Dry Associates Newsletter
July - Sept. 2013

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Dear Investor,

An article in the *International Herald Tribune* on August 22, 2013 stated that "Since Mr. Bernanke and the Federal Reserve first indicated that stimulus efforts might be eased, trading in both developed countries and in emerging markets has been volatile" (by Nelson Schwartz). What an understatement!

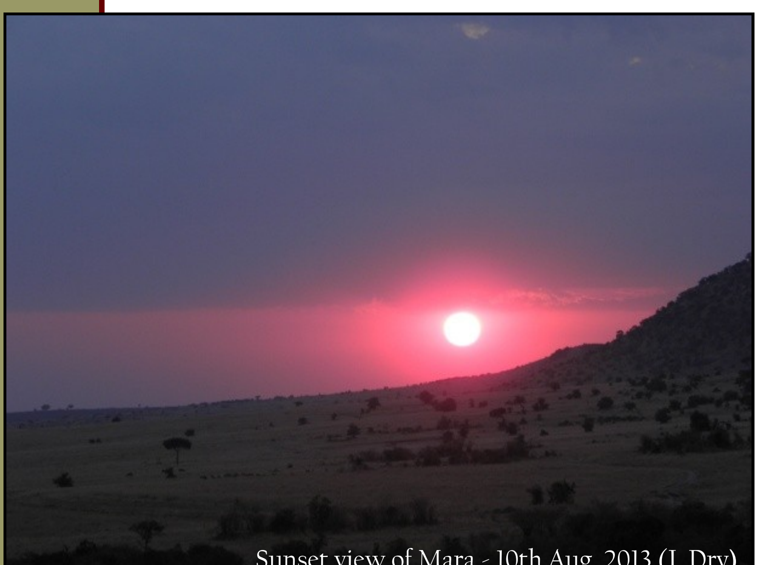
Emerging market currencies, equities and bonds have all swooned as investors reduce their holdings in these assets in anticipation of the Fed's "tapering", an improving US economy, rising US interest rates and eventually higher US equity prices.

What has made outflows from emerging markets so pronounced is the massive inflows that came into these markets since the financial crisis began in 2008. Prodded by low interest rates in developed economies, big investors like mutual funds, sovereign funds and hedge funds dumped $1.2 trillion into emerging markets in 2012 alone – almost 6x that of a decade ago – according to a recent HSBC study.

Now in moving the other way, certain economies like India, Turkey and Indonesia are experiencing major devaluations in their local currencies. Interest rates in emerging markets will rise in an attempt to stem the outflows.

What's Going On …

Economists long ago gave up on the pretext that modern economies are market driven. To the contrary, most economies today – including the US economy – are "managed".


Sunset view of Mara - 10th Aug. 2013 (J. Dry)

Central banks are increasingly important players in the global economy masking fundamental economic signals. The European Union is a case in point. Instead of Greece and Cyprus exiting the EU, which free market economics would suggest, the EU continues its endless summits, bail-outs, and bail-ins with no end in sight. Angela Merkel's pronouncements move the markets more than any economic data.

The US Federal Reserve, for its part, has been similarly engaged in expansionary monetary policies on a scale never seen before. Ben Bernanke is effectively the leading US economic indicator today.

Frustrations of an Investment Manager

Accurately predicting the supply and demand for an asset has always been the key to making good investments. Today, of course, this requires a global perspective. Looking ahead, here's what we think :

"Volatility" will continue over the next 18 months as interest rates rise across both emerging and developed markets and capital returns to the US.

Bearing this in mind, a reasonable investment strategy would favor short term debt rolling into longer term debt as rates rise.

Our Kenyan investors, in particular, are well placed to do this through commercial bank fixed deposit receipts (FDRs), Kenyan Treasury bills, and for larger investors, commercial paper. Returns in excess of 10% per annum can be achieved here. That's the easy part.

Real wealth creation, however, will require some equity investment for capital appreciation. As higher taxes and higher inflation eat into investment returns, yields of 10% per annum will only be minimally adequate.

In developed economies like the US, already higher bond yields are beginning to compete with equity dividend yields. Increasingly, investors should be seeking exposure to both debt and equity. Unit trust (or mutual fund) investors should be looking at "balanced" funds which offer both debt and equity. Franklin Templeton Global Balanced Fund, for example, is comprised of 63% equity and 21% fixed income (balance in cash) and has returned 22% over the last 12 months.

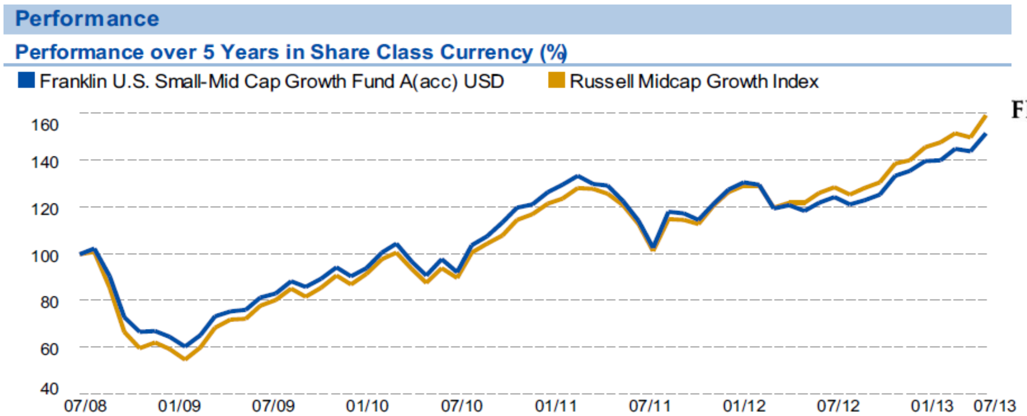
For more aggressive investors who can take on slightly more risk, equity investments in fast growing companies makes sense. This would imply a focus on smaller listed companies rather than larger mature companies. Franklin Templeton's US Small-Mid Cap Fund invests only in smaller companies and is up 28% over the past year (see next page).

Some emerging and frontier equity markets have done well up to now, for example, Templeton's Frontier Markets Fund is up 23% over the past 12 months. These markets, however, we expect will be affected by the capital outflows from emerging markets over the next 18 months. In spite of this "hot" money outflow, we expect certain emerging and frontier economies like Kenya to continue to grow their GDPs at 5%+ over the next several years. Increasingly, we see value in not yet listed companies that trade OTC (Over the Counter).


Maasai Mara—11th August, 2013 (J. Dry)

Dry Associates is currently working with a number of excellent companies in Kenya that are considering private equity (PE) placements.

Franklin Templeton's US Small Cap Fund for debt and equity exposure



Performance in Share Class Currency (%)

	Cumulative									Annualised
	1 Mth	3 Mths	6 Mths	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Incept	Since Incept
A(acc) USD	5.57	8.34	13.84	21.11	28.35	55.30	51.94	113.24	61.21	3.87

Kenya Fixed Income Securities

The Kenyan interest rate environment is stable but we expect will trend up. While the official Central Bank of Kenya (CBK rate) has remained at 8.5% since May 2013, Treasury bill rates will almost certainly rise.

The average 91, 182 and 364 day Treasury bill rates are 9.9%, 10.5% and 11.4% respectively (as at 05 September). These rates are historically slightly higher than normal but we expect them to rise further as Treasury tries to hold the shilling's value, fund the current account deficit and plug the domestic budget deficit. Kenya's Ksh 1.6 trillion annual public budget has an 8% budget deficit … equivalent to Ksh 128 billion!

As part of the Government of Kenya's efforts to finance deficits and carry the accumulated public debt, the GOK is planning to issue its first sovereign bond denominated in US dollars before year end. This $1-2 billion Eurobond is expected to carry a coupon of 8% in US dollars. Please contact your Dry Associates investment advisor for more details.

As we've noted in the past, the only thing that can hold back the rising tide of debt would be balanced budget amendment or possibly an amendment to prohibit debt from exceeding say, 50% of GDP. Kenyan politicians, like politicians worldwide, need to legislate themselves into fiscal responsibility. Then again, the probability of that happening is up there with the gold standard and bitcoin!


Annual Migration
- 10th Aug, 2013 (J. Dry)

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In any event, Kenya continues to be a high interest rate environment per the following:

Average Bank Overdraft Rates	16.97% per annum (Source: CBK)
Average Commercial Paper Lending Rates	12.00% per annum (Source: Dry)
Average FDR rates (with DAL partner banks)	10.50% per annum (Source: Dry)
Average Treasury Bill Rates	9.93% per annum (Source: CBK)
Average Bank Deposit Rates	6.65% per annum (Source: CBK)

Kenyan Equities

Kenyan equities are meeting resistance at these levels.

Foreign investors have been net sellers on the NSE. This, we believe, is in concert with the global retreat from emerging markets and nothing particularly Kenyan specific.

NSE companies have reported half year earnings and the banking sector continues to astonish. In fact, the majority of companies have reported robust earnings.

Nevertheless, these generally favorable earnings figures have not translated into new highs. In fact, the NSE 20 Share Index doesn't look like it's going to breach the 5,000 watermark any time soon.

To some extent, NSE equities are fairly priced with the average trailing P/E ratio of 12 times as at August month end. Value investors would not be aggressive buyers here.

Even momentum investors that should be looking at companies like Safaricom are not seeing new highs. In fact, Safaricom has backed off its high of Ksh 8.30 last week.

As we indicated above, we expect interest rates in Kenya to trend up. Higher interest rates are never good for equity markets. Nevertheless, if interest rates do not go too high and businesses have time to adjust to higher rates, there is no reason that company earnings cannot also rise and be reflected in higher equity prices over the longer term.


11th Aug,.2013 (J. Dry)

Sincerely,