Market Insights & Strategy
Global Markets

Kenya
East African Power House Faces A Difficult 2017

Despite an ongoing challenge by Ethiopia and Tanzania, Kenya has thus far managed to cling onto its spot as East Africa's largest economy displaying a robust performance over the past few years, with 2016 proving to be no different as the country's GDP expanded by 5.90%. However the year ahead could be a much more difficult one especially on the financial and political side.

Foreign & Domestic Politics

On the political front two key risks lie ahead, firstly the future of a trade deal between the US and Africa (AGOA), which gives products from certain African states like Kenya preferential access to the American market, could along with NAFTA, be reviewed by a Trump administration which has already indicated its determination to scrap and/or renegotiate trade deals ensuring an 'America First' policy going forward. Domestically Kenya's general elections are scheduled to take place in August, and there are fears that the widespread violence seen following the 2007 poll could again raise its ugly head especially with the recent build-up in tensions between supporters of the current government and opposition groups, triggered by concerns over certain electoral laws and allegations from both sides of fraudulent voter registration. Meanwhile President Uhuru Kenyatta and his ruling Jubilee party may face a more unified coalition in this upcoming election after the leaders of four separate parties, the ODM, WDM, FK and ANC, joined forces to create what they have called the 'National Super Alliance' and appointed a committee to select one of them to stand as their Presidential candidate.

El Nino

Along with tourism, agriculture is one of Kenya's most important sectors, directly contributing up to 24% of overall GDP and 45% of government revenues, as well as being the economy's largest employer. However up to 80% of the countryside is now classified as semi-arid or arid (UN), and due to probably the worst drought in over a decade which according to meteorologists could continue into the months ahead, domestic crop production this year is expected to be sharply lower. This in turn could see the percentage of food imports, which had declined in recent years, begin to rise along with inflation, while the lower rainfall levels have also affected the country's hydro-generated power supplies resulting in both water and electricity rationing. This latest regional bout of extremely dry weather was triggered in part by last year's El Nino effect, but Kenya is also facing the continued encroachment of desertification and this particular issue was highlighted recently in a survey undertaken by the country's forestry ministry which revealed that an estimated 25% of the Mau Forest region, a key rainfall catchment area, has been lost due to human actions. The inflationary effect of higher food prices is already being felt, and this was amplified by February's CPI data which recorded a jump of 9.04% y/y against 6.99% in January.

Monetary & Fiscal Policy

A law enforcing a controversial cap of 4% above the Central Bank's benchmark interest rate on the local banking sector's loan rates, which was approved by the Kenyan parliament last year following an angry public debate over what was seen as the generally high cost of bank loans, could also negatively affect growth. The IMF has described this restriction as 'ineffective,' warning that it will likely make it harder for small banks to survive and force larger institutions to cut costs by shutting branches, this in turn could see a wave of layoffs within the financial sector and force SMEs into the much more expensive informal sector in order to

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source their loan requirements. The IMF has also estimated that the effects of this cap could reduce economic growth by almost 1% per annum. Meanwhile the country's budget deficit widened to 9.60% of GDP in 2016 and although the government has pledged to reduce this to 7.00% via tax increases and other measures this year, it has at the same time also promised to raise civil servant salaries. The latter decision highlighting the fact that we have entered an election year making major tax rises unlikely in our view, which means borrowing looks set to increase in order to cover the funding gap.

Shilling vs REER

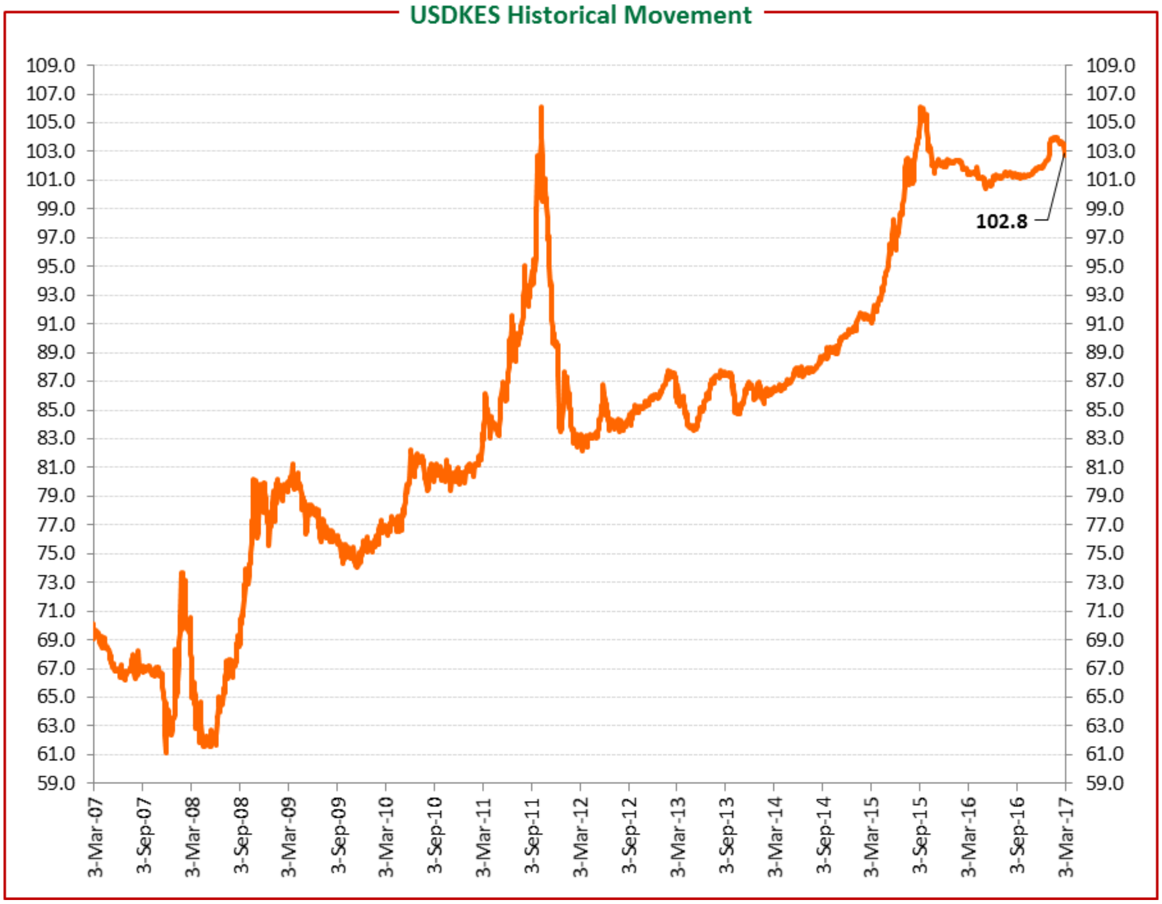
We consider the Kenyan shilling to be overvalued on the basis of the real-effective exchange rate and in relative terms compared to its peer currencies in Sub-Saharan Africa. Over the past few years the rate of inflation accumulated over time exceeds the pace of depreciation of the Shilling. For example, for the period between 2010-2016 non-compounded aggregate inflation was around 53% but the Shilling only weakened by 34% over the same timeframe. In terms of relative value the graph below reveals that USD/KES is still trading below the 2011 peak of 106.75, conversely the greenback is much higher against most other African currencies, such as ZAR, UGX, ZMW and GHS since then, and even major currencies like the EUR and GBP which are also major export destinations for Kenyan produce are much lower against the dollar now compared to 2011. In other words, the Kenyan shilling has appreciated significantly in the past few years not only against the dollar but versus a broad basket of currencies, and its only since the beginning of 2017 that pressure on the local currency appears to finally be building.

Conclusion

Taking all of the above issues into account we believe that 2017 will be a far more difficult one for the Kenyan economy, we also think that the Shillings' outperformance is unsustainable going forward especially when adding in the likelihood of further FED rate hikes and a strengthening US Dollar this year.

	2012	2013	2014	2015	2016 (e)
Economy					
Population (million)	40.70	41.80	43.00	44.23	45.48
Nominal GDP (USD bn)	50.41	54.93	60.94	61.41	64.69
GDP/ capita (USD)	1,238	1,314	1,417	1,439	1,516
Real GDP growth (%)	4.56	5.69	5.33	5.59	5.90
Fiscal balance / GDP (%)	-5.03	-5.71	-7.45	-8.38	-9.60
Public debt / GDP (%)	41.69	41.62	47.02	52.69	55.15
External debt / GDP (%)	38.10	37.80	38.20	42.50	45.10
Investment / GDP (%)	21.51	20.11	21.37	23.9	21.2
National Savings / GDP (%)	13.07	11.24	10.97	14.39	14.17
Balance of Payments					
Trade balance (USD bn)	-9.31	-9.44	-9.91	-10.52	NA
Current account (USD bn)	-4.26	-4.87	-6.34	-5.01	-4.40
Current account / GDP (%)	-8.44	-8.87	-10.40	-8.16	-5.50
FX reserves (USD bn)	5.71	6.60	7.11	7.33	6.97
Credit Rating (LT FC)					
Moody's	B1	B1	B1	B1	B1
Standard & Poor's	B+	B+	B+	B+	B+
Fitch	B+	B+	B+	B+	B+
Monetary & Financial Indicators					
Consumer Inflation (%) pa	9.38	5.72	6.88	6.58	6.70
M2 money supply (% y/y) pa	17.15	11.15	NA	NA	NA
Central Bank rate (%)	11.00	8.50	8.50	11.50	10.00
Exchange rate (USD/KES)	86.10	86.30	90.60	98.27	101.50

Source: NBAD; IMF; World Bank; IIF



Source: Bloomberg/NBAD

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