



Better Times Ahead But Caution Still Required

The first half of 2010 closed on a much brighter note in the financial market compared to last year. The NSE and NAS indices went up by 34% and 33%, respectively, compared to declines of 5% and 2% during the same period last year. However, the upward momentum of share prices was slower compared to the first five months where year on year gains for the NSE and NAS indices were 49% and 55%, respectively.

Unfortunately, the situation was not pleasant in international markets where almost all major markets were in decline. The Morgan Stanley Capital International (MSCI) World and MSCI Emerging Markets indices declined by 11% and 10%, respectively. The downward trend is attributed to renewed fears about threats to global economic recovery due to sovereign debt risk in selected European Union member countries. The injection of close to \$1 trillion by the EU did little to ease the anxiety of investors but the unveiling of extensive austerity programs later on seemed to provide some confidence about the sustainability of debt repayments.

One of the direct impacts of the sovereign debt crisis to the Kenyan economy was the strengthening of the Shilling against the Euro, which is likely to dampen demand for exports and export earnings, especially of horticultural produce. The trend was due to a flight to the US Dollar which is currently perceived to be a low risk currency compared to the Euro. It is worrying to note that about 20% of Kenya's exports are to the UK, Netherlands and Germany. Austerity measures are likely to dampen demand for Kenya's horticultural produce and possibly also lead to a decline in tourists arriving from the region.

Despite the doomsday analyses regarding the high budget deficits and public debts of the EU members, we do not expect a disintegration of the EU or the Euro as the zone's single currency. Critics of the austerity measures contend that it might be too soon to cut down on the heavy government spending intended to stimulate the recovery of the world's largest economic bloc. However, the extremely high levels of budget deficits and public debt pose an even greater threat to the region's long term economic prospects in terms of erosion of confidence in the area's government debt instruments and financial markets, and prolonged periods of slow growth and high unemployment. Heavy government spending in an environment of weak consumer demand is a catalyst for runaway inflation. However, the fact that interest rates in the area are still very low provides ample room for increased investment and production to drive forward the region's economy.

Perhaps the market jitters and waning investment confidence about the strength and stability of the EU economy is because, other than during the two world wars, there is no other peacetime period when governments have had to run such massive budget deficits. If it is seen as a natural progression after the bail-out of corporations during the global financial crisis then it appears a normal outcome as opposed to another major crisis in the making.

Meanwhile back home, the money market is still awash with liquidity which has plunged yields on government paper to levels last seen in early 2004. Consequently, bond prices have risen significantly resulting in very attractive capital gains that have won the hearts of most investors over equities. However, we expect share prices to rally after the referendum as investors search for higher returns relative to the current low money market yields; for starters, quite a number of shares are currently trading at dividend yields much higher than Treasury bills rates.

Apart from political uncertainty related to the referendum, other possible threats to growth include a possibility of drought arising from La Nina, which tends to follow the rain-heavy El Nino phenomenon. Given the country's dependency on rainfall, especially for food production and energy generation, there is a high likelihood of higher inflation in the months ahead if weather conditions deteriorate. Rising prices will compel holders of fixed income securities to demand higher yields, unless the current levels of unprecedented high liquidity continue, interest rates on Government securities could reverse direction by early next year.

The most effective safeguard against internal and external shocks to the economy might be the speedy and efficient utilization of funds allocated for development expenditure in the budget. The government allocated kshs.321 billion for development expenditure, which also included kshs.22 billion for the second phase of the Economic Stimulus Program (ESP). Additionally, the Finance Minister tasked permanent secretaries to ensure that at least 90% of the funds are disbursed and utilized as planned. If this goes according to plan then there is a high likelihood of a surge in demand following increased economic activity. Outside the development expenditure, the economy might not be able absorb other shocks so soon after the last triple shock of post election violence, drought and the global financial crisis.

Finally, the fact that companies are turning to the equity market to raise funds for growth and expansion through rights issues is a good sign about business confidence and growth. If the threats previously highlighted shall not come to pass then the equities market might be on the verge of an extended bull run. On a selective basis, we still consider the equity market favorable for those with medium term horizons especially given the possibility of a prolonged environment of low interest rates. However, there is still need for cautious optimism given the clouds of uncertainty still looming. Those with short term horizons should try out the Zimele Savings Plan, which is currently offering very competitive yields on very flexible and convenient terms (see adjacent table).

Save and invest wisely and God bless you.

	H1 2010	Chg
Balanced Fund	3.53	16.0%
Pension Fund	10.17	10.3%
MMF Yield	8.5%	-
NSE Index	4,339.28	6.5%

Top 3 Stocks	H1 2010	Chg
CFC-Stanbic	74.00	85%
Equity Bank	24.00	52%
Co-op Bank	15.00	50%

Bottom 3 Stocks	H1 2010	Chg
NBK	39.50	-31%
Eaagads	52.00	-25%
Express	8.95	-22%

Selected Indicators	Jun 2010
Econ. Growth Rate (Q1 '10)	4.4%
Inflation Rate (June)	3.18%
91 day T-Bill Rate (July)	1.801%
182-day T-Bill Rate (June)	2.450%
364-day T-Bill Rate (June)	4.199%
Inter Bank Rate (July)	1.169%
Avg Lending Rate (May)	14.46%
Avg Savings Rate (May)	1.76%