



On the Road to Recovery

Although the year is barely four months old, there are indications that investors might have reasons to smile after a prolonged spell of bad news. The tally from financial market and economic indicators point a system in a steady recovery.

The NSE index closed the quarter 26% stronger compared to a decline of 19% during the same time last year. On a year to year basis it rose by 45% compared to a drop of 42% during the same period last year. In the money market, all interest rates were on the decline with the 91 days and 182 days Treasury Bill tenors falling to 6.17% and 6.69%, compared to 7.77% and 8.63% last year.

The decline in interest rates resulted in an unprecedented rally in Treasury Bonds at the secondary market. Investors in search of attractive yields were willing to pay a hefty premium for Treasury bonds with double-digit coupon rates resulting in significant capital gains to their holders. The trend is likely to continue if short term interest rates continue to trend downwards. The signal to observe is a shift in monetary policy stance as revealed to the market through the Central Bank Rate (CBR). We do not expect the current expansionary stance of monetary policy to be reversed until there is clear evidence that the economy has sufficiently recovered.

Consumer prices were also on the decline after almost two years of pocket-draining double digit rates. Overall inflation settled at 4% in the year to March mainly due to an improvement in food production and easing of fuel prices. If the trend continues it will have the much desired effect of leaving more money in consumers' pockets for spending and saving.

Although the economy did not grow in the third quarter of last year, there are indications that a strong recovery may be taking place. Overall liquidity or broad money supply, which is an indicator of economic activity, increased by 21% in the first two months of this year compared to an 11% rise during the same time last year. The decline in inflation and interest rates is expected to act as a catalyst for a robust economic recovery in the months ahead.

Unfortunately, it may be too early to put on party hats and break out the bubbly given the clouds of uncertainty in the horizon. As always, politics presents one the main challenges to a favorable investment climate this year. Perhaps the event with the most impact is the referendum scheduled in July. A repeat of 2005 when the draft was rejected in its entirety would be catastrophic to investor confidence. We can only hope that the process will come to pass without any detrimental polarization of the country based on ideological differences.

The second factor that might dampen a sustained recovery is a sharp rise in the level of public debt.

Public debt is the government's total indebtedness to locals and foreigners, and currently amounts to kshs.1.16 trillion. The ratio of public debt to GDP is currently about 47% compared to 44% during the same period last year.

However, if the ratio continues to grow, and the bulk of new borrowing is used for recurrent expenditure, there might be undesirable effects on sustainability of repayments and credit availability to the private sector. Although there is no rule of thumb as far as the preferred ratio is concerned, evidence shows that the economy starts approaching the red zone once the ratio surpasses 60%. In Kenya's case, this translates to an incremental borrowing of about kshs.336 billion from current levels, which could easily be attained if the government runs substantial budget deficits in the next two years. The steady increase in domestic debt is mainly related to a shortfall in revenue collection arising from a weak economy.

In addition to increasing the burden to future generations, high public debt levels can only be reduced through expenditure cuts and/or tax increases, both of which are difficult to implement in a weak economy.

At the global level, high levels of sovereign debt imply a prolonged and sluggish economic recovery. Although there are fears of sovereign debt default, the fact that the increase in debt is attributed to massive economic stimulus to rescue their economies from the effects of the global financial crisis implies there is room for debt reduction once economic growth picks up.

Overall, we expect an improvement in corporate earnings and more vibrant activity at the stock market characterized by rising share prices and share offerings through rights issues and even IPOs; this process is likely to be supported by the high levels of liquidity in the market and the search for better returns in a low interest rate environment.

Also on the plus side, if the draft constitution is passed, we expect most of the reforms to push the limits of the economic frontier to new heights given some of the growth-inhibiting factors existing in the current constitution.

Although interest rates are on the decline, our money market fund still offers attractive prospects for short term funds. Finally, we would like to repeat our advice that investing in shares should always be taken as a medium to long term venture to avoid disappointment.

Vote like a patriot and God bless you.

	Q1 2010	Chg
Balanced Fund	3.10	13.7%
Pension Fund	9.36	17.3%
MMF Yield (Net)	8.76%	-
NSE Index	4,073.93	26.0%
Top 3 Stocks	Q1 2010	Chg
Eaagads	69.50	247.5%
Kakuzi	79.00	148.8%
Sasini	14.40	92.0%
Bottom 3 Stocks	Q1 2010	Chg
CFC-Stanbic	40.00	-14.0%
BOC	130.00	-12.8%
Marshalls	19.00	-12.6%
Selected Indicators	Mar 2010	
Econ. Growth Rate (Q3 '09)	0.0%	
Inflation Rate (Mar)	3.96%	
91 day T-Bill Rate (Mar)	5.74%	
182-day T-Bill Rate (Mar)	6.29%	
364-day T-Bill Rate (Feb)	7.38%	
Inter Bank Rate (Feb)	2.39%	
Avge Lending Rate (Feb)	14.98%	
Avge Savings Rate (Feb)	1.81%	