2020 Capital Flight: A Round-Trip?

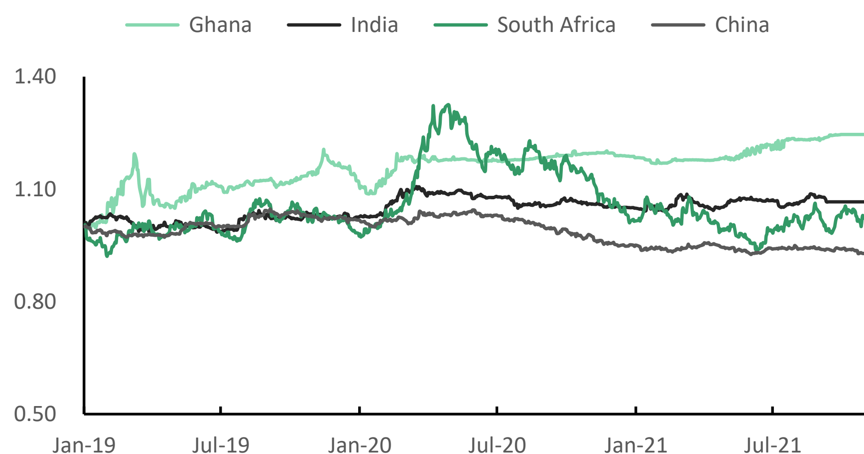
One of the major effects of the COVID-19 pandemic was the disruption in global supply chains and the crippling of world trade. Though it has been eleven (11) months since the first vaccine received FDA emergency approval and significant progress has been made in terms of economic reopening, the existence of newer variants to the virus as well as uneven vaccination across countries has somewhat dampened the global growth process. Developed economies like the US and UK have achieved 58.40% vaccination rate while Africa as a whole has barely vaccinated 1% of its population.

The impact of the pandemic on global trade has also been severe. The United Nations Conference on Trade and Development (UNCTAD) reported world trade to have dropped by 16.12%YoY as at Q2:2020 – *its worst contraction since the global financial crisis*. Being mainly commodity exporting economies therefore, Emerging and Developing Economies were bedeviled by falling commodity prices and capital flight. This triggered significant depreciation in the exchange rates of currencies in the group and monetary authorities had to respond with various policy actions that could boost capital flow.

Plunge in Commodities Prices Leave Emerging Economies Vulnerable

Last year, the pandemic heightened economic vulnerabilities of emerging markets and led to capital flight to jurisdictions considered as havens (mostly the United States and Japan). A visible effect was the broad-based depreciation in these emerging economies' local currency to the USD (save for China) and sell-offs across different asset classes.

Chart 1: Exchange Rate Movement Across some Emerging Economies

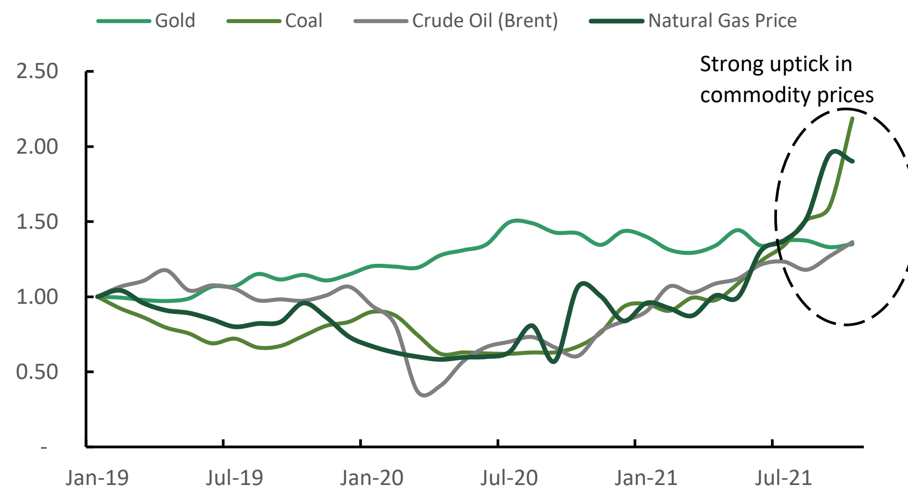


Source: Bloomberg, Meristem Research

Recently, some emerging market currencies have strengthened (compared to 2020 levels) on the back of economic recovery and improved commodity prices. Reflecting on the global recovery, it is not surprising to see that growth in emerging market has been the slowest considering the region's vaccination progress. Growth in emerging markets have been significantly flattered by the low base effect (South Africa 19.30%, India 20.13%, and Russia 10.50% all recorded double digit growth rates in Q2:2021) given that major economies slid into recession in Q2:2020. However, China remains the best-in-class, with a growth of 7.90% in Q2:2021 despite the high base effect in the corresponding period last year (3.20% YoY in Q2:2020).

Tailwind to growth for major emerging economies has majorly been the general improvement in commodities prices following the pick-up in international trade and better activities across services, manufacturing, and transportation sectors. On a year-to-date basis, prices of commodities like Oil (+125.25%) and Coal (+227.08%) have improved notably. This has contributed to the appreciation of currencies seen in many markets. For context as at Q3:2021, South African Rand relative to the dollar had appreciated by 11.15% YoY, Russian Rubles 6.75% YoY, Chinese Yuan 5.19% YoY.

Chart 2: Recovery in Commodity Prices Support EM currencies



Source: Bloomberg, Meristem Research

Will there be another Tantrum?

The Bloomberg Emerging Markets Capital Flow Index indicate that capital flows to EMs have since picked up, signaling an improvement in investor confidence. While we reason that inflation concerns could result in a broad-based monetary

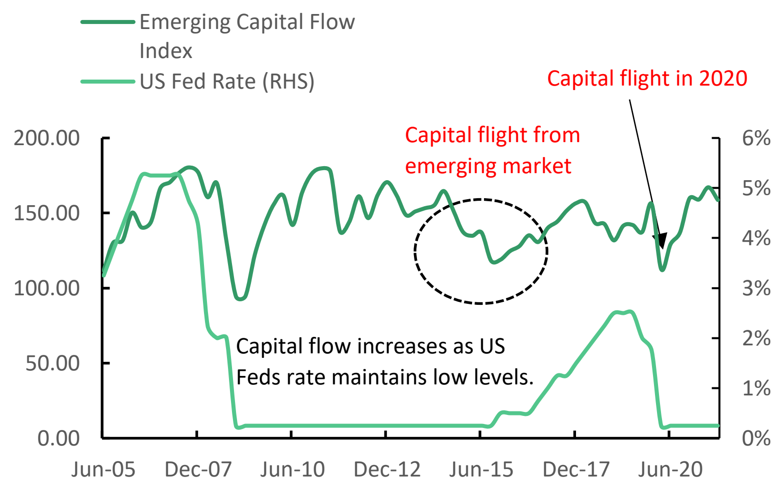
tightening, we expect that the fragility of growth even in advanced markets should discourage sudden capital flight from EMs.

We recall a similar capital flight to haven markets during the 2008 financial crisis and the relapse that soon followed between March 2013 and March 2014 in response to the US Fed's decision to scale back its asset purchase. Investors exited their positions from riskier asset in the Emerging Markets to purchase safer US bonds. While we could have reasons to expect a replay of events (especially given the spiraling rate of inflation in advanced markets that could induce monetary action – of a nature seen in the 1970s where the policy rate was hiked in response to worsening inflation), we expect that crisis peculiarities (unlike in 2007, monetary policy rate has been at near zero levels for some time and threats of virus resurgence) could alter the narrative.

The Fed, in its November FOMC meeting stated intentions to reduce the monthly pace of its net assets purchase Similarly, the European Central Bank (ECB) has also committed to moderately lower the pace of net assets purchases under the pandemic emergency purchase program (PEPP), while the Bank of England (BoE) has indicated that the recent spike in the inflation rate has strengthened the case for moderate tightening of the monetary policy stance. While relaxation of asset purchases is underway in the US, the much-anticipated taper tantrum is yet to be seen. We attribute this to the presence of more developed debt markets in the emerging economies compared to the last taper episode, and the US Treasury announcement stating its intention to reduce the sizes of the 2-, 3- and 5-year note auctions by USD2bn per month (which has ensured that yields remined sticky) among other reduction.

Chart 3: US 10 YR Bond Yields

Chart 4: Bloomberg EMs Capital Flow Index



Source: Bloomberg, Meristem Research

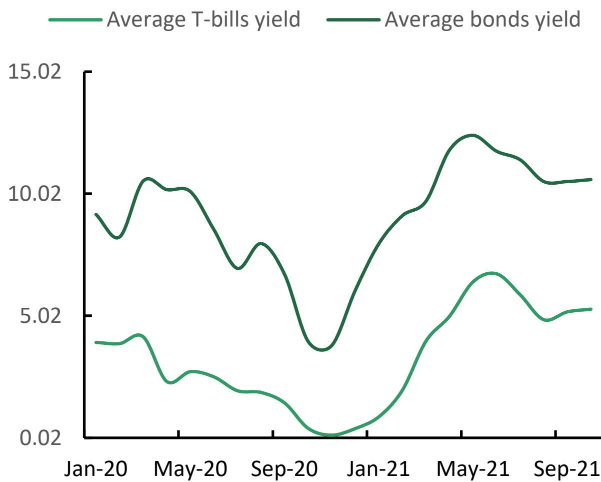
Nigeria

Improving Narrative for FX Liquidity…

Nigeria's case reflected the reality in most frontier and emerging markets in many respects; capital imports plunged, the local bourse suffered prolonged periods of selloffs and foreign participation in the domestic equities market came down to 20.44% in January 2021 (from 29.86% in the corresponding period last year). The apprehension by foreign investors was also felt in the debt markets; FPI inflows into the money markets declined by 90.61%YoY in Q2:2020 and were nonexistent in the bonds market, while FDI inflows declined by 33.41%YoY in the same period.

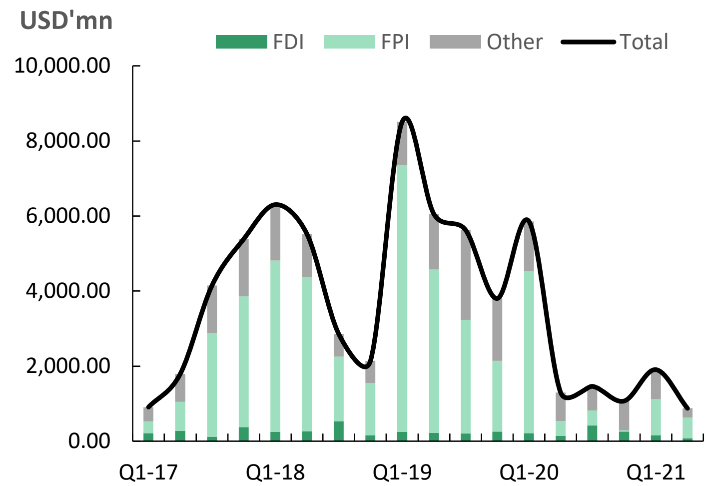
The country also succumbed to the pandemic induced economic slowdown and capital flight which further strained the prevailing exchange rate regime. Oil prices crashed to historic lows (USD22.74pb – *lowest since Feb 2002*), and thus, external reserves faced significant pressure. Though the CBN through interventions at different times have taken efforts to manage the price of FX, this has had minimal impact as a number of devaluations have had to occur to keep the exchange rate up with current reality. Also, despite improvements in the fixed income yield environment earlier in the year, FPI participation was largely unresponsive (declining by 50.78% QoQ in Q2:2021).

Chart 4: Average T-bills Yield (Jan 2020- date)



Source: FMDQ, Meristem Research

Chart 5: Capital Importation (Q1:2017 – Q2:2021)



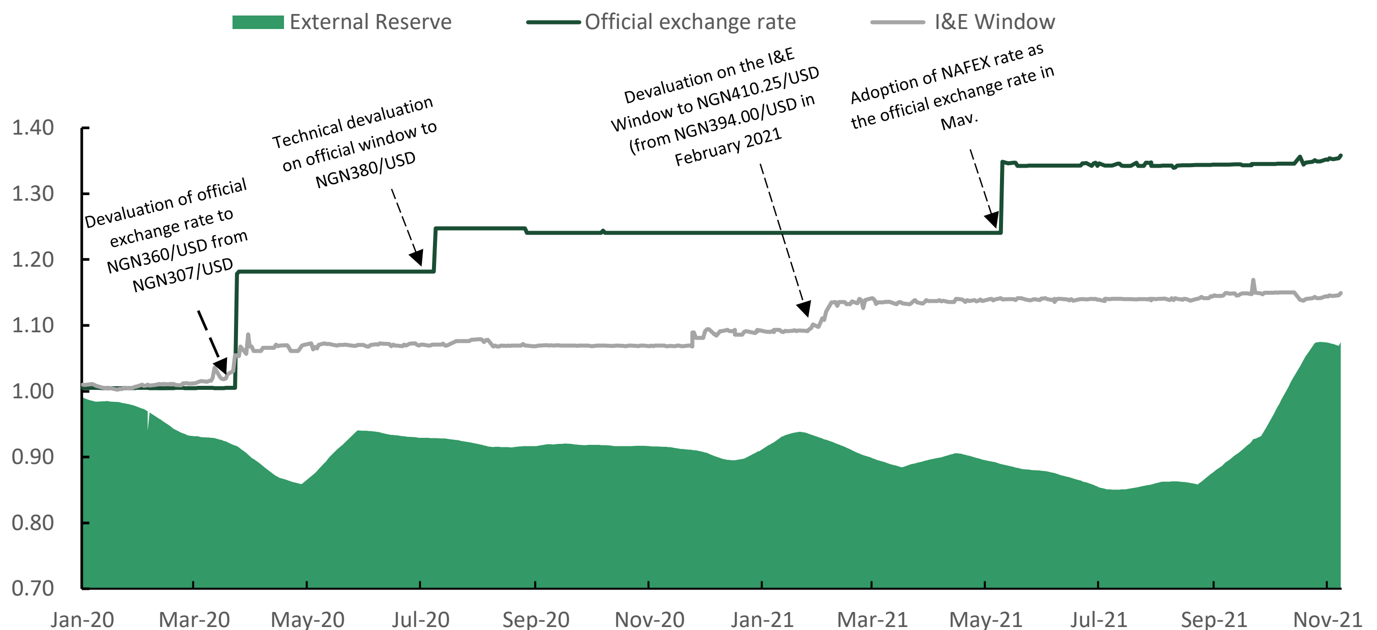
Source: NBS, Meristem Research

However, developments in recent months have provided more reasons to expect an improvement in foreign portfolio investments in 2021FY. First, the Federal Government issued a USD4.00bn Eurobond in September 2021 (which was oversubscribed by USD8.2bn - indicating an increasing foreign investors' confidence in the economy). Also in September, Access bank issued USD1.00bn

Eurobond – *in tranches of USD500,000.00* – which was oversubscribed by above USD2.6bn. In our view, the uptick in oil prices which contributed to an improved economic outlook, as well as the competitiveness of the yield offered, played a major role in attracting investors.

Oil prices have since moved up significantly to USD84.78pb (as of November 2021), contributing its quota to shoring up the external reserve (USD41.82bn as of November 2021). A major headwind remains the consistent drop in production volume which continuously falls far short of quota and in the near future, threats posed by the Omicron variant of COVID-19. Nigeria production since July 2021 has averaged about 1.36mbpd, below the approved production quota at 1.65mbpd, constituting a major downside risk to the reserve balance.

Chart 6: External Reserve balance, Official and I&E Window



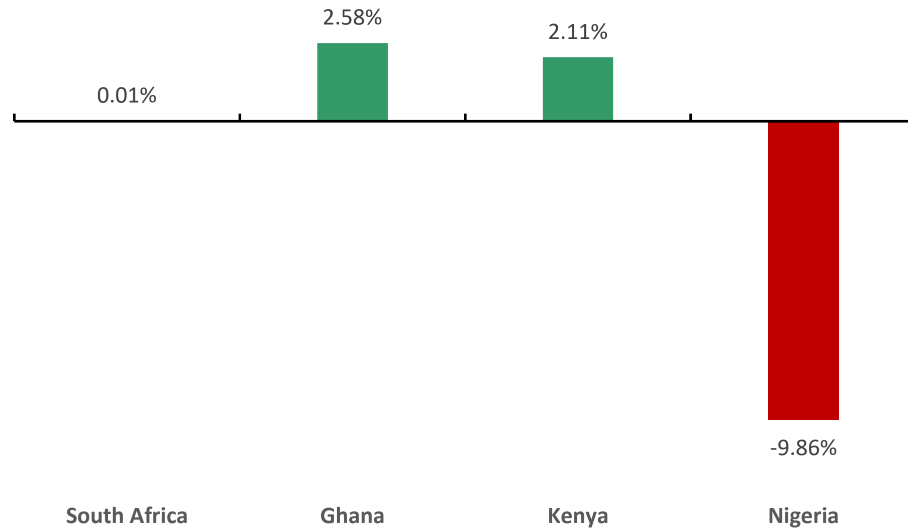
Source: CBN, FMDQ, Meristem Research

FX Liquidity Should Remain Prima Concern for FPIs

Inflation in Nigeria remains a major concern for FPIs. While emerging and frontier markets are expected to enjoy some level of foreign participation in the meantime, the winners would be those that provide adequate returns given the country-specific risks. Real rate of return (on 12-month treasury bill instruments) in Nigeria is currently -9.86%, compared to a peer average of 1.57%.

However, we hold that foreign investors should prioritize exchange rate liquidity and fiscal sustainability as the key consideration for portfolio investment decisions.

Chart 7: Real Rate of Average Treasury Bills Return (Nigeria and SSA Peers)



Source: Bloomberg, Meristem Research

In the equities space, we note that foreign participation in the equities market has slighty improved recently (20.61% in October 2021, compared to 17.52% in April 2021). We expect investors to take position in the equities market ahead of 2021FY dividend announcement and for capital appreciation. However, the generally low confidence in the Nigerian economy as well as difficulties associated with capital repatriation could act as a deterrent to sizable foreign interests.

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