Global Economy

The international monetary fund (IMF) has revised its global economic growth upwards to 3.6% from 3.5% projected back in April 2017. The upward revision was driven by broad-based upward revisions in the Euro area, Japan, Emerging Asia, Emerging Europe, and Russia which more than offset downward revisions for the United States and the United Kingdom. Activity in the UK slowed more than anticipated in the first half of 2017. As for the United States, IMF reversed its initial assumption of fiscal stimulus that were adopted in the April forecasts, and adopted an assumption of unchanged policies.

They however noted that despite this strengthening in baseline outlook, growth remained weak in many countries and inflation remains weak in many advanced economies. They identified commodity exporters, especially fuel exporters as the hardest hit as far as output is concerned. Despite expectations of more robust global demand going forward, commodity prices have remained low; with oil prices reflecting stronger-than-anticipated supply. IMF further noted that short term risks remained balanced, while medium term risks were tilted to the downside.

Financial market sentiments have generally been strong, with continued gains in equity markets in both advanced and emerging market economies. For the financial markets in advanced economies, sentiment has mainly been driven by the expectations of a more gradual pace of monetary policy normalization. ***(Source: IMF, AIB Research)***

Sub-Saharan Africa

World Bank recently released the African pulse report-Oct 2017, indicating upbeat recovery in African economies although at a slower pace than earlier anticipated. Following two years of a sharp slowdown, the World Bank notes that a recovery is currently underway with GDP growth expected to rebound to 2.4% in 2017 up from 1.3% in 2016. The rebound is being led by the region’s largest economies. In the second quarter of 2017, Nigeria exited a five-quarter recession and South Africa emerged from two successive quarters of negative growth. Economic activity has also picked up in Angola. World Bank has however reduced this projection from 2.6% it had given in April 2017. The downward revision was driven by a slower than expected recovery in Nigeria and Angola.

World Bank further notes that external conditions are more favorable for Sub-Saharan Africa, with a stronger trend in global growth, robust growth in global goods trade, rising energy and metals prices, and supportive global financing conditions. Higher commodity prices are observed to be helping to narrow current account deficits in the region, especially of oil exporters.

Beyond 2017, the World Bank projects Sub-Saharan Africa to continue seeing a moderate pickup in activity, with growth rising to 3.2% in 2018 and 3.5% in 2019. These forecasts are unchanged from April, and assume that commodity prices will firm and domestic demand will gradually gain ground, helped by slowing inflation and easing monetary policy. ***(Source: African Pulse report-Oct 2017, AIB Research)***

CERTIFICATIONS AND REQUIRED DISCLOSURES BEGIN ON PAGE 9

Kenyan economy:

Quarter 2 GDP numbers released by KNBS justified our view for a slowdown in the economic growth in 2017, as economic activity struggles to recover from weak loan growth and agricultural output in recent months. GDP growth is estimated to have slowed down to 5% in the Q2 of 2017 compared to 6.3 % in the corresponding quarter of 2016. Growth in all segments was positive although 11 out of 16 segments slowed down on a quarter on quarter basis. By virtue of being the largest economic segment (24% of total output), agriculture was the main driver of the overall slowdown. Growth in Agriculture decelerated to 1.4% down from 7.1% in Q2 2016. The quarter was characterized by low agricultural output and high food prices. Manufacturing (10% of output), decelerated to 2.3% growth down from 5.3% a year ago. Tourism (13.4% growth), Construction (7.5%), transport (8.2%) and real estate (9.7%) continued to record robust performance. Tourism was supported mainly by improved security around the country, Construction by increased government expenditure on infrastructure, transport by low fuel costs, and Real estate by robust credit to the sector.

Why is the economy slowing?

We looked at the various factors that in our view we believe may be contributing to the slowdown in economic activity. We categorized the factors into two, Transitory Factors and Structural factors.

Transitory factors-

These are effects that are seasonal and are expected to wade off with time. They are mostly event related.

a. ***Recent Drought***

   Top on the list is the drought that hit the country from H2 2016, whose effects are still being felt to date. The drought affected food production across Kenya's food baskets, creating a shortage that led to significant increase in food prices. (See discussion on inflation). The drought also affected production of electricity. We are of the view that these effects have started to wade off with the harvest season beginning. Although the country received below normal rainfalls during the March-May long rain season, food production is expected to improve compared to 2016.

b. ***Politics-***

   Second on the list are the effects of the political uncertainties. Kenya has had an extraordinary electioneering period in 2017 which has led to significant deterioration in business activity. The country conducted a general election on the 8th of August, which was later annulled by the Supreme Court due to the electoral commission's (IEBC) failure to adhere to provisions of the constitution and the electoral act. The Supreme Court subsequently ordered a repeat election in 60 days from the date of annulment (1st September). Initially, IEBC set the date for the repeat elections on 17th of October, but later pushed it to 26th of October when the full judgment of the annulment was read by the Supreme Court. As the country continued to prepare for the repeat election, a new twist came into play when the main opposition candidate-Raila Odinga withdrew his candidature in protest of minimal reforms in the electoral body. Raila Odinga and his coalition party-NASA, now expect that the 26th October election will be cancelled in adherence to a Supreme Court ruling made in 2013. Currently the country is engaging on a national debate on whether the 26th election will be carried out, and if yes, whether the election will be upheld by the Supreme Court in case it is challenged in court.

It is still uncertain on the time it will take to resolve these political standoffs. The opposition has vowed to continue with their demands of reforms and is organizing protests around the country. Businesses are still expected to hold back on investments as the uncertainties continue.

Structural factors

These are factors that are more permanent in nature and can only be resolved through some form of policy change, fiscal, monetary or legislative.

a. Twin deficit.

Kenya bureau of statistics (KNBS) reported that the current account deficit expanded to Kes 138 Bn in quarter 2 up from Kes 123 Bn in quarter 1. This represents a current account to nominal GDP ratio of 6.6% in Quarter 2 from 6.3% in quarter 1. The increase was mainly attributed to increase in imports (16%) of food and petroleum products while exports grew by a mere 2.3%.

On the other hand Treasury released its draft Budget review and outlook paper released on 22nd September indicates that treasury will be looking to increase the fiscal deficit this year following recurrent expenditure pressures. The target budget deficit is expected to move up from Kes 530 Bn (6.2% of GDP) to Kes 750 Bn (8.5% of GDP)-See discussion on public finance below.

Theoretically, an economy with an expanding fiscal deficit will be required to fund it through either by increasing the national savings rate, reducing private investments, or increase foreign capital inflows. Going by the increase in local borrowing targets by treasury (see public finance) we are of the view that the reducing private investments may be the outcome of this increase in fiscal deficit.

b. Slowing private sector credit growth

Related to the twin deficit discussed above, we believe that the increased government borrowing in Kenya shilling is slowly crowding out private sector from the credit market. In our Q2 economic discussion, we discussed in length private sector credit growth, and what we believe will be the turning point going forward.

c. The interest rate cap.

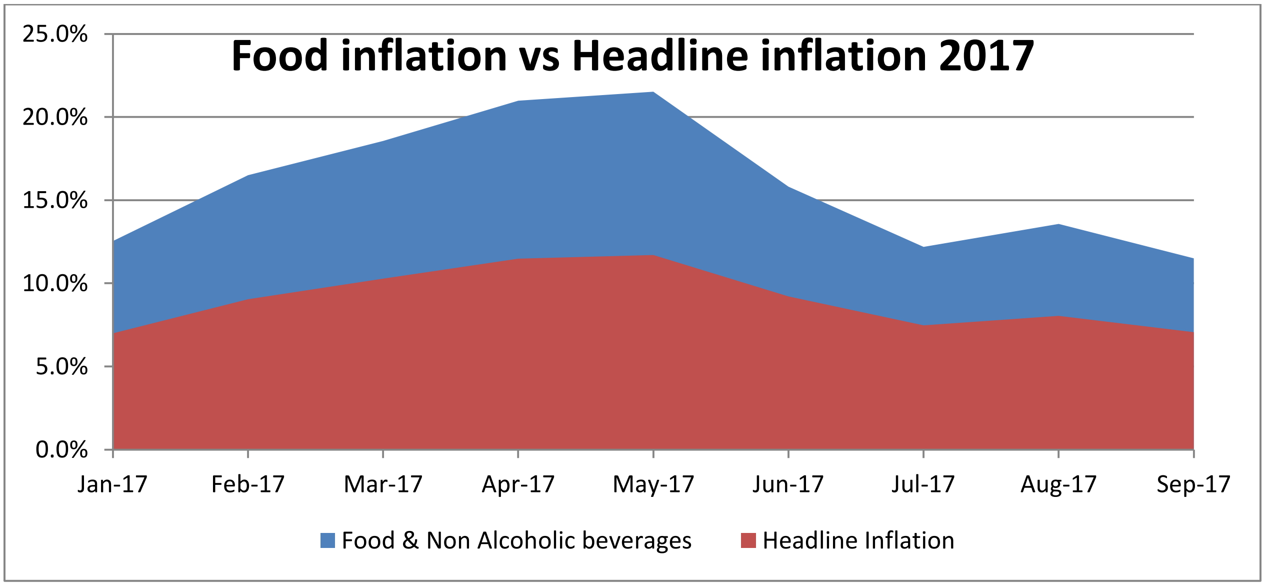
While we don't see it as the sole reason for the slowdown in lending, we believe the banks are going to discriminate risky borrowers going forward. These are mainly informal businesses which form the bulk of private sector businesses.

Investors should keep a close eye on any action that is expected to reverse some of these structural causes.

Inflation: The cool off

In line with expectation, headline inflation was on a downward trend during the quarter although remained above the central bank upper limit of 7.5%. Q3 inflation averaged 7.52% down from 10.8% in Q2 2017. Food inflation has remained the key driver of inflation throughout the quarter (see graph below) averaging 12.42% down from 19.4% in Quarter 2. The decline in food inflation was largely driven by improved supply of certain food items, and government interventions in form of maize subsidies and tariff reduction in maize imports.

Kenya Metrological department 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. Harvest yields may therefore remain low in 2017. Government has also stated that it will be removing the Maize subsidy as the harvest season begins in October.



Housing, Water, Electricity, Gas and other Fuels index increased slightly during the quarter, averaging 3.26% up from 2.93%. This was largely driven by increases in local pump prices which have been on the rise since the beginning of the quarter. This is despite Crude oil prices remaining fairly unchanged at USD 48 per barrel during the quarter.

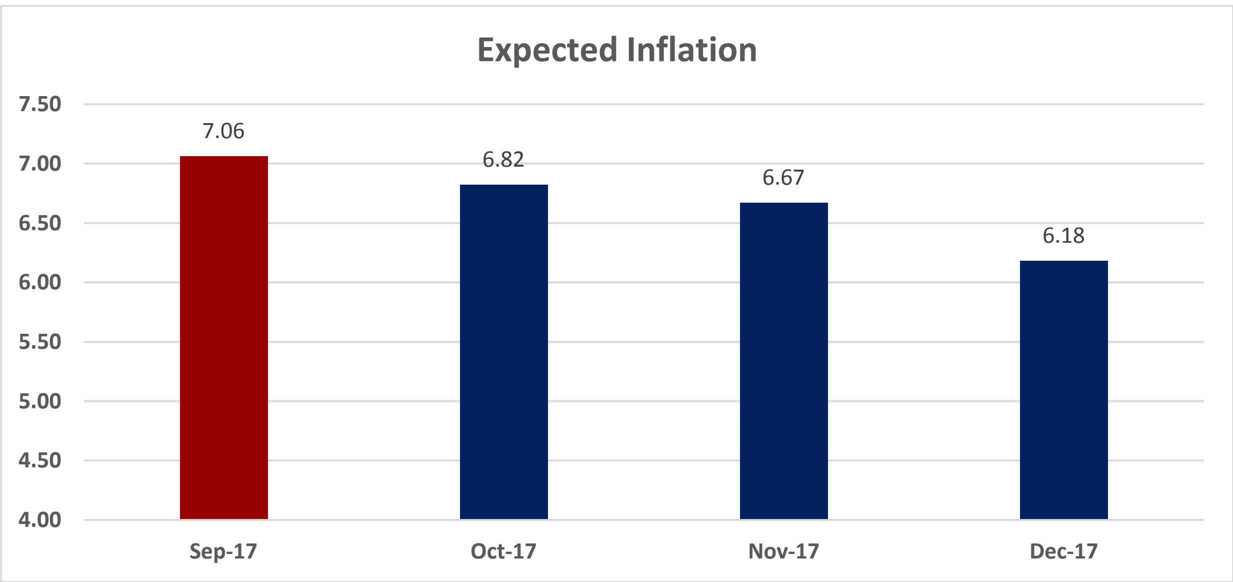
Going forward, we see two factors that may potentially pose some risks to inflation.

1. ***Crude oil prices.*** The global economic recovery has continued to increase global demand for crude oil in the recent past months. This coupled with the extension of the Opec-Non Opec

production cut deal, is expected to push oil prices upwards. Further to this, recent natural catastrophes in the US may reduce oil production from the US.

2. ***Secondly on fuel prices***, the ministry of energy recently announced plans to remove price controls on local fuel prices. The ministry cited a study that recommended the pricing deregulation, on the back of improved efficiencies and discipline in the sector. The petroleum institute (a lobby group for oil marketers) has however warned against those plans citing the possibility of increased costs due to the removal of single sourcing of fuel imports.

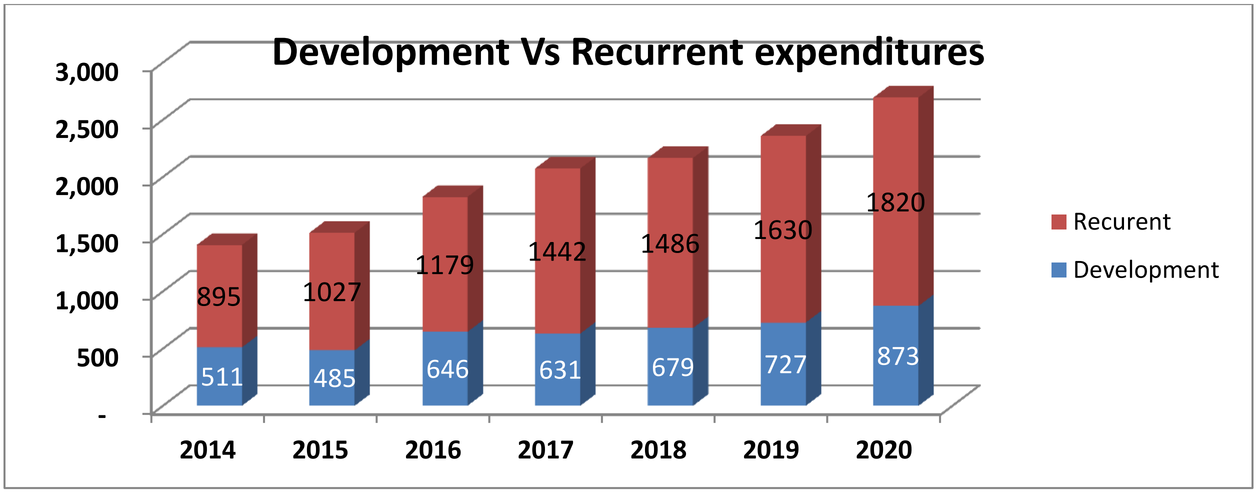
That said, we still believe improved food prices will continue to drive inflation downwards. With the onset of the harvest period, and the short rain period, prices of key food items may reduce. The Metrological department expects most of the country to experience enhanced rainfall during the short rain period of October, November and December. It should be noted that this is the first time since Q4 2015 that they have given a positive outlook with regards to rainfall. This is expected to significantly boost food supplies in the medium terms. See below our inflation outlook.



Public Finance:

Towards the end of the quarter, treasury released the 2017 draft Budget Review and Outlook paper (BROP). The purpose of the BROP is to provide a review of fiscal performance for the FY 2016/17 and how this performance impacts on the financial objectives and fiscal responsibility principles set out in the 2017 Budget Policy Statement (BPS). Further, the document provides highlights of recent economic developments and outlook and sector ceilings for the 2018/19 budget and the medium term.

Our impression after reading the document is that government has shelved its initial plans and intentions of fiscal consolidation. The document indicates a revision of target revenues reduced from Kes 1.7 trillion given in the 2017 budget policy statement (BPS) to Kes 1.6 trillion, while target expenditures have been increased from Kes 2.3 trillion to 2.4 trillion. The target budget deficit will consequently move up from Kes 530 Bn (6.2% of GDP) to Kes 750 Bn (8.5% of GDP). Target recurrent expenditures were revised upwards from Kes 1.3 trillion to Kes 1.4 trillion as target development expenditure was reduced from Kes 640 to Kes 631. See Graph below on treasury's projections of Development vs recurrent expenditures



(Source; 2017 Budget review and outlook paper)

What surprised us in the document was the intention to finance the increase in the deficit primarily from domestic borrowings. Domestic borrowing target was increased from Kes 275 Bn to Kes 410 Bn. Target foreign borrowings was increased slightly from Kes 256 Bn to Kes 277 Bn. This will consequently increase the stock of public debt to Kes 5.2 trillion which represents 59% of Nominal GDP. We suspect this specific development to be the primary reasoning behind Moody's Investors Service placing the B1 long-term issuer rating of the government of Kenya on review for downgrade (See below).

Moody's set to downgrade Sovereign rating

During the quarter Moody's Investors Service placed the B1 long-term issuer rating of the government of Kenya on review for downgrade. The rating agency stated the following as the reasons behind the action;

- *Persistent, large, primary deficits and high borrowing costs continue to drive government indebtedness higher*
- *Government liquidity pressures risk rising in the face of increasingly large financing needs*
- *Uncertainties weigh over the future direction of economic and fiscal policy, in part due to evolving political dynamics*

In the latest 2017 draft Budget Review and Outlook paper (BROP) released by treasury, the government expects its debt to nominal GDP ratio will increase to 72% from the current 52% by fiscal year 2019/2020. The Moody's review will be focused on this medium term outlook as well as the likely policy responses to these budgetary pressures.

A downgrade in the sovereign rating is expected to increase the cost of raising foreign debt for both the government and private business. Any sovereign rating revision automatically results to revision of private company's ratings.

Monetary policy:

During the quarter the monetary policy committee met twice bringing the total number of meetings to 5 in the first nine months of the year. The committee retained the CBR rate at 10% in both these meetings as they continued to overlook the pressure on inflation and the slowdown in credit growth. The committee observed in both cases that the demand pressure on prices has remained mute, referencing the Nonfood non fuel inflation which has consistently been below 5% throughout the year.

With stability in the forex market, and lower inflation expectations, slowdown in credit growth seems to be MPC's current headache. Lowering the CBR to boost lending would be the ideal move for the committee going forward. Effectiveness of the CBR in monetary policy transmission is however being questioned by market participants due to the interest rate cap.

Going forward, we see a lot of uncertainties in the direction that MPC is expected to take as far as setting the Policy rate. With the interest rate cap law in play, reducing the policy rate may not necessarily boost credit growth as banks may reduce supply due to lower margins. At this point the only remedy we see for slowing private sector credit growth is on fiscal policy.

Equities Market: The Recovery

	Q2 2017	Q3 2017	% change
Equity+I Reit Turnover (KES)	44,990,283,380	53,572,099,221	19.1%
Total Volume Traded	1,893,474,849	2,019,534,756	6.7%
Market Cap (KES billion)	2,221.29	2,376.69	7.0%
Bond Turnover (KES billion)	131	105	-20.2%
NSE 20 share Index	3,607.18	3,751	4.0%
NSE All share Index	152.92	162	6.1%
FTSE NSE Kenya 15 index	189.82	204	7.4%
FTSE NSE Kenya 25 index	195.26	208	6.3%
FTSE Kenya Govt. Bond Index	91.56	91.47	-0.1%
Foreign buys	27,128,483,348	22,232,664,336	-18.0%
Foreign sales	29,693,034,709	32,541,438,660	9.6%

Activity in the stock market continued to improve although sentiments remained mixed during the quarter. The period started with upbeat activity as local institutions made a comeback to the market. However, in the last month of the quarter, activity and valuations have declined significantly following the annulment of the presidential elections on 1st September.

Overall, Market turnover improved 19% to total Kes 53 Bn. Volumes were up 6.7% to total 2 bn Shares. The NSE 20 index improved 4% to close the quarter at 3751 points. September alone saw the index decline 7%. Foreign sales intensified during the quarter, with foreign net sales coming in at Kes 10 Bn up from Kes 2.6 Bn in the previous quarter.

We maintain our expectations of modest earnings outlook for the full year 2017 owing to the slowdown in business activities the Banking Amendment Act will continue to impact banking sector earnings. Sectors like Energy, Banking and Agriculture are expected to report negative to low digit growth numbers this year.

Political uncertainties are further expected to negatively impact both market activity and business activity. As noted in the discussion on causes of economic slowdown, the uncertainties are short term and transitory in nature.

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