

January 22, 2021



Nigeria Strategy Report

H1 2021

Domestic Economy and Policy Environment

Fixed Income: No bounce back for yields

Executive Summary

It was a turbulent second half of the year for secondary market yields as sustained bullish sentiment kept yields pressured. This was in part attributable to a lofty maturity profile of ₦8.46trillion that matured during the period, but also the CBN's decision to cut MPR by 100bps to 11.5%, a move that further diminished the allure of savings and drove investors in search of more profitable pastures. This saw average fixed income yield fall by 205bps in H220, as average bond and NTB yields shed 242bps and 270bps respectively. Similarly, in the primary market, stop rates continued their decline from H120. In the bond market the average stop rate declined by 341bps to close the year at 6.97% while in the NTB space the average stop rate dropped by 195bps over the half to 0.58%.

Looking ahead to 2021, the FG have a planned borrowing of ₦2.34 trillion which we expect them to stick to, despite our forecast that fiscal deficit will print 17% higher (₦5.74 trillion) than the FG's budgeted amount (₦4.89 trillion). The maturity profile is much lower this year compared to last year (₦7.42 trillion vs ₦17.3 trillion) but there will still be enough liquidity in the system to keep yields subdued over 2021. We expect rollovers for the NTB maturities (₦2.7 trillion) as well as the OMO maturities (₦4.14 trillion). Meanwhile, we do not expect the ₦561 billion bond maturity in July to be rolled over, consequently translating to an addition to system liquidity. There are coupon payments totaling ₦877.7 billion this year which would further add to system liquidity (and overall demand) as well as an estimated ₦318 billion from net pension contributions. These will all add to the system liquidity which we estimate was at ₦658 billion as at the start of the year and ensure that demand exceeds supply over the course of the year, keeping yields subdued.

In this report, we look at the major themes that dominated the fixed income space over H2 2020 and delineate our outlook for 2021.

Secondary market yields hit record lows

Similar to what played out in the first half of the year, sustained bullish sentiment in the secondary market led average fixed income yield down further by an accumulated 205bps to 3.08% in H220 (H120: -258bps to 5.14%). Notably, we saw fiscal and monetary authorities play significant roles in influencing demand levels. On the former, demand was once again spurred by a lofty maturity profile in the form of ₦8.46trillion worth of fixed income instruments during the period. While on the monetary side, the CBN's policy decisions served as an indirect trigger for a demand drive witnessed in the fixed income space. Firstly, there was the decision to reduce the minimum savings deposit rate to 10% of MPR (from 30% of MPR) in August. More specifically however, the bank's decision to reduce the Monetary Policy Rate (MPR) in late September made savings even more unattractive, driving investors to the secondary market in search of higher returns.

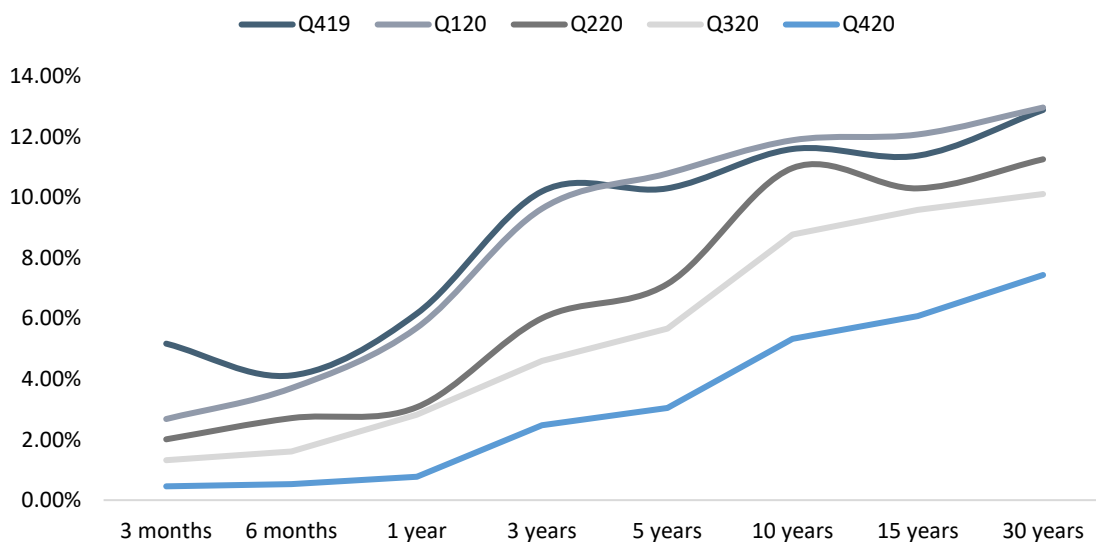
At the long end of the curve, average bond yields dipped by 242bps to print at 5.70% at the end of the year, with the 30-year¹ down by 367bps to 7.42%. Average yield edged up 106bpsMoM to 7.57% in August, following a 161bps decline in July. The increase occurred after PENCOM directed PFAs to refund contributions previously made by the regulator on behalf of Government agencies and departments. This led to a largescale sell-off in bonds to raise funds for the aforementioned payment. Furthermore, the upward repricing of bonds at the short end following the release of the savings bond calendar also supported the higher yields seen during the period. In September, yields slid by 136bpsMoM to 6.20% owing in no small part to the CBN's decision to slash MPR by 100bps to 11.5%, its lowest rate since 2016. For context, average bond yield declined 80bps in the week following this decision. October brought about the lowest monthly close of the year as bond yields shed 250bpsMoM to print at 3.70%. The largest weekly decline (-103bpsWoW) was recorded in the second week, as the contraction coincided with the DMO's announcement to offer only ₦30billion across only two instruments- a fraction of what they have offered at previous auctions. Amongst individual bonds, the largest monthly contractions were observed in Apr-37 (-390bps), Jul-34 (-387bps), Feb-28 (-381bps) and Mar-36 (-371bps).

The mood in December was relatively bearish, as market players relentlessly sort avenues to reduce their exposure on debt instruments. This led to a bit of profit-taking from local investors who sought to close their book positive for the year-end and was corroborated by a 228bps rise in the average bond yield. Overall, investors favored papers at the short, mid and long-end as the Jul-2021(-406bps), Jul-2030(-371bps) and Apr-2049 (-363bps) papers experienced the biggest contraction in H220.

¹ Instrument was issued in Q120

In the NTB space, yields maintained its tepid performance for most parts of the second half the half as average NTB yields fell by 169bps to 0.46% (H120: -270bps to 2.15%). Average NTB yield fluctuated over the first three months of the half, with August bringing about the first MoM increase. Specifically, upticks in the 182-day (+58bps) and 364-day (+22bps) bills drove average yield up 37bps MoM to 2.12% (July: -40bps MoM) as only ₦254billion worth of treasury bills matured during the month. Increased system liquidity over the following two months kept NTB yields pressured, so much so that the average NTB yield plunged to a 7-year low of 0.10% by November. Surprisingly, market momentum was rather sluggish in December despite buoyant liquidity at the disposal of investors. This saw yields trend northwards for most parts of the month. Glancing at individual bills, the 270-day and 1-year bills led the way in terms of declines during H220, shedding 211bps and 224bps respectively.

Figure 1: Trend in fixed income yields



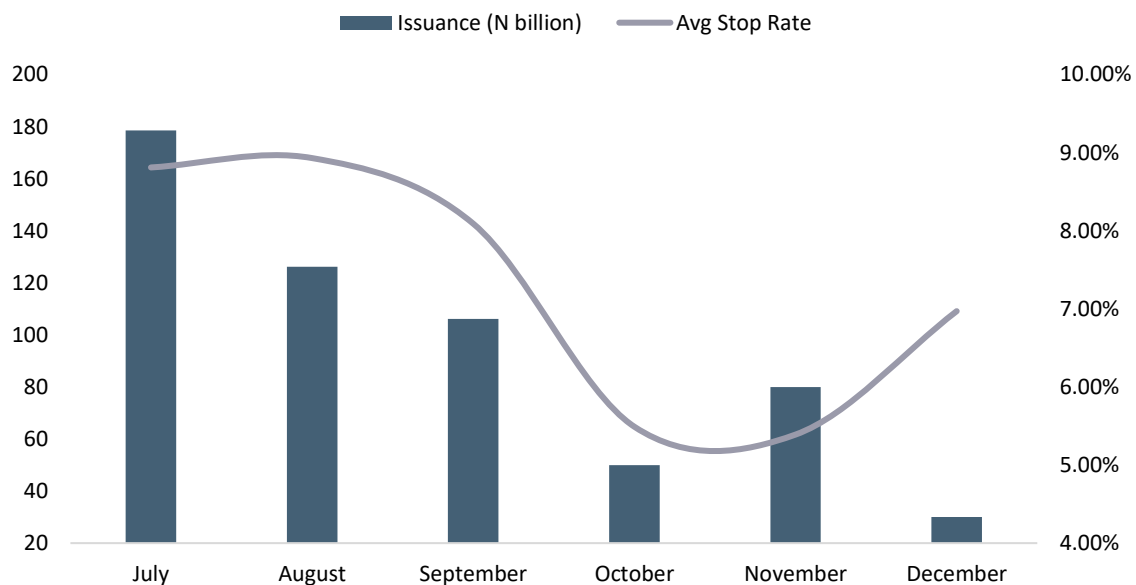
Source: FMDQ, ARM Research

Issuances and stop rates plummet in the bond market

In our last NSR we highlighted how the DMO had substantially ramped up its borrowings in the bond market over H120 as it looked to meet its higher borrowing target for the year. It borrowed ₦1.31 trillion over the first 6months of the year, a rate of ₦0.22 trillion per auction which is double the average from the two previous years (2018 and 2019) of ₦0.11 trillion per auction. However, in H220, we saw the total issuance drop to ₦570.8 billion which brings the average issuance rate down to approximately ₦0.10 trillion per auction. Another interesting contrast between the two halves of the year was how the DMO made use of the oversubscription at the auctions.

In H120, they offered ₦615 billion, received a total subscription of ₦2.45 trillion (3.98x the offered amount) and eventually sold ₦1.31 trillion (2.13x the offered amount). However, in H220, the DMO offered ₦595 billion, received ₦1.63 trillion in total subscriptions (2.73x the amount offered) but then sold just ₦570.8 billion, which was 0.96x the amount that was offered. The decision to sell more than was offered in H120 could simply be one borne out of the need to meet their higher borrowing target and the slowdown in H220 could simply be because they had made good progress towards meeting that target and felt they could ease off on the borrowings. What really stood out in the bond auctions in H220, more so than the fall in issuances, was the sharp drop in the average stop rate. In H120, the average stop rate declined 168bps to close the half at 10.38% but in H220 the rate of decline more than doubled to 341bps which led the average stop rate to close the year at 6.97%. The final thing of note was, from the October auction, the DMO cut the number of instruments it offered at auctions to two (March-2035 and July-2045) after increasing the number from three to four at the July auction. This undoubtedly played a role in the decline of the average stop rate.

Figure 2: Trend in Bond issuances and marginal clearing rates



Source: FMDQ, ARM Research

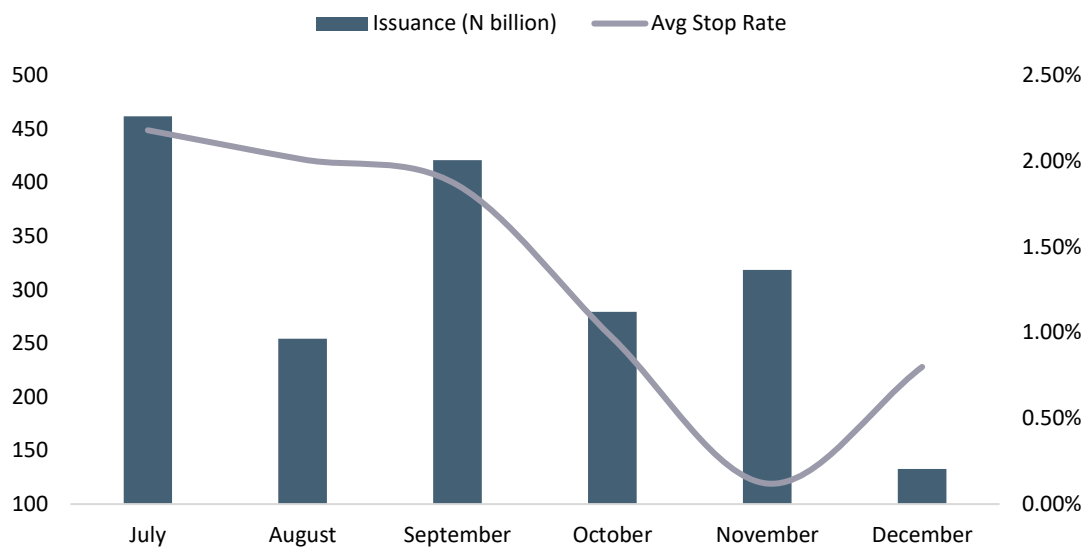
NTB stop rates continue their decline

After falling by 230bps in H120, the rate of decline in the average NTB stop rate slowed to 195bps in H220. This brought the average stop rate to a year close of 0.58%, a far cry from the 4.83% it closed in the previous year (2019).

The continuous fall in these rates has been as a result of a conscious decision by the DMO to lower the borrowing costs of the FG as well as a consequence of the MPC's decision to cut the MPR by a further 100bps at the end of Q320 to 11.5%. Despite these lower rates, the average subscription rate over H220 rose to 3.69x from 2.60x in H120. The total NTB maturity in H220 was ₦1.91 trillion, which is a 43% increase from the ₦1.33 trillion that matured in H120. In terms of issuance, the DMO rolled over in all but one month – September, where they net repaid by ₦40 million – to bring total issuance over H220 to ₦1.87 trillion, which is 1% higher than the ₦1.85 trillion that was offered over the period. September's net repayment represents the first time this year the DMO has gone down that route; over H120 the DMO went the complete opposite direction and net issued twice which led to a total issuance (₦1.51 trillion) which was 18% more than the maturity for the period (₦1.33 trillion). Combining the total borrowing at the bond leg to the net repayment in the NTB space, we get a total borrowing of ₦530.82 billion for H220. Adding that to H120's total borrowing of ₦1.65 trillion, we get a sum of ₦2.18 trillion for total borrowing for FY20. This is just slightly under the ₦2.19 trillion they planned to borrow based on their amended budget.

In the OMO market, the CBN continued to wind down its balance sheet in H220 only offering and issuing a small fraction of the total maturity. The total OMO maturity in H220 was ₦6.56 trillion, slightly less than the ₦6.91 trillion from H120. However, the CBN offered and sold a smaller amount at the auctions compared to H120. The total amount offered in H220 was ₦1.59 trillion (H120: ₦3.49 trillion) which represents 24% (H120: 53%) of total maturity over the period. The amount sold was even less: ₦1.47 trillion (22% of maturity) compared to ₦3.39 trillion (53% of maturity) in H120. The CBN also continued to reduce its borrowing cost with the 1yr rate declining 299bps to close the year at 6.00%. In the Eurobond market, the average yield declined 119bps in H220 to 6.25% signifying a return of demand. Over H120 as oil prices crashed and Nigeria's fiscal situation looked increasingly precarious, we saw the average yield on Eurobonds rise 125bps to 7.44%. Over H220, the biggest declines were seen in the Nov-25 (-159bps), the July-23 (-144bps) and the Jan-31 (-133bps). The yield on the Jan-21, which expires next and has an outstanding value of \$500 million, fell 124bps over H220 to 3.35%.

Figure 3: Trend in NTB issuances and marginal clearing rates



Source: FMDQ, ARM Research

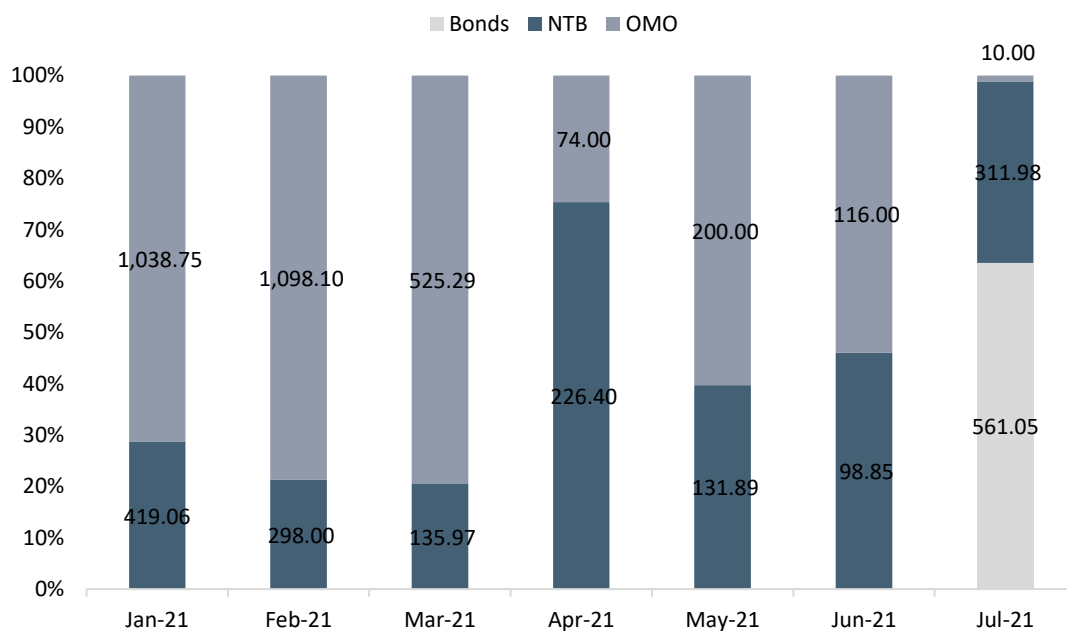
Liquidity from 2020 still keeping yields subdued

On a global scale, we still expect developed markets to keep their rates low as their economies make the tentative steps out of recession and into recovery. In the US, the Fed have said that rates can be expected to remain low until inflation rises consistently which, according to projections from some individual members, might not be until 2023. The ECB announced that they would be keeping their key interest rates at present or lower levels until it has seen “inflation outlook robustly converges to a level sufficiently close to, but below, 2%”. And according to its macroeconomic projections, inflation is expected to be at 1.0% in 2021 meaning a rise in rates is not in the offing this year. It is a similar message of dovishness and low yields across developed markets, and some developing markets, which might help make Nigeria more attractive to foreign investors on their global search for yields.

Looking domestically, the direction of yields can be assumed by looking at demand and supply for fixed income instruments during the year. Starting with supply, with focus on the main avenue to pay attention to is new borrowings from the FG. In the budget signed by the President passed by the Senate, the deficit prints at ₦4.89 trillion, 18% smaller than 2020’s, with ₦2.34 trillion of that to be funded by new domestic borrowings which is approximately 7% higher than the ₦2.19 trillion of domestic borrowings in their 2020 budget. This new borrowing represents the supply of new fixed income instruments that would come into the system. And similar to what has happened in the past, we believe majority of this new borrowing will come in the form of bonds while they will continue to rollover at the NTB leg.

However, based on our calculations and assumptions, we expect the actual FG deficit in 2021 to print higher at ₦5.74 trillion which means the FG have a funding gap of ₦874 billion. In the past, the FG have relied on backdoor funding to cover any funding gap they might have, rather than to increase their domestic borrowing and we expect this to continue in FY21. One instance we could see the FG increase its domestic borrowing is if it is unable to meet its foreign borrowing target of ₦2.34 trillion, in this case we could see domestic borrowings rise substantially. But as laid out in our fiscal report, we fully expect the FG to meet its foreign target by tapping into the Eurobond market, most likely in the second half of the year. Post-pandemic, Cote d’Ivoire is the only Sub-Saharan African country to have issued a Eurobond and they did so at a yield of 5%, which according to Fitch Ratings is a record low for the nation. They raised €1billion for their 12y-year instrument which was 5 times oversubscribed despite the low yield. Cote d’Ivoire is rated B+ by Fitch while Nigeria is rated slightly lower at B but Cote d’Ivoire’s story bodes well for Nigeria’s chances to borrow at a lower rate than they have in the past.

Figure 4: H121 Maturity Profile (N’billion)



Source: FMDQ, ARM Research

Moving on to demand, by making use of financial data from the CBN, we estimate based on our calculations system liquidity carried over as at the start of into 2021 was at ₦658 billion. Looking at further additions to this liquidity one of the main drivers will be the maturity profile for the year.

The most up-to-date figures puts total maturity in 2021 at ₦7.42 trillion which is 42% of the ₦17.3 trillion that matured in 2020. NTB maturity is at ₦2.72 trillion (FY20: ₦3.24 trillion) but the FG is expected to simply rollover the instruments here as they have done in the last few years. OMO maturity is at ₦4.14 trillion, 31% of the ₦13.47 trillion that matured last year, which is a testament of how far the CBN went in reducing their borrowing profile. One of the major drivers of the higher system liquidity last year was that about a third of this maturing OMO instruments belonged to non-bank financial institutions who were no longer allowed to participate in OMO auctions. This meant that they had to reallocate these funds into other fixed income instruments which drove the demand for these other instruments higher and played a major role in decline we saw in yields. This year, however, there are no such issues. Those with maturing OMO bills will still be allowed to participate in future OMO auctions, hence, we will not see the level of forced reallocation as we saw last year. We believe this should lead to majority of bills being rolled over. With rollovers expected in the OMO and NTB markets, we believe there would be no additional system liquidity from their maturities which would have depressed yields further. There is also a ₦561.05 billion bond maturity to look out for in at the start of H221. We believe the DMO will not rollover here, so we expect to see these funds flow back into the system increasing overall liquidity and boosting demand as investors look to reallocate the funds.

Aside from maturities, another important driver of system liquidity and, ergo, demand is FG bond coupon payments. Total coupon payments across FY21 is ₦877.69 billion with 82% (₦719.35 billion) coming in the second half of the year. Once received, chances are majority of these funds will look to be reinvested in fixed income instruments increasing the demand for these instruments. Though little, additional maturities to pay attention to that would play a role in boosting the system liquidity and boost overall demand include: ₦4.3bn of FGN savings bonds, ₦6.48bn of sub-national bonds and ₦79.59bn of corporate bonds. There is also ₦390.69bn worth of commercial papers maturing in 2021 but we expect bulk of these to be rolled over as companies rely on these to meet with their short-term funding. Overall, the total amount of funds coming into the system that we believe would boost system liquidity and consequently demand, is ₦1.53 trillion. This is lower than what we saw in 2020 where the total amount of maturity from OMO bills alone that flowed into the system was ₦8.6139 trillion.

Another factor to consider is the special bills recently introduced by the CBN. Commercial banks are one of the biggest holders of NTBs, holding ₦2.99 trillion worth of bills as at FY19 which is considerably more than ₦1.88 trillion held by PFAs over the same period. A reason banks hold so much NTBs is they need these instruments to serve as collateral when making inter-bank loans.

However, these special bills introduced by the CBN can also serve the same collateral purposes. This means we can see commercial banks switch some of their demand from NTBs to these special bills, especially if these special bills start to offer more attractive yields compared to the NTBs. This switch should reduce the downward pressure on NTB yields and support an increase there. The last boost to demand comes from net pension contributions. Within three years – precisely between 2017 and 2019 - net pension contribution averaged ₦490 billion and as at Q320 it stood at ₦447 billion. Approximately 65% of total pension assets is currently invested in fixed income instruments. Hence, should total net contribution in 2021 come in at the average of ₦490 billion, it translates into an additional ₦318.5 billion chasing fixed income instruments this year.

In summary, we assume that the FG is able to meet its foreign borrowing target and sticks to its domestic borrowing of ₦2.34 trillion despite our estimates putting actual deficit 17% higher than the budgeted amount (₦4.89 trillion) at ₦5.74trillion. We also assume complete rollover at the OMO, NTB and commercial paper markets which means total boost to system liquidity would be ₦1.53 trillion, mainly from bond, other maturities and coupon payments. The demand picture would also be supported by an estimated ₦318.5 billion from new pension contributions. Combining these additions to the present liquidity in the system of c.₦658 billion, we get a total liquidity figure of ₦2.51 trillion for 2021. Putting this all together paints a picture of higher demand in relation to supply which would support yields remaining low in 2021. Given the bond maturity and the higher coupon payments in the second half of the year, we expect yields to be more subdued in H221 compared to H121, but we would need to see the FG borrowing schedule before making a definite conclusion. Risk factors to this conclusion include:

1. The FG increasing their domestic borrowing target either to cover the funding gap or because they were not able to meet their foreign borrowing target which would increase supply and lead yields even higher.
2. CBN allowing more participation from banks in the OMO market which would see banks switch their demand from NTB to the higher yielding OMO bills. The lower demand for NTBs would help drive yields to higher.
3. Lower than average net pension contribution would decrease system liquidity and thus overall demand, pushing fixed income yields lower higher.

Based on this outlook, we recommend that HTM² clients with a low risk-appetite stick to the longer end of the curve where they can easily exit while those with a higher risk appetite play longer to benefit from the higher modified duration. HFT³ clients should take advantage of the expected fall in prices as yields rise over H120 before yields fall and prices rise in H220.

² Hold-till-maturity

³ Hold-for-trading

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