CORONATION

2023 Investment Strategy

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Better times in 2023

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NB: Prices given in this report are as of 10 January, unless otherwise stated.

2022 was a miserable year for global savers. Central banks hurriedly raised policy rates to combat inflation which caused prices to correct across equity and bond markets. Then inflation corroded whatever nominal returns were left. As we enter 2023, equity valuations and bond yields are far more convincing than a year ago. At some point - it is difficult to say exactly when - global markets will anticipate the easing of policy rates and assets will start to perform again. The reset in valuations and yields has created opportunities though not always in the same stocks, or sectors, as were favoured before.

US dollar savers have opportunities they have not enjoyed for years. US Government bond yields are at multi-year highs. Emerging market and developing market US dollar Eurobond yields have risen substantially. In cases where there is no actual risk of distress, African sovereign bond yields are attractive. We favour holding short-dated durations for now and taking medium and long-term durations when global market sentiment improves. This tactic means not getting the full benefit of an upturn in markets, but it reduces risk.

Naira fixed income savers benefit from the best conditions since 2019. The drought appears to be coming to an end, with 1-year T-bill yields edging up towards the level of inflation. Granted, rates are not there yet and may not actually exceed inflation this year, but conditions in the fixed-income markets have improved significantly since the Central Bank of Nigeria adopted an inflation-fighting stance last May. Investors' money is flowing back into Money Market Mutual Funds.

The current level of liquidity in Naira money markets is high and we expect it to remain so for the first four months of the year, so we expect T-bill rates and FGN bond rates to soften. Then, and assuming that the Federal Government seeks to finance its deficit in the Naira bond and T-bill markets, as detailed in its budget presentation, and as long as the CBN stays the course in fighting inflation with its policy rate, we expect upward pressure on market interest rates in the second half of the year. If this turns out to be the case, the down-and-then-upwards pattern of rates in 2023 might resemble that of 2022.

All these forecasts may be profoundly affected by Nigeria's general elections, due next month. As our study of 2015 and 2019 shows, general elections are likely to impact on Naira money markets and equities. Look out for changes in interest rate policy and departures from the established course in fiscal policy for potential downside: or for a continuation of interest rate policy and tight fiscal policy for potential upside.

The Nigerian equity market is due a re-think. Surely, after three successive years of positive returns, it should feature as part of a long-term investment portfolio. Our study of earnings per share gains ahead in 2023 suggests that equities are hardly more expensive than they were a year ago. And our study of gross dividends shows that substantial benefits accrue to those who hold stocks for yield.

Many factors make the outlook uncertain - as is the case in any year - but our analysis of what went wrong in 2022 and of the reset in asset values point to real opportunities to make positive investment returns in 2023.

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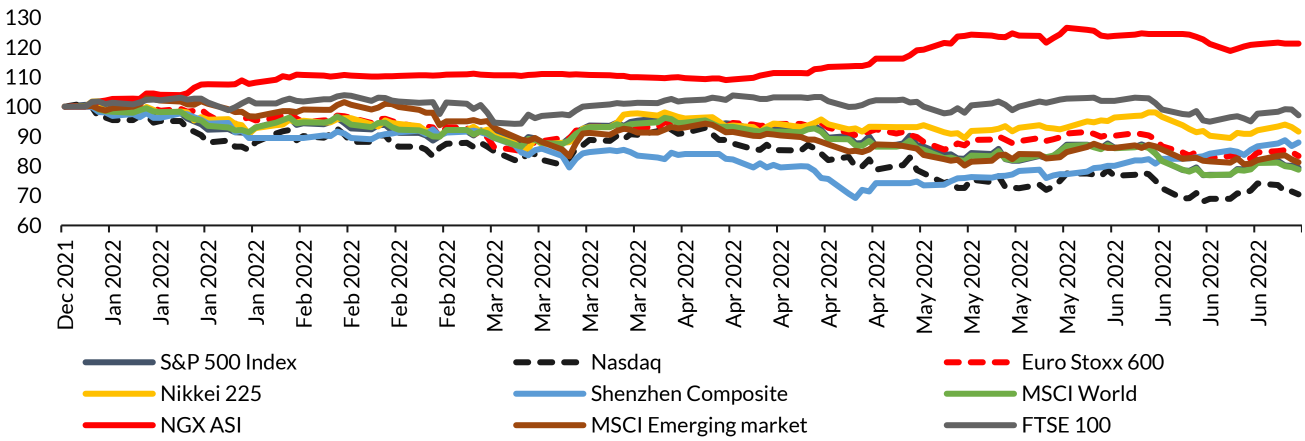
Global markets

2022: worst performance since 2008's global financial crisis

Global markets underwent a reversal in 2022. The year was characterised by rising inflation, monetary policy tightening and was deeply affected by the outbreak of war in Ukraine and then by a strict lockdown followed by surging Covid-19 cases in China. Inflationary pressures were not fully understood at the beginning of the year, with powerful knock-on effects during 2022 that will be transmitted into 2023. Global central banks responded to multi-year high inflation data with a barrage of interest rate hikes which prompted corrections in equity markets, bond markets and other asset classes. Investors, both institutional and individual, were hit by a combination of asset price corrections and by the effects of inflation on their nominal wealth. This made 2022 one of the worst investment years on record.

Chart 1: Global Equity Indexes, H1 2022. Rebased 31 Dec 2021 =100

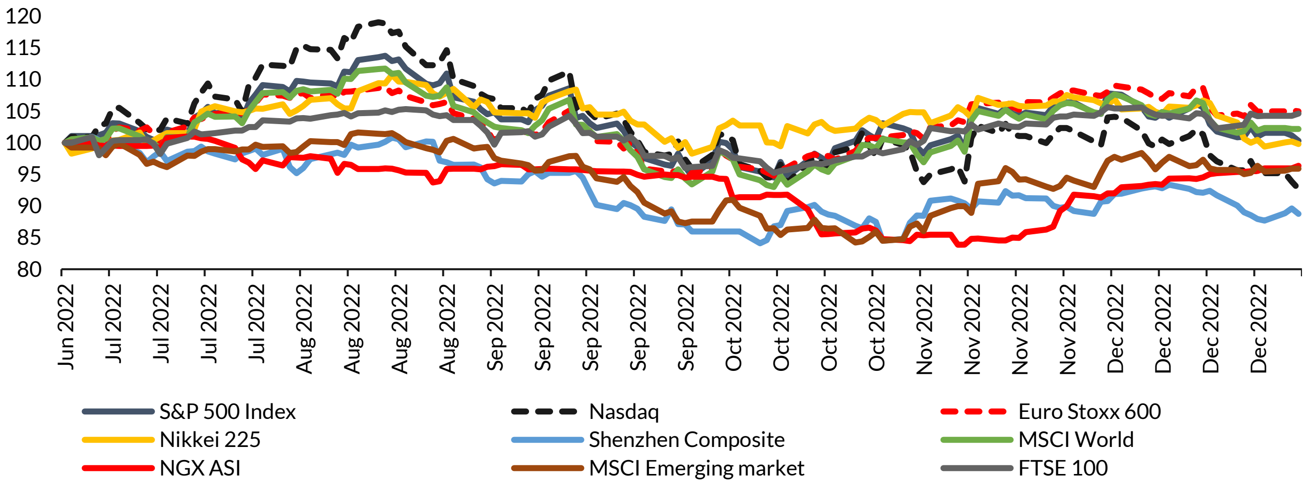


Source: Bloomberg, Coronation Research

In the US the Federal Open Market Committee (FOMC) raised its funds rate by 400bps to a band of 4.25% to 4.50% over the course of the year. The S&P 500 Index lost 19.44% and the Nasdaq Composite Index lost 33.10%, recording their steepest annual declines since the global financial crisis of 2008. The FOMC remains committed to keeping rates high for much, if not all, of 2023 in spite of the cumulative effects of rate hikes acting as a restraint on economic activity and their dampening effect on key economic indicators.

The world's other large equity and bond markets were severely affected by central bank tightening and by region-specific factors such as the energy crisis in Europe and the UK. The European Central Bank raised its main refinancing rate by 250bps to 2.50% and the Eurostoxx 600 Index fell by 12.90%, its worst performance since 2008. By contrast, the UK's FTSE 100 Index rose by 0.91% in 2022, driven by the performance of energy, mining and pharmaceutical companies which fared well during the year's sector rotation from growth to value stocks.

Chart 2: Global Equity Indexes, H2 2022. Rebased 30 June 2022 =100



Source: Bloomberg, Coronation Research

The Chinese economy was disrupted by zero-Covid-19 measures but, once those restrictions were lightened, faced an increase in Covid-19 infection rates going into 2023. Coupled with its property sector crisis, this saw the Shenzhen Composite Index enter a bear market with a loss of 21.63% for the year.

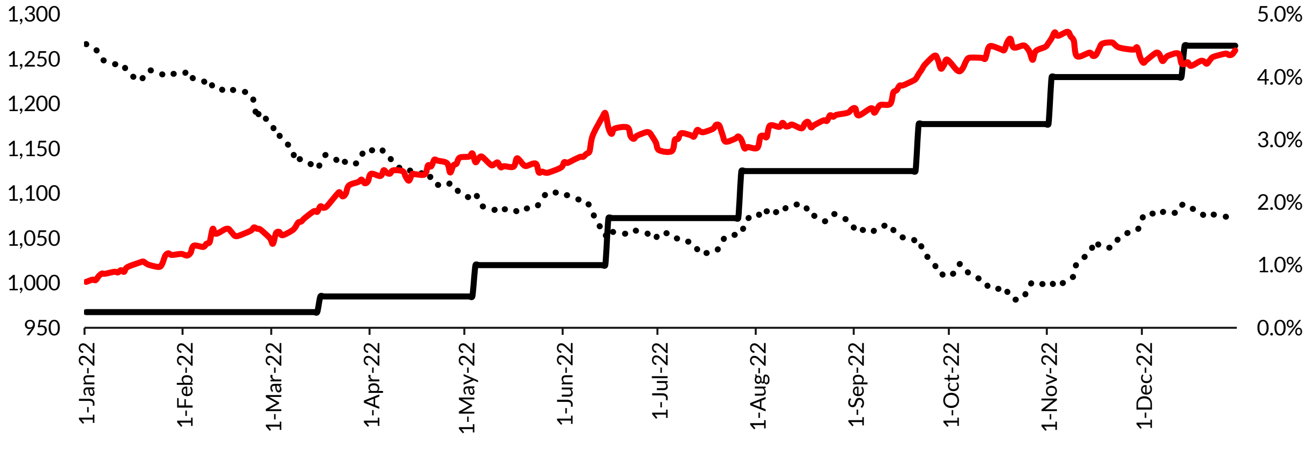
The Japanese Nikkei 225 Index closed the year with a loss of 9.37% its first annual loss in four years. Reflecting these losses across different exchanges the broad MSCI World Index shed nearly a fifth of its US dollar value in 2022, losing 17.73%.

Emerging Market Bonds

Asset price corrections in 2022 extended deep into global bond markets, with severe effects on emerging market bonds and on emerging market policy rates. The key to the disruption was not just the rise of inflation in developed economies, but the slow response of their monetary authorities when it came to raising policy rates, which spooked investors.

As we wrote a year ago: "inflation is rising across developed economies, and interest rate rises are on the way." The fact that monetary authorities were slow to react meant that for much of the year, developed bond markets were telling a different story about inflation than central banks. This was particularly true in the US where, for example, the US Federal Funds Rate (at least, the upper limit of the target range) only recently matched the US Government 2-year bond rate.

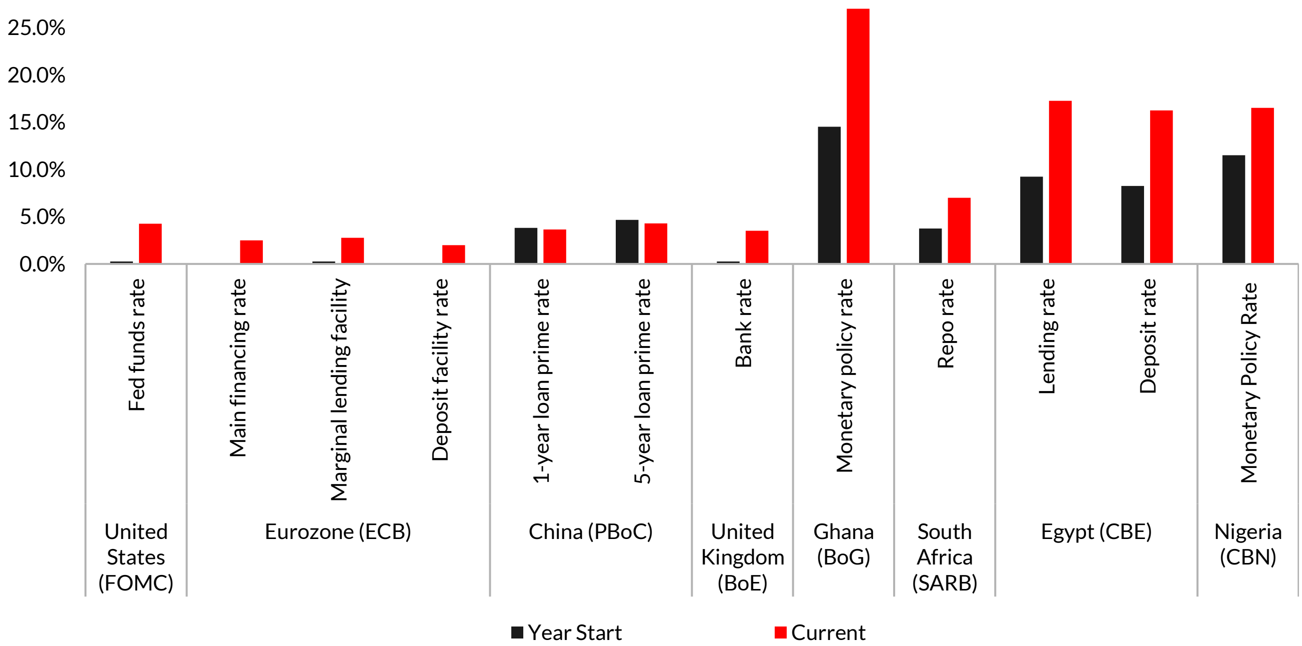
Chart 3: US Fed Funds Rate, US Government 2-year bond yield and Emerging Market Bond Prices (lhs)



Source: Bloomberg, Coronation Research. *Bloomberg Emerging Markets Hard Currency Aggregate Index

For emerging and developing markets, rising yields in US Government bonds had far-reaching consequences. Bond prices crashed. Not only investors but sovereign issuers were surprised by the reckoning. 2022 brought to an end a very long period during which low US interest rates encouraged nations to borrow in US dollars.

Chart 4: Global Central bank policy responses in 2022



Source: Bloomberg, Coronation Research.

Global Commodities

2022 was a year of mixed fortunes for global commodities. As nearly all global commodities (bar some soft commodities such as palm oil) are priced in US dollars, it is significant that the US dollar appreciated against other major currencies as US dollar strength is usually associated with commodity weakness.

As an indicator of global demand for commodities we prefer to look at copper prices rather than oil, because oil prices are strongly influenced by a producers' cartel, namely the Organization of the Petroleum Exporting Countries (OPEC) and its ally Russia (OPEC+). Copper prices fell by 13.9% during the year (the story for Aluminum was similar, though Iron Ore prices rose).

Chart 5: Brent Crude price, US$/bbl in 2022

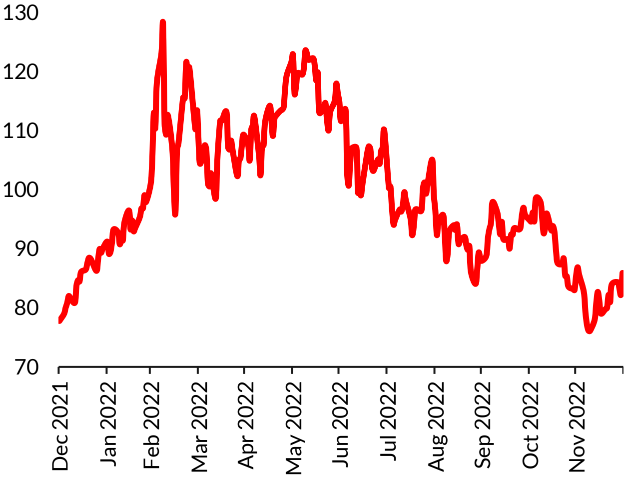
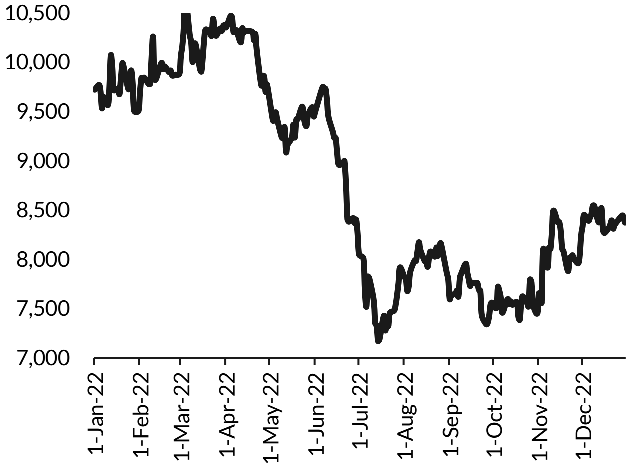


Chart 6: Copper price, US$/tonne in 2022



Source: Bloomberg, Coronation Research.

Commodity prices generally were much less volatile than equity and bond prices in 2022, suggesting that equity and bond prices have the capacity to overreact to changes in policy rates and market interest rates, a factor to bear in mind when considering the potential for a market recovery this year.

The price of oil, taking Brent as our measure, rose by 10.5% during the year to US$85.91/bbl. More tellingly, the average price of Brent in 2022 was US$99.09/bbl, 27.4% higher than in 2021, a factor in the increasing weight of money in middle eastern sovereign wealth funds. There were multiple factors at work on oil prices: Russia's war in Ukraine and the consequent sanctions; limits on exports of natural gas from Russia and an energy crisis in central and western Europe; restrictions, i.e. price caps, on exports of Russian oil; the release of strategic reserves by the US government, among others. The ability of OPEC+ to influence supply was a key factor, in our view, and is likely to be again in 2023.

Chances of a recovery in 2023

At some point in 2023 global investors are likely to regain their confidence in risky assets, such as equities, corporate bonds, emerging market bonds and developing market bonds, and commit to these markets again. The question is when. The good news is that a dramatic reset in valuations, with improved dividend and bond yields together with lowered valuation multiples, point to attractive entry points, as was the case after the Covid-19-induced slide in values during the first quarter of 2020. The bad news is that global central banks may be in no hurry to cut rates and may keep the reins held tight for much of 2023.

Anticipating the easing of monetary conditions will be the key to finding the inflection point in markets. Meanwhile, the effects of tightening may play out in recessions in major economies and problems in asset classes such as private equity and property. We expect to see pockets of optimism develop around better-than-expected company earnings, drop-offs in reported inflation and, above everything else, indicators of slowing economic activity that induce central banks to take the pressure off interest rates.

Elections and Nigerian markets

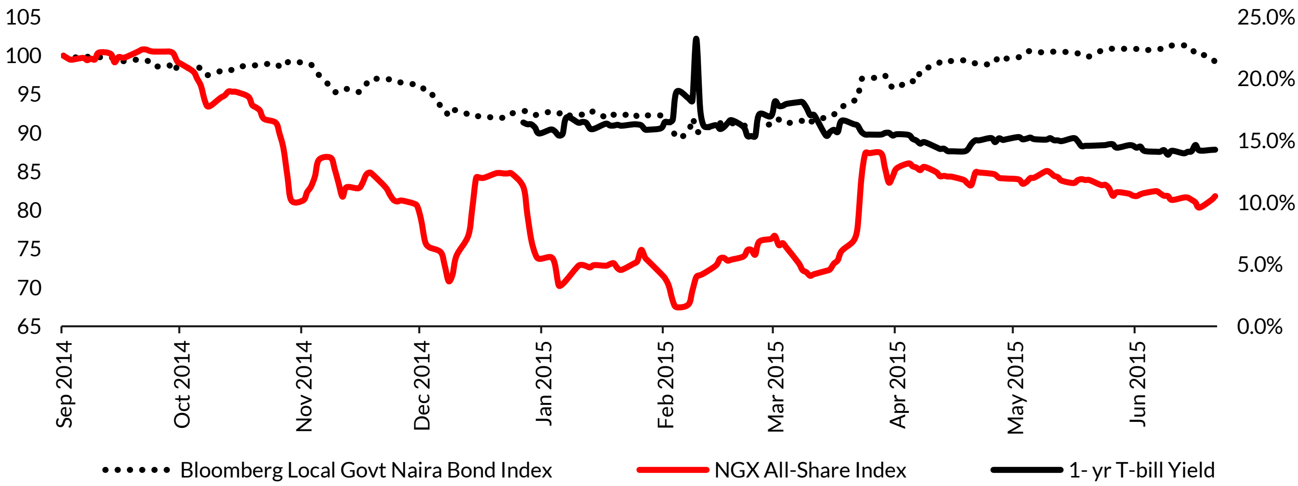
Nigerian markets are influenced by oil prices, inflation, central bank rates, system liquidity and company earnings: once every four years they are influenced by general elections. 2023 is one such year as general elections are due in February.

An inflection is almost guaranteed

What does the history of the last two general elections, in 2015 and 2019, tell us? Far from being indifferent to politics, the markets reacted strongly on both occasions.

Nigerians recall that February 2015's elections involved a high degree of uncertainty: an incoming party, the All Progressives Congress (APC), threatened the long-established Peoples Democratic Party (PDP); an incoming candidate, Muhammadu Buhari, challenged an incumbent President, Goodluck Jonathan. The equity market did not like this, the NGX All-Share Index fell 20.4% from the beginning of the year to 15 February. The T-bill market was similarly spooked, with 1-year yields touching 23.5% at this time as rates were raised to address the concerns of foreign portfolio investors.

Chart 7: FGN Bond Index and NGX All-Share Index (lhs, rebased) and 1-year T-bill yields (rhs) around February 2015's general elections



Source: FMDQ, NGX Exchange, Bloomberg, Coronation Research

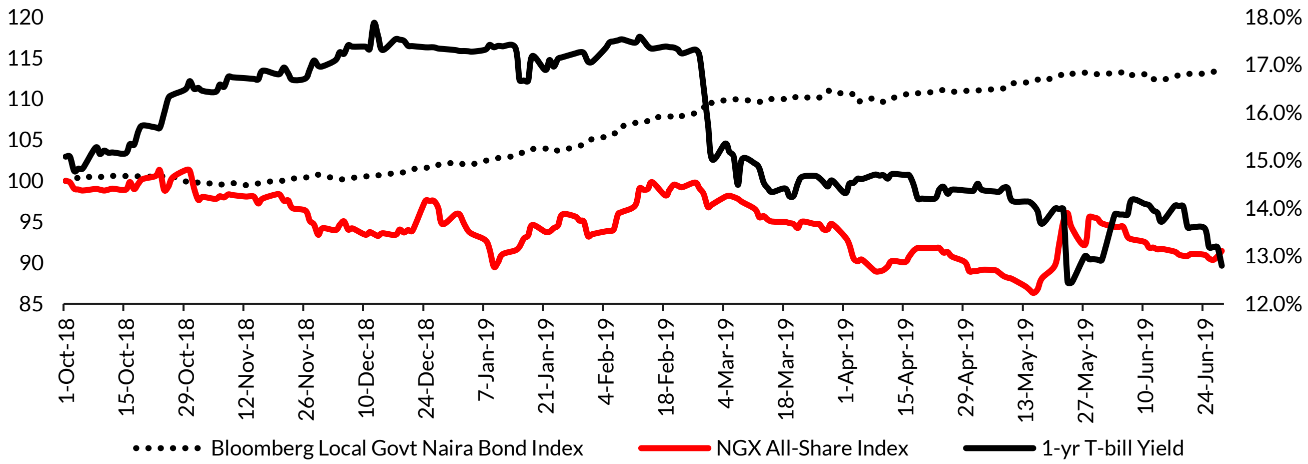
The election count in 2015 itself was eventful, but a peaceful and decisive resolution in favour of the APC and President Muhammadu Buhari spurred markets to rally. The NGX All-Share Index rose 29.5% from its February trough to a peak of 35,728.12 points on 2 April. T-bill rates fell and the FGN bond market began to perform.

However, the effects of the elections were short-lived for the equity market. The incoming administration took several months to make appointments to key posts and, amid deteriorating external conditions (oil prices fell for the rest of the year, with Brent touching US$36.46/bbl by year-end) the market corrected. At the close of the year the NGX All-Share Index was down to 28,642.25 points, 17.4% lower than its opening level in January.

2019 general elections

The markets' behaviour during 2019's general elections was very different, in some ways the opposite of 2015. President Muhammadu Buhari was standing for a second term and was challenged by Atiku Abubakar of the PDP. The equity market did not appear to put much weight on the outcome, the NGX All-Share Index rising 4.1% from the beginning of January to 32,715.20 points by mid-February. 1-year T-bills yields were steady, rising by just 3bps to 17.34% at the time of the polls. FGN bonds performed well.

Chart 8: FGN Bond Index and NGX All-Share Index (lhs, rebased) and T-bill yields (rhs) around February 2019's general elections



Source: FMDQ, NGX Exchange, Bloomberg, Coronation Research

T-bill rates then fell significantly at the end of February and continued to trend down for several months. The market anticipated a cut in the Monetary Policy Rate (MPR) by the Central Bank of Nigeria (CBN) from 14.0% to 13.5% in March. The FGN bond market continued making mark-to-market gains, the index rising steadily.

Of course, by the second half of the year (when the mandatory loan-to-deposit ratio for banks was introduced) and in particular by Q4 (when rules governing the OMO Bill market were changed, causing market interest rates to crash) it was clear that the CBN had embarked on a program of lowering market interest rates and increasing bank lending with a view to stimulating economic growth.

If this stimulus package was intended to spur company profits, the equity market did not think much of it. The NGX All-Share Index fell from its mid-February high to reach 26,842.07 points by the end of December 2019, down 14.6% on the year.

The effect of 2023's general elections

In our view 2023's general elections resemble 2015's general elections in one key respect, namely that the outcome is very open. There are three major parties (APC, PDP and the Nigeria Labour Party) contesting the presidency and the outcome is generally considered difficult to predict. Following the maxim that equity markets do not like uncertainty, it is possible that we will see some poor equity market performance in the run-up to the polls.

A lesson from 2015 and 2019 is that the CBN's actions around the time of elections, together with changes in base prices (like oil prices) count for as much as politics. Our expectations for the development of Naira market interest rates are based on our assumption that current CBN policy (i.e. anti-inflationary) will be maintained in 2023 and on current and expected liquidity conditions in the financial system – see the section Saving in Naira in 2023.

That said, we would expect the market to react to any significant challenge to CBN policy by an incoming government, given that the CBN has adopted an orthodox approach to managing inflation with successive policy rate rises since May 2022. Likewise, we would expect the market to react to any radical departure from current fiscal policy, expecting the market to see the current 2023 draft budget of N21.83 trillion as a benchmark. In other words, an incoming government with a radical policy agenda would have the potential to upset markets.

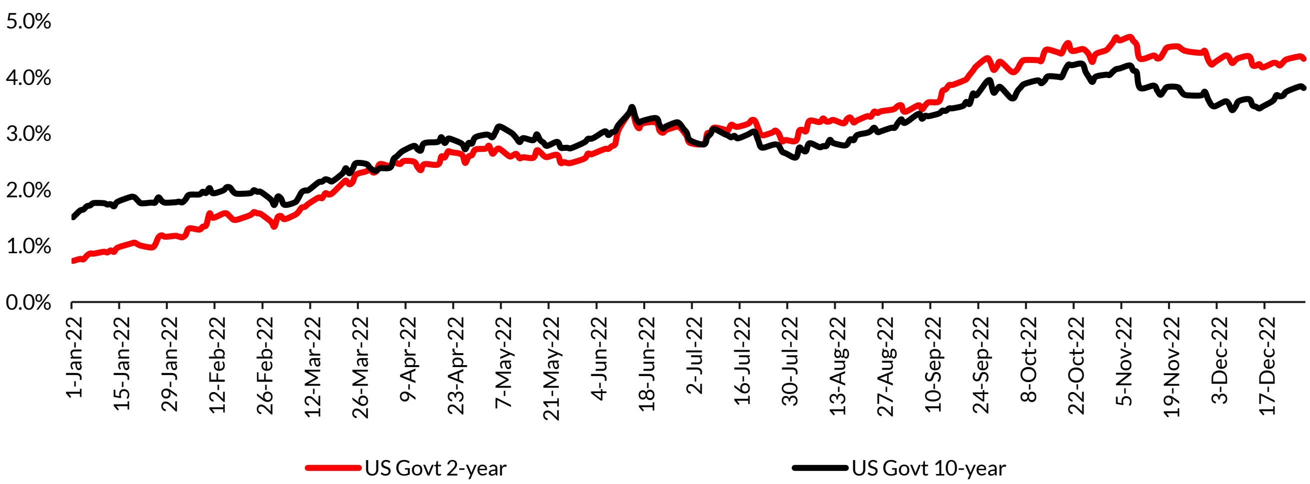
Saving US dollars in 2023

In 2022 US Government bond yields reached levels few people could have imagined a year ago. The 2-year bond yield rose by 3.6 percentage points from 0.7% to 4.3% while the 10-year bond yield rose by 2.3 percentage points from 1.5% to 3.8%. We must understand how these interest rates have changed our investment universe.

Remember the carry trade?

US dollar savers, both individual and professional investors, have opportunities that did not exist a few years ago. For example, two years ago the US Government 2-year bond yield was 0.12% and the 10-year bond yield was 0.92%. It made very little sense to save US dollars in risk-free US Government bonds, and plenty of sense to take on risk by buying emerging market bonds.

Chart 9: US Government 2-year and 10-year bond yields



Source: Bloomberg, Coronation Research

Among these were African bonds. An attractive proposition was to buy a Ghanaian Government US dollar Eurobond, maturing in March 2027, yielding (two years ago) 5.78%, or a Nigerian Government US dollar Eurobond, maturing in November 2027, yielding (two years ago) 4.95%. What could go wrong?

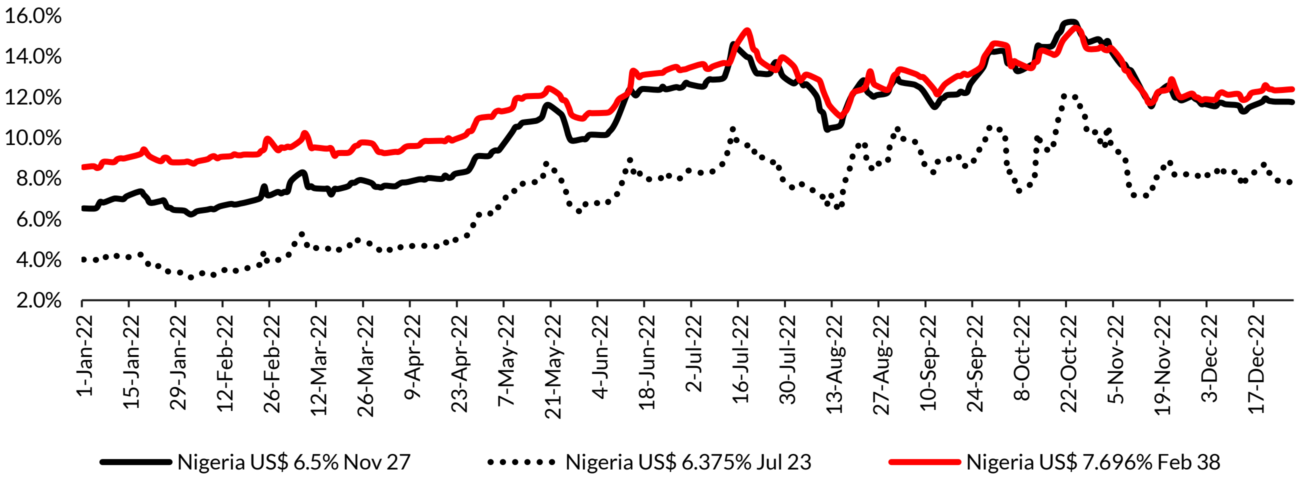
What goes wrong in bond markets is as follows: developed markets catch a cold and emerging markets catch a severe case of 'flu. Rising yields on US Government bonds attracts investment flows into liquid US dollar securities (making the US dollar rise in value along the way) driving out investors from relatively illiquid emerging market securities. The yields of emerging market Eurobonds do not march in lockstep with US Government bonds: they rise at multiples of the rise in US rates.

The rise in the value of the US dollar presents another problem. The term 'carry-trade' applies not so much as to buying emerging market Eurobonds but to the practice of borrowing in US dollars and purchasing emerging market bonds denominated in local currencies, usually with forward contracts to protect foreign exchange risk. Many of these trades no longer work as both exchange rates have moved unfavourably and foreign exchange liquidity, in several emerging markets, has dwindled. The term 'carry-trade' was ubiquitous from 2010 to 2021: one barely hears it now.

Nigerian Eurobonds

The yields of Nigerian Government US dollar Eurobonds have risen by four or five percentage points over the past year, much more than the increments in US Government bonds. The yield of Nigeria's November 2027 Eurobond rose 5.2 percentage points from 6.5% to 11.7% in 2022, while the yield of its February 2038 Eurobond rose by 3.8 percentage points from 8.5% to 12.3%.

Chart 10 Yield-to-Maturity of selected Federal Government of Nigeria US dollar Eurobonds



Source: Bloomberg, Coronation Research

And, all the while in 2022 the Naira was depreciating in the official foreign exchange market, from N435.00/US$ to N461.50/US$.

Among the consequences of these changes are:

- A constraint on the Federal Government of Nigeria's (FGN) ability to borrow in public US dollar debt markets: its US dollar debt yields roughly as much as its Naira-denominated debt;
- A heightened reliance, on the part of the FGN, on Naira borrowing going into 2023;
- Challenges for Nigerian companies borrowing in US dollars;
- Mark-to-market losses for international holders of Nigerian Eurobonds, a problem repeated across portfolios of emerging market debt (as well as several other classes of debt, including corporate debt).

Investment opportunities

Does this mean that US dollar investors have a golden opportunity today, to reap these rates (even if they are sitting on mark-to-market losses from earlier trades)? The bull case is that the withdrawal of investor money from emerging markets has not changed the fundamental ability of Nigeria to service its debt and that global interest rates will return to normal at some point, with positive implications for Nigerian Eurobonds.

The challenge here is that interest rates in developed markets may remain high for a while yet, perhaps for the duration of 2023, so an upturn in fortunes may be some way off.

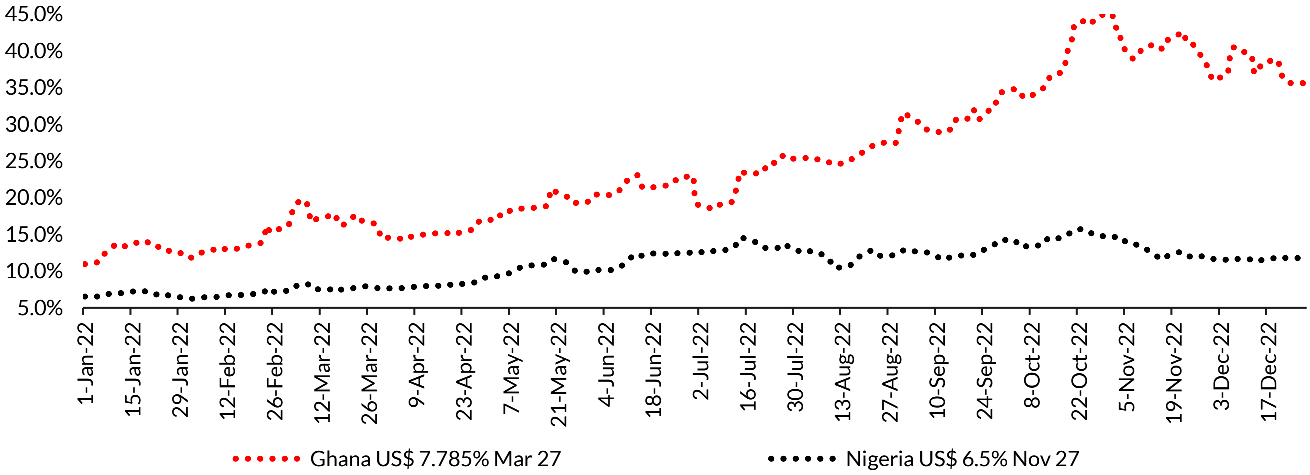
This, in our view, argues for focusing on short durations when it comes to FGN Eurobonds. We find it remarkable that the FGN Eurobond due in July 2023, just six months from now, still has a yield-to-maturity of 6.7% annualised.

By contrast, investors with a bullish view on global interest rates might be advised to take longer durations. One can imagine a situation, not too far in the future, when global investor appetite turns back towards risky assets, in which case FGN Eurobonds would look cheap.

When the music stops

In another age, and a year before an earlier crisis (the one in 2008) the CEO of a US bank argued that one should dance in the debt markets as long as the music is playing. In 2022, and continuing into 2023, some nations are figuring out what happens when the music stops.

Chart 11:Yield-to-Maturity of Ghana March 2027 and Nigeria November 2027 Eurobonds



Source: Bloomberg, Coronation Research

Ghana is a case in point. The Ghanaian Eurobond maturing in March 2027, which we described above as yielding 5.78% two years ago, now yields 34.4%. This is a distressed debt yield, meaning that it is associated with a restructuring of the bond. Indeed, at the end of 2022, and at the prompting of the International Monetary Fund, Ghana announced a restructuring of much of its domestic (Cedi-denominated) and US dollar Eurobond debt.

It is extraordinary how quickly Ghana's fortunes have declined. Just three years ago (February 2020) Ghana issued a Eurobond of US$1.15 billion, with a coupon of 6.375%. It beat Nigeria to the new issuance market that year. And only two years ago Ghana issued a further Eurobond of US$535 million, which traded with an initial yield-to-maturity of 6.437%.

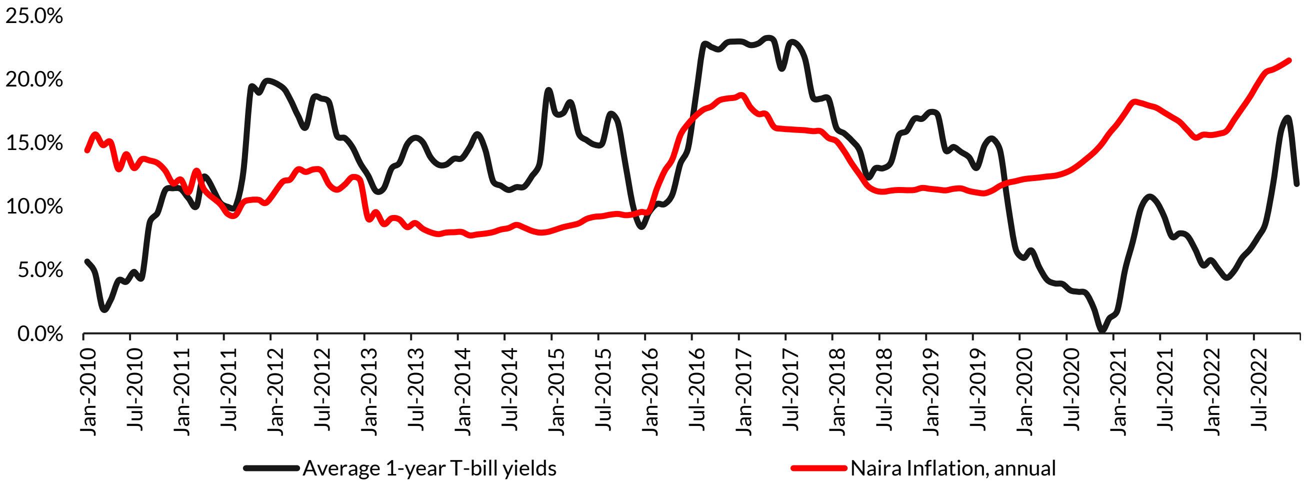
Ghana's misfortune looks like a cautionary tale to us. The yields of Nigerian US dollar Eurobonds today do not signal any significant underlying problems, but we believe investors will take close interest in future Nigerian government policies so see whether fiscal and economic issues are being addressed satisfactorily.

Saving Naira in 2023

The past three years have been tough for Naira savers, but things are improving. Since the fourth quarter of 2019 it has been difficult to obtain a positive inflation-adjusted return in Naira T-bills, and the same has been true of Federal Government of Nigeria (FGN) bonds. From 1 January 2011 to 1 October 2019 the yield of 1-year T-bills exceeded the rate of inflation by 4.0 percentage points, on average. This represented a net transfer of wealth from the public to the private sector. From 1 October 2019 to the end of 2022 the yield of 1-year T-bills was, on average, 9.4 percentage points lower than the rate of inflation. Savers have been subsidising government.

Innovation has been the order of the day. Professional asset managers, for example of Mutual Fixed Income Funds, have improved yields by trading duration in the FGN bond market; by creating and managing credit-linked portfolios; and by placing money with the cash-strapped banking sector (see below) when deposit rates are high, amongst other techniques. Risk-based and active fund management has come back into vogue because risk-free returns have been insufficient for many investors.

Chart 12: Annual Inflation versus 1-year Nigerian Treasury Bill (T-bill) yields



Source: FMDQ, NBS, Coronation Research

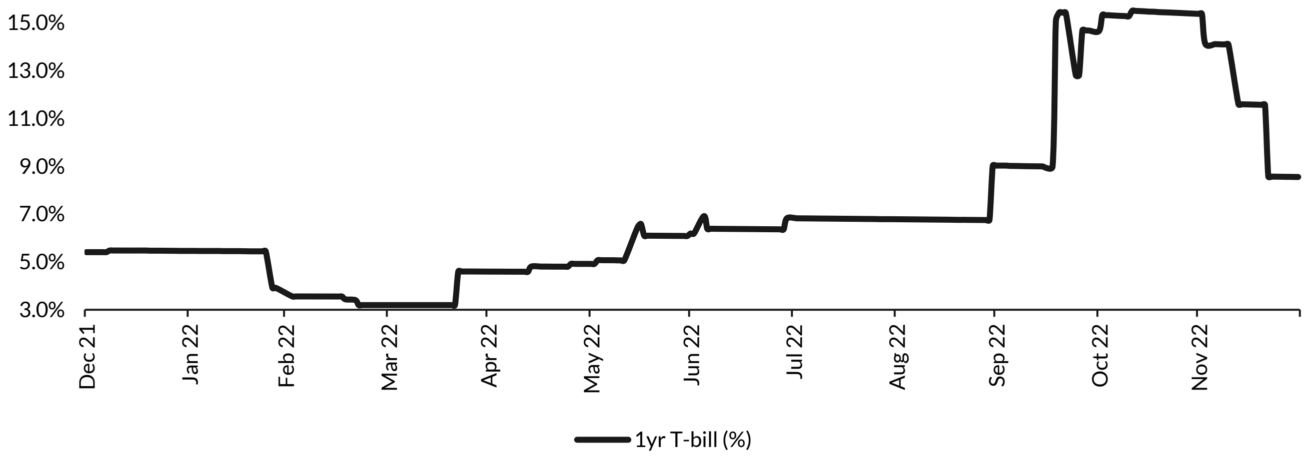
Things have been getting better, much better. Since the dark days of early 2020 1-year T-bill yields have been moving upwards, and towards the rate of inflation. Inflation itself has been trending upwards, but the upward trend in 1-year T-bill rates has been faster. At the beginning of 2022 the 1-year T-bill yielded 14.7 percentage points less than inflation: by November the deficit had shrunk to 4.6 percentage points. A direct result was a net inflow into Money Market Mutual Funds. We expect the Mutual Fund industry to expand again in 2023.

The drought comes to an end

How much better will things get? In the short-term T-bills rates are influenced by the issuing schedule of the Debt Management Office (DMO) and the timetable of redemptions (of T-bills and FGN bonds) which together influence market liquidity. The end of 2022 and the beginning of 2023 are times of quite heavy redemptions combined with moderate issuance, so market liquidity is high, leading to a dip in T-bill rates and FGN bond rates. These dynamics suggest that T-bill rates and bond yields are set to fall moderately during the first quarter of this year. This would coincide with general elections due in February.

In an election year, and with a new presidential administration to take office in a matter of months from now, there can be little certainty over future fiscal policy and issuance levels. The current planned government budget for 2023, of N21.8 trillion (US$47.7bn), with a deficit of N10.8 trillion, implies a high level of T-bill and FGN bond issuance, so our current view is that T-bill and FGN bond rates are likely to rise when system-wide liquidity begins to tighten four months from now.

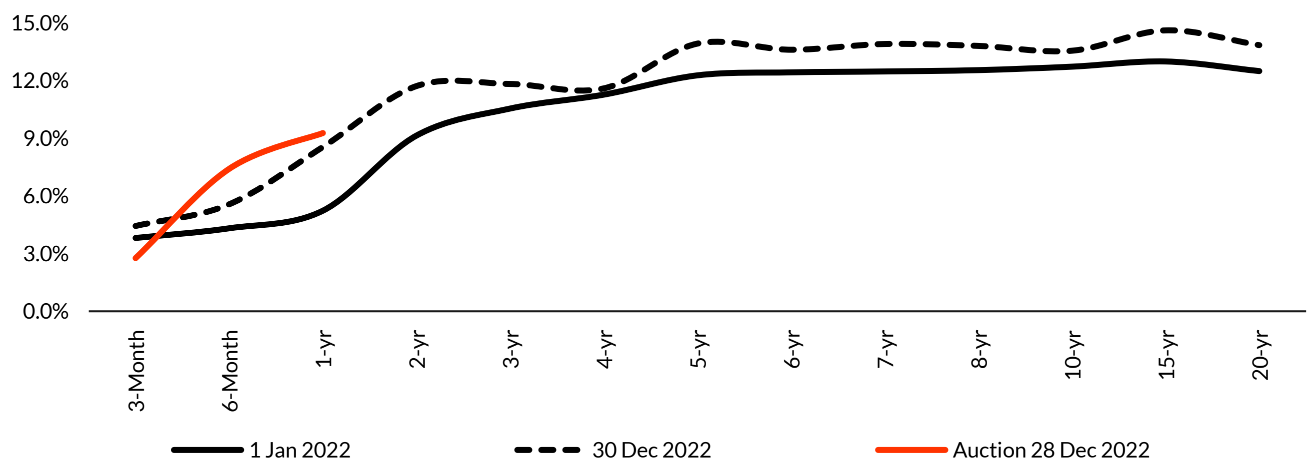
Chart 13: 1-year T-bills rates



Source: FMDQ, NBS, Coronation Research

FGN bond rates also improved during 2022, though the increase in bond yields was less than for T-bills. Taking our regular measurement of 10 FGN bond maturity spreads between two and 20 years, the average FGN bond yield increased by 1.35 percentage points (135bps) from 11.89% to 13.24% during 2022.

Chart 14: Nigeria Government T-bill and bond yield curve



Source: FMDQ, Coronation Research

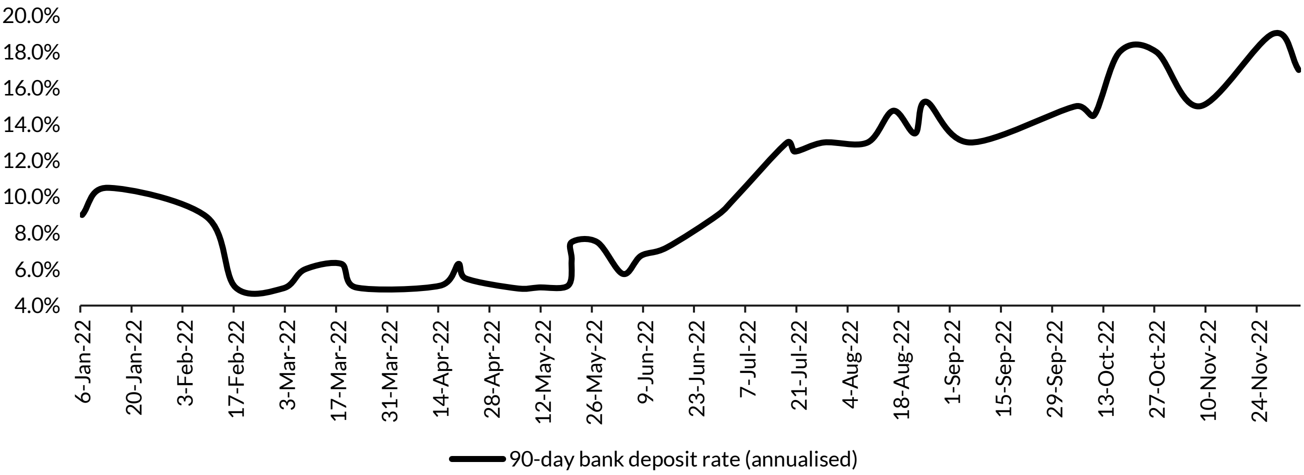
The steepness of the FGN yield curve changed significantly. The difference between the 2-year duration and the 20-year duration fell from 336 basis points (bps) at the beginning of the year to 213bps by year-end as short-term rates rose swiftly. Skillful fund managers were able to trade duration and optimise returns if they could correctly position portfolios alternately at the long and short ends of the curve.

Recall that 2022 saw four rises in the Monetary Policy Rate: from 11.50% to 13.00% in May; from 13.00% to 14.00% in July; from 14.00% to 15.50% in September; and from 15.50% to 16.50% in November. The feed-through to market interest rates was not swift to begin with (certainly not after the first MPR rise) but it certainly caught on. Long-term observers of the FGN yield curve may be reassured that today it has resumed its familiar gentle slope, from left to right.

Naira deposit rates

Naira savers in general, and Money Market Mutual Funds in particular, were helped by rising bank deposit rates in 2022. The annualised deposit rate for a 90-day deposit, as monitored by Coronation Asset Management, rose from 9.00% in early January 2022 to 17.00% in early December. Although the path of deposit rates was somewhat similar to that of 1-year T-bill rates, the dynamics were different. Naira liquidity in the Nigerian banking sector (as opposed to the financial system overall) is strongly influenced by the Cash Reserve Requirement (CRR) of the CBN. Early in 2022 the official CRR stood at 27.5% (i.e. 27.5% of deposits need to be banked with the CBN) but it was widely acknowledged that the effective CRR debit was over 50.0% for many banks.

Chart 15: Nigerian Banks' 90-day deposit rates



Source: Coronation Research

Later in the year the official CRR was raised to 32.5%. Many banks found themselves short of liquidity and successive rises in the MPR made it more and more expensive to refinance with the Central Bank. As MPR rate hikes translated into market interest rates, the effect of CRR debits was to make banks look for cash, and the results were deposit rates offered comfortably above T-bill rates. Managers of Money Market mutual funds, which can invest a proportion of their assets under management in bank deposits, were able to pass on benefits to their clients.

Prospects for 2023

As detailed above, a high level of liquidity in the financial system in the first quarter of 2023 is likely to push market interest rates down, with the effect of lowering T-bill rates and, quite likely, bank deposit rates. This also implies mark-to-market gains on FGN bonds so we would look for investors to crystallise these. Indeed, Fixed Income Mutual Funds, those that report according to mark-to-market rules (as SEC rules require), may record significant gains early in the year.

Elections, as we have already discussed, are very likely to provide an inflection point, as they have on previous occasions. Given that we cannot know the results of the elections it is difficult to know what the inflection will be. An incoming government could attempt, for a number of reasons, to make market interest rates fall - this is a possible outcome.

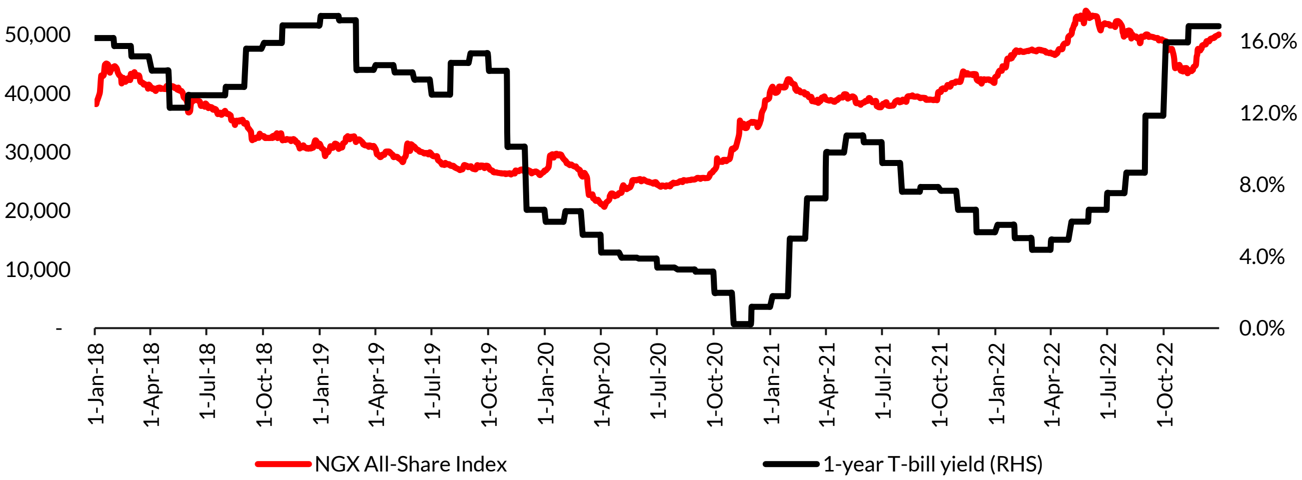
Alternatively, and given that almost the entire world has adopted monetary policy orthodoxy in the face of inflation, the CBN may well continue with its anti-inflationary policies. Such policies combined with a high level of issuance of T-bills and FGN bonds could see market interest rates rise again in the second half of the year. The path of interest rates in 2023 would then look very much as they did in 2022. This is our base case.

The new case for Nigerian equities

In each of the past three years the NGX All-Share Index (NGX-ASI) has provided a positive Naira return. Given that five (2014, 2015, 2016, 2018 and 2019) of the past ten years yielded negative returns, this marks a welcome departure from trend. What is happening?

To begin with, we are witnessing the effects of low market interest rates. For most of the period from 2011 to 2019 investors obtained returns above the rate of inflation simply by buying and holding Nigerian Treasury Bills (T-bills). The excess return of T-bills over inflation was 4.00 percentage points per annum, on average, which gave a strong disincentive to take risks in the equity market. Then, in the fourth quarter of 2019, the CBN's rules governing OMO Bills caused market interest rates to crash, with rates declining in that quarter and throughout 2020. Investors were given the incentive they needed to take risks, and this included buying equities.

Chart 16: NGX All-Share Index and 1-year Nigerian T-bill yield



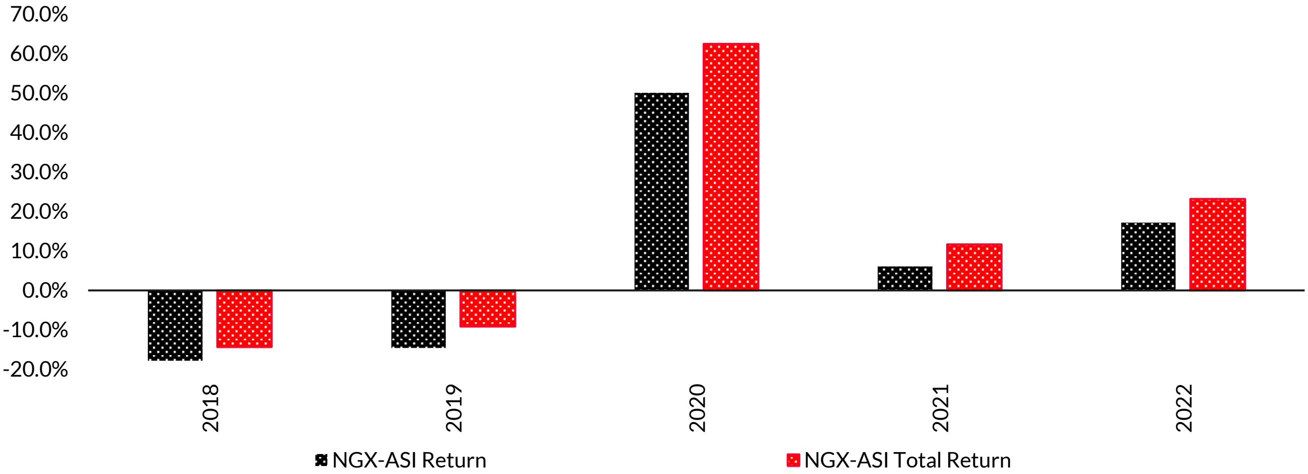
Source: NGX Exchange, Bloomberg, FMDQ, Coronation Research

As ever in the equity market, many different factors have influenced outcomes, not least in 2020 when the onset of the Covid-19 pandemic caused the market to fall 29.8% during the first three months (a low point was reached on 6 April) before rallying to end the year with a gain of 50.0%. The constant theme for the past three years has been the inability of T-bills to provide a return in excess of inflation. Even as T-bill yields improved in 2022, inflation was rising ahead of them.

The total index return has been better

The total index return, which measures the effects of receiving dividends and reinvesting them, has been significantly better than the index return over the past five years. In 2022 the total return exceeded the index return by 6.0 percentage points (600bps) taking the total return for the year to 23.2%, beating inflation (at least November 2022 year-on-year inflation: we await December's print) at 21.47%. Neither T-bill yields nor FGN bond yields came close to doing this in 2022.

Chart 17: Annual Nigerian Stock Exchange All-Share Index (NGX-AS) returns and NGX-ASI Total Returns



Source: NGX Exchange, Bloomberg, FMDQ, Coronation Research

Note that using total returns in this way depends on a market trending upwards. If markets are trending downwards then it makes more sense to keep dividends in cash rather than reinvest them. However, even in years when the market falls it can still make sense to reinvest dividends if the stocks fall in the aftermath of dividend payments (the largest dividend payments are made in the first half of the year), giving the opportunity to reinvest cheaply. This explains the out-performance of the NGX-ASI Total Return over the NGX-ASI Return in 2018 and 2019.

Equities in Naira risk management

Equities need to be re-established as an asset class for individual and institutional Naira-based investors, in our view. As long as the monetary authorities abstain from offering risk-free returns above the rate of inflation, then investors will remain interested in risky assets, including equities. The performance of Nigerian equities over the past three years challenges the behaviour of Nigerian pension funds, which have low allocations to equities, and that of retail investors who hold very little money in Equity Mutual Funds. If 2023 turns out to be another good year for equities, they may miss out again on returns superior to T-bills and FGN bonds.

2023: another year for equities

In order not to become overvalued, a market's principal listed companies need to increase earnings per share at least in line with market performance. And so long as: (a) the market is not overvalued; (b) there is a reasonable expectation of earnings growth; and (a) other mainstream assets (i.e. T-bills and Naira-denominated bonds) do not become much more attractive than they are currently, then it is reasonable to expect that the equity market will perform well.

In the table we present a spot-check on this thesis. It features the ten largest stocks of the NGX-ASI by weight, accounting for 81.36% of the index. For each stock we give the expected upside in earnings for 2023, as given by mean estimates and forecasts collated by Bloomberg, as reported on 29 December 2022. The indication is that weighted average earnings are set to grow by 18.07% which, in our view, has the capacity to cause the market to appreciate if available T-bill and Naira-denominated bond returns do not improve significantly in 2023.

Chart 18:2023 Earnings Expectations

Stock	Index weight		Net Income, 2023/2022 increase in Mean Estimates*
Airtel Africa	21.73%		29.87%
Dangote Cement	15.84%		15.32%
MTN Nigeria	15.53%		16.10%
BUA Cement	11.53%		11.59%
BUA Foods	4.76%		20.65%
Nestle Nigeria	3.03%		5.54%
Zenith Bank	2.72%		9.84%
Seplat Energy	2.29%		-31.00%
GTCO	2.50%		32.71%
FBN Holdings	1.43%		52.78%
Total index weight	**81.36%**	**W/A change in forecast earnings****	**18.07%**

Source: NGX Exchange, Bloomberg, Coronation Research. * Mean Estimates provided by Bloomberg for Net Income, Adjusted, in the case of Airtel Africa, Dangote Cement, MTN Nigeria, BUA Foods, Nestle Nigeria and Seplat Energy: EPS Adjusted in the case of BUA Cement, Zenith Bank, GTCO and FBN Holdings. Index weights and estimates provided by Bloomberg at close of business on 29 Dec. 2022. NB GTCO=Guaranty Trust Holding Company **Weighted Average change in forecast earnings

There are some risks to this equity view. Our own research during 2022 (notably *Coronation Research: BUA Cement: King in the North, 29 July 2022*,and *Nigerian Telcos: Delivering a digital future, 20 January 2022*) detailed the high valuations of Airtel Africa and BUA Cement relative to their sector peer-group companies. The market could de-rate either or both stocks accordingly going forward, and indeed de-rate any of the other eight stocks featured in the table (i.e. the market could in future give valuations in line with lower multiples of earnings than it currently does). In our view this would be more likely to happen as a consequence of market interest rates (e.g. T-bill yields, FGN bond yields) rising rapidly than if market interest rates fall, stabilise or rise gently in 2023. On balance, the outlook for equities is good, we believe.

Dividends are the essential ingredient

As described above, the total return of the NGX All-Share Index tends to exceed the simple index return. For this to happen companies need to pay dividends. Our study of dividends paid during 2022 by the top-20 listed companies by index weight shows that a considerable contribution was made by dividends.

Chart 19: Top-20 NGX All-Share stocks by index weight, Share Price and Gross Yields, Total Dividends, by 32 Dec 2022

Stock	Index Weight	Stock price, Naira, 1 Jan 2022*	Implied Gross Yield, Total Dividends	Average Stock Price, Naira, year-to-date	Implied Gross Yield, Total Dividends
Airtel Africa	21.73%	955.00	2.42%	1,526.80	1.51%
Dangote Cement	15.84%	257.00	7.78%	264.87	7.55%
MTN Nigeria	15.53%	197.00	7.19%	209.51	6.76%
BUA Cement	11.53%	67.05	3.88%	69.21	3.76%
BUA Foods**	4.76%	40.00	8.75%	58.68	5.96%
Nestle Nigeria	3.03%	1,556.50	3.24%	1,327.01	3.81%
Zenith Bank	2.72%	25.15	12.33%	23.04	13.45%
Seplat Energy	2.29%	650.00	6.55%	1,123.45	3.79%
GTCO Holding	2.50%	26.00	11.54%	22.05	13.61%
FBN Holdings	1.43%	11.40	3.07%	11.02	3.18%
Stanbic IBTC Holdings	1.49%	36.00	9.72%	32.33	10.83%
Nigerian Breweries	1.75%	50.00	3.20%	40.27	3.97%
Lafarge Africa	1.36%	23.95	4.18%	24.72	4.05%
Geregu Power***	1.32%	110.00	0.00%	118.46	0.00%
Access Holdings	1.21%	9.30	9.68%	9.18	9.80%
United Bank for Africa	0.97%	8.05	12.42%	7.64	13.09%
Dangote Sugar	0.69%	17.40	5.75%	16.38	6.11%
Union Bank of Nigeria	0.70%	5.90	0.00%	6.04	0.00%
Ecobank Transnational	0.73%	8.70	0.02%	10.98	0.01%
Okomu Oil	0.56%	142.00	11.97%	173.23	9.81%
Weighted Average	**N/a**	**N/a**	**5.79%**	**N/a**	**5.38%**

Source: NGX Exchange, Bloomberg, Companies, Coronation Research. *Opening price on the first day of trading in 2022. **Listed on 4 January 2022. ***Listed on 4 October 2022

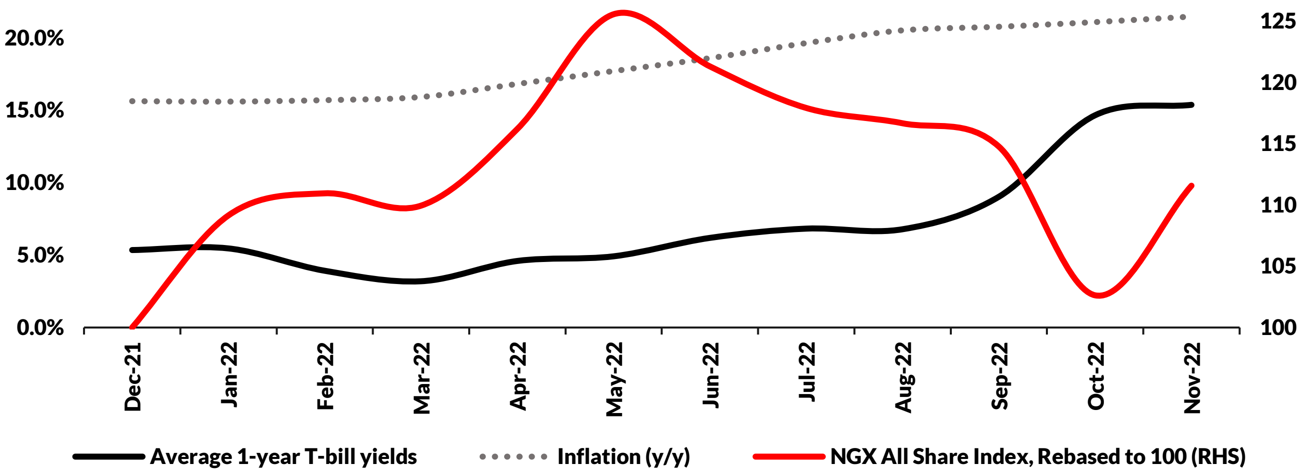
Nigerian mutual funds

In 2022 Nigeria's mutual fund industry grew. Rising interest rates spurred savers to subscribe to Money Market funds while the desire to protect portfolios against currency devaluation prompted growth in US Dollar funds. Investors are increasingly turning to mutual funds for long-term savings and we forecast that the industry will grow again in 2023. That said, we believe that adoption of Global Investment Performance Standards (GIPS) is key to increasing both domestic and international participation in Nigerian mutual funds.

Mutual funds to grow again in 2023

The beginning of 2022 did not start well for Money Market mutual funds when market interest rates fell is response to high financial system liquidity. During the first half of the year 1-year T-bill yields fell from 5.46% to as low as 3.19%, before beginning an upward shift in the second half, briefly exceeding 15.00% per annum during the fourth quarter. The upswing in rates was due to tightening in system liquidity and the eventual pass-through effect of MPR hikes that had commenced in May. As a result, subscriptions to Money Market funds increased, with their assets under management (AUM) rising by 12.2% y/y in 2022.

Chart 20: Average 1-year T-bill yields, NGX All Share Index & Inflation in 2022



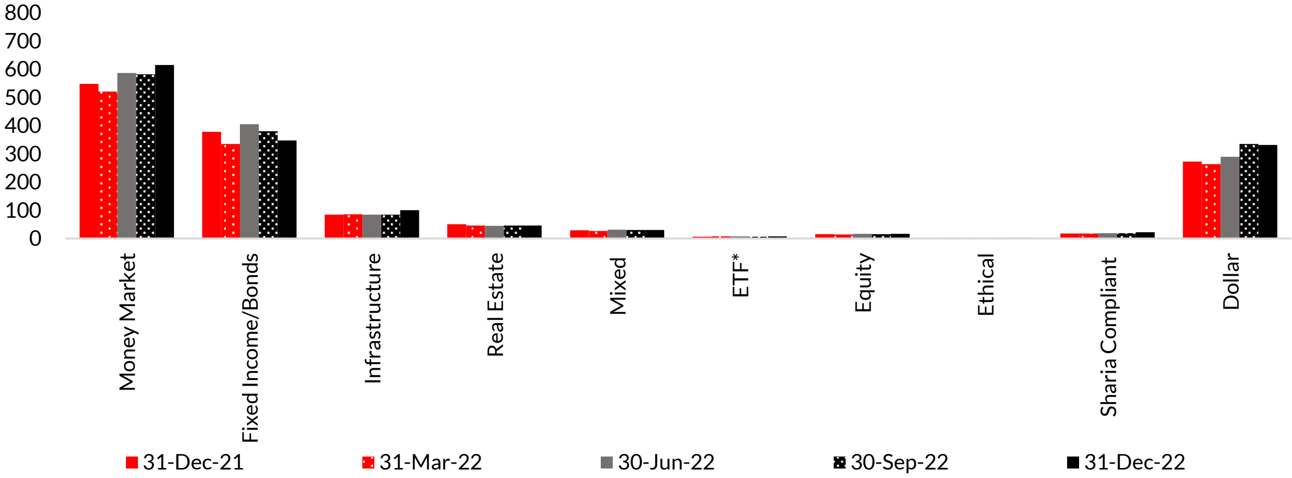
Source: FMDQ, NBS, NGX Exchange

Money Market funds can use their bargaining power as holders of large pools of liquidity to command superior deposit rates from banks and combine these with T-bill yields. In this way subscribers to Money Market funds can enjoy rates of interest higher than those they might find directly from banks. This is becoming increasingly evident to both individuals and companies, and it is one factor driving the long-term shift in the Nigerian savings culture away from banks and towards mutual fund investment.

Equities make up only a small slice of the Nigerian mutual fund pie, a legacy of many prior years of negative equity returns (see The new case for Nigerian equities). Yet the last three years have provided positive returns from the NGX All-Share Index (NGX-ASI), and holders of both Mixed funds (also known as Balanced funds, which hold a combination of Naira fixed income and equities) and Equity funds stood to benefit. 2022 began with a January rally that extended into the first half of the year with the NGX-ASI peaking at 54,085.30 points on 27 May (its highest level since 15 July 2008). The index corrected from late

May onwards and was shy of a bear market by 30 October, before staging a strong year-end rally to close the year up 19.98% at 51,251.06 points.

Chart 21: Total Mutual Funds Industry AUM, N'bn , Year-to-date

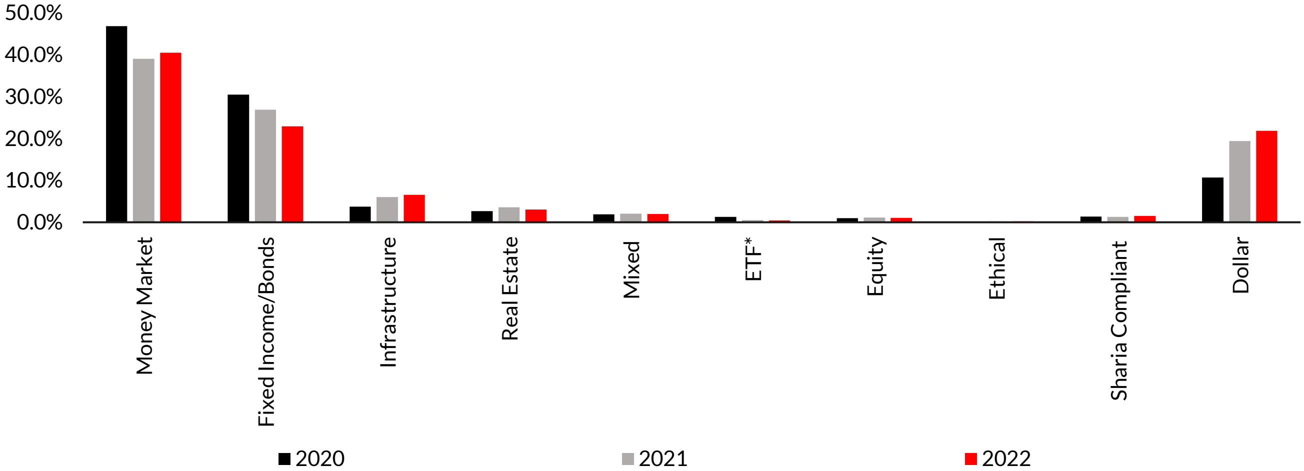


Source: Securities and Exchange Commission (SEC), Coronation Research

According to data from the Securities and Exchange Commission (SEC), between 31 December 2021 and 31 December 2022, the total Net Asset Value of all regulated mutual funds grew by 8.06% from N1.41tn (US$3.27bn) to N1.52trn (US$3.53bn). This gain was primarily driven by the growth in Money Market funds (+12.19% y/y) from N547.91bn to N614.70bn and Dollar funds (+21.80% y/y) from N272.19bn to N331.53bn. These funds now make up over 62% of all regulated mutual funds' total Net Asset Value.

Looking at the distribution of all regulated mutual funds by type from 2020 to 2022, we are seeing a gradual shift in appetite from Fixed Income & Bond Funds into Dollar funds. The percentage of the industry accounted for by Dollar Funds has more than doubled in two years from 10.67% to 21.83%, while Fixed Income & Bond Funds have shrunk from 30.47% to 22.86%.

Chart 22: Distribution (%) of Mutual Funds Industry by type



Source: Securities and Exchange Commission (SEC), Coronation Research *Exchange-traded Funds

Clearly, individual Nigerian savers, as well as companies, are making the migration from keeping savings in bank deposits to saving in mutual funds. An increasing number of savers prefer Money Market funds to deposit accounts and US Dollar funds to US Dollar domiciliary accounts. Fixed Income / Bond funds also confer advantages over Naira-denominated deposit savings accounts with banks.

What is required, in our view, is a truly effective reporting regime, following mark-to-market principles and Global Investment Performance Standards (GIPS) so that investors can properly compare the performance of funds. We described the challenges in our report *Comparing Mutual Funds II, Apples and Oranges and a Hand Grenade 29 Jun 2022*.

Adoption of GIPS would enormously increase investor confidence in the industry, in our view, and enable Nigerian mutual funds to be featured on international fund comparison sites such as Morningstar, Yodeler and the Financial Times Fund Comparison service. This, in turn, would pave the way for international investment in Nigerian mutual funds.

Model Equity Portfolio

Every week (or almost every week: public holidays interrupt us) the Coronation Research team publishes a Model Equity Portfolio in its *Nigeria Weekly Update*. This is not a real portfolio, but a notional portfolio that began with notional N10 billion to manage at the beginning of 2020. It is a vehicle to express our opinions about stocks listed on the NGX Exchange and our view of the direction of the equity market overall. We impose on ourselves certain rules: we respect actual market liquidity when making notional trades; we warn our readers in advance of changes we intend to make; we publish a meticulous record (to the nearest basis point) of performance attribution. The performance attribution spreadsheet is useful when figuring out the effects of past trades, for better or worse.

We were fortunate to launch the Model Equity Portfolio (MEP) at the beginning of a three-year period of annual gains for the NGX All-Share Index (NSX-ASI). Last year was exceptional for the Model Equity Portfolio as it outperformed the NGX All-Share Index by 503 basis points (bps).

Chart 23: NGX ASI vs MEP, rebased 1 Jan 2022=100

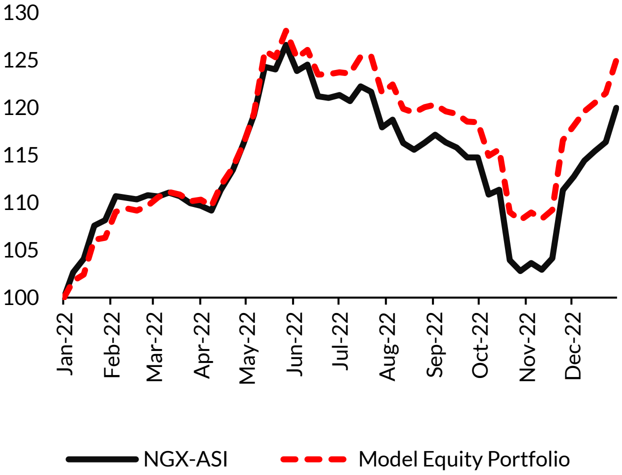
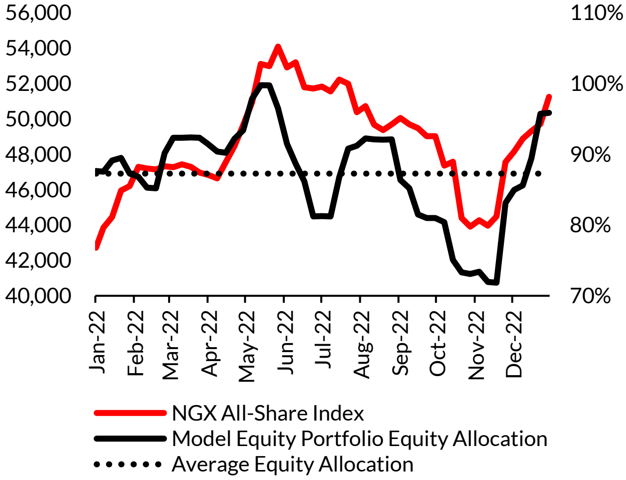


Chart 24: Model Equity Portfolio Equity Allocation in 2022



Source: NGX Exchange, Coronation Research

Before going into details, a word on what outperformance really means. Fund managers (of real funds) justify their existence by outperforming the market. If they do not, then investors will simply choose index-neutral funds, i.e. passive investing as opposed to active investing. If fund managers add one or two percentage points of outperformance per annum, over time, they are highly regarded (though maintaining outperformance can be a nerve-wracking experience). But it only makes commercial sense to outperform if the market itself is going up: nobody needs to pay for negative investment returns, even if the fund manager outperforms the market.

In 2022 we were fortunate to select three stocks in which to hold notional overweight positions and these together delivered 429bps. They were Okomu Oil, Presco and Seplat. At the same time, we took an 'if you can't beat them, join them' attitude to six other stocks as we watched them rally and decided to join in by making notional purchases. There were Fidelity Bank, BUA Foods, Geregu, Guinness Nigeria, Nigerian Breweries and Flour Mills of Nigeria. Merely to join in the fun in this way may not seem very principled, but together these notional positions delivered 246bps.

The third strand in our approach was to underweight our exposure to the equity market when we sensed it was about to fall, notably when market interest rates were rising during the third and early fourth quarters of the year. This is simply trading the market overall, by adjusting the amount of notional cash held, as opposed to selecting stocks. Many fund managers cannot do this (their guidelines have caps on how much cash may be held) but for us, it was an important source of outperformance.

Lessons from running a Model Portfolio

When it comes to making successful stock selections, bear in mind several things. First, nobody can pick all the best stocks at the beginning of the year (we did not pick PZ Cussons nor Guinness Nigeria in 2022, for example, though we later added Guinness Nigeria to the portfolio). Second, do not hang onto strongly performing stock selections for too long, unless they are the next Microsoft (which in any case fell 28.7% in US dollars last year). We scored some outperformance with Okomu Oil, Presco and Seplat but lightened our positions once their respective base prices (palm oil, rubber and crude oil) began to weaken mid-year. Third, if you make a poor stock selection, in our case Custodian Investment in 2022, and it is not very liquid (even in the context of a small portfolio) you are stuck with it. Grin and bear it.

Another lesson is that valuation is not everything. Airtel Africa looked overvalued relative to MTN Nigeria at the beginning of the year, in our view. But Airtel Africa stock was driven by its fungibility by way of its foreign listing. Airtel Africa rose 71.2% last year while MTN Nigeria rose by 9.1%. Being underweight Airtel Africa and overweight MTN Nigeria would have caused problems.

Overall, do not be too dogmatic. Being dogmatic (for example, about valuations) might have your portfolio underperforming while you complain that the market fails to understand the story. But the market is the boss, remember.

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Security Name	Available Disclosure
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Guaranty Trust Holding Company	
Access Bank	D, E, F, G
FBNH Holdings	E, F, G
United Bank for Africa	
Stanbic IBTC Holdings	
MTN Nigeria Communications	D, G
Airtel Africa	G

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Price Targets:	Price targets reflect the analyst's estimates for the company's earnings. The achievement of any price target may be impeded by general market and macroeconomic trends and by other risks related to the company or the market and may not occur if the company's earnings fall short of estimates.

In cases where issuing of research is restricted due to legal, regulatory or contractual obligations, publishing investment ratings will be restricted. Previously published investment ratings should not be relied upon as they may no longer reflect the analysts' current expectations of total return. While restricted, the analyst may not always be able to keep you informed of events or provide background information relating to the issuer.

If the investment rating on a stock has not been reviewed for a period of one year, coverage of the stock will be discontinued by Coronation Research. Investment decisions should be based upon personal investment objectives and should be made only after evaluating the security's expected performance and risk. Coronation Research reserves the right to update or amend its investment ratings in any way, and at any time it determines.

Ratings and Price Target History

Ticker	Date	Recommendation	Date	Recommendation	Date	Recommendation	Target price, Naira/s
ZENITHBANK	25-Jun-21	Buy	22-Feb-22	Buy	01-Nov-22	Buy	30.86
GTCO	25-Jun-21	Buy	22-Feb-22	Buy	01-Nov-22	Buy	36.63
ACCESS	25-Jun-21	Buy	22-Feb-22	Buy	01-Nov-22	Buy	12.88
FBNH	25-Jun-21	Hold	22-Feb-22	Sell	01-Nov-22	Sell	8.34
UBA	25-Jun-21	Buy	22-Feb-22	Buy	01-Nov-22	Buy	11.72
STANBIC	25-Jun-21	Buy	22-Feb-22	Buy	01-Nov-22	Buy	45.00
MTNN	25-Jun-21	Not Rated	22-Feb-22	Buy	01-Nov-22	Buy	274.41
AIRTELAFRI	25-Jun-21	Not Rated	22-Feb-22	Sell	01-Nov-22	Sell	1,051.07
DANGCEM	25-Jun-21	Not Rated	22-Feb-22	Not Rated	01-Nov-22	Buy	328.65
BUACEMENT	25-Jun-21	Not Rated	22-Feb-22	Not Rated	01-Nov-22	Sell	44.60
WAPCO	25-Jun-21	Not Rated	22-Feb-22	Not Rated	01-Nov-22	Buy	39.23

Coronation Research Investment Rating Distribution	
Buy	72.7%
Sell	27.3%
Hold	0%
Under Review	0%

CORONATION

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