

Nigeria Strategy Report Update

Economic Snapshot

September 2015 Inflation Data/Indices

	MoM	YoY	Prev YoY
Headline	0.60%	9.4%	9.3%
Food	0.64%	10.2%	10.1%
All Items Less Farm	0.56%	8.9%	9.0%
Imported food	0.85%	10.8%	10.6%
Energy	0.43%	9.7%	9.6%

Currency Markets

	Latest	Daily Chg	YTD
USDNGN	198.66	-0.35%	8.30%
EURNGN	227.37	-0.26%	2.76%
GBPNGN	307.48	1.18%	8.18%
JPYNGN	167.22	0.44%	8.92%

Monetary Aggregates – August 2015

	(N'bn)	MoM	YoY
M2	18,492	-2.1%	12.2%
CPS	18,631	-1.2%	8.2%
NCG	-2,762	14.5%	N/A
NFA	5,498	-4.4%	-29.2%
NDC	21,393	0.6%	36.6%

External Position

	Latest	QoQ	YoY
Trade Balance (\$'mn)	-234	-82.1%	NM
External Reserves (\$'mn)	30,343	4.6%	-23.2%
Foreign Debt (\$'mn)	10,316	9.0%	10.5%

Growth Data – Q2 2015

	(N'bn)	%of total	YoY
Real GDP	16,463	100%	2.35%
Agriculture	3,478	21.1%	3.49%
Oil	1,614	9.8%	-6.79%
Services	6,114	37.1%	4.49%
Wholesale and Trade	2,835	17.2%	5.07%

Introduction

In this report, we review happenings on the global front and domestic scene over Q3 15, to assess how events stack up to our H2 15 Nigeria Strategy Report prognosis, but more importantly, implications for our capital market strategy. In line with our views, the EM growth slowdown continued over the quarter with all BRIC countries, except India, reporting markdowns in GDP growth, whilst economic recovery across developed markets remained modest. Consequently, IMF slashed its global growth forecast, for the third time in 2015, by 20bps to 3.1% YoY. The softening global growth picture combined with anxiety over US interest rate trajectory and renewed bear trends across commodities in roiling global financial markets. Africa's growth also floundered as bearish commodity prices, alongside other challenges, weighed on the region's export proceeds, leading to deterioration in the continent's fiscal deficit, depreciation of its currencies as well as decline in its equities markets. Events on the domestic stage were also broadly in line with our expectation, with the economy taking a turn for the worse. Output plunged to multi-year lows in Q2 15 (+2.35%) while inflation climbed to a 31-month high. Though the Naira remained relatively flat, stability largely reflects impact of CBN curbs on FX trading and supporting administrative measures which proved to be a double-edged sword following the country's exclusion from the JP Morgan EM government bond index. On the political scene, after a four month wait, President Muhammadu Buhari submitted his list of ministerial

nominees to the senate for confirmation. The dour macroeconomic picture, lack of economic direction by the new government and adverse sentiment triggers on the global front all combined to drag the equity market further into negative territory. In the fixed income space, the impact of a 6pps cutback in cash reserve ratio to 15% in September neutered earlier monetary tightening by the CBN to drive the Nigerian yield curve lower. Overall, with developments across the global and domestic terrain largely echoing our views, our call in our H2 15 strategy report remains broadly intact.

Review of Global Economy and Markets

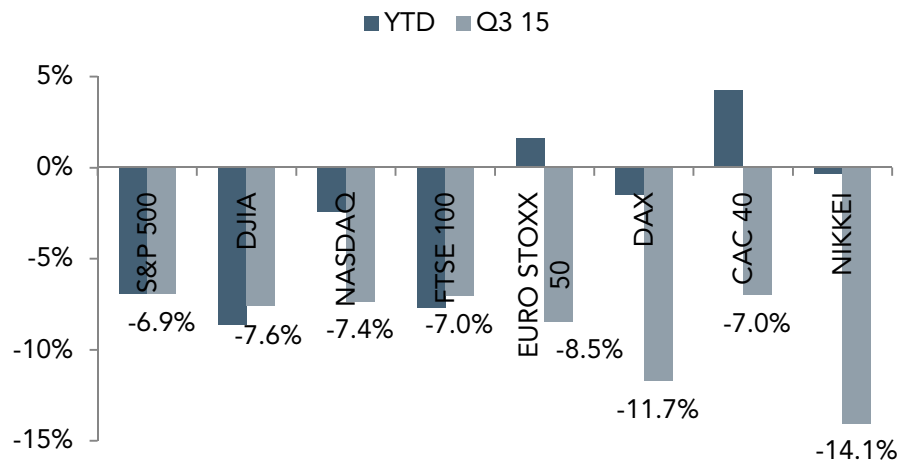
Floundering EM output and tame DM recovery moderates global growth expectations

Largely reflecting a deteriorating macroeconomic picture among emerging market (EM) countries and a slower recovery in developed market (DM) economies, the IMF lowered 2015 global growth forecast by 20bps to 3.1% YoY. Across DMs, US economy rebounded from Q1 15 contraction recording a 3.9% YoY rise in Q2 15. In addition, unemployment continued to decelerate, sliding to a 7 year low of 5.1% in latest reading in September. Nonetheless, US financial markets closed lower due to investor concerns over negative spillovers from EM growth slowdown and investor anxiety over US rate trajectory following the US Federal Reserve's decision to leave rates unchanged in September. Across the Atlantic, after pushing the Euro zone to the brink in July, the Alexis Tsirpas-led Greek government pulled back and acceded to a deal with its creditors which helped ease tensions. Overall, Euro zone Q2 15 GDP rose 0.4% YoY as stronger-than-expected growth in Spain, Italy and Ireland offset weaker-than-expected growth in Germany. Nonetheless, despite ECB's €60 billion bond buying program, lower commodity prices swung the euro area back into deflation in September which together with concerns over flagging global demand drove a bearish trend across European equities.

Over in the UK, the economy continued to show signs of improvement with GDP expanding 2.6% YoY in Q2 15 while unemployment now averages pre-

crisis levels at 5.5%. Elsewhere, Japanese economic growth shrank 1.2% YoY (Q1 15: 3.9% YoY) while a contraction in inflation for the first time in more than two years in August reignited deflationary fears and raised questions over the state of ‘Abenomics’. The growth disappointment and widening gap between current inflation and 2% target drove investor concerns about the feasibility of the BoJ’s 2% inflation target, resulting in a strengthening yen (Q3 15: +15%) and, by extension, weaker equities performance.

Figure 1: Performance of Select DM Equity Markets

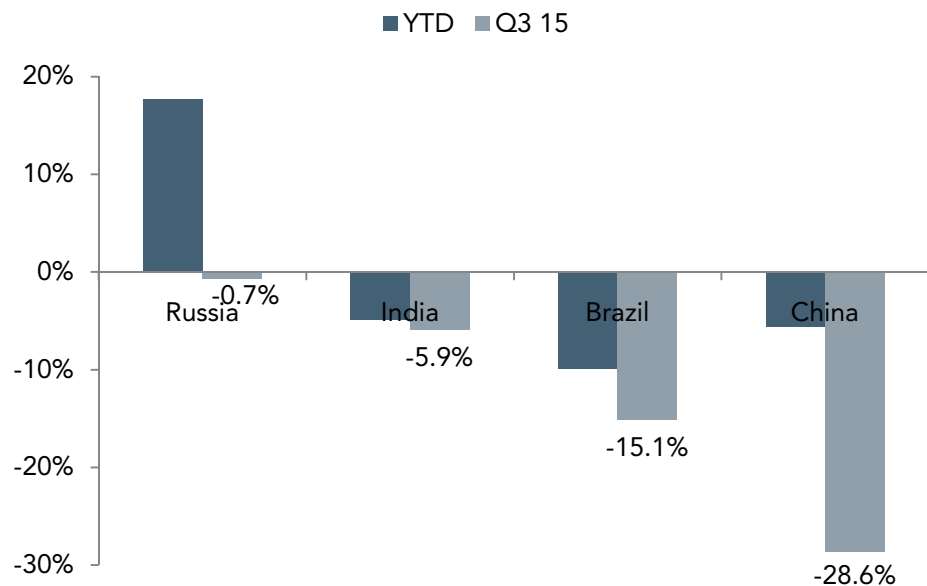


Source: Bloomberg, ARM Research

For EM economies, whilst Chinese GDP growth maintained the Q1 15 run rate of 7% YoY, the official Chinese manufacturing PMI dropped below 50 in August and remained so in September implying a contraction in manufacturing activity. Largely reflecting the growth slowdown, Chinese authorities moved to prevent hard landing with several measures: cuts to interest rate and reserve requirement ratio in Q3 15, 4.4% devaluation of the Chinese yuan, largest single drop in 20 years, and active intervention via State owned enterprises, in the form of share buybacks and technical suspensions, to prop up the stock market. Nonetheless, markets remained unconvinced with Chinese equities declining 29% over the quarter. Elsewhere, Brazil sank into recession as its economy shrank 1.9% YoY in Q2 15 (Q1 15: 0.7% YoY) amid worsening fiscal deficits and continuing political wrangles which led to a credit rating

downgrade to junk status by S&P. Furthermore, softening commodity prices underpinned 27.2% decline in Brazil's currency. Consequently, Brazilian equities softened 15.1% over the quarter. Similarly, the commodities downdraft and chastening impact of Western sanctions drove 4.9% YoY contraction in Russia's GDP growth - the steepest drop in output since 2009 global economic recession. Nonetheless, India bucked the trend with Q2 15 GDP climbing 7% YoY whilst tamer commodity prices drove continued decline in inflation which fell to a 5 year low of 2.4%. The foregoing provided the legroom for the RBI to embark on further policy rate cuts (-50bps to 6.75%) over Q3 15.

Figure 2: Equity Market Performance of BRIC Countries



Source: Bloomberg, ARM Research

Going into Q4 15, whilst the tamer commodity prices should support continued recovery in DM outlook, the slide should exacerbate growth deceleration in EM commodity exporters like Brazil and Russia. Despite the authorities' measures, China's structural rebalancing should continue to underpin further moderation in its GDP growth.

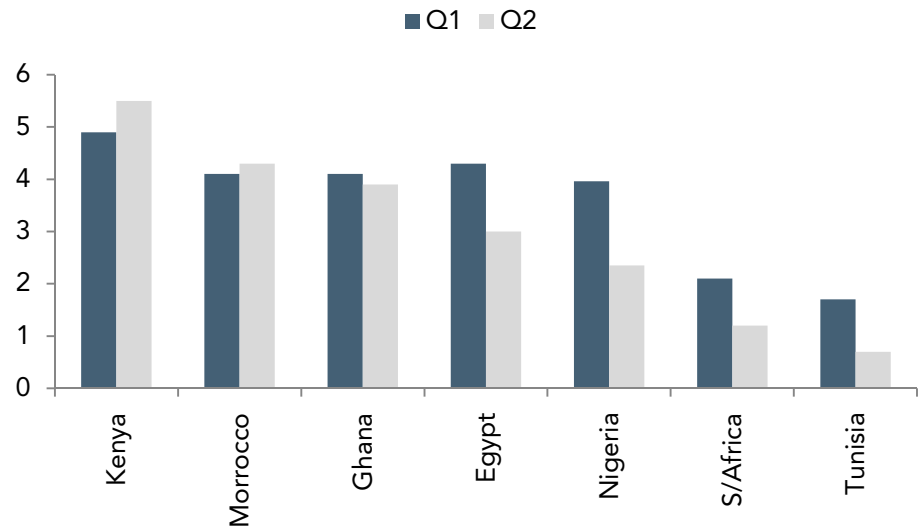
Africa's economic growth continues to falter...

Africa's economy continues to be hampered by a combination of plunging commodity prices, (GSCI: -14% YTD¹) electricity supply bottlenecks², slowing growth among trade partners, political uncertainty (epitomized by the coup d'état in Burkina Faso), security challenges, tightening external financing, as well as weak agricultural produce (especially in South Africa which is experiencing its worst drought in 23 years). These challenges which dragged GDP growth in the continents' two largest economies—Nigeria and South Africa's—to respective multiyear lows of 2.35% and 1.2% YoY in Q2 15, induced a 50bps cutback in World Bank's 2015 growth forecast for SSA to 3.7%. The World Bank similarly guided to revising its 2015 growth forecast for North African countries (current mean estimate: 3.5%) following terrorist attacks in Tunisia which crippled the country's tourism industry (7% of GDP). Continuing the pattern of economic weakness, fragile export growth and higher costs of inputs (after a steep depreciation in January) which held back industrial production in Egypt weighed on its economic growth which slowed YoY to its lowest in four quarters at 3% in Q2 15.

¹ As at 30th September 2015

² Electricity shortages hampered copper production in Botswana, Namibia, and Zambia while economic activities in Nigeria, South Africa, Ghana and Senegal were similarly affected.

Figure 3: 2015 YoY GDP Growth Rates (%) for Select African Countries



Source: Trading Economics, ARM Research

Amid these macroeconomic vulnerabilities, capital flows to the region slowed with only Zambia (\$1.25 billion), Côte d'Ivoire (\$1 billion) and Gabon (\$500 million) issuing Eurobond debts. The reduced autonomous flows together with deterioration in fiscal revenues—underpinned by heavy dependence on commodity exports—exacerbated current account deficit. IMF forecasts both SSA and mean North African current account deficit will widen 1.3pps YoY to 4.6% and 4.6pps YoY to 16.4% of GDP in 2015). Consequently, currencies across the region maintained their depreciating trend with the Ugandan Shilling (-33.2%), Angolan Kwanza (-31.6%), South African Rand (-19.7%), Kenya Shillings (-15.7%), Egyptian Pound (-9.4%) and the Nigerian naira (-8.6%) all falling through 9M 15. The Zambia Kwacha (-88%) however became the worst performing currency in Africa replacing Ghanaian Cedis (-16.5%) which pared back most of H1 15 losses following increased dollar sales by the Bank of Ghana (+43% to \$20 million) and donor inflows associated with the country's aid programme with the IMF.

In response to the sustained currency pressures, African central banks

intensified monetary policy tightening with the Central Bank of Angola hiking its benchmark interest rate four times since March 2015 to 10.5% as well as raising both lending facility (+50bps to 12.5%) and liquidity absorption rate (+175bps to 1.75%). Similarly the Bank of Ghana raised its benchmark interest rate thrice since May 2015 (+300bps to 25%) while the South African Reserve bank pushed its benchmark repo rate higher (+25bps to 6%) for the first time in 12 months in July. However, amid stable trends in the Naira,—since the devaluation in February—the Central Bank of Nigeria decided to cut its Cash Reserve Ratio 6pps lower to 25% to boost economic growth.

In tandem with the aforementioned macro-economic challenges which necessitated credit rating downgrades for Zambia, Mozambique and Angola, risk sensitiveness amongst African investors remain high, underscoring broad based equity sell-offs across the continent with the S&P All Africa index³ falling 13.3% YTD as all but the South African bourse (+0.6%) declined over the period.

Table 1: Countries whose credit ratings were downgraded in Q3 15

Country	Rating Agency	Previous Rating	New Rating
Zambia	Moody's	B1	B2
Zambia	S&P	B+	B
Mozambique	S&P	B	B-
Angola	Fitch	BB-	B+
Mozambique	Moody's	B1	B2

Source: S&P, Moody's, Fitch, ARM Research

Commodities down-leg not quite over

Oil glut keeps a lid on Brent oil prices

Brent crude oil prices plunged 23% QoQ to \$48.37/bbl in Q3 15 primarily on fears that additional supply out of Iran, after Iranian nuclear deal in July, could add to the oil glut in the global crude oil market (2.5mbpd excess as at Q2 2015). On the fundamental front, while increased idling of oil rigs in the US

³ The S&P African index is a comprehensive benchmark including stocks from 13 African Markets which includes Botswana, Cote d'Ivoire, Egypt, Ghana, Kenya, Mauritius, Morocco, Namibia, Nigeria, South Africa, Tunisia and Zambia and Zimbabwe

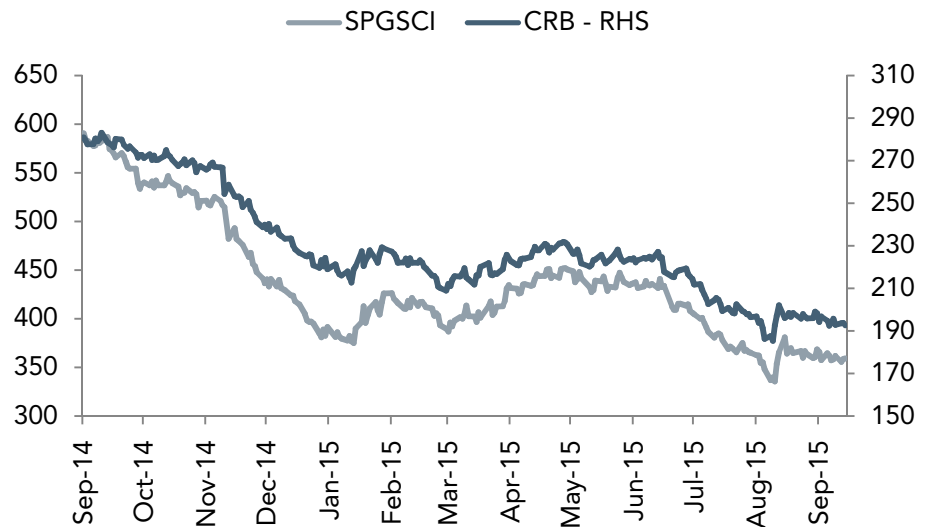
dragged oil production 150kbpd lower QoQ to 9.3mbpd in Q3 15, impact on overall supply was muted by higher OPEC output. Specifically, OPEC, led by Saudi Arabia and Iraq, continued to play for market share, ramping up output by 400kbpd QoQ to 31.7mbpd in the period which helped sustain growth in overall global supply to 96.6mbpd. The demand picture was also mixed with the US enjoying greater pass-through of lower oil price on petroleum products even as the stronger dollar capped gains elsewhere. Indeed, buoyed by seasonal demand over the summer driving season, US oil consumption climbed over 700kbpd, accounting for nearly 80% of the increase in global oil consumption to ~95mbpd. On balance, stronger demand growth, relative to supply narrowed the glut marginally to just over ~2mbpd in Q3 15. Over the rest of the year, OPEC's stance on market preservation—with Saudi Arabia reducing crude prices to Asia by \$1.00/bbl in early October, combined with surging output from Russia—which hit pre-soviet record of 9.74mbpd in September 2015, should offset slowdown in US output. On the other hand, amidst slowing growth across EMs, we expect weaker oil demand in the US, due to reduced driving in the winter season, to weigh on global demand. Put together, we see less scope for further narrowing of the excess oil supply over the rest of 2015. Whilst this dims the scope for sizeable declines in oil prices to the \$40/bbl level we had anticipated in our H2 15 strategy report, possible rebound in Iranian crude oil supplies in the coming month also caps the upside. Consequently, we expect oil prices to stay depressed over the rest of the year. Overlaying the fundamental picture with concerns on possible rebound in Iranian crude oil supplies in the coming month, we expect oil prices to remain depressed over the rest of the year.

Strengthening El-Nino weather shock to drive wedge in bearish commodity tale

Commodity prices gave up gains recorded in Q2 15 as markets turned bearish in Q3 15 with the Jefferies CRB and S&P GCSI declining 15% and 18% respectively. The downdraft largely reflects moderation in oil and metal, where concerns over global growth, in particular China's, weighed on prices. For soft

commodities, the pattern was mixed. For wheat, USDA forecast for global inventories to rise for the third consecutive (+7.2% YoY to 226.56MT) year on rising production from USA, France, Russia and India underpinned 17% price decline over the quarter. On a similar note, raw sugar prices declined 6.4% over the quarter to \$13.75/lb as the supply overhang drove bearish sentiments. Nonetheless, prices closed the quarter strongly, rallying 12% from a multi-year low of \$11.55/lb in August, on lower sugar exports from Brazil and India. Elsewhere, despite measures by leading rubber producers Malaysia, Indonesia and Thailand (~70% of global output) through their cartel, International Tripartite Rubber Council, to stimulate prices by slashing production, prices continued their free fall (Q3 15: -27%). The rubber downdraft continues to reflect weak demand from China where economic growth continues to decelerate. However crude palm oil prices bucked the downtrend with a 4% gain over Q3 15 as a weakening ringgit and concerns over the impact of the developing *El Niño* South Oscillation⁴ weather pattern on CPO output in Malaysia offset oversupply sentiment.

Figure 4: Jefferies CRB and S&P GSCI Indices performance



Source: Bloomberg, ARM Research

⁴ The ENSO results in drier weather in Australia, Asia and parts of Africa and flooding in South America

Over the rest of the year, whilst the over-supply dynamic should continue to drive broadly bearish outlook, the growing prospects of the *El Nino* poses price upside for soft commodities. The US NOAA⁵ now forecasts a 95% probability of an El-Nino occurrence vs. 50-60% in January. The weather impact is more central to crude palm oil output, where dry weather is projected to negatively impact CPO output in South East Asia. On a similar note, the prospect of flood shocks to cane sugar output dovetails into projections for the global raw sugar market to swing to a deficit for the first time in the crop cycle starting in October⁶ 2015. Nonetheless, for wheat, impact of crop losses to regions exposed to *El Nino* (like Australia and India) should be offset by earlier mentioned increases in global stockpiles driving an extension of weak price trends. On a similar note, China's economic slowdown and high inventory stockpiles should override El-Nino linked damage to rubber harvest in South-East Asia.

Key Developments in Domestic Economic and Policy Environment

Early gains for the new administration...

Following the precarious fiscal position of most states in the country which underpinned their inability to pay workers' salaries, the Federal Government approved a bailout package of ~N700 billion⁷, aimed at offsetting the backlog of salaries and loan repayments of state governments' (SGs) debt to commercial money banks. With the states' insolvency threat averted, the President moved to facilitate the efficient running of Federal government's agencies by appointing quality individuals at the head of NNPC, Customs, NCC and FIRS as well as ordering a comprehensive audit of all government's revenue generating agencies to identify possible disparities between actual revenue generated and amount remitted to the FG as well as the means through which

⁵ National Oceanic and Atmospheric Administration

⁶ The International Sugar Organization (ISO) expects sugar consumption to outstrip production during this period by 2.49million MT

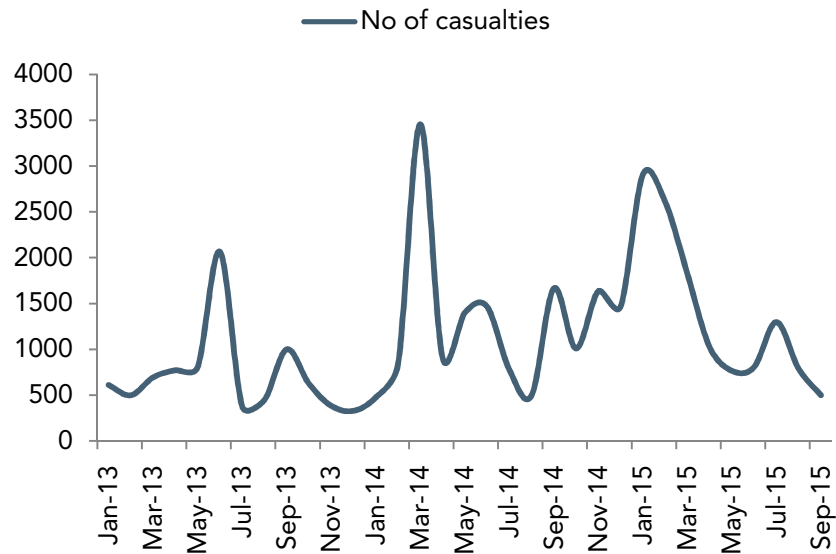
⁷ Consists of 2014 income tax paid by NLNG and Shell (N400 billion and CBN's ₦300 billion soft loan.

these funds were possibly siphoned. To this end, the federal government also enforced an earlier directive mandating all federal government Ministries, Department and Agencies (MDAs) to close revenue accounts with commercial banks and utilise the Treasury Single Account (TSA) in a bid to plug leakages and reduce the scope of government borrowings.

The new administration also made progress in terms of security following a pledge of support from Western countries regarding intelligence gathering, provision of ammunition and training of military officers. The US committed \$5 million to the cause whilst President Buhari pledged \$100 million to reinforce the Multi-National Joint Task force (MNJTF)⁸. Notwithstanding the aforementioned efforts, much of the gains (liberated towns, freed captives and captured terrorists) came after the country's defence chiefs were replaced, with the new military top brass given a December 2015 timeline to end the Boko Haram menace. Nonetheless, the spate of attacks remain high and perhaps more daring—given the recent bomb blast in Abuja (the first in the nation's capital for over a year) that killed 15 people, raising questions of the feasibility of the set deadline and whether the military campaign is all that is needed to end the BH menace.

⁸ It comprise of military personnel from Benin, Cameroon, Chad, Niger and Nigeria.

Figure 5: Boko Haram Casualty Numbers



Source: Council of Foreign Relations, ARM Research

...with tarry in the presidential cabinet announcement set to end

Finally, after four months of waiting, President Buhari forwarded the list of his ministerial nominees to the senate for confirmation. The list which reflects a mix of experienced civil servants and technocrats—but nonetheless politician laden— might have been drawn to pacify the various parts in the political coalition that brought the President into power. However, the likely candidates for key ministries such as defence, petroleum resources and finance have a strong track record which suggests capabilities to cope with the pertinent issues of security and economic slowdown in the country. Even with inter and intra party tensions resulting from the appointment of Dr. Bukola Saraki as the Senate President, the screening and confirmation of the ministerial nominees by the senate are expected to go smoothly and we anticipate the official announcement of the presidential cabinet in a few weeks.

Cutback in government expenditure underpins contraction in fiscal deficit

Similar to the preceding quarter, Q2 15 gross federally collected revenues contracted 43.1% YoY to ₦1.49 trillion (-28% QoQ) as both oil and non-oil proceeds plunged over the period. Notwithstanding higher crude oil production (+4.2% YoY to 2.04mbpd) over the period, sustained pressure on crude oil prices (Mean: -35.2% YoY to \$61.2) dragged gross oil revenues to its lowest in 23 quarters (-53.3% YoY to ₦839 billion). Similarly, gross non-oil revenues fell to its lowest in 8 quarters as plunges in Companies Income Tax (CIT)—which reflects the impact of challenging macro environment on companies' bottom line— as well as a decline in customs and excise duties' receipts (-6.4% YoY to ₦128 billion) more than offset improvement in both VAT (+4.7% YoY to ₦203 billion) and Other (+88.4% to ₦156 billion) proceeds. Consequently, FG's retained revenues contracted to its lowest in 14 quarters at ₦628.72 billion, 32.4% short of budgeted estimate. However, amid sustained scale back in capital expenditure (Q2 15: -98.1% YoY to ₦5.3 billion) as well as lower recurrent expenditure (-26.4% YoY to ₦604.5 billion)—possibly reflecting gains on FG's drive to plug leakages as well as absence of ministers, and their associates, in the month of June—the fiscal deficit shrank 89.4% YoY to ₦34.9 billion (Q2 15 budgeted fiscal deficit: ₦260.25 billion) Going forward, though the economic forces which drove weaker revenues remain intact, FG's sustained drive to plug leakages with at least 600 MDAs having already complied with the TSA directive should continue to temper the effect of lower revenues on the country's fiscal position. This dynamic is further aided by the Presidency's commitment to enforce the Integrated Payroll and Personnel Information System (IPPIS) in a bid to flush out ghost workers.

PENCOM sustains reform drive...but not without conditions

The National Pension Commission (PENCOM) intensified its efforts to ensure more allocation of pension funds towards Variable Income securities (Ordinary Shares; participation units of Open, Close-ended and Hybrid Funds; Real Estate Investment Trust; Infrastructure Funds; and Private Equity Funds) by issuing a guideline that will govern withdrawal of RSA funds for residential

mortgage. According to the guideline, RSA holders with a Debt/Income ratio not exceeding 33.33% and in active employment shall be allowed access of up to 25% of their pension funds towards equity contribution in respect of first home ownership mortgages after having consistently contributed for a minimum of 10 years. Furthermore, the mortgage loan must range between N1.5 million and N50million with a tenor of between 5 to 20 years. Although this reform has the noble intention of reducing the nation's 17 million housing deficit it will exclude at least half of pension contributors. In that light we believe the pension regulator is targeting middle income earners with a very consistent source of income, as this demographic is the most likely to successfully service the residential mortgage loan.

In addition to the release of the mortgage guideline, PENCOR issued regulations for the transfer of RSA funds, affording RSA holders the opportunity to move their funds among PFAs once every twelve months. This regulation which heralds the commencement of the transfer window, should lead PFAs to improve and uphold a high quality of service to prevent customers' transferring to a different fund administrator. . In all, we expect the launch of these reforms to drive a more competitive pensions market in Nigeria going forward.

Economic Review and Outlook

GDP and external trade challenges persist...

GDP growth decelerated a further 419bps YoY (-161bps QoQ) to 2.35% in Q2 15—besting only 7.6% YoY contraction in Q1 2004 over the past 11 years. Dissecting the components, oil GDP extended its decline for a second consecutive quarter, trimming 11.94pps YoY to -6.79% whilst non-oil GDP slumped to an eighteen-quarter low of 3.5% YoY. Importantly, narrowing oil GDP continues to reflect second order effect of constraint on NNPC's ability to meet cash call obligations to JV partners, arising from ~45% YoY contraction in average oil prices to \$61.53/bbl and a consequent shrinking of overall FGN revenue receipts. Specifically, while the cutback in JV investments largely underpinned reduction in average oil production on one hand (-7.3% YoY to 2.05mbd in Q2 15), impact of a global supply glut allowed deceleration in demand for Nigerian oil to further cap production, on the other. On the non-oil front, receding oil refining (-65% YoY), Food, Beverage and Tobacco (-5.9% YoY), Textile, Apparel and Footwear (-3.2% YoY) and Electricity (-12% YoY) triggered a cutback in manufacturing GDP whilst the slowest pace of growth in services GDP mirrored weakness in Telecommunications, Real Estate, and Public Administration following protracted period of socio-political uncertainties over H1 15.

In H1 15, Nigeria recorded trade deficit of \$1.5 billion (vs. surplus of \$11.3 billion in corresponding period of 2014) as ~45% YoY contraction in exports to \$24.7 billion more than offset ~22% decline in imports to \$26.2 billion. Similar to its influence on GDP weakness, lower crude oil prices and production weakened oil exports (~90% of total exports)⁹ and, amid growing competition for Nigeria's traditional oil export markets, led to a relapse in total exports receipts in the review period. This was in spite of the commencement of ECOWAS common external tariffs (CET) in April 2015 which was meant to strengthen intra-country trade between member countries. For its part, weakness in imports was mainly underpinned by declines in fuel and other

⁹ Organisation of Petroleum Exporting Countries, Annual Statistical Bulletin 2015

lubricants (-54% YoY) and transport equipments and parts (-34% YoY). Importantly, while NBS data highlights contraction in passenger motor parts (-58% YoY) as key driver of decreasing transport and equipment importation over the period—reflecting impact of higher tariffs, we attribute lower fuel and lubricant imports largely to ~19% YoY drop in approved PMS import allocation to 1.5 metric tons in Q2 15 and difficulty in obtaining bank financing for imports in view of uncertainty over the PSF scheme as well as lower refined product prices.

CBN basks in currency stability as inflation and money supply rise

Despite the aforementioned macro concerns and, in particular, evidence of flat to falling market demand, price levels maintained an uptick over the first 9 months of 2015. Precisely, while grim macro milieu crimped both private and public demand for goods and services, YoY inflation reading accelerated to a thirty one month high of 9.4% in September 2015 with YTD average 79bps higher YoY at 8.9%. The headline pressures over the period were primarily driven by core inflation which recorded a mean ~100bps increase to 8.0% while mean food index was only 15bps higher YoY at 9.7%. Interestingly, while processed food pressures drove core and food inflationary pressures over H1 15, more recent releases pin growing price stress on ‘Housing Water, Electricity, Gas and Other Fuels (HWEGO)’ and ‘farm produce’ prices as additional core and food inflation drivers respectively. Despite these price pressures, the semblance of currency stability since the adoption of order-driven interbank FX market in February appears to explain CBN’s apparent comfort. Aided by the first real sign of political backing from the executive arm for its monetary policy tack, and the dis-incentive to make further changes as the ‘worst-case scenario’ crystallized with Nigeria’s exclusion from JP Morgan’s emerging market bond index, the apex bank suddenly appears more tolerant of greater systemic liquidity compared with the peak of its currency management efforts. Nonetheless, falling external reserve (-23.5% YoY) and crashing export receipts offer little support, fundamentally, for sustenance of CBN’s currency “protectionism”. In the interim, the liquidity being allowed to sit in the system, coming from the 6pps cut in CRR in partial restoration of TSA withdrawn

funds, could further boost money supply growth. Already, recent CBN data indicates 11.2% and 9.9% growth in both narrow and broad money supply year through August. On other fronts, net domestic credit was 32.6% higher over the period, mainly driven by positive credit to government balances following outflow of public sector deposits from deposit money banks on TSA implementation. Thus, with credit to private sector rising only a meager 2.7% in same period, we note that growth in money supply has failed to cascade to a commensurate increase in credit extension in the review period.

Table 2: Macroeconomic dashboard

GDP (% YoY)	GDP			
	Q1 15 GDP		Q2 15 GDP	
	3.96		2.35	
	Q1 15 Oil	Q1 15 Non-oil	Q2 15 Oil	Q2 15 Non-oil
	-8.1	5.6	-6.8	3.5
External trade (YoY)	TRADE			
	H1 15 Deficit (\$, million)		H1 14 Surplus (\$, million)	
	(1541)		11, 339	
	H1 15 Oil Export (%)		H1 15 Non-oil Imports (%)	
	-45		-22	
Inflation (% YoY)	MEAN INFLATION			
	H1 15 Headline			
	8.9			
	H1 15 Core		H1 15 Food	
	8.0		9.7	
Currency/ reserve (% YoY)	USDNGN		RESERVE	
	-20.8		-23.5	

Source: NBS, CBN, ARM Research

Overall macro outlook: Dim light at end of tunnel

In all, we expect cumulative impact of restricted JV investments by NNPC and lag created by NNPC's ongoing adjustments to leave oil GDP pressured for remainder of 2015, while grimmer public and private demand outlook seem set to extend weakness in non-oil GDP components of manufacturing, cement, and services. Beyond this, domestic production constraints as well as rising global market competition remain significant constraint on Nigeria's overall

export outlook going forward. On other fronts, in line with FGN's position on CBN's currency protection measures, we believe current FX demand management initiatives of the apex bank would have to give way to more realistic medium to long term solutions. Specifically, dwindling fundamentals (with foreign reserves at a four months low of \$30.3 billion and widening trade deficit) should force CBN to revisit devaluation proposition eventually with potential knock-on effect on medium to long term inflation.

Capital Market Review and Outlook

Renewed oil price weakness and policy uncertainty weigh on NSEASI

In Q3 15, NSEASI reversed the positive run recorded in the prior quarter (+5.4%) with a 6.7% decline which swung market performance thus far in 2015 deeper into negative territory (9M 15: -9.9% vs. H1 15: -3.5%). The development sits well with our thesis, as contained in our NSR H2 15, where we outlined that negative sentiment triggers on the global front (continued weakness in oil prices, Grexit, EM volatility etc) should combine with a policy uncertainty on the domestic front and deadbeat earnings outlook in driving a resurgence in market downdraft.

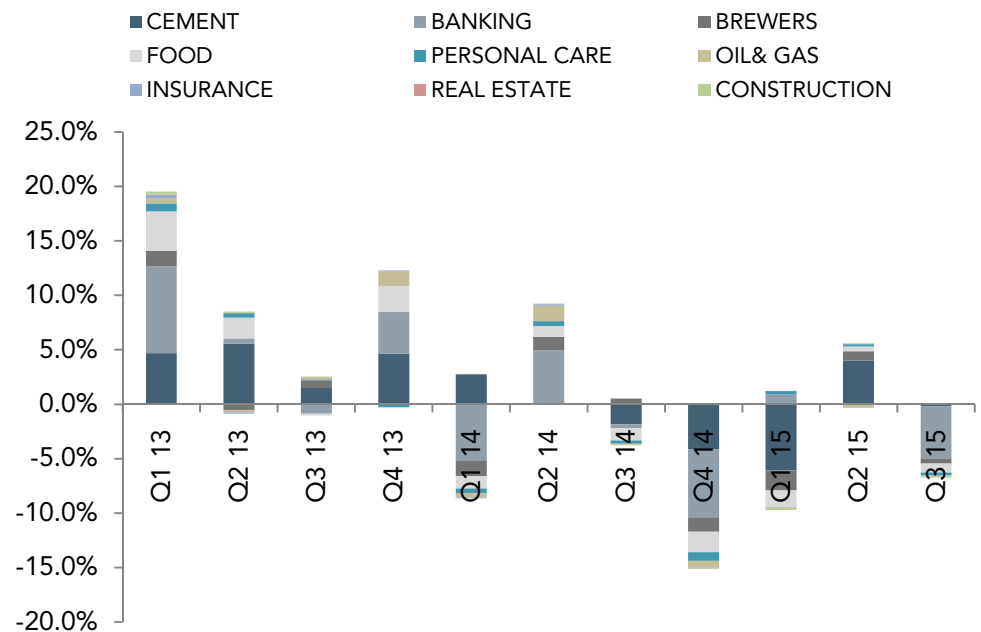
Going through market movement on a monthly basis illustrates this point more clearly as renewed weakness in oil (-18% MoM to \$52.2/bbl) following the progress on the Iranian P5+1 talks underpinned a 9.8% MoM contraction in market performance. The down-leg in oil prices, the sharpest MoM contraction since December 2014, renewed fresh concerns over Nigerian equities and induced a return to net short FPI positions in July of ₦10 billion vs. ₦16 billion net long positions in Q2 15. Domestic investors also took flight with NSEASI data showing an 81% MoM plunge in domestic transactions to ₦26 billion. Though oil prices recovered in August (+4% MoM), NSEASI put in another negative shift (-1.6% MoM) as, following Chinese Yuan devaluation over the month, which roiled global financial markets¹⁰, FPI net short positions widened

¹⁰ MSCI EM (-9% MoM) MSCI FM (-6% MoM)

to ₦15 billion. Despite JP Morgan's exclusion of Nigeria from its EMGBI, extended sell-offs across EM/FM equities and an 11% MoM contraction in Brent crude prices, domestic equities rallied 5.2% over September. Notably, 60% of NSEASI's MoM gain was recorded over the last five trading days as investors kept an eye on President's Buhari's pledge to announce his cabinet by the end of September.

Over the quarter, our attribution analysis on sectoral performance reveals that price compression across banking stocks (-14.9%) and defensives¹¹, which both cumulatively account for ~59% of market cap explained ~94% of market downturn over the quarter. Whilst price performance reflects fundamental earnings weakness for consumers with H1 15, the same cannot be said for banks where actual earnings trajectory was positive¹².

Figure 6: Attribution analysis of quarterly sectoral performance



Source: NSE, ARM Research

¹¹ Breweries (-3.3%), Food producers (-6.6%) and personal care (-8.3%)

¹² Across our coverage, banks cumulatively reported 7% YoY expansion in H1 15 earnings.

A bearish prognosis remains the base case

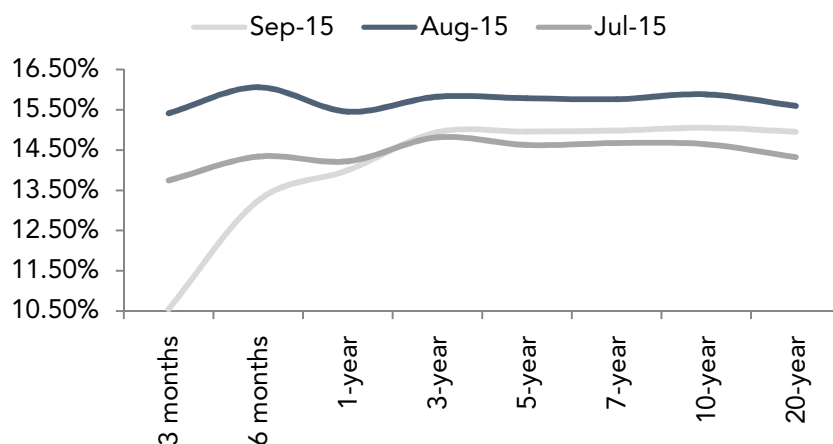
Over the last three months of 2015, as in prior quarters further down leg in oil prices should fuel investor anxiety over equity exposures in oil exporting countries. Having established a bearish outlook on oil over Q4 15 as elucidated under our commodities review, the foregoing should combine with market jitters around US Federal Reserve FOMC meetings in driving subdued portfolio flows to EM universe and the oil exporting countries in particular. On the domestic front, major sentiment drivers over the quarter are the pending release of the cabinet list and Q3 15 earnings releases. On the former, recent release of the ministerial list sprinkled with more politicians than technocrats dims scope for a sentiment driven market rally. Markets should now take to second-guessing fiscal policy measures of the Buhari administration in mitigating impact of weaker government revenues. Furthermore, as the drivers of earnings slowdown in prior quarters remain broadly intact, the release of our Q3 15 financial results across the various sectors, with the possible exception of banks, should support extension of bearish market sentiment.

Fixed income: A lot of gyration but outlook appears firm

The Nigerian yield curve fell 64bps on average QoQ to 13.72% in Q3 15 with divergent movements at both ends of the curve. While rates tightened ~140bps to 12.6% at the short-end over the period, the long-end witnessed modest expansion (+10bps) to 14.88%. Over the quarter, however, yield movement mirrored investors' reaction to a number of events—including new admin measures by the CBN and economic uncertainty—we had highlighted in our H2 15 strategy report. In July, the step up in monetary manoeuvres by the apex bank, in response to currency pressures with the exclusion of 41 items from the Nigerian forex market, stoked market expectation for further tightening at the July MPC. Indeed, reflecting this perspective, but also uncertainty caused by the haziness of fiscal policy weeks after inauguration, investors stayed in cash, driving call rates ~200bps lower to 9.84% while bond yields push higher to a peak of 15.11% on average prior to the MPC meeting. However, with no change at the July meeting, investors ramped up bond purchases with yields tightening to 14.78%. Over August, it was the combination of the CBN's 48

hour forex prefunding requirement and looming deadline (initially 1st September) for the implementation of TSA that underpinned the 130bps spike in yields to 15.71%. In particular, commercial banks sold-off to boost liquidity positions, after the drain in system liquidity occasioned by the implementation of the forex pre-funding and, in anticipation of the liquidity squeeze that could trail the eventual closure of federal government's bank accounts in line with TSA deadline. In the final month of the quarter, however, yields recorded the sharpest MoM contraction (-200bps) in more than two year as robust demand following the 600bps cut in CRR at the September MPC more than offset the sell-off that trailed the announcement to exclude FGN bonds from JP Morgan index and the final implementation deadline (15th September) of the TSA.

Figure 7: Naira yield curve



Source: FMDQ, ARM research

Although the cut in CRR should see up to ₦1trillion flow into the system, easing the liquidity squeeze from the on-going implementation of the TSA, our estimates suggest a net credit to the system. Overlaying the likelihood of an inflow, with the attitude of the apex bank towards liquidity build up in September as ₦300 billion OMO paper matured, hints at a possible change in monetary policy tack. Indeed, amidst flagging growth, the crystallisation of JP Morgan risk' should see the CBN more open to liquidity build up, particularly, with limited opportunities for forex round-tripping under the order based forex

market. For the fiscal authorities, the DMO's drive to cap borrowing cost resulted in the sale of only 65% of the offer at the September bond auction. Despite the increase in proposed bond issuance over the rest of the year to ₦225 billion (+7.1% QoQ), we believe on-going reforms across major revenue generating agencies, including the NNPC and customs, as well implementation of the TSA are likely to have emboldened the DMO's stance to cap interest cost. In any case, we think that elevated debt service to revenue ratio of nearly 30% constricts the FG's capacity to continue to borrow at high rates. Putting the hints from the CBN side by side with the body language of the fiscal authorities, we see scope for further moderation in yields over the rest of 2015.

Capital Market Strategy

Deadbeat outlook throws up windows for deep value entry

In our H2 15 strategy report, amid a dour outlook for oil prices, and by extension, Nigerian equities, we posited that currently depressed valuations across NSEASI offered entry opportunities for investors. Relative to defensives and other cyclicals, the relatively cheaper valuations of banks, in our view, offered more upside, informing our strategy for investors to leg-in to the sector for long-term value. Indeed, amid renewed weakness in crude oil prices over the quarter, the sell-off suggests investors continue to aggressively price in feed-through from weaker macro-environment on company earnings. This pattern was more strongly felt on banks, which despite a 7% YoY expansion in H1 15 earnings, remained under pressure over the quarter with P/E multiples sliding 13% over the quarter to 5.3x. In our view, it would appear investors continued to incorporate prospects of higher impairments on earnings as lower oil price adversely impacts upstream O&G loans and while feed-through from CBN FX restrictions roils general commerce loans. Similarly, cement sector P/E multiples shrank 26% to 11.7x over the period reflecting weak performance following price cuts initiated by sector heavyweight Dangote Cement. In contrast, petroleum marketers' valuations continued to climb (+10% to 84x) in part reflecting weaker earnings and renewed price upswing following sizable

deal-making activity over the quarter.¹³ Elsewhere, sustained downtrend in earnings continued to drive upswing in consumer sector P/E multiples, which climbed to 46.7x (H1 15: 39.8x) by our estimates.

Over the rest of the year, whilst Buhari has named his cabinet, policy direction remains uncertain and with our bearish oil thesis broadly unchanged from the end of H1 15, market sentiment should rely on release of Q3 15 earnings results for direction. On this wise, following aforementioned price cuts, in response to softening volumes, cement producers should report weaker earnings as tempered revenues continue to moderate federal and state government capital spending. For banks, though monetary policy eased at the September MPC, the gains to net interest margins from the CRR reduction are more likely to reflect in Q4 15 numbers. Amid a slew of restructuring of upstream O&G loans by some banks, we expect impairments to continue the ascent which began in Q2 15 results over Q3 15 which underpins a tepid outlook for earnings expansion. Lastly, FMCG companies should continue to grapple with issues (naira devaluation, soft consumer spending, rising debt costs etc) that have dogged performance over H1 15. On balance, with a broadly weak Q3 15 earnings outlook underpinning a bearish outlook for equity prices, we continue to see scope for downward market performance which provides opportunities for long term value play. On valuation basis, our strategy call continues to favour a phased entry to financials relative to consumers as valuations remain attractive relative to the rest of the NSEASI on risk-reward basis.

Fiscal and monetary policy harmony to drive yields to new lows

Fixed income yield trajectory over Q3 15 reaffirmed our earlier prognosis of rising influence of domestic factors on yields. Indeed, reflecting whittling foreign influence, market reaction to the crystallisation of JP Morgan index exclusion was relatively mute, against consensus expectation of severe collateral damage. Also fitting with expectations in our H2 15 strategy document, was the posture of the financial authorities—monetary and fiscal—over the period,

¹³ Mercuria agreed to acquire 17% of Forte Oil for \$200million while Vitol-Helios acquired a minority stake in Oando's downstream business for \$267million in Q3 15.

which indicated much less desperation despite the circumstances, especially when one considers cut back in paper issuance in the period. Specifically, in the face of fiscal pressures, the DMO sold 75% of bond offer in Q3 15, while the CBN repaid ~~~N~~90 billion OMO despite elevated liquidity. However, more important for us, are signs of growing harmony between both authorities, a dynamic only reinforced by the executive arm clear support of the current monetary policy stance. Going forward, this improved synchronisation has even more reason to deepen: despite its reticence thus far, the FG might see domestic borrowing as a more viable option in a lower rate environment even as economic growth and financial system stability challenges appear to be leading monetary policy down an easing path. Hence both fiscal and monetary authorities could both soon be dancing to the same tune. Indeed, having lost the battle to keep Nigeria government bonds on the JP Morgan index, the monetary authorities appears in no haste to mop up the bulging system liquidity, particularly with limited impact on currency since the switch to the order based forex market. Perhaps reflecting this disposition, the CBN injected ~~~N~~700 billion CRR credit which pushed liquidity over ~~N~~1 trillion, the highest level since January 2014. Possibly hinting at the potential benefits of such synchronisation, Q4 15 bond issuance calendar shows a planned increase in bond issuance, with ~~N~~80 billion (+14 MoM) planned for October. Coming at a time of record liquidity level, makes the outcome of the auction is likely to be more favourable for the FG, relative to the September auction. At the October auction not only did marginal rates collapse 250bps to 13.5%--the lowest in 2015—the DMO took advantage of the lows rates to sell additional N40 billion on non-competitive basis. Consequently, it would appear that monetary policy, in concert with the fiscal authorities, could be at an inflection point, and slowing economic growth, benign inflation and relative stability of the currency all stack up in favour of easing. In this wise, it would seem that the expectation for yield downtrend that underpinned our strategic call to build is fully on. However, this does not rule out room for upswings that could provide short window of trading opportunity for investors, with US policy and crude oil prices being the central risks for such a scenario. Nonetheless, inflation and currency concerns have now eased and the dusts raised on the political scene, going by internal wrangling within the ruling party, are unlikely to match the

jitters caused by the general elections earlier this year. The overall picture, after fitting the puzzle pieces together, emboldens our duration building strategy with any spikes simply an opportunity for more attractive entry.

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