DYER & BLAIR INVESTMENT BANK MACROECONOMIC OUTLOOK 2023

Founder Member of the Nairobi Securities Exchange

APRIL 5TH 2023

DYER & BLAIR INVESTMENT BANK

WE KNOW. YOU KNOW.

KENYA: 2023 MACROECONOMIC OUTLOOK

- Global growth is projected to decline from an estimated 3.4% in 2022 to 2.9% in 2023. Global economic activity in 2023 is principally expected to be adversely affected by the general wave of aggressive policy tightening across economies globally and the spillover effects of Russia's grinding war in Ukraine.
- Our projections for GDP growth in 2023 range between 5.0% and 6.0% supported in part by strong credit growth to the private sector, resilient diaspora remittances and government spending; but curtailed by elevated inflation, sustained depreciation of the Kenya Shilling against the US Dollar and protests by the opposition.
- We expect average inflation to range between 7.0% and 7.5% in 2023 from an average of 7.6% in 2022 owing to the expected depressed rainfall during the MAM rainfall season, the increase on the excise duty stamp costs on a number of items, higher electricity prices, the expectation of higher global crude oil prices and elevated core inflation.
- We expect the current account deficit to remain largely unchanged in 2023 ranging between 5.0% and 5.5% of GDP. We expect to see import expenditure in 2023 impacted by the expectation of rising global crude oil prices, the anticipated persistent depreciation of the Kenya Shilling (KES) against the US Dollar (USD) and the planned importation of duty-free food items. We expect export earnings in 2023 to be supported by receipts from manufactured goods, horticultural products, tea exports and rising diaspora remittances.
- As the Federal Reserve has reiterated its resolve to keep interest rates higher for longer in an attempt to keep inflation in check, we expect this hawkish stance to continue resulting in a relatively stronger US Dollar in comparison to the Kenya Shilling, resulting in further depreciation of the KES/USD exchange rate in 2023.
- Whilst we expect interest rates to continue to remain elevated in 2023, we do not expect interest rates to rise with a commensurate magnitude with which they did in 2022. We believe the slower pace of the rise in the yield curve in 2023 compared to 2022 potentially points to a stabilization in interest rates in the short-term as rates approach their peak.

KEY RATES & INDICATORS (%, END OF YEAR)

	2018	2019	2020	2021	2022
CBR	9.0	8.5	7.0	7.0	8.8
Inflation	4.7	5.2	5.6	5.7	9.1
Interbank	6.7	5.5	6.2	5.0	6.5
91-Yield	7.3	7.2	6.9	7.3	9.4
182-Yield	9.0	8.2	7.4	8.1	9.8
364-Yield	10.0	9.8	8.3	9.4	10.3
5YR-Yield	11.6	11.5	10.5	11.4	13.5
10YR-Yield	12.5	12.1	11.9	12.5	13.8
15YR-Yield	12.6	12.6	12.8	13.0	13.9

Source: CBK, KNBS, NSE

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Global Economic Environment

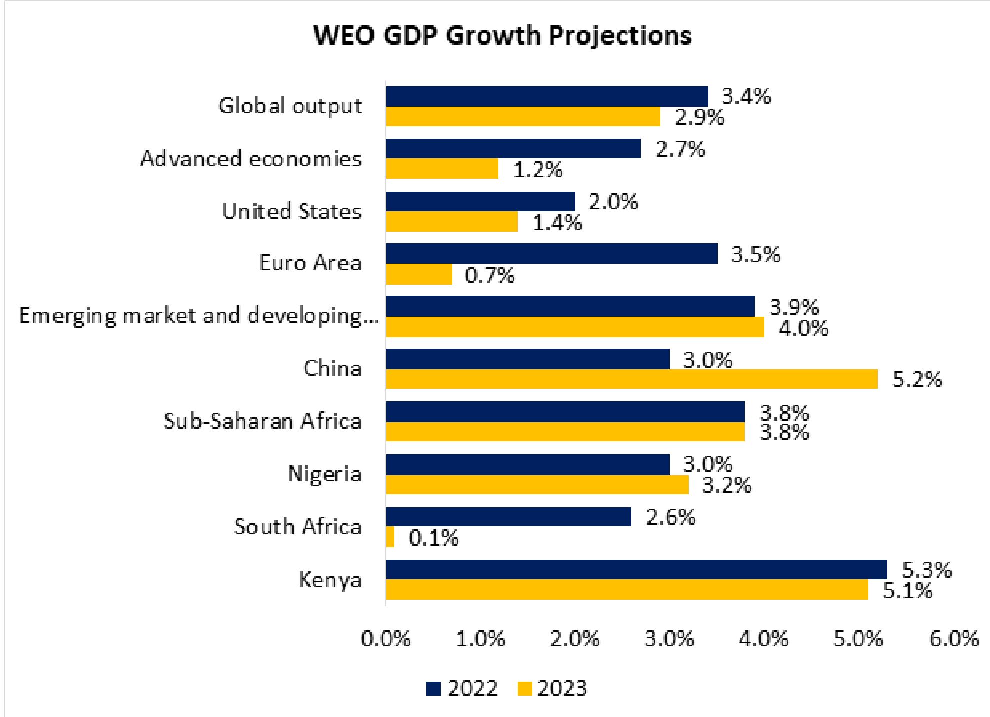
Global Output

According to the IMF's January 2023 World Economic Outlook (WEO) report, global growth is projected to decline from an estimated 3.4% in 2022 to 2.9% in 2023. Global economic activity in 2023 is principally expected to be adversely affected by the general wave of aggressive policy tightening across economies globally and the spillover effects of Russia's grinding war in Ukraine. Advanced economies are expected to contribute significantly to the slower growth in 2023 as growth in emerging markets and developing economies is estimated to have hit a nadir in 2022.

In a number of advanced economies, GDP growth remained resilient in 4Q22 amid global economic shocks largely due to strong private consumption (owing to pent-up demand from the pandemic, supported by excess private savings from the pandemic) and investment supported by fiscal measures, even as the labor markets remained tight. However, growth projections for 2023 in advanced economies seem bleak. Growth in advanced economies is anticipated to decline from 2.7% in 2022 to 1.2% in 2023 primarily owing to the view that monetary policies could remain restrictive for longer than previously expected.

For emerging market and developing economies, growth is forecast to rise marginally from 3.9% in 2022 to 4.0% in 2023.After months of widespread COVID-19 lockdowns and a historic downturn in the property market in China, economic growth is estimated to have decelerated to 3.0% in 2022. However, with the recent re-opening, economic growth is expected to rebound in 2023, rising to 5.2%.

A moderate growth of 3.8% is projected for sub-Saharan Africa in 2023 (unchanged from 2022) predicated on a prolonged fall-out from the COVID-19 pandemic. Nigeria's economic growth in 2023 is placed at 3.2%, higher than an estimated 3.0% in 2022 owing to the country's adoption of measures to improve insecurity issues in the oil sector. Contrastingly, in South Africa, a weaker growth of 0.1% is anticipated in 2023 (from 2.6% in 2022) occasioned by weak external demand, structural constraints and the ongoing electricity crisis.



Source: IMF WEO Jan 23

Global Inflation

The IMF's January 2023 World Economic Outlook (WEO) report projects global inflation to ease from 8.8% in 2022 to 6.6% in 2023. Despite this expectation of global disinflation, inflation is still forecast to remain higher than pre-pandemic levels of 3.5% (2017 to 2019). The slower inflation rate in 2022 is premised on declining global fuel and non-fuel prices weighed down by weaker global demand due to declining economic growth. The effects of the aggressive policy tightening adopted in 2022 are largely expected to be witnessed in core inflation which is projected to ease to 4.5% in 4Q23 from 6.9% in 4Q22.

On 2nd April 2023, OPEC+ announced production cuts of 1.16 million barrels a day from May until the end of 2023 in an attempt to prop up global oil prices. This move is generally expected to lift oil prices higher in 2023 (against previous expectations) — adversely raising inflationary pressures and entrenching the prospect of central banks keeping interest rates higher for longer.

Potential Shocks to Global Economic Outlook

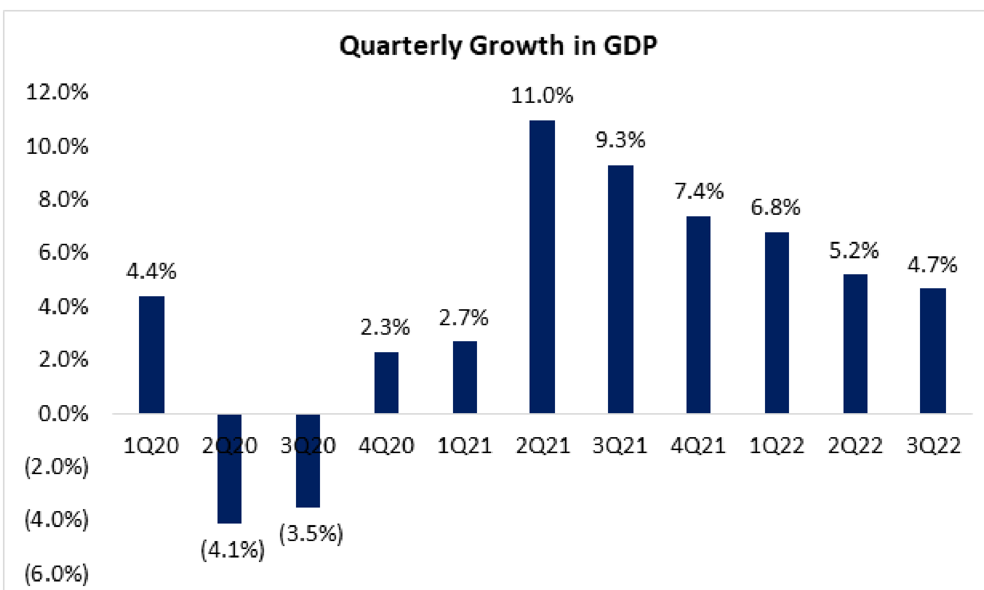
- **COVID-19:** Another string of COVID-19 outbreaks in China could — amidst low population immunity levels and inadequate hospital capacity — portend weaker growth in China and global spillover effects would manifest in renewed global supply chain constraints.

- **Russia-Ukraine war:** A worsening of the war in Ukraine could interfere further with growth in Europe. As it stands, Europe's energy crisis seems to be under control owing to robust gas inventories that should cover them through winter. However, in the event that the continuing recovery in China propels energy prices higher while Russian gas imports remain inaccessible, the energy crisis could worsen.

- **Restrictive monetary policy:** As monetary authorities retain their aggressive tightening crusade, interest rates are expected to remain elevated in 2023. This continues to pose a big threat to emerging market and developing economies which are still struggling with high debt levels from the pandemic whose repayment is likely to be impeded by higher debt service costs (on account of weakening currencies), shortage of forex reserves and limitations in raising debt in external markets (due to the elevated interest rates).

- **Elevated inflation:** In advanced economies, persistently tight labor markets continue to remain a key risk to inflation by the way of higher wage growth.

Kenya Economic Growth



Source: KNBS, CBK & DBIB Analysis

In 2023, we expect GDP growth to moderate as the base effect of the high growth rates reflective of the recovery from the pandemic continues to abate. Our view is that this moderating growth is most likely going to be witnessed amongst a majority of the economic sectors. However, we expect to see growth in 2023 being primarily supported by the trade, transport, finance, education and construction sectors.

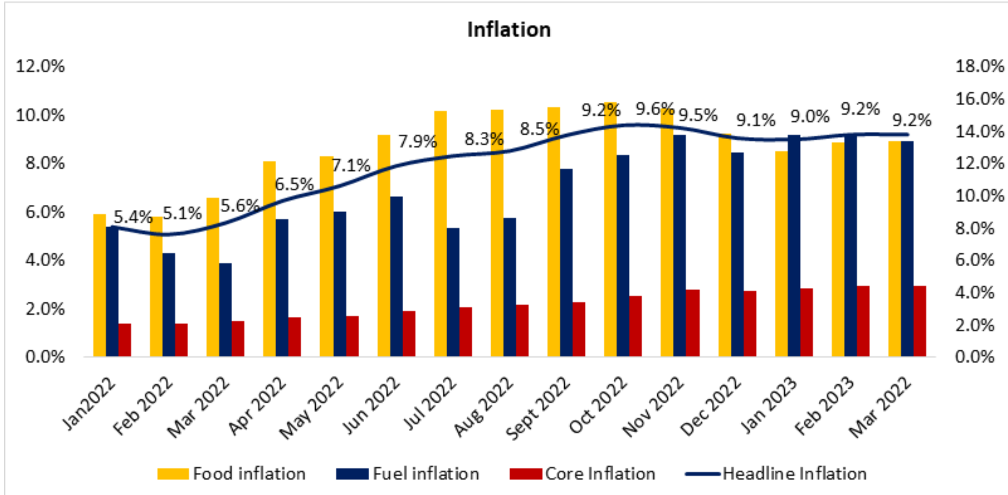
We expect the robust growth in credit to the private sector witnessed in 2022 to support the financial services sector, especially in light of the ongoing approvals of risk-based pricing models. As the global repercussions of the COVID-19 pandemic continue moving into the rear-view mirror, we expect the tourism sector to continue posting solid growth albeit at a decelerating pace owing to the aforementioned base effects and tourist jitters sparked by a wave of ongoing protests by the opposition.

The trade sector is expected to be largely supported by rising diaspora remittances, government interventions to reduce prices of select food items and access to credit. Both the construction and real estate sectors are poised to benefit from the government's affordable housing program agenda and renewed business confidence following the conclusion of the general elections, but could potentially be curtailed by high input costs and the ongoing protests.

We continue to expect the agricultural sector to come under pressure from the effects of the prolonged regional drought coupled with the expectation of depressed rainfall during the March–May rainfall season.

Against these factors, our projections for GDP growth in 2023 range between 5.0% and 6.0% supported in part by strong credit growth to the private sector, resilient diaspora remittances and government spending; but curtailed by elevated inflation (potentially hampering consumption and business investment), sustained depreciation of the Kenya Shilling against the US Dollar (which we see piling pressure on the import bill, constraining debt service obligations and increasing energy costs) and protests by the opposition.

Inflation



Source: KNBS, CBK & DBIB Analysis

We expect inflation to remain largely elevated in 2023. The persistence in elevated inflationary pressures is informed by:

- the expected depressed rainfall during the MAM rainfall season which we expect to keep food prices generally elevated — albeit with a decelerating bias
- the looming implementation of the increase on the excise duty stamp costs on a number of items (alcohol, juices, bottled water) sometime in 2023
- higher electricity prices (due to the sustained depreciation of the Kenya Shilling against the US Dollar and efforts by Kenya Power to raise electricity prices)
- elevated core inflation (as the pass-through effects of high input costs, the persistent depreciation of the Kenya Shilling and higher import duty costs continue to crystallize)
- the expectation of higher global crude oil prices following the decision by OPEC+ to cut oil production by more than 1.0 million barrels per day

With regard to the government's initiative to import a number of food items (rice, cooking oil, sugar, wheat and beans) duty-free, we believe that the sustained depreciation of the KES/USD exchange rate will continue to result in expensive imports, effectively offsetting the impact of the duty-free element.

Taking the aforementioned forces into consideration, we expect average inflation to range to between 7.0% and 7.5% from an average of 7.6% in 2022.

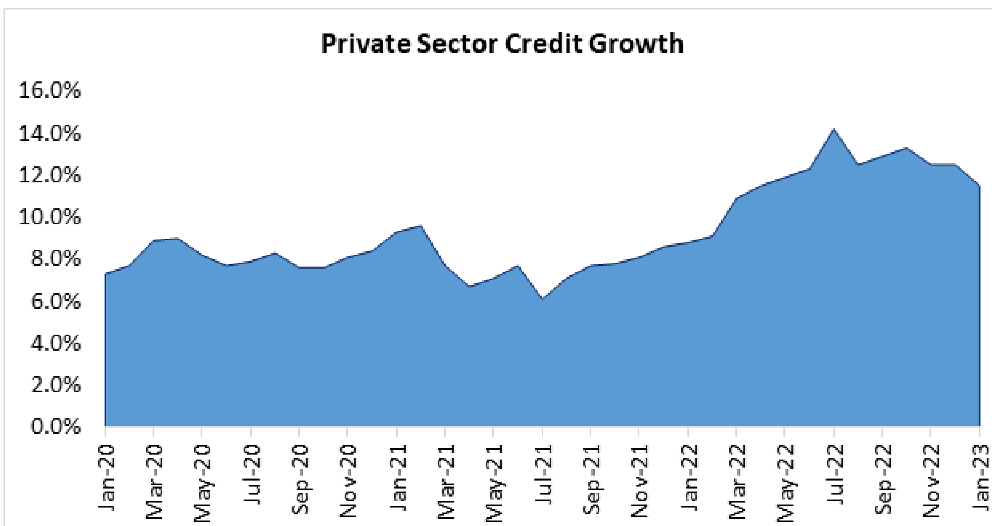
Private Sector Credit Growth

Owing to rising lending rates (fueled by the elevated interest rate environment) coupled with increasing approvals for risk-based lending by CBK, we expect to see private sector credit growth remain strong in 2023.

We also see the growth in credit to the private sector being influenced by banks' preference for lending to the private sector as opposed to the government owing to the elevated interest rate environment which has resulted in mark-to-market losses on government securities.

We also expect the strong growth in credit to the private sector to be supported by improving asset quality conditions within the banking industry; the NPL industry ratio has been on a downward trajectory from June 2022 where it stood at 14.7% to 13.4% in January 2023. The main sectors we see benefiting from the strong growth in private sector credit are transport & communication, agriculture, manufacturing, mining and trade.

A key risk to growth in credit to the private sector is the rising cost of credit that could temper credit demand as well as deteriorating asset quality owing to macroeconomic challenges.



Source: CBK & DBIB Analysis

Current Account Deficit

We expect to see import expenditure in 2023 impacted by the expectation of rising global crude oil prices, the anticipated persistent depreciation of the Kenya Shilling (KES) against the US Dollar (USD) and the planned importation of duty-free food items even as imports of machinery & transport goods reduce (due to the completion of projects).

Despite the recent banking turmoil witnessed in the global markets (the collapse of three US Banks; Silvergate Bank, Silicon Valley Bank and Signature Bank) in part as a result of a restrictive monetary policy, the Federal Reserve has doubled down on its commitment to combat inflation by raising the Federal Funds Rate by 25 bps in its March 2023 meeting. This points to the perception of inflation as being a more immediate concern for the Fed. Thus, with US inflation remaining stubbornly above the 2.0% inflation target, we expect to see further rate hikes in 2023 – albeit with reduced aggression. This should continue piling pressure on the KES/USD exchange rate.

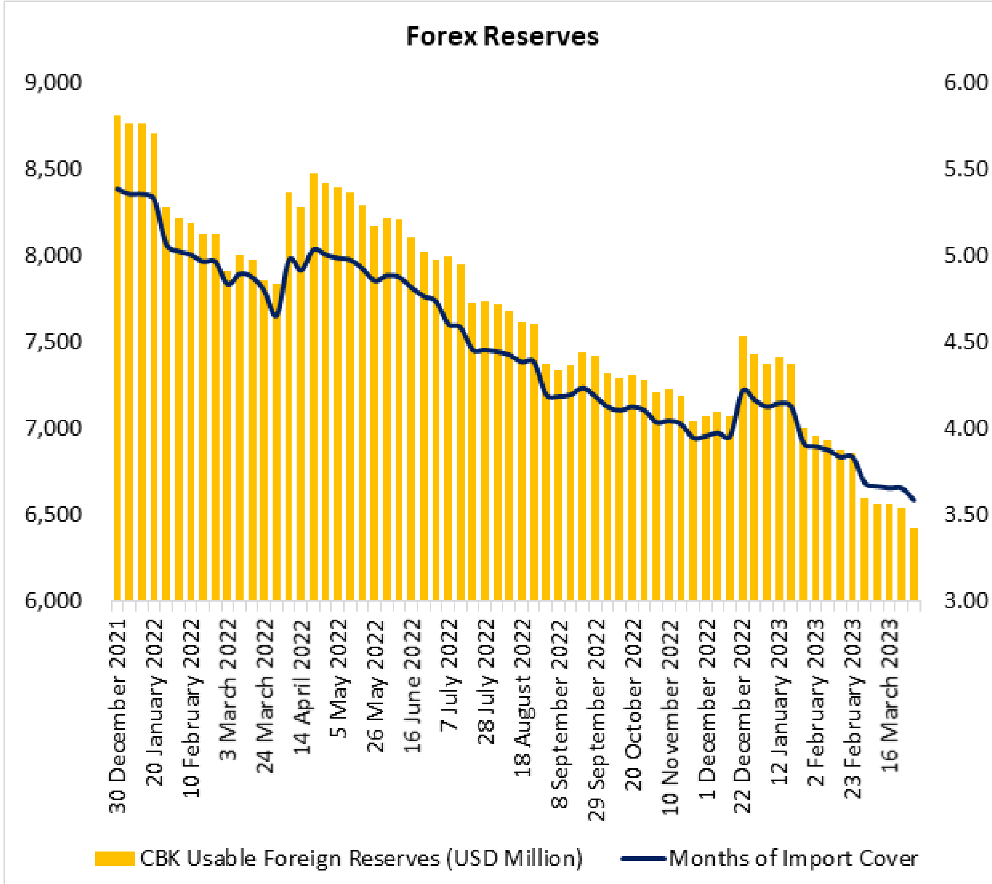
The government recently put in place a number of measures to revive the foreign exchange inter-bank market (through the implementation of the Foreign Exchange Code) and to shore up forex reserves through the importation of oil on a 180-day credit period (government-backed agreement with Saudi Arabia and the United Arab Emirates).

Despite these efforts, we are cautiously optimistic about the stabilization of the KES/USD exchange rate in the short-term as we believe a longer period is necessary for these changes to crystallize.

We expect export earnings in 2023 to be supported by receipts from manufactured goods, horticultural products and earnings from tea exports especially after the government of Pakistan classified tea as an essential import commodity while approving the use of US Dollars as the transaction currency. We also expect the current account deficit to benefit from rising diaspora remittances.

Taking all these factors into consideration, we expect the current account deficit to remain largely unchanged in 2023 ranging between 5.0% and 5.5% of GDP.

Forex Reserves



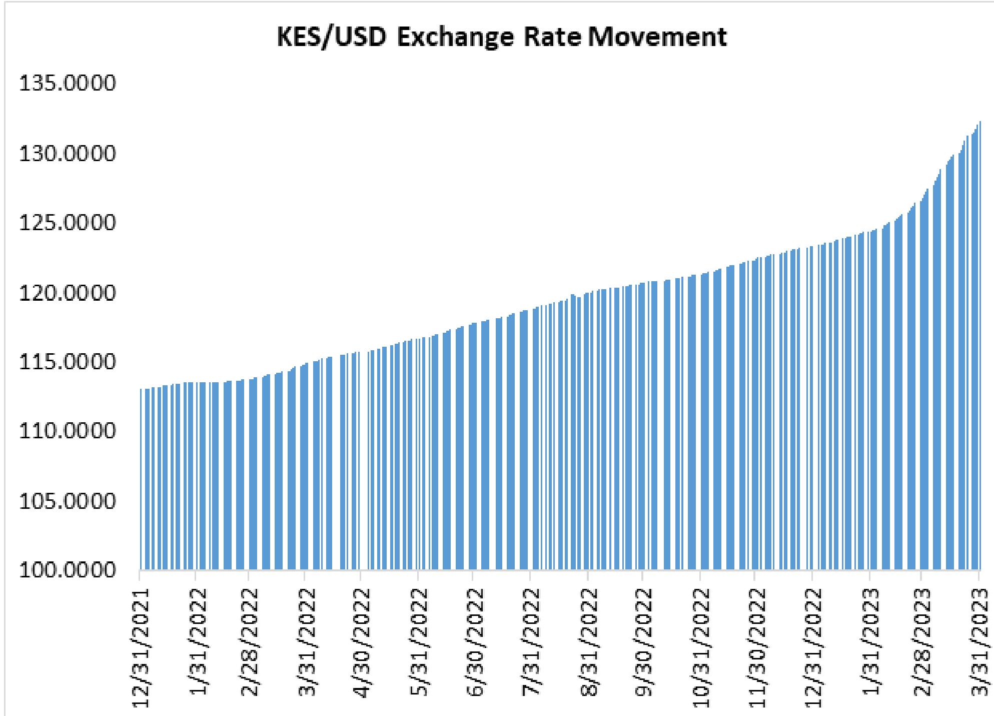
Source: CBK

We expect the government's decision to import oil on a 180-day credit period as well as the planned receipts of approximately USD 1.0 BN Development Policy Operation (DPO) from the World Bank by the end of April 2023 and c. USD 300.0 MN from the IMF to provide a reprieve to forex reserves in the near-term. However, we see forex reserves continuing to come under pressure sometime in July 2023 owing to foreign debt service obligations (especially those associated with the Standard Gauge Railway).

Furthermore, following the expiration of the 180-day credit period at the end of September 2023, we could see further pressure on forex reserves as the oil payments should resume on a monthly basis.

With the looming maturity of the inaugural Eurobond due in 2024 and the expectation of less restrictive global financial conditions in 2024, we anticipate the government to potentially issue another Eurobond in 2024 to settle its obligation. At present, the external debt strategy remains reliant on concessional funding and commercial loans.

Exchange Rate



Source: CBK

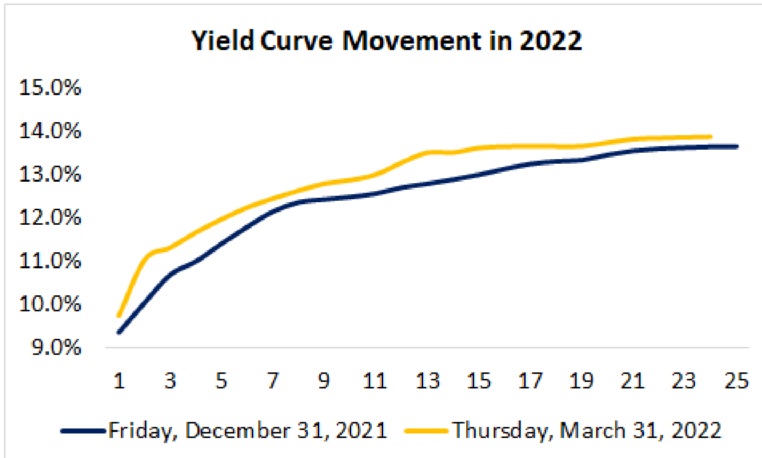
As the Federal Reserve has reiterated its resolve to keep interest rates higher for longer in an attempt to keep inflation in check, we expect this hawkish stance to continue resulting in a relatively stronger US Dollar in comparison to the Kenya Shilling, resulting in further depreciation of the KES/USD exchange rate in 2023.

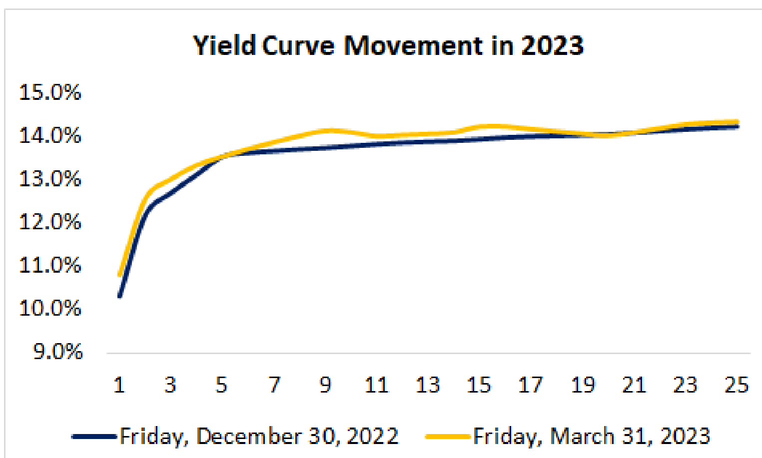
Within the foreign exchange inter-bank market, we view the implementation of the Foreign Exchange Code positively. We expect it to enhance US Dollar availability (especially from participants who were holding the US Dollar) and stability in that market which we see materializing in the form of reduced spreads — both between buying/selling and potentially between the CBK indicative rate/ commercial banks' rate in the long-term.

Interest Rates and Fixed Income Securities

Whilst we expect interest rates to continue to remain elevated in 2023, we do not expect interest rates to rise with a commensurate magnitude with which they did in 2022.

By the end of 1Q23, the yield curve had risen by 19 bps on average across all maturities on a year-to-date basis. We, however, note that compared to a similar period in 2022, the yield curve had risen by 45 bps on average across all maturities on a year-to-date basis.





Source: CBK

We believe the slower pace of the rise in the yield curve in 2023 compared to 2022 potentially points to a stabilization in interest rates in the short-term as rates approach their peak.

With regard to the CBK's Central Bank Rate, we expect the Monetary Policy Committee to hike the CBR further this year due to the expected strengthening of the US Dollar (on the back of the anticipated rise in the Federal funds rate, by the Federal Open Market Committee) and elevated inflationary pressure.

Budget Operations

Going by the draft budget policy statement for 2023, the government plans to reduce total debt financing in FY23/24 by 13.6% to KES 720.1 BN from the current fiscal year's projected borrowing of KES 833.9 BN. The bulk of this reduction is projected to stem from foreign borrowing which is anticipated to shrink by 49.8% to KES 198.6 BN in FY23/24. Domestic financing on the other hand is projected to rise by 19.0% y-o-y to KES 521.5 BN from KES 438.1 BN in FY22/23.

We note that for foreign financing, the cut is expected to emanate from programme loans (-76.2% y-o-y to KES 65.4 BN) and the absence of an IMF Special Drawing Rights (SDR) allocation which stood at KES 47.3 BN in FY22/23. Both commercial financing and project loans are expected to increase by 8.8% y-o-y and 145.5% y-o-y to KES 270.0 BN and 338.8 BN respectively. The rise in commercial financing points to the potential issue of another Eurobond in 2HFY23/24 and/or the reliance on commercial loans for external borrowing.

In FY23/24 the government will be met by the redemption of the inaugural Eurobond, as a result, external debt repayments are expected to jump by 112.5% y-o-y to KES 475.6 BN.

	FY22/23	FY23/24	Change
	KES BN	KES BN	(%)
Total Financing	833.9	720.1	(13.6)
Net Foreign Financing	395.8	198.6	(49.8)
Net Domestic Financing	438.1	521.5	19.0
Net Foreign Financing	395.8	198.6	(49.8)
Disbursements	619.5	674.2	8.8
Commercial financing	110.0	270.0	145.5
Total project loans	186.9	338.8	81.3
IMF SDR allocation	47.3	-	(100.0)
Programme loans	275.3	65.4	(76.2)
Debt repayment	223.8	475.6	112.5

Source: Budget Policy Statement 2023

From 2H22, the 91-day Treasury bill has more often than not been oversubscribed as investors positioned themselves in highly liquid assets in anticipation of a further rise in interest rates while Treasury bonds remained undersubscribed (with the exception of IFB1/2022/14).

We note that this poses undue pressure on the government's short-term debt service obligation costs that may necessitate the government to issue additional switch bonds similar to IFB1/2022/6 – in order to lengthen their maturity profile.

Given our outlook on elevated interest rates, we generally recommend investment in short-dated papers as the additional yield from longer-dated papers will most likely not be significant enough to justify mark-to-market losses as rates rise further (albeit at a slower pace).

Equities

Despite the disinflation witnessed in several advanced economies, it is becoming increasingly clear that the tightening policy adopted by monetary authorities around the world may remain longer than expected as inflation still remains above target. This realization has subdued some of the optimism that global equity investors had initially adopted towards the end of 2022.

Within emerging market and frontier economies, in addition to the risk of further capital flight (on the back of tighter global financial conditions), foreign currency availability issues, as well as debt sustainability concerns have managed to dampen investor sentiment, resulting in weak performance of equities markets.

Domestically, high inflation, elevated interest rates, the persistent depreciation of the KES/USD exchange rate, fiscal pressures and drought conditions have resulted in reduced interest from equity investors.

The weak investor sentiment has been mirrored in the performance of NASI, NSE 20 and NSE 25 which have declined by 11.5%, 3.2% and 5.4% respectively on a year-to-date basis as at the end of 1Q23 in comparison to declines of 6.4%, 2.9% and 4.8% respectively on a year-to-date basis as at the end of 1Q22.

Thus, in light of the aforementioned factors, we continue to expect subdued interest in equities in 2023. At present, we however recommend taking positions in a number of dividend-paying stocks, particularly for income investors.

With regard to the broader market, we do not expect a significant reversal of the current YTD downtrend and see the current low valuations as buying opportunities for value investors with a long-term investment horizon.

COMPANY	DECLARED	AMOUNT	PRICE**	DIVIDEND YIELD (%)	CLOSURE	PAYMENT
Stanbic Holdings	Final Dividend	12.60	110.00	11.5	19-May-23	STA***
Standard Chartered	Final Dividend	16.00	170.00	9.4	21-April-23	25-May-23
ABSA Bank	Final Dividend	1.15	12.80	9.0	28-April-23	25-May-23
KCB Group	Final Dividend	1.00	35.50	2.8	6-April-23	26-May-23
Co-operative Bank	First & Final Dividend	1.50	13.15	11.4	24-May-23	9-Jun-23
Kakuzi	First & Final Dividend	24.00	264.00	9.1	31-May-23	15-Jun-23
Equity Group	First & Final Dividend	4.00	45.50	8.8	19-May-23	30-Jun-23
Limuru Tea	Final Dividend	2.50	400.00	0.6	14-Apr-23	30-Jun-23
Umeme Ltd*	Final Dividend	63.90	331.23	19.3	27-Jun-21	20-Jul-23
Kenya Re	Final Dividend	0.20	1.89	10.6	16-Jun-23	28-Jul-23
DTB Kenya	First & Final Dividend	5.00	51.25	9.8	12-May-23	15-Jun-23
NCBA Group	Final Dividend	2.25	36.70	6.1	28-Apr-23	31-May-23
I&M Group	First & Final Dividend	2.25	20.85	10.8	20-Apr-23	25-May-23
CIC Insurance	Final Dividend	0.13	1.96	6.6	08-May-23	26-May-23
ILAM Fahari I-REIT	First & Final Distribution	0.65	6.52	10.0	06-Apr-23	30-Apr-23

*Source: NSE, Company & DBIB Analysis. *UGX ** as at 31st March 2023 *** Subject to Approval*

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