

Nigeria Strategy Report

H1 2019

Domestic Economy and Policy Environment

Currency: A test of nerves and resilience

Executive Summary

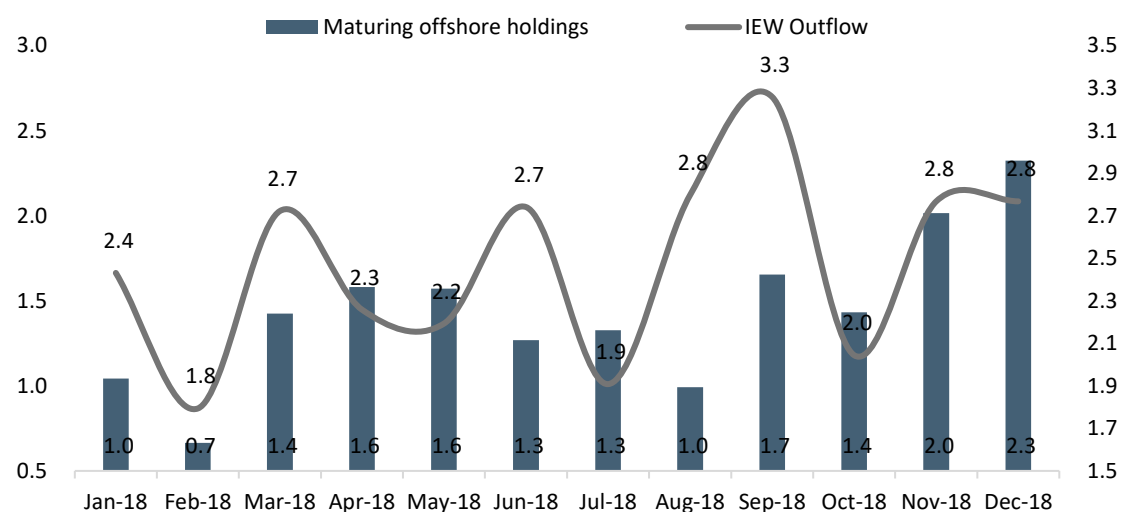
In our H2 18 Nigeria Strategy Report, we modeled the impact of capital flight and lower portfolio flows due to political uncertainty, and thus projected a \$1.9 billion drawdown in the external reserve over the 2nd half of 2018 relative to a \$7.8 billion accretion recorded in H1 18. True to our words, but at a greater scale, Nigeria's external reserve took a plunge over H2 18 with a depletion of \$3.9 billion. Consequently, the external reserve's position closed the year at \$43.2 billion, lower than our estimate of \$45.7 billion. The marked drawdown stemmed largely from an enlarged repatriation of maturing fixed income instruments held by offshore investors, which we estimate at 30% of outstanding instruments. The sizable repatriation and paucity of flows at the Investors and Exporters Window (IEW), prompted the Central Bank of Nigeria (CBN) to stepped up its intervention over H2 18 across markets compared to H1 18 with overall intervention printing at \$26.5 billion. Consequently, the NAFEX, BDC and parallel rates remained relatively stable over H2 18, closing the period at ₦363.2/\$1, ₦362.3/\$1, and ₦363.7/\$1 accordingly.

With our model suggesting cumulative slower CBN intervention over 2019 to the tune of \$53 billion (3% lower YoY), we estimate average monthly sale of \$4.5 billion (vs. \$4.7 billion in 2018). Coalescing this with our estimate of average oil and non-oil inflows to the apex bank, we estimate monthly average reserve drawdown of \$431 million which summed up to \$5.2 billion over 2019 relative to \$3.7 billion accretion in 2018. The foregoing would exert some pressure on the foreign reserve to close 2019 at \$38.5 billion (\$41.2 billion if adjusted for the proposed \$2.7 billion Eurobond). While this suggest a comfortable position for the apex bank and the naira, we believe the distorted interplay of demand and supply at the IEW and the increased demand at same would drive short term volatility in rates and an eventual adjustment to our fundamental driven purchasing power parity (PPP) estimate of between ₦397.61/\$ to ₦401.50/\$ (8-10% down-leg from current NAFEX rate of ₦362.00/\$ at the end of December 2018).

In this report, we look at the major themes that dominated the foreign exchange market in 2018 as well as our outlook for pull and drag of foreign exchange flows over 2019.

Currency: A test of nerves and resilience

In our H2 18 Nigeria Strategy Report, we modeled the impact of capital flight and lower portfolio flows due to political uncertainty, and thus projected a \$1.9 billion drawdown in the external reserve over the 2nd half of 2018 relative to a \$7.8 billion accretion recorded in H1 18. True to our words, but at a greater scale, Nigeria's external reserve took a plunge over H2 18 with a depletion of \$3.9 billion. Consequently, the external reserve's position closed the year at \$43.2 billion, lower than our estimate of \$45.7 billion. The marked drawdown stemmed largely from an enlarged repatriation of maturing fixed income instruments held by offshore investors, which we estimate at 30% of outstanding instruments. To put in context, we had estimated that about half of the maturing instruments held by foreign investors, which we estimated at \$9.7 billion (H1 18: \$7.6 billion), will be repatriated. However, from our analysis, ~70% of maturing instruments held by FPI was repatriated over H2 18. In fact, between October and December, the outflow of funds was in excess of 80% of maturing fixed income instruments of \$6.8 billion (Forecast: \$3.4 billion).

Figure 1: Offshore holdings of maturing FI instrument vs. IEW Outflow (\$'billion)

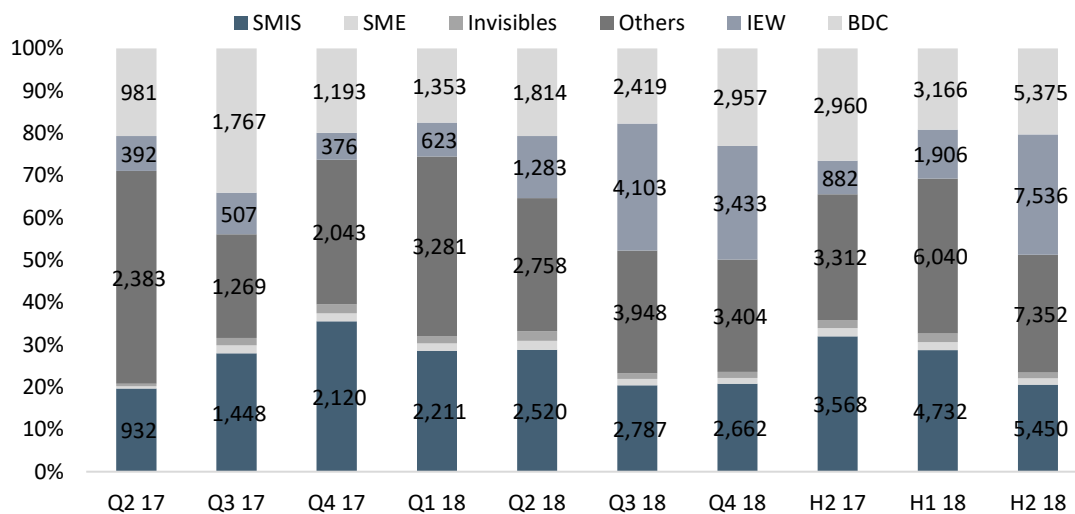
Source: FMDQ, ARM Research

The sizable repatriation and paucity of flows at the Investors and Exporters Window (IEW), prompted the Central Bank of Nigeria (CBN) to stepped up its intervention over H2 18 across markets compared to H1 18 with overall intervention printing at \$26.5 billion, which is 60% higher relative to H1 18¹. Also, in November, the CBN increased the frequency of dollar sales to BDCs to four times a week (previously three), bringing weekly intervention per BDCs to \$60,000 from \$45,000.

¹ IEW (+295% to \$7.5 billion), BDC (+70% to \$5.4 billion) and Interbank sales (+18% to \$13.6 billion)

Consequently, the NAFEX, BDC and parallel rates remained relatively stable over H2 18, closing the period at ₦363.2/\$1, ₦362.3/\$1, and ₦363.7/\$1 accordingly. (H1 18: ₦360.5/\$1, ₦359.4/\$1, and ₦360.9/\$1 accordingly).

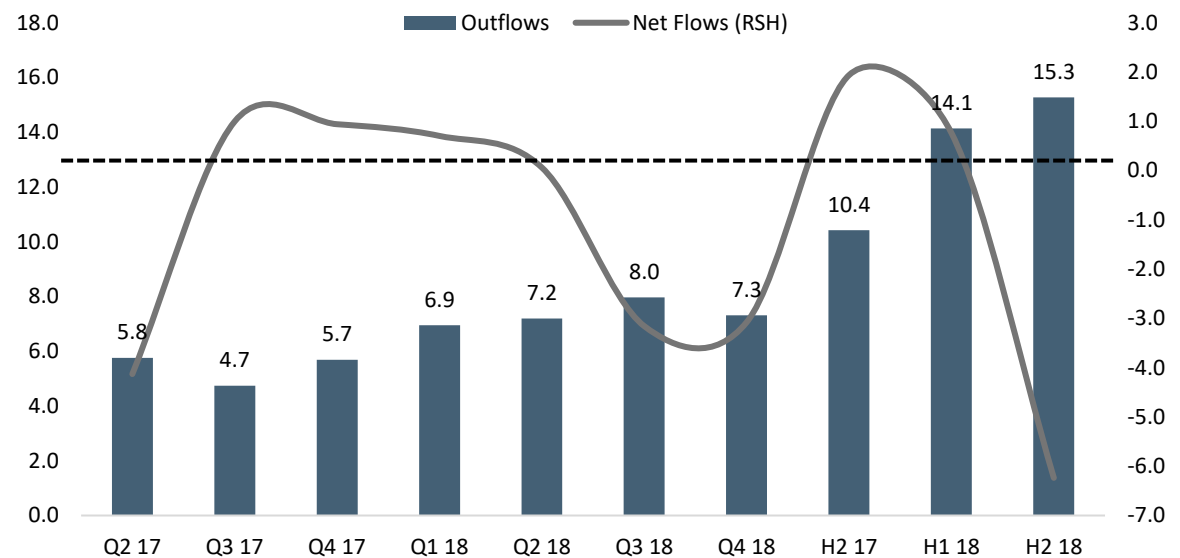
Figure 2: CBN intervention across FX markets (\$'Million)



Source: FMDQ, ARM Research

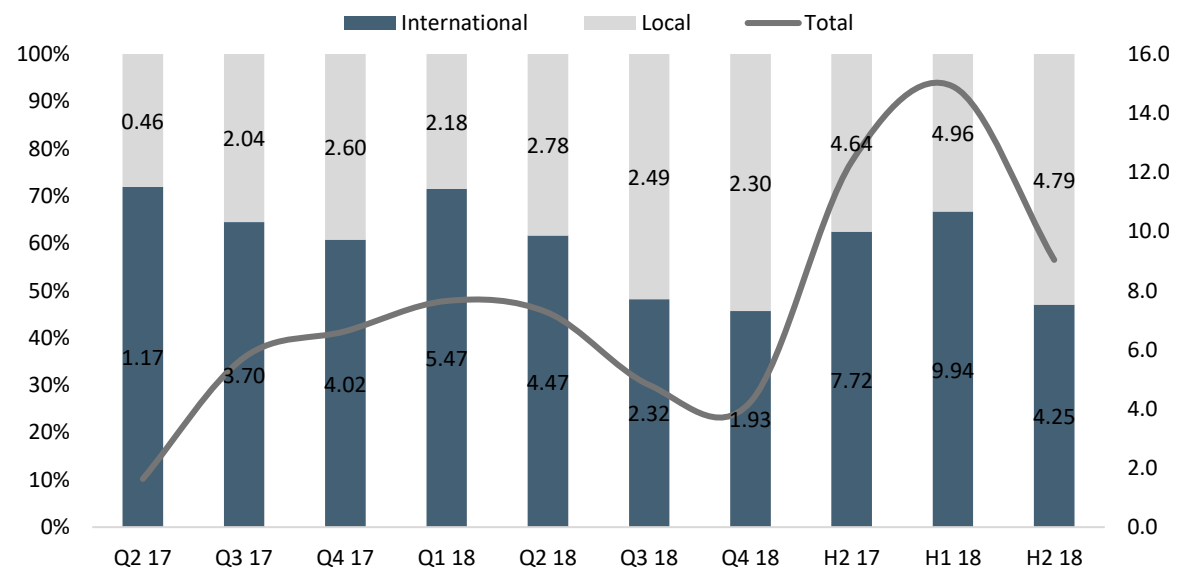
CBN hits Wall of Worry as FPI shirk the window

We had stated that electioneering concerns ahead of the general election and interest rate hike in the US would strangle capital flows into the domestic economy with current funds taking a safe flight. As expected, following higher quantum of outflows necessitated by repatriation of offshore funds, amidst paucity of inflows, the CBN had to mediate in the IEW to cover net-dollar demand of \$6.2 billion over H2 18, relative to H1 18, when the market was dollar liquid with net-dollar supply of \$763 million in H1 18. Overall, outflows at the IEW rose to a high of \$15.3 billion (compared to outflow of \$14.1 billion in H1 18). Consequently, total dollar sales by the CBN at the window stood at \$7.5 billion compared to net purchase of \$3.1 billion in H1 18. Specifically, the single largest intervention by the apex bank was in September, wherein it sold a total of \$2.1 billion, following pent up demand by exiting offshore funds of \$3.3 billion – largest monthly outflow since the inception of the IEW.

Figure 3: Structure of flows at the IEW vs. Balance (RHS) in \$'Billion

Source: FMDQ, ARM Research

On supply, relative to H1 18 when the IEW was finely greased, the paucity of FPI inflows left the market illiquid. Over H2, total dollar inflow (ex-CBN) declined 39% to \$9.0 billion (average monthly flows of \$1.5 billion) compared to total inflow of \$14.9 billion in H1 18 (monthly avg - \$2.4 billion). The slowdown in flows was driven by decline in offshore funds to \$4.3 billion from \$9.9 billion in H1 18, reflecting lower FPI flows to a low of \$3.7 billion (vs. \$8.7 billion in H1 18). For context, FPI flows accounts for 51% of total inflows and 89% of total offshore funds.

Figure 4: FX Inflow at the I&E Window (\$'Billion)

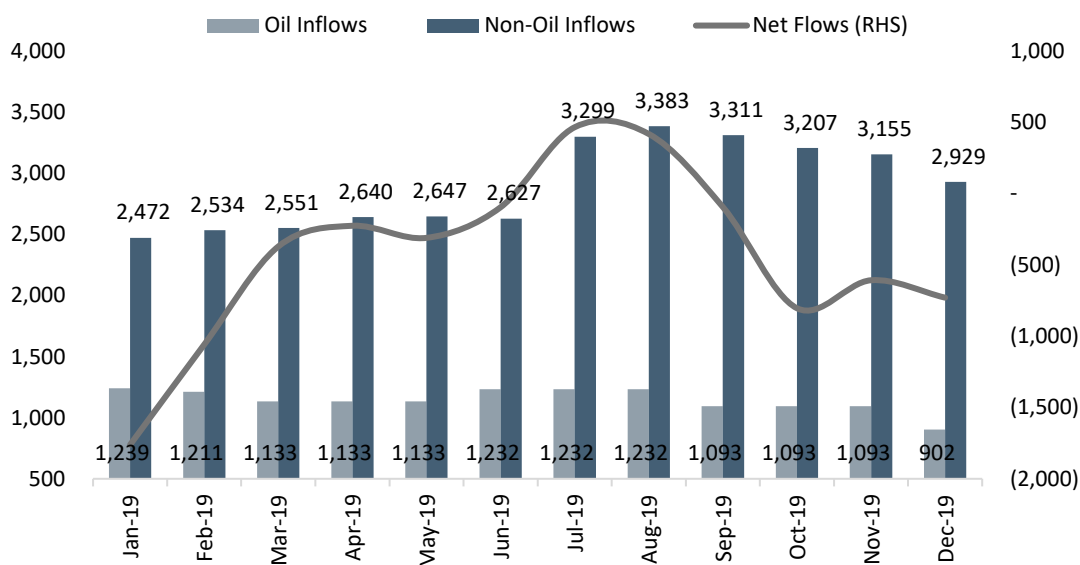
Source: FMDQ, ARM Research

Dollar inflows: How slow will it go?

In trying to estimate the FX liquidity position of the central bank, we start from the oil side. On CBN oil inflow, we have modeled crude oil production of 2.07mbpd over 2019 with crude oil export of ~1.7mbpd and FG share of export at 964kbpd. We have also factored our crude oil price forecast of \$55.95/bbl. for 2019 (H1 average: \$59.7/bbl. and H2 19: \$52.2/bbl.). On balance, we forecast average monthly crude oil inflow to the CBN of \$1.14 billion over 2019 (H1 average: \$1.18 billion and H2 19: \$1.11 billion) with overall flow for the year estimated at \$13.73 billion (-10.1% YoY).

On non-oil inflows, beyond the political concerns which necessitated flight to safety of maturing money market instruments over H2 2018, we believe the global shocks and tensions will further constrain the return of flows. As such, while we note the relative stability post-election in Q1 2019, we estimate total FPI flows over 2019 to decline 38% YoY to \$7.3 billion. As such, we see significant contraction in non-oil inflows to \$34.8 billion compared to FY 18 of \$44.1 billion, with the largest portion of \$19.3 billion expected over H2 19. Overall, we believe the apex bank will run on lower flows over 2019, with average monthly inflow of \$3.9 billion (H1 average: \$3.7 billion and H2 19: \$4.3 billion), with sum of inflow for the period contracting to \$47.9 billion (vs. \$58.9 billion in 2018). The foregoing is expected to constrain the apex bank's ability to shore up the external reserve.

Figure 5: CBN oil and non-oil inflows and forecast (\$'Billion)

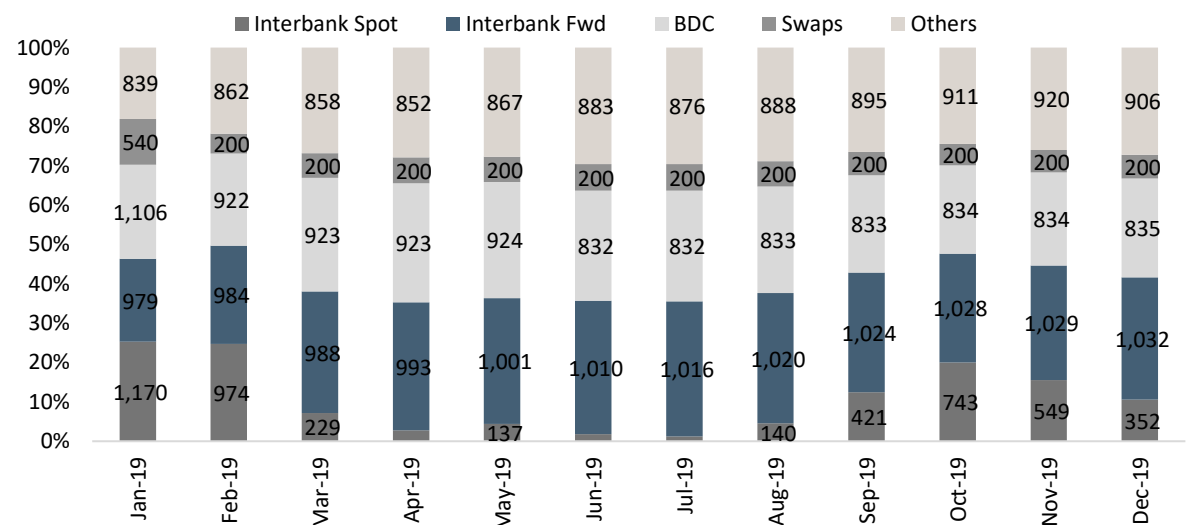


Source: CBN, ARM Research

How justified is the worry on capital flight?

On portfolio outflows, our estimate suggests that foreign holdings of maturing treasury bills (incl. OMOs) in 2019 of ₦12.5 trillion trillion (\$34.9 billion) stands at \$11.4 billion, with estimated repatriation of \$5.5 billion (42% of foreign holdings). Also, we have factored further outflows from our estimate of FPI inflow during the year, which stands at \$1.56 billion and bring total portfolio outflows to \$7.1 billion. On other outflows, we expect imports valid for CBN sales to decline by 25.6% YoY to \$33.4 billion (H1: \$16.2 billion & H2: \$17.2 billion) largely due to the exclusion of fertilizer imports from CBN list. As a result, the confluence of lower demand for imports (visible and invisibles) and slower rate of repatriation of offshore holdings maturing fixed income instruments, we see a decline in CBN interbank forward and spot intervention by 8.5% YoY to \$19.2 billion (H1 19: \$8.9 billion and H2 19: \$10.3 billion).

Elsewhere on BDC sales, with the increase in CBN sales to \$60,000 per week, we expect CBN sales to that segment to increase 37.5% YoY to \$10.6 billion. On swaps and other sales, we do not expect initiation or renewal of maturing swap positions over 2019, with consequent impact on lower maturity and sales. Thus, we forecast swap and other sales to contract by 42.4% YoY to \$13.3 billion.

Figure 6: CBN sales and forecast across FX markets (\$'Billion)

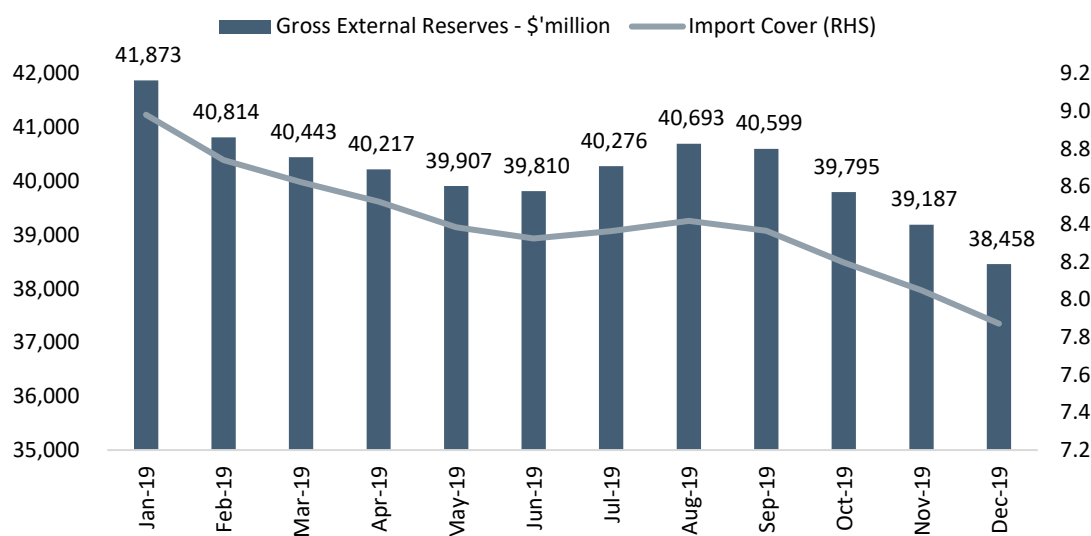
Source: FMDQ, ARM Research

Naira stability: A test of nerves and resilience

Overall, with our model suggesting cumulative slower CBN intervention over 2019 to the tune of \$53 billion (3% lower YoY), we estimate average monthly sale of \$4.5 billion (vs. \$4.7 billion in 2018). Coalescing this with our estimate of average oil and non-oil inflows to the apex bank, we estimate monthly average reserve drawdown of \$431 million which summed up to \$5.2 billion over 2019 relative to \$3.7 billion accretion in 2018, though supported by

Eurobond issuances of \$5.3 billion. The foregoing would exert some pressure on the foreign reserve to close 2019 at \$38.5 billion (\$41.2 billion if adjusted for the proposed \$2.7 billion Eurobond to finance the 2019 budget). While this suggest a comfortable position for the apex bank and the naira, we believe the distorted interplay of demand and supply at the IEW and the increased demand at same would drive short term volatility in rates and an eventual adjustment to our fundamental driven purchasing power parity (PPP) estimate of between ₦397.61/\$ to ₦401.50/\$ (8-10% down-leg from current NAFEX rate of ₦362.00/\$ at the end of December 2018). However, we fully recognize many stipulations behind expecting mean reversion from real effective exchange rates (REERs) and PPP, we refrain from interpreting the results of our analysis as a viable trading signal, as currencies do not always trade in line over short term horizons due to current account trends and interventions by monetary authorities.

Figure 7: Forecast FX reserves and import cover



Source: FMDQ, ARM Research

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