

01 February 2018

## Nigeria Strategy Report – H1 2018 Excerpts

Domestic Economy and Markets

### **Fixed Income: The unstoppable force of liquidity**

In the last 24 months, more than in any other period in recent memory, inflationary pressure provided a ready cover for monetary tightening in defence of the key policy anchor, the naira. In our inflation outlook, we highlighted that the absence of supply shocks and base effects, guides to benign inflationary pressure in 2018, as removing the positive real yields justification of contractionary monetary policy. Furthermore, following expected boost in reserve inflows, we expect the monetary policy to loosen its grip, over 2018, with an expected cut in MPR to 12% in H2 2018. In addition to the foregoing, monetary policy looks set to grapple with an elevated liquidity profile for NTBs, OMOs and bonds over 2018. This view would sit well with a fiscal side, now inclined to reduce its borrowing cost and should result in more forceful fiscal pressures on the apex bank to adopt an accommodative stance given its renewed attempts at economic stimulation. More so, given FG's appetite for external borrowings to fund the budget and refinance maturing treasury bills, the combination of lower bond issuance and net NTB maturity, is expected to drive a gravitational force in rates.

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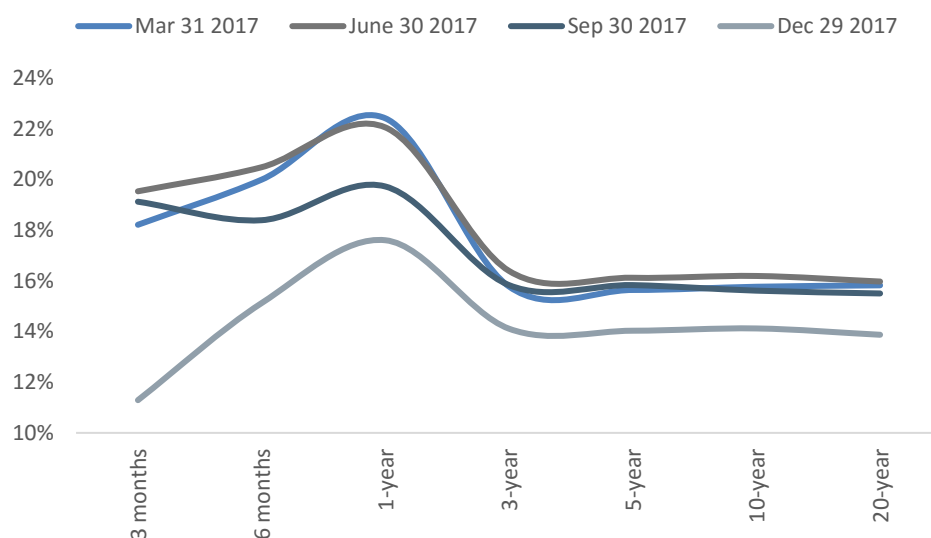
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#### ***Policy shift slims the bulge in the curve***

In our Q4 2017 NSR update, we identified the confluence of a less hawkish monetary policy, lower domestic borrowings, and perhaps some form of coordination between fiscal and monetary policy to ease financing costs, as key drivers for a downtrend in yields. In sync with our views, after expanding over H1 2017 (+142bps to 18.28%), the naira yield curve declined by 636bps to 17.1% over H2 2017. The moderation in the yield curve rode on the wings of policy shifts by the fiscal and monetary authorities. On the monetary leg,

after a hostile strain on system liquidity via OMO issuance (net OMO issuance in H1 17: ₦893 billion), the CBN allowed liquidity build up into massive demand at the primary market which eventually resulted in rates decline at the primary market auction (PMA). For context, contrary to net OMO issuance in the first half, it was a case of net OMO maturity of ₦636 billion between July and November 2017. However, on the back of increased liquidity from maturing treasury bills in December, the CBN issued ₦1.3 trillion in December to drive overall net OMO issuance for the review period. In addition, the CBN ceased issuance of the one-year bills at its OMO auctions, which led to a downtrend in Treasury bill yields with longer term rates dropping faster than that of shorter-term instruments. Consequently, average yield at the short end of the curve decline by 508bps to 13.4% in the period.

**Figure 1: Trend in the naira yield curve**



Source: FMDQ, ARM Research

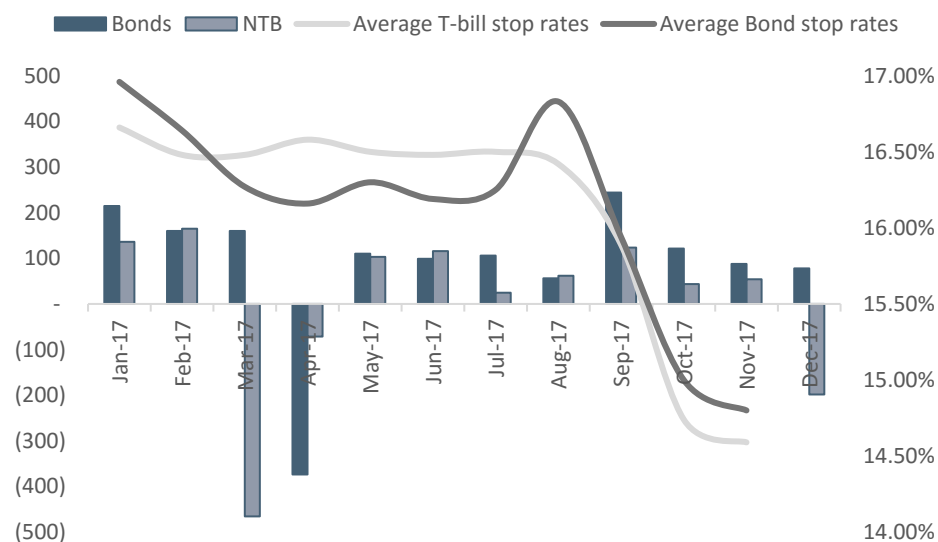
On the other side, given bulging debt service costs, especially on the domestic leg, the fiscal authorities switched borrowing preference in favour of foreign debt and raised a total of \$4.5 billion from the external market over 2017. Consequently, total bond issuance over H2 of ₦692 billion was 20% lower than issuance in the first half. More so, the DMO withdrew the issuance of the 20-year bond and redeemed maturing Treasury bills in December (₦198 billion) using \$500 million from the recently issued Eurobond proceeds (\$3 billion). Accordingly, mean marginal clearing rate at the bond auction declined by

89bps to 15.54% over H2 2017. The attendant impact of this cascaded into a downtrend in secondary market rates on bonds. Overall, bond yields declined 205bps to 14.15%.

### *Debt rebalancing...gaining its mojo*

In a bid to fix its weak debt profile and rising debt service, the DMO lowered its domestic borrowings in the second half, showing more preference for external debt even as revenue improved. Specifically, the DMO issued ₦692 billion over the second half, which is 19% lower than bond issuance in H1 of ₦849 billion. The lower supply, a reflection of a 25% decline in bond issuance to ₦635 billion, was hinged on successful Eurobond issuance of \$3 billion which also allowed redemption of ₦198 billion maturing treasury bills in December. Given FG's lower appetite for domestic borrowings in the second half of the year, borrowing cost moderated 422bps to 14.22% in H2 17. This came despite strong appetite for FGN Bonds at the primary auction as bid-to-cover ratios in H2 17 tracked higher by 40bps to 2.2x from H1 2017. The tamer FG bond issuances and CBN's easing at the short end of the curve forced markets to demand a lower return at FGN auctions, with the upper range bids declining 700bps from H1 2017. Accordingly, marginal clearing rates also fell 300bps to 15.9% in H2 17. FG debt profile split between domestic and external equally improved and currently stands at 68:32, which properly aligns to the 2019 target debt profile of 60:40.

**Figure 2: FG's Net paper issuances vs borrowing cost**



Source: FMDQ, ARM Research

### *The reach for yield beams on sovereign Eurobond*

As in 2016, movement across Eurobond yields continued to reflect improving perception of Nigeria's credit risk on account of the stronger oil price and growing FX reserves. Relative to FX reserves, Nigeria's outstanding Eurobonds account for 16% and in an atmosphere of rising oil prices, these instruments are largely well matched with investors facing little risk of default. Consequently, average yields on the sovereign Eurobonds declined by 41bps over the second half – 2018 (17bps to 3.1%), 2021(33bps to 4.47%), and 2023 (71bps to 5.03%). The robust investor confidence was evident in the oversubscribed issuances of a debut 30-year Eurobond in November at yields which slipped 31bps apiece in 2017. The rally in dollar bond prices emanated despite ratings downgrade<sup>1</sup> and further interest rate hikes in the US. The bullish trends reflect increased investor comfort with Nigeria's dollar risk following the recovery in oil prices as Z-spreads to comparable US treasuries fell by 1700bps over H2 2017. Overall, the pattern across Eurobond yields reflects positive sentiments trailing improved external sector balances.

**Figure 3: Nigeria's sovereign z-spreads to comparable US treasuries**



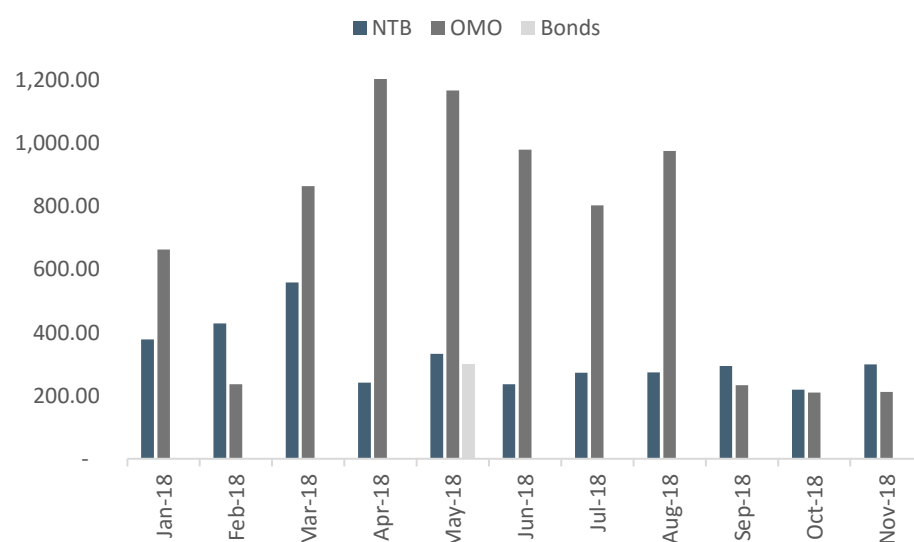
Source: Bloomberg, ARM Research

<sup>1</sup> Moody's Investors Service downgraded the Government of Nigeria's long-term issuer and senior unsecured debt rating to B2 from B1 and the senior unsecured MTN program rating and the provisional senior unsecured debt rating to (P)B2 from (P)B1

### *Liquidity influence melds into prior dovish yield outlook*

Having established the key influence of a less hawkish CBN in forcing yield downtrend in H2 2017, a discussion about 2018 outlook should begin with likely policy trajectory. In the last 24 months, more than in any other period in recent memory, inflationary pressure provided a ready cover for monetary tightening in defense of the key policy anchor – the naira. In our inflation outlook, we highlighted that the absence of supply shocks and base effects, guides to benign inflationary pressure in 2018, as removing the positive real yields justification of contractionary monetary policy. Furthermore, following higher crude oil prices (forecast: \$60/bbl.) and production (forecast: 2mbpd) over 2018 which should support FX inflows, we expect the monetary policy to loosen its grip, over 2018, with an expected cut in MPR to 12% in H2 2018. In addition to the foregoing, monetary policy also looks set to grapple with an elevated liquidity profile for NTBs, OMOs and bonds over 2018.

**Figure 4: Maturity profile over 2018 (OMO, NTB and Bonds)**



Source: FMDQ, ARM Research

This view would sit well with the fiscal side, now inclined to reduce its borrowing cost and should result in more forceful fiscal pressures on the apex bank to adopt an accommodative stance given its renewed attempts at economic stimulation. More so, given FG's appetite for external borrowings to fund the budget and refinance maturing treasury bills, the combination of lower bond issuance and net NTB maturity, is expected to drive a

gravitational force in rates. To estimate the quantum of domestic FG's debt over 2018, we use our base case budget deficit estimate of ₦2.9 trillion (vs. ₦2.0 trillion stipulated in the budget) – see our fiscal review for more details. Our base case assumes successful asset sale of ₦306 billion and Eurobond issuance of \$4 billion (\$2.5 billion maturing treasury bills, \$1.5 billion budget support). Consequently, the FG would need to raise ₦1.3 trillion (Gross: ₦1.6 trillion, maturity: ₦302 billion) in 2018 from the bond market. This scenario assumes ₦200 billion of CBN funding to the government.

**Table 1: Scenario analysis of 2018 proposed borrowings**

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

Source: Budget Office, ARM Research

Tying it all together, we see downward slope in the naira yield curve over 2018 with dovish monetary policy and elevated repayment cycle creating a gravitational pull on yields. Headwinds to our forecast are the feed-through of US rate hike and political risk on capital flight, increase in PMS price and the impact on inflationary pressure, possible militant attack in the Niger delta and the resultant impact on crude oil disruption. Tailwinds to our projection remains the possibility of re-inclusion to JP Morgan and Barclays EM bond indices.

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