FUSION INVESTMENT MANAGEMENT

Rooted in the African growth story

ACK Garden House, 1st Ngong Avenue, Nairobi
www.fusioninvestmentmanagement.com
+ 254 (20) 2738460/1

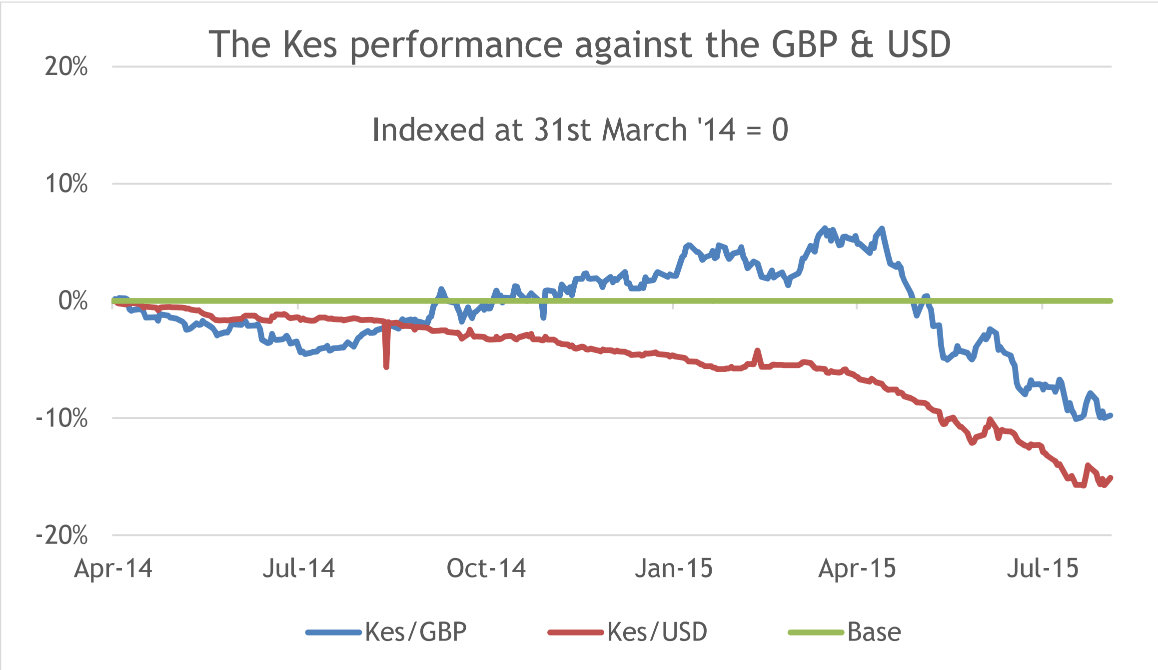
The case for Kenya shillings:

The shilling performance against major currencies, the factors behind the slide against sterling and why we believe it is a buying opportunity

The Kenya shillings performance against major currencies

The Kenyan Shilling has recorded significant volatility against the major currencies especially the Sterling Pound and the US Dollars. This year alone to 31st July 2015, the Kes has depreciated 11.16% and 14.45% to the GBP and USD respectively. The situation is not unique to the Kenya shilling and it is a reflection of international developments: general strengthening of the USD and the pound against other world currencies. For example, this year alone, the Tanzania shilling has lost 23% and the Uganda shillings 24% to the pound.

The graph below shows the Kes performance against the USD and the GBP for the last 16 months.



Source: Central Bank of Kenya

What are Factors behind the weakening of the Kenya shilling?

The Kenya Shilling has been affected by factors both within and without the country which includes the following:

i. **Widening Current Deficit**

Kenya's foreign currency reserves currently amount to 4.14 months of import cover. This is on the back of a rising import bill especially on capital goods necessary for the increased infrastructure development (Standard gauge Railway, Roads, port etc), depressed foreign currency inflow from the tourism sector resulting from general insecurity and terrorism attacks and depressed tea earnings owing to the overall decline in tea prices. Data from the Kenya National Bureau of Statistics (KNBS) shows that the current account balance recorded a deficit of USD 1.0bn in Q1'2015 compared to a deficit of USD 0.63bn in the same period last year.

This current level remains below 4.5 months import cover CBK target, but is still relatively sufficient to aid in seeing the Kenya Shilling trade within an acceptable range.

ii. Reduced Inflows

The cases of insecurities and subsequent issuance of travel advisories by key source market dealt a significant blow to the Kenyan tourism industry which is a key earner of foreign exchange. In addition, the country experienced inadequate rainfall in first part of the year dampening export of key export crops which are key earner of foreign exchange.

iii. Policy Uncertainty

At the beginning of the year, the Central Bank of Kenya was left without a substantive Governor for quite a while leading to market uncertainty about policy direction to be taken by the new governor. The governor position has now been filled by an ex-IMF Kenyan and we expect that the market will start to appreciate his policy guidance.

iv. Closure of the remittance firms

There has been suspicion that the shilling has suffered even more after several remittance firm's licenses (Dahabshill and other small 'Hawala' Players), were suspended on the grounds that they were being used to fund terrorism. The freeze cut the transfer of money into the country on the platforms. Some of these firms are used by international agencies and charities in Somalia and it is estimated that Somalis abroad send over USD 1.5 Billion and most of this pass through Kenya. These remittance firms have since been re-opened after the investigations confirmed they were not involved in funding terrorism and we expect to start seeing their effects albeit small on the Kenya shilling.

v. International factors

The interdependent nature of relationship between major currencies like the KES, GBP and USD has seen the shilling losing ground against the two major currencies due to the expectation that the Federal Reserve of the US will raise interest rates leading to investor flight to safe currencies like the US dollars. It is worth noting that the United States is one of the major sources of diaspora remittance

Does the shilling have to further to go down?

Our view is that the right measures are now being taken to shield the shilling from further weakening and we believe the shilling will remain relatively stable against major foreign currencies, will recover some of the losses suffered this far and will continue to strengthen against other East African currencies, as these measures bear fruit.

What are the measures being taken to shield the shilling and what are the prospects for recovery?

The Central Bank has continued to intervene through monetary policy to stem the volatily. It has raised its key rate leading to increased credit rates so as reduce liquidity in the market. Last month, the Central Bank issued a circular curbing the volume of daily foreign exchange trading by banks in a move aimed at limiting speculative trading on the shilling. We expect further intervention from the central bank to curb further volatility through monetary policy.

The lifting of travel advisory by the United Kingdom and the recent visit by the President of the United States, President Obama, is expected to significantly aid in recovery of tourism industry. The United Kingdom is a key source market for tourism. We also expect that this will set precedence for further travel advisory lifting by other governments, which are still running travel advisories.

Diaspora remittances have recorded noteworthy growth in 2015, amounting to USD 129.1m in May 2015 (7.9% y/y, 3.7% m/m), boosted by inflow from Kenyans in Europe and North America. The Government plans to reduce taxes and transfer fees charged on Diaspora remittances from September 2015, as well as offer preferential duty waivers on local businesses set up by Kenyans living in the Diaspora. These initiatives could see an increase in remittances in the months to come.

We also note that in Q15, the government secured a USD 688.3m precautionary loan facility from the International Monetary Fund (IMF), that it intends on utilizing to assist in warding off excess volatility in the forex market.

Is it a buying opportunity?

With the above measures being taken, we believe they will start to bear fruits soon and the Kenya shilling will stabilise and start to recover the losses incurred this far.

Secondly, the current levels are some of the highest levels we have seen in the recent past and we believe forms a good entry point. Such rates would also help one to lock in good forex gain.

Thirdly, the Kenyan banks are faced with tight liquidity and for this, they are paying a premium on the Kenya shillings deposit with our Kenya shillings deposit are now earning a minimum of 14.5%.

The increased volume, from the favourable exchange rates coupled with these good returns we believe makes these levels a good entry point.