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February Primary Auction Note

Date: 1 February 2019

Recommendation:
Bid **12.70%** to **12.85%** for **FXD 1/2019/15**

Bid **10.50%** to **10.70%** for **FXD 1/2019/2**

Sovereign Credit Rating (outlook):
Moody's: *B2 (stable)*
Fitch: *B+ (stable)*
S&P: *B+ (stable)*

CPI: (2009=100)
193.51

December Inflation:
5.71%

Interbank rate (30th Jan-19):
4.98%

C.B.R (As set in 28-01-18):
9.00%

91-Day T-Bill (7th Jan-19):
7.122%

182-Day T-Bill (7th Jan-19):
8.833%

364-Day T-Bill (7th Jan-19):
9.905%

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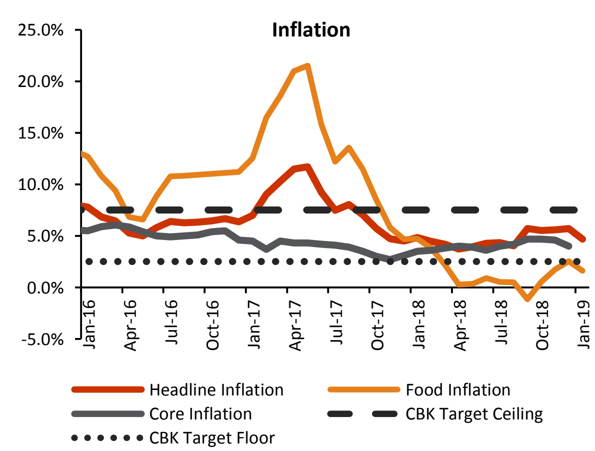
In February, the CBK is reopening the auction of two fixed income bonds: the **15-year bond** (**FXD 1/2019/15**) and the **2-year bond (FXD 1/2019/02)**, in a bid to raise a total of **KES 12 billion** (**USD 120.0 million**) for budgetary support. The **2-year** bond, **FXD1/2019/02,** offers a coupon of **10.701%** p.a for investor, while the **15-year, FXD1/2019/15,** offers a coupon of **12.857%** p.a.

In the current market condition of high liquidity and market uncertainty, the short term paper will remain in high demand by the market participants. In contrast with the **2-year** paper, the **15-year** might continue to receive lukewarm reception at the auction. We expect high subscriptions for the **2-year bond** and we therefore we prescribe investors to bid within the **10.500%** to **10.700%** range. Those investors who find the **15-year** bond suitable, we recommend investors to bid within the range of **12.700%** to **12.850%.**

Interest rates are currently on a slide supported by high money market liquidity as evidenced by high subscriptions for T-Bills. Upward risk for the rise of interest rates in the medium term still exists given that the government pursuits continues to be driven by an expansionary fiscal stance. Even though the government continues to project fiscal consolidation, fiscal slippage is the most likely outcome. Liquidity has been on the mend in January helped on by government payments and net redemptions over the month. This liquidity, we caution investors, may make the CBK more discerning especially around the 2-year bond.

Secondary Bond Market:

In January, secondary market saw a remarkable resurgence in market activity. Turnover during the month firmed up by **104%** to **KES 43.3 Billion** (**USD 429.7 Million**) from **KES 21.23 Billion** (**USD 210.7 Million**) recorded in December. Turnover in January was propelled by the issue of the **2-year** and **15-year** in January. High investor activity around the 5-year FXDs, 10-year FXDs, 15-year FXDs, 20-year FXDs and the longer term IFBs also made a crucial contribution to the recovery of Bond turnover from December lows.

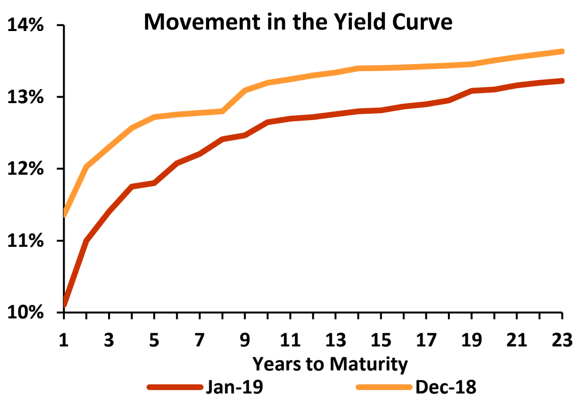


January Inflation: CPI weakened over January driven by a decline in prices of foodstuffs and a slide in the transport index. Headline inflation frittered down to a five month low of **4.70%** from **5.71%** recorded in December. Good weather and agricultural production has provided strong headwinds that have stunted food inflation. The decline of prices of foodstuff namely: maize flour, sugar and beans inspired the food index to only increase by **1.62%** down from **2.54%** in December. Subdued petroleum prices also pushed the Transport index inflation from the **14.3%** registered in December production to **11.1%.**

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 3

Interbank: Money market liquidity continued putting a downward pressure on the average interbank rate in January to hit a weekly average of **3.26%** by for the week ending 24th January compared to a weekly average of **6.76%** recorded in the week ended 27th December.

T-Bills: During the month of January, T-bill auctions under subscription firmed up, with the average subscription rate of **75%** registered in December strengthening to an average subscription rate of **188%.** High liquidity in the market helped drive bids to overshoot offers in all the T-Bills: the 91, 182 and 364. Average. The most sought short term paper still remains the **364-Day** T-Bill that hit a subscription level of an average of **240%** at 4 auctions in January. We advise those investors who wish to remain short, to manage interest rate uncertainty, to maximize their yield by investing in the **364-Day** T-Bill.



NSE Yield Curve: The current yield curve, (**25/1/2018**), continued to exhibit a downward shift in the short and long-term key rates. Short term rates have fallen further than the long term key rates in the last one year, steepening the yield curve. Over the month of January, the NSE yield curve slid further lower. The one year end of the yield curve fell **125.4bps** from the end of last year levels to yield **9.9050%** as high investor demand on the shorter end continues to manifest. The longer end fell slower during the period under review, as the 23 year bond yield fell by only **41.4bps** mostly driven by demand on the longer dated IFBs. The bond yields could continue steepen as a consequence of increased demand on the short end of the yield curve. Active managers should consider decreasing their bond portfolio duration by investing mainly in short term bonds to outperform.

Currency: The Kenya Shilling remained stable against most major currency in January. The dollar plunged in value against the Kenya shilling. The green back in January lost more ground against the Kenya shilling upended by demand for Kenyan government debt from offshore investors and a paper thin demand for the dollar. The Kenyan Shillings also continues to enjoy tailwinds from an strong remittances during the month of January. The Kenya shilling in January strengthened by **0.94%** against the Dollar, recovering from its first week stumble to hit **KES 100.89/USD** by the end of January from **KES 101.85/USD**.

Usable foreign exchange reserves in January closed out strong and untested. The reserve on the 24th of January stood at **USD 8,076Bn**, flat from the **USD 8,001Bn** recorded at the end of December. The current foreign exchange reserves translate to about **5.29 months** of import cover flat from the 27th December import cover of **5.25 months** of import cover. The stability of the shilling in 2019 we reiterate will be determined by the government's ability to refinance existing debt. A syndicated loan and a 5-year Eurobond are maturing in 2019. The repayment of this maturing debt, such as the maturing 5-year Eurobond and a maturing syndicated loan could decrease CBK's usable reserves. The inflow of funds and extension loan tenor could also help shore up the reserves.

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Research Disclosure

NOTICE TO US INVESTORS

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 3