MACRO REPORT: MOMENTUM SHIFTS

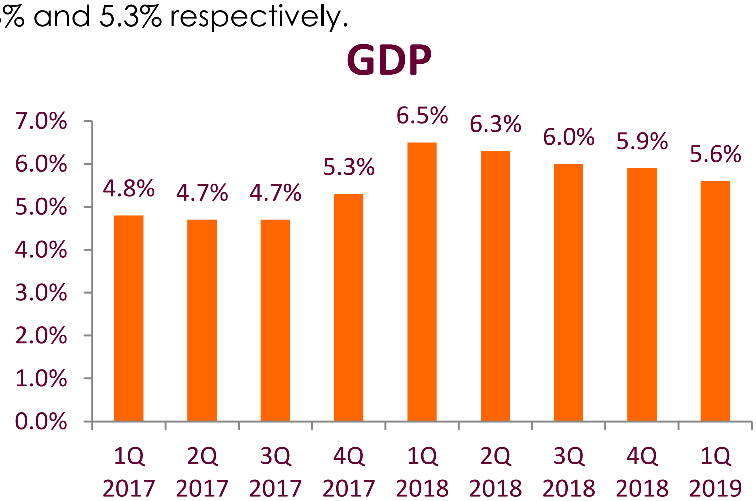
- Kenya's economic growth slowed to 5.6% in 1Q19 from 6.5% in 1Q18 mainly due to reduced growth in the Agricultural, Manufacturing, and Transport & storage sectors. We expect growth to decrease in 2019 on the back of reduced activity in the Agriculture, manufacturing, construction, and real estate sectors.

- On the fixed income space, the current factors support a continued downward shift in yield curve. However, expect yields to increase in FY2019/20 due to our view on currency, inflation, liquidity, and interest caps.

- In the East African region, economic activity slowed significantly in Uganda and Rwanda in 1Q19. We believe that the border issues between Uganda and Rwanda could continue to affect economic growth. Meanwhile, inflation in the region remains low as food prices remain subdued.

SLOWDOWN IN ECONOMIC ACTIVITY

Kenya's economic growth slowed to 5.6% in 1Q19 from 6.5% in 1Q18 mainly due to reduced growth in the Agricultural, Manufacturing, and Transport & storage sectors. Growth in the Real estate and Construction sectors also slowed to 5.6% and 4.2% from 6.6% and 5.3% respectively.



Date: 10th July 2019

Sovereign Credit Rating (outlook):

Moody's: B2 (stable)

Fitch: B+ (stable)

S&P: B+ (stable)

June Inflation: 5.7%

91-Day T-Bill (5th Jul-19): 6.67%

182-Day T-Bill (5th Jul-19): 7.40%

364-Day T-Bill (5th Jul-19): 8.61%

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CERTIFICATIONS& REQUIRED DISCLOSURES BEGIN ON PAGE 10

Economic growth in 2018 was expected to lead to improved company earning and support performance of listed companies. However, that wasn't the case as the growth was mainly supported by increased activity in the agricultural sector while growth in a number of sectors declined. We think that things are likely to change in 2019 as even though GDP growth is expected to decline (due to reduced activity in the agriculture sector), a number of listed companies may report an increase in earnings. The following sectors are likely to record a reduction in growth:

a) Agricultural Sector

Global prices of tea and coffee are forecasted to decline in 2019. Furthermore, the country has experienced unfavourable weather which has affected the production of the crop. Given the sector's huge contribution to GDP, we expect overall growth to be negatively affected.

b) Manufacturing

The sectors growth is largely dependent on growth in the Agricultural sector as in 2018, the increased growth in the sector was mainly attributed to a rise in agricultural production. Given our view on the growth of agricultural sector, we are of the opinion that the manufacturing sector will also record a slowdown in growth.

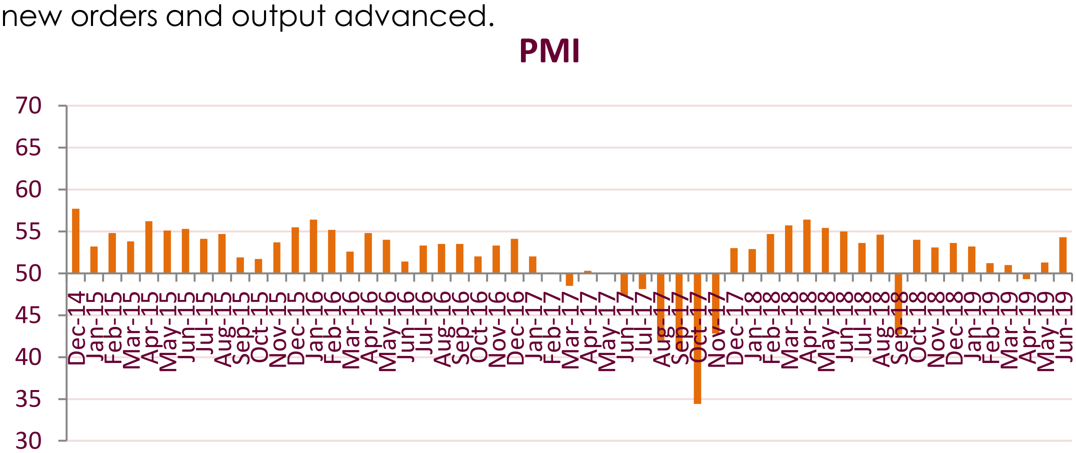
c) Construction and Real Estate Sectors

The latest figures from CBK indicate that commercial banks are lending less to these two sectors. Commercial bank's allocation to the building and construction sector has declined to 4% in April from 5% in December while the value of loans to the sector stood at KES 108.6 billion from a high of KES 120.9 billion in September 2018. Meanwhile, commercial banks started reducing their total allocation to the Real Estate sectors in March 2018 when it stood at 15.9% of total loans to the private sector and has since decreased to 14.97% as at the end of April.

Our view of a slowdown in the sector is reinforced by data from KNBS in 1Q19, cement consumption and production continued to decline. This is the 3rd consecutive year that the sector has declined.

➢ Business Confidence increases

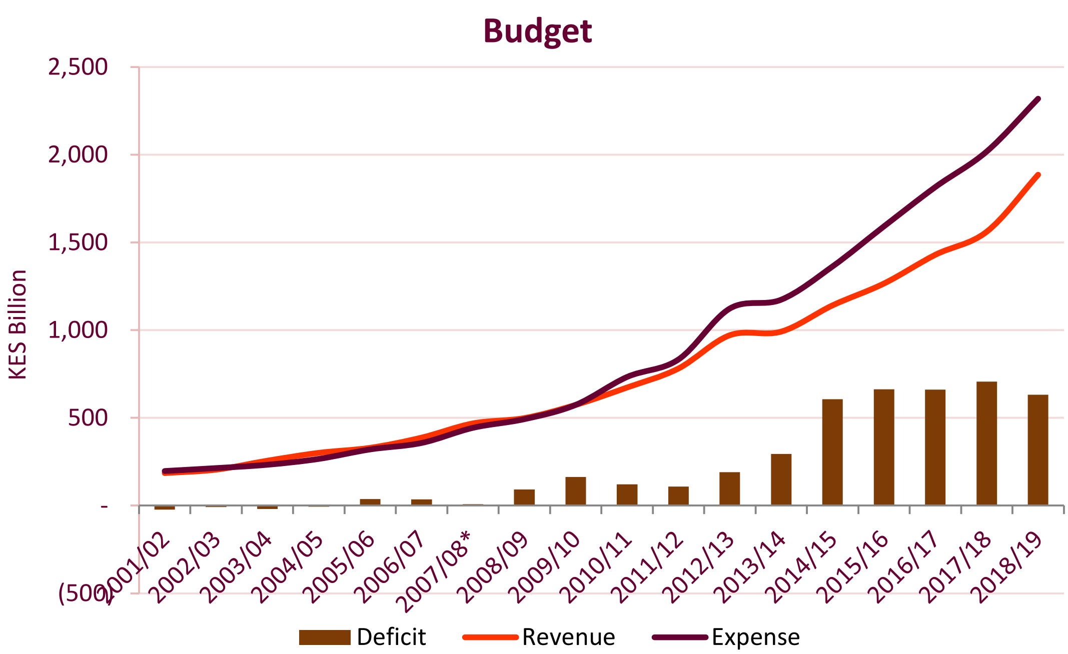
Business confidence, as measured by the Stanbic Bank Kenya PMI, has increased in the past two months, a trend that could continue into the rest of the year. The reading of 54.3 in June was the fastest since August last year as new orders and output advanced.



Fiscal Policy to support growth

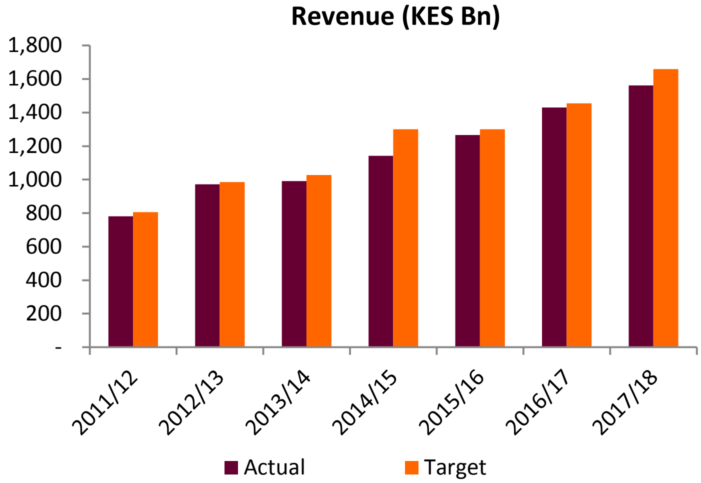
The government has announced plans to start paying suppliers. Delayed payments to suppliers by the national and county governments are one of the reasons for the high NPLs in the banking sector. We believe that the payments will help drive economic growth.

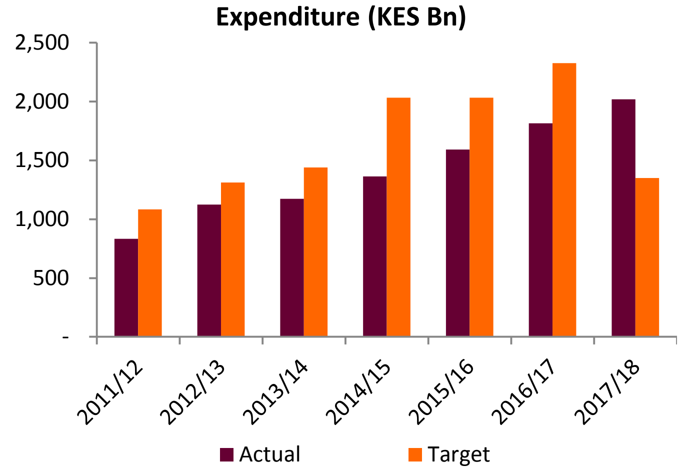
Since FY2005/06, the government has consistently run budget deficits as it forecasts on infrastructure projects. Recent infrastructure projects have been large ticket projects that required a longer period before their impact on growth is felt. This financial year, the focus will be small projects whose impact on the economy will be felt sooner.



Due to the nature of development projects that the government has undertaken (huge single ticket projects with long payback periods), tax revenue growth has been low. Consequently, the Kenya's debt has increased and government is currently borrowing to fund maturing debt. This raises issues over the sustainability of the country's debt.

As the budget expenditure increases, the government has raised taxes rates in a bid to increase revenue. However, this hasn't had the desired effect as revenue has consistently fallen below original budget targets forcing the government to revise these targets downwards.

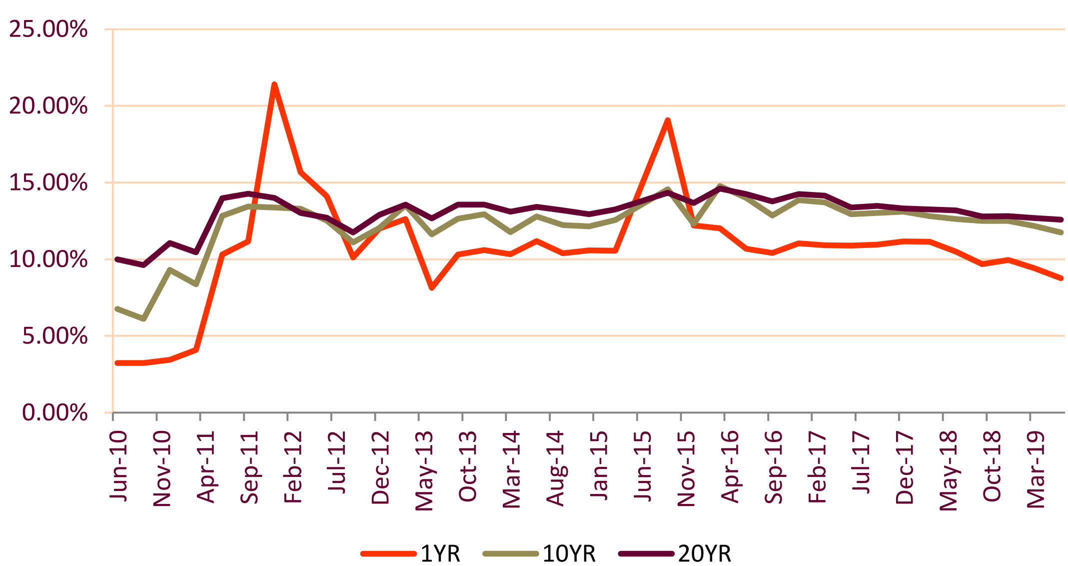




Every year, over the period 2011/12 to 2017/18, forecasted revenues have diverged from actual revenues by an average of 9.27% raising concerns about the quality of the projections. Treasury's projections tend to be aggressive which has resulted in supplementary budgets.

FIXED INCOME

In the past, long-term rates have remained relatively stable while short-term rates have spiked during periods of high inflation.

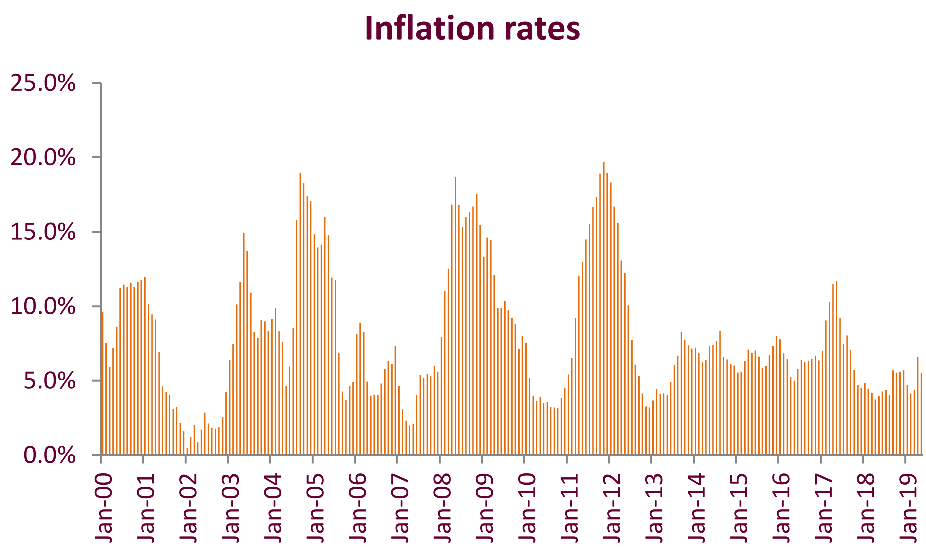


There has been a downward shift in the yield curve mainly due to the elevated demand for government debt in the rate cap environment. As the risk free rate declines, the risk premium has become more attractive and commercial banks have increased lending to the private sector.

➢ Possibility of drought possess risk to inflation

Inflation in Kenya is mainly driven by an increase in food prices. Historically, Kenya has experienced drought every 3 to 4 year. However, since 2012, the cycle has shortened to 2 years. The last drought cycle was in 2016/17 and thus drought could hit the country this year.

During the long rains season, certain parts of the country received depressed rainfall, while the onset of rain in most parts of the country was delayed. If the Kenya Meteorological Department's forecasts are accurate, the Rift Valley and Western will receive normal to above normal rainfall during the June to August period. This could exert downward pressure on inflation.



On the demand side, we expect a pick-up in consumer demand as private sector credit growth increases. Current demand in the economy, however, remains muted. Core inflation has generally been on a downward trend since September last year when it touched a high of 5.7%. This is despite an increase in private sector credit growth.

➢ The shilling is likely to depreciate against the USD

The Kenyan shilling lost ground against the USD during the quarter as dollar demand increased. Export earnings where also negatively affected as the price of tea decreased.

	USD	GBP	EURO	ZAR	UGX	TZS	RWF
Jun-19	102.298	129.960	116.306	7.223	36.120	22.513	8.910
Dec-18	101.846	129.018	116.446	7.080	36.460	22.583	8.770
Y.T.D	-0.44%	-0.72%	0.12%	-1.98%	-0.93%	-0.31%	1.59%
Mar-19	100.750	131.848	113.043	8.961	36.948	23.077	8.961
Q.O.Q	-1.51%	1.45%	-2.80%	24.06%	-2.24%	-2.45%	-0.57%

The demand and supply for foreign currency is mainly determined by the balance of payment position.

- **Imports are expected to increase**: In 1H19, govt.'s crackdown on illicit goods helped reduce the country's import bill. However, the import bill could soon increase as the government has announced that it intends to import maize to deal with the shortage in the country.
- **Exports are expected to remain flat**: The global prices of Kenya's key exports, tea and coffee, have been declining while volumes are expected to decrease due to the unfavourable weather conditions experienced in 1H19. However, the direct flights to the US have opened up the market for horticulture and other exports which could benefit the country.
- **Capital and financial account inflows to remain unchanged in 2H19**

In 1Q19, the country's overall balance of payment position deteriorated to a deficit for the first time since June 2016, mainly due to a decrease in the financial account. We expect the position to record a surplus in 2Q19, due to the Eurobond proceeds, then deteriorate to a deficit in 2H19.
A key determinant of the direction of the shilling during the next few months will be local demand. Following the introduction of new currency, the KES is expected to depreciate as dollar demand picks-up.

Have rates bottomed out?

We believe that the factors that have pushed rates lower still remain. In the first half of FY2019/20, we expect the yield curve could remain unchanged with a downward bias. Target net domestic borrowing for FY2019/20 has decreased to KES 283.5 billion from a revised target of KES 310 billion. This should reduce pressure on the government's domestic borrowing target.

In the second half of FY2019/20, rates could rise as CBK tries to support the shilling. The Central Bank is likely to withdraw liquidity from the market and raise interest rates in a bid to support the shilling. A possible drought could lead to a spike in short-term interest rates.

We are concerned about the level of government debt which currently stands at above 60% of GDP, but believe that this is unlikely to affect domestic interest rates.

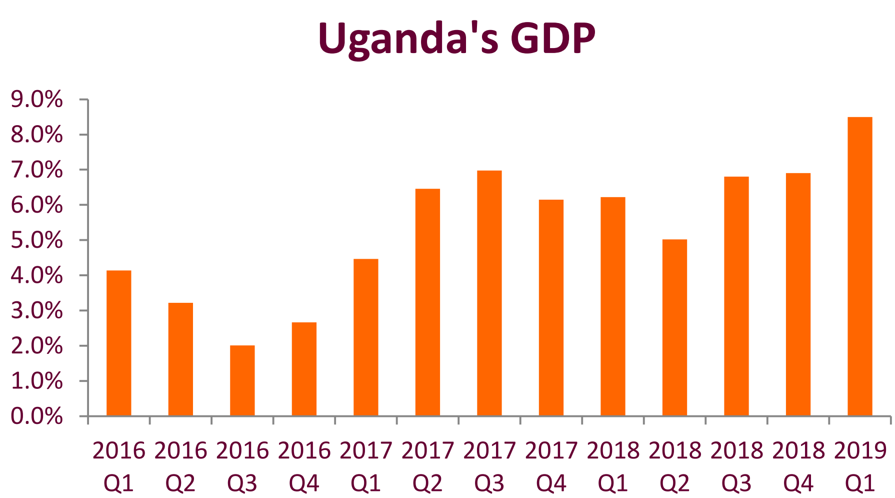
EAST AFRICA

In 1Q19, economic activity slowed significantly in Uganda and Rwanda while Tanzania rebased its GDP figures. We believe that the border issues between Uganda and Rwanda could continue to affect economic growth. Meanwhile, inflation in the region remains low as food prices remain subdued as the three countries received favourable rainfall.

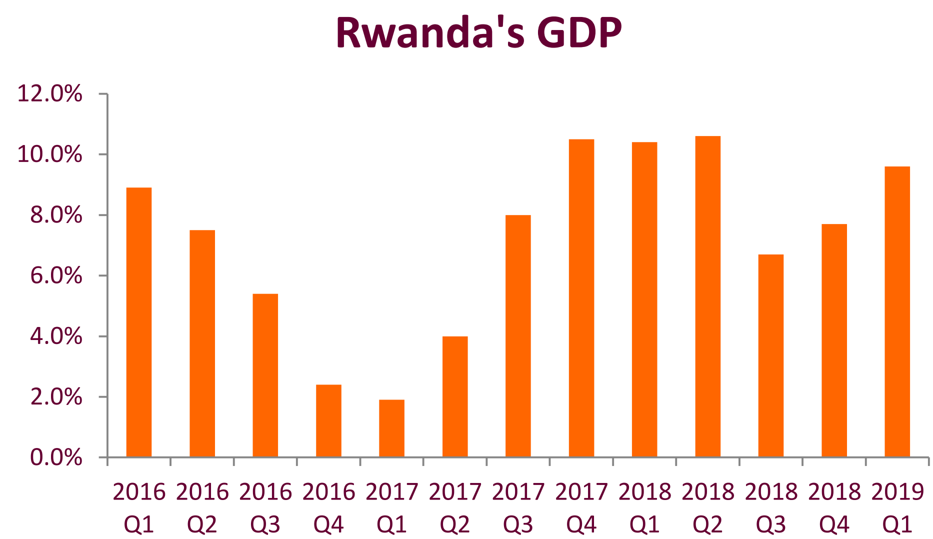
➢ Gross Domestic Product Growth

Growth in **Uganda** decreased to 5.6% in 1Q19 compared to 6.9% recorded in 1Q18 on account of a decline the services and industrial sector. Meanwhile, economic activity in the agriculture sector increased to 4.8% in 1Q19 from 1.6% in 1Q18 on the back of an increase in food and cash crop activities. In the industrial sector the growth decreased to 2.9% in 1Q19 compared to 7.5% in 1Q18 on account of a decline in construction activities, while growth in the services sector decline to 6.5% from 8.4% on account of reduced activity in the Information & communication and Real Estate sectors.

Economic growth may continue to decline during the year as tensions between Uganda and Rwanda escalate.



Growth in **Rwanda** decreased to 8.4% recorded in 1Q19 from 10.4% in 1Q18 as growth in the Agriculture and services sector declined. The services sector which contributed 48% to overall growth registered a decrease in activity as growth declined to 8% in 1Q19 from 12% in 1Q18 while growth in the Agricultural sector declined to 4% from an 8% growth in 1Q18.

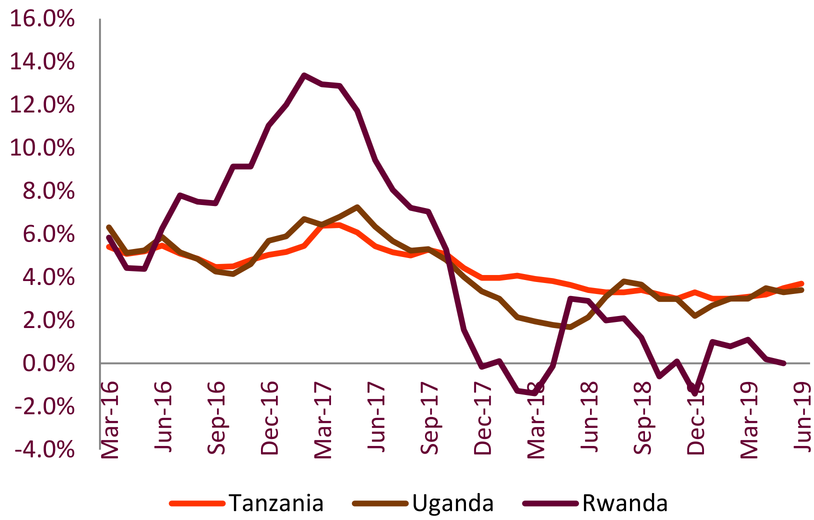


Tanzania started the revision of their national accounts in September 2017. The revision was aimed at enhancing the quality of accounts statistics to better portray the performance of the economic activities in the country and ensure international comparability in accordance with the United Nations system of National Accounts 2008. The effect of the rebase was that the GDP values grew by 3.8%.
Although this was a positive for the country it was still lower than the 32% expansion that was recorded in 2013 during the rebase from 2001 to 2007. Agriculture and farming remained the country's main sector.

➢ Inflation

- In 1Q19, inflation rates for Uganda increased while that of Tanzania and Rwanda decreased.
- In **Tanzania**, there was low and stable inflation during the quarter as inflation stood at 3.7% in June. This was mainly driven by the low food inflation as a result of adequate food supply across the country.
- In **Uganda,** inflation remained subdued increasing marginally to 3.4% at the end of June from 3.0% in March. This was due to rise in core inflation to 4.9% in 2Q19 from 0.8% in 2Q18. Inflation is expected to remain subdued as food prices remain low.
- In **Rwanda,** the inflation rate declined from 1.1% in March to 0.2% in April then remained unchanged in May. This occurred on the back of decreases in food and energy prices. Food deflation was driven by the increase in supply of vegetables, fruits bread and cereals. Meanwhile core inflation remained subdued at 1.5%. Food prices are expected to rise due to reduces rainfall in some areas leading to decrease in food supply.

Inflation


16.0%
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
Mar-16
Jun-16
Sep-16
Dec-16
Mar-17
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Tanzania
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Rwanda

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