Investment Newsletter, October 2019

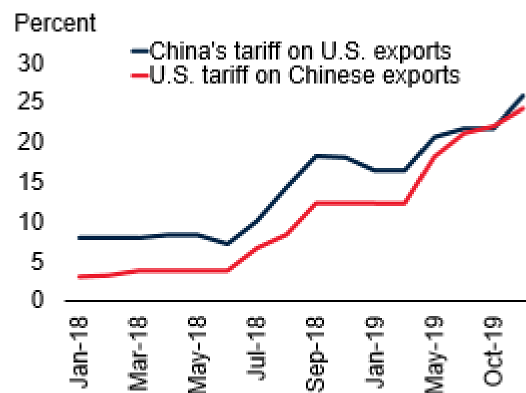
Sunset on the beach at Sarasota - Florida, USA. 30th June 2019 (*Courtesy of J. Dry*)

Dear Investor,

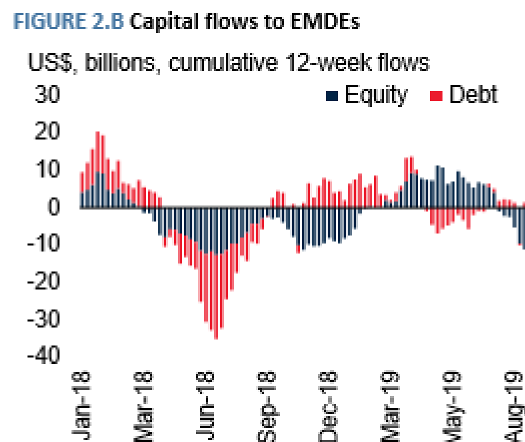
The good news is that the global economy continues to expand. The bad news is that the expansion is slowing. The World Bank has revised its 2019 Global GDP (Gross Domestic Product) forecast downward to 2.6% from 2.9% last January.

Why is Global Growth Slowing?

The major reason behind this fall off in growth is the continuing trade war between the US and China. According to the World Bank, tariffs on Chinese imports into the US will have risen from an average 3.1% two years ago to 24.1% by year end. The Chinese have responded in kind per the attached graph.



The World Bank also notes there are increasing capital outflows, particularly from the equity markets of emerging markets and developing economies, beginning in the second half of 2019 as global capital seeks a safe haven. Kenya seems to be front and center in this scenario. When the elephants fight, the grass suffers! See the graph below:



The US Market

The US economy, for its part, is beginning to show signs of fatigue. US GDP growth has slipped from 3.1% in the first quarter of 2019 to 2% in the second quarter of 2019. While exports are obviously down, the US manufacturing sector in August recorded its first contraction in three years. The Federal Reserve has also felt the need to lower the Fed Funds target rate to 1.75 – 2% in September. This is the second reduction in 2019 per the chart below:

Instead of reducing interest rates, the Fed wants very much to raise interest rates to more historically normal levels – something in the 5-6% range. It wants to do this so that in the event of a US recession, it can slam interest rates down substantially to stimulate the economy. Reducing interest rates, of course, means lower interest cost for private sector borrowers, leading to higher profits, higher stock prices and so on.

So, the Fed is in a quandary. It is being forced to stimulate economic activity with interest rates already at historically low levels. In effect, it doesn't have the fire power it needs to jolt the economy. In addition, the Fed has recently been active in the "repo" market which means it is repurchasing government securities from banks and fund managers, thereby injecting liquidity into the market. This is effectively QE (quantitative easing) all over again.

US as an Investment Destination

Goldman Sachs' recent "Easy Does It" market commentary advises that investors should "beware of global politics". This is an understatement. Global politics is playing an increasing role in economics today – from trade wars to central bank interventions. The trade war between the US and China is a result of global politics – not market forces. And it could end just as quickly as it started with the stroke of a pen. With US presidential elections looming in November 2020, a truce before then would seem a likely bet. But in the meantime, there is uncertainty and investors must make decisions not only on how to create wealth but preserve it. Many of our offshore investors have exposure to the US markets, particularly the **Franklin US Opportunities** and **Franklin Technology Funds**. While these two funds are up 60.45% and 115.73% respectively over the past five years, we think it is time to review large positions.

From a technical perspective, both the S&P 500 Index and the Dow Jones Industrial Average haven't been able to pierce their July 2019 highs. This indicates continuing resistance to higher valuations. The average Price/Earnings Ratio of the S&P 500 Index today is 22 times which is higher than the historical average of 16x. And from a "global politics" perspective, the coming US presidential elections raises the possibility of a new administration with a not so business friendly agenda. In light of these and other considerations, it

seems prudent that investors should consider moving some of their US equity portfolios to other funds with more fixed income exposure. **The Franklin GCC (Gulf Cooperative Council) Bond Fund** (+21.75% over last 1 year) is a good candidate.

Enkaji Osiwo House, Champagne Ridge 30th September 2019 (Courtesy C. Dry)

Growing Global Debt

We've mentioned the heavy hand of "global politics" and the fact that world economies are not being left to self-correct. Over the past decade or so, central banks have taken on an increasingly active role in propping up the banking systems of many countries - Greece, Spain, Italy, Iceland, Ireland, the UK and US immediately come to mind. The US Fed's bailout of the financial sector in 2008 authorized over $1 trillion in government support for investment banks, commercial banks, insurance companies and money market funds. While the Fed's efforts are generally acknowledged as the right thing to do in that panicked situation, trillions of dollars were created by the Fed. The Fed balance sheet expanded from $858 billion in August 2008 to $2.24 trillion by the end of 2009. It is $3.9 trillion today. This represents money the Fed has injected into the US economy though the purchase of essentially promissory notes from borrowers. Although the Fed's monetary operations must operate within in the Congressionally mandated US debt ceiling, which keeps getting raised, this is new money that has been injected into the economy. This money is fiat money, meaning it is not backed by anything other than the government's word that it is legal tender.

For background, the US and other countries used to be on the gold standard until President Nixon closed the US gold window in 1971 which meant the US would no longer settle international debts in gold. Conversion of US dollars to gold by private citizens was discontinued under President Roosevelt in 1933 although Americans have been allowed to personally own gold since 1974.

Fiat money has no such backing. With nothing anchoring the continual issuance of fiat money, US dollars or any other currency for that matter will continue to lose value – unless economic productivity were to outstrip money creation which is certainly not happening. The US Consumer Price Index Inflation Calculator tells the story. One hundred US dollars in 1913 is equal to $2,529 today. So, it's a given that as new fiat money is created, it lessens the value of existing money.

The US government has a public debt of $23 trillion today. It was $5.6 trillion in the year 2000. Does anyone really think that will be repaid? No, it will probably never be repaid and what will be repaid will be repaid in inflated dollars. Short of the government defaulting on these debts, that is the only way it can repay these debts. It will pay it back in devalued currency. And that is what many economists are beginning to seriously fret about in this age of debt binging.

As currencies around the world are debased, one obvious investment is gold. There are several ways to buy and hold gold. One vehicle is **Franklin Gold & Precious Metals Fund** (+37.86% over last 1 year). The long term investor ought to consider some exposure to gold – say 10% of portfolio value – in light of the above.

For an engaging look at the possible consequences of out of control global debt, read monetary economist's Jim Rickard's new book "Aftermath: Seven Secrets of Wealth Preservation in the Coming Chaos".

The Kenyan Economy

The International Monetary Fund (IMF) expects Kenya's economy to expand at 5.6% for 2019 which was recently revised downwards. Kenya's GDP expanded 6.3% in 2018 so this year's expansion would be eleven percent; less robust than last year.

Interest Rate Caps

The IMF has estimated that the interest rate capping legislation enacted in 2016 may have reduced Kenya's GDP growth 0.4% to 0.7% which could entirely explain this year's fall off in GDP expansion. This may well be the case. As we've noted in earlier newsletters, this short-sighted legislation has starved the private sector of credit for the last three years. The good news is that President Kenyatta last week sent the Finance Bill 2019 back to Parliament to eliminate interest rate capping. Parliament can only overrule the President with a 2/3 majority.

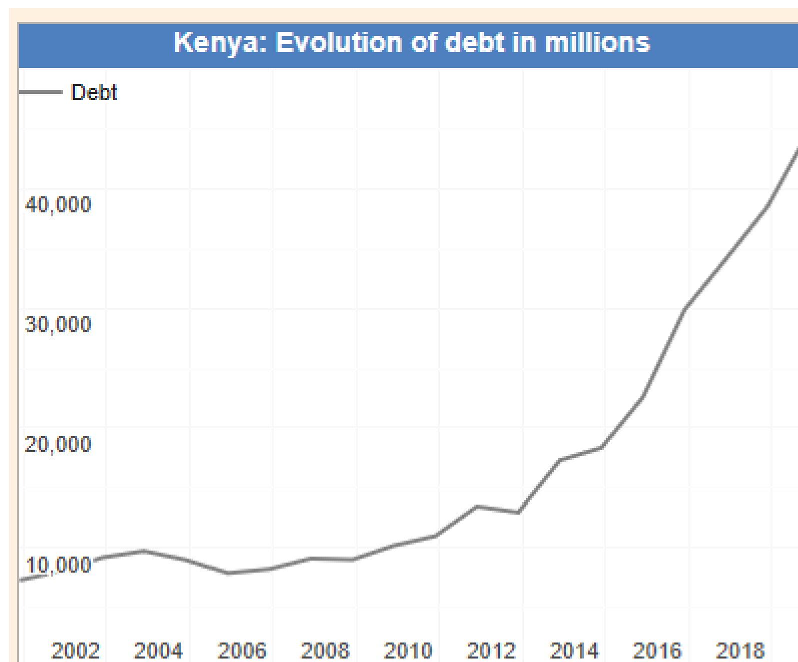
If this populist piece of legislation can finally be put to rest, we expect credit to begin to flow back to the private sector. Small and medium sized enterprises (SMEs) in particular will have access to credit once again and the private sector as the engine of growth can get back to work.

What parliamentarians do not understand is that the price of money must be market determined. One size does not fit all and 13%, the current cap, is too expensive for some borrowers (for example, Fortune 500 companies operating in Kenya like Coca-Cola and Procter & Gamble) and too cheap for SMEs like your internet startup. This is an ideal time for the new credit rating agencies in Kenya to make their presence known. Companies and individuals need to be credit scored so that banks can properly evaluate credit applications and price loans accordingly. At the same time, banks will evolve their own unique business models with some banks targeting riskier SMEs and retail customers and charging higher interest rates and other banks limiting their clientele to more creditworthy large corporates.

Looking onto Lake Oloiden, from Mundui House, 12th August 2019 (Courtesy of S.Dry)

Kenya's Ballooning Debt

So eliminating interest rate caps is the good news. The worrying news is that Kenya continues hell bent on saddling the country with debt – both foreign currency denominated and local currency debt. What was said earlier in this newsletter about the perils of debt binging in developed economies, applies spades to frontier economies like Kenya. Kenya might be able to inflate away the Kenya shilling debt, debasing the shilling in the process, but not the forex denominated debt. Here's a graph of Kenya's spiraling debt:



Total public debt now totals KES 6 trillion of which about half is foreign currency debt. KES 6 trillion represents 60% of GDP. Servicing this debt, that is, just paying interest and some principal on the debt now eats up a third of the national budget. Another third is probably stolen leaving a mere third of the debt being put to work. It is true that there are some countries which are carrying larger relative debt burdens. Japan is the obvious example with debt to GDP of 235% and the US is another with debt representing 106% of GDP, but these debts are denominated in their own national currencies and these developed economies have enormous public wealth assets that can be monetized if necessary. Kenya does not.

Kenya – Stocks and Bonds

The Nairobi Securities Exchange's (NSE) record for making money over the past five years (even ten) is not impressive per the attached:

What should Kenya do? What about a balanced budget amendment to the Constitution meaning the government can only spend what it collects in the form of taxes. That would quickly prioritize things. White elephant projects – read trains and dams - would not make the cut but hopefully Nairobi roads would. Parliamentarian salaries would have to be reviewed. The Kenyan shilling would strengthen meaning interest rates would come down. Maybe one day!

Converse Dry and Rob Porter conducting an product training session for the Investment Executive team (17th October 2019)

Better to have invested abroad. This home bias, that is the tendency of investors to limit their investments to their home country, concentrates too much risk and means investors do not participate in the growth of other countries and companies. Nevertheless, we note that the possible lifting of interest rate caps has investors' attention and has resulted in increased prices of seven NSE-listed banks to the tune of KES 21 billion as of 18th October 2019.

Fixed Income Securities

On the other hand, Kenya's fixed income securities offer investors attractive interest rate returns. High interest rates, fortunately or unfortunately, go hand in hand with risky countries. These yields are currently available on Kenyan fixed income securities:

Private Issue Bond (5 years) (BBB credit rated)	**15.00%**	Source: Dry Associates
Private Issue Medium Term (2 year) Notes (BBB)	**13.00%**	Source: Dry Associates
Average Commercial Paper Rates (91 – 364 days)	**12.25%**	Source: Dry Associates
364 Day Kenyan Treasury Bill	**9.79%**	Source: CBK
Dry Associates KES Money Market Unit Trust	**8.33%**	Source: Dry Associates
91 day Tier I (KES 5M) Fixed Deposit Receipt	**7.75%**	Source: Dry Associates
182 day Kenyan Treasury Bill	**7.24%**	Source: CBK
91 day Tier 1 (KES 5M) Fixed Deposit Receipt	**6.36%**	Source: Dry Associates

Yours sincerely,

Dry Associates Investment Bank

25th October 2019

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