



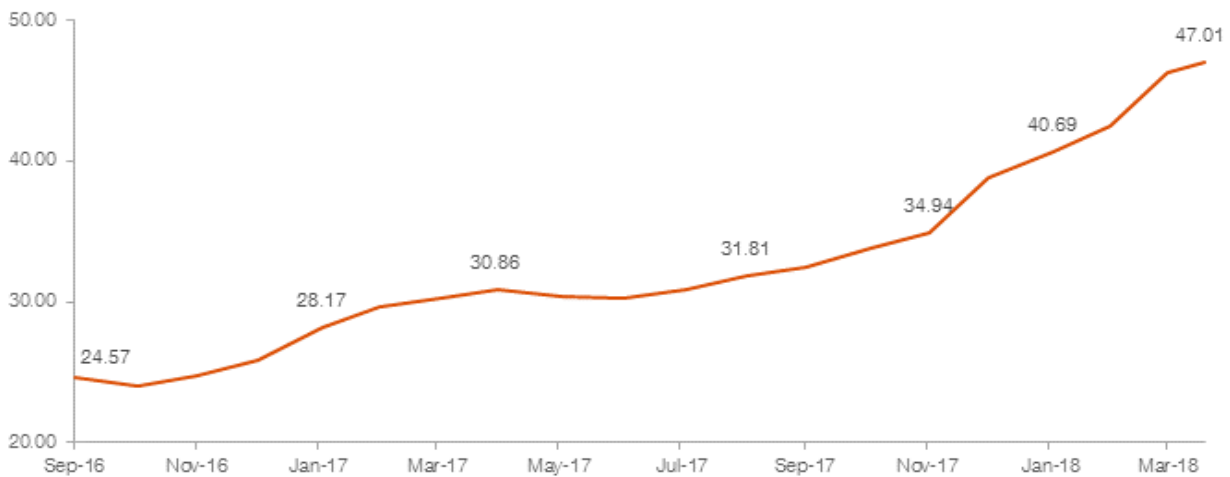
NIGERIA | FOREIGN EXCHANGE MARKET

Love at first sight?

On April 21st 2017, the CBN established the Investors' & Exporters' (I&E) Window with the purpose of boosting liquidity in the FX market and ensuring timely execution and settlement of eligible transactions.

The creation of the I&E FX Window followed the increase in foreign exchange reserves to US\$30.3billion in April 2017, from a low of US\$23.90billion in October 2016, on the back of higher oil production and Brent oil prices.

Foreign Exchange Reserves Movement



Source: CBN, Investment One Research

This effectively increased foreign exchange liquidity in the economy and the appreciation of the Naira in the parallel market which had depreciated to a low of N520/USD in February 2017 due to demand pressures and speculative activities.

A year later, the I&E FX window has played an instrumental role in stabilising the local currency. Since inception, the window has seen total foreign currency inflows reach a US\$25 billion as at 13th of April 2018, with foreign portfolio investors (FPI) constituting about 54%.

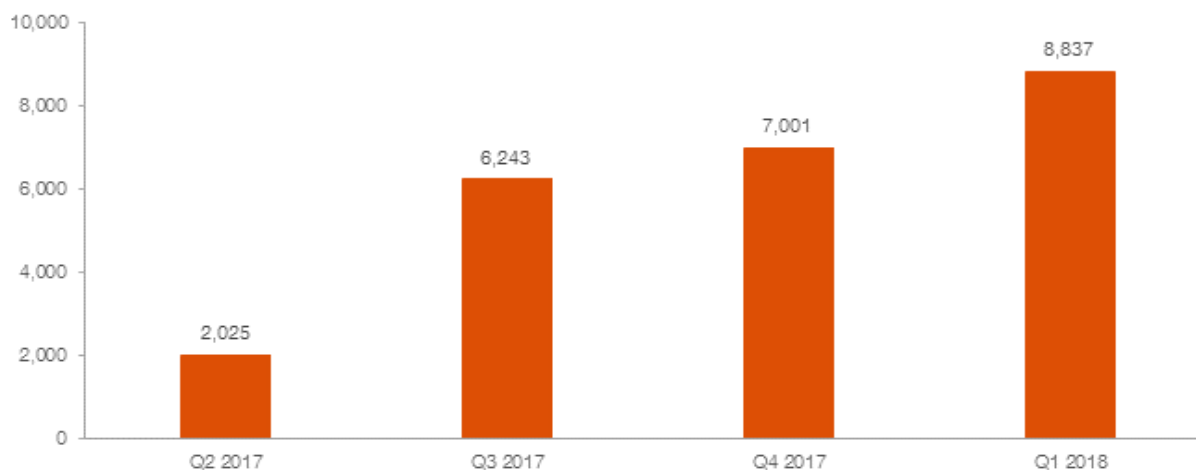
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Investors' & Exporters' FX Window Turnover Per Quarter



Source: FMDQ, Investment One Research

Who is involved?

The window was created to facilitate the exchange of foreign currency between suppliers of FX (FPIs, exporters, authorized dealers and others) and parties with foreign currencies obligations (corporates, individuals etc.). However, CBN retained the right to promote liquidity and professional market conduct in the window. Exchange rates were expected to be agreed between trading parties on a demand and supply basis and officially documented to foster a market determined and transparent exchange rate

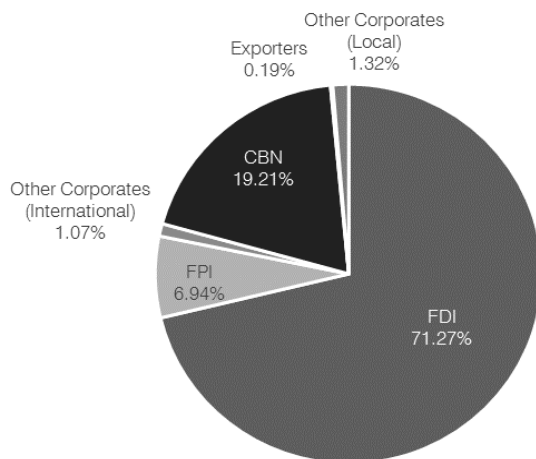
Eligible transactions include:

- Invisible transactions such as; dividends and income remittances, capital repatriation, loan repayments, etc.
- Bills of collection.
- Any other trade related payment obligations.

Nonetheless, on establishment of the I&E FX window, stakeholders were initially apprehensive of the CBN's participation given the failed attempt in June 2016 to allow the local currency exchange rate be market driven. These concerns were intensified by the fact that oil proceeds from International Oil Companies, one of the nation's largest sources of foreign currency inflows and liquidity, were not to be traded at I&E FX window.

This initial scepticism saw CBN account for about 20% of the total US\$310million inflow into the market in April 2017, while FPI's represented just 7%. Foreign direct investors accounted for 71% while exporters and other corporates, both international and local, were responsible for the residual (1.40%)

Investors' & Exporters' FX Window Participation in April 2017

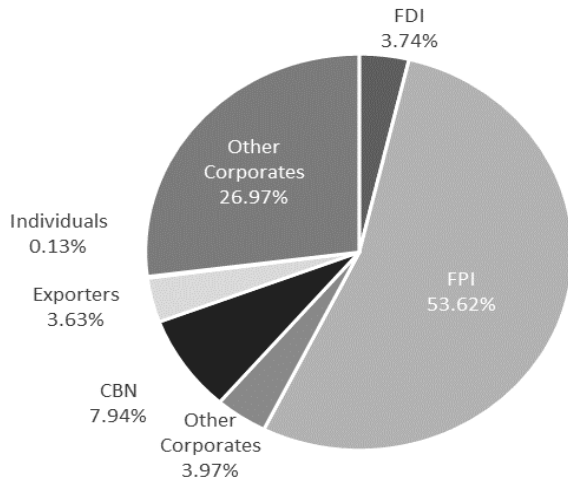


Source: FMDQ, Investment One Research

Nevertheless, as credibility of the CBN's FX policy improved and FX reserves gradually increased, we saw a steady increase in investor confidence and consequently, participation in the window. As such, we point out that FPIs have accounted for 54% of the total US\$24.8billion inflows into the I&E FX window since inception while the CBN represents just 8% of this total figure.

Also, we believe the participation of exporters and other corporates in the window (30% of total inflows) has seen the Nigerian Autonomous Foreign Exchange (NAFEX) rate become the benchmark FX rate for the economy.

Investors' & Exporters' FX Window Participation Since Inception



Source: FMDQ, Investment One Research

What have you done for me lately?

Although foreign investors were initially sceptical on the new FX window, sentiments in the country improved, notably in the equities market performance. The Nigeria Stock Exchange gained 29.79% in Q2 2017 on the back of improved foreign investor participation, and anticipation that Nigerian Equities would be retained in the MSCI frontier index.

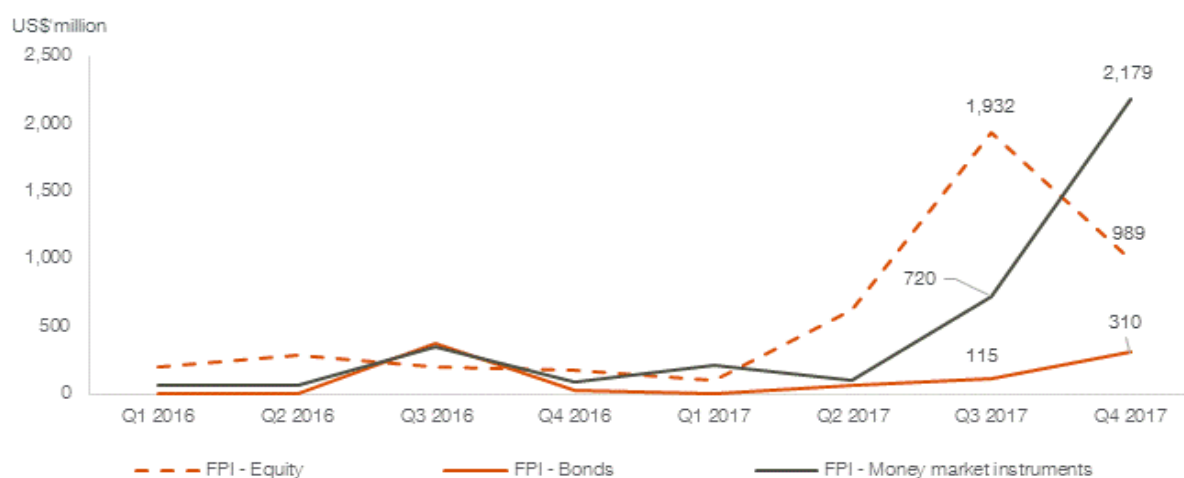
Equities Market Performance



Source: NSE, Investment One Research

Furthermore, from the Nigeria Bureau of Statistics' 2017 capital importation report, we highlight that following initial scepticism, FPI inflows surged in Q3 2017 (up 201% y/y to US\$2.8billion) and Q4 2017 (up 1124% y/y to US\$3.5billion), with the majority targeted at the equities as well as money market instruments which were offering yields as high as 22% on one year treasury bills.

Foreign Portfolio Investor Capital Importation



Source: NBS, Investment One Research

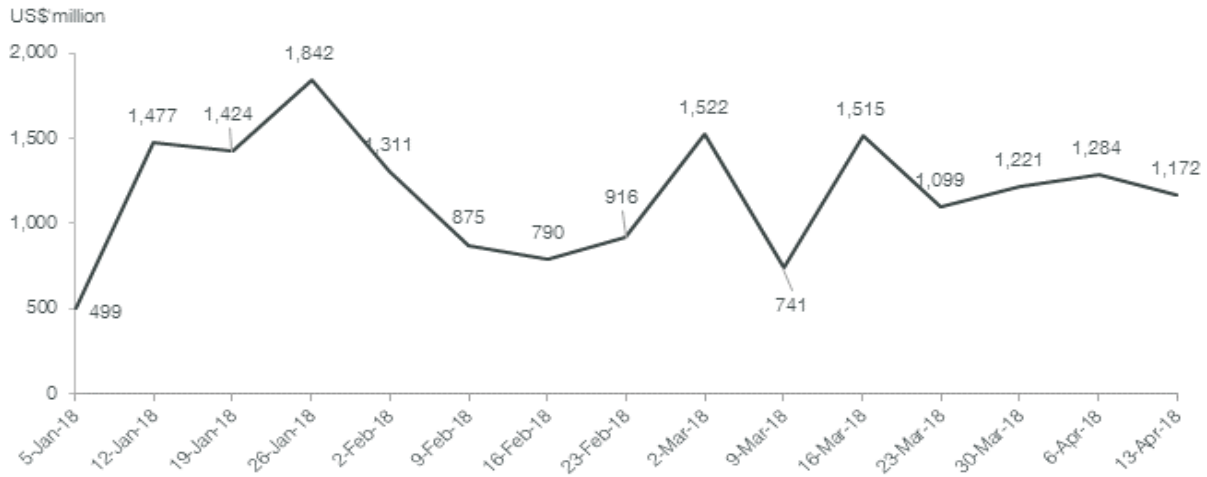
We also saw business sentiment improve as suggested by CBN's PMI reading which has been indicative of an expansion in manufacturing and non-manufacturing activities.

Where do we go from here?

Turnover at the I&E FX window has remained strong in recent times, averaging US\$1billion per week, although there was some volatility in February 2018.

We expect this to continue in the near term given higher oil prices (currently above US\$70/b), stability in oil production levels (1.8million barrels per day excluding condensates), rising FX reserves (US\$47billion according to official data from CBN), and strengthening GDP growth.

Weekly Turnover at the Investors' & Exporters' FX Window

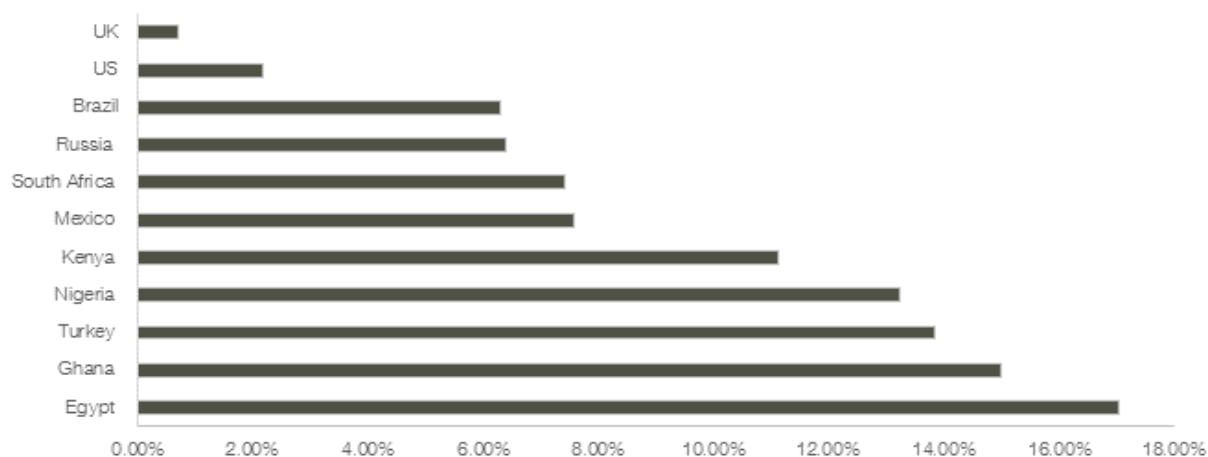


Source: FMDQ, Investment One Research

However, concerns remain for some level of capital flight in H2 2018 given the potential for heightened political risk as we move towards the 2019 elections. In addition, the US Fed's Hawkish stance indicates further rate hikes expected in 2018 and the continued decline in fixed income yields in the domestic market could contribute to exit of FPIs. In our view this could be a negative for the performance of the equities and fixed income markets.

Even in the absence of political risk, there remains a potential for foreign investor outflows as treasury bills purchased in 2017 mature in 2018 due to the lower yield environment (one treasury bill in Nigeria is currently 13.80%) compared to other Africa countries, particularly Egypt (one treasury bill currently offers a yield of about 17%). With this said, returns in both countries cannot be compared in absence of their risk profiles.

Yields One Year Government Treasuries



Source: Bloomberg, Investment One Research

Nonetheless, we are of the view that the likely re-inclusion of Nigerian Government Bonds in the J.P. Morgan Government Bank Index – Emerging Market (GBI-EM), could be a positive catalyst for increase in FPI inflows.

Nigeria was initially excluded from the index in 2015 as a result of CBN's FX rules following the crash of oil prices, which made it difficult for foreign investors to repatriate funds and restricted the ability to replicate the J.P. Morgan GBI-EM.

However, with the 12month minimum exclusion period already over as well as the significant improvements in FX liquidity and foreign investor participation, we believe the re-inclusion of Nigeria in the index could be imminent with J.P. Morgan conducting its reviews on a monthly basis.

Although J.P. Morgan highlighted that the depth and liquidity of the Nigeria's fixed income market was satisfactory, feedback from foreign investors has been mixed. Smaller foreign investors claimed to be participants in the Nigerian treasury market and were somewhat satisfied with the modalities of the I&E FX window. But larger foreign investors remain concerned with the multiple exchange rates, CBN being a primary source of FX in the economy (via its Special Market Intervention Sales) as well as how regulators may react to a significant decline in oil proceeds as a result of lower oil prices or production levels.

Conclusively, we believe the DMO as well as the CBN may need to do more to convince foreign investors on the credibility of its FX policy. This could help J.P. Morgan reach a consensus on the re-inclusion of Nigeria in the GBI-EM. While Nigeria would only represent 1-1.2% of the US\$232billion tracking the GBI-EM, we believe the potential improvement in sentiments towards the Nigeria economy as a result of the re-inclusion could lead to significant inflows in addition to funds tracking the J.P. Morgan GBI-EM. This would further boost turnover at the I&E FX window over the medium to longer term.

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