The Kenyan Economy

Impressive Q2 GDP Growth

Kenya's economic performance and outlook continues to outpace most of Sub-Saharan Africa's owing to its diversified economy and stable macro-economic environment. GDP growth in Q2, as reported by Kenya National Bureau KNBS, continued to be broad based with all economic sectors contributing positively to overall output. Year on year growth in GDP came in at 6.2% supported largely by agriculture sector (5.5%), transport & storage (8.8%), real estate (8.7%), and wholesale& retail trade (6.1%). Accommodation and food services, which captures activities in the tourism sector, demonstrated significant signs of recovery growing 15.3% compared to a decline of 5% in the same quarter of 2015. Manufacturing on the other hand remained largely subdued growing 3.2% compared to 5.1% in Q2 2015. Slowdown in this sector can be mainly attributed to increased competition from cheap imports.

We expect economic growth to remain robust in the near term on the back of a stable economic environment, low commodity prices, government infrastructure expenditure and continued regional integration. We however note the following risks to our economy's long term growth;

- Quarter 3 witnessed one of the most significant policy changes in Kenyan history - the passing of the interest rate capping bill. Key economic sectors are expected to be negatively affected. Financial intermediation is expected to significantly decline as banks shy away from taking more expensive deposits and reduce lending to sectors of the economy that are perceived as risky. Given that our economy is largely driven by informal sector (high risk), directing capital away from this sector is going to negatively affect the overall economy.
- Another key risk brought by this law is the possible break down of monetary policy transmission. The IMF Deputy Managing Director recently noted that the linking of deposit rates and lending rates to Central Bank policy rate may compromise the independence and functionality of the Central Bank, thereby hampering its ability to use monetary policy towards achieving its objectives.

The disruption in capital flows combined with an ineffective monetary policy may cause adverse effects in the economy as has been evident in other countries that have adopted similar policies. Countries like Tanzania, Nicaragua and Ecuador offer good benchmarks of how such a law can affect the economy negatively. We however note that these negative effects may manifest with a lag, and are expected to affect the long term growth of the economy.

Inflation: the sun sets the price

Headline inflation averaged 6.33% in Q3 compared to 5.36% in Q2 and 6.12% in Q3 2015. The slight uptick in consumer prices was mainly due to food inflation which averaged 10.3% in Q3 2016 compared to 7.2% in Q2 2016. Low fuel prices provided some reprieve to headline inflation in the quarter with the transport index barely being affected.

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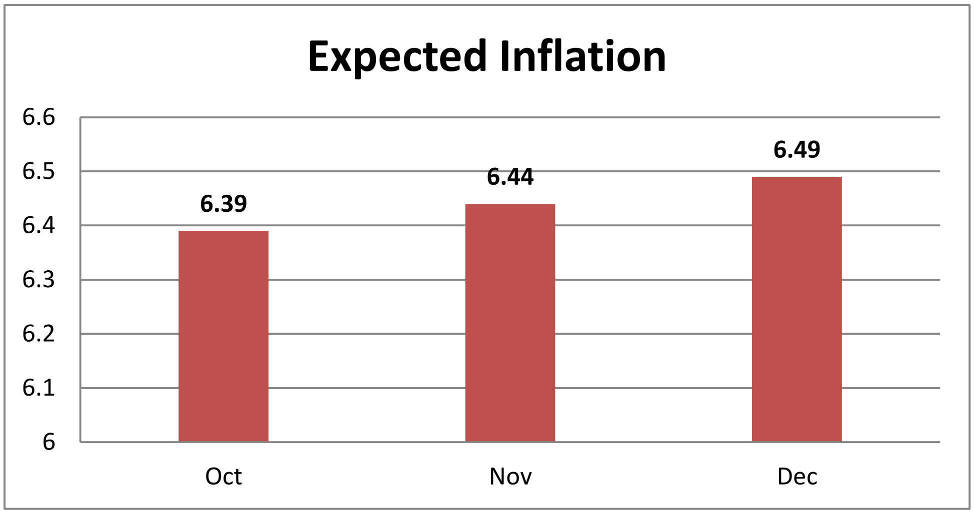
We expect food inflation to moderately increase this quarter. The Kenya Meteorological Department is expecting most parts of the country to experience depressed rainfall in the October to December short rains due to La Nina. Although we expect the adverse effects of La Nina will be fully felt early next year, the inflation figures should reflect rising food prices as early as November.

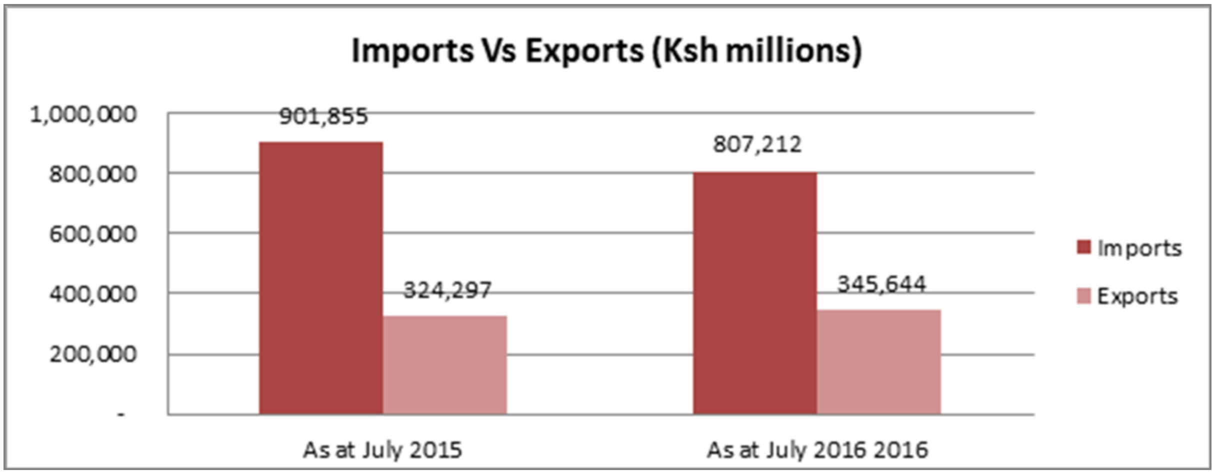
Petroleum prices are expected to remain low in the near term on the back of low crude oil prices. The continued shift in energy dependence from hydro to geothermal is expected to offer some reprieve to energy prices going forward. We outline our inflation projections for the next 3 months below.



Source: AIB Research

International trade: narrowing deficit

Kenya's current account position has improved on the back of export receipts increasing faster than import expenditure. The trade deficit for the first 7 months of 2016 declined to Kshs 462 billion from Kshs 578 billion for a similar period in 2015. Our main imports still remain Petroleum products & Machinery, while our exports are predominantly horticultural products, refined oil and minerals. Favorable petroleum pump prices coupled with improved harvests in our cash crops were the key drivers of the narrowing trade balance. While data in this category comes with a lag, we expect this trend to continue in the 3rd and 4th quarters of 2016.

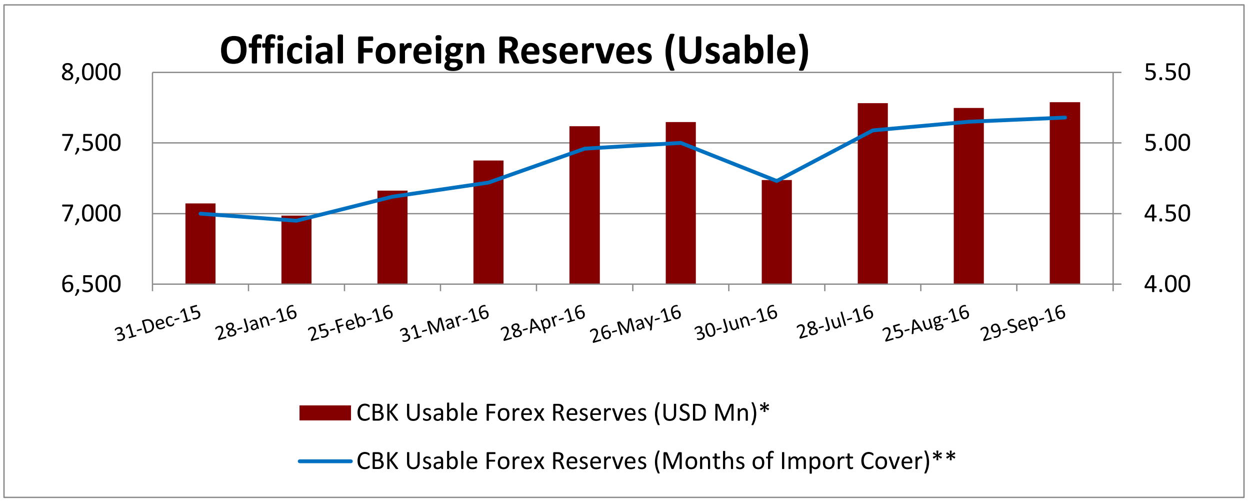


Source: KNBS, AIB Research

Key risks to international trade going forward include a slowdown in advanced economies, increasing anti-globalization sentiments and political instability in the Middle East and parts of Sub-Saharan Africa.

Currency: Stable as the Shilling

The shilling continued to show stability against the major currencies, unlike its African peers. During Quarter 3 it depreciated 0.2% against the dollar and 1.2% against the euro. It however strengthened 3.5% against the pound. The Central Bank of Kenya's (CBK) foreign exchange reserves closed the quarter at USD 7.8 bn an equivalent of 5.18 months of import cover. This was the highest in 2016. On top of this, CBK has a USD 1.5 bn standby credit facility with the IMF in case of excessive currency volatility.



Source: CBK

Kenya, being a net importer of oil, has greatly benefited from the stability of the shilling against the US dollar, and this has allowed it to build up its forex reserves as the chart above shows. The sharp dip seen toward the end of June was due to the extraordinary measures the Central Bank took to keep the Kenya shilling from being battered following the vote by Britain to exit the European Union. These measures were successful in protecting the Kenya shilling from wide fluctuations.

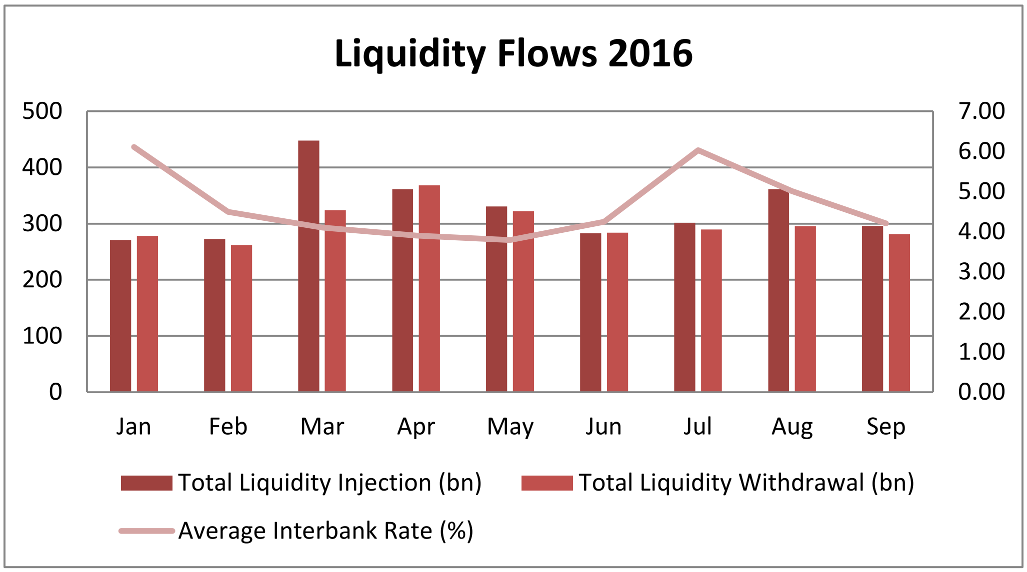
Going forward, we expect the shilling to continue trading within a narrow band with a strengthening bias against the dollar, at least in the coming 3 months. This will largely be driven by our improving trade balance, strong diaspora remittances and recovery in the tourism sector.

One of the key risks to the currency will be potential capital outflows as monetary policy normalization continues in the US. Further to that, returns in the fixed income markets have been dwindling relative to peer economies. This may further fuel movements in capital outside our markets. Poor rainfall in the coming few months may also affect our cash crop production thereby reducing our exports. We however note that the CBK's strong forex reserve position should support the shilling in any of these eventualities.

Interest rates: Permanent floors?

Liquidity in the short term debt markets remained relatively high driving interest rates downwards. The 91 day T-bill averaged 8.0% in Q3 compared to 8.1% in Q2. The 182 and 364 papers averaged 10.5% and 11.2% in Q3 compared to 10.2% and 11.4% in Q2 respectively. CBK activities during the quarter resulted in net liquidity injection of about Ksh 27 billion. Towards the end of the quarter, the monetary policy committee met and decided to reduce the CBR from 10.5% to 10.0%, citing a decline in private sector credit growth as well as a favorable outlook in prices which would accommodate the lower rates. Following a spike in interest rates last year, lending rates increased significantly, thereby discouraging borrowing. These high rates continued well into 2016, reducing the rate of credit growth.

Going forward, interest rates are expected to remain fairly low, owing to the recent policy shift of pegging interest rates to the CBR. The policy objective of spurring growth while maintaining stable prices will be harder to achieve using interventions in the money markets. It will be of great interest to market participants to observe how the Central Bank works around these constraints.



Equities Markets: Uncertainty forges on

Equities market turnover in Q3 was 30% higher than the previous quarter, totaling Kshs 48.1 billion. Foreign investors were the most active with purchases increasing 45.81% from the previous quarter and sales increasing by 31.11%. Bond turnover dropped by 48.11% compared to the previous quarter.

Overall valuation declined significantly following a series of global and local events that occurred during the quarter. NSE 20 declined 11% during the quarter to close at 3,243.21 points. The NASI declined 3% to close at 136.75 points, FTSE 15 declined 6% closing at 165.81, and the FTSE 25 declined 3% to close at 171.63.

The uptick in activity and subsequent decline in valuations was due to a number of extraordinary events such as the Brexit vote, the announcement of a special dividend by Safaricom and the signing of the interest rate cap bill into law. Banking stocks were the most affected by the President's assent to the interest rate capping bill on August 24th. Their valuations dropped significantly with only Barclays recording a price gain in August. The most affected banks were Equity and I&M, which shed 23.61% and 22.9% respectively between August 1st and August 31st.

A couple of possible upcoming events are poised to affect our equities valuations going forward. Banking sector Q3 earnings announcements, though expected to be robust will see a lot of banks downgrade there full year guidance as they strive to realign their strategies in light of the new changes in law. For the banks, the year 2016 was characterized by slowdown in loan book growths, increased loan loss provisions and declines in non-funded income. A key positive in the first three quarters was improved margins which boosted earnings in the first half of the year.

The decline in credit growth evident in the half-year banking sector reports is a sign that private businesses have had a tough year. Central Bank also came out to acknowledge that the slowdown in credit growth was a big blow to economic activity. The cement sector registered a decline in earnings in the first half of 2016 owing to softening homebuilders' markets in the construction sector. Manufacturing firms seem to be succumbing to their struggles with three companies publicly announcing that they have stopped their Kenyan operations.

The continued rhetoric around poor governance structures among listed companies is not helping much either. Key listed companies have been associated with corruption allegations, negligence and questionable business activities.

We do not foresee many positive corporate announcements in the coming six months. We however feel that investors could benefit from companies that are immune to business cycles, such as utilities and energy companies. Consumer-based businesses are also poised to do well.

Bonds Market: Be on the right side

Activity in the bonds market declined significantly during the quarter. Turnover stood at Kshs 76 billion, which was a 48% decline compared to Q2 2016. The number of deals also went down 23% to stand at 1,202 deals. Bond prices however were on the rise implying a decline in yields across the yield curve. The FTSE Kenyan government bond index closed the quarter at 89.11 points representing a 1.3% gain. During the quarter the government came to the primary market twice through a 10 & 20 year issue seeking to raise a total of Kshs 50 billion. It received a total of Kshs 44 billion, but accepted only Kshs 30.6 billion.

We expect activity to be robust In primary markets as banks seek to increase their holdings in government securities. Inflexibility in pricing credit will result in banks prefering safe assets like credit to big corporates and government securities, and rationing credit to small borrowers who are viewed as risky. Activity in the secondary markets is expected to pick up as interest rates find a new equilibrium. The expectation of declining rates following the spike in October 2015 led investors to hold their bonds as they sought capital gains. Trading is expected to resume when interest rates bottom out, a scenario we see occuring before year end.

Conclusion

Going by historical performance, the economy seems to be moving in the right direction. We however remain weary of the long-term growth prospects of the economy given the changes in banking regulations, and possible crowding out of the private sector in the credit markets. We further expect a series of negative corporate actions in the coming few months. This coupled with the uncertainities in movement of portfolio flows is expected to affect stock prices negatively. We recommend investors to remain underweight in their equities portfolio, giving prominence to utility and consumer stocks. For the fixed income securities we see some opportunities in the primaries as well as the longer end of the yield curve.

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