Global Economy

The global economy continued its broad-based cyclic revival in 2017, urged on by the recovery of commodity prices, the growth of world trade and the rebound in investments globally. Global GDP grew by **3%** in 2017, an increase from the **2.4%** recorded in 2016. Global GDP growth is expected to continue to gain momentum in the next two years; World Bank forecasts a growth of **3.1%** in 2018 and **3.0%** in 2019. World GDP is expected to be accelerated by benignant global financing conditions, accommodative monetary policies, rising global investor confidence and the recovery of the commodity market.

Advanced economies in 2017 showed marked growth of **2.3%** driven mainly by an increase in capital spending, growth in turnover and the strengthening of external demand. The Emerging Market and Developing Economies (EMDEs) grew by **4.3%** in 2017, helped on by the recovery of commodity prices and increase in global trade.

The threats to the medium term and long term global recovery, however, are still present. The global growth in the medium term is expected to be muted by declining global potential output growth, slowing rates of capital accumulation, weakening global productivity and emerging protectionist sentiments worldwide. Advanced economies, on the other hand, are expected to slow down gradually in the medium term to their suppressed potential growth rates as slacks in their labour markets evaporate and their ultra-accommodative monetary policies are gradually unwound. The Emerging Market and Developing Economies (EMDEs), in contrast, are expected to grow even faster, boosted by commodity prices and continued growth of non-resource intensive countries.***(Source: World Bank, AIB Research)***

Sub-Saharan Africa

Sub-Saharan Africa (SSA) is estimated to have grown by **2.4%** in 2017, a recovery from the dismal growth of **1.4%** witnessed in 2016. The uptick in growth in the Sub-Saharan African region was inspired by a host of tailwinds in 2017 which included: an increase of global metal prices; improved household demand; increased mining output in 2017; favourable global funding conditions; growth in agricultural output and infrastructure investments. It must be noted, however, that this recovery was blighted by negative per capita income growth, low investments and a slowdown in productivity growth.

Growth in Sub-Saharan Africa was weaker than anticipated due to a modest recovery in the region's three largest economies: Nigeria, Angola and South Africa. The Central African Economic and Monetary Community (CEMAC) on the other hand witnessed mixed fortunes in 2017, with the Oil producing countries in the region recording subdued growth in sharp contrast with their metal producing neighbours who registered a sharp upturn in economic activity. SSA region economic recovery in 2017 was also boosted by the strong economic growth in West African Economic and Monetary Union (WAEMU) and the East African region.

The overall outlook for the region remains positive as the momentum of growth is expected to continue in the short to medium term with World Bank projecting a growth of **3.2%** in 2018 and **3.6%** in 2019. The key drivers for SSA's regional growth are; the global commodity prices and strong domestic demand. Downside risks include: a consumer-led slowdown in China threatens commodity prices globally; exuberant external borrowing has left the region vulnerable to the tightening of global financing conditions and finally insecurity still plagues the region. ***(Source: World Bank, IMF, AIB Research)***

Kenyan economy:

Recent data released by the KNBS show that Kenya's GDP in the third quarter of 2017, grew by **4.4%** compared to the **5.6%** registered in the third quarter of 2016. The growth of **4.4%** is the slowest growth registered since the fourth quarter of 2013 mainly driven by heightened political uncertainty, soft consumer demand and the drought in 2016/2017. The following are the sector performance play by play:

Agriculture, Forestry & Fishing: This sector slowed down **to 3.1% (Q/Q)** in the third quarter of 2017 from the **3.8% (Q/Q)** registered in the third quarter of 2016. The growth of the sector was mainly driven by increased tea production, increased horticultural exports and improved fish production that was offset by the decline of the rest of the subsectors. The dry and sunny weather conditions caused depressed agricultural outputs in all but three sub-sectors, the notable sub-sectors that declined include: milk production, dry maize production, beans production and potato production.

Manufacturing: The third quarter of 2017**,** saw the growth in this sector sharply decline **to 2.1% (Q/Q)** growth from **the 4.4% (Q/Q)** growth witnessed during the same quarter of 2016. The major downswing in growth was driven by a decline in the growth of the non-food sub-sector, that was partially mitigated by accelerated growth in the food sub-sector. The decline in the no-food sector was a consequence of high inflation that caused household demand to contract during the period under review. The food Sub-Sector of the Manufacturing Sector was, however, able to weather the storm in the period under review, buoyed by growth in soft drinks production, growth in edible oils Sub-Sector, expansion in wheat flour output and government maize subsidy that boosted maize flour production.

Construction: In Q3 2017, the construction sector slowed down **to 4.9% (Q/Q)** growth from **the 7.8% (Q/Q)** growth witnessed in the same period in 2016. The suppressed growth was partly driven by the electioneering jitters that halted investments into construction. The slowdown in the construction activities also impeded the consumption and importation of construction materials.

Electricity and Water supply: During the third quarter of 2017 Electricity and Water supply witnessed a mild deceleration **from a growth of 5.4% (Q/Q)** in the same quarter in 2016, **to 4.8% (Q/Q)**. This sector's growth was mainly due to geothermal electricity generation that rose by **13.6%** in the period**.** Drought, however, hindered it's growth, as low rainfall caused a **34.9%** decline in hydroelectricity generation that prompted the use of the more expensive thermal sources in the sector.

Accommodation and Food Services Activities: The accommodation and Food Services sector also slowed during the elections-charged third quarter of 2017. The quarter growth tumbled to **7.3% (Q/Q)** from the **13.5% (Q/Q)** growth penned in the same quarter in 2016. The slowdown in the sector during Q3 of 2017 could be partly attributed to the softening of tourist arrivals growth numbers, which decelerated **to 7.7% (Q/Q)** from the **14.4% (Q/Q)** growth in Q3 of 2016.

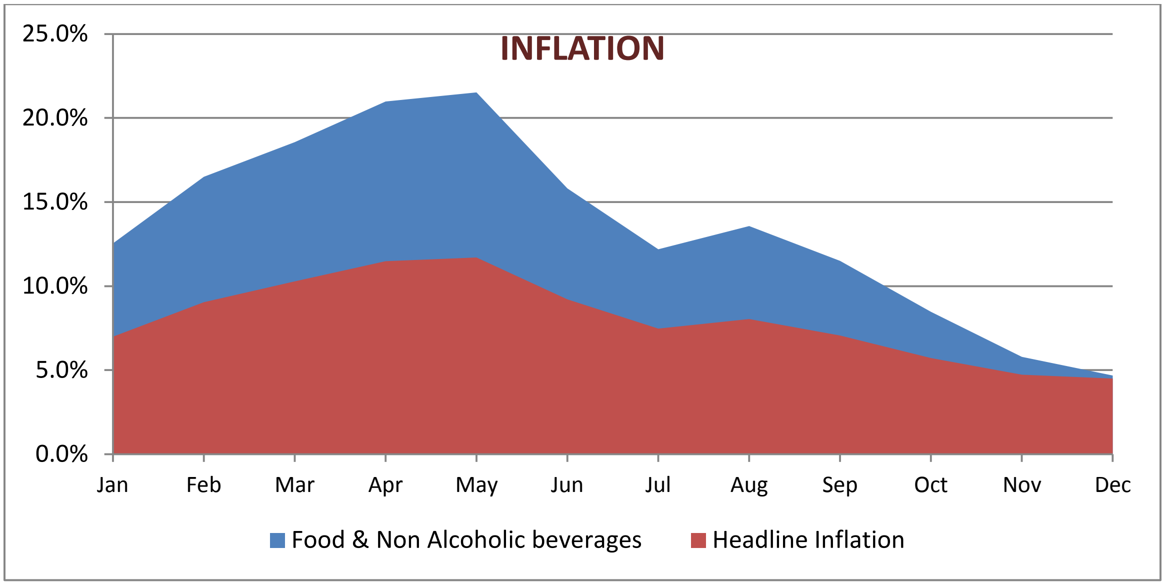
Transport and Storage: The transport and storage sector growth slumped to **5.4% (Q/Q)** in the 3rd Quarter of 2017 from **6.2% (Q/Q)** growth in the 3rd Quarter of 2016. The growth was buoyed by a **10.9%** increase in traffic at the Mombasa Port. The overall growth in this sector during the period under review was, however, constrained by deceleration of growth in road transport.

Information and Communication: Information and communication was the only Sector to show resilience during the third quarter of 2017. The sector recorded relatively flat growth during the period under review to grow by **9.0% (Q/Q)** compared to the **8.8% (Q/Q)** growth registered in the Q3 of 2016.

The sector continues to ride the strong tailwinds of affordable ICT gadgets and internet connectivity to continue its momentum of growth.

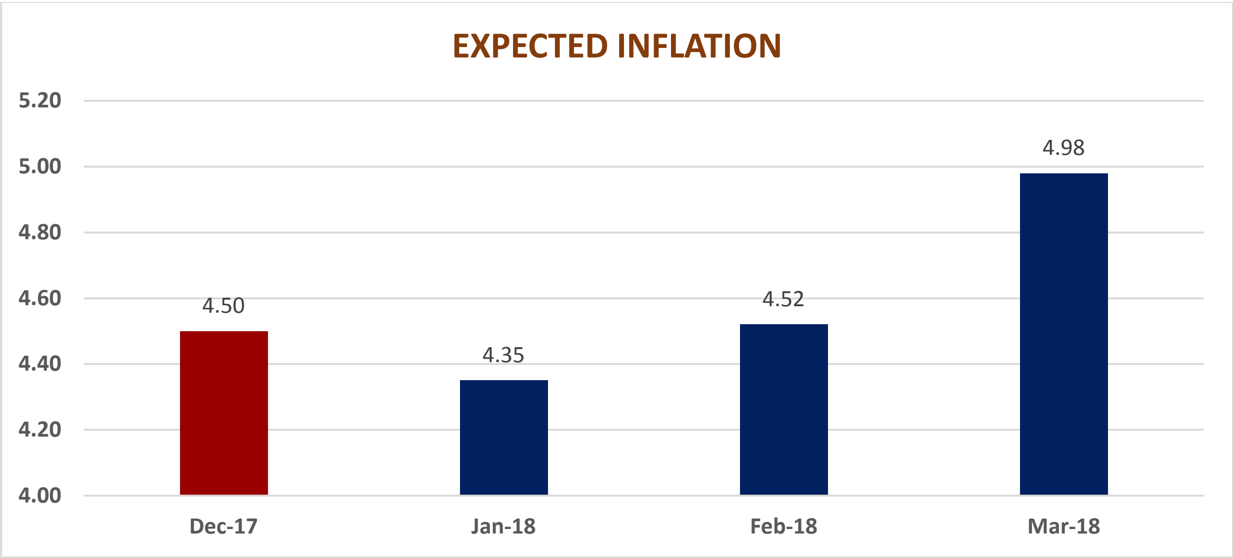
Inflation:

In line with our expectations, headline inflation continued on its downward plunge during the fourth quarter of 2017 to stand **4.50% (Y/Y)** at the end of December**.** The average inflation of **7.52% (Y/Y)** witnessed in Q3 softened to an average inflation of **4.98% (Y/Y)** in Q4. The decline of Food inflation remained the most important driver of headline inflation throughout the quarter (see graph below), averaging **6.31% (Y/Y)** in Q4 2017 down from **12.42% (Y/Y)** in Q3 2016. Favourable weather and government subsidies in both the preceding quarter and in the quarter under review improved the supply of key food items. Housing, water, electricity, gas and other fuels inflation, the second most important driver of headline inflation, in contrast, grew in Q4 2017 from an average inflation rate of **3.26% (Y/Y)** in Q3 2017 to average inflation rate of **4.66% (Y/Y) ,** egged on by sustained increases in electricity, Kerosene and other cooking fuels during the period.



We update our outlook on inflation to reflect our new expectation of a depreciating Kenyan shilling, firming up of crude prices, updated weather forecasts and the cessation of maize subsidies. We expect inflation to decline gradually over the next month and reverse gradually to increase over 2018, but stay within CBK's target inflation limits of **2.5%** to **7.5%.** The Kenya Metrological department is currently forecasting a dry and sunny January-February that would curtail agricultural output in Q1 of 2018, which in turn will push food inflation up gradually over the first Half of 2018. January 2018 will also see market demand and supply determine the price of maize, a key stable food, for the first time since May 2017 after the government ended its market intervention on the 31st of December last year. Given the prominence of Maize flour on the Kenyan dining tables, the liberation of prices controls will inevitably accelerate food inflation gradually over the first half of 2018.

We also expect pump prices to trend upwards as well, gradually driven up by the recovery of global crude prices. The gradual increase in fuel prices will: propel the cost of agricultural output (diesel is heavily used); increase the prices of cooking fuels for the household; increase the cost of transportation; increase the costs of manufacturing inputs and increase the cost of thermal power generation.

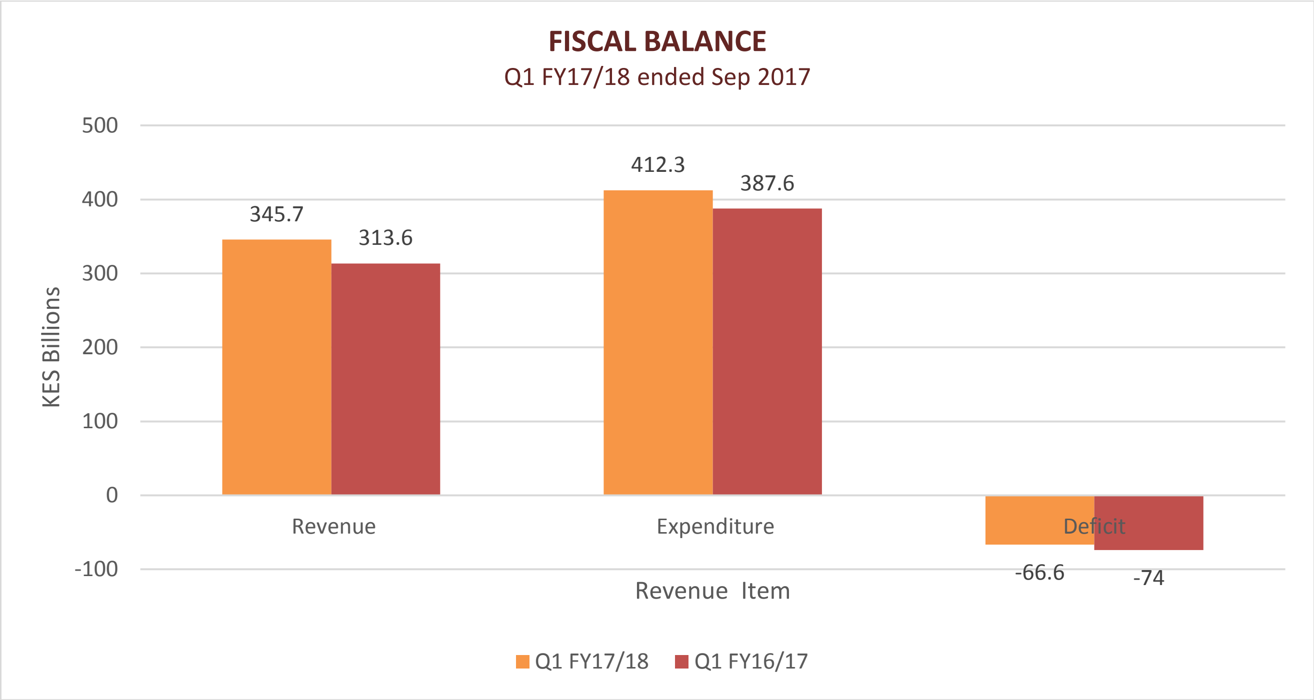


Public Finance: *The Q1 FY17/18 Quarterly Economic and Budgetary Review*

On the 23rd of November last year the Treasury in conformance with the Public Finance Management Act of 2012, published the Quarterly Economic and Budgetary Review (QEBR) for Q1 FY17/18. The review is aimed at divulging the Treasury's performance on a quarterly basis. Numbers from the quarterly report showed that the government collected a cumulative Total Revenue of **KES 345.6 billion** (**or 3.9% of GDP**) in the period between July and September 2017. This meant that that government revenue collection missed their **KES 388.0 billion** (**or 4.4% of GDP**) by **KES 42.5 billion**. This total revenue underperformance was attributed to the shortfalls in Income Tax and Excise duty caused by business activity contraction during the electioneering period. Despite the underperformance, Total Revenue collection is growing, with Total Revenues and External Grants (TREG) rising **10.2%** from **KES 315.1 billion** reported in Q1FY 16/17 to **KES 347.2 billion** in Q1 FY 17/18.

Total expenditure and net lending for the first quarter of the financial year also grew **6.4%** in Q1 FY17/18 compared to Q1 FY16/17, mainly driven by the growth of recurrent expenditures. Total government expenditure and net lending for the Q1 of FY17/18 was **KES 412.3 billion,** compared to the **KES 387.6 billion** spent in Q1 FY16/17.

GOK's Q1 FY 17/18 recurrent expenditure also rose by **28%** to **KES 294.7 billion** from **KES 230.2 billion** recorded during the same period last year. Q1 FY17/18 development expenditure, in contrast, fell by **4.1%** to **KES 90.7 billion** in Q1 FY16/17 from **KES 94.6 billion** in Q1 FY16/17. The growth of expenditure was, however, slower than previously anticipated because of lower than expected absorption of funds by National and County government.



Sources: Treasury, AIB

Monetary policy:

The monetary policy committee held their last meeting on 23rd November 2017 to enable the committee to discuss and review the effects of its policy decisions and review recent economic developments. After deliberations, the committee chose to retain the **CBR rate at 10%** for the eighth consecutive time. The committee observed that the demand pressure on prices remained mute, referencing the Nonfood non-fuel inflation which has consistently been below **5%** throughout the year.

With stability in the forex market, and continued lower inflation expectations, the MPC expects the 12-month current account deficit gap to narrow to **6.2%** of GDP by December. The Committee noted that growth had been mainly supported by the services sector especially Micro, Small and Medium Enterprises.

The Balance of Payment:

In the most recent numbers released by the KNBS, Kenya's third-quarter current account deficit worsened by **28.9%** to a deficit of **KES 145.4 billion** in Q3 2017 from a deficit of **KES 112.8 billion** recorded in Q3 2016. The firming up of the current account deficit in Q3 2017 was mainly driven by the **32.5%** widening of the merchandise trade deficit from **KES 218.7 billion** to **KES 289.7 billion,** caused by the growth of the import bill of food and petroleum products. The current account deficit will most likely worsen in 2018 as household consumption increases and as the upswing in global crude prices drives Kenya's import bill even higher.

Equities Market: *What is in store in 2018?*

Activity and valuations in the stock market declined during the 4th Quarter of 2017. The period under review witnessed a decline in market activity throughout the period especially in the month of October. This can be attributed to the political uncertainties and the prevailing anxiety around the fresh presidential elections held on the 26th of October. There was also a marked decline in foreign participation in the market as foreign investors awaited the outcome of the second presidential election and the subsequent Supreme Court ruling that followed.

Overall, the market turnover witnessed a downswing of **32.8%** to total **KES 36 billion** in Q4 2017 from **KES 53.6 billion** in Q3 2017. Volumes were also down **36.5%** to a total of **1.3 billion** shares traded in Q4 2017 from the **2.0 billion shares** traded in Q3 2017.

The blue-chip index, NSE 20, declined by **39 points** during the fourth quarter of 2017 to close at **3712 points** from **3751 points** recorded at the end of Q3. Kenya's All-Share Index, NASI, grew marginally by **9 points** in the period under review to close at **171 points** from **162 points** recorded at the end of Q3. The intensity of foreign sales weakened during the fourth quarter, with foreign net sales coming in at **KES 0.4 billion** down from **KES 10.3 Billion** recorded in the previous quarter.

We expect activity in the equities market and bond markets to recover this year beginning Q1 of 2018. The first quarter of 2018 will record double-digit growth in turnover and carry the momentum to reach a crescendo in the fourth quarter. Foreign activity will have a pre-eminent role in driving the market valuations and turnover in the medium term as more global investments flow into Europe and Emerging markets in 2018. We estimate on average, large market capital stocks (above KES 50 billion) will see more activity than small capitalization due to their high liquidity. We also expect better market valuation in 2018 with NSE 20 reaching **3800 points** in the first quarter and **4000 points** within the first half of 2018.

	Q3 2017	Q4 2017	% change
Equity+I Reit Turnover (KES)	53,572,099,221	36,021,665,458	-32.76%
Total Volume Traded	2,019,534,756	1,283,473,978	-36.45%
Market Cap (KES billion)	2,376.69	2,521.77	6.10%
Bond Turnover (KES billion)	105	87	-16.99%
NSE 20 share Index	3,751	3,712	-1.05%
NSE All-share Index	162	171	5.54%
FTSE NSE Kenya 15 index	204	209	2.52%
FTSE NSE Kenya 25 index	208	215	3.65%
FTSE Kenya Govt. Bond Index	91.47	92.87	1.53%
Foreign buys	22,232,664,336	21,905,198,777	-1.47%
Foreign sales	32,541,438,660	22,268,864,329	-31.57%

The Outlook: *What should you expect?*

Kenya's Gross Domestic Product is projected to grow by an estimated **5.0%** in 2017, its slowest growth in half a decade, after battling significant headwinds during the year. The recovery of Agricultural output, the rebound in tourism, the recovery of the construction sector, increased infrastructure spending and the recovery of household demand are all set to propel the growth of GDP in the next three years. The World Bank projects that Kenya's GDP will grow by **5.5%** in 2018 and rebound back to the 2016 GDP growth rate levels of **5.9%** by 2019. Conditions are also ripe for the widening of the interest rate cap in the short to medium term and the complete removal of the interest rate cap in the medium to long-term. In line with the above economic outlook, we set about the earnings outlook, sector by sector:

Construction & Allied Sector: Cement sub-sector and paints sub-sector being cyclic in nature, will likely ride the tailwinds of Kenya's economic recovery and see improved turnovers starting 2018. Expect healthy top-line growth and the sector's revenue growth to outperform the market at least in the medium-term boosted by the resumption of infrastructure spending and recovery of the home builders market.

Agricultural sector: The agricultural sector as a whole is set to recover from adverse weather witnessed in 2016/2017. The better agricultural output should improve the supply of raw materials to Agro-processing companies and translate to higher turnover. Producers of coffee and tea will also benefit in the medium term by the increase in global prices of the speciality beverages. The depreciation of the Kenyan shilling will also be an added bonus to the export segment of the sector.

Banking sector: The sector stands to benefit immensely from the amendment or removal of the interest rate cap in the medium term. Recovery of the economy is also likely to reduce the level of Non-Performing Loans in the sector as their clients' in cyclical industries experience enabling business conditions in the medium term.

Energy sector: Increased business activity will boost the consumption of energy in Kenya. The Electricity sub-sector is likely to benefit from upcoming government investments in geothermal power generation. Downstream petroleum products companies are however going to see the cost of their imported refined petroleum products increase over the next few years as global crude prices continue to rise and as the dollar strengthens against the Kenyan shilling.

Manufacturing sector: The Non-food subsector will mount a comeback in 2018 as new orders increase with household demands. We see headline inflation growing within the CBK target range of 2.5% and 7.5% helped by a tailwind of low food prices but stocked upwards by the upswing in global crude oil prices. Lower inflation this year will free up the household budget to buy more non-food products from the manufacturing sector.

Telecommunications sector: Lower food inflation in 2018, 2019 and 2020, will mean more consumption of telecommunication services by the Kenyan household. The sector will continue on its growth path helped by increased volumes in the medium term. Low per capita income growth will, however, mean that consumers will be more discerning of price rather than value.

Investment sector: Diversified investment companies with exposures to any of the sectors we have mentioned above will benefit from the improved profitability of their portfolio companies. Expect exits to intensify in the coming years as investment companies can now sell their investments in a bull market.

AIB Forecast: *Expect Recovery in 2018.*

We expect a broad economic recovery starting in the fourth quarter of 2017 after the conclusion of two growth impeding transitory factors: the heightened political uncertainty and drought. We, however, estimate that broad economic slowdown in the first three quarters of 2017 will cause GDP growth to decelerate to **4.9%** in 2017 from the **5.8%** growth recorded in 2016. Assuming amendment of the interest rate cap happens in 2018, we project that Kenya's GDP will accelerate to a growth of **5.6%** in 2018 and accelerate even further in 2019 to **5.9%** in 2019.

Projections of Growth of Gross Domestic Product by Activity at Constant 2009 Prices, 2010 - 2019
Constant 2009 Prices - KES Million

Industry	2014+	2015+	2016*	2017E	2018F	2019F
Agriculture, forestry and fishing	4.3%	5.5%	4.0%	3.5%	4.0%	4.2%
Mining and quarrying	14.9%	12.4%	9.5%	6.0%	9.0%	8.5%
Manufacturing	2.5%	3.6%	3.5%	2.3%	3.3%	3.8%
Electricity supply	7.3%	11.5%	9.1%	7.0%	9.0%	9.0%
Water supply; sewerage, waste management	3.9%	2.7%	2.6%	3.0%	3.0%	3.0%
Construction	13.1%	13.9%	9.2%	8.0%	9.0%	9.5%
Wholesale and retail trade, repairs	6.9%	5.9%	3.8%	4.3%	4.5%	4.8%
Transport and storage	5.5%	8.0%	8.4%	7.9%	8.0%	8.2%
Accommodation and food service activities	- 16.8%	-1.3%	13.3%	11.5%	12.0%	12.0%
Information communication technology	14.5%	7.4%	9.7%	9.0%	9.8%	9.9%
Financial and insurance activities	8.3%	9.4%	6.9%	3.5%	5.0%	6.2%
Real estate	5.6%	7.2%	8.8%	6.0%	8.3%	8.8%
Professional, scientific and technical activities	4.1%	3.6%	4.8%	5.5%	5.5%	5.5%
Administrative and support service activities	2.4%	1.5%	3.9%	4.0%	4.2%	4.5%
Public administration and defence	5.6%	5.5%	5.3%	5.0%	5.3%	5.0%
Education	7.8%	4.5%	6.3%	5.4%	5.5%	6.0%
Human health and social work activities	8.1%	6.1%	5.8%	5.7%	5.8%	6.0%
Arts, entertainment and recreation	3.0%	1.5%	4.0%	3.0%	4.0%	4.5%
Other service activities	6.5%	6.0%	6.0%	5.0%	6.0%	6.2%
Activities of households as employers	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Less: Financial services indirectly measured	11.3%	13.5%	3.0%	5.0%	6.0%	6.0%
All industries at basic prices	**5.6%**	**6.1%**	**6.0%**	**5.0%**	**5.8%**	**6.2%**
Taxes less subsidies on products	**3.4%**	**2.8%**	**4.5%**	***4.0%***	***4.0%***	***4.0%***
GDP Growth (at market prices)	***5.4%***	***5.7%***	***5.8%***	***4.9%***	***5.6%***	***5.9%***

We see the growth of five sectors as crucial drivers for Kenya's GDP in the medium term: Agriculture, Manufacturing, Construction, Real Estate and Education. Investors actively looking to improve returns on their investments in the long term should consider exposure to these sectors as we enter the expansionary of Kenya's business cycle.

AIB Investment Strategy: *Time to embrace risk and cyclical companies.*

- **Overweight small-cap stocks and underweight large-cap stocks**: Small caps (less than **KES 50 billion**) have the ability to outperform large-cap companies during the early stages of the current bull market. The Small-cap stocks are more levered to economic growth than their large-cap counterparts hence can grow their earnings faster. Impressive results will eventually drive their market valuation higher to the benefit of their investors, at least in the medium term. The companies with less than KES 50 billion market capitalization and have a buy rating include: Centum (target price= **KES 60.70**) , I&M (target price= **KES 122.00**), CFC Stanbic (target price= **KES 86.19**), NIC Bank (target price= **KES 38.90**)
- **Consider investing in sectors with exposure to key growth sectors**: We have singled out five sectors as key drivers for growth in the medium term: Agriculture, Manufacturing, Construction, Real Estate and Education. Overweight your portfolio with companies who have exposure to the sectors to capture growth rates above GDP. Market-beating positive earnings, dividends and positive headlines will drive the price of companies in these sectors towards their intrinsic values in the short to medium term. The Companies with exposures to the above sectors and have a buy rating include: Centum (target price= **KES 60.70**), EABL (target price= **KES 264**), BAMBURI (target price= **KES 233.00**) and ARM Cement (target price= **KES 21.81).**
- **Consider exposure to cyclical sectors:** Sectors such as consumer credit, energy and consumer discretionary will profit the most from the economic recovery and growth in the medium term. Banking stocks, for example, will benefit from both the expansionary credit cycle that will allow them to lend aggressively and from the potential amendment of the interest caps. Energy stocks like KenolKobil, Total, KPLC, KENGEN and Umme will benefit from increased demand for energy as business activity grows.
- **Consider reducing bond portfolio risk:** As we have highlighted in our recent January fixed income note, we expect interest rates to rise due to increasing inflation, increased government borrowing and the pending downgrade of Kenya's sovereign credit rating by Moody's. Investors should reduce their portfolio duration, buy floating rate bonds and consider diversifying their fixed income portfolio to mitigate the effects of rising interest rates.

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