Dry Associates Investment Newsletter

August 2016

A night view of the whitewashed, cliff-side buildings of Oia, Santorini, Greece (May 2016), Courtesy: S. Dry

Dear Investor,

<u>The World Economy</u>

The World Bank has revised downward its earlier estimate for global growth in 2016 from 2.9% to 2.4%. The Bank cites continued low commodity prices and weak trade combined with continued low growth in developed economies. So, global growth in 2016 is expected to be the same as 2015.

Drilling down, however, there is a great deal of difference amongst nations. Here's a selected list:

Country	2016 Forecast GDP Growth
India	7.6%
China	6.7%
Kenya	5.9%
USA	1.9%
Euro Area	1.6%
South Africa	0.6%
Japan	0.5%

Source: World Bank (Global Economic Prospects, June 2016)

US Market

From the above figures, the growth of the US economy is certainly not outstanding. Second quarter 2016 corporate earnings are not particularly reassuring either. Eighty six percent of the companies in the Standard & Poor 500 index have reported their 2nd quarter 2016 earnings and they're showing an overall decline of 5.5% according to FactSet. Several business sectors, however, show increased earnings led by Information Technology, with Google's earnings coming in 28% higher this quarter than the same quarter in 2015.

It is also noteworthy that the US bull market began in 2009 and is now 7 years old – much longer than the average 4 year bull market. The trailing 12-month Price/Earnings ratio of the large industrial companies in the Dow Jones Industrial Average is now 20.15x versus 16.63x a year ago according to the Wall Street Journal. Add to all this the uncertainly of the US presidential elections on November 8th.

So, why is Dry Associates still recommending US equities market? Well, for a number of reasons. First of all, the economy continues to grow – albeit slowly. Secondly, the dollar continues to hold its value and even appreciate against most other currencies. But perhaps most importantly, the Federal Reserve continues to be accommodative and is now not expected to raise interest rates until December making equities just about the only game in town. And while the Fed's actions are not impartial economic events, let's face it, central banks' behavior around the world is affecting economics, whether we like it or not.

Balanced Investing

So, for the time being, in spite of an uninspiring projected 1.9% growth rate, we continue to recommend exposure to the US market. Our reasoning reflects our emphasis on capital preservation AND wealth creation. This thinking is reflected in Dry Associates' own proprietary portfolio. For example, our Investment Committee currently has a policy of investing 50% of its own proprietary portfolio in US equities. [The other 50% is invested in high yielding Kenyan debt instruments denominated in shillings and dollars.] The US portfolio, however, includes exposure to gold producers and international real estate. The actual US portfolio is invested through Franklin Templeton mutual funds as follows:

Fund	Percentage of Portfolio	Appreciation since 4-Jan-16
Franklin US Opportunities Fund	28%	1.7%
Franklin Gold & Precious Metals Fund	26%	113%
Franklin US Small-Mid Cap Growth	21%	7.7%
Franklin Global Real Estate Fund	15%	11.2%
Templeton Global Balanced Fund	5%	4.4%
Franklin Technology Fund	5%	9.6%
	100%	

This is admittedly an aggressive portfolio with no US debt and the reasoning is simple. US debt paper in the US pays very little. The 10 year US Treasury bond currently pays 1.51%. Nevertheless, older investors whose aim might understandably be focused on maximizing current income would substitute some of the above equity with income funds such as the Franklin Global Income Fund or the Franklin High Yield Fund.

<u>Glass-Steagal Act</u>

Staying with the US for a moment, the Democrats and the Republicans don't agree on much. One thing, however, both parties have put into their respective party platforms is reinstatement of the Glass-Steagall Act of 1933 which separated commercial banking from investment banking. While it is not at all clear that the collapse of Bear Sterns and Lehman Brothers in 2008 could have been prevented if the Act were not abolished in 1999, there are good reasons, we think, for keeping the two businesses separate. Most advocates for reinstatement use the argument that commercial banks should stick to the knitting, which is lending out depositors money. They argue that by allowing them to engage in creating derivatives, issuing and underwriting stocks and bonds, engaging in merchant banking type activities, they are taking on too much risk with depositors' money. That may be so, but our thinking focuses on something else. We think that both activities – commercial lending and investment banking are critical to developing deep, sound financial and capital markets. Our sense is that when there is a legal separation of commercial from investment banking, both sectors have an opportunity to grow and develop. In continental Europe, for example, where universal banking is the norm, the investment banking sector has never really taken off. If a large company wants inexpensive short or long term funds, in Germany, for example, odds are you'll end up talking with Deutsch Bank and you'll end up with a bank loan. In the US, a large company would consider commercial paper for short term funds and a corporate bond for longer term funds. The US has a very vibrant investment banking sector that we think owes its existence to the Glass-Steagall Act separating the two types of "banking". Maybe the Dems and the Republicans are on to something.

The famous port of Ammoudi where tourists gather to watch the sunset and snack on a seafood mezze, Santorini (May 2016), Courtesy: S. Dry

Kenyan Financial Market

The Kenyan financial market is currently experiencing a liquidity squeeze. This has been evident since early April when Chase Bank became the third commercial bank to close its doors in ten months. The bank was partially re-opened on April 27th when current account holders were allowed to access their funds up to KES 1 million. Since then, KCB acting as the Receiver Manager has restarted other services such as ATM, wire transfers, and other normal bank functions but always only up to KES 1 million unless the account holder added additional funds.

Institutional investors, such as fund managers and pension funds who did not have current accounts but had placed funds with Chase on time deposits, have not been allowed access to these funds.

So on July 26th with some other 250 stakeholders in Chase Bank, we attended a briefing by KCB on the status of the bank. The hoped for announcement that institutional investors would be allowed access to their funds was not forthcoming. Instead, what KCB advised stakeholders was that a due diligence report was being prepared by a third party which would evaluate the bank with a view to its sale to other banks.

The 25% maximum ownership rule which applies to banks presumably would not allow a single bank to purchase the bank outright. This evaluation report was to be finalized and provided to the Central Bank of Kenya (CBK) by month end August.

By all indications, Chase Bank is a viable bank. Further evidence of this was the announcement on 15 August 2016 that Chase Bank was accepting term deposits and paying interest on these new deposits (for example, 4.63% for KES 5M for 6 months) and resuming lending. The announcement, however, stated that earlier placed fixed deposits were still “under moratorium” and investors would be advised “in due course” regarding these deposits.

So, the fall out of three bank closures has understandably made the investing public nervous with many depositors moving their funds to larger Tier I banks starving smaller banks of liquidity. As a consequence, there is a degree of hesitance by larger banks to continue interbank lending to their smaller bank colleagues.

Then, on top of this, the Kenyan Parliament has passed the Banking (Amendment) Bill and sent it to President Uhuru for assent. The bill would cap interest rates charged by banks to 4% over the CBK's recommended interest rate. The road to hell is paved with good intentions and while good intentioned, it would cause a great deal of harm to the Kenyan economy. Credit to the less credit worthy would be stifled. Good credit risks will always be able to get credit, but risk must be priced. And it needs to be as accurate as possible.

Besides, there are many other constructive actions Parliament could take to reduce interest rates. Here are a few:

- The Kenya Deposit Insurance Corporation (KDIC) could increase the deposit insurance on bank accounts from KES 100,000 to say, KES 5 million.Small banks would benefit immediately as funds flowed to Tier II, III and IV banks reducing their current high cost of deposits meaning they could lend at lower interest rates.
- The current tax on bank interest earned could be reduced from 15% to 10% which would encourage new funds to flow into banks further reducing banks' cost of capital.
- Legislation opening saccos to a wider clientele would provide competition to banks
- Encouraging other sources of credit such as consumer finance companies would provide more competition
- Deepening the financial sector through increased use of investment banking products such as corporate paper (e.g. commercial paper and corporate bonds) would provide direct competition to banks forcing rates down (and incidentally allowing private sector investors to participate directly in the growing Kenyan economy)

You get the point. There are scores of ways to bring down interest rates but in the end it requires deepening and widening the financial sector – certainly not price controls which history teaches us never work in the long run.

Kenyan Stock Market

The Kenyan stock market continues to underperform as the chart below illustrates:

Source: www.mystocks.co.ke

The securities market is certainly not reflecting the World Bank's rosy economic projections of 5.9% GDP growth in 2016. Confirmation of that is the depressed Price/Earnings ratios (currently 10.45x if you exclude companies with negative ratios or ratios over 50x) on the NSE.

The poor management exhibited by more than a few of the major listed companies – Uchumi, KQ and others – is certainly weighting down the stock exchange. In addition, high interest rates are not helping corporate profits with some 19 of the 64 counters issuing profit warnings (meaning anticipated fall off in earnings of 25% or more) in 2016. On the positive side, however, foreign interest in the NSE continues to be strong representing some 65% of holdings on the exchange up from 61% in December 2015.

Within the broader context of a growing Kenya, however, we still recommend some "dollar" cost averaging meaning adding to positions in excellent companies like Safaricom on the promise of long term appreciation. The continued high yields on Kenyan corporate and government paper, however, we feel offer a relatively better investment than Kenyan equities for the time being.

Sincerely,

Dry Associates Ltd

24th August 2016

Looking towards the setting sun and the island of Crete, Ammoudi Bay, Santorini (May 2016), Courtesy: S. Dry

Dry Associates Ltd
Dry Associates is an Investment Group in Kenya and offers a wide range of products and services.

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We hope you enjoy this months Investment Newsletter

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