DYER & BLAIR INVESTMENT BANK
FIXED INCOME REPORT

Founder Member of the Nairobi Securities Exchange

February 23RD 2021

DYER & BLAIR INVESTMENT BANK

WE KNOW. YOU KNOW.

KENYA: 2021 FIXED INCOME OUTLOOK

- We expect that fixed income will dominate equities largely due to investor concerns over the quickness of the post-Covid-19 recovery, rising political risk and asset quality issues in the banking sector. We expect any price rallies in the equities market to be event driven and transitory.
- We expect that yields on government securities will rise on the back of auction pressure as market sentiment around the government's fiscal position remain negative and as month by month distribution of liquidity vary.
- While we expect inflation to continue rising towards the upper limit of 7.5%, we also expect this to be transitory, in part because policy makers are likely to respond to cost pressures in a campaign year (referendum) and because demand pressures will remain muted due to consumers' subdued purchasing power.
- We see successful and timely receipts of IMF facility, World Bank facility and planned Eurobond adding about USD 3.0-4.0 BN into the official forex reserves, creating a transitory momentum for a domestic bond rally and an exchange rate gain.
- We expect local institutional investor sentiment to remain negative on account of the government's ambitious agenda (BBI, legacy projects, Big 4) despite its weak fiscal position. That said, lack of viable investment opportunities will see them adopt a short term focused strategy as they wait to see the impact of any intervention measures by the government such as concessions on debt, foreign borrowing and new taxes.
- We expect that the liquidity profile will be irregular as the re-opening of the economy, the BBI campaigns, and the government's commitment to complete key projects drive more usage of otherwise surplus liquidity interfering with the nearly seamless recycling of liquidity we saw in 2020. We believe that the economy will not recover fast enough as to see liabilities growth drive surplus liquidity in 2021.
- While concerns over the KES's misalignment remain, we do not expect to see material depreciation this year on the back of concessions on external debt payments, potential recovery of tourism and key exports as well as official reserves boost from the expected IMF facility, World Bank facility and Eurobond.
- In the long term, we expect that interest rates will rise and recommend that market players position themselves accordingly.

KEY RATES & INDICATORS (%, END OF YEAR)

	2016	2017	2018	2019	2020
CBR	10.0	10.0	9.0	8.5	7.0
Inflation	6.3	8.0	4.7	5.2	5.3
Interbank	8.2	6.9	6.7	5.5	6.2
91-Yield	8.6	8.0	7.3	7.2	6.9
182-Yield	10.5	10.6	9.0	8.2	7.4
364-Yield	11.0	11.1	10.0	9.8	8.3
5YR-Yield	13.1	12.5	11.6	11.5	10.5
10YR-Yield	13.9	13.1	12.5	12.1	11.9
15YR-Yield	14.1	13.2	12.6	12.5	12.8

Source: CBK, KNBS, NSE

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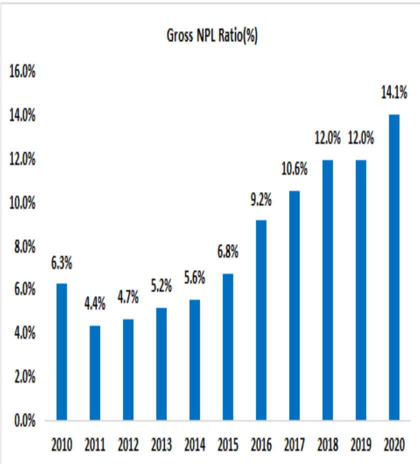
Fixed Income Will Dominate Equities

We expect that fixed income will dominate equities largely due to investor concerns over the quickness of the post-Covid-19 recovery, rising political risk and asset quality issues in the banking sector. We expect any price rallies in the equities market to be event driven and transitory.



Source: CBK

The Post Covid-19 Recovery

The National Treasury expects Kenya's economy to slow down to around 0.6% in 2020 followed by a sharp recovery of about 6.4% in 2021. While Kenya should see a bump from the continued opening up of the global economy, we emphasize that the Covid-19 crisis has accelerated underlying structural problems in the economy that will take longer to resolve. We for instance underscore, the asset quality issues in the banking sector as an impediment to the kind of broad based growth that would be key for equities and one that would require more time and better policy coordination than is apparent. We highlight that:

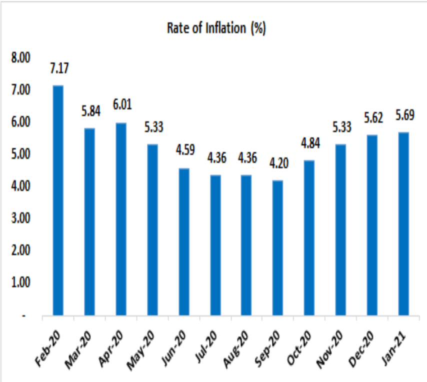
- Resolution of Gross NPLs may require fiscal deficit expansive measures such as payment of outstanding bills, and expansion of the credit guarantee scheme.
- While addressing apparent obstacles to the banking sector's transition to risk based pricing is a necessary key step, such a transition would most likely see yields on government securities rise as government competes for thinning liquidity with risk markets.

Rising Political Risk

We see rising political risk as the biggest impediment to a sustained economic recovery in light of the ongoing BBI referendum campaigns and the upcoming general election campaigns in 2022. Firstly, history shows that electioneering periods tend to see low economic growth. Secondly, we observe that the high stakes nature of the BBI and the 2022 campaigns may lead to an extended electioneering period that could disrupt economic activity or anchor an extended wait and see approach among private sector players. Thirdly, we are concerned that expected external relief initiatives may see policy makers bury their heads in the sand with respect to necessary economic reforms creating a fertile ground for political opportunism and populism on the part of some political players.

Potential Equities Rallies

We expect any price rallies in the equities market to be event driven and transitory. We believe that political uncertainty and asset quality issues will suppress equities market with temporary rallies corresponding with related announcements. While the post-Covid-19 recovery may see a return to EM and FM markets among foreign investors, we anticipate that political uncertainty will see foreign investors adopt a short term opportunistic equites strategy in Kenya.



Source: KNBS

Inflation Concerns

Inflation has consistently risen to a 9 month high of 5.69% as at January 2021 partly due to a base effect normalization to pre-Covid-19 figures in 1Q20. We are concerned that rising cost pressures are manifesting at a time when the economy is barely recovered and when fiscal and political priorities run askew of the path to a sustained recovery. While we expect inflation to keep rising towards the upper limit of 7.5%, we also expect it to be transitory, in part because policy makers are likely to respond to cost pressures in a campaign year (referendum) and because demand pressures will remain muted due to consumers' subdued purchasing power.

Short-Term Focused Policies

We have over the years expressed concern that policy responses have been ill-timed and short term focused. We see this trend in the return to pre-Covid-19 tax rates and the introduction of new tax measures. We are skeptical that these measures will have a positive impact on revenue over the long term and are concerned that they will add onto the cost push pressures in the short term. In light of this, we worry that investors are overlooking the likely lag on an appropriate policy response that may be occasioned by the government's persistent liquidity crunch in light of competing needs for cash (unremitted dues to Counties, ongoing legacy projects, unpaid bills, refinancing needs etc.) Thus on account of this lag, we expect transitory upward pressure on short term interest rates.

Rising Maize Prices

Maize millers expect the price of maize to continue to rise on account of tightening supply. In recent weeks, the National Cereals and Produce Board (NCPB) has also had to raise its offer price to KES 2,700 per bag as it ratchets up competition with millers. We thus expect food related inflation to continue to rise but expect policy makers to intervene given ongoing referendum campaigns.

Rising Global Oil Prices

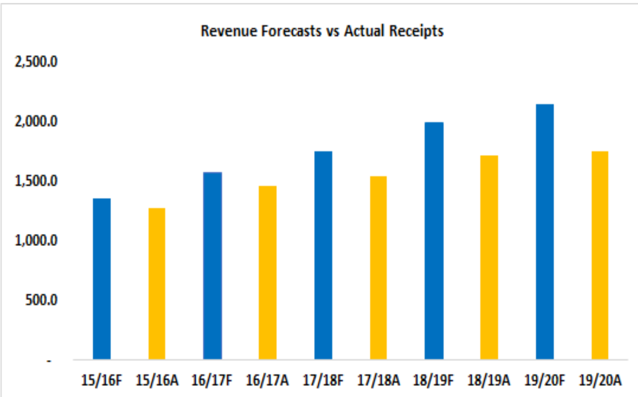
Global oil prices (Brent) have continued to rise from a low of $20.00 in April 2020 to $40.00s when vaccines were first announced in November 2020 to the current $60.00s. We expect the price rise to continue on account of backwardation as markets anticipate supply shortfalls on the back of a continued re-opening of major economies. Rising prices will pressure OPEC+ countries to increase their supply lest they lose market share to US Shale as has happened in recent years. However, the speed with which OPEC+ decide will depend on individual countries key priorities especially between safeguarding market share and funding their fiscal deficits. Thus we expect higher oil prices to exert upward pressure on inflation.

Conclusion

In general, while we see upward pressure on interest rates on account of inflation, we see it as transitory enough to receive no permanent policy response such as an upward review of the Central Bank Rate.

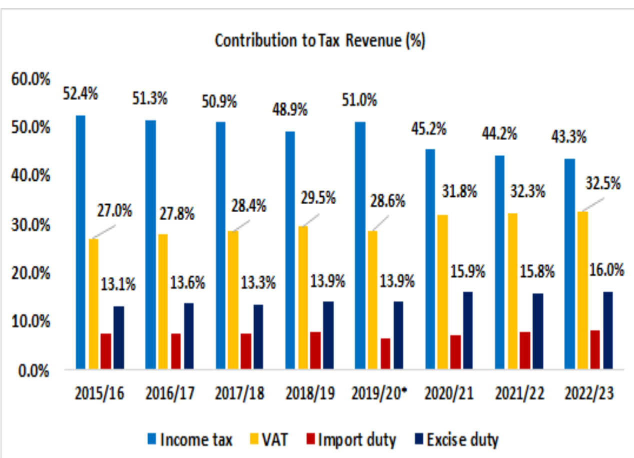
The Revenue Forecast Problem

We take it for granted that revenue forecasts will not hold as they have not held for the last 5 years even after the estimates have been revised several times through supplementary budgets.



Source: National Treasury

While we note the fair expectation that contribution of income taxes to tax revenue will decline with time, we are skeptical that other components such as VAT will pick up the slack sufficiently.



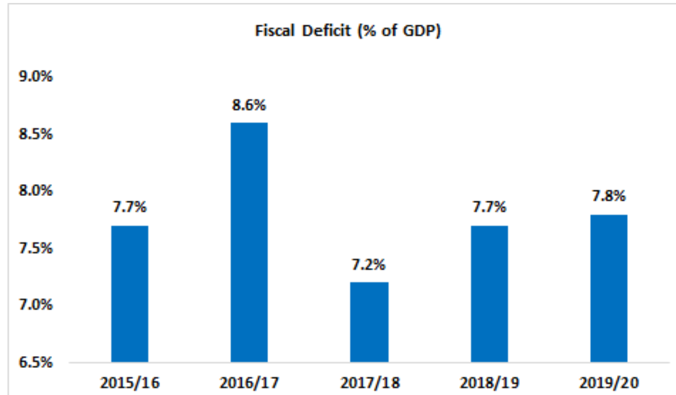
Source: National Treasury, PBO

We highlight that:

- As the Covid-19 crisis exacerbated an economic crisis that was already brewing, a sustained recovery will be contingent on wide ranging reforms beyond the post-Covid-19 normalization of economic activities.
- The political campaigns around BBI and 2022's elections are likely to slow economic activities and hence revenue performance and detract from key policy priorities among the political class.
- Revenue performance will thus remain deficit negative.

Fiscal Consolidation Dilemma

As revenue estimates have not held and as expenditure has remained elevated, actual fiscal deficits have remained wider than projected compromising the government's commitment to lower the deficit to 3.0%.

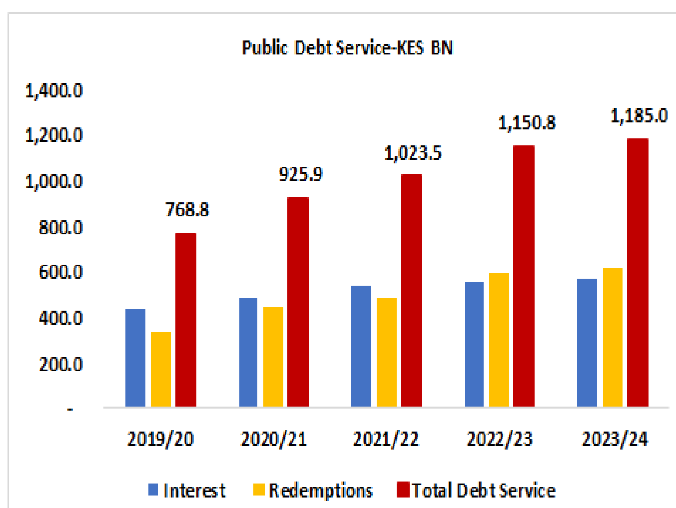


Source: National Treasury

Whereas we acknowledge the need for the government to commit to deficit reduction we highlight that future deficits are already locked in by the debt refinancing burden and by the need to stimulate the economy post COVID-19. Therefore, we expect fiscal deficit to remain elevated over the medium term implying that the associated upward pressure on interest rates will remain.

The Debt Refinancing Burden

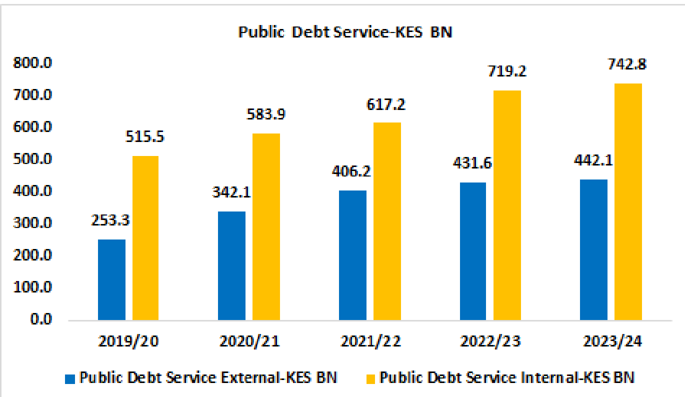
The National Treasury expects the public debt service to worsen year on year moving forward from about KES 0.8 TN in 2019/20 to KES 0.9 TN this year and to KES 1.2 TN in 2023/24. Increasing debt service burden will thus sustain the upward pressure on interest rates.



Source: National Treasury, PBO

Debt Refinance and Liquidity

While growing domestic maturities are a positive for liquidity and hence interest rates, rising use cases for cash by the government are likely to slow down the speed with which government recycles proceeds of taxes and auctions back into the system via payments. Moreover, in the context of a slow recovery and an extended political campaign period, rising external component of debt service may see growing domestication of budgeted borrowing and thus more liquidity withdrawals.



Source: National Treasury

Debt Concessions & Restructuring

We observe that the Treasury has successfully pursued debt service suspension initiatives as follows:

- About KES 33.0 BN of payments due between January 2021 and June 2021 for 4 years from the Paris Club
- About KES 27.0 BN of payments due in the first 6 months of 2021 from China
- And is pursuing waivers for approximately KES 40.6 BN from G20 countries.

While we acknowledge that these concessions are a positive for short term liquidity management, we find them insufficient relative to for instance, the KES 162.4 BN of external debt interest payments expected in 2020/21. Secondly, while the COVID-19 crisis has provided a window for such concessions, we argue that, all else held constant, Kenya needs to restructure its debt significantly to see a long term impact on the trajectory of interest rates. Lastly, as there is no silver bullet that can work in lieu of rationalizing expenditure, for a positive long term outlook on interest rates, such restructuring needs to be in exchange for an expenditure consolidation plan.

The Liquidity Factor Continued...

We believe that the economy will not recover fast enough as to see liabilities growth drive surplus liquidity in 2021. We also believe that an improvement in inflows will be contingent on an unpredictable progress of COVID-19 containment measures including deployment of vaccines.

For trading oriented investors, the domestic maturity and refinance profile is useful at determining ideal entry and exit points due to its immediate impact on liquidity.

2021's Maturity Profile

The domestic maturity profile in 2021 appears tepid with only 2 more maturities remaining in the current fiscal year, a testament to Central Bank's commitment to extend the maturity profile of domestic debt in recent years. Whereas this suggests that the government will not be under pressure to borrow to refinance it also means that the recycling of liquidity back into the system through maturities will be significantly affected.

Issue No.	Maturity	Amount KES MN	Coupon
IFB1/2009/12Yr	Feb 8, 2021	7,868.37	12.50%
FXD1/2016/5	Apr 19, 2021	19,544.20	14.33%
FXD2/2016/5	July 19, 2021	24,395.30	14.07%
FXD3/2016/5	Sept 20, 2021	23,051.05	13.11%
IFB2/2009/12Yr	Nov 22, 2021	5,388.83	12.00%

Source: NSE

But the coupon payment schedule appears significant with at least KES 21.0 BN due every month in the current fiscal year. As the market players are likely to continue to prefer short term papers, it is possible that the Central Bank can refinance these payments through treasury bills. However, rising inflation may dis-incentivize investors from investing in short term bills to avoid negative real returns.

KES MN	Coupon Due	Bond Maturity	Total
February	28,279.87	7,868.37	36,148
March	20,829.77	-	20,830
April	27,284.28	19,544.20	46,828
May	28,747.53	-	28,748
June	24,385.15	-	24,385

Source: NSE

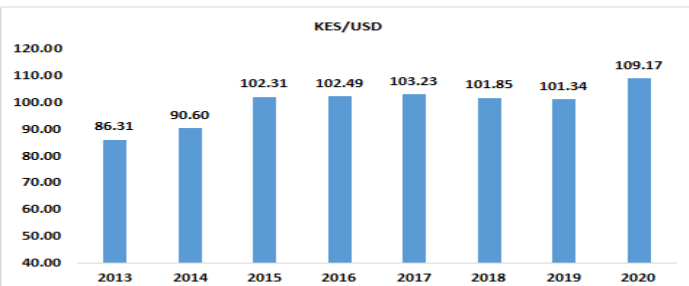
But Treasury Bill maturities will also present a re-financing challenge that may prompt usage of switch auctions as we saw in 2020. While Central Bank has been fairly successful at lengthening the maturity of the domestic bond book through long term bond issues, it has also had to rely a lot more on treasury bill auctions to fill any short falls occasioned by the market's players lack of appetite of long term issues.

KES BN	Coupon	Bond Maturities	Bills Maturities	Total
February	28.3	7.9	48.6	84.7
March	20.8	-	86.5	107.4
April	27.3	19.5	44.3	91.1
May	28.7	-	23.2	52.0
June	24.4	-	40.3	64.5

Source: NSE

The Exchange Rate Factor

In 2020, the KES saw its biggest depreciation against the USD in recent years due to appreciation of the USD and COVID-19 induced uncertainties which saw a flight to USD deposits.



Source: CBK

While concerns over the KES's misalignment remain, we do not expect to see material depreciation this year on the back of a potential boost in official reserves from the expected facilities from IMF and the World Bank as well as the planned Eurobond issue.

We see successful and timely receipts of these loans adding about USD 3.0-4.0 BN into the official forex reserves, creating a transitory momentum for a domestic bond rally and an exchange rate stability/gain. We think that a bond rally would follow increased liquidity especially if the proceeds are quickly injected into the real economy.

We also argue that the regulator would be in a better position to more aggressively defend the exchange rate thus driving demand for local currency bonds from foreign investors. This could see a rally on IFBs.

While the impact of these facilities can anchor a short term trading strategy, we believe that investors should position their portfolios for the long term rise of interest rates. We believe that the confluence of all key factors: current allocation levels, fiscal metrics, political uncertainty, inflation and exchange rate dynamics point to an upward shift in the yield curve and that there is no silver bullet that can address all of them in the short term.

Debt Sustainability

We think that the debt profile is going to break all sustainability thresholds in the next 3 years. Presently, Kenya's debt is unsustainable from a PV of debt to revenue and grants ratio and from a debt service to revenue and grants ratio.

Indicator	Threshold	2020	2021	2022	2023	2024
PV of debt to GDP	70.0	61.3	63.4	63.9	63.6	62.2
PV of debt to rev*	300.0	338.1	356.6	357.4	351.3	341.2
Debt service to rev*	50.0	53.8	68.0	74.5	71.5	78.6

Source: PBO, Treasury, rev= Revenue and grants*

In readiness, several market players expect the government to rebase its GDP. While this will improve the PV of debt to GDP ratio, we observe that debt to GDP is less useful a measure for investors. We highlight that the projection of debt service to revenue and grants ratio to 78.6% in 2024 creates an impossible situation for the government unless the current debt position is restructured.

External Debt Sustainability

External debt sustainability stands shaky at a time when the exchange rate outlook remains uncertain and when the negative effects of COVID-19 are likely to stall economic recovery for a while.

Indicator	Threshold	2020	2021	2022	2023	2024
PV of Debt/Exports	240.0	288.0	260.6	258.5	255.2	249.2
PPG Debt service/Exports	21.0	27.5	25.9	25.5	24.4	36.1
PPG Debt Service/ Rev*	23.0	14.5	15.9	15.9	14.8	22.0

Source: PBO, Treasury, Rev= Revenue*

DOMESTIC COUPONS

FEBRUARY

Issue No.	Coupon Date	Coupon Rate	AMT KES MN
IFB1/2009/12Yr	Feb 8, 2021	12.50%	491.77
FXD1/2013/15	Feb 15, 2021	11.25%	2,370.29
FXD3/2019/10	Feb 15, 2021	11.52%	2,591.62
SDB1/2011/30	Feb 15, 2021	12.00%	1,688.68
FXD1/2017/005	Feb 22, 2021	12.47%	1,844.77
FXD1/2019/05	Feb 22, 2021	11.30%	3,678.45
FXD1/2016/10	Feb 22, 2021	15.04%	1,376.55
FXD1/2018/10	Feb 22, 2021	12.69%	2,574.28
FXD1/2019/10	Feb 22, 2021	12.44%	3,236.62
IFB1/2017/12Yr	Feb 22, 2021	12.50%	895.65
IFB1/2020/011Yr	Feb 22, 2021	10.90%	4,285.87
FXD1/2020/015	Feb 22, 2021	12.76%	3,245.32

Source: NSE

MARCH

Issue No.	Coupon Date	Coupon Rate	AMT KES MN
FXD1/2007/15	Mar 8, 2021	14.50%	264.96
FXD1/2008/15	Mar 15, 2021	12.50%	2,174.36
FXD1/2010/15	Mar 15, 2021	10.25%	1,419.31
FXD1/2012/15	Mar 15, 2021	11.00%	2,691.54
FXD3/2016/5	Mar 22, 2021	13.11%	1,511.23
FXD1/2018/05	Mar 22, 2021	12.30%	1,893.77
IFB1/2011/12Yr	Mar 22, 2021	12.00%	704.13
IFB1/2013/12Yr	Mar 22, 2021	11.00%	1,535.89
IFB1/2015/12Yr	Mar 22, 2021	11.00%	2,815.57
FXD1/2016/20	Mar 22, 2021	14.00%	893.28
FXD1/2018/20	Mar 22, 2021	13.20%	3,899.17
IFB1/2019/25Yr	Mar 22, 2021	12.20%	1,026.55

Source: NSE

APRIL

Issue No.	Coupon Date	Coupon Rate	AMT KES MN
FXD1/2009/15	Apr 12, 2021	12.50%	1,997.03
FXD2/2019/10	Apr 12, 2021	12.30%	3,156.49
IFB1/2020/09Yr	Apr 12, 2021	10.85%	4,036.05
FXD1/2019/20	Apr 12, 2021	12.87%	1,516.44
FXD1/2016/5	Apr 19, 2021	14.33%	1,400.73
FXD2/2017/005	Apr 19, 2021	12.52%	1,296.27
IFB1/2014/12Yr	Apr 19, 2021	11.00%	1,487.53
FXD2/2013/15	Apr 19, 2021	12.00%	3,966.18
IFB1/2016/15Yr	Apr 19, 2021	12.00%	2,401.78
FXD2/2018/015	Apr 19, 2021	12.75%	1,852.85
IFB1/2019/16Yr	Apr 26, 2021	11.75%	4,172.93

MAY

Issue No.	Coupon Date	Coupon Rate	Amount KES MN
FXD3/2007/15	May 10, 2021	12.50%	2,059.88
FXD2/2019/05	May 10, 2021	10.87%	2,130.99
FXD1/2020/05	May 10, 2021	11.67%	1,757.16
FXD2/2019/015	May 10, 2021	12.73%	2,702.62
IFB1/2016/9Yr	May 17, 2021	12.50%	2,268.95
FXD1/2011/20	May 17, 2021	10.00%	1,691.15
FXD1/2012/20	May 17, 2021	12.00%	2,674.90
IFB1/2018/20Yr	May 17, 2021	11.95%	2,198.04
IFB2/2009/12Yr	May 24, 2021	12.00%	323.33
IFB1/2017/7Yr	May 24, 2021	12.50%	2,591.84
FXD4/2019/10	May 24, 2021	12.28%	4,250.26
FXD1/2018/015	May 24, 2021	12.65%	3,115.37
IFB1/2020/06Yr	May 31, 2021	10.20%	983.05

Source: NSE

JUNE

Issue No.	Coupon Date	Coupon Rate	Amount KES MN
FXD2/2007/15	Jun 7, 2021	13.50%	2,206.08
IFB1/2015/9Yr	Jun 7, 2021	11.00%	904.93
FXD1/2012/10	Jun 14, 2021	12.71%	2,240.76
FXD3/2019/05	Jun 14, 2021	11.49%	2,586.42
FXD2/2010/15	Jun 14, 2021	9.00%	1,103.96
FXD1/2008/20	Jun 14, 2021	13.75%	2,622.48
FXD2/2018/10	Jun 14, 2021	12.50%	3,377.70
FXD1/2010/25	Jun 14, 2021	11.25%	1,135.83
FXD1/2013/10	Jun 21, 2021	12.37%	2,427.70
FXD1/2018/25	Jun 21, 2021	13.40%	5,779.30

Source: NSE

JULY

Issue No.	Coupon Date	Coupon Rate	Amount KES MN
FXD1/2021/002	Jul 12, 2021	9.49%	2,649.45
FXD2/2016/5	Jul 19, 2021	14.07%	1,716.09
FXD1/2014/10	Jul 19, 2021	12.18%	2,183.40
FXD1/2017/10	Jul 26, 2021	12.97%	2,280.36
IFB1/2018/15Yr	Jul 26, 2021	12.50%	2,574.05
FXD1/2019/015	Jul 26, 2021	12.86%	5,194.81
FXD3/2019/015	Jul 26, 2021	12.34%	3,119.12
IFB1/2021/016Yr	Jul 26, 2021	12.26%	4,967.30
FXD2/2018/20	Jul 26, 2021	13.20%	3,703.21

Source: NSE

FISCAL ESTIMATES

	FY2019/20	FY2020/21	FY2021/22	FY2022/23	FY2023/24	FY2024/25
TOTAL REVENUE	**1,736,982**	**1,849,213**	**2,033,930**	**2,379,720**	**2,796,351**	**3,099,808**
Ordinary Revenue	1,573,418	1,594,009	1,775,624	2,141,597	2,516,259	2,807,370
Ministerial Appropriation in Aid	163,564	255,204	258,305	238,123	280,092	292,438
TOTAL EXPENDITURE	**2,565,444**	**2,864,529**	**3,010,035**	**3,201,990**	**3,495,624**	**3,762,898**
Recurrent Expenditure	1,645,222	1,838,005	1,986,040	2,119,982	2,318,597	2,506,048
Development	594,944	638,520	609,146	670,465	759,760	834,364
County Transfer	325,278	383,004	409,849	406,542	412,267	417,486
Contingency Fund	-	5,000	5,000	5,000	5,000	5,000
BALANCE EXCL. OF GRANTS	**(828,461)**	**(1,015,316)**	**(976,106)**	**(822,270)**	**(699,273)**	**(663,090)**
Grants	19,820	48,737	46,057	46,929	48,102	49,304
BALANCE INCL. OF GRANTS	**(808,642)**	**(966,579)**	**(930,048)**	**(775,341)**	**(651,171)**	**(613,785)**
Adjustments to cash basis	11,801	-	-	-	-	-
Balance Incl. of Grants (Cash Basis)	(796,841)	(966,579)	(930,048)	(775,341)	(651,171)	(613,785)
Discrepancy	(6,036)	-	-	-	-	-
TOTAL FINANCING	**790,804**	**966,579**	**930,048**	**775,341**	**651,171**	**613,785**
Net Foreign Financing	340,431	426,491	267,276	263,147	173,779	154,265
Net Domestic Financing	450,373	540,088	662,773	512,195	477,392	459,520
Nominal GDP (Fiscal Year)	10,175,226	11,168,511	12,393,063	13,759,945	15,373,117	17,128,374

Source: National Treasury

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