Nigeria: 2022 Mid-Year Outlook

SAME CHALLENGES, NEW SHOCKS

July 2022

Executive Summary

The roils from geopolitical tensions, and their consequent passthrough to commodities prices and global inflation created an early dilemma for monetary authorities at the start of 2022. And even though it was hard to tag it as a surprise, the Russia/Ukraine war sent shockwaves to economies miles away from Eastern Europe. The crisis led to material trade routes disruptions, a surge in commodities prices that worsened the baggage from inflation, and for a while, several permutations on the likelihood of a third world war.

By accident or design, the war is yet to deteriorate into the initial worst-case scenario. After the early jitters, the rest of the world appears to have markedly shifted attention to managing its economic fall-outs and other older impasses. In particular, central monetary authorities appear to be consolidating on the "war" to contain inflation, with monetary policy tools often repeatedly unleashed. Here, in Africa, the distortion of the global world order had mixed impacts. Proactive net commodities exporters are reaping the dividends of recent rallies, while net importers of commodities count their trade balance losses.

Expectedly, global markets for risky investments have been mostly below the water. Yet, Nigerian markets stood relatively firm amidst this almost ubiquitous market rout. Its major equity index remains the second -best performing in the world, while its fixed income market staged a decent rally in Q1'22. This report assesses the character and sustainability of this relative resilience of naira assets. In particular, it gauges the potential impact of rising political uncertainties—especially as campaigns for the 2023 elections intensify—and dynamic macros on investment opportunities across the oil-rich giant with mostly unique policy management systems.

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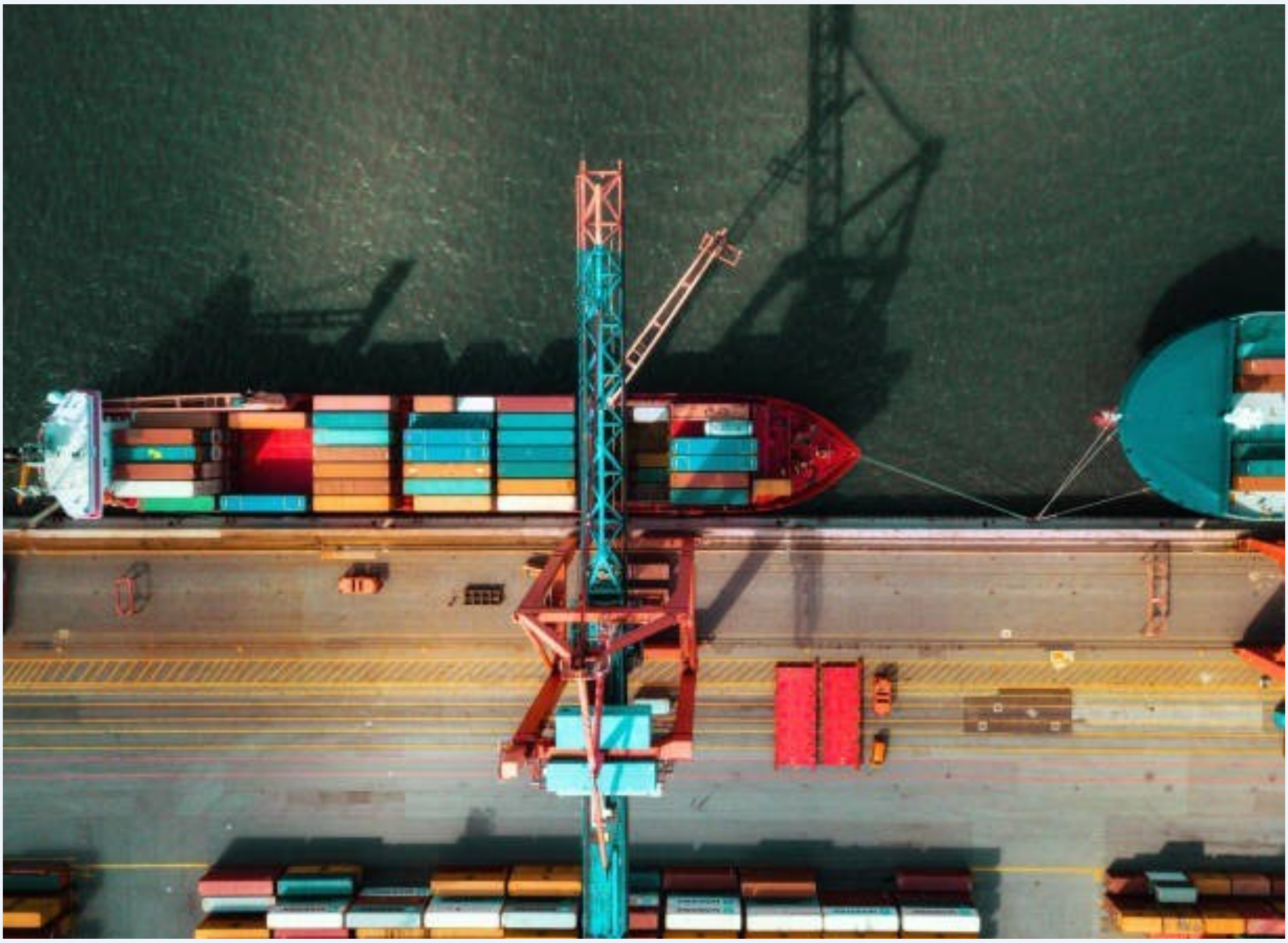


Global Economy

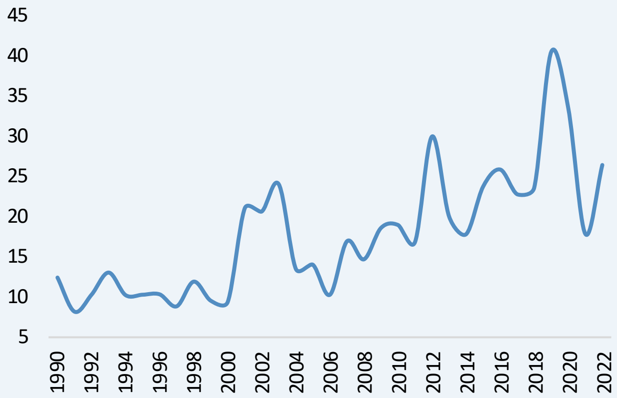
Recession fears resurfaces

Across the globe, concerted monetary policy efforts to contain inflation have yet to yield desirable results, creating latitude for interest rate increases and balance sheet unwindings. Key triggers have also increased the risk sensitivities of investors, resulting in material capital flights from emerging and frontier markets. For SSA countries, these reversals have the worrying acceleration of debt burden as an extra justification. More than half of the region's low-income countries are either in debt distress or at a high risk of the same. These countries will likely lose more sleep over the tightening global financing conditions, given that most of their domestic savings and capital market institutions are considerably underdeveloped. Yet, risk-seeking investors could see in these markets opportunities to boost portfolio returns within the confines of their risk objectives.

Geopolitical unrest hampering post-covid recovery

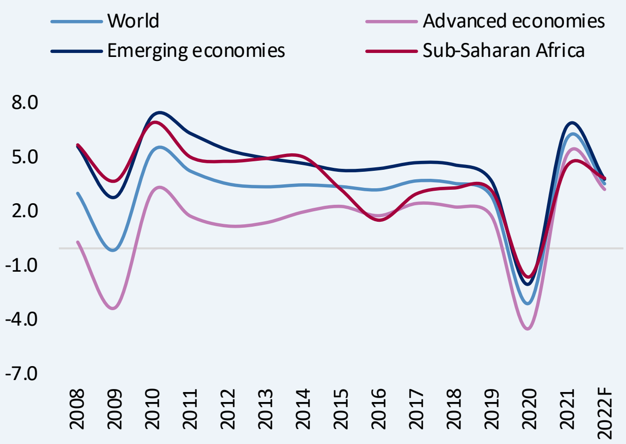
The withdrawal of COVID era monetary and fiscal stimuli, combined with the Russia-Ukraine war and associated sanctions, disrupted global economic prospects in H1'22. As the war unfolded, World Uncertainty Index[1] worsened (see figure 1), reflecting weaker economic expectations and forcing an IMF global growth downgrade to 3.6% from 4.4% at the start of the year. In Q1'22, developed countries like the U.S and Japan contracted by 1.4% and 0.5%, respectively, with consensus suggesting further weaknesses in Q2'22.

Figure 1: Global uncertainty index on the rise due to Ukraine war



Source: Federal reserve bank of St. Louis, CardinalStone Research

Figure 2: Weaker global growth(%) expectations for 2022



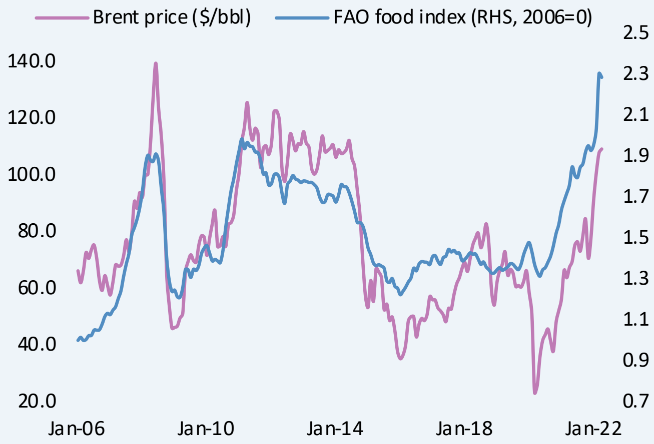
Source: IMF, CardinalStone Research

[1]The World Uncertainty Index is a measure that tracks uncertainty across the globe by text mining the country reports of the Economist Intelligence Unit. The index is available for 143

Global inflation at new highs

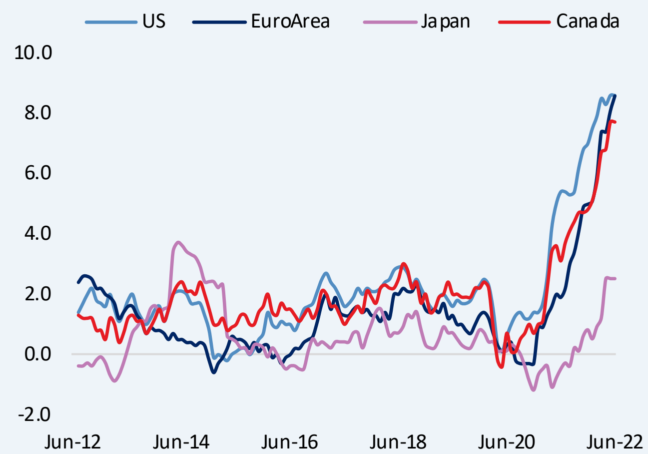
Global inflation was poised to increase due to supply chain bottlenecks, labour market disruption, and the resurgence of global demand post the covid-19 recovery. But the Russia-Ukraine war, which sent commodities and energy prices soaring, led to a faster than expected acceleration in inflation in advanced and emerging economies to record heights. Consequently, the soaring inflation prompted a hastening of hawkish rendition from global monetary policymakers. So far, the responses have not stopped real rates from being in negative territory across most markets, leaving latitude for continued interest rate increases and balance sheet unwinding.

Figure 3: Geopolitical tensions drive spikes in commodity prices



Source: Bloomberg, CardinalStone Research

Figure 4: Global inflation (%) at an all-time high



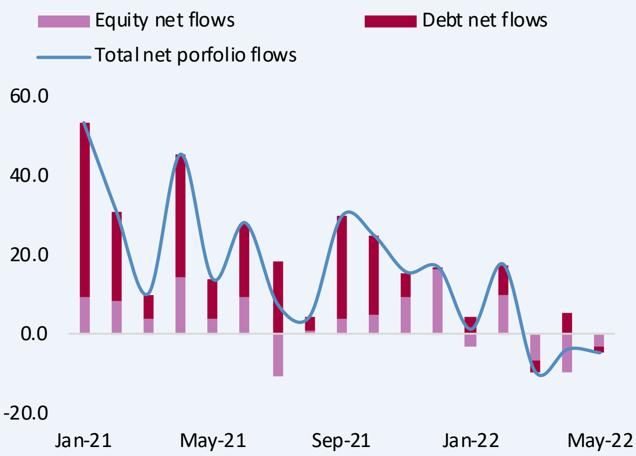
Source: Bloomberg, CardinalStone Research

Increasing capital flights from emerging markets

Global inflationary pressures, coupled with renewed covid concerns in China and persisting anxiety over geopolitical tensions, jolted emerging market credits in H1'22, as the JPM-EM Bond Global Diversified Index slumped by 14.7% YtD. Since Russia invaded Ukraine, emerging market (EM) debts and equities have suffered a net outflow of $18.7 billion from foreign portfolio investors. Investors were largely risk-averse due to 1) global hawkish rendition, 2) decline in global liquidity, and 3) erosion of the stock of negative-yielding debt across developed markets from $11.3 trillion at the start of the year to the current value of $2.7 trillion.

Elsewhere, while the global tightening cycle may further strengthen the dollar, we do not believe an EM currency crisis is imminent. Our view is premised on the relatively strong FX reserves and proactive policy responses of most central banks in EM countries.

Figure 5: Net flows to EMs slumped to negative in February



Source: IIF, CardinalStone Research

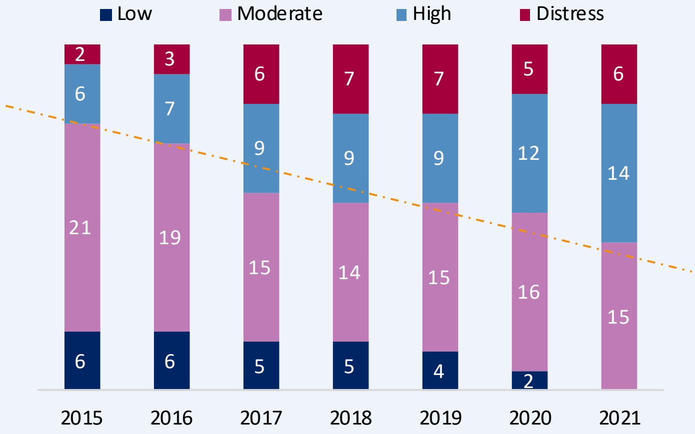
$18.7 bn

The net outflow of debts and equites suffered by emerging market from foreign portfolio investors since February 2022.

Figure 6: EM currencies marginally down by 1.1% In 2022

Source: Bloomberg, CardinalStone Research

Figure 7: Risk of debt distress is worsening across SSA



Source: IMF, CardinalStone Research

SSA Countries: Higher commodities prices, a bitter-sweet pill

The SSA region has particularly experienced a surge in food and energy prices due to the Russia-Ukraine war. IMF estimates reveal that food accounts for c.40.0% of the region's consumption, suggesting that sustained pressures on food-related products like wheat and fertiliser could further depress consumer wallets. Across the board, the higher prices could also increase import bills and push up logistics & haulage costs. Net importers of commodities may face the extra burden of worsening trade imbalances in a world where net exporters are experiencing windfall gains from the commodity rally.

Further more, the IMF debt sustainability model indicates that more than half of the region's low-income countries are either in distress or at a high risk of same. This is a marked deviation from the position in 2015, wherein only 23.0% of the countries were facing real distress risk. With the ongoing tightening of financing conditions, distressed countries may find it harder to manage their fiscal positions, while those at risk may experience a further worsening of their profiles.

Domestic Economic and Political Environment

Politics, progress and pressures

The build-up to the 2023 elections is generating the expected buzz as front runners for the top job roll out their manifestos and investors assess the likely politically-inspired market shifts in the coming year. In our view, the forthcoming presidential election may be one of the most keenly contested in recent history, with four of the country's six geopolitical zones having a chance to produce the next president. Historical precedence suggests that this spread may cascade to better voter participation in the represented zones and, on average, the country. That said, security concerns and potential victimisations will likely disenfranchise a proportion of the populace, particularly in traditionally hot zones.

Nigeria's insecurity has also been a long-dragging headwind to growth, distorting trade routes and farming activities and acting as a critical driver of inflation. On core economic issues, the burden of currency management is central. This impasse is strongly linked to legacy problems like subsidies and deterioration in foreign flows. Interestingly, the country was able to dig itself out of the COVID-inspired recession despite these FX concerns, even though the jury is out on whether the over 5.0% growths of the pre-2016 years are still attainable. This section reviews some of these major economic themes and delineates outlooks on the same.

Ahead of 2023: Electioneering to intensify in the coming months

Ahead of the February 2023 presidential elections, investors appear to have commenced ferreting the potential impact of what is likely to be one of Nigeria's most keenly contested elections in decades. Even though the leading candidates have expressed a desire to embark on issue-based campaigns, historical precedence suggests that long-dragging sectionalism and negative tactics are likely to distract from core issues. However, issue-based campaigns, if surprisingly prioritised, could focus on surging public debt & related sustainability issues, rapid inflation & associated erosion of consumer discretionary income, the materially low influx of long-term foreign capital, the poor state of infrastructure, very weak human capital development, and deterioration in security, among others. The onus may also be on the ruling party to demonstrate how its gains outfoxes the reported worsening of the country's misery index reflected in the prevailing high economic and social costs. We guess that the opposition may do everything to ensure this task is as difficult as possible, inadvertently creating a disincentive for issue-based campaigns.

Narrowing the presidential race down to the front runners

Across 18 registered political parties, 15 presidential candidates are vying for the top job in Nigeria. However, we have narrowed our focus to those we consider the top -tier candidates based on their party structure, spread, and funding bases. This stratification threw up the candidates of the ruling party (APC), Bola Ahmed Tinubu, and the leading opposition (PDP), Atiku Abubakar, as the aspirants to beat in the coming elections. There are also other notable entrants in the race for the Presidency, like Peter Obi of the Labour Party and Rabi'u Musa Kwankwaso of the NNPP, both of whom are viewed in some quarters as the third force. The former has generated a lot of social media frenzy and following, which intensified after his defection from the PDP in May 2022. Still, it remains to be seen how this buzz would translate to a positive election outcome in the face of the tested electioneering frameworks of the two largest parties in the country and in a contest where funding and geographical reach have always proven pivotal.

Key issues awaiting the incoming president

Source: CardinalStone Research

Figure 9: A snapshot of some of the most talked about candidates for the presidential election

Candidate	Key Macroeconomic Considerations

Atiku Abubakar

- Atiku's economic agenda is materially tilted to a market-driven ideology that emphasises greater private sector participation and the breaking of government monopoly in all infrastructure sectors, including the refineries, rail transportation, and power. His policy orientation also favours market determination of prices aimed at reducing distortions driven by the current interventionist exchange rate management policy.
- The PDP candidate has expressed a strong desire to heed cries of restructuring the polity by initiating relevant constitutional amendments, devolving issues bordering on minerals and mines, policing, railways, communications, transport, environment, and land matters to the concurrent list. He also advocates the devolution of social and welfare issues (such as education and healthcare) to the states and local governments. Notably, one of his key campaign focuses is making local governments true third-tier governments with financial autonomy.
- He also prioritises human capital development as part of his economic development strategy. He plans to achieve this through strengthening of the education sector and the improvement of healthcare

Candidate	Key Macroeconomic Considerations

Bola Ahmed Tinubu

- Tinubu favours the creation of six regional economic development agencies to exploit sub-regional competitive edge. He also plans to extend loan guaranty schemes to small businesses to boost growth and bridge funding gaps.
- He has also discussed plans to collaborate with the Central Bank to harmonise fiscal and monetary policies to achieve immediate Naira stability against the U.S. Dollar. His short-term goal is to achieve an appreciation of the Naira to N300/$ (vs N421/$ and N615/$ current rates at the official and parallel markets)
- Like Atiku, Tinubu aims to encourage more devolution of revenue and powers to the state and local governments to bring decision-making and governance closer to the people. In line with the above, Tinubu is also proposing a federal revenue-sharing formula revision for the benefit of states and local governments. He is also looking to sponsor appropriate laws and constitutional amendments that support true federalism initiatives

Candidate

Peter Obi

Key Macroeconomic Considerations

- The key theme of Peter Obi's campaign appears to be building a production-led economy driven by solid human capital development.
- He favours the strengthening of the production capacity of states to make them self-reliant and less dependent on the centralised sharing of federally-generated revenue.
- The Labour Party candidate also advocates strengthening small & micro businesses to alleviate poverty and curb insecurity.

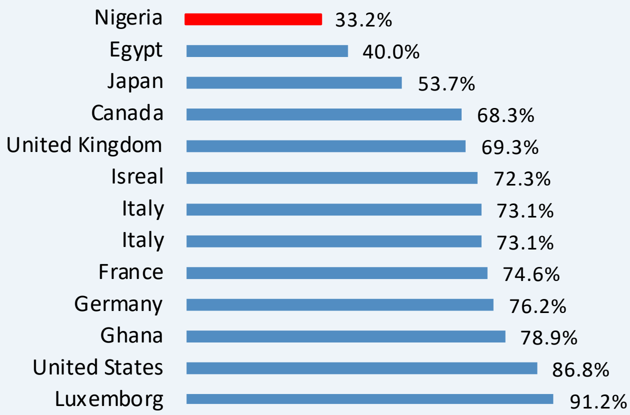
Source: Multiple media outlets, CardinalStone Research

Voter apathy in Nigeria one of the highest in the world

Core to the practice of democracy is citizens' involvement and active participation in civic and political matters. Nigerians, however, have a history of low participation in politics, with the country boasting one of the lowest voter turnouts in the world. In the 2019 presidential elections, for instance, only 28.6 million people voted, representing 32.8% of total registered voters.

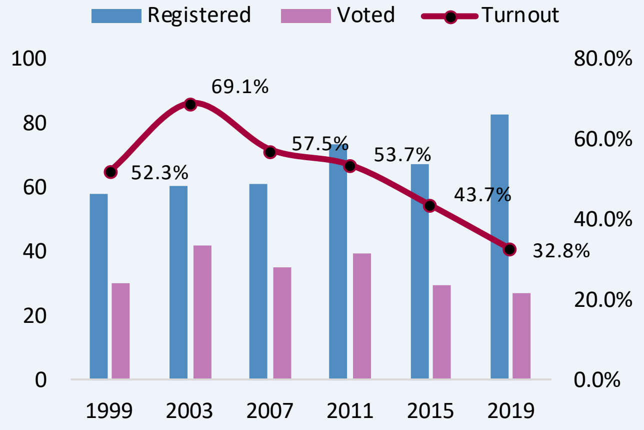
Offseason elections between 2019 and 2022 reveal that this voter apathy has persisted. Particularly, the proportion of actual to registered voters materially declined in each of the country's last four offseason elections held in three different geopolitical zones.

Figure 10: Voter turnout (as % of registered voters) is very low in Nigeria



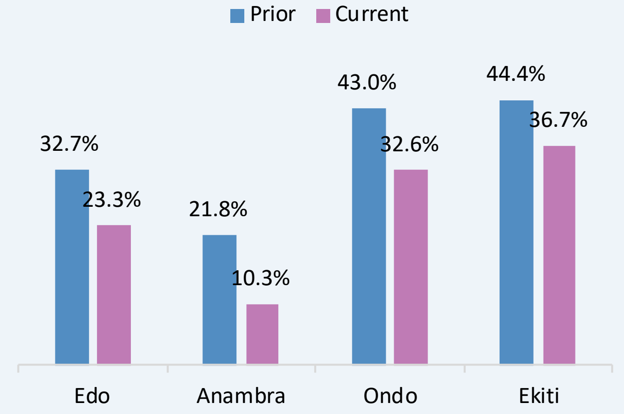
Source: World Population Review, CardinalStone Research

Figure 11: Turnout in presidential elections has been on the decline since 2003



Source: INEC, CardinalStone Research

Figure 12: Voter turnout in last 4 offseason elections trended lower



Source: INEC, CardinalStone Research

Figure 13: National assembly elections aren't any different, with the 3 most recent legislative elections having voter turnout of less than 5%.

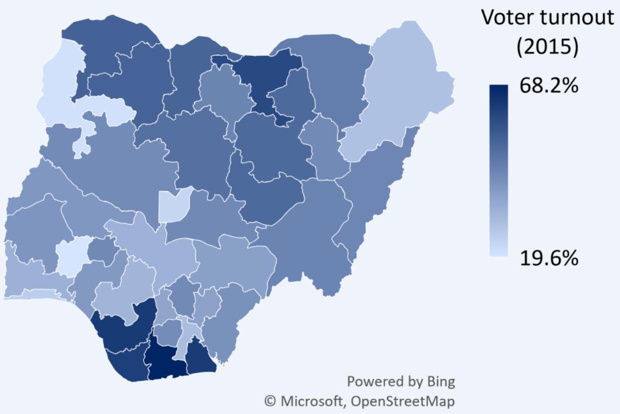
	Date	No of registered voters	Total votes cast	Voter turnout
Ifako/Ijaye Federal Constituency, Lagos	December 2020	339,864	9,884	2.90%
Aba North/Aba South Federal Constitu-	March 2021	496,000	15,772	3.29%
Eti - Osa State Constituency, Lagos	September 2017	183,551	6,280	3.42%

Source: INEC, CardinalStone Research

Voter apathy is worst in the South

In the last two presidential elections, the northern geopolitical zones have had the highest voter turnout (40.5% vs 33.7% for the South). Across the board, the South East has had the lowest average turnout (29.2%), followed by the South West (31.2%). In our view, this voter apathy primarily reflects a dissatisfaction with the quality of candidates being put up for elections, a belief that their votes would not count, security concerns, ethnicity and religion

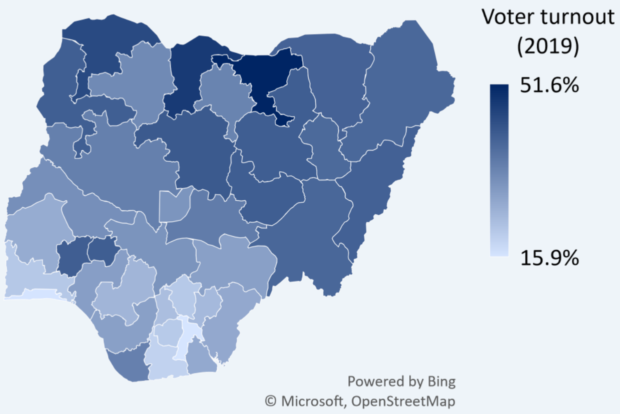
Figure 14: Voter participation was strongest in North West and South South in 2015 as both zones presented the key contenders



Region	Voter turnout (2015)
North West	47.2%
North East	42.5%
North Central	38.3%
South South	54.6%
South West	33.2%
South East	37.3%

Source: INEC, CardinalStone Research

Figure 15: The absence of a strong southern candidate in the 2019 election may have driven the weak turnout from the southern zones



Region	Voter turnout (2019)
North West	42.0%
North East	39.9%
North Central	33.4%
South South	27.0%
South West	29.2%
South East	21.1%

Source: INEC, CardinalStone Research

2023 could be different for voter turnout

The 2023 presidential election is set to be historic for the country as four regions are well represented by candidates with a fair chance of winning. From the North, we have Atiku Abubakar from the North East and Rabiu Kwankwaso from the North West. We also have Bola Ahmed Tinubu from the South West and Peter Obi from the South East. Going by the historical trend, we see scope for increased turnouts from the highlighted zones in the coming election. The recent surge in interest in election-related activities induced by the #getyourpvc movement further supports our prognosis. Already, INEC CVR data indicates that at least an additional 10 million voters (11.9% of 2019 registered voters) have registered to participate in the 2023 election.

Economic growth to remain above 2019 level

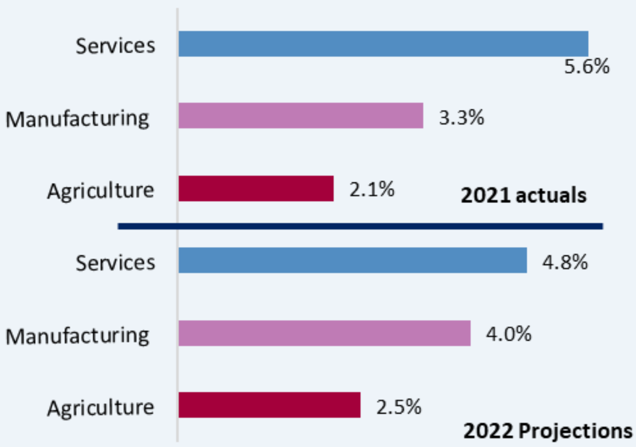
We retain our growth forecast for 2022 at 3.0%, primarily to reflect sustained stimulatory support from the monetary authority, which has left its intervention rates at Covid levels. In the first half of 2022, Nigeria was also relatively insulated from the pass-through of the Russia-Ukraine war and benefitted from steady private sector recovery.

Elsewhere, Nigeria's agriculture sector has shown its resilience to economic volatility, avoiding contractions during the 2016 and 2020 recessions. We believe the CBN's developmental finance interventions and the absence of weather shocks will likely leave growth momentum mostly unchanged in the sector. That said, insecurity remains a downside risk to the sector.

The primacy of the non-oil sector remains undisputed

Nigeria's growth prospect reflects potential windfall gains from the non-oil sector, which are likely to stem from the services, agriculture, and manufacturing segments. We expect the services sector to feed off ICT, with CAPEX-induced data growth, the prevalence of mobile money, and the rollout of the 5G technology as the fulcrum. In addition, we expect the financial services to remain supportive, aided by credit growth and improvement in digital technology, which could enable a broader suite of financial transactions and increase financial inclusion in the country. We, however, view the tighter tax regime evinced by the recent healthcare levy of 9.0% and excise tax of 5.0% as a downside risk to our ICT growth expectation.

Figure 16: The key drivers of non-oil sector growth



Source: NBS, CardinalStone Research

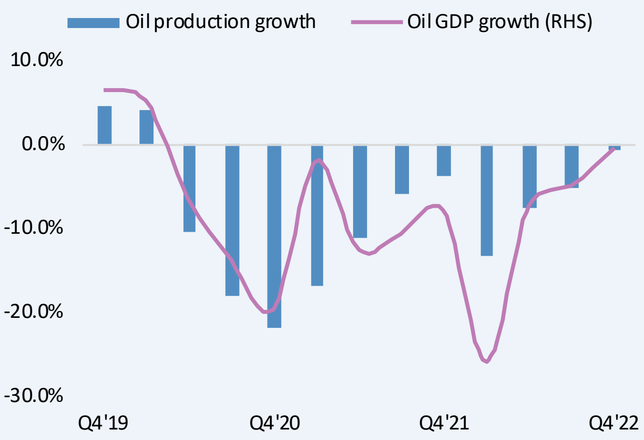
Increasing B2B and B2C activities are tailwinds to manufacturing

We are optimistic about the manufacturing sector, which will likely be supported by continued volume push-out. Our view is premised on the ability of manufacturers to leverage the improving B2C activities and telesales to broaden product distribution networks. In addition, the product innovation and product portfolio expansion undertaken by some FMCG players are expected to increase visibility and support volumes. Elsewhere, we expect the lagged impact of credit allocation to remain supportive for the rest of 2022, despite the risk of a potential slowdown on election concerns. To this point, we note that the increase in private sector credit to a historic high of N37.1 trillion helped the manufacturing GDP to 7-year peak growth of 5.9% in Q1'22.

Oil sector to remain in the trenches

The oil sector experienced its widest contraction of -26.0% in Q1'22, dragged by the slump in domestic crude oil production (1.49mb/d vs 1.72mb/d in Q1'21). The Q1'22 decline primarily reflected increasing oil theft, low investment, pipeline sabotage and a slowdown in drilling activities. Overall, we forecast 2022 crude oil production (including condensate) at 1.53mb/d, with related GDP decline of 6.8% YoY.

Figure 17: Oil production recovery may be in offing for 2023, supported by low base

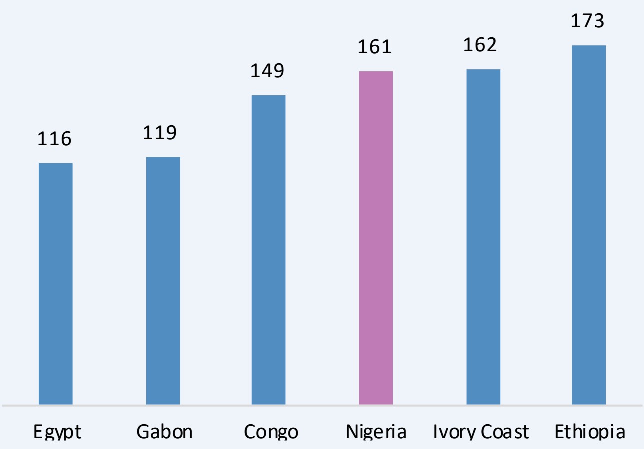


Source: NBS, CardinalStone Research

Nigeria's GDP improving but needs to be inclusive

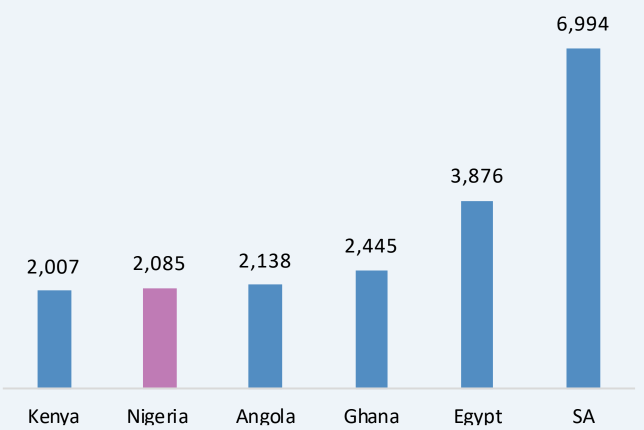
Although growth continues to strengthen post-covid, it is not yet inclusive. IMF explains inclusive growth as both the pace and distribution of growth across the economy (formal and informal sectors). We examined 5 key inclusive growth indicators – poverty index, wealth inequity, unemployment, human capital development, and GDP per capita. Our findings revealed that Nigeria's performance is below average, suggesting the need for economic & structural reforms

Figure 18: Nigeria is one of the least ranked countries based on human capital development



Source: World Bank, CardinalStone research

Figure 19: Nigeria's GDP per capita (in $) trails those of Sub-Sahara African peers

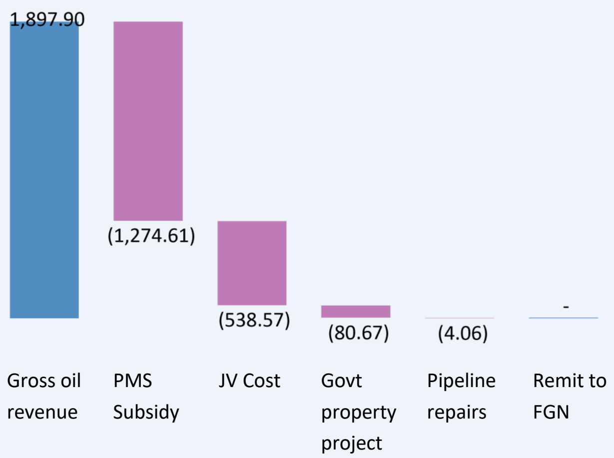


Source: World Bank, CardinalStone research

Fiscal space seems eroded

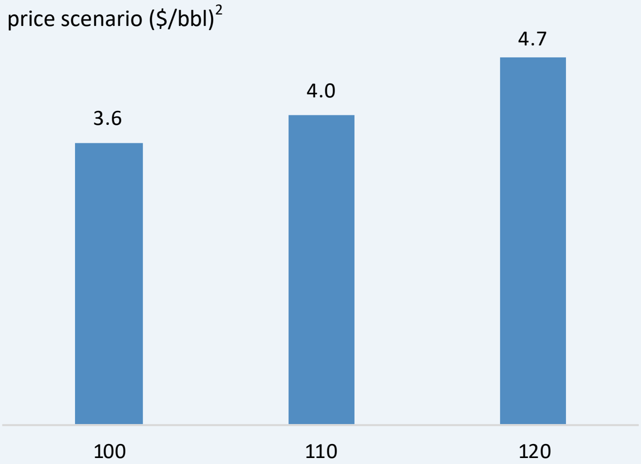
In our last communique, we projected a N10.7 trillion fiscal deficit (5.3% of the GDP) for 2022. Our prognosis remains unchanged as elevated subsidy payment continues to erode fiscal space. Specifically, there were no transfers to the Federation Account between January and May 2022 (compared to an average of N45.2 billion in 2021), despite a price-driven 32.7% YoY accretion in monthly gross oil revenue. The lack of transfers reflected sustained increases in subsidy payments, which totalled N1.3 trillion (67.2% of gross oil revenue) in the review period and suggested an annual subsidy burden of N3.1 trillion. This may have influenced the government's decision to float a supplementary budget of N2.6 trillion, given the apparent inadequacy of its prior provision of N450.0 billion.

Figure 20: Subsidy burden erodes oil revenue (N' billion)



Source: NNPC, CardinalStone Research

Figure 21: Potential subsidy burden (N' trillion) at different oil price scenario ($/bbl)[2]



Source: NUPRC, CardinalStone Research

Crude oil production (1.49mb/d) in the review period was lower than the OPEC benchmark of 1.68mb/d, reflecting technical challenges, oil theft and ageing infrastructure. This lower oil production appeared to have combined with the impact of subsidy to engulf any potential transfers to the Federation Account. By our assessment, assuming a $10 increase in oil prices, a 100,000 bbl/d decline in oil production is likely to cap the associated increase in net revenue to the Federal Government to only 3.1% (vs 10.0% if oil production was constant).

[2]In estimating the subsidy cost, we held other factors constant and sensitized for changes in oil prices

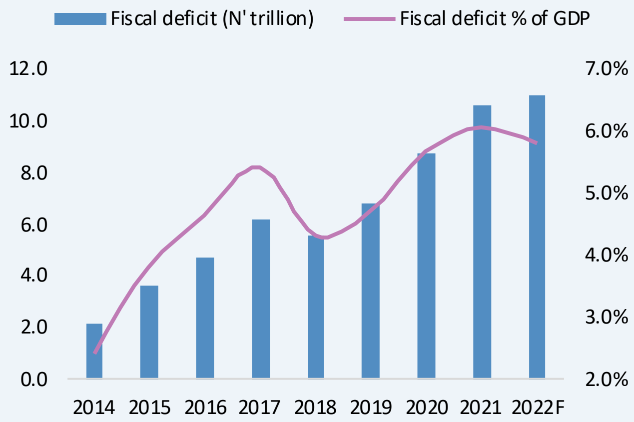
Elsewhere, we remain optimistic about the non-oil revenue segment, as strong company earnings and sustained economic recovery increase both the CIT and VAT. This pattern was largely in play in Q1, wherein CIT and VAT increased by 53.1% QoQ and 4.4% QoQ, respectively. Further upsides to our view on non-oil revenue are new tax initiatives such as the N10/litre duty on carbonated drinks, the 10.0% Capital Gains Tax on disposed shares worth N100 million, the healthcare levy of 9.0%, and the excise tax of 5.0%.

Revenue pays debt, not GDP

In the face of expensive subsidy payments, low revenue mobilisation has inadvertently resulted in rapid growth in public debt. According to the Debt Management Office (DMO), total government debt amounted to N41.6 trillion (23.0% of GDP) In Q1'22 from N39.6 trillion in 2021. Adjustments for AMCON debt (N4.4 trillion) and CBN's advances to the government (N19.0 trillion) could potentially raise total debt to GDP to 36.8%. Despite these growing debt concerns, Nigeria's debt-to-GDP is still considered sustainable. Precisely, it is below the 70.0% MAC-DSA[3] benchmark and close to the 40.0-58.0% identified as safe and growth-supporting for lower-middle -income countries with weak revenue mobilisation.

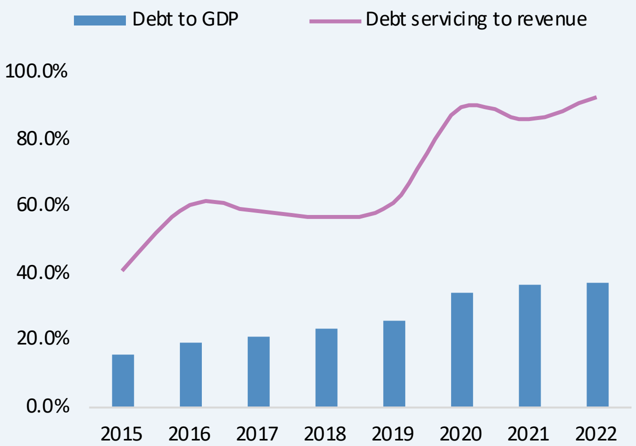
Notwithstanding the perceived debt sustainability, interest expense pressure remains a burden on federally generated revenue. Specifically, 85.0% of FGN's retained revenue in the last 3 years was channeled towards debt servicing. In 2022, we believe the burgeoning debts, amidst weaker revenues, will likely drive debt service to revenue ratio above 90.0%

Figure 22: Fiscal deficit as % of GDP



Source: Budget office, CardinalStone Research

Figure 23: Accelerating debt service to revenue elicits concerns



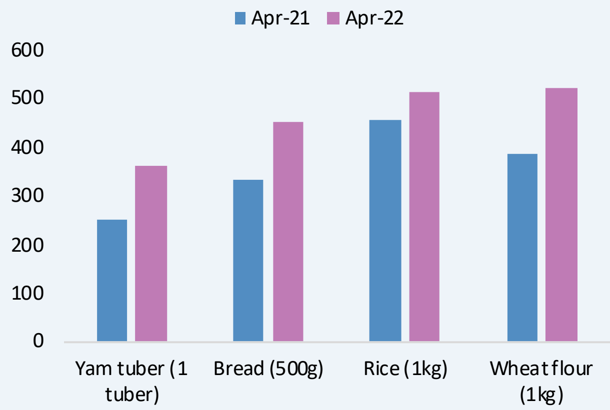
Source: Budget office, IMF, World Bank, CardinalStone Research

[3]Market Access Countries Debt Sustainability Analysis

Monetary policy: Inflation and currency in focus

In May 2022, the CBN switched to a hawkish stance, hiking the policy rate by a faster-than-expected 150bps to 13.0%. The CBN's new posture reflected a willingness to tackle inflation, which touched an 11-month high of 17.7% YoY in May 2022. The drivers of the spiraling prices were energy shocks and persistent currency pressures. The former was primarily stoked by the supply disruptions provoked by the Russia-Ukraine crises, while the latter was an offshoot of the difficulty in accessing foreign exchange in the official market. Our assessment revealed strong inflation pass-through from products like gas, which increased by over 100.0% YoY, and AGO, which accelerated three folds. On other fronts, there were negative inflationary impacts from the rise in farm input costs, traditional seasonal shortages and higher transportation costs.

Figure 24: Average prices of locally-produced staples

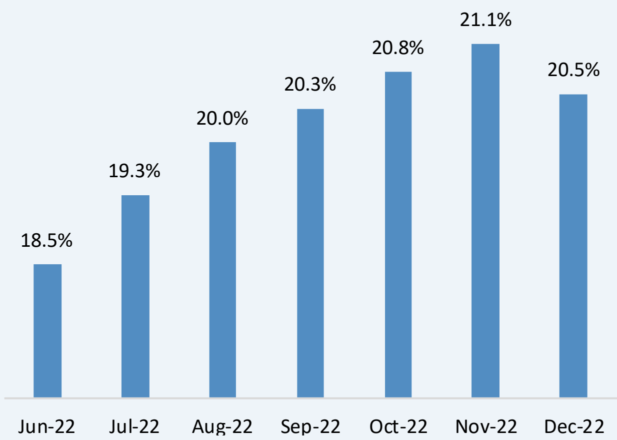


Source: NBS, CardinalStone Research

No respite for inflation

We see scope for sustained inflationary pressures in H2'22 due to the negative impact of the prior year's low base. In addition, we see less respite for energy costs in the near term, with diesel and gas prices poised to stay elevated. Furthermore, there are indications that PMS pump price could be adjusted upwards from N165/litre, as Independent Petroleum Marketers Association of Nigeria (IPMAN) members complain of the rising cost of operations and the jump in the ex-depot price of PMS from N148.17 to N162.0/litre. Overall, we expect inflation to average 20.2% in H2'22 compared to 16.7% in H1'22 .

Figure 25: Monthly inflation forecasts for H2'22

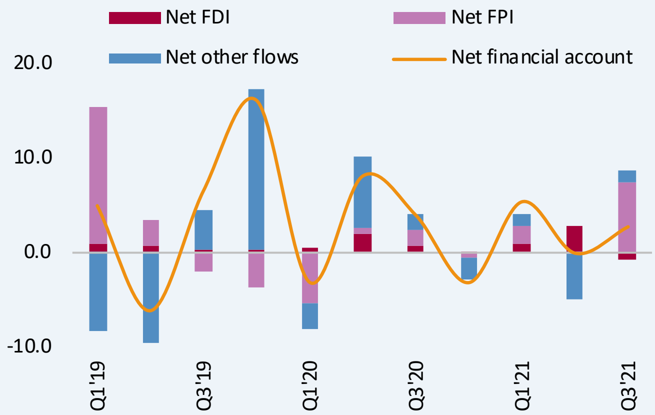


Source: NBS, CardinalStone Research

Foreign inflow to remain tepid

Akin to the trend witnessed in emerging and frontier markets, Nigeria was also mostly unappealing to foreign capital providers in H1'22. This risk-off sentiment was fanned by geopolitical uncertainties and hawkish rendition from global central banks. In addition to these global factors, the lack of market reflective FX rates, illiquidity and a backlog of uncleared foreign exchange demand dampened investors' sentiments. Even though it is yet to have any noticeable impact on the market, the recent MSCI proposal to reclassify Nigeria to a stand-alone status was inspired by similar FX concerns. In the first quarter of the year, the combined impact of the mentioned drivers (ex MSCI proposal) cascaded to a 17.5% YoY decline in foreign inflows. Specifically, the "other investments" component of capital importation nosedived by 43.3% YoY, while FPI contracted by 1.7% YoY. In our view, the imminent intensification of pre-election activities will likely keep foreign investors at bay and throw up more financial account-related concerns .

Figure 26: Foreign inflow (N'billions) to remain tepid

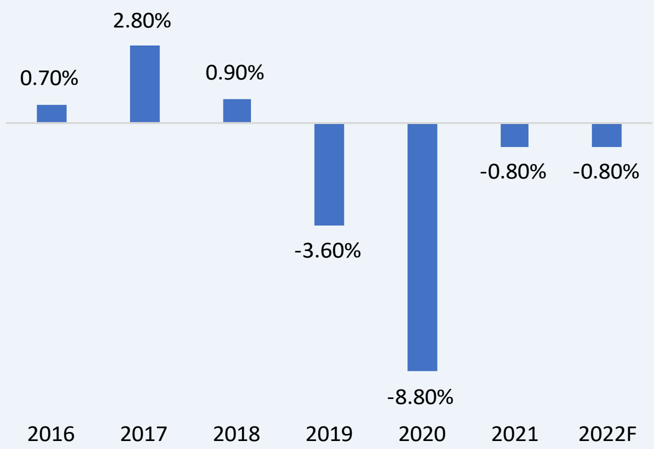


Source: CBN, CardinalStone Research

Nigeria's external position to remain in deficit

The current account deficit narrowed to 0.8% of GDP in 2021 from 3.8% in 2020, helped by elevated crude oil prices and higher remittance inflows (+11.2% YoY). In the first quarter of 2022, the total value of exports (at $14.0 billion) returned to pre-pandemic levels, supported by gains from higher crude oil prices. On the flip side, import bills ($14.8 billion) touched a 4-quarter high due to domestic economic recovery and import of refined oil products. Our expectation for 2022 is for the current account balance to remain unchanged at -0.8% of the GDP. Our view is premised on the lower-than-expected oil earnings due to production concerns and higher import bills due to higher commodity prices, which will likely mask gains from higher remittance inflows.

Figure 27: Current account deficit (as % of GDP) may remain unchanged in 2022



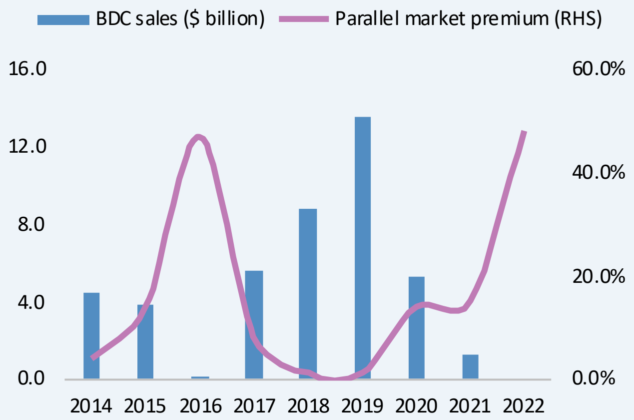
Source: IMF, CBN, CardinalStone Research

Modest currency adjustment expected in H2’22

While currency pressures exists, we think that pre-election year concerns and fears of negative pass-through to inflation will likely limit the magnitude of currency adjustment made at the official market in the current year. Elsewhere, parallel market premium (at 35-45%) will likely remain elevated, weighed by the election-induced dollar demands and reduced FX supply by the CBN[4]. ***However, we strongly believe that a resumption of FX sales to the BDCs may materially shrink the premium relative to the official market, akin to the pattern observed in 2016.***

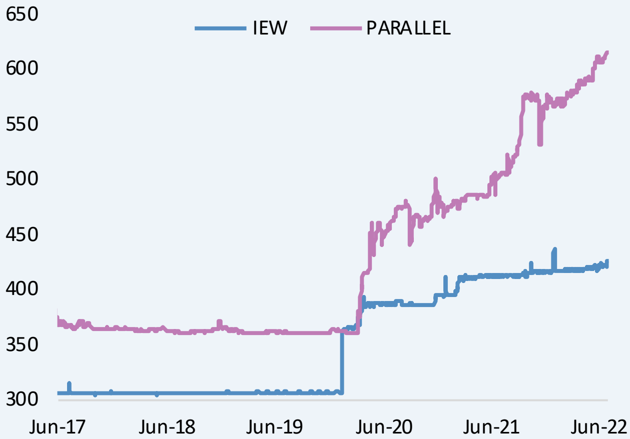
According to the IMF, Nigeria’s FX reserve is likely to close 2022 at $38.0 billion, aided by reduced CBN intervention, dollar demand restrictions and higher oil prices.

Figure 28: Parallel market premium to persist till year-end



Source: CBN, CardinalStone Research

Figure 29: Modest Naira depreciation expected at the IEW



Source: CBN, CardinalStone Research

[4] The CBN’s data suggested an average monthly intervention of $1.7 billion across different FX windows in Q3’21, significantly lower than the pre-pandemic level of $3.1 billion

Asset Allocation Views

Navigating uncertainties

This section of the report focuses on identifying the winning investment plays across equities and fixed income in H2'22. It also investigates the critical drivers of performance in H1, with particular attention to the pass-through from geopolitical developments on asset classes in Nigeria. The report attributes the insulation of equities from global shocks to the reduced foreign participation in the local market, difficulty in assessing FX, and, more importantly, the impact of high liquidity on yields. The reduction in yield was more pronounced in Q1, providing decent rewards to long duration play in the fixed income space.

Q2'22 was marked with leaner system liquidity and reactions to monetary policy rate increase, which forced investors to reassess investment actions. In particular, there were notable profit taking activities in stocks following the excitements that greeted the release of Q1'22 earnings, and short duration play became attractive in the fixed income space in the face of anticipated interest rate increases. We also advocate an extension of short duration strategy across Nigerian and most global fixed income securities in line with the almost ubiquitous monetary policy tightening. In addition, we see opportunities for tactical play ahead of the release of Q2'22 earnings, particularly in commodity and dividend-paying stocks. On the strategic front, we emphasize the purchase of banking stocks as an opportunity to gain positive exposure to interest rate. For us, increasing positive exposures to commodity and interest rate is likely to be one winning equity strategy over the next nine to twelve months.

Pre-election risks: a dark cloud over equities

As an asset class, Nigerian equities has largely outperformed global peers in 2022. The All-Share index is currently up 22.9% in USD terms, making it the 2nd best performing index in the world. This interest in local equities may have been driven by investors' reaction to FY'21 & Q1'22 earnings performances. However, the traction in equities has inordinately reflected earnings growth with market's current P/E 10.3% higher than its level at the end of 2021. On this wise, the market performance may have reflected the impact of other drivers such as repatriation-induced demand and exposure to commodity names, among others.

Figure 30: The core drivers of market performance in H1'22

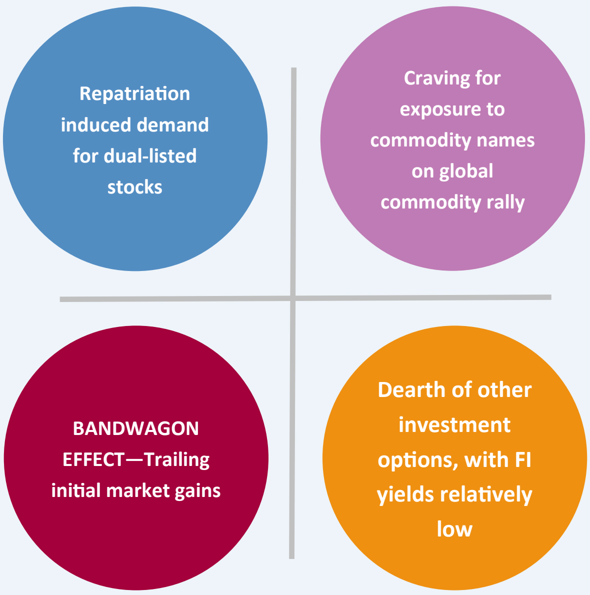
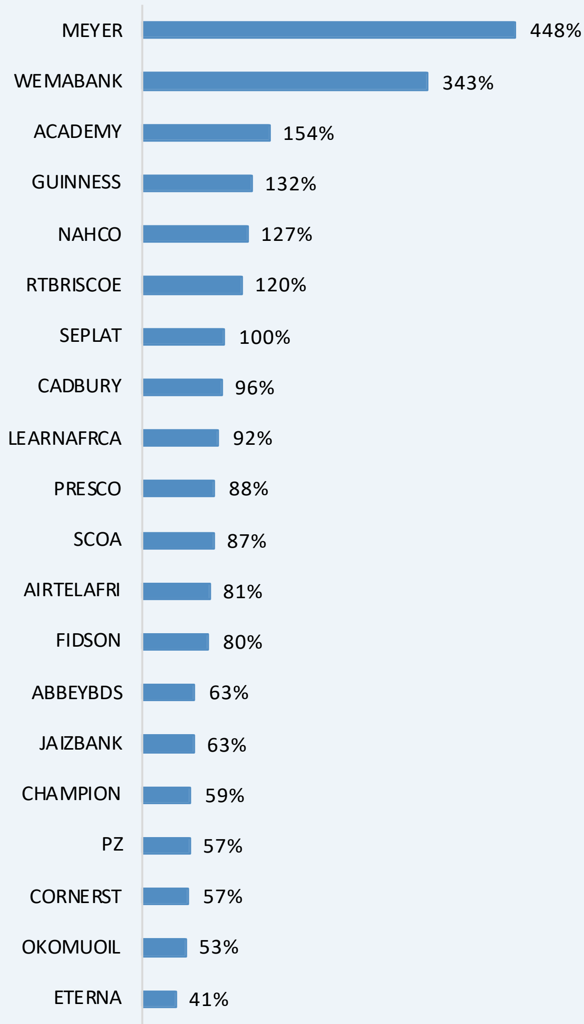
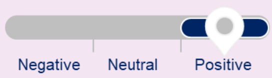


Figure 31: Top performing counters on the NGX year-to-date



Source: NGX, CardinalStone Research

Key equity market considerations for H2'22			
Variables	**Commentary**	**Impact**	
Pre-Election Activities	Election related spending is likely to support consumer discretionary income and drive positive passthrough to FMCGs, cement producers etc. However, pre-elections are typically associated with heightened risk sensitivities that often dissuade investors from equities. (i.e Nigerian equities was down in 3 of the last four pre-election years	The reduction of foreign participation in Nigerian equities market would soften the degree of negative reaction to pre-election concerns	
Yield Dynamics	The expected uptick in yields will likely alter equities' momentum. A first-order effect could come from the higher cost of borrowings for listed entities, which could be negative for earnings. Secondly, cashflow discount factors, particularly for companies with a high level of debt, may become materially higher. This may result in lower DCF valuations. Conversely, higher yields may be positive for coverage banks given the strong positive correlation between yields and interest income	Higher yields could increase the attractiveness of fixed income securities and encourage a rotation into same ahead of the elections However, investors are likely to rotate into banks as a means of gaining exposure to potential yield increases.	
Company Performances	Company performances are likely to be slightly mixed, with commodity producers, banks, and companies who proactively took advantage of low yields to restructure their balance sheets likely to perform better than net commodity net importers and debt-laden companies	Passthrough to equity performance could also be mixed with investors reaction likely to be dictated by quality of earnings	
Geopolitical Developments	Further deterioration of the Russia/Ukraine crisis and adverse climate changes are likely to keep commodity prices elevated. The former materially distorts global supply chain dynamics while the latter raises the risk of below average harvests of agricultural commodities	Stocks of commodity producers are like to remain attractive on the impact of sustained geopolitical and climate related tensions. However, companies with high raw materials exports exposure and relatively elastic demand are likely to experience negative investor reactions	
Others	The lingering dollar illiquidity is likely to lure foreign investors looking to repatriate funds to their home countries into dual-listed stocks. Other positive corporate actions such as delistings, M&As, share buybacks and new offerings may also be experienced in H2'22	These are likely to have broadly positive impact on the affected stocks	

Sectoral Views

The Russia-Ukraine war has generated shortages in global commodities and further dislocations in supply chains. Investing in producers trying to address this challenging situation may offer a portfolio hedge.

Higher commodity prices to remain supportive of upstream energy and oil palm stocks

We see potential opportunities in the upstream energy and oil palm sectors. The Indonesian government's plans to ease some export restrictions temporarily halted CPO price momentum in early May. Since then, the logistical quagmire in the black sea has worsened the impact of the war-induced decline in the production of sunflower and soybean oil (CPO's two main substitutes) on CPO prices. Over H2’22, these constraints are likely to keep CPO prices elevated and support the earnings of listed producers of the product.

Similarly, crude oil producers are likely to experience further bump up in earnings on the impact of materially elevated oil prices. This prognosis is aided by constrained production in countries like Nigeria and Libya, both of which are struggling to meet OPEC+ production quotas, and threats to Russian output. Elsewhere, recent strike actions by Norwegian offshore workers in July could place additional strain on global oil supply.

Further down the value chain, we remain cautious on the downstream sector, with the government's price cap on petrol likely to keep margins constrained.

Telecoms stocks to ride on data wave

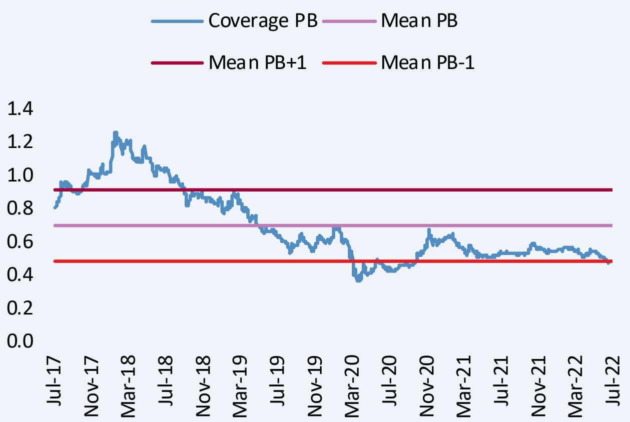
Unstoppable trends continue to reshape the world around us. We see a compelling case for portfolio exposure to the data-inspired telecoms stocks, that have posted an average earnings growth of 42.8% YoY over the last eight quarters. Over this period, internet and mobile services continue to inspire change in communication patterns among citizens and businesses. It has also led to innovations in payment systems, pioneered by existing and new FinTechs and telecoms operators.

In our view, Nigeria’s demographic characteristics (i.e high proportion of youthful population) is likely to continue to drive increase in adoption rate of data-enabled devices and digital offerings.

Prospects of higher yields may spur interest in banking names towards year end

Based on our expectation for an uptrend in fixed income yields in the second half of 2022, we envisage a significant pick up in banks' net interest income. Our positive earnings expectation is premised on CBN's switch to relatively hawkish stance, already demonstrated by the 150 bps increase in benchmark rate to 13.0%. Overall, we assess that the relative underperformance of banking names in H1'22 could present attractive entry opportunities for investors over the next one year

Figure 32: Banking stocks appear materially undervalued relative to their historical performance



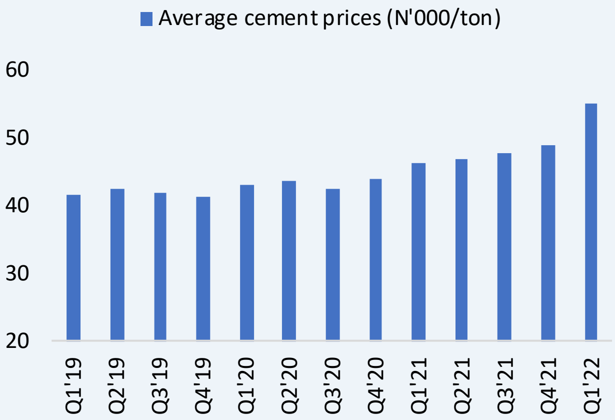
Commodity pressures remain a threat to consumer names

In the consumer goods space, we expect the sturdy topline growth across our coverage names to subsist on higher product prices passed and capacity expansion. Successive shocks have driven commodity prices sharply higher since 2020. Given that the resulting economic, geopolitical, and social instability in Eastern Europe may linger for some time, we are wary of cost pressures for consumer companies induced by higher raw material cost and FX impasse. This case is likely to be more precarious for companies with relatively elastic demand for their products and cutthroat competition. Beyond potential gross margin pressures, the continued FX setbacks are likely to drive exchange losses for companies with high exposure to foreign liabilities. In general, consumer companies are also likely to grapple with high interest burden on account of potential interest increases

Industrials to ride on higher cement prices

The valuation of cement stocks has vastly improved from the pandemic lows, underscored by higher cement prices and inelastic demand. We believe this demand - primarily from private sector real estate – would remain strong enough to keep prices elevated over the next six months, despite the touted consumer wallet shrinkage due to spiralling inflation. While time will tell when the real estate boom suffers some stagnancy, we do not see construction/real estate-related spending slowing down in 2022. With our >20% YoY FY’22 earnings growth & ROE expectation, we could see further positive re-rating of cement valuation in the second half of the year.

Figure 33: Average cement prices in the last 13 quarters



Source: Company Financials, CardinalStone Research

Equity security selection

We favour stocks with sound fundamentals (i.e BUY recommendation within our rating system), proven track record of resilience in pre-election years, positive exposure to interest rates (for banks), low leverage (for non-banks), positive exposure to commodities, and decent dividend yield (i.e above 1-year T-bill rate).

Figure 34: Summary of equity coverage

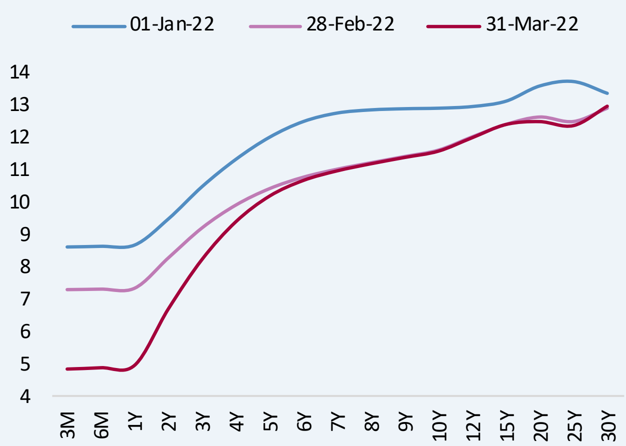
Company Ticker	TP (N)	Ref Price[5] (N)	Upside/ Downside	Market Cap (N'bn)	2022F P/E	2022F D/ Y	Links to latest report
Financial Services							
ACCESS	**12.73**	9.50	**34.00%**	337.68	1.8x	13.5%	Click here
ETI	**16.21**	10.60	**52.92%**	194.51	1.8x	6..6%	Click here
FBNH	**11.52**	10.95	**5.21%**	393.05	2.7x	4.1%	Click here
FCMB	**3.05**	3.24	**-5.86%**	64.16	3.0x	7.3%	Click here
FIDELITYBK	**3.86**	3.24	**19.14%**	93.88	2.5x	9.5%	Click here
GUARANTY	**33.67**	20.30	**65.86%**	597.45	3.3x	14.5%	Click here
STANBIC	**42.30**	33.55	**26.08%**	372.61	5.9x	9.3%	Click here
UBA	**10.94**	7.50	**45.87%**	256.50	2.0x	12.5%	Click here
ZENITHBANK	**30.23**	21.75	**38.99%**	682.87	2.7x	15.2%	Click here
Consumer Goods							
DANGSUGAR	**21.08**	16.00	**31.75%**	194.35	7.8x	6.9%	Click here
FLOURMILL	**30.39**	32.50	**-6.49%**	133.26	4.3x	5.0%	Click here
GUINNESS	**86.68**	90.50	**-4.22%**	198.23	5.0x	0.5%	Click here
NB	**67.14**	55.85	**20.21%**	446.63	13.9x	2.9%	Click here
NESTLE	**1602.86**	1400.00	**14.49%**	1,109.72	19.9x	3.6%	Click here
UACN	**14.88**	11.20	**32.86%**	32.27	23.5x	5.8%	Click here
Industrial Goods							
DANGCEM	**349.76**	275.00	**27.19%**	4,686.14	11.4x	6.7%	Click here
WAPCO	**35.20**	26.20	**34.35%**	422.02	5.3x	7.4%	Click here
Agriculture							
OKOMU	**183.22**	216.90	**-15.53%**	206.90	12.0x	4.8%	Click here
PRESCO	**183.21**	165.00	**11.04%**	165.00	6.8x	4.2%	Click here
Telecoms							
MTNN	**292.73**	230.30	**27.11%**	4,687.64	13.4x	5.0%	Click here
Utilities							
TRANSCORP	**1.36**	1.25	**8.80%**	50.81	1.9x	0.9%	Click here
Oil & Gas							
SEPLAT	**1376.10**	1300.50	**5.81%**	765.27	14.8x	3.0%	Click here
TOTAL	**245.05**	234.50	**4.50%**	79.62	4.7x	9.4%	Click here

[5]Reference prices were obtained as at market close of 7th July, 2022.

Fixed Income: Remain nimble ahead of further yield upticks

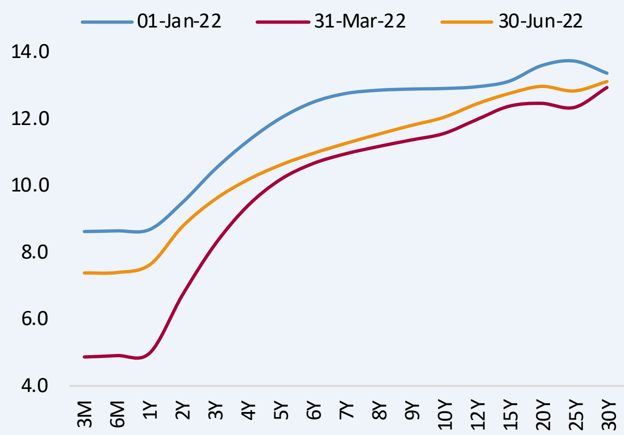
The appeal for long-tenured securities was strong in Q1'22, aided by elevated liquidity from the heavy bond maturity (N602.0 billion) in January, coupon payments (c.N250 billion), and cumulative FAAC disbursement (N1.2 trillion). However, in Q2'22, expectations of gradual liquidity thin-out and a possible switch in monetary policy disposition led to greater activities in the short-end of the bond curve, whose average yield increase consequently trailed that of the long end. Across Q2'22, average bond yields rose by 57bps (Q1'22: -25bps) to provide ample rewards to investors who switched to a short-duration strategy, in line with our earlier prognosis

Figure 35: Yield curves indicate significant buying pressures in Q1’22



Source: FMDQ, Bloomberg, CardinalStone Research

Figure 36: Yield curves indicate material re-rating in Q2, particularly in the short end



Source: FMDQ, Bloomberg, CardinalStone Research

Elsewhere, we had opined that the material overvaluation of NTB (relative to bonds), following the broad-based liquidity-induced rally in Q1'22, should orchestrate pacier yield adjustments for the instrument in Q2'22. This view largely panned out in the review period, wherein the average NTB yields accelerated by 195bps. Interestingly, trade flows to the NTB secondary market were uninspiring, with the auctions being livelier. In our view, the hush trading activity levels and bearish sentiment can partly be explained by the wide G-spread, which drove rotation into corporate issuances and placements, both of which traded at premiums of c.300-350bps over the one-year secondary market NTB yield .

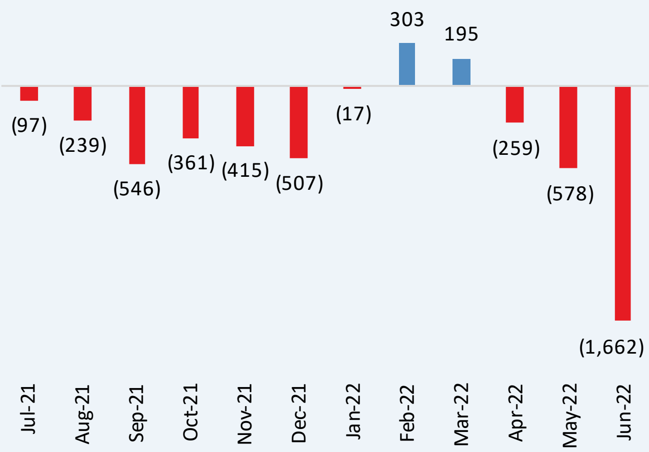
Modest yield expansion in H2'22

- **Domestic borrowing is likely to become less pronounced in H2'22:** Over H1'22, the government raised N4.1 trillion via bonds and NTBs. After effecting the huge bond repayment of N605.3 billion in January and rolling over N1.6 billion NTB maturities, an estimated N2.0 trillion was available for budgetary purposes. This net issuance was 53.9% of the domestic borrowing target for 2022 (including supplementary provision). For H2'22, we expect the government to raise N3.9 trillion in bonds and NTBs.

- **Tighter global financing conditions unfavourable for foreign borrowing target:** Over H1'22, the government raised at least $1.25 billion via Eurobonds compared to the 2022 foreign target of $6.1 billion. In our view, the increasing cost of raising funds in the global financial market may make Nigeria's foreign borrowings target difficult to achieve in the current fiscal year. The government may therefore tilt to domestic funding options, with recourse to either additional local bonds or ways and means— a key risk to our expectation for domestic borrowings.

- **Tight system liquidity in H2.** On the liquidity front, only 40.0% of all 2022 maturities are expected in the second half, indicating a possible liquidity tightness. In addition, in its May MPC meeting, the CBN switched to a relatively hawkish orientation and suggested more intermittent liquidity management. Moderation in liquidity may also increase the presence of banks at the CBN's discount window. These factors support the argument for yield increases

Figure 37: Tight liquidity forcing banks' into net borrowing positions (N'billions) at the CBN discount window



Source: Bloomberg, CardinalStone Research

Figure 38: High-level view on some selected SSA Eurobonds

Selected Eurobonds	Average yield (%)	Upside risks	Downside risks
Ghana	18.3%	• Agreement to IMF programme to drive fiscal reform and reduce vulnerabilities • Possible $3.0 billion IMF programme to support the Cedi	• Debt at 84.9% of GDP is still elevated
Kenya	15.0%	• Progress on fiscal consolidation through the IMF programme	• Election-related uncertainty and fiscal concerns • Currency at the lowest level since 1988, due to increased demand for dollars from energy and general goods import • Worsened external position
Nigeria	13.02%	• Moderate risk to debt distress	• Pre-election year risk • High debt servicing to revenue of over 90% • Risk to lower oil prices on global recession fears

Source: Bloomberg, CardinalStone Research

Figure 39: Fixed income asset allocation views

Opportunity Set	View			Projected Yield Change	Commentary
	Overweight	Neutral	Underweight		
FGN Eurobonds	○	○	●	▲	Stay short duration primarily due to global tightening cycle
FGN Local bond	○	○	●	▲	Stay short on expected impact of yield increases to reflect monetary tightening and likely political risk
Corporate Eurobonds	○	○	●	▲	Spread likely to widen and this could drive underperformance. Stay short duration
Placement and CPs	●	○	○	▲	Materially decent spread over NTBs makes placements and CPs good instruments for executing short duration
NTB	○	●	○	▬	Neutral view reflects the need of some funds to allocate some of their asset to NTB despite the relatively low yields

Source: Bloomberg, CardinalStone Research

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