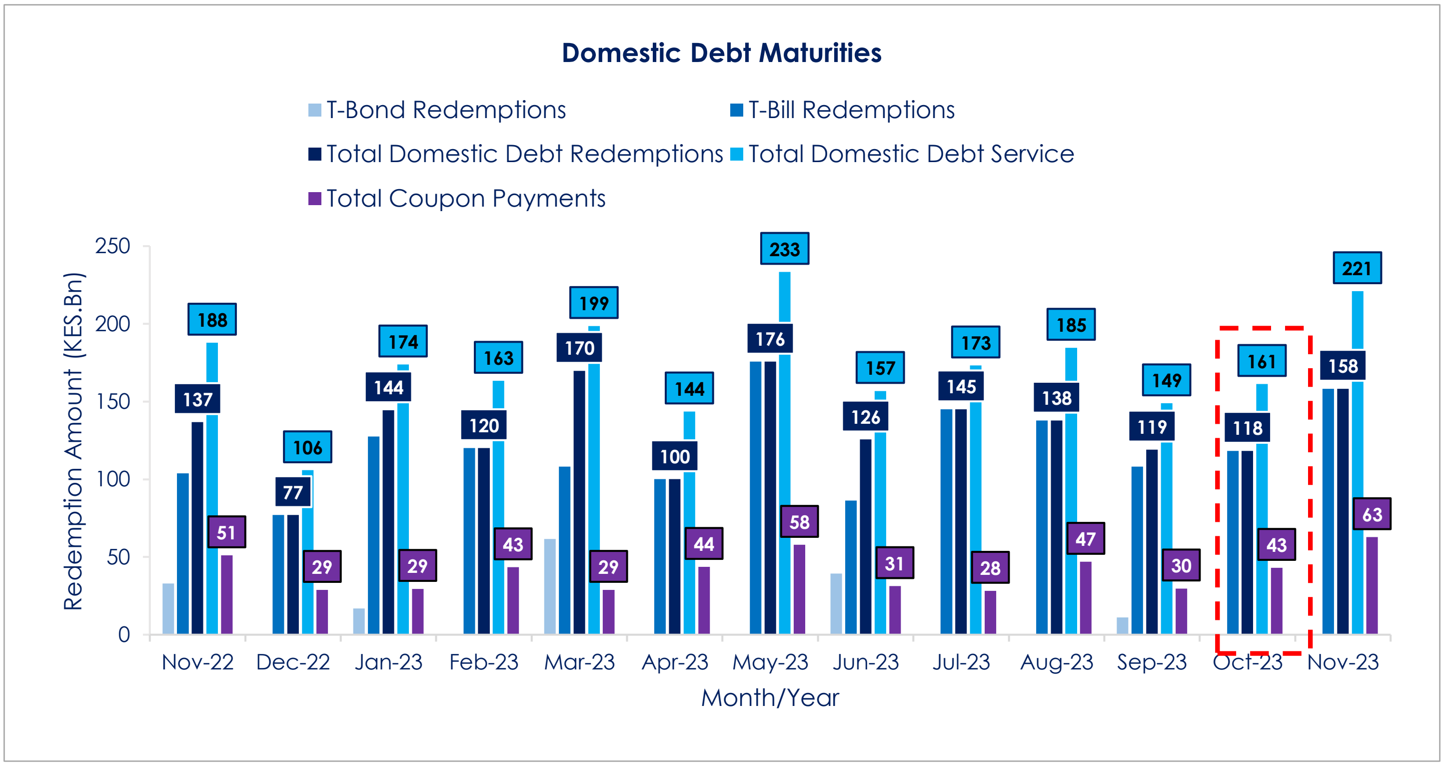


Source: Central Bank of Kenya

Domestic debt service to increase in October 2023

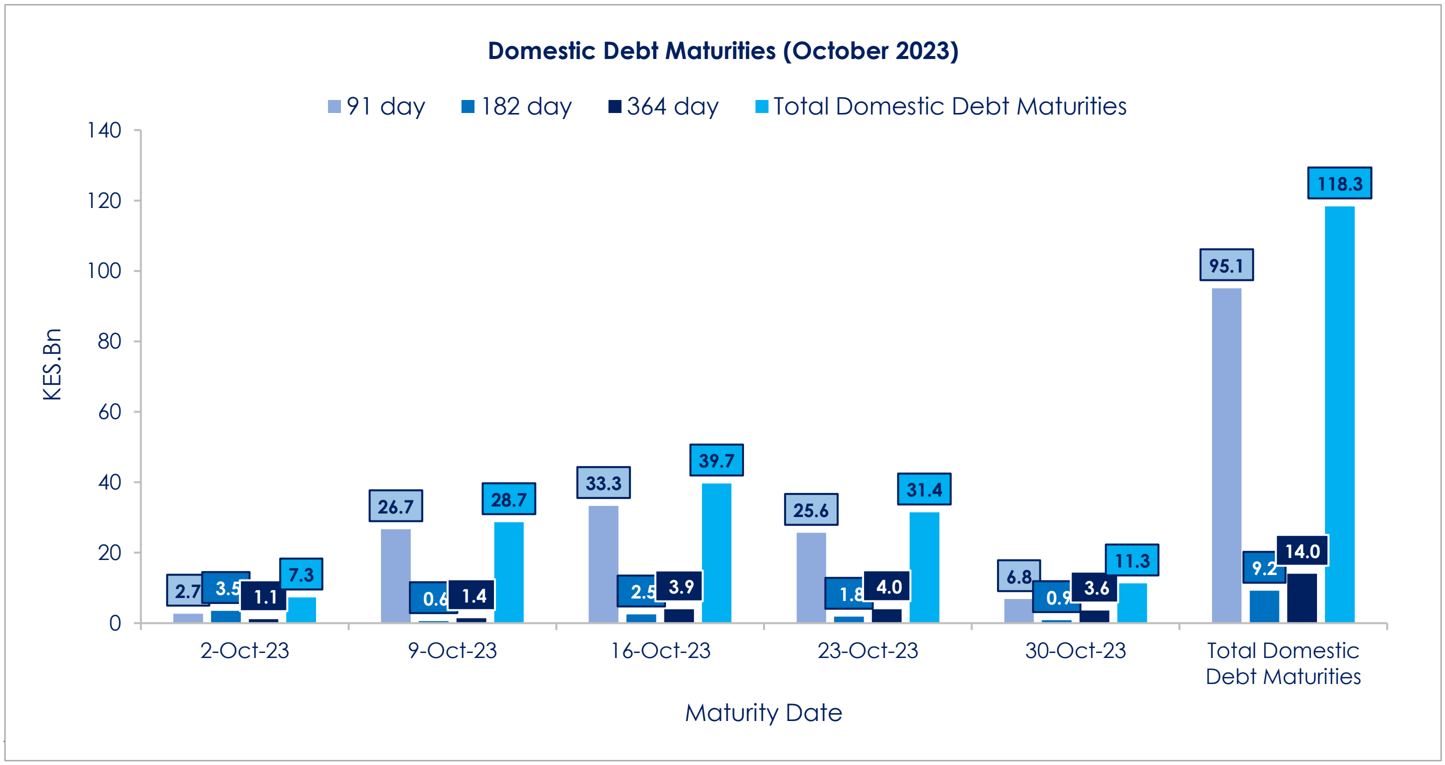
- Total domestic debt service is set to increase by 8.4% in October 2023 to KES.161.3Bn from KES.148.9Bn in September 2023. (Figure.9).
- This includes KES.118.3Bn and KES.43Bn in T-Bill redemptions and coupon payments respectively.
- Redemptions for the 91, 182 and 364-day T-Bills amount to KES.95.1Bn, KES.9.2Bn and KES.14Bn respectively with the third week of the month having the highest redemptions at KES.39.7Bn (Figure.10).

Figure.9: Uptick in debt service set for October 2023 given a rise in T-Bill redemptions



Source: Central Bank of Kenya

Figure.10: Second week of September 2023 with highest T-Bill redemption at KES.39.7Bn



Source: Central Bank of Kenya

Actual 2023/24 domestic borrowing remains above our linear target run rate

- Data at the end of the second month of the 2023/24 fiscal year (31st August 2023) shows domestic borrowing at KES.83.6Bn which is equivalent to 18.3% of the KES.688.2Bn fiscal year estimate (Table.4 & Figure.12).
- We however continue to see the underperformance of tax revenue at 12.7% of the 2023/24 target of KES.2.5Tn and this has a significant impact on the underperformance of total revenue.
- We have repeatedly stated in previous reports that a 27% increase in tax revenue for the current fiscal year over the previous one is ambitious.
- On account of the above, we expect a downward revision of tax estimates and upward revisions of not only domestic but external borrowing estimates.

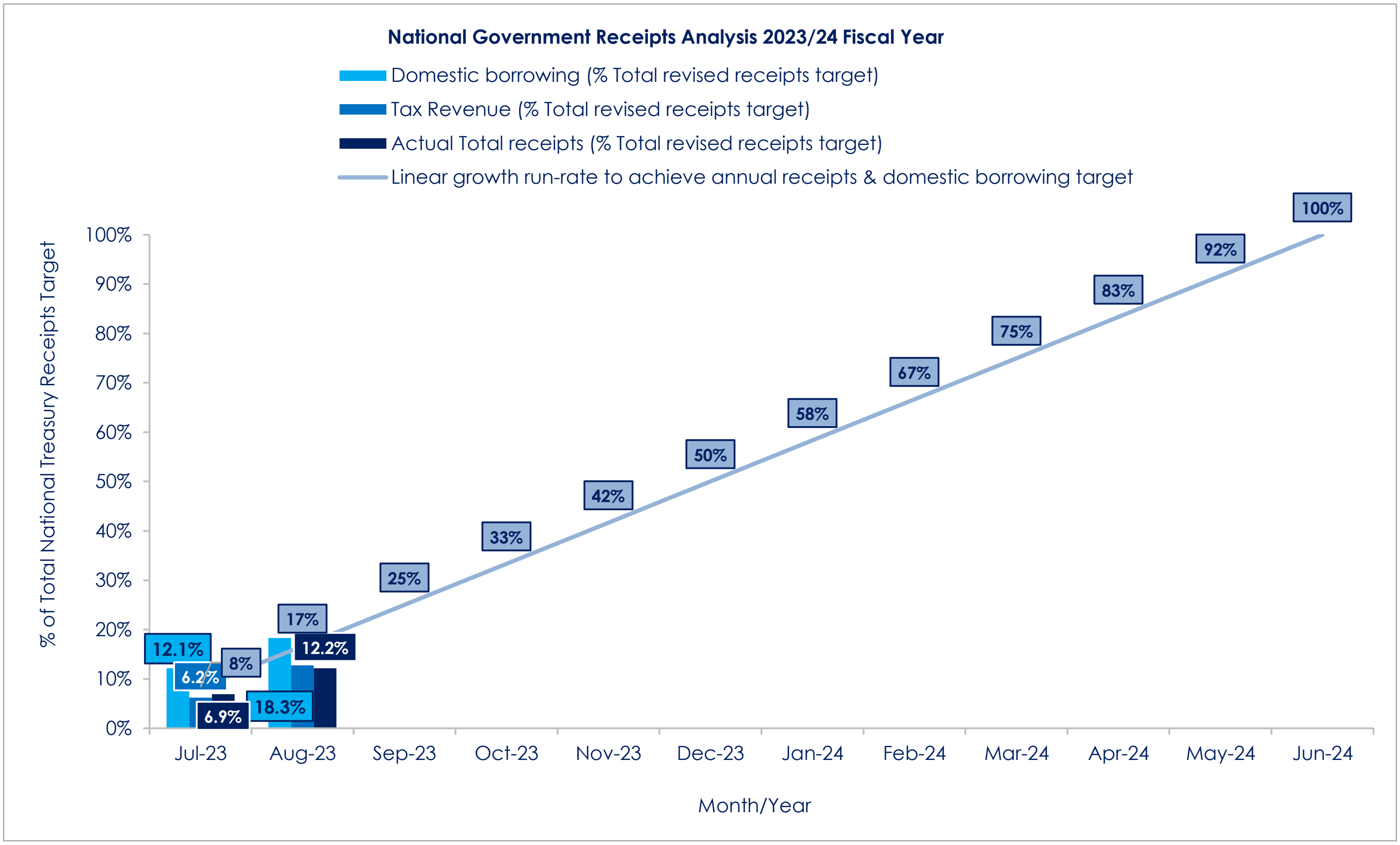
Table.4: Domestic borrowing above linear target run rate after first month of 2023/24 fiscal year

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 August 2023	Proportion of Total Receipts 31st July 2023
Opening Balance (1st July)	616.5			2.6	
Tax Revenue	**1,962**	2,495.8	**27.2%**	317.6	**12.7%**
Non-Tax Income	82	75,3	**-8.2%**	3.2	4.3%
Domestic Borrowing*	**696.4**	**688.2**	**-1.2%**	**83.6**	**18.3%**
External Loans & Grants	488.3	870.2	**78.2%**	125.7	6.1%
Other Domestic Financing	16.1	3.2	**-80.1%**	2.8	89.1%
Total Revenue	**3,244.8**	**4,132,7**	**27.4%**	**502.4**	**12.2%**
Linear Run Rate target 2022/23					**16.7%**

* 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.206 15th September 2023

Figure.12: Domestic borrowing is above our linear target run rate

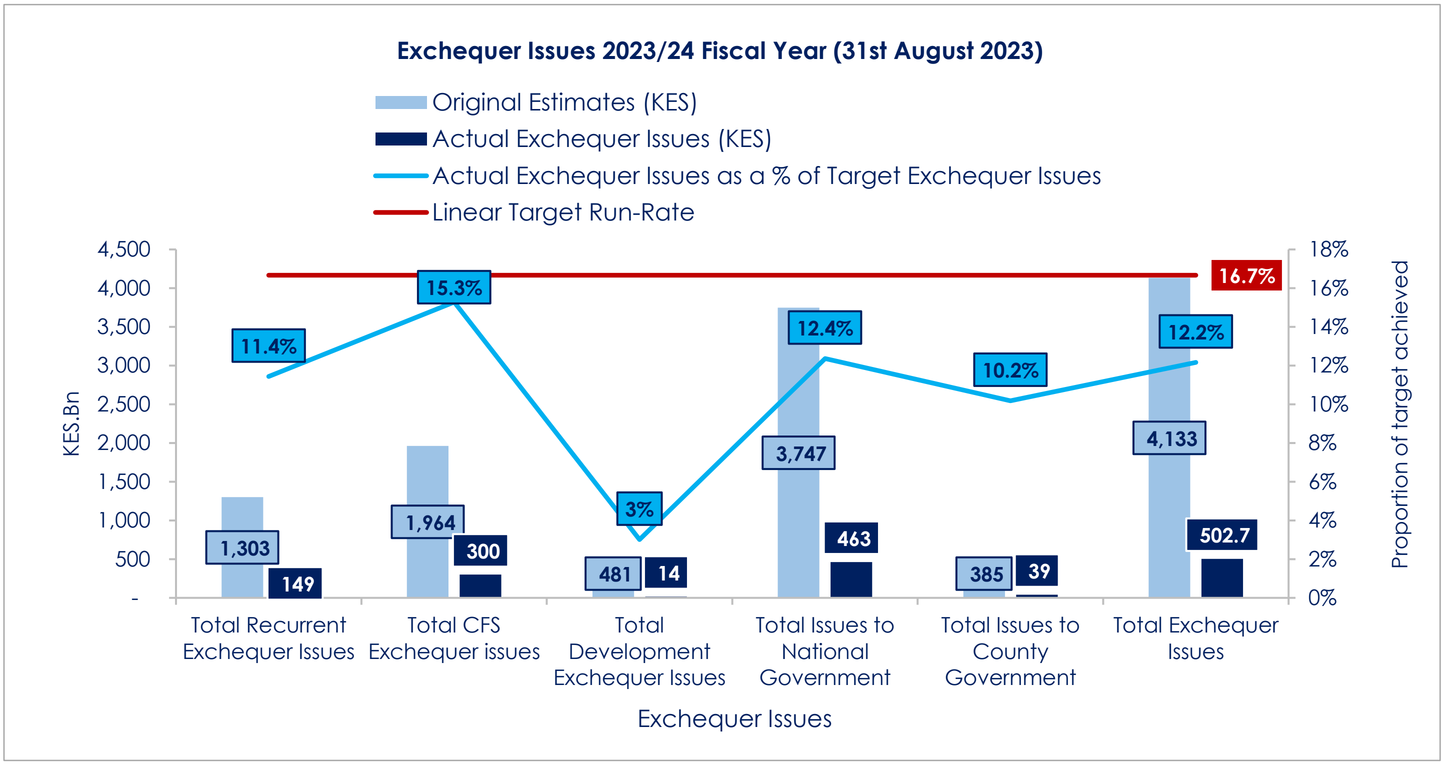


Source: The Kenya Gazette Vol. CXXV - No.206 15th September 2023

2023/24 exchequer issues fell below revised targets

- Our analysis of exchequer issues at the end of August 2023 shows that all exchequer issues remain below our linear target run rate of 16.7% which we attribute to the underperformance of Government revenue (Figure.13).
- Of particular note is development expenditure which stands at KES.14Bn or 3% of the fiscal year target.
- The trend in recent years has been cutting down on development spending to manage Government expenditure while recurrent expenditure continues to grow at a fast pace.
- Also of great interest to investors would be CFS exchequer issues where we see the strain of salaries and allowances (KES.6.6Bn against a target of KES.23.5Bn) as well as public debt (KES267Bn against a target of KES.KES.1.75Tn) on the country's income.

Figure.13: Total 2023/24 exchequer issues constrained by slow growth in Government revenue

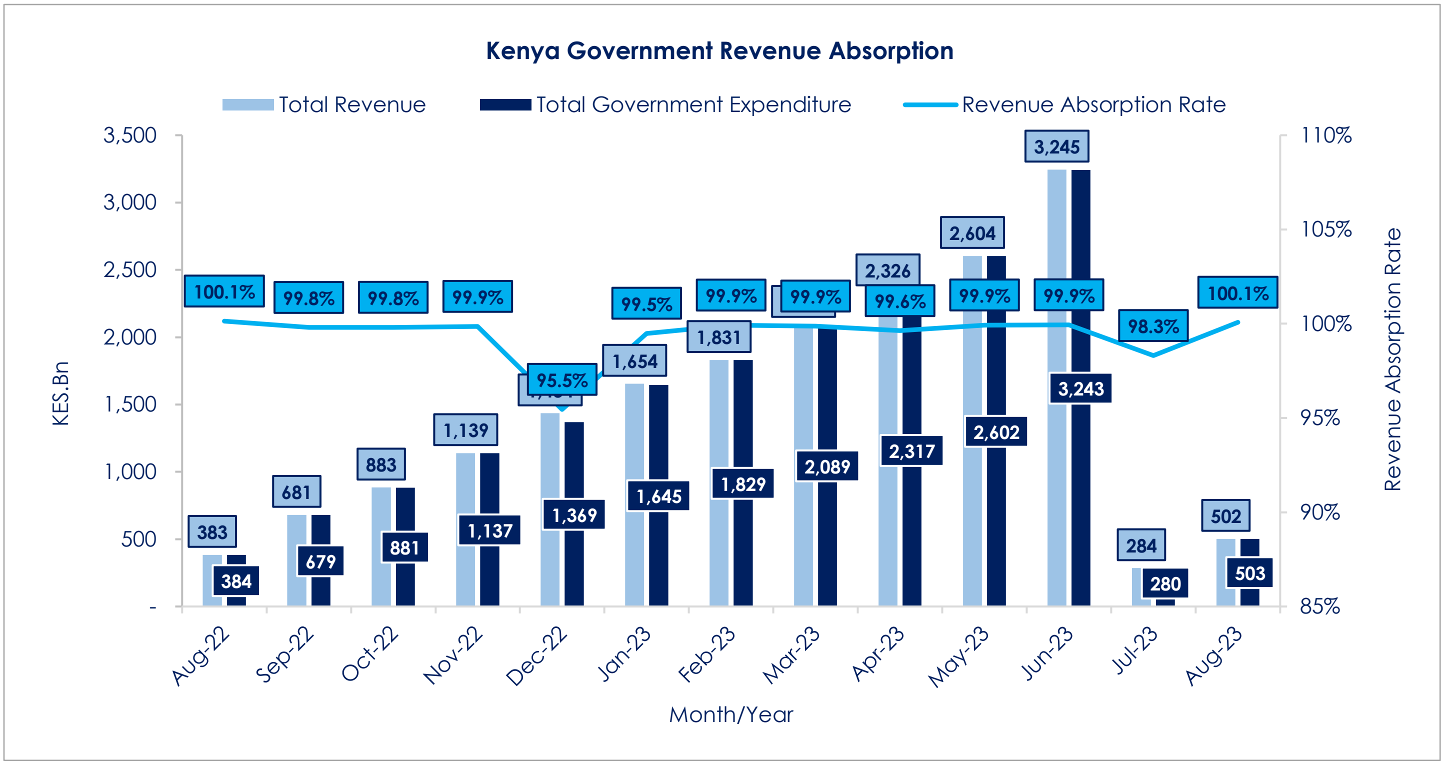


Source: The Kenya Gazette Vol. CXXV - No.206 15th September 2023

Full Government Revenue Absorption for August 2023

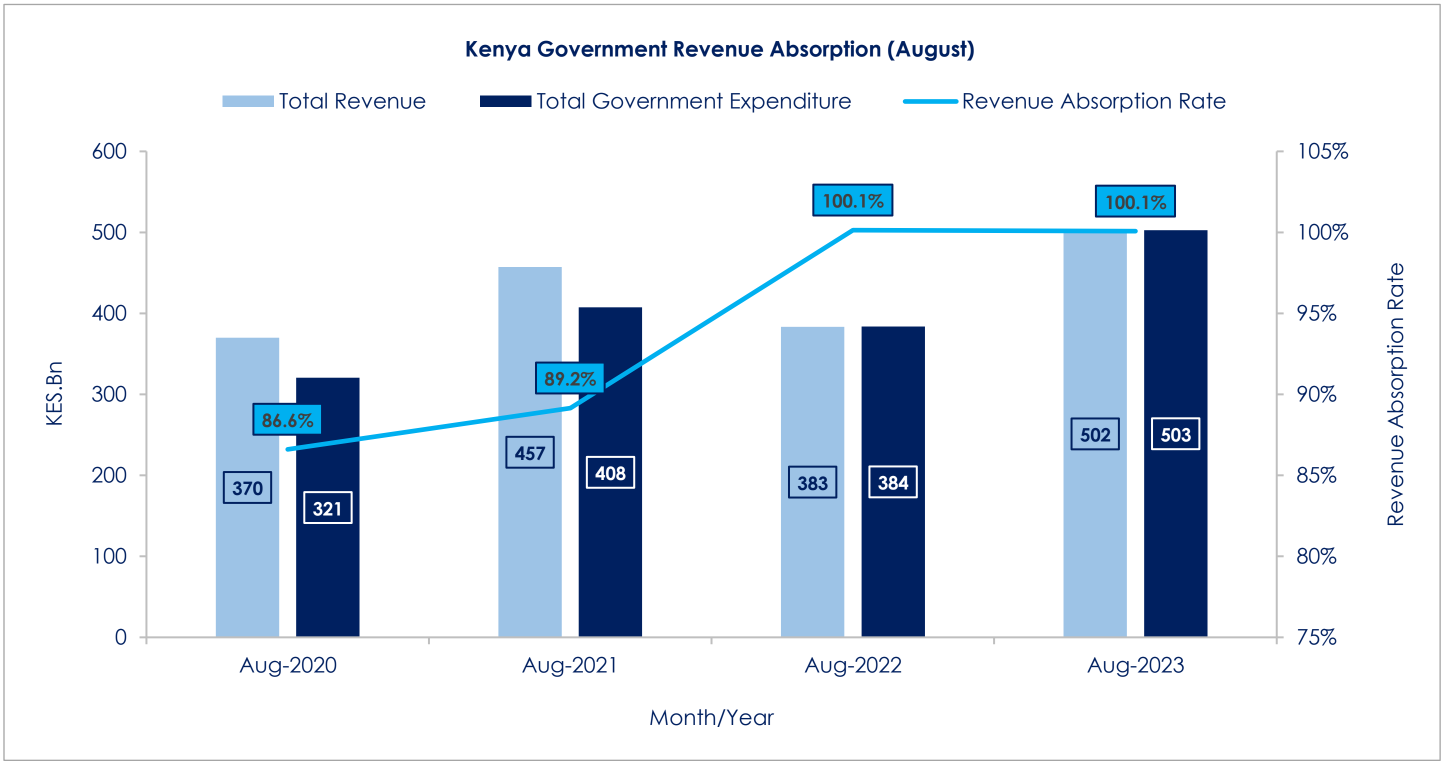
- A full Revenue Absorption Rate (RAR) was reported in August 2023 similar to the same period in 2022 (Figure.14).
- This is an indication of the Government's revenue constraints relative to its expenditure needs.
- When we do a year on year comparison since 2020, we note that full absorption has been reported over the last two fiscal years with 2020 and 2021 reporting significantly lower absorption rates (Figure.15).
- Also notable is the 31% increase in both revenue and expenditure in the current over the last fiscal year.
- The same period in 2022 saw a 16.1% and 5.8% decline in revenue and expenditure over the same period in 2021.

Figure.14: Full Revenue Absorption Rate reported in August 2023



Source: The Kenya Gazette Vol. CXXV - No.206 15th September 2023

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

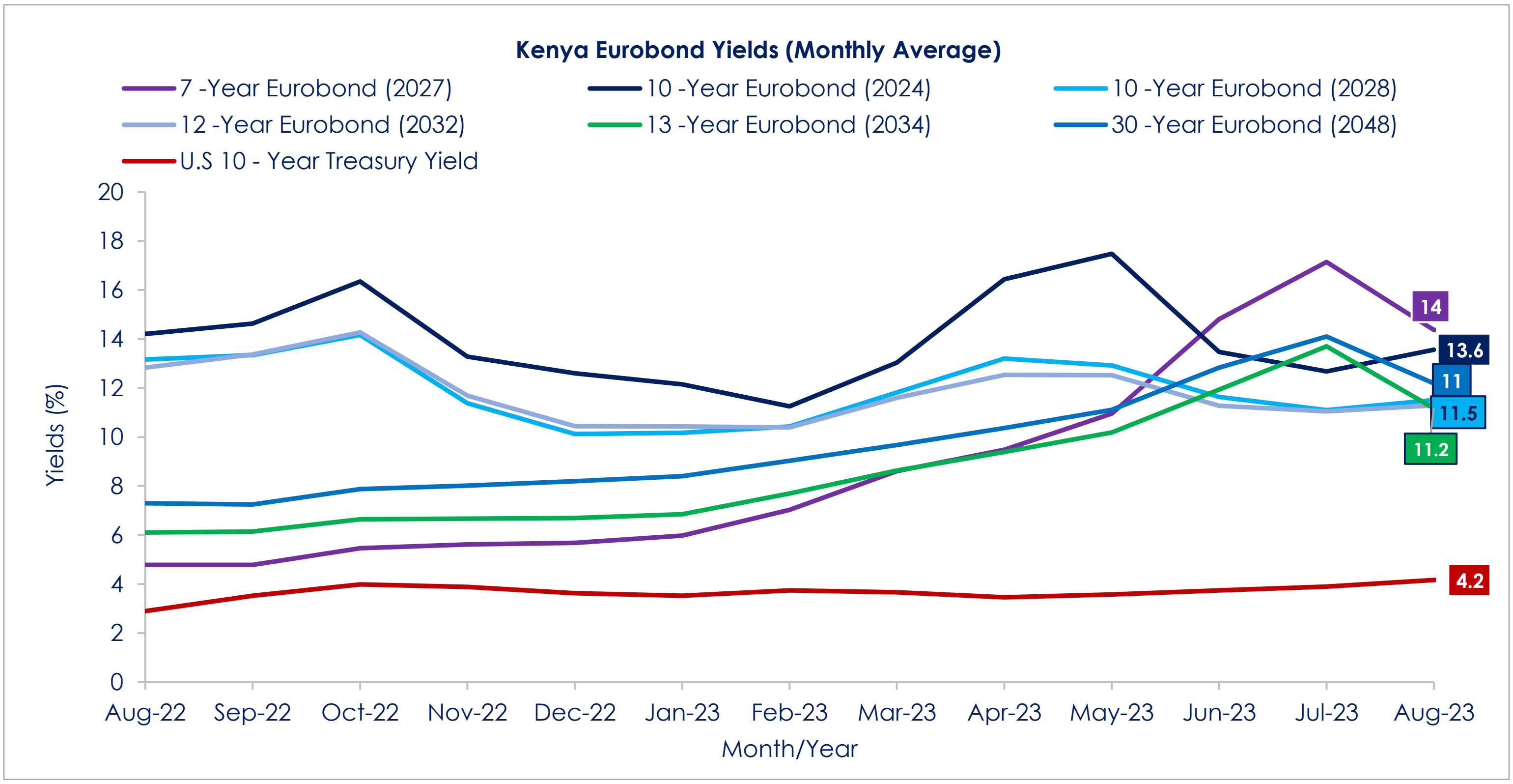


Source: The Kenya Gazette Vol. CXXV - No.206 15th September 2023

Kenya Eurobond yields rise in September on investor fears

- Average yields on Kenya Eurobonds rose 129 bps in September compared to the previous month (Figure.16).
- The increase largely attributable to the sharp rise in yields on the 10-year bond maturing in 2024 (237 bps), 10-year bond maturing in 2028 (199bps) and the 7-year bond maturing in 2027 (143 bps) (Figure.16).
- The bond has seen a steep increase in yields in recent weeks from yields as low as 14% on 15th September 2023 as investors priced in comments made by President William Ruto around debt relief.
- As highlighted in our Public Debt analysis report, "Is Kenya going the debt restructuring route," we find it highly unlikely that Kenya will default on this Eurobond debt and is likely to refinance in the coming months.
- Over the same period, the US 10-year treasury yield rose 21 bps to 4.38% with the yield curve inversion still persisting.
- It is expected that yields will continue to rise for the rest of the year as the Federal Reserve continues to counter high inflation.

Figure.16: Kenya Eurobond yields up in August 2023



Source: Central Bank of Kenya

NSE Yield curve continues to shift upwards in September 2023

- A comparison of average debt security NSE yields as at 29th September 2023 against those as at 18th August 2023 (Close to issuance of **FXD1/2023/2**) and 14th July 2023 (Close to issuance of **FXD1/2023/5**) and a year ago shows a sharp in interest rates increase across the curve for the reasons mentioned earlier in this report. (Table.5 and Figure.17).
- We expect this upward shift in the yield curve to continue for the short term.

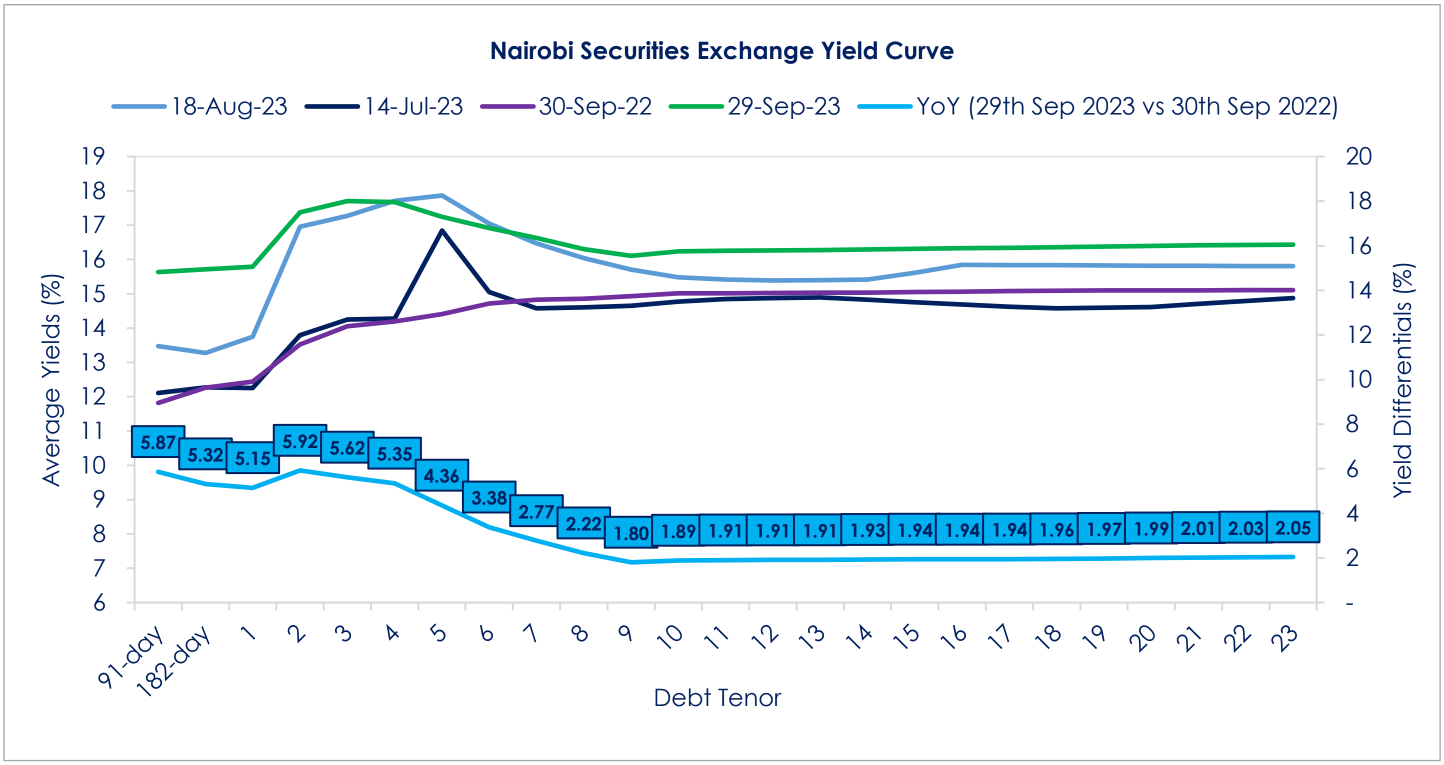
Table.5: Yield curve has significantly shifted upward across all tenors

Tenor	Yields (18th Aug 2023)	Yields (14th July 2023)	Yields (30th Sep 2022)	Yields (29th Sep 2023)	∆ 29th Sep 2023 vs 18th Aug 2023) Bps	∆ 29th Sep 2023 vs 14th Jul 2023) Bps	YoY ∆ (29th Sep 2023 vs 30th Sep 2022) Bps
1	13.7459	12.2500	9.9050	15.0544	↑ 130.9	↑ 280.4	↑ 514.9
2	16.9598	13.7887	11.5772	17.5018	↑ 54.2	↑ 54.2	↑ 592.5
5	17.8660	16.8440	12.9382	17.2996	56.6	↑ 45.6	↑ 436.1
10	15.4817	14.7745	13.8625	15.7542	↑ 27.3	↑ 98	↑ 189.2
15	15.6154	14.7556	13.9206	15.8599	↑ 24.4	↑ 110.4	↑ 193.9
20	15.8190	14.6165	13.9970	15.9912	↑ 17.2	↑ 137.5	↑ 199.4

Source: Nairobi Securities Exchange

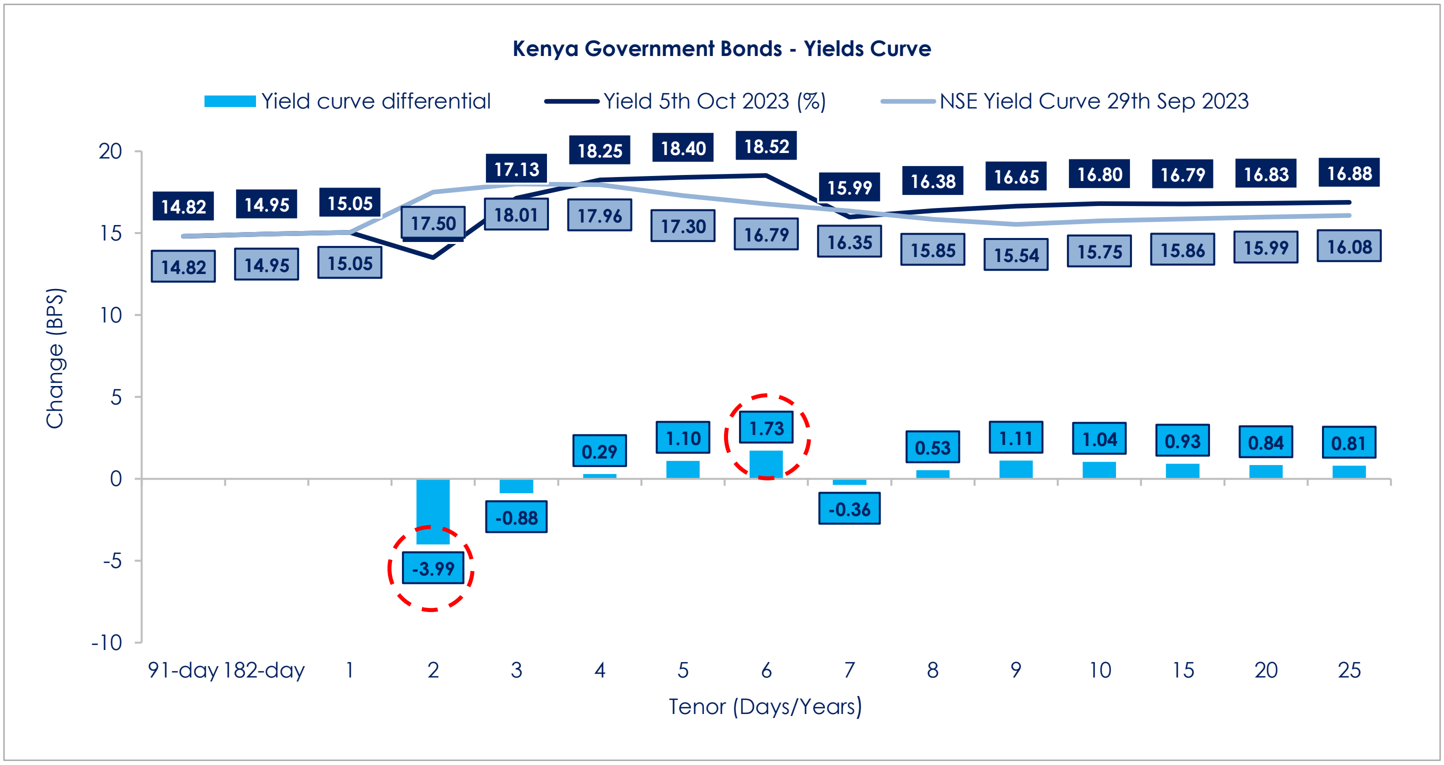
- We also use the Kenya Government bonds yield curve (source: World Government bonds) to determine possible investor bidding levels (Figure.18).
- We notice disparities in yields in the short and medium end of the curve.
- This curve puts the 2-year yield at 13.50% which is 399.5Bps below the current NSE yield curve and 18.40% for the 5-year bond which is 110Bps above the NSE yield curve.
- Investors bidding for the re-opened debt issues could therefore use both these yield curves to set their bidding levels where we recommend fairly aggressive bidding on both debt issues.

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 & short-term domestic debt

- 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.
- This is on account of high yields with investors also having the option of holding till maturity or disposing if trading opportunities arise (Table.6).
- **XS1028952403** had a yield of 18.4% as at 6th October with about eight months until maturity.
- The bond has seen a steep increase in yields in recent weeks for the reasons mentioned earlier in this report under Kenya Eurobond yields.
- Investors looking for higher yields on domestic debt could dispose their current bond holdings in favour of new short term bonds but be wary of actualizing price losses.
- The comparatively higher yields on the new investments however might be sufficient to compensate them for the losses incurred combined with coupons already earned from the previous holdings.

Table.6: Trading ideas - Consider Kenya Eurobonds

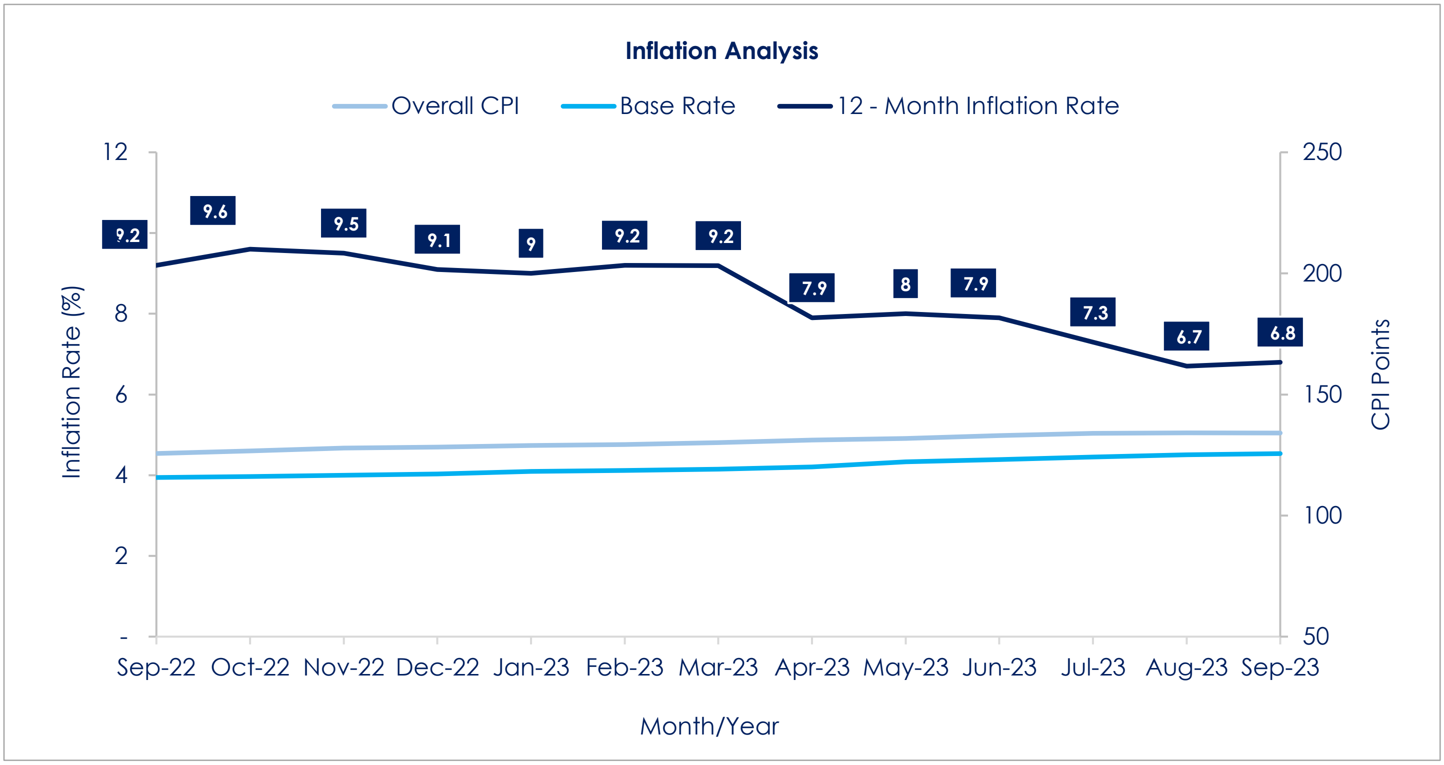
ISIN Code	Issue date	Tenor (Years)	Maturity	Outstanding amount (US.$ Bn)	Coupon	Yield to maturity (28th Sep 2023)
XS1028952403	Jun -14	10	Jun-24	2	6.875%	18.696%
XS1843435840	May -19	7	May-27	0.9	7%	14.558%
XS1781710543	Feb -18	10	Feb-28	1	7.25%	13.490%

Source: Bloomberg & Central Bank of Kenya

September 2023 inflation increases slightly to 6.8%

- September 2023 inflation increased marginally to 6.8% from 6.7% in August on account of a general rise in prices (Figure.19).
- Prices of commodities under transport; food and non-alcoholic beverages; housing, water, electricity, gas and other fuels increased 13%, 7.9% and 6.3% respectively accounting for over 57% of overall inflation.
- With an uptick in global fuel prices and currency depreciation, we expect fuel inflation to continue ticking upwards.
- We are also cognizant of the upcoming El Nino rains which, depending on their intensity may lead to destruction of certain crops due to flooding thus resulting in shortages of certain food crops and rise in prices.
- As a result of all these factors, we foresee inflation coming in a range of 6.5% - 7.5% in October.

2023 inflation forecast at 6.5% - 7.5%



Source: Kenya National Bureau of Statistics

MPC retained CBR at 10.5% in October 2023 meeting

- The Monetary Policy Committee (MPC) met on 3rd October 2023, press release available here.
- We highlight the following noteworthy points of discussion from the meeting;

1) Exports increased marginally in the twelve months to August 2023, up 0.5% compared to a similar period in 2022 while imports declined 11.9%.

   We attribute this trend to an uptick in taxes coupled with the continued depreciation of the Kenya Shilling, both of which have the dual effect of decreasing imports by both volume and value while increasing exports by value. We would also like to highlight that this trend points to the difficult business environment currently being experienced in the country.

   Banking sector Non-performing loans (NPLs) rose to 15% in August 2023 compared to 14.2% in August 2022 and 14.5% in June 2023. This trend is reflective of the difficult macro-economic environment prompted by rising interest rates, currency depreciation and back to back tax increases.

   Increases were observed in manufacturing, mining, real estate, building and construction sectors. This trend is further reflective of the difficult macro-economic environment prompted by rising interest rates, currency depreciation and back to back tax increases.

2) Private sector credit growth at 12.6% in August 2023 compared to 10.3% in July 2023.

- As per expectations spelt out in our September fixed income note, 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 September (6.8%) 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 is expected to decline indicative of easing underlying inflationary pressures.

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

- The committee will meet again in December 2023 to review the impact of policy decisions made.
- We maintain a high probability of the CBR being maintained at the current level.

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