Cytonn H1’2018 Markets Review

C. Kenya Macro Economic Review

Economic Growth:

During the first half of 2018, we tracked Kenya GDP growth projections for FY’2018 released by 15 organizations, that comprised of research houses, global agencies, and government organizations. The average GDP growth, including our projection of 5.5% as at Q2’2018, came in at 5.5%, unchanged from average projections released in Q1’2018. The common view is that GDP growth will improve in 2018, from 4.9% in 2017, generally due to (i) recovery in the agriculture sector on the back of improved weather conditions, and (ii) recovery in the business environment following easing of political risk caused by the prolonged political impasse over the 2017 presidential elections.

Kenya 2018 Annual GDP Growth Outlook

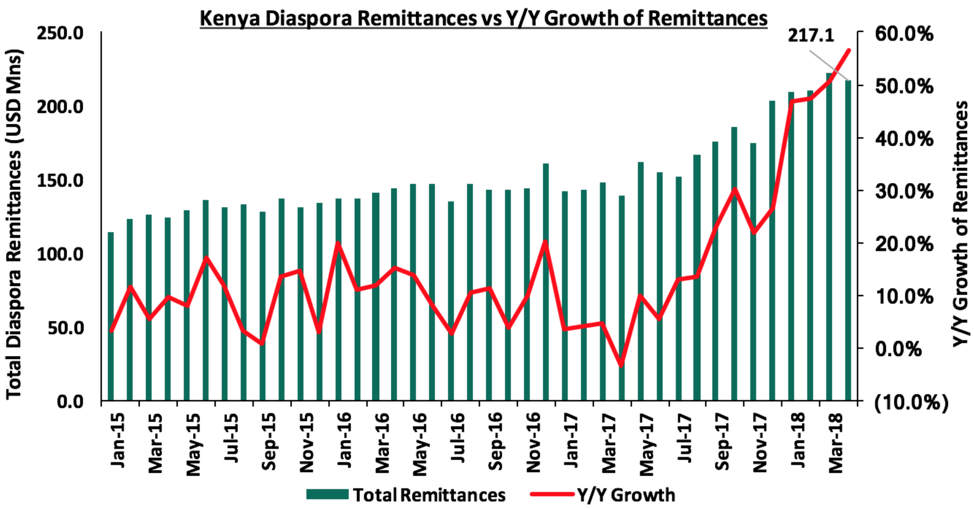
No.	Organization	Q1'2018	Q2'2018
1	Central Bank of Kenya	6.2%	6.2%
2	Kenya National Treasury	5.8%	5.8%
3	Oxford Economics	5.7%	5.7%
4	African Development Bank (AfDB)	5.6%	5.6%
5	Stanbic Bank	5.6%	5.6%
6	Citibank	5.6%	5.6%
7	International Monetary Fund (IMF)	5.5%	5.5%
8	World Bank	5.5%	5.5%
9	Fitch Ratings	5.5%	5.5%
10	Barclays Africa Group Limited	5.5%	5.5%
11	**Cytonn Investments Management Plc**	**5.4%**	**5.5%**
12	Focus Economics	5.3%	5.3%
13	BMI Research	5.3%	5.2%
14	The Institute of Chartered Accountants in England and Wales	5.6%	5.6%
15	Standard Chartered	4.6%	4.6%
	Average	**5.5%**	**5.5%**

The macroeconomic environment in Kenya has remained relatively stable in the first half of 2018, supported by (i) continued investment in infrastructure, (ii) a stable interest rate environment, (iii) a relatively stable currency, having gained by 2.1% in H1’2018, and (iv) improved business confidence and strong private consumption as evidenced by an average Stanbic PMI of 55.0 in the first 5 months of 2018 up from 50.2 in the first 5-months of 2017. The outlook on economic growth for 2018, is positive following improved weather conditions set to boost agricultural productivity, water supply and electricity that will in turn favor the manufacturing sector. Low private sector credit growth, which stood at 2.8% as at April as compared to the 5-year average of 14.0%, remains one of the key concerns for economic growth.

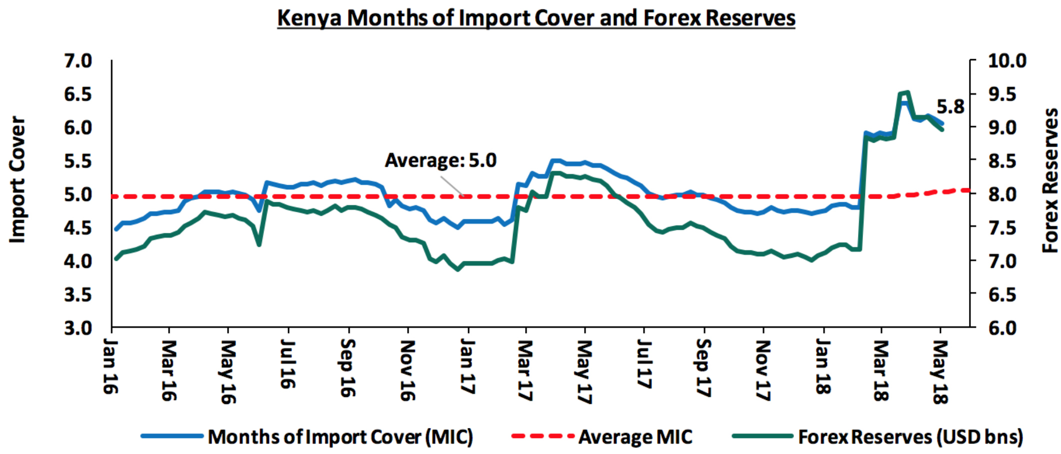
The Kenya Shilling:

The Kenya Shilling appreciated against the US Dollar by 2.1% in H1’2018 to close at Kshs 101.1 from Kshs 103.2 at the end of 2017. This week, the Kenyan Shilling declined by 0.2% against the dollar to close at Kshs 101.1 from Kshs 100.8 the previous week due to end month dollar demand from oil importers and manufacturers. In our view, the shilling should remain relatively stable in the short term, supported by,

i. The narrowing of the current account deficit which stood at 6.1% of GDP as at March 2018 from 6.4% in December 2017,
ii. Stronger inflows from principal exports which include coffee, tea and horticulture which increased by 9.3% during the month of April to Kshs 21.9 bn from Kshs 20.0 bn in a similar period the previous year, with the exports from coffee, and horticulture increasing by 6.7%, and 25.0% y/y, respectively, despite tea exports declining marginally by 1.6% y/y,
iii. Improving diaspora remittances, which increased by 56.6% to USD 217.1 mn in April 2018 from USD 138.6 mn in April 2017 with the bulk contribution coming from North America at USD 114.0 attributed to (a) recovery of the global economy, (b) increased uptake of financial products by the diaspora due to financial services firms, particularly banks, targeting the diaspora, and (c) new partnerships between international money remittance providers and local commercial banks making the process more convenient, and,



iv. High forex reserves, currently at USD 8.7 bn (equivalent to 5.8 months of import cover) and the USD 1.5 bn stand-by credit and precautionary facility by the IMF, still available until September 2018.



Inflation:

The average inflation rate for H1'2018 decreased to 4.2% from 9.8% in H1'2017, with June's inflation having risen to 4.3% from 4.0% in May. Y/Y inflation in June 2018 declined mainly due to the base effect, however, m/m inflation declined by 0.9% due to a 2.2% decline in the Food and Non-Alcoholic Drinks' Index driven by a decrease in prices of some food basket items such as onions, potatoes, maize and cabbages outweighing increases in others. Key to note is that inflation in June was not in line with our expectations of between 6.1% and 6.4%, which we expected to be driven by a base effect given declining inflation in June 2017, and increases in the transport index, the housing, water, electricity, gas & fuel index, and food inflation, as highlighted in our Cytonn Weekly #25/2018.

Major Inflation Changes in the Month of June 2018

Broad Commodity Group	Price change m/m (June-18/May-18)	Price change y/y (June-18/June-17)	Reason
Food & Non-Alcoholic Beverages	(2.2%)	0.9%	This was due to a decrease in prices of some food basket items outweighing increases recorded in others
Transport Cost	0.4%	7.5%	This was on account of an increase in the pump price of petrol and diesel
Housing, Water, Electricity, Gas and other Fuels	0.5%	14.2%	This was mainly attributed to significant increases in prices of kerosene and charcoal which outweighed decreases in electricity charges
Overall Inflation	**(0.9%)**	**4.3%**	**The m/m decline was due to a 2.2% decline in food prices which has a CPI weight of 36.0%**

We expect relatively higher inflation during the second half of the year, mainly due to the base effect, as June was the inflexion point last year where inflation started declining. Going forward, we expect inflation to average 7.0% in 2018, which is within the government target range of 2.5% - 7.5%.

Monetary Policy:

The Monetary Policy Committee (MPC) met thrice in H1'2018, In the January 22nd meeting, they decided to retain the CBR at 10.0%, noting an increased optimism for growth prospects in the economy and inflation expectations anchored within the Government target range of 2.5% - 7.5%. In the March 19th meeting, the MPC decided to lower the CBR to 9.5% for the first time since July 2016, noting that there was room for monetary policy easing to further support economic activity as evidenced by (i) inflation, which had eased to 4.5% in February 2018 from 4.8% in January, and (ii) increased private sector optimism as per the MPC private sector market perception survey. They later retained the CBR at 9.5% in the May 28th meeting, citing that the impact of the 50-bps reduction in March had not yet been fully transmitted to the economy, despite there being room for monetary policy easing to further support economic activity.

Half-Year Highlights:

The Kenyan National Treasury released the fiscal year 2018/19 national budget in June 2018. Below are some of the key highlights

Amounts in Kshs trillions unless stated otherwise

Comparison of 2017/18 and 2018/19 Fiscal Year Budgets

	2018/19	**% change 2017/18 to 2018/19**	**2017/18**	**% change 2016/17 to 2017/18**	**2016/17**
Revenue	**1.9**	**14.5%**	**1.7**	**9.6%**	**1.5**
Recurrent expenditure	1.5	7.7%	1.4	13.3%	1.2
Development expenditure	0.6	7.8%	0.6	(27.3%)	0.8
County governments	0.4	7.3%	0.4	16.4%	0.3
Total expenditure	**2.5**	**7.7%**	**2.3**	**(0.2%)**	**2.3**
Deficit as % of GDP	***(5.7%)***	***1.5%***	***(7.2%)***	***1.9%***	***(9.1%)***
Net foreign borrowing	0.3	(11.2%)	0.3	(30.3%)	0.5
Net domestic borrowing	0.3	(8.6%)	0.3	(14.7%)	0.3
Total borrowing	**0.6**	**(10.0%)**	**0.6**	**(23.6%)**	**0.8**

Key take-outs from the table:

i. Total expenditure in the fiscal year 2018/2019 is set to increase by 7.3%, to Kshs 2.5 tn from Kshs 2.3 tn in the fiscal year 2017/18,
ii. Development expenditure is set to increase at a slightly faster rate than recurrent expenditure; with recurrent increasing by 7.7% to Kshs 1.5 tn from Kshs 1.4 tn, while development will increase by 7.8% to Kshs 625.0 bn from Kshs 579.6 bn in FY 2017/18,
iii. The budget deficit is projected to decline to 5.7% of GDP from an estimated 7.2% of GDP in the FY 2017/18; this in line with the International Monetary Fund's (IMF's) recommendation, in a bid to reduce Kenya's public debt requirements,

iv. The total borrowing requirement to plug in the deficit is expected to decline to Kshs 558.9 bn from Kshs 620.8 bn, in a bid to reduce Kenya's public debt burden which is estimated at 55.6% of GDP as at 2017 by the IMF, 5.6% above the East African Community (EAC) Monetary Union Protocol, the World Bank Country Policy and Institutional Assessment Index, and the IMF threshold of 50.0%, but well below the 74.0% mark considered a signal for debt unsustainability, and,
v. Debt financing of the 2018/19 budget is split 51:49 between foreign and domestic borrowing, with the foreign and domestic debt being estimated at Kshs 287.0 billion (equivalent to 3.0% of GDP) and Kshs 271.9 billion (equivalent to 2.8% of GDP), respectively.

Key to note is that the Treasury proposed a repeal of the interest rate cap, subject to passing by the National Assembly, stating that the rate cap had not achieved its intended purpose; this is after failing to mention it in the Draft Financial Markets Conduct Bill, 2018 – see our Focus Note on the Conduct Bill here. The Kenyan budget has always been expansionary given that Kenya is a developing country, and this has led to a budget deficit usually bridged through debt, resulting in a rising debt-to-GDP ratio, estimated to have hit 55.6% by the end of 2017, 5.6% above the East African Community (EAC) Monetary Union Protocol threshold of 50.0%. To reduce this deficit, a few changes have been proposed to beef up revenue collection as follows: (i) an expected implementation of the 16.0% VAT on petroleum products from September 2018, (ii) the raising of excise duty fee on cellular money transfer services to 12.0% from 10.0%, previously, and (iii) introduction of a robin hood tax of 0.05% on any amount exceeding Kshs 500,000 transferred through financial institutions. As we continue to see significant changes to taxes, we are of the view that this should be accompanied by equally significant reduction efforts in recurrent expenditure, as only this joint effort will lead to a substantial decline in the budget deficit and in turn the public debt burden.

Macroeconomic Indicators Table:

The table below summarizes the various macroeconomic indicators, the expectation at the beginning of 2018, the actual H1'2018 experience, the impact of the same, and our expectations going forward:

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
Government Borrowing	Government to come under pressure to borrow as it is well behind both domestic and foreign borrowing targets for FY 2017/18, and KRA is unlikely to meet its collection target due to expected suppressed corporate earnings in 2017	i. The government surpassed its domestic borrowing target for the 2017/18 fiscal year, having borrowed Kshs 390.2 bn against a target of 297.6 bn ii. The government borrowed 79.1% of its foreign borrowing target, for the fiscal year 2017/18, with the estimate having been revised up to Kshs 323.0 bn as per the 2018 BPS	With the interest rate cap still in place, we don’t expect upward pressure on interest rates. Should the cap be repealed, we expect this to result in upward pressure on interest rates in the next borrowing cycle, as the government will no longer have an easy time collecting funds from the domestic market. However, with National Assembly against a complete repeal and The Draft Financial Markets Conduct Bill, 2018 having not addressed the issue of the interest rate cap, we still remain positive on government borrowing.	**Negative**	**Positive**

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
Exchange Rate	Currency projected to range between Kshs 102.0 and Kshs 107.0 against the USD in 2018. With the possible widening of the current account deficit being a possible point of concern, we expect the CBK to continue to support the Shilling in the short term through its sufficient reserves of USD 7.1 bn (equivalent to 4.7 months of import cover)	The Shilling has appreciated by 2.1% against the USD YTD to 101.1. The country’s current account deficit expanded to 6.7% of GDP in 2017 from 5.2% in 2016 as per the KNBS report on account of faster growth of imports at 20.5%, as compared to export growth at 2.8% while Diaspora remittances increased by 56.6% to USD 217.1 mn in April 2018 from USD 138.6 mn in April 2017.	The government projects the current account deficit to narrow to 5.4% of GDP in 2018 due to lower food and SGR imports. We expect the currency to remain relatively stable against the dollar, supported by, (i) stronger horticulture export inflows driven by increasing production (ii) improving diaspora remittances, and (iii) the ample reserves with the IMF having extended the standby credit facility of USD 1.5 bn (approx. 1 month import cover) by 6 months, to allow for review	**Neutral**	**Neutral**

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
Interest Rates	Upward pressure expected on interest rates, especially in the first half of the year, as the government falls behind its borrowing targets for the fiscal year. However, with the Banking (Amendment) Act, 2015, the MPC might be unable to do much with the CBR which has remained at 10.0% throughout 2017	The MPC met on 28th May 2018 and maintained the CBR at 9.5 citing that the impact of the 50-bps reduction in March had not yet been fully transmitted to the economy, despite there being room for monetary policy easing to further support economic activity	The interest rate environment is expected to remain relatively stable with the CBK not accepting higher yields on treasury securities	**Neutral**	**Neutral**
Inflation	Inflation expected to average 7.5% compared to 8.0% last year	Inflation has averaged 4.2% in the first half of 2018. The year on year inflation rate for the month of June rose to 4.3% from 4.0% in May, driven by a 0.5% rise in Housing, Water, Electricity, Gas and Other Fuels' Index attributed to an increase in prices of kerosene and charcoal which outweighed decreases in electricity charges	Inflation in H2'2018 is expected to experience upward pressure, partly due to the base effect, and the expected rise in fuel and transport prices with the introduction of 16.0% VAT on petroleum products as from September 2018. However, we expect Inflation to average 7.0% in 2018 down from 8.0% in 2017 and within the government target range of 2.5% - 7.5%.	**Positive**	**Positive**

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
GDP	GDP growth projected to come in at between 5.3% - 5.5%	Kenya's economy grew by 4.9% in 2017, compared to 5.9% in 2016 in line with our expectation of between 4.7% - 5.2%. The consensus GDP growth projection for Kenya in 2018 is at 5.5% (an average taken from 15 research firms, global agencies and government organizations projections), which is an improvement from the GDP growth experienced in 2017	GDP growth is projected to come in between 5.4% - 5.6% in 2018 driven by recovery of growth in the agriculture sector, continued growth in the tourism, real estate and construction sectors, and growth in the manufacturing sector	**Positive**	**Positive**
Investor Sentiment	Investor sentiment expected to improve in 2018 given the now settling operating environment after conclusion of the 2017 elections	The Kenya Eurobond was 7.0x oversubscribed partly showing the appetite for Kenyan securities by the foreign community, and investor confidence in Kenya's stable and relatively diversified economy	Given (i) the now settled operating environment following the elections in 2017, (ii) the expectation that long term investors will enter the market seeking to take advantage of the valuations which are still historically low, and (iii) expectations of a relatively stable shilling, we still expect investor sentiment to improve in 2018	**Positive**	**Positive**

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2018 Expectations at Beginning of Year	YTD 2018 Experience	Going Forward	Outlook - Beginning of Year	Current Outlook
Security	Security expected to be maintained in 2018, especially given that the elections were concluded and the USA lifted its travel warning for Kenya, placing it in the 2nd highest tier of its new 4-level advisory program, indicating positive sentiments on security from the international community	The political climate in the country has eased, compared to Q3’2017 with security maintained and business picking up. Kenya now has direct flights to and from the USA, a possible signal of improving security in the country	We expect security to be maintained in 2018, especially given that the elections are now concluded, the government has settled into office, and the country's two principals are working together towards growing the economy after the recent hand shake	**Positive**	**Positive**

Of the 7 indicators we track, 5 are positive and 2 are neutral, with government borrowing being the only indicator whose outlook has changed, to positive from negative. This is a positive change from the last half of 2017 where we had 4 positives, 1 negative and 3 neutrals. From this, we maintain our positive outlook on the 2018 macroeconomic environment.