Cytonn 2021 Markets Outlook

Kenya Macro Economic Outlook

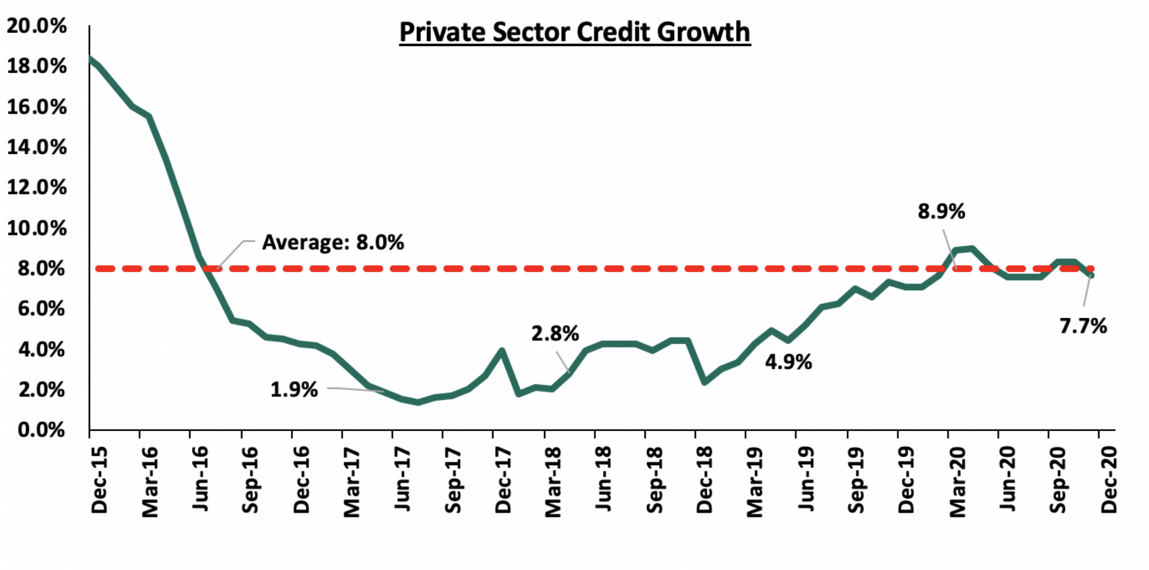
a. Economic Growth

The Kenyan economy contracted by an average of 0.4% in H1'2020 and is projected to contract by an average of 1.0% in the whole of 2020 according to the World Bank. The performance was driven by declines in most sectors with accommodation and food being worst hit declining by 83.3% as the travel ban affected them significantly. The lockdown restrictions imposed on the onset of the pandemic led to subdued business performance through the year. This downturn was however mitigated by resilient growth in the agricultural sector which recorded a growth of 6.4% during the same period.

In 2021, we project the economy to recover and the projected GDP growth to come in at a range of 3.9% - 4.1%.

The key factors that shall support growth include:

i. Improved Business Recovery: A recovery in the business environment has been recorded as evidenced by PMI index numbers in the second half of the year, which averaged 54.2, higher than the H1'2020 average of 42.4, where a reading of above 50 indicates improvements in the business environment, while a reading below 50 indicates a worsening outlook. With the vaccines now being ready for distribution, we expect that the gradual lifting of movement restrictions will reduce the supply chain disruptions experienced globally and also help improve consumer demand,
ii. Access to affordable Credit: Private Sector Credit growth, has remained relatively stable even during the pandemic averaging about 7.7%. According to data from the latest Monetary policy committee, strong growth was observed in the manufacturing, trade, transport & communication and real estate sectors where credit grew by 22.7%, 18.7%, 14.5% and 12.8%, respectively. Given that the main concern is the loan quality, with the expected recovery of the business environment, we might see a gradual improvement in credit growth in the private sector.



iii. Stable growth of the agricultural sector, following the favorable weather experienced in Q4'2020, and the re-opening of the economies of some of Kenya's major trading partners. The sector is expected to support growth despite the expectations of a mild locust invasion where there have been reports of immature locust swarms located in the semi-arid areas of the country,

Risks abound to economic growth however include:

i. The speed at which the Vaccines shall reach the country and how fast they shall be distributed shall determine how fast the economy can get back to normalcy. A resurgence of the Corona Virus cases could lead to further measures not supportive of growth,
ii. Ongoing concerns on the sustainability of the country's debt levels. It is expected that the government will have a shortfall in terms of revenue collection in 2021 due to the depressed business environment. With the country's debt to GDP ratio currently at 69.6%, 15.6% above the recommended IMF threshold for developing countries, it is expected that the government will have significant pressure considering the limited fiscal space.
iii. The Country's early politicking on issues such as the coming general election in 2022 and the BBI initiative, which gets people away from focusing on the economy.

b. Currency:

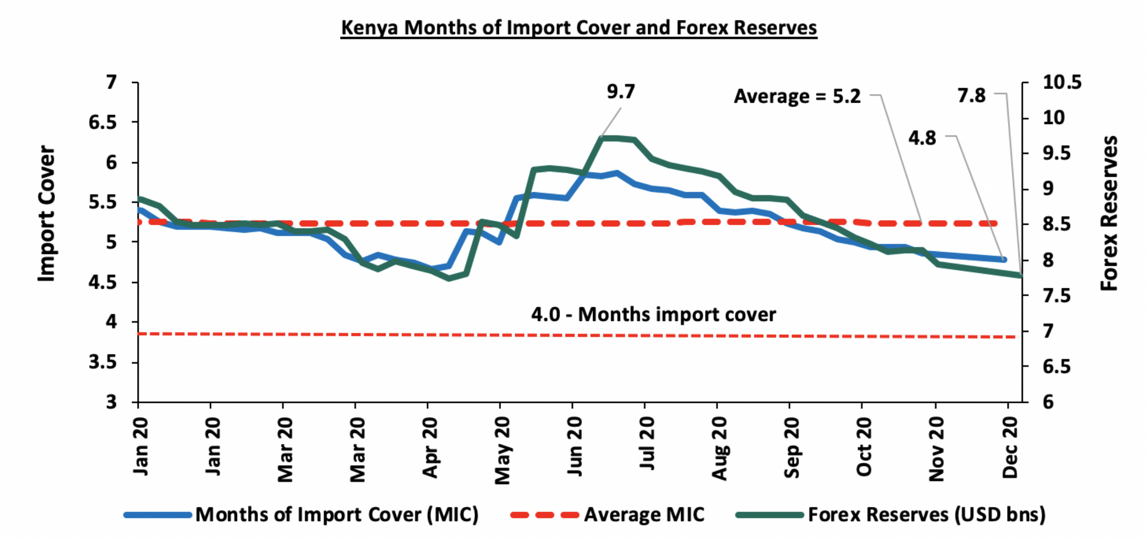
The Kenyan Shilling depreciated by 7.7% against the USD during the year to close at Kshs 109.2, mainly due to increased dollar demand as people prefer holding onto hard currency during such times and also a decline in dollar inflows from both exports of goods and services like tourism.

Going forward we expect the shilling to remain range-bound this year supported by:

i. High Diaspora inflows which rose by 10.7% to a record high of USD 3,094 mn for 2020, compared to the USD 2,796.6 mn recorded in 2019. In December 2020 it rose to USD 299.0 mn, a 19.5% improvement from the USD 250.3 mn in December 2019. This has been possible through financial innovations that have provided Kenyans in the diaspora more convenient channels to transact,
ii. CBK's supportive activities through open market operations, such as sale and repurchase agreements,
iii. Improving Current account position which narrowed to 4.7% of GDP in the 12 months to November 2020 compared to 5.4% of GDP during a similar period in 2019. This will be mainly driven by increased exports of tea and horticulture,
iv. Increased flows into the capital markets as there are expectations of improved investor sentiment,
v. The expectation of stable fuel prices in the global markets attributable to the continued global recovery, coupled with increased production in the US which should counterbalance the supply cuts by the OPEC hence making the amounts spent on Oil predictable,

The Kenyan shilling will however face the following challenges:

i. Dwindling forex reserves which have been on a downward trend since June 2020 where we had USD 9.7 bn, compared to the close of 2020 where we had USD 7.8 bn. Notably, we are still well above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover,



ii. Lower exports especially horticultural products due to lower demand as the countries that they are exported to are affected by the lockdown restrictions and also as the individuals have lesser income to spend, support forex inflow through remittances inflows, and export earnings which have been on the rise in the tail end of 2020.

We expect the shilling to remain within a range of Kshs 107.0 and Kshs 110.0 against the USD in 2020 with a bias to a 0.4% appreciation by the end of 2021.

c. Inflation:

In 2020, inflation averaged 5.2%, slightly lower than the 5.1% recorded in 2019. Inflation was varied through the year but closed at an eight-month high of 5.6% in December, due to an increase in the food and non-alcoholic beverages index which was up 2.5%. The year's performance can be attributed to the low fuel prices experienced during the first half of the year, coupled with the favorable weather conditions experienced at the tail end of the year which has ensured that food commodity prices remained low through most of the year.

We expect inflation to average 5.2% in 2021, within the government target range of 2.5% - 7.5% with inflationary pressure gradually easing off, due to improved agricultural production. According to the UN, there is a risk that a few locust swarms could breach the central region through the bulk should be constrained to the semi-arid regions.

d. Interest Rates:

The Central Bank Rate is expected to remain stable as the governments seeks to continue supporting the economy from the adverse effects of the pandemic. This is in-line with the policy stance in other developed economies such as the United States and various counties in the Eurozone

Despite the government being 11.1% ahead of its domestic borrowing target at the end of 2020, it is expected that there will be a need for more borrowing as the Kenya Revenue Authority lags behind revenue collections. According to the Treasury, tax cuts introduced in April 2020 to cushion businesses and households from the pandemic had resulted to persistent revenue shortfalls where collections for the five months through November 2020 declined by Kshs 100.7 bn, compared to a similar period in 2019. The risk on interest rates stems from the rising debt levels and expected domestic maturities amounting to Kshs 531.6 bn, coupled with the limited fiscal space which might result in a slight upward pressure on the yield curve due to the pressure on the government to meet its domestic borrowing target to plug in the fiscal deficit, considering the decline in tax collection during the pandemic.

The table below summarizes the various macro-economic factors and the possible impact on the business environment in 2021. With two indicators being positive, one at negative and four neutral, the general outlook for the macroeconomic environment in 2021 is NEUTRAL.

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2021 Outlook	Effect
Government Borrowing	• With the expectations of KRA not achieving the revenue targets, we expect this to result in further widening of the fiscal deficit which ought to be plugged in by debt • On the domestic front, due to the rate cap repeal, we expect banks to increase their credit accessibility and admit riskier borrowers including SMEs and individuals, which will see a reduction in subscription rates for government securities • On the foreign front, the Government had budgeted to pay Kshs 139.0 bn (USD 1.4 bn) in foreign interest in FY'2019/20, coupled with the repayment of the principal loan extended to Kenya for the first phase of the mega railway project which will kick off this year which will see loan repayments to China's Exim Bank jump by 130.0% to Kshs 71.4 bn in the current financial year	Negative
Exchange Rate	• We expect the shilling to remain within a range of Kshs 107.0 and Kshs 110.0 against the USD in 2021 with a bias to a 0.4% appreciation by the end of 2020	Neutral
Interest Rates	• Given the accommodative policy stance utilized in 2020, we expect the same to be maintained through 2021 with the intention of continued support to the economy from the adverse effects of the pandemic. There is however the risk of the yield curve adjusting upwards.	Neutral
Inflation	• We expect inflation to average 4.3% and within the government target range of 2.5% - 7.5%	Positive
GDP	• We project GDP growth for 2021 to come in at 3.9% - 4.1%, lower than the 5-year historical average of 5.7%.	Neutral
Investor Sentiment	• We expect 2020 to register improved foreign, mainly supported by long term investors who enter the market looking to take advantage of the current low/cheap valuations in select sections of the market	Positive
Security	• We expect security to be maintained in 2021, although of concern is the political environment which we expect to heat up gradually as we edge closer to the 2022 General Election, coupled with the recent talks around the BBI initiative which have proven to be quite polarizing	Neutral

The change from last year's outlook is:

- Security to *neutral* from *positive* in 2020, necessitated by the increased activity on the political front where politicians are getting ready for the next general elections and discussions around the BBI initiative,

Out of the seven metrics that we track, two have a positive outlook while four have a neutral outlook and one with a negative outlook, from last year where three had a positive outlook, three had a neutral outlook and one had a negative outlook. Our general outlook for the macroeconomic environment will remain NEUTRAL for 2021, unchanged from 2020.