

Nigeria Strategy Report

H2 2019

Domestic Economy and Policy Environment

Fixed Income: Will the CBN give in to liquidity pressure?

Executive Summary

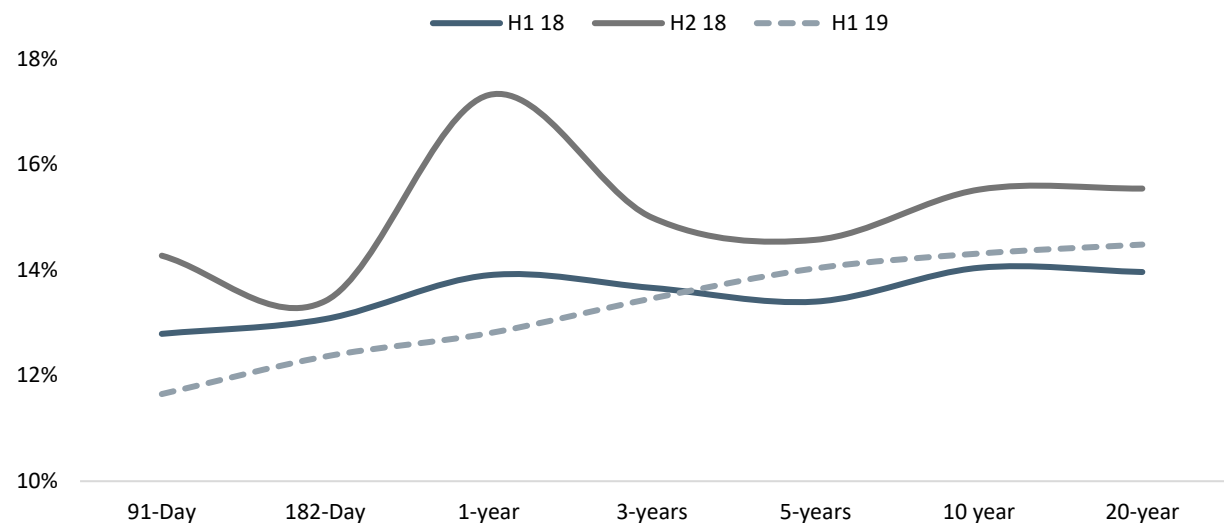
Coming into the first half of 2019, we painted the picture of staggered OMO sale in line with the concentration of OMO maturities over the year. Specifically, we stated that the combination of higher maturities and the risk of exodus of offshore holdings of maturity instruments will propel higher OMO sales in the first and last quarter of 2019. Furthermore, we carved out the possibility of higher domestic borrowings based on our pessimistic stance on FG's revenue. While our view played out with the apex bank pacing up its liquidity mop-up, this was done at lower cost with OMO rates plunging 252bps to 12.48% in H1 19. However, despite our expectation for a wider fiscal deficit, FG's borrowings remained subdued with unorthodox funding of the deficit over same period through drawdown on overdraft with the CBN. In fact, the fiscal authorities continued their apathy for naira debt at the open market, net repaying ₦225 billion worth of Nigerian treasury bills and keeping bond supply stunted (-15% to ₦342.5 billion) relative to H2 18.

Going forward, with Emerging market assets receiving a boost from FED's gradual tilt towards dovishness, which has led to US treasuries losing their attractiveness (-72bps YTD to 1.96%), CBN appears to be in a position of comfort relative to the second half of 2018. Coupled with our expectation for dissipating inflationary worries in the coming months, the stage appears set for monetary policy easing by the MPC. However, on the currency front, the CBN is faced with elevated maturity profile in H2 19. For context, out of the total maturing OMO and NTBs staged to mature this year (₦9.9 trillion), foreign holdings of Nigeria's NTB and OMOs stands at ₦3.2 trillion (32% of total maturity). Thus, despite CBN's gradual tilt towards dovishness, we see scope for mild uptick in OMO rates, with our estimates at 12.5% -13.5%. On the fiscal side, given that FG remains committed to trimming its cost of debt service, appetite for short end borrowings appears weak – thus paving way for downtrodden NTB yields over the near term. More so, given FG's open-endedness to part financing its fiscal deficit via CBN's overdraft, we rule out any sizeable ramp in FGN Bond supply this year.

In this report, we look at the major themes that dominated the fixed income market in H1 19 as well as our outlook for same over the rest of the year.

Dovish influences and lower borrowings dictate the tune

Coming into the first half of 2019, we painted the picture of staggered OMO sale in line with the concentration of OMO maturities over the year. Specifically, we stated that the combination of higher maturities and the risk of exodus of offshore holdings of maturity instruments will propel higher OMO sales in the first and last quarter of 2019. Furthermore, we carved out the possibility of higher domestic borrowings based on our pessimistic stance on FG's revenue. While our view played out with the apex bank pacing up its liquidity mop-up, this was done at lower cost with OMO rates plunging 252bps to 12.48% in H1 19. However, despite our expectation for a wider fiscal deficit, FG's borrowings remained subdued with unorthodox funding of the deficit over same period through drawdown on overdraft with the CBN. In fact, the fiscal authorities continued their apathy for naira debt at the open market, net repaying ₦225 billion worth of Nigerian treasury bills and keeping bond supply stunted (-15% to ₦342.5 billion) relative to H2 18.

Figure 1: Trend in Naira yield curve

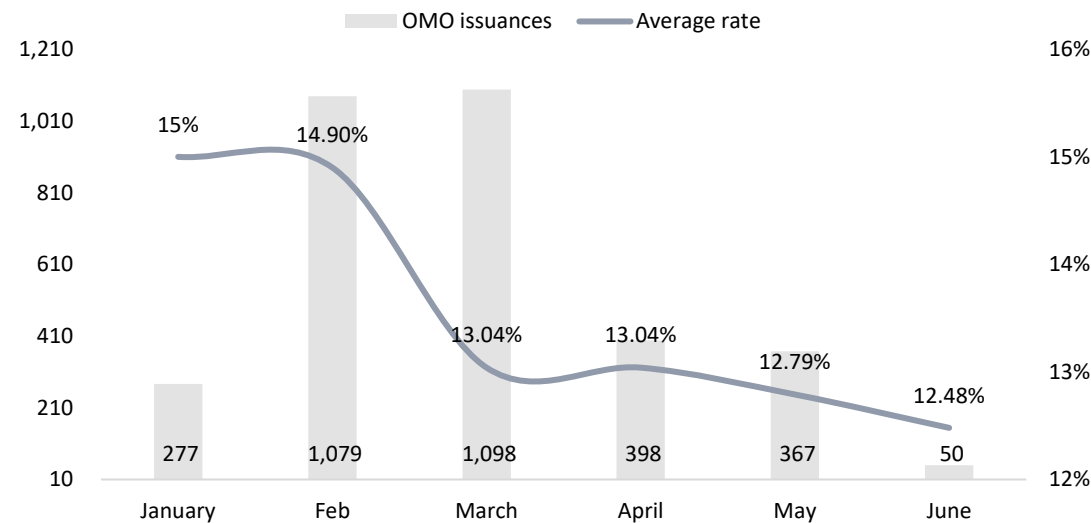
Source: FMDQ, ARM Research

Dovish tilt compresses short end yields

As stated above, the CBN increased its spate of liquidity mop up in Q1 2019, net issuing ₦2.5 trillion over the first three months of the year, albeit at lower stop rates (-196bps YTD to 13.04% in March) due to dissipating inflationary pressures and moderating US treasury yields. The ramp up in OMO sales was largely driven by CBN's quest to rid the system off excess liquidity in a bid to defend the naira amidst higher fixed income maturities (Q1 19: ₦5.3 trillion) and possible capital flight in the build up to the election. However, tides turned in Q2 19 as CBN relaxed its liquidity sterilization (OMO net issuance: ₦814 billion in Q2 19), following the layout of lower fixed income maturities which kept the CBN at ease in its defense of the naira. Similarly, OMO rates continued their descent

into Q2 19 on the back of easing posture by the MPC (MPR: -50bps to 13.5%) and gradual tilt in the monetary policy across developed countries to an easing posture from a tightening stance. The lower OMO rates by the CBN alongside apathy for short end debt by the FG kept NTB yields subdued (-4bps to 12.2%) over the first half of the year.

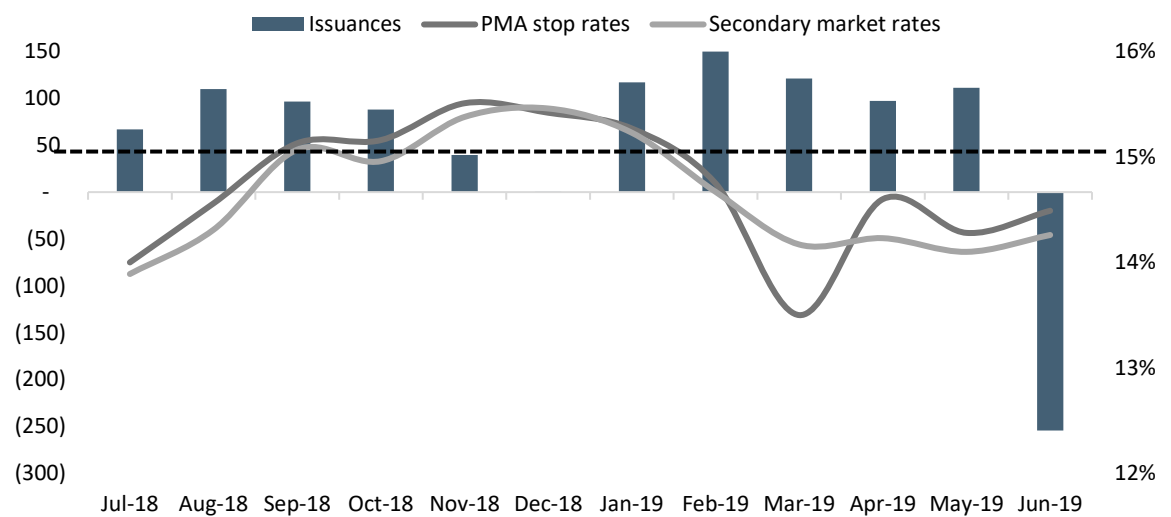
Figure 2: Trend in OMO issuances (₦'billion) and average rates over H1 19



Source: FMDQ, ARM Research

Similar treaties greet long end yields

Coming into the year, we projected FG's domestic borrowings for 2019 would print at ₦1.5 trillion owing to our pessimistic view on FG's revenue picture and our case for wider fiscal deficit. The first half of 2019 marked a watershed to our expectation as FG only borrowed a meagre ₦342.5 billion (vs ₦401 billion in H2 18) from the bond market and kept borrowings at the long end muted as backdoor funding via the monetary authority dominated FG financing. This came in despite pent up demand at the primary market auction (+72% to ₦1.2 trillion) relative to the second half of 2018 as FG remained keen on pushing its cost of debt servicing lower. Consequently, following FG's tamer supply for long dated paper, average PMA stop rates at the bond auction dipped 93bps to 14.49%. The lower stop rates alongside foreign investors interest in Nigeria's fixed income instruments post-election, and monetary easing by the CBN meld into lower bond yields at the secondary market over the period (-37bps to 14.46% in H1 19).

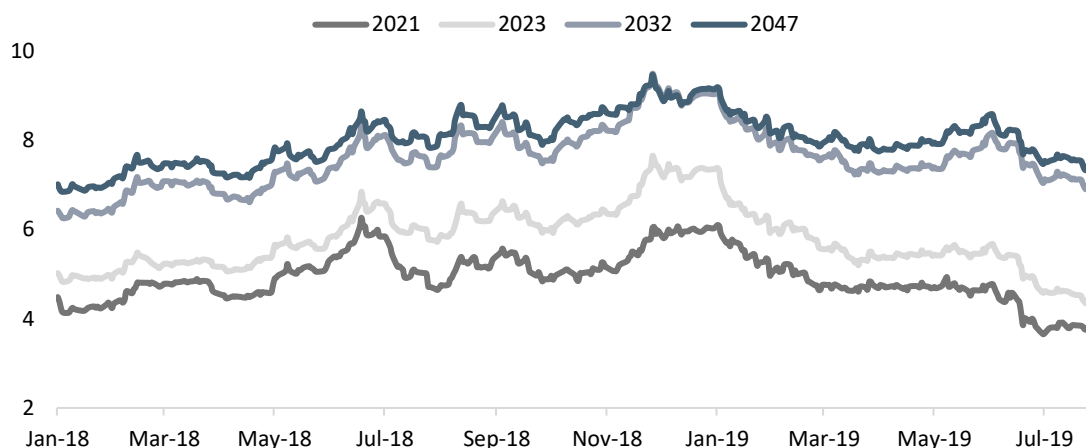
Figure 3: Trend in Bond issuances (N'billion) and rates

Source: FMDQ, ARM Research

On the backdoor financing, according to recent publication by the CBN (Quarterly statistical bulletin), Nigeria's fiscal deficit for the first five months of 2019 printed at ~~₦~~825 billion. This higher than actual bond issuances over the same period (₦597.1 billion). The variance between actual borrowings in relation to fiscal deficit largely reflects FG's reliance on non-conventional means of deficit financing. For context, in addition to local borrowings, FG overdrew ₦530.1 billion – 18% of prior year revenue – from the CBN in Q1 19 alone. In our view, FGN's resolve to tap back door financing from the apex bank largely explains its tamer paper issuances this year amidst burgeoning fiscal deficit.

Bullish trend across Nigeria's Eurobond

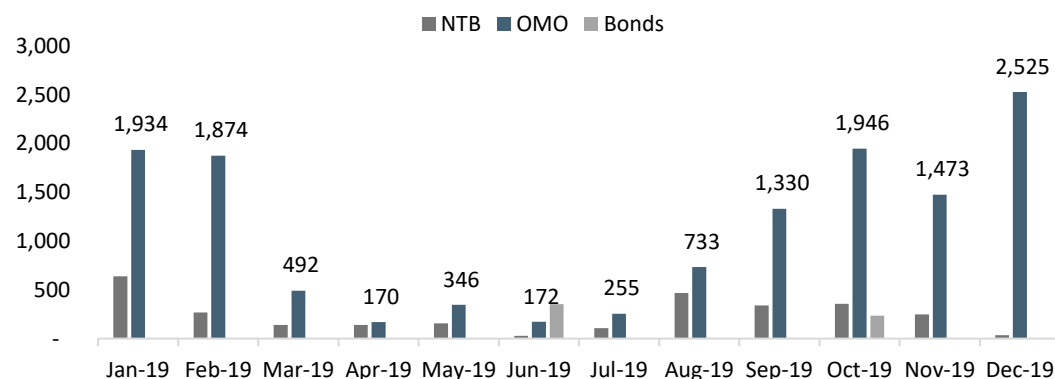
So far this year, Nigeria's Eurobonds have rallied -194bps YtD on average, higher than the JP Morgan EMBI spread over the same period (-69bps). For us, the bullish run in Nigeria's Eurobond market reflects improved macroeconomic fundamentals alongside accommodative monetary policy stance in developed markets. More importantly, we think the lower Eurobond yields presents ample opportunity for Nigeria to tap the Eurobond market, to fund part of the fiscal deficit (proposed external sourcing: \$2.2 billion). Especially given the successful Eurobond issuance, even at attractive rate by other African peers; Benin (6% for 7year), Ghana (7.875% for 7years) and Egypt (7.6% for 10 years), with combined issuance of \$9.8 billion this year, we think this is a good time for the FG to test the Eurobond market.

Figure 4: Trend in Eurobond yield

Source: Bloomberg, ARM Research

Mixed bag for Nigerian fixed income yields

Going forward, with Emerging market assets receiving a boost from FED's gradual tilt towards dovishness, which has led to US treasuries losing their attractiveness (-72bps YTD to 1.96%), CBN appears to be in a position of comfort relative to the second half of 2018. Coupled with our expectation for dissipating inflationary worries in the coming months, the stage appears set for monetary policy easing by the MPC. In fact, the recent CBN circular which mandates banks to maintain a minimum of 60% loan to deposit ratio (LDR) in a bid to stimulate economic growth gives credence to our view. However, on the currency front, the CBN is faced with elevated maturity profile in H2 19. For context, out of the total maturing OMO and NTBs staged to mature this year (₦9.9 trillion), foreign holdings of Nigeria's NTB and OMOs stands at ₦3.2 trillion (32% of total maturity). Thus, despite CBN's gradual tilt towards dovishness, we see scope for mild uptick in OMO rates, with our estimates at 12.5% -13.5%.

Figure 5: Maturity profile over H2 2019

Source: FMDQ, ARM Research

On the fiscal side, given that FG remains committed to trimming its cost of debt service, appetite for short end borrowings appears weak – thus paving way for downtrodden NTB yields over the near term. More so, given FG's open-endedness to part financing its fiscal deficit via CBN's overdraft, we rule out any sizeable ramp in FGN Bond supply this year. Tying it all together, while the confluence of lower interest rate in the US, waning inflationary pressures and CBN's financing of FG's fiscal paves way for little or no uptick in bond yields, CBN's rein on massive liquidity profile in Q4 19 should keep short end yields slightly higher.

Table 1: Scenario analysis on domestic borrowings

₦'billion	Asset sale + \$2.70bn debt + Annualised Ways & Means	50% asset sale + \$2.70bn debt + Annualised Ways & Means	No asset sale + \$2.70bn debt + Annualised Ways & Means	Asset sale + \$2.70bn debt + FY 18 Ways & Means	50% asset sale + \$2.70bn debt + FY 18 Ways & Means	No asset sale + \$2.70bn debt + FY 18 Ways & Means
Projected deficit	3,741	3,741	3,741	3,741	3,741	3,741
Sale of Assets	210	105		210	105	
Foreign Borrowings	803	803	803	803	803	803
Domestic Borrowings	2,728	2,833	2,938	2,728	2,833	2,938
CBN ways and means	1,845	1,845	1,845	2,107	2,107	2,107
Borrowings from capital market	883	988	1,093	622	727	832
2018 net issuance	290	290	290	290	290	290
2017 net issuance	1,277	1,277	1,277	1,277	1,277	1,277
2019 YoY increase ((₦ billion)	594	699	804	332	437	542
Total Borrowing	1,686	1,791	1,896	1,425	1,530	1,635

Source: CBN, ARM Research

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