A Vote for Recovery

Recovery was mapped out by a pick-up in economic growth, having averaged 6.9% for the first three quarters of 2021. Despite the prevailing uncertainties occasioned by the vicious cycle of new variants and waves of infection, we expect an increase in economic activity. Global supply chain bottlenecks, rising oil prices and elevated inflation are expected to negatively affect the local economy and will likely be a pain point for some sectors. However, we do not expect any new restrictive measures to be introduced providing relief for sectors such as transport and storage, education and accommodation and food services.

- **Economic Rebound:** GDP growth figures for the period of 3Q21 expanded by 9.9% compared to a 2.1% contraction in 3Q20. The recovery was mainly driven by rebounds across various sectors of the economy following the negative effects of the pandemic in corresponding quarters in 2020. The Agricultural sector contracted, for a third consecutive quarter, by 1.8% compared to a 4.2% growth in 3Q20, mainly attributable to unfavorable weather conditions experienced in the country for the better part of the year.

- **Inflationary Pressure:** In 2021, inflation remained relatively stable with a gradual rise between 2Q and 3Q to a high of 6.91% in September. The rise in inflation, during the year, was mainly driven by higher food prices and fuel prices.

- **Accommodative monetary policy:** During the year, the MPC met six times and elected to maintain the Central Bank Rate (CBR) at 7.0% while the cash reserve ratio was increased by 100bps to 5.25%. We expect the CBK to maintain an accommodative monetary policy stance, at least for the first half of 2022.

- **Fiscal risks:** The National Treasury proposed a KES 3.03 trillion budget for FY2021/22 with revenue anticipated to come in at KES 2.04 trillion and a fiscal deficit of KES 0.93 trillion. The government's revenue collections for most parts of 2021 has been above target. However, in order to plug the increasing budget deficits, the government has been forced to increase its borrowing resulting in an increase in total debt that currently stands at KES 7.99 trillion. The sustainability of this debt remains a concern as the government breaches a number of debt sustainability indicators.

- **Equity market:** In 2022, company earnings are expected to increase as economic conditions improve. This coupled with a historical trend of a positive performance during election years. We expect an increased interest in the Banking stocks more so in 2Q following the resumption of dividend payments.

19th January, 2022

Sovereign Credit Rating:

Moody's: B2 (negative)

Fitch: B+ (negative)

S&P: B+ (negative)

GDP Growth (3Q21): 9.9%

Dec Inflation: 5.73%

Interbank rate (18th Jan 2021:

3.84%

C.B.R: 7.00%

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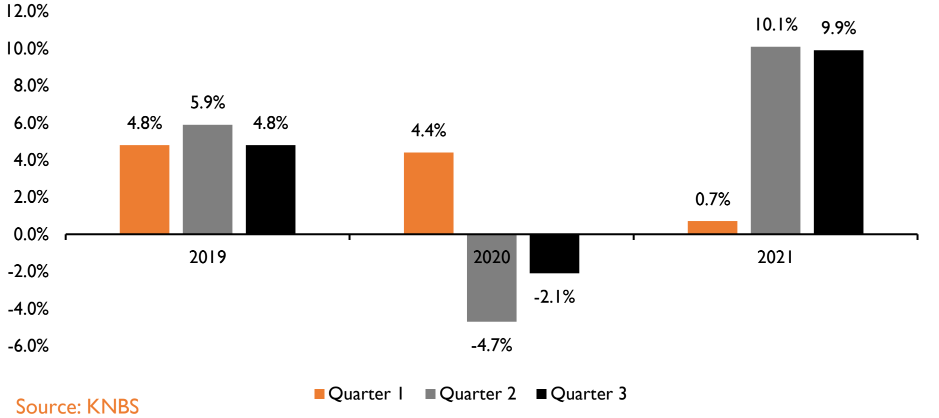
Economic Performance

- **Increased economic activity:** In 2021, economic activity increased as the government relaxed COVID-19 restrictions. A slow 0.7% growth in 1Q21 was supplemented by higher 10.1% growth in 2Q and a 9.9% growth in 3Q. The recovery was mainly driven by rebounds across various sectors of the economy that were mostly affected by the pandemic in corresponding quarters in 2020. The Agricultural sector contracted in the first three quarters of the year, mainly due to unfavorable weather conditions experienced in the country for the better part of the year.

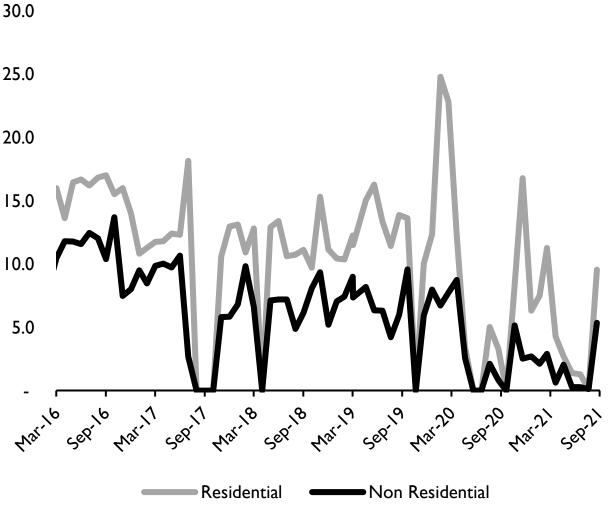
Graph 1: GDP Growth



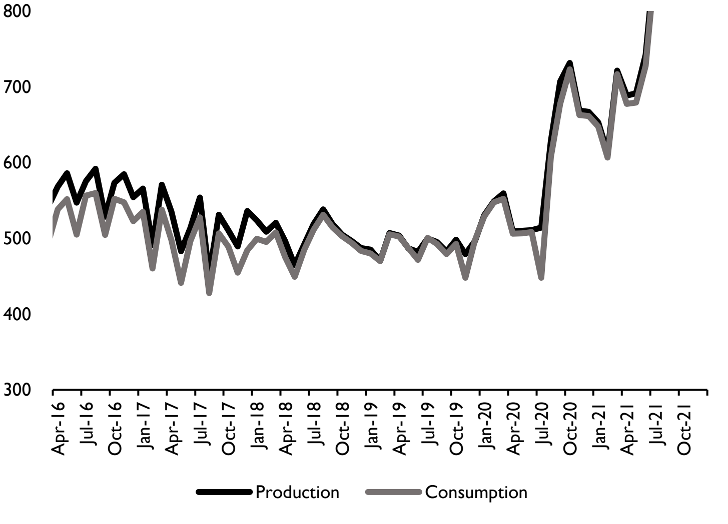
Source: KNBS

- **Improved growth across the year:** Economic activity, as measured by the Stanbic Purchasing managers Index (PMI), recorded an averaged growth of 50.56 compared to an average of 48.00 in 2020. PMI closed the year at 53.7 a marginal increase from the previous month and the 53.2 recorded at the start of the year. The emergence of the Omicron variant and a spike in the number of daily recorded cases in 4Q21 has seen fears of another round of lockdown restrictions resurfacing. Increased vaccination, to around 10Mn dosses, has brought renewed hope of a speedy recovery. However, the heated political climate preceding the 2022 polls will likely dampen economic growth.

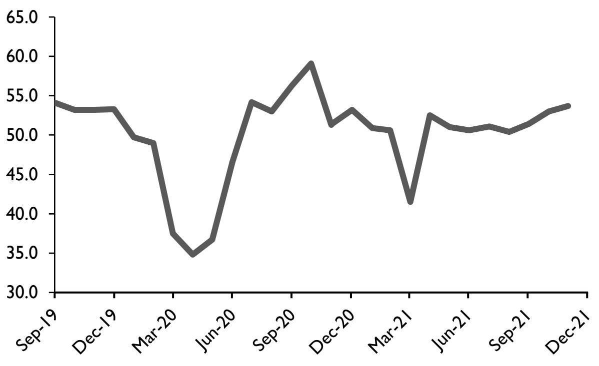
Graph 2: Value of Buildings Approved



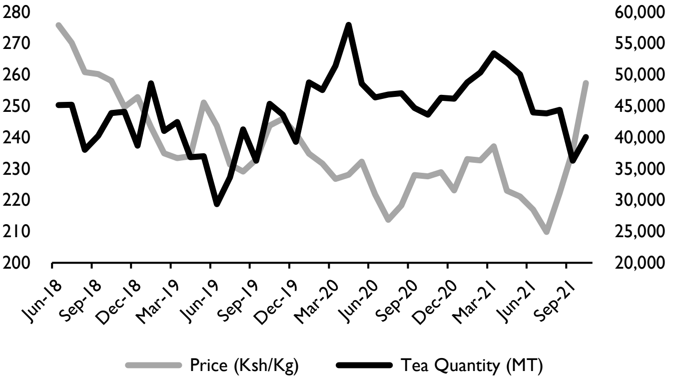
Graph 3: Cement Consumption



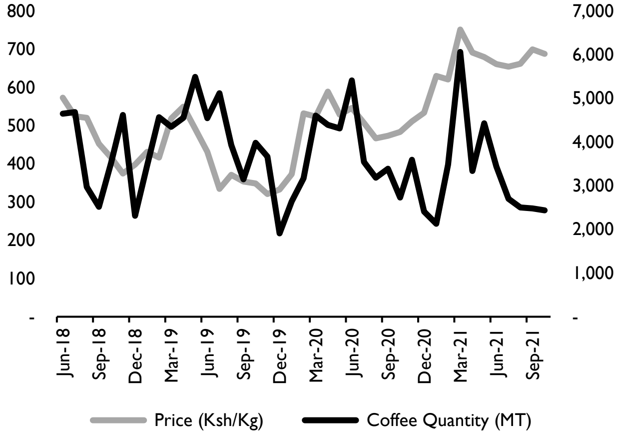
Graph 4: Stanbic PMI



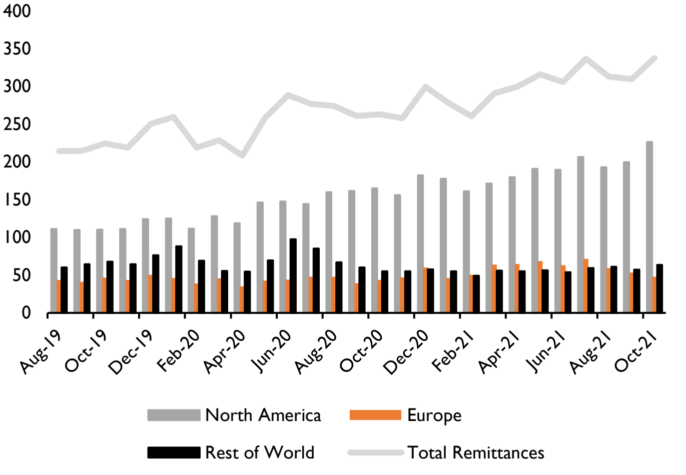
Graph 5: Tea



Graph 6: Coffee



Graph 7: Diaspora Remittance

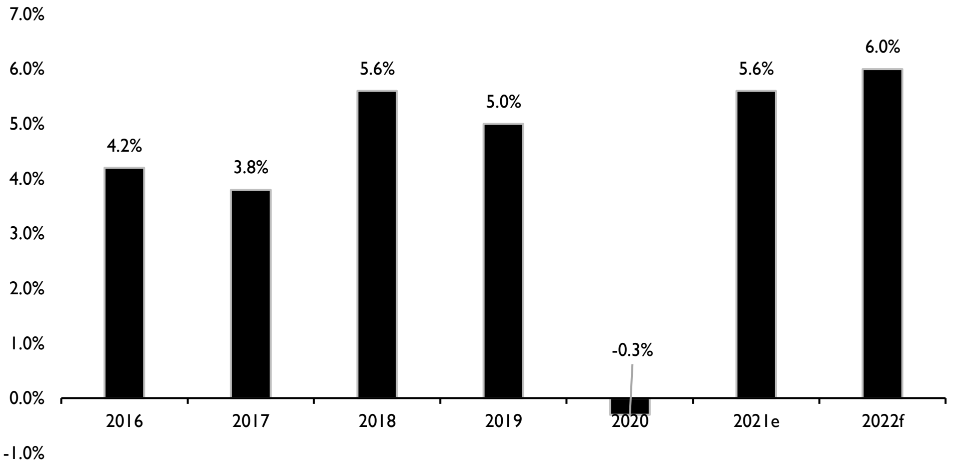


Source: KNBS, CBK, AIB-AXYS Research

- **Faster Economic growth in 2H21-** Economic activity is expected to have picked up in 2H21 as more sectors of the economy reopened and vaccination rates increased. Sectors such as Transport, Manufacturing, Wholesale and Retail, Construction, and Real Estate are expected to have recorded an increase in activity. The IMF has projected a 5.6% GDP growth in 2021, with the National Treasury being more ambitious at 6.1%. We, however, remain concerned about the elevated inflation rate on the back of high food and fuel prices. Given that growth averaged 6.9% in the first three quarters of the year, we expect the overall 2021 GDP growth to range between 6.5% -7.0%.

We expect a better GDP growth in 2022 but?.....

Graph 8: GDP Growth forecasted



Source: KNBS, IMF, AIB-AXYS Research

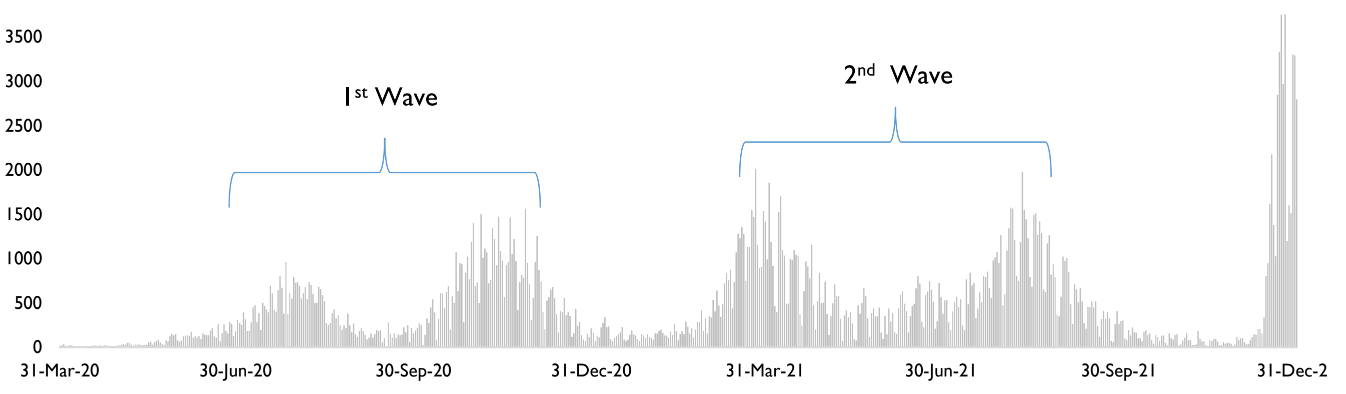
We foresee the following factors dampening economic growth in 2022:

- **Political Risks:** Attention has shifted to the August 2022 general elections. Some investors may adopt a wait and see attitude as they monitor the political developments. We believe that there is minimal risk of major pre/post-election violence.

- **Reduced Agricultural production:** Food supply is likely to remain muted due to the unfavourable weather conditions experienced during the short rain season. With agriculture being the largest contributor to the economy as well as Kenya's dependence on rain fed agriculture, we expect the sector to record a reduction in activity.

- **Pandemic related risks:** The discovery of the Delta and Omicron variants in 2021 increase the possibility of more strenuous variants in 2022. With the low vaccination rates, we expect enforcement of additional vaccine mandates and government restrictions on unvaccinated to have a negative effect on economic growth.

Graph 9: Daily Confirmed COVID cases

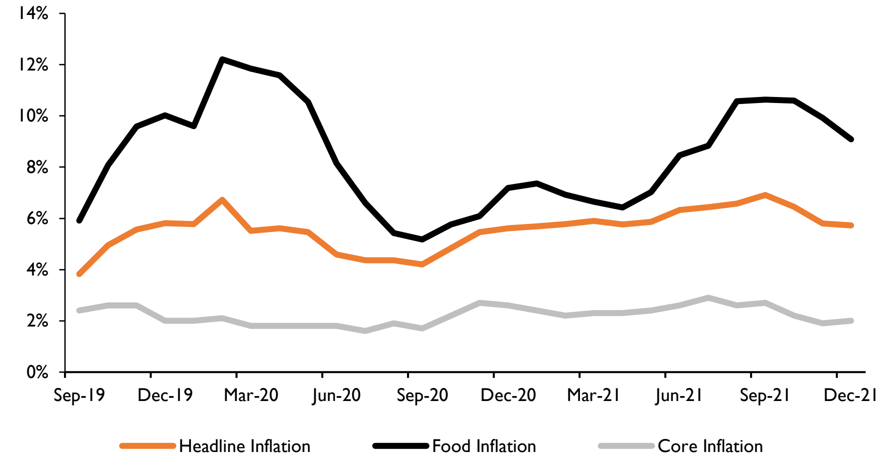


Source: MOH Kenya

Inflation

- **Elevated inflationary pressure -** In 2021, inflation remained relatively stable with a gradual rise between 2Q and 3Q to a high of 6.91% in September. The rise in inflation, during the year, was mainly driven by higher food and fuel prices. Meanwhile, core inflation declined to 2.0% from 2.4% as consumer demand decreased.

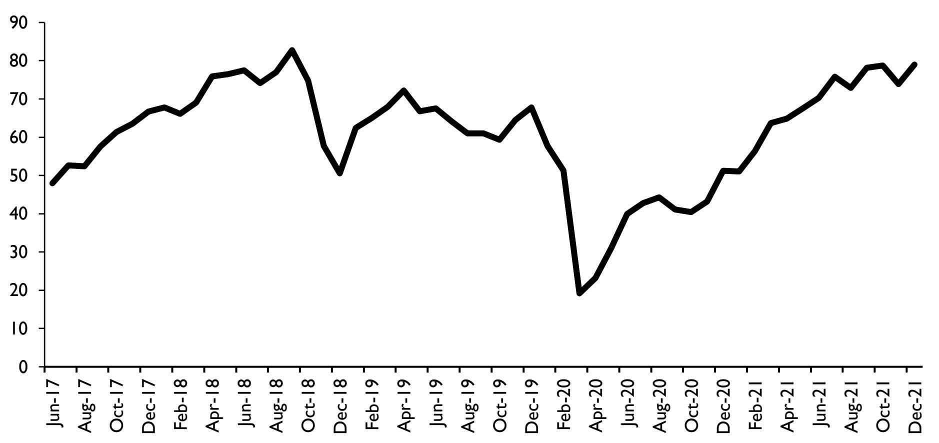
Graph 10: Inflation



Source: KNBS, AIB-AXYS Research

- **Inflation and crude oil prices to remain elevated:** In 2022, headline inflation is likely to edge higher driven by an uptick in local food prices, increased global commodity prices, and the depreciation of the Kenyan shilling. Meanwhile, core inflation is likely to register a marginal increase but remain below 3.0%. Discovery of a new variant has led to introduction of lockdowns and restrictions in some parts of the world which might reduce oil demand. However, a rise in global growth may increase demand for oil causing supply pressures on the fuel prices. Earlier in November, OPEC+ agreed to maintain a gradual 400,000 bpd increase on a monthly basis with other major economies expected to release their strategic reserves to drive down oil prices. We expect the prices to remain elevated during the first half of 2022 with a likelihood of a gradual drop later in the year driven by shifts in demand cycles.

Graph 11: Brent Crude Prices (USD)

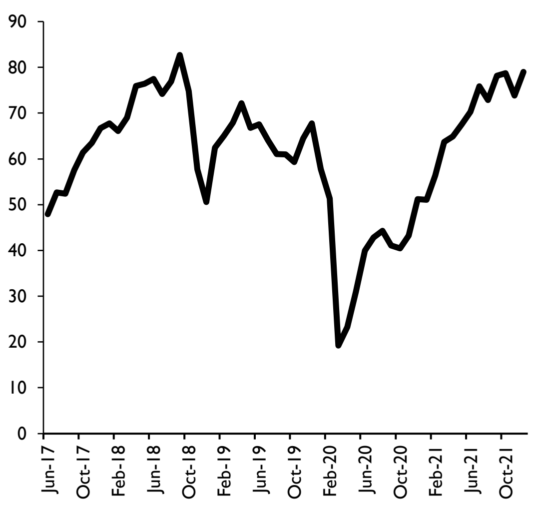


Source: Opec

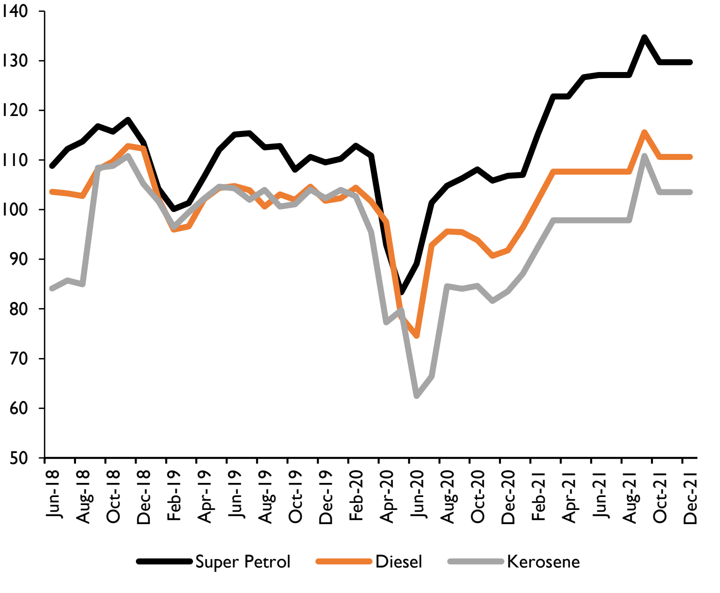
- **Local pump prices continue to rise -** During the year, local pump prices increased in line with the rise in global crude oil prices as petrol, diesel and kerosene increased by KES 22.90, 18.78 and 19.98 per liter, respectively. The prices of petrol, diesel and kerosene touched a historical high of KES 134.72, 115.60 and 110.82 per liter, respectively in September. Public out cry, led the Energy & Petroleum Regulatory Authority (EPRA) to reinstate the government subsidy which led to a decrease in its October pump price review.

We believe that the subsidy, which was re-introduced in October, offers a short-term reprieve to consumers. A reduction in taxes would be a more lasting solution, as the government has been gradually increasing taxes and levies on local pump prices which have become a larger portion of the cost of petrol. However, given the government's desire to increase tax revenue, the government is unlikely to choose this option thus we could soon see an increase in local pump prices.

Graph 12: Brent Crude Prices (USD)



Graph 13: Local Pump Prices



Source: EPRA

- **Prices to continue rising in 2022:** We expect a further uptick in headline inflation in 2022 mainly driven by a rise in food prices on the back of unfavourable weather conditions, the continued rise in global oil prices and imported inflation due to a relatively weaker shilling. Meanwhile, core inflation is likely to remain muted.

Currency Performance

- **Shilling on a loosing streak against the USD:** In 2021, the shilling lost ground against the dollar depreciating by 3.51% y/y to close at 114.14 from 109.22 recorded at the beginning of 2021. The depreciation against the greenback is mainly attributed to the increased dollar demand from oil marketers as global oil prices increased while inflows from perennial dollar earning sectors such as agriculture and tourism remain low.

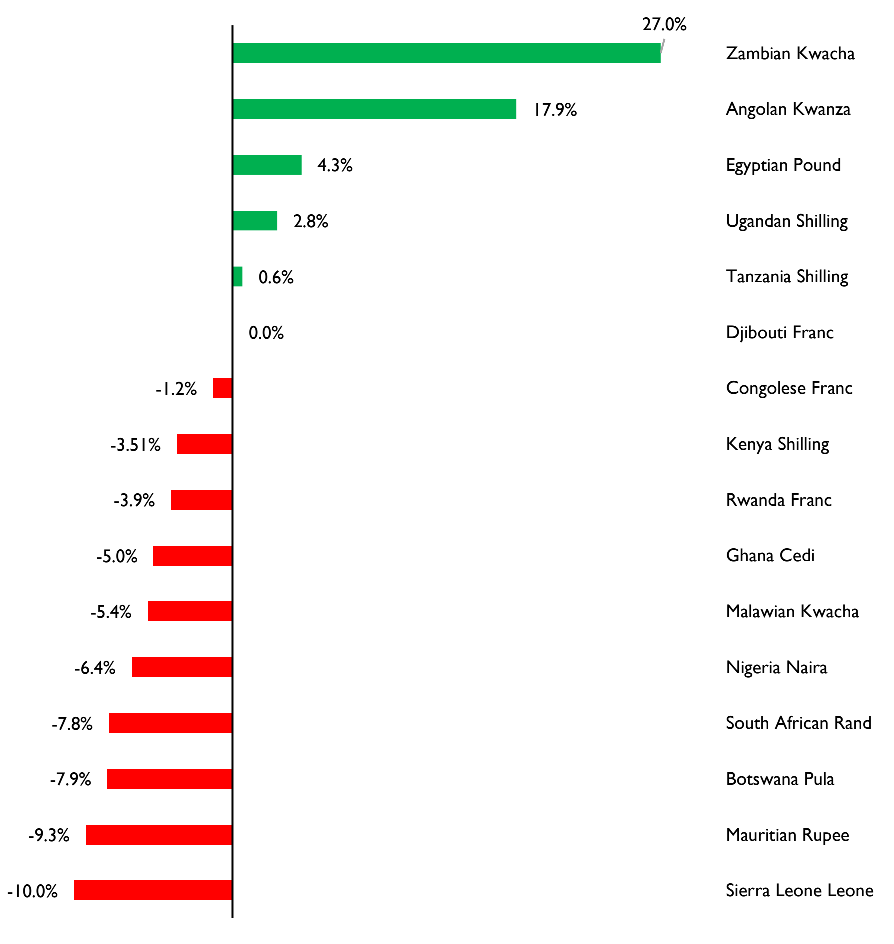
Table 1: KES Performance

	USD/KES	EUR/KES	GBP/KES	JPY /KES	YUAN/KES	RAND/KES	KES/UGX	KES/TZS
1Q21	-0.27%	3.83%	-1.55%	6.76%	0.38%	2.04%	0.26%	-0.31%
2Q21	1.54%	0.29%	0.99%	1.81%	-0.04%	-2.66%	-1.51%	1.54%
3Q21	-2.39%	-0.61%	-0.29%	-1.71%	-2.41%	2.52%	-2.93%	-2.76%
4Q21	-2.35%	0.79%	-1.58%	0.86%	-3.74%	3.01%	-2.15%	-2.56%
2021	-3.51%	4.32%	-2.43%	7.75%	-5.74%	4.89%	-1.25%	1.23%

Source: CBK, AIB-AXYS Africa

We expect the local currency to continue to depreciate against major currencies, as dollar inflows are likely to remain relatively low. Additionally, the gaining of the dollar against other currencies will also likely lead to further losses.

Graph 14: Currency Performance against the USD



Source: Bloomberg

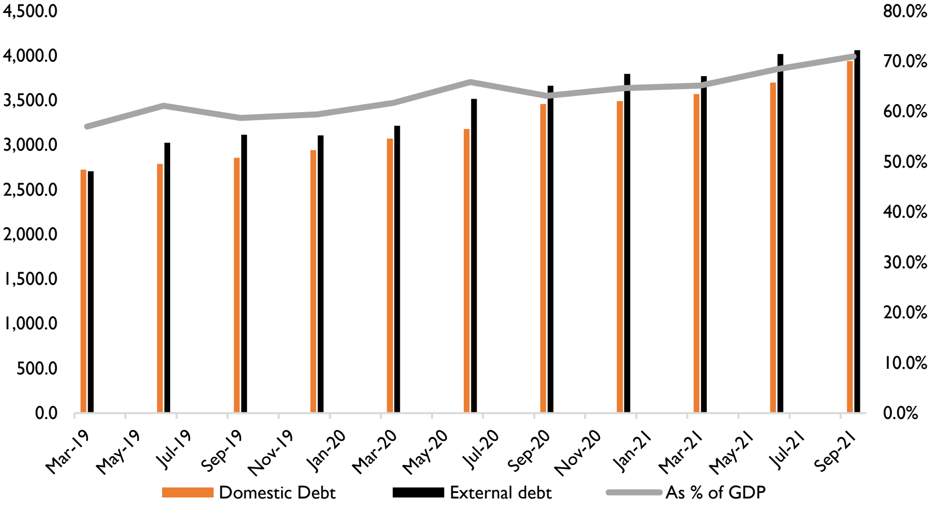
Fiscal Policy

- **Revenue collection above target -** In Q1 of FY2021/22, government collected revenues of KES 506.30Bn ($ 4.58Bn) which was KES 25.99 Bn($ 0.23Bn) below the target of KES 480.13 Bn($ 4.34Bn). The year-on-year growth rate of the collections were higher than those of a similar period in 2020. This may be attributed to improved business conditions, removal of COVID-19 relief measures and enhanced compliance measures domestically. The largest individual category growth was recorded in Pay as You Earn (PAYE) which grew by 47.70% y/y signifying increased employment and reversal of salary cuts previously imposed after the pandemic. Revenue as a percentage of GDP rose 72bps to 4.10% compared to the previous fiscal year. We expect revenue collection to continue above target mainly due to continued economic recovery and KRA's sustained efforts in tax mobilization.

- **Expenditure remains within target:** In the quarter ending September 2021, total expenditure came in at KES 631.66 Bn ($ 5.72Bn), which was 76.58% of the prorated expenditure estimates of KES 665.78 Bn ($ 6.03Bn). Furthermore, net disbursements to recurrent expenditures were at 86.31% of the prorated estimates having disbursed KES 444.6 Bn ($ 4.02Bn). However, we noted with concern the minimal disbursement to development expenditure which came in at KES 116.95 Bn ($ 1.06 Bn), being 50.53% of the prorated estimates of KES 124.67 Bn ($ 1.13 Bn). Under absorption of expenditure was partly contributed to a lower development spending. As the jubilee government rushes to complete on key legacy projects, we expect a pick up in development spending at least until the close of the current fiscal year.

- **Increasing Debt position:** The sustainability of Kenya's debt remains a key concern as sovereign debt levels increase. The continued depreciation of the shilling makes debt servicing even more expensive as 50.8% of the total debt is foreign denominated. The latest figures from the National Treasury indicate that in September, the country's total public debt stood at KES 7.99 trillion ($ 72.30Bn) which is 68.40% of GDP and a 15.21% increase in the corresponding period in 2020. Domestic debt was at KES 3.93 trillion ($33.77 Bn), while the external debt stood at KES 4.06 trillion ($ 36.73 Bn).

Graph 15: Debt-to-GDP

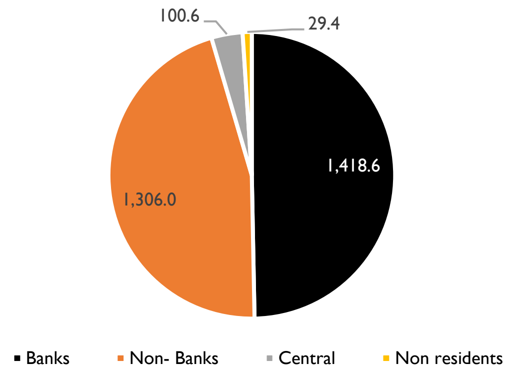


Source: National Treasury, AIB-AXYS Africa Analyst Estimates

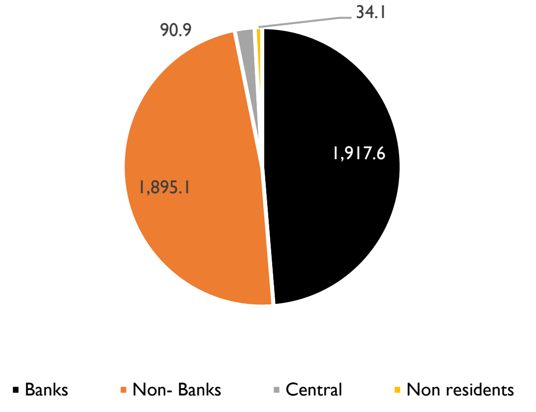
Public Debt Evolution

- **Bank lending drives domestic debt –** In the year to September 2021, government domestic debt grew 13.90% to KES 3,937.8Bn. Meanwhile treasury bonds, which account for the highest form of domestic debt, increased by 22.72% to KES 2,155.60Bn, over a similar period. Majority of the domestic debt 48.70% is held by commercial banks which was 6.06% y/y growth indicating continued private sector crowding out as banks prefer the safer government lending. Non banking institutions, mainly pension funds and insurance companies, account for KES 1,895.11Bn with central bank and foreign investors holding the rest. Compared to September 2019 the total domestic debt has grown increasing the risk of negatively impacting private sector credit growth as banks are the major lenders.

Graph 16: Domestic debt Composition 2019



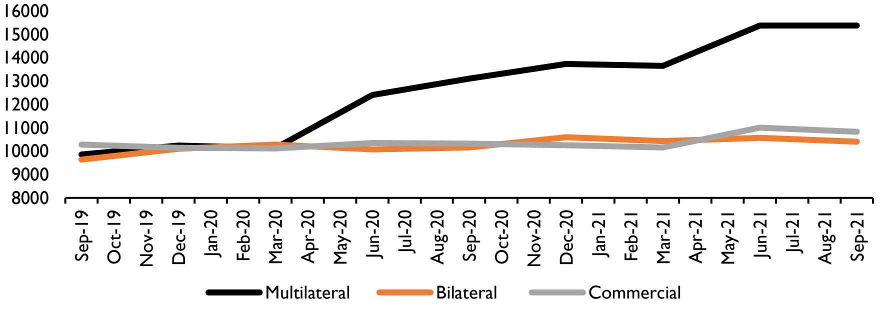
Graph 17: Domestic debt Composition 2021



Source: National Treasury, AIB-AXYS Africa Analyst Estimates

- **Multilateral borrowing dominating external debt:** Measured in dollar terms, as at the end of September, 2021 external public debt increased by 8.79% to $ 36,733.1Mn from $ 33,765.8Mn. The growth was expected due to further disbursement by IMF and the World Bank, during the year, as well as the depreciation of the Kenyan shilling. Multilateral debt has been driving the growth accounting for 41.87% of total external debt which is 8.96% points higher than two years prior. In the quarter to September, external debt servicing totaled to KES 77.3Bn with 61.06% being principal payments. We noted the burden commercial loans have on debt servicing given that it accounted for 42.40% of payments while contributing a lower 29.48% of the total external debt.

Graph 18: External Debt Evolution



Source: National Treasury, AIB-AXYS Africa Analyst Estimates

- **Debt outlook 2022:** The sustainability of Kenya's debt remains a key concern as sovereign debt levels increase. The continued depreciation of the shilling makes debt servicing even more expensive as more than 50.0% of the total debt is foreign denominated.

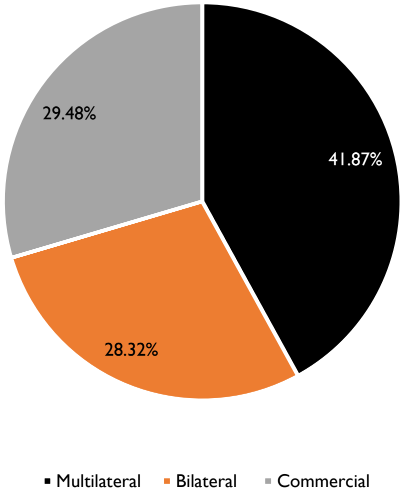
IMF Influence

The IMF recently asked Kenya to include debt guarantees in the calculation of total public debt. As at the end of September 2021, the total amount of government guaranteed debt was KES 157.7 billion. This is likely to result in an increase in the country's reported debt levels.

Overtime, increased borrowing has raised questions over the sustainability of debt. A number of factors that should be considered when looking at sustainability of Kenya's debt are:

- ✓ **Debt to GDP ratio:** As shown in graph, the country's debt to GDP ratio has been increasing at a rapid rate and now above the IMF recommended rate of 50.0%. We expect that the ratio will surpass the 70.0% mark in 2022.
- ✓ **Debt servicing:** Continued currency depreciation and additional debt have contributed to high debt service costs which in turn is emerging as a threat to fiscal sustainability. Debt service to revenue can be used as an indicator of government's ability to repay its debt. Since 2013, government's debt has remained above the threshold of 30%.
- ✓ **Currency composition of the debt:** Kenya faces a fiscal risk in the event of a depreciation of the shilling as 50.8% of debt is held in foreign currencies. The Kenya's shilling's depreciation against other currencies is likely to increase the debt servicing costs.

Graph 19: External Debt Composition



Source: National Treasury

More Funding from IMF and World Bank: As a debt sustainability measure the government has switched away from expensive commercial loans to more bilateral and multilateral borrowing. We therefore expect that the government's key sources of financing to come from development financing corporations such as the World Bank and the IMF.

Multilateral borrowing likely to result in the following:

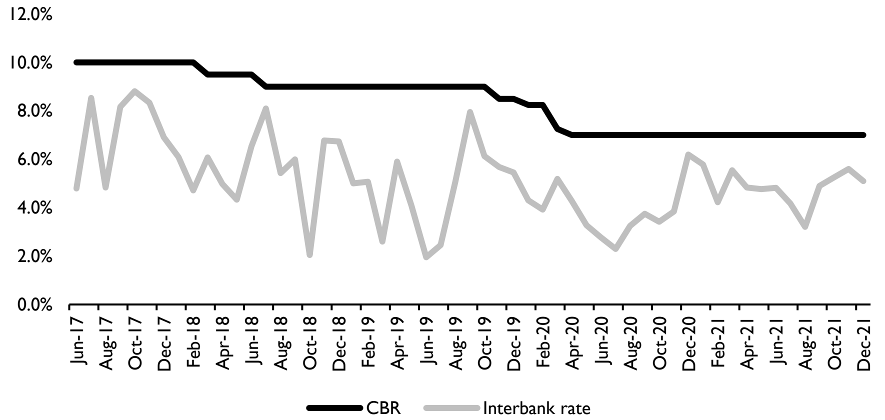
- ✓ **Lower interest payment:** These loans are concessional and tend to attract relatively lower interest rates over a longer period of time.

- ✓ **Focus on reducing the budget deficit:** The multilateral lending tends to come with conditions for the government to reduce the deficit by increasing revenue through an increase in taxes.

Monetary Policy

- **Accommodative policy continues:** During the year, the CBK monetary policy committee met six times and, in all instances, maintained the Central Bank Rate (CBR) at 7.0%. The cash reserve ratio was increased by 100bps to 5.25%. The CBK also introduced three new surveys; the Hotels, the Flower farms and the CEOs' surveys, to monitor economic growth and partly check the effects of the pandemic on various sectors.

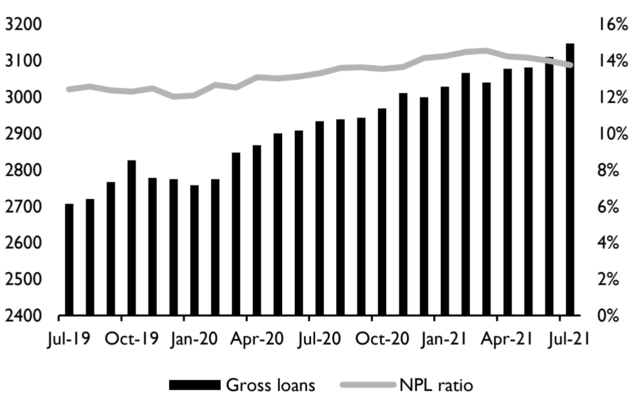
Graph 20: Central Bank Rate



Source: CBK, AIB-AXYS Africa research

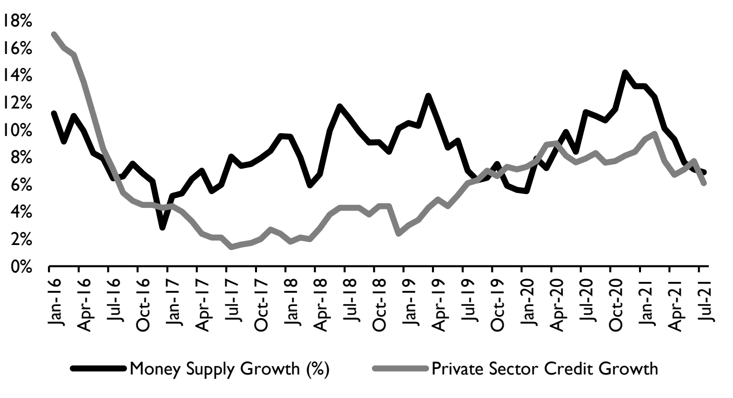
- **Reduced Private Sector Credit Growth:** During the year, credit growth to the private sector reduced as commercial banks' risk appetite decreased. The high Non –Performing Loans remain a source of concern. Private sector credit growth is likely to remain muted as we expect banks to continue to focus on the relatively high risk-free interest rates.

Graph 21: Gross Loans and NPL Ratio



Source: CBK, AIB-AXYS Africa research

Graph 22: Private Sector Credit Growth



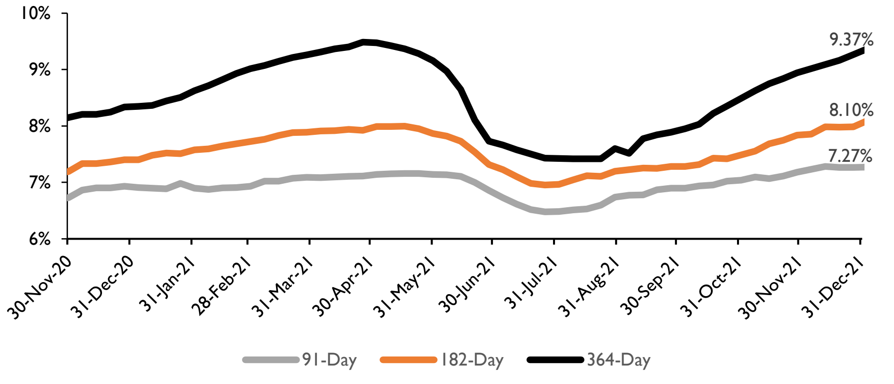
Source: CBK, AIB-AXYS Africa research

- **Monetary policy expectation:** The Central Bank's monetary policy decisions seek to maintain price stability and support economic activity. The currently accommodative monetary policy is likely to support growth. We expect the Bank to maintain its accommodative monetary policy stance thus maintain the CBR at 7.0%, at least for the first half of 2022.

Interest Rates Outlook

- **Gradual increase in short-term interest rate:** A widening fiscal deficit and pressure on revenue collections saw the government's appetite for debt remain elevated.
  We expect short term rates to continue their gradual upward trend. The performance in weekly auctions, however, will continue to be determined by the prevailing liquidity trends at the time of the auction.

Graph 23: T-Bill rates

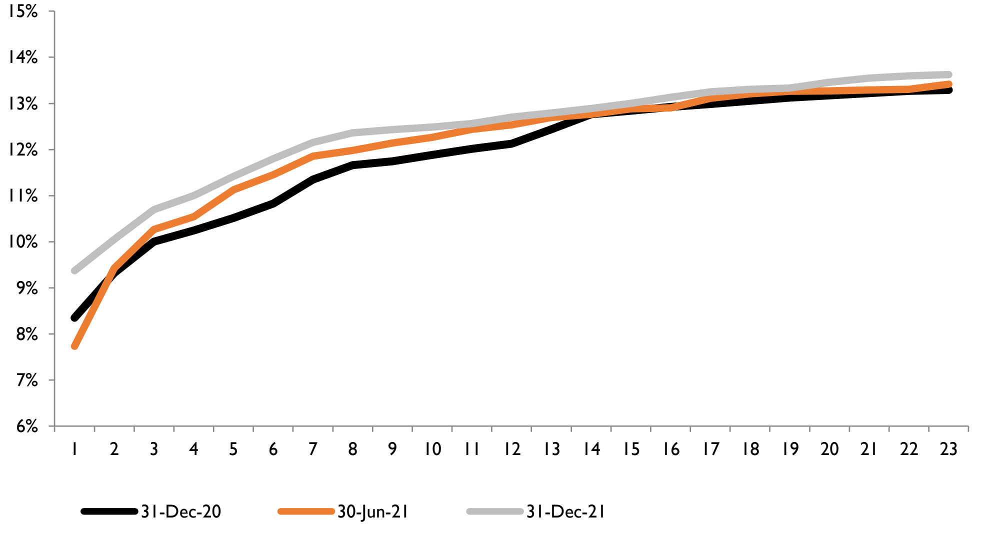


Source: CBK, AIB-AXYS Africa research

- **Yield curve expected to steepen further:** In 2021, the yield curve steepened across both the short and long end of the curve, despite occasional moments of easing liquidity through out the year. Yields in the shorter end rose the fastest with the 1-year paper gaining 163bps while the 25-year papers rose by 11bps.

  In 1H22, we expect investors to continue bidding aggressively exerting an upward pressure on the curve. Political and pandemic related risks are likely to influence subscription of longer dated papers.

Graph 24: Yield curve



Source: NSE, AIB-AXYS Africa research

Equity Market

NSE on an upward trajectory: 2021 was a good year for the NSE with individual stories being the needle movers in the market. As such the NASI gained 9.43% to close at 166.46 points while NSE-20 gained 1.83% to close at a 1902.57 points. These gains have mainly been driven by improved investor sentiments as economic activity picks and an increase in local institutional investor participation.

The wins were mostly concentrated in counters such as Car & General (54.32%), Equity Group (44.32%) and Nairobi Business Ventures (41.59%) being the top gainers. Meanwhile, counters such as Standard Group, EAPC and WPP Scan Group were points of maximum pain for investors being the largest losers with an y/y loss of 39.78%, 39.45% and 31.00%, respectively.

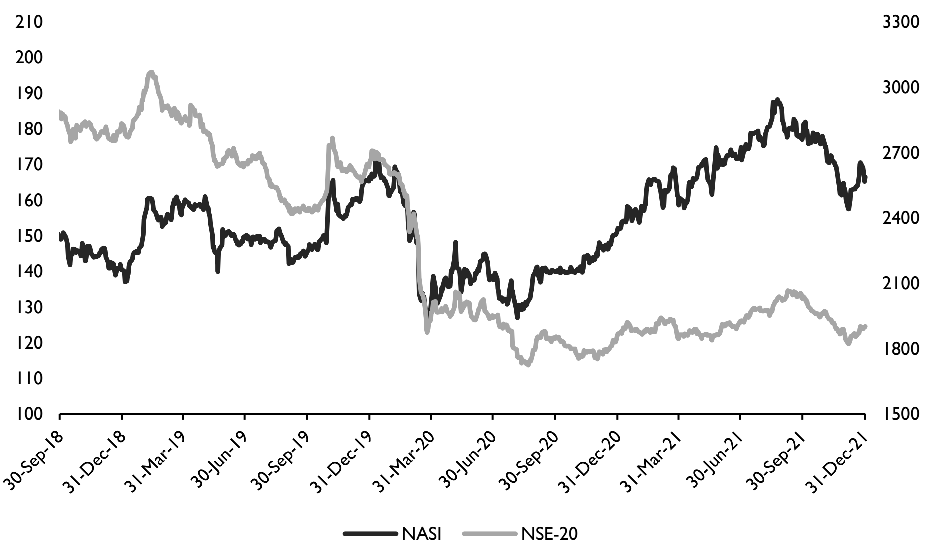
Table 2: NSE Indices Performance

	Q121	Q221	Q321	Q421	2021
NASI	4.28%	9.40%	2.75%	-6.65%	9.43%
NSE-20	-1.18%	4.39%	5.38%	-6.33%	1.83%

Source: NSE, AIB-AXYS Africa research

Meanwhile, foreign investors have generally been net sellers recording net outflows of $ 91.90Mn. The net foreign investor outflows may be attributed to the depreciation of the KES, increased investor risk aversion, and profit taking on several counters.

Graph 25: NSE Indices



Source: NSE, AIB-AXYS Africa research

During the year, we saw the delisting of National bank of Kenya following the take over by KCB while KQ and ARM shares remained suspended. Nation media Group (NMG) successfully participated in the first share buyback with an 82.25% performance and in the process contributing to a 19.42% y/y gain in its share price. Additionally, there was the introduction of shares trading using Bonga points and the commencement of day trading at the bourse.

Is 2022 election likely to negatively affect the market? During the past general elections, the NSE 20 has tended to register gains with 2007 being the only exemption. However, the years prior and after the election have recorded mixed performances. Not withstanding our expectation of a wait and see attitude among investors, In 2022, we expect the market to maintain its upward trajectory as improving economic conditions are likely to buoy company earnings.

Table 3: NSE-20 Performance during elections

Pre-Election	NSE-20	Election Year	NSE-20	Post -Election	NSE-20
1991		1992	21.81%	1993	116.49%
1996	-10.30%	1997	0.12%	1998	-4.91%
2001	-29.18%	2002	0.58%	2003	100.87%
2006	42.10%	2007	-3.56%	2008	-35.33%
2011	-27.07%	2012	36.84%	2013	23.63%
2016	-15.74%	2017	25.02%	2018	-19.63%
2021	1.83%	2022		2023	

Source: Bloomberg, AIB-AXYS Africa research

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