Dry Associates Investment Newsletter

April—June 2013

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Dear Investor,

World Bank Revises Global Growth Prospects

On June 12, the World Bank revised downward its global GDP growth projections for 2013. Originally, the World Bank was forecasting 2.4% global growth this year, but now has revised that figure down to 2.2%. Six months ago, the World Bank expected the emerging markets to continue their export driven growth unabated while the developed economies continued their quantitative easing (QE).

What these new projections acknowledge is that commodity exports in some of the BRICS are falling short of projections AND there are indications that QE in the developed economies may begin to slack off.

Tree House Dining in the Chyulu Hills, on Horseback Safari — 17-19th May 2013 (P. Wesolek)

Perhaps not stirring front page news, but probably worth a slight reformulation in investment strategy. Now we are obliged to anticipate central bank action at the same time we monitor real economic growth!

The drop off in exports in emerging markets like Brazil and South Africa has resulted in depletion of these countries' foreign currency reserves. The current account deficits must be plugged with inward financial flows to a country's capital account. The current account deficit in Brazil is now 2.4% of GDP. The deficit is 6.3% of South Africa's GDP and it's 11.5%

for Kenya! The net effect is that the local currency depreciates. One important knock on effect is lower emerging market bond prices and interest payments when translated into dollars, Euros and Sterling.

US Economic Recovery??

The other investment consideration is the US economy. On balance, there seems to be signs the world's largest economy is recovering. The US Bureau of Economic Analysis reports that GDP in the US expanded 2.4% in the first quarter of 2013 over the prior quarter.

Housing prices are rising in the US, the US stock market has risen although in fits and starts, and consumer confidence is on the uptick. The fly in the ointment, so to speak, is the inevitable fall off in Quantitative Easing (QE). QE in the US represents $ 50 billion+ of monthly Federal Reserve bond buying. As these purchases fall off, less money will be injected into the US economy, credit will tighten and interest rates will rise. Rising interest rates are not good for any economy but again, on balance, if the economy starts growing at a reasonable clip, the US Federal Reserve believes that a gradual easing in QE can be accommodated without disrupting economic recovery.

A giraffe nursery — looking toward the Chyulu Hills — May 2013 (Courtesy: P. Wesolek)

What to Do?

What does all this mean for the investor? Well, we believe it would be wise at this time to consider some portfolio rebalancing. Specifically, we would recommend 1) eliminate exposure to US bond funds 2) lighten up or move to shorter duration emerging market bond funds and 3) increase exposure to US equities.

This is not to suggest that emerging markets will not continue to outperform. They will. As Mark Mobius, the Chairman of Templeton's Emerging Markets Group recently stated "The three key ingredients driving the [emerging] markets are still in place: fast economic growth, high foreign reserves and low government debt."


Black-legged Golden Orb Spider, Chyulu Hills (P. Wesolek)

Kenyan Real Estate as an Investment

The real estate market in Kenya has outperformed most other asset classes in Kenya over the last 10 years. House prices have increased threefold in that time. Current research undertaken indicates that prices for apartments continue to strengthen even while supply has dramatically increased.

Knight Frank, in its global assessment of high end properties last year rated Nairobi as the fastest growing market in the world, with a 25% appreciation of high end properties.

Despite the increase in the supply of apartments in Nairobi over the last decade, Nairobi still suffers from a housing shortage. Furthermore, this shortage increases every year as the increase in supply is outstripped by the increased demand. Across Nairobi, the average price of an apartment is now over 12 million shillings, an increase of 5.7% in 2012. Lettings for apartments also increased in 2012 by 15%, with the average rental price now just less than Ksh 70,000 per month. Real estate returns are well above inflation and above most portfolio investment returns. In other words, middle income housing is currently a desirable investment.

With the government focus on developing infrastructure, new areas around Nairobi have opened up for growth. The projects are led by the Thika Highway, but just as important are the Eastern, Northern and Southern bypasses. With the expansion of the road network and the upgrading of the commuter train network, peri-urban areas of Nairobi have now become viable residential apartment locations. By locating developments to the edge of the city, property developers can benefit from lower land costs, while the new upgraded infrastructure allows residents easy access to Nairobi.

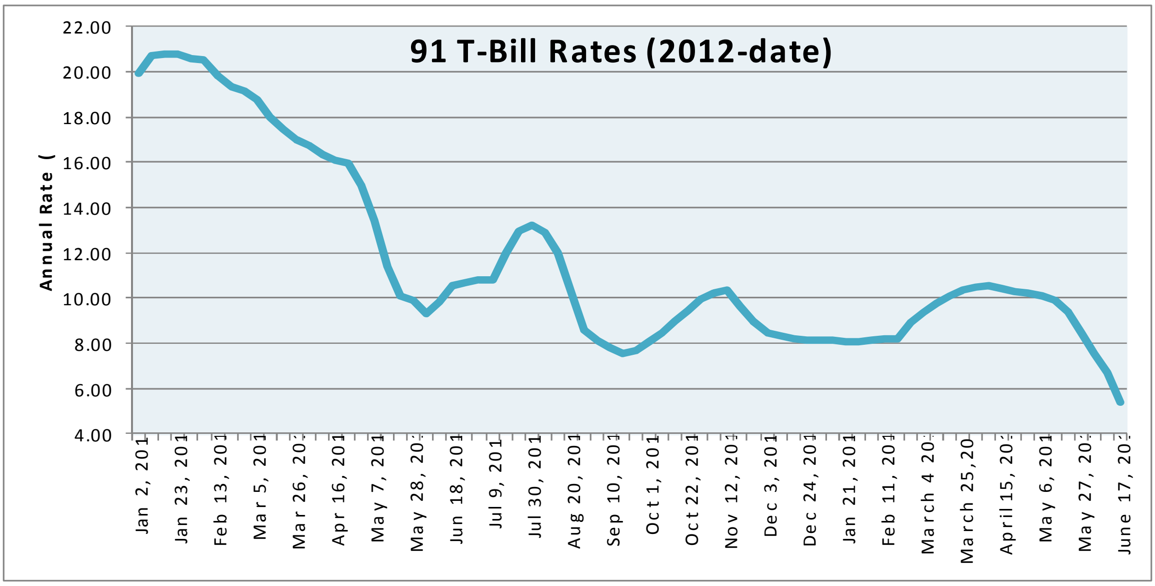
On the back of peaceful elections and Kenya's GDP growth forecast by the World Bank to reach 5% in 2013, Nairobi is attracting significant Direct Foreign Investment. The discovery of oil in Northern Kenya is set to speed up Kenya's growth pattern, and we see the Vision 2030 goal of Kenya achieving middle income status become a reality over the next two decades.

With inflation at a much lower 4.05% in May 2013 and interest rates at more historic levels, we anticipate the real estate industry to continue to do well in 2013 and beyond.

Dry Associates is currently working with a real estate developer to structure partnerships targeting construction of middle income apartments. The first partnership will focus in the Karen area. These partnerships are structured for sophisticated and institutional investors. Please contact your Dry Associates Investment Advisor for more details.

Kenyan Interest Rates

Official interest rates – that is, the Central Bank Rate and Treasury bill rates – have declined significantly over the past three months. The CBK Rate is 8.5% and the 91 and 182 day Treasury bills rates are 5.4% and 6.7% respectively as of 17 June 2013.



Source: Central Bank of Kenya

Bank overdraft rates, however, have not dropped correspondingly and are currently in the 15% to 18% per annum range. Interest rates on commercial paper are currently in the 11% - 13% range.

In light of the Government of Kenya's growing budget demands, it is likely that Kenyan interest rates will rise over the next two quarters. The public deficit must be funded one way or another. In fact, this may be shaping up for a classic case of "crowding out" where the public sector competes with the private sector for tight money in a growing economy.

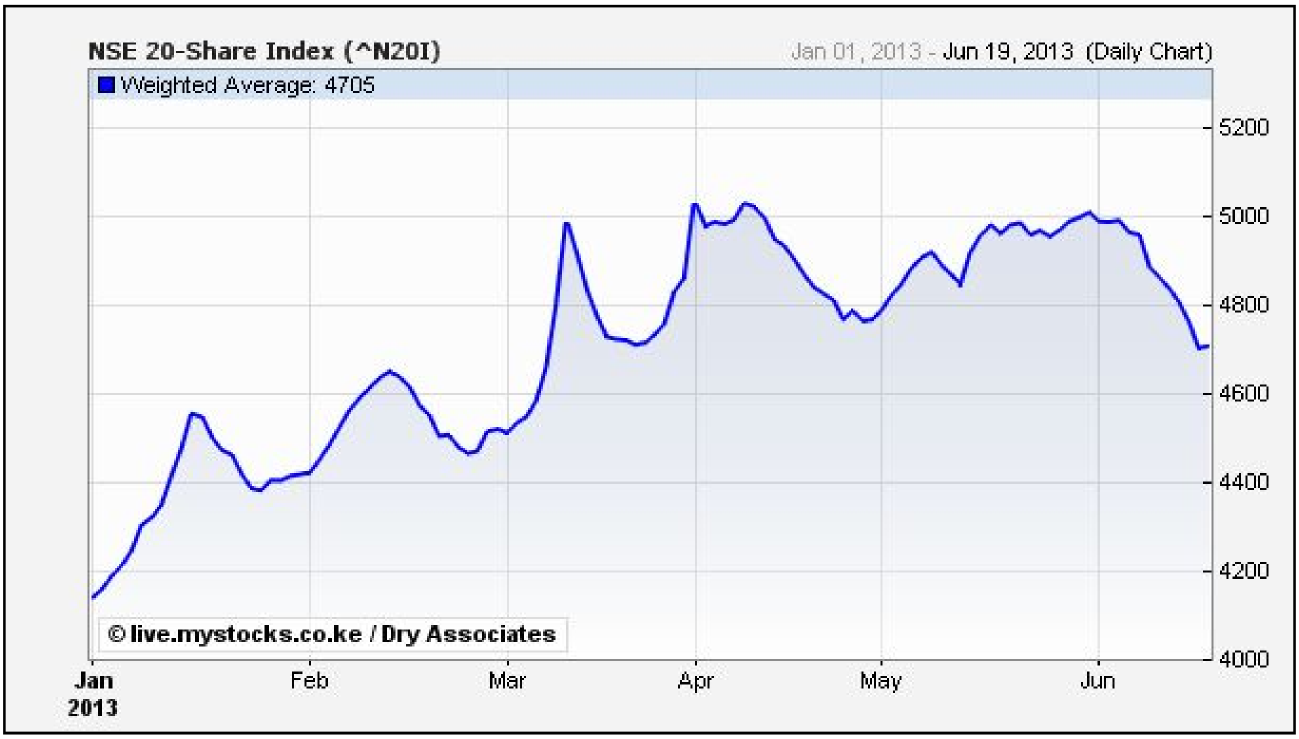
The Government of Kenya has indicated it intends to issue up to a billion dollar sovereign bond in late 2013. This could provide some breathing space but to quote the former World Bank Country Director Johannes Zutt, Kenya is "spending above its means".

Kenya's budget deficit last year was 5% of GDP. The 2013/2014 Ksh 1.6 trillion budget read on 14 June 2013 has an 8% deficit. Kenya's total accumulated budget deficit now approaches 50% of GDP.

While Kenya's economy is currently expected to grow at 5% per year, more attention needs to be paid to fiscal restraint. The current path of ever expanding government expenditure and deficit spending will eventually lead to inflation, higher taxes and quite possibly fiscal crisis.

Kenyan Equities

The Kenya securities market has had quite a run. The NSE 20-share index was up 22% from January to March but has fallen off 4% since April 1st per the following chart:



On the plus side, official interest rates are down, presidential elections came and went in March without violence, and the economy is expected to expand in 2013. On the other hand, Kenyan's stock market is not immune from the changing global economics picture described above. In addition, the prospect of reintroducing a capital gains tax in Kenya will not sit well with international or local investors for that matter.

That said, as a value investor, we still see some securities with relatively low valuations although most are in the relatively unexciting agricultural sector. On the other hand, Price/Earnings valuations of 26 times earnings for East Africa Breweries and 20 times earnings for Nation indicate to us that these securities are fully priced in the absence of significantly higher earnings.

We occasionally look beyond our value investor philosophy. Safaricom continues to be impressive from a growth perspective. A P/E ratio of 16 in the case of Safaricom seems well deserved and at Ksh 6.70 per share we see future value.

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As always, we look forward to working with each of our clients going forward. Our objective remains the same whether an individual or corporate client and that is to ensure financial independence for all our clients now and in the future!

Sincerely,

Dry Associates