

July 17, 2020



Nigeria Strategy Report

H2 2020

Domestic Economy and Policy Environment

Fixed Income Strategy: Cloudy outlook, play short/medium term

Executive Summary

We predicted a decline in yields this year driven by higher demand which emanated from the CBN's decision last October to ban non-bank financial institutions from participating in further OMO auctions. Although this has largely played out, it has happened on a larger scale than we expected. The average fixed income yield declined 258bps over H120 with the average bond yield down 247bps and the average NTB yield down 270bps. Liquidity has been higher than we expected as a result of the CBN's decision to allow 48% of the ₦6.56 trillion worth of OMO bills that matured to flow back into the system.

On the supply side, following the revision of the FG's budget, the total domestic borrowing was increased by 190% from ₦749 billion to N2.19 trillion. Of this amount, based on our calculation, ₦1.48 trillion was borrowed over H120 which represents 68% of the total. Majority of this has come via FGN bonds with the rest coming via a sukuk bond and a couple NTB net issuances. Interest has been high at the primary market auctions, with oversubscription a common theme, thanks to the teeming liquidity. The FG has taken advantage of this high interest to reduce their borrowing costs – by 80bps in the bond market and 230bps in the NTB market.

Looking ahead to the rest of the year, the FG still needs to borrow at least ₦710 billion in H220 to be able to cover its fiscal deficit for the year. However, the maturity profile is still high and includes a ₦6.51 trillion worth of OMO bills. Based on this, we can expect the high demand to remain and have a stronger effect than the increased borrowing. Thus, keeping yields depressed over the rest of the year.

In this report, we look at the major themes that dominated the fixed income space over H1 2020 and delineate our outlook over H2 2020.

Turbulent half year for bond yields¹

In the first six months of the year, average fixed income yields fell 258bps to 5.40% highlighting the strong demand in the system. This demand was greatly boosted by the ₦8.5 trillion worth of fixed income instruments that matured over the period, which includes OMO bills worth ₦6.56 trillion. Of that OMO maturity, the FG only offered ₦3.49 trillion back to the market (53% of total maturity) and sold ₦3.39 trillion (52% of total maturity). This followed on from last October's decision to bar non-bank financial institutions from participating in OMO auctions and is also in line with the CBN's posture to wind down their balance sheet and invariably borrowing costs. The decline in yields was felt at both ends of the curve.

At the long end, bonds had a bumpy 6months which culminated in a 247bps drop in the average yield to 8.12%. Over the first two months of the year the average bond yield fell 154bps driven by the aforementioned high liquidity. Specifically, January and February had the largest maturity profile for the year with a total of ₦5.6 trillion which included a ₦606 billion bond maturity – the only one for the year – and ₦4.35 trillion worth of OMO bills. At the subsequent OMO auctions following the maturity, the CBN only issued ₦2.67 trillion meaning there was a net repayment of ₦1.68 trillion which boosted the liquidity situation. By March, there was a complete reversal in the direction of bond yields following a crash in oil prices that tainted Nigeria's economic picture and led to a ratings downgrade by Fitch. Foreign investors rushing to the exit and the repricing of bonds saw bond yields surge 254bps MoM on average to 11.59%. At a point during the month, average yields rose as high as 11.92%, heights not seen since last November.

After the frenzy in March, demand returned to the fore over the next 3 months led by interest from domestic investors. For context, between March and April, PFAs increased their bond holdings by 2.98% to ₦5.77 trillion after a MoM decline of 0.22% in March. The effect of this was a 347bps fall in bond yields, between March and the end of June, to 8.12%. Clearly, investors settled for short to mid -tenor bonds amidst volatility and market uncertainty, with the Jan-2022 (-537bps), April-2023 (-456bps), Jan-2026 (-405bps), March-2024 (381bps) and July-2021 (-365bps) papers recording the largest decline, so far this year.

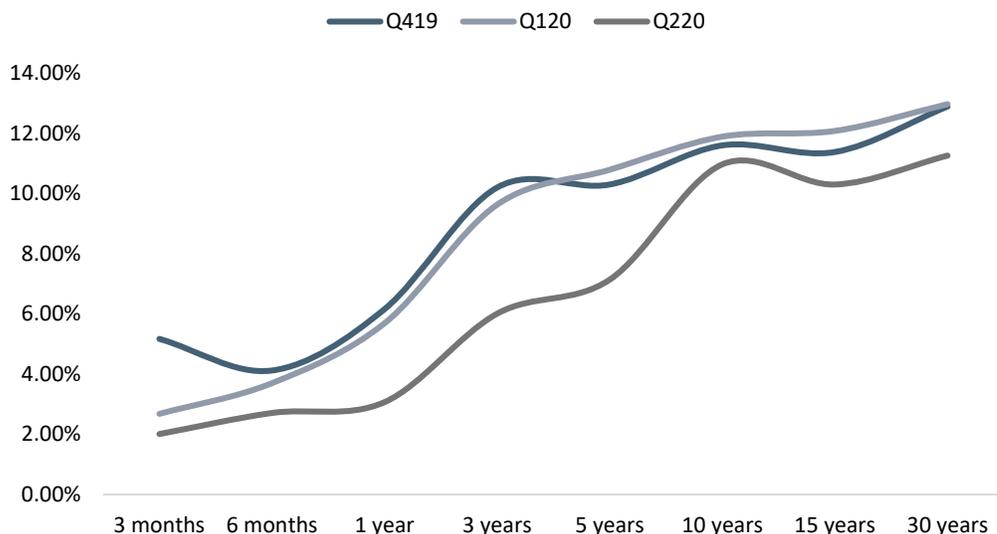
Meanwhile, NTB yields have maintained a downward trend all year, with the only MoM increase coming in February when the average yield rose by 28bps. For the first half of the year, the average NTB yield was down 270bps to 2.15% (H119: -273bps to 12.27%), with the biggest MoM decline coming in Jan when it fell 112bps. This came in line with the expectation we communicated in our last NSR².

¹ Figures recent as at EOD 30/06/2020

² [NSR H1 2020 - Fixed Income: Liquidity surfeit to keep yields subdued](#)

The deluge of liquidity following the CBN’s OMO barring policy in last October, sparked the significant demand for NTBs which have seemed to have now become a de facto substitute to OMO bills for investors. Looking at individual tenors the 91-day and 1-year recorded the biggest declines of 316bps and 320bps respectively.

Figure 1: Trend in fixed income yields



Source: FMDQ, ARM Research

FG goes big in the bond market

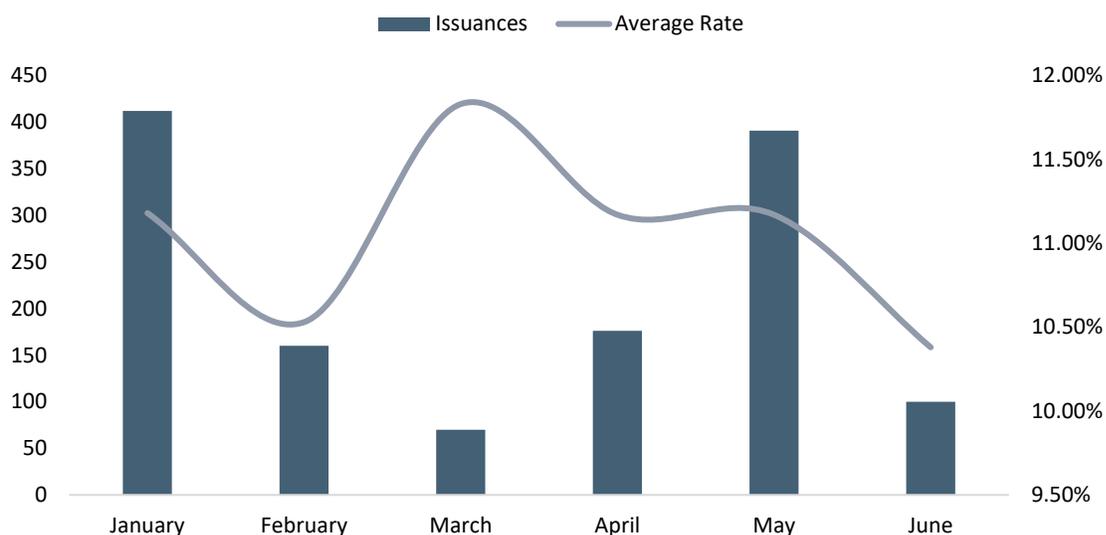
The revision to the 2020 budget came with a 194% increase in the planned domestic borrowing from ₦749 billion to ₦2.19 trillion³. The increase in domestic borrowings was made necessary by a combination of factors including: (1) a collapse in the oil market and invariably oil receipts; (2) reduced economic activities which posed a threat to non-oil receipts and; (3) expensive international capital market owing to risk-on sentiments.

The FG have made concerted efforts to meet this new target by ramping up borrowing at the various auctions, especially at the bond auctions. In the six bond auctions so far this year the DMO, on behalf of the FG, has sold a total of ₦1.31 trillion worth of instruments which is 2.12x the ₦615 billion that was offered at these auctions. This also testifies to the strong demand that was present at these auctions, a claim that is buttressed by an average subscription rate of 4.3x (vs 1.61x in H2 19). Of the total sale ₦1.11 trillion (85%) came via competitive allotment with the remaining ₦200 billion came via non-competitive allotment.

³ Includes the N850 billion foreign borrowing which was converted to domestic borrowing

To give context to how much the FG ramped up borrowings, the ₦1.31 trillion sold in H120 year represents 75% of the total sold over FY19 (₦1.74 trillion). Aside from the share scale of the borrowing, another standout feature of the FG’s bond borrowing over H120 was the removal of the April-2029 and April-2049 from the auction list and the addition of the March-2035 and March-2050. The two removed instruments had a combined outstanding value of ₦1.54 trillion which the FG, understandably, no longer wanted to add to. The average stop rate at these auctions has declined 80bps YTD to 10.38% (H119: -78bps) as the FG continues to lower its borrowing costs.

Figure 2: Trend in Bond issuances and marginal clearing rates



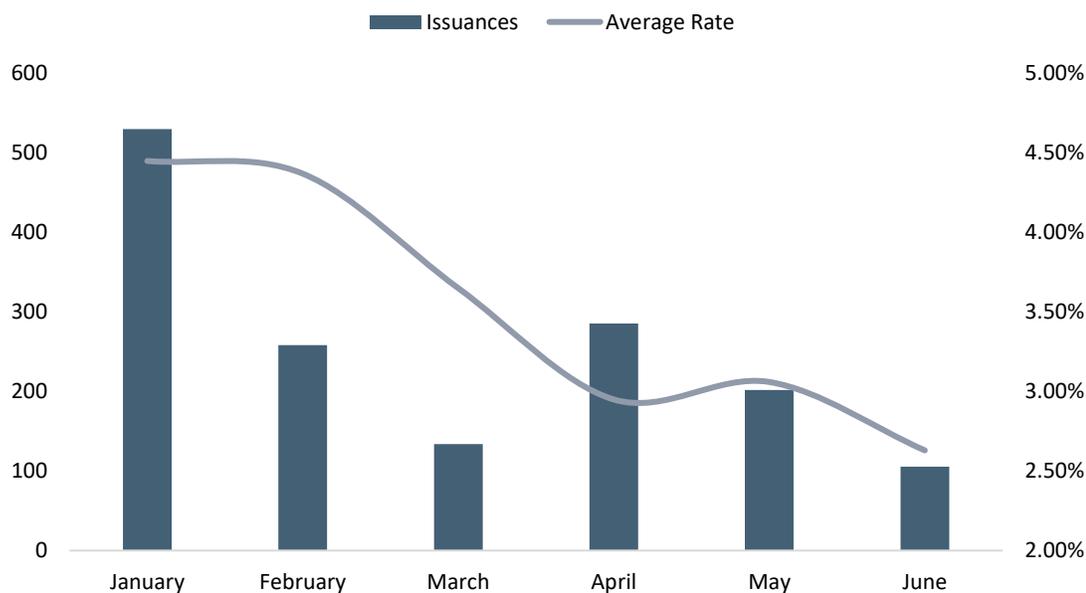
Source: FMDQ, ARM Research

Rollovers the theme at NTB auctions while OMO volumes decline

Staying true to form, the FG rolled over in 12 of the 14 NTB auctions over H120, net issuing in those other two. The first net issue came way back in January where they offered and sold ₦225.45 billion which is 48% higher than the ₦152 billion that was maturing, this could possibly have been to raise funds for the ₦600 billion bond maturity the following month. The next net issuance came at the start of May when the FG offered ₦33.84 billion, which matched what was maturing, but decided to take advantage of the large subscription of ₦165.55 billion (4.89x oversubscribed) and sold ₦142.76 billion. So, over the course of H120 the FG net issued a total of ₦182.37 billion worth of bills, which is more than they did over the entirety of 2019. The average subscription rate over the H120 was 2.60x while the average stop rate has declined 230bps YTD to 2.53%. Combining the borrowings from both bond auctions and NTB auctions we get a total net issuance of ₦1.49 trillion which is 68% of the total borrowing target of the year.

Finally, in the OMO market, with non-bank financial institutions no longer allowed to participate in OMO auctions and DMBs now “morally persuaded” to issue loans, the CBN has been able to successfully wind down its balance sheet. Only a fraction of the total maturity at these auctions were offered, excluding the ineligible portions. The total offering over H120 was ₦3.49 trillion, 53% of total maturity. The total sold is even less at ₦3.39 trillion (97% of total issuance and 52% of total maturity) and it came off the back of a strong subscription of ₦5.56 trillion (subscription rate of 1.6x). Market sources confirmed that some of the resurfaced demand seen in this space (particularly from April) can be attributed to foreign investors were unable to repatriate their funds and settled for re-investment position in short-term OMO instruments. Just like the FG, the CBN has sought to reduce its borrowing costs and that has been evident in the 429bps YTD fall in the 1-year stop rate to 8.29%, a far cry from the 13.28% observed at the end of 2019. Besides the resurfaced interest, we believe the influx of FX multilateral loans also eased the CBN’s desperation to appease FPIs by keeping the stop rate high.

Figure 3: Trend in NTB issuances and marginal clearing rates



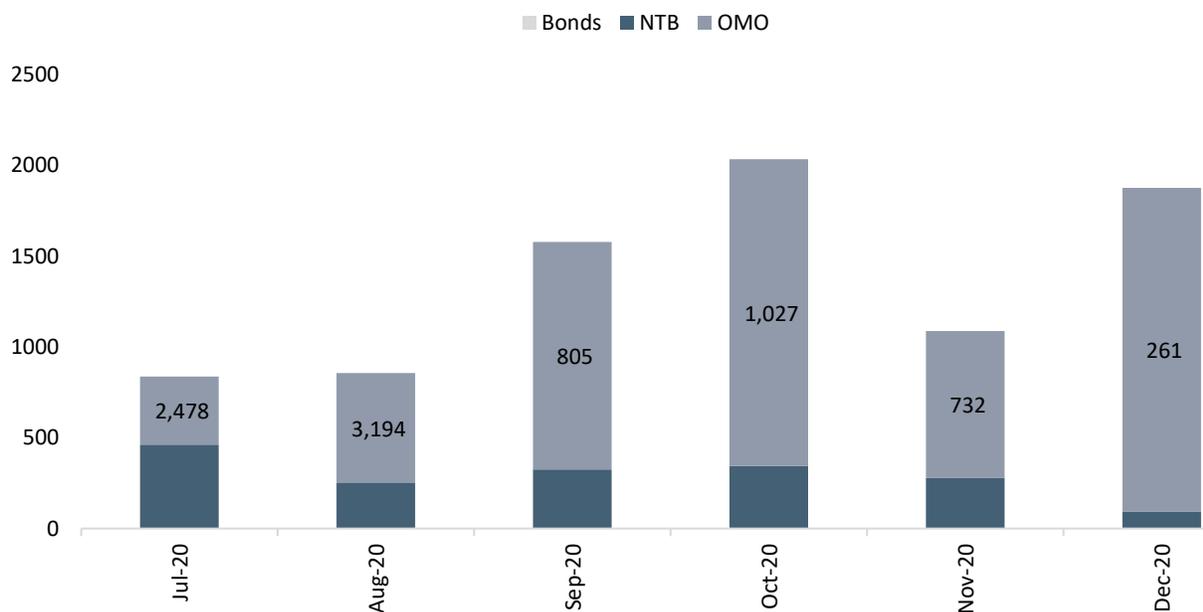
Source: FMDQ, ARM Research

Increased supply not enough to overpower demand

Going forward, we examine the demand-supply dynamics to establish the direction of yields over the rest of the year. On the supply leg, with c.68% of the borrowings done over H1 20⁴, we expect minimum borrowings of ₦535.9 billion over H2 20. However, we believe the FG might take up more borrowing to the tune of ₦100 billion as we are unoptimistic on anticipated proceeds from privatization which has historically remained below budget.

On demand, total NTB maturity over H220 is ₦1.76 trillion, 32% more than the ₦1.33 trillion that matured in H120. However, we expect the FG to fully rollover here so the expected increase in demand will not be from this space. Additionally, with no bond maturities left this year, the major driver for demand over the second half of the year will stem from OMO maturities which total ₦6.51 trillion over H220 (H1 20: ₦6.56 trillion). Assuming the CBN maintains the same offering/maturity rate as H120, only 53% of that total – ₦3.45 trillion – will be offered at auctions. This means that there will be ₦3.06 trillion moving back into the system, which is 6.4x the amount of new borrowings. In fact, if total OMO sold over H220 is less than 85% of total maturity then the liquidity moving back into the system will be higher than the supply from new borrowings.

Figure 4: H220 Maturity Profile



Source: FMDQ, ARM Research

⁴ Includes N162.6 billion sukuk bond issuance

Adding to the system liquidity, and thus demand, over H220 will be coupon payments from outstanding bonds. According to our calculations, these will total ₦536billion over the period with September seeing the largest amount at N195 billion. Also, ₦371.6 billion worth of commercial papers and ₦186.5 billion worth of promissory notes mature over the next 6months. On that note, despite increased appetite for risky assets with domestic investors dominating the equity market in recent times, we believe a large chunk of these funds will still flow to FI instruments, thus giving way for further compression in yields.

Opportunities still exist in this low yield environment

- Short-tenor bonds have seen the strongest declines so far this year⁵ and as a result the spread between the spread between the NTB yields and yields for the very short tenor bonds (1-4yrs) has narrowed over H120⁶. Thus, we think we could see some interest return to the NTB market, despite the low yields. We recommend having the NTBs and 1-4year tenor bonds in the **Hold till Maturity** portfolio.
- For our **Hold for Trading** portfolio we recommend splitting allocations between mid-tenor and long-tenor bonds. The latter should give adequate exposure to higher returns should interest rates continue to decline as we expect. However, to hedge against possible redirection in yields, we propose that there should be a higher allocation to mid-tenor bonds for this portfolio. This allows for some exposure to returns (taking advantage of duration) from lower yields, while also reducing the downside that could follow should yields rise, especially on the longer tenor bonds. This will limit our downward duration exposure but at the same time limit our upward exposure.
- Going into 2021, the MTEF⁷'s projection of a ₦5.16 trillion deficit in the year, points to a likely increase in borrowings. However, we believe the direction for yields could pan out in either of two scenarios;
- In the first scenario, the coronavirus takes the turn for a worse and the vaccine is still not within reach. This could translate to still-suppressed crude oil prices and decline in oil revenues. The pent-up risk could still make financing from the international Eurobond market an expensive option.

⁵ Average short tenor: -311bps YTD, 96bps more than the average bond decline

⁶ The spread on the 1yr, for example, declined from 2.9% at the start of the year to as low as 0.4%

⁷ Medium Term Expenditure Framework

- Meanwhile, we think it is unlikely the government will be able to secure the same scale of concessionary loans in 2021, like it did this year. Thus, a ramp up in domestic borrowing will be needed to fund the deficit. With the increase in supply, we could see uptick in yields in 2021.
- On the other hand, if a vaccine is found and declared safe for human use, we should see the underlying risks of the virus start to dissipate. This could see oil prices tick higher and foreign investors start to return to the country. This also increases the chances of a Eurobond issuance and mean that less will have to be borrowed domestically. This could translate to less supply and potentially higher demand from the returning foreign investors. In this scenario, yields could trend lower.

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