Dry Associates Investment Newsletter

JANUARY—MARCH 2013

Dear Investor,

INSIDE THIS ISSUE:

As we write this newsletter, there is an understandably a consuming preoccupation here in Kenya with the elections to be held March 4th - just a few days away. This is to be expected as it will impact Kenya's economic prospects for years to come.

Kenyan Elections

The Danish Refugee Council, an NGO with an obvious interest in regional stability, estimates in a special circular, a 60% chance that there will be a presidential runoff meaning no candidate will win 51% of the popular vote AND 25% of the vote in half the 47 counties for an outright victory. Such a scenario requires a runoff between the leading two candidates over the next 4 weeks which subjects the country to further tension and uncertainty. The Council goes on to estimate a 30% probability for a clear winner on the first ballot and a 10% probability of a flawed election ending up in the courts.

From where we sit, we see the election process as a necessary democracy building exercise that must be gotten through. It would be naïve to think there will not be at least sporadic violence. Nevertheless, most of our investors appear to have enough confidence in Kenya to believe that we'll come out on the other side of this relatively intact. And at a practical level, with businesses and homes in Kenya what can local investors do other than grim and bear it. But it is one more reminder that a properly structured investment portfolio today should be geographically diverse.

The peaks of Mt. Kenya, looking on from the airstrip at Rutundu, Jan. 26th '13 (Courtesy: J. Schmalzle)

Europe

There has been a reduced sense of urgency concerning the eurozone crisis over the past couple months. But don't be fooled, the EU has yet to find a solution to its single currency / multiple fiscal regime dilemma. The last few months have seen some band aids – more Greek bailout money, more liquidity injected by the European Central Bank- but little else. Maybe it's just eurozone fatigue that's pushed Greece, Spain and Portugal off the front pages – and we're not complaining.

Across the Atlantic, things are arguably a bit better. The US economy grew at 2.2% during 2012. However, it continues to face public debt problems. On January 2, 2013, Congress delayed the so called fiscal cliff budget cuts until March 1, 2013. These cuts are meant to save some $1.2 trillion over the next 10 years. One interesting compromise from the negotiations surrounding that 3 month budget extension was the new estate tax exemption. Congress and the President signed into law a permanent life time exemption of $5 million for each American. In other words, no death taxes will be due on estates up to $5 million.

Currency Wars

This topic has been in the news lately as all the developed economies would love to grow their way out of their economic problems. That's because fiscal and monetary policies are not doing the job. In other words, the tool box is empty.

Quantitative easing to increase liquidity has grown to the point of diminishing returns. Monetary policy's two big tools – interest rate reductions meant to increase consumer and business demand and bond buying to inject liquidity are not having the desired effect. Hence all the talk about currency wars at the January World Economic Forum in Davos and more recently the Group of Seven and G20 meetings.

Lake Rutundu Fishing Lodge, Mt. Kenya, Jan. 26th '13 (Courtesy: P. Wesolek)

The theory behind a central bank purposely depreciating a nation's currency is that it will make exports cheaper and therefore more competitive in world markets. Maybe so, but it has serious side effects like making imports more expensive possibly triggering inflation. We looked at exports and imports as a percentage of GDP for several countries in 2011. Here's what we found (see next page):

	USA	UK	Japan	Germany	Kenya	Uganda
Exports/GDP	13%	32%	15%	50%	29%	24%
Imports/GDP	18%	34%	16%	45%	46%	59%

Source: 2012 Statistics / World Bank

Notice that in almost every developed economy, imports approximate exports. Therefore, currency depreciation may help grow exports but at the risk of importing inflation. If imports can be reduced, well and good. But often imports – such as gas and oil – are vital ingredients of economic growth.

Note also that currency depreciation would be particularly bad policy for countries like Kenya and Uganda which import considerably more than they export.

So, purposefully depreciating a nation's currency may have its uses as when Switzerland pegged the Swiss franc to the euro to stop the franc's runaway appreciation as a result of eurozone investors' flight to safety. But it is seldom sensible long term strategy. It's a beggar-thy-neighbor attitude that results in a merry go round of depreciations amongst trading partners with nothing to show for it in the end except a debased currency.

Economic policy deserves better. It should be based on a pro-business policy designed to support human capital, infrastructure, entrepreneurship and new technology within a framework of sensible taxes and labor law. That's where economic planning needs to start!

Skiing the French Alps, above the village of *La Toussuire* looking toward *Les Aiguilles d'Arves*, Feb. 13th '13 (Courtesy: S. Dry)

Estate Planning — Keeping What's Yours

We've never discussed estate planning in these newsletters and that's an oversight since estate planning is very much a part of wealth management. That said, we must state categorically that we are not providing expert tax or legal advice. We discuss here only broad considerations which need legal verification in every instance. Everyone's case is unique and requires the direct input of legal counsel whether here or abroad. Dry Associates does have a legal officer on staff with whom investors may wish to discuss Kenyan estate planning.

Of course, Kenyan citizens are fortunate that the government does not assess taxes on the estate of deceased persons. However, unless property is titled to pass to a surviving party, or a beneficiary, or is gifted before death, a deceased person's estate must be probated. Even though you have a will bequeathing your worldly assets to someone, unless the property is titled to convey on death, the property must be probated meaning it is inventoried, gazetted, etc. before it passes legally to another. The probate process is cumbersome.

" Kenyan citizens are fortunate that the government does not assess taxes on the estate of deceased persons"

Of course, probate is a reality in many countries including the US and the UK. A little foresight, however, can go a long way in avoiding the expense and time involved in such an exercise.

Besides probate, the other major estate planning consideration for expatriates is reducing or eliminating death taxes. In the US, as noted above, the law allows for a lifetime exemption of up to $5 million per person from estate taxes with amounts above that taxed up to 40%. US law does allow a surviving spouse to inherit the other spouse's property for the remainder of his/her life without taxes, but estate taxes are due on the death of the last spouse on amounts above $5 million. One way around this in the US is to establish a spousal living trust that becomes an irrevocable trust upon the death of the first spouse permitting amounts up to $10 million to be exempted from estate taxes.

US estate taxes are based on nationality. UK estates taxes are based on domicile which can be complicated.

Nevertheless, there are parallels between US and UK estate taxes. The UK law has a "nil rate band" which excludes taxes on estates up to Sterling 325,000 above which an estate is taxed at 20%. UK law, similar to the US, provides for transferring the nil rate band exemption to a surviving spouse without incurring a taxable event and also increases the nil band to Sterling 650,000 at death.

Estate planning should be a natural part of family planning. You'll need help with this and it will require some reflection.

Kenyan Fixed Income

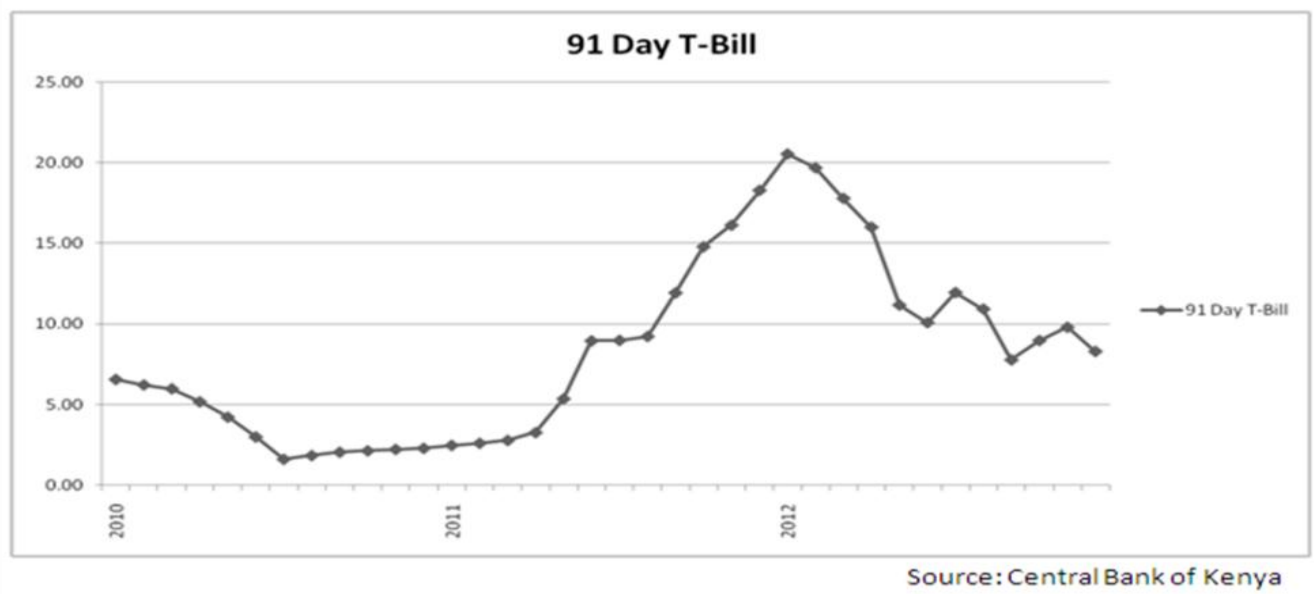
Spotted Genet Cat eating Trout Roe — Lake Rutundu, Jan. 26th '13 (Courtesy: J. Schmalzle)

Interest rates have remained fairly stable over the last two months. The Central Bank Rate (CBR) was adjusted downward to 9.50% per annum on January 10, 2013. This is the rate the Central Bank lends overnight money to commercial banks. The CBR, however, is a committee determined rate and not a market rate.

Treasury bill rates are perhaps a closer approximation of market rates. Currently they are 9.37% for 91 days and 9.08% for 182 days.

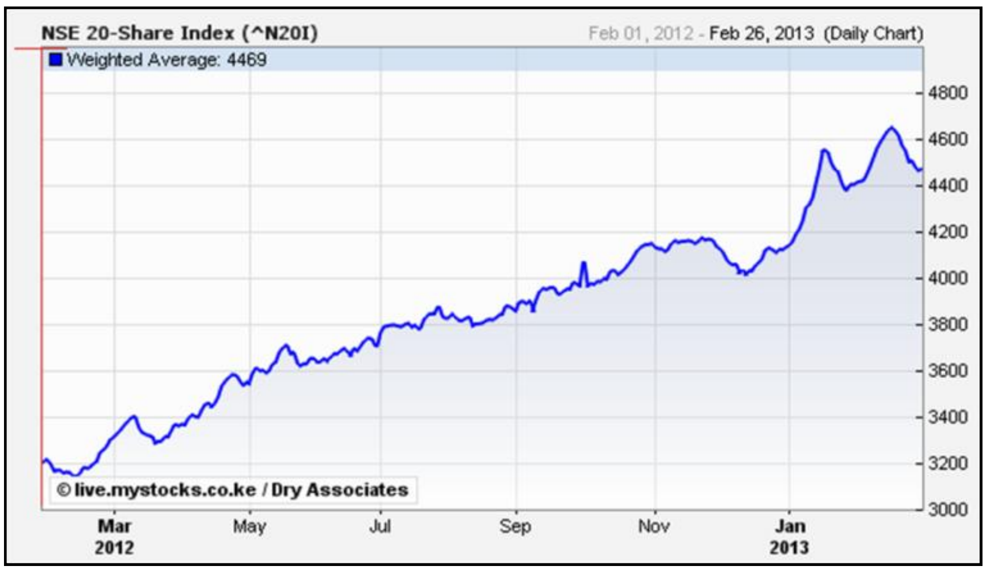
Bank overdraft lending rates are generally in the 16-20% region whereas Fixed Deposit Receipts were paying depositors 5-10% depending on the bank. Commercial Paper is currently paying 12-14%.

For perspective, Kenyan short term interest rates have bounced around 10% over the past several years per the chart below. Notice how volatile the rates are, however. Recall that as recently as April 2010, T-bills were only 2% and yet were 20% in December 2011!



Going forward, we would expect interest rates to rise above 10% as election anxiety approaches.

Kenyan Equities



The Nairobi Securities Exchange has continued its steady march up the mountain over the past twelve months as illustrated to the right:

In fact, the NSE over the past 12 months has lifted almost all ships – and in some cases over 100% - as with BAT and Athi River Mining. Other stocks are up a mere 60% such as Standard Chartered Bank as detailed to the right below:

So, friends, we'll see you all on the other side of these elections. We know you join us in praying for fair and peaceful elections as we welcome the New Kenya!

Sincerely,

Dry Associates