

## Nigeria Strategy Report

### H2 2018

#### Global Economy and Markets

# EM portfolio flows: Slowing the flow, but far from a dribble

### Executive Summary

At the start of the year, we projected some bouts of headwinds to emerging market portfolio flows, despite stable and growing global economy, higher commodity prices and improving fundamentals in key financial markets. First was our expectation of interest rate hike in the US, then was the projected scale back on QE by the ECB, and lastly was geopolitical risks, particularly trade protectionism policies. As posited, after a stout first quarter in 2018, that saw average net portfolios flows to Emerging markets (EM) touch a 3-quarter high of \$19.9 billion, EMs flows fell short over the second quarter, reporting average net outflows of \$6.2 billion.

Over the rest of 2018, the confluence of several pull factors across DMs including sturdy DM growth picture and currencies, drive towards interest rate normalization, higher yields and ripple effect of escalating trade wars between US and China points to unabated portfolio outflows from EMs over 2018. However, the misery seems moderated as higher commodity prices for EM commodity exporters provides war chest for withstanding headwinds from the external front and boosting economic growth. In addition, the scale of outflows from EM debt market should be subdued as EM central banks are more inclined to switching from monetary easing to tightening with India and Turkey leading the way. As a result, the Institute of International Finance now projects a slight pull back in portfolio flows to emerging market (-12.5% YoY to \$351billion) over 2018.

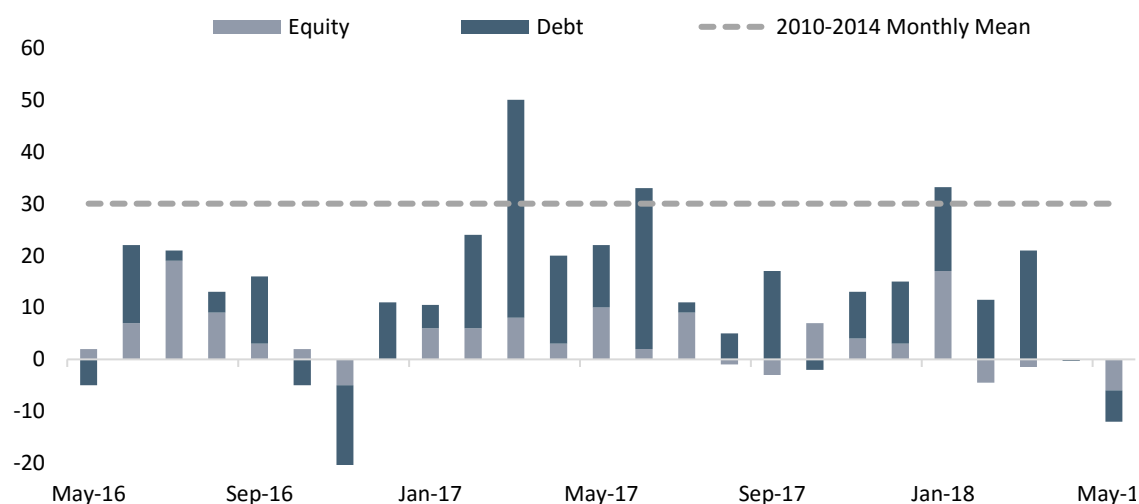
***In this report, we look at the major themes that dominated portfolio flows to EM in H1 2018 as well as our outlook for flows to EM for the rest of the year***

### *Portfolio flows bow to pull factors*

After a stout first quarter in 2018, that saw average net portfolio flows to emerging markets (EM) touch a 3-quarter high of \$19.9 billion, EMs flows fell short over the second quarter, reporting average net outflows of \$6.2 billion. The dearth of hot money across EMs reflected more of the pull factors, from higher rates in the US, geopolitical concerns, and trade tensions, that impacted on both debt and equity segments, reporting average net outflows of \$3 billion and \$3.2 billion respectively (Q1 18: net flows of \$3.7 billion and \$16.2 billion accordingly). That said, a parse-through the numbers revealed that portfolio flows started to moderate, after a strong showing in January, specifically on the equities segments as attractive carry opportunities in selected EM countries kept EM debt awash with flows. For clarity, on a monthly basis in Q1 2018, while foreign investors remain upbeat on EM debt over Q1 2018 (Jan: \$16.2 billion, Feb: \$11.5 billion, Mar: \$21 billion), portfolio flows to equities saw a downturn after touching its highest point in 17 months in Jan (\$17 billion), as Feb (-\$4.5 billion) and Mar (-\$1.5 billion) net outflows trimmed equity portfolio flows to EM to \$11 billion. To our minds, this reflects FPI repatriation of funds into DMs made clear by expansion in US portfolio flows by 39% QoQ to \$292 billion over the same period.

Nonetheless, tides turned in subsequent months following higher inflation expectation in the US which incited hikes by US Fed in March and June by 25bps apiece thus, paving way for a rise in US 10-year bond yields to highest level in four years in May 2018. As a result, EM debt became unattractive, pushing the EM sovereign spreads higher by 8.96bps and 31.75bps respectively, while prospect for stronger DM growth continues to trump FPI flows into equities. The foregoing alongside heightening trade spat between US and China drove investors reassessment for riskier asset as net FPI flows into EM turned negative in April (-\$300 million) and May (-\$12 billion).

**Figure 1: Net foreign portfolio flows to EMs**



Source: IIF, ARM Research

***Divergent fortunes across various EM dance floors***

In EM Asia, portfolio flows were largely positive with China and India recording strong flows. First off in China, consolidating on its impressive run in 2017 where the currency recorded its strongest annual gain in nine years, the Yuan got off to a solid start in 2018 (Q1 2018: +3.85%) – a reflection of resilient domestic growth (Q1 2018: 6.8% YoY) and tighter monetary conditions. As a result, China witnessed positive net portfolio inflows in Q1 2018 (\$1.3 billion). Bulk of the flows were to China's debt market (\$1.72 billion) as investors priced in the impact of a stronger Yuan as well as ongoing reforms to enhance offshore investor participation in fixed income instruments. Similarly, in India, FPI flows sustained its positive run in Q1 18 as investors embraced India's upbeat GDP growth in Q1 18 (+70bps QoQ to 7.7%) – its highest in seven quarters.

Emerging Market Europe witnessed higher portfolio inflows largely reflecting favorable economic picture across member countries. In Russia, net capital flows swung to positive territory in the last two quarters (Q1 18: \$3.7 billion vs Q4 17 \$622 million) amid series of external shocks including western imposed sanctions, as FPI priced in higher commodity prices on economic growth (Q1 18: +70bps YoY to 1.3%). Over to Turkey, portfolio investment got off to a positive start in 2018 after net FPI flows rose to \$5.3 billion in January 2018 (vs \$772 million in prior month) following the trickle-down effect of fiscal stimulus which provided ample support for a resilient Q1 2018 GDP performance (+200bps YoY to 7.4% in Q1 2018). However, tides turned in subsequent months as heightening political risk ahead of its June 2018 Presidential election, rising consumer prices (CPI: +504bps to 15.39% YTD), investors' apprehension over the independence of Turkey's Central Bank – following Erdogan's incessant pressure to influence interest rate decision – and a slew of global uncertainties trimmed portfolio flows to \$763 million in the first five months of the year following four months of consecutive outflow since February 2018. As a result, the Turkish Lira depreciated (-20.9% YTD), informing a strong hawkish decision by the Turkish Central Bank to raise interest rate in May (+300bps to 16.5%) and June (+125bps to 17.75%) to combat currency and inflationary worries.

In other climes, flows to Africa sustained its resilience in Q1 18 driven by positive flows into Nigeria, South Africa, and Egypt. For Nigeria, average flows jumped 31% QoQ to \$1.5 billion in Q1 18 as investors cheered the impressive macroeconomic fundamentals in the wake of higher crude oil prices. Bulk of the flows were channeled to money market instruments, with average monthly inflow rising 62% QoQ to \$1.2 billion in Q1 2018 whilst average flows to Nigeria's bond market only rose by 8.5% QoQ to \$112 million over Q1 18

as investors tapped into higher yields at the short end of the curve. In our view the slowdown in portfolio flows to the equity market reflects political risk ahead of electioneering activities in Nigeria as well expectation of possible currency concerns. Elsewhere, South Africa recorded net FPI inflow of \$2.3 billion over Q1 18 (vs \$646 million in Q4 17) largely stemming from flows to the equity segment of the market as market cheered the new President, Cyril Ramaphosa, with loads of optimism of reviving the sluggish economy. However, fortunes changed in latter months as South Africa witnessed a massive net outflow of \$3.8 billion in May 18. Elsewhere, Egypt conducted a Eurobond sale of \$4 billion in February and €2 billion bond (Euro-denominated) in April 18. Both issuances were more than 3x oversubscribed as investors reacted to upbeat macroeconomic fundamentals following IMF support program that ushered in the implementation of pro-market policies.

In Latin America, Brazil shrugged off its FPI flows woes of Q4 17, where it witnessed net outflows of \$3.3 billion, by posting net inflows of \$5.5 billion in Q1 18 as investors priced in the impact of waning inflationary pressures (Q1 18: 2.79% vs 2.81% in Q4 17) and higher crude oil prices on economic growth (+20bps QoQ to 0.4% in Q1 18). However, events turned in May as FPI exit from Brazil printed at \$2.62 billion as investors priced in a stronger US dollar, strain on economic activities caused by trucker's strike<sup>1</sup> induced inflationary pressures (May: +10bps MoM, June: +153bps MoM) and political uncertainty ahead of its October 2018 elections. Consequently, following massive FPI exodus, Brazilian real plunged 13% in Q2 2018.

### ***Portfolio flows to EM: No leap in sight***

Over the rest of 2018, we think flows will be driven by the confluence of interest rates trajectory in developed markets, strength of the US dollar, geopolitical and trade tensions, global growth path including global growth picture, and other idiosyncratic factors across EM countries. To start, economic growth across DMs is expected to strengthen over H2 18 following a sturdy economic growth in US and Euro area. Precisely, robust external demand, consumer spending, and positive labor data have reinforced outlook for a stronger growth in the US, while stronger-than-expected domestic and external demand across the euro area and supportive monetary policy provide a basis for a stronger growth outlook for Euro area. Even so, FOMC's forward guidance of further rate hikes (two) over H2 18 on the back of expectation further pressure to inflation outlook – offshoot of rising energy prices, ongoing trade war rhetorics and Donald Trump's fiscal expansionary policies (tax cut and increased government spending) provides leeway for rising US treasury yields over the rest of the year.

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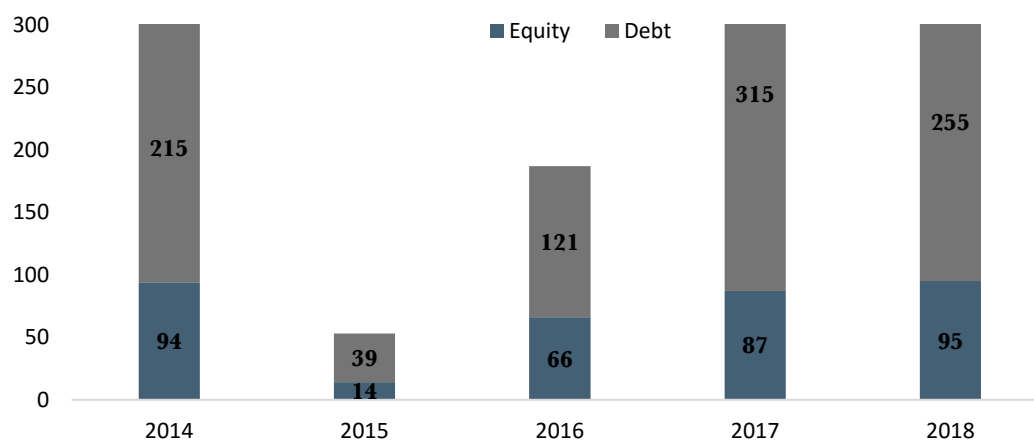
<sup>1</sup> As private truck drivers protested over hike in energy for two weeks

Also, the ECB took cautious step at normalizing interest rate by hinting at scaling back its QE program to €15 billion in Q4 18 with possible extinction at the end of the year. Consequently, the convergence of a sturdy economic growth in DMs and prospect of interest normalization in DMs provides scope for further strengthening of DM currencies over the rest of the year. Lastly, the ongoing trade spat, and heightening global protectionism further exacerbates the ongoing volatilities in EM markets. Specifically, the recent tariff bouts between the US and China (\$34 billion apiece) and further escalation of the trade war poses threat for global growth with downside risk skewed towards EM countries.

### ***Slowing the flow, but far from a dribble***

Thus, the confluence of several pull factors across DMs including sturdy DM growth picture and currencies, drive towards interest rate normalization, higher yields, and ripple effect of escalating trade wars between US and China points to unabated portfolio outflows from EMs over 2018. However, the misery seems moderated as higher commodity prices for EM commodity exporters provides war chest for withstanding headwinds from the external front and boosting economic growth. In addition, the scale of outflows from EM debt market should be subdued as EM central banks are more inclined to switching from monetary easing to tightening with India and Turkey leading the way. As a result, the Institute of International Finance (IIF) now projects a slight pull back in portfolio flows to emerging market (-12.5% YoY to \$351billion) over 2018.

**Figure 2: IIF Projections for portfolio flows to EM over 2018 (\$'billion)**



Source: IIF, ARM Research

Starting with China, while the economy is expected to journey through rough edges following a potential trade dispute with the US and its ongoing deleveraging exercise, recent government efforts to open its bond market to offshore investors provides some cheer to

investors. Elsewhere in India, the pass through of higher petroleum product prices and its attendant impact on higher consumer prices and widening current account deficit – due to India's higher importation of petroleum product – could wary foreign portfolio investors over H2 18. However, we expect a shift in Central Bank of India's monetary stance (+25bps to 6% in June 2018) to provide respite for offshore interest in India's debt

Over to EM Europe, across our coverage, Turkey appears to be poorly positioned to wade off current negative sentiments trailing investors' appetite for EM assets. First off, being a net-energy importer, Turkey's economy remains vulnerable to rising energy prices with knock on effect widening its current account deficit (2016: 4% vs 2018: 6%). Also, foreign investors remain apprehensive of the perceived lack of independence of Central Bank of Turkey's decision. Thus, we see scope for sustained FPI outflows from Turkey. Elsewhere in Russia, we expect portfolio flows to moderate following western imposed sanctions, albeit marginal, as macroeconomic fundamentals remain strong following higher commodity prices.

Meanwhile in Africa, despite sturdy macroeconomic fundamentals, the outlook for portfolio flows into Nigeria remains subdued as investors stay on the sideline ahead of general elections in 2019. While in South Africa, despite resurfacing inflationary concerns we see scope for capital flows into South Africa on expectation of better economic reforms under the new government of Ramaphosa. In Latin America, political uncertainties ahead of general elections in October 2018 should dampen portfolio flows into Brazil over H2 18

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