

July 25, 2018



# Nigeria Strategy Report

## H2 2018

Domestic Economy and Policy Environment

# BOP: CA surplus recycled through record portfolio outflows

## Executive Summary

In our H1 2018 strategy report, we had posited that in the face of currency-induced jump in import, sustained crude price rally would provide some cheers for oil export with knock-on effect keeping surplus trade balance largely intact. Upon our thesis, external trade balance stretched its growth to Q1 18, rising by +5.1% QoQ to \$5.8 billion. Elsewhere, whilst surge in investment deficit drove expansion in income deficit, it was the case of slower deficit increase in other business services that supported the mild growth in service deficit. Irrespective, remittances-driven surge in current transfer largely masked income and service deficit with the attendant impact leaving the burgeoning CA surplus without a scratch. On the financial account ledger, capital flows into Nigeria reached a record high of \$9.9 billion in the first five months of the year, surpassing flows in the pre-oil crisis period with driver largely linked to the surge in FPI.

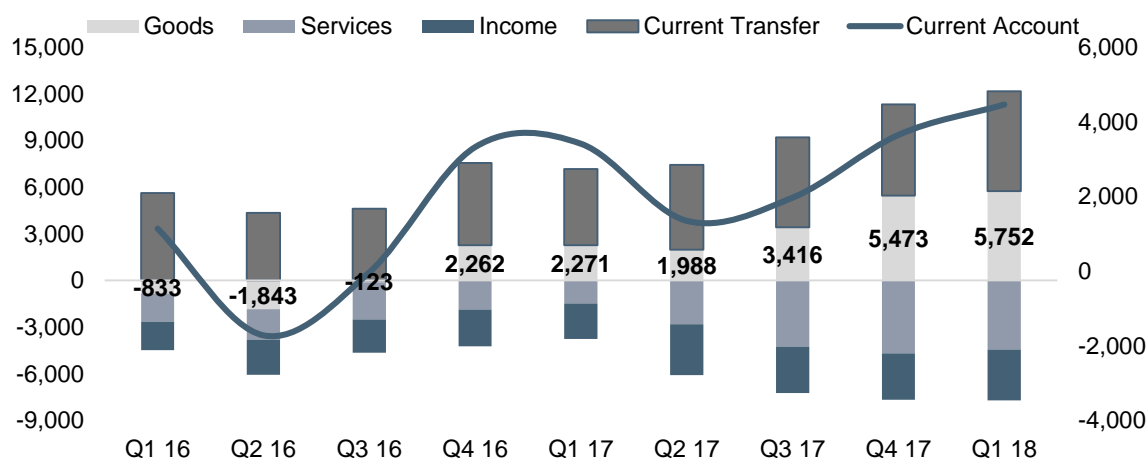
Into the rest of the year, with regard to the current account, we believe that the confluence of higher crude production and prices will continue to support export earnings, while tepid non-oil import should mask the substantial jump in oil import. On the rest of the ledger, we expect the combined impact of improved economic activities and sustained FX liquidity to drive sizeable deficit in travel, transportation, and other businesses, thereby leaving overall services net debit position higher. On financial account, we expect the double whammy of policy normalization in advanced economies and election uncertainties in Nigeria to potentially create foreign investors' aversion towards naira assets and, by extension, amply reduce capital importation into Nigeria. Against that backdrop, we expect sluggish capital importation to mask sturdy trade surplus with knock-on effect leaving BOP picture on a knife edge.

***This report focuses on domestic economy and policy environment with special interest on events in the country's current and financial accounts position***

### *Current account balance sustained surplus trajectory*

Over Q1 2018, Nigeria's current account (CA) surplus position with the rest of the world touched a new high after expanding by 22.2% QoQ to \$4.5 billion (Q4 17: \$3.7 billion). Despite the widening income deficit, the unswerving current account surplus was particularly supported by continued expansion in trade and current transfer surpluses, even as services deficit moderated for the period. To our mind, the persisting increase in trade surplus continued to ride on higher crude oil prices, and more importantly, ramp up in crude production following sustained calm environment in the Niger-Delta. Furthermore, whilst surge in investment deficit drove rapid expansion in income deficit, it was the case of slower deficit increase in other business services that supported the mild growth in service deficit. Irrespective, remittances-driven surge in current transfer largely masked income and service deficit with the attendant impact leaving the burgeoning CA surplus without a scratch.

**Figure 1: Movement in component of CA balance (\$'million)**



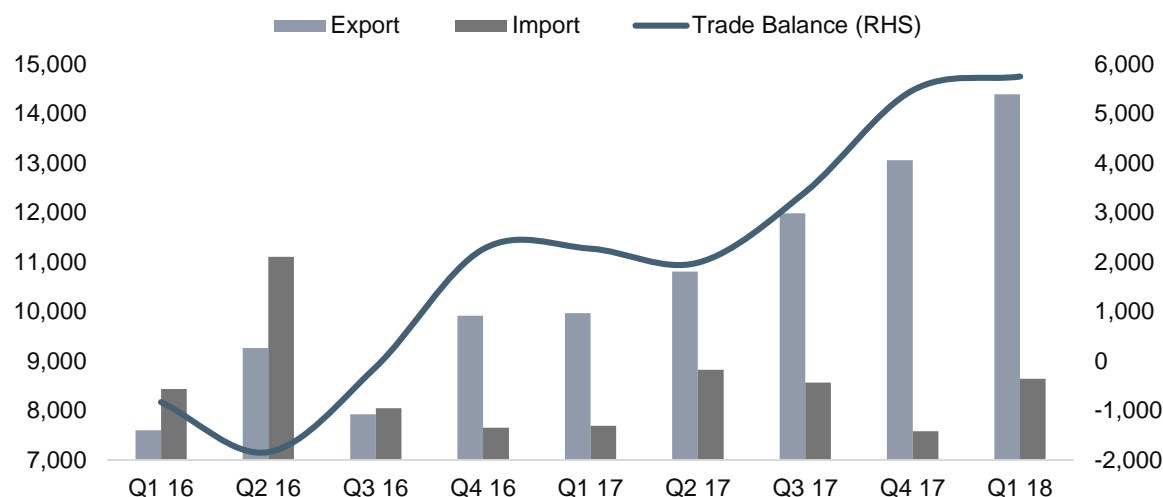
Source: CBN, ARM Research

### *Higher Oil earnings propels trade, and in turn CA balance*

In our H1 2018 strategy report, we had posited that in the face of currency-induced jump in import, sustained crude price rally would provide some cheers for oil export with knock-on effect keeping surplus trade balance largely intact. Upon our thesis, external trade balance stretched its growth to Q1 18, rising by +5.1% QoQ to \$5.8 billion. The sustained improvement in trade balance came as the value of export (\$14.3 billion) continued to dwarf the value of import (\$8.6 billion) thereby leaving the surplus picture unmarred. Again, the impact of higher crude production (+2.0% QoQ to 2.0mbpd) and prices (Avg Brent: +10.2% QoQ to \$67.2/bbl.) largely buoyed the 10.1% QoQ upsurge in crude oil and gas export to \$13.4 billion. On the other leg, non-oil and electricity export expanded to \$967 million (Q4 17: \$860 million) for the period under review. Elsewhere, after

shrinking in the prior quarter due to substantial decline in oil import and mild moderation in other imports, overall import expanded in Q1 18 (+13.9% QoQ to \$8.6 billion) driven by upsurge in oil import (+99.5% to \$2.5 billion). To underscore the driver of oil import, petroleum product import data from NBS suggest that NNPC's PMS import over Q1 18 expanded 60.7% QoQ to 5.7 billion liters (highest level in recent times) with the attendant impact propelling oil import. For us, the sharp increase in oil import was a play to duck any potential fuel scarcity which was pervasive for much of Q4 17. Elsewhere, we link the decline in non-oil import to improved government initiative of import substitution which reduced importation of most non-oil items. Evidently, balance of trade (BOT) breakdown provided by NBS revealed that the sharp jump in other petroleum product (+122.7% QoQ) largely neutered declines across agriculture (-18.9% QoQ), solid mineral (-17.3%) and manufactured goods (-1.7% QoQ).

**Figure 2: Trade balance (\$'million)**



Source: CBN, ARM Research

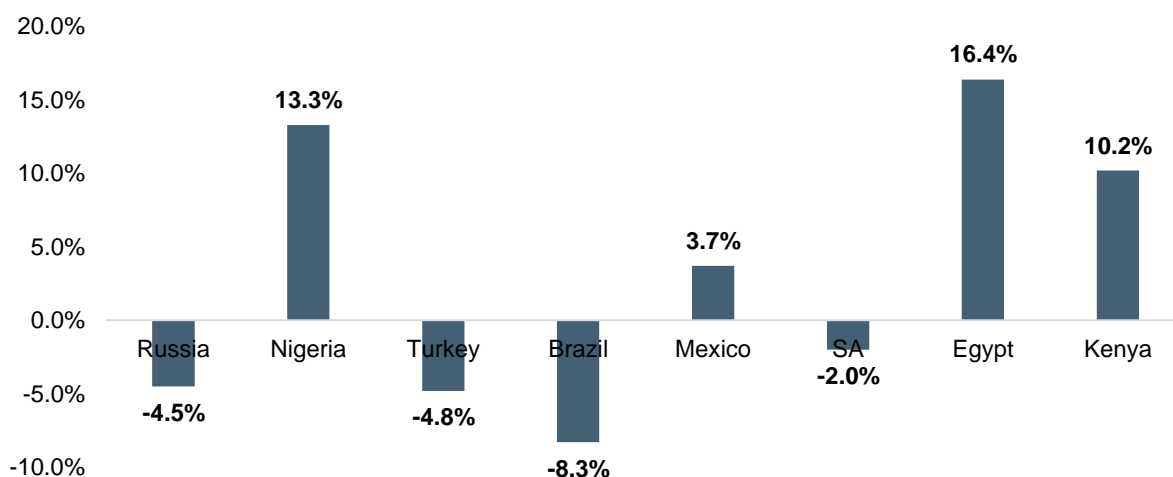
On other fronts, services sustained its deficit run (-5.1% QoQ) albeit at a mild pace largely supported by slower deficit expansion in other business services (-10.3% QoQ) even as transportation (+1.2% QoQ) and travel (+12.5% QoQ) deficits expanded for the period. Precisely, whilst transport deficit continued to track improved economic activities through movement of goods and services, increase in travel deficit was driven by personal travel, with education and health related travels contributing the largest chunk. Elsewhere, income deficit expanded for the period (+9.7% QoQ) driven by expansion in investment income deficit (+9.5% QoQ). Overall, the impact of higher trade combined with current transfer surpluses (+10% QoQ) largely underpinned robust CA surplus for the period.

### ***Deluge of Portfolio flows storm Nigeria***

On the financial account ledger, capital flows into Nigeria reached a record high of \$9.9 billion in the first five months of the year (H2 17: \$9.5 billion), surpassing flows in the pre-oil crisis period. In line with historical pattern, the strong capital flow was driven by surge in portfolio investment flows (Jan – May: \$7.5 billion vs. H2 17: \$6.2 billion) which contributed circa 75% of the total flow into the economy while Foreign Direct Investment (FDI) and ‘Other Investment’ printed lower over the review period. Interestingly, total flows in the first five months of the year is already 81% of total flows in 2017 of \$12.2 billion.

Breakdown shows the sizeable portfolio flows was directed at money market instruments which amounted to \$5.6 billion - ~75% of total portfolio investment flows. Since Q3 2017, foreign flows flooded Nigeria’s debt instruments on the back of attractive rates relative to other frontier and emerging markets. Particularly, most of the flows seen was majorly to short term instruments (T-Bills and OMO) given the higher yield spread relative to bonds yield. Though higher flows to bonds expanded slightly to \$684 million relative to \$425 million in H2 2017.

**Figure 3: FX Adjusted return of FI markets (H1 2018)**

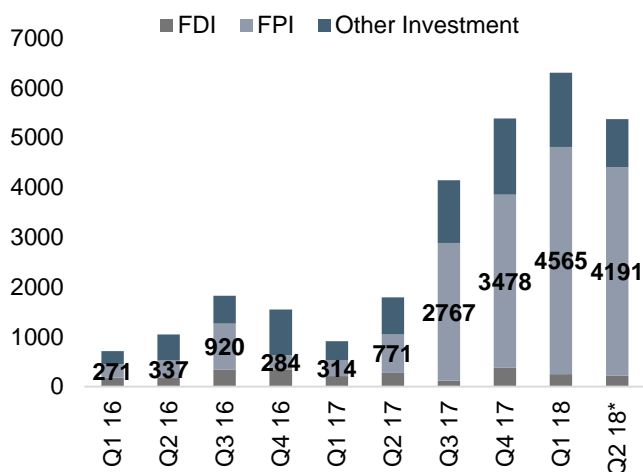


Source: Bloomberg, ARM Research

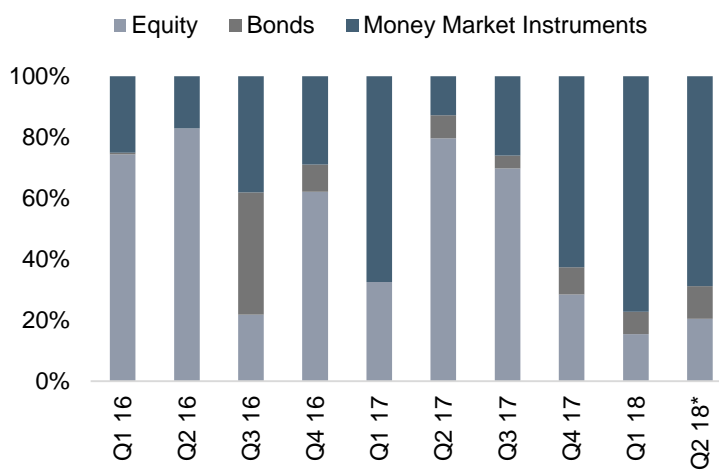
In line with our expectation for a sell-off in the equity market, flows to the equity market slowed down its momentum with total flows between January – May printing at \$1.2 billion (H2 17: \$2.9 billion). We link the lower flows to several factors. First off, after Nigeria’s equity market booked sizable gains in previous periods (2017: 42% YoY, Jan 18: 16% MoM), we believe foreign investors took profit ahead of elections coming up in 2019, the impact of which reduced capital flows. Elsewhere, Other Investments printed at \$2.0 billion in Jan – May (H2 17: \$2.8 billion) largely reflecting foreign loans into Nigeria. While Nigeria may have successfully attracted hot money (FPI), longer-term capital investment (FDI) remained largely depressed. Specifically, total FDI flow for the

review period printed at \$376.6 million relative to total flow of \$496 million in H2 17. Irrespective of the improved macroeconomic environment, we believe that foreign investors are threading cautiously to investing long term in Nigeria on stability concerns. To buttress, Nigeria currently ranks 145 out of 190 countries on ease of doing business, which is lower than most African peers. In line with trend, a breakdown of flows from countries showed both UK and US combined to contribute 56% of overall portfolio flows into Nigeria, with majority of the flows invested in shares and the banking sector.

**Figure 4: Capital Importation Composition (\$'mn)**



**Figure 5: Foreign Portfolio Flows Composition (\$'mn)**



Source: CBN, ARM Research

### ***Sturdy trade and current transfer surpluses to underpin robust CA***

Into the rest of the year, we believe that the confluence of higher crude production and prices will continue to support export earnings, while tepid non-oil import should mask the substantial jump in oil import. Specifically, we forecast crude production to remain largely stable at 2.0mbpd (+8.5% YoY) on the back of sustained calm environment in the producing regions. That, together with our projection of Brent crude price averaging \$70bbl should propel export to \$48.9 billion (+16% YoY). Elsewhere, we forecast non-oil export to expand by 14% YoY to \$4.0 billion. The impact of the foregoing should leave overall export at \$52.9 billion (15.4% YoY). For import, we strongly believe that NNPC will – on the instruction of the fiscal authorities – continue to import oil heavily in a bid to pre-empt oil shortages as election period draw closer. Irrespective, we believe that sluggish non-oil import (FY 17: 75% of overall import) will largely cap the uptrend in oil import. Firstly, on the oil leg, we expect oil importation to average 6.6b/litres over 2018 (Q1 18: 6.8b/litres) with PMS taking the

biggest share (72.4%)<sup>2</sup>. Against that backdrop, we forecast oil import to surge by 48% YoY to \$12.1 billion (Q1 18: \$2.6 billion). On the other leg, we see benign movement in non-oil import which is expected to print largely flat at \$24.8 billion (+1.0% YoY) (Q1 18: \$6.1 billion). Our views on tepid non-oil import hinged on continued pressured consumer wallets and improved government effort on import substitution which should taper non-oil import demand. Overall, we expect import to expand by 12.8% YoY to \$36.9 billion. Accordingly, we now look for trade surplus of \$16.0 billion (+21.9% YoY).

On the rest of the ledger, we expect the combined impact of improved economic activities and sustained FX liquidity to drive sizeable deficit in travel, transportation, and other businesses, thereby leaving overall services net debit position higher by 21% YoY to (\$16.0 billion). For income, our views suggest that the deficit run will moderate through the rest of the year on the back of depressed equity market return and lower yield environment. Hence, we forecast income deficit to slow to (\$10.5 billion) (-8.8% YoY). Lastly, we look for 13.7% YoY increase in current transfer driven by sturdy remittances. That said, superimposing our outlook for trade and current transfer surpluses, together with income and service deficits, we project CA surplus to print at \$14.5 billion (FY 17: \$10.4 billion).

### ***Gloomy second half to shake portfolio flows***

Going into the rest of the year, we expect the double whammy of policy normalization in advanced economies and election uncertainties in Nigeria to potentially create foreign investors' aversion towards naira assets and, by extension, reduce capital importation into Nigeria. In fact, as at June, we have seen foreign portfolio flows in the IEW slow to \$1.3 billion relative to a monthly average of \$1.5 billion in the first 5 months of 2018.

For money market instruments, we expect further rate hikes in the US to cause lower inflow for the rest of the year. To be specific, we see flows printing at \$10.5 billion (+225% YoY). Elsewhere, flows to the equity market is expected to remain tepid at \$950 million for H2 2018 (H1 18: \$1.42 billion, 2018: \$2.38 billion) while bond investment is expected to expand 2.3x YoY to \$1.59 billion largely due to higher inflow in H1 18. On balance, we expect higher flows in H1 18 to consolidate relative lower flows in H2 18 to drive an overall increase of 54.7% YoY in capital importation to \$18.9 billion over 2018.

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<sup>2</sup> PMS: 72.4%; AGO: 25.8%; 1.8%

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