2014 Market Review & Outlook for 2015

Cytonn Weekly

Kenyan Market Report - 2014

General Update

The Kenyan economy registered a number of key milestones in 2014. Key among them was the rebasing of the economy from the 2001 base year to 2009, which led to a 25% increase in the size of the economy. This came soon after the Nigerian rebasing which saw their economy become the largest economy in Africa. Economic growth in 2014 was on an upward trend with the overall growth for 2015 expected to come in at above 5%, given the strong growth through the last two quarters of 2014.

Economic Sectorial Review

Agriculture continues to be the backbone of the Kenyan economy, but with the new GDP data it is clear that other sectors like Real Estate and Construction are taking up more and more prominence in the country?s economy. Despite the positive news, there were also some challenges that faced the Kenyan economy in 2014:

1. Waves of insecurity in the country increased, however the Government is taking effective steps to combat this;

2. Current Account deficit widened due to increased importation of machinery but the increase in the financial inflows led to a surplus in the overall Balance of Payment position

There is a lot of support towards the integration of the East African community and if that goes through then there will be continued growth in the entire region through collective synergies.

Fixed Income Review

The rates in the Fixed Income Government securities markets remained relatively stable in the year 2014 driven by:

1. The twin successful issuance of the Euro bond of USD 2bn and 0.75bn in the first and the second tranche;

2. Respectively low and stable inflation rates averaging 6.9% and;

3. Moderately liquid money markets

The Treasury Bill rates declined from 9.3% in January 2014 to 8.5% in December 2014 while the yields on long term papers were unchanged with the 20 year trading at around 13% for the better part of the year. The inflation rates remained in the single digits range in 2014 on account of falling fuel costs and stable food prices.

Stock Market Review

The stock market remained significantly buoyant in 2014 touching a new high with total shares value of traded shares at approximately Kshs. 219 trillion. The high trading was largely dominated by local players as the foreign investors into the market declined to USD 86mn worth of turnover, compared to USD 392mn and USD 269mn in 2012 and 2013 respectively. The NASI also performed well, returning 19.4% supported by the large capitalization liquid stocks in the market like Safaricom, Equity Bank, KCB and BAT. There were also a few companies that listed in the Securities Market which were Flame Tree Group, Atlas Development and Kurwitu. The valuation of some of companies in the exchange are stretched but given the good performance in some of the listed stocks the markets price to earning ratios remains attractive at about 15X.

Alternatives Market Review

The Alternative markets continues to do really well and we have seen increased interest from both the local and the international pools of capital looking for investment opportunities in the large East African region. This renewed interest is largely due to:

I. Increased economic growth prospects in the region;

II. Improved governance across the Region and;

III. An improving demographic trend driven by the growth of the middle class.

There are a number of huge Real Estate and infrastructure projects expected to boost the sector e.g. the Two-rivers projects, Tatu City, Standard Gauge Railway and the improved road networks in the country. Over last year the property prices continued to appreciate, especially the housing focused on the middle-income segment and this is expected to continue in the medium to long term.

Kenya Outlook, and what should Investors be doing

Most of the sectors are expected to continue expanding in the coming year, with the exception of tourism as it continues to face two main issues, namely the insecurity threats facing the country and the fear of further spread of Ebola. The significant drop in international oil prices is expected to reduce exploration investments towards that sector but we still believe that there will be continued increase in activity in the mining sector.

The Kenya Shilling remains under pressure due to increased investments by the country with no significant increases in exports however increased flows into the Capital Account and increased diaspora remittances should continue to buffer the Shilling against any major shocks. As oil prices remain low, inflation should be contained and this should lead to a more stable interest rates environment. With low rates, and as government diversifies its sources of funding to international markets, the private sector will continue to access capital for further growth as we saw in 2014.

The stock market will remain a stock pickers market as select companies and sectors will continue doing well. The banking stocks remains one of the investor?s favorite, with high valuations expected to be supported by the positive growth in earnings in the coming years. The clarity on the implementation of the capital gains tax is still pending but that should slow the market just for a bit then the market picks up because in our view it is not significantly material to deter active trading by investors.

There is continued lack of institutional play on the Real Estate sector and this has continued to create opportunities for investors looking for good investments. We continue to expect that returns in the sector will be attractive if investors focus on the right sectors mainly focusing on the middle income. Given the good returns we expect to see a lot of both global and local funds looking for opportunities in the region. Most of the good investments are expected to be closer to major cities with good infrastructure surrounding them.

In General there is still room to make good returns in both listed and unlisted markets. For the unlisted stock the banking stocks are expected to continue edging up as earnings improve. On the unlisted stocks and Real Estate expectations are more players will come into the market to chase the good opportunities in the right sectors like financial service, Mining etc.

Global Markets Report - 2014

2014 began as the year that would validate the returns that were seen in the global Equity markets in 2013. It lived up to expectations as strong corporates earnings drove returns for equities in most regions. Strong returns from government bonds were the main surprise as long-term yields across developed markets declined from already low levels. Sentiment was shaped by the steep fall in the oil price and the strengthening US dollar, which had a negative impact on emerging economies, as well as the increasing divergence in central bank policy.

The beginning of Central Bank Policy divergence

Economic growth trends in the US and UK diverged from other major Western economies in 2014. While improvement in both US and UK economic conditions has begun to lead to expectations for interest rate increases in both countries by 2015, continued weakness in the Eurozone and Japan, exasperated by deflationary pressures and falling oil prices, further supports the case for monetary policy to be eased by the European Central Bank (ECB) and Bank of Japan (BoJ), in an attempt to stimulate demand.

Central Bank Outlook

In order to push for a well-orchestrated Global recovery efforts, for those countries possibly raising interest rates in 2015?such as the US and UK?the timing could be pushed back, and we expect to see the earliest rate hikes in the US only by Q2 2015. In the Eurozone, given the disappointment that the ECB took no further steps to boost growth at its December meeting, we expect further easing to come early, by Q1 2015.

United States

Major indexes all closed out 2014 within roughly 2% of their all-time highs, with the large-cap S&P 500 Index ending with double-digit gains for 2014, at 11.4%. US equities recorded strong gains in 2014, driven by corporate earnings, as the domestic economy continued to perform well amid hopes that lower oil prices would sustain momentum in the consumer-led recovery. This was despite the threat of rising interest rates and associated market volatility, which quieted down in Q4 2014 as the Fed took steps to ease anxiety indicating they will be ?patient? with interest rate hikes.

United States Outlook

A wide array of economic data has shown a clear pickup in momentum in the US economy towards the end of 2014. The uptrend in payroll gains will give a welcome push forward to personal income, which combined with falling energy costs, should boost consumption expenditure in Q1 2015.

However, even with a strong 2015 earnings outlook and other fundamental metrics signaling an equity upside, valuations seem stretched, with the Cyclically adjusted P/E ratio currently at 26.77X, and overly favored by investors, only to underperform when bond yields begin to climb, combined with the pressure of looming rate hikes.

We hence feel that US stock market appears set for further gains into Q2 2015, although risks are elevated stretched valuations.

Eurozone

The Stoxx Europe 600 ended 2014 with a 4.36% gain despite political uncertainties surrounding the markets. Market turbulence was evident towards the beginning of Q4 2014, with a sharp sell-off in early October following some weaker-than-expected macroeconomic data, stemming largely from Germany?s industrial sector, with manufacturing orders falling 5.7% month on month in August while industrial production declined by 4.0%. Overall though, the Eurozone?s economic performance remained lackluster with GDP growth of just 0.1% in Q3 2014 and inflation remaining low at only 0.3% by the end of 2014.

The end of 2014 was not to be without drama, as we saw the re-emergence of Eurozone break-up risk with Greece calling parliamentary elections for 25 January 2015 after the ruling party?s presidential candidate failed to garner sufficient support.

Eurozone Outlook

We have a bullish view on European markets for 2015 driven by:

1. Anticipated Quantitative Easing (QE) and aggressive liquidity actions by the ECB,

2. Improvement in European earnings trends should see a rising demand for equity.

This will not be without headwinds though, as the Russian sanction pressures amidst declining commodity prices, Greek elections and European deflation fears may erode confidence in many investors.

Japan

The Japanese stock market surged in the final quarter of 2014 and gained 6.2%, in yen terms, after a dramatic end to October that saw the announcement of further monetary policy easing by the Bank of Japan (BoJ). This constituted a genuine surprise for the financial markets and much of the market gain coincided with a significant weakening of the Yen.

Japan Outlook

We expect additional easing from the BoJ in the form of increased asset purchases by Q2 2015. Additionally, we expect core inflation to remain extremely low?close to 0%?in 2015, would prompt policymakers to take an action again in order to support inflation expectations. We are bearish on Japanese equities, guided by the risks that they could decline when markets start to price in rate hikes by the US Fed from Q2 2015.

Global Bonds

2014 presented a number of challenges to fixed income investors. Though fixed income broadly generated positive returns, bouts of elevated volatility led relative underperformance. Determined policy adjustment from the world?s major central banks, combined with weakness in oil prices, was the principal driver of returns for fixed income markets.

The 10-year US Treasury yield fell from 2.49% to 2.17%, and the equivalent gilt yield fell from 2.43% to 1.76%. The 10-year Bund yield fell further into historically low territory, from 0.95% to 0.54%. Peripheral Eurozone debt yields also fell, with Italian 10-year yields falling from 2.33% to 1.89% as the equivalent Spanish yield fell from 2.14% to 1.61%.

Conclusion

It feels, however, that 2014 was a year of reprieve from the inevitable low-return future in the Global Markets. Bond yields are likely unsustainably low, credit spreads are unlikely to narrow further and equity market valuations, at least in the United States, are stretched. The bar for generating returns is rising each year, returns which can now mainly be found in the alternatives space. This is evident, with Investor confidence in Private Equity and Real Estate increasing over the last six months, with 32% of investors stating that their investments have exceeded expectations over the last 12 months, an increase from the 10% of respondents that stated so in August 2013, a recent report by PREQIN shows. Looking ahead, 29% of investors plan to commit more capital to the asset class over the next year than they did over the previous 12 months, compared to 18%, which stated so in December 2013.

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