

6 September 2018

## Macro Economic Report | Monthly Update

### *Hot Money's quick exit drags foreign reserves*

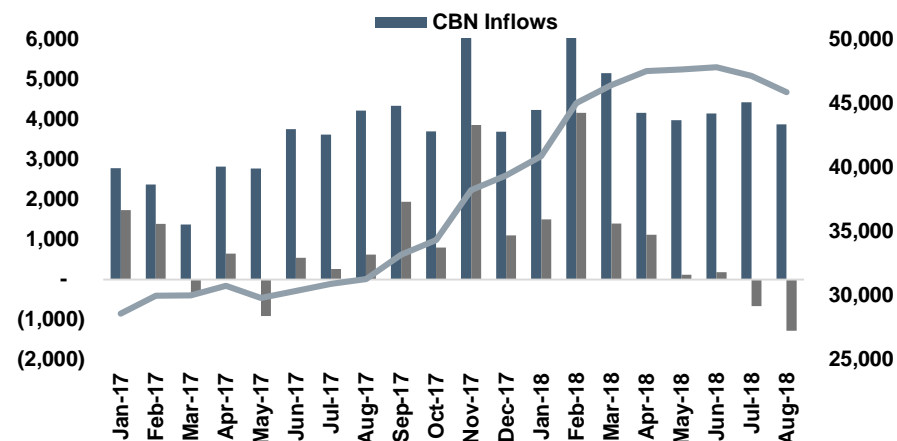
Extending the decline in July, the nation's external reserve depleted further by \$1.3 billion in August, culminating in a total of \$2.0 billion depletion over the last two months to \$45.8 billion. While the drawdown in July of \$669 million was largely due to the payment of maturing Eurobond (\$500 million) which matured in the month, the steep outflow in August was driven by rising demand by offshore investors exiting the market as evidenced by the net demand at the IEW which rose 74.4% MoM to \$1.1 billion (vs. \$625 in July).

Notably, total CBN sales at the IEW increased 79% MoM to \$1.2 billion in July – the highest since the inception of the window – as the apex bank fired up its intervention following lower FPI inflows (-37% MoM to \$495 million) – CBN sales accounted for 54.5% of total dollar demand at the IEW. On offshore inflows, the decline stemmed largely from hot money, which contracted 43% MoM to \$397 million. Overall, the IEW recorded total inflow of \$2.4 billion (ex-CBN: \$1.2 billion which is 19.8% lower MoM), which compared to total outflow of \$2.1 billion translates to a net inflow of \$269 million. However, Ex-CBN sales net outflow in the market would have risen to \$903 million vs. \$357 million in July.

Across other markets, in a bid to ensure stability, the apex bank intervened to the tune of \$2.2 billion. At the SMIS, SME and Invisibles market, the apex bank auctioned a total of \$943 million, while non-auction related transactions rose 71%

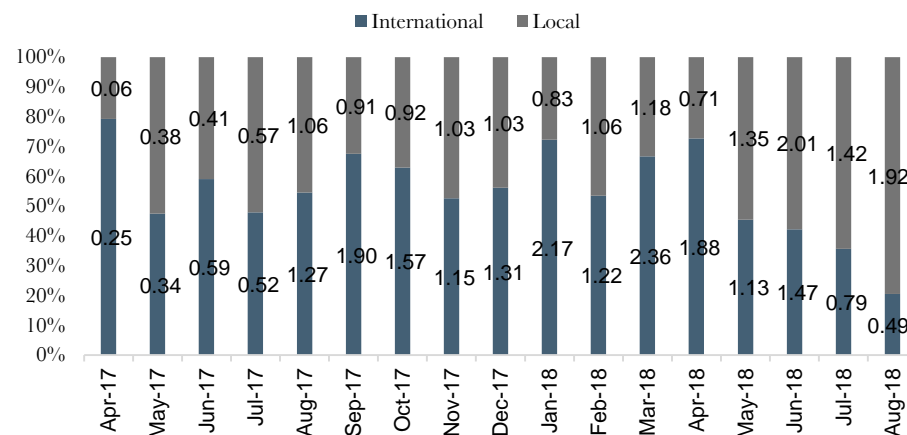
## Macro Economic Update – August 2018

**Figure 1: CBN inflow, net flow and Gross Reserve position (\$'Million)**



Source: CBN, ARM Research

**Figure 2: FX Inflow at the I&E Window (\$'Billion)**

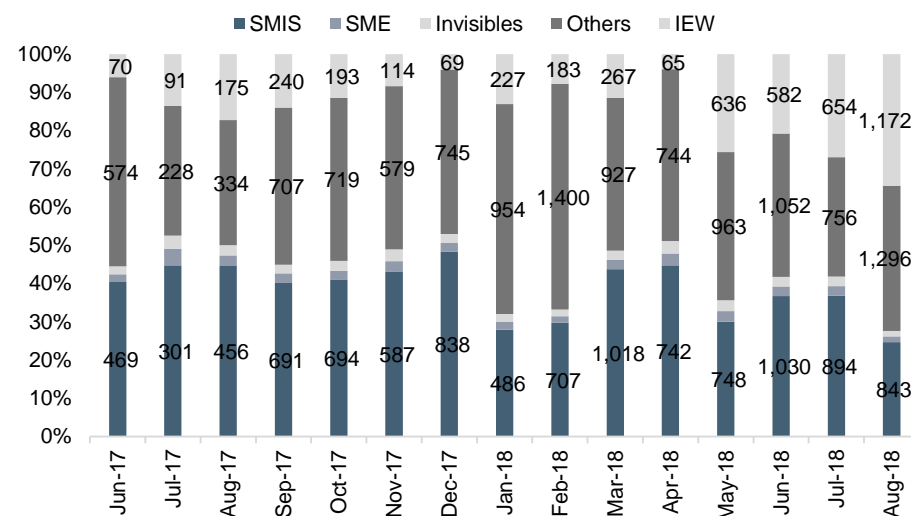


Source: CBN, ARM Research

MoM to \$1.3 billion. Accordingly, overall apex bank outflow at the IEW and special interventions rose 40.5% to \$3.4 billion. Reflecting the increased intervention, the naira firmed at the BDC (~~₦~~358.0/\$ vs. ~~₦~~359.4/\$ in July) and parallel (~~₦~~362.3/\$ vs. ~~₦~~361.8/\$ in July) markets. However, the most noticeable depreciation was at the NIFEX (~~₦~~357.6/\$ vs. ~~₦~~350.3/\$ in July), as the convergence to the NAFEX becomes more evident.

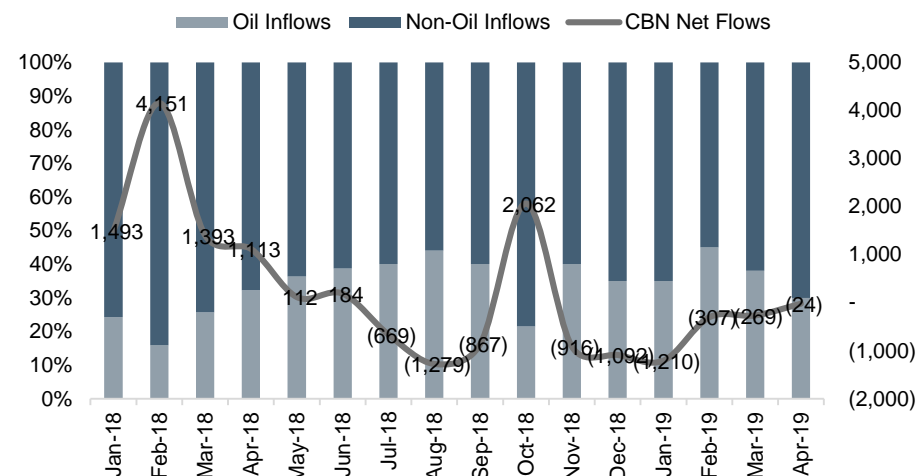
Over the rest of 2018, we remain optimistic on crude oil production and prices and thus, forecast average monthly crude oil inflow of \$1.5 billion for the rest of the year. On non-oil inflows, save for the \$2.8 billion Eurobond which we now expect in October, we believe the decline in offshore inflows at the IEW will limit overall inflows to the apex bank over the rest of the year. As such, ex-Eurobond, we expect average monthly non-oil inflow of \$2.4 billion with sum of monthly inflow for the rest of the year averaging \$3.9 billion. On outflows, we expect the hot money exit to persist, thus, we expect average monthly outflow from the CBN of \$4.6 billion. Net impact of our inflow and outflow expectation translates to an average monthly reserve drawdown of \$636 million over the rest of the year, which should instigate a further depletion in the reserve to \$43.5 billion (which adjusted for the Eurobond issuance should rise to \$45 billion).

**Figure 3: CBN intervention across FX markets (\$'Million)**



Source: FMDQ, ARM Research

**Figure 4: Foreign Currency flows through the CBN**



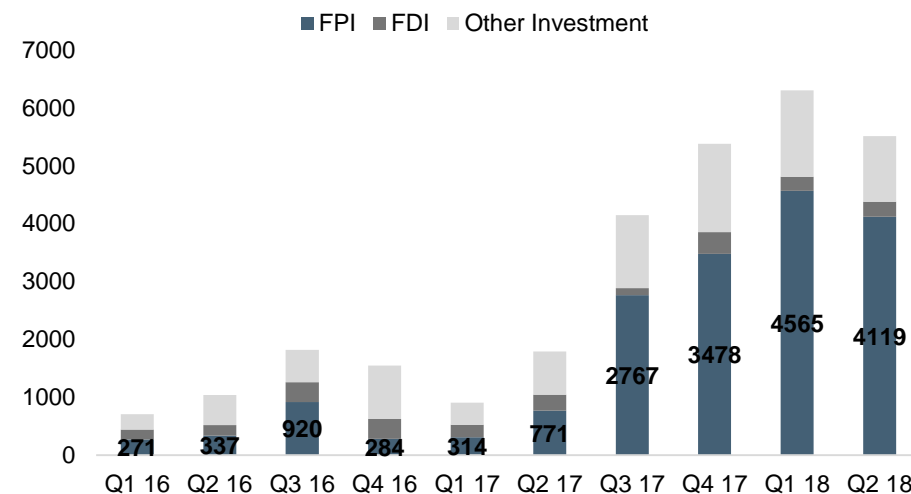
Source: FMDQ, ARM Research

### Capital flows loses steam

In line with our expectation, data released by the National Bureau of Statistics (NBS) revealed that capital importation into Nigeria moderated by 12.5% QoQ to \$5.5 billion (+207% YoY) in Q2 18. Much of the decline emanated from lower portfolio investments (-9.8% QoQ to \$4.1 billion) with flows to money market instruments (-24% QoQ to \$2.7 billion) truncated after touching a record quarter peak of \$3.5 billion in Q1 18. We link the lower flows to higher risk-adjusted rates in advanced economies relative to lower domestic short-term yields (Q2 18: 12.77%, Q1 18: 14.98%). Surprisingly, flows to equity market climbed higher by 49% QoQ to \$1.0 billion with most of the flows (56%) recorded in June (+199% MoM to \$585 million). Similarly, portfolio investments in bonds expanded 19.1% QoQ to \$400 million. Elsewhere, other investments tanked to a 4-quarter low of \$1.1 billion (-24.1% QoQ) while Foreign Direct Investment (FDI) expanded 5.9% QoQ to \$261 million. We believe the moderation in total flows reflected foreign investors' aversion to Nigeria's risk assets due to election uncertainty and higher rates in advanced economies.

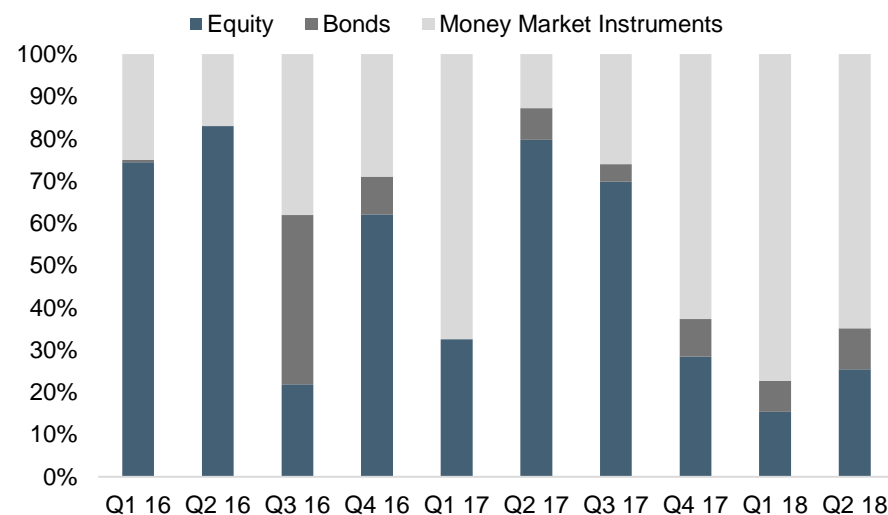
Going into the rest of the year, we expect the duo impact of policy normalization in advanced economies and election uncertainties to continue to weigh on capital importation into Nigeria. For evidence, flows in the IEW has moderated to an average of about \$550 million in Q3 18 relative to an average of \$1.5 billion in H1 18. In addition, data from the Central Bank of Nigeria (CBN) showed total capital importation into the country for the month of July tanked to an 11-month low of \$1.3 billion (vs. \$1.9 billion in June) on the back of lower portfolio investments (-34% MoM to \$804 million) and other investments (-75% MoM to \$143 million). Thus, we expect flows to remain depressed in the coming quarters.

**Figure 5: Capital Importation into Nigeria (\$'mn)**



Source: NBS, ARM Research

**Figure 6: Foreign Portfolio Flows Composition (\$'mn)**



Source: NBS, ARM Research

## Q2 18 GDP: Non-oil sector reclaims the spotlight

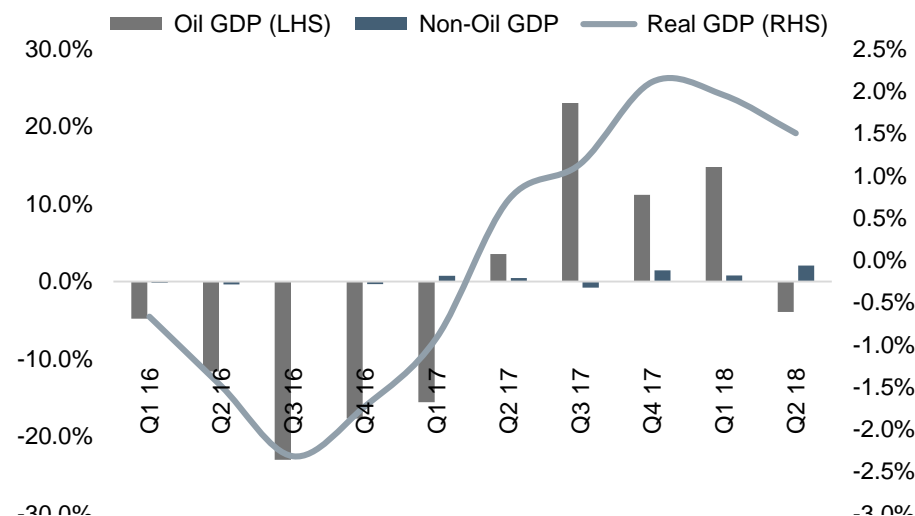
The Nigerian economy grew by 1.5% YoY in the second quarter of 2018, relative to 1.95% YoY in Q1 18. Remarkably, the non-oil sector was the major driver for growth, contrary to the trend of an oil led growth since the economy exited recession. Precisely, the non-oil sector grew by 2.05% (vs. 0.8% in Q1 18) while oil sector output contracted by -3.95% (vs. growth of 14.8% in Q1 18), hinged on a drop in crude production to 1.84 mbpd (-1.6% YoY). The decline in production mirrored the temporary closure of the transoceanic pipeline and Nembe creek trunk line for repairs, due to leakages discovered in May 2018.

Growth in the non-oil sector was largely driven by higher output in the services sector, buoyed by an improvement in ICT (+11.8% YoY), stemming from the growth in subscriber base (+11% YoY to 162 million subscribers). Elsewhere, manufacturing sector grew 0.7% YoY, mirroring improved activities in the cement, Food, beverage & Tobacco as well as the textiles, apparel & Footwear subsectors while the trade sector contracted by -2.1% YoY (vs. -2.6% in Q1 18) reflecting weak domestic demand. Lastly, growth in the agric sector slowed to 1.2% as the impact of the farmers-herdsmen conflict led to a slowdown in crop production (+1.5% YoY vs. 3.5% in Q1 18).

## Services Output, the backstop for Q3 2018 growth

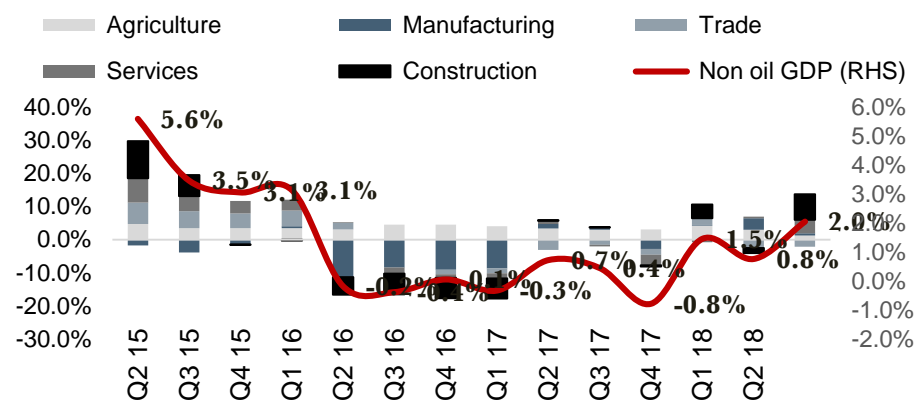
Going forward, we revise our Q3 18 growth estimate lower to 1.6% (vs. prior estimate 2.1%), majorly due to downward revisions to our Agriculture, manufacturing and Oil growth estimates, while we make upward adjustment to our services GDP estimate.

**Figure 7: Historical Movement in Real, Oil and non-oil GDP**



Source: NBS, ARM Research

**Figure 8: Historical Movement in components of the non-oil sector**

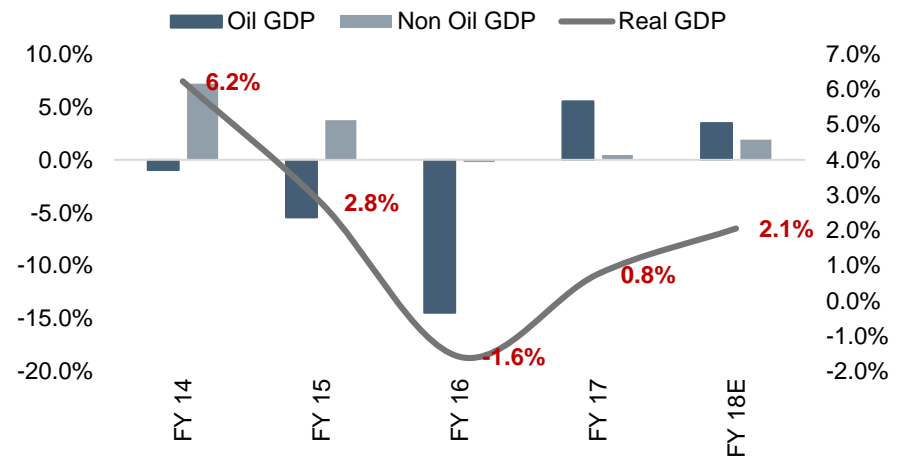


Source: NBS, ARM Research

Starting off with the agriculture sector, given the unrelenting farmers-herdsmen conflict and the impact its having on harvest and crop production, we believe growth in the sector will remain weaker in the interim. Although, the government rolled out a national livestock transformation plan in June and deployed security agents to the affected states in the Northern region, we think the action plans are moving at a slow pace and do not envisage a material improvement in the subsequent quarter. Overall, we now expect the Agric sector to grow by 1.8% YoY (vs. prior estimate of 3%). Still in the non-oil sector, growth in the manufacturing sector was revised lower 1.7% YoY (vs prior estimate of 2.3%) following the slow pick-up in consumer demand .On the positive, we forecast growth of 3.5% (vs. prior estimate of 0.5%) for the services sector, predicated on expected recovery in the ICT subsector (32% of sector output), as major telecommunication players sustain capital investment and customer acquisition drive. The foregoing translates to a non-oil sector growth of 1.9% YoY.

On the flipside, oil sector output is expected to contract at a much slower pace of -0.4% YoY (vs. prior estimate of +6%) relative to Q2 18. For us, we expect a pick-up in crude production hinged on the resumption of bonny light exports following the lifting of the force majeure in June. We, however, do not see production recovering to the 2mbpd levels as Trans Ramos pipeline is yet to be re-opened. Accordingly, average crude production estimate for Q3 18 is expected to print at 1.94mbpd (-1.9% YoY). Juxtaposing these changes with the actual growth numbers reported in H1 2018 translates to a full year growth of 2.0% YoY (prior forecast: 2.1% YoY) with the oil and non-oil sector expected to grow by 3.5% YoY and 1.9% YoY respectively.

**Figure 9: Movement in Annual Real GDP, Oil and Non-oil GDP**



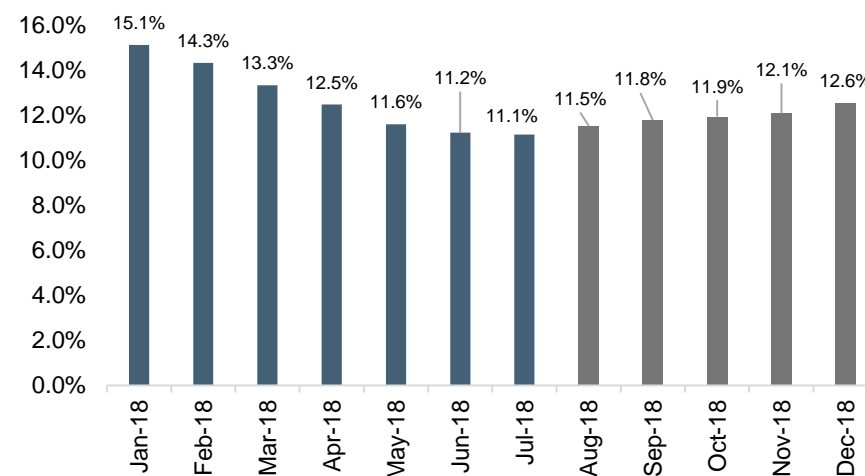
Source: NBS, ARM Research

### *Inflation declines in July, but upside risk abounds*

Nigeria's headline inflation for the month of July came in at 11.14% YoY, representing a 9bps decline from 11.23% reported in the month of June. Broadly, amidst still favourable base effects, the decline was driven by softening consumer prices in the food and core basket with MoM inflation declining 17bps and 22bps respectively, driving headline MoM to decline 11bps to 1.13% (June: 1.24%). We note that June's headline MoM inflation was strikingly high as prices, particularly food, was pressured by the higher demand associated with the Ramadan season. Hence, given that the Ramadan ended in June, it appears consumer prices normalized to previous levels which explains the decline in MoM headline inflation. Elsewhere, MoM core inflation slowed to 0.81%, 22bps lower than 1.03% in the prior month. The decrease reflected declines in education, clothing and HWEGF – Housing, Water, Energy, Gas and other Fuel.

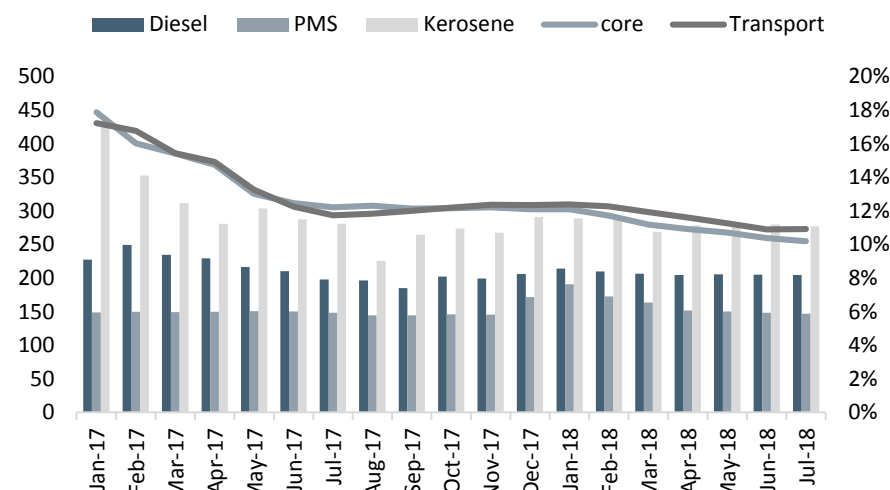
Going forward, we expect pressures on MoM inflation following the recent ~400% hike in the cost of container haulage from the Apapa port terminal to importers warehouses around the country. The hike was borne out of the bad state of the road leading to the Apapa port which resulted in constant gridlock and reduced turnaround time for the haulage operators. We expect the passthrough of the higher haulage costs by importers to instigate price pressures on imported food, clothing & footwear, and processed food inflation, accounting for 13%, 7.7% and 4% of headline inflation respectively. Given this and dissipating base effects, we expect August headline inflation to print at 11.5% YoY.

**Figure 10: Inflation rate – Actual and Forecast (YoY)**



Source: NBS, ARM Research

**Figure 11: Avg. energy prices (₦/litre) vs. Core & Transport Inflation (% YoY)**



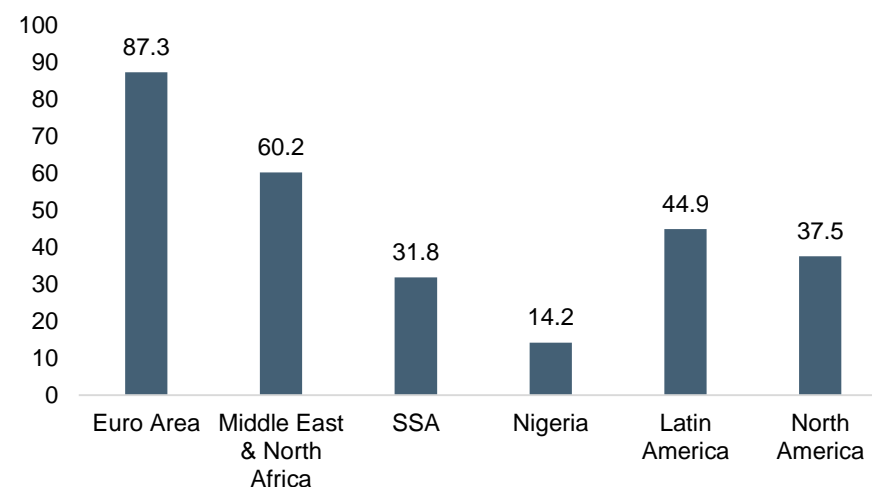
Source: NBS, ARM Research

### ***CBN Real Sector Support Facility (RSSF)***

In a bid to consolidate and sustain the nation's economy, the Central Bank of Nigeria (CBN) introduced a facility which is intended to spur the flow of credit to the real sector of the economy through a Differentiated Cash Reserve Requirement (DCRR) and Corporate Bonds. Notably, the CBN intends to achieve this through two means. First off, the CBN intends to incentivize the DMBs to direct affordable, long-term bank credit to the manufacturing, agriculture as well as other sectors considered by the CBN as employment and growth stimulating. The second means is through encouraging Corporates/Triple A-rated companies to issue long term Corporate Bonds (CBs). Specifically, the funds will be channeled into greenfield and brown field projects while trading and refinancing of existing loans are prohibited under the facility. Furthermore, the maximum amount allowed for each project is ₦10 billion with an interest rate set at 9% and tenor of 7 years. In addition, the facility offers a 2-year moratorium for the DCRR while moratorium for the CBs will be as stipulated in the prospectus.

Despite the economy exiting recession in Q2 2017, DMB's credit to the private sector has slacked off, moderating by 0.7% to ₦15.6 trillion between Q2 17 and Q1 18 with credit to the agriculture and manufacturing sectors declining 6.5% to ₦2.07 trillion over the same period (vs.+15% pre-recession historical five-year average). This reflects DMB's cautious stance to creating new credit risk assets due to the fragile state of the economy and its slow recovery. For context, non-performing loan ratio in the banking sector is currently at an elevated level of 15% on average (vs. 5.3% NPL ratio pre-recession), prompting the banks to be cautious in creating risk assets with the sector tilting more to investment in risk free government securities.

**Figure 12: Credit to private sector (% of GDP)**



Source: World Bank, ARM Research

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The DCRR offers DMBs the opportunity to create assets from an interest-free funding source. Nonetheless, we don't envisage any significant addition to DMBs' loan book, in our view, as the specified interest rate of 9% doesn't adequately justify the prevailing risk in the real sector – we estimate DMB's current net lending rate at 13.7%.

On the corporate bond – which the CBN, financial institutions and general public are eligible to invest in – we do not see many large corporates benefitting from the funding mechanism due to the stringent criteria of having a triple A rating. From our finding, only one company – Dangote Cement – holds a triple A issuer rating in the country. Noting this as well as CBN's core objective of stimulating economic growth, we believe the apex bank will relax the rating criteria in the interim to allow for more participation by large corporates.



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