



Nigeria Strategy Report

H1 2013



TABLE OF CONTENTS

SUMMARY	3
INTRODUCTION	4
REVIEW OF GLOBAL ECONOMY AND CAPITAL FLOWS	5
• Oil market outlook supportive of Naira assets	7
• Commodities outlook pose limited threat to Naira assets	15
• Portfolio flows make grand entry	16
REVIEW OF DOMESTIC POLICY	24
• New guidelines for pension assets to shape market outlook	24
• Fiscal conditions taking broadly favourable turn.....	27
• Improved budgeting signals better fiscal management	29
ECONOMIC REVIEW AND OUTLOOK.....	34
• Money markets in roller-coaster run	34
• Improving external position underpins fiscal balances	38
• Fortuitous turn of events in currency markets	41
• An anticlimactic year for inflation	43
CAPITAL MARKET REVIEW AND OUTLOOK.....	47
• Equities: Bull run for the price of base case.....	47
• Heady half year for bond markets	49
• Diminishing “tail risks” boost outlook	51
• Paying heed to key risks.....	57
CAPITAL MARKET STRATEGY	59
• Feature Report: The dark side of foreign portfolio inflows	62
• Abbreviations	67

NIGERIA STRATEGY REPORT H1 2013

ARM Research

SUMMARY

Despite looming risks, coordinated policy action in major markets led to signs of economic recovery, particularly in leading emerging markets in the tail end of 2012. We believe this development moved the risk facing the global economy away from being dominated by high impact uncertain events towards more conventional growth concerns which are nonetheless still important.

The inclusion of Nigeria into bond indices, in response to more favourable domestic policy drove an upsurge in portfolio investments. Alongside this, however, we believe domestic policy in 2012 also tied Nigeria more closely to trends in global oil prices.

Incidentally, oil prices found firm support in H2 2012 amid substantial turbulence in global investor sentiment and economic performance. We explore trends that suggest crude oil pricing will continue to be undergirded by improving economic outlook, particularly in major emerging markets, in 2013.

The NSEASI rebounded sharply from its 16.3% decline in 2011, rising 35.4% in 2012—30.4% in H2 alone. Performance was underpinned by a major turnaround in the banking sector, which rose 50.5% in 2012, as well as continued buoyancy of Brewers (up 43%). An H2 2012 surge in the Banking and Consumer sectors underscored a significant increase in foreign portfolio inflows, but also a modest rebound of domestic investor interest in the face of improving conditions.

After the post MPC meeting spike in July, fixed income yields contracted sharply, falling as much as 400bps on average for FGN bonds in Q3 2012. Declines were mainly on the back of a sharp increase in foreign investments sparked by Nigeria's inclusion in the JP Morgan Emerging Market Bond index though a moderation in the implementation of monetary policy, with increased currency stability, also supported fixed income prices.

We believe portfolio flows will attain heightened significance in Nigerian capital markets, tying outlook much more closely with global trends and oil prices.

This trend is underscored by recent domestic policy stance.

We expect buoyant performance in Nigerian equity markets to persist in 2013, largely on the back of a recovery in the global cyclical theme as global economic outlook improves. This should drive a tendency towards valuation convergence between domestic cyclical (e.g. banking and cement sectors) and richly valued defensives (brewers, food and personal care) amid an overall rerating of the Nigerian market.

We also expect duration to gain increasing momentum in the bond markets, though performance could become more volatile in view of many uncertainties in domestic markets and policy. We also see heightened risks for naira assets though we believe these are contained by more benign global economic outlook and increasingly supportive policies in major markets.

INTRODUCTION

With continued evolution under the influence of gradual but substantial ongoing changes in the economy, our outlook for Nigerian Capital markets in 2013 is hinged on an analysis of the potentially critical impact of three key trends.

Ongoing macro-economic and capital market reforms which have helped spark an ongoing re-evaluation of Nigeria's economic prospects. Nevertheless despite their significance, heightened skepticism by local investors still smarting from the 2008/09 Nigerian financial crisis—and its 2011 aftershocks in the banking sector—may very well have curtailed the translation of improvements into favourable market outcomes, but for a major shift in foreign investor perception and interest in Nigerian markets.

It is in this regard that underlying trends in the global economy which have turned attention towards emerging markets have proved favourable for Naira assets. While there is an element of good fortune in the timing of these two themes in the context of the post-crisis evolution of global investments sentiment, the intrinsic ties between the two are clarified by positive ratings action for Nigeria in H2 2012. This episode is embedded in an ongoing trend that underscores gradual shifts in global economic power, itself intensified by the onset of the major financial crisis that hit the global West in 2008. Our analysis situates Nigeria in the cross currents of these events, which serve as the basis of a framework that integrates potential significance of these different strands in exploring likely outcomes for domestic capital markets in 2013.

In this regard, the sharp rise in portfolio flows in 2012, accentuated by inclusion of Nigerian bonds into two key emerging market indices, emerged as a highly influential sub-theme in the direction of asset markets during the year. In view of these developments, global trends feature much more prominently in our analysis than previously—as do portfolio flows, which we investigate in some depth to explore their potential impact on medium term outlook for Nigerian capital markets.

In a sharp departure from the inferences we drew in our recent strategy reports, Nigerian assets exhibited much closer ties with global peers in H2 2012, which serves to draw attention to the likely implications of upcoming events in the global economy and markets on outlook for Nigerian assets. In particular, we explore the closer links we believe domestic policy has established between Naira assets and global trends, primarily through the commodities channel.

Significantly, in the interaction between global and domestic policy actions, developments in international and local markets and economies and patterns in commodity prices and portfolio flows, we discern a substantial change in the risks facing investors. For Nigerian assets in particular, this leads to interesting inferences that suggests that while a diminution of “event risks” in the global markets serve to bolster outlook for naira asset prices, domestic policy has made these more susceptible to “tail risk” in the global economy. Consequently, an exploration of risks facing domestic investors also features substantially in our analysis and help shape our conclusions and strategy.

REVIEW OF GLOBAL ECONOMY AND CAPITAL FLOWS

Tepid DM recovery amid persisting headwinds

2012 was characterized by continued weaknesses across the global economy which led to a series of broad-based monetary easing in both emerging and advanced economies. Intermittent improvements in investor sentiment during the year were underpinned by events such as the launch of QE3 in the US and a pro-EU ruling in German courts which validated the ECB bond buying program. Sentiment nevertheless succumbed to renewed uncertainties surrounding the looming fiscal cliff in the US in Q4 2012, highlighting its fundamental fragility.

The US Federal Reserve came under pressure for a third round of quantitative easing in a bid to boost a lackluster economy. The eventual announcement of QE3 late Q3 2012 buoyed markets temporarily as investors priced in expectations of a rise in domestic demand from the implementation of an indefinite \$40billion bond buying program—the first with specific conditionalities (unemployment rates of 6.5% and inflation below 2.5%) attached. Economic indicators and unemployment statistics subsequently showed signs of tepid recovery in Q3 2012, with the latter trending below 8% for the first time since the beginning

of the financial crisis to 7.7%⁽¹⁾, while GDP growth also accelerated to an upwardly revised 3.1% in Q3 2012. However, since the conclusion of the US presidential elections, the impending fiscal cliff emerged at the forefront of investors concerns in Q4 2012 temporarily taking focus off the Euro debt crises. US lawmakers eventually came up with a makeshift agreement just at the nick of the January 1st deadline, affording the markets a substantial relief rally but merely shifting attention to the new squabbles over debt limits in March. The latter remains a potential risk event in Q1 2013 with the US government flirting with the congressionally imposed debt ceiling of \$16.4 trillion, reminiscent of a similar event in August 2011 that sent global markets into a tailspin.

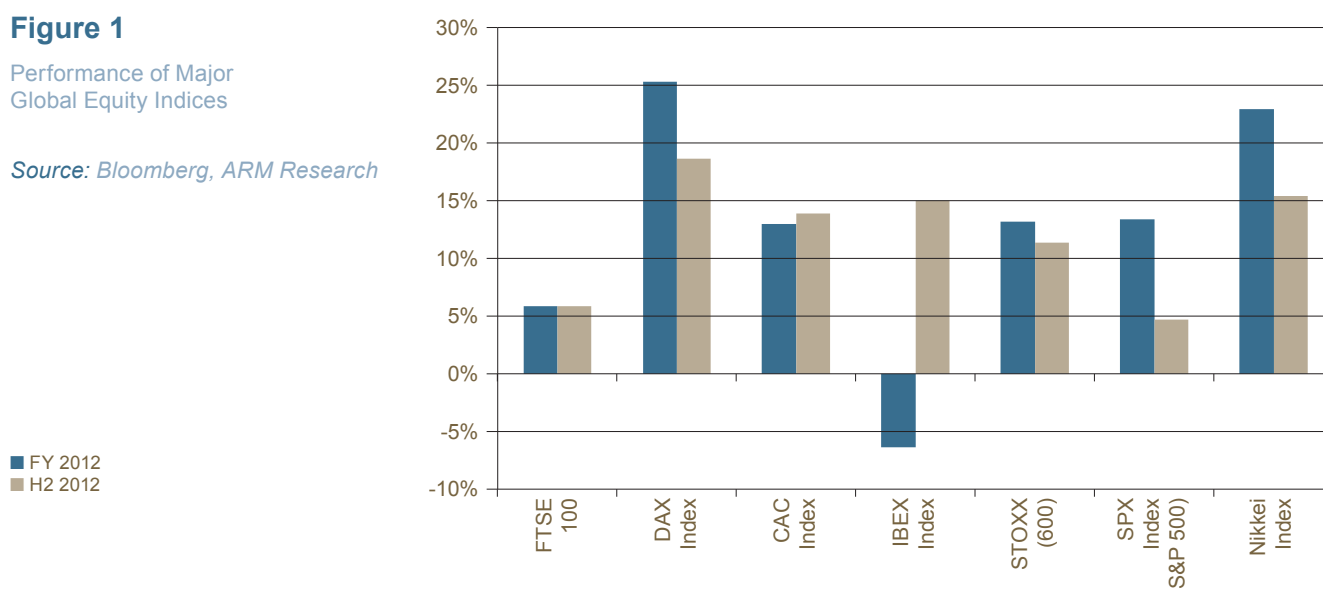
The Euro area debt crisis intensified in H2 2012 with continued contraction in economic output as contagion persists within the region. A rare credit rating downgrade by Moody's for one of the region's economic bulwarks, France, in Q4 2012 amid persisting fears of default by the Spanish and Italian governments, periodically fed into debt markets keeping the region's fiscal challenges in firm focus and constituting a major headwind for EU risk assets. The favourable ruling given by German courts paved

(1) As at November 2012

Figure 1

Performance of Major
Global Equity Indices

Source: Bloomberg, ARM Research



the way for the creation of the zone's €500 billion rescue fund which is targeted at ailing economies and was widely interpreted as ameliorating the primary risk event for the region. However governments in the key countries in question, Spain and Italy, have since refused to seek financial aid from the Troika group of lenders, leaving investors flummoxed amid ongoing fears of a possible sovereign default in the region.

Greece maintained the spotlight in H2 2012 though a six-notch upgrade to an 18-month high by S&P late 2012 boosted perceptions about the country's progress, considerably whittling the much feared possibility of an exit from the Eurozone as another major risk factor. Though performance across major European economies highlight persisting uncertainties within the region—which we expect to persist in 2013—major indices nevertheless had a decent year with the pan-European STOXX 600 rising 13% in 2012, testament to the soothing impact of concerted policy efforts, which helped the region dodge primary pitfalls during the year.

Japanese GDP slumped 0.9% in Q3 2012 as the world's third largest economy continued to deteriorate in light of weakening global demand and persisting uncertainties in the Eurozone and US, two of its leading export destinations. Its Asian exports were also dented by an ongoing spat with China over the disputed Senkaku Islands, further compounded by the strengthening of the Yen which appreciated 8.72% in 2012 (Q4 : 11.28%) against the US dollar. However, Japanese growth was also hampered by weak domestic consumption after a rather short-lived recovery in Q2 2012, even as the Bank of Japan (BOJ) extended its asset purchases by \$138 billion in November and announced its plans to offer unlimited loans to banks in a bid to boost credit to the private sector. Industrial production fell 8.1% YoY at the end of Q3 2012, its steepest rate since the Tsunami struck in March 2011; December figures also showed a contraction of 5.8%, prompting a downward revision of growth forecast for 2012 to 2.2%.

Economic outlook was further complicated by a rift between the central bank and the government which persisted through Q4 2012 as government urged the BOJ to embark on fundamental measures to energize the economy. Things came to a head when the new government of Shinzo Abe issued a veiled ultimatum for the BOJ to drive down the Yen with aggressive

purchase of foreign bonds or face new bank laws. Indeed the BOJ appears to have caved in recent weeks leading to a sharp depreciation in the Yen into YE 2012. Essentially, we expect to see a persisting trend of aggressive monetary easing in Japan in the near term as its recovery is partly hinged on a weaker Yen. We also expect signs of global recovery to provide some support for exports—and economic growth—in the medium term.

Asian revival afoot as China reboots...

In continuation of a trend observed from year start, Chinese economic growth slowed further in H2 2012, a pointer to the fact that the world's second largest economy was still experiencing spillover effects of faltering economic recovery in U.S., Japan and the Eurozone; the largest destinations for Chinese exports. The latest GDP data showed the Chinese economy grew 7.4% YoY in the Q3 2012—the lowest since 2000—tapering off from 7.6% and 8.1% in Q2 and Q1 respectively, largely on the back of weaker than expected demand for Chinese exports and lagged effects of monetary tightening in 2011. Exports, which have been a major driver of growth in recent years, also grew a tepid 2.9% YoY in November—substantially lagging the 10% growth predicted in a FactSet survey of economists. On the other hand, imports held steady, leading to a 35% YoY expansion in trade surplus of \$19.6 billion in November 2012 which was nevertheless well behind the \$31.9 billion recorded in the previous month; signaling the possibility that weak exports could weigh further on growth. An ongoing spat between China and Japan over disputed Islands forced the temporary closure of a number of Japanese flagship companies in China and could have also contributed to the weaker growth.

Nevertheless, a string of somewhat positive data released in November suggests China could be on the path of a—albeit slow—recovery. After declining for the better part of 2012, industrial output, a key proxy for China's growth, rose 10.1% YoY in November the strongest reading since March and a third consecutive month of higher growth figures since it bottomed at 8.9% in August. In addition, PMI data for the same month came in at 50.6% up 0.4ppt from the previous month, with most of the rise coming from the new orders index which rose 0.8ppt MoM. Significantly, growth in retail sales expanded 40 bps MoM to 14.9% in November.

In a reversal of the tight monetary policy stance taken by the Peoples Bank of China (PBoC) the previous year to curb rising inflation, the Chinese apex bank effected a second rate cut in July 2012, reducing both lending and deposit rates, whilst easing lending rules for commercial banks. Inflation has since trended lower, declining 2.5pps YTD to 2% as at November providing greater scope for policy easing. Also, with political transition in October 2012, this relatively tepid performance has now prompted the government to fast-track previously planned infrastructure projects. In September, China's National Development and Reform Commission, announced approvals for projects estimated to exceed \$ 150 billion which had been delayed previously to allow China recover from side effects of its 2008/2009 stimulus. Thus, policy easing and increased infrastructure spend amid a structural shift towards domestic consumption appear set to spark a modest rebound in Chinese growth in 2013.

...and India rejigs

In India, weak external demand, persistently high inflation, a string of corruption scandals, political disputes over planned reforms, a weak rupee, rising current account deficit and dented investor confidence saw GDP growth decelerate 20bps QoQ to 5.3% in Q3 2012. Nevertheless, the Reserve Bank of India (RBI), kept policy rates on hold since a 50bps cut in April 2012 indicating that inflation remains a priority, but has hinted the possibility of further easing in Q1 2013 when inflation is expected to trend lower.

After months of policy paralysis, the Indian government announced a slew of policy reforms in September 2012 that include a cut in fuel subsidies, approval for increased FDI in multibrand retail, civil aviation and broadcasting industries as well as divestment from four public sector companies. Markets reacted favorably to the announcement with the SENSEX gaining 7.8% by YE 2012, while the rupee also stabilized over the period after substantial volatility which saw the currency slump to its lowest level vs. the USD in June 2012. Incidentally, inflation has declined more than 80bps in the three months leading to November to 7.24%, despite concerns that the recent reduction in energy subsidy could push prices higher. Thus, prospects of monetary easing and substantial increase in portfolio and direct investment in 2013 has bolstered outlook for Indian growth.

In Latin America, Brazil's 0.6% Q3 GDP growth was a slight improvement over H1 2012 where its agricultural commodities output paid the price of exposure to the European and US markets. Significantly, expansion in Q3 was attributed to increased output in agriculture and livestock. Overall, growth in Brazil was weakest amongst the major emerging markets, falling well below the 5.7% 9M 2012 average growth rate for the other BRIC countries. Amid relatively high inflation and expansionary policy which saw benchmark SELIC rates reduced to a nine month low of 7.5%, outlook for Brazil is largely hinged on its ability to adapt and cushion effects of external shock as any further deterioration in the US and Europe weigh on exports. Overall, along with Russia, its limited capacity to contribute to global demand means that weakness in the "other 2" may not have major implications for global growth in 2013.

OIL MARKET OUTLOOK SUPPORTIVE OF NAIRA ASSETS

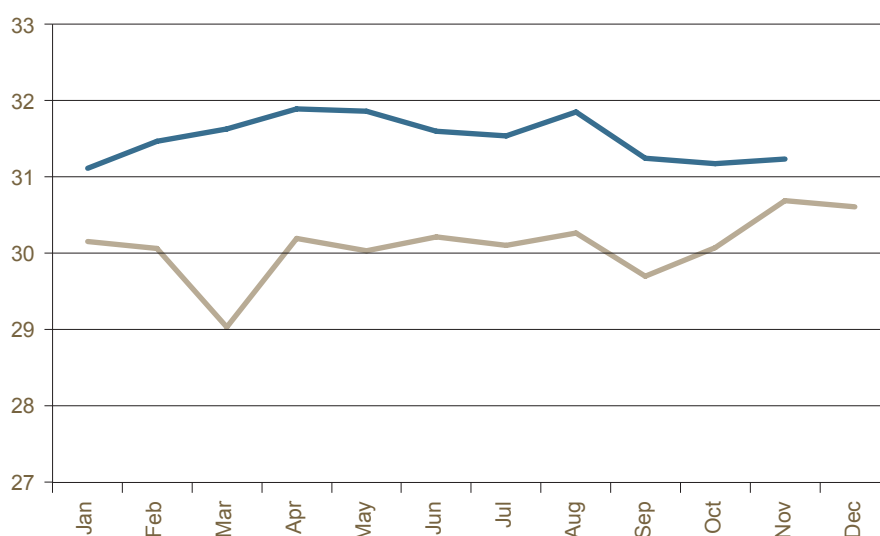
OPEC supply holds steady

Iranian output dropped 12.9% to 2.81mbpd in Q3 2012 on the back of UN sanctions, with increases from Iraq, Nigeria and Libya unable to cover the shortfall resulting in a marginal decline in OPEC output for the quarter. Nevertheless, high crude prices have made OPEC—which controls ~80% of proven oil reserves and reportedly has ~3.83mbpd spare production capacity according to IEA October estimates—more cautious about expanding supply. Earlier in the year, Saudi Arabia, which accounts for >50% of the cartel's spare capacity, hinted that it considered a \$100 a barrel benchmark for oil prices fair and a slight decline in the Kingdom's Q3 2012 output perhaps reflects this position. Nevertheless, upon further contractions in Iranian and Nigerian output—the latter temporarily on account of flooding and sabotage—Saudi Arabia and Iraq ramped up production in November.

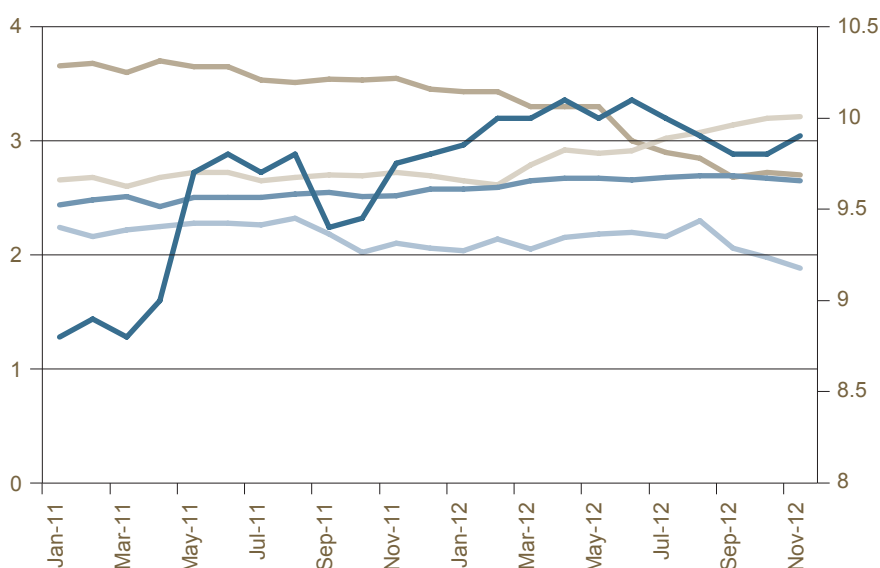
As a whole, OPEC retained its overall output quota at 30mbpd at its December meeting though members failed to agree on allocation increases to cover Iran's declining output. With Iranian output set to decline further in 2013 as additional US financial sanctions take effect in February, we expect members to continue ramping up production into 2013 to cover the shortfall. The lifting of pre-existing force majeure on Nigeria's output in December and preliminary loading

Figure 2OPEC Supply Trends
(bpd 'mln)

Source: IEA, ARM Research

■ 2012
■ 2011**Figure 3**Output of 5 OPEC Members
(bpd 'mln)

Source: IEA, ARM Research

■ IRAN
■ IRAQ
■ UAE
■ NIGERIA
■ SAUDI ARABIA (RHS)

data for January and February suggest a rebound in the country's production, while Libya, Angola and Iraq also increased output in November. Overall, we expect stable output for OPEC into 2013 but note that increasing capacity both within and outside the cartel would weaken its control of crude oil prices which is already undermined by members' spotty compliance.

Shale oil boosts Non-OPEC output

Non-OPEC production rebounded in Q4 2012 after a series of maintenance activities, coupled with impact of hurricane Isaac and sanctions on Syrian export, saw non-aligned output drop ~0.5mbpd QoQ in Q3 2012 to 52.6mbpd. Production recovered somewhat in Q4 2012 to 53.4mbpd in October, trending higher

through November with the completion of scheduled maintenance, calmer weather, growing output from North Dakota tight oil formation and surging production in Russia—whose production hit a post-soviet record of 10.9mbpd during the year. Increased production from Gazprom due to asset expansion in Orenburg region in Russia should continue into 2013 further boosting the country's output, though accelerated drop in output of mature assets in the region could net out these additions. North Sea fields face a gloomier outlook for 2013 as planned restart of production at aging Gryphon and Tullich fields in Q4 2012 was postponed for the umpteenth time (now slated for Q1 2013) to complete ongoing maintenance. Eventual output from these fields is seemingly set to be more moderate than envisaged.

On the other hand, fields in the US state of North Dakota added over 200kbpd on the back of increased production from shale formations which saw PADD 2 output hitting new highs, contributing to the 800kbpd increase in US production in 2012 through October. Furthermore, scheduled resumption of production in some Canadian fields in Q1 2013 and increased exploration in Russia could add as much as 400kbpd in 2013 even as planned resumption in production at offshore fields Hibernia, Terra Nova and White Rose

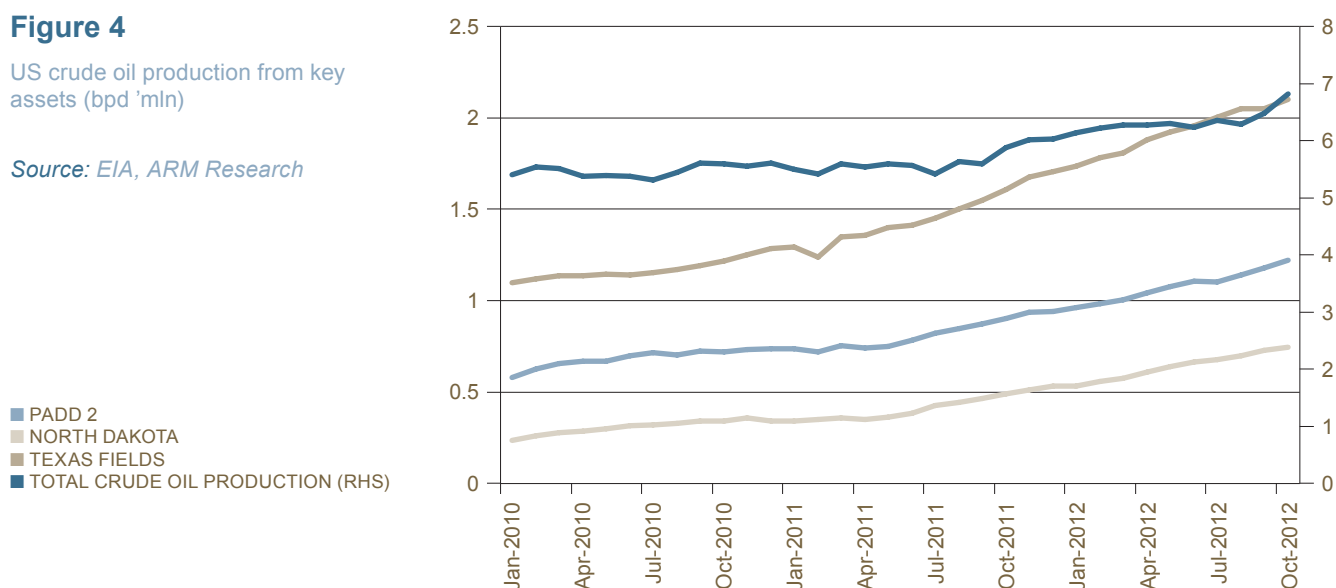
in Canada are expected to add > 300kbpd.

However, much of the increase in North American output will come from production from shale formation via the costlier hydraulic fracturing method through 2013. This is an important consideration since prices will need to remain elevated (> \$80/bbl by most estimates) for the new fields to remain viable suggesting the availability of this additional capacity will be somewhat linked to oil prices.

Figure 4

US crude oil production from key assets (bpd 'mln)

Source: EIA, ARM Research



Shifting demand patterns alter market response

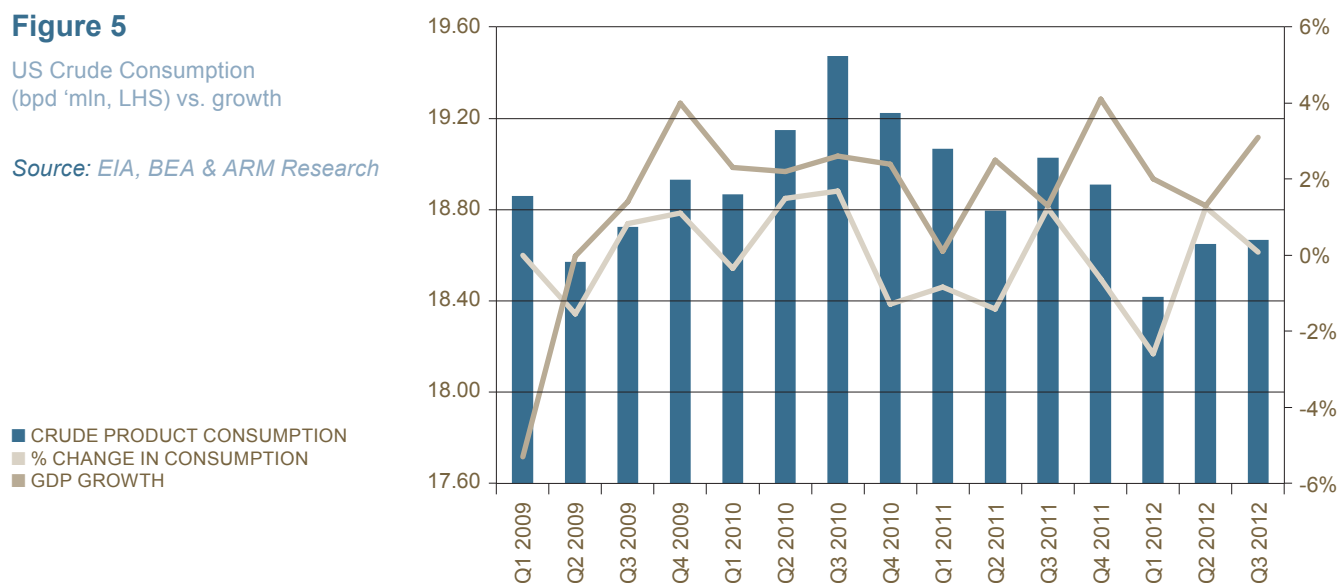
There has been a clear recalibration of demand supply balance across the globe since the financial crisis. Remarkably, US crude oil consumption ceased tracking movement in economic output since 2011 with such factors as warmer weather, 0.5% increase in fuel efficiency, its transportation fleets (amid softness in transport markets) and a weakening in the economy having driven a downtrend in oil consumption, which has shed 4.1% from its Q3 2010 peak, falling a further 1.9% in 2012 to 18.6mbpd as at 9M 2012. Increased domestic oil production—particularly from the tight oil formation in North Dakota and Montana—has resulted in steady decline in US imports of crude oil and petroleum products, with net imports as a share of consumption around 50% as at October from 68% in 2009.

China's crude oil demand rose strongly in Q4 2012 through November, after a 6.9% QoQ decline in Q3 to 107 MT (~8.5mbpd) – on the back of improving economic fundamentals, shift in energy use towards transport sector, increase in stockpile for winter and rising refining throughput volumes. As at November, both crude oil consumption and refining throughput rose 9.1% YoY to hit record highs of 10.5mbpd and 10.2mbpd, respectively. In a bid to cater for growing demand, China plans to increase refining capacity to 14mbpd by 2015 (currently 11.6mbpd according to IHS Global estimates), and we believe that, coupled with increased expansion in the manufacturing sector—as corroborated by PMI figures—and continued shift in energy use in the transportation sector, this will drive a rise in Chinese crude oil demand in 2013. With aggregate crude oil demand (which grew 3.5% YoY to November) still expected to exceed domestic production, which is forecasted to grow 4.6% to

Figure 5

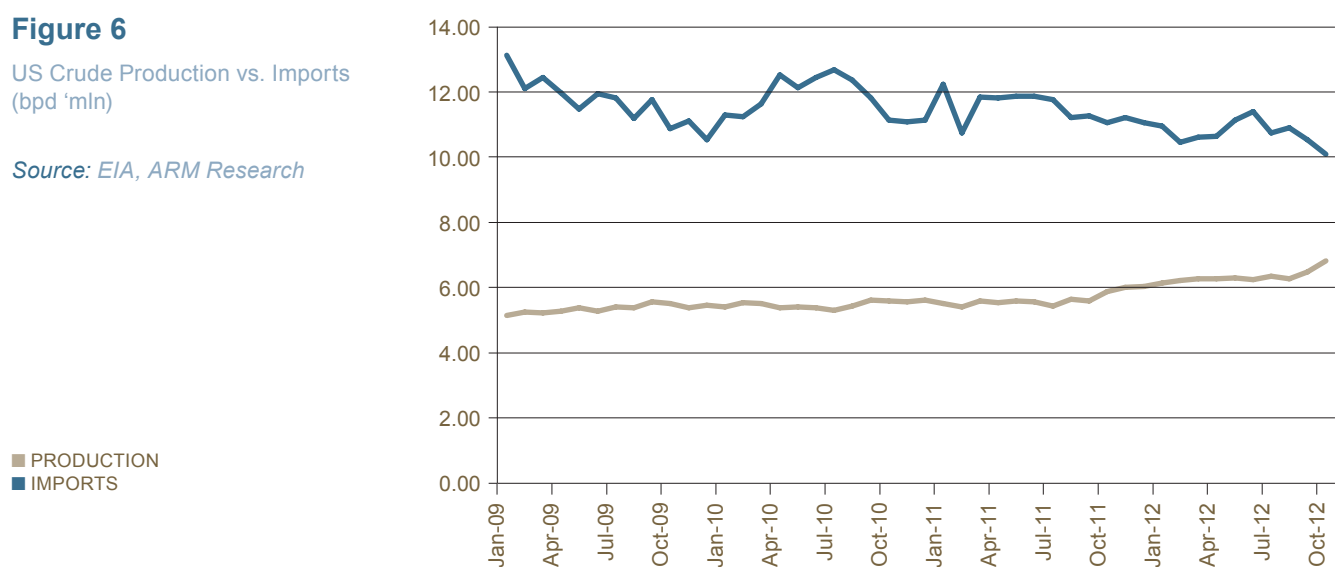
US Crude Consumption
(bpd 'mln, LHS) vs. growth

Source: EIA, BEA & ARM Research

**Figure 6**

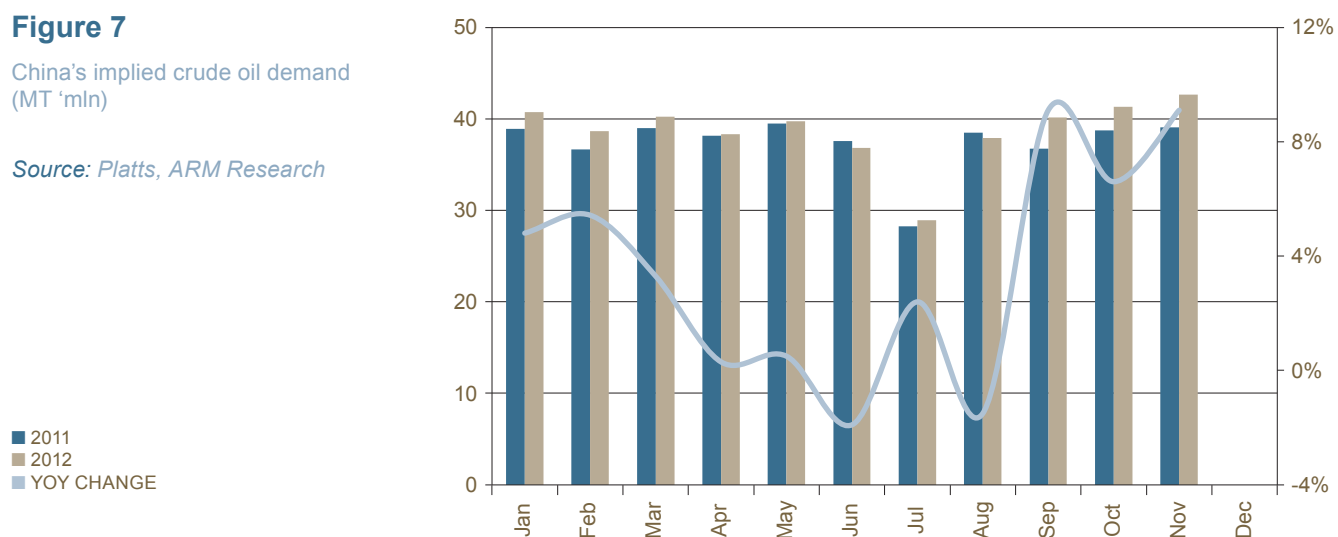
US Crude Production vs. Imports
(bpd 'mln)

Source: EIA, ARM Research

**Figure 7**

China's implied crude oil demand
(MT 'mln)

Source: Platts, ARM Research



4.5mbpd from 2011 through 2013 and to 4.7mbpd by 2035⁽²⁾, Chinese imports of crude appear set to expand, helping support global crude oil prices.

Indian crude oil demand was higher in H2 2012 largely on the back of additional refining capacity, with utilization up 680kbpd YoY to 4.5mbpd in October 2012 – about a third was exported. The Indian Oil Corporation (IOC) is adding over 400kbpd refining capacity in 2012/13 suggesting increased import demand when the facility comes on stream early in 2013.

Prices track demand patterns as QE lends support

Average crude prices (Brent) have risen ~460% over the past decade to \$111.11 in 2012, largely on the back of strong demand from China and India. Between 2000 and 2007, crude oil consumption in China and India recorded a CAGR of 7.1% and 4.1%, respectively. US and Japan which, along with

China and India account for ~40% of global crude oil consumption, recorded a more subdued consumption CAGR of 0.7% and -1.4% respectively over the same period. After a collapse in global output—which shrank 0.7% in 2009 on the back of the financial crisis—crude prices plunged to an average of \$62 that year, 36% lower than the previous, with a 4.2mbpd cut in OPEC's production to 24.845mbpd helping contain the decline.

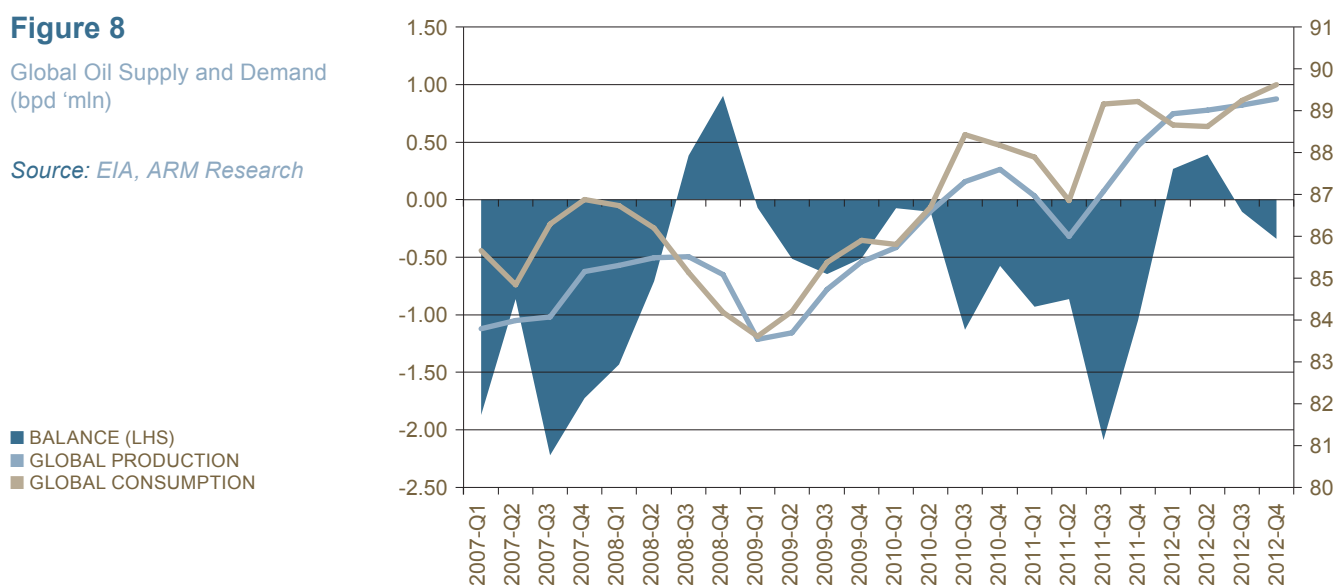
However, improving demand—and risk appetites—underpinned by resumption in economic growth and monetary stimulus by major Central Banks post the financial crises lifted oil prices ~25% between 2010 and 2012. Demand from India and China, rose at a CAGR of 3.26% and 6.17%, while the US and Japanese consumption expanded at a 0.3% and 1.5% CAGR, respectively, over the same time frame. Among other factors, crude prices were periodically buoyed by supply concerns brought to the fore by the revolution in the Middle-East, which saw Libya's oil production plunge 87% to 200kbpd in March 2011.

(2) EIA estimates

Figure 8

Global Oil Supply and Demand
(bpd 'mln)

Source: EIA, ARM Research



According to the EIA, demand for crude oil has grown at a CAGR of 0.33% since the launch of QE 1 in Q4 2008, a mere 8bps ahead of supply growth suggesting that price increases (and volatility) are not entirely backed by fundamentals. Nevertheless while price appreciation during QE1 may have been muted by severe weaknesses in the global economy

in 2008/09 which saw US oil demand contract 3.5% in 2009, the impact of subsequent QEs were somewhat less ambiguous. Global oil prices surged 26% in the immediate aftermath of QE2 though this was most likely exaggerated by the onset of “Arab Spring” protests soon afterward. With US inflation rising ~ 240bps to over 3.50% by end H1 2011, the Fed opted

for more unconventional policy tools with a \$400 billion bond maturity switching programme dubbed “operation twist”. The response to this event and its subsequent extension was rather short-lived as has

been the case with the announcement of QE3. Oil prices rose ~12% from its Q2 2012 announcement through to YE 2012, perhaps undermined by “fiscal cliff” fears, but its effect is clear nonetheless.

Figure 9

Impact of QE in spot Brent crude prices (\$per barrel)

Source: Bloomberg, ARM Research

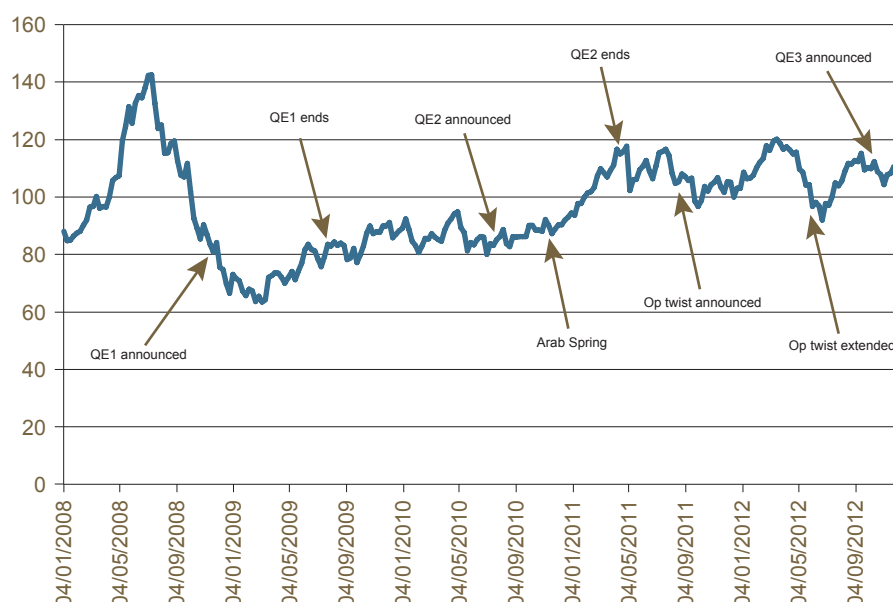


Table 1

Oil Price Response to QE

Event	Period	Amount	Performance of Brent
QE 1	Sept '08 – March '10	\$1.75 trillion	3.57%
Post QE1	April' 10 – October' 10	N/A	1.04%
QE 2	November'10 – June'11	\$600 billion	26.4%
Post QE 2	July' 11 – September' 11	N/A	-13.12%
Operation twist	September'11 – June'12	\$400 billion	0.92%
Op twist extended /QE 3	July'12 – December'12/ September'12 -	\$40 billion continuous/ \$40 billion	12.9%

Source: Bloomberg, ARM Research

Compared to H1 2012, crude prices traded 150 bps lower on average in H2 2012 at \$107.95, as concerns over a fragile recovery (the Eurozone sank back into recession in Q3) and US fiscal cliff weighed negatively on investor's sentiments, though resurgence of geopolitical tensions in the middle east limited downside. On the whole, after substantial declines in US energy consumption and imports earlier in that year, both metrics appear to have stabilised in H2 2012, as has consumption in Europe. Furthermore, with increasing scope for monetary easing and fiscal

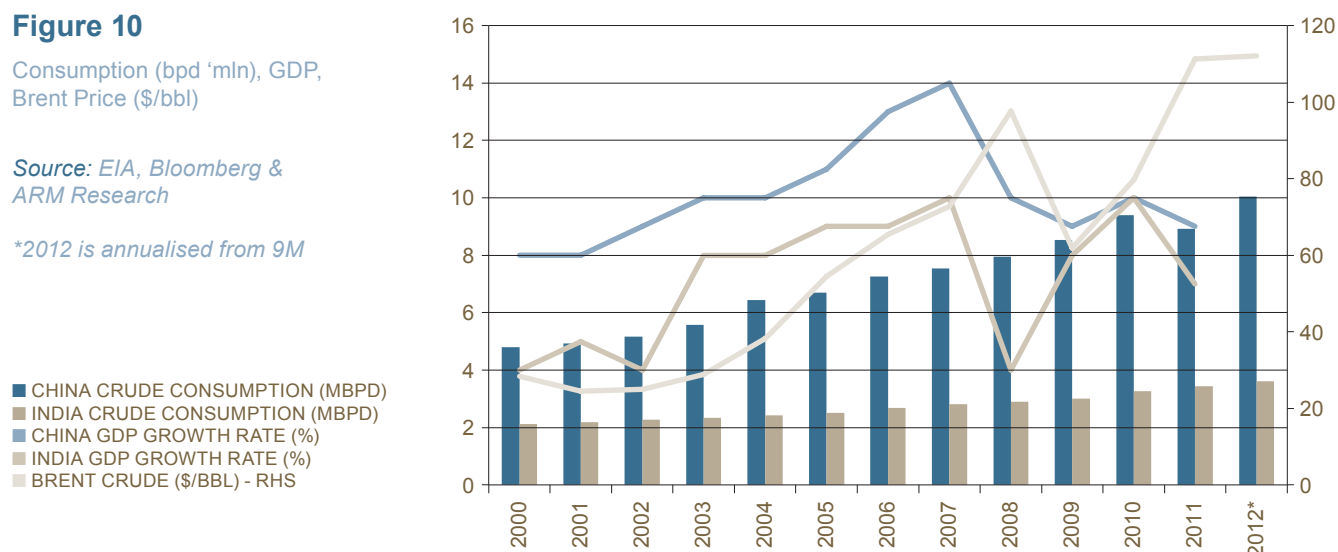
stimulus in China pointing to stronger growth in that economy, we believe demand in the world's second largest energy market is set to offset losses elsewhere.

Figure 10

Consumption (bpd 'mln), GDP,
Brent Price (\$/bbl)

Source: EIA, Bloomberg &
ARM Research

*2012 is annualised from 9M



Nigeria set to benefit from Asian recovery

Nigeria's benchmark crude price—Bonny Light closed the year at \$112.72/barrel posting a 0.23% gain in December which pared 0.6% and 0.31% losses over the quarter and year respectively. This contrasts with a 7.76% gain by the benchmark Brent which closed the year \$111.11/barrel, highlighting rising discount on Nigerian oil exports on account of rising

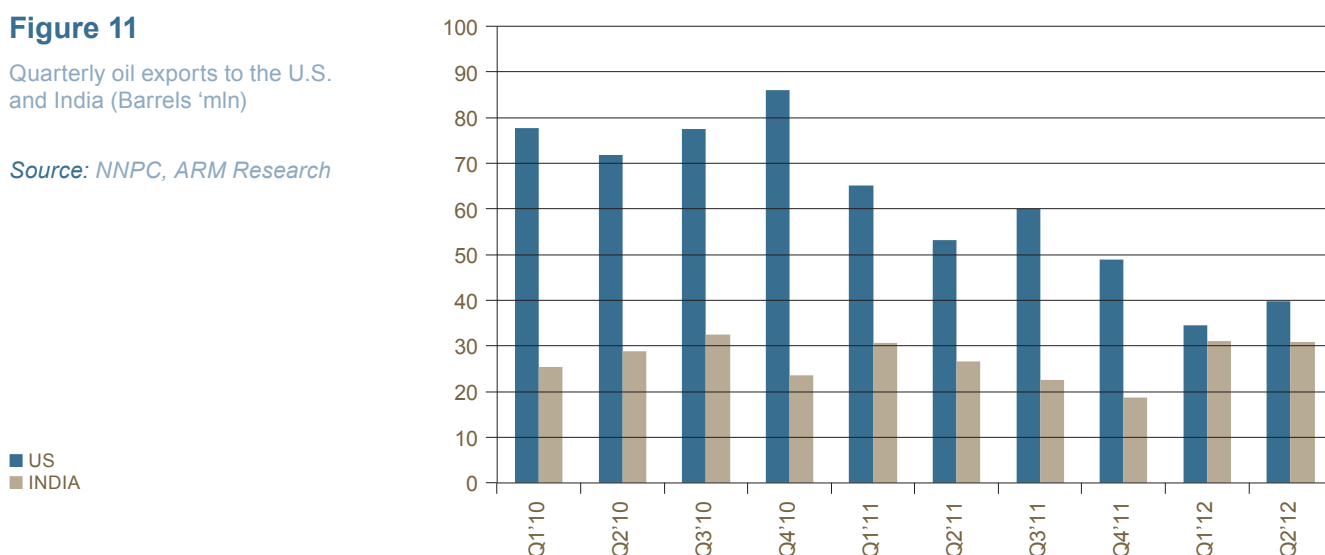
preponderance of Asian buyers as US cut Nigerian crude imports in H1 2012.

Incidentally, we believe Nigeria's increasing reliance on Asian exports following a 14pps decline in its crude exports to the US to 19% have tied Nigeria's outlook closer to Asia's largest emerging economies. In contrast, its oil exports to India have been on the increase, reaching 15% of total oil exports in Q2 2012 from 13% in 2011.

Figure 11

Quarterly oil exports to the U.S.
and India (Barrels 'mln)

Source: NNPC, ARM Research



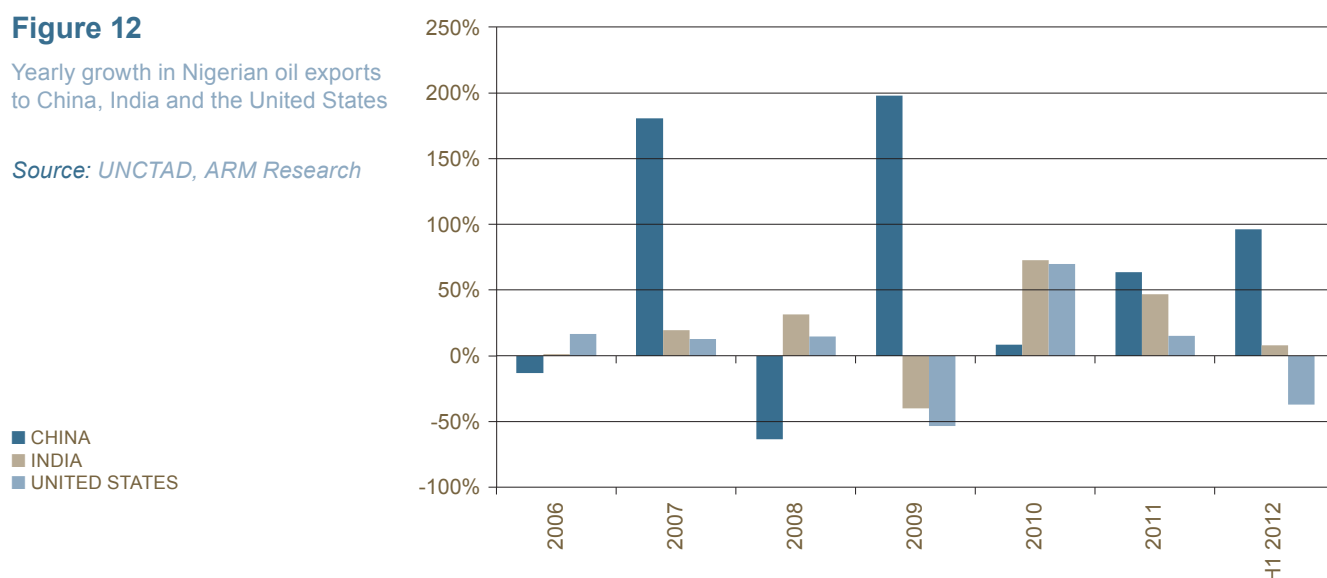
Also despite choppy growth in recent years absolute values of Nigeria's oil exports to China have been on the rise. It is perhaps significant that the period

of highest growth in oil export to China coincided with the 2008/2009 Chinese stimulus, suggesting that the new programme could also boost demand

Figure 12

Yearly growth in Nigerian oil exports to China, India and the United States

Source: UNCTAD, ARM Research



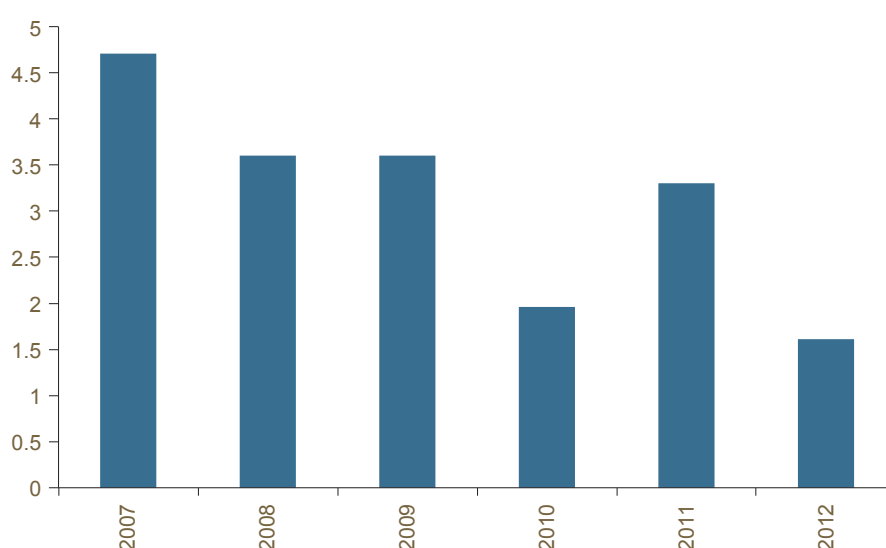
for Nigeria's oil in 2013 as it increasingly looks east to make up for the shortfall in oil exports to the U.S. amid a sharp decline in differentials between Bonny Light and Brent in 2012. We expect that with balanced global demand/supply scenario helping stabilise Brent prices, the likely emergence of higher Asian demand will serve to underpin demand for Nigerian crude in 2013 perhaps leading to a modest recovery in Bonny-Brent differentials.

Overall, we believe that in the base case Nigerian benchmark crude prices will trade near current levels, with marginal declines at worst. Consequently, much of the gains we expect in Nigeria's oil revenues will come from expanded production, which ultimately leads to much better quality revenues as it does not feature a corresponding leakage from subsidy payments, assuming domestic demand for petroleum products hold steady.

Figure 13

Bonny Light and Brent differentials (\$)

Source: EIA, Bloomberg & ARM Research Estimate



COMMODITIES OUTLOOK POSE LIMITED THREAT TO NAIRA ASSETS

Weather shocks inflating soft commodity prices

The performance of commodity prices in 2012 is mixed with food prices being hit by weather shocks and energy and metal prices moving lock-step with trends in global demand. Having explored outlook for energy prices, we review trends in prices of major food imports to form a view on their possible BOP impact, with an eye on the implications on domestic dollar demand.

The surge in prices of major crops—corn, soybeans, and wheat were majorly on account of weather-related supply disruptions to major grain producing areas with the US, Australia and the Black Sea region (Russia, Ukraine, Kazakhstan) hit by a deep drought which clearly underscores the increasing impact of climate change. The World Bank asserts that 2012 stock-to-use ratios remain below their long-term historical average levels for corn and rice and have been declining for wheat and soybeans which leaves global food markets at risk to supply shocks. Notwithstanding, food demand remained robust in 2012 led by strong growth in developing countries with China at the helm.

The drought to major wheat producing regions; the Mid-West US plains, Australia, Russia, Ukraine and Kazakhstan resulted in record low grain harvests, pared by gains by India and South America, leading

to a 6% decline in global wheat stocks to 24.071 billion bushels in 2012. The reduced harvest over the May-June 2011/12 planting cycle resulted in a 25% surge in wheat prices between June and July.

In its December 2012 report the USDA reduced its forecast for U.S. exports by 50-million bushels to 1.05 billion bushels, as high domestic prices and strong competition from European export appear to be hurting U.S. sales leading to a marginal correction late in the year. Also, the US Midwest plains have received substantial snow in December, while the USDA had, in November, reported that 37% of crops planted were not in excellent conditions as opposed to 57% a year earlier. The agency suggests that the US harvests need another cycle of normal weather to stabilise prices after 2012's record drought. Nevertheless, outlook for wheat production was brightened somewhat by its forecasts that India will take advantage of higher prices and declining Eastern supplies and increase exports by 7% to 7.5MMT owing to surplus harvests from 2011/12 season.

On the other hand, sugar prices hit two-year lows on account of good weather in Brazil which resulted in a bumper harvest creating a surplus in the process. The ISO expects that global production will climb to a record 177.6 million tons while global sugar consumption will be 171.4 million tons in October to September 2012-2013 cycle. This is expected to see sugar prices remain subdued over the next 12 months with consensus estimates putting this along the 18-22cents/kg range.

Figure 14

World Bank Monthly Commodity Price Indices

Source: World Bank, ARM Research

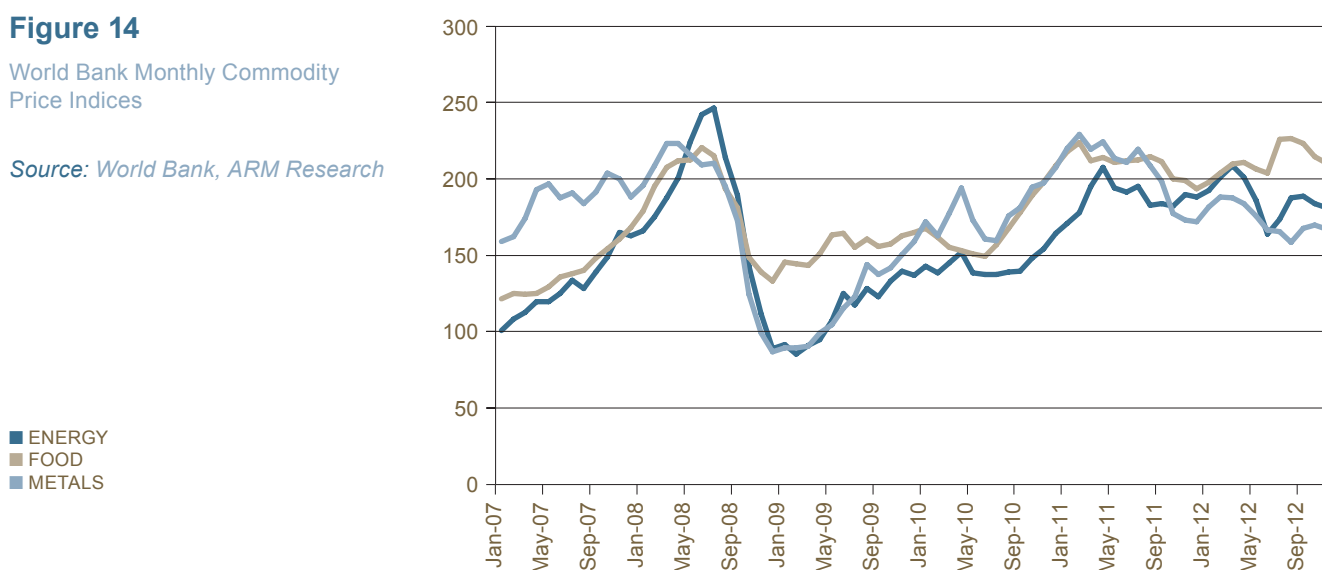
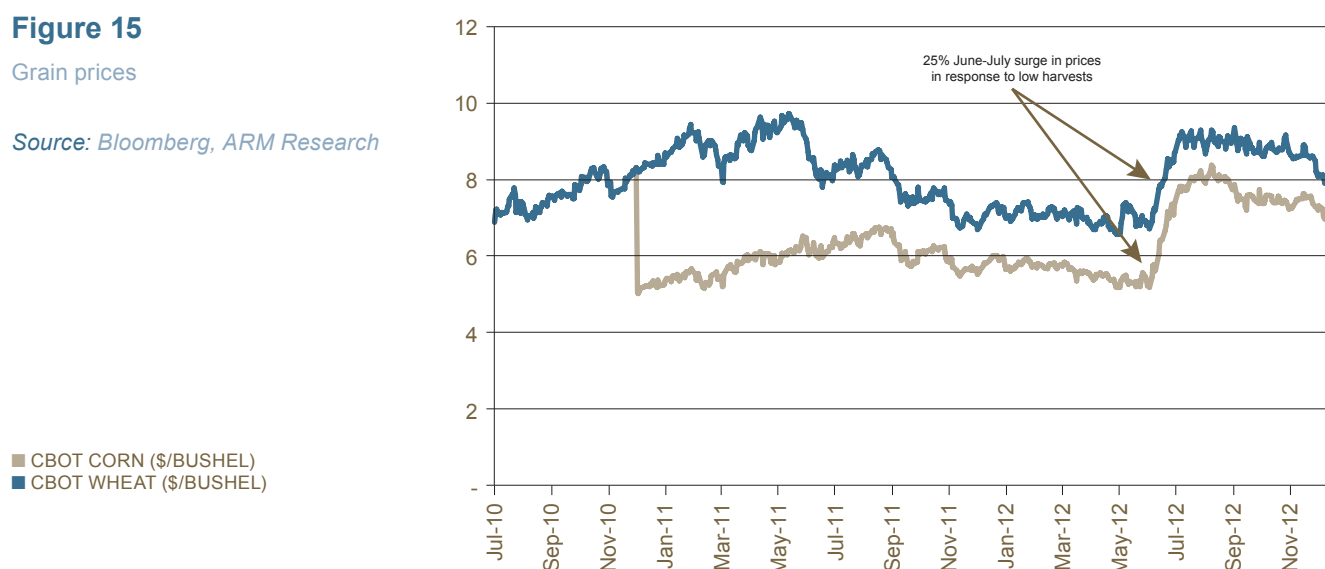


Figure 15

Grain prices

Source: Bloomberg, ARM Research



Falling import demand will likely limit Naira impact

The USDA forecasts a 3% rise in Nigeria's overall wheat imports in 2012/13 to 3.9 million tons in a minor break from a flat trend observed over 2011/12 where imports stood at 3.8million tonnes.

Wheat millers in Nigeria typically do not hedge using forward contracts but make use of storage at the ports with average holdings of 200,000 - 250,000tons capable of lasting between 1-2months. This ensures that the transmission of global shocks to wheat prices is usually lagged. Total milling capacity is expected to increase to 6.6 million tons with the completion of HFM's second 500MT/day factory in 2013. The USDA forecasts global wheat prices are expected to remain along the \$7.75 to \$8.45 per bushel corridor compared to an average of \$7.24 per bushel reported for 2011/12. However, in combination with the global rise in wheat prices, a 20% increment in wheat import tariffs in July 2012 drove a 15% price increase by domestic wheat millers, which would tend to undermine the USDA's growth forecasts.

The local Sugar industry is dominated by huge refiners who depend almost exclusively on sugar imports in the form of brown sugar with Brazil accounting for ~98%. Estimated local demand for 2012 is put at 1.45 million tons, unchanged from 2011 while refining capacity estimated at 2.1 million tons is expected to increase with the 750,000MT refinery by FMNL. The benign outlook for prices should enable local refiners

grow margins as input costs should come in lower, but a sharp hike in raw sugar import tariffs to 60% may also curb domestic demand and we do not see much pressure from this front either.

PORTFOLIO FLOWS MAKE GRAND ENTRY

Surveying the global scene: EMs in a QE world

The resumption of LSAP by the US Federal Reserve in H2 2012 led to \$40billion monthly purchases of mortgage backed securities in addition to the monthly \$45billion Operation Twist program. This was supported by similar programs across the globe. The BoJ launched a 90trillion yen (\$1trillion) asset purchase program in October while the ECB announced the OMT program to purchase bonds of troubled member states in September. The collective effects of these programs is estimated to have driven \$1.026trillion in capital flows to emerging market economies in 2012, just ~7% shy of 2011 levels⁽³⁾ despite significant bouts of uncertainty in H1 2012. A divergent growth outlook provides further support to capital flow trends--the IMF expects world economic growth to slow to 3.3% in 2012 from 3.8% and a rebound to 3.6% in 2013. Underpinning these forecasts is a 5.7% growth in EM in 2013 which contrasts sharply with a 0.5% contraction in the EU and a relatively tepid (2.1%) recovery in the US over the same period.

(3) IIF – Capital Flows to Emerging Markets, October 2012.

Despite different policy measures and various covert and overt forms of capital controls, EM continue to witness strong portfolio flows. The key 'push' factors for portfolio flows to EMs were low yields on developed market fixed income securities, on account of weak economic recovery, and the renewed effort by global monetary authorities to stimulate recovery via QE. This, in conjunction with pull forces of widening real interest differentials between EMs and advanced markets, has

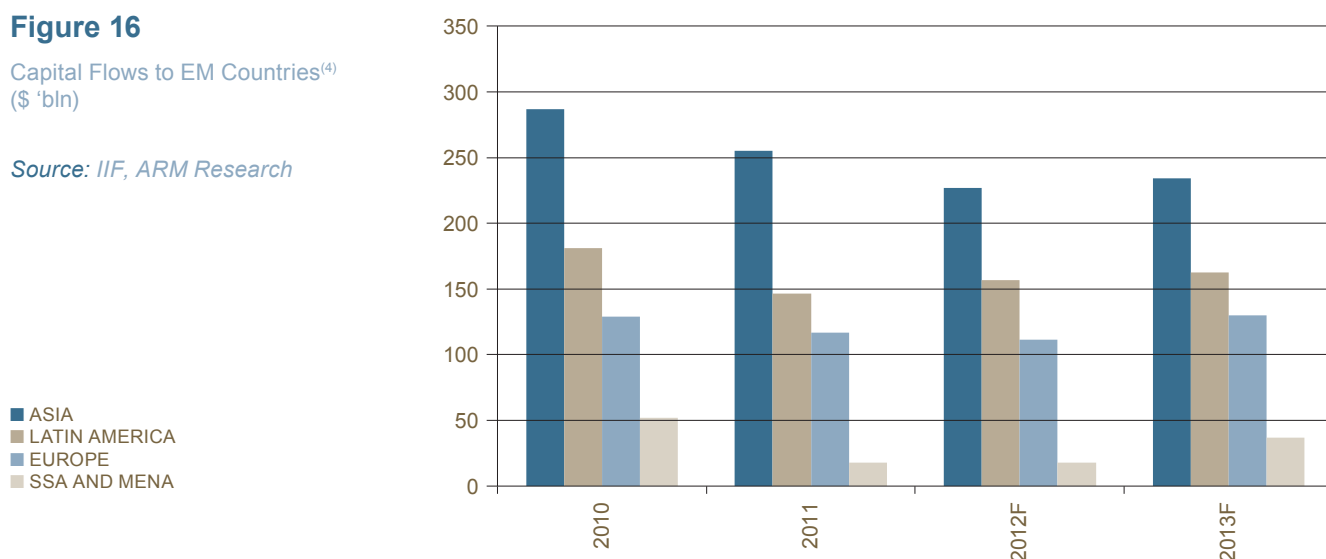
underpinned capital flows towards EMs in recent years.

Two categories of emerging markets - those countries where there is an abundance of policy tools to deal with the contagion of global weakness (e.g. China); and those countries positioned to benefit from the elevated prices in commodities/natural resources on account of these easing — have been the biggest beneficiaries of these flows.

Figure 16

Capital Flows to EM Countries⁽⁴⁾
(\$ 'bln)

Source: IIF, ARM Research



Different strokes: Policy responses diverge

EMs benefit from the prospect of lower financing costs and higher asset prices implied by stronger capital flows but their relatively shallow financial markets and much more significant external sectors are more susceptible to the risks of unwanted currency appreciation, asset prices bubbles, and the destabilizing effects of sudden flow reversals leading to a wide range of policy responses among recipients.

This divergence has been particularly marked in the largest EMs which are also the biggest targets of capital flows. Among the BRICs, Russia tightened policy with a surprise 25 bps hike in base rates to 8.25% in September 2012—the first since April

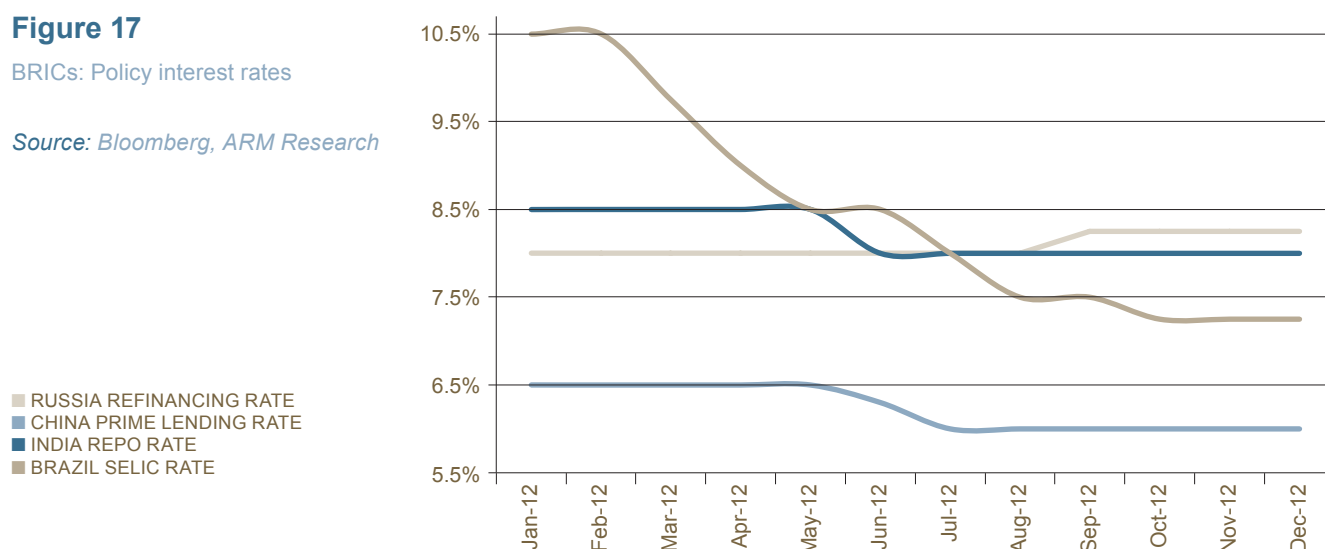
2011—and appears to have replaced a policy anchor centered on the rouble's exchange rate with inflation targeting. On the other hand, Brazil has responded to weakening economic growth by cutting its policy rate over 2012 to record lows despite a surge in inflation. Similarly, the PBoC responded to weakening economic growth by cutting key interest rates for the first time since 2008 twice over June-July to 6% and lowered the CRR and raised the limit below which interest rates can deviate from official rates to 30%. In India, the RBI which hiked base rates by 200bps in 2011 to 8.5% in response to surging inflation cut them by 50bps in June 2012 with scope for easing in 2013 provided prices stabilize.

(4) EM Asia - China, India, Indonesia and Thailand, EM Europe - Russia, Turkey, Poland, Hungary and Ukraine, EM Latin America - Brazil, Argentina, Chile, Uruguay, Peru, Colombia and Mexico while Nigeria, South Africa Egypt, Lebanon, Morocco, Saudi Arabia and the U.A.E refer to EM SSA and MENA

Figure 17

BRICs: Policy interest rates

Source: Bloomberg, ARM Research

**Too strong to contain**

Although Brazil's economic growth is expected to come in under 1%, down 150bps from 2011 and after recording growth of 7.5% in 2010, given 2012 quarterly figures – Q1 (0.2%), Q2 (0.4%) and Q3 (0.6%), it still continued to see strong flows - FPI holdings of Brazilian government debt stood at \$115 billion in July 2012 (13% of local government bonds), up from \$108 billion in December 2011. This saw yields in its \$1.25billion 10-year, 2.625% coupon, global bond issue in September come in at 2.686%, sharply lower than the issue yield of 3.449% on its \$825million bond of similar tenor issued in January at a coupon of 4.875%. The IIF also reports that the share of inflation-linked securities is rising amid worsening inflation expectations. However, somewhat ironically, the key driver of non-resident investment inflows has been the depreciation of the real against the US dollar—9% in 2012—and a still significant interest rate differential.

Following reforms which will see opening of its retail sector to foreign investment, we expect substantial increase in portfolio flows to India. Further support will come from liberalization of its insurance and pension sectors which could bolster the attraction of Indian markets to portfolio investors: India's BSE Sensex rose 25.7% in 2012 versus 5.4% for Russia's Micex, 3.17% in the Shanghai Composite and 7.4% for the Brazilian Bovespa.

Despite its efforts, Russia appears set to record more portfolio inflows in the near term. IMF projects that

its growth will decline 60bps YoY to 3.7% in 2012 but expects recovery to 3.8% in 2013 on the back of an expected expansion in fiscal policy as Vladimir Putin enters his second year. Russia's interest rate hike and sentiment around surging commodity prices will likely increase FPI to Russia buttressed by its 2012 entry into the WTO which expands access to its markets and has gone some way in ameliorating long held investor concerns about weak corporate governance in the country. In addition, at 5.9x earnings, Russia's equity market valuations are cheapest among the BRICS which should make it more attractive to investors in 2013.

Outside of the BRICs, Latin America led by Mexico has seen heightened foreign investments in its local debt markets on account of substantial interest rate differentials versus advanced markets which has expanded with monetary easing in the latter. Nonresident holdings accounted for 32% of internal public debt in September 2012, up from 8.5% in 2005⁽⁵⁾. In addition to its strong fundamentals, 3.8% growth estimated by the IMF in 2012 and lower debt to GDP ratio at 44% saw it record \$7.36billion of FPI flows into its debt markets⁽⁶⁾. The outlook for fund flows is hinged on pledges by the new president Enrique Peña Nieto to reform statutes that limit foreign involvement in Mexico's oil industry whose production of 2.96mbpd in 2011 has been declining in recent years as the state oil firm struggles to expand capacity.

(5) IIF – Capital Flows to Emerging Markets, October 2012.

(6) Bloomberg report: <http://www.bloomberg.com/news/2012-12-24/pimco-s-gross-savors-free-lunch-as-peso-bonds-beat-stocks.html>

For emerging Asian countries like Indonesia and Thailand with significant export sectors, the policy response to QE has been to weaken their currencies with lower interest rates alongside other measures to dampen portfolio flows. Following a ratings upgrade by Fitch and Moody's between December 2011 and January 2012 that saw it regain its investment grade, the Bank Indonesia held interest rates at a record low 5.75% throughout 2012 (after a 25bps cut in February), while Bank of Thailand cut rates by 25bps to 2.75% in October after a similar cut in January, in a bid to weaken their respective currencies to prevent an erosion of export competitiveness. In addition, both instituted capital controls. Thailand imposed a 15% withholding tax on nonresidents' interest earnings and capital gains on new purchases of state bonds in October 2010. Indonesia introduced a one month holding period for central bank bill purchases (later extended to six months) and phased out shorter maturity bills replacing them with longer tenored paper⁽⁷⁾. However, the IIF holds that the outlook may change the easing cycle as these countries begin to face current account deficits. Indonesia Q3 2012 reading of \$5.3billion puts it on track for its first deficit in 7 years while Thailand's October reading of \$199million is on track for its first deficit since 1997⁽⁸⁾.

While capital control measures and mutually reinforcing easing cycles in EMs with large external

sectors have tended to constrain FPI flows, recent trends—and near term outlook—suggests that monetary easing in DM and the consequent 'search for yield' have ultimately dominated overall capital flow trends to EMs.

African FPI in strong rebound

Significantly, after a slump induced by the 2008/09 financial crisis, Africa is in the midst of a renaissance in portfolio inflows with total flows for 2012 projected to hit \$16.72billion, mimicking the remarkable trend that saw FPI rise from \$2billion in 2000 to peak of \$22billion in 2006. South Africa with its well developed financial market has been the prime destination for these flows amounting to ~79% according to the AFDB.

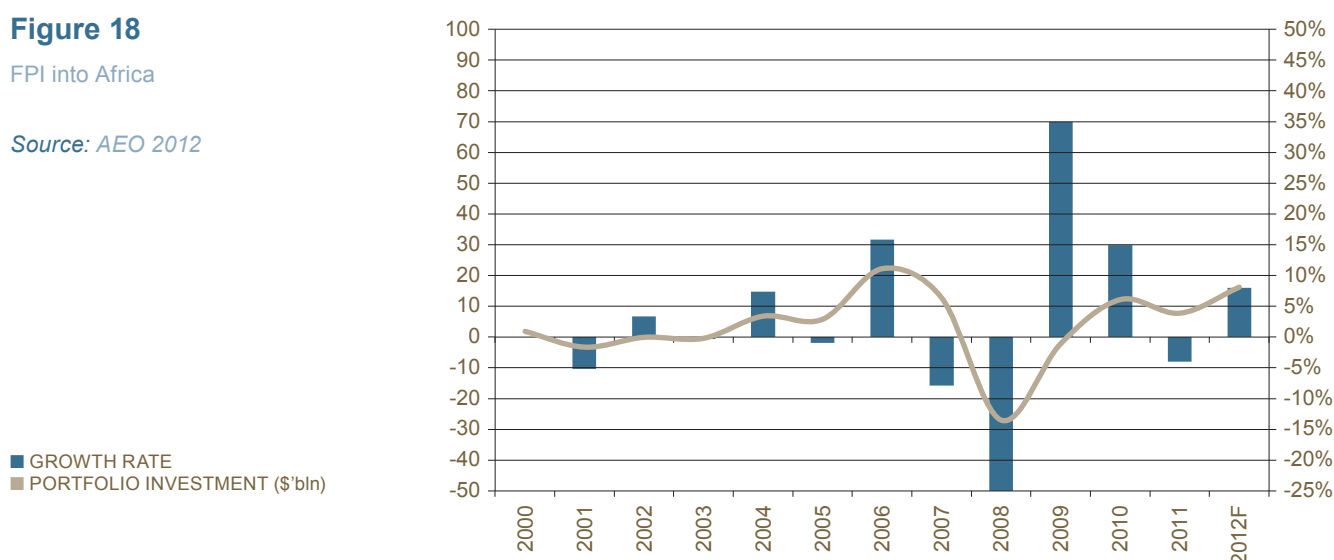
Where global upheavals have a well demonstrated potential for undermining this growth, recent rebound bears the imprints of a more fundamental transformation hinged on the repeal of a wide range of institutionalized constraints that existed in previous decades including non-existent or weak debt, equity and currency markets, poor regulatory framework and unstable macro-economic policy environment. In contrast, recent growth reflects growing democratization, a steady pace of economic reforms that have quickened the pace of financial market liberalization ensuring greater access.

(7) Balakrishnan, Nowak et al - Surging Capital Flows to Emerging Asia: Facts, Impacts, and Responses. IMF Working paper May 2012.
(8) Trading economics – Thailand Country Page.

Figure 18

FPI into Africa

Source: AEO 2012



The potential strength of the underlying trend was clearest in sovereign debt, where issuance has rapidly expanded beyond the traditional theaters comprising the more developed North African countries and South Africa to a broad range of SSA countries. This has come amid substantial improvements in macro-economic policy environments which has spared SSA the worst of the global crisis, with the region's growth estimated to clock 4.9% in 2012 and rebound to an average of 5.7% between 2013 and 2017 according to the World Bank.

In this regard, Zambia's \$750 billion, 5.375% coupon, 10-year bond issued in 2012 was a watershed of sorts. The 5.625% yield on issuance and 15.87x over-subscription is a first for a country with B+ rating and has brightened the prospects for similar rated countries. Ghana is back in the market for \$750million in 2013 while Nigeria and Angola are mulling further issuances ranging from \$500million-\$1 billion.

Table 2

Eurobond Issuance in Africa since 2007

Country	Issuance date	Amount (\$ millions)	Tenor (years)
Ghana	2007	750	10
Gabon	2007	1000	10
South Africa	2007	1000	15
	2009	2000	10
	2010	2000	10
	2011	750	30
	2012	1500	12
Egypt	2010	1000	10
		500	30
Ivory Coast	2010	2332	22
Senegal	2011	500	10
Nigeria	2011	500	10
Namibia	2011	500	10
Angola ⁽⁹⁾	2012	1000	7
Zambia	2012	750	10
Tunisia ⁽¹⁰⁾	2012	485	7
		500	5
Morocco ⁽¹¹⁾	2012	1000	10
		500	30

Source: C-bonds, ARM Research

(9) Angola's issuance was a private placement.

(10) Tunisia has also issued a 20-year JPY 30billion samurai bond in 2007.

(11) Morocco also issued 10-17year bonds worth €1.5billion in 2007.

Commodity producers also record strong flows

Resource rich countries constitute yet another category contending with a sharp rise in portfolio flows as the combination of current account surpluses and strong

foreign reserves, driven by elevated commodity prices, boost currency outlook and investment. With rising revenues amid slowing global growth, commodity producers have typically embarked on expansionary fiscal measures to support growth, while aiming to counter inflationary threats with higher interest rates, all

of which provide impetus for FPI inflows. Furthermore, where weak domestic manufacturing coincides with higher imports, these countries have an additional incentive to encourage FPI to prop-up currencies. However, this dynamic tends to tie portfolio flows to prevailing global commodity prices which are subject

to the state of the global economy. Higher commodity prices in the run-up to the global economic recession of 2008 coincided with heightened portfolio flows while subsequent price declines triggered sharp reversals. Recent resurgence in global commodity prices has also coincided with recovery of flows to these countries.

Figure 19

S&P GS Commodity Index⁽¹²⁾

Source: Bloomberg, ARM Research

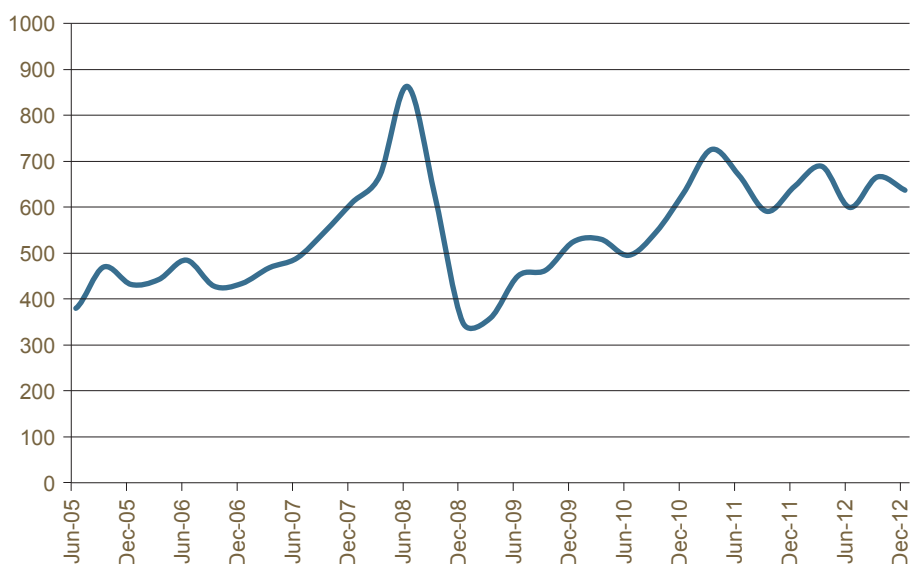
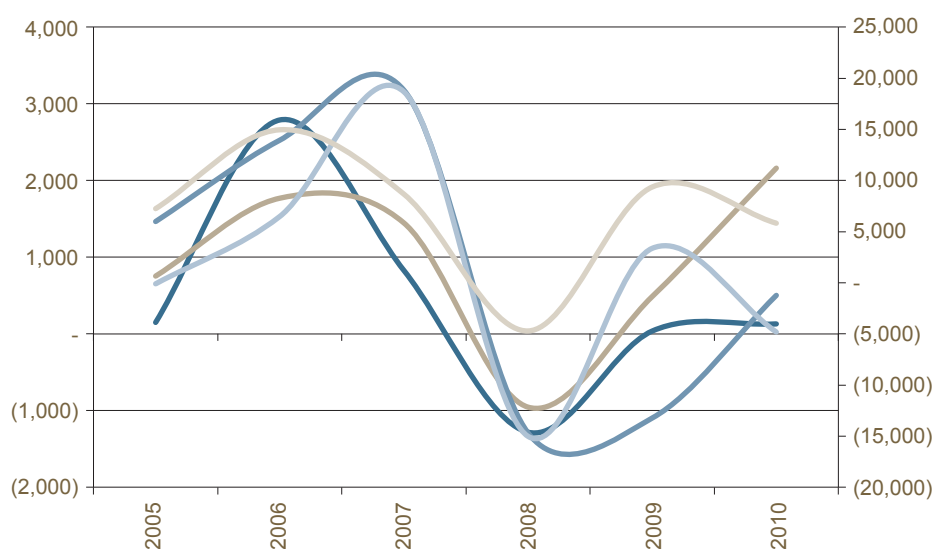


Figure 20

Net Portfolio inflows to Selected Natural Resource-rich Countries (\$ 'mln)

Source: World Bank, ARM Research

■ KAZAKHSTAN
■ NIGERIA
■ PHILIPPINES
■ RUSSIA (RHS)
■ SOUTH AFRICA (RHS)



J.P Morgan inclusion accelerates portfolio flows into Nigeria

Nigeria fits snugly into the various categories of countries that have benefited from portfolio flows in recent years. Foreign share of total transactions on

the NSE has steadily risen from ~15% in 2007 to ~69% in 2011, averaging 60% as at 9M 2012.

However while the removal of capital restrictions in Q3 2011 and the gradual resolution of recent crisis in the domestic banking sector spurred a modest recovery in FPI, the real turning point came in Q3 2012 after JP Morgan announced the inclusion of

(12) S&P GSCI is the Standard and Poor's Goldman Sachs Commodity Index comprises 24 commodities across - energy, industrial and precious metals, food and livestock and serves as a benchmark for investment in the commodity markets.

Nigerian bonds in its emerging market bond index in August, just ahead of the announcement of QE3 by the US Fed in September 2012. Bond market yields compressed 400bps over August and September while the naira strengthened 3% over Q3 2012. Concurrently, foreign reserves rose 12% in Q3 2012 to \$41.18 billion while vibrant dollar supply at the

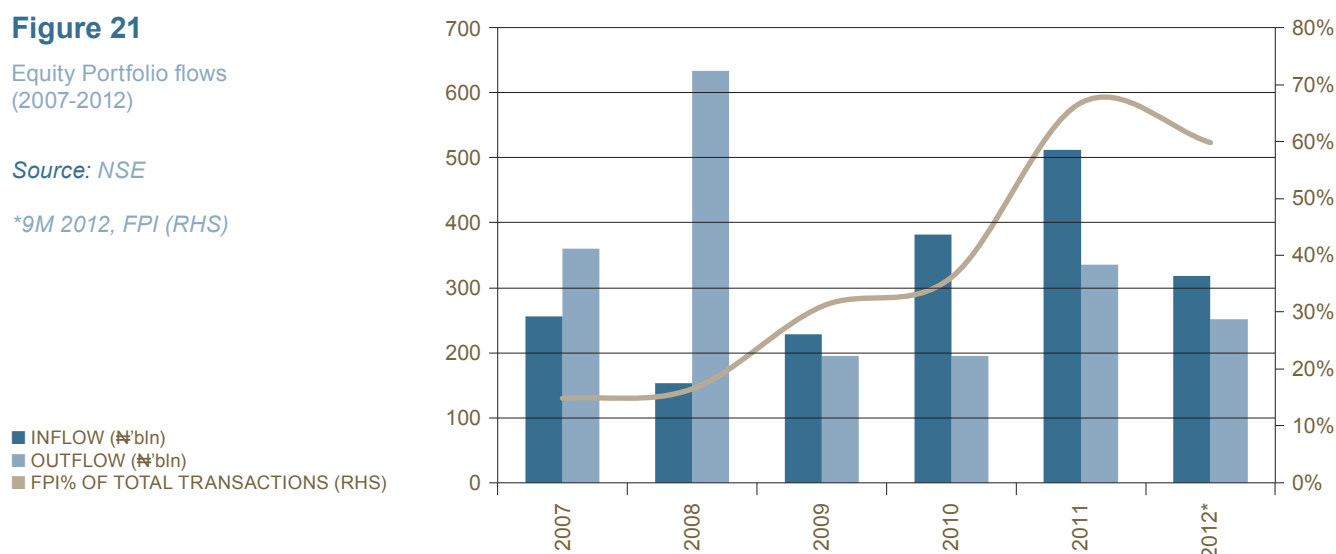
interbank market moderated total WDAS sales in 2012 which, at ~\$18.95billion in 2012, hit its lowest point over the last four years. These flows also drove a sharp reduction in the monthly volatility of the NGNUSD exchange rate in Q4 2012. As at November, the CBN put estimated stock portfolio flows to Nigeria at \$10billion, up from \$5billion as at July 2012.

Figure 21

Equity Portfolio flows
(2007-2012)

Source: NSE

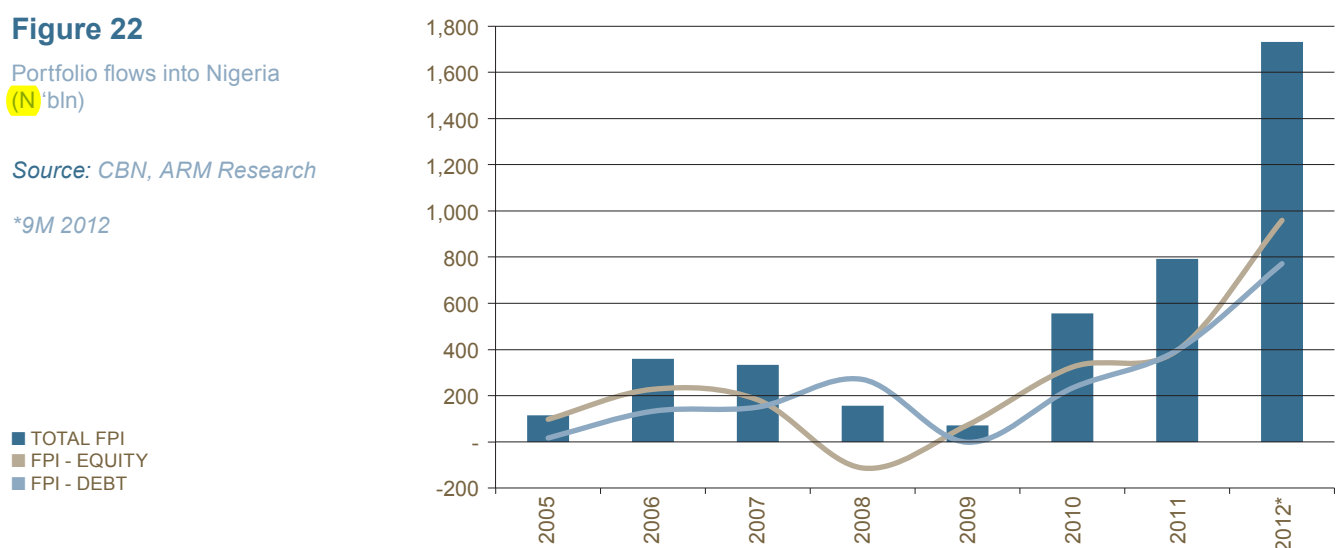
*9M 2012, FPI (RHS)

**Figure 22**

Portfolio flows into Nigeria
(N'bn)

Source: CBN, ARM Research

*9M 2012

**Table 3**

Comparative Yield Changes

	June	December
Average Yield FGN securities	16%	12%
Average Yield on JP GBI EM	6%	5%
Average Yield on 10 Yr US treasuries	2%	2%

Source: Bloomberg & ARM Research

Barclays has since announced Nigeria's inclusion in its own emerging market bond index starting March 2013; a trend which we believe will eventually come to characterize naira assets over the next few years. As we explore further on, this development has clear implications for risks in domestic assets as well as the stability of the economy and markets. We believe

strong inflows have definitively changed the nature of Nigerian capital markets and despite the near term benefits, we are concerned about the capacity of the country's economic managers to deal satisfactorily with the often unforeseen consequences of these changes.

Figure 23

Bond Yield Compression

Source: FMDA, ARM Research

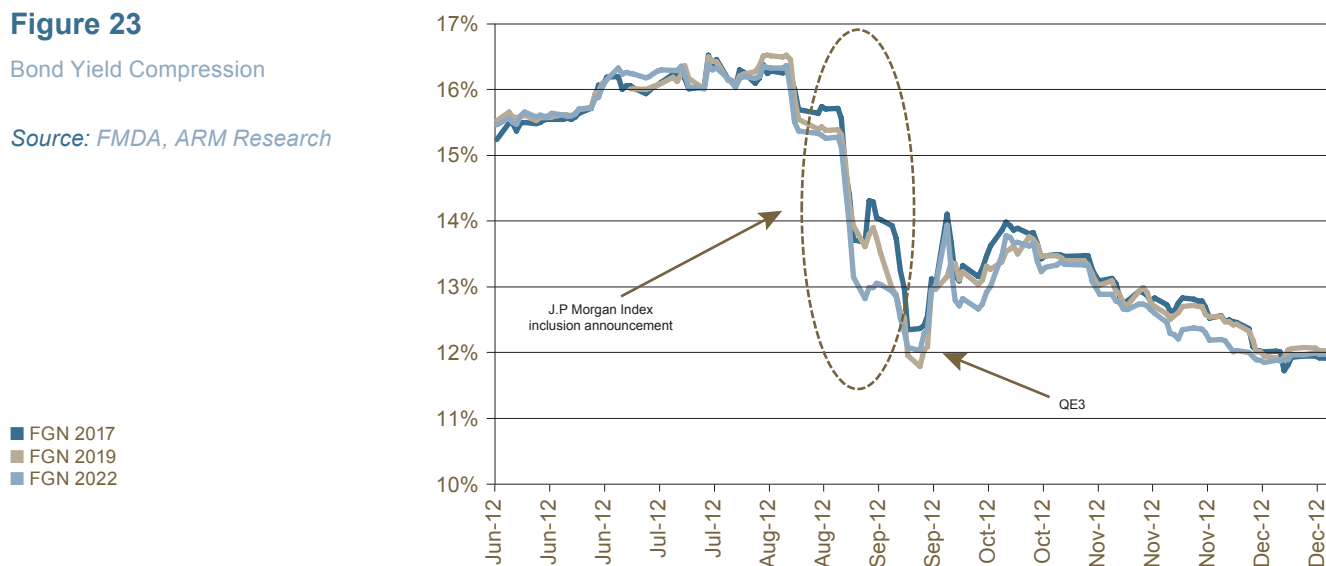
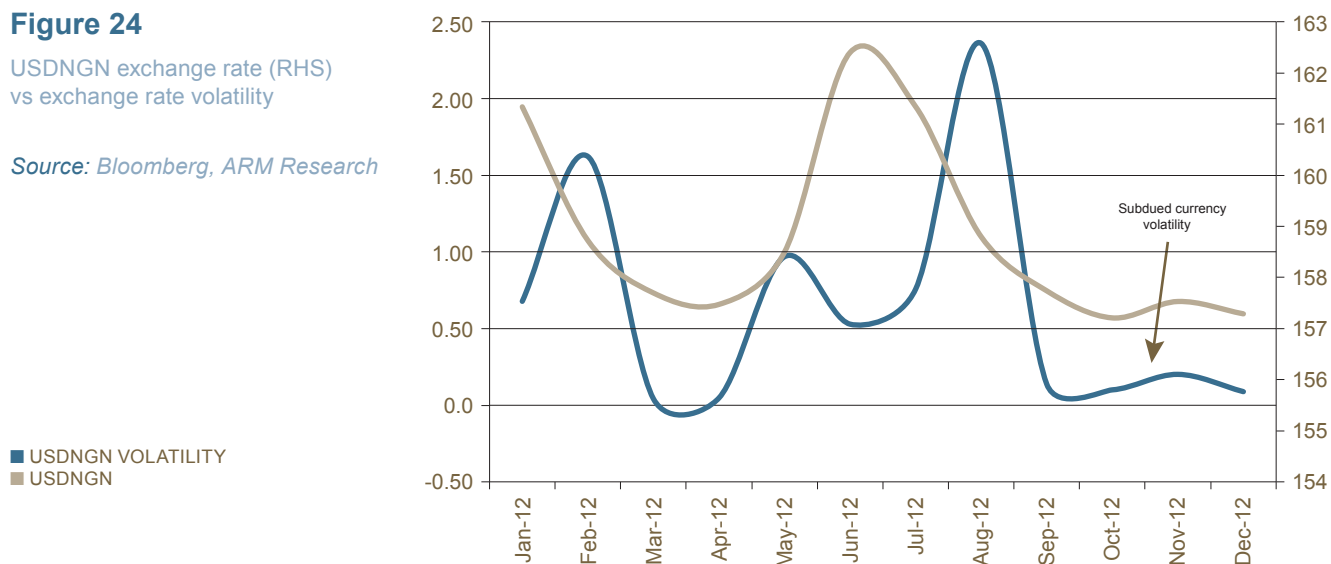


Figure 24

USDNGN exchange rate (RHS)
vs exchange rate volatility

Source: Bloomberg, ARM Research



REVIEW OF DOMESTIC POLICY

NEW GUIDELINES FOR PENSION ASSETS TO SHAPE MARKET OUTLOOK

PENCOM finally released amendments to the regulation on investments of pension fund assets in December to coincide with the departure of the outgoing board of the commission which has governed

the body since inception. As widely anticipated, the new regulations fell broadly in line with the draft proposal released earlier this year with a number of important revisions around Exchange Traded Funds (ETFs), guidelines on private equity and GDRs/GDNs investment and as well as management of potential conflicts of interest as highlighted in Table 4.

Table 4

Summary of differences between the previous and current Guidelines

	Regulation on investments of Pension Fund asset (Dec, 2010)	Regulation on investments of Pension Fund asset (Dec, 2012)
Exchange Traded Funds (ETFs)	Excluded from the list of allowable instruments.	Included as an allowable instrument for pension fund investments.
Global Depository Receipts/Notes & Eurobonds	No guidelines provided.	Incorporation of guidelines on investing in GDRs/GDNs and Eurobonds.
Private Equity	Fund Manager to retain 5% of the Fund.	i) Fund Manager to retain 1% if the Fund has a development finance institution as co-investor or Limited Partner. ii) Fund Manager to retain 3% of Fund if the Fund does not have development finance institution as co-investors or Limited Partner.
Conflict of Interest	No limits on total trades executed with broker dealer firms that are related parties to the PFA.	PFAs not to transact more than 30% of total trades in equities and debt instruments in a calendar year, with broker dealer firms that are related parties to the PFA.

Source: PENCOM

Multi-Fund initiative delayed but gets a (somewhat) definite timeline

In our H2 2012 report, we discussed the potential impact of the new regulations— which eventually became effective on the 17th of December, 2012—on capital market outlook. Among other conclusions, we highlighted that the new guidelines which in our view signals the beginnings of an endeavour aimed at guiding the pension industry into new, more dynamic phase were also very favourable to riskier assets. In particular, we noted the profound impact the multi-fund structure would likely have on domestic institutional

investor allocation towards equities, highlighting the propensity of the proposed Islamic Fund component to skew allocation decisions in favour of non-financials, and away from high-flying brewery subsector of the consumer space—with significant implications for liquidity and valuations across board. Those assumptions are still intact. Specifically, we still hold the view that in gradually teasing ~~PFA's~~ ^{PFAs}—who are still the dominant block of institutional investors—away from fixed income, the new guidelines will likely underpin recent equity gains into 2013 and along with increased foreign interest could drive a substantial upward rerating of equity market valuations in 2013. Its timing

is also significant and somewhat fortuitous, since—as we discuss later—it coincides with a period when we anticipate that increased interest in Naira assets would raise the stakes on investor requirements for liquidity, which will likely become an important requirement in equities performance in coming quarters.

Where we had anticipated an earlier launch in our H2 2012 report, the new Multi-fund structure for RSA funds is now scheduled to come into effect in Q1 2013 and has been incorporated into the amended regulation; giving PENCOM time to sensitize the public and ensure PFAs are prepared for implementation. We believe the adoption of the multi-fund structure could see increased participation and investments of PFAs in the equities markets and alternative asset classes which presently constitute about 19% of the industry's portfolio. The transfer window which was scheduled

to commence in H2 2012 is also yet to kick off and industry sources attribute the delay to operational issues i.e. difficulties with client biometrics but believe the window would be opened once these issues are resolved, possibly in H1 2013.

New proposals also important in their own right

However, in addition to the effects of other proposals, we believe new guidelines on ETFs could have important implications for market liquidity and potential direction of equities in 2013. In particular, ETFs are likely to develop into a useful vehicle for channelling investment funds into Nigeria's shallow equity markets and—as we also discuss in the strategy section—this development could have a far reaching impact on market trends, particularly with regard to intra and

Table 5

Classification of GDRs, GDNs & Eurobonds under Amended Regulation

Issuer	Instrument	Underlying Asset Class
Federal Government of Nigeria	Eurobond	FGN Securities
Corporate Entity	Eurobond	Corporate Bonds/Debt securities
Corporate Entity	GDR	Ordinary Shares
Corporate Entity	GDN	Corporate Bonds/Debt securities

Source: PENCOM

Table 6

Summary of Pension Industry Portfolio as at 30th September, 2012

Asset Classes	₦mIn	%
Domestic Ordinary Shares	321,329.35	10.90%
Foreign Ordinary Shares	38,810.68	1.32%
FGN Securities	1,729,028.60	58.66%
State Govt. Securities	113,810.65	3.86%
Corporate Debt Securities	82,679.72	2.81%
Local Money Market Securities	412,986.66	14.01%
Foreign Money Market Securities	5,339.08	0.18%
Open/Close Ended Funds	13,341.61	0.45%
Real Estate Property	179,583.04	6.09%
Private Equity Fund	9,895.34	0.34%
Cash & Other Assets	40,757.62	1.38%
Total Pension Fund Assets	2,947,562.35	100.00%

Source: PENCOM

inter sectoral divergences in valuations.

As we also highlighted in our last report, there are also consequences for other “non-traditional” asset classes but the reduction in retention level of PE managers in their funds which makes a greater number of Funds eligible for pension fund investments is a particularly important development in encouraging greater variety drive to promote completeness in Nigeria’s capital markets. We see this expansion breathing new life into the sorely underserved incubation end of the capital market pipeline, which promises a more vibrant future for primary market activity in equities, but possibly also in corporate bonds as conditions in debt markets continue to improve. If valuations are not to exceed reasonable bounds that imperil markets over the long term, this development is critical to long term outlook for Nigerian capital markets, particularly equities, which we see facing substantial new constraints as it hits limits imposed by limited depth and breadth.

Can IFRS requirement make a difference?

Based on the roadmap on the planned adoption of International Financial Reporting Standards (IFRS) set forth by the Minister of Commerce and Industry in September 2010, Public Interest Entities (PIEs) are expected to mandatorily adopt IFRS for statutory

reporting purposes by 2013. Compliance by PFAs also portends substantial changes to the industry’s asset allocation preferences.

Pension fund assets are currently valued on a mark-to-market basis with exception of the industry’s bond portfolios which are valued at amortized cost irrespective of how the bonds are classified. This practice, which was necessitated by substantial illiquidity in the bond markets which were nascent at the time the revamped pension industry came into being in 2006, has come under substantial scrutiny in the recent past due to fears that pension funds are generally overstating the value of their current portfolios in view of recent yield trends and significant improvements in fixed income market liquidity over the past few years.

The adoption of IFRS however, would compel PFAs to mark bonds that are classified as available-for-sale and held -for-trading to market. Given that government securities constitute about 62%⁽¹³⁾ to total pension fund assets, the upward trajectory of yields since 2010 implies that most PFAs could indeed take a substantial hit on their portfolios upon adoption. Nevertheless while we work with limited information and make a number of broad assumptions, the analysis that follows leads us to believe the impact would be more limited than commonly assumed.

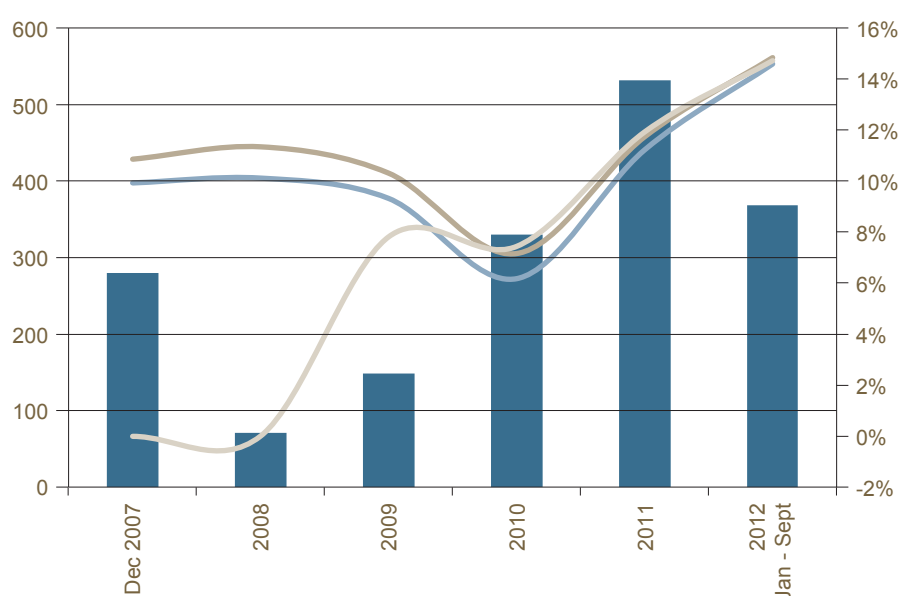
(13) As at 30th September 2012

Figure 25

Average Bond Yields (RHS) and
Net Yearly Bond Purchases (N'mln)

Source: FDHL Analytics, PENCOR,
ARM Research

■ NET YEARLY BOND PURCHASES
■ FGN 2014
■ FGN 2017
■ FGN 2019



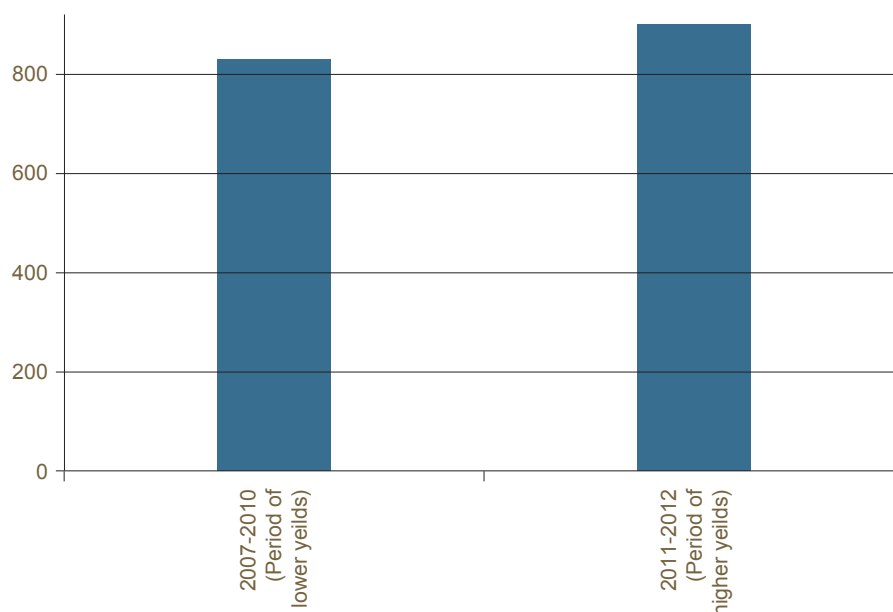
A majority of the bonds were purchased during periods of high yields: Figure 25 aggregates estimated net bond purchases over the lifespan of the pension fund industry, based on asset holding information provided by PENCOM it suggests that most of the bonds which constitute the total sum of PFA bond portfolio were purchased during the period of high yields- between

2011- 2012 in which yields averaged 13% compared to 9% between 2007-2010. Given our views on yield direction in coming quarters, at least 50% of the industry's fixed income holdings will probably be substantially in the money as the new regulations come into being.

Figure 26

Net Bond Purchases (₦'mln)

Source: PENCOM, ARM Research



Substantial scope for HTM Classification: Current dynamic of the pension industry is such that it continues to record significant new inflows of fresh capital, which over time serves to dilute current holdings. In addition, given Nigeria's demographic structure, its mapping on pension fund holdings (as we explored in our H2 2012 report) imply that the Nigerian pension liability structure have quintessentially long term features. Thus, since the industry faces no pressing liquidity problem, we see that it has substantial scope to avoid losses on PFAs bond portfolios by classifying problematic holdings as HTM. However, along with the implications of the new reporting standards, we expect intensified competition in the industry in view of the proposed opening of a transfer window and the resulting increased scrutiny of pension industry performance to spur more active trading of bonds as well as heightened incentive to invest in riskier assets, especially if vibrant equity market performance persists. Furthermore, with the intensification of the artificially subdued volatility of PFAs fixed income portfolio holdings we expect fund managers to recalibrate their views of the risk-return trade-offs relative to riskier assets particularly equities,

further encouraging a shift into the latter.

Overall, we believe the amended regulations give PFAs more flexibility with respect to investable assets and should prove supportive to equities in 2013 as the combination of yield declines and performance pressures imposed by new regulation encourages the market's primary (domestic) institutional investors to move into riskier assets.

FISCAL CONDITIONS TAKING BROADLY FAVOURABLE TURN

Outlook brightens for SWF as take-off date announced

As promised by Minister of Finance earlier in the year, the board of the Nigerian Sovereign Wealth Fund (SWF) was inaugurated by the President in October 2012, and has proceeded with the development of investment policy guidelines and strategy documents even as reports suggest that the \$1 billion seed fund has been transferred, to kick start the fund. The

ECA reportedly hit ~ \$9.7 billion by mid December, suggesting the government was on track to meet its \$10 billion target for 2012 in spite of several withdrawals from the account amounting to ~\$2 billion by our estimates. These figures suggest that accretion to the ECA tracked ~\$1 billion per month an average since July, somewhat below our \$1.3 billion estimate, on account of production outages in H2 2012.

The Finance Minister also announced March 2013 as the commencement date while the Fund's designated CEO has indicated the fund will start investing the Fiscal Stabilization (FSF) and Future Generation (FGF) Funds in securities from that date with investment of the infrastructure fund (IF) set to commence in H2 2013. The SWF board has also reportedly approved the strategy report for operations while the investment policy guidelines are in final stages. The three funds- FSF, FGF and IF – will receive 20 per cent each while the board and management will make investment decisions on the balance of 40 percent.

Based on the initial seed capital, each fund will start off with \$200 million (~N31 billion) which is not necessarily significant especially as guiding laws do not put any geographical restrictions on investments such that there is no guarantee that the funds will be directed at Nigerian capital markets. Clearly, the SWF's ability to fulfil its potential as the primary avenue for investment capital flows in Nigeria—as we highlighted in our last report—is hinged on the resolution of lingering disputes over the status of the ECA.

Extended litigation still weighs on fund outlook

The issues surrounding the constitutionality of the SWF came to a head again when State Governments reneged on a supposed out of court settlement reached with the FGN on the ECA and SWF, demanding the former be scrapped and exemptions from contributions to the latter.

Since the matter was filed at the Supreme Court (SC) in 2008, the matter has been adjourned – for out-of-court settlement - 12 times, all at the instance of the FGN, possibly indicating the FGN might actually have a weak case as does the fact that governors appear to have been dictating the terms of settlement thus far.

The grouse of the state governments seems to be

the unilateral management of the ECA by the Federal Government and the latter's serial withdrawals, without recourse to the National Assembly, of large sums (including \$8.4 billion for National Integrated Power Project, (NIPP) and \$250 million for Rail Modernization Project (RMP) between 2004 and 2007). Legal views suggest that the States will have a fairly easy judgement should courts adopt a literal rule of interpretation to provisions 162(1) of the 1999 constitution which prescribes as follows:

The Federation shall maintain a special account to be called “the Federation Account” into which shall be paid “ALL” revenues collected by the Government of the Federation, except the proceeds from the personal income tax of the personnel of the armed forces of the Federation, the Nigeria Police Force, the Ministry or department of government charged with responsibility for Foreign Affairs and the residents of the Federal Capital Territory, Abuja.

Be that as it may, weary of the governments' antics, the Supreme Court has issued an ultimatum of sorts, adjourning hearing to the 9th of May 2013 on which date the matter will be adjudicated upon its merit if both parties fail to reach a binding out-of-court settlement. Thus either way, we are set to see an end to the nearly 5-year long dispute in H1 2013. Surprisingly, these squabbles appear not to have featured prominently in the considerations of analysts and ratings agencies, which is perhaps a good thing as interpretation would no doubt be unfavourable.

Not as bad as it seems

As things stand, there are two broad possibilities - (1) the FG and states file terms of settlement which becomes the judgement of the court, binding on parties or (2) the matter is decided on merit in favour of either party. In our view, the latter appears the more likely outcome as the States' position appears to have hardened over time making an out-of-court settlement less likely.

A decision in favour of the FG will probably lead to the full implementation of the SWF as proposed, with the closure of the ECA which has no legal backing. Such an outcome would be clearly positive for markets. A verdict for the States will be the more interesting outcome. It will probably also lead to repeal of the ECA but it is not clear what becomes of the SWF under this scenario. For one, we are of the opinion that the FGN's

preparation for the fund's launch is a clear signal of its commitment. Technically, about half of the ECA still belongs to the FGN which means the SWF can proceed on this basis, only with less accrual than initially envisaged. It is not clear that this would be negative for ratings since the assumption were based on having a formal savings mechanism and presumably, not on the size of the inflows. Besides, improvement in most States budgetary processes over the past decade is such that many now have funds of their own to which we believe much of the "excess" allocations that currently go to the ECA will be channelled. Ironically, this may be the better outcome for domestic markets as the States tend to have a clear domestic mandate in their investment guidelines.

There is the impact of monetization of the savings that would otherwise go into the ECA—which is really the only healthy part of Nigeria's foreign reserves—to worry about. However it is our view that with astute monetary policy, to the extent that it can be hoped for in Nigeria, the issue can easily be dealt with. On the whole, we view the clarity the Court's decision brings as the biggest positive on this front.

Power sector privatisation – is the end in sight?

Nearly 7 years after the passing of the Electric Power Sector Reform Act of 2005 – and <3 years after the launch of Road Map for Power Sector Reform - it seems the end is in sight with the approval of bids for 5 Generating (Gencos) and 10 distribution (Discos) companies by the National Council on Privatisation (NCP) on October 29, 2012. This feat marks a milestone in the privatisation process and confirms the resolve of the government to revive the sector; the tumultuous exit of the much respected erstwhile power minister notwithstanding. In line with the final requirements, the Bureau of Public Enterprise (BPE) confirmed that all preferred bidders submitted bank guarantees to the tune of 25% of acquisition cost, by November 23, 2012, paving the path for next stage of negotiation on the terms of the 13 legal agreements. Further negotiations including the signing of all 13 agreements should last 7 weeks commencing from January 15, 2013 upon which the balance 75% becomes payable within 6months.

Given the magnitude of the transactions and dilapidated state of some of the successor companies, we envisage different timelines for consummation of these deals as investors and their financiers make their own assessment of target facilities after the exchange of

bank guarantees for equivalent payment. Also, vetting of the various agreements by various stakeholders' – especially financing institutions – and the titling of about 500 land properties could add new bottlenecks. In view of the forgoing, we work with a more conservative timeline of Q4 2013 through to Q2 2014 for the 15 companies while the Afam Genco and Kaduna Disco – with 31st January as deadline submission of EOIs – may come a couple quarters further.

Developments in another key component of the power sector value chain, the Transmission Company of Nigeria (TCN), appear more upbeat with media reports quoting Ministry of Power sources as stating that the management contract with Canadian firm, Manitoba Hydro International, had been activated after earlier confusion caused by its purported cancellation and subsequent review by the BPE and FGN. Whilst there are still some gaps in clarity around its financing—for which the FGN still retains responsibility—we believe the FG will come forward with a credible funding plan in H1 2013; over ₦70 billion is reported to have been allocated to the sector in the 2013 budget.

Overall, we remain optimistic about the progress to be made in the power sector in 2013, especially its impact on domestic productivity. While we believe the full realisation of its benefits could still elude the country for a few more years, substantial improvement in the overall energy situation possibly as early as H2 2013 would send a clear signal to the markets and economy.

IMPROVED BUDGETING SIGNALS BETTER FISCAL MANAGEMENT

2013 budget passed in record time, but with optimistic assumptions

Two months after the budget proposal of ₦4.92 trillion was presented to the National Assembly (NA) by the President, the NA approved same with a net upward revision of ~₦63 billion to ₦4.99 trillion. According to reports, some of the revisions over the proposals include, ₦7 billion increase in Statutory Transfers to ₦387 billion, ₦40 billion reduction in recurrent to ₦2.38 trillion and about ₦80 billion rise in capital expenditure to ₦1.62 trillion. The budget is premised on an oil price benchmark of \$79 per barrel – \$4 over proposal - with crude oil production of 2.53 mbpd. Based on assumptions in the proposals, we estimate that the extra \$4 per barrel will accrue about ₦261

billion to the FGN, thus reducing deficit 15% to ₦893 billion –1.85% of GDP.

While the executive has reportedly taken umbrage at the alterations stalling passage, it has taken its disputes behind the scenes, with the promise that a version it can agree upon with lawmakers will pass in January. Incidentally, the December passage by the NA is the first time in decades a budget is approved before commencement of the fiscal year, suggesting that implementation would be much more robust than the abysmal levels recorded in the past few years.

With oil prices well above even the NA's more optimistic benchmarks, the key threat to the budget lies in its production assumptions. According to NNPC data, production in 2012 averaged ~2.3mbpd through August—well below the 2012 budget assumption of 2.4 mbpd and also the 2013 benchmarks— and is expected to be lower by full year as output was dogged by floods and sabotage in Q4 2012 that resulted in a series of force majeure. Production has since improved with the lifting of force majeure, but preliminary export data compiled by Bloomberg put January and February 2013 exports at 2.16 and 2.12 mbpd, which would imply that overall production still tracks behind the approved benchmarks based on the historical relationships with exports. While the government and the NNPC point out that it expects additional capacity with the gradual ramping up of production in recently launched deep offshore fields,

the persistent risk of sabotage looms as a threat to budget production estimates that leave little room for error.

Domestic fiscal outlook influential for markets in 2013

According to the IMF, the 2008-9 global economic crises resulted in the greatest deterioration of fiscal balances since World War II as governments provided stimulus packages and financial support to banks and other financial institutions to prop aggregate demand and save their economies from collapse. Consequently, a concurrent increase in government borrowing saw public debt exceed 100% of GDP across the major economies - the US, Japan, and several European countries. The issue was again at the heart of uncertainty over the unsustainable trajectory of US debt captured in the debates over the US “fiscal cliff” and the structural problems in Euro-zone arising from over-laden welfare systems and partly ongoing disruptions in the financial systems.

Although, Nigeria does not suffer from the legacy problems bequeathed by the social welfare and benefits system prevalent in western economies, the country has almost consistently⁽¹⁴⁾ recorded fiscal deficits since 1979 on account of expansionary government expenditure.

(14) In 1995 and 1996, Nigeria recorded a small fiscal surpluses amounting to 0.1% and 1.2% of GDP respectively

Table 7

FGN Expenditure pattern

	1961-1969	1970-1979	1980-1989	1990-1999	2000-2011
Total expenditure CAGR (%)	17%	26%	12%	36%	17.9%
Capital expenditure (% of total budget)	34%	43%	46%	49%	29%
Recurrent Expenditure (% of total budget)	66%	57%	54%	51%	69%

Source: CBN, ARM Research

Following the historic 2006 debt repayment/forgiveness deal, debt to GDP ratio—which had surpassed 100% by 1986—fell to below 20% comparing very favourably to a 30% sustainability benchmark set by the IMF for developing economies. Subsequently, Nigeria moved to institutionalize fiscal consolidation with the 2007 FRA, setting a 3% ceiling on fiscal deficit to GDP ratio⁽¹⁵⁾.

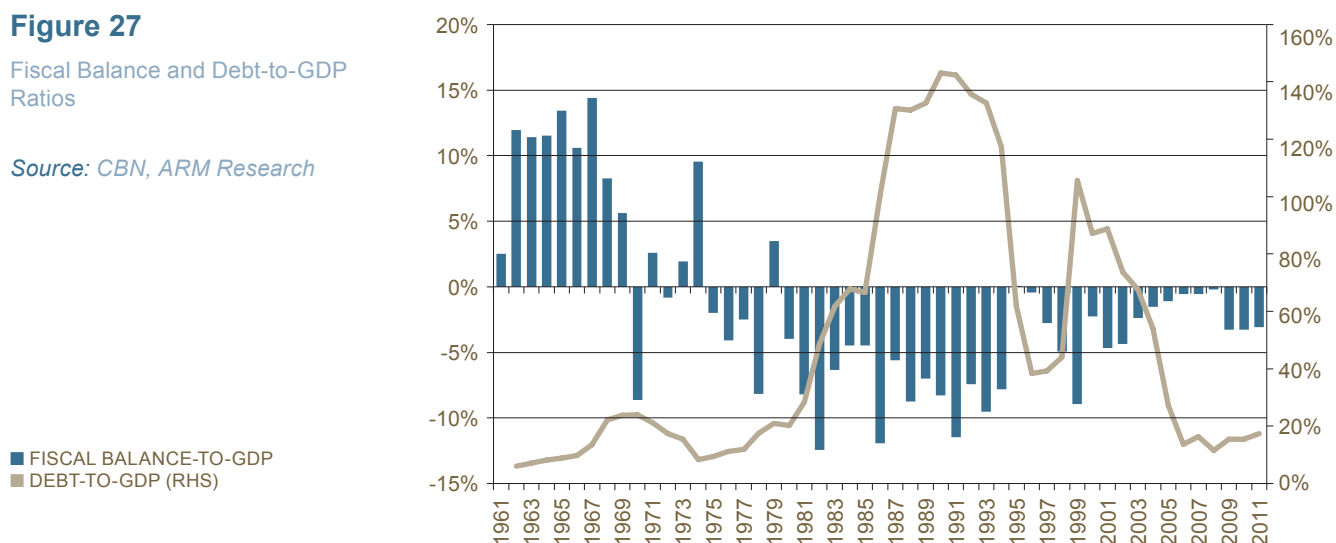
(15) Sections 12(1) FRA 2007. The EU also prescribes a 3% cap for fiscal deficit to GDP ratios.

Since 2009, the fiscal deficit to GDP ratio which previously was less than 1% just two years before has, in contravention of the FRA, averaged 3.2% despite upward trend in real GDP growth over the same period. Comparison with budgeted figures suggest that shortfalls in actual revenue owing to outages in crude oil production which in combination with lower oil prices and under-provisioning in budget for fuel

Figure 27

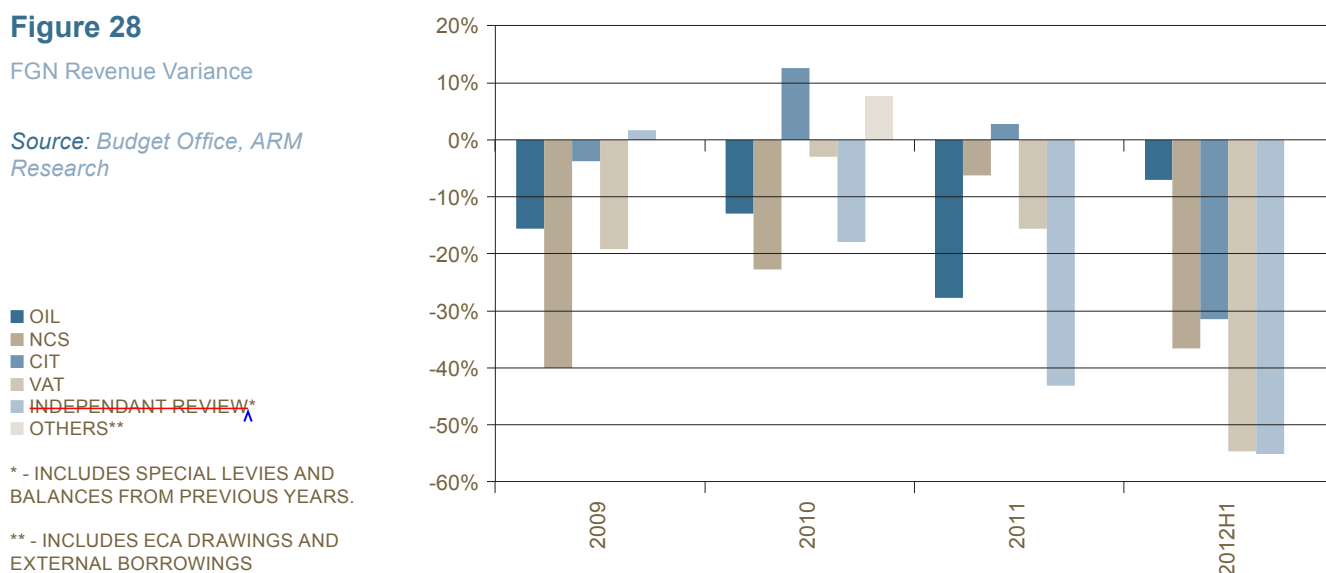
Fiscal Balance and Debt-to-GDP Ratios

Source: CBN, ARM Research

**Figure 28**

FGN Revenue Variance

Source: Budget Office, ARM Research



* - INCLUDES SPECIAL LEVIES AND BALANCES FROM PREVIOUS YEARS.

** - INCLUDES ECA DRAWINGS AND EXTERNAL BORROWINGS

subsidy payments are some of the primary factors behind the deficit overshoot⁽¹⁶⁾. Indeed, oil revenues have missed budget forecasts on average since 2009 by 19%, while collections by the NCS has fallen short of budget by an average 23% over the same period.

FGN's fiscal consolidation drive bearing fruit?

The government recorded a rare fiscal surplus of ₦12.6billion in Q1 2012 and deficits of ₦212billion and ₦459billion in Q2 2012 and Q3 2012 respectively. While the Q1 figure possibly reflects the late passage of the 2012 appropriation the implied 2.1% average deficit for the first three quarters is well behind both

the 2.85% target⁽¹⁷⁾ and legislative prescriptions. On the other hand, while a ₦161billion supplementary budget for petroleum product subsidies in Q4 2012 and our expectations for lower government revenues during that quarter threaten outlook for moderate deficits, the overall trend does lend some credence to the FGN's seriousness about pursuing fiscal consolidation starting 2012. Significantly, the 2013 budget as announced by the president envisions a further drop to 2.17% to be driven by cuts in recurrent expenditure and given the stricter subsidy verification process now in place, we believe this item is now less likely to cause huge variances from budget as was the case in 2011, which should help keep deficits under control.

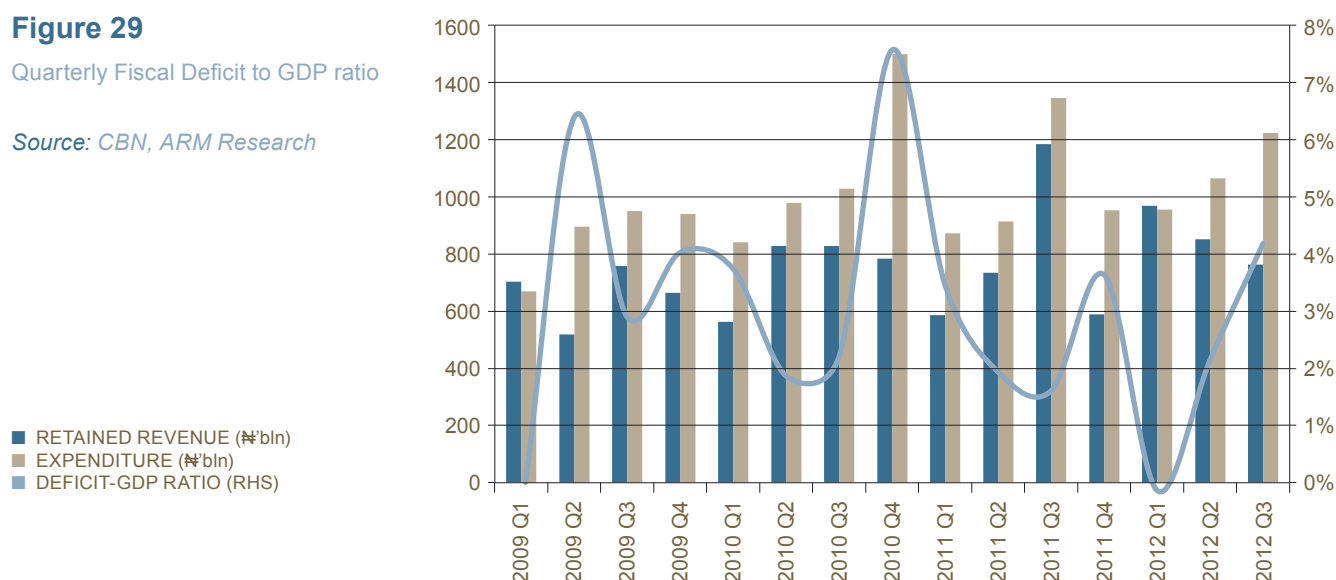
(16) Oil revenues have accounted for 80% of total federal revenues on average over the past decade

(17) According to the President's 2013 budget presentation to National Assembly

Figure 29

Quarterly Fiscal Deficit to GDP ratio

Source: CBN, ARM Research



DMO issuance should be lower on higher oil price benchmark in 2013

Domestic bond markets have financed between 73-75% of budget deficits with ECA drawings meeting the shortfall (except in 2010 when dwindling ECA reserves forced the DMO to aggressively tap the debt markets) creating a strong relationship between fiscal deficits and government borrowing. Total bond issuance in 2012 stood at ₦988billion—15% higher YoY—accounting, in line with the historical trend for 75% of projected deficits.

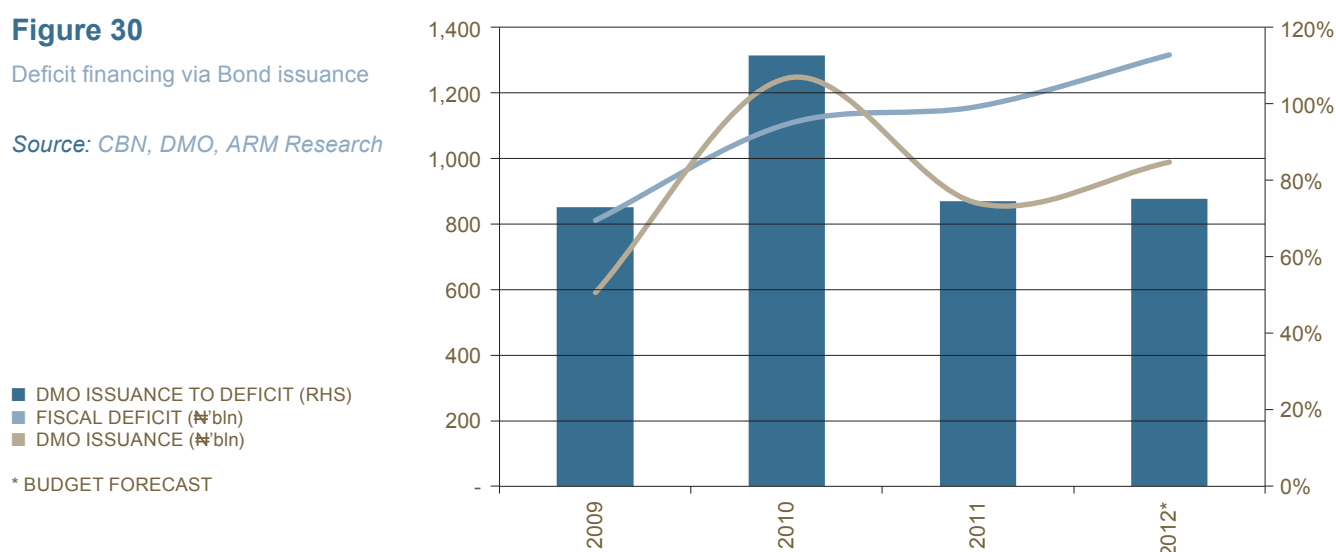
The Budget Office had earlier projected the 2013 budget deficit at ₦1,037 billion under assumptions of

oil prices at \$75 per barrel and a 2.5mbpd oil production with ₦727billion (70%) to be financed via FGN bonds. However after revising the oil benchmark higher to \$79, the National Assembly projects that deficit will reduce to ₦887billion such that, assuming that the trend in deficit financing via the domestic bond market is sustained, the total DMO bond issuance for 2013 could reduce markedly to ₦620billion–₦665billion all things being equal. Given the sheer size of maturing paper in 2013, this outcome would be a hugely important development for capital markets that have long grappled with being 'crowded out' by government borrowing. While we maintain some reservations on extrapolating the import of these assumptions on debt market trends in 2013, we note that along with other

Figure 30

Deficit financing via Bond issuance

Source: CBN, DMO, ARM Research



* BUDGET FORECAST

capital market developments discussed elsewhere in this report, it does set a tangible positive tone to asset market outlook. In particular, declining yields and lower government borrowing would signal resurgence in private sector lending and the long awaited revival of corporate and sub-national debt markets, which we believe improves overall efficiency of capital markets and would have a much more positive impact on the economy than the status quo.

Oil dominance magnifies risks but outlook still benign

Given the dominance of oil in government revenues, there is increased likelihood of shocks emerging there filtering through to fiscal balances implying that unless budget assumptions hold firm over the course of the year fiscal balances could be thrown into disarray once again. Nevertheless, the assumptions underpinning revenues appear realistic – \$79 per barrel and an average daily crude production of 2.5mbpd.

The NBS reports that crude production averaged 2.5mbpd in Q3 2012 up from 2.34mbpd from Q2 2012 on account of the on streaming of more offshore platforms. However, according to the DPR and Ministry of Petroleum Resources output is expected to dip in

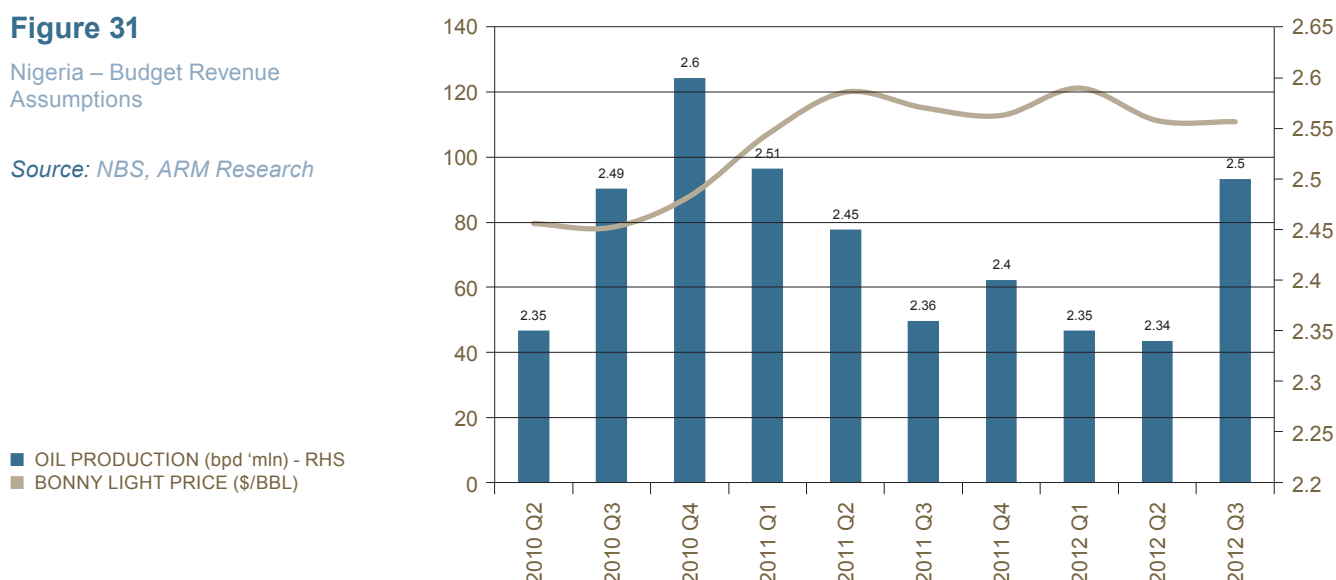
Q4 2012 due to shut-ins on account of heavy floods in October and force majeure declared by several IOCs on account of pipeline sabotages along the loading platforms of the Bonny Light, Qua Iboe, Forcados and Brass River grades. The US EIA and IEA both report that output dropped to record lows over the period, nevertheless, they expect a full rebound in Q1 2013 on account of loading schedules for January which show a recovery. This implies that barring any major flare-up of violence in the Niger Delta, the oil production target is achievable.

Although global oil markets were in a glut in H1 2012 amounting to 0.66mbpd, Bonny light prices remained above the \$100 throughout the period except during June-July on heightened European uncertainty. With the rebound in the Chinese economy in H2 2012 and further monetary easing measures by global central banks, the oil market swung to a shortfall which propped prices in between bouts of political tension in the Middle East. The IMF expects the global economy, which it estimates grew 3.3% in 2012–50bps lower than 2011—to rebound to 3.6% in 2013. This should provide sufficient boost to demand, diminishing the likelihood of a sharp fall in oil prices below budget benchmarks.

Figure 31

Nigeria – Budget Revenue Assumptions

Source: NBS, ARM Research



ECONOMIC REVIEW AND OUTLOOK

MONEY MARKETS IN ROLLER-COASTER RUN

Issuance stays elevated

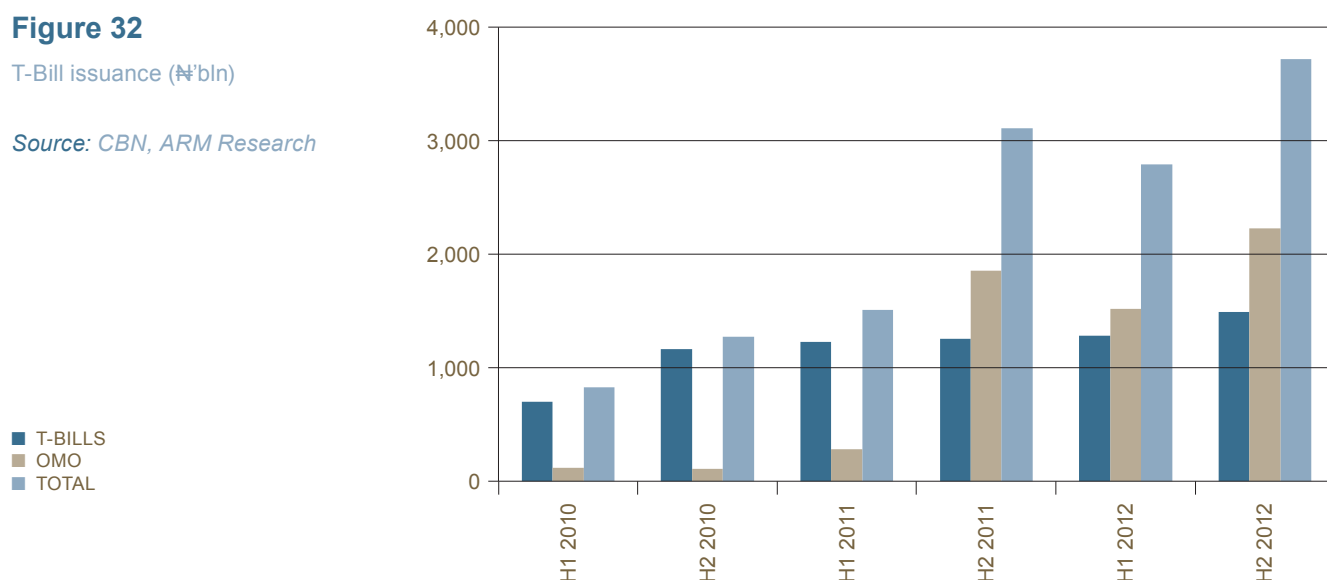
Treasury bill issuance touched new highs in H2 2012. The CBN issued ₦3.7trillion worth of bills, 33% ahead

of H1 2012 levels and 19% higher YoY. As has been the case in recent times, OMO continued to dominate T-bill issuance, accounting for 60% of total and was 75% higher than 2011 levels, on aggregate basis, versus a 41% YoY aggregate increase for Primary Market Auction (PMA) paper.

Figure 32

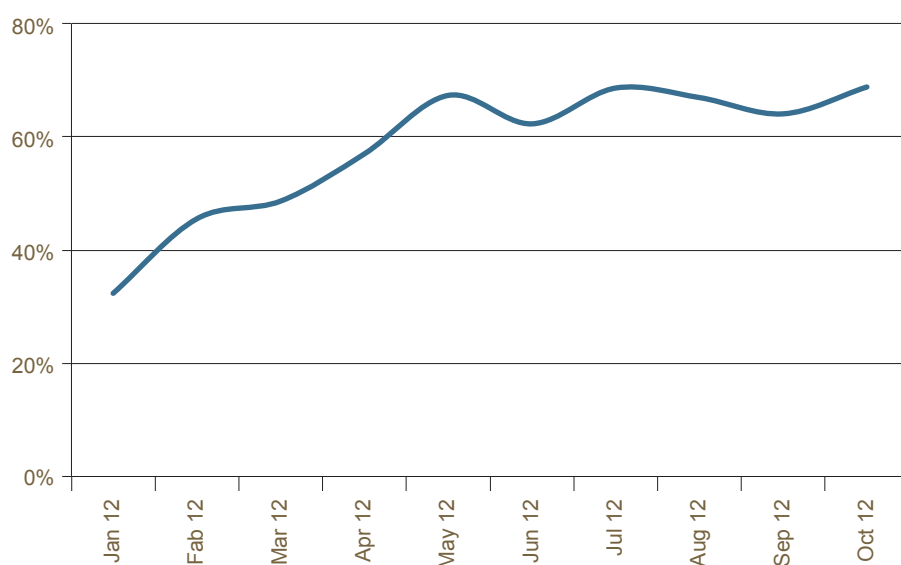
T-Bill issuance (₦'bn)

Source: CBN, ARM Research

**Figure 33**

Maturing bills as % of total money market inflows

Source: FMDA, ARM Research



Yields maintain downtrend, underpinned by maturities

In spite of this surge, money market rates maintained an overall downtrend during the period and, at the end of 2012, were ~370bps lower on average, than year-start. Whilst external factors like the JP Morgan bond inclusion also had a spillover into T-bill markets in August/September 2012, increased domestic liquidity which already set an undertone for rate declines in H1 2012 also drove yield moderation. An analysis of traditional liquidity drivers points to the rising profile of maturing paper while FAAC allocations have remained broadly stable year-long. Data from FMDA highlights the sharp rise in contribution of maturing paper to money market inflows through H1 and elevated levels thereafter which helped explain the downtrend in rates in spite of aggressive issuance. Indeed on a net basis, aggregate issuance declined 15% YoY to ₦1.23 trillion, largely driven by tamer OMO where

net issuance halved to ₦679 billion amid a 4-fold YoY increase in net issuance for PMA to ₦554 billion in 2012.

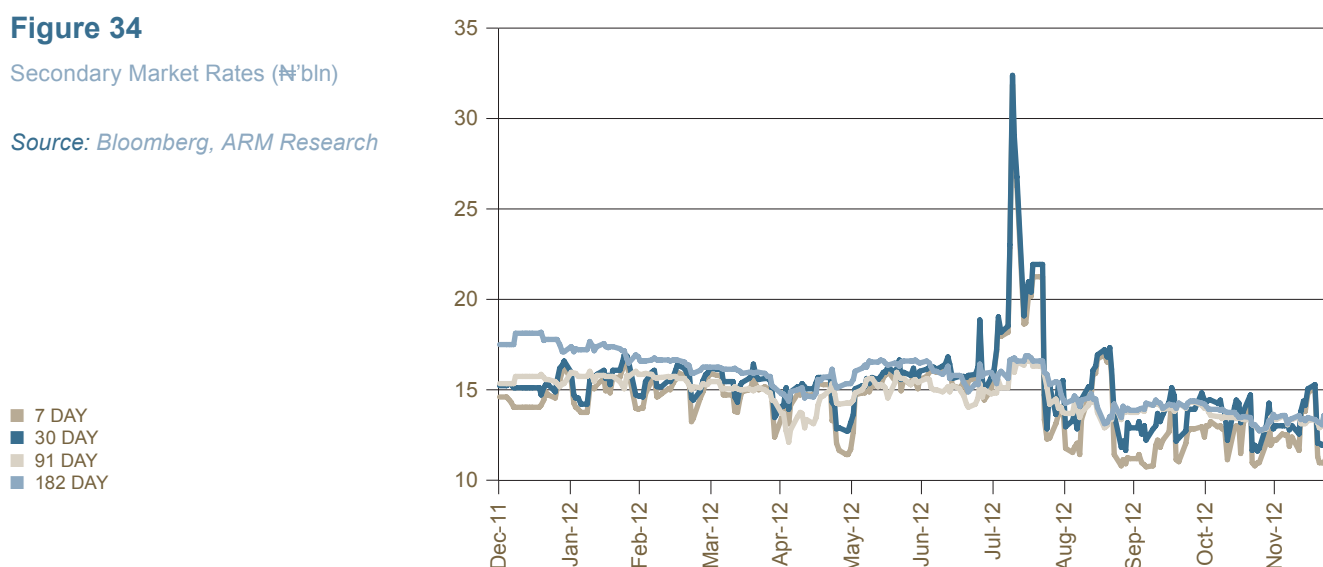
Interbank market exhibits similar pattern

Interbank rates also trended lower over the course of the year, falling by an even greater margin of 560bps on average in 2012. However, while the underpinning factors were broadly the same, the trend was not nearly as smooth as in the T-bill markets. Notably, a surprise tightening move at the July MPC—which hiked CRR by 400bps to 12% amongst other hawkish measures—led to a multiyear high rate spike which moderated only after considerable portfolio inflows in August. The dip in interbank rates at the tail end of the year (Dec 2012: -30bps MoM) appear to reflect increased liquidity within the banking system after profit-taking on T-bills kept yield flat in December 2012.

Figure 34

Secondary Market Rates (₦'bln)

Source: Bloomberg, ARM Research



Money supply growth accelerates

Money supply growth gained momentum in H2 2012 after slow paced growth in H1 2012. Broad Money (M2), which had risen a tepid 1.4% YTD as at June 2012 (₦13.4trillion) rose 13.2% to ₦15.0trillion as at November, which included a substantial 4.6% MoM growth in that month. Evidently, the pickup of broad money supply growth in H2 2012 was largely on account of a 18.9% growth in quasi money from start of H2 2012 to November (25.3% YTD).

Furthermore, narrow money supply inched up 1.6% YTD as at November, after declines in the first half of the year (H1: -2.5%); rising 4.3% in H2 compared to a 11.7% growth in broad money in the same period. Similarly, YTD growth in base money accelerated in H2 after declining 9.8% as at June 2012. By November, base money had grown 18.6% in four months, translating to a 7% growth YTD. The aggressive growth in CBN reserves exhibited in 2011 was replicated in 2012, though at a more subdued rate—Bank reserves had grown 27.1% YTD

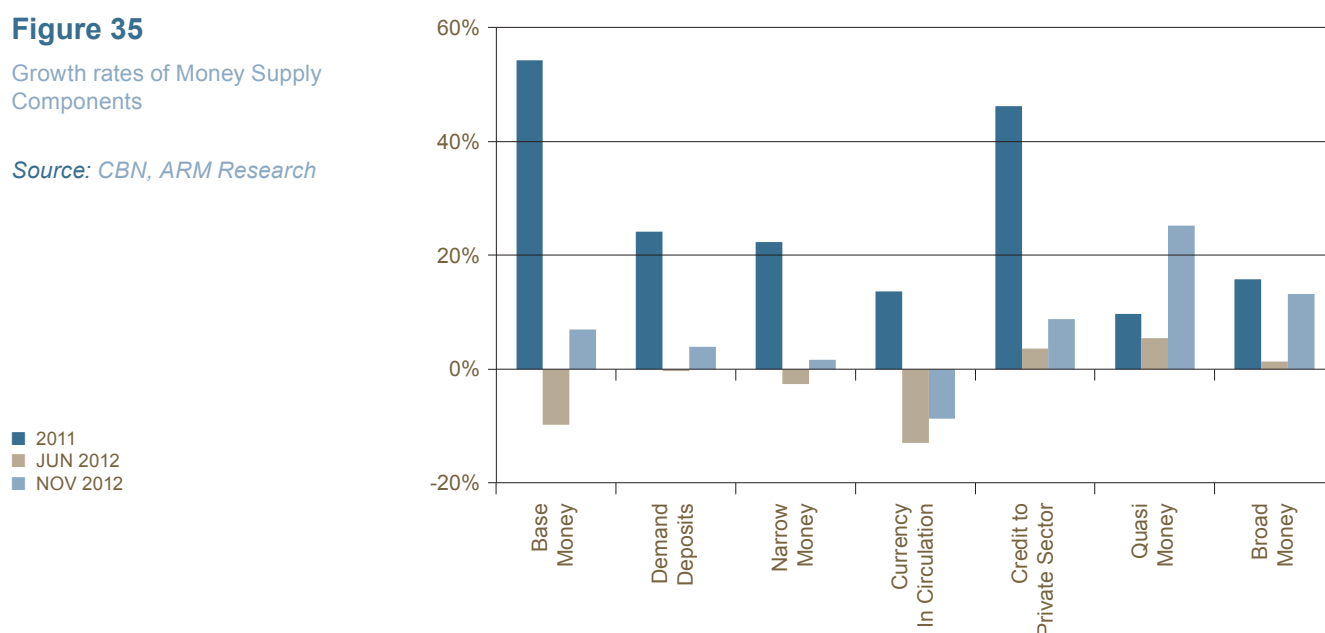
as at November. We note that the growth in reserves coincided with the 400bps hike in Cash Reserve Ratio (CRR) in July 2012 from 8% to 12%; prior to this, bank reserves had declined 5.7% YTD as at the end of H1 2012. Notable was a reversal in net credit to

government from a multi-year peak of ₦1.7 trillion in July 12 to a debit position of ₦2.4 trillion November, probably in reflection of the success of the Treasury Single Account implemented in May 2012.

Figure 35

Growth rates of Money Supply Components

Source: CBN, ARM Research



Tight monetary policy gives way to portfolio inflows

In a differently themed 2012, the Monetary Policy Committee (MPC) maintained MPR rates at 12% in all its meetings but signaled further tightening via the 400bps hike in CRR and a 4pps slash in forex net open positions to 1% at its July meeting, barring of banks from borrowing funds through the CBN window to participate in forex auctions. A sharp drop in systemic liquidity led to a 262 bps (to 17.8%) spike in interbank rates in August.

However conditions have changed dramatically since the surge in portfolio inflows in Q3 2012, which clearly reflect a more relaxed stance by the CBN, ostensibly due to its primary concerns over currency being assuaged by this phenomenon. A sharp fall in interbank rates through November 2012 coincides with an 8.1% MoM jump in currency in circulation in the preceding month. Increased liquidity during the period arose from a much tamer CBN response to disbursement of statutory revenue allocation to the three tiers of government as well as substantial amount of T-bills and OMO maturities (See Figure 36). Nevertheless, for all the expansion in the

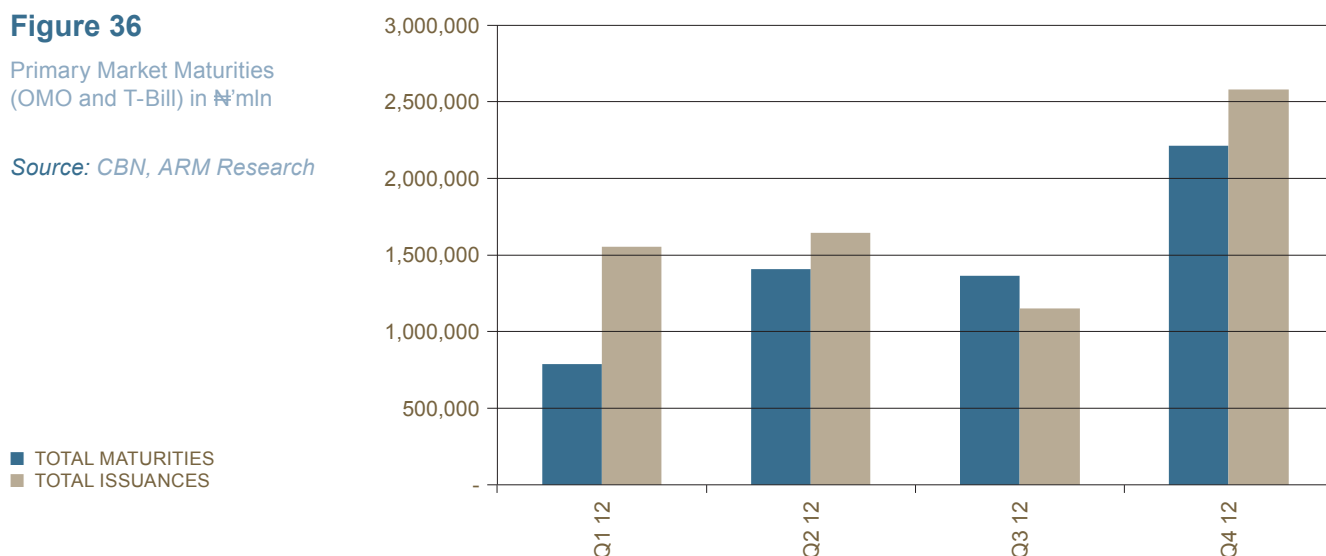
monetary base, lending rates were barely changed and continued to trend higher through the period, expanding its already wide spreads over interbank rates.

Credit to private sector also hardly improved rising 1.0% on average between July and November 12, compared to 0.6% in H1 2012 (YTD (Nov): 8.7%).

With over ₦1.5trillion of government securities maturing through April 2013 we expect to see continued acceleration in money supply in H1 2013 as lower interest rates will probably temper appetite for government securities in 2013, compared to 2012 even as CBN steps up OMO, as was the case in Q4. Nevertheless, we believe current monetary policy stance which features a combination of high base rates and a massive spike in T-bills issuance will continue to pose constraints to private sector lending. Indeed the CBN has shown limited commitment to channeling funds in this direction, claiming that the constraints are structural—a premise which is only half true in our view. Nevertheless, the metric could improve by H2 2013 with progress in public asset sales, particularly in the power sector, while declines in government paper yields and possible rate cuts should be supportive, in our view.

Figure 36Primary Market Maturities
(OMO and T-Bill) in ₦mln

Source: CBN, ARM Research

**Figure 37**

Lending and Interbank Rates (%)

Source: CBN, ARM Research



Rising T-bill maturities, point to lower yields

The role of maturities in forcing rates lower in spite of seemingly hawkish monetary policy tracked our expectations earlier in the year. The sheer quantum of maturing paper has now reached higher levels than when we first highlighted concerns about unbridled issuance in 2010, when monthly peaks were well below ₦500billion. The ever rising peaks in maturities since then—and shorter interludes between these—highlight the compounded effect of aggressive issuance and ensuing conundrum with liquidity management we envisaged. The rising domestic liquidity profile is also reflected in continued

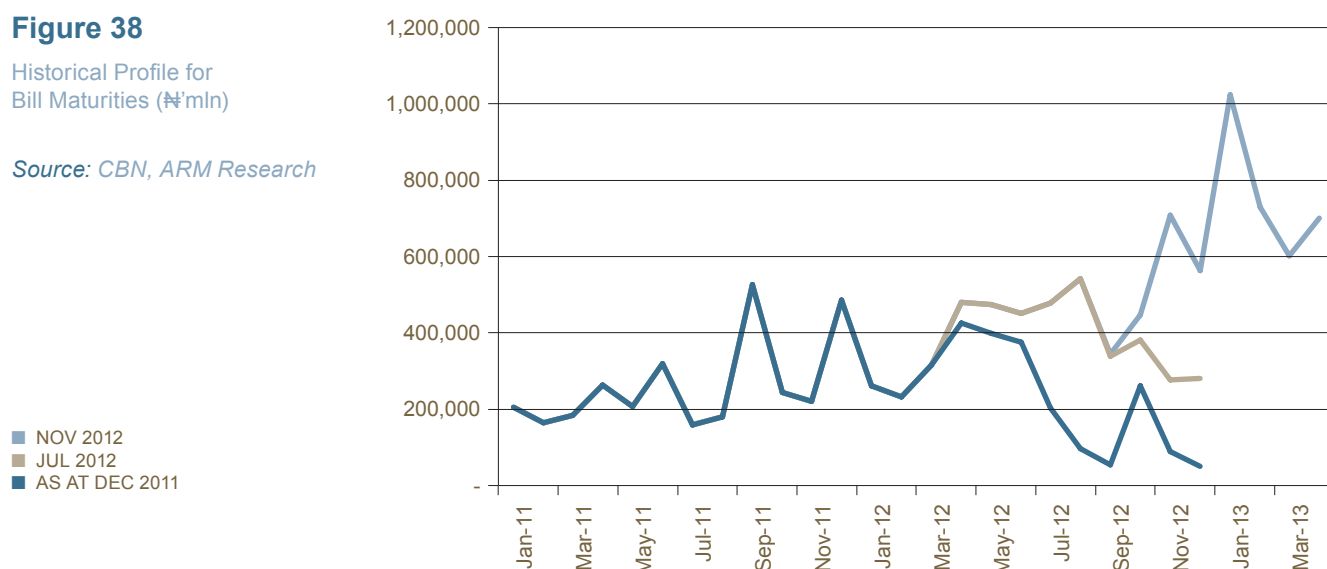
strong bid-cover ratios, suggesting that maturities and new inflows would likely offset issuance going into 2013.

Fundamentally, based on current issuance levels, the ₦3.1 trillion maturities in first four months of 2013 (already 58% of total 2012 maturities) implies more pressures from this front in 2013 which could potentially take control of yield levels away from the MPR. Coupled with reinvestment by financial institutions this could drive a particularly subdued start to the year for T-bill yields.

Figure 38

Historical Profile for
Bill Maturities (₦'mln)

Source: CBN, ARM Research



IMPROVING EXTERNAL POSITION UNDERPINS FISCAL BALANCES

Trade surplus expands on lower imports...

Nigeria's positive trade balances expanded in 2012 even as drivers became clearer. Dips in June and September 2012 coincided with reports of difficulty with crude oil sales and flood-induced oil production outages, respectively. Nevertheless, crude oil receipts remained the dominant factor in exports and total exports as at 9M 2012 was 4% above the corresponding period in 2011. Thus the expansion in trade balance largely came from lower imports over 9M 2012 which was

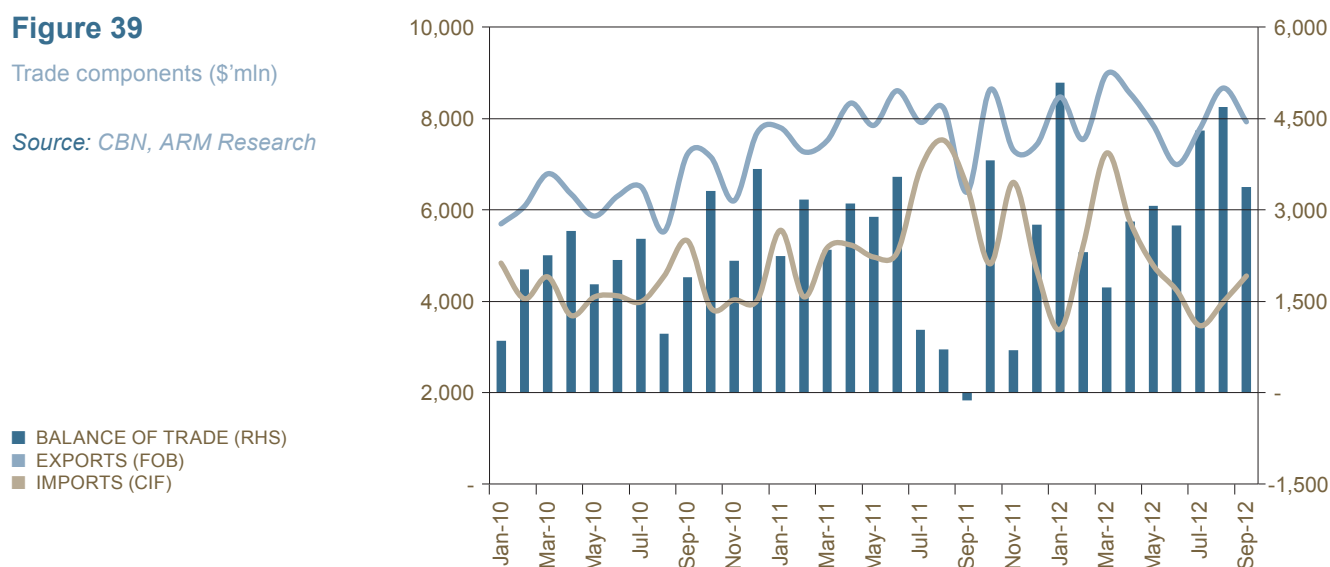
17% lower YoY. Lower imports coincide with a drop in oil-related categories amid a yearlong review of the petroleum product subsidy mechanisms as well as fresh restrictions on importation of major agricultural products like rice, wheat and cement during the year. Oil related imports (which accounts for 27% of the total) were down 26% while non-oil imports were 12% lower YoY.

Largely as a consequence of the downtrend in imports, the cumulative 9M 2012 trade surplus rose 53% over 2011 levels to \$30.1 billion, with a (~40%) rebound in Q3 2012 trade surplus to \$13.7 billion – highest in nearly 3 years—putting it 36% and 43% higher than Q1 and Q2, respectively.

Figure 39

Trade components (\$'mln)

Source: CBN, ARM Research



...bolstering current account balance

The improvement in trade balance played a critical role in the current account surplus of \$15.4billion in 9M 2012 compared with \$8.8billion in FY2011 and \$13.4billion in FY 2010. However its impact was blunted by Services component which posted its largest deficit in 3 years at \$17.5billion; while Income and Current Transfers declined 6% and 1.5% to -\$16.6billion and \$16billion respectively, driven by outbound investment income (mostly equity i.e. dividends/branch profits) and inbound worker's remittances. The larger deficit in Services (which was 25% and 17% larger than in 2010 and 2011, respectively) reflects a surge in transportation, specifically freight, costs and the overall trend underscored the Nigerian economy's

continued dependence on imported services on numerous fronts. Nonetheless, larger Services deficit was compensated by trade surplus and with CBN reporting that oil receipts have recovered somewhat in October, positive trade (and current) account surplus should be maintained through Q4 2012.

Decline in US oil imports from Nigeria following closure of several US Gulf Coast refineries— was partly to blame for a 14% MoM contraction in oil revenues in June 2012 as Nigeria struggled to find new buyers— emerged as a new threat to naira outlook in Q2 2012. Export to the EU which stood at 40% in Q2 2012 (up from 15% in 2010) helped offset a sharp decrease in US bound exports to 18% from 40% over the same period, and along with improved off-take from Asian

Figure 40

Export by destination (\$'mln)

Source: UNCTAD, ARM Research

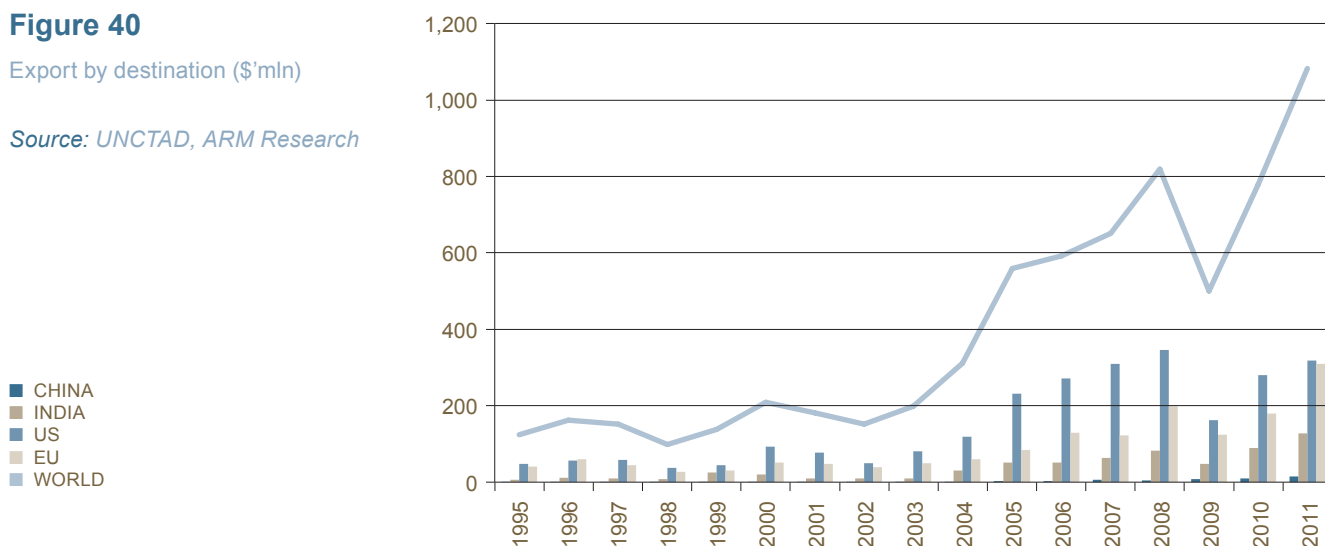
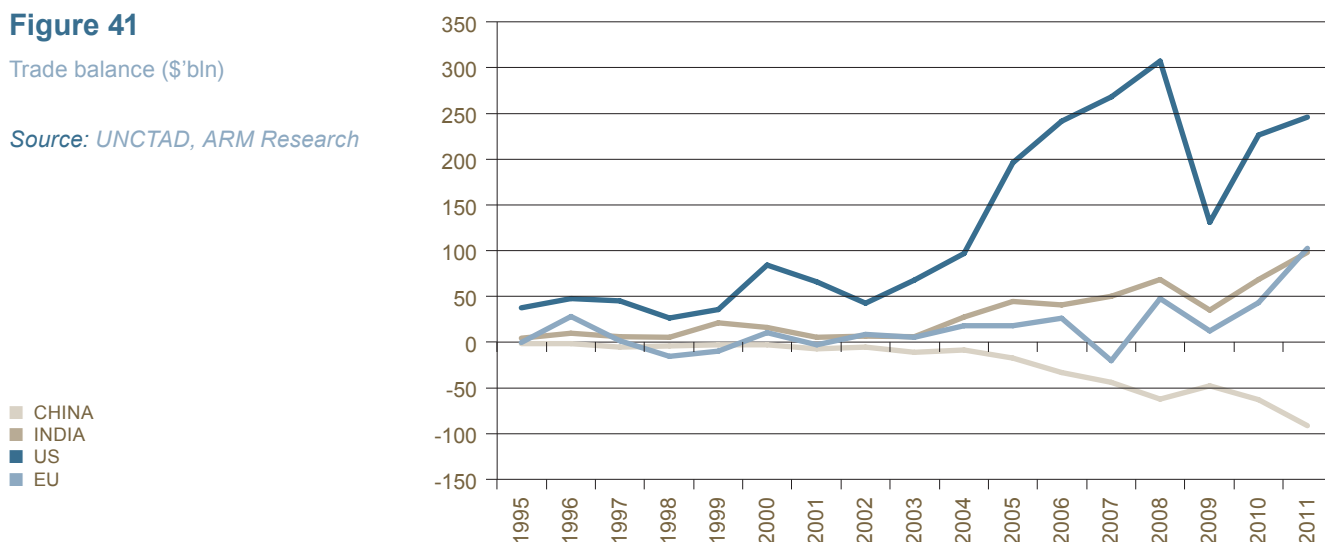


Figure 41

Trade balance (\$'bln)

Source: UNCTAD, ARM Research



buyers (notably India and China) has since helped recover some of the crimped differentials on Qua Iboe and Bonny Light. We expect demand interest to persist over the medium term even as the impact of shale oil discoveries still take a while to fully materialise.

We expect current account to trend lower in Q4 2012 on the back of lower crude revenues after production reportedly declined from a peak of 2.56mbpd in August to 1.89mb in October and November (based on IEA's estimates) on temporary disruptions, reflecting in a smaller (vs. Q3) trade surplus. However we expect the trade surpluses to recover in H1 2013 supported by a modest rebound in oil revenues following a recovery in production at affected platforms. Oil majors lifted their respective force majeure in December and are estimated to have added between 300 – 400kbpd

since. Furthermore, preliminary loading data compiled by Bloomberg also suggest substantially higher cargo exports in January and February 2013. Existing and new government import tariff hikes will also likely keep imports subdued, dampening the effect of a surging trade deficit with China.

Reserve position improves on oil receipts

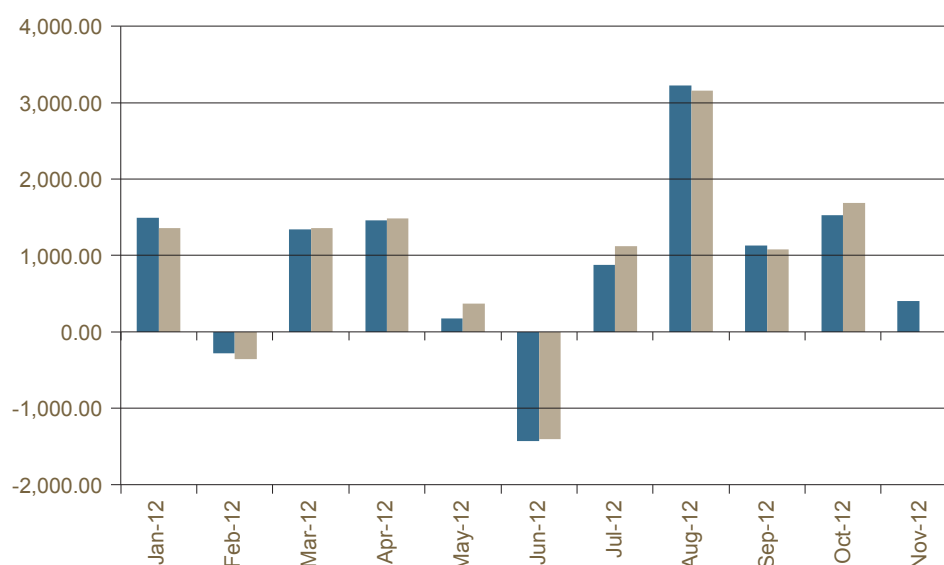
According to the CBN, the reserves increased by a total of \$11.3 billion in 2012. Forex receipts at the CBN totalled \$39.1 billion dominated by oil (91%) while outflows totalled \$29.2 billion dominated by WDAS outflows (85%). The resultant netflow over 10 months matches the total reserve accretion when extrapolated over the rest of the year, suggesting trends continued beyond the available data points.

Figure 42

Reserve accretion and official forex flows (\$'mln)

Source: CBN, ARM Research

■ CHANGE IN ADJ RESERVES
■ NETFLOW THROUGH CBN



Hidden but stronger support from capital flows?

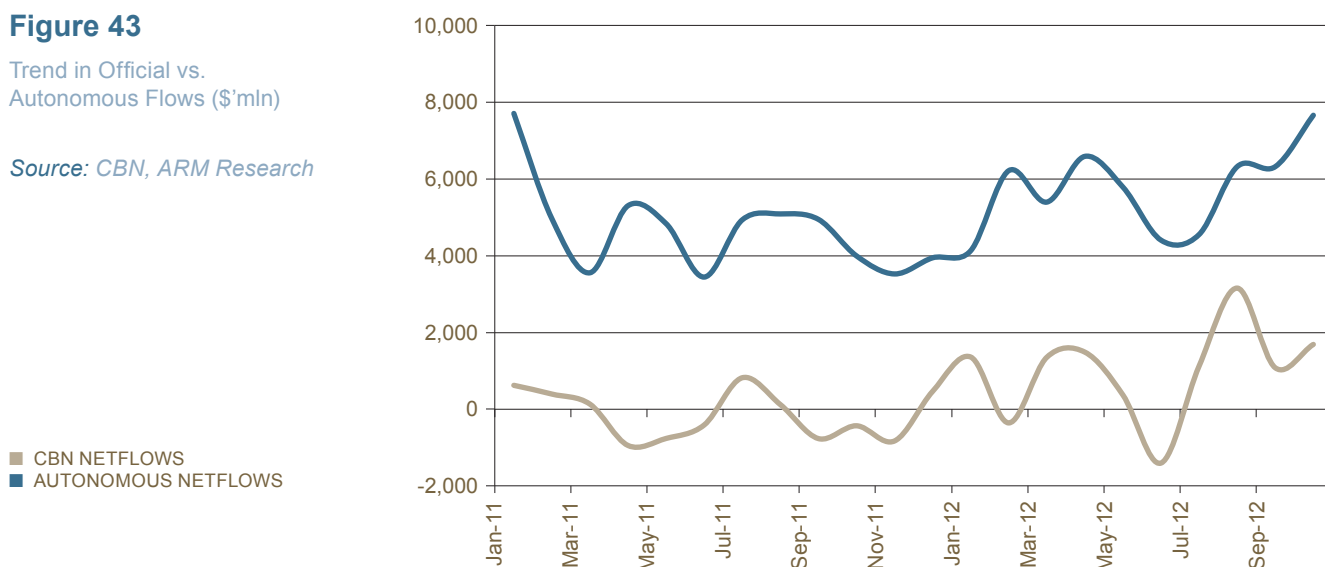
Less visibly, capital flows were also strong rising 33% YoY in 9M 2012 to \$15 billion--already ahead of \$14 billion FY2011 total. However, through Q3 2012, FDI declined 42% YoY on the back of a reduction in fresh equity capital while reinvested earnings maintain the same pace at ~\$2.2 billion dollars. Conversely, portfolio flows tripled YoY to \$11 billion reflecting roughly 3x increase in both equity (+206%) and debt (+170%) investments, the latter emerging as the dominant contributor in Q3 2012 with a focus on

long-term instruments. Thus, portfolio flows was the primary underpinning for the overall surge in capital flows as reflected in CBN data which also shows that, at an estimated \$57 billion, autonomous net flows continued to dwarf official flows in dollar supply.

Pertinently, given the considerable negative differential between official and parallel market exchange rates, portfolio inflows have almost entirely been in the autonomous category and therefore had little direct impact on official reserves. This also helps explain substantial Naira appreciation in the interbank market on the back of substantial influx of dollar liquidity

Figure 43Trend in Official vs.
Autonomous Flows (\$'mln)

Source: CBN, ARM Research



where the CBN maintained its (un-official) peg at the WDAS. Portfolio inflows nevertheless had the effect of lowering dollar demand at the WDAS, where dollar sales declined 36% YoY in 2012 to \$19 billion, its lowest level in 4 years. It is also pertinent to note that more favourable dollar purchase terms at the WDAS and CBN's constant attempts to stem divergence in official vs. parallel market exchange rates invariably transmit demand pressures in the interbank market into outflows at the WDAS—and thence, official reserves. Thus, substantial improvement in autonomous supply is less visibly reflected in reserve accretion in the latter part of 2012 in line with the attenuation of demand pressure at the interbank market.

This situation provides that the link for an expectations based investor reaction to the Naira that focuses on (significantly smaller) available dollar supply at the official window—which is in turn tied to energy prices—as a gauge of Naira direction. It also informs our long standing criticism of the two tier market system and repeated attempts by the CBN to act as an explicit guarantor for Naira exchange rates at arbitrary pre-determined levels. Here again, the sharp rise in portfolio inflows via the interbank market further highlight the risk of a reversal to Naira outlook.

FORTUITOUS TURN OF EVENTS IN CURRENCY MARKETS

Naira has a strong year

Although the year started on a somewhat bearish

note, a rebound in the N/\$ in Q3 12 which featured four straight monthly gains in the July-October led to a 3.8% appreciation in 2012, and seven monthly gains in twelve—the most in the 5 years. The Naira's performance compares favourably to that of a basket of African and other emerging markets.

Adducing drivers to currency gains

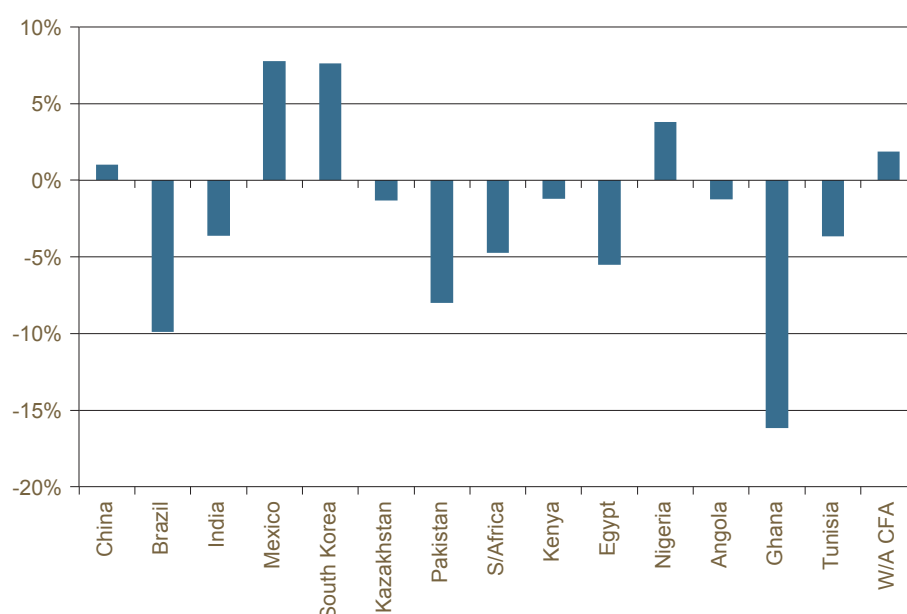
Official inflows from FGN receipts were 4% higher YoY through October 2012. Incidentally, trends in Naira performance closely track autonomous inflows particularly with respect to the Q3 surge which was directly linked to increased capital flows in response to the announcement of the inclusion of Nigerian bonds in the JP Morgan EMBI. CBN data reports a 39% MoM rise in net autonomous flows to \$6.3billion in August which reached \$7.7billion in October 2012. August marked the peak level of monthly autonomous net inflow since January 2011 and the third-highest level in six years. The further 21% MoM rise in October coincides with the announcement of Nigeria's inclusion in a Barclay's index.

Corroborating the impact of autonomous inflows was a 36% YoY decline in USD sales at the WDAS in 2012, linked to healthy supply at autonomous markets and a sharp fall in (especially oil related) imports. However, amid rising autonomous dollar supply, our expectations framework for demand appeared to be particularly strong in 2012 as focus on the impact of oil prices and production on reserve accretion was clarified by the corresponding effect of net-

Figure 44

Performance of select currencies in 2012

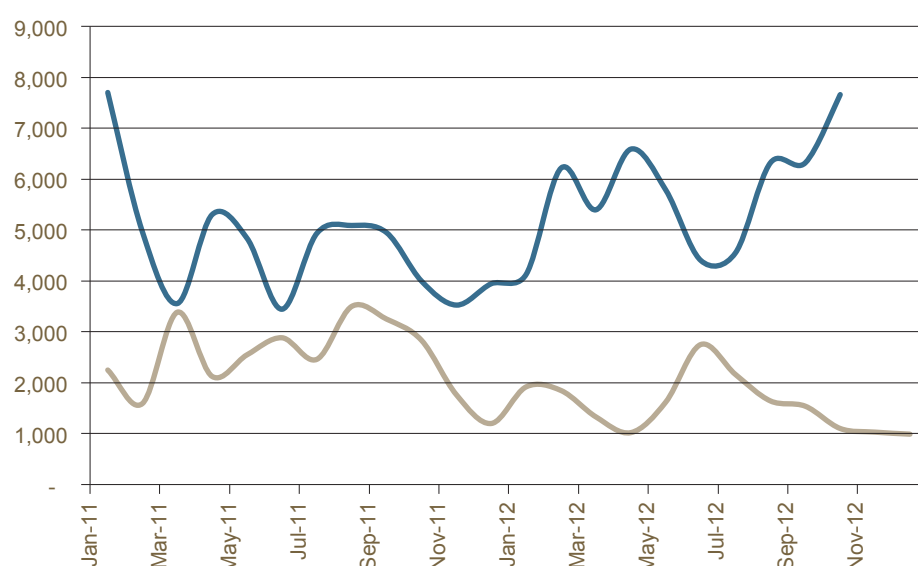
Source: Bloomberg, ARM Research

**Figure 45**

Autonomous inflows vs. WDAS sales (\$'bln)

Source: Bloomberg, ARM Research

■ AUTONOMOUS NETFLOWS
■ WDAS



flows through the CBN on reserve growth during the period. Consequently, the indications are that events in the official market dominate Naira performance at the interbank. CBN net-flows of \$0.3billion and -\$1.4billion coincided with weak Naira performance in May (-1.5%) and June (-1.8%) respectively whilst the rebound to \$1.1billion in July heralded the 4-month streak of gains for the Naira that included MoM gain of 1.7% in NGNUSD in August which coincided with a surge in net-flows to \$3.3billion during that month. Notably however, gains were decidedly more muted at 0.6% as net-flows dropped to \$1.1billion in September, despite autonomous flows matching August levels leading to a 53% YoY decline in WDAS

dollar sales for that month. It would appear that the Naira was more responsive to lower dollar receipts from weaker oil revenues which highlights portfolio inflows secondary role in interbank dollar pricing.

Fundamentals point to positive USDNGN outlook

The foregoing analysis highlights the importance of official dollar inflows--and by extension oil revenues (and prices) on Naira outlook. Despite a 0.4% decline in 2012 on average, Nigeria's benchmark Bonny Light prices have remained fairly resilient above \$100/bbl in 2012 aside marginal dips below this threshold in June

Figure 46Oil price (RHS) vs
USDNGN rebased

Source: Bloomberg, ARM Research



and early July. The recovery has persisted through H2 amid disappointing global economic growth and easing supply tensions (especially with Iran), probably supported by global monetary easing. Rising consensus expectations for improved global economic performance, as well as the likely persistence of loose monetary policy, suggest oil prices will remain supported through 2013. Furthermore, recovery in production after flooding which helped drive an 8% MoM improvement in October oil revenues is supportive for outlook particularly with expectations for expanded output at new oil fields in 2013.

Overall, strong oil prices and higher production remain supportive of netflows—and currency outlook—in light of prospects of robust current account balances on the back of trends highlighted earlier. However, the indirect impact of autonomous flows on net official inflows suggests that alongside oil price (and revenue) outlook, a potential reversal of portfolio flows has emerged as a primary risk factor which magnifies downside risk of oil prices for the Naira given the relationship between the two—a risk which intensifies with rising stock of portfolio inflows. Thus, while our expectations that improved global growth prospects and the commitment of global central banks to provide liquidity support limit the probability of a major adverse event for oil (and the Naira)—even as Nigeria’s progressively improving visibility as an investment destination helps latency of portfolio flows—it is not clear if our strong base case outlook for Naira in 2013 is accompanied by the attenuation of downside risks.

AN ANTICLIMACTIC YEAR FOR INFLATION

Inflation outcomes in 2012 broadly ended up more benign than expected with headline inflation averaging 12.3% (versus earlier consensus of >14%-15%) in January-November 2012 largely on the back of better behaved food inflation which belied the impact of a number of adverse events including weak agricultural output (from GDP reports), heightened insecurity, floods and higher import tariffs on several food staples. This broad muted pattern suggests that underlying counter-themes of recent improvements in storage, a stronger dry season harvest in February-March and the potent disinflationary impact of petroleum subsidy withdrawal which we have dwelt upon in past analyses, are much stronger than initially appreciated.

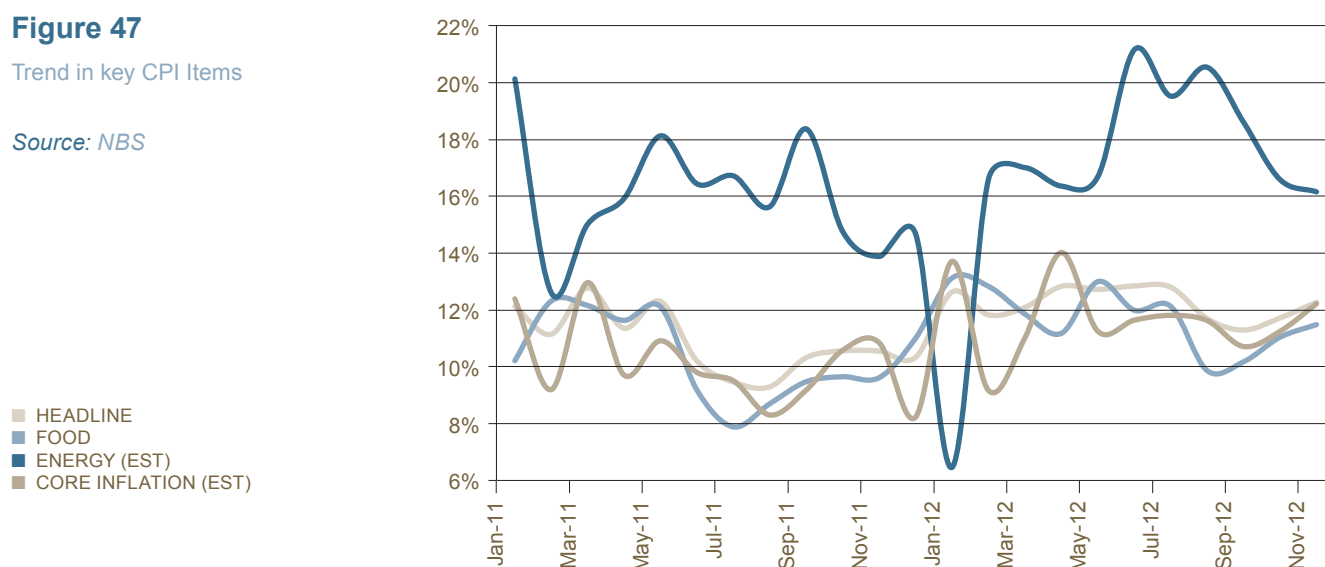
Perhaps most poignant in its underwhelming effect was the September to October 2012 floods which displaced ~3million people and destroyed farmlands in 14 states and, more than any other single event, was expected to significantly affect food availability. However unlike the evident impact on crude production (which declined 9% MoM in September⁽¹⁸⁾), the impact on food was much weaker than expected. The CPI trajectory was scarcely altered in September 2012 when headline maintained a 3-month downtrend to reach the lowest point of the year at 11.3% despite a MoM uptick in food inflation. Overall, while MoM CPI readings through the September-November harvest season remained well above five year averages, the impact of the floods

(18) Bloomberg

Figure 47

Trend in key CPI Items

Source: NBS



was nowhere near as material as feared. Given its importance to overall outlook (Food constitutes 51% of the overall CPI basket), exploring the trends in food inflation drivers is particularly instructive.

Farm produce: FEWS NET⁽¹⁹⁾ November 2012 publication estimates the floods affected 1.9million hectares of cropland which appears to support the Minister of Agriculture's assertion that only 1.4million hectares were affected, of which only 460,000 hectares was under crop cultivation. This compares with a total 33.6 million hectares under cultivation in Nigeria implying that only ~1.2% of total crop was affected. Also, highlighting that, prior to the flooding, the 2012/2013 harvest season was expected to be much better than the previous year's, the agency credits "early green harvests of maize, cowpeas and tubers in September to mid-October" as helping to improve food availability. This presumably helped offset price pressures on other items such as cassava, beans, rice, yam and sorghum. The relatively muted impact of flooding possibly also reflects the impact of the release of 40,000MT from national storage in mitigating potential food pressures.

Imported food: Tariff hikes continues to be reflected in imported food trends in H2 2012, in line with the trend in the preceding half-year when a 120bps jump in the contribution of food inflation in January 2012 was adduced to a +25pps increment in rice levy to 30% that month. Effective 1st July, the FG also implemented a tariff hike of +35pps to 100% for wheat flour, +15pps to

20% for wheat grains – which appeared to help sustain elevated YoY readings through October 2012. However, in absence of sharp depreciation, currency effects were not nearly as evident as in H1 2012. In June, a 1.8% depreciation in N/\$ exchange rate contributed to a near doubling of YoY imported food inflation from the previous month to 18.5%. Nonetheless, more than for any other major component base effects featured prominently in imported food inflation, helping curtail its upward trend. A decline in elevated YoY imported food inflation from an average of 16.4% in June-October to 9.7% in November reflects a sharp drop in MoM changes in that month relative to corresponding period in 2011 (Nov. 2012: 0.7%; Nov. 2011: 6.2%), repeating an earlier pattern in February (February 2012: 7.8%; February 2011: 29.2% MoM) when imported food inflation reached a nadir of 5.7% YoY and helped keep overall imported food trend under control in 2012.

Other items of the basket also proved better-behaved than expected in 2012.

Energy: The surprisingly low (in light of subsidy removal) reading for energy inflation in January 2012 (-0.9% MoM; 6.5% YoY) turned out to be the low point for the year. Jumps in February (4.6% MoM) and June (5% MoM) respectively drove a resumption of normal rate of growth (of ~16-17%) and a further push beyond (21% YoY). The former was related to diesel price hikes as a result of hiccups with the subsidy regime in the wake of the probe while 3-fold hike in Electricity tariff which was implemented 1st June drove the latter. However, the YoY trend has been

(19) FEWS NET is a USAID funded agency that examines food security situation in many countries.

lower since September as the impact of electricity price hikes in September 2011 dropped off.

Core inflation⁽²⁰⁾: As we expected, Core inflation has been on a steadier path after a volatile start to 2012. However, a four-month streak of declines terminated in the latest reading (November 2012) after core inflation rose 70bps YoY to 13.1% with the MoM reading unchanged at 0.4% from October. The NBS attributed this jump to “increases in the Housing, Electricity, Gas and other Fuel division, in particular rental and imputed rent prices, increased liquid fuel prices (such as kerosene due to the prevailing supply gaps), increased air transportation costs, and clothing prices.”

Trajectory keeps 2013 on course for single digit inflation

Food trend remains central to broad inflation outlook. The Agriculture Ministry asserts that it has put in place a recovery programme to jumpstart dry-season farming, with the provision of rapid maturity, ‘improved

(20) As reported by NBS

variety’ seed stock, such that it expects harvests to more than compensate for lost crop. This programme reportedly incorporates a longer term strategy to build up food reserve buffers, as it did earlier in 2012. Incidentally, prices of a basket of food items we monitor have begun to recede.

The muted trajectory already points to benign picture in 2013 and with FEWS NET indicating food stocks are already being replenished from post-flood November harvests, pressure should be reduced. The agency further points to resumption of food flows from surplus (which were not as affected by floods) to deficit areas as well as return of most displaced families (to resume normal agricultural activity) in asserting that overall food demand was easily met. This view is further supported by steady declines in MoM farm produce inflation from September through November by over 50% which is masked by rising YoY trend. Note that, according to the NBS, November food prices also incorporate higher transport costs due to fuel scarcity suggesting that deceleration would have been faster otherwise.

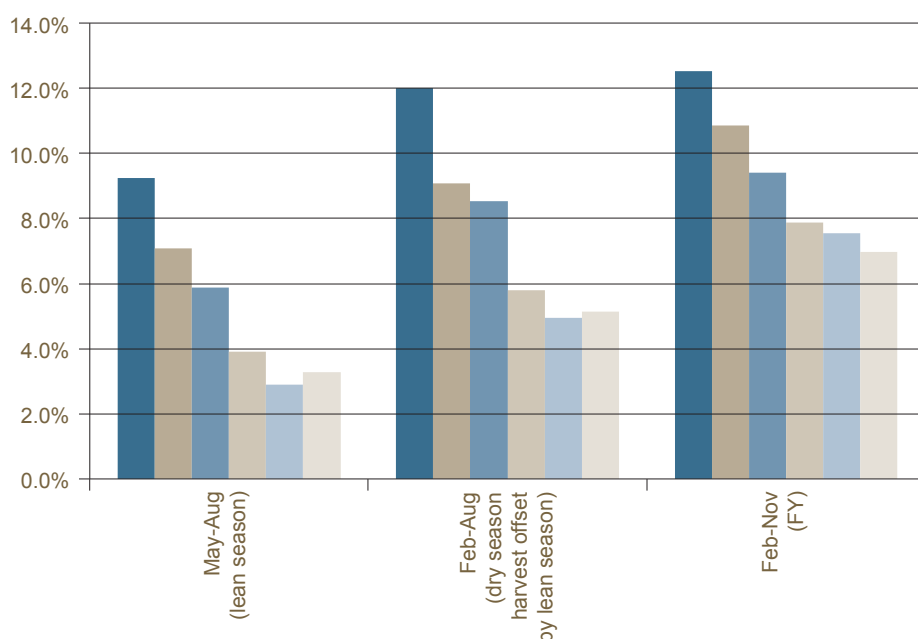
Figure 48

Cumulative inflation trends

Source: NBS, ARM Research

Note: January excluded for FY because of subsidy impact in 2012 and December figures yet to be released

■ 2008
■ 2009
■ 2010
■ 2011
■ 2012
■ 2013E

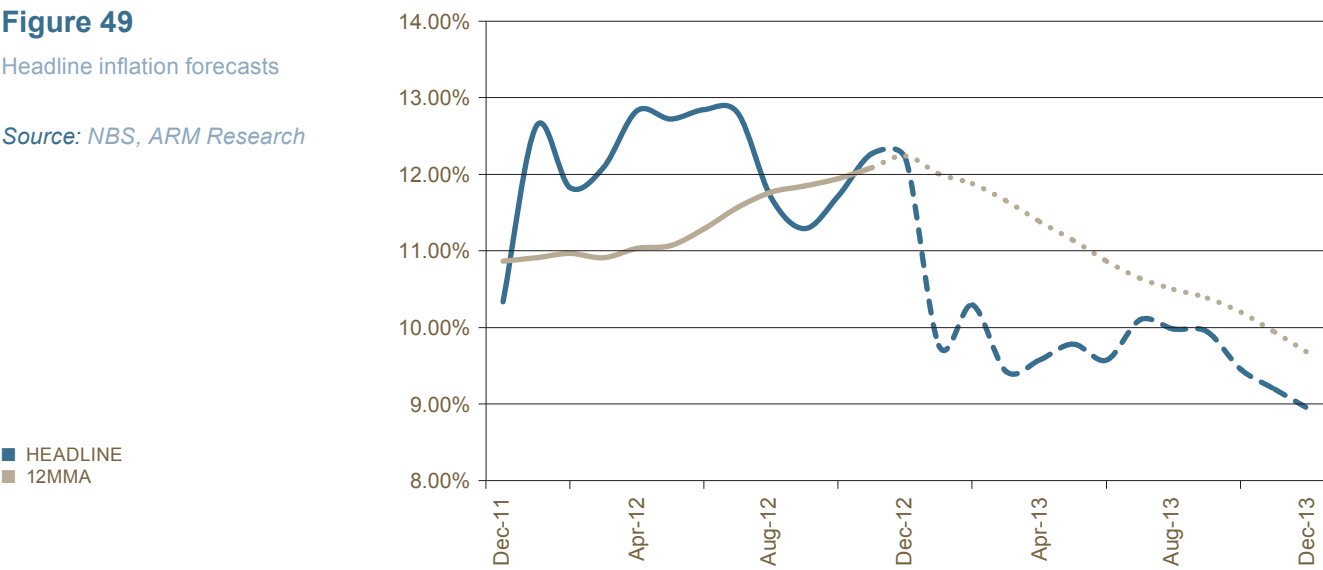


This reinforces our benign outlook for 2013 already evident in a cumulative increase in CPI between February-November⁽²¹⁾ 2012 that is lower than at any other time in the preceding 5 years (see Figure 48). Overall we expect the steady improvement in

(21) Which excludes the significant base effects of the 3.3% rise in headline CPI in January 2012

cumulative inflation to persist and project single digit levels for much of 2013 with an average level of 9.7%+/-0.5%. Single digit readings should commence in January 2013 for the first time in 17 months supported by the elision of 3.3% MoM January 2012 base effect.

Figure 49
Headline inflation forecasts
Source: NBS, ARM Research



CAPITAL MARKET REVIEW AND OUTLOOK

EQUITIES: BULL RUN FOR THE PRICE OF BASE CASE

In our H2 2012 report, we outlined our market expectations in the context of three primary scenarios: bull, base and bear, via which we attempted to link potential market outcomes to impending socio-political and economic events under a probabilistic framework.

Subsequent events mostly bore out our high probability base case scenario both on the domestic and global fronts with our expectations for a wide range of factors—from oil prices and global fiscal issues to domestic growth and socio-economic indicators (See Capital Market Strategy, NSR H2 2012)—falling right in line. As we elaborate further on, market reaction also proved a remarkable match to our expectations in this scenario, aside taking a slightly more bullish tone.

Our bull case was largely hinged on domestic triggers, assuming (as in fact turned out to be the case) status quo on the global scene to provide a sufficient platform. However while none of the three key features of the putative bull scenario—structural changes in the financial sector, progress

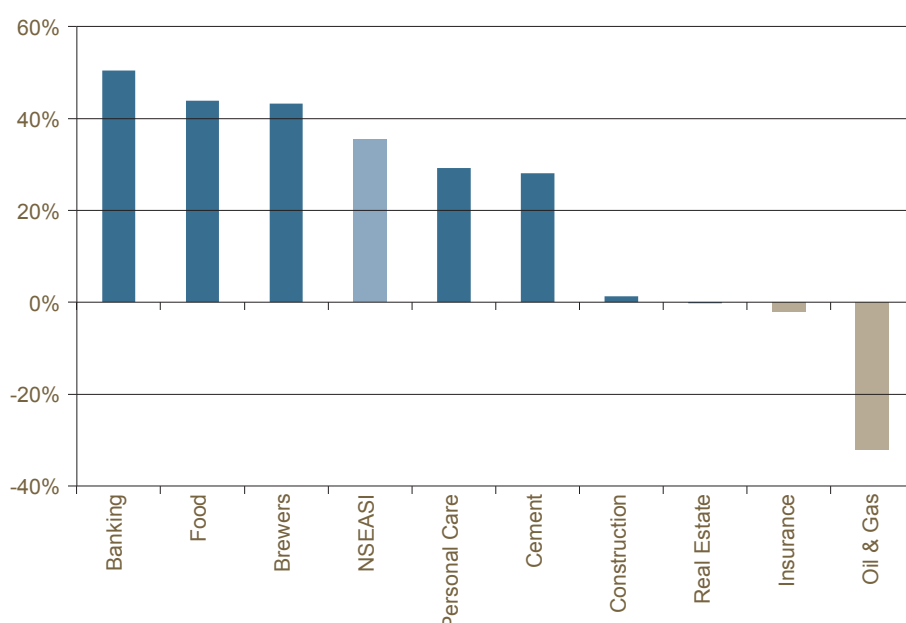
with fiscal and socio-economic reforms and significant monetary easing—manifested in full, the markets were delivered a healthy hors d'oeuvre. One can point to a few areas of modest progress. First, while the SWF did not take off as hoped, the board was at least inaugurated. Also, the PIB scaled the second of three readings in the national assembly and appears on course for passage in some form, though squabbling over its contents continues with oil majors still far from impressed by its fiscal prescriptions. In addition, the security and socio-political situation, while not particularly inspiring, did improve modestly. These developments as well as others triggered positive ratings action in Q4 2012 with S&P issuing an overdue upgrade and Moody's joining the fray on the heels of Fitch's boosting its assessment of the country's outlook.

In one particular area, however, our expectations were let down by proceedings which nevertheless took a turn that well nigh matched our more bullish hopes. Where we expected a “modest” (up to 100bps) cut in base rates that pointedly failed to materialise, the announcement of Nigeria's inclusion in the JP Morgan Emerging Market Bond index ultimately rendered this redundant, delivering a collapse in fixed income yields akin to our more optimistic bullish scenario which

Figure 50

ARM NSE Sector Performance for 2012

Source: NSE, ARM Research



called for rate cuts of up to 250bps base. This turn of events crowns an otherwise middling outcome with one of our primary bull-case drivers. Consequently, those familiar with our analysis will quite likely not have been surprised by equity market trends in H2 2012. The slightly more-bullish-than-expected equity market performance that ultimately prevailed is remarkably consistent with the “base-plus” outcome captured in our interpretation, and therefore validates its premises.

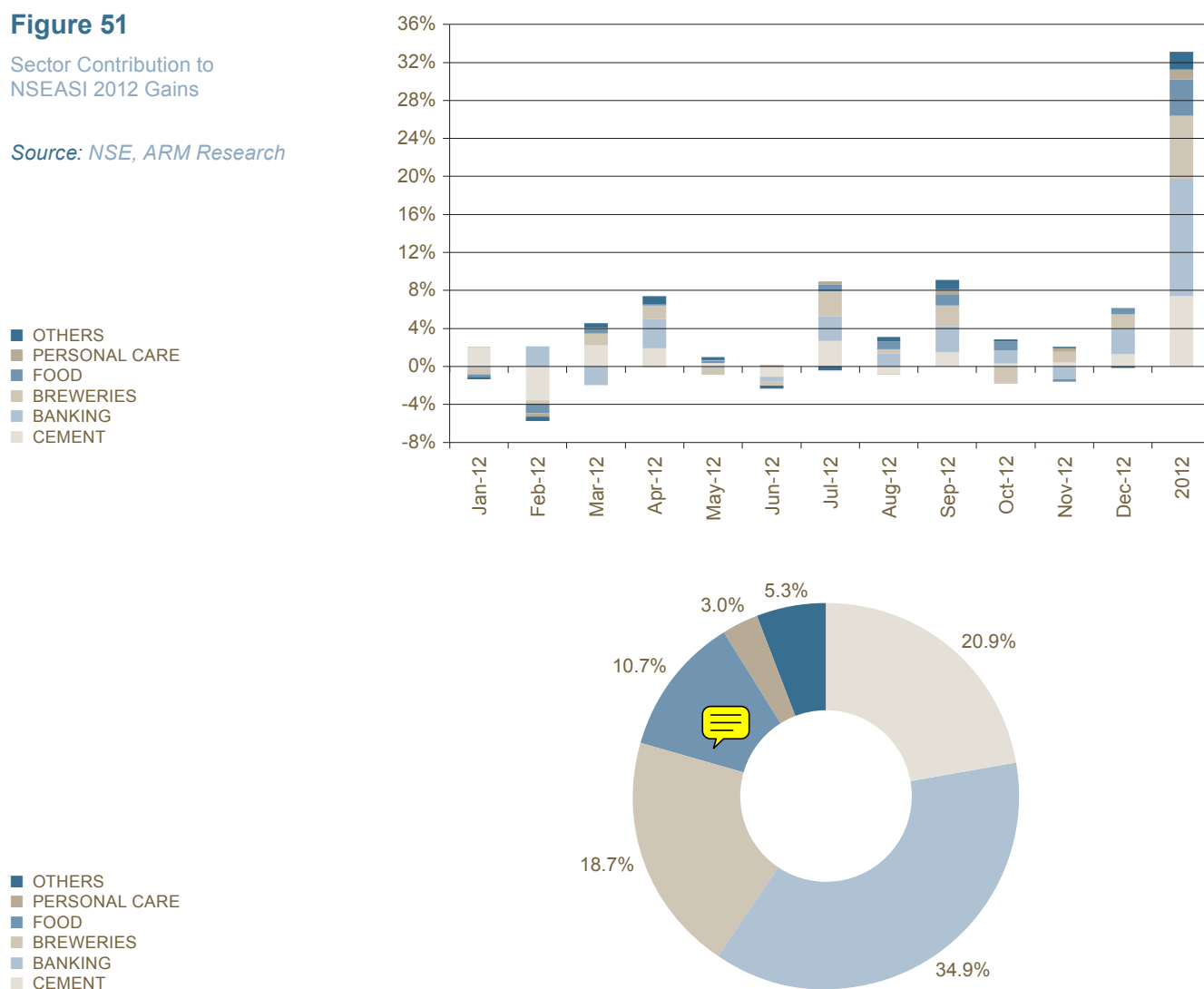
Incidentally, the key market actors delineated in our analysis, as well as the various market segments served as basis for our performance forecasts largely responded as expected. Both our base and bull

case scenarios anticipated a positive response from domestic investors. NSE data suggests that this was indeed the case with domestic investors accounting for ~38% of equity market traded volumes in 9M 2012, up from ~19% in Q1, which proved a significant factor in both market and sector performance. However, even more important was the role yield declines apparently played in the equity market’s uncharacteristically strong H2 returns. The NSEASI witnessed its biggest monthly gain of 2012 in September, surging 9.1% during the month across virtually all sectors, just as yields contracted sharply on the heels of the JP Morgan announcement. Equities thereafter clung (sometimes tenuously) to these gains through Q4, as yields steadied.

Figure 51

Sector Contribution to
NSEASI 2012 Gains

Source: NSE, ARM Research



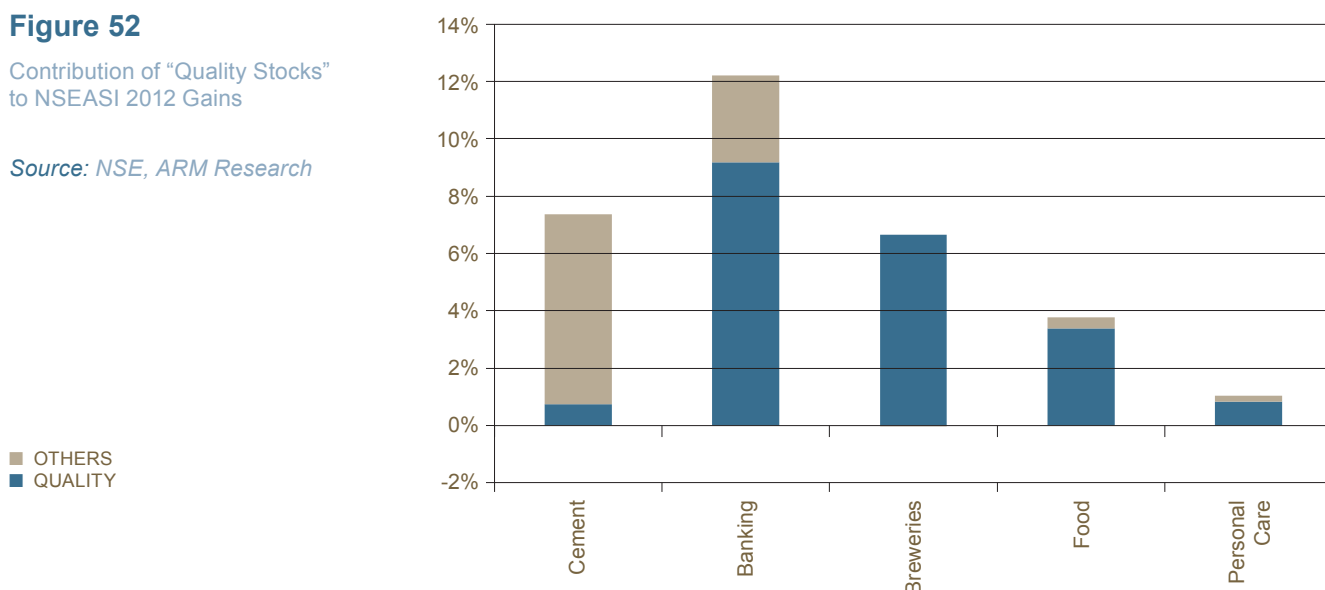
Our expectations for strong performance in the Banking, Food and Personal Care sectors also panned out though similarly vibrant gains amongst brewers came as a surprise. Also consistent with our base case, foreign investors played the leading role in market movements, but the influence of emergent domestic investor interest was clearly evident in the broader scope of activity

across sectors. Overall our thesis was intact. In line with our base case scenario, as a group, the most highly capitalized and liquid “quality” stocks on which foreign investors are typically focused were primarily responsible for positive market performance. However, as anticipated, stocks on the quality periphery—particularly in the Banking sector—also rallied.

Figure 52

Contribution of “Quality Stocks”
to NSEASI 2012 Gains

Source: NSE, ARM Research



While improvements on the domestic front helped lay the groundwork for equity performance in H2 2012, it certainly still bore strong imprints of global influence in its key drivers particularly via the still decisive role of foreign investor interest and the impact of yield declines which was also largely driven by foreign portfolio inflows. With hindsight, considering the risks the global economy had to contend with, investors were exceedingly fortunate to escape a market meltdown. This, of course, owes much to concerted efforts by governments and financial sector regulators in leading economies to ward off disaster amid a growing consensus that extraordinary measures were required. However it is also quite fortunate that a capitulation of sorts by fiscal hawks (as illustrated, for instance, in the outcome of the US general elections and the subtle shifts in position by IMF and European policy makers on the appropriateness of austerity measures) helped create the enabling environment for much more robust fiscal and monetary response, in contrast to 2011. The combined effect of these was that the probability of our bear case materialising was greatly diminished in H2 2012, as we had anticipated.

HEADY HALF YEAR FOR BOND MARKETS

The DMO issued ₹411.49 billion worth of bonds in H2 2012, bringing the total for the year to ₹988.76 billion; 15% higher YoY and ~29% above its scheduled issuances for 2012. On a net basis, the DMO borrowed an additional ₹716 billion in 2012.

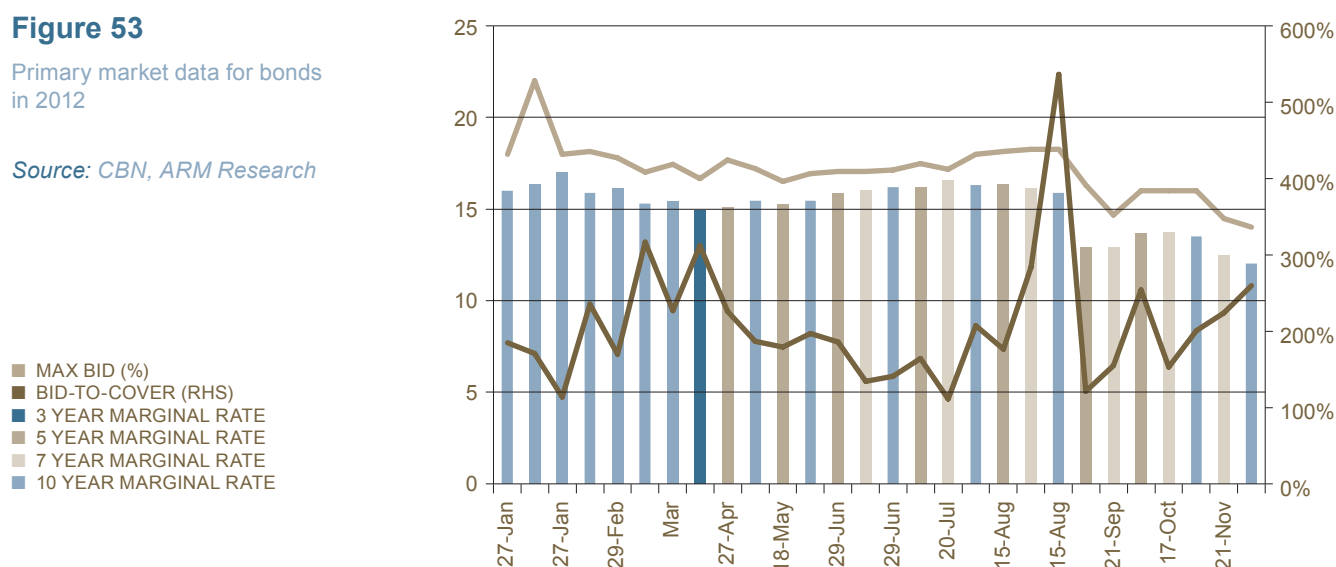
On the back of a sharp increase in non-competitive allocations in February (₹41 billion), March (₹50 billion) and June (₹48.7 billion), much of that borrowing came in H1 2012 indicating a better controlled issuance in H2 2012 in spite of improved liquidity conditions in the latter period, suggesting greater discipline in the latter period.

The DMO also remained responsive to market preference for tenor risk exclusively issuing intermediate term paper in H2 2012, the 7-year paper featuring regularly after initial introduction in June 2012. Reflecting rising demand, primary market yield declined significantly in September, aided by JP Morgan index inclusion, with a further dip in October/November due to improvement in liquidity conditions.

Figure 53

Primary market data for bonds in 2012

Source: CBN, ARM Research



Turning off the switch

Notably, the improvement in rates defied the suspension of a proposed bond-switching program which had been expected to allay market concerns regarding a sharp rise in maturities in 2013. As we suspected earlier, the switch turned out to be a non starter as the DMO's hopes for lower costs in switching maturing bonds failed to materialise given its implicit attempts to dictate pricing amidst other transactional constraints around (largely unfavourable) treatment of the target bond holdings on banks' books. Furthermore, in our view, the proposed program in actual terms did little to address the structural concerns of uneven maturity profile with concentration in the short end. However, if there are any concerns about the government's ability to refinance maturing bonds in 2013—a question which also pertains to AMCON bonds, whose quantum (and narrow maturity window) have recently returned to the forefront—it does not appear to have been reflected in fixed income markets in H2 2012.

AMCON bonds: waiting to exhale

The release of financial results by AMCON itself, late in Q4 2012, has done little to instill confidence in the institution's ability to seamlessly refinance the maturing bonds. AMCON reported operating losses for FY 2011 of ₦2.3 trillion mostly related to MTM haircuts on acquired loans. The results also put the size of the sinking funds by banks at ₦153billion currently and expected to attain ₦400billion by FY 2013 with plans to increase banks contributions by 20bps to

0.5% of assets. Whilst a more aggressive recovery drive in 2012 appears to have yielded fruit (with a ₦141billion from Zenon alone eclipsing the 2011 total of ₦85billion) the diverse reported figures fall well short of the ~₦4trillion bonds maturing within a 6month window starting 31st December 2013. At a point, news of a ₦600billion buyback of AMCON bonds by CBN from one of the acquiring banks raised possibility that resolution may come through the back door where the bonds are effectively monetized. However indications have emerged that this was a one-off transaction (the motivation for apparently preferential targeting which remain unclear) and the bulk of the bonds will remain outstanding at maturity, posing a major challenge going into 2013 which, as we have long anticipated, could yet rile investors as maturity approaches.

Yield declines reflect increasingly favourable environment...

Indeed gains in the domestic bond market in spite of concerns about refinancing maturities, failure of switch program and hawkish monetary policy highlight the positive impact of a number of factors. Nigeria's inclusion into the JP Morgan bond index at a 0.7% weight was an especially material development that led to a sharp rise in portfolio inflows into FGN debt and is estimated to have attracted \$2.4billion direct inflows into domestic bonds particularly into the 2017 and 2022 bonds that were slated for inclusion. In a clear sign of its influence, yields across all segments of the bond market dipped ~400bps in the one month following the mid-August announcement—after having

risen nearly 50bps in the prior month following the MPC's July action. Further gains in Q4 largely appear to reflect domestic liquidity with improved budgetary releases in combination with significant maturities from T-bill markets and announcement of inclusion into the Barclays bond index. While base rates appear to have set the floor for yield declines, the aggregate impact of these events drove bond yields slightly below MPR by the December auction, leading to a curve inversion as investors sought to lock in the yields for longer.

...as Nigeria's sovereign Eurobond yield signal broader trends

The Eurobond also witnessed a remarkable 2012 with near-unbroken declines from year

start. Amid general rise in capital flows towards more fundamentally sound EM markets, the yield improvements were underpinned by fiscal positives (including low budget deficit and SWF creation), positive ratings action—though the latter didn't appear to have altered the trajectory very much suggesting markets were well ahead of ratings agencies. As we canvassed earlier in the year, the favourable yield trend has apparently encouraged government to double proposed issuance for 2013 to \$1billion, though we believe there is far greater scope (and reason) to do more amid improvements in overall fiscal conditions and substantially more prohibitive domestic yields held hostage by monetary policy.

Figure 54

Nigeria's Sovereign Eurobond yields (%)

Source: Bloomberg, ARM Research



DIMINISHING “TAIL RISKS” BOOST OUTLOOK

Beyond the fiscal valley—vanishing tails meld into the mainstream

As indicated by our earlier analysis, we side with a growing consensus that the global economy may find new traction in 2013. While it is probably too early to pronounce it a definitive turning point given the many risks that still lie ahead, we are increasingly confident that the worst of the recent global financial/economic crisis is already behind us. In our base case expectations, Europe will most likely dawdle but we see a firm line finally being drawn under its lingering

fiscal crisis and uncertain future. Nevertheless, three of the most important economies—the US, China and Japan—all appear set for an, albeit tepid, revival. In particular, underpinned by fundamental restructuring that is well underway household and corporate balance sheets across the economy, we view the potential clarification of US fiscal outlook beyond the “fiscal cliff” and “budget hill” as a signal event for the global economy with positive implications for asset markets across the globe. Furthermore, as hawkish policy positions increasingly lose ground in the economic debate, providing greater headroom for the implicit “puts” on the global economy. We believe such initiatives as the Fed’s “conditional” stimulus programme and deepening commitment by fiscal and

monetary authorities in major economies to growth-boosting interventions, profoundly change the nature of the risks facing the global economy in 2013.

In our view, coordinated stimulus programmes and copious assurances by policy makers has succeeded in significantly attenuating tail risks—and many potential problems have loomed so protractedly that they have, in fact, lost much of their capacity to surprise or dismay markets. Heading into 2013, it also appears that the potential for event risk in much of Eurozone's more recent trouble spots—Greece, Spain, Italy—are gradually succumbing to containment efforts. Even the global economy's current main bogey, the US "fiscal cliff", may have lost much of its "shock effect" as investors become increasingly accustomed to the last-minute antics of US lawmakers. In our view, the ongoing US fiscal drama is increasingly being interpreted as a process rather than an event and we believe the fallout of the debt-ceiling face-off that will doubtless take place towards the end of Q1 2013 will have a much more limited impact than the similar event in Q3 2011.

The key implication of this perspective is that the potential "tail risks" from unforeseen adverse developments on any of the many potential threats to the global economy have gradually been subsumed into more conventional risk factors. No doubt, we see increased likelihood of a prolonged and listless recovery, and substantial inertia from inevitable efforts

by major central banks to unwind overly generous economic band-aid programmes. We also see distinct risks that, wearied from long standing accommodation, apex lenders like the US Fed may be overly eager to pull the plugs on stimuli at the merest signs of economic life; sending a signals that could have a disproportionate negative impact on asset markets that have become accustomed to easy conditions. Nevertheless, implicit in these projections is a relatively subdued inflation outlook, which may temper more aggressive adjustments to monetary policy. Moreover, given the current fragile state of global economy, well dimensioned, devil-you-know-esque, conventional risks are a far more palatable to global asset markets, and we see the transformation of risks alluded to earlier as having a major bearing on their probable trajectory.

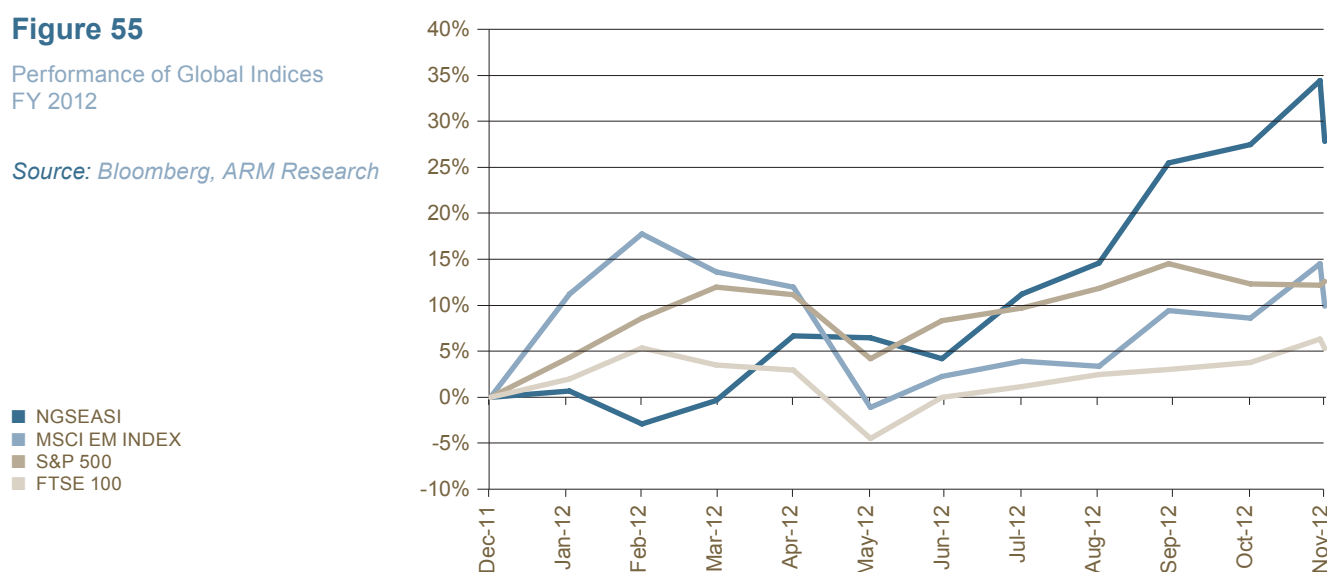
Nigeria assets to swim along with global currents

This view is critical to our Nigeria outlook through two primary channels. First, as we argue further on, the specific policy choices adopted by Nigeria's economic managers have tied its economy much closer to global currents via its long-standing exposure to soft commodity price movements, particularly oil. In addition, a marked increase in the country's visibility in line with a broader trend in emerging markets have made potential portfolio flows a much more significant variable in the country's market and economic outlook.

Figure 55

Performance of Global Indices
FY 2012

Source: Bloomberg, ARM Research



On the commodities front, prospective return to modest global growth and generous stimulus programmes are two key tailwinds in 2013. However, it is also true that previous stimulus has played a role in the relative resilience of commodity prices since the 2008 meltdown. So how do our relatively optimistic economic expectations and attendant fears that stimulus programmes may be heading for early retirement factor in price expectations? To this clearly complicated question we propose a rather tentative rejoinder. We believe that, while it is beyond question that repeated stimulus has helped buoy commodities prices, the fact that they have remained relatively robust for so long suggests that pricing is also underpinned by consumption demand for most commodities. In addition, even as the Fed and other central banks begin to readjust, there is still considerable scope for capital to be reallocated towards riskier assets to compensate for higher funding costs. Thus, absent a major adverse event that could cause a (temporary) retracement, we believe prices are well supported at current levels over the medium to long term and while we do not expect spikes in the prices of most soft commodities in the near to medium term, we do not foresee a collapse either.

This is particularly true for oil prices which are central to Nigeria's global linkages. With recent oil findings and growing output from unconventional sources, equilibrium appears to have shifted decisively in favour of the demand side in recent years and much has been made about the new socio-economic and political dynamic implied in growing US domestic production. However, as highlighted in our previous analysis, ongoing attempts to stimulate demand in the leading emerging economies of the East do bode well for global energy demand in the near to medium term. In this regard, it is instructive that there is still little indication of major changes in price trends associated with regional (and overall demand) supply-balance despite long standing dichotomy between the US WTI and the global Brent benchmarks. We posit that the relatively slow convergence of these two benchmarks supports the view that any correction in oil prices to a new, lower, equilibrium level will be gradual.

Domestic outlook—entering consolidation mode

Global developments will certainly play a crucial role in Naira asset price movements in 2013. However in keeping with the approach we have adopted over the

past couple of years, our outlook for 2013 still draws upon a framework that maps the distinct influence of foreign and domestic investors into probable capital market outcomes.

The revival of domestic investor interest we had anticipated paved the way for a broadest and deepest market rally since the 2008/09 financial market crisis, which puts domestic issues back in the forefront of market near term drivers in our view. However, in the context of the changes we expect on the global economic and investment scene, these issues also carry considerable weight amidst significant reallocation of investment capital we foresee among the broad variety of global investment managers that have fuelled foreign portfolio flows into Nigerian capital markets over the past few years.

With this in view, while many of the major policy initiatives we identified in past reports have yet to fully materialise, it is instructive (and somewhat heartening) to note that after a tumultuous first year for the current administration, policy direction appears to have settled into a more positive pattern. Improving fiscal balances and reserve growth have been notable features in recent ratings action on Nigeria and with successful conclusion of the primary phases of the power sector reforms, the prospects for this all important item appears to have taken definitive positive turn. Also, long awaited release of the pension administration guidelines have also set the tone for important changes in the investment landscape which are largely positive and these developments will likely serve to underpin a growing sense of confidence in the Nigerian economy in 2013. However, despite recent progress, important drivers like the PIB and SWF are still clouded by some measure of uncertainty.

We have never quite given much credence to the influence of domestic monetary policy on real macro-variables and investment flows. In our view, monetary tightening as implemented by the CBN has been largely ineffective in achieving its putative goals of price stability. Indeed, despite all of the MPC's recent efforts in this regard, prices have been anything but stable and have largely been driven by factors outside the control of monetary authorities. In addition, the CBN/MPC rate policy, far from having any positive impact on markets, has merely constituted a distortion, around which market yields continue to contort unintuitively and to no constructive effect. However, in setting the floor for fixed income rates, monetary policy features heavily in

setting Naira asset prices, while implicit guarantees on the exchange rate have also acted as a confirmatory secondary signal—and will perhaps remain so long as oil prices remain well behaved as a pointer to CBN's actual ability to maintain its implicit peg. We see few changes to this picture: monetary policy in Nigeria will likely continue to have limited impact on real economic variables or investment inflows. Nevertheless, policy direction is still central to a long overdue domestic capital reallocation we anticipated since we concluded that policy tightening had outlived its usefulness by the end of 2011. However, while hypothetical considerations evidently continue to preclude an objective assessment

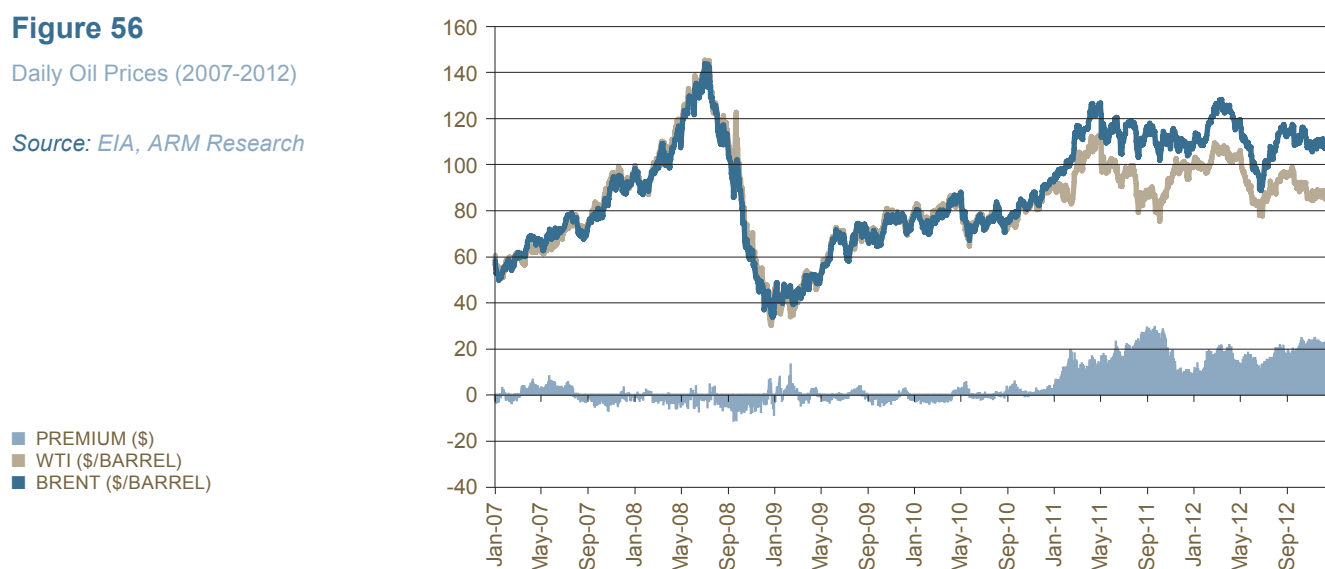
of policy effectiveness in the deliberations of the MPC, we see in impending macro-developments, a continued erosion of the basis of its assumptions, hopefully leading to a useful re-evaluation of its current stance.

On the whole however, in contrast with the rocky start in 2012 which opened to a series of policy upheavals, our interpretation of ongoing developments suggest diminishing downside risks from domestic policy in 2013. In particular, while many major policy items could still be derailed, we now see a much higher—and growing—probability that outcomes on these items would be positive.

Figure 56

Daily Oil Prices (2007-2012)

Source: EIA, ARM Research



Changing nature of risk to drive investment behaviour

Central to our projections for market movements, we believe that prospective changes in global economic fortunes will drive significant alterations in asset allocation and draw inferences for Naira assets from this conclusion. To assess how these changes could affect Naira assets, we categorise foreign investors with exposure to Nigeria along three broad buckets with respect to risk appetite implied by the assets they hold: Nigeria's Eurobond, Naira denominated FGN paper, and equities. Under fairly loose set of assumptions, this rather arbitrary classification serves two key purposes. First, it provides a rough framework upon which drivers of—and risks to—capital flows toward Nigerian assets can be assessed in the

context of global developments. Secondly, it helps us explore the impact of potential shifts in foreign investment flows and the attendant impact on naira asset pricing.

To proceed, we make broad conclusions about the characteristics of investors in the identified classes. We assume that Eurobond investors are liability driven and relatively risk averse. Nevertheless, they have enough need for yield pickup that the obliteration of real returns in DM fixed income under a deluge of stimulus has prompted a move beyond traditional credit bounds—though this has come in our view, with high-levels of risk awareness. In our estimation, such investors do not necessarily follow Nigerian developments closely and typically default to a summary indicator of fiscal health, such as oil prices. Such an interpretation would be consistent with the

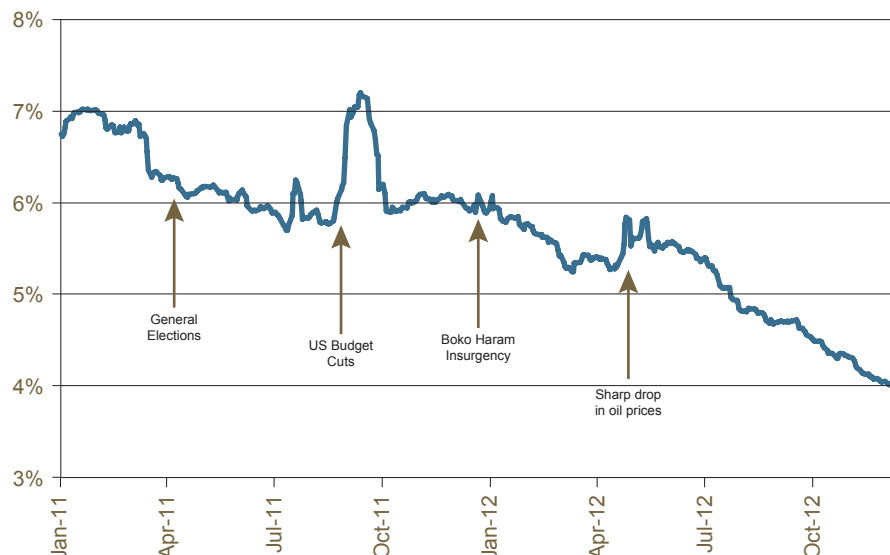
sensitivity of Nigeria's Eurobond yields to oil price declines, but virtual inertness to much of the internal

socio-political and macro-economic developments that we have observed since its January 2011 launch.

Figure 57

Nigeria's Eurobond Yield

Source: Bloomberg, ARM Research



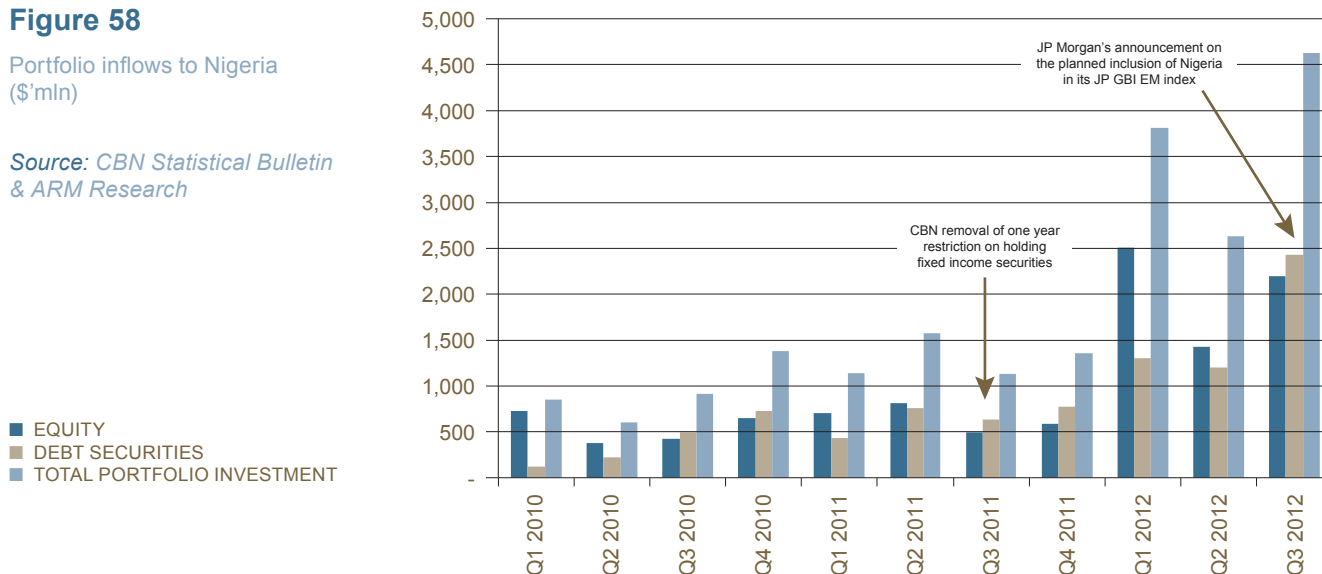
The original investors in FGN bonds (and T-bills) were clearly somewhat less concerned about currency risk—or perhaps took a strong view of Nigeria's ability to maintain stability—and would presumably also be quite familiar with domestic developments. While therefore not particularly risk averse, we assume these investors were rather sensitive to price volatility. Little surprise, then, that portfolio inflows were a relatively small proportion of overall fixed income market activity and had tended to concentrate in

money markets—until Nigeria's inclusion in the JPM Bond index. A second sub-category emerged from this group: indexers, who presumably share a similar risk profile but likely have a different orientation and holding strategy, by virtue of their investment style. Given the changes in flows to this segment since the announcement of the index inclusion, it is safe to say that indexers will probably dominate this group of investors henceforth altering trends in capital flows via this segment.

Figure 58

Portfolio inflows to Nigeria (\$'mln)

Source: CBN Statistical Bulletin & ARM Research



Foreign investors have driven equity market activity in the past few years. However, using market value traded—and foreign portfolio contribution of this—to proxy holdings, we estimate that net holdings of domestic stocks stands at ~ \$2.8billion. Instructively, relative to free float, we estimate that average annual churn on the NSE is less than 40%, suggesting that current group of foreign investors in the NSE are

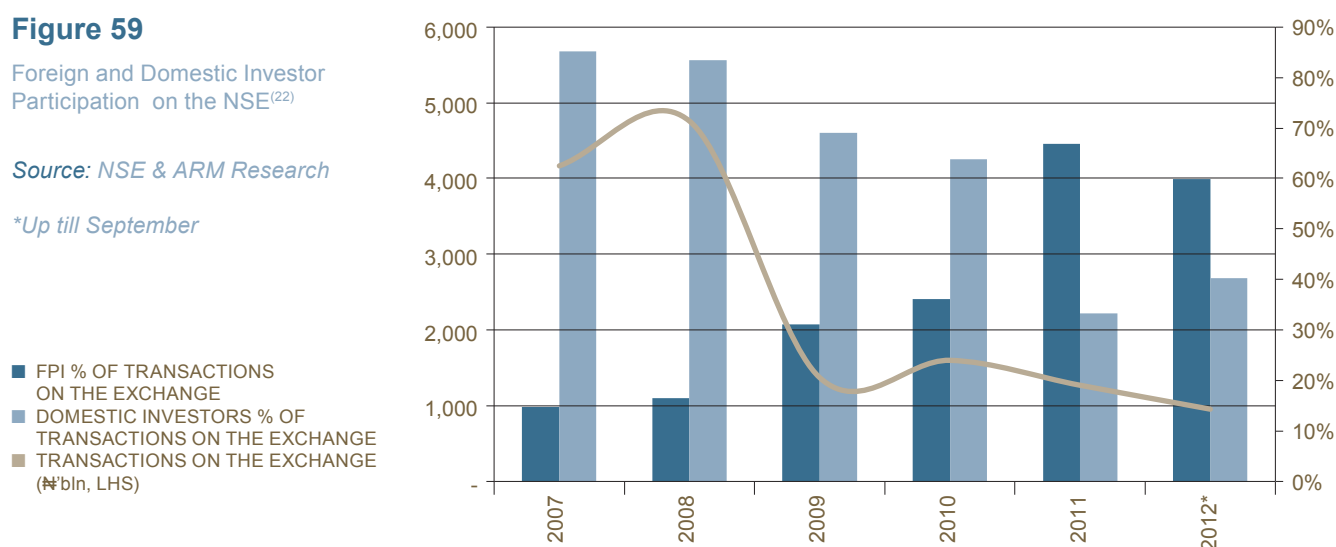
relatively long term holders with a strategic orientation. Along with liquidity constraints and difficulties associated with obtaining reliable information, this may help explain focus on quality stocks. This consideration also suggests that such investors are theme focused, and may also explain the relatively high valuations they apparently set on market leaders in a particular theme (e.g. consumer sector).

Figure 59

Foreign and Domestic Investor Participation on the NSE⁽²²⁾

Source: NSE & ARM Research

*Up till September



Reforms likely to encourage further yield declines

Given the impact of global conditions and capital flows on domestic yields, it is important to appraise sustainability of these flows and we believe reforms to be a key factor that shapes outlook. While Nigeria's reform drive already received some validation from recent ratings upgrades and thus would presumably have been reflected in market pricing to some extent, we believe progress with key initiatives, including the power privatisation process, PIB and SWF could still drive further foreign interest in the domestic market. A recent IMF paper⁽²³⁾ sought to extend the study of capital flows to domestic bond yields having highlighted hitherto focus was on Eurobonds. The paper concluded that whilst fiscal variables do not seem to be a significant determinant of domestic bond yields in emerging economies during tranquil times in global markets, to quote the authors, "when market participants are on edge, they pay greater attention to country-specific fiscal fundamentals,

revealing greater alertness about default risk." We heartily subscribe to this conclusion which, in fact, constitutes one of the bulwarks of our market outlook for Nigeria in 2013.

Overall, whilst global outlook remains mixed, major central banks have demonstrated unwavering commitment to providing liquidity which underpinned portfolio influx in 2012. On the domestic front, the status quo in monetary policy increasingly appears like the worst case scenario, in which case we expect rising maturities and possible early budget implementation to improve liquidity and underpin further rate declines. These could significantly accelerate should long-anticipated rate cut materialise in 2013, especially if reform gains persist. The latter could be an added justification for foreign investors whose continued interest is implicitly underwritten by CBN commitment to currency stability.

Notably, in spite of massive yield declines, differentials between Nigeria's Naira and dollar denominated which still stands at ~ 8pps (down from more than 13pps in Q3 2012) still implies that

(22) Transaction on the exchange is defined to include purchases and sales.

(23) Jaramillo and Weber, August 2012 <http://www.imf.org/external/pubs/ft/wp/2012/wp12198.pdf>

domestic bonds will still attract substantial interest from investors seeking Nigeria risk. The extent to which these factors will outweigh uncertainty around impending maturities remains to be seen but the 2013 budget signals substantial cuts in government borrowing corroborating repeated assurances from the Finance Ministry about the government's intention to substantially reduce outstanding domestic debt. In our view, public asset sales, about which the 2013 budget is virtually silent, or privately arranged restructurings (particularly for AMCON bonds) appear to be the only viable means around this conundrum. Nevertheless, should the government retire the nearly ₦176 billion implied by issuance proposed in the budget versus impending maturities, we anticipate substantial further yield compression, particularly if accompanied by base rate cuts.

PAYING HEED TO KEY RISKS

By virtue of the approach we have adopted, our 2013 outlook has been framed on a narrower set of premises that are primarily hinged on a more robust global economic and investment climate in coming months. Needless to say, this constitutes the biggest risk to our outlook for despite the diminution of the worst tail risks, the global economy still faces substantial uncertainty and, as indicated earlier, even recovery carries its own risks (e.g. premature removal of policy supports).

Incidentally, unlike the case for many financial assets, the market does not appear to have priced event risks into global commodities which have proved quite resilient, in general, post-crisis. From Nigeria's perspective, this is problematic for two key reasons.

Figure 60

S&P Goldman Sachs'
Commodities Index

Source: Bloomberg, ARM Research



First, despite our relatively benign near to medium term outlook for the commodity, we believe oil prices to be particularly vulnerable to event risk given profound changes currently occurring in its global crude oil supply chains /consumption patterns and the commodity's highly cyclical tendencies.

Secondly, we argue that recent CBN policies have served to tie the fates of Nigeria's asset markets to oil prices via the reserve channel. Specifically, by maintaining elevated policy rates to attracting portfolio flows while simultaneously maintaining a hard peg on the Naira, monetary authorities have essentially

acted to shore up the currency by underwriting foreign investment. However the effectiveness of such a strategy presupposes some measure of control over the primary driver or forex reserve growth—oil in Nigeria's case—which the CBN clearly does not have. A sharp deterioration in oil prices immediately calls into question the viability of the CBN's implicit guarantees and would clearly imperil the latency of portfolio investments, precisely at a time when the economy can least afford this.

We note here that while Naira exhibits low correlation with energy prices in normal market conditions,

this relationship strengthens in a highly asymmetric fashion in periods with shocks; i.e. sharp drops in oil prices tend to have an outsize impact on the Naira⁽²⁴⁾, probably reflecting the vulnerability of the CBN's peg. Thus, market stability have become more dependent on the implicit assumptions about energy prices holding firm and we believe both currency and reserve trends will be closely watched as indicative parameters for capital market outlook; and will likely have outsized impact in coming quarters.

There are mitigants in the fact that the Nigeria's imports also feature a significant energy component such that the impact of a drop in oil prices on reserves is often moderated by lower import demand for forex. It is also true that the risk lie more in a sharp and disorderly decline in oil prices as a gradual decline allows orderly

fiscal adjustments that limit the damage. However overall risks to Naira assets from these channels are non-trivial and probably more pronounced for fixed income markets, the assumption being that equity investors are less sensitive to volatility.

We also note that more robust than expected improvements in US economy lead to less focus on EM even as earlier removal of stimulus robs the EM trade of substantial liquidity. There is also an inherent risk for Naira assets here given Nigeria's growing ties with international markets, in that the increasing view of EM as a theme will tend to propagate any significant shocks in one EM economy across markets in this space. While this is likely a low probability event, it lingers as a tail risk that accompanies global recovery.

(24) This analysis is based on the NGN-USD in interbank markets

CAPITAL MARKET STRATEGY

Employing our recent methodology, we adopt a thematic approach to navigating our capital market strategy for 2013. However, in acknowledgement of the broad range of outcomes that could arise with substantial changes in market mood—such as we anticipate in 2013—we embrace a minor variation to our last report, focusing on a variety of themes and their possible outcomes rather than framing these under scenarios. The leads we explore and the inferences we draw are informed by the foregoing analyses of trends and their consequences.

A more thematic interpretation of Nigeria outlook ahead

It is clear that the increased visibility Nigeria has gained in recent months from its inclusion of Naira assets in a number of global indexes clearly has important ramifications for capital markets. What may

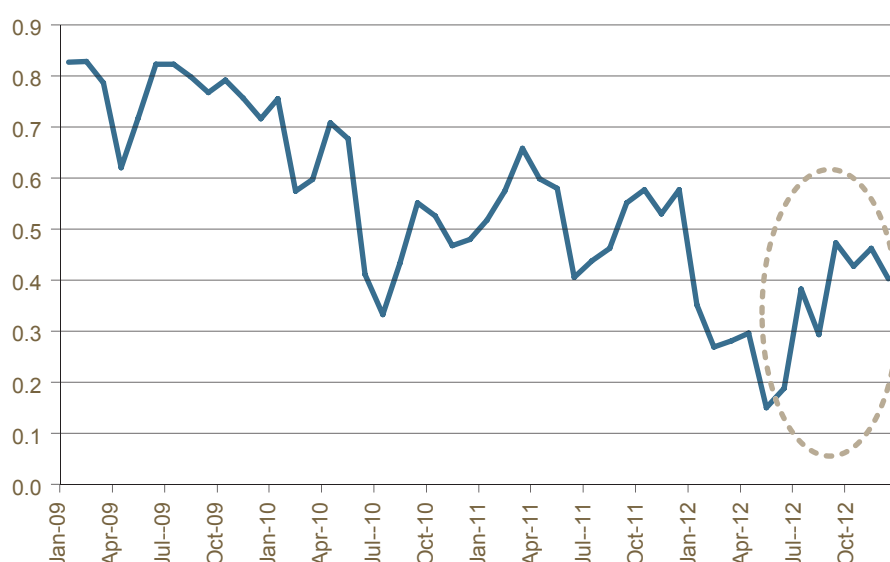
not be so obvious is the way it could influence pricing across assets. In this regard, it is instructive to observe the changes that have already manifested in 2012 where near exclusive foreign investment interest in the major brewers, NB and Guinness over the past few years widened to accommodate an ongoing focus on the broader consumer space. In our view, this transition accounts for the belated rallies in the food and personal care segments in H2 2012.

The rolling correlation analysis that formed the springboard of our theme focused approach in the last few reports reveals some interesting patterns that support this view. First, we note the substantial increase in rolling correlations between the NSEASI and the MSCI frontier market index in H2 2012, after a rather peculiar divergence over the past three years had suggested that Nigeria was increasingly decoupling from global themes.

Figure 61

NSEASI Rolling Correlation
with MSCI Frontier Market Index

Source: Bloomberg, ARM Research



Nevertheless, it would be helpful to examine the earlier breakdown in correlations. With the banking sector accounting for nearly two thirds of total capitalization at the beginning of the crisis in 2008, its tumultuous multi-year decline through 2011, on the back of industry specific factors, certainly meant that the overall index would reflect its idiosyncrasies.

In our view, this probably helped drive the sharp deterioration in the NSEASI's correlation to a wide range of indices over the period as highlighted in our H2 2012 NSR. It is, perhaps, also not surprising then that these correlations have been on the rise with strong recovery in the banking sector in H2 2012.

This consideration raises an important reflection for framing our outlook. By implication, the increasing identification of Nigeria with themes will correspond with rising dominance of summary statistics in shaping investment sentiment towards Naira assets. In particular, for good or ill, Nigeria will wear the oil economy label for the foreseeable future and energy sector trends will continue to loom over its capital markets.

Positive drivers line up for Naira assets

Following from the previous point, we see a distinct opportunity in the nexus of the materialisation of key items in Nigeria's quest for economic reform. As we noted earlier, the likely fruition of such initiatives as the privatisation of the power sector, implementation of new guidelines for the pension industry, the launch of the SWF and possibly the PIB etc. at a time when the profile of many frontier markets has been advanced by global focus on growth oriented themes is quite fortuitous, and has already begun to manifest in positive ratings action and the inclusion of Nigeria in global capital market indices. We believe the materialisation of a series of positive macro-economic markers in 2013 could help promote a more positive interpretation of Nigeria's prospects among investors, boosting capital markets.

In terms of their direct capital market impact, two of these—the implementation of the new pension guidelines and the launch of the SWF—are particularly important. While much of our expectations have failed to materialise until now—as we highlight later—the

timing of the release of the long awaited guidelines which prescribe a wider range of asset classes in Q1 2013 keys into favourable contemporaneous global developments. Also, while the SWF is still beset by uncertainty, the March 2013 timeline for commencing investments—with recommended focus on domestic assets—also ties into this trend. We have already noted that the SWF has far greater potential to increase investible capital in Nigeria than the pension industry. It is probably also helpful that market has yet to price the full impact of these and other significant developments on the macro-policy front, which preserves the substantial—in our view—upside available from these developments.

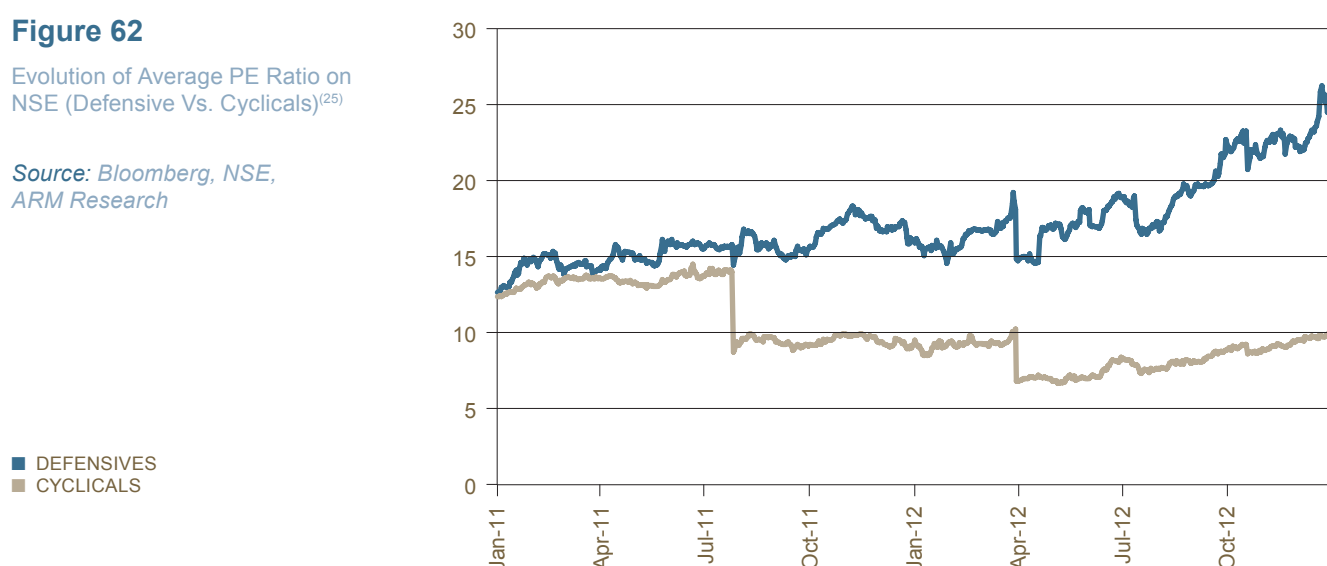
Indexers to drive foreign interest

The recent spotlight put on Nigeria by ratings agencies and global indices, as well as its recurrent identification with countries at the vanguard of potential global growth, suggests the country will attract substantially more attention than in the past. However, we also believe rigidities in domestic capital markets (especially with regard to size and liquidity) make it more conducive for indexers than active investors. This phenomenon can certainly work both ways with regard to the latency of portfolio investment flows but, overall, the increasing prevalence in the growth theme and the difficulties associated with trading money in and out of Nigeria's relatively small capital markets, leads us to believe that increased tendency towards indexing (and use of ETFs) will generally tend to improve stability.

Figure 62

Evolution of Average PE Ratio on NSE (Defensive Vs. Cyclical)⁽²⁵⁾

Source: Bloomberg, NSE, ARM Research



(25) We proxy defensives with Food, Personal Care and Brewery Stocks and cyclicals with Banking and Cement sectors

Consistent with the thematisation of Nigeria's capital markets, we expect a broader macro-view of the economy to take increased precedence over sector specific considerations.

There are two key inferences that may be drawn from this. First, while valuation for defensives—particularly of the high quality variety—have diverged from the broader market, playing into the global defensive theme that has held sway over the past few years, a more thematic view of Nigeria's prospects could result in a tendency towards convergence in valuations across major sectors. This rerating has also been supported by this sector being among the most liquid and visible on the Nigerian bourse largely owing prevalence of subsidiaries of global brands in this segment.

Less emphasis on defensive theme

To be clear, the combination of potential growth and downside protection offered by the defensive theme—particularly in EM space—in the current risk sensitive investment climate is quite powerful and capable of keeping valuations elevated for an extended period. Significantly however, we believe an improving global economic climate in 2013 will prove slightly more favourable to cyclical themes, as defensives lose steam precisely because valuations in the latter segment have diverged. In Nigeria we expect this to manifest in a moderation of gains for the more highly valued consumer sectors (particularly brewers and the high quality segment of the food industry) a trend that will likely be underpinned by an increased focus (on the part of foreign investors) on getting broader exposure to Nigeria and a more active—and price sensitive—domestic institutional investor base.

A second dimension to this trend arises from the acceleration of domestic investor interest we anticipate over the near to medium term. As domestic investors are more familiar with a broader range of stocks and presumably more sensitive to widening valuation gaps, we believe revived local interest in equities will focus on relatively liquid stocks that have yet to benefit from recent foreign investor interest. These stocks typically inhabit a space a few rungs below the typical market leaders in quality and visibility but are large enough to rank among the most capitalized—and liquid—equities.

As we anticipated in the bullish scenario of H1 2012 outlook, broadening focus should also lead to intra-sectoral convergence, benefitting the larger, more liquid, “second tier” stocks as near-exclusive focus on quality wanes. Renewed domestic investor focus should help boost liquidity among this category of securities, making them more attractive to indexers, and we advocate increased investor exposure to “yet-to-recover angels”; liquid, moderate-to-highly capitalised stocks that retain value in prominent segments, particularly in the consumer space.

Overall, we believe these factors will favour the more liquid “cyclical” segments of the Nigerian bourse. In particular, with a line firmly drawn underneath the recent problems in the banking sector, current valuations provide substantial upside. We also believe current policy environment remains very favourable for the cement sector but has yet to reflect substantially in its valuation metrics. In our view, given their liquidity relatively subdued valuations these two sectors are best placed to benefit from a prospective variation in market leading themes. Consequently, we recommend an overweight position in cyclical (including banks, cement and petroleum marketing). Conversely, while we believe the leading consumer stocks in the brewery, food and personal care segments can retain value, interest in them could take a more speculative undertone at current valuations, suggesting more limited upside and greater volatility in this segments. We would underweight these positions.

Lengthening horizons for fixed income

Despite substantial increase in foreign investor interest in bonds, the high composition of domestic investors in this asset class relative to equities suggest that local investors will continue to play an important role. As we anticipated, inflows into Nigerian bonds have already exceeded the levels implied in its index weighting, which suggests that much of the potential upside from inflows targeted at Nigeria have been exceeded. Nevertheless, it should benefit from ongoing rotation into fixed income, underpinned by a secular trend towards a reallocation to fixed income with developed markets increasingly driven by ageing demographic. In view of our discussion about different investor categories, an improving global economy need not curb flow to emerging markets. In fact, we believe a domestic currency denominated paper could benefit in this scenario from a shift from corresponding

Eurobonds as EM market and macro-economic outlook continues to improve.

However, domestic developments could prove more important in the near to medium term. With issues like a reallocation in domestic pension assets, and substantial impending maturities of both FGN and AMCON bonds coming into focus in 2013, we expect to see substantial volatility in bond prices. Also, with greater indexation, we believe volatility could be driven further by increased portfolio inflows which would drive a tendency for Nigeria to be evaluated on ever-changing global outlook and summary metrics based on energy prices and such domestic macro-economic data as growth and inflation. Nevertheless, this also means that Naira fixed income will have increased scope to benefit from an improving macro-story. As long as fiscal stability and consolidation persist, net impact is likely to be positive.

Both on the back of changes to domestic pension rules and the increased role of foreign investors we believe capital gains will increasingly dominate yield in investor evaluation of Nigerian fixed income markets. In addition, as yields trend lower, we expect domestic institutional investors to show preference for long dated instruments to lock in existing yields. As such, in spite of the risks highlighted above, we see increasing duration as a key theme in bond pricing in 2013 and beyond. This should intensify as relatively expensive paper issued in 2009/10 mature allowing institutional investors to reprogramme their portfolios for a new market landscape—a significant chunk which will come through in 2013/14. Incidentally, even in the event that risks to the global economy crystallize, leading to a downturn, we expect that the impact on EM bonds in general will be much more limited, which should limit downside for Naira denominated bonds.

Perhaps the bigger risks to Nigerian fixed income under this scenario will come from policy response. It is safe to say that monetary policy response is quite predictable, though how much scope for tightening in this event remains to be seen. However, barring a sharp collapse in oil prices which would undermine the currency, we believe that potential inflows into Nigeria as domestic rates rise will be large enough to cap yield uptrend. This suggests that at current levels, a long duration strategy offers more price upside for bonds.

FEATURE REPORT: THE DARK SIDE OF FOREIGN PORTFOLIO INFLOWS

Indonesia in the Asian Financial crisis

Despite the many benefits of capital flows to emerging markets, history provides cautionary lessons.

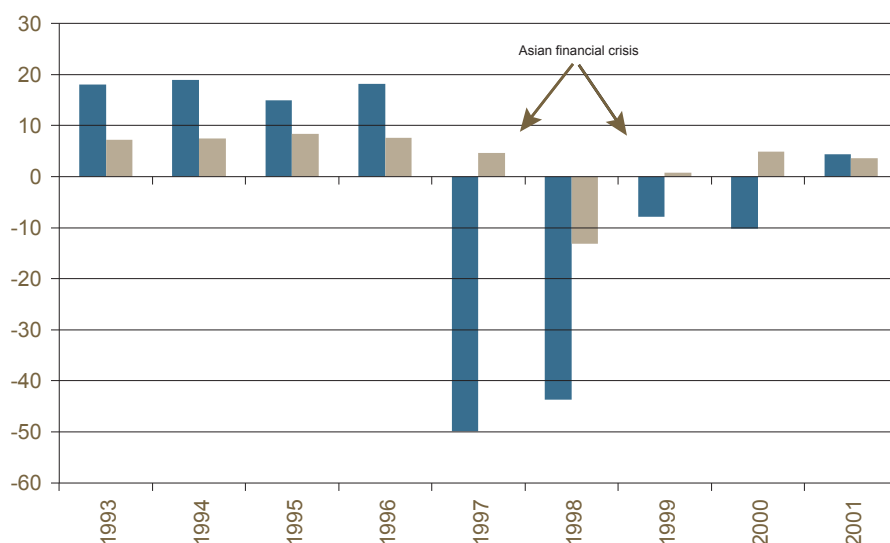
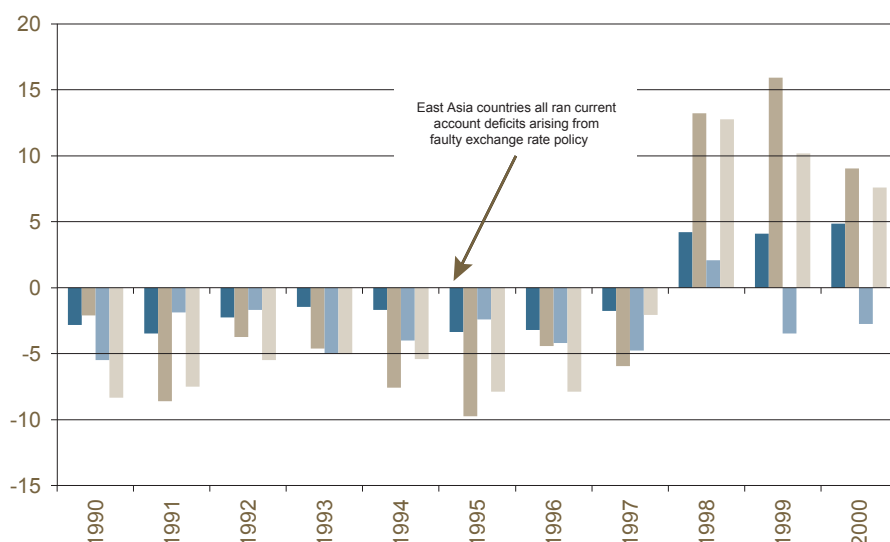
The Asian financial crisis triggered by the collapse of the Thai baht in 1997 was the most severe and least anticipated financial crisis in EMs since the 1980s debt crisis and demonstrated the susceptibility of global financial markets to sudden swings of market confidence. Although opinion is divided on the root cause of the crisis among competing factors – large portfolio inflows into weak banking systems and the subsequent sudden exit amidst several policy missteps are widely believed to be primarily responsible for the crisis.

Prior to the crisis, Indonesia was the archetypal 'Asian success story' with a 6% growth rate in the 1980s bettered by an 8% rate in the early 1990s on the back of its commodity exports; crude oil, palm oil, rubber and manufacturing. Driven by the economic recession in the US and its effect on the major advanced economies, FPI flows to East Asia increased dramatically in the latter part of the 1980s and led to an expansion in the money supply, which in turn fuelled aggregate demand at levels exceeding the absorptive capacity of productive sectors. In the early 1990s, narrow money (M1) and broad money (M2) widened by an average of 26.9% and 20% respectively resulting in heightened leveraging which inflated asset prices. Prior to the crisis, inflation was low relative to other ASEAN countries at an average of 8% in the 1990s.

At the heart of the Asian financial crisis was a misalignment of currencies with their equilibrium levels. As with other East Asian currencies, the Indonesian rupiah was determined under a managed float regime that pegged exchange values to the US Dollar within narrow bands. The major benefit of this policy was the resulting stability in currency which dampened perceived risks for foreign investors and encouraged capital inflows into the financial sector. However, this created other distortions as is often the case with economies with large export sectors, the exchange rate regime was aimed at keeping currencies artificially weak to guarantee export competitiveness but ran counter to the upward

Figure 63

Indonesia in the 1990s

Source: World Bank,
ARM Research■ FPI (\$'bln)
■ GDP GROWTH RATE (%)**Figure 64**Current Account
(% of GDP)Source: IMF WEO 2012
Database, ARM Research■ INDONESIA
■ MALAYSIA
■ PHILIPPINES
■ THAILAND

currency pressures created by portfolio inflows. In addition, weaker currency spurred 'cheaper' foreign imports creating huge current account deficits.

With portfolio inflows, dollar reserves which hovered between \$2.5-\$8.6billion range over the 1980s surged to \$19billion in 1997. Private net inflows to Indonesia, Thailand, Malaysia, South Korea and the Philippines increased 129% to \$92.8billion in 1996⁽²⁶⁾. The choice vehicle for these inflows was short term dollar denominated debt and at the end of 1996, the proportion of these loans with maturity of one year or less was 62% for Indonesia, 68% for South Korea, 50% for the Philippines, 65% for Thailand, and 84%

for Taiwan largely held by private corporations. In addition, these inflows helped inflate real estate and equity prices well beyond their fundamentals.

With the recovery of the US and a strengthening dollar set against a steady weakening of the Japanese yen in the mid 1990s, exports from East Asian countries became non-competitive relative to Japan and increasingly China which exacerbated trade deficits, and should have triggered a downward currency adjustment. However in most of these countries and in Indonesia, this adjustment did not take place as overall BOP accounts were supported by surpluses in the capital account which hit \$11billion in 1996. However, a devaluation and subsequent floating of the Thai baht in 1997 in response to foreign outflows as Thailand's

(26) Jeffrey Sachs and Steve Radelet - The East Asian Financial Crisis: Diagnosis, Remedies, Prospects. April 1998.

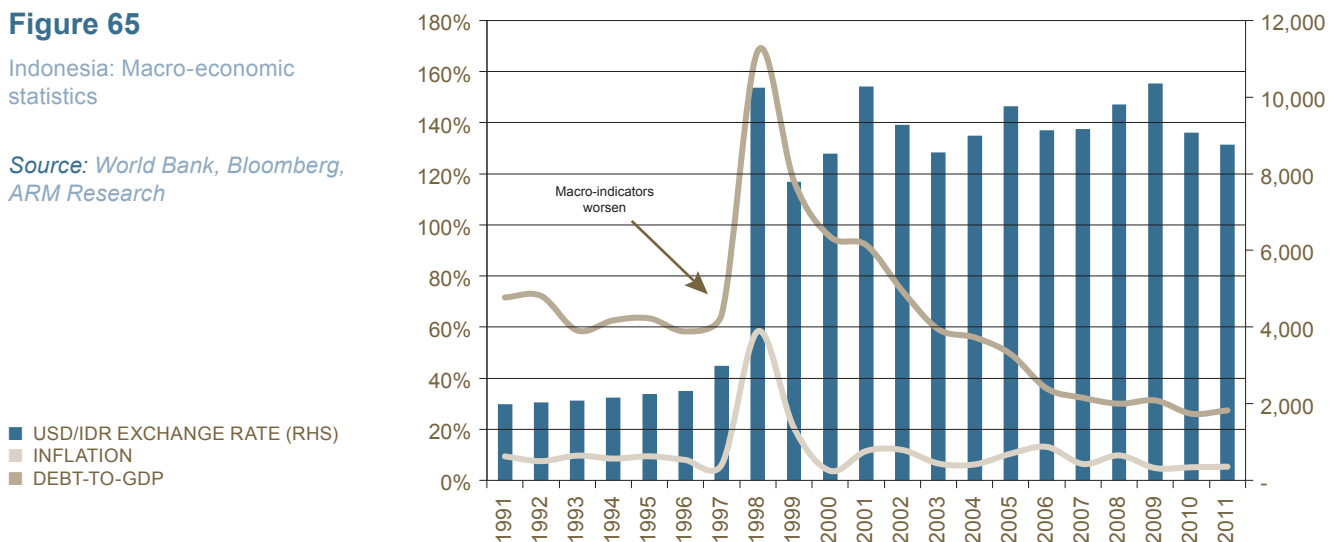
economic fundamentals began to deteriorate on account of the loss of export competitiveness in lock-step with a dollar strengthening to which the baht had been pegged essentially triggered the East Asian crisis. This created a domino effect through

East Asia with the result being a 77% reduction in the Indonesian capital account surplus in 1997 and subsequent \$3.8 billion and \$4.9 billion deficits in 1998 and 1999 respectively.

Figure 65

Indonesia: Macro-economic statistics

Source: World Bank, Bloomberg, ARM Research



Indonesia responded to the sudden portfolio flight beginning in July 1997 by selling reserves and subsequently widening the currency band by 4pps to 12% with no effect as the rupiah lost 67% in three months to close at \$1= Rp4000 in October 1997. With rapidly dwindling reserves, Indonesia hiked interest rates and abandoned the managed float system for a market determined exchange rate leading to further devaluations. East Asia recorded a reverse in flows from \$93billion inflows pre-crisis to a net outflow of around \$12.1billion amounting to ~11% of the pre-crisis dollar GDP. The preponderance of shorter tenured foreign currency debt created a tense environment that needed only a small external shock which created a self-fulfilling cycle of rapidly depreciating exchange rate and a collapse in asset prices with outflow of foreign capital resulting in contracting balance sheets and economic growth.

This attraction to foreign debt occurred as substantial government credit allocations effectively crowded out the local private sector, and coupled with a weak regulatory and supervisory framework left the Indonesian financial system at the mercy of a sudden reversal in portfolio flows.

How at risk is Nigeria?

In contrast to East Asian economies that largely supported their BOP accounts via capital inflows, Nigeria's BOP statement is buoyed by a current account surplus driven by its major export – oil, ~97% of total exports which is sold internationally in dollar prices, implying no strong incentive to distort its currency negatively.

However, given that the CBN is the dominant supplier of dollars locally (~83%), a conflict of interest arises as regards exchange rate management and its price stability mandate. Furthermore, given the significant role imports play in aggregate supply in Nigeria, the apex bank appears to have an incentive, to seek to attract 'hot money' in order to support the NGNUSD exchange rate in a bid to dampen the pass through effects of elevated international commodity prices on domestic inflation.

This suggests two potential problems associated with FPI flows to Nigeria; size and volatility. These problems emerge from an understanding of the three competing goals of monetary policy (the so-called impossible 'trilemma'): a fixed(stable) exchange rate, free capital movement (absence of capital controls)

and an independent monetary policy.

The 'size' problem arises where, given favourable conditions and in the absence of capital controls, a stable exchange rate attracts large inflows that, in addition to inflating asset prices in destination markets, could sufficiently impair the ability of a central bank to attain target independent non-reactionary objectives for the financial system e.g. interest rates, liquidity, etc. The 'volatility' problem arises in that, in desiring a stable exchange rate, countries have to choose between the other two mutually exclusive goals of running an independent monetary policy in sync with national policies (e.g. currency strengthening/weakening for countries with significant import/export sectors) or reducing the variance bands of their

exchange rate. Countries choosing independence like Nigeria thus have perverse incentives to hike rates to attract FPI to reduce currency volatility under the guise of inflation targeting.

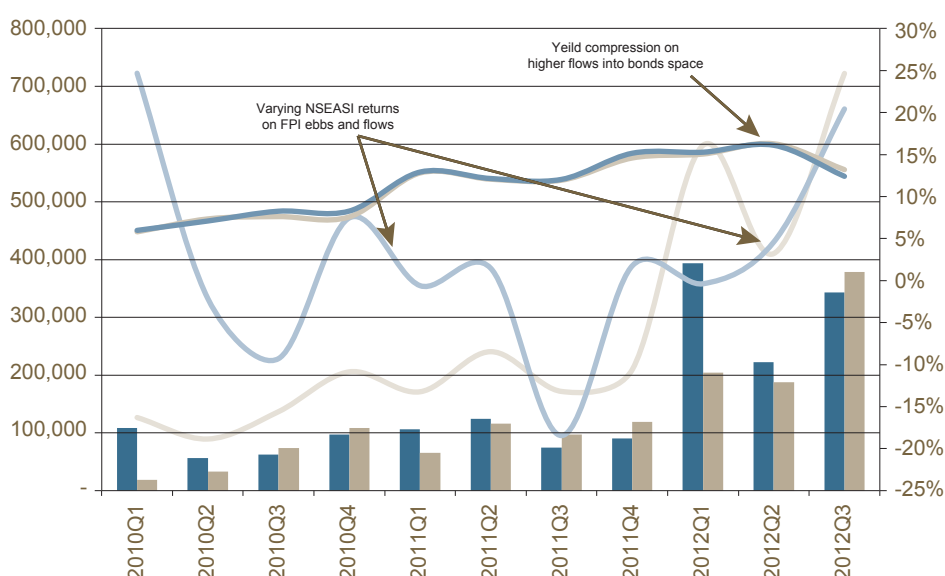
With regard to the size problem, non-resident transactions on the NSE have exceeded 50% of total deals since 2010 which clearly poses downside risks to equity markets in the event of a reversal in flows. Similarly, the 400bps decline in long tenored FGNs following the announcement of Nigeria's inclusion in the J.P Morgan and Barclays bond indices was driven by a sharp increase in portfolio inflows and the resultant strengthening of the Naira against the USD, but also highlights the potential downside from a reversal of flows into Naira denominated.

Figure 66

FPI flows into Nigeria's capital markets

Source: NSE, CBN, FDHL, ARM Research

■ EQUITY SECURITIES (₦mln)
■ DEBT SECURITIES (₦mln)
■ PORTFOLIO INVESTMENT (₦mln)
■ NSEASI RETURNS (RHS)
■ FGN 2017 (RHS)
■ FGN 2019 (RHS)



From Nigeria's standpoint, the volatility problem is prefigured by the substantial increases in the correlations between Nigerian capital markets to events unconnected to its fundamentals which drive global investor sentiment. Thus, as with East Asia, a recovery in developed markets could heighten investor sensitivity to previously overlooked macro-economic indicators.

A more structural aspect of the problem is that, barring any reversals, unhindered portfolio flows neuter the development of mechanisms of domestic savings mobilization in the long term as the continued presence of these flows dampen the urgency for reforms to institutional systems which help stimulate

the development of less volatile sources of long term investible funds.

In the event of a portfolio reversal, the near term consequence as historical evidence suggests is significant currency devaluation as countries try to stave off dwindling reserves and fight off speculators. This devaluation in a country with large import sectors could create inflationary pressures. Thus, given the dominant role of the current account surplus in sustaining the BOP in Nigeria, foreign reserve accumulation may appear to be an appropriate strategy to counter currency devaluations from capital account deteriorations. However, as Nigeria's current account surplus is largely hinged on crude oil – a commodity

whose prices tend to follow global cycles—this creates a non-trivial possibility that downside risks to oil prices could place the BOP under significant strain; falling prices could create the perfect storm—pushing the current account into deficit and constituting a trigger for portfolio reversals. Furthermore, given that Nigeria's foreign reserves are essentially monetized crude oil receipts, the ability of the CBN to defend its currency policy anchor in the face of dwindling

reserves is somewhat naturally impaired with a range of negative implications for domestic prices and interest rates. Overall, this analysis would tend to cast some measure of doubt about the appropriateness and effectiveness of a monetary policy that anchors stability on maintaining high domestic interest rates to attract portfolio investments—such as is apparently pursued by the CBN currently—especially where BOP has very volatile components.

Figure 67

Nigeria - Balance of Payments

Source: CBN, ARM Research

*9M 2012



Clearly, further QE by major central banks and continued weakness in global economic outlook continue to drive sustained FPI flows in search of higher risk adjusted yields in EMs. However as EMs become more integrated into global financial markets, heightened scrutiny of economic indicators, policies, regulatory processes and financial markets and greater expectation, of themselves, that they meet up to global standards, pose new risks. As the East Asian crisis showed, markets sometimes

overreact, and fiscal and monetary authorities must be able to either anticipate and take corrective policy action when their economies face episodic portfolio reversals unconnected to their fundamentals or apply preventive measures by directing these flows away from asset markets towards direct investment to target growth sectors. The Indonesian example suggests the latter approach is the less risky—and costly—option.

ABBREVIATIONS

AEO	– African Economic Outlook
AFDB	– African Development Bank
BI	– Bank Indonesia
BoE	– Bank of England
BoJ	– Bank of Japan
BoT	– Bank of Thailand
CIT	– Company Income Tax
DMO	– Debt Management Office
ECA	– Excess Crude Account
ECB	– European Central Bank
EIA	– Energy Information Administration
EM	– Emerging Markets
EMLCGBI	– Emerging Markets Local Currency Government Bond Index
FDI	– Foreign Direct Investment
FMF	– Federal Ministry of Finance
FMNL	– Flour Mills Nigeria
FPI	– Foreign Portfolio Investment
FRA	– Fiscal Responsibility Act
HFM	– HoneyWell Flour Mills
IEA	– International Energy Agency
IIF	– Institute of International Finance
IMF	– International Monetary Fund
LSAP	– Large Scale Asset Purchases
MENA	– Middle East and North Africa
NBS	– National Bureau of Statistics
NCS	– Nigeria Customs Service
OMT	– Outright Monetary Transactions
OPEC	– Organization of Petroleum Exporting Countries
PBoC	– People’s Bank of China
PSF	– Petroleum Subsidy Fund
RBI	– Reserve Bank of India
SSA	– Sub-Saharan Africa
SLF	– Standing Lending Facilities
TSA	– Treasury Single Account
USDA	– United States Department of Agriculture
VAT	– Value Added Tax
WB	– World Bank
WDAS	– Wholesale Dutch Auction System
WTI	– West Texan Intermediary

All rights reserved. Unauthorised use, reproduction, distribution or disclosure of this document is strictly prohibited. All text, images, logos and information contained in this document are the intellectual property of ARM unless specifically noted otherwise or copyrighted by other firms under relevant laws. Copyright violations such as content reproduction and modification without permission are prohibited. Permission from ARM must be obtained for “reproduction for personal use” and content use except for simple “citations”.

This material has been issued by Asset & Resource Management Company Limited (“ARM”), a Company regulated by the Nigerian Securities and 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 ARM and its analysts believe to be reliable but do not imply endorsement or credibility of any service, information, or product offered through such sources. Neither ARM 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 ARM, 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 and you agree to indemnify and hold ARM, its analysts, directors, officers, employees and affiliates, harmless from any claims, losses or damages, including legal fees, resulting from your violation of these limitations, and to fully cooperate in ARM’s defense against any such claims. ARM may modify the limitations contained in this document at any time at its discretion and modifications are effective upon being included.

ASSET & RESOURCE MANAGEMENT COMPANY LTD.

Lagos Office

1 Mekunwen Road
Off Oyinkan Abayomi Drive
P.O. Box 55765, Ikoyi, Lagos

Tel: +234 (1) 269-2976 or 269-2097

Fax: +234 (1) 269-2835

Email: info@arm.com.ng

Abuja Office

129 Adetokunbo Ademola Crescent
Wuse II, Abuja, Nigeria

Tel: +234 9 461 8405

Fax: +234 9 413 0530

Email: info@arm.com.ng

Port-Harcourt Office

12 Circular Road
Presidential Estate II
Off GRA Junction, Port Harcourt

Tel: +234 (84) 462-591

Fax: +234 (84) 462-592

Email: info@arm.com.ng

INVESTMENT MANAGEMENT AND RESEARCH

Email: invest.mgt@arm.com.ng

January 2013



*Our ambitions are what make for a life less ordinary.
Each day is an opportunity to realise them.*

Realising Ambitions

ARM Research

research@armsecurities.com.ng

+234 (1) 269 2976

