

Fixed income Monthly Update | October 2019

CBN's circulars rattles the fixed income market

Highlights from last month

CBN rattles the market: While the main talking point in October should have been the ₦2.3 trillion OMO maturities staged to mature in October and its far-reaching effects on pressuring the naira, the fixed income market was rattled by varying circulars issued by the CBN. The first, being an instruction to the banks preventing any borrowing customer of the bank, including customers in receipt of intervention funds, from investing in treasury bills or OMOs. The second, similar to the first, prevents corporates and individuals from investing in OMO bills at the auction. While local players appear to be at the receiving end of this directive, foreign investors interest were preserved, however downside exist. The downside for foreign investors is the relative illiquidity in trading OMO securities which in some sense could limit exiting OMO positions at juicy profit levels. Bearing this in mind, we think foreign investors will demand for higher yields from the CBN to adequately compensate for the relatively illiquid market. This could come in form of 1) demand for higher rates at the OMO auction 2) providing more comfort as regards FX forward at a higher rate for illiquidity or 3) the combination of both.

Further decline in OMO rates: Against our expectation that the apex bank would keep OMO rates elevated in a bid to dissuade any pressure on the naira, OMO rates dipped 14bps MoM to 13.25%. This mirrors higher demand at the auction following increased subscription levels of ₦3.71 trillion which trumps CBN's offer of ₦1.48 trillion. For us, the change in monetary posture by the CBN reflects apex banks efforts to encourage credit to private sector and above all trim its cost of financial system liquidity management.

More of the same for NTBs: NTB yields dipped 59bps MoM to 12.42%, an almost identical performance to September where they shed 53bps to 13.28%. Surprisingly, compared to bonds, the CBN directive did not have as big an effect on NTB yields – average yields declined 43bps leading up to the directive but then only 16bps thereafter. Over the 3 auctions in the month of October, the FG rolled over ₦388.41 billion worth of bills. This came in despite subscription levels of ₦1.53 trillion (bid-to-cover of 3.957x) as FG continues to shun short dated paper despite lower stop rates (-157bps MoM to 10.48%).

Bond yields nosedive: Akin to the NTB market, the Bond market also experienced a huge surge in demand for secondary market FGN bonds which brought yields lower by 147bps MoM to 13.16%. For context, prior to the announcement of the new directive on the 22nd of October, bond yields were only down by 12bps which means they declined by a whopping 136bps in the ensuing 8days in the month. This culminated in bond yields dropping below 13%, for the first time since May 2018, to 12.76%. The primary bond auction was not spared, as subscription levels were 1.7x the ₦150 billion offered (much higher than the 1.07x at last month's auction). Despite this higher demand the FG was unable to fill its order as total allocation for the month came in at ₦142.81 billion, of which ₦3 billion came via non-competitive bids. However, given the maturity of a ₦233.9 billion in the month, October saw a net repayment of ₦91.09 billion. Consequently, average stop rates dipped 19bps to 14.29%.

Table 1: Net PMA Issuances/ (Maturity) in billion naira

	OMO Issuances	NTB 91-day	NTB 182-day	NTB 364-day	Total	Bond 5-year	Bond 7-year	Bond 10-year	Bond 30-year	Total	Grand Total
Aug-18	-904.1	27.3	-46.2	28.5	9.6	40.2	48.5	21.4	-	110.1	119.7
Sep-18	-74.6	-	-	-	0	17.5	7.4	71.9	-	96.8	96.8
Oct-18	86.96	-	-	-	0	12.7	20.1	55.3	-	88.1	88.1
Nov-18	526.7	-0.45	41.9	5.9	47.35	1.1	4.27	34.15	-	39.5	86.87
Dec-18	765.1	-2.65	-70	-	-70	1.05	3.41	1.29	-	5.8	-64.3
Jan-19	276.6	20.6	-24.8	-153.7	-157.9	5.85	20.1	91.04	-	117	-40.9
Feb-19	1,078	-	-	-	0	1.5	12.25	136.25	-	150	150
Mar-19	1,094	-	-	-	0	39.8	62.15	20	-	121.95	122
Apr-19	397.7	-	-	-	0	6.81	-	37.43	53.16	97.4	97.4
May-19	367.12	-	-	-	0	27.38	-	35	48.93	111.31	43.91
Jun-19	49.6	-	-	-	0	28.99	-	36.36	31.49	96.84	96.84
Jul-19	484.5	-	-	-	0	28.19	7.23		51.4	86.82	86.82
Aug-19	-347	-	-	-	0	14.05	17.68		27.8	59.53	59.53
Sep-19	174	-	-	-	0	20.33		71.16	55.12	146.61	146.61
Oct-19	-495	-	-	-	0	32.11		64.4	46.3	142.81	142.81

Source: FMDQ, ARM Research

Table 2: Average OMO, NTB and Bond stop rates

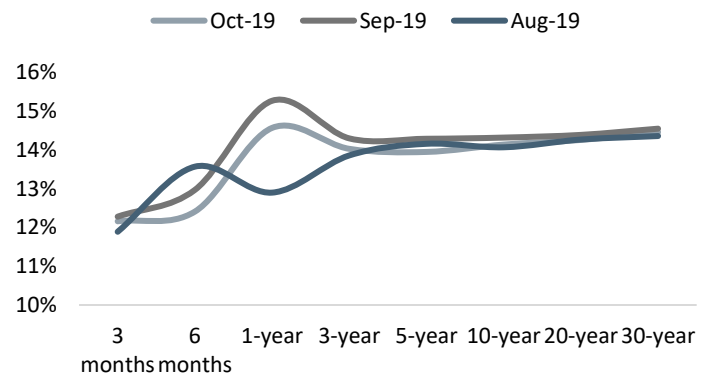
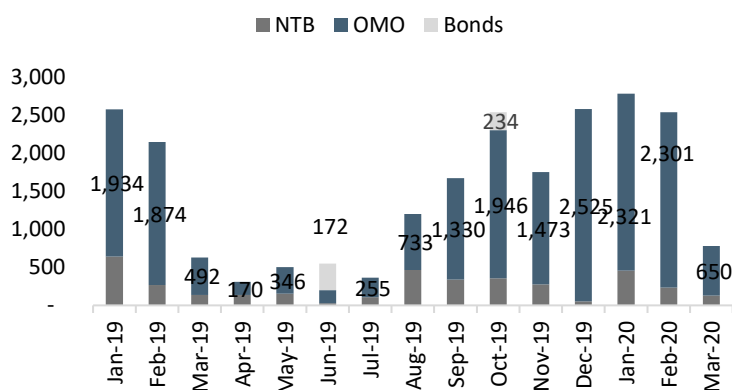
	Aug-18	Sep-18*	Oct-18*	Nov-18*	Dec-18*	Jan-19*	Feb-19*	Mar-19*	Apr-19*	May-19*	Jun-19*	Jul-19*	Aug-19*	Sept-19*	Oct-19*
OMO	12.15%	13.40%	13.90%	14.50%	15.00%	15.00%	14.30%	13.04%	13.02%	12.78%	12.48%	11.84%	12.12%	12.29%	11.44%
NTB	11.07%	12.27%	12.23%	12.88%	N/A	13.01%	12.93%	11.82%	12.16%	11.58%	11.29%	10.87%	11.13%	12.05%	11.34%
BOND	14.56%	15.13%	15.16%	15.51%	15.42%	15.27%	14.75%	13.50%	14.60%	14.28%	14.49%	13.70%	14.42%	14.49%	14.29%

Source: FMDQ, ARM Research ** reflective of 1-year OMO bills

Figure 1: Maturity profile over 2019

Source:

Figure 2: Trend in Naira yield curve



Source: FMDQ, ARM Research

Outlook

Following the recent policy directive by the CBN that restricts participation in primary market OMO auction by corporate and individual investors, local institutional and individual investors are left with no choice than to combine or do either of the following 1.) channel their funds to primary and secondary treasury bills, 2.) invest in Bank term deposits, 3.) increase appetite for corporate commercial papers or 4.) increase exposure to equities. That said, we see the first three cases as plausible and envisage buy pressure from local investors in the fixed income market over the near term following expected liquidity surfeit in the system. Having laid down the prospect for higher demand for naira paper over the near term, we see scope for lower primary and secondary market treasury bills and FGN bonds yields, lower Bank term deposits rates and lower rates on commercial papers over the near term.

No doubt, this sits well with FG's plan to trim its cost of debt service. In fact, given the prospects for lower fixed income yields and higher fiscal deficit (+13% YoY to ₦2.17 billion), we see scope for higher paper supply over the near to medium term and less reliance on CBN's back door financing. Nonetheless, given that Non-bank institutions hold sizeable portion of the OMO bills (~44.8%), we think the demand pressure will more than outweigh pressures from higher FG paper supply. Although the prospect for inflationary pressures appears prominent given hike in VAT (from 5% to 7.5%) and possible electricity tariff hike next year, we remain less sanguine of a spike in fixed yields given the discordant between movement in headline inflation and fixed income yields.

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