Global Economy

Global economic growth is projected to improve from 3.1% in 2016 to 3.5% in 2017 and 3.6 % in 2018 (IMF World Economic Outlook April 2017). The pick-up in global growth reflects developments in both advanced economies and emerging market and developing economies (EMDEs).

In the advanced economies, growth is projected at 2.0% in 2017 from 1.7% in 2016, largely driven by expected accelerated economic growth in the United States on the assumption of fiscal stimulus and higher infrastructure spending, but policy uncertainty could undermine investor and consumer confidence. In the Euro area, the pace of expansion is expected to be sustained around the 2016 level but to decline to 1.6 % in 2018 due to weak productivity in some countries and unresolved problems of public and private debt overhang. The medium-term growth prospect in the United Kingdom is likely to be restrained by heightened uncertainty related to the country's future trade relations with the EU. The expected 2017 growth momentum in Japan is supported by the government's large-scale stimulus measures, although the medium-term growth pace is projected to decelerate due to the cyclical slowdown in business fixed investment and the effects of the scheduled consumption tax hike. ***(Source: IMF, AIB Research)***

Sub-Saharan Africa

In Sub-Saharan Africa, (SSA) growth is expected to recover to 2.6% in 2017 from 1.4% in 2016, following a gradual rise in global commodity prices with developments in Nigeria and Angola expected to contribute to the recovery. Growth in Nigeria is forecast at 0.8% in 2017 and 1.9% in 2018 from -1.5% in 2016, while in Angola, economic activity is forecast at 1.3 % in 2017 and 1.5 % in 2018 from 0 % in 2016. Growth in South Africa is projected to improve to 0.8 % in 2017 and 1.6 % in 2018 from 0.3 % in 2016 reflecting recovery from effects of drought. However, the impact of the sovereign credit rating downgrade continues to weigh on both public and private investment through higher funding costs. ***(Source: IMF, AIB Research)***

Kenyan economy: *The tipping point*

The first quarter of the year saw the economy decelerate to grow at 4.7% which was lower compared to 6.1% recorded in the previous quarter and 5.3% growth in a similar quarter of 2016. The subdued performance was largely reflected in the Agriculture and Electricity and Water Supply sectors following the unfavorable weather conditions experienced since the second half of 2016. Growth was supported by the strong performance of Accommodation and Restaurant, Wholesale and Retail Trade, Real Estate, Transport and Storage, and Information and Communication sectors. The sectorial breakdown clearly shows how diversified our economy is. Despite the contraction in Agriculture and deceleration in other sectors, growth still remained robust. We summarize the sectoral performance in the table below giving an outlook on each sector.

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Sector	Q1-17 Contribution		Sector output Growth			Key Highlights	OUTLOOK
	To GDP	To growth	FY16	Q1-16	Q1-17		
Agriculture	25%	-0.3%	4.0%	4%	**-1.1%**	• Unfavorable weather during Q4 16 and Q1 17 was detrimental to food crops • Food prices increased across the board • Tea production declined 27% YOY • Coffee exports improved 27% YOY	• Kenya Metrological reported most parts of the country reported below normal rainfall in April, May and June long rain season. • Rainfall distribution was also poor over the same period. • This may result to below average production in food crops as well as cash crops • We generally expect the sector to underperform in the second half.
Manufacturing	10.1%	0.3%	3.5%	1.7%	**2.9%**	• Improved production of soft drinks, bakery products, edible oils & wheat flour. • Steel bars & iron sheet production also improved • Cement production was up 1.6% • Depressed performance in agriculture caused low production in agro processing.	• We remain bullish on the long-term outlook for manufacturing sector due to policy initiatives by GOK which are expected to attract investments in value addition. Implementation of the special EPZ Act 2015, the National industrialization policy and ease of doing business initiatives are expected to improve the sector in the long term. Efforts to improve infrastructure will also improve performance in the sector. • In the near term, however, the sector continues to face challenges spanning from import competition, the high cost of power, skills gaps and the existing infrastructure gap in the region.

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Construction	5%	0.4%	9.2%	10.2%	**8.4%**	• Scale down of the SGR works • Cement consumption up 6.1% • Credit to the sector improved • 19% increase in cement imports • 39% increase in steel products	• We start to see some slowdown in the sector as government key infrastructure projects came to a close. Private Developments around the project are further expected to boost construction activity. • Further softness is expected in the homebuilders market this year following the low uptake of credit the past one year. We, therefore, expect further slowdown for the sector in the coming few quarters. • Beyond 2017, the sector is expected to continue growing at high growth rates as credit markets improve and as GOK engages in more infrastructure projects.
Elec & water supply	2.4%	0.1%	7.1%	8.6%	**5.1%**	• Low water levels in H2 16. • Electricity generation remained fairly flat at 2,401 KWPH. • Hydro and geothermal production declined while thermal doubled to cover the decline in hydro and geo.	• This is the 3rd consecutive quarter that geothermal production is declining. • The decline is largely attributed to • We expect the sector to remain robust on account of increased penetration of electricity. • We, however, expect generation activities to slow down owing to the slower than expected build-up in demand.
Accommodation & food services	1.3%	0.2%	13.3%	10.4%	**15.8%**	Tourist arrivals during the quarter increased to 326,875 from 317, 024 in Q1 16 Hotel bed occupancy increased to 2.1M from 1.9M	Improved security in the country, & enhanced marketing efforts, has driven the recovery of the sector in the past 4 quarters. We expect this to continue going forward although the upcoming elections pose a significant but short-term risk to the sector.

Real Estate	8.4%	0.8%			**9.6%**	Strong performance supported by • Resilient credit uptake by the sector and • Increased use of alternative sources of funding.	Key drivers that support real estate sector include high economic growth rates, high population growth rates, improved income levels, and improvements in infrastructure. Kenya is currently in a favorable position with regards to all the above factors and we thereby expect the sector to continue outperforming the economy.
Financial Sector	6.1%	0.3%				• Private sector credit growth in Q1 4.5% • Credit to GOK up 9.7% • M3 expanded to 2.8 trillion up from 2.7 trillion • Interest rates were on the decline • Equities value declined	• As we will discuss in the next section, we expect private sector credit to rebound in the second half of the year, • Interest rates are expected to remain low on the expectation of narrowing of the fiscal deficit • Equities are expected to continue with the recovery in the second half.

(Source: KNBS, AIB Research)

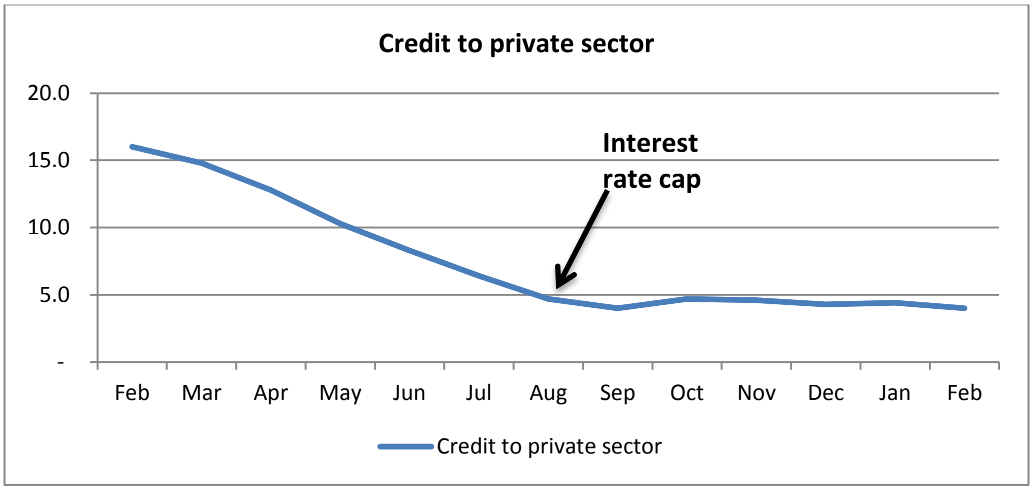
According to the World Bank's latest country update for Kenya (April 2017), the Kenyan economy is expected to decelerate to 5.5% in 2017 and revert back to 6.1% by 2019. The report identified the effects of the recent drought and the slowdown in credit growth as the primary drivers for the deceleration. Public sector expenditure is still expected to drive growth in the near term. This expectation is largely in line with our medium-term outlook which we gave earlier in the year. (Click here to view report).

While the drought effects are expected to fade in the second half, Credit growth still remains an area of concern to policy makers. In this report, we review this development further, looking at where we are and also review the evidence of why we believe that credit growth is looking to rebound in the near term.

Private sector credit growth: Time to switch it on!

With the effects of the droughts slowly fading away, credit growth remains an impediment to growth going forward. CBK data shows that year on year private sector credit growth decelerated from 16% to 4% between Feb 2016 and Feb 2017. The continued widening of the fiscal deficit at the time is seen to be the biggest contributor to the slowdown. Heavy government borrowing at the time pushed interest rates to high levels which effectively crowded out the private sector from the credit markets.

Further to that, the widening current account deficit in 2015/2016, triggered currency pressures which forced the central bank to tighten the credit markets in a bid to smoothen the currency movements. This may have also contributed to the slowdown over the period.



We believe the twin deficit situation will correct, albeit slowly in the medium term. In the recently read budget statement (May 2017), the government gave **very strong** indications of fiscal consolidation, by maintaining the planned expenditure levels for 2017/2018 fiscal year at previous year's levels while increasing revenue targets (see discussion on the Budget deficit). Tax policies were also observed to be in favor of increasing national savings while curtailing private consumptions. We believe this move will keep interest rates at low levels and may provide an ideal environment for credit growth going forward. We further expect lenders to refocus on sectors that were affected by the drought.

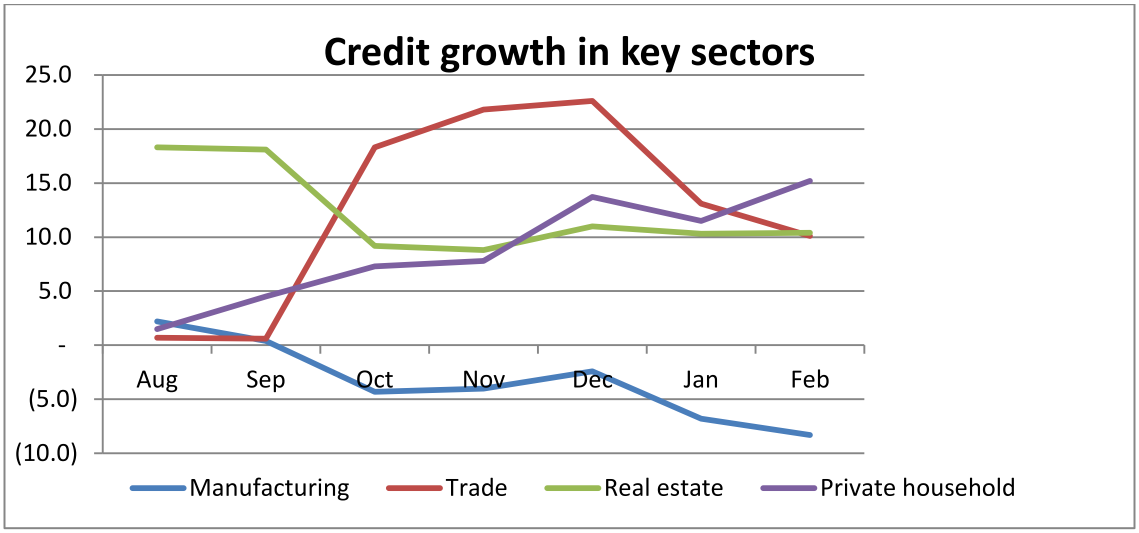
Interest rate cap and its effects on credit growth

In our view, there seems to be little evidence at this point that the interest rate cap slowed credit growth further since implementation. Banking Industry players have continuously warned that the interest rate cap law is going to worsen the credit growth situation by depriving credit, especially to the small and micro-enterprise segment. We are of the view that this narrative is largely for lobbying purposes

As observed in the graph above, the slowdown had started before the cap, and there has been less of change since then. We would like to argue that the slowdown in credit growth was largely attributed to

1. Crowding out effect by GOK- as the fiscal deficit widened between 2015 and 2016, interest rates increased substantially, which led to slowed credit growth.
2. Poor rainfall- The drought situation led the banks to reduce their credit exposure to the agriculture sector, as businesses in the sector struggled.
3. Other sector-specific issues- Manufacturing sector has in the recent past suffered stiff competition from imports as the cost of inputs increased.

The graph below shows credit growth in the 4 main credit sectors of our economy (61% of total credit). The graph covers between August 2016 when the interest rate cap was signed into law and Feb 2017. Save of manufacturing, credit to the main credit sectors was robust over the period.



The table below shows how credit in the various sectors performed since the rate cap law was signed.

Sector	% of total credit	Average growth Aug-16 to Feb-17
Private Households	17.5%	8.8%
Trade	16.4%	12.5%
Real Estate	14.9%	12.3%
Manufacturing	12.0%	-3.3%
Transport and Communication	8.5%	15.7%
Consumer Durables	7.4%	26.1%
Business Services	6.7%	-13.0%
Building and Construction	4.7%	1.6%
Agriculture	4.1%	1.0%
Finance and Insurance	3.8%	16.0%
Other Activities	3.4%	-25.3%
Mining and Quarrying	0.7%	-16.2%

Monetary policy committee pointed out in their May meeting that credit growth in the key economic sectors had started recovering in the month of March and April. Further to that, KNBS reported that growth in credit to private sector came in at 4.5% in Q1 2017.

Conclusion- Due to the above indicators, We believe that credit growth is headed for a rebound, regardless of whether the interest rate cap remains or not. As noted earlier, GOK has shown strong indications of fiscal consolidation which may keep interest rates low in the second half. With reduced credit appetite by the government, banks are expected to redirect their excess liquidity towards the private sector.

The effects of the drought are also expected to reduce in the near term. We may, therefore, start to see credit flowing towards the agriculture sector. While the challenges in the manufacturing sector are largely structural, ongoing policy reforms are expected to boost activity in the sector.

The obvious implication of improved credit growth is the rebound in business activity which had slowed down from the beginning of 2017. This is expected to boost growth beyond 2017 while improving sentiment in the near future.

A key risk to our expectation is;

1. Failure of government to go through with its fiscal consolidation plan.
2. Political instability in case the elections aren't peaceful may dampen business activity further

Politics: General election 2017

Kenya will hold a General Election on August 8th of this year. The national-level elections will include races for president, members of the National Assembly, and the Senate. County-level races will include those for governor (47) and members of County Assemblies (in 1450 wards).

We expect the presidential race to be more closely contested this time than in 2013.

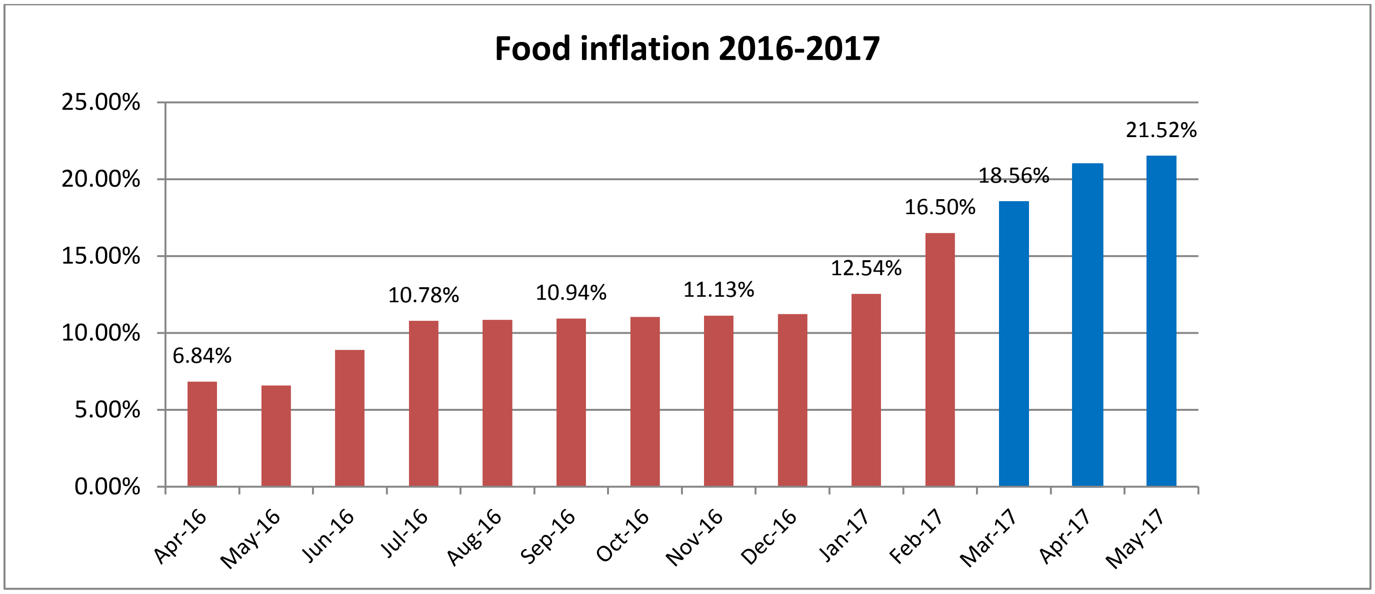
Similar to 2013, the presidential election is expected to be a two-horse race between the incumbent President Uhuru Kenyatta who is the candidate for the Jubilee party, and former Prime Minister Raila Odinga who is the presidential candidate of the NASA coalition. The NASA Coalition brings together 5 political parties ODM, Wiper, Ford Kenya, Amani and Mashinani party. The Jubilee party was a merger of the two main parties that won in 2013; the TNA and the URP parties, although other small parties were included in the merger.

The Constitution requires the winning presidential candidate to garner more than half of the votes cast and at least 25 % of the votes in at least 24 counties. A quick mapping of the geographical support of these two political camps indicate NASA may have a bigger geographical footprint support compared to the Jubilee party. While the Jubilee party holds the incumbent advantage, President's Kenyatta mixed record in office coupled with a bigger opposing coalition (compared to 2013) may make this election to be closely contested with a possibility of a runoff.

We do not expect any serious disruptions to business activity before, during and after the elections. We do however expect the stock market to be mute activity wise, during the election period and rebound back to normal once the results are announced.

Inflation: The cool off

Against our expectation of gradual decline, Inflation remained elevated throughout the quarter due to the higher than expected food prices, as price increases in other basket items remained muted. Headline Inflation averaged at 10.8% compared to 8.8% in the quarter. The graph below shows how food inflation evolved in the past I year.

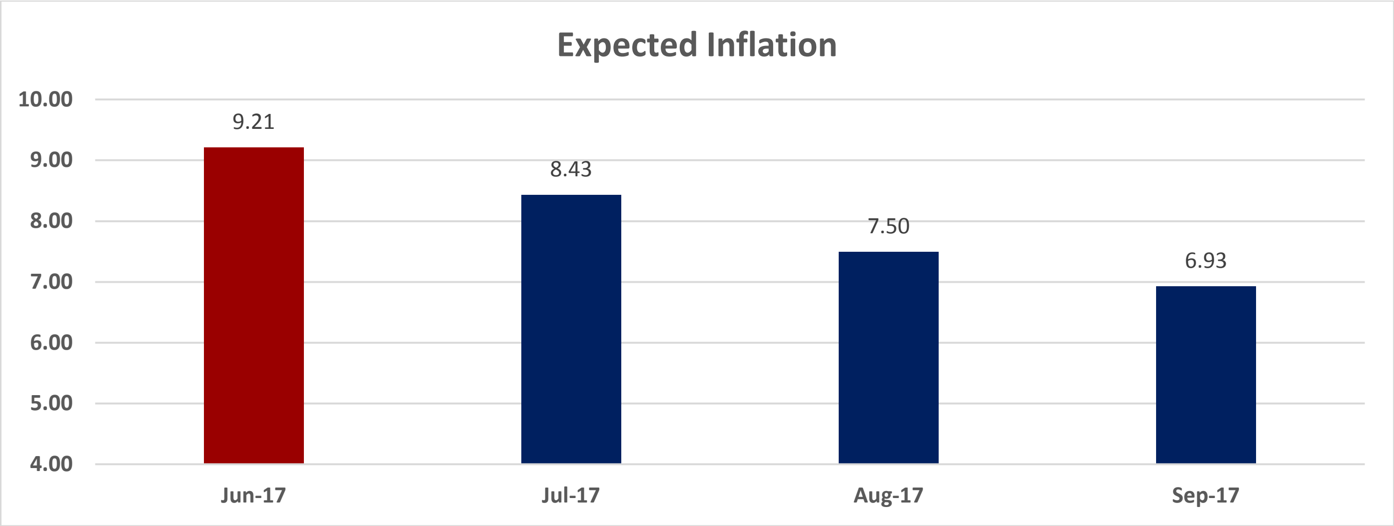


We now believe inflation levels have flattened out and food inflation will decline gradually over the coming months. While food production is still expected to be low this year (due to the erratic rains), government interventions are expected to offer some reprieve to food prices.

As noted earlier on the outlook for the agricultural sector, Kenya Metrological reported most parts of the country had below normal rainfall in April, May and June long rain season. Rainfall distribution over the same period was also poor. This may lead to low food production in the second half of 2017.

International crude oil prices declined to an average of USD 48.2 per barrel in quarter 2 from an average of USD 52 per barrel in Q1. Efforts by OPEC and some non-OPEC members to limit production in a bid to prop up prices were countered by increased production in the US, Libya, and Nigeria. Demand remained fairly flat hence pushing the prices lower. While it is still unclear on how the supply-demand mismatches will span out in the coming half, the world bank is expecting prices to average at USD 55 per barrel for the rest of the year. This will translate to fairly stable petroleum prices in Kenya. We thereby do not foresee any inflationary pressure from fuels.

In conclusion, while we expect inflation to trend downwards in the second half of 2017, we expect it to stabilize at 7% to 7.5% in the next 3 months. See below our latest revised outlook on inflation.



Budget Deficit:

As per the Budget statement 2017/2018, Treasury will be looking to reduce its budget deficit to 6% of GDP in the fiscal year 2017/2018 from 9.3% estimate for 2016/2017. This is expected to be achieved through revenues collection amounting to Kes 1.76 in tax revenues up from Kes 1.57 trillion in 2016/2017 while at the same time maintaining expenditures at Kes 2.3 trillion. This will reduce the absolute deficit from 2016/2017 estimate of 690 Bn to 2017/2018 projection of Kes 525 Bn. The Deficit is expected to be financed equally by foreign and domestic borrowings.

It should be noted that the 2016/2017 fiscal year deficit is estimated at 9.3% of GDP compared to the target of 6.1%. Treasury noted that the variance was due to unforeseen expenditures related to the drought, the various strikes, security and preparations for the 2017 general elections. There were also additional expenditures for projects financed by development partners.

According to provisional data for the fiscal year 2016/2017, Treasury was able to meet its targeted revenues, at Kes 1.57 trillion against a target of Kes 1.5 trillion.

If the government implements the 2017/2018 budget as planned, and maintain its expenditure levels in check, we are likely to see reduced borrowing pressure from the local markets over the period. This will go a long way in reducing the market interest rates. With expected slowdown in business activity (see above discussions), it remains speculative whether the government will be able to raise the revenues it has targeted, given that it is mostly dependent on economic expansion rather than increases in sources of revenue.

Monetary policy:

MPC met once during the quarter, bringing the total number of meetings in H1 to 3. The committee in all three meetings retained the policy rate at 10%, overlooking the pressure on inflation and the slowdown in credit growth. While the need to balance the two seems to have informed the decisions, it may be likely that the interest rate cap may have contributed to retaining the cap. The IMF had earlier warned that the cap may be rendering CBR useless as a monetary policy tool.

In the latest meeting on 29th May 2017, the committee, for the first time discussed some of the possible effects of the interest rate cap since it was implemented. The committee did not mention the effects of the cap to the overall credit growth or on monetary policy transmission, and instead, choose to show its effects on loan sizes and preferred clientele for the banks. ***See extract from MPC press release dated 29th May 2017.***

- The Committee evaluated available data on the impact of capping interest rates. The number of loan applications increased by 23.4 percent between August 2016 and April 2017, but the value of loan applications decreased by 18.3 percent, suggesting smaller size of loan applications. The number of loan approvals increased by 35.7 percent while their value decreased by 16.3 percent. Moreover, commercial banks' lending to Micro, Small and Medium Enterprises (MSMEs) fell by an estimated 5.7 percent between August 2016 and April 2017, but with small banks recording an increase on average.

Going forward, the need to boost growth is expected to dominate monetary policy action, and we may, therefore, see some easing. There is the need to, however, detach the policy rate from the interest rate cap benchmark, and establish a more market driven benchmark. This may ensure proper transmission of the policy stance into the credit markets.

Equities Market: The Recovery

Valuations at the stock market rebounded strongly during the quarter, posting the single biggest quarterly gain since Q1 2013 (NASI). The recovery was partly triggered by the generous dividend payouts by most companies for the FY 2016 results. NASI went up 17.2% while the NSE 20 went up 16%. The activity also improved impressively with equity turnover going up 21% while bonds turnover increased 25%. Local investors were observed to making a comeback as foreign activity remained at Q1 levels.

The earnings outlook for 2017 is modest, owing to the slowdown in business activities and as the Banking Amendment Act continues to be implemented. Sectors like Energy, Banking and Agriculture are expected to report negative to low digit growth numbers this year. Business and economic activity is however expected to rebound in the second half, as the effects of the drought reduce, and as we conclude the election cycle. This expectation may see the market continue to rally after the election

	Q1 2017	Q2 2017	% change
Equity Turnover (KES)	37,096,714,289	44,990,283,380	21.3%
Total Volume Traded	1,860,776,174	1,893,474,849	1.8%
Market Cap (KES Billion)	116,402	123,582	6.2%
Bond Turnover (KES Billion)	105	131	24.6%
NSE 20 Share Index	3,113	3,607	15.9%

NSE All-share Index	131	153	17.2%
FTSE NSE Kenya 15 index	162	190	17.0%
FTSE NSE Kenya 25 index	165	195	18.4%
FTSE NSE Kenya Govt. Bond Index	90	92	2.1%
Foreign buys	28,227,528,936	27,128,483,348	-3.9%
Foreign sales	26,184,326,170	29,693,034,709	13.4%

Top gainers Q2 2017

	31st March 2017	30th June 2017	% change
Standard Group Ltd Ord 5.00	19.00	39.25	107%
Crown Paints Kenya Ltd Ord 5.00	44.00	72.50	65%
National Bank of Kenya Ltd Ord 5.00	6.45	8.90	38%
Diamond Trust Bank Kenya Ltd Ord 4.00	116.00	160.00	38%
Nairobi Securities Exchange Ltd Ord 4.00	12.85	16.70	30%
Safaricom Ltd Ord 0.05	17.95	22.75	27%

Top losers Q2 2017

	31st March 2017	30th June 2017	% change
Nairobi Business Ventures Ltd Ord. 1.00 *GEMS*	8.00	6.20	-23%
Umeme Ltd Ord 0.50	16.95	13.30	-22%
Sameer Africa Ltd Ord 5.00	3.00	2.45	-18%
Kenya Airways Ltd Ord 5.00	6.00	5.05	-16%

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