Dry Associates Investment Newsletter

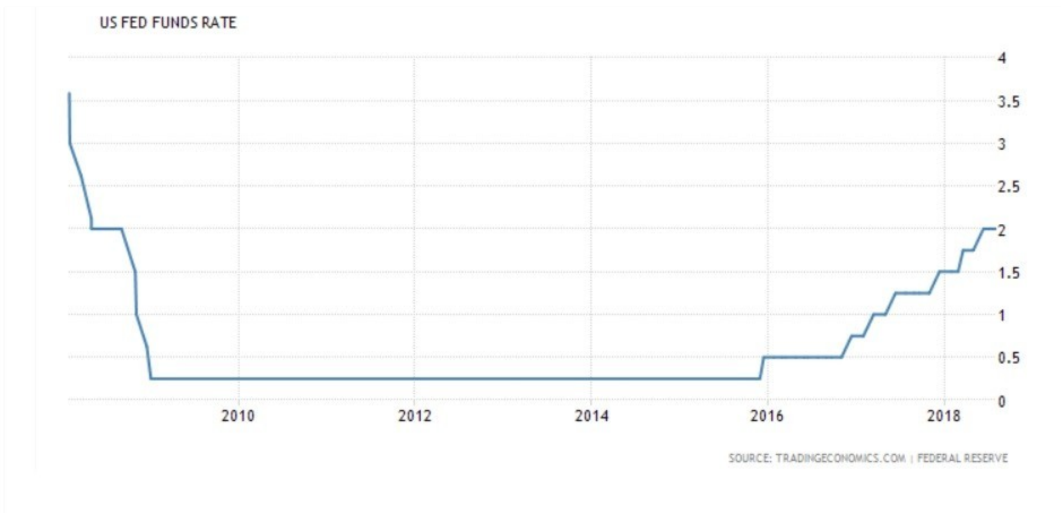
September 2018

"The Rock" Restaurant , Pingwe, Zanzibar (Sept. 2018) - Courtesy: S. Dry

Global Growth Continues

The global economy continues to expand. The World Bank estimates that the global economy will expand by 3.1% in 2018 – the same as 2017 – but decelerate slightly to 2.9% by 2020. This slight fall off in growth is expected as "accommodative" monetary policies (that is, low interest rates) in developed economies begin to rise.

The US is out front in terms of raising interest rates. The US Federal Reserve has hiked the Fed Funds rate – the rate at which banks lend to each other in the US – from 0.25% to 2% over the past two years per the chart below.



Historically, this key rate has been much higher in the US but the Fed has learned many lessons over the years and is expected to target a 2 – 5% range which means credit in the US is not too expensive while keeping unemployment and inflation in check.

Strengthening Dollar

The rise in the Fed Funds rate has the effect of strengthening the dollar vis-à-vis other currencies. A stronger dollar is not good for many emerging markets. A strong dollar depresses demand for commodities since commodities are typically priced in dollars. In addition, emerging markets with dollar denominated debt must pay more in local currency to service and pay back this dollar debt.

This strengthening of the dollar has a disrupting effect on emerging market economies in general. And in particular, we've seen a few countries like Argentina and Turkey seriously go off the rails with Turkey's lira dropping 40% against the dollar and Argentina's peso dropping more than 50%.

And then you've got Brazil and South Africa. Brazil's real has dropped 25% against the US dollar in the last 6 months. Closer to home, South Africa's rand has fallen 12% and India's rupee is down by 10% over the same 6 months. So, not to put too fine a point on it, the dollar's continuing strength is having repercussions.

Other Global Factors

A fuller discussion on the global economy would have to include the possible effects of trade disputes between the US and China and other countries, but in our estimation, these will be worked out – probably to the benefit of the US economy. The US has already negotiated a trade deal with the EU. In addition, the US has negotiated a revised North American Free Trade Agreement (NAFTA) with Mexico. We suspect a similar deal with be forthcoming with Canada. The NAFTA trade agreement represented over one trillion dollars in trade between the US, Mexico and Canada last year.

African penguins on Boulder's Beach, Simon's Town, South Africa (March 2018) - Courtesy: S. Dry

Where to Invest?

So, as investors "Where should you invest?" The US market is doing well – up 44% since November 2016. But this bull market is in its 10th year which makes it the third longest bull market in US history. If it continues for another year, it will be the longest in US history. That does give us pause.

The reason it gives us pause is that everything is cyclical. As billionaire investor Howard Marks recently said in an interview quoting Mark Twain, "History doesn't repeat itself, but it does rhyme." We understand that "there are no rules of physics at work here" to quote Marks again, but the bull market will end. We just don't know when or particularly why.

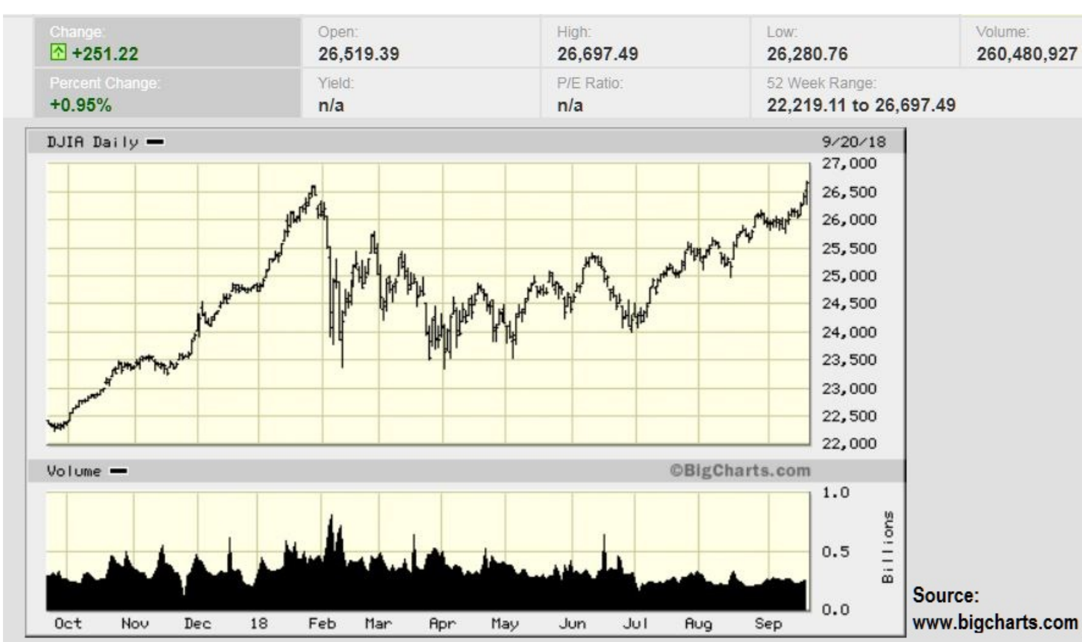
"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." - Sir John Templeton

But common sense also tells us that as the market rises, euphoria sets in. This is when investors lose a sense of value. Paying the right price for something is the essence of good investing.

We know that valuations are historically high on the New York Stock Exchange and Nasdaq - where most technology stocks trade. On 14 September 2018, all the stocks in the Dow Jones Industrial Average had an average Price Earnings Ratio (P/E Ratio) of 24.63 - meaning shares were trading at almost 25 times last year's earnings. The Nasdaq 100 had a higher P/E ratio of 26 times on the same day.

On the other hand, the P/E Ratio for the iShares Emerging Markets ETF (that is, the popular Emerging Market Exchange Traded Fund with ticker symbol EEM) is only 12.9 times. This is half the valuation of US stocks.

The Dow Jones Industrial Average (Oct 2016 to Sep 2018)



So, while we think the US market is strong - unemployment at a 50 year low, wages up 3% year on year, GDP growing at 3%, corporate profits up - our thinking is that the market will and should continue its bull run - for now. But things will change. The mid-term elections in the US on 6th November 2018, for example, could place the current Administration on a back foot taking the emphasis off the economy. There could be any number of unfortunate things that could upset the apple cart.

So as a wise investor, we need to be a little contrarian and never lose sight of value. It makes sense to us to begin to get some exposure to emerging markets now because their valuations (that is, P/E ratios) are relatively lower. In other words, while maintaining exposure to the US market, we ought to be taking a little off the table and start building some positions in emerging market stocks and funds.

Suggested Offshore Portfolio

In the offshore space, we've worked with Franklin Templeton (FT) Investments for almost 20 years and we've found them to be highly reputable and offering a wide range of investments in emerging and developed countries. In Africa, they offer some 90 funds which are mirror images of the same funds offered in the US. For background, the following are the best performing FT funds over the past 1 and 5 years:

Best Performing Franklin Templeton Funds as at 31st August 2018

Annual Performance (Aug. 2017 – Aug. 2018)	Percentage Growth	5 Year Performance (Aug. 2013 – Aug. 2018)	Percentage Growth
Franklin Technology Fund	29.56%	Franklin Technology Fund	153.16%
Franklin U.S. Opportunities Fund	24.47%	Franklin India Fund	117.21%
Franklin Natural Resources Fund	15.33%	Franklin U.S. Opportunities Fund	92.60%
Franklin Select U.S. Equity Fund	14.80%	Templeton Thailand Fund	75.55%
Templeton Thailand Fund	14.06%	Franklin Biotechnology Discovery Fund	68.63%
Franklin Global Convertible Securities Fund	13.38%	Templeton Asian Smaller Companies Fund	57.54%
Franklin Japan Fund	10.03%	Franklin Select U.S. Equity Fund	52.43%
Franklin MENA Fund	8.69%	Templeton Emerging Markets Smaller Companies Fund	51.27%
Franklin World Perspectives Fund	8.47%	Franklin World Perspectives Fund	44.19%
Templeton Global Smaller Companies Fund	8.07%	Franklin Global Listed Infrastructure Fund	42.19%

But remember, today's leaders probably will not be tomorrow's. Yes, we currently recommend continuing exposure to US equities such as the US Opportunities Fund and the Franklin Technology Fund. After all, what America continues to do well is come up with disruptive technologies that brought us the likes of Facebook, Uber, Airbnb. And evolving technologies such as blockchain and artificial intelligence will continue to spin off new and profitable companies.

But there are also other companies in emerging markets that are doing very well – companies like India's Infosys, Brazil's Telefonica or China's Asia Info Linkage. Exposure to these companies is available at lower valuations. So, in addition to the US focused funds, a well structured portfolio would also include some exposure to funds like the Franklin World Perspectives Fund and the Franklin Global Convertible Securities Fund.

Suggested Onshore Portfolio

Creating private wealth portfolios is what our Private Wealth Department does at Dry

Associates. Every portfolio is different, however, as each portfolio should reflect one's risk appetite, age, financial goals, current cash needs, and so on. These portfolios almost always include an onshore component denominated in local currency for two reasons: 1) Because Kenya shilling fixed income securities offer much higher interest returns that similar instruments denominated in US dollars, Sterling or Euros and 2) To pay local expenses.

There are a wide range of fixed income securities on offer in Kenya such as Treasury Bills and Bonds, Bank Fixed Deposit Receipts, Commercial Paper and Corporate Bonds. Each security carries its own risk.

But there is only one investment that combines all these high yielding securities into a single investment and that is the money market unit trust. In addition, these different securities can only be bought up to certain maximum limits as stipulated by the Capital Markets Authority. For example, with the exception of government securities and bank products, securities not traded on a stock exchange cannot make up more than 25% of a money market unit trust.

<u>Kenya Shilling Money Market Fund</u>

There are many unit trusts offered by many fine companies in Kenya. Dry Associates offers one such Money Market Unit Trust. All investments in this unit trust must mature within 18 months so there is no long term paper in the portfolio. The yield changes slightly every day, but as at 19 September, for example, it was paying 9.58%. But importantly, this unit trust like others offers the following very real benefits for an investor:

1. <u>Safety</u> through diversification (e.g. our fund is invested in 22 different holdings)
2. Liquidity - funds can be withdrawn within 3 days
3. Tax Advantages – interest accumulates tax free while in fund (like pension funds)
4. Compounding Interest – 12 interest compounding periods a year(unlike T-bills and Bank Fixed Deposits)
5. Higher interest rates than most public fixed income options
6. Transparency in reporting – all interest rates published daily NET of fees
7. No cost to buy in or exit
8. No minimum hold period

So, these are reasons that unit trusts are becoming popular with investors. Now one caveat - the Kenya Shilling has historically depreciated against the dollar over time. As such, most of our portfolios are split between the US dollar and the Kenya Shilling. The split will depend on the individual but generally, we've found that a 50/50 split – dollars and shillings - is about as sensible as you can get.

A dung beetle, Baringo (June 2018) - Courtesy: S. Dry

Kenyan Economy

The World Bank predicts the Kenyan economy will expand by 5.6% in fiscal 2018 up from 4.9% in 2017. We're not so sure. What is evident to us is that significant sectors of the economy are not doing well - manufacturing, construction, real estate, transportation to name a few – not to mention the average Kenyan consumer.

From where we sit, there are two very troubling trends, namely, lack of credit to the private sector and a ballooning national debt.

The lack of credit, we believe, can be laid directly at the feet of the interest rate capping legislation which came into effect on 14 September 2016. Parliament in its wisdom decided to cap all commercial bank lending to the private sector at an administratively determined Central Bank Rate plus 4% which translates to 13% today. Even a cursory knowledge of economics confirms that whenever a government body sets a price on anything, whether it is a commodity like money or a service like medical care, there will be shortages. That is what has happened here. Credit to the private sector has dried up. The reason is that since banks cannot price risk into their lending decisions, they've decided not to take risk. Banks with funds are simply passing these funds to the government collecting the difference between what they pay on deposits and what they earn on government T-bills and bonds. The government has effectively "crowded out" the private sector. And credit to the private sector is like oxygen to the brain. Without it, the goose that lays the golden egg will stop laying. Already the banking industry is being decimated. Deposits are flowing from small banks to bigger Tier 1 banks as all banks are paying relatively the same deposit rates. It's a move to safety as depositors at smaller banks no longer can count on higher deposit rates like they used to get before the rate capping. The big banks will get bigger and the small banks will go out of business or be forced to merge.

The other worrying trend is the explosion in public debt. Kenyan national debt now exceeds Kenya Shillings Five Trillion or approximately 60% of GDP. Last February, Moody's credit rating agency downgraded Kenyan sovereign debt from B1 to B2. Moody's defines a "B" rating as "speculative and subject to high credit risk." In addition, on 15 September 2018, the IMF withdrew its US$ 100 Billion Back Up Facility which could have been used to support the shilling if needed. Because the GOK has not kept debt in check and not kept its promise to abolish the interest rate cap, among other things, the IMF has withdrawn its facility.

So these are worrying developments that need to be fixed. Rate caps need to be abolished and the government needs to stop borrowing and spending money it doesn't have. It the absence of this, a depreciated currency and higher taxes are the logical outcomes.

<u>Kenyan Stock Market</u>

Stock markets are typically forward looking anticipating what the economy will be doing 3 – 6 months hence. If that's the case, the NSE is not showing a lot of confidence in the future as this one year chart of the NSE All Share Index shows:

The red line is the 50-day moving average. Chartists will tell you that when a market index (or stock price for that matter) falls below the 50-day moving average, an investor should be out of the market (or stock). Buy signals come when the index (or stock price) pierces upward through the average. As this graph shows, the All Share index has recently fallen significantly below the moving average.

To some extent, we believe this recent fall off reflects investors selling bank shares after Parliament decided not to abolish interest rate capping. It also reflects foreign investors selling off NSE counters in reaction and anticipation to a strengthening dollar. After all, if the shilling weakens against the dollar, even an up market could result in losses when translated to dollars.

On the other hand, there is value in the NSE. The average Price/Earnings ratio for a NSE stock (excluding companies in the red) is less than 20 times. Twenty three of the 60 stocks trading on the NSE have a P/E ratio less than 10 times. So for long term investors, a buy and hold strategy will reward over time.

Dry Associates now an Investment Bank

We're pleased to announce that Dry Associates is now licensed by the Capital Markets Authority as an Investment Bank as opposed to our former status as Fund Manager. Be assured we'll be doing everything we've been doing for the last 24 years, only more.

Sincerely,

Dry Associates
20 September 2018

Rothschild Giraffes on "Giraffe Island", Lake Baringo (June 2018) - Courtesy: S. Dry

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