

July 26, 2019



# Nigeria Strategy Report

## H2 2019

Domestic Economy and Markets

# Balance of Payment: Foot on the pedal

## Executive Summary

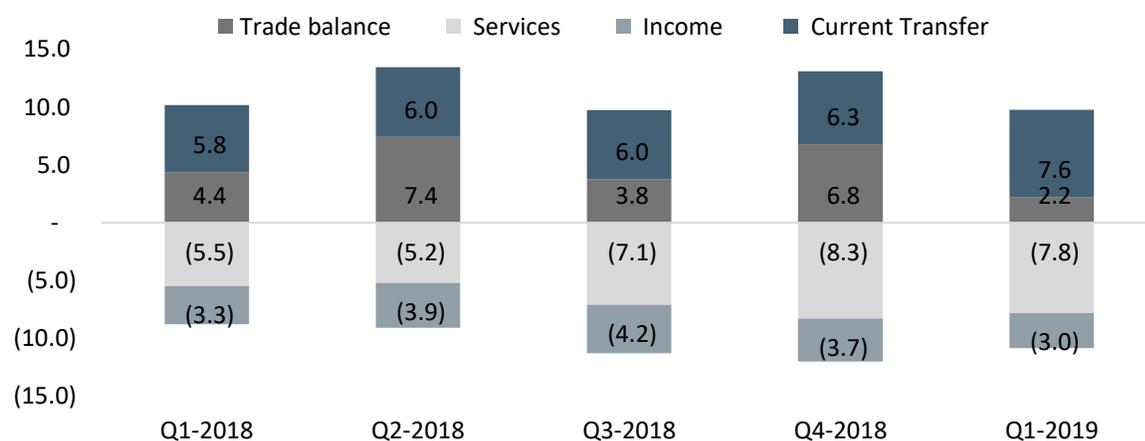
At the start of the year, we had guided to moderation in Nigeria's current account surplus in Q1 19 to \$420 million as we estimated that lower crude oil price over the quarter will constrain the value of oil exports. While we projected a moderation in overall imports, driven by faster decline in oil imports, we stated the impact will be muted by the decline in export. In line with expectation, oil exports faltered over the quarter on the back of lower oil prices. However, a material jump in non-oil imports worsened the narrative with the current account balance returning to a deficit of \$1.09 billion in Q1 19. On the financial account, capital flows into the country expanded faster than expected. Particularly, the US Fed tapered its aggressive stance, with guidance of multiple rate cuts over the year to mute the impact of unsettled trade agreements with China on the overall economic growth. The resultant effect saw foreign investors seek carry trade opportunities in emerging markets with capital flows into Nigeria over the first five months of the year reaching a record high of \$12.6 billion.

Going into the rest of the year, we project moderation in the current account surplus to \$2.2 billion (FY 18 surplus of \$5.3 billion) emanating from reduction in trade surplus, which more than outweighs expectation of better performance across other lines. For capital flows, we highlight two factors dominant to flows into the country over the year. First, a sustained dovish stance from the US Fed and secondly, the attractiveness of fixed income yields (OMO and Treasury bills) relative to other EM peers. While we believe inflows into the country will persevere, we think flows will however slow relative to H1 19 on the back of thinner carry trade opportunities. On asset classes, barring any near transformation that could trigger economic growth in the country, we expect foreign investors to remain biased, leaning towards short term instruments.

*In this report, we focus on development in the Domestic environment, Highlighting our views on the Nigeria's current and financial accounts position.*

*One-off non-oil import narrowed trade surplus*

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**Figure 1: Current account Surplus components (\$'billion)**

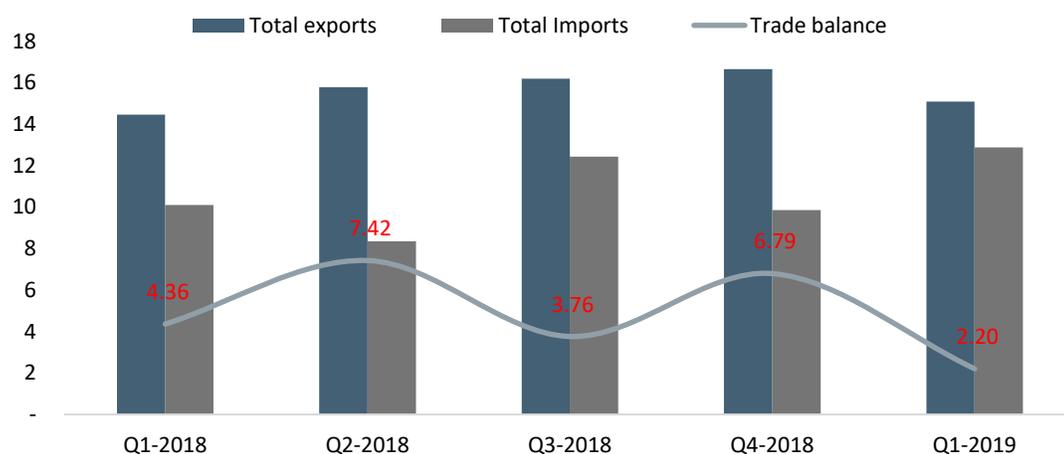
Source: CBN, ARM Research

Trade surplus dropped 68% in the quarter to \$2.2 billion, mirroring the surprise increase in imports (+30% QoQ to \$12.9 billion) after the festive season in Q4 18 and lower value of exports (-9% QoQ to \$15.1 billion) from to lower crude oil prices. According to data from the National Bureau of Statistics, the one-off jump in imports was due to purchase of a pharmaceutical glassware valued at \$1.44 billion<sup>1</sup> (12% of total non-oil imports). Meanwhile, import of refined oil products declined 67% QoQ to \$804 million during the quarter, reflecting lower volumes imported<sup>2</sup> as well as lower product prices. Elsewhere, value of exports declined following the 18% drop in oil receipts (85% of total exports) to \$12.8 billion -- reflecting the 7% decline in crude oil prices to \$63.8/bbl., notwithstanding the increase in oil production to 1.96mbpd from 1.91mbpd – while value of non-oil exports jumped 2.2x to \$2.3 billion following increased sale of manufactured goods.

<sup>1</sup> Based on N360/\$ exchange rate

<sup>2</sup> According to NNPC, Imported Petroleum Products via DSDP dropped from 1.7 billion litres in Q4 18 to 1.5 billion litres in Q1 19

Figure 2: Trade balance and components



Source: CBN, ARM Research

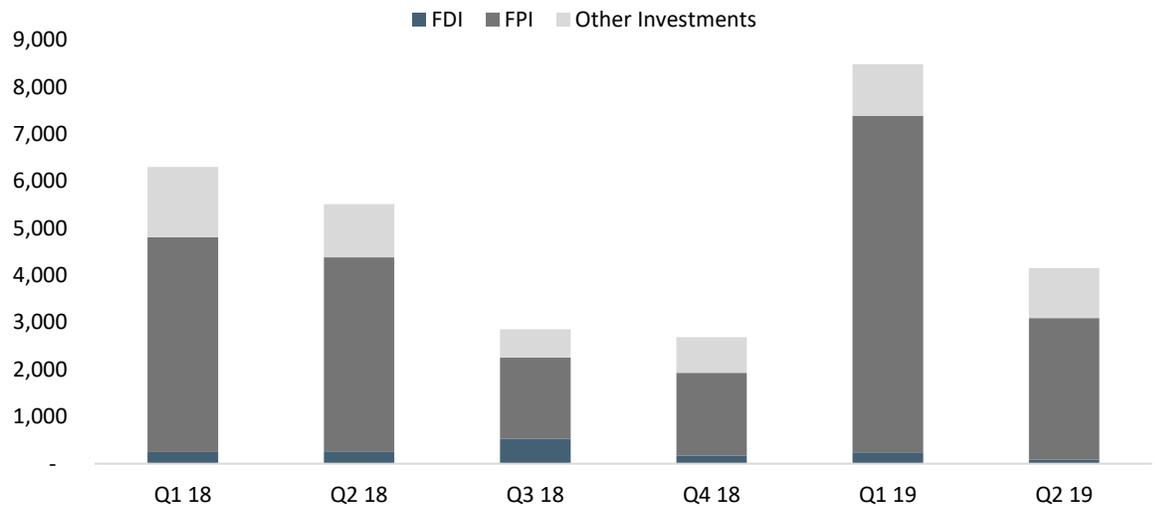
On the flip side, other components of the current account balance improved over the quarter. The services deficit contracted 6% QoQ to \$7.8 billion, from lower fees on professional and technical services (-23% QoQ) – which offset increased spending on personal and business travel (+20% QoQ). Meanwhile, non-residents booked lower receipts in returns on Foreign Direct Investments (-20% QoQ to \$2.9 billion), leading to lower income deficit from \$3.7 billion in Q4 18 to \$3.04 billion in Q1 19. Lastly, surplus in unilateral flows went further north, as Nigerians abroad paced up remittances home by 20% QoQ to \$7.6 billion.

### *The ‘Fed effect’ delivers a fillip to capital inflows*

At the start of the year, we outlined a base case outlook for capital importation into the country with our forecast assumptions centering on development in advanced economies (especially the trajectory of monetary policy in the US), our forecast average oil price as well as a stable post-election outcome. Coming into the year, the US Fed tapered its aggressive stance, with guidance of multiple rate cuts over the year to mute the impact of unsettled trade agreements with China on the overall economic growth. As expected, the US 10-Yr bond yield fell from 2.7% at the start of the year to 2.1% at the end of Q2 19. The resultant effect saw foreign investors seek out higher yields especially in emerging markets (See report: **NSR H2 19 - EM Capital Flows - Break out the champagne**). Focusing on Nigeria, capital flows over the first five months of the year reached a record high of \$12.6 billion (H2 17: \$9.5 billion), surpassing the flurry of flows following the establishment of IEW in 2017 and even the pre-oil crisis period. In line with historical pattern, the strong capital flow was driven by surge in portfolio investment flows (Jan – May: \$10.2 billion vs. H2 18: \$3.1 billion) which contributed circa 80% of the total flow into the economy. Elsewhere, while ‘Other Investment’ printed higher at \$2.2 billion (H2 18: \$1.2 billion), Foreign Direct Investment

(FDI) witnessed the first decline since H2 17 to print at \$326 million (H2 18: \$686 million). Notably, total capital imported in the first five months of the year is already 75% of total flows in 2018 of \$16.8 billion.

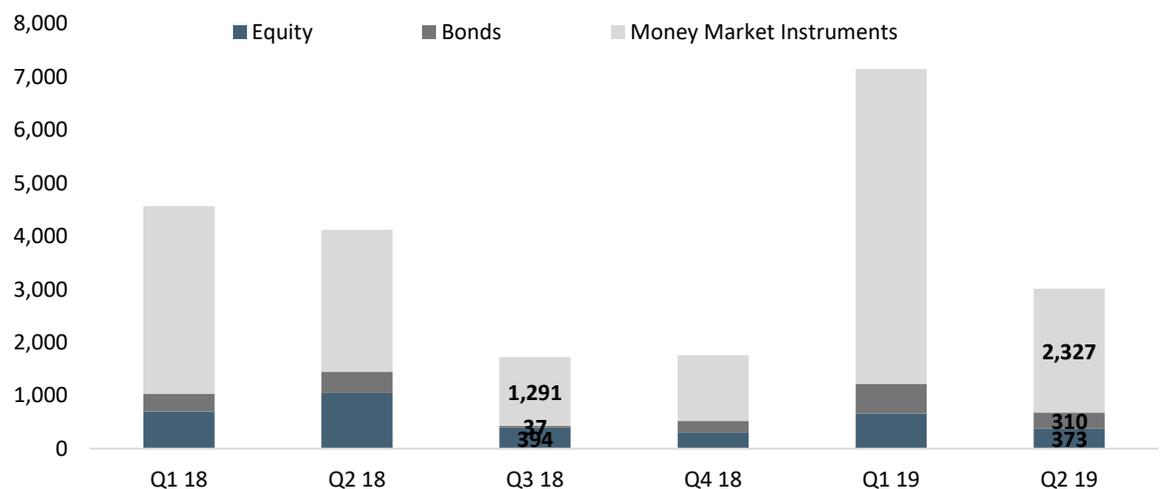
**Figure 3: Capital flows into Nigeria (\$'million)**



Source: CBN, ARM Research

Perusing the breakdown, FPI flows to equity market (\$1.0 billion) expanded only 68% relative to H2 18 while investments in the bond market (\$875 million) and money-market (\$8.3 billion) jumped 2.8x and 2.6x respectively. Elsewhere, Other Investments surged 81% on the back of increases in Loans (+33% to \$1.5 billion) and Other Claims (+12x to \$647.7 million). Foreign Direct Investment (FDI) into the country remained weak with flows (\$326.3 million) declining 53% over H1 19.

**Figure 4: Foreign Portfolio Investment (FPI) into Nigeria (\$'million)**



Source: CBN, ARM Research

***Still juggling, but surplus within reach***

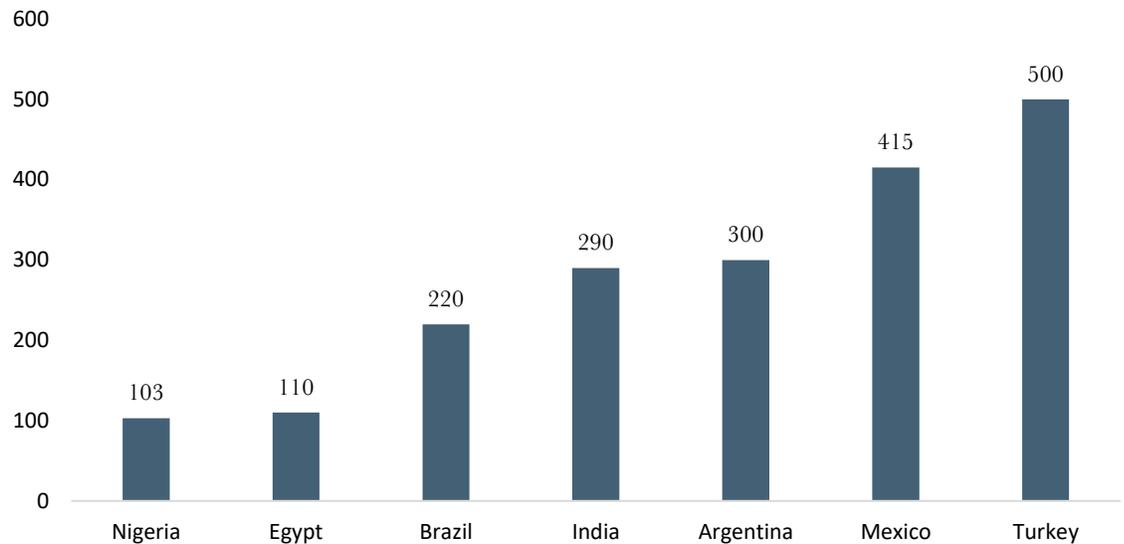
Going into the rest of the year, we project moderation in the current account surplus to \$2.2 billion (FY 18 surplus of \$5.3 billion) emanating from reduction in trade surplus, which more than outweighs expectation of better performance across other lines. On trade, we expect the trade surplus to contract further to \$15 billion (FY 18: \$22 billion), reflecting an increase imports to \$45 billion (FY 18: \$41 billion). Specifically, we expect the relatively stable FX to continue to spur non-oil import demand in the interim. On oil import, we believe the increasing supply of petroleum products by NNPC's with the recent signing of the direct sale-direct purchase (DSDP) agreements with 34 companies (previously 22) will further support increase imports in the year ahead. Furthermore, latest data by NNPC shows the volume of imported petroleum products via DSDP has jumped 31% over April and May from Q1 average. Elsewhere, following the upward review of forecast crude oil price over the second half of the year (\$58.5/bbl, compared to previous estimate of \$52.2/bbl.), we model total exports of \$60 billion (FY 18: \$63 billion) In FY 19. Across other constituents, we expect persisting deficit in services with an upward adjustment over the second half of the year. However, we believe income deficit will moderate going into the year to \$11.5 billion (FY 18: \$15.1 billion) due to lower repatriation of returns on investments (particularly FDIs). On the other hand, our estimate for unilateral transfer surplus was revised higher to \$27.9 billion (FY 18: \$24 billion), given the strong start to the year and the historically higher transfer over the second half of the year.

***How likely is capital importation drying up soon?***

Going into the rest of the year, we highlight two factors dominant to flows into the country. First, a sustained dovish stance from the US Fed and secondly, the attractiveness of fixed income yields (OMO and Treasury bills) relative to other EM peers. We believe a prolonged dovish posture by the US Fed will spur increase in global liquidity and definitely see foreign investors chase higher yields in fundamentally sound economies. At its last monetary policy meeting, though the US Fed left rates unchanged, it however opened the door for a rate cut in the future as the US economy weakens under the burden of trade tariffs and a slowdown in consumer spending after years of rapid growth against a backdrop of subdued inflation. As a matter of fact, according the Fed-dot plot, 8 out of 12 members now favor a rate cut this year. That said, we went further to make a comparison of domestic yields against comparable frontier and emerging markets. To buttress, we computed real returns between domestic yields across the markets against the US 10-Yr bond yield. From our findings, we observed

that while Nigeria real return remains positive, real returns in specific markets including Egypt, Mexico and Turkey are few notches higher. Hence, while we believe inflows into the country will persevere, we think flows will however slow relative to H1 19 on the back of thinner carry trade opportunities. On asset classes, barring any near transformation that could trigger economic growth in the country, we expect foreign investors to remain biased, leaning towards short term instruments.

**Figure 5: Real Return across Frontier and Emerging Markets (bps)**



Source: Bloomberg, ARM Research

**ARM Securities Contact**

Research	234 (1) 2701653	<a href="mailto:research@armsecurities.com.ng"><u>research@armsecurities.com.ng</u></a>
Institutional Sales & Trading	234 (1) 448 8833	<a href="mailto:trading@armsecurities.com.ng"><u>trading@armsecurities.com.ng</u></a>
Customer Service	234 (1) 4488282	<a href="mailto:customerservice@armsecurities.com.ng"><u>customerservice@armsecurities.com.ng</u></a>

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