The Analyst™ Note.

Nigeria's Financial Markets in the Face of Rampaging Inflation: No Time to Die, But No Place to Escape.

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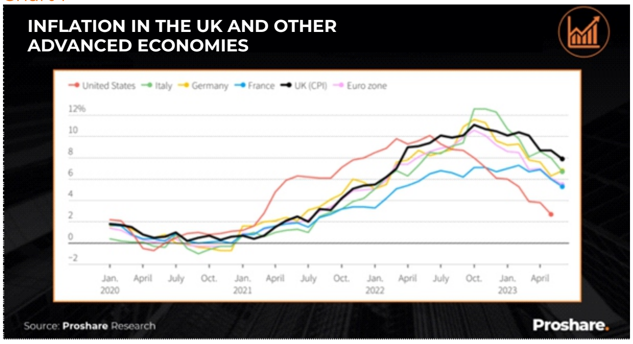
With inflation blazing holes in investors' wallets and scorching household pockets, escaping the smog, of fried wages, roasted investment yields, and toasted asset values signals the need for inflation-protection strategies which like James Bond, gesture that this is no time to die. June headline inflation numbers came at a widely debated 22.79% or 38 basis points higher than May's headline rate of 22.41%. According to an in-house analyst, ***'The economy is simply melting under the scorching heat of rising inflation fuelled by exchange rate depreciation and petrol pump price adjustments. With the official and parallel market foreign rates locked in a race to an unmarked finish line, local investors and households are going to see earnings buried under the rubble of rising prices unless they cleverly create inflation-indexed instruments.'***

Indeed, by applying the rule of 70, it would take roughly three years for the value of the naira in individual Nigerian bank accounts to be worth around half of their current value. It is for this reason that economists urge governments to bare down on inflation with the ferocity of Rottweiler. The outcome of anti-inflation aggression can be seen in a fall in America's inflation rate from over 10% in 2022 to under 4% by mid-2023. Even though the United Kingdom (UK) has struggled valiantly to contain inflation, the old lady has only succeeded to bring it down to 7.9% from slightly over 10% at the end of 2022 (*see chart 1 below*).

Chart 1



In Europe, the situation is no different. Economists note that Inflation is an economic tax that a few governments silently relish but solemnly mute because of its harmful effects on economic productivity. According to the previous economist, ***'spanking a dead horse over again neither brings it back to life nor makes its carcass more useful. Therefore, shrugging off the consequence of higher inflation could come at a huge cost. Unlike a dead horse inflation has many lives, some more vicious than others.'***

Running in 2023, all eyes were glued to the elections, with investors brooding over the possible outcome and the implications for financial markets and real sector growth. While domestic investors could take chances, foreign investors were cagey, holding onto their cash-stuffed briefcases. Foreign portfolio participation in equity trading fell by -58% to N53.71bn in Q1 2023. However, uncertainty quickly dissipated after the president's inauguration, boosting investors' confidence. The anticipated reforms drove optimism across markets, ignoring fundamental macroeconomic indicators such as inflation, currency risk, and interest rate direction, particularly in May and June. Analysts have decided to look beyond the new market optimism and view asset performance and investment options in light of familiar macroeconomic indicators (inflation, interest rate, and naira depreciation) in H2 2023.

Nigeria's Equity Market Unwrapped: **Bullish but Not Uncautious.**

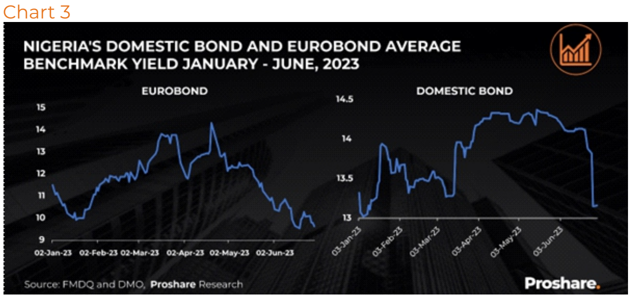
The Nigerian equity market reached its best level in over 15 years, with the All-Share Index (ASI) producing a year-to-date (YTD) return of 18.96% to settle at 60,968.27 bps and market capitalisation rising to N33.30trn in June 2023. Sectorally, Oil and gas led with 68% YTD return, driven by the clamour for a deregulated market (subsidy removal). The insurance sector came second at 59%, and banking came third with a 55% YTD return. Being the least negative real return asset, the chance of a bullish outcome is strong, driven by the expected huge inflow of foreign participation in the market. On the flip side, the expected low performance of companies can slightly water down the bullish outcome (*see chart 2 below*).

Chart 2

Bonds, Unlike Diamonds, Are Not a Girl's Best Friend in **2023.**

The domestic bond market started the year with a bearish tone as yields maintained an upward trend, driven by higher inflation expectations, credit rating downgrades, and debt sustainability concerns about Ways & Means Securitization. Subsequently, the naira redesign policy diluted the selloff sentiments as banks with excess liquidity invested in risk-free instruments in February and March. By Q2 2023, investors began to exit the market given the worsening negative real return; the average yield rose to 14.37% as of May 16, 2023. Analysts spotted a consistent decline in the average yield since the inauguration of the new President from 14.27% on May 30, 2023, to 13.16% as of June 30, 2023. The average yield for the Domestic bond (YTD) dropped by 113bps to 13.16% as of June 30, 2023. The buoyant system liquidity during the period strengthened large subscriptions for PMAs held.
Relatedly, the Eurobond average yield compressed by 1582bps to 9.63% on June 29, 2023, from 11.44% on December 29, 2022, as demand improved at the tail end of May to June 30, 2023. The market witnessed significant selloffs In March, April, and May, slightly like the domestic market, driven by the Fed hike and credit rating downgrade (*see chart 3 below*).

Chart 3



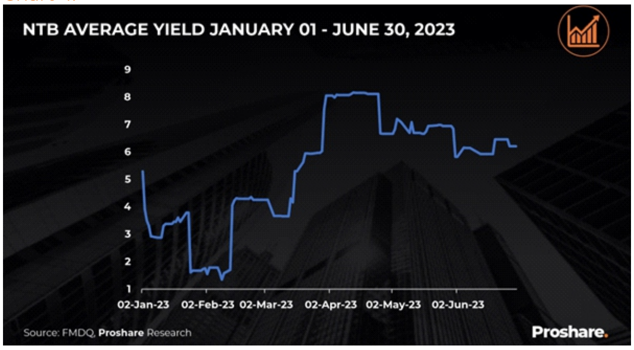
As liquidity is the critical determinant of the domestic bond market, CBN's policy direction should dictate the market. Analysts see a strong chance for yields to moderate if CBN becomes less hawkish and cut down CRR in line with the new administration's preference for a low-interest rate environment. However, if monetary tightening persists, yields will likely increase as investors' prices in currency depreciation and rising negative returns.

Preceding the policy reforms, the less currency risk exposure has strengthened interest in the country's dollar-denominated bond, driving yields down. The recent reforms have increased optimism about a possible credit rating upgrade, which will likely fuel interest in the market in H2 2023.

Treasury Bills Make a Stand, as Investors **Get Frazzled.**

The ample idle cash in banks induced by the naira redesign policy made the treasury bill bullish at the beginning of the year, with the average yield hovering around 1.30% - 1.80%. The NTB PMA's stop rates slumped across the tenors; notably, the 365-day dropped to a single digit from the double-digit in December 2022. The bullish sentiments diminished in March as money in circulation improved, making the average yield slope upward to reach a peak of 8.17% on April 13, 2023. Treasury bill prices became competitive from May to June 2023, with the average yield dropping to 6.21% on June 30, 2023. The preference for treasury bills mildly differs from the long-dated instruments; the low coupon rates attached to the issuance might slightly dissuade investors (real return on 365day tenor is -16.56% as of July); however, the rising default risk and robust liquidity can slow down market bearishness (*see chart 4 below*).

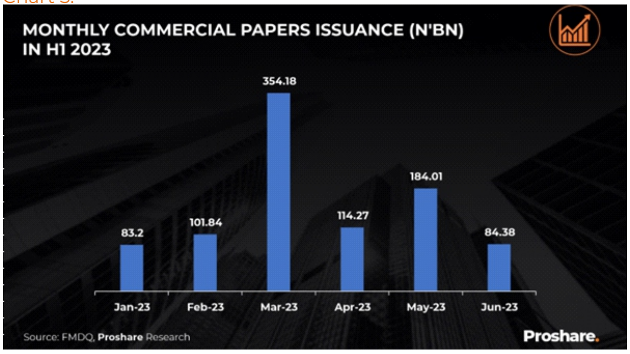
Chart 4:



Commercial Papers Come Alive, As **Inflation Shifts Gear.**

Nigerian firms' participation in the debt market improved in H1 2023 with the enormous issuance of commercial papers to escape the high lending rates in deposit money banks. A total of N921.88bn of commercial papers was quoted on the FMDQ exchange in H1 2023, higher than N503.68bn quoted in H1 2022. The issuances were from the financial services, manufacturing, commodities trading, and real estate sectors. While investors' risk appetite has increased to offset rising inflation, CP issuances will likely fall in H2 2023, given the impact of inflation on consumption (drop) and companies' inventories (surge). Companies' need for fresh capital should shrink in H2 2023 (*see chart 5 below*).

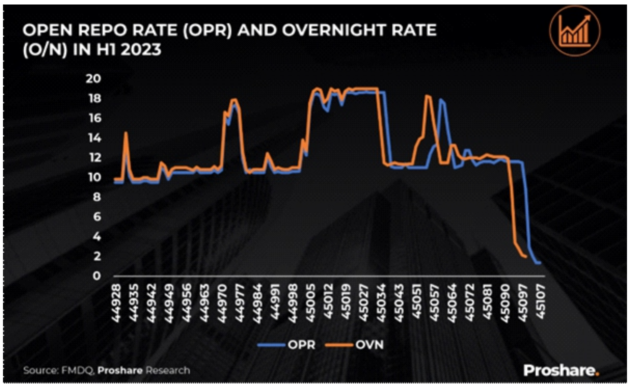
Chart 5:



Understanding Money Market's Micromoments as **Liquidity Scampers Upwards.**

The money market slumped to a single digit, driven by the upshoot in systemic liquidity, a function of larger federation account allocations (FAAC), and lower cash reserve requirement (CRR) discretionary debits. The Open Repo and Overnight rates dropped by 86bps and 80bps (YTD) to 2% and 1.36% on June 30, 2023. The money market outlook is quite dicey, coined on the monetary policy direction. A dovish MPR would sustain low rates, while a hawkish outcome would push rates upward (*see chart 6 below*).

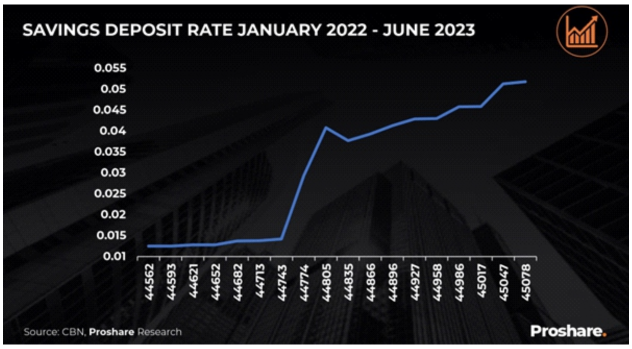
Chart 6:



Savings Rates **Rise** but **Suffer Inflationary Rate Sucker Punches.**

Bank's savings rates trended upwards in response to rate hikes, rising from 4.29% in January to 5.18% in June 2023. Despite the positive adjustment, investors saw a negative return of 16.6%, an outright disincentive to save. With inflation climbing above the cliff and naira depreciation, holding idle funds might be a disadvantage (wider negative real return). The rising deposit rate will rescind based on the expected dovish monetary policy (*see chart 7 below*).

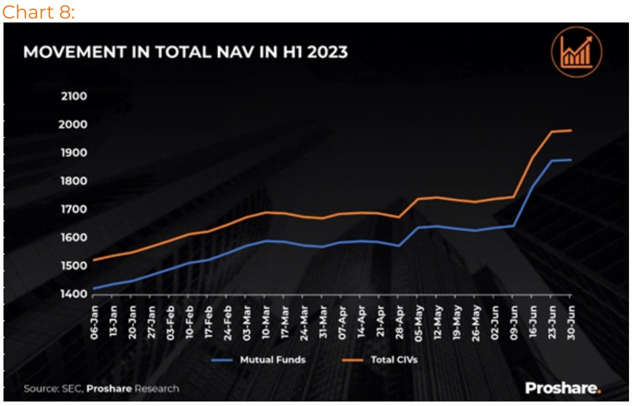
Chart 7:



Alternative Investments Pull Up Real Rates in **H1 2023** but **Remain FX-Sensitive.**

Nigeria's collective investment vehicles (CIVs), comprising mutual funds, infrastructure funds, and ETFs, recorded a positive real return of 6.63% in H1 2023. Movement in the Net Asset Value (NAV) of SEC's CIVs kicked off the year bullish, gaining 8% by the end of February 2023. However, the market took a modestly bearish turn that progressively worsened month-on-month (M-o-M) between March and May 2023. As of May 2023, the market had gained 14% despite a mixed performance. By June, analysts noticed a sharp spike in the NAV as investors gained 14% on average during the month due to a foreign exchange reform that caused a 67% increase in the NAV of dollar-based funds. As such, H1 ended positively, as the total CIVs recorded a 29% year-to-date (YTD) return in H1 2023 (*see chart 8 below*)

Chart 8:



Analysts noted that the double-digit returns recorded in June were primarily caused by the new administration's foreign exchange reform that led to significant currency depreciation. As such, the top-performing funds in the first half of 2023 were REITs, dollar-based funds, and money-market funds, with each fund recording positive real returns despite the 22.79% inflation recorded in June 2023. On the downside, the top loser in the first half of the year was the Bonds/fixed income-based funds, which declined by -7% following substantial equity market gains during the year (*see Table 1 below*).

Table 1:

YTD RETURN BREAKDOWN OF SECs COLLECTIVE INVESTMENT VEHICLES (CIVs) IN H1 2023

Funds	YTD	Real Return
Equity	27%	3.80%
Money-market	29%	6.13%
Bonds/ Fixed Income	-7%	-29.90%
Dollar-based	73%	50.11%
REITs	102%	79.55%
Balanced	21%	-1.31%
Ethical	17%	-5.99%
Shari'ah Compliant	13%	-9.48%
Mutual Funds	32%	9.19%
Infrastructure	-6%	-28.76%
ETFs	16%	-6.74%
Total CIVs	29%	6.63%

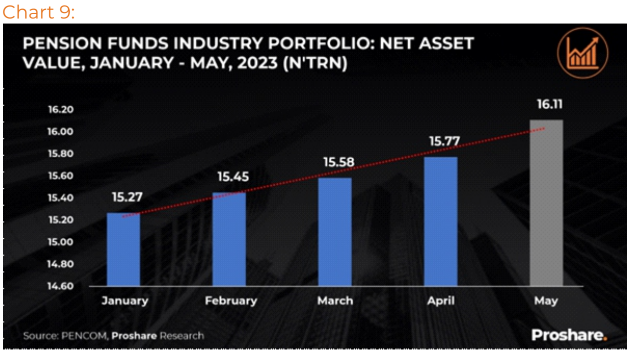
Source: SEC, Proshare Research

Proshare.

Pension Funds Begin to Look Perky, but **Suffer Inflation Heartburns.**

Data published by the Pension Commission (PENCOM), shows that the Pension funds industry has been bullish in 2023. Contemporary data shows that the industry's Net Asset Value (NAV) has grown 6% as of May 2023, a slight increase from the 5% recorded in 2022. However, high inflationary pressure caused a negative real return of -17% as inflation hit 23% in June 2023, according to NBS data (*see chart 9 below*).

Chart 9:



In the face of a sliding Naira and soaring inflation, investors in the alternative investment market need to adopt a cautious approach to seeking emerging opportunities. This involves focusing on sectors that could do well in a high inflationary environment with limited hedges against currency declines. Real estate appears to be a resilient market, offering protection against inflationary headwinds, suggested by real estate investment trusts (REITS) gaining 102% YTD in June 2023. Furthermore, the numbers show that the earnings potential of Mutual Funds and Exchange Traded Funds (ETFs), grew significantly in H1 2023. Nonetheless, analysts believe that strategic asset allocation should be to sectors with inherent stability and growth potential, taking into view investors' specific risk appetite. The default risk of each asset class should be effectively weighed to prevent a sour outcome.

Endnote: **When Dying is Not an Option.**

Tough times are integral to human growth, just as tough economic situations are critical to financial markets. Nigerian asset traders are passing through tough cycles but investors will not day, diminution of asset values? Maybe. Lower inflation-adjusted yields? Most likely. Recovery of investment values on breaking out of market support values within 360 days? Definitely. For Nigeria's financial markets, this is no time to die.

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