

Nigeria Strategy Report

H1 2020

Domestic Economy and Policy Environment

Fixed Income: Liquidity surfeit to keep yields subdued

Executive Summary

Contrary to our expectations, average fixed income yields suffered massive compression over H2 19. While this was in part fueled by lower paper issuances—predominantly at the short end and less liquidity sterilization by the CBN, the straw that broke the camel’s back was CBN’s policy directive in October. This directive restricted local non-bank investors from participating in OMO auctions. Consequently, OMO redemptions which would previously have been reinvested in OMO bills had to chase FGN securities, thereby compressing local fixed income yields by 540bps to 7.72%.

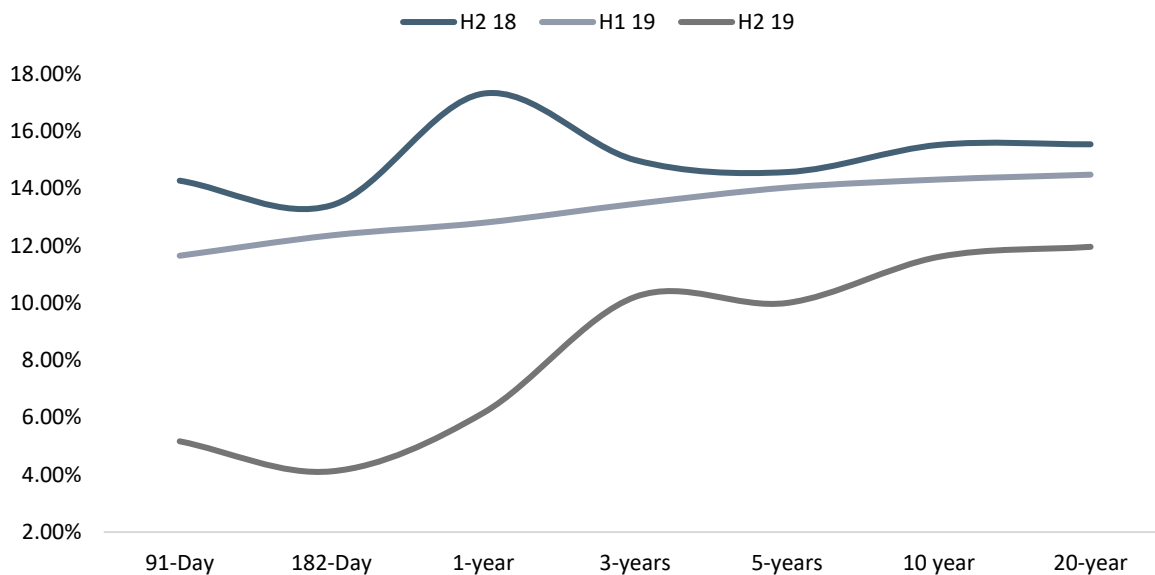
In determining the yield curve trajectory over the medium term, we take a cue from CBN’s actions over the last four months where it increased its tolerance for naira liquidity emanating from OMO redemptions. For us, given that these monies have little propensity to hurt the naira, we rule out a reversal in the directive over the near term. Our view is hinged on the apex bank’s decision to preserve the interest of foreign investors by granting access to participate in OMO sale and providing ease of exit from their OMO positions. More so, out of the 27.7% OMO bills held by non-bank corporates¹, we estimate PFA holdings of 17% (~~~N~~2 trillion). Given the strict PENCOM regulations that prevents PFAs from directly purchasing dollar with naira contributions, we see little room for these liquidities queuing behind dollars at the parallel market. Against this backdrop, most local institutional investors who hold OMOs are left with no choice than to combine or do either of the following 1.) channel their funds to primary and secondary treasury bills, 2.) invest in banks term deposits, 3.) increase appetite for corporate commercial papers or 4.) increase exposure to equities. That said, we envisage buy pressure to persist over the near term following expected liquidity surfeit in the system. Against this backdrop we see scope for lower fixed income yields over H1 2020.

In this report, we look at the major themes that dominated the fixed income space over H2 2019 and delineate our outlook over 2020.

¹ 2020 FI maturities: ₦16.2 trillion

CBN's OMO policy causes FI yields to crash

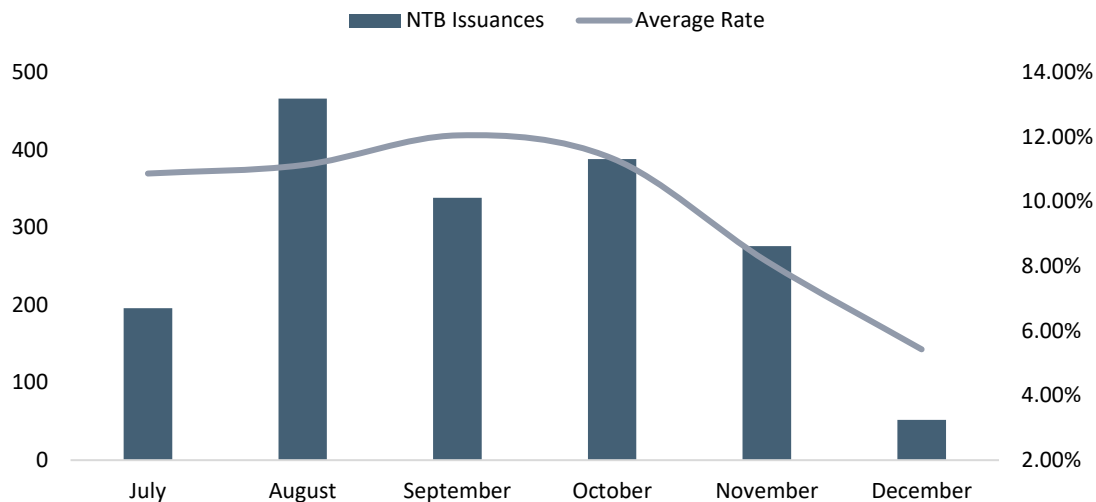
Contrary to our expectations, average fixed income yields suffered massive compression in the second half of the year. While this was in part fueled by lower paper issuances—predominantly at the short end and less liquidity sterilization by the CBN, the straw that broke the camel's back was CBN's policy directive in October. This directive restricted local non-bank investors from participating in OMO auctions. In our view, this policy is aimed at reducing CBN's liabilities and interest expense. Consequently, OMO redemptions which would previously have been reinvested in OMO bills had to chase FGN securities, thereby compressing local fixed income yields by 540bps to 7.72%.

Figure 1: Trend in fixed income yields

Source: FMDQ, ARM Research

Short end borrowing subdued despite higher interest

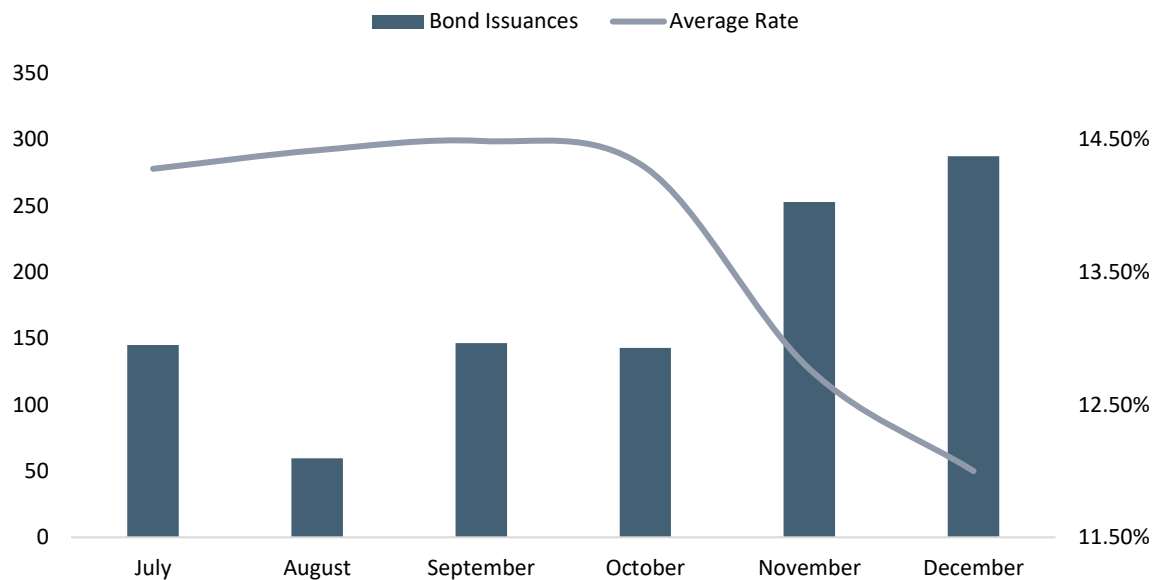
In our last report, we highlighted the FG's weak appetite for short end borrowings and that continued through H2 19 despite a surge in demand. NTBs have been the primary substitute destination for the funds that have been barred from the OMO space and this has been particularly evident during subsequent PMAs following the directive. For context, while mean subscription rate over H1 19 was 2.72x, it increased to 3.21x on average in H2 19. Given the additional demand, stop rates at NTB PMAs fell 634bps to 4.83%. However, despite the huge demand and the opportunity to ramp up short-end borrowings, the FG only rolled over maturing treasury bills (₦1.72 trillion). Similarly, demand was also strong for secondary market NTBs evidenced by the precipitous drop in yields by 742bps to 4.85%.

Figure 2: Trend in NTB issuances and average NTB stop rates

Source: FMDQ, ARM Research

FG ramps up long-term borrowing

To finance the ₦1.9 trillion deficits in the 2019 budget, the FG proposed domestic borrowing of ₦802.82 billion and as of the end of H1 19 they had gone some way to meeting that target with a net issuance of ₦345.6 billion. But in the second half of the year they supercharged their borrowing, net issuing ₦742.2 billion which is more than the entire borrowing in FY18 (₦610.9 billion). Bulk of the H2 19 borrowings in the last two months of the year (₦540.3 billion)— clearly reflects CBN's quest to take full advantage of higher demand and lower rates at the PMAs. Regarding higher demand, subscription increased from 1.59x in the first 10 months of the year to 1.80x in the last three months of the year, while average stop rates declined to 12% by year end. In the secondary market, bond yields declined 338bps in the second half of the year (vs -129bps in H1 19). This bullish sentiment in secondary market bond yields was largely driven by investors' interest in Feb-2020 bonds as investors saw it as an attractive substitute for the one-year paper.

Figure 3: Trend in Bond issuances and marginal clearing rates

Source: FMDQ, ARM Research

Liquidity surfeit to keep yields subdued

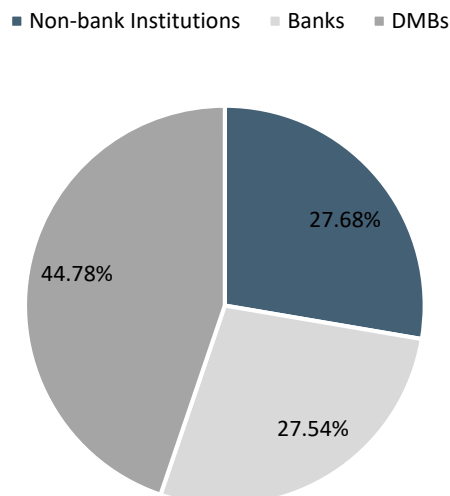
On the external front, the central theme for monetary policy discuss across most developed markets is centered around monetary easing. For clarity, the US Fed signaled it will leave rates unchanged through the end of 2020 barring sustained increase in inflation. Elsewhere while the ECB left interest rate unchanged at its last monetary policy committee meeting, the bank kicked off its asset purchase programme (APP) in November 2019, at a pace of EUR 20 billion per month and will last for as long as is deemed necessary. This was aimed at combating protracted economic slack and stubbornly low inflation. While this paves the way for lower fixed income yields in the domestic front, we think events on the domestic front—particularly the monetary side, will play a greater role in carving the shape of the yield curve.

On the local front, we think FX will be the major undertone for monetary policy actions in 2020. Our view is premised on the following 1.) prospect for softer oil receipts due to lower oil prices 2.) possibility for foreign investors repatriation given the sizeable maturity profile this year 3.) heightening external risk. However, in determining the yield curve trajectory over the medium term, the major question that comes to mind is if the segregation in the OMO market will persist. In answering this, we take a cue from CBN's actions over the last four months where it increased its tolerance for naira liquidity emanating from OMO redemptions.

For us, given that these monies have little propensity to threaten naira stability we rule out a reversal in the directive over the near term. Our view is hinged on the apex bank's decision to preserve the

interest of foreign investors by granting access to participate in OMO sale and providing ease of exit from their OMO positions. More so, out of the 27.7% OMO bills held by non-bank corporates², we estimate PFA holdings of 17% (~₦2 trillion). Given the strict PENCOR regulations that prevents PFAs from directly purchasing dollar with naira contributions, we see little room for these liquidities queuing behind dollars at the parallel market.

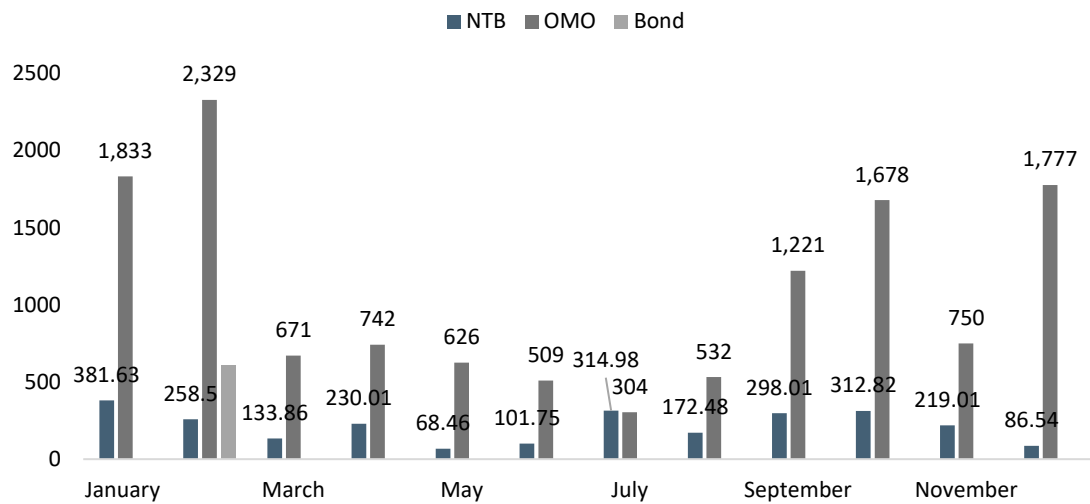
Figure 4: OMO holdings by investors



Source: CBN Statistical Bulletin, ARM Research

Against this backdrop, most local institutional investors who hold OMOs are left with no choice than to combine or do either of the following 1.) channel their funds to primary and secondary treasury bills, 2.) invest in banks term deposits, 3.) increase appetite for corporate commercial papers or 4.) increase exposure to equities. That said, while we think all these cases are plausible, we envisage buy pressure from local investors in the fixed income market over the near term following expected liquidity surfeit in the system. Having laid down the prospect for higher demand for naira paper over the near term, we see scope for lower primary and secondary market treasury bills and FGN bonds yields, lower bank term deposits rates and lower rates on commercial papers over the first half of 2020.

² 2020 FI maturities: ₦16.2 trillion

Figure 5: Maturity Profile over 2020

Source: FMDQ, ARM Research

No doubt, this sits well with FG's plan to trim its cost of debt service. In fact, given the prospects for lower fixed income yields and higher fiscal deficit, we see scope for higher paper supply over the near to medium term. Notwithstanding, given that Non-bank institutions hold sizeable portion of the OMO bills (~27.7%), we think the demand pressure will more than outweigh pressures from higher FG paper supply. Although the prospect for inflationary pressures appears prominent given hike in VAT (from 5% to 7.5%) and possible electricity tariff hike next year, we remain less sanguine of a spike in fixed yields over the first half of 2020.

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