

Nigeria Strategy Report

H1 2020

Global Economy and Markets

Happy days ahead for EM foreign portfolio flows

Executive Summary

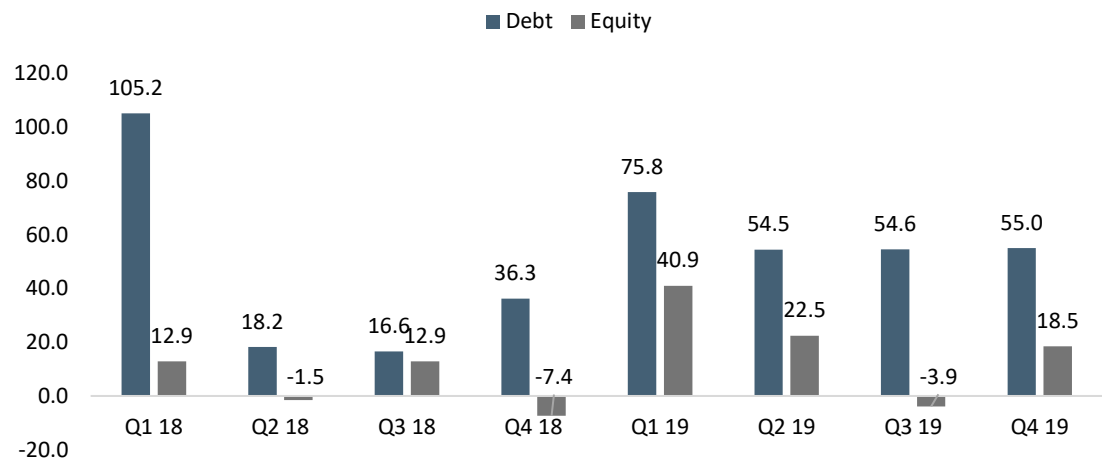
After strong performance (+10.6%) in the first half of the year, emerging markets equities had a difficult third quarter (-5.1%) and rallied in the fourth quarter (+11.4%). The third quarter slump was largely driven by heightening trade tension between US and China over the period. Specifically, United States levied an additional 10% tariff on US\$300 billion worth of Chinese imports, labeled China a currency manipulator, and threatened to de-list Chinese companies from American exchanges. However, following reconciliatory talks that saw US reduced existing tariffs on Chinese goods and cancelled additional planned tariffs as part of a prospective Phase 1 trade deal, EM equities rallied in Q4 (+11.4%). In the fixed income side of things, Emerging markets government bond spreads tightened more than 28bps and 83bps in Q3 19 and Q4 19 respectively over comparable U.S securities. This largely reflects investors' appetite for riskier assets in the wake of accommodative monetary policy across most developed markets.

In charting the course for portfolio flows to emerging market in 2020, we think developments around heightening trade protectionism, the direction of monetary policy across developed markets and prospects for commodity prices (especially crude oil) would play a dominant role. On trade, the US and China finally agreed to the phase one deal which provides temporary pause in the trade war. However, possibilities of a flare up over the phase two agreement and tariff hike by the US on importation of goods from Europe could spell doom for global growth and investments. This is further exacerbated by our expectation for lower crude oil prices (ARM forecast: \$61.26/bl) in 2020 which does not bode well for the fiscal conditions of most crude oil exporters. Notwithstanding, the dovish monetary policy stance across most developed markets could serve as a push factor for portfolio flows into emerging markets this year. This in addition to International Monetary Fund's forecast for emerging market growth to accelerate in 2020 and remain more than double that of developed markets makes valuations for EM relatively attractive. Hence, we see scope for higher portfolio flows into EMs in 2020.

In this report, we look at the major themes that dominated portfolio flows to EM over H2 2019 as well as our outlook for flows to EM over 2020.

Portfolio flows to emerging market loses steam in H2 2019

Portfolio flows to emerging markets continued their downward spiral in Q3 19 with net inflow of \$50.7 billion (vs \$117.8 billion and \$76.1 in Q1 and Q2 19)— its second consecutive quarterly decline. Of the two major asset classes, equity flows have suffered the most from the twists and turns of trade tensions and several country specific idiosyncrasies. On the other hand, declining interest rates in developed markets and a decline in external credit spread (-28bps in Q3 2019) have sustained debt portfolio flows to emerging markets.

Figure 1: Trend in EM net portfolio flows ('billion \$)

Source: IIF, ARM Research

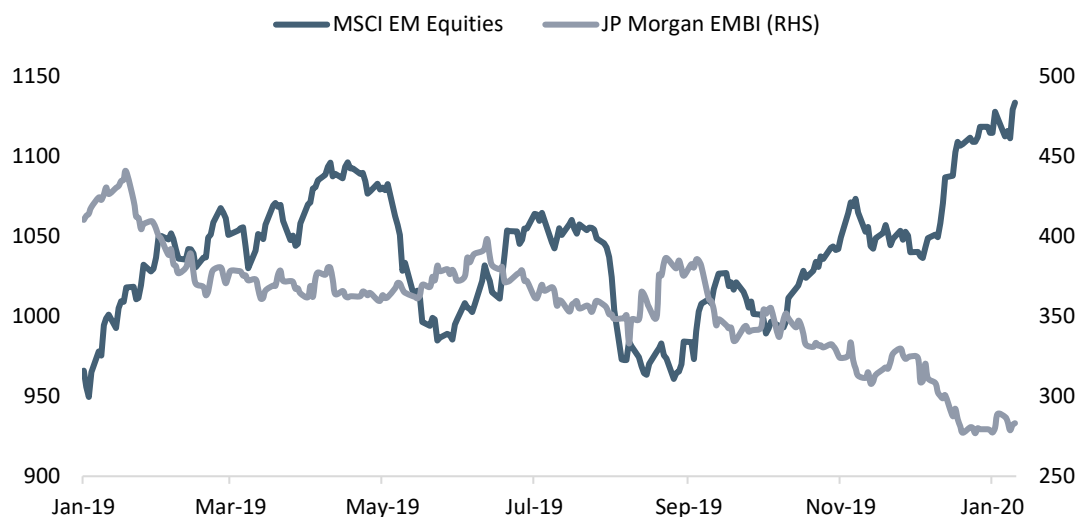
Contrarily, in Q4 19 portfolio flows to EM showed some signs of improvement. Specifically, debt portfolio flows sustained its positive run in October and November, recording a \$22.5 billion and \$20.3 billion net inflow respectively; albeit lagging the 2019 average of \$27.2 billion. Equity portfolio flows also turned positive in October and November, signaling a gradual return of confidence in EM equity securities.

Emerging market assets blossom

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In the fixed income side of things, Emerging markets government bond spreads tightened more than 28bps and 83bps in Q3 19 and Q4 19 respectively over comparable U.S securities. This largely reflects investors' appetite for riskier assets in the wake of accommodative monetary policy across most developed markets. To buttress, the US Fed cut interest rate for the third time in 2019 by 25bps in October. Furthermore, while the ECB left interest rate unchanged at an all-time low of -0.5%, it announced the resumption of Quantitative easing at a monthly rate of 20 billion Euros.

Figure 2: Performance across EM asset class



Source: Bloomberg, ARM Research

Divergent fortunes across various EM counters

Despite heightening uncertainty over the US-China trade deal, portfolio flows to China rose 4% to \$7.3 billion in Q3 19. This was largely driven by investors interest in Chinese equities and bonds. For equities, portfolio flows to Chinese shares mirrored government's effort to open its economy to foreign investors. For context, Chinese equity received a boost from MSCI's 20% partial inclusion of China A-shares in major indexes. Meanwhile for debt, FPI flows to Chinese bonds rose to its highest level in one year by 10% QoQ to \$9.1 billion. Aside benefiting from the negative yielding bonds across the globe amid monetary easing in many countries, the People's Bank of China rolled out slew of measures aimed at opening its financial sector. This includes scrapping investment limit for the qualified foreign investor program (widely known as QFII and RQFII channel) and opening the onshore derivatives market to meet the need of overseas investors to hedge against foreign exchange risks. Elsewhere in India, foreign portfolio investors pulled out \$1.9 billion in Indian investments.

The downturn in FPI flows to India mirrors slowdown in economic growth (-50bps YoY to 4.5% in Q3 19) which dampened prospect for corporate profitability.

Elsewhere in Latin America, foreign portfolio flows to Mexico rebounded in Q3 19 to \$1.77 billion (vs net outflow of \$975 million in Q2 19). Specifically, while Mexico's lackluster macroeconomic performance over the last three quarters continue to dampen investors' appetite for private sector shares and money market, FPI flows to foreign currency securities more than compensated. Over Q3 19, Mexico's foreign currency denominated debt rose to \$5.3 billion. While this provides a cause for cheer, we think a large chunk of these flows were investments in the \$7.5 billion Eurobond issued by the state-owned oil & gas firm (PEMEX). Elsewhere in Argentina, the outflow lingered for the sixth consecutive quarter in Q3 19 (Net outflow: \$1.8 billion). This mirrors the tapestry of macroeconomic woes which includes; weakening peso, inflationary pressures (51.4% as at November 2019), receding economic growth (-17% YoY in Q3 19) and a looming debt crisis (External debt: \$276.7 billion in Q3 19).

Over to EM Europe, for the sixth consecutive quarter, portfolio flows into Poland sustained its negative run in Q3 19 (Net outflow: 4.1billion Euros). While the persisting exit of foreign investors is in part fed by slowing economic growth concerns due to its crawling industrial output, fears of a possible fallout with the EU over its judicial reform proposals continues to wary foreign investors. Elsewhere, following its sturdy economic growth—Russian economic growth accelerated to 1.7% in the third quarter, the fastest pace this year— portfolio flows continued its positive run in Q3 19 (\$1.2 billion).

Happy days ahead for EM foreign portfolio flows

In charting the course for portfolio flows to emerging market in 2020, we think developments around heightening trade protectionism, the direction of monetary policy across developed markets and prospects for commodity prices (especially crude oil) would play a dominant role. On trade, the US and China finally agreed to the phase one deal which provides temporary pause in the trade war. However, possibilities of a flare up over the phase two agreement and tariff hike by the US on importation of goods from Europe could spell doom for global growth and investments. This is further exacerbated by our expectation for lower crude oil prices (ARM forecast: \$61.26/bl) in 2020 which does not bode well for the fiscal conditions of most crude oil exporters. Notwithstanding, the dovish monetary policy stance across most developed markets could serve as a push factor for portfolio flows into emerging markets this year. This in addition to International Monetary Fund's forecast for emerging market growth to accelerate in 2020 and remain more than double that of developed markets makes valuations for EM relatively attractive. Hence, we see scope for higher portfolio flows into EMs in 2020.

On a regional basis, in EM Asia, while China's economy is expected to weaken on the back of lingering uncertainty trailing the second phase of the US-China trade deal as well as tighter financial conditions, portfolio flows to China should remain above par. This is premised on introduction of reforms and initiatives by the government to increase foreign investors access to its financial market¹. Away in India, we see scope for softer portfolio flows over the first half of 2020. Our view is premised on the Reserve Bank of India's quest to pursue accommodative monetary policy in a bid to spur economic growth which does not bode well for bond prices. This in addition to high levels of bad debt in the banking sector should taper appetite for India's risky asset in 2020.

Meanwhile in Latin America, we are slightly positive on foreign investors inflow into Mexico in 2020. Our optimism is hinged on projected pickup in economic growth due to firmer domestic demand, particularly on a rebound in public spending and business investment. Nevertheless, we highlight concerns over its heavily-indebted state-owned Oil & Gas firm – Pemex, policy uncertainty which continues to dampen investor confidence and threats of U.S. tariffs as possible risks to our expectation during the period. Over in Argentina, we see no respite for portfolio flows as Argentina's economy shows no sign of recovery. The country is still laced with sky-high inflation rate, looming debt crisis and uncertainty regarding economic policies and reforms. Meanwhile in EM Europe, fears of a possible fallout with the EU over its judicial reform proposals could continue to keep foreign investors flow into Poland subdued over 2020.

¹ — 1the kickoff of the new Foreign Investment Law (FIL) in January 1, 2020 aimed at improving the business environment for foreign investors and ensuring that foreign invested enterprises participate in market competition on an equal basis

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