



# ARM RESEARCH

## Q4 2017 Strategy - **Pathway in Turning Tide**

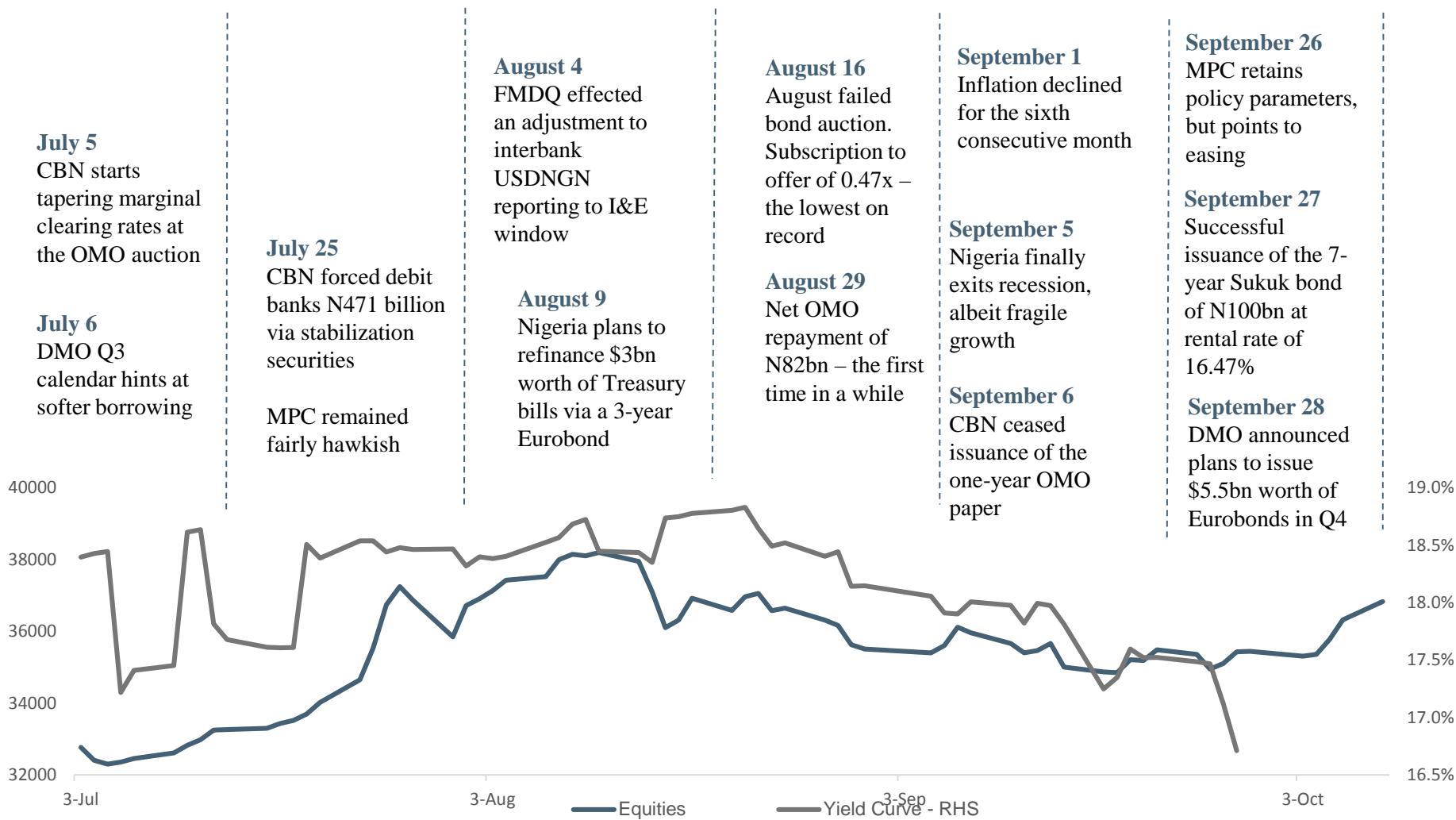
16 October 2017

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# Q3 2017 Recap

# The Quarter in Review



# CRUDE OIL

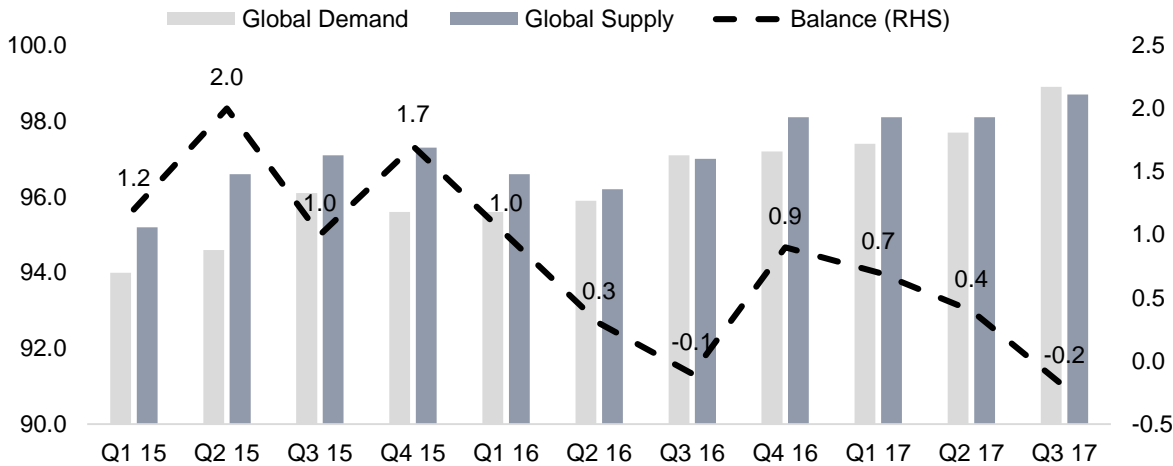
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# Crude Oil Price Market

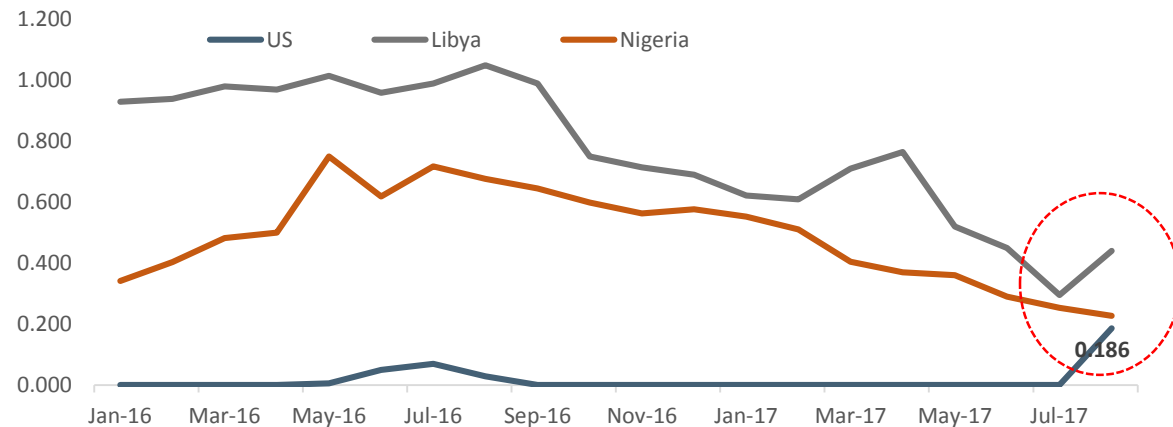


*Crude oil market switched to a deficit (160kbpd) to drive a bull run in the commodity price.*



Source: EIA, ARM Research

*Hurricane stirs increase in est. unplanned crude oil production outages in US*



Source: EIA, ARM Research

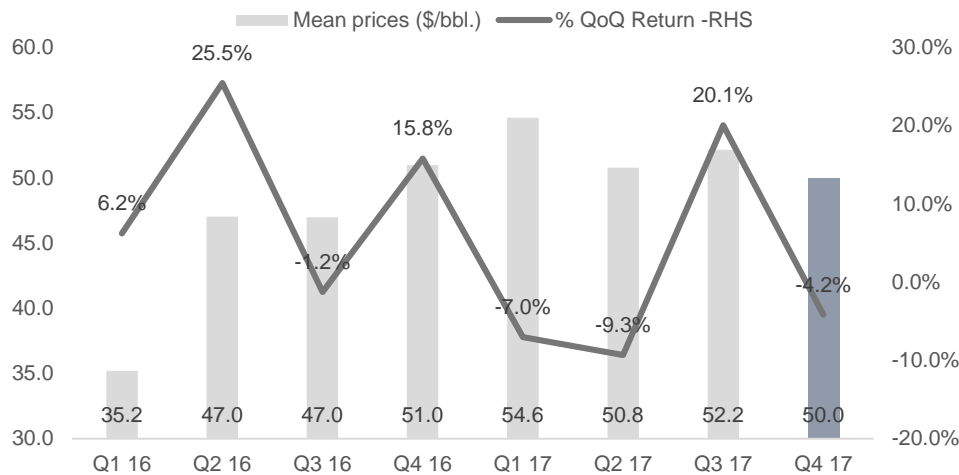
- Rise in demand was largely driven by growth in the OECD region (2.0% QoQ to 47.6mbpd) – Europe’s demand and the re-opening of US refinery.
- Slower than expected rise in supply hinged on further production cut by Russia (-330kbpd) and hurricane impact on increase in US shale production
- US supply came in only slightly higher relative to prior quarter (+280kbpd)
- 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 a much-needed rebalancing in the crude oil market in the review period.

## Will crude oil 'roller coaster' linger?

- We see scope for greater supply from US as the impact of Hurricane subsides - 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.
- Expected higher production from Nigeria and Libya of 120kbpd and 100kbpd respectively to moderate the impact of production cut by other OPEC members.
- Finally, expectation of further rate hike and unwinding of balance sheet by the US Fed guides to a stronger dollar and consequently lower crude oil prices.

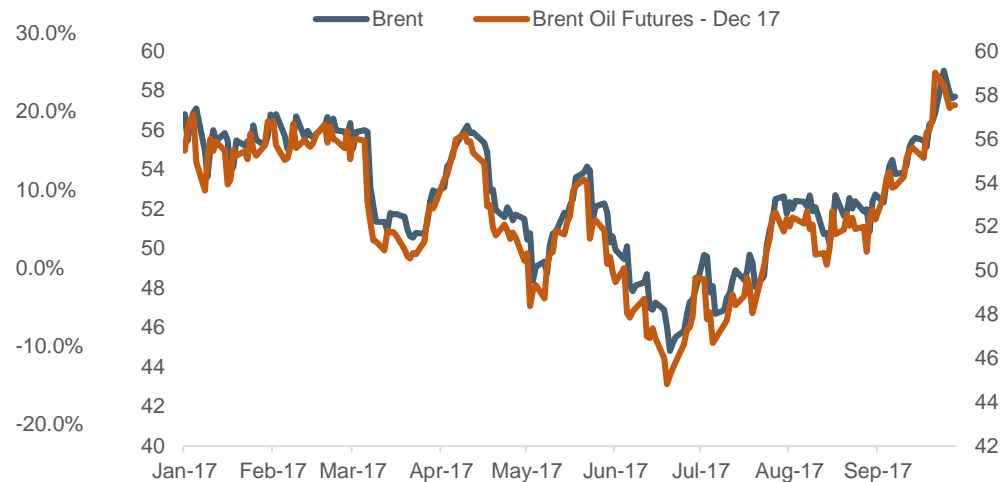
*...we resist the enticement to raise our crude oil prices forecast given recent development.*

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.



Source: Bloomberg, ARM Research

**...sharp swing in sheer backwardation indicating a possible decline in crude stocks and positive for prices**



Source: Bloomberg, ARM Research

# DOMESTIC MACRO

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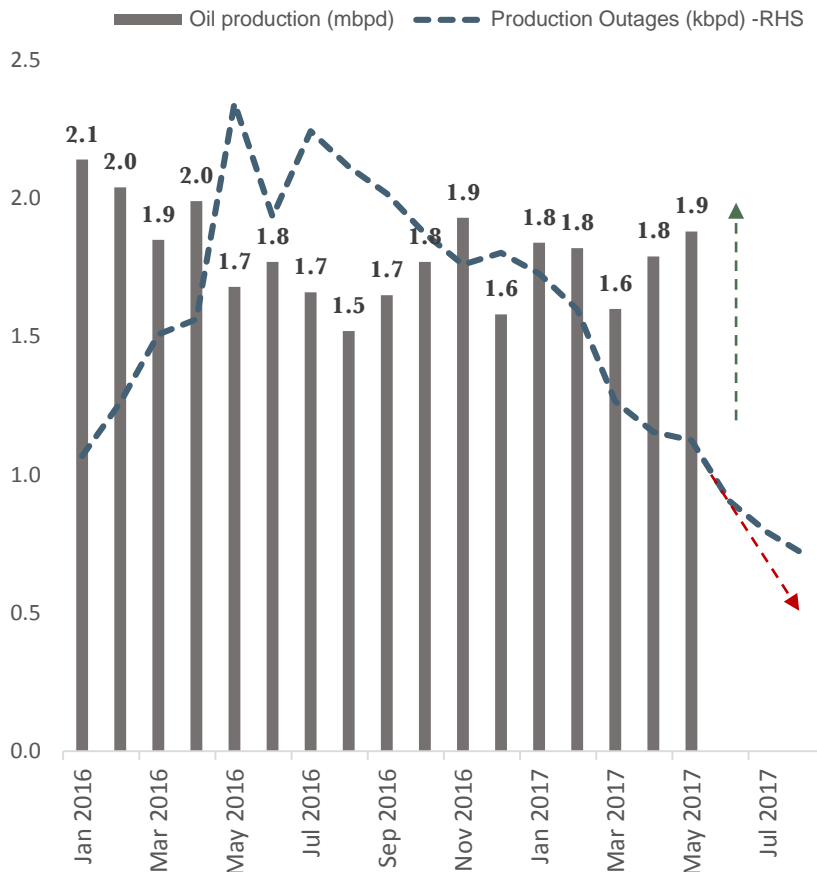


# Rebound in oil production

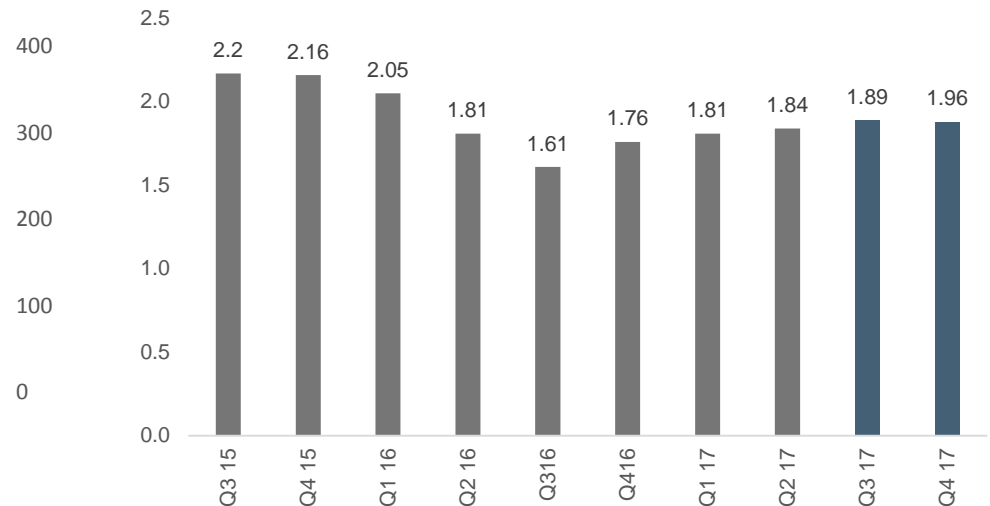


## Aside from crude oil prices, a key issue was Nigerian oil production

...sizable decline in crude oil production outages points to higher production for the rest of the year



- 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).

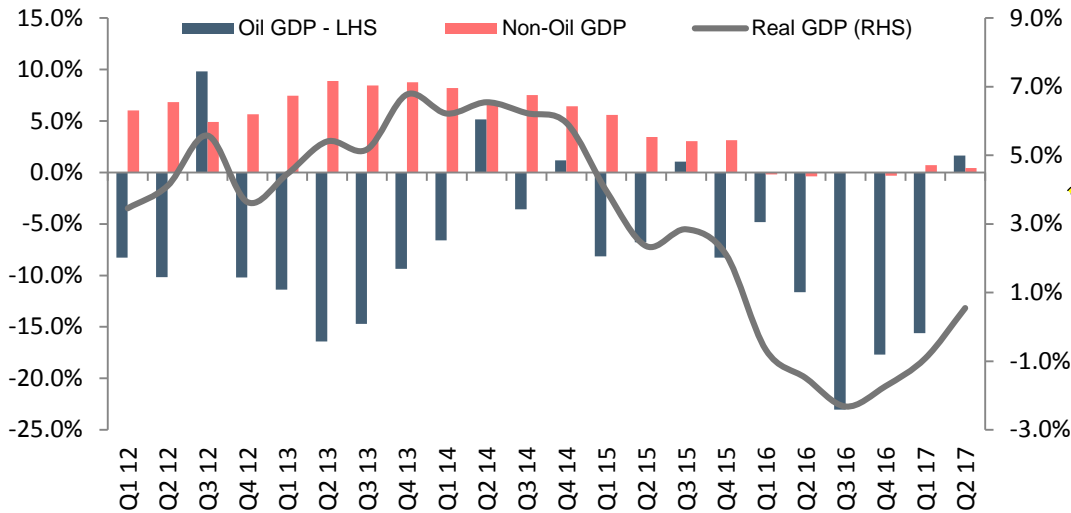




# Gross Domestic Product (GDP)



## Uphill with the handbrake on

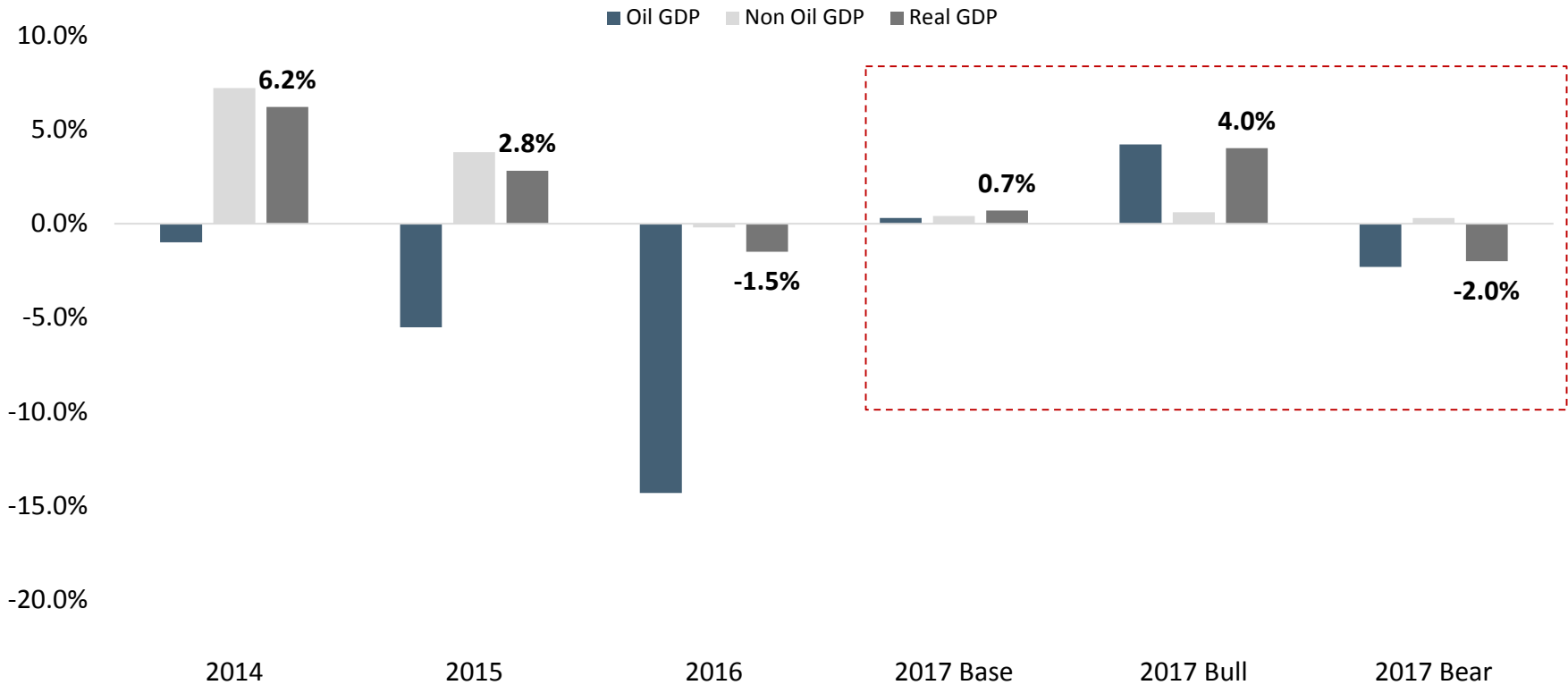


Source: NBS, ARM Research

- Nigeria's recession ended in 2nd quarter of 2017 (0.5% YoY) majorly driven by growth on the oil front (1.6% YoY) that was hinged on improved crude production.
- 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 the prior quarter (Q1 17: +0.7% YoY).
- Growth deceleration in non-oil led by Services, which reverted to negative growth (-0.5% YoY) coupled with further contraction in the real estate sub sector.
- Weakness in non-oil GDP points to a slower recovery than expected.

- Given, our oil production forecast for Q3 and Q4, we now expect oil GDP of 0.7% and 1.5% YoY for Q3 and Q4 17 respectively
- For the rest of the year, we expect sustained pressures in the Services sector should leave growth at current or even lower levels.
- Improved FX liquidity should still sustain the expansion in manufacturing sector
- The end of the lean season, improved access to inputs, continued government support and cheap financing should sustain the growth in Agric.
- 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 at 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).

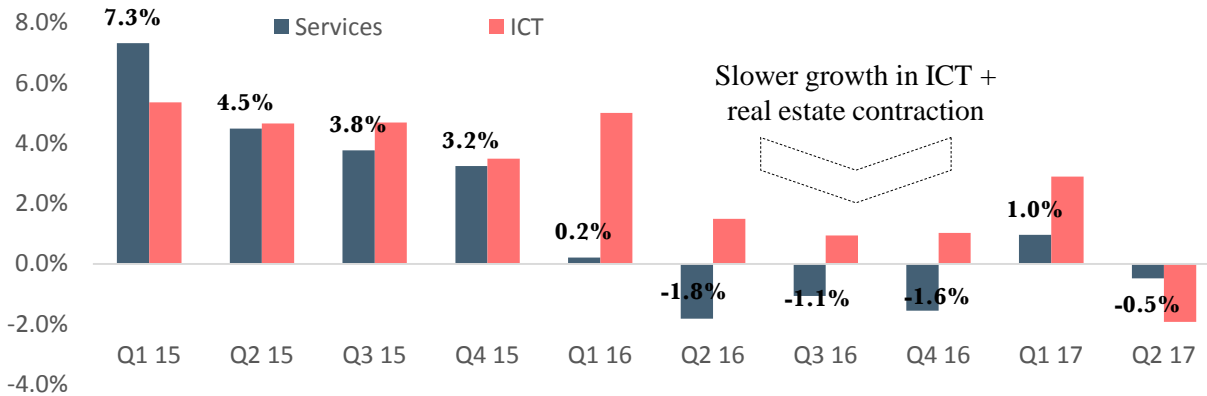
*We revise our 2017 real GDP forecast slightly lower to 0.7% YoY (previous: 0.8% YoY), but...*



Source: NBS, ARM Research

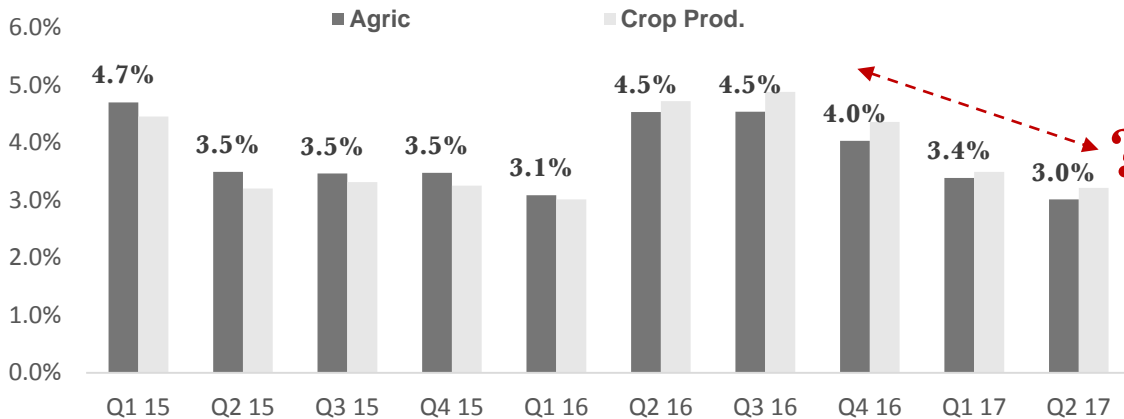
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*...Services sector will be the key driver of 2018's growth fragility*



- On Services, with tele density over 100%, tepid subscriber growth should continue to underpin the deceleration in telecommunications GDP.
- Consequently, ICT GDP growth should remain slack in 2018.
- The increase in crude oil production over 2017 brings a high base for oil GDP and thus guides to a slower growth.
- We hold a pessimistic view driven by the high base in Agriculture
- On balance, we think a slower growth in the oil sector and Agriculture front holds a fragile view on overall GDP in 2018.

Source: NBS, ARM Research



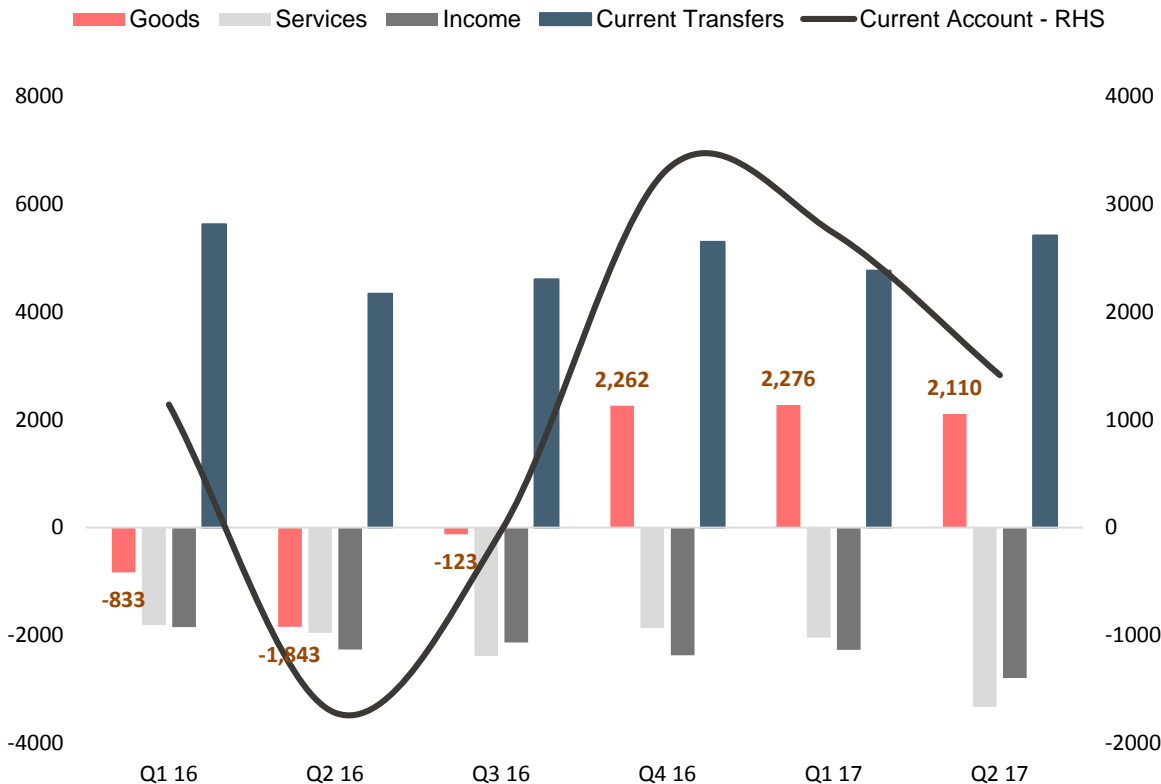
Source: NBS, ARM Research

# Current Account



## Nigeria's net creditor status diminishes again

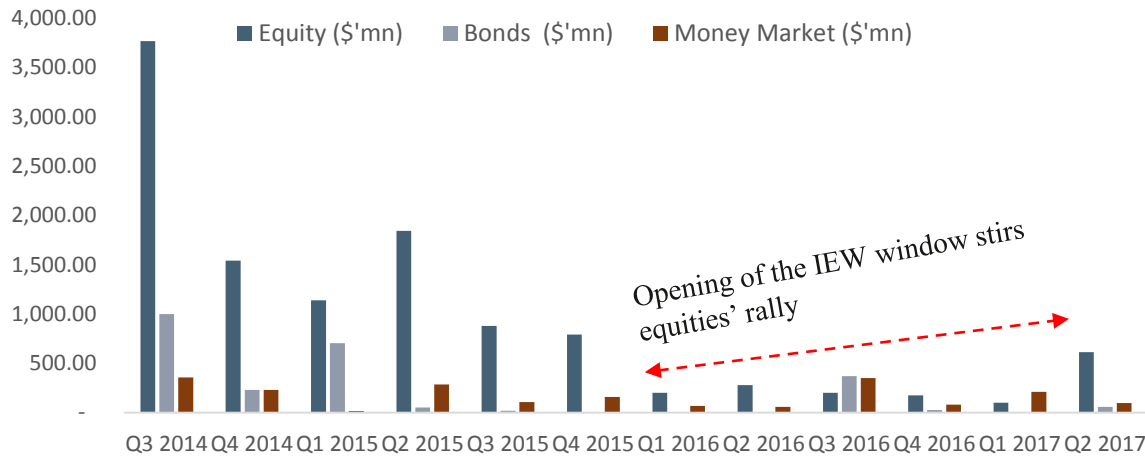
CA surplus narrowed from \$2.7bn to \$1.4bn - the second consecutive QoQ contraction. Largely reflective of decline in trade surplus (goods) & sharp jumps in services and income deficits.



- Contraction in trade (goods) surplus - underpinned by FX liquidity-induced jump in imports which slightly offset milder export growth.
- Cumulative deficits across services and income segments expanded 42% QoQ to \$6.1bn to nullify milder growth in current transfers and leave 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)
  - ✓ 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).
  - ✓ increases in other investments (such as trade credits and loans), FPI and FDI
  - ✓ 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.

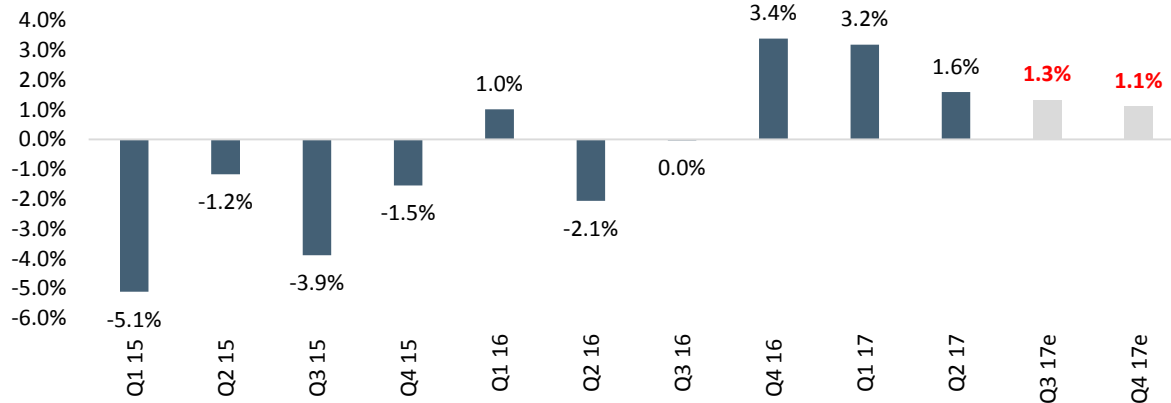
## Balance of Payment to survive murky waters

FPI flows to naira equities starts to recovered from previously battered levels



Source: CBN, NBS, ARM Research

## CA surplus to GDP ratio – historical and forecast



Source: CBN, NBS, ARM Research

- Our views on crude oil production and prices guides a 4.3% increase in exports to \$11.3bn, relative to prior quarter.
- Sustained dollar liquidity should support import growth relative to prior quarter - +9% to \$9.5bn
- Trade surplus should further contract by 15% to \$1.79bn.
- Overlaying the implied goods trade surplus with target services and income deficits of \$3.6 billion and \$3.2
- 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.

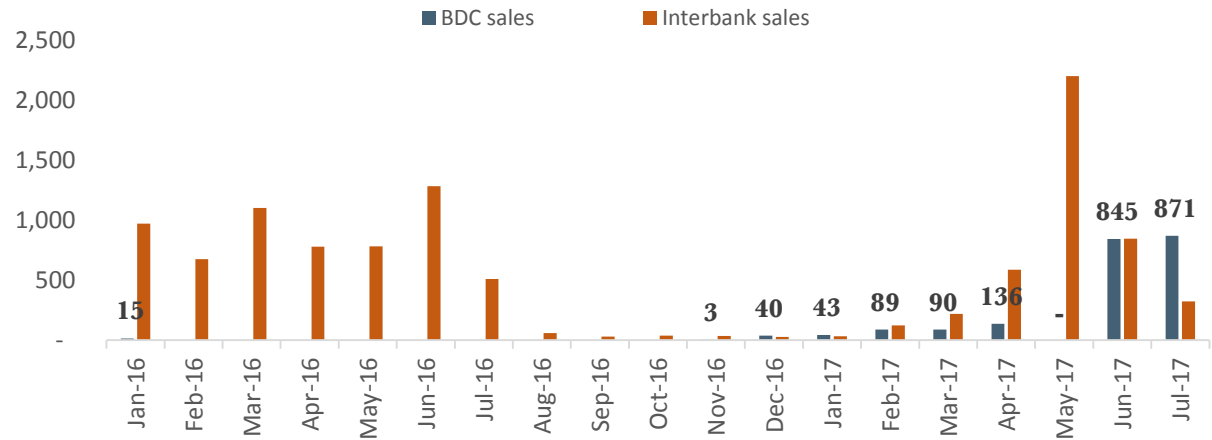
# Exchange Rate



## How has the CBN responded?

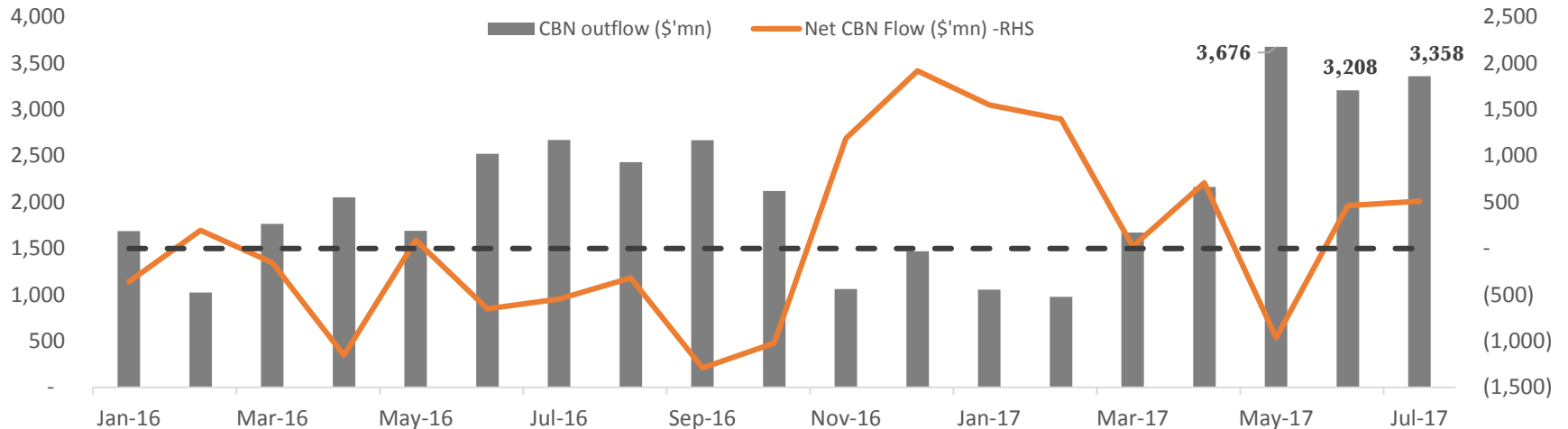
- The new-found strength in the naira reflects sustained CBN dollar injections into various FX market strata
- Foreign portfolio flows into naira assets was equally boosted by the improving fundamentals and the floating market
- Moves were seem to be geared towards a unified, floating exchange rate market.

Sales to the BDCs was the game changer from the CBN alongside opening of the IEW



Source: CBN, ARM Research

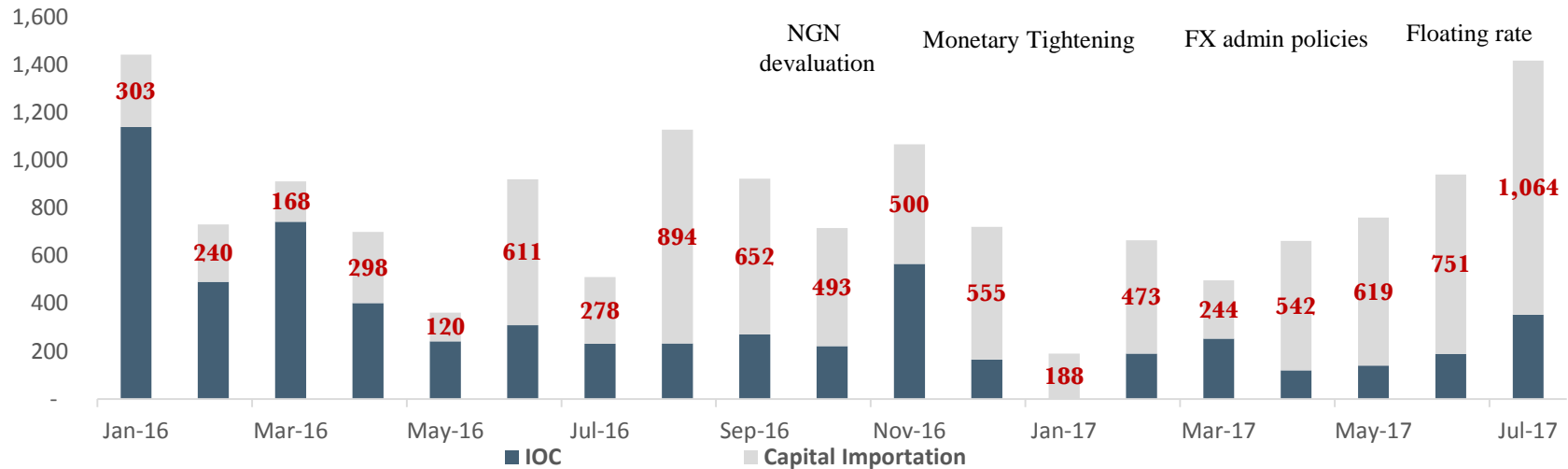
The CBN was able to meet huge dollar demand and still keep its flows positive, thanks to oil receipts



Source: CBN, ARM Research

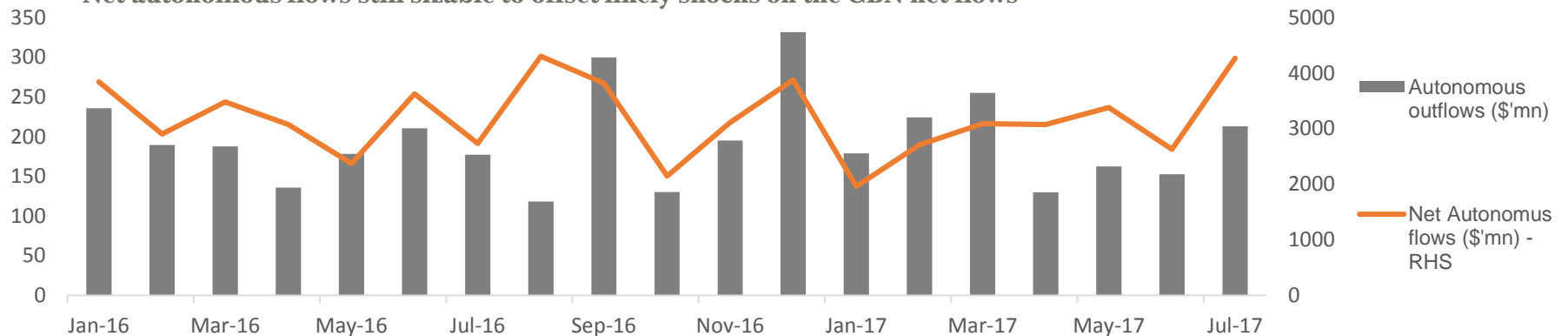
### Autonomous inflows back to the fore as FPIs buy naira assets

Autonomous inflows – Invisibles – OTC purchases – IOCs vs. Capital Importation (\$'mn)



Source: CBN, ARM Research

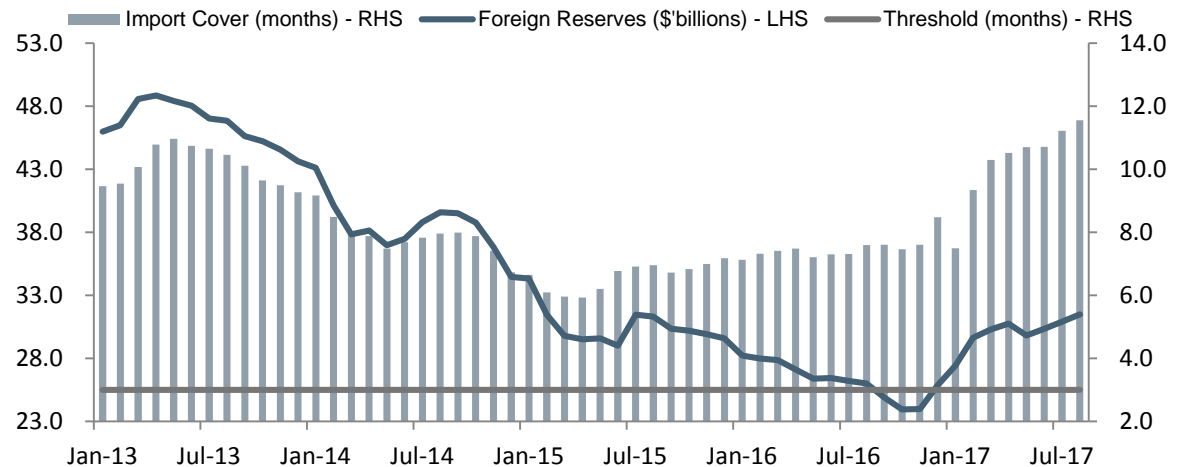
### Net autonomous flows still sizable to offset likely shocks on the CBN net flows



Source: CBN, ARM Research

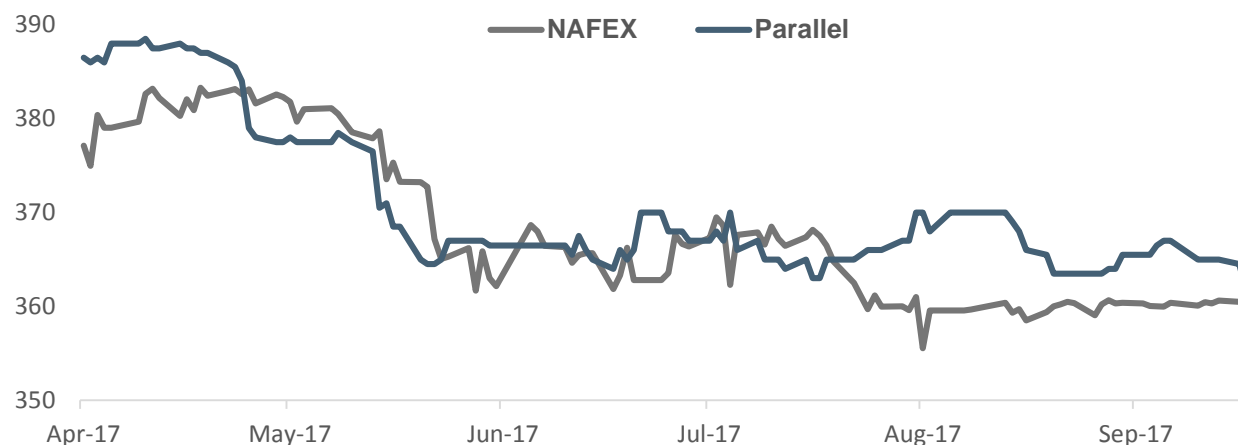
## Naira resilience – new normal or fleeting reality?

- From a BoP perspective, our expectation of continued growth in the financial account suggest that the naira would still hold its own in the near term despite expected decline in CA surplus.
- In any case, CBN’s net dollar inflow and surging autonomous dollar supply provides impetus to currency markets amidst recent pro-market initiatives (i.e. gravitation towards synchronized exchange rate for the country).
- 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.



Source: CBN, ARM Research

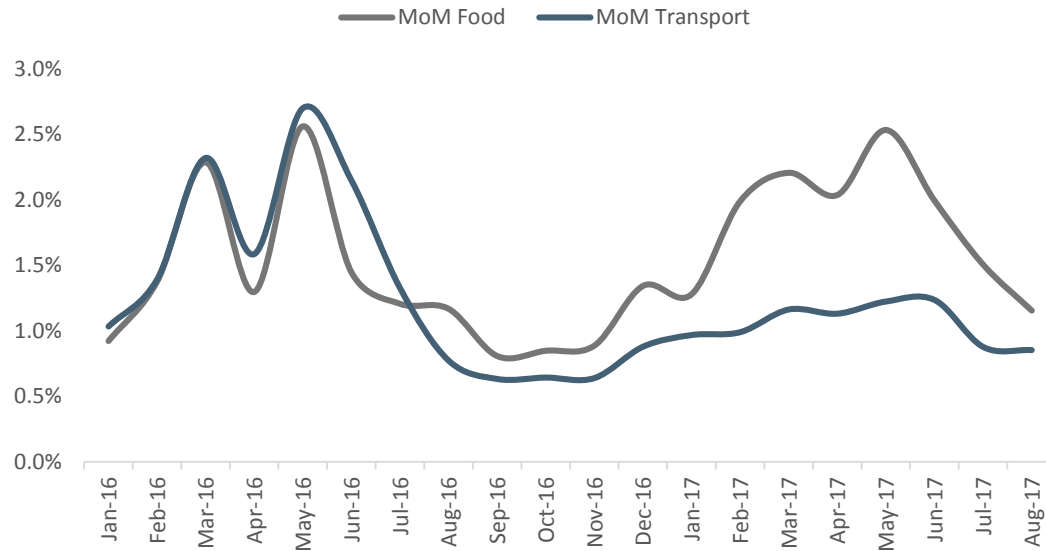
### Rates should remain at current levels with little leg-room for expansion in spread



Source: FMDQ, ABOKI FX, ARM Research



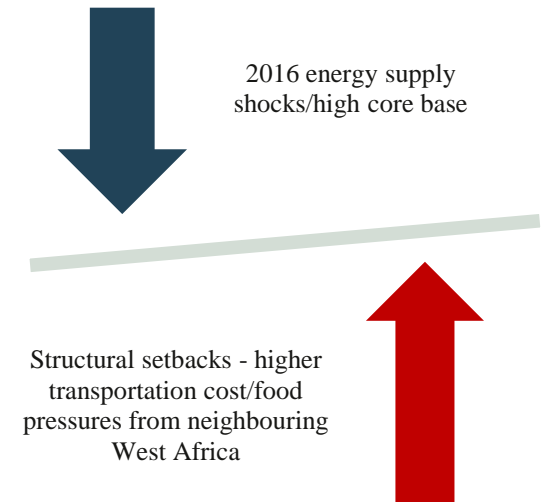
## *Inflation rate drops for the sixth consecutive month*



Source: NBS, ARM Research

- The deceleration in core inflation speaks to extended moderations in energy prices across the country
- However, the scale of decline, relative to our forecast, was much muted following greater than expected jump in food prices.
- In August though, 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

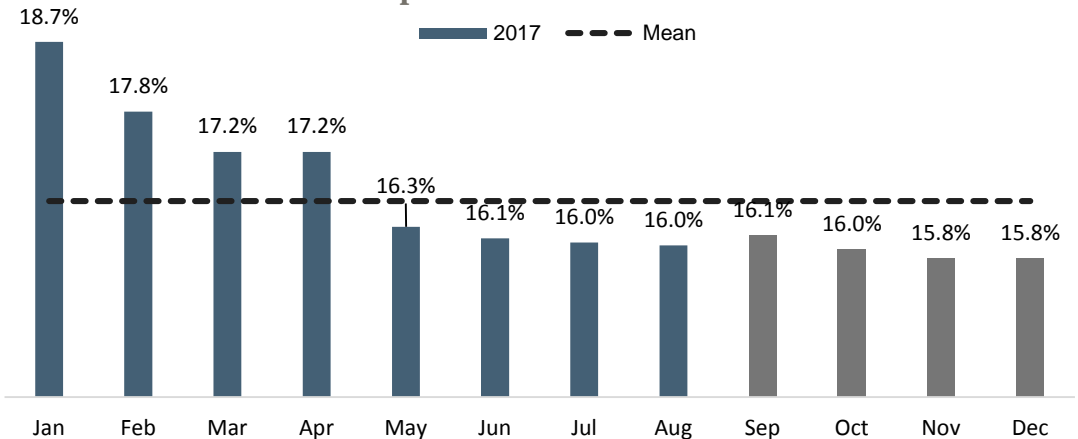
## The 2017 inflation story



## High 2017 base implies cap to 2018 price increases

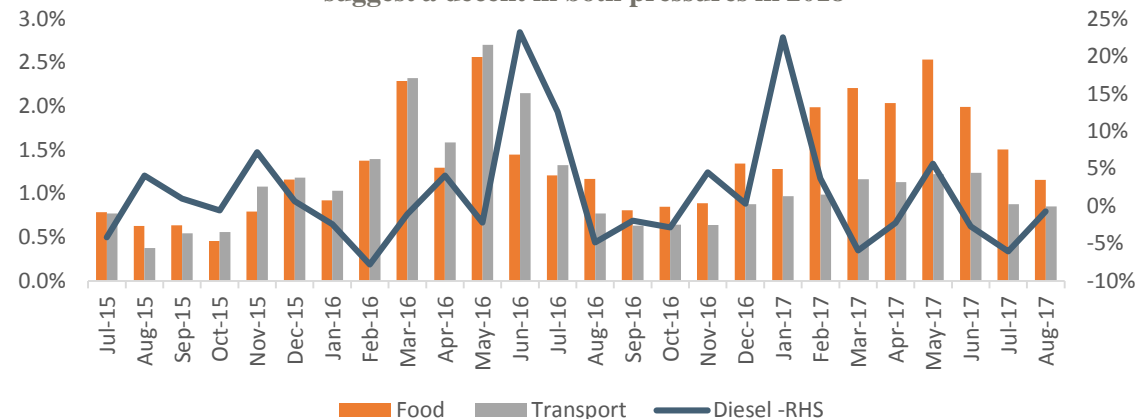
- The recent flooding disrupted harvesting in September, with knock-on effect likely to keep MoM food reading ahead of trend levels, while YoY core inflation to resume deceleration in September.
- Over Q4 2017, we expect MoM food inflation to print above trend levels despite the commencement of main harvest season
- The case for core inflation remains premised on extended deceleration in energy prices. In view of the foregoing, we now forecast mean headline inflation of 16.6% over 2017 (vs. 15.6% in 2016).
- Going into 2018—the year preceding 2019 general elections, we see little scope for substantial shocks on the inflation front owing to high base effect
- The FG would have little or no motivation to tow the unpopular path of energy price
- **For us, headline inflation should average 12.6% over H1 18.**
- 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.

### Food pressures to move from “villain” to “hero”



Source: NBS, ARM Research

### Correlation (lagged) between MoM changes in diesel prices to Transport and Food suggest a decent in both pressures in 2018



Source: NBS, ARM Research

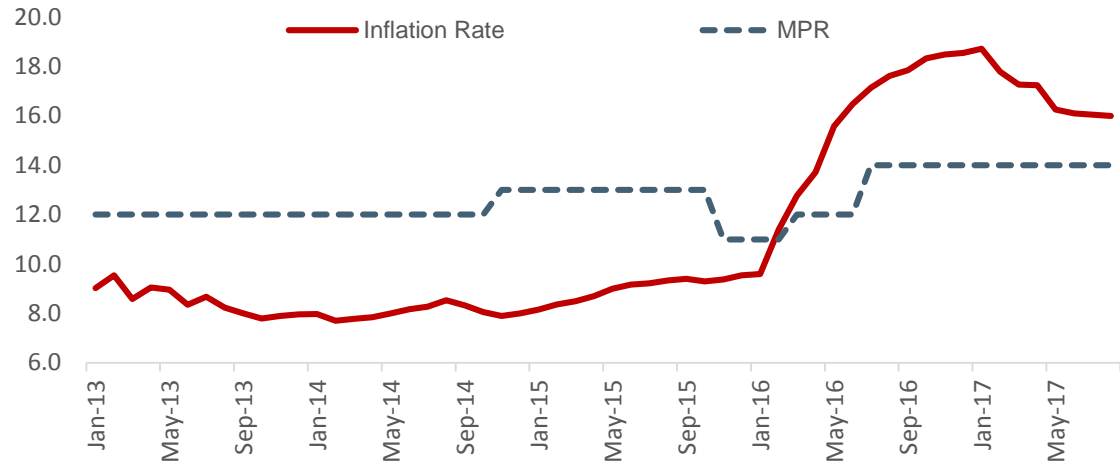
# Monetary Policy



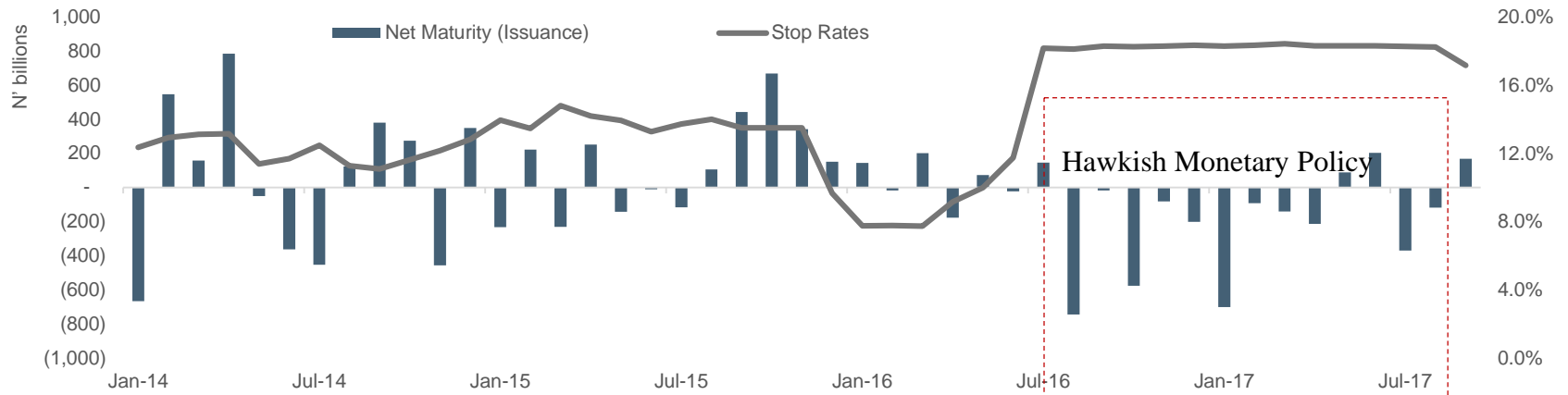
## Is MPC at a turning point?

- The MPC has achieved something impressive - now has markets speculating on its language rather than on actual policy changes.
- This means that its forward guidance is working.
- We expect the MPC to upgrade its assessment of risks in its next meeting, which should guide to an imminent change in policy.
- 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

The argument of trying to ensure positive real returns on investments supported CBN's ongoing monetary policy tightening.



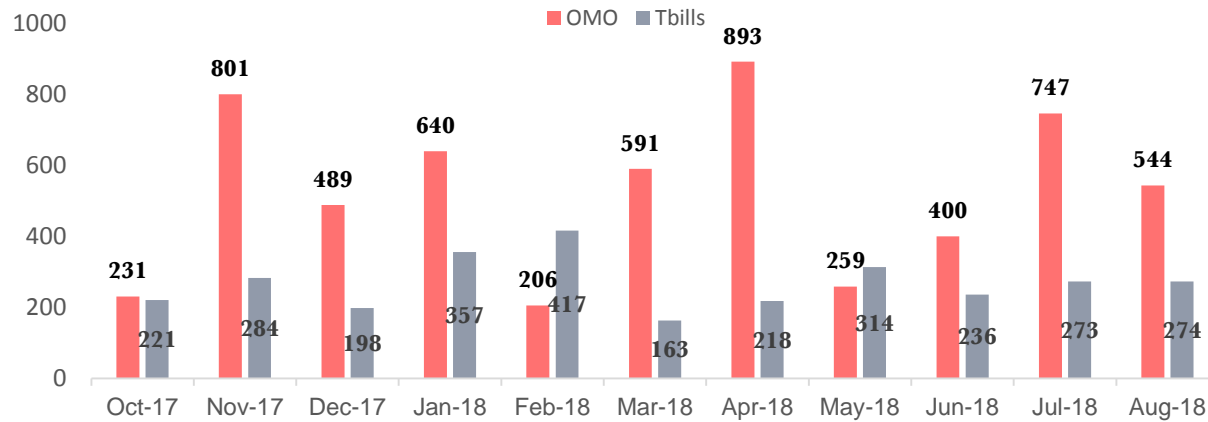
Source: NBS, CBN, ARM Research



Source: FMDQ, ARM Research

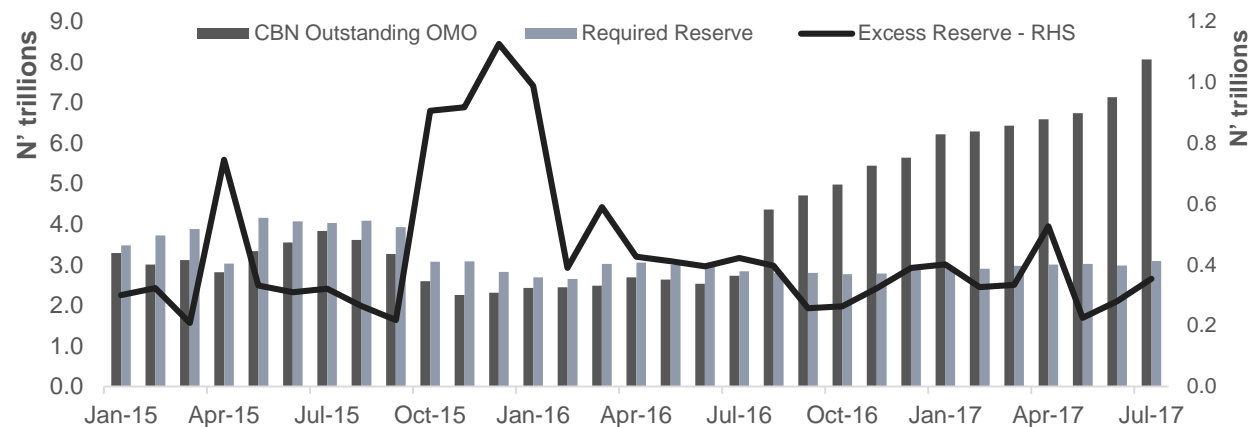
## The case for CRR hike

Maturing OMO & Treasury bills Oct 2017 – Aug 2018 (N'billion)



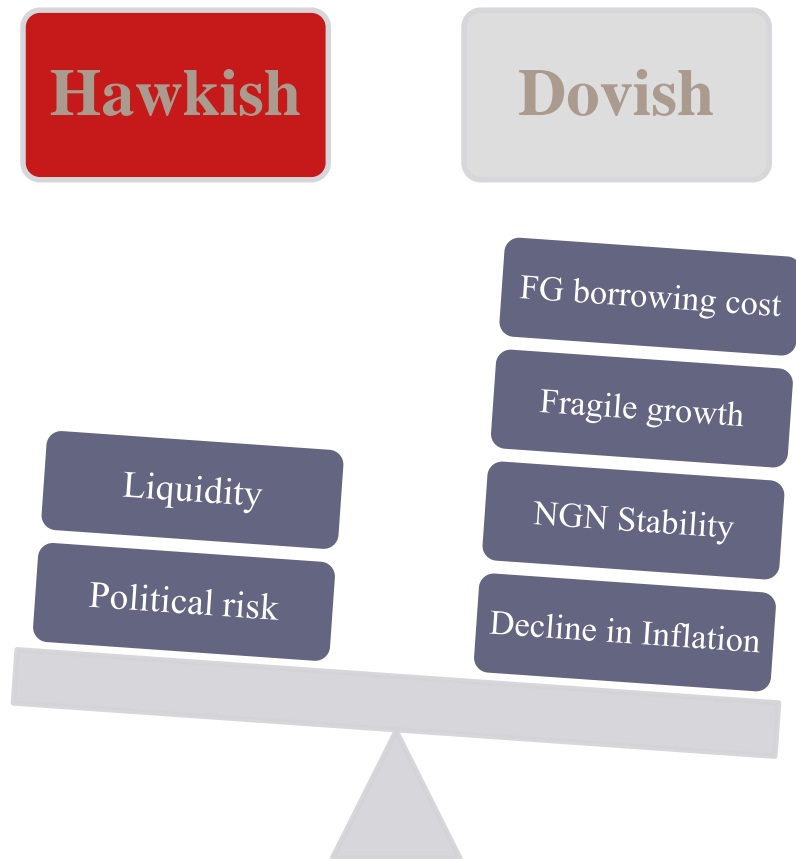
How will the CBN manage this expected liquidity in 2018, if the FG sticks to its path of financing maturing bills via Eurobond?

Source: FMDQ, ARM Research



Source: CBN, FMDQ, ARM Research

## *Balance of factors guides to an accommodative stance in H1 18*

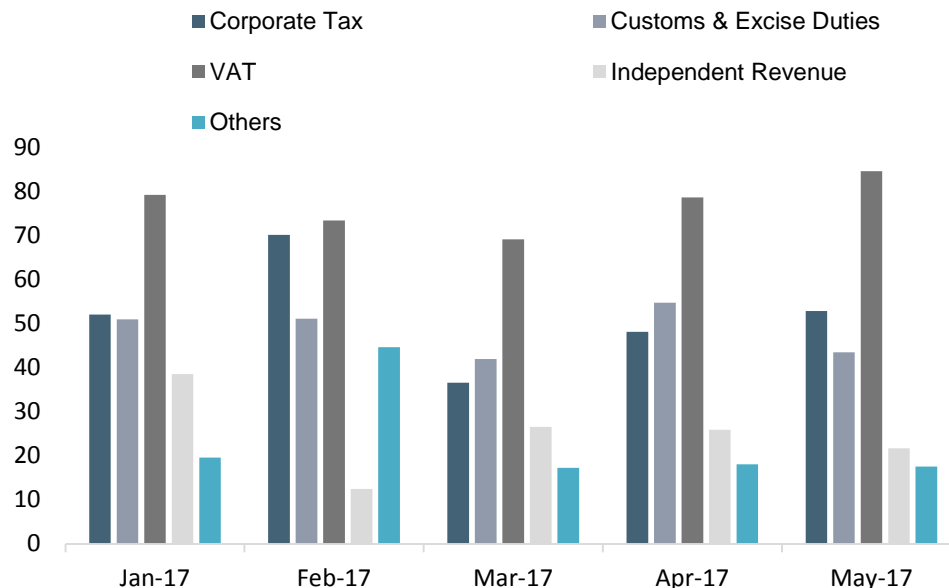


- On balance, comparing the fragile growth picture with expected downtrend in inflation and improved FX picture because of rising dollar inflows with a subsisting CA surplus, we see more scope for the apex bank to ease gradually to support the slow pace of economic recovery.
- In the interim, we expect 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.

## Federal Revenue Growth Shows Signs of Life

- FG’s fiscal deficit printed at N1.828 trillion (~77% of projected fiscal deficit estimate for 2017), largely reflecting sizable revenue shortfalls on the oil and non-oil fronts.
- 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 ~N1.51 trillion over the first seven months of 2017.
- 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 N2.65 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.

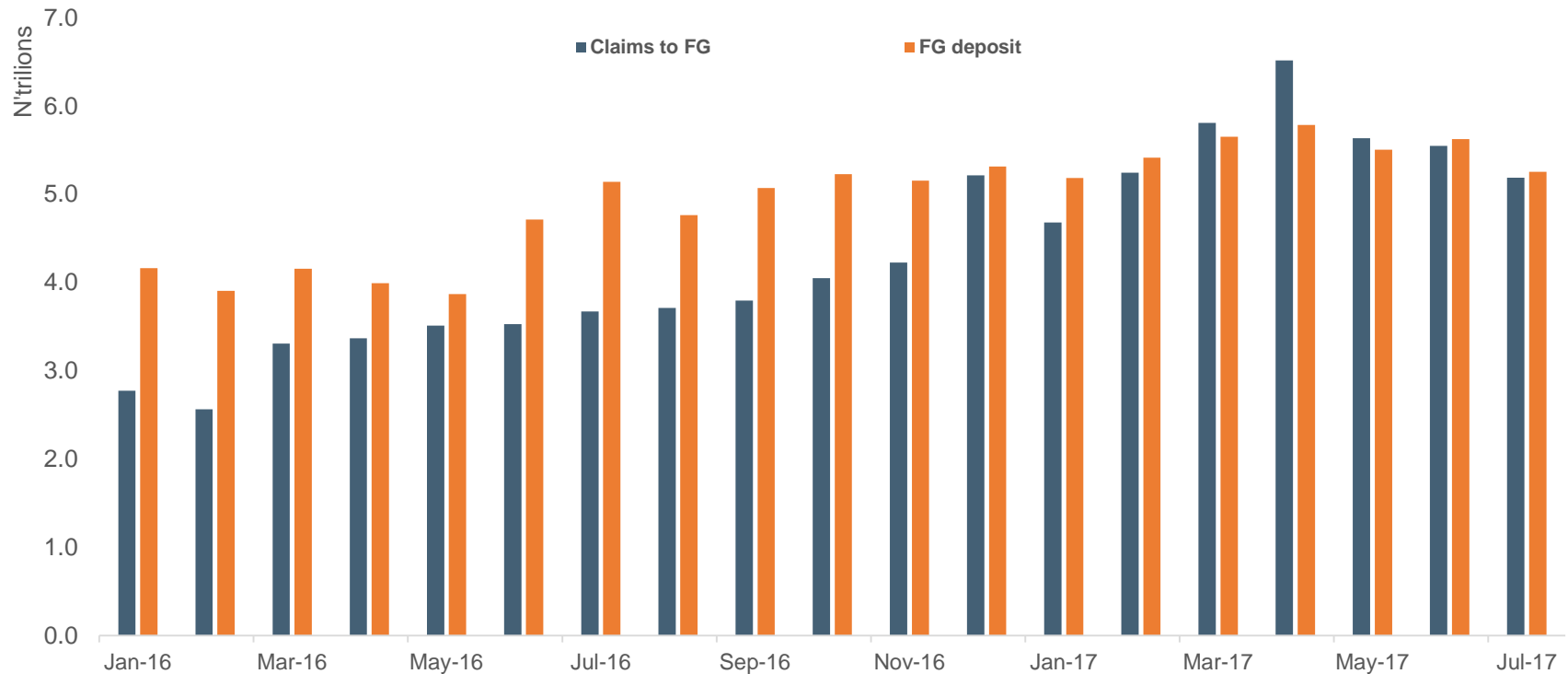
Breakdown of non-oil revenue (N’ billion)



Source: CBN, ARM Research

## No cause for alarm on CBN's financing to the FG

We allay market worries on the 'high' CBN financing to FG. On the back of TSA, FG's deposit to the CBN fully covers the said claims, though higher than the stipulated 5% of prior year's revenue



Source: CBN, ARM Research

### *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.
- 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 scenario suggesting an implied fiscal deficit of N3.4 trillion in 2017E.

	2017	Estimates		
	Budget	Bear	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
<b>Oil and gas receipts (N' billion)</b>	<b>5,080</b>	<b>2,254</b>	<b>4,171</b>	<b>9,756</b>
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
<b>FG Share of oil revenue (N' billion)</b>	<b>2,144</b>	<b>713</b>	<b>1,760</b>	<b>4,117</b>
<b>FG share of non-Oil revenue (N' billion)</b>	<b>1,370</b>	<b>729</b>	<b>825</b>	<b>922</b>
<b>FG independent revenue (N' billion)</b>	<b>808</b>	<b>200</b>	<b>325</b>	<b>450</b>
<b>Other revenue (N' billion)</b>	<b>776</b>	<b>250</b>	<b>290</b>	<b>350</b>
<b>FG Total revenue (N' billion)</b>	<b>5,097</b>	<b>1,893</b>	<b>3,200</b>	<b>5,838</b>
FGN Expenditure (N' billion)	7,444	5,955	6,551	7,444
<b>Fiscal deficit (N' billion)</b>	<b>(2,347)</b>	<b>(4,063)</b>	<b>(3,351)</b>	<b>(1,606)</b>



# CAPITAL MARKET

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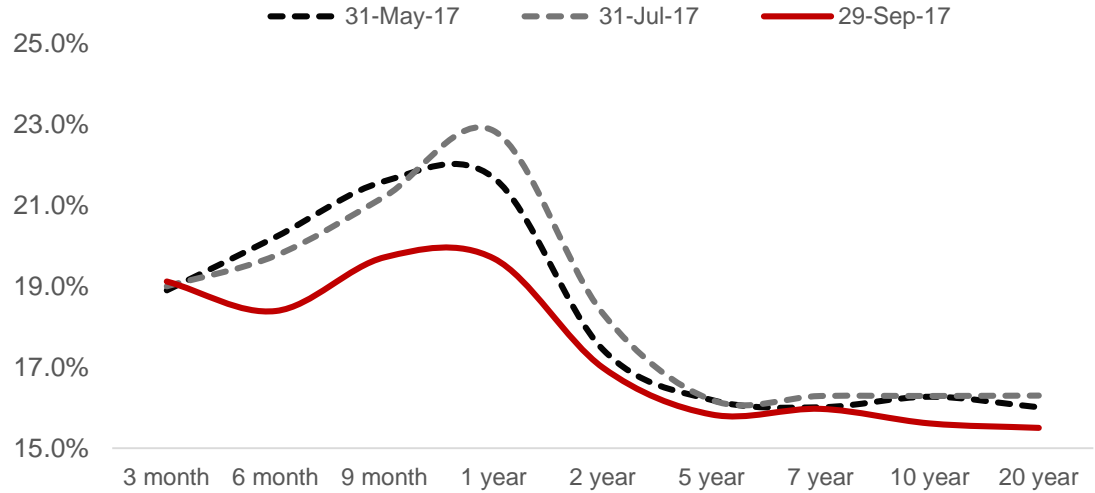
# Fixed Income



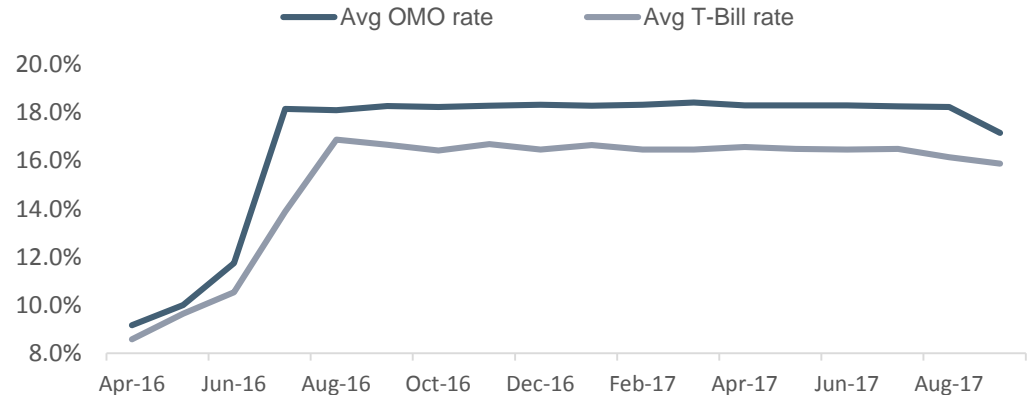
## Yields trend lower as apex bank changed front

- The CBN allowed liquidity build up into massive demand at the PMA
- Largely reflecting the build-up in system liquidity in Q2 (Net OMO maturity of N79.8 billion vs. Net issuance of N933.4 billion in Q1 17), the CBN cut back on rates at its OMO auction in the review period.
- 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.
- 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.

Flattening Naira Yield Curve



Source: FMDQ, ARM Research



Source: FMDQ, ARM Research

### *Rates sensitivity and waning inflation meld into dovish 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, as noted in the fiscal review, we have a base case scenario suggesting an implied fiscal deficit of ₦3.4 trillion in 2017E
- Consequently, we assume a fiscal deficit of N1.6 trillion for the second half of the year.
- Excluding N724billion issued in Q3 2017 (Net T-bill issuances: N318billion, Bond Issuance: N406billion), the FG would need to borrow circa. N900billion over the rest of this year.
- Given the foregoing, we adopt a successful Eurobond issuance of \$2.5billion, translating to N900billion to fully cover our proposed borrowings by the FG and displacing the need for domestic borrowings.
- We go on to provide a further N450billion (Q4 17 Bond issuance: N300billion and Net T-bills issuances: N150billion).
- 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.

### *Go long but be mindful of duration risk*

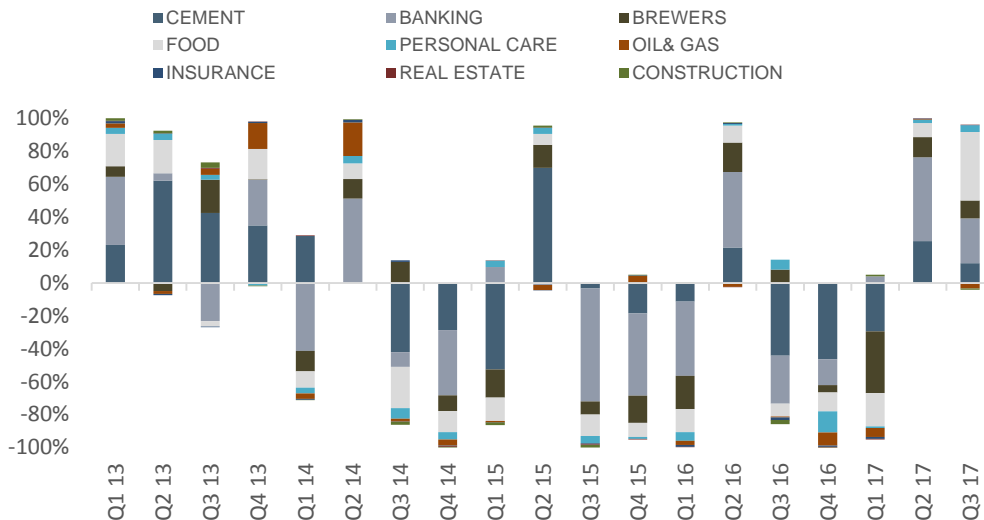


- While we expect a downtrend in the level and slope of the naira yield curve over the next six months, we think beyond the first half of 2018 comes a looming risk that can volte-face our call – political risk gearing towards the election.
- First off, increased electioneering spending—expected to commence 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
- Also, 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.
- 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.
- 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.
- 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.

## Equities set to maintain upbeat momentum

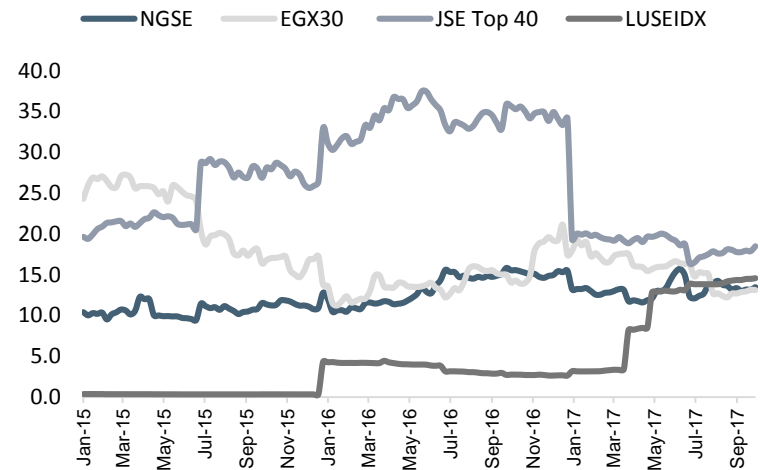
- NSE ASI posted an 8.3% QoQ gain in Q3 17 largely reflecting strong market performance in July (+8.5% MoM) which more than offset weaknesses in August and September.
- Food sub-sector (+29.7% QoQ) had the greatest impact on the equity bourse in the quarter accounting for 49.7% of the uptrend in the 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.
- 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 MXEE (Bloomberg Emerging markets, Europe, Middle East, and Africa Index).
- However, equity investing opportunities look more attractive in Egypt (EGX 30 P/E: 13.1x)

## Attribution analysis of quarterly sectoral performance



Source: NSE, ARM Research

## Historical P/E ratios NGSE vs. African peers



Source: Bloomberg, ARM Research

*Equities to ride domestic and foreign excitements.*

- 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.
- 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.
- With alternative yield-paying investment outlets such as treasuries set to become relatively unattractive, we expect domestic investors to pay greater attention to equities
- On balance, we see improved economic fundamentals and gradual recovery as potential drivers of a bull outlook in the coming months.

# Thank you





## **ARM Securities**

Research	234 (1) 2701653	research@armsecurities.com.ng
Institutional Sales & Trading	234 (1) 448 8833	trading@armsecurities.com.ng
Customer Service	234 (1) 4488282	customerservice@armsecurities.com.ng

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