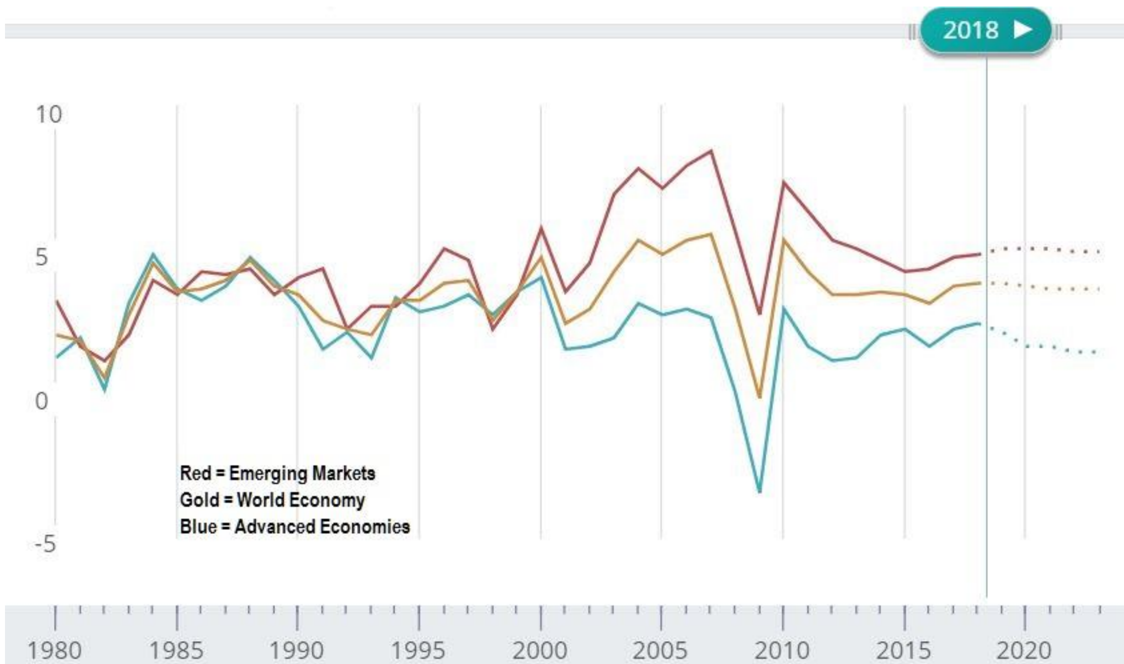
Dry Associates Investment Newsletter

May 2018

A view over "the Blue City" of Chefchaouen in the Rif Mountains, Morocco (Dec. 23, 2017) Courtesy: S. Dry

Dear Investor,

The good news is that the World Bank and the IMF are both projecting continued global economic expansion in 2018. Not just expansion, but broad based expansion across 120 of world's 195 countries per the chart below.



Source: www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

While it's obvious that we're not seeing the kind of global expansion we did going into 2007 – where emerging markets were growing at 7.8% at their peak - we are seeing growth ticking up since 2016.

More specifically, for 2018, the IMF estimates emerging markets will grow at 4.9% and advanced countries at 2.4%. In other words, emerging markets will grow at twice the rate of advanced economies.

<u>Where is Growth Coming From?</u>

Another perspective that we find useful are the historical returns on different asset classes within these markets. Here's a chart showing the returns by asset class over the past 10 years:

2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018*
US Treasuries 14.0%	MSCI EM 79.0%	Gold 29.2%	US Treasuries 9.8%	REITS 23.8%	S&P 500 32.4%	S&P 500 13.7%	S&P 500 1.4%	Global HY 14.8%	MSCI EM 37.8%	Commodities 22.7%
Gold 4.3%	Global HY 62.0%	MSCI EM 19.2%	Gold 8.9%	Global HY 19.3%	MSCI EAFE 23.3%	REITS 11.7%	US Treasuries 0.8%	S&P 500 12.0%	MSCI EAFE 25.9%	Gold 11.6%
Cash 2.1%	MSCI EAFE 32.5%	Commodities 16.8%	Global IG 4.5%	MSCI EM 18.6%	Global HY 8.0%	US Treasuries 6.0%	Cash 0.1%	Commodities 11.8%	S&P 500 22.0%	MSCI EM 6.5%
Global IG -8.3%	REITS 31.7%	REITS 15.9%	Global HY 2.6%	MSCI EAFE 17.9%	REITS 0.7%	Global IG 3.2%	MSCI EAFE -0.8%	MSCI EM 11.2%	Gold 12.9%	S&P 500 6.3%
Global HY -27.9%	S&P 500 26.5%	S&P 500 15.1%	S&P 500 2.1%	S&P 500 16.0%	Global IG 0.1%	Gold 0.1%	REITS -3.4%	Gold 8.6%	REITS 11.5%	MSCI EAFE 5.9%
Commodities -35.6%	Gold 25.0%	Global HY 13.9%	Cash 0.1%	Global IG 11.1%	Cash 0.1%	Cash 0.0%	Global IG -3.8%	Global IG 4.3%	Global HY 10.2%	Global HY 3.4%
S&P 500 -37.0%	Global IG 19.2%	MSCI EAFE 8.2%	REITS -9.4%	Gold 8.3%	MSCI EM -2.3%	Global HY -0.1%	Global HY -4.2%	REITS 1.3%	Global IG 9.3%	Cash 1.4%
MSCI EAFE -43.1%	Commodities 18.9%	Global IG 6.0%	MSCI EAFE -11.7%	US Treasuries 2.2%	US Treasuries -3.3%	MSCI EM -1.8%	Gold -10.4%	US Treasuries 1.1%	Commodities 7.6%	Global IG -2.0%
REITS -50.2%	Cash 0.2%	US Treasuries 5.9%	Commodities -13.3%	Cash 0.1%	Commodities -9.5%	MSCI EAFE -4.5%	MSCI EM -14.9%	MSCI EAFE 1.0%	US Treasuries 2.4%	US Treasuries -5.7%
MSCI EM -53.2%	US Treasuries -3.7%	Cash 0.1%	MSCI EM -18.2%	Commodities -1.1%	Gold -27.3%	Commodities -17.0%	Commodities -24.7%	Cash 0.3%	Cash 0.8%	REITS -14.6%

The growth in emerging markets is evidently being fueled by increased commodity prices represented by the 22.7% annualized increase for the first several months of 2018. This is followed by gold up 11.6%, the Morgan Stanley Capital Index of Emerging Markets up 6.5%, and the US Standard & Poor 500 Index up 6.3%.

Exposure to commodities can be captured through purchase of commodity ETFs (exchange traded funds). ETFs are open ended investment funds that are made up of various commodities. Shares in these investment funds trade on stock exchanges just like ordinary shares of a company. The most popular commodity ETFs are the iShare index which trades under the ticker symbol “GSC” and the Power Share index with the trading symbol “DBC”. Note, however, that both are heavily weighted toward oil. The easiest way to invest in gold, the second best performing asset class in 2018, is by purchasing the gold ETF with the ticker symbol “GLD”. All these ETFs can be purchased through Dry Associates’ Old Mutual International platform.

While our house view has emphasized investment in the US market over the past 5 years, the above chart indicates that “EM” or emerging markets are beginning to outperform the US markets (S&P 500). In fact, our Investment Committee is currently recommending several Franklin Templeton funds which offer exposure to select emerging markets as well as some US exposure.

The famous 11th century Chaouwara Tanneries, Fez medina, Morocco (Dec. 22, 2017) Courtesy: S. Dry

Emerging Market and US Exposure in Investment Portfolios

For example, the Investment Committee recommends the following 4 funds for investors prepared to take moderate risk. These tend to be balanced funds with equity and debt components. The Committee, of course, has other recommended funds for conservative investors such as pension funds as well as straight equity funds for aggressive investors.

Recommended for Moderate Risk (All in US Dollars)

Fund Name	Original Investment in US Dollars	12 Month Return in Percentage	5 Year Return in Percentage	5 Year Return in US Dollars
Franklin World Perspectives Fund	25,000	13.45%	48.55%	37,127
Franklin US Opportunities Fund	25,000	20.69%	83.06%	45,765
Templeton Global Equity Income	25,000	13.15%	33.35%	33,375
Templeton Global Balanced Fund	25,000	8.44%%	23.98%	30,995
Total Investment	100,000			147,272
Currency Gain over 5 Years				24,575
Total including Currency Gain				171,847

If you had invested $25,000 equally in each of the above funds 5 years ago, your $100,000 investment would have grown to $147,272 today. In addition, 5 years ago (in May 2013) the Kenya Shilling was KES 83.73/USD. So, the shilling depreciated KES 16.77/USD over the past 5 years. Multiplying KES 16.77 times the $147,272 and dividing by today's rate of KES 100.50/USD an investor would have earned another $24,575 for a total return of $171,847. Investors who do not take advantage of global opportunities available to them today are ignoring one of the best ways to accumulate wealth today.

Home Investing Bias

We've found that many Kenyan investors are reluctant to invest outside Kenya. The economic reasons for investing outside Kenya, however, are compelling. First of all, Kenya's economy and market capitalization (i.e. the value of all stocks listed on the NSE) is tiny. Kenya's GDP at $70 billion is less than 1/10 of 1% of the world's GDP at $75 trillion. Kenya's GDP was approximately the same as Procter & Gamble's sales last year. It was less than ¾ of the sales of Nestle chocolate company. Why would an investor limit their investing opportunities to so small a geographic area?

The reason of course is home bias. It's common everywhere. US investors are US-centric, UK investors UK-centric, Europeans EU-centric and Kenyan investors Kenya-centric. It is short sighted but the reasons are many. In Kenya, there is not a tradition of investing abroad. Other investors cite not being able to "see" or "touch" their investments –as you can with land. Also important is the fact that many off shore fund managers are not known to Kenyan investors and have not built trust with investors that is so important in investing. And to be fair, not all fund managers are created equal. At Dry Associates, we have had numerous off shore fund managers present their bona fides and many come up short. Some do not have a record of making money for their investors. Others charge ridiculous fees – entry fees, exit fees, buy-sell spreads or they require vesting and lock in periods and so on. These and other considerations give investors pause.

Franklin Templeton

However, having been in the investment industry for almost a quarter of a century in Kenya, Dry Associates has a great deal of experience in this area. Over the past 20 years, we have built a special relationship with Franklin Templeton Investments. During this time we have found them professional, experienced and good at making money over the long term.

Started in 1947, Franklin Templeton (FT) is currently one of the largest global asset management companies the world. It has offices in 35 countries and manages over $740 billion of client funds from 150 countries. Once an investor invests with Franklin Templeton, they have their own FT account which can be accessed in real time with a password. Dry Associates also includes an investor's FT investments in all monthly statements forwarded to our Private Wealth Clients.

The Rock of Gibraltar, looking towards Morocco (Dec. 27, 2017) Courtesy: S. Dry

Kenyan Economy

Kenya's economy grew at 4.9% in 2017 according to the Kenya National Bureau of Statistics. That is 11% less than the 5.5% growth in 2016. The agricultural sector was adversely affected by drought which is ironic in light of the torrential rains Kenya has received during March, April and May 2018. Most of the blame for the slower pace of economic activity in 2017, however, can be laid at the feet of politics and electioneering. The preoccupation with politics began with the annulled August 5th presidential elections, followed by the re-run on October 26th and the eventual inauguration on November 28th. Investors local and foreign put their plans on hold during 2017 which impacted construction, transport, retail, finance and many other sectors.

From an investment perspective, however, we also see continuing damage to the economy as a result of the Interest Rate Capping legislation enacted in September 2016. This piece of well intentioned but economically unsound legislation has killed off bank credit to the private sector. Instead of banks lending to the private sector, they have shifted lending to the government. Unable to price risk, banks cannot be blamed for avoiding risk that cannot be compensated by higher interest rates. Even within the financial sector, the *Business Daily* reports over 1,500 job losses in the banking sector over the past year or so. This legislation will continue to strangle growth until it is repealed or at least substantially revised.

As a result of this and other factors, projected GDP growth for 2018 varies widely from 4.5% to the government estimate of 6.2%. The rains are certainly back which is good for agriculture but we're approaching the half way mark of 2018 and the financial sector – the sector that fuels the private sector – remains depressed. We continue to believe that much of this can be traced directly interest rate capping. We will say it again, whenever there are price controls, there will be shortages whether it is sugar, houses or money. And then there is the ballooning public debt which is crowding out the private sector from what little credit there is available. In fact, the government Debt/GDP ratio now stands at 57% - up from 40% five years ago. The economy would be better off scrapping the interest capping Banking (Amendment) Act of 2016 and passing a Balanced Budget Amendment.

Kenya Fixed Income Market

The Kenya Shilling has appreciated against the US Dollar since January 2018. It is now trading at slightly over KES 100/= per dollar per the chart below. We attribute much of this to a less robust economy meaning less demand for dollars to pay for imports, high dollar remittances from overseas workers, and some funds inflow from tax amnesty repatriation.

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

Private Issue Corporate Bonds (5 year)	15%	Source: Dry Associates
Private Issue Medium Term Notes (2 years)	14%	Source: Dry Associates
Average Commercial Paper Rates	12.5%	Source: Dry Associates
365 Day Treasury Bills	11.145%	Source: CBK
182 Day Treasury Bills	10.269%	Source: CBK
Dry Associates Shilling Money Market Unit Trust	9.5%	Source: Dry Associates
Average Commercial Bank Deposit Rates	8.22%	Source: CBK
91 Day Treasury Bills	7.97%	Source: CBK

Chase Bank (Kenya) Limited

As has been announced publicly by the Central Bank of Kenya, SBM (State Bank of Mauritius) has agreed to purchase 75% of Chase Bank's assets and liabilities. The other 25% will remain with Chase Bank pending monetization of these assets. SBM will re-brand Chase Bank taking over its infrastructure and personnel. The plan is to transfer 75% of Chase depositors' funds to SBM which will place 33% of those transferred funds to a checking account which can be withdrawal immediately. Another 33% of the transferred funds will be placed into a savings account paying 6%. The final 33% tranche will be placed into 1, 2 and 3 year Fixed Deposit Receipts. The date that all this will happen is what remains unknown. We are advised SBM will make an announcement "soon". Sooner rather than later would suit everyone.

Kenyan Equities

The Nairobi Securities Exchange All Share Index as at May 10th 2018 was 178. The index is down 9% since its peak on April 5th but up 30% since May 10th 2017 per the following:

A recent article in the *Financial Standard* estimated that NSE listed companies' combined profit has fallen by a third over the past 5 years. Only Safaricom and most of the 11 listed bank stocks managed to maintain profits. That highlights what we've been noticing. From working with a number of companies ourselves - listed and non-listed – it is evident that many are facing profitability constraints. Twelve of the 62 listed companies issued profit warnings in 2017 (indicating annual profits would be 25% less from the prior year). One new obstacle we are hearing from the business community is how to deal with disruptive government directives from banning plastic bags to forced cargo transport on the Standard Gauge Railroad to minimum wage increases. All well intentioned but apparently lacking consensus.

Nevertheless, the bigger picture is encouraging. Whether GDP growth in 2018 comes is 5% or 6% - that is still an enviable growth rate. While Kenyan companies work through some of these problems, we continue to encourage accumulation of established, deep pocketed companies like Safaricom, Kenya Commercial Bank, Equity Bank and Cooperative Bank.

A horse drawn cart winding through an orange lined street, Cordoba, Spain (Dec. 30, 2017) Courtesy: S. Dry

Cyber currencies

A final word on cyber and crypto currencies. To our clients who are even considering: No! No! No! These so called currencies have no place in your portfolio. They have no intrinsic value and there is no way of assessing value. A currency must be backed by something of value – whether a country's national product or a scare commodity like gold or silver. These "currencies" are mined out of the ether by computer techies. Block chain technology and cloud ledger computing, a by-product of this creative technology, will of course have value going forward, but as a medium of exchange, a store of wealth, we're not buying and neither should you.

Sincerely,

Dry Associates

16th May 2018

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