

Nigeria Strategy Report | Q2 2017 Outlook

Economic Snapshot

March 2017 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	1.7%	17.3%	17.8%
Food	2.2%	18.4%	18.5%
All Items Less Farm	1.3%	15.4%	16.0%
Imported food	1.5%	18.1%	19.4%
Energy	1.4%	22.5%	24.1%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	306.25	0.00%	0.18%
EURNGN	343.74	0.40%	6.31%
GBPNGN	406.47	0.90%	7.06%
JPYNGN	280.00	0.00%	6.46%
Monetary Aggregates – February 2017			
	(₦'bn)	MoM	YoY
M2	22,365	-4.3%	8.5%
CPS	22,362	0.1%	17.4%
NCG	4,408	2.9%	25.3%
NFA	8,547	-11.3%	56.2%
NDC	26,771	0.5%	18.6%
External Position			
	Latest	QoQ	YoY
Trade Balance (\$'mn)	185.73	-21.5%	N/A
External Reserves (\$'mn)	30,975	19.8%	4.3%
Foreign Debt (\$'mn)	11,406	0.9%	10.4%
Growth Data – Q4 2016			
	(₦'bn)	%of total	YoY
Real GDP	18,292	100%	-1.3%
Agriculture	4,662	25.5%	4.0%
Oil	1,338	7.2%	-12.4%
Services	6,865	37.5%	-1.6%
Wholesale and Trade	3,046	16.7%	-1.4%
Manufacturing	1,757	9.6%	-2.5%

Introduction

In this edition of our quarterly strategy report, we take an in-depth look at economic indicators on the global and domestic scenes over Q1 17 as well as isolate influences of more recent developments on our outlook for the rest of Q2 17.

The ever-reverberating twist in global economy was again the toast of discuss over the past quarter, with investors ruminating over fledging recovery in advanced economies and what turned out to be a mixed growth picture for Africa. On the former, a combination of healthy jobs data and rising inflation in the US, export-led growth in Japan, as well as a shock economic expansion in the Euro zone appears to have catapulted economic growth expectations across DMs to a place of relative comfort. Elsewhere though, dour outlook for soft commodities in the aftermath of the El-Nino weather shock, which once provided inorganic support for CPO and rubber prices, and broadly expanding oversupply picture appear to have thrown a spanner into growth works across emerging and frontier economies with Sub-Sahara Africa (SSA) indisputably on the receiving end. Expectedly, with the possible surge in commodities' output expected to compete for an increasingly constrained market demand, the IMF swiftly revised its 2017 growth expectation lower for the region. Amidst this broadly weaker macro tapestry, recent resurgence in crude price should dovetail to slight rechanneling of growth pressures from oil-led SSA economies to their oil importing counterparts.

However, near term growth in the latter should be protected by relatively stable currencies, lower inflation, improved agricultural production and large infrastructure programs built over the last three years of soft crude oil prices.

Against this backdrop, this report seeks to distil possible pass-through to a Nigerian market fettered by a three-quarter old economic recession for which emerging forward indicators have failed to provide tangible hopes for forbearance despite sustained gains in oil prices and a CBN-induced improvement in FX liquidity. On the issue of currency, the apex bank's reversion from a celebrated entry into a fully float regime to a controlled float in less than 3 months is hardly news. Thus, our research focuses more on the sustainability of ongoing market interventions as well as a realistic fair value for the naira. By way of linkage, we also investigate the implications of currency developments on overall inflation basket with keen attention paid to an over six month's old food demand pressures from neighboring West Africa. Perhaps adding more strength to our enquiry is the conscious effort made to situate Nigeria's economic dilemma in the context of its volatile socio-political environment that could very easily revert to boiling point if the shenanigans embroiled in the last two gubernatorial elections and the characteristic unpredictability of the Niger Delta is anything to go by.

Review of Global Economy and Markets

Global recovery shrugs political worries

Global financial market closed the first quarter of 2017 on a positive note (MSCI World Index: +5.9%) despite lingering geopolitical tensions, as optimism on US growth prospects and sustained pace of economic recovery elsewhere boosted investors' confidence. Particularly, despite Brexit worries and political concerns ahead of the Dutch, French, and German elections, which were meant to weigh on output, the Eurozone economy expanded 0.4% QoQ in Q4 16 (unchanged from prior quarter) even as improved net exports¹ and resilient household consumption drove a faster growth in the growth in the United Kingdom (Q4 16: +0.7% QoQ, Q3 16: +0.6% QoQ). Elsewhere, Japan recorded its first 'fourth consecutive

¹ The weaker pound partly boosted UK's net trade position

quarterly growth in three years' as higher exports, government spending and non-residential investment buoyed output in Q4 16 (+0.3% QoQ). Though growth in the United States eased off its Q3 16 peak of 3.2%, an annualized economic growth of 2.1% in Q4 16, robust jobs data² and rising inflation², all of which painted a strengthening economy, underpinned the US Fed's second rate hike in 3 months in March (+25bps).

Economic picture also improved across emerging markets with as a rebound in China's GDP from multi-year lows of 6.7% YoY in Q3 16 (Q4 16: +6.8% YoY, Q1 17: +6.9% YoY) combined with Russia's first economic growth in eight quarters (Q4 16: +0.3% YoY) trumped demonetization-induced slowdown in India (-40bps from prior quarter to 7% YoY in Q4 16) and sustained economic contraction in Brazil (Q4 16: -2.5% YoY). Specifically, the Chinese rebound mirrored higher investments and a greater industrial output and government spending while gains in Russia remained consistent with the country's monetary easing (-50bps QoQ to 10% in Q4 16)³. Against these backdrops, the World Bank, projected a 2.8% QoQ growth in global output in Q4 16 (2016: +2.3% YoY). Perhaps a more lucid backing to this upbeat expectation is a robust global manufacturing PMI of 53 in February—a reading unchanged in March—and printing at the indicator's highest level in over 69 months. Relatedly, and further aided by strong readings on the Services end⁴, the IMF revised its global growth projection to 3.5% in April (+10bps from its October 2016 forecast). This upward revision largely reflects better than expected output in advanced economies (+20bps from October forecast to 2% YoY) with Japan⁵ and the US⁶ notable contributors.

² March Unemployment rate of 4.5% is near a decade low while March inflation of 2.4% is higher than the US Fed's target

³ The Bank of Russia again lowered its benchmark interest rate to 9.75% (-25bps) in March

⁴ Global Services PMI sustained its expansionary trend over the prior 91 months at 53.6 in March

⁵ Japan is expected to further benefit from higher net export and government spending

⁶ United States is expected to be driven by expansionary fiscal policies and improved manufacturing output

Figure 1: Q1 17 equity and currency performance of selected countries



Source: Bloomberg, ARM Research

Going forward, we expect these growth prospects to engender greater appetite for global risk assets. However, prospects of further rate hikes in the U.S could negatively impact EM currencies, even as political considerations in Europe (elections in France, Britain, and Germany as well as Brexit negotiations), rising geopolitical tensions in Asia (Syria and Korean peninsula) trigger volatilities across financial markets over the rest of the year.

Resurging commodity prices tilt SSA growth higher

After decelerating 180bps from an average growth of 5% in prior five years to 3.2% in 2015, Sub-Sahara Africa (SSA) growth decelerated to a 21-year low of 1.3%⁷ in 2016, re-highlighting impact of the end of commodity super cycle. Precisely, dour performance from commodity giants such as Angola, Nigeria and South Africa (~60% of SSA GDP) stoked subdued growth across the zone, with the latter and a few other key East African countries (Ethiopia, Mozambique, and Uganda) experiencing severe drought due to the El Niño weather phenomenon which prompted a decline in agricultural production and cutback in hydroelectric generation. On the former, Angola's GDP stagnated while growth contracted in

⁷ According to the IMF

Nigeria (-1.5% YoY) largely reflecting impact of lower crude oil prices and weaker production. The decline in Angola's crude production reflected price induced slowdown in investment while material militant incursion on oil and gas infrastructure weighed on production in Nigeria. In South Africa, GDP printed at its weakest level in seven years in 2016 owing to the aforementioned declines in agricultural output, deterioration in political environment, and unfriendly investor policy environment which cascaded to two major credit rating downgrades⁸ in March and April. Elsewhere, whilst other commodity exporters, particularly exporters of metals, also struggled to adjust to softer prices, non-resource intensive economies such as Ethiopia and Tanzania continued to grow above 6% due to benefits from lower crude price-induced energy savings, strong infrastructure investments and healthy private consumption.

Amidst the relatively improved risk environment, Africa bourses closed higher (S&P All Africa Index: 5.7% Q1 17) as gains in Ghana (+10.4%), Egypt (+5.3%), South Africa (+2.9%), and Tunisia (+1.0%) outweighed losses from Nigeria (-5.1%) and Kenya (-9.9%). To our minds, improved equity performance in the period was reflective of impact of relatively upbeat growth momentum on consumer confidence. In addition, currency have fared relatively better in 2017 after a deplorable 2016 with the Egyptian pound down only 0.2% after the country's pro-market switch to currency floatation. Elsewhere, the South African Rand rode sustained monetary easing across Europe and expectations of relatively subdued interest rate adjustments in the US to record a 2.4% gain over Q1 17. Going forward, we expect growth rates to vary across countries in Africa with recovery in crude oil proceeds slightly shifting pressures from SSA oil producers to SSA oil importers such as Côte d'Ivoire, Kenya and Ethiopia. Irrespective, near term growth in the latter is expected to be protected by stable currencies, lower inflation, improved agricultural production and large infrastructure programs built over the last three years of soft crude oil prices. Elsewhere, North Africa is expected to post strong growth in 2017 owing to improving crude production from Libya with IMF's latest review implying a 460bps upward growth adjustment to 10% for the sub-region.

⁸ S&P and Moody's

Push-pull factors strengthen FPI flows

Despite two rate hikes in the US and lingering political concerns across Europe, FPI flows to emerging markets (EM) hit a ten-quarter high of \$61 billion (+141% QoQ) with net portfolio inflow of \$29.8 billion in March been the highest in fourteen months. The strong capital flows to EM markets reflected recovery in commodity prices (GSCI: +5.1% QoQ), but to a greater extent, broader economic recovery across EM markets. In addition, a more dovish outlook by the FOMC on interest rate trajectory fueled appetite for risk assets, with the IIF reporting an upsurge in flows after the rate normalization in March. In terms of asset classes, FPI flows to EM equities and bonds came in strong at \$35.7 billion (Q4 16: \$3.8 billion) and \$26.8 billion (Q4 16: net outflow of \$29 billion) respectively while, EM Latin America experienced the biggest inflows based on region. Argentina (\$17.5 billion) and Brazil (\$14.4 billion) were biggest destination for foreign flows following implementation of pro-market reforms and improved political stability, especially in the case of the latter. Across Africa, FPI flows also improved as uptick in commodity prices and sustained monetary tightening boosted investors' confidence. Hence, despite currency concerns in Nigeria, FPI inflow of \$256 million over the first two months of 2017 is 22% higher YoY—though still significantly below trend levels, while despite deterioration in South Africa's political environment, the pace of net FPI outflow subsided (-76% QoQ to -\$1.2 billion in Q1 17). The picture was much better with dollar denominated debt as strong foreign appetite ensured Eurobond issuances by Egypt (\$4.0 billion) and Nigeria (\$1.0 billion) were both oversubscribed by 3.5x and 7.8x respectively.

Going forward, we expect recent slowdown in US economic activities to temper the scope of monetary tightening in the country which together with sustained monetary easing in Europe and Japan on one hand and upbeat economic fundamentals in EM markets on the other to sustain the positive momentum in portfolio flows over the near term. That said, likely deterioration in conflict in the Asian Peninsula or election of anti-EU candidates in France or Germany could trigger a temporary flight to safety. Across Africa, we expect a mixed movement in capital flows as ratings downgrade of South Africa credit rating should spook investors while improved FX supply in Nigeria should improve demand for naira assets.

Commodities market Review

Crude price goes from bang to whimper on untempering Shale

Despite the double whammy in the crude oil market, we believe the market remains on track for rebalancing in 2017 as near term bearish sentiments continue to shove crude oil prices pending further impetus from fundamental. On the heels of a bull run in H2 16 (+14.4% to \$56.82/bbl.)—following OPEC’s production cut in November 30 which saw crude price track higher in December (+12.6% MoM), Brent crude commenced 2017 on a soft note with prices sliding 2% to \$55.7/bbl. in January. This moderation was pinned to faster than expected increases in oil inventories and production in the US. In addition to rising shale production, a stronger dollar also supported the bearish run in the crude price, albeit subsequently moderated by lower crude oil productions from OPEC countries (-900kbpd QoQ) and Russia (-100kbpd QoQ) which saw crude prices close marginally lower in February (-0.2% to \$55.59/bbl). That said, a March recovery in US crude stocks⁹ compounded re-invigorated downward pressures on crude prices. Consequently, Brent prices closed Q1 17 7% lower QoQ to \$52.83/bbl.

Away from impact of investor expectations, actual global demand remained relatively upbeat in Q1 17, slowing only 0.7% QoQ to 95.4mbpd after cutback in demand from OECD and other regions. Specifically, OECD demand contracted 30kbpd owing to declines in Europe’s crude oil consumption (-270kbpd to 13.7mbpd).¹⁰ In addition to this, mounting sales of alternative-fuel vehicles—a product of improving government backing—and extended turnaround maintenance for US refineries further accentuated squeeze on crude demand. Elsewhere, slower demand in India and China underpinned a mild contraction in non-OECD demand (-680kbpd). On supply, OPEC and non-OPEC outputs declined 3.4% and 0.4% (QoQ) in the review period following syndicated supply cuts across the industry.

⁹ US crude stocks rose for the ninth straight week to 528 million barrels even as US shale production increased 109kbpd to 4.96mbpd—compounding the downtrend in crude prices in March

¹⁰ Lower European crude production reflected fall-outs of Brexit and uncertainty in the Euro area

Booming Shale poses risk to OPEC supply cut

In view of elevated prices over Q1 17 (average: \$54.60/bbl.), US oil producers became fully active with associated rig counts rebounding (+31% QoQ to 688) and crude inventories touching a record high of 532m/bbl. In addition to this, the US had a record number of contracts on short positions against the WTI in the period. Elsewhere, the energy policies of the Trump administration, in relation to the removal of regulatory/environment roadblocks which has forced the opening of more onshore and offshore leasing on US federal lands and waters to oil exploration as well as relaxation of restraints on US energy exports, supported US production (+10% QoQ to 9.25mbpd). Overall, we think a renaissance in US shale production could cap the OPEC-induced crude price rally. Perhaps providing further backing to this position, the U.S. Energy Information Administration (EIA) said it expected full year 2017 production to average only 9.2mbpd (+8.3% YoY) which amounts to circa 60% of the OPEC cut.

Will extension in OPEC cut support crude oil prices?

Going forward, the big question is whether OPEC will extend ongoing production cut at its next meeting on May 25. To start, given the influence of Saudi Arabia on the cartel, we look to the kingdom's body language in relation to expectations of further production cut. Indeed, Saudi Arabia and OPEC's technical committee continue to reference global crude inventories relative to five-year average as a gauge of rebalancing. Thus, with global inventory unlikely to fall that much before May, it is our view that an extension of the productions cuts seem inevitable. Basically, the combination of high global inventories and recent oil price weakness should prompt OPEC to extend its production cap through the end of the year. Looking at the demand picture, EIA projects a rise in demand to 1.4mbpd in 2017 supported by China and India. Thus, largely reflecting expectations for an extension of OPEC's cut as well as the possible rebalancing, we are still positive on oil prices over 2017. However, an extension in cuts and a tighter oil market would put upside pressure on prices and could encourage an even steeper rebound in US oil output. Based on the foregoing dynamics as well as immediate impact of an OPEC cut extension, we envisage that the steady rebalancing of the crude markets should cause prices to trend higher in Q2 17. Brent crude prices averaged

\$54.60/bbl. in Q1 17, we see a slight uptick keeping crude oil prices at \$55/bbl. in Q2 17.

Surplus picture sustains bearish trend in soft commodity prices

Growth in global soft commodity prices was muted in the early months of 2017, with the S&P GCSI Agriculture index rising only 0.06% YTD (2016: +2.6%). To our minds, tame growth in commodity prices reflected pass-through from weather-induced increases in production and inventory levels which reversed earlier commodity price gains. A scan through our coverage commodity universe reveals that surplus picture across CPO, sugar, cocoa, barley and rubber markets was the trigger for bearish undertone in commodity prices.

Figure 2: S&P GSCI agriculture index



Source: Bloomberg, ARM Research

Specifically, CPO prices turned bearish (-13.9% YTD) due to a rebound in production levels in Southeast Asia following recovery from El-Nino weather shock. Also, aiding the price moderation were slowing demand from major importers (India and China) and global oversupply of edible oils which are effectively substitutes to CPO. In a similar vein, contraction in cocoa prices (-8% YTD) was stoked by benign weather conditions, bumper harvests, elevated inventory levels and political stability in Cote D'Ivoire which bolstered outlook for production levels.

Akin to CPO and cocoa, sugar prices (-17.75% YTD) also turned bearish following reports of weaker demand as well as stronger output from Brazil with Thailand's decision to auction off 107,000 tonnes of rubber acquired at weaker prices also flinging rubber prices into red zones (-29.7% YTD). Elsewhere, oversupply also weighed on barley prices as elevated inventory levels, favourable weather conditions, greater availability of pasture and competing feedstock for livestock worsened investor sentiment towards the commodity. That said, wheat prices however bucked the bearish commodity price trend following its 6.9% YTD growth driven by significant fall in US' wheat planting area, unfavourable weather conditions in the Americas and Europe and rising demand. Our overall outlook on soft commodities remains bearish as we expect the impact of improved weather conditions to drive stronger harvests and further exacerbate the impact of elevated inventory levels. In addition, weakening demand from consumers in key markets¹¹ should also weigh on bargaining power of key commodity producers thereby exerting additional layer of pressure on commodity prices.

Key Developments in Domestic Economic and Policy Environment

Nigeria attempts mission complicated amidst fragile socio-political milieu

After overcoming wrangling over the contentious 2016 budget, which was undermined by delayed presidential assent that left it ham-fisted to lift the country out of recession, Nigeria appears to be facing fresh challenges with the successor appropriation bill. Specifically, the National Assembly only recently communicated intentions to pass the 2017 budget before May 2017- one and two months later than in 2016 and 2015 respectively with hard realities also threatening to taper optimism for early budget passage even further. First, as at the last working day of April, the Senate committee on Appropriation was yet to get reports from all standing committees on the 2017 budget with the legislature quick to pin the delay to the

¹¹ particularly China and India

seizure of essential documents by the police high command following a reported whistle blowing. The ongoing fracas assumes extra importance when viewed against the backdrop of traditional delays in obtaining executive approvals for budget documents—especially after wholesale amendments by the Nigerian National Assembly. Indeed, the delays could gradually stifle optimism over the execution of major programmes and projects in the current year with forward indicators (such as PMI) suggesting that a whole lot more needs to be done to attain what now appears like an overly ambitious ERGP growth target of 2.17% YoY over 2017. This is even as the sustained saga over the president’s health offered ample distraction to overall policy direction with the vice viewed to be more pro-market inclined.

On growth, perhaps a more compelling concern is the sustained militant activities in the Niger Delta Creeks. For one, the Trans Forcados—Nigeria’s largest crude export terminal—is yet to re-open even after long-winded guarantees and assurances from major stakeholders. Elsewhere, latest NNPC reports¹² indicate further onslaught on oil and gas infrastructure with shutdowns in Trans Niger Pipeline (TNP) and Nembe Creek Trunk Line (NCTL) as well as subsisting force majeure at Brass Terminal providing scanty support for FG’s campaign. Although more recent releases from OPEC indicate steady increases in Nigeria’s rig count relative to Q4 16 (+11% to 25.5 over Q1 17¹³), the level of activities in the oil and gas space remain considerably muted (-6% YoY) relative to 2016 with stakeholders still skeptical of the volatile oil-rich region. Added to the highlighted challenges is the build up to the coming governorship election in Anambra state which promises to be equally enthralling if the heightened political shenanigans at the last Ondo and Edo gubernatorial elections are anything to go by. On the Niger Delta, while we still see enough in FG’s current efforts to suggest that further improvements in Niger Delta security may not be farfetched—given the declines in pipeline vandalized points, we remain wary of the security situation in the volatile region with key onshore and shallow water assets still within purview of militant attacks.

¹² January 2017

¹³ January and February 2017

Revenue slippages drag fiscal deficit to six year high

In line with prior eight quarters, Q4 16 gross federally collected revenue fell 14.4% YoY to ₦1.2 trillion as oil and non-oil proceeds maintained a contractionary trend over the period. Fallout of the weak receipts from both sources was fairly evident on FY 16 gross federally collected revenue which declined 17.4% YoY to ₦5.0 trillion—lowest in over six years. Across income sources, oil receipts dipped 19.4% YoY to ₦654 billion (FY 16: -28.2% YoY to ₦2.7 trillion) in Q4 16— as production shortfalls (-18% YoY) springing from continued attacks on oil installations more than offset the combined effect of higher than projected crude oil prices (+13.8% YoY to \$49.91/bbl vs. budgeted \$38/bbl.) and weaker exchange rate (-21.5% to ₦253.49/\$ vs. assumed ₦199/\$). Elsewhere, though weaker corporate taxes in Q4 16 drove a contraction in gross non-oil revenue (-7.8% YoY to ₦525 billion), however improved picture over 9M 16 kept FY 16 reading in the positive territory (+0.1% YoY to ₦2.2 trillion).

Interestingly, despite the steep contraction in gross federally collected receipts in Q4 16, FG's retained revenue rose 8% YoY to ₦804.6 billion (FY 16: -7% YoY). On the expenditure leg, total expenditure in Q4 16 was largely unchanged from the prior year at ₦1.5 trillion as cutback in CAPEX (-12.8% YoY to ₦404 billion) neutered effect of higher recurrent expenses (+12.9% YoY to ₦997 billion). Hence, largely reflecting improved FGN retained revenue, the fiscal deficit over Q4 16 declined 7% YoY to ₦681 billion. That said, full year 2016 fiscal deficit of ₦2.3 trillion (+51% YoY) is the highest in six years. The record deficit reflected the impact of lower retained revenue (-6.5% YoY to ₦3 trillion) on one hand and higher capital (+12.3% YoY to ₦919 billion) and recurrent (+7.4% YoY to ₦3.9 trillion) expenditure on the other.

Going forward, rising oil prices (Q1 17: \$51.77 vs Q4 16: \$49.91) and gains from a weaker currency (-38.1% YoY, budget estimates: ₦305) and improved crude production point to higher oil receipts relative to 2016 levels. On the non-oil leg, prevailing macroeconomic headwinds should underpin weaker corporate profitability in 2017 and translate to lower receipts from Company's Income Tax. The same applies to incomes from Customs and Excise Duties as well as Value Added Taxes (VAT) where below-trend import levels and economic activities

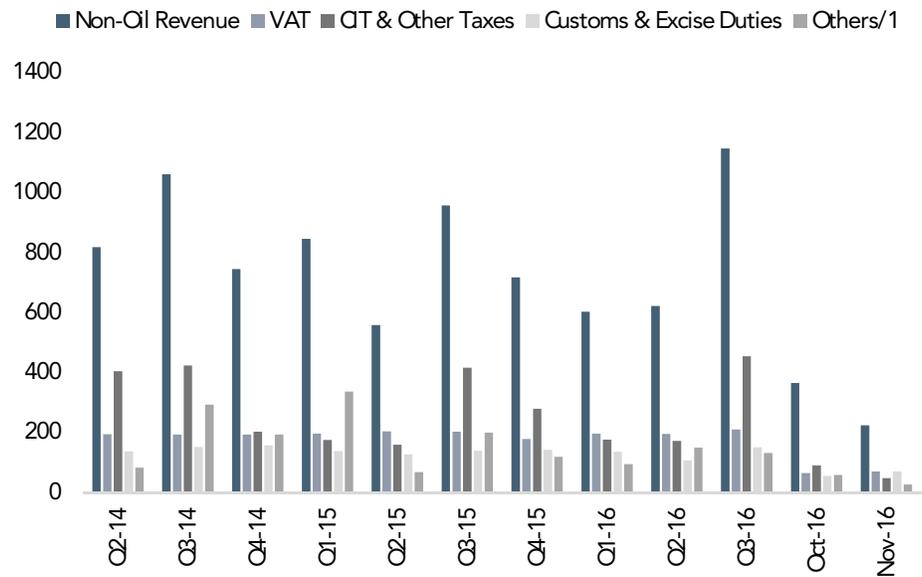
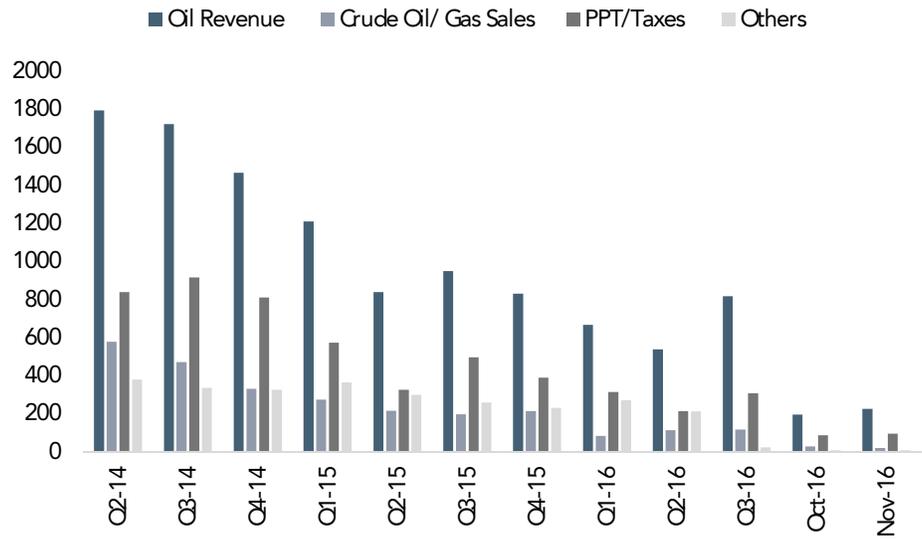
underpin our bleak outlook. In line with Q1 17, we expect soft revenues in the non-oil sector to filter through to retained revenues which placed alongside projected FG expenditure of ₦7.3trillion culminates in a deficit of ₦3.2trillion (₦3.2 trillion previously)

Table 1: 2017 Federation revenue budget vs ARM revised estimates

	2017		Estimates	
	Budget	Bear	Base	Bull
Oil production (mbpd)	2.20	0.80	1.98	2.20
Oil price (\$/bbl)	42.50	30.00	55.00	60.00
Exchange rate (N/\$)	305.00	305.00	330.00	450.00
Oil and gas receipts (N' billion)	4,684	1,202	5,903	9,756
Deductions				
JV Cash calls (N' billion)	-	301	-	-
13% derivation (N' billion)	609	117	767	1,268
Net Oil Revenue (N' billion)	4,075	785	5,135	8,488
FG Share of oil revenue (N' billion)	1,976	380	2,491	4,117
FG share of non-Oil revenue (N' billion)	1,370	729	825	922
FG independent revenue (N' billion)	808	213	323	404
Other revenue (N' billion)	776	356	454	776
FG Total revenue (N' billion)	4,930	1,679	4,093	6,218
FGN Expenditure (N' billion)	7,298	7,298	7,298	7,298
Fiscal deficit (N' billion)	(2,368)	(5,619)	(3,205)	(1,080)

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

Figure 3: Nigeria's oil and non-revenues in 2016



Source: CBN, ARM Research

Economic Review and Outlook

Economic recovery still underway

Following the release of Q4 16 GDP numbers (-1.3% YoY), emerging signals indicated that the pace of recession was slowing and we look for growth to eventually return from Q2. Precisely, over Q4 16, the pace of Nigeria's economic contraction slowed from the 2.2% YoY decline recorded in the preceding quarter to only -1.3%, as slower contraction in oil GDP (-12.4% YoY) tapered pass-through from reversal to negative growth in the non-oil front (-0.33% YoY). Tamer contraction in the former was consistent with a fragile truce in the Niger Delta which supported repair works on some key oil and gas pipelines and bolstered crude production (+16.5% QoQ to 1.9mbpd). This was even as the FG intensified conciliatory efforts that led to a nosedive in the number of vandalized pipeline points to 18 (from over 200 in January 2016). At the other end, after eking out a tepid expansion in Q3 16 (+0.03% YoY), Non-oil GDP was hauled back to negative growth by steeper decline in Services (Q4 16: -1.6% YoY, Q3 16: -1.1% YoY) and slower growth in Agriculture (Q4 16: +4.0% YoY, Q3 16: +4.5% YoY). Services contraction stemmed from a sharper weakening in real estate at -9.3% YoY (Q3 16: -7.4% YoY) which is reflective of the pressures in ancillary sectors: Building & Construction, and Cement even as Urban office rentals remained under chains. Overall, the dip over Q4 brings 2016 real GDP growth to -1.5% YoY—the first contraction in 25 years.

Over Q1 17, a charm offensive by the FGN in the Niger Delta region, in lieu of a military option in 2016, reportedly drove stability in oil production from the setback in December (-20% MoM to 1.57mbpd). In addition, the FGN raised proposed amnesty payments in the 2017 budget by over two-fold YoY to ₦65 billion. For us, both tactics should support stability in the volatile region and leave crude production at an average of 1.98mbpd with the possibility of a return to prior year's level of 2.2mbpd in the latter half of 2017 still in the cards. Consequently though, noting that average oil production would have need to surmount the high base of 2.16mbpd—recorded in Q1 16—for GDP to swing back to the positive, we expect another negative growth on the oil front in Q1

17. Unfortunately, dour PMI readings over the first few months of the year also suggest sustained deceleration in non-oil GDP over the last quarter. On the back of the strong correlation between past PMI readings and GDP performances therefore, we see scope for an extension in GDP contraction over Q1 17. Pertinently, given seasonality patterns of quarterly GDP growth in the last three years which suggest that Q1 numbers have printed at an average discount of 13% relative to Q4 numbers, we see legroom for another contraction in GDP in Q1 17 despite gains on the oil front. To be clear, our base case scenario of a 13% discount would imply a 0.5% YoY contraction in real GDP over Q1 17.

Exports switch gear on rising organic propellant

According to data provided by the nation's statistical agency (NBS), Nigeria exited trade deficit in the last quarter of 2016 after posting trade surplus of ₦671 billion (FY 16 deficit: ₦290 billion). This resurgence, which tapered impact of deficits from preceding three quarters, was aided by 53% YoY surge in value of exports to ₦2.98 trillion. Effect of the foregoing neutered impact of sustained rise in imports (+46% YoY to ₦2.308 trillion). At the export end, growth was aided by a 59% YoY jump in value of mineral products exports to ₦2.87 trillion (or +3pps YoY to 96% of total exports) which rendered impact of declines across Vehicles, Aircraft and Parts thereof; Vegetable products; Prepared foodstuff & Beverages, Spirits & Vinegar and Tobacco exports immaterial. Unsurprisingly, gains in mineral products reflected 58% rise in crude oil exports to ₦2.43 trillion as resurgence in global crude prices (+6% YoY to \$49.91) and the revenue-amplifying impact of 55%-naira depreciation trumped continued weakness in oil production (-12% YoY to 1.9mbpd). Elsewhere, movement in import value was characteristically triggered by currency-induced sturdy growth in value of imported mineral products (+128% YoY to ₦724 billion), including refined crude, in the review quarter. In passing, we note that the steep depreciation of the NGN relative to only 46% rise in overall imports suggest that actual imported volume contracted in the review period. Elsewhere though, a similar analysis suggests only slight decline in overall export volumes which could be linked to prevailing motivation from a potential to obtain the expensive greenback. Going forward however, recent production numbers (-12% YoY to 1.9mbpd in our estimates) and recovery in crude prices (+53% YoY to \$51.18 on average) are indicative of a

potential return to strong organic growth in Nigeria's exports in the coming reading. At the other end, improving liquidity in Nigeria—an offshoot of continued CBN dollar sales—should gradually lead to rebound in volume of imports as well as sustain gains in the implied naira value of imports. That said, with most of the gains in dollar availability having trickled in March, the increase in imports is likely to be relatively subdued. On the strength of these, we now see scope for another round of balance of trade surplus in Q1 17.

Food inflation defies the dollar spree...

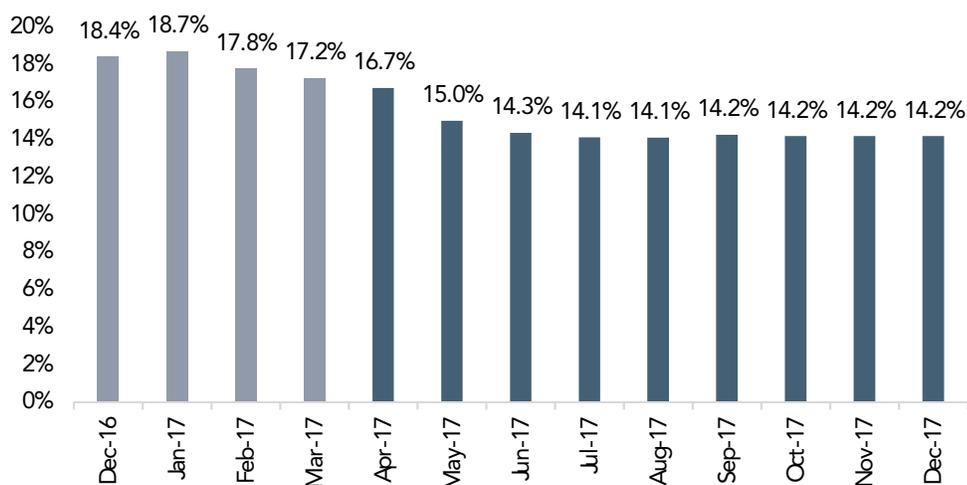
Over the first three months of 2016, Nigeria experienced a moderation in headline CPI (-132bps to 17.25% YoY) as hurdle from 2016 high base took center stage. Notably, the decline was ubiquitous across a few core constituents, with energy-related inflation (-879bps to 22.5% YoY), which houses electricity prices, pulling core inflation to a 10-month low of 15.38% YoY in March. Meanwhile, food inflation (+103bps to 18.44%) tracked higher despite efforts by the FG and CBN to curtail the soaring prices. We had expected FG's imposition of a maize export ban but more importantly naira gains (+21.4% to ₦385/\$) at the parallel FX market—following increased dollar sales (monthly average of \$1 billion since the turn of the year)—to inhibit demand from neighbouring West African countries, and consequently drive food prices lower in March. However, propelled by structural challenges, restriction on use of foreign exchange reserve for food imports as well as higher transactions and transportation cost (March transport inflation: +1.2% MoM)¹⁴, MoM food inflation printed at a ten-month peak of 2.21% (vs. 1.99% in the preceding reading) in NBS' latest filing.

Going forward, we expect impact of high base effect to continue to dictate core inflation and overall headline trajectory despite concerns on the food front. Precisely, high base effect from the 68% hike in PMS prices in 2016 which should completely wane in May 2017 as well as recent gains in Kerosene, and Diesel prices suggest a much-tempered core reading over the rest of the year. However, we are less sanguine on the food side of things over the near term owing to recent pressures from higher transactions and transportation costs. That said, a more

¹⁴ Importantly, MoM transport inflation steadily increased over Q1 17, with the March reading (1.2% MoM) printing at the highest level since July 2016 following price hikes by major transport associations across the country in response to the sharp jump in Diesel prices in December.

recent retrace in diesel prices suggest that pressures on the transport front would be less impactful in coming readings. In addition, the allure of higher domestic prices, cheap financing, as well as FG’s continued push on the Anchor Borrowers Program which should incentivize production are notable signposts of gradual near and medium term gains relating to domestic food availability respectively. On the balance, we hold out for mean inflation of 15.4% over 2017 (2016: 15.6%).

Figure 4: Inflation forecasts



Source: NBS, ARM Research

Convergence on the horizon?

On the back of 53% NGN nosedive over 2016 which had provoked CBN’s tilt back to a managed float regime, naira remained stable at Nigeria’s interbank market (-0.5% from 2016 end to ₦306.40/\$) in Q1 17. Whilst the policy reversion (from a fully floating regime) should ordinarily have worsened dollar illiquidity in the FX market—as foreigners’ become increasingly worried of clogs to capital repatriation, the apex bank’s policy tweaks to the FX market including suspension of the 60:40 FX allocation rule in favour of the manufacturing sector and resumption of direct dollar injection to the so called “invincible market” (BTAs, PTAs, medical and educational fees) helped reduce dollar scarcity over the review period. More importantly, riding the relative comfort of steady gains in the FX

reserve¹⁵, amid higher crude oil proceeds and inflows from inorganic sources¹⁶, the apex bank raised its dollar sales (forward, interbank spot market¹⁷ and BDCs¹⁸) which underpinned a 21% naira appreciation at the parallel market over Q1 17. Consequently, the premium between the interbank and parallel market plunged to 26% (from 61% at the end of 2016). However, amidst calls from international organizations including the IMF and World Bank for a further depreciation (10%-20%) in the interbank naira rate of N305/\$—a move that should further discourage portfolio flows to naira assets—, a key question to investors is what the realistic fair value of the greenback is. To answer this question, we re-invoke quarterly REER data on the NGN from IMF over the last three decades to apply the Purchasing Power Parity (PPP) concept which holds that currencies gravitate towards their long run mean over time. On extrapolating into nominal terms, the long run REER average for the naira would correspond to an exchange rate of ₦351.07/\$, which confirms that the current interbank naira rate, which falls outside the acceptable EM/frontier market band of +/-10%, is slightly overvalued. On this wise, CBN's execution of an increasing number of FX interventions at ₦360/\$ suggest that it may well have realistically assessed the possibility of a naira devaluation to levels consistent with this long run naira REER—providing some backing to our oft noted expectation for an eventual naira devaluation (to ~₦360/\$) by YE 2017.

At the other end, the apex bank in late April introduced a new FX window for investors and exporters (IEW), which seeks to deepen FX market and ensure timely settlement of eligible obligations via FX supplies from portfolio investors, authorized dealers, and other parties. In addition, the apex bank expects the launching of the window to help formalize and properly re-channel autonomous dollar inflows (~56% and ~19% of total dollar inflows and outflows respectively). Given that the rate at this window is expected to be market determined with ongoing rates of ₦380/\$ close to the parallel market rate, —a mark that investors reference rates in the parallel market for fair valuing the naira— we believe the apex bank has a greater incentive to ensure currency stability in the parallel

¹⁵ Nigeria's FX reserves have risen by 17.9% since December 2016 to \$30.8 billion at the end of April 2017

¹⁶ The apex bank reported a \$3.3 billion inflow from other official receipts over the five months ending February 2017, nearly two-fold higher than the preceding five months

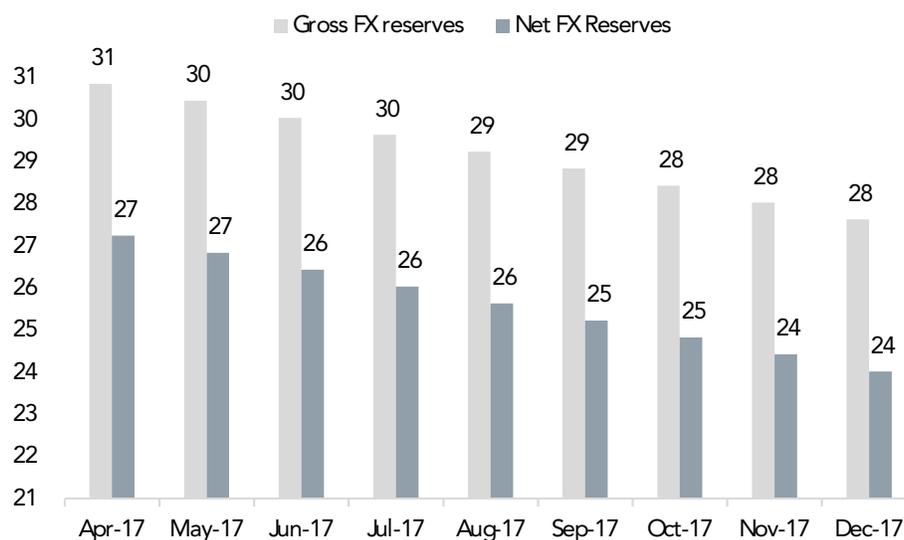
¹⁷ FX sales of \$157 million over the first two months of the year is 51% higher than total sales in Q4 16

¹⁸ Combined sales of \$131 million over and January and February 2017 was more than two-fold higher than sales in 2016

market, hence the need for sustained dollar sales. In analyzing the potential quantum of CBN's FX sales, we reviewed dollar inflow and outflow patterns over prior years, as well as expectations for same going forward, with a view to ascertaining impact on the nation's reserve—a partial indicator of how deep down the rabbit hole the apex bank could be willing to travel, in our view. As per specific assumptions, we believe that, in addition to the potential \$2.2billion inflow from external borrowings (Eurobond: \$1.5 billion, Diaspora: \$300 million, AfDB: \$400million), Nigeria should be able to rake in \$12.5 billion in oil inflow over 2017 (+23% YoY), reflecting a base case oil production for 2017 to 1.98mbpd (2016 average: 1.83mbpd) and an oil price target of \$55/bbl. (2016 average: \$43.87/bbl.). In addition, assuming a \$9.3billion non-oil inflow (average over the prior four years), we estimate total 2017 inflow of \$25.2 billion, with the implied monthly average of \$2.1 billion providing the apex bank with enough ammunition to sustain its aggressive FX sales without significantly depleting the FX reserves. Particularly, assuming an average monthly sale of \$2billion (April 2017: \$1.9 billion by our estimate) to the FX market together with \$500 million (average over 2017) sold to non-WDAS sources, we expect the net FX¹⁹ reserves to only fall by \$3 billion to \$24 billion by the end of the year—a time period, we believe is sufficient to return confidence to the interbank market.

¹⁹ Gross FX reserves less outstanding swaps

Figure 5: 2017 FX reserves projection (\$'billion)



Source: CBN, ARM Research

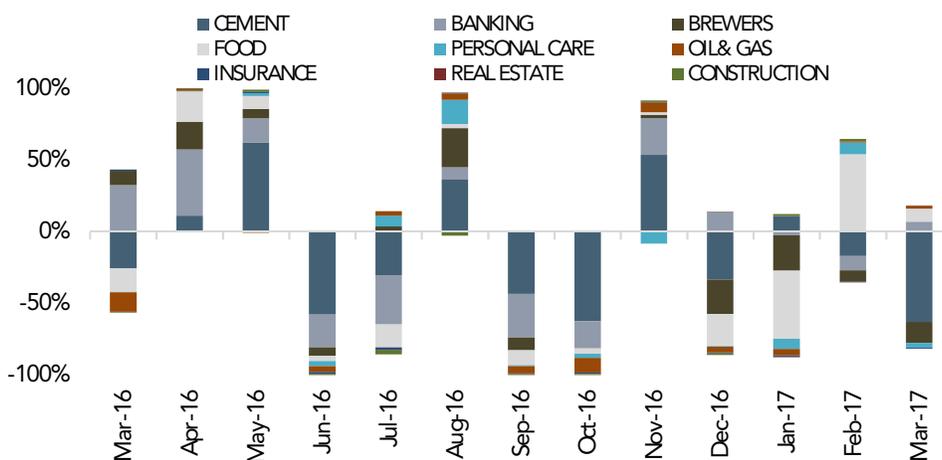
Capital Market Review and Outlook

Equities attractiveness remain depressed

In our H1 17 Nigeria Strategy Report, we projected a nuanced outlook for naira equities against the backdrop of subsisting reticence of foreign and local investors towards naira equities as well as weak fundamentals. Pertinently, US interest rate normalisation, rising political concerns on the global front and FX worries in the domestic market, continue to drive foreign apathy while local support continues to dissipate as rising yields which aside from raising discount rate for equity valuations provided a significantly compelling investment outlet in the fixed income market. Certainly, market performance played out as expected with the NSE ASI extending the bearish trend of Q4 16 (-5.2%) by contracting another 5.1% QoQ in Q1 17, after reporting losses in January (-3.1% MoM) and February (-2.7% MoM). After recording two consecutive months of negative FPI flows (Nov 16: N9 million and Dec 16: N5 billion), net FPI flows swung positive in Jan 2017 (N1.2billion) while the month of February witnessed an outflow of N2.3billion.

Unbundling market performance by sectors, sell pressure in the cement sector (-3% QoQ) which mirrored weakness in construction activities as well as expectation of weak full-year corporate scorecard accounted for 36% of the downtrend in the NSE ASI. Elsewhere, investors priced in asset quality concerns and weak dividend expectation on the banking sector which lost 1% QoQ and accounted for 29% of Q1 17 market declines by our estimate. To add, our attribution analysis reveals that investors priced in weak full-year results and economic headwinds on Brewers (-10% QoQ), Oil & Gas (-4.8% QoQ), Personal care (-2.9% QoQ), Real Estate (-2.9% QoQ), Insurance (-2.4% QoQ) and Food (-0.2% QoQ). Bucking the negative trend was the Construction sector which closed positive (+13.8% QoQ). Overall, at close of Q1 17, the equity market's performance proved to be a tale of macro headwinds, weak fundamentals, attractive FI returns and feeble full-year expectation – all flagging appetite towards equities.

Figure 5: Attribution analysis of monthly sectoral performance



Source: NSE, ARM Research

Muted outlook remains Intact

Over the second quarter of 2017, political uncertainty in Europe, swelling predictions of geo-political crisis, prospects of further rate hike by the US Federal Reserve should continue to drive cautious approach to EM/frontier market investing. Whilst domestic FX markets have seen improved liquidity since March 2017, we expect FPI participation to be gradual with more allocation in the FI

market. 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, our views about fiscal revenue struggles constraining capital expenditure at federal and state level translate to muted demand for construction materials. Further confounding the sectors' revenue picture is the potential pull back in demand following an over 47% increase in cement price. That said, margins should recover from battered 2016 levels largely reflecting price hikes and a more efficient energy mix, with the latter stemming from restoration of gas supplies and construction of coal plants. In addition, Lafarge's restructuring of its dollar loan obligations, which shrinks its FX exposure to \$106 million at the end of Q1 17 (-82%) should mitigate the risk of earnings compression from future NGN depreciation.

Undertaking a similar exercise for banks, asset quality fears on the Power sector, General commerce and Manufacturing sectors remain a cause for concern. In addition to loan quality issues, capital adequacy worries remain on the horizon after the over 180bps shrinkage across our coverage banks which should drive muted organic loan growth (excluding NGN depreciation and CBN on-lending). Nonetheless, as in 2016, our prognosis about further naira weakness retains scope for FX revaluation gains for banks with net long positions even as improved FX liquidity should support trading income and ultimately NIR for banks with liquid balance sheet. Outside these banks, the underlying earnings picture is soft.

Elsewhere, for Oil and Gas, upstream names should benefit from sentimental buying associated with rising crude oil prices though production woes imply limited reprieve for battered earnings. Downstream, the dark side to the double-edged sword of the crude price rally should force upward adjustments to the retail pump price. That said, we think fears of a backlash from the populace would drive the FGN towards absorbing these increases for some time which holds negative portents for petroleum marketers' margins.

Away from cyclical names, depressed valuations for basic food producers and strong pricing power implies this segment should come to pique investors' interest. For more

elastic sectors, negative real wage growth should continue to see price increases trail cost pressures leading to gross margin compression. Given currently elevated valuation levels, bearish bias should remain dominant for these names.

Lastly, palm oil producers should remain in the sweet spot of monetary and fiscal policy and given the fundamental demand-supply mismatch, as annual CPO production of 970,000 MT remains inadequate in the face of national consumption at 1.5million MT, we see more price upside over 2017 and expect stronger earnings performance. Notwithstanding strong YTD price performance, we believe current pricing is yet to fully reflect the stellar earnings performance reported so far, but more importantly, the robust earnings outlook.

Overall, we believe the key risk to performance are unchanged from our last call—they include US interest rate normalization, political uncertainty, domestic macro concerns, and a drag in fiscal push to uplift the economy. Investors will continue to be especially sensitive to the state of the economy, a devaluation of the naira and any policy missteps by the monetary and fiscal authorities. On balance, the outlook for naira equities is more nuanced—low foreign and local appetite for equities combine with weak fundamental picture across most sectors underpins our muted outlook for naira equities in Q2 2017.

Quest for currency stability to leave rate elevated

After climbing a whopping 873bps over 2016, the naira yield curve maintained its ascent by rising by another 122bps QoQ to a record high of 18.13% at the end of Q1 17. The upswing in yield curve coincided with views in our H1 2017 Nigeria Strategy report where we noted that CBN's desire to ensure currency stability should keep interest rate elevated over Q1 17. Alas, buoyed by accretion in the FX reserves, the apex bank raised its FX sales which magnified impact of OMO issuances on system illiquidity with the resultant effect driving T-Bill yields (+247bps QoQ to 20.58%) higher. Meanwhile, a combination of sizable external borrowings and lower inflation helped keep bond yields largely in check (-2bps QoQ to 15.69%). Examining the yield trajectory on a monthly basis, the naira yield curve expanded 25bps MoM in January largely reflecting yield uptrend on longer dated instruments (+47bps MoM) and muted movement in T-bill yields (+3bps MoM to 18.13%). The

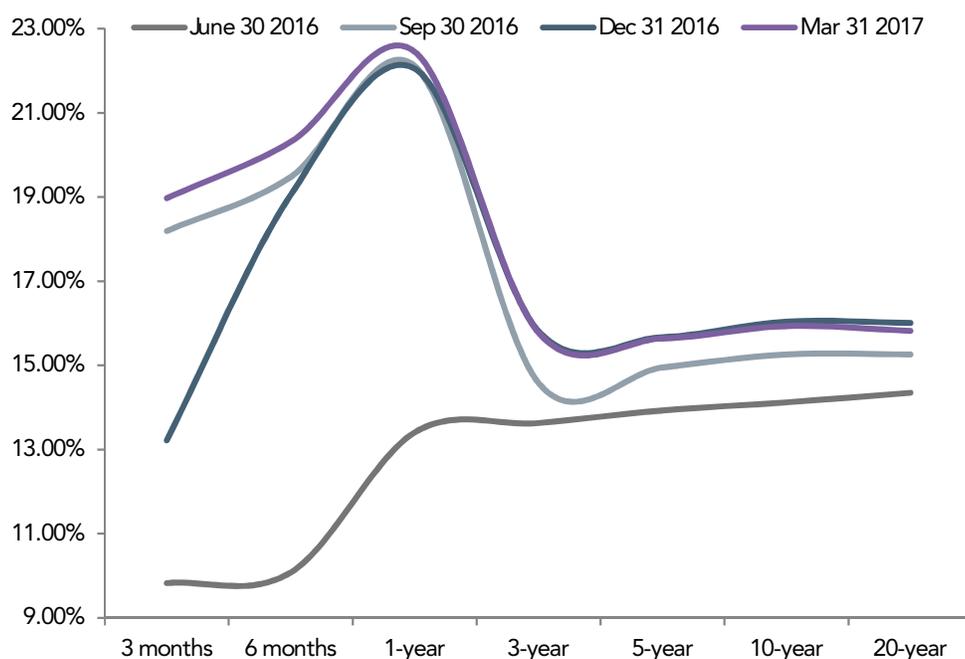
rise in the former reflected investors' reaction to activities at the January bond auction where aggressive borrowing patterns by the DMO²⁰ drove average marginal rates to a record high of 16.96% (+74bps MoM). Similarly, at the short end of the curve, the apex bank maintained its tightening policy evidenced by a more than two-fold MoM rise in net OMO issuance to ₦492 billion. Notwithstanding a net maturity of ₦136 billion in February, the monetary authorities' decision to raise dollar sales (+32% MoM to \$588 million), including an offer of \$500 million in its Secondary Market Intervention Sales (SMIS), kept the banking system relatively illiquid with the overnight rate rising to 133% (mean: February: 26%, January: 9%). Unsurprisingly, T-bill yields climbed a further 39bps to 18.52% over the month. At the long end of curve however, successful issuance of the \$1 billion Eurobond and increasing prospect of other external financing tempered scope for elevated domestic borrowings by the FG. Against this backdrop, the bond market experienced a bullish run (yields fell 7bps on average MoM) with the sentiment driving cautious bid rates by investors at the monthly bond auction which by extension underpinned a 32bps MoM contraction in mean marginal clearing rates to 16.64%. Buoyed by the first inflation decline in 16 months, which drove concerns about a potential monetary easing, the buying pressure at the long end of the curve extended to March with bond yields declining another 41bps MoM to 15.69%. In contrast, T-bill yields rose at the fastest pace since the MPR hike in July 2016 (+206bps MoM to 20.58%) as raised FX sales (+104% MoM to \$1.2 billion by our estimate) and net OMO issuance of ₦130 billion weighed on system liquidity. Overall, CBN hawkish policy drove the naira yield curve to new highs.

Hitherto, we had projected yield downtrend over Q2 17 largely reflecting potential descent in YoY inflation reading on monetary easing and elevated maturity profile. However, the rising MoM reading, which the monetary authorities have noted as a concern, should dampen influence of YoY inflation movement on interest rate trajectory over the quarter. Hence, we focus our attention on the currency market which have been the biggest driver of monetary tightening over the last few months. In the wake of rising crude oil proceeds and gains from other officials receipts which have boosted the FX reserves, we believe recent gains in parallel market would incentivize higher dollar sales as the CBN attempts to bring confidence back into the

²⁰ The FG raised N214.95 billion in the month (+211% MoM and +65% higher than amount on offer)

interbank FX market. Moreover, the apex bank's flirtation with a floating FX market in the name of a specialized FX window for Investors and Exporters makes any easing in the short term unlikely. Consequently, we project a continuation of aggressive OMO issuances which together with liquidity sapping effect of FX sales should keep short term interest rate elevated. At the long end, we believe DMO's sensitivity to higher borrowing cost should put a cap to yield upswing leaving the humped yield curve unchanged.

Figure 7: Movement in the naira yield curve



Source: FMDQ, ARM Research

Farther out, whilst a combination of improved revenue picture, prospective foreign borrowings, and positive impact of currency stability on economic growth should dampen agitations for monetary easing by the fiscal authorities over the near term, we believe an extended tightening cycle that threatens the issuance of the budgeted, but conservative, ₦1.3 trillion domestic borrowings (Year to April net borrowings: ₦406 billion) could redirect attention to YoY inflation reading. On this wise, projected downturn in the headline numbers on the back of dissipating base effect and impact of parallel market naira appreciation on food and energy prices (key drivers of renewed uptick in MoM inflation) could compel a temperance in the tightening stance which we believe should be initiated via lower clearing rates at the

OMO auction. However, we see this scenario only playing out in the second half of H2 17 after sufficient time as been given to forestall confidence in the FX market.

Capital Market Strategy

Flexibility remains crucial

Coming into H1 17, our call was for a flexible approach to fundamentally strong stocks—buying the dips and selling the rally as against a “Buy and Hold” strategy—given subsisting bearish sentiment for equities. Basically, notwithstanding our cautious outlook on equities, we expect depressed valuation to spur buy momentum in selected stocks even as expectations of earnings recovery and improvement in FX liquidity keep prices upbeat. The expected dividend play should drive appetite in most of the selected names, though with a relatively shorter holding period for Naira equities by local investors compared to foreign investors. Thus, market gains are likely to be short-lived. Indeed, the muted equity market performance despite pockets of gains across selected stocks suggests our call largely played out.

Going forward, our views regarding tempered local and foreign activities on the bourse amid slight improvement in the fundamental picture suggest caution. That said, we look out for sentiment triggers majorly from expectations of upbeat H1 17 earnings, recovery in the macro climate as well as improved confidence in the FX market which should create enough incentive for portfolio flows. Here, as in Q1 17, we continue to feel positive vibes around palm producers with favourable CBN disposition on FX as a boon for the sector. On banks, we reiterate our preference banks as those 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, higher cement prices, energy efficiency and expected roll-out of government capex plans should support the cement players. For the FMCG, while depressed real wages should continue to stifle sales, we think naira appreciation at the parallel market, improved FX liquidity and higher prices across product lines moderate the bearish view on the sector. In sum, elevated rate environment which keeps a pricey opportunity cost for equity exposure and broadly unsavoury fundamentals call for a highly flexible approach in Q2 17.

Investing in the market at the trough is imperative, and being flexible with tactical positioning can be beneficial. We emphasize that times of higher market volatility, while often trying for individual investors, can present opportunities for skilled active managers. For us, we think after a strong counter trend move, as long as 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.

Barbell Strategy to generate Alpha

In our H1 17 NSR, we recommended a short duration strategy, capturing higher yields at the short end of the curve while avoiding the bearish twists to bond yields. To add, we suggested a staggered approach to building duration with emphasis on mid-tenored bonds on the downward slope of the naira curve in a bid to ‘run-down the curve’ as dovish influences kick into gear over Q2 17. Farther out, as the liquidity influence wane and currency pressures become self-evident, we advised a rotation back into money markets to wait out the FX market storm. Overall, our strategy call was for investors to position bond portfolios with an eye on flexibility ahead of what promises to be a roller-coaster half year for debt markets.

Going forward, the rising MoM inflation reading, which the monetary authorities have noted as a concern, should dampen influence of YoY inflation moderation on interest rate trajectory over the quarter. Hereafter, we focus our attention on the currency market which have been the biggest driver of monetary tightening over the last few months. In the wake of rising crude oil proceeds and external borrowings which have boosted the FX reserves, we believe recent gains in parallel market would incentivize higher dollar sales as the CBN attempts to bring confidence back into the interbank FX market. Moreover, the apex bank’s flirtation with a floating FX market in the name of a specialized FX window for Investors and Exporters makes any easing in the short term unlikely. Consequently, we project a continuation of aggressive OMO issuances which together with liquidity sapping effect of FX sales should keep short term interest rates elevated. At the long end, we believe DMO’s sensitivity to higher borrowing cost should put a cap to yield upswing leaving the humped yield curve unchanged.

Hence, Q2 17 should see an extension of the current yield curve dynamics. Thus, in this humped yield environment, Barbell strategy remains the reasonable call - 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 farther out in the year.

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