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Vetiva Research

A rude awakening

H2'22 Macroeconomic Outlook

June 2022

Executive Summary

A rude awakening

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Vetiva Research

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The build-up of Russian aggression, which culminated in its invasion of Ukraine, sent both the warring states and the rest of the world into a frenzy of unpleasant events. The attacked, Ukraine, severed by a humanitarian and economic crisis, suffered the tragic loss of civilian lives, destruction of key infrastructure, and the overnight transformation of its peaceful streets into a war zone. After months of denying any intention of an invasion, Russia launched a full-fledged attack, deploying foot soldiers and sophisticated arsenals to destroy its brother state. While the West applied weighty economic sanctions to bring Russia to its knees, the backlash from these sanctions has been seen and felt worldwide.

The impact of the war on several economies - Africa inclusive - is far-reaching: from high energy prices to expensive food imports, weaker currencies, tight financing conditions, and slowing economic growth. From Q2’22, base effects from the pandemic-induced recovery could fade, as central banks turn on the hawkish taps to rein in inflation. With elections on the horizon, the fiscal authorities in Kenya, Nigeria, and Angola, could stall reforms.

In Nigeria, the countdown to the 2023 general elections has begun, keeping fiscal authorities in a welfarist mode. From the postponement of subsidy removal to the reopening of the borders, we see increased commitments to tame inflation from the fiscal angle. The monetary authority has finally picked up its inflation-fighting tools, preparing for the demand-pull inflationary threats from Nigeria’s longest campaign cycle. The Naira could remain under the weather as volatile oil production, postponement of key reforms, and risk-off sentiments stall external flows.

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Global Economy

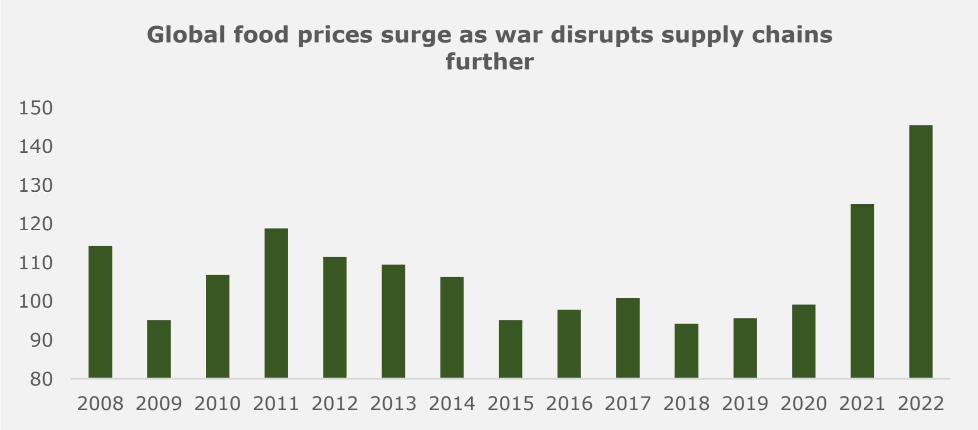
Geopolitics: The great reset

A trip down memory lane reveals that the brewing tension between Ukraine and Russia dates back to the disintegration of the Soviet Union in the 1990s. Ukraine surrendered its nuclear arsenal to Russia in exchange for security guarantees, but a series of aggressions, beginning with the annexation of the Crimean Peninsula in 2014, shattered the trust of protection, Russia was supposed to provide to Ukraine. As a result, Ukraine gravitated towards the West with stronger intentions to join Western allies. Between 2017 and early 2020, renewed escalations resulted in the deaths of 14,000 people and the displacement of 1.5 million others. Under the guise of a "special military operation" to protect those being bullied and threatened with genocide (with no evidence of such an operation), Russia launched an offensive on a country of over 43 million people.

Source: Wikipedia, Vetiva Research

The economic implications of the war and resulting sanctions are severe. Ukraine's economy is expected to contract, but the magnitude will depend on how long the conflict lasts, the resulting disruptions in economic activity, and the depth of infrastructural decline.

We note that both warring countries are key commodity exporters, and supply disruptions would reverberate globally. Russia is the world's largest supplier of wheat, accounting for nearly 25% of total global exports, and the world's third-largest oil producer. Ukraine, on the other hand, a world leader in agricultural products and known as "Europe's breadbasket" due to its dark, rich soil, had to halt not only cultivation, but also exports to meet its domestic needs. Hence, the dual ban on key exports by both countries has further complicated stressed supply chains, heightened pricing pressures, and entrenched protectionism, putting net importers of food and fuel in a bind.



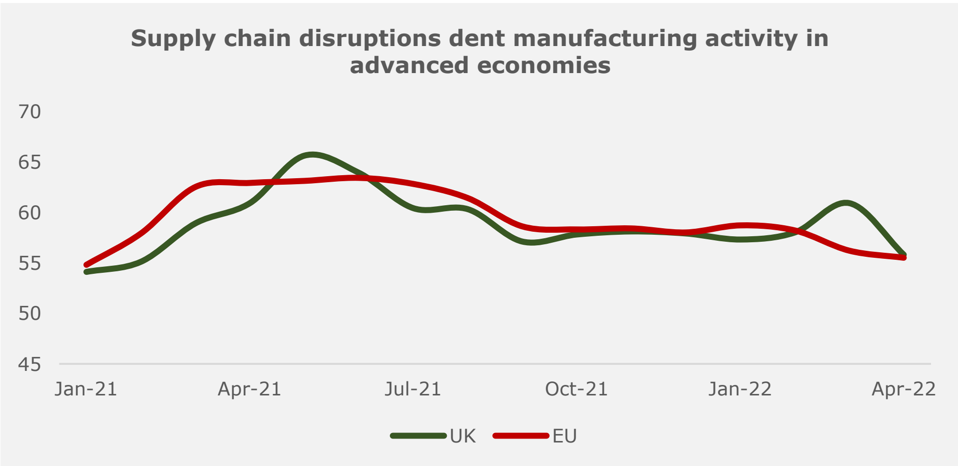
Source: FAO, Vetiva Research

Advanced Economies: Stagflation lurks

As supply chains tighten and commodity prices soar, inflation is rising to multi-year highs in advanced economies. Policymakers are in a fix, as the trade-off between growth and inflation leads to difficult policy choices.

In the Eurozone, the impact of the invasion was not evident in its output numbers, as the region expanded by 5.4% y/y in Q1'22. Base effects spurred output levels, boosted by improvements in household spending, investments, and exports. Armed with savings from expansionary fiscal policies, consumption withstood the shock of the war. The rollback of restrictions has supported the labour market, as employment levels have improved over the past 12 months. A key risk facing the region however is restricted access to Russian natural gas, as inflation bites hard. With inflation running hot in the Eurozone, the European Central Bank (ECB) is faced with the dilemma of raising interest rates during a season of job-led expansion in the economy.

While the ECB remains accommodative, the Bank of England (BOE) became the first advanced central bank to raise interest rates. The BOE has done so in five successive meetings, raising its policy rate by 25bps apiece. Despite the hawkish stance, inflation has remained stubborn, rising to a 40-year high of 9% in April. Amid rising inflation, the number of job vacancies reached new highs, a consequence of increased job switching following the Great Resignations of 2021.



Source: Trading Economics, Vetiva Research

In the United States, the risk of recession is growing as oil prices rise sharply. According to Bloomberg, every time oil prices rise 50% above trend, a recession follows. This recession has also been predicted by the inversion of the yield curve (before the release of the Q1'22 GDP data). With the US economy slipping by 1.5% in Q1'22, the risk of a recession is still high, as sour Ukraine-Russia tensions keep oil prices significantly above trend. In a late bid to curb inflation, the US Federal Reserve has toed the path of monetary normalization. After a 25bps (March) and 50bps rate hike (May), the US Fed recently raised its benchmark interest rate by 75bps in June, pushing the Fed funds rate range to 1.50% - 1.75%.

Yield curve inversion predicts recession in the United States

Date of inversion	Time to recession (Months)
April 1968	19
March 1973	7
August 1978	16
September 1980	9
December 1988	18
February 2000	12
June 2006	17
August 2019	20
March 2022	???

Source: Statista, Vetiva Research

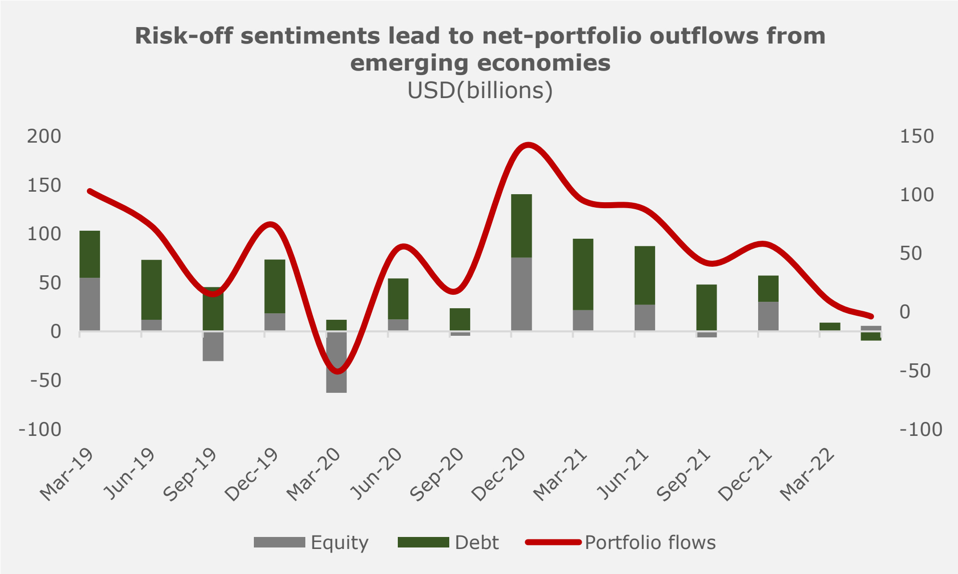
With the United States facing its most severe inflation, the Chair of the US Fed., Jerome Powell, has been more inflation-tolerant than his distant predecessor, Paul Volcker, who raised interest rates to nearly 20% in tackling inflation in the 70s. The major worry of Powell is to address inflation without hurting the labour market. Strong jobs reports and lower unemployment figures give the US Fed the impetus to gradually raise interest rates. While 390,000 jobs were added in May'22 (Apr'22: 428,000), unemployment rate is flat at 3.6%.

Over to Asia, the Japanese economy shrank by 0.5%, because of falling business investment and surging commodity prices. Although consumption and government spending have held up quite well, the Japanese Yen has weakened due to the Bank of Japan's dovish stance. Japan, which has been battling deflation in prior times, implements a Yield Curve Control (YCC) mechanism to achieve its targets. The laws of monetary trilemma come to play, where the currency has to depreciate if interest rates are fixed to allow the free flow of capital. Market selloffs caused by Japan's yield curve controls are pushing yields to the bank's upper limit.

Emerging and Developing Economies: Running on quicksand

While emerging markets (EM) have made some progress in overcoming the effects of the pandemic, the risks we see include the recent tightening of global financial conditions and fading fiscal support, as well as sticky inflation levels exacerbated by Ukraine-Russia tensions. With inflation reaching new highs, the Fed's increasingly hawkish stance, combined with a stronger dollar, poses new challenges for emerging and frontier markets. While higher commodity prices weigh in on the balance of payments and currencies of net-oil importers, commodity exporters are better positioned to benefit from the price surge.

The hawkish stance of the US. Fed could hasten risk-off sentiments, as capital flight heightens. Following the rate hikes in the US, emerging economies have recorded net portfolio outflows, as a rising dollar and a hawkish Fed provides a safe haven for investors.



Source: IIF, Vetiva Research

BRIC Economies: Bouts of resilience

The Chinese economy rebounded by 4.8% y/y in Q1'22, defying the impact of the strict reactive lockdown measures in Shanghai, which compounded already tight supply chains. While zero-COVID policies pushed unemployment to a 2-year high in China, inflation remained at a 5-month high of 2.1% y/y in May. With inflation well anchored, the People's Bank of China (PBOC) reduced its main mortgage interest rate by 15bps to 4.45% to boost the economy and revitalize the property sector.

Even in the face of sanctions, the Russian economy appears to be defying predictions of an impending collapse, after expanding by 3.5% in Q1'22. Although growth was slower than the preceding quarter, the surge in its export commodities kept the nation's current account position in a surplus ($58.2 billion), more than double its trade position in the prior year. After the sanctions by the West on Russia's Central Bank on February 28, the Russian Rouble weakened. However, this weakness has been reversed as Russia imposed capital controls and increased interest rates to entice foreign investors.

While the West has largely shunned Russia on account of its assault on Ukraine, India is ladened with the conflicting interest of maintaining a relationship with Russia, a major supplier of its arsenal, while strengthening ties with the West, specifically the United States. Surging inflation has led to a 50bps rate hike in India to 4.9%.

Brazil's output was up 4.6% in 2021, the fastest growth rate since 2010, fuelled by soaring consumer demand following the lockdown. However, headwinds from the Ukraine conflict may result in slower growth in 2022. While Brazil is not directly dependent on Russian oil production, the combined effect of high energy and fertilizer prices could intensify inflation and induce more aggressive rate hikes.

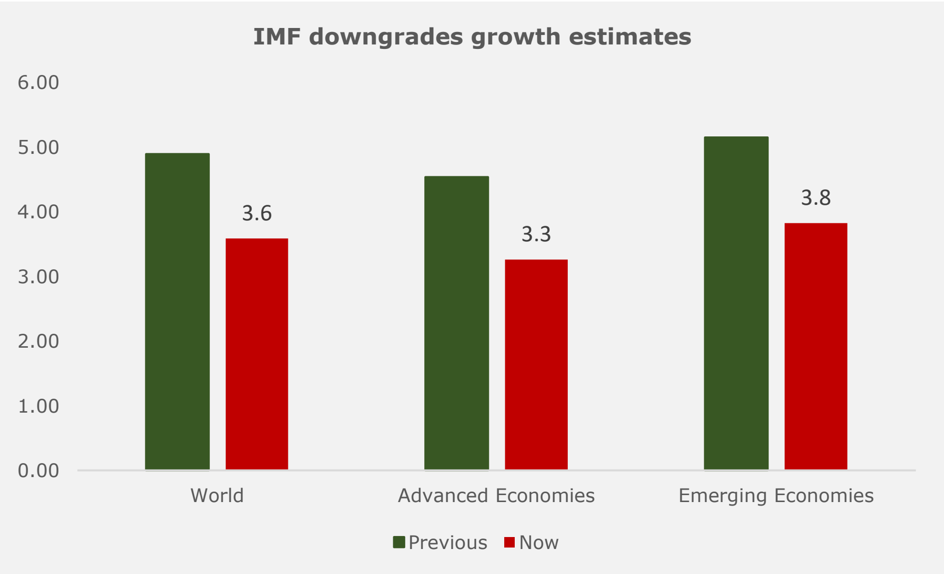
IMF Apr'22 Forecasts	GDP (%)	Inflation (%)
World	**3.6**	**7.4**
Advanced Economies	**3.3**	**5.7**
US	3.7	7.7
Euro Area	2.8	5.3
UK	3.7	7.4
Japan	2.4	1.0
EMDEs	**3.8**	**8.7**
China	4.4	2.1
India	8.2	6.1
ASEAN-5	5.3	3.5
Saudi Arabia	7.6	2.5
Russia	-8.5	21.3
SSA	3.8	9.8

Source: IMF, Vetiva Research

Macroeconomic and policy themes in H2’22

Declining global growth

After the downturn of 2020, 2021 marked the beginning of recovery. However, recent global developments, particularly tensions between Russia and Ukraine, and the resurgence of the COVID-19 pandemic in certain regions have posed significant headwinds to growth. As both warring countries are major global commodity producers, the resulting supply disruption has triggered a commodity super-cycle, worsened inflation, and increased the possibilities of global famine and slowdown.



Source: IMF, Vetiva Research

Monetary Policy Normalization

The Bank of England (BOE) leads in lifting interest rates and shrinking its balance sheet. In March, the BOE shrank its balance sheet to the tune of $37 billion. The US Fed started its quantitative tightening in June, by permitting a gradual monthly run-off of $95 billion worth of treasury and mortgage-backed securities. This could lead to increased financial market volatility, especially as liquidity is withdrawn from the system. While the BOE and US Fed have begun quantitative tightening, the ECB Chair, Christine Lagarde, has hinted that the ECB could raise interest rates in July, while the pace of asset purchases are reduced. As a result of the change in monetary policy, emerging markets could reel under tighter global financial conditions, risk-off sentiments, and elevated debt burdens. Central banks in emerging markets may raise interest rates more aggressively in the near term.

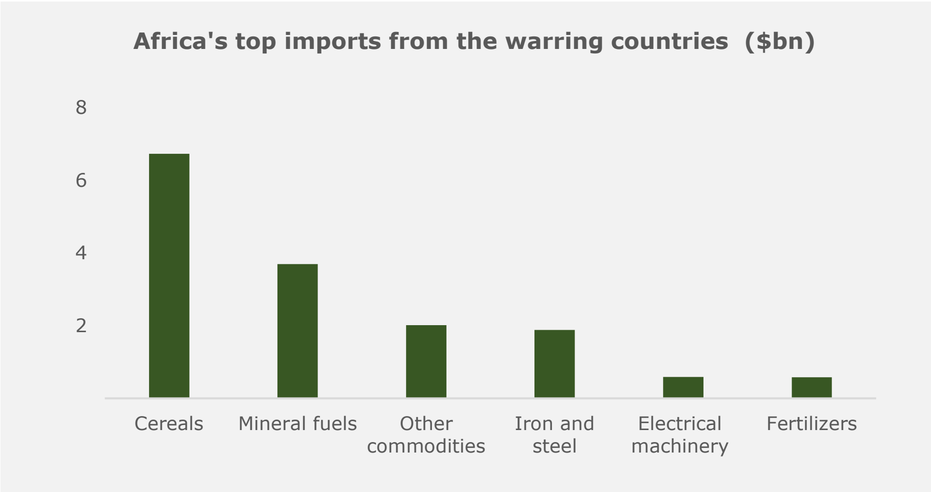
US mid-term elections

The election to fill vacancies in the Senate and House of Representatives, the two bodies known collectively as Congress, will take place in November. Democrats currently control the Senate, making it easier for the President of the US, Joe Biden, to pass legislations. The declining popularity of Joe Biden following his first year in office could be a high-scoring point for the Republicans, especially as inflation worsens in the US. This lends credence to the historical precedent that in most mid-term elections, the sitting President loses seats in the House. If the Republicans regain control, this could make legislative processes more laborious for the President.

Sub-Saharan Africa

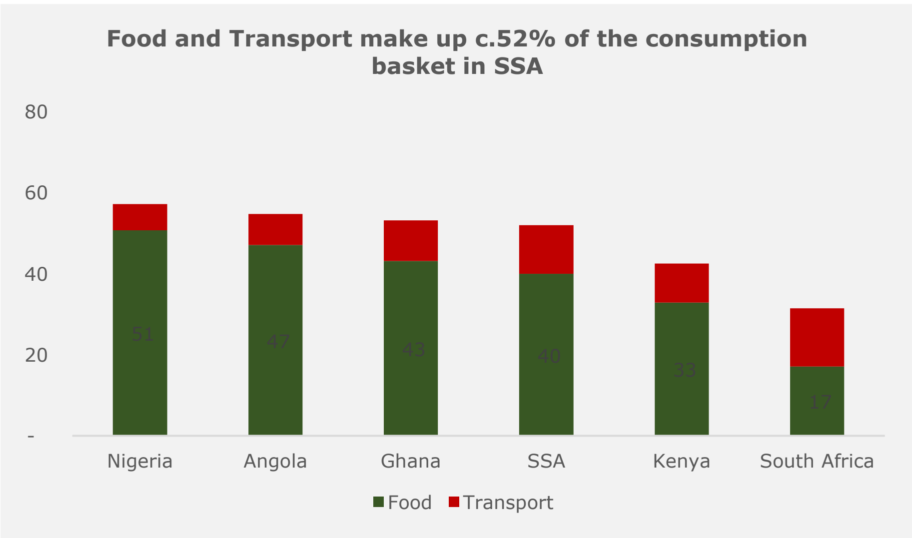
Geopolitics exposes vulnerabilities

Russia's invasion of Ukraine has far-reaching implications for Sub-Saharan Africa. Our attribution analysis revealed that the warring economies are responsible for 3.6% of African imports. Despite the little exposure to Ukraine and Russia, constrained supply from these economies means prices of these commodities -most of which are essential- will be elevated.



Source: COMTRADE, TradeMap, Vetiva Research

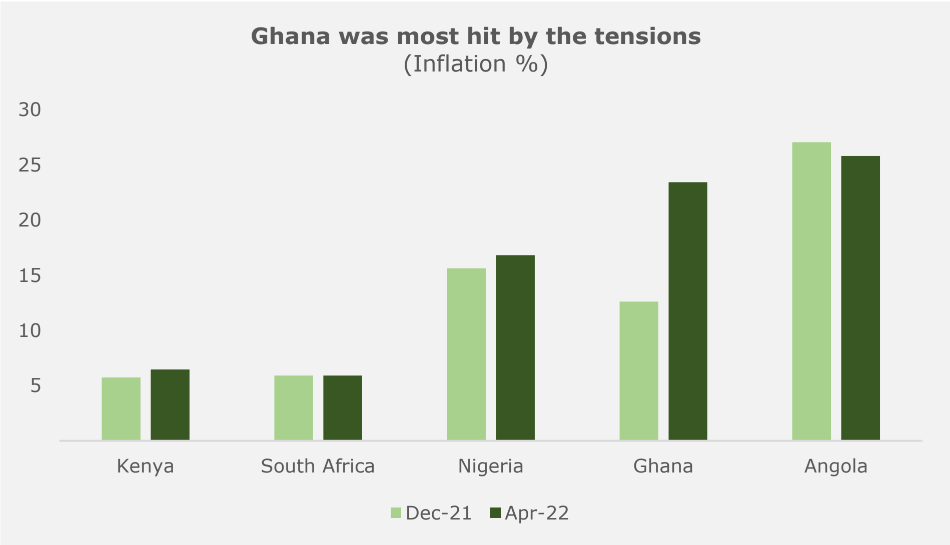
With cereals dominating the import list, food prices may continue to rise if the Ukraine-Russia tension lingers. Food makes up 40% of the consumption basket in Sub-Saharan Africa while transport makes up c.12% of the region's consumption basket. This implies that food and fuel are major drivers of inflation in SSA. The twin build-up in food and energy prices, which has raised inflationary pressures, could widen inequality and degenerate into social unrest. Economies, which cushion limited domestic food supply with imports, could reel under severe pricing pressure.



Source: IMF, NBS, GSS, KNBS, Vetiva Research

Rising energy prices send inflation on a tear

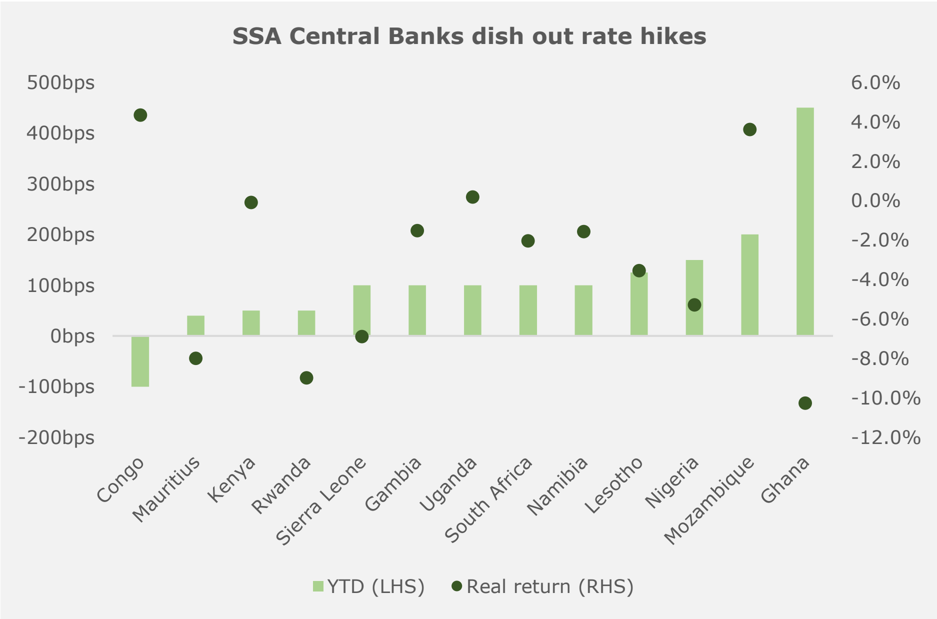
Across our coverage economies, Ghana has been the most affected, reeling from a weaker currency and high energy prices. On the flip side, Angola, which is a net exporter of oil, has seen inflation moderate because of its strengthening currency. Nigeria was unable to achieve a similar feat as fuel shortages erased the soothing impact of subsidies. Like Nigeria, Kenya also experienced fuel shortages. With both economies in an electioneering season, it is highly unlikely that their fuel subsidy regimes would be truncated. Should tensions between Ukraine and Russia ease, we could see inflation decelerate across all economies. Else, economies with floating currencies and volatile fuel prices would be adversely affected (Ghana and South Africa) by high energy prices. In the same vein, we could see the increased fiscal strain on economies that operate fuel subsidy regimes (Nigeria, Kenya, and Angola).



Source: Bloomberg, Vetiva Research

Monetary Policy: Will foreign investors take the bait?

Balancing growth and inflation has been a challenge across the region. With geopolitical tensions fuelling inflationary and external pressures, monetary policy normalization in advanced economies has awakened the hawks in Africa. In the sub-region, Ghana has been the most aggressive in raising interest rates, as inflation surged to multi-year highs. Despite the hikes, the real return remains negative. Mozambique, despite having positive real rates of return, has raised interest rates by 200bps YTD. On the flipside, Congo swam against the hawkish tide by rendering a 100bps rate cut, supported by positive real returns. In H2'22, we expect the direction of the Ukraine-Russia war and inflation in the United States to determine the direction of monetary policy. Should inflation accelerate, the US Fed could maintain its hawkish pace. However, a truce in the Ukraine—Russia war could provide room for accommodative monetary policy in the US. Nonetheless, in the SSA, the hawkish ride may be far from over.

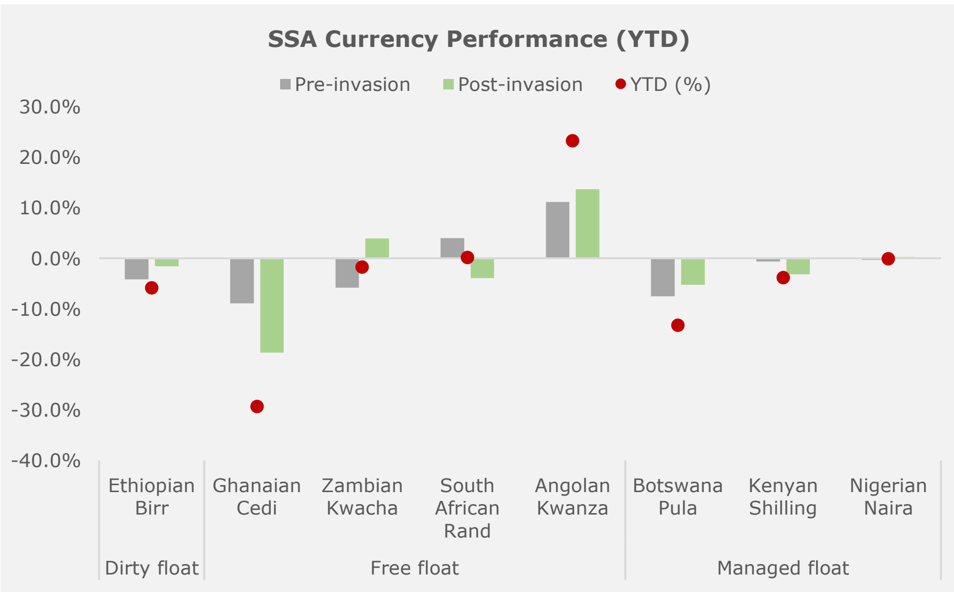


Source: Bloomberg, Vetiva Research

SSA Currencies: Commodity prices polarize currencies

SSA currencies had to deal with several negative forces in H1'22. From the Ukraine-Russia war to higher interest rates in the US, ensuing risk-off sentiments piled more pressure on SSA currencies, particularly net importers of petroleum products and countries heavily reliant on non-resident investment flows.

In H2'22, further hawkish renditions could keep SSA currencies in panic mode. Nonetheless, there are still upside risks from Russia's incursion into Ukraine and the sustained backlash on SSA Economies. We also regard China's bypass of Russian sanctions as another imminent threat to SSA currencies, should newer sanctions emerge.

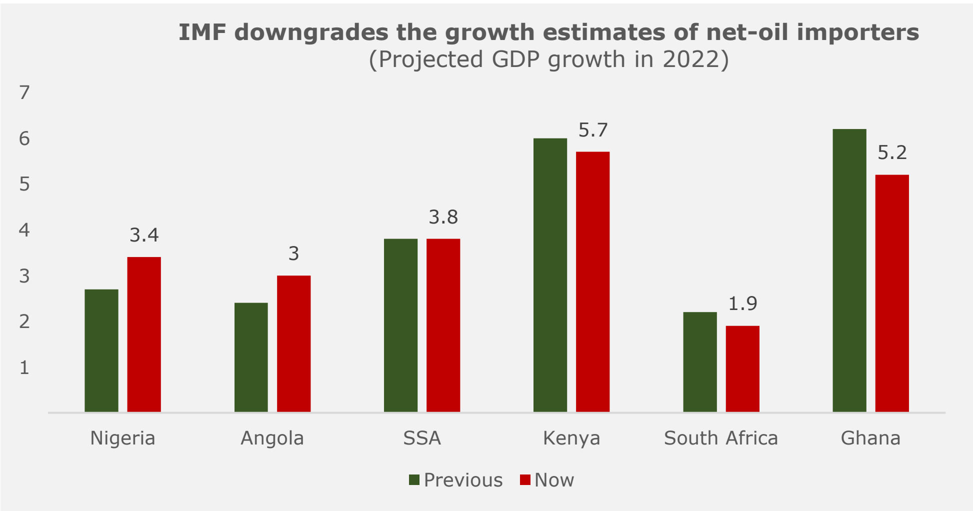


Source: Bloomberg, Vetiva Research

Growth could wane in 2022

The International Monetary Fund (IMF or The Fund) has tagged the Ukraine-Russia tension as a new shock with little room to manoeuvre. For many economies in Africa, the commodity shock calls for policy responses, which the prevailing environment does not support. Rate hikes in advanced economies would make it increasingly difficult to raise funds from the international debt market, a development that resulted in the downgrade of Ghana's sovereign credit rating. As a result, only oil and metal exporters – which are substitutes for Russian exports - have raised funds from the international debt market this year (Nigeria, Angola, and South Africa). While Nigeria and Angola are oil producers (like Russia), South Africa is also a key producer of palladium (like Russia). With export prices exceeding import prices, the positive terms of trade have led to favourable revisions from credit rating agencies (following upgrades in Angola and South Africa sovereign debts by Moody's and Fitch). On the flip side, a hawkish Fed has made other sovereigns like Ghana reluctant to visit the markets.

From the commodity shock to tighter financing conditions, the tensions between Ukraine and Russia have compounded problems in the region. Thus, the Fund expects growth to slow in the region from 4.5% in 2021 to 3.8% in 2022. Oil exporters are tipped to grow at a faster pace, barring security and infrastructure challenges. Due to the scourge of higher oil prices, other economies are expected to grow at a slower pace relative to their respective 2021 outcomes. Key risks to watch out for are China's zero-COVID approach, further escalation of Ukraine-Russia tensions, and aggressive rate hikes by central banks in advanced economies.



Source: IMF, Vetiva Research

South Africa: Stability in adversity

Supported by a favourable base, the South African (SA) economy expanded by 4.9% y/y in 2021 (2020: -6.4% y/y). Nevertheless, SA's output level is still below pre-pandemic levels, as other challenges threatened recovery during the year, ranging from the spread of the Delta variant, subsequent restriction measures, civil unrest, and cyber-attacks on the country's rail, port, and pipeline company - Transnet. In H1'22, while the pandemic has been less of a challenge, the economy is grappling with load shedding, industrial actions, flooding, and high fuel prices.

For context, South Africa has been lagging in generating enough power to run its economy, due to legacy structural challenges resulting from years of underinvestment in the power sector. Concerning industrial actions, a decline in mining activity has been linked to prolonged strikes at a major gold mine in the country. On flooding, heavy downpours in KwaZulu Natal have weighed on manufacturing activity in the region. High fuel prices, an offshoot of the ongoing Ukraine-Russia war, have been tempered by a reduction in fuel levies. This explains the modest 20bps increase in inflation thus far in 2022. Nonetheless, higher fuel prices are expected from June 2022. With inflation close to the Reserve bank's target, the South African Reserve Bank (SARB) has increased its policy rate in every MPC meeting since November 2021. Dishing out 25bps at the first three meetings, the SARB delivered a 50bps rate hike in May to 4.75%, representing the largest rate hike in 6 years. While the reduction of fuel levies provides temporary relief for consumer prices, the SARB may retain its hawkish stance due to monetary policy normalization in the United States and the prevailing risk-off sentiment.

On the fiscal angle, revenues have exceeded expectations, with high commodity prices buoying mining tax receipts while post-pandemic recovery in consumption demand improved tax collections (Value Added Tax and Personal Income Tax). A major highlight of the 2022 budget speech was that permanent expenditure increases would not be implemented amid the windfall from elevated commodity prices. Instead, income tax brackets could be adjusted to mitigate the impact of high inflation on low-income earners. The Finance Minister hinted at a future reduction in corporate taxes. The bright outlook for South Africa's fiscal position resulted in upgrades from Moody's and Fitch. Moody's upgraded SA's outlook from 'negative' to 'stable', citing improved tax revenues on the back of the commodity-driven increase in revenues and the government's fiscal consolidation efforts.

High metal prices supported the South African Rand early in the year, coupled with the SARB's hawkish posture. However, the strengthening dollar has resulted in weaknesses in the Rand. Conclusively, we expect inflation to rise in H2'22 and average 6.0% y/y in 2022. On growth, we expect the

South African economy to grow at a slower pace of 1.7% y/y in 2022 (IMF; 1.9% y/y) as base effects fade and legacy issues impede growth.

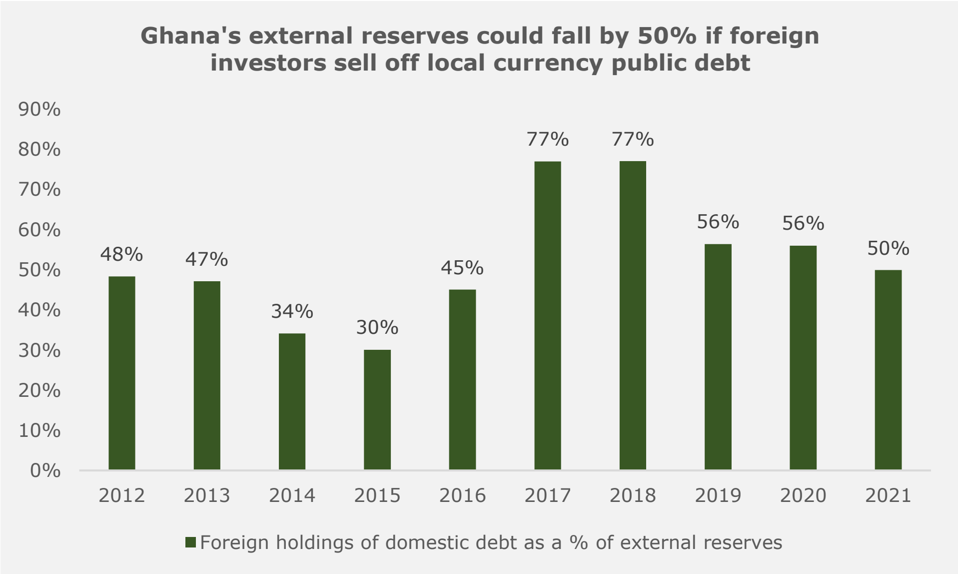
Ghana: Fiscal vulnerabilities laid bare

The Ghanaian economy expanded by a revised figure of 5.3% y/y in 2021, driven by expansion in agriculture, manufacturing, and trade. In 2022, Ghana has been under severe pressure from fiscal sustainability concerns. To put this in perspective, Ghana, like many other SSA countries, has been running a deficit budget for several years. Ghana has funded its deficit through the domestic and external debt markets. Over the past 18 years, the Ghanaian Government has raised funds predominantly from one source (domestic) for 3 years, before raising more funds from the other source. Going by this trend, the Ghanaian Government should have funded its deficits with more external debt from 2019 through 2021. However, the Government had to rely more on domestic debt markets in 2020 and 2021, due to the pandemic. We note here that despite the trend, Ghana's sustainability issue does not stem from its current inability to finance its debts, as Ghana's revenue covers its interest payments more than twice.

The first worry is revenue mobilization. By our estimates, if Ghana keeps growing its revenue and interest payments as it did in the past decade, by 2029, interest payments could exceed revenues. Thus, the Ghanaian government has to trudge the path of fiscal consolidation, to curb expenditure while mobilizing more revenue. To raise its revenues, the Government of Ghana introduced the e-levy, a tax of 1.5% on digital transactions. While implementation faced initial difficulties, over financial inclusion concerns and parliamentary discord, the e-levy finally went live in May 2022. Cheery news followed that the Ghanaian Revenue Authority raked in more than GH₵ 1 million ($126,183) in a day from charging the levy on a single entity.

The next source of worry is debt sustainability. Ghana's external debt has dominated the debt-mix for nearly three decades. Over the past 10 years, Ghana has borrowed from the international debt market than it has from any other external source. Consequently, cheaper multilateral loans have been substituted for more expensive Eurobonds. Due to its increased dependence on the international debt market, the current uptick in yields has kept Ghana out of the international debt market. We note that although $750 million worth of Eurobonds would be maturing in H2'22, a decision to redeem the Eurobonds could reduce its current external reserve stock by 9%.

Apart from Ghana's penchant for the Eurobond market, large foreign investor holdings of domestic public debt is a major external risk. At our last check, foreign investors hold 16% of domestic debt. This paints a fainter picture than the scarier picture; In dollar terms, non-residents' holdings of domestic debt is half the size of its external reserves. In simpler words, if all foreign investors decide to sell-off and repatriate their holdings from the Ghanaian domestic debt market, Ghana's external reserves could fall by 50%, other things being equal (including exchange rate). On the flipside, allowing the Cedi to slide could lead to FX revaluation losses for foreign investors, despite reducing the pace of reserve depletion. While this is a mere bear case scenario, this paints a valid picture of concerns over Ghana's fiscal sustainability, especially as Eurobond redemptions could add a new layer of pressure on its currency and external reserves. Thus, Ghana has to continually offer attractive local currency yields to make returns from the carry trade positive. We believe this is what justifies the successive downgrades by Moody's and Fitch ratings agencies.



Source: Bank of Ghana, Vetiva Research

This year alone, the Bank of Ghana has had course to raise interest rates by 450 basis points year-to-date to 19%. Irrespective, inflation continues to rise (May: 27.6% y/y). While the surge in inflation is majorly driven by cost-push factors, the rate hikes are needed to incentivize foreign investors to remain in the market amid a depreciating Cedi. These rate hikes could also bring to question the fiscal sustainability of these hawkish policies. However, the fiscal authorities have implemented the e-levy to mobilize revenue and keep its commitments to meeting its obligations. Restructuring of debt could be an option, however, the Ghanaian Government has insisted on handling the situation without help from the IMF.

Should investors be worried? Visiting the IMF could raise debt sustainability signals in the short-term leading to some volatility in the Cedi. However, this could help stabilize the sovereign over the medium term. Its current fiscal model may not be sustainable if revenue mobilization and fiscal consolidation is not aggressive enough. Thus, the sovereign intends to raise $2 billion in syndicated loans to settle its budget and balance of payments deficit. The Ghanaian Cedi, which has fallen by about 28% YTD, could weather off some weakness upon receipt of this external flow. Overall, the volatility in the Cedi would largely be dependent on ongoing geopolitical tensions.

Our outlook for the Ghanaian economy is mixed. We see legroom for a 4.3% y/y expansion in 2022, driven by sustained recovery from the pandemic, and pick-up in economic activities. However, increased currency volatility and high inflation could weigh on consumption and keep inflation elevated at a 12-month average of 18.0% y/y in 2022. We also expect interest rate to rise to 20.0% in H2'22.

Kenya: Election bells jingle

The Kenyan economy rebounded by 7.5% in 2021 following a 0.3% contraction in 2020. The recovery was driven by expansions in the Manufacturing, Trade, Real Estate, Transport and Financial Services sectors. With elections slated for August 2022, the government could maintain a welfarist stance to support economic recovery. Kenya is approaching a keen contest, where the incumbent President has completed his term limits, and the deputy President, Williams Ruto, would be contesting against a five-time contender and opposition leader, Raila Odinga, amidst other contenders.

Due to the upcoming elections, Kenya's 2022/23 budget was released in April, two months earlier than the usual deadline. In its recent budget, the government expects revenue (+20%) to grow at a faster pace than expenditure (+10%), mainly because of sustained economic recovery, lower COVID-19 cases, and improved vaccination rates. Capital expenditure takes a backseat, as debt servicing and personnel costs keep recurrent expenses elevated. The budget would be funded predominantly from the domestic debt market (71%). Measures to mobilize revenue were introduced in its Finance bill, including a 50% increase in its Digital Service Tax (to 3%), a 10% increase in capital gains taxes on property sales, and higher excise duties on non-alcoholic drinks.

Inflation in Kenya was mild earlier in the year, due to some reduction in electricity tariffs. Since March, we have seen inflation tick up. With risks tilted to the upside, the Bank of Kenya decided to raise interest rates by 50bps to 7.5%. The destruction of food export routes by Russia adds to global food inflation and impacts the Kenyan economy. To cushion the impact of the Ukraine-Russian crisis on the Kenyan economy, the government waived import duty on maize and fertilizers. As oil prices are expected to remain high in the near term, inflation is expected to rise to 7.3% y/y in 2022 (2021: 6.1% y/y).

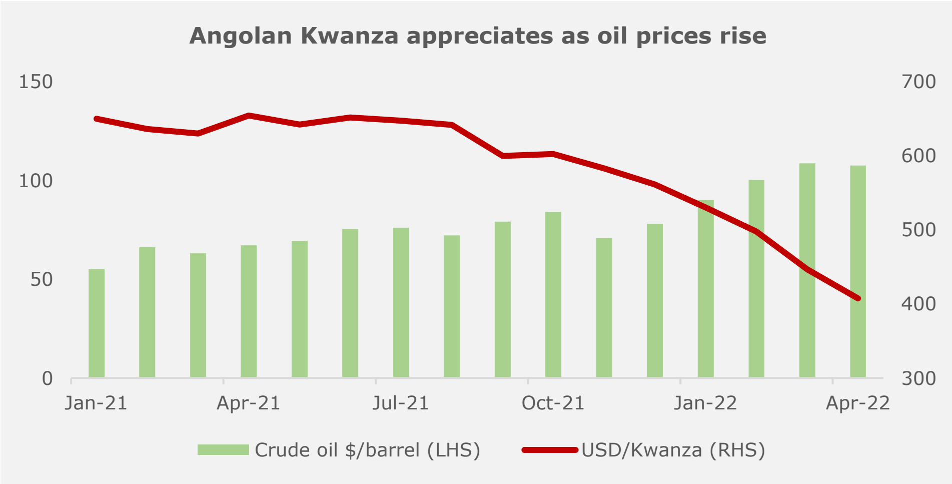
We think more rate hikes could surface in H2'22, especially as the Shilling continues to depreciate to all-time lows. A weakening Shilling reflects Kenya's net-oil importing status. While external receipts from tea exports (+1.3% y/y), manufactured exports (+25.2% y/y), tourism, and remittances (+2.0% y/y) have improved, high oil prices could keep Kenya's current account balance in the deficit region. Nevertheless, Kenya has seen inflows from multilateral institutions in 2022, including a $750 million loan facility from the World Bank, to support its external reserves. $244 million from the IMF is expected via the Extended Credit Facility (ECF). In 2022, we expect the Kenyan economy to grow by 5.20% y/y (IMF: 5.7% y/y).

Angola: Riding the oil bull

In 2021, the Angolan economy recovered from a 5-year long recession. The Angolan economy expanded by 0.7% y/y, driven by expansions in the oil, fishing, transport, and other sectors. In 2022, the Angolan economy has benefitted largely from the windfall in oil prices, culminating in a strengthening currency and slightly lower inflation outcomes. Oil production has picked up from the lows of 1.0 million barrels/day (mb/d) in mid-2021 to around 1.18mb/d in April 2022. This provides a tailwind for expansion in 2022, especially as oil production remains below the OPEC+ production target of 1.45 mb/d. The recovery in the economy is also hinged on reforms seeking to improve private participation in the economy.

As a result of high and rising oil prices, S&P upgraded the rating on the sovereign from CCC+ to B-, citing fiscal prudence and a supportive external environment. On the back of supportive external factors, the Angolan Kwanza has appreciated by 31% YTD. The strengthening of the Kwanza improves Angola's fiscal and debt position as the fiscal arm continues to trail the path of fiscal consolidation, keeping a lean budget deficit while privatizing public assets.

On the external front, the surge in oil prices made production more viable as export revenues recovered by 50% in 2021. Our major worry in 2022 is the country's huge dependence on China. With China being a major buyer of Angolan Crude (64% of exports), demand destruction from stringent lockdown measures could undermine the recovery in the oil-rich economy. As oil prices remain strong, inflation could decelerate in 2022 to 24% y/y (2021: 25.73% y/y). Ultimately, we see room for a 3.5% y/y expansion in real output this year.

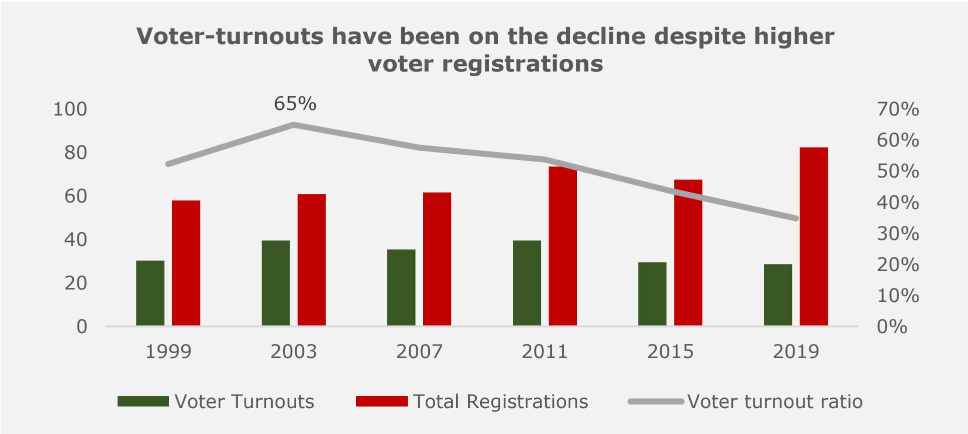


Source: Banco Nacional De Angola, Vetiva Research

Domestic Economy

Elections dominate the scene

After 24 years of uninterrupted democratic rule, Nigeria is gearing up for her 7th general election in 2023. Following the signing of the New Electoral Act, primary elections were scheduled to take place earlier than in past elections. At the writing of this report, primaries are reaching their conclusive phases. This is also true for voter registrations, as more young people are enfranchised. A trip down memory lane shows that despite increased voter registrations, the voter turnout ratio has declined steadily since 2003.



Source; Wikipedia, INEC, Vetiva Research

Beyond voter turnouts, a cursory glance at the economic outcomes of previous elections shows one clear fact – economic performance is tied largely to the performance of the oil sector. We believe the decline in both oil production and real output growth post-2010 was driven by the oil shock from the loss of a major trade partner (2014), attacks on pipelines (2015/16), COVID-19 (2020), and the incidence of crude thefts (2021 – 2022).

Growth in every administration is highly correlated with oil production

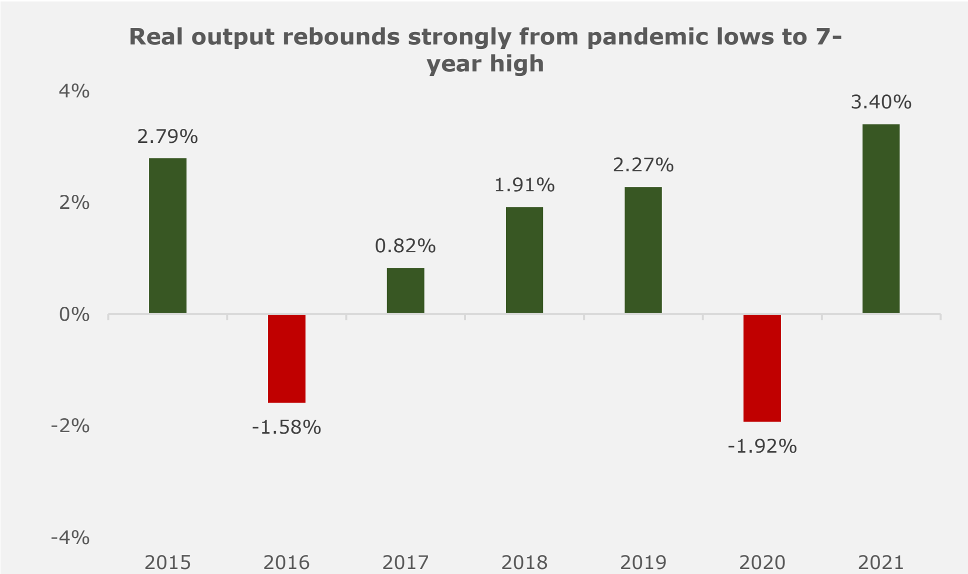
Year	Winner (mn)	Runner-up (mn)	Total Votes (mn)	RGDP growth	Oil production (mb/d)	Inflation	Reserves (end, $bn)
1999	18.7	11.1	30.3	6.71%	2.05	11.5%	7.13
	PDP	AD-APP					
2003	24.5	12.7	39.5	7.14%	2.28	12.2%	51.33
	PDP	ANPP					
2007	24.6	6.6	35.4	7.17%	2.02	10.8%	30.07
	PDP	ANPP					
2011	22.5	12.2	39.5	4.80%	2.03	9.7%	25.96
	PDP	CPC					
2015	15.4	12.9	29.4	1.24%	1.78	12.9%	36.02
	APC	PDP					
2019	15.2	11.3	28.6	1.25%	1.66	13.8%	38
	APC	PDP					

NB: Economic indicators (except reserves) are averages

Source: Wikipedia, INEC, Bloomberg, Vetiva Research

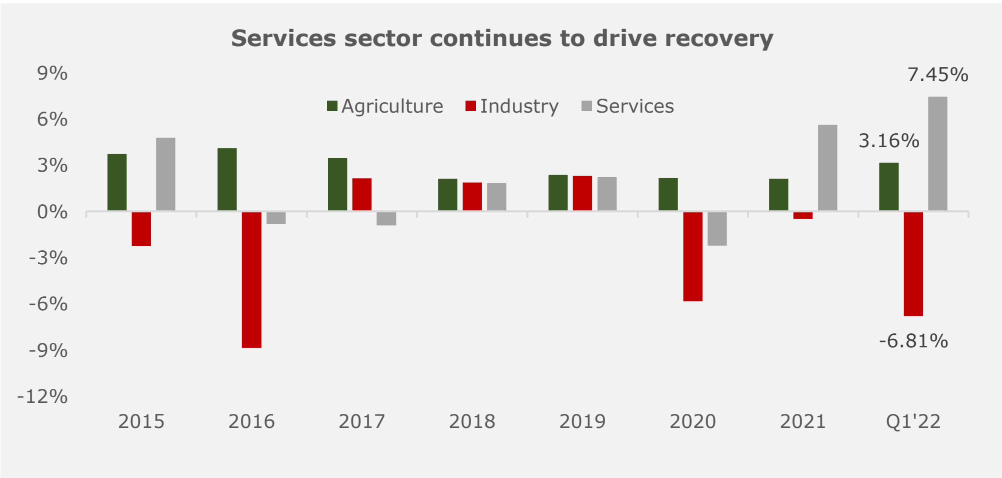
Base effects buoy real output but the oil sector disappoints

In 2021, Nigeria experienced its fastest growth in 7 years, expanding by 3.40% y/y (Vetiva: 3.1%). This 'bull' run was sustained in Q1'22 as the domestic economy expanded by 3.10% y/y (Vetiva: 2.97% y/y). Coincidentally, this was Nigeria's strongest Q1 expansion in 7 years. In our GDP Report, we explained that base effects from the prior year provided a springboard for above-average growth.



Source: NBS, Vetiva Research

On a broad basis, the Nigerian economy is divided into the Agriculture (26%), Industrial (21%), and Services (54%) sectors. Most of the growth recorded in the past year was driven by the Services sector. While the Services sector rebounded strongly, the Industrial sector remained in a recession. The Agricultural sector remained resilient, even during the COVID-19 lockdowns, as sustained interventions keep the sector afloat.



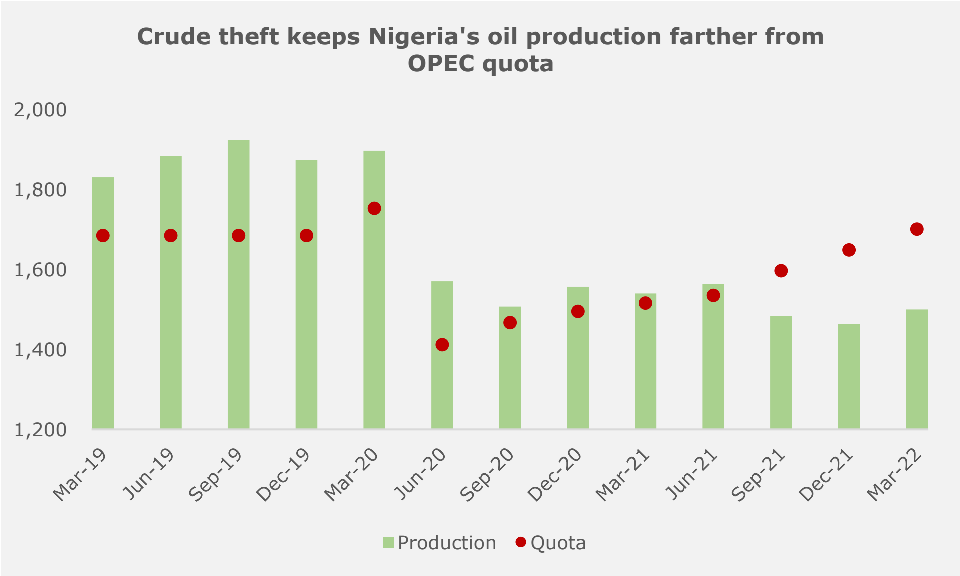
Source: NBS, Vetiva Research

Agriculture remains the most resilient sector

Agriculture has been the poster child of both the Federal Government and the Central Bank of Nigeria (CBN). The Anchor Borrowers Programme (ABP) has been a key intervention in supporting small-scale farmers. According to the CBN Governor, the capacity of rice mills has grown from 350,000 metric tons before the launch of the ABP to 3 million tons as of January 2022. The Governor has a target of 10 million metric tons capacity to be commissioned later in the year. We see these developments as tailwinds to the agricultural sector, which has withstood several shocks that have hit the broader economy over the past decades. We expect growth to remain above 2% in the near term, as further interventions are made. We however note that insecurity and climate change are downside risks to our outlook.

Frequent shut-ins bleak oil sector outlook

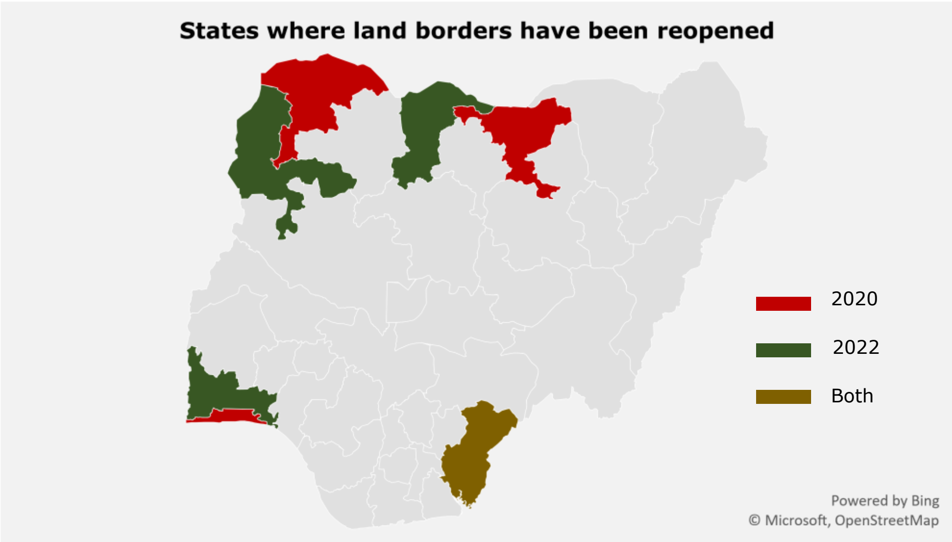
In Q1’22, the oil sector recorded its steepest decline (-26.0% y/y) in over two decades. A deeper dive shows us that an attack on one of Nigeria’s major onshore (land) terminals - Escravos - was responsible for the historic decline in Q1’22. We, however, observed that since March, crude transport via the affected terminal has recovered by 80%. Nonetheless, the crude theft menace cuts across other onshore terminals, including the Bonny, Forcados, and Brass terminals. Thus, we do not downplay the risk of further disruptions. We found out that although Nigeria has just 5 land/onshore terminals (compared with over 20 offshore terminals), these land terminals are responsible for c.40% of oil storage/transport. On this basis, we retain cautious optimism over the oil sector, as this exposes the sector to levels of crude theft that could distort production levels and prevent the oil sector from reaching its quota.



Source: NNPC, Bloomberg, Vetiva Research

Border reopening could support Trade

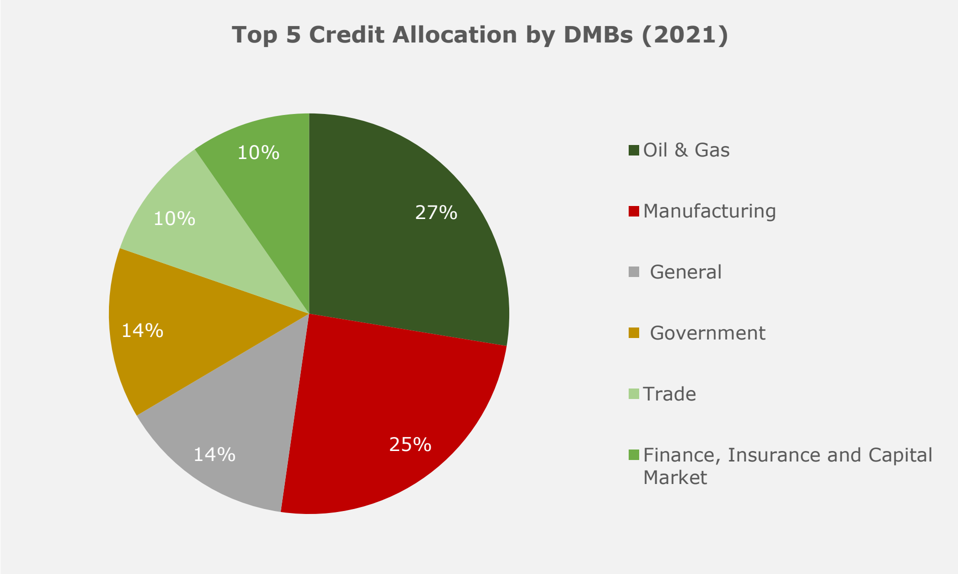
The Trade Sector recovered from a 5-year recession in 2021. This can be traced to the backlash from constrained FX liquidity in 2016, the FX ban on 41 items (which has now increased to 43), border closure (2019), and the pandemic (2020). The recovery in the trade sector in 2022 could further be strengthened by the full reopening of the borders. At the beginning of Q2’22, the Federal Government reopened four additional land borders - Idiroko, Jibiya, Kamba, and Ikom borders. This reopening is happening 16 months after an earlier reopening exercise, when the following borders were reopened - Seme, Maigatari, Illela, and Mfum borders. While the border reopening announcements were made, media reports show restrictions on food imports remain in place. We believe the trade sector could receive a boost if all land borders are fully reopened.



Source Vetiva Research

Unconventional monetary policies fuel credit growth

Since the CBN introduced the Loan-to-Deposit floors in H2'19, which punishes banks for underperforming lending targets (60/65% of deposits), credit by Deposit Money Banks (DMBs) has grown immensely. Since Q3'19, the financial services sector has grown by an average of 13% y/y, compared to the preceding 10-quarter average of 0.1% y/y. More loans have been disbursed by DMBs to the Manufacturing sector and General sectors, despite their huge exposure to the oil sector. Other interventions by the apex bank to target sectors also played a role in boosting overall credit growth. We recognize that the recent rate hike could result in slower loan growth, especially to the non-priority sectors. On the flip side, the issuance of mobile money licenses to telcos could serve as a tailwind.



Source: CBN, NBS, Vetiva Research

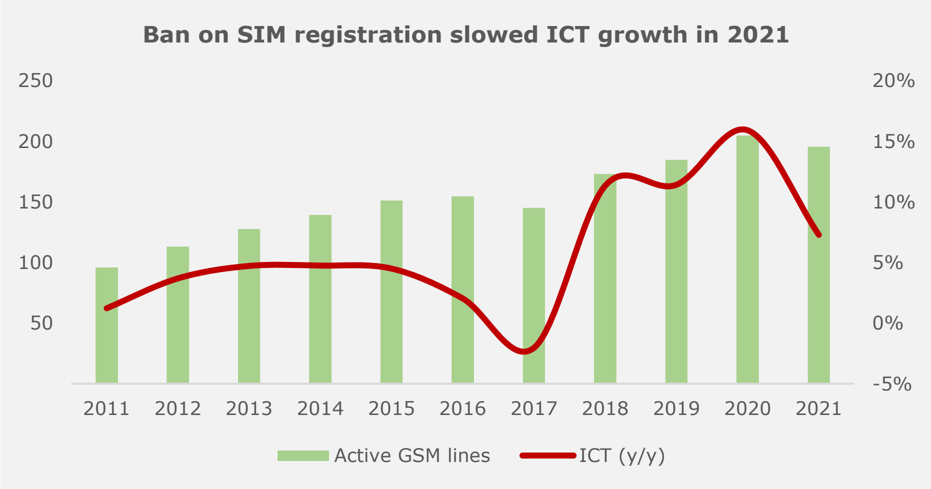
Interventions could keep the manufacturing sector afloat

Amid increased lending from DMBs and the apex bank, the manufacturing sector delivered a surprise growth of 5.89% y/y in Q1'22, exceeding the Q1'21 growth outcome of 3.40% y/y. Late last year, the Central Bank of Nigeria introduced the 100 for 100 Policy for Production and Productivity (PPP). The policy is aimed at creating 20,000 jobs and generating over $125 million in foreign exchange earnings. We note that the manufacturing sector was the largest beneficiary of the pilot batch, as half of the beneficiaries were in the manufacturing sector. Broadly speaking, the manufacturing sector continues to thrive on improved volumes from the Food, Beverage, and Tobacco (FBT) sub-sector (supported by border closures and resizing) and export-led growth in the Cement sub-sector, despite the ailing textile sub-sector.

In 2022, we see the reopening of the borders as a major downside risk to the manufacturing sector, as border closure supported consumer goods. However, as of the writing of this report, we have learned that selected food items are still banned from entering through the land or sea borders. The Cement sector could continue to expand as preferential border access and the CBN's FX restriction policy insulates the cement sector. We note that the textile sub-sector (Q1'22: -1.23% y/y) continues to constitute a drag on manufacturing output. Nevertheless, the apex bank continues to step-up interventions in the cotton value chain to drive growth.

Relaxation of SIM bans buoy growth in the ICT Sector

The ICT sector is one of the fastest-growing sectors in Nigeria. In 2021, the sector grew at its slowest pace in 4 years (FY'21: 6.5% y/y). The reduced pace is an offshoot of the NIN-SIM linkage exercise, which restrained people from registering new SIM cards. In April last year, the Federal Government lifted the ban on new SIM registrations. We expect the removal of the ban on SIM registrations to support the ICT sector in 2022.



Source: NCC, NBS, Vetiva Research

GDP Outlook: Nigeria is tipped to grow by 2.7% y/y in 2022

Going into 2022, we see several factors influencing growth – base effects, border reopening, crude production, exchange rate, and the launch date for the Dangote refinery. Our base case assumes volatile oil production through 2022, and sustained growth in active GSM lines, amid slight depreciation in the Naira. We do not see the refinery coming on stream this year, although, there are high prospects for a launch in the nearest future. That said, we expect the Nigerian economy to expand by 2.7% y/y in 2022 (2021: 3.4% y/y).

GDP Forecast

Metric	Bear	Base	Bull
GDP	1.40%	2.70%	3.50%
Borders	Full closure	Partial reopening	Full reopening
Oil production	Declining	Volatile	Full OPEC compliance
Currency	Full float	Slight depreciation	Appreciation
Refinery	Nil	Nil	Launched

Source: Vetiva Research

A word on rebasing

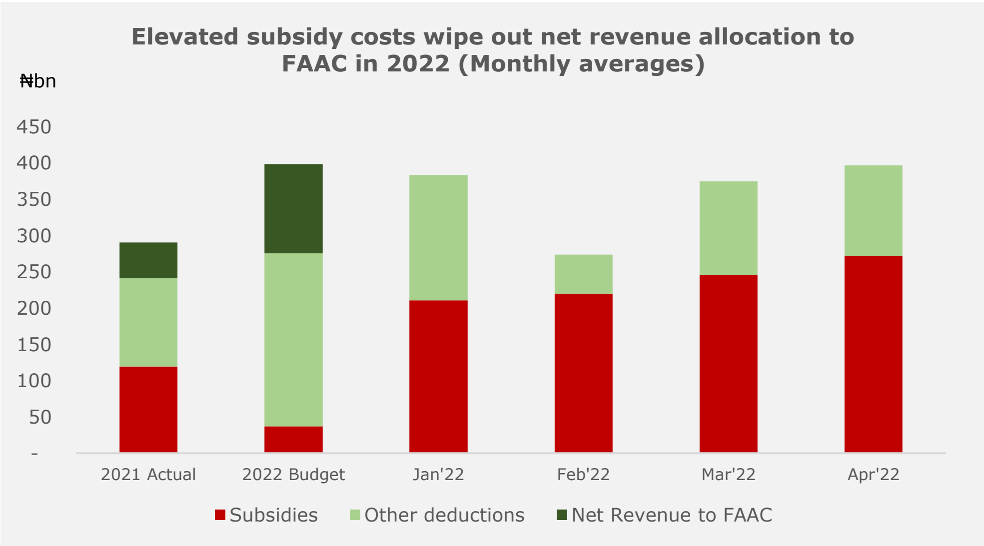
The NBS has announced plans to rebase the country's National Account Statistics - Consumer Price Index (CPI) and Gross Domestic Product (GDP). While the rebasing of the GDP would be concluded in 2023, the rebasing of the CPI could be concluded by the end of 2022. The National Bureau of Statistics would be engaging in a fresh Nigerian Living Standard Survey (NLSS) that could make the base year for the CPI series a more recent year (other than 2018/19 earlier chosen). We regard the move as timely due to the significant changes in the economy over the years. While the rebasing exercise could result in artificial improvement in key economic indicators such as debt-to-GDP and fiscal deficit-to-GDP, this is purely a statistical exercise that does not translate into better living conditions. Investors could however keep a watch on the newly rebased CPI figures to ascertain inflation-adjusted returns.

Fiscal policy: Subsidies make Nigeria oil-neutral

In our 2022 Outlook, we had taken a deep dive into Nigeria's 2022 budget – the Budget of Economic Growth and Sustainability. In 2022, however, the Ukraine-Russia war provided a bullish case for oil prices, while increased incidences of crude theft dampened oil production. The Federal Government's stance on subsidies also changed as the government postponed its subsidy removal decision by 18 months (August 2023), effectively transferring the decision to the new government. This decision has been frowned upon by Moody's, a rating agency, citing that the decision is credit-negative.

As a result of the surge in oil prices, the Federal Government amended the 2022 budget. The key changes include a higher oil price benchmark of $73/barrel (up by $11), a lower oil production volume of 1.6 million barrels/day (down by 0.29mb/d), and a higher provision for PMS subsidy of ₦4 trillion (up by ₦442 billion).

A closer look at Nigeria's oil revenues in 2022 thus far shows that the attack on the Escravos Terminal affected the oil revenues. In February, oil revenues fell by one-third to a year-to-date low of ₦274 billion. We have seen considerable recovery in revenues (+45%; Apr'22: ₦396 billion), as surging oil prices compensate for the slump in oil production. The bitter pill, however, is that monthly subsidy deductions have risen by 100% on a year-on-year basis. The implication is that the Nigeran National Petroleum Corporation (NNPC) was unable to remit any revenue to the government. This was the major driver behind JP Morgan's downgrade of Nigeria from the 'Overweight' category. Failure to take advantage of high oil prices could elevate debt vulnerabilities, as currency weaknesses stalls growth in the non-oil sector and invariably takes a toll on non-oil revenue.



Source: NNPC, Vetiva Research

Amid the headwinds in the oil sector, the Federal Government has rolled out measures to boost non-oil revenues. Of all measures introduced, four stand out for us –

(i) the partial rollback of exemption of shares from Capital Gains Taxes (10% Capital Gains Tax on disposed shares worth ₦100 million and above in any 12 months calendar),

(ii) imposition of a ₦10/litre duty on Non-alcoholic, carbonated, and sweetened beverages

(iii) taxation of e-commerce businesses owned by non-resident companies

(iv) restriction of VAT obligations to Digitally Non-Resident Companies

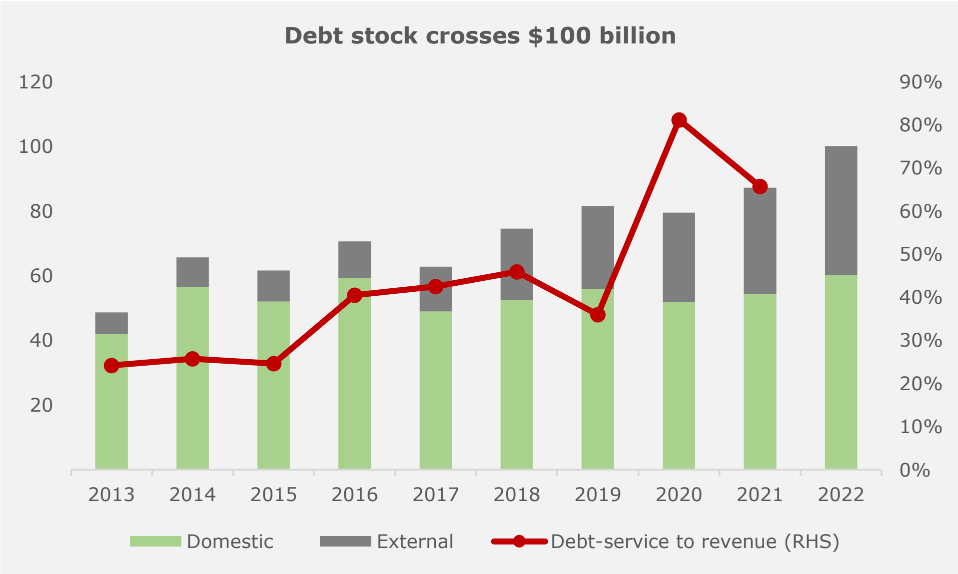
Nigeria could have saved ₦1.6 trillion by removing subsidies and implementing safety nets

In H2'22, we regard sour Ukraine-Russia tensions as tailwinds for higher oil prices. Volatile oil production could keep actual federal revenues below the target, while subsidies could continue to nullify the gains from high oil prices. In our 2022 outlook, we had correctly predicted that the Federal Government would relax its stance on fuel subsidies. Using the run rate for the first four months of the year, we estimate Nigeria's subsidy bill could rise to ₦2.8 trillion, holding other factors constant. On the contrary, the Nigerian Senate has approved a larger subsidy bill of ₦4.0 trillion, which incorporates upside risks to oil prices, that could stoke the subsidy bill. This is almost twice the cost of the alternative- removing subsidies and providing a ₦5,000 subsidy relief to the poor (₦2.4 trillion). With electioneering in full swing, reforms may not be implemented in the current year. More energy products (like jet fuel) have been included in subsidy provisions. Conclusively, we expect these events to keep the fiscal deficit above 5.0% of GDP in 2022, which is almost twice the limit allowed by the Fiscal Responsibility Act.

To fund its deficits, the fiscal authority visited the international debt market, raising a 7-year Eurobond worth $1.25 billion in March. The offer was issued at 8.375%, a premium to existing tenors despite oversubscription, pointing to healthy demand for SSA Eurobonds. Plans to raise an additional $900 million in the market were stalled due to unfavourable market conditions, as risk-off sentiments keep yields elevated in the secondary market.

Amid increased external borrowing and depreciation in the Naira over the years, the nation's external debt stock has grown by a 10-year CAGR of 19% to $40 billion, compared with the slight increase in the domestic debt stock ($60 billion; +4%). The nation's total debt stock now stands at $100 billion (₦41 trillion; 24% of GDP).

On the debt-servicing angle, in line with our expectations (Debt outlook: Growing debt burden raises sustainability concerns), debt service-to-revenue moderated in 2021 to 66%. While rising subsidies could erode net oil revenues in 2022, we could see further improvements in the debt servicing to revenue ratio, as newly introduced revenue mobilization efforts spur non-oil revenues. Already, we have seen Company Income Taxes rise to pre-pandemic levels. Other non-oil revenue items could broadly benefit from the ongoing recovery in economic activities.

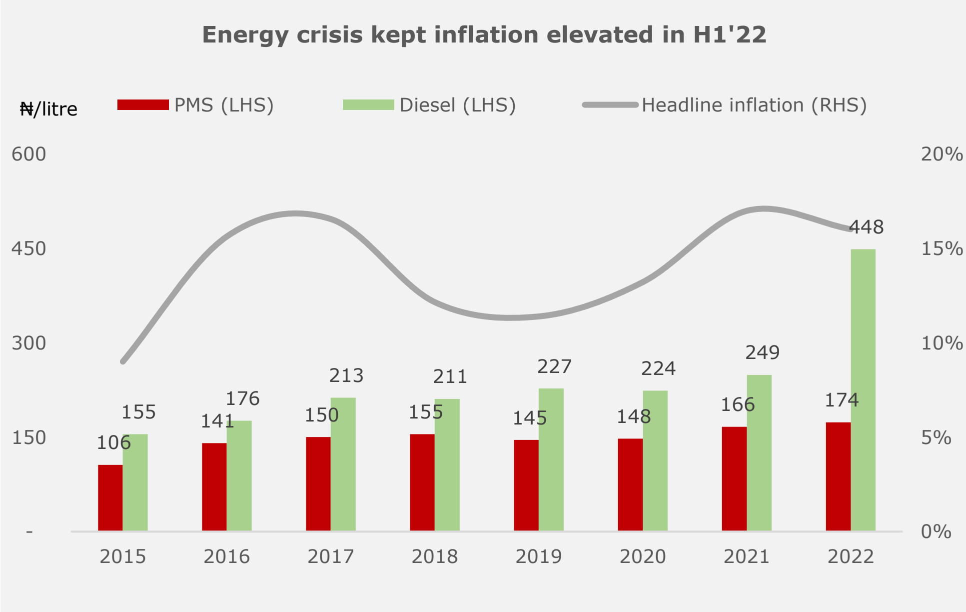


Source: DMO, CBN, Vetiva Research

Inflation: Uncertainties cloud outlook

History provides us with evidence that inflation slows in every pre-election year since 1999 (excluding 2010). There are a couple of factors that could alter that trend in 2022, including the sustained rise in energy prices, resurging incidences of fuel scarcity, and elevated demand for FX (as a result of Nigeria's long election campaign cycle). In addition, incidents of crude theft could degenerate into further oil revenue losses and weaker exchange rates. These combined risks create a lot of uncertainty in H2'22.

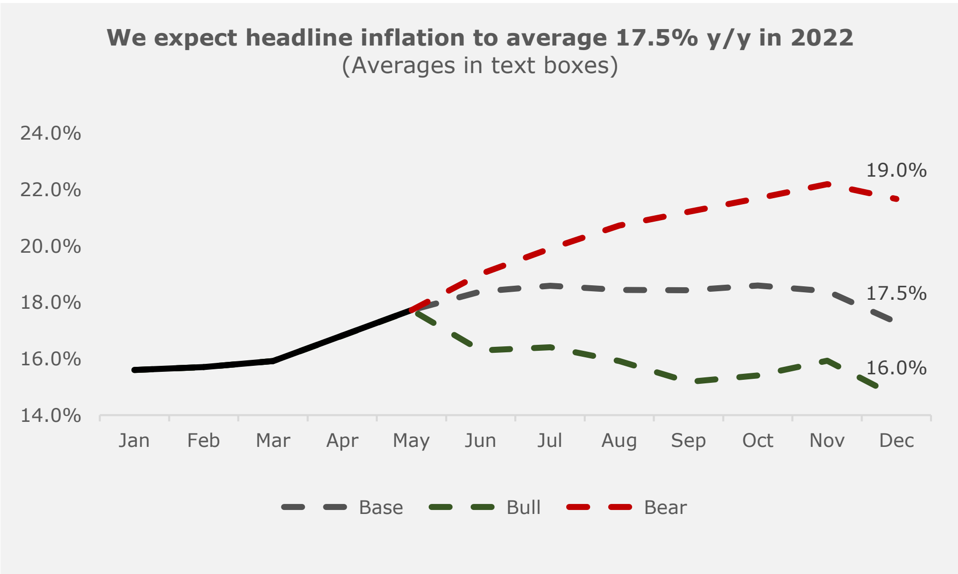
In H1'22, we observed several policy choices geared at taming inflation, including the postponement of subsidy removal. However, the importation of off-spec Premium Motor Spirit (PMS) upset consumer prices, as the ensuing fuel scarcity drove the price of PMS to a 50-month peak of ₦185/litre in March 2022. While the price of PMS has moderated subsequently, the price of deregulated energy products as diesel have since gone up. We understand that the recent incidences of fuel scarcity some northern states are caused by high cost of fuelling petrol tankers (which run on diesel). High operational costs led to the deployment of fewer tankers. Media reports suggest that the President has approved higher freight rates for transporters, while keeping the pump price of PMS constant.



Source: NBS, Vetiva Research

As the energy shock reverberated across the nation, the Federal Government introduced a softener to food inflation, by reopening four additional borders. Market reports showed that an increased supply of grains from Cameroon, a border country, provided a brief relief for food prices, but these gains were given away. We understand that trade activities at the border have reduced drastically, especially as custom procedures have been implemented to eliminate informality.

In H2'22, we see considerable risks from global food shortages, sustained fuel shortages, another energy crisis (if debts owed to the Independent Petroleum Marketers Association of Nigeria remain unpaid – a recurring pre-election threat), higher power tariffs, and weaker exchange rates. Amid these varying outcomes, our base estimate for inflation is 17.50% y/y in 2022 (2021: 16.98%).



Source: NBS, Vetiva Research

Monetary Outlook: More rate hikes loom

In a swift turn of events, the apex bank decided to turn hawkish at its May'22 MPC meeting – raising interest rates by 150bps to 13.0%. The unanimous decision to raise interest rates was driven by the prevailing monetary policy normalization in advanced economies and money demand pressure from the election season in the domestic economy. True to the CBN's prognosis, the early deadlines issued by the Independent National Electoral Commission (INEC) provide more time for electoral campaigns, which could result in demand-pull inflation. The apex bank carefully recognized that although supply-side factors drive the current inflationary trend, a proactive rate hike was necessary to tame inflation from the demand side.

From our historical analysis of rate hikes under the current CBN Governor's tenure, we see a sync in historical trends – monetary policy normalization & geopolitics on the global scene, domestic oil shocks and slowing growth on the domestic scene. During the past hiking cycles, the apex bank tinkered with more than one benchmark variables (MPR and CRR in 2014, MPR and Official peg in 2016). This gives credence to our prognosis that the apex bank could increase the benchmark rate by 100bps – 200bps in H2'22 (to 14% - 16%). A possible adjustment of the corridor rates around the MPR or the Cash Reserve Ratio could also be on the cards, as the apex bank trudges the path of monetary policy normalization.

Synchronized events led to rate hikes under Godwin Emefiele

Scale	Event	2014	2016	2022
Global	Oil price movement	Bearish	Bearish	Bullish
	Oil price	$80/barrel	$38/barrel	$122/barrel
	Geopolitical tensions	Yes (Middle East)	Yes (Middle East)	Yes (Ukraine-Russia)
	Monetary Policy Normalization	Yes	Yes	Yes
Domestic	Slowing Growth	Yes	Yes	Yes
	Rising inflation	No	Yes	Yes
	Inflation Rate (pre-decision)	8.1%	11.4%	16.8%
	Oil Production	2.18 mb/d	1.65 mb/d	1.48 mb/d
	Exchange rate Depreciation	Yes	Yes	Yes
	Money supply growth	4.2%	2.3%	6.2%
	Shock	Loss of major export partner	Attack on oil facilities	Crude theft
	External Reserves	Declining	Declining	Declining
	Fuel Scarcity	No	Yes	Yes
	Election factor	Pre-election	Post-election	Pre-election
Decision	Monetary Policy Rate	Raised by 100bps to 13%	Raised by 300bps to 14%	Raised by 150bps to 13%
	Cash Reserve Ratio	Raised 250bps to 22.5%	Nil	??
	Exchange Rate	Devalued by 8.4% to ₦165/$	Free float of the Naira	??

Source: CBN, Vetiva Research

Tracing the performance of several economic and financial market indicators after previous rate hikes, we find interesting revelations:

(i) GDP growth slowed, as the impact of the underlying shock prevailed over output growth

(ii) Exchange rates weakened because of lower oil production/prices

(iii) Inflation rose, as the devaluation of the Naira had a negative passthrough to inflation.

How economic indices fared after previous rate hikes (averages)

Metric	T	T+1	T+2	T+3	T+6	T+12
Inflation	12.6%	13.9%	14.4%	14.7%	15.0%	15.0%
Official	229	229	262	272	269	270
Parallel	295	313	346	360	365	351

NB: T - the time MPR was hiked, T+1 - average performance of the metric/index/instrument after 1 month

Source: CBN, NBS, Vetiva Research

Down to the financial market, we discovered that rate hikes led to higher stop rates at primary market auctions and higher bond yields in the secondary market. Due to attractive rates in the fixed income market in those years (2014 & 2016), investors rotated out of the equities market into the fixed income market. With respect to the equities market, we found conflicting results. The stock market turned bearish 12 months after the rate hike in 2014, while the sell-off in the stock market did not last in 2016. This was majorly due to the subsequent FX reforms in 2017, specifically, the introduction of the Investors & Exporters (I&E) Window.

In the current year, a couple of variables have changed - unorthodox monetary policy by the CBN, and the dominance of domestic investors in the equities market. As a result, the performance of asset classes in the current year may differ from historical records. Our equity analysts still see the stock market closing the year in a positive terrain. We share similar sentiments as unorthodox policies keep real yields in the fixed income market in the negative territory, leaving investors to chase stocks with compelling upsides and/or dividend yields. With domestic investors calling the shots in the equity market, foreign portfolio investors, on the other hand, have been buying more fixed income instruments (bonds to be precise), as rising inflation on the global scene accelerates the hunt for positive real yields.

Sell-offs occurred after previous rate hikes, but in 2017, FX reforms spurred recovery in the equities market

Index	T+1	T+2	T+3	T+6	T+12
All Share Index	-2%	-5%	-3%	-8%	19%
Banking	-2%	-3%	3%	-4%	40%
Oil	-6%	-3%	-11%	-15%	-8%
Industrial	-3%	-8%	-10%	-10%	5%
Food, Beverage, and Tobacco	-1%	-2%	3%	-5%	19%

Average PMA Stop rates and benchmark bond yields rose after previous rate hikes

Instrument	T	T+1	T+2	T+3	T+6	T+12
91-day	10.0	11.1	10.9	12.9	12.5	11.2
182-day	11.4	13.7	13.4	15.8	15.9	13.4
364-day	12.7	14.8	15.2	16.7	17.4	14.4
5-yr	13.5	14.4	15.2	15.1	15.7	14.2
10-yr	13.8	14.7	15.4	15.3	15.8	14.3
15-yr	13.8	14.5	15.2	15.6	15.8	14.4
20-yr	13.7	14.8	15.4	15.2	15.6	14.5

Source: FMDQ, DMO, NGX, Bloomberg, Vetiva Research

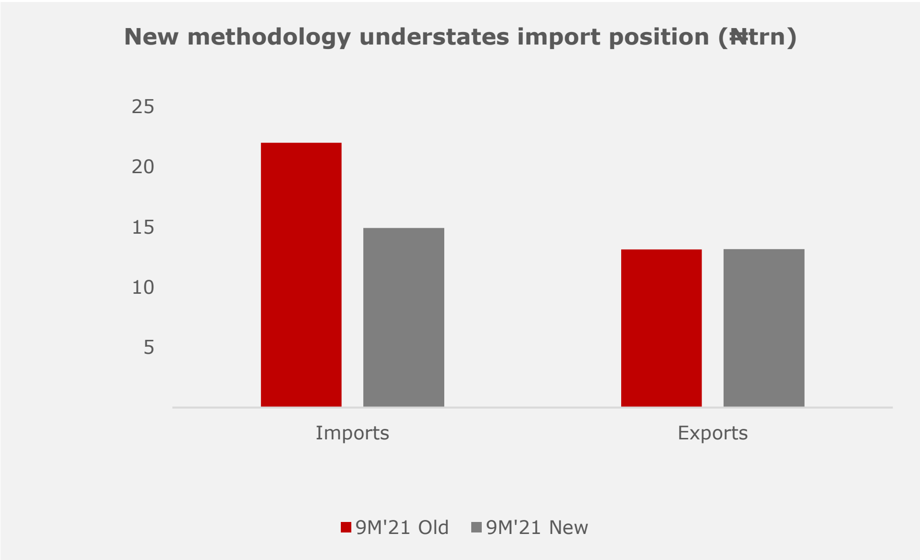
External Outlook: Still in deep waters

Trade Analysis – New methodology understates import position

It is no news Nigeria's oil production fell to an all-time low in Q1'22 (1.39 million barrels per day). As we saw under the GDP section, this was majorly due to the attack on the Escravos Terminal. With the Ukraine-Russia tensions sending oil prices to 8-year highs, Nigeria was able to earn decent export earnings (+137% y/y) in Q1'22. The restoration of crude transport via the terminal provides some beam of hope for Nigeria's export earnings. However, risks of further disruption remain, especially as a significant proportion of Nigeria's terminals are onshore.

On the import leg, we observed a 21.0% y/y increase in the import bill in Q1'22. As a result of this, Nigeria recorded a trade surplus in its goods account in Q1'22. We believe the trade surplus was driven majorly by above-average oil prices and the change in NBS' methodology (Computing export & import figures using the Nigerian Autonomous Foreign Exchange (NAFEX) rate). While above-average oil prices are tailwinds for exports (most of which are crude exports and are valued using the official exchange rate), the usage of the NAFEX rate in computing imports implies that there is no inherent official-parallel market gap in the economy.

Comparing data under the old and revised version of trailing 9-months data, we observed a 32% and 36% decline in 9M'21 and 9M'20 import figures, respectively. The change in imports mirrors the official-parallel gaps in both periods. In reality, however, we note that manufacturing companies often import at a blended rate, subject to CBN's supply at the usual window. After adjusting the Q1'22 trade position to reflect a blended 25% official-parallel gap (Actual FX gap: 37%), we estimate that Nigeria could still be in a deficit position, in naira terms, under the old methodology.



Source: NBS, Vetiva Research

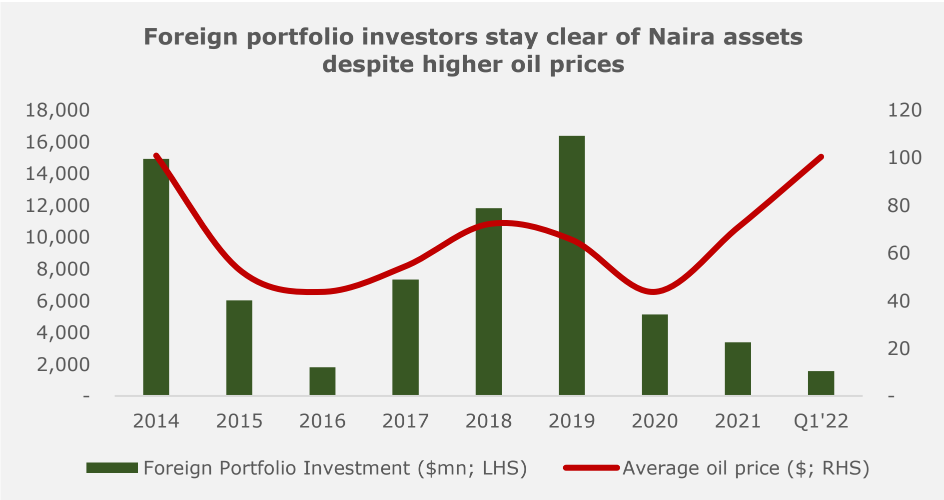
Foreign investors' apathy lingers

Since 2019, foreign portfolio investors have become less enthusiastic about Naira assets. This is majorly because of monetary policy unorthodoxy and the pandemic-induced shock of 2020. The exodus out of Nigeria in 2020 was due to prevailing risk-off sentiments as oil prices plummeted to record levels. This was worsened by the dovish cycle. Both unfavourable signals made investors wary of investing in Nigeria. The combined impact of falling oil prices, demand destruction, and sour investment interest led to the gradual downward adjustment in the exchange rate, to prevent reserves from depleting.

Amid the FX crunch, we saw the implementation of similar measures including the restriction of FX sales to Bureau de change operators, which lead to wide official-parallel gaps, raising concerns on the valuation of the Naira.

In 2022, the story remains the same, as Nigeria recorded net portfolio outflows in Q1'22 (-17% y/y). While portfolio investors remain the dominant capital import providers, their preference for money market instruments waned due to unattractive returns. Rising inflation spurred increased buying interest in the bond (+124% y/y) and equity (+18% y/y) markets.

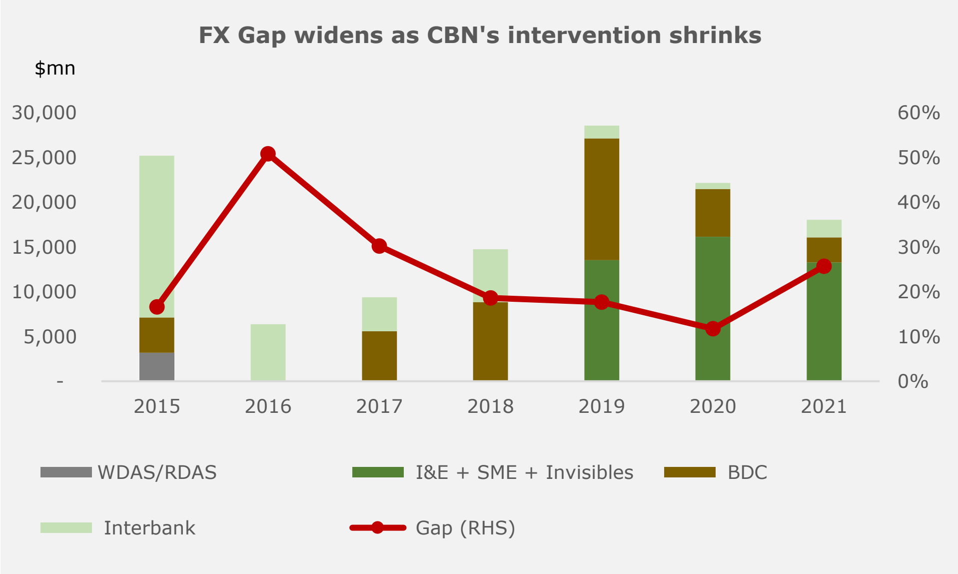
We expect foreign investors to underweight Naira assets in the near term, especially after JP Morgan's concerns on fiscal sustainability. We also recognize risks from pre-election jitters.



Source: CBN, NBS, Vetiva Research

FX Supply wanes as shocks persist

Nigeria's FX crisis has not blown out of proportion yet, at least, not up to 2016 levels. Reserves are above $38 billion, supported by high oil prices, multilateral support, and a Eurobond issuance ($1.25 billion). Although tight financing conditions prevented Nigeria from raising additional funds, reluctance to execute critical reforms could block access to cheaper multilateral loans. The apex bank is likely to manage its intervention scheme in the near term by rationalizing FX allocation. As Bureau de Change (BDC) operators flouted the CBN's permissible spread guidelines, the apex bank decided to cut them off from direct FX supply. Fears of similar treatment to banks have been doused as the FX market reacted negatively to the CBN's call for banks to source dollars independently by the end of 2022. This could induce further weakness in the parallel market. While we recognize the attempts by the CBN to induce non-oil export earnings via its RT200FX programme, we think the immediate drivers of FX supply would still be oil production. As a result, we only see FX supply improving significantly when crude production crosses the 1.7 mb/d benchmark sustainably. This could trigger renewed FX supply to BDCs and ultimately an appreciation in the parallel market.



Source: CBN, Vetiva Research

FX Outlook: The Naira is slightly overvalued

Amid the numerous headwinds, one question on the mind of several investors is, what is the fundamental value of the Naira? Estimating the fundamental value of a currency is usually carried out by estimating the exchange rate that makes the price of a basket of goods equal irrespective of the location. As a result, exchange rates should adjust in line with the changes in prices. While the existence of transaction costs and tariffs could distort valuation, Purchasing Power Parity (PPP) is still used in assessing the competitiveness of economies and the valuation of currencies.

Using the economic and financial market valuations, we find the Naira overvalued in the official market (hence depreciation is possible) and undervalued in the parallel market (hence appreciation is possible). The CBN's PPP estimate places ₦445/$ (as of Dec'21) as the fair value estimate of the Naira. Players in the Investors & Exporters window have a slightly weaker estimate - ₦476/$ (for Dec'22). We note here that the Naira hardly trades at its fair value in the official market. However, it does trade significantly below its fair value in the parallel market during times of crisis. This is what makes speculative hoarding of dollars a bad investment decision, especially when fundamentals normalize. Thus, decent exposure to domestic, foreign, and alternative assets (e.g. commodities) could help mitigate losses from the swings in the Naira.

We believe the adoption of a moving NAFEX rate helps in preventing the Naira from being grossly overvalued before critical adjustments are made. Overvaluation of the NAFEX (6%) is lower than the defunct de-facto peg of ₦379/$ (17%). Thus, we do not see room for any significant downward adjustments in the official value of the Naira (as it was in 2016). The gradual adjustment in the exchange rate also weakens the inflationary pass-through of a one-off devaluation. We expect oil production to remain volatile in H2’22, and as a result, we expect the Naira to weaken slightly to ₦440/$ by the end of H2’22.

In the parallel market, we see elections as a key driver of unofficial exchange rates. Unlike previous elections, primary elections were held early (May – June 2022), giving room for the longest season of election campaigns in the fourth republic. This implies more demand in the retail segment of the market, which has been starved of dollar supply since the proscription of BDCs. We expect the apex bank to step up its inflation-fighting tools to prevent buoyant banking system liquidity from exerting pressure on the Naira. Thus, we believe higher benchmark rates are inevitable in H2’22.

The resumption of FX supply to Bureau de Change operators is still a wild card the CBN could play in H2’22, if Nigeria’s crude production picks up sustainably. This could cause the parallel market rate to appreciate considerably to ₦520/$. However, our base case estimate is premised on a sustained ban on BDCs, which could cause the Naira to slip to new all-time highs of ₦630/$ in the parallel market (Bear case: ₦712/$).

Vetiva Exchange Rate Forecast

Period	Indicator	Forecasts		
		Worst	Base	Best
Jun-22	Reserves ($'mn)	34,301	38,678	40,523
	I&E (₦/$)	460	420	410
	Parallel (₦/$)	612	605	570
Sep-22	Reserves ($'mn)	32,520	37,883	42,409
	I&E (₦/$)	480	430	408
	Parallel (₦/$)	660	615	550
Dec-22	Reserves ($'mn)	31,737	36,770	43,107
	I&E (₦/$)	500	440	400
	Parallel (₦/$)	712	630	520

Source: Vetiva Research

Forecast Assumptions

		Worst	Base	Best
Jun-22	Brent (avg.)	$78/bbl	$95/bbl	$110/bbl
	Imports restriction	Yes	Yes	Yes
	Foreign investors' sentiment	Risk-off	Risk-off	Risk-on
	Crude oil sales	Sustained decline	Volatile	Moderate recovery
	Spending limits relaxed	Yes	No	No
	Ban on BDCs	Remains	Remains	Lifted
	Remittances	Low	Modest	Strong
	External fund raise			Nil
Sep-22	Brent (avg.)	$77/bbl	$94/bbl	$105/bbl
	Imports restriction	Yes	Yes	Yes
	Foreign investors' sentiment	Risk-off	Risk-off	Risk-on
	Crude oil sales	Sustained decline	Volatile	Moderate recovery
	Spending limits relaxed	Yes	No	No
	Ban on BDCs	Remains	Remains	Lifted
	Remittances	Low	Modest	Strong
	External fund raise			$990mn
Dec-22	Brent (avg.)	$70/bbl	$85/bbl	$95/bbl
	Imports restriction	Yes	Yes	Yes
	Foreign investors' sentiment	Risk-off	Risk-off	Risk-on
	Crude oil sales	Sustained decline	Volatile	Moderate recovery
	Spending limits relaxed	Yes	No	No
	Ban on BDCs	Remains	Remains	Lifted
	Remittances	Low	Modest	Strong
	External fund raise			$990mn

Source: Vetiva Research

Risks to the outlook

Health risks

Uneven vaccination rates and a resurgence of the pandemic are downside risks to our outlook. New variants could be vaccine-resistant, and warrant renewed restrictive measures, lower economic activity, and further slowdown in the global economy.

Geopolitics

Given the current tensions between Russia and Ukraine, an escalation into a full-fledged war could fuel market volatility, push commodity prices higher, fuel inflation, intensify the humanitarian crisis, and send the global economy into another recession.

In Asia, China's ambition to seize control of its less powerful neighbour, Taiwan, is causing growing concern, drawing parallels with recent Ukraine-Russia tensions. With growing concerns of escalating tensions, the United States, for one, has vowed to defend Taiwan with its military forces if China launches an attack. An attack on Taiwan will come with both humanitarian and economic consequences, as the nation continues to be a major producer of computer chips, which power much of the world's electronic equipment.

In East Asia, following President Biden's visit to US allies, South Korea and Japan, North Korea conducted its first nuclear test in five years. Though North Korea has not made any significant moves, an attack could be disastrous; however, the US has reiterated its commitment to defending its allies.

Financial risk

Tight financing conditions could make borrowing difficult and push emerging economies closer to a debt crisis. Weaker currencies and higher domestic interest rates to improve the carry trade could impede fiscal capacity to respond.

Domestic Risks

Uncertainties could cloud growth in Nigeria, as the focus shifts from policymaking to politicking. Increased dollar demand for electioneering activities, oil theft and unrest in the Niger Delta region, could exert significant pressures on the Naira. Insecurity in food-producing states could trigger famine alerts, amid constrained food supply chains on the global scene.

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