Economic Outlook 2020

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Global Economy: Stable but fragile - Is this the era of "*secular stagnation*"?

Trade tensions, geopolitical uncertainty and a manufacturing downturn disrupted global economic growth in 2019, resulting in the slowest expansion since the financial crisis of 2008/2009.

The brakes on growth were synchronized across both developed and emerging markets albeit with disparities across the economies. To offset the impact of the above headwinds, central banks eased financial conditions further to help stimulate demand.

Into 2020, lagged effects of the synchronous central banks' response of 2019 coupled with improved risk sentiment following the signing of a "Phase One" of the multi-pronged US-China trade deal could help stabilize growth.

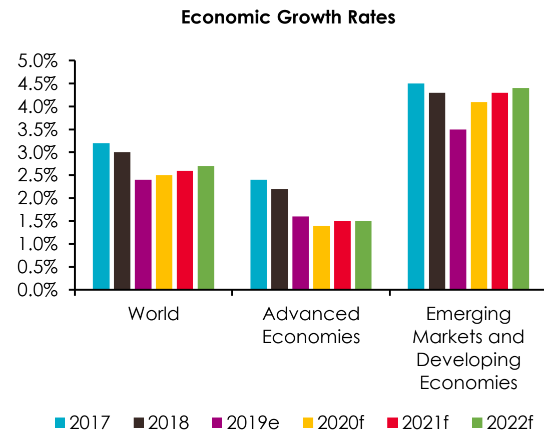
However, risks remain inclined to the downside. Fragile demand, heightened geopolitical uncertainty, persistent anti-globalization currents and climate change will continue to cloud growth outlook in 2020 and beyond. Further, the Corona virus pandemic, completely unforeseen, now threatens to exacerbate the negative outlook.

As uncertainty weighs on private investments and spending, and policies test the limits of conventional wisdom, global growth will remain weak, in spite of benign financial conditions.

2019 Recap:

Broad-based slowdown led by Emerging Markets

The World Bank estimates that global growth softened to 2.5% in 2019, the slowest pace in 10 years. The slack was broad-based as fixed investments weakened in the face of tariffs fights between the US and China. Weak business confidence offset the impact of benign financial conditions.



Source: World Bank, NCBA Research

Developed markets, led by the US took over the cyclical leadership of global growth as external headwinds, trade uncertainty and idiosyncratic domestic strains dampened expansion in emerging markets. Across all regions growth dispersion remained evident.

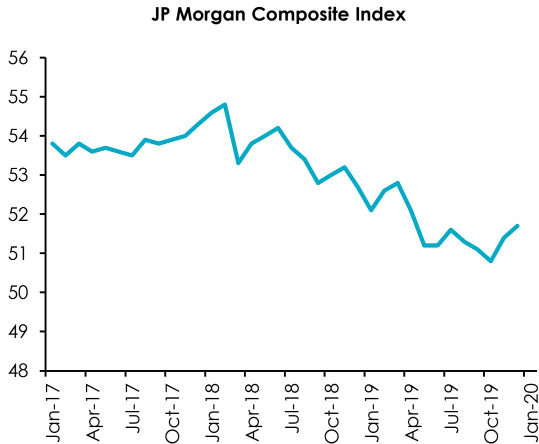
Trade uncertainty was the principal risk to growth…

In the year, the US scaled up its use of trade barriers to enforce its foreign policy agenda. The US slapped tariffs on nearly US$ 560Bn worth of Chinese goods. Threats of escalation and the inherent uncertainty dealt a blow to investor sentiment and confidence.

However, the uncertainty ebbed somewhat later in the year with the signing of Phase One US-China trade deal that averted further escalation and dialed back tariffs on China. The approval of the new NAFTA deal also bolstered optimism on the trade front.

Consumers offset impact of factory activity slump on growth…

Haunted by disruptions to global supply chains from protectionist trade barriers, the manufacturing sector eased into a recession in 2019.



Source: Bloomberg, NCBA Research

While the sector has shown nascent signs of recovery it remains vulnerable to the additional tariffs in place and the fragility in global demand.

On a brighter note, services remained upbeat thanks to easier financial conditions and tighter labour markets. Despite slower growth, unemployment rates remained low across developed economies.

However, persistent vagaries in manufacturing could spill over to services, dampening demand. Employment in factories revealed some vulnerability notably in China and Europe particularly Germany, as slowdown in trade volumes hurt new investments.

Politics and policy…

Geopolitical uncertainty remains one of the principal threats to global growth today. As international order is restructured and global trends converge, governments may face increased tensions both local and foreign. Citizens will continue to question their relationship with governments especially in countries where economic conditions are deteriorating.

Investors will continue to watch the US elections, US-Iran developments, the protests in Hong Kong and potential for unexpected political changes especially in Europe.

Protectionist undertones have continued to gain prominence with the proliferation of far-right tendencies posing an existential threat to the European Union. Emerging markets also saw increased political unrest hurting investments and growth.

Brexit, UK economy and the European Union

Dogged by Brexit induced uncertainty, the British economy eased into a lower gear. GDP is estimated to have expanded by 2.0%, the slowest pace in 5-years. The push and pull between the UK government as well as parliament and the EU, generated a deep cloud of political and economic uncertainty dampening sentiment, confidence and investments.

On a brighter note, the general election in December paved way for Brexit at the end of January. With a strong majority, the government secured UK parliament's approval for the Brexit deal passed and should officially exit the block upon EU parliament's ratification.

However, the process of re-negotiating a trade accord with the EU during the one-year transaction period promises a fair share of volatility in 2020. Failure to secure a deal will expose businesses to World Trade Organization (WTO) terms, which may be relatively punitive.

Synchronized response by central banks bolstered sentiment…

To sustain the decade long expansion, central banks world over unleashed some of the most aggressive stimuli since the financial crisis of 2009. This was despite doubts on policy efficacy in some countries and evident depletion of tools available to the regulators.

The Fed cut its policy rate by 75bps in the year. Across the Atlantic, the ECB dropped its deposit rate by 10bps and restarted its bond purchase program to inject more liquidity in the market. In addition to cutting the reserve rates, China increased its fiscal spending to cushion the economy after growth fell to a two-decade low on the back of domestic imbalances and increased external shocks.

The action by the major central banks provided a breather for emerging markets allowing them more policy maneuverability. Inflation remained low and exchange rates relatively stable or stronger.

But central banks are increasingly under attack!

Since the unorthodox policy response to the financial crisis, the public has come to expect more from central banks - sometimes beyond their mandate and merit. While economic growth is not their primary dictate, markets have continued to expect central banks to drive strong economic growth.

This has emboldened attacks on the monetary authorities despite their waning credibility in stimulating growth. The attacks have been more aggressive in countries with pronounced populist backlash.

The US President Donald Trump has been most pronounced, branding the Federal Reserve (Fed) "naive boneheads" for not cutting interest rates as fast as he wished. Turkey, India, South Africa have also seen increased turnover at their central banks due to pressure to align monetary policy to the government's growth agenda.

Despite the increased attack on central banks' independence, the regulators will keep their limited tool kits open, ready to wade further into the unchartered policy waters should economic conditions weaken further. Inflation remains low providing a credible base for further easing.

The year ahead - Key themes that will define the global economy in 2020

Will growth stabilize?

Recession indicators dimmed towards the end of 2019 following central banks' pivotal dovish shift which caused the US yield curve to steepen. Risk sentiment were further lifted by progress in the US-China trade talks, diminished Brexit uncertainty and signs of a nascent recovery in Manufacturing.

The World Bank estimates that growth will stabilize at 2.5% in 2020. This will be underpinned by recovery in emerging markets which will offset the slack in developed economies.

Emerging markets will benefit from a combination of easier monetary conditions as well as fiscal catalysis.

Countries with high participation in global supply chain could see stronger growth as trade sentiment recover.

However, in view of lurking geopolitical risks and persistent nationalistic tendencies that have frustrated policy making and countries' response to shocks, growth may remain just about the same level as 2019.

Climate change and other epidemics notably the Coronavirus outbreak may hurt recovery. Moreover, late cycle imbalances including higher government debt, negative interest rates and highly valued assets may undermine the rebound in growth.

Even then, the trade-screen will remain smoky…

The US and China agreed to a tariff cease fire and dialed back some of the existing tariffs in "Phase One" of the anticipated multi-pronged deal.

While this coupled with the new NAFTA deal has helped restore some confidence that could bolster a mild recovery in capex, risks of extending the tariff war to other regions or a reescalation remain.

Any interference in China in line with the US' Hong Kong Human Right & Democracy Act, viewed by China as interference in its sovereign internal affairs, may derail any meaningful resolution to the trade tiffs beyond phase one.

While an escalation, as that witnessed in 2019, may be unlikely, given that the bulk of Chinese imports are already heavily taxed, the US may still use non-trade barriers similar to the Huawei approach to drive its foreign policy agenda. This may restrict investment flows and capex in some countries.

Moreover, there is a real risk of an extension of the tariff wars beyond China to the EU and other emerging markets. Trump has already cautioned the EU that should they fail to strike a trade deal before the November elections, they risk being slapped by new tariffs.

Elections 2020 – US elections/febrile politics will be most consequential

The global political landscape continues to be upended by the rise in populism. Besides hard rhetoric against other countries, politicians are framing politics as a battle between the will of ordinary people and corrupt sell-serving elites.

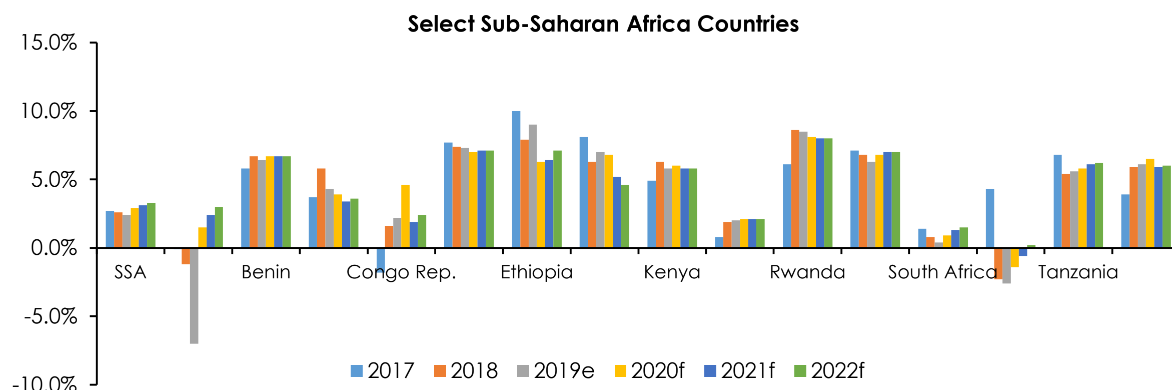
Politics will therefore remain a potential tipping point for economies in 2020. Governments will continue to fight for their political legitimacy, as discontent rises on the back of deteriorating living conditions especially in emerging markets. This will inform voters behavior in 2020.

Meanwhile, political polarization between democrats and republicans in the US has deepened further in recent months and will escalate ahead of November elections. Risks of political paralysis remains high given the divisions between the Democrat controlled House of Representative and the Republican dominated Congress.

All said, the election will be the most consequential for markets given the profound way that President Trump has upset global order through his America First leadership approach. A win may sustain status quo, upholding the immense uncertainty. His loss will also be material. For his successor, repairing the damage caused by his actions will be difficult. Restoring the global order, we once knew, anchored on globalization may be impossible.

That said, the ongoing impeachment trial will be a test to US institutions and the outcome may influence the US' voice as a global leader. While a Senate acquittal for Donald Trump is now fait accompli, the debris of febrile politics the impeachment process leaves behind will reverberate all through to November.

External headwinds coupled with domestic structural strains will undermine recovery in Sub-Saharan Africa



Source: World Bank, NCBA Research

A harsh and volatile external environment has made it increasingly difficult for countries in SSA to strike the policy mix that will restore growth to the glory years of the 2000's.

The effects of the commodity rout of 2016 that set the SSA economy in a downward spiral, pre-maturely halting the "African Rising" narrative are still evident. The World Bank estimates that growth slowed further to 2.4% in 2019 from 2.6% a year earlier.

Like most regions, growth in Sub-Saharan Africa has been uneven. Whereas growth in the big commodity dependent economies of Nigeria, South Africa, Angola have remained fragile, non-resource dependent economies have continued to report steady and upbeat expansion rates.

Whereas growth is projected to only rise to about 3.3%, expansion in about 20 economies in the region is projected to top 5.5% mostly driven by the sound domestic consumer base.

Meanwhile a lower base in the major economies may help them shift into a slightly faster gear, but still significantly lower than the historical averages.

Despite opportunities from favorable demographics and vast amounts of underexploited resources, risks from the external environment, political and regulatory uncertainty and poorly managed debt in some countries will weaken the green shoots restraining growth below the region's potential.

Monetary policy to take over as fiscal constraints rise

While demand is fragile, fiscal policy remains constrained either by low government revenues especially in commodity reliant markets or high debt in some economies following the debt driven infrastructure development binge of yesteryears.

The high deficits in the East African region are almost reaching unsustainable levels and may necessitate fiscal consolidation in the near to medium term.

Therefore, like in developed markets, monetary policy will be critical in driving demand. Further accommodation will be enabled by low inflation and fairly stable exchange rates, thanks to reduced capital flight from the region.

Even then, susceptibility to vagaries of weather heralds some upward risk to inflation. Any further evidence of global slack may provide increased headroom for monetary accommodation. However, its efficiency will depend on the coordination with the fiscal side which is critical for business confidence.

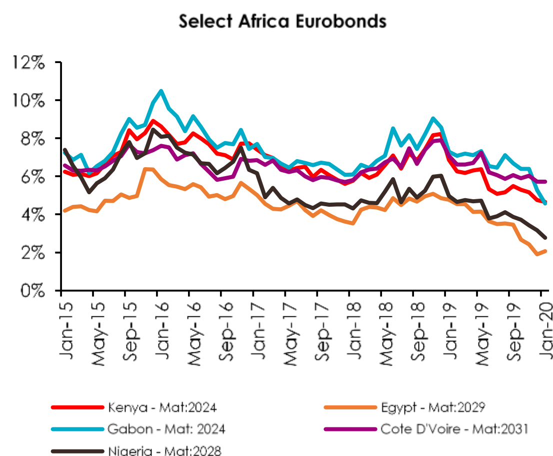
Payment of arrears to complement central bank easing in bolstering demand and investments

The IMF estimates that arrears have accumulated to 3.3% of GDP in SSA with pervasive effects on the economies (reduced fiscal multiplier). The deliberate focus on settlement of arrears across the regions may help bolster liquidity in businesses with potential to support demand. Kenya, Uganda and Tanzania have expressly communicated intention to reduce the arrears.

Weakening debt metrics may sustain hefty premiums on some sovereigns

A range of political, structural and economic risks have weakened fiscal metrics of some SSA countries. Risk scores for several African countries have deteriorated somewhat in recent months.

This may hurt capital raising for some countries although investors will continue to cherry-pick which sovereign exposure they take on.



Source: Bloomberg, NCBA Research

Kenya: Growing amidst rising imbalance

Key Themes and Events 2019

Summary

- ✓ Kenya's economic growth remained close to its potential in 2019. GDP is estimated to have expanded by a healthy 5.7%, albeit slower than the remarkable 6.3% expansion of 2018.
- ✓ Growth was underpinned by sturdy government spending, estimated at an average of 26% of GDP over the last five years, favorable weather in the latter half of the year, service sector resilience and a healthier external sector.
- ✓ However, this was against a backdrop of a growing "show me the growth" narrative and increased public angst over the country's management of public finances. Business confidence was fragile, credit markets tight and the external environment threatening.
- ✓ Given the potential destabilizing effect of high debt with increased concentration of external borrowing, public finance management will remain perhaps the biggest concern for investors and consumers into 2020.
- ✓ The tradeoffs of ensuring robust demand with the Big Four as the guiding policy framework and the need to ensure deficit and public debt sustainability, on a backdrop of rising political tensions, will make for a difficult policy landscape.
- ✓ All said, the economy has potential to sustain the near potential growth in 2020. We expect that GDP expansion will stabilize at 5.7% in 2020.
- ✓ However, this assumes that the government will successfully manage risks posed by record high debt levels, lethargic private sector activity and emerging political uncertainty.
- ✓ With a narrowing fiscal space, monetary policy may continue to anchor growth. The central bank has considerable room to further ease financial conditions although doubts on immediate impact continue to linger.
- ✓ Volatility may return to markets. A combination of emerging fiscal imbalances, the inevitable adjustments and the repeal of interest rates may set the base for some yo-yoing in asset prices. Even then, this will vary across asset classes.

The difficult trade-off between fiscal rebalancing and catalyzing demand

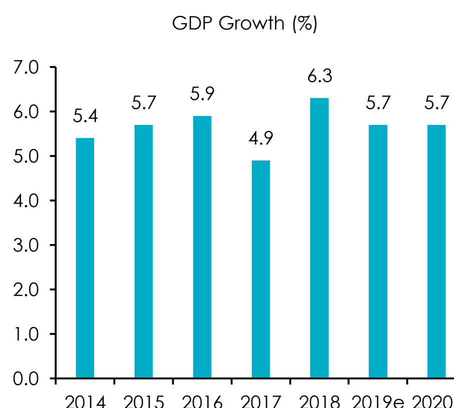
It's been argued that the Kenya shilling which is a mirror of the economy is a safe haven. This assertion has been predicated on the countries continued defiance of traditional economics. To be sure, in 2019, the economy delivered strong growth, a stable exchange rate and low interest rates, while keeping its current account open, almost in defiance of the Mundell Fleming's theory of "impossible Trinity".

Despite some loss of control on monetary policy and a high fiscal deficit, volatility, inflation and interest rates remained low throughout the year. Yet, with growing imbalances, it remains unclear whether this unusual economic out-turn reflects sound macroeconomic policy underpinning, sheer luck or a confluence of both.

However, as some of the externalities that may have underpinned this unorthodox stance wanes, 2020 should provide a good basis for testing the 'haven hypothesis', with scope for increased volatility.

Economic growth moderated in 2019 but remained above the historical and Sub-Saharan Africa average

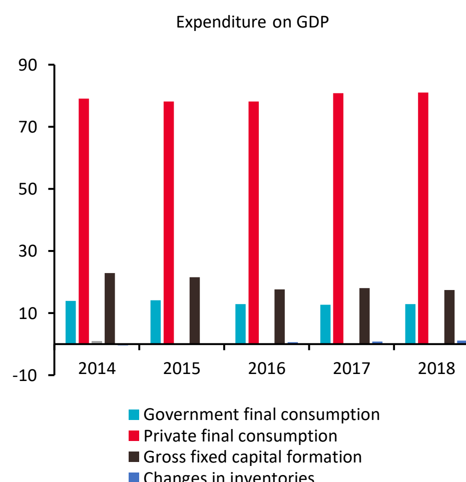
Economic growth moderated in 2019 but remained close to its estimated potential of 6.0% in 2019. GDP is projected to have expanded by a healthy 5.7%, albeit slower than the remarkable 6.3% expansion of 2018.



Source: KNBS, NCBA Research

The expansion was on the back of sturdy government spending, estimated at 26% of GDP over the last five years, favorable weather in the latter half of the year, service sector resilience and a healthier external sector.

That said, the biggest upside to the economy has been its solid consumer base. Private consumption accounted for about 80% of GDP in 2018.

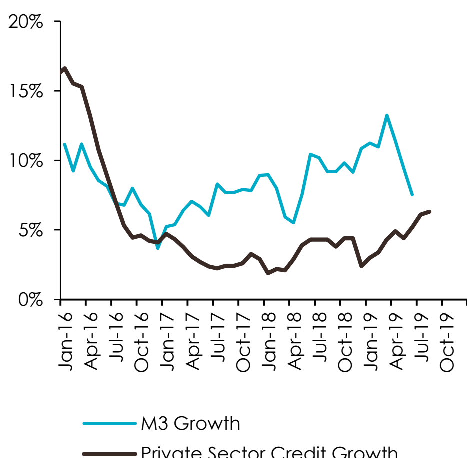


Source: KNBS, NCBA Research

While this may have remained solid given the broad-based slowdown in growth, we believe that growth in absolute terms slowed in 2019. Persistent slack in credit markets, fragile investor sentiment and weak incomes/demand may have hurt private consumption and investments.

Tight financial conditions contributed to the broad-based slowdown

Growth was slow across nearly all sectors as demand waned. In addition to the effects of slower government spending, financial conditions remained tight. Growth in monetary aggregates notably M3 slowed and private sector lending stagnated. The impact may have been compounded by the demonetization exercise that reduced money in circulation by 17% in the year.



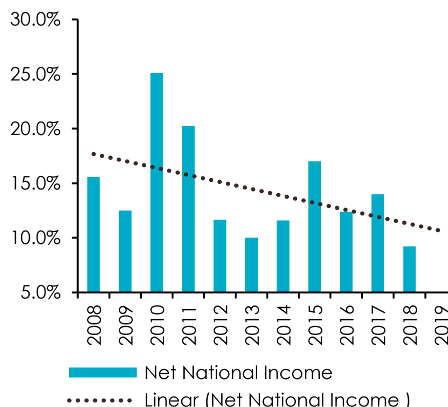
Source: CBK, NCBA Research

Credit growth averaged 5.0% in the year, undermined by fragile intermediation channels and the crowding out effects of a persistently high fiscal deficit.

Headlines were positive but sentiment fragile – The growth Vs Income paradox?

Whereas growth remained decently above the global and regional average, a "show me the growth" narrative continued to gain momentum. Business earnings weakened further and personal incomes slackened, with increased search for efficiencies as well as lower earnings from businesses. Where is the gap?

Growth in National Income



Source: National Treasury, NCBA Research

Whereas public spending has increased, national income has been decelerating. This may be a result of increased public spending inefficiencies or greater mismatch between investments and returns on projects in the last decade.

The outlook is healthy but downside risks have increased

Amidst increased global growth uncertainty, geopolitical risks and climate change, Kenya's near term growth prospects remain promising. In 2020, GDP is expected to remain buoyant expanding by 5.7%.

This will be supported by improved agricultural output which have positive knock on effect on manufacturing as well as consumer incomes. Tourism, FDIs and the external sectors are also projected to remain healthy. Despite consolidation plans, we believe that the projected spend of 23% of GDP should still support solid growth.

The focus on the Big Four Agenda should have a greater fiscal multiplier to the economy.

The Big Four Agenda framework will continue to shape the policy environment

Undoubtedly, aspects of policy making environment will remain tricky given the difficult balance between stimulating demand and correcting the current fiscal imbalances. Even then, the Big Four Agenda will continue to drive public policy in the next two years.

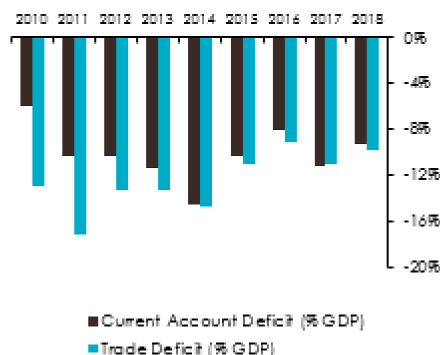
The government will scale up spending on the four pillars beyond the estimated KES 450Bn in 2019/20 as it expands the programs beyond the pilot phase.

This may be a considerable stimulant to growth given the savings on health care, business savings from a better tax and competitive regimes, cheaper homes and low inflation due to enhanced food supply.

Risks are increasingly tilted to the downside

However, with emerging structural imbalances, growth may be less impressive than in recent years. Public debt has risen; debt service is diverting funds from public welfare programs and macroeconomic vulnerabilities have increased. Monetary policy efficacy in stimulating demand has also waned.

On a brighter note, the external position has rebalanced favorably. However, this reflects diminishing international trade which may be unhealthy in the longer term.



Source: National Treasury, NCBA Research

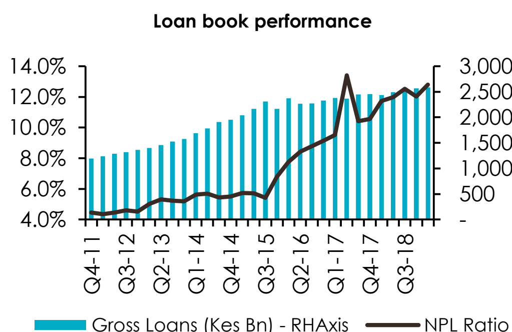
This reflects reduced spend on infrastructure as well as capex by the private sector due to tighter macroeconomic conditions.

Repeal of interest rate cap offers some hope but recovery will be slow

The government has taken a raft of measures to offset the impact of fiscal consolidation on private investments and consumption.

After persistent lethargy in credit markets, the government successfully made a case for the repeal of the interest rate cap in October last year. The attribution of the cap to the credit market's stupor was legit although the impact of a high fiscal deficit was equally significant.

This combined with several other initiatives by commercial banks in launching innovative, tailor made products for riskier borrowers may help restore access to credit. However, recovery will be slow.



Source: CBK, NCBA Research

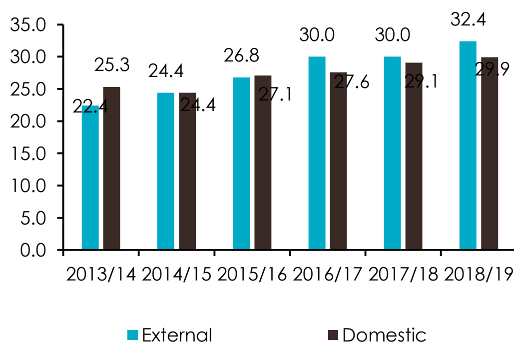
While demand is undoubtedly solid, supply side constraints remain. Certainly the removal of the cap on credit pricing may improve bank's risk appetite at the "right" cost. However, credit risk concerns remain. Following the business lethargy of 2018 and 2019, corporate balance sheets have weakened, personal incomes have stagnated if not slowed and general demand remains fragile.

On individual lending portfolios, prospects of customer overleverage due to proliferation of mobile lending apps may invite caution among lenders due to increased risk of poor asset quality.

On a positive note, the ongoing payment of pending bills may inject some liquidity into businesses with positive spill-over effects to commercial bank balance sheets, reducing NPLs.

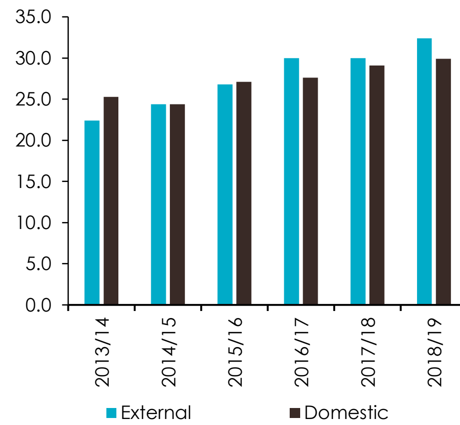
Economic deleveraging – the costs and tradeoffs

Public debt concerns have continued to dominate headlines as investors wary of their destabilizing effects. Debt to GDP ratio surged to more than 60% from 49% in 2014 reflecting persistently high deficit.



Source: National Treasury, NCBA Research

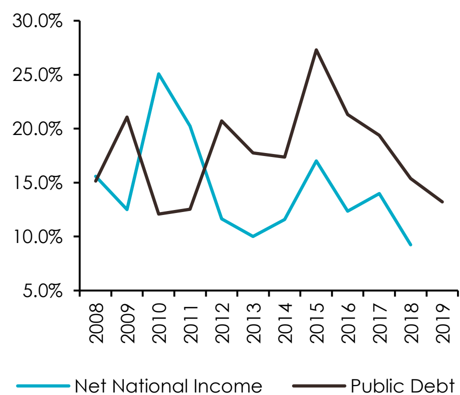
Over the last decade, growth in debt has outpaced the growth in national income. To reduce the resultant debt burden and the economy's vulnerability to shocks, 'economic deleveraging' is inevitable.



Source: National Treasury, NCBA Research

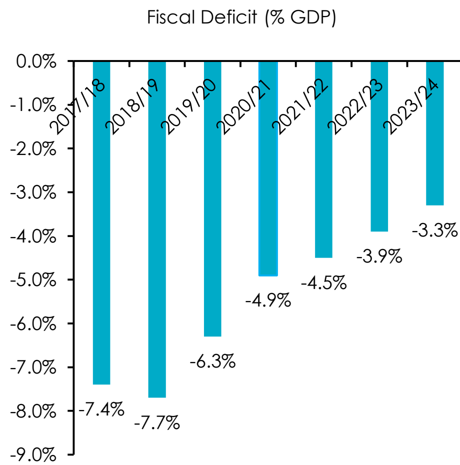
Reducing debt levels while maintaining growth and stability will require some delicate and potentially painful policy balancing. A sustainable equilibrium may require a combination of growing incomes, public expenditure rationalization, declining debt levels and robust economic growth.

Growth in National Income Verses Debt



Source: National Treasury, NCBA Research

The government has outlined a clear consolidation path that envisions a 3.3% budget deficit by FY2023/24.



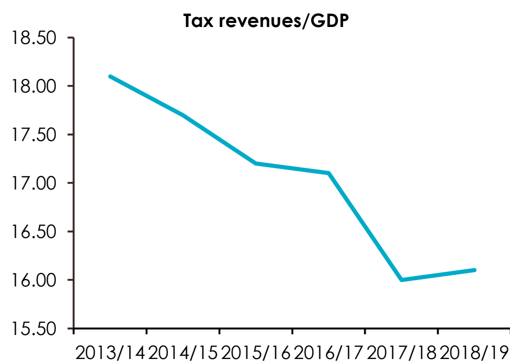
Source: National Treasury, NCBA Research

However, the administration is reluctant in making material adjustments to the recurrent budget notably the public wage bill and/or substantially increasing the tax base. T

Delaying the pain amid limited scope for spending cuts?

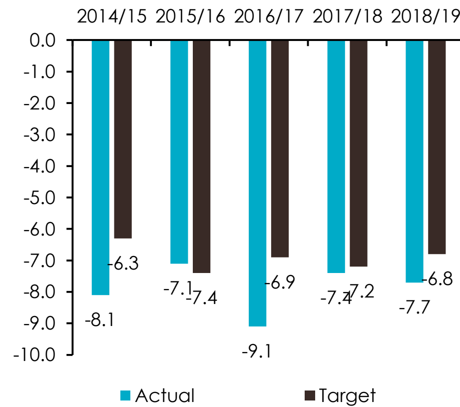
As showed above, growth in public debt has continually outpaced the growth in national income increasing the debt burden.

However, the pains of spending cuts at a time when business confidence is fragile and individual incomes weak may slow economic activity in the short term potentially proving self-defeating.



Source: National Treasury, NCBA Research

The government may stretch the strain by increasing taxes for the wealthy to help redistribute wealth. However, the chances of having it passed through parliament are considerably slim especially on the backdrop of a deeply polarized ruling party.



Source: National Treasury, NCBA Research

Politics over prudence? – The pains and tradeoffs of economic deleveraging

The political question of fiscal consolidation is hardly easy given the unpopularity of spending cuts and tax hikes. While the administration has demonstrated willingness to rebalance public finances and keep debt on a sustainable path, reducing deficits on the back of weak revenues and spending pressures will be difficult.

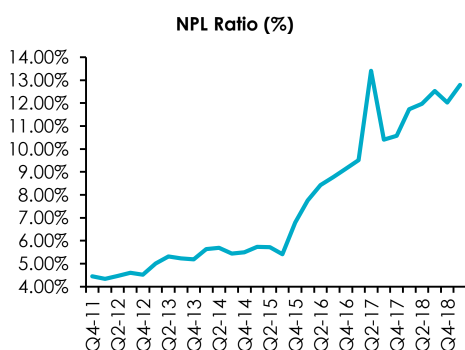
As a result, the perennial deviations from the outlined fiscal path may persist delaying stabilization of public debt around 50% of GDP.

Additionally, spending pressures from emerging risks to food security from the Locust infestations in parts of the country, BBI/ referendum related expenditure and the need to maintain buffers against external shocks will make rebalancing even more challenging.

Meanwhile, revenue outlook remains fragile and may remain below 17% of GDP.

In the short run, the impact of ongoing reforms in tax administration may be offset by the slowdown in income tax due to slower business earnings and PAYE. At the same time, weak demand may further dampen the trade related taxes and duties.

Moreover, with just two years in his final term, the President will fast track the implementation of the Big Four Agenda that may require considerable subsidies, hurting revenues in the short term.



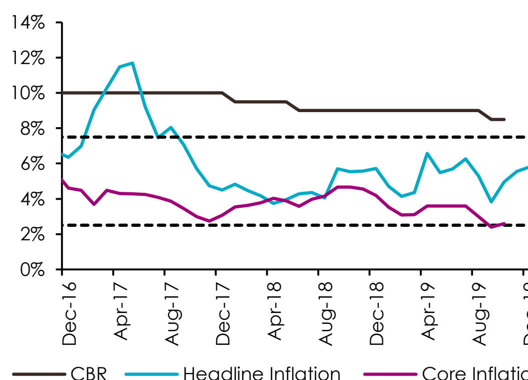
Source: CBK, NCBA Research

Could the central bank offer the much needed catalyst?

In response to a widening output gap, the central bank will aggressively loosen monetary conditions to stimulate demand and offset the effects of fiscal retrenchments.

This will be supported by fairly tame inflation in 2020. We expect that inflation will average 5.2% in the year although possible shocks to food prices herald some upward risks to our projection.

We believe that the central bank has headroom to reduce interest rates by at least 100bps to 7.50% at the end of 2020.



Source: KNBS, CBKNCBA Research

However, while there is little doubt on the central bank's headroom for more accommodation, its effectiveness in generating immediate upside to demand is arguable.

To be sure, creditworthiness of borrowers has diminished and the value of some collateral notable real estate related is declining.

Labor markets have equally weakened making personal lending even more challenging. For now, it remains doubtful whether lending to both individuals and business has generated material additional capacity or investments.

More tools for the central bank.

However, the central bank still has more tools in its kit for catalyzing demand. While reducing CRR is an option, this may be delayed until there is some evidence of liquidity shocks in the interbank market. So far markets remain liquid.

The response to the financial crisis of 2008, shows that central banks can increase monetary aggregates in a way that stimulates growth without causing dramatic increases in inflation.

However, with the economy still printing over 5.0% growth, a tailored version of QE may be premature.

However, a combination of high debt and persistent spending pressure some of which may stem from domestic and external shocks may warrant more support from the central bank. Such an inflationary measure may be balanced out by deflationary tax hikes to cushion the economy from heating up.

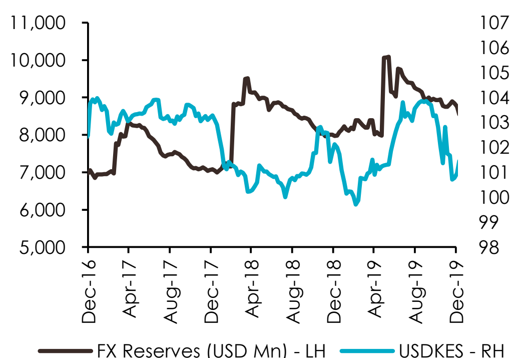
While the government's initiatives are welcome, we believe that the need to restore fiscal space while still ensuring solid growth will present a major headache for policy makers.

Further complication may arise from possible policy paralysis due to political polarization. This may make consensus on necessary austerity measures impossible delaying the much needed fiscal restructuring.

While this may be ground for volatility, we believe that the government will be keen on ensuring an investor friendly environment, as a major enabler of the Big Four Agenda.

Exchange rate: More of the same… Lower trade imbalances to uphold recent stability

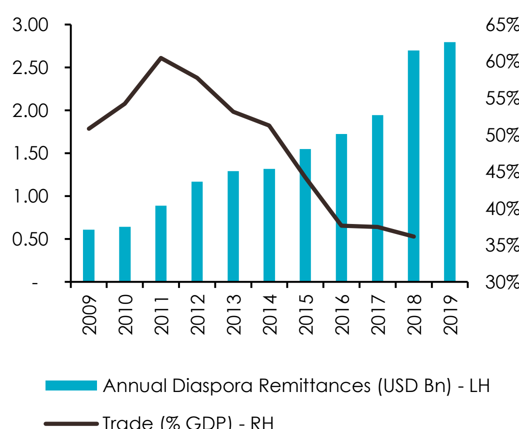
Over the last three years, the shilling has posted marginal nominal depreciation averaging 0.2% in the three years. In real terms the currency has appreciated over the period.



Source: CBK, NCBA Research

The stability reflects diminishing pressure on the current account. Trade volumes, predominantly imports have reduced well in line with the government's slowing spend on infrastructure projects. Although to a smaller extend, this also reflects some slack in private capital expenditure.

A steady growth in diaspora remittances and capital flows especially from private equity deals has helped fund the current account gap.



Source: CBK, NCBA Research

This has considerably reduced the need by the central bank to fund the gap. By extension, this should somewhat water down the government's appetite for external borrowing. This is likely to hold into 2020. Current account will remain below 4.5% of GDP given the decline in capital intensive government projects. Recovery is capacity expansion within the private sector will also remain lethargic reflecting the overall business confidence.

Moreover, the central bank will continue to utilize a host of controls and interventions to tackle any distortions in the foreign exchange market.

The main downside may stem from the political environment with the imminent referendum. The BBI vote has potential to markedly elevate uncertainty around 2020 succession politics.

Forecasts	USDKES
Q1 2020	102.76
Q2 2020	103.04
Q3 2020	103.29
Q4 2020	103.62

Source: NCBA Research

Fixed income outlook: Government securities will remain a good source of income

Complexities in generating Alpha for investors have increased in recent months. High on easy money, asset price valuations have continued to defy fundamentals. To be sure, stocks surged to an all-time high across major markets as central banks' promise of even cheaper money fueled exuberance among investors, despite persistent economic growth hazards. Similarly, local stocks remained somewhat depressed, in spite of the upbeat growth narrative.

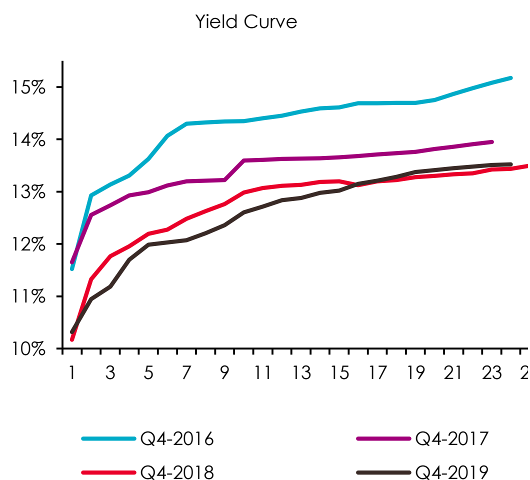
Into 2020, the easing bend by central banks in developed market should provide Emerging and frontier economies more monetary easing headroom. As the strong US/weak emerging market narrative reverses, investors may relook at the latter favorably albeit with notable dispersions across countries.

Additionally, with stretched valuations in developed markets, emerging market will sustain their appeal for investors seeking to diversify their portfolios away from low or negative risk free rates in domicile markets.

However, with trade uncertainty, investors may require a convincing cyclical upturn in emerging markets for a sustainably bullish view on the region. Even then, sovereigns with proper risk metrics may continue providing an attractive risk return balance.

Local bonds: Risk aversion to sustain their appeal

Local fixed income securities have continued to provide a cushion for investment portfolios, amidst increased risk aversion both locally and globally. The upside on prices has been further supported by mild currency gains and low inflation.



Source: NSE, NCBA Research

As risk premium on risky assets increases, risk of investing will sustain the flight to safety witnessed since late 2016. This may be exacerbated by slower growth prospects as well as mounting political angst ahead of the 2020 general elections.

With slow expansion of the credit cycle, government securities will remain popular. Continued search for real yields may still favor local IFBs. Limited currency volatility may further improve the risk return balance on infrastructure bonds.

Gradual steepening of the curve will favor longer investments for income seekers

The absence of optimal coordination between monetary and fiscal policy has been primarily credited for the uncertainty in the direction of interest rates. This year, it is unlikely that the influence of monetary policy on reducing interest rates will be sufficient by itself.

While the monetary authority will continue to signal lower interest rates, keeping the lower end fairly tame, fears of fiscal implosion will sustain a greater premium on the longer end of the curve.

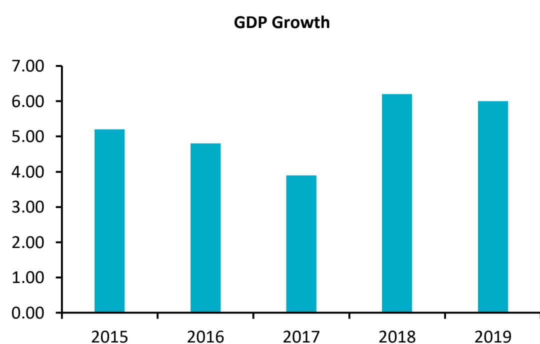
Stickiness on the shorter end of the yield curve may be further underpinned by heavy liquidity as a result of slower pick up in the credit cycle.

This may inflict pain for fixed income dealers who have in the recent past considerably increased their exposure on longer dated papers.

Duration management will remain at the core of bond portfolio administration. To cushion their returns, traders may increase their concentration in shorter dated securities in the near term. As for income buyers, selective duration play may still be favorable.

Uganda: *Growth was underpinned by strong domestic demand*

The economy is estimated to have expanded at a healthy pace of 6.0% in 2019. This was a slight moderation from the peak performance of the last five years in 2018 when GDP expanded by 6.2%.



Source: UBoS, NCBA Research

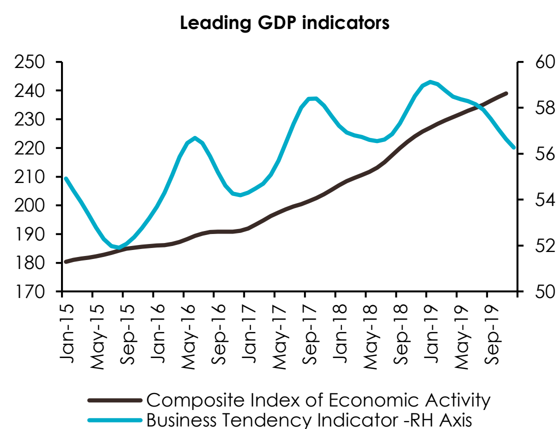
Domestic demand was healthy underpinned by benign financial conditions and spillover effects of a pro-growth fiscal cycle. Moreover, low inflation and increased incomes from agriculture helped bolster spending.

Similarly, external demand from peripheral economies notably Kenya, DRC and South Sudan boosted local output. This is despite the border row with Rwanda which may have absorbed some steam from export growth. Rwanda accounts for 8.0% of Uganda's exports.

On the supply side, agriculture outperformed last year's growth, thanks to favorable weather. Industries also saw increased activity owing in part to spillover effects of strong agricultural output.

Generally, business sentiment and confidence remained sound but slowed somewhat in the latter half of the year, suggesting some relative slack in economic activity.

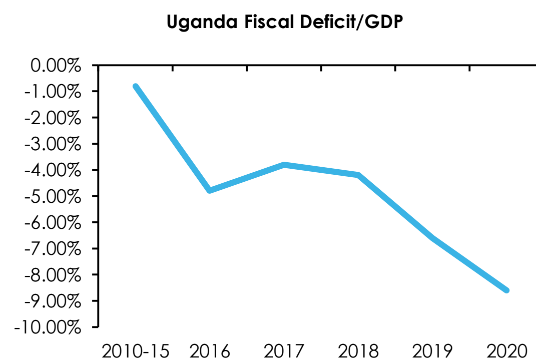
However, this should be offset by steady government spending in the run up to the early 2021 elections.



Source: BoU, NCBA Research

Policies were synchronized and growth oriented

Uganda is estimated to have relaxed its fiscal deficit to 6.6% of GDP in 2019 from 4.8% a year earlier. This was well in line with the government's ambitious infrastructure pipeline mostly in transport and energy. However, the actual deficit may be lower given the slow project execution although persistent revenue shortfalls will keep the gap wider.

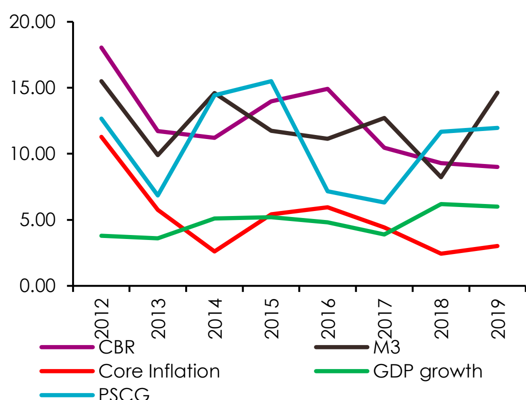


Source: World Bank, NCBA Research

That said, while spill overs from the infrastructure spend has helped anchor growth, the more direct impact was through the payment of pending bills

which improved business liquidity supporting capacity expansion/new investments.

At the same time, the central bank managed to expand money supply while keeping inflation contained. Money supply, measured by M3 increased by 14.5% in the year.



Source: BoU, UBoS, NCBA Research

In the period, the central bank cut interest rates by 100bps to 9.0% underpinning the 12.0% increase in private sector lending in the period. This was consistent with the central bank's target, hence the non-inflationary growth in demand.

Policy coordination supported macroeconomic stability

The expansionary cycle of the last two years was accompanied by broader macroeconomic stability, thanks to a harmonized policy framework.

Despite the easy financial stance that stimulated domestic demand, headline and core inflation remained below the medium term target at 2.9% and 3.6% on average, respectively. Policy response especially from the central bank has been remarkably proactive in ensuring a fair equilibrium between growth and broader macroeconomic stability.

Similarly, despite widening twin deficits – current and fiscal, the exchange rate remained stable.

The shilling was cushioned by a natural hedge from external financing of the mega projects as well as increased capital flows. Relatively high yield, low inflation and a stable currency supported carry trading in the period.

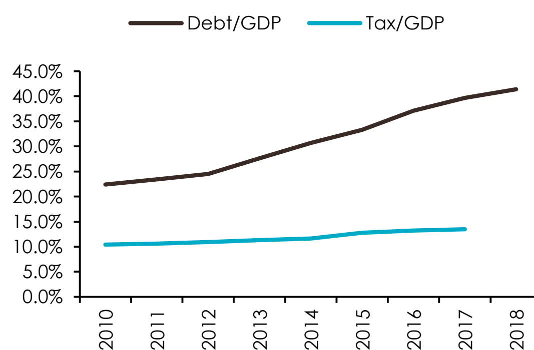
Growth will remain strong albeit relatively slow.

Growth is expected to remain robust but may record some cyclical cooling after the rapid expansion of the last two years. GDP is projected to expand by 5.8% from an estimated 6.0% in 2019.

On the demand side, growth will be supported by an expansionary fiscal stance as government fast tracks its public infrastructure investments. Populist social spending in the run up to the election could also ratchet up personal consumption. However, slow project execution will remain a drag to growth.

Meanwhile, government tax revenues have remained weak at below 14% of GDP even as expenditure increase towards 20% of GDP. High borrowing as a result has elevated fiscal sustainability concerns.

Public debt has risen to an estimated 43% of GDP and may reach 50% in the medium term, a level that may impose considerable strain on the economy.

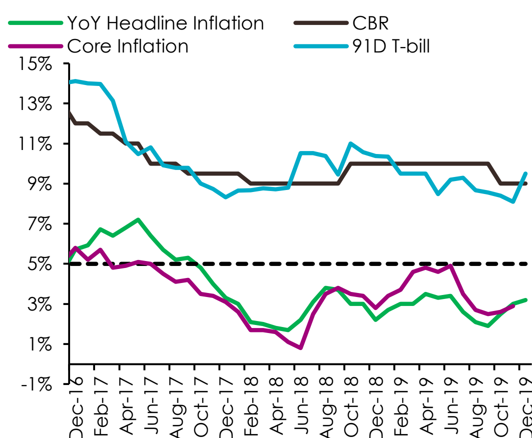


Source: World Bank, NCBA Research

Moreover, delayed exploration of the expansive oil reserves may defer further economic progress for the country.

Monetary policy may tighten somewhat to contain inflationary pressures

Uganda's central bank has run perhaps the most predictable monetary policy across the region. Policy actions have been consistent with its core objective of price stability. This year, inflation is expected to converge around the 5.0% medium term target as government spending increases.



Source: UBoS, NCBA Research

Demand pressure may also be driven by lagged effects of the monetary easing in 2019. That said, we expect that the central bank may raise interest rates by 100bps to 10.00% in 2020.

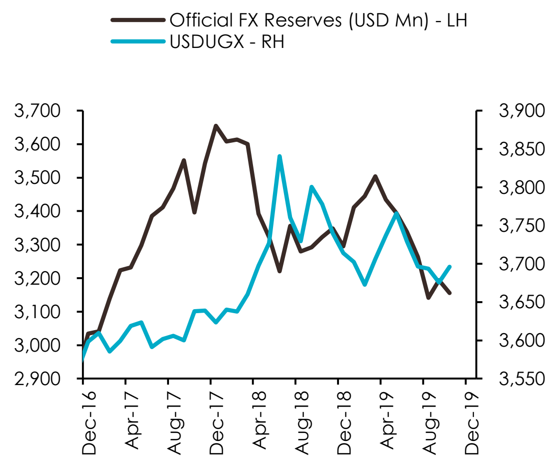
Already, markets are pricing in higher inflation expectations although a relatively stable exchange rate as well as stable food prices may help soften overall pressures.

	Headline Inflation	Core Inflation	CBR
Q1 2020	3.40%	2.90%	9.00%
Q2 2020	2.90%	3.40%	9.00%
Q3 2020	3.40%	4.30%	10.00%
Q4 2020	3.30%	4.70%	10.00%

Source: NCBA Research

The exchange rate will depreciate marginally

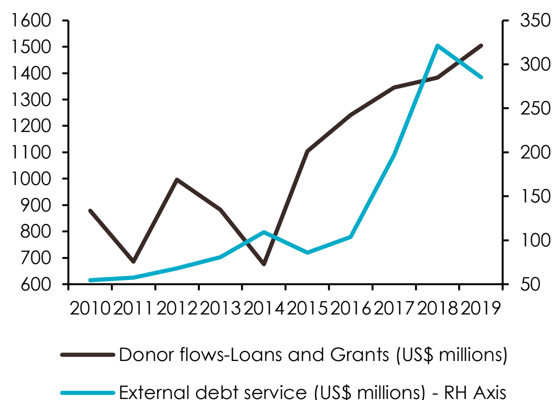
Despite acute current account pressures, the shilling appreciated by 1.3% in 2019.



Source: BoU, NCBA Research

This was the strongest performance yet in the last decade and came on the back of increased external sector pressure, global uncertainty/risk aversion and fragile foreign exchange reserves which remained at 4.1 months of import cover.

Support for the local unit primarily stemmed from increased capital flows and FDIs. Favorable interest rate differentials supported the later while donor funding and some Public-Private-Partnership especially in the energy sector supported some inflows. The World Bank lift on project financing also helped anchor flows.



Source: NCBA Research

At the same time, export growth doubled to 12% in the period from 5.6% a year earlier. While this was offset by a 10% increase in imports, the net effect was somewhat positive. External financing provided a natural cushion against increased hard currency demand from the public sector. At the same time, the increase in exports helped stem the demand for dollars.

The surge in demand from the government could support some mild shilling depreciation in 2020. However, this may be partly offset by a relative slack in private sector activity.

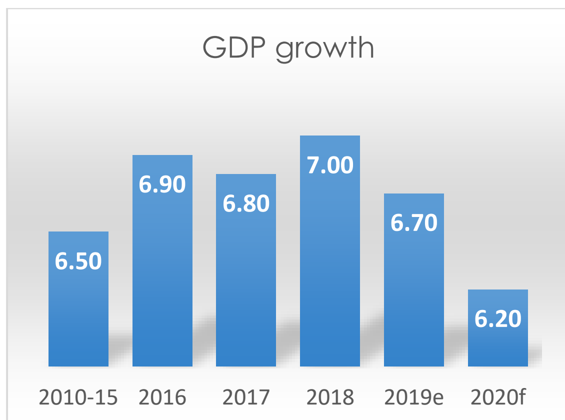
Moreover, the exchange rate may be vulnerable to increased political noise ahead of the general elections.

	USDUGX
Q1 2020	3697
Q2 2020	3734
Q3 2020	3739
Q4 2020	3757

Source: NCBA Research

Tanzania – Public sector led investments to anchor growth

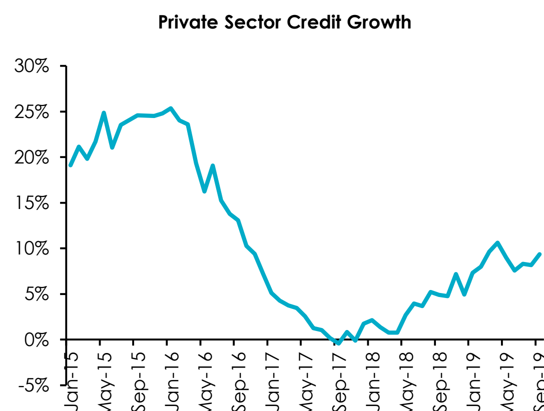
Tanzania has sustained a relatively healthy growth rate despite increased domestic headwinds in recent years. Real GDP is estimated to have expanded by 6.7% in 2019, a touch lower than the 7.0% growth in 2018.



Source: The IMF, NCBA Research

On the demand side, public spending continued to underpin growth as the government fast-tracks its journey towards industrialization by plugging the necessary infrastructure gaps. This has resulted in a considerable increase in fixed investments over the last three years.

Personal consumption remained sound supported by low inflation. However, investments remained somewhat lethargic amidst persistent wary over policy predictability. Even then, slight recovery in private sector lending, stronger activity in mining helped lift sentiment albeit modestly.

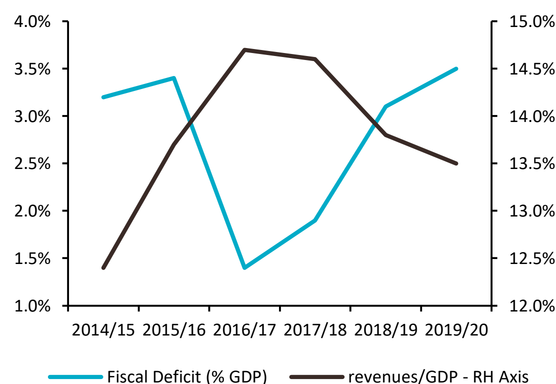


Source: NCBA Research

On the supply side, agriculture expanded at an accelerated pace. Production was underpinned by favorable weather throughout the year. Mining activity also began to regularize, expanding by 11% in the third quarter of 2019.

Growth will moderate further in 2020

GDP is projected to slacken further to 6.2% in 2020. Whereas government spending will remain sound in the election cycle, the weak revenues coupled with slow project implementation may cool off the growth momentum.



Source: NCBA Research

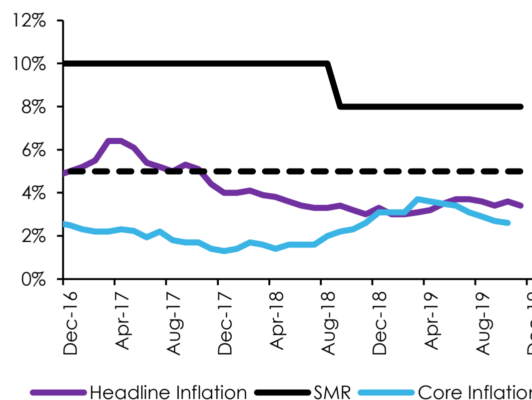
Fiscal deficit is set to widen in the period due to a combination of both higher spending and slower revenue growth. Fairly fragile corporate earnings and personal incomes, slow recovery in private sector demand and diminishing returns from tax reforms will provide little scope to increase public spending.

Meanwhile, with unlikely changes in the political landscape following the crackdown on dissent, investors will remain wary over the policy landscape.

While we expect a relatively friendlier policy environment, President Magufuli's protectionist stance may still underpin some uncertainty with scope to further upend the progress towards East African Cooperation. His stance and about-turns on some of the joint regional projects, his administration's reluctant to sign the East African Partnership agreement with the EU will continue to hinder progress towards regional integration.

Monetary policy will remain accommodative

The government and the central bank have both showed a high affinity for a low interest rate regime in an effort to jump start domestic demand. This stance has been well supported by a benign inflation landscape. Inflation averaged 3.4% in 2019 below the statutory medium term target of 5.0%. Core inflation averaged 3.0% in the period and declined to 2.1% at the end of the year.



Source: NCBA Research

Inflation is expected to remain below 5.0% through 2020 on stable food prices, low oil prices and tame demand pressures. This should provide headroom for more policy accommodation. Risks could stem from climate change or oil supply shocks although risks on the latter are fairly muted.

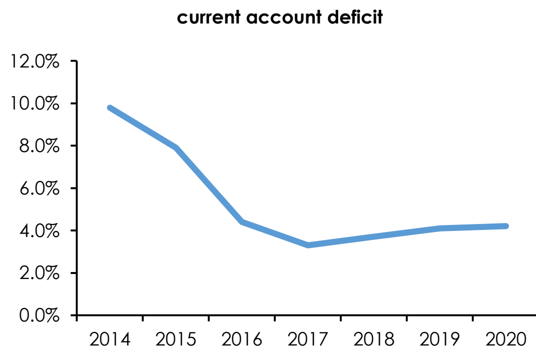
	Inflation	SMR
Q1 2020	4.0%	8.0%
Q2 2020	3.8%	8.0%
Q3 2020	3.5%	7.5%
Q4 2020	3.7%	7.5%

Source: NCBA Research

However, effects of monetary easing will continue to be undermined by a deeply fragment interbank market and persistent flight to quality. On a brighter note, this should complement the effect of a comparatively low fiscal deficit. Deficit financing remains inclined towards external financing which currently constitutes 75% of the public debt.

The exchange rate will gradually depreciate but BoT may cap downside

The shilling held steady in 2019 despite a relatively wide current account deficit. The widening of the external account reflects unfavorable shifts in the balance of payments, weak FDIs and low capital flows due to fragilities in investor sentiment.



Source: NCBA Research

While the pressure is expected to moderate somewhat on the back of increased mineral exports, the shilling is expected to remain somewhat fragile.

The central bank may soften intervention on the back of declining foreign exchange reserves. The regulator's buffer has been diminishing as increased external debt servicing as well as the continued financing of the current account deficit deplete the reserves.

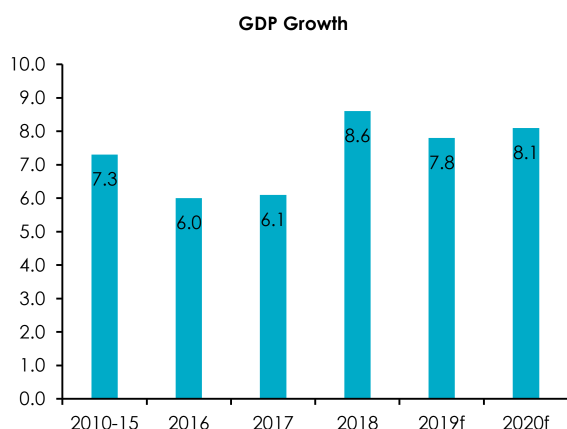
Upside for the exchange rate may stem from increased vigilance by the central bank and further tightening of margin controls in the foreign exchange market.

	USDTZS
Q1 2020	2306
Q2 2020	2310
Q3 2020	2318
Q4 2020	2330

Source: NCBA Research

Rwanda – Strong domestic demand, FDIs to sustain above average growth

Rwanda is one of the countries that have given some life to the "Africa Rising" narrative, its relative small size notwithstanding. The economy has sustained its growth miracle, recording steady and high growth in the last five years.



Source: The World Bank, NCBA Research

Public and private investments have supported steady expansion

Growth has been underpinned by a combination of stronger public and private spending. Government spending has inclined towards infrastructure development including construction of the Bugasera airport, a new inland port, dams for electricity generation and roads with marked impetus for the country's fixed capital formation.

At the same time, progress towards institutional reforms aimed at enhancing the business environment and general investment landscape including the development of a Public Private Partnership framework has continued to support FDIs into the country. In 2018, the stock of FDIs was estimated at USD 2.2 billion, roughly 23.8% of the country's GDP.

Deliberate marketing of Rwanda by the government will continue to place the economy in a favorable limelight strengthening FDIs and tourism.

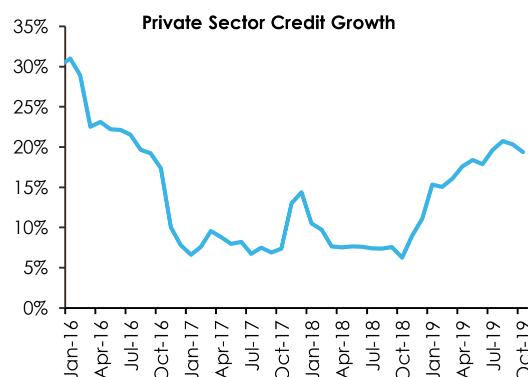
Personal consumption improved with a mild uptick in income although high inflation towards year end may have weakened the momentum.

On the supply side, industries expanded at an accelerated pace, backed by the government led "Buy Rwanda Build Rwanda" initiative that has seen increased reforms and subsidies to uplift domestic investments.

Moreover, favorable weather supported agriculture although growth was marginally slower than in 2018.

Monetary accommodation supported domestic private consumption

Lending to the private sector accelerated to over 20% in 2019 thanks to central bank easing and strong business and investors' confidence.



Source: BNR, NCBA Research

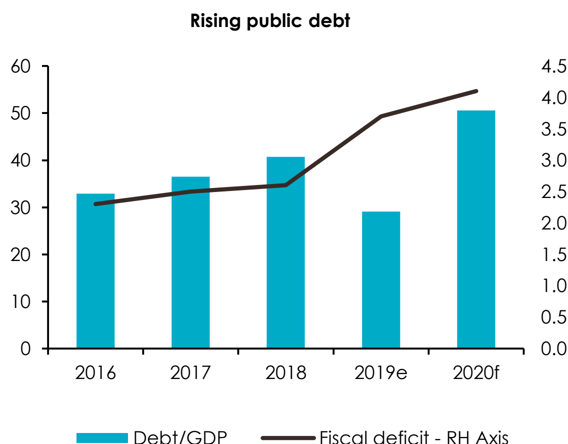
While lending is likely to remain healthy, the momentum should soften somewhat in 2019 as high inflation limit scope for further accommodation with growing risk of tightening.

Unlike Uganda, Rwanda has shown a higher tolerance to inflation, as a tradeoff for solid growth.

Growth will remain upbeat in 2019 although government spending may moderate

The economy looks poised to sustain the solid expansion of last year. Growth is projected to reach 8.0% in 2020 underpinned by tailwinds from both sound public and private demand. A weak external sector may cloud the outlook somewhat but this may not be sufficient to put brakes on growth or push it to a slower gear.

However, the government may have to moderate spending in the near term to allow the economy to first absorb the impact of the recent sharp increase in spending.

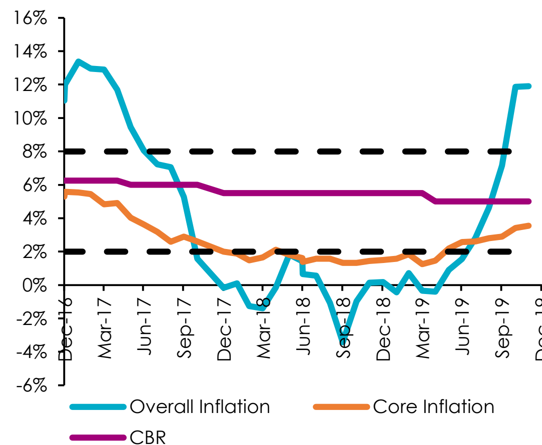


Source: The IMF

This may however be offset by a stronger momentum in private investment and fairly benign financial conditions.

Monetary policy will likely remain on hold

Amidst increased inflationary pressures, monetary policy is likely to remain on hold. While there is some scope for tightening given the increase in demand pressures on the back of accelerated private sector lending, the central bank is likely to be tolerant especially on a backdrop of potentially softer increases in government spending.



Source: Rwanda Statistics, NCBA Research

Inflation is expected to accelerate driven by increased food price pressures, potentially temporary, some demand pressures as well as low base effects. The risk posed by possible locust infestation and border row with Rwanda may exert further pressure on prices.

	Inflation	CBR
Q1 2020	8.00	5.00
Q2 2020	9.30	5.00
Q3 2020	4.40	5.00
Q4 2020	5.00	5.00

Source: NCBA Research

The currency will depreciate further but losses may be capped

Rwanda has in recent years run a “managed float” exchange rate regime. In 2019, the exchange rate depreciated by 4.8% well in line with the central bank’s target for the year.

While the central bank has managed to contain volatility on the exchange rate through margin management and regular intervention, inadequate reserves have necessitated continuous albeit gradual depreciation to avoid the need for sharp devaluation.

This is likely to persist in 2020 allowing for just about 5.0% loss in the Francs value. The mismatch in demand and supply will remain. However, some slowdown in government spending could help cool down demand for dollars.

At the same time increased flows from tourism and FDIs may help offset the effects of incessant demand for dollars in the market.

	USDRWF
Q1 2020	949
Q2 2020	961
Q3 2020	973
Q4 2020	980

Source: NCBA Research

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