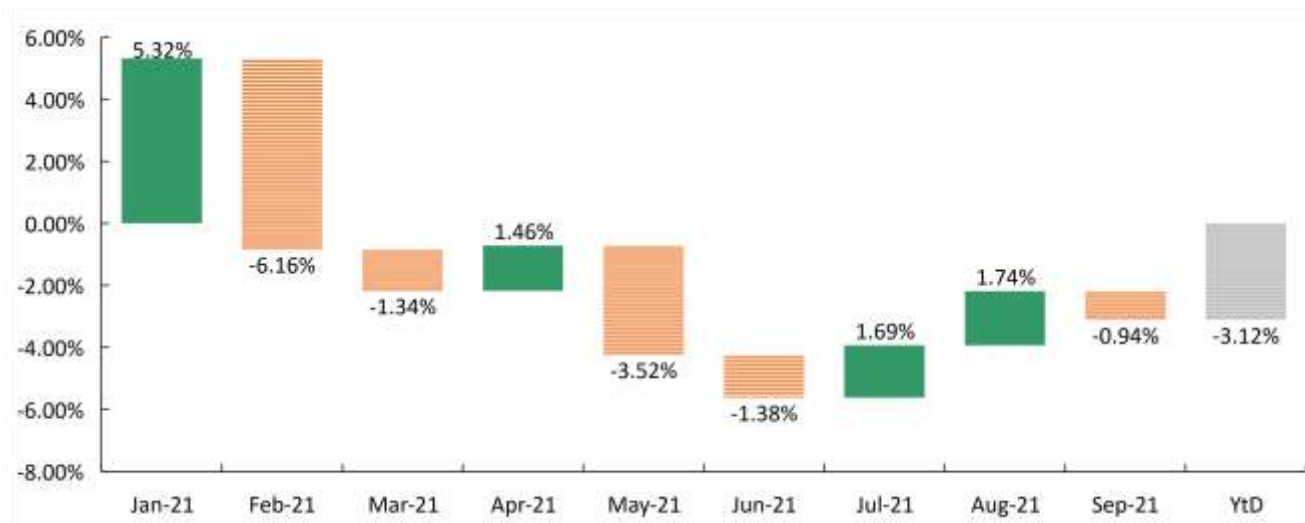


Macro- Economic Recovery and Equity Performance

Stock prices typically reflect investors’ expectations about future corporate performances while corporate profits depend on the current state of economic activities. Thus, equity price indices are described as a leading indicator of future economic performance. For context, in the wake of the outbreak of the COVID-19 pandemic, before economies began registering contractions and eventually recessions, the stock markets gave pointers. Sell-offs overwhelmed most markets as broad indices slumped to record-lows across different regions. Economic data were later published to support the ‘*predictions*’ of the market.

The domestic economy is gradually recovering from last year’s recession, with real GDP growth rate of 0.51% and 5.01% in Q1:2021 and Q2:2021, respectively. Furthermore, the most recent PMI readings (in July) also show a marginal improvement in the manufacturing activities (with manufacturing PMI at 46.6points, vs. 45.5points in June). In addition, headline inflation has also recently begun moderating (being lower by 116.2bps since April). Overall, these indicators suggest improving macroeconomic conditions. However, the movement in equity prices seems to suggest that investors are not convinced or impressed.

Chart 1: Monthly NGX All Share Index Return



Source: NGX, Meristem Research

A market in disagreement?

The most obvious answer is that investors have priced these events into their expectations. As economies reopened and the pace of vaccinations increased across regions, equity investors’ optimism strengthened, and buying sentiment resumed much before economic data was available to back it up.

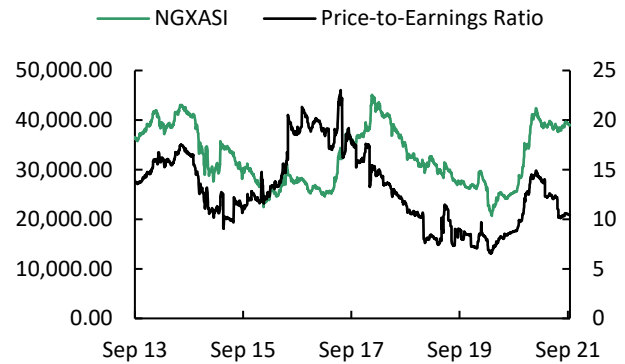
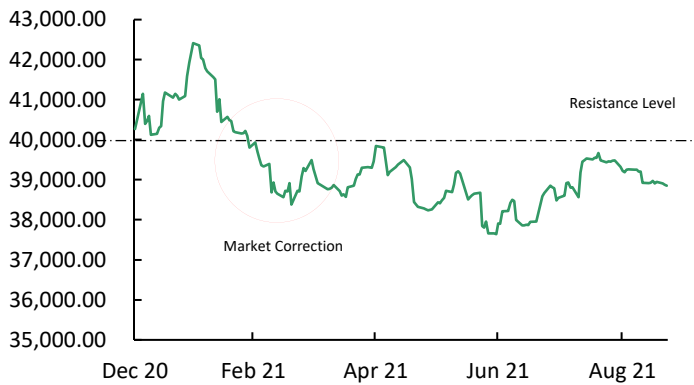
Another plausible explanation is that the domestic economic recovery remains fragile, and risks to its growth outlook are tilted to the downside. Moreover, the lingering insecurity challenges constitute a significant drag on production in the agricultural sector, while infrastructural challenges hinder the pace of economic activities in other sectors.

Will Cheap Valuation Spur Sentiment?

Relative to its 5-year PE of 12.84x, the market currently trades at a 23.46% discount to its PE of 10.4x (and much steeper discounts to Emerging Markets PE of 16.1x and Frontier Market PE of 18.2x). Since the mild correction between February and March, the market has not breached the 40,000pt mark, setting a resistance around the 39,000pt mark- *it is currently about 3% below this point.*

Chart 2: NGX Broad Index

Chart 3: NGX Price to Earnings Ratio 2016-2021

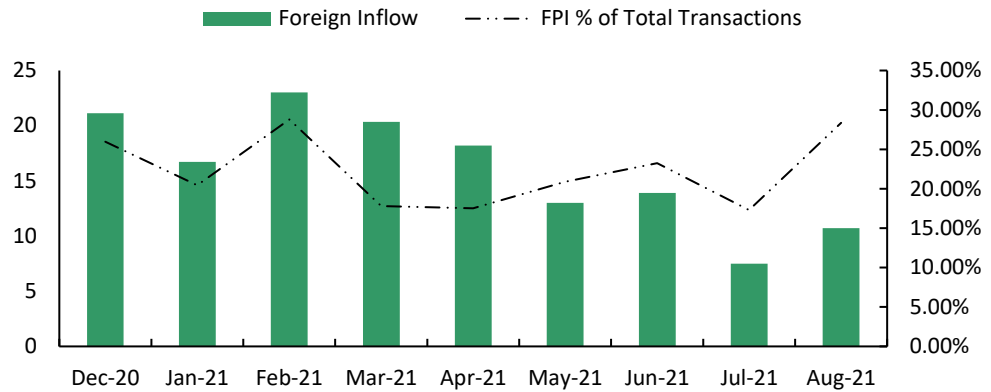


Source: NGX, Bloomberg, Meristem Research

The likely triggers of a reversal in sentiment in our view include strong earnings expectations, the performance of the fixed income market, a stronger appetite for equities by domestic institutional investors, and portfolio rebalancing. However, these catalysts are weak; Half-year financial results were impressive (ex-financial services), but the reaction of investors has been rather muted.

In a similar vein, the allocation of pension assets to domestic public equities has remained flat at an average of 6.87% in the past year, growing by 0.43% in naira terms since the start of the year- reflecting their weak appetite for stocks. In contrast, the allocation to fixed income assets has grown by 5.76% in naira terms and by 1.59% as a proportion of total assets. Even with the recent moderation in fixed income yields, the current allocation to equities appears consistent with the historical, and it is less likely to play a big part in prodding prices.

Chart 4: Foreign Portfolio Investments in Equities December 2020- July 2021 (%)



Source: NGX, Meristem Research

Is there still value in value?

To compensate for periodic market jitters and to minimize losses in the second half, we recommended a reallocation of funds to value and income strategy for long-term and short-term investors, respectively. Since the start of the second half, the weighted portfolio has returned 2.51%, outperforming the broad market Index and the NGX30 index. Barring any significant economic development (depressed fixed-income yields, and improvement in foreign inflows), the fundamental case for a rally in equities is rather weak. However, we reaffirm our confidence in stocks that meet the criteria outlined in our Half-Year Equity Strategy. These are stocks of firms with strong brand equity, competitive advantage in their respective industries, impressive ROEs, and significant upside potentials for 2021FY- particularly in the industrials, energy and consumer goods sectors.

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