

Nigeria Strategy Report | Q4 2017 Outlook

Pathway in turning tide

Economic Snapshot

August 2017 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	1.0%	16.0%	16.1%
Food	1.1%	20.3%	20.3%
All Items Less Farm	0.9%	12.3%	12.2%
Imported food	1.3%	14.4%	14.1%
Energy	0.4%	10.7%	11.6%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	360.1	0.08%	14.8%
EURNGN	425.5	0.24%	31.6%
GBPNGN	474.7	0.07%	25.1%
JPYNGN	321.0	0.63%	19.3%
Monetary Aggregates – August 2017			
	(₦'bn)	MoM	YoY
M2	21,851	-1.55%	-0.93%
CPS	21,997	-0.79%	-3.55%
NCG	4,824	-17.7%	35.9%
NFA	9,733	11.3%	32.4%
NDC	26,821	-4.32%	1.76%
External Position			
	Latest	QoQ	YoY
Trade Balance (\$'mn)	2,110	-7.3%	N/A
External Reserves (\$'mn)	32,491	7.27%	6.98%
Foreign Debt (\$'mn)	15,047	8.97%	31.9%
Growth Data – Q2 2017			
	(₦'bn)	%of total	YoY
Real GDP	16,307	100%	0.5%
Agriculture	3,745	23.0%	3.4%
Oil	1,449	8.9%	1.6%
Services	5,974	36.6%	-0.5%
Wholesale and Trade	2,787	17.1%	-1.6%
Manufacturing	1,529	9.4%	0.6%

Introduction

Developments in the last few months encapsulated some of the overarching themes we've previously laid out. Much of the third quarter seemed to have put to rest keen worries on near-term stability of the naira as well as a five-quarter old economic recession. For now, we awaken to a CBN volte-face and a louder expectation of accommodative monetary policy. Similarly, our conservative outlook on 2017 growth has largely been justified by a contraction in the bellwether Services sector that tapered optimism over latest GDP reading.

Momentum for investments appeared to have switched gear, with Nigeria's equity market notably turning the corners in May following the introduction of the IEW a month earlier. Foreign portfolio investors finally received their bidding in a market wherein CBN involvement in activities is south of 10%. In a word, improvement in FX liquidity restored foreign confidence in a market that was once be-devilled by intense dollar demand management and an overall obsession for "currency protectionism". Indeed, currency was central to financial markets and economic discuss over the past months, but it did not fully explain the bull run in equities or the fading away of high treasury yields.

Against this backdrop, this report directs attention to a critical assessment of major market drivers in the review period with a view to ascertaining the sustainability of current gains as well as highlighting appropriate investment plays in Nigeria's ever dynamic terrain. What, for instance, is the fate of equity markets going into 2018? Will it continue to ride FX-induced momentum? On fixed income, there is a much louder call for yield moderation in the coming year, but that's the obvious part. Thus, rather than end at obvious assertions, we ask the all-important question: "now that attractive yields are exiting the economic stage, what is the next step? As we approach year-end and subsequently first half of 2018, we are looking at the continuation of some trends and starting to see others a little differently.

Table of Content

Introduction	1
<i>Crude Oil:</i> Will crude oil ‘roller coaster’ linger?	4
Domestic Macro	
<i>GDP:</i> Uphill with the handbrake on	7
<i>Fiscal:</i> Federal Revenue Growth Shows Signs of Life	10
<i>Balance of Payment:</i> Nigeria’s net creditor status diminishes again	12
<i>Naira:</i> Naira resilience – new normal or fleeting reality?	15
<i>Inflation:</i> still an eye into CBN’s monetary policy mind	16
<i>Monetary Policy:</i> Is MPC at a turning point?	18
Capital Market	
<i>Fixed Income:</i> Yields trend lower as apex bank changed front	21
<i>Equities:</i> Equities set to maintain upbeat momentum	24
Capital Market Strategy	
<i>FI Strategy:</i> Go long but be mindful of duration risk	28
<i>Equity Strategy:</i> See buying opportunities in coming shocks	29

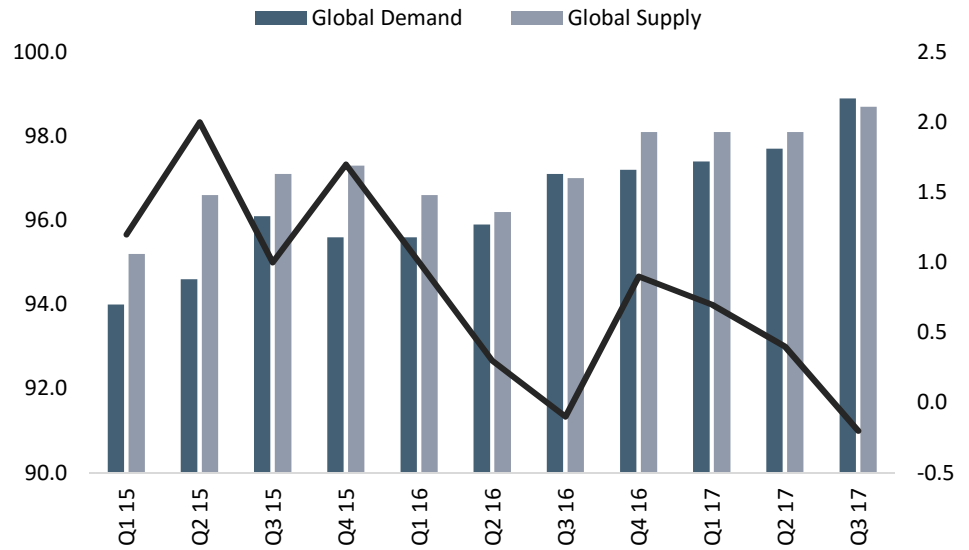
Crude Oil: Will crude oil 'roller coaster' linger?

Crude oil market rebalancing in the third quarter of 2017 was ahead of our forecast, as US oil production was partially disrupted by the Hurricane while OPEC stuck to its pact. For context, at the start of the quarter, we had forecasted a slower rebalancing of the crude oil market with excess supply projected to decline to 100kbpd (Q2 17: 400kbpd). This view was hinged on quick increases in shale production, which we expected to moderate the impact of rising demand and OPEC's production cut. Irrespective, the impact of hurricane on production made our earlier call look too pessimistic, after having stoked a faster than expected rebalancing. Precisely, crude oil market switched to a deficit in the quarter (-160kbpd) to drive a bull run in the commodity price.

Further examination of the crude oil market reveals increases in global crude demand over the review period to 98.9mbpd (1.6% QoQ) largely reflecting growth in the OECD region (2.0% QoQ to 47.6mbpd). The growth was driven by rising European demand, a reflection of positive vehicle sales, combined with increases in demand stoked by the re-opening of US refinery.¹ Nonetheless, demand was relatively sticky in China and India as economic recovery remained slow. At the other end, the market witnessed increases in supply (1.0% QoQ to 98.7mbpd), but the momentum was slower than earlier expected. For us, the mild increase in supply was on the back of further crude production cut by Russia as well as slower than expected rise in US shale activities. Specifically, following Hurricane Harvey which led to a 186kbpd unplanned production outages, US's supply came in only slightly higher relative to prior quarter (+280kbpd). This, in addition to the 300kbps cut in Russia's production, was enough to offset the impact of a rise in OPEC's supply that was triggered by higher supply from previously battered members: Nigeria (+176kbpd) and Libya (+230kbpd). On balance, a tamer crude supply picture (relative to demand) led to the much-needed rebalancing in the crude oil market in the review period.

¹ Refinery demand was tapered by hurricane disaster in the US.

Figure 1: Crude oil Supply/Demand vs. Balance (in mbpd)

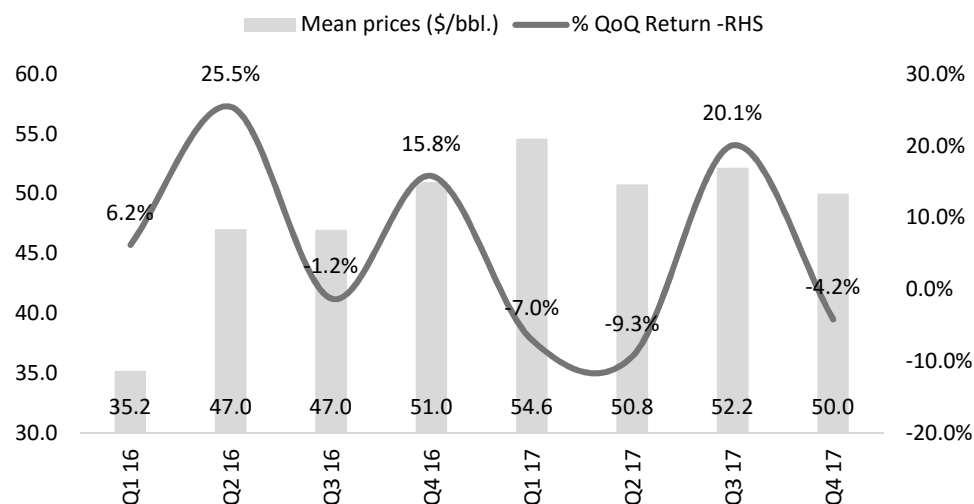


Source: EIA, ARM Research

Market re-balancing propels best oil price rally since November cut. After trading below \$50/bbl. in July on the back of bearish data from the US, crude oil prices kicked-off a recovery from August. Pertinently, after the re-opening of US refineries² in the prior quarter, weekly data from the US showed subsisting drawdown in US crude inventories and rig count in the last 8 weeks of the quarter. The foregoing, combined with knock-on effects of the hurricane contributed to a 20% QoQ increase in the Brent crude price. In terms of sentiment, market switched to a sharp swing in sheer backwardation (longer-dated contracts trading lower than the spot price), indicating a possible decline in crude stocks and positive for prices.

²following routine turn-around maintenance (TAM)

Figure 2: Quarterly mean prices vs. return (historical & forecast)



Source: Bloomberg, ARM Research

We retain our base case forecast. In framing our outlook for crude oil prices over the next six-months, we hold our base case assumptions. Firstly, while we think the market has fully rebalance, we expect greater supply from US as the impact of Hurricane subsides to shake the rebalancing. Pertinently, the impact from recent Hurricane has yielded smaller damage compared to past storms with a sizable number of US drillers expected to resume drilling activities in the near term. Also, feelers from the market suggest that higher production from Nigeria and Libya (of 120kbpd and 100kbpd respectively) is moderating the impact of production cut by other OPEC members. Finally, we think the long-held converse in the US dollar to the Brent posit a likely retraction in crude oil prices. Hence, expectation for further rate hike and unwinding of balance sheet by the US Fed guide to a stronger dollar and consequently lower crude oil prices.

Given the above, we think risks are more tilted to the downside and our long-held call of a rebalancing has moved the market's implied price in line with our call. Based on the foregoing dynamics, we envisage that a rebalancing of the crude markets would leave 2017 prices stable, albeit slightly lower in the last quarter of 2017. Precisely, we expect the confluence of factors to keep mean crude oil prices at a range of \$45 - \$50/bbl. with a base case of \$50/bbl. The key risk to our forecast will be a

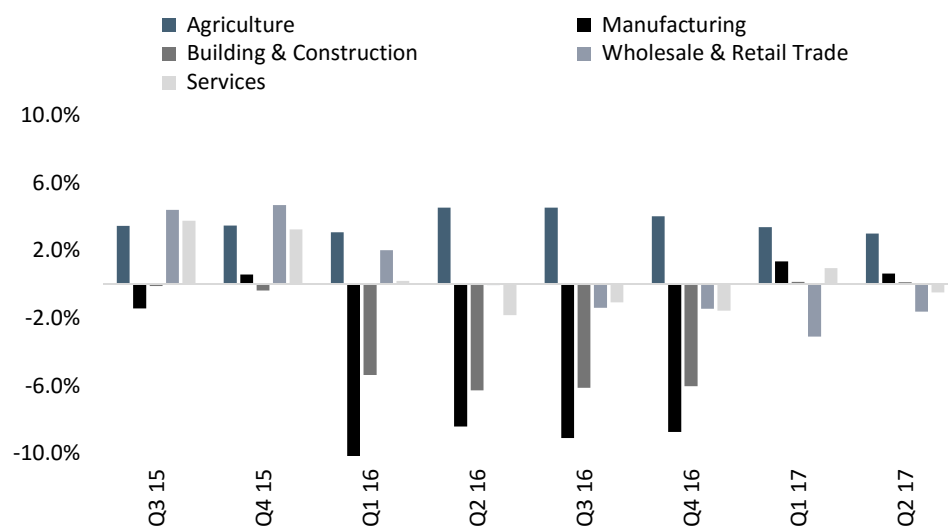
slower than expected ramp up in US production as well as higher compliance by OPEC and non-OPEC.

Economic Review and Outlook

GDP: Uphill with the handbrake on

After five quarters of negative growth, Nigeria's recession ended in the second quarter of 2017 (0.5% YoY) majorly driven by growth on the oil front (1.6% YoY) that was hinged on improved crude production (Q2 17: 1.84mbpd). Irrespective, optimism over the reading was weak as non-oil GDP (91% of overall GDP) recorded a slower pace of growth (0.4% YoY) relative to prior quarter (Q1 17: +0.7% YoY). A breakdown of the non-oil GDP into its underlying components showed that growth deceleration in Q2 was led by Services, its largest component, which reverted to negative growth (-0.5% YoY) after coming out of recession in the prior quarter. The decline in services was due to weaker output in the ICT sub-sector (-1.2% YoY) – the first time in 21 quarters—coupled with further contraction in the real estate sub sector. On the former, the contraction in ICT largely reflected activities in the telecommunications subsector where active lines declined (-4.7% YoY to 143 million). Meanwhile subdued activities in luxury real estate segment extended the sector's pressures for the sixth straight quarter to leave related output lower by 3.5% YoY (vs Q1 17: -3.1%). Consequently, though non-oil GDP remained upbeat on the surface, sustaining its expansion at 0.4% YoY (Q1 17: 0.7% YoY), the growth was disappointing and pointed to a slower recovery than expected.

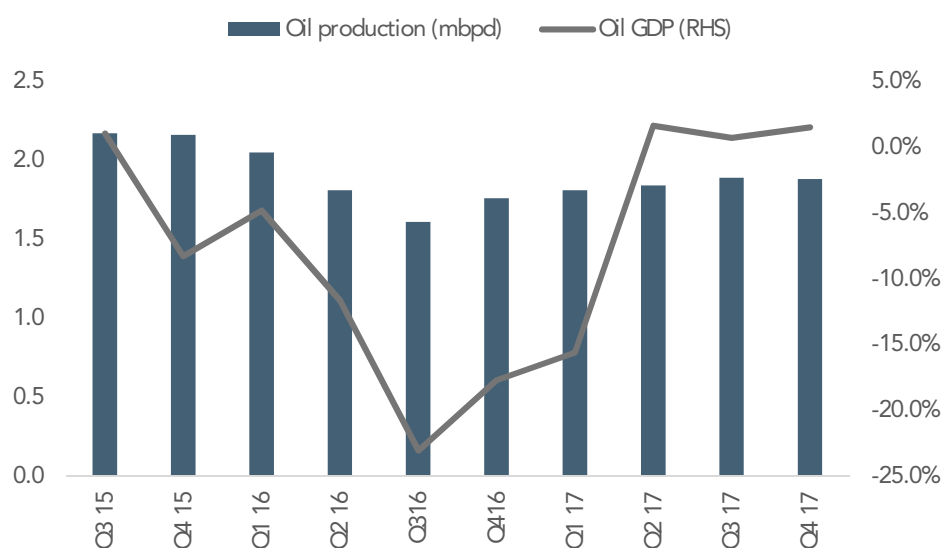
Figure 3: Growth for the non-oil components



Source: NBS, ARM Research

Oil production rebound leads to cautious optimism. Going forward, given the relative stability in the Niger delta region coupled with the reopening of the Forcados pipeline, we expect higher oil production over the last two quarters of 2017. Extrapolating oil production for July using an average 28-month spread between NNPC and OPEC production data, we think production printed around 1.93mbpd in July. That said, we estimate Q3 and Q4 2017 crude oil production at 1.9mbpd and 2.0mbpd consecutively. The foregoing brings H2 17 average crude production to 1.89mbpd taking our full year crude production estimate to 1.86mbpd (+1.5% YoY). Consequently, we now expect oil GDP of 0.7% and 1.5% YoY for Q3 and Q4 17 respectively – with the latter bolstered by the weak base in the corresponding period of 2016.

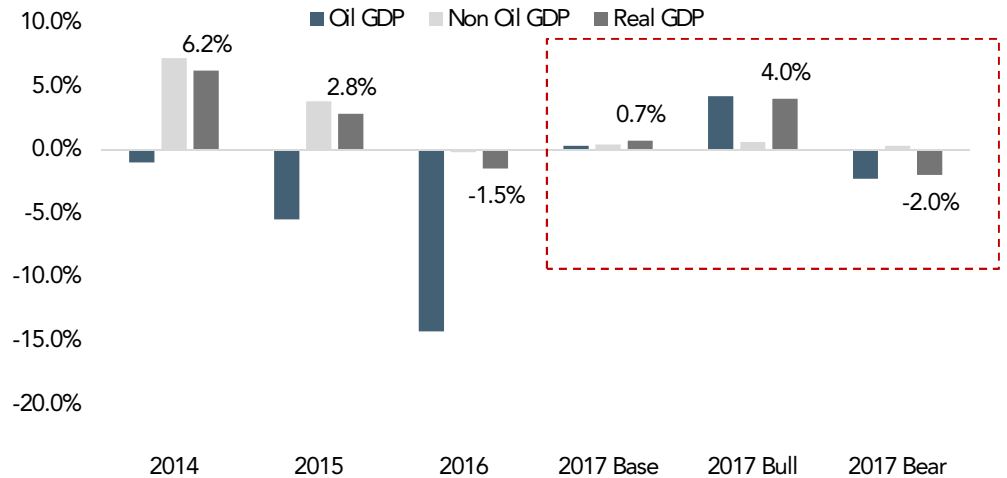
Figure 4: YoY Oil GDP growth vs. Oil production



Source: NBS, ARM Research

Services contraction sets hurdle for faster recovery. For the rest of the year, we expect sustained pressures in the Services sector as we believe the largest sub sector (telecommunications) appears to be at its peak which should leave growth at current or even lower levels. Elsewhere, irrespective of the high interest rate environment and the decline in consumer purchasing power which should ordinarily remain a drag on output, improved FX liquidity coupled with continued efforts by the FG to ease the business environment should still sustain the expansion in manufacturing sector. For evidence, the manufacturing PMI survey for the month of September already revealed further progress in manufacturing with 15 of its 18 sub-sectors reporting expanded activities (vs. 12 in the prior two months). On other fronts, subdued demand from high-end users should leave construction GDP relatively flat while the end of the lean season, improved access to inputs, continued government support and cheap financing should sustain the growth in the Agriculture sector. On balance, we now look for non-oil GDP growth of 0.4% and 0.5% YoY in Q3 and Q4 17 respectively. Tying our views across oil and non-oil GDP, we forecast real GDP growth for Q3 17 and Q4 17 of 1.1% and 2.0% YoY accordingly. On this basis, we revise our 2017 real GDP forecast slightly lower to 0.7% YoY (previous: 0.8% YoY).

Figure 5: YoY Oil, non-oil, and real GDP growth



Source: NBS, ARM Research

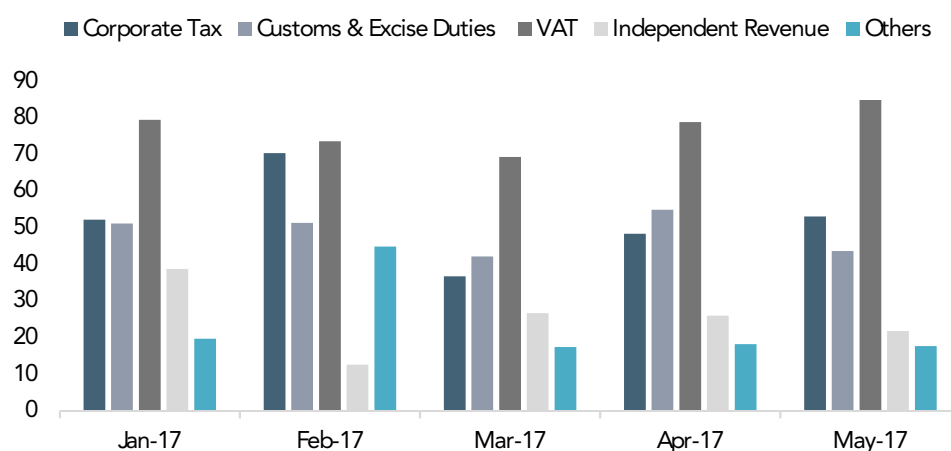
Over 2018, we think the movement in non-oil GDP will be key to overall economic growth. The increase in crude oil production over 2017 brings a high base for oil GDP and thus guides to a slower growth on that front. More so, given weak investment in the oil sector, we think Nigeria's crude oil production will peak at 2.2mbpd. For non-oil, we hold a pessimistic view driven by the high base in Agriculture and a sustained slack in Services. On Services, with tele density over 100%, tepid subscriber growth should continue to underpin deceleration in telecommunications GDP. Consequently, ICT GDP growth should remain slack in 2018. Elsewhere, we see limited respite for real estate which is already grappling with over-supply across most segments. On balance, we think a slower growth in the oil sector and Agriculture front holds a fragile view on overall GDP in 2018.

Fiscal: Federal Revenue Growth Shows Signs of Life

Over the first five months of 2017, FG's fiscal deficit printed at ₦1.828 trillion (or ~77% of projected fiscal deficit estimate for 2017), largely reflecting sizable revenue shortfalls on the oil and non-oil fronts. For context, actual federally retained revenues over the period was sizably lower than budget target (-55% at ₦1.015 trillion). However, our analysis points to improved revenue picture in the subsequent two months. In arriving at this conclusion, we leverage on the seeming relationship

between historical FAAC and gross federation account revenue, with the former having accounted for ~93% of the latter over the past 18 months. Using this relationship and other adjustments as a basis for estimation, we arrive at cumulative retained revenue of ~~~N~~1.51 trillion over the first seven months of 2017. Whilst, like the case all though January-May, our estimated retained revenue remains sizably higher than in the corresponding period of 2016, it still lags government's 2017 projections by a whopping 70%—with drivers of revenue weaknesses on both the oil and non-oil fronts already detailed out in our H2 17 strategy update.

Figure 6: Breakdown of non-oil revenue (N' billion)



Source: CBN, ARM Research

Despite the disappointing revenue picture, we believe FG's expenditure remained at elevated levels going by budget implementation of 88% between January and May 2017. Thus, cautiously assuming same level of implementation for June and July, we estimate FG's fiscal deficit of ~~N~~2.65 trillion (or over 100% of FG's target deficit for 2017). Of this lot, cumulative FG foreign and domestic borrowings have, thus far in 2017, only covered 65% on a net basis—with borrowings from external sources accounting for 58% and domestic debt constituting the remainder. To this point, we note that FG's debt-service to revenue ratio printed at 41% over H1 17 to further underpin FG's gravitation towards cheaper external borrowings.

Improving oil revenue picture trims deficit forecast. Going forward, we expect gross oil revenue to ride on both price and production momentum in the coming months. That said, we still view FG's oil production target of 2.2mbpd and

2.3mbpd for 2017 and 2018 (vs. 1.83mbpd and 1.90mbpd in FY 17E and Q1 18E) as a tall target which would again see actual receipts lag projections. On the non-oil leg, we acknowledge potential pass-through from improved FX liquidity that could gradually cause import duties to track rising imports. That said, with the level of import activities still expected to be sizably lower than in prior years, we see scope for only limited pass-through to non-oil revenue. In view of the mentioned, we project actual retained revenues to lag FG's projection in the coming months with our base case scenario³ suggesting an implied fiscal deficit of ₦3.4 trillion in 2017E.

Table 1: 2017 Federation revenue budget vs ARM revised estimates

	2017 Budget	Bear	Estimates Base	Bull
Oil production (mbpd)	2.20	1.50	1.85	2.20
Oil price (\$/bbl)	44.50	30.00	45.00	60.00
Exchange rate (N/\$)	305.00	305.00	305.00	450.00
Oil and gas receipts (N' billion)	5,080	2,254	4,171	9,756
Deductions				
JV Cash calls (N' billion)	-	564	-	-
13% derivation (N' billion)	660	220	542	1,268
Net Oil Revenue (N' billion)	4,420	1,471	3,628	8,488
FG Share of oil revenue (N' billion)	2,144	713	1,760	4,117
FG share of non-Oil revenue (N' billion)	1,370	729	825	922
FG independent revenue (N' billion)	808	200	325	450
Other revenue (N' billion)	776	250	290	350
FG Total revenue (N' billion)	5,097	1,893	3,200	5,838
FGN Expenditure (N' billion)	7,444	5,955	6,551	7,444
Fiscal deficit (N' billion)	(2,347)	(4,063)	(3,351)	(1,606)

Source: ARM Research

Nigeria's net creditor status diminishes again

In Q2 17, Nigeria retained its net creditor status with the rest of world after posting current account (CA) surplus of \$1.4 billion. However, the reading implied a second consecutive quarterly decline in CA balance after the nation recorded surpluses of \$2.7 billion and \$3.3 billion in Q1 17 and Q4 16 respectively. Notably, the recent plunge in CA surplus was 2.7x that of the prior quarter and was triggered by a decline in trade surplus and, more importantly, sharp jumps in services and income deficits. On the goods (trade) front, contraction in surplus position was underpinned by a surge in imports (+13% QoQ to \$8.7 billion) which slightly offset milder export

³ Going by current run rate of FG expenditure patterns, we project FY 2017 at N6.6 trillion.

growth (+8.5% QoQ to \$10.8 billion) to leave the country's trade surplus at \$2.1 billion in Q2 17 (vs. \$2.3 billion in Q1 17). In our view, import activities were boosted by improved FX liquidity following the introduction of I&E window in April with an isolation of quarterly developments indicating strongest gains in non-oil (+25% QoQ to \$6.6 billion). Specifically, non-oil imports received robust support from higher importation of food & beverage as well as industrial supplies, both of which jointly accounted for 47.4% of total imports in Q2 17 (vs. 27.4% in Q1 17). On other fronts, sizeable net debits in travels, professional and technical services as well as losses on equity investment positions abroad led to expansion in services and income deficits in the review period. For context, cumulative deficits across both segments expanded 42% QoQ to \$6.1 billion in Q2 17 to largely nullify milder growth in current transfers (largely unilateral transfers with nothing received in return e.g. workers' remittance) and leave the country's CA surplus 48% lower relative to Q1 17 levels.

However, the moderation in CA balance was compensated for by a strong surge in financial accounts (over three-fold QoQ to \$4.3 billion) largely reflecting slower absolute reduction in foreign reserves (i.e. from debit of more than \$2.9 billion in Q1 17 to just over \$290 million in Q2 17). In addition, the financial account was supported by increases in other investments (such as trade credits and loans), FPI and FDI—with higher FPI mainly skewed towards equities according to information provided in CBN's capital importation report⁴.

Balance of Payment to survive murky waters

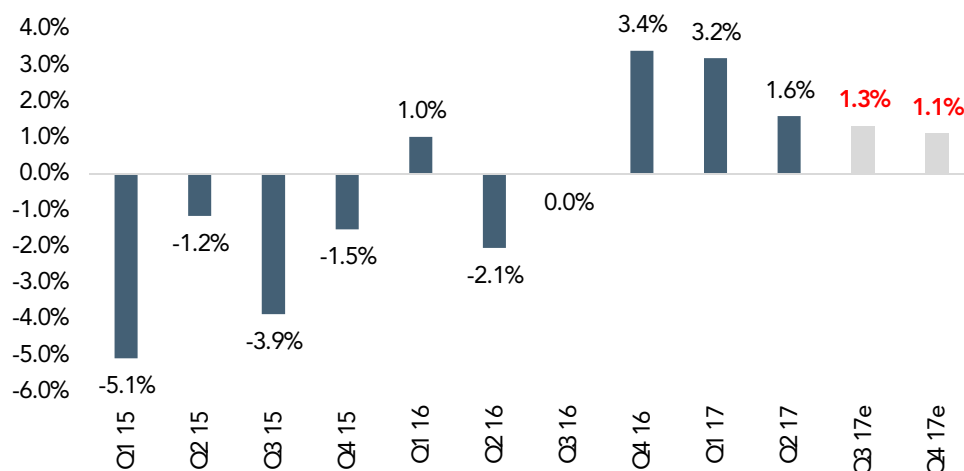
With data on the economy set to be released in coming periods, we expect crude export to consolidate gains from the first full quarter of Forcados re-opening in Q3. In line with this, recent production estimates are already pointing to crude production of ~1.9mbpd in Q3 17 (+3% QoQ). However, with mean crude prices having remained relatively stable over the past three months (+1% QoQ to \$51.28), we see scope for only 4.3% QoQ growth in exports to \$11.3 billion in Q3 17E. On imports, despite the huge dollar sales thus far in 2017, CBN's dollar cash inflow numbers (+5.8% MoM to \$3.9 billion in July alone) still present ample re-assurance that ongoing interventions would be sustained in the near term. This, combined with

⁴ Capital importation into Nigeria increased by 97.3% QoQ to \$1.8 billion in Q2 17 with breakdowns showing the biggest jumps in flows to the equity market.

continued improvements in FX liquidity, FPI flows, and rising reserves (+1.8% QTD to \$30.8 billion), leaves scope for continued USDNGN stability and availability in the coming months—with knock-on effect likely to further buoy imports (+9% QoQ to \$9.5 billion in Q3 17) and leave Nigeria’s trade surplus 15% narrower QoQ at \$1.79 billion. Overlaying the implied goods trade surplus with target services and income deficits of \$3.6 billion and \$3.2 billion (respectively 4.1% and 3.6% of forecast Q3 16 GDP) as well as net current transfers of \$6.2 billion, we expect the country’s current account to print at \$1.36 billion (Q4 17: \$1.1 billion) and 1.3% of GDP in Q3 17 (Q4 17: 1.1%).

On the financial account, we expect a combination of improving economic picture and flexible exchange rate system to sustain the demand for naira-denominated assets over the coming months. Specifically, flows to equity should be buoyed by the gradual reduction in clearing rates at CBN auctions, and high levels of maturities expected over the first half of 2018. In our view, all three variables should stoke downward pressure on yields and increase the viability of equities as an investment option—especially with the outlook for earnings still positive across select names. Overall, despite the expected moderation in current account surplus—which should subsist into H1 18 in our view, projected improvement in financial account picture suggests little downside risk for the naira in the near term.

Figure 7: CA surplus to GDP ratio – historical and forecast



Source: CBN, ARM Research

Naira resilience – new normal or fleeting reality?

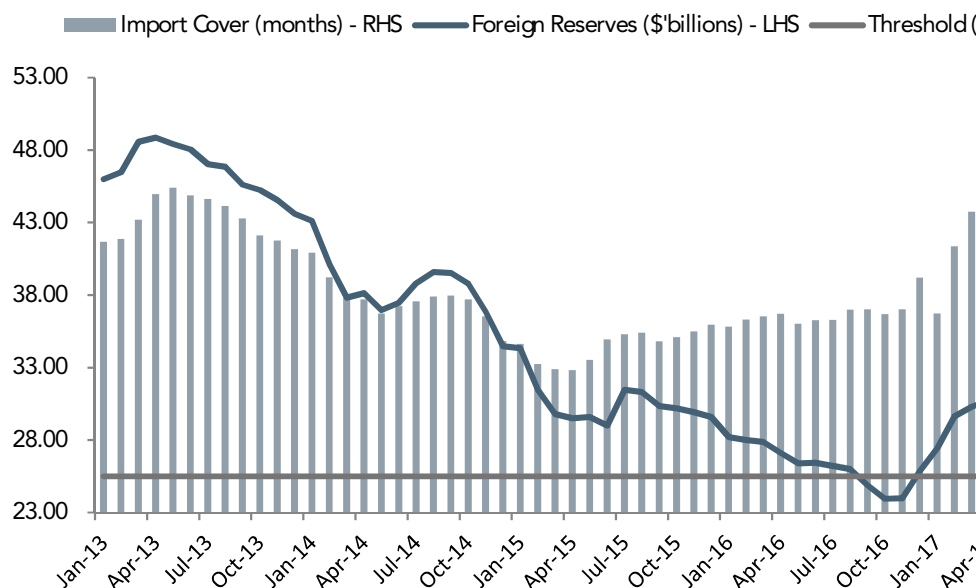
As seen in the previous sections, recent plunge in ‘reserve depletion’ (-90% QoQ to ~\$290 million) improved Nigeria’s financial account and tapered concerns over narrowing CA surplus and naira resilience over much of Q2 17. Going by latest CBN numbers, the naira again showed toughness at both the NIFEX and BDC markets over July and August—with breakdowns suggesting a 4.1% appreciation in the latter relative to Q1 17 average. At the NAFEX end, naira appreciation extended further into September (+0.9% MoM to mean of ₦359.79/\$) with daily market turnover reaching \$279 million by mid-month. Consequently, narrower spreads have reduced the potential for arbitrage transactions. For us, the new-found strength in the naira reflects sustained CBN dollar injections into various FX market strata and higher foreign portfolio inflows—with the former tracking improvements in Q3 17 reserves (+4.8% QoQ at \$31.8 billion) that have left net monthly dollar inflow into the economy printing 21% higher at \$3.5 billion relative to the average over 2016. No doubt, optimism over the apex bank’s ongoing FX interventions was aided, to a great degree, by currency-induced collapse in imports which first became noteworthy in July 2016 (-36% MoM to \$2.5 billion—lowest level since February 2009). Precisely, the low base for imports masked the impact of collapse in reserves over 2016 by flattering import cover over the last eight months (+54% to ~12 months). That said, foreign appetite for naira assets was equally boosted by the regulatory mandate directing banks to quote the floating IEW rate rather than a fixed exchange rate. This was seen by markets as a move towards a unified, floating exchange rate.

Irrespective, the jury is still out on if the current naira traction is sustainable. However, from a BoP perspective, our expectation of continued growth in the financial account—with reserve drawdown expected to contract further as FPIs and other investments remain elevated—suggest that the naira would still hold its own in the near term despite expected decline in CA surplus. In any case, notwithstanding CBN’s huge FX injections into the economy⁵, its net dollar inflow has, thus far, remained positive (save for the one-off deficit of \$936 million in May) even as surging autonomous dollar supply provides impetus to currency markets amidst recent pro-market initiatives (i.e. gravitation towards synchronized exchange rate for the

⁵ Dollar sales have remained strong despite reduced demand backlog

country). Whilst we note that, farther out, currently rebounding imports could slightly dim the picture—especially from an import cover perspective, we retain our near-term bullishness on the USD across FX market strata and bet on it trending around current levels till the end of H1 18.

Figure 8: Historical changes in reserve and import cover numbers

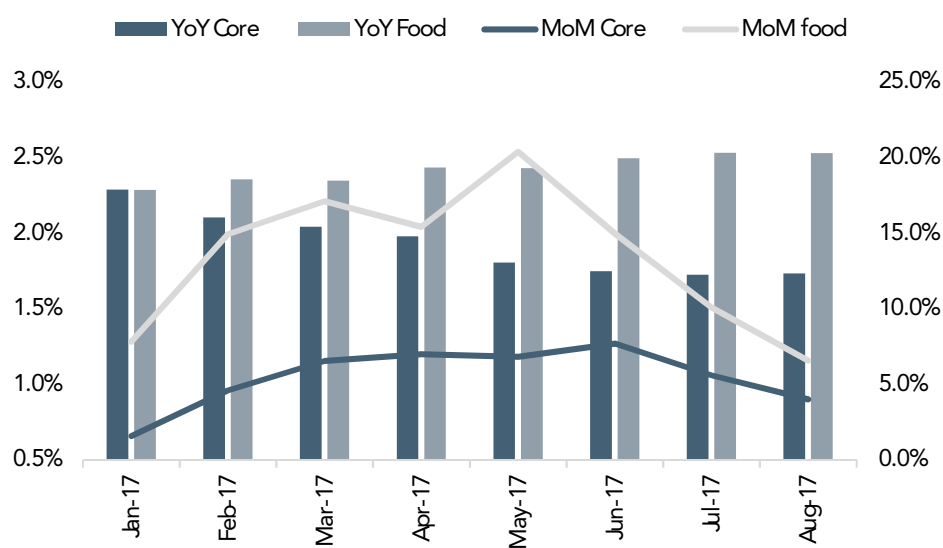


Source: CBN, ARM Research

Inflation: still an eye into CBN's monetary policy mind

Inflation has, without doubt, overwhelmingly influenced monetary policy discuss in the last few months with the CBN holding the reality of negative real return on investment as justification for a sustained hawkish monetary policy thrust. This position has persisted despite recent moderations in MoM core (-41bps to 1.06% June through August) and food inflation (-84bps to 1.16% since June). Instructively, the deceleration in core inflation speaks to extended moderations in energy prices across the country (August: Petrol: -1.9% YoY, -2.5% MoM; Diesel: -0.15% YoY, -0.70% MoM; Kerosene: -7.66% YoY, -0.49% MoM) while the surprise clampdown in food pressures reflected the duo of delayed pass-through from naira gains as well as the impact of higher domestic production of key agricultural produce in the wake of CBN's move to blacklist the importation of some locally available products which was further bolstered by the run-up to main harvest season in the south.

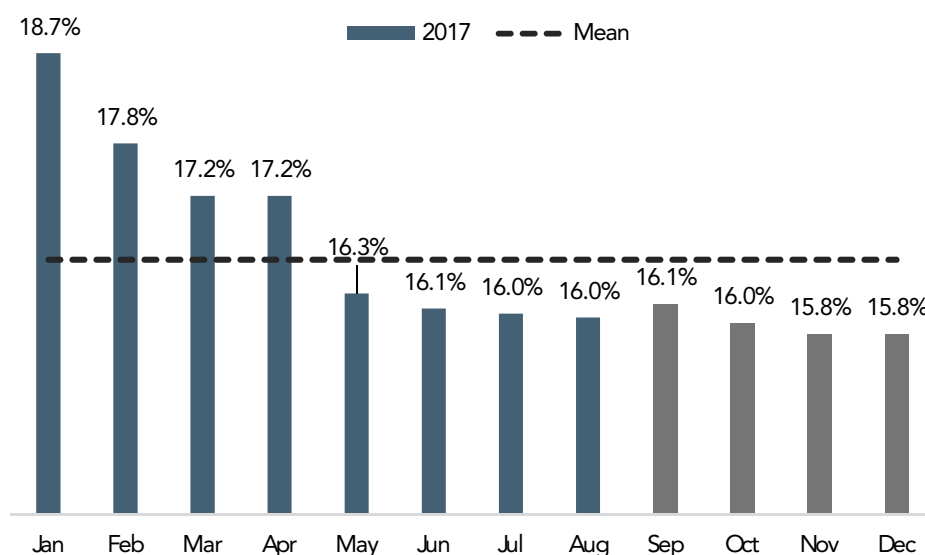
Figure 9: MoM Core and Food vs. YoY headline Inflation



Source: NBS, ARM Research

Despite the retrace in food price pressures in August, we still hold the view that the last flooding disrupted harvesting in September, with knock-on effect likely to keep MoM food reading ahead of trend levels. Elsewhere, despite the recent blip, we expect YoY core inflation to resume deceleration in September as gains from monthly improvements in FX liquidity become more telling. However, largely reflecting flood-induced food pressures, we now look for MoM headline reading of 0.95% for September (average in the three years leading to 2016: 0.79% MoM) which translates to a YoY inflation of 16.14% for September. Farther out (over Q4 2017), we expect MoM food inflation to print above trend levels despite the commencement of main harvest season (2017 mean: 0.81%; average in five years leading to 2017: 0.78%). This view is aided by extended flooding in key agricultural communities such as Benue, wherein portions of farmland and food storage facilities were washed away. The case for core inflation remains premised on extended deceleration in energy prices which have, not surprisingly, intersected with steady improvements in FX market liquidity that we expect to subsist at least in the near term. In view of the foregoing, we now forecast mean headline inflation of 16.6% over 2017 (vs. 15.6% in 2016).

Figure 10: 2017 Inflation- actual and forecasts



Source: NBS, ARM Research

High 2017 base implies cap to 2018 price increases. Going into 2018—the year preceding 2019 general elections, we see little scope for substantial shocks on the inflation front. To be clear, higher crude oil production while sustained pro-market initiatives look set to keep encouraging autonomous dollar inflows. In addition to this, the FG would have little or no motivation to tow the unpopular path of full PMS deregulation or significant alterations to electricity prices amidst, what looks set to be, a tough electioneering campaign. With no inflationary shocks in sight therefore, we see scope for substantial deceleration in headline inflation in 2018 owing largely to high base effect from 2017. That said, increased electioneering spending—expected to commence in the latter period of H2 18—raises scope for some temperance in the pace of inflation deceleration towards the close of the year. For us, headline inflation should average 12.6% over H1 18.

Is MPC at a turning point?

The MPC has achieved something impressive. It now has markets speculating on its language rather than on actual policy changes. This means that its forward guidance is working. So, turning to its language, the communicate from the latest monetary policy meeting showed that there was an agreement on the fragility of growth and

expected moderation in inflation, though the call for caution still echoes. We expect the MPC to upgrade its assessment of risks in its next meeting, which should guide to an imminent change in policy.

The talk in markets is that a near-term cut in interest rate is back on the cards. Recent cessation of the one-year OMO paper and gradual reduction in clearing rates at OMO auctions suggest that the CBN is edging closer to an inflection point policy wise if one goes by historical patterns. For evidence, we note the recent action by the CBN in money markets, which saw it allow liquidity build up into massive demand at the primary market with the eventual impact driving rates lower at primary market auctions. In addition to this, CBN's cessation of one-year bills at its OMO auctions also explained the current yield trajectory at the treasury end with longer term rates dropping faster than that of shorter-term instruments. We look again at key drivers to delineate our outlook for domestic monetary policy.

Sharper moderation in Inflation expected beyond 2017. We expect to end the year at 15.8%, resulting in a 2017 average of 16.7% YoY. Further, we see pressures gradually falling apart in 2018 as high base effect and lack of material price shock take out the steam from current price momentum. For us, headline inflation should average 12.6% over H1 18. These figures suggest that the CBN will gradually phase out its liquidity sapping programme with the need to support the fragile economic growth set to provide more backing. In the near term though, with mean 2017 inflation still materially above CBN target 11% and the MPR, the argument of trying to ensure positive real returns on investments is likely to remain in support of CBN's ongoing monetary policy tightening.

External liquidity position stabilized. In Q2 17, Nigeria retained its net creditor status in relation to the rest of world after posting current account (CA) surplus of \$1.4 billion. However, the reading implied a second consecutive quarterly decline in CA balance after the nation recorded \$2.7 billion and \$3.3 billion in Q1 17 and Q4 16 respectively. Going forward, overlaying the implied goods trade surplus with target services and income deficits of \$3.6 billion and \$3.2 billion as well as net current transfers of \$6.2 billion, we expect the country's current account to print at \$1.36 billion (Q4 17: \$1.1 billion) and 1.3% of GDP in Q3 17 (Q4 17: 1.1%), with a sustained surplus in 2018.

Fragile growth outlook. non-oil GDP growth disappointed as the Q2 17 reading (0.4% YoY) signaled a slowdown from Q1 17 levels (+0.72% YoY) following contractions in Services and Trade. The pattern in non-oil, owing to a slack in ICT (12% of GDP) and impact of credit tightening on Trade (17% of GDP), suggests that the pace of economic recovery is likely to remain soft over the rest of 2017 and even going into 2018.

Balance of factors guides to an accommodative stance in H1 18. On balance, juxtaposing the fragile growth picture with expected downtrend in inflation and improved FX picture because of rising dollar inflows with a subsisting CA surplus, we see more scope for the apex bank to ease gradually to support the slow pace of economic recovery. In the interim (Q4 17 and Q1 18), we expect the CBN to assume a less aggressive stance at its weekly OMO auctions leading to lower rates on government securities. Farther out, we forecast a cut in monetary policy rate (MPR) from Q2 18 and expect the MPR to be at 12% by year-end 2018.

Capital Market Review and Outlook

Fixed Income: Yields trend lower as apex bank changed front

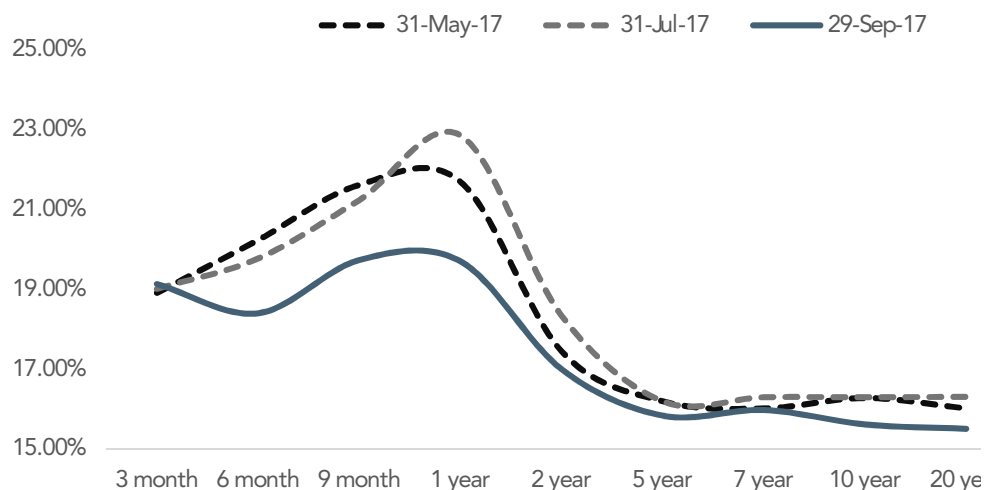
Coming into the third quarter, our prognosis for the naira yield curve was a subsisting uptrend over H2 17 followed by a moderation over H1 18. Our expectation for the yield uptrend was premised on a retention of the hawkish monetary stance due to concerns on recent naira stability as well as persisting inflationary pressure, even as we expected higher FG borrowings over the period. However, the extent to which actual yield trajectory matched expectation was limited by the evolution of two events. First, the CBN signaled an inflection point policy wise, going by historical patterns. Pertinently, the apex bank allowed liquidity build up into massive demand at the primary market which eventually resulted in rates decline at the primary market auction (PMA). In addition, the CBN ceased issuance of the one-year bills at its OMO auctions, which led to a downtrend in Treasury bill yields with longer term rates dropping faster than that of shorter-term instruments. The second is tied to the FG's growing concerns over the debt service metrics with recently released Q2 17 budget implementation report showing that debt service to revenue ratio has hit 41%. Consequently, the FG was less aggressive with its bond issuance even as market favored the primary auction for short-dated securities. Overall, the outcome of these events underpinned a 98bps contraction in the yield curve to 17.47% over Q3 17 against expectation.

Taking a closer look at the evolution of the yield curve over Q3 17, yield movement at the short and long-end of the curve was divergent in the first two months of the quarter, though contraction in September cuts across both segments. Largely reflecting the build-up in system liquidity in Q2 (Net OMO maturity of ₦79.8 billion vs. Net issuance of ₦933.4 billion in Q1 17), the CBN cut back on rates at its OMO auction in the review period. In addition, banks increased purchase of treasury bills following sustained issuance of stabilization securities which raised the opportunity cost of sitting on excess liquidity⁶. Farther out, the CBN ceased issuance of the one-

⁶ Amidst continued special forex intervention by the CBN, banks had increasingly channeled available funds towards meeting forex purchases with the consequent impact resulting in less participation at OMO auctions. However, faced with subsequent increase

year bills at its OMO auctions. Overall, the combination of liquidity build-up, increasing purchase of treasury bills at both the primary and secondary markets, as well as cessation of the one-year OMO bills drove a downtrend in treasury bill yields (-160bps QoQ) with longer term rates dropping faster than that of shorter-term instruments.

Figure 11: Naira Yield Curve



Source: FMDQ, ARM Research

At the long end of the curve, mean marginal clearing rate rose in July (+5bps to 16.25% on average), reflecting lower subscription (bid-ask ratio contracted 25% MoM to 1.56x) and higher government borrowings (+7% MoM to ₦106 billion). Bond yields further climbed in the subsequent month (August) as investors reacted to the higher marginal clearing rate (+59bps to a seven-month high of 16.83%) at August's bond auction, reflecting lower subscription⁷ (-47% MoM to ₦56 billion) which compelled the DMO into allotting only 42% of the ₦135 billion on offer. However, over September, amplified subscription levels at the bond auction, on the back of declining rates at the PMA and cessation of the one-year bills drove a decline in bond yields. Specifically, at the last treasury bills' auction in the quarter, the stop rate on the one-year paper dropped by 152bps (compared to prior auction) to close

in market liquidity, the apex bank responded to banks' behavior with a total forced debit of N471 billion via stabilization securities in June—with 61% of the issuance occurring on the 29th of June and at below market rate of 16%

⁷ Lower subscription was driven by liquidity constraint reflecting CBN's N61 billion OMO issuance, the highest since the turn of the year, as well as the issuance of a combined N112 billion debt by Lagos state government.

at 17.0%. The attendant impact of this has cascaded into a downtrend in secondary market rates on bonds. Overall, bond yields declined 34bps relative to prior quarter. Insert chart on T-Bills and bond auction in the last 6 months and 4th quarter of 2017 (Offer, Subscription, Allotted, Marginal rate)

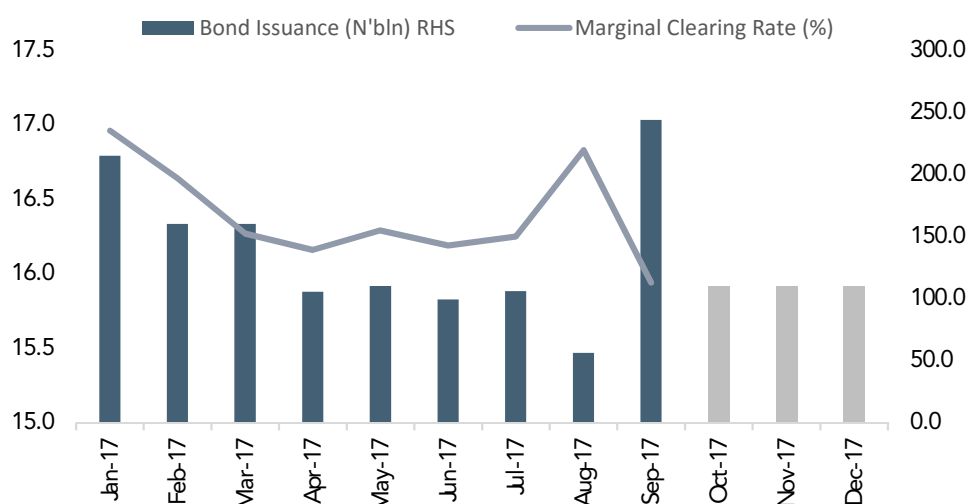
Rates sensitivity and waning inflation meld into dovish yield outlook

Having established the key influence of CBN's change of stance in fueling yield decline in Q3 2017, likely policy trajectory of the apex bank remains central to our yield outlook. In our monetary policy forecast, we expect the CBN to assume a less aggressive stance at its OMO windows to continue to drive rates lower in the near term. On the strength of the mentioned, we expect T-bill yields to decline to sub 18% levels in Q4 2017, with a sizable decline (100-150bps) in H1 2018.

At the longer end of the curve, FG's borrowing pattern remains crucial in formulating an outlook. As noted in the fiscal review, we have a base case scenario⁸ suggesting an implied fiscal deficit of ₦3.4 trillion in 2017E (vs. ₦2.4 trillion stipulated in the budget and ₦1.8 trillion over the first five months of 2017). Consequently, we assume a fiscal deficit of ₦1.6 trillion for the second half of the year. Precisely, excluding ₦724billion issued in Q3 2017 (Net Treasury bill issuances: ₦318billion, Bond Issuance: ₦406billion), the FG would need to borrow circa. ₦900billion over the rest of this year. Given the foregoing, we adopt a successful Eurobond issuance of \$2.5billion, translating to ₦900billion to fully cover our proposed borrowings by the FG and displacing the need for domestic borrowings. We go on to provide a further ₦450billion (Q4 17 Bond issuance: ₦300billion and Net T-bills issuances: ₦150billion). To add, we believe concerns over mounting debt service burden will keep the FG mindful of borrowing cost in the near term. On balance, this would mean moderated domestic borrowings for the remainder of the year and, by extension, sustained yield downtrend at the long end. Tying it all together, we see a subsisting downtrend in the level and slope of the naira yield curve over the next six months with dovish monetary policy, lower domestic borrowings, and perhaps some form of coordination with monetary policy to ease financing costs to drive yields lower.

⁸ Going by current run rate of FG expenditure patterns, we project FY 2017 at ₦6.6 trillion.

Figure 12: Bond sales and borrowing cost



Source: DMO, ARM Research

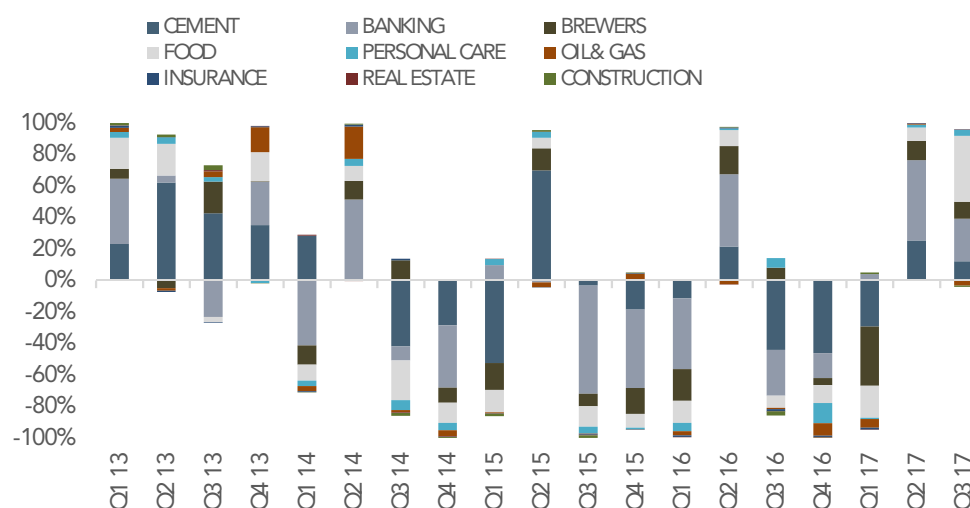
Equities set to maintain upbeat momentum

In our H2 Nigeria Strategy Report, we had predicted that sizable foreign and domestic demand for equities, aided by improved fundamental picture and greater pro-market FX initiatives, would underpin upbeat performance for naira equities. True to this, the NSE ASI posted an 8.3% QoQ gain in Q3 17 largely reflecting strong market performance in July (+8.5% MoM) which more than offset weaknesses in August (-0.3% MoM) and September (-0.1% MoM). As foreign excitement over the introduction of IEW tapered in July—with net FPI flows having shrunk 46% MoM to ₦16.38 billion, it was domestic participation (+13% to ₦133.65 billion) that left the bourse in positive territories. Precisely, the domestic support for markets came from the relatively stickier institutional investors, ~60% of local equities participation in the period (vs. 47% in May), who are less apt to cash in on profits in the near term. That said, this resilience on the domestic front slightly gave way in August after domestic retail investors extended profit taking activities to the home turf. As can be inferred from the narrowing moderations in the nation's equity market bourse (September: -0.1% MoM), investors appear to be gradually re-entering to strategically position ahead of the Q3 17 results.

Cascading to sectoral levels, our attribution analysis revealed that the food sub-sector (+29.7% QoQ) had the greatest impact on the equity bourse in the quarter

accounting for 49.7% of the uptrend in the NSE ASI with banking (+7.95% QoQ), cement (+3.6% QoQ) and brewer's stocks (+7.6% QoQ) following closely contributing 32.3%, 14.3% and 13.0% respectively. On the food front, performance was largely supported by rallies in Dangote Sugar (+52.2% QoQ), Dangote Flour Mills (+27.9% QoQ), and Nestle (+34.0% QoQ) following substantial price increases across product portfolios and improved dollar liquidity which buoyed investor sentiments on earnings. Elsewhere, Nigerian banks tactfully cut back on loans to private sector to rewrite lingering issues on asset quality and further stamp their preference for lending to FG via treasuries—with the drive to the latter ably aided by elevated interest rate environment. Similarly, cement sector largely rode price-induced topline growth which offset the impact of expensive energy-mix across the sector. On brewers, support largely stemmed from rallies in Guinness (+32.8% QoQ) and International Breweries (+21.0% QoQ) following impact of price-induced revenue growth and belt tightening measures on earnings. Beyond noted gains across named sectors, investors were also endeared to Personal Care (+4.8%) sector in the period.

Figure 13: Attribution analysis of quarterly sectoral performance



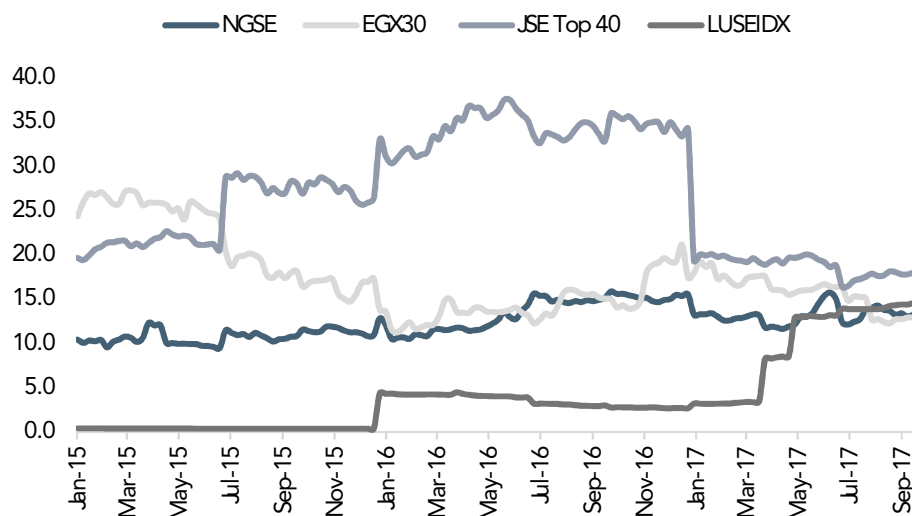
Source: NSE, ARM Research

Irrespective of the recent rallies, Nigeria's equity bourse remains cheaper relative to some Africa climes given its P/E of 13.2x (vs. 17.9x for JSE top 40, 14.5x for LUSEIDX, and 13.2x for MXEE9). However, equity investing opportunities look

⁹ Bloomberg Emerging markets, Europe, Middle East, and Africa Index

more attractive in Egypt (EGX 30 P/E: 13.1x) with fall-outs from the country's tilt to pro-market initiatives such as removal of the cap on dollar deposits & withdrawals and an eventual floatation of the Egyptian pound in late 2016 viewed as particularly pivotal.

Figure 14: Historical P/E ratios NGSE vs. African peers



Source: Bloomberg, ARM Research

Equities to ride domestic and foreign excitements. In arriving at our broad outlook for the rest of the year and the first half of 2018, we retain our view that the trajectory of crude oil prices, domestic macro recovery, FX liquidity, fiscal policies, and pension reforms will continue to dictate the performance of the equity market. On crude oil, we believe that the concussion of US supply resurgence post hurricane setbacks, reported production ramp-up in Nigeria and Libya, coupled with the potential squeeze of spot crude demand & new contracts leave scope for deceleration in crude prices going into 2018. Nonetheless, domestic macro appears set to extend its positive momentum going into 2018 with recent PMI numbers providing earliest indications of sustained resurgence. Beyond this, continued rise in crude export proceeds leaves the nation's reserves well above the \$30 billion mark with CBN's cash flow position also providing positive re-assurances that the apex bank's FX market interventions across strata is not yet done and dusted. Needless to mention, recent efforts at achieving unification of FX rates via relatively pro-market and transparent measures are feelers that the market could still see further FPI flows to

equity. Perhaps providing some support for this view is the sharp resurgence in net FPI inflows to equity (over seven-fold MoM to ~\$123 billion) that came off the back of some profit taking in August. To be clear, with the re-entry targeted towards the end of the third quarter, we believe that foreign investors may have started taking positions in anticipation of further FX-induced earnings. Elsewhere, we expect domestic equity investors to carefully latch on to the bandwagon with key support expected to come from institutional players. Precisely, with alternative yield-paying investment outlets such as treasuries set to become relatively unattractive in line with our expectation for yield downtrend, we expect domestic investors to pay greater attention to equities with companies currently burdened with high domestic interest expense potential benefactors.

Cascading to sectors, while lower interest rate environment should ordinarily deem prospect for strong gains in interest income for most banks, we are of the view that the gap would be largely plugged by a tilt towards private sector loan growth. In addition, recent recoveries in crude oil prices and ongoing power sector loan restructuring should limit concerns on asset quality front. Similarly, improved crude production should give hand to upstream O&G share price even though weaker margins in petrol segment—owing to higher input cost—remains likely to drive earnings lower in the downstream. Elsewhere, sectors that largely rode on price-induced gains this year (i.e. cement) are unlikely to reproduce the aggressive top-line growth momentum in 2018, but investors are likely to take solace from a relatively stable energy cost environment. On balance, we see improved economic fundamentals and gradual recovery as potential drivers of a bull outlook in the coming months.

Capital Market Strategy

FI Strategy: Go long but be mindful of duration risk

In our Fixed Income review and outlook section, we made our call of a further downtrend in yields up till H1 2018 on the back of accommodative monetary policy and FG lighter borrowing patterns on the domestic leg. To be clear, we see a subsisting downtrend in the level and slope of the naira yield curve over the next six months with dovish monetary policy, lower domestic borrowings, and perhaps some form of coordination with monetary policy to ease financing costs to drive yields lower.

Irrespective, beyond the first half of 2018 comes a looming risk that can volte-face our call – political risk gearing towards the election. First off, increased electioneering spending—expected to commence in the latter period of H2 18—raises scope for some temperance in the pace of inflation deceleration towards the close of the year. Secondly, a possible desperation by the FG to fulfil its earlier mandate will moderate earlier sensitivity towards borrowing cost and channel a sizable portion of deficit financing on the local market as the uncertainty gearing towards election may keep foreign investors jittery, moderate inflows and stir capital flight, thus pushing yields up. Consequently, naira would likely come under pressure. Tying it all together, we see a more volatile pattern in the level and slope of the naira yield curve over the next 15 months with dovish monetary policy and elevated repayment cycle in H1 2018 creating a gravitational pull on yields. Farther out, the political risk in H2 2018 implies some form of yield uptick, which would certainly point to further yield curve twists.

Having framed our outlook, we see merits in positioning bond portfolios towards the long end of the curve but slightly lowering position at the very long-end. Short and medium term is a good place to be at this point because the segment has been doing well. We are not completely in favor of going all-out long-end because that would mean higher volatility as our H2 2018 call plays out. Basically, we recommend a staggered approach to building duration with emphasis on mid-tenured bonds on

the downward slope of the naira curve in a bid to ‘run-down the curve’ as dovish influences kick into gear over H1 2018. Farther out, as yield uptick slightly sets in and currency shows up, we advise a rotation back into the money market to wait out the political risk storm. Overall, our strategy calls for investors to position bond portfolios with an eye on flexibility ahead of what promises to be a roller-coaster 15 months for debt markets.

Equity Strategy: See buying opportunities in coming shocks

In our H2 17 outlook, we held the view that investors adopted a contrarian approach to selected names as against a ‘Buy and Hold’ strategy. This view reflects our less sanguine outlook for equities over the second half of the year relative to H1 17 given the rich valuation across most of our selected names in the equities space which limited the scope of significant upside compared to H1 17. In all, we projected a more tepid rise in the NSE-ASI with short term market volatility attributed to the intersection of profit takers and bargain hunters. Indeed, the muted equity market performance measured in terms of average daily traded (volume and value) in Q3 17 relative to Q2 17 suggests our call largely played out.

In arriving at our strategy for the rest of the year and the first half of 2018, we retain our view that the trajectories of crude oil prices, domestic macro, FX liquidity, fiscal policies, and pension reforms remain crucial with developments in the last four expected to support further rallies. To be clear, we expect gains from the quartette to make up for impact of potential interest rate hike and balance sheet downsizing in US, European tilt towards hawkish monetary policy orientation and prospective crude price contraction going into 2018. That said, initial reactions to global monetary policy changes and shocks to oil are still likely to provoke transitory upsets in the market even though our overriding view remains bullish. To re-iterate, a major underpin for our equity market optimism is the projected moderation in yields that would limit investment options for both domestic and foreign investors in the coming months. Even now, institutional appear to have switched into panic mode as they attempt to lock in higher yields for fear of the coming interest rate downslide. Thus, with the allure of higher yield gone, 2018 should see a gravitation towards investments powered by company fundamentals with companies currently burdened by high domestic interest expense (i.e. UACN) likely to be among beneficiaries. In

passing, we also note that on the back of expected rates moderation, tier two banks' funding costs should fall more quickly than their interest income to provoke some rebound in net interest margin in the coming year.

Thus, juxtaposing this tempered bullish run with the positive view on selected stocks, we assume steady swings in coverage names for the rest of 2017 and H1 18 and thus retain our recommendation of a flexible approach to comfortable stocks—buying the dips and selling the rally as against a “Buy and Hold” strategy. For instance, we expect the intersection of lower crude price as well as interest rate increase & balance sheet downsizing in the US to present the last buying opportunity of 2017 by December. Farther out, with 2017 largely a year of strong earnings rebound for most coverage names, attractive dividend yields on FY 17 corporate result is expected to spur buy momentum and create selling opportunities early in the second quarter of 2018. For clarity, this expected dividend play should also drive appetite for most part in Q1 18 though with the incline for profit taking currently high amongst foreign portfolio investors and domestic retail players, market gains are likely to be short-lived.

In conclusion, we re-emphasize that times of higher market volatility, while often trying for individual investors, can be opportunities for skilled active managers. For us, we think after a strong counter trend move, if the longer-term outlook remains intact, looking for opportunities to “buy the dip” and “sell the rally” will be a solid investment strategy for choice names.

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