

# Nigeria Strategy Report

## H1 2019

### Domestic Economy and Policy Environment

## Balance of Payment: Feeling the Strains

### Executive Summary

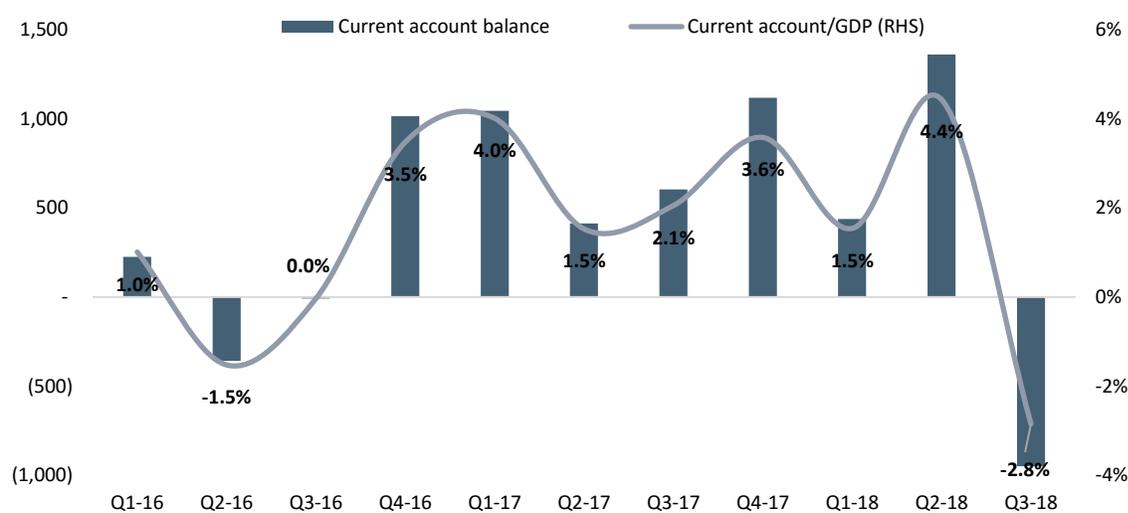
Over Q3 18, the ink in Nigeria's current account turned red – the first since the last 8 quarters. While we had expected higher oil price over the quarter to spur Nigeria's current account surplus, the current account deficit reflected lower trade surplus due to the one-off jump in imports over the period – a fallout of the import of a submersible drilling platform. As a result, current account surplus for the nine-month period is tracking lower by 59% YoY to \$2.78 billion. Shifting our gaze to the other segment of Nigeria's balance of payment (BoP), we saw capital flows outturn over the year play exactly in tandem with our view, plunging to a 6-quarter low over Q3 18 on the back of policy normalization in advanced economies and election uncertainties in the country. The net impact of current account deficit and lower capital flows resulted to a drawdown in external reserves.

Going into 2019, we estimate a decline in the current account surplus to \$1.45 billion in FY 19, with surplus in the first half of \$3.01 billion offsetting a deficit of \$1.6 billion in H2. Our projection is largely hinged on our expectation of a higher trade surplus in H1 (\$9.59 billion) than H2 (\$6.53 billion). Our forecast for lower oil prices (avg. of \$56.95/bbl.) – despite stable production (avg. 2.08 mb/d) – in 2019 constitutes a major driver of our projection of a decline in exports by 11.9% to \$54.8 billion during the period. Imports on the other hand is expected to normalize from the record high posted in 2018 to \$38.7 billion (-10.40% YoY) by FY 19. To state, excluding the one-off jump imports recorded in Q3 18, our estimate for imports in 2019 will be slightly lower by 0.98% to \$38.7 billion from \$39.04 billion. Consequently, we forecast trade surplus of \$16.12 billion relative to \$19 billion in prior year. The foregoing alongside higher income deficit, slightly lower services deficit, and increased current transfer surplus, informs our decline in the current account surplus to \$1.45 billion. Elsewhere, we expect election uncertainty in Q1 19, higher US yields and lower oil price to weigh negatively on capital flows to the country. Consequently, we forecast capital flows to moderate 39% YoY to \$10.2 billion with flows in H2 19 expected to be lower due to a more bearish oil price outlook.

***In this report,  
we focus on  
development  
in the  
domestic  
environment,  
highlighting  
our views on  
the Nigeria's  
current and  
financial  
accounts  
position***

***Current account balance takes a nosedive in 2018.***

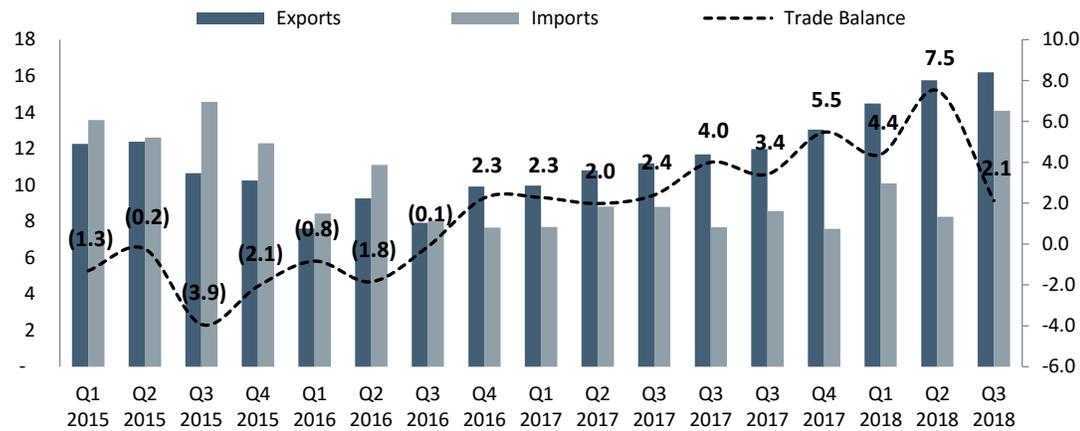
In the second half of the year, the current account (CA) surplus fell short of the mark, as we had higher expectations for the 2018E current account surplus (est. \$14.5 billion). However, with a decline in the surplus to \$2.78 billion as at 9M 18 (9M 17: \$6.74 billion) from \$5.89 billion in H1 18, we have had to adjust our post for 2018E to \$3.45 billion. The decline was largely on the back of a one-off jump in the non-oil imports which dragged on the trade surplus in Q3 18 as well as a spike in services deficit. This led to a switch in the overall CA balance to a deficit of \$3.1 billion – the first deficit in two years. This in turn translated to a CA to GDP ratio of -2.84% in Q3-18, vs 3.58% recorded in Q4-17.

**Figure 1: Current account balance (\$'billion) and CA as % of GDP**

Source: CBN, NBS, ARM Research

A look at the current account components shows that the trade surplus plunged 72% in Q3 2018 to \$2.13 billion, following a one-off jump in imports of drilling machinery. This bolstered increase in 9M 18 imports by 29% YoY to \$32.4 billion. However, excluding the one-off surge, imports in 9M 18 would have been higher by only 10% YoY at \$27.5 billion. Meanwhile, higher oil prices (avg. \$72.74/bbl.) and stable oil production (avg. 1.90 mb/d) over 9M 18 supported growth in the value of oil exports (+42% YoY) which makes up 92% of total exports. This, together with a jump in non-oil exports (+38% YoY) led to a jump in total exports over 9M 18 by 42% to \$46.5 billion. A look at the Q3 18 performance, shows that oil exports grew by 10% QoQ, offsetting the 49% decline in non-oil exports. In ascertaining the driver, breakdown of non-oil exports by NBS shows that the sharp drop in non-oil exports was driven by decline in sale of solid mineral (-52% QoQ), agriculture (-47% QoQ) and manufactured (-5.9% QoQ) goods sales.

Figure 2: Trade Account (\$'billion)



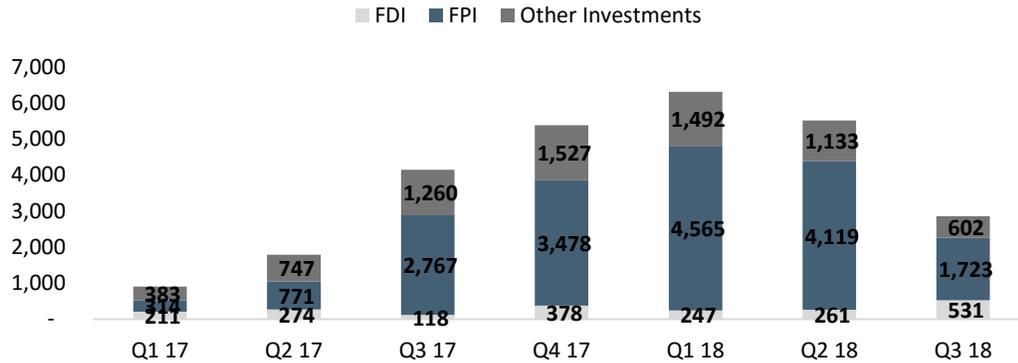
Source: CBN, ARM Research

On the other hand, there was a spike in services deficit by 107% YoY to \$17.7 billion in 9M 18, as relatively stable FX supported overseas spending during the period. Basically, the Nigerians spending on foreign travel and transport expanded 56% and 143% accordingly over 9M 18 while foreign professional/technical services expanded by 176% to \$8.12 billion. Also, Domestic consumers’ spending on foreign education and health services rose to new highs with respective net outflows of \$2.86 billion and \$1.07 billion, compared to lower deficits in 2016, during the crux of the exchange rate crisis. On the income front, deficit increased over the 9 months period by 33% YoY to \$11.36 billion, due to investors’ increased pace of returns repatriation.

**Capital Flows: What goes up ‘must’ come down**

In our H2 2018 strategy outlook, we outlined our expectation for a gloomy second half for capital flows into Nigeria on the back of policy normalization in advanced economies and election uncertainties in the country. True to our expectation, the ecstasy that accompanied foreign investors’ appetite for naira assets over 2017 until early 2018 appears to have faded. Importantly, after scaling to an apogee in Q1 18, capital flows into the country withered for two straight consecutive quarters hitting a 6-quarter low of \$2.9 billion in Q3 18. Despite the stability in the naira and attractive valuation of the equity market and competitive local FI yields; foreign investors flow towards naira assets was soured largely due to rising US yields, change in sentiments towards emerging markets and concerns over the upcoming general elections.

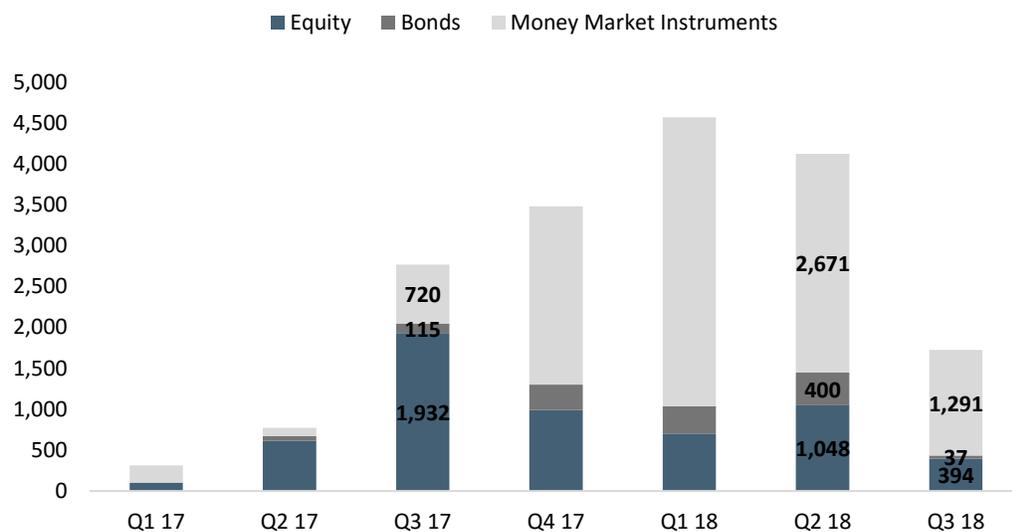
Figure 3: Capital flows into Nigeria (\$'million)



Source: NBS, ARM Research

Perusing the breakdown of flows into the country, the lower flow reflected a shrink in Foreign Portfolio Investments (FPI) and other investments. On the former, most of the decline emanated from lower investment in short-term instruments (-51.7% QoQ to \$1.3 billion) despite CBN tweaking OMO rates higher over the period to curb FX outflows and attract foreign investors. Similarly, investments in equity instruments (-62.4% QoQ to \$394 million) as well as FGN bonds (-90.6% QoQ to \$37 million) were not spared out of the inflow crunch. Elsewhere, other investments, largely loans from governments into the country moderated 50% QoQ to \$561 million.

Figure 4: Foreign Portfolio Investment (FPI) into Nigeria (\$'million)



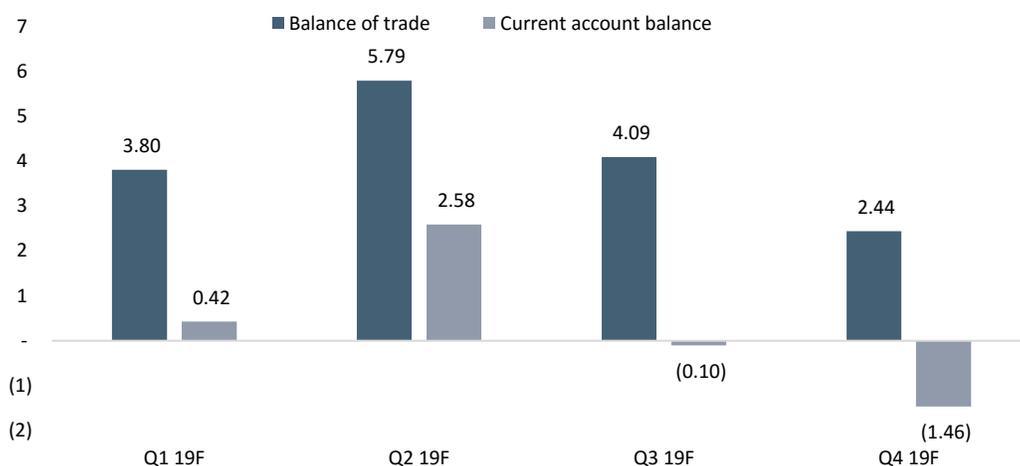
Source: NBS, ARM Research

Meanwhile, Foreign Direct Investment (+103% QoQ to \$531 million) into the country surged over Q3 18 with most of the flows coming in July and August (\$488 million). Overall, the impact of the deficit in Nigeria’s current account ledger and lower capital flows into the country resulted in a depletion of Nigeria’s FX reserve to the tune of \$4.5 billion over the period – the first quarterly depletion since Q3 2016.

**Free fall in 2019 current account surplus**

Going into 2019, we estimate a decline in the current account surplus to \$1.45 billion in FY 19, with surplus in the first half of \$3.01 billion offsetting a deficit of \$1.6 billion in H2. Our projection is largely hinged on our expectation of a higher trade surplus in H1 (\$9.59 billion) than H2 (\$6.53 billion). Our forecast for lower oil prices (avg. of \$56.95/bbl.) – despite stable production (avg. 2.08 mb/d) – in 2019 constitutes a major driver of our projection of a decline in exports by 11.9% to \$54.8 billion during the period. Imports on the other hand is expected to normalize from the record high posted in 2018 to \$38.7 billion (-10.40% YoY) by FY 19. To state, excluding the one-off jump imports recorded in Q3 18, our estimate for imports in 2019 will be slightly lower by 0.98% to \$38.7 billion from \$39.04 billion. Consequently, we forecast trade surplus of \$16.12 billion relative to \$19 billion in prior year. The foregoing alongside higher income deficit, slightly lower services deficit, and increased current transfer surplus, informs our decline in the current account surplus to \$1.45 billion.

**Figure 5: Current account forecast (\$'billion)**



Source: ARM Research

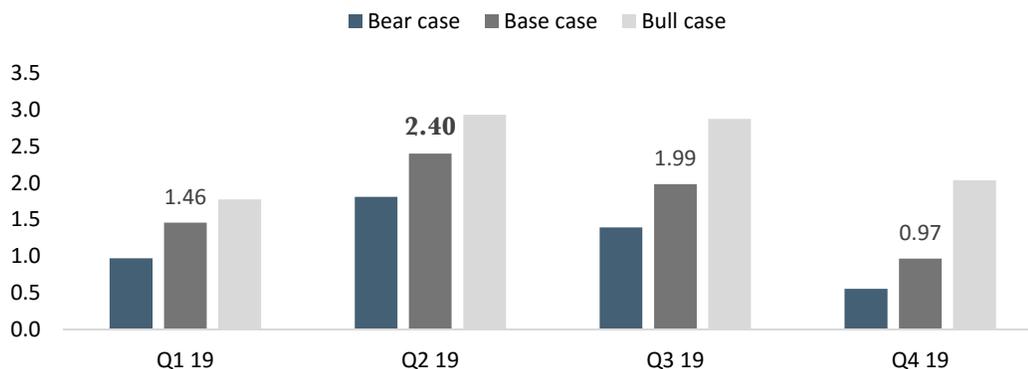
*Capital flows: a flight of no return?*

Taking a cue of drivers for capital flows into Nigeria over the past two quarters, we saw the impact of global tightening condition and election concern weigh heavily on flows despite strong fundamentals. It is worthy to note that Nigeria's market still looks attractive in terms of price and valuation relative to other emerging markets. Similarly, Nigeria yields still looks attractive as we even expect rates to be higher over 2019. Hence, we believe the magnitude of US yields over 2019, global oil price trend, FX stability and importantly the outcome of the 2019 elections will be central to the trajectory of flows into Nigeria over 2019.

Outlaying our outlook for 2019, we played out three different scenarios: (1) a base case which factors in higher US yields over 2019 but capped in H2 19 due to slow economic growth, average oil price of \$56, stable post-election outcome. (2) a bear case which factors in faster rate hike and in extension higher US yields than expected, lower oil price (\$50/bbl), FX pressure and post-election crisis. (3) a bull case which factors in US yields maintaining current levels or possibly even lower due to surprised weaker economic growth, oil price averaging \$66/bbl and no post-election crisis.

Based on the foregoing, we expect foreign portfolio flows to print \$3.9 billion over H1 19 (H2 18: \$3.0 billion) with most of the flows in Q2 19. Going into the second-half (\$2.9 billion), we anticipate portfolio flows to print relatively lower to H1 19 due to our expectation of lower oil price. On balance, we expect portfolio flows to print at \$6.8 billion (-42% YoY). Specifically, portfolio flow to equity instruments should expand 4.5% YoY to \$2.6 billion with most of the flow expected to surface over Q2 19. We believe foreign investors would take advantage of the relatively cheap post-election in February.

**Figure 6: Capital Importation forecast (\$'billion)**



Source: ARM Research

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