Dry Associates Investment Newsletter

February 2019

Looking at the Kandalama Reservoir from the Heritance Kandalama Hotel, Sigiriya, Sri Lanka (Dec. 2018); Courtesy: S. Dry

Dear Investor,

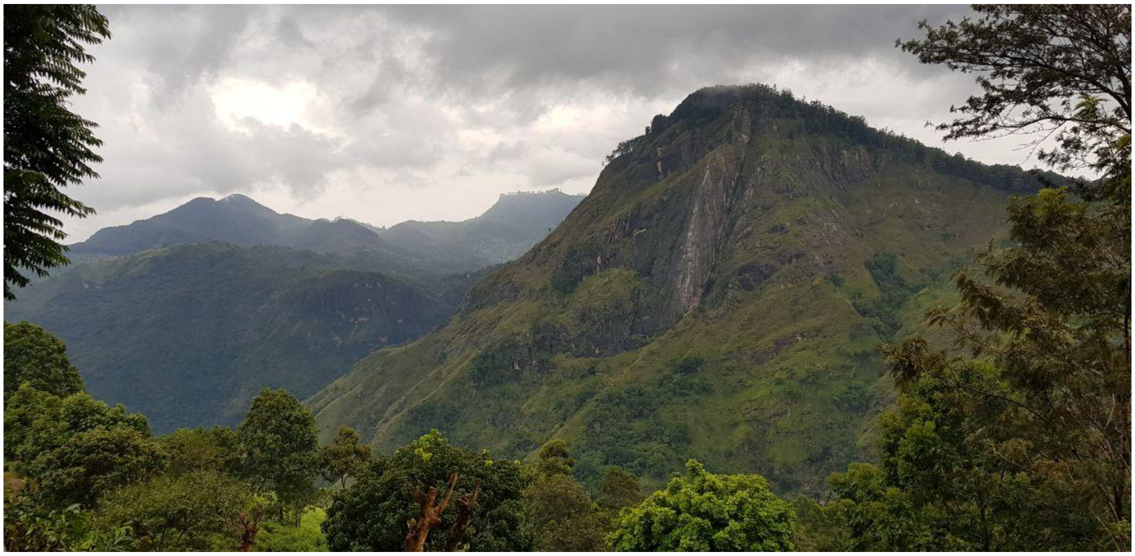
Benjamin Franklin famously said “In this world nothing is certain except death and taxes.” That may be so, but economic expansions are always followed by economic contractions. Investors taking the long view can take a “buy and hold” strategy but savvy investors take measures to avoid loss of wealth – even temporary – in the face of economic contraction. Since stock markets are leading indicators of economic change, it is stock and bond prices that take an immediate hit when economies contract.

The US Market

As an investment institution, we keep an eye on the US economy because it affects so many other markets. The US stock market represents 40% of global market capitalization. Incidentally, Japan is a distant second place representing 7.59% and China only 7.51% according to www.seekingalpha.com. The US bond market is even bigger representing some 44% of the global bond market according to Wikipedia.

So, even though we’re in Kenya, we need to take cognizance of US markets. While we do not expect a contraction in the US economy in 2019, we think there is more than a 50% chance there will be in 2020. Here’s why. The US Federal Reserve Bank (“Fed”) is purposefully and deliberately raising interest rates in the US. We’re not particularly worried about the trade spat with China – that can be sorted quickly and probably will be in the next several months. What the Administration cannot do, however, is prevent the Fed from raising interest rates. President Trump knows perfectly well the stock market will knock off trillions of dollars of private wealth if interest rates rise substantially and in fact he threatened to “fire” Federal Reserve Chairman Powell last month for raising interest rates in 2018. He can’t do that, but he was certainly sending a message to his new Fed appointee.

There’s an old expression in the US stock broking community that says “Don’t fight the Fed.” The reason is simple – when America’s central bank pushes up interest rates, stock markets go down. Incidentally, so do bond, real estate and precious metal prices. The main reason stock prices fall is that money becomes more expensive and higher interest expense means lower corporate profits.



A view of Ella Rock from Ravana Heights, Ella, Sri Lanka (Dec. 2018), Courtesy: S. Dry

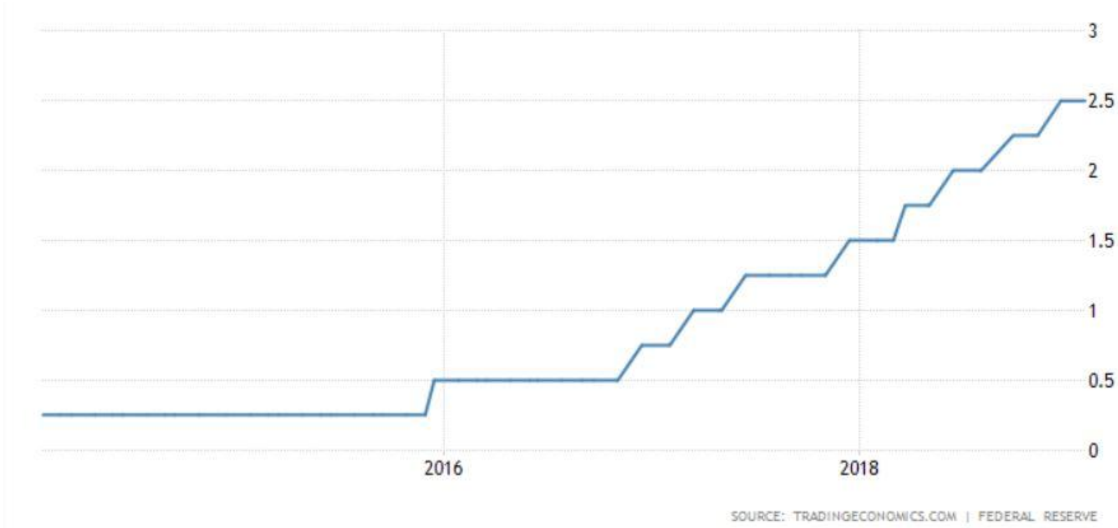
So why would the Fed raise interest rates deliberately?

The answer is that the Fed has spent all its fire power and needs to rebuild the US interest rate infrastructure. Since December 2007, when the Great Recession began, the Fed has injected billions and billions of dollars into the US economy to stimulate economic activity. The Recession is over now but interest rates are basically on the floor at 2.25%.

The Fed knows that if US economic growth flags, it doesn't have the monetary muscle to do anything about it. Dropping interest rates 2.25% wouldn't be enough of a jolt to jolt the US economy. In fact, the Fed dropped interest rates an average of 7.25% in each of the last four US contractions in order to stimulate the economy according to Daniel Amerman (www.danielamerman.com).

The negative impact of interest rates hikes on most asset valuations cannot be overstated. The Fed raised interest rates a quarter point four times in 2018 – in March, May, August and November. The fall in the Dow Jones Industrial Average over this same period is not coincidental.

Three Year View of Federal Reserve Interest Rate Hikes



Look at the Dow Jones Industrial Average over the same 3 year period. You can almost see the cause and effect on a quarterly basis of interest rate hikes in 2018 per the following chart. The last interest rate hike in the fourth quarter of 2018 was apparently just too much for the market and it fell from 26,000 to 22,000 or 15%. The New York Stock Exchange lost over $2 trillion in October 2018 alone ending 2018 pretty much where it began the year.

<u>Three Year View of Dow Jones Industrial Average</u>

So the Fed believes it must hike interest rates – in spite of the damage it will do to investors' wealth. While the Fed has recently said it will be "patient", it is pretty certain to us the Fed plans more hikes in order to regain monetary policy control. Indications are, however, that there may be only one or two hikes in 2019 which might be gradual enough not to spook the market. By 2020, however, pressure will have built within the Fed to get interest rates up to a level that monetary policy once again becomes an effective economic tool.

<u>So how do investors protect themselves?</u>

To recap, while the Fed's actions seem counter intuitive and will undoubtedly knock trillions of dollars off investors' wealth, the Fed feels justified in doing this for the greater good.

Knowing this is important. Taking appropriate action is the next step.

2019 will be a year of transition. Certainly, by mid-2019 investors should begin to implement measures to counter further interest hikes. Here are some of the actions we can take:

a. Go short. This means selling securities which you don't own and buying them back after they've fallen in price. The difference is profit. This is risky, however, since being short means you're assuming unlimited risk. Unlimited because a stock's price can go up instead of down *ad infinitum*. If you were long a stock, meaning you owed the stock, your loss is limited because the price can only fall to zero – no further. Rather than engaging in short selling yourself (where limit prices are an absolute must) there are unit trusts and mutual funds – sometimes called long-short funds - that are professionally managed and do this sort of thing daily.

b. Invest in stocks of banks, mortgage and insurance companies. All these institutions will benefit from higher interest rates. There are a number of ETFs (Exchange Traded Funds) that are focused on financial stocks. This can be done through our Old Mutual International platform.

c. Invest in short term bonds. This means taking money out of equities and putting money into debt instruments with reasonably short maturities. These securities always mature at full face value. On maturity, the funds are reinvested in more short term debt instruments until the recession is over. This is a good idea and Franklin Templeton has a number of money market and bond funds which can provide a safe haven during periods of rising interest rates. Some of the most popular are the Templeton Global Bond Fund and the Franklin US Dollar Short Term Money Market Fund.

d. Invest in Emerging Markets (EM) equities. This is a common sense approach since US equities are trading at historically high multiples. In fact, the average Price/Earnings multiple of all stocks in the Dow Jones Industrial Average is 18 times compared to the long term average of 16 times. By taking profits during 2019 and investing in EM equities with lower Price/Earnings multiples, you are value investing – that is, reducing the chance of a steep fall in prices. Franklin Templeton offers several attractive EM funds including the Templeton EM Fund and the Templeton EM Smaller Companies Fund. A more geographically focused fund might be the Franklin Brazil Opportunities Fund.

e. Convertible bonds. These are fixed income instruments which can be converted into shares at a pre-determined rate. For example, a $1,000 bond issued by XYZ Corp. might be convertible into 20 shares of XZY at $50 per share. The conversion price is always higher than the price at which the stock is trading at the time the bond is issued. So, in this case, the current trading price of XYZ stock might be $45 per share. So while you're waiting for the share price to rise to $50 or more, you're enjoying a fixed rate coupon, perhaps 5% until such time as you convert or the bond matures. The Franklin Global Convertible Securities Fund is an ideal investment for this sort of investment.

At 263m, Bambarakanda Falls is the tallest waterfall in Sri Lanka, near Belihuloya (Dec. 2018); Courtesy: S. Dry

Kenya

The World Bank and the IMF expect Kenya's economy will expand 6% in 2019 up from about 5.5% in 2018. That's good but not as good as some of its neighbors – Ethiopia is expected to expand 8.5% and Tanzania 6.6% and Uganda 6.1%. Nevertheless, it's an enviable growth rate.

Unfortunately, Kenya's debt burden is expanding even faster than GDP. Moody's, Standard & Poor and Fitch all rate Kenyan sovereign debt as "highly speculative". Kenya's total domestic and foreign government debt now exceeds KES 5 Trillion representing almost 60% of GDP. That's roughly KES 100,000 for every Kenyan man, woman and child (KES 50 Trillion/50 million people). What is particularly worrying is that half of this debt is denominated in foreign currency. Kenya could inflate away its domestic debt (wiping out domestic wealth in the process) but it can't do that with foreign denominated debt. If the shilling were to depreciate even slightly, servicing foreign currency debt becomes problematic. Already 45% of all tax collections in Kenya are used to service and pay off official debt. Of course, sovereign debt is not just a Kenyan problem. It's a global problem. Frankly, the only solution we know to keep politicians from spending what they don't have is a Balanced Budget Amendment – that is, a law allowing Parliament to spend only what it takes in in tax revenue.

The other dark cloud over Kenya is the continuing Interest Rate Capping legislation passed by Parliament in September 2016. This perhaps well intentioned piece of legislation is bad economic policy and continues to cut off bank credit to the private sector.

Here's what a typical commercial banker's probably thinking. Under the rate caps, the maximum I can lend my money out is 4% above the Central Bank Rate (which is currently at 9%) meaning the maximum lending rate is 13%. If I lend to the average private sector client, the loan might have a say, 10% chance of default meaning I would earn 11.70% on my loan book (that is, 13% x (90% chance of repayment)). But I can earn more than 11.70% or very close to that by simply purchasing government bonds with no risk of default since the government can simply print more money. Result, only prime private sector companies get lending facilities. The entrepreneurs, SME's and not so prime customers go out of business or are forced into the arms of hire purchase and loan sharks because the bank cannot price risk into its lending rate. In short, this law needs to be repealed. It does not reflect reality in Kenya. On the other hand, enacting a usury law preventing loan sharks from charging 30-50% or higher interest rates would make sense.

Kenyan Fixed Income Securities

The Central Bank of Kenya continues to do a commendable job maintaining the strength of the Kenya shilling helped in large part by significant monthly remittances. In the month of October 2018 remittances (last reported by CBK) totaled $219 million. Inflation currently stands at 5.7%. The Kenya shilling foreign exchange mid-rates are as follows:

Foreign Currency Unit	Exchange Rate in Kenya Shillings
US Dollar	100.22
Sterling	131.15
Euro	113.81

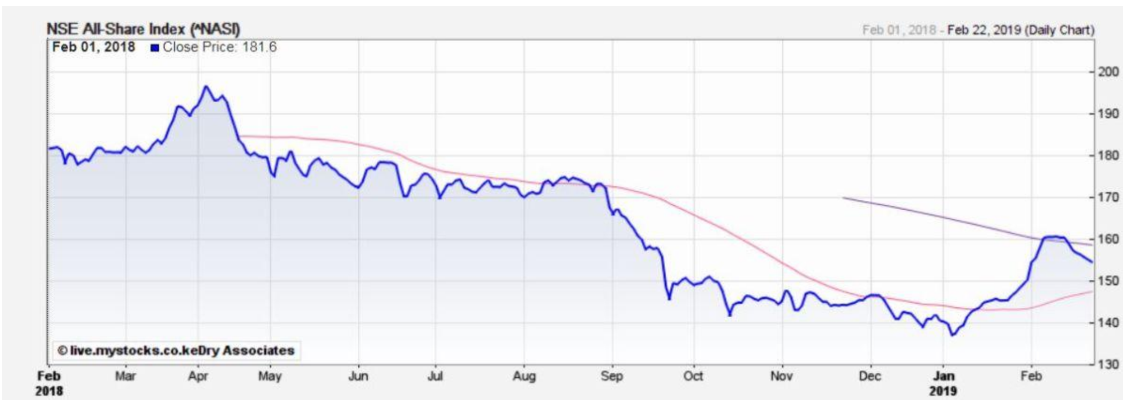
Sigiriya Rock, site of the palace of an ancient Sri Lankan Kingdom and a UNESCO World Heritage Site (Dec. 2018); Courtesy: S. Dry

The interest rates currently available on fixed income securities in Kenya today are indicated below:

Private Issue Corporate Bonds (5 year)	***15.00%***	***Source: Dry Associates***
Private Issue Medium Term Notes	***14.00%***	***Source: Dry Associates***
Average Commercial Paper Rates	***12.50%***	***Source: Dry Associates***
364 Day Treasury Bill	***9.86%***	***Source: CBK***
Dry Associates Money Market Unit Trust	***9.12%***	***Source: Dry Associates***
182 Day Treasury Bill	***8.78%***	***Source: CBK***
Average Commercial Bank Deposit Rate	***7.57%***	***Source: CBK***
91 Day Treasury Bill	***7.06%***	***Source: CBK***

Kenyan Equities

The Nairobi Securities Exchange (NSE) has sprung to life since January 2019 with the NSE All Share Index up 17% since January 4, 2019. Some of the rise is attributable to the 40% jump in NIC's price since its merger announcement with CBA Bank. Other bank stocks seem to have been carried along as well. Equity Bank is up 28%, HFCK up 20% and KCB up 18% since the start of the year. Could there be more bank mergers the wings? Other counters are up as well with East African Breweries up 25% on good earnings and Centum up 21%.



Other NSE Initiatives

The NSE and the CMA (Capital Markets Authority) have launched the new IBUKA (Swahili for "Emerging") program. This initiative seeks to attract young, growing companies to list on the NSE either "By Introduction" or by "IPO" (Initial Public Offering). Listing by Introduction means the company is not raising funds for the company; rather, existing shareholders are merely listing their shares so the shares can be priced and become tradable. An IPO, on the other hand, seeks to raise capital for the company with new shares while also allowing existing shareholders to sell shares. In any event, the IBUKA program was launched on 1st February with APT Commodities, a Mombasa tea company, being the first "hosted" company on the Incubator Board. Having attended the opening, we learned that APT is the only company in Kenya that cold presses tea seeds for oil which is used in cooking, salad dressing, and other sauces. So, there's some value add for Kenya! Apparently there are another 20 or so smaller companies interested in possibly listing.

Succession Planning

The IBUKA initiative should be well received in Kenya and Dry Associates intends to bring some of these emerging and even mature companies to market in the future. We've found that many companies, family owned companies in particular, are not doing a good job of succession planning so that their businesses survive the founder's generation. In fact, a 2016 Price Waterhouse survey found that less than 12% of Kenyan family owned businesses made it to the 3rd generation and less than 4% to the fourth generation. Just two weeks ago we learned Ebrahim Supermarket has shut its doors after 75 years in Kenya. It is these kinds of businesses that would have benefited from a more professional footing offered by the listing experience.

Private equity buy-outs are one way for companies to "cash out" and bring professional expertise into management and onto the Board. Listing on the NSE is another way. The NSE listing requirements effectively force smaller businesses to strengthen corporate governance, plan for the future and put in place long term financing and strategic plans. The NSE has three trading boards – the smallest being the GEMS Board (Growth Enterprise Market Segment), the AIMS Board (Alternative Investment Market Segment) and the MIMS Board (Main Investment Market Segment). They each have slightly different requirements for listing. For example, the MIMS board requires the company to have 1,000 shareholders, the AIMS board 100 shareholders and the GEMS something less than 100 shareholders. There are also tax reductions for 3-5 years for listing at least 20% of a company's shares. So, it's an option many companies ought to be exploring. Dry Associates plans to work with many of its corporate "Associates" to explore these options going forward.

Sincerely,

Dry Associates Investment Bank
Your Financial Partner … today and tomorrow!

Looking towards 98 Acres Resort & Spa in the middle of the Finlay's Tea Plantation, from Little Adam's Peak, Ella, Sri Lanka (Dec. 2018); Courtesy: S. Dry

Dry Associates Ltd

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