

Economic & Market Report - 31 December 2009



A SUBSIDIARY OF CO-OPERATIVE BANK OF KENYA

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1. A Festive Closing

The festive fourth quarter period is usually associated with heavy expenditure by individuals mainly on household goods. Most economies therefore record significant growth in the services and manufacturing sectors as demand peaks. Even during the worst of economic periods, individuals still make adequate provisions to ensure a worthy year end experience.

Kenya is no exception and the economic resilience in the last three months of 2009 can be attributed to increased household expenditure. The telecommunications, tourism, construction and retail/wholesale businesses were major beneficiaries as the year drew to a close. The financial sector was stable as risk aversion led to a more cautious lending programme. Indeed, lending to households during the whole year was muted and banks lent selectively to some sectors. Government securities, being the safe investment avenue, became the main attraction to banks and most other investors. We therefore estimate a real gross domestic product growth of 2.7% for 2009.

Sector	Growth in 2008	Contribution to GDP 2008	Growth 2009E*	Contrib. to GDP 2009E
Agriculture, Forestry & Fishing	-5.10	-1.19	-3.00	-0.70
Manufacturing	3.80	0.40	5.50	0.58
Wholesale and retail trade, repairs	5.10	0.51	10.00	1.00
Hotels & Restaurants	-36.10	-0.40	2.00	0.02
Financial Services	3.10	0.15	2.50	0.12
Construction	8.30	0.32	7.50	0.29
Transport & Communication	3.10	0.32	3.50	0.36
Government	2.20	0.28	2.40	0.30
Others	3.00	0.34	2.50	0.28
TOTAL GDP	1.70		2.70	

Source: CBK, CISL

1.1. Resilience in the Storm

The inaugural World Bank Economic update on the status of Kenya's economy explores several policy issues and chronicles the impact of major private and public sector initiatives. The report, '*Still Standing: Kenya's Slow Recovery From a Quadruple Shock*', December 2009, applauds government's effort in alleviating economic pressure through several measures that have so far ensured stable macroeconomic environment.

Such performance, coming in the midst of the multiplicity of shocks has been driven by the government's support to the real economy through noble initiatives like *Kazi kwa Vijana*; supporting innovation in the financial and telecommunication sectors; transfers and subsidies to the agricultural sector and lately the launch of the stimulus package.

Further, the reduction in the key Central Bank policy rate (CBR Rate) and a cut in the cash reserve ratio for banks helped in stimulating economic activity.

In its November meeting, the Monetary Policy Committee cut the CBR Rate to 7.00% from 7.75% in order to support credit extension to the private sector. The other previous initiative on the required cash reserves were felt to be yielding desirable benefits to the economy and so was left unchanged at 4.5%. Implementation of these 'Monetary Policy Expansionary Policies' has been felt with the fourth quarter of 2009 witnessed a rebound in lending.

Despite all these initiatives, the economy still lagged owing to the high energy costs resulting from prolonged drought in the country. Manufacturing sector suffered a major setback as power rationing (load shedding) was implemented in the third quarter of 2009. Adding to the agony was the reduced demand for Kenya's manufactures in the region. The fourth quarter witnessed normal power supply as emergency power production was commissioned and short rains received.

Some jobs in the sector were lost as companies scaled down production due to high cost and grim economic outlook. The month of December nonetheless provided a closing relief with increased demand and favourably priced raw (agricultural) materials. Improvement in Kenya's road and other infrastructure network should support sustainable development.

Capacity enhancement in the fight against graft is ongoing. With the stable macroeconomic environment (low inflation, interest rates, exchange rates) and reduced cost of doing business, a conducive governance structure will motivate inflow of huge investment capital into the country.

2. Discarding the Basics or back to them?

Over the decades, agricultural sector has been the mainstay of Kenya's economic growth (despite the inherent pricing problems). The sector was greatly valued and its contribution to the economy exemplified. With the onset of liberalization and shift in policies, the sector began to deteriorate and has been the consistent worst performing sector in the past four years. Inadequate funding for the sector, poor marketing channels, erratic rainfall experience, inefficiency in pricing and fragmentation in production (from large scale commercial to small scale subsistence) have been major causes for decline. The sector currently constitutes about 23.2% of the economy but its estimated contribution to year 2009 economic growth is negative, at -0.7%.

Reliance on rainfall has led to massive food shortages and inadequate hydro-electric power production. In a bid to forestall this collapse, reasonable budgetary allocation was made to this sector in the 2009/10 budget. The once successful, celebrated irrigation

schemes concept are to be revived and marketing and pricing systems addressed. No country can be considered stable if there is food insecurity. The World Bank report lays emphasis in resolving the food supply constraints including smoothening the value chain costs (transportation); reforming the National Cereals and Produce Board to ensure parity in its prices; and establishing a warehousing and receipting system to reduce downside risks in commercialized grain marketing.

The budgetary proposals, once substantially implemented, are expected to lead into Kenya being a net exporter of food, unlike currently where it imports a large proportion to supplement the meager domestic production. On the energy front, focus is shifting to renewable sources, especially geothermal production. The Geothermal Development Corporation is spearheading these projects as the capital investment is high and the inherent risks make them unattractive to the private sector. We do appreciate this change as it would lead to a cheaper and sustainable source that will relieve the economy of the current burden associated with costly thermal and unreliable hydro sources. With affordable energy sources, we expect production costs to normalize and make Kenya's manufactures competitive.

3. Sectoral Performance

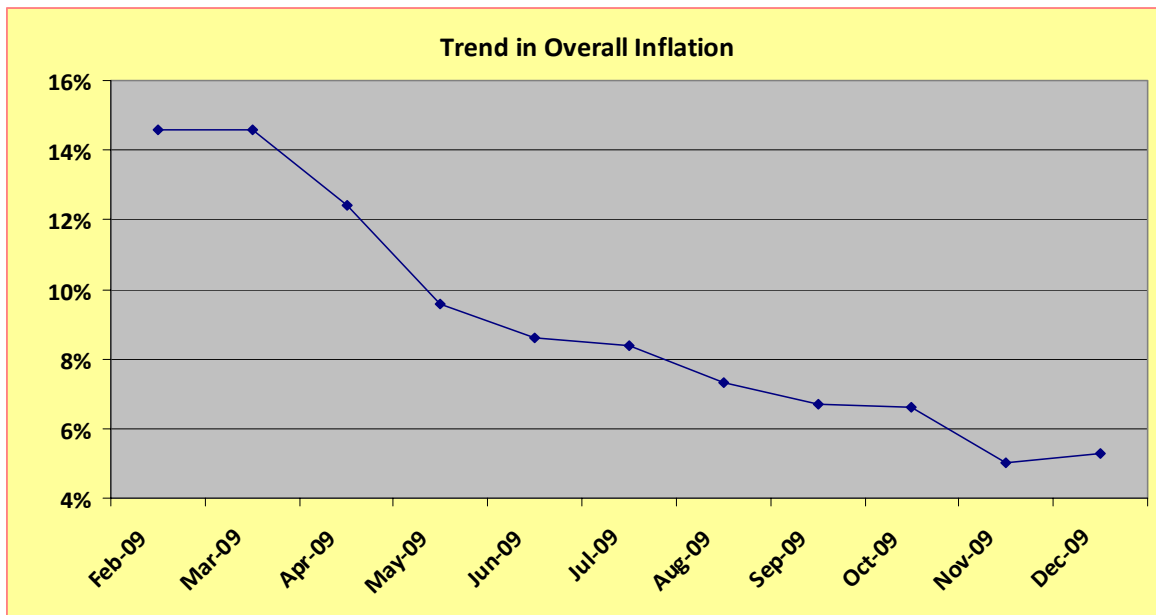
The fourth quarter saw mixed activity in various sectors. Robust activity was witnessed in the telecommunications, construction and tourism sectors. Rapid innovation in the telecommunication sector is fast translating into other sectors especially the financial sector where mobile money is revolutionizing businesses. With the several submarine cables fast getting linked to the other parts of the country, we expect internet penetration to skyrocket. In the short term, prices may remain fairly high owing to the high initial investments made by the operators. However in the medium to long term, we expect significant price deceleration as economies of scale set in. The government continues to be supportive of this sector and has adopted issuance of unified licenses to operators.

The lowering of tax on mobile handsets and agitation for infrastructure sharing should support growth and penetration of mobile telephony to over 60% in the short term. Consumers have been the main beneficiaries of efficiency enhancements resulting from competition. New products have been introduced by the operators and tariffs have declined markedly and are dynamic. The banking sector has become more aggressive in embracing mobile telephony and internet in the provision of services to clients. Such convergence is set to raise banking penetration to the rural unbanked consumers.

Risk based surveillance of the banking sector as implemented by the Central Bank is bound to raise confidence. The regulator has directed banks to provide additional disclosures on the deposit products to enable assessment of risk exposure and hence remission of adequate insurance premiums. This is laudable to support stability of this

crucial intermediary sector. With our forecast economic growth for 2010 (please refer to page 11), we foresee a reasonable decline in the non performing loans portfolio for the industry and profitability for the sector may rebound strongly. Most banks undertook expansion projects and we expect this to slow in 2010 as they focus in realizing value. Aggressive lending to the private sector may resume as the outlook improves.

As discussed above, the manufacturing sector recorded some subtle growth in the fourth quarter of 2009. Data from Kenya Revenue Authority (KRA) show that Value Added Tax (VAT) on domestic goods was above target by Kshs 3.1 billion as at 31st December 2009 while excise duty was just at the periphery, being below target by Kshs 1.3 billion. However, the whole year remained challenging as high inflation eroded the purchasing power of consumers. Paradoxically, Kenya is now being considered a low inflation economy following the revised computation methodology adopted by the Kenya National Bureau of Statistics (KNBS). The result was evident in the last quarter of 2009 where the inflation rates were low (on the range of 5% to 7%) but consumers struggled to keep up with the high prices. Manufactured goods especially were largely avoided and reliance on primary produce increased.



Source: KNBS

Domestic tourism has become a major source of growth for the sector and significantly complements revenues generated from foreign visitors. Kenya remains a favoured conference hub in the Eastern and Central African region and hosted several international functions in 2009. The benefits were multi faceted and the impact felt in all the other sectors. Notably has been the publicity that the functions accorded the country that we witnessed increased arrivals from the world over. Bed capacity for the sector, which was

a major constraint four years ago, is no longer a challenge with the private sector having embarked on expansion projects. The aviation industry, which is an anchor service for tourism remained subdued in 2009 but the outlook for 2010 is positive. Global economic revival in 2010 is also supportive of better performance of the sectors.

The fortunes of coffee and tea farmers were rekindled following improved pricing of the produce. This was on the back of reduced production across the major world producing countries which led to a shortfall at a time when demand was strong. Data from the Tea Board of Kenya show that domestic production declined by 10% to 278,085 tonnes for the eleven months ending November 2009. The slowdown in most Kenyan export destinations led to contraction in horticultural exports. Production constraints also faced farmers thereby hindering robust outputs. The outlook for 2010 is nonetheless favourable for most horticultural products.

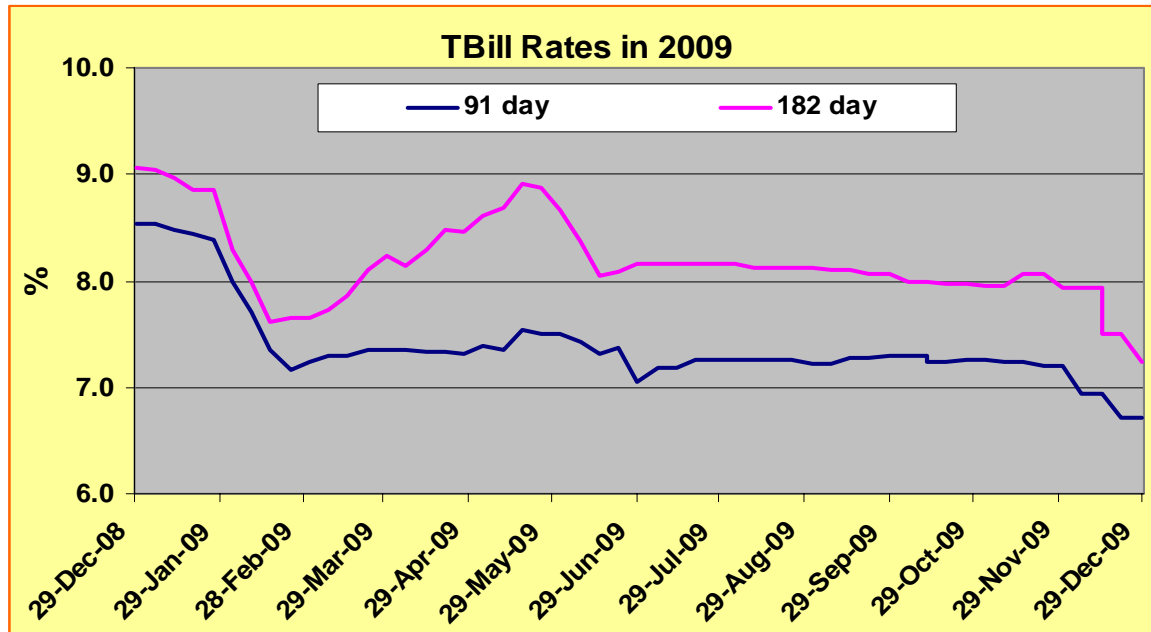
4. The Financial Markets

4.1. *Government securities*

With the heightened risk aversion on the back of uncertain economic performance, investors sought refuge in government securities. Banking sector lending to the private sector, especially to households, was largely shunned in favour of the safe Treasury securities. Businesses found it extremely challenging to secure lines of credit with banks and lending was extremely selective to fairly secure segments like construction and transport. The bearish trend of the equities markets at the Nairobi Stock Exchange (NSE) also prompted investors to shift their funds to government securities.

Benefiting from these actions was the government, through the Central Bank. Weekly auctions were generally successful and enabled the government to borrow at relatively lower rates. As shown in the chart below, the first half of 2009 experienced volatility in rates but the second half was relatively stable, until November when rates declined. In summary, the 91-day TBill rate averaged 7.36% while 182 days TBill averaged 8.15% in 2009 as compared to 7.70% and 8.52% for 91 days and 182 days respectively recorded in 2008.

The CBK Weekly Bulletin for the week ending December 31, 2009 shows that commercial banks and pension funds had increased their holding of government securities markedly to 55.6% and 25.6% respectively as at 18th December 2009 as compared to 52.4% and 22.3% in June 2009. On the flip side, economic performance was constrained as lending to the real sector declined and the rate of absorption of government funds (from the weekly Treasury auctions) remained low.

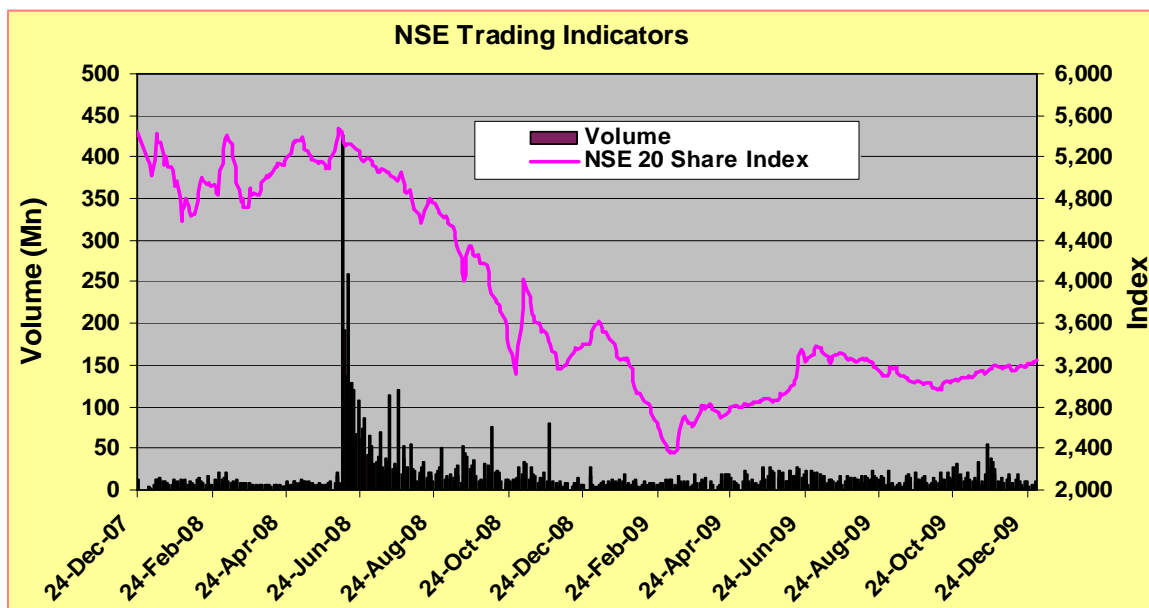


Source: CBK

CBK continues to closely monitor the banking sector, and has streamlined its stress testing mechanism to ascertain the health of the sector. This may help identify and mitigate any potential threats to the sector and the economy at large. Capitalization requirements and additional disclosures to Central Bank are deemed to forestall any potential systemic risks. Once CBK publishes positive status reports on the industry, customers' confidence will rise and more business generated for the banks and the economy at large.

4.2. Equities Market

During the fourth quarter, trading at the NSE was relatively active, with the NSE 20 Share Index gaining 8.1% and the NASI rising by 7.4%. Market capitalization also edged higher by 8.1% in the quarter. Due to the myriad of challenges facing the Kenyan economy, the equities market nonetheless witnessed another year of decline albeit lower decline than year 2008 experience. The NSE 20 Share Index declined by 7.8% (2008 – -35%) to close the year at 3,247.44 points; the NASI declined by 2.4% (2008 – -23%) to 71.64 points while market capitalization fell in tandem by 2.2% to 834.7 billion. While turnover and volumes traded in the fourth quarter of 2009 were barely changed as compared to activity in the fourth quarter of 2008, the annual aggregates for turnover and volume dipped significantly by 61% and 47% respectively.



Source: NSE

High profile initial public offerings that took place in 2008 were conspicuously absent in 2009. Runaway inflation and reduced investor confidence (intermediary concerns and economic uncertainty) led to the dismal equity market performance in 2009 and thus did not provide optimal conditions for IPOs. Corporate earnings during the year were mixed but did little to impact on the trading front as investors remained uncertain of future profitability. We believe that with the positive economic outlook for 2010, equities will realize better returns as corporate profitability rises and valuations equilibrate.

4.3. The Bond Market

Benefiting from the slump of the equities market was the bond market. Turnover improved to Kshs 111.35 in 2009 compared to Kshs 60.16 billion done in 2008. This scenario was premised on some overtones of potential interest rate volatility in the medium term despite Central Bank's vigilance. Primary bond auctions during the year received great enthusiasm from investors, and mainly the banks and institutional investors. Due to high liquidity, which was largely induced by the Central Bank prior to most primary issues, oversubscriptions became the norm.

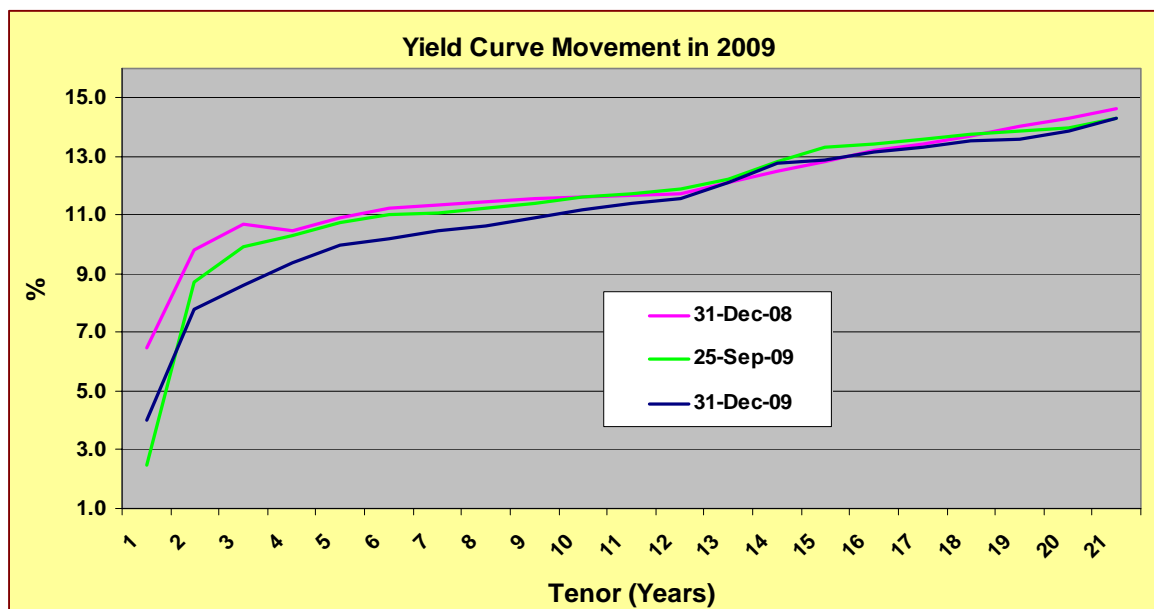
Auction Date	CBK Offer Kshs Mn	Total Bids Kshs Mn	Subscription rate	Accepted Bids Kshs Mn
26-Jan-09	5,000	7,066	141%	6,110
23-Feb-09	18,500	26,884	145%	18,573
23-Mar-09	8,500	14,347	169%	8,500
27-Apr-09	10,000	16,800	168%	10,017
25-May-09	13,000	16609	128%	13148
29-Jun-09	13,000	19,284	148%	13,114

27-Jul-09	12,000	14,785	123%	11,888
24-Aug-09	11,000	10,545	96%	10,008
21-Sep-09	11,000	15,450	140%	11,015
26-Oct-09	12,000	10,666	89%	8,704
7-Dec-09	18,500	44,121	238%	18,417
28-Dec-09	10,000	20,248	202%	10,880

Source: CBK

As shown in the chart below, some volatility was experienced in the short end of the yield curve, largely due to liquidity imbalances in the banking sector which impacted on overnight and TBill rates. With horizontal repos gaining momentum, interbank rates declined to as low as 2.1% on 9th October 2009 before rising to close the year at 4.00%. There has been marginal movement of the yield curve, especially in the long end during the third quarter of 2009.

Oversubscriptions during the primaries were the major cause for the marginal downwards shift in the yield curve as at December 2009. Additionally, the revised inflation data and the Monetary Policy Committee (MPC) action in November (to cut CBR Rate to 7%) made investors to be content with lower yields.



Source: NSE, Equity

The corporate debt market was equally active, with most companies seeking to tap into the exuberance elicited by the success of the debut of government infrastructure bonds in February 2009. The need to maximize returns during the depressed economic times prompted investors to diversify into this asset class, which was previously avoided. A total of Kshs 36 billion of bonds was issued in 2009 as compared to Kshs 4.0 billion in 2008. Notable issuers were Kengen (Public Infrastructure Bond Offer for Ksh 25 billion) and Safaricom who managed to raise Ksh 7.5 billion.

Loan syndication became unattractive for corporates as most banks placed strict conditions and could only participate at high premiums yet the investor zeal at the NSE was sufficient to meet the demand. The declining (falling) yields at the NSE do indicate an even primer period for corporate papers. The building optimism on economic growth would further trigger more issues in the medium term. We do feel that the issues will still be at some premia to government securities thereby likely to be embraced by the market.

5. Outlook for 2010

The economy seems to have weathered the storm pretty well and most policies needed to stimulate and sustain growth mooted. The government remained a major player in the economy during 2009, in a bid to stem the effects of the global economic crisis. We nonetheless note that the economy is still vulnerable, especially to volatilities in the global markets. Foreign direct investment flows, donor funding and availability of export markets are all dependent on the performance of the global economy.

Implementation of the fiscal stimulus programme is key to faster revival of the economy. The government borrowing programme has been on track but the rate of absorption of the funds has been dismal. This starves the economy of development finance. With the modest economic growth outlook and continued CBK imploration on banks to increase private sector credit (at reduced cost), we forecast revival of lending to most sectors, which should fuel economic activity. Coupled with improving efficiency and innovation in the sector, performance of the financial industry is bound to be strong in 2010. Energy costs remain a major factor to the competitiveness of Kenya's manufactured goods. Addressing this through sustainable/renewable sources would offer a lifeline to the sector and the economy at large.

The telecommunications, tourism and construction sectors may ride on their 2009 growth trajectories to record impressive growth rates in 2010. Opportunities do still exist in these sectors, with the low internet penetration rates, the dynamic tourism scenarios and shortage of affordable low cost housing. Major construction projects that were initiated in 2009 are set to run in 2010 and we also forecast rapid growth in certain sectors of real estate development especially the middle income housing segment.

On the macroeconomic front, we forecast stability in the key indicators – Tbill rates, foreign exchange rates, inflation rates. The 91-days TBill rate is likely to be in the 6% to 7% range; US\$ exchange rate at Kshs 75 to Kshs 76 and inflation rate to remain in single digit in 2010. We however note that delays in the implementation of the stimulus programme will be a major setback to the envisaged stability as supply constraints will cause serious imbalances to economic fundamentals. Moving from rain-dependent agricultural production to a more reliable commercialized irrigated production together with improving other infrastructure networks will drive the economy to an estimated 3% growth rate in 2010.

With the coming into effect of the East Africa Customs Union, we see immense opportunities in the region, comprising of an estimated population of 80 million people. Kenya, being currently the largest economy in the bloc, would benefit from the

anticipated accelerated growth especially in Rwanda, Burundi and Uganda. Additionally, with the discovery of commercially viable oil in Uganda, the region may experience a rejuvenated growth rate on the back of sustainable and probably cheaper oil and gas. Again, electricity generation in Uganda and mineral exploitation in Tanzania bode well for the bloc's growth potential. However, sustainability of the trade bloc is uncertain owing to mistrust among the partners.

6. Global markets

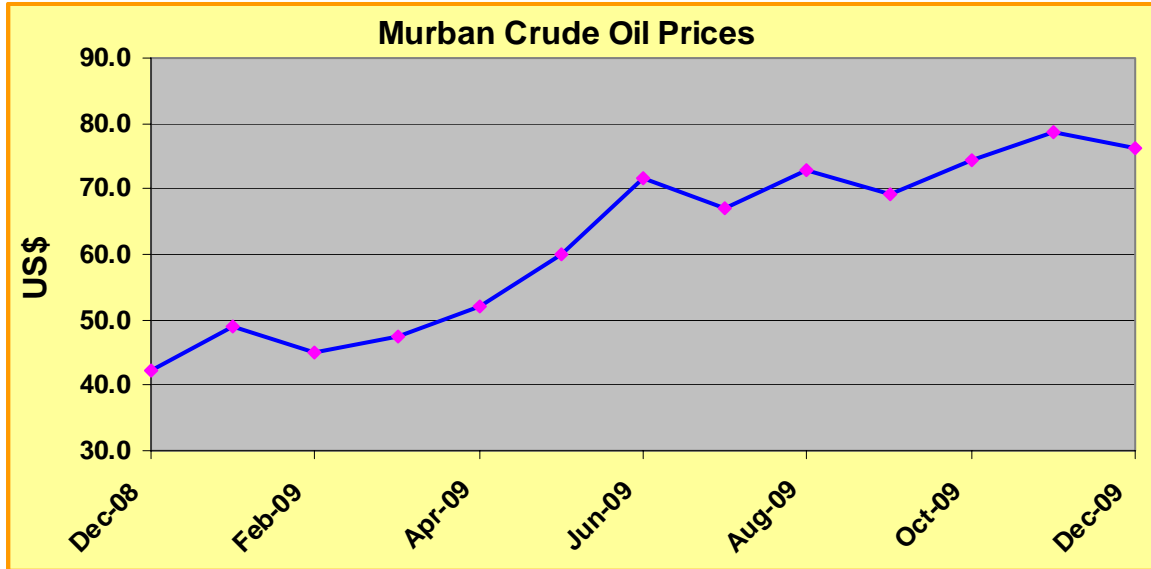
With concerted (and mostly painful) effort and submissions, the global markets are stabilizing, with the year ending buoyantly. All major markets recorded impressive gains as investor sentiment soared. Earnings reports revealed some strong recovery, and there is optimism that the economies will perform better from 2010. A raft of regulations has been proposed to check on excessive risk taking by investment houses. Stemming moral hazards would improve on ethics/integrity of the markets, which is the bedrock of investments.

Index	Performance in 2009
MSCI Emerging Markets	78%
NASDAQ	44%
MSCI World Index	26%
DAX	24%
S&P	23%
FTSE 100	22%
DJIA	19%
NIKKEI	19%

Source: MSCI, Bloomberg, BBC

Trading in commodities and related instruments (stocks and derivatives) was endeared by investors and is set to continue into 2010. Gold price rallied by 26%, closing 2009 at US\$ 1,090/ounce as it became the prime hedge against volatile economic periods. Crude oil prices also soared to close at US\$ 76/barrel in December 2009 from US\$ 49/barrel in January 2009. Apart from the positive (but cautious) economic outlook, the extent of rallies especially on commodities was due to the weakening of the US Dollar against other world currencies notably the Euro and the Japanese Yen.

Despite the turmoil experienced by the US and increasing agitation to have another world reserve currency to replace the US Dollar, there is growing skepticism that an alternative would be found. Additionally, the expected rebound in the US economy will entrench its economic power thereby reinstating the dollar's prominence.



Source: ADNOC

There exists uncertainty on the outlook for the crude oil prices as the movement is dependent on geopolitical developments around the world, and mostly in the major oil producing regions. Speculative tendencies have always contributed to price distortions for oil, gold and other precious commodities. Such volatilities have always tended to impact on consumer prices and corporate earnings. The financial markets are sensitive to such developments and do respond in tandem.

Most governments are mulling over blanket withdrawal of stimulus packages (from all economies) introduced from 2008. It has remained challenging owing to the slow pace of economic recovery at a time when inflationary pressure is building. It is therefore feared that unwinding of fiscal packages would aggravate price shocks and also lead to huge losses to holders of government securities. We foresee consensus being built for a case-by-case withdrawal since some economies are trailing the others and so require custom approaches. Interest bearing assets will therefore remain a bit more exposed as compared to equity and commodity investments.

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