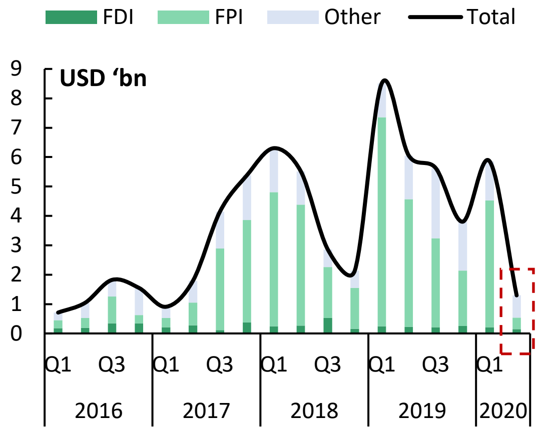
Macroeconomic Update

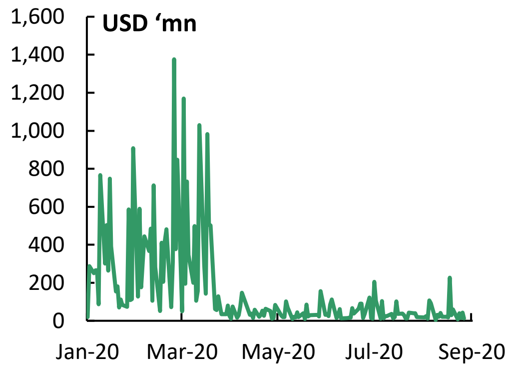
Capital Importation | Q2:2020

Chart 1: Capital Importation (Q1:2016 – Q2:2020)



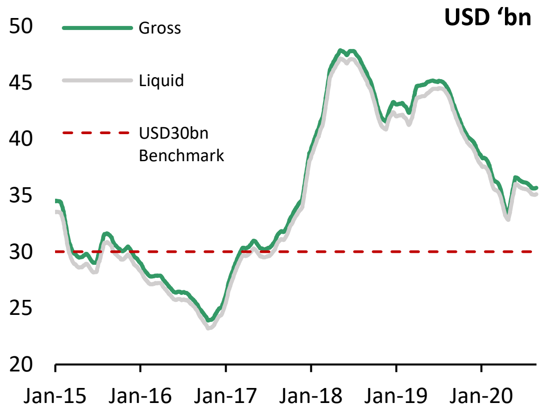
Source: NBS, Meristem Research

Chart 2: I&E FX Window Daily Turnover



Source: FMDQ, Meristem Research

Chart 3: External Reserves (2015 – 2020)



Source: CBN, Meristem Research

Capital Inflows at Lowest Level Post-Recession

Figures from the Capital Importation report for Q2:2020 recently published by the Nigerian Bureau of Statistics (NBS), revealed that the total value of capital inflows during the period settled at USD1.29bn, indicating a decline of 78.60% from Q2:2019 or 77.88% from Q1:2020. Strikingly, these figures represent the lowest levels of capital inflows in over twelve quarters since the economy exited recession. A marked drop in Foreign Portfolio Investment (FPI) by 91.14% YoY or 91.06% QoQ, to USD385.32mn was largely responsible for this decline. In similar fashion, Foreign Direct Investment (FDI) fell by 33.41% YoY or 30.65% QoQ to USD148.59mn, while Other Investment Inflows dipped by 48.60% YoY or 42.81% QoQ to USD761.03mn.

Unorthodox Monetary Policies Proving Costly

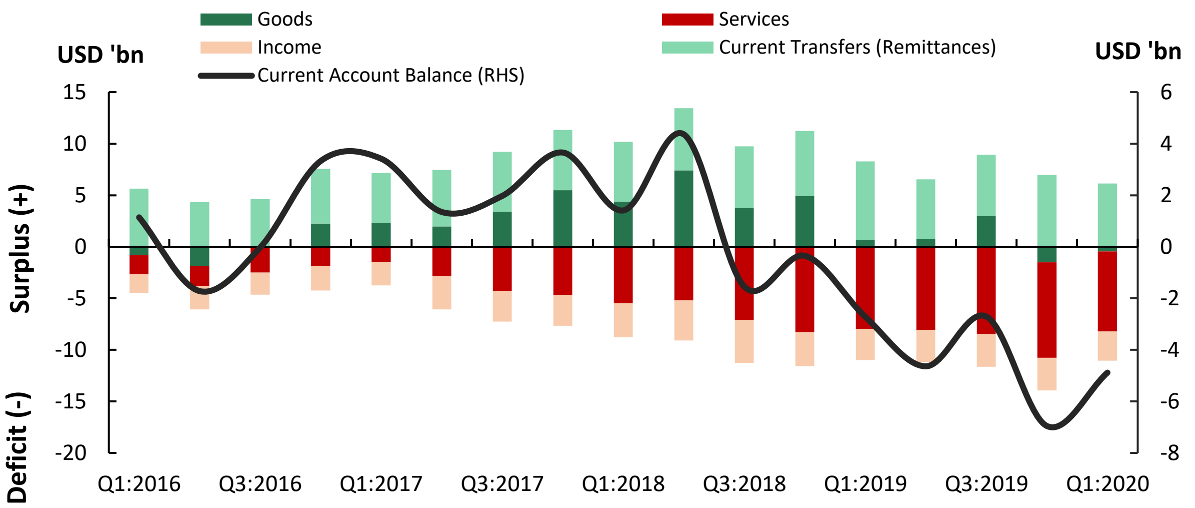
As we pointed out in our H2:2020 Outlook: *Unmasking Value in a Scourge*, the panic caused by the spread of the Corona Virus pandemic triggered a significant wave of capital outflows from emerging markets. At its peak in late March, capital flow reversals reached a high of *c.*USD100bn, approximately four times the level of outflows experienced during the Great Financial Crisis. Thus, considering that FPI inflows have historically constituted the chunk of capital inflows into the country, the significant decline in total capital inflows during the second quarter comes off as no surprise. Furthermore, in our view, another major contributor to the decline in FPI inflows was the effect of CBN's OMO policy on domestic interest rates. The implementation of this policy has led to a reduction in interest rates at the OMO and T-bills market to levels which are insufficient to compensate investors for the risk inherent in the economy. This has made the country relatively unattractive for foreign capital while the lack of sufficient liquidity at official FX channels has only exacerbated the situation, given the difficulty with capital repatriation (see Chart 2).

Weak Capital Inflows Spark BoP Headaches

Since swinging into a deficit in Q3:2018, Nigeria's current account balance has remained firmly entrenched in the deficit region (see chart 4). Provisional Balance of Payment (BoP) figures for Q1:2020 from the CBN reveal that the current account deficit widened by 79.51% to USD4.88bn. Again, as we indicated in our H2:2020 outlook, the negative impact of the pandemic on oil prices and remittance inflows is expected to trigger a further widening of the current account balance in 2020. Unfortunately, the significant decline in capital inflows have exacerbated BoP challenges, sparking a continuous decline in external reserves and a dearth of FX liquidity, given the CBN's managed float FX regime.

Thus, now faced with the prospect of a wider current account deficit in 2020, attracting foreign capital inflows into the country is crucial to financing the balance of payment, reducing pressure on external reserves, and keeping the exchange rate stable. Recall that the significant influx of FPI from Q2:2017 supported accretion to the external reserves (see chart 3) and the relative stability of the exchange rate post-recession.

Chart 4: Current Account Balance (Q1:2016 – Q1:2020)



Source: CBN, Meristem Research

What Policy Options are Available to Stem the Tide?

So far, the Government has turned to multilateral lenders such as the IMF and World Bank for support in financing the balance of payment gaps, while simultaneously employing FX rationing and demand management tactics to reduce pressure on the external reserves. The Rapid Financing Instrument (RFI) of USD3.4bn disbursed by the IMF earlier in April provided a temporary relief to the external reserves, while the proposed USD1.5bn loan facility from the World Bank is also expected to have the same effect. However, considering the magnitude of the current account deficit (we estimate this at *c*.USD16bn for 2020), these facilities are insufficient to finance the deficit. Hence, the importance of increasing the level of capital inflows cannot be over emphasized.

We posit that in addition to solving the inefficiencies caused by the multiple FX window regime, higher interest rates would be required to attract foreign capital in a similar manner as experienced in 2017. However, this option might prove unpopular given that an easier monetary policy stance is essential to supporting the post-pandemic recovery. Unofficial sources have hinted that the CBN is mulling the introduction of special OMO auctions to foreign investors, which would be settled in dollars and offer yields between 4 – 5%. Although these reports are unconfirmed, we highlight that this might potentially put the debt servicing capacity of the CBN under pressure should further FX risks crystallize, given that the oil markets are not expected to fully recover until at least a vaccine for the Coronavirus is developed.

Given this backdrop, a further devaluation of the currency or an increase in rates, or both are options which should come to the fore to rebalance the BoP. However, a devaluation would imply that existing FPI investors in the country will suffer losses on their holdings, a scenario which would make the country even less attractive to new foreign capital and increase the risk premium required from willing investors. **Also, it is not lost on us that the CBN might continue to play a waiting game over the short term as they have done thus far, while continuing to deploy its external reserve holdings to finance the BoP. In our opinion, this will prove unsustainable if other external variables, oil earnings most especially, do not improve.**

Fixed Income Markets to Remain Unfazed but Equities will be Sluggish

A glut of system liquidity stemming from CBN's OMO policy has ensured that the impact of the reduced FPI inflows on the fixed income market performance has been minimal. Year to date, average T-bills yields have fallen by 288bps to 1.78%, while T-bond yields have dropped by 271bps to 7.86%. This is despite the significant drop in FPI flows into money market instruments during the quarter by 90.34% QoQ or 90.61% YoY to USD332.07mn, and zero inflows to the bond market, the first occurrence since Q1:2017. **We expect both segments of the fixed income market to remain buoyant as long as the liquidity surfeit persists.**

The equities market has gradually clawed back some losses following the massive selloffs that ensued at the peak of the pandemic shock. After shedding 20.72% in the first quarter, the **NSEASI** gained 14.92% in the second quarter and 3.46% thus far in the third quarter. This has largely been fueled by increased domestic investor participation in the market, considering that FPI inflows into the equities market in the second quarter also dropped by 89.30% YoY or 91.68% QoQ to USD53.25mn. Looking ahead, we expect activities in the equities market to be driven by domestic investors who seek to take advantage of bargain hunting opportunities on relatively cheap counters. We maintain that although the **NSEASI** holds attractive bargain opportunities considering its cheaper valuation relative to peer markets, the constraining macro factors will dampen foreign interest in the market. **Thus, while bargain hunting from domestic participants has the potential to sustain the bullish trend in the market, ultimately, the market will continue to trade at a deep discount to fair value without strong interest from foreign investors.**

Contact Information

Investment Research

ahmedjinad@meristemng.com (+234 809 187 8917)
research@meristemng.com

Corporate websites: www.meristemng.comwww.meristemwealth.comwww.meristemregistrars.com

Meristem Research can also be accessed on the following platforms:

Meristem Research portal: meristem.com.ng/rhub
Bloomberg: MERI <GO>
Capital IQ: www.capitaliq.com
ISI Emerging Markets: www.securities.com/ch.html?pc=NG
Reuters: www.thomsonreuters.com
FactSet: www.factset.com