



ARM Research

Fixed Income Strategy

04 April 2018



REVIEW

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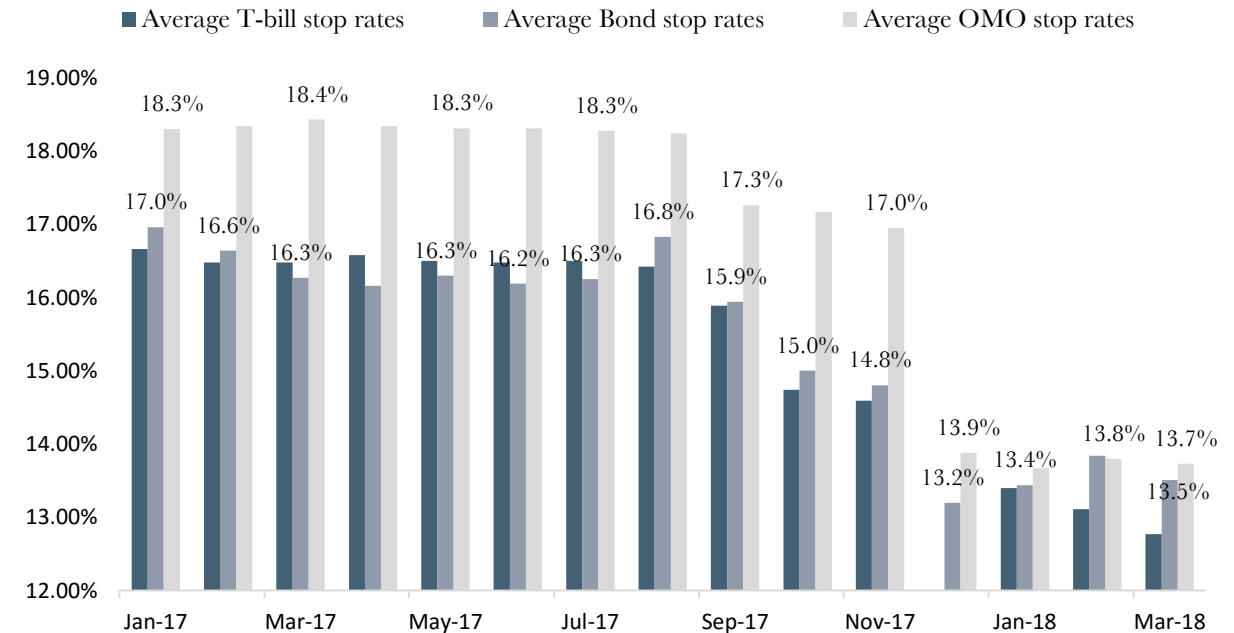
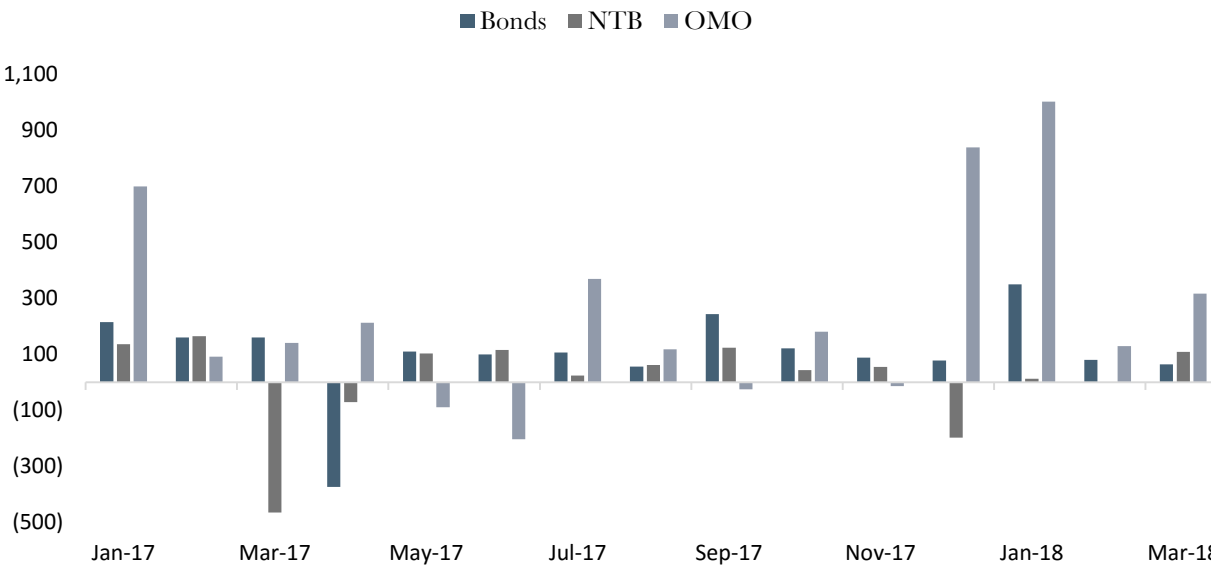




Naira yield curve dropped on the back of subduing inflation and tilt to external borrowings

- The last three months has witnessed some sort of harmony between the fiscal and monetary side in bringing down the yield curve in Q1 18 (-24bps to 13.98% Ytd)
- On the fiscal side, in a bid to reduce its cost of borrowings, FG issued \$2.5 billion worth of Eurobond to refinance maturing treasury bills. This in addition to lower budgeted borrowings and improved fiscal revenue picture translated into tamer domestic borrowings over Q1 18 (NTB: ₦12billion, Bonds: ₦189.6 billion)
- This emanated despite higher subscription levels at the PMA. Also, the DMO introduced two new issues in Q1 2018 (2021s and 2028s)
- Elsewhere, to taper the impact of burgeoning system liquidity emanating from series of coupon payments and higher FAAC allocation, CBN intensified its pace of OMO issuances by mopping a whopping ₦2 trillion from the system in January. However it became more tolerant to naira liquidity in succeeding months (OMO sale in February: ₦557 billion)
- CBN's increasing comfort for naira liquidity is in part fed by waning inflationary pressures tailing the off take of a high base in prior year (YoY Headline inflation: Feb (14.33%)

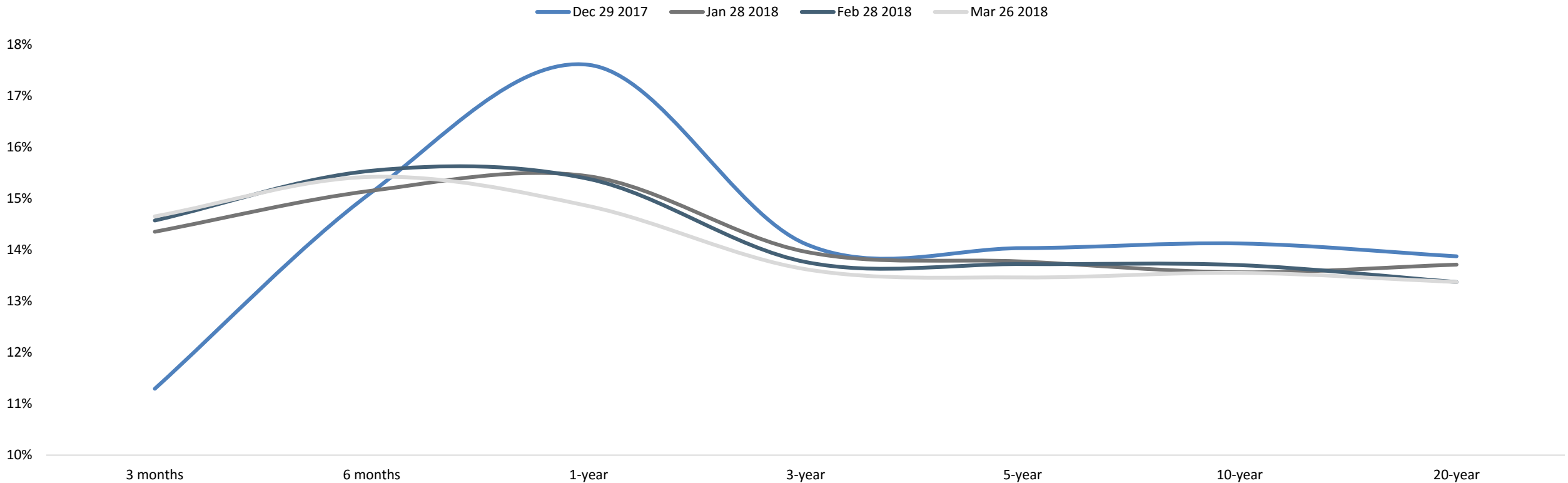
Bond, NTB and OMO Net Issuances (₦Billion)





- Against the backdrop of weak domestic borrowings, average stop rate at the PMA plunged by 182bps and 129bps QoQ to 12.77% and 13.51% for NTB and Bonds respectively in Q1 2018.
- Similarly, following pent up liquidity in the system and waning inflationary pressures, the apex bank cut average OMO rates by 21bps in January to 13.67
- Given the aforementioned, the naira yield curve closed relatively flat (-0.05% QoQ to 14.27%) as the impact of liquidity strain drove yield uptick at the short end which neutered the bullish run at the long end.

Trend in Naira yield curve



OUTLOOK

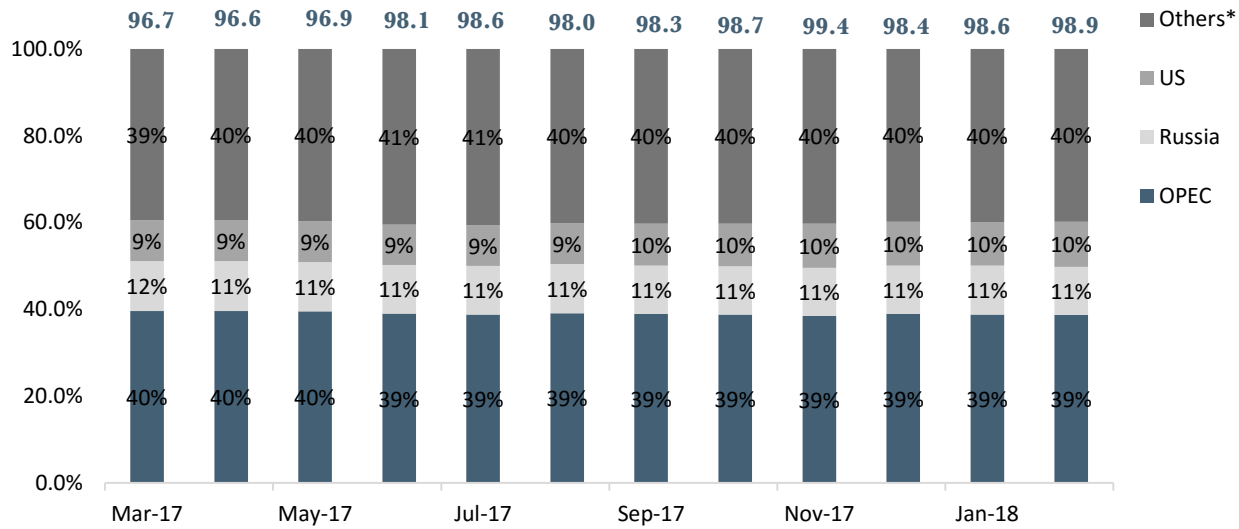
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We expect oil prices to moderate going into 2019 – a new low of \$50/bbl. much likely

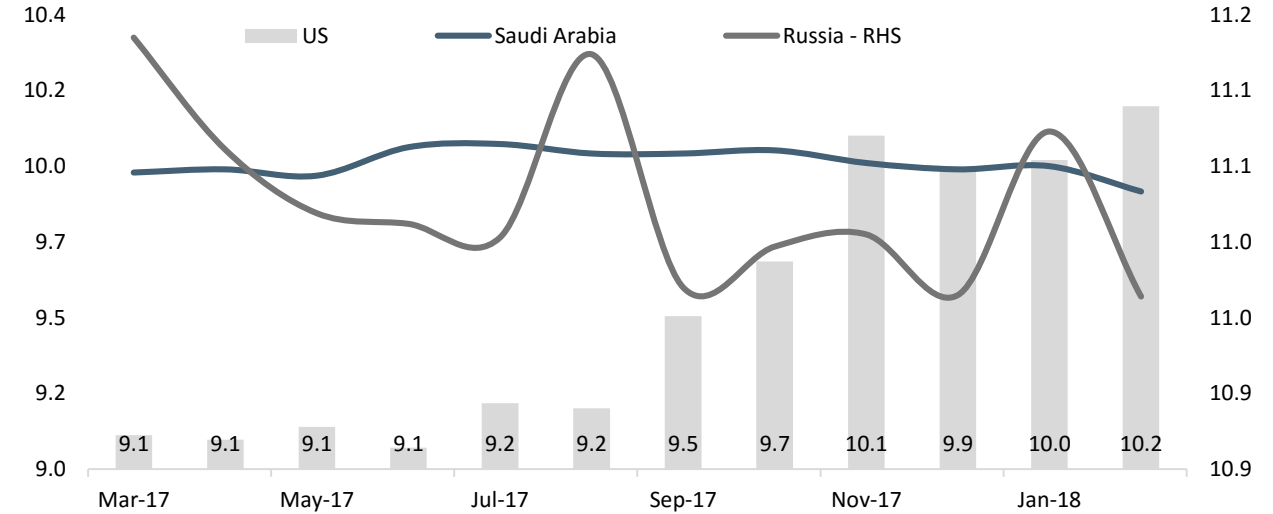
Nothing much has changed in terms of the overall supply picture.



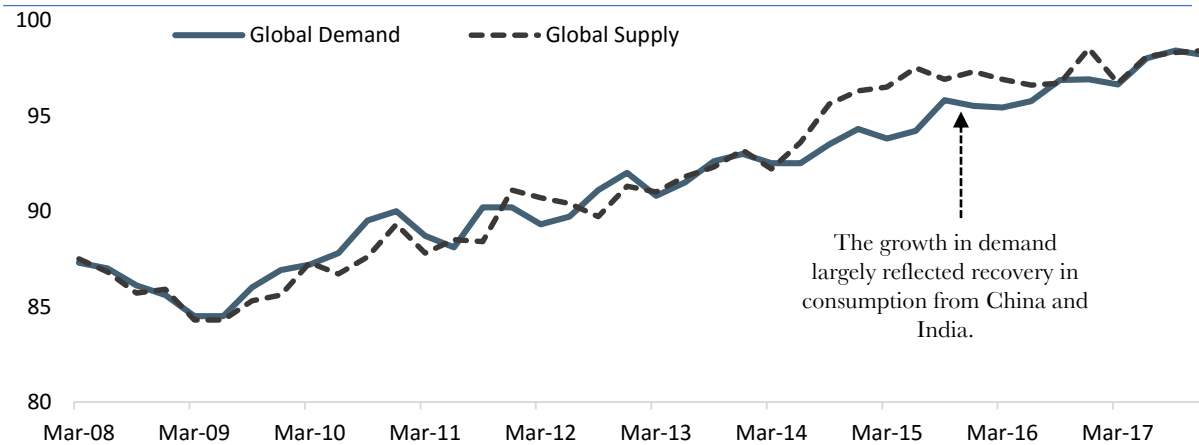
Source: Bloomberg, ARM Research

*Others are largely dominated by non-OPEC fringe players involved in the OPEC agreement

The risk to the supply picture, is not US, but Saudi Arabia and Russia. The probability of lower compliance by Saudi Arabia post the Aramco IPO is pointing inches up.

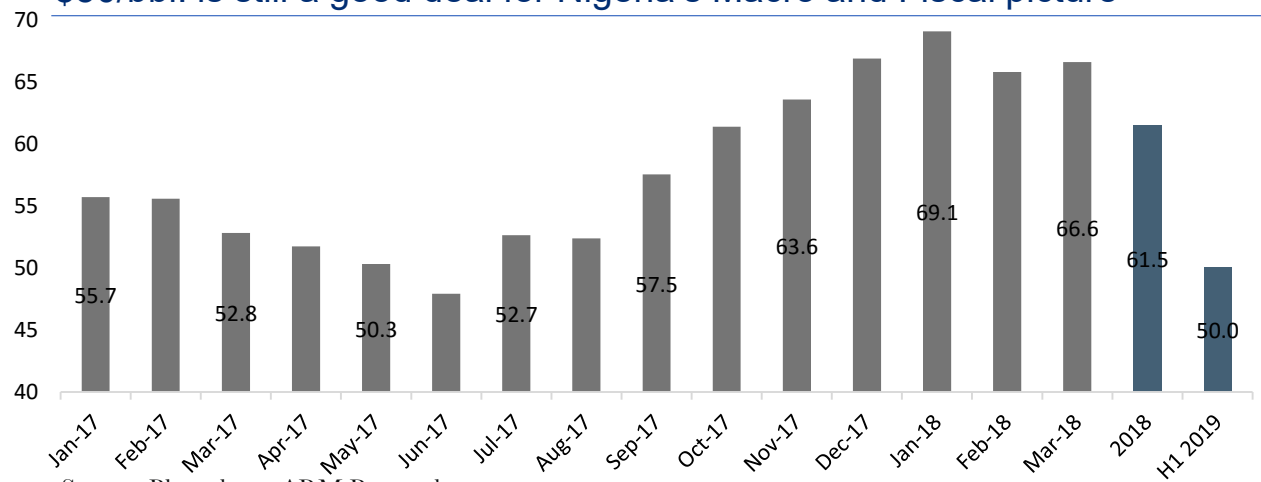


Demand seems to have peaked, hovering around current range



Source: Bloomberg, ARM Research

\$50/bbl. is still a good deal for Nigeria's Macro and Fiscal picture

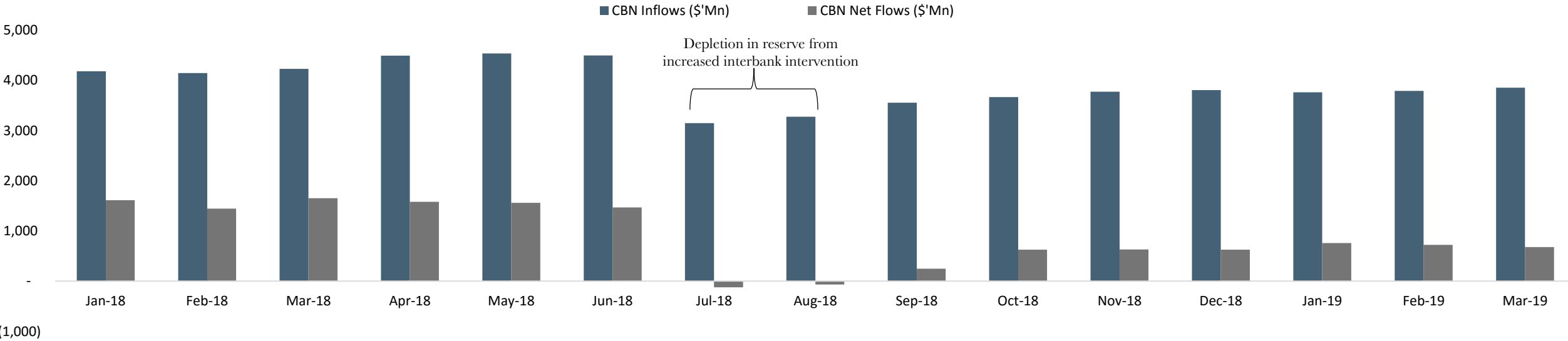


Source: Bloomberg, ARM Research



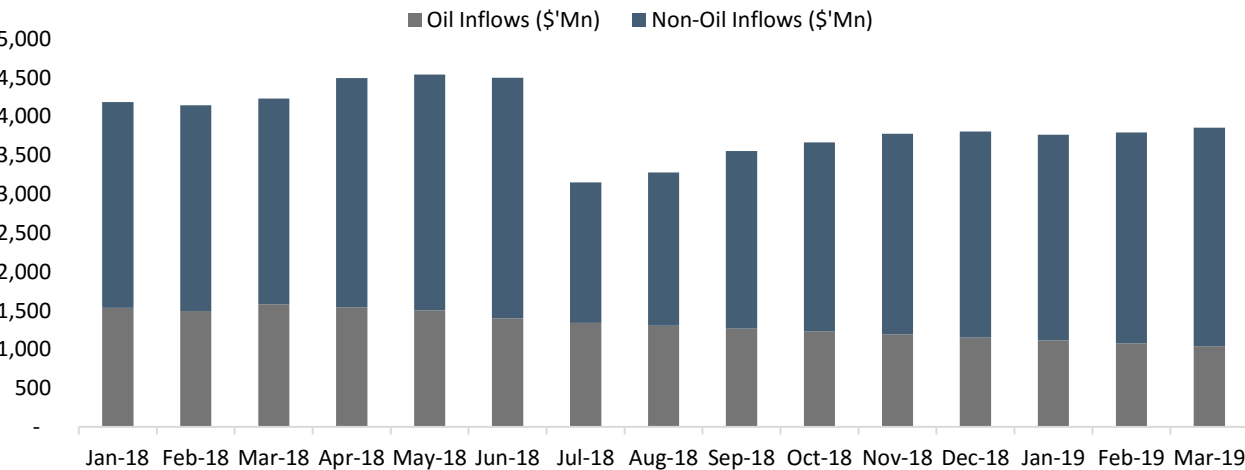
Sizable FX outflows in Q3 2018, largely from FPI holdings of maturing NTB and OMO – ~~N~~1.35 trillion, will intensify the CBN's supply to the market.

Oil inflow to remain sturdy going into the year, to average \$1.3 billion monthly



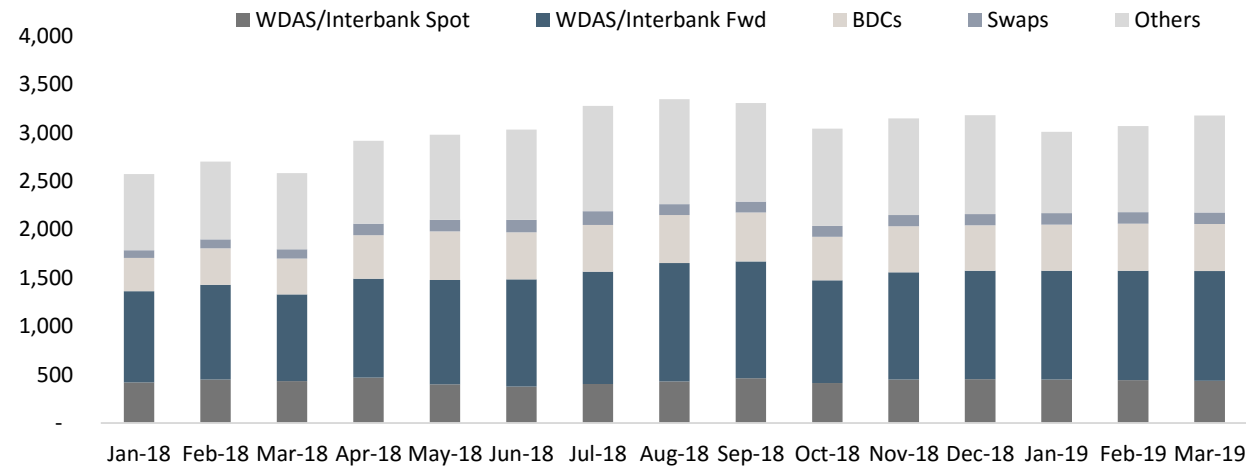
Source: CBN, ARM Research

Breakdown of total inflows through the CBN



Source: CBN, ARM Research

CBN supply to different segments of the market (\$' Million)

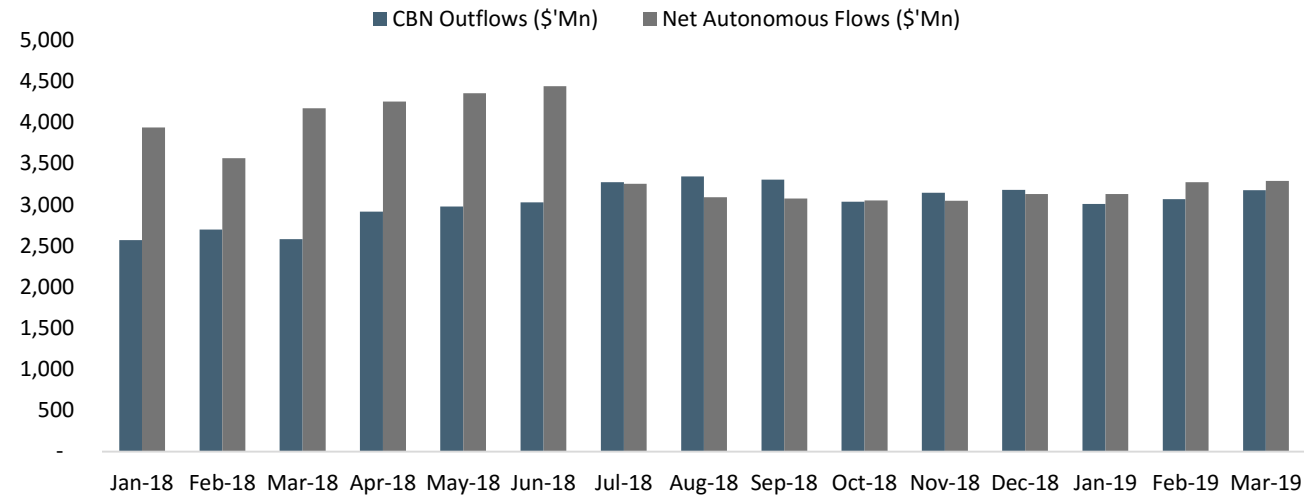


Source: CBN, ARM Research



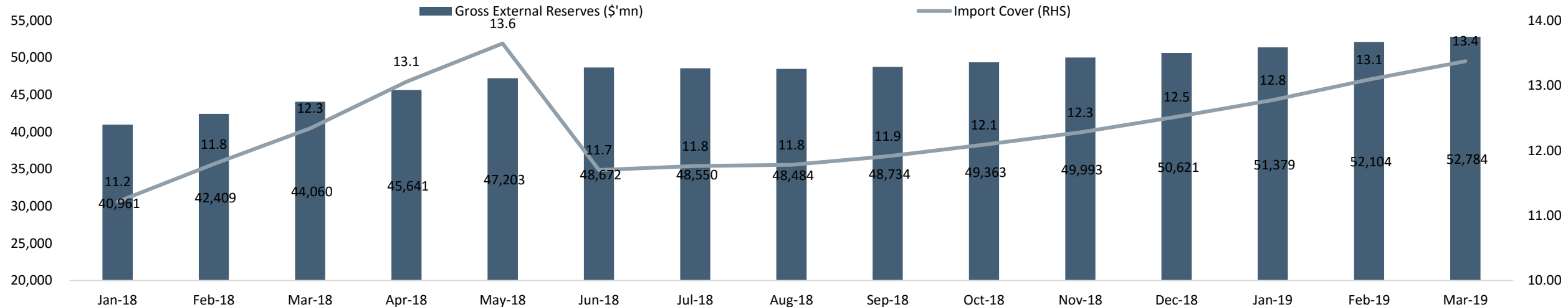
Based on our analysis, we expect the FX reserve to hit \$45 billion by June 2018, and cross \$50 billion by end year.

Political uncertainty and moderating yield environment would drive lower net autonomous flows



Source: CBN, ARM Research

However, depressed outlook on autonomous flows will have a mild impact on gross reserves



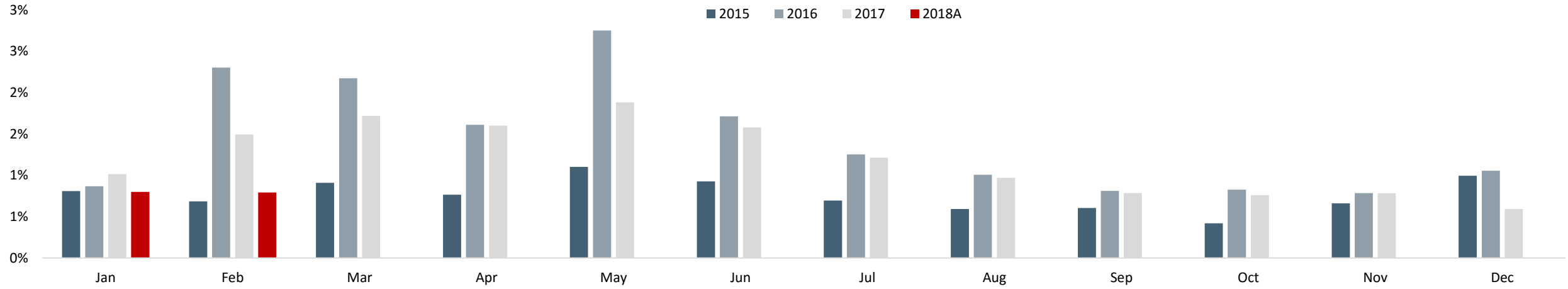
Source: CBN, ARM Research

- We expect moderation in net autonomous flows over H2 18 as the political concerns—with electioneering activities expected to enter its prime and the lower yield environment—dampens flows into the economy, with current flows finding solace in fixed income instruments.
- While noting the healthy reserve at the disposal of the apex bank, our expectation of decline in portfolio flows, speaks to a more aggressive sale by the apex bank (even a stronger participation by the apex bank in the IEW) to keep the dollar within current band.
- Accordingly we expect a lower accretion in the reserves over H2 18.



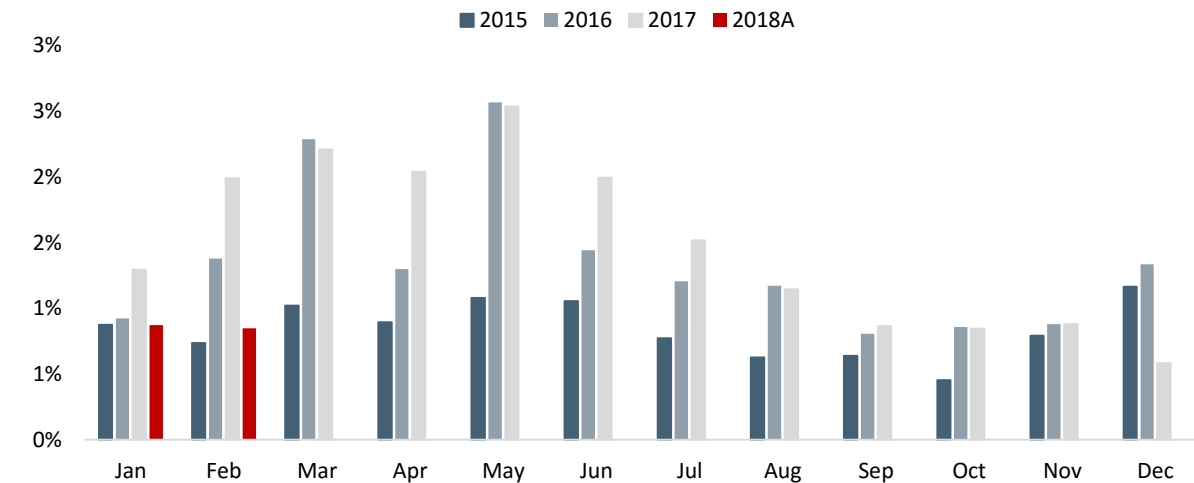
Headline inflation fast-tracks its descent, contracted 114bps to 14.7% over the first two months of 2018

We expect modest food prices to drive MoM headline inflation lower over 2018



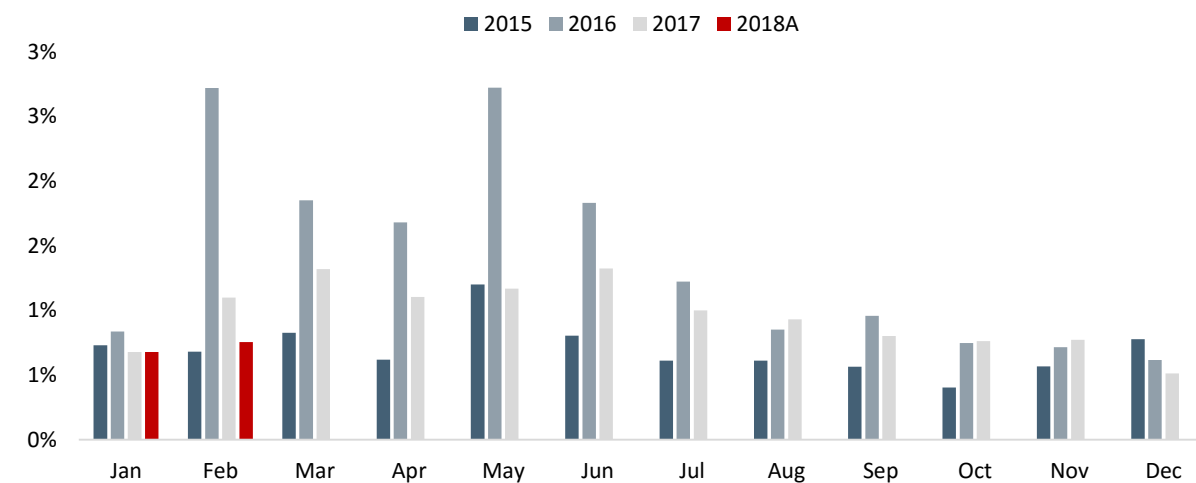
Source: NBS, ARM Research

Improved market supplies keep MoM food inflation lower



Source: NBS, ARM Research

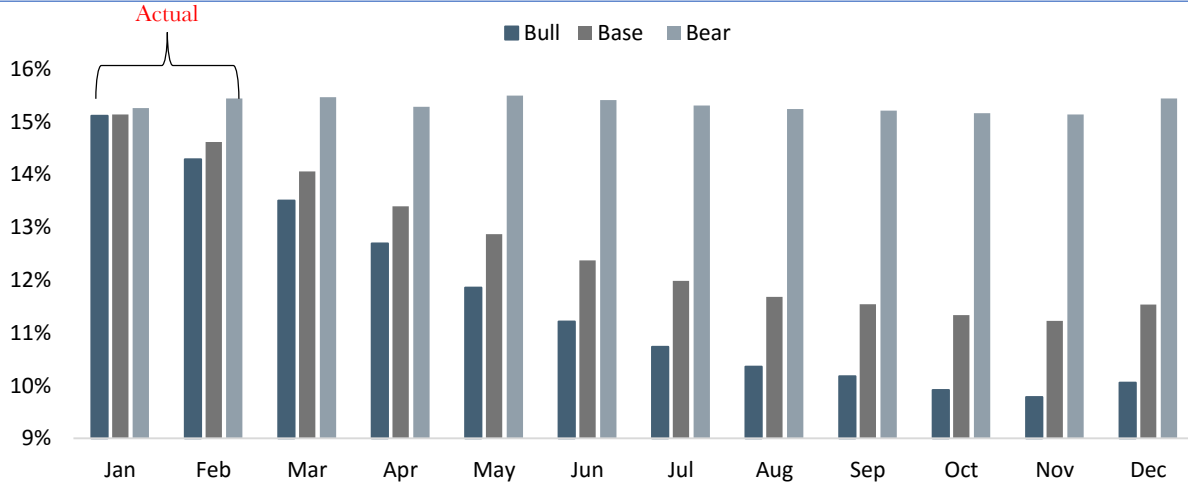
Historical MoM Core Inflation



Source: NBS, ARM Research



Actual Inflation numbers in Jan & Feb 2018 aligns with our bull case scenario at the start of the year.



Source: NBS, ARM Research

**2018
Average YoY**

Base	12.70%
Bull	11.68%
Bear	15.30%

Scenario analysis for inflation forecast over 2018

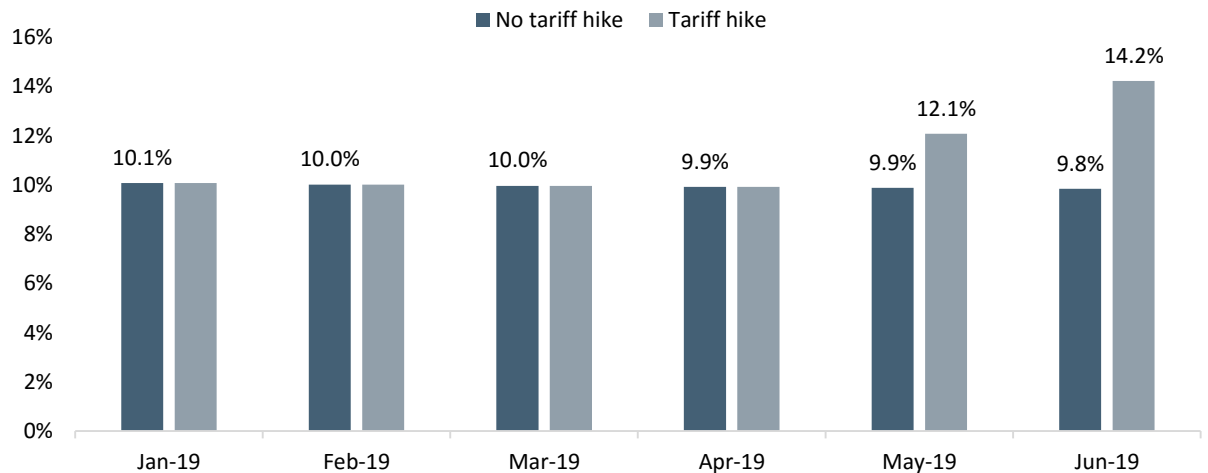
Weights	2014	2015	2016	2017
Bull	40%	40%	0%	20%
Base	30%	35%	15%	20%
Bear		20%	40%	40%

Source: ARM Research

**We project mean headline inflation to hover around
11.7% YoY over 2018 (2017: 16.6%).**

- New set of risks, however, have emerged which include the planned three-fold wage increase and the review of the excise duty rate on alcohol and tobacco
- Irrespective, given that the alcohol and tobacco division contributes a meagre 1% to overall headline inflation, we do not envisage a material impact following the review
- We also do not see the planned wage increase having sizeable impact on MoM headline inflation given that Nigeria's inflation is largely cost push and not demand pull
- Farther out into H1 19, we do not see an upward review in PMS price as our crude oil estimate of \$50 as well as currency range of ₦330 - ₦360/\$ suggests a landing cost between ₦135 - ₦144 which is lower than current price of ₦145.
- We, however, consider the possibility of a hike in electricity tariff (+61%) which would mostly likely take place after the elections and inflict pressures on core and headline inflation.

Inflation forecast for Jan-Jun 19

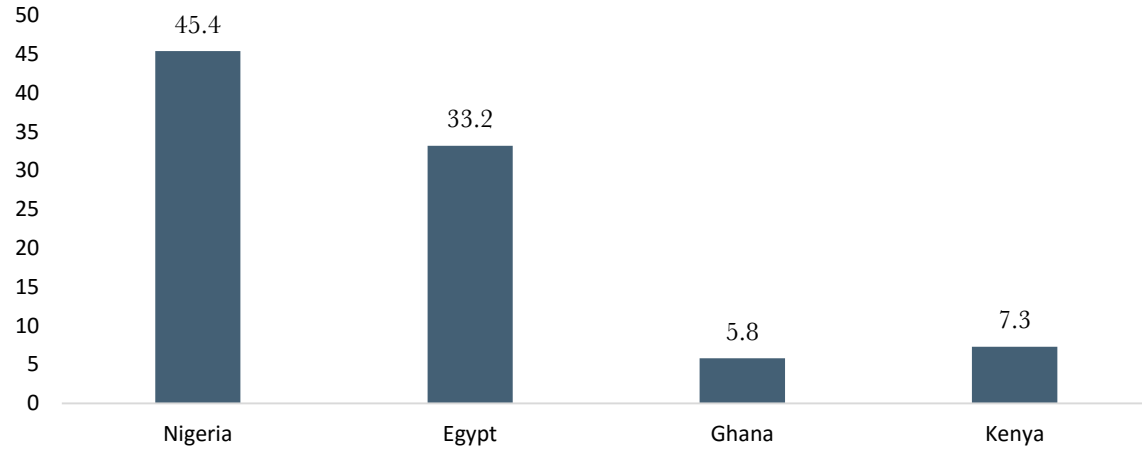


Source: NBS, ARM Research



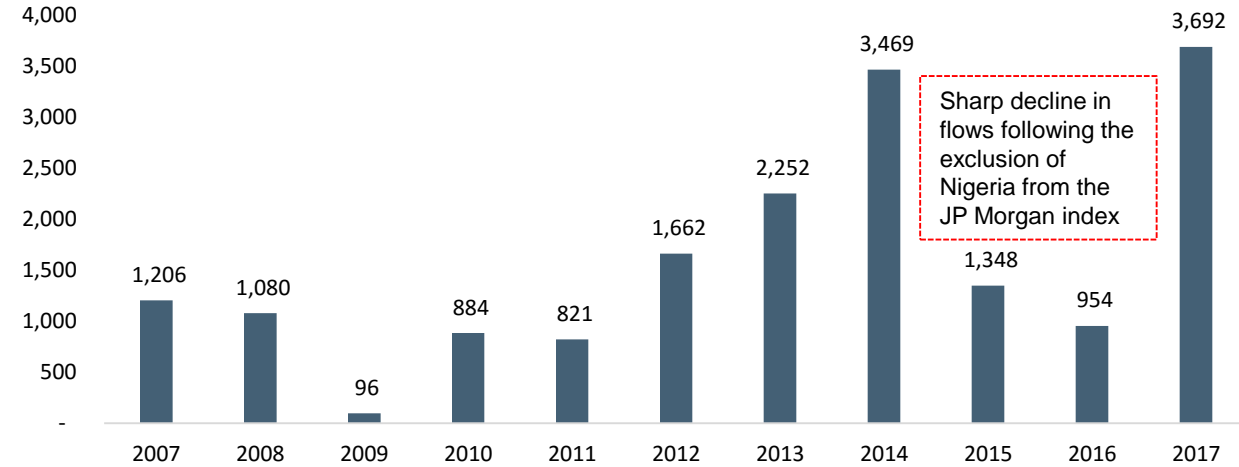
FPI have found a new love in Egypt, we expect sizable outflows in Q3, largely from maturing bills, but we are banking on a re-inclusion & ABABI

Prospect for sizeable accretion to reserves to guide the direction of flows



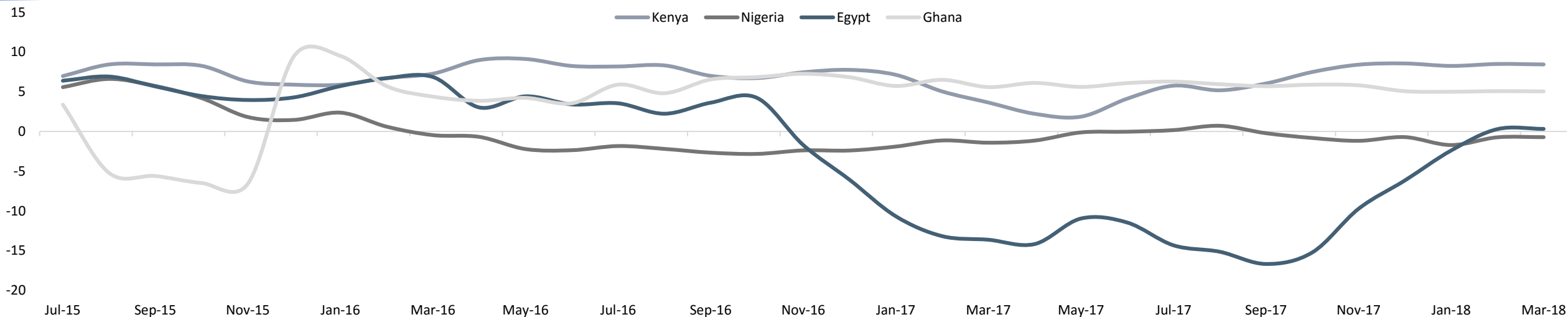
Source: Bloomberg, ARM Research

Will FPI flows to fixed income set a new benchmark in 2018?



Source: Bloomberg, ARM Research

While real yield in Nigeria is at its low relative to peers, our forecast of a faster decline in headline inflation speaks to a positive real yield but will still lag behind Egypt.



Source: Bloomberg, ARM Research



JP Morgan Index re-inclusion would be the game changer for Nigeria fixed income market

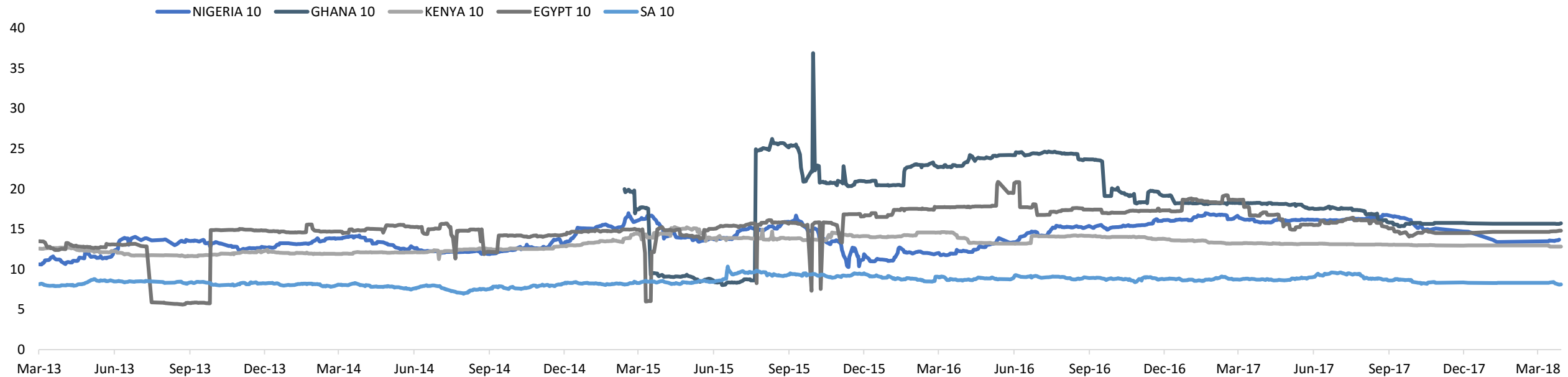
- We envisage a re-inclusion of Nigeria into the JP Morgan index towards the end of H1 2018 as we believe the reasons (majorly FX liquidity) for the exclusion has been addressed to a large extent following higher oil receipt, introduction of the I&E Window and resumption of weekly dollar sales.
- Should this play out, we could see flows to fixed income instruments touching \$4 billion in 2018.
- On the downside, we note the possibility of an election risk and a possible crash in oil price which could dampen flows to fixed income asset.

Scenario of risks to FPI flows

	BEAR	BASE	BULL
Oil price crash (\$mn)	1,500	2,500	3000

Source: ARM Research

Comparison of Bond yield (10-YR Bond) among Nigeria peers

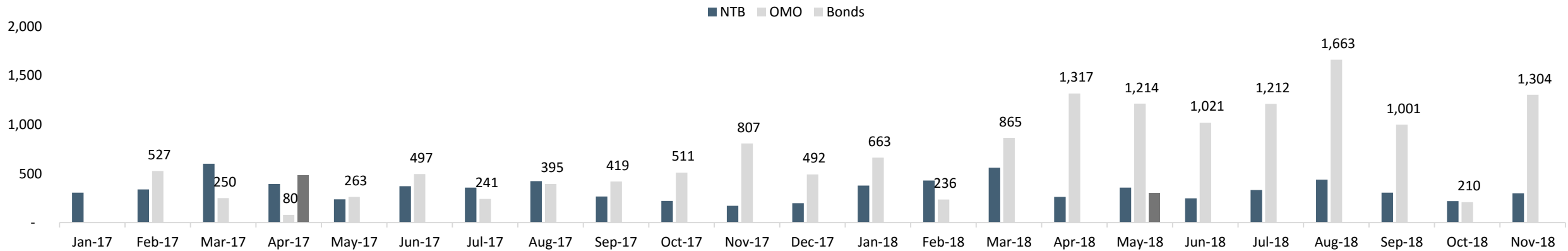


Source: Bloomberg, ARM Research



OMO rates will bow to dissipating inflationary concerns and burgeoning liquidity levels.

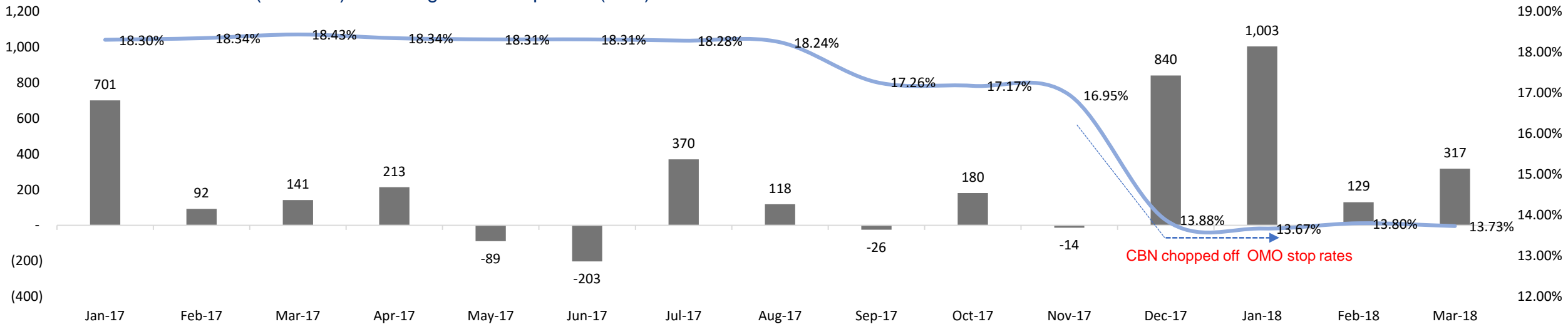
The CBN is faced with an elevated maturity profile over 2018



Source: FMDQ, ARM Research

CBN continues its liquidity straining in Q1 18, albeit, at lesser intervals. CBN resorted to easing via OMO stop rates cut in response to waning inflationary pressures.

OMO Net Issuances (N' Billion) vs Average OMO stop rates (LHS)



CBN chopped off OMO stop rates

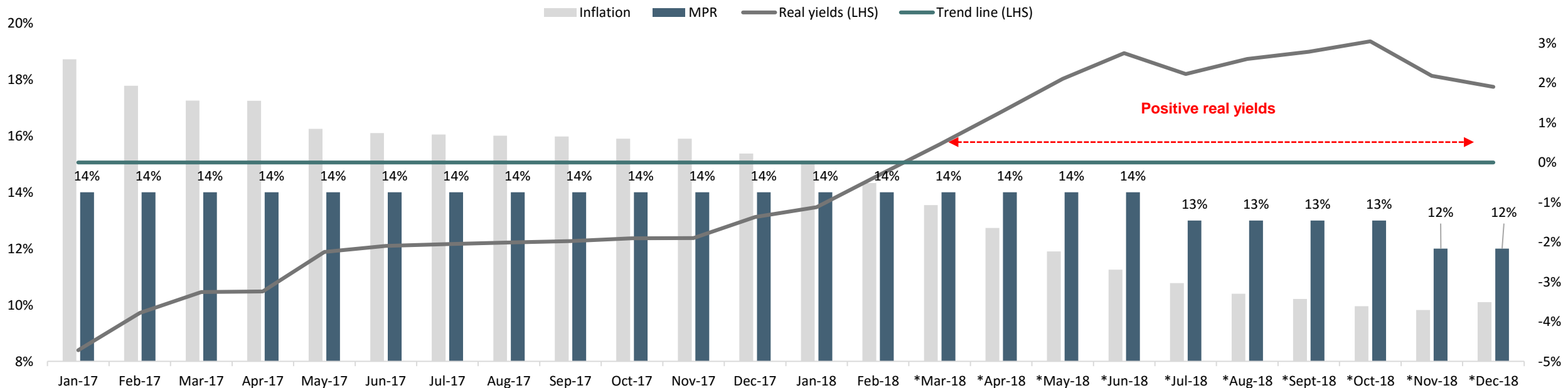
Source: FMDQ, ARM Research



Lower for longer interest rate on the horizon

- Given the foregoing, our outlook for monetary policy direction is hinged on our prognosis for headline inflation and CBN's disposition toward naira liquidity over 2018.
- On inflation, the narrowing differential between headline line inflation and the MPR provides leeway for easing in 2018. Particularly via the OMO leg, where CBN has succeeded in narrowing the differential between OMO yields and headline inflation, we believe this hold out the possibility of further cuts in OMO rates in 2018.
- Overlaying this with an elevated maturity profile in 2018, we hold the view that the CBN will leverage on liquidity levels to drive rates lower, in the face of aggressive issuance.
- In addition to backdoor easing via the OMO leg, we see scope for a 100bps cut in MPR in July due to expanding positive real yields and further cut (100bps) in November where we see headline inflation gravitating toward single digit.

We expect real yields to turn positive in March, informing our view of a 200bps cut in MPR in H2 2018.

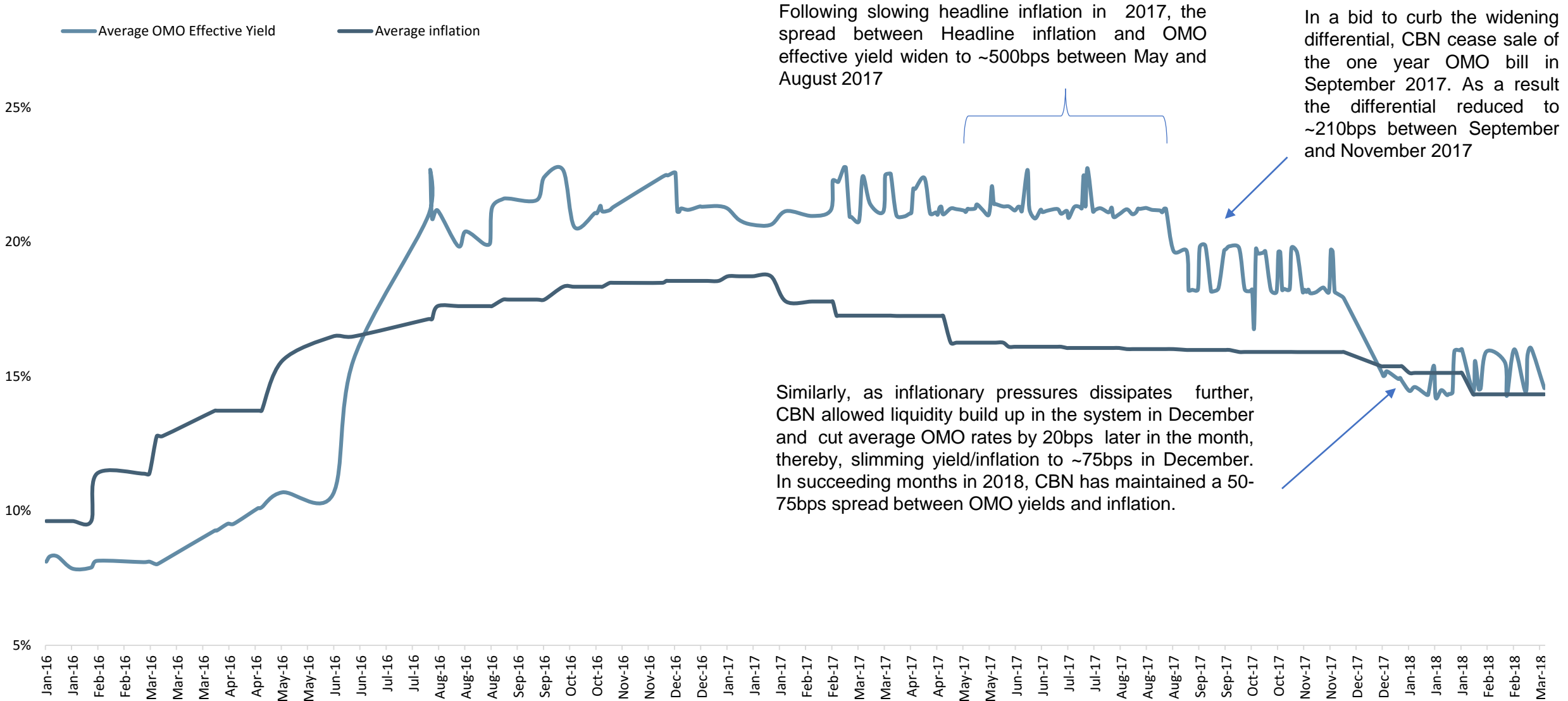


Source: NBS, CBN, ARM Research

*ARM Inflation forecast



The CBN is likely to maintain a 50-75bps spread between OMO Yields and Inflation, and then cap its inflation targeting at some point.

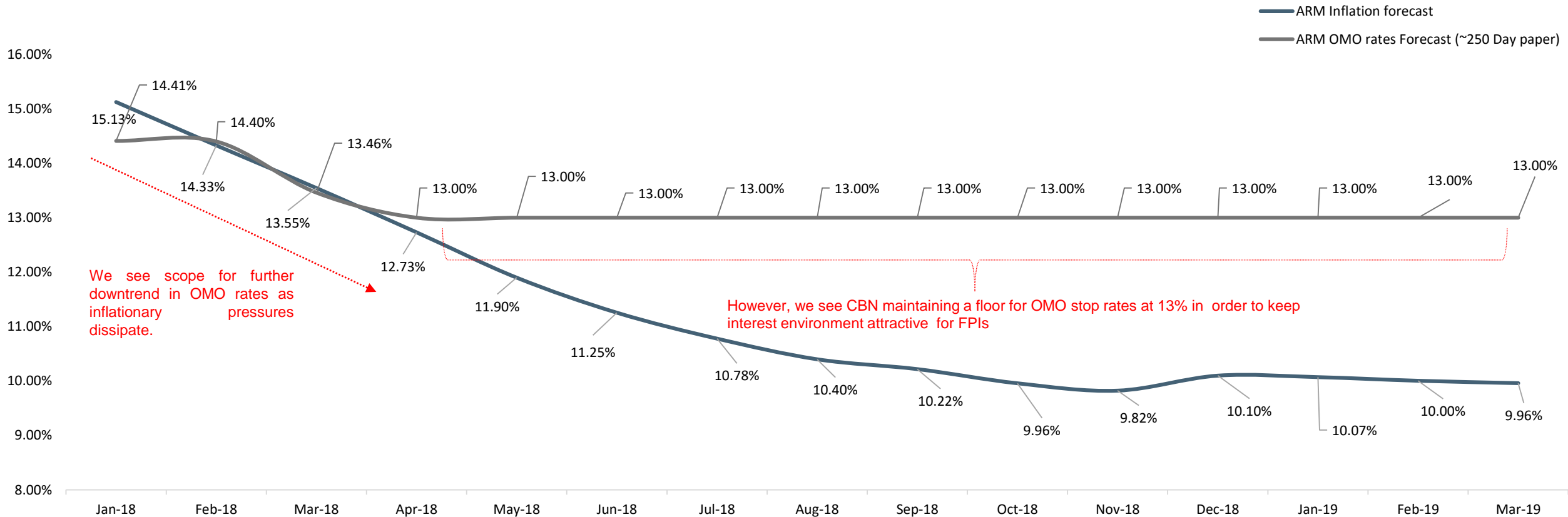




OMO stop rate will be capped at 13% in order to keep interest environment attractive for FPIs

- Going by trends in the past few months where yields on CBN OMO bills are issued at a narrow premium (50bps – 75bps) to headline inflation, we envisage further downtrend in OMO rates in the near term due to waning inflationary pressures. However, we see the CBN maintaining a floor at 13% to sustain FPI interest in the Nigerian fixed income market.

ARM Inflation forecast vs ARM OMO rates forecast





Domestic borrowings will outpace prior year albeit modest

N' billion	(Asset sale + \$2.78 bn foreign debt)	Asset sale + \$1.5 bn foreign debt	Asset sale + \$1 bn foreign debt	50% asset sale + \$2.78bn foreign debt	50% asset sale + \$1.5bn foreign debt	50% asset sale + \$1bn foreign debt	+No asset sale + \$2.78 bn foreign debt	No asset sale + \$1.5 bn foreign debt	No asset sale + \$1 bn foreign debt
Projected deficit	2,912	2,912	2,912	2,912	2,912	2,912	2,912	2,912	2,912
Sale of Assets	306	306	306	153	153	153	-	-	-
Foreign Borrowings	850	458	305	850	458	305	850	458	305
Domestic Borrowings	1,756	2,149	2,301	1,909	2,301	2,454	2,062	2,455	2,607
CBN ways and means	221	221	221	221	221	221	221	221	221
Borrowings from capital market	1,535	1,928	2,080	1,688	2,080	2,233	1,841	2,234	2,386
2017 net issuance	1,268	1,268	1,268	1,268	1,268	1,268	1,268	1,268	1,268
YoY increase ((N' billion)	267	660	812	420	812	965	573	966	1,118

Estimated monthly domestic borrowings in 2018

Month	2018	2017	YoY
Jan (Actual)	122,678.9	350,809.0	-65.0%
Feb (Actual)	109,620.3	325,177.9	-66.3%
Mar	124,758.0	(305,792)	140.8%
Apr	97,064.7	(445,069)	121.8%
May	(155,250)	213,432.8	-172.7%
Jun	134,874.0	215,274.0	-37.3%
Jul	144,263.1	130,451.9	10.6%
Aug	155,001.2	118,050.0	31.3%
Sep	150,657.7	367,233.8	-59.0%
Oct	142,486.9	164,651.6	-13.5%
Nov	150,719.3	254,587.0	-40.8%
Dec	361,394.0	(111,793.0)	423.3%

- Using our 2018 estimated fiscal deficit of ~~€~~2.9 billion as well as a successful Eurobond sale of \$2.8 billion (different from the \$2.5 billion raised earlier in the year vis-à-vis the 2017 budget), we estimate that to finance the budget, the FG would net issue ~~€~~1.5 billion in 2018
- This guides to higher domestic borrowings (+21%) in 2018 despite the federal government preference towards foreign borrowings

STRATEGY

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Defending the Defensive - Strategies for a low-rate environment

The current low-yield environment appears ready to continue in the near future and perhaps beyond. Thus, traditional sources of high quality income may no longer be sufficient to meet investors' needs. At the same time, a strategy focused on picking the highest-yielding securities may leave investors vulnerable to significant downside risks or market shocks.

In this low yield environment, the key challenge will be to generate a high and sustainable income stream from traditional sources such as government bonds

Recommendation	
Overweight non-traditional FI Instruments	<ul style="list-style-type: none">• Areas of bond market that we still find attractive today are investment grade corporate and municipal bonds.• A diverse mixture of these assets is helpful in generating more return in a low yield environment.• However, we advise balancing additional yield against credit risk
Fix the rate	<ul style="list-style-type: none">• In a lower yield environment, we recommend going fixed.• If rates decline, your fixed yield will look better in comparison.
Lengthen Duration	<ul style="list-style-type: none">• With rates staying lower and potentially going lower, it is typically recommended to go long.• We recommend longer-dated bonds, focusing on corporates and municipals, which boast higher rates than government treasuries



Commercial Papers

Issuer	Issue date	Tenor (Days)	Yield	Premium*	Issue Size (N'bn)
Wema Bank	29-Sep-17	180	20.99%	2.60%	3.41
Wema Bank Plc	29-Sep-17	270	22.79%	3.07%	13.62
UACN Property Dev	18-Oct-17	180	19.75%	1.37%	1.97
Dufil Prima Foods	18-Dec-17	180	16.92%	4.77%	4.53
Dufil Prima Foods	18-Dec-17	270	17.50%	1.90%	7.51
Access Bank	22-Dec-17	270	17.51%	1.96%	32.78
Sterling Bank	8-Feb-18	180	16.25%	1.18%	10.19
Sterling Bank	8-Feb-18	270	16.75%	0.53%	25.38
FSDH Merchant Bank	20-Feb-18	180	16.20%	0.60%	4.51
FSDH Merchant Bank	20-Feb-18	270	16.67%	1.02%	14.05

Corporate Bonds

Issuer	Issue date	Tenor (Yrs)	Coupon	Premium*	Issue Size (N'bn)
Mixta Real Estate	17-Jan-17	5	17%	0.86%	4.5
Dufil	31-Aug-17	5	18.25%	1.78%	10
Viathan	15-Dec-17	10	16%	2.35%	10
Lapo Microfinance	20-Dec-17	5	17.75%	3.70%	3.15

Source: FMDQ, ARM Research

* Spread between the corresponding risk free rate at the time of issuance relative to the coupon/yield



Thank you

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