FAIDA INVESTMENT BANK

Faida Macroeconomic Outlook Report

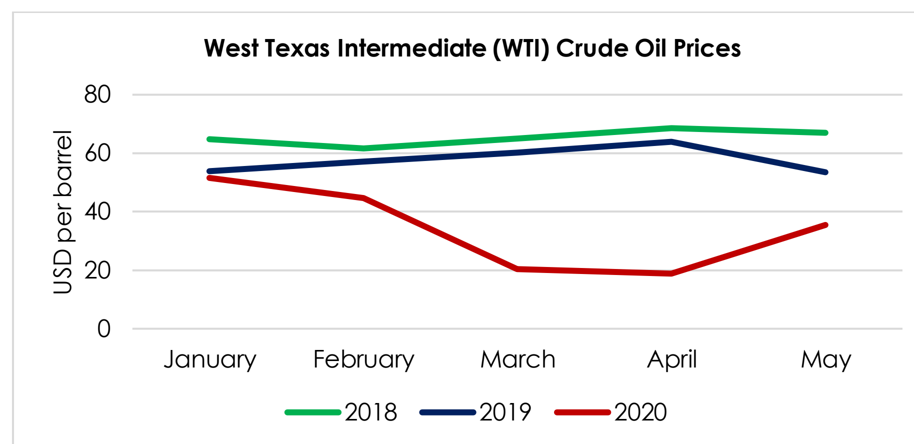
23rd June 2020

Global Economic Trends

- According to the International Monetary Fund (IMF), global growth significantly slowed down to 2.9% in 2019 from 3.6% recorded in 2018.
- The subdued growth, which was synchronized across the world, was occasioned by escalating trade tensions, geopolitical uncertainty, country specific shocks in a number of emerging market economies (South Africa, India & Mexico) and structural issues (particularly aging demographics and low productivity growth) in advanced economies. These factors particularly weighed down growth in trade and manufacturing.
- Global growth in 2019 was however supported by a stable services sector across the world.
- 2019 was also characterized by an accommodative monetary policy across emerging market and advanced economies – influenced in part by the absence of inflationary pressures and the need to spur economic growth.

Outlook

- The prospects of the global economy in 2020 have been shattered by the COVID-19 (coronavirus) disease, which originated in China, and was declared a pandemic by World Health Organization (WHO).
- The COVID-19 health crisis has had an adverse impact on the global economy as the containment measures (lockdowns, suspension of international travel) initiated have reduced economic activities globally.
- Owing to the effects of the global pandemic, the IMF projects the global economy to contract by 3.0% in 2020 – significantly worse that the contraction of 0.6% witnessed in 2009 during the 2008 – 2009 financial crisis.
- Owing to difficulties in predicting the evolution of the pandemic, ascertaining the efficiency of containment measures (lockdowns, social distancing) direction of commodity prices and shifts in consumer demand among other factors, the contraction in the global economy could be exacerbated.
- Currently, most countries are facing a delicate balance between implementing measures that contain the spread of the disease while also lessening the economic impact of the pandemic.
- In a bid to support economic growth, most economies have initiated expansionary fiscal and monetary measures.
- In the first four months of 2020, crude oil prices sustained a downward trend culminating in a price crash in April. The price crash in April was occasioned by a price war between Russia and Saudi Arabia. However, in April, OPEC and its oil producing allies agreed to cut production by 9.7 million barrels per day (largest output cut in history). This led to a recovery in oil prices, but currently oil prices remain lower than those witnessed in 2019. Crude oil prices are expected to remain lower in 2020 in comparison to 2019) on the back of reduced global demand due to the expected contraction in the world economy.



Source: Bloomberg

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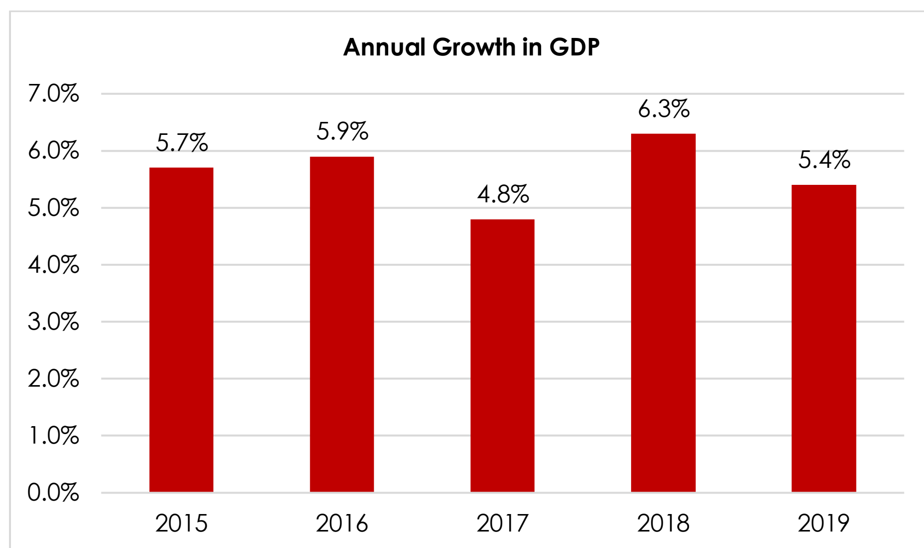
KENYA

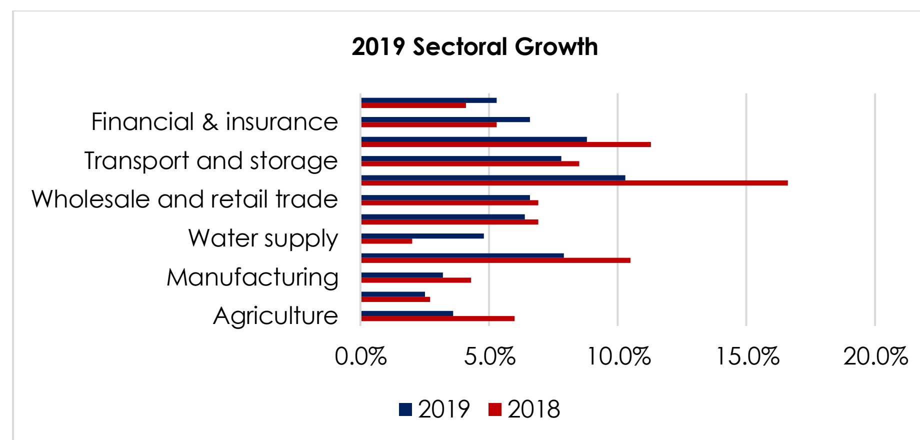
GDP Growth

- In 2019, economic activity was relatively subdued in comparison to 2018.
- The real Gross Domestic Product (GDP) is estimated to have advanced by 5.4% -- slower than a growth of 6.3% registered in 2018.



Source: KNBS - Economic Survey 2020

- The slowdown in real GDP growth in 2019 was brought on by decelerated growth across most sectors of the economy, but especially by the agriculture, forestry and fishing sector which accounted for 34.1% of total economic activities.



Source: KNBS - Economic Survey 2020

- Growth within the agriculture, forestry and fishing sector eased t0 3.6% from 6.0% in 2018 predominantly due to insufficient long rains that interrupted the normal planting season in key agricultural zones.
- The manufacturing sector grew by 3.2% in 2019, lower than 4.3% growth in 2018 – partly influenced by constrained supply of raw materials due to reduced agricultural activities.
- Growth in the electricity supply sector eased to 7.9% from 10.5% in 2018 largely reflecting the slowdown in total electricity generation (growth of 3.2% in 2019 vis-à-vis a 9.1% growth in 2018). The reduction in electricity generation was mostly on the back of a 19.6% decrease in electricity generated from hydroelectric sources – due to insufficient long rains.
- The construction sector continued to encounter decelerated growth (for the fourth consecutive time), rising by 6.4% compared to 6.9% in 2018. The persistent slowdown in the construction sector has been attributed to the gradual reduction in activities related to the construction of the Standard Gauge Railway (SGR).
- The financial services sector continued in its recovery path in 2019, rising by 6.6% in comparison to 5.3% in 2018 and 2.6% in 2017. This growth was

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supported by improved growth in domestic credit which recorded a 7.5% growth in 2019 – higher than 6.4% in 2018.

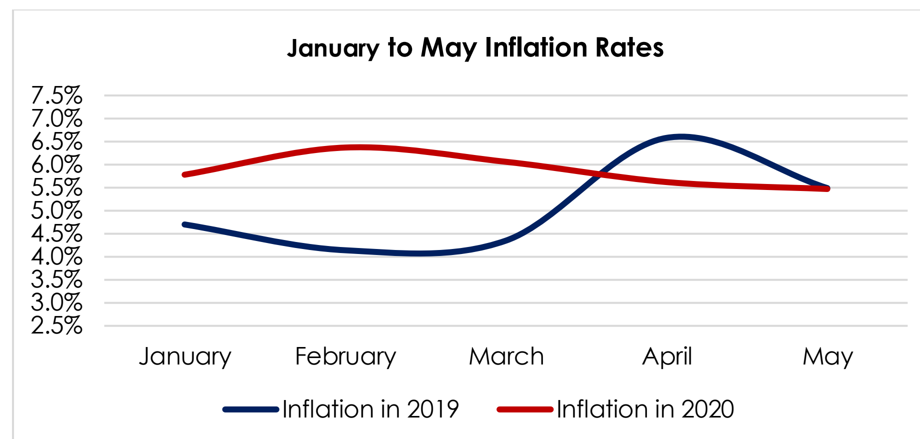
- The accommodation and food services sector experienced robust growth in 2019 rising by 10.3%. Growth in the sector was bolstered by heightened security, relaxation of travel advisories by governments of key tourism markets and political stability. However, this growth was considerably lower than the growth of 16.6% recorded in 2018 partly reflecting the subdued growth in international visitor arrivals (+0.4% in 2019 against +14.0% in 2018).

Outlook

- The Kenyan economy is anticipated to be adversely affected by both global and domestic shocks in 2020 (especially in 2Q2020):
    - global outbreak and rapid spread of COVID-19 & ensuing containment measures (which have disrupted the business environment and lowered the global economic outlook)
    - invasion of desert locusts (damaged crops)
    - floods (that have resulted in deaths, displacement and loss of livelihoods)
- Owing to the ensuing impact of the aforementioned shocks on the economy, Kenya's real GDP is now projected to expand by 2.5% (Treasury) and 1.0% by the IMF in 2020.
- The sectors that are expected to be worst hit by the pandemic are mainly the services sectors:
    - Tourism – mainly due to the closing of borders by major travel destinations as a measure to control the spread of the COVID-19 (United Nations World Tourism Organization (UNWTO) holds that tourist numbers could fall by c. 60.0% - 80.0% in 2020) and reduced domestic tourism affected by restrictions in movement.
    - Wholesale & retail trade – mostly due to disruptions of supply chains.
    - Transport and storage – on the back of restrictions in domestic movement (curfews, cessation of movements) and slowdown in economic activities.
- Economic growth in 2020 is however, expected to be supported by agricultural production for domestic consumption – supported by favourable weather.
- The government expects economic growth to rebound to 5.8% in 2021 and 6.5% by 2024 upon the implementation of Economic Stimulus Programme and a Post Covid-19 Economic Recovery Strategy.
- On the other hand, assuming there is a gradual recovery in the global economy through 2020–21, the IMF expects real GDP growth to recover to 5.5% in 2021 and 6.1% in 2022 and stabilize to 5.8% in 2023.

Inflation

- In the first 5 months of 2020, inflation has generally been higher than the inflation witnessed during a similar period in 2019; inflation averaged 5.9% between January and May 2020 and 5.1% between January and May 2019.



Source: KNBS and Faida Investment Bank Analysis

- The relatively higher inflation rate witnessed in most of 2020 has been occasioned by higher food prices, despite lower transport and utility costs as shown in the table below:

Average Rates Between January and May	2019	2020
Annual Headline Inflation	5.1%	5.9%
Food & Non-Alcoholic Beverages Index	4.0%	10.8%
Transport Index	10.5%	5.1%
Housing, Water, Electricity, Gas and other Fuels Index	8.7%	3.0%

Source: KNBS

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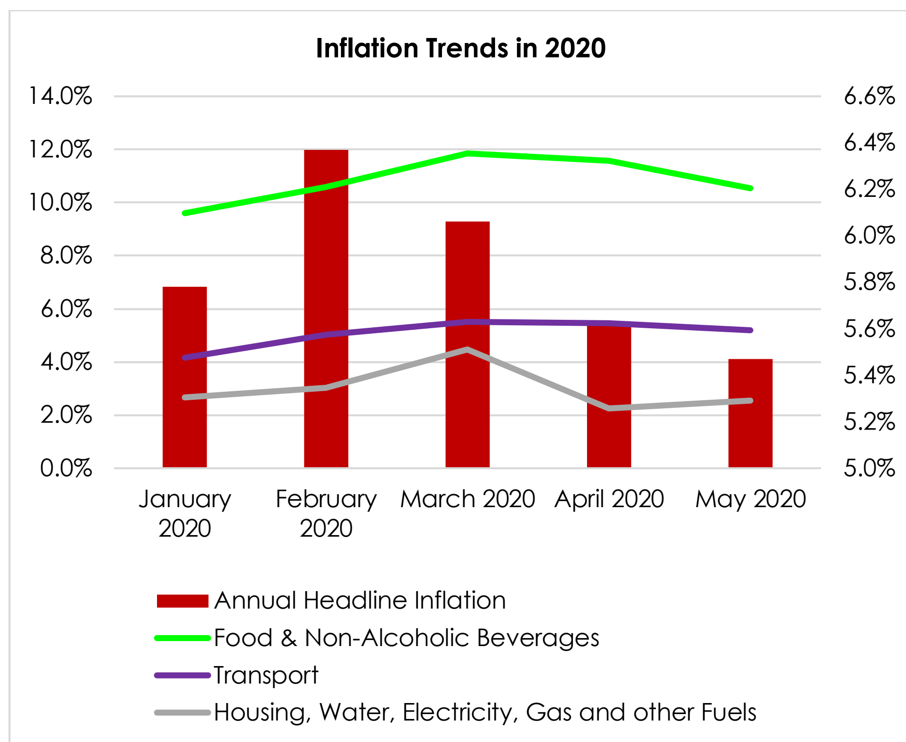
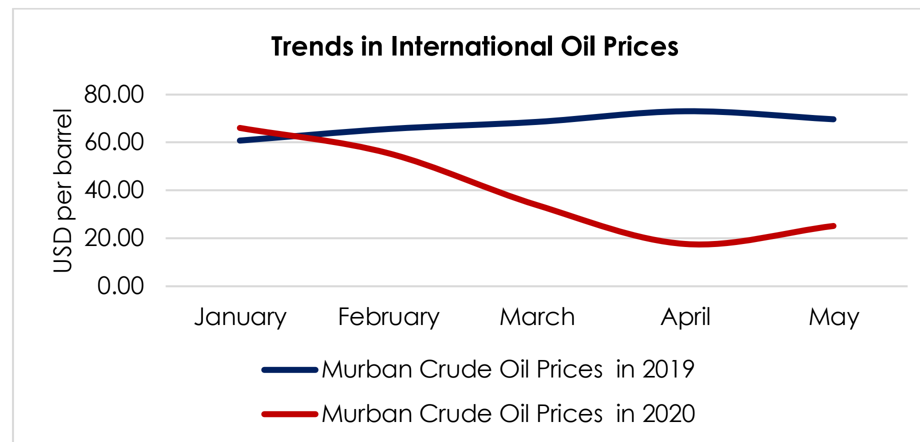
- The higher food costs in 1Q2020 were mostly attributable to food supply disruptions owing to above average rainfall during the October-November-December (OND) short rain season, which resulted in flooded farms resulting in delayed harvests and destruction of crops.



Source: KNBS and Faida Investment Bank Analysis

- From April 2020, the pressure on food prices eased slightly due to reduced prices on some food items (due to favourable weather). However, food prices continued to be elevated (in comparison to 2019) owing to supply disruptions brought on by the Covid-19 containment measures (curfews, cessation of movements).
- Annual headline inflation witnessed in the months of April and May 2020 benefitted mainly from low fuel prices and a VAT reduction from April (part of the measures adopted by the government to cushion the economy from the impact of the COVID-19 pandemic).

- The transport index was markedly lower in the first 5 months of 2020, averaging at 5.1% against 10.5% in a similar period in 2019. This was occasioned by reduced global oil prices in the wake of COVID-19.



Source: Bloomberg

- The Murban crude oil prices averaged USD 39.67 per barrel between January and May 2020 from USD 67.56 per barrel in a similar period in 2019.
- The lower global crude oil prices were initially prompted by a price war between Saudi Arabia and Russia (Russia declined to initiate further supply cuts in line with the OPEC+ alliance and Saudi Arabia retaliated by raising its crude oil output and reducing its prices) and reduced global demand for crude oil on the back of reduced global economic activity brought on by COVID-19 containment measures globally (lockdowns).

Outlook

- In 2020, inflation is expected to remain within the CBK's target range of 5.0% +/- 2.5%.
- At present, inflationary pressures remain low characterized by rising food supply (supported by favourable weather conditions), lower international oil prices (in comparison to 2019), reduced VAT and subdued demand pressures.
- Despite the OPEC+ decision to agree to cut crude oil production by 9.7 million barrels a day in May and June (as an attempt to buoy international oil prices), global energy demand continues to remain

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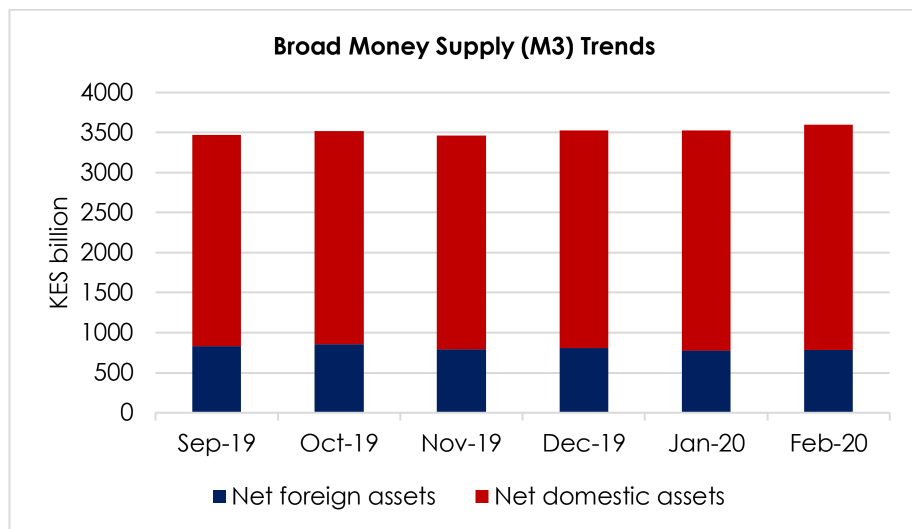
subdued due to the global coronavirus pandemic. Thus, the impact of supply cuts is not expected to significantly offset that of reduced global demand for energy. This is expected to result in relatively lower energy prices.

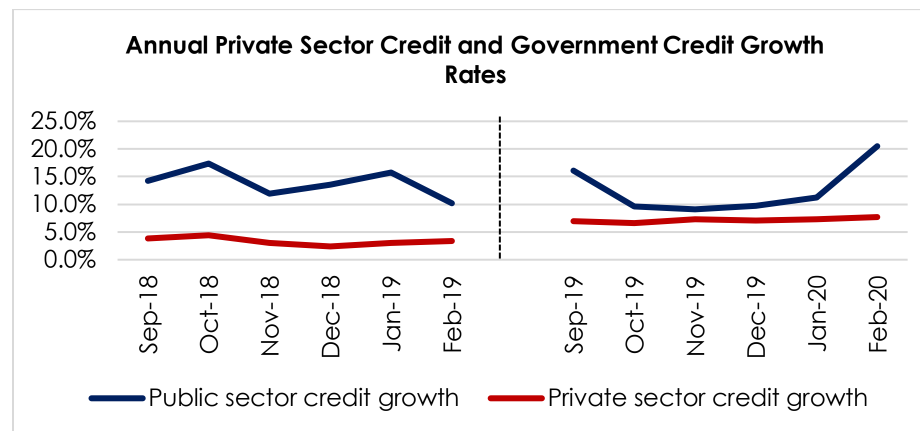
Money Supply

- Between September 2019 and February 2020, broad money supply rose by 3.5% from KES 3.5 trillion in September 2019 to KES 3.6 trillion in February 2020.
- This growth was mostly underpinned by a 6.6% rise in net domestic assets, within the same period, to KES 2.8 trillion as net foreign assets declined by 6.1% to KES 784.5 billion.



Source: Central Bank of Kenya

- With regard to domestic assets, domestic credit rose by 5.3% to KES 3.8 trillion in February 2020 principally propelled by a 17.6% rise in domestic credit to the government to KES 1.1 trillion in comparison to a 1.6% growth in domestic credit to the private sector to KES 2.6 trillion.
- Between September 2019 and February 2020, the annual growth in credit to the government continued to outperform the annual growth in credit to the private sector as shown in the table below.
- Within this period, the annual growth in credit to the government averaged 12.7% whilst annual growth in credit to the private sector averaged 7.2%.
- In comparison to a similar period a year earlier (September 2018 and February 2019), the average rate of 7.2% was a significant improvement in credit growth as the annual growth in credit to the private sector averaged 3.3% between September 2018 and February 2019.
- This improvement was mainly underpinned by the removal of the interest rate caps.



Source: Central Bank of Kenya

Outlook

- As part of the measures to help support the economy and maintain financial stability in the wake of the COVID-19 crisis within the country, the Central Bank of Kenya (CBK) in March 2020, lowered the Cash Reserve Ratio (CRR) by 100 bps to 4.25% and reduced the Central Bank Rate (CBR) by 100 bps to 7.25% (and later by 25 bps to 7.0%).
- According to the CBK, the lower CRR resulted in KES 35.2 billion being released to the banking sector (for onward lending to borrowers) and this coupled with the lower CBR enhanced growth in private sector credit -- private sector credit grew by 8.9 % y/y in March 2020 and 9.0% y/y in April 2020.
- In 2020, we expect lending to the private sector to be supported by Credit Guarantee Schemes, which are expected to assuage bank's concerns against lending to high risk borrowers.

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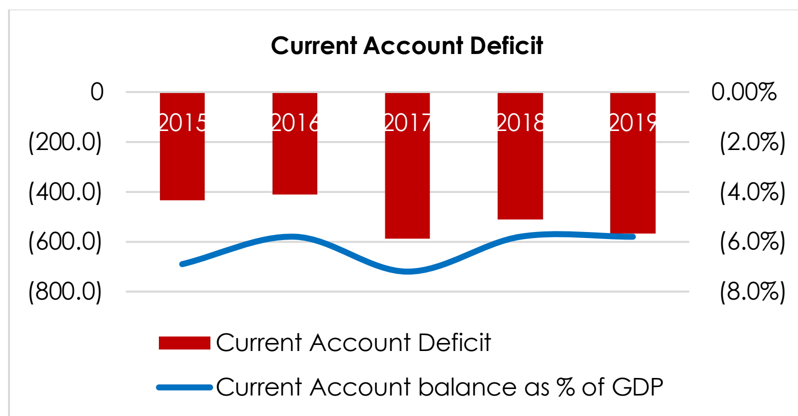
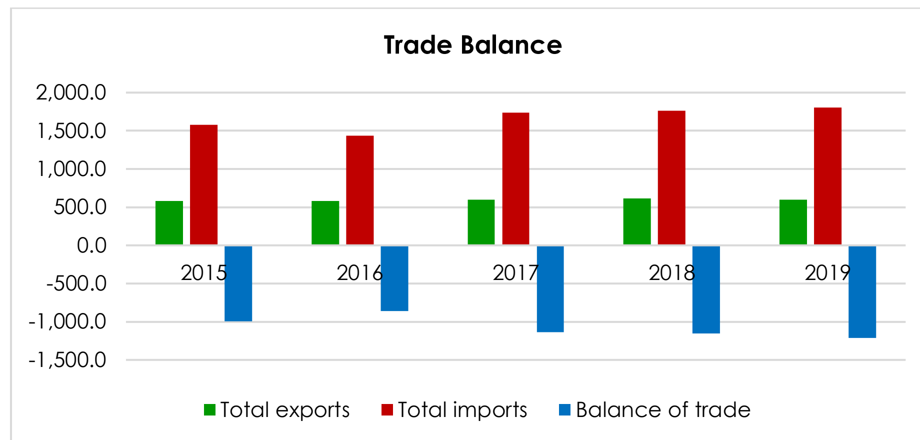
Current Account Deficit

- In 2019, the current account deficit widened by 10.9% to a deficit of KES 567.0 billion (5.8% of GDP) from a deficit of KES 511.3 billion in 2019 (5.8% of GDP).
- The increase in the current account deficit was mainly due to a 5.5% increase in the merchandise trade deficit to KES 1,090.0 billion and a 33.7% worsening of the primary income account to a deficit of KES 196.3 billion.
- The wider merchandise trade deficit was occasioned by a 2.9% decline in merchandise exports to KES 598.8 billion and a 2.3% increase in merchandise imports to KES 1,688.3 billion.
- The rise in merchandise imports was on the back of increased importation of petroleum products, and machinery and other capital equipment.
- Receipts from international trade in services rose by 3.3% to KES 573.2 billion in 2019 supporting thee net international trade in services to record a surplus of KES 180.0 billion – an 11.3% growth from 2018.
- Diaspora remittances went by 5.0% to KES 289.5 billion in 2019 boosting net receipts in the secondary income account which grew by 6.3% to KES 538.9 billion.



Source: Kenya National Bureau of Statistics

- In 2019, balance of trade deficit widened by 5.2% to KES 1,209.7 billion weighed down by a 2.4% increase in the total value of imports to KES 1,806.3 billion and a 2.9% decrease in the total value of exports to KES 596.7 billion.
- The decline in the total value of exports was on the back of a 4.1% decrease in the value of domestic exports to KES 520.8 billion due to declines in the value of tea, unroasted coffee and horticultural exports.
- On the other hand, the rise in the total value of imports was mainly driven by increased import expenditure on petroleum products, industrial machinery, sugar, molasses, honey, unmilled wheat, iron and steel.



Source: Kenya National Bureau of Statistics/Kenya Revenue Authority

Outlook

- The CBK projects that the current account deficit will remain stable at 5.8%.
- The current account deficit is expected to be weighed down by lower receipts from (i) horticulture exports - due to low demand and restrictions in key destination markets - (ii) tourism services and (iii) diaspora remittances – owing to the negative economic impact (particularly job losses) of the COVID-19 pandemic in source markets.
- However, a lower import bill underpinned by lower petroleum import costs (anchored by low international crude oil prices) is expected to offset the impact of lower receipts.
- The relatively stable outlook in the current account deficit is also informed by an improving outlook in horticultural exports:
    - The prices of horticulture exports were relatively high in April 2020 – moderating the impact of low export volumes
    - May 2020 recorded rising horticultural exports

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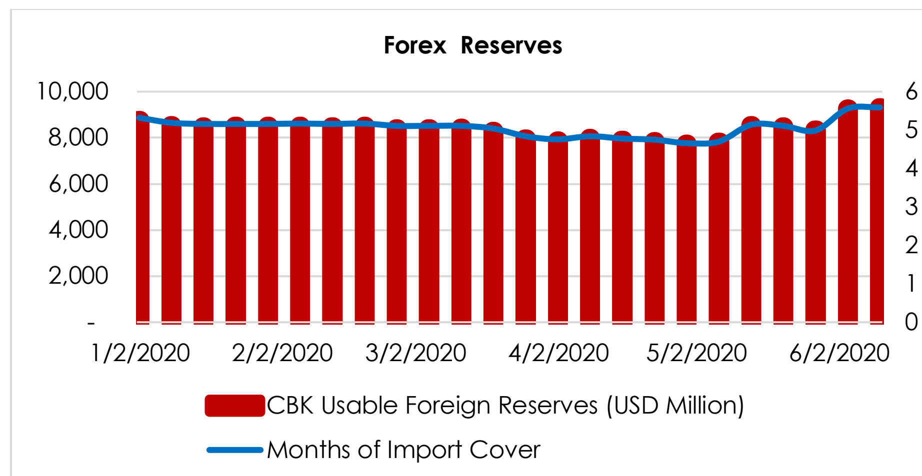
- Key destination markets are relaxing their restrictions
  - Cargo capacity is rising
- The IMF projects a narrower current account deficit of 4.4% in 2020.

Forex Reserves

- Kenya's foreign exchange reserves remained adequate and stable within most of the 1Q2020, averaging USD 8.5 billion (c. 5.2 months of import cover) between January and 19th March 2020.
- However, from 26th March 2020, foreign exchange reserves encountered some pressure, declining from USD 8.3 billion (5.0 months of import cover) in 19th March to USD 7.7 billion (4.7 months of import cover) at the end of April.
- This decline in forex reserves was brought on by reduced foreign exchange inflows from remittances, tourism and exports due to the global containment measures necessitated by the global COVID-19 pandemic as well as efforts to support the Kenya Shilling which was under pressure (hit an all-time low of 107.29 at the end of April 2020).
- As a defensive measure to the expected decrease in forex reserves, in early March, the CBK announced its plan to buy US Dollars, up to USD 100.0 million a month, in order to progressively increase its reserves above normal levels.
- From May 2020, forex reserves have adopted an upward trend, rising from USD 7.7 billion at the end of April, to USD 9.3 billion (5.6 months of import cover) as at June 11th 2020.
- The rise was supported by the disbursement of several foreign funds to help Kenya in dealing with the economic shocks arising from the global coronavirus pandemic and plug the budget deficit:
  i. USD 739.0 million economic support loan from the International Monetary Fund (IMF),
  ii. USD 1.0 billion loan from the World Bank and
  iii. USD 225.0 million from the African Development Bank



Source: Central Bank of Kenya (CBK) and Faida Investment Bank Analysis

Outlook

- For the remainder of 2020, forex reserves we expect forex reserves to remain adequate supported by the aforementioned disbursements by international finance institutions.
- The government has stated its intention to increase its reliance on external concessional debt in addition to fund the budget in the FY2020/2021.
- This may enhance forex reserves further in 2020.

Exchange Rate

- The Kenya Shilling has adopted a weakening bias in the first 25 weeks of 2020, depreciating by 4.9% against the US Dollar to close at 106.29.
- This reveals a stark contrast to a similar period in 2019, where the Kenya Shilling depreciated by 0.2% against the US Dollar.

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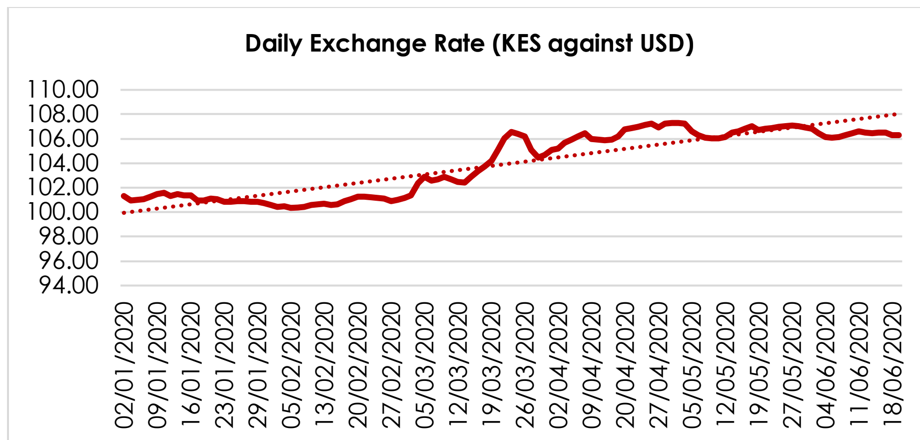

Source: Central Bank of Kenya and Faida Investment Bank Analysis

- In January and early February 2020, the Kenya Shilling strengthened against the US Dollar appreciating by 1.0% to 100.35 at 5th February 2020 – this was partly due to inflows targeting Treasury bonds auctions.
- However, towards the tail end of February, the Kenya shilling encountered some pressure on the back of seasonal dollar demand by corporates in the interbank market, closing at 101.29 on 21st March 2020 – before stabilizing towards the end of the month (closed at 100.98) supported by inflows from the tea sector.
- In early March, the Kenya Shilling depreciated significantly, touching 102.90 on 10th March 2020 owing to increased USD Dollar demand by the Central Bank of Kenya as part of its efforts to progressively increase its reserves above normal levels.
- By 13th March, the Kenya Shilling had strengthened marginally against the US Dollar hitting 102.32 mainly supported by inflows from offshore investors.
- With the announcement of the first COVID-19 patient, the Kenya Shilling reacted strongly depreciating by 3.7% to reach 106.54 on 24th March 2020. This was also attributable to strengthening of the USD as well as low supply of the US Dollar.
- Between 24th March 2020 and 31st March 2020,the Kenya Shilling strengthened by 1.6%, closing the month at 104.69, and this was attributable to
    i. Announcement of the first stimulus package (reduction in VAT, corporate tax and income tax) and
    ii. retreating US Dollar demand from retailers, manufacturers as a result and importers due to slowing economic activity
- April 2020, was characterized by a persistent weaker Kenya Shilling the Kenya Shilling breached the 107.00 level, reaching 107.29 at the end of April -- and this was attributable to heightened US Dollar demand.
- In May and June the Kenya Shilling remained relatively stable averaging 106.55 – but this still remains a significant depreciation from the levels (average of 101.22 between January and 13th March 2020) witnessed before the confirmation of the first COVID-19 patient in the country and the commencement of the global pandemic.

Outlook

- We expect the Kenya Shilling to remain stable albeit with a depreciating bias. This is informed by the expected stability in the current account deficit and adequate reserves (that should enable the CBK to stabilize the Kenya Shilling in case of any volatility).

Short-term Rates

- In the first 25 weeks of 2020, short-term interest rates have generally adopted declining bias.
- In comparison to the last week of 2019, the 91-day, 182-day and the 364-day Treasury bill yields have declined by 11, 41 and 115 basis points to 7.1%, 7.7% and 8.7% respectively.
- The downward trend has been largely influenced by the Treasury's (i) efforts to minimize domestic debt costs by rejecting expensive bids and (ii) strategic focus on Treasury bonds vis-à-vis Treasury bills (as indicated in the Medium-term Debt Management Strategy.

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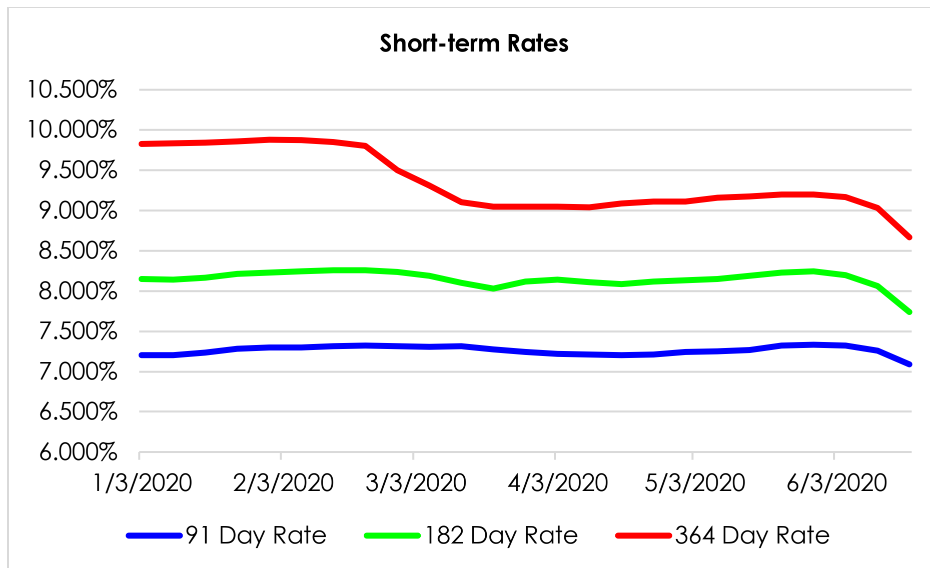

Source: CBK and Faida Investment Bank Analysis

- Contrary to the yields on the 364-day Treasury bill, the yields of the 91-day and 182-day Treasury bills have remained relatively stable.
- Between the weeks ending 21st February and 13th March 2020, the yield on the 364-day Treasury bill declined by 70 bps to 9.1%. This significant drop was underpinned by the Treasury taking advantage of heavy bidding by investors (subscription rates averaged 435.2% in these weeks) to keep interest rates low. Investors sought to invest in the 1-year tenor amidst an uncertainty brought on by the global COVID-19 pandemic.
- In the second and third weeks of June 2020, there was a noticeable persistent decline in yields across all tenors as the Treasury offered lower rates as it reduced its uptake of domestic debt towards the tail-end of the fiscal year. Treasury bill yields fell by 23 bps, 46 bps and 50 bps for the 91-day, 182-day and the 364-day Treasury bills to 7.1%, 7.7% and 8.7% respectively at the auction for the week ending June 19th, 2020 from 7.3%, 8.2% and 9.2% respectively at the auction for the week ending June 5th, 2020.

Outlook

- Owing to the uncertainties surrounding economic growth, we expect investors to focus on shorter dated papers.
- We also expect Treasury to continue to minimize domestic debt costs by rejecting expensive bids.

Lending Rates

- The Central Bank's monetary policy stance as reflected by the Central Bank Rate (CBR), remained largely unchanged for most of 2019.
- However, in November 2019, the CBK lowered the CBR by 50 bps from 9.0% to 8.5% (indicating an expansionary stance) and this happened after the removal of the interest rate capping regulations.
- In January 2020, there was an additional 25 bps cut in the CBR to 8.25% in a bid to support economic activity.
- In March 2020, as a pre-emptive measure against the expected adverse economic impact of the COVID-19 pandemic, the Central Bank's Monetary Policy Committee (MPC) further lowered the CBR by 100 bps to 7.25% and also reduced the Cash Reserve Ratio (CRR) to 4.25% from 5.25% (initially releasing KES.35.2 billion as additional liquidity to banks to directly support distressed borrowers).
- In April 2020, the MPC decided to further sustain its accommodative monetary policy stance, lowering the CBR by 25 bps to 7.0% and this was premised by the continuing adverse economic outlook for 2020.
- Prior to the introduction of interest caps, commercial banks response to the CBK monetary policy direction was weak with banks slowly adjusting their lending rates in reference to CBK guidance.
- However, after the removal of interest rate caps in November 2020, banks have improved their responsiveness to the changes in CBR, revising lending rates downwards in line with the CBR.

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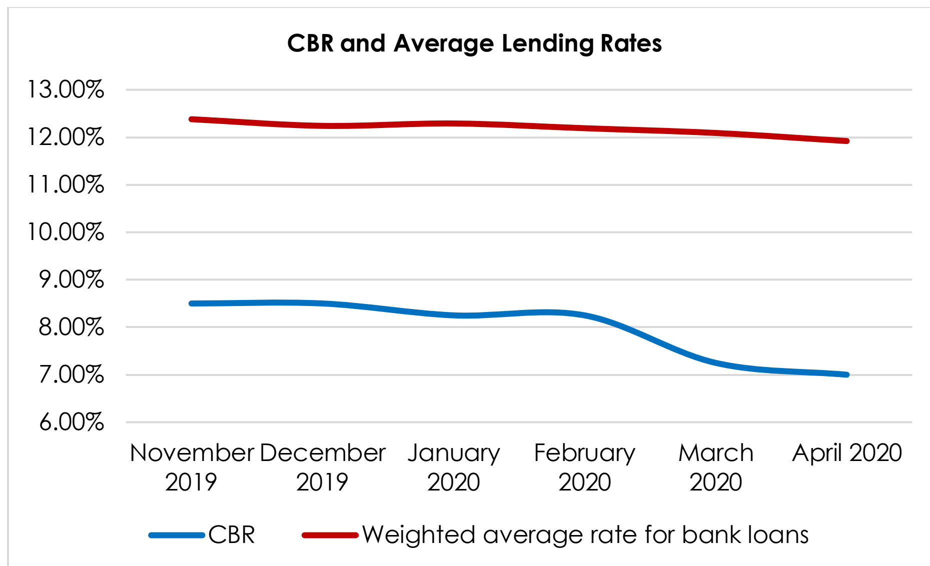


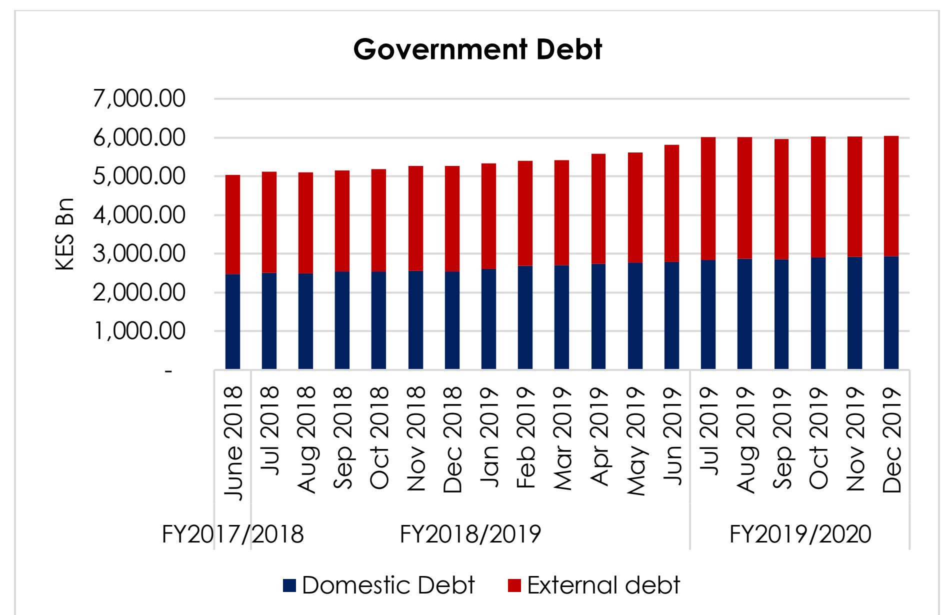
Source: Central Bank of Kenya

Outlook

- Whilst we believe there is room for further CBR cuts by the CBK (demand pressures remain muted, economic growth outlook for 2020 still remains low and annual headline inflation is expected to remain within the CBK's target range of 5.0% +/- 2.5%), we opine that the CBK will hold the CBR at 7.0% for the remainder of 2020.
- We expect the policy measures adopted in March and April (lower CRR and CBR) coupled with the fiscal measures (such as the economic stimulus package, tax cuts) outlined in the FY2020/2021 budget to catalyze economic growth in 2020, negating the need for additional CBR cuts.
- Furthermore, as the economy continues to gradually open up throughout 2H2020, we may see banks increase lending at the current rates (despite them being low) owing to expectations of improving economic conditions.

Public Debt

- Kenya's total debt has risen by 20.0% from KES 5,039.0 billion (59.2% of GDP) at the end of June 2018 to KES 6,048.9 billion as at the end of December 2019 (57.9% of GDP).
- The rise in the country's total debt during this period was driven by an 18.7% growth in domestic debt to KES 2,942.1 billion and a 21.4% growth in external debt to KES 3,106.82 billion.
- On average, during this period, domestic debt accounted for 48.7% of total debt while external debt accounted for 51.3%.
- Despite the significant increase in total government debt, total public debt as a proportion of GDP remained below the lower-middle income country debt sustainability benchmark of 70.0% GDP.
- The rise in government debt has been occasioned by a widening fiscal deficit. The fiscal deficit is expected to widen by 33.5% from KES 631.3 bn in FY2017/2018 to KES 842.7 bn in FY2019/2020 underpinned by a faster rise in expenditures in comparison to revenues.



Source: National Treasury and Central Bank of Kenya

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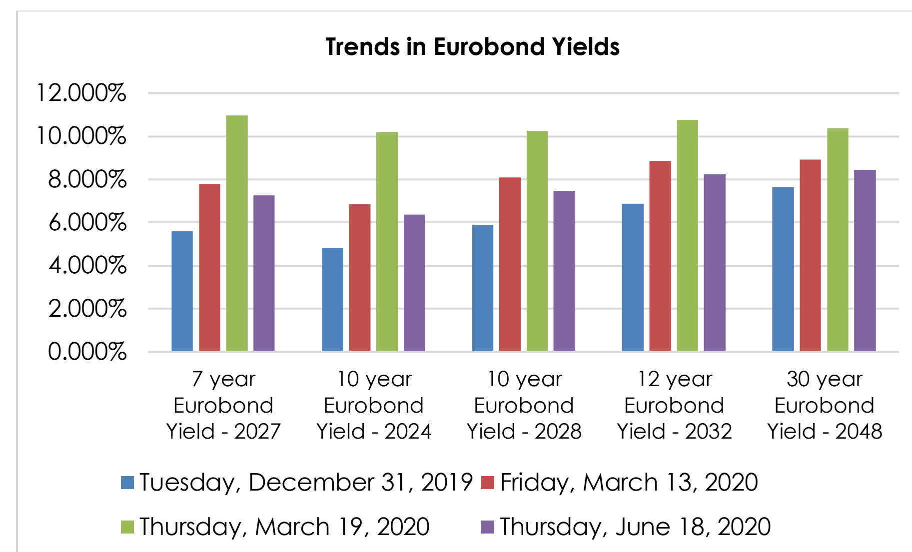
Outlook

- The budget for FY2020/2021 has been prepared with a key emphasis on the helping the country to recover from the COVID-19 pandemic and aptly allocates funds to the hardest hit sectors in order to spur economic growth in the medium term.
- Despite a deterioration in public debt indicators (due to the COVID-19 crisis), current debt levels still remain sustainable (below the lower-middle income country debt sustainability benchmark of 70.0% GDP).
- As much as we are going to see rising debt to finance the fiscal deficit in FY2020/2021(the fiscal deficit (including grants) is estimated to decline to KES 840.6 bn (7.5 % of GDP)) the government plans to shift towards concessional external borrowing and lengthening of maturity structure of the domestic debt. This could lead to lower short-term rates.
- There is also possibility of another Eurobond issue. This is partly informed by the fact that the government, in rejecting the G20 debt relief deal, cited the restrictive terms of deal. One of the terms was limiting the country's ability to issue external commercial debt (e.g. Eurobond). We also note that Eurobond yields are almost back to the levels there were pre-COVID-19 despite the negative outlook by credit rating agencies. Interest rates are currently low in advanced economies due to the expansionary policies. We opine that investors may be looking at emerging and frontier debt issues in search of higher yields.



Source: Central Bank of Kenya

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