Investment Newsletter, June 2019

Palacio de Cristal (Buen Retiro Park) - Madrid, Spain. *Photo courtesy of M. Dry*

The US Economy - why is it important?

Dear Investor,

In our newsletters we often review the US economy. The reason is simple. The US economy is the largest economy in the world representing a quarter of the world's GDP (Gross Domestic Product) and approximately a third of global stock market capitalization. US business cycles are, for better or worse, highly correlated with business cycles around the world. One only has to look at how the 2007 US home loan meltdown resulted in the Great Recession of 2008.

Another consideration investors must take into account is that the US economy for all its capitalist and free market rhetoric has significant government oversight and regulation. The Federal Reserve is the single most important player in this framework of government oversight.

US Federal Reserve Reverses Course

In our last newsletter, we suggested that the US Federal Reserve would hold interest rates steady in 2019 but raise rates in 2020. We felt that pressure was building on the Fed to replenish its arsenal, so to speak, and raise interest rates to historically more normal levels which incidentally would knock off billions of investor wealth in the process. The average Fed Funds rate was 5.67% from 1971 to 2019 according to TradingEconomics.com. In other words, with the Fed Funds rate currently on the floor at 2.5%, our expectations was that the Fed would have to raise rates so that it could lower rates if and when the US economy needed a jolt.

Well, we're reminded once again that predicting interest rates is a 'fool's game'. The Fed is now indicating that it may drop interest rates in June or July of this year. So even though the US interest rates are "on the floor", it's all relative. The EU and Japan currently have negative interest rates. The reason the Fed is considering dropping rates is to counter the possibility of a US economic slowdown. What has economists worried is the escalating trade tariffs wars between the US and trading partners beginning with China.

A drop in US interest rates will have repercussions. For example, it should weaken the value of the dollar, boost US exports, encourage consumption and so on, but from a stock investors point of view, it should benefit the US equities market. Lower interest costs mean higher corporate profits and higher stock prices.

"You get recessions, you have stock market declines. If you don't understand that's going to happen, then you're not ready, you won't do well in the markets." - Peter Lynch

Global Slowdown

There's more than a little truth in the quip that when the US sneezes, the world catches a cold. Indeed, if the US is experiencing a slowdown then it follows that global growth will slow. Confirming that, the World Bank has revised downward its global growth estimate to 2.6% in its latest June 2019 edition *Global Economics Prospects: Heightened Tensions, Subdued Investment*. The OECD (Organization for Economic Co-operation and Development) has also revised downward its estimate of global GDP growth from 3.5% to 3.3% over the past six months. The OECD cites Brexit, a slowdown in Germany's economy, banking problems in Italy, as some of the factors behind its downbeat forecast. Interestingly, the OECD has suggested that monetary policy stimulus (that is, lowering interest rates) is not an option for many countries because interest rates are already at zero in so many developed economies. In effect, the OECD is saying that Central Banks have run out of ammunition. As such, the OECD is suggesting developed economies need to coordinate global fiscal stimulus to counter the slowdown, that is, increase direct (deficit) government spending to stimulate economic growth. So much for free market economics!

Emerging Markets

Aside from developed economies, there is a compelling case for investing in emerging markets long term. Not only for portfolio diversification, but growth rates are higher in developing countries and equity valuations are often lower. India is a good example.

India's economy is estimated to expand 7.5% this year according the World Bank. That is significantly higher than the other BRIC countries (Brazil 2.2%, Russia 1.5% and China 6.4%). Prime Minister Modi's overwhelming re-election results this May are generally seen as a strong mandate to govern and a source of stability going forward. His efforts to stamp out corruption are commendable by any standard and the markets have responded well to his re-election. The Sensex is up 60% since Modi was first elected in May 2017, as per the chart


Mountain View in Sóller - Mallorca, Spain - *Photo courtesy of M.Dry*

A Well Structured Portfolio

A properly structured portfolio must, of course, reflect an individual's long term financial objectives, risk profile, age, current financial status, income requirements and a host of other considerations. But one thing is always true and that is there should not be a concentration of risk in any one asset class or geographic region. That is why as a general rule investors in Kenya should consider including some portion of their portfolio in off shore investments. In a country as small as Kenya, a 50/50 split of Kenya/offshore investments is as good a starting place as any.
Our concern here is that concentration of risk is one country subjects the investor to the vagaries of a single currency, a single stock market, a single property market, and so on. That is the reason we stress investment opportunities not only in Kenya but abroad.

Investment Opportunities

Taking into account the global investment landscape today, we think that the US market, particularly in light of the likelihood of reduced interest rates would warrant continued exposure to US equities. The *Franklin Technology Fund* (for aggressive investors) and the *Franklin US Opportunities Fund* continue to offer good exposure to the US market. Some exposure to the *Franklin India Fund* also makes sense. A more risk adverse fund offering international diversification is the *Franklin Global Convertible Securities Fund* which is made up of fixed income securities that can be converted to equities. The following is the cumulative performance of these funds up to 7th June 2019 expressed in US dollars:

	Year-to-Date	**1 year**	**5 years**
Franklin Technology Fund	31.45%	23.97%	**145.81%**
Franklin US Opportunities Fund	24.43%	15.88%	82.85%
Franklin India Fund	5.32%	-6.67%	53.87%
Franklin Global Convertible Securities Fund	14.32%	13.01%	32.52%

"It's not how much money you make, but how much money you keep, how hard it works for you, and how many generations you keep it for." - Robert Kiyosaki

If you're a millionaire by the time you're 30, but blow it all by age 40, you've gained nothing. Grow and protect your investment portfolio by carefully diversifying it, and you may find yourself funding many generations to come.

Recommended on-shore investments would include money market unit trusts such as the Dry Associates' Kenya Shilling or US Dollar Money Market Funds. These funds offer safety and yield as they are comprised of numerous fixed income investments including government Treasury Bills and Bonds, Bank Fixed Deposit Receipts and some short term corporate debt. With Kenya shilling yields between 9 - 10% per annum, they pay considerably more than Tier 1 and 2 bank time deposits. In addition, investors need pay no tax upon payout which is similar to bank interest. Tax free Kenyan Infrastructure Bonds are another good choice for a local portfolio, although their maturity is longer.

African Economic Prospects

The following are actual 2018 (African Development Bank) and 2019 forward looking estimates (World Bank) for GDP expansion in selected African countries:

	2018a	2019f	2020f	2021f
Kenya	**5.8%**	**5.7%**	**5.9%**	**6.0%**
Tanzania	6.7%	5.4%	5.7%	6.1%
Uganda	6.1%	6.1%	6.5%	5.8%
Rwanda	**8.6%**	**7.8%**	**8.0%**	**7.5%**
Nigeria	1.9%	2.1%	2.2%	2.4%
S. Africa	0.7%	1.1%	1.5%	1.7%

And for the record, here are the **Best** and **Worst** performing stock markets in the world in 2018:

Best		Worst	
Ukraine	+80%	Venezuela	-95%
Macedonia	+30%	Argentina	-50%
Qatar	+21%	Turkey	-43%
UAE	+12%	China	-28%
Saudi Arabia	+9%	Pakistan	-28%

Source: CNBC

View of the Eiffel Tower from the Seine River - Paris, France. *Photo Courtesy of M.Dry*

The Kenyan Economy

The Kenyan economy as noted above is expected to grow 5.7% in 2019 compared to 5.8% in 2018. The World Bank cites delayed rains affecting agricultural output, low credit growth to the private sector and resultant impotency of monetary policy.

This low credit to the private sector, as we've noted in earlier newsletters continues to starve private sector companies of funding. The Banking Amendment Act passed in September 2016 caps the rate at which commercial banks can lend at 4% above the Central Bank Rate (CBK Rate) which is currently set at 9% so all in lending is capped at 13%. In other words, bankers are hand cuffed. Risk cannot be priced. Naturally, banks play it safe and lend to the risk- free government starving the private sector – which is the engine of growth in every economy.

The High Court did declare the legislation unconstitutional in March 2019 but allowed Parliament twelve months to amend the legislation meaning legislators will simply re-word the document to maintain the status quo. So this is another example of government meddling in the market, in this case to the detriment of the economy. Any time there are price controls on a commodity or a service, whether sugar, housing, or credit, there will be shortages which is what is happening to credit.

The World Bank's observation that interest rate capping neuters monetary policy is evident when you consider the following. If the Central Bank of Kenya felt the economy was slowing and needed a jolt, and it dropped the CBK rate to say, 4%, bankers could only lend at 8% (that is, CBK rate of 4% + 4% cap). But instead of stimulating the economy, as lowering of interest rates usually does, it would almost certainly cut off all lending to the private sector. If banks won't lend to the private sector at 13% they certainly won't lend at 8%. Better to lend to the government risk free. And ironically, if the CBK raised the CBK rate to 13%, banks would be able to lend at 17% which might actually stimulate the economy. This is monetary policy gone backwards.

Then there is additional irony is that mobile credit lenders – not subject to the Banking Amendment – have taken off in spite of lending at rates of 50 – 150% per annum.

Kenyan Fixed Income Securities

The yields on fixed income securities in Kenya today are as follows:

Private Issue Corporate Bond (5 years)	**15.00%**	Source: Dry Associates
Private Issue Medium Term Notes	**13.00%**	Source: Dry Associates
Average Commercial Paper Rates	**12.50%**	Source: Dry Associates
364 Day Treasury Bill	**9.30%**	Source: CBK
Dry Associates Money Market Unit Trust	**8.88%**	Source: Dry Associates
182 Day Treasury Bill	**7.61%**	Source: CBK
91 Day Treasury Bill	**6.92%**	Source: CBK
91 Day Tier 1 Bank (KES 5M) FDR	**5.50%**	Source: Dry Associates

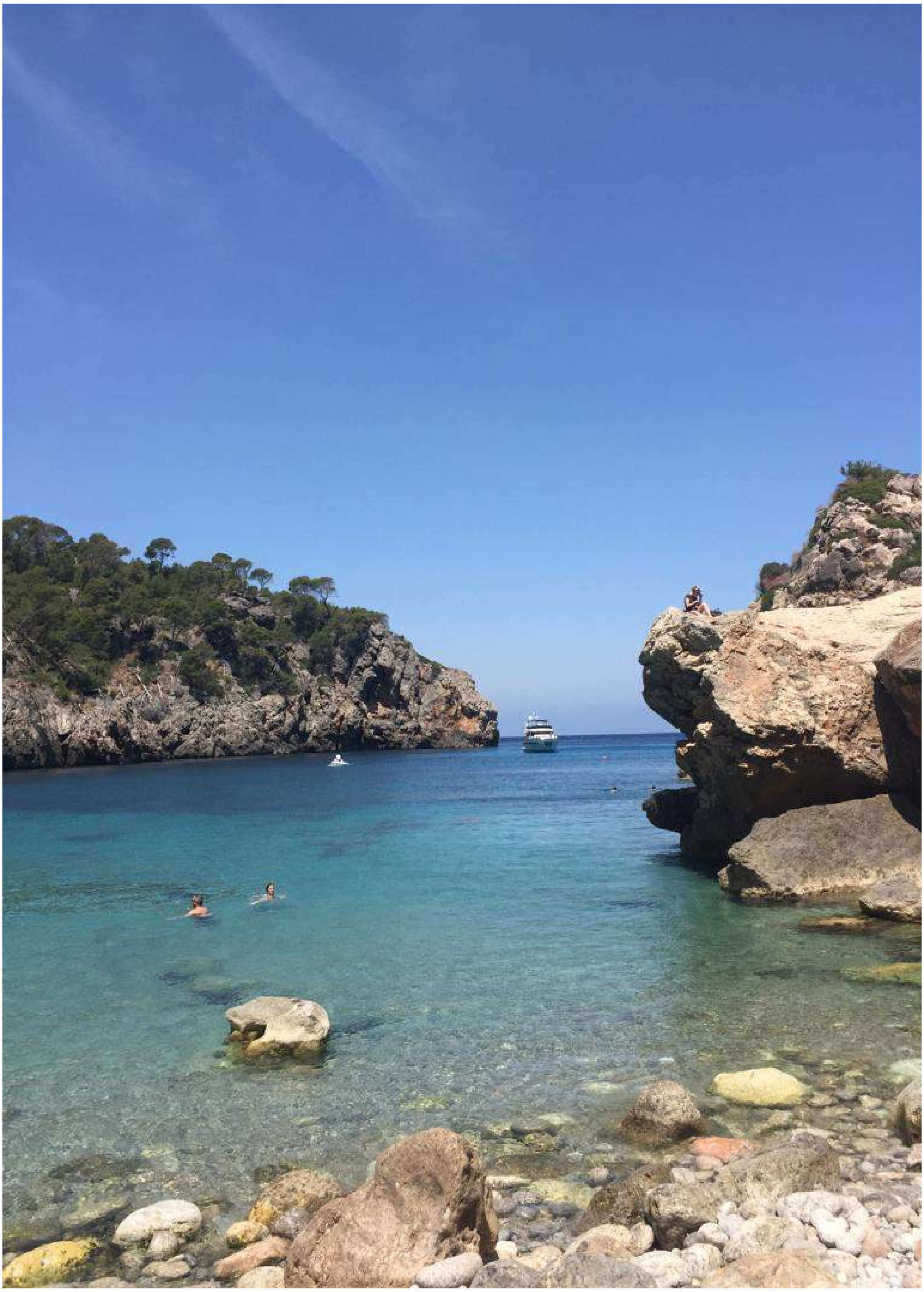
Kenyan Securities Market

The Nairobi Securities Exchange (NSE) has rebounded significantly since January 2019. There has been a marked increase in foreign flows into the market in the 2nd Quarter 2019. Nevertheless, if you look at the

10 year performance of the NSE (see below) it is underwhelming. Compare this 10 year graph of the NSE 20 Share Index to the 10 year graph of the New York Stock Exchange, Dow Jones Industrial Average (DJIA) and you can see where your money should have been. Another reason to be a global investor.

Yours sincerely,

Dry Associates Investment Bank



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The Finance Ministers Budget 2019 - Read more
here

Treasury Snubs KES 46bn in Closing Bond Offers - Read more
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