

23 January 2018

Nigeria Strategy Report – H1 2018 Excerpts

Domestic Economy and Markets

Balance of Payment: Visibly losing size but gaining weight

We expect a slower growth in exports to shrink the CA balance to 2.75% of GDP in 2018. (2017: 3.6%). Elsewhere, a confluence of pull and push factors is expected to cause a slight moderation in the financial account. Overall, our expectation for a decline in both the current account and financial account implies a downside to the country's balance of payment, albeit benign.

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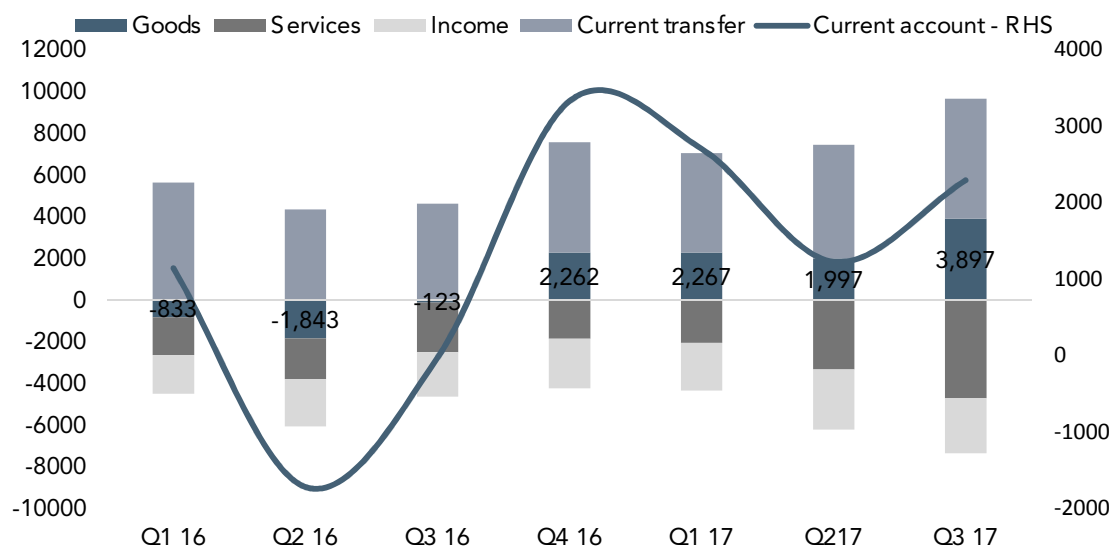
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Current Account riding on a rising oil price wave

Nigeria's current account (CA) surplus expanded to \$2.3 billion in the third quarter (from \$1.2 billion in Q2 2017), the 'bluest ink' in the overall current account in four quarters. There are a few factors that have acted to push the surplus higher in recent quarters. First, the increased trade surplus, which was largely in a deficit between Q3 15 and Q3 16 due to collapse in crude oil production and prices, recovered in 2017 in tandem with the rebound in oil prices from their multi-year lows in early 2016 and more importantly, crude oil production has recovered sizably. In addition, following the more flexible exchange rate regime, remittance flows through the financial system recovered which bolstered transfer payments into Nigeria. Though the deficit in the services balance has trended higher in recent quarters, but not enough to prevent the overall current account surplus from expanding. That said, we think the CA surplus, which was equivalent to ~2.4% of GDP as at the end of September (Q2 17: 1.4%), is likely to shrink reflecting a pick-up in imports in tandem with the recovery in economic growth. Consequently, we believe a shrinking CA

balance under a backdrop of tamer net capital flows places the positive balance of payment on a tightrope.

Figure 1: Trend in components of CA balance (\$'million)



Source: CBN, ARM Research

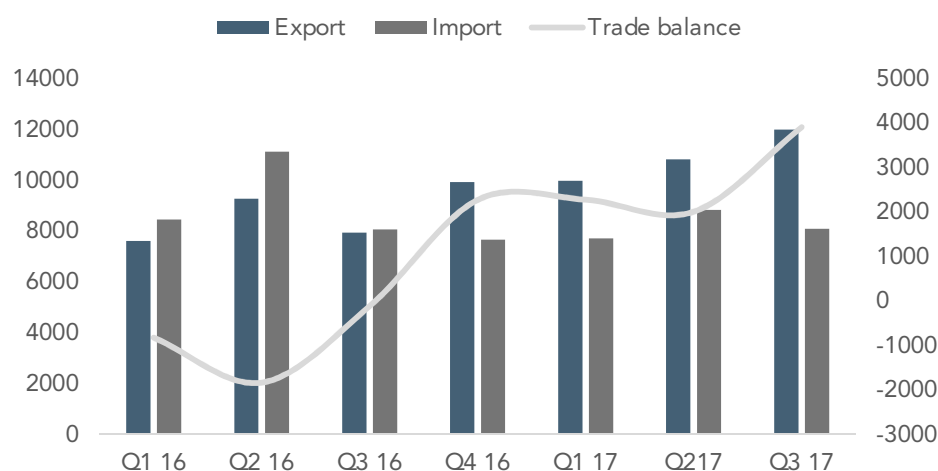
Rising crude oil exports fuels trade surplus

In line with patterns observed since the recovery in crude oil production in Q1 2017, Nigeria's external trade balance improved significantly by 95% QoQ to \$3.8 billion. The jump in the trade balance was largely impacted by higher oil receipts as exports (\$11.9 billion) continued to trump imports (\$8.1 billion) leaving the surplus picture intact. As earlier stated, exports were propped by the \$1.7 billion jump in crude oil and gas reflecting the dual impact of improved crude production which supported the rebound in crude oil export (+9.2% QoQ to 1.55mbpd) as well as the rebound in crude oil prices (avg Brent: +3% QoQ to \$52/bbl.). Outside of crude oil and gas, however, non-oil and electricity export dropped by \$536 million relative to prior quarter.

On the other side of the ledger, imports were restrained across board reflecting import normalization following the one-off jump in import after the opening of the I&E window as well as improved dollar sales by the CBN. For context, overall import in Q2 17 of \$8.8 billion is the highest in the last 5 quarters, trailing \$11.1 billion worth of import in Q2 16 following the NGN devaluation of June 2016. From the breakdown provided, oil and non-oil imports in the third quarter contracted by \$439 million and \$297 million respectively

despite currency gains (+4% over Q3 17). Prior to the claw-back, expectation was for excitement over currency gains to motivate importers to ramp up their scale of orders having seen how bad things could get in prior periods. In our view, the deviation from expectation may have been underpinned by depressed consumer spending, continued focus on demand curtailment measures for agricultural raw material imports and increased import substitution. Furthermore, the decline in ‘other petroleum product’ reflected reduced activities from other importers as NNPC became the sole importer of PMS following the shortage of foreign exchange earlier in the year and increase in crude prices, which in combination made it unprofitable for other importers.

Figure 2: Trade balance (\$'million)



Source: CBN, ARM Research

On other fronts, sizeable net debits in travels (+90% QoQ), other business services (+52% QoQ) and transportation service (+7% QoQ) led to expansion in services deficit (+41.7% QoQ) in the review period. Specifically, the jump in travels deficit reflected increased purchase of goods and services by business and personal travellers from Nigeria in other countries while the increase in transport deficit mirrored a pick-up of economic activities in the country through the movement of passengers and goods out of the country. Elsewhere, income services continued its deficit run but at a slower pace (-9% QoQ) on the back of lower outflow of income from investments. On balance, the sizeable deficits in both

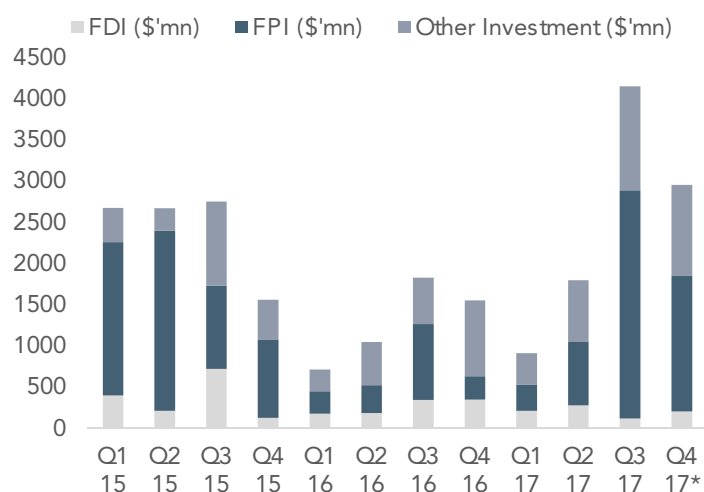
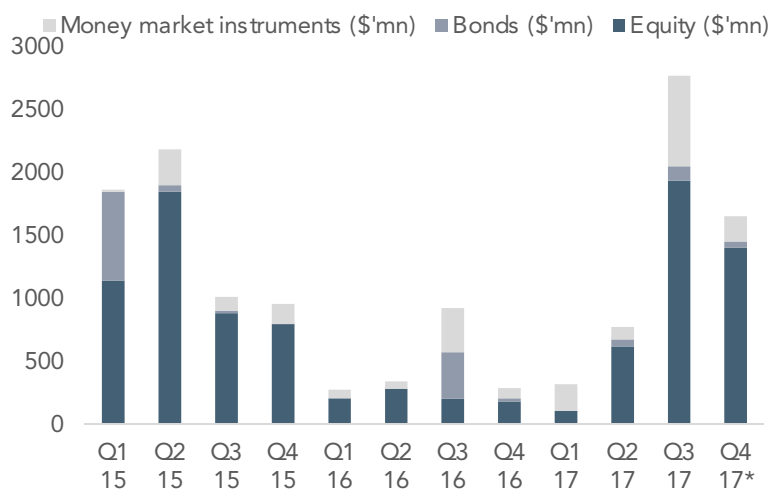
service segments were not enough to mask the mild growth in current transfers¹ (+5.4% QoQ to \$5.7 billion) leading to a higher CA surplus (+87% QoQ) in the review period.

Net Capital Inflows remain buoyant

Capital flows to Nigeria extended its solid growth into a second successive quarter in Q3 17, with combined flows of \$4.1 billion over the quarter being \$2.4 billion and \$2.3 billion higher QoQ and YoY respectively. The strong capital flows largely reflects higher portfolio flows which stood at \$2.8 billion (\$2 billion higher QoQ), even as ‘other investment’ sustained its expansion, rising \$513 million QoQ to \$1.3 billion largely on account of loans. Elsewhere, foreign direct investment (FDI) printed at an 11-quarter low of \$117 million dropping \$157 million QoQ. Following the conception of the IEW in April which greatly improved FX liquidity² in the market and also the attractive valuation of the equity market compared to peers, foreign portfolio investors flooded naira equities to the tune of \$1.9 billion (\$1.3 billion excluding one-off transactions in Dangote cement and Mobil) - contributing almost half (48%) of the total flows and the highest in the last 11 quarters. Furthermore, amidst elevated interest rate environment and falling YoY headline inflation³, foreign investors were upbeat to short term debt instruments (+630% QoQ) and bonds (+100% QoQ). Overall, the strong appetite for naira assets, which was mainly pull driven, largely reflected the combined impact of the liberalization of the currency market, higher crude oil proceeds and external reserve (+7% QoQ to \$32.5 billion), improved FX liquidity as well as the thirst to lock-in on higher interest rate in the domestic market on expectation of a moderation in interest rate over 2018. On other fronts, ‘other investment’ continued to reflect strong flows in form of loans following an increase of \$209 million QoQ. On FDI, the decline largely mirrors investors’ concern towards the fragile growth picture of the country. In line with trend, a breakdown of flows from countries showed both UK and US combined to contribute 65% of overall portfolio flows into Nigeria, with majority of the flows invested in shares and the service sector.

¹ largely workers’ remittance

² Over \$23 billion turnover since inception

Figure 3: Capital Importation composition (\$'mn)**Figure 4: Foreign Portfolio flow (\$'mn)**

Source: NBS, ARM Research, *ARM estimate

Despite the strong growth in portfolio flows to the country in the review period, sizable drawdown in the FX reserve (+8x QoQ to \$2.8 billion) nullified the growth in capital flows to cause a decline in financial accounts (-9% QoQ to \$3.1 billion).

	Q1 16	Q2 16	Q3 16	Q4 16	Q1 17	Q2 17	Q3 17
Current Account Balance as % of G.D. P	1.00	-1.51	-0.03	3.42	3.17	1.38	2.38
Capital and Financial Account Balance as % of G.D. P	-6.73	6.62	8.62	-5.98	0.42	3.85	3.22
Overall Balance as % of G.D. P	-0.65	-0.72	-3.04	3.36	3.49	0.34	2.89
External Reserves - Stock (US \$ million)	27,336	26,506	23,807	26,991	29,996	30,341	33,160
Number of Months of Imports Equivalent	9.72	7.16	9.05	10.58	11.69	10.33	9.05
External Debt Stock (US\$ million)	11,195	11,262	11,583	11,406	13,808	15,047	15,352

More breathing space for trade balance

Going into next year, we remain conservative on crude production thus leaving little scope for further jump in crude oil export. However, we believe OPEC-induced higher crude prices would lend some support and thus provide some cheers for oil export outlook. Specifically, with crude production averaging 1.91mbpd in 2017, we forecast 2018 production to average 2.0mbpd on the back of receded militant activities. Incorporating our views from oil price review, where we forecast \$60/bbl. (+9% YoY) and a flat change in crude production (2.0mbpd), we estimate a 9% YoY increase in oil export to \$44 billion.

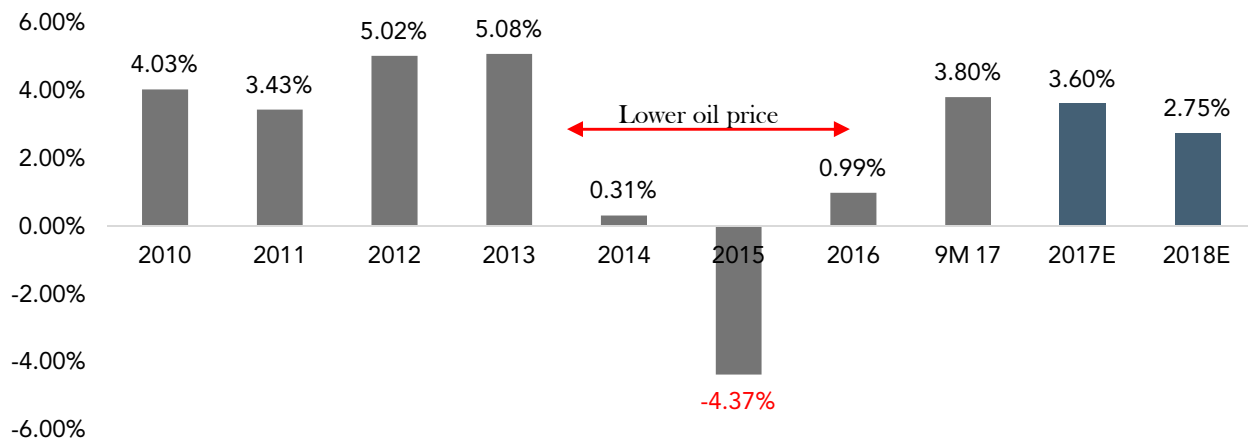
On the other hand, we forecast non-oil export to expand 36% YoY to \$3.3 billion. This brings our outlook for exports to be \$47.3 billion (+10% YoY).

For import, whilst continued FX liquidity should leave increased importation of manufacturing products largely intact, sustained reduction in the importation of petroleum products and raw materials should moderate the impact. We see NNPC remaining the sole importer of PMS as lower margins leave importation of petroleum products uneconomical for other independent players. In addition, we do not envisage an upward adjustment of petrol pump price next year, as government would not want to pluck the beard of electorates come 2019 election; an act which could spur activities from independent importers. On balance, we expect import to expand at a faster rate of 15% YoY to \$37.3 billion. Consequently, we look for trade surplus of \$10.19 billion in 2018 (FY 17E: \$10.7 billion).

Away from trade, we expect a combination of improved economic activities and higher consumer income to drive growth in transportation and travel debits respectively. We therefore expect a 5% YoY increase in net services debit to (\$14.2 billion). For income, net income deficit remained suppressed since 2016 compared to previous levels. However, with an improved FX liquidity in the country and positive return in the stock market (2017: +42% YoY), we expect this to spur investment income out of the country. In addition, sizeable Eurobond issuances by both the FG and commercial banks in previous periods should spur an increase in interest payments outside the country. With no much expectation from investment income into the country, we expect net income debit to expand 11% YoY to (\$11.6 billion). Last in the current account is current transfers. We forecast net current transfer credit to expand 3% YoY to \$22 billion on the back of increased workers' remittance to the country.

Overlaying the implied trade surplus with our expectation of services and income deficits as well as our target for net current transfer, we expect the country's current account to print at \$6.3 billion (FY 17E: \$8.1 billion).

Figure 5: Current account (% of GDP)



Source: CBN, NBS, ARM Research

House of cards imminent, but no cause for alarm

In framing our outlook for financial account (capital flows), we think the confluence of pull and push factors suggest a moderation in capital flows. Though more central banks are likely to pursue monetary tightening, stronger global growth and persisting low yields in advanced markets implies demand for EM risk assets will likely remain over 2018. For evidence, though the US Fed increased interest rate three times in 2017, this did not deter FPI flows into EM economies neither did it strengthen the US Dollar. Over 2018, while the forward guidance from reading the US Fed dot-plot curve points to a repeat performance with regards to rate hikes, interest in EM risk assets is likely to remain. On the domestic front, in the light of an emerging lower yield environment as well as heightening political risk ahead of the 2019 election, we think flows to short-term debt instrument as well as bonds will likely cool off in coming quarters. On equities, while valuations remain attractive relative to peers especially in the light of the naira depreciation, the temptation to take profits ahead of the elections might prove too strong to resist for foreign investors in the second half of 2018. Throwing in prospects of tamer oil prices in the second half of 2018, we see bearish influences on NGN assets as raising scope for outflows and accordingly estimate capital flows to be \$6 billion for the year (down 39% YoY). On balance, we expect the financial account to print at a lower level relative to prior year. Overall, our expectation for a decline in both the current account and financial account implies a downside to the country's balance of payment and consequentially suggest a risk to the currency.

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