

Nigeria Strategy Report

H2 2019

Domestic Economy and Policy Environment

Currency: Near-term FX stability remains intact

Executive Summary

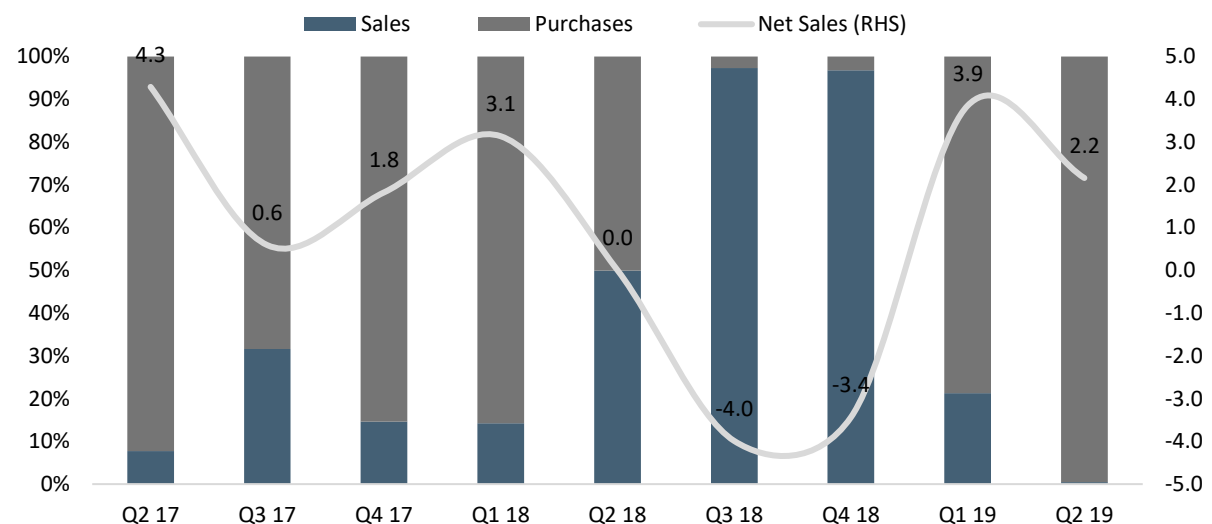
In our H1 2019 Nigeria Strategy Report, we projected that the confluence of lower demand for imports, slower rate of repatriation of offshore holdings of maturing fixed income instruments and CBN's apathy to initiate/renew maturing swap positions will result in slower intervention by the apex bank over 2019, with estimated average monthly sale of \$4.5 billion. True to our words, average monthly FX outflows through the CBN declined 11.4% over H1 2019 to \$4.9 billion (vs. \$5.6 billion in H2 2018). Specifically, relative to H2 18, CBN intervention sales at the IEW declined by 81.3% to \$1.43 billion, while sale at the Interbank (SMIS, SME, Invisibles and Others) declined by 18.8% to \$11.1 billion. On the flipside, average BDC sales over H1 19 expanded by 28% to \$1.2 billion from \$943 million in H2 18, as CBN increased its frequency of sales over the review period. For clarity, CBN tuned up its frequency of dollar sales to BDCs to four times a week (previously three), bringing weekly intervention per BDCs to \$75,000 by December 2018.

While our base scenario (even worst scenario) suggest a comfortable position for the apex bank and the naira, we believe the distorted interplay of demand and supply at the IEW and the increased demand at same would drive short term volatility in rates to result in Naira depreciation between ₦363.0/\$ to ₦366/\$ over H2 19. On our purchasing power parity model (PPP), the fundamental value of naira lies between ₦395.0/\$ to ₦400.4/\$ (8-8% - 10% down-leg from current NAFEX rate of ₦361.6/\$). However, we fully recognize many stipulations behind expecting mean reversion from real effective exchange rates (REERs) and PPP, we refrain from interpreting the results of our analysis as a viable trading signal.

In this report, we look at the major themes that dominated the foreign exchange market in H1 19 as well as our outlook for pull and drag of foreign exchange flows over the rest of the year.

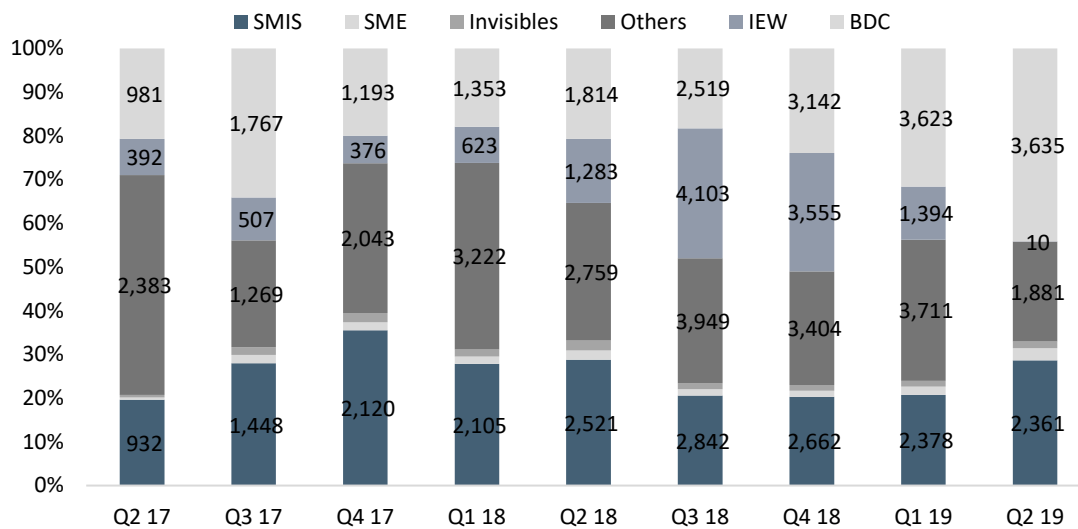
Hot Money's inflow spur foreign reserves accretion

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Figure 1: CBN activity at the IEW (\$'billion) vs. Balance (\$'billion)

Source: FMDQ, ARM Research

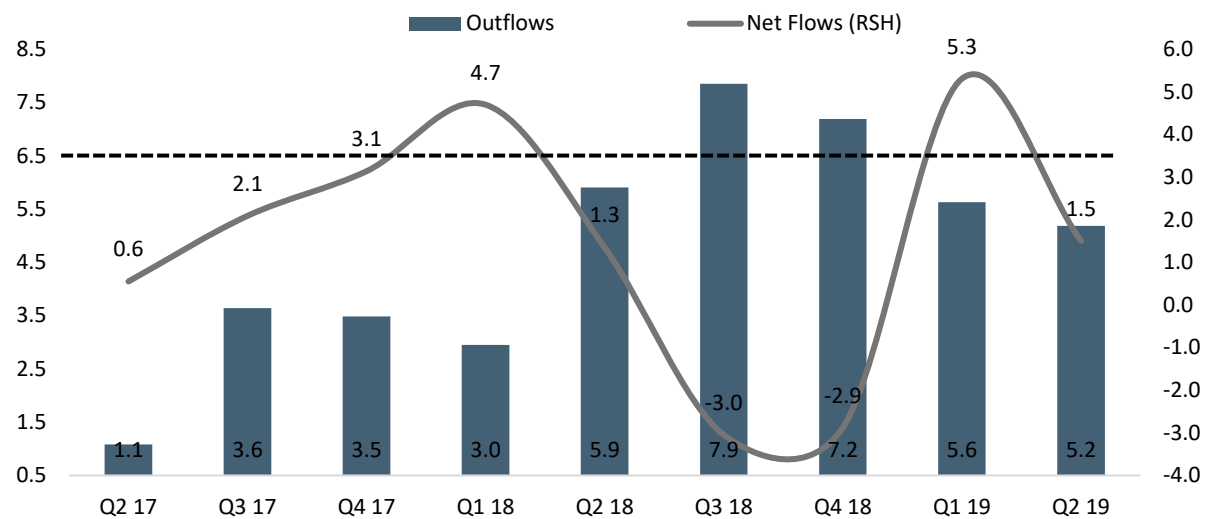
Particularly, we expected the decline in sales would necessitate moderation in the rate of drawdown in external reserve to \$3.4 billion over the first half. However, the combination of strong foreign flows in the first quarter, with CBN purchasing a total of \$6.7 billion, and steady oil inflows (+20.6% to \$9.0 billion) propelled robust net flows with \$2.6 billion accretion in the FX reserve to \$44.8 billion at the end of H1 19. Consequently, the NAFEX, BDC and parallel rates appreciated when compared to H2 18, closing the period at ₦360.5/\$1, ₦359.0/\$1, and ₦359.8/\$1 (H1 18: ₦364.8/\$1, ₦363.5/\$1, and ₦363.7/\$1) respectively.

Figure 2: CBN intervention across FX markets (\$'Million)

Source: FMDQ, ARM Research

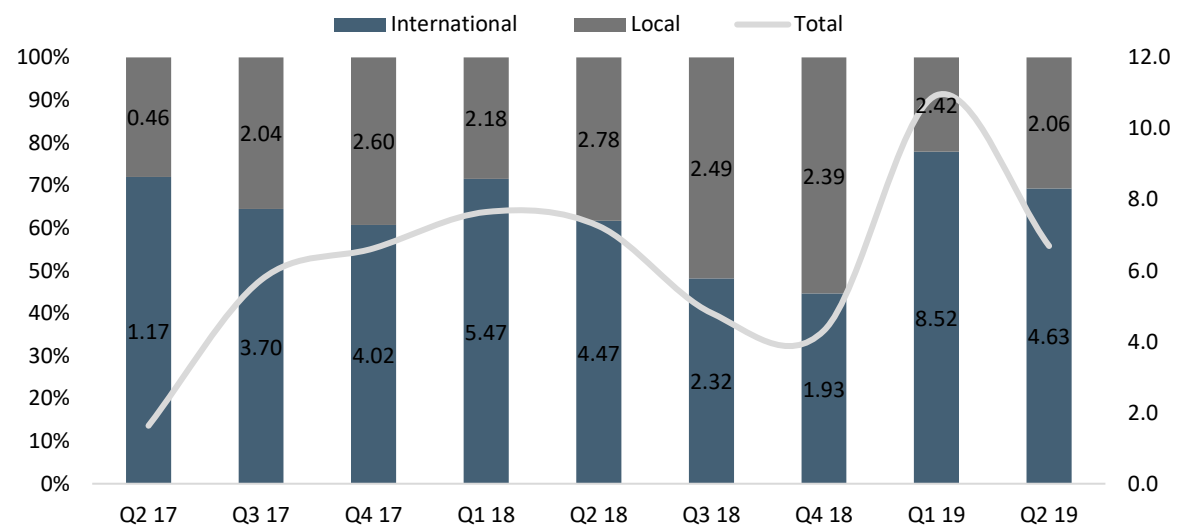
Attractive carry-trade propelled growth in FPI flows

The Investors and Exporters Window (excluding participation by CBN) was well lubricated over the first half of 2019 with a net inflow of \$6.8 billion (compared to a net outflow of \$5.9 billion in H2 18), 13% higher than H1 18. Notably, despite electioneering concerns in the first quarter of the year, the market was at its most liquid level since inception with net inflow of \$5.3 billion. While inflows slowed in the second quarter, outflows were largely unchanged with the market closing with a net surplus of \$1.5 billion. Consequently, compared to H2 18 wherein CBN was a net supplier at the IEW, the apex bank net purchased a total of \$6.0 billion (Q1: \$5.0 billion and Q2: \$2.0 billion) at the window over H1 19. Specifically, going by the recently published Q1 statistical bulletin, the single largest purchase by the apex bank was in March, wherein it bought a total of \$4.2 billion. Largely, the turn of events at the IEW emanated from the dissipated electioneering concerns, receded global idiosyncrasies and the guidance of a more accommodative monetary policy in advance markets which moderated the rate of repatriation of offshore holdings of maturing fixed income instruments over the period. Notably, compared to exodus of funds in H2 18 to the tune of \$15.3 billion, total outflows over H1 19 declined to \$10.8 billion.

Figure 3: Structure of flows at the IEW vs. Balance (RHS) in \$'Billion

Source: FMDQ, ARM Research

In terms of inflows (Excluding CBN), the IEW witnessed a strong rebound over H1 19 with inflows printing at \$17.6 billion compared to H2 18 levels of \$9.1 billion. Notably, notwithstanding the electioneering concerns, Q1 19 welcomed the largest flows with a total of \$10.9 billion, with a slowdown to \$6.7 billion in Q2 19. On the source of flows, while local flows (Exporters, individuals and non-bank financial institutions) declined to \$4.5 billion (H2 18: \$4.9 billion), offshore funds leapfrogged to \$13.2 billion (H2 18: \$4.2 billion). Specifically on offshore funds, hot money continue to dictate the velocity of flows, with FPI accounting for 90% (H1 19: \$11.8 billion, H2 18: \$3.7 billion) and contribution of FDI increasing to 8% (H1 19: \$1.0 billion, H2 18: \$245 million), with the excess coming from foreign non-bank financial institutions.

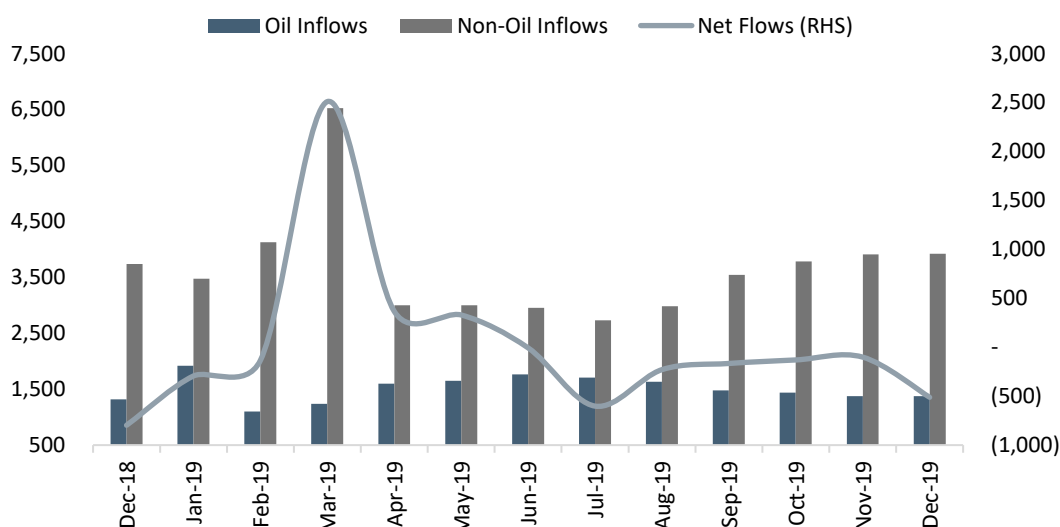
Figure 4: FX Inflow (Ex-CBN) at the I&E Window (\$'Billion)

Source: FMDQ, ARM Research

Dollar inflows: Slowing but still strong

Against the backdrop of the Naira resilience (depreciated 1.1%, 0.17% and 0.20% at the IEW, BDC and Interbank) in the face of exodus of offshore funds in H2 18 and subsequent appreciation over H1 19, we see a strong case for Naira stability over the rest of 2019. Irrespective, we believe the quantum of maturity over the second half the year presents greater uncertainty on the position of the gross external reserve and risks to the currency beyond 2019. To estimate the FX liquidity position of the CBN, we start from the oil side. On CBN oil inflow, we have modeled crude oil production of 2.04mbpd with crude oil export of ~1.6mbpd. We have also factored our crude oil price forecast of \$58.00/bbl. for H2 2019 (H1 19 average: \$67/bbl.). On balance, we forecast average monthly crude oil inflow to the CBN of \$1.5 billion over H2 19 (H1 19 average: \$1.54 billion) with overall flow for the year estimated at \$18.28 billion (+20% YoY).

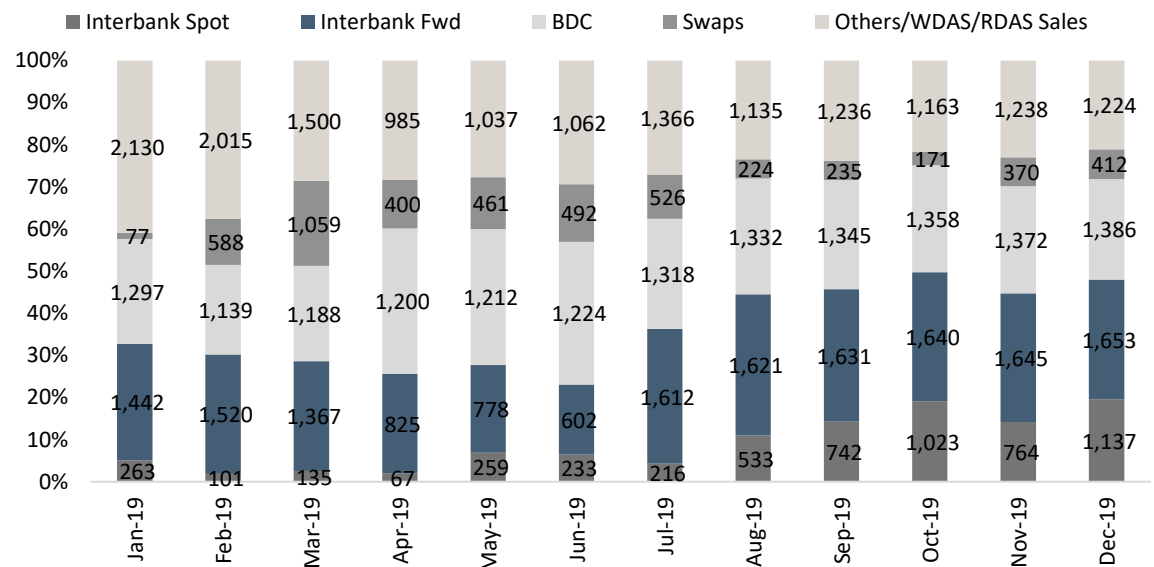
On non-oil inflows, we highlight two factors dominant to flows into the country 1) a sustained dovish stance from the US Fed, and 2) the attractiveness of fixed income yields (OMO and Treasury bills) relative to other EM peers. From our findings, we observed that while Nigeria's real return remains positive, real return in specific markets such as Egypt, Mexico and Turkey are few notches higher. Hence, while we believe inflows into the country will persevere, we think flows will slow relative to H1 19 on the back of thinner carry trade opportunities. As such, we see contraction in non-oil inflows to \$20.9 billion compared to H1 19 of \$23.1 billion. Overall, we believe the apex bank will run on lower flows over H2 19, with average monthly inflow of \$4.9 billion (H1 19 average: \$5.4 billion), with total inflow for the period contracting to \$29.9 billion (vs. \$32.4 billion in H1 19).

Figure 5: CBN oil and non-oil inflows and forecast (\$'Billion)

Source: CBN, ARM Research

Maturing offshore holdings, how tragic could the impact on reserve?

On portfolio outflows, with total maturing global outstanding (incl. OMOs) of ₦9.9 trillion (\$27.6 billion) over H2 2019, and our estimate suggesting foreign holdings of \$8.8 billion (32% of total maturing global outstanding), we assumed exit of 50% of such funds at maturity over H2 19. On other outflows, with imports valid for CBN (visible and invisibles) sales averaging \$3.2 billion monthly (total of \$19.2 billion) over H1 19, we estimate increase over H2 19 by 15% to \$22.1 billion (monthly average of \$3.7 billion). Coalescing our modeled FPI repatriation and increased dollar demand for imports over H2 19, we see increase in CBN interbank forward and spot intervention to \$14.2 billion (+76.1% higher compared to H1 19).

Figure 6: CBN sales and forecast across FX markets (\$'Billion)

Source: CBN, FMDQ, ARM Research

Elsewhere, with the increase in CBN sales to \$75,000 per week (to each BDC operator), we expect CBN sales to that segment to remain elevated over H2 19 due to the perpetually increasing number of operators. Also, with our expectation of upward adjustment to \$80,000 per week during the festive season, we see total sales increasing over H1 19 by 12% YoY to \$8.1 billion. On swaps and other sales, we do not expect initiation or renewal of maturing swap positions over 2019, with consequent impact on lower maturity and sales. Thus, we forecast swap and other sales to contract by 27% over H1 19 to \$8.7 billion. Overall, with our model suggesting cumulative higher CBN intervention over H2 19 to the tune of \$31 billion (5% higher compared to H1 19), we estimate average monthly sale of \$5.2 billion (vs. \$4.9 billion in H1 19). Coalescing this with our estimate of average oil and non-oil inflows to the apex bank, we estimate monthly average reserve drawdown of \$290 million which summed up to \$1.7 billion over H2 19 (relative to \$2.8 billion accretion in H1 19). Consequently, gross reserves are expected to print at \$43.8 billion by year end.

Table 1: Scenario analysis on repatriation of offshore holdings

\$'Billion	Bull Case	Base Case	Worst Case
Maturing offshore holdings	8,830	8,830	8,830
Repatriation rate	30%	50%	100%
Portfolio Outflow	2,649	4,415	8,830
Interbank Spot/Forward Sales	12,451	14,217	18,632
BDC Sales	8,111	8,111	8,111
Others	9,298	9,298	9,298
Total CBN Outflow	29,860	31,626	36,041
Inflows	29,888	29,888	29,888
Reserve accretion/depletion	28	(1,738)	(6,153)
External Reserve	45,610	43,844	39,428
Import Cover	12.3	11.9	10.7

Source: CBN, FMDQ, ARM Research

While our base scenario (even worst scenario) suggest a comfortable position for the apex bank and the naira, we believe the distorted interplay of demand and supply at the IEW and the increased demand at same would drive short term volatility in rates. On our purchasing power parity model (PPP), the fundamental value of naira lies between ₦395.0/\$ to ₦400.4/\$ (8-8% - 10% down-leg from current NAFEX rate of ₦361.6/\$). However, we fully recognize many stipulations behind expecting mean reversion from real effective exchange rates (REERs) and PPP, we therefore refrain from interpreting the results of our analysis as a viable trading signal. As such, we expect the short term volatility due to increase demand at the IEW to result in Naira depreciation between ₦363.0/\$ to ₦366/\$ over H2 19.

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