

H2 2016

Nigeria Strategy *Report*

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SUMMARY

Global economic recovery remained lukewarm over H1 16 as a slowdown in economic activities in the US and UK as well as faltering output from EM economies trumped modest improvements in Japan and the Euro-Area. The flaccid growth conditions underpinned downgrades in IMF/World Bank 2016 growth forecasts in January which weighed on investors' appetite for risk assets with global equity markets recording their worst start in nearly fifty years even as commodity prices sank to twelve-year lows. However, expansionary monetary policies undertaken in the Euro Area and Japan to stimulate growth, as well as a less hawkish stance of the US Fed, which held off from further rate hikes, helped diminish aversion for risk assets. The renewed vigour to monetary policy accommodation across global central banks helped drive a recovery across markets with FPI flows to EM countries turning positive by March. Portfolio flows to Africa however remained tame as the macroeconomic picture deteriorated further with more countries reporting slower growth, worse fiscal and current account balances and soaring inflation. Nigeria, more than any other African country, illuminated this picture in H1 16 as GDP contracted for the first time in twelve years in Q1 16, inflation climbed to an eleven year peak in June 16 and trade balance, again, printed red in Q1 16. Output weakness reflects impact of renewed militant attacks on oil installations and contraction in non-oil as negative real wage growth and FX curbs hampered the manufacturing sector. The oil production headaches and depressed Brent price were also instrumental in perpetuating a deficit in the trade balance. Second-order impact of the low oil receipts were felt in the currency market where a paucity of dollars induced a surge in the mean parallel market premium to the interbank to a two decade high of 59%. The dollar shortfall which triggered higher PMS prices coincided with a hike in electricity tariff and largely accounted for the upswing in inflation. Following a languid response to the

economic crisis, Nigeria's economic managers began to show signs of coming to grips with the situation late in H1 with the adoption of a liberalized FX market and greater flexibility in fuel pricing. The policy volte-face helped drive a rally in naira equities which closed the first half in positive territory. For fixed income markets, the change in policy stance—with the monetary authorities now intent on driving short end rates higher without regard for the borrowing cost sensitivity of their fiscal counterparts who, because of crimped revenues had little choice anyway—drove an expansion in the naira yield curve by the end of H1.

Going forward, uncertainty following Britain's decision to exit the EU, which the IMF expects to dampen global growth should dominate sentiment across global markets. In addition, markets are likely to continue trying to second-guess US interest rate trajectory even as a testy US presidential election hits the homestretch. Against this back-drop of uncertainty, investors are likely to gravitate towards safe haven instruments which holds negative connotation for portfolio flows to EM markets. For commodity markets, the lingering fight for market share among oil producers and slack demand growth should leave prices stuck in a narrow range over the rest of the year. Aside from the consequent weakening of EMs' ability to attract capital, the deadbeat commodity price picture also implies further testing of the quality of policy responses of economic decision makers across Africa and Nigeria, in particular. For markets, we think shocks from policy choices in H1 16 (currency depreciation, price hikes, etc.) should increasingly reflect in macroeconomic data and, by extension, corporate earnings over H2 16. On the fixed income space, the monetary authority's dilemma between stimulating economic growth and supporting the naira should continue to influence yield trajectory over the second half of the year.

INTRODUCTION

Global financial markets started the year in red as renewed uncertainty over growth induced heightened volatility. Whilst for China the depth of economic slowdown and its monetary authority's attempt to defy the "impossible trilemma"¹ were at the heart of worries, concerns over the sustainability of US' fledgling recovery—despite its strong labour market growth—and danger of potential reversion to deflation in Europe compounded decision making for investors. On the policy front, apex banks across developed markets largely maintained their expansionary course, with Bank of Japan (BoJ) and European Central Banks (ECB) respectively guiding to extension of negative interest rates and quantitative easing programmes in coming periods. Whilst the US had looked the more likely to buck the DM easing trend on the back of its December 2015 rate adjustment—the first in nearly ten years, concerns over Brexit and slowing global growth have made it harder for FOMC to justify a rate hike in 2016, after December 2015's 25bps raise.

Across most emerging markets, commodity price depression and flagging Chinese growth continued to

drive subdued macroeconomic conditions, save for India where private consumption benefitted from energy savings and boosted economic growth. In Nigeria, renewed insurrection in Niger Delta creeks and extended FX crises conspired to aggravate impact of falling crude prices—leaving the largest economy in Africa in a fight against looming recession. Worse still, an acceleration of inflation to six year highs of 16.5% and rising unemployment rate have kept disposable income suppressed just as the late passage of the budget quenched hopes of stimulatory government spending in the current year. Nonetheless, clear positives emerged on the policy front with partial deregulation of PMS prices in May and switch to flexible FX market architecture a month later with the former appearing to be particularly well-received by markets. In our last report, we framed the key assessment parameter for the Buhari government as the question of whether the economic ravages are so deep cutting as to render untimely economic intervention ineffectual in the near term. So far, lingering fundamental weakness with faint signs of countercyclical government spending have served to re-enforce that the answer is in the affirmative.

¹Chinese authorities have so far tried to simultaneously achieve three critical goals: an independent monetary policy, a controlled exchange rate, and an easing of capital controls.

REVIEW OF GLOBAL ECONOMY AND MARKETS

FOGGY OUTLOOK AS UNDERLYING GROWTH PICTURE REMAINS FRAGILE

Economic recovery remains weak across DMs

The global economy started the year on a drab note, rising 2% YoY in Q1 16² as recovery across advanced economies (DMs) remained modest while the macroeconomic landscape in emerging markets (EMs) deteriorated further.

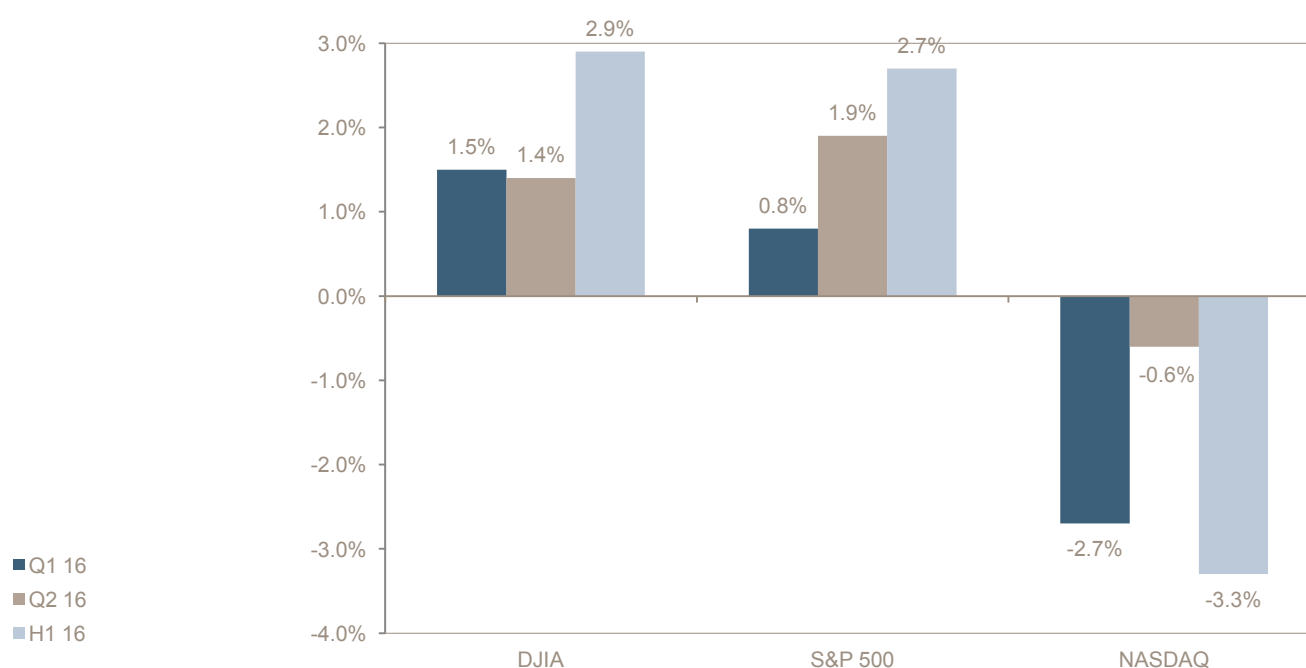
Scanning across DMs, economic data from the US showed that, from Q4 15, output growth slowed 30bps to 1.1% in Q1 16 largely on the back of deceleration in both personal consumption expenditure (-50bps) and private domestic investment (-160bps). Investment slowdown largely reflects impact of the extended decline in global

²World Bank estimate

crude oil prices on US energy sector as shale producers cut-back on capital spending. Other macroeconomic indicators over the period were mixed, with inflation slowing from January's level of 1.4% YoY to 1% in May—well below the US Federal Reserve's 2% target—even as the pace of US job growth³ in June 2016 was the highest in eight months. Largely reflecting the mixed pattern in macro indicators and concerns about global economic and financial market developments, the US Fed held off from raising interest rates over H1 16. The less aggressive monetary policy stance alongside a recovery in commodity prices helped pull the US equities market into positive territory after entering—alongside other global bourses—a bear market in February 2016. Nonetheless, the pause in monetary tightening which lowers interest rate trajectory as well as slowing growth underpinned a 2.5% weakening of the US dollar over H1 16.

³ Nonfarm payroll employment rose by 287,000

Figure 1: Performance of US equity indices

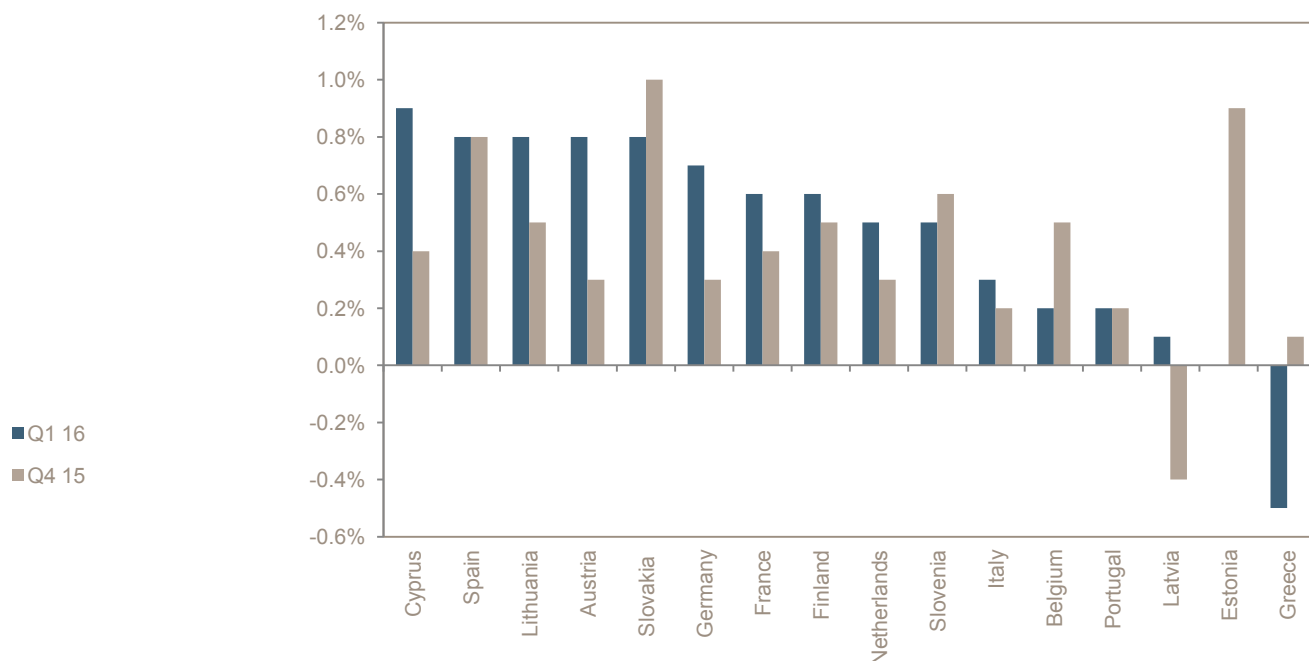


Source: Bloomberg, ARM Research

Across the Atlantic, the Euro Area grew at its fastest pace in a year at 0.6% QoQ (+1.7% YoY) as recovery in Germany—highest growth in two years—and France as well as continued robust growth in Spain more than offset slowdown in Estonia and Belgium and a contraction in

Greece. The Euro Area’s economy benefitted from lower energy prices alongside accommodative monetary policy which boosted household spending (+0.6% QoQ) as well as investment expenditure (+0.8% QoQ).

Figure 2: GDP growth across Euro Area countries



Source: Eurostat, ARM Research

Amidst further monetary easing unveiled by the ECB in March 2016, which included lowering interest rate⁴, inclusion of non-bank corporate bonds in its asset purchase program, which it expanded by €20 billion to €80 billion, and plans to launch a new series of four targeted longer-term refinancing operations (TLTROs) with maturities of four years, starting in June, industrial output rose for the first time in three months in April (MoM: +1.1%, YoY: 2%) while

unemployment rate of 10.1% in May 2016 is the lowest since July 2011. Nonetheless, the Eurozone remained in deflation (May 2016: -0.1% YoY) with negative annualised rates observed in 16 member states over May 2016. Whilst the impact of ECB’s accommodative stance on equities was overshadowed by Brexit concerns and slowing global growth, corporate bond prices rallied following the commencement of the ECB’s corporate bond buying program in June.

⁴Benchmark refinancing rate: -5bps to 0%, deposit rate: -10bps to -0.4% and marginal lending rate: -5bps to 0.25%

Figure 3: Trend in European corporate bond prices



Source: Bloomberg, ARM Research

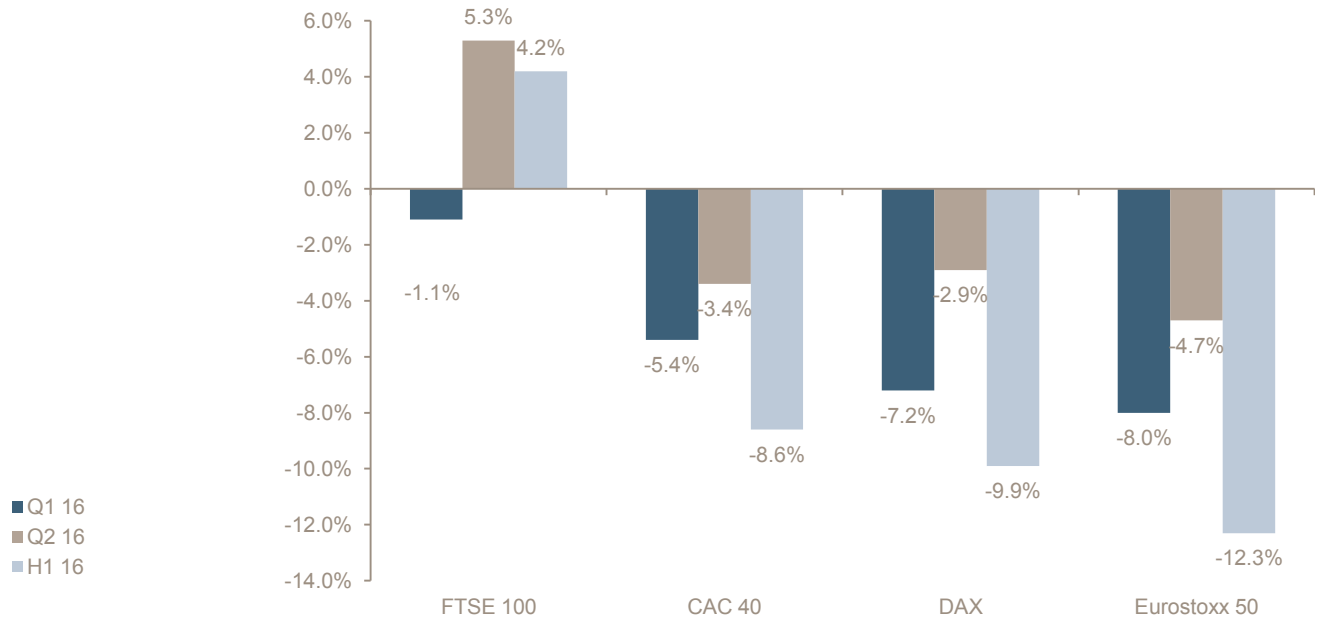
Elsewhere the UK’s economy floundered in Q1 16 rising 0.4% QoQ vs. 0.6% in the prior quarter as growth in services sector (+0.6% QoQ) was muted by contraction in the other three parts of the economy: production (-0.4% QoQ), construction (-1% QoQ) and agriculture (-0.1% QoQ). Importantly, the services sector which had supported economic growth plunged to a 38 month low in April at 52.3 (PMI), and only mildly improved in May at 53.5, as growth of new businesses slowed to its lowest in 41 months. The slowdown in the services sector follows similar weakness in manufacturing⁵ (May 2015: 50.1) and construction (May PMI of 51.2-lowest in nearly 3 years). In the aftermath of the Brexit vote, the FTSE 100 reported its highest two day loss (5.7%) on record while the pound fell to a 31 year low of \$1.3225/£ on the 27th of June 2016. Yields on European sovereign bonds fell to record levels

⁵Manufacturing PMI contraction in April 2016 is the first since March 2013

epitomized by Germany’s 10-year government bond which fell below zero for the first time on record in June to -0.13%.

The softening growth climate resulted in the BoE leaving both its interest rate and asset purchase program unchanged at 0.5% and £375 billion respectively even as it injected £5.9 billion in three extra liquidity operations to the banking system in a special funding program. In the aftermath of the financial market volatility that trailed Brexit, the BoE pledged to inject £250 billion of additional funds into the UK financial system to forestall any liquidity squeeze and if required will provide substantial liquidity in foreign currency. Largely reflecting the dovish statement and concerns about Brexit, the UK pound depreciated 10.7% over H1 16. However, the UK’s bourse recovered from the Brexit shocks closing the period with a 4.2% gain.

Figure 4: European equity market performance

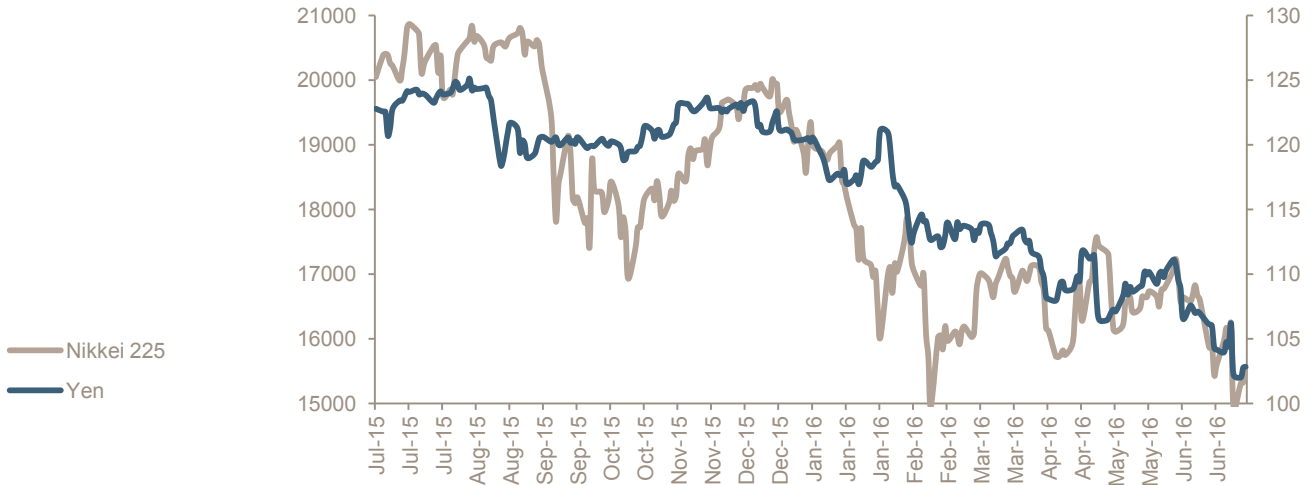


Source: Bloomberg, ARM Research

Japan’s economy recovered from Q4 15 contraction (-0.4% QoQ) as Q1 16 GDP rose 0.5% QoQ even as the BoJ in January introduced negative interest rate (-0.1%) and expanded the scope of its ¥80 trillion asset buying program to include real estate investment trusts. Growth in domestic demand (+0.3% QoQ) and private consumption (+0.6% QoQ) more than offset contractions in private residential, non-residential and public investment (-0.7% QoQ for each). However, beyond the growth in Q1, 16 Japan’s economic activities have been weak as manufacturing activities, impacted by earthquake and contraction in international demand, fell to its lowest level in May (PMI: 47.7) since January 2013. The services sector (65% of GDP) has also been lacklustre, contracting in April at its fastest pace in

two years at 48.9, only returning to a modest growth in May at 50.4. As a result of the deceleration in economic activities over Q2 16 and anaemic inflation figures (April 2016: -0.3% YoY), the Japanese government postponed proposed hike in sales tax (+200bps to 10% by 2017) to October 2019. The slowing economic output had underpinned expectations of further expansionary policies over Q2 16, but the BoJ surprisingly left its policy tools unchanged, resulting in the Japanese Yen appreciating 14.2% over H1 16 (Q2 16: +8.3%). Largely reflecting the strong currency which placed downward pressure on consumer prices and weakened exports, the Nikkei index fell 18.2% over H1 16.

Figure 5: Trend in Nikkei 225 and Japanese Yen



Source: Bloomberg, ARM Research

India remains bright as EM growth flounders

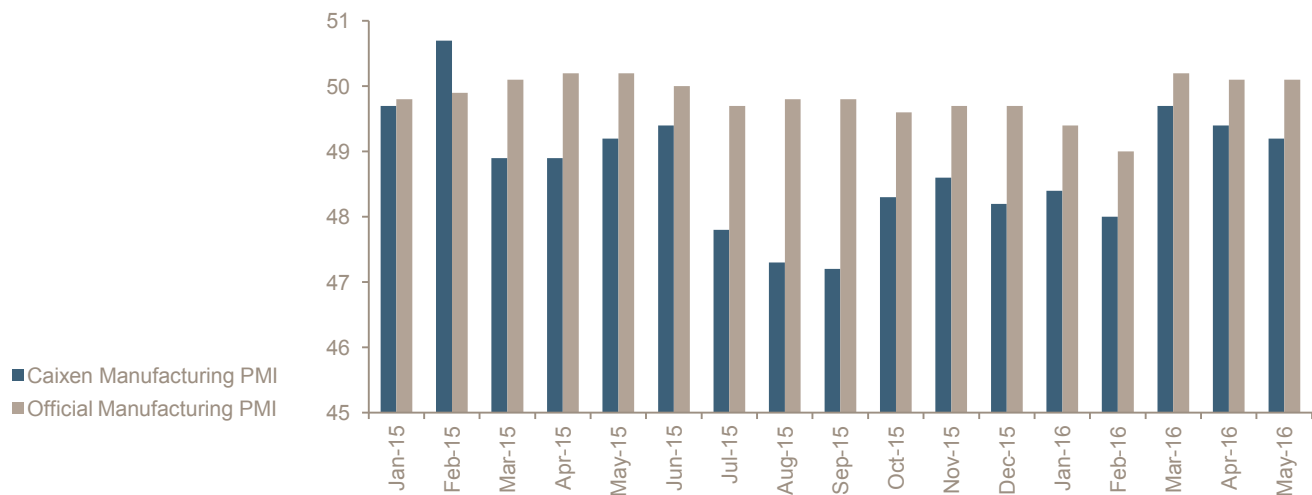
China’s restructuring of its economy to a service driven one continues to weigh on its output with Q1 16 growth of 6.7% YoY (Q4 15: 6.8% YoY) being the lowest since Q1 2009. In response, the Chinese monetary authorities further eased with its latest action in February being the reduction⁶ in reserve requirement ratio (RRR) for banks (-50bps to 17%). Importantly, the country’s manufacturing activities

appear to have stabilized as the official manufacturing PMI⁷ expanded for the third consecutive month in May 2016. However, concerns remain as retail sales growth remained soft while growth in fixed asset investment continued its downtrend. Largely reflecting mounting concerns over Chinese growth and sustained FPI outflows, the Shanghai composite declined 17.2% over H1 16 while the Yuan depreciated by 2.4%.

⁶5th RRR cut in the last 12 months

⁷According to the caixen, manufacturing index (a private gauge of China’s factory activity) contracted for the 15th consecutive month in May; however the pace of contraction has been subdued over the three months ending May 2016.

Figure 6: Trend in China's manufacturing PMI



Source: Markit, China federation of logistics and purchasing

Amid depressed commodity prices and political turmoil, Brazil's economic growth contracted for the eighth consecutive quarter in Q1 16 (-5.4% YoY) with declines across board: investment spending (-17.5% YoY), consumption (-6.3% YoY) and Government spending (-1.4% YoY). In addition to the worsening growth picture, other macroeconomic indicators were uninspiring as inflation continued to rise (May 2016: 9.32%, target rate: 4.5%), unemployment tracked higher⁸ and budget deficit widened (Q1 16: 2.3% of GDP). The economic frailty and worsening public finance also underpinned Fitch's downgrade of Brazil's credit rating further into junk territory (from BB+ to BB, with a negative outlook). In response to the rising inflation, the Brazilian central bank has maintained its tight monetary policy stance leaving its benchmark Selic rate unchanged at 14.25% for the seventh consecutive meeting in June 2016. Despite the weak fundamental picture, the Brazilian equity bourse rallied in H1 16 (+18.9%) while the Brazilian real experienced a bullish run (+18.9%) as impeachment proceedings which led to the suspension of President Dilma Rousseff and subsequent replacement with Vice President Michel Temer were viewed as positive for the investment climate.

Elsewhere, Russia reported its fifth consecutive quarter of contraction in Q1 16 (-1.2% YoY), as the economy continues to be impacted by the combination of plunging commodity prices and western sanctions. Nonetheless, contraction in economic activities was milder than the prior quarter (-3.8% YoY) largely on the back of slower decline in manufacturing (Q1 16: -4% YoY, Q4 15:-6.2% YoY)

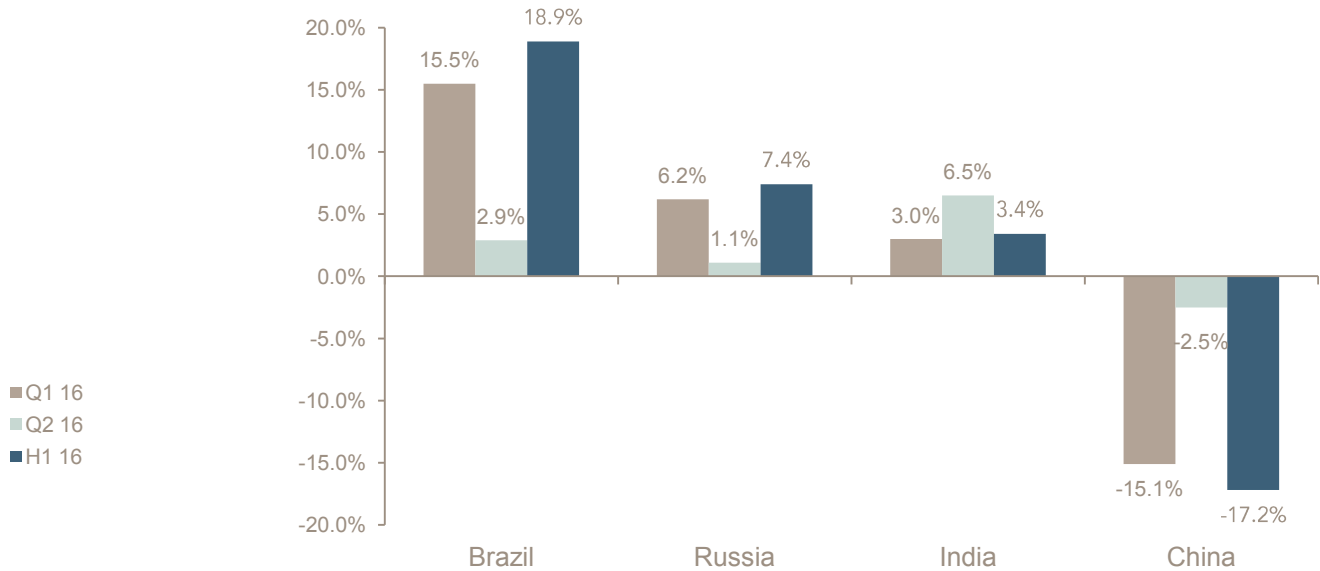
construction (Q1 16: -1.6% YoY, Q4 15:-4.6%) YoY), as well as wholesale and retail trade (Q1 16: -2.5% YoY, Q4 15:-13.6%) sectors activities. Importantly, economic data point to a recovery from the trough with services PMI expanding over the four months ending May 2016 (51.8)—longest expansionary trend since February 2014. Amidst a deceleration in inflation figures (June 2016: 7.5%), the bank of Russia lowered its benchmark one-week repo rate by 50bps to 10.5% in a bid to stimulate economic growth. The modest economic recovery and a rebound in Brent Crude (H1 16: +33.8%) underpinned a surge in Russian Micex index to its highest level since December 2008 on the 28th of April 2016 (H1 16: +7.4%) while the ruble appreciated 11.9% over the first half of 2016.

Meanwhile India continued to buck the weak EM trend with Q1 16 GDP rising 7.9% YoY (Q4 15: 7.3% YoY) largely reflecting improved private consumption (+8.3% YoY) which continues to benefit from lower oil prices as well as ongoing liberalization of India's foreign direct investment (FDI) regime. According to World Bank, FDI to India surged 37% from the launch of the "Make in India" campaign in October 2014 to February 2016. Further supporting economic growth is the expansionary monetary policy of the Reserve Bank of India which cut its repo rate to its lowest in over 5 years (-25bps to 6.5%) as inflation fell below its target of 5% in April 2016. The glowing macroeconomic landscape spurred positive sentiment on the Indian Bourse (H1 16: +3.6%). However, the Indian rupee fell 2.1% largely reflecting the fallout of Brexit fears. Importantly, a day⁹ after Britain decided to exit the EU, the Indian Rupee recorded its worst daily loss (-1.1%) since August 2015.

⁸Unemployment rate of 11.2% over three months ending April 2016 is the highest reading since the beginning of the survey in January 2012

⁹24th of June 2016

Figure 7: Equity performance across EM countries



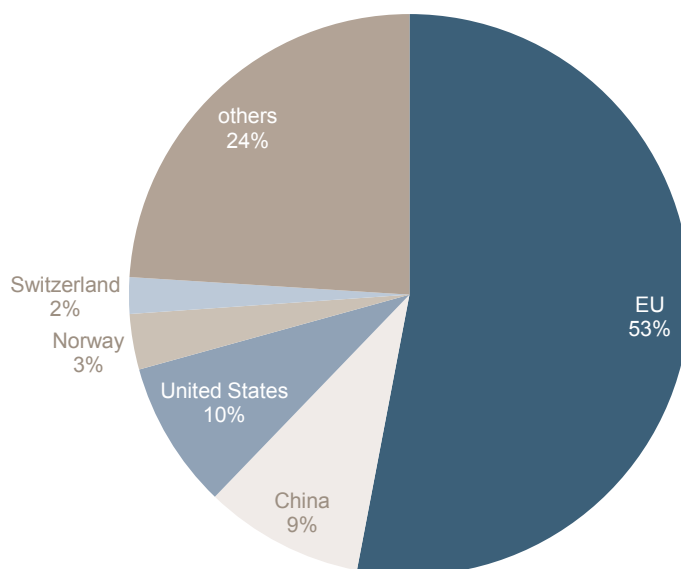
Source: Bloomberg, ARM Research

Slowing growth and Brexit fears to sustain expansionary monetary policies

Over the rest of the year, economic conditions across the globe remain soft with both the IMF (April forecast) and World Bank (June forecast) respectively slashing their 2016 GDP growth forecasts from January level to 3.2% (-20bps) and 2.4% (-50bps). The downbeat picture reflects expectation of a slower recovery across DM countries as well as lower growth projections for commodity exporters. For advanced countries whose 2016 GDP has already been lowered by the IMF in its April 2016 report, (-20bps from January forecast to 3.2%) and the World Bank in its June 2016 (-50bps from January forecast to 2.4%), fallout from Brexit further dampens outlook. Importantly, the UK government has forecast the British economy will lose up to 6% of its GDP by 2017 as uncertainty about future direction of the economy should weigh on business investment and consequently result in job losses. The apprehension trailing the referendum

should also constrain consumer spending which should be further impacted by reduced purchasing power of the pound. According to the UK government, the pound could depreciate by as much as 15%, underpinning a 2.7pps surge in inflation and lower average real wages by as much as 4%. Other prognoses included a 2.4pps jump in unemployment rate while public sector borrowing should rise by £39 billion as downgrade of UK’s credit rating raises premium for lending to UK government.

In 2015, 44% of UK exports went to EU while goods and services from the continent accounted for 53% of UK imports. Given the linkages between the UK and the rest of the EU, the uncertainty surrounding Brexit should affect business sentiment and fixed investments. Already, the IMF guides to lowering its 2016 growth forecast for Germany on the back of its significant trade relationship with the UK (Germany’s 14.4% contribution to UK’s total import is the largest from any single country) which should limit Germany’s exports.

Figure 8: Top exporting countries to the UK

Source: Office for National Statistics, ARM Research

The growth slowdown in Europe should exacerbate output moderation from other DM countries with the US economy being impacted by subdued manufacturing activities and lower energy investments while rising Yen holds negative connotation for Japanese exports.

For emerging markets, growth is expected to remain uninspiring as the Chinese economy continues to grapple with deceleration in its industrial, real estate, upstream and manufacturing activities while rising unemployment and shrinking real income should constrain consumption and, by extension, growth in Brazil. As for Russia, effects of international sanctions alongside lower oil prices should continue to weigh on its economic output. Meanwhile, India's economy is expected to continue to improve (World Bank: 7.6%, IMF: 7.5%), largely driven by private consumption, which has benefited from lower energy prices and higher real incomes—amid slowing inflation. However, the slowdown in China as well as contractions in Brazil and Russia¹⁰ trumps the sanguine growth outlook in India. As a result of the foregoing, both the IMF (April 2016) and the World Bank (June 2016) revised their 2016 growth projections for EM to 4.1% (-20bps) and 3.5% (-

60bps) respectively from their January forecasts.

The subdued outlook for economic growth alongside increased uncertainty, following Brexit fears, should incentivize dovish monetary policy across Europe with the BoE governor pointing to interest rates cuts over the second half of 2016. Similar concerns over potential Brexit fall-out on the Euro Area should accentuate further monetary easing by the ECB. In Japan, the Prime Minister, Shinzo Abe, has urged the BoJ to provide ample funds to the market to prevent any credit squeeze even as he pledged to use all available policy tools to keep the wheels of the economy turning. The fiscal authorities' worry of an unwelcome spike in the Yen on the back of Brexit, which could derail the country's fragile growth, points to a possible expansion in current asset purchase program. Last, for the US Fed, Brexit and the onset of the US presidential election season tempers outlook for interest rate hike over 2016. On balance, largely on account of slowdown in economic activities across DMs, decelerating output from EMs, heightened financial market volatility, as well as potential fallout from Brexit, global monetary policy should swing dovish over the rest of 2016.

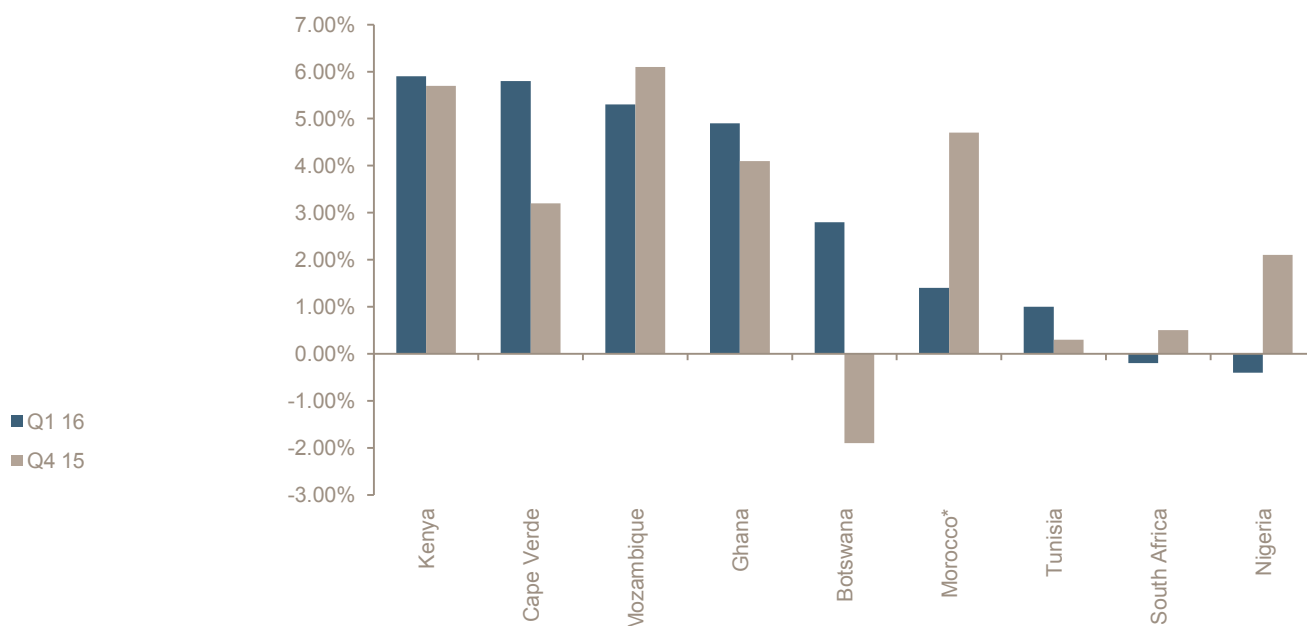
¹⁰IMF: Brazil: -3.8%, Russia: -1.8%, World Bank: Brazil: -1.2%, Russia: -1.2%

AFRICA'S GROWTH STORY TURNS SOUR

Africa's economy continues to be impacted by soft commodity prices, adverse weather challenges as well as political and security uncertainties. The economic challenges were particularly profound in Nigeria and South Africa—Africa's two biggest economies—whose GDP contracted for the first time in 12 and 61/2 years respectively in Q1 16. For Nigeria, lower oil prices, FX supply shortage and declining real wage growth were the main culprits while South Africa's growth was impacted by softer industrial metals' prices on the one hand as well as lower agricultural and manufacturing activities, largely, on the other. The latter outcomes reflect impact of severe drought on farm produce and hydroelectricity supply even as many other Southern African countries have declared national drought disasters. Similarly, adverse weather was responsible for Morocco's slowest growth in 7 years as recorded in Q2 16 when its agricultural output contracted 12.1% YoY. For Egypt, impact of FX shortage over Q1 16 which constrained manufacturing activities as well as sustained weakness in its tourism sector—in the wake of last

year's bombing of Russian plane and March's hijack of an Egypt Air plane weighed on economic output. Elsewhere, security concerns undermined activities in Niger Republic in the run up to its Presidential election while sustained political violence trailing President Pierre Nkurunziza's announcement to run for a third term in office weighed on investors' sentiment in Burundi. Economic weakness in the aforementioned countries trumped improved output from prior quarter in Ghana (+40bps to 4.9% YoY), Tunisia (+70bps to 1% YoY), Kenya (+20bps to 5.9%), Rwanda (+20bps to 7.3%), Cape Verde (+360bps to 5.8% YoY) and Botswana (+470bps to 2.8%). Ghana's GDP, which rose at its fastest pace in six quarters in Q1 16 (+ 4.9% YoY), was buoyed by expanding oil and gas production and waning electricity shortages. Also, Tunisia's GDP recovered from its sixteen quarter trough in Q4 15 to 1% in Q1 16 driven by higher manufacturing (+1.4% YoY) and services (+1% YoY) output which overshadowed impact of last year's terrorist attacks on its tourism activities (-12% YoY). Meanwhile, a recovery in Kenya's tourism sector (Q1 16: +12.1% YoY, Q4 15: -21.2% YoY) in line with improved security buoyed a 20bps expansion in its Q1 16 GDP.

Figure 9: Latest GDP growth rate for select African countries



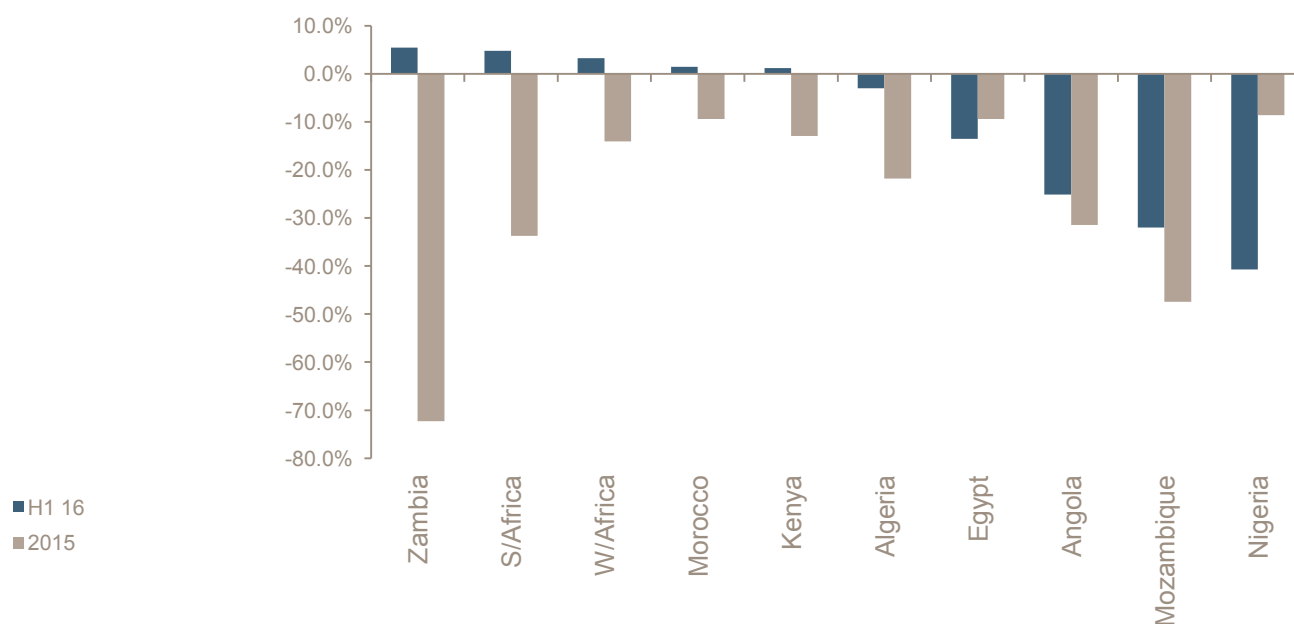
Source: Trading economics, ARM Research *-Q2 16

Weaker balance of payments still hurting currencies, underpin rating downgrades

The reverberating effect of lower commodity prices, which weighed on export proceeds, extended to the region’s current account position with the IMF forecasting a deterioration in SSA current account deficit to 6.2% of GDP in 2016 (-30bps from 2015 level) while mean current account deficit for North African countries is projected to improve to 15.2% of GDP in 2016 (+97bps YoY). Compounding the balance of payment concerns is the reduced capital flows (Eurobond issuance fell 51% YoY to \$1.98 billion in H1 16) to the region which reflects the

commencement of interest rate normalization in the US and the region’s macro-economic challenges. Consequently, many African currencies have remained under pressure with the Mozambique’s Metical falling to a record low of 63.34/\$ over June (H1 16: -32%), while both the Angolan Kwanza (-21%) and the Egyptian Pound (-14%) were devalued in the first half of the year. Similarly the Congolese franc depreciated 6.7%, while the 40.7% decline of the Nigerian Naira—after being fully floated by the Central Bank of Nigeria in June 2016—is the worst currency performance in the continent over the first half of 2016.

Figure 10: Currency performance of select African countries



Source: Bloomberg, ARM Research

The balance of payment concerns as well as deterioration in fiscal position of many African countries underpinned various credit downgrades by ratings agencies over H1 16. The fiscal strait in Mozambique was particularly alarming as its government had to swap the outstanding balance of a state-backed international bond of \$697 million with a new sovereign bond (\$726.5 million) amidst dwindling revenue of state backed Tuna fishing company. Whilst the debt swap underpinned the commencement of credit downgrades from all rating agencies, as it was considered a technical default,

investors were further confounded by the discovery of \$1.35 billion of sovereign borrowing arranged without parliamentary approval that is required by law. Consequently, UK suspended financial aid to the country, IMF halted a \$55 million emergency loan while World Bank put a \$40 million budget support to the country on hold. Furthermore, Mozambique Asset Management (MAM)—another state backed entity—defaulted on its first loan repayment (\$178 million) to Russia’s VTB, compelling the country’s President, Filipe Nyusi, to guide towards restructuring of 20 state-owned companies with a possibility of

privatizing or liquidating them. Similarly, Zambia faced fiscal pressures over the period as lower export proceeds was compounded by currency induced higher fuel subsidies and borrowing costs. Amidst worsening fiscal position, with net government debt expected to rise 7pps YoY to 55% of GDP in 2016, Moody's downgraded the country's

credit rating one step lower to B3 in April 2016. Meanwhile, impact of lower oil prices was the major reason for credit downgrades in Congo, Gabon and Angola, Nigeria, with downgrade in the latter also reflecting rising fiscal deficit and surging borrowing costs (36% of 2016).

Table 1: Ratings downgrade of African countries

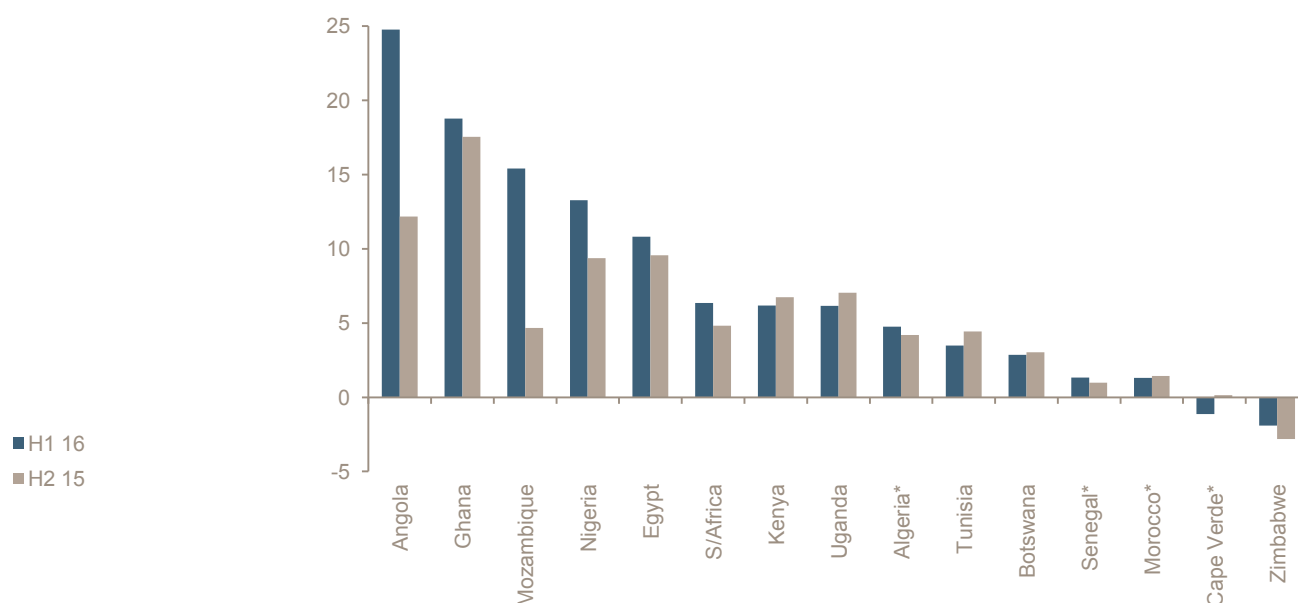
Country	Previous Rating	New Rating*	Rating Agency	Reason for Downgrade
Nigeria	Ba3	B1	Moody's	Oil weakness
Nigeria	BB-	B+	Fitch	Oil weakness
Angola	Ba2	B1	Moody's	Oil weakness
Angola	B+	B	S&P	Oil weakness
Gabon	Ba3	B1	Moody's	Oil weakness
Republic of Congo	Ba3	B2	Moody's	Oil weakness
Republic of Congo	B+	B	Fitch	Oil weakness
Mozambique	B2	Caa1	Moody's	Debt default
Mozambique	B	CC	Fitch	Hidden debt and debt default
Mozambique	B-	CC	S&P	Debt default
Zambia	B2	B3	Moody's	Fiscal slippages

Source: Moody's, Fitch, S&P, * end of H1 2016

Surge in food and energy costs induce inflationary pressures

Compounding the weak growth picture is the acceleration of headline inflation in many African countries with currency induced pressure been a common driver. In addition to the foregoing, higher electricity tariff and PMS prices drove Nigeria's headline inflation to an 11 year high in June while upswing in food prices—as a result of adverse weather effects underpinned inflationary pressures in

Morocco, Algeria, Tunisia, Zambia, South Africa, Mozambique and Angola, with pressures in the latter also reflecting impact of a 31% cut in petroleum subsidies. Similarly, inflation climbed to a 7 year high in Ghana on the back of a 59.2% hike in electricity tariffs and an energy sector levy while water tariffs were raised by up to 89%. Meanwhile, largely reflecting lower oil prices, inflation eased in Kenya—to a 3 year low—and Botswana, while Cape Verde mired into deflation (-1% YoY in May 2016).

Figure 11: Mean Inflation across select African countries

Source: Bloomberg, ARM Research (Jan-May 2016)

Expectedly, amidst rising inflation, many central banks intensified monetary policy tightening over H1 16 with the Central Bank of Angola raising its benchmark interest rate 400bps (March: +200bps, June: +200bps) to 16%—highest in nearly five years—over H1 16 while the Central Bank of Egypt raised interest rate 250bps (March: +150bps, June: +100bps) to 11.75%. Similarly, monetary authorities tightened in Mozambique (+450bps to 14.25%), Namibia (+50bps to 7%) and South Africa (+75bps to 7%) in the first half of the year. However, amidst slowing inflation and stabilizing currency, the Central Bank of Kenya cut its benchmark interest rate by 100 bps to 10.5%, while growth concerns underpinned interest rate cut by both the Central Bank of Madagascar (-40bps to 8.3%) and Morocco's Central Bank (-25bps to 2.25%).

Notwithstanding the macroeconomic challenges, equity markets closed H1 16 on a positive note largely reflecting the recovery in commodity prices (+15.6% QoQ in Q2 16). Notably, the S&P All African Index climbed 8.8% in the first half of the year as gains in Namibia (+13.1%), Morocco (+6.5%), Tunisia (+4.9%), Nigeria (+3.3%), South Africa (+3%) and Egypt (+1.5%), more than offset losses in Ghana (-10.4%), Botswana (-4.9%), Kenya (-3.5%) and

Mauritius (-3.2%). The bullish equity performance in Nigeria reflect positive sentiment surrounding pro-market policies such as liberalization of both the petroleum sector and FX market while investors' appetite for Egypt's equities improved following the devaluation of the Egyptian pound in March. Meanwhile, Ghana's poor equity performance reflects impact of higher electricity tariff and borrowing costs—the Bank of Ghana raised interest rate to a thirteen year high in 2015— on corporates earnings performance.

Weaker purchasing power underpins uninspiring growth outlook

Africa's output is expected to remain subdued over the rest of the year against the backdrop of weaker consumer purchasing power—amidst rising inflation—growth slowdown of trading partners, rising political activities and pressured commodity prices. The downbeat economic picture also underpinned IMF's downward revision of its 2016 growth forecast for SSA to 1.6% (-240bps from January's estimate), slower than 2016 growth projection for advanced economies (1.8%) for the first time in 17 years. For South Africa, higher interest rate and electricity supply shortage should hold back private investment

while declining real wage growth and sustained militant attacks on oil installations dampens growth outlook in Nigeria. Elsewhere, Ghana revised its 2016 growth forecast to its lowest in more than 30 year at 3.2%, 220bps lower than its earlier forecast (2015 GDP: +3.9%). The change in the growth outlook for the year follows a revision of gold production forecasts for 2016 and the shutdown of the FPSO Kwame Nkrumah oil production vessel on the Jubilee oil field. Compounding Africa's bleak

economic picture is the rising political activity across the continent with nineteen (19) elections and three (3) constitutional referendums taking place over H2 16. Overall subdued growth prospect, rising fiscal and current account deficit and fallout from Brexit which has diminished appetite for riskier asset class point to sustained weakness in capital flows which should drive financial market volatility across the region.

Table 2: Election cycle for African countries over H2 16

Country	Type of election	Date
South Africa	Local	August 2016
Zambia	Legislative, Presidential	August 2016
Gabon	Presidential	August 2016
Cape Verde	Presidential	August 2016
Somalia	General	August 2016
Cote D' Ivoire	Constitutional Referendum	September 2016
Morocco	Parliamentary	October 2016
Guinea	Municipal	October 2016
Ghana	Parliamentary, Presidential	November 2016
Cote D'Ivoire	Parliamentary	November 2016
DR Congo	Legislative, Presidential	November 2016
The Gambia	Presidential	December 2016
Sudan	Legislative	December 2016
Tanzania	Constitutional Referendum	H2 2016
Mauritania	Legislative	H2 2016
Chad	Parliamentary	H2 2016
Libya	Constitutional Referendum	H2 2016
Egypt	Local	H2 2016
Mali	Municipal	H2 2016
Rwanda	Parliamentary	H2 2016
DR Congo	Local	H2 2016
Sierra Leone	Local	H2 2016

Source: NDI, ARM Research

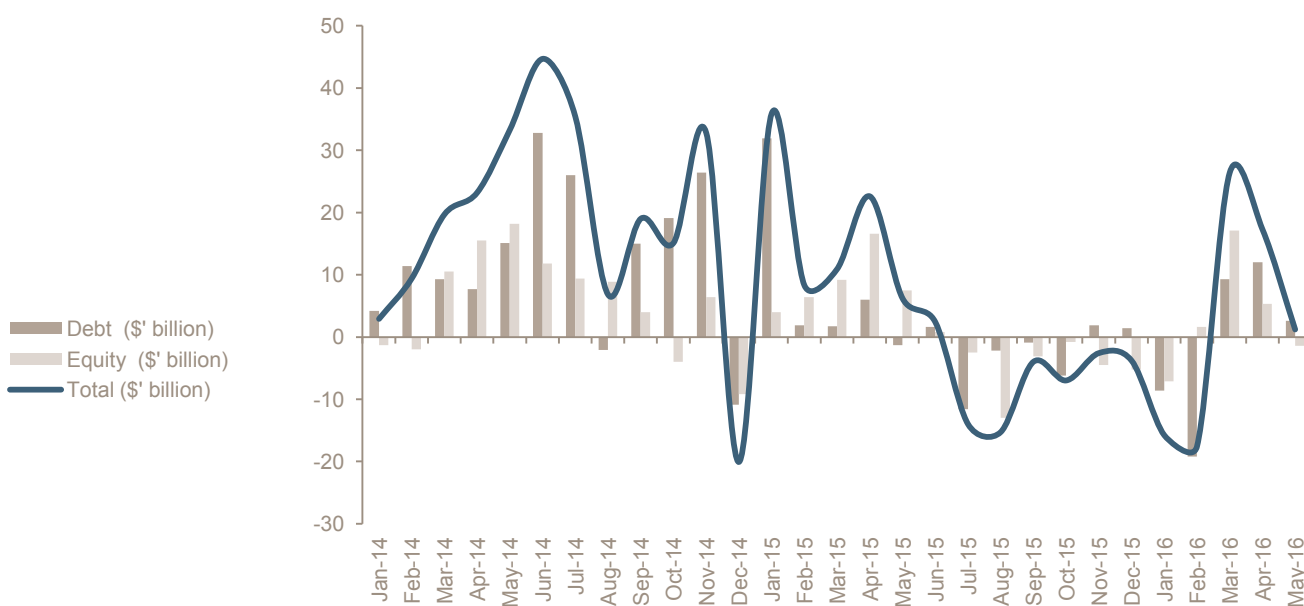
BREXIT DUST BLURS OUTLOOK FOR PORTFOLIO FLOWS

Perfect storm for risk aversion drives contraction in FPI flows to EM

Amid concerns about slowing global growth, adverse investor reaction to risky assets on the heels of the 25bps hike in US interest rate in December 2015 and forward guidance about further interest rate hikes drove heightened FPI outflows from emerging markets (EM) in the first two months of 2016. The capital outflows were on the heels of a plunge across global commodities in January which spurred a sell-off across global financial markets during the month. Furthermore, renewed concerns over EM growth prospects with manufacturing activity contracting for the 11th consecutive month in February 2016, led by

China's disappointing numbers, dampened FPI appetite for risk assets. Consequently, portfolio outflows over January and February 2016 printed at the highest levels since the 2008 financial crises. Nonetheless, following dovish comments from the US Federal Reserve regarding interest rate trajectory over 2016, expansion in ECB's monetary easing (+€20 billion to €80 billion) and upswing in oil prices (+19% MoM in March), FPI flows turned positive in March for the first time in nine months. The sustained uptrend in commodity prices alongside largely accommodative monetary policies from advanced countries ensured a run of portfolio inflow to EM countries in the months of April and May 2016. Nonetheless, reflecting outflows in the first two months of the year, IIF reports a contraction (-86.3% YoY to \$11.5 billion) in portfolio flows over the first five months of 2016.

Figure 12: FPI flows to EM



Source: IIF, ARM Research

Softening macroeconomic picture in EM drives FPI outflows

In EM Asia, the Yuan's difficult start to the year (-1.8% over the first week of 2016), a reminiscence of August 2015 devaluation, together with China's disappointing manufacturing activity stoked fears of a

hard landing for the Chinese economy and curbed investors' appetite. As a result, China witnessed its highest monthly portfolio outflows on record (\$28.7 billion) while India (\$1.5 billion) and Korea (\$3.4 billion) witnessed similar repatriation of funds from their capital markets in January 2016. Whilst the PBoC reduced reserve requirement ratio for banks

by 50bps to 16.5% in a bid to stimulate economic growth and allay investors' fears, portfolio flows only turned positive in March. The reversal of portfolio flow in March also reflected accommodative monetary policies from developed economies. Consequently Q1 16 net outflow of \$15 billion from China is the highest quarterly outflow on record. Similarly, South Korea witnessed portfolio outflows of \$4.8 billion over the first five months of 2016 on the back of slowdown in economic growth (Q1 16: +0.4% QoQ; Q4 15: +0.7% QoQ) and rising tensions with North Korea. However, India and Indonesia bucked the trend in Asia with net capital inflows of \$766 million and \$4.5 billion respectively in the first five months of 2016 reflecting improved economic activities (India GDP: Q1 16: 7.9% YoY, Q4 15: 7.3% YoY) in the former and sustained reforms in the latter. The surge in portfolio flows to Indonesia reflects removal of restrictions on 100% foreign ownership in certain sectors.

Over in Latin America, FPI appetite for the Brazilian debt waned, with net outflows of \$9.5 billion, following the deterioration in economic activity as GDP contracted for the eighth consecutive quarter in Q1 16 and budget deficit widened over the period. Nonetheless, as impeachment proceedings against President Dilma Rousseff progressed, Brazilian equities witnessed net foreign portfolio flows of \$4 billion over five months ending May 2016. In Mexico, the improving economic picture—Q1 16 GDP of 2.9% YoY is the highest in three years—induced capital inflows to its equity market (Jan-April 2016: \$2.7 billion). Nonetheless, investors remained apprehensive of sovereign risk with FPI repatriations from Mexican debt (\$7.4 billion) more than offsetting inflows into equities. As a result, both countries reported their longest streak of outflow since the 2009 financial crises. Elsewhere, Argentina returned to the international bond market for the first time in over a decade following successful negotiation with most holdout creditors regarding the 2002 default. The sovereign bond issuance of \$16.5 billion—largest EM bond sale ever—was four times oversubscribed as investors view new President Mauricio Macri's policies (including cutting export taxes and adopting a flexible exchange rate policy) as progressive.

Net portfolio flows to EM Europe was divergent as Ukraine, Poland, Hungary reported outflows while Turkey and Czech Republic posted inflows over Q1 16. The crises in Ukraine continues to drive net portfolio outflow (\$57 million) while Hungary's surprise GDP contraction in Q1 16 (-0.8% QoQ), which overshadowed Fitch's upgrade of Hungary's credit rating above junk for the first time since 2012, underpinned outflows (\$1.9 billion). Similarly, Poland's first GDP contraction (-0.1% QoQ) in 13 quarters over Q1 16 underpinned its first portfolio outflow (\$5.9 billion) in 5 quarters in the period. Meanwhile largely reflecting reduced political risks following President Recep Tayyip Erdogan's party's convincing win at the national elections, Turkey recorded its first quarterly net portfolio inflow in 5 quarters in Q1 16.

In the Middle East, concerns regarding lower oil prices, which drove Fitch and S&P's downgrade of Saudi Arabia's credit rating, underpinned a third consecutive quarter of portfolio outflows in Q1 16 (twenty-six fold QoQ larger to \$345 million). Elsewhere in the region, portfolio flows to Tunisia continued to plunge (QoQ: -67.8%, YoY: -85.6%) largely reflecting subdued tourism activities which has weighed on its economic outlook (Q1 16 GDP: +1% YoY). On the other hand, Egypt's devaluation of its currency (-14%) as well as interest rate hike (+250bps to 11.75%) buoyed portfolio flows into the country's equity and debt market over the period.

Deteriorating economic fundamentals soften FPI appetite for African assets

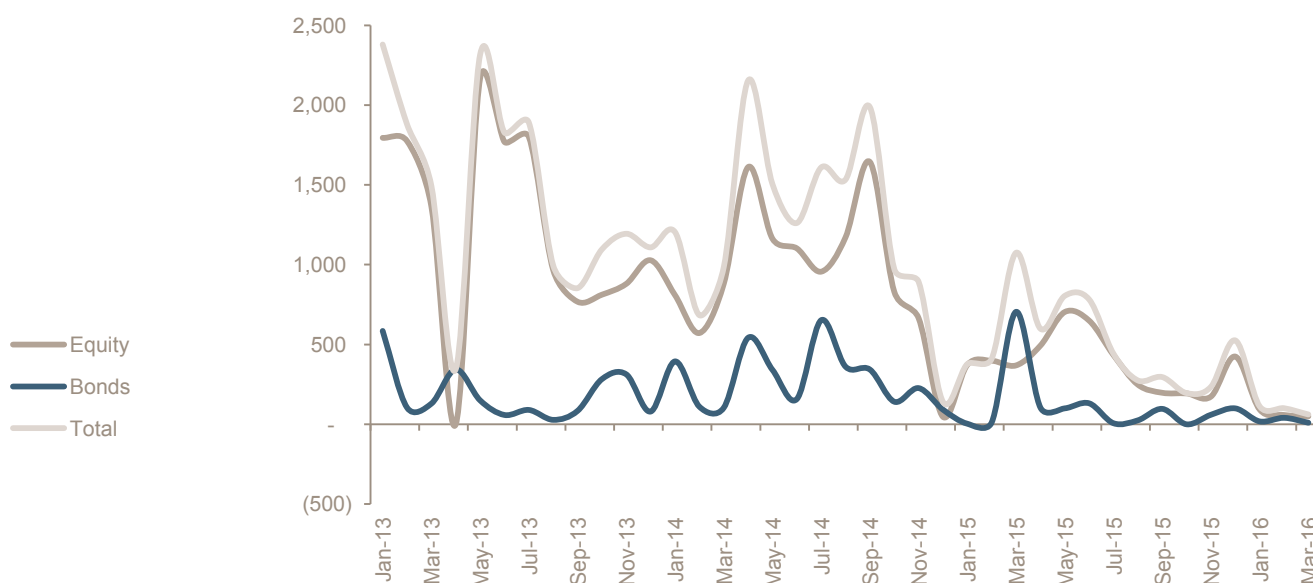
Capital flows to Africa have been on the downturn since the start of the commodity price rout given the sizable share of commodity exports in government revenues. On the heels of the price declines, the rising strain on fiscal and current account balances and softening growth picture weighed on FPI sentiment. These fundamental concerns and increased prospect of currency weakness has lowered demand for African assets, requiring higher risk premiums for debt issuance. Consequently, Eurobond issuances have either been delayed or shelved by most countries. In H1 16, only South Africa (\$1.25 billion) and Mozambique (\$726.5 million) raised international bonds (Eurobonds) vs.

four sovereign bond issuances totalling \$4 billion in H1 15.

Looking at trends in key economies across the region, South African equities witnessed portfolio outflows of \$3.6 billion over the first five months of the year reflecting deceleration in economic activities, underpinned by a sharp contraction in mining output, minimal growth in the manufacturing sector, and declines in electricity production and consumption. However, following accommodative

monetary policies in the advanced countries as well as 75bps hike in policy rate (to 7%) by the South African Reserve Bank, South Africa's debt markets reported \$1.5 billion portfolio inflow over the first five months of 2016. Elsewhere, the slide in the Nigerian economy, with real GDP contracting for the first time in twelve years in Q1 16, FX market illiquidity and renewed militant attacks on oil installations in the Niger Delta dimmed FPI appetite for naira risk with FPI flows shrinking (QoQ: -72%, YoY:-85%) to \$271 million in Q1 16—lowest quarterly flow on record.

Figure 13: FPI flows across Nigerian financial markets (\$'million)



Source: CBN, ARM Research

Brexit cloud of uncertainty dims H2 16 FPI outlook

Over the second half of 2016, beyond the weak macro outlook, we believe two events are central in charting outlook for FPI flows. First, fallout from Brexit should herald new layer of uncertainty in both the UK and the EU with the European Council on Foreign Relations (ECFR) noting that a total of 34 referendum votes are being promoted by various political parties across Europe (including France, Italy and Netherlands) to determine EU membership or other specific policy issues such as refugee relocation quotas. Thus, the higher prospect of copy-cat exits across the EU raises serious question about

the future of the European bloc. On Brexit itself, the split across Scotland and Northern Ireland raises concerns over the UK as nationalist sentiment in both countries could stoke fresh calls for independence. The second key event on the horizon is the timing of the next US interest rate hike. On this front, we expect the turmoil across financial markets following the Brexit vote should temper hawkish sentiment in the FOMC. The rising uncertainty over the potential outcomes should heighten investor sensitivity to risk assets, driving increased demand for safe haven instruments with negative connotation for portfolio flows to EM markets.

Scanning across the various regions to gauge potential impact, FPI outflows from China should continue following renewed concerns over growth as a result of deceleration in fixed asset investment (May's 9.6% YoY growth is the lowest in 16 years). In addition, continued decline in China's FX reserves (May's \$3.2 trillion is the lowest since 2011) which raises prospect of further depreciation of the Yuan should dampen investor appetite for China's securities. Elsewhere in Asia, improving economic momentum in India and continued liberalization policies in Indonesia should continue to attract FPI inflows into both countries. In Latin America, Brazil's junk bond status and rising budget deficit, projected to widen to a record \$45.9 billion over 2016, should continue to moderate investor appetite for its debt securities. Nonetheless, rising investor confidence following Rousseff's ouster, could drive inflows into Brazilian equities in the second half of 2016 as in H1. Similarly, EM Europe should see sizable outflows over H2 16 largely reflecting impact of Brexit as well as continued outflows from Russia whose economy is being impacted by lower commodity prices and western imposed sanctions.

In Africa, capital flows should remain tame largely on the back of slower economic growth with 2016 growth forecast lowered by the IMF (SSA: -130bps to 3% YoY) in April and the World Bank (SSA: -170bps to 2.5% YoY) in June from January's estimate. Compounding the bleak economic picture is the rising political activity across the continent with nineteen (19) elections and three (3) constitutional referendums taking place over H2 16. Furthermore, given the weakening trend across most African currencies, FPI should remain reticent towards African assets leading to higher external borrowing costs and lower Eurobond issuances with only Ghana (\$1 billion) and Nigeria (\$1 billion) looking to raise Eurobonds over H2 16 vs. \$6.7 billion issued in H2 15. Nonetheless, following adoption of a fully floating exchange rate system as well as other market friendly policies, FPI sentiment towards Nigeria could progressively turn favourable.

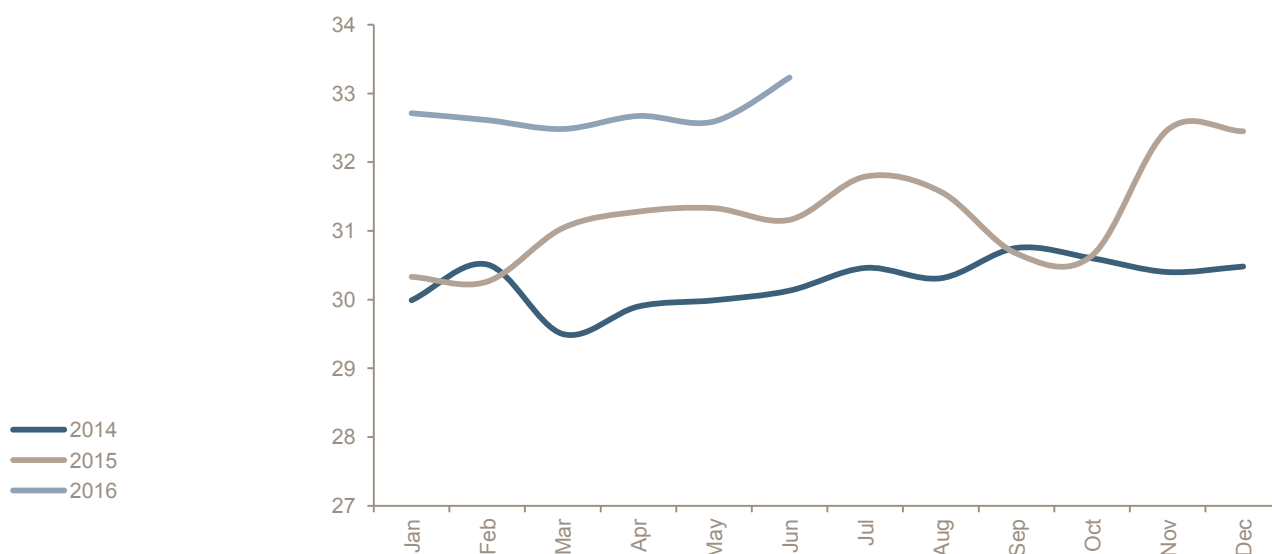
On balance, rising uncertainty post Brexit, increased risk aversion as well as slowing global growth point to tempered FPI flows to EM over H2 16.

Following the bear rout across global commodities in 2015, the weak global macro picture and flailing Chinese influence pointed to extended selloffs in 2016. However, a fortuitous run of events, from the third strongest El Nino in decades, raging wild fires in Canada and renewed unrest in Nigeria, commodities swung positive in H1 16. However, as the weather shocks dissipate, we see increasing focus across coverage commodities on developments on the fundamental front.

OIL MARKET ON THE BRINK OF STABILITY?

Resurgence of Iranian output extends OPEC's record output

Extending trends in 2015, OPEC's production tracked higher in H1 2016 (+3.2% YoY to 32.6mbpd) on the back of the inclusion of Indonesian output (700kbpd), after it re-activated membership in December 2015, as well as higher output from Iran and Saudi Arabia. Following suspension of nuclear sanctions in January, Iran ramped up oil output by ~700kbpd to four year high of 3.7 mbpd by June, while Saudi Arabia, in a bid to retain market share, maintained record production levels above 10.2mbpd (+1.4% YoY) over H1 16. These increases offset production pressures in Nigeria, Libya and Venezuela. Combined, these three countries lost over 500kbpd of output versus a year ago, with Nigeria and Libya accounting for nearly 80% of the drop. In Nigeria, production dipped nearly 10% YoY to 1.6mbpd in H1 16 on increased vandalism of oil installation in the oil rich Niger Delta by militant groups while blockage of ports by Petroleum Facilities Guard (PFG) militia in Libya saw its output decline nearly 200kbpd YoY to 340kbpd. For Venezuela, weak output (-100kbpd YoY to 2.3kbpd) reflects acceleration in natural declines due to years of under-investment compounded by power crisis and cash crunch.

Figure 14: OPEC Crude Oil Production (mbpd)

Source: IEA, ARM Research

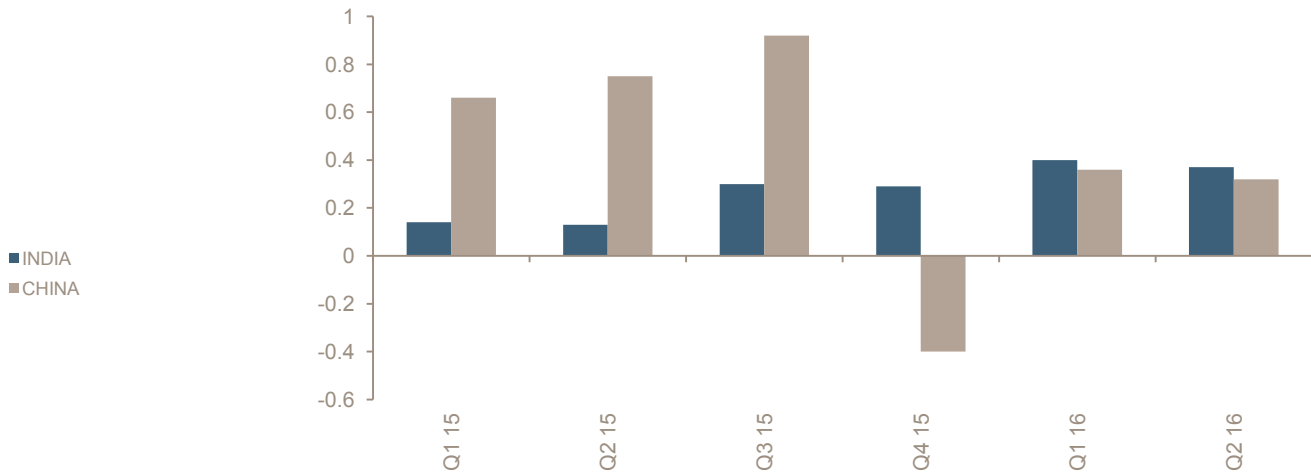
Falling US production drag non-OPEC volumes lower

On the other side of the divide, after proving resilient in face of low oil prices, non-OPEC crude oil production caved in H1 16, falling 500kbpd YoY to 57.0mbpd (H2 15: 57.4mbpd). The decline in non-OPEC output primarily stemmed from North America, particularly the US, where increased idling of oil rigs (-79% to 318) following cutback in capex in response to soft oil prices caused production to drop nearly 300kbpd YoY to 9.0mbpd over H1 16. Significantly, US output by the end of June 2016, is 1 mbpd below its peak production same period last year. Interestingly, though Canada output remained fairly resilient, with output up 2.2% YoY in Q1 16, wildfires burning through Fort McMurray, Alberta, forced nearby oil sands companies to shut-in 1.2 mb/d of production in early May, dragging H1 output 3% lower YoY to 4.3mbpd. These dips more than offset record production levels of 11.2mbpd (2.3% YoY) in Russia. On aggregate, global crude oil supply was largely flat (+0.4%) at 96.13mbpd in H1 16 (H2 15: 96.7mbpd).

India overtakes China as driver of global oil demand

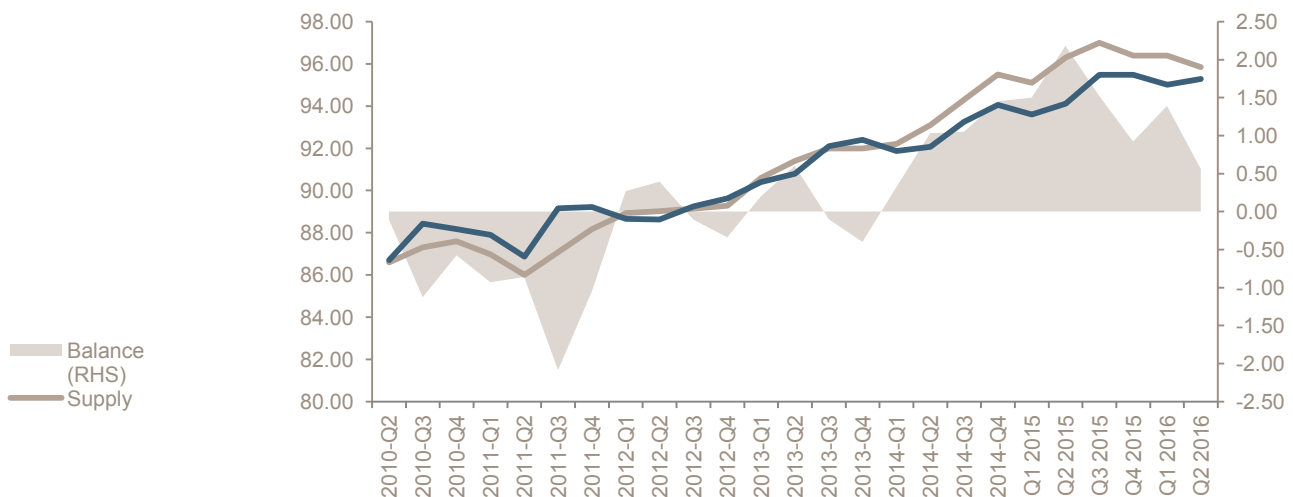
World demand for crude oil rose 1.5% YoY to 95.2 mbpd in H1 16. The rise in global demand was driven by increased consumption in Asia, particularly in India and China, which combined, accounted for over 60% growth. In China, though buoyed by government stimulus program, demand for oil rose about 300kbpd YoY to 11.6mbpd in H1 16, it is less than half the YoY growth in the corresponding period of 2015 as the economy continues to slow. Consequently, India's oil demand growth overtook China for the first time in decades as demand hit a record 4.4mbpd (+400kbpd YoY) in H1 16. India's strong oil consumption was underpinned by robust vehicle sales—with double digit growth in gasoline and diesel consumption—infrastructure push and government's LPG penetration scheme. Europe and North America also recorded modest growth in oil demand as low prices continue to buoy motor way miles. Consequently, the quicker growth in global oil demand, relative to supply, resulted in a contraction in global oil glut from H2 15 (~1.3mbpd) to 1mbpd in H1 16 which is about half in the same period in 2015.

Figure 15: India and China oil demand (kbpd)



Source: IEA, ARM Research

Figure 16: Supply – Demand gap (mbpd)

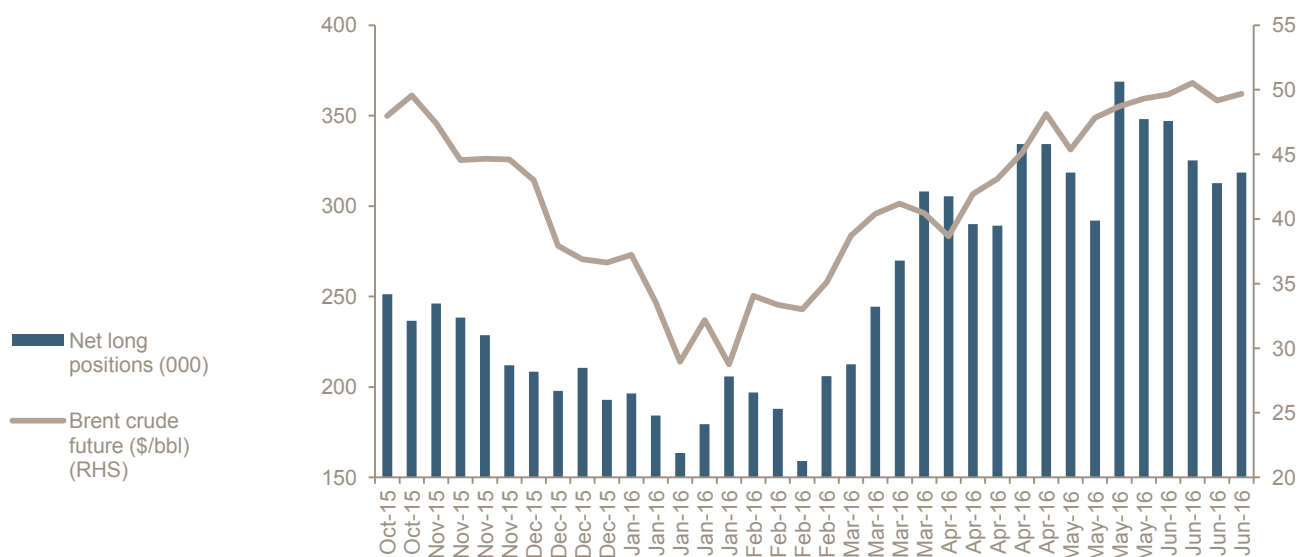


Source: IEA, ARM Research

Prices rebound as money managers bet big on oil market rebalancing

Although the global oil market remained in surplus over H1 16, oil prices staged a remarkable comeback to close the half year at \$49.68/bbl (+33%) after initially touching 12 year nadir of \$27.88/bbl in January—days after the Iranian nuclear sanctions were lifted. Oil prices rebounded quite sharply for a number of reasons. First, the Iranian return to the oil market was less dramatic than initially feared, with production up only about 220kb/d over February vs. the 550kb/d ramp up

within a week which Iranian oil minister had claimed was possible. The slower Iranian output disappointment coincided with a mid-February offer by Saudi Arabia, Venezuela, Qatar and Russia to freeze production at January output levels, even as unexpected supply shocks particularly Canadian wildfires and militant activities in Nigeria added more bullishness. In many ways, the recovery also reflected a bet that on-going rebalancing of global oil market with net long positions of money managers climbing 70% from YE 15 to 318,000 by the end of H1 16 will persist.

Figure17: Crude oil net long positions (000)

Source: CFTC, Bloomberg, ARM Research

Global production to accelerate on higher Iranian and Canadian output

Going into H2 16, we expect OPEC to continue to boost crude oil production in a bid to maintain its market share, particularly with the breakdown in the oil-freeze deal between some of its members and Russia. Indeed, signs of this play were visible with Saudi Arabia, the cartel's largest producer, ramping up production near 2.45mbpd in June even as it cut prices on shipments of Arab extra Light to US, Asia and the Mediterranean. Similarly, Iran would be looking to boost oil production to pre-sanction levels of 3.4 mbpd—that is another 700kbpd increase—after adding nearly 700kbpd over H1 16. We expect increases on these fronts; particularly from Iran to continue to offset civil unrest induced shocks in Nigeria and Libya as well as the natural declines in Venezuela. On the flipside, we see scope for recovery in non-OPEC supply led by Russia and Canada. Like other OPEC countries, the breakdown in freeze deal should see Russia continue to fight for market share and sustain output around record levels of 10.9mbpd, while Canadian output should recover to prior levels (4.5mbpd) as operators return to Fort McMurray following the cessation of the wild fires. In the US, though we expect the descent in output to persist, the modest rebound in

oil prices, but crucially the stability around \$45/bbl level, which is encouraging return of some producers to well-pads, suggest the pace of declines could decelerate. Indeed, rig counts have climbed in last 5 of the 6 weeks of H1 16 and producers have increased hedging around current prices with net short positions climbing to four and half year highs late in H1 16. In all, primarily reflecting recoveries in output as Canada and Iran rush back to the market, we expect global oil production to quicken over H2 16.

Slowdown in European market to taper demand growth

For demand, we expect Asia to remain the engine of growth of global oil demand, which is continually led by India. In addition to robust economic outlook, strong oil demand in India should be buoyed by a filling up of its strategic petroleum reserves (SPR) as the country seeks to hedge against its increasing dependence on oil import. For China, while we expect the deceleration in consumption to continue as the economy continues to cool, the country will remain a major driver of demand over the rest of the year. In the west, particularly Europe, the demand picture is not so rosy as uncertainty around the Brexit vote is likely to compound the flagging

demand for oil which should keep a lid on growth. US demand is also expected to slow as energy refiners look to reduce their stock piles which have continued to climb with the glut in the crude oil market.

More down side risk for oil prices as glut potentially widens over the rest of the year

On balance, the expected recovery in global supply, amidst the drag down in Asian demand by Europe and the US, suggests, unlike the first half of 2016, supply will accelerate at a quicker pace than demand in H2 16. This prognosis, which suggests some widening of the glut, should also drive a pick up in the rate of onshore and floating storage inventory build-up, after recent decelerations. The fundamental outlook which remains bearish for oil prices is compounded by strengthening US dollar on increased Brexit related capital flight, trimming of long positions by money managers as well as increased hedging around the \$45- 50/bbl level through to 2017. The latter perhaps signals disbelief on the sustainability of the Q2 16 rally amongst high cost producers. Brent crude prices has averaged \$41.9/bbl in H1 16, but based on the foregoing

dynamics and historical price movements, we envisage higher pressures could lead prices to trade within the range of \$35-\$40.00/bbl on average over most of H2 16.

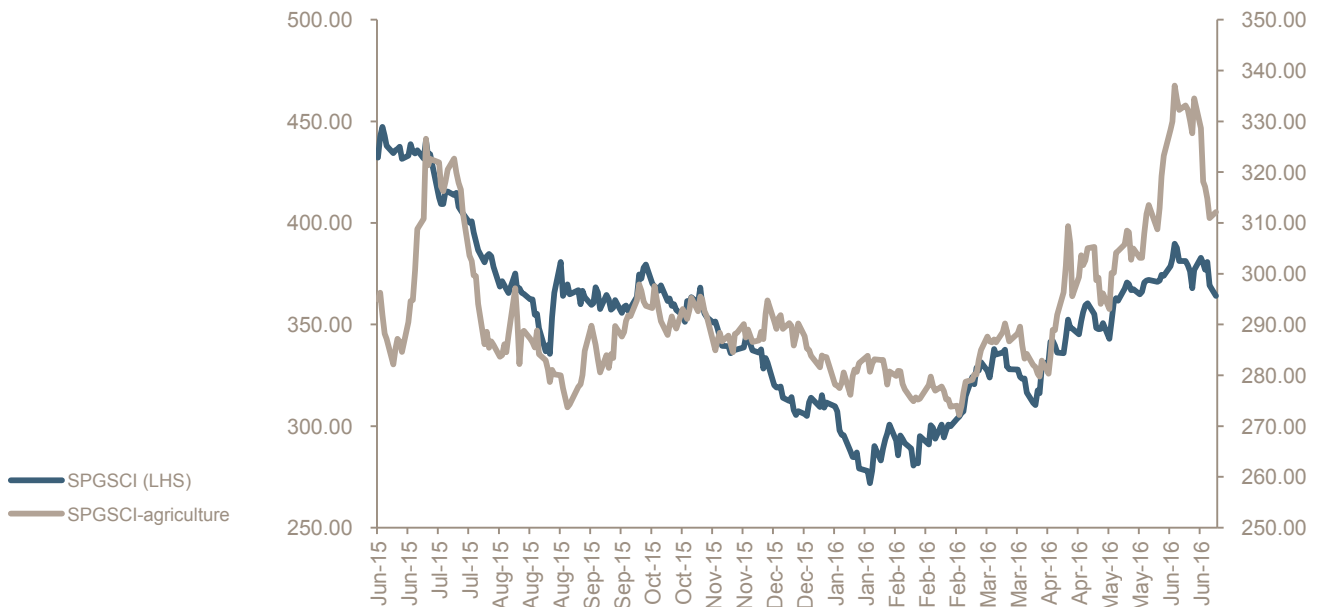
RECEDING WEATHER SHOCKS HANDS BATON TO FUNDAMENTALS

El Nino tide lifts soft commodity prices

In the aftermath of the third strongest *El-Nino* on record¹¹, which resulted in unusual weather patterns across various key agriculture producing regions, the S&P GSCI Agriculture index posted a 17% gain over the first half of 2016 (H1 15: -19%). In addition to weather shocks, a softening US dollar and fluid demand-supply imbalance across regions and crops helped underpin the positive return on the index. Across our soft commodities coverage, adverse impact of the weather shocks on farm production was primarily responsible for price increases across raw sugar, rubber, barley, corn and palm oil while subsisting over-supply concerns weighed on wheat and cocoa prices.

¹¹US NOAA

Figure 18: S&P GSCI - commodities and agriculture indices



Source: Bloomberg, ARM Research

Parched planting conditions spurs rally in raw sugar price

In line with our expectations in our last update for an expansion in global sugar deficit, raw sugar prices extended the uptick recorded at the start of 2015/16 planting season, when they climbed 18% in Q4 15, by rising a further 36.5% YTD to 20.04 cents/lb. Over the 2015/16 season in line with USDA projections (+1.2% YoY), sugar consumption rose slightly by 1% YoY to 172 million MT. However, declines of 7% YoY in production overshoot forecast for a 1.7% decline. This surprise was driven by record El Nino activity,

which caused prolonged dryness in major planting regions in South Asia. Towards the end of the 2015/16 season, the International Sugar Organization's (ISO) voiced concerns that fall-out from the *El Nino* on Indian production, amid rising global consumption, would exacerbate the expected deficit across global sugar markets, and in February 2016 the organization raised estimates of supply shortfall by more than double to 5.02million MT, from prior forecast in Q4 15. The upward adjustment and implications for global sugar stockpiles, which closed the 2014/15 season at five year lows of 37.7million MT, underpinned price gains over H1 2016.

Figure 19: Raw Sugar prices

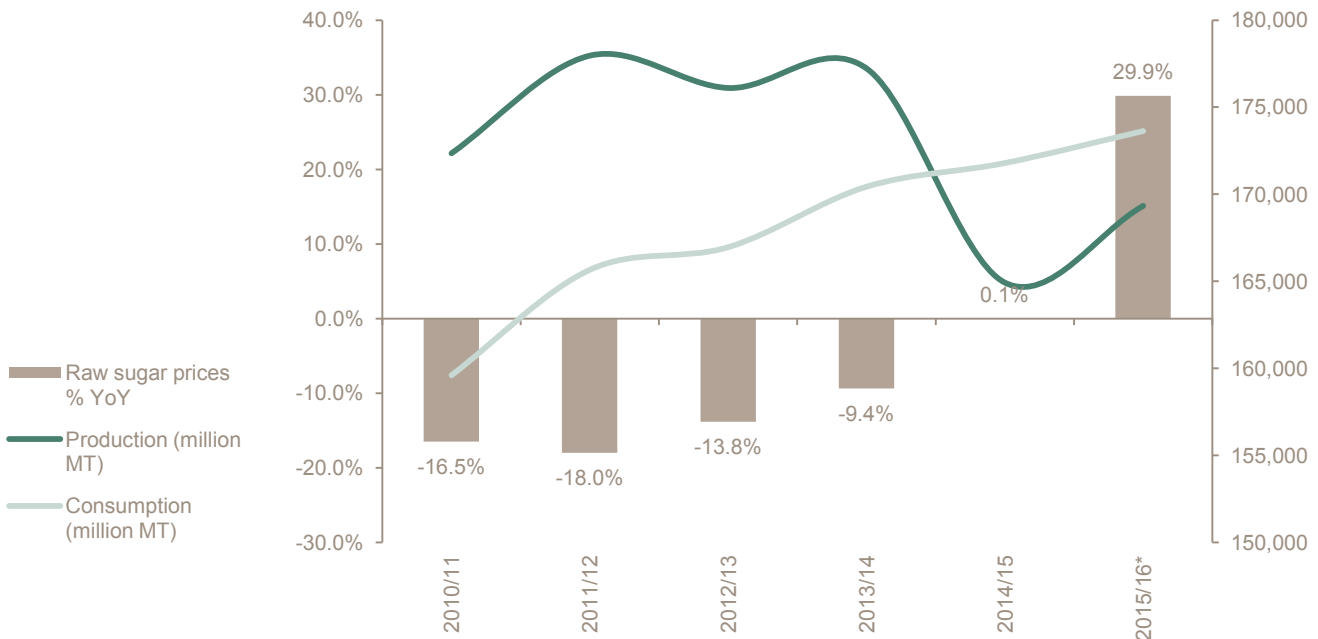


Source: Bloomberg, ARM Research

Going into the second half of 2016, the USDA expects combination of a weaker Brazilian real and lower sugar-to-ethanol conversion to result in a 6.5% YoY increase in sugar output to 37.1million MT. Assisted by a 15.5% YoY expansion in European beet and sugar output to 16.5million MT, the increase should offset impact of drier weather, on account of the El Nino, on Indian output (+8% YoY to 225.5million MT), leading to an aggregate 2.7% YoY

rise in global sugar production to a record 169million MT. On the consumption side, the USDA cites rising consumption of homemade jams, preserves and production of home-made alcohol in Russia, increased demand in India and China as providing scope for a 1.1% YoY increment global demand to 173million MT. Though the deficit is smaller, we expect momentum in prices to remain intact over the rest of 2016.

Figure 20: Annual raw sugar production, consumption and price trends



Source: Bloomberg, ARM Research * H1

Government intervention in South East Asia buoys rubber prices

Despite being mired in a significant supply glut, rubber prices have been among the best performers in H1 16 having ended the period 33% up. Prior to H1 16, declining imports from China (40% of global demand) had pushed rubber into a prolonged bear market with prices sliding nearly 70% over the last five years. Indeed, coming into 2016, global supply was expected to climb 3.8% YoY to 13 million MT and with continued slowdown in China, where rubber imports declined 10% YoY in 2015, the outlook was for an expansion in global rubber inventories by 411,000 MT to 3.7million MT. Nonetheless, on the

heels of intervention by Thailand and Indonesia, rubber prices swung higher defying the fundamental oversupply picture. Starting in January, both countries began domestic shorting prices with the Thai government authorizing the purchase of 200,000 MT at a 43% premium to export prices, while the Indonesian government authorized 500,000 MT. Further steps were taken in February, when Thailand, Indonesia and number three exporter, Malaysia, acted under the aegis of the International Tripartite Rubber Council to compress rubber exports by 615,000 MT¹² in the six months to August.

¹²ITRC members collectively accounts for 70% of rubber production

Figure 21: Rubber Prices (\$/kg)

Source: Bloomberg, ARM Research

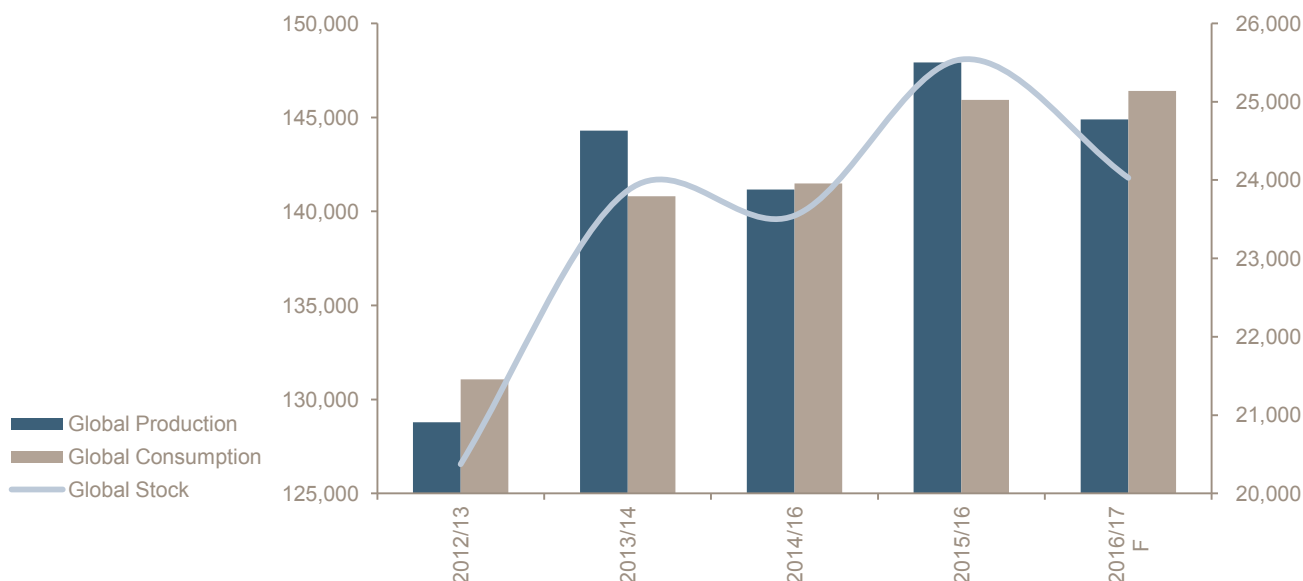
Going forward, due to a longer dry season, a fall-out of the El Niño weather patterns, the Association of Natural Rubber Producing Countries (ANRPC) forecasts that lower yields across major growing regions would drive flat (+0.3% YoY) trends in global rubber output. On the demand side, subdued economic activity in China, where rubber stockpiles are at 13-year highs and subdued Japanese and European automobile production point to weak consumption demand in the second half of 2016. Thus, barring any agreements to extend the export curbs which should terminate in August, the drag from slack rubber demand should apply downward pressure on prices in the second half of 2016.

Demand picture raises scope for more Barley price resilience

Barley prices staged a comeback in H1 16 by closing

at \$134.5/MT (YTD: +3.9%) compared with a 10.3% decline seen in H2 15. Price declines in the second half of 2015 reflected market estimates that suggested a return to oversupply in the 2015/16 season, versus forecasts of undersupply made early on in the season. According to data from the USDA (and corroborated by the IGC), for the 2015/16 season, global Barley supply stood at 147.9 million MT; representing a 4.7% increase on the prior year. In a reversal from the prior season, supply outstripped global consumption which grew at a slower pace of 3.1% YoY. Consequently, inventories ended the season 1.9 million MT higher. The USDA cited favourable planting conditions as the chief reasons for the unexpected bumper harvest, as output increases from the EU (1% YoY), Canada (+16% YoY) and Australia (+9% YoY) more than offset declines from Russia (-15%) and Ukraine (-7%).

Figure 22: Global Barley Output, Consumption and Inventories



Source: USDA, ARM Research

For the 2016/17 season, consumption is again forecasted to outstrip supply, which explains the rebound in prices in the late part of the 2015/16 season. Citing abundant rainfall and favourable growing conditions which boost yield prospects for Spain, the USDA raised EU barley production forecast for 2016/17 by 2.3 million MT, as abundant rainfall and favourable growing conditions boost yield prospects for Spain, while the agency also raised its estimate for Ukraine’s barley production by 0.9 million MT as the impact of fall dryness seems to have been less than expected. Nevertheless, improvements in large growing regions are expected to be insufficient to offset declines from the rest of the world. Consequently, global production for 2016/17 is forecasted to decline by 2% to 144.9 million MT. On the other hand, consumption is expected to stay flat at 146.4 million MT as higher demand for Barley for feed purpose in the EU, Iran, and Saudi Arabia offset major declines in China, where demand is shifting towards grains with greater domestic availability

El Nino shocks spur modest gains in CPO price

In contrast to the sharp declining trend in 2015, crude palm oil (CPO) prices have shown resilience in H1 16

by climbing 8%. Similar to raw sugar, concerns over the impact of the El Nino on production levels arose after CPO inventories in Malaysia declined for six consecutive months to a two year low of 1.66million MT in May 2016. Further stoking price upside was the reintroduction in April 2016 of the 5% duty on CPO exports in Malaysia which was soon followed by a similar levy on Indonesia’s CPO exports in May. In addition, Indonesia’s B30 biodiesel program, which mandates 30% CPO inclusion in diesel production, was viewed as positive for market fundamentals. However, towards the end of H1 16, prices began a retracement as supply glut projections were raised for the 2016/17 season, and concerns rose over the likelihood of success of the B30 program.

Contrary to its forecast at the end of 2015, for the 2015/16 season, the USDA reports that global CPO supply shrunk 1.2% YoY (vs +1.9% forecast) to 60.9 million MT while consumption jumped 6% (vs +7.1% YoY forecast). The decline in production was driven a 5.7% contraction in Malaysian output¹³ even as Indonesian output stayed flat, both of which offset modest gains from the rest of the world. Analysts had expected the latter part of the 2015/16 season to compensate for lower yields caused by El Nino and

¹³ These two countries account for over 85% of global CPO output

flooding in the earlier part of the year. However, sustained dryness in the two biggest markets caused by prolonged El Nino activity prevented recovery in output. On the consumption side, the growth was driven by rising demand in India, the world's largest consumer, in line with higher demand for edible oil blends. Also pushing consumption higher was a 21.6% jump in Indonesian consumption in response to the B30 program. These increases offset declines in China and Europe where a preference for alternative oilseeds and rising activism over environmental impact of CPO cultivation put a lid on palm oil use.

For the 2016/17 season we maintain a cautious

outlook for CPO prices, leaning to the upside. On the one hand, consumption prospects are greatly improved on the back of the B30 mandate, but recent price action demonstrates concerns over the long term success of the program given the technical difficulties involved with its high biodiesel requirement. Furthermore, India has replaced China as the world's fastest growing economy and seems poised to continue being the biggest consumer of CPO, we expect growth in consumer power within the country to continue supporting consumption growth in CPO. On the other hand, depreciation in the price of other oilseeds like Soybean (which serves as a substitute for CPO) also suggests muted expectations for CPO price performance.

Figure 23: Trends in CPO prices



Source: Bloomberg, ARM Research

In line with these expectations, the USDA forecast a 7.5% increase in global output for the season to 65.6 million MT. This growth is forecasted as driven by 12% and 6% YoY improvements in Malaysian and Indonesian output respectively, on the back of less severe weather conditions compared to the prior year. On the demand side, consumption is expected to pick up 4.1% to 64.6 million MT, which would represent the second consecutive demand lags supply. The USDA expects strong growth in India (+7.1% YoY), Indonesia (+3.7% YoY), and China (+1.8% YoY) to offset impact of declines in Malaysian

consumption.

Surplus across wheat market continues to weigh on prices

In line with our over-supply induced bearish outlook, wheat prices have declined 7% YTD as excellent weather across major planting areas in US resulted in upward adjustments to harvest estimates from the world's largest exporter. In contrast to bullish bets across other commodities in our coverage, Bloomberg reports show that net-short positions on

wheat futures continued to increase over the period, providing more fire-power to price downside. Going forward, whilst the USDA forecasts lower wheat production in the EU (-2.2% YoY) and China (-0.1% YoY) – the two largest growers of wheat, the agency notes that increased acreage in Russia (+6.5% YoY) and improving conditions in India (+1.7% YoY) and the United States (10.25 YoY) should have an offsetting impact which should see global output stay flat (+0.5% YoY) at 739 million MT. On the demand

side, global wheat consumption continues to rise with the USDA forecasting a 3.1% YoY rise in consumption in 2016/17 to 730 million MT. Despite consumption growing at a faster rate than supply, the market still remains over supplied, though the gap continues to narrow. Consequently global wheat inventories remain close to record levels, and are projected to rise 4% YoY to 254 million MT. Consequently we expect wheat price to remain bearish for the remainder of the season.

Figure 24: Trend in wheat prices



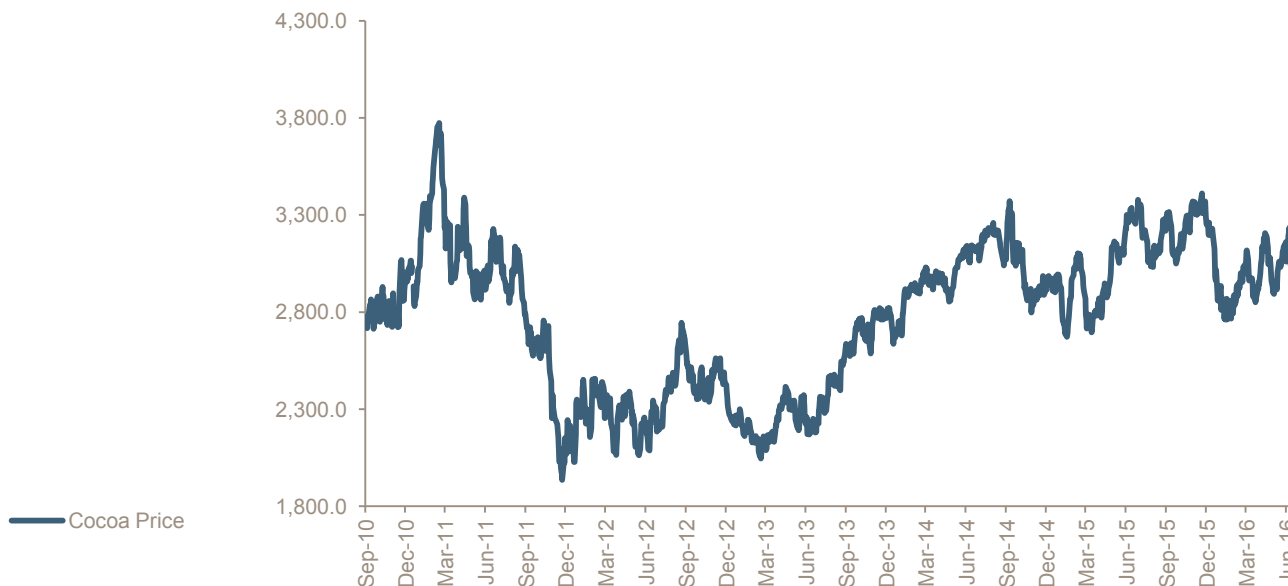
Source: Bloomberg, ARM Research

Lower Ivorian production to underpin global cocoa deficit

In addition to wheat, Cocoa prices bucked the positive trend which made it the best performing commodity in 2015 with 10% YTD contraction. Despite a difficult start to the 2015/16 Cocoa season which began in October with a prolonged Harmattan season in Ivory Coast, improved rains in March and a recovery in cocoa production in Ghana, from five-year lows, dragged prices lower¹⁴. Despite the weather-linked improvement in H1 16, cocoa bean arrivals at the main ports in Ivory Coast are 8% lower

YoY at 1.31million MT according to the ICCO. Furthermore, the ICCO reports that the heavy rainfall provides a second layer of headaches as farmers were unable to dry Cocoa beans leading to a high rejection rate at the export ports due to the higher acid content of the beans. On the demand side, Cocoa grinding activity remains weak thus far in 2016, as overcapacity and slack global chocolate consumption continues to drive moderation in processing capacity. Largely reflecting the slack demand growth, top processor and largest maker of bulk chocolate Barry Callebaut AG reports that global chocolate sales slid 2% YoY even as the company mothballed several factories in Thailand and Malaysia.

¹⁴Ghana and Ivory Coast account for 56% of global cocoa output

Figure 25: Cocoa price (\$/MT)

Source: Bloomberg, ARM Research

In framing our Cocoa price outlook for the rest of 2016, we note that recent regulatory changes on bean export sizes¹⁵ in Ivory Coast which reject smaller beans for shipping should lower Ivorian cocoa exports. Consequently, the ICCO estimates that Ivorian Cocoa production for the 2015/16 season should decline 3% YoY to 1.65million MT. Due to adverse weather in South America, the agency estimates that Brazilian production should contract 22% YoY to 180,000 MT while similar concerns mute harvest outlook in Indonesia, Cameroon and Nigeria. Overall, the ICCO forecasts a 3.4% YoY contraction in global cocoa production to 4.04million MT in the current crop year. Despite slack consumption growth, the ICCO expects the supply cutbacks to result in a global cocoa shortfall of 140,000 MT which points to a bullish price outlook in the second half of 2016.

¹⁵Ivory Coast seeks to increase cocoa available for local processing

NGN depreciation more a concern, than soft commodity price trends, for naira equities

For the Nigerian market, while the soft commodity price trends drives a mixed bag across listed companies, recent move to a flexible exchange rate regime and resulting NGN depreciation should more than offset effect of input cost trends. On the positive side, the raised CPO price outlook combines with CBN FX proscription for CPO imports (amid deficit in CPO supply-demand) in boosting revenue growth outlook for listed palm producers. For flour millers, our bearish outlook for wheat prices should be positive for the FCMGs like Flour Mills, Honeywell, Dangote Flour and UACN – for whom wheat represents a substantial input. Nonetheless, naira weakness should offset these input cost gains. On the flipside, higher raw sugar prices and the weak naira outlook point to gross margin pressures for sugar refiners. Similar sentiments on margins apply for cocoa and barley consumers where price outlook is bullish.

KEY DEVELOPMENTS IN DOMESTIC ECONOMIC AND POLICY ENVIRONMENT

NEW THREATS SLOWING PROGRESS

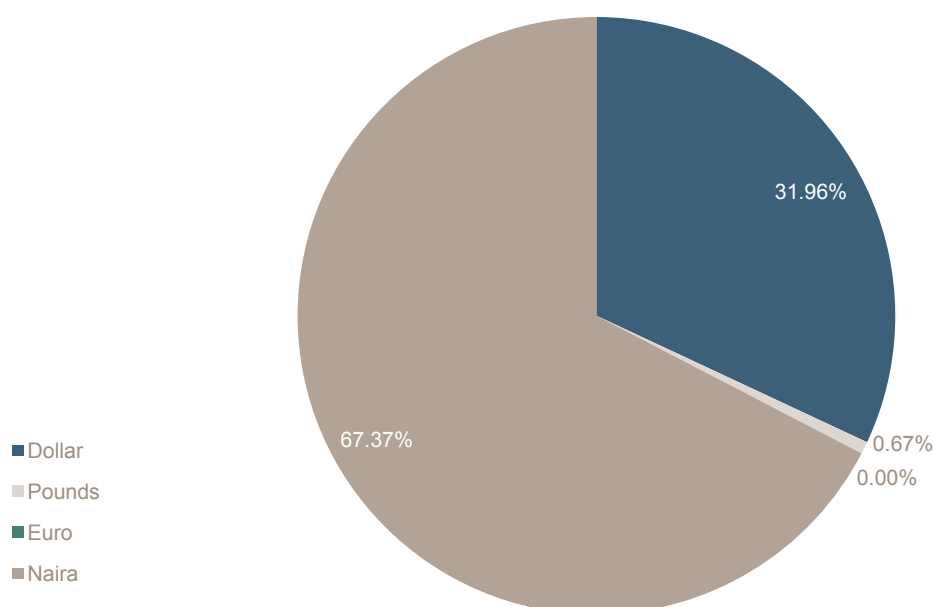
Barely a year into the enthusiastic change of baton at Nigeria’s political helm, developments on the socio-political front continue to emit muted signals to warrant initial optimism. Starting with the submission of a budget document laced with summation errors which delayed its passage to fresh insecurity challenges and uncelebrated currency policies, the first six months of 2016 has largely served to douse investor optimism. So far, the new administration’s vigorously pursued anti-corruption crusade has done little to revamp market sentiments, which remained bearish as insecurity worries expanded back to the Niger Delta creeks. That said, the increasing amount of recovered stolen funds suggests that the current anti-corruption drive holds some promises on Nigeria’s fiscal front. However towards the end of H1 2016, adoption of pro-market policies on fuel and currency has provided promise about more firm

footed policies going forward.

Anti-corruption drive eventually yielding fruits

Within a year of coming to power, the current government has recovered nearly ₦130 billion of looted public funds and obtained interim forfeiture orders on non-cash assets (land, buildings and vehicles) valued at ₦2.9 trillion. Moreover, the FGN concluded arrangements with the governments of Switzerland, UK, USA and UAE for the repatriation of more than ₦940 billion of corruption proceeds stashed away in those countries. In all, if the monies under interim forfeiture and those abroad are collected, the government would have succeeded in recovering over ₦3 trillion about half of the 2016 budget. In that sense, the president’s drive to recover stolen public funds appears to be yielding fruit.

Figure 26: Currency split of recovered funds



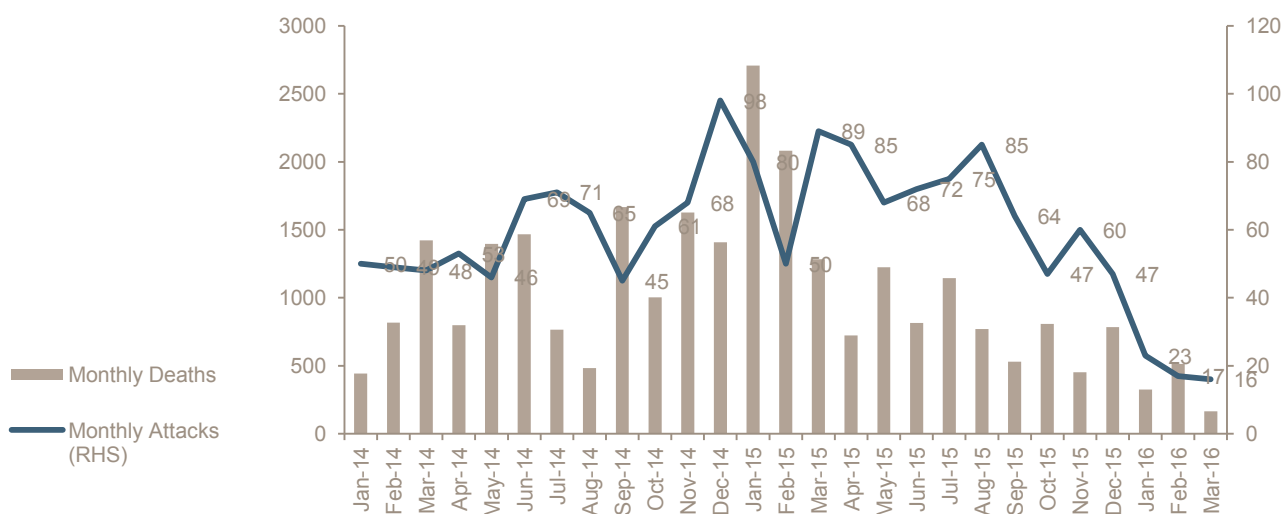
Source: Minister of Information and Culture; ARM Research

The President’s foreign trips: jamboree or proper socio-political engagement?

The President extended his globetrotting into H1 16 with 13 additional travels over the period bringing cumulative foreign trips since to 30 since stepping into office. The frequency of the foreign trips, at a time of dwindling resources and heightening insecurity, generated significant debate, in terms of general value derived and specifically whether this was the sole focus of the government. Notwithstanding, it is clear important decisions were reached, some of which could prove significant in terms of a plan to put the economy on sustainable footing long-term. Amongst many others, the president’s trip to China and African neighbouring

countries were quite significant as several terms which could have far reaching implications were agreed upon. The visit to China gave birth to a \$6 billion loan offered to Nigeria to fund infrastructure projects, agreements primarily focused on infrastructural developments—totalling \$6.4 billion—which captures the \$2.5 billion Lagos Metro Rail Transit Red Line project and the \$1 billion development of a Greenfield expressway for Abuja-Ibadan-Lagos, scheduled for completion in four years. Beyond tackling corruption, the trips to neighbouring African countries including Chad, Cameroon, Niger gave birth to the creation of a Regional Force whose coordinated offense has helped turn the tide decisively against Boko Haram with attack frequency sliding to multi-year lows.

Figure 27: Boko Haram attack profile



Source: Council on Foreign Relations, ARM Research

Insecurity assumes more worrying dimension

While the Boko Haram menace appears to be subsiding, insecurity assumed a more disturbing dimension in H1 2016 starting with a series of violent clashes between herdsmen and locals in several parts of the country. Worryingly the attacks transcended geographical boundaries, as attacks were recorded in locations away from the historical middle belt epicentres to southern states like Enugu and Edo. At least over 300 persons are reported to

have been killed, 250 homes destroyed and left many displaced in recent clashes in Benue State. Rather than directly tackling the menace as an insecurity issue, the FGN resorted to moving ahead with plans hatched under previous governments to establish grazing reserves across the country with seed money of ₦940 million. Unsurprisingly, the FGN response has drawn the ire of some southern state governors which accused the Buhari administration of an ethnic slant and kicked against the plan. In addition to loss of life, herdsmen attacks hurt food production in the Middle Belt, long seen as food

basket, and likely accentuated current upswing in local grain prices.

Barely had the dust from the herdsmen attacks settled, fresh insecurity issues flared up in the Niger Delta with the resumption of attacks on oil installations by militants under a new group called the Niger Delta Avengers (NDA). Citing long-standing concerns about environment pollution and resource control, the NDA targeted various oil production platforms resulting in *force majeure* across major export terminals (Trans-Forcados, Bonny and Qua Iboe) leading to a drop in mean crude oil production to 2.11mbpd in Q1 16 (Q4 15: 2.2mbpd). The NDA attacks inspired copycat assaults by similar groups on oil installations, which extended to include gas pipelines leading to prolonged power outages in H1 16. After initially sounding hawkish in response the attacks, with reports about orders to military to bombard the region, President Buhari adopted a more conciliatory stance, seeking to open negotiations to address the issues. That said, as most of the militant agitations are unchanged from the past, we think the fresh insurgency stem from proposed cuts in Niger Delta amnesty payments under the 2016 budget.

Overall, the FG's inability to come to grips with the security issues and wrong-footed responses to the crises did little to improve investor perception regarding economic policy decisions. Indeed impact of the weak handling of the issues on agriculture and crude oil GDP indirectly contributed to onset of recessionary growth conditions across the economy in H1 16.

Flexible currency and fuel policies show flicker of hope on credible policy decision making

After holding out for nearly a year on the FX, the CBN, after obtaining the fiscal nod, announced the move to a floating exchange rate regime. The move which resulted in 43% depreciation in the naira marks a volte face by the presidency on the FX policy. Following on from 66% hike in retail PMS prices in May 2016, which included a shift to more

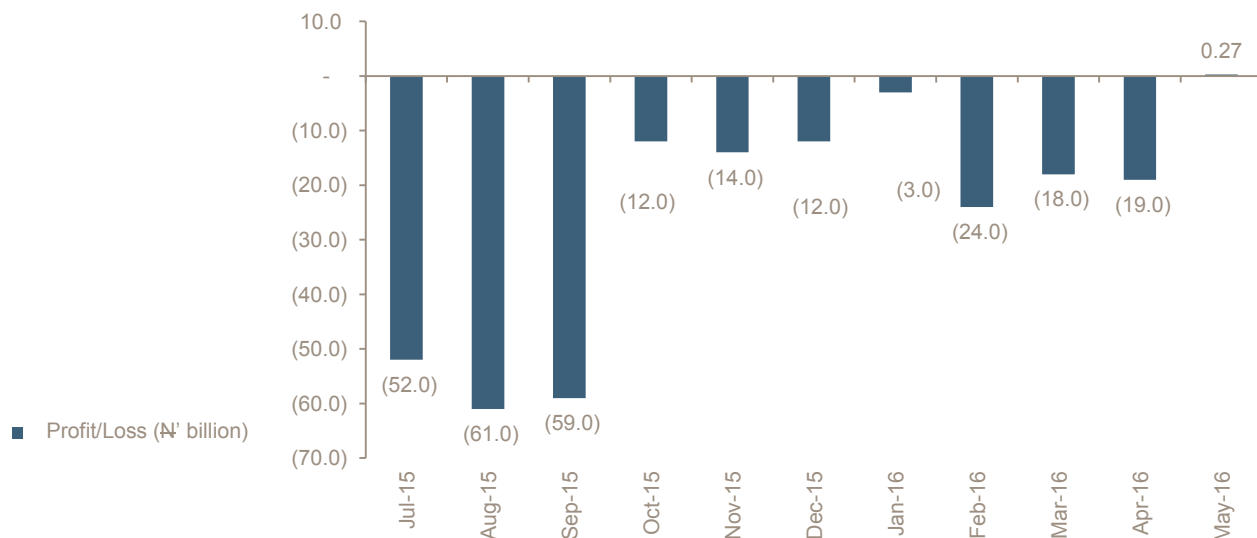
flexible price mechanism, the change in currency stance provided firm hints about a change in policy inclination of the Buhari administration. While increasingly difficult revenue realities could have forced a shift anyway, the adoption of flexible exchange policy as opposed to devaluation suggests a change at heart.

REFORMS PROGRESS AT SNAIL SPEED

NNPC records success in downstream sector reforms...

The reforms of the Nigerian oil and gas sector continued apace in H1 2016 with the NNPC recording some level of progress in about 8 of the 20 fixes initiated by the Minister of State for Petroleum at the tail end of 2015. Almost all the gains were recorded in the downstream segment and at corporate level with only little success on the upstream front. In the downstream space, the corporation made headway in subsidy and the implementation of the Direct Sale Direct Purchase (DSDP) agreement while it was able to cut operational directorates and top management to 4 and 8 from 83 and 122, respectively. NNPC went beyond its earlier commitments of streamlining the administration of the subsidy regime by completely eliminating it via a 67% hike in PMS price to ₦145/litre. Beyond the improvement in product supply, after nearly 8 months of severe shortage, the removal of PMS subsidy should translate into annual savings of about ₦793 billion for the Federal Government by our estimates. The corporation also made savings on its Offshore Processing Agreement since it commenced the Direct Sale Direct Purchases in March 2016, whereby the NNPC eliminates all the cost elements of middle men and directly controls the sale and purchases of crude oil transaction with its partners. Since March 2016, nearly half of crude oil processed offshore for local consumption has been via this agreement, with a potential to save the NNPC nearly \$1billion annually. Against this backdrop – Corporate restructuring and downstream initiatives—the NNPC reported profit in May 2016 for the first time in 15 years (₦273.74 million).

Figure 28: NNPC's monthly profit (₦ billion)



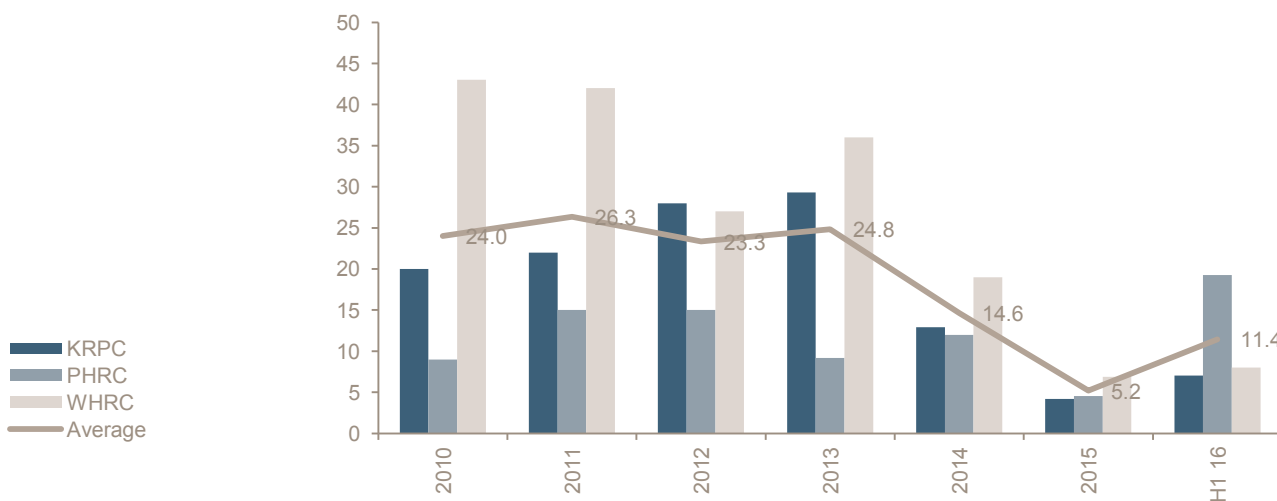
Source: NNPC, ARM Research

...but sub-par refinery output and political jostling leave sector issues unresolved

Nonetheless some other chokepoints remain intact with the refining segment continuing to remain a drag on performance. Despite numerous efforts to revamp the existing refineries average capacity utilization printed an abysmal 11.4% over H1 2016— well below the 20% trend mean of the last five years. The persistent underperformance,

despite official pronouncements about reform initiatives, hints at deep lying issues around poor maintenance, operational failures, sabotage of crude oil pipelines feeding the refineries etc. Though the NNPC continues to avoid mention of privatization due to concerns about political resistance, we think the conclusion of the 650kpbpd Dangote Refinery, with ability to meet national consumption, should allow discussions to proceed on sale of the refineries.

Figure 29: Capacity utilisation at Nigeria's refineries



Source: NNPC, ARM Research

On the regulatory front, the story of slowing reform momentum is also in play as shortly after it successfully passed the second reading, the Senate indefinitely suspended further reading on the Petroleum Industry Bill (PIB) now christened Petroleum Industry Governance Bill (PIGB). The decision stemmed from opposition from Southern states who disagreed over the exclusion of 10% royalty for host oil communities tagged Petroleum Host Community Fund (PHCF) which was drafted in the botched bill but removed in the new version to win the heart of IOCs who were against the high emphasis on local content. Ironically, the inclusion of the PHCF in the old PIB lay at the heart of opposition from Northern senators who wanted to increase the size of oil revenues accruing to the Federation account. Thus, an inability to reach a consensus with both camps threatening to veto further reading of the PIGB over the inclusion or exclusion of the PHCF has dampened initial optimism regarding early passage of the two bills. While the currently low oil price has put off investment decisions on oil fields, lack of progress on the legal framework for investment in the oil industry should continue to deter IOC investments in Nigeria.

New tariff regime (MYTO – 2015) takes centre stage

After several failed attempts, the NERC hiked electricity tariffs ~45% on average in February 2016 with the introduction of the Multi Year Tariff Order (MYTO) 2015 to replace MYTO 2012. In addition to

the price hike, the new price regime also abolishes the controversial fixed tariff charge of between ₦650 and ₦1,382. Explaining the rationale for the increase, NERC noted that the prior pricing regime ignored key costs faced by Discos and therefore made it difficult for them to operate profitably. Specifically, the commission noted that though other variables in the electricity tariff pricing model—including inflation, exchange rate and gas prices—were on average ~23% lower than assumed, exclusion of start-up costs, but crucially, Aggregate Technical Commercial Collection (ATCC) losses underpinned the increase. On the losses, Discos reportedly experienced losses of up to 20% of energy sent out, amounting to ₦215 billion as at last MYTO due to weak distribution network, old and obsolete transformers, breakers and other distribution equipments in the distribution network.

Though the upward tariff review went into effect in February, the labour unions took the issue to court which resulted in a ruling that suspended the increment. Whilst the NERC appealed and obtained a stay of execution on February hike, delays in the administration of justice could see uncertainty around the electricity pricing—linger well into 2017. In the interim, the electricity pricing regime is set to get even more uncertain in the coming months following significant spike in other variables in the pricing model—inflation and exchange rate. Incorporating these changes suggest that the Discos will, in no time, request further upward review of the electricity tariff.

Table 3: Summary of Assumptions

Parameters	MYTO-2 Assumptions	Actual November 2014	Actual June 2016
Inflation	13%	7.90%	16.50%
Exchange rate	₦178	₦166.15	₦280 – ₦290
Gas /mmBtu	\$2.30	\$1.80	\$2.50

Source: NERC (MYTO 2.1), ARM Research

Gas shortages cripple power generation

Aside the hike in electricity prices, challenges across the power sector value chain persisted in the period, particularly with power generation, which buckled under the weight of gas supply disruptions. Despite attaining an all-time high of 5070MW of power generated in February, power generation subsequently declined following renewed attacks on gas pipelines in the Niger Delta. Given the high share of gas in national energy production (~80%) the pipeline vandalization which drove a 27% decrease in gas supply (January to April 2016) underpinned a corresponding decrease (24%) in power generation to 2,466MW over the period. In addition to the costs of repair (₦120 million), the electricity outages triggered factory downtime across the manufacturing sector and resulted in increased substitution with more expensive energy sources. Following the unabated pace of attacks on gas pipelines running overland from the Niger Delta, Dangote group commenced preparations on a ₦500 billion subsea gas pipeline which will take off in 2018. The gas pipeline which would start in Bonny Rivers and through Olokola and Lekki before linking up with the West African Gas pipeline should help reduce the risk of gas pipeline vandalism to power distribution on completion. On its part, the FG is seeking to diversify power away from gas fired-plants towards alternatives like Hydro power and solar plants. On the hydro front, the FG commenced work to increase capacity utilisation of the Shiroro hydro plant, which currently runs at 50% of its available 600MW capacity, by upgrading and repairing existing infrastructures. On the other hand, the Ministry of Power, through the Nigerian Bulk Electricity Trading (NBET), signed 12 PPA agreements for 14 solar power plants which would collectively add 975-1150MW to the electricity grid. Though both investments are set to be private sector driven, we remain sceptical on timely consummation given challenges around collection of energy charge by the Discos. According to the Minister of Power, due to low remittances by the Discos, the bulk trader owes Gencos over ₦140 billion. Thus the difficulty in collection should temper private sector optimism about increased investment across the power value chain.

REVENUE SLIPPAGES DEEPEN FISCAL CONUNDRUM

Budget passed after political impasse

After months of legislative and executive wrangling on the 2016 budget, President Buhari assented to it in May 2016. The budget which proposes fiscal spending of ₦6.06 trillion (+21% YoY) is slightly lower than the version submitted to parliament in December (₦6.07 trillion) due to minor revisions to capital spending (-1% from prior). On the revenue side, the National Assembly made no changes to projections for oil (of \$38/bbl for oil prices and 2.2mbpd for production) and non-oil receipts which kept FGN retained revenues at ₦3.85trillion (+35% YoY). Consequently, the expansionary FGN budget deficit is largely unchanged at ₦2.2trillion (2.14% of GDP) and is still to be primarily (~80%) financed via borrowing, split almost equally between the domestic credit market and foreign, as well as proceeds from misappropriated funds (16%).

Nigeria's revenue shy of budget estimates by wide margin

The concern we raised in our H1 16 strategy report that revenue projections, particularly for non-oil, appear optimistic in light of current realities have materialised, with actual receipts in Q1 16 significantly below budget targets. Specifically, federally collected revenue which dipped to a 30 quarter low of ₦1.3 trillion (-40% YoY) in first quarter of 2016 is ~35% below projections, with underperformance of non-oil receipts the bigger driver. Non-oil receipts fell ~40% short of projection to ₦602 billion (-28% YoY) due to lower than estimated VAT, corporate taxes and custom duties. However, given that these components were largely flat YoY, the shortfalls were indeed symptomatic of the aggressive assumptions.

That said, oil receipts also fell shy of estimates (-24%) as average oil prices (\$35/bbl) and output (2.1mbpd) were both ~8% below estimate. While the dip in oil prices continues to reflect the pressure from lifting of Iranian nuclear sanctions in January, lower output was due to the closure of Forcados export terminal following vandalism that resulted in deferral

of nearly 380kb/d of oil export. Indeed, following the closure, oil output dropped to 1.9mbpd in March

2016, the lowest level since April 2009 when pipeline attacks were also elevated).

Table 4: Q1 2016 federally collected revenue (₦ billion)

	Q1 16 Budget	Q1 16 Actual	Surplus/ (shortfall)	YoY
Oil production (mbpd)	2.2	2.0	-9.1%	-9.1%
Oil price (\$/bbl)	38.0	34.5	-9.2%	-37.4%
Oil and gas receipts	883.70	666.13	-24.6%	-44.1%
Deductions:				
JV cash calls	(273.58)	(157.11)	-42.6%	-86.8%
Others deductions				
Subsidy				
Net oil revenue	610.12	509.02	-16.6%	-48.4%
13% derivation	(79.32)	(66.17)	-16.6%	-47.6%
Oil to Federation Account	530.81	442.84	-16.6%	-47.6%
Non-oil receipt				
VAT	368.76	196.57	-46.7%	0.5%
Corporate taxes, CIT, Stamp duties	469.26	176.26	-62.4%	1.0%
Custom: Import, Excise & Fees	215.60	135.51	-37.1%	-1.9%
Special levies				
Cost of Collection	(48.61)	(24.40)	-49.8%	-0.4%
Non-oil to Federation Account	636.2	287.4	-54.8%	-2.9%
Total to Federation Account	1,167	730	-37.4%	-36.0%
VAT pool account	368.8	196.6	-46.7%	4.7%
Grand total	1,535.8	926.8	-39.7%	-30.3%

Source: Budget Office, MTEF (2016 – 2018), ARM Research

TSA implementation fails to bolster FG's dwindling revenue profile

As expected, the soft federally collected revenue filtered into the Federal government's retained revenue (₦500 billion in Q1 16), but it was the 90%

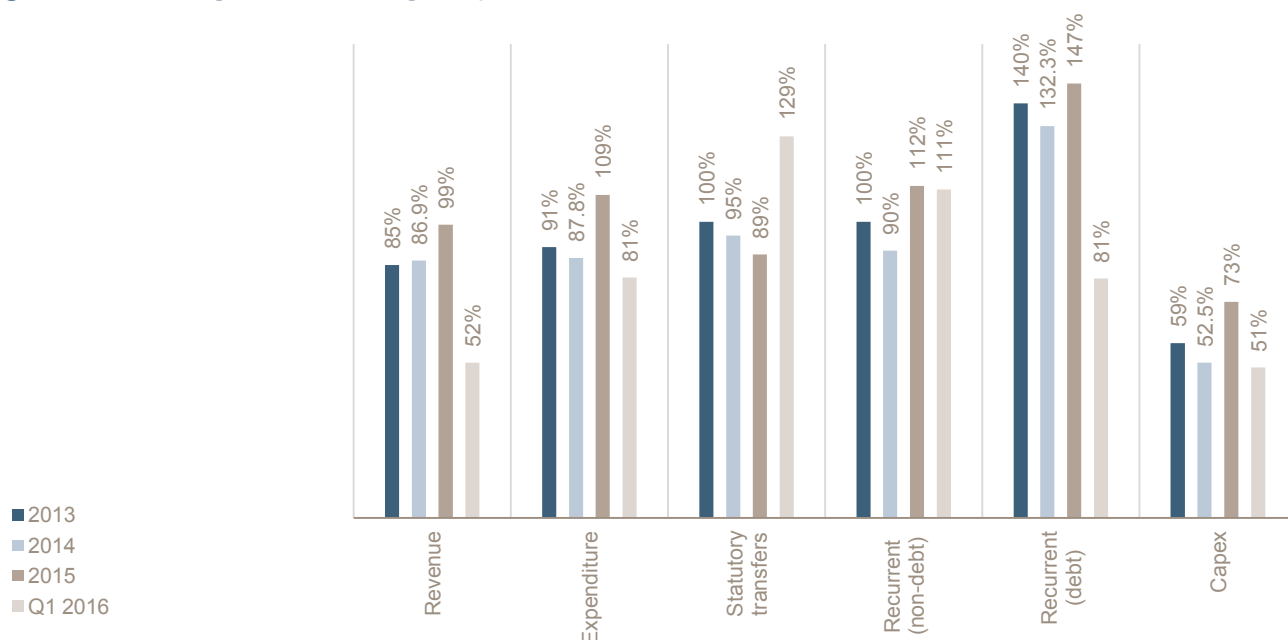
shortfall in FGN independent revenue—which is projected to account for 40% of FG revenue in 2016—that primarily underpinned the nearly 50% shortfall from FGN budget projections. Quite frankly, given implementation of the TSA late last year, we were a bit sanguine on the FG independent revenue

and thus assumed the 2016 targets were achievable despite implying a twofold increase relative to prior years. However, the Minister of finance noted that a huge portion of the ₦3 trillion in the TSA have existing commitments, like JV cash calls and FAAC, and thus not available for budget implementation.

Despite the weak fiscal receipts, the budget was 81% implemented in Q1 16 but, as in prior years, the skew was in favour of recurrent expenditure which

accounted for 91%. Reflecting higher-than-estimated non-debt recurrent spend, cumulative recurrent expenditure overshoot Q1 16 budget estimate by 18% while only half of the capex budget was implemented. Consequently, reflecting the revenue short fall, Q1 16 fiscal deficit came it at ₦725 billion—32% higher than projections or just at the 3% of GDP threshold when annualised—primarily financed with short and long-term borrowings of ₦450 billion.

Figure 30: Federal government budget implementation



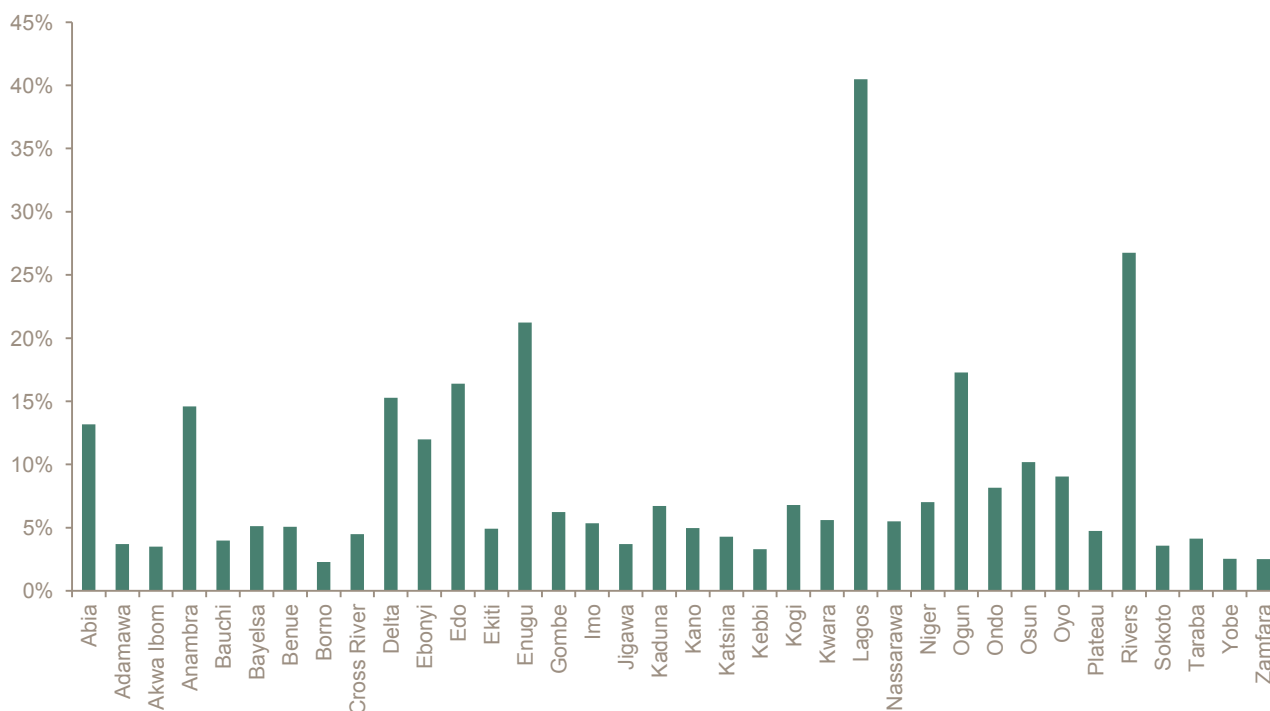
Source: Budget Office, CBN, MTEF (2016 – 2018), ARM Research

Sub-national governments wallow in financial distress

For state governments, the lower receipt cuts Q1 2016 federal allocation by 34% to ₦380 billion which, annualised, is 26% of cumulative state government budget for 2016 and covers only 60% of recurrent expenditure for the year. Unsurprisingly, the fallout of the revenue shortfall was another bout of salary

backlog that resulted in strike actions in certain states. The bad shape of state governments’ finances highlights their over-reliance on the central purse for budget implementation which is reflective of poor internally generated revenue. On the latter, using 2015 IGR numbers, we find only 11 states of the 36 states of the Federation with IGR of 10% of 2016 budget.

Figure 31: IGR to 2016 expenditure ratio for subnational government



Source: OAGF, ARM Research

FG looks to instil fiscal discipline with conditional bailout

The dire fiscal position of state governments forced the FG to announce additional ₦90 billion bailout programme for states, just months after the ₦300 billion salary bailout. However, unlike the prior bailout, the FG attached 22 conditions targeted at reforming public financial management at state government level over the next year. The conditions which are contained in the Fiscal Sustainability Plan for Sub-National Governments in Nigeria border on promoting accountability & transparency, managing cost, increasing public revenue and facilitating sustainable debt management.

Amongst other things, states that access the bailout will be required to publish audited annual financials and quarterly budget implementation report. In addition, such states are required to implement versions of some of the on-going reforms at the Federal level, including the Treasury Single Account (TSA), biometric capture of personnel to eliminate

payroll fraud, creation of efficiency units and domestication of Fiscal Responsibility Act (FRA). Furthermore, states that access the facility will be barred from obtaining commercial loans and are required to set realistic and achievable targets to improve internally generated revenue as well as certain ratio of capital to recurrent expenditure. The Federal Government will encourage States to access funds from the capital markets for bankable projects and issue “Fast-track Municipal bond” guidelines to support smaller issuances and shorter tenures. The biggest plus we see is the potential to develop a municipal bond market as state governments will now have to attain and maintain credit ratings. Already, revenue pressures are forcing states to implement these reforms, with more than 6 States already with TSA and over 10,000 ghost workers taken off payrolls of states. Assuming average wage bill of ₦30,000, that number translates to payroll expenditure savings in excess of almost ₦4 billion annually.

Fiscal pressures to persist across tiers of government

Over the rest of 2016, we expect revenue pressures to persist despite the upside from the depreciation in currency. On the oil front, despite the nearly 80% recovery from the 13-year trough of late January 2016, prospects for widening global surplus leaves our H2 16 target (\$35 - \$40/bbl) around the budget benchmark (\$38/bbl). For output, the spate of attacks on multiple oil installations suggest outages elsewhere will trump expected recovery in volumes on completion of the Trans Forcados slated for July 2016. The foregoing should level oil output below target. Notwithstanding the pressure on both sides of the oil equation, adjusting for potential increase in naira inflow could push 2016 oil receipts to ₦1.9 trillion—about 11% above budget estimate. Similarly, we think each major component of non-oil receipts—VAT, CIT and Customs—will continue to underperform target over the rest of the year. Specifically, shrinking disposable income as a result of high inflation should translate to broadly weak corporate sales and ultimately earnings. This prognosis suggests that shortfall of VAT and tax receipts will continue to underperform, particularly as the value from widening the tax net might be minimal under current macroeconomic headwinds. For customs, the contraction in import bill (-30% YoY) year till April due to depreciation of the naira and dollar illiquidity should extend over the rest of the year and ultimately keep custom duties soft. Overall, we have cut our prior estimates for non-oil receipts to 60% of projections (₦2.5 trillion) from 70% previously, which combined with oil receipts should cumulate to federally collected revenue of ₦4.02 trillion for 2016 (40% lower than budget projections).

FG to post record deficit on full implemented budget

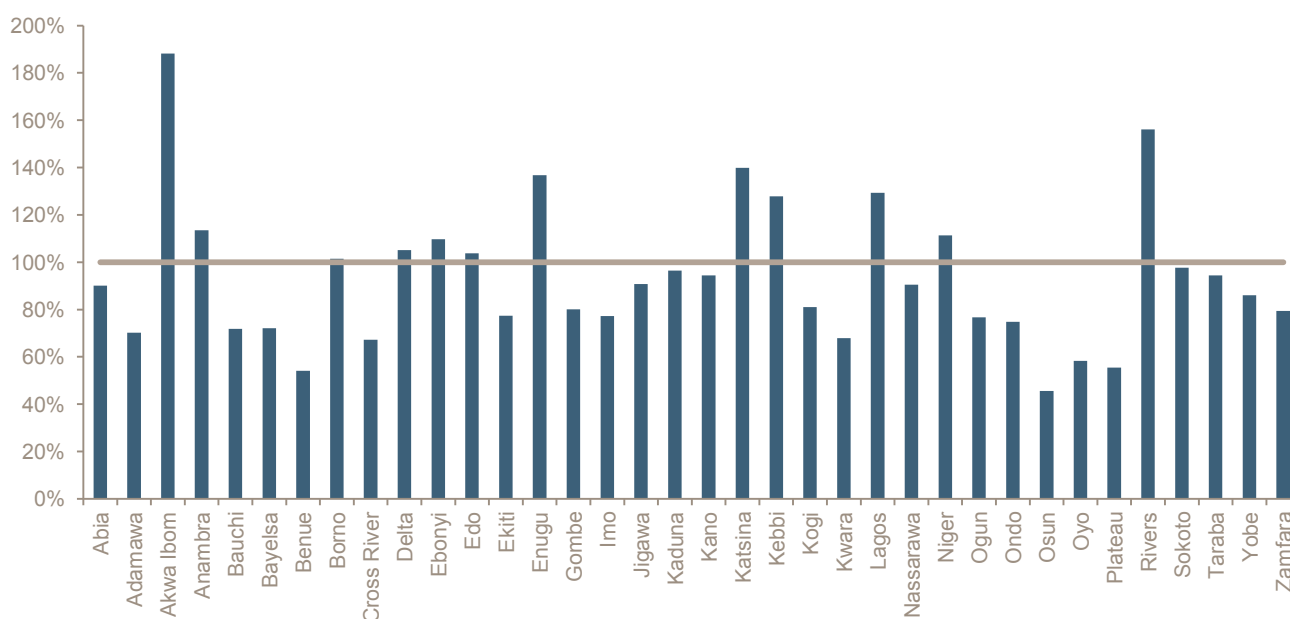
For FG independent revenue which was 90% shy of Q1 16 estimate, we have cut 2016 projection by half to a still optimistic—in view of actual receipts in the three preceding years—₦750 billion. As a consequence, we now expect fiscal deficit of ₦3.4 billion on a fully implemented budget (vs. ₦2.8 trillion earlier). Given that fiscal deficit to GDP is in excess of 3% recommended in the FRA 2007, our prognosis implies that the 2016 budget is unlikely to be fully implemented, with the discretionary capex spend aimed at reflating the economy likely to get the short end of the stick. Furthermore, the fact that the FG's revenue projection is only 60% of recurrent expenditure implies an extension of the practice in which sizeable portion of the 2016 borrowing will be for consumption. Regarding funding sources, though the domestic leg is running 9% ahead of offer, we see scope for quicker ramp-up as the FG desperately aims to deliver on campaign promises. On the external leg, we see modest possibility for sizeable inflow as global uncertainty around Brexit continues to stoke risk aversion to emerging markets.

The position is much worse for state government where, using FAAC and 2015 IGR estimate, we find only 10 states able to meet recurrent expenditure as per 2016 budget, potentially leaving nearly ₦2.5 trillion in capital projects unimplemented. Overlaying with potential funding challenges at the FG and sub-national level, Nigeria stands to miss potentially ₦3.5 trillion in capital expenditure for 2016, a development likely to worsen aggregate demand expenditure and ultimately output growth.

Table 5: 2016 federation revenue budget vs ARM estimate

	2016B	2016E
Oil production (mbpd)	2.2	1.9
Oil price (\$/bbl)	38	38
Oil and gas receipts	3,534.8	4,204.4
<i>Deductions</i>		
JV cash calls	1,094.3	1,378.8
Others deductions	740.2	932.7
<i>Subsidy</i>		
Net oil revenue	1,700.3	1,892.9
13% derivation	221.0	246.1
To Federation account	1,479.2	1,646.8
Non-oil		
VAT	1,475.0	885.02
Corporate taxes, CIT, Stamp duties	1,877.0	1,126.21
Custom: Import, Excise & Fees	862.4	517.45
Special levies	-	
<i>Deductions</i>	198.1	118.9
To Federation account	4,016.4	2,409.8
Federation account	5,495.6	3,171.6
VAT pool account	1,416.0	849.6
FGN		
FAAC	2,274.7	1,323.4
FG Independent revenue	1,505.9	903.53
Others	75.17	75.17
FGN retained	3,855.7	2,302.1
FGN expenditure	6,077.7	6,060.7
Fiscal deficit	(2,221.9)	(3,758.5)

Source: Budget Office, MTEF (2016 – 2018), ARM Research

Figure 32: Ability of state governments to meet 2016 budget recurrent expenditure

Source: Budget office, Ministry of Finance, ARM Research

FRESH REGULATORY INITIATIVES HOLD LITTLE PROMISE

PENCOM drums up new tack for informal market penetration...

The revised Pension Reform Act (2014) now permits self-employed persons and organisations with less than three employees to participate in the Contributory Pension Scheme (CPS). Given that nearly 70% of the 9 million formal market already have a pension account, it appears that the uncovered segment of Nigeria's 68 million working population is largely in the informal market where most workers have widely dispersed and irregular income streams. In a bid to penetrate the space, the National Pension Commission (PENCOM) is set to introduce the Micro Pension Plan (MPP) by the end of 2016. According to PENCOM, the MPP is a customized financial programme for the provision of pension services to employees in the informal market. Without giving further details, the commission explained that the scheme would be structured to encourage small, regular and sustainable savings by low income earners and estimates that successful implementation should triple CPS clients to 20.4 million (~30% of working

population) by 2020.

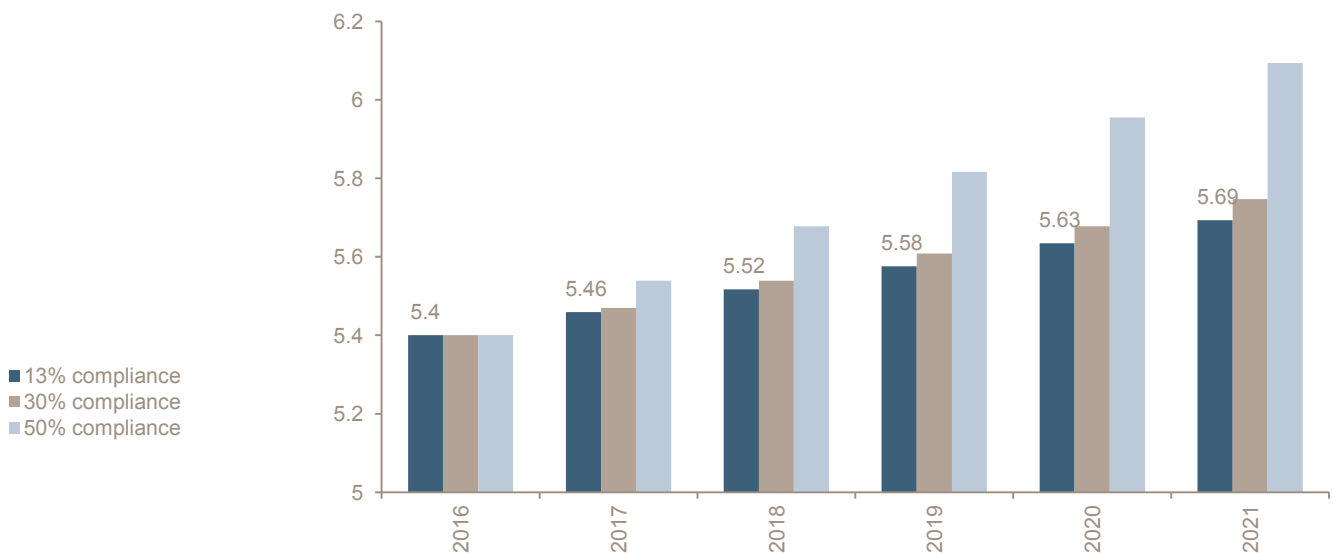
...amid dreams of significant growth in client base

Indeed MPP is not a novel concept having already been implemented in countries like Kenya and Ghana, albeit with limited success. In June 2011, the Kenyan Retirements Benefit Authority launched an innovative programme for extending pensions and savings scheme coverage to the informal sector in Kenya: the Mbao pensions plan. The Mbao plan is a voluntary individual savings account or pension plan where low income workers can make small contributions at flexible intervals of their choosing. In its first year of implementation, the Mbao had 38,000 members who had contributed KES37 million (USD 513, 054) or 6.5% of total pension fund assets. However, despite further increase in number of contributors to 67,000 (up 76% from 2011) as at 2015, the Mbao only boasts 6% of Kenya's informally employed population. Even close neighbours—Ghana—targeted only a modest 5% penetration of its 10 million informal market for the first five years of micro pension implementation. By contrast, PENCOM's expectation of securing 30% of working population by 2020 (or 20.4 million of working

population) would imply significant inroads into the informal space (i.e. 27% of the 53 million workers in the informal space). Indeed, aside the signals from other climes that expectations may need to be tempered, current domestic realities suggest that this target may be difficult to attain even in the medium term. To start off, in line with MPP implementations in other terrains such as Kenya and Ghana, PENCOM is suggesting the use of mobile phone applications for micro pension products transactions. Whilst this strategy appears plausible on the basis of Nigeria’s high mobile penetration of ~83%, Efina surveys suggest that knowledge of the availability and use of mobile transaction options—a key contributor to micro pension implementation in other developing climes—is still significantly low amongst Nigeria’s informal population. Precisely, only 13% of Nigeria’s adult population (or 11.9 million) are aware of mobile transaction options. We believe this ‘aware’ segment likely also includes 6 million formal sector workers already under pension coverage. Thus, optimistically

assuming the balance figure constitutes only informal workers, realistic target market via mobile technology narrows to only 5.9 million—and this is without adjusting for 12.1% unemployment rate. Thus, using a working definition for the target market as part of the poorest 53 million earners in Nigeria with combined annual income of ₦6.7 trillion, we estimate a mere ₦59 billion addition to pension asset by 2020 assuming an 8% monthly pensions savings. Even then, PENCOM’s plan to adapt the mobile strategy would still require significant investments in raising the level of awareness and conviction of the informal populace before this target can be meaningfully penetrated, given the voluntary nature of micro pension schemes. Thus, given typically low and irregular nature of micro pension contributions, the extra cost burden imposed by the need for aggressive informal market education is likely to substantially compress margins for potential players in the segment in the near term.

Figure 33: Forecasted impact of micro pension on total pension fund asset (N’ trillion)



Source: PENCOM, ARM Research

Asset re-allocation in the offing as PFAs maintain safety plays

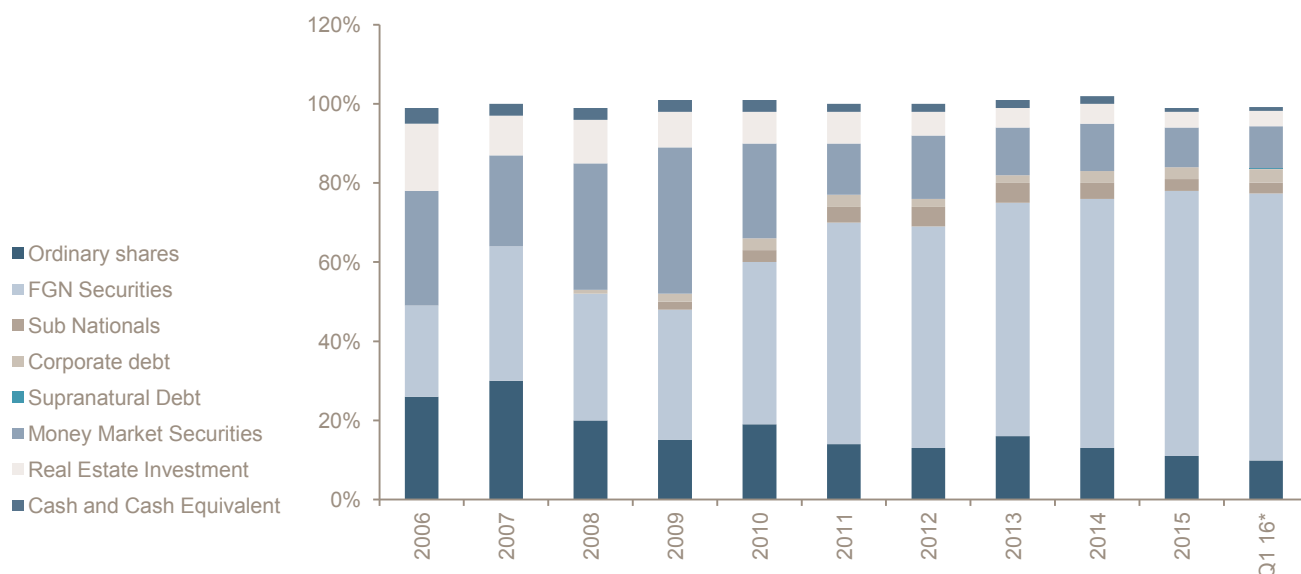
Despite concerns over impact of rising unemployment rates, in Q1 16, RSA registration maintained an 8% YoY growth for the seventh

consecutive quarter (vs. 2% growth in number of employed Nigerians). This largely reflects increased pension penetration following PENCOM’s continued application of stiff penalties on errant eligible employers which coerced more businesses into compliance. Notably, the commission had issued

2,762 compliance certificates by 2015 (relative to 2,178 and 1,163 in 2014 and 2013 respectively). Corresponding with the registration growth, size of overall pension assets sustained its growth trajectory in Q1 16 (+15% YoY to ₦5.4 trillion) as expansion in Fixed Income (FI) instruments (+19% YoY to ₦4.6 trillion) muted declines in Variable Income (VI) securities (-8% YoY to ₦538 billion). Specifically, FGN securities (bonds and treasury bills) rose 17% YoY to ₦3.7 trillion over the period due to higher bond purchases in the period (Q1 16 FGN securities

weight: +1.3pps YoY to 67%; +1ppt QoQ). Similar to prior periods, higher bond purchase reflects impact of delayed adoption of IFRS standard, which has seen PFAs carry bond portfolios at amortized cost instead of marking to market. This has helped taper volatility of overall asset value and beyond its investment characteristics, the relative stability bonds provide to fund prices also underpins why the class is so favoured by PFAs (over 66% of total portfolio in the past 3 years).

Figure 34: PFA Asset Allocation



Source: PENCOR, ARM Research

On other fronts, infrastructure allocation remained at a low 0.02% of total pension assets over Q1 16. However, PFAs are expected to re-direct fresh investments to infrastructure once the multi-tier structure is finally approved. According to the draft guideline, PFAs are mandated to invest a minimum of 5% of fund I and II portfolios in infrastructure with maximum allowable allocations set at 10% and 5% for funds I and II respectively. However, the draft guideline did not provide for allowable infrastructure allocations thresholds for funds III and IV, both of which will be heavily weighted towards investments in corporate and government securities. Whilst PFAs will have leeway to direct portions of these funds (III & IV) to corporate and FGN/CBN securities which the

FGN could target at infrastructure, current realities suggest that this is unlikely to translate to meaningful infrastructural investments in the near term. Specifically, inflows from FGN issuances in Nigeria are primarily directed at financing government recurrent expenditure, with the FGN recently guiding to a continuation of this trend due to the collapse of oil revenues. In addition to this, assuming no pension contributor opts for fund I due to its relatively higher risk, fund II will be left as the only potential outlet for flow of pension funds to infrastructure. Going by the recent classification of overall pension fund portfolio, Fund II closely approximates the RSA active—which currently houses 67% of total pension fund portfolio (₦3.618 trillion)—in terms of risk profile of clients in

the bucket. Thus, taking fund II as a replacement for RSA active, adoption of the multi-tier structure would translate to fresh ₦181.9 billion of new PFA investment in infrastructure. However, with Nigeria needing to raise ₦485 trillion in the next 30 years (or over ₦16 trillion annually) to plug her infrastructure gap, potential inflows from fund II would clearly

amount to a trickle relative to set infrastructure investment targets. That said, to slightly quicken the pace of infrastructure ramp up, FGN could recalibrate utilization of funds accessed via funds III and IV – by reducing utilization for recurrent expenditure and increasing utilization for infrastructure investment.

Table 6: Multi-tier portfolio classification

	Fund 1	Fund 2	Fund 3	Fund 4
Fund definition	This fund is for contributors who choose more aggressive investments (possibly higher risk and higher rewards)	This fund category is for contributors aged 49 and below.	The fund type for contributors aged 50 and above.	This is for RSA retirees
Minimum allocation to infrastructure (%)	5%	5%	0%	0%
Maximum allocation to infrastructure (%)	10%	5%	0%	0%
% of total pension fund in our estimates	0%	67%	17%	6%
Potential addition to infrastructure investment (₦billion)	0	181.9		

Source: PENCOR, ARM Research

ECONOMIC REVIEW AND OUTLOOK

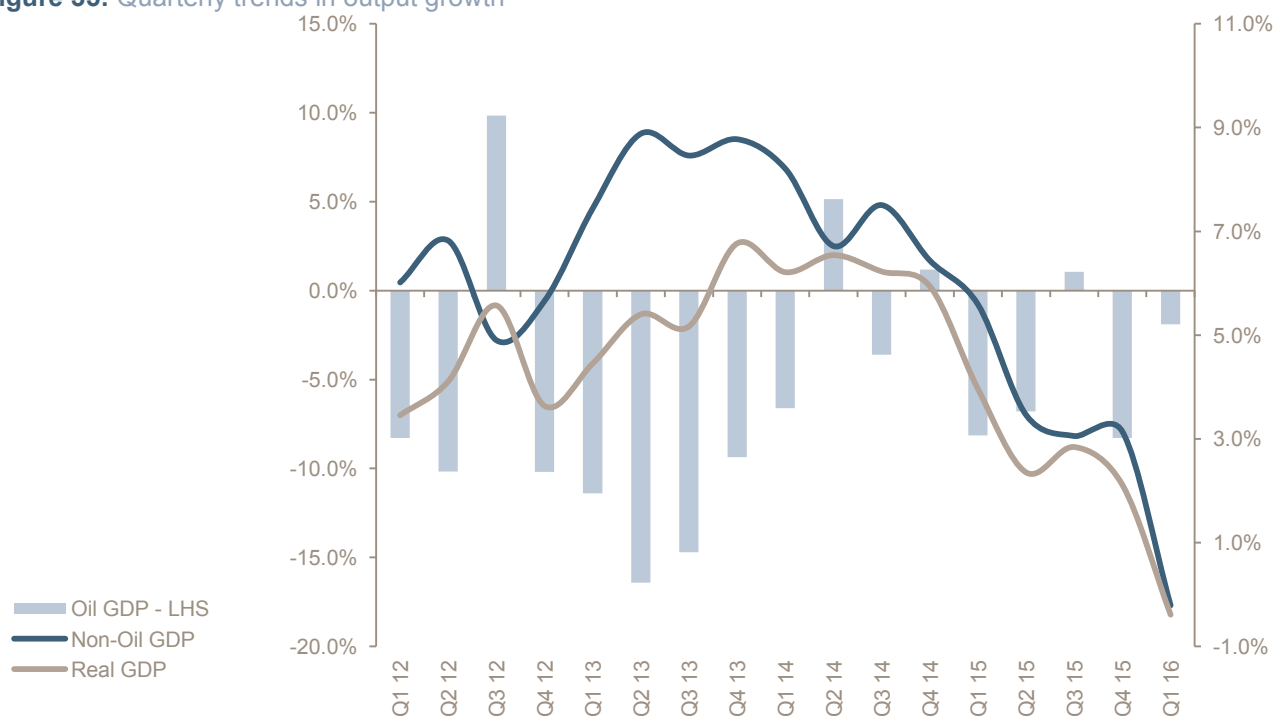
GDP SAILS INTO RECESSIONARY SHORES

Economic contraction sets in...

On the heels of the marked slowdown in economic activity in 2015, with annual real GDP expanding at its slowest pace since 1999, the macroeconomic climate deteriorated further in Q1 16 with the

National Bureau of Statistics (NBS) reporting that output contracted 0.36% YoY - a break from a 12-year positive streak. Dissecting the components, non-oil GDP swung negative (-0.21% YoY) while oil GDP extended negative reading into the second consecutive quarter with YoY shrinkage of 1.89% (Q4 15: -8.28% YoY).

Figure 35: Quarterly trends in output growth



Source: NBS, ARM Research

...as renewed attacks on oil installations weigh on oil GDP

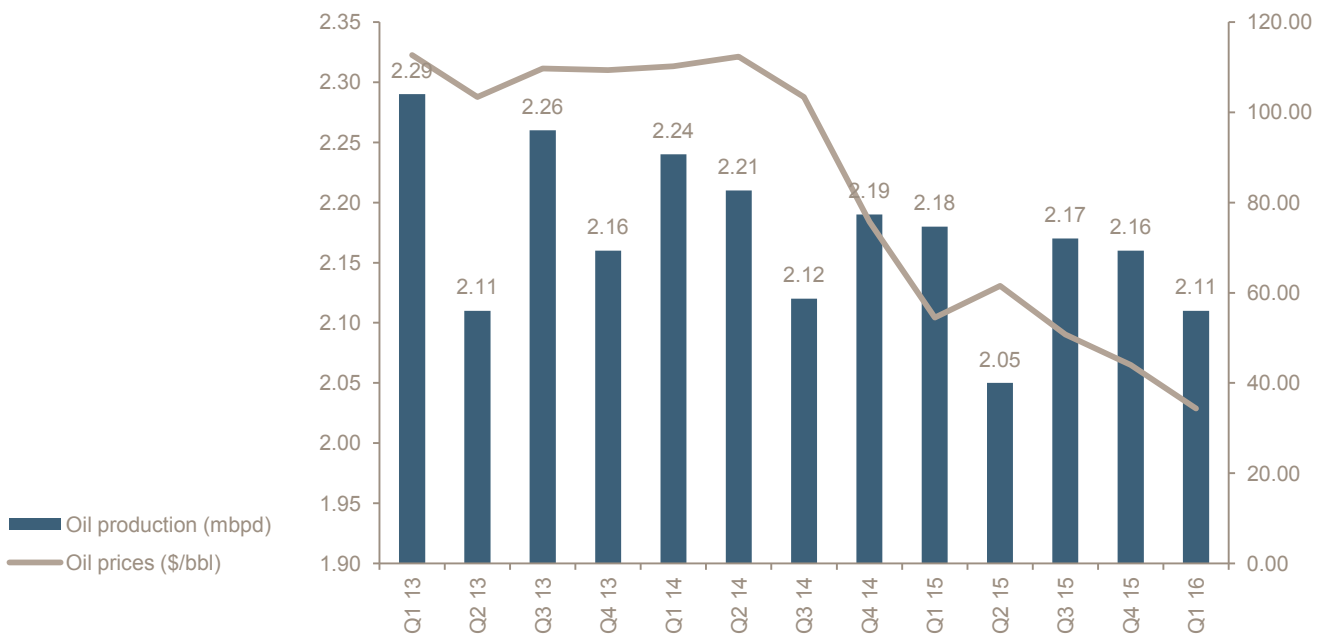
Though declines in oil prices set the stage for oil production to decline, as NNPC cut down on JV cash calls and marginal indigenous oil producers struggled to obtain financing for exploration, renewed militancy activity in the Niger Delta created fresh production headaches over Q1 16. Starting in February with the disruption along the 300kbpd Trans-Forcados pipeline, IOCs declared *force majeure* along Nembe Creek and Trans Niger pipelines during the period,

resulting in oil production declining 5.6% YoY to 2.04mbpd in Q1 16 (-6.3% QoQ). The disruptions did not end there, as in Q2 16 the emergence of a new group (Niger Delta Avengers), which also launched attacks on oil installations, led to further declines in oil production to as low as 1.4mbpd. Furthermore, sustained decline in crude oil prices, which already induced industry-wide cutbacks in oil exploratory activity, continued to weigh on domestic production. The impact of disruptions to oil production offset effect of the March 2016 on-streaming of the 40kbpd Aje oil field in Lagos. On the policy front, following

pushback from southern senators, the upper house of the National Assembly indefinitely suspended second reading on the first of the two bills related to the Petroleum Industry Governance Bill, successor to the PIB. The setback stems from omission of the

Host communities development fund in the PIGB – an item whose inclusion in the old PIB generated opposition from Northern senators and was one of the many thorny issues which delayed passage.

Figure 36: Oil prices and production

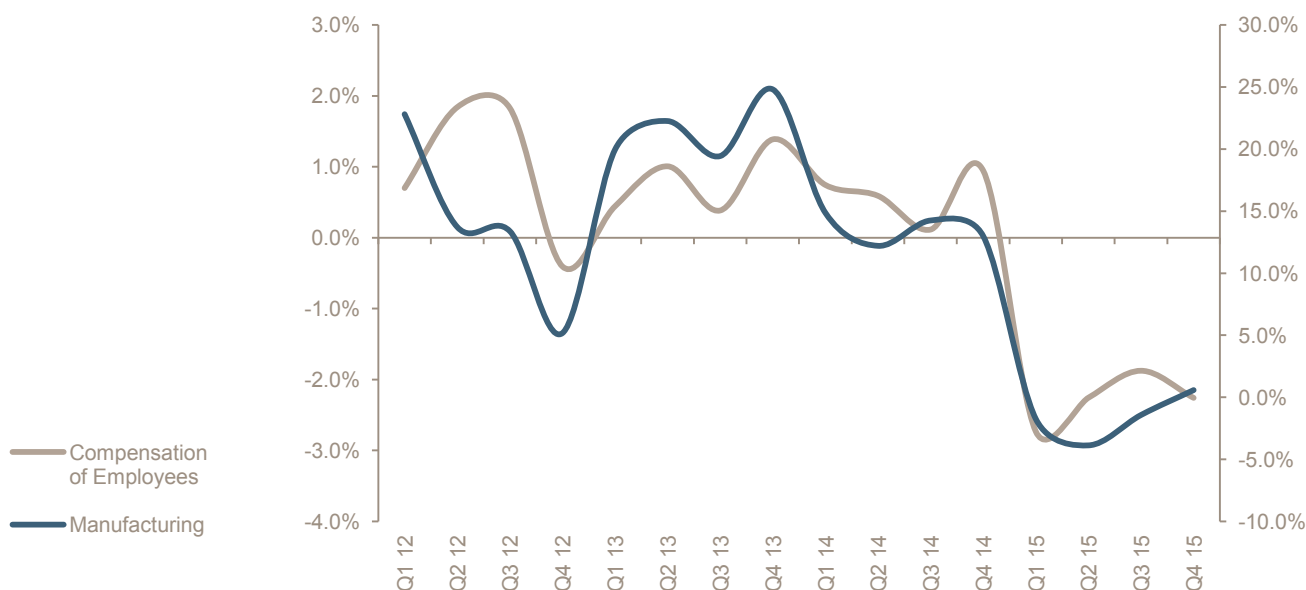


Source: NNPC, CBN, ARM Research

Negative real wage growth and FX challenges plague manufacturing GDP

On the non-oil front, scanning across sub-components reveals slowdown across services (Q1 16: -710bps to 0.2% YoY) and trade (-445bps to 2% YoY) and contraction in constructions (-5.4% YoY) and manufacturing GDP (-8.1% YoY) largely account for the negative non-oil reading. Manufacturing resumed the negative trend, which was bucked in Q4 15, by contracting 8.1% in Q1 16, as key segments:

Food, Beverage and Tobacco (FBT) and Textiles, Apparel and Footwear (TAF) declined 11% YoY and 3% YoY respectively. In line with our views, the renewed contraction in the real sector reflects impact of declining real wage growth, which turned negative in 2015 (-8.8% YoY), and difficulty associated with obtaining FX for imported raw materials during the period. Furthermore, following disruptions to gas pipelines and incessant bouts of fuel shortages over the period--a fall-out of the FX issues, higher factory downtime exacerbated manufacturing weakness.

Figure 37: YoY growth in employee compensation and manufacturing GDP

Source: NBS, ARM Research

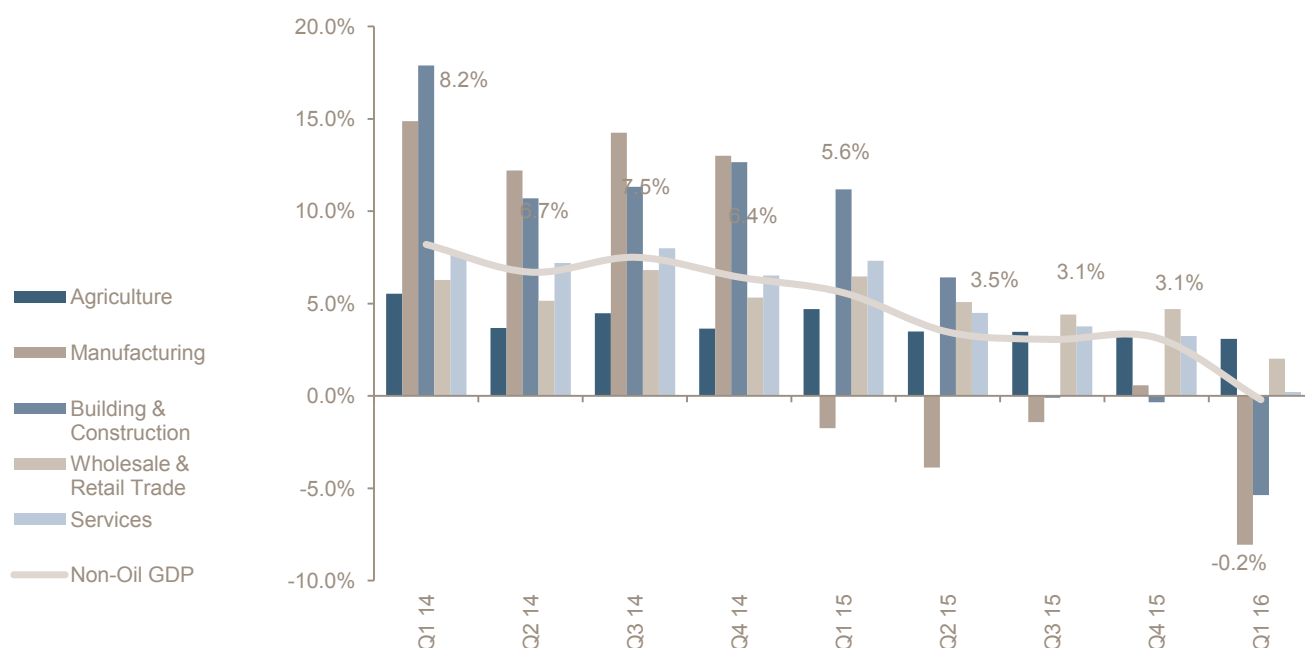
For building and construction, which is now in a three-quarter recession, slowdown in capital spending at Federal and State level, a fall-out of the dire fiscal straits, continues to visibly impact construction activity. For evidence, over the first five months of the year, FAAC allocations declined 29% YoY to ₦2.3 trillion even as the list of states failing to meet salary payments expanded, impacting construction budgets. Furthermore, squabbles between the FG and National Assembly, which led to delayed passage of the budget, dimmed private sector planning and mobilization for capital projects and adversely affected the sector.

Elsewhere, decline in Services GDP (Q1 16: 0.2% YoY) largely reflects slowdown in Telecommunications (-35bps to 5% YoY) and contraction in Real estate (-4.7% YoY)¹⁶ which jointly account for slightly over half of the sector output. Deceleration in the former continues to show cutback in subscriber growth following regulatory action on sector heavyweight (MTN) while emergence of

negative growth in the latter is largely explained by the slowdown in the luxury real estate market, a fall-out of the ongoing anti-corruption crusade, and supply overhang of office space in urban centres. The low take-up of new office space is a fall-out of the slowing economic activity which has resulted in companies reducing current scale of their operations and expansion plans. Compounding the picture was the negative reading in financial services (-13.2% YoY), the first since 2011, which reflects shrinking loan activity across banks as the slowing economic climate and mounting asset quality concerns drove moderation in credit risk appetite. Last, on agriculture, where growth slowed 160bps to 3.1% YoY from Q1 15, FEWSNET notes that the weak fiscal picture resulted in no subsidized fertilizer distributions under the Growth Enhancement Scheme (GES) in Q1 16 even as the reduced FAAC allocations weighed on state support for farming activities. In addition, disease outbreaks in poultry (*avian influenza*) and tomato (*tuta absoluta*) adversely impacted livestock and crop production respectively.

¹⁶First contraction in eighteen quarters

Figure 38: Trends in components of Non-oil GDP



Source: NBS, ARM Research

Oil worries, lagged fiscal stimulus and negative real wages point to three quarter recession

Given the negative Q1 16 GDP reading and developments during Q2 16 (the slide in crude oil production to multi-decade lows, energy shortages, constrained purchasing power etc.), the prospects of a recession being triggered by a consecutive quarterly contraction appear inevitable. Indeed, the question is how deep and long the recession might last. In framing our outlook for the second half of 2016, we examine developments across the various sectors and combine with insights from our output expenditure framework using updated data up till the end of 2015.

Starting off with oil GDP, while the rebound in oil prices raised prospects for improvement in sector outlook as oil field feasibility improves to the point of comfort for financing, the renewed unrest poses severe downside risks to oil production over H2 2016 and impairs exportability, neutering the impact of price gains. For evidence, leading indigenous producer SEPLAT reported sizable losses in Q1 16 from downtime on the Trans-Forcados. Furthermore,

the decision by the legislature to jettison debate on the proposed oil sector reform bills should continue to delay IOC investment decisions which dims medium term industry outlook. Overall, largely reflecting the delayed repairs to destroyed pipelines and continuing outages, oil GDP should remain stuck in negative territory over the second half of 2016.

On the non-oil side, while recent removal of FX restrictions—key constraints to foreign investors—raises scope for increased investment inflows to various sectors of the economy, subsisting dollar shortage and reservations over its lack of volatility should result in a wait-and-see approach for new private sector investments. For existing manufacturers, the lag in improving dollar accessibility should result in a delayed recovery even as companies try to get accustomed to naira volatility by using the new OTC futures market in planning input purchases. Furthermore, the ability of companies to pass-on the feed-through of the currency weakness to consumers in form of higher prices given contraction in real wages over 2015 (-8.8% YoY) is in doubt. Thus, we see scope for the recessionary trend to remain intact over the second half of 2016.

On the Services sector, whilst the successful negotiation of the hefty fine on MTN clarifies outlook for the company, increased regulatory scrutiny on subscriber registration and continuing sector maturity¹⁷ point to subdued growth for Telecommunications GDP going forward. For the finance sub-segment, the weak macroeconomic climate and heightened aversion to credit risk should continue to drive subdued loan growth across the banking industry. In a similar vein, mounting over-supply in office real estate space in urban centres¹⁸ and tempered demand at the luxury segment (as purchasing power remains weak and Buhari's anti-corruption crusade continues) leaves outlook for real estate GDP largely negative. In sum, weakness across the three segments¹⁹ point to flat growth in Services GDP over H2 16. For building and construction, commencement of construction activities post budget assent ought to drive improvement in sector fortunes from the recessionary trough. Nonetheless, challenges obtaining funding and lags associated with deploying Chinese concessionary funding temper the scale to which the fiscal capex injections could work. Furthermore, the dire fiscal straits at state level which limit execution of capital projects, and could potentially shave off ₦2 trillion using state capital budgets in 2015, exacerbates already weak sector outlook. Last, for agricultural production, the limited Federal and State support to cultivation activities points to average to below-average harvests over 2015/16 season.

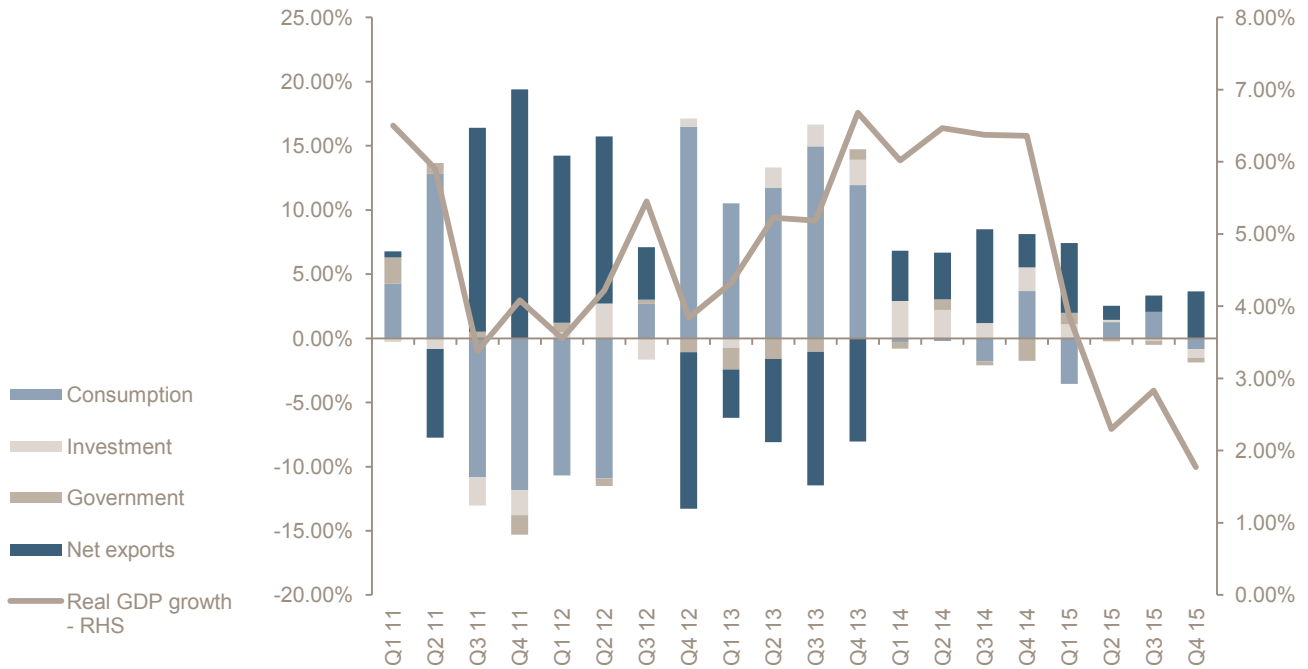
In all, most sectors across the economy should experience depressed growth over the rest of 2016. In applying the expenditure framework in arriving at our GDP forecasts, the negative real wage growth recorded over 2015, fresh shocks to purchasing power in 2016 (electricity tariff hikes, 67% increase in retail PMS price and 43% NGN devaluation) and salary delays at state level should result in negative growth in consumption expenditure over 2016. On the heels of the flat pattern in private investment expenditure over 2015, the delayed budget passage, uncertainty over currency and economic policy in general should result in muted private sector activity in H2 2016. Nonetheless, with much improved policy clarity (budget passage, naira floatation, PMS deregulation), private investment activity should recover, though not significantly, over H2 16. In a similar vein, while government spending should provide some injection into the economy, uncertainty over financing, delays and tempers scale of any stimulatory impact. Lastly, oil production headaches should leave net exports subdued over 2016. Incorporating the foregoing, we expect Nigeria to go into a two quarter recession with a potential for recovery in the last quarter as tangible repairs on damaged oil infrastructure boost oil production. Overall, the three negative quarters should result in 2016 real GDP growth averaging out in negative territory (2016E: -0.8% YoY +/- 50bps). Over the medium term, impact of the various policies changes, improving crude oil prices and rebound from a recessionary base in 2016 should spur stronger GDP growth in 2017.

¹⁷Teledensity as at March 2016 is 106%

¹⁸It is estimated that over 150,000sqm of lettable space is currently being produced for delivery within 6 to 24 months (North court Real estate)

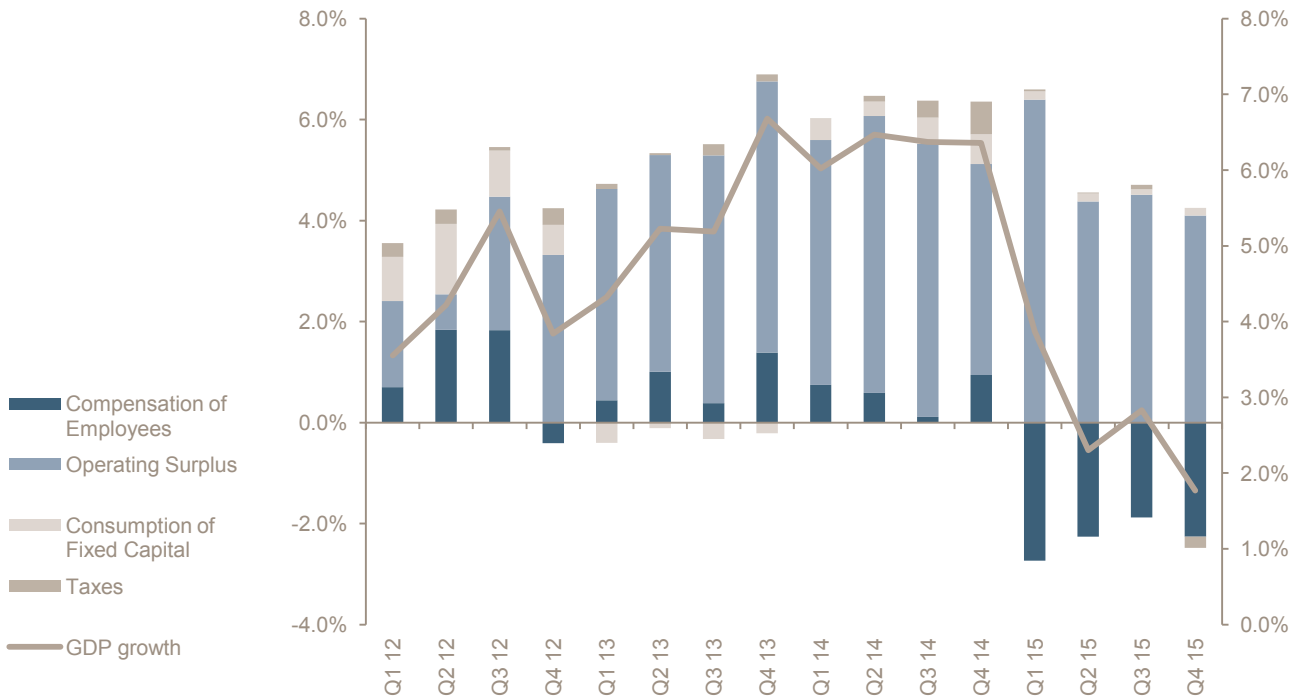
¹⁹Real estate, ICT and Finance account for 60% of Services GDP

Figure 39: Disaggregation of GDP growth by expenditure



Source: NBS, ARM Research

Figure 40: Disaggregation of GDP growth by income



Source: NBS, ARM Research

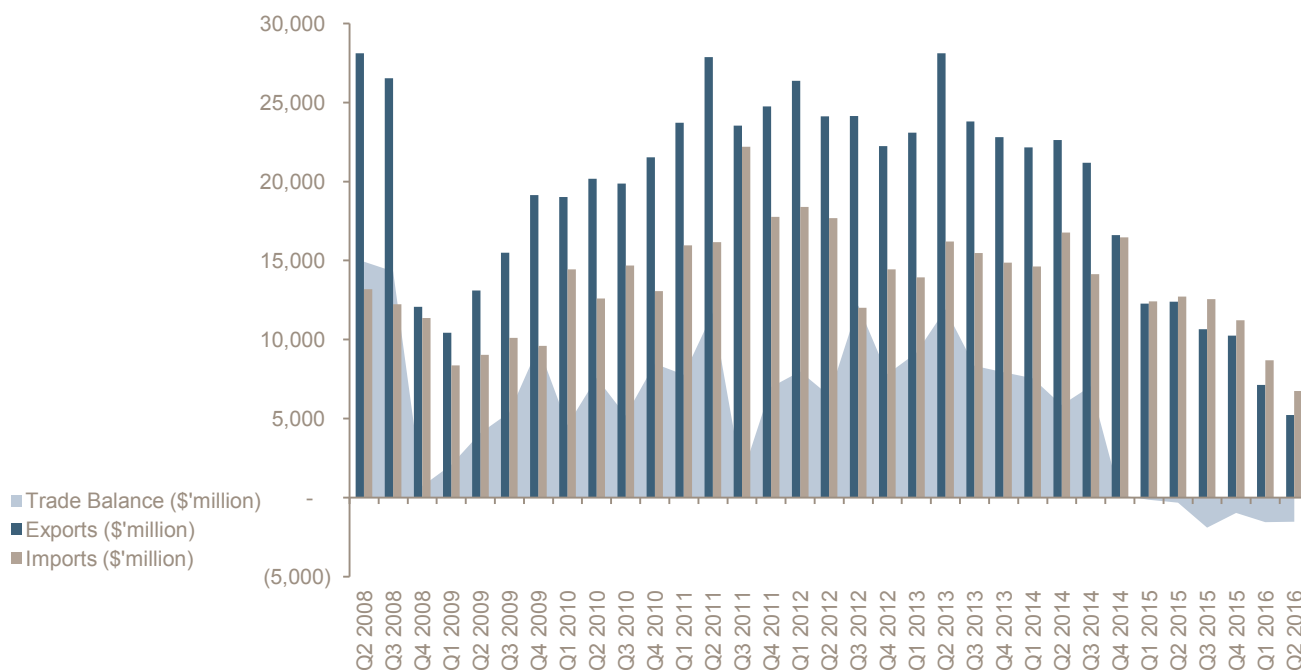
TRADE BALANCE: DEFICIT NEW NORMAL?

Oil export contraction continues to hurt balance of trade

Extending patterns observed since crude oil prices plunged in H2 14, Nigeria’s external trade balance continued to print in the red. Q1 16 data showed that a 42% YoY slide in exports, to \$7.1 billion, more than

offset impact of a 33% YoY contraction in imports to \$8.6 billion. Consequently, Q1 16 trade deficit more-than-doubled YoY (+60% QoQ) to \$1.6 billion (1.1% of GDP). The trend continued into Q2 16 with April and May data revealing that a 39% YoY cutback in exports to \$5.2billion outweighed the impact of an 11% YoY drop in imports to \$6.7 billion which points to sustained deterioration in trade balance.

Figure 41: External trade data

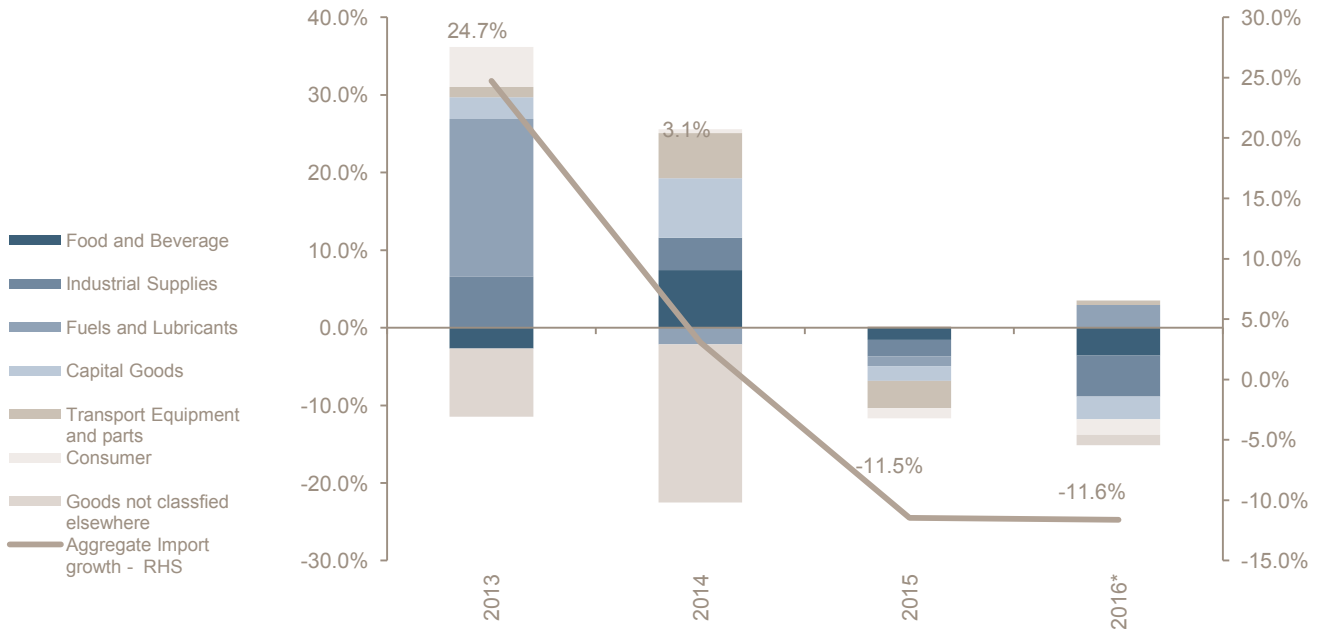


Source: CBN, ARM Research

Digging deeper, export weakness over Q1 16 reflects compression across all sub-components: Crude Oil exports (-41% YoY to \$5.4 billion), gas (-43% YoY to \$1.3 billion) and non-oil exports (-47.5 YoY to \$552 million). On Crude oil, though Brent Crude prices rose 6% through the period, lower mean prices (-36% lower YoY to \$35/b) and crude oil production during the period (-7% YoY to 2mbpd) largely account for weaker crude oil exports. Softer production is a fall-out of the renewed unrest across the Niger Delta with several attacks on oil and gas installations over the period.

On the import side, breakdowns provided by the National Bureau of Statistics (NBS) isolate contractions across oil imports (-57% YoY), manufacturing imports (-8.7% YoY), as well as vehicles, aircrafts and parts imports (-19% YoY). The slide in oil imports over Q1 16 reflects lower import costs and difficulty accessing forex for imports which led to several bouts of fuel shortages over the period and lower allocation to independent marketers. In a similar vein, difficulty and delays in sourcing dollars at the interbank window underpinned downtrend in non-oil imports.

Figure 42: Attribution analysis of import growth



Source: NBS, ARM Research * Q1 2016

Recovery in Iranian exports to Europe offset gains from rebounding US Bonny purchases

In our H1 16 NSR, we highlighted the potential adverse impact of the removal of western sanctions on Iran on Nigerian crude exports to Europe. Using data from NNPC in Q1 16, Nigerian global exports shrank 7% YoY (-9% QoQ) to 182million barrels as cutback in European imports more than offset a recovery in US purchases of Nigerian crude. Over the period, European purchases of Nigerian crude fell 33% YoY to 58.74million barrels. Moderation on this front reflects a recovery in Iranian shipments to about half of pre- 2012 sanction levels as Iran re-established dealings with European buyers, securing new sales arrangements with core international oil marketers – Vitol and Glencore, as well as Spanish and French energy giants, Repsol and Total respectively. However, it is pertinent to note that Iran exports remain below potential as continuing US restrictions, which prohibit trade in dollars to Iranian entities, has limited access to dollar funding for oil and tanker trades and constrained the ability of shippers to obtain ship insurance as the dollar restraint holds back U.S. reinsurers. The returning Iranian exports also wreaked havoc on Bonny-Light

sales to Africa with crude shipments to the continent halving YoY to 20.5million barrels as South Africa replaced crude imports from Saudi Arabia and Nigeria with Iranian imports, which was the norm prior to when sanctions were placed on Iran.

Though geographical constraints capped Iran’s reach across the Atlantic, South American purchases of Nigerian crude shrank 13% YoY to 13.7million barrels as a burgeoning economic crisis in Brazil slowed offtake of Bonny-Light (Nigeria accounts for slightly over half of Brazilian crude imports). Importantly, the corruption crisis engulfing state energy producer (Petrobras) continued to foreclose access to international debt markets which weighed down on its ability to raise financing for its operations. Consequently, Brazilian gasoline and diesel consumption both fell 6% YoY in Q1 16, bucking the 7% mean growth observed over the last decade.

On the other hand, driven by declining US rig counts and shrinking differentials between Bonny light and WTI (H1 16 average: -95% YoY to \$0.24/b), Nigerian crude exports to North America rose five-fold YoY to an eleven-quarter peak of 31.5million barrels. Furthermore, citing data on driving miles from the US

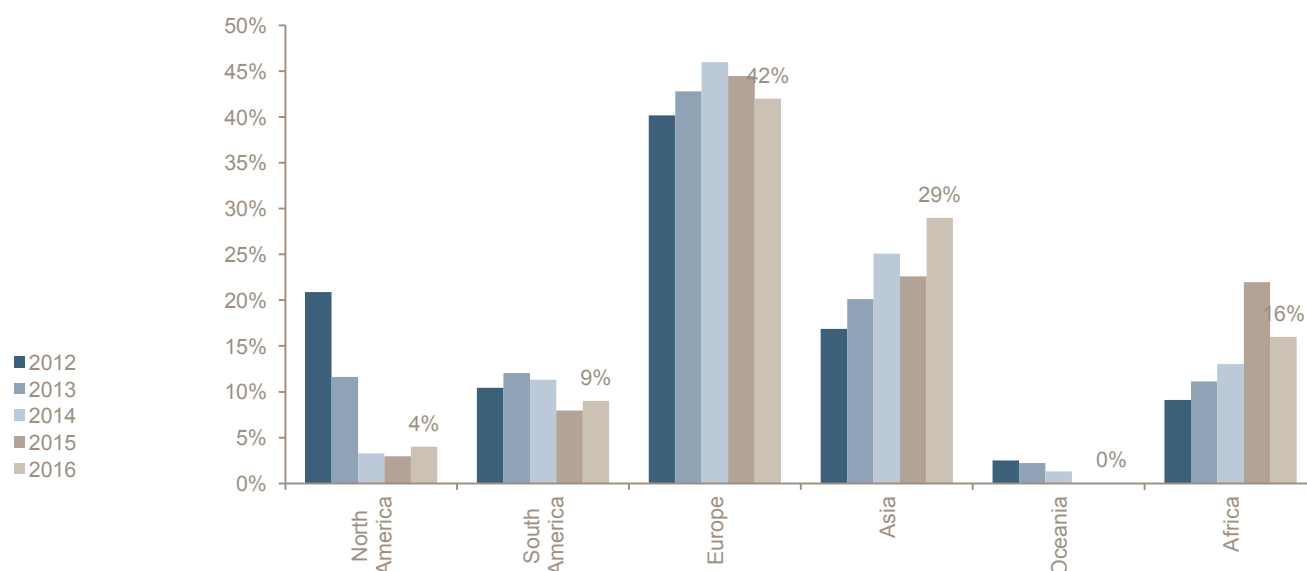
Federal Highway Administration, EIA reports that the low energy prices were inducing not only growth in US car miles (which hit a record in 2015) but also higher car purchases. The re-discovery of American appetite for Nigerian light-sweet crude drove a 4.5pps YoY (+1.4pps QoQ) rise in North American share of Nigerian exports to 7% in Q1 16.

Elsewhere, despite the return of Iranian crude exports to global markets, Asian purchases of Nigerian exports continued to rise (+30% YoY to 57.7million barrels). The development reflects the strength of Indian oil demand growth which rose 13% YoY to 4.24mbpd in Q1 16 including a record

4.33mbpd in March. The robust oil demand growth in India emanates from a shift in consumer preference towards gasoline vehicle, which has seen India's largest automakers (Maruti Suzuki and Hyundai) posting record sales and lower pump prices.

Overall, while production headaches created fresh worries over exports, underlying export volume weakness reflect our concerns over the implications of the return of Iranian oil to global crude markets which together with events in South America and Africa casts a cloud of uncertainty over already beleaguered export outlook for Nigeria over the rest of the year.

Figure 43: Breakdown of Nigeria's oil exports by region



Source: NNPC, ARM Research (2016-Q1)

Shocks to oil production to extend balance of trade deficit

Given the dominance of oil exports in total exports and, by extension, trade balance, developments around the oil industry remain central in charting outlook for the second half of 2016. First, beyond the militant attacks which create a ceiling on oil export potential, the threats of violence for attempts to repair damaged oil installations leaves a cloud of uncertainty over potential for recovery in crude oil production. For evidence, delayed repairs on Trans-Forcados pipeline has resulted in a one month

extension (till July) of the timeline for the removal of the existing *force majeure* even as repair-works on other platforms such as Qua Iboe continue at snail-speed due to the unclear security situation in the region. Furthermore, recent slew of attacks point to an extended negotiation period before unimpeded pipeline repairs can occur. Overall, production should remain at multi-year lows over the rest of 2016 which caps gains from any recovery in crude price on oil exports.

Across export regions, Iranian oil exports to Europe

and South Africa should continue to eat into Nigeria's exports to these regions, though the US restrictions should constrain the scale of Iran's ambitions. Elsewhere, increasing American driving should bolster off-take of Nigerian light sweet crude, though the recovery in crude prices which has resulted in an upturn in US rig counts could temper recent strength in exports to this region. In Asia, sustained strength in Indian consumption stemming from a growing manufacturing sector and strong automobile sales should remain supportive for Indian oil demand.

On the import leg, naira weakness and still depressed dollar liquidity point to greater domestic substitution towards locally sourced inputs which should extend negative import growth into the second half of 2016. In addition, the softer crude oil price should continue to drive lower refined petrol imports. Overall, outlook speaks to subdued imports over H2 2016.

Hence, on balance, we expect issues around oil production to continue to undermine crude exports which leave scope for trade deficit over 2016. Farther out, improving crude price outlook and completion of pipeline repairs should lead to a rebound in crude oil exports which together with progress on domestic crude oil refining should drive restoration in Nigeria's trade balance.

FLOATING NAIRA, HIDDEN DOLLAR

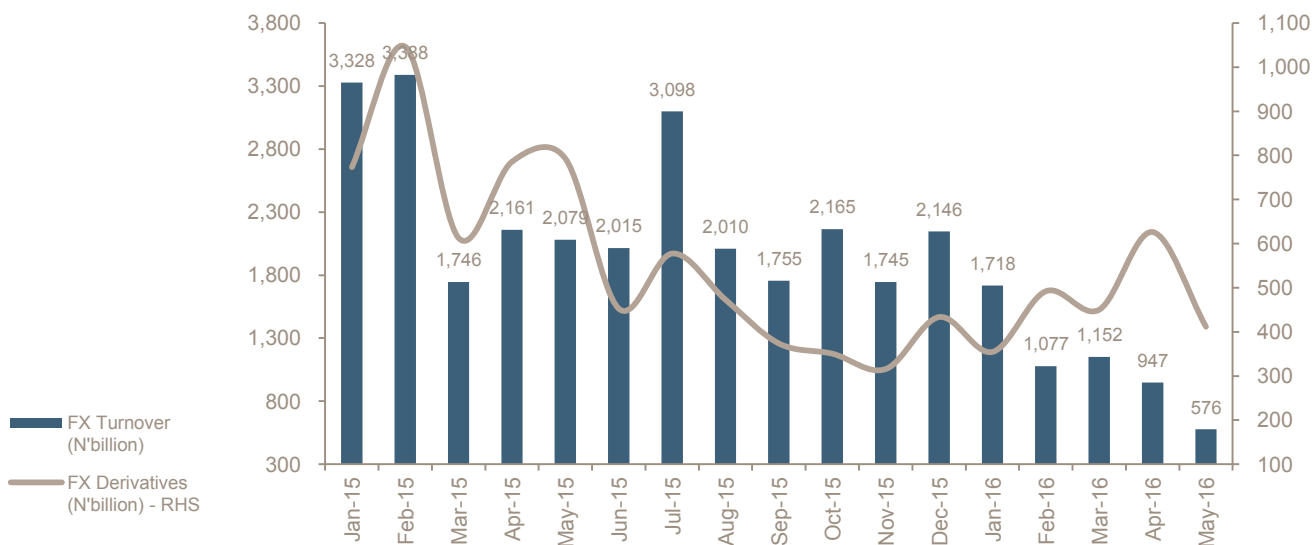
Authorities cave in to fundamental pressures on the naira

After resisting fundamental pressures to weaken the naira peg from ₦197/\$ for 16 months, the CBN

capitulated in the face of a deteriorating macro-economic picture with a 43% depreciation in the interbank exchange rate to ₦281.67/\$ in June 2016. In addition, the apex bank announced a shift to a floating interbank exchange rate market, purportedly surrendering its role as the explicit guarantor of the USD/NGN. The outcome broadly matches our view as outlined in the H1 2016 NSR, where we highlighted that the emergence of a current account deficit in 2015 and widening parallel market premiums would render the 'calm' at the interbank market temporary. Given our long-held concerns about CBN's monopoly over NGN determination (especially considering the larger size of autonomous inflows) the adverse impact of the prior naira inflexibility in the face of softening economic fundamentals was two-fold. First, it induced reluctance on the part of autonomous flows, which continued to exceed CBN inflows in 2016²⁰, to plug dollar shortfalls at the going misaligned USD/NGN rate. Hence, with this substantial flow 'hidden', FX market liquidity shrank with turnover sliding 53% YoY over the first five months of 2016 (See Figure 1). Second, the perception of a mispriced NGN resulted in speculative behaviour by economic agents to exploit the arbitrage window at the parallel market. The cumulative effect of the shrinking activity of autonomous flows in the interbank market and CBN's reduced dollar sales was in the spill over of unmet interbank dollar demand to the parallel market which resulted in a jump in average BDC premium over interbank (38pps QoQ to 59%) to the highest in over two decades.

²⁰ Using available CBN data over Jan-Feb 2016, autonomous inflows were 3x inflows to the CBN.

Figure 44: Interbank FX Market turnover



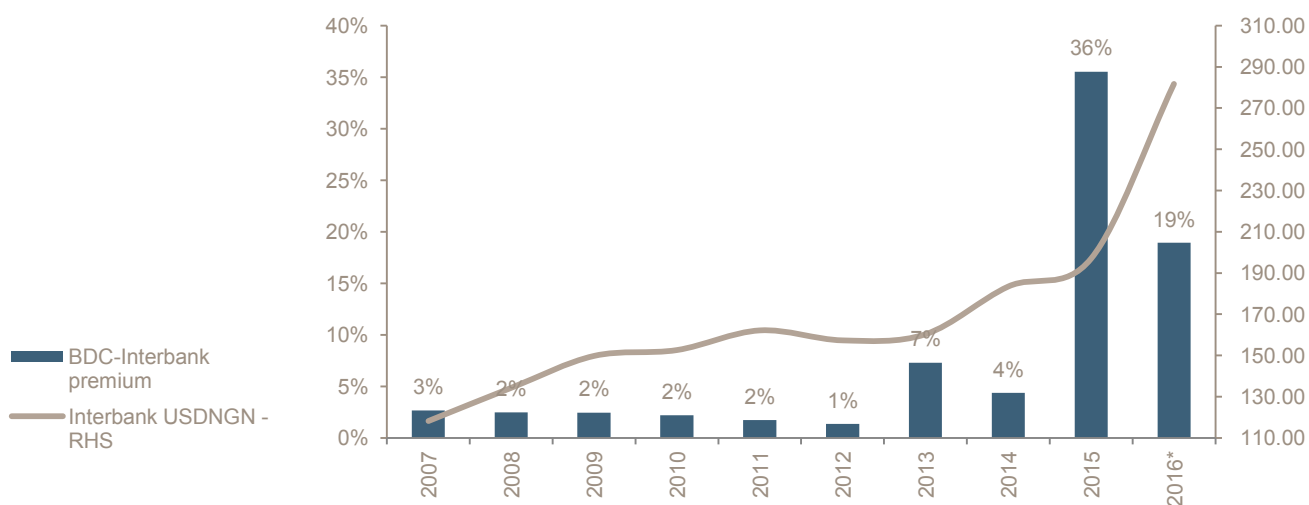
Source: FMDQ, ARM Research

Despite the gradual relegation of the interbank FX market in terms of relevance in the economy as market liquidity shrunk, the apex bank, backed by the Presidency, persisted with the inflexible stance on currency at the January and March 2016 MPC. It would take a combination of the forced deregulation of the downstream petroleum industry in early May (with an implicit devaluation of the naira to ₦285/\$) and a stream of economic indicators pointing to a recession, to force the hand of fiscal and monetary

policy makers to adjust their position on the currency. The *coup-de-grace* came in June when the apex bank announced the adoption of a flexible exchange rate policy with the USDNGN dropping 43% on the first day of trading²¹. Post the move to a floating regime, parallel market premiums shrank 59pps MoM to 19% at the end of June.

²¹ 20th June 2016

Figure 45: Trend in USDNGN



Source: CBN, AbokiFX, ARM Research * Jan-June

Naira moves into the realm of floating

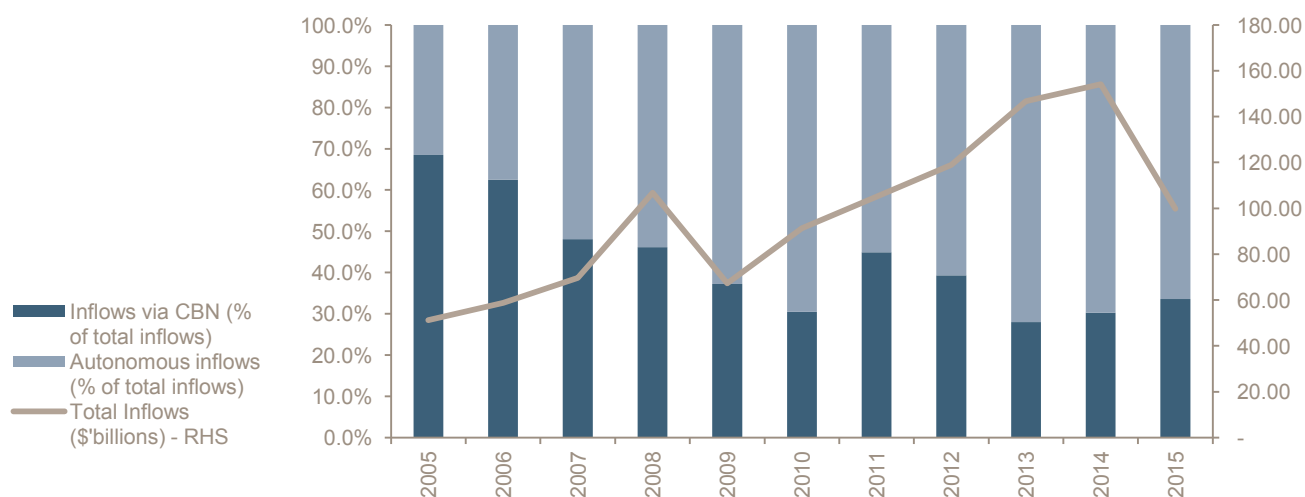
At the May MPC, the CBN governor had alluded to the establishment of a two-tier FX window with a full floating interbank market operating alongside a small window for critical transactions. In light of that, markets appeared surprised by the Governor’s announcement that naira would trade in a single autonomous interbank market (though we always felt this was the only viable solution). In this one-tier window, apex bank participation is restricted to either direct interventions via 2WQ in the interbank market or dynamic Secondary Market Intervention Mechanisms (SMIS) auctions. In both instances, there is to be no predetermined bid-offer spreads on CBN intervention funds and trade with market participants (authorized dealers, authorized buyers, oil companies, exporters, end-users etc.) would now be captured on the FMDQ Thomson-Reuters order matching system to ensure transparency. To improve price discovery, authorized dealers were instructed to display 2-way quotes in transactions with other authorized dealers but were also permitted to show one-way quotes in transactions with other market participants. In a step to improve FX market liquidity, the apex bank introduced FX primary dealers (defined as a sort of ‘market-maker’) for large trade sizes. Another addition to the FX market design was the establishment of a tenured futures market for the naira to reduce the need to front-load future dollar

demand at the spot market.

In our view, the creation of a unified FX market is in line with our consistent position, as this new framework would allow NGN determination to fully reflect the influence of autonomous inflows on the supply side while concurrently tackling the problem of speculative demand attracted to arbitrage windows occasioned by the existence of a two-tier naira rate. By solving the moral hazard problem emanating from undue focus on CBN’s ability to maintain the arbitrarily determined peg in the face of shocks to oil revenues, the new market architecture is a clear improvement from the past.

Furthermore, the new system allows the CBN to intelligently manage FX reserves by entering into the market to buy dollars during periods of increased FPI flows and supplying dollars to the market during periods of heightened volatility (vs. weekly). Importantly, CBN interventions would now carry the risk of loss for market participants which should curb appetite for speculative positions. Another positive from the floating framework is the move towards establishment of a liquid OTC futures market. This development is a natural fall-out as the naira moves from the low volatility era of a peg to uncertainty associated with floating system. However, the naira settled nature of the OTC futures casts doubts over its near term efficacy as maturity market participants are still facing dollar shortages.

Figure 46: USD Inflows to Nigerian economy



Source: CBN, ARM Research

But continued CBN interventions expose a flawed floating motive

Post the drop on the first day, the NGN remained largely static at ₦281/\$ despite the occurrence of events such as Brexit, which drove turmoil across global FX markets. The lack of volatility and continued CBN daily dollar sales, at an unchanged rate of ₦281/\$, which constituted a sizable share of market liquidity, gave the appearance that devaluation, and not a shift to a flexible regime, had occurred. The daily intervention at a fixed rate removed the risk of loss to speculators and suggested that the apex bank was unwilling to allow unwarranted currency depreciation - a development which runs counter to the intent to float. In electing to float vs a routine devaluation, the apex bank signalled that it would no longer be interested in controlling the going USD/NGN rate, however its actions over the rest of June suggested continued obsession with exchange rate determination. To our minds, reading the CBN moves through the impossible trilemma suggests that the apex bank could deploy tightening tools to raise returns for holding naira in a bid to attract FPI. Furthermore, the apex bank decisions are likely to have raised doubts for FPI, who are likely to adopt a wait-and-see approach. While this could yet change, as sliding reserve levels constrain CBN ability to continue interventions, the apex bank appears to have pulled defeat from the jaws of victory, as the move to retain control over FX markets post adoption of a flexible regime does further damage to its already battered credibility. Perhaps not surprising, the switch to a flexible FX regime has not resulted in any sizable gains to interbank dollar liquidity leading to continuing pressures at the parallel market²².

Near term fundamental picture speaks to soft NGN outlook

In framing our currency outlook, we examine developments in the BoP starting with the current account where, despite recent recovery in Brent crude in H1 16 (+33% YTD to \$48.8/b), mean prices

remain 24% lower YoY at \$40.3/b. Furthermore, renewed insurgency in the Niger Delta which has resulted in oil production plummeting 27% to two decade lows of 1.5mbpd should offset the feed-through from price gains to overall exports. Though imports shrank 26% over first four months to \$11.6 billion, and are likely to continue shrinking over H2 16 the scale of the production declines suggests BoT deficit²³ should remain over the rest of the year. Overlaying the potential negative trade balance with the historically deficit laden services account²⁴ (Q1 16: 2% of GDP, 2015: 3.3% of GDP), should result in Nigeria posting a CA deficit over H2 16 leaving the fundamental pressures on the NGN, from this side of payments, intact.

On the financial account, while the move to a flexible currency regime should have raised outlook for capital flows, as earlier stated, we think CBN's actions in the aftermath of the floatation of the FX market are likely to induce continued FPI reticence. More importantly, the increased prospect of recession should deter FPI flows from Nigeria till the economic climate improves. Overlaying the foregoing with fall-out from ongoing turmoil from the Brexit vote which should temper FPI flows into EM/FM, including Nigeria, the financial account is unlikely to provide any reprieve to CA deficit. Slightly tempering these concerns on the financial account is the currency swap deal between Nigeria and China signed in April 2016 which would see the PBoC provide yuan liquidity to CBN via its clearing bank (ICBC). Though details remain sketchy, the deal should result in both countries holding each other's currency in their foreign exchange reserves—the CBN already converted 10% of reserves to yuan in 2011—making it easy for importers to settle trades in their currencies without the need for the US dollar. Based on our estimates, we believe that, over the typical three-year period for such deals, Nigeria must receive at least about CN¥152 billion (₦4.66 trillion)—three times the average of imports from China over the last three years—for the deal to have significant impact on dollar demand pressures. Under this best case scenario that Chinese authorities provide notional principal in line with our estimates,

²² In between writing and publishing this report, the CBN eased up on the informal restrictions and allowed the FX market to trade at higher levels which resulted in NGN dropping to as low as ₦330/\$. Furthermore, the apex bank tightened monetary policy with a 200bps hike in MPR at the July MPC and issued OMO bills at rates between 16-18%.

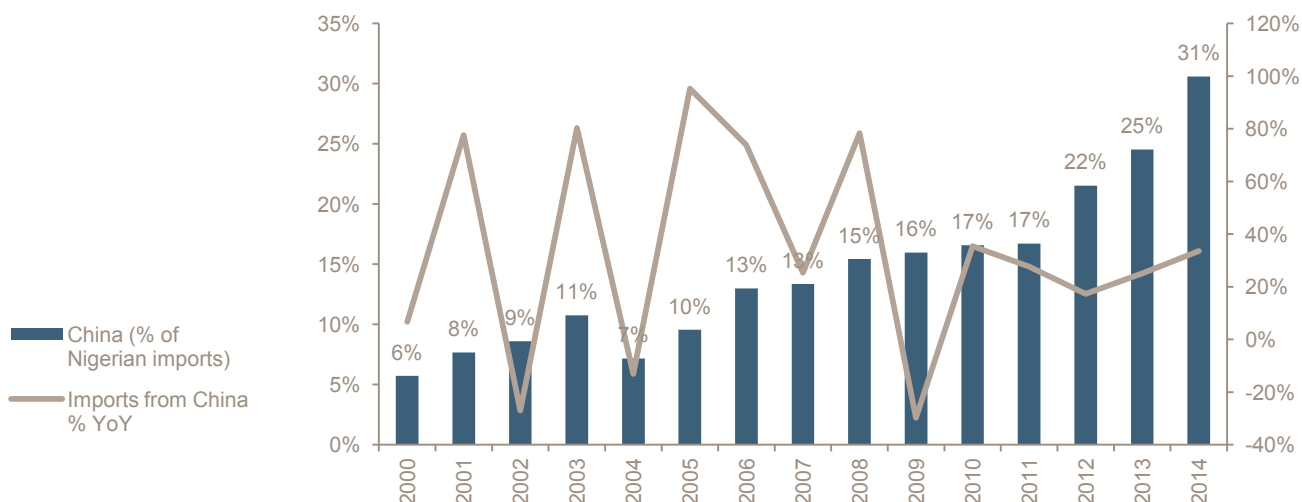
²³ BoT deficit surged fivefold YoY to \$2.9billion in first four months of 2016.

²⁴ Using data since 1981, Nigeria's Services deficit to GDP has averaged 6.4% over the last decade.

the yuan swap should drive moderation in dollar demand pressures. That said, delayed announcement of the details of the swap hints at

lengthy negotiations, which might extend deep into H2 2016, leaving the weak fundamental picture intact.

Figure 47: Nigeria: Imports from China



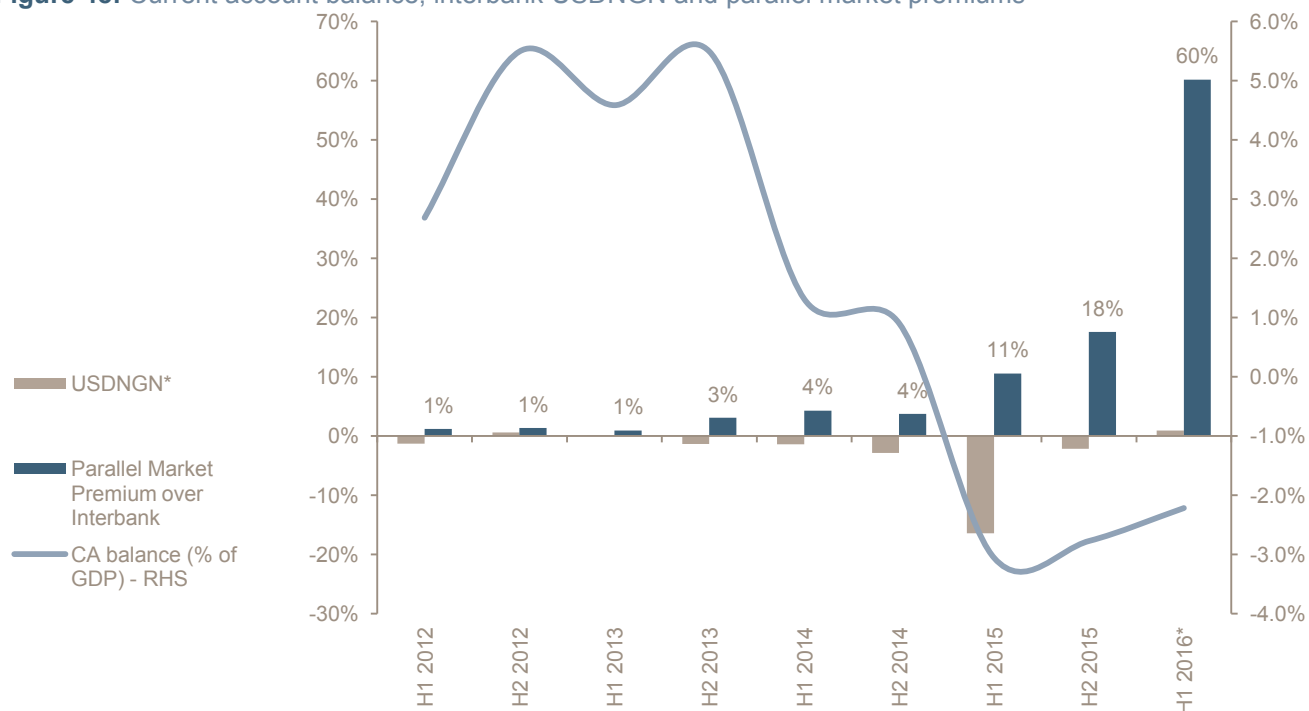
Source: UNCTAD, ARM Research

Tying it all together, the dim fundamental picture points to persisting dollar shortages across the Nigerian FX market. Given continued isolation of BDC from interbank/CBN dollar window, the tightening grip on the ₦280-285/\$ range should lead to parallel market premiums continuing to remain above historical trends. Calibrating projected current account balances and prevailing parallel market premiums to our exchange rate forecasts, we see scope for down-leg in interbank USDNGN (5-10% from current levels) over the rest of the year²⁵.

Beyond 2016, recovery in oil prices and cutback on the import front with the on-streaming of the 500kbpd Dangote refinery should return the current account to the historical surplus position. Potentially, the longest-lasting impact from this regime change is on the structure of economic production. A more adjustable rate provides a greater incentive to grow competitive non-oil exports on the one hand and reduce elastic components of import demand. From a policy perspective, Nigeria’s economic managers can now develop policies which target sectors with potential to improve trade balance.

²⁵ At the time of writing, the Naira Spot rate, 6M and 12M forwards are at ₦282/\$, ₦306/\$ and ₦317/\$ respectively.

Figure 48: Current account balance, interbank USDNGN and parallel market premiums



Source: CBN, ARM Research

INFLATIONARY PRESSURES TO SUBSIST ON CURRENCY WOES

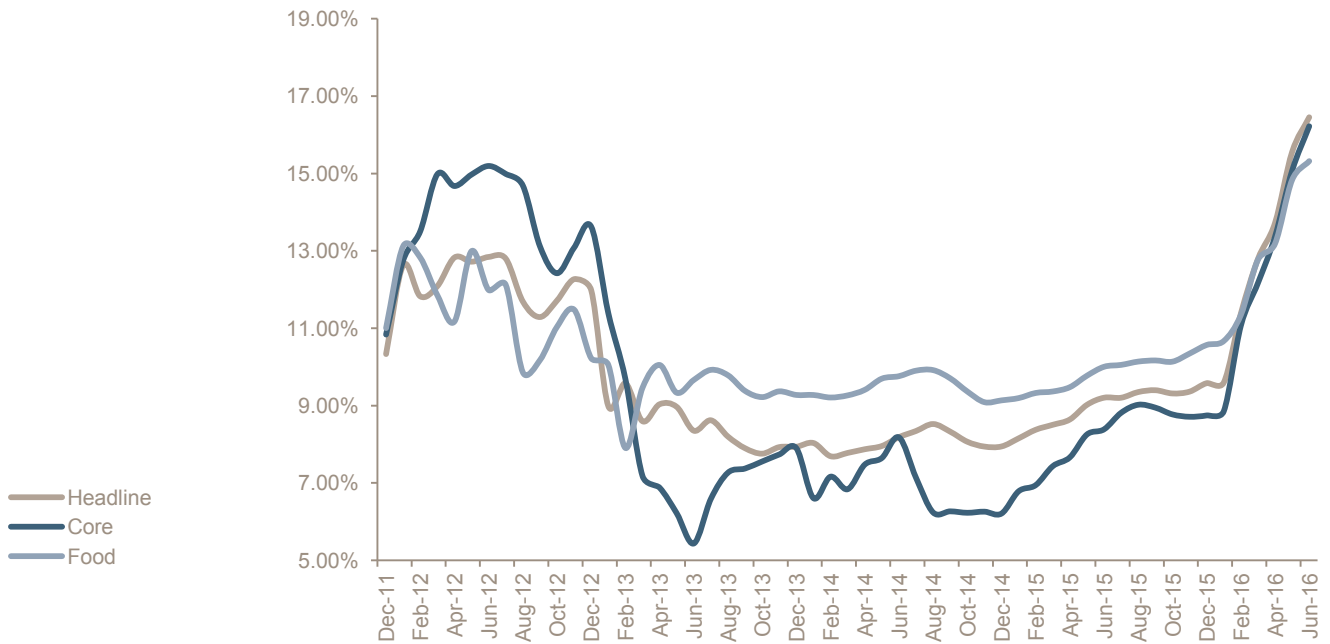
Energy shocks propel inflation to multi-year highs

In our H1 2016 NSR, we highlighted a tripod of factors: impending electricity tariff hike, possible deregulation of downstream petroleum industry and currency weakness as key underpins for northward shift in inflation. In addition to dimensioning the impact of the 52-70% electricity tariff increment and rising parallel market premiums, we noted that the shift to price modulation embodied greater volatility on PMS pricing going forward. Indeed, fuel price volatility proved central to inflation trajectory over the first six months of 2016 as mean headline inflation surged 460bps to 13.25% from 2015 average with the latest reading in June marking an eleven year high of 16.5% YoY.

Tracing the CPI evolution over the period, after a slow start to the year with only 2bps rise in January, inflation surged 178bps in February post implementation of the electricity price increase. Thereafter, rising PMS prices—mostly fallout of severe fuel shortages—underpinned inflation upswing from March through June with mean headline reading climbing 276bps. Further breakdowns provided by the NBS show that inflationary pressure was weightier in urban cities (H1 16: +832bps to 18.1% YoY), while rural inflation rose a relatively milder 557bps to 15.1% YoY over the same period.

For us, one justification for the higher urban inflation is the relatively bigger jump in PMS prices in urban communities, where average price of petrol were nearer PPPRA’s benchmark price of ₦87/litre prior to extended fuel shortages in March and April and the subsequent adjustment to PMS price band of between ₦138 and ₦145/litre in May 2016.

Figure 49: Trends in headline, core, and food inflation



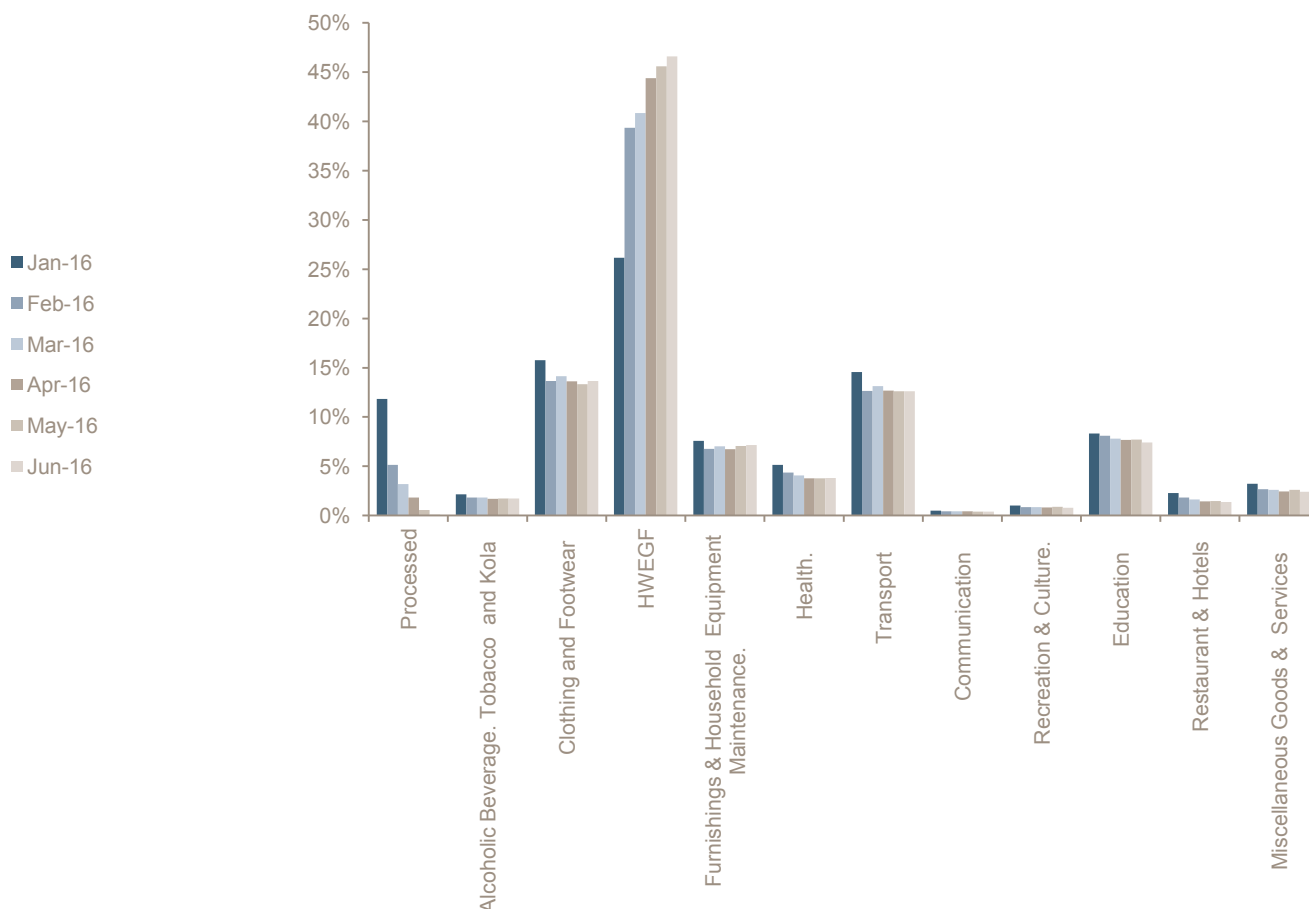
Source: NBS, ARM research

Pressures in HWEGF underpin surge in core CPI

Digging deeper into the trends in sub-components, mean core inflation at 12.79% YoY was 521bps higher relative to the corresponding period of 2015. In line with our views, the dual price shocks across electricity and PMS manifested via the housing, water, electricity, gas, and other fuel (HWEGF) component of core inflation, which jumped 16.8pps to 24.2% YoY and largely underpinned pressures over H1 2016. Whilst pressures on other core components such as clothing and footwear, transport, furniture and fittings and education were also evident in the period, that from HWEGF intensified at a much faster

pace. In evidence, whereas HWEGF accounted for only 26.2% of core inflationary pressure in January, higher energy prices drove its attribution to 47% of total core pressures by mid-year: vs. -2.1pps to 13.7%, -1.9pps to 12.6%, and -0.4pps to 7.2% for clothing and footwear, transport, and furniture and fittings respectively. In addition to being the primary driver of higher PMS prices and, by extension, pressures on HWEGF, a 25% naira weakening to ₦335.00/\$ at the parallel market also stoked pressures on other core components in the review period, with NBS singling out increases in prices of furniture and fittings, and furnishings as cases in point.

Figure 50: Attribution analysis for components of core inflation

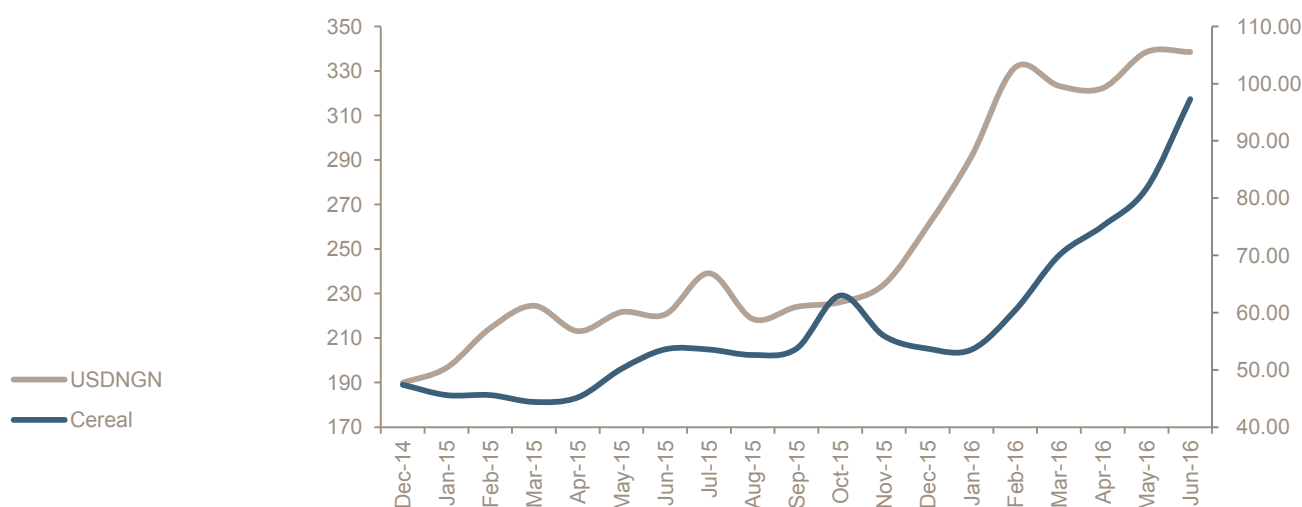


Source: NBS; ARM Research

Higher grain prices push food inflation to a six year peak

Food prices tracked higher over the first six months of 2016 with the NBS reporting that mean food inflation rose 350bps to 13.02% YoY. Over the review period, pressures on food basket were mainly reflective of higher farm produce prices (Mean: +389bps to 13.78% YoY) which offset moderation in processed food (- 75bps YoY to 4.9% YoY). Pressures on farm produce were underpinned by a combination of unfavourable supply and demand side factors. On the supply side, cost of food transportation—especially to urban centres—was significantly higher following several incidents of fuel

shortages. On the demand side, FEWSNET notes that naira depreciation relative to the CFA franc induced greater cross-border purchases of Nigerian cereals from neighbouring West African markets. In a related light, naira weakness and difficulty sourcing dollars underpinned ramp-up in domestic offtake of local cereals by Nigerian manufacturers. Consequently, dual demand and supply shocks drove a surge in mean cereal prices over the first six months of 2016 (maize: +67% YoY to ₦97.93/kg, millet: +76% YoY to ₦102.31). Beyond this, limited offseason activities/harvest due to guerilla attacks by militants on farming communities as well disease outbreaks (tomato) kept prices elevated during the period.

Figure 51: Parallel Market USDNGN and cereal prices in naira

Source: Aboki FX, FEWSNET, ARM Research

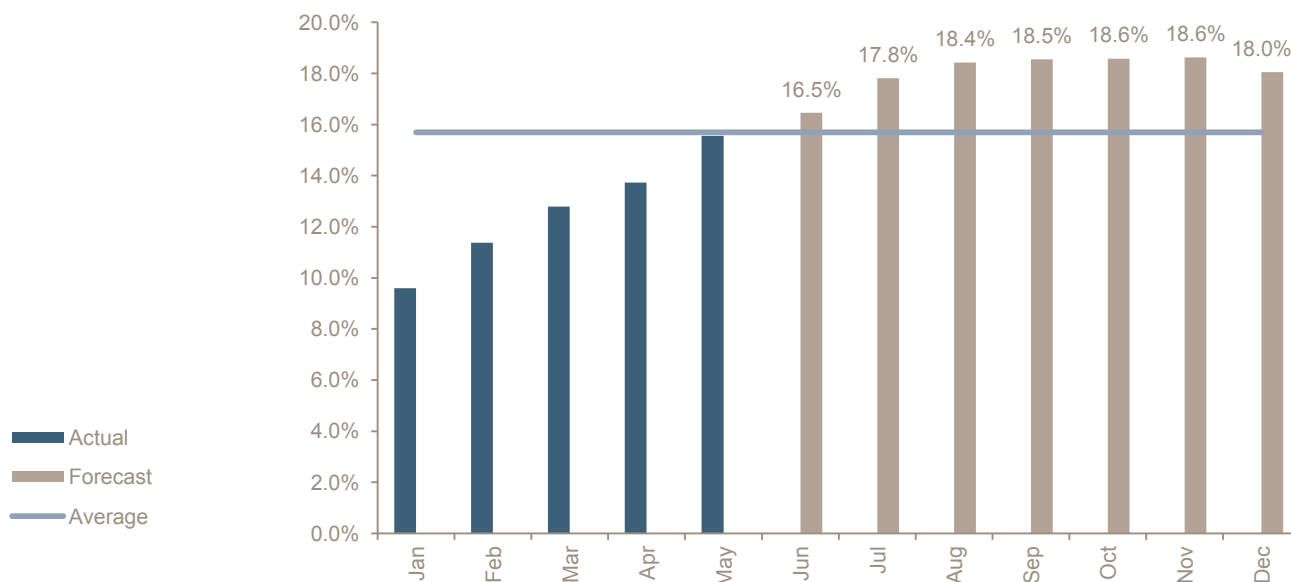
Pass-through from NGN weakness to fire inflation momentum

Over H2 16, improving PMS supply, which follows deregulation of downstream oil and gas industry, looks set to quash the challenges of limited PMS availability across the country. Whilst this should ordinarily have resulted in slight moderations in MoM inflationary pressures, CBN's policy switch to flexible exchange rate regime in June which saw the naira nosedive by over 43% in the first few weeks of implementation poses fresh upside risks to CPI. Thus, aided by pressures from higher PMS prices—which should subsist on YoY basis despite the noted MoM moderation—and a weaker naira outlook under the new FX market architecture, we expect core inflation to rise ~268bps to 18.9% YoY by December 2016.

On the food inflation front, the relationship between the value of the naira and growing domestic market appeal for local grains and continuing cross border purchases as observed in H1 2016 is suggestive of further price pressures over the remaining months of the lean season. Largely in line with this thought, FEWSNET expects current naira depreciation to pressure imported food prices and force greater

domestic demand towards cereals. To delineate impact of the currency movement on food inflation, we carry out a series of regressions using monthly historical data dating back to January 2014. In our first regression analysis, we uncover a statistically significant positive relationship between exchange rate and domestic cereal prices wherein a N1 devaluation of the USDNGN leads to a 11kobo rise in monthly cereal prices. In the second regression between farm produce and cereal prices, our results show that a 1% increase in cereal prices should result in a 10bps rise in aggregate farm produce prices. Tying insights from both regressions, we estimate that local cereal prices should rise 21% to ₦118.72/kg by year 2016 which should result in 210bps and 192bps surges in YoY farm produce and food inflation to 18.8% and 17.2% respectively by the close of year 2016. Summing up developments across both core and food inflation sub-components and adjusting for their respective weightings in the CPI basket, currency pressures should cascade to mean headline inflation of 15.8% YoY over 2016 (vs. 9.01% over 2015).²⁶

²⁶ We had previously noted that the 2012 structural break which hinged on better food storage facilities and greater value chain integration restricted impact of devaluation outcomes on inflation basket relative to prior episodes in 2008 and 2011. However, we expect impact of current naira depreciation to be exacerbated by higher PMS prices.

Figure 52: Inflation forecasts

Source: NBS; ARM Research

MONETARY AND CREDIT INDICATORS RISE TO CURRENCY TUNES

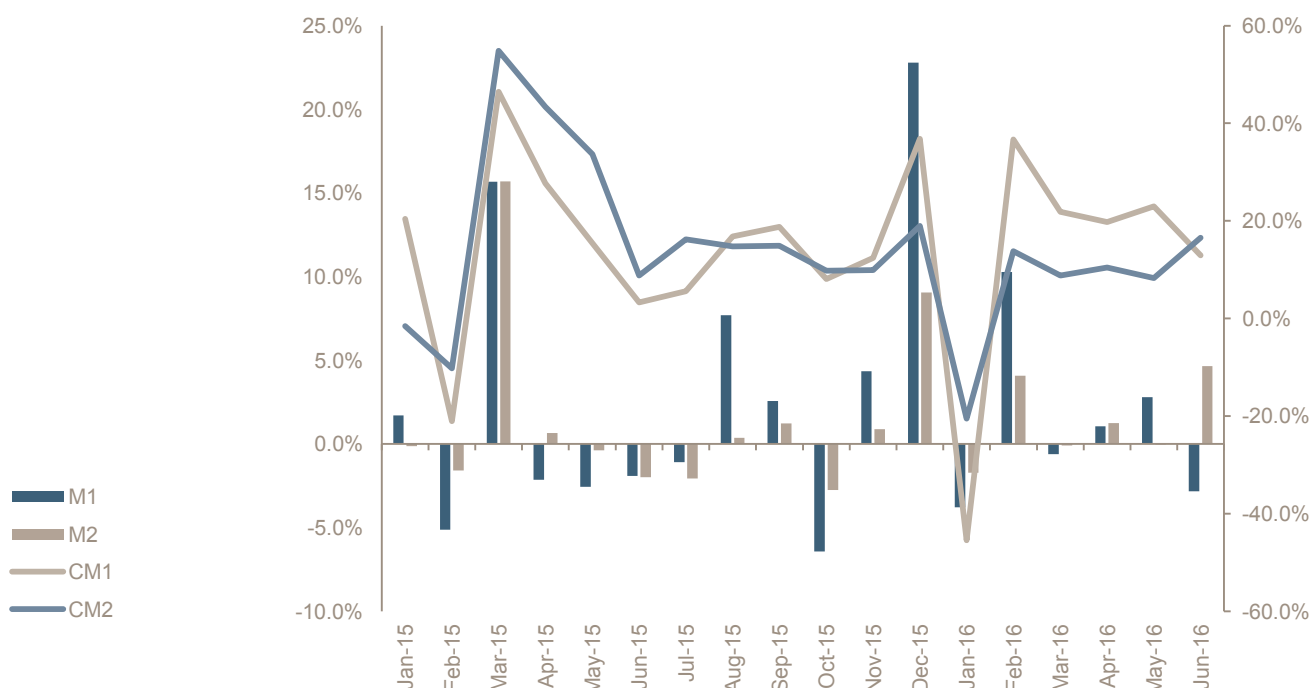
Naira weakness drives expansion in monetary and credit aggregates

In a reverse from Q4 15, when CBN's switch to an accommodative policy stance fuelled strong growth in monetary aggregates, narrow money (M1) and broad money (M2) contracted at the start of 2016 (M1: -3.8% MoM, M2: -2% MoM) largely on account of cutback in demand deposits. Though growth in both measures recovered in subsequent months, the annualised reading for M2 for most of H1 2016 remained under CBN preliminary targets. However, following the 43% NGN depreciation in June, M2 quickened 4% MoM to close June at ₦21.6 trillion while M1 contracted 3% MoM to ₦9.1 trillion. The divergence between M1 and M2 reflects impact of strong expansion in net foreign assets (+36.5% MoM) post the NGN depreciation, which offset contraction in net domestic assets over the month (-

6% MoM). Parsing through NFA sub-components reveals expansion of similar magnitude in CBN foreign assets which reflects translation impact of NGN depreciation on FX reserve holdings. The strong June reading is singularly responsible for annualised M2 growth for H1 16 (+16.5%) exceeding provisional CBN targets (+10.98%) as the surge in NFA (annualised H1 16: +51%) offset slack NDA growth (annualised H1 16: +3% YTD).

In a similar vein, developments on the credit side closed H1 16 stronger with annualised net domestic credit growth up 25% YTD as credit to private sector (CPS) jumped 28% over the period overriding impact of stagnant government borrowings. Amid a softening macro landscape with heightened sensitivity to credit risk among banks, CPS expansion stems from translation impact of currency weakness on FCY loans in the banking industry rather than from actual credit creation. Consequently, annualised NDC growth for H1 is well ahead of CBN 2016 benchmark growth at 17.94%.

Figure 53: Growth in Monetary aggregates



Source: CBN, ARM Research

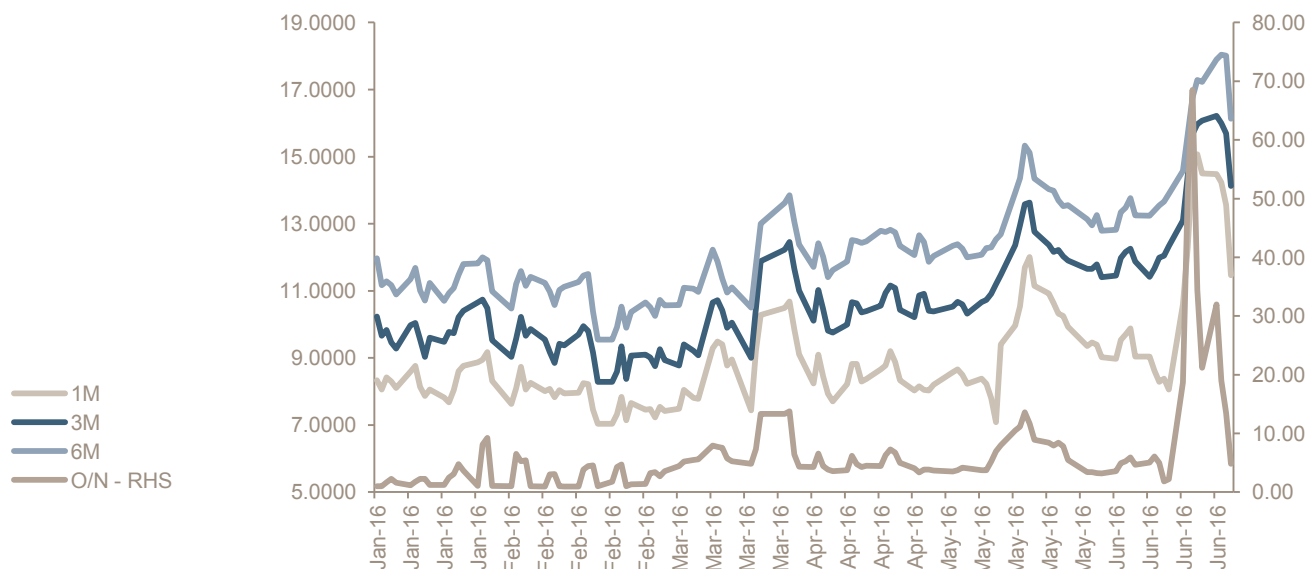
Monetary tightening and increased NTB issuance drives interest rates higher

Extending the easing-induced declines from Q4 15, interbank call and OBB rates opened the year at ~2% levels. The depressed rate environment emanated despite resumption of OMO activity, after a three-month hiatus, with net issuance of ₦230 billion in January and average marginal rates of 7.7%. To some extent, the relatively low OMO clearing rates and CBN’s guidance to still being on an easing path to aid fiscal attempts to stimulate the economy contributed to overnight rates remaining depressed. Indeed, despite a switch to tightening in March, with a 100bps hike in MPR to 12% and CRR raised to 22.5%, rates inched up only slightly to 4% in March. However, in line with trends in money supply, average interbank call/OBB rates sprang to 35.5% over June, including intra-day spikes to 68.5%,

following the implementation of a flexible exchange rate regime. Particularly, CBN’s move to clear interbank backlog of \$4.02billion on the first day of the floating FX system which resulted in nearly ₦1.0trillion debit swung system liquidity negative and resulted in banks re-initiating exposure to the SLF window.

As monetary authorities then sought to discourage potential speculation from excess liquidity in an open market structure, the resumption of OMO issuance at double digits marginal rates in June exacerbated upward pressure on money market rates. Complementing the CBN action was increased FGN borrowing at higher rates at the short end, with net NTB issuance of ₦141 billion in June, a departure from the refinancing pattern in prior periods fuelled the upswing in interbank call/OBB rates.

Figure 54: NIBOR rates



Source: FMDQ, ARM Research

Money market rates to remain elevated

Going forward, similar to H1 2016, and in line with our expectation for further naira weakness, FX translation impact on FCY assets and liabilities should continue to directly spur expansion in monetary and credit aggregates over the second half of 2016. Less directly, the continuing exchange rate depreciation and slack FPI inflows should induce monetary tightening to raise the returns on holding naira assets. This view is based on clear signs that, post the switch to a flexible exchange rate regime, managing the implications of that switch for domestic economic conditions, specifically exchange rate direction, has assumed centre stage for monetary policy. Whilst we continue to feel that the monetary policy makers need to focus on the broader economic situation especially output growth, the lack of actual Q2 16 numbers (so far) to confirm a recession and the more quickly visible inflation upsurge provide the CBN the technical copout to

persist on a currency-supportive tightening stance in the interim. Accordingly, we expect more efforts to directly target liquidity with the ₦908 billion OMO maturity profile over H2 16 implying sizable OMO activity. On the fiscal side, increased borrowing at the short end with recently released Q3 16 calendar pointing to ₦160 billion net NTB issuance over the quarter should stoke pressure across money markets. Furthermore, as in the latter part of H1 16 when the FGN issued NTBs at higher rates, the continuing fiscal struggles should result in the DMO continuing to display cost insensitivity at auctions. In a nut shell, currency and revenue concerns, respectively, should induce higher paper issuance at the monetary and fiscal levels, leading to a rising rate environment through Q3 16. That said, we think onset of recessionary conditions raises scope for tightening action to pave way to easing by the end of 2016.

CAPITAL MARKET REVIEW AND OUTLOOK

YIELD CURVE WIDENS AS POLICY MAKERS CHANGE TACK

In many respects, the fixed income market faced more yield stoking events in H1 16 relative to the preceding half year, particularly as the carnage caused by soft oil prices worsened Nigeria's macroeconomic vitals; currency pressures persisted, inflation spiked to multi-year highs, fiscal and external imbalances deteriorated while economic growth shrank for the first time in 12 years. The downbeat economic data—which in part resulted in ratings downgrade by Moody's and Fitch—and crucially, monetary authorities' response to same, stoked massive sell-off that largely underpinned the 4.3 percentage points upward shift in the yield curve to 12.7% by the end of H1 16.

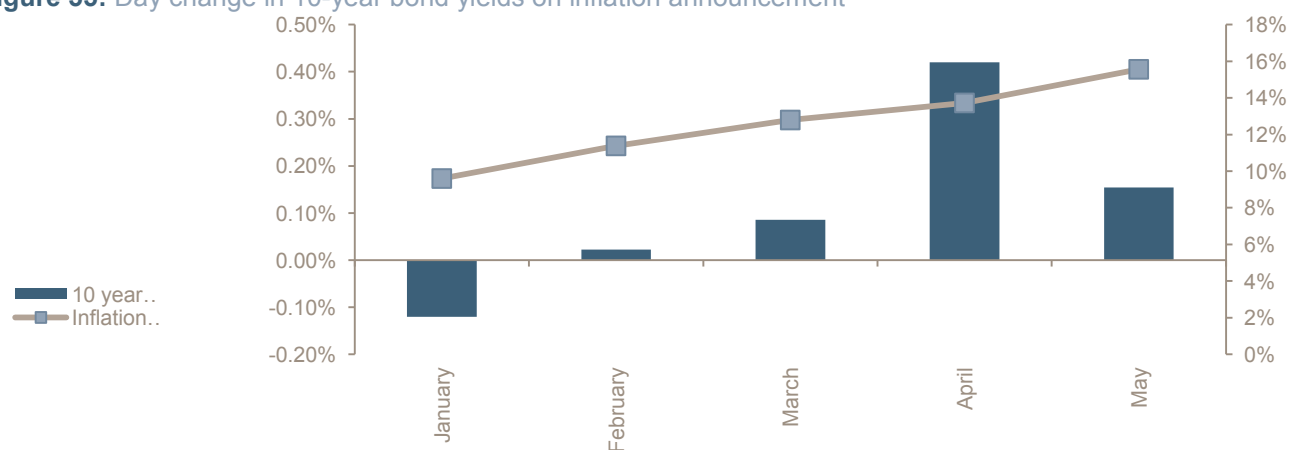
Monetary policy switch alters direction of yields...

Reviewing trajectory on a quarterly basis, the yield curve expanded 200bps QoQ to 10.38% in Q1 16, reversing the monetary easing-induced slump over Q4 15 (-545bps QoQ). As we noted in our Q1 16 Strategy Update, the widening across the curve over Q1 16 was primarily due to the sell-off in January, as oil prices dropped to 13 year lows, and MPC switch—after repeated commitments by the apex bank to stimulate credit creation—to a hawkish

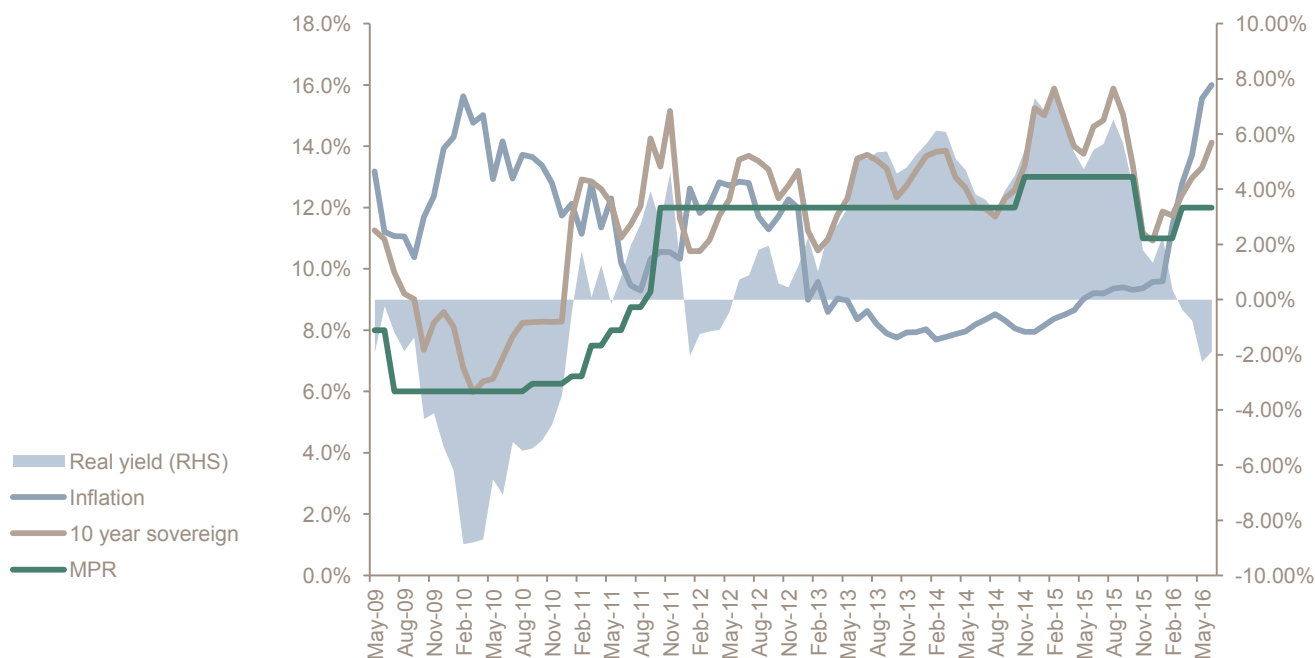
stance. Consequent upon the latter, OMO sales rose over six-fold QoQ to ₦1.4 trillion in Q1 16 while CRR and MPR were hiked 225bps and 100bps respectively at the March meeting. Thus, as in prior quarter, monetary influence remained the dominant driver of yields trajectory in Q1 16 with the short-end of the curve jumping +3.2pps QoQ to 8.9% relative to the +1.1pps QoQ increase to 11.4% at the long-end. Over the second quarter of 2016, the yield curve widened another 230bps, but this time, the biggest rise was at the long-end (+ 2.4pps QoQ to 13.8%) compared to 2pps QoQ to 11.1% at the short-end. However, in contrast to Q1 16 divergence of actual yield direction from expectations, this latter outcome largely matched our expectations both in terms of direction and drivers—monetary tightening and elevated paper supply.

Perhaps, the most significant event in H1 16, particularly in the second quarter, is that investors started to price-in inflation expectations into tenured investments after the CBN linked the March rate hike to the need to ensure positive real returns. To buttress this, the yield on the 10-year bond which had barely changed (+2bps day change) after inflation spiked to double digits in February, rose 22bps on average over the rest of H1 16 on expectation of further monetary tightening as negative real yields widened.

Figure 55: Day change in 10-year bond yields on inflation announcement



Source: NBS, FMDQ, ARM Research

Figure 56: Historic real yields on 10-year sovereign benchmark

Source: NBS, CBN, FMDQ, ARM Research

FG ramps up domestic borrowings on revenue shortfalls...

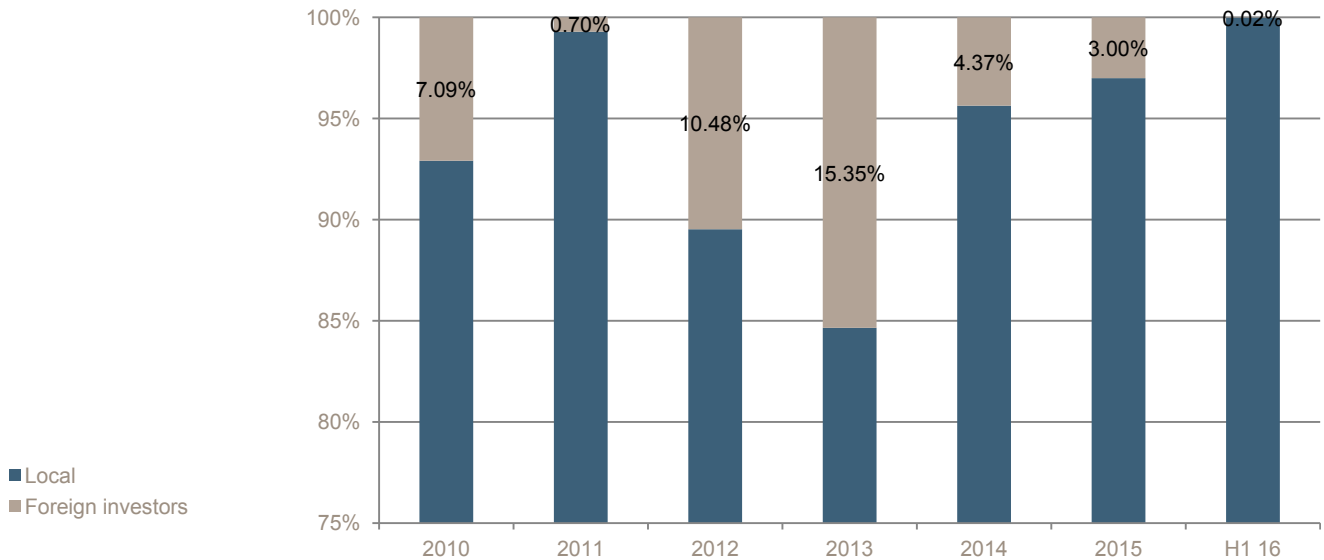
In line with our expectations, the Federal Government ramped up domestic borrowing in H1 16. Specifically, to plug the bulging FG budget deficit (Q1 16: ₦725 billion), the DMO sold ₦642 billion worth of bonds in H1 16 (+9% higher YoY and above proposed issuance) which combined with net T-bills issuance of ₦190 billion (vs. H1 15: ₦66 billion net repayment), puts cumulative domestic borrowing at ₦830 billion in H1 16. On the other hand, though demand was fairly robust-- with bid-cover ratio across the curve in excess of 2x in each quarter, investors, quite noticeably, demanded higher premium for tenor risk to compensate for inflation risks. Upper bid rates, at the primary bond auction, climbed 2.4pps QoQ to 18% on average in Q2 16, forcing the DMO to sell over 40% on a non-competitive basis at the April auction and only half (₦50 billion) of the offer at the May auction in a bid to avoid higher rates. However, with realities of plummeting government revenues, the DMO eventually caved in at the June auction where it sold ₦112 billion (~7% higher than offer) not only all on

competitive basis, but also ultimately paying the highest marginal rate (14.5%) in 10 months. At the short-end, upper bid rates also climbed in Q2 16 in response to monetary tightening, but the major spike to record levels (22%) for the 1 year came on the heels of a forex debit of nearly ₦1 trillion as the apex bank cleared over \$4 billion forex demand backlog. Notably, there was almost no foreign participation at the primary bond auction as FPIs continue to show aversion to naira assets since the slump in oil prices.

...but now faces significant refinancing risk

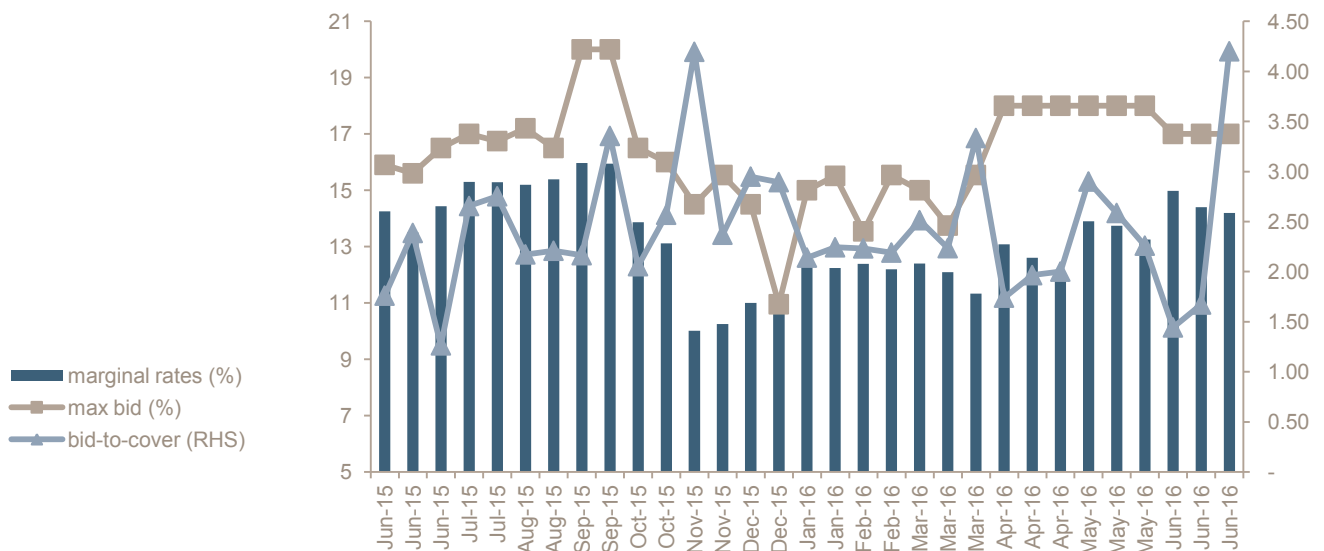
When we place the evolution of the yield curve over H1 16 side by side with the FG's borrowing over the period, a pertinent observation is that the FG appears not to have fully taken advantage of the lower rate environment in Q1 16 to elongate the duration on its outstanding debt at lower cost. Specifically, over a third of the securities issued in Q1 16 was at the short end thus exposing the FG to significant refinancing risk. Indeed, the FG paid an extra 200bps premium for securities sold in Q2 16, relative to the prior quarter.

Figure 57: Foreign participation in FGN bond auctions



Source: DMO, CBN, ARM Research

Figure 58: Primary market data for bonds



Source: DMO, CBN, ARM Research *Blue (20 year), Black (10 year, green (5 year)

Eurobond funding option looking appealing again

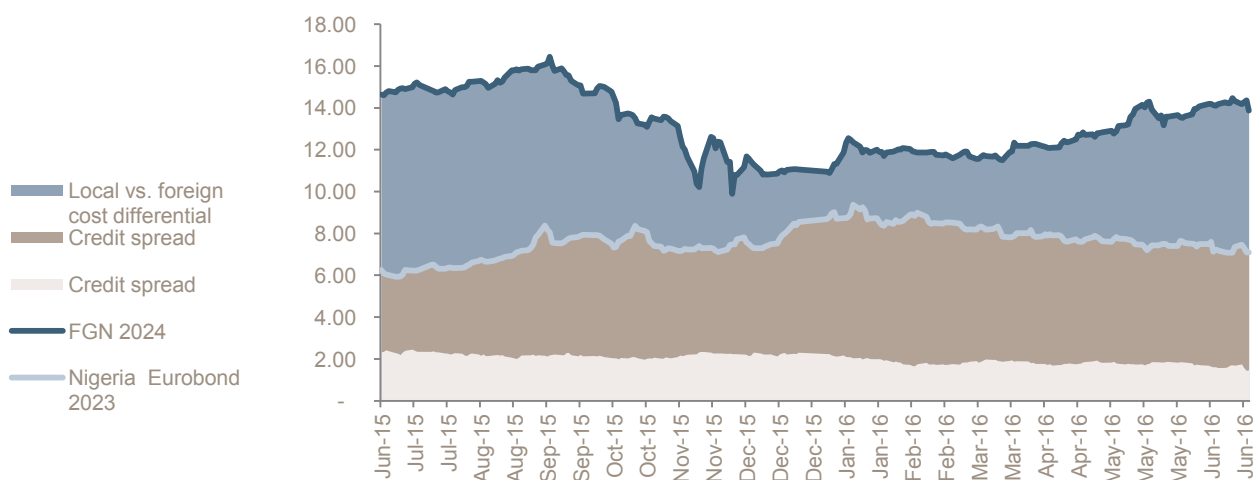
After spiking to record peaks of 9% on average mid-January as oil prices slumped, yields on the Nigerian Eurobond contracted 200bps to 7% by the end of H1

16, as investors ramped up purchases across the curve as oil prices rebounded. However, credit spreads narrowed much less (only 60 bps to 5.6pps) as the US treasury curve also contracted on deferment of rate hike by the US Fed and increased ‘flight to safety’ following the Brexit vote. That said,

due to the divergent movement in foreign vs domestic bond yields, cost differentials have widened to 7pps from 2pps as at FY 2015, thus making the international capital market an attractive funding

option for the 2016 budget. Indeed, given elevated domestic borrowing costs, an increasing number of African countries, including Angola and Ghana, have tapped into this market in the past few months.

Figure 59: Nigerian local & foreign currency bonds and US 10-year Treasury note



Source: Bloomberg, FMDQ, ARM Research

Table 7: Recent Eurobond Issuances in Africa

Issuer	Rating at issue			Date Issued	Amount (US\$ billion)	Tenor (years)	Coupon (%)	Issue Yield (%)
	Fitch	S&P	Moody's					
Ghana	B	B-	B3	7-Oct-15	1	15	10.75	10.75
Namibia	BBB-	NA	Baa3	23-Oct-15	0.75	10	5.25	5.375
Angola	B+	BB-	Ba2	4-Nov-15	1.5	10	9.5	9.5
Cameroon	B	B	NA	13-Nov-15	0.75	10	9.5	9.75
South Africa	BBB-	BBB-	Baa2	8-Apr-16	1.25	10	4.875	4.875

Source: Bloomberg, Thomson Reuters, ARM Research

Hawkish monetary policy and inflation risk premia to sustain yield uptrend

Without a doubt, monetary influence remained the primary driver of yields trajectory over H1 16, particularly as the forward guidance of monetary authority on maintaining real yields was also central to the increased responsiveness of long-end of the

yield curve to inflation reading. Over H2 16, though we expect the monetary influence to remain dominant, we think developments with fiscal balances will also stake a claim on deciding the path of yields, given our view that fiscal deficit could hit ₦3.8 trillion. The implication of the latter expectation is that, in contrast to budget assumptions, the FG will need to borrow to fund nearly 40% of its ₦4.0 trillion

recurrent expenditure. In this guise, after late passage of the 2016 budget, prospects of recession puts even more pressure on the government to reflate the economy. To achieve that, the FG will need to accelerate implementation of the capex portion over H2 16 and, given outlook for fiscal revenue, implies government will need to borrow more. On monetary policy, after floating the currency for the first time in decades, we think currency stability will remain the main policy focus. Thus, despite prospects of recession, the need to attract foreign portfolio to buoy the naira is likely to drive tighter monetary policy environment over most of H2 16. On the flipside, demand for government paper from various classes of investors is likely unchanged. On the external front, in addition to flagging domestic economy, the uncertainty brought to the global markets by Brexit vote is unlikely to make FPI attracted to naira-denominated paper. In contrast, amidst broad deterioration in credit quality, maturity of ~N2.8 trillion—OMO and Bonds—over H2 16 suggests domestic interest in FG securities should remain robust perhaps more from a perspective of limited options. Nevertheless, as in Q2 16, we expect domestic investors to continue to demand a premium to compensate for inflation risks. In all, despite prospects for fairly robust local demand for FGN securities, we expect the confluence of hawkish monetary policy, higher FGN paper supply and the pricing-in of inflation, at a minimum, by investors to combine to drive rates higher over much of H2 16.

EQUITIES STUCK IN A MACRO SEA-STORM

'Roller-coaster' first half for Nigerian equities

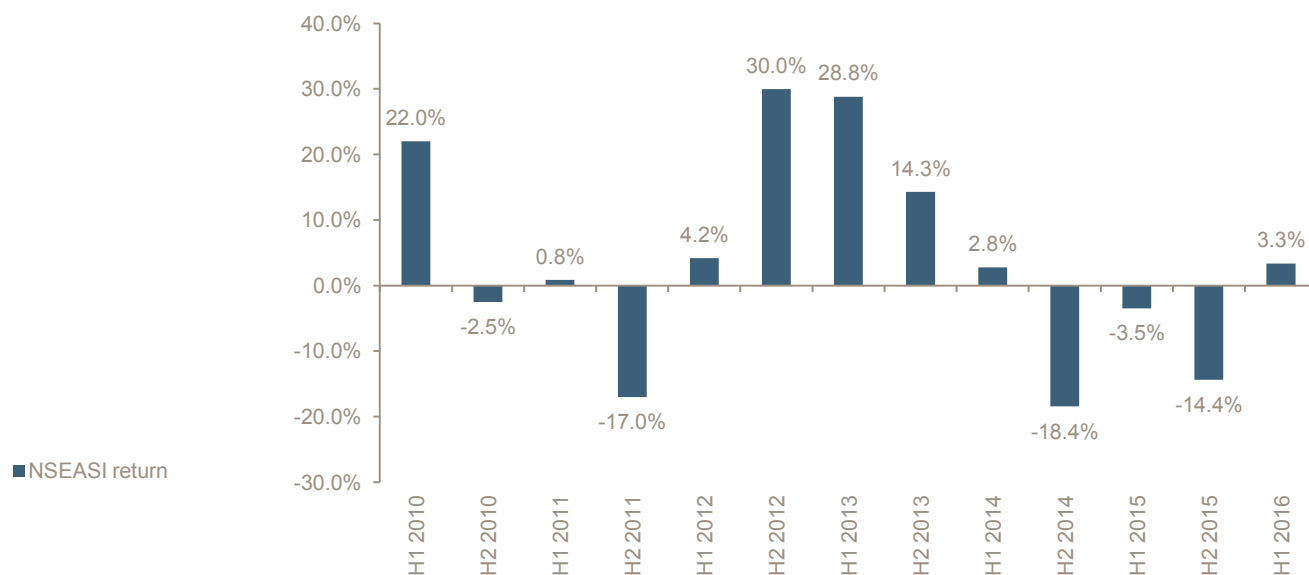
In our H1 2016 Nigeria Strategy Report, we highlighted how oil price-driven fundamental weakness and lack of investor confidence in the policy responses of Nigeria's economic managers would, as in 2015, be key drivers of equity market performance. Indeed, during the first half of the year, developments along oil prices and economic policy

choices dictated NSEASI movement. Starting off in January, Nigerian equities, akin to global markets, opened to the worst start to a year since 2009 (-16.5% MoM), on bearish sentiments following Brent crude's drop to thirteen-year lows of \$27/bbl. However, subsequent recovery in the months which followed (+40% to \$49/bbl) provided scope for positive sentiment towards NSEASI, aided by adoption of pro-market policies in May (Fuel) and June (FX), and helped achieve a positive close to H1 16 (+3.3%).

Splitting market performance into quarters to illuminate the sentiment drivers more clearly, starting with Q1 16, lower crude price and unclear domestic policy (delayed budget, FX market) underpinned a torrid start with NSEASI sliding 11.6%. In Q2 16, recovery in Brent (+22.5%) and implementation of greater flexibility in PMS pricing, in early May, and CBN adoption of flexible exchange rate system, in June, underpinned a +17% return in Q2 16 – highest quarterly return in thirteen quarters. Importantly, Q2 16 return emanated despite an abundance of negative macro-economic data with NBS reporting a contraction in GDP growth, fresh attacks on oil production and soaring inflation. But for the Brexit turmoil in late June, the NSEASI was on track for its best quarter since Q1 2010 as investors overlooked these issues. Indeed, the +17% return in Q2 16 remains the highest quarterly return in thirteen quarters.

Interestingly, the strong market rebound occurred without foreign participation, which continued to remain on the sidelines, with net short positions (N32 billion)²⁷ on naira equities, leaving local investors, who were facing less attractive real fixed income yields, as the source of equity market gains. Overall, at halftime, the equity market's recovery proved to be a tale of rebounding crude oil prices and improved investor clarity on the domestic economic policy.

²⁷ January-May 2016

Figure 60: NSEASI Half year returns

Source: NSE, ARM Research

Macro shocks and pro-market policies dictate sector price movements

The theme about policy perception becomes clearer when tracing out index performance across the various sectors. In contrast to prior periods, when drivers of sectoral performance were idiosyncratic, a distinctive feature of H1 2016 NSEASI performance was that sectoral movement was broad-based. Similarly, the recovery in Q2 16 cut across most sectors with banks, again, being the greatest beneficiaries. The depth and diversity of macro-shocks in Q1 16 drove a 21% decline in banks with the core of that happening in January (-13% MoM) when oil prices hit multi-year lows, stoking investor concerns over deterioration in upstream O&G loans. Elsewhere, concerns over impact of shrinking fiscal revenues and legislative impasse over the 2016 budget weighed on cement stocks which should have benefitted from the increased capex allocation: the sector shed 4% over the period. For FMCGs, constrained consumer spending and fears surrounding FX illiquidity continued to drive investor pessimism towards the sector (Brewers: -18%, Food: -15%, Personal Care: -25%). For O&G, the decline in Brent crude prices and severe bouts of fuel

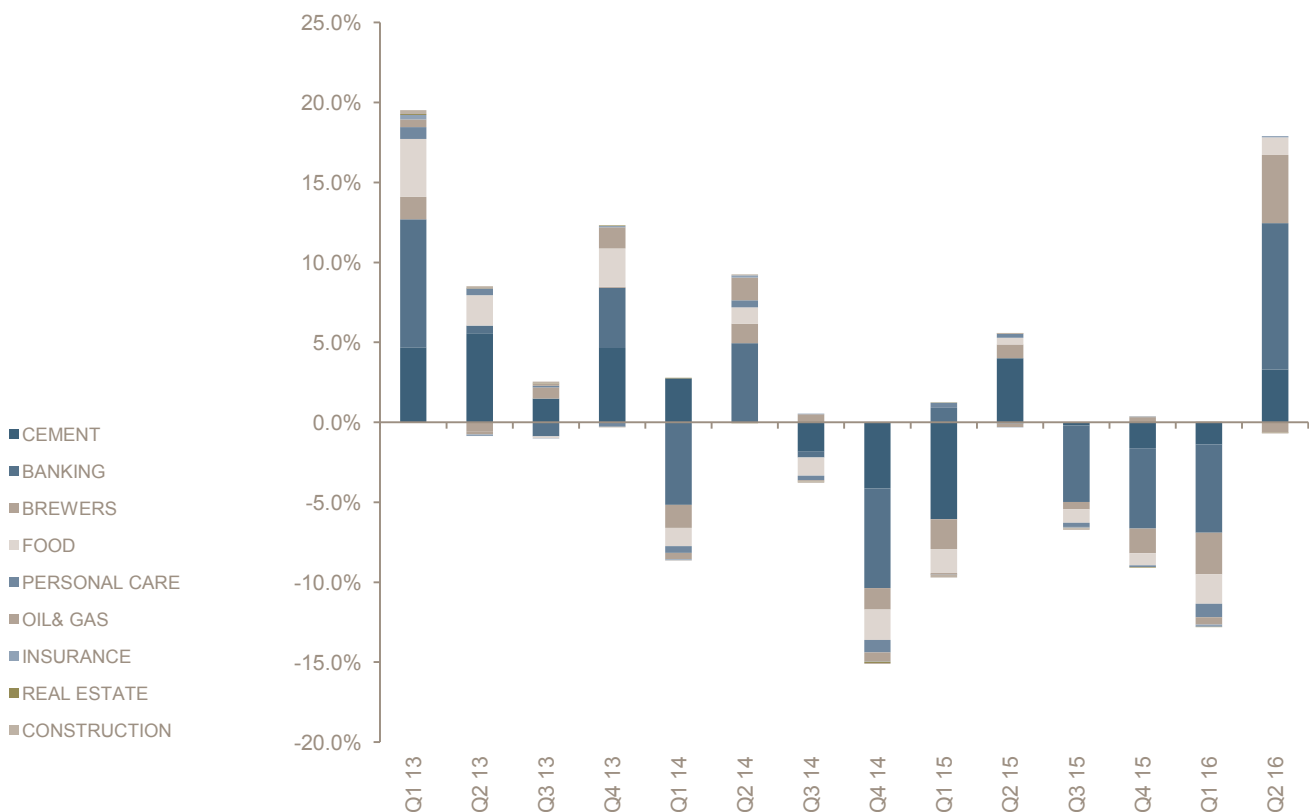
shortages, which suggested declining sales for marketers, weighed on sector performance (-10%).

Nonetheless, by Q2 16, aforementioned policy turnaround proved to be triggers to turn dovish bias into a firm bull tide. Banks led the way with a 35% QoQ rebound reflecting largely net positive impact for the sector from the FX regime change with more companies in the sector being net long dollars than any other segment. In addition, we believe recovery in oil prices from January's troughs to levels above E&P loan break-even helped temper investor concerns over upstream loans. Other sectors also benefitted from the changing perception on policy with Consumers rallying (Brewers: +23%, Food: +17%, Personal Care: +6%) despite the negative implication of the 43% NGN depreciation on earnings. Similarly, cement producers gained 12% as the policy changes coincided with budget passage in Q2 16 in buoying optimism on the sector. Nonetheless, O&G sector sank 14% as negative sentiment over upstream heavyweights SEPLAT and Oando following the pipeline attacks outweighed gains to downstream O&G from deregulation.

Applying our cyclical defensive framework, consumers continued to remain expensive (H1 16: +57% to 90x) as underlying earnings deteriorated over the period. On the other hand, cyclicals (Banks: -27% to 3.8x, Cement: +2% to 14x) continue to remain compelling. In sum, despite the abundance of

negative triggers, negative GDP, soaring inflation and negative impact of the depreciation on sector fundamentals (except banks), as investors overlooked the aforementioned issues in favour of increasing confidence in Nigeria’s economic policy choices.

Figure 61: Sectoral performance



Source: NSE, Bloomberg, ARM Research

Domestic investors take over...

In line with patterns over 2015, FPI participation on the NSEASI continued to shrink with transactions on the exchange sliding 54% YoY to ₦269 billion in H1 2016 (H2 2015: ₦436 billion). The continued foreign reticence, despite a recovery in oil prices over the period which should have been positive for sentiment, implies mounting concerns over delayed fiscal response to stimulate the economy and uncertainty over the CBN’s ability to hold the naira peg. Further dampening FPI sentiment was April’s

announcement by MSCI about a review of Nigeria’s position on the Frontier Market Index²⁸ citing “the restrictions on foreign currency trading and the resulting deterioration of foreign exchange market liquidity. Though by the end of the month the index provider stayed execution by retaining Nigeria on the list, it would later place Nigeria’s position under scrutiny with a decision date in September 2016. However, in line with our earlier thesis about impact of the adoption of flexible policies (fuel and currency),

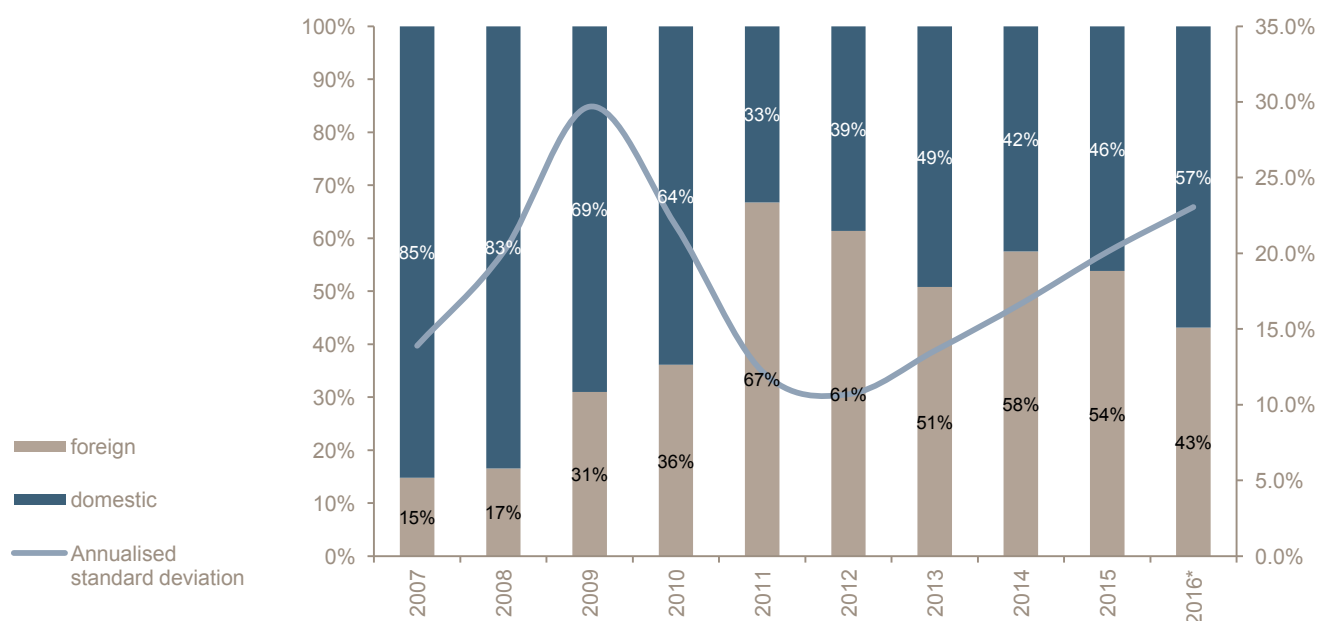
²⁸ MSCI frontier Index Market cap as at March 31 2016 is \$28billion

FPI flows increased modestly in May (+44% MoM to ₹21 billion) and June (+103% MoM to ₹42 billion) resulting in two straight month of net inflows. The recovery in May and June resulted in net long FPI positions (₹7.3 billion) on naira equities for Q2 16 -- the first time in four quarters.

Except in February, when domestic activity rebounded (+82% MoM to ₹74.5 billion) pricing in

sentimental bounce of oil price recovery (and possibly an eye on attractive dividend yields), domestic interest mirrored declining trend in FPI with trading activity in H1 16 sliding 32% YoY to ₹355 billion. Nonetheless, as testament to the strength of foreign aversion to NSEASI, domestic share of transactions assumed dominance in market activity with share of transactions at 57% over the first half 2016.

Figure 62: Share of transactions and market volatility



Source: NSE, ARM Research *H1 2016

On the latter theme, mean volume and value traded shrank 18% and 50% YoY to 323million shares and ₹2.7 billion respectively as market participants continued to moderate exposure to equity markets. The shrinking liquidity levels continued to dampen prospects of any capital raising activity with no primary or seasoned offerings over the period.

Market downtrend spurs further NSE market reforms

In a bid to stem the market volatility at the start of the year, the NSE concluded approval process for the index circuit breaker protocol from the Securities and Exchange Commissions (SEC). Under this process

which went into effect in February 2016, the NSE would halt trading in the event of significant market dips and ultimately resort to market closure, should the earlier stoppages fail to stem sharp market downturns. Furthermore, to allow investors properly dimension risk, companies began providing full disclosure by accompanying results filings on the NSE with notes to financial accounts. This was supported by increased usage of profit warnings by listed companies to help minimize investor reaction to weak earnings releases.

In addition, to tackle the issue of weak compliance with financial reporting timelines among listed companies, the NSE commenced the use of

enhanced Compliance Status Indicator (CSI) codes on the ticker tape for listed companies in May 2016. The CSI codes which will follow company initials on the NSE ticker tape would allow investors quickly identify companies with up-to-date earnings releases and other statutory listing requirements.

Furthermore, the agency also proposed adjustments to the tick movement for the various price bands of listed companies in a bid to help improve bid-ask spreads and aid better price discovery. The adjustments involve the inclusion of a third tier of pricing which will require minimum of 100k units to move pricing for stocks below ₦5 per share.

Table 8: Proposed changes to pricing methodology

Grouping	Minimum quantities	Price
Group A: Stocks prices greater than or equal to ₦100	(10,000) units (presently 50,000 units)	10kobo
Group B: Stocks prices greater than ₦5 but less than ₦100	(50,000) units (presently, 10,000 units)	5kobo
Group C: Stocks prices greater than ₦0.01 but below ₦5.00	(100,000) units (newly introduced)	1kobo

Source: NSE, ARM Research

Uncertain post Brexit world and subsisting fundamental weakness point to tame outlook

In building our outlook, we recall the centrality of positive perception to policies to the market's recovery in Q2 16, and take a position on how well that will hold going into H2 16. For foreign investors, the Brexit vote and onset of the US presidential election seems to be the biggest influences. Considering the steep declines across global equities as a result of the former, the tepid interest indicated by positive net flows in May and June hardly provides a strong counterpoint and we thus expect muted FPI appetite for naira assets in H2. On the domestic front, the initial perception by local investors that Nigeria's economic managers were starting to address the issues at the heart of the current economic turmoil is unlikely to be sustained with likely formal confirmation of onset of economic recession by Q3 16. Thus, whilst any support for market outlook is still likely domestic, the recent uptick in yields as a result of actions of the same policy makers to which local money previously responded is, ironically, likely to be the biggest hurdle as it provides a significantly

compelling investment outlet in the FI market and sharply raises the discount rate for equity valuations.

From a sector-dimensioning fundamental perspective, across the NSEASI, the NGN depreciation directly translates to higher raw material costs for FMCGs who should struggle to pass-on the shocks to end consumers given the depressed state of consumer incomes already grappling with tariff hikes and fuel price increment. Exacerbating the input cost outlook is the switch to more expensive LPFO as militant attacks on energy infrastructure have disrupted use of cheaper gas to fire manufacturing plants. Beyond the bleak outlook for gross margins on the aforementioned issues, FMCGs also face a rising interest rate environment (a double whammy for sector players carrying local and foreign debt) which points to depressed earnings over H2 16. Elsewhere, using net FCY positions as at the end of FY 15, cement players are largely net short dollars on their balance sheet, though scale of net FCY liabilities is less than FMCGs, implying more muted margin compression. In addition, the dire revenue picture at Federal and State Government levels should underpin lower capital spending and, by extension, scant construction activities. Amid a

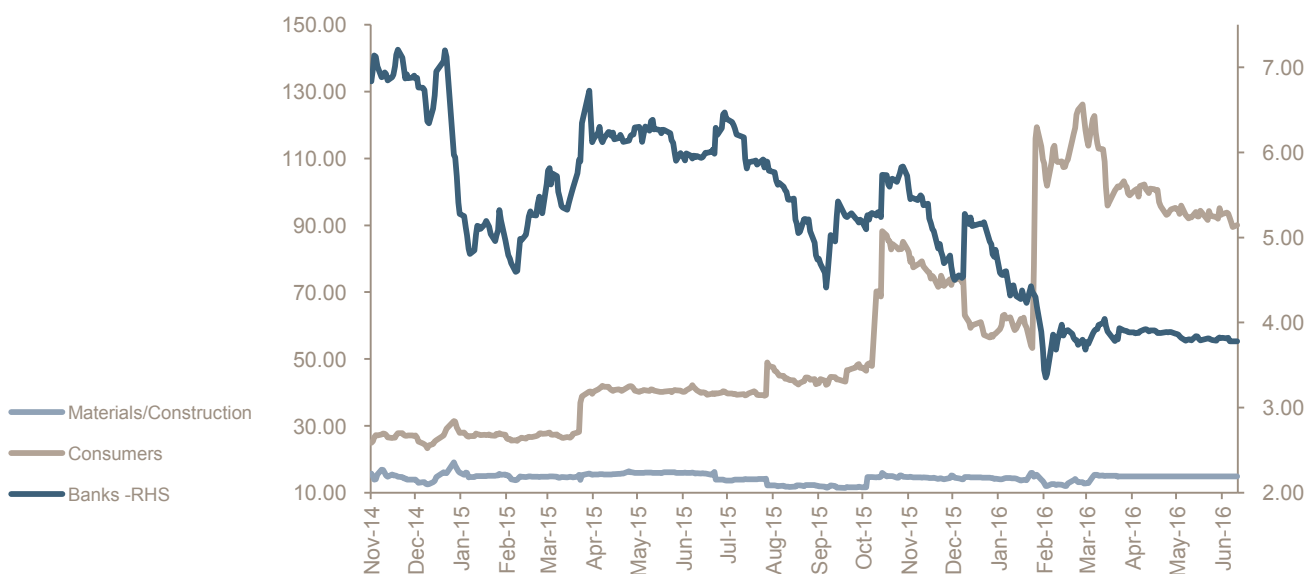
fight for market share, led by sector weight (DANGCEM) and which resulted in price cuts over H1 16 (-23%), revenue outlook for cement stocks is quite dim. For O&G equities, while NGN depreciation is positive for upstream players with dollar receivables, the lost revenues from downtime caused by renewed attacks on pipelines is a bigger concern for earnings. For downstream O&G companies, our analysis reveals that naira depreciation is positive for the bigger players (Total and Mobil) with net long positions and negative for indigenous players.

Undertaking a similar exercise for banks reveals largely net long positions across our coverage universe which should imply in sizable FX translation gains in the aftermath of naira weakening. Assisted by the resumption of FX trading, improvement in non-interest revenues should combine with impact of

monetary policy tightening on interest income leading to higher revenues. Nonetheless, the naira depreciation combines with a weak economic backdrop in raising concerns over asset quality which should weigh on earnings. In our views, the latter point favours banks with a tight lid on asset quality and strong capital buffers. Another sector on the positive side of currency divide are agro-allied producers, as the USDNGN depreciation induces greater local raw material sourcing. On this front, following proscription of FX access for 41 items, including palm oil, listed CPO producers should benefit from rising local prices and greater volumes.

On balance, weak currency picture combines with low fiscal and consumption spending in driving a muted fundamental picture across sectors.

Figure 63: Valuation Multiples



Source: Bloomberg, ARM Research

CAPITAL MARKET STRATEGY

Naira curve may flatten but the focus is not to balance

Having assessed the role of monetary policy in steepening the yield curve in the later part of H2 15, our H1 16 fixed income strategy was for investors' to build duration as we anticipated that the CBN's monetary easing would persist over most of the period. However, the apex bank's abandonment of its growth stimulating mandate, for pursuit of real yield, with a surprise hike in monetary policy rate at the March MPC, led to a slight tweak in our fixed income strategy as delineated in our Q2 16 update. Specifically, in cognisance of the possible dent the flip-flopping of the CBN policies could have on investors' confidence, we recommended a more active strategy as we expected volatility across the curve to heighten. For full disclosure, the executive-legislative squabble over the contents of the 2016 budget, bearish inflation outlook as well as continued instability in the currency market also influenced our push for more frequent rebalancing. Whilst we believe a timely execution of this strategy should have minimised P&L losses occasioned by the upward shift in the yield curve over Q2 16, the real question is what the second half of 2016 holds for the FI market.

To that end, we believe the drivers of the evolution of the yield curve over H1 16 are worth revisiting. Tracking back, though the long end became more responsive to inflation readings, the role of monetary policy in shaping the yield curve was evident over first half of 2016. As the short end of the curve rose more rapidly, in response to monetary tightening, term spread between maturities narrowed and the yield curve, as a whole, inverted. However, that was also partly because of events at the long end which appeared to see increased buying interest after inflation-induced yield upticks and allotment cutbacks at primary market bond auctions. The latter half of that dynamic is important as increased purchases at the long end, despite poor outlook for inflation and fiscal challenges, suggest investors doubt the sustainability of the hawkish policy that was driving the short end. Certainly, there was fundamental

backing for such a view, not the least of which was the contraction in real output.

In tying the limited response at the long end of the yield curve to a view on sustainability of tightening-mode monetary policy rather than inflation or fiscal challenges, we do not ignore the latter two but simply feel that the former has run ahead of itself. Indeed, after initially driving rates up across the breadth of the short end, the apex bank backtracked on issuing one-year paper at the 17th August 2016 auction. Furthermore, whilst it persisted with OMO which it had used to drive rates up, a repeated pattern of no-sales for the longer tenor, with a comfort zone that appeared maxed out at ~200days, further reinforced the hint that the CBN does not seem ready to drive the hawkishness for an unduly long time. Indeed, having pinpointed currency support (curious as it were) as the primal undercurrent for July's rate hike, a short intense tightening to see whether FPIs are tempted fits snugly with that focus. At the long end, despite the somewhat sanguine outcomes thus far, our pessimistic outlook for inflation (>18% in H2 16) and need to finance part of the record budget deficit of ₦3.8 trillion (our estimate) provides enough impetus for rates to climb to fresh highs, especially when for the fiscal side one considers that the lag in crude sales to actual cash receipts suggest the full impact of the weak revenues thus far in 2016 will just be materialising in H2 16. However, we feel that all these will remain more in the realm of 'risk': bond yields are already ignoring inflation levels and could well do so for a while even as FG looks set to focus more on plugging loopholes than borrowing to implement the budget and even for the spending, seems to be increasingly favourably disposed to a Eurobond. Importantly, as long as government does not 'play its part' in the response to the crisis by rapidly ramping up domestic paper, the scope for yields upticks at the long end remain limited even as predominance of buy and hold money caps secondary market responses. To be clear, we see some scope for yields to climb a bit higher from current levels given slow response thus far, possibly by 100-200bps, but we expect institutional demand to rapidly provide resistance at that level. Combining

this with the likelihood that short-end tightening will reverse as the desperation of the macro-picture becomes technically confirmed via further GDP releases, on balance, yield outlook seems surprisingly benign with potential for significant negative real rates though largely hinged on short-term liquidity. Accordingly, whilst some volatility will inevitably present itself at the short end, providing opportunity for quick gains, we feel the better rewards are to be gleaned by building duration mid H2 16 when its most likely dire macro-fundamentals will be at their most visible, before the influence of monetary reversal. On that wise, our barbell strategy is very much uneven with the long end compelling a more sizable allocation in our view, especially if the modest uptick materialises as expected.

Difficult macro terrain leaves equities facing higher hurdles

In our review of equity market performance, we established that NSEASI's positive close over H1 16 owed much to sentimental buying by local investors as the fundamental case for naira equities remained depressed. Thus after the Q2 16 rally, outlook boils down to how long sentimental issues can continue to offset the weak fundamental case for equities exposure. To tackle this *sentiment vs fundamental* conundrum along foreign and local investor perspectives, we think two questions are focal. First, can foreign investors look beyond a foggy post Brexit global environment to seek out value in a near recessionary economy? Second, how long can equity markets hold on to gains induced by domestic investors front-running? To our minds, even an optimistic scenario wherein global financial markets sail smoothly over H2 16—ignoring potential fall-out from feisty negotiations between Britain and the EU, a testy US presidential election season and the continued see-saw over US interest rates trajectory—the already chastened domestic terrain swiftly quells investor appetite for naira risk. Across all macro-indicators, our base case analysis for H2 16 projects bleak economic picture: real GDP contraction, close to 20% CPI inflation, fiscal and trade deficits and continuing currency pressures. While Nigeria's economic managers are now taking steps which directly deal with issues currently blighting the macro landscape, the timeframe over

which the remedial actions are likely to have sizable impact extends beyond H2 16. Thus, to the first question, the answer is fairly obvious, foreign interest in Nigeria, and by extension NSEASI, should remain marginal. On the second question, CBN's pivot to a hawkish posture ostensibly to support the naira provides an answer as the higher opportunity costs for equities implicit in the rising yield environment should test the patience of local investors. Lacking FPI reinforcement, we think currently attractive yield levels, which are likely to be short-lived as the recessionary conditions induce resumption of monetary easing, could herald local investor reticence to NSEASI in H2 16.

Beyond the likely direction of sentiment, we examine the fundamental case across the various sectors to overlay with our position on liquidity flows. Having identified a high dependence on foreign inputs and restrained consumer purchasing power as too potent a cocktail for FMCGs, we see already burdened valuation levels as placing the sector as most exposed to the deterioration in the macro environment. Though modest valuations leave cement as one to watch, uncertainty over fiscal financing plans, repressed capital spending at state level and market share pursuit of industry heavyweight (DANGCEM), which has crashed prices, underpins a subdued earnings outlook. For NSE O&G, improvement in downstream fortunes on the adoption of a flexible pricing framework in May poses upside to earnings. However, NGN depreciation beyond the implied ₦285/\$ adopted in price template and as yet unclear FGN disposition towards further upward price adjustments tempers optimism over the sector as whole. Our preference is for the international plays in the sector in particular Total and Mobil, whose upstream O&G affiliations leave these players better positioned to deal with dollar shortages.

Clearly, NGN movement and impact on NSEASI sectors is a key theme in deciding winners and losers over the next six months. In this regard, banks are a sector where we find more firms with net long FCY positions, implying sizable possibility for NGN depreciation assisted top-line momentum over H2 16. Aided by aforementioned monetary tightening stance of the apex bank, which provides tailwinds for

net interest margins for banks with low cost funding, revenue prospects appear much better than at the start of 2016. Nonetheless, investors need to be wary of the rising tide of loan loss provisions, as the macro stress feeds-through to loan quality, and potential impact on earnings and capital adequacy. Thus, while banks remain the cheapest valuation play across our coverage universe, our call is to be selective. In particular, we favour banks with net long positions to benefit from naira downside, liquid balance sheets to tap into the rising yield

environment and tight lid on asset quality. Rounding up our views on NSEASI sectors, we see continuing naira weakness and increasing shift towards locally sourced inputs as favourable to agro-allied producers. Here, listed palm oil producers have fared better as CBN FX proscription for CPO imports should extend pattern of rising CPO prices and sturdy sales volumes. Overall, the uncertain global landscape and dour domestic climate call for caution and increased selectivity in the equities space over H2 16.

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