

August 3, 2018



# Nigeria Strategy Report

## H2 2018

Domestic Economy and Markets

## Fixed Income: *Have Yields hit the bottom?*

### Executive Summary

Entering 2018, our prognosis for the naira yield curve was a continued downtrend over the year. This view was hinged on the expectation that the intertwining effect of elevated liquidity profile and base effect induced downtrend in headline inflation will pave way for a loser monetary policy in H1 2018. True to our expectation, our views of a steeper naira yield curve played out as average fixed income yields dipped 100bps to 13.22% over the first half of 2018 on the back of sustained descent in inflation over H1 2018 and loser monetary policy via tapered liquidity mop up and cut in OMO rates. In terms of drivers, the decent in FI yields resonated FG's drive to trim its cost of debt financing and CBN's quest to keep OMO rates submerged in lockstep with plummeting headline inflation while keeping an eye on market liquidity to wade off currency attacks.

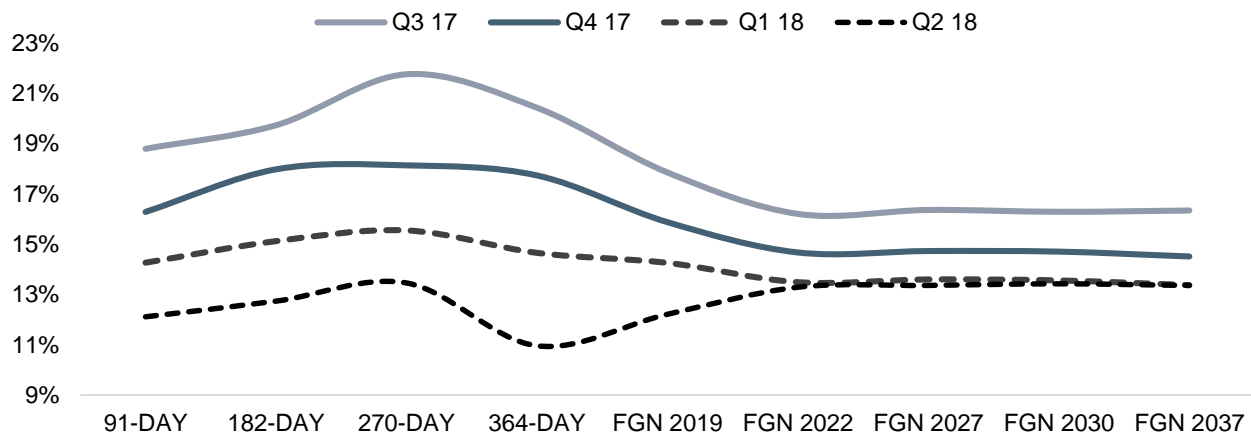
Over the rest of the year, we expect activities of the monetary authorities to continue to influence the naira yield curve trajectory particularly at the short end. Specifically, the elevated liquidity profile over H2 2018 provides ample justification for a stay in MPR at current levels (14%) over H2 2018. Whilst on the fiscal side, FG's borrowing pattern remains crucial in formulating an outlook. Having net repaid ₦49.7 billion over H1 2018, FG will need to borrow more over the rest of the year with our projections pointing to domestic borrowings of ₦437 billion in H2 18 and overall borrowings of ₦388 billion over 2018. Furthermore, on the external front, in addition to political uncertainty ahead of the general elections in 2019, the upbeat macroeconomic picture as well as drive towards interest rate normalization in the US amid rising inflation could further dampen foreign investors' appetite for naira denominated paper. Over all, despite prospects for fairly robust local demand for FGN securities stemming from elevated liquidity, we expect the confluence of hawkish monetary policy, higher FGN paper supply and rising US treasury yields to drive rates a touch higher over H2 18.

***This report focuses on trends in Nigeria's fixed income market and our outlook for same over the rest of the year.***

### *Yield curve sinks further*

Entering 2018, our prognosis for the naira yield curve was a sustained downtrend over the year hinged on the expectation that the intertwining effect of elevated liquidity profile and base effect induced downtrend in headline inflation will pave way for a loser monetary policy in H1 2018 thus, plunging yields at both ends of the curve. True to our expectation, inflation sustained its descent over H1 2018 (-285bps to 13.02%) largely on the back of base effect induced plunge in the both core (-101bps to 11.17% in H1 18) and food (-452bps to 16.63% in H1 18) components. Similarly, although the apex bank left its policy parameters unchanged all through H1 2018, it tapered its liquidity mop up, with OMO sales in H1 2018 (-61% to ₦597.4 billion) falling shy of prior period in H2 17. Based on the foregoing, our views of a steeper naira yield curve played out as average fixed income yields dipped 100bps to 13.22% over the first half of 2018. In terms of drivers, the decent in FI yields resonated FG's drive to trim its cost of debt financing and CBN's quest to keep OMO rates submerged in lockstep with plummeting headline inflation.

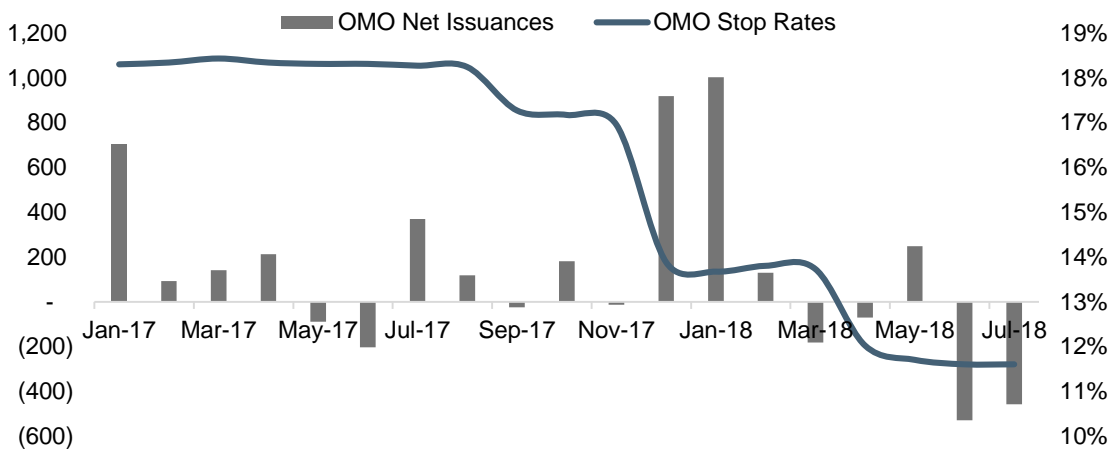
**Figure 1: Trend in Naira yield curve**



Source: FMDQ, ARM Research

On the monetary leg, in tandem with December 2017 where CBN resumed its assault on naira liquidity due to liquidity surfeit stemming from refinancing of maturing NTB, the apex bank sustained tightness at the start of the year – with OMO net issuances touching it's highest in January (₦1 trillion). However, as base effect induced deceleration in headline inflation became pronounced and higher crude oil prices provided room for accretion in reserves (+23.3% to \$47.8 billion), the apex bank slashed OMO rates by -421bps to 12.75% in H1 2018 and loosened its grip on naira liquidity—with total OMO net issuances of ₦597 billion in H1 2018 plunging 61.4% in relation to H2 17 (₦1.5 trillion). Consequently, average yields at the short end dipped by 138bps over H1 18 to 12.95%.

**Figure 2: Trend in OMO Net Issuances vs Stop Rates (₦billion)**



Source: CBN, FMDQ, ARM Research

On the fiscal side, FG took compelling steps towards reducing its debt service cost in H1 2018. Instructively, FG raised \$2.5 billion in February 2018 to refinance maturing treasury bills. As a result, after net issuing ₦151.4 billion in Q1 18, FG net repaid ₦410.7 billion in Q2 18, which translated to a net repayment of ₦259.3 billion over H1 18 (vs net issue of ₦222.3 billion in H2 17). Against this backdrop, marginal clearing rates at the NTB auction dipped 393bps to 10.67% as FG muscled rates to its favor. Similarly, the much-improved fiscal revenue picture drove FG's apathy for naira denominated debt with Bond issuances of ₦209 billion over H1 2018 being 70% and 58% lower than issuance in H2 17 and its planned offer in H1 18. Although the net-repayment was in part fed by ₦302 billion bond maturity in May, the tamer bond issuance reflects FG's tilt towards external borrowings as offshore borrowings account for bulk of FG's budgeted borrowings (52%) for the year. The attendant impact of this cascaded into downtrodden secondary market yields at the long end (-61bps to 13.5% over H1 2018).

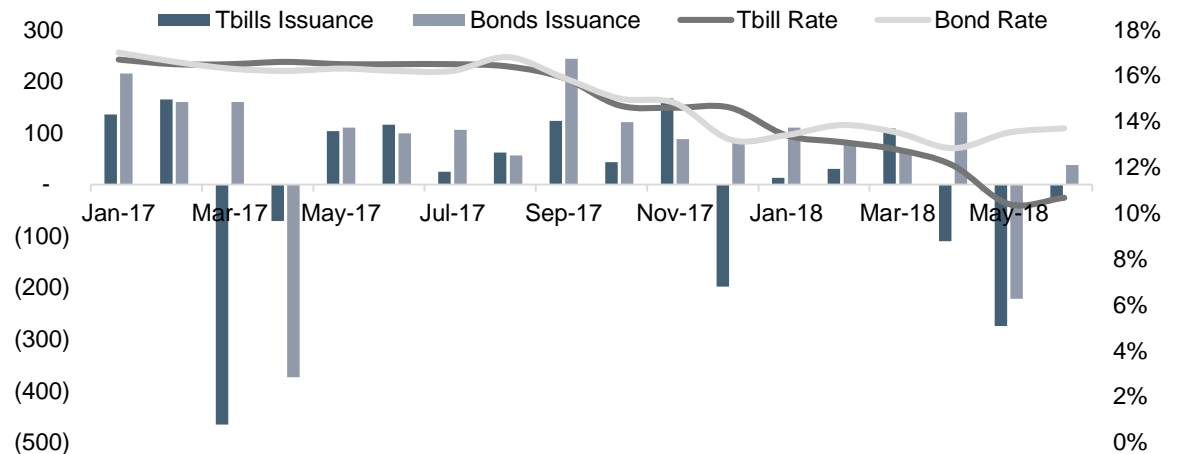
### ***Debt Rebalancing bears fruit***

True to its words, after fully redeeming ₦198 billion worth of NTBs in December 2017 with \$500 million out of the \$3 billion off shore borrowings in November while the balance was earmarked for fund 2017 capital expenditure needs. Similarly, FG tested the Eurobond waters in February 2018 to source \$2.5 billion (₦762.5 billion) for refinancing maturing treasury bills, bringing total foreign borrowings for NTB refinancing to \$3 billion. After the successful issuance in February, the DMO released the Q2 18 Treasury Bills Calendar which showed sizable decline in planned borrowings with FG planning to net-repay ₦484 billion in Q2 18.

In compliance with its script, FG net repaid ₦410 billion worth of NTB in Q2 18 (vs ₦151.4 billion net-issuance in Q1 18) which translated to a ₦259.3 billion net repayment over H1 18. This emanated despite investors' appetite for short dated FG paper over the period with higher bid to cover over the period (H1 18: 2.2x vs 1.78x in H2 17) as FG stayed its course on pushing cost of borrowings lower with knock on effect dragging stop rates lower (-393bps to 10.67%) at NTB auctions in H1 18.

However contrary to trend at the short end, FG struggled to drive stop rates lower at bond auction—with stop rates closing higher in five out of six auctions (+50bps to 13.7%). In our view this reflects investors wary for longer dated FGN securities at the PMA (total number of bids over H1 18 dipped 21% to 834 relative to H2 17) due to the more attractive yields on short dated securities as well as upward repricing of bids triggered by flashes of FPI exit which drove bond yields higher in May (+24bps MoM to 13.2%) and June (+30bps MoM to 13.5%). Regardless, the tamer bond net issuances of ₦209 billion in H1 18 (-70%) echoes FG's increasing preference for external borrowings in a bid to trim its debt service cost.

**Figure 3: Trend in NTB and Bond Issuances vs Borrowing cost**



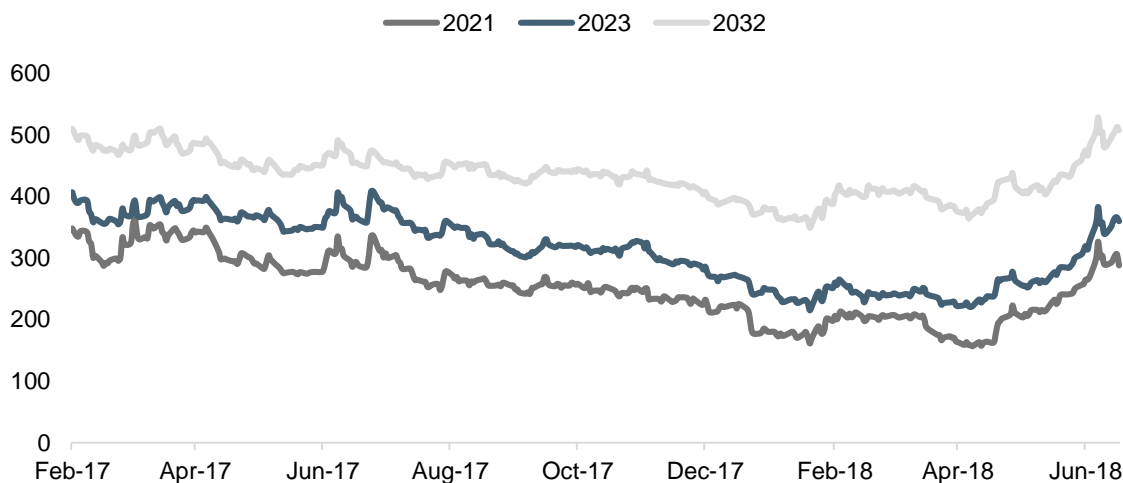
Source: FMDQ, ARM Research

### ***Eurobond yields rise on flight to Safety***

In H1 18, after barely three months of issuing its fourth Eurobond in November 2017, Nigeria closed out on a \$2.5 billion worth of Eurobond issuance to refinance maturing treasury bills. The issuance was split into 12-year and 20-year series of \$1.25 billion apiece with coupons of 7.14% and 7.69% respectively. The issue was largely oversubscribed with bid to cover of nearly 4.6x. Relative to similar Eurobond issuance by Egypt (10 year: 6.59%) in the same period, the pricing of Nigeria's

issue seems elevated. In our view, investors demanded a higher return for taking on Nigeria's debt following signaling effect of higher yields on US treasuries over 2018. Elsewhere, despite improving macroeconomic fundamentals, movement across Eurobond yields reflects investors' apprehension towards Nigeria's credit risk as US treasury yields moved north with Z-spreads to comparable US treasuries rising by ~88bps over H1 2018. Consequently, average yields on the sovereign Eurobonds jumped over H1 18 (2021: +29bps to 4.83%), (2023: +8bps to 5.42%) and (2032: +31bps to 7.02%).

**Figure 4: Trend in Nigeria's Eurobond Spread (bps)**



Source: Bloomberg, ARM Research

### ***Have Yields hit the bottom?***

Over the rest of the year, we expect activities of the monetary authorities to continue to influence the naira yield curve trajectory particularly at the short end. Hence, we re-analyze the key underpins of monetary policy, in a bid to predict potential policy change in the second half of the year. The monetary policy committee's (MPC) body language took a new turn in its July MPC meeting, ushering in the introduction of heterodox approach towards economic growth stimulation which implied that CBN could directly purchase Commercial papers issued by large constrained corporates. It also saw the introduction of a new CRR regime to direct cheap long-term bank credit to the Manufacturing and Agriculture sector. For us, this is unsurprising as the persisting descent in headline inflation since the turn of the year provides leeway for a temporary tilt in monetary policy drive towards economic stimulation. To our minds, while this could stoke yields downtrend over the long term, the elevated liquidity profile over H2 2018 provides ample justification for a stay in MPR at current levels (14%) over H2 2018.

For context, given the elevated maturity profile over H2 18 (NTB: ₦1.8 trillion, OMO: ₦8.9 trillion), expectation for higher FG spending in a bid to speed up implementation of the 2018 budget and increased money in circulation from electioneering activities, we think the CBN will maintain a proactive stance towards dissuading speculation on the naira to drive stability in the currency.

On the fiscal side, FG's borrowing pattern remains crucial in formulating an outlook. Having net repaid ₦49.7 billion over H1 2018, FG will need to borrow more over the rest of the year with our projections pointing to domestic borrowings of ₦437 billion in H2 18 and overall borrowings of ₦388 billion over 2018. Especially, we hold the view that FG will max out of its \$2.5 billion earmarked for refinancing maturing bills in August given that it has only ₦138 billion left. As a result, we think the fiscal authorities will net-issue in subsequent Treasury bill auction, albeit lower in the range of ~ ₦100 – ₦200 billion over H2 2018. Furthermore, the late passage of the 2018 budget and looming general elections in 2019 puts even more pressure on the government to ramp up borrowings to accelerate implementation of its 2018 fiscal outlay to keep the economy afloat ahead of the polls.

On the external front, in addition to political uncertainty ahead of the general elections in 2019, the upbeat macroeconomic picture as well as drive towards interest rate normalization in the US amid rising inflation could further dampen foreign investors' appetite for naira denominated paper. For context, economic growth across DMs is expected to strengthen over H2 2018 with US and Euro area posting strong GDP growth in Q2 2018<sup>1</sup>. This in addition to rising headline inflation in the US could steer further hikes in US interest rate over 2018 with knock on effect driving US treasury yields higher (+45bps to 2.86% in H1 18) over the rest of the year. As a result, based on our analysis we model repatriation of funds from the Nigeria fixed income market to the tune of \$10.3 billion over H2 2018. Given the foregoing, we expect sustained sell pressures in the Nigeria Fixed income space with pass through effect driving secondary market rates higher over H2 18. However, in contrast, the pent-up maturity of ~ ₦8.9 trillion—OMO and ₦1.8 trillion - NTB over H2 18 suggests that domestic interest in FG securities should remain robust perhaps more from a perspective of limited options. Nevertheless, as in Q2 18 Bond PMA auction, we expect domestic investors' bids to be reflective of higher secondary market rates which would in turn drive higher stop rates at the PMA auctions. In all, despite prospects for robust local demand for FGN securities, we expect the confluence of hawkish monetary policy, higher FGN paper supply and rising US treasury yields to drive rates a touch higher over H2 18.

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<sup>1</sup> US: +4.1% YoY, Euro Area: +0.3% YoY

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