November 6th, 2018

Highlights

Up until last month, the global stock market performance had been characterized by distinct and divergent trends, reflecting equally de-coupling economic narratives. While emerging markets were consistently on the back foot due to heightened risk aversion and reversal in capital flows, developed markets had continued to charge to higher highs, propped up by favourable economic prospects.

A few weeks later, the narrative is changing. In October, the risk sell-off extended to developed markets, even as sentiment for emerging markets continued to falter! While the bloodbath may have been a technical correction due to inflated valuations, the convergence may also reflect the underlying concerns over the health of the global economy.

✔ **Kenya**: Kenya’s economic outlook for the rest of the year remains broadly upbeat. Forecasts by both the IMF and the World Bank have placed 2018 growth at about 6.0% in 2018 from 4.7% a year earlier. The sanguine outlook is predicated primarily on strong agricultural performance which has had positive snowball effects on other sectors, especially manufacturing and trade. This should cushion economic growth from effects of reduced government spending as Treasury goes full throttle on its consolidation agenda.

✔ **Tanzania**: The economy continues to reel from the effects of radical policy shifts that soured business sentiments and investments in the country. Consumption has been weak, in part due to lethargic private sector credit growth as well as reduced money circulation partly due to a slack in government spending. As a result, the IMF projects that growth could decelerate to 5.8% in 2018 from 6.7% a year earlier.

✔ **Uganda**: The Uganda economy lost momentum in the second quarter to grow at 5.0%, its softest pace since the first quarter of 2017 and considerably below the 6.2% expansion in the first quarter. Even then, growth is expected to pick up in the second half of the year bolstered by robust government spending, especially on infrastructure projects, as well as increased output growth in the private sector.

✔ **Rwanda**: Ranked among the top 10 reformers globally and the most business friendly country in Africa, Rwanda continues to lay grounds for sustained capital investments. In the latest World Bank ranking, Rwanda was rated top in Africa having improved further to 29th place globally from 41st in the previous survey.
Broader risk sell-off underlines concerns over the health of the global economy

Up until last month, the global stock market performance had been characterized by distinct and divergent trends, reflecting equally de-coupling economic narratives. While emerging markets were consistently on the back foot due to heightened risk aversion and reversal in capital flows, developed markets had continued to charge to higher highs, propped up by favourable economic prospects led by the US.

A few weeks later, the narrative has changed. In October, risk sell-off extended to developed markets, even as sentiment for emerging markets continued to falter! To be sure, equities across the globe lost 6.4% in the month, dragged mostly by developed markets which ended the month 6.7% lower.

This reflects the mounting downside risks to earlier sanguine forecasts. The US-China trade war has escalated with negative ramifications for global supply chains and hence, trade volumes. While the effects are yet to be quantified, the effects are starting to manifest especially so in China.

Moreover, Europe’s domestic problems including Brexit and Italy’s populist policies have heightened uncertainty with growth pacing down to below 1.7% in Q3 2018, its slowest in four years. Italy’s latest budget which proposed a 2.4% deficit was rejected by the EU citing breach of the bloc’s budgeting guidelines. While Brussels may continue to reject Italy’s populist agenda, the risk of contagion to other European sovereigns cannot be underestimated.

Meanwhile, recent data suggests that the US economy is firing on all cylinders and is on course to register its highest annual growth since the financial crisis. This partly reflects underlying solid consumer spending and tightening labour markets, accentuated by the effects of the fiscal stimulus.

That said, the momentum could wane in 2019 as effects of the government’s tax cuts and deregulation fade. The November mid-term elections may also see some paralysis on Trumps’ pro-growth agenda should he fail to retain both the House of Representatives and the Senate. Moreover, the ongoing trade war with China and other developed countries could cool down the momentum.

At the same time, with rising inflation, the US monetary policy will in the near term remain divergent to other major economies as the Fed keeps on its path of gradual interest rate hikes with one hike in December 2018 and three more in 2019.

FTSE Indices – Nov 02,2018

<table>
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<th>IM</th>
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Source: FTSE, Bloomberg

While the bloodbath may have been a technical correction given the recent stretch in developed market equity valuations, the convergence could underline the emerging concerns over the vigor of the global economy!

Although healthy, optimism in global economic growth is waning. Median baseline forecasts are no longer suggesting topside surprises to growth. In fact, consensus forecasts continue to suggest a cyclical peak at 3.5% in 2018 before leveling off in 2019. The IMF projects that growth will plateau at 3.7% in 2019 before slackening marginally in 2020.
While financial conditions will remain accommodative, the relative tightening could somewhat reduce aggregate demand in the economy.

Meanwhile, fragilities in emerging markets remain profound. Continued deceleration in capital inflows amid increased outflows have been accompanied by a sustained stock market slump and currency depreciations. A combination of tightening monetary policy and trade protectionism in Washington has weakened investor sentiment, sustaining the selloff in the emerging economies.

More worrying is the deepening economic slowdown in China. The economy expanded by 6.5% in the third quarter, the slowest since the depths of the financial crisis in 2009. The lethargy could be compounded next year when the full effects of the trade war with the US become apparent.

Already, Chinese manufacturing and new export orders have shown considerable weakness, contracting for the 5th straight month, with deteriorating sentiment suggesting that the outlook may be grimmer than the current headlines are telling. This could be aggravated by potential slowdown in the broader global growth.

Looking ahead, the heightened uncertainty is likely to sustain the recent volatility in global financial markets. Markets are likely to see more risk aversion to year end with greater need for flexibility and liquidity in investment portfolios. This is likely to support demand for haven assets, with a combination of both liquidity and rising yields likely to favor the US dollar.

The greenback may be further supported by weaker sentiments for Euro and the British Pound. The Euro will remain vulnerable to the growing tensions between the EU and the populist Italian government, effects of trade wars on Germany and underlying growth weaknesses. At the same time, uncertainty around the eventual outcome of Brexit negotiations, with less than 5 months to go, is likely to dampen sentiment in the broader Eurozone. In the near term, the outcome of the US mid-term elections also has potential to add to the volatility, due to its implications for fiscal policy which has been a considerable driver of US 2018 economic performance.
This will likely see increased de-risking from emerging markets with aggravated portfolio outflows. Meanwhile, as undertones of prospects of yet another global recession build up, expectations are that sentiment will remain largely anti-risk.

Closer home, the near term outlook for Sub-Saharan Africa has firmed somewhat underpinned by higher commodity prices, domestic structural adjustments and stronger global growth expansion. Growth is expected to top 3.0% this year from 2.7% in 2017 before accelerating to 4.0% in 2019. However, this is likely to be an onerous task given the souring external environment.

Moreover, while governments have stepped up reforms, underlying vulnerability in most economies are yet to be decisively dealt with. Debt sustainability concerns have been partly blamed on the rising value of the US dollar and weaker revenue collections in most SSA countries, amid consistent spending pressures.

Closer home, while East Africa is not immune to the aforementioned risks, growth outlook remains considerably healthy. According to both the IMF and the World Bank, the region will outperform its peers in 2019 to grow at about 6.0%.

This will be underpinned by sustained solid investments in infrastructure and strong agriculture output on the back of favorable weather. Expansion across all the East African economies could top 6.0% in 2019 led by Rwanda at 7.8%, Tanzania at 6.6% and Kenya and Uganda at 6.1%, according to the IMF. Even so, emerging fiscal concerns, weak credit growth and heightened external vulnerabilities threaten this sanguine outlook. Furthermore, any adverse weather shocks could also see a considerable slack in the economies given the current strong anchor on agriculture.

Meanwhile, persistent currency weakness amid widening current account deficits and fairly weak foreign exchange reserves have reignited considerable pressure on the fairly respective currencies. Amid sustained threats from the external environment, we posit that more central banks will be shifting to tighter policy stance. This could exacerbate credit growth challenges in the region.

![Private sector credit growth](image)

In Kenya, the hemorrhage at the NSE continues to suggest the country’s vulnerability to external shocks. The stock market is estimated to have lost USD 282Mn. Part of the selloff reflects sustained concerns over the currency which until a week ago had exhibited enviable stability against the US dollar. Meanwhile, the Tanzania shilling and the Rwandese Franc showed vulnerability in October, while policy action in Uganda led to remarkable recovery in the period.

All said, it’s is apparent that downside risks to global growth have increased. The uncertainty presented by the evolving trade wars, domestic challenges in Europe, Brexit, debt and growth concerns in emerging markets could sustained the global risk going forward. Therefore, while emerging markets may have gotten a breather in the last couple of days, there is sufficient reason to remain wary. For portfolio holders, trading off some yields for flexibility, liquidity and safety may be a good call amidst elevated uncertainty.
Kenya’s economic outlook for the rest of the year remains broadly upbeat. Forecasts by both the IMF and the World Bank have placed 2018 growth at about 6.0% in 2018 from 4.7% a year earlier. The sanguine outlook is predicated on solid agriculture sector performance which had positive snowball effects on other sectors, especially manufacturing and trade.

This is expected to cushion the economy from effects of reduced government spending as Treasury goes full throttle on its consolidation agenda. GDP is forecast to accelerate further in 2019 to 6.2%. Even so, the dependency on agriculture for growth could leave the economy susceptible to extreme weather shocks. The fiscal-led growth is expected to moderate as the government targets to restore fiscal space and stabilize debt.

The country’s fiscal sustainability concerns hit headlines once again in October after the IMF downgraded the country’s risk of external debt default to moderate from low citing continuous breach on key external debt sustainability metrics. This could further complicate Kenya’s fiscal dynamics by attracting heavy premiums on external financing, at a time when benchmark interest rates are also rising in line with the tightening stance adopted by the US Central Bank.

At the moment, a return to the international debt markets seems inevitable given the continuous underperformance of revenue targets and the fear of crowding out the private sector. In the first two months of 2018/19, government revenues expanded by 12.6% against a full year growth target of 17.5%. While this is partly due to cyclical factors and may pick up somewhat in subsequent months, performance is likely to remain below expectations given that private sector activity still remains fairly lethargic partly due to persistent headwinds from credit markets.

That said, according to recent media reports, Treasury plans to raise about KES 250Bn out of the KES 267Bn external debt target, through Eurobonds. This will in part be used to refinance maturing debt. This could aggravate the debt concerns in view of the above mentioned structural challenges.

The shilling came under intense pressure depreciating to a low of 102.25/35 to the US dollar following IMF’s pronouncement. The main pressure point was the assertion that the currency is overvalued by 17.5%. The report further questioned the country’s exchange rate regime-whether it is free floating or managed. The shilling has been remarkably stable, gaining 1.72% against the US dollar so far this year. While this has been partly attributed to the level of intervention by the regulator, it is also apparent that dollar supply has remarkably increased and demand is still fairly tepid. Accordingly, further shilling losses are likely to be measured relative to its frontier market peers, the IMF’s assertion notwithstanding. The Central Bank is also expected to maintain its defense of the shilling using both interest rates and FX reserves potentially keeping the currency below 103.00 to the US dollar for the rest of the year.

While inflationary pressures unexpectedly abated to 5.5% in October from 5.7% a month earlier, suggesting little scope for interest rate hikes, we believe that persistent pressure on the exchange rate may be ground for tightening. For now, the Central Bank is likely to remain on hold as it monitors developments on the currency front.

### 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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<tbody>
<tr>
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Source: CBA Research, Bloomberg
**Inflation and Central Bank Rate (CBR)**

Source: KNBS

**Money Supply and Private Sector Credit Growth**

Source: KNBS, CBK

**USDKES and FX Reserves**

Source: KNBS, CBK

**Quarterly GDP Growth Rates**

Source: KNBS, CBK
The economy continues to reel from the effects of radical policy shifts that soured business sentiments and investments in the country. Consumption has been weak, in part due to lacklustre private sector credit expansion as well as reduced money supply, partly due to the slack in government spending. The resultant weakness in aggregate demand could see the growth decelerate to 5.8% in 2018 from 6.7% a year earlier, according to the IMF’s latest economic outlook report.

Even then, economic activity could pick up in 2019 as the fiscal investment drive picks up pace. Already, notable progress has been made on the SGR with estimates suggesting close to 30% completion. Moreover, signals from the private sector suggests some mild recovery in industries driven primarily by value addition in agriculture, increased activity within the tourism sectors and some pick up in transport especially for transit goods.

On a positive note, inflation remains below 4.0% underpinned by declining food inflation, tame foreign exchange pressures and weak demand in line with the challenges in credit growth. Annualized credit expansion remained low at 5.20% in August, a slight uptick from 3.70% a month earlier. This could still allow the Central Bank some wiggle room to run an accommodative policy stance. Even then, the benchmark Repo rate is likely to remain on hold as the regulator targets to transition from quantity to a price targeting regime. A launch of the CBR will help harmonize the conduct of monetary policy across the region.

The local currency which gave up about 8 shillings to the US dollar in the month got some footing towards the end month as the Central Bank stepped up vigilance and intervention to keep it below the 2300 level. Moral suasion also helped the shilling recover marginally, stabilizing at 2286/96 against its US counterpart. Near term outlook favors a stable shilling as export earnings from cashew nuts lend support.

Fundamentally, the shilling remains exposed to lower interest rates and weakening current account dynamics and is expected to resume its gradual depreciation in 2019. Reduced repatriation of profits has offered some support but this is likely to stabilize with the overall policy environment.

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*Source: CBA Research, Bloomberg*
**Uganda**

- The Uganda economy lost momentum in the second quarter to grow at 5.0%, its softest pace since the first quarter of 2017 and considerably below the 6.2% expansion a quarter earlier. The slowdown was primarily driven by slower output growth in the service sector, although agriculture and industry sectors also moderated. On a quarterly basis, the economy expanded by 1.9% compared to 1.1% in the previous quarter.

- Even then, growth is expected to pick up in the second half of the year bolstered by robust government spending, especially on infrastructure projects, as well as increased output growth in the private sector. The service sector is also expected to remain anchored by increased domestic consumption partly due to low inflation and pick up in credit growth. Industries are also likely to see better performance as value addition especially within the agriculture sector increase. On the downside, concerns over public debt sustainability may reduce the impetus from government spending. Public debt/GDP ratio has risen consistently over the last eight years to 38.4% with 32.7% of this year’s revenues set to be channeled towards debt service.

- Meanwhile, the effects of the 100bps rate hike in September have thus far been positive. Inflation expectations appear to be well anchored for now and output growth somewhat uncompromised as revealed by the persistent surge in the leading economic indicators. Annual headline inflation declined to 3.0% in October from 3.7% a month earlier due to lower food prices. Food inflation reached -2.5% in October due to favorable weather. Energy, Fuel and Utility inflation also declined to 6.9% from 10.1% in September.

- Relatedly, core inflation also reversed course to 3.5% from 3.9% in September, somewhat dispelling fears that declining output gap has been negative for inflation, at least for now. Furthermore, recent exchange rate gains could also help keep prices stable. The Producer Price Inflation (PPI), a leading indicator for inflation, declined by 1.7% in October suggesting that inflationary pressure may remain below 5.0% for the rest of 2018.

- Intuitively, the relatively benign short-term inflation outlook coupled with a fairly stable shilling could see the BoU hold rates for the rest of the year. The shilling gained 1.6% in October to 3735/45, clawing back from earlier losses against the US dollar. Whereas fragilities from the resurgent US dollar, upside risks to global oil prices, fairly fragile current account dynamics and foreign exchange reserves may remain, rising interest rates should bolster the shilling’s appeal in the interim.

- The yield curve has adjusted sharply higher following the move by the Bank of Uganda to raise interest rates. The yield on the benchmark 91-day T-bill has increased by 151bps following the move by the regulator. Yields continue to edge higher albeit at a declining pace as the Central Bank intensifies its support for the shilling.

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*Source: CBA Research, Bloomberg*
Inflation and Central Bank Rate

Source: Uganda Bureau of Statistics, Bank of Uganda

Money Supply and Private Sector Credit Growth

Source: Bank of Uganda

USDUGX and Official FX Reserves

Source: Bank of Uganda

Quarterly GDP Growth Rate

Source: Uganda Bureau of Statistics (UBOS)
Rwanda

- Ranked among the top 10 reformers globally and the most business friendly country in Africa, Rwanda continues to lay proper grounds for sustained capital investments. In the latest World Bank ranking, Rwanda was rated top in Africa having improved further to 29th place globally from 41st place in the previous ranking. This would in part explain why Chinese e-commerce giant Alibaba chose Rwanda as the pioneer of eWTP (electronic world trade platform) in Africa. The partnership is meant to promote policy innovations, enable cross border trade between Rwanda and China, promote tourism and enhance capacity to grow Rwanda’s digital economy.

- Continued legislative reforms especially around the ‘Made in Rwanda’ initiative has had commendable effects on the economy. It is estimated that the initiative has reduced the trade deficit by 36% and improved total exports by 69% over the last three years of implementation. Even then, the performance has been less than optimal, largely due to the relatively high cost of production in Rwanda.

- To improve its success, the government launched a new policy in October aimed at improving access to products by increasing local production of raw materials. Moreover, the state rolled out a new industrial tariff structure to reduce the cost of electricity in the country. Despite the high cost of production, the policy will also make preferential considerations of products and services produced locally (even if they are up to 15% more expensive than imports) in public procurement.

- The government has pledged to provide the necessary infrastructure and other support to ensure that locally produced goods are up to standard. It has set aside RWF 274Bn for the ‘Made in Rwanda’ initiative over its seven-year implementation period. Fifty four percent of the budget will be channeled towards attracting foreign investments.

- Meanwhile, GDP growth is expected to top 7.5% this year having averaged 8.6% in the first half of 2018. Besides the positive impact of the aforementioned initiative on industries, agricultural performance continues to overshoot expectations on the back of favorable weather. The strong agriculture output has seen a sustained deflation in food prices, which will continue to support an accommodative policy. In September, the MPC left the policy rate unchanged at 5.5%. This is despite the persistent pressure on the franc.

- The Franc continued on its path of gradual depreciation on the back of fragile foreign currency flows. The local currency has lost 3.34% year to date, currently exchanging at 886/892 against the US dollar. The depreciation has been well managed by the proactive intervention by the National Bank of Rwanda which has contained any speculative activity. With US dollar demand set to remain robust on the back of increased capital imports amidst thin dollar supply, the Franc could remain under pressure, although further depreciation will be in line with the projected annual weakening of 4.0%.

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*Source: CBA Research, Bloomberg*