

January 18, 2021



Nigeria Strategy Report

H1 2021

Global Economy and Markets

EM Portfolio flows: A light at the end of the tunnel

Executive Summary

Over H1 2020, emerging markets equities performance declined by 10.7%. This reflects strong selloffs in Q1 2020 (-23.9%) – a fallout of the coronavirus pandemic and oil price shock which rippled through global financial markets, outweighing the rally seen in Q2 2020 (+17.3%). Specifically, the adoption of an accommodative stance by the US Fed as well as other monetary bodies to combat the adverse impact of the pandemic sparked positive sentiments across EMs equities over Q2 2020. For context, US Fed trimmed rates by a cumulative of 150bps in March 2020 to 0.25% and pledged to keep interest rates low while simultaneously offering trillions of dollars in credit to spur growth. However, EMs equities saw a rebound (+26%) over H2 2020. While EM equities maintained a positive return over Q3 2020 (+8.7%), positive COVID-19 vaccine news and the conclusion of the US presidential election which curtailed uncertainties, led to a rally in Q4 2020 (+15.8%). On the fixed income leg, emerging markets government bond spreads tightened more than 15bps and 61bps in Q3 20 and Q4 20 respectively over comparable U.S securities. This largely reflects investors' appetite for riskier assets with attractive valuations, in the wake of accommodative monetary policy across most developed markets.

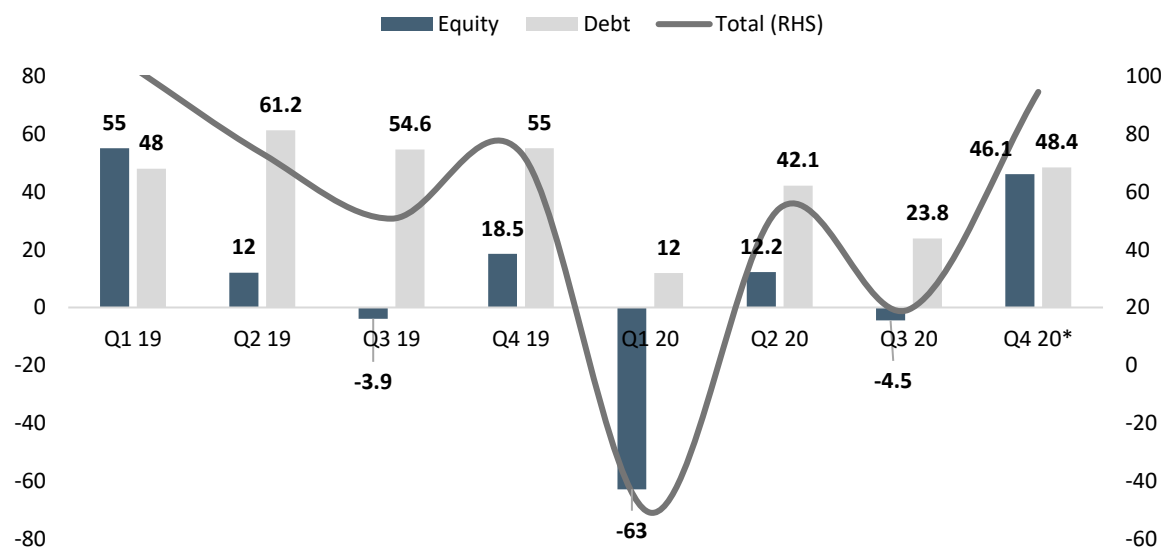
Going forward, we think the confluence of rollouts of the COVID-19 vaccine across various countries, prospects for commodity prices, election of Joe Biden as US president, direction of monetary policy across developed market as well as growth expectations for emerging markets will chart the course for portfolio flows to the emerging markets in 2021. On the COVID-19 vaccine, since the vaccine trial success by Pfizer Inc and its German partner – BioNTech SE, the rollout of the vaccine across countries including US, UK, Japan, amongst others, serves as a significant positive catalyst for global recovery and an upside to capital flows to EMs. Meanwhile, the conclusion of the US-presidential elections in November 2020 with Joe Biden emerging the winner is expected to curb US-China trade tensions. This, in addition to IMF's forecast for EMs growth to rebound by 6% in 2021 - a faster growth relative to developed economies (+3.9% in 2021) - makes valuations for Ems relatively attractive. Against these backdrops, we see scope for higher portfolio flows into EMs in 2021.

In this report, we look at the major themes that dominated portfolio flows to EM over H2 2020 as well as our outlook for flows to EM over 2021.

Vaccine induced optimism spurs portfolio flows to emerging market in H2 2020

Portfolio flows to emerging markets rebounded in H2 2020, following the downward reversals witnessed in H1 2020. For context, while Q1 2020 saw a significant net outflow of \$51 billion triggered by the Covid 19 pandemic, portfolio flows to the emerging market rebounded in Q2 2020, with a net inflow of \$54.3 billion. Hence, net portfolio flows printed at \$3 billion over H1 2020. Over the second half of 2020, positive COVID-19 vaccine news as well as the resolution of uncertainty regarding the US election boosted positive sentiments that lured non-resident flows toward emerging markets. In addition, we believe the extensive liquidity due to stimulus packages from advanced economies gave a boost to portfolio flows during the period. For context, in H2 2020, total net inflow printed at \$113.8 billion with 63% (\$72.2 billion) of the total flows channeled towards EM debt counters, while equities (\$41.6 billion) accounted for 37% of total flows.

Figure 1: Trend in EM net portfolio flows ('billion \$)



Source: IIF, ARM Research

Dissecting the quarterly numbers, Q3 2020 saw slower net inflows with a cumulative of \$19.3 billion amidst sell-off in the equities market (recording an outflow of \$4.5 billion in Q3 2020) while flows to the debt securities totaled \$23.8 billion over the period. However, bulk of the funds flowed into EMs over Q4 2020¹ printing at \$94.5 billion, spurred by interests across debt (\$48.4 billion) and equity securities (\$46.1 billion).

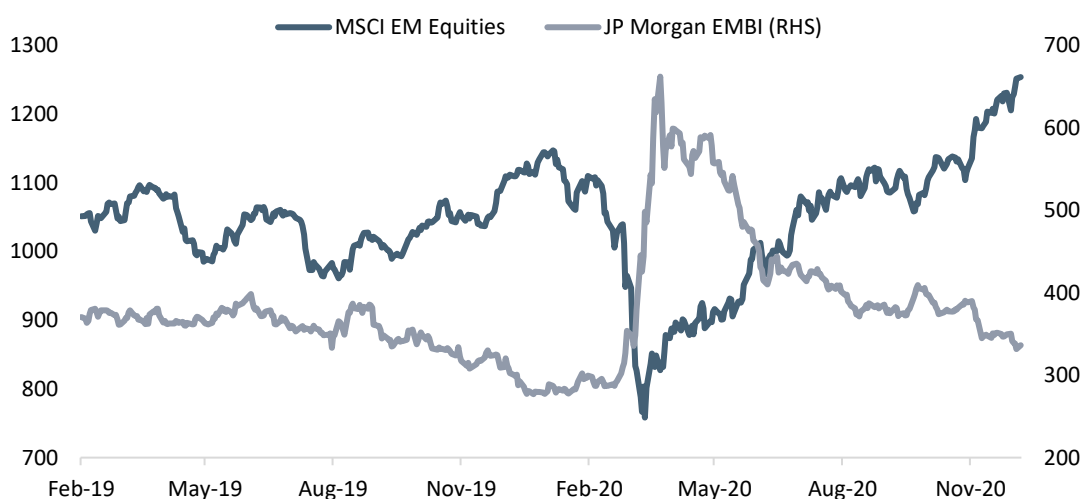
¹ October and November 2020

A boomerang in emerging market assets

Over H1 2020, emerging markets equities performance declined by 10.7%. This reflects strong selloffs in Q1 2020 (-23.9%) – a fallout of the coronavirus pandemic and oil price shock which rippled through global financial markets, outweighing the rally seen in Q2 2020 (+17.3%). Specifically, the adoption of an accommodative stance by the US Fed as well as other monetary bodies to combat the adverse impact of the pandemic sparked positive sentiments across EMs equities over Q2 2020. For context, US Fed trimmed rates by a cumulative of 150bps in March 2020 to 0.25% and pledged to keep interest rates low while simultaneously offering trillions of dollars in credit to spur growth. As a result, EMs equities saw a rebound (+26%) over H2 2020. While the positive momentum continued in Q3 with market return at 8.7%, positive COVID-19 vaccine news and the conclusion of the US presidential election which curtailed uncertainties, fueled a rally in Q4 2020 (+15.8%)².

On the fixed income leg, Emerging markets government bond spreads tightened more than 15bps and 61bps in Q3 20 and Q4 20 respectively over comparable U.S securities. This largely reflects investors’ appetite for riskier assets with attractive valuations, in the wake of accommodative monetary policy across most developed markets. As mentioned earlier, the US Fed cut interest rate twice in 2020 by 150bps in March. Furthermore, while the ECB left deposit facility unchanged at an all-time low of -0.5%, it expanded its pandemic-related bond purchases³ by 600 billion euros to a total of 1.35 trillion Euros, extending it to June 2021.

Figure 2: Performance across EM asset class



Source: Bloomberg, ARM Research

² 1st October to 12th December, 2020

³ Formerly 750 billion euros

A rebound in portfolio flows across various EM countries over H2 2020

Over in EM Asia, China saw a continued increase in FPI inflows to \$79.6 billion in Q3 20 relative to a portfolio inflow of \$66 billion in Q2 2020, and significant outflow of \$1.68 billion in the first quarter of the year. Precisely, the increase in FPI inflows was driven solely by increases in flows to debt investments to \$75.9 billion by 96% QoQ, while flows to equities declined sharply by 86% QoQ to \$3.7 billion. The upsurge in portfolio inflows to Chinese debt mirrors a recovery in economic activities with GDP rebounding to 3.2% in Q2 2020 and 4.9% in Q3 2020, after posting its first GDP contraction on record (Q1 20 GDP: -6.8% YoY) induced by the pandemic. In addition, China rolled out a ream of relaxations – effective June 2020 – under the QFII⁴ and RQFII⁵ channel, aimed at encouraging foreign participation in its financial markets. Key changes include removal of quota restrictions, multiple options allowed for currency remittance into China, easier repatriation of funds as well as a broader range of financial derivatives for hedging purposes. To further broaden its investment base, China combined the QFII and RQFII programme into one scheme. Meanwhile, towards the latter part of Q3 2020, FTSE Russel announced that China's government bonds will be added to its flagship world government bond index. We believe this further supported flows to Chinese debt market during the review period.

Elsewhere in India, foreign portfolio investors channeled a net inflow \$1.098 billion in Indian investments in Q2 2020, compared to a significant net outflow of \$14.7 billion in the prior quarter. The upturn in FPI flows to India mirrors an improvement in current account surplus to \$19.8 billion in Q2 20 (Q1 20: \$600 million), slower economic contraction in Q3 2020 (-7.3% YoY vs Q2 2020: -23.9% YoY) as well as India's higher prospects weightings in MSCI EM index⁶. On India's current account, lower importation reflecting the significant decline in crude oil demand (Q2 20: 3.77mbpd vs Q1 20: 4.77mbpd) due to the pandemic as well as stable services income contributed to the improved current account surplus in Q2 2020. Meanwhile, India's decision to expand the statutory foreign portfolio investment in a company from 24% to the sectoral foreign direct investment limit⁷, increased the prospect for an expansion in India's weight on MSCI EM index. To simplify, the implementation of this policy supports increased investments in India's Equities from non-residents. These more than outweighed the impact of other restrictive measures imposed by India. To shed more light, in Q2 2020, India initiated new rules to inspect foreign portfolio investors precisely from

⁴ Qualified foreign institutional investor

⁵ Renminbi qualified foreign institutional investor

⁶ An index is used to measure equity market performance in global emerging markets

⁷ Implemented on April 1st, 2020

China, in a bid to prevent takeovers as asset prices were depressed during the period owing to the corona virus.

Over in Latin America, after recording a net outflow of \$1.18 billion in Q2 2020, foreign portfolio flows to Mexico rebounded in Q3 20 to a net inflow of \$2.53 billion. For context, Mexico's dour macroeconomic performance worsened as the economy shrank by 18.67% YoY in Q2 2020 induced by the impact of the coronavirus pandemic on economic activities as well as crude oil price shock. In addition, Moody's downgrade on Pemex's⁸ credit ratings to "Junk" status further aggravated the outflow of funds from Mexico in Q2 2020. However, gradual pickup in economic activities as well as crude oil prices spurred portfolio flows to the Mexican economy in Q3 2020. Precisely, Mexico's economy saw a slower contraction in GDP by 8.57% YoY while crude oil prices increased by 19.8% to \$41.6/barrel in Q3 2020 relative to the prior quarter. Likewise, Portfolio flows to Brazil switched to an inflow of \$1.94 billion in Q3 2020, relative to an outflow of \$4.37 billion in Q2 2020. In our view, renewed foreign investors interest in Brazil's market reflects the resumption of economic activities at the start of Q3 2020. This resulted in slower economic contraction (Q3 20: -3.9% YoY vs Q2 20: -10.9% YoY).

Meanwhile, Columbia saw positive net foreign portfolio flows in Q3, albeit lower 2020 relative to the prior quarter. Specifically, flows to Columbia printed at \$1.96 billion in Q3 2020 (Q2 20: \$4.7 billion) mirroring a worse than expected GDP result as well as the maintenance of the country's credit outlook as negative⁹. To buttress, Columbia recorded a GDP contraction of 9% YoY in Q3 2020, above market expectation of an 8.6% contraction. However, Chile recorded non-resident net outflow of \$1.48 billion in Q3 2020 (vs an inflow of \$2.63 billion in Q2 2020). This mirrors political uncertainties in Chile's changes to the legal framework following massive votes to rewrite constitution.

Over to EM Europe, non-resident investors pulled out \$1.3 billion from Turkey in Q3 20, albeit an improvement compared to the massive outflow of \$10.84 billion in Q2 2020. A swift recovery in Turkey's GDP growth rate (Q3 20: +6.7% YoY vs Q2 20: -9.87% YoY) due to resumption in economic activities as well as the increase in monetary policy rate by 200bps to 10.25% in September 2020, curtailed net outflow from foreign investors. Meanwhile, in Q3 2020, portfolio flows to Poland rebounded to \$223 million, from an outflow of \$8.7 billion in Q2 2020.

⁸ Mexican state-owned petroleum company

⁹ August 2020

Elsewhere in Africa, portfolio flows into Nigeria market remained depressed since the inception of the pandemic in Q2 2020. Precisely, non-resident flows into Nigeria printed at \$407.3 million (Q2 20: \$385.3 million), which is meagre compared to 2019 where foreign portfolio flows averaged \$4.09 billion. The breakdown showed foreign portfolio flows to equities market moderated sharply to \$53.23 million over Q2 2020 (Q1 20: \$639.7 billion), and \$44.1 million in Q3 20. For us, we believe the adverse impact of the pandemic on crude oil prices and other macroeconomic variables resulted in significantly lower flows. For context, GDP contracted by 6.1% YoY in Q2 20 and -3.6% YoY in Q3 2020. In addition, inflation rate rose sharply during the period by 136bps to 13.7¹⁰% while monetary policy rate was trimmed twice by 200bps cumulatively to 11.5% between Q1 and Q3 20. On the other hand, foreign portfolio interest in Nigeria's fixed income securities remained tepid in Q3 2020 as there was no flow to the bonds (same as Q2 20), while flows to money market printed at \$363 million (Q2 20: \$332.07 million). To our minds, the tamer interest in Nigeria's debt reflects depressed yields (-111bps to 4.03%¹¹), lower interest rates significantly below inflation rates, as mentioned earlier. Elsewhere, South Africa witnessed a net foreign portfolio outflow of \$1.7 billion in Q3 2020, albeit slower relative to the prior quarter (Q2 20: net outflow of \$3.05 billion). We believe the moderate pickup in economic activities resulted in a slower outflow as GDP contracted by 6% in Q3 20 (Q2 20: -17.5% YoY)

A light at the end of the tunnel

Going forward, we think the confluence of rollouts of the COVID-19 vaccine across various countries, prospects for improvement in commodity prices, election of Joe Biden as US president, direction of monetary policy across developed market, growth expectations for emerging markets as well as excess liquidity from stimulus package will chart the course for portfolio flows to the emerging markets in 2021. On the COVID-19 vaccine, since the vaccine trial success by Pfizer Inc and its German partner – BioNTech SE, the rollout of the vaccine across various countries including US, UK, Japan, amongst others, serves as a significant positive catalyst for global recovery and an upside to capital flows to EMs. This is expected to positively impact commodity prices (especially crude oil) by accelerating the pace of global oil demand recovery. Meanwhile, the conclusion of the US-presidential elections in November 2020, with Joe Biden emerging the winner is expected to curb US-China trade tensions. Furthermore, the accommodative monetary policy stance across most developed markets targeted at combating the economic fallout from the pandemic could spur portfolio flows into the emerging markets in 2021.

¹⁰ Nigeria Inflation rate as of September 2020

¹¹ Average fixed income yields as of September 2020

This, in addition to IMF's forecast for EMs growth to rebound by 6% in 2021 - a faster growth relative to developed economies (+3.9% in 2021) - makes valuations for EMs relatively attractive. Against these backdrops, we see scope for higher portfolio flows into EMs in 2021. However, an austere second wave of the COVID-19 pandemic and its possible adverse impact on global economy poses a downside risk to capital flows into emerging markets.

On a regional basis, in EM Asia, we are positive on the prospects for portfolio flows into China. Our optimism is hinged on projected rebound in economic growth rate of 8.2% in 2021, according to the IMF, reflecting a pickup in economic activities. Also, the end of Trump's era as the US president in 2021 which could curtail the tensions between US and China, bodes well for China. Furthermore, the combination of QFII and RQFII into a single "qualified foreign investor" administration to spur foreign investors access to China's capital market, as well as FTSE Russel's decision to include Chinese government bonds to its flagship world government bond index from October 2021, is expected to drive portfolio flows to China. Elsewhere in India, despite the accommodative monetary stance adopted to spur economic growth, we see scope for improved portfolio flows hinged on a revival in economic activities, with a growth rate forecast of 8.8% in 2021, according to the IMF. Nevertheless, we highlight concerns over India's plans to impose tighter trade restrictions on commodities from China to protect local businesses, as this may taper appetite for India's assets in 2021.

Meanwhile, in Latin America, the anticipated pickup in economic growth as well as gradual recovery in global crude oil demand informs our expectation of positive inflow into Mexico in 2021. However, the heavily indebted state-owned oil & Gas firm –Pemex, stands as a downside to our expectation during the period. In Brazil and Columbia, the possibility of a continuous dovish stance in most developed economies coupled with improved economic activities should support foreign investor's interest in both markets. Elsewhere in EM Europe, Turkey's switch to a tightening monetary policy stance (+475 bps to 15% in November) in order to stem the rise inflation fused with an expectation of recovery in GDP in 2021, informs our expectation of positive inflow of funds to Turkey. Meanwhile, the conclusion of the Brexit deal which should curtail economic uncertainties in the EU is expected support foreign investors flow into EM European countries over 2021.

Lastly in Africa, over 2021 we see room for possible return of FPI flows to Nigeria. Our view is hinged on an expectation of recovery in GDP in 2021 with IMF forecasting a 1.7% YoY growth in 2021. Albeit we think continuous rise in inflation rate, low fixed income yields as well as unstable FX poses a risk to positive flows in Nigeria. Similarly, in South Africa,

prospects for a rebound in economic growth by 3% YoY according to the IMF (vs -8% YoY in 2020), should support portfolio flows to Turkey in 2021.

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