

Nigeria Strategy Report

H1 2020

Domestic Economy and Markets

Balance of Payment: Edge of the Cliff

Executive Summary

Over the first three quarters of 2019, the current account balance recorded a total deficit of \$9.2 billion compared to a \$4.2 billion surplus recorded over similar period in 2018. This is the lowest point the current account balance has touched since 9M 2015 at -\$13.4 billion. The deterioration largely reflects the surge in non-oil imports and services deficit which offset the dip in the income deficit and rise in current transfers. On capital importation, coming into the second half of the year, we highlighted our concerns of thinner carry trade opportunities in the Nigerian market, relative to some other emerging markets (EM). In line with our expectations, we did see a slowdown in the pace of capital inflows over the second half of the year. Over Q3 19, capital flows dropped 11% QoQ to \$5.4 billion. However, total capital importation over 9M 19 (\$20 billion) still printed higher than corresponding period in 2018 (\$15 billion), thanks to the record-high flows which came in Q1 19. Overall, the aforementioned increased pressure on the foreign reserves which dropped by \$4.5 billion YoY to \$38.5 billion over FY 2019.

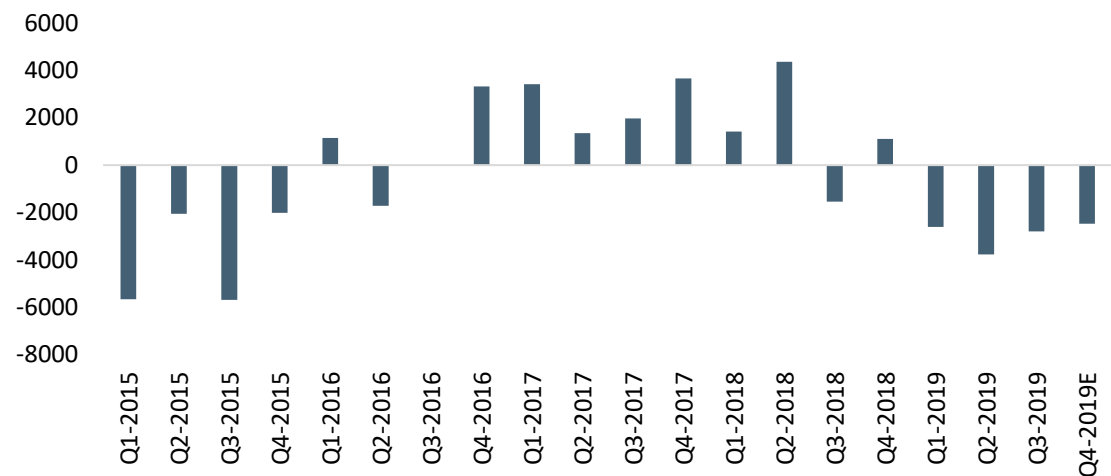
We envisage an increase in the current account deficits going into 2020. Our forecast is hinged on our expectations of lower oil prices going into the year as well as the strengthening domestic purchasing power greased by the CBN's expansionary policies which could increase pressure on imports and services deficit. Overall, we see all the quarters in 2020 closing in deficits with a FY total of \$16.9 billion, compared to our 2019E of \$11.6 billion. On capital flows, there is some uncertainty on the direction for flows over 2020. However, foreign investors' concerns regarding the steep declines in the FX reserves and valuation of the naira, as well as direction of the CBN's unorthodox policies (which has resulted in lower liquidity in the OMO market) are likely to outweigh any positives which hover around the relatively stable yields on OMO rates and cheap equity valuations.

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 deficit comes to a head in 2019

Over the first three quarters of 2019, the current account balance recorded a total deficit of \$9.2 billion compared to a \$4.2 billion surplus recorded over similar period in 2018. This is the lowest point the current account balance has touched since 9M 2015 at -\$13.4 billion and marks the longest consecutive quarters of deficit since Q4 15. You will recall that the 2015 deficits were fallouts of the significant drop in oil receipts, following the plunge in crude oil prices from the \$100's in Q3 14 to mid-\$30 levels (per barrel) by Q4 15 as well as the militant attacks which crimped crude oil production. As a result, the foreign reserves nosedived from \$34 billion in Q4 2014 to \$29 billion in Q4 2015 while the official naira depreciated from ₦160 to ₦196.5 over that period before eventually been devalued to ₦305 in 2016.

Going by the recent trends, we envisage FY 19E could close the year with a current account deficit of \$11.6 billion – which would be the highest since 2015 of \$16.5 billion. The deterioration to the staggering deficit levels in 2019E largely reflects the surge in non-oil imports (which has weighed on the trade balance) and services deficit. These offset the slight dip in the income deficit and rise in current transfers. Overall, coupled with receding FPI flows and the CBN's persisting interventions in the FX market (in a bid to keep naira stable), the foreign reserves dropped \$4.5 billion YoY to 38.5 billion¹ in FY 2019.

Figure 1: Current Account Balance (\$'million)

Source: CBN, ARM Research

Taking a closer look at the 9M 19 current account deficit figure, we note that bulk of the pressure stemmed from the decline in the trade surplus and a jump in services deficit. On the former, trade

¹ Bulk of the erosion in the reserves occurred over H2 19, as FPI inflows receded and oil prices dropped lower (vs. H1 19), adding to the pressure of the expanding current account deficit.

surplus over the review period has dropped 70% YoY to \$5.1 billion in 9M 19, owing to a surge in imports which offset a slight increase in exports. Imports rose 34% YoY to \$42 billion, following a 60% jump in non-oil imports to \$35 billion, which neutered the 26% decline in oil imports to \$7 billion. It is worth stating that in Q1 2019, there was a sharp jump in non-oil import figures (+64% QoQ to \$12 billion), following the purchase of pharmaceutical wares valued at \$4.7 billion, according to NBS data. At the time, we viewed the Q1 2019 non-oil import number as an outlier and expected some sort of normalization. However, through Q2 and Q3 2019, non-oil imports remained strong; non-oil imports over those two quarters averaged \$11.2 billion (much higher than the quarterly average of \$7.3 billion in 2018). We believe this is reflective of a 'new normal' in non-oil imports, as the naira remained stable amid availability of FX during the period. In addition, we believe the recent ease in ports gridlocks (especially the Apapa ports) has aided a faster flow of goods. Specifically, the latest NBS data shows there have been notable increases in the import of fairly used cars (+214% YoY), motorbikes (+174% YoY), machinery etc., which has driven the surge in non-oil imports.

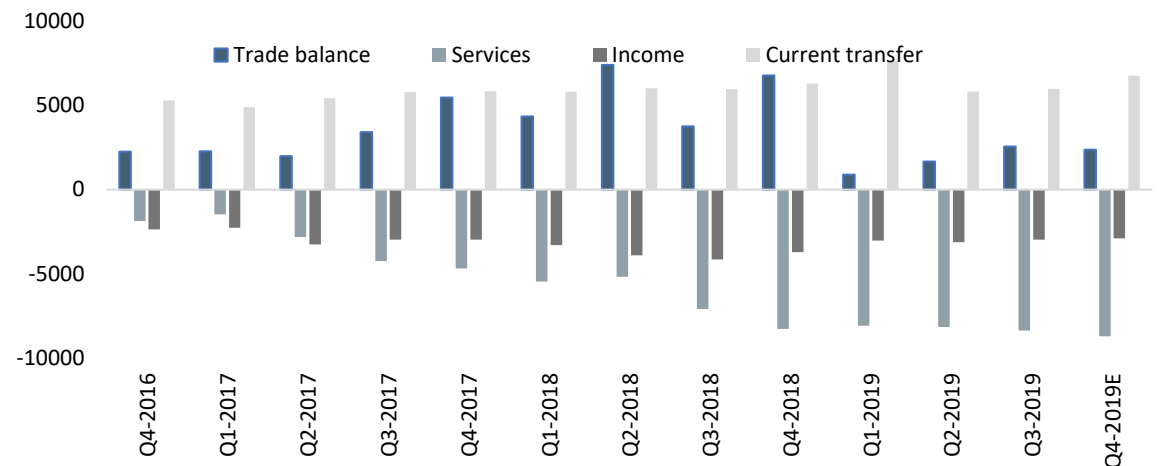
On the other hand, exports grew by only 0.43% over the year to \$47 billion. Growth in exports was supported by a 56% increase in non-oil exports (to \$5.7 billion) which accounted for 14% of the total exports (2018: 9%). We believe improved non-export figures are reflective of the improved GDP growth in the non-oil sector, which grew 30 bps faster YoY by 2% over 9M 19. Data from the NBS shows that the increases in non-oil exports have stemmed from exports of manufactured products. Meanwhile, oil exports, which accounts for the chunk of total exports, declined 4% YoY to \$41 billion, owing to the 10% YoY decline in bonny light crude prices to \$66.5/bbl. which neutered the slight improvement in production from 1.92mbpd to 2.02mbpd.

Meanwhile, the services deficit jumped 38.7% YoY to \$25 billion in 9M 19. Bulk of the increases is attributable to increased spending on personal and business travel expenses (+74% YoY to \$8.9 billion) which include payment for health and education related expenses. There was also increased demand for foreign business and professional services which added a \$3.6 billion strain on FX demand during the period.

On a positive note, there were slight improvements in the income deficit and current transfer surplus over the 9M 19 period. The income deficit line was \$2.2 billion lower YoY, as investors likely repatriated less returns on their investments – mirroring the not-so-profitable state of most financial assets over the period (especially equities). On the other hand, the current transfer surplus grew by \$1.7 billion over the 9M 19 period to \$19.5 billion. However,

this was largely driven by a one-off \$1.6 billion increase in ‘other transfers’ which came in Q1 19. Ex the impact of this inflow, current transfer would have been flat at \$18 billion. The major component in the current transfers (workers remittances) which makes up over 90% of the total was down slightly by 0.89% YoY.

Figure 2: Current Account Balance (\$'million)



Source: CBN, ARM Research

Receding Capital Flows, as Investors stay on the Ropes

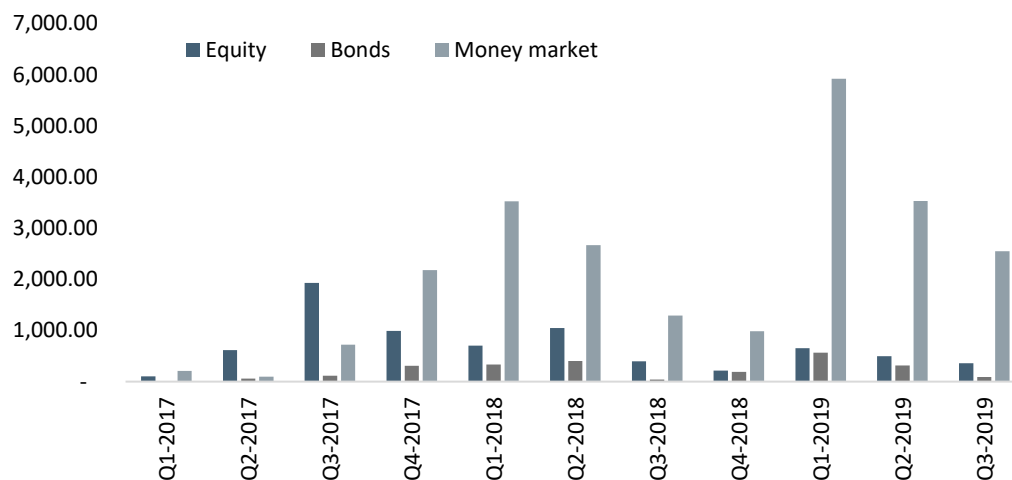
Coming into the second half of the year, we highlighted our concerns of thinner carry trade opportunities in the Nigerian market, relative to some other emerging markets (EM). As a result, we stated that flows could slow over H2 19. In line with our expectations, we did see a slowdown in the pace of capital inflows over the second half of the year. However, adding to our concerns of a non-competitive carry trades, there was also increased risk-off sentiments by foreign investors to EM assets. This stemmed from the intensified trade rifts between US and China which raised concerns of a slowdown in global economic growth.

As a result, investors shunned relatively higher yields in fixed income offerings, cheap valuation of Nigerian equities and relatively stable naira to stay put in advanced markets (such as the US equities). Thus, while total capital importation over 9M 19 printed higher than corresponding period in 2018 (\$20 billion vs \$15 billion), we note that almost half of these flows came in Q1 19 when the influx of capital touched a record high of \$8 billion. However, post-Q1 19, there has been a decline in the rate of capital inflows to \$6 billion and \$5 billion in Q2 and Q3 19, respectively.

While Q4 19 numbers are yet to be released, we think flows are likely to go further south in the quarter, following the CBN's recent policies regarding the OMO market. In October, the CBN restricted access to the OMO market to just foreign investors and Deposit Money Banks in Nigeria.

As a result, this led to reduced participation in the OMO market⁴, leading to a squeeze in the market's liquidity and increasing uncertainty on foreign investors' expectations. Since this announcement, and despite the CBN's offer to act as a buyer of last resort, we understand that foreign participation in the OMO primary market auction has dropped, as investors 'wait on the sidelines' to see how developments pan out. Data from the IE FX window in Q4 2019 showed that FPI flows slowed after the CBN's announcement, corroborating our view.

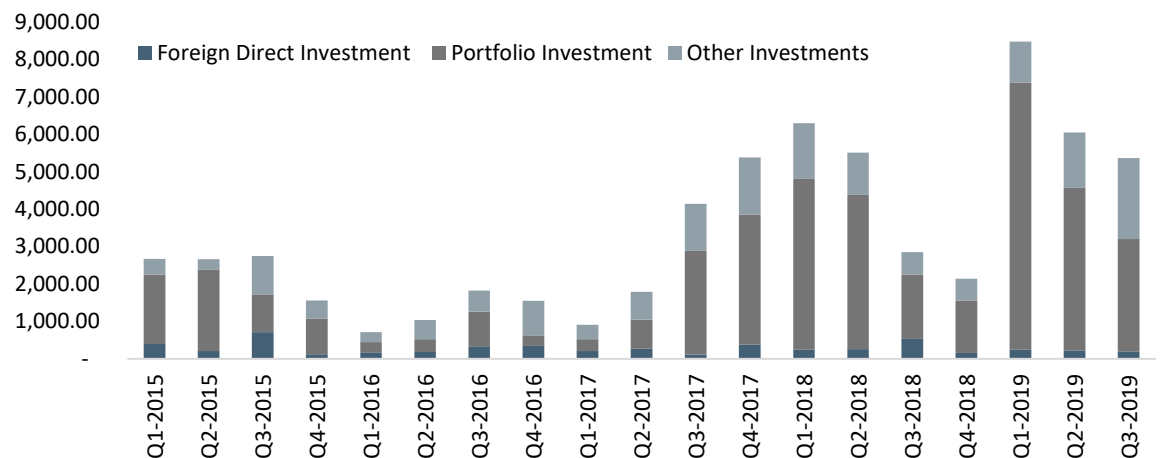
Figure 3: Portfolio flows breakdown (\$'million)



Source: CBN, ARM Research

A closer look at the break down of capital importation in Q3 19 shows bulk of the decline stemmed from lower portfolio flows. Total FPI flows dropped 31% on the quarter to \$3 billion, as investor's interest across money market (-28% to \$2.5 billion), bonds (-71% to \$92 million) and equity (-28% to \$358million) instruments declined. Influx of Foreign Direct Investments (FDIs) also dipped 10% QoQ to \$200 million over the period. However, impact of the declines in FPIs and FDIs were partly offset by increased inflow of FX loans which was \$708 million higher QoQ to \$1.8 billion in Q3 19.

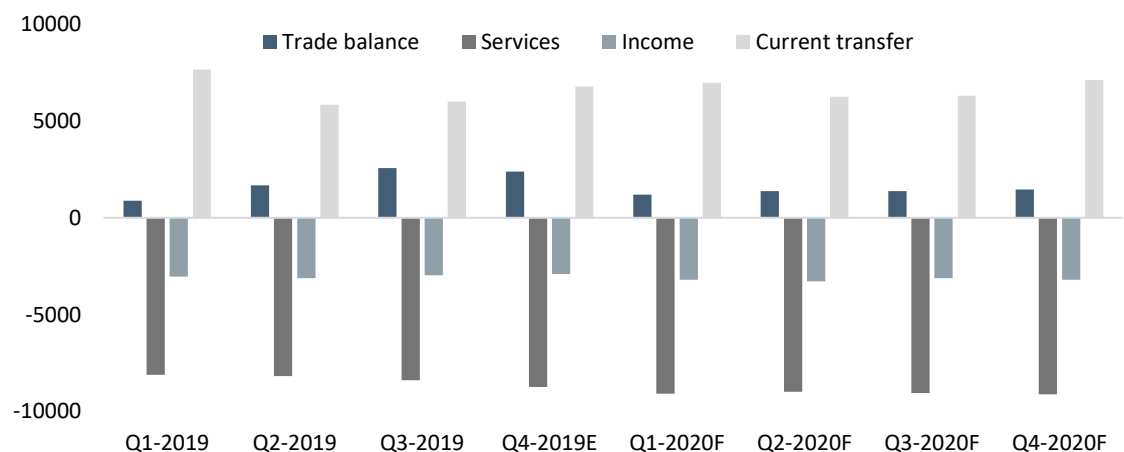
⁴ As about 30% of the holders of OMO maturities (comprising largely Pension Fund Administrators and other Asset managers) were banned from buying or trading OMO in the primary and secondary market

Figure 4: Capital Importation Breakdown (\$'million)

Source: CBN, ARM Research

No backing down in 2020 Current Account deficits

We envisage an increase in the current account deficits going into 2020. Our forecast is hinged on our expectations of lower oil prices going into the year as well as the strengthening domestic purchasing power greased by the CBN's expansionary policies. Overall, we see all the quarters in 2020 closing in deficits with a FY total of \$16.9 billion, compared to our 2019E of \$11.6 billion.

Figure 5: Current account Forecast (\$'million)

Source: CBN, ARM Research

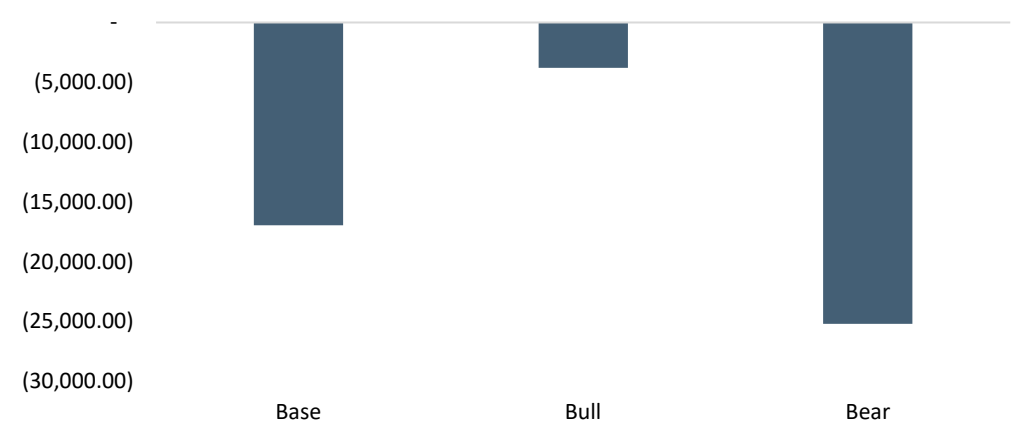
We expect the trade surplus to decline further in 2020, as imports likely maintain an upward trajectory while exports grow at a slower pace. We envisage a rise in imports (especially non-oil imports), as the CBN's recent expansionary policies are likely to keep demand for foreign goods and

services stoked. Thus, we estimate non-oil imports could touch a new record high of \$50 billion (+8% YoY) while oil imports increase by 14% to \$10 billion in 2020.

On the other hand, we estimate slower exports growth of \$3 billion over 2020 with most of the growth stemming from the non-oil segment. We also expect this should be aided by the CBN’s drive for credit growth which we envisage will translate to some improvement in economic growth. Meanwhile, we estimate oil exports will be relatively flat at \$54 billion (up only 1% YoY) as improved oil production (2.10mbpd vs 2.02mbpd) makes up for the lower bonny light crude oil prices (\$63.76 vs \$65.64/bbl.) in 2020 (vs. 2019). To mention, we expect improvement in the bonny-brent spread in 2020 (\$2.3 vs 2019: \$1.4), given the preferred demand for our light sweet blend vis-à-vis other heavy blends, following implementation of the IMO 2020 regulation (*See [Crude oil H1 2020 Outlook for details](#)*).

Meanwhile, we do not see any reprieve in the expanding services deficit in 2020. We forecast a \$3 billion increase in the services deficit to \$36 billion in 2020 – a new record high. This is also hinged on our expectation of stronger purchasing power in the coming year which should drive spending on travelling and transport expenses, educational and health expenses as well as imported professional and technical services (That is, BTA and PTA). We project relatively flat movement in the current transfer surplus (+1% YoY to \$27 billion) in the absence of any one-off drivers like we saw in 2019, while income deficit (+5% YoY to \$13 billion) could print slightly higher in 2020.

Figure 6: Base, Bull and Bear Cases (\$’million)



Source: CBN, ARM Research

That said, we think a key upside to our projection that could drive the current account deficit lower than our base case estimate could stem from a curtailment of the staggering increases in imports. We think the recent sharp increases in FX spending could attract regulatory restrictions by the CBN in 2020 similar to the 'list of 41 banned items' which were restricted from FX in 2016. However, we see the curtailment panning out more effectively for imports than the components in the services segment (PTA and BTA), as the former is known to have easier access to local substitutes than the former. The availability of substitutes would be vital in curbing the extent of diverted FX demands to the parallel markets which could exert more pressure on the naira.

In addition, we also see some upsides for higher exports, should oil prices print higher than we estimated (\$69.8 vs \$63.5/bbl.) – buoying oil exports -- and where economic growth comes in stronger than we estimated -- pushing non-oil exports higher. Based on the foregoing, the current account deficit could print lower at \$4 billion in our bull case scenario, following a stronger trade surplus (\$16 billion) and lower services deficit (\$34 billion).

On the flip side, our forecast for FY 2020 current account deficit could print higher should the trade balance print in a deficit. This could be triggered by (1) lower than expected oil prices and production, (2) slower than expected economic growth, and (3) faster than expected growth in imports. Playing these scenarios in our forecast, the current account deficit could print north of \$25 billion in 2020 which serves as our bear case.

2020 Flows Outlook... Many moving parts

Going into 2020, we take a cue from the recent drivers of flows into the country to paint the picture of what we see playing out for capital inflows over the first half of the year. There is some uncertainty on the direction for flows over 2020. However, foreign investors' concerns regarding the steep declines in the FX reserves and valuation of the naira, as well as direction of the CBN's unorthodox policies (which has resulted in lower liquidity in the OMO market) are likely to outweigh any slight positives which hover around the relatively stable yields on OMO rates and cheap equity valuations. Overall, in FY 2020, we think flows are likely to print lower than in 2019. More so, given the high-base in the record-high flows posted in Q1 19.

However, the possible upsides which could push flows higher in 2020 could stem from (1) an increase in OMO rates, should the CBN see a need to attract more FPIs; and (2) significant increased risk-on sentiments towards frontier markets (especially following the partial resolution of the US-China trade rifts) which could lead to some flows into Nigerian equities - especially in notable blue chips names.

On the flip side, while the US-China tensions have subsided, there are fresh brewing tensions in the middle east which could trigger negative sentiments towards EM assets. Another downside risk to the outlook for flows subsists if the US Fed deviates from its guidance to begin increasing rates. This could be triggered by higher inflation which is known to be sensitive to higher oil prices – a possible fallout in our bull case should middle east tensions get more intense.

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