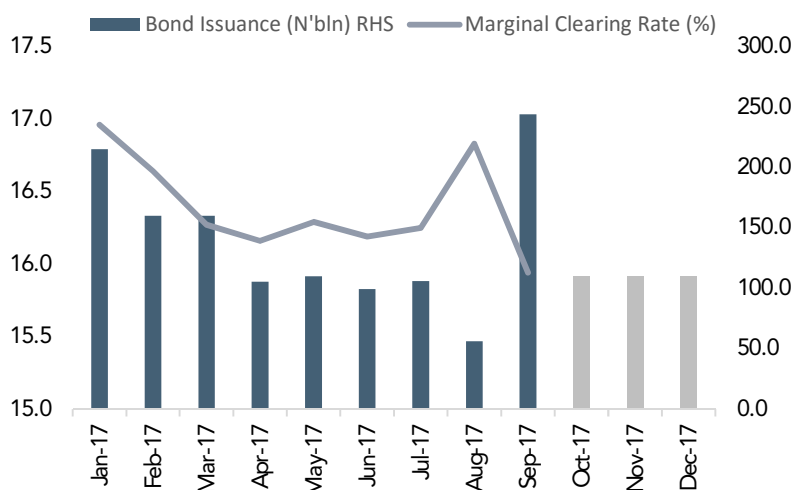


A 'letter' from the DMO

- Different treatise and varying views greeted the astonishing letter. The message taped up our earlier views on policy direction in the short term. This week, the Debt Management office (DMO) released its bond issuance calendar for the fourth quarter of 2017 which points to a lighter borrowing pattern with FG intending to borrow all-out ₦330 billion, split across the 5-year (2021) and the 10-year (2027) of ₦165 billion apiece. The calendar also saw the removal of the 20-year bond (April 2037). The issuance, which is 19% lower than the offer and allotted in the prior quarter, reflects growing sensitivity to rising debt service cost (H1 17: 62% of revenue) and sits well with a recently announced plan to issue \$5.5 billion worth of Eurobonds in this quarter for budget support (\$2.5 billion) and refinancing naira denominated debt (\$3 billion).

Figure 1: Bond sales and borrowing cost



Source: DMO, ARM Research

Economic Snapshot

| August 2017 Inflation Data/Indices | | | |
|------------------------------------|--------|-----------|----------|
| | MoM | YoY | Prev YoY |
| Headline | 1.0% | 16.0% | 16.1% |
| Food | 1.1% | 20.3% | 20.3% |
| All Items Less Farm | 0.9% | 12.3% | 12.2% |
| Imported food | 1.3% | 14.4% | 14.1% |
| Energy | 0.4% | 10.7% | 11.6% |
| Currency Markets | | | |
| | Latest | Daily Chg | YTD |
| USDNGN | 360.0 | 1.4% | 14.4% |
| EURNGN | 422.9 | -0.1% | 30.8% |
| GBPNGN | 472.7 | -0.3% | 24.5% |
| JPYNGN | 320.0 | 0.0% | 21.7% |
| Monetary Aggregates – July 2017 | | | |
| | (₦'bn) | MoM | YoY |
| M2 | 22,200 | 2.4% | -1.5% |
| CPS | 22,172 | 0.8% | -1.1% |
| NCG | 4,987 | 12.7% | 66.0% |
| NFA | 8,743 | 3.3% | 15.6% |
| NDC | 27,160 | 2.9% | 6.8% |
| External Position | | | |
| | Latest | QoQ | YoY |
| Trade Balance (\$'mn) | 84.76 | -9.6% | N/A |
| External Reserves (\$'mn) | 31,883 | 5.5% | 28.0% |
| Foreign Debt (\$'mn) | 13,808 | 21.1% | 23.3% |
| Growth Data – Q2 2017 | | | |
| | (₦'bn) | %of total | YoY |
| Real GDP | 16,307 | 100% | 0.5% |
| Agriculture | 3,745 | 23.0% | 3.4% |
| Oil | 1,449 | 8.9% | 1.6% |
| Services | 5,974 | 36.6% | -0.5% |
| Wholesale and Trade | 2,787 | 17.1% | -1.6% |
| Manufacturing | 1,529 | 9.4% | 0.6% |

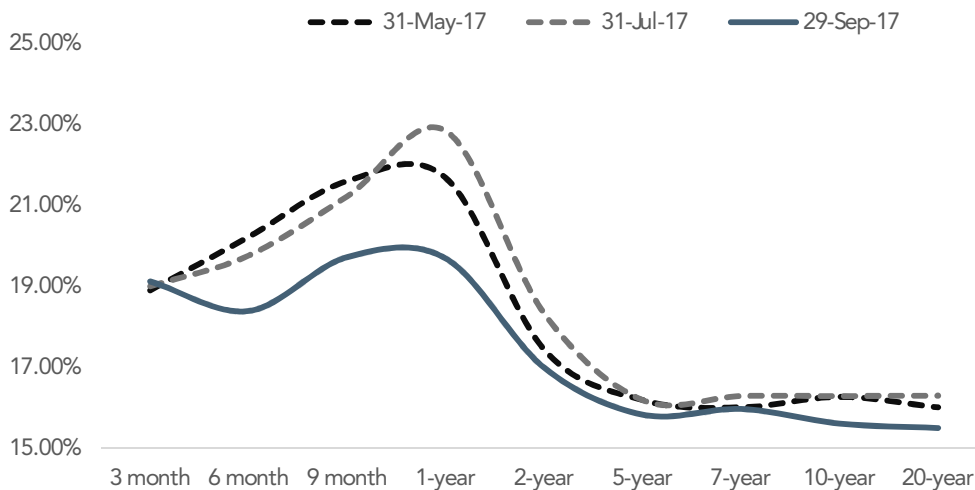
A transition like no other

- It is hard to fathom a path that took a sharper turn than that of fixed income market in Q3 2017. Even though the MPC left its policy stance unchanged at the July meeting, it had already struck a dovish tone after it allowed the build-up in naira liquidity by net repaying OMO bills into the financial system at the end of Q2 17. In addition to this, the MPC also went ahead to cease issuance of the one-year bills at its OMO auctions at the end of August. The cumulative impact of CBN actions cascaded into massive demand at the primary market auction (PMA) which eventually resulted in collapse of marginal clearing rates. Importantly, the switch in CBN's stance followed a failed bond auction in August, then the FG was only able to fill 41% of its offer. Though the CBN retained its policy stance in September, we note that the follow-up communique was less hawkish (relative to earlier MPC meetings). Aided by the downtrend in inflation, CBN's increasing tolerance for naira liquidity underpinned a slide in the yield curve to 16.45% (-199bps from the start of the September).
- In framing our outlook, our fiscal call projects actual retained revenues to lag FG's projection in the coming months with our base case scenario¹ suggesting an implied fiscal deficit of ₦3.4 trillion in 2017E (vs. ₦2.4 trillion stipulated in the budget). For clarity, given deficit of ₦1.8 trillion over the first five months of 2017, we assume a fiscal deficit of ₦1.6 trillion for the second half of the year on the back of improved revenue. Precisely, excluding ₦824 billion issued in Q3 2017 (Net Treasury bill issuances: ₦318 billion, Bond Issuance: ₦406 billion, Sukuk: ₦100 billion), the FG would need to borrow circa. ₦800 billion over the rest of this year. Given the foregoing, we assume a successful Eurobond issuance of \$2.5billion, translating to ₦900billion to fully cover our proposed borrowings by the FG and displacing the need for domestic borrowings. We go on to provide for a further ₦450billion (Q4 17 Bond issuance: ₦300billion and Net T-bills issuances: ₦150billion). To add, we believe concerns over mounting debt service burden will keep the FG mindful of borrowing cost in the near term. On balance, this would mean moderated domestic borrowings for the remainder of the year and, by extension, sustained yield downtrend at the long end. At the short end of the curve, we expect the CBN to assume a less aggressive stance at its OMO windows to continue to drive rates lower. Farther out, our call for decelerating inflation and currency stability in the face of fragile growth picture should drive

¹ Going by current run rate of FG expenditure patterns, we project FY 2017 at N6.6 trillion.

monetary policy shift towards easing. On the strength of the mentioned, we expect T-bill yields to decline to sub 18% levels in Q4 2017, with a more sizable decline (100-150bps) projected for H1 2018.

Figure 2: Trend in the naira yield curve



Source: FMDQ, ARM Research

Going long is the only way to go

- There is much that can be read into the slope of the yield curve. It reflects the anticipation of imminent rates, and at any given time a good bit of that reading by the markets can be over or under dramatized. Nonetheless, given the sharp turn in rates, it is useful to look at what this trend in the spread between short and longer-term rates could mean for investors. In our opinion, this sharp drop—not just in terms of absolute rates, but also the yield curve—reflects growing expectations of a downshift in rates. We feel the environment will be one in which short-term yields will drop and long-term yields will drop faster. We recommend going long on the curve, against the natural leaning to stay short under the guise of playing defense. Overall, we recommend building duration with emphasis on mid-tenured bonds on the downward slope of the naira curve in a bid to ‘run-down the curve’ as dovish influences kick into gear.

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