



## **Dry Associates Investment Newsletter**

**July 2017**



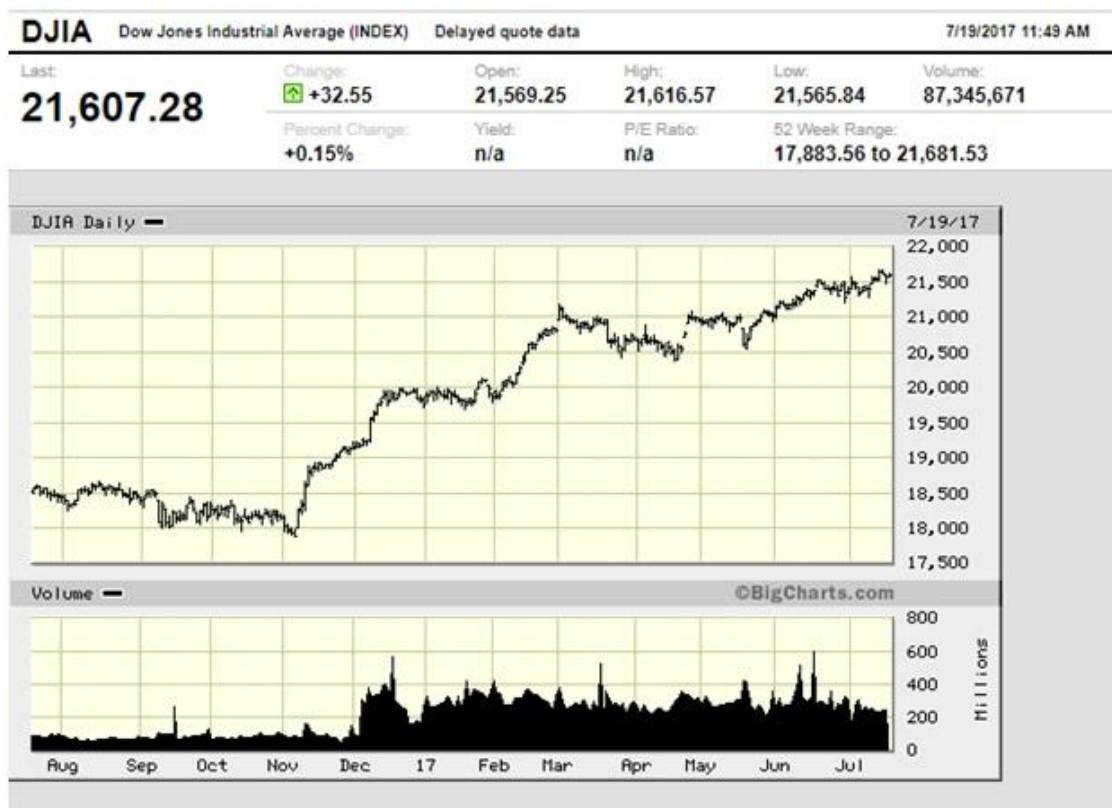
*Looking south onto the Ngong Hills on a sunny afternoon at Enkaji Osiwo, Champagne Ridge (June 2017) Courtesy: M. Dry*

# Dear Investor,

Half way through 2017, this seems an appropriate time to re-evaluate the investment landscape. The good news is that the global economy continues to expand. The World Bank estimates the global expansion at 2.7% this year. While 2.7% is not particularly inspiring when compared to the 4%+ average annual growth during the years leading up to the 2008 financial crisis, it is growth. And within this moderate growth, there are some good investing opportunities. Let's take a look at the US market first.

## The US Market

The US economy is forecast to grow 2.2% in 2017, but the Dow Jones Industrial Average (DJIA), an index of the 30 largest stocks on the New York Stock Exchange, is up 8% from January and up 17% since November 8, 2016 which was the day Donald Trump was elected president (per the chart below). The US stock market has risen no doubt on the prospects of a pro-business president with an agenda to cut taxes, regulations and rebuild infrastructure. Political in-fighting between Republicans and Democrats since the elections, however, has resulted in little actual legislation to-date. Nevertheless, it appears that investors remain convinced that some or all of these pro-business actions will come to fruition.



This recent rise in the US stock market comes on the back of an 8-year bull market. As such, it is increasingly evident that valuations are a bit stretched. The average Price/Earnings of the DJIA index is 20.8 times – which is 30% above the average DJIA Price/Earnings ratio of 16 over the past 10 years. But consider that corporate earnings of US companies according to *FactSet* for the 2<sup>nd</sup> Quarter of 2017 are running 6.5% higher than last year. Consider also that unemployment is down to 4.3% which is a 16 year low. So the US market has a lot going for it, but there are other countries and regions that are attractive as well. We are not suggesting a wholesale exit from the US market by any means, but including some exposure at this time to other promising emerging markets makes sense to us.

### Emerging Markets on the Move

Consider the economic growth of a few emerging markets around the world:

<u>Country</u>	<u>Estimated GDP Growth 2017*</u>	<u>Regional Area</u>
India	7.2%	Asia
Philippines	6.9%	East Asia
Panama	5.2%	Latin America

\*According to World Bank GDP Growth Rates dated 25<sup>th</sup> June 2017

These GDP growth rates are much higher than the 2.2% estimated growth for the US. And while these countries carry obvious political risk, currency risk, and other emerging market concerns, it seems prudent to hedge our bets. After benefitting from the US bull market for so long, we think it wise to adjust portfolios to include some of these other economic success stories.

India, for example, appears to be benefitting from Prime Minister Modi's increasing grip on infrastructure development and economic policies. India is already the world's fastest growing economy and will continue to be if it continues growing at 7%. By 2025, it is variously estimated that it will be world's most populous nation at 1.5 billion people and will have doubled its GDP from the current \$2.2 trillion to over \$5 trillion. While that's a long term story, India's Sensex stock exchange index is up 19.45% the first 6 months of 2017. Some exposure to Indian securities (for example, through Franklin Templeton's India fund (up 24% YTD) makes sense to us. Exposure to some of the other fast growing economies can be achieved through the Templeton Asian Smaller Companies fund (up 20.16% YTD).

Looking around the globe, there are other interesting growth stories. Japan's Nikkei is up 24% since November 2016, the Euro's Stoxx 50 index is also up 19% since November 2016, and South Korea's KOSPI is up 18% over the same period. These are all impressive returns but in each case we have some short term reservations. We prefer to structure investment portfolios based on long term perspectives.

## Old Mutual International – A Global Portfolio

Dry Associates has recently concluded an agreement with Old Mutual International (Isle of Man) that allows Dry Associates' clients to invest and trade in almost any security on any stock exchange around the world. This allows investors, for example, to invest in US securities like Facebook or Google on the American NASDAQ exchange or, Exchange Traded Funds like INDA (iShares India ETF up 29% YTD) or EEM (iShares Emerging Market ETF up 24% YTD). For setting up and administering this “portfolio wrapper”, Old Mutual International does charge an annual fee of roughly 2% per year, but investing in this manner eliminates the 30% withholding tax that foreign investors would incur if they invested on their own through a stockbroker (at least in the US market). Contact us if this is of interest as we will need to craft an individualized portfolio for you. The minimum investment size for this product is \$75,000 or foreign currency equivalent.

## Kenya

The Kenyan economy is expected to expand 5.5% in 2017 according to the World Bank (revised down from 5.7% earlier this year). The IMF is estimating 5.2% growth and the Government of Kenya is forecasting 5.8%. Anything above 5% would be good, but will we get there. The 1<sup>st</sup> quarter 2017 for Kenya came in at 4.6% and the upcoming presidential elections on August 8<sup>th</sup> are causing more concerns. In any event, if we have learned anything from the 2008 elections it is that actions have consequences and the rule of law must prevail. No matter who becomes president, the Parliament will convene with 349 members who will represent the diversity of Kenya and address matters of concern to all Kenyans.



*Elephants drinking at the Bwatherongi River, Meru National Park (May 2017) Courtesy: S.Dry*

## Interest Rate Capping

As investment advisors our focus is primarily the economy. One major concern is the interest rate capping legislation that came into effect in September 2016. It was legislation that was well intentioned but is causing serious economic disruption in the financial sector and downstream. Kenya's *Business Daily* reports that for the one year period through May 2017, credit to the private sector has grown a mere 2.1% according to Central Bank statistics. Optimal credit expansion to the private sector is said to be in the 12-15% region. As David Smick says in his recent book "The Great Equalizer" ... a vigorous economy depends on a vigorous banking system. Banks, big and small, are the nerve center of the private economy. Crush the nerve center, and you crush the economy."

Any time there are artificial price controls on a commodity or service, whether it is sugar, rent or money, there will be shortages. This is exactly what is happening now. Entrepreneurs, small and medium size enterprises, even large corporations are not able to access bank finance. Money is the oxygen that feeds the economy and that supply is being cut off by this legislation. It needs to be repealed or substantially revised to allow willing borrowers to pay the prevailing cost of money – whether it's 10%, 15% or 20% - if the banks deem the borrower capable of repaying based on cash flow analysis and other factors.

If this ill advised legislation were repealed, there are many ways to keep bank borrowing costs in check, most of which revolve around competition. For example:

1. The Kenya Deposit Insurance Corporation could introduce legislation to guarantee all commercial bank deposits up to KES 5 million per bank account. Currently, bank accounts in Kenya are insured up to KES 100,000 which is not realistic. Doing so would immediately restore confidence in Tier II and Tier III banks meaning money would again flow to these banks who would then be in a position to start lending to the private sector again. It would also reintroduce competition among banks for deposits of which there is little today.

2. Reduce the tax paid by individuals on interest earned on time deposits from 15% to 10% as a final tax. Lower taxes will draw money into the banking sector.

3. Reduce the tax paid by individuals on interest earned on all corporate financial instruments such as corporate bonds to a final tax of 10%. This levels the playing field between commercial banks and investment banks providing an alternative to bank lending while deepening and broadening the financial and capital markets in Kenya.

4. And then there are a number of simple things that would engender bank customer goodwill such as requiring that all banks to prominently display in banking halls their prime lending rates and their offer rates on Fixed Deposit Receipts. Publishing these rates in newspaper dailies would also lead to healthy competition.

### Kenya Shilling versus Hard Currencies

The Kenya Shilling has slipped recently against the US dollar to KES 104/= which may reflect anxiety about upcoming elections. Foreign exchange reserves, however, remain reasonably healthy at over 5 months import cover.

On the other hand, Kenya's fiscal deficit continues to rise with Debt-to-GDP now at 55%. There is a point at which carrying debt becomes a headwind to economic expansion although economists cannot seem to agree at what level it becomes a serious drag. Suffice to say that debt, particularly foreign currency denominated debt which represents some 50% of Kenya's debt, must be repaid with interest. Fiscal restraint at this point would be good thing but without any attempt at balancing the annual government budget, higher taxes and a debased currency are increasingly likely.

### Nairobi Stock Exchange

The NSE 20 Share Index is up 13% year-to-date. It appears to have bottomed out and like most stock markets has its sights six months or so forward and that would be after the presidential elections. Some of the counters have experienced excellent appreciation over the last six months, for example, Britam (+52%), NIC Bank (+51%) and KCB (+46%). Some of the other counters currently offer deep value with very low Price/Earnings ratios, for example, Stanbic Bank (3x), Kenya-Re (4.12x) and KP&L (4.82x). A lot of these equities can be found in our Dry Associates (Unit Trust) Balanced Fund.



## Chase Bank

The Central Bank of Kenya published its timetable for bringing Chase Bank out of administration on 31<sup>st</sup> March 2017. According to that schedule, the CBK was to engage a single preferred investor on 23<sup>rd</sup> June and engage with shareholders, the preferred investor and depositors on 26<sup>th</sup> June 2017. This has not happened as of 19<sup>th</sup> July. From our inquiries with Chase Bank management, we were told that the process was well under way but required another 10 days or so. We're now beyond that, of course, but we are hopeful that these engagements will be announced any day.

## Private Debt Issues Brought to Market

Dry Associates brought to market a 2<sup>nd</sup> Tranche of a Garda World (KK Security) note program. The issuance is meant primarily to convert their short term commercial paper program into 5 year notes. The issue opened on 2<sup>nd</sup> June and closed on 13<sup>th</sup> June and offered a 15% coupon for Kenya Shillings and 6.5% for US dollars. The issue raised KES 250 million equivalent. We expect to bring a 3<sup>rd</sup> Tranche to market late 2017/early 2018.



## Dry Associates Unit Trusts

Dry Associates held its first Annual General Meeting (AGM) on 30<sup>th</sup> June 2017 for the KES Money Market Fund, the US Dollar Money Market Fund and the Balanced Fund. All these funds began operations on 1<sup>st</sup> July 2016 so they have been operating for slightly over a year. The growth of the Assets under Management (AUM) has been good rising from zero on 1<sup>st</sup> July 2016 to KES 201 million as at 31<sup>st</sup> December 2016 and further to KES 430 million as at 30<sup>th</sup> June 2017. The most popular fund, the KES Money Market Fund had an annual yield of 9.62% as of 17<sup>th</sup> July 2017. This is the return published in two English language newspapers daily and is after all fees. In addition, at the AGM certain changes to the Information Memorandum supporting the unit trusts were approved including a resolution to add an administrative fee of 0.2% to cover certain costs such as the bi-annual newspaper publication of unit trust results which had been underestimated at the commencement of the funds. Overall it was a good opportunity to meet unit trust members and we encourage all unit holders to attend next year's AGM.



*Hetal Shah, an adventurous Dry Associates employee, posing at Gokyo Ri Peak, Himalayas  
(April 2017) Courtesy: P. Nagda*

As we cross the half way mark of 2017, we recommit ourselves to working with each of our investors to ensure that your investment portfolio reflects your individual objectives – whether wealth preservation, capital growth, or income generation or all the above. Please plan to sit with your individual Dry Associates Advisor to a least twice a year to ensure your financial goals are becoming a reality.

Sincerely,

**Dry Associates**

20<sup>th</sup> July 2017





*Our employees on the right Hetal Shah and Poonam Nagda, representing Kenya at Mount Everest Base Camp, Himalayas (April 2017) Courtesy: P. Nagda*

*Disclaimer*

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