Cytonn Q3'2023 Markets Review

Kenya Macroeconomic Review

The KNBS Economic Survey 2023 reported that the Kenyan economy grew by 4.8% in FY'2022, albeit lower than the 7.6% growth recorded in FY'2021. Notably, KNBS recently released Q2'2023 GDP Report highlighting that the Kenyan economy recorded a 5.4% expansion in Q2'2023, higher than the 5.2% growth in over a similar period last year. On a quarter-on-quarter basis, the expansion was 0.1% points above the 5.3% registered in Q1'2023. The performance in Q2'2023 was mainly driven by the 7.7% growth in agricultural sector due to the favorable weather conditions, which led to more agricultural output as evidenced by the 15.2% increase in tea output to 155.5 thousand metric tonnes and 13.7% growth in coffee exports to 18.9 thousand metric tonnes in the quarter under review. Other sectors that contributed to the growth were financial & insurance, accommodation and food Service and Information & Communication, having increased by 13.5%, 12.2% and 6.4% respectively during the quarter under review. However, the performance was weighed down by the subdued quarterly growth in electricity and water supply, manufacturing, construction, and transport & storage of 0.8%, 1.5%, 2.6% and 3.0% respectively. The Kenyan Economy is projected to grow at an average of 5.2%, in 2023 according to various organizations as shown below:

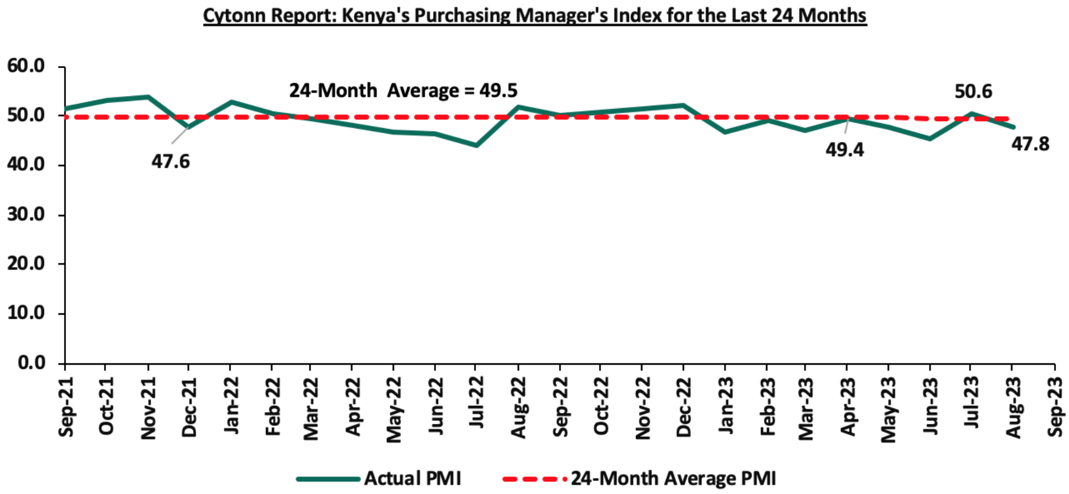
Cytonn Report: Kenya 2023 growth Projections

No.	Organization	2023 GDP Projections
1	International Monetary Fund	5.1%
2	National Treasury	6.1%
3	World Bank	5.0%
4	Fitch Solutions	5.1%
5	Cytonn Investments Management PLC	5.0%
Average		**5.2%**

Source: Cytonn Research

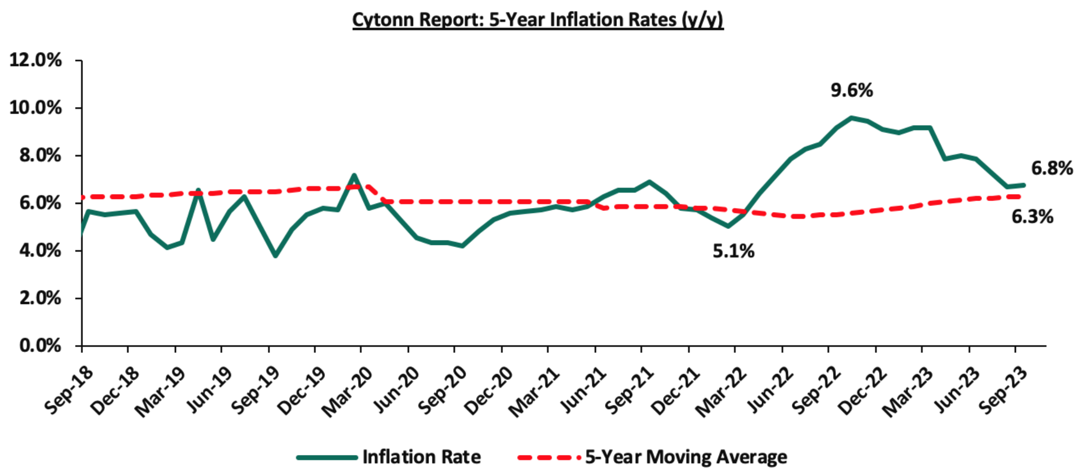
Key to note, Kenya's general business environment improved in Q3'2023, with the average Purchasing Manager's Index for the quarter coming at 48.0, compared to 47.4 recorded in a similar period in 2022. The improvement was mainly on the back of the eased inflationary pressures experienced in the country, with the inflation rate averaging 6.9% in Q3'2023, lower than the 8.7% recorded over a similar period in 2022. After seven months of decline, the private sector showed signs of recovery in August evidenced by the increase in output and new orders as well as businesses hiring more workers and purchasing more goods. However, the economy continues to be under inflationary pressures following the increase in fuel pump prices by an average of Kshs 23.8 by the Energy and Petroleum Regulatory Authority (EPRA), along with more taxes and probable future tax hikes, coupled with aggressive depreciation of the Kenyan shilling which has contributed significantly to the fall in production output by most businesses. Additionally, the Moody's Credit

Rating agency downgraded Government of Kenya's long-term foreign currency and local-currency issuer ratings and senior unsecured debt ratings to B3 from B2 with a negative outlook, on the back of increased liquidity risk as investors were less interested in buying long-term government bonds resulting in higher bond yields. The downgrade shows that the risk of default was higher with very little room for error because of the low liquidity and the high debt payments in the next fiscal year. The chart below summarizes the evolution of PMI over the last 24 months. (A reading above 50.0 signal an improvement in business conditions, while readings below 50.0 indicate a deterioration):



Inflation:

The average inflation rate eased to 6.9% in Q3'2023, compared to 8.7% in Q3'2022, attributable to a decrease in the price food and beverages following the favorable weather conditions that have boosted agricultural production, resulting in increased food supplies. Notably, fuel prices increased by 22.9%, 28.3% and 35.6% in June 2023 to Kshs 195.5, Kshs 179.7, and Kshs 173.4, from Kshs 159.1, Kshs 140.0, and Kshs 127.9 per liter in June 2022 for Super petrol, Diesel, and Kerosene, respectively. Inflation for the month of June 2023 marginally eased to 7.9%, from 8.0% recorded in May 2023, mainly driven by a 1.3% increase in the food and non-alcoholic beverages index. Below is a chart showing inflation trend for the last five years:



In July 2023 Kenya's inflation rate decreased to 7.3% from the 7.9% recorded in June 2023, marking the first time in 14 months that Kenya's inflation fell within the Central Bank of Kenya (CBK) target range of 2.5% - 7.5%. This follows the tightened monetary policies instituted by the Monetary Policy Committee (MPC) to contain the rise by raising the Central Bank Rate (CBR) by cumulative of 300.0 bps to 10.5% in June 2023 from the 7.5% CBR rate that was set in July 2022. Going forward, we expect the inflationary pressures to remain elevated in the short to medium term, mainly on the back of high fuel prices, which is key components of the headline inflation index. Additionally, the complete removal of the fuel subsidy, coupled with the increase in VAT on petroleum products to 16.0% from 8.0% in the new Finance Act 2023 and the decline in oil supply following Russia's oil supply cut is expected to add more pressure on the fuel prices in the country.

September 2023 Inflation

The y/y inflation in September 2023 increased marginally by 0.1% points to 6.8%, from the 6.7% recorded in August 2023. This was in line, but below our projections of an increase to within a range of 7.2% to 7.6%. The headline inflation in September 2023 was majorly driven by increase in prices of commodities in the following categories, food and non-alcoholic beverages; housing, water, electricity, gas and other fuels, and transport. The table below shows a summary of both the year on year and month on month commodity indices performance;

Cytonn Report: Major Inflation Changes – 2023

Broad Commodity Group	Price change m/m (September-2023/August-2023)	Price change y/y (September-2022/September-2023)	Reason
Food and Non-Alcoholic Beverages	0.7%	7.9%	The m/m increase was mainly driven by the increase in prices of commodities such as potatoes, cabbages and Kales (Sukuma-Wiki) of 18.4%, 7.4% and 4.2%, respectively. However, the increase was weighed down by decrease in prices of Maize flour-loose, maize flour-sifted, maize grain-loose, and wheat flour-white by 6.7%, 6.0%, 5.4%, and 3.6%, respectively.
Housing, Water, Electricity, Gas and Other Fuel	1.4%	6.3%	The m/m performance was mainly driven by the increase in prices of 13.0kg gas/LPG by 3.2%. However, there was a decrease in prices of Electricity of 200kWh and 50kWh by 2.1% and 2.5% respectively.

Cytonn Report: Major Inflation Changes – 2023

Broad Commodity Group	Price change m/m (September-2023/August-2023)	Price change y/y (September-2022/September-2023)	Reason
Transport cost	3.5%	13.0%	The m/m increase in transport Index was mainly due to increase in prices of nationwide bus fares on the back of the rise in the prices of petrol and diesel by 8.7% and 11.8%, respectively.
Overall Inflation	**1.0%**	**6.8%**	**The m/m increase was mainly driven by 3.5% increase in transport costs.**

Notably, the overall headline inflation remained within the Central Bank of Kenya (CBK) target range of 2.5% to 7.5% for the third consecutive month. The increase in headline inflation in September 2023 comes amid the recent rise in fuel prices which increased by 8.7%, 11.8% and 19.4% to Kshs 211.6, Kshs 200.6 and Kshs 202.6, per litre of Super Petrol, Diesel and Kerosene, respectively, for the period between 15th September 2023 to 14th October 2023.

The Kenyan Shilling:

The Kenyan Shilling depreciated against the US Dollar by 5.4% in Q3'2023, to close at Kshs 148.1, from Kshs 140.5 as at the end of Q2'2023, partly attributable to increased dollar demand from importers, especially in the energy, oil and manufacturing sectors. Key to note, this is the lowest the Kenyan shilling has ever depreciated against the dollar. During the week, the Kenya Shilling depreciated against the US Dollar by 0.4% to close at 148.7, from 148.1 recorded the previous week. . On a year to date basis, the shilling has depreciated by 20.5% against the dollar, adding to the 9.0% depreciation recorded in 2022. We expect the shilling to remain under pressure in 2023 as a result of:

i. An ever-present current account deficit which came at 3.7% of GDP in Q2'2023 from 6.0% recorded in a similar period last year,
ii. The need for government debt servicing, continues to put pressure on forex reserves given that 66.8% of Kenya's external debt is US Dollar denominated as of April 2023, and,
iii. Dwindling forex reserves currently at USD 6.9 bn (equivalent to 3.7-months of import cover), which is below the statutory requirement of maintaining at least 4.0-months of import cover.

The shilling is however expected to be supported by:

i. Diaspora remittances standing at a cumulative USD 2,766.3 mn in 2023 as of August 2023, 3.4% higher than the USD 2,674.5 mn recorded over the same period in 2022, which has continued to cushion the shilling against further depreciation. In the August 2023 diaspora remittances figures, North America remained the largest source of remittances to Kenya accounting for 57.0% in the period, followed by Europe at 17.3% while the rest of the world accounted for 25.7% of the total remittances, and,

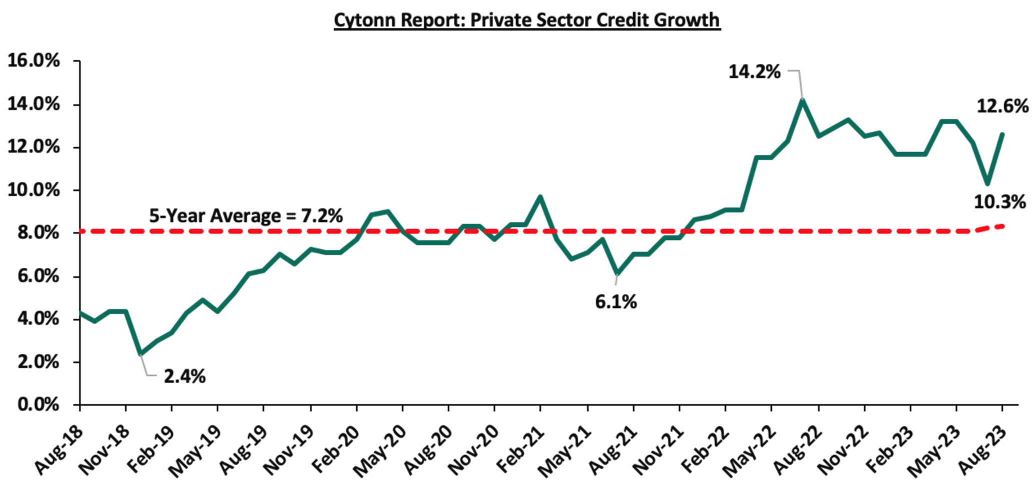
ii. The tourism inflow receipts came in at USD 268.1 bn in 2022, a significant 82.9% increase from USD 146.5 bn inflow receipts recorded in 2021.

Monetary Policy:

The Monetary Policy Committee (MPC) met once during Q3'2023, with the MPC announcement on 9th August 2023 retaining the Central Bank Rate at 10.5% in the second consecutive sitting. Below are some of the Key highlights from the meeting:

i. The overall inflation eased to 7.3% in July 2023 from 7.9% in June, marking the first time in 14 months that the inflation has fallen within the CBK target range of 2.5%-7.5%. The overall easing in inflation was driven by lower food and non-food non-fuel inflation. The food inflation eased to 8.6% in July 2023 from 10.3% in June 2023, attributable to lower prices of vegetables as a result of the long rains, and improved supply of select non-vegetable food items. On the other hand, fuel inflation remained elevated at 14.5% in July from 12.9% in June, largely attributable to increased electricity prices and implementation of the 16.0% VAT on petroleum products. Fuel inflation was however moderated by lower prices of cooking gas following the removal of VAT on liquefied petroleum gas (LPG). The MPC expect the overall inflation to ease further in the short-term, due to the lower food prices and improving supply of key food items particularly maize,
ii. The recently released GDP data for the first quarter of 2023 showed continued strong performance of the Kenyan economy, with real GDP growing by 5.3%. This was attributable to a strong rebound in the agriculture sector due to favourable weather conditions and resilient performance of the services sector. Leading indicators of economic activity pointed to continued strong performance in the second quarter of 2023. Despite the global uncertainties, the economy is expected to continue to strengthen in 2023, supported by resilient services sector, the rebound in agriculture, and implementation of measures to boost economic activity in priority sectors by the Government,
iii. Goods exports have remained resilient, growing by 2.1% in the 12 months to June 2023 compared to 11.2% in a similar period in 2022. Receipts from tea and manufactured exports increased by 7.0% and 23.0%, respectively, attributable to increased demand from traditional markets. Additionally, Imports declined by 6.1% in the 12 months to June 2023 compared to 20.2% in a similar period in 2022. The slowed growth of imports is partly attributable to drop of imports of infrastructure related equipment, mainly on the back of completed projects as well as manufactured goods. Oil prices have continued to ease since the fourth quarter of 2022. Receipts from services exports increased reflecting improvement in international travel and transport. Remittances totalled USD 4,017.0 mn in the 12 months to June 2023, 0.1% higher than USD 4,012.0 mn recorded in the same period in 2022. The current account deficit is estimated at 4.2% of the GDP in the 12 months to June 2023 and is projected to improve to 4.8% of GDP in 2023 from the 5.1% of GDP in 2022,
iv. The CBK foreign exchange reserves, which currently stand at USD 7,338.0 mn representing a 4.0 months of import cover, continues to provide adequate cover and a buffer against any short-term shocks in the foreign exchange market,
v. The banking sector remains stable and resilient, with strong liquidity and capital adequacy ratios. The ratio of gross non-performing loans (NPLs) to gross loans stood at 14.5% in June 2023 compared to 14.9% in May 2023. Decreases in NPLs were noted in the transport and communication, agriculture, manufacturing, and personal and household sectors. However, banks have continued to make adequate provisions for the NPLs,
vi. Growth in private sector credit declined to 12.2% in June 2023 from 13.2% in May 2023. Strong credit growth was observed in sectors such as; transport and communication, manufacturing, trade, and consumer durables of 19.9%, 18.0%, 12.5% and 11.8% respectively. Additionally, the number of loan applications and approvals remained strong, reflecting resilience in economic activities. Notably, the private sector credit increased by 12.6% in August 2023, up from 10.3% in July, supported by credit growth in sectors such as transport and communication, manufacturing,

consumer durables and trade of 24.9%, 19.6%, 12.7% and 9.4%, respectively. The number of loan requests and grants stayed high, indicating robust economic activities. The chart below shows the movement of the private sector credit growth of the last five year;



vii. The Committee noted the outcome of the FY'2022/23 Government Budget operations, which resulted in a lower budget deficit of 5.3% of GDP in FY'2022/23 from 6.2% of GDP in FY'2021/22. Additionally, the MPC noted the ongoing implementation of the FY'2023/24 Government Budget, which continues to reinforce fiscal consolidation. The MPC welcomed the efforts by the National Treasury to source new external financing for the budget, noting that, as a result of the identified new external financing, the projected net domestic borrowing by the Government had been reduced to Kshs 316.0 bn from Kshs 586.5 bn, which is consistent with the government's economic programme. The MPC observed that the revised borrowing requirements should exert downward pressure on domestic interest rates, while the additional external financing will bolster the foreign reserves of the CBK, and,

viii. The MPC also considered and approved a new monetary policy implementation framework designed to enhance monetary policy transmission. This new framework is based on inflation targeting and introduces an interest rate corridor around the Central Bank Rate (CBR) set at ± 250.0 bps. Henceforth, the monetary policy operations will be aimed at ensuring the interbank rate, as an operating target, closely tracks the CBR. In addition, to improve access to the Discount Window, the Committee agreed to reduce the applicable interest rate to 400.0 bps above the CBR from the current 600.0 bps above CBR.

The committee noted that, the impact of its move to tighten the monetary policy in June 2023 to anchor inflationary expectations was still transmitting in the economy and therefore it concluded that the current stance on monetary policy was appropriate and decided to retain the central Bank Rate at 10.50%. Additionally, the committee noted that inflation was already within the target range and was expected to decline further as food inflation is expected to come down. The Committee will closely monitor the impact of the policy measures, as well as developments in the global and domestic economy, and stands ready to take further action as necessary. The Committee last met on 3rd October 2023 and the next meeting is scheduled for December 2023.