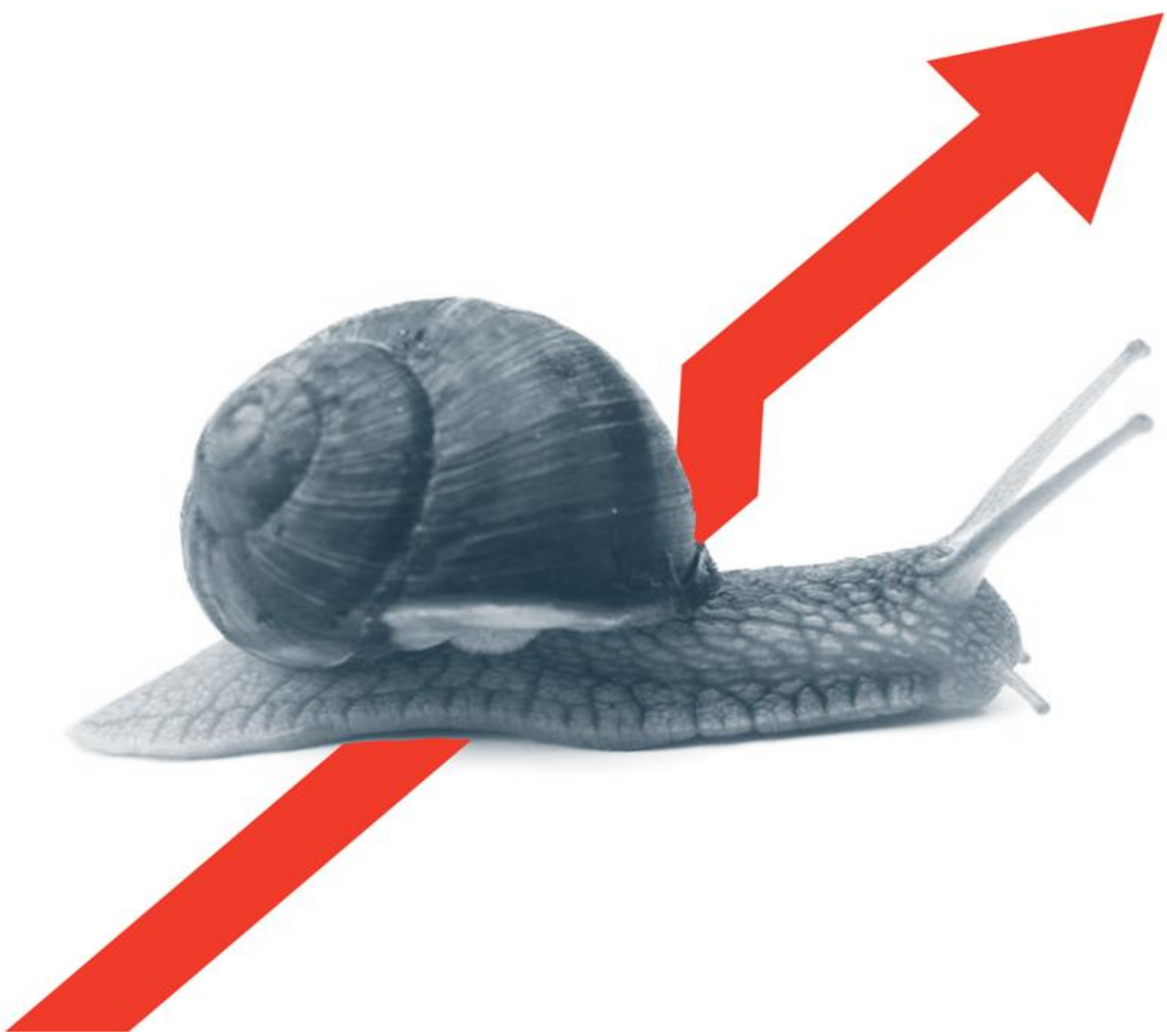
CORDROS
SECURITIES

Nigeria in Q4 2018.

Weaker Growth
Rising Inflation
Stable FX

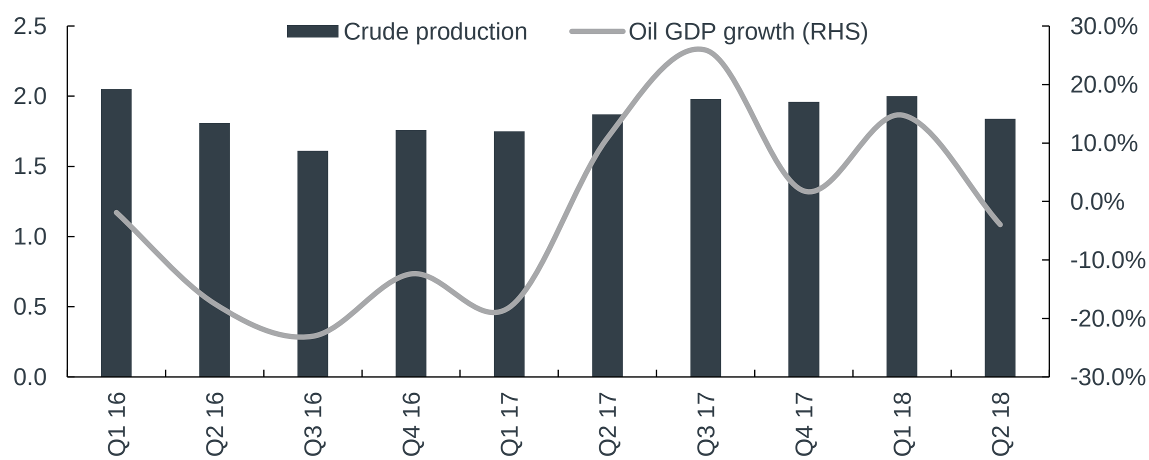


GDP: Crude oil sector; the new deadweight.

In our H2-2018 outlook report, we explored the key drivers of growth, taking cognizance of the peculiarity of the Nigerian economy vis-a-vis the impact of political risk, structural reforms, and the second-order impact of crude oil prices and production on the overall growth. In so doing, we modelled our base case scenario for FY-2018 GDP growth at 2.63% y/y, anchored on the fact that businesses will remain uncompetitive due to the absence of meaningful reforms, household consumption will be constrained as consumer wallets remained pressured, and positive policy implementation to drive sturdy non-oil GDP growth is lacking. In this report, we cut our growth estimate for FY-2018 to 1.9% y/y, driven by slower-than-previously expected oil sector growth, flood-induced cutback in Agriculture output, and the absence of structural reforms to propel sturdy manufacturing sector growth even as the FX market remains stable.

Over Q2-2018, GDP growth slowed to 1.50% y/y, against 1.95% y/y in Q1-2018. Notably, in the face of a slump in Oil GDP (-3.95% y/y vs. Q1-2018: +14.77% y/y), it was the case of strong non-oil GDP growth that kept overall GDP afloat in the review period. On the oil leg, National Bureau of Statistics (NBS) reported that average daily crude production over Q2-2018 printed at 1.84mb/d (Q1-2018: 2.0mb/d), representing a 1.6% decline relative to the corresponding period of last year. To our mind, amidst continued peace in the Niger-Delta region, the slack in production largely reflected the temporary shutdown of Trans- Forcardos pipeline for patch-ups due to minor leak. In addition, Shell also declared force majeure on Bonny light exports on the back of a shutdown of the Nembe Creek Trunk Line which had led to the build-up of unsold crude.

Figure 1: Trend in crude production and oil GDP growth

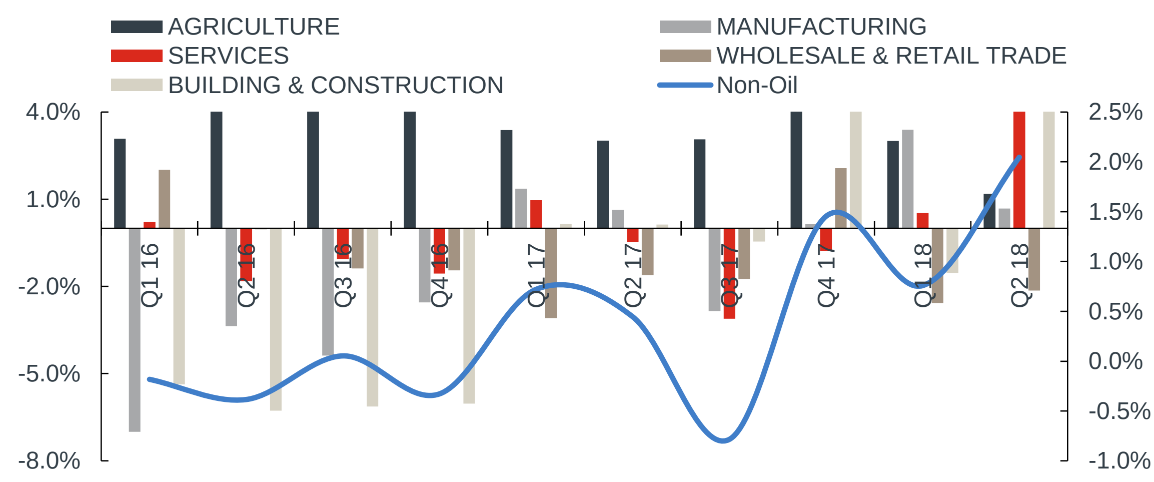


Source: NBS, Cordros Research

Service GDP superintends in the absence of Agric.

On the other leg, non-oil GDP strengthened in the period, expanding by 2.05% y/y against 0.76% in the prior quarter. We highlight that the strong non-oil GDP growth was supported by sturdy Service (+4.11% y/y) and Construction GDP (+7.7% y/y), both of which largely neutered security-induced slowdown in Agriculture (1.19% y/y). Dissecting the components, the strong Service GDP was on the back of sharp jump in Information and Communication (+11.81% y/y) and Transportation (+21.76% y/y) sectors. Growth in ICT was braced by improved active subscribers for voice and data usage. For clarity, Nigeria Communication Commission (NCC) reported that the number of voice subscribers improved markedly by 11.0% to 161.93 million users (Q1-2018: 148.32 million users), with internet data users also expanding by 12.4% y/y for the review period. Elsewhere, after sustaining solid momentum over the past years, Agriculture sector succumbed to the security-induced pressure following continued farmers-Fulani headsmen clash in the food-producing states of the federation. Evidently, the sloppy performance of crop production (+1.49% vs. Q1-2018: 3.45% y/y) – which contributes 89% of Agriculture GDP – and livestock (-1.95% y/y vs. Q1-2018: -1.85% y/y) largely dragged Agriculture output for the period. Away from Agriculture, Manufacturing GDP (+0.68% y/y vs. Q2-2018: 3.39% y/y) softened, driven by sharp decline in oil refining (-21.5% y/y) and slower growth in cement sector (+3.84% vs. Q1-2018: 5.28% y/y). On oil refining, NNPC reported that capacity utilization for the month of May was disappointing at 7.0% compared to 14.41% in April, due to the downturn witnessed in Kaduna Refinery. Overall, despite the disappointing performance across, Agriculture and Manufacturing, sturdy Service and construction GDP largely buoyed the robust non-oil GDP in the period.

Figure 2: Movements in non-oil GDP (RHS) and Components



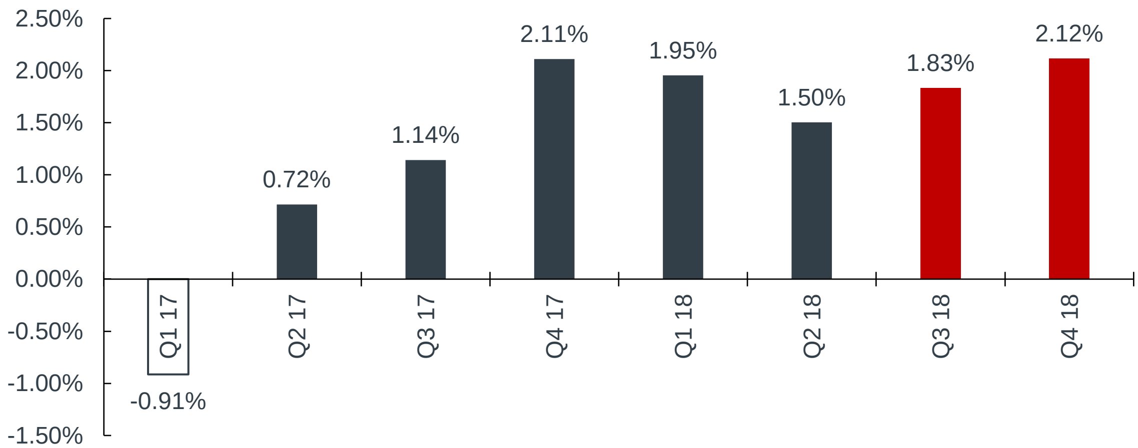
Source: NBS, Cordros Research

Rebound in oil production underpins positive outlook

Going forward, we expect the efforts of the FGN at ensuring continued cease-fire in the Niger-Delta region – especially with elections around the corner - combined with improved oil production following the lifting of force majeure on Forcados, to aid rebound in oil GDP. Specifically, we expect crude production to average 2.00mb/d through the rest of year, hinged on expected crude production ramp up in the Trans-Forcados Terminal which has already resumed activities. Against that backdrop, we now look for oil GDP growth of 1.5% y/y and 2.5% y/y for Q3-2018 and Q4-2018 respectively.

On the other hand, crop and livestock outputs are expected to remain pressured, with the herdsmen and farmers clash largely unresolved, and exacerbated by the recent reported cases of flooding in the food producing areas. The reverberating effect will continue to drag Agriculture GDP. However, sustained momentum of Service GDP, combined with strong Construction GDP, is expected to neuter sluggish Agriculture GDP, with knock-on effect driving strong non-oil GDP. On Service sector, we expect ICT and Transportation sector to dictate the pace of growth, with ICT playing the lead role. Specifically, for ICT, we estimate that active subscribers for voice and data usage over Q3-2018 surged 15.7% y/y and 13.0% y/y respectively. Overall, we project non-oil GDP growth of 1.87% y/y and 2.08% y/y for Q3-2018 and Q4-2018 respectively. On balance, we now look for Q3-2018 and Q4-2018 GDP growth of 1.83% y/y and 2.12% y/y, leaving FY-2018 estimate at 1.9% (FY-2017: 0.82% y/y).

Figure 3: Real GDP growth estimates



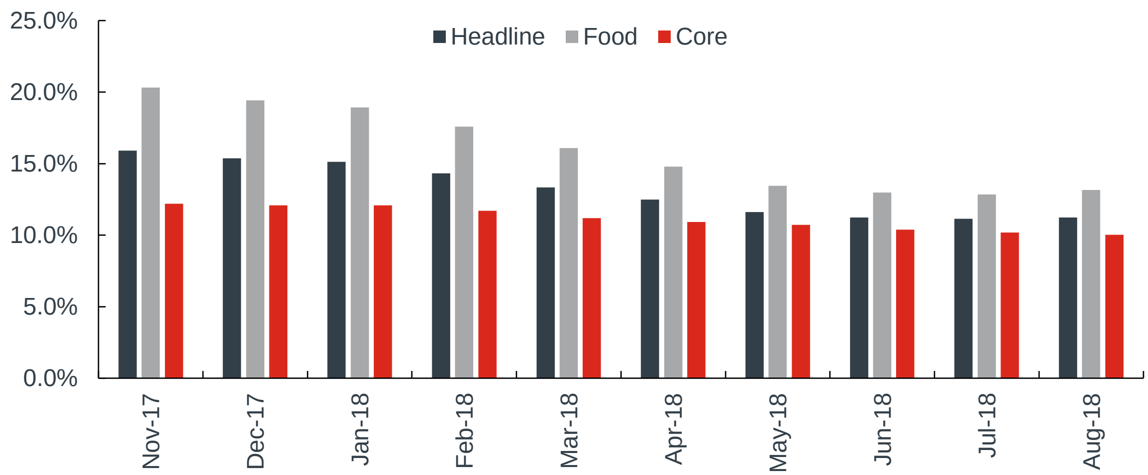
Source: NBS, Cordros Research estimates

15 October 2018

Inflation: Elevated month-on-month subdued scale of moderation.

As we had projected, headline inflation sustained deceleration in June, principally driven by the positive impact of the high base effect from the prior year. However, the scale of moderation – relative to our expectation – was again tempered by elevated month-on-month headline number, which was driven by higher food prices from the concluded Ramadan fasting period and lean season in the Southern region. Accordingly, headline inflation moderated by 9bps to 11.14% y/y in July. Meanwhile, inflation resumed uptick in August (+9bps to 11.23% y/y), as the impact of base effect induced gains waned. Notably, amidst sustained FX stability, the renewed pressure stemmed from food inflation which jumped 31bps to 13.16% y/y while core inflation (-17bps to 10.02% y/y) sustained its deceleration, driven by stable energy and electricity prices.

Figure 4: Trend in year-on-year headline inflation



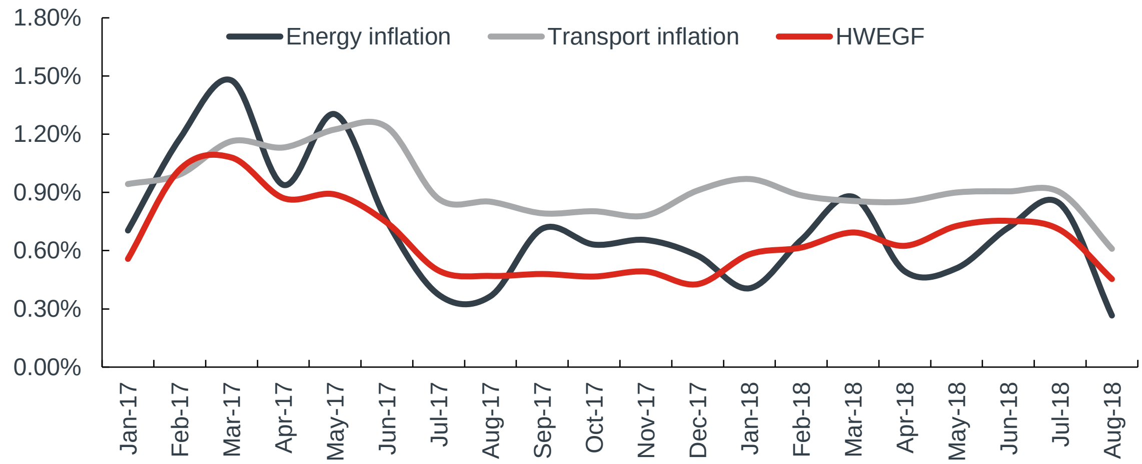
Source: NBS, Cordros Research

Lower energy price drives core inflation deceleration

Core inflation extended its benign campaign since August 2017, slowing by 37bps between June and August to 10.02% y/y, taking its average for the year to 10.90% y/y which is significantly lower than 2017 average of 13.55% y/y. Pertinently, the moderation in the core basket largely stemmed from Furnishing & Household Equipment Maintenance (FHEM) and transport divisions both of which constitute 22.5% of the core basket. Focusing on the later (12.7% of core basket), deceleration in transport inflation largely mirrored sustained decline in energy inflation (Jun-Aug: -39bps to 7.59% y/y vs. 2017 average: 16.05% y/y) with knock-on effect applying downward pressure on transport prices. With furnishing and household manufacturers facing sustained FX stability and liquidity, together with lower energy prices, we were astonished at nothing that FHEM components declined in tandem.

On a month-on-month basis, core inflation also tracked lower between June and August with average reading of 0.80% m/m, lower than H1-2018 average of 0.86% m/m. Importantly, month-on-month core reversed uptick in June (1.03% m/m), and sustained deceleration through August (0.78% m/m). Decline in the core inflation was supported by moderation in energy inflation (-45bps) and HWEGF (-30bps) with the attendant impact also evident in Transport inflation (-30bps) division. Lower energy inflation reflects pass through from cutback in PMS price (-0.8% to NGN146.9/litre) even as diesel price (+1.5% to NGN207.98) expanded over the review period.

Figure 5: Trend in Energy, HWEGF and Transport inflation



Source: NBS, Cordros Research

Food inflation shows no sign of retreating

Over the first two months of Q3-2018, food inflation expanded by 18bps to 13.16% y/y, driven by jump in farm produce (+34% y/y) and imported food (+6bps) amidst moderation in processed food (-458bps). Importantly, Food inflation bucked its 10-month decelerating trend in August (+31bps) largely reflecting ebbing market supplies following the advent of lean season in the Northern region. The cyclic factor was aggravated by unrelenting farmers and Fulani herdsmen clash, the impact of which curtailed food supplies. Against that backdrop, average food prices tracked by NBS jumped by 30bps with highest increases seen in the prices of cereal, potatoes, yam and other tubers.

On a month-on-month basis, food inflation normalized from the 12-month high of 1.57% m/m in June to 1.40% m/m in July as the impact of festive-motivated demand surge for grains and cereal faded. However, month-on-month food resumed uptick in August to 1.42%. To our mind, the impact of persisting lock jam in the Apapa port terminal which have significantly contributed to the lower turnaround time for haulage operators, thereby leading to higher haulage cost most have contributed to higher food prices for the period as the operators hiked haulage cost by 360% to compensate for days lost to traffic. Evidently, notwithstanding the moderation in farm produce (-1.13%), acceleration in processed food (+292bps) and imported food (+105bps) largely buoyed higher food inflation for the period.

Food supply shortages to dictate headline trajectory

Key to our outlook is sustained stability across the different strata of FX markets, as the CBN remains committed to supplying hard currencies to stem the impact of capital flows reversal on the naira. Hence, the we believe the risk to headline inflation centres around the (1) possible implementation of minimum wage increase, (2) combined impact of flood and herdsmen-farmer clash on food supplies, (3) impact of election-related spending, budget implementation, and higher FAAC disbursement on system liquidity –which could drive speculative tendencies on the naira.

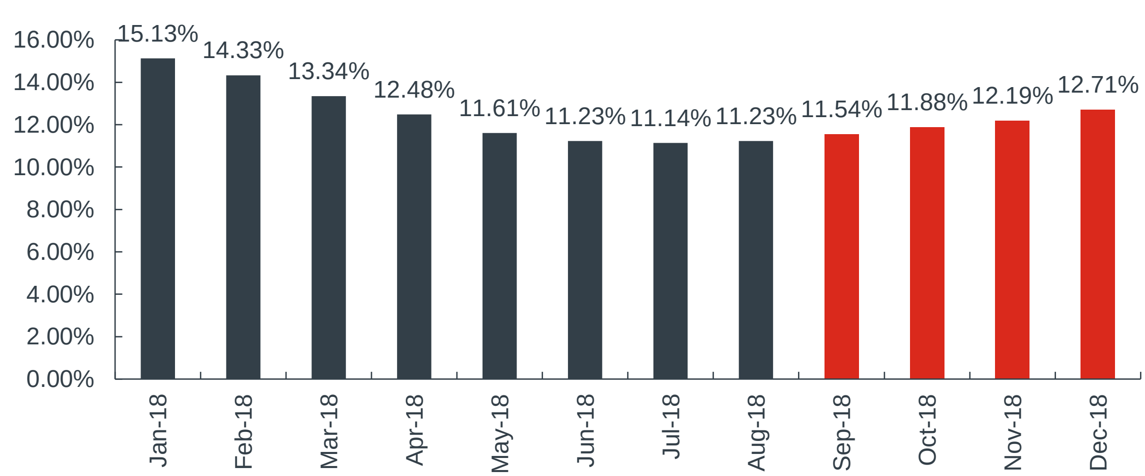
On the core basket, we maintain the views that PMS prices will remain at current levels through the rest of the year, with the NNPC expected to sustain supply of petroleum products to steer clear scarcity. Also, with buoyant FX reserves, supported by rising oil prices and production, including unwavering statements from the CBN to keeping the naira stable, we do not see devaluation risk in the near term. Against that backdrop, we forecast core inflation to average 0.80% through the rest of the year.

On food inflation, with the commencement of main harvest season in the North and South, we expect the influx of food supplies to temper the current pressure on food prices. In addition, as the NNPC is expected to sustain supply of diesel to keep prices in check, we believe the second-order impact from tempered transport inflation will support moderation in food prices. However, this will be largely neutered by the (1) impact of security cataclysms – including herdsmen-farmers clashes across major farming communities and Boko Haram insurgent attacks in the northeast – on the food supplies and (2) recent (in September and October) flooding incidence in some food producing areas. Against the backdrop of the foregoing, we expect month-on-month food inflation to remain largely downward sticky, averaging 1.29% through the rest of the year. Juxtaposing our views on food and core inflation, we expect headline to average 1.06% m/m through the rest of the year (FY-2017: 1.20%).

Overall, with the gains from base effect already dissipated, together with our expected higher m/m inflation over Q4-18 compared to 2017, we expect the year-on-year headline CPI to sustain upward trajectory through the rest of the year. We now look for headline CPI of 11.54% y/y in September and 12.71% in December (FY-2018 average: 12.37% y/y).

Beyond 2018, the risk to inflation is loftier, considering the low base of H1-2018, amidst possible increases in PMS price and electricity tariff – as the realities of higher exchange rate and crude oil prices sets - as well as the implementation of minimum wage.

Figure 6: Headline inflation forecast



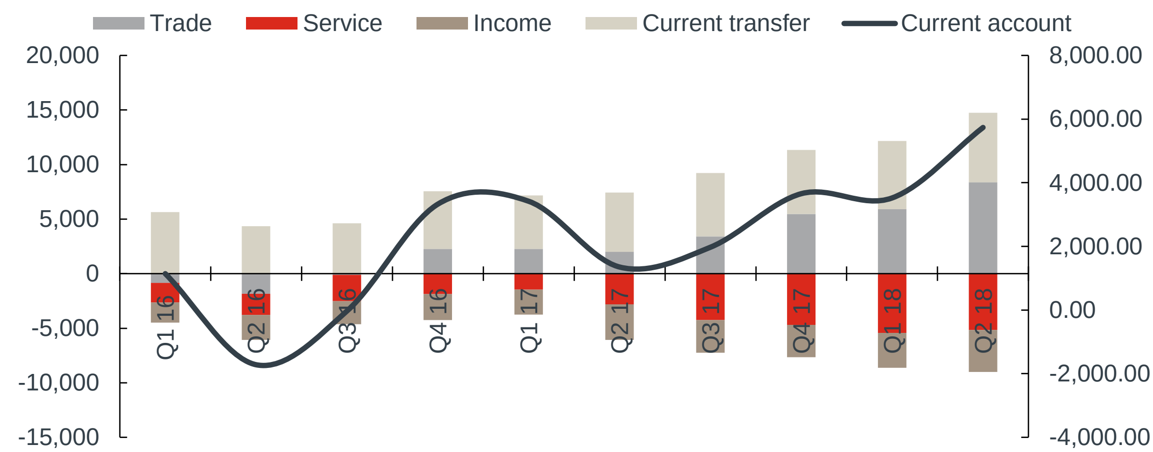
Source: NBS, Cordros Research

15 October 2018

Currency: Current account extends surplus position...

According to the data released by the CBN, Nigeria's current account position remains resolute in the surplus terrain over H2-2018, printing a record of USD9.3 billion against USD5.6 billion in H2-2017. Notwithstanding the widening service and income deficits, the firming current account surplus was largely supported by sharp jump in trade and current transfer. Sifting through the data, we note that the continued increase in trade surplus benefitted from higher crude prices following heightened tension between U.S and Iran, together with politically-instigated crude supply disruption in Venezuela. Elsewhere, service and income deficits widened further during the period, however neutered by remittances-induced surge in current transfer.

Figure 7: trend in current account balance and components

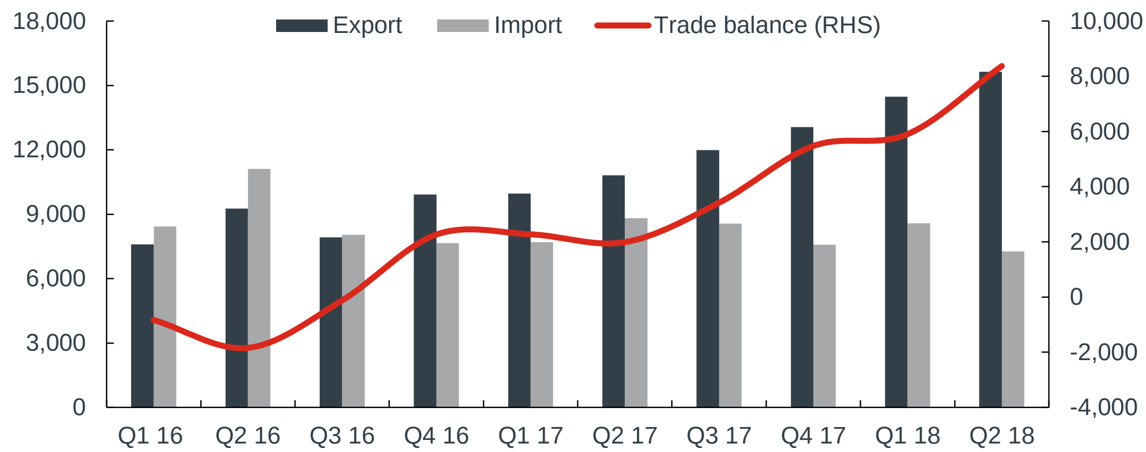


Source: CBN, Cordros Research

...with support stemming from crude oil price

In line with the trend in recent quarters, external trade balance extended its surplus position in Q2-2018 by 41.2% q/q to USD8.4 billion, taking trade surplus over H1-2018 to USD14.3 billion, against USD8.9 billion in H2-2017. The sustained improvement in trade balance reflected rapid expansion in export (+8% q/q to USD15.6 billion), amidst moderating import (-15.3% q/q to USD7.3 billion). As stated earlier, pass through from crude oil price rally (average Brent: +11.2% to USD74.96), which made of for production shortfalls (-1.84% to 1.84mb/d), must have lend a hand to crude oil and gas export earnings (2.5% q/q to USD13.8 billion) for the period. Also, non-oil export surged by 84.9% q/q to USD1.8 billion, driven by expansion in electricity (+7.9% q/q) and other non-oil export (+87.6% q/q). On the other leg, we attribute the decline in import primarily to moderation in oil import (-54.2% q/q), even as non-oil import (+0.9% q/q) sustained expansion. On oil import, we note that the NNPC slowed down importation of petroleum product over Q2-2018 by 16.6% q/q to 4.73 billion litres (Q1-2018: 5.67 billion litres), citing that its inventory is buoyant enough to meet domestic demand.

Figure 8: Trend in external trade balance



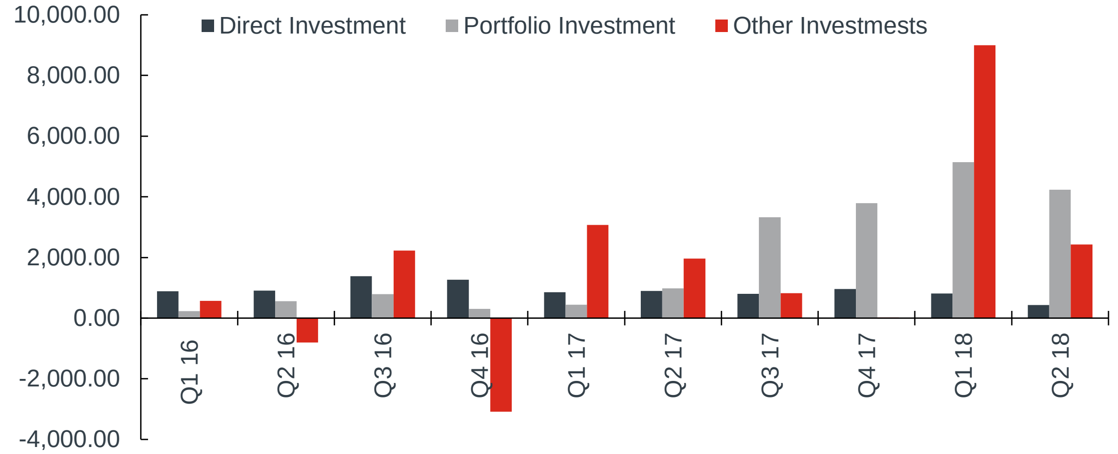
Source: CBN, Cordros Research

Elsewhere, whilst trade surplus continues to strengthen, developments across income and service line of the ledger inspired less confidence. Instructively, income deficit expanded faster by 55.3% q/q, driven by rapid expansion in investment income deficit (+20.8% q/q), meanwhile, service net debt position lingers amidst slower deficit expansion in transport services. However, the impact of sustained surge in current transfer, driven by increased workers remittances, combined with robust trade surplus, largely subdued the service and income deficit, thereby leaving overall current account surplus picture set in concrete.

Financial flows slowed on investors' apprehensions to emerging market assets

On the rest of the ledger, financial account (the line that record capital flows into the economy) hit a record high of USD14 billion in Q1-2018, albeit slowed in Q2-2018 (-52.5% q/q to USD7.1 billion) following sharp moderation across all lines. Specifically, declines in foreign direct investment (-46% q/q to USD436 million), foreign portfolio investment (-17.7% q/q to USD4.2 billion), and other investment (-73% q/q to USD2.4 billion) largely necessitated the slowdown in capital flows. However, the capital flows of USD22.1 billion recorded over H2-18 is 1.3x higher than the USD9.7 billion in H2-2017 (when the I&E window was just established).

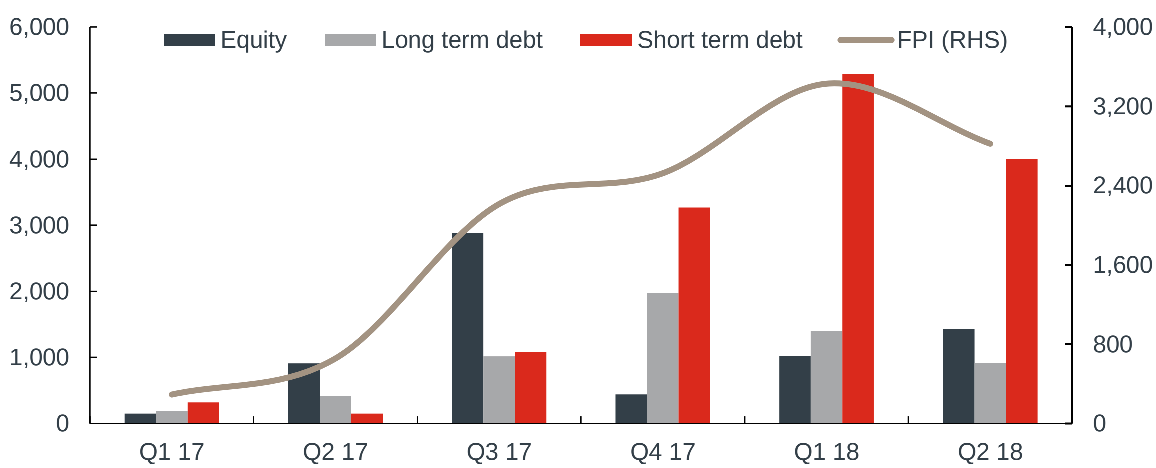
Figure 9: Movements in capitals flows into the Nigerian economy



Source: CBN, Cordros Research

Notably, the sizeable decline in FPI over Q2-18 largely reflects cutback in flows to short- and long-term investment securities, even as flows to equities expanded for the period. To our mind, the duo impact of attractive rates in the U.S, which contributed to the asset routs across emerging and frontier markets, together with moderating domestic yield (avg. yield Q2: -90bps), which left Nigeria's debt market unattractive compared to the prior periods, drove the benign flow to naira debt instruments. On flows to equities, in spite of the permeate sell-off witnessed over Q2-2018 (-7.8% vs. Q1-2018: 8.5%), foreign portfolio flows to equity market tracked by NSE showed that flows to equity increased by 9.2% q/q, taking the percentage of foreign participation in the equity bourse to 52.8%, from 43.4% in Q1.

Figure 10: Trend in foreign portfolio flows and components



Source: CBN, Cordros Research

Away from FPI, decline in other investment was on the back of sharp moderation in general government and bank loans (-66.6% q/q). Meanwhile, slowdown in equity (-97.9% q/q) and other capital (-96.9% q/q) drove a moderation in FDI, even as reinvested earnings (+5.0% q/q) expanded for the period.

Mushrooming trade surplus leaves naira with little downside risk

Going forward, we expect the combined impact of sustained rally in crude oil price and improved crude production will continue to buoy overall export while lower petroleum import should keep import at bay, even as weak consumption continues to subdue non-oil import amidst still-high USD/NGN. Evidently, after the temporary shutdown in May due to pipeline leaks, Trans-Forcados terminal is back in operation, with market hints already pointing to crude production of c.2.0mb/d. That, together with higher crude oil price over H2, should reinforce overall export. Hence, we expect FY-2018 export to print USD60.2 billion (FY-2017: USD45.8 billion).

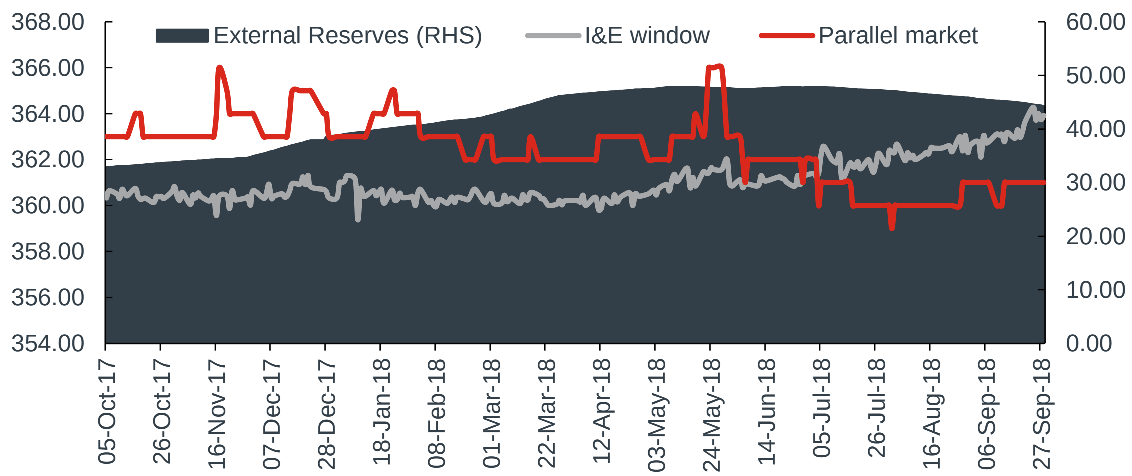
On imports, we highlight that since the introduction of the I&E window last year, import has been largely sluggish, trailing pre-shock year of 2015, despite FX stability and availability. Again, we attribute this to weak consumption level, as clearly reflected in non-oil import (84% of overall import). With NNPC slowing down petroleum import on the justification of robust inventory level to meet domestic demand, we see scope for further slowdown in import (-3.0% y/y to USD31.7 billion), with the attendant impact driving higher trade surplus (+1.2x to USD28.5 billion). Juxtaposing our implied trade surplus and projected service deficit of (USD19.6 billion) and income deficit of (USD13.8 billion), together with expected current transfer surplus of USD25.1 billion, we now project current account surplus at USD20.3 billion in 2018 (FY-2017: USD10.4 billion).

On financial account, we expect a combination of elevated interest rate in the U.S, sustained emerging and frontier assets sell-off, election related risk, and weak economic fundamental to continue to drive foreign investors apprehension towards naira assets over the coming quarter, thereby leaving capital importation on a knife edge. On balance, despite the moderation in capital flows, still positive balance of payment picture suggests minute downside risk to the naira.

CBN remain unperturbed as foreign sell-offs continue.

In our H2-2018 outlook report, we posited that improvement in external balances, together with strong FX reserves, will continue to lend credence to the CBN's forex strategy and sustain the naira – against U.S dollars – at current levels. However, we posited that the downside risk to our view will stem from political uncertainty relating to brewing election period, combined with foreign investors persistently exercising caution towards emerging markets – anchored on normalization of interest rate in the US (and possibly, stronger signal coming from the ECB). True to this, CBN continued its intervention to ward off speculative tendencies against the naira. As foreign sell-off of naira assets continues into Q3-2018, with consequent increased demand for FX at the I&E window, the CBN stepped up its intervention across its different strata of FX windows. To be specific, over Q3-2018, CBN sold a total of USD3.96 billion at the I&E window – 2.3x higher than total sales in Q2 – as foreign investors FX purchases surged to USD7.1 billion, against USD5.1 billion in Q2 and USD2.6 billion in Q1-2018. Against that backdrop, FX reserve depleted by USD3.48 billion over Q3 (Q2-2018: USD1.5 billion increase), leaving the naira within our projected band of NGN353-NGN365/USD and NGN363-NGN368/USD at the I&E and parallel markets.

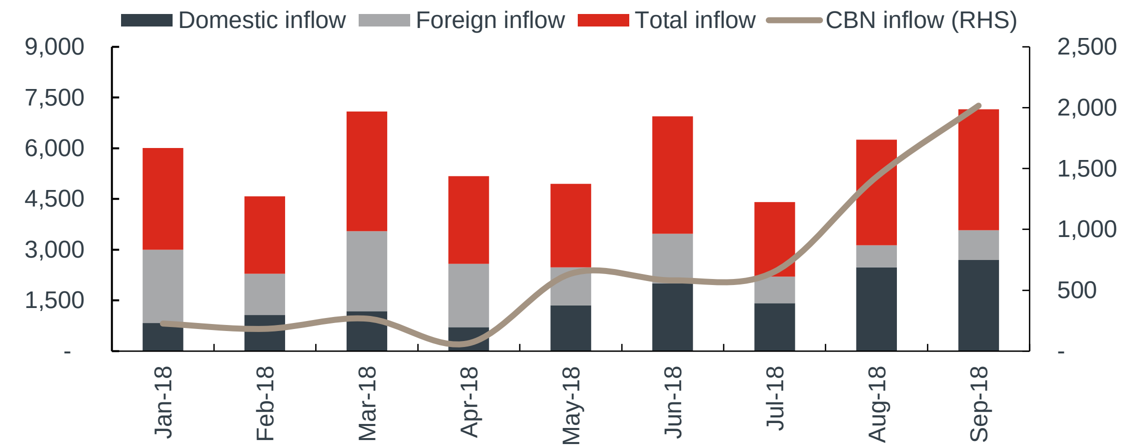
Figure 11: Trend in FX reserves and rates at the I&E and parallel market



Source: CBN, FMDQ, Cordros Research

Extending the trend since May 2018, FX inflows to the I&E window sustained moderation in Q3-2018, with the CBN plugging the shortfall, thereby keeping the market largely stable. Available data suggests that total inflows to the I&E window stood at USD4.4 billion, largely driven by the sharp jump in local inflow (+62.2% to USD6.6 billion), amidst huge moderation in foreign inflow (-48.2% to USD2.3 billion). Focusing on the later, the moderation of FDI (-61.9% q/q), FPI (-50% q/q), and other corporates inflows (-7.6% q/q) dragged total foreign inflow in the review period. To our mind, widespread emerging market sell-offs, amidst attractive rates in the U.S, together with the impact of election-related risk, largely drove reduced FPIs, as investors continue to keep naira assets at arm's length. On the other leg, in the face of slowdown in foreign inflow, the CBN stepped in to plug the deficit with an inflow of USD4.1 billion (+220%), with knock-on effect driving local inflows higher. Stripping off CBN inflow, local inflow would have moderated to USD2.5 billion (-10.4% q/q), underscoring our views that inflow to I&E has been supported by CBN's supplies.

Figure 12: Movements in FX inflows into the I&E window

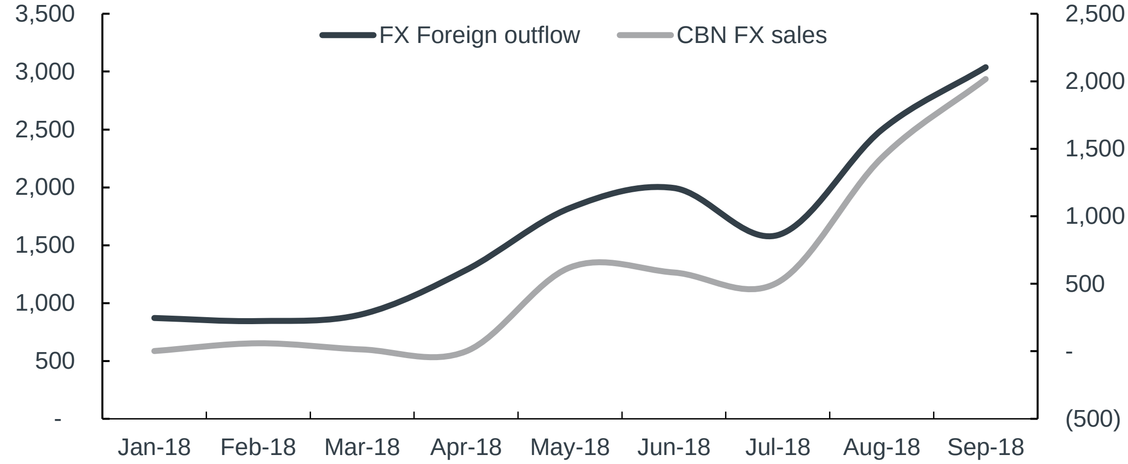


Source: FMDQ, Cordros Research

Elsewhere, whilst CBN significantly reduced its FX purchase in the window, we highlight that the increased total outflow was on the back of faster rise in foreign investors demand (+39.6% to USD7.1 billion) as the naira proceeds from local assets sell-off queued at the I&E window. As stated earlier, CBN provided USD3.96 billion of the total foreign demand while the balance was met via foreign inflows.

To add, in an effort to achieve analogous stability across other markets, CBN sustained its intervention by selling a total of USD7.2 billion (26.8% q/q) in the SMIS, SMEs, and invincible windows. Overall, the CBN's total dollar sale stood at USD11.1 billion (Q2-2018: USD6.9 billion), with 65% of the total channelled to the I&E window. Against that backdrop, USDNGN rates was stable at NGN363.92 and NGN361 at the I&E window (-0.7% q/q) and the parallel market (+0.3% q/q) respectively.

Figure 13: Foreign FX demand (LHS) vs. CBN sales at the I&E window



Source: FMDQ, Cordros Research

The apex bank alacrity will leave the naira unchanged

In framing our views on currency for the rest of the year, we analysed key fundamentals across balance of payment vis-à-vis its impacts on CBN's cash flows position, and subsequently flows into FX reserves. On balance of payment, we estimated FY-2018 current account surplus of USD20.3 billion – cut across trade surplus (USD28.5 billion), service (USD19.6 billion), income (USD13.8 billion) and current transfer (USD25.1 billion). Also, we projected a slowdown in flows to financial account, anchored on sustained investors apprehension towards emerging and frontier markets, together with sell-offs ahead of the imminent local general election.

Having resolved the BOP consideration, we then evaluate CBN dollar sales across its different FX markets going forward. In our model, we expect the elevated dollar sale by CBN to persist (September: USD4.51 billion vs. H1 monthly average: USD2.1 billion) on the back of sustained pent-up FX demand occasioned by continued offshore sell-offs as general elections draw closer and policy normalization continues in the U.S. In any case, with our views of sturdy CBN inflow (driven by higher crude oil price and prospects of USD2.8 billion Eurobond), combined with strong FX reserves (USD43.9 billion), we believe the CBN has more than enough legroom to keep the naira at current level through the rest of the year.

15 October 2018

Disclosures.

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Important Disclosure

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