

Nigeria

Assessing the investment case

Samir Gadio | Global Research

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A decorative background featuring a horizontal line at the top, split into green and blue segments. Below the line, there are several overlapping, curved, light gray shapes that create a sense of depth and movement.

Global macroeconomics

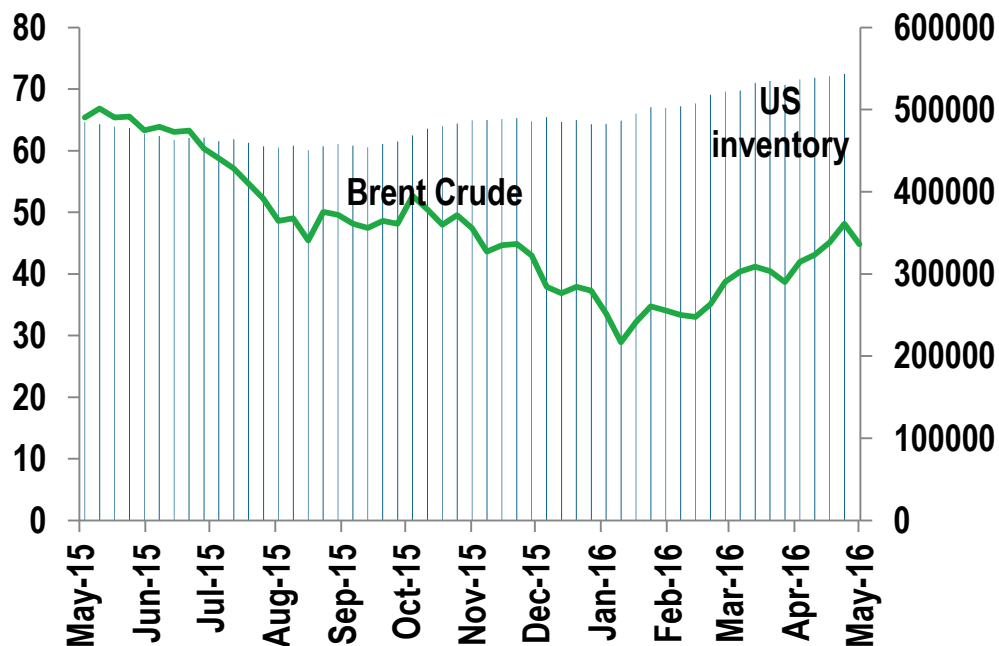
Relative recovery in oil prices

- The Brent oil price has recovered from January lows (USD 27/bbl) and stood at USD 44.6/bbl on 6 May
- A weak USD and relative output adjustment/shortfall in the US/Americas have supported oil prices; there may be a lag between higher oil prices and a rebound in US supply, but a number of OPEC countries could seek to retain/increase their market share, despite earlier attempts to freeze production
- Global demand remains relatively subdued, although OPEC expects a pick-up in demand driven by China in H2-2016; inventories still remain significant

Brent crude vs. US inventory

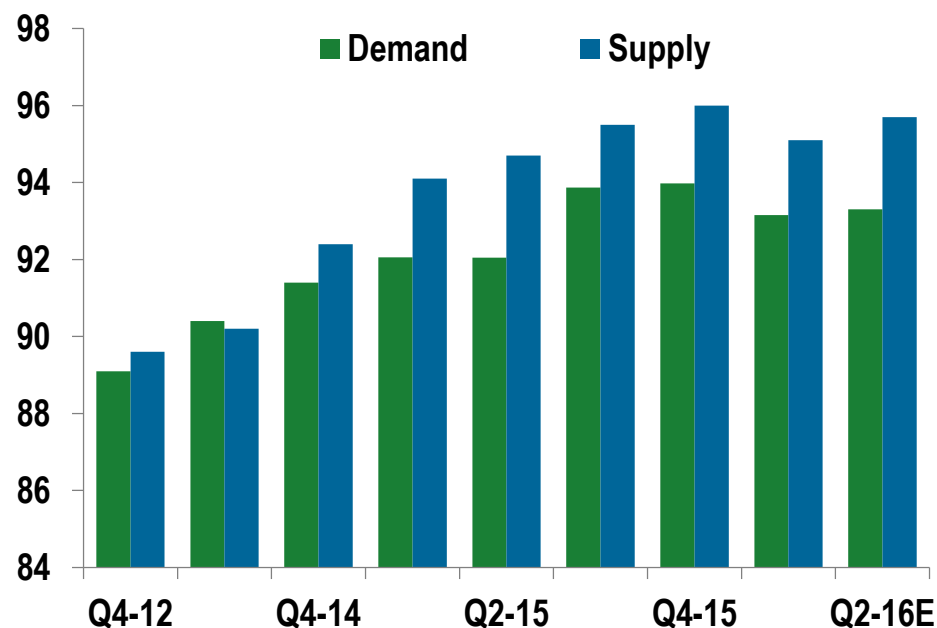
USD bb/(LHS)

Barrels, 000 (RHS)



Demand/supply dynamics in the global oil market

Bpd mn

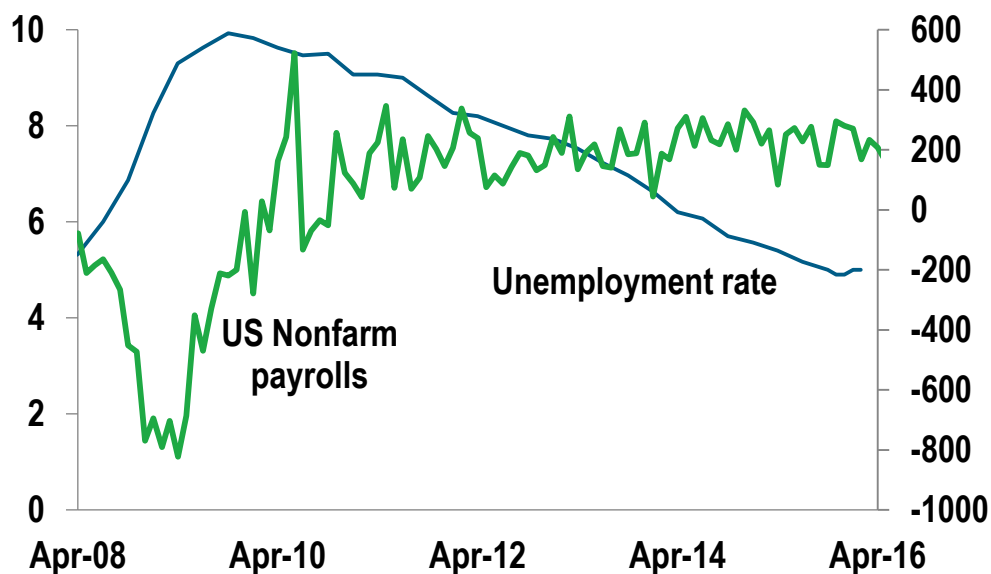


Global rates outlook still looks supportive

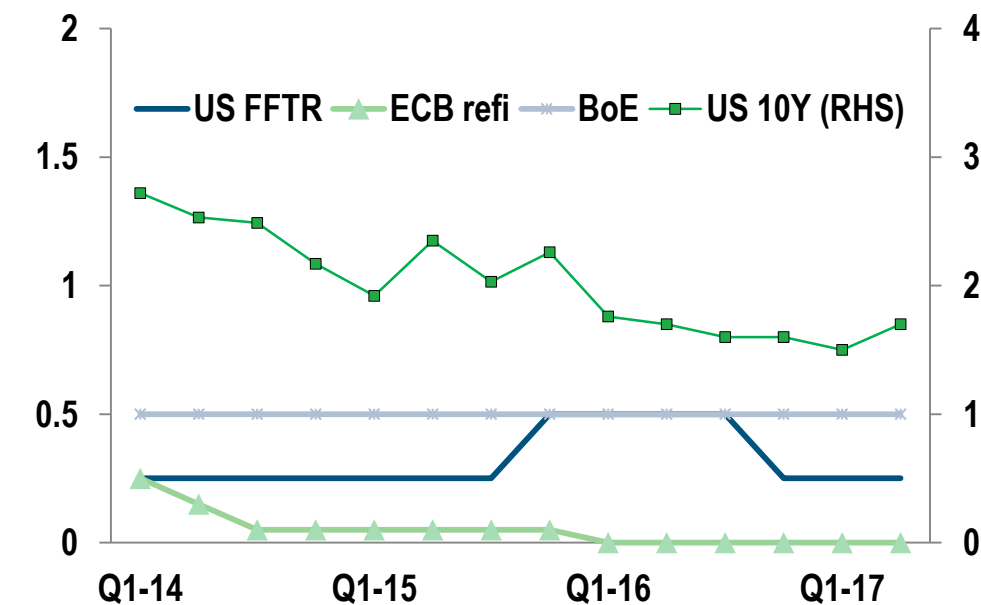
- US interest rate expectations have turned more dovish after a first 25bps Fed rate hike in December 2015
- The Fed's underlying tone has remained cautious, with no clear signal of any imminent tightening; a June hike looks unlikely given the lack of market preparation and the UK EU membership referendum; the risk of a hike in H2 is mitigated by the November US presidential election
- Concerns about the global economy, a recent deterioration in some indicators (for example GDP) and soft core PCE inflation may provide leeway for Fed patience; the April NFP print (160k) was also weaker; better-than-expected economic data or higher oil prices could challenge the Fed's sanguine view

US labour conditions

Unemployment, % (LHS); Nonfarm payrolls, 000 of employees, MoM (RHS)



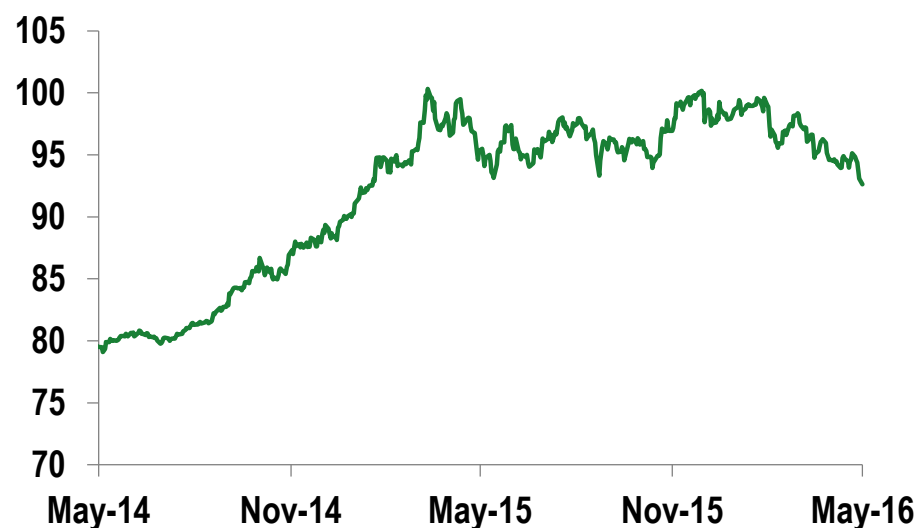
Global policy rates and 10Y US yield



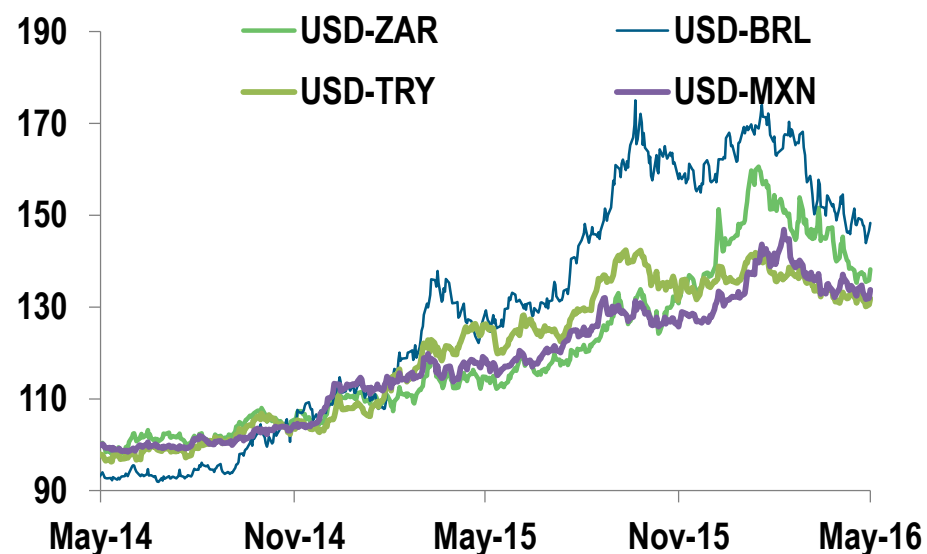
Weaker USD is EM FX-positive

- The weaker USD has underpinned EM currencies which have posted a better performance this year
- A dovish Fed rate stance may ensure supportive conditions for EM FX and investment flows into these countries, but the key question is how long this soft USD cycle can last
- Upside risks to USD-JPY stem from the BoJ's accommodative monetary bias; EUR-USD could shift lower on ECB loose policies; the GBP may come under renewed pressure ahead of the EU membership referendum in June 2016

USD index
Index



High-Beta EM FX
Normalised FX (1 Jan 2014 = 100)



Recent CNY developments

Aug 11 2015
devaluation of
the yuan
increased the
chances of SDR
inclusion

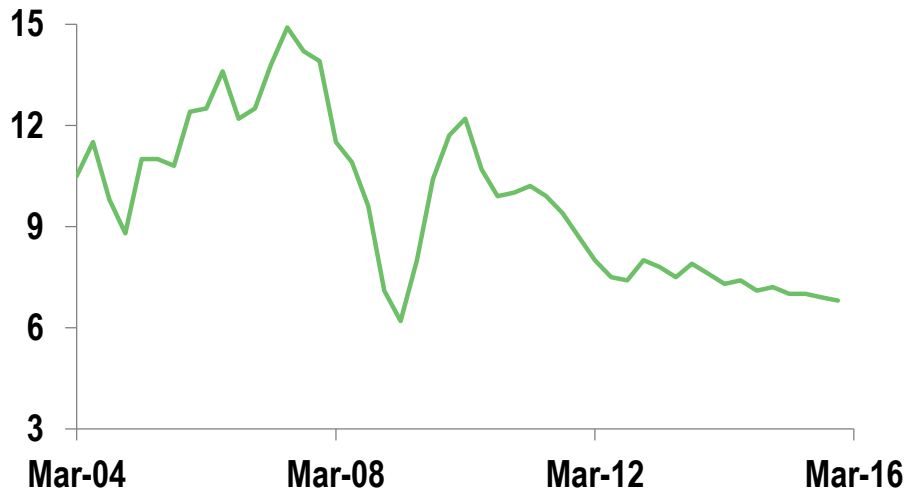
November
2015
Adoption of
the CNY into
the SDR
basket effective
October 2016

Slower
economic
growth, as
focus shifts
to domestic
consumption
from
investment

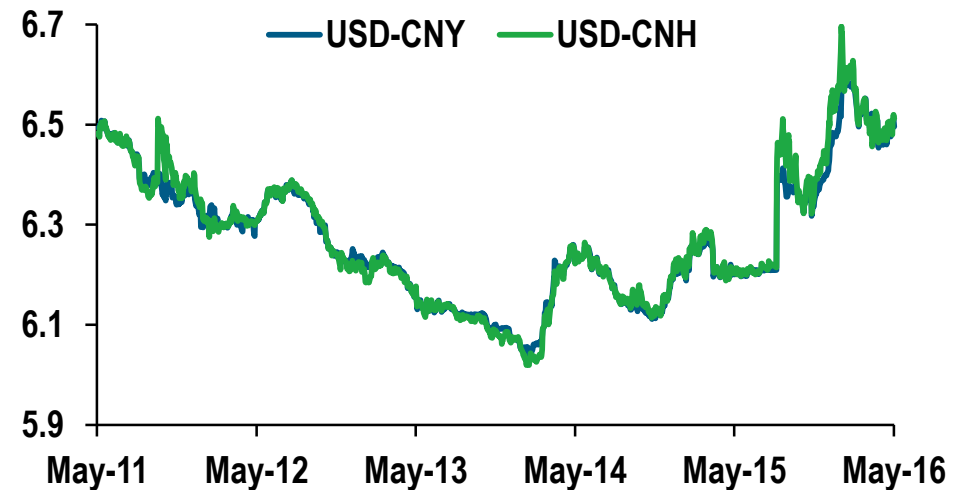
Stock market
downturn
exacerbates
capital outflows
affecting the
CNY

CNY reversed
losses against a
weaker USD in
early 2016; China
is opening up its
bond market and
may join global
indices

China GDP growth
% YoY



USD-CNH and USD-CNY
Exchange rate



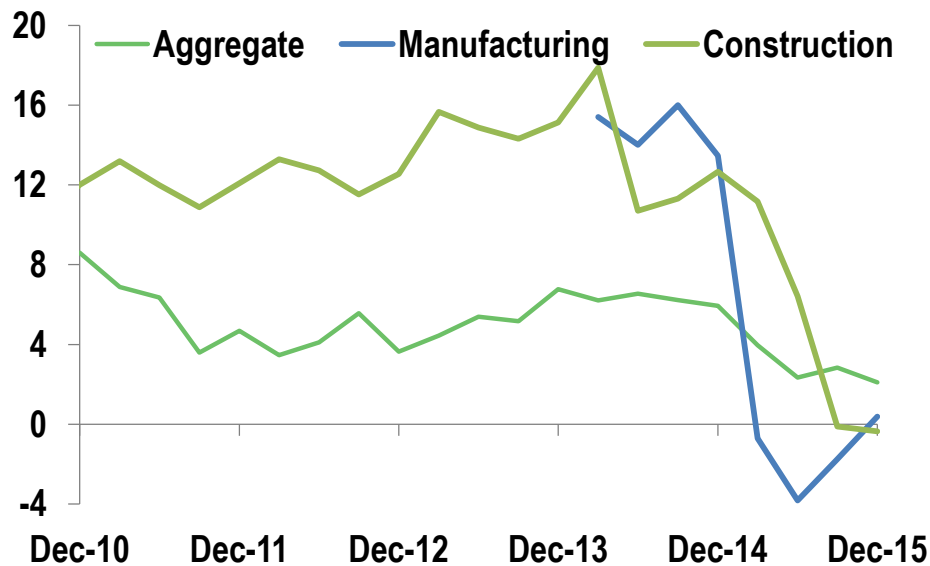
Nigeria: Fundamental outlook

Economic slowdown post-2014 mirrors low oil prices

- Growth slowed to multi-year lows in 2015 (2.1% y/y in Q4); the industrial sector continued to contract while growth in services decelerated further; agricultural growth remained subdued, albeit less volatile
- The oil price shock has weighed negatively on aggregate demand and investment; current FX policies and import restrictions have also affected output (for example, in manufacturing and import-dependent sectors)
- Inflation has accelerated (12.8% y/y in March), as the parallel FX market appears to be playing a more important role in influencing price expectations

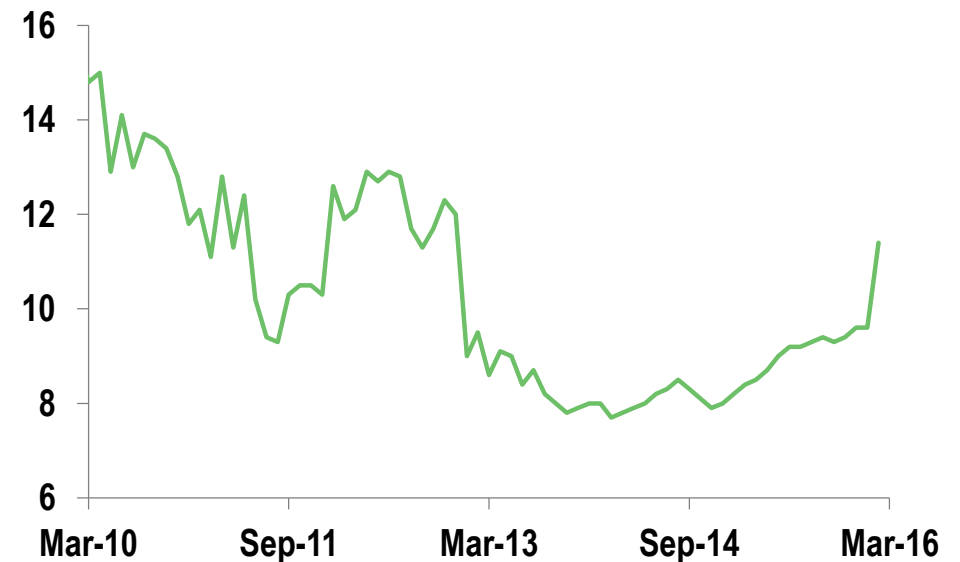
Real GDP growth

% YoY



Inflation

% YoY

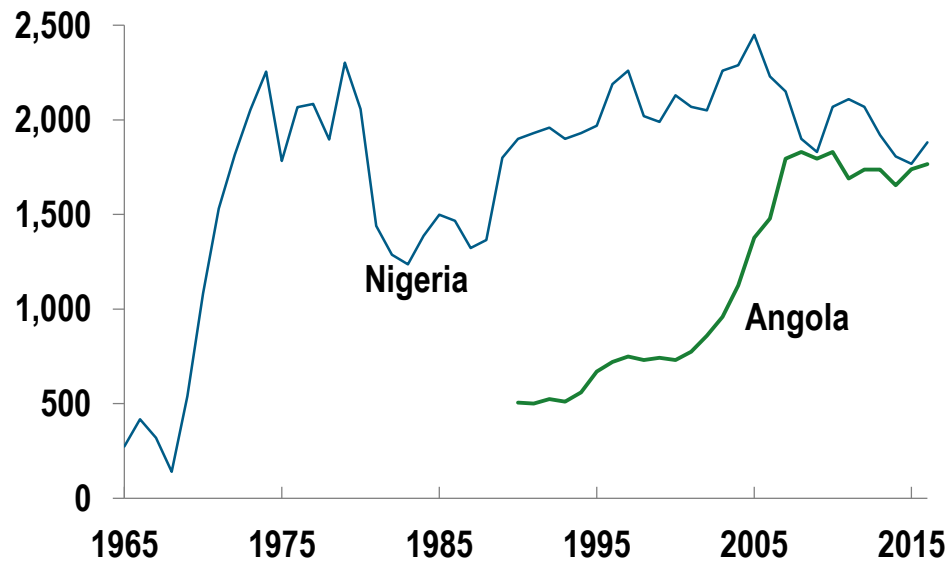


Nigeria faces a significant terms of trade shock

- Crude oil output has remained well below capacity; new investment in oil and gas is even more unlikely given current price dynamics in the sector
- The trade balance turned negative in 2015 as exports fell sharply (-43.0% y/y) in line with lower oil prices; oil still accounted for 92.5% of exports
- Imports have also contracted given FX scarcity and policy restrictions, albeit by a less significant margin (down 9.1% y/y in 2015)

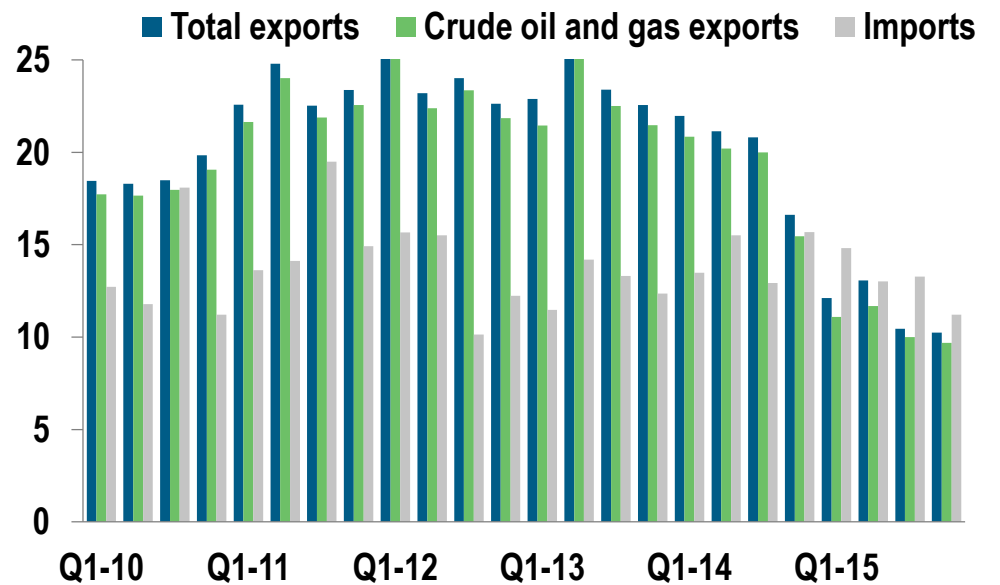
Crude oil production in Nigeria and Angola

Bpd 000



Exports versus imports

USD bn

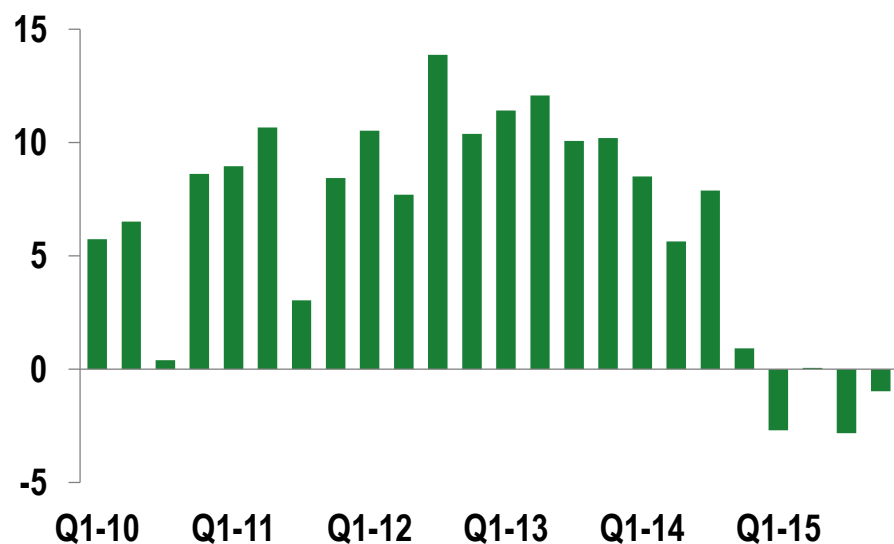


The current account position has turned negative

- The trade deficit, coupled with negative services and income balances, has resulted in a much weaker current account (C/A) position (a deficit of USD 6.4bn in 2015 versus a surplus of USD 22.9bn in 2014)
- Although there is a relationship between the oil price and the C/A position, this must be nuanced: the C/A surplus had eroded in the early 2010s even amid elevated oil prices as the import bill remained sticky
- A negative C/A position and sluggish portfolio/FDI position will weigh negatively on the overall balance of payments

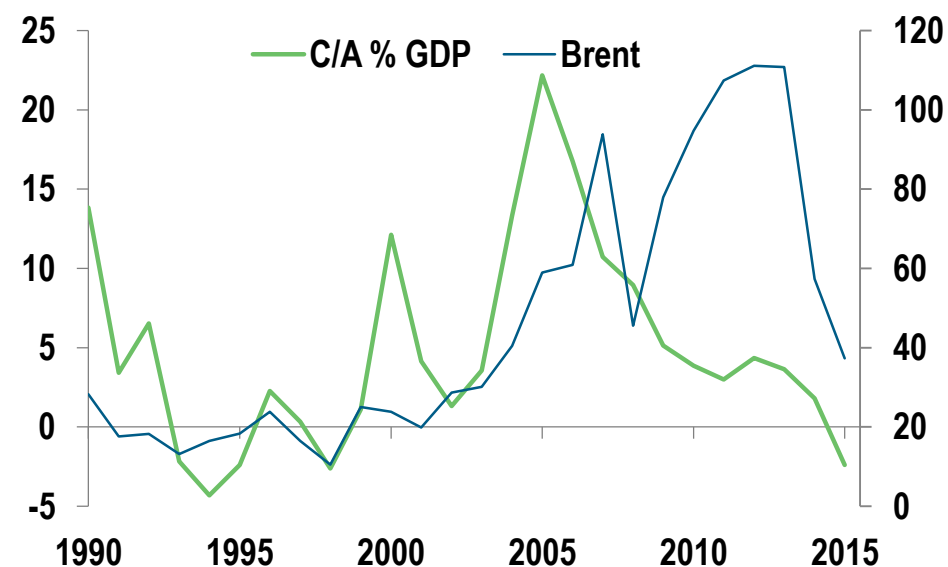
Current account balance

USD bn



Current account position versus oil price

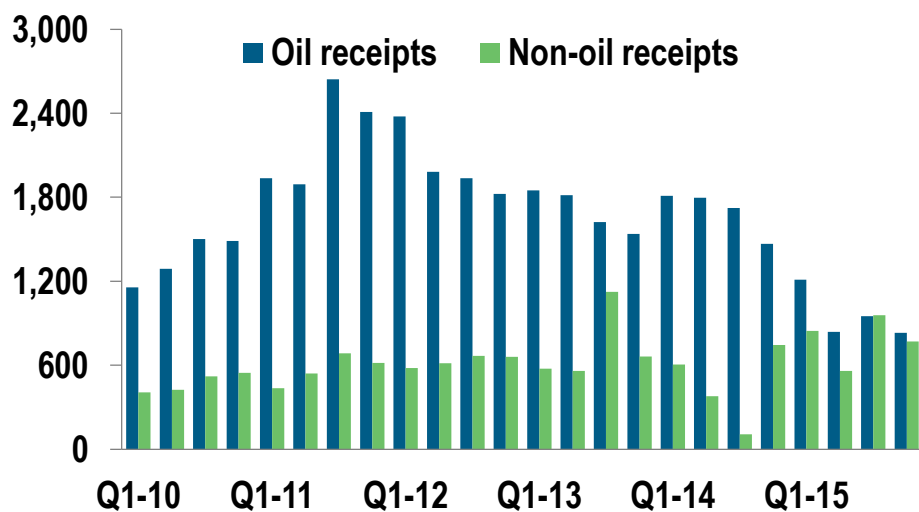
C/A, % GDP (LHS); Brent, USD/bbl (RHS)



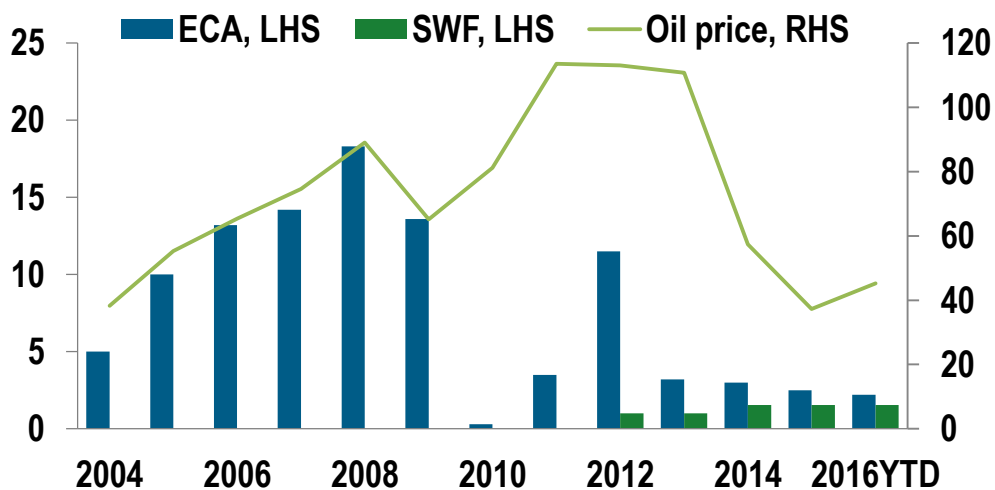
Diversifying the revenue base

- Oil revenue has dropped considerably in line with lower oil prices which will weigh on the fiscal position
- Oil revenue may contribute only c.NGN 820bn to the FG NGN 3.86tn revenue target (2016 budget draft)
- The authorities are keen to widen the tax base and improve tax collection efficiency
- This may be constrained by sluggish business activity and weaker corporate earnings
- Unlike in 2008-09, Nigeria has barely any fiscal savings left to support countercyclical fiscal policies; can the TSA proceeds be partly used for budget financing?

Breakdown of Federation Account revenue
NGN bn



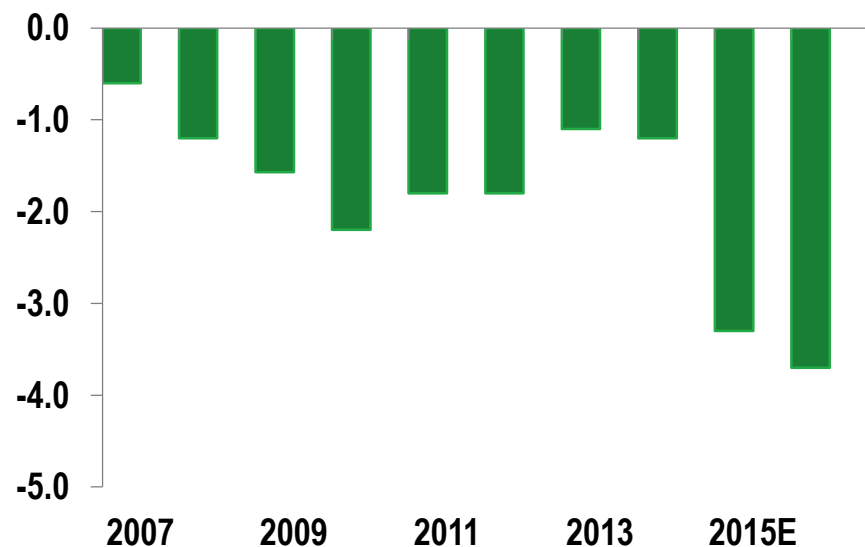
ECA/SWF balance versus the oil price
USD bn (LHS); USD bbl (RHS)



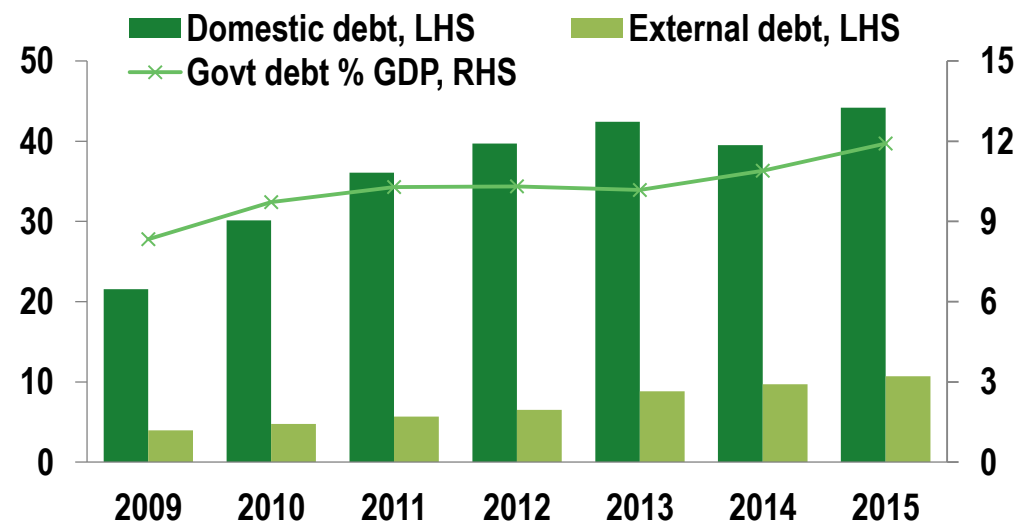
Financing a wider fiscal gap

- FG spending may reach NGN 6.06tn in 2016 from a median of c.NGN 4.5tn in recent years
- Recurrent expenditure and capex are estimated at NGN 2.64tn and NGN 1.58tn, respectively
- The authorities project the FG's fiscal deficit at NGN 2.2tn (USD 11bn); the federally consolidated gap may be even higher, especially if accounting for arrears
- Domestic borrowing is tentatively projected at NGN 984bn; debt service, excluding the retirement of maturing loans, may reach NGN 1.36tn (35% of revenue); the authorities also plan to issue FCY bonds and borrow at concessional (or preferential) terms externally to plug the financing gap

Federal Government fiscal deficit
% of GDP (2015-16 SCB estimates)



ECA/SWF balance versus the oil price
USD bn (LHS); % of GDP (RHS)





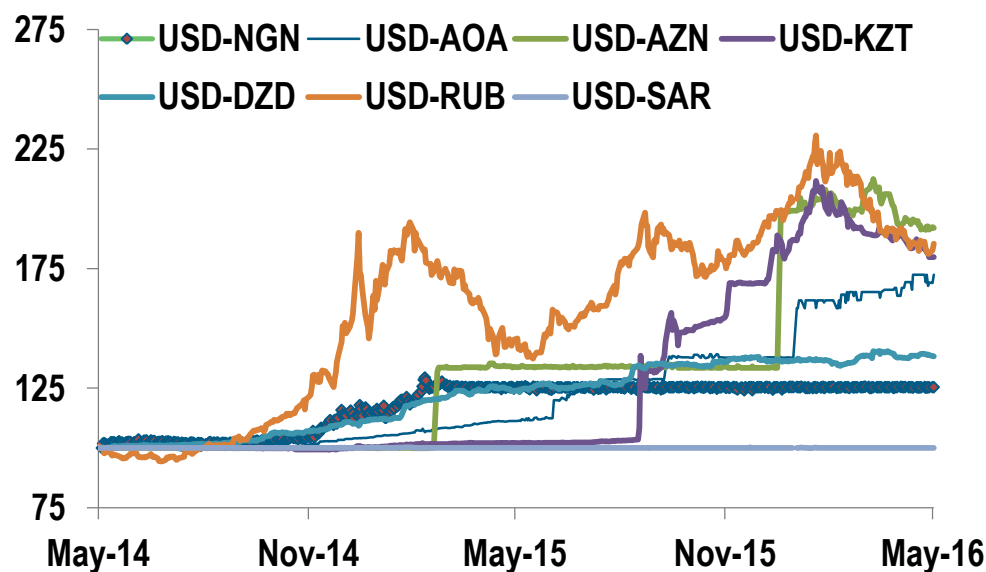
Further NGN devaluation looks inevitable

FX regime remains under pressure

- The CBN has maintained a heavily managed exchange rate near the 197.0-199.5 level; yet a wide parallel market rate (c.320), FX shortages and a multi-billion USD demand backlog have persisted
- FX supply restrictions have prevented a faster decline in gross reserves, but the net FX reserves position points to increased vulnerabilities
- Nigeria trails other oil producers in terms of exchange rate adjustment since mid-2014
- There has been speculation that a multi-tier FX market could be introduced at some stage

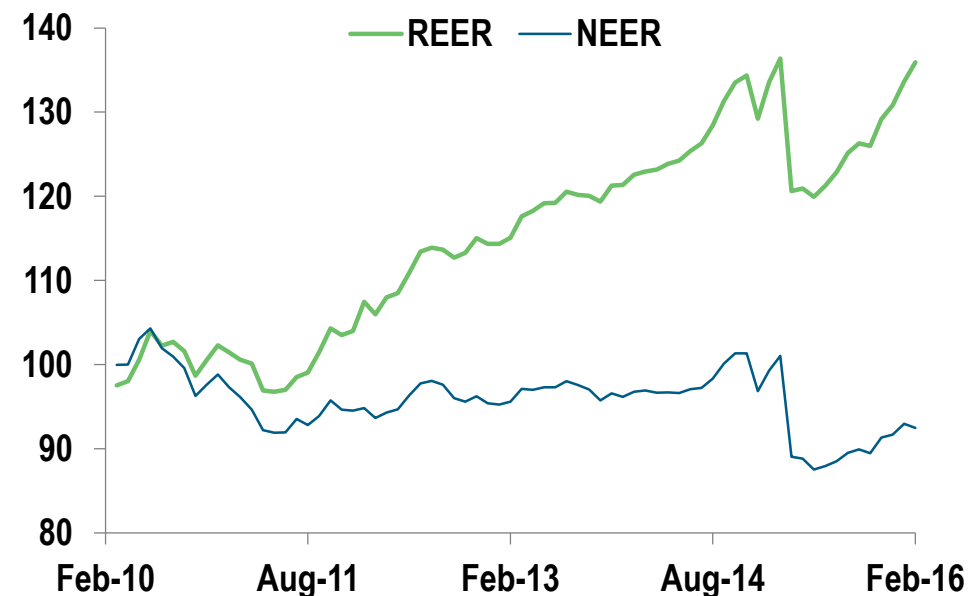
Exchange rates in oil and gas economies

FX, normalised levels (1 Jan 14 = 100)



REER and NEER exchange rates

Index

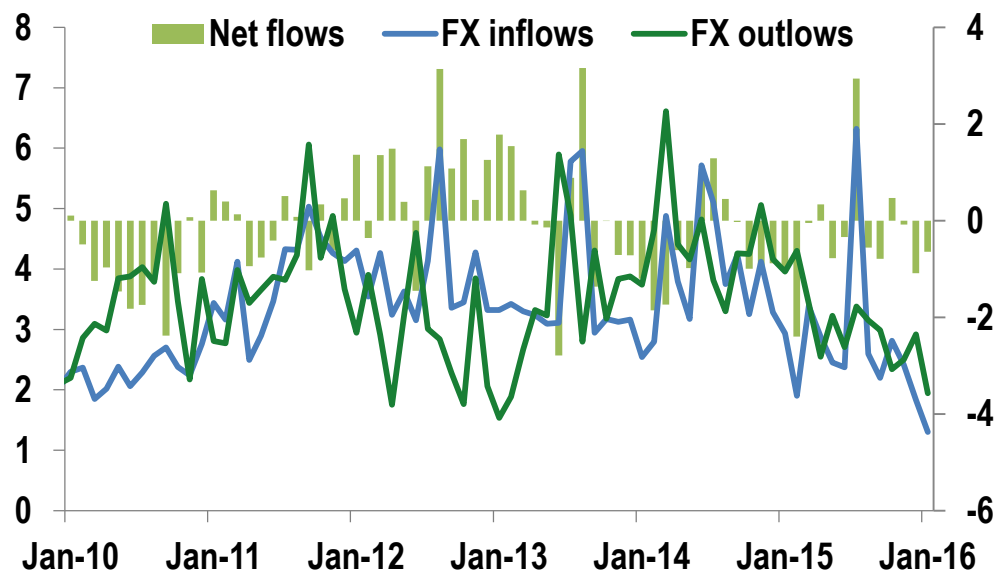


FX rationing has prevented a faster drop in reserves

- The FX flow position through the CBN has generally been negative post-oil price shock as FX earnings fell; portfolio outflows peaked in Q4-2015 as foreign investors exited the market, but eased afterwards
- CBN FX rationing has prevented a faster decline in reserves, but this has resulted in a significant backlog of unmet USD demand
- The downtrend in gross FX reserves (USD 27.0bn on 5 May) has been contained by FX supply limitations; however, net FX reserves (adjusting for the ECA/FG account and forward book) are lower

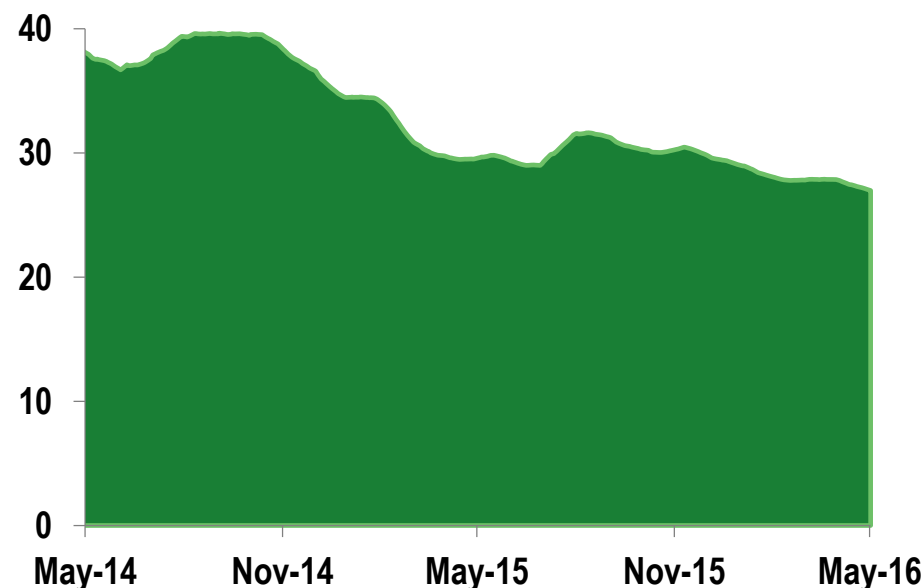
FX flows through the CBN

USD bn



Nigeria's gross FX reserves

USD bn

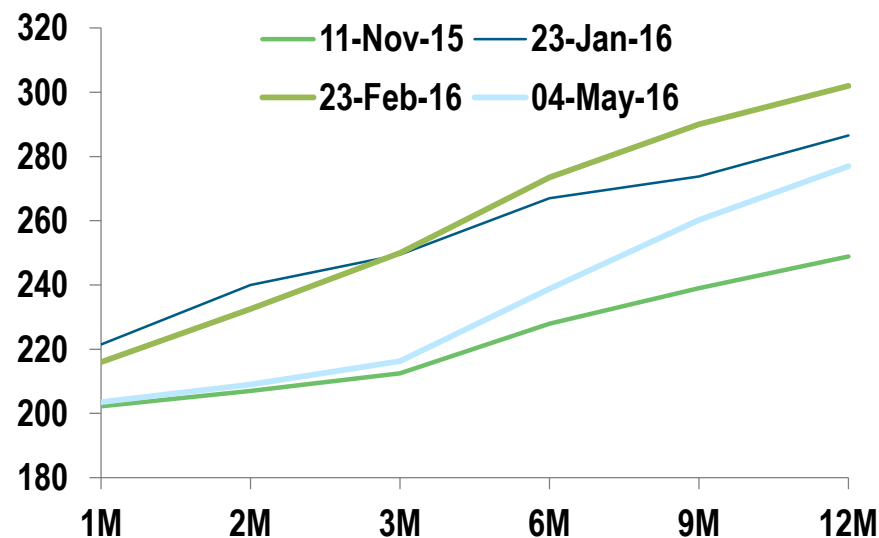


The market expects further NGN devaluation medium-term

- The NDF curve has compressed in recent weeks, but remains relatively steep; this suggests that market stakeholders do not foresee imminent currency devaluation given the authorities' reluctance to adjust their FX stance for now, but expect a sharper depreciation in the medium-to-long term
- The NDF curve tends to be influenced by the (wide) parallel market premium, oil prices as well as technical and flow factors
- Liquidity in the offshore USD-NGN NDF market is around USD 20-50mn a day; the onshore forward market has remained largely inactive due to RHS utilization restrictions/regulations in place

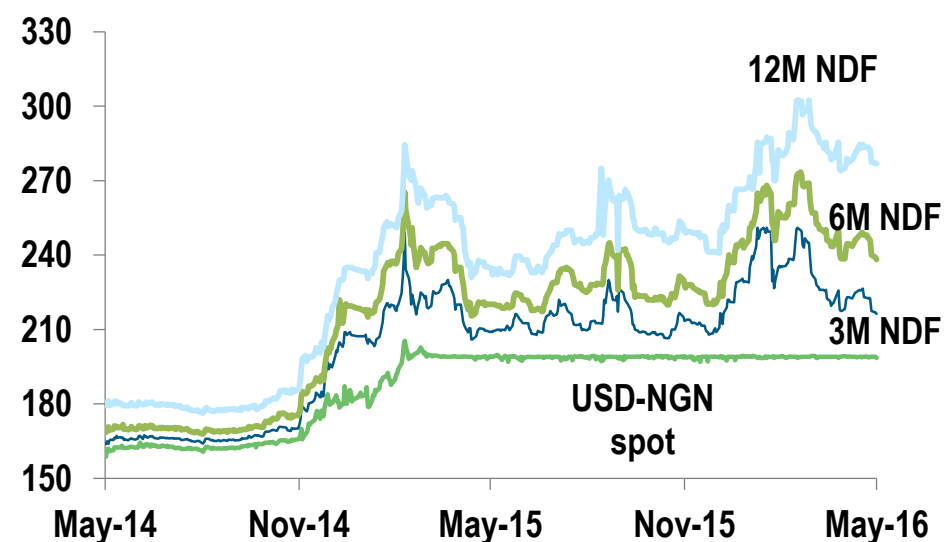
NDF curve

USD-NGN outright



USD-NGN spot versus NDF outright

USD-NGN



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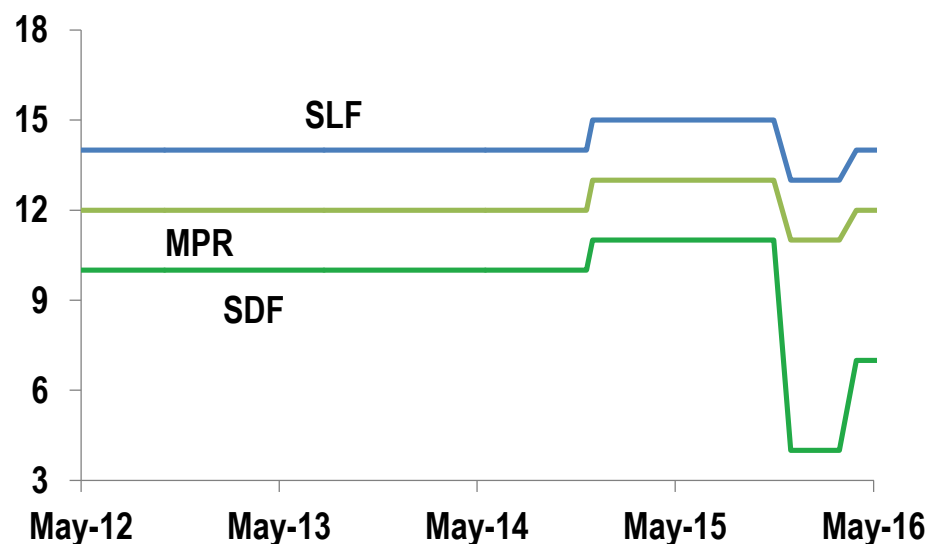
Positioning in the fixed income market

Monetary policy has turned more hawkish

- The CBN surprised the market by raising the MPR by 100bps to 12% at the 21/22 March MPC; the central bank also tightened the asymmetric corridor around the MPR to +200bps/-500bps and raised the CRR by 250bps to 22.5%
- The partial reversal of previous monetary easing may reflect the uptrend in inflation and weak confidence in monetary and FX policy; this probably prompted the CBN to act to anchor expectations
- The CBN has recently indicated that a negative CPI-adjusted policy rate would not be acceptable

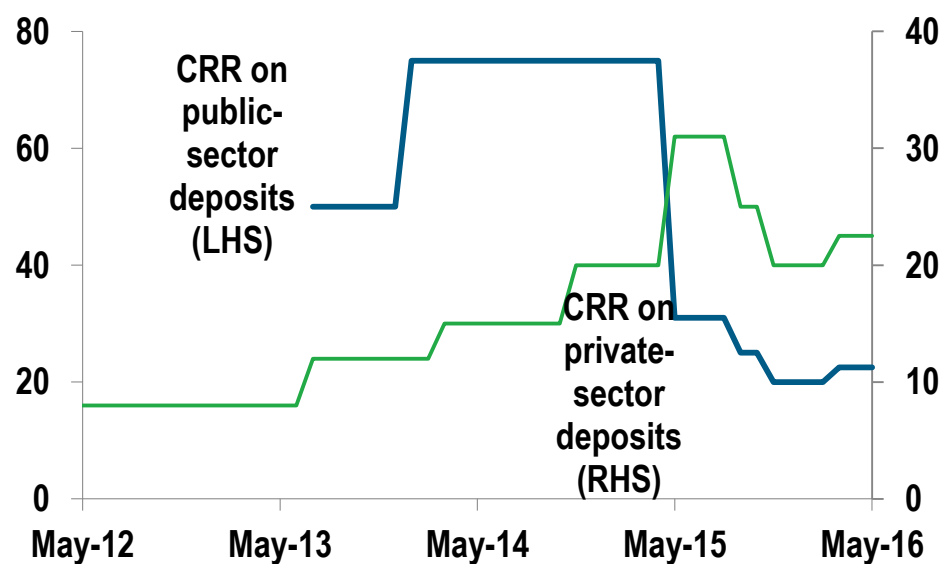
Key policy rates

%



CRR ratios

%

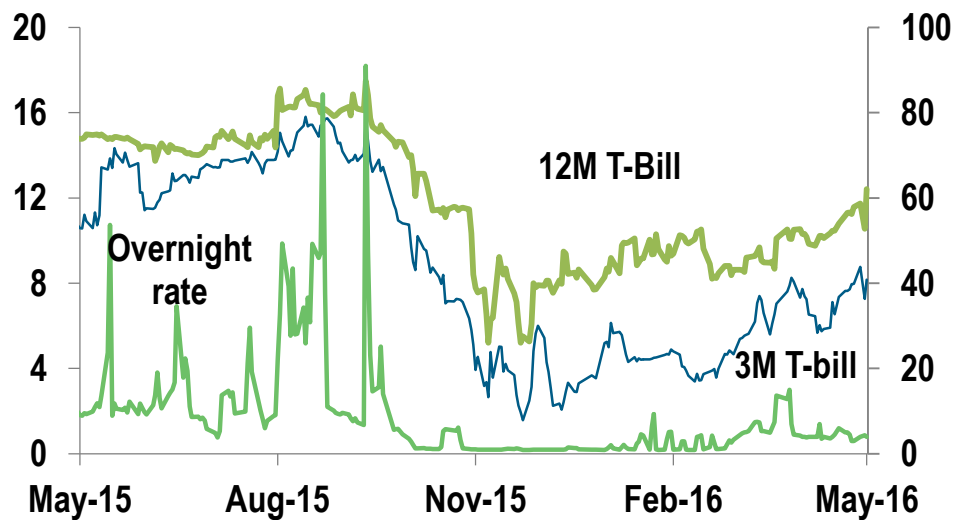


Short-dated rates have picked up from multi-year lows

- The short end of the yield curve has moved higher recently from the depressed levels recorded earlier this year, although rates still remain moderate by historical standards
- After tighter market conditions in March, the liquidity position has improved (c. NGN 400bn presently), but the liquidity surplus is less significant than in early 2016
- The overnight rate (c.3-4.5% over the past month) has broadly tracked shifts in the liquidity balance
- Recent OMOs have generated limited investor appetite, as T-bill yields continue to trend higher

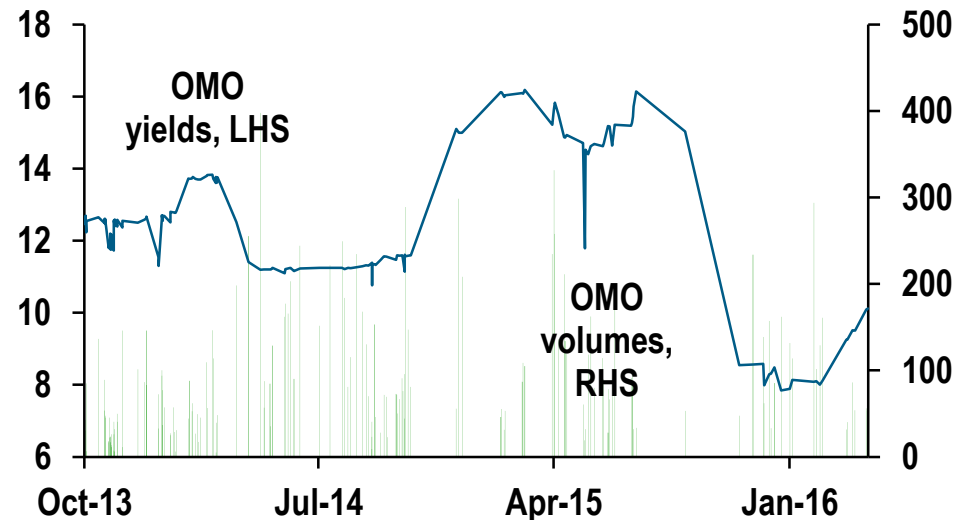
T-bill yields and overnight rate

T-bill yields (LHS); overnight rate (RHS)



CBN OMO operations

Yield, % (LHS); Volumes, NGN bn (RHS)

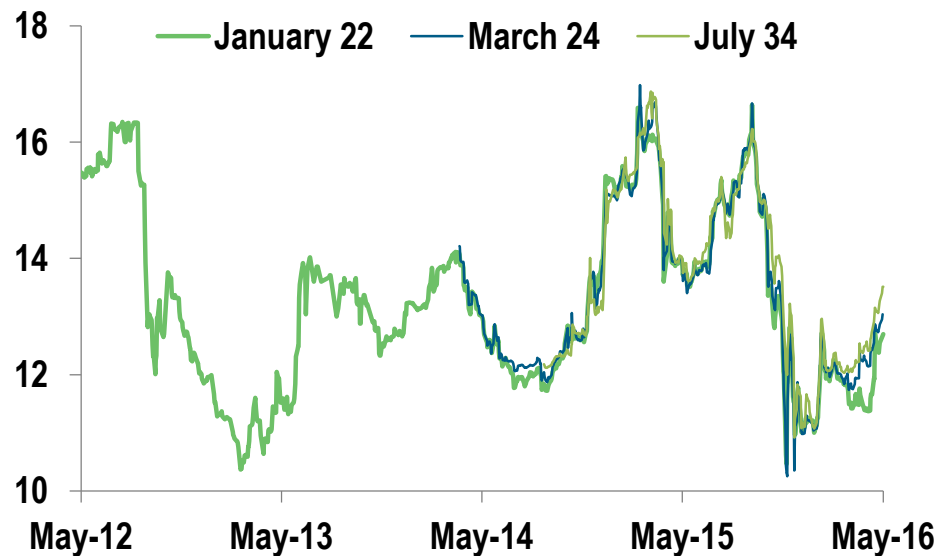


FGN bond yields have risen, but this may not be fair value yet

- Bond yields have picked up gradually in recent months after bottoming out in late 2015; this probably reflects investor concerns about further potential monetary tightening, rising inflation as well as supply risk
- The re-pricing has taken place from a low base while more upward pressure on yields could be associated with future normalisation of FX market conditions; that said, the domestic bid may smooth the upside
- The average 10Y yield over the past four years was 13.3%, with a high of 17.2% in February 2015
- Nigeria's bond yields now exceed those of GBI EM countries, but the premium is insufficient to compensate for FX (and liquidity) risk

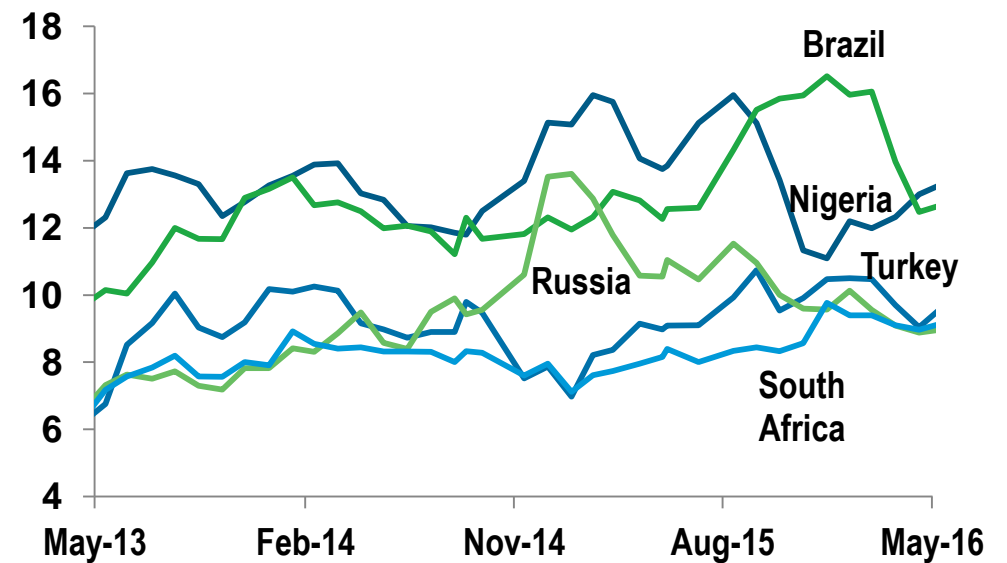
FGN bond yields

%



10Y bond yields in GBI-EM countries and Nigeria

%

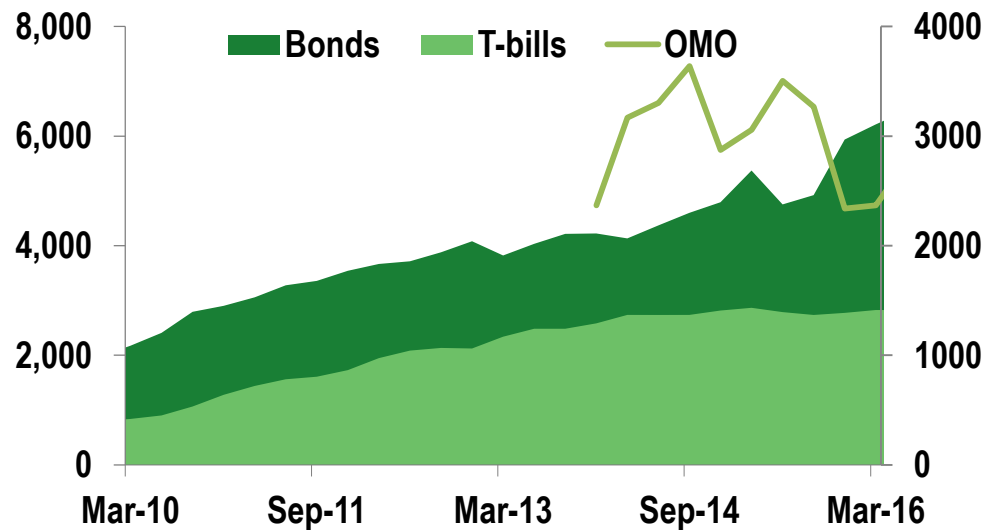


Supply has picked up, albeit not disproportionately

- The wider fiscal gap may result in higher domestic borrowing which was already projected at NGN 984bn in the initial draft of the 2016 budget (net issuance between January and May is c.NGN 497bn)
- The DMO's issuance calendar for Q2-2016 suggests bond supply is likely to remain close to the upper end of the range recorded in recent years; T-bill supply remains more contained though
- Increased reliance on the local market may be constrained by the recent pick-up in bond yields and the deterioration in the debt service/FG revenue ratio (c.35% in the 2016 budget draft versus 16% in 2010)

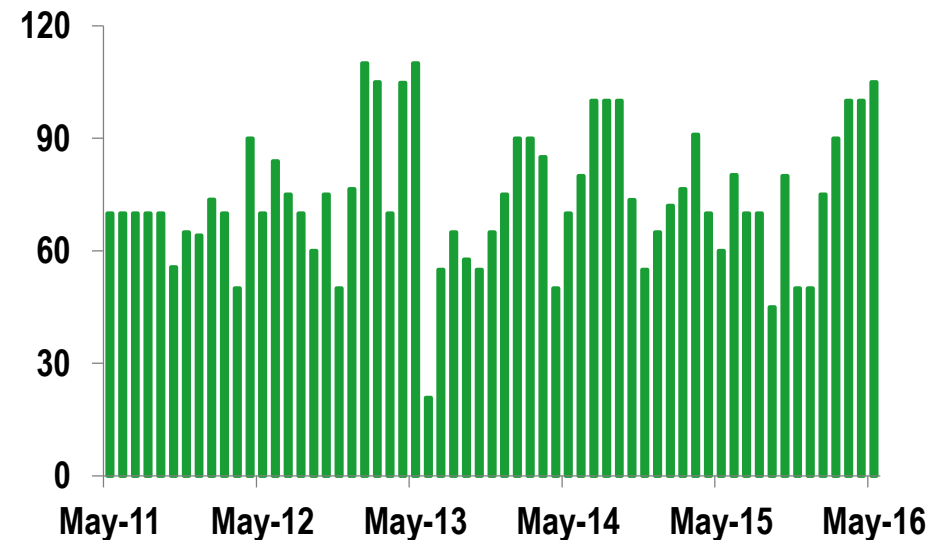
Public debt stock

Bonds, bills, NGN bn (LHS); OMO, NGN bn (RHS)



Aggregate monthly gross bond issuance

NGN bn

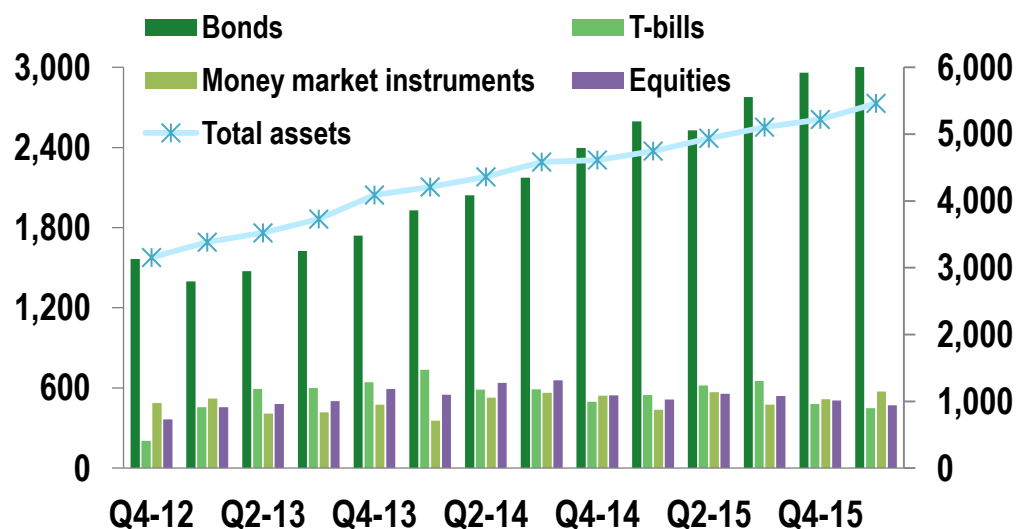


Domestic demand may partly mitigate supply risk

- Nigerian banks will likely remain the largest holders of T-bills due to their short-dated funding structure; this bias may be somewhat supported by the recent pick-up in yields
- PFAs' AUMs (NGN 5.46tn in Q1-2016) have grown at a slower pace (c. 10% y/y) due to the challenging market environment and exposure to public-sector contributions
- PFAs held 52.1% of the bond stock in Q1-2016 and will likely remain the dominant holders of FGN bonds given the need to match long-term assets and liabilities

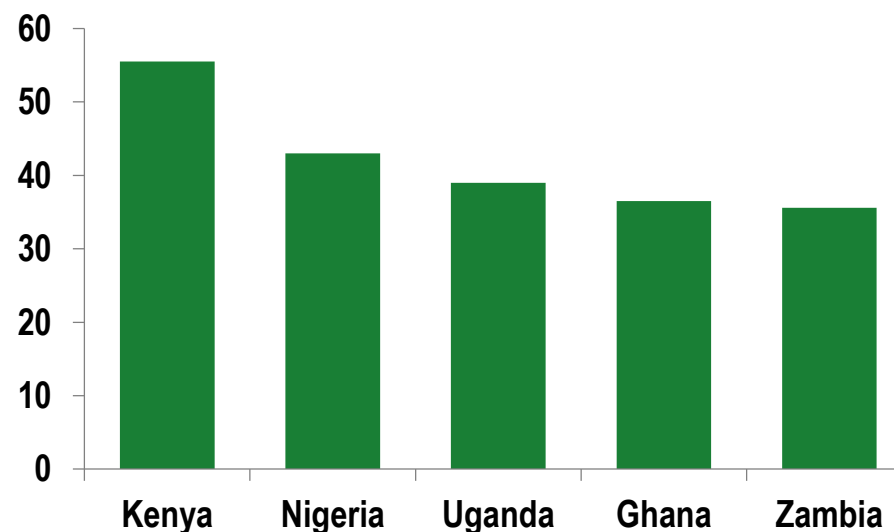
PFAs' AUMs in Nigeria

NGN bn; Total assets (RHS)



Debt holdings by SSA financial institutions

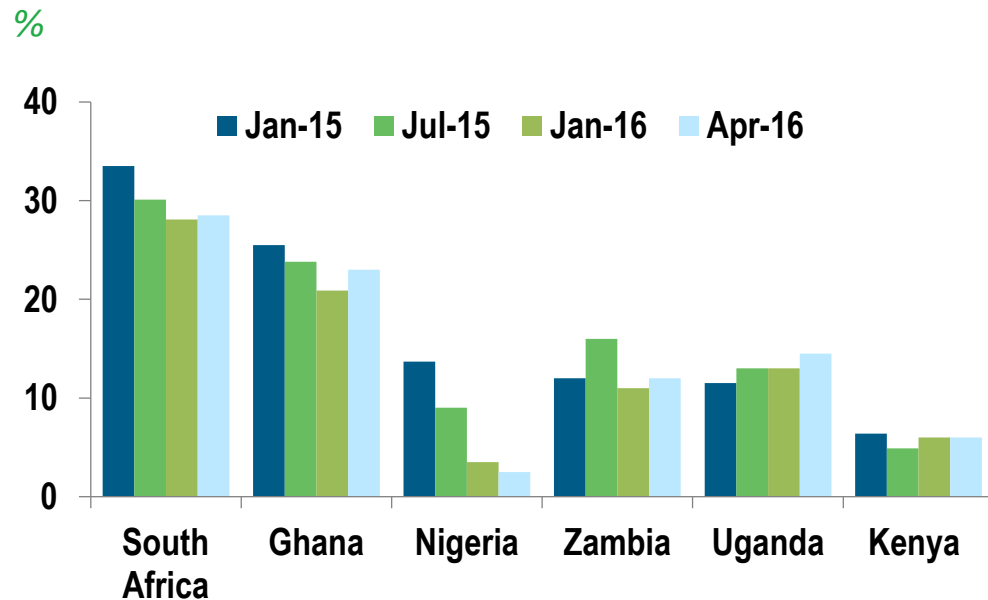
% of total issuance



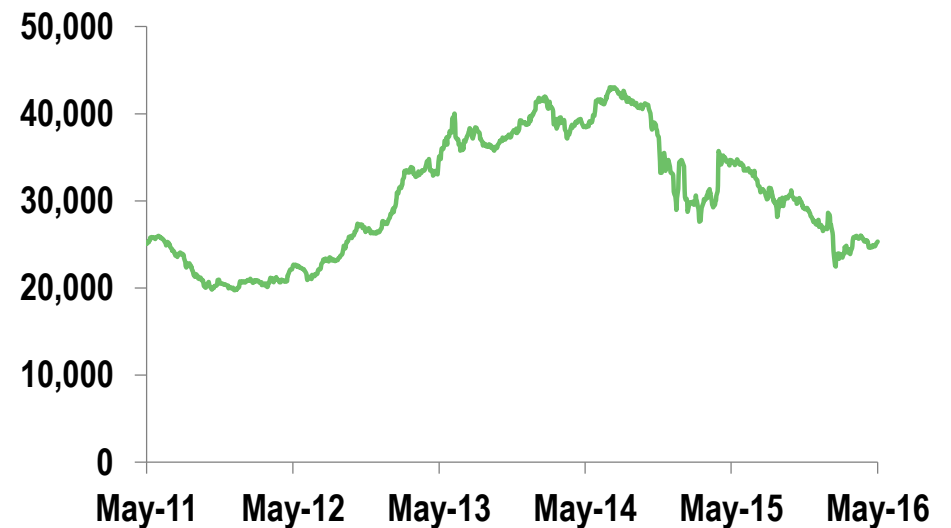
Limited foreign participation in local markets

- Foreign participation in fixed income remains marginal given FX market bottlenecks
- Offshore holdings of FGN debt had decreased substantially even before Nigerian bonds were excluded from the GBI-EM indices in September-October 2015
- Foreign equity investors are underweight Nigerian stocks (5% average fund weight vs c.12% weight for Nigeria in MSCI or c.USD 500mn of holdings)
- MSCI retained Nigeria in its Frontier Index in late April, but may remove selected stocks going forward

Foreign investor participation in selected debt markets



NSE All-Share Index
Index

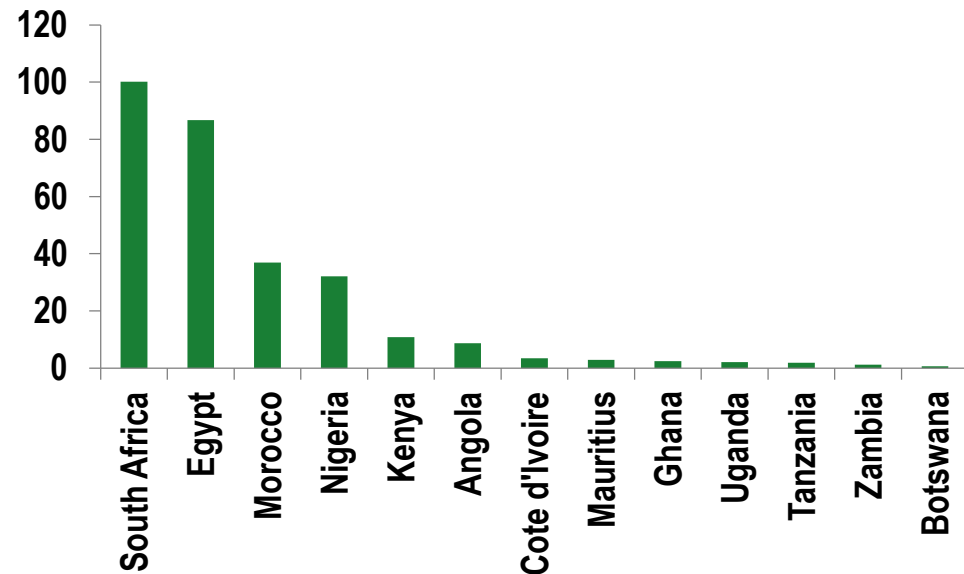


Decent liquidity of FGN debt market makes it relevant in EM

- Given its relative fixed income liquidity by SSA and even EM standards and its size, we think Nigeria's debt market will remain on the radar of foreign investors
- Daily turnover is around USD 150mn for bonds and USD 375mn for T-bills
- A narrower pool of investors may resume NGN debt purchases in the future, but this will require a more sustainable exchange rate level, higher oil prices and improved FX turnover

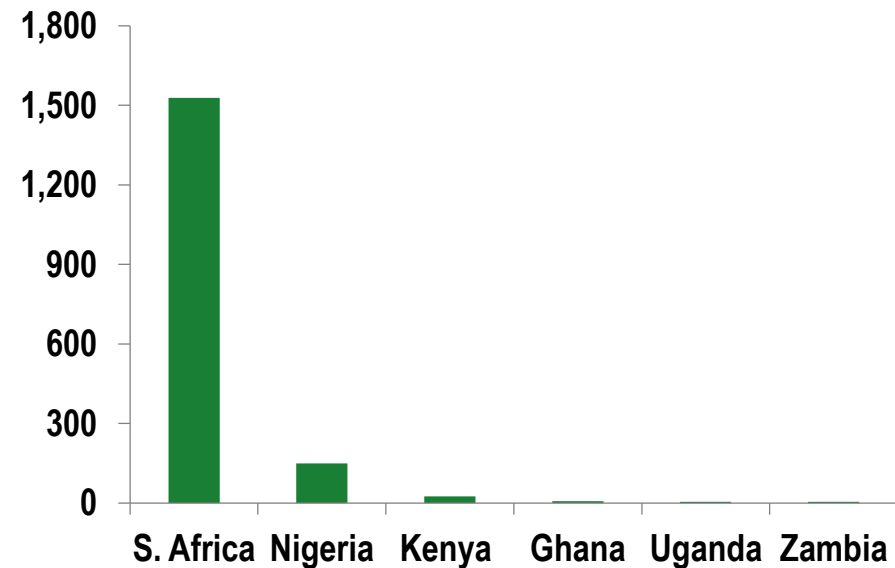
Bond market size in African countries

USD bn



Average secondary-market bond turnover (daily)

USD mn

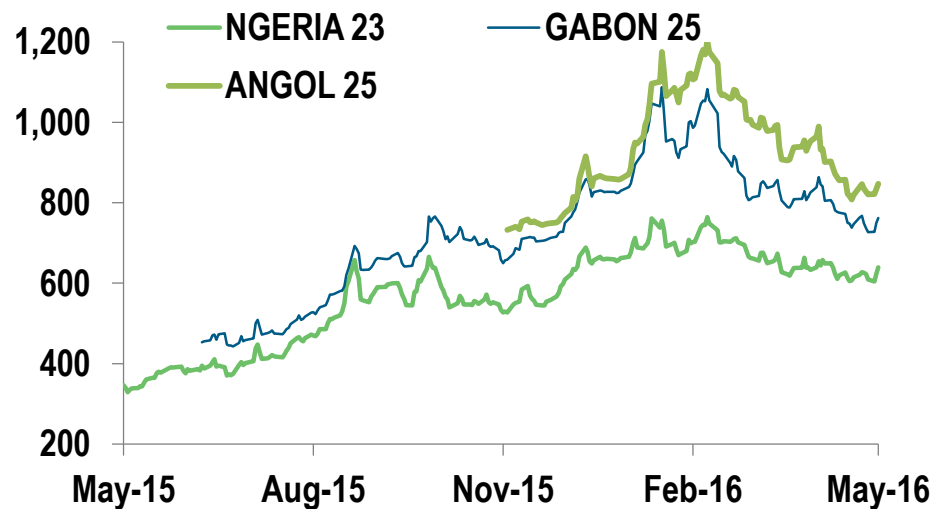


FGN Eurobonds trade tight to SSA oil peers

- FGN Eurobonds trade tight to comparable SSA oil issuers (Gabon and especially Angola) which limits their relative value in a regional portfolio
- This tight price action may reflect Nigeria's marginal FCY redemption profile and low USD interest costs, even though the ratio of external debt/net FX reserves is less impressive
- The authorities could potentially issue new Eurobonds in 2016 which may re-price the USD NGERIA curve
- Other alternative external financing options are also under consideration (for example, Panda bonds)

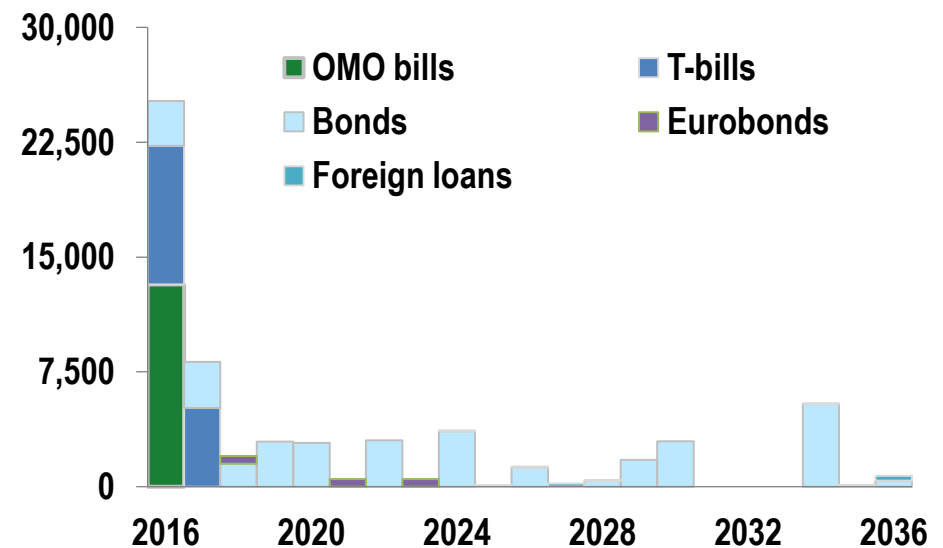
Eurobond spreads

bps



Public debt redemption profile

USD mn



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