

February 8, 2022



Nigeria Strategy Report

H1 2022

Domestic Economy and Markets

Fixed Income: 2022, A Tale of Two Halves

Executive Summary

The Fixed Income market realities in FY2021 was a game of two halves that manifested a stark contrast in direction. While the market recorded a surge (+587bps) in average yields to 10.19% in H1 2021, the latter half was headlined by the contraction (-95bps) in secondary market yields to 9.25%. The selloffs in H1 2021 were marked by a flurry of CRR debits that drained system liquidity and pushed fixed deposit rates higher. On another hand, CBN raised the marginal rates at OMOs auctions to retain FPI flows, and this heightened the clamor for higher yields at the FI market by local investors. On the supply side, the government through the DMO borrowed ₦1.42tn in the first half of 2021 out of the budgeted ₦2.7tn.

Our outlook for the fixed income market in 2022 is hinged on key factors that we believe would largely influence yields movement: global and domestic monetary policy direction, domestic fiscal policy direction, expected maturities, and pre-election jitters. The US Fed, as well as other global systemically important central banks, already signaled the return to a tightening stance with reduction in asset purchases and proposed hikes in rates in 2022. Higher rates in AEs would trigger selloffs in Ems, hence, necessitating higher yields in these markets. The CBN would need to guide marginal rates at auctions higher to retain flows and steer secondary market yields in the same directions. Although we believe that capital flight should have minimal impact on the FI (excl. OMO) markets as foreign investor participation in the T-bills and bonds market is currently low, significant higher rates at the OMO auction may induce local participants to reprice instruments in these markets as recorded in the first half of 2021.

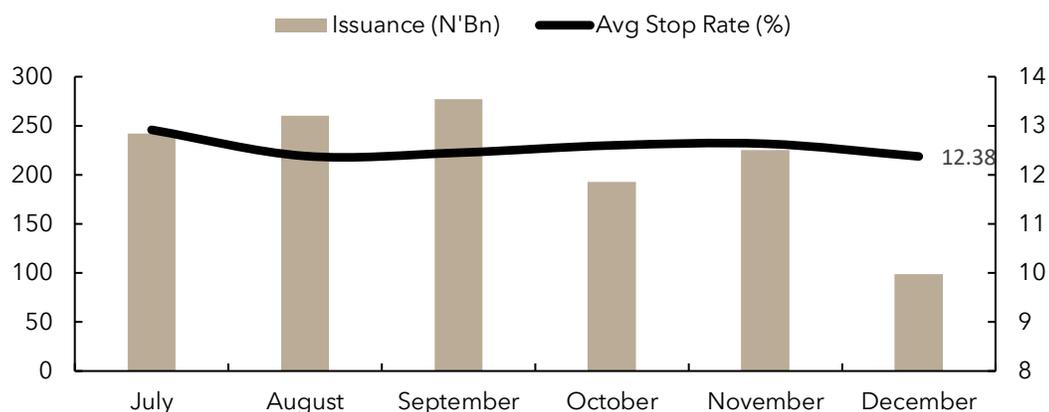
In this report, we look at the major themes that dominated the fixed income space in 2021 and delineate our outlook for 2022.

Yields in the Fixed Income Market slowed in H2 2021

The Fixed Income market realities in FY 2021 was a game of two halves that manifested a stark contrast in direction. While the market recorded a surge (+587bps) in average yields to 10.19% in H1 2021, the latter half was headlined by the contraction (-95bps) in secondary market yields to 9.25%. The selloffs in H1 2021 were marked by a flurry of CRR debits that drained system liquidity and pushed fixed deposit rates higher. On another hand, CBN raised the marginal rates at OMOs auctions to retain FPI flows, and this heightened the clamor for higher yields at the FI market by local investors. On the supply side, the government through the DMO borrowed ₦1.42tn in the first half of 2021 out of the budgeted ₦2.7tn.

H2 2021 was less eventful compared to the initial half due to lower flows from maturing instruments; T-bills (₦1.74tn), OMO (₦1.54tn), Bonds (₦561.05bn), and Promissory notes (₦133.66bn) amounting to ₦3,98tn matured in H2 from the ₦6.61tn recorded in H1 2021. On the supply side, the FG issued a slightly lower amount at bond auctions (₦1.2tn) than the ₦1.42tn sold in H1. In the bonds market, average yields declined 41bps to 11.41% with marginal rates at the auction down 68bps to an average of 12.63% across the three reopened instruments. Yields initially pared 7bps in July as the inflows from the maturing July 2021 bond fueled buying interest. This bullish sentiment was sustained to August when the bonds market witnessed the most buying interest and yields declined 92bps to 10.83% as evidenced in the highest bid-to-cover ratio of 2.4x at the August auction. The bullish streak was fueled by elevated flows in late July from maturing instruments across T-bills (₦246.88bn), Bond (₦561.05bn), and Promissory notes (₦104.90bn). Conversely, there were sell-offs in September and October with average yields up 37bps and 8bps respectively.

The bonds market performance was particularly driven by the buy-and-hold decisions of long-term investors, especially Pension Fund Administrators (PFAs) evidenced by the PFAs holding 63.7% of total bonds outstanding as of September 2021. On the supply side the record-level deficit of the FG necessitated higher offer amounts at the bond auctions (₦850bn in H2 2021 vs ₦595bn in H2 2020) and an increased issue amounts of ₦1.30tn (vs ₦730.03bn in H2 2020) as the DMO cleared more bids to meet FG's funding requirement.

Figure 1: Trend in Bond issuances and marginal clearing rates

Source: DMO, ARM Research

At the short end of the fixed income market, the bullish sentiment was more felt as the average yields in the secondary T-bills market declined 206bps to 4.51% in H2 2021 due to sustained demand from short-term players: banks and money market fund managers. The most demand tilted to the longer-dated instrument with yields paring 437bps in the six-month period under review. At the primary market auctions, demand exceeded H1 levels with aggregate bid-to-cover ratio of 2.9x (vs 1.8x in H1 2021) following aggressive mop-up of bids in line with the record-level budget deficit in 2021. Like the narrative in the secondary market, the 364-day instrument recorded the most buying interest at the auction. Net issuances (issuances net of maturities) in the T-bills segment in H2 totaled ₦1.25tn.

In the OMO market, the CBN sustained the winding-down of its balance sheet as witnessed since H1 2020, issuing way less than the maturing amounts (39% of maturities), hence, net repayment in H2 2021 totaled ₦333.1bn.

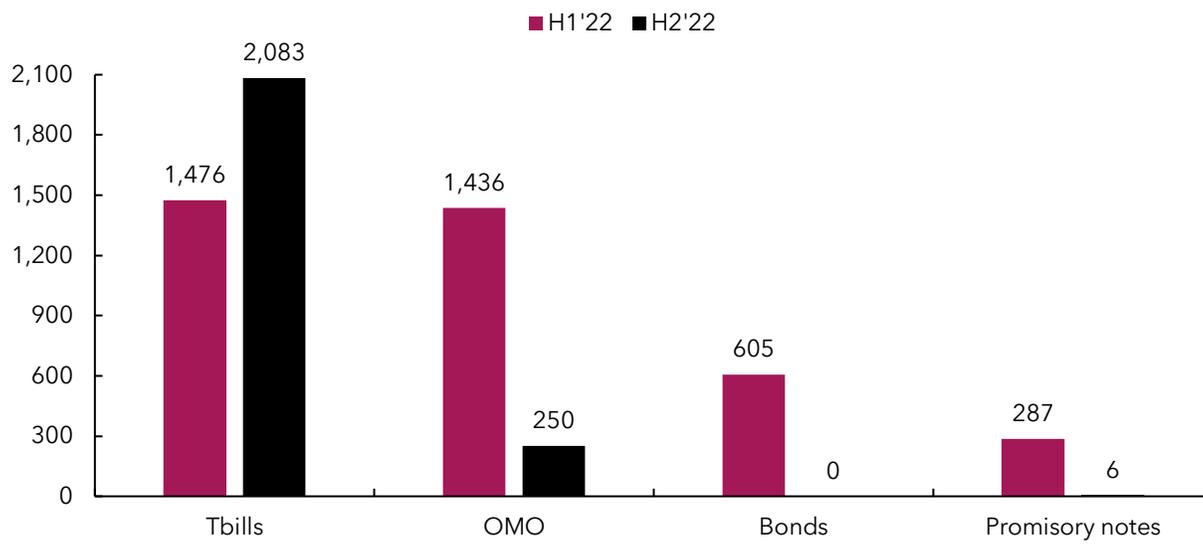
In terms of policy stance, the monetary policy stance remained on the part of tightening for the most part of H2 2021. Though the MPC maintained status quo across all major policy parameters, the incessant CRR debits by the CBN in H2 2021 kept a lid on system liquidity levels at the short end of the curve. Fiscal policy remained accommodative with the FG's budgeted fiscal deficit and domestic borrowing of ₦6.4tn (including the supplemental budget) and ₦2.7tn respectively. In H2 2021, FG's net borrowing at both the short and long-end of the market totaled ₦5.06tn (Bonds - ₦2.05tn and T bills - ₦3.01tn) in 2021. In September, the FG approached the Eurobonds market as scheduled to raise \$3.0bn (₦1.6tn) in line with the Debt Management Strategy 2020 - 2023 and ended up borrowing \$4.0bn as investors, propelled by large global liquidity, oversubscribed the offer by 4x.

Outlook: 2022, A Tale of Two Halves

Our outlook for the fixed income market in 2022 is hinged on key factors that we believe would largely influence yields movement: global and domestic monetary policy direction, domestic fiscal policy direction, expected maturities, and pre-election jitters. The US Fed, as well as other global systemically important central banks, already signaled the return to a tightening stance with reduction in asset purchases and proposed hikes in rates in 2022. Higher rates in AEs would trigger selloffs in Ems, hence, necessitating higher yields in these markets. The CBN would need to guide marginal rates at auctions higher to retain flows and steer secondary market yields in the same directions. Although we believe that capital flight should have minimal impact on the FI (excl. OMO) markets as foreign investor participation in the T-bills and bonds market is currently low, significant higher rates at the OMO auction may induce local participants to reprice instruments in these markets as recorded in the first half of 2021.

For fiscal policy, the 2022 budget already stipulates government deficit and subsequent domestic borrowings of ₦6.39tn and ₦2.57tn, respectively. Although, we estimate actual deficit to be 41% higher than the stated amount in our fiscal highlights, we expect sustained backdoor funding of the FG by the CBN through Ways & Means. The budgeted ₦2.57tn coupled with the refinancing of the maturing Jan-22 bonds worth ₦605.3bn would ensure a sizeable supply of papers to the market in 2022. On the demand front, maturities profile of ₦6.10tn for 2022 is considerably smaller than the ₦10.6tn (incl. promissory notes) in 2021 and 61.9% of the funds are skewed to the first half of the year. In this light, we would expect the market to remain range bound in H1 2022 as policy decisions unfolds in line with global proceedings. Although investors' response to pre-election uncertainties are unclear, we may see sell-offs in the second part of the year. In the same vein, lower maturity profile in the face of large government deficit may command higher marginal rates and hence, yields. We expect average yields at the short end of the curve to rise by 150bps due to monetary policy tightening while increased supply of bonds should push yields higher by 100bps at the long end.

Overall, we advise mid-to-long term play for investors in the early part of the year to cash-in on duration effects as yields decline marginally. However, we advise a shorter-term play in the later part of the year due to expected rise in yields to minimize losses.

Figure 2: Expected Maturities in 2022 (₦'Bn)

Source: DMO, FMDQ, ARM Research

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