

Nigeria Strategy Report | Q4 2016 Outlook

Economic Snapshot

September 2016 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	0.8%	17.9%	17.6%
Food	0.8%	16.6%	16.4%
All Items Less Farm	0.9%	17.6%	17.2%
Imported food	0.9%	20.8%	20.7%
Energy	1.4%	31.6%	30.4%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	309.50	1.74%	-55.3%
EURNGN	354.94	0.67%	-60.0%
GBPNGN	382.93	0.80%	-30.2%
JPYNGN	302.00	0.66%	-88.0%
Monetary Aggregates – August 2016			
	(₦'bn)	MoM	YoY
M2	21,647	-2.4%	17.1%
CPS	22,664	1.3%	21.6%
NCG	3,291	18.2%	19.2%
NFA	7,623	0.8%	38.6%
NDC	25,955	3.2%	21.3%
External Position			
	Latest	QoQ	YoY
Trade Balance (\$'mn)	-1,292	165%	131%
External Reserves (\$'mn)	24,596	-5.9%	-18.0%
Foreign Debt (\$'mn)	10,718	0.9%	10.4%
Growth Data – Q2 2016			
	(₦'bn)	%of total	YoY
Real GDP	16,102	100%	-2.1%
Agriculture	3,636	22.6%	4.5%
Oil	1,332	8.3%	-17.5%
Services	6,003	37.3%	-1.8%
Wholesale and Trade	2,834	17.6%	0.0%
Manufacturing	1,602	10.0%	-3.4%

Introduction

In this edition of our quarterly strategy outlook report, we take a big-picture look at the indicators on the global stage and domestic scene over Q3 16 and how these have been influenced by recent events, to postulate our expectations for Q4 16, but more importantly, possible implications for our proposed capital market strategy. Global economic recovery faltered as advanced economies recorded slower growth while emerging markets continued to grapple with the fall-out of weaker commodity prices and tighter global financial market conditions.

The anecdote across Africa remains bleak, as in our H2 16 outlook, economies continue to contend with impact of the softer commodity exports on fiscal and current account balances and its implications for internal macroeconomic stability. Largely reflecting the sliding growth fortunes, the IMF cut its 2016 growth forecast for Sub-Saharan Africa (-20bps) to 1.4% YoY. Bringing it home, the domestic scene was shaped by weak output, elevated interest rate environment, sustained inflationary pressure and currency weakness.

The weak macroeconomic picture, continued foreign reticence to equities coupled with the recent uptick in yields which dissipated domestic interest in equities combined to pare the bull run in Q2 16 with the NSE ASI down 3.1% in Q3 16.

In the fixed income space, the hawkish monetary policy stance largely influenced the widened Naira yield curve a further 380bps in Q3 16. Going into the last quarter, while the baseline for global growth remains broadly soft, the recovery in crude oil prices which drives scope for modest improvement in the fiscal picture as well as other developments on the domestic front necessitates mild tweaks in our views regarding how investors should navigate capital markets in Q4 16.

Review of Global Economy and Markets

Global recovery remains 'slower than molasses'

The IMF estimates that global GDP rose 2.9% YoY over the first half of 2016 which places it in line for the agency's full year forecast of 3.1% YoY (-10bps from 2015). Examining growth developments along developed markets, US GDP growth strengthened over Q2 16 to 1.4% YoY (Q1 16: +0.8%) on account of improved consumption growth, higher exports and increased non-residential fixed investment. However, less than stellar jobs data¹ and the still low inflation (August 2016: 1.1%, target: 2%) prevented the US Fed from raising interest rate over Q3 16. Across the Atlantic, Euro-Area GDP declined 30bps to 0.3% QoQ in Q2 16 as slowdown in Germany (-30bps to 0.4% QoQ) as well as stagnation in France (-70bps to 0% QoQ), Italy (-30bps to 0% QoQ) and Austria (-60bps to 0% QoQ) more than offset improved economic activities in Greece (+40bps to 0.3% QoQ) and Estonia (+30bps to 0.3% QoQ). Consequently, the ECB retained its accommodative policy stance with its stimulus program and benchmark refinancing rate² at €80 billion/month and 0% respectively. Elsewhere, while UK growth improved in Q2 16 (+20bps to 0.6%), the BoE in August eased monetary policy significantly: interest rate cut (-25bps to 0.25%), a plan to purchase government (£60 billion) and corporate (£10 billion) bonds, as well as a potential £100 billion loan program for banks to ward off impact of Brexit fallout. In Japan, after growth slowed to a seasonally adjusted annualised rate of 0.7% in Q2 16 (Q1 16: +2.1%), Japanese government announced a new fiscal stimulus worth ¥28.1 trillion (\$276 billion) while the BoJ declared changes to its policy approach including introduction of a target for 10-year interest rates at 0%. In addition, Japan's monetary authorities committed to an expansionary policy until YoY rate of increase in the observed inflation exceeds target of 2%.

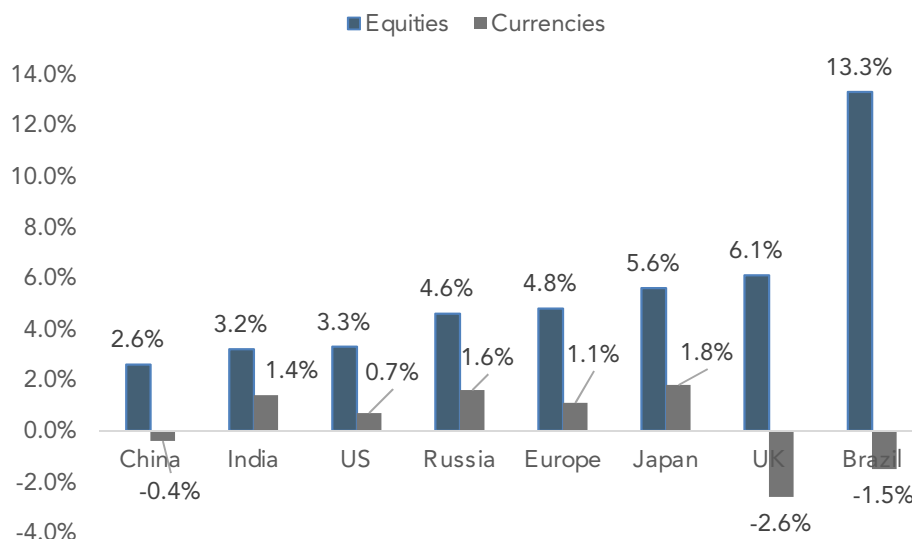
For Emerging Markets (EMs), growth remained tame with China's growth flat lining at 6.7% YoY in Q2 16, Brazil and Russia remaining in recession, while growth softened in India (-80bps to 7.1% YoY) following a late start to the monsoon rainfall season. In response, monetary policy remained accommodative, except in Brazil

¹ August Non-farm payrolls contracted 45% MoM to 151,000 jobs

² Other policy rates unchanged by the ECB include deposit rate at -0.4% and marginal lending rate at 0.25%

where soaring inflation (August: 8.97%, target: 4.5%) continued to induce hawkish monetary policy.

Figure 1: Q3 16 equity and currency performance of selected countries



Source: Bloomberg, ARM Research

Into the last quarter of 2016, global economic conditions should remain soft reflecting slowing momentum across developed countries which should more than offset moderate improvement in EM markets. In US, economic activities should remain modest largely on the back of ongoing inventory correction cycle, weak business investment in the oil and gas sector, and policy uncertainty related to the electoral cycle while uncertainty surrounding Brexit is projected to weigh on investors' confidence and investment decisions across Europe. For Japan however, output is expected to benefit from recent growth enhancing policies. Across the EM countries, India should shrug off its monsoon induced slowdown, China being supported by fiscal and monetary policies should maintain current economic stability, while contractionary trend in Russia and Brazil should ease further on waning effects of past economic and political shocks. Overall, whilst the dispirited growth picture should induce most monetary authorities into maintaining current accommodative stance, possible US Fed rate hike in Q4 16 and a testy US election in November point to continued volatility in global financial markets.

Bearish commodity prices soften Africa's growth picture

Continuing the pattern in H1 16, African economies continue to grapple with the impact of softer commodity prices with Nigeria officially going into recession while Ghana, Botswana and Senegal experienced growth deceleration. Largely reflecting the sliding growth fortunes, the IMF cut its 2016 growth forecast for Sub-Saharan Africa (-20bps) to 1.4% while mean North Africa growth is projected to remain unchanged at 2.5%. The current account pressures continued to induce currency weakness across Africa most notably with the Nigerian Naira plunging 10% since the end of June 2016. Feed-through from the currency woes underpinned rising inflation across board with most countries across the region reporting faster rise in prices except Kenya, where declining transport costs on cheaper fuel prices drove benign inflation trends. In response, monetary policy remained tight as the apex bank of Angola, Nigeria and Liberia raised their benchmark interest rates, while interest rates were left unchanged in Algeria, Ghana, Egypt, Morocco, Tunisia, Gabon and South Africa in order to cushion subdued economic growth. On the fiscal side, the lower commodity exports drove wider fiscal deficits and induced downward ratings action for African sovereigns over the period. As in H1 16, Eurobond issuance remained tight with only Ghana testing the market with a \$750 million issue which was 5x oversubscribed. Despite the macro headwinds, African equities closed Q3 16 4.3% up (YTD: 13.8%) as gains in Egypt (+12%), Morocco (+12%), Ghana (+8%), Tunisia (+6%), Mauritius (+5%), South Africa (+3), more than offset losses in Kenya (-19%), Zambia (-9%) Botswana (-8%) and Nigeria (-1%).

Table 1: Policy rate decisions and Ratings Action

	Q2 16	Q3 16	Changes (bps)	S&P Ratings
Ghana	26.00%	26.00%	-	B-
Tunisia	4.25%	4.25%	-	BB-
Nigeria	12.00%	14.00%	200	B
Egypt	11.75%	11.75%	-	B-
Angola	14.00%	16.00%	200	B
Gabon	2.45%	2.45%	-	B
Morocco	2.25%	2.25%	-	BBB-
Kenya	10.50%	10.00%	50	B+
South Africa	7.00%	7.00%	-	BBB-

Source: Various central banks, ARM Research

Over the rest of the year, African growth looks set to contract further as shocks from declining commodity prices, tighter financial conditions, policy uncertainties, adverse weather conditions, and political concerns continue to weigh on activity in the region.

‘Search for yield’ underpins rebound in FPI flows

Despite persisting concerns over Brexit, FPI flows to emerging markets accelerated to an eight quarter high of \$64 billion in Q3 16 according to the Institute of International Finance (IIF). The upsurge in capital flows reflect reduced concerns about global growth, particularly across EM countries, as well as foreign investors’ quest for higher returns. Amidst sustained monetary easing which pushed yields across developed markets to near record lows, appetite for EM securities improved with both equities (\$37.2 billion—highest in eight quarters) and bonds (\$26.8 billion—highest in six quarters) witnessing sizable inflows. EM Asia experienced the biggest inflows with sizable chunk of the capital (\$5.7 billion) flowing to India’s booming economy (Q2 16: +7.1% YoY). FPI flows to Africa also improved with South Africa reporting its first net inflows (\$463 million) in four quarters while Nigeria’s portfolio flows of \$661.5 million over July and August 2016 is the highest of any two months so far this year. Similarly, Ghana’s \$750 million Eurobond issuance in September was also over five times oversubscribed. Owing to growth outlook however, capital flows to Africa remain lower than 2015 levels with total

Eurobond issuance of \$2.7 billion so far in 2016 being 56% lower YoY, even as FPI flows to Nigeria (-7.4% YoY) and net portfolio flows to South Africa (-28.9% YoY) similarly declined.

Going forward, the fragile recovery of economic growth across developed countries suggest an extension of current accommodative policies and by extension continued low yield environment. Thus, whilst prospect of a rate hike in the US holds negative connotation for FPI flows over the last quarter, we believe the quest for higher returns should leave FPI flows to EMs positive.

Commodities market Review

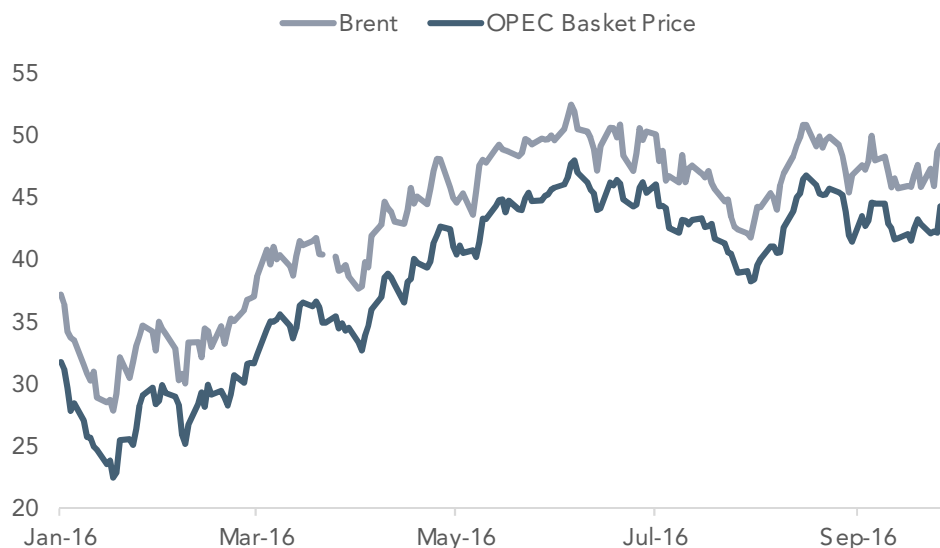
Prospect for OPEC freeze props up prices

On the heels of a bull run in H1 16 (+33% to \$49.68/bbl), Brent crude started off H2 16 on a bearish note with prices sliding 14.5% MoM to \$42.46/bbl in July on prospects of increased supply from OPEC and non-OPEC producers as well as dim outlook on demand. However, as production shut-ins remained over August, price recovered 10.8% MoM to \$47.04/bbl. Further supporting price recovery in August was fresh talks of possible production freeze at the informal OPEC meeting slated for September which received Russia's support. Ahead of the talks in September, which eventually culminated in an agreement by OPEC to cut production to a target of 32.5-33.0mbpd, prices climbed further 3.3% to \$48.6/bbl in September. Nonetheless, largely reflecting the scale of July's selling, Brent prices closed Q3 16 2% lower QoQ.

On the fundamental front, while global crude markets continued to remain over-supplied, a faster rise in demand (+1.8% QoQ to 95.1mbpd) relative to global production (+1.2% QoQ to 96.7mbpd) drove contraction in the glut (-24% QoQ to 1.6mbpd) in Q3 16. Consumption growth was fueled by growth in OECD purchases (+2.0% QoQ) due to rising gasoline demand in the Europe and USA on the back of expansions in transportation, automobile and industrial sectors. Similar strength in Asian consumption, particularly in India and China, underpinned expansion in non-OECD growth (+1.7% QoQ). On the other leg,

dual expansion in OPEC and non-OPEC output which respectively advanced 1.1% and 1.3% (QoQ) with return of disrupted Canadian oil supply³ as well as Russia's production at its peak (11.6mbpd) driving growth in the former while record Saudi production pushed OPEC output to its highest level since 2008.

Figure 2: Brent vs. OPEC Basket 1yr price history



Source: Bloomberg, ARM Research

Can OPEC decision stabilize the oil market?

Going forward, all eyes shift to OPEC's meeting in November and the likely distribution of cuts which will omit Iran, Nigeria and Libya. The exemptions reflect a desire by Iran to return production to pre-sanctions levels while Nigeria and Libya try to recover from attacks on oil facilities. From our analysis, the said target works out to be a 690kbpd-1.19mbpd cut in current OPEC oil production of circa 33.7mbpd. Beyond OPEC, recent Russian willingness to limit production, currently at peak pace of 11.5mbpd, provides greater scope for a backward shift in the crude supply. The last unknown in the equation is the decision of other non-OPEC producers, particularly the US shale oil producers. Following the moderation in crude prices (<\$40/bbl), US production slid from 9.6mbpd to 8.7mbpd in Aug 2016.

³ The drop on the non-OPEC leg was led by cyclical reductions in the US (-310kbpd) from independent producers as well as unprecedented outages in Canada due to wildfires (-340kbpd).

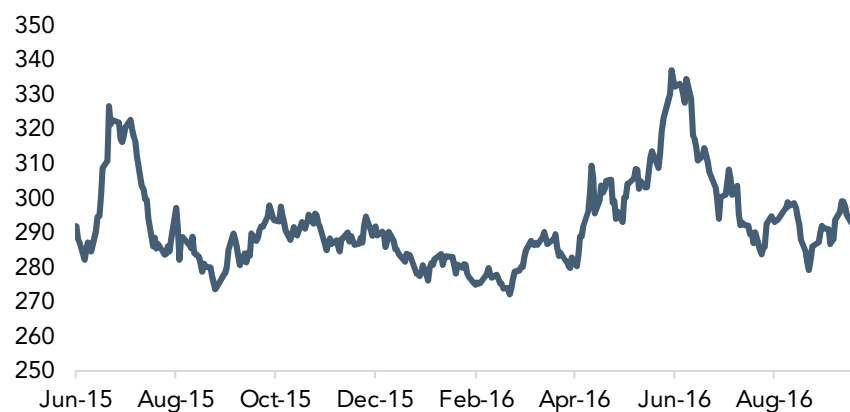
However, crude oil prices returned to a range of \$40 - \$45/bbl and has instigated resilience in US shale oil production which has hovered around 8.7mbpd and 8.9mbpd in the last 3 months to August 2016. Therefore, we see scope for further increases in US output should crude oil prices trade around the \$50/bbl mark. Thus, more resilient non-OPEC production, or fewer OPEC production outages, could keep the market oversupplied. A lasting ceasefire in Nigeria and Libya could result in a return of 1mbpd or more of supply.

On the demand side, the key events over Q4 16 are: restart of a number of nuclear plants in Japan and the seasonal refinery maintenance which should drive moderation in global consumption. On balance, global oil production looks set to rebalance further with the OPEC agreement which has driven recent momentum in prices with dated Brent crude prices crossing \$50/bbl in recent days. Consequently, we raise our forecast trading range for Brent oil to \$45-\$50.00/bbl for most of Q4 16 vs. \$35-\$40/bbl as per our earlier outlook for H2 16.

Positive production surprises halt bullish streak across soft commodities

In contrast to the bullish run in H1 16, Global soft commodity prices headed south in Q3 16 with the S&P GSCI Agriculture index sliding 6% QoQ as higher than expected production and inventory levels induced bearish trends across cocoa, wheat, CPO and barley. The sell-offs across these crops offset continued momentum in raw sugar and rubber prices.

Figure 3: S&P GSCI agriculture index



Source: Bloomberg

In line with prevailing trends over H2 16, wheat prices maintained a downward trend in Q3 16 (QoQ: -17%) amid the persistent supply glut in the global wheat market. In a similar vein, cocoa prices turned dovish in Q3 16 (QoQ: -2.2%) amid improved weather conditions and surplus cocoa production from key producing regions in West Africa (Ghana and Ivory Coast). Akin to cocoa and wheat, Barley prices commenced a decline in Q3 16 (QoQ: -5%) underpinned by high inventory levels and rising global supplies of alternative feed grains. Completing the lineup, average CPO prices in Q3 16 declined marginally by 1% QoQ. However, prices trended upwards in August (+13.7%) supported by low inventory levels of palm oil as dry weather linked to *El-Niño* event drove declining yields across top producing countries: Indonesia and Malaysia.

However, global sugar prices maintained the bullish trend recorded over H1 2016 (QoQ: +10%), buoyed by lower global production and declining inventory levels: a fallout of the impact of drought and frost on key sugar planting countries such as Brazil and India. Prices were also impacted by expectations of higher global demand particularly from India which guided to removal of import tax on sugar by mid-2017. Similarly, rubber prices extended the positive streak from H1 16, rising 5% YoY on the back of weaker output from major regions (particularly China, Malaysia and the Philippines) and strong increases in natural rubber consumption⁴. Overall, our outlook on soft commodities remain bullish, supported by lower inventory levels, weak oil prices and strong demand from major consumer countries including China and India.

⁴ Association of Natural Rubber Producing Countries

Key Developments in Domestic Economic and Policy Environment

Nigerian socio-political tensions remain hard nut to crack

Faced with a more direct response from a better equipped Nigerian Army and the West African alliance (Chad, Cameroun and Niger Rep), Boko Haram's insecurity threat continued to whittle over Q3 16 with the CFR⁵ reporting that casualties' figures from the insurgency nosedived to 1,377 in Q3 16 (Q3 15: 2,914). Whilst the northern fires gradually die out, the situation in the Niger Delta remained tense over Q3 16 as subsisting *force majeure* across major crude export terminals (Trans Forcados, Bonny and Qua Iboe) remained intact. However, reports about IOCs taking orders for crude delivery in November hint at progress on repair works on the damaged pipelines with NNPC data over July indicating a rise in crude production to 1.7mbpd (Q2 16: 1.6mbpd).

Away from security issues, the political front remains tense with further cracks emerging in the ruling All Progressive Congress (APC) following a thorny primary process in Ondo state, whose elections are set to hold in November. The fissures, which came to the surface following the emergence of Chief Rotimi Akeredolu (SAN) as the governorship party candidate, highlighted the strong discord among leaders of the party. Despite the shaky undercurrent, the various factions appeared united to deliver victory at the Edo gubernatorial elections with the APC candidate taking 55% of the vote.

Going forward, we view ongoing fractionalization in the ruling party as a catalyst for political gridlock within the legislative chamber that could provide ample distraction to timely resolution of bills and proposed policies. On other fronts, both the Boko Haram and Niger Delta threats look set to diminish in coming periods as the military cements on prior successes while FG's conciliatory stance on the latter should hold up over Q4 16.

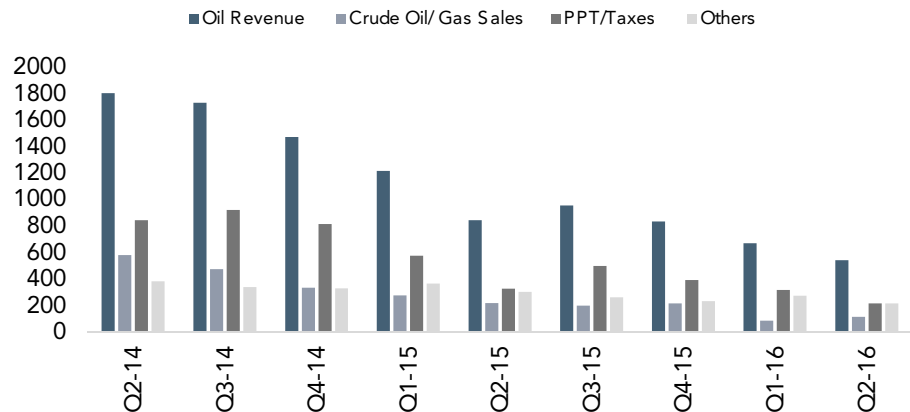
⁵ Council on Foreign Relations

Missed oil revenue targets deepen fiscal revenue woes

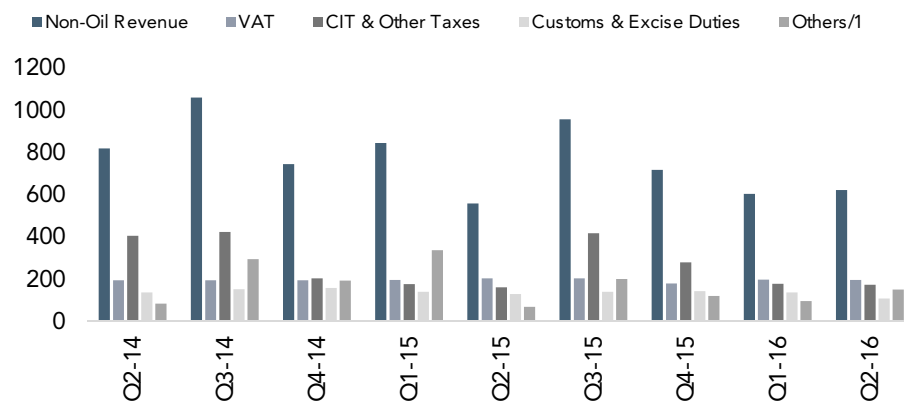
Gross fiscal receipts in H1 16 declined 30% YoY to ₦2.4 trillion, missing budget estimates by 48% largely on account of lower oil revenues which declined 41% YoY to ₦1.2 trillion. The miss in oil revenues stems from softer output (H1 16 avg: 1.7 mbpd⁶) which drove declines across all key components with crude oil, gas, and royalties posting YoY declines of 60%, 41% and 27% respectively. On the non-oil front, declines were broad-based with VAT, Customs & Excise Duties and independent revenue sliding YoY by 2%, 9% and 40% respectively. Overall, shortfalls in gross oil and non-oil revenues in H1 16 filtered into FG's retained revenue driving a 20% YoY contraction to ₦1.22 trillion.

Despite the revenue pressures, FG expenditure rose 32% YoY to ₦2.9 trillion on the back of higher capital (which rose thirty-fold YoY to ₦571.7billion) and recurrent expenditure (+95% YoY to ₦2.2trillion). Overall, the FG's fiscal operations in H1 16 translated into an estimated deficit of ₦1.6 trillion (+166% YoY) – well ahead of the provisional half-year budget deficit of ₦816 billion.

Figure 4: Nigeria's oil and non-revenues in H1 2016



⁶ OPEC



Source: CBN, ARM Research

Improving oil revenue picture trims deficit forecast

Going forward, continued improvement in oil prices (Q3 16: \$46.9/bbl vs \$41.9/bbl in H1 16) which have since crossed the \$50/bbl and increased prospects for recovery in oil production from H1 16 should result in higher oil revenues. On the price angle, following OPEC's decision to cut rates, we forecast Brent oil to trade within the range of \$45-\$50.00/bbl on average over most of Q4 16 which brings 2016 average to ~\$47/bbl. For output, our view regarding a recovery in production informs upward revision in our forecast mean output to 1.8mbpd (previously 1.5mbpd) which still remains well below the 2.2mbpd assumed in the 2016 budget. Overall, we forecast gross oil receipts to the federation account 18% higher at ₦1.9 trillion buoyed by exchange rate gains. On the non-oil leg, revenues are on cue to disappoint as fallout of prevailing macroeconomic headwinds and its negative impact on corporate earnings drive contraction in the non-oil tax base. Furthermore, the persisting FX shortages and NGN depreciation should drive tempered imports, as in H1 16, which should weigh on custom receipts. Thus, in line with prevailing trend over H1 16, we expect soft revenues in the oil and non-sector to filter through to retained revenues. On the spending side, annualizing the H1 16 run rate of FG expenditure places the 2016 figure at ₦5.77 trillion which culminates in a deficit of ₦3.7 trillion (₦3.9trillion previously).

Table 2: 2016 Federation revenue budget vs ARM revised estimate

	2016B	2016E
Oil production (mbpd)	2.2	1.8
Oil price (\$/bbl)	38	47
Exchange rate (N/\$) - Average	197	262
Oil receipts to Federation Account	1,479.2	2,039 ⁷⁷
Non-oil		
VAT	1,475.0	782.4
Corporate taxes, CIT, Stamp duties	1,877.0	695.9
Custom: Import, Excise & Fees	862.4	484.1
Special levies	-	486.2
<i>Deductions</i>	198.1	92.2
To Federation account	4,016.4	2,356.4
Federation account	5,495.6	4,308.6
VAT pool account	1,416.0	751.1
FGN		
FAAC	2,274.7	1,665.2
FG Independent revenue	1,505.9	282.46
Others	75.17	146.66
FGN retained	3,855.7	2,094.3
FGN expenditure	6,077.7	5,775.6
Fiscal deficit	(2,221.9)	(3,652.7)

Source: Budget Office, MTEF (2016 – 2018), ARM Research

Economic Review and Outlook

Recession makes land-fall...

Following the release of Q2 16 GDP numbers (-2.06% YoY), Nigeria officially descended into recession for the first time since 2004. The contraction over Q2 16 reflects sustained deterioration across oil (-17.6% YoY) and non-oil (-0.4% YoY) GDP. The renewed unrest in the Niger Delta drive a collapse in oil production to a fourteen-year nadir of 1.69mbpd (-16% YoY, -19% QoQ) which impacted on oil GDP. For non-oil GDP, negative growth across Services (-1.8% YoY), Construction (-6.3% YoY), and Manufacturing (-3.4% YoY) accounted for

⁷⁷ Gross fiscal revenues are calculated using exchange rate of N262.68/\$.

compression in that space. Over Q3 16, PMI readings continued to decline with manufacturing (42.1) and Services (43.7) currently at their lowest levels since June⁸. Overall, the macroeconomic picture over the first nine months was broadly depressed.

Over the rest of the year, while media reports about resumption in loading schedules in November hint at likely lifting of *force majeure* on key export terminals over Q4 16, the timing of the recovery, in our view, is too late to raise mean production over 2mbpd. Thus, we expect the contractionary trend in oil GDP to remain intact over H216. Elsewhere, the tripod of depressed real wage growth, FX shortages, and incessant energy challenges should continue to drive non-oil GDP weakness. Thus, largely reflecting our bearish outlook on both GDP fronts, we expect Nigerian economy to contract 1.4% YoY over 2016.

...as oil production woes drive wider trade deficit

In addition to weakness in domestic production, Nigeria recorded an over five-fold YoY jump in trade deficit to ~\$2 billion in Q2 16—extending a run of deficits to the sixth consecutive quarter. Save for the high \$1.9 billion reading in Q3 15, current deficit is the widest observed in the last six quarters. According to CBN reports, Q2 16 deficit was underpinned by a 25% YoY contraction in exports to \$9 billion which more than offset the decline in imports (-13% YoY to \$11 billion). Further breakdowns provided show that weakness in the former was driven by 26% and 9% YoY declines in oil and non-oil exports to \$8.7 billion and \$577 million in that order. On the oil export front, contraction mirrored 26% YoY fall in crude oil prices to \$45.69/bbl as well as a 19% YoY deterioration in production of condensates, natural gas liquids, and crude to 1.54mbpd which left volume of crude exports 25% lower YoY at 1.09mbpd owing to shut down of key export terminals in Niger Delta⁹. At the import end, significant declines in naira value of Mineral Fuels (-18% YoY), Food and Live Animals (-22% YoY), and Oil Fats and Waxes (-33% YoY)—despite currency impact—is suggestive of sizable drop in volume of Nigerian imports in the review quarter.

⁸ Both Services and Manufacturing PMI have remained below 50 since January 2016.

⁹ Oil export contraction accounted for 98% of total export weakness in Q2 16

Going forward, rising crude oil prices and resumption of oil production in major export terminals should buoy oil export outlook. On the import side, contractions in Mineral Fuels¹⁰ (due to fall in oil prices) and increasing import substitution should also leave imports lower in the coming quarters driving a progressively weaker trade deficit over the rest of 2016.

Price pressures take the chill pill

After accelerating on average of 137bps MoM over the first six months of 2016 to 16.5% YoY, headline inflation grew a tamer 47bps on average, over Q3 16 to 17.9% YoY. Further breakdowns reveal that mean growth in core sub-index slowed to 48bps MoM over the third quarter (H1 16 average increase: +147bps) with the latest reading printing at 17.6% YoY. Similarly, after rising by an average of 93bps MoM over H1 16, growth in food sub-index also moderated to 43bps over the last three readings (September Food Reading: +20bps MoM to 16.6% YoY). Isolating the first sub-index, we note that pressures on core inflation has been steadily decelerating since the partial deregulation of downstream oil and gas in May, which saw sustained moderation in prices of PMS and Diesel tame pressures on the HWEGF sub core basket over the review period. On the other hand, slowdown in food pressures have mirrored impact of early harvests of maize, millet, legumes and tubers on market stocks prior to official commencement of main harvest. Despite this relative moderation, food inflation remained the key trigger of headline pressures over July and August readings as demand from West-African neighbors, following naira depreciation, continues to offset gains in supply. Farther out, latest FEWSNET report appears to douse concerns over expected flooding across Niger-Benue trough with the agency now guiding to above average harvest in most areas in the coming months. This, combined with sustained moderation in core inflation, has informed a 20bps cut-back in our 2016 target mean headline inflation to 15.6% YoY.

¹⁰ 15% of Q2 16 naira imports

CBN measures drive dislocation across FX markets

On the heels of Nigeria's switch to flexible exchange rate regime in June—which drove the largest MoM depreciation in naira in more than a decade (-41% MoM to ₦282.95/\$), USDNGN weakened a further 10% to ₦311.62/\$ by September end at the interbank. At the parallel markets, naira crashed a wider 36% to a historic low of ₦490/\$ over the same period. The divergence reflects impact of various CBN measures seeking to exert influence over autonomous flows in the period. First, the apex bank required mandatory registration of International Money Transfer Unions (IMTUs) which reduced number of IMTU's operating to three. This development drove an expansion of mean BDC interbank premium to 31% in August (vs. 14% in July). Though the CBN rolled back this requirement with the licensing of several IMTUs, it introduced other measures in September that mandated banks to allocate 60% of FX sales to manufacturers. In addition, the apex bank introduced fresh directives on how banks handle dollar sales, marking a reversal of its liberal stance adopted upon announcement of floating in June. In between introduction of the restrictions, CBN barred nine banks from accessing FX at the interbank after they failed to meet its demand for upfront payment of \$2.3billion (~10% of FX reserves at the time) NLNG dividend, with the move pushing the naira over ₦400/\$ at the parallel market. Importantly, interbank dollar liquidity over the period remained thin with average daily turnover of \$252million - 16% lower than H1 16 mean (2015: \$571.35 million). Overall, CBN's attempts at re-instituting influence on the FX market amid persisting dollar paucity at the interbank fueled further divergence in parallel and interbank rates.

In the last quarter of 2016, we see persisting FPI reticence towards naira assets and subsisting negative trade balance as leaving pressures on USDNGN intact. In addition, CBN directives on dollar allocation are more likely to drive wider divergence between the parallel market and the interbank.

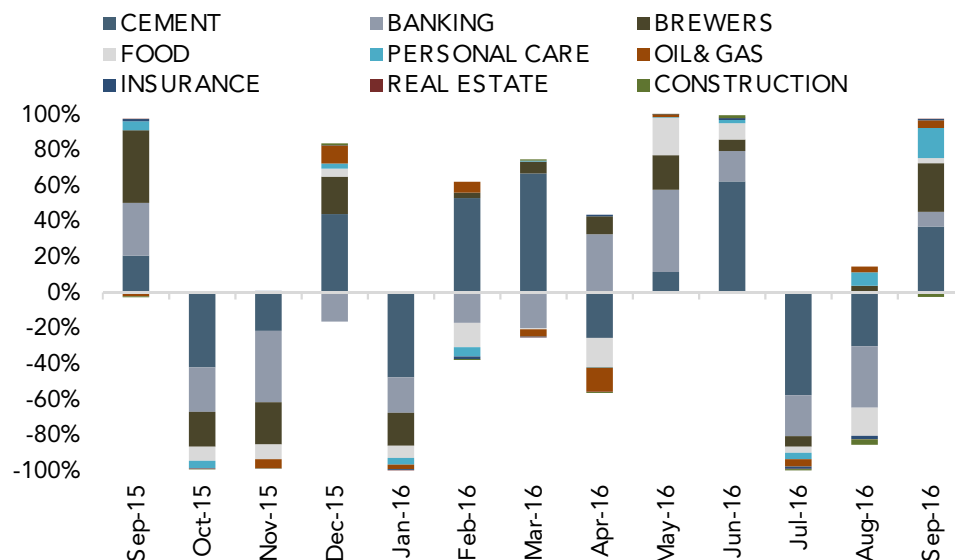
Capital Market Review and Outlook

Market recovery falters, when will the smoke clear?

In our NSR H2 16 outlook, we noted that given continued foreign reticence to naira equities, local support, which underpinned the strong Q2 16 performance would dissipate on the back of rising yields which aside from raising discount rate for equity valuations provided a significantly compelling investment outlet in the FI market. Indeed, events panned out with the NSEASI paring the bull run in Q2 16 with a 3.1% QoQ decline in Q3 16. After rising in the three months to June, net FPI flows contracted 50% MoM in Jul 2016 to ₦2.4 billion as continuing dollar paucity drove FPI aversion. Tracking foreign apathy, domestic transactions pulled back 40% MoM to ₦45.9 billion in July, though as in H1 16, local investors continued to dominate with equity participation improving 2.1pps MoM to 50.9%. Net impact of the waning appetite by foreign and local investors in naira equities resulted in 34% and 32% QoQ cutback in average volume and value traded in Q3 16.

Unbundling market performance by sectors, sell pressure in the banking sector (-6.3% QoQ) which largely reflect concerns over loan exposure to weak sectors and FCY liabilities accounted for 26% of the downtrend in the NSE ASI over the quarter. Elsewhere, investors priced in the impact of weaker construction activity on the cement sector which lost 7.1% QoQ and accounted for 36% of Q3 16 market declines by our estimate. To add, our attribution analysis reveals that investors priced in economic headwinds on Food (-3.6%), Oil & Gas (-1.3%), Real Estate (-0.9%), Insurance (-4.3%) and Construction (-17.7%). Bucking the negative trend were Brewers (+2.9%) on account of 6.5% gains in NB over the period. Overall, at close of Q3 16, the equity market's downtrend proved to be a tale of macro headwinds, lack of clarity on economic policies, weak fundamentals and attractive FI returns – all flagging appetite towards equities.

Figure 5: Attribution analysis of monthly sectoral performance



Source: NSE, ARM Research

Muted outlook remains intact

Over the last quarter of 2016, persisting uncertainty over the Brexit fallout, increased prospects of rate normalisation by the Fed and onset of the US presidential election should continue to drive cautious approach to EM/frontier market investing. Whilst domestic FX markets have since liberalised with MSCI retaining Nigeria on its frontier index, albeit with a proviso¹¹, low interbank FX market liquidity should continue to keep FPI participation in NSEASI muted. Complicating the outlook for equities is the elevated domestic yield environment which works to dilute local investor interest in equities.

Dimensioning our outlook based on sector fundamentals, the downstream sector should continue to benefit from the flexible price regime which raised retail pump prices by 67% in May. Though concerns remain over availability of FX for imports and in particular pricing as the USDNGN has moved above the implied exchange rate (of ₦285/\$) in the May 2016 price adjustment. Nonetheless, we see significant upside in select tickers in the space who continue to access dollars from the NNPC

¹¹ MSCI retained Nigeria in its benchmark frontier-index but formally declared plans to ready Nigeria for potential reclassification to Standalone status during its 2017 Annual Market Classification Review in June.

and IOC at rate of ₦285/\$ – ₦310/\$. Another sector in our sweet spot are CPO producers who continue to benefit from rising local prices and greater volumes on the back of proscription of interbank FX access to 41 items which includes palm oil. Nonetheless, given the minor weight in the overall equities basket, these sectors are unlikely to swing market performance.

Elsewhere, earnings outlook should mirror the underlying macro pressures starting with upstream O&G where the continued disruption to export terminals should result in deadbeat Q3 16 earnings releases in Q4 16. That said, news about IOCs taking orders for November hints at likely resumption of exports in the period (which is too late to spur turnaround in FY 16 earnings). This could provide positive sentiment around sector players. For Banks, tight monetary policy stance and asset quality strain holds mixed connotation for earnings. Whilst the higher rates should translate in strong net interest income for Tier I banks, the sizable share of term deposits across Tier II banks hint at funding cost pressures for the grouping. Ahead of FY 16, we see greater scope for banks to progressively raise impairment provisioning allowing greater visibility on the asset quality issues at the heart of investor concerns. Though naira weakness persisted over Q3 16, the quantum was much tamer implying less scope for strong FX translation gains as in Q2 16.

For cement producers, recent hike in cement prices to offset cost pressures should ordinarily be positive. That said, volume softness on account of lower capex, particularly at the state level, and scant construction activities should temper the scale of the price gains. Exacerbating outlook is the persistent currency weakness which drives scope for further FX loss on dollar loans for sector heavyweight Lafarge. Lastly, the combination of pass-through from currency pressures, weak consumer spending and higher interest rate environment should continue to buffet FMCGs margins and earnings, as companies struggle to pass-through inflationary pressures to consumers via price hikes. Given the already burdened valuations for FMCGs, the deadbeat sector performance over the first three quarters should extend over Q4 16. Overall, low foreign and local appetite for equities combine with weak fundamental picture across key sectors underpins our muted outlook for naira equities in the last quarter of 2016.

Monetary tightening humps yield curve

On the heels of the 430bps rise in H1 16, the Naira yield curve widened a further 380bps in Q3 16. In contrast to the roughly parallel shift in first half, the expansion was focused on the short end with NTB yields rising 670bps vs 100bps increase for FGN bond yields. The non-linear rise resulted in the emergence of a pronounced hump in the yield curve, with a marked elevation of yields on short dated paper resulting in negative term premiums in Q3 16.

In our H2 16 Nigeria Strategy Report, we identified a tripod of factors (hawkish monetary policy stance to shore up currency, deficit induced FGN paper supply and inflationary spiral) as providing strong underpins for interest rates rising over the second half of the year. Of the three, the influence of monetary policy was most dominant over the period with the CBN hiking interest rates 200bps at the July 2016 MPC to a record-high of 14%, citing a need to bolster the liberalized currency market. Beyond just signaling for higher rates, the apex bank raised average marginal rates at OMO auctions in July by over 600bps from June levels to 18-18.5%. Market participants took the cue from the CBN actions to NTB auctions where the upper range of bids across the three tenors climbed an average 690bps from H1 16 levels. In terms of volume, both the CBN and the FGN net issued ₦225 billion and ₦172 billion respectively over Q3 16 with the fiscal side extending the trend from H1 16 (net issuance of ₦190 billion). Nonetheless, the DMO was unwilling to extend the rate bonanza to bonds where auction clearing rates peaked at 15.6% on the ₦461 billion¹² (QoQ: +38%, YoY: +172%) worth of bonds issued over the period. As with the short end, upper bid ranges rose over the period (hitting a peak of 19% in August) which forced the DMO to accept 96% of its ₦350billion offer and relying on non-competitive bids to fill the till. In addition, the period also witnessed redemption of ₦464 billion outstanding FGN 2016 bond implying net repayment at the long end of the curve over the period. Overall, the DMO sensitivity to rising borrowing costs on longer tenors set the stage for limited uplift in bond yields over Q3 16.

¹² Non-competitive allotments accounted for 27% of total sales.

In contrast to the upswing on the naira curve, Nigeria's Eurobonds extended the declining trend over H1 16 (2021: -172bps, 2023: -154bps) in Q3 16 with the 2021 and 2023 sliding to 6.4% and 6.6% respectively. The contraction emanated despite the onset of an economic recession and one-notch ratings downgrade over the period and, as in H1 16, largely mirror recovery in Brent Crude prices from January's multi-decade trough. Importantly, set against the trends along the naira curve, the widening cost differential to local market makes the case for dollar financing of the budget deficit more compelling.

Over the rest of 2016, recent developments along the fiscal and monetary policy fronts point to a breakdown in the 'alliance' which drove yields higher over 9M 16. First, the fiscal side is now gearing up for a Eurobond issue in November which in the light of strong appetite for African paper, evidenced by the oversubscription of Ghana's recent Eurobond issuance, could result in the FGN raising more than the planned \$1 billion on offer. Furthermore, the FGN seems to be gaining traction on its external concessionary borrowing plans with the AFDB announcing that it was offering Nigeria a \$1 billion line for budget support. Given naira depreciation since the end of June, progress on the external leg reduces the need for sizable local deficit financing. Indeed, scanning through the FGN bond and NTB calendars for Q4 16 which both show a drop off in paper issuance, the overall theme is the fiscal pull on the local debt market is set to withdraw. Unsurprisingly, having voted for a rate hike in July 2016, the fiscal side is now singing dovish tunes on interest rates. The foregoing shifts focus to the CBN and its policy agenda where developments on the currency leg could stoke retention of a tight stance. Though the deceleration in MoM CPI and the apex bank's own admission of a benign outlook for inflation over the next six months hints at less hawkish stance going forward. Thus, we think CBN is more likely to use the window, before base effects work to pull down inflation in 2017, to cling to its currency support argument. The foregoing implies that 'humped' yield curve is likely to remain intact over the rest of 2016 as CBN's retention of OMO issuance at current rates keep the short-end rates elevated while tame fiscal debt raising and robust buy-and-hold institutional demand drives yield compression at the long end of the curve.

Capital Market Strategy

An 'uneven bars' strategy remains the call

In our H2 16 NSR, our call was for investors to execute an uneven barbell strategy of building duration at the short and long end of the naira curve with emphasis of the latter to benefit from possible macro induced monetary policy reversal. To our minds, the confluence of FGN reliance on local debt markets to plug a soaring deficit and CBN's pivot to a tightening stance to attract FPI flows in its bid to shore up the fledgling FX market raised prospects for yield elevation. However, we viewed the deterioration in the domestic macro landscape, hinged on a descent into recession, as likely to catalyze a policy rethink for Nigeria's economic managers leading to monetary and fiscal policy expansion. While our strategy helped investors harvest income as rates tracked higher, it allowed investors build duration to benefit from potential decline in interest rates. Thus, going forward, the key call would be whether a window would open for investors to harvest price gains from these positions i.e. what are the prospects for a collapse in rates in Q4 16?

In addressing this issue, we reiterate our view on fiscal and monetary policy over Q4 16 as in our fixed income review. On the fiscal leg, recent progress with the AFDB, Eurobond issuance in November and gradual recovery in crude receipts imply the FG is less likely to remain a source of naira yield elevation much longer. Indeed, the lower bond and NTB issue implied in the released calendar firms up this position. On the monetary side, CBN's fixation on the FX market at the September 2016 MPC, despite the onset of an economic recession and emerging benign inflation outlook, should remain intact over Q4 16. Hence, we see an extension of the current yield curve dynamics over Q4 16 with lower fiscal supply driving compression in bond yields while CBN influence keeps short dated yields elevated. In this humped yield environment, our barbell strategy remains the reasonable call over Q4 16.

Keep calm and stay in the shade

Coming into H2 16, our call was for equity investors to display caution and selectivity as the twin pillars of continued foreign reluctance towards naira assets, given the tight FX market liquidity and recessionary concerns among others, and local investor attraction towards high yielding risk free instruments should leave NSEASI broadly starved of investors' interest. Consequently, we viewed a measured approach to equity exposure with preference for downstream petroleum marketers, palm oil producers and select banks with the adoption of a flexible price regime favouring the former while the balance sheet and economic positioning of the latter class were deemed positive in the light of naira weakness. Indeed, the muted equity market performance and below trend patterns in average daily traded (volume and value) suggests our call largely played out.

Going forward, our views regarding tempered local and foreign activity on the bourse amid limited change in deadbeat fundamental picture suggests caution. In the last quarter, sentiment triggers remain scant with the release of Q3 16 earnings, which should largely reflect the impact of naira weakness and depressed aggregate demand, as the sole event. Here, as in Q3 16, we continue to feel positive vibes around palm producers and petroleum marketers with favourable CBN disposition on FX, a boon for the former, and continued access to dollars at subsidized rates keeping margins intact for the latter. On banks, we reiterate our preference for banks with net long dollar positions to benefit from naira downside, liquid balance sheets to tap into the rising yield environment and tight lid on asset quality. Elsewhere, we struggle to see how anything positive can come out of FMCGs burdened by expensive multiples and currency issues.

In sum, elevated rate environment which keeps a pricey opportunity cost for equity exposure and broadly unsavoury fundamentals call for a highly discerning approach in Q4 16.

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