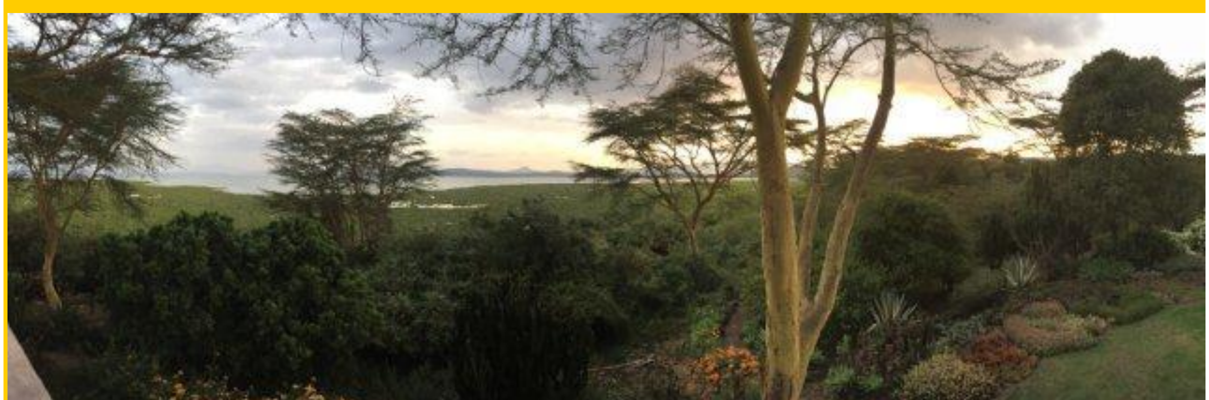
Dry Associates Investment Newsletter

December 2016



View from the balcony at Karuru Tuu on October 20th 2016
Courtesy: C. Dry

Dear Investor,

Goodbye 2016

As we come to the end of 2016 we're reminded of the changing world we live in. From an economic perspective, the winds of change from the US feel like a gale force. Among other things, the new Administration vows to reduce taxes, regulations and welfare. Fiscal spending will replace monetary policy in a renewed effort to spur economic growth. In Europe, the UK has turned its back on the EU even as other countries reassess their relationship with the EU. Globalization – the driving force towards free trade, markets and open borders is under attack. Closer to home in Kenya, we're still in the grip of a stressed financial sector having absorbed three bank failures in a row and now exacerbated by interest rate capping legislation.

A Few Predictions

Predicting the future is a fool's game but as investment advisors we're obliged to do the best we can. After all, if your stock broker isn't right more times than he's wrong, he's in the wrong business. So here's a few predictions.

The US dollar will strengthen in 2017 against other currencies particularly emerging markets currencies. The short reason - because interest rates in the US will rise. They will rise not only as a result of the Fed's own determination to raise rates but the new Administration is proposing massive investment in infrastructure and the military to the tune of $1 trillion. Whether the spending is paid for through deficit budget spending or massive tax credits to businesses, we predict this will accelerate inflation which will spur further hiking of US interest rates by the Fed. The net result is that the rise in interest rates will make the dollar more attractive to global investors and capital will flow to the US.

The US stock market is a harder call. As interest rates go up, generally stock markets come down. In addition, a stronger dollar will stunt US exports reducing profits for US multinationals. However, factor in a reduction in US corporate income taxes from 35% to 15% as is being proposed and business profits should soar. In summary, a mixed bag but we suspect a halving of corporate taxes will be a net boost to US stock markets.

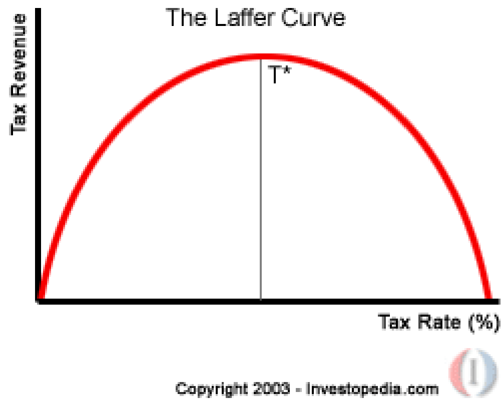
Predictably, the value of the Kenya shilling along with other emerging market currencies is likely to fall relative to the dollar. Quite apart from any dollar interest rate hikes in 2017, the shilling is under pressure from forces within. Kenya is becoming increasingly burdened with public debt which now represents some 55% of the Gross Domestic Product. The World Bank in a recent Debt Sustainability Analysis warns that Kenya's debt-to-GDP which has increased from 42% of GDP to 55% over the past 3 years has the potential to derail Kenya's impressive growth over the past 8 years. The *Business Daily* reported on 2nd December that debt servicing (repaying of interest and principal) on existing government debt will represent 40% of tax revenues next year up from 30% this year. In the absence of continued GDP growth, a country's public debt can only be paid off in debased currency or higher taxes both of which are detrimental to investors.

US Markets – Post US Elections

Continuing with the US for a moment, the Dow Jones Industrial Average is up substantially since Donald Trump was elected US president on 8th November. This flies in the face of what the media predicted going into the elections, that is, US and global stock markets would tank in the event Trump were elected. Instead the Dow Jones Industrial Average is up 5% gaining 911 points as of today (5th December 2016). This is an all time high along with new highs in the NASDAQ and the S&P 500 indexes.

Source: BigCharts.com

One likely reason behind some of this market euphoria is Trump's campaign pledge to drop US corporate tax rates from 35% to 15% as noted above. This pledge we understand can be traced back to the fact that economist Dr. Arthur Laffer is part of the Trump tax reform team. He came to prominence in Ronald Regan's administration by making the case that government tax revenues would increase up to a certain tax rate (T* on the chart below) after which tax revenue falls. The Laffer Curve is based on the theory that after a certain rate of taxation, business activity and individual incentives to work fall away – in fact, all the way to zero when tax rates are 100% as the chart shows:



What the ideal tax rate is that maximizes productivity and tax revenue – whether 30%, 15% or somewhere else – is not certain, but lower corporate taxes are certainly good for stock markets and this may explain part of what's behind the surge in US markets.

Chase Bank

We attended a stakeholders meeting on 24th November 2016 chaired by CBK Governor Patrick Njoroge regarding the status of Chase Bank. He reiterated the three-phase process, the first two of which have been completed:

1) Reopening of the Bank;
2) Business Stability; and
3) Lifting Chase Bank out of receivership status.

Regarding the 3rd phase, the Governor confirmed that the CBK has received multiple expressions of interest in Chase Bank from various local and international institutions including KCB and at least 3 foreign banks. The existing shareholders have also expressed an interest.

In considering the most suitable institution to acquire Chase Bank, the Governor insisted that CBK is looking for a credible institution which will present a sustainable business plan. As pertains to timelines, the CBK Governor is expectant that the Bank will be lifted from receivership status within the first quarter of 2017. The KPMG Due Diligence Report is still ongoing but will be concluded within the next few weeks immediately after which a public offer for expressions of interest prepared by the CBK will be announced.

All bids put forward will be considered and the CBK expects the deal to be concluded within Q1 2017.

Rusinga School

Dry Associates hosted a group of Form 5 senior students from Rusinga School on 23rd November. The event was a tie in between Rusinga graduate, Arnold Kipkoti, working at DAL, and the Coordinator of Rusinga's Business Technology program. The event featured a number of DAL employees describing what they do on a daily basis and the role of financial services in Kenya. DAL is always pleased to be a part of educating young people.

Viral Patel, an Investment Advisor, giving a presentation to Rusinga School students in the Dry Associates board room on 23rd November 2016

Courtesy: C. Dry

New Private Issuances of Debt by Dry Associates

The 4th quarter of 2016 has been a busy three months for DAL with the following new private placement issues brought to market:

Issuer	**Amount**	**Description**	**Outcome**
Multiple Hauliers	KES 500 million	Insured 6 month & 1 year Notes	Sold Out
RA International	US$ 3 million	Insured & uninsured 18 month Notes	Rolling Subscription with $650,000 placed to date
GardaWorld/ KK Security	KES 1.8 billion	5 year Notes	First Tranche KES 425 million placed to date
Nakumatt	KES 500 million	Insured Short Term Notes	Sold Out

Kenyan Stock Market

The Government of Kenya forecasts Kenyan GDP growth in 2016 at 6%. The World Bank estimates 5.9%. These projections are based on increased growth in agriculture, tourism and construction in particular. These are reassuring numbers but there are some troubling issues on the horizon particularly in the financial sector.

Apart from a ballooning debt-to-GDP and the increased debt servicing hardship that brings, the government is effectively crowding out the private sector in the credit market. First, the government appetite for credit continues unabated. Second, there is a flight to safety into Treasury bills and bonds by institutional and retail investors as Tier II, III and IV banks are considered risky places to put their money. And on top of that, these banks cannot lend at more than 14% under the new interest rate capping Bank Act Amendment. The result is predictable. Lending to smaller businesses and consumers in the private sector is falling. The Business Daily reported last week that the growth of credit to the private sector has fallen to 4.8% from 20.6% the same time last year. Add to this the announced termination of hundreds of bank employees at Sidian Bank, Family Bank, Ecobank and now First Community and you have some serious problems in the financial sector.

So, it's no wonder that the Nairobi Stock Exchange is not doing well. With the exception of a few bright stars like Safaricom, the NSE continues to perform poorly and may well continue to do so until after presidential elections in August 2017.

Kenyan Fixed Income Securities

The Kenyan fixed income market is still unsettled from the three recent bank closures. However, the purchase of Fidelity Bank by SBM Holdings of Mauritius was a reassuring event. The lifting of Chase Bank out of receivership hopefully in the First Quarter 2017 will also provide a boost to the sector.

In the meantime, here are the latest interest rate offerings in Kenya Shillings:

Avg Commercial Bank Lending Rates	14.0%	Source: Dry Associates
Avg Commercial Paper Lending Rate	13.0%	Source: Dry Associates
365 day Treasury Bill Rate	10.9%	Source:CBK
182 day Treasury Bill Rate	10.5%	Source:CBK
91 day Treasury Bill Rate	8.4%	Source:CBK
Avg Commercial Bank Deposit Rate	7.0%	Source: Dry Associates

Holiday Schedule

As we close out 2016, we want to thank all our clients for their continuing patronage. We renew our pledge to do whatever we can to preserve and grow our clients' hard earned savings in 2017 and beyond.

Please note that our offices will be closed from Friday evening December 16th 2016 to Tuesday morning January 3rd 2017. We wish all our readers a joyful festive season and a very prosperous New Year.

Sincerely,

Dry Associates

8th December 2016

Impala Wildlife Foundation, Laikipa, September 3rd 2016
Courtesy: J. Dry

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We hope you enjoy this months Investment Newsletter

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