Friday, 24 January 2020

**Issue No.1**

# Macroeconomic Report

## January 2020

# Kenya Economy Review & Outlook 2020

**"A year of Pluses and Minuses"**

**Analysts:**

**Renaldo D'Souza**
+254 (20) 2222651
Renaldo.DSouza@sterlingib.com

**Susan Makena**
+254 (20) 2222651
Susan.Makena@sterlingib.com

**Elizabeth Njenga**
+254 (20) 2222651
Elizabeth.Njenga@sterlingib.com

**Justina Vuku**
+254 (20) 2222651
Justina.Vuku@sterlingib.com

**For queries call:** +254 (20) 315414; 2244077 or
**Email:** research@sterlingib.com
**Website**
www.sterlingib.com
**Bloomberg Code:** SCLK <GO>

*For important disclosures refer to the disclosures section located at the end of this report.*

**Table of Contents**

Executive Summary ....2
1. ECONOMIC PERFORMANCE & OUTLOOK ....3
Global economy to slow down in 2019, gradual recovery expected in ....3
2020 ....3
2. KENYA ECONOMIC REVIEW & OUTLOOK ....4
A) Economic Growth - Economy to bounce back in 2020 from 2019 slowdown ....4
Private and Government expenditure to drive 2019/2020 economic growth ....6
B) National Accounts - Growing fiscal budget deficit and debt financing a key concern ....8
Kenya's Debt to GDP Ratio crosses 60% mark putting pressure on debt service costs ....10
C) Interest rates & monetary policy ....11
Commercial Bank interest rates and private sector credit growth ....12
Monetary policy likely to remain unchanged in 2020 ....14
D) Inflation - Edged up in 2019, forecast 5.5-6% in 2020 ....14
3. CURRENCY PERFORMANCE/FOREIGN EXCHANGE ....15
Kenya Shilling's ends on a high after temporary demonetization setback ....15
Diaspora remittances, capital inflows and favourable reserve position support the KES. ....16
Marginal currency depreciation expected in 2020 ....21
4. PERFORMANCE OF CAPITAL MARKETS ....21
A) Equities - Banks end year rally reverse early year losses ....21
NSE's tepid performance to continue into 2020 ....23
B) Fixed income - Investors preference for shorter tenor debt ....24
Optimistic about fixed income returns and secondary market trading opportunities in 2020 ....25
Rising public debt a political risk concerns ....26
5. POLITICAL OUTLOOK ....26
Disclosures: ....28



*For important disclosures refer to the disclosures section located at the end of this report.*

## Executive Summary

- Our Kenya macro-economic review and outlook 2020 report titled **"A Year of Pluses and Minuses"** highlights the performance of the economy in 2019 and our forecast of the main macro-economic variables and influences on the economy in 2020.
- The report begins with a 2019 review and 2020 forecast of the economic performance of the global economy which is **expected to record a marginal improvement to 2.5% (2019-2.4%)** and includes specific economic regions including the United States, the Euro area, emerging markets and Sub-Saharan Africa.
- The performance of Kenya's main macro-economic factors including **Gross Domestic Product (GDP), public debt, interest, inflation and foreign exchange rates** are discussed in the next section.
- On economic growth, **Kenya's GDP is forecasted to grow at 5.8% an improvement from the estimated 5.6%** with **private consumption** expected to drive this growth
- **Government revenue, expenditure, fiscal deficit** and its implication on the country's public debt is extensively covered in national accounts where we show **concern for rising fiscal deficit, debt and costs of debt financing.**
- **Interest rates and monetary policy** formed the basis of most debates and legislation in the country in 2019 and the potential impact of the **repeal of the interest capping law on both domestic debt and commercial bank interest rates as well as private sector credit** is covered.
- **Inflation and foreign exchange rates** have been and are expected to remain relatively stable in 2020 but not without risks.
- The **Nairobi Securities Exchange (NSE)** forms part of the country's financial sector its performance, outlook and risks are discussed under **performance of capital markets**.
- The macro-economic report would be incomplete without an **overview of the country's current and near future political environment**, which has a significant impact on both local and foreign investor sentiment and general economic performance.
- In summary, **we are optimistic about the overall performance of the economy in 2020** with minimal deviations in the performance of specific macro-economic variables.
- Internal and external risks including local and **global geo-political tensions, rising public debt levels and fiscal pressures** exist and could alter our forecasts.



*For important disclosures refer to the disclosures section located at the end of this report.*

## 1. ECONOMIC PERFORMANCE & OUTLOOK

### Global economy to slow down in 2019, gradual recovery expected in 2020

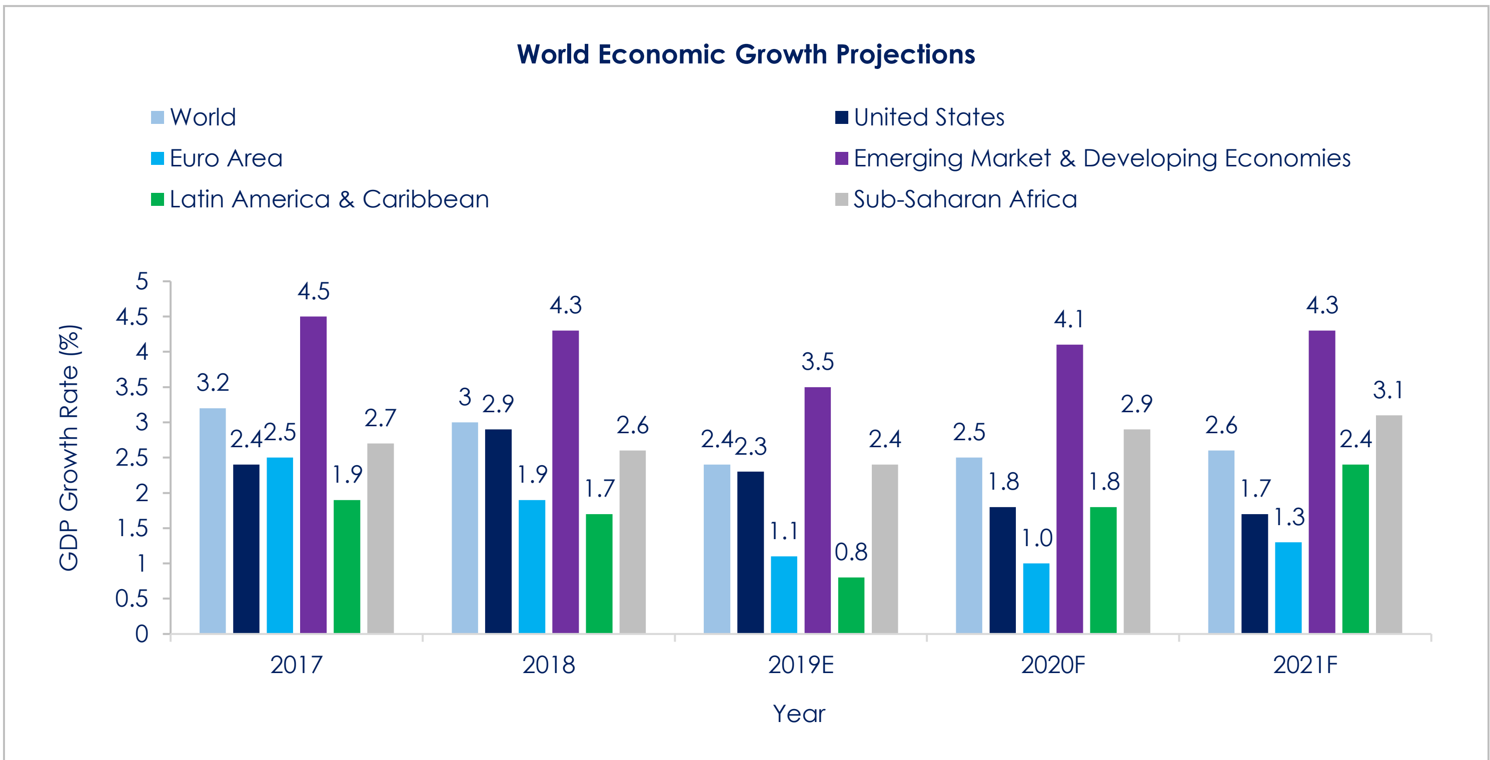
Global economy expected to make a modest recovery 2.5% in 2020 from 2.4% in 2019, its slowest growth since the financial crisis in 2008.

- Global economic growth is expected to rise to 2.5% in 2020 from an estimated 2.4% in 2019 (slowest growth reported since the global financial crisis in 2008) on improved trade and investment (Fig.1).
- The World Bank attributes subdued growth in 2019 to "continued weakness in global trade and investment".
- Trade disputes between the United States and China and protectionist policies adversely impacted trade and investor sentiment during the year.
- Improved growth in 2020 to be driven by improved performance of selected emerging market economies in Latin America, the Middle East and Emerging Europe.
- In China, trade disputes with the United States and low domestic consumer demand is expected to negatively impact growth of both countries in 2020.
- Developing countries are expected to exhibit strong growth but are exposed to external risks such as the trade wars, Brexit, domestic economic policies amongst other factors.
- GDP growth in Sub-Saharan Africa is estimated at 2.9% in 2019 and forecasted at 3.1% and 3.2% in 2020 and 2021respectively driven by improved investor confidence, improved oil production for oil producers and increased agricultural export volumes.
- Downside risks in the region include lower export trade volumes, rising public debt, currency depreciation and political instability.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.1: World Economy to slow down in 2019, expected to pick up in 2020**




Source: World Bank

## 2. KENYA ECONOMIC REVIEW & OUTLOOK

### A) Economic Growth - Economy to bounce back in 2020 from 2019 slowdown

> 2019-2020 GDP forecast 5.6 - 5.8% driven largely by private sector and Government consumption spending.

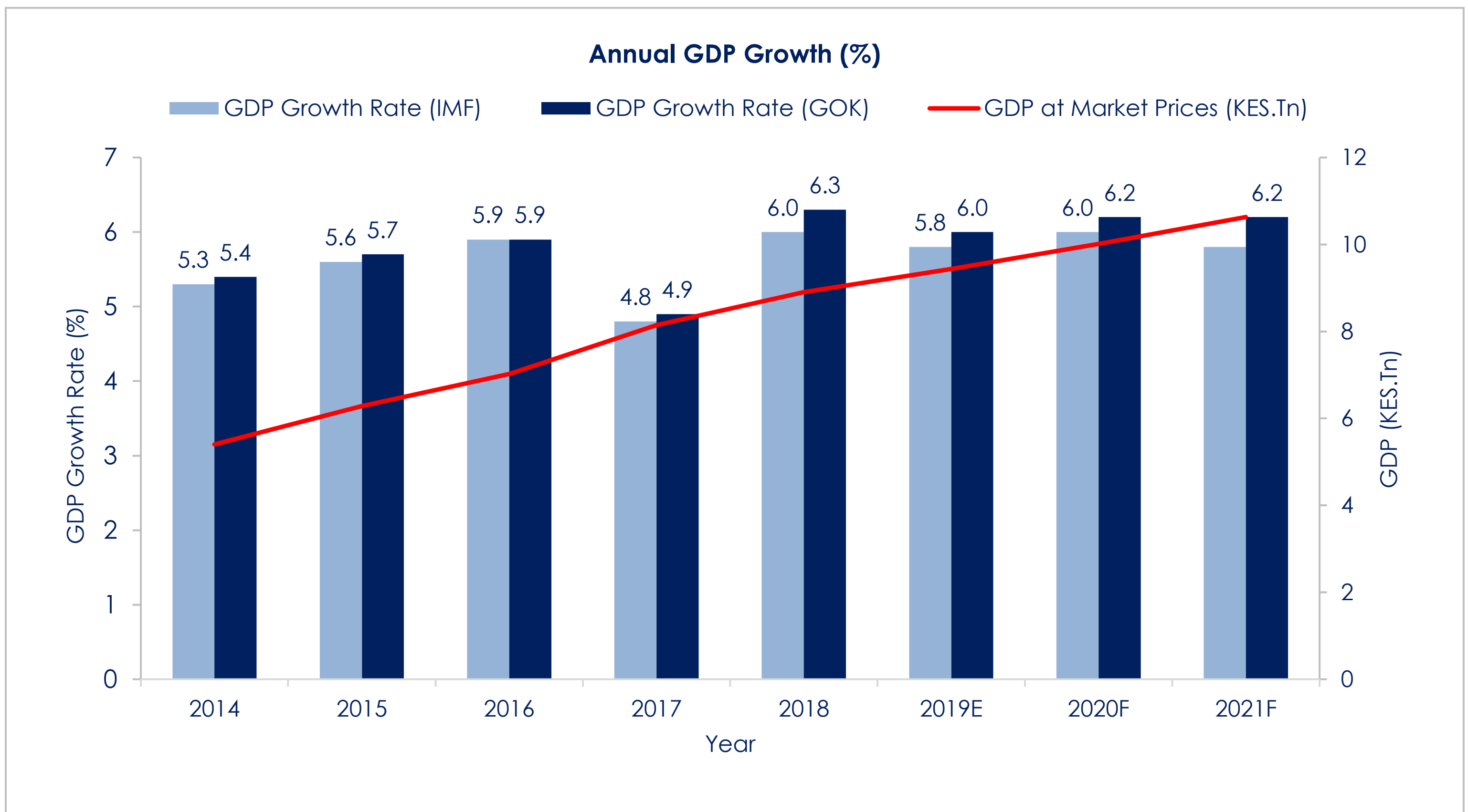
- Economy recorded growth rate of 5.6% in both Q1 and Q2 2019 compared to 6.5% and 6.4% respectively over the corresponding periods in 2018 and this forms our 2019 growth forecast of 5.6% - 5.8% (Fig.2).
- We believe that the Government's 6% forecast for 2019 is optimistic considering the slowdown in economic output of the main economic sectors particularly agriculture, manufacturing and construction.
- On the contrary, we expect the financial sector to record an improved performance in both 2019 and 2020.
- This performance will be a direct result of positive performance of the Nairobi Securities Exchange buoyed by the repeal of the interest rates capping law in November 2019 and general positive sentiment on the prospects of the sector.
- Improved weather conditions should be supportive of growth of the agricultural sector while increased investment by the Government and private sector in the Big 4 agenda focus areas of manufacturing and housing (construction) will have a positive impact on the performance of the sectors in 2020.



*For important disclosures refer to the disclosures section located at the end of this report.*

- We are concerned that most economic activity in 2019 and 2020 will be driven by debt driven Government expenditure with minimal contribution by the private sector sectors.
- Increase in private sector credit following the law repeal will result in gradual growth in both private investment and household consumption.
- Government spending on the big 4 agenda together with private investment on the same should be supportive of economic growth although we are concerned on the availability of funding.
- Risks to this forecast include external shocks from US/China trade wars, Brexit with the UK being a key trading partner, political tensions in the run-up to the 2022 general election and possibility of a referendum before the election.

**Fig.2: Economy to make a modest recovery in 2020 from 2019 slowdown**




Source: National Treasury, International Monetary Fund and Sterling Capital Research



*For important disclosures refer to the disclosures section located at the end of this report.*

## Private and Government expenditure to drive 2019/20 economic growth

Private consumption is the biggest GDP growth driver and is expected to increase following the repeal of the interest capping law.

- Private consumption remains the biggest contributor to GDP growth at an average of 80% over the last 5 years (Table1. and Fig.3).
- We forecast a gradual improvement in private sector credit growth that will boost household consumption (improved growth already recorded in 2019 and higher growth expected in 2020 following the repeal of interest rate capping law in November 2019) (Table.2.).
- Private sector investment is subdued a trend attributable to significant increase in domestic borrowing with banks showing a preference for Government debt over private sector lending.
- **In addition, delayed Government payments to the private sector have negatively impacted cash flow and resulted in a decline in employment and in turn private consumption, investment and savings (Fig.4).**
- **Regulation especially on minimum wage and employer-employee relations as well as increased taxation has increased business operation costs and negatively impacted employment as companies have been forced to downsize thus explaining our grim forecasts.**
- Government expenditure has declined in spite of increased borrowing with most capital investment projects near completion.
- Government expenditure will remain relatively low following a combination of a decline in domestic borrowing and an expected rise in borrowing costs following the interest rate cap repeal (national accounts shows a drop in domestic and external borrowing in 2019/20) with more focus on driving tax revenues to finance the fiscal budget deficit.
- Import/export data available up to September 2019 shows a decline in both exports (-4.9%) and imports (-3.7%) compared to the same period in 2019.
- Following the expected increase in credit growth and its impact on economic activity, we also expect an improved contribution to GDP in 2020.

### Table.1: GDP composition analysis and forecasts

| **Expenditure on the Gross Domestic Product 2014-2018 (% Contribution)** | | | | | | |
|---|---|---|---|---|---|---|
| **Expenditure Category** | **2014** | **2015** | **2016** | **2017** | **2018*** | **2019E** |
| Government final consumption expenditure | 13.9 | 14.1 | 12.9 | 12.7 | 12.9 | 12.7-13.0 |
| Private final consumption expenditure | 79.9 | 78.8 | 78.8 | 81.6 | 81.8 | 80.0-82.0 |
| Gross fixed capital formation | 22.9 | 21.6 | 17.6 | 18 | 17.3 | 17.0-18.0 |
| Changes in inventories | -0.4 | -0.1 | 0.6 | 0.8 | 1.1 | N/A |
| **Gross domestic expenditure** | **116.2** | **114.4** | **110** | **113.1** | **113.1** | **110-112** |
| Exports of goods and services | 18.3 | 16.6 | 14.3 | 13.3 | 13.2 | 13.0-13.2 |
| Imports of goods and services | 33.0 | 27.6 | 23.3 | 24.2 | 23.0 | 23.0-24.0 |
| Discrepancy** | -1.5 | -3.4 | -1.0 | -2.1 | -3.3 | N/A |
| **Gross domestic product at market prices** | **100** | **100** | **100** | **100** | **100** | **100** |

* Provisional
**Difference between GDP production approach and expenditure approach

Source: Kenya National Bureau of Statistics, World Bank and Sterling Capital Research



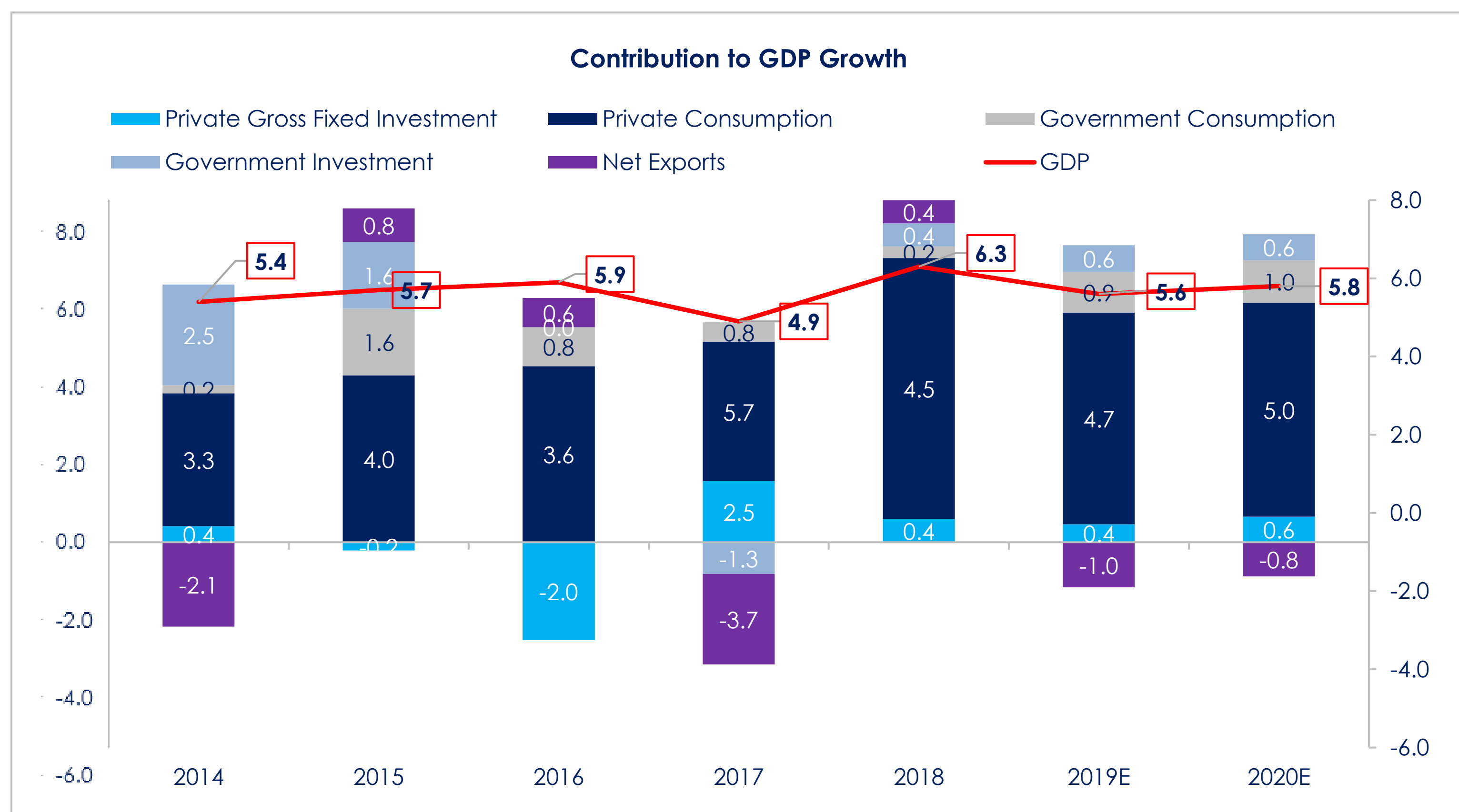
*For important disclosures refer to the disclosures section located at the end of this report.*

## Table.2: GDP growth trends analysis and forecasts

| Growth in expenditure on the Gross Domestic Product 2014-2018 (% Change) | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Expenditure Category** | **2014** | **2015** | **2016** | **2017** | **2018** | **2019e** | **2020F** |
| Government final consumption expenditure | 1.7 | 11.5 | 5.6 | 5.1 | 1.0 | **6.6** | **5.6** |
| Private final consumption expenditure | 4.3 | 5.2 | 4.7 | 7.6 | 5.9 | 6.1 | 6.6 |
| Gross fixed capital formation | 14.2 | 6.6 | -9.2 | 6.4 | 4.6 | 5.7 | 5.1 |
| Changes in inventories | 295.2 | 43.7 | -91.4 | -545.5 | 150.9 | N/A | N/A |
| **Gross domestic expenditure** | **5.1** | **5.9** | **3.2** | **7.5** | **5.5** | **N/A** | **N/A** |
| Exports of goods and services | 5.8 | 6.2 | -2.2 | -6.8 | 4.0 | 4.5 | 4.6 |
| Imports of goods and services | 10.4 | 1.2 | -3.4 | 8.7 | 2.6 | 5.9 | 6.0 |
| **Gross domestic product at market prices** | **5.4** | **5.7** | **5.9** | **4.9** | **6.3** | **5.6** | **6.0** |

Source: Kenya National Bureau of Statistics and World Bank

## Fig.3: Private consumption remains the biggest driver of Kenya's GDP

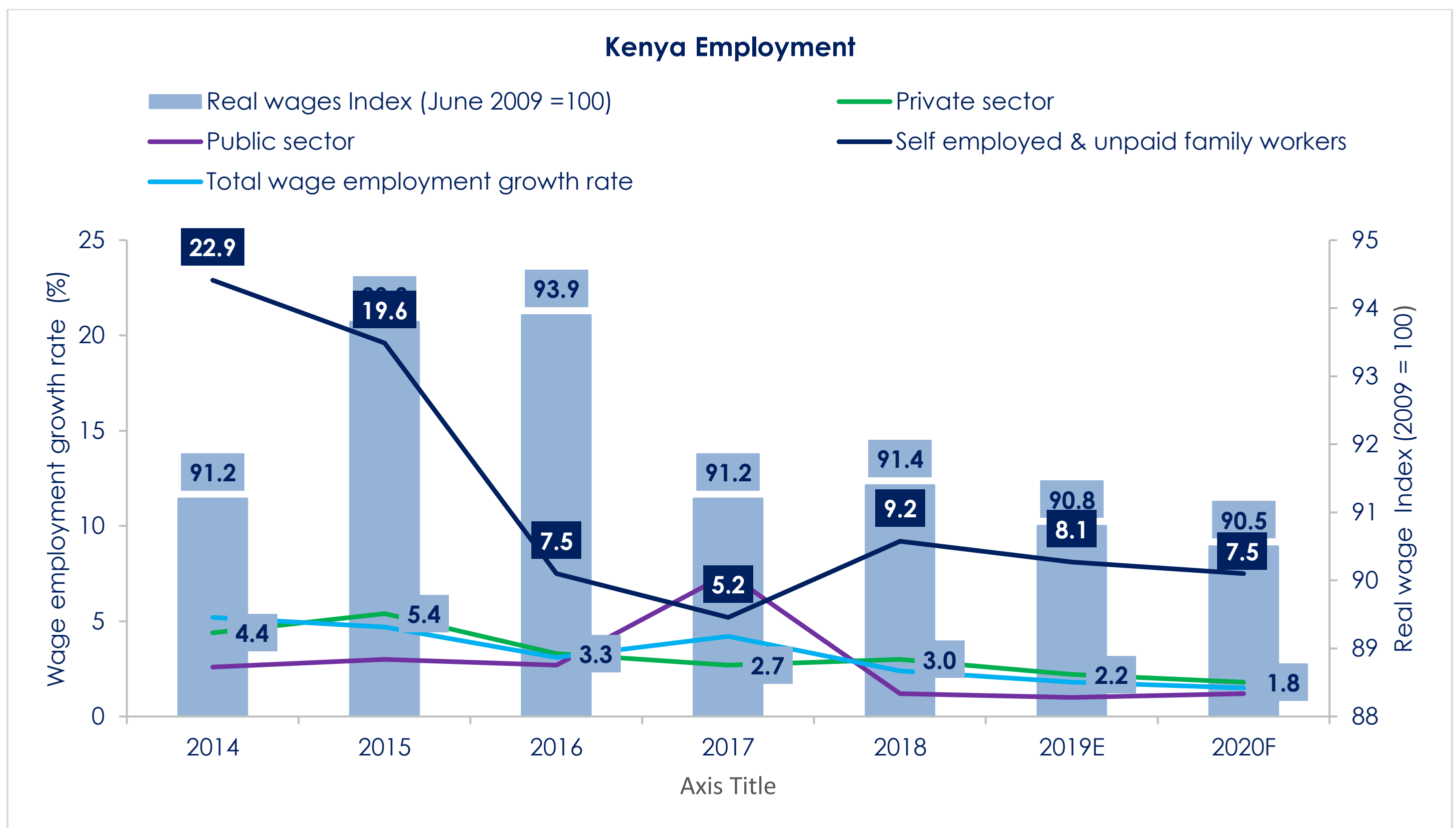



Source: Kenya National Bureau of Statistics and Sterling Capital Research



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.4: Total wage employment and real wages declining, to continue negatively impacting economic growth**




Source: Kenya National Bureau of Statistics and Sterling Capital Research

## B) National Accounts - Growing fiscal budget deficit and debt financing a key concern

> Fiscal deficit expected to grow on increased expenditure and lower than forecasted revenue collection.

- An analysis of Kenya's current and projected financial position shows a growing budget deficit amid rising expenditure and lower than projected revenues (Table.3 and Fig.5).
- The 2019/20 supplementary budget shows a KES.80.1Bn increase in overall budget comprising of a 12.2% increase in development expenditure (KES.85.5Bn) and a 0.5% reduction in recurrent expenditure (KES.5.7Bn).
- We believe that the 25.9% increase in projected revenue in FY2019/20 over actual revenue FY2018/19 is optimistic and unachievable at the current run rate.
- The supplementary budget shows a deficit financing target of KES.331.3Bn (external) and KES.308.9Bn (domestic) 2.1% and 8.2% higher than what was projected in the 2019/20 fiscal budget (KES.324.3Bn external and KES.283.5Bn domestic).
- There is a deficit of KES.146.3Bn deficit that is yet to be allocated to domestic or external financing and for this reason we expect further upward adjustments in both financing sources.
- We also take note the expected increase in domestic financing costs following the repeal of the interest capping law which means debt service



*For important disclosures refer to the disclosures section located at the end of this report.*

costs are likely to arise.

**Table.3: Kenya National Accounts - Fiscal deficit on the rise**

| Fiscal Budget Item | 2017/18 Actual | 2018/19 Target | 2018/19 Actual | Growth | 2019/20* Target |
|---|---|---|---|---|---|
| **Total Revenue and Grants** | **1,549** | **1,830** | **1,691** | **9.2%** | **2,129** |
| **Revenue** | **1,522** | **1,795** | **1,671** | **9.8%** | **2,091** |
| Ordinary Revenue | 1,365 | 1,588 | 1,497 | 9.7% | |
| Appropriation in Aid** | 157 | 206 | 174 | 10.8% | |
| Grants | 26 | 35 | 20 | -23.1% | 38.8 |
| **Expenditure and Net-Lending*** | **2,147** | **2,555** | **2,406** | **12.1%** | **2,916** |
| Recurrent | 1,350 | 1,583 | 1,496 | 10.8% | 1,739 |
| Development and Net Lending | 470 | 602 | 542 | 15.3% | 793.2 |
| County Governments | 327 | 365 | 361 | 10.4% | 384 |
| **Deficit** | | | | | |
| **Deficit Excluding Grants (Commitments)** | **-624** | **-761** | **-735** | **17.8%** | **-825** |
| **Deficit Including Grants (Commitments)** | **-598** | **-726** | **-715** | **19.6%** | **-787** |
| Deficit Including Grants (Cash) | -632 | -651 | -721 | 14.1% | |
| **Financing** | **631** | **651** | **721** | **14.3%** | **640** |
| Foreign Financing | 355 | 445 | 415 | 16.9% | 331 |
| Other Domestic Financing | 3 | 4 | 3 | 0.0% | |
| Net Domestic Financing | 274 | 202 | 304 | 10.9% | 309 |
| **Financing Gap** | **274** | **202** | **304** | **10.9%** | **-146** |

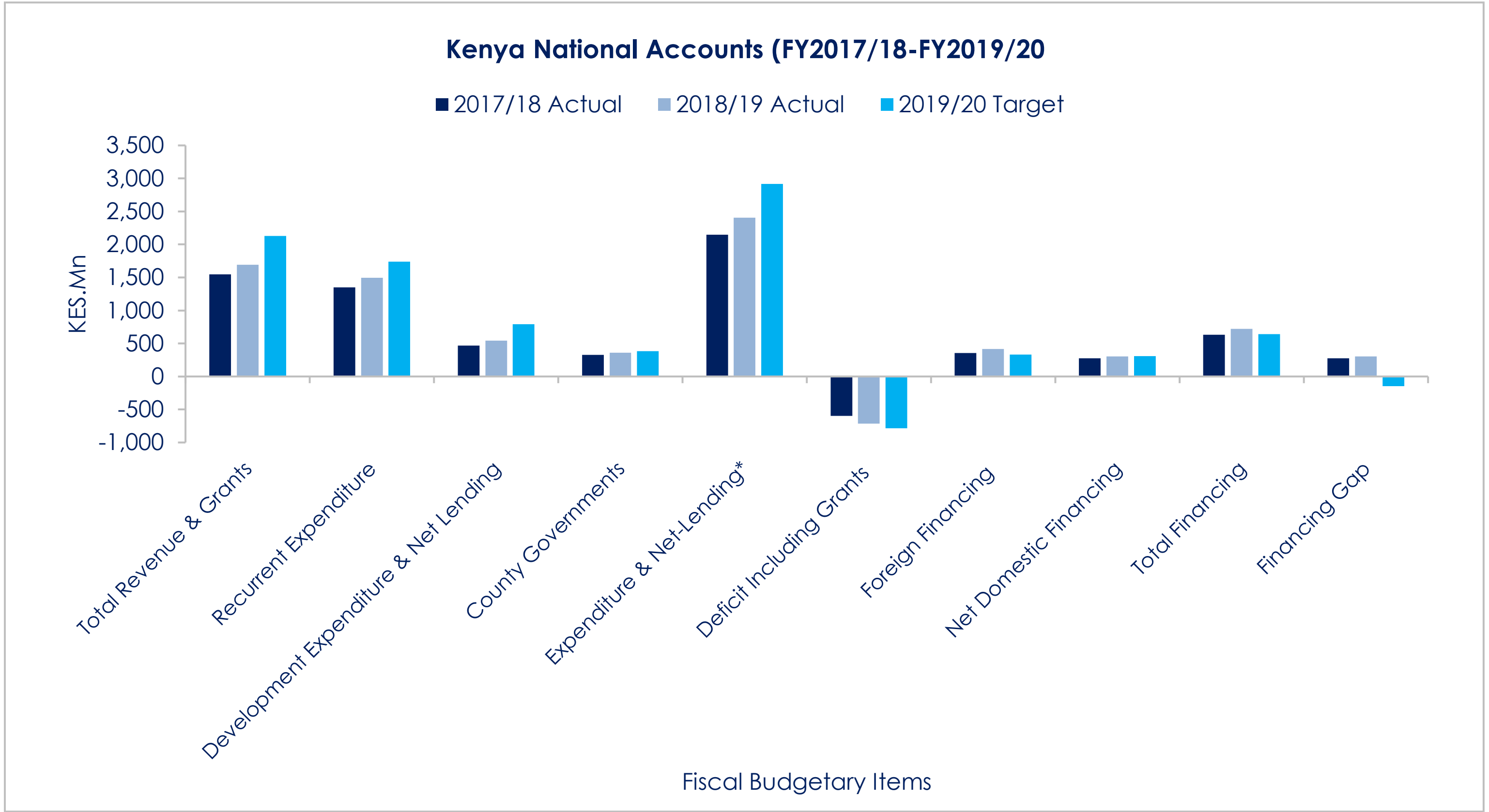
*Supplementary Budget Estimates 2019/20 (November 2019)

Source: Kenya National Treasury



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.5: Rising expenditure and lower than forecasted revenues has resulted in a widening fiscal deficit**




Source: Kenya National Bureau of Statistics and Sterling Capital Research

## Kenya's Debt to GDP Ratio crosses 60% mark putting pressure on debt service costs

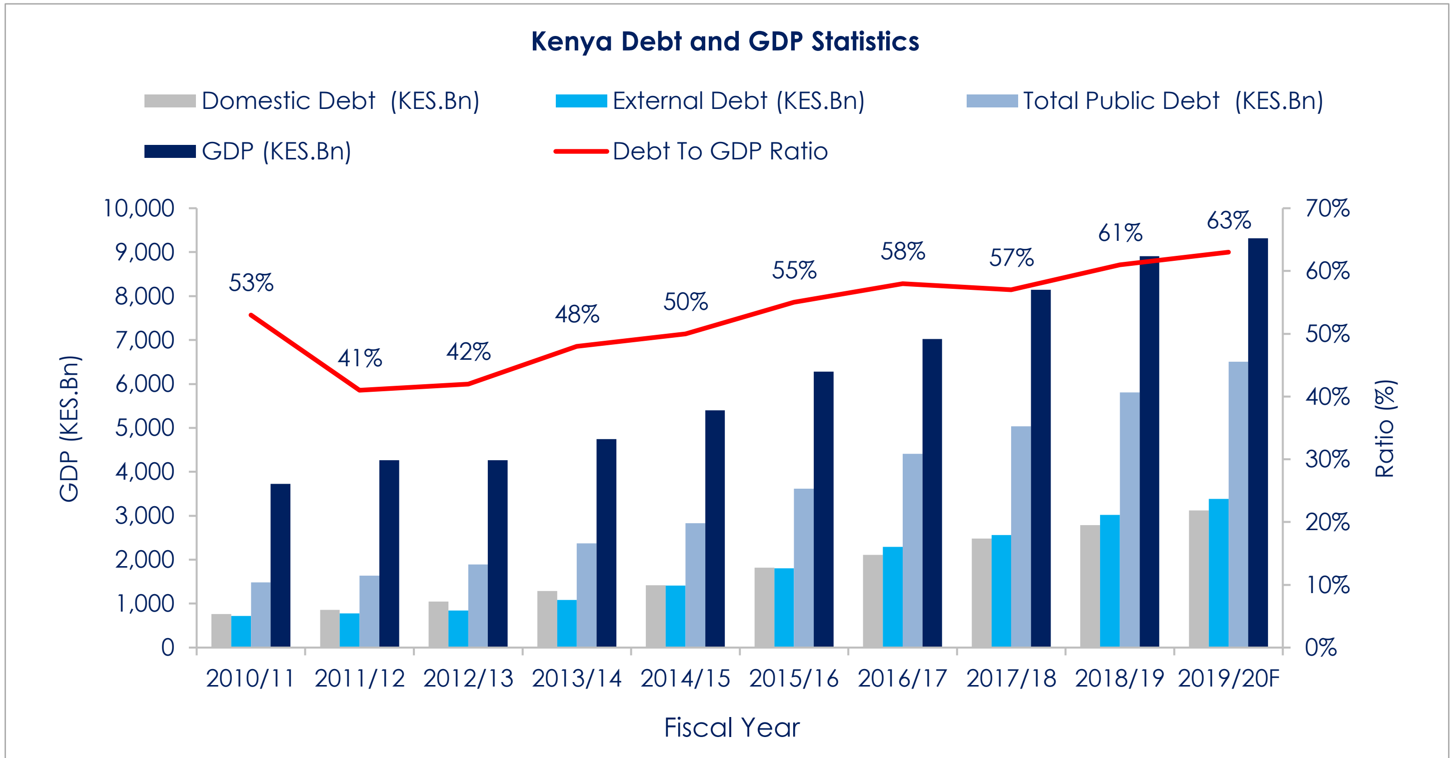
Rising debt and slowdown in economic growth to push GDP further above 60%.

- Kenya's debt to GDP is estimated at 61% and is forecasted at 63% in 2020 (Fig.6).
- This is a concern considering the expected slowdown in economic growth in 2019 and 2020 and rising debt service costs.
- Domestic debt service costs in particular are expected to increase following the repeal of the interest capping law and this rise should offset declining average external funding costs following declining global interest rates.
- In addition to rising interest rates, the Government is faced with a growing budget deficit which means additional domestic financing as indicated in the supplementary budget released in November 2019 will be required.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.6: High commercial bank liquidity a result of low private sector credit**




Source: Kenya National Treasury, World Bank and Sterling Capital Research

## C) Interest rates & monetary policy

- Both domestic debt and commercial bank interest rates remained stable during the period in review largely due the impact of interest rate caps.

**Domestic debt interest rates**

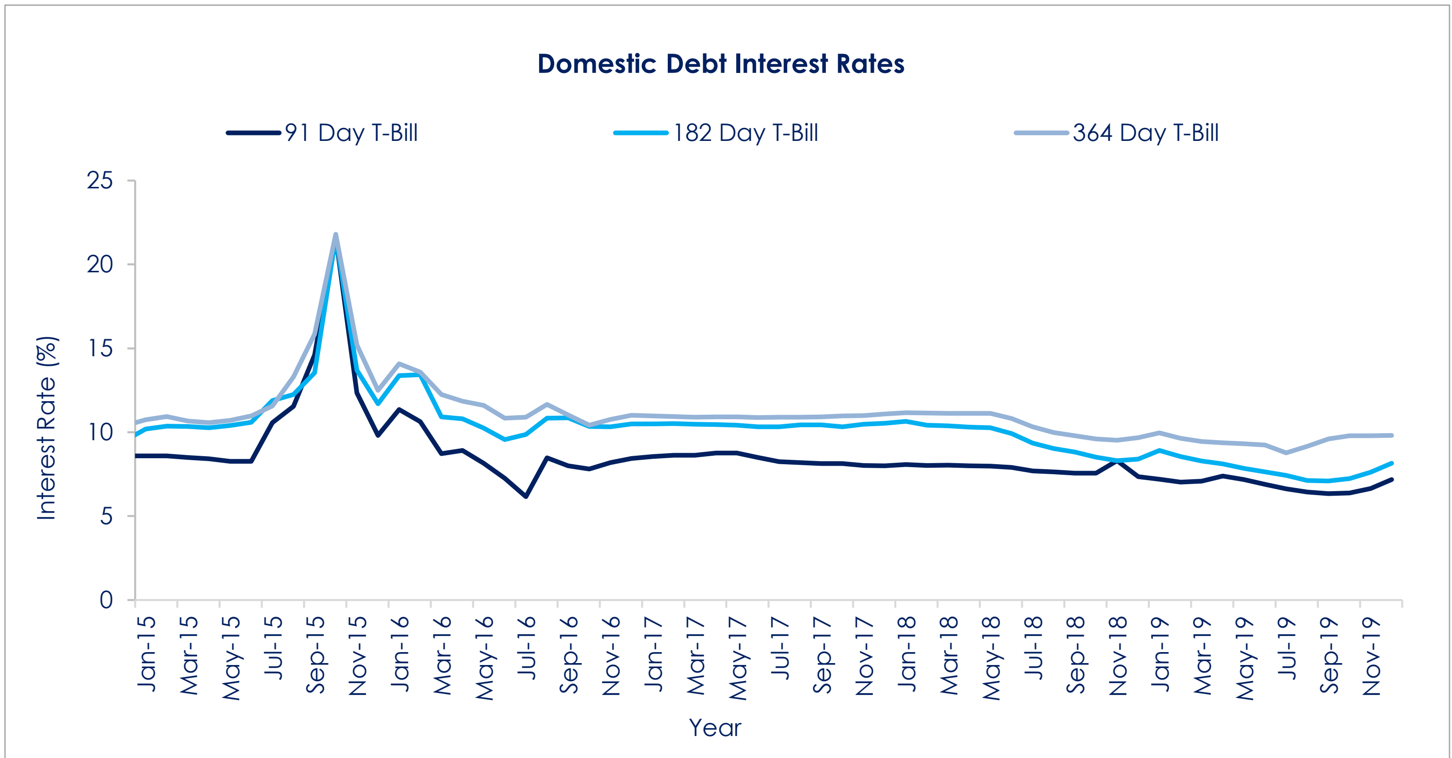
> With the interest rate cap no more, Interest rates on domestic debt likely to rise marginally in 2020

- Short term domestic debt interest rates (T-Bills) declined gradually in the first three quarters of 2019 before a slight uptick in the last quarter following the repeal of the law capping commercial bank interest rates (Fig.7).
- CBK continued to manage its cost of borrowing throughout the year by rejecting aggressive investor bids in debt auctions and we expect the same to be the case in 2020.
- The absence of an interest rate cap and an ever widening fiscal gap could result upward pressure albeit slight on T-Bill rates during the year.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.7: Domestic debt interest rates stable in 2019 in spite of slight uptick in November 2019**




Source: Central Bank of Kenya

## Commercial Bank interest rates and private sector credit growth

Commercial bank lending rates unlikely to spike.

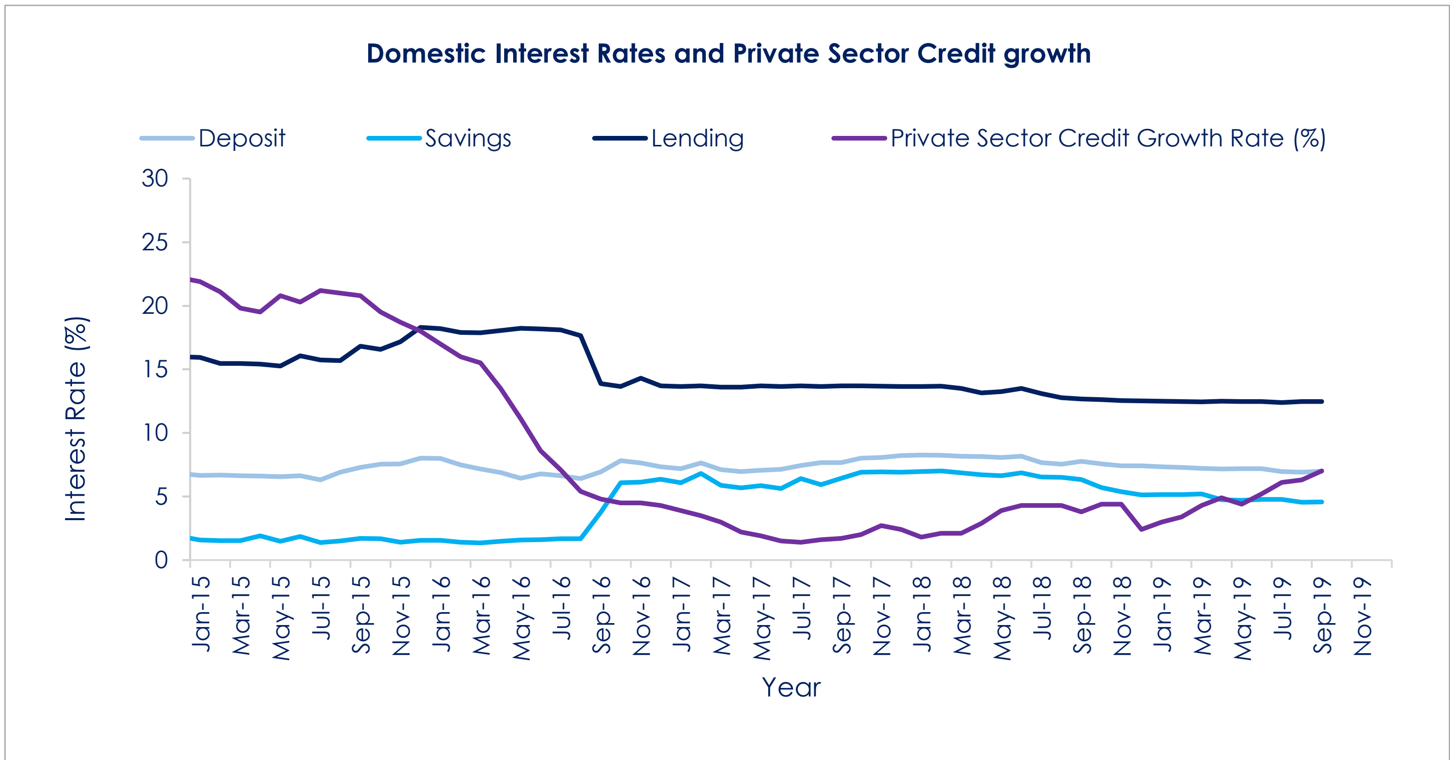
Private sector credit growth to range at between 6% - 8% below the CBK's ideal target range 12%-15%

- Commercial Bank interest rates remained stable during the year with a lending rate cap of 13% (4% above CBR - 9%) - Fig.8.
- Average deposit, savings and lending rates for the year stood at 7.1%, 4.8 and 12.5% respectively.
- We expect lending rates to remain stable in the short-term on account of a "hidden cap".
- That is banks appear unwilling to revise lending rates upwards even without a cap even as the CBK signals its monetary easing (downward revision of the CBR to 8.5%).
- Private sector credit growth averaged 5.1% in the 10 months to October 2019 (3.4% in 2018) with increased growth recorded in the second half of the year (Fig.8 and Fig.9).
- Overall private sector credit growth remains below the CBK's ideal range - 12% -15%
- Private sector credit is likely to remain between 6% and 8% in 2020, still below the CBK target largely due to the slowdown in economic activity and poor asset quality.



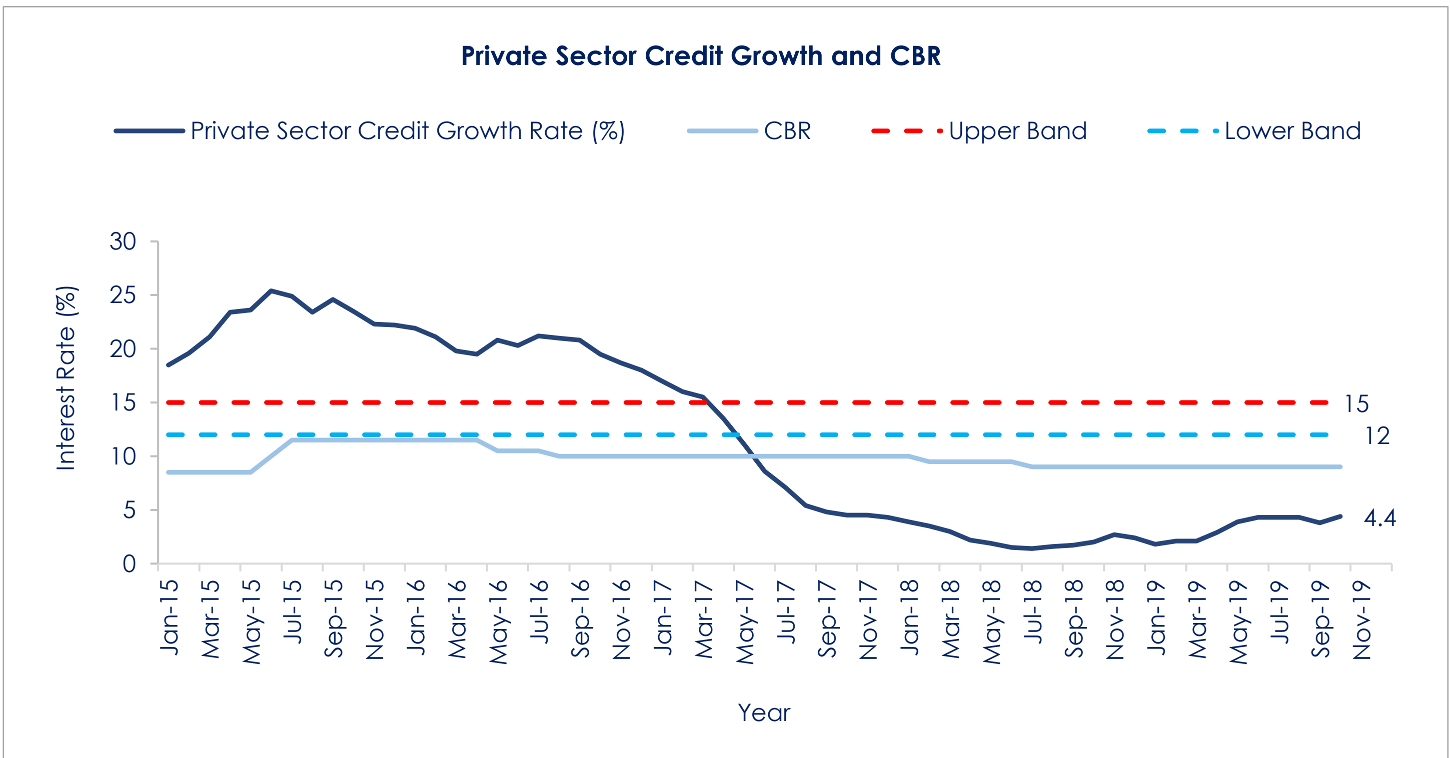
*For important disclosures refer to the disclosures section located at the end of this report.*

## Fig.8: Commercial bank interest rates have been largely stable and the same is expected in 2020




Source: Central Bank of Kenya

## Fig.9: Private Sector Credit growth to remain below CBK target range




Source: Central Bank of Kenya



*For important disclosures refer to the disclosures section located at the end of this report.*

## Monetary policy likely to remain unchanged in 2020

CBR likely to remain at 8.5% in H1 2020 under stable macro-economic conditions

- In November 2019, the Monetary Policy Committee (MPC) revised the benchmark rate downwards to 8.5% from 9% driven by the need for economic stimulus through private sector lending.
- **We expect this rate to be maintained in the first half of 2020 on account of macro-economic stability.**
- Risks to this view include heightened global geo-political and economic volatility adversely impacting the domestic economy particularly through inflationary pressure and foreign exchange rate volatility.
- Similar to central banks in major advanced economies the CBK has implemented a more accommodative monetary policy to support private sector credit growth and generally spur on economic activity
- **A rate of 8.5% is in our view is ideal on account of current macro-economic conditions but does not necessarily translate to a in a decline in lending rates (as banks are not legally compelled to review rates downwards) and a sharp rise in private  sector credit.**

## D) Inflation - Edged up in 2019, forecast 5.5-6% in 2020

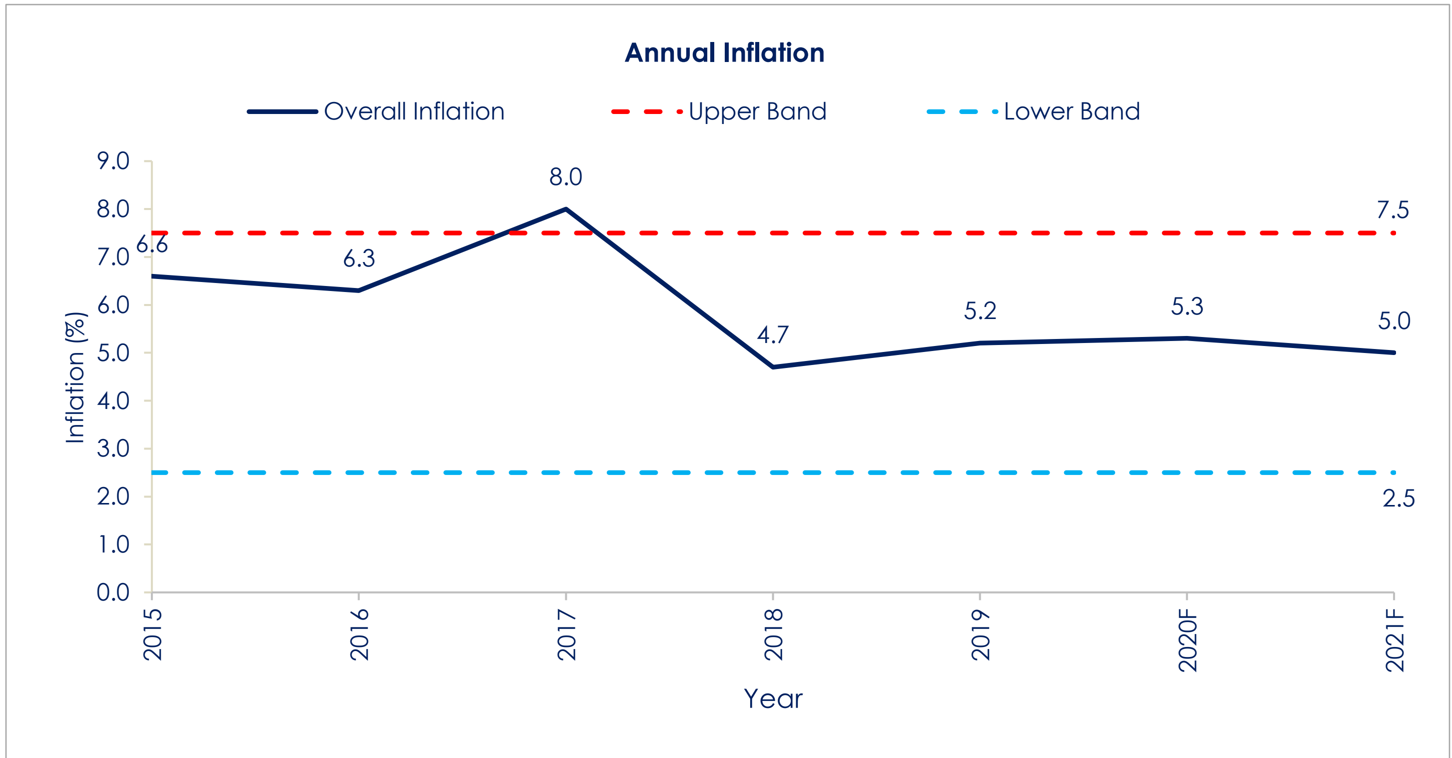
Inflation to edge up in 2020 but remain within the CBK's medium term range

- The 12 month average inflation rate in Kenya rose to 5.2% in December 2019, from 4.7% in the previous year.
- Main upward pressure came from prices of food which was offset by lower energy prices and stability of the Kenya shilling during the year.
- We forecast stable inflation in the medium term to remains well within CBK's target range (2.5% to 7.5%) but above the 5.0% midpoint - 5.5% - 6.0% driven by food, housing and electricity as well as the transport indices which account for 63% of the total Consumer Price Index (CPI) - Fig.10.
- Global oil prices (Brent) are expected to tick upwards from the current price of USD.66 per barrel due to price premium on crude oil from geopolitical events.
- Brent crude oil is expected to trade at US$.70.41per barrel by the end of Q1, (Trading Economics) and we estimate an end year price of US$.76 per barrel.
- Stable inflation means that monetary policy is likely to remain unchanged at least in the first half of the year.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.10: Annual inflation to remain within the CBK's lower and upper bound signaling an unchanged monetary policy**




Source: Kenya National Bureau of Statistics and Trading Economics

## 3. CURRENCY PERFORMANCE/FOREIGN EXCHANGE

- Kenya Shilling was stable in 2019 in spite of unusual but temporary high demand between June and September (demonetization).

### Kenya Shilling's ends on a high after temporary demonetization setback

Kenya Shilling appreciated marginally against the US$ in 2019 in spite of midyear depreciation

- Overall, the Shilling reported a mixed performance against global currencies in 2019 (Table.4).
- Kenya Shilling remained largely stable in the first half of the year trading at an average rate of KES.101.
- We however observed a 2.5% weakening of the Shilling in the run up to the demonetization deadline of 30th September 2019 (a trend we attribute to increased dollar demand) before making gains towards the end of the year.
- On the regional front, the local currency made the gains against the Rwandese Franc and Tanzania Shilling but lost to the South African Rand and Uganda Shilling.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Table.4: Shilling's reports mixed performance in 2019**

| Currency | 2018 | 2019 | % Change |
|---|---|---|---|
| US Dollar | 101.85 | 101.34 | 0.5 |
| STG Pound | 129.02 | 132.94 | 3.0 |
| EURO | 116.45 | 113.37 | 2.6 |
| Japanese Yen | 92.27 | 92.80 | 0.6 |
| SA Rand | 7.08 | 7.19 | 1.6 |
| KES/USHS | 36.46 | 36.17 | 0.8 |
| KES/TSHS | 22.58 | 22.68 | 0.4 |
| KES/RWF | 8.77 | 9.36 | 6.7 |

Source: Central Bank of Kenya

## Diaspora remittances, capital inflows and favourable reserve position support the KES.

Diaspora remittances growth forecast positive but slowdown expected

- The Shilling's stability in 2019 is attributable to the following:-

    1) **Strong diaspora remittances** - The biggest source of foreign exchange earnings (US$.218.8Mn in November 2019) ahead of horticulture, tea and coffee exports and tourism (Fig.11).

    Diaspora inflows rose to an all-time high in June 2019 amounting to US$.295.5Mn as Kenyans in diaspora took advantage of the tax amnesty on foreign earnings that lapsed on 30th June, 2019.

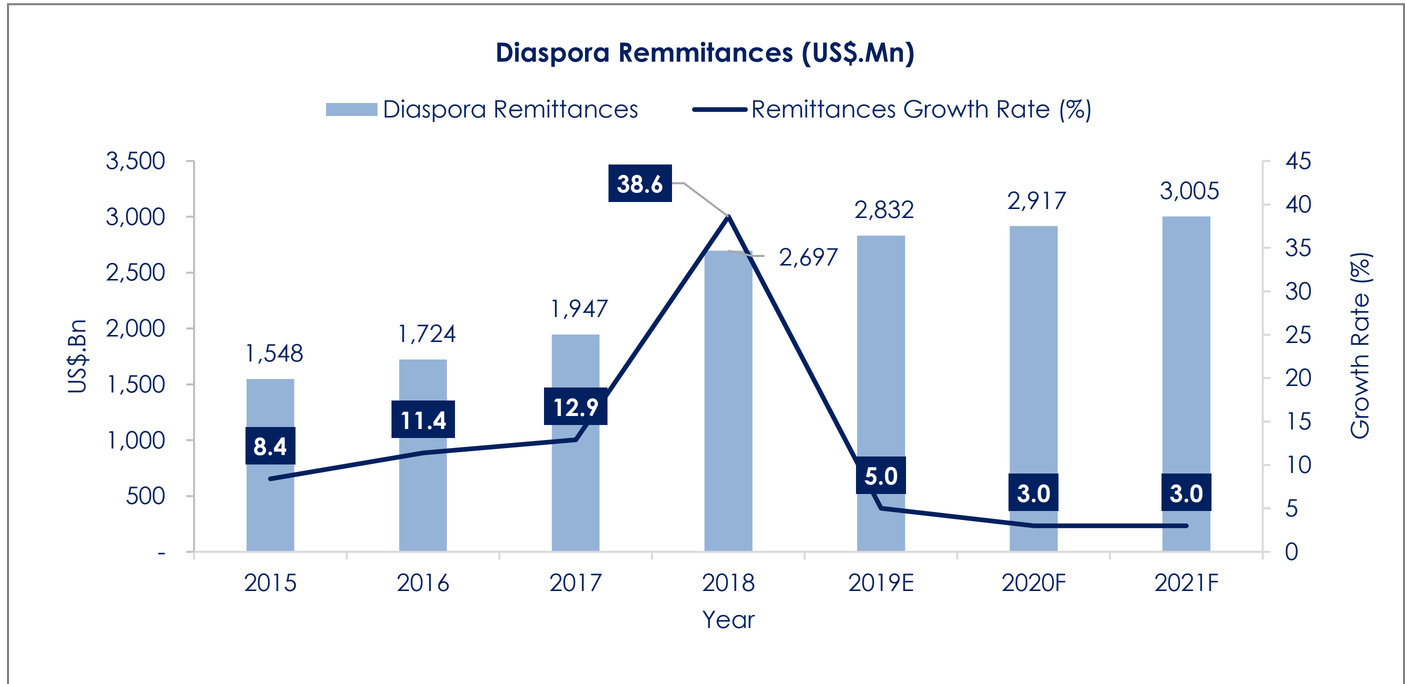
    Remittances have been on a decline after the expiry of the tax amnesty as any money repatriated into the country attracts a 10% tax from 1st July 2019.

    In 2020 we estimate a lower growth rate in remittances in 2020 (3%) due to a combination of the economic slowdown in the US and the expiry of the tax amnesty period.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.11: Diaspora remittances growth rate to slow down in 2020**




Source: Central Bank of Kenya

2) **Narrowing current account deficit** - Kenya's current account balance has generally been in deficit since 2004 when the deficit stood at 0.8% of GDP.

Current account deficit expected to rise in line with GDP growth but to remain manageable

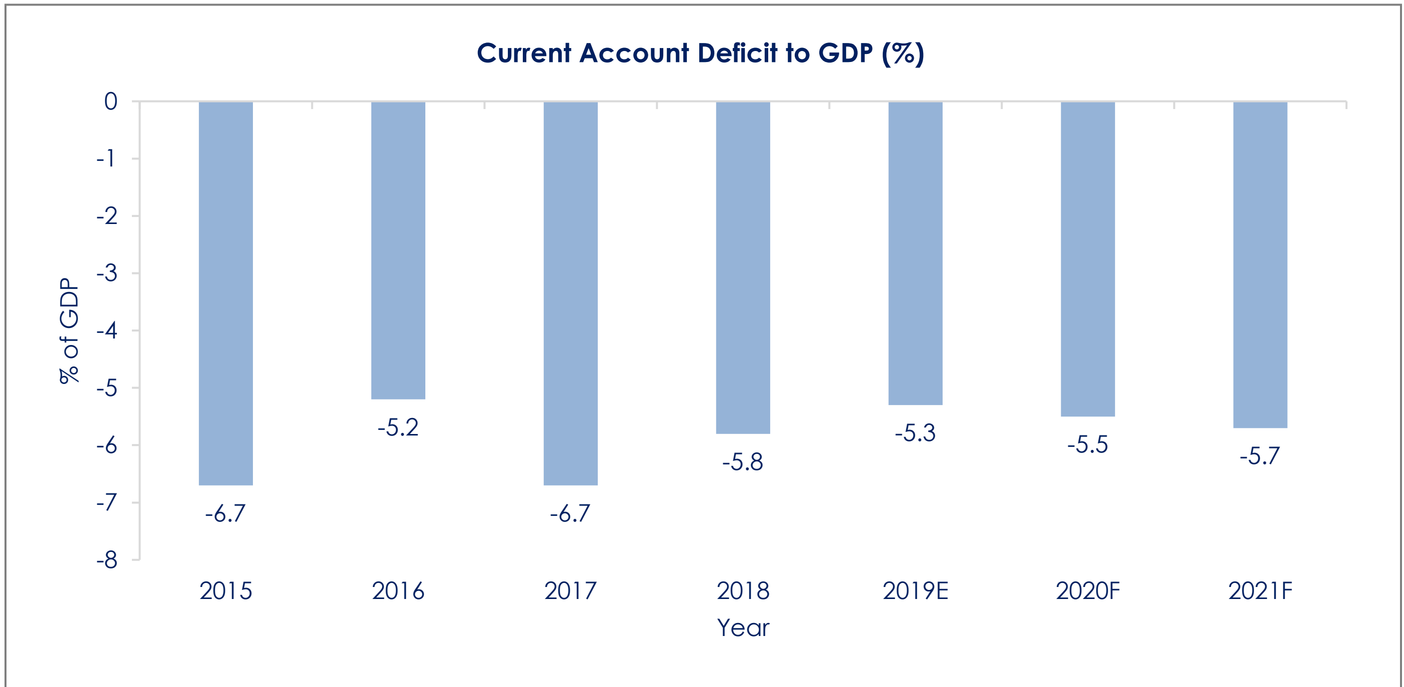
Kenya's current account deficit is estimated to have narrowed to -5.3% in 2019 of Gross Domestic Product (GDP) from 5.8% in 2018 as a result of an improved trade balance brought about by improved earnings from agriculture and tourism and lower import costs (Fig.12).

The World Bank forecasts a manageable increase to 5.7% by 2021 in line with increased GDP growth baring shocks in the prices of food and oil imports.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.12: Current account deficit to rise in 2020**




Source: Central Bank of Kenya and World Bank

3) **High levels of foreign exchange reserves** – Favourable foreign exchange reserve position - US$.8.8Bn equivalent to 5.4 months of import cover (2nd January 2019) - Fig.13.

This continues to provide adequate buffer against short-term shocks in the foreign exchange market in the absence of the IMF facility (US$1.5Bn).

Forex reserves hit an all-time high of US$10.1Bn (KES.1.0Tn/6.4 months of import cover) in May 2019 as a results of the Government successful issuance of a US$2.1Bn (KES.210Bn) Eurobond in April.

Forex reserves adequate but could decline due to external debt service and the event of sudden shocks

Government used reserves to service foreign debt including the US$750Mn (KES.75Bn) 5-Year Eurobond which matured in June 2019.

A US$.750Mn loan from the World Bank in July 2019 and improvement in trade also contributed to the growth of the forex reserves.

There was a gradual decrease in forex reserves to US$8.8Bn as at end of December 2019

Forex reserves are likely decline further in January as the Government settles the first instalment (KES.25Bn) of the KES.324Bn Standard Gauge Railway (SGR) loan in January 2020.

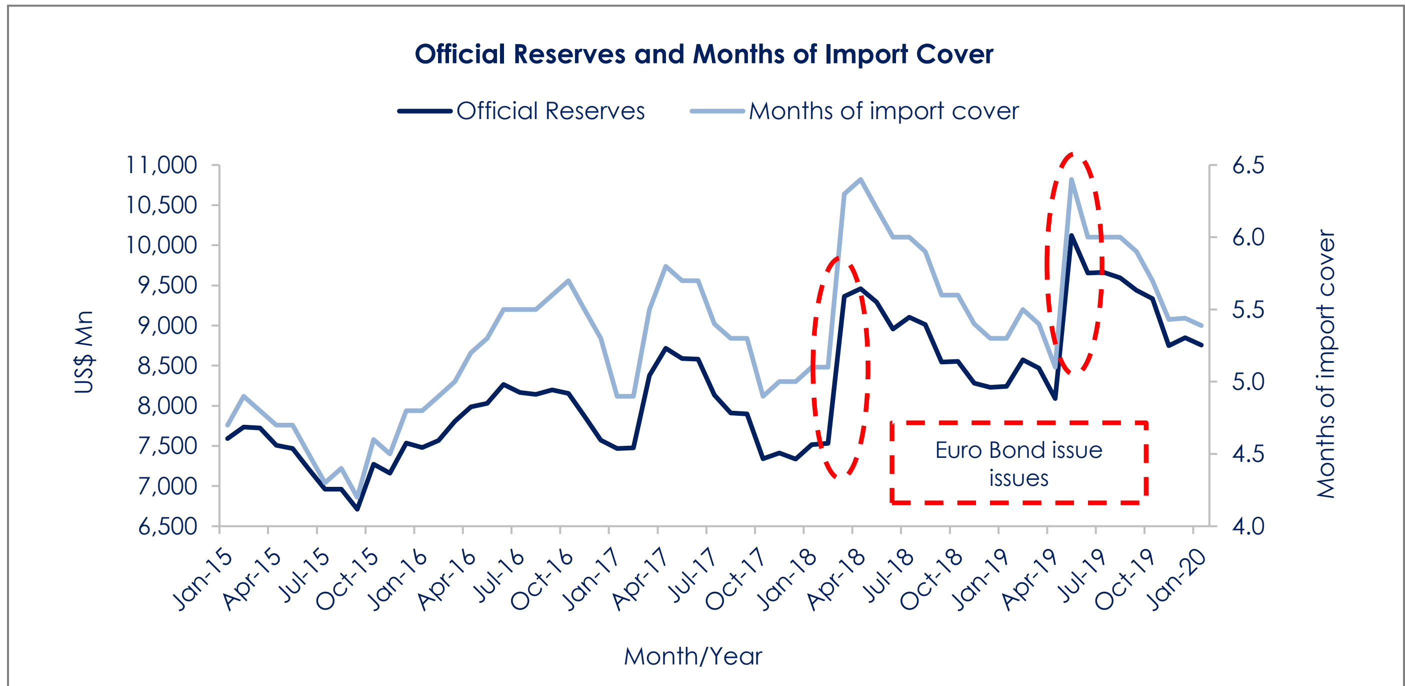


*For important disclosures refer to the disclosures section located at the end of this report.*

Downside risks include Brexit and political tensions between U.S and Iran which could adversely affect trade and the cost of oil imports

Nevertheless, we expect the forex reserves to remain above the requirement of at least 4 months of import cover.

**Fig.13: Forex reserves boosted by inflows from diaspora remittances and sovereign debt proceeds**




Source: Central Bank of Kenya

4) **Foreign capital inflows and Foreign Direct Investment - Foreign investor inflows** on the NSE turned positive in 2019 from the slump in 2018 that saw outflows of KES.22.9Bn (US$.0.3Bn) attributed to capital outflows from emerging and frontier markets as well as political instability following the disputed 2017 elections (Fig.14).

Foreign investor inflows and FDI outlook positive both as a result of improved financial performance of listed companies and the economy in general

At the time, investors shifted capital to safe haven markets like US where interest rates were rising following the upward revision of Fed rate.

Following the market slide in 2018, equities' valuations in 2019 were deemed attractive thus the reversal in foreign flows during the year.

As at September 2019, the foreign investor net cash inflows stood at KES.2.2Bn as investors took advantage of attractive valuations.

We predict an 8% growth in foreign investor capital inflows largely as a result of improved performance of the listed companies and particularly banks after the repeal of the interest capping law.

In 2018 Foreign Direct Investments (FDI) inflows rose significantly by 128.6% to US$.1.6Bn driven by domestic demand and inflows mostly in the ICT industry. The Kenyan government also provided additional tax incentives to foreign investors.

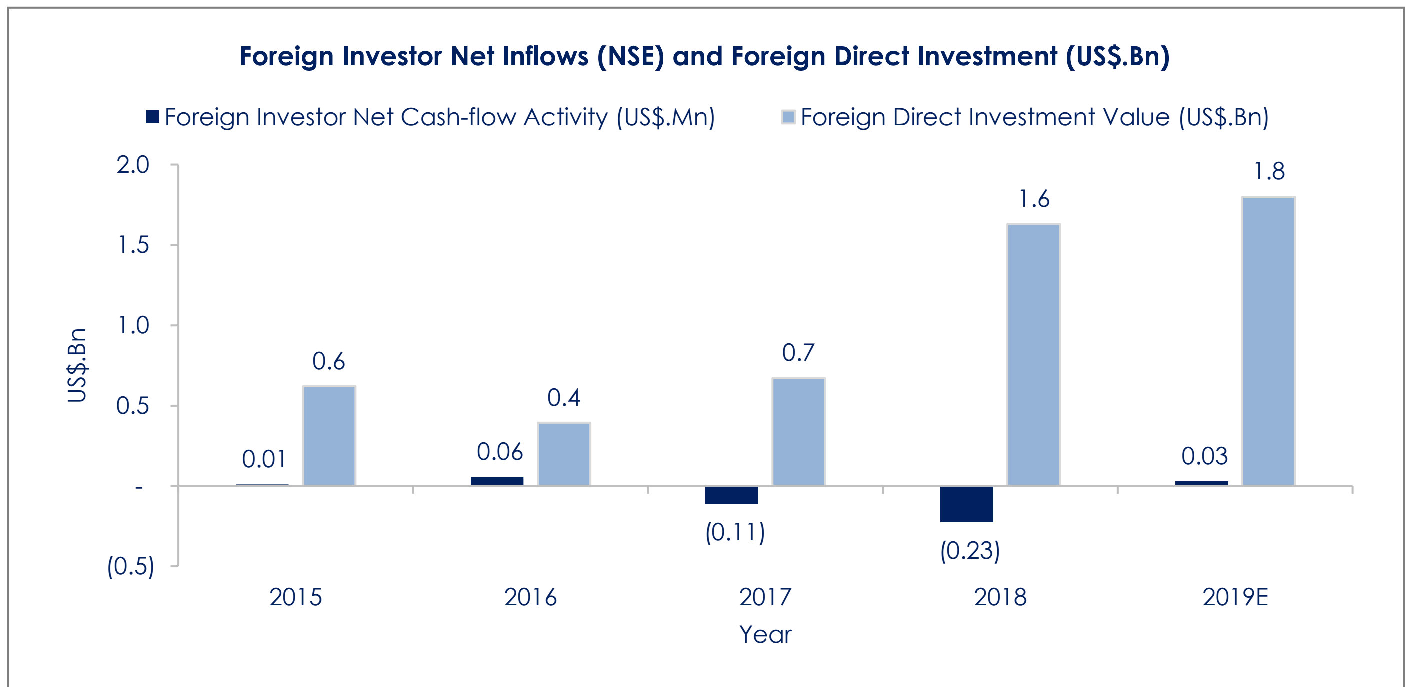
2019 FDI estimated at US$1.8Bn with most investments in technology, financial services, hospitality, infrastructure and manufacturing

FDI is estimates to grow US$.1.8Bn from US$1.6Bn in 2018 with a bulk of investments channeled to information communication technology, financial services, hospitality, infrastructure and manufacturing.

Kenya improved its position In the World Bank's 2020 Doing Business survey to 56th place out of 190 economies up from 61 in 2019 and 80 in 2018.

Going forward, we expect a positive growth in FDI mainly driven by ongoing infrastructure projects such as the redevelopment of the Northern Corridor and the development of a commuter rail system around Nairobi. These infrastructure projects are likely to boost economic growth thus generating FDI inflows in 2020 and beyond.

**Fig.14: Positive NSE foreign investor and Foreign direct inflows in 2019**




Source: Central Bank of Kenya



*For important disclosures refer to the disclosures section located at the end of this report.*

## Marginal currency depreciation expected in 2020

- We expect the Kenya shilling to depreciate marginally in 2020 KES.102.35 against the US$ (Table.5).
- "The Economist" forecasts the shilling to depreciate to KES.109.5 against the US$ in 2020.
- The shilling is likely experience occasional periods of volatility and range between KES.100 -103.00 in 2020 due to slow growth in capital inflows and growing current account deficit.
- Political tensions between US and Iran likely to ignite a surge in crude oil prices and Brexit are risks to our forecasts.

**Table.5: Kenya Shilling Forecasts**

| Currency | 2015 | 2016 | 2017 | 2018 | 2019 | 2020F | 2021F |
|---|---|---|---|---|---|---|---|
| **US$KES** (average) | 98.59 | 101.50 | 103.41 | 101.30 | 102.01 | 103.03 | 103.55 |
| **US$/KES** (year-end) | 102.31 | 102.49 | 103.23 | 101.85 | 101.34 | 102.35 | 102.87 |
| **KES:€** (EURO)(average) | 109.05 | 112.36 | 116.70 | 119.69 | 114.21 | 113.07 | 112.50 |
| **KES:€** (EURO)(year-end) | 111.78 | 107.06 | 123.28 | 116.45 | 113.37 | 112.24 | 111.68 |
| **KES:£** (GBP)(average) | 150.31 | 137.64 | 133.11 | 135.34 | 130.15 | 129.50 | 128.85 |
| **KES:£** (GBP)(year-end) | 151.80 | 125.42 | 138.75 | 129.02 | 132.94 | 130.28 | 128.98 |

Source: Central Bank of Kenya, International Monetary Fund Sterling Capital Research

## 4. PERFORMANCE OF CAPITAL MARKETS

- Kenya capital markets recorded a better performance in 2019 compared to the previous year.
- While fixed income maintained a trend of stable performance, equities needed a rally towards the end of the year to post a positive return with the bourse held back by the respective companies' poor financial performance.

### A) Equities - Banks end year rally reverse early year losses

Safaricom and banking stocks continue to drive the NSE's performance

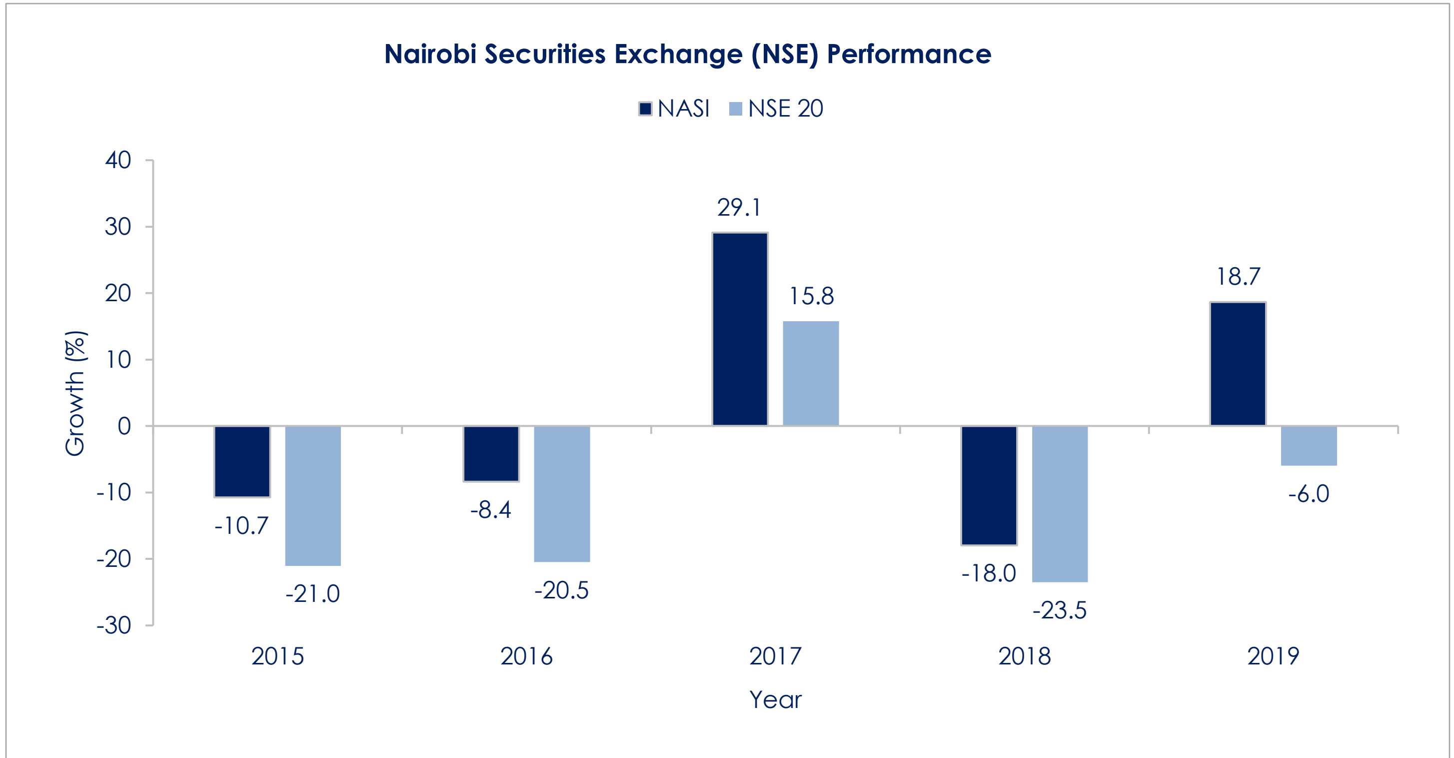
- A sterling performance by Safaricom and a rally towards in the last quarter of the year on banking stocks following the removal of interest rate caps saw the NSE All Share Index (NASI) reverse losses made in the first three quarters of the year and post a 18.7% gain while the 20 Share Index lost 6% (Fig.15 and Fig.16).
- The double digit performance making it a top performer in the continent was partly a function of a low base following major sell offs into the end of 2018.
- Poor corporate earnings with 17 companies issuing profit warnings compared to 15 in 2018.
- The year was eventful in terms of corporate action with Athi River Mining (ARM) and Deacons placed under administration while Kenol-Kobil was delisted from the NSE after acquisition by French owned Rubis Energie.



*For important disclosures refer to the disclosures section located at the end of this report.*

- No new listings equity listings were made either through an Initial Public Offering (IPO) or introduction on the main share segment although 22 companies were listed in the new Small and Medium Company (SME) segment "IBUKA"

**Fig.15: Late banking rally drove NSE in 2019**

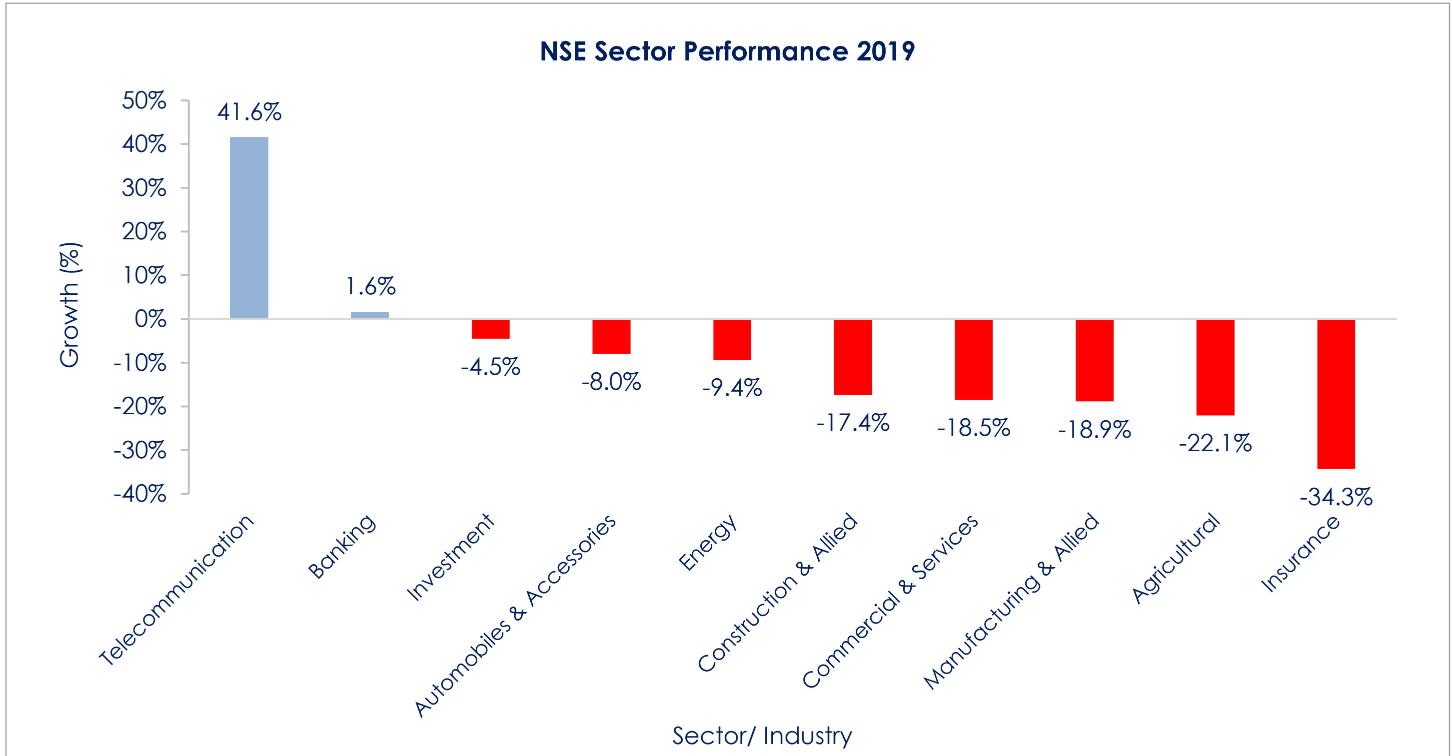



Source: Nairobi Securities Exchange



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.16: Safaricom and banks positive with all other sectors in the red in 2019**




Source: Nairobi Securities Exchange

## NSE's tepid performance to continue into 2020

Safaricom and banking stocks continue to drive the NSE's performance

- Overall, we expect the NSE to record better performance in 2020 compared to 2019 in consideration of our economic outlook and as a result of improved corporate earnings.
- The **banking** sector presents good opportunity in its first full year post interest rate caps with improved margins expected to positively impact profitability.
- A concern for banks would be how to deal with poor asset quality with sector Non Performing Loans (NPLs) averaging 12% in 2019.
- **Safaricom** has made significant investment in fixed data and its 4G network, as well as innovative financial service solutions and we expect this to counter declining voice and messaging revenues and result in an overall improved financial performance for the telecommunications giant.
- We expect the **agricultural** sector to remain in the red due to low tea and coffee earnings with the US/Iran political tensions and sanctions having a major impact on tea earnings.
- High operational costs, stiff competition and relatively low consumer demand spells gloom for most **manufacturers** with East African Breweries Limited (EABL) one of the few exceptions in this segment.



*For important disclosures refer to the disclosures section located at the end of this report.*

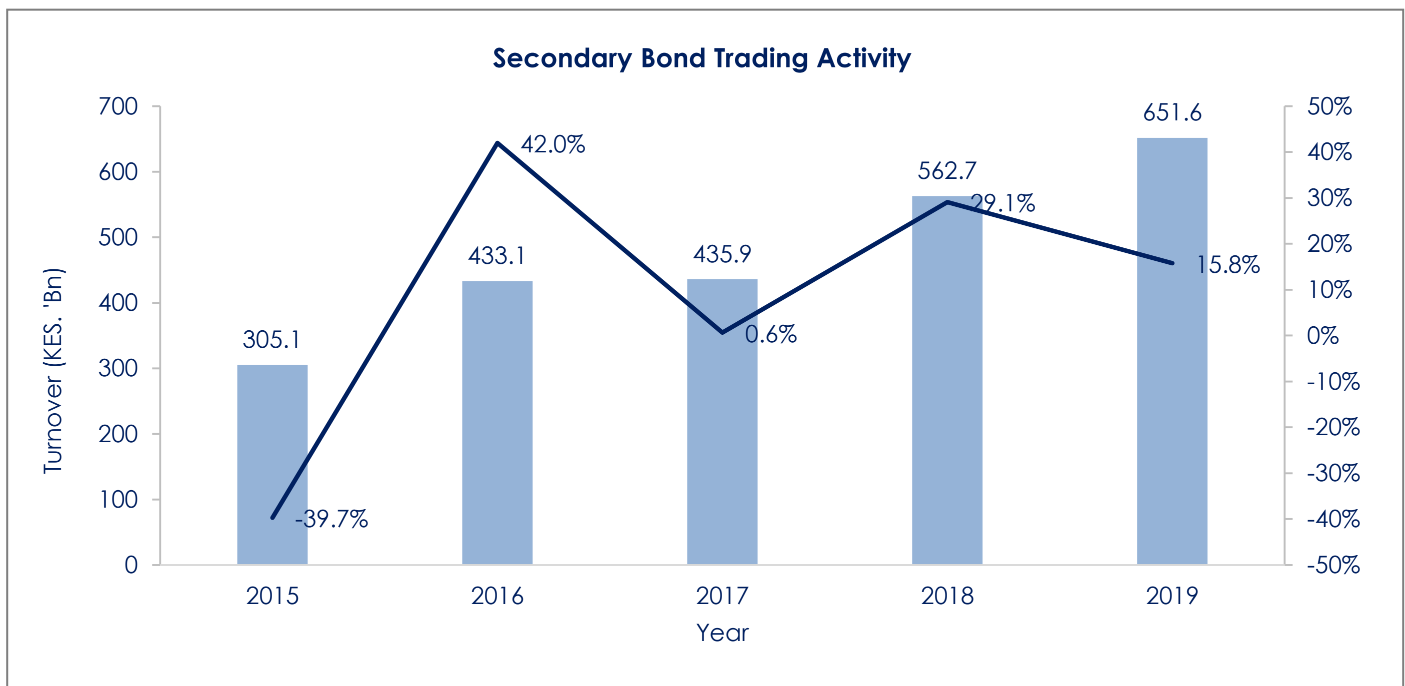
- The **insurance** industry presents attractive growth opportunities especially in light of the low penetration levels in the country. However, the performance of the industry is highly dependent on the performance of equities and fixed income investments and how to manage under the new capital requirements.
- The prospects of the insurance underwriting sector will depend on how effectively they grow premiums, fight fraudulent claims and compete effectively.
- The NSE continues to face **political risk** with a potential referendum and 2022 general election succession politics causing investor anxiety.

## B) Fixed income - Investors preference for shorter tenor debt

IFBs and 10-year bonds the most traded in the secondary market

- T-Bill subscription levels remained high throughout 2019 as most investors showed a preference for short term papers in anticipation of removal of interest rate caps.
- With regards to primary auctions, the CBK issued domestic debt worth KES.1.3Tn managing to raise KES.1.1Tn equivalent to 90.9% of the issued.
- Majority of bond issues in 2019 were medium and long term (10-15 years), as the CBK's strategy involved lengthening the average term to maturity of public debt.
- The most traded bonds in the secondary market were 5 and 10 year (as well as Infrastructure Bonds (IFB) because of the tax free component they are tax free.
- Secondary market bond trading activity increased largely as a result of capital transfer from underperforming equity portfolios (Fig.17).

**Fig.17: Bond Turnover up 15.8% in 2019**




Source: Capital Markets Authority, NSE and Sterling Research

## Optimistic about fixed income returns and secondary market trading opportunities in 2020

Increased domestic borrowing due to rising fiscal deficit.

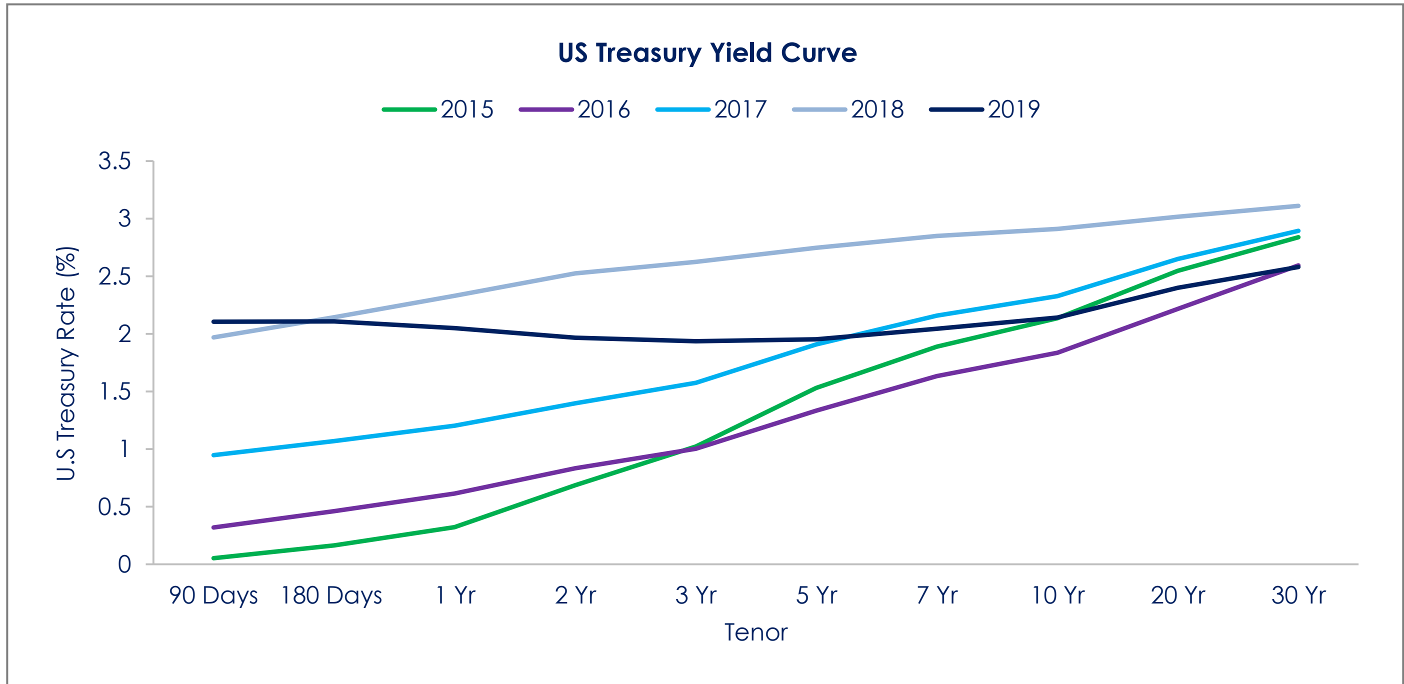
Investors demand higher on short and medium tenor issues.

- Parliament approved Government's plan to raise the debt ceiling to KES.9Tn, a signal towards aggressive government borrowing in 2020 and beyond.
- The supplementary budget shows an additional KES.146.3Bn funding gap which means an upward revision of the domestic borrowing target past the KES.514Bn budget target.
- We see further revisions with the tax authorities likely to fall short of the revenue target and the Government likely to exceed its expenditure.
- Following the removal of interest rate caps in November 2019, we anticipate a gradual rise in yields on government securities. This presents opportunity for higher real return given our stable inflation outlook.
- We see high investor participation in both the primary and secondary bond market on account of high liquidity and limited higher yielding and low risk investment option available in the market.
- We expect majority of bond issues in 2020 to be long term bonds in line with the medium term debt strategy to lengthen the maturity structure of public debt, lower interest costs and minimize refinancing risk.
- The CBK is likely to reject highly aggressive bids in the primary market in order to manage the cost of borrowing, which has significantly gone up following the removal of interest rate caps.
- **Our recommendation for fixed income investor is BUY short and medium term bonds and HOLD long term papers.**
- Kenya's first green bond started trading on the NSE in January 2020. This provides diversified products for investors and we expect this to contribute towards improved investor participation from funds that are climate-conscious
- The inverted U.S yield curve (Fig.18) as well as overall low interest rates in other global markets presents an attractive investment opportunity for foreign investors on the NSE (local currency debt and sovereign debt) and other frontier and emerging markets.
- The consensus view is that the Federal Reserve is likely to maintain the Fed Rate at 1.75% with a growing possibility of a cut on account of stable inflation and employment figures.
- The impact would be lower treasury yields resulting in capital flight to higher yielding markets such as Kenya especially with the forecasted weakening of the shilling.



*For important disclosures refer to the disclosures section located at the end of this report.*

**Fig.18: U.S treasury rates yield curve inverted as yields on short-end rise and long-end decline**




Source: Capital Markets Authority and Sterling Research

## Rising public debt a political risk concerns

Fiscal challenges and rising public debt as well as rising political tensions concern for investors

- According to the IMF, Kenya is at the risk of debt distress given that public debt has risen to 60% of GDP, causing the debt servicing to revenue ratio to reach 40% percent in 2019, a level typically only associated with countries at high risk of debt distress.
- Rising debt service costs and fiscal consolidation difficulties present challenges including externa financing due to tightening global markets.
- Investors in Kenya's bond market face also face political risk with talks of a possible constitutional change referendum in 2020 and succession politics presidential elections adversely impacting the investment climate.

## 5. POLITICAL OUTLOOK

- Political stability will continue having a significant bearing on the performance of the economy (Fig.19).
- We observe that there is a significant slowdown in economic activity in periods of political instability as was the case of the 2002, 2007, 2012 and 2018 general elections.
- The political temperature in the country is rising with focus debate on the Building Bridges Initiative (BBI) which to some observers is a big part of the 2022 presidential succession politics.
- This is in contrast to the calm atmosphere following the March "handshake" between Uhuru Kenyatta and his longtime political foe Raila Odinga.



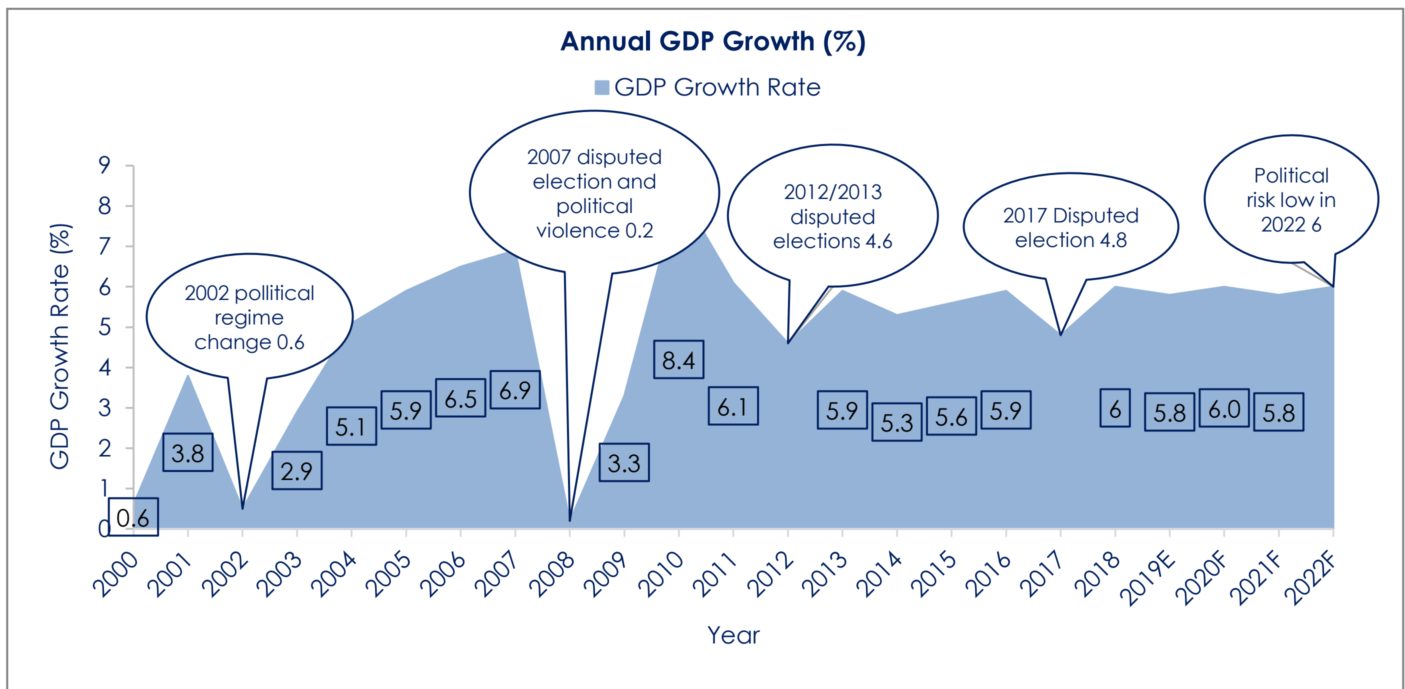
*For important disclosures refer to the disclosures section located at the end of this report.*

Political tensions rising ahead of the 2022 general election.

Constitutional referendum could happen ahead of the general election

- The president appears keen to pursue the "Big Four agenda" of delivering food security, affordable housing, more manufacturing, and affordable healthcare to Kenyans.
- Positive for investor confidence is the fight against corruption with a series of high profile indictments.
- A BBI referendum in 2020 is a growing possibility with this being a key risk to investor confidence and economic performance reversing gains made in the last two years.
- A lot depends on the political alignments going into 2022 with the referendum in 2020 a likely sign of who will be the key players in the next general election in 2022.
- The political risk in the country in the run up to the next election is low and for this reason we do not expect it to adversely impact economic growth.

**Fig.19: Politics and business - trends shows economy slowdown in years of heightened political activity**




Source: International Monetary Fund and Sterling Capital research

## Disclosures:

### Ownership and material conflicts of interest:

The authors or a member of their household, of this report do not hold a financial interest in the securities of this company. The authors or a member of their household, of this report do not know of the existence of any conflicts of interest that might bias the content or publication of this report.

**Position as an officer or director:** The authors or a member of their household, do not serve as an officer, director or advisory board member of the subject company.

### Research analyst certification:

The research analyst(s) primarily responsible for the preparation and content of all or any identified portion of this research report hereby certifies that all of the views expressed herein accurately reflect their personal views. Each research analyst(s) also certify that no part of their compensation was, is, or will be, directly or indirectly, related to the view(s) expressed by that research analyst in this research report.

### Additional Disclosures:

This research report is for distribution only under such circumstances as may be permitted by applicable law. This research report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient, even if sent only to a single recipient. This research report is not guaranteed to be a complete statement or summary of any securities, markets, reports or developments referred to in this research report. Neither SCL nor any of its directors, officers, employees or agents shall have any liability, however arising, for any error, inaccuracy or incompleteness of fact or opinion in this research report or lack of care in this research reports preparation or publication, or any losses or damages which may arise from the use of this research report.

### Disclaimer:

This research report was prepared under the supervision of the Research Department of Sterling Capital Limited (SCL), a company authorized to engage in securities activities in Kenya, and with partnerships in Uganda, Rwanda, Zimbabwe, and Tanzania. Data used in this report was gathered from reliable sources, but the analyst(s) and the publishers of this report do not hold themselves responsible for the accuracy or completeness of data used. The report provides the opinions, analyses and conclusions of the Research division only and is provided without any warranties of any kind.

This report does not constitute an offer, or the solicitation of an offer, for the sale or purchase of any security. The reader should independently evaluate the investment risks and is solely responsible for their investment decisions. Whilst every care has been taken in preparing this report, no representation, warranty or undertaking (express or implied) is given and no responsibility or liability is accepted by SCL or any employee of SCL as to the accuracy, timeliness, completeness merchantability or fitness for any particular purpose of any such recommendation or information contained and opinions expressed herein. SCL do not accept any liability for any direct or remote loss or damage arising out of the use of all or any part of the information contained in this report.

This report is published for information purposes only and is not an offer to solicit, buy or sell any security of any kind. This report does not provide customized investment advice. It has been prepared without regard to the individual financial circumstances and risk and return objectives of individuals who receive it. The appropriateness of a particular investment will depend on an investor's individual circumstances, risk tolerance and return objectives. The investments securities referred to in this document may not be suitable for all or certain categories of investors. The Research Division and SCL have implemented Chinese walls procedures to prevent any conflict of interest. Other additional information may be available at SCL.

Further disclosure regarding SCL policy on potential conflicts of interest in the context of investment research and SCL policy on disclosure and conflicts in general are available on request. The opinions presented in this note may be changed without prior notice or cannot be depended upon if used in the place of the investor's independent judgment. The historical performance of a security is not representative of the security's future returns. Investment in securities can be highly risky as security prices may go down in value as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may adversely affect the value, price or income of that investment. In case of illiquid investments for which there is no organized market it may be difficult for investors to exit investment positions or to obtain reliable information about its value or the extent of the risk to which it is exposed. The information contained in this report is confidential and is solely for use to those persons to whom it is addressed and may not be reproduced, further distributed to any other person or published, in whole or in part, for any purpose.