Cytonn Annual Markets Review - 2017

Kenya Macro Economic Review

The Kenyan economy remained resilient in 2017 despite recording a decline in growth compared to last year. KNBS data indicated that the economy expanded by an average of 4.7% for the first three quarters of 2017 compared to an average of 5.7% in a similar period in 2016. This slowdown was due to (i) slower growth in the agricultural sector at 3.1% as compared to a growth of 3.8% recorded in Q3’2016, due to the effects of the 2016/17 drought, and (ii) a slowdown in the growth of the financial intermediation sector, which expanded by 2.4%, down from 7.1% recorded in Q3’2016. Some of the key sectors that supported growth are tourism and transport that grew by 13.4% and 8.2%, respectively. The Kenya National Treasury, World Bank and IMF cut their 2017 GDP growth projections to 5.5%, 4.9% and 5.0% from 6.0%, 6.0% and 5.7%, respectively, at the beginning of the year. Reasons cited for the revision include:

i. slower growth of the agricultural sector which grew by (1.1%), 1.4% and 3.1% in Q1, Q2 and Q3 of 2017, compared to 4.0%, 7.1% and 3.8% in Q1, Q2 and Q3 of 2016 following the prolonged 2016/17 drought,
ii. the interest rate cap, which led to a reduction in corporate earnings for commercial banks with EPS growth for Q3’2017 at (8.2%), compared to 15.1% in Q3’2016,
iii. political uncertainty during the year, and
iv. low private sector credit growth which averaged 2.4% in the first 10 months to October 2017 compared to a 5-year average of 14.4%.

Kenya’s Kshs 2.3 tn Budget for the current fiscal year 2017/18 was released, with a 72:28 split between recurrent and development expenditure. The budget, which increased by 2.4% from the 2016/17 Budget, focused on job creation, encouraged investments into the country through tax incentives, and improvement of living standards of the low income population through an increase in the lowest monthly taxable income to Kshs 13,489 from Kshs 11,135, as detailed in our Cytonn Q1’2017 Quarterly Markets Review. According to the Quarterly Economic and Budget Review for the first quarter of the Fiscal Year (FY) 2017/18, the Kenyan Government had only borrowed 43.8% of its first quarter foreign borrowing target, having borrowed Kshs 7.5 bn of the targeted Kshs 17.0 bn. The government signed a new 8-year commercial loan of Kshs 77.0 bn from the Eastern and Southern Africa Trade and Development Bank (TDB), formerly PTA Bank, at 6.7% above the 6-month London Interbank Offer Rate (Libor), currently at 0.6% to pay off debt holders of the 2015 syndicated loan, who declined to extend maturity. The government exceeded the first quarter of the FY’2017/18 spending targets for both recurrent and development expenditure at 102.4% and 102.9% absorption rates having spent Kshs 299.9 bn and Kshs 90.7 bn respectively. The total revenue collections for that quarter stood at Kshs 345.6 bn compared to the target of Kshs 388.0 bn, indicating that 89.1% of the target was met. The higher absorption rates coupled with lower revenue collection could lead to excessive demand for borrowing by the government, and yet they have not met their borrowing targets, meaning that there could be increased upward pressure on interest rates.

At the beginning of the year, we expected the Kenya Shilling to come under pressure due to (i) to expected strengthening of the dollar due to expectations of three Fed rate-hikes in 2017, and (ii) continued importation of capital goods for infrastructure and real estate investments, which was expected to have a negative effect on the current account position. However, the Shilling has remained resilient in 2017, only depreciating by 0.7% against the USD during the year to close at Kshs 103.2 from Kshs 102.5 at the beginning of the year, supported by (i) weakening of the USD in the global markets as indicated by the US Dollar Index, which shed 9.9% in 2017, and (ii) the CBK's intervention activities, as they had sufficient forex reserves, which closed the year at USD 7.1 bn (equivalent to 4.7 months of import cover).

Inflation in 2017 has been characterized by rising food inflation in H1'2017 brought on by the drought, causing inflation to hit a high of 11.7% in May driven by food inflation. Towards the tail end of the year, inflation declined, hitting 4.5% in December driven by declining food prices, despite pressure from rising fuel prices. 2017 average inflation came in at 8.0% which is above the government annual target of 2.5% - 7.5%.

The graph below shows the summary of returns by asset class in 2017 (T- Bonds, T-Bills and Equities). The best performing asset in 2017 was equities, with NASI gaining 28.4% compared to (8.5%) in 2016, and the least returning was the 91-day T-bill at 8.4% p.a. The FTSE Bond Index improved significantly, gaining 16.5% from (0.2%) in 2016. Clearly, investors who did not have diversified and balanced portfolios, with exposures to equities and bonds, registered under-performance in 2017. The positive thing to note however is that all asset classes gained despite the political unrest witnessed during the year.

The NASI return is in Kshs and the T-bill returns are an annual average for 2017

The table below summarizes the seven macro-economic indicators that we track, the expectations at the beginning of the year, the actual 2017 experience and the impact of the same on the operating environment:

Macro-Economic Indicators	**2017 Expectations**	**2017 Experience**	**Effect**
GDP	GDP growth of 5.4% - 5.7% in 2017	GDP growth for Q2'2017 came in at 5.0%, compared to 6.3% in Q2'2016, slowed down by a 1.7% decline in growth in agriculture, and financial intermediation that slowed to a growth of 4.3% from 8.1% recorded in Q2'2016. The World Bank has also cut the projections for 2018 and 2019 to 5.5% and 5.8% from 5.8% and 6.1% previously. Cytonn Investments revised downward their GDP growth expectations from 5.4% - 5.7% to between 4.7% - 5.2%	**Neutral**
Interest Rates	A stable outlook on interest rates in 2017, with the CBR maintained at 10.0%	The CBK has maintained the CBR at 10.0%, while remaining disciplined in the auction market and rejecting expensive bids, following the capping of interest rates	**Neutral**
Inflation	Expected to average above the 2.5% - 7.5% government target	Inflation declined to 4.5% in the month of December from 7.0% in January after touching a high of 11.7% in May. For 2017 it averaged 8.0%, on account of a decline in food prices brought about by improved weather conditions	**Neutral**
Currency	Shilling to depreciate against major currencies	The shilling has depreciated by 0.7% against the dollar YTD, following a relatively peaceful election period	**Positive**

Corporate Earnings	Corporate earnings growth of 8.0% in 2017 due to lower earnings for commercial banks attributed to the cap on interest rates	Banks have recorded a weighted average decline in core EPS of 8.2% in Q3’2017, compared to an average growth of 15.1% in Q3’2016. Non-Financial companies performed better, with Safaricom recording an EPS growth of 9.0% in H1’2018	**Neutral**
Investor Sentiment	Foreign investors to demand higher premiums due to political risks posed by elections and economic risk due to the planned rate hikes by the US Fed	Investor sentiment has been positive, with foreign investors entering the market in search of attractive valuations, amid a relatively peaceful election period	**Positive**
Security	Expect the government to put initiatives in place to ensure improved security. However, the 2017 election remains a challenge	Despite political unrest in Q3, security has remained tight following the conclusion of the election period and going forward we expect the government to put in place strong measures to ensure there are no security threats facing the country	**Neutral**