

Nigeria Strategy Report

H1 2019

Global Economy and Markets

EM portfolio flows: A tale of differentiation

Executive Summary

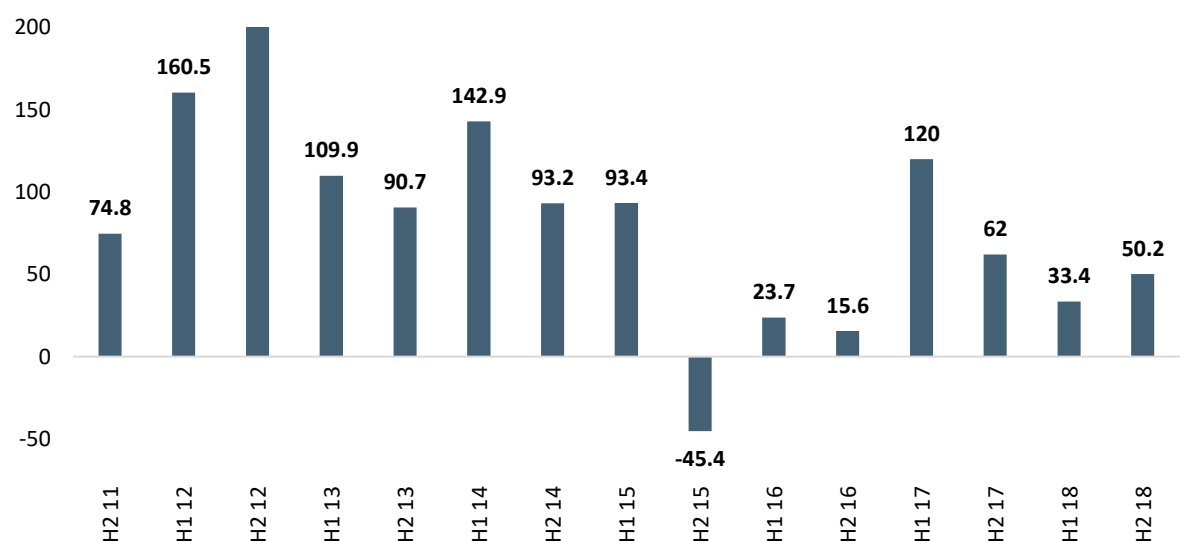
In our H2 2018 NSR, we noted that the confluence of sturdy DM growth picture and currencies, interest rate normalization in US, and ripple effect of escalating trade wars between US and China should temper the scale of portfolio flows into EMs, idiosyncratic factors and monetary tightening across various EM economies would limit the scale of repatriation. In line with our expectation, after episodes of capital flights that saw dearth of hot money in emerging market (EM) in second quarter of 2018 with net outflow of \$26.3 billion, fortunes changed slightly in second half of 2018 as net portfolio flows to EM turned positive (\$50.2 billion) following selective play across EMs, shaped by fundamentals rather than general contagion.

Going into 2019, although the recent spate of selloff across EMs provides entry opportunity and attractive valuations for investors, the litany of potential risks globally from rising U.S. interest rates and increased volatility in equity markets due to escalating trade tensions, political unrest and risk to commodity prices now spurs the need for differentiation and idiosyncrasy in EMs allocation. In sync with our projection for lesser havoc to EM flows in 2019, the Institute of International Finance (IIF) now projects a slight uptick in portfolio flows to EMs (+11% YoY to \$340 billion) in 2019, which will be driven by portfolio flows to equity (+89% YoY to \$121 billion), while portfolio flows to debt (-10% YoY to \$222 billion) is expected to remain subdued on declining debt issuance in most EMs.

In this report, we look at the major themes that dominated portfolio flows to EM in 2018 as well as our outlook for flows to EM over 2019.

Staying afloat in turbulent waters

After episodes of capital flights that saw dearth of hot money in emerging market (EM) in second quarter of 2018 with net outflow of \$26.3 billion, fortunes changed slightly in second half of 2018 as net portfolio flows to EM turned positive (\$50.2 billion). The change in fortune was largely shaped by selective plays across EMs as specific fundamentals and vulnerabilities rather than general contagion dictated flows. On one hand, the on-going Fed rate hike, rising US treasury yields and strengthening green back (+5% YoY) softened foreign investors' appetite for risk assets even as specific EM vulnerabilities impacted on selected EM economies led to widening of the EM spread¹ (H2 18: +26ppts to 414bps). On the other hand, the effects of monetary policy normalization in advanced economies have been offset by hawkish monetary policy in some EM countries, higher commodity prices as well as improvement in external balance.

Figure 1: FPI Flows to EM (\$' billion)

Source: IIF, ARM Research

Peaks and valleys across various destinations

In EM Asia, despite China's economic growth in Q3 18 GDP numbers (-30bps to 6.5%) – fallout of ongoing trade negotiations between China and US – portfolio flows to China remained resilient in Q3 18 (Q3 18: \$21.5 billion). Although portfolio flows to equity remained soft over the period (Q3 18: \$492 million vs \$11.2 billion in Q2 18) on concerns of slowdown in economic activities, while portfolio flows to Chinese debt remained robust. The sustained Foreign interest in Chinese debt reflects efforts by Chinese officials to increase investors access to Chinese bond

¹ The JPMorgan Emerging Market Bond Index (EMBI) are a set of three bond indices to track bonds in emerging markets operated by J P Morgan

market. This paid off with foreign portfolio flows to Chinese debt market sustaining positive run in Q3 18 to \$21 billion (vs \$36.7 billion in Q2 18). More so, the bullish run in Chinese bonds (+15% YoY) which tailed Government's deleveraging exercise further incentivized foreign investors' appetite for Chinese bonds in Q3 18. Elsewhere, amid higher US Treasury yields, Portfolio investment in Malaysia by non-residents sustained negative run with outflow of \$880 million in Q3 18 (Q2 2018: net outflow \$9.4 billion) following net liquidation of non-resident holdings of ringgit-denominated domestic debt securities.

Over in Latin America, following the sequence of macroeconomic woes, foreign investors continue to retract their investment from Argentina. FPI flows in third quarter of 2018 printed negative (Q3 18: -\$3 billion vs -\$2.5 billion in Q2 18) for the second consecutive quarter in the year. Specifically, investors feared government's ability to rein in on spiraling inflation (+250bps MoM to 48% in November) emanating from a plunge in the Argentina Peso (-31% in H2 18) against the backdrop of higher interest rates in the US and strengthening US dollar. The capital flight in Argentina was further exacerbated by high current account deficit (+25% YoY to \$8.3 billion in Q2 18) – highest since 1994 – and foreign debt levels (+18% YoY to \$117.8 billion in Q2 18). In response, the Central bank left interest rates elevated (60%) and turned to the IMF for a \$57 billion support facility. Across the border, after a gloomy second quarter that saw FPI exit to the tune of \$2.56 billion in Brazil, tides turned in Q3 18. For context, FPI flows rebounded in Q3 18 (\$2.6 billion vs -\$2.6 billion) as foreign investors cheered Brazil's upbeat growth picture (+50bps to 1.3%YoY) after exiting recession in 2017 as well as subdued prices (2018 average inflation: 3.65%).

Meanwhile in Europe, Turkey appears to be one of the worst hit with FPI repatriation in 2018. To buttress, after recording FPI outflows of \$1.5 billion in Q2 18, foreign investors exit from Turkey heightened in Q3 18 with net portfolio outflows of \$2 billion. The increasing pace of FPI outflows reflects weakening macroeconomic fundamentals following widening current account deficit and heightening inflationary pressures which went as high as 25.2% in October 2018. In addition, foreign investors reacted to US-Turkey diplomatic spat following the extradition of a US pastor. The reverberating effect of this plunged the Lira markedly, pushing YTD plunge in Lira in Q3 18 to -39%. Given the marked depreciation in the Lira, foreign investors questioned government's ability to pay back its elevated external debt (Q3 18: \$448.5 billion). Consequently, in a bid to combat inflationary concern and attract non-resident portfolio flows, the Central Bank raised interest rates by +625bps to 24%.

Over in Africa, after bucking four consecutive quarters of positive portfolio inflows into Nigeria's equity market in Q2 18 (-\$192 million), foreign investors turned net buyers of Nigeria's shares in Q3 18 with flows printing at \$7.2 million. Although, when compared to 2017 high of \$520 million, foreign investors flows appear weak. To our mind, despite the upbeat macroeconomic fundamentals following higher crude oil prices, the impending general elections in February 2019 and prospect for a stronger US dollar continues to dampen Non-resident capital flows into Nigeria. On the other hand, foreign portfolio interest in Nigeria's fixed income securities waned in Q3 2018 as flows to bonds and money market fell 90.6% and 51.6% respectively to \$37.5 million and \$1.3 billion respectively. To our minds, the tamer interest in Nigeria's debt reflects FPI flight to safety following higher US treasury yields and stronger US economy. Elsewhere in South Africa, after falling sharply due to investor risk aversion towards emerging markets in Q2 2018 (-81% QoQ to 16.6 million ZAR), FPI inflow into South Africa rebounded slightly by 8% QoQ to 17.9 million ZAR. The Central bank alluded this to jump in portfolio flows to the debt segment of the market following issuance of foreign currency denominated bonds by a public corporation during period.

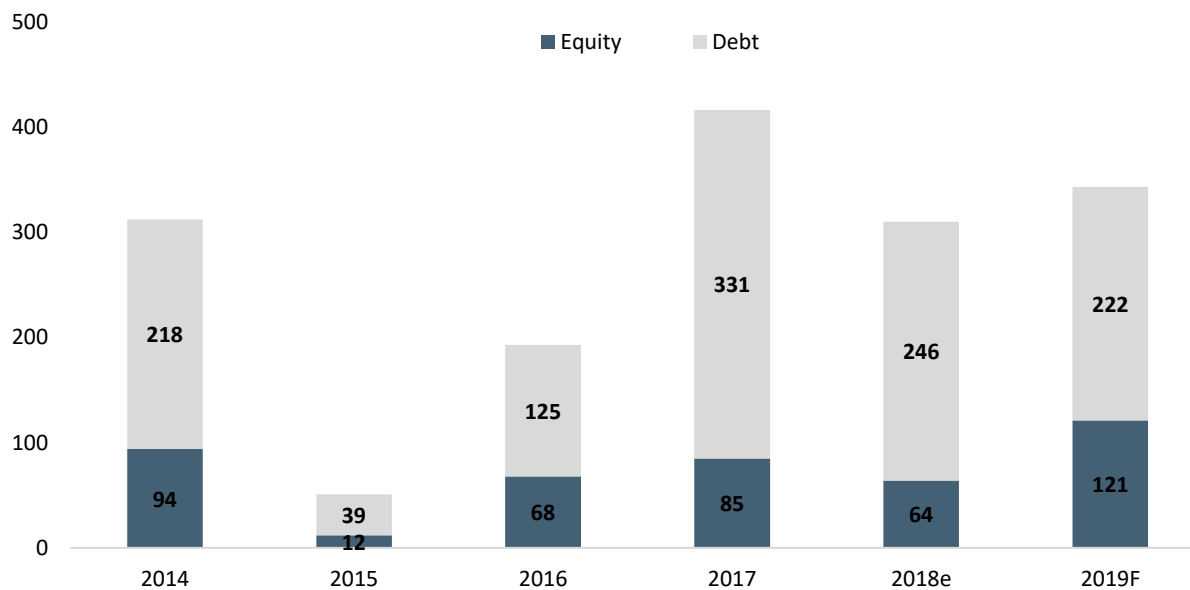
Differentiation shaped by country specific fundamentals and vulnerabilities

Going into 2019, although the recent spate of selloff across Emerging market provides entry opportunity and attractive valuations for investors, the litany of potential risks globally from rising U.S. interest rates and increased volatility in equity markets to escalating trade tensions, political unrest and risk to commodity prices now spurs the need for differentiation and idiosyncrasy in EMs allocation.

Looking at the pull factors, we see room for higher dollar borrowing cost and stronger dollar over the near term. This view is premised on feelers from the US Fed at its December 2018 monetary policy meeting which suggest the possibility of two rate hikes this year which could push US interest rate to 3% in 2019. To add, following the culmination of ECB's Asset purchase program (APP) in December 2018 and its gradual tilt towards interest rate normalization, ECB hinted at a possible return to monetary tightening in summer 2019 if inflationary pressures persist. Regardless, we do not expect the impact of higher interest rate in Developed Markets to be as grave as 2018 due to the lesser spate of interest rate hikes. Hence, we foresee tamer disruption to EM portfolio flows emanating from monetary tightening in DMs. More so, despite expectation of tighter monetary conditions in DMs we hold the view that differences in macroeconomic fundamentals across various EMs will play a major role in plotting the trajectory for portfolio flows over 2019. Specifically, countries with macroeconomic challenges such as high external indebtedness, higher trade imbalances with US, current account deficit, dependence on commodity export, geopolitical risk

and upcoming elections are susceptible to frail FPI flows in 2019. In sync with our projection for lesser havoc to EM flows in 2019, the Institute of International Finance (IIF) now projects a slight uptick in portfolio flows to emerging market (+11% YoY to \$340 billion) in 2019. The higher flows in 2019 is largely driven by portfolio flows to equity (+89% YoY to \$121 billion) on the back of significant differentiation across various EM countries. While portfolio flows to Debt (-10% YoY to \$222 billion) is expected to remain subdued on declining debt issuance in most EMs.

Figure 2: IIF Projections for portfolio flows to EM over 2018 (\$'billion)



Source: IIF, ARM Research

US-China Trade war: Will China throw in the towel?

As international trade tensions are beginning to escalate, global markets are laced with uncertainties as investors gauge potential aching areas across various EM economies. Regardless, one thing is clear, all parties involved could be hard hit by further protectionist actions. More explicitly, Countries imposing tariffs and countries subject to tariffs would experience losses in economic welfare, while countries on the sidelines are also on the row to experience collateral damage. Although, US-China reached a 90-day cease fire that would see US hold off on plans to raise tariff on \$200 billion worth of Chinese goods, markets still fear the outcome of a full-blown trade war if negotiations go south. If a full-blown trade war occurs, China appears to be the most vulnerable given that 20% its exports are destined for the US while it only exports about 10% of its goods to the US. Furthermore, EM financial market uncertainties are being fueled by concern over potential deterioration in global trade

conditions that could result from further trade escalation and by extension indirect impact on businesses, consumption and global investments. Thus, we think further escalation in US-China trade rift would trigger more caution in investors behavior thereby limiting portfolio flows to EMs. In addition to that, ambiguity over major EMs response to heightening trade war could cast another layer doubt in the mind of foreign investors. However, given that China is at the receiving end of the trade tension and the ongoing trade spat has started taking a toll on its economy we think China might concede to pressure from the US.

Staying afloat in turbulent waters

On regional basis, in the wake of recent global trade tensions, China's government official is faced with policy dilemma of pursuing a dovish monetary policy in a bid to stimulate economic growth or tighten monetary conditions to constrain elevated private sector debt. To our mind, given that the ongoing trade rift with the US has started taking a toll on China's economy, we think Chinese officials will be more inclined to holding off a rate increase to pursue economic growth. While these serves as a major repellant to foreign investors seeking high yielding EM debt asset, we think Chinese authorities' efforts to stimulate the economy via expansionary policies should help curb potential resident capital outflows from China's equity market over the near term. To add, further steps to open China's bond market and MSCI's decision to include CNY-denominated Chinese stocks in its benchmark index could boost portfolio flows to China. Meanwhile in Malaysia, although scope for further monetary tightening across DMs places a lid on sizeable foreign capital rush into Malaysia, government's target initiative to support the bottom 40% of the population (B40 group), advance financial inclusion, increase household electricity subsidy for the poor by ~100%, fuel subsidy and minimum wage (+5%) could boost economic growth next year. Hence, we expect this to temper the scale of capital flights over 2019.

Over to Latin America, whilst the confluence of waning political uncertainties and subdued interest rate environment (four year low of 6.5%) bodes well for Brazil's economic growth and investments, downsides for foreign portfolio flows exist going into 2019. First off, the biggest uncertainty is whether president Jair Bolsonaro's reform drive will turn out positive given the wide divide between opposition party members in the Congress. This in addition to higher US yields could leave FPI flows into Brazil subdued over 2019. Elsewhere in Argentina, although political uncertainty ahead of its 2019 general election as well as depressed macroeconomic fundamentals does not bode well for FPI flows, upside abounds for FPI flows in 2019. This reflects government's decision to trigger more front-loaded disbursements from its \$57.1 billion IMF program to cater for its 2018-19 financing needs. This is expected to stem currency pressures and boost economic activities over the near term.

Elsewhere in EM Europe, despite Central Bank's decision to keep interest rate elevated to curb further depreciation of the Lira (-15% in H2 18) and spiraling inflation (H2 18 avg: 21% vs 11.54% in H1 18), Turkey's bleak macroeconomic outlook should keep portfolio flows subdued in 2019. To buttress, given the monetary authority's strong will on maintaining a hawkish monetary policy, there appears to be little scope for credit growth going into 2019. This is expected to keep consumption and investment low with IMF now expecting a possible leap into recession in 2019. Consequently, we anticipate further hurt to the Private sector which currently grapples with elevated debt levels. Thus, we see scope for tamer foreign portfolio flows to Turkey in 2019.

Lastly in Africa, over 2018 we see room for possible return of FPI flows to Nigeria. Our view is hinged on stable macroeconomic climate following dissipating inflationary pressures, sustained economic growth and stable FX. More importantly, with elections coming up in February we see possible return of FPI as political uncertainty wanes. Elsewhere in South Africa, although economic growth is expected to rebound in 2019 with IMF forecasting a 1.4% YoY growth in 2019 (vs 0.8% in 2018) foreign investors should remain cautious ahead of general elections in 2019.

Table 1: Election dates across major EM country in 2019

Country	Date
Nigerian General Election	2nd February 2019
Tunisian Presidential election	December 2019
South African General election	2019
Indonesian General election	4th April 2019
Romanian Presidential election	November/December 2019
Ukrainian Presidential election	31st March, 2019
Uruguayan General election	October 2019
Argentine General election	27th October 2019

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