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Nigeria Strategy Report – H1 2018 Excerpts

Global Economy and Markets

Constructive flows to EMs but headwind prospers

Although we expect policy normalisation to weigh on portfolio flows to emerging markets (EMs) over 2018, higher commodity prices, positive current account balances, attractive equity valuations and high yield differentials should tame capital outflows from EMs.

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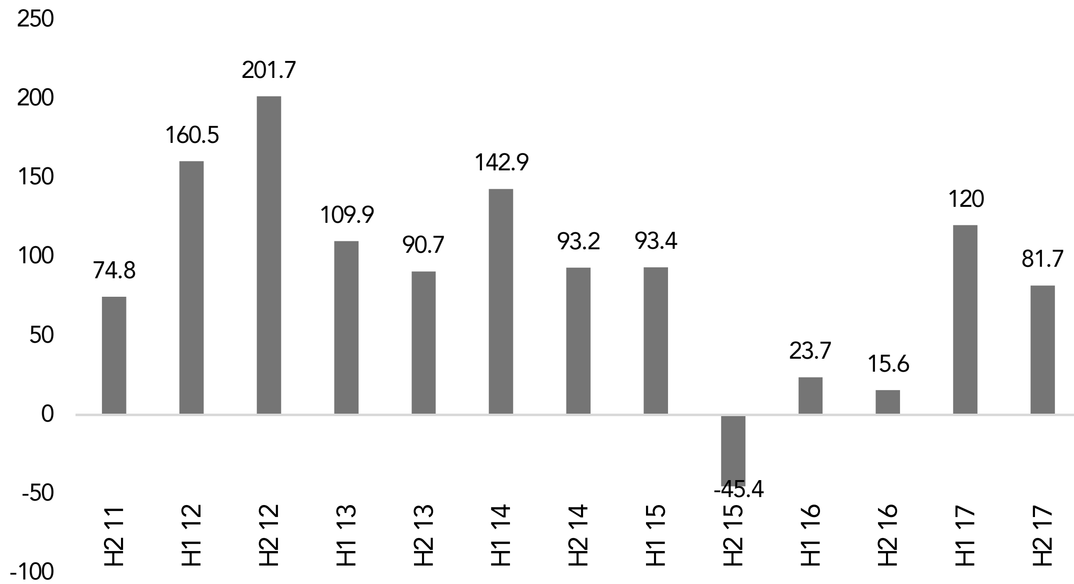
Recovery in EM growth spurs portfolio flows

In contrast to a sharp decline in capital flows to emerging markets between 2015 and 2016, portfolio flows proved resilient in 2017. The Institute of International Finance (IIF), estimated portfolio inflows to EMs over 2017 at $243 billion (+40%% YoY)— the highest level since 2014— underpinned by broader global economic recovery, higher risk appetite and favourable global financial conditions. On the pull side, higher commodity prices and improving economic fundamentals which lessened default risk as well as a more stable currency market were key drivers for the strong portfolio flows. Importantly, despite rate hikes by global central banks, flows to EMs debt was boosted by significant interest differentials with DMs which incentivised carry trade opportunities.

Examining trends in asset classes, IIF estimates EMs debt flows at $183 billion (+63.4% YoY) while portfolio flows to equity was projected to moderately contract by 3% to $60 billion. On the supply side of debt flows, rise in government spending across most EM countries underpinned the ramp up in domestic and external debt issuances. Whereas, concerns over fragile economic recovery, political and policy risk in key EM countries continued to trump portfolio flows into equity. In summary, the ripple effect of improving growth picture in major EM economies and higher commodity prices sustained positive

FPI flows over H2 2017 ($81.7billion). Subsequently, we delineate how the interplay between pull and push factors shaped FPI flows across key EM geographies.

Figure 1: Net FPI Flows to EM ($'billion)



Source: IIF, ARM Research

Capital flows track higher across varying EM regions

Over Q3 2017, net portfolio flows to EM Asia were largely positive underpinned by strong flows in China and India. Portfolio inflows to India expanded by 19% QoQ to $2.5 billion as net flows to equities and debt securities remained upbeat. The gains largely reflected improved economic fundamentals, recent reforms in India (GST and demonetization) as well as government initiatives aimed at attracting FPI[1]. Furthermore, the People's Bank of China (PBoC) invested $500 million in Indian bonds for the first time since the Indian government eased restrictions on foreign investors. Similarly, in China, improvement in macroeconomic fundamentals, higher short-term lending rate and appreciation of the Yuan stabilized net portfolio flows which turned slightly positive through much of 2017. Importantly, following tighter enforcement of capital flow management measures, a weaker US dollar and pickup in growth momentum, resident outflows moderated significantly with

[1] SEBI has allowed FPIs to invest in units of REITs, infrastructure investment trusts (InvITs), category III Alternative Investment Funds (AIFs), and also permitted them to acquire corporate bonds under default. Also, he RBI has allowed a number of foreign investors to invest, on repatriation basis, in non-convertible/redeemable preference shares or debentures issued by Indian companies listed on established stock exchanges in India.

net capital outflows declining to ~$20 billion in the review quarter from a peak of $210 billion in Q3 2016. Elsewhere, Malaysia and Taiwan witnessed capital outflows of ~$1.3billion and $10.3billion respectively as growing geopolitical tensions in Asia weighed on foreign investors' appetite. Latin America also witnessed improved portfolio inflows on the back of investors' positive reassessment of Brazil's growth potential. In variance to preceding quarters where economic recession, lower commodity prices and political uncertainty drove FPI reticence, portfolio flows to Brazil rebounded strongly in Q3 17 with $6.1 billion (equities: $4.3billion, Debt: $1.8billion) net inflow – highest in eighth quarters. The renewed foreign appetite for Brazilian real asset reflects investors' expectations for sustained economic growth after bucking eleven quarters of economic contraction. Similarly, FPI flows to Mexico extended the positive trend in H2 2017, reflecting sustained appetite for both peso denominated debt and equity instruments which attracted $5.3billion over the quarter. To add, higher commodity prices as well as waning concerns over Donald Trump's trade protectionism campaign which stalled FPI flows in 2016 supported the resilience in portfolio flows.

In EM Europe, portfolio investments into Turkey turned negative, printing at -$25.3billion against the backdrop of weaker macroeconomic fundamentals even as inflation touched an all-time high in November (12.98% YoY) alongside heightened political risk ahead of the 2019 elections. On the other hand, Czech Republic reported $9.1billion worth of net portfolio flows in Q3 2017 which was hinged on improved economic activities as rising private and public spending drove a 5% expansion in GDP over Q3 2017.

Over in MENA, portfolio flows into Egypt remained resilient (Q3 17: $7.5 billion) due to improved investors sentiment towards local currency denominated assets in the wake of its currency flotation. Precisely, Egypt's elevated interest rate environment lured foreign investors into the debt segment, with investment in Egyptian treasury bills recording net purchases of $7.4 billion. On the other hand, the meagre portfolio flows to equities reflected the adverse impact of currency depreciation on corporate dollar denominated borrowings and banks' bulging portfolio of riskier asset. Elsewhere in Saudi Arabia, portfolio flows turned negative in H2 17 to -$2.5billion due to weaker macroeconomic fundamentals. Precisely, Saudi Arabia remained in recession following pressures from lower crude production, hike in PMS prices as well as the near-term impact of adjusting to other economic reforms.

Capital flows to Africa remained resilient in H2 2017 largely underpinned by positive flows into Nigeria and South Africa. In Nigeria, Net portfolio flows touched a 16-quarter high in Q3 17 to $5.32billion as investors' demand for naira-denominated assets remained strong underpinned by higher crude oil revenues, pickup in economic activities and FX availability stemming from increased dollar sales by CBN. Also in Q4 17, Nigeria issued a $3billion worth of Eurobond for 10yr and 30yr at 6.5% and 7.625% respectively, with the offer oversubscribed by 3.8x. In South Africa, portfolio flows remained sturdy at $5.8billion as investors cheered South Africa's economic recovery (Q3 GDP: 2% YoY) after slipping into recession in Q1 2017.

Hawkish renditions across DMs set to weigh on EM asset

Going into 2018, we think EMs are more resilient. In our view, a stable and growing global economy, higher commodity prices and improving fundamentals in key financial markets will support flows to EMs. More so, EMs growth is expected to further outpace the growth picture for the developed market. Irrespective, while we remain broadly constructive on EM fundamentals and valuation, flows to EMs will certainly face headwinds. First, key central banks are headed for monetary policy normalisation. The US Fed has hiked its benchmark interest rate four times since 2016 and we expect 3 further rate hikes in 2018. Furthermore, the ECB has guided towards balance sheet reduction and tapering of its QE program. Historically, the adoption of a tightening stance typically leads to capital flight from riskier assets such as EMs. More worrisome to EM portfolio flows is geopolitical risks across regions. Key concerns include tensions between North Korea and the US, growing conflict between Saudi Arabia and Iran as well as NATO conflicts and territorial disputes in the South China. To add, a tough stance by the US on the NAFTA agreement could lead to a breakdown in talks with a U.S withdrawal from NAFTA hitting EM equities in the near term as trade concerns emerge. Also, political risk in South Africa, India, Brazil, and Nigeria is expected to scale up as these countries gear towards impending elections.

Table 1: Risk assessment across Key EM countries in 2018

	Political Risk	Other Risk
Egypt	Presidential elections	
India	Legislative Assembly elections	
Russia	Presidential elections	
Mexico	General election	NAFTA Negotiations
Brazil	General election	
Indonesia	Local elections	
Malaysia	Parliamentary elections	Religious crisis
Taiwan	Local elections	

Source: ARM Research

Starting with China, we think that portfolio flows have peaked, and a slight moderation is in the offing. In our view, the Chinese economy is likely to slow from sustained high levels in 2017 due to tightened regulations on property purchases and the shadow banking sector. More so, an ever-increasing corporate debt burden and the difficulty of managing monetary policy for the two-staged economy[2] remains a challenge. The pace of tightening and easing cycles has increased, and we believe that walking the tightrope of monetary and growth policies is getting more difficult as the complexity of the economy increases. On balance, while outflows are expected to remain subdued on the back of capital controls, concerns on the Chinese economy will moderate portfolio inflows to drive lower net portfolio flows into China.

Elsewhere in the region, while the policy normalisation in advanced market is expected to impact portfolio flows to India, we think the risk of a sizable impact is largely subdued, First, India has a manageable current account deficit that is being funded by foreign direct investment. Second, domestic liquidity support is strong, thanks to dedicated monies flowing into mutual funds each month through systematic investment plans. Irrespective, with rising crude oil prices and recovery in consumer demand, the inflation cycle in India is likely to turn. Consequently, we think the quantum of inflows seen in 2017 will moderate albeit marginal.

[2] coastal, primarily service-oriented economies operate very differently than interior provinces that are more industrial

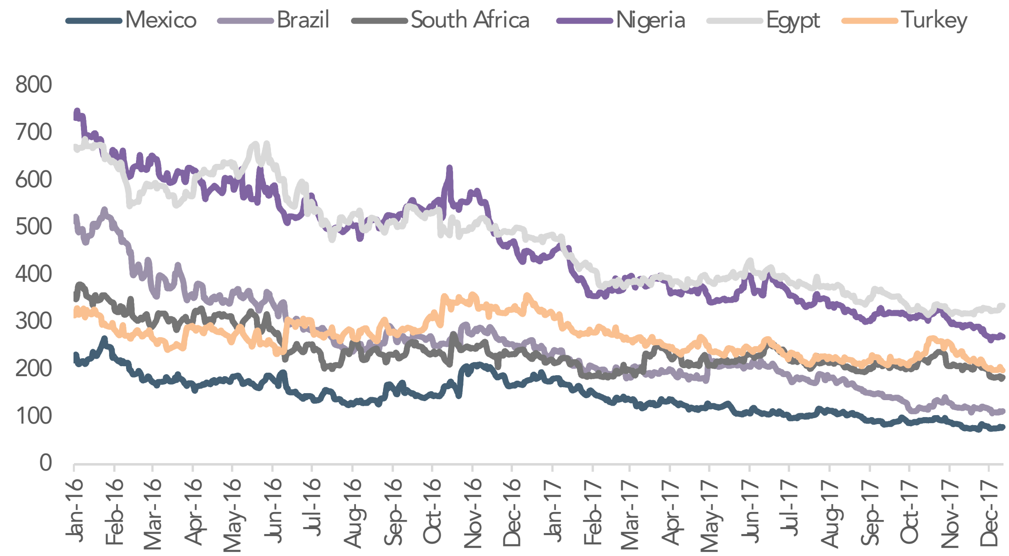
Over in Latin America, while the recent rise in global commodity prices should continue to trigger foreign investor appetite into Brazil and Mexico's equity markets, the downside for Brazil remains political risk ahead of next year's presidential election and the recent political dilemma trailing corruption charges against Brazil's President Michel Temer. The hitch for Mexico remains uncertainty over NAFTA negotiations which could see reduced trade ties with the US— its largest trade partner.

Elsewhere, the reduction in ECB's QE could slow down the pace of economic growth in EM Europe, which could dampen foreign investors' appetite for shares in EM Europe. In our view, Turkey is most vulnerable to lower appetite for EM risk given its reliance on short-term capital inflows to finance a widening current account deficit. Capital flows to Russia is also expected to moderate ahead of its March 2018 elections as well as financial sanctions levied on Russia since 2014. In addition to recovery in oil prices which lowers risk premium across GCC countries, Saudi Arabia's plan to allow foreign investors to invest directly in Saudi stocks at the time of their IPO, should boost flows towards the country's equity market. More importantly, projected proceeds of $50 billion from the sale of 5% of the state-owned oil giant Aramco, which is valued at $2 trillion, will be the key driver of capital flows in Saudi Arabia.

Over in SSA, political risk in the run up to elections is expected to drive declines in portfolio flows in South Africa and Nigeria. In South Africa, the unstable political clime puts the rand and credit rating at risk. More so, a possibility of a one notch downgrade of its local currency debt rating will likely trigger a removal of SA's debt from international bond indices and thus drive capital outflows. To add, given rate cuts by SARB in the prior year, interest rate in SA is low relative to its peers (Brazil, Russia, Turkey) which dampens the attractiveness of rand-denominated bonds. Elsewhere in Nigeria, despite higher commodity prices and stable FX outlook, political risk is set to drive subdued portfolio flows.

On balance, notwithstanding upbeat growth projections across EM countries, rising yields in the US and political concerns should weigh on portfolio flows over 2017. That said, we see current account balances, equity valuations, earnings-per-share growth differentials between emerging markets and developed markets and the yield-differentials moderating the scale of outflows from EMs despite policy normalisation in developed markets.

Figure 2: Z-spread of comparable Eurobond across key EM markets



Source: Bloomberg, ARM Research

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