Cytonn INVESTMENTS

Probable direction of Equities in 2016, & Cytonn Weekly Report #5

Cytonn Weekly

Executive Summary

- **Fixed Income:** Yields on government securities changed trend this week, falling for the first time this year. The fall in yields was due to increased subscriptions that were driven by a more liquid market; increased liquidity was due to increased maturities of T-bills in the market. Treasury released the draft budget proposal which indicates a reduction in domestic borrowing by Kshs 53.0 bn for the 2015/2016 financial year; If the proposal gets approved, we may revise our fixed income recommendation from investing in short dated paper to investing in long dated paper;
- **Equities**: The market was on an upward trend during the week with NASI, NSE 20 and NSE 25 gaining by 3.3%, 1.6% and 2.9%, respectively. Kenya Airways got a 2-year loan extension period for its short term loans worth Kshs 25.6 bn;
- **Private Equity:** The PE landscape has seen increased inflows as global investors aim to capitalize on Africa?s growth prospects;
- **Real Estate:** Mombasa county government sets up a public private partnership (PPP) project to redevelop residential estates in the region, a project that will benefit 10,000 residents in its initial stage. Canada?s Mascon Construction Systems plans to develop 20,000 low cost apartments at Kibera and Mathare slums;
- **Focus of the Week:** Following the weak start for Kenya's equities market in 2016 with indices down over 6% in January 2016, we compare the last bear cycle in 2011 with the current cycle to try and figure out the probable direction of the market going forward.

Company Updates

- This week we formally re-launched our brand in the market with Sharp is the New Smart campaign. The essence of the campaign is that with a more dynamic and fast evolving investment landscape, characterized by increased volatility in interest rates, inflation and exchange rates; changing demographics; rapid urbanization and globalization , investors need sharp solutions to meet their investment objectives. The old, smart approaches to investments won?t deliver superior returns: See more: Cytonn Investment Campaign video.
- We concluded our Middle East road show that targeted both institutional investors and the Kenyan diaspora. Shiv Arora, Head of Private Equity Real Estate met leading global private equity players in the Middle East
- Our Senior Investment Analyst, Duncan Lumwamu discussed the Kenyan government economic forecast for 2016 and the closure of EABL?s South Sudan subsidiary. See Duncan Lumwamu on CNBC.
- This week, we launched the Cytonn Real Estate Nairobi Commercial Office Sector Report. See Cytonn Real Estate Nairobi Commercial Office Sector Report.
- We continue to beef up the team with other ongoing hires: Careers at Cytonn.

Fixed Income

This week T-bills were oversubscribed with overall subscription at 313.0% compared to 211.6% the previous week. Subscriptions remained high as a result of increased demand for government securities due to (i) high liquidity in the money market as a result of high T-bill maturities in the month, and (ii) investors? appetite for short-term instruments as opposed to longer dated bonds as they anticipate upward pressures on rates. The 182-day treasury bill has been the investors? favourite as they expect higher rates after the start of the next financial year when the 182-day matures; the higher rate expectations are due to investors anticipating that the rates will continue to rise as the government borrows to repay already existing obligations. Yields fell for the first time this year, with the 91-day, 182-day and 364-day falling to 11.4%, 13.9% and 14.0% from 11.7%, 14.4%, and 14.5%, respectively, last week. The decline in yields is attributed to the increased liquidity in the money market coupled with the indication that the government shall be reducing the target domestic borrowing by Kshs. 53.0 bn to Kshs. 166 bn from the current Kshs 219.0 bn; this is a positive development given market anxiety around the direction and levels of borrowing and spending. The money markets were relatively liquid during the week as evidenced by the interbank rate declining to 4.8% from 6.7% last week owing to maturity of government securities and liquidity injection in the market through reverse repos worth Kshs. 8.6 bn.

The Kenyan Shilling remained steady during the week, closing at 102.2 to the dollar from 102.3 last week. The shilling is expected to trade within range bound on the back of strong dollar reserves of USD 7.0 bn, equivalent to 4.5 months of import cover.

Inflation rate for the month of January was 7.8%, against our projections of 8.5%, down from 8.0% in December 2015. This is due to lower transport costs, which declined 0.9% from December 2015 attributed to decline in energy prices, as oil prices remain subdued. Food prices were up 0.5%, a slowdown from the 1.2% increase in December 2015. We project the 2016 inflation to remain above the CBK target driven by (i) the El-Nino effects that will continue to be felt in Q1?2016 and the expected drought thereafter which will have an uptick effect on food prices, and (ii) the expected 16.0% VAT to be levied on all petroleum products as from September 2016.

The National Treasury has released a draft budget policy statement (BPS) for the 2016/ 2017 financial year to be tabled before parliament. The draft proposes a reduction in government expenditures by Kshs 93.8 bn, of which Kshs. 70.6 bn is a reduction of development expenditure. The total revenue reduction is by Kshs. 46.9 bn, thus netting off with the reduced expenditures of Kshs. 93.9 bn gives a total budget reduction of Kshs. 46.9 bn. The proposed expenditure reduction is driven by the expectation of lower revenues collection by Kenya Revenue Authority by Kshs. 46.9 bn. The government is also expected to lower its net domestic borrowing by Kshs. 53.3 bn, easing pressures on the Government borrowing to finance the budget. We draw the following views from this development;

- Currently the Government needs to borrow Kshs. 74.8 bn every month but if the proposal is approved by Parliament, they will need to borrow Kshs. 64.2 bn every month to meet their domestic borrowing target and refinance maturities. This is as a result of expected borrowings reducing from Kshs. 357.0 bn to Kshs. 310.0 bn as a result of the reduced borrowing requirements in the revised budget.
- Having borrowed Kshs 146.3 bn already, compared to a target of Kshs. 132.3 bn (assuming a pro-rated borrowing throughout the financial year of the budgeted Kshs. 219 bn of total domestic borrowing for this year), upward pressures on interest rates is expected to ease off in the short term.

With the above proposal pending approval, 2 scenarios face fixed income investors, whether to keep short or go long on duration. If the proposal is approved, then pressures on interest rates will ease off and the bias will be to longer dated papers, but if it is not

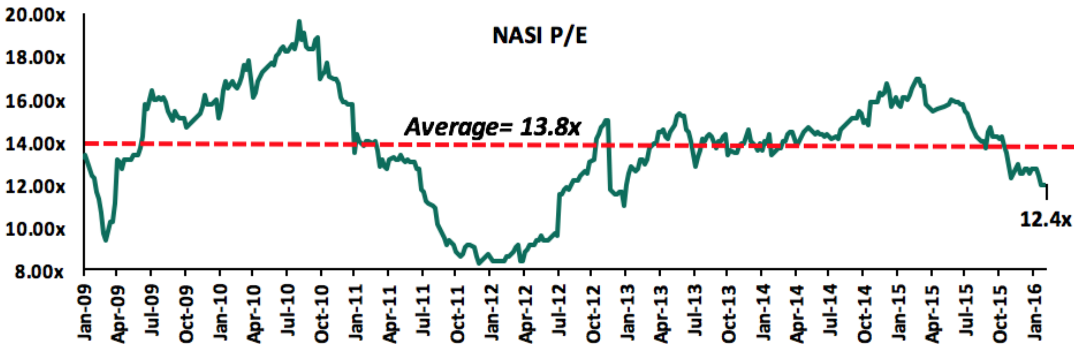
approved, keeping short will be the best option. However, given the uncertainty surrounding the decision, we continue to advise investors to be biased towards short term fixed income instruments with a key focus on the developments on the draft budget proposal.

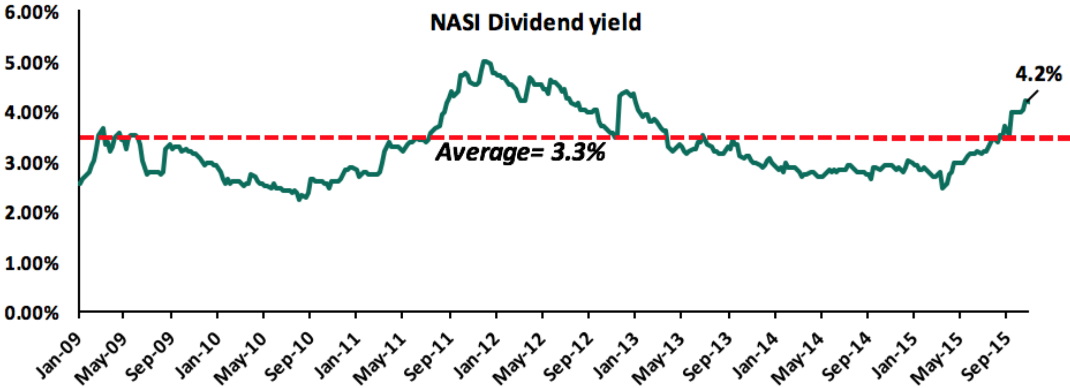
Equities

During the week, the market registered gains, with the NASI, NSE 20, and NSE 25 indices rising 3.3%, 1.6%, and 2.9%, respectively. This was on the back of gains in Safaricom, KCB and EABL that rose 6.9%, 4.6% and 3.0%, respectively. On an YTD basis, the three indices are down 3.0%, 5.1%, and 3.4%, respectively.

Equities turnover declined by 14.7% during the week to Kshs 3.4 bn from Kshs 4.0 bn the previous week. Foreign investors were net buyers for the second consecutive week, with net inflows rising 408% to Kshs 1.2 bn, the highest in four and a half months, compared to net inflows of Kshs 235.1 mn the previous week.

The market is currently trading at a price to earnings (PE) ratio of 12.4x versus a historical average of 13.8x, and with a dividend yield of 4.2% versus a historical average of 3.3%. Note that at 4.2%, market yields are now approaching peaks last seen in late 2011, when yields peaked at about 4.9%. The charts below indicate the historical PE and dividend yields of the market.





Kenya Airways has entered into an agreement with 9 of its 11 Kenyan lenders to extend its loan tenures by converting short-term loans worth Kshs 25.6 bn into longer-term loans of between 2-5 years, with a grace period of 2 years before repayments resume. The company plans to raise Kshs 60 bn of long-term capital through a mix of debt and equity in about six months and it will unveil an international transaction advisor to oversee the capital-raising process. The company?s short-term borrowings stood at Kshs 52.0 bn while long-term borrowings stood at Kshs 115.9 bn as at September 2015, with the high amounts of debt weighing on the airline to the point it has to take additional loans to meet its payroll obligations. The debt restructuring will likely bode well for the company as it strives to get back to profitability, through raising of additional capital and lowering finance costs with the new cheaper capital.

As per our Cytonn Weekly #3, we started our review on Uchumi Supermarkets following shareholders? approval of raising additional capital of Kshs 5.0 bn to fund its turnaround strategy. We relooked at our assumptions and scenarios based on the new capital. Currently Uchumi is in its first phase of stabilization. Under this strategy, the main aim is to close and stop all the bleeding and it was expected to last 90 days. On capital restructuring, the decision to engage a strategic investor was already approved by the board and the process is to be implemented in the next 8 weeks. The key objectives for the capital raise by Uchumi are (i) restoring supplier confidence, (ii) stocking up on supplies, and (iii) retiring bank loans. Uchumi thus hopes to return to normal credit with a maximum overdraft limit of Kshs 500 mn, which is essentially enough to deal with seasonal variation and also manageable in terms of finance costs. In our view;

1. The company will find it hard to attract investors who will inject the amount needed to restructure the company, Kshs 5.0 bn, considering the only positive value on offer is the brand,
2. The said capital injection will be deployed towards;
   - Pay off the debts but not be useful to advance the company to the next level (considering that Kshs 2.2 bn will go towards retiring supplier debt while the balance will be used to retire existing debt),
   - The company will still face financing expenses from the raised capital, which part should come in as a convertible loan.

Consequently, we recommend a Sell on Uchumi.

We remain neutral on equities given the low earnings growth prospects for this year. The market is now purely a stock picker?s market, with few pockets of value.

Below is our recommendation for our stock coverage universe:

all prices in Kshs unless stated								
EQUITY RECOMMENDATIONS - for the week ending 05/02/2016								
No.	**Company**	**Price as at 29/01/16**	**Price as at 5/02/16**	**w/w Change**	**Target Price***	**Dividend Yield**	**Upside/ (Downside)****	**Recommendation**
1.	KCB	38.3	40.0	4.6%	59.1	5.5%	53.1%	Buy
2.	Standard Chartered	193.0	191.0	(1.0%)	247.9	5.5%	35.3%	Buy
3.	Barclays	12.4	12.3	(1.2%)	15.5	8.2%	34.3%	Buy
4.	DTBK	188.0	191.0	1.6%	250.1	1.3%	32.2%	Buy
5.	Equity	38.5	39.0	1.3%	48.6	5.2%	29.7%	Buy
6.	Kenya Reinsurance	19.8	20.0	1.3%	23.5	3.3%	20.8%	Buy
7.	NIC	38.0	40.5	6.6%	45.4	2.7%	14.8%	Accumulate
8.	Britam	11.5	12.0	4.4%	13.4	1.3%	13.4%	Accumulate
9.	I&M	98.0	101.0	3.1%	110.5	2.6%	12.0%	Accumulate
10.	Co-operative bank	16.6	16.9	2.1%	18.0	3.7%	10.4%	Accumulate
11.	Safaricom	15.2	16.2	6.9%	16.6	5.1%	7.6%	Hold
12.	Liberty	17.7	15.7	(11.3%)	16.7	0.0%	6.9%	Hold
13.	CIC Insurance	5.4	5.7	4.6%	5.8	1.3%	3.8%	Lighten
14.	Housing Finance	20.0	20.5	2.8%	20.1	5.7%	3.7%	Lighten
15.	National Bank	16.3	16.7	2.5%	16.8	0.0%	0.8%	Lighten
16.	Uchumi	7.6	7.6	0.0%	7.5	0.0%	(0.7%)	Sell
17.	CfC Stanbic	79.5	80.0	0.6%	77.2	0.0%	(3.5%)	Sell
18.	Jubilee Insurance	462.0	474.0	2.6%	440.7	1.5%	(5.5%)	Sell
19.	Pan Africa	59.0	58.5	(0.8%)	52.8	0.0%	(9.7%)	Sell
***Target Price as per Cytonn Analyst estimates**								
****Upside / (Downside) is adjusted for Dividend Yield**								
Accumulate ? Buying should be restrained and timed to happen when there are momentary dips in stock prices.								

Lighten ? Investor to consider selling, timed to happen when there are price rallies
Data: Cytonn Investments

Private Equity

Centum Foundation has invested an undisclosed amount in Blissful.co.ke, an online start-up that connects businesses in the wedding and events industry to prospective clients. The start-up, which has grown to list over 700 businesses, is the first to benefit from Centum's commitment to invest about USD 5 mn in start-ups in the next three years. Centum will invest up to USD 150,000 as seed capital in each eligible start up and do follow-on funding for businesses that qualify. Eligible start-ups will have to highlight their competitive advantage, the team?s ability, the potential market size, and the potential impact. Besides funding, recipients will receive mentorship and guidance from the Centum team on how to pitch an idea and run their businesses effectively.

Atlanta-based Coca-Cola has bought a 40% stake in Chi, Nigeria's largest juice maker for USD 240 mn, which it plans to increase to 100% in 3 years. The acquisition is part of Coca-Cola's strategy to invest USD 17 bn in the African continent this decade, a move driven by sluggish sales in more developed markets. The transaction also signals Coca-Cola's redoubled efforts to expand beyond its core soda brands including Coke, Sprite, and Fanta. Coke and TGI Group, Chi's parent company, have also announced plans to discuss and explore other opportunities in the region. Increased interest in the FMCG sector in Africa has also seen Centum raise its stake in Almasi, the holding company of three Coca-Cola bottlers that it owns. Centum currently has a 50.95% stake in Almasi, up from 35%, and plans to take full control of the company. Centum has already made an offer to a section of Almasi?s minority shareholders at Kshs 6 per share.

Ethos, a South African PE firm, has announced an exit in CQS, a leading South African value-added distributor of software products, for around USD 13.0 mn. The firm, which has over the last 12 months made five acquisitions and two exits, had earlier last week announced the acquisition of The Eazi Group in a USD 99.0 mn deal. Ethos acquired CQS through its Ethos Technology Fund I in 2008 for an undisclosed amount.

Africa continues to demonstrate strong fundamentals that signal continued growth in the medium term, with improvements in governance and the creation of a supportive environment for businesses providing incentives for PE firms.

Real Estate

This week has seen increased activities in the Kenyan real estate sector most especially at the Coastal region. In a bid to curb the rising housing demand in the county, Mombasa county government is set to roll out a housing project to redevelop its 9 housing estates as well as set up 2 new ones. The project will involve a public private partnership (PPP) where private investors will bring in a total of Kshs 5 bn while the county government will bring in land as equity. The initial phase will involve redevelopment of 5 estates and is set to benefit over 10,000 residents. The concept is highly welcome given that it is set to provide low cost housing to the county residents, if implemented. It is also expected to boost the county government?s plan to phase out residential buildings from Mombasa CBD by 2040 through creation of satellite towns with cheap housing units that will lure residents out of the CBD. Uptake of the project will be mainly by the growing middle income class in the county.

Canadian based Mascon Construction Systems is set to construct 20,000 low-cost apartments in Mathare and Kibera slums, a project that will run from July 2016 to June 2018. The project is estimated to cost a total of Kshs 7.5 bn, a reduced sum given the fact that low cost cast-in-place technology, in which concrete walls are made using ready-mix concrete, then placed into removable forms and erected on site will be employed. Targeting a maximum price of Kshs 400,000 per housing unit, the project is keen on acquiring land donations from the government through a public private

partnership. A competitive mortgage facility is expected to be employed so as to enable selling of the housing units on 5 to 10-year payment plans that involve monthly payments ranging from Kshs 1,500 to Kshs 4,000. If successful, the project can play a huge role in narrowing down the over 200,000 housing demand gap in urban areas in Kenya.

Focus of the Week: Probable direction of Equities in 2016

Given the weak start in Kenyan equities market in 2016, with NASI, NSE 20 and NSE 25 losing 6.1%, 6.6% and 6.1%, respectively, in January, the purpose of this Focus Note is to try and figure out the probable direction of the Kenya equity markets going forward. We use the Last 7-years market valuation chart below as the basis of our discussion.

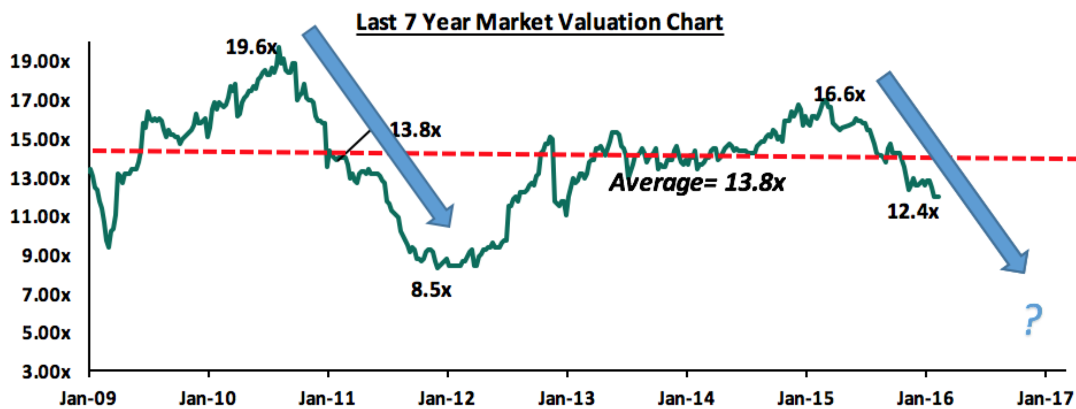
Since the February 2015 peak, the stock market valuation, as measured by price to earnings ratio (**?PE?**), has been on a decline for an entire 12-months ? peaking at a 17.0x PE in February 2015 and declining steadily over the last 12-months to the current PE at 12.4x. The question then is, when and where is the valuation likely to trough and reach the bottom?

To try and understand where valuations are likely to trough, we reviewed the last peak to trough cycle, which was the period from August 2010 to January 2012, duration of 17 months. As of August 2010, markets were valued at peak valuation of about 20x PE, then valuations declined over 10 months to touch the historical average PE of 13.8x as of June 2011, and then further declined for another 7-months, from June 2011 to January 2012, to touch a trough valuation of 8.5x in January 2012. By the time the market troughed, valuations had been cut by almost 60% from peak of 20x PE to trough of 8.5x PE.

In the current bear market, valuations peaked at 16.5x PE in February 2015. The market then declined over a 9-month period to touch the historical 13.8x PE average in October 2015. The peak to average time of 9 months in this cycle is almost similar to the peak to average in the last cycle time of 10 months in the last cycle. Since October 2015, valuations have declined over the last 3 months to below historical average to be at a PE of 12.4x currently. Should we then expect a further decline in valuations? How much more decline and over what period?

A casual look at the chart trends would indicate that just like the last cycle, the markets continued to decline even after reaching the historical average valuation of 13.8x; in fact, from historical average to trough, which was between June 2011 and January 2012, the markets declined from 13.8x average to 8.5x average over a period of 7-months. So one may guesstimate that we may be in for another 7-months of market decline. And to reach the trough of 8.5x from the current 12.4x, it means another 30% dip in market valuations.

To try and figure out what may actually happen and hence what investors ought to do, we compare the actual market conditions during the last bear run of July 2010 to January 2012, to the current bear run that began in February 2015.



In order to understand the direction the local equities market might take, we carried out an analysis of the key metrics that determine stock market performance, drawing comparison with what happened in 2011. These metrics include:

i. GDP growth,
ii. Interest rates,
iii. Trends of inflation rates,
iv. Exchange rates,
v. Corporate earnings,
vi. Investors sentiments, and
vii. Valuation of the market.

We take a detailed look at market conditions for the 6-month period from July 2011, when markets reached the historical average PE of 13.8x, to January 2012 when markets troughed. Our hypothesis is that if we can draw parallels between the current market conditions during this cycle and the market conditions in the last cycle, we can make a judgment call as to whether we may continue on a downward path as we seek a bottom, assuming the market conditions in this cycle are similar to past cycle; or whether a recovery is imminent, assuming current market conditions are better than the last cycle.

In 2011, the GDP growth rate from July 2011 to December 2011 averaged 4.2%, as a result of economic challenges that were witnessed during that period, including a spiraling rate of inflation and high interest rates. In tandem, the local stock market fell by 21.3% during the same period. In the period that followed between January 2012 and December 2012, GDP growth rate came in at 5.6% while the local stock market recorded a return of (1.4%). We observe a positive correlation between GDP growth rate and the performance of the stock market. Going forward, we project a GDP growth rate of between 5.5%-6.0% for 2016, which is above the 2015 projected GDP of 5.3% - 5.7%. Based on past experience, projected higher GDP growth may provide some level of support to the performance of the market, and will provide a stronger underlying base for fundamental growth in earnings.

The year 2011 was characterized by volatile interest rates environment with 91-day T-bill rising from 9.0% in July 2011 to 18.9% in December 2011, later falling back to 10.1% in June 2012. The policy-lending rate was increased by 1,100 basis points to 18.0% in June 2012, from 7.0% previously. This unstable interest rates environment led to poor performance of the stock markets as most corporations that relied on debt financing found it difficult to fund their operation. The poor performance of the stock market was also as a result of investors preferring to invest in near money fixed income instruments. The period that followed from July 2012 to June 2013 was characterized by stable interest rates environment with 91-day T-bill averaging at 9.2% while CBR closed at 9.0% in June 2013 from 16.5% in July 2012. This stable interest rates environment supported the

performance of the market during this period. The year 2016 is expected be characterized by slightly unstable interest rates mainly due to Government borrowing to fund their budgetary obligation. We don?t expect 2016 to be as volatile as 2015, and with the Government proposing a cut in domestic borrowing for the 2016/2017 fiscal year, we expect pressures may reduce on high rates. However, the upward pressures and instability in the rates environment is likely to affect the performance of the stock market negatively. The expected stability in interest rates environment will be positive to the performance of the stock market.

In 2011, inflation averaged at 14.0%, rising from 15.5% in July to peak at 19.7% in November 2011, before closing at 10.1% in June 2012.This affected negatively the performance of the stock market. In 2016, inflation is projected to remain above the CBK upper bound of 7.5% but within the single digit level. This points to relatively stable inflation rates, which may not result into policy tightening by the CBK in order to tame the inflationary pressure. As a result, we expect the stable inflation levels to provide some levels of support to the local stock market performance.

In 2011, the Kenya Shilling reached a low of 105.9 against the dollar in October 2011 from 85 in July 2011.This resulted into sell-offs in the stock market performance leading to poor performance of the stock market. The same trend was also observed in 2015 where the currency depreciated by 13%. We expect the currency to remain under pressure against major currencies in 2016. We note in 2011, the depreciation of the shilling was as a result of speculative position taking, while in the current environment, the weakening of the shilling will be due to structurally issues that affect the strength of the currency, and the recovery of the US economy. Additional dollar obligation in terms of Euro bond, which was not present in 2011, may further add to the pressure that will result into weakening of the Kenya Shilling. This will have a negative effect and add to the downward pressure on the equities market.

Corporate earnings in 2011 were robust especially in the financial services sector, with the banking sector recording earnings growth of 20.5% for the period of July 2011 to June 2012 with only five listed companies issuing profit warnings. In 2015, earnings growth was lower than historically, with banks recording earnings growth of 9.3% in Q3?15. In addition, 17 listed companies issued profit warnings for the full year, compared to just 5 in 2011. We expect earnings growth to remain subdued in 2016 at 10%, trading at a forward PE of 10.9x and this translates to a PEG ratio of 1 indicating that the markets are fairly valued. This is not expected to positively support the performance of the stock market.

The year 2011 was characterized with low global economic growth at 3.8%. This was mainly as a result of Euro zone crisis, which further led to a reduction in foreign investors? activities at the Nairobi Securities Exchange. We also note that during the same period the US economy was also struggling with the impacts of 2008 credit crunch. For the year 2016, the world economy is faced with the Chinese economic crisis, which has resulted into poor performance of most world?s equities market indices with Shanghai Composite index losing more than 7% in 2 of the first 5 trading sessions this year. We also believe that the impacts of the expected rate hike in the US have also been priced into the market, given the high levels of foreign participation in the market at 67.8%, we are likely to witness no significant foreign outflow from the market.

1. **GDP Growth Rates**
2. **Interest Rates Environment**
3. **Inflation Rates**
4. **Exchange Rate**
5. **Corporate Earnings**
6. **Investor Sentiment**
7. **Valuations**

In 2011, the stock market was relatively cheap, trading at a PE of 8.4x-11.4x in the period July 2011

to June 2012.Currently, the market is trading at a PE of 12.4x. We project the earnings will grow at a rate of 10%, this gives a forward PE of 10.9x indicating the market is trading at the same level compared to where it was in 2011.

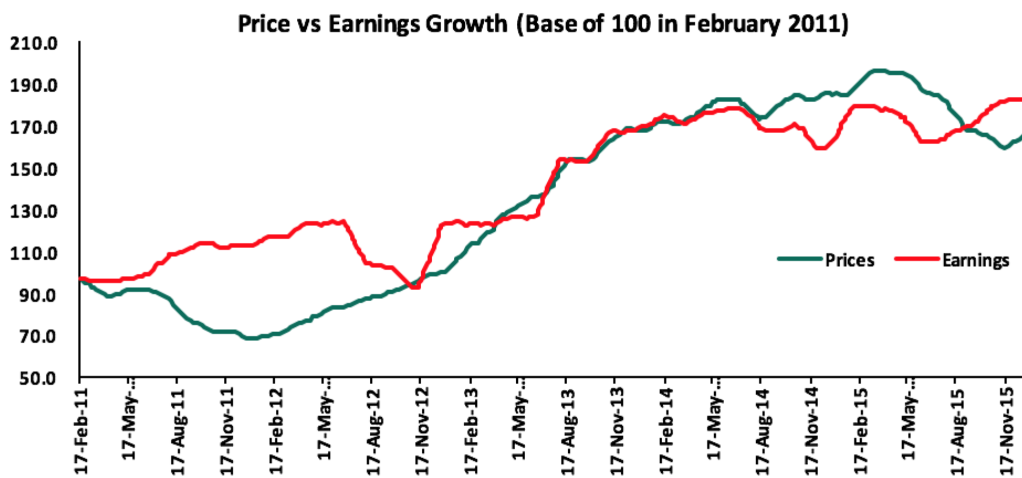
The table below summarises the above factors:

Macro-Economic Indicators	July 2011-December 2011 Experience	2015 Experience	2016 Projections	Effect (2016)
GDP	1. 3.7% growth in Q3'2011 2. 4.6% growth in Q4'2011	1. 4.9% growth in Q1' 2015 2. 5.5% growth in Q2' 2015 3. 5.8% growth in Q3' 2015 4. IMF and World Bank downgrade their GDP projections to 5.6% and 5.4%, respectively. We project the 2015 GDP to come in at between 5.3% and 5.7%	5.5%-6.0% expected growth in 2016	**Positive**
Interest Rates	1. The CBR rate was at 6.25 % in June 2011 and was increased to 18.0% by December 2011. 2. 91 Day T-Bills was at 8.99% in July 2011. It increased to 18.95% by December 2011 3. The 91-Day T-Bills rate hit 20.8% in Jan 2012 before reducing to 10.6% by June 2012	1. CBR at 8.5% up to June, 10% in July. CBR increased 300 bps to 11.5% from August 2015 2. 91 Day T-Bill hitting a high of 22.5% with the rate at 11.7% in January 2016	Expected upward pressure on interest rates but not to the levels witnessed in 2011-2012	**Positive**
Inflation	1. Inflation was at 14.5% in June 2011 and increased to 18.93% by December 2011. The inflation rates decreased gradually remaining in double digits to 10.1% by June 2012	1. Inflation remained within CBK's expectations of 2.5%-7.5% 2. December inflation at 8.01% (highest for year)	To remain within single digit levels, but above CBK's upper bound of 7.5%	**Positive**
Exchange Rate	1. The shilling depreciated 25.2% against the USD from an average of 85 in June 2011 to highs of 105.96 in Oct 2011. In Dec 2011 the KES averaged 85.1 before gaining to average 85 by June 2012 2. The foreign reserves hit a low of 3.59 months of import cover, but climbed to 3.74 months in December 2011	1. Shilling depreciated 13.0% against the dollar from 90.70 in Jan to 102.30 in Dec 2. The foreign reserves cover hit a low of 3.9 months of cover in the period but improved to 4.5 months by December 2015	Shilling to remain under pressure against major currencies	**Negative**

Corporate Earnings	1. The banking sector pre-tax profit grew 20.5% from December 2010 to December 2011, with an overall growth of 7.8% for the same period 2. NASI and NSE-20 index fell 21.3% and 29.0%, respectively 3. 5 listed companies issued profit warning	1. Weak earnings from banking sector. Banks recorded slower growth in Q3' 15 of 9.3% y/y compared to 13.1% in Q3' 14 2. 17 listed and 1 unlisted companies issued profit warnings 3. 5.8% growth in Q3' 2015 4. Most companies reported low earning due to the tough operating environment in 2015	Remain subdued due to the relatively unstable interest rate environment, depreciating shilling, and inflationary pressures	**Neutral**
Investor Sentiment	1. The Euro zone crisis led to reduced foreign investors activities at the Nairobi Securities Exchange which dampened investor sentiment, setting the NSE on a bear run, losing 29.0% 2. High oil prices and high interest rates were also pertinent in this period	1. Flows out of Kenya owing to the US interest rate hike 2. Increased flows into Kenya's debt market. However, few flows into the equities market	Chinese economy slow-down and continued devaluation of their currency leading to poor performance of most emerging and frontier markets indices. Flows out of Kenya from the rate hike have been priced into the market	**Neutral**
Valuations (PE)	Stock market was undervalued, trading at a PE of 8.36x-11.4x in the period July 2011 to December 2011	Stock market seem to be fairly valued, trading at a PE of 12.4x compared to a historical average of 13.8x	Assumption of corporate earnings growth rate of approximately 10% gives a forward P/E of 11.6x ? 11.9x	**Neutral**

Following the above comparison, we find that out of the seven metrics that we track;

i. Three factors (GDP growth, Inflation and Interest rates) support the positive performance of the stock market,
ii. Three factors (investors? sentiments, Corporate earnings growth and valuations) support a neutral stance, and
iii. Only one of the seven factors, exchange rate, points towards poor performance of the market.



Looking at the above, we observe that in the year 2011:

1. Prices were falling despite earnings growth, due to investor sell-off. This later corrected in 2012, and moved in tandem until 2015
2. In 2015, we saw price appreciation outpace earnings growth, with the expectations of investors of higher projected earnings growth, which did not materialize.

However, in the year 2016, we have seen a sustained price decline, which is lower than the earnings growth, owing to investor sell-off as a result of (i) panic in developed markets, which has negatively affected the Kenyan market investors, (ii) a volatile interest rate environment, and (iii) the depreciating shilling.

Despite all the above, earnings growth prospects, and the prospects for the macroeconomic environment for 2016 are more positive, and as such, we do not expect a repeat of 2011, but rather markets to correct based on fundamentals, with prices to grow in tandem with earnings. We then recommend for investors to purchase stocks, which have pockets of value and strong earnings prospects. This is due to:

1. **GDP Growth:** A growth of 5.5% - 6.0% in 2016 is a positive for the economy. This GDP growth is also being backed by continuous development expenditure in the economy, which will grow our sources of revenue and continue to diversify the market in terms of growth of industry, which are supported by this increased spending and growth. This is a positive for earnings, investor confidence and growth of prices in the stock market,
2. **Interest Rates:** Despite the levels we witnessed in 2015, the Government is putting in place measures to be more proactive with managing interest rates, and have maintained the CBR at current levels of 11.5%, despite upward pressures and the threat of inflation. This will stabilize the economy, allow the private sector to begin borrowing to fund growth, and grow earnings. The more stable interest rate environment will also improve investor confidence, which will see increased forays into the equities markets, leading to prices rising in tandem with earnings,
3. **Investor Sentiment:** As global markets struggle with the negative effects of a Chinese slowdown, the Kenyan market has been more resilient due to its diversity of revenue away from hard commodities, and investors have already priced the outflows in the prices. Any further earnings growth will then result to price growth in the market, with PE of 11.6x ? 11.9x expected in the market.

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