

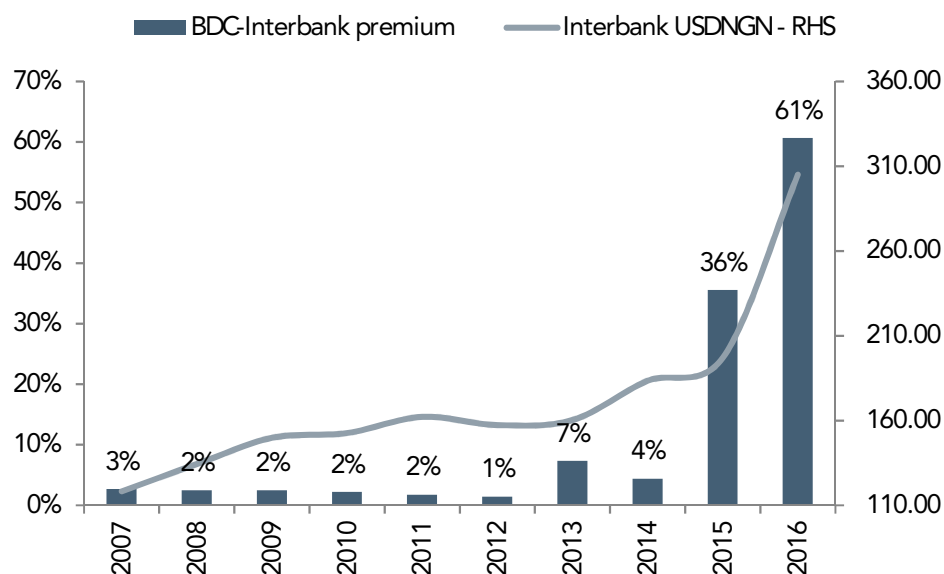
Nigeria Strategy Report – H1 2017 Excerpts
Economic Review and Outlook
Economic Snapshot

December 2016 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	1.09%	18.55%	18.5%
Food	1.34%	17.40%	17.2%
All Items Less Farm	0.63%	18.05%	18.2%
Imported food	0.99%	21.08%	21.2%
Energy	0.71%	31.33%	31.4%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	305.8	2.9%	3.0%
EURNGN	340.9	-1.0%	-5.5%
GBPNGN	399.1	-1.7%	-5.1%
JPYNGN	281.0	-2.2%	-6.8%
Monetary Aggregates – October 2016			
	(₦'bn)	MoM	YoY
M2	22,276	0.7%	22.4%
CPS	23,070	1.9%	20.9%
NCG	3,705	1.2%	63.8%
NFA	7,742	-1.7%	64.7%
NDC	26,775	1.8%	25.4%
External Position			
	Latest	QoQ	YoY
Trade Balance (\$'mn)	-214	84.8%	-86.1%
External Reserves (\$'mn)			
	27,493	15.0%	-3.2%
Foreign Debt (\$'mn)			
	10,718	0.9%	10.4%
Growth Data – Q3 2016			
	(₦'bn)	%of total	YoY
Real GDP	17,574	100%	-2.2%
Agriculture	5,035	28.7%	4.5%
Oil	1,439	8.2%	-22.0%
Services	5,950	33.9%	-1.1%
Wholesale and Trade	2,880	16.4%	-1.4%
Manufacturing	1,700	9.7%	-4.3%

SHAKY NGN OUTLOOK AS CBN RESUMES PLAYING OSTRICH

In our H2 16 Nigerian Strategy Report, we noted that despite a 42% drop in USDNGN in H1 16, subsisting current account pressures on account of oil production headaches, and capital account weakness stemming from foreign reticence towards naira assets as leaving sizable scope for a 5-10% NGN depreciation over the second half of 2016. In line with our thesis, the naira slid 8% in H2 16 to ₦305/\$ bringing YTD depreciation to 53% and making the currency one of the worst performing in 2016. That said, events at the parallel market, where after contracting 37pps to 24% post NGN depreciation in June, mean premiums over the interbank exchange rate expanded over H2 16 to 61%, casts doubt over growing 'stability' at the interbank. Indeed, as in 2015, renewed pressures at the segment suggests all is not yet *uhuru* for the naira.

Figure 1: Interbank USDNGN and Parallel market premiums



Source: CBN, AbokiFX, ARM Research

The naira float at the interbank that never was...

Recasting currency performance in H2 16 on a monthly basis, on the heels of the 42% drop in June after the CBN liberalized the FX market, the naira shed 14% over July to ₦321.16/\$ as downside pressures from a weak current account¹ and reduced capital flows (-54% MoM to \$278 million) impacted interbank dollar supply. Importantly, following the start of floating, the apex bank intervened via the spot (\$510million) and forward (\$699 million) market transactions, even as it tightened monetary policy with hikes in MPR and the marginal clearing rate at its OMO auctions. Improved foreign investor confidence over naira trading and positive real interest rates following CBN tightening helped drive a surge in capital flows (+221% MoM to \$894 million) which underpinned naira strength over August (+2% MoM).

Though capital flows shrank 27% MoM to \$650 million over September, the naira appreciated (+2% MoM) for the second consecutive month. However, the significant decline in interbank naira volatility and subdued trading levels suggested that all was not as it seemed. The month coincided with fresh regulations by the CBN which

¹ Nigeria's current account remained in deficit over H2 16 (\$855million)

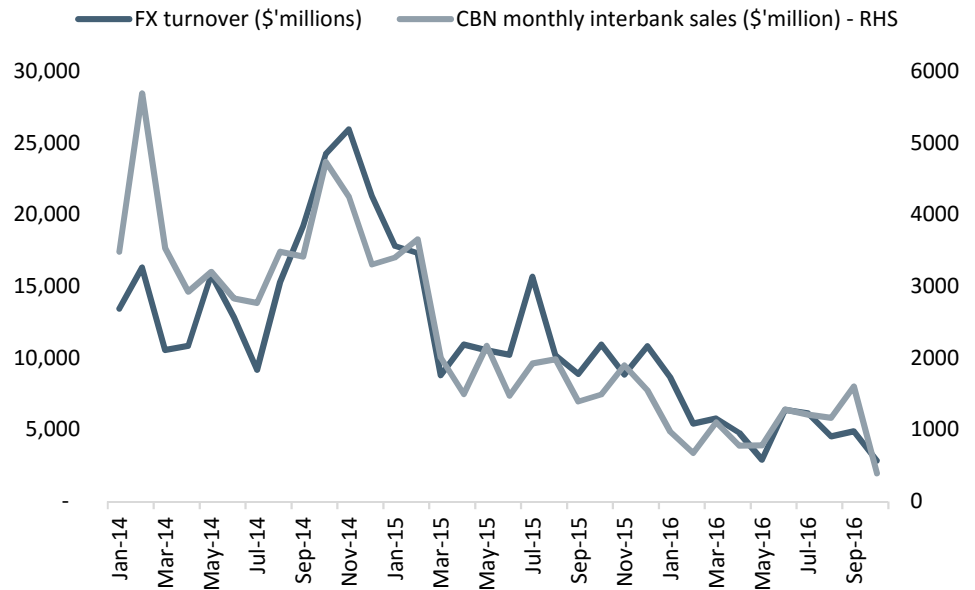
mandated that banks allocate 60% of forex for manufacturers – directive which harks to the allocation theme that was pervasive under the OB2WQ and is inconsistent with the tenets of a flexible exchange rate framework.

CBN heavy-handedness did not end there as in October the apex bank imposed a ₦320/\$ ceiling on exchange rate for card transactions, mandated that banks sell all remittance flows to Travelex and barred all but one bank from selling dollars to BDCs. Though the Naira gained at the interbank over October (+1% MoM), the development was out of sync with the underlying picture as capital flows declined (-24% MoM to \$493 million) and dollar shortages persisted which induced a special CBN intervention of \$313 million at the segment to clear backlog to airlines and manufacturers. Amid a drop in monthly volatility, which had dipped to pre-floating levels, it had become clear that naira determination no longer emanated via market forces. Indeed, media comments by the FMDQ CEO who linked naira strength to closing trades by the CBN put paid to all pretensions about a floating exchange rate regime.

Extending the pattern in September and October, the naira strengthened over November (+1.2%) with a hard peg at ₦305/\$, reminiscent of the old ₦199/\$ peg prior to the adoption of a flexible regime – a development which remained intact over December. Irked by the imposition of a hard peg on naira trading, the FMDQ OTC Securities Exchange announced in mid-November the suspension of its **Spot FX Closing Rate**² with immediate effect with substitution with a new rate to be called the ‘**CBN closing rate**’ which would capture the rate of the last available executed trade on the Thomson Reuters platform. In justifying its decision, the FMDQ cited “transparency and liquidity challenges, and prevalent disequilibrium in the FX market” as reasons for its decision. In electing to term the new spot FX rate to be published henceforth “a CBN rate”, the FMDQ extricated itself from CBN’s FX market maneuvers which effectively determined the closing spot interbank exchange rate.

² Exchange Rate would be purely market-driven using the Thomson-Reuters Order Matching System as well as the Conversational Dealing Book

Figure 2: CBN dollar sales and Interbank FX turnover

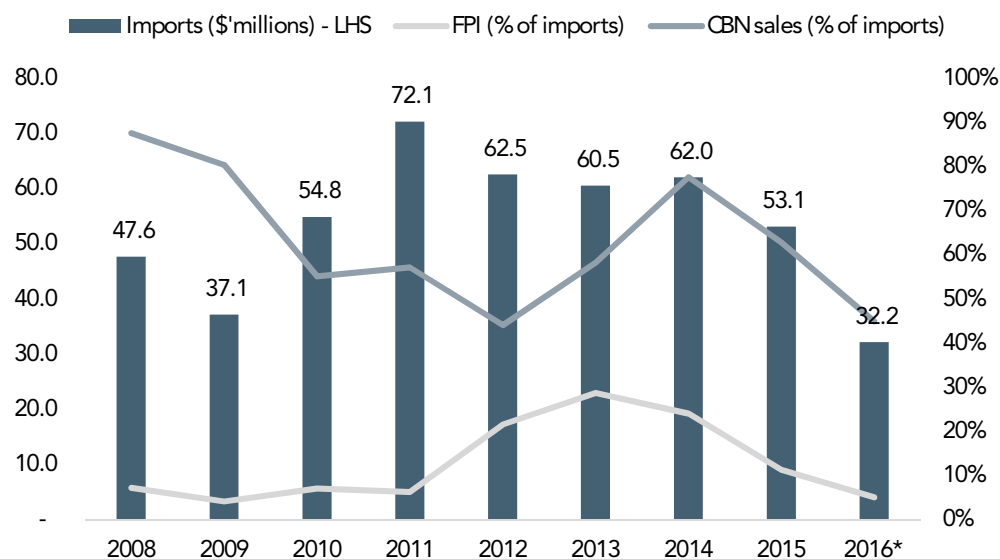


Source: CBN, FMDQ, ARM Research

From a fundamental perspective, despite CBN’s attempts to influence the naira clearing rate, actual dollar supply to the interbank FX market declined³ as apex bank interbank dollar sales (-49% YoY to \$14.5 billion) and FPI flows (-69% YoY to \$1.6 billion) as share of imports shrank 18pps and 6pps YoY to a 45% and 5% respectively. Accordingly, interbank FX market turnover levels remained below levels in 2014 and 2015 as CBN activity shrank. Thus, while imports have moderated, supply shortfall remains an issue which continues to underpin spillover demand to the parallel market. Overall, while the apex bank is yet to formally announce its divorce from the flexible exchange rate regime, it is evidently clear that the apex bank had reached its bus-stop with floating and would no longer allow market forces to set the FX rate. A natural consequence of the CBN action was that parallel market premiums which had shrank in the aftermath of naira floatation in June trended higher.

³ January to October 2016

Figure 3: Dollar supply and import demand



Source: CBN, ARM Research *January to October

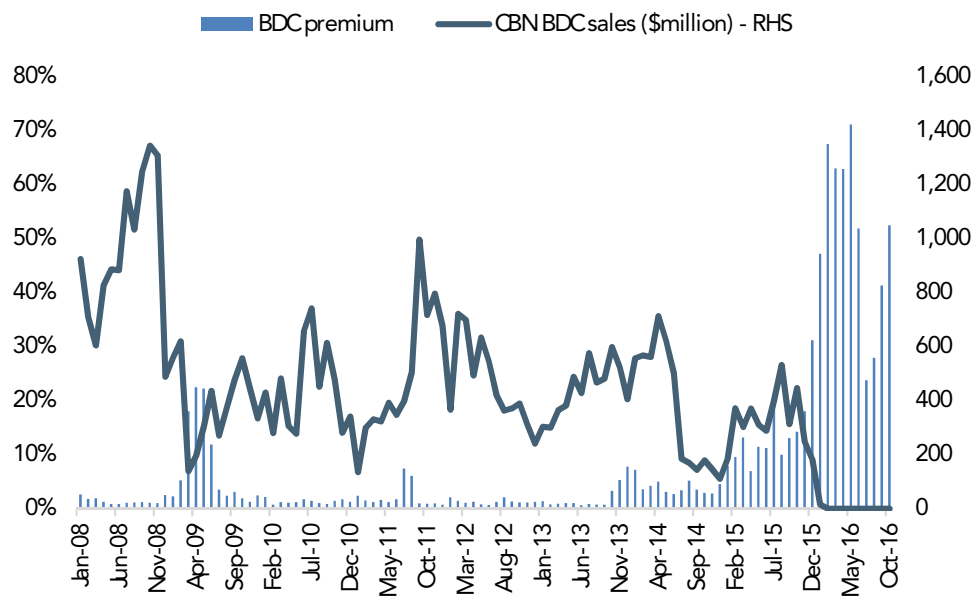
Parallel market premiums rise as CBN endorses gunboat tactics

As the alternate universe to the interbank, developments at the parallel market largely moved in opposite direction, where relative to the 14% depreciation in July, the naira only weakened 1.5% MoM to ₦364/\$. The opposite movements continued in August, gaining at the interbank as earlier noted but weakening further at the parallel, where it crossed the psychological ₦400/\$ level in the aftermath of CBN’s actions against money transfer unions⁴ and the ban placed on nine banks over failure to paydown outstanding \$2.3 billion NLNG dividend balances. Though the apex bank later unwound its actions with negotiated settlement with the banks and relaxed requirements, average parallel market premiums widened 4pps MoM to 28%. CBN’s interventions did not end in August as in the following month, the apex bank mandated that banks allocate 60% of forex to manufacturers and advised banks to block accounts used as MTOs. The action drove further wider divergence with parallel market premiums expanding 13pps to 41% in September. After imposing a hard peg at the interbank, the apex bank went further at the parallel market, where in the aftermath of a curious meeting between the CBN, BDC operators and security agencies, the

⁴ The CBN introduced regulations requiring that MTOs hold minimum of \$1billion in net assets

parallel market rate split into two: one official rate for licensed BDC operators with a hard peg at ₦400/\$ and an unofficial rate representative of the old parallel market. The adoption of gestapo tactics, which the apex bank endorsed at the November MPC, and its actions at the interbank, coincided with the appearance of two bills seeking to equip the CBN with more powers to control the foreign exchange markets. Though the CBN denied its involvement behind both legislative efforts, the emerging picture is that several key segments of Nigeria’s economic management set-up are no longer willing to leave NGN determination to market forces. This new posture would go against the thinking behind adoption of a flexible FX regime and signals a return to the pre-floating era. That said, as with the interbank, the fundamental issues with the parallel market largely revolve around diminished supply, following CBN’s termination of forex sales to BDCs, and rising spillover demand from the interbank. Thus, rather than addressing the supply and demand imbalance the apex bank is concentrating efforts on price fixing.

Figure 4: Parallel market premiums to interbank



Source: CBN, ARM Research

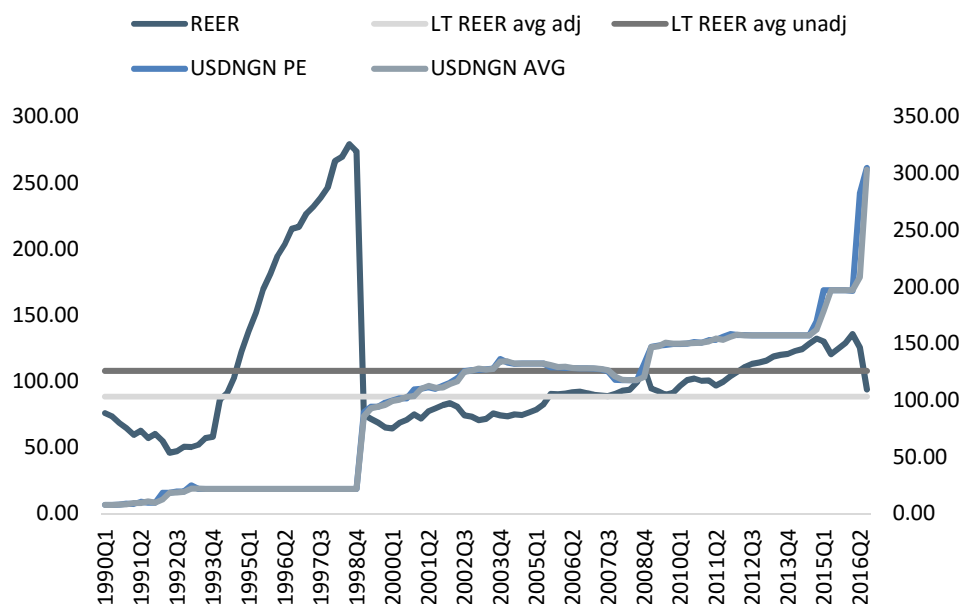
PPP analysis indicates NGN is fairly-valued

At the heart of the debate behind the abandonment of a flexible exchange rate regime is that following over 97% depreciation in USDNGN since 2014 relative to the 40-60% decline in crude oil prices, that the NGN weakness is out of sync with levels dictated by long run fundamentals. To ascertain the extent of undervaluation or otherwise, we examine quarterly REER data from the IMF on the NGN over the last three decades to apply the Purchasing Power Parity (PPP) concept which holds that currencies gravitate towards their long run mean over time. Looking at the data, it is clear that recent NGN depreciation has driven a retracement in the REER towards its long run average (defined as the average over the time period of the data)⁵. Extrapolating into nominal terms, the long run REER average for the naira would correspond to an exchange rate of ₦323.46/\$ which implies that the current naira rate, which straddles a +/-10% band is fairly-valued⁶. Nonetheless, as currencies do not always trade in line over short term horizons due to current account trends, indeed our analysis reveals that since the return to democratic rule in 1999, the NGN has been overvalued 37% of the time relative to fair valued (34%) and undervalued (30%). Thus, in framing NGN outlook for 2017, the key question is not whether the NGN is fairly valued but the interplay of demand and supply forces.

⁵ We have adjusted this to exclude regime change in the data over the 1990s when Nigeria's then military government imposed a hard peg on the naira which drove sizable REER appreciation.

⁶ Given their relatively higher volatility a 10% band is permissible for EM/frontier market currencies

Figure 5: REER and nominal USDNGN



Source: IMF, ARM Research

Little respite on dollar supply picture points to further NGN downside

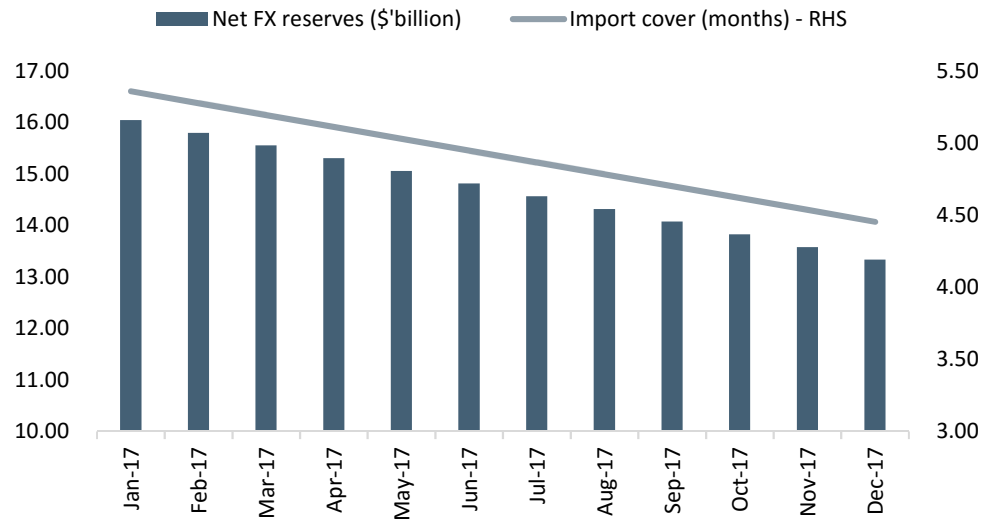
In framing our outlook for the NGN, we start by examining fundamental levels through BoP data, where oil market rebalances bolsters prospects for rebound in oil prices and by extension in Nigeria’s exports. Applying insights from our analysis of trade balance, using an average \$55/bbl as our base case and production unchanged from current levels at 1.88mbpd, we estimate a modest recovery in exports to \$40.5 billion for 2017. Nonetheless, as our analysis of import data revealed, current contraction largely stemmed from declines in industrial equipment and capital goods due to lower CBN dollar sales. Thus, we do not believe current depressed levels are sustainable, given the adverse implications for economic growth, and as such model modest recovery to under trend levels of \$45 billion.

Overlaying our forecast trade deficit with historical deficit in the Services account (5-year avg. 4.4% of GDP), we see overall CA balance remaining in the red in 2017. For portfolio flows, as we noted in our FPI review, rising US interest rates and an increasingly bullish growth outlook in developed countries should continue to induce net FPI outflows from emerging markets. Tying the foregoing with weaker growth

picture in Nigeria relative to peers and persisting concerns over market illiquidity, FPI cold-feet towards naira asset should remain intact over 2017. The overall picture across the current and capital/financial account suggests greater reliance on reserve depletion to support the naira.

Thus, the question becomes at what point would the apex bank throw in the towel? Adjusting current reserve levels of \$25 billion for outstanding swap liabilities of \$3.1 billion and noting that as at 9M 2016, CBN portion of external reserves only amount to 73% of the figure, we estimate that import cover, using net reserves, should drop below 5 months by the end of H1 2017. Our analysis assumes a recovery in CBN dollar sales to trend average of monthly imports (\$2.9 billion vs 2016: \$1.4 billion) as we think growth concerns given the cutback in critical imports should force a CBN rethink. That said, in the event the apex bank maintains the depressed interbank dollar sales level in 2016, then the gains from crude oil prices could harden resolve on the naira. Furthermore, likely inflows from a potential Eurobond issue in Q1 17 and AFDB's budget support facility could help bolster reserves, leaving wider scope for the CBN to continue playing ostrich with the exchange rate in H1 17. However, maintaining the current peg risks increasing the returns to currency speculation for autonomous flows at the parallel market, which remain more than double official flows while relegating the importance of interbank exchange rate in the economy. Thus, we do not think the status quo is rationally sustainable and post eventual capitulation, we think NGN is likely to overshoot its current long run REER level under a managed floating exchange rate system. Calibrating for historical parallel market premiums to the interbank we see interbank moving to a target range of ₦400-430/\$ in H2 17.

Figure 6: Forecast net FX reserves and import cover



Source: ARM Research estimates

Copyright © 2017 ARM Securities Limited (“ARMS”).

All rights reserved. Unauthorised use, reproduction, distribution or disclosure of this document is strictly prohibited.

This material has been issued by ARM Securities Limited, a member of the Asset and Resource Management (“ARM”) Group, and a Company regulated by the Nigerian Securities & Exchange Commission. The analyst(s) primarily responsible for preparing this research report, in whole or in part, certifies that with respect to each security or issuer covered; all of the views expressed accurately reflect his/her personal views about the subject securities and issuers and no part of his/her compensation was, is, or will be, directly or indirectly, related to the inclusion of specific recommendations or views in the report.

This research report is based on information from sources that ARMS and its analysts believe to be reliable. Neither ARMS nor any of its research analysts, nor any member of the ARM Group, gives any representation or warranty, express or implied, or undertaking of any kind or assumes responsibility or liability of any kind with respect to the accuracy or completeness of the information set out in this report or any third party’s use (or the results of such use) of such information. This report is provided solely for informational purposes and is not to be construed as providing advice, recommendations, or endorsements of any kind whatsoever. The investments and strategies discussed here may not be suitable for all investors; counsel of investment advisor should be obtained with regard to such investments and or strategies. This research report is not a replacement for advice from an accountant, lawyer, personal finance advisor or other category of investment advisor. The investments discussed in this report may oscillate in price or value. Opinions and information provided are made as of the date of the report issue and are subject to change without notice. This research report is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Reference herein to any specific security or financial instrument does not necessarily constitute or imply its endorsement or recommendation by ARMS, its directors, officers, employees or designated agents. Members of ARM may act as broker, advisor or lender, or make a market in any investments or issuers referenced in this report. Further information on any of the securities discussed herein may be obtained upon request to ARM. By accepting this document, you agree to be bound by the foregoing limitations.