

July 23, 2019



Nigeria Strategy Report

H2 2019

Global Economy and Markets

EM portfolio flows: Break out the champagne

Executive Summary

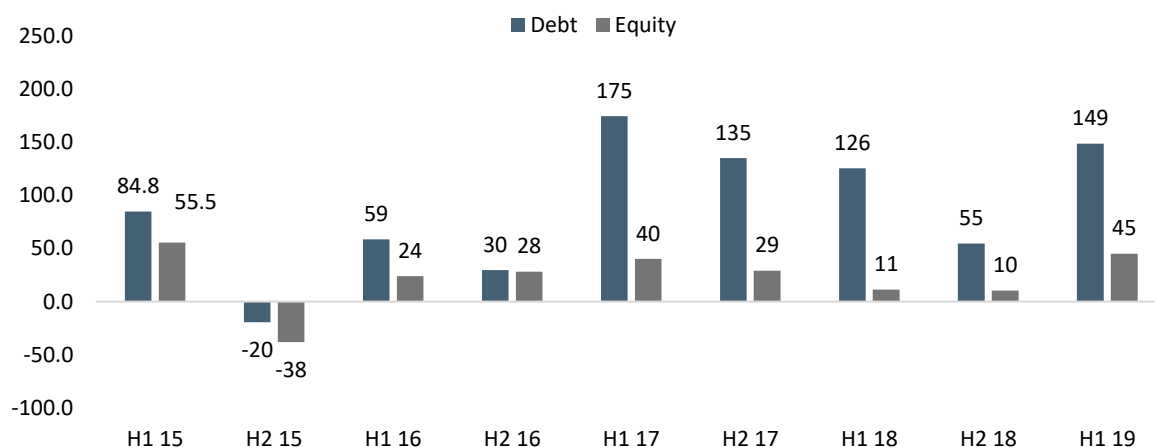
Rebounding from paucity of flows over H2 18, total net FPI flows to emerging markets (EMs) more than tripled to \$193.9 billion in the first half of 2019 (from a low of \$65.1 billion in H2 18), with 77% (\$148.7 billion) of the total flows channeled towards EM debt counters while equities (\$45.2 billion) continues to account for a meagre share of the pie. Despite prospect of further escalation in trade conflict between US and China and its reverberating effect on broader EM market, a change in narrative by the US FED to a more dovish stance and reduced imbalances in EM economies relative to prior year triggered foreign investors' appetite to attractive carry trades in emerging market assets. The surge in FPI flows cuts across all regions, as total FPI flows into Asia, Latin America, Emerging Europe more than doubled over the period, while net flows into Africa and the Middle East turned positive from a net outflow in the prior year.

Going forward, anchored on slowdown in both GDP growth (Q1 19: 3.1%; FYE 19: 2.3%) and inflation (Average CPI 19: 1.7%; Average PCE 19: 1.6%), the US FED signaled dovish tone at its last meeting with market expecting at least 50bps cut in the Fed rate by its December meeting. Furthermore, ECB's body language has been one of dovishness. Especially given its recently introduced quarterly targeted long-term refinancing operations (TLTRO-III) set to kick off in September 2019 and ending in March 2021 – with the sole aim of encouraging private sector lending. Consequently, with the accommodative stance across DMs, we see scope for portfolio flows into Emerging markets, with IIF forecasting 11% YoY growth to \$344 billion over 2019.

In this report, we look at the major themes that dominated portfolio flows to EM in H1 2019 as well as our outlook for flows to EM over the rest of 2019.

Foreign portfolio flows to EM...Break out the champagne

Rebounding from paucity of flows over H2 18, total net FPI flows to EMs more than tripled to \$193.9 billion in the first half of 2019 (from a low of \$65.1 billion in H2 18), with 77% (\$148.7 billion) of the total flows channeled towards EM debt counters while equities (\$45.2 billion) continues to account for a meagre share of the pie. Despite prospect of further escalation in trade conflict between US and China and its reverberating effect on broader EM market, a change in narrative by the US FED to a more dovish stance and reduced imbalances in EM economies relative to prior year triggered foreign investors' appetite to attractive carry trades in emerging market assets. The surge in FPI flows cuts across all regions, as total FPI flows into Asia, Latin America, Emerging Europe more than doubled over the period, while net flows into Africa and the Middle East turned positive from a net outflow in the prior year. Stripping into quarters, shows that majority of the funds flowed into EMs over Q1 19 – totaling \$117.8 billion – triggered by interest across debt and equity securities. However, Q2 19 saw slower inflows amidst self-off in the equities market (outflow of \$14.3 billion in May alone), with net flows over the period contracting to \$76.1 billion over Q2 19.

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

Source: IIF, ARM Research

Against all odds, flows to Asia flourish

In EM Asia, FPI flows more than doubled to \$110.6 billion with Asia's largest economy – China accounting for a third of total portfolio flows to the region. Parsing through foreign investors flow to China, though positive, FPI inflows contracted 30% YoY to \$35.8 billion with flows to both Debt and Equity sliding 48% and 9% to \$14.1 and \$21.7 billion respectively. The slowdown in foreign portfolio flows to Chinese equities mirrors slowdown in economic activities with GDP touching a 27-year low in Q2 19 (-20bps YoY to 6.2% in Q2 19). Furthermore, escalation of the US-China

trade spat in May further dampened foreign investor's appetite for Chinese assets. For context, after successive positive monthly net inflow in the first three months of the year, tides turned in May as FPI flows turned negative, touching a multiyear low. The dour performance came in after a breakdown in extensive trade talks between US and China ended without an agreement on May 10, 2019 and US raising tariffs on another \$200 billion worth of Chinese imports with China retaliating three days later, announcing new tariffs on \$60 billion tariffs on American imports entering China. However, following MSCI's decision to partially include china large cap "A" shares in the MSCI Emerging market index and prospect of tighter monetary conditions in DMs, portfolio flows to China rebounded in June.

Elsewhere in India, after dearth of foreign portfolio flows in H2 18 (net outflow of \$4.6 billion), FPI flows rebounded in H1 19 to \$12.8 billion, split between Equity (\$11.4 billion) and Debt (\$1.3 billion). The upsurge in equity inflows was despite tepid economic growth in 2018/19 full year (6.8% vs 7.0% in 2017/18) as investors cheered the possibility of the incumbent Prime minister – Narendra Modi returning to power and the successful conduct of the election. On the debt side, following Reserve Bank of India's (RBI) decision to cut interest rate by 75bps to 5.75% over its last three meetings in a bid to stimulate economic growth, FPI flows to Debt only accounted for a meagre share (11%) of total FPI flows into the country. Similarly, FPI flows to Indonesia jumped to \$11.2 billion with flows to Debt (\$6.4 billion) taking the lion share of overall flows, while flows to Equity turned positive in H1 19 (\$4.8 billion) from a net outflow of \$87 million in H2 18. The massive flows to Indonesia's debt mirrors Central bank's quest to rein on inflationary threat by leaving key rate unchanged at 6% after a 25bps hike in Q3 18.

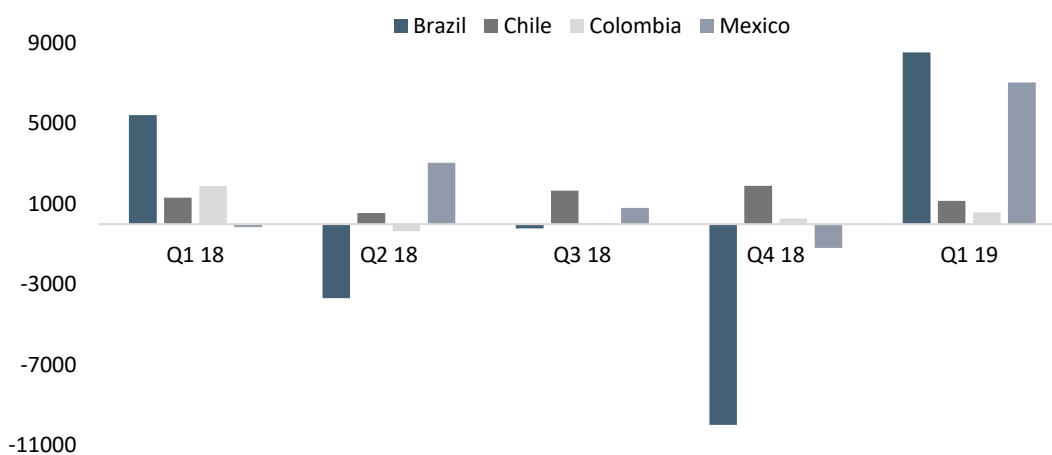
Table 1: Trend in portfolio flows to Asia (USD million)

Period	China		India		Indonesia		Thailand		Vietnam
	Equity	Debt	Equity	Debt	Equity	Debt	Equity	Debt	Equity
H1 16	6,162	-1,049	2,956	-1,924	984	6,119	1,038	8,326	-81
H2 16	17,253	28,132	-53	-4,535	274	1,534	1,203	1,129	-275
H1 17	14,940	14,242	8,506	14,617	1,304	7,923	393	4,492	384
H2 17	21,270	73,850	-492	8,353	-4,264	4,139	-1,189	6,129	692
H1 18	33,325	75,711	-622	-6,109	-3,570	-595	-5,642	3,466	1,506
H2 18	27,343	23,826	-3,936	-636	-87	4,058	-3,272	5,388	295
H1 19	14,111	21,710	11,415	1,348	4,846	6,363	1,318	1,892	332

Source: IIF, ARM Research

Meanwhile in Latin America, after weak appetite for riskier assets in Emerging markets that saw softer foreign portfolio inflow into the region over H2 18, flows rebounded in H1 19 to \$48.1 billion vs \$4.6 billion in the prior year. The uptick in FPI flows was largely driven by foreign investors interest in regional heavy weights – Brazil, Mexico, Colombia and Chile. Starting with Brazil, while uncertainties trailing the passage of the Pension reform bill continue to dampen foreign investors interest in Brazil’s equity market with IIF reporting a net outflow of \$621.5 million in H1 19, investors continue to embrace Brazil’s fixed income securities (H1 19: \$5.9 billion vs -\$8.4 billion in H2 18). In our view, renewed foreign investors interest in Brazil’s debt reflects investors search for higher yields following depressed US treasury yields (-68bps YTD to 2%) over the period. Likewise, Portfolio flows to Mexico switched to a net inflow (Q1 19: \$7 billion) from a net out flow in Q4 18 (-\$1.2 billion). The increase in portfolio flows to Mexico reflects tamer economic and policy uncertainty following progress made on United States-Mexico-Canada Agreement (USMCA). More so, foreign investors interest was further strengthened by President Trump’s indefinite suspension of the 5% tariff on Mexico’s import following an agreement reached by both parties. Lastly, dissipating inflationary concern and higher commodity prices fueled foreign investors flows into Chile and Colombia with net inflow of \$1.1 billion and \$585 million respectively.

Figure 2: Trend in portfolio flows to Latin America

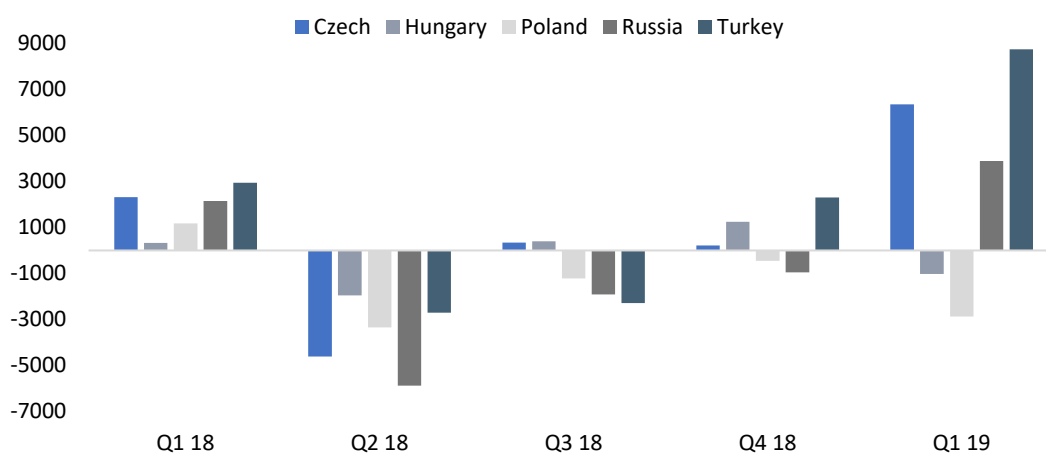


Source: IIF, ARM Research

EM Europe was no exception as foreign portfolio flows to the region more than doubled to record net inflow of \$19 billion from a net inflow of \$7.4 billion in H2 18. Parsing through individual country flows in the region, Turkey and Czech Republic were the biggest destination for foreign portfolio investors into Europe, jointly accounting for ~74% of total portfolio flows into the region. In Turkey, following massive foreign investors exodus from Turkey last year on the back of tapestry of macroeconomic woes that plagued the economy, foreign investors reassessed riskier assets in the country following cheap equity and fixed income valuations. This alongside waning inflationary

pressures over the first quarter of 2019 (-250bps to 19.9% in Q1 19) spurred entry into Turkey's Debt (\$6.9 billion) and Equity (\$827 million) in Q1 19. However, over the second quarter of 2019, foreign investors exited Turkey as political jitters trailing the Presidential election drove sell off across equity (-\$55 million) and fixed income markets (-\$890 million). This was further exacerbated by the tepid economic growth as Turkey slid into recession in Q1 19 (-2.6% in Q1 19). Similarly, portfolio flows to Czech Republic jumped to \$6.4 billion in Q1 19 from \$221.8 million in H2 18. This was largely driven by interest in Czech Republic debts which appear attractive following Central Bank's decision to hike interest rate by +25bps to 2% in a bid to rein on higher consumer prices (CPI: +70bps to 2.8% in Q2 19).

Figure 3: Trend in portfolio flows to Latin America



Source: IIF, ARM Research

In Middle East and Africa (MEA), foreign portfolio flows turned the corner, switching from a net outflow of \$1.9 billion in H2 18 to a net inflow of \$16.2 billion. Contrary to trend observed in other regions, flows to MEA was largely mixed with South Africa reporting \$3.6 billion net outflow due to foreign investors sell off at both the equity and fixed income counter. Foreign investors apathy for South Africa's riskier assets is reminiscent of its weakening macroeconomic picture following stagnant economic growth in Q1 19 after series of blackouts that hampered manufacturing activities. Elsewhere in Egypt, after two consecutive quarters of net outflow, foreign portfolio flows rebounded strongly in Q1 19 with a whopping \$7 billion foreign investors fund into Egyptian Treasury bills as investors continue to cheer President Abdel Fattah el-Sisi's market friendly policies.

US-China trade rift: Winners and losers will emerge

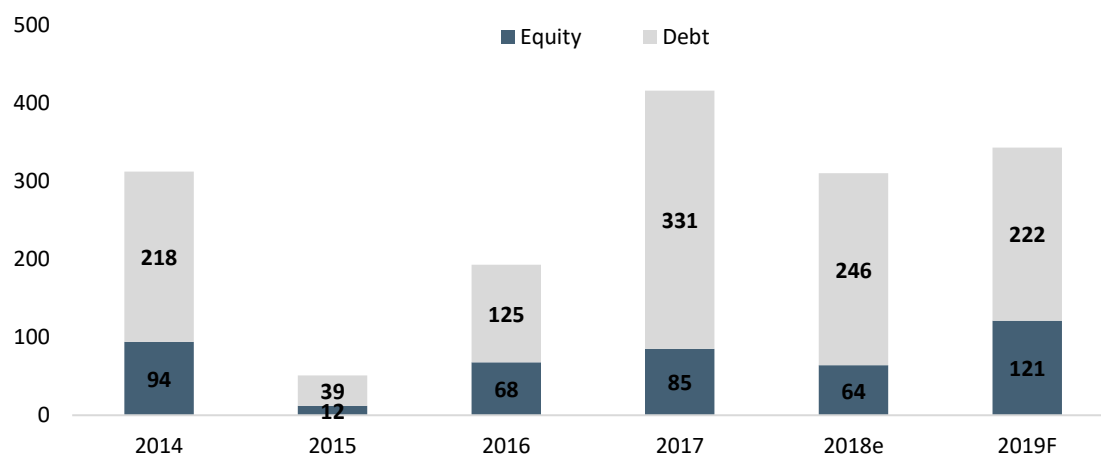
No doubt, in charting the course for foreign investors capital flows into EMs over the rest of the year, the heightening trade protectionism plays a dominant role. While the general feeling

has been one of worry for the two parties involved in the trade rift (US and China), the most concerning aspects is the spillover effect to countries and sectors beyond those targeted. For context, the United Nations Conference on Trade and Development (UNCTAD) now estimates that the East Asian value chain will shrink by \$160bn as a result of the high volume of Chinese exports affected by US tariffs. There is also serious distress with regards to the impact this trade tension will have on the fragile global economy and how it increases the risks of a global economic downturn. However, rather than general EM risk off, we envisage selective play by foreign investors across fundamentally sound EM economies with less vulnerability to the trade war shocks.

Breaking out the champagne

Going forward, anchored on slowdown in both GDP growth (Q1 19: 3.1%; FYE 19: 2.3%) and inflation (Average CPI 19: 1.7%; Average PCE 19: 1.6%), the US FED signaled dovish tone at its last meeting with market expecting at least 50bps cut in the Fed rate by its December meeting. Furthermore, ECB's body language has been one of dovishness. Especially given its recently introduced quarterly targeted long-term refinancing operations (TLTRO-III) set to kick off in September 2019 and ending in March 2021 – with the sole aim of encouraging private sector lending. Consequently, with the accommodative stance across DMs, we see scope for portfolio flows into Emerging markets, with IIF forecasting 11% YoY growth to \$343 billion over 2019.

Figure 4: IIF Projections for portfolio flows to EM over 2018 (\$'billion)



Source: IIF, ARM Research

On a regional basis, in EM Asia, while we hold the view that headwinds from the trade rifts with US will continue to take a toll on the Chinese economy over the rest of the year, we see room for sustained portfolio flows into China, albeit moderated. We hold the view that the recent MSCI's decision to partially include china large cap "A" shares in the MSCI Emerging market index and prospect for tighter monetary conditions to rein on high private sector debt would keep the tap of

portfolio flows running into China. Similarly, in India, we remain upbeat on foreign portfolio flows to India hinged on President's Modi's expansionary drive, as well as recent monetary easing by the Reserve Bank of India. Furthermore, our expectation for lower crude oil prices paves way for better current account picture due India's reliance on importation of PMS.

Over in Latin America, while uncertainty trailing the passage of the pension reform bill could tame FPI flows to Brazil's equity, the possibility of a rate cut by the US FED should support foreign investors interest in Brazil's debt market. Meanwhile in Mexico, given that US is the main export partner (US accounts for roughly 80% of Mexico exports), the slower growth prospect for the US is a major drag to economic activities in Mexico going forward, which supports our view of softer portfolio flows to Mexican equities over the rest of the year.

Elsewhere in Europe, crumbling domestic demand should continue to derail economic activities in Turkey even as higher consumer prices, rising unemployment and a weaker Lira continue to erode consumer purchasing power. That said, akin to Q2 19, we envisage further repatriation of funds from Turkey over the rest of the year. Meanwhile in Czech Republic, with the slowdown in Germany taking a toll on Czech external sector, we see lower portfolio interest in the country over the rest of the year. Lastly in MEA, with the absence of election related currency volatility, South Africa's gloomy economy is staged for a modest rebound over the rest of the year. Notwithstanding, the possibility of further power supply disruption will continue to sap economic sentiment and eventually weigh on spending and investment. That said, we remain less sanguine on portfolio flows into South Africa. Meanwhile, reflecting favorable business reforms, ease in political risks and healthy tourism in Egypt, the outlook for portfolio flows into Egypt is more buoyant than the prior year.

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