

Nigeria Strategy Report – H2 2017 Excerpts

Review of Global Economy and Markets

Economic Snapshot

May 2017 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	1.9%	16.3%	17.3%
Food	2.5%	19.3%	19.3%
All Items Less Farm	1.2%	13.0%	14.8%
Imported food	1.3%	14.9%	16.9%
Energy	1.3%	16.3%	18.8%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	305.9	0.0%	0.0%
EURNGN	322.5	3.0%	2.7%
GBPNGN	372.3	4.4%	4.8%
JPYNGN	261.0	3.3%	3.0%
Monetary Aggregates – April 2017			
	(₦bn)	MoM	YoY
M2	21,713	-1.4%	4.8%
CPS	21,943	-1.5%	13.2%
NCG	5,592	7.5%	42.2%
NFA	7,262	-4.1%	43.2%
NDC	27,535	0.2%	18.1%
External Position			
	Latest	QoQ	YoY
Trade Balance (\$'mn)	185.73	-21.5%	N/A
External Reserves (\$'mn)			
	30,323	0.95%	3.68%
Foreign Debt (\$'mn)	13,808	21.1%	23.3%
Growth Data – Q1 2017			
	(₦bn)	%of total	YoY
Real GDP	15,861	100%	-0.5%
Agriculture	3,385	21.3%	3.4%
Oil	1,411	8.9%	-11.6%
Services	5,975	37.7%	1.0%
Wholesale and Trade	2,819	17.8%	-3.1%
Manufacturing	1,543	9.7%	1.4%

After bullish run, portfolio flows to EM look set to moderate

Strong pull factors stimulate FPI flows to EM assets

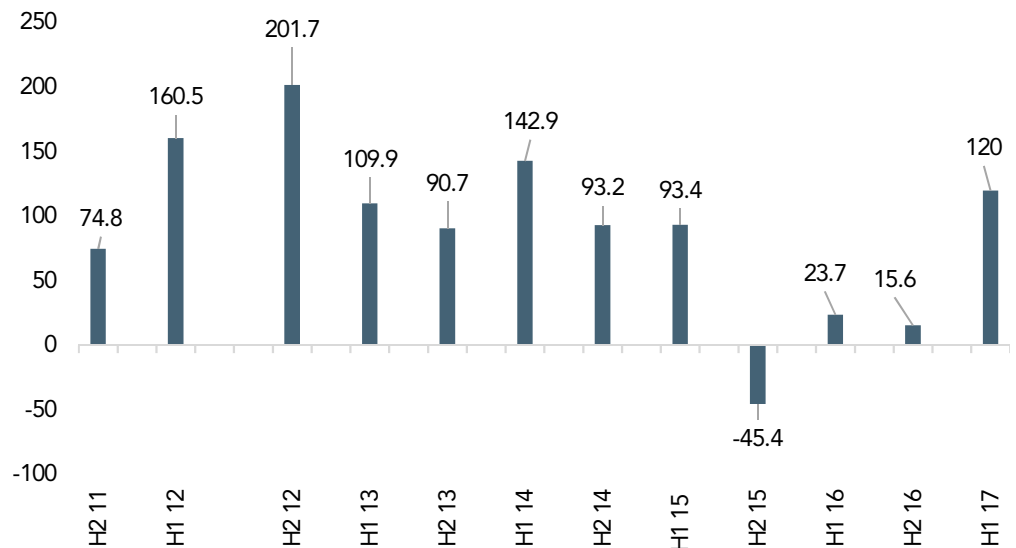
According to the Institute of International Finance (IIF), net portfolio flows sustained its positive trend for the seventh consecutive month in June 2017, with combined flows of \$121 billion over H1 17 being fivefold higher YoY. The strong capital flows emerged despite three rate hikes in the US and political worries in Britain (legislative election and Brexit concerns), as investors cheered the strong economic picture across Emerging markets. Particularly, over Q1 17, EM growth expanded at its fastest pace in ten quarters at 4% YoY with the upbeat picture sustaining appetite for equities¹. Against the backdrop of improved fundamentals, which lessened default risk, foreign demand for local denominated fixed income instruments also tracked higher². Importantly, despite rate hikes by the US Fed, portfolio flows to EM debt was boosted by falling yields³ in the US. The declines derived from worries that President Trump will have trouble pushing forward with a pro-growth agenda focused on taxes and infrastructure, which had raised scope for higher government borrowings.

¹ At \$25.3 billion, Q1 17 FPI flows to equities surged sevenfold QoQ (twofold YoY)

² According to the IIF, net portfolio inflow to EM debt market printed at \$37.5 billion in Q1 17, a sharp turnaround from a net outflow of \$29 billion in the preceding quarter

³ After surging 58bps in the last two months of 2016, average (5, 10 and 30 years) US yields declined 10bps over H1 17

Figure 1: FPI flows to EM (\$' billion)



Source: IIF, ARM Research

Capital flows track higher across varying EM regions

Across the various regions, EM Asia witnessed improved portfolio inflow following investors reassessment of India's growth prospect. In contrast to the preceding quarter where demonetisation-induced worries weighed on investors' sentiment, portfolio flows to India rebounded strongly in Q1 17 with the \$11.1 billion (equities: \$6.4 billion, debt: \$4.7 billion) net flow being the highest in eight quarters. Improved foreign demand for Rupee assets reflected investors' expectation for a faster than expected economic recovery, following the rebound in Manufacturing and Services PMI in February 2017. The electoral victory of ruling Bharatiya Janata Party (BJP) in key state assembly elections in March, which raised prospects for the implementation of the Goods & Services tax(GST) as well as other economic reforms, further bolstered investors' confidence. Similarly, portfolio flows to Thailand rebounded in Q1 17 to \$1.8 billion (from a net outflow of \$6.07 billion in the previous quarter) following improved political climate. The October 2016 death of King Bhumibol Adulyadej, who was perceived as a pillar of stability in the country's tumultuous political environment, had stoked worries over planned general elections⁴ initially scheduled for 2017. However, the peaceful transition to his son, Maha Vajiralongkorn, as the head of country's monarchy allayed investors' fears irrespective of the postponement of the general election by another year. The mix of

⁴ First since 2014 coup

political stability, upbeat economic picture (Q1 17 GDP: +30bps from reading to 3.3% YoY) and rising real interest rates⁵ underpinned the influx of portfolio flows to equities (Q1 17: \$262 million, Q4 16: \$3.7 billion outflow) and debt (Q1 17: \$1.6 billion, Q4 16: \$2.4 billion outflow). In contrast, the pace of portfolio outflow from Malaysia accelerated in Q1 17 (+67% QoQ) as investors continue to react to the Central Bank's curbs on the Ringgit trading at the non-deliverable forward market (which is used for hedging by foreign investors). Given perceived illiquidity at the onshore market (alternative to NDFs), foreign investors, worried about currency risk, began to scale down on their investments. Despite the robust economic picture (Q1 17 GDP of 5.6% YoY is the strongest in eight quarters), Elsewhere in the region, given sustained rise in China's foreign reserves⁶ (printed at a seven-month high of \$3.1 trillion in May 2017), portfolio outflows from China likely reduced against the backdrop of better than expected economic growth, monetary tightening and capital control curbs implemented in 2016.

Over in Latin America, capital flows continued to exit the Brazilian economy (January to May 17: -\$1.8 billion) against the backdrop of lingering economic recession⁷, lower interest rate and rising political instability. In less than a year after impeaching its former President (Dilma Rouseff), Brazil faced another period of political uncertainty following corruption allegations levied against current President Michel Temer by the country's attorney general. Elsewhere, in the region, FPI flows to Mexico extended the positive trend in H2 16, printing at \$8.6 billion, reflecting sustained appetite for both peso denominated debt and equity instruments. Focusing on the former, improved economic picture which saw Q1 17 GDP print at a six-quarter peak of 2.8% YoY, and the partial liberalisation of the oil and gas sector⁸ underpinned the \$2.3 billion net inflow into the country's equities market. In the debt market, a 75bps rate hike by the Bank of Mexico over Q1 17 sustained influx of portfolio flows. Meanwhile, just over a year after returning to the international capital market, Argentina issued its first century bond worth \$2.75 billion which was nearly four times oversubscribed. It is our view that investors continue to cheer the pro-market policies (including allowing a free float on the peso, removing grain export

⁵ Inflation fell 118bps to -0.05% in June 2017

⁶ China's FX reserve rose for four consecutive months ending May 2017—its first in three years

⁷ The country reported its 12th consecutive quarter of economic contraction in Q1 17

⁸ Subsidies were removed on fuel prices in January 2017 resulting in a 20% increase in gasoline prices

taxes as well as a tight lid on fiscal deficit) implemented by the country's President, Mauricio Macri.

Emerging Market Europe witnessed higher portfolio inflows (+80% QoQ to \$54 billion) in Q1 17 largely reflecting favourable economic picture across member countries. Specifically, GDP printed at a five-quarter peak in both Czech Republic (Q1 17: +3% YoY) and Poland (Q1 17: +4% YoY), underpinning an upsurge in FPI flows into these countries' assets in the first quarter of the year. In addition to the upbeat economic picture, higher FPI flows to Czech Republic reflected investors' expectation for the floatation of the Koruna⁹, vs. a currency cap in place previously. However, the optimism into Koruna denominated assets soon turned sour¹⁰ following political wrangling between the Prime Minister and his Finance Minister, which eventually led to the exit of the former. Elsewhere, following the failed coup in July 2016 which triggered capital outflows in the second half of 2016, FPI flows to Turkey rebounded strongly over H1 17 (January to April: \$7.4 billion) as investors reassess impact of the political event which appears to be less severe than predicted. Importantly, Turkey's President has consolidated his powers¹¹ after the approval of the government-proposed constitutional referendum even as the economy's GDP printed at a three-quarter high of 5% in Q1 17.

Over in the Middle East and North African (MENA) region, Egypt concluded its largest public bond issuance, a multi tranche bond of \$4 billion, in January and an additional \$3 billion in May 2017. Foreign appetite for Egyptian securities improved in the wake of IMF support program which has resulted in implementation of pro-market policies (including removal of fuel subsidy and floatation of the Egyptian pound). Despite robust economic growth in Tunisia (Q1 17 GDP of 2.1% YoY is the highest in nine quarters), net FPI flow to the country plunged 74% QoQ to 11.2 million Tunisian Dinar as investors fret about the country's rising trade deficit (+57% YoY to \$1.68 billion in Q1 17). Elsewhere in the region, the pace of capital outflows accelerated in Qatar (four-fold QoQ to 5.8 billion Qatari Riyal).

⁹ The Koruna was eventually floated in April 2017

¹⁰ FPI outflow in April \$2.3 billion

¹¹ Mr Erdogan will rule uncontested, appointing senior officials, judges and members of his own cabinet, with little oversight by an expanded but weakened parliament.

Higher commodity prices bolster capital flows to Africa

After two years of reticence, foreign investors' appetite for Sub-Sahara Africa's (SSA) assets appear to have improved following the upswing in commodity prices. The rebound is expected to bolster economic recovery, narrow the widening trade deficit and by extension stabilise the frail currencies in the region. Largely reflecting these improved fundamentals, Eurobond issuances across SSA rebounded strongly (+133% YoY to \$3.5 billion over H1 17) with Cote D'Ivoire, Nigeria and Senegal's offer been oversubscribed by 4x, 8x¹² and 8x times respectively. Interestingly, South Africa reported a net portfolio inflow of 25.9 billion Rand in Q1 17 (Q4 16: 1.9 billion Rand) despite the contractionary trend in the country's economy as well as lingering political worries. Though foreign investors continue to shun South Africa's equities¹³ (Q1 17 net FPI outflow: +34% QoQ to R16.1 billion), the net positive capital flow largely stemmed from higher demand for Rand-denominated debt securities (Q1 17 net portfolio inflow surged threefold QoQ to R42.1 billion). According to the South African Reserve bank, increased capital flows to South Africa's debt market reflected rising real interest rate following a downtrend in inflation as well as improving trade balance (which swung from a deficit of R7 billion in Q3 16 to a surplus of R57 billion in Q1 17).

Similarly, net portfolio flows to Nigeria picked up from a three-quarter trough of \$303 million in Q4 16, rising 45% QoQ to \$438 million (Q1 16: \$227 million). The renewed appetite for naira securities largely reflected the combined impact of higher crude oil proceeds and more importantly improved FX liquidity stemming from the increment in CBN's dollar sales. Instructively, amidst elevated interest rate environment and falling YoY headline inflation, foreign capital largely flowed to short term debt instrument which contributed nearly half¹⁴ (QoQ: +107%, YoY: +212% YoY to \$212 million) of the net inflow. Though net portfolio flow data for Q2 17 is yet to be released, inflow data released so far suggest an upsurge in portfolio flows in the wake of CBN's liberalisation of the currency market in late April. Aside from boosting liquidity in the FX market, the creation of a market-determined FX window is expected to boost earnings of companies listed on the Nigerian stock

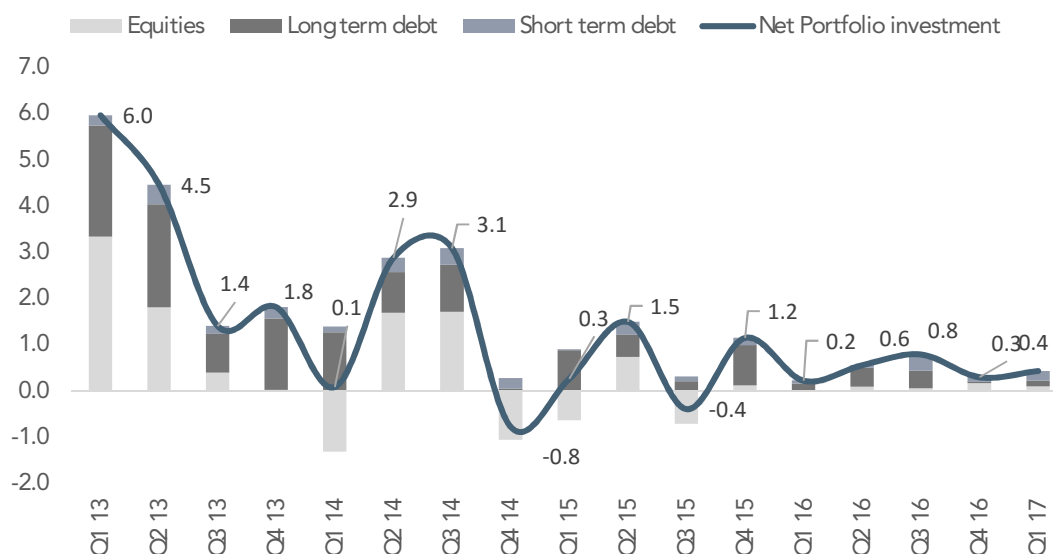
¹² The \$1 billion Eurobond issued in February was eight times subscribed, the \$500 million Eurobond was later consolidated in March

¹³ Despite a 21% YoY in new issuances to R33 billion over the first five months of the year

¹⁴ 48%

exchange after difficulties in assessing FX for critical imports had crimped earnings. Against this backdrop as well as improvement on the macro front, inflow of capital to the equities market surged to a 17-month high of \$267 million which, together with flows to the debt market, raised influx of portfolio flow to a nine-month high of \$337 million in May.

Figure 2: FPI Flows into Nigeria (\$' billion)



Source: CBN, ARM Research

Hawkish US policy and geopolitical concerns to weigh on EM risk appetite

Going into the second half of the year, the demand for EM equities is expected to remain strong amidst expectation of improving growth prospects. Specifically, the World Bank and IMF both project that the EM group would record its first GDP growth in seven years over 2017. However, the outlook for capital flows to EM debt is less sanguine. The expected slowdown in FPI flows to EM debt instrument is set against the backdrop of anticipated decline in commodity prices, which should increase the vulnerabilities of resource-rich countries, as well as an increasingly divergent outlook on global monetary policy. Focusing on the latter, after lowering its interest rate to a record low of 0.25%, the BoE is now considering raising interest rates as it aims to combat rising inflation which hit a four-year peak in May 2017.

Elsewhere, despite subdued inflation reading¹⁵, improving economic prospects in the US as well as concerns over equity valuation raises the prospect of both rate hikes and a gradual retrenchment of the US Fed's \$4.5 trillion balance sheet of the bond holdings amassed during the financial crises. Set against dovish policies across other developed markets (ECB and BoJ), a tighter monetary policy in US increases probability of exchange rate volatility across EM currencies. Overlaying the foregoing with the adoption of accommodative monetary policies in key EM countries (Brazil, India, and Russia), the scale of capital flows to EM debt market should be more subdued as the pull attraction from these key destinations dim.

Scanning across the various regions, EM Asia should be impacted by recent worries in the Korean Peninsula. In the wake of North Korea's latest long range ballistic missile testing, which can reach Alaska in the US, there is now a growing potential for increased militarisation in the region. Given the possibility of an escalated conflict, foreign investors are likely to reduce their exposure to the continent's assets. Elsewhere, whilst MSCI's decision to add 222 Chinese stocks to its emerging market benchmark in 2018 could spur foreign demand for Chinese stocks in the medium term, portfolio flows are likely to be adversely impacted by the potential slowdown of the Chinese economy in the wake of recent monetary tightening by the PBoC as well as Moody's downgrade of the country's credit ratings to (A1 from Aa3). However, as demonetisation-induced slowdown in India's economy continues to dissipate, improved growth outlook should drive higher FPI flows to India.

Across EM Europe, uncertainties surrounding Brexit negotiations which commenced in June, and political worries in Germany which is scheduled to hold its Federal election in September, should weigh on investors' sentiment. Elsewhere in the region, recent downtrend in commodity prices as well as lingering imposition of western sanctions on Russia should accelerate the pace of capital outflow from the country. In Latin America, the corruption charges levied against President Temer, a stark reminder of the political crises that ousted the Brazil former President, Dilma Rousseff, should likely weigh on investment sentiment and by extension portfolio flows. Elsewhere, uncertainties surrounding the NAFTA renegotiation, which should

¹⁵ According to the US Fed, idiosyncratic factors (such as sharp declines in prices of wireless telephone services and prescription drugs) caused the tempered inflation and expects these developments to have little bearing on inflation over the near term

commence in August 2017, together with political considerations ahead of next year's elections, should trigger dollar outflows from Mexico.

Over to the Middle East, in addition to the effect of lower oil prices, the diplomatic rift between Saudi Arabia, UAE, Egypt, and Bahrain, on one hand, and Qatar on the other, should dominate investors' sentiment to the region's assets.

Given the recent downturn across commodities, Eurobond issuance by Sub-Saharan African countries is expected to decline as countries reduce FX exposure and stabilize their debt ratios. In South Africa, concerns on the economic front, prospects of further credit rating downgrades as well as political worries ahead of the ruling ANC leadership contest and, by extension, the 2018 general election should dampen the pace of portfolio flows to the country. In contrast, foreign investors should continue to cheer the recently liberalized FX market in Nigeria which, together with elevated interest rate environment and improving economic picture, bodes well for capital flow to the country.

On balance, we expect the impact of hawkish monetary policy outlook in the US as well as the UK, aided by the rising spate of political uncertainties across the various regions, to moderate growth induced rise in portfolio flows to EM markets.

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