January 23, 2019

Nigeria Strategy Report
H1 2019

Domestic Economy and Markets

Fixed Income: Will yields hump or shift?

Executive Summary

Coming into second half of 2018, our expectation for a tighter monetary policy by the CBN came to bear. The drivers, much in line with our thoughts, were the elevated liquidity profile, currency concerns due to capital flight, and ramp up in FG borrowings, which overall drove an expansion in naira yield curve over the period (+166bps to 15.13%). To buttress, the apex bank heightened its liquidity sterilization and raised OMO rates to their highest level in one year. Aside monetary influences, the uptrend in yields was in part fed by fiscal borrowings as FG borrowed ₦339.5 billion in the local market, with a large chunk of the borrowings coming from the bond segment of the market. Lastly, Nigeria's FI market buckled under pressures from the external front as interest rate hike by the US Fed drove wild sell off across Nigeria's FI market. For context, dollar treasury yields expanded by 14bps over H2 2018 to 2.98% and our estimated FPI outflows from the fixed income market stands at $6.8 billion in H2 18 (vs $3.8 billion in H1 18).

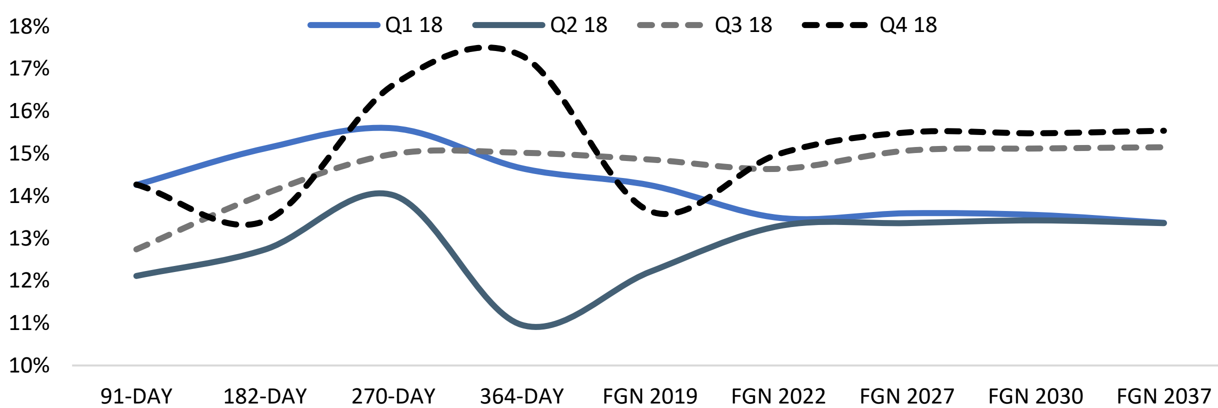
In charting the path for the naira yield curve over 2019, we take a cue from recent activities in the fixed income market. On the monetary front, akin to 2018, the apex bank is faced with a greater liquidity pressure this year with total maturities of ₦14.3 trillion. Thus, we hold the view that CBN will keep OMO rates at current elevated levels and sustain the current pace of liquidity squeeze over in 2019, albeit staggered in line with concentration of maturities over the year. As a result, we expect higher OMO sale in the first and last quarter of the year where maturities are the highest (Q1 19: ₦5.4 trillion, Q4 19: ₦5.9 trillion). On the fiscal side, although FG's proposed fiscal outlay for 2019 points to a lower fiscal deficit (₦1.88 trillion) our pessimistic stance on the FG's revenue picture points to higher fiscal deficit (ARM Estimate: ₦2.8 trillion). Base on the foregoing we pen down ₦850 billion in external borrowings and domestic borrowings of ₦1.5 trillion in 2019 (vs Actual borrowings of ₦290 billion in 2018) whilst the balance would be funded via CBN's ways and means (₦698 billion). Tying it all together, we see upward thrust in the naira yield curve over 2019.

In this report, we focus on developments in Nigeria's fixed income space over 2018. We also delineate the impact of monetary, fiscal and external influences on Nigeria's fixed income market over 2019.

Yields trend higher in second half of 2018

Coming into second half of 2018, our expectation for a tighter monetary policy by the CBN came to bear. The drivers, much in line with our thoughts, were the elevated liquidity profile, currency concerns due to capital flight, and ramp up in FG borrowings, which overall drove an expansion in naira yield curve over the period (+166bps to 15.13%). To buttress, the apex bank heightened its liquidity sterilization and raised OMO rates to their highest level in one year. Aside monetary influences, the uptrend in yields was in part fed by fiscal borrowings as FG borrowed ₦339.5 billion in the local market, with a large chunk of the borrowings coming from the bond segment of the market. Lastly, Nigeria's FI market buckled under pressures from the external front as interest rate hike by the US Fed drove wild sell off across Nigeria's FI market. For context, dollar treasury yields expanded by 14bps over H2 2018 to 2.98% and our estimated FPI outflows from the fixed income market stands at $6.8 billion in H2 18 (vs $3.8 billion in H1 18).

Figure 1: Trend in Naira yield curve



Source: FMDQ, ARM Research

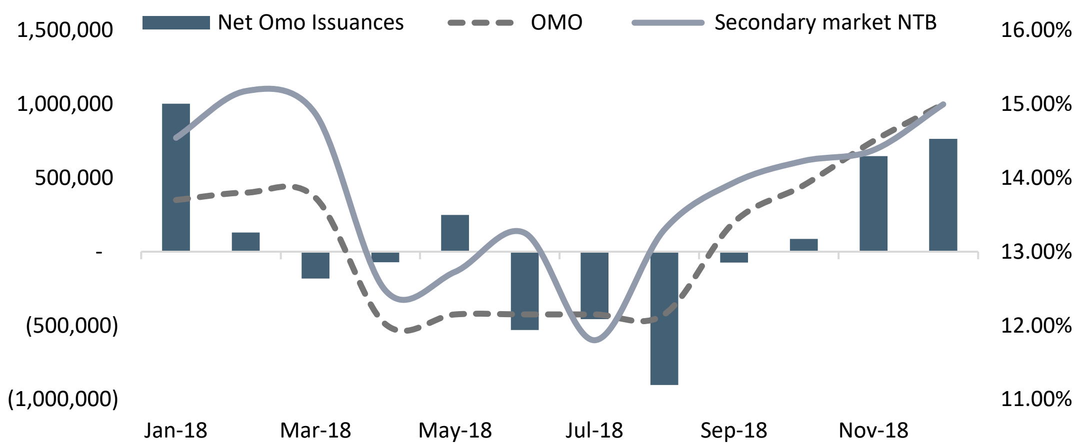
Monetary influences drive short end yields higher

In a bid to curb the mounting liquidity pressure in the system and intervene on the growing currency concern, the central bank raised the OMO[1] rates five-times over the period with the one-year tenor closing at 15.0%. Consequently, yields at the short end of the curve expanded by 174bps to 15.0% in H2 2018. Putting things in perspective, liquidity pressure, over the second half, emanated from maturity profile of ₦10.6 trillion (OMO: ₦8.8 trillion, NTB: ₦1.8 trillion) as well as higher FAAC inflows (avg. monthly: +15% to ₦753.1 billion). Also, with higher rates in the US as well as political risk in Nigeria, offshore outflows almost doubled to $6.8 billion, from our estimate, relative to $3.8 billion in H1 18, which drove the interbank FX market (IEW) to a net-outflow in the period of

[1] Open Market Operation – Central Bank's Liquidity Management Tool

$6.2 billion (H1 18: net-inflow of $763 million) and led to a depletion in the external reserves by 9% to $43.1 billion. In fact, largely reflecting mounting pressures from the currency leg, CBN resumed its special OMO auction where it sold Stabilization securities (STAB) worth ₦1.3 trillion in December 2018. Consequently, the pass through of the foregoing tighter monetary policy by the apex bank, FPI repatriation and currency pressures resulted into higher yields at the short end of the curve (+174bps to 15% in H2 18).

Figure 2: OMO issuances (Repayment) vs NTB yields



Source: FMDQ, ARM Research

Domestic and External influences melds into higher long end yields

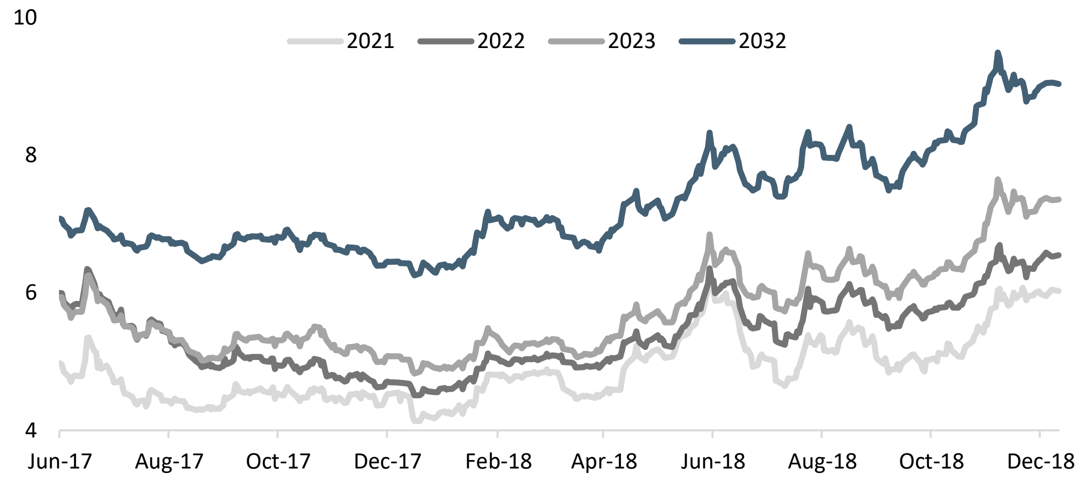
After net-repayment of ₦49.7 billion in the first half of 2018 due to the refinancing of maturing treasury bills with Eurobond, the federal government (FG) net borrowed the sum of ₦239 billion in the second half of 2018. Most of the borrowings were at the long end of the curve (H2 18: ₦401 billion vs ₦209.6 billion in H1 18) which drove higher stop rate at bond auctions to 14.96% in the period relative to 13.47% in H1 2018. Also, bond investors, particularly offshore investors, were net-sellers in the market. Consequently, the confluence of higher borrowings and foreign investors sell off drove a 157bps jump in yields to 15.26% at the long end of the curve.

It all pointed North for Nigeria's Eurobonds

In H2 18, FG tested the Eurobond waters, raising $2.86 billion (₦856.8 billion) to part finance its fiscal deficit of ₦1.96 trillion for the 2018 fiscal year. The switch to external sources sits well with FG's plan to trim its debt service cost. The Eurobond issuance was split between 7-year ($1.18 billion), 12-year ($1 billion) and 30-year ($750 million).

However, unlike February 2018[2], the issuance which attracted coupon 7.625%, 8.75% and 9.25% for the 7-year, 12-year and 30-year respectively appears expensive. Despite favorable domestic clime in the wake of higher crude oil prices, the higher Eurobond pricing reflected higher rates in the US with 10-year US govt bond touching a year high of 3.2% in October. Also, reflecting higher rates in the US, concerns over crude oil prices and political uncertainty, Nigeria's Eurobond Z-spreads expanded by ~16.8bps over H2 2018, with average yields expanding across all instruments - (2021: +18bps to 6.03%), (2023: +77bps to 7.36%) and (2032: + 97bps to 9.03%).

Figure 3: Trend in Eurobond yield



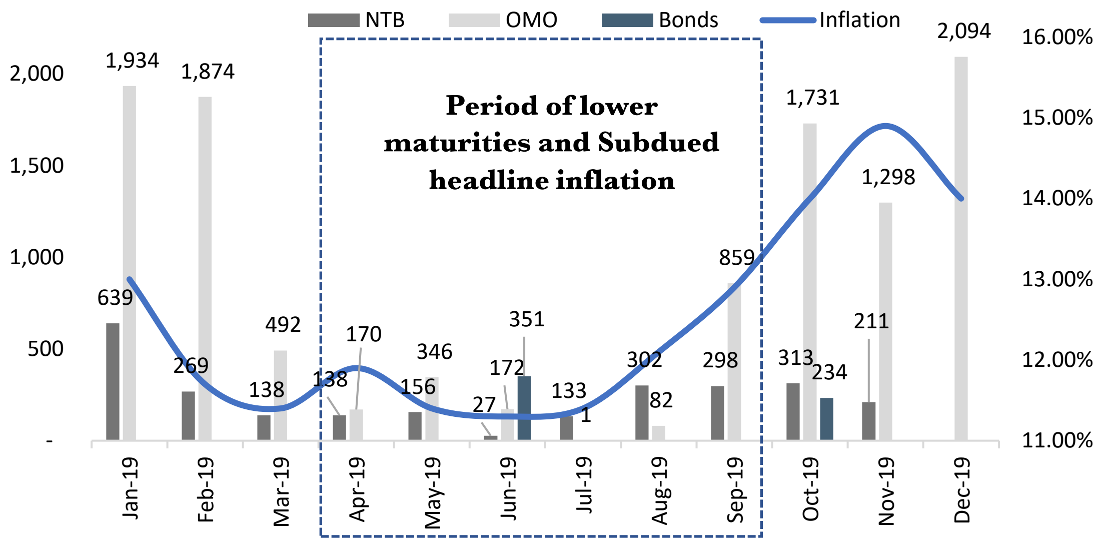
Source: Bloomberg, ARM Research

Will yields hump or shift?

In charting the path for the naira yield curve over 2019, we take a cue from recent activities in the fixed income market. On the monetary front, akin to 2018, the apex bank is faced with a greater liquidity pressure this year. Specifically, the maturity profile over 2019 which stands at ₦14.3 trillion (NTB: ₦2.6 trillion, OMO: ₦11.1 trillion, Bonds: ₦585 billion) could become a thorn in the flesh for the apex bank in 2019. Thus, we hold the view that CBN will keep OMO rates at current elevated levels and sustain the current pace of liquidity squeeze over in 2019, albeit staggered in line with concentration of maturities over the year. As a result, we expect higher OMO sale in the first and last quarter of the year where maturities are the highest (Q1 19: ₦5.4 trillion, Q4 19: ₦5.9 trillion). In like manner, our expectation for tamer OMO sale in Q2 and Q3 sits well with subdued headline inflation over the same period and further pick up in headline inflation as the year draws to a close.

[2] FG raised $2.5 billion in February 2018

Figure 4: 2019 Maturity profile vis a vis ARM Inflation forecast



Source: FMDQ, ARM Research

On the fiscal side, although FG's proposed fiscal outlay for 2019 points to a lower fiscal deficit (₦1.88 trillion) our pessimistic stance on the FG's revenue picture points to higher fiscal deficit (ARM Estimate: ₦2.8 trillion). Base on the foregoing we pen down ₦850 billion in external borrowings and domestic borrowings of ₦1.5 trillion in 2019 (vs Actual borrowings of ₦290 billion in 2018) whilst the balance would be funded via CBN's ways and means (₦698 billion). **Tying it all together, we see upward thrust in the naira yield curve over 2019. Our expectation is largely hinged on CBN's monetary tightening as well as higher FG paper supply over the year.**

Table 1: Scenario analysis of 2019 proposed borrowings

₦'billion	Asset sale + $2.70bn debt + Statutory Ways & Means	50% asset sale + $2.70bn debt + Statutory Ways & Means	No asset sale + $2.70bn debt + Statutory Ways & Means	Asset sale + $2.70bn debt + Av. Historical Ways & Means	50% asset sale + $2.70bn debt + Av. Historical Ways & Means	No asset sale + $2.70bn debt + Av Historical Ways & Means
Projected deficit	**3,206**	**3,206**	**3,206**	**3,206**	**3,206**	**3,206**
Sale of Assets	210	105		210	105	
Foreign Borrowings	825	850	850	850	850	850
CBN ways and means	189	189	189	698	698	698
Borrowings from capital market	**1,982**	**2,062**	**2,167**	**1,448**	**1,553**	**1,658**

Source: ARM Research

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