Why is Kenya's equity index lagging its SSA peers, despite better Inflation, Policy Rate, FX and Bond Yields readings?

- Sighting the potential impact of sustained inflationary pressures and elevated global risks on the Kenyan economy, last week, the Monetary Policy Committee hiked the policy rate by 75bps to 8.25%. This marked the highest rate hike since July 2015's 150bps increase - directed towards taming a weakening KES. At 8.25%, the policy rate is at a level last seen in January 2020.

- The September 2022 inflation print released 2 days after the policy rate decision reflected a 70bps m/m increase in headline inflation to 9.2%, the highest level since June 2017. September's reading was largely driven by higher prices of food (+15.5%), household equipment (+10.7%) and transportation (+10.2%). In the medium-term we expect inflationary pressures to remain elevated on account of the removal/scaling-back of subsidies on petroleum products, coming into effect (in October) of annual inflationary excise duty increase on consumer goods and low food production amidst poor rains.

- In our **2H22 Kenya Investment Outlook Report**, we observed that Kenya's monetary policy intervention was trailing peer SSA countries and aggressive tightening "to catch-up" remained a key short-term risk for Kenya's equity returns. A review of equity price performance across SSA, amidst varying policy actions point to Kenya's equities as being **OVERSOLD**, in our view.

- Despite having the lowest increase in inflation & currency depreciation, translating to below average increase in policy rate and local currency yields, **Kenya's equity index** has declined the most, -28% since Jan 2021. In contrast, over the same period, **Egypt's equity index** has declined 15% (the 2nd highest decline amongst peer SSA Indices), despite inflation, policy rate, currency depreciation and 10-year yields shifting 2.9x, 2.4x, 2.2x & 2.2x more than Kenya's. The top outlier is **Nigeria's equity index** which has gained 16%, despite Nigeria's inflation, policy rate, currency and 10-year yields shifting more than Kenya's – for Nigeria, our conversations with investors revealed that the out of sync equity performance is being driven by forced re-investment of sale proceeds owing to the long wait to convert funds into USD at the official FX rate.

  So why is Kenya's equity index lagging its SSA peers?

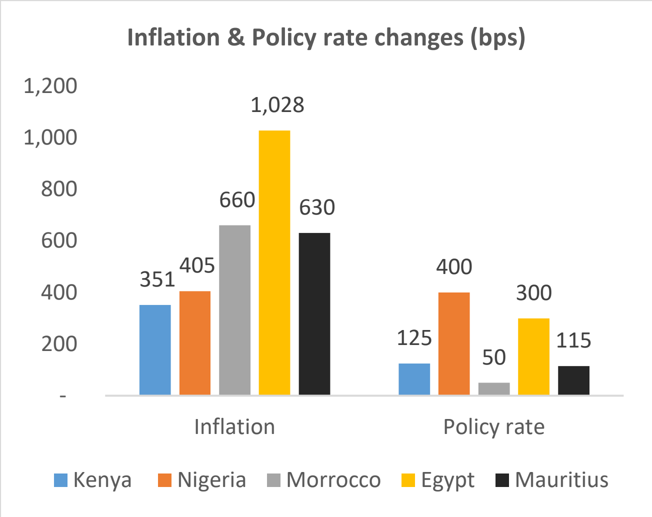
  - **One reason could be equity investors (bond investors hold a different view) expect inflation and policy rates to shift further over the coming months, translating into a weaker KES and higher bond yields.** To be at par with Egypt, Kenya's inflation & policy rate would have to increase by 540bps and 350bps, respectively. Even if this were to happen, which we cannot entirely rule out, investors are still pricing Egypt's equities higher than Kenya's.

  - **Another possibility is that equity investors expect Kenya's corporate earnings to be less resilient/deteriorate faster – on a trailing PE basis Kenyan equities are trading at 6.8x versus peer SSA average of 15.0x**. Our analysis of Kenyan equities shows that during periods of high inflation, equity returns have been driven by investors' sentiment (PE de-rating) and less so by earnings performance – as earnings have tended to remain resilient. Similar to peer SSA economies, other than Nigeria, the Services Sector drives more than 50.0% of Kenya's GDP – by extension corporates in the services sector, mostly financial services and telecoms, dominate equity market capitalizations. For Kenyan equities this has been a positive in the past with listed corporate revenues and profitability bouncing back rapidly – riding on sticky & at times expanding margins.

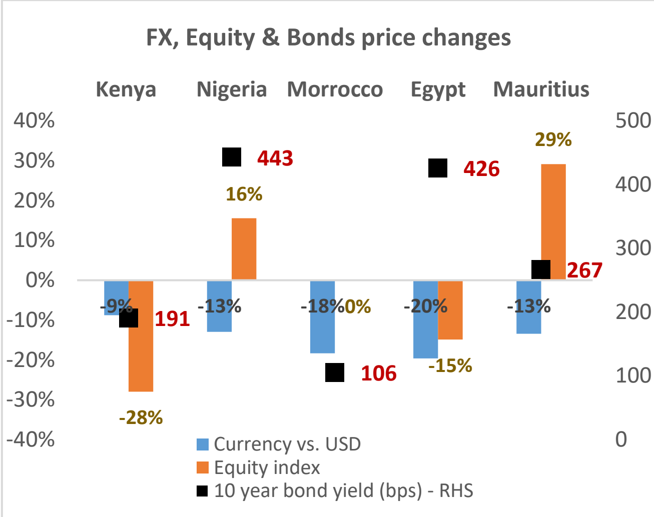
  - **A more plausible explanation, in our view, has to do with excessive price volatility triggered by reduced market liquidity and Kenya's equity index significant exposure to Safaricom (49.7% of NSE total market cap)**. Successive years of foreign investor net outflows and the absence of new listings has weighed on SSA equity markets liquidity. Compared to the 10-year average, in 2022, Kenya's equity daily average value traded has nearly halved to 53%. The average for peer SSA countries is 73%. YTD, Safaricom alone makes up for 87.9% of the decline in the NASI. However, we note that other large-caps have also registered high single digit or double-digit price declines.

Other than the uncertainty that comes with a new Government, in our view, compared to peer SSA countries, Kenya does not face excessively higher idiosyncratic macro-economic risks. In the past, once macro-economic headwinds have come under control, Kenya's equity returns have rebounded rapidly, largely making up for prior period losses.

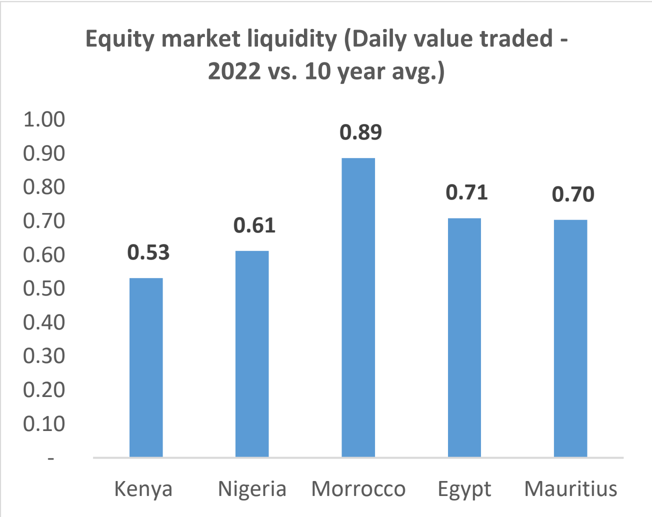
Divergence in inflation & policy response



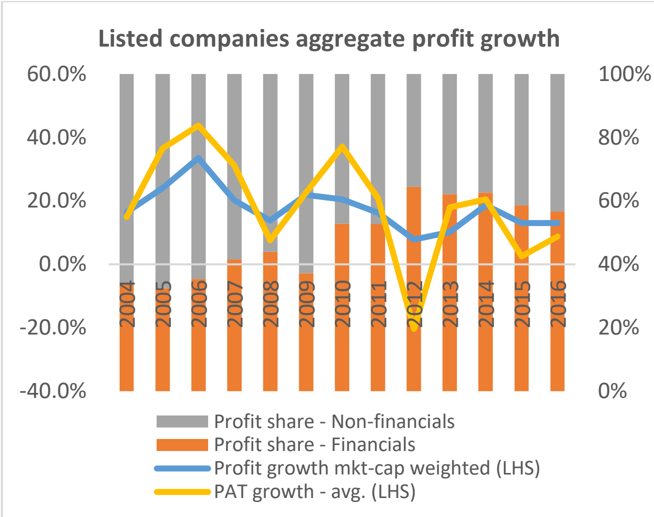
Conflicting pricing of equites and bonds



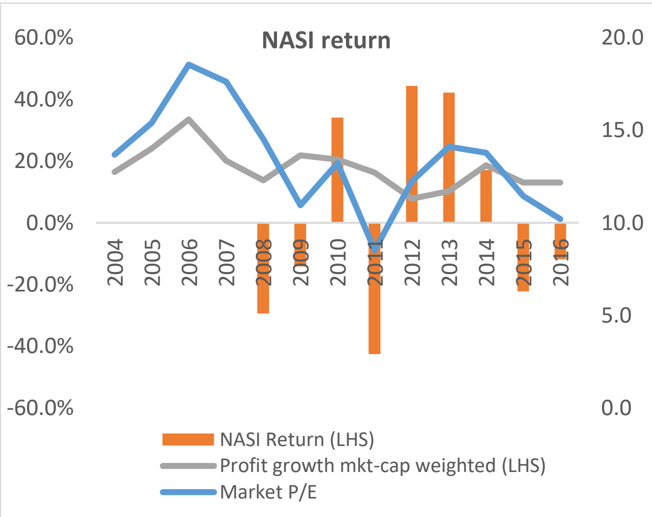
Low liquidity as foreign investor participation slows



Kenya's corporates resilient during past macro crisis



Rebound in equity returns once crisis is over



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