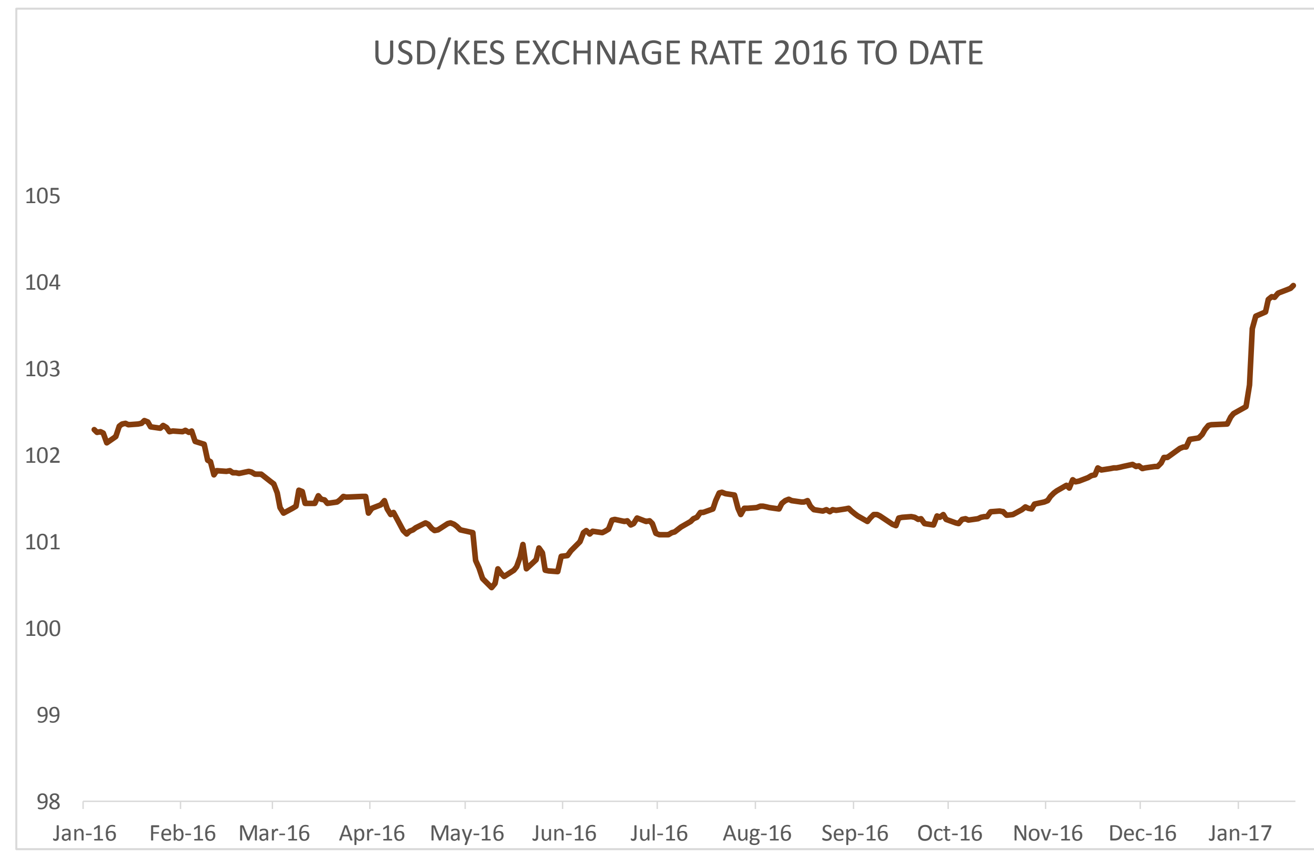
Diaspora Special Note

January 24, 2017

KENYA SHILLING Vs US DOLLAR OUTLOOK: 2017

The year 2016 was a relatively strong year for the Kenya Shilling, marking just a 0.1% depreciation against the Dollar. Indeed strong economic growth, hawkish monetary policy looking to intervene whenever downward pressure escalates on the Shilling, and low inflation that saw the Shilling appreciate by 1.2% against the Dollar in the first half of the year, the longest sustained period since 2007. This is in stark contrast to 2015 when the Shilling depreciated 10.5% against the Dollar. However, towards the end of 2016, driven by global Dollar strength due to the Federal Reserve rate hike, and subsequent heightened Dollar demand from anxious importers, the Shilling has depreciated against the Dollar, losing 1.4% since the beginning of the year to close at 103.8 as at January 20 (see chart).

Looking at 2017 and beyond, it is instructive to explore key factors at play.



GOING FORWARD

The performance of the Kenya Shilling against the Dollar in 2017 will be influenced by local and international factors outlined below

Import Bill

Our imports, specifically oil and infrastructure spending contribute to high demand for Dollars which puts pressure on the Shilling. For most part of 2016, oil prices were averaging below USD50 per barrel region. However, with the recent deal by the Organization of Petroleum Exporting Countries (OPEC) to cut global oil supply, we have seen oil prices spike higher to test the highs of 2016 in the USD55 per barrel price region. With volumes now building on both the weekly and monthly charts, we could see oil prices continue higher, to hit the USD60 per barrel in 2017, exerting further pressure on the Shilling .

There is also sustained government infrastructural spending as it races to fulfil its manifesto before the election. This coupled with the aggressive investments in the ever expanding real estate sector demanding massive importation of capital goods, further ramping up the greenback demand. The ongoing drought, we note, will not only create inflationary pressures, but may necessitate food imports thereby increasing strain on the Shilling.

Tourism, Agriculture, Diaspora Inflows

Tourism and Agriculture are major sources of Dollar inflows in Kenya. Last year, tourism numbers grew by over 15% compared to the same period in 2015, lifting our FOREX reserves. 2017 being an election year, we are likely to witness flat or declining numbers caused by the uncertainities associated with elections. However, this decline of Dollar inflows may be offset by increase in diaspora remittances set to hit USD2Bn in 2017 as well as tea and coffee sales inflows with their prices having kicked off 2017 on high note. This is reflective of the high pricing in the world market. However, we note that the prevailing drought may reduce output thereby dampening our hopes of receiving more than the USD850Mn inflows of 2016

Forex Reserves

The Central usually supports the Shilling using its foreign reserves. In the recent weeks, we have seen the forex reserves reduce from a high of USD7.8Bn in October 2016, equivalent to 5.2 months imports cover, to USD6.97Bn at the end of December.

This is the first time they have fallen below USD7Bn since January 2016, partly signifying the level of support extended to the Shilling in the last two months. Even though the nation can rely on a USD1.5Bn precautionary fund with the IMF, we foresee that the CBK Governor may be reluctant to access it, meaning that the gradual decline of the reserves will significantly impede the Central Bank ability to intervene in support of the Shilling. Putting it mildly,there is no sufficient muscle for the CBK to keep on strongly intervening in the market.

Servicing Debts

According to the International Monetary Fund report of 2016, the country's rapid rise of its borrowings has pushed the Kenyan debt to Ksh3.2Tn, out of which 40% is foreign denominated. As the Dollar strengthens we expect considerable pressure on the Shilling, as we service these international obligations.

US Economy

During former President Obama's tenure, the US economy recovered with the Dollar gradually gaining strength. This is underlined by the recent data showing strong consumer spending and a solid labour market. No wonder, for the second time in a decade, the Federal Reserve raised rates by 0.25% and further promised three more hikes in 2017 if the growth happens too quickly, making the Dollar attract significant global inflows.

Then comes President Trump. Even though it will not be right to speculate on Trumps' economic strategy without more detail, the feel of global community of analysts is that whatever the President weakness, the pro-business attitude of his administration, combined with the Republican control of Congress, will lead to a new era of support for business, along with much lower taxes and regulatory burdens. This in turn will set a virtuous cycle of economic growth, meaning more rates hikes thereby a strong Dollar, which will put on pressure overseas profits expatriation and enfeeble the already weak global economy further.

OUTLOOK AND RECOMMENDATION

In the highly uncertain short term period, we see a stable to a mildly and gently depreciating Kenyan Shilling from the current region of Kshs103/USD. This is due to the rising import bill, occasioned by sustained infrastructure spending and elevated oil prices coupled with likely reduction in tourism and Foreign Direct Investments in a competitive electioneering year, and inflationary pressures brought about by the biting drought. Even though expecting a little bruising on the Kenya Shilling, it may perhaps be less and less forceful from the Trump bump. However, the Shilling will find solace from the increasing diaspora remittances, improved tea and coffee inflows, and a cautious intervention by the Central Bank to smoothen the Shilling from the weakening spikes. In the long run, we believe the potential for a significant strengthening Shilling against the Dollar is slim, as the greenback surges, not only against the Kenya Shilling, but also against other major global currencies

Having said that, the biggest lesson of 2016, and which should be carried in 2017 is that there is no safety in keeping safe; that there is no benefit of trying to stay 'even' by sitting on the side-lines and not making any investments for fear of being on the wrong side of the Dollar.You will probably be going backwards on an after tax and inflation adjusted basis. Regardless of the Kenya Shilling direction in 2017, Kenya still offers attractive returns on physical assets e.g. Real Estate, and above average returns on the low valued Kenyan stocks, offering long time investors an opportunity to gain entry. Any exchange risk born out of being in the opposing side of the Dollar, will easily be offset by the competitive returns expected in these sectors in the medium term. Don't stay even…