DRY ASSOCIATES
INVESTMENT BANK

Investment Newsletter November 2023

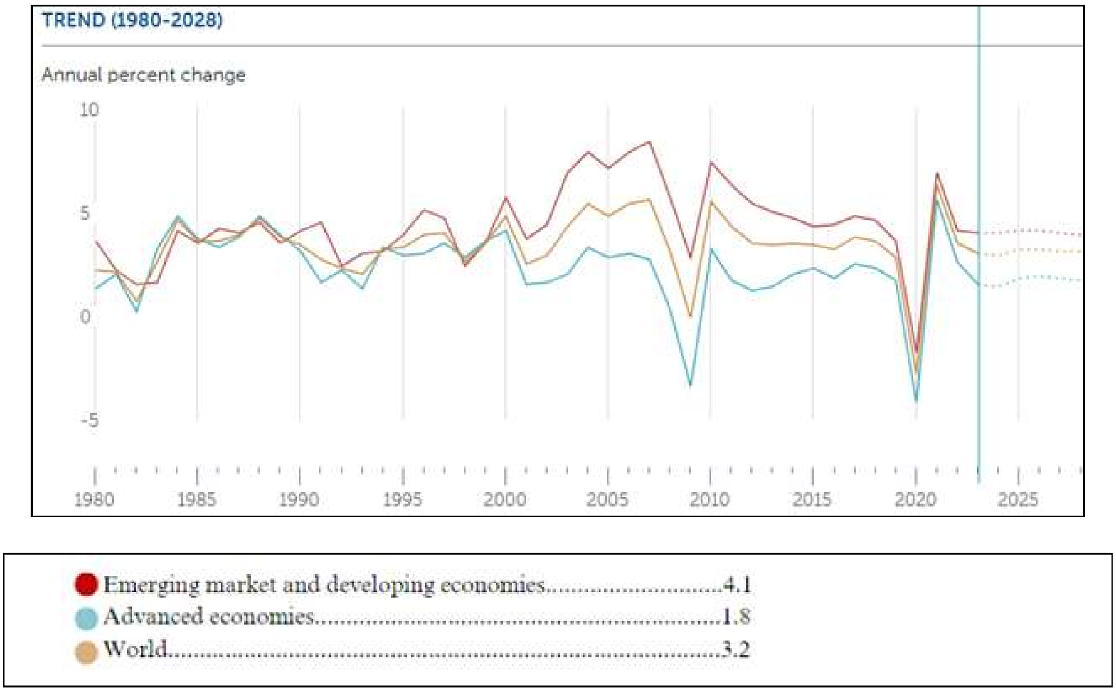
Photo Courtesy: Dry Associates Marketing Department

Table of Contents

Dear Investor,

Global Outlook

The graph below shows the International Monetary Fund's (IMF) forecast for global economic growth through 2028. The Great Recession of 2009 and Covid in 2020 are the big dips. While the global economy rebounded strongly in 2022 after the pandemic, excessive spending by governments, particularly the US government, led to runaway inflation. Too much money chasing too few goods and services. To contain inflation, the US Federal Reserve raised interest rates from zero to 5.5% today. This led to an increase in the value of the dollar putting downward pressure on other currencies. The Kenya shilling's fall from grace is evidence of that.



The good news is that the hike in US interest rates is over – or almost over – and economies around the world can begin to adjust to the new "new" normal. We do not expect US interest rates to come down soon – perhaps not for another year. And if that is so, these flat projections through 2026 make sense. Nevertheless, savvy investors will recognize trends and with help from their financial planners, will be able to build winning investment portfolios.

One investment theme that is not evident from these latest global projections is that equity markets outside the US have contracted. This contraction was largely a result of weakening local currencies vis-à-vis the US dollar. This resulted in a so-called "flight to safety" by investors into the US dollar combined with higher yields on offer by US debt securities. Many non-US markets now offer investors an opportunity to acquire stocks at historically low valuations. The average Price/Earnings ratio of the Nairobi Securities Exchange, for example, is 7.6 (excluding companies with negative earnings and one outlier), while the P/E ratio of stocks traded on the New York Stock Exchange is 28.

[A P/E ratio, of course, is the number of times last year's after-tax profit per share of a company can be divided into its current price per share. Amazon has a P/E ratio of 72 and is trading at $138.60 per share. This means it earned $1.93 per share last year (dividing one by the other). In other words, the current price of $138.60 represents 72 years of last year's after-tax profit. Coca-Cola's P/E is 22. Safaricom's is 7.81. It is all about investors current expectation of a company's future profitability.]

US Market Outlook

Another investment theme that is not apparent from the above chart is that technology continues to be a driving force in raising valuations (P/E ratios) of equities - particularly US equities. The US has historically been a leader in technological innovation. The increased capabilities of Artificial Intelligence will probably be as important a driver of new technology as the microchip was in the 1980's. For an insightful and entertaining view of human existence altered by AI, read Isaac Asimov's "*Naked Sun*". Elon Musk refers to Asimov often in his ruminations on AI.

The technology heavy NASDAQ

Technology funds have significantly outperformed other sectors of the market, whether investing in the New York Stock Exchange traded stock QQQ (a stock that includes the 100 largest stocks on the tech heavy US stock exchange NASDAQ) or Franklin Templeton's Technology Fund (a fund that largely mirrors these same tech stocks). According to Portfolioslab.com, QQQ has a 38.70% return year-todate while the broader Standard & Poor 500 index has a 14.93% return over the same period.

Furthermore, over the past 10 years, QQQ has an annualized return of 17.11% versus 11.48% for the S&P 500. While the continuing tech revolution is a driving force, the broader US market has been impacted by the Fed's interest rate hikes. Interest rates affect the performance of commercial banks and these banks have been the albatross around the neck of the broader market. A gentle rise in interest rates tends to work in a banks favor as higher interest rates mean banks charge more on overdrafts and loans meaning higher profits. However, when interest rates rise as rapidly and high as they have, the bond holdings of these banks, which represent their capital, must be marked-to-market.

For non-accountants, bonds held by financial institutions must be classified as "available for sale" or "held to maturity". Available for sale means bonds must be marked-to-market meaning bond holdings must be repriced continuously to their current fair value. As interest rates go up, bond prices go down. Banks, of course, can classify their bond holdings as "held to maturity" meaning they cannot be sold but are to be held to maturity. As interest rates have risen, the aggregate value of the banks' holdings in bonds has declined, reducing the value of their capital.

The problem commercial banks have is that they must always have liquidity to pay out unexpected withdrawals. So more than half of US banks' bond holdings are classified as available for sale and must constantly be repriced lower as interest rates rise. In addition, the market for these bonds dries up as other banks have their own liquidity concerns. When these banks report their earnings, the loss on these bonds must be reported. Depositors see this and sometimes panic and withdraw their funds. This is what happened to Silicon Valley Bank when it reported a $1.8 billion loss on its bond holdings. Two days after that collapse there was a run on Signature Bank in New York and it collapsed as the 3rd largest banking failure in US history.

This scenario of bank failures, largely as a result of fast rising interest rates, has a long history in the US and other countries. Since May 2023 when these two collapses happened, this fear has spread to other commercial banks and even investment banks with a commercial banking arm. This fear of losing one's money continues to grip bank depositors even though US bank accounts are insured up to $250K by the Federal Deposit Insurance Corporation. This, to a large extent, explains why US banks like Bank of America have low P/E ratios. Bank of America's P/E ratio is 8.

"There will always be bull markets followed by bear markets followed by bull markets."

Sir John Templeton

Franklin Templeton (FT)

We continue to work with FT as we have over the past 30 years to deliver consistent exposure to investment opportunities – both debt and equity - around the world. While the performance of these funds will vary from year to year, our investment recommendations generally replace equity funds with debt funds as clients get older. That said, some equity exposure in investment portfolios is always useful if only to deal with inflation. The performance (after fund fees) of some of the more popular FT funds over the past several years is shown below:

Fund Name	Sept. '22 – Sept. '23	Sept. '21 – Sept. '22	Sept. '20 – Sept. '21
European Small-Mid Cap	39.70%	(35.30%)	36.91%
Franklin Technology Fund	28.48%	(40.25%)	33.57%
US Opportunities Fund	20.46%	(34.91%)	24.49%
Franklin India Fund	17.26%	(13.88%)	56.32%
Franklin High Yield Fund	5.55%	10.32%	(14.19%)

Source: www.franklintempletonme.com (latest available figures)

Increased Compliance Reporting

Just a housekeeping note on collective investment schemes like FT and financial institutions like ourselves. We are all under growing pressure from regulators worldwide to provide additional "Know Your Client" (KYC) and "Anti-Money Laundering" data. We know it can be burdensome in dealing with this increased compliance some of which may seem unnecessary. We apologize for the inconvenience but if you bear with us, we will do our best to assist in every way we can. In the end, this additional information is directed at making the world a safer place.

When will the Kenya Shilling stabilize?

The short answer is no one knows. What we do know is that one major cause of the shilling's devaluation is the US dollar's appreciation. But that begs the question, why has the shilling fallen so far so fast? Why, for example, has Uganda's shilling depreciated 0.24% against the dollar over the past 4 years versus Kenya's 50.81% depreciation?

The answer to that is that Kenya has been spending recklessly for years. It is irresponsible to continually spend funds that are not in the public purse. We all realize that Kenya is a poor country in terms of per capita income and has many unmet needs. But continuously borrowing to spend has consequences and we are all paying the price in a debased currency, imported inflation and higher taxes.

Not only has the shilling depreciated 50% since February 2020 when the shilling was 100 to the dollar, but the World Bank says Kenya is in "debt distress". We do not think Kenya will default on the $2 billion Eurobond repayment due in June 2024. The government has announced it will pay off $300M of the bond early in December 2023. Kenya is also in talks with the World Bank and IMF about debt relief and Kenyan foreign exchange reserves are currently US Dollars 7.51 billion. But profligate "overspending" debases any currency.

So, when will the shilling stabilize … perhaps not until we are past the June Eurobond payout, or when the trade balance squeezes off expensive imports, or when the government adopts a pro-business agenda. Where will the shillings stabilize? 170? 180? No one knows but it should not have happened. This devaluation has eviscerated billions of dollars of hard-earned wealth across the private and public sectors. Any company what had borrowed foreign exchange to operate in Kenya, has had to absorb large foreign exchange losses over the past three years as it basically "marks to market" this forex exposure. A good place to begin to restore the shilling's value would be to move towards a balanced budget. It would focus the government on spending money wisely and restore the value of the shilling … eventually.

Mogo Auto Floating Rate Note launch at Dry Associates Headquarters on 16th Nov. 2023

<u>Building a Strong Financial Foundation for Corporations</u>

Investment banks typically have what is called a buy side and a sell side. The sell side issues securities for its corporate clients and the buy side purchases financial securities for investment by private and institutional investors. There must be what is sometimes called a “Chinese Wall” between the two sides so as not to raise any conflicts of interest. That is the case in this investment bank.

On the sell side we are trying to help corporations build a strong and secure financial foundation. Historically in Kenya, commercial banks have provided the capital for corporations. Commercial banks, however, by their nature are short-term oriented. Investment banks on the other hand can issue long-term debt instruments on behalf of their corporate clients’. There is a natural progression that forward looking corporations adopt to achieve financial security. They begin with bank debt and possibly short-term commercial paper (CP). However, after several years of issuing CP, these corporations have built up a nursery of investors. If the CP has consistently paid interest payments to investors, these same investors are usually willing to buy longer dated debt instruments, that is, bonds. Some corporations are now taking this sensible path to financial stability.

The other sensible thing that corporations are starting to do in Kenya is not permitting commercial banks to place a floating charge on all the assets of a corporation when taking out an overdraft or loan. Instead, forward looking corporations only permit commercial banks to place a charge on assets sufficient to provide collateral for the amount being lent. In other words, it makes no sense for a company to allow a bank to place a floating charge on assets of KES 5 billion for an overdraft of KES 500 million. By leaving other assets free of a floating charge, a corporation can allow those assets to be used as collateral for long term debt, that is, bonds. Needless to say, longer term debt and a diverse creditor base allows Kenyan companies to focus on achieving strategic goals rather than short term financial constraints.

So, we are working with corporations that put aside assets that provide collateral to back up corporate bonds. Some of these assets can be easily registered on the Movables Registry in Kenya. Implementing these sensible ways of securing short- and long-term lending will go a long way to expanding and securing the financial infrastructure of corporate Kenya. It also promotes capital formation which every country needs to finance long term success.

Kenyan Debt Securities and Yields

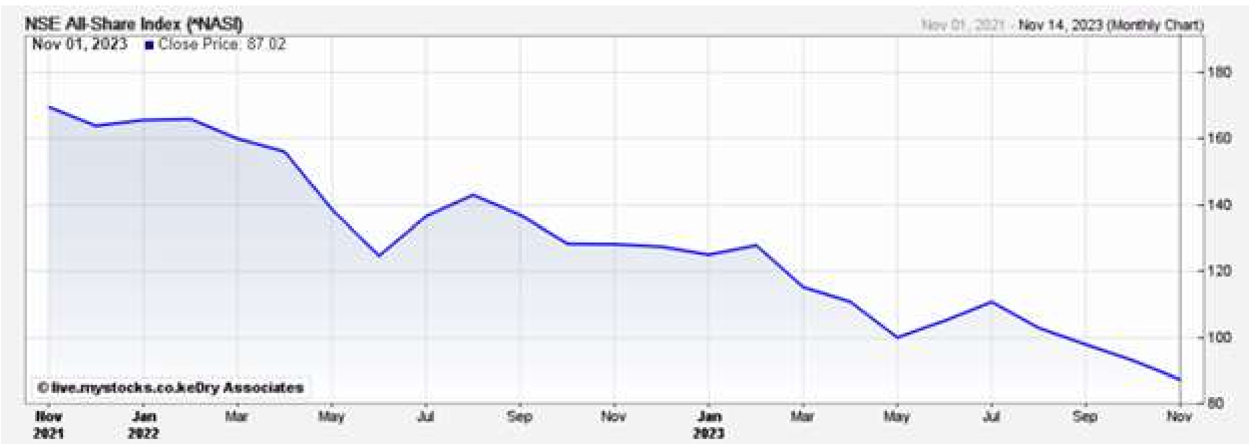
The following are yields available on Kenyan fixed income securities today:

Issue	Interest Rate
Commercial Paper (KES) 3 years (floating rate)	18.41%
GOK Infrastructure Bond (KES) 6.5 year (tax free)	***18.10%***
Commercial Paper (KES) 12 months	17.00%
GOK Treasury Bill (KES) 12 months	***15.62%***
Dry Associates Money Market Fund (KES)	11.64%
Commercial Paper (USD) 24 months	11.50%
Commercial Paper (USD) 12 months	10.00%
12-Month Inflation – Oct 2023	***6.92%***
Dry Associates Money Market Fund (USD)	5.31%

Source: Dry Associates and Central Bank of Kenya

Nairobi Securities Exchange

The NSE continues to underperform as the two year NSE All-Share Index below illustrates. However, these counters offer very low valuations relative to their developed country stock exchanges. Some long-term investors are beginning to “dollar-cost-average” at these levels. This means building positions in certain securities by investing the same Kenya Shilling amount monthly over the next 12 – 18 months. Some of the securities recommended in our ***Weekly Report*** are Safaricom (P/E 7.81), Standard Chartered (P/E 4.85) and Carbacid (P/E 5.38).



New Corporate Debt Issues

Dry Associates Investment Bank has acted as Arranger and Placement Agent of the following recent Kenya Shilling and US Dollar fixed income issuances:

Burn Manufacturing first came to market late June 2023. This BBB+ rated company raised US Dollars 5 million through a secured one and two-year note programme. In October 2023, Burn increased the capital raise to US Dollars 10 million in two-year notes to facilitate its expansion across Africa. This US-based company manufactures cookstoves with advanced technologies like improved insulation and combustion resulting in fuel savings and reduced emissions. Due to its contribution to positively impacting climate change, the bond has officially been certified **Green**. It is Dry Associates' first green bond.

Mogo Auto, one of Kenya's largest lenders in the vehicle (car and motorcycle) sector, originally came to market in August 2022 with a KES 1 billion issue. In January 2023, this secured note programme was increased to KES 2 billion. On November 16, 2023, Mogo officially launches at Dry Associates Headquarters a longer term 3-year KES 2 billion programme which will also permit the conversion of short-term notes into longer term notes. This innovative programme carries a floating rate interest coupon tied to the 6-month Kenya Treasury bill. Mogo Auto is a subsidiary of the Eleving Group operating in 12 countries on 3 continents. The programme is collateralized, carries a home office guarantee and is credit rated A- by Global Credit Ratings Co.

Watu Credit (Kenya) is a first mover in the 2 and 3-wheel boda boda financing sector and now mobile phone financing. We arranged and placed a Kenya Shilling KES 1 billion secured programme for Watu Credit (Kenya) in 2021. It was increased to KES 2 billion in 2022 and fully subscribed. In October 2023, the programme was increased to KES 2.5 billion. In June 2023, Watu (Uganda) came to market with a US Dollar 5 million short term programme which has also been well received.

RA International is a leading provider of construction, facilities management and supply chain services in remote areas working mainly with aid agencies and western governments. In 2020, RA International raised $15 million in a 2.5 year note programme. In December 2023, RA International is refinancing the $15 million. The programme also includes a $5 million Green Shoe option meaning RA International can take up an additional $5 million. The notes will have a January 2027 maturity. The terms and conditions of this AA+ rated company are being finalized.

Season's Greetings

As we approach the New Year, please plan on meeting with your Dry Associates CISI (Chartered Institute for Securities and Investment) certified Investment Executive to discuss your investment portfolio. These reviews are helpful in ensuring that your portfolio reflects your risk profile and financial goals and is positioned to maintain and grow your net worth in 2024.

Also, please note that our offices will be closed from December 16, 2023 to January 3, 2024. If we do not get a chance to see you in person before then, we wish each of our valued clients Happy Holidays and a Prosperous 2024.

Sincerely,

Dry Associates Investment Bank

"***We Know … Investment Matters!***"

November 20, 2023

Dry Associates Investment Bank offers a wide range of products and services:

Private Wealth Management | Unit Trusts | Commercial Paper | Investment Advisory Services | Pension Fund Management | Offshore Funds | Consulting | Corporate Finance | Treasury Management | Portfolio Management

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