October 12, 2018

Highlights

- The cyclical global economic upturn seems to have hit the peak as risks including escalation of trade wars between the US and China, liquidity reduction by major central banks, political fragilities in the Eurozone among others crystallize, diluting tailwinds from US’ fiscal stimulus. Unlike in earlier years, the peak will not be marked by the traditional catalysts of a slowdown including higher interest rates and financial blowups although risks to the latter have increased considerably. Even as the risks permeate through emerging markets sustaining the near year-long risk selloff, East Africa seems to be carving a divergent path with output gap narrowing considerably across the four countries.

- **Kenya:** The economy defied the lethargy in government spending to accelerate to 6.3% in the second quarter from 4.7% a year earlier, in part reflecting the benefits of economic diversification. Supported by tailwinds from strong agricultural production, the economy seems on course to record over 5.5% growth this year. Although the lethargy in government spending in the third quarter and potential impact of consolidation may see the momentum taper off somewhat, growth is expected to remain solid mostly supported by increased agricultural production.

- **Tanzania:** Headline economic data from Tanzania underscores a very solid growth momentum. The economy is expected to expand by 6.5% in 2018 bolstered by strong government spending. At the same time, favourable weather has also added tailwind risks through robust agriculture performance. Moreover, recovery in the hospitality sector and stronger transport sector performance have also added some impulse to growth. However, private sector performance remains fragile as effects of the government induced policy shocks and reduced private sector lending reverberates through the economy.

- **Uganda:** The positive output gap in Uganda places the economy at its sweetest spot in nearly 5 years. GDP is estimated to have expanded by 6.0% in the year to June 2018 buttressed by a rebound in agriculture, growth in industries and a fairly resilient service sector. Growth is expected to remain robust bolstered by government spending on infrastructure and arrears settlement. Moreover, increased FDIs into the country as well as rising local demand will support the upbeat growth outlook.

- **Rwanda:** Leading economic indicators from Rwanda show activity consistent with over 7.0% economic expansion for this year. GDP growth is estimated to have accelerated to 8.6% in the first half of 2018 bolstered by recovery in industry and agriculture as well as a fairly resilient service sector.
Local economy and markets exhibit remarkable resilience despite rising risks from the external environment….will the stability hold?

The cyclical global economic upturn seems to have hit the cycle peak as risks including escalation of trade wars between the US and China, liquidity reduction by major central banks, political fragilities in the Eurozone among others crystalize, diluting tailwinds from US fiscal stimulus.

To this, the IMF in its latest review of global economic outlook projects that economic growth will plateau at the 2017 level of 3.7% in 2018 and 2019, an average 30bps downgrade to its earlier forecasts. This was across both developed and emerging markets.

Unlike in earlier years, the peak will not be marked by the traditional catalysts of a slowdown including higher interest rates and financial blowups although risks to the latter have increased on the back of elevate almost unsustainable US equity valuations. Interest rates remain near zero or negative in most major economies while emerging and frontier markets are just coming off an easing cycle.

The current economic underpinnings reflect very divergent scenes in both developed and emerging markets.

The US has been powering ahead fueled by increased government spending and tax cuts which have seen the country record a positive output gap for the first time since the 2008/09 financial crisis. Labor markets have tightened with unemployment dropping to over 50-year low of 3.7%. As a result, inflation has risen above the central bank’s 2.0% target giving the Fed confidence to maintain its gradual pace of monetary tightening. The Fed raised its benchmark interest rate by 25bps in September and signaled one more hike of 25bps in December.

Even then, although the impact of the ongoing tariff wars with China remain mute, perhaps just lagged, further escalation could absorb some steam from this momentum. Moreover, the effect of fiscal stimulus should wane somewhat in 2019.

Meanwhile, the tariff wars could exacerbate the slowdown in the Euro zone with major economies like Germany expected to be significantly affected. Sentiment in the region has remained fragile due to sustained protectionist undertones with uncertainty over Italy’s new government’s political and fiscal agenda likely to keep investors guarded. Meanwhile, with no firm position by the European Union (EU) on Brexit, investments and growth in the UK will remain subdued. Thus far, prospects of a hard landing for the UK remain high as EU seeks to dissuade other members from pulling out of the union.

In China, policy makers continue to face difficult tradeoffs between stabilizing its corporate debt levels and shielding the economy from the impact of trade wars. The biggest concern around the tariffs wars is that monetary policy may not have the tools to adequately manage its impact on the economy.

The risks have permeated through emerging markets sustaining the near year-long risk selloff. Emerging markets assets and currencies have lost nearly 20% in value from their January peak as measured by the MSCI indexes.
Perceived risky assets and emerging markets are expected to remain under pressure as the Fed maintains its pace of monetary tightening. The recent forecasts by the FOMC indicate that the Fed Fund Rate may increase to 3.1% in 2019 form 2.4% at the end of this year. This could sustain capital reversal from the emerging markets exerting downward pressure on currencies and triggering inflation. The International Institute of Finance estimates that capital flows to EM declined to $2.2Bn in August from $14.5Bn in July. The magnitude of capital flight is has been fairly varied depending on country specific macroeconomic fundamentals which have been fairly divergent.

Despite the rout in emerging markets, with clear contagion in the currency markets, local financial markets remained calm throughout the third quarter. The Shilling which has gained 2.3% so far this year, held fairly steady between 100.50-101.30 levels in September as emerging and frontier market currencies sold off.

Additionally, short term interest rates maintained a downward bias bolstered by sound liquidity, continued to monetary policy signals and sustained demand for the papers due to sustained risk aversion by local investors. Liquidity for government bonds with less than five-years to maturity has thinned out in both the primary and secondary markets attracting considerable premiums on any available papers within this scope. Meanwhile, constrained by limited risk pricing due to the interest rate cap, banks have been cautious of increasing their exposure to the private, with credit extension to the productive sector only increasing by about 4.5% in the year to August 2018. This has seen sustained strong liquidity allocation towards treasury bills.

While proliferation of risks from persistently low credit growth, fiscal consolidation and external vulnerabilities from rising US interest rates and dollar, higher oil prices, trade wars and fears of emerging contagion, Kenya has shown remarkable resilience growing at an average of 6.0% in the first half of 2018.
While the relative calm could be a sign of steadfast sentiment, it could also be a signal of a disconnection. As a barometer of economic sentiment, the stock markets seems to be carving a divergent path from the economic outturn, staging its longest bear run since the political crisis of 2008/09, which was aggravated by the global financial crisis.

For how long can the economy continue to curve a divergent path from the events in global markets?

For now, the economy seems well diversified and fairly cushioned from the global shocks. The upside from Agriculture seems steadfast given the upbeat weather outlook by the Kenya Meteorological Department. The weather man has projected above average rainfall in the last three months of the year. This should support a recovery in agro-processing and dilute inflationary pressures bolstering consumption. This should offset the impact of fiscal consolidation on economic performance.

Meanwhile, improving current account dynamics and solid foreign exchange reserve should offer support to the currency for now. Meanwhile, the yield curve may steepen further in the near term as investor concentration on the shorter end of the curve persist.

Undoubtedly, risks from the external environment have increased to the upside. Even so, while Kenya remain vulnerable to the potential shocks, the economy seems fairly cushioned for now. Therefore, the emerging shocks from the external environment may be less disruptive in the near-term. However, how long this calm lasts, remains a top dollar questions! With sustained structural weaknesses on both the fiscal and current accounts, this calm may not hold to the medium term should risks from external environment crystalize! This will continue to invite caution among investors.
The economy defied the lethargy in government spending to accelerate to 6.3% in the second quarter from 4.7% a year earlier, in part reflecting the benefits of economic diversification. Supported by tailwinds from strong agricultural production, the economy seems on course to record over 5.5% growth this year. A combination of improved business sentiment and increased agriculture production shored up the agro-processing segment of the manufacturing sector as well as the retail and wholesale sectors. Although the lethargy in government spending in the third quarter may see the momentum taper off somewhat, growth is expected to remain solid mostly supported by increased agricultural output.

Even then, the initiation of the fiscal consolidation cycle aimed at cutting deficit and stabilizing debt will likely see a reduction in aggregate demand. Already, overall consumption seems to have moderated evident by slower growth in government revenue. In the year to June 2018, tax revenues grew by 3.4%, a significant decline from 14.3% a year earlier. Notable was the slowdown in income taxes (+2.8%), excise duty (+1.5%), VAT (+5.2%) and Import duty (+4.2%). Over the last five cycle, the revenues grow at an average of 15.0%, 16.0%, 11.8% and 13.1% respectively. This underscores the onerous task at hand for Treasury in raising its projected KES 1.9 Trillion in revenues for this fiscal year. In the period, GDP is estimated to have expanded by 5.5%, which indicates a fairly weak link between revenues and GDP growth.

As scope for fiscal influence on GDP diminishes, monetary policy has failed to step up despite the continuous easing by the central bank. This largely reflects the challenges presented by interest rate capping and persistent fiscal dominance. The MPC, which cut rates two times this year, is now running out of headroom as risks to inflation rise. In addition to effects of tax, rising oil prices heralds considerable risks to inflation outlook. Inflation rose to 5.7% in September from 4.0% in August and is expected to accelerate further towards the statutory target band’s upper limit of 7.5%.

The combination of rising inflation and potential pick up in government borrowing could limit further downside for the yield curve which has been steepening for most part of the year. Short term rates have remained under downward pressure from heavy liquidity and increased appetite from the market. Liquidity has stabilized with overnight rates dropping to below 5.0%. As a result, yields on benchmark T-bill rates dropped by 4.9bps, 28.6bps and 18.7 bps to 7.600%, 8.590% and 9.638% on the three, six and twelve month papers respectively.

Meanwhile, the shilling continued to outperform its regional peers, having gained 2.3% so far this year. This is against a backdrop of persistent emerging and frontier market sell off due to rising US interest rates and a strengthening dollar. The shilling has been anchored by improved US dollar liquidity from diaspora remittances, hawk-eyed surveillance and intervention by CBK through proactive liquidity management and deployment of foreign exchange reserves currently at KES 8.44Bn (5.58 months imports cover). The shilling is expected to remain under some pressure from higher fuel prices, unfavorable interest rate differentials and although the regulator should be at hand to ensure only a smooth depreciation.

### Forecasts

<table>
<thead>
<tr>
<th>Quarter ending</th>
<th>March 2018 (A)</th>
<th>June 2018</th>
<th>Sept 2018</th>
<th>Dec 2018</th>
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<tr>
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Source: CBA Research, Bloomberg
Inflation and Central Bank Rate (CBR)

Money Supply and Private Sector Credit Growth

Quarterly GDP Growth Rates

Source: Central Bank of Kenya, Bloomberg, CBA Research
Tanzania

- Headline economic data from Tanzania underscores a very solid growth momentum. The economy is expected to expand by 6.5% in 2018 bolstered by strong government spending. With 75% of financing having been secured, the construction of the first phase of SGR between Dar es Salaam and Morogoro is already at 22.0% completion. Other mega projects in energy, roads and transport sector should underpin growth in the period. These projects could add over 3.0 percentage points to GDP over the construction period.

- At the same time, favourable weather has also added tailwind to growth through robust agriculture performance. Moreover, recovery in the hospitality sector and stronger transport sector performance, with the latter benefiting from increased investments in air transport and heightened activity at the port mostly in transit goods, has added some impulse to growth.

- However, private sector performance remains fragile. This is a result of slow recovery from government induced policy shocks, which has aggravated the lassitude in the country’s credit markets. Business sentiment remain generally negative with the policy fragilities and weak credit growth topping investors’ concerns. At the same time, ripple effects of the current government investment on business remains low, given the external leaning for these projects, both in funding and construction, understandably due to the limited local capacity.

- Credit growth remains extremely low at 2.4% in July 2018. Besides the weak credit risk environment, the lethargy has been attributed to increased caution due to the current double-digit NPL ratio and more stringent regulation under the IFRS 9 framework. After the capital erosion through NPLs over the last two years, banks remain wary of any lending activity that could increase their credit risk exposure.

- Meanwhile, the interbank market remains segment as flight to quality in the market increase. This was aggravated by the collapse of Bank M. De-risking from smaller banks perceived as riskier has necessitated proactive and consistent liquidity support by the central bank to ensure the sector’s stability. This is likely to encourage a more accommodative stance going forward. Inflation remains below the central bank’s target of 5.0% at 3.3%. As a result, interest rates are expected to remain low and stable. While some pressure is expected from the fiscal stance, the bias towards external financing should keep local liquidity sound. Overnight rates have remained sub-2.0% and are likely to remain tame into the foreseeable future.

- Meanwhile, despite weakening current account position due to the infrastructure related capital imports, the shilling has only experienced mild pressure only losing 0.35% to the US dollar in the last quarter. The trend is expected to continue with potentially strong resistance at the 2300 levels. With USD 5.9Bn (6.6 months import cover) in foreign exchange reserves, the BoT remains in a good place to protect this level.

Forecasts

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<tr>
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Source: CBA Research, Bloomberg
Uganda

- The positive output gap in Uganda places the economy in its sweetest spot in nearly 5 years. GDP is estimated to have expanded by 6.0% in the year to June 2018 buttressed by a rebound in agriculture, growth in industries and a fairly resilient service sector. Growth is expected to remain robust as government spending especially through deliberate focus on payment of arrears and infrustucture spending bolsters aggregate demand. Moreover, increased FDIs into the country as well as rising local demand will support the 6.5% growth outlook for 2018/19 financial year.

- Meanwhile, with positive shift in business sentiment, private sector lending has picked up averaging 10.7% over the last three months. This has also been supported by benign monetary conditions following the continuous central bank easing. However, the Bank of Uganda has shifted gear towards tightening raising interest rates by 100bps in its latest policy review meeting. Besides the risks presented by rising US interest rates and a stronger dollar, the tightening stance reflects domestic risks to inflation including the tax environment and a positive output gap.

- As a result, the Bank of Uganda revised its inflation forecast to between 6.5-7.5% by end year from 5.0% earlier in the year. While food supply remains solid, second round effects of especially higher oil prices and taxes will propel prices higher. The move to increase interest rates was also directly informed by the need to attract foreign capital which should support the currency.

- The currency has been extremely volatile oscillating in the ranges of 3750-3850 in the last quarter. Besides the broader emerging markets sell off due to the widening interest rate spreads with the US dollar, the currency has been impacted by a widening current account deficit. The deliberate settlement of supplier debts by the government pumped money back to the economy triggering a recovery in activity. Improved credit profile for some borrowers also saw banks increase their overall lending further buttressing growth.

- In the near term, the currency may remain supported by the relatively higher interest rates. However, with the dollar expected to appreciate and oil sentiment turning bullish, the low foreign exchange reserves by the bank of Uganda at 4.5 months import cover-just slightly above the regional threshold of 4.0-may warrant more tightening to effectively anchor expectations. This is especially with the twin deficits, the current and fiscal, expected to widen. This comes at a time when Uganda is expected to intensify its investments in public infrastructure which will require heavy capital imports. Accordingly, we still expect the shilling to weaken further albeit at a more reduced pace.

- With commendable yield curve response to policy signals, interest rates should soon adjust upwards although the prevailing heavy liquidity could make this gradual. Already, overnight rates have adjusted to 10.0%. We expect BoT to try to ensure the signal permeates across the curve.

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<tr>
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Source: CBA Research, Bloomberg
Rwanda

- Leading economic indicators from Rwanda show activity consistent with over 7.0% economic expansion for this year. GDP growth is estimated to have accelerated to 8.6% in the first half of 2018 bolstered by recovery in industry and agriculture as well as a fairly resilient service sector.

- The stimulatory effects of the on-going government spending on infrastructure on the construction sectors are becoming apparent. Specifically, resource channeling towards the new Bugasera airport is likely to add considerable impetus to growth. The transport sector has equally benefited from the expansion of Air Rwanda activities as well as increased export volumes.

- More commendable is the continued improvement in Rwanda’s external sector. The balance of payment remained in surplus as export growth of 17.9% considerably outweighed the 7.3% increase in imports in the second quarter of the year. This is a response to the deliberate government efforts to increase the export base and enhance import substitution. The upside was also bolstered by favourable prices of key imports including base metal minerals and coffee. High tea export volumes compensated for the decline in prices over the period.

- Meanwhile, monetary policy remains generally supportive. Earlier this month, the MPC held the repo rate at 5.5% to help bolster credit expansion in the market. Private sector lending has slowed to just about 7.5% from 14.7% at the beginning of the year but is expected to slowly pick up as economic activity improves and quality of banks’ balance sheets improves.

- Supporting the policy stance has been persistently low inflation currently at 1.20% primarily on low food prices. Moreover, moderate exchange rate pressures due to improving current account dynamics and proactive intervention by the central bank, reinforced by IMF precautionary facility have keep inflation expectation well anchored. Even then, pressure on the currency is expected to persist amid deficiency of US dollars in the market with cumulative losses expected to increase to 4.0% by year end.

- The Franc has been relatively stable depreciating by 2.9% so far this year. The trend has been well managed by the Central Bank which has been very proactive in providing market with dollar liquidity amid a persistent deficiency of the hard currency. FDIs to the country have equally improved, as a stable policy and improving business environment attract investors to the market. According the Central Bank, the exchange rate is expected to depreciate further towards 900 levels with a cumulative loss of 4.0% for the year.

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Source: CBA Research, Bloomberg
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