



ICEA ASSET MANAGEMENT LIMITED
Providing investment solutions in East Africa and beyond

A SUBSIDIARY OF



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Investment *report*

ECONOMIC REVIEW

The much expected economic recovery in Q3 2009 appeared to be a mirage as extraneous shocks kept the economy in the doldrums. An aggravation of the weather conditions brought about serious food shortages, badly dented water supply and significantly reduced hydro power generation. This in turn increased overall cost of living and doing business, as the cost of most inputs went up. The government finances were also strained as importation of food resumed and emergency packages to ameliorate the impact of the drought on livestock farmers were put in place. The Monetary Policy Committee report after the September meeting best captured the effects of the drought on the economy, terming it “deleterious”. The committee continues to maintain an easy money stance to stimulate the economy.

Official statistics show that the economy grew by 2.1% in Q2 2009 after a revised 4.0% growth in the first quarter and a 2.2% growth in same quarter in 2008. The positive growth was on the back of a recovery in tourism, vibrancy in the construction sector and resilience in the transport and telecommunications sector. The hotels and restaurants sector grew by 24.2%; the construction sector grew by 10.7% while transport and telecommunications grew by 5.7%. Agriculture and utilities sectors shrank an estimated 5.0% while manufacturing shrank by 0.7%; pulling down the economy.

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Highlights

Economy grew by 2.1% in quarter two.

Positive growth

- Hotels & restaurant up by 24.2%.
- Construction sector up by 10.7%
- Transport & telecommunication grew by 5.7%

Negative growth

- Agricultures & utilities sector -5.0%.
- Manufacturing -0.7%

Outlook



The growth recorded in the second quarter of the year was encouraging. However, all the challenges foreseen came into full play in the third quarter. It is therefore highly likely that the overall economy shrank in the third quarter, with only a few sectors like construction showing growth.

The weather remains the largest single risk to the economy. With the economy being over-reliant on rain fed agriculture and hydro power sources, the vulnerability to weather patterns has strong linkages across sectors. The meteorological forecasters are warning of an impending el nino. This could have both positive and negative effects to the economy. On the positive side, this is likely to solve the energy, water and hope-

fully, food problems the country is currently experiencing. On the negative side, past experience has shown that heavy rains are devastating to our infrastructure. The country could therefore lose most of what has been done in rehabilitation of the road network in the last one year. Politics remains an ancillary concern but with the current pressure on the government to implement reforms before the next elections, there is likely to be more cohesion with the coalition government.

“Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man.” Ronald Regan, 1978

Highlights—Inflation

Headline inflation

Ended quarter at 17.9%.

Key inflation drivers;

- Food
- Energy

Underlying inflation

Fell to 3.2% .

Cause:

Slow down in money supply growth

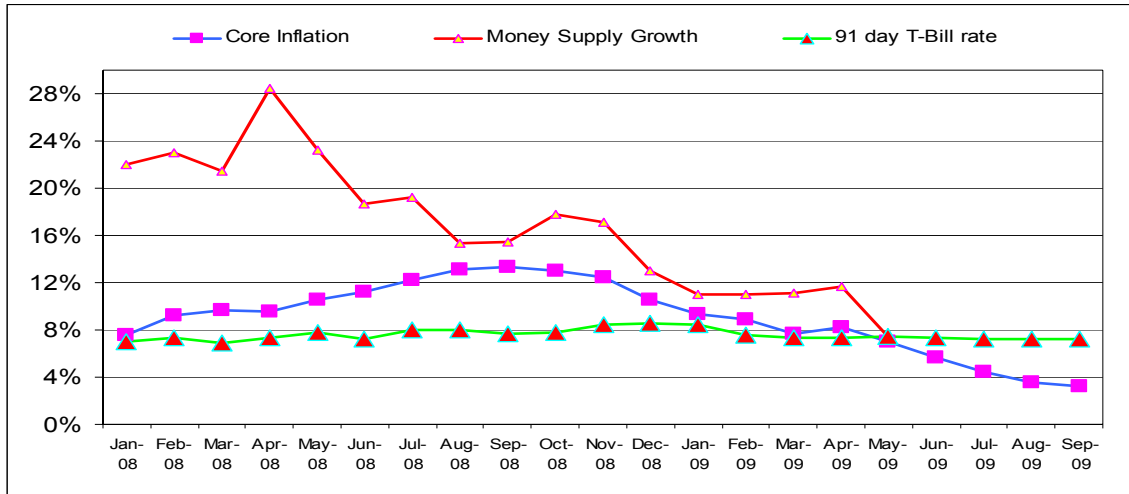


INFLATION

Overall headline inflation had shown strong signs of abating in the third quarter, mostly on base effects. However, it ended the quarter flat at 17.9% after rising to 18.4% in August. Food and energy costs remain the key inflation drivers. Underlying inflation fell from 7.0% in June to 3.2% in September. The steep decline in underlying inflation is as a result of significant slow down in money supply growth as banks keep off lending to the privates sector.

Outlook

Overall inflation is likely to remain high in the last quarter of the year due to a lag in the positive impact of the expected rains and high fuel pump prices. The inflationary pressures should ease thereafter as food supply improves and energy supply constraints come to an end.



INTEREST RATES

The Monetary Policy Committee and the Central Bank remain committed to keeping a low interest rates regime. The Central Bank Rate (CBR) was lowered further to 7.75% during the quarter, with the cash reserve ratio reduced to an all time low of 4.5%. These measures have helped to keep short term interest rates low. Over the quarter, Treasury bill rates were on a down-trend. The 91 day T-bill rate declined by 20 basis points to 7.3% while the 182-day rate decreased by 60 basis points to 8.1%. The graph below shows the interaction between interest rates, inflation and money supply.

Outlook

Competition for funds is gradually increasing. However, as long as banks are still unwilling to lend to the private sector, there will be ample liquidity playing in the government debt market. As such, interest rates are unlikely to move upwards until 2010. The new Treasury bill auctions rules are also likely positively impact on stability of rates.

Highlights

Interest rates

- Central Bank Rate (CBR) lowered to 7.75%.
- Cash ratio reduced to an all time low of 4.5%.
- The 91 day T-bill rate declined by 20% basis point to 7.3%
- The 182 day rate declined by 60 basis point to 8.1%.

Highlights

Bond Market

- The CBK introduced a 364-day T-Bill to be issued two months going forward.
- Over the counter planned for the security.
- Secondary market jumped to Kshs. 50.47 billion from Kshs. 45.28 billion in the second quarter.
- Shelter Afrique and KENGEN successfully raised debt in the market.
- Foreign investor increased uptake of local debt.



BOND MARKET

In Q3 2009, CBK has continued to issue and re-open benchmark bonds. All offerings received strong support especially from the banks, which have been shifting from perceived higher risk private sector lending to risk-free government securities. The bank also introduced a 364-day T-bill to be issued every two months going forward, in an effort to lengthen the money market yield curve. An over the counter market is also planned for this security.

Secondary market activity improved in the quarter with turnover jumping to Kshs. 50.47 billion from Kshs. 45.28 billion in the sec-

ond quarter. Most bonds that traded were the re-opened or newly issued bonds. Institutional and insurance companies focused on the long-end of the yield curve while banks were most active in short to medium tenor bonds.

The corporate bond market gained renewed activity with Shelter Afrique and KENGEN successfully raising debt in the market.

Foreign investors have also increased their uptake of our local debt instrument due to relatively high rates being offered.

Outlook

CBK has, from this month, adopted new auction rules for T-bills, which will be adopted later on for T-bonds. In the new rules, competitive bids above cut off may be accepted and allocated at the cut off rate. Once implemented, the rules will give the CBK greater flexibility in raising desired amount of debt without distorting the interest rates structure.

Plans are currently at an advanced stage to have connectivity between the CBK Central Depository System (CDS) for bonds and the NSE Automated Trading System in a bid to automate secondary trading of bonds. The CMA and CBK are also working on a framework for an over the counter (OTC) platform for Treasury bills. Once completed, these two initiatives will increase the liquidity and efficiency of the debt markets and boost activity in the market.

The government plans to issue Kshs. 32 billion in infrastructure bonds in the current fiscal year. A couple of other issuers among them Safaricom, TPS Serena and Centum have expressed interest in raising debt in the coming quarter. This will overall increase activity in the debt market. However, despite this increased demand for debt by the government and private companies, we don't envisage a major interest rate spike.

EQUITY MARKET

The market lost the upward momentum it had gathered towards the end of Q2 as it became apparent that earnings were under significant pressure in virtually all the sectors. Earnings reports from banks and a number of manufacturing companies confirmed difficult operating environments that are likely to crystallize significant shrinkage in earnings this year. There was therefore little enthusiasm among investors causing the market to decline. The NSE 20 Share Index lost 8.8% and the NSE All Share Index (NASI) was down 6.0%. The NSE index closed a touch off the now psychologically important 3,000 points mark. With the market having become cheaper on a Price to Earnings (P/E) multiple basis (average market P/E declined from 13.1X in June to 12.3X in September), foreign bargain hunters had a notable presence in the market accounting for an average of 69% of the market turnover in Q3. They were the largest support to the market. Local retail and institutional investors had little activity concentrated on the sell-side. The market lost 6.1% in shareholders' wealth to close at Kshs. 771.6 Billion.

Construction sector stocks emerged the highest gainers in Q3 as investors continued to hold positive views of those companies' performance, based on the strong activity in the sector. ICT companies had mixed fortunes despite the benefits expected from the uptake of the capacity of the landed fibre optic cables.

Highlights

Equity Market

- NSE 20 Share Index lost 8.8%
- NSE All Share Index (NASI) down 6.0%.
- NSE index closed 3,000 points mark.
- Foreign bargain hunters accounted for an average of 69% of market turnover in Q3.
- Market lost 6.1% in shareholders' wealth to close at 771.6 billion.
- Highest gainer sector: Construction.

In the stock market, heroes get crushed. Averaging down on losing position is a "heroic move". The stock market is not about blind courage. It is about finesse. Don't be a hero.

Outlook

There are three key challenges to the market:

Firstly, the poor economic performance with its attendant challenges to listed companies. Economic performance has declined to its lowest in the recent past and this is impacting companies negatively, especially those that had entered into aggressive expansion and growth phases. We do not foresee a quick return to robust economic growth.

Secondly, competition from the lower risk government debt market. The government has been borrowing aggressively to finance its stimulus budget. This has kept most large investors out of the equity market in favour of the lower risk debt instruments. The equation is unlikely to change in the near term.

Thirdly is the high level of shares, in several counters, overhanging the market that are held by retail investors, who are likely to sell into any strength. The increased level of participation by offshore investors is likely to increase volatility significantly. We therefore expect a weaker and more volatile market, at least over the next two quarters.





Highlights

Exchange Market

Local currency remained firm against the Dollar and the Sterling Pound.

- Against the Dollar up by 2%.
- Against the Euro up

Slipped against Euro and Japanese Yen.

- Against the Euro -2.2%
- Against the Yen -5.8%

Factors to determine direction of shilling;

1. External trade position like tourism.
2. Decreased economic activity and growth.
3. Movement in the basket of international currencies.



EXCHANGE RATES

The movement of the local currency unit during the quarter was mixed, firming up against the Dollar and the Pound Sterling, but slipping against the Euro and Japanese Yen. The Shilling gained 2% against the US Dollar, and edged up 4.4% relative to the Euro. The local currency unit however lost 2.2% against the Euro, and was down 5.8% against Yen.

As highlighted in our last quarterly report, the general position and direction of the Shilling would be largely underpinned by three main factors. Firstly, the rate of recovery of the external trade position of the country. The Shilling will

gain if tourism receipts and other inflows firmed up. The tourism sector has recovered from its lows and this is positively impacting on the shilling strength. Secondly, decreased economic activity and growth. Reduced economic activity has led to lower demand for imports and hence foreign exchange. Thirdly, movements in the basket of international currencies, particularly Dollar-specific movement in global currency markets.

Against regional currencies, the Kenya Shilling also had mixed trading, shedding 3% against the Tanzanian Shilling while inching up 4.5% against the Ugandan Shilling.

Outlook

We expect some downside ahead, particularly driven by a growing trade deficit. Importation of food and oil is likely to remain high over the next year. Tourism has improved significantly but the main source of Kenyan tourism (the EU region) is still undergoing significant shock effects from the global crisis. The persistent current account deficit casts doubt on the ability of the Shilling to hold its gains over the medium term.

Movements in international currencies, in particular the emerging unease in the global markets regarding long-term Dollar stability as a reserve currency. Some concerns have been raised by several key nations including China, Japan, France, Russia and Brazil as well as entities such as OPEC and the UN regarding the propensity for Dollar weakness in light of the rising debt levels in the US. This is already having an impact on the Shilling position.

We anticipate the Shilling demonstrate stability but with greater probability of a break into weakness.

OFFSHORE

Over the past several months, the international capital markets have experienced a strong rally, as well as some firming up of economic fundamentals within the wider economic front. With moderation in risk averseness taking root, a lot of money that had been sitting at the sidelines rushed back into the market, leading to large gains in asset prices both in developed markets as well as in high-liquidity developing markets such as the Asian markets. Global markets on aggregate rose 64% from their lows, with a lot of the liquidity released by various governments finding its way into the capital markets.

Major Central Banks continued with their stimulative macro policy approach geared towards supporting their domestic economies. The Chairman of the US Federal Reserve Ben Bernanke, who was re-appointed for a second 4-year term, declared late August that the recession was 'very likely over.'

At the same time news has not all been rosy. Some nations, such as Spain, fell further into a recession indicating that there were some real concerns. The world economy is still far from 'normal,' with a lot of the current state of growth stemming from sources that may not necessarily be sustainable. Tremendous levels of fiscal and monetary stimulus have managed to keep the system going, but the underlying problems hover. In the US, unemployment remains an issue, and in Asia manufacturing capacity is largely idle.

Outlook

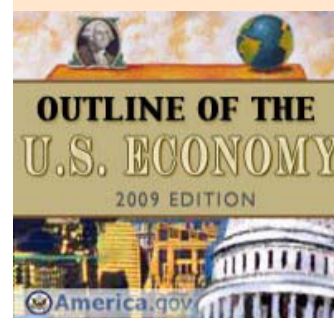
Looking beyond market noise and sentiment bias reveals that the global recovery is definitely underway, but that there are a number of very real downside risks that need to be put into consideration. Unemployment is on the rise, manufacturing is still subdued, there is still a shortfall of demand relative to supply, as well as an overhang of debt. The economic recovery has not trickled down to the population in terms of earnings increases or better jobs. Questions are being raised on the sustainability of the global stock market rallies, and whether they are being fueled by fundamentals or by the huge amounts of liquidity that are trying to get higher returns than those provided by risk-free assets. Indeed, many believe that might be in a 'W' shaped recovery, and warning that the Great Depression consisted of two separate recessions (one beginning in 1929 and ending in 1933, and the other beginning in 1937 and ending in 1938), and we could be having a similar recession.

All the same, through all the disparate noise we still remain aware that opportunities are available, and as such we are looking for 'deep-value' offshore opportunities whereby the prices of the assets are far below their intrinsic price. This way, we can be able to get some upside, while hopefully staying away from the very probable downsides that exist in the global markets.

Highlights

Offshore Markets

- Global markets on aggregate rose 64% from their lows.
- Spain fell further into a recession.
- World economy is still far from 'normal'.
- In Asia, manufacturing capacity is largely idle.
- In the US, unemployment remains a threat.



“... Professional traders actively take small losses. Amateurs resort to hope and sometimes prayer to save their trade. In life, hope is a powerful and positive thing. In executing a trade, hope is a virus that can infect and destroy.”

RECOMMENDED STRATEGY

Economic recovery appears to have been postponed and the current slow pace of growth could persist for much longer than initially thought. We are concerned about the rising cost of doing business and continuously falling demand. Investment markets remain tenuous. This calls for greater caution and risk averseness.

The stock market is improving in valuations for those who are not already invested. Current investors continue to lose value, a trend that we expect to persist. We are not enthusiastic to build positions as there is scope to gain better value in the future.

Fixed income markets have gained greater vibrancy lately and remain the mainstay for most institutional investors. The monetary authority is doing the best it can to keep rates stable. We see a lot of value in investing in the fixed income assets for the next quarter.

Offshore markets appear to be overvalued as part of the stimulus package funds patronise the markets. The global economy is showing signs of recovery but we are concerned that there could be another dip before a sustained growth. We recommend a cautious entry.

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