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Economic Outlook

19 Jul. 23

Charting a new course for sustainable growth



Fast-paced start with bold economic reforms

President Bola Tinubu has assumed office with a commitment to driving economic growth. His administration implemented transformative changes immediately. Fuel subsidies were eliminated to confront fiscal challenges. Simultaneously, sweeping reforms revamped the foreign exchange (fx) market, uniting fragmented market segments, eliminating trading restrictions, and bridging the gaping chasm between the official and parallel market rates. These actions aim to attract investments and stimulate economic growth. We are optimistic that the policy reforms investors have embraced will steer the nation towards a positive growth trajectory and lay the foundation for sustainable growth.

Ambitious growth targets likely to be tempered by headwinds to consumer spending

The administration has set a target of 6% average GDP growth over the next four years. However, the target has challenges. Rapidly rising consumer prices contribute to a contraction in household consumption and a drag on economic activity. Reduced consumer spending could also result in a slowdown in private investment in the near term. Consequently, achieving the ambitious target seems doubtful. Considering the constraints to consumer spending, we anticipate growth of 2.9% in 2023 and rising to an average of between 3.5% to 5% over 2024-27F.

Fx supply deficit driving exchange rate volatility

Despite the CBN's floating of the naira, a large supply deficit remains in the fx market. Therefore, we expect substantial volatility in the naira exchange rate, at least in the near term. Also, we do not see an increase in liquidity from foreign portfolio investors as they will likely remain on the sidelines until they can repatriate a substantial proportion of their trapped fx funds, estimated at roughly USD3bn. In this context, we see an end-year rate of NGN825/USD.

Likely pause in MPC's rate hikes: inflation to remain elevated

We expect the MPC to pause its rate hike cycle at its Jul '23 meeting to assess the effectiveness of prior rate hikes. Therefore, we see the policy rate unchanged at 18.5%. However, monetary policy will remain tight. We expect a year-end inflation rate of c. 28.2%.

Central economic indicators

	2021	2022	2023F	2024F
Real growth (in per cent)	3.4	3.1	2.9	3.5
CPI (in per cent; y/y Dec)	15.6	21.0	28.2	21.0
Monetary policy rate (%; year-end)	11.5	16.5	18.5	17.5
Current account/GDP (in per cent)	0.2	1.7	0.2	0.8
Bonny Light (end-period spot; USD/b)	79	83	76	83
Bonny Light (average spot; USD/b)	72	104	79	77
Official fx reserves (in USD bn)	41	37	34	36
NGN/USD (NAFEX/I&E; end-period)	424	462	825	925
NGN/USD (NAFEX/I&E; average)	414	430	661	886

Source: CBN; National Bureau of Statistics (NBS); IMF; Bloomberg ; FBNQuest Capital Research

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The policy and political backdrop

President Tinubu's dynamic agenda unleashed

President Bola Ahmed Tinubu assumed office on 29 May '23 after a rigorous presidential campaign that generated significant public interest and anticipation. In his inaugural speech, the President articulated his commitment to driving economic growth through a radical shift in economic policies. He emphasised the importance of enhancing the security architecture. He announced plans to invest in security personnel, recognising security's critical role in fostering a conducive environment for business and economic growth. The President's speech infused hope and optimism among the populace, setting high expectations for the country's economic trajectory.

Since assuming office, the administration has implemented significant changes to foster economic development, attract investments, and address pressing issues. In his inaugural address to the nation, the President eliminated fuel (petrol) subsidies, a long-standing policy that had posed significant fiscal challenges to the government. The President promoted the idea of subsidy removal during his campaign. However, the timing of its execution surprised many, given previous unsuccessful attempts by previous leaders.

Thus, it was necessary given the dire fiscal situation and its burden on government finances. It is estimated that the federal government (FG) spent over NGN7trn on petrol subsidies in 2022, equivalent to approximately 3.5% of 2022 GDP.

As a preliminary step towards fulfilling his commitment to implementing a comprehensive review of monetary policy and achieving exchange rate unification, the President promptly suspended Mr Godwin Emefiele from his position as the Governor of the Central Bank of Nigeria (CBN) within two weeks of assuming office. This action was immediately followed by the CBN's announcement of foreign exchange (fx) policy reforms. Key elements of the reforms include:

1. The elimination of all fx market segments and their consolidation into the Investors and Exporters (I&E) window.
2. The removal of trading caps on the I&E window to allow for the free float of the naira exchange rate.
3. The reintroduction of the willing buyer and willing seller model aimed to match fx buyers with fx suppliers.
4. The reintroduction of two-way order quotes, among others.

Consolidating the fx market is anticipated to improve transparency, streamline fx operations, and foster a more efficient and unified fx market. We anticipate that this consolidation will attract the interest of foreign offshore investors and stimulate economic growth. Since the CBN's announcement, the naira has depreciated by over 40%, almost completely closing the previous arbitrage gap between the official and parallel market rates.

A benefit of eliminating losses from the arbitrage spread is that it could help alleviate pressure on the gross official reserves. CBN data reveals that total fx sales through its official windows reached almost USD15.3bn in 2022, resulting in an estimated opportunity cost of around NGN4.6trn. The full benefits of the new fx policy will not be realised immediately. However, we expect the changes to gradually improve fx liquidity over the medium term, particularly as foreign portfolio investors (FPIs) and foreign direct investor confidence are rebuilt. In our view, the single largest hurdle remaining is the ability of FPIs to repatriate their backlog of trapped funds in the country.

The administration set up a Presidential Committee on Fiscal Policy and Tax Reforms to address the historical underperformance of fiscal policy. This committee is responsible for:

1. Reviewing existing tax policies,
2. Proposing improvements to government fiscal policies,
3. Suggesting reforms to enhance tax administration,
4. Promoting efficiency in tax collection, and
5. Ensuring sustainable revenue generation.

These policies aim to increase the nation's tax revenue-to-GDP ratio to 18% over the next three years from its current level of around 11%. Other measures taken to increase tax revenue include implementing a 7.5% value-added tax (VAT) on automotive gas oil (diesel) and establishing the VAT direct initiative, which aims to facilitate VAT collection from the informal sector. Furthermore, in response to the concerns of manufacturers and private sector operators, the President took several actions through executive orders:

1. He signed the finance Act (effective date variation) order, 2023, which postponed the implementation of changes outlined in the Act from 23 May '23 to 01 Sep '23.
2. Suspended the customs, excise tariff (variation) amendment order, 2023, deferring the commencement date of the tax changes from 27 Mar '23 to 01 Aug '23.
3. He suspended the 5% Excise Tax on telecommunication services.
4. Suspended the proposed green tax, also known as the excise tax on single-use plastics.

The President has also prioritised the power sector by signing the 2023 Electricity Act into law. This new act liberalises the electricity sector, granting authority to states, companies, and individuals to invest in electricity generation, transmission, and distribution. According to the Act, state governments can now license private investors to operate mini-grids and power plants within their respective states.

However, the Act does not allow for interstate and transnational electricity distribution. This action is significant given Nigeria's well-known energy deficit, which is reported to be the largest in the world. According to the SDG7 tracking report, around 90m people in Nigeria or 45% of its population, lack access to power.

The administration has set an ambitious growth target of achieving an average GDP growth of 6% over the next four years. While this goal is commendable, there are challenges ahead. Private household consumption, which typically contributes around 70% to GDP, experiences severe strain. We anticipate a significant contraction in household consumption in 2023 as households respond to the relentless rise in consumer prices. Factors contributing to this include the elimination of fuel subsidies and the 40% devaluation of the naira following the CBN's currency floatation.

Furthermore, reduced consumer spending will likely lead to a deceleration in business spending (private investment) due to lower household demand. Also, the government's push for increased revenue through its aggressive tax measures may further impact corporate earnings and lead to lower capital investment. Given the prevailing conditions and weak growth expectations of around 2.9% in 2023, it is doubtful that the 6% average GDP growth target will be achieved. However, we anticipate a more modest growth rate of 3.5% to 5% over the 2024 to 2027 forecast period.

Drivers of the economy

Nigeria’s economy remains relatively weak after a subdued performance in Q1 '23, which recorded real GDP growth decelerating to 2.3% from 3.5% in Q4 '22. While this growth represents the tenth consecutive quarter of expansion since the country emerged from recession in Q4 '20, it was the second weakest quarter of economic activity out of the past eight.

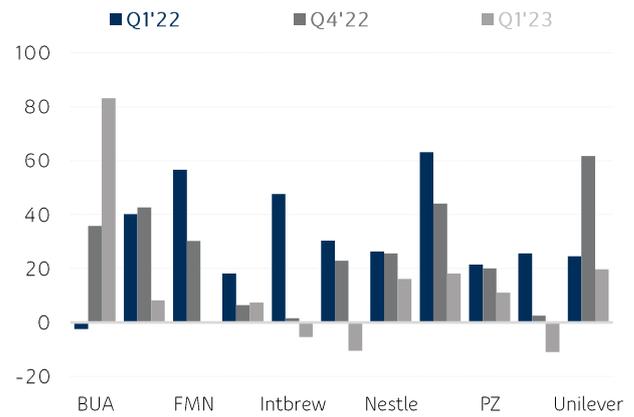
The slowdown was primarily due to the adverse impact of cash scarcity resulting from the CBN's naira redesign policy and uncertainties surrounding the general elections held during the quarter. The impact of these factors was evident in the corporate earnings results for Q1 '23 of several companies within our equity research coverage, which showed y/y moderation in sales growth. The average sales growth for our universe of consumer goods stocks declined to 14% y/y in Q1 '23 compared to 27% and 32% in Q1 '22 and Q4 '22, respectively.

Real GDP growth (%)



Source: National Bureau of Statistics (NBS); FBNQuest Capital Research

Y/y sales growth rate of consumer good companies (%)



Source: Company financials; FBNQuest Capital Research

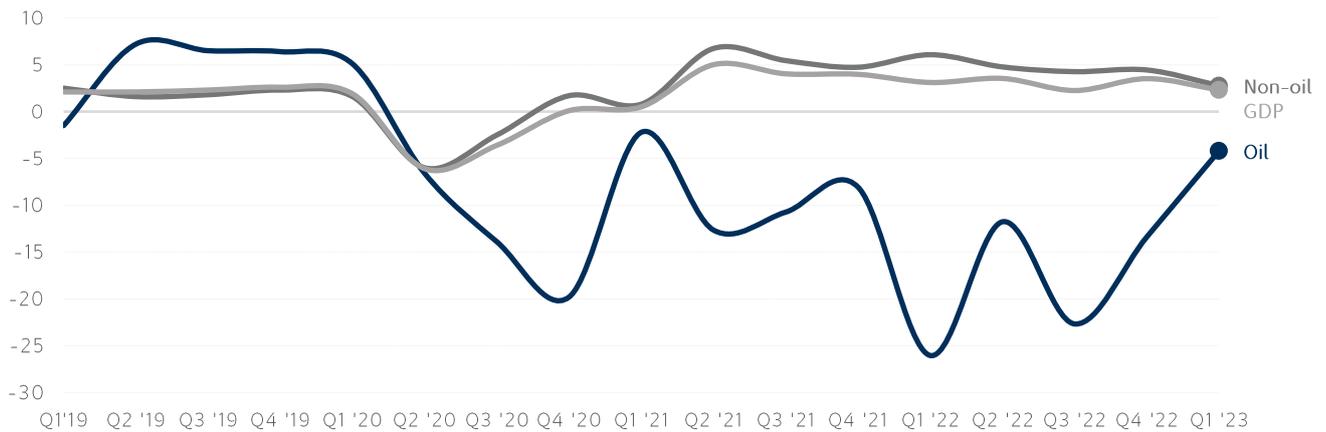
Regarding the two broad sectors that make up the Nigerian economy, the non-oil sector has remained the mainstay. Its growth averaged 4.9% y/y over the past eight quarters leading to Q1 '23, slightly surpassing the 4.7% growth registered for the previous eight quarters. However, in Q1, the sector's growth experienced a slowdown, declining to 2.8% from 4.4% in the preceding quarter.

While the non-oil sector has demonstrated consistent growth, the performance of oil GDP has been persistently weak, exerting significant downward pressure on aggregate GDP. Specifically, the oil sector has remained in recession for 12 consecutive quarters. Over this period, the sector's GDP reduced by an average of -13.4%, primarily driven by a steady decline in crude oil production. However, data for Q1 '23 showed a modest contraction of -4.2% compared to sharper declines of -13.4% and -26.0% in Q4 and Q1 '22, respectively.

The sector’s sustained decline limited the country's ability to fully benefit from the high oil prices experienced in 2022. According to the NBS, average crude oil output (including condensates) improved to 1.51m barrels per day (mbpd) from 1.34mbpd recorded in Q4 '22 and 1.49mbpd in Q1 '22. However, the decline in oil prices, which averaged c. USD 84 per barrel during Q1, compared to USD 104 per barrel in Q1 '22, had a more pronounced impact on the sector’s economic output. Despite the rise in crude oil production during the quarter, the output level was still well below Nigeria's OPEC quota of 1.8mbpd.



GDP, oil and non-oil growth (% change y/y)

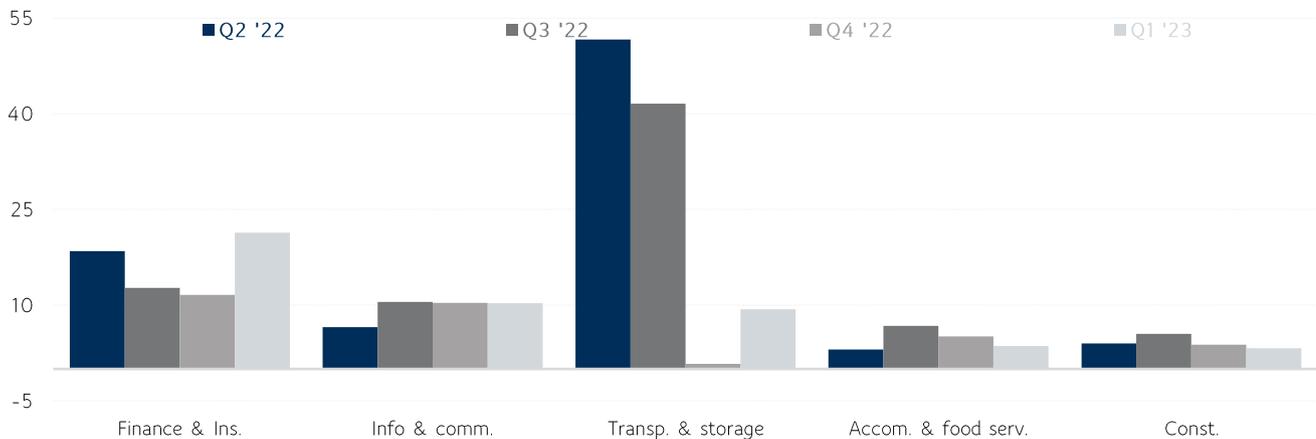


Source: National Bureau of Statistics (NBS); FBNQuest Capital Research

The tertiary sector encompassing services, played a significant role in driving the growth of the non-oil sector, with notable contributions from finance and insurance, and information and communications (ICT). These sectors expanded by 21.4% and 10.3%, respectively.

The robust growth in finance and insurance was mostly due to elevated market interest rates resulting from monetary policy tightening measures implemented by the CBN. This led to stellar growth in non-interest income for the banking sector, which accounts for the largest share of economic activity within finance and insurance. Additionally, banks' revenue growth was supported by significant increases in non-interest income due to several factors such as fx revaluation gains and growth in trading and fee-based income.

Top performing sectors (% chg; y/y)



Sources: National Bureau of Statistics (NBS); FBNQuest Capital Research

Growth for ICT has been the most consistent among the activity sectors and is primarily supported by the revenue growth of GSM network operators. These operators have experienced double-digit sales growth across various business verticals, particularly in data, digital services, and fintech. While the voice segment has reached a mature growth phase, it is still experiencing modest single-digit growth. Transportation and storage also grew healthily by 9.4%, led by an expansion in road transportation, an improvement over the 0.8% it delivered the previous quarter.

In the underperforming sectors, mining and quarrying experienced a contraction of approximately -4.0%, largely driven by the decline in crude petroleum and gas, which contracted by -4.2%. The sector has been in a recession since Q2 '20, mainly due to the decline in oil production caused by large-scale crude oil theft.

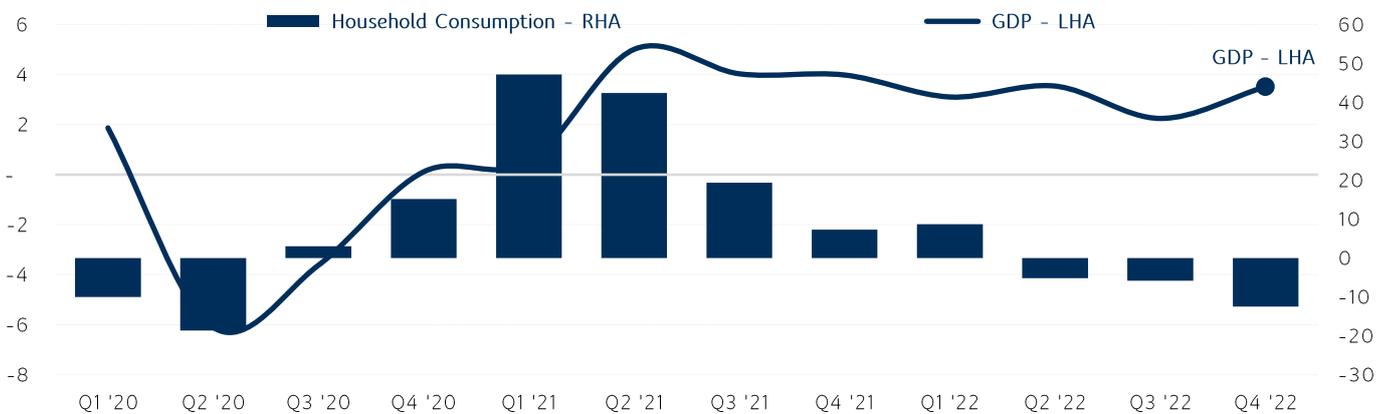


Additionally, agriculture GDP decreased by -0.9%, primarily reflecting issues related to insecurity in food-growing regions and challenges in transportation and logistics, among other factors. Trade, real estate, and manufacturing sectors also recorded weak growth rates ranging from 1% to 2% due to cash shortages, uncertainties surrounding elections, inflationary pressures, high-interest rates, and fx pressures.

Weakening consumption of households

GDP data based on expenditure patterns are typically released with a lag, and the NBS has not yet published data for Q1 '23. However, the Bureau's most recent report on GDP using the expenditure approach provides valuable insights into the growth trends of different expenditure components. According to the available data, there was a significant weakening in private consumption during Q3 and Q4 '22, with household consumption contracting by approximately -5.8% y/y and -12.5% y/y in Q3 and Q4 '22, respectively. These findings align with observations from anecdotal evidence. Overall, the data indicates household consumption declined by -4.1% year-on-year in 2022.

Real GDP growth and household consumption (% chg; y/y)



Source: National Bureau of Statistics (NBS); FBNQuest Capital Research

The primary cause of weaker private consumption was the strain on household wallets resulting from the detrimental effects of double-digit inflation. The situation was worsened by the adverse impact on economic activity resulting from the cash scarcity caused by the introduction of the CBN's naira redesign policy in Q4 '22. A key outcome of the weakness in household demand was that household consumption's share of aggregate GDP shrunk to 61% in Q4 '22 from 73% in Q4 '21. On a full-year basis, its share also declined to 67% from 72% in 2021.

However, the external sector made a notable positive contribution to real GDP growth in Q4, with a y/y growth of c.162%. Crude oil remains Nigeria's primary export, representing around 89% of merchandise exports in Q4 '22. Since services make up only a small portion of total export trade, it can be inferred that the remarkable output growth in the external sector was largely driven by the surge in oil prices. In Q4 '22, oil prices averaged around USD91/b, compared with an average of USD77/b in the corresponding quarter of 2021.

Other notable contributors were gross fixed capital formation (or private investment) which increased by 3.3% y/y in Q4 '22, after declining marginally in Q3 '22, and changes in firm inventories, which rose by 38.1% in Q4 '22, after a contraction of -29.6% in the previous quarter.

Considering the slowdown in economic activity in Q1 '23, it is evident that household consumption further declined in real terms during the quarter. This decline can be attributed to reduced consumer discretionary spending, which was impacted by the adverse effects of double-digit inflation. Given the almost -20% y/y drop in crude oil prices in Q1 '23, we also anticipate that the external sector (net exports) likely registered a y/y contraction during Q1.

Looking ahead, we have revised our GDP growth forecast for 2023 to 2.9%, down from our previous projection of 3.2%. This adjustment primarily reflects the slowdown in economic activity in Q1 '23 and the reduction in the real spending power of households due to multiple headwinds, including high inflation, the removal of fuel subsidies, and the effective devaluation of the naira via the adoption of a free float regime. Additionally, given the subdued levels of crude oil prices in 2023 compared with 2022, we anticipate that the external sector will be unable to replicate its positive contribution to GDP growth this year as it did the previous year.



Unrelenting rise in unemployment; new methodology to flatter

Since its last publication in Q4 '20, which revealed a dramatic increase in the unemployment rate, the NBS has not released updated employment and labour force reports. Its last report for Q4 '20 reveals that the unemployment rate rose to 33.3% from 27.1%. This figure sums up to 56.1% when we add underemployment. This steep rise was worsened by the COVID-19 induced recession of 2020. As a result, Nigeria's unemployment seems to be worsening, with a low-single-digit GDP growth rate that barely exceeds the estimated population growth rate of approximately 3%.

The number of Nigerians of employable age (between the ages of 15 and 64) was 122m in Q4 '20, an increase of 4.4% vs. Q2 '20. This figure included a 69.7m labour force (of employable age and willing to work), a 13.2% decline from Q2 '20. Of the total labour force, 39.1m people were either unemployed or underemployed, compared to 44.6m in Q2 '20. The younger population recorded the highest rate of unemployment. During the period under review, Nigerians aged 15-34 accounted for 69.1% of the total unemployed population.

Unemployment rate (%)



Source: National Bureau of Statistics (NBS); FBNQuest Capital Research; NOTE: There are no quarterly reports in this series between Q3 '18 and Q2 '20

In Apr '23, the NBS announced that it had revised its methodology for the computation of labour force and unemployment statistics to align with international standards and best practices. According to the Bureau, the new methodology falls within the standards of the 19th International Conference of Labour Statisticians (ICLS).

The new methodology introduces notable differences, such as employing a broader measure of employment that encompasses all forms of productive work contributing to the economy, including casual work and other irregular employment, paid and unpaid. Furthermore, the working age population now includes individuals aged 15 and above, whereas the previous methodology set the minimum working age at 15 years and the maximum age at 64 years. Below are some of the key differences between the old and new methodologies



Old vs new labour force survey methodology

Definition	Old framework	New framework
Employment definition	Narrow definition. Entails remunerated and productive work only	All forms of productive work including casual, and other irregular work
Non-working age	<15 or >64 years old	<15 years
Working age	15 to 64 years old	15+ years
Employed (work hours)	Employees working for 40+ hours	Employees working for 40+ hours
Underemployed (work hours)	Employees working for 20-39 hours	Employees working between 1 and 39 hours
Unemployed	Employees working for 1-19 hours, and those not employed and searching	Not employed but searching
Sample size	33,300 households	35,520 households
Reporting and disaggregation	Quarterly with State-level Disaggregation	Quarterly reporting with national Disaggregation, and full-year with State-level disaggregation

Source: National Bureau of Statistics (NBS); FBNQuest Capital Research

With the implementation of the revised Labour Force Statistics methodology, which includes a broader range of employed categories, we can anticipate a decline in unemployment figures. One notable outcome of the revised definitions is a reduction in the unemployment rate, resulting from the adjustment in the minimum number of work hours required for employment calculation, now set at 1 hour instead of the previous 20 hours. Additionally, the new definition of unemployment considers individuals who are not employed and actively seeking work. This differs from the previous definition, which considered those working for 1-19 hours as unemployed under the old LFS methodology.

According to the Bureau's LFS data for Q4 '20, Nigeria's unemployment rate would have been 17.5% using the new methodology, in contrast to the reported rate of 33.3% under the old methodology at that time. The distinction between the two lies in the calculation method. The new methodology considered only the 12.2m individuals who were completely unemployed (working for zero hours) out of a total labour force population of 69.7m. In contrast, the old methodology included a total unemployed population of 23.2m, encompassing 11 individuals who worked for 1 to 19 hours.

Unemployment figures under the old and new methodology

Unemployment (Old LFS)	=	$\frac{(\text{Work 1-19 hours}) + (\text{Unemployed - 0 hours})}{\text{Labour Force population}}$	=	33.3%
Unemployment (New LFS)	=	$\frac{(\text{Unemployed - 0 hours})}{\text{Labour Force population}}$	=	17.5%

Source: National Bureau of Statistics (NBS); FBNQuest Capital Research

While the new methodology results in a significantly lower figure, it does not alter the economic realities faced by the working population. Despite the expected improvement in the unemployment rate, Nigeria's social indicators remain among the weakest globally. According to the NBS' 2022 report on the country's Multidimensional Poverty Index (MPI) survey, approximately 63% of individuals in Nigeria live in multidimensional poverty. This means that around 133m people out of the country's 200m population experience extreme poverty across four dimensions:

1. Health,
2. Education, l
3. Living standards, and
4. Unemployment.

The results of the MPI survey imply that two-thirds of the nation's population survive on less than USD2 per day. Furthermore, Nigeria's score of 0.535 in the latest Human Development Index published by the United Nations Development Programme (UNDP) places it in the 163rd position out of 191 countries surveyed, categorising it within the low human development bracket.

An additional point is that even with the anticipated decrease in the unemployment rate from adopting the new methodology, Nigeria's unemployment rate will remain high, even compared with other African countries. The exception is South Africa, whose unemployment rate was 32.9% as of Mar '23. In comparison, the unemployment rates for sub-Saharan African countries such as Ghana and Kenya are below 15%.

Monetary policy

Revamping monetary policy

The Monetary Policy Committee (MPC) maintained its hawkish stance on monetary policy and unanimously raised the policy rate by +50bps to 18.5% at its last policy meeting in May '23, while other parameters were left unchanged. May's rate hike took the committee's cumulative rate increases to a staggering +700bps since it began tightening measures in May '22.

In alignment with the President's commitment to overhaul monetary policy, the CBN has begun charting a new monetary policy course. Implementing a new monetary policy direction has led to the introduction of substantial fx reforms, which include the liberalisation of the fx market and enhanced confidence among offshore investors. Noteworthy fx reforms unified all fx market segments into the investors' and exporters' (I&E) fx window. Additionally, free quotes were reinstated for fx market participants, limits on customers' domiciliary accounts were removed, and customers gained unrestricted access to deposit cash into domiciliary accounts.

The departure of the former CBN governor resulted in cash refunds to some banks that had previously been debited for exceeding the Cash Reserve Ratio (CRR) limit. The borrowing restriction, set at +200bps over the Monetary Policy Rate (MPR), and the Standing Deposit Facility (SDF) rate, established at -700bps below the MPR, were also lifted. These significant policy changes led to a notable increase in liquidity and subsequently fueled positive sentiments and buying activity across the yield curve.

The combined impact of these adjustments triggered a surge in buying activity, particularly in the short-term segment. T-bill yields dropped to the 4-5% range, while bond yields retraced by approximately 100bps by the end of Q2 '23. Considering the anticipated rise in inflows from the Federation Account Allocation Committee (FAAC), the near-term outlook indicates a steepening in yields. T-bills and short-term bond maturities are expected to experience substantial declines compared to longer-duration investments.

Inflation still surging ahead

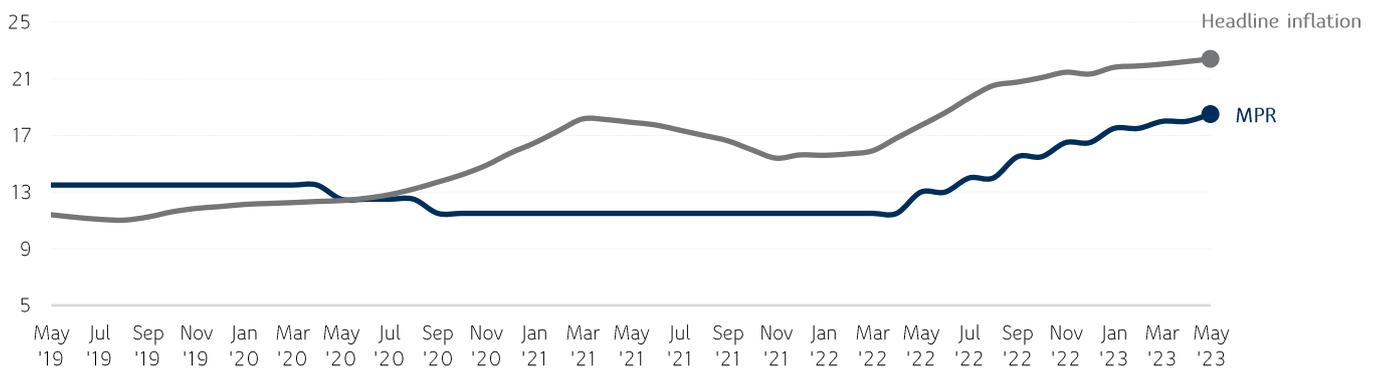
Headline inflation has remained stubbornly high despite the best efforts of the CBN to maintain a tightening stance. Apart from two brief periods of moderation in Jan '22 and Dec '22, headline inflation has steadily increased since Dec '22.

In response to the upward inflationary trend, the monetary policy committee (MPC) initiated its rate tightening cycle in May '22. Since then, it has raised the monetary policy rate (MPR) seven times, the most recent being a 50bps increase in the policy rate in May '23. Despite the central bank's tightening posture, the inflationary trend has been upward, with headline inflation surging to an 18-year high of 22.8% in Jun '23.

The upward trajectory of inflation has been further compounded by the CBN's monetisation of the federal government's fiscal deficits through ways and means (W&M) advances. CBN's data reveals a significant increase in W&M advances to the FG, rising from NGN17.5trn in Dec '21 to NGN23.7trn in Oct '22. To mitigate the consequences of these actions, the CBN resorted to a system liquidity mop-up through discretionary Cash Reserve Ratio (CRR) debits and other administrative measures. However, these measures have sometimes resulted in notable effects on financial system liquidity. One of the unintended consequences of the CBN's naira redesign policy was the scarcity of new naira notes intended to replace the old ones that had been withdrawn from circulation. The scarcity resulted in higher transaction costs and contributed to inflationary pressures.



Headline inflation and MPR (%)



Source: CBN; National Bureau of Statistics; FBNQuest Capital Research

However, a major challenge for the monetary authorities is that most of the significant drivers of inflation are due to structural and supply-side factors. Therefore, the impact of monetary policy has been largely blunted. Notably, except for a brief pause in Dec '22, food inflation which accounts for over 50% of the inflation basket, rose consistently since Mar '22. More specifically, food inflation increased by around 762bps between Mar '22 and May '23. Although its rise can be due to a combination of factors such as inadequate infrastructure, transportation, and logistics challenges, a particularly noteworthy factor is the insecurity in major food-producing states of the country.

Core inflation has also shown persistence, although its smaller weight in the overall basket means its impact is less pronounced. Between Mar '22 to May '23, core inflation experienced a notable increase of around 615bps. Considering the supply-side drivers of inflation, there appears to be limited scope for monetary policy effectiveness, as the majority of these drivers fall within the purview of fiscal policy.

Inflation outlook

The outlook for inflation remains elevated as consumer prices rise in response to some of the policy measures of the new administration, notably the removal of petrol (gasoline) subsidies and the floating of the naira exchange rate. The near tripling of the pump price of petrol following the inaugural day speech of the President and the downward adjustment of the naira exchange rate towards parity with the parallel market rate taking a significant toll on household wallets.

Considering Nigeria's reliance on imports and the widespread use of petrol, including its role in powering generators for households and businesses, we anticipate that the price increases in these variables will have a ripple effect on the overall inflation rate. As a result, we forecast headline inflation to reach approximately 28.2% by the end of 2023, approaching the 30% mark.

Given the elevated outlook for inflation, we expect the monetary policy authorities to keep a tight rein on monetary policy throughout the year. Consequently, since the drivers of the current upward trend in inflation are primarily driven by supply-side structural factors, and considering the significant rate increases of approximately 700bps implemented since May '22, we believe there is limited scope for further rate hikes by the Monetary Policy Committee (MPC) without risking significant harm to the still fragile economic growth.

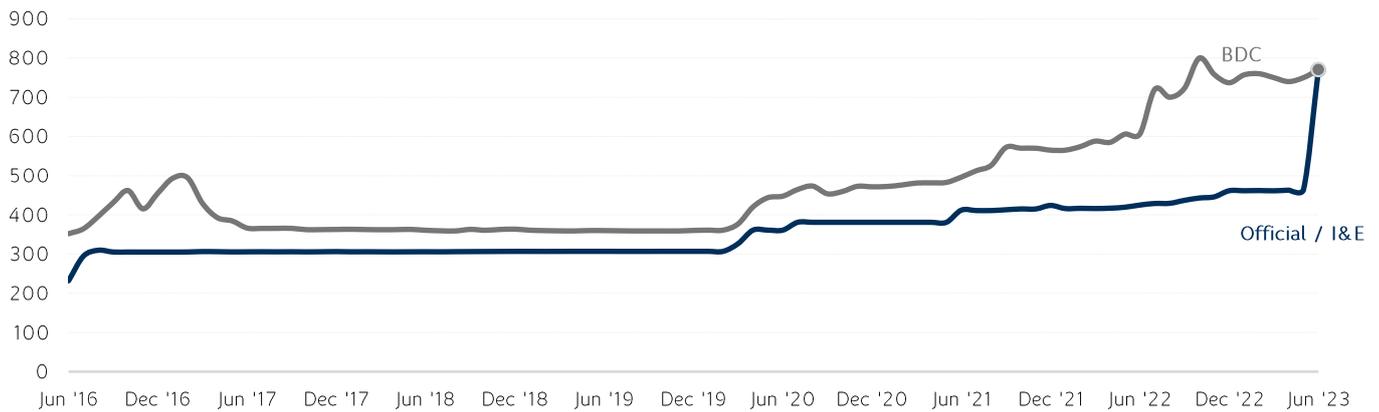
Exchange rate and official reserves

Historically, Nigeria's monetary policymakers preferred a stable but fixed naira exchange rate regime, given its significant impact on domestic inflation. This mindset largely influenced the actions of the central bank and the MPC. However, under the suspended CBN governor, the rigid adherence to the fixed exchange rate regime led to implementing a multiple exchange rate system with various rate windows for different market segments. A significant drawback was the substantial disparity between the official and parallel exchange rate markets, resulting in a premium of over 60% for the latter compared to the former.

As part of his presidential campaign promise, President Tinubu had pledged to implement a comprehensive overhaul of monetary policy with a view to achieving exchange rate unification. Consequently, there were widespread expectations that the monetary authorities would initiate a convergence of exchange rates following the President's election victory.



Average exchange rates (NGN per USD)



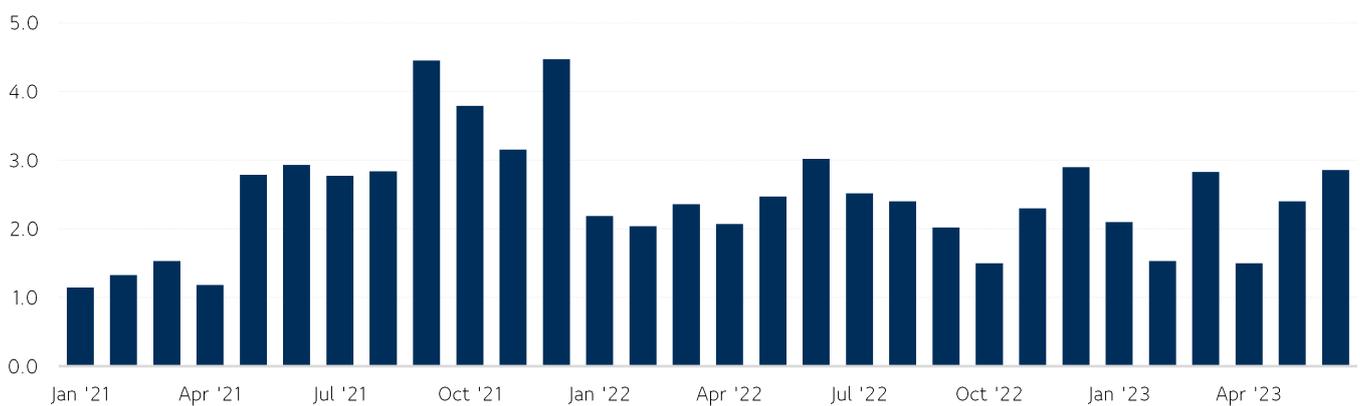
Source: CBN, FBNQuest Capital Research

However, despite the anticipation of exchange rate unification, financial markets were still shaken when the news broke in mid-June that the central bank had consolidated all segments of the exchange rate market into the investors and exporters (I&E) window. This decision eliminated all restrictions and empowered banks to determine their own foreign exchange trading rates, initiating the floatation of the naira

Predictably, the announcement initially led to intense volatility in the fx markets. Removing fx trading restrictions effectively signalled a shift in the central bank's monetary policies. Therefore, the official exchange rate on the I&E window initially depreciated to NGN664/USD from NGN461/USD before settling at NGN760/USD at the end of the quarter. Although the fx market is still in the process of discovering appropriate pricing for the naira, the current trading rate is currently hovering at around NGN760/USD, implying a >40% depreciation and a near closure of the c. NGN300 arbitrage gap that previously existed.

Despite the elimination of fx trading regulations, there has been no discernible improvement in fx liquidity. While FMDQ data show that market turnover increased from USD2.4bn in May '23 to USD2.9bn in Jun '23, the turnover amount is not remarkable, as shown in our chart below. In fact, non-bank corporates and exporters have consistently accounted for around 70% of the total value of fx inflow in the I&E market in recent times.

I&E market turnover (USD'bn)



Source: FMDQ; FBNQuest Capital Research

The market has yet to experience a substantial influx of foreign currency from the offshore investment segment. Over the past two years, FPIs and FDIs have encountered difficulties in repatriating funds from their investment portfolios in Nigeria. Consequently, this community is eagerly seeking clear indications of fx liquidity and assurance that the backlog of fx funds stuck in Nigeria can be repatriated.



Although the naira has been officially floated, and the expectation is for markets to function based on willing buyers and sellers, there are still constraints on fx liquidity, evident from pricing trends. To address this issue, the CBN has to demonstrate a stronger commitment by increasing its interventions in the I&E market to help facilitate the clearance of trapped funds for FPIs and FDIs.

Looking ahead, we anticipate significant volatility for the naira. Due to the substantial gap between fx supply and demand, and the fluctuations in the exchange rate, forecasting the year-end exchange rate has become quite challenging. Despite this, we expect the naira to continue to range from NGN760/USD to NGN850/USD by the end of 2023, with our year-end rate forecast being NGN825/USD.

However, there are potential upside risks to fx supply, as certain policy measures implemented by the current administration may improve fx liquidity when they take effect. One notable measure is the cancellation of NNPC Ltd.'s (NNPCL) crude oil swap arrangements, which will facilitate direct sales of crude oil and the direct purchase of refined petroleum products, eliminating the previous practice of exchanging crude oil for refined products. This change is expected to increase dollar inflows to the gross official reserves. Additionally, with the removal of petrol subsidies, NNPCL is expected to reduce its importation, while oil marketers are anticipated to resume imports. The central bank's approval for international oil companies (IOCs) to resume fx sales to banks will also help inject much-needed liquidity into the market.

Sustained decline in gross official reserves

The gross official reserves have been on a downward trajectory since Oct '21, when they climbed to USD41.8bn due to a combination of the IMF's USD3.3bn SDR allocation, a USD4bn Eurobond issuance, and rising oil prices. According to data from the CBN, the gross official reserves declined by USD975m m/m and USD1.4bn q/q to USD34.1bn as of the end of Q2 '23. YTD, total reserves have decreased slightly over USD3bn to just over USD34bn, indicating an average monthly depletion rate of approximately USD467m.

Gross official reserves (USD bn)



Source: CBN; FBNQuest Capital Research

Total reserves at end-Jun '23 covered 7.1 months of merchandise imports per the balance of payments (BoP) for the 12 months to Dec '22 and 5.3 months when we add imported services. The cover has deteriorated materially in recent months. Despite this, it exceeds the international benchmark of 3.0 months of import cover. However, for a fuller picture, we must adjust these figures for the delayed external payments estimated at roughly USD3bn and the CBN's fx swaps.

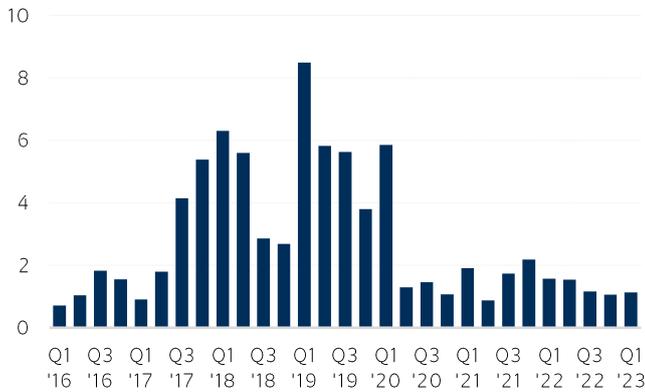
The decreasing fortunes of the external reserves mostly reflect minimal accretion from crude oil sales and, to a lesser extent, limited inflow of imported capital. Regarding capital importation, the most recent data from the NBS show that the total value of capital imported into Nigeria was a paltry USD1.1bn in Q1 '23, representing a -28% y/y decrease. This compares with an average quarterly figure of USD5.0bn in the eight quarters before the COVID-19 pandemic started in Q2 '20.

The central bank's decision to float the naira and liberalise the fx market already yields some positives. Recently, the MSCI made an important announcement regarding its consultations with Nigerian market participants. It is now reconsidering its initial stance of removing Nigeria from the MSCI frontier market index and classifying it as a standalone market.



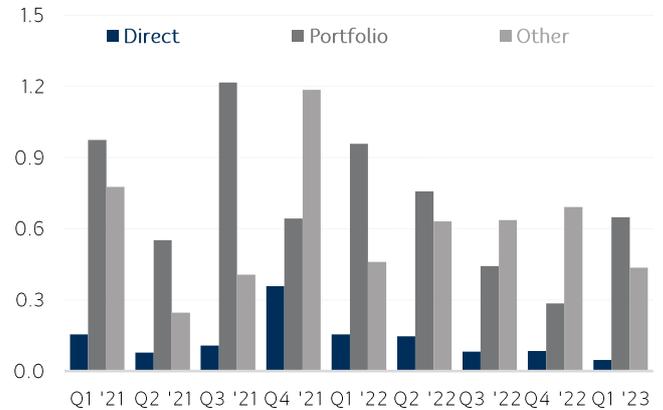
The results of these consultations will be announced by 31 Oct '23. The consultations will specifically assess the accessibility of Nigeria's fx market, particularly the impact on the clearing of the fx queue during the capital repatriation process. With the recent changes to the fx market, including the removal of restrictions, we are optimistic about receiving a positive assessment from the MSCI. This development could enhance Nigeria's appeal as an investment destination and pave the way for the gradual return of FPIs to the country.

Capital importation (USD 'bn)



Source: National Bureau of Statistics; FBNQuest Capital Research

Capital importation by type (USD 'bn)



Source: National Bureau of Statistics; FBNQuest Capital Research

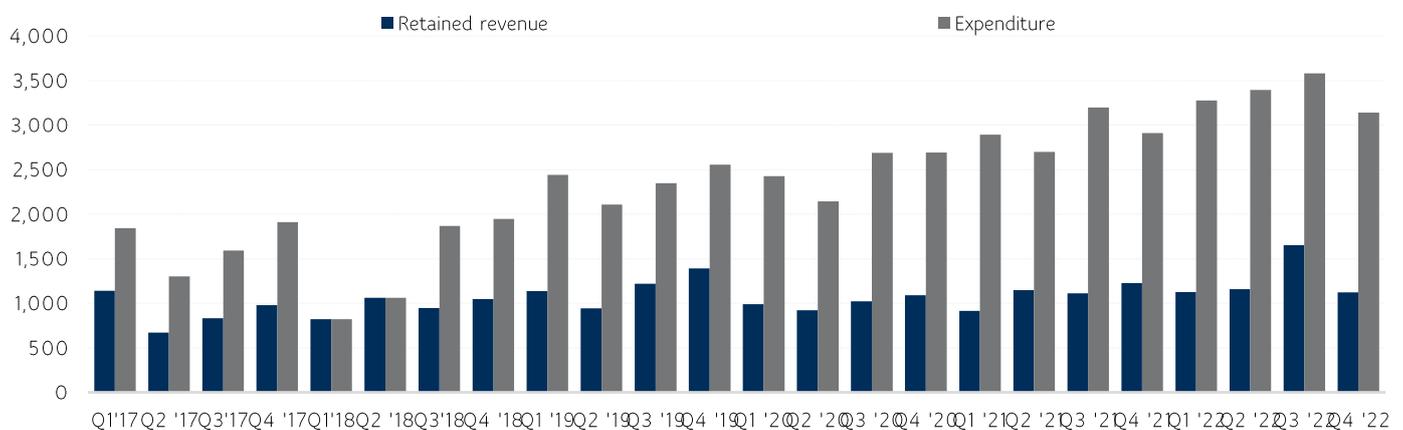
Fiscal policy

Macroeconomic policy has been weaker on the fiscal than the monetary side, for which the CBN and the MPC have felt the need at times to overcompensate. A pattern has emerged over several years of the government setting aggressive revenue targets and trimming the capital expenditure to correct some shortfalls.

According to data from the CBN, the FGN recorded a higher fiscal deficit of NGN8.3trn in 2022, or 4.2% of (2022) GDP, compared to roughly NGN7.3trn in 2021 (4.2% of 2021 GDP). However, these data are provisional, and a fuller account is expected to be published by the budget office of Nigeria. The NGN8.3trn deficit is comparable with the NG8.2trn budgeted for 2022.

Although the FGN's retained revenue increased by 15% y/y to NGN5.1trn, retained revenue again fell short of the NGN10trn (inc-revenue from government-owned enterprises - GOEs) projected in the budget. The revenue shortfall versus budget is mostly due to an underperforming oil sector. Based on the CBN figures, gross oil revenue into the federation's account was NGN4.6trn compared with a projected budget benchmark of NGN9.4trn.

FGN revenue and expenditure (NGN'bn)



Source: CBN; FBNQuest Capital Research



From the CBN data, we see that the FGN’s total expenditure for 2022 was also up 14% y/y NGN13.4trn. Recurrent spending accounted for 86% of total spending. At 14%, capital expenditure remains insignificant. Debt service costs consumed around 42% of total expenditure. Given the revenue underperformance, the debt-service cost-to-revenue ratio increased to 112% from 96% in 2021, reflecting the government's fiscal pressures.

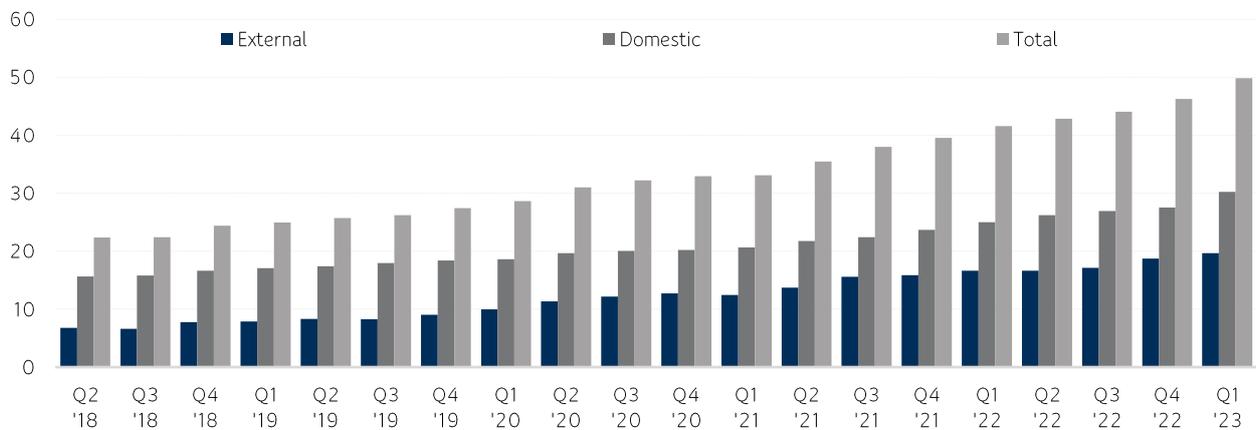
In an effort to increase revenue, *President Tinubu* has recently established a fiscal committee. This committee has been assigned the task of improving the efficiency of revenue collection, ensuring transparent reporting, and facilitating the effective utilisation of tax and other revenues. The government aims to raise the country's tax revenue to GDP ratio to approximately 18% within the next three years, a significant increase from the current rate of around 11%.

Fast rise of public debt stock

The public debt stock continues to rise at a very rapid pace. According to the Debt Management Office’s (DMO) latest data, total public debt increased by c. 8% q/q to NGN49.9trn (USD66.1bn) as of Q1 '23. The total debt stock expanded by 20% y/y. In terms of composition, the domestic and external debt components make up roughly 61% and 39% of the gross public debt, respectively. This compares to the target split of 70:30 proposed in the DMO’s debt management strategy for 2020-2023. The public debt figure excludes the FGN’s NGN22.7trn way and means (W&M) advances. Including it brings the gross public debt figure to NGN72.6trn, implying a debt-to-GDP ratio of 36.4% of 2022 GDP.

Based on the recent data, the country’s total public debt stock rose to about 25% of 2022 GDP, higher than the c. 24% recorded in the year-earlier period. Domestic debt stock, which increased by 10% q/q to NGN30.2trn was the main contributor to the rise in the overall total debt in Q4 '22. Similarly, foreign debt rose by 5% q/q to NGN19.6trn. The total public debt covers the external and domestic debt stock of the federal and state governments.

Public debt stock (NGN'trn)



Source: Debt Management Office (DMO), FBNQuest Capital Research

The FGN’s total domestic debt stock increased by 11% q/q and 23% y/y to NGN24.7trn as of Q1 '23. The FGN’s share of domestic debt represents c. 82% of the nation’s total domestic debt stock of NGN30.2trn, with the balance comprising domestic debt of the state governments and the federal capital territory (FCT). The FGN’s total domestic debt share equals roughly 12.4% of the 2022 GDP. However, this figure rises to 23.8% of 2022 GDP if the W&M advances are included.

We anticipate that overall public debt for Q2 '23 will have grown to NGN85.3trn when the Debt Management Office publishes the Q2 '23 figures, up from NGN49.9trn at the end of Q1 '23. In addition to the NGN22.7trn W&M advances being included in the public debt stock, we anticipate that using the exchange rate of around NGN760/USD, which prevailed as of the end of Jun '23, will result in a rise in the external debt stock to around NGN32trn from NGN19.6trn as of the end of Q1 '23.



The rapid rise of the country's public debt raises concerns about its debt sustainability, particularly considering the continued underperformance of the government's revenue. Although we commend the new administration's fiscal reforms and initiatives to improve the nation's revenue generation capacity, there is still some distance to cover to effectively reduce the fiscal deficit and curb the rapid rise of public debt.

Our outlook

We have revised our GDP growth forecast for 2023 to 2.9%, down from our previous projection of 3.2%. This lower adjustment primarily reflects the slowdown in economic activity in Q1 '23 and the reduction in the real spending power of households due to multiple headwinds, including:

1. High inflation,
2. The removal of fuel subsidies, and
3. The effective devaluation of the naira via the adoption of a free float regime.

However, we expect GDP growth to be driven by expansion in the tertiary (services) sector of the economy. We expect service sector growth to be supported by increased activity within the information and communications, trade, and financial and insurance services sectors.

We expect financial services firms to benefit from the high-interest rate environment, particularly banks holding significant US dollar-denominated assets. As such, their profit and loss statements will be positively impacted by substantial foreign exchange revaluation gains. However, there is a downside risk to the industry's capital ratio as banks' risk-weighted assets expand due to the effects of the higher exchange rate on their fx-denominated risk asset exposures. Consequently, banks will see a decrease in their capital adequacy ratios (CAR).

We expect to see the initial signs of accretion to the gross official reserves towards the end of the year. This view is based on several implemented measures, including cancelling NNPC Ltd.'s crude oil swap arrangements, which could increase foreign exchange (fx) inflows into the gross official reserves. Additionally, the CBN's approval for international oil companies (IOCs) to resume fx sales to banks will result in much-needed liquidity in the market. However, irrespective of the timing, our forecast for the gross official reserves is approximately USD34bn by the end of 2023.

On inflation, we anticipate significant upward pressure on the headline reading due to the removal of fuel subsidies and the CBN's decision to float the naira and eliminate trade restrictions on the fx market. Given Nigeria's import dependence and that the exchange rate is one of the largest contributors to headline inflation, we expect the passthrough effect from both items (for example, fuel subsidy removal and naira devaluation) to reflect across all components of the inflation basket. Our base case forecast sees headline inflation at c. 28.2% by the end-2023.

We anticipate a change in the direction of the MPC's posture in combating rising inflation. Considering that the primary drivers of inflation are mainly due to supply-side and cost-push factors that are mainly within the realm of fiscal policy, we believe that it is unlikely that the MPC will continue to implement aggressive rate hikes. Based on our assessment, it is more probable that the MPC will maintain interest rates at their current levels at their Jul '23 meeting. Therefore, we have retained our year-end 2023 forecast for the monetary policy rate at 18.5%.

We expect a slight expansion of the fiscal space in H2 '23, mostly due to removing the subsidy burden and, potentially, higher FAAC due to a higher conversion rate of over NGN760/USD compared with NGN460/USD previously. The government's initiatives to increase revenue mobilisation, such as implementing VAT on automotive gas oil (diesel) and informal trade transactions, along with expanding the tax net to encompass more businesses and individuals, will contribute to an increase in government revenue.

We expect the fx market to remain highly volatile to market forces due to the decision of the CBN to remove trade restrictions on the fx market, which signalled a shift in the apex bank's fx policies. Consequently, we see the exchange rate hovering between NGN760/USD and NGN850/USD by the end of 2023. We forecast a year-end exchange rate of NGN825/USD. However, our forecast threshold may be breached if the lingering issues with the fx supply persist.

Recent reports

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Rating	General Equities
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NEUTRAL	The analyst expects the stock to perform in line with the NSE All Share Index over the next 12 months or the specified investment horizon.
UNDERPERFORM	The analyst expects the stock to underperform the NSE All Share Index over the next 12 months or the specified investment horizon.
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BENCHMARK	The Nigerian Stock Exchange All Share Index.
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ASSET ALLOCATION	The recommended weighting for equities, cash and fixed income instrument is based on a number of metrics and does not relate to a particular size change in one variable.

Rating distribution for Nigeria listed equities rating

As at 19 Jul. 23 Recommendation	Total FBNQuest	
	Count	% of Total
Outperform	10	41.7
Neutral	11	45.8
Underperform	3	12.5
Total	24	100



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