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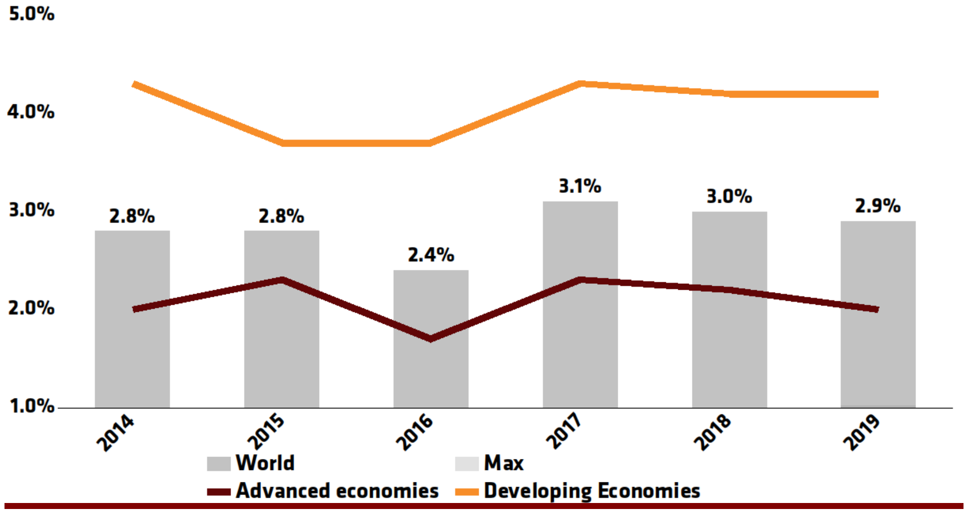
Kenya Economic & Market Update

Stock Broking | Bond Dealing | Corporate Finance Advisory

Global growth slowdown

- Global economic activity is set to ease off slightly in 2019. According to the World Bank and the IMF, global growth is projected to moderate to 2.9% in 2019 from a downwardly revised 3.0% in 2018. The deceleration this year may be driven by the gradual normalization of monetary policy and the deterioration in international trade. The volatility in the equity markets is likely to continue amid softening international trade and investment, elevated trade tensions, and tightening financing conditions.

Figure 1: Global Growth



- The developed economies are facing a stable to declining prospects in 2019 as economic slack in developing countries dissipates. Growth in the US is likely to be weighed down by tightening fiscal, monetary and trade policies. 2018 was a good year for the US economy as economic stimuli helped drive growth. Meanwhile, growth in the Eurozone may be weighed down by trade war fears, political turmoil, and uncertainty surrounding Brexit.

- In 2018, emerging and frontier markets were negatively affected by tighter financial conditions, a stronger dollar, improved US growth, and trade war fears. Growth in these economies has lost momentum and is projected to stall at 4.2% this year. Risks to the developing economies are increasing, given the recent episodes of financial stress.

- Emerging and frontier markets may benefit from an inflow of funds in 2019 as investors seek higher returns. There was a general sell-off in 2019 and valuations are now attractive. Furthermore, the possible weakening of the USD could support an inflow of funds.

Stable macroeconomic environment in East Africa

- Economic activity in Sub-Saharan Africa (SSA) is estimated to have grown slower than expected at 2.7% in 2018 dragged down by reduced growth in its three biggest economies: Angola, Nigeria and South Africa. Activity could pick-up in 2019 as Angola and Nigeria are likely to be propelled by the recovery of oil production and a pickup in private demand could push the SSA weighted average regional growth to 3.4% this year. There may also be tailwinds from the recovery of the South African economy as increased activity in the manufacturing and agricultural sector could help the nation on its path to recovery from recession in the 2H18.

- In East Africa, economic activity picked up in 2018 in Uganda and Rwanda but slowed significantly in Tanzania.

- Growth in Uganda and Rwanda was driven by increased activity in the manufacturing and the service sectors.

- Growth in Tanzania was affected by govt.'s unfavorable policies.

- Sufficient food supply kept inflationary pressures subdued across the region. Deflation was experienced in Rwanda

Figure 2

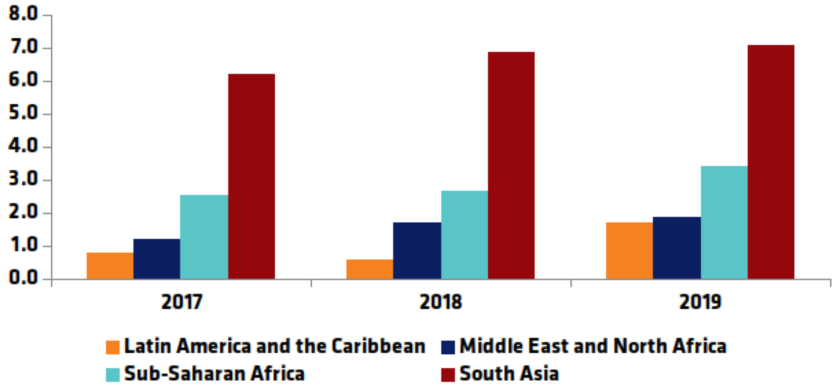


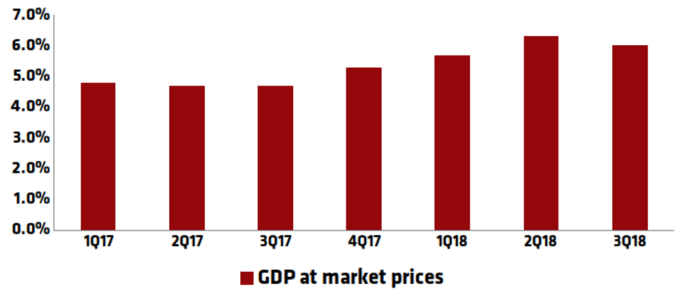
Table 1

		Kenya	Tanzania	Uganda	Rwanda
Inflation	Dec - 18	5.70%	3.30%	2.20%	1.14%
Private Sector	Oct -18	4.40%	4.80%	11.30%	
Credit Growth	Nov -18	4.40%	5.00%	12.20%	
USD	2018	1%	-3%	-2%	-3%
GBR	2018	7.5%	3.2%	3.9%	2.0%
EUR	2018	5.9%	1.9%	2.6%	-1.6%

Agriculture supports GDP growth

- Economic growth in the first three quarters of 2018 averaged 6.0% versus an average of 4.7% in the first three quarters of 2017. The growth was spurred by a stable political environment and favorable weather conditions which enhanced agricultural production.
- 3Q18 growth came in at 6.0% supported by pickup in activities of agriculture, construction, and electricity and water supply. There was a rebound in the manufacturing sector from a contraction of 0.1% in 3Q18 to a growth of 3.2%.

Figure 3: Quarterly GDP

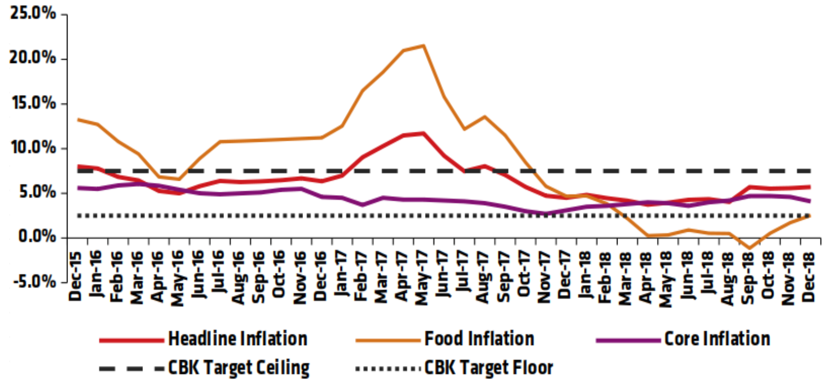


- 2019 growth is likely to be supported by:
  - **Favorable weather conditions:** the country received favorable rainfall during the short rain season which resulted in increased food production. This is expected to continue in 2019 thereby supporting growth.
  - **Increased private sector credit growth:** Private sector credit growth has remained anemic over the past two year due to interest rate caps. To circumvent the caps banks have been using alternative channels, such as mobile lending, where loans are not capped. In 2019, banks are likely to continue to use alternative channels to grow their loan book. There is also a proposal to increase the interest rate margin to 6% from 4%. This could increase bank's appetite for risk.
  - **Big four agenda:** The govt. is likely to focus on its affordable housing initiative. Although this has faced some headwinds as the compulsory contribution has been challenged in court, there are still a number of initiatives that the govt. is likely to take.
  - Risks to this outlook are fiscal consolidation and subdued private sector activity. Although commercial banks have increased lending, their focus has mainly been on individual borrowers and large corporates. Meanwhile, SMEs which are said to be the drivers of the economy aren't getting credit thus overall GDP growth is likely to be affected.

Mild inflationary pressures

- Inflation was generally low and stable in 2018 supported by subdued core and food inflation. The average inflation rate stood at 4.7% in 2018 versus an average of 8.0% in 2017. Favourable rainfall during the year kept food inflation depressed as the average food inflation rate stood at 1.4% versus an average of 13.5% in 2017. Core inflation marginally increased to an average of 4.1% from 3.8% in 2017 buoyed by a pickup in private sector activity.

Figure 4: Inflation



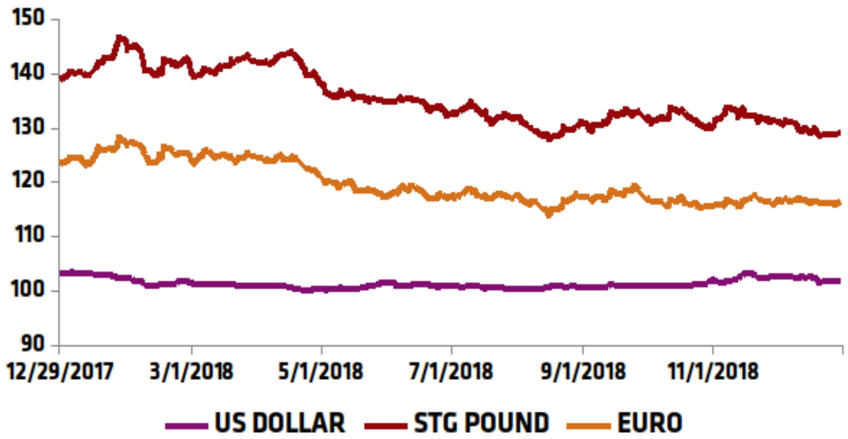
- In 2018, global oil prices generally trended upwards on the back of geo-political risks. Fears of supply shortfalls drove crude oil prices to above USD 85 a barrel in October. Prices later declined to close the year at below USD 60 per barrel. Local oil prices generally trended up as ERC raised prices in line with the increase in international oil prices. Oil prices were further escalated by the implementation of the 8% VAT on petroleum products. This year, concerns over reduced oil demand as global growth moderates and increased US shale production could exert downward pressure on prices. However, geo-political risks pose the greatest threat to oil price stability.

- In 2019, headline inflation is expected to remain subdued on account of lower food and fuel inflation. Favourable weather in 2018 led to increased food production which is expected to keep food prices subdued during 1H19 and could extend to 2H19 if the long rains are also favourable. We therefore expect inflation to remain below CBK's upper target of 7.5%. Risks to this outlook are unfavourable weather conditions and the currency which could exert upward pressure on inflation.

Shilling to remain stable

- During the first nine months of the year, the Kenyan shilling remained relatively stable against the USD supported by strong diaspora remittances and CBK'sintervention. In late October to early November, the shilling came under pressure due to a report published by the IMF stating that the shilling was ove rvalued by 17%. The shilling depreciated to a low of 103.2 but later stabilized and appreciated against the USD as CBK reduced liquidity in the money market.

Figure 5



- In 2019, the Kenyan shilling is expected to depreciate against the USD on account of the strengthening of the USD and a higher current account deficit. Attractive yields in the US and improving economic conditions, which may result in more Fed rate hikes, are likely to lead to the appreciation of the dollar against other hard currencies.

- The stability of the shilling will be determined by the government's ability to refinance existing debt. A syndicated loan and a 5-year Eurobond are maturing in 2019. The repayment of this debt could decrease CBK's reserves which were very useful in maintaining the shillings stability in 2018. The government is currently in talks with TDB (formerly PTA Bank) to extend the tenor of the syndicated loan to either 7 or 10 years. If successful, this could lengthen the maturity of foreign debt and reduce pressure on government's repayment schedule.

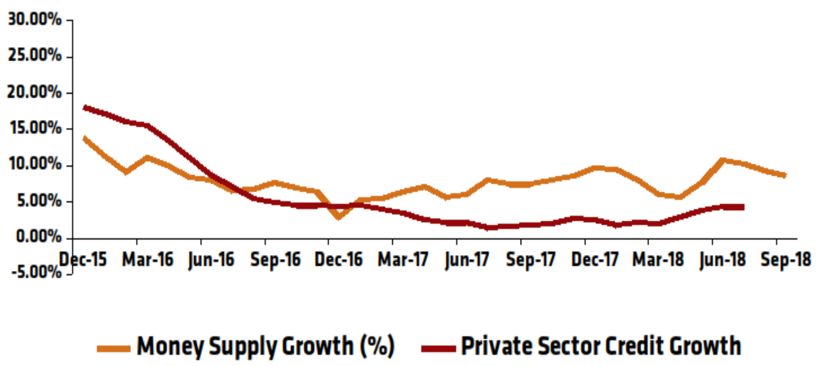
- There is also talk that another Eurobond could be issued next year. However, the cost is likely to be higher as interest rates in the US are increasing. Furthermore, the IMF recently revised Kenya's risk of debt to moderate thus investors will require a higher premium.

Accommodative policy stance

- In a bid to spur economic growth, CBK maintained an accommodative monetary policy stance during the year. CBK's monetary policy committee decreased the rate twice during the year on the back of a stable macroeconomic environment.

- Private sector credit growth remained depressed on the back of interest rate caps and increased government borrowing which is crowding out the private sector. Private sector credit growth increased to 4.4% in October 2018 from a 2.7% growth in November 2017.

Figure 6: Money Supply & Private Sector Credit



- The growth of credit to the private sector was supported by an increased lending to the manufacturing sector, business services, building & construction, as well as finance & insurance industries, which grew by 14.9%, 12.4%, 7.2%, and 9.1% respectively.

- In 2019, CBK is likely to maintain an accommodative monetary policy stance as it seeks to support growth. The Monetary Policy Committee will likely maintain an expansionary policy over the short term with global oil prices weakening, headline inflation within CBK's target and slack in the economy. Key risk to this outlook is shock which could lead to a weakening of the shilling.

Downward pressure on interest rates

- During the first half of FY2018/19, high money market liquidity led to oversubscription of T-bills. The bonds on offer were undersubscribed as CBK mainly offered long term bonds that were not attractive to the market. High money market liquidity enabled the Central Bank to reject aggressive bids thus exerting downward pressure on interest rates especially on the short end of the yield curve causing the yield curve to steepen.

- Parliament's decision to retain the interest rate caps will most likely keep the money market liquid. Treasury bond yields are likely to remain unchanged with a downward bias

- In the second half of FY2018/19, the govt. has increased its domestic borrowing target to KES 310.2 billion from KES 271.9 billion. This coupled with the fact that it is behind on its domestic borrowing program as net borrowing was at KES 90bn as at the end of 2018 (29% of its revised target), should exert upward pressure on interest rates. However, we believe that yields will remain unchanged with a downward bias due to the elevated demand for government paper.

Figure 7: Movement in the Yield Curve

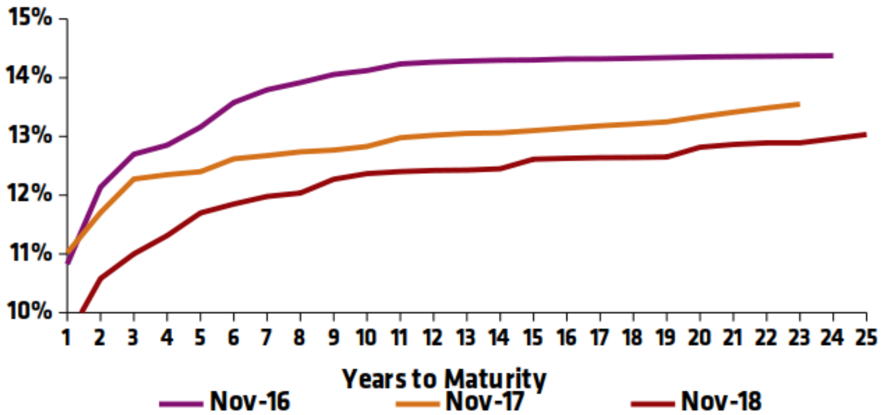


Table 2

T-bill	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
91-day	8.01%	8.01%	7.73%	7.64%	7.34%
182-day	10.58%	10.39%	9.67%	8.82%	9.00%
364-day	11.13%	11.13%	10.54%	9.79%	9.95%
Interbank	6.91%	6.07%	6.53%	5.99%	6.73%

Valuations remain attractive

- Foreign investor net outflows and reduced local investor participation were the main reason for the poor performance of the NSE towards the end of the second half. Volatility in the emerging market, the tightening of the accommodative global conditions and souring of investor sentiments after parliament maintained the interest rate cap roiled up the market into a foreign investor selloff frenzy that hurt market valuations.

- Given the outlook our positive outlook on emerging and frontier markets, we expect that an inflow of funds could spur the equity market. Turnover is bound to improve in the short term as low valuations of the large cap stocks with outstanding fundamentals attract value investors back into the market. The normalization of the equity market in the medium term will also help equities recover. Investors with a long term horizon should consider buying into companies with attractive fundamentals, strong profitability performance and strong cash generation ability to outperform the market

Figure 8

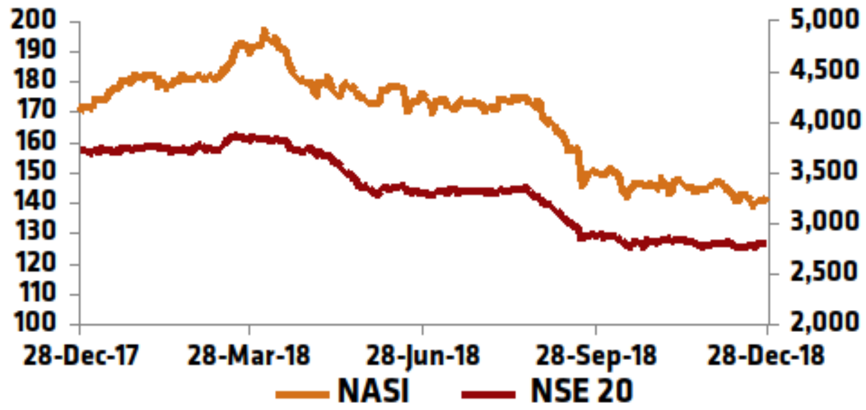


Table 3

Index	2018	2017	% Change
NSE 20	2,834	3,712	-23.66%
NASI	140.43	171.2	-17.97%
NSE 25	3,552	4,283	-17.08%
Net foreign flows(USDm)	-291.05	-117.43	

AIB Investment Strategy

A tough operating environment that included a slowdown in consumer spending, the decline of the equity market and loss of consumer confidence in 2018, led to a number of companies issuing profit warnings. In 2019, we believe that the business environment will be more conducive. We advise value investors to continue to invest in companies with good solid fundamentals and capable management

- **Focus to the Large Cap stocks on the NSE to benefit from the recovery of valuations on the NSE.** Investors should priorities the top 25% of the Market Capitalization of the NSE to benefit from a recovery of market segments in the medium term. The good coverage, liquidity and resilient fundamentals that underpin large stocks will enable investors follow a conservative path with a greater possibility of fair value actualization especially if foreign investors return back to the market. The large Cap stocks (the top 20th percentile) we are bullish about their prospects are:

  Safaricom (**SCOM**-Target Price of **KES 28.39**), Equity Group (**EQTY:** Target Price **KES 54.40**), East African Breweries (**EABL**: Target Price **KES 218**), KCB Group (**KCB**: Target Price **KES 56.64**), Cooperative Bank (**COOP**: Target Price **KES 21.00**), Bamburi Cement (**BAMB:** Target Price **KES 233.00**) Diamond Trust Bank (**DTK:** Target Price **KES 186.00**).

- **Banking stocks:** Over the past two years, banks have proved to be resilient in the wake of rate caps and IFRS 9. If a proposal to amend interest cap to allow banks to price in more credit risk and help grow their interest income over the medium term is approved, we could see an increase in earnings. We believe that the next phase in the banking industry will be consolidation. Banks with a large balance sheet are at an advantage. We currently have a BUY rating and form parts of our Top Picks are: Cooperative Bank (**COOP**: Target Price **KES 21.00**), Equity Group (**EQTY:** Target Price **KES 54.40**), KCB Group (**KCB**: Target Price **KES 56.64**).

  We believe the current prices reflect foreign selling pressures and not their fundamental values.

- **The dividend play is on:** Investors should supplement their portfolio returns with income from dividends. In a down market, stocks with a high dividend yield will bode well in a portfolio shorn of capital gains. Declining prices mean a increase in dividend yields for dividend paying stocks. If the valuation remains depressed for strong dividend payers, passive investors should shift to a tactical asset allocation with a focus of capturing dividends in the short term irrespective of their long term view. The current counters that are currently trading at an attractive dividend yields are:

  Nation Media Group with a dividend yield of 14.34% (**NMG-**Target price **KES 62.50**), I&M Holdings with a dividend yield of 7.85% (**I&M-**Target price **KES 122.22**), KCB group with a dividend yield of 7.73% (**KCB**-Target price **KES 56.64**), Kenya RE with a dividend yield of 6.16% (**KNRE**-Target price KES 41.56), Cooperative Bank with a dividend yield of 5.73% (**COOP**: Target Price **KES 21.00**), Equity Group with a dividend yield of 5.09% (**EQTY**: Target Price **KES 54.40**).

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