East Africa
Investment Themes for 2019

Sanlam Investments

Economic Growth

Kenya: Improved weather conditions and a more tranquil political environment brought some relief to Kenya's economy in 2018. We project a rebound of GDP growth to 5.8% in 2018 from 4.9% the previous year, supported by a pickup in agriculture, construction, and electricity. The World Bank forecasts a further expansion of 5.8% in 2019. However, we believe 5.3-5.5% will be achieved due to the interest rate cap that will continue to limit the availability of private sector credit. Further, the low base effect in Kenya's agricultural sector as the country recovered from a drought in 2017 that buoyed 2018 economic growth, might not recur in 2019. These factors, combined with possible fiscal tightening measures and increased expenditure on debt repayments, are the most likely headwinds to the outlook.

Uganda: We expect 2018 GDP to have increased to 6.1% from 3.9% in 2017, driven by a pickup of activity in the services sector, a rebound in food crop production and an unexpected and sudden pick-up in private sector credit whose growth is estimated to have increased to 11% in 2018 from 4% in the previous year, responding with a delay, to the reduction in the monetary policy rate. Since January 2016, the monetary policy rate has been reduced from 17% to a low of 9% in February 2018. The World Bank projects economic growth of 6.0% in 2019, anchored on both growing public and private spending including from the oil sector. Uganda could however face headwinds from a narrowing fiscal space which has seen a surge in public debt, increasing the country's vulnerability to shocks.

Tanzania: Policy uncertainty has been the main headwind to economic growth over the last two years. This has considerably dampened investor and business sentiment undermining output. Nevertheless, economic growth in 2018 should remain robust, buoyed by increased government spending, strong agricultural output and investments in the transport sector. 2018 GDP growth is projected to decelerate slightly to 6.7% in 2018 from 7.1% in 2017. The World Bank projects a growth rate of 6.0% in 2019. A key risk to these projections is diminished foreign investor appetite due to policy uncertainty on human rights and international mining companies.

Government Debt and Fiscal Performance

There has been mounting concern over increased government expenditure by the East African Countries (EAC). In Kenya, government expenditure is projected to increase by 15.0 % in the 2018/19 budget. The government has indicated that it will raise its domestic debt target from Ksh 272 billion to Ksh 319 billion for the fiscal year 2018/19 to bridge anticipated lower revenue collections and expensive external debt. The Kenya Revenue Authority missed the collection target by Ksh 60 billion (Treasury target of 381 billion vs Actual of 320 billion) in the three months ended September on the back of a slowdown in economic activity and delayed implementation of some new tax measures.

The bulk of Uganda's public debt, approximately 41% of GDP, is external. Stress tests by the IMF suggest that the 50% debt/GDP level may expose the economy to significant strain. Therefore, unless revenues increase considerably, the government may be compelled to reduce its spending to ensure that public debt remains on a sustainable path.

Tanzania has been the exception by having the lowest increase in public expenditure for the current financial year and the lowest fiscal deficit compared to its peers (see table below).

Country	2018/2019 budget (Trillion)	2017/2018 budget (Trillion)	% change	Budget Deficit as % of GDP at current prices
Kenya	Ksh3 ($30b)	Ksh2.6 ($26b)	15.0	7.2
Tanzania	Tsh32.5($14.3b)	Tsh31.7 ($14b)	2.0	2.1
Uganda	Ush32.7($8.5b)	Ush29 ($7.5b)	13.0	4.8

Source: Bloomberg, KPMG 2018 Budget report

The various governments in the EAC expect enhanced taxation measures to result in lower budget deficits. Kenya is amending its presumptive tax regime, Uganda has increased excise duty on financial services and introduced withholding VAT while Tanzania is reviewing its gaming tax.

Monetary Policies

Kenya's Monetary Policy Committee (MPC) reduced its policy rate in 2018 on the back of well-anchored inflation within the target range of 2.5% and 7.5%. The MPC reduced the key lending rate from 10.0% to 9.0% underpinned by low food inflation, lower oil prices and weak currency demand pressures. There has however been concern that the interest rate cap has diminished the effectiveness of monetary policy and undermined the transmission of policy signals.

In Uganda, the MPC increased the Central Bank Rate from 9.5% to 10% due to expectations of rising inflation stemming from the weakness of the Ugandan Shilling against major world currencies. The MPC has indicated that it expects to maintain the current contractionary monetary stance in 2019 due to increasing inflationary pressures.

The Bank of Tanzania (BoT) plans to introduce a benchmark interest rate in FY19. This was initially planned for March 2018 but has been delayed. Measures to improve private-sector credit growth appear to have boosted lending.

Currency

The Kenya shilling was immune to volatility, compared to currencies of emerging market economies. It appreciated by 1.3% against the US Dollar in 2018. In our view, this was supported by sufficient foreign exchange reserves and open market operations. In our view the Kenya shilling is susceptible to downward pressure from negative sentiment due to persistent fiscal concerns. In the longer term, the cost of debt from increased external borrowing could exert further downward pressure on the Kenya shilling. However, we believe the authorities will likely seek to limit significant Kenya shilling volatility given its rising external debt. In addition, the extension of tax amnesty inflows and robust diaspora remittances could mitigate pressure on the shilling. Relatively robust foreign exchange (FX) reserves, despite declining in 2018 to USD 8.0 billion (5.2 months of import cover) from USD 8.45 billion, could provide sufficient ammunition for any currency smoothing interventions by the CBK.

The Uganda shilling depreciated slightly against the US Dollar by 1.7% in 2018. We expect further depreciation in 2019. Latest data indicates that FX reserves declined to USD 3.3 billion (4.4 months of import cover) in October 2018 from USD 3.7 billion (5.2 months of import cover) in December 2017 and could be strained further as we expect a further pick up in import demand. However, increased foreign currency inflows targeting high yielding government securities should slow down the pace of the Ugandan Shillings depreciation against the US Dollar.

The Tanzania Shilling depreciated by 2.5% in 2018. This was attributable to import pressure that was unmatched by dwindling FX inflows. We expect that the substantial public investments that have been announced will require significant importation of capital goods which is likely to increase pressure on the currency.

Overall across East Africa, we note that a key risk for the East African currencies is from further sustained US Dollar strength in 2019. However, oil prices have moderated from highs in first half of 2018 and this is positive for all the East African currencies – which are for now all net oil importers.

Inflation

Inflation in Kenya, Uganda and Tanzania remained within target of the respective governments in 2018. Kenya's overall average inflation increased to 5.7% in 2018 from 4.5% in 2017 while in Tanzania inflation averaged 3.4% in 2018. In Uganda, headline inflation steadied at 3.0%.

In Kenya and Tanzania, overall inflation in 2019 is expected remain within the set targets. Kenya's inflation could be supported by favorable rainfall for the first half of the year and lower oil prices. Inflation in Tanzania eased sharply in 2018 closing at 3.0% y/y in December as good weather drove softer food prices. Tanzania's inflation could remain below the 5.0% target, albeit with an upward bias given a low base, normalizing food prices, higher oil prices and a weaker Tanzanian shilling.

Uganda's inflation could exceed the central bank's 5% target by end-2019 and in 2020 considering its rising fiscal deficit and likely further currency depreciation.

Credit Markets

Kenya's credit growth has stagnated at single digits, expanding by just 4.4% in the year to October 2018. Growth in private sector lending has been constrained by the interest rate cap and persistently high non-performing loans.

In Uganda, Private sector credit growth is estimated to have increased by 10% up to November 2018 from 4% in 2017, responding with a delay to the reduction in the monetary policy rate. Since January 2016, the monetary policy rate has been reduced from 17% to a low of 9% in February 2018. The current monetary policy rate is at 10%.

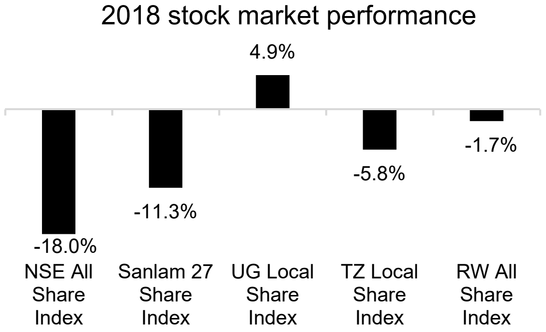
Tanzania's credit growth was below 5.0% in 2018 mostly due to increased risk aversion following the poor liquidity and deterioration in asset quality across the banking sector. These conditions are likely to persist in 2019.

Bond Markets

Bond yields in Kenya declined by more than 200 basis points across the curve in 2018. There was high demand for government securities given the prevailing ample liquidity in the banking sector as a result of the cap on lending rates. Investor preference for bonds may continue given that there appears to be little political will to amend the interest rate cap framework and we expect high demand for treasury bonds. However, there are growing concerns from credit rating agencies such as Moody's about Kenya's debt sustainability and we might see slight upward pressure on rates because of the government's increased domestic borrowing.

In Uganda, yields on government securities increased across all tenors. This was caused by increased government borrowing to support infrastructure projects and bridge government revenue shortfalls. With concerns over rising external debt, Ugandan interest rates could remain elevated over the next 2 to 3 years and could rise again as the country approaches general elections in 2021.

Regional Equity Markets – to remain subdued



Equity markets across East Africa did not have a stellar year in 2018. The best performer was the Uganda local share index, which gained 4.9%. However, the All Share indices in Kenya and Tanzania fell by 18.0% and 14.6% respectively, whilst Rwanda's market was more stable - the All Share index declined by only 1.7%.

East African equity markets could remain subdued in the near-term as international investors remain cautious about Emerging Markets. This is due to the expectation of rising interest rates in the US, the impact of the recent strengthening of the US Dollar and uncertainty over trade in the US - China dispute. However, valuations across East African markets have improved considerably making them increasingly attractive for long term investors.

Global Markets

Global equity markets fell sharply in 2018. Developed world economies lost the previous year's gains. Increased uncertainty over the escalating global trade conflict between the US and China weighed on business sentiment and prospects for global economic growth.

The risks to the 2019 global economic outlook remain elevated. More interest rate hikes are expected in the US albeit at a slower pace. China could mitigate against the negative impact of US tariffs on their goods by easing both their monetary and fiscal policies.

Alternatives - Private Equity & Property

Private equity (PE) activity in the region increased in 2018 after a tough 2017. The disclosed value for deals recorded almost doubled to USD 834.3 million, compared with USD 446.78 million last year, according to East Africa Venture Capital Association (EAVCA). The increased deal activity is indicative of East Africa's growing prominence as a private equity capital destination largely driven by the stability of the region's economies. There were 47 private equity deals announced in 2018, up from 27 in the previous year. Kenya led with 24 transactions, up from 18 in 2017.

Going into 2019, we expect the momentum of deal activity to increase in the region, backed by its economies' resilience. Investor interest in PE suggests increasing appetite for private equity investments considering the limited opportunity in listed equity markets. The preferred sectors for PE funds seem to be Fintech, Education, Consumer Products and Services, and Energy.

In 2018, from available data, the Kenyan property market did not recover substantially from the slowdown that started in 2017. The latest house price index reports revealed that house prices were generally stable although with signs of softening in some sectors such as high-end residential properties. The Q3 2018 Kenya Banker's Association (KBA) Housing Price Index showed a 1.35% quarter on quarter (q/q) overall increase in house prices. The Q3 2018 Hass Consult Sales and Rental index showed an improvement in asking sales by 1.1% q/q and asking rents increased by 1.5% q/q. Asking sales improved by 8.1% y/y and asking rents increased by 4.7% y/y. This reflects a sense of price stabilization.

Data from the Kenya National Bureau of Statistics (KNBS) also indicates that construction activity is yet to rebound. Cement consumption and production of galvanized sheets used for roofing fell in 2018. The decrease in production and consumption of cement, coupled with the current oversupply in the market and subdued transactions have made developers more reluctant to commence new-builds. The KNBS October issue of the Leading Economic Indicators, indicated a 21.5% y/y decline in the total value of building approvals by the Nairobi City County for the first 10 months of the year. The current oversupply in the market and limited bank credit was cited as reasons why developers have been hesitant to commence new projects.

In 2019, there seems to be a similarity between the listed equity and the real estate markets. Though the overall equity market is looking lackluster, there are a few stocks which offer good value. Similarly, though the broader real estate market is flat, there are pockets of opportunity in selected sectors. In this environment, investors will need to be very careful and comprehensive feasibility studies are recommended to ensure that investors make fully informed and rational decisions.

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