Cytonn INVESTMENTS

Cytonn 2020 Markets Outlook

Kenya Macro Economic Outlook:

In 2019, the Kenyan economy recorded an average growth of 5.4% for the first three quarters of 2019, compared to an average of 6.0% in a similar period in 2018. The subdued growth was mainly as a result of (i) slowdown in agricultural activities due to delayed long rains, which curtailed agricultural production, and (ii) decreased output in transport and electricity activities, due to the rise in prices of fuel and insufficient long rains in the first and second quarters, respectively.

We project 2020 GDP growth to come in between 5.6% and 5.8%, supported by:

i. Improvement in private sector credit growth, following the repeal of the interest rate cap, which is expected to improve market liquidity, coupled with improved access to credit by Micro, Small and Medium Enterprises (MSMEs). Banks will have sufficient margin to compensate for risks, and allocate funds away from the government towards lending,
ii. Stable growth of the agricultural sector, due to spillover effects from the heavy rains experienced in Q4'2019 and increased budgetary allocation to the sector for ongoing irrigation projects, strategic food reserves, cereal and crop enhancement and crop insurance schemes, in order to enhance food security and nutrition, which is a key pillar on the "***Big 4 Agenda***", and,
iii. Public infrastructural investments are expected to be driven by the budgetary allocations in infrastructural projects, with the 2019/20 allocation increasing by 3.9% to Kshs 435.1 bn from Kshs 418.8 bn in 2018/19.

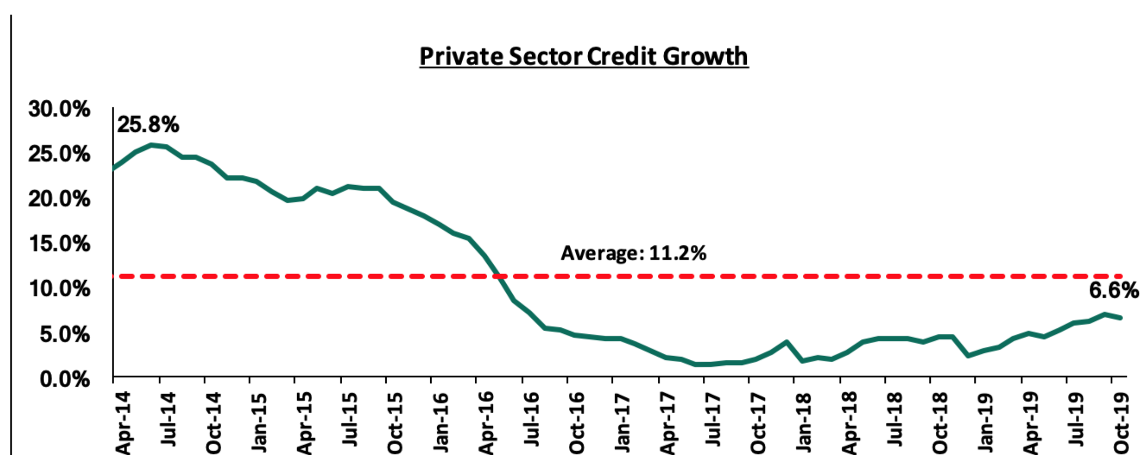
Risks abound to economic growth however include:

i. Debt sustainability which continues to be a key concern, with the public debt to GDP ratio currently estimated at 62.0% and the Government having substituted the debt ceiling that was previously pegged at 50.0% of GDP to an absolute figure of Kshs 9.0 tn. One of the key elements of debt sustainability in any economy is the ability to service it, and this is usually measured by revenue collection to total outstanding payments required, both in principal and interest payments. In this Financial year, the Government had budgeted to pay Kshs 139.0 bn (USD 1.4 bn) in foreign interest coupled with the repayment of the principal loan extended to Kenya for the first phase of the mega railway project which will kick off this year after the expiry of a five-year grace period that Beijing had extended to Nairobi for the loans used to build the standard gauge railway (SGR) line. Pressure from debt repayment raises a concern of the Government funding the fiscal deficit in the FY'2019/20 budget, which might force a reduction in expenditure and in effect a decline in economic growth,
ii. The Kenyan Government has continued to stress out its fiscal consolidation strategy going forward in order to reduce country's fiscal deficit, which is currently at 6.2% of GDP, from 7.7% in 2018/19, and against a target of 5.6% of GDP. This might adversely affect economic growth due to reduced government spending and in a bid to mitigate this, there are expectations of adoption of an accommodative monetary policy stance to support economic activity. We are of the view that accommodative monetary policy which is a strategy implemented by the Central bank in order to stimulate and encourage economic growth by lowering short term interest rates, however, cannot fully offset the impact of a fiscal tightening and as such this might lead to slower economic

growth. We also believe that the Kenyan Government has limited fiscal space due to the continued underperformance of tax revenues, coupled with the pressure to plug in the fiscal deficit due to the expectations of reduced accessibility to local debt in the post rate cap era. This is in addition to pressure to meet the external borrowing with repayment of the principal loan extended to Kenya for the first phase of the mega railway project having kicked off this year after a five-year grace period that Beijing had extended to Nairobi for the loans used to build the standard gauge railway (SGR) line ended on 31st December 2019, and,

iii. Ongoing concerns on the sustainability of growth in some of the major sectors, which recorded subdued performance in 2019 such as the agricultural sector, manufacturing sector, taxes on products and tourism sector which recorded an average growth of 4.2%, 3.5%, 4.8%, 9.9% in the first 3 quarters of 2019, respectively down from 4.2%, 3.5%, 4.8% and 9.9% in a similar period of review in 2018.

Private sector credit growth improved in 2019, averaging 4.2% in the 10-months to October, compared to 3.4% in a similar period in 2018, but remained below the 5-year average of 11.2%. The low credit growth had persisted since the enactment of the Banking (Amendment) Act, 2015, which made it difficult for banks to adequately price risk, prompting them to reassess their risk assessment framework, preferring to lend to the government where the returns were higher on a risk-adjusted basis, at the expense of the private sector. With the rate cap repeal and the ongoing reforms in the banking sector to strengthen the credit information sharing mechanism and promote transparency in pricing, we expect private sector credit growth to improve but remain well below the government target of 18.3%.



Currency:

The Kenyan Shilling remained resilient in 2019, appreciating by 0.5% against the USD during the year to close at Kshs 101.3, from Kshs 101.8 in 2018, mainly supported by inflows of hard currency from remittances by Kenyan workers abroad and offshore investors. On a YTD basis, the Kenyan Shilling has depreciated by 0.3% against the US Dollar.

We expect the shilling to remain stable within a range of Kshs 101.0 and Kshs 104.0 against the USD in 2020 with a bias to a 2.4% depreciation by the end of 2020.

We expect the pressure on the Kenyan shilling to arise from:

i. Increased oil imports bill, as a result of the U.S - Iran diplomatic row, which has seen average crude oil prices increase by 9.9% to an eight-month high to USD 72.0 a barrel, from USD 65.5 a barrel in December 2019,

ii. Subdued diaspora remittances growth following the close of the 10.0% tax amnesty window in July which has seen cumulative diaspora remittances increase by a marginal 5.0% in the 12-months to November 2019 to USD 2.8 bn, from USD 2.7 bn, which was slower than the 40.8% growth recorded in a similar period of review in 2018 and the ongoing spat between U.S and Iran which

could lead to a slowdown in diaspora remittances, and,

iii. Repayments of the principal loan extended to Kenya for the first phase of the mega railway project having kicked off this year which is expected to cause a decline in the country's forex reserves with a good chunk of forex reserves in Kenya being from the issuance of debt.

Inflation:

In 2019, inflation averaged 5.2% compared to the 2018 average of 4.7%. Inflation rose towards the tail end of the year to 5.8% in December, mainly due to rising food prices.

We expect inflation to average 5.2% in 2020, within the government target range of 2.5% - 7.5% with inflationary pressure gradually easing off, due to improved agricultural production thus causing a decline in food prices following favorable weather conditions.

We expect inflationary pressure from an expected increase in fuel prices due to increased external uncertainties such as the current U.S-Iran diplomatic row.

Interest Rates:

Despite our expectations of a bias towards expansionary monetary policy in 2020 to support economic activity, we still expect upward pressure on interest rates due to increased pressure on the government to meet its domestic borrowing target to plug in the fiscal deficit, in the current post- interest rate cap era.

According to the 2019 Budget Review and Outlook Paper, total revenues for the FY'2019/20 are projected at Kshs 2.1 tn (equivalent to 20.2% of GDP), with ordinary revenues at Kshs 1.9 tn (equivalent to 17.9% of GDP).

The fiscal deficit is therefore projected at Kshs 640.2 bn (equivalent to 6.2% of GDP), which is expected to be financed by net external financing of Kshs 331.3 bn (equivalent to 3.2% of GDP), and Kshs 305.7 bn (3.0% of GDP) from domestic borrowing. Following the repeal of the interest rate cap repeal, which will now allow banks to price risk and thus admit riskier borrowers including SMEs and individuals, we expect to see a reduction in subscription rates for government securities as banks increase their focus on private sector lending. This was also recorded in the tail end of 2019 where T-bill subscription in the primary auction market declined from an average of 125.4%, from January 2019 to November 7th 2019 before the repeal of the rate cap, to 48.4% for the post interest rate cap period between November 7th 2019 and 31st December 2019.

Considering banks are the largest holders of domestic debt, we expect this to force an upward readjustment on the yield curve in order to incentivize more uptake.

The table below summarizes the various macro-economic factors and the possible impact on the business environment in 2020. With three indicators being positive, three at neutral and one negative, the general outlook for the macroeconomic environment in 2020 is NEUTRAL.

Macro-Economic & Business Environment Outlook

Macro-Economic Indicators	2020 Outlook	Effect
Government Borrowing	• With the expectations of KRA not achieving the revenue targets, we expect this to result in further widening of the fiscal deficit which ought to be plugged • On the domestic front, due to the rate cap repeal, we expect banks to increase their credit accessibility and admit riskier borrowers including SMEs and individuals, which will see a reduction in subscription rates for government securities • On the foreign front repayment of the principal loan extended to Kenya for the first phase of the mega railway project kicks off this year after a five-year grace period that Beijing had extended to Nairobi for the loans used to build the standard gauge railway (SGR) line ended on 31st December 2019 which will see Loan repayments to China's Exim Bank jump by 130.0% to Kshs 71.4 bn in the current financial year from the Kshs 31.0 bn paid in the last fiscal year putting more pressure on the Government in meeting the foreign debt target	**Negative**
Exchange Rate	• We project that currency will range between Kshs 101.0 and Kshs 104.0 against the USD in 2019, with continued support from the CBK in the short term through its sufficient reserves currently at USD 8.8 bn (equivalent to 5.4-months of import cover), above the statutory requirement of maintaining at least 4.0-months of import cover, and the EAC region's convergence criteria of 4.5-months of import cover	**Neutral**
Interest Rates	• Despite the expectations of a bias towards expansionary monetary policy in 2020, we expect slight pressure on interest rates following the repeal of the interest rate cap which in effect is expected to result in increased competition for bank funds from both the private and public sectors as the Government tries to raise funds to plug in the budget deficit	**Neutral**
Inflation	• We expect inflation to average 5.2% and within the government target range of 2.5% - 7.5%	**Positive**
GDP	• We project GDP growth for 2020 to come in at 5.7%, slightly higher than our 5.6% 2019 expectations, but similar to the 5-year historical average of 5.7%	**Neutral**
Investor Sentiment	• We expect 2020 to register improved foreign, mainly supported by long term investors who enter the market looking to take advantage of the current low/cheap valuations in select sections of the market	**Positive**
Security	• We expect security to be maintained in 2020, especially given that the political climate in the country has eased	**Positive**

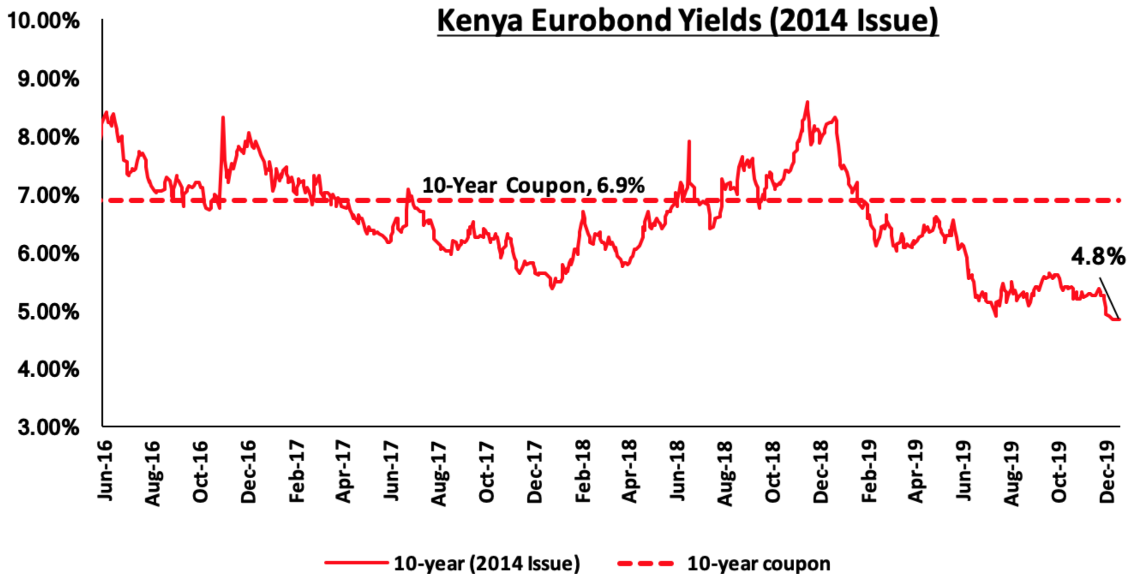
The two changes from last year's outlook are:

- GDP to *neutral* from *positive* in 2019 necessitated by the government's fiscal consolidation strategy going forward in order to reduce country's fiscal deficit, which might adversely affect economic growth due to reduced government spending and existing concerns on the sustainability of growth in some of the major sectors which recorded subdued performance in 2019 such as the agricultural sector, manufacturing sector, taxes on products and tourism sector, and,
- Investor sentiment also changed to *positive* from *neutral* in 2019, necessitated by the increased net foreign inflows in the equity markets as well as the reduced risk perception, which has seen the country's credit rating by Fitch Ratings come in at B+ highlighting the country's stable outlook.

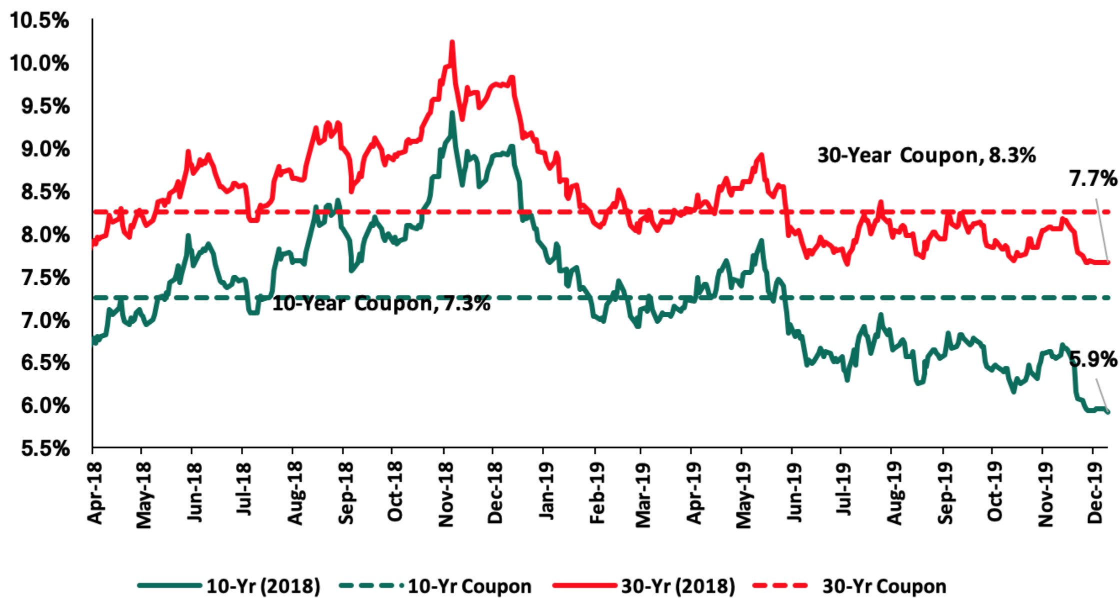
Out of the seven metrics that we track, three have a positive outlook while three have a neutral outlook and one has a negative outlook, unchanged from last year where three had a positive outlook, three had a neutral outlook and one had a negative outlook. However, the general outlook for macroeconomic environment changes to NEUTRAL for 2020, from POSITIVE in 2019.

Eurobond Yields:

According to Reuters, yields on the 10-year Eurobond issued in 2014 decreased by 3.5% points to close at 4.8% at the end of 2019, from 8.3% at the end of 2018. With Rating agencies Moody's and Fitch Ratings having retained the country's credit at "B2" and "B+", respectively, highlighting the country's stable outlook, we do not expect investors to attach a higher risk premium on the country and as such the yields to remain stable. Risks are however abounded due to concerns on the country's debt sustainability with the debt to GDP ratio in 2019 estimated at 62.0%. According to the IMF, the target debt to GDP for developing countries should be at or below 50.0%, meaning that the current debt level in the country has surpassed the standard set by the global lender, and this may pose fiscal challenges if mechanisms are not put in place to improve on Kenya's fiscal and public finance management framework.



For the February 2018 Eurobond issue, the yields on the 10-year Eurobond and the 30-year Eurobond have declined by 3.1% points and 2.1% points to close the year at 5.9% and 7.7% from a yield of 9.0% and 9.8% at the close of 2018, respectively.



For the May 2019 dual-tranche Eurobond issue, the yields on the 7-year Eurobond and the 12-year Eurobond have declined by 1.2% points and 1.1% points to close the year at 5.8% and 6.9% from a yield of 7.0% and 8.0% when they were first issued in 2019, respectively.