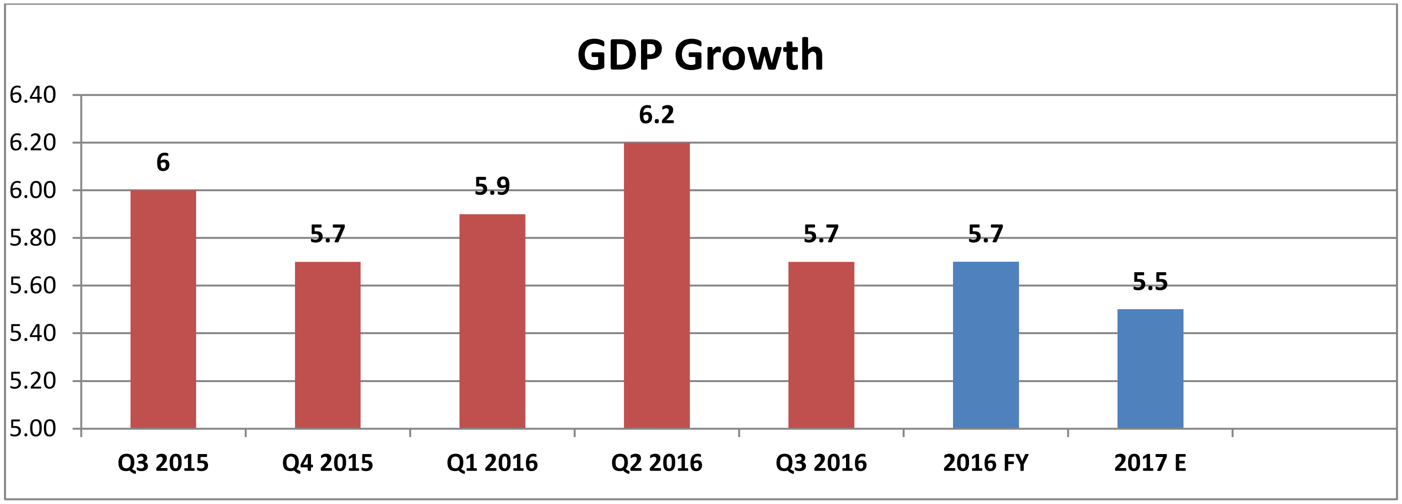
The Kenyan Economy

GDP: 2016 and 2017 Outlook

Relative to other SSA countries, Kenya continues to reap the benefits of its diversified economy coupled with stable macro-economic environment. The economy is estimated to have expanded by 5.7% in Quarter 3 of 2016 compared to 6% in quarter 3 of 2015. Growth continued to be broad based with all sectors registering positive growth. Most sectors however registered decelerated growth over the review period. We estimate that the economy will grow by 5.7% in 2016 and slow down to 5.5% in 2017.



We project a slowdown in 2017 growth due to the low rains in Q4 2016 and the expected drought in 2017. This will slow down growth in The Agriculture sector which constitutes 23% of the economy. Credit growth has remained low in 2016 and we expect it to continue into 2017. The upcoming elections will further slowdown investments and general business activity.

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The table below summarized the performance of the key sectors. We look at how they performed in Q3 2016 compared to Q3 2015. We also estimate the 2016 full year growth for these sectors and give a 2017 projection.

Sector	**Contribution %**	**Growth**				**Key Drivers**	**Key constrains**	**OUTLOOK**
	2016	**Q316**	**Q315**	**FY16 E**	**FY17F**			
Agriculture	22.6%	3.9%	5.5%	**4.6%**	**4.0%**	Increased output in cut flowers, Dairy farming	Slowed production of maize, Tea, Coffee & fruits, low global tea prices, droughts, a drop in demand from Europe	We do not expect much recovery in the near term, owing to the erratic rains that the country has experienced the last 6 months. We however expect growth to be steady in the long term as the country explores many opportunities in the field, from new technology, imported skills & expertise and the large unutilized arable land.
Manufacturing	10.5%	1.9%	3.3%	**2.6%**	**2.0%**	Growth supported by processing of maize meal, wheat flour & milk.	Growth slowed by decline in manufacture of soft drinks, beer and stout, motor vehicle assembly and cement production	The outlook for the sector remains mixed. We have observed manufacturing plants shutting down owing to stiff competition from imported brands as well as high production costs (E.g. Sameer, Softa, Eveready, Cadburys, and Proctor & Gamble). On the other hand new policies for the sector are expected to reduce constraints for manufactures in the long run. Government's pursuit for low energy prices coupled with incentives for manufactures is also expected to boost the sector.
Construction	5.2%	9.3%	15.6%	**9.1%**	**8.0%**	Continued development of the Northern Corridor Transport Improvement Project (NCTIP) and the Lamu Port and Lamu Southern Sudan-Ethiopian Transport Corridor (LAPSSET).	Low cement consumption owing to reduction of civil works in SGR. Softening homebuilders market.	Construction of Key infrastructure projects boosted the performance of the sector historically. Government has indicated that it will be reducing its development expenditure budget this financial year (Budget policy statement). Further softness is expected in the homebuilders market following the low uptake of credit the past one year. We therefore expect further slowdown for the sector in the coming few quarters.

Elec & water supply	2.5%	7%	10%	**8.3%**	**7.0%**	Increased connections. 12.8% increase in hydroelectricity.	4.1% decline in electricity from geothermal sources	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.
Accommo-dation & food services	1.1%	13.8%	-6.5%	**13.6%**	**10.0%**	High profile meetings Improved security hence downgrade of travel advisories Key policy incentives	Security concerns	We expect the sector recovery to continue in the coming year although at a slowed pace due to the upcoming elections. High profile meetings are expected to slow as our politicians concentrate on campaigns. In the long run we expect the following to drive growth in the industry; improved security in the country, strengthening tourist experience by packaging tourism sector incentives and revamping the tourism communication strategy.
Transport	6.6%	10.3%	9.4%	**9.5%**	**10.5%**	Improvement in freight and passenger road transport. Increased port activities-10% increase in imports through Mombasa.	Operational challenges by national carrier. 21% drop in volume of cargo handled.	Government's investment in Key transport infrastructure projects, seem to be boosting activity in this sector. Modernization of the Sea port, the International airports and completion of Railway projects is expected to boost the sector further. Further to that, the Government has begun working on customs reforms, transport and trade partnerships, and encouraging privatization (through Public Private Partnerships, or PPP). We expect these initiatives to continue driving growth in this industry.
Financial Sector	6.1%	6.1%	10.3%	**6.6%**	**5.0%**	Narrowing of interest rate spread from 14.9% in Q3 2015 to 10% in Q32016	Slowdown in domestic credit growth-2.4% Slowdown in credit to private sector-4.8% Low activity & valuations at the Stock exchange.	We expect growth to slow down in this sector owing to the following factors: ➢ The new banking act 2016 ➢ Erosion of consumer confidence in the banking sector ➢ Stricter prudential and conduct regulations that have been enforced since the appointment of the current CBK Governor ➢ Depressed domestic equities market expected to reduce revenues for insurance companies. In 2017 The Financial services industry will be characterized by themes on consolidation, with both the industry's regulators and players expected to consolidate.

(Source: KNBS, AIB Research)

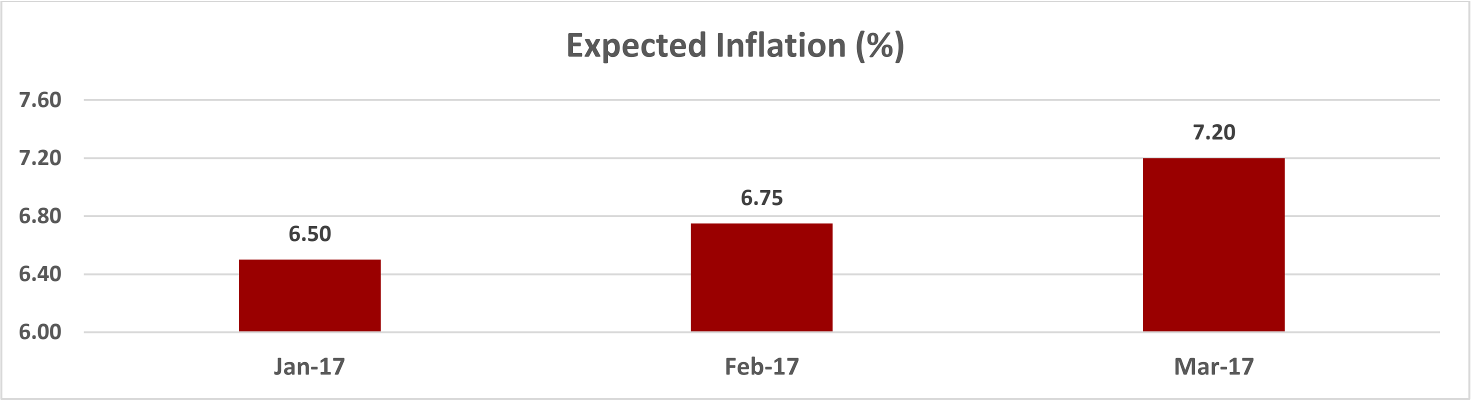
Inflation: Pressure becomes real

Headline inflation averaged 6.46% in Q4 compared to 6.33% in Q3 and 7.35% in Q3 2015. Although headline inflation is still within Government target of 2.5% to 7.5%, we observe moderate price pressure from Food items, which continue to be the main driver of inflation. Food inflation averaged at 11.13% in Quarter 4 up from 10.86% in Quarter 3.

The Kenya metrological department in its latest seasonal forecast indicated that most parts of the country were expected to receive below normal rainfall during the short rain season (October to December). This is due to the evolving lanina effects which are expected to continue into the New Year. We therefore expect lower food output in the coming few months which may put pressure on food prices.

Petroleum prices are expected to increase significantly in the coming months as international crude oil prices continue to soar. An agreement between OPEC members in early December to cut production saw prices rally 18% in December to a high of USD 56 per barrel. Non OPEC members will also be joining their counterparts in cutting production. These moves are meant to reduce inventory levels across the globe thereby pushing up prices. We thereby expect local pump prices to increase by similar margins in the coming 2 months. The effect on inflation may further be exuberated by the low base of Q1 2016.

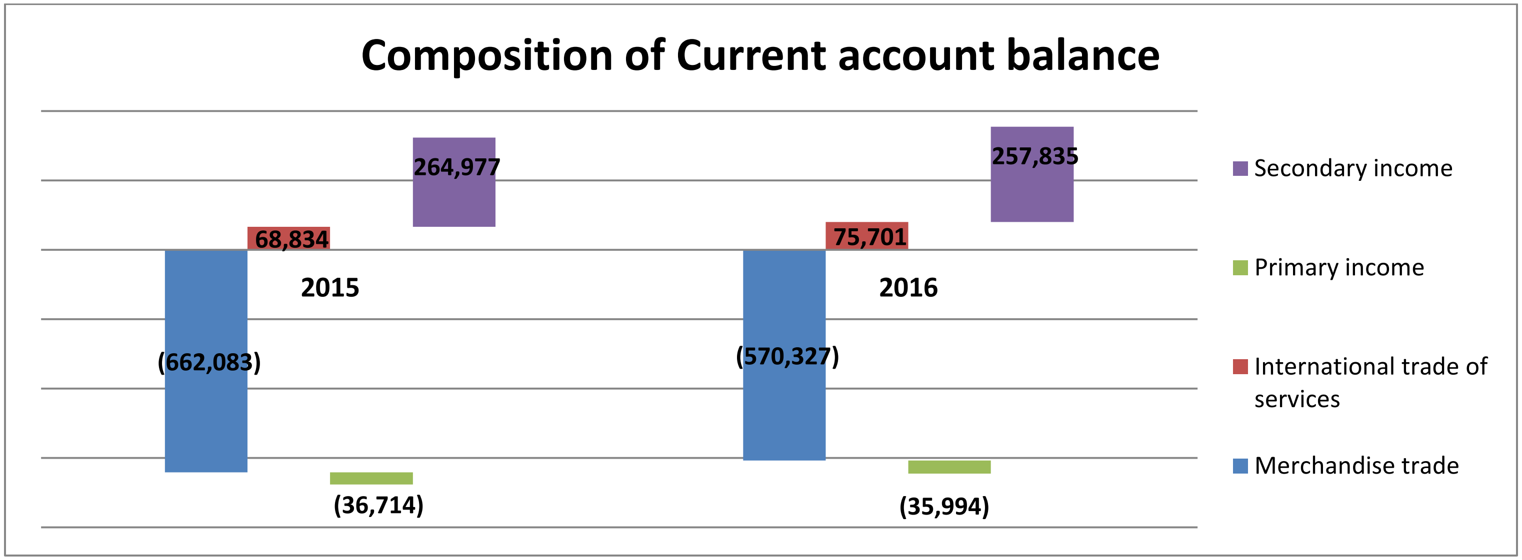
We therefore expect inflation to rally to 7.2% in the coming 3 months.



Balance of Payments: The turning point

Kenya national bureau of statistics (KNBS) in its latest balance of payment report indicated that our current account deficit improved to Kes 273 Bn (Jan- Sept 2016) down from Kes 365 Bn in a simmilar period in 2015. Merchandise trade balance (Export goods less import goods) improved to Kes -570 Bn down from Kes -662 Bn over the same period. Net Receipts from trade in services improved to Kes 76Bn from Kes 69 Bn over the same period. Incomes which mainly comprise diaspora remmitance declined slightly to Kes 222 bn down from Kes 228 Bn. (see graph)

These improvements in the current account deficit represent improvements in earnings from key exports(Tea, coffee and holticulture), reduction of our import bill due to lower oil prices as well as less importation of capital goods.



Going forward, we expect the current account **to come under pressure** due to the following;

1. Third quarter (July- Sept) in isolation showed that exports weakened, partly due to reduced demand from Europe and partly due to reduced production. The economic uncertainity in europe may further dumpen demand for our exports.
2. As we have noted earlier, International crude oil prices are on the rise. *(see inflation)* We therefore expect some pressure on the import bill going forward.
3. Net earnings from international trade of services were mainly boosted by increase in travel receipts which was boosted by conference tourism in Q3 2016. This is unlikely to recure this year since conference tourism is expected to slow down owing to the upcomming elections.

Kenya Shilling: Trotting ahead

Relative to other emerging and frontier markets currencies, the Kenyan shilling showed tremendous stability against the US dollar through out 2016. The low oil prices that prevailed in the year, strong diaspora remmittance and the recovery in the tourisim sector are just but a few of the factors that led to its stability. This was despite an array of key political and economic global events that have destabilized global foreign exchange markets.

Against the US dollar, the shilling depreciated 0.2% in 2016 to close the year at 102.49. It apreciated 17% against the pound, and 4.2% against the Euro, to close the year at Kes 125.4 and Kes 107.06 respectively. During the last quarter of the year the shilling depreciated 1.2% against the dollar. The dollar appreciated globally following donald trumps win in the US elections as well as the continuation of monetary policy widening in the US.

On the Back of our outlook on the current account deficit, we expect the shilling to come under pressure this coming quarter. This may be further fueled by the increased global demand for the dollar. It should however be noted that the central bank continues to hold a healthy sum of usable foreign currency reserve (currently at USD 7 Bn equivalent to 4.6 months of import cover) . It also has access to a precautionary funding facility of USD 1.5 Bn from the IMF incase of exogenous shocks that may lead to Balance of payment need.

Fixed Income Market: The Norm returns

Activity in the secondary bonds market was robust during the quarter, with turnover totaling Kes 94 Bn compared to Kes 75.8 Bn in Quarter 3. Yields were generally on the rise albeit marginally. This factor may be attributed to the uptick in inflation expectation. During the quarter the government released the budget policy statement indicating that it may be looking to raise more debt from local markets following the abandonment of its earlier stance of raising money from external debt markets (**SEE NOTE**)

During the quarter Interest rates went up marginally on the short end of the yield curve, but declined on the long end. The 5 year paper closed the year at a yield of 13.13% up from 13.0% at the end of Q3. The 10 year paper also went up to 13.85% from 13.63% over the same period. The 15 year and 20 year papers declined marginally closing the year at 14.11% and 14.25% down from 14.36% and 14.66% respectively.

On the money markets interest rates remained fairly stable throughout the quarter. The 91 day Tbill averaged at 8.16% up from 8.02% in the previous quarter. 182 day Tbill declined to 10.38% from 10.52% in Q3 and the 364 also declined to 10.7% from 11.23%.

The monetary policy committee (MPC) will be meeting this month to review the economy as well as set the CBR. We do not expect them to change their current stance as they seek to balance between inflationary pressure and boosting growth. We are of the view that interest rates are at equilibrium and we expect them to remain stable with an upward bias.

Equities' Markets: The uncertainty forges on

During the quarter the equities market was characterized by reduced trading, declining valuations and continued dominance by foreign investors. Turnover totaled Kes 25.4 Bn which was 47% lower than Quarter 3. Foreigners remained net buyers, albeit at a slower pace, injecting Kes 1.2Bn compared with Kes 5.9bn in the previous quarter. Valuations continued to decline albeit at slower pace than Q3. NSE 20 declined 1.8% to close the year at 3,186.21 points (-21% for the full year). NASI and FTSE 15 declined 2.5% to close at 133.34 and 161.6 points respectively (-8% & -13% full year).

Banking sector showed some form of recovery during the quarter, with the whole banking sector gaining by 1.3%. The quarter began with the earnings release for the banks. (**See our Banking sector results update**). As expected the results were characterized by slow loan book growths, low loan quality and increased margins. Three listed companies announced profit warnings during the quarter. These were NSE, Sanlam and Deacons. Also during the quarter ARM listed its newly issued shares, doubling its market cap from Kes 12 Bn to Kes 24.5 Bn.

Following the decision by US Federal Open Markets Committee (FOMC) in mid-December, to increase the benchmark interest rate (The FED Rate) by 0.25% we witnessed a bit of volatility on some large cap stocks led by Safaricom, EABL, Cooperative bank and Kengen. We expect this decision to lead to some form of capital flight from our market in the coming quarter. This may leave valuations further lower than they closed 2016 (**See note**).

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