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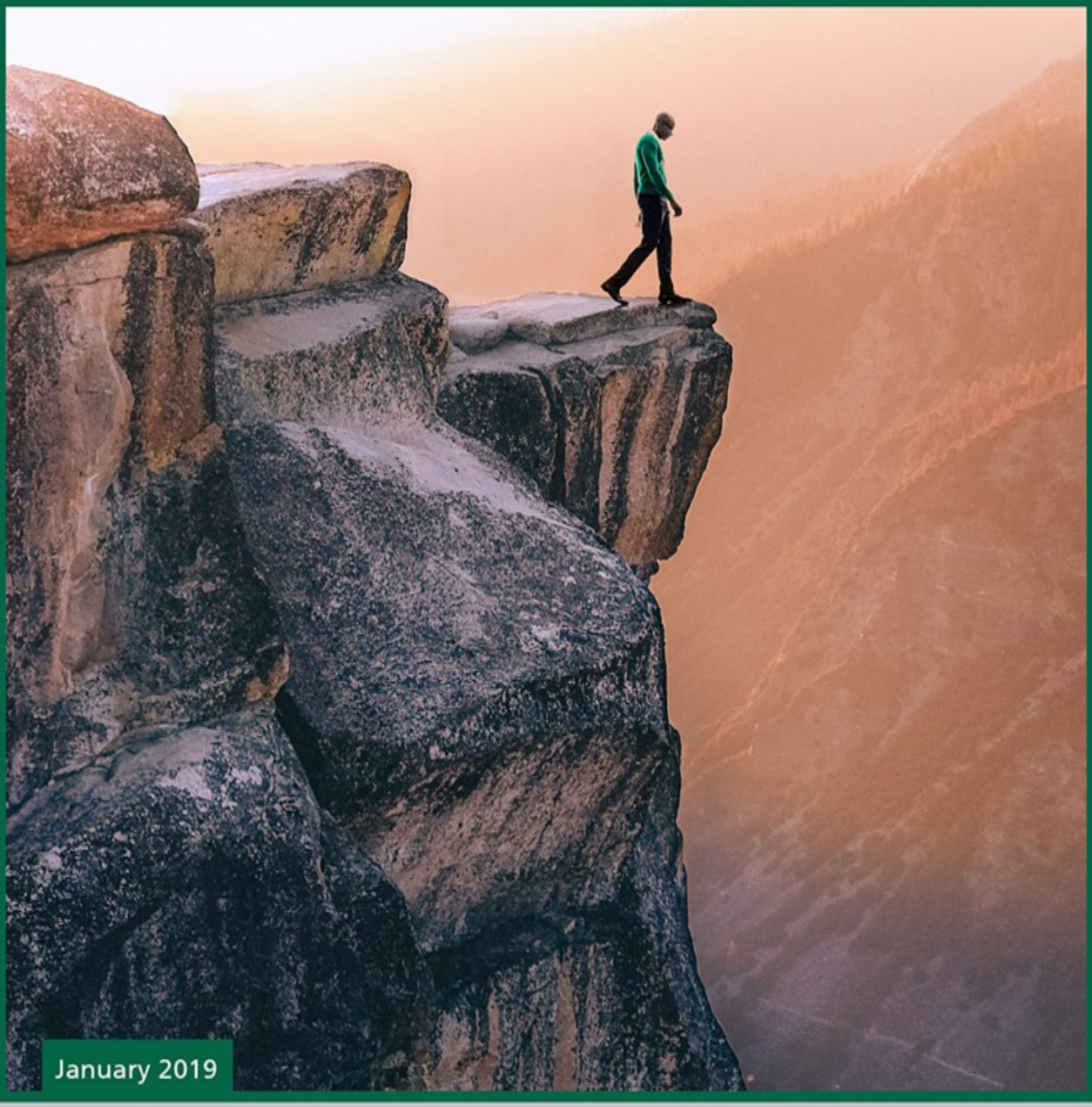
The Nigerian Economy and Financial Markets | **2018 Review & 2019 Outlook**



January 2019

On the Precipice

Outline

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Executive Summary

Global Macroeconomic Highlights

Trade Wars…A Threat to Global Growth

In its April 2018 World Economic Outlook (WEO), the International Monetary Fund (IMF) initially estimated global growth at 3.9% in 2018, owing to expectations of sustained momentum in advanced economies and emerging markets. However, in its October 2018 WEO, the IMF revised global growth downwards to 3.7% in 2018 – unchanged from growth in 2017. The downward review in growth mainly reflected slower than expected economic activity in advanced economies as global trade and industrial production declined.

In 2019, global growth is anticipated to remain unchanged at 3.7%, revised downwards from the initial forecast of 3.9% in April 2018. This is expected to reflect an uneven pace of economic activity across the world as slower global trade, tighter financial conditions and political risks soften economic activity. The IMF hinted that growth has peaked and is expected to decelerate over the medium-term. In advanced economies, growth is projected to slow to 2.1% in 2019 from 2.4% in 2018. Similarly, growth is expected to stay at 4.7% in 2019 in Emerging Markets and Developing Economies (EMDEs), unchanged for three consecutive years.

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Moderating Global Growth Prospects to Weigh on Oil Demand

The rally in oil prices, which began in 2017, was sustained into 2018 as global oil demand improved, with oil prices reaching a 2-year high of US$86.29/b (03/10/18). In addition to improved demand for oil, higher oil prices were expected as renewed sanctions on Iran curbed global oil supply. On the contrary, a downturn was recorded in the market as oil prices trended lower owing to waivers granted to eight countries to continue importation of Iranian oil as well as increased supply from the US (17.8mb/d) which now produces more oil than Saudi Arabia (12.1mb/d) and Russia (11.2mb/d). Despite weaker prices in the last two months of 2018, oil prices averaged US$71.7/b, higher than the average oil prices of US$52.51/b in 2017.

In 2019, the prospects for higher oil prices are dim, with oil prices estimated to average US$60.0 /b which is below the average of US$71.7/b in 2018. The projected oil price reflects steady oil supply and a moderate increase in global oil demand due to the ongoing slower global growth momentum.

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Sustained Policy Normalisation from Systemically Important Central Banks

Monetary policy in advanced economies has largely been accommodative since the global financial market meltdown in 2008, providing cheap capital to support economic growth. However, in recent times, central banks in advanced economies have guided towards a tighter monetary policy, in line with pre-crisis conditions. In emerging markets, monetary authorities have responded by also adopting a tighter monetary stance to keep rates attractive in order to retain and sustain capital flows.

The major theme in 2019 is likely to be monetary policy convergence across advanced economies. We believe central banks of developed economies will continue to reverse accommodative monetary policy stances and eventually follow the Federal Reserve's path towards higher interest rates. This is expected to negatively impact Emerging Markets (Ems) owing to capital flow reversals, but the extent to which policy normalisation will have a negative impact is

uncertain given a moderating growth outlook for developed markets and the global economy.

Turmoil in Global Financial Markets amidst Geopolitical Tensions

Following a bullish run in global markets in 2017, the year 2018 started with the same positive momentum. However, concerns of weaker economic growth, geopolitical tensions and uncertainties surrounding trade disputes resulted in sell -offs across equity markets. As a result, the MSCI World, Emerging and Frontier Markets indices all posted negative returns in 2018.

The Federal Reserve has led the charge for policy normalisation raising rates four times in 2018 to 2.25-2.50% on the back of stronger economic growth driven by rising consumer spending, low unemployment and steady inflation around the 2.0% target. As a result, the benchmark 10-year treasury yield reached a seven-year high of 3.2% which triggered volatility across global markets. Against the backdrop of expected rate hikes and sustained monetary tightening in the US and other advanced markets in 2019, we anticipate continued volatility in emerging and frontier markets. Also, in Europe, Brexit and the EU-Italy fiscal standoff are poised to have significant effect on market performance.

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Domestic Macroeconomic Highlights

2019 Elections: Politics Takes Centre-Stage

In many ways, our outlook for 2019 is dependent on the outcome of the general elections and the likely impact it will have on the overall economy. The presidential election will be a tight contest between the two leading political parties, similar to 2015 when President Buhari of the All Progressives Congress (APC) unseated President Jonathan and the People's Democratic Party (PDP) which had hitherto been in power for sixteen years. In 2015, anti-corruption, security and the economy were on the ballot. President Buhari was considered an honest politician who would fight corruption and a former army general capable of resolving Boko Haram insurgency as well as security issues in the Niger-Delta. Similarly, President Buhari received wide approval because he promised social interventions to reduce poverty. This was because despite robust growth under the PDP, inequality and poverty worsened.

Going into the 2019 elections, these issues are still on the ballot, but the larger part of the conversation has been focused on the economy. Growth has retreated, below long-term growth rate of 6-7%, just as unemployment & underemployment have worsened at 23.1% and 20.1% respectively in Q3:2018 (8.2% and 18.3% respectively in Q2:2015). According to a report by the Brookings Institution, Nigeria now has the highest number of poor people in the world making Nigeria the world's poverty capital. Also, while security has improved slightly, the risk of instability is still elevated across regions. In the North-East, Boko-Haram continues to wreak havoc. In the South-East, secessionist agitations which have recently calmed down remain a latent risk, while conflict between farmers and herders has elevated insecurity in the Middle-Belt of the country. Meanwhile, the situation with cattle rustling in the North-West is yet to abate. In the Niger-Delta, a delicate pact has restored calm, but the situation remains precariously balanced.

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Real GDP: An Improved but Sluggish Growth Expected in 2019

In 2018, two distinct growth paths emerged. However, the pace of growth remained slow and uneven, well below our historical long-term growth rate of 6 -7% and the pre-recession level of 2.8%. Real GDP growth came in at 1.9% in Q1:2018, below our estimate, due to a poor performance in the Service sector and a slower expansion in Agriculture. In Q2:2018, growth further moderated to 1.5% due to both a 5.0% contraction in oil output and a slump in Agriculture growth to 1.2% - the lowest in more than a decade. In Q3:2018, growth came in better at 1.8% but this was slower than the 2.1% we expected. Oil output contracted by 2.9% and agriculture growth remained weak at 1.9% in Q3:2018. This prompted a revision of our forecast of FY:2018 growth to 1.9% from 2.1%.

Our growth expectations in 2019 are somewhat linked to the outcome of the election. We modelled three scenarios to capture different effects:

1. the Base case assumes that President Buhari wins the election, there is policy continuity, and not much else changes.
2. the Optimistic case is that regardless of the winner, the government implements reforms to attract investment.
3. the Pessimistic case assumes that political risks intensify and leads to continued violence in the Middle-Belt, North-East and the Niger-Delta.

In our '**Base case**' for 2019, we do not expect a marked turnaround in the economy. We estimate that growth will improve to 2.5% from 1.9% in 2018 based on the expectation of improved oil GDP and sustained expansion in the non-oil sector. This forecast implies that with population growing at 2.6-3.0%, Nigerians are projected to remain poorer on the average in 2019. We believe this growth outcome will reflect a soft rebound in Agriculture, increased oil output and better performance in the Services and Manufacturing sectors. The downside risks remain the slower than expected recovery in Agriculture, oil prices below budget benchmark of US$60.0/bl and oil production at less than 2.0mb/d (including condensates).

In our '**Pessimistic case**', we expect the impact of insecurity to be felt through lower agricultural and oil output. We assume that the decline in oil production will mirror the drop seen between Q2:2016 and Q3:2016. For agriculture, we expect growth to continue at its underwhelming pace of sub 2.0%. The combined impact of these will lead to a moderation in growth below 1.0%. Meanwhile, growth in the Services and Manufacturing sectors will weaken as lower oil exports and investment prompt an exchange rate depreciation. This will lead to high input costs for manufacturers and pricing adjustments will affect consumer purchasing power.

In our '**Optimistic case**', we expect reforms to set the pace for H2:2019. Most important is the removal of energy subsidies which will improve government revenues. We also expect increased private sector investments due to the liberalisation of the downstream Oil & Gas and Power sectors. Although this is likely to inflict pains in the short-term, gains will not be visible until the medium-term. Hence, while we forecast GDP to slightly expand at 2.7% in 2019, we expect a faster pace of growth in the medium-term. The main risks to our projections remain poor implementation of reforms and the lack of political will to follow-through on proposed plans.

Inflation Outlook: Power and Oil & Gas Reforms Pose Inflationary Risks

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deceleration to a 30-month low of 11.1% in July 2018 (January 2018: 15.1%). This disinflation was mainly driven by a high base and continued exchange rate stability. However, the streak turned for most of H2:2018 as inflation rose slightly due to a low base, although moderating food prices tempered the increase in headline inflation. We estimate monthly inflation to average 12.2% in 2019, an improvement over 16.5% in 2017.

In 2019, we expect inflation to remain elevated at double-digit levels but we note that the inflation trajectory remains largely unclear for various reasons. The biggest downside risk we foresee is supply shocks. These will come from an adjustment of petrol and electricity prices as well as continued insecurity in the food planting Middle-Belt. In our opinion, the impact of the new minimum wage will be moderate as funding remains unclear due to weak government finances. This will likely cause implementation to suffer, especially at the sub-national level.

External Balance: Oil Prices and Remittances Provide Support

Nigeria's external balance was strong in H1:2018, sustaining its return to positive territory since Q4:2016. The external balance also breached record highs during H1:2018 as the global environment was favourable. In H2:2018, the diverse headwinds we expected crystallised. Capital flow reversals intensified due to increasing interest rates in advanced economies which made EMs and Frontier Markets (FM) assets less attractive. Geo-political risks – the spat between Turkey and US for example – spurred a contagion which led to capital outflows in EMs and FMs. The broad implication of these headwinds was depreciations of currencies and negative external balances. South-Africa, Turkey and Argentina recorded the deepest currency depreciations in EMs while Nigeria saw mild depreciations at year-end 2018.

In 2019, we expect sustained positive current account balances due to stable remittances, expectation of stable oil production at around 2.1mb/d and stable oil prices at US$60.0. However, the current account balance to GDP is expected to slightly moderate due to slower growth in trade surplus. Post-2019 elections, we could see the return of investors as there is more clarity. This would support a much-improved external position. Also, fewer rate hikes by the US Fed would also support improved capital flows. However, weak economic prospects in the UK due to Brexit and the halt of monetary stimulus in the EU are major downside risks to capital inflows.

Exchange Rate to Breach Resistance Levels in 2019

The exchange rate stability which we anticipated was achieved for most of 2018. The official rate remained unchanged from N305.00/US$1.00, its level since September 2016. However, in the I&E window and parallel market, rates converged at N360.00/US$1.00. The current account balance to GDP which hit a five-year high of 4.4% in Q2:2018 supported exchange rate stability. However, turbulence soon emerged in H2:2018 when investors retreated from emerging and frontier markets. In Nigeria, policy uncertainty as a result of the upcoming elections also made investors jittery. Consequently, increased FX demand led to depreciation in rates to N366.00/US$1.00 in the parallel market and the rate at the I&E window was also pressured. To support stability, the CBN responded by

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increasing the size and frequency of its intervention for BDCs and this restored calm.

In 2019, the currency faces a downside risk. Foreign capital flows may remain constrained due to both political risk and elevated interest rate in advanced economies. This will heavily impact Nigeria's external position and weaken external reserves accretion. However, the CBN has guided towards a tight monetary policy stance which should help attract capital inflows. We also expect a stable current account surplus to support reserves accretion, if oil production remains steady at 2.1mb/d as expected, and oil prices remain above US$50.00/b. Overall, we believe the exchange rate will remain stable, especially in H1:2019, since the CBN has ample reserves for interventions. However, we note that pressures on the currency will intensify in H2:2019. Hence, we may see a depreciation in the currency to N401.00/US$1.00, mirroring the rate of 12-month non-deliverable forwards quoted on Bloomberg. We note that the likely emergence of a new CBN governor by mid-2018 may result in a new exchange rate policy.

Monetary Policy to Remain Tight in 2019

The monetary policy environment has remained tight since 2016 despite weak economic growth. While growth has stayed below population growth rate of 2.6% since 2016, inflation has remained elevated at double-digit – slowing to 12.2% monthly average in 2018 (2017: 16.5%). With price stability as objective, the MPC retained Monetary Policy Rate at 14.0% with a corridor of +2%/-5% in 2018, as well as Cash Reserve Ratio at 22.5% and liquidity ratio at 30.0% in 2018.

Looking forward, the guidance offered by the Bank so far is that the restrictive monetary policy stance will remain in place for the early part of 2019. This is due to expected inflationary pressures from food shortages, fiscal spending and possible implementation of a new minimum wage of N30,000/month. In our view, food shortages and a devaluation in exchange rate are the biggest threats to inflation, as well as pricing adjustments for electricity and petrol.

Nigerian Financial Markets

Equities Market Pressured in 2018 … Recovery Slated Post-Elections?

The performance of the domestic bourse in 2018 was largely bearish as sustained sell offs dragged the benchmark index down 17.8%. The year began with optimism, riding on the positive wave of 2017 which was stoked by the launch of the Investors' & Exporters' (I&E) FX window but this slowly dissipated by the end of January 2018. In January, the benchmark index rapidly accelerated to as high as 17.9% (19/01/2018) before the bearish run set in. The gains recorded at the start of the year were largely in line with our views on the performance of the market for 2018, although we expected a weaker performance for H2:2018 as jitters of the impending elections filtered in. However, the impact of the upcoming elections was somewhat underestimated as this was a major drawback to market performance in the year alongside increased policy normalisation in systemically important central banks.

Consequently, investor sentiment remained weak for the greater part of 2018 despite rising oil prices and stronger reserves (2018 high US$47.9bn on 10/5/2018) as foreign and domestic participation in the market waned significantly. On the average, domestic investors accounted for 50.5% of transactions relative to 49.5% of foreign investors, while net value of transactions by foreign investors

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was negative as outflows (N513.5bn) surpassed inflows (N477.7bn).

In 2019 we expect that equities will remain unfavoured by investors until after elections, which wraps up in March 2019, when the effect of the negative sentiment is expected to dissipate. Also, we opine that some of the expected drivers of market performance in 2018 still hold true, although we do not expect the impact to be seen until after the elections. Against this backdrop, we forecast market performance to strengthen in 2019 and we highlight some key themes that are anticipated to shape the market. These factors include:

- Post-Election Stability Leading to Return of Foreign Investors
- New listings
- Corporates' Earnings Performance
- Sustained improvement in Macroeconomic Indicators

Finally, we modelled market return scenarios around expectations on domestic monetary and fiscal policy, possible election outcomes, momentum of economic growth, dynamics of funds flow and outlook on global growth with the possible effect on policy normalisation. Although we are positive on equities market performance post-elections, our expectation hinges on possible scenarios amidst the various risk factors envisaged for equity investing in 2019. We conceptualized three major possible outcomes that could play out irrespective of the winner of the presidential elections. Consequently, our forecasted market return for 2019 on the three scenarios are Bear: -33.4%, Base: +42.0% and Bull: +117.7%.

Our '**Pessimistic Case**' with a probability of 40.0% envisions a less likely post-election violence characterised by slower than expected pace of economic growth in addition to negative signals in monetary policy management and increased pace of policy normalisation, especially from the Bank of England (BoE). We estimated that this scenario would necessitate at least 20.0% decline in market EPS and force P/E as low as 6.7x; hence, crystallising in 33.4% decline in the broader index by year end.

Our '**Base Case'** assumes that the status quo is maintained in major policy disposition with successful and violence-free elections, irrespective of the winner, this will result in a base case. Our scenario also envisages that the country maintains slow but steady economic growth path with fiscal and monetary policy conditions subsisting while current pace of global policy normalisation remains. In our analysis, this scenario would result in a 6.8% EPS growth with higher market P/E (11.4x) resulting in 42.0% market return. We believe the possibility of this occurrence is most plausible at 50.0%.

In our '**Optimistic Case'**, which we assess as the least likely scenario in our view with a probability of 10.0%, given the current realities, we assume a change in monetary and fiscal policy to drive investments would improve macroeconomic fundamentals. This scenario would be most bullish for equities if combined with liberalisation of downstream oil and gas sector, new big listings on the NSE (including MTN) and weaker than expected global growth that could reverse the current course of policy normalisation. This we estimate would result in 15.0% growth in EPS with estimated market P/E at 15.2x and market return of 117.7%.

Fixed Income Market Volatility Tempers …

We forecast market performance to strengthen in 2019 and we highlight some key themes that are anticipated to shape the market. These factors include:

- Post-Election Stability Leading to Return of Foreign Investors
- New listings
- Corporates' Earnings Performance
- Sustained improvement in Macroeconomic Indicators

The fixed income market was quite volatile in 2018, similar to the previous year, even as the Monetary Policy Committee (MPC) opted to maintain the policy rate at 14.0% through the year. The Central Bank of Nigeria (CBN) maintained its tight monetary stance more vigorously as issues around weak global growth, heightened polity risk and higher interest rates in advanced economies which prompted capital flow reversals in developing markets came to the fore in 2018.

From the direction of yields through the quarters in 2018, the volatility in the market was apparent, with the sharpest moves recorded at the short-end of the curve. This afforded investors the opportunity to record substantial gains in the year, as the CBN utilised policy levers to affect market yields and stem intensifying capital flow reversals precipitated by a combination of EMs and FMs market pressures and policy normalisation by systemically important central banks.

We expect the policy normalisation in the US and UK, as well as the EU's decision to end its asset purchase program in 2018, to continue to play a part in defining the narrative in 2019, given the expected impact on the direction of capital flows. Nonetheless, we do not expect a significantly different direction to monetary policy from what was witnessed in 2017, with the focus still on driving growth and maintaining price stability.

The Nigerian economy is expected to remain on a tentative path of growth, just as monetary policy is expected to remain tight in the face of expected pressure. However, with risk factors such as policy normalisation in the US and UK and cessation of monetary easing in the EU, as well as soft issues such as the potential change of the CBN governor expected to crystallise in the year, we expect more volatility, that should allow investors position and ride the curve to boost income. Overall market yields on Treasury Bills and Bonds are anticipated to moderate by c.2.0% apiece to the range of 13.0-13.5% in 2018 with the yield curve transitioning back to steepness.

We expect yields to maintain an uptrend going towards the presidential elections which will be held in February 2019, with average yields on bonds and Treasury Bills forecasted to top out at the 16.0% level. Following the end of the elections, we anticipate a resurgence in capital inflows into the country, which should result in a moderation in yields as foreign investors take advantage of relatively high yields in the market. This expectation is however dependent on the peaceful transition of the new government, be it the incumbent or an opposition candidate. We highlight some of the revelations from our crystal ball below:

- Inflationary Pressure Could Buoy Rates
- Short-term Yield Spike Provides Opportunity
- Yields on Long-Term Instruments Optimal for Duration Play
- Eurobonds Market Will Continue to Hold Trading Value
- Real Sector Support Facility Will Drive Corporate Issuances

Investment Strategy: Optimising amid Cautious Optimism – In Search of Value!

Developments within global and domestic markets cast doubts on investor optimism for optimal returns in an – expected to be keenly contested – election year. Whilst there is a clear case of undervaluation of Nigerian equities and a

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relatively higher yield environment compared to frontier and emerging market peers, we imagine that, in search of value, investor confidence will be laced with caution in 2019. Earlier in 2018, our investment strategy had envisioned an equities market driven by sound fundamentals in the first half but with price corrections in H2 while lower yield in the second half of 2018, after rising yield in H1, was forecast to inspire a bullish performance in the fixed income market.

Sadly, rising interest rates in the US and UK, coupled with anticipatory election apprehensions, compelled a bearish equity outing while sustained high yield environment, yet less active fixed income market, especially at the long end of the yield curve, delivered less desirable return. Again, as the markets refocus with renewed vigour in 2019, worries around the possible election outcomes, which could sustain recent bearish tone set since 2018, remain the greatest consideration for determining the most optimal strategy that will deliver alpha.

Hence, our strategy preaches significant overweight on the fixed income market for H1:2019 and a balance of play between equities and fixed income markets in H2:2019. Election concerns are projected to further drain equities market performance until a peaceful transition is achieved in May. Conditioned on other macro and market developments, this is anticipated to largely swing equity sentiment for unmatched bullish run. Yet, regardless of policy changes post elections, for as long as a successful government transition holds sway, the yield environment should moderate and swell fixed income assets by H2:2019.

On the Precipice!

The year 2017 seemed to herald a resurgence of the Nigerian economy as exports recovered and investor confidence was restored in the FX market following the introduction of the I&E window. However, these only papered over the cracks as strong economic growth has been elusive and calm is yet to return in troubled regions. We observe that the widespread economic challenges that induced a recession in 2016 persist and will be exposed by any substantial economic pressure. These issues prompted us to highlight the dire economic outcomes we foresee in the medium-term in our 2018 Banking Sector Report:

"*… in view of the insufficient response to economic frailties so far, we believe that challenges facing the Nigerian economy are bound to persist. The two pillars of growth since the start of the millennium within the non-oil sector – agriculture and services sector – have come under enormous pressure of late and only a rejig of the current economic structure and fundamentals through reforms will provide respite. As critical structural reforms have been abandoned, we only anticipate anaemic growth, making a return to trend over the next five years highly elusive. Already, forecasts from the IMF also paint a worrying picture with the suggestion that Nigeria could suffer declines in per capita income up till 2023 – this would indicate eight-consecutive declines from 2016.*"

The Nigerian economy is currently at crossroads, and 2019 is a defining year considering the grim socio-political and economic developments in recent times. Since the 2015 elections, growth has persisted below the long-term growth rate of 6-7.0%, the unemployment rate has more than doubled from 9.9% in Q3:2015 to 23.1% in Q3:2018 and insecurity has spread across all regions of the country. Furthermore, according to World Data Lab, the highest number of extremely poor people in the world can be found in Nigeria.

The issues which plague the Nigerian economy and market are storied and have been reflected by us through various publications. In our view, the country has

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come to a point where there needs to be a reset to set the country on the path of prosperity or the country faces a bleak future from which the path to recovery may extend through a generation. In our 2018 Banking sector Report, we highlighted an Economic Agenda for A New Government, focused on 7 key areas where we believe market-driven reforms can drive strong economic growth and development. These included;

1. Oil & Gas Sector reform
2. Power sector reform
3. Boosting economic competitiveness
4. Transportation & Infrastructure
5. Human capital development
6. Reorganising security architecture
7. Building Stronger institutions

The cost of inaction cannot be overstated as we move towards another important inflexion point. The risk factors remain on the horizon and remain poised to break the bonds of this tenuous seal. The country remains vulnerable to oil price shocks as buffers remain weak. While crude oil production levels are expected to increase, latent security risks in the Niger-delta region, amid volatile oil prices could pressure government finances. Crude oil receipts pressure would most definitely filter into FX liquidity risk, which would exert immense pressure on the economy. The issues are rife and seemingly insurmountable, if political expediency remains the first set of criteria for decision making.

We view the country as being "On the Precipice" because this point in history will determine the next cycle and could very well lock the country into a spiral of weak or contracting growth or lay the foundations upon which the country emerges to the high phase of growth only witnessed not so long ago. Hence, in many ways, our outlook for 2019 and for the medium-term is dependent on the elections and the likely impact it would have on the overall economy.

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- Power sector reform
- Boosting economic competitiveness
- Transportation & Infrastructure
- Human capital development
- Security
- Building Democratic institutions & Imbibing Professionalism in Governance

Section Two

Global Macroeconomic Review and Outlook

Global Macroeconomics and Financial Markets

Trade Tensions…A Threat to Global Growth

In its April 2018 World Economic Outlook (WEO), the International Monetary Fund (IMF) initially estimated global growth at 3.9% in 2018, owing to expectations of sustained momentum in advanced economies and emerging markets. However, in its October 2018 WEO, the IMF revised global growth downwards to 3.7% in 2018 – unchanged from growth in 2017. The downward review in growth mainly reflected slower than expected economic activity in advanced economies as global trade and industrial production declined. In the US, growth momentum from 2017 was sustained, supported by fiscal stimulus from President Trump's tax cuts. However, growth disappointed in the Euro Area and United Kingdom (UK) due to slower export growth, weak demand due to higher energy prices in net importing countries and political uncertainty. In Emerging Markets and Developing Economies (EMDEs) growth remained moderate; in emerging Asia, China's economy slowed, although a better momentum in India helped offset this weakness. Commodity exporters buoyed growth in Sub-Saharan Africa (SSA), helped mainly by higher prices. In Latin American countries such as Argentina and Brazil, political risk affected investor sentiment and drove lower economic activity.

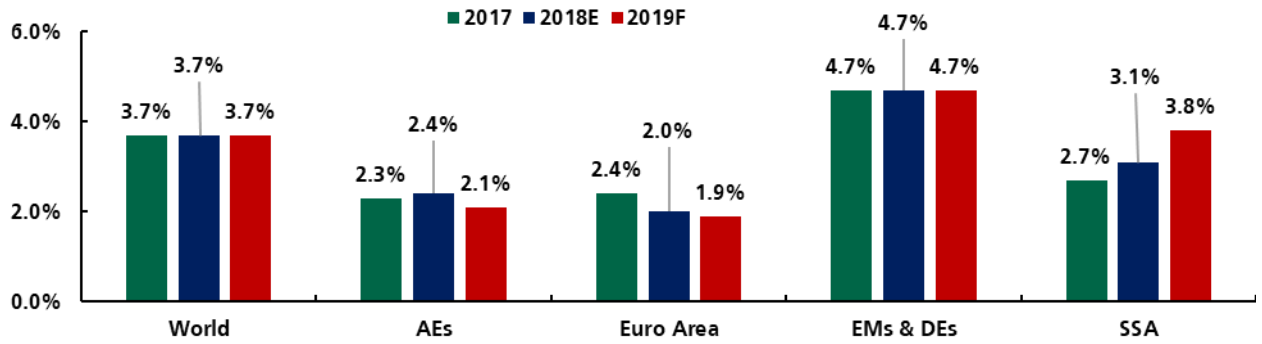
Global growth in 2019 is also anticipated to remain unchanged at 3.7%, revised downwards from the initial forecast of 3.9% in April 2018. This is expected to reflect an uneven pace of economic activity across the world as slower global trade, tighter financial conditions and political risks soften economic activity. In advanced economies, growth is projected to slow to 2.1% in 2019 from 2.4% in 2018. The IMF hinted that growth has peaked and is expected to decelerate over the medium-term. This is especially so in the US where the impact of recent fiscal stimulus is expected to fade, suggesting lower positive spillovers to the rest of the world. In EMDEs, growth is expected to stay at 4.7% in 2019, unchanged for three consecutive years. This would reflect a slowdown in emerging Asia where growth is estimated 0.2ppts lower at 6.3%, driven by weaknesses in China and the ASEAN-5. In Emerging and Developing Europe, a further slowdown is expected to 2.0% in 2019, showing a sustained sharp weakness since a growth of 6.0% in 2017. In Latin America, the Caribbean, Middle East & North Africa and SSA, a stronger momentum in growth is expected to partly offset the deceleration in other major regions.

Elevated Downside Risks Weigh on Global Growth Prospects

Trade tensions and tighter financial conditions are the two main risks likely to weigh on global growth in 2019. Higher interest rates due to policy normalisation in systemically important banks such as the US Federal Reserve (US Fed) and the unwinding of quantitative easing by the European Central Bank (ECB) have resulted in volatility in financial markets and net capital outflows from emerging and frontier markets. The implications are weaker currencies and lower growth prospects, especially for economies with greater financing needs. Meanwhile, the trade war is expected to weigh on growth because the US and China have strong linkages with the rest of the world through global trade and the financial markets.

The protectionist sentiment of President Trump prompted the trade war as higher tariffs on Chinese goods were implemented to reduce US' trade deficit with China. In mid-2018, the US announced a tariff of 15.0% on US$50.0bn worth of Chinese goods and China retaliated with tariffs of 25.0% on US$50.0bn worth of US goods. Despite several trade negotiations, both

Chart 1: IMF's Global Growth Forecast (2017 – 2019F)



Source: IMF, Afrinvest Research

countries could not secure a trade deal. Hence, by year-end 2018, the US and China had placed import tariffs on US$250.0bn and US$110.0bn worth of goods on either side respectively. The tariffs have been imposed on aluminium, steel, agricultural and technological products while Intellectual Property (IP) protection has remained contentious.

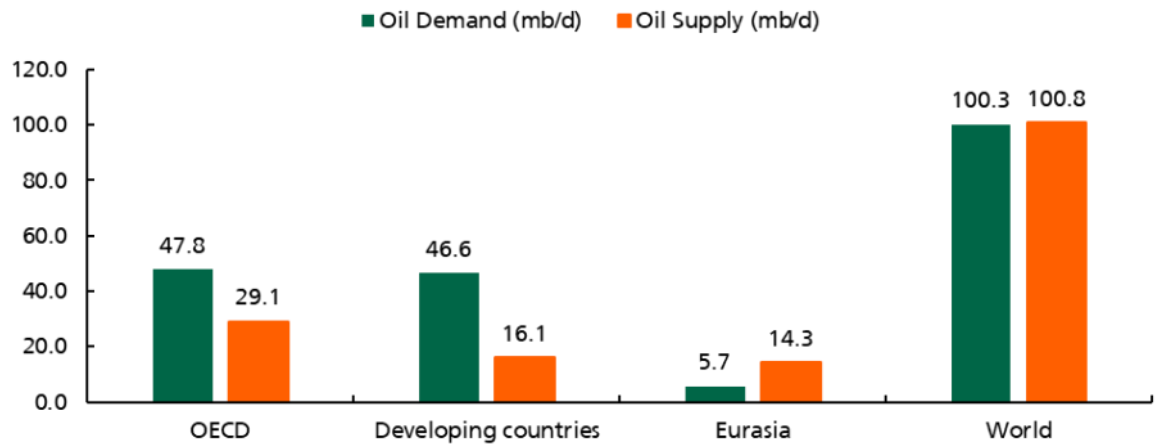
Towards the end of 2018, a 90–day ceasefire was reached as the Presidents of both countries met on the side-lines of the G-20 Summit. This allows for more negotiations with the aim of reaching a trade deal that works for both parties. Without a deal at the end of the stipulated period in 2019, we expect hostilities to resume. There is a likelihood that the US. President, Donald Trump, will impose tariffs on additional US$267.0bn worth of Chinese goods imports and we expect China to retaliate. We anticipate that continued trade friction would reduce the growth prospects of both countries and result in sustained volatility in global financial markets. Although the growth forecast for 2018 remained unchanged at 2.9% for U.S. and 6.6% for China, the IMF revised downwards its growth projections for the US to 2.5% in 2019 (from 2.9% in IMF's April outlook) while China's growth projections was also revised to 6.2% (from 6.4%). For the global economy, heightened trade tensions could have a dire impact on long-term growth given the combined size of both economies. The Sino-American trade relations are expected to be negotiated before March 1, 2019, after which the direction of global trade would be clearer. However, the outcome of the trade talks is uncertain at this time as both US and China maintain a hard stance on policy positions and would need to make significant concessions for progress.

Moderating Global Growth Prospects to Weigh on Oil Demand

The rally in oil prices, which began in 2017, was sustained into 2018 as global oil demand improved, with oil prices reaching a 2-year high of US$86.3/b (03/10/18). In addition to improved demand for oil, higher oil prices were expected as renewed sanctions on Iran curbed global oil supply. On the contrary, a downturn was recorded in the market as oil prices trended lower owing to waivers granted to eight countries to continue importation of Iranian oil as well as increased supply from the US (17.8mb/d) which now produces more oil than Saudi Arabia (12.1mb/d) and Russia (11.2mb/d). Despite weaker prices in the last two months of 2018, oil prices averaged US$71.7/b, higher than the average oil prices of US$52.5/b in 2017.

In 2019, the prospects for higher oil prices are dim, with oil prices estimated to average US$60.0 /b which is below the average of US$71.7/b in 2018. The projected oil prices reflect steady oil supply and a moderate increase in global oil demand which is due to the ongoing slower global growth momentum. On the supply side, oil production is expected to expand slower at 1.4% to 101.8mb/d, mainly reflecting the divergent strategies of both the US and OPEC+ – a coalition of OPEC and other major exporters such as Russia. The United States is expected to boost production by an additional 1.8mb/d in 2019 to 19.6mb/d. However, OPEC+, reached a deal to cut supply by 1.2mb/d in December 2018 to support prices. Hence, OPEC supply is expected to moderate to 38.3mb/d in 2019. On the demand side, global oil demand is expected to remain upbeat, although the anticipated slowdown in the global economy cast doubts on a fast-paced expansion. With oil demand expected to increase 1.6% to 101.6mb/d, the global oil market seems to be balanced and this informs the projection of oil prices at

Chart 2: Global Oil Demand and Supply by Region (2019F)



Source: OPEC, Afrinvest Research

current levels. The demand for oil is expected to be driven by both advanced economies, represented by OECD countries, and by a much faster growth in Non-OECD countries.

Global Monetary Policy: Sustained Normalisation in Systemic Central Banks

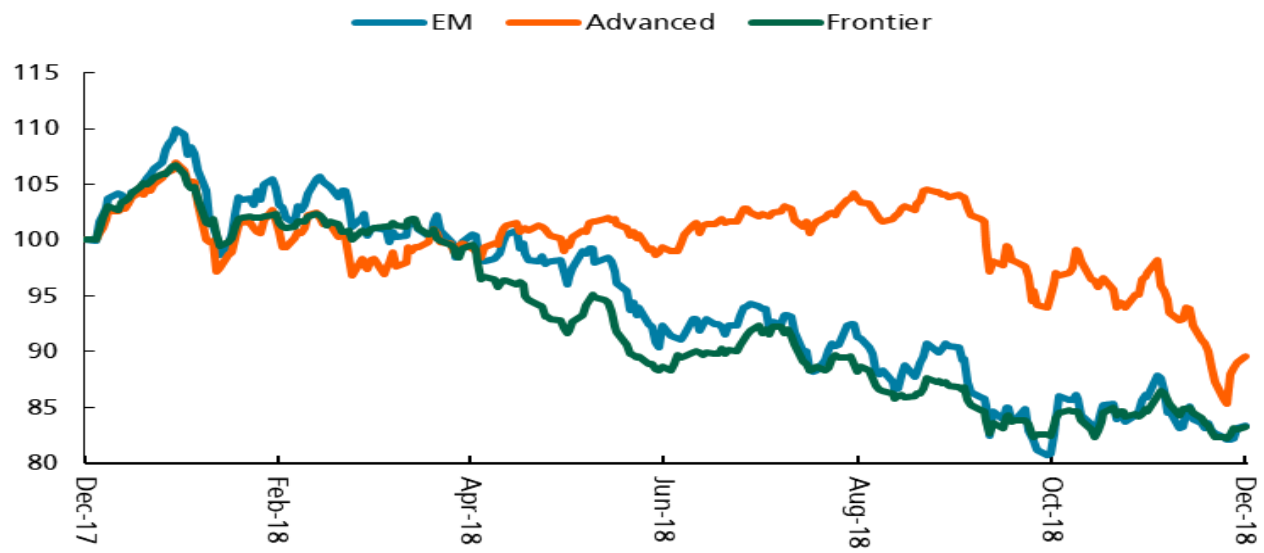
Monetary policy in advanced economies has largely been accommodative since the global financial market meltdown in 2008, providing cheap capital to support economic growth. However, in recent times, central banks in advanced economies have guided towards a tighter monetary policy, in line with pre-crisis conditions. In emerging markets, monetary authorities have responded by also adopting a tighter monetary stance to keep rates attractive in order to retain and sustain capital flows.

The major theme in 2019 is likely to be monetary policy convergence across advanced economies. We believe central banks of developed economies will continue to reverse accommodative monetary policy stance and eventually follow the Federal Reserve's path towards higher interest rates. This is expected to negatively impact Emerging Markets (EMs) owing to capital flow reversals, but the extent to which policy normalisation will have a negative impact is uncertain given a moderating growth outlook for developed markets and the global economy.

The Federal Reserve has led the charge for policy normalisation, raising rates four times in 2018 to 2.25-2.50% on the back of stronger economic growth driven by rising consumer spending, low unemployment and steady inflation around the 2.0% target. As a result, the benchmark 10-year treasury yield reached a seven-year high of 3.2%, which triggered volatility across global markets. However, forward guidance from the FOMC suggests that the pace of rate hikes will temper in 2019. Specifically, two rate hikes are expected in 2019 with a projected interest rate band of 2.5-3.5%.

The US economic situation contrasts sharply with the unimpressive economic performance in Europe where the pace of policy normalisation has been slow. The ECB reduced its monthly asset purchase programme from € 30.0bn to € 15.0bn in October 2018 before ending asset purchase programme in December 2018. However, guidance from the ECB suggests that the benchmark interest rate would most likely be retained through the first half of 2019 given weak growth and inflation expectations. In the UK, as Brexit clouds the direction of the economy, the MPC unanimously voted to retain rates at 0.75% in October 2018 after a previous 25bps hike in August. Inflation in the UK has persistently been above target of 2.0% and the Bank of England (BoE) envisages a tightening of monetary policy if the economy moves in line with projections of 1.8% GDP growth in Q4:2018 and stable unemployment rate of 4.0%.

Chart 3: MSCI Indices Performance (Dec 2017-Dec 2018)



Source: MSCI, Afrinvest Research

The Bank of Japan's (BoJ) monetary policy has been mostly stable and unchanged throughout 2018. In its October meeting, a decision was made to maintain short-term policy rate at -0.1% and long-term interest rates (10 -year yields) at 0.0%. Inflation has remained below the bank's target of 2.0% and Japan's easy monetary policy and negative policy rate have not produced desired results. The BoJ guided towards sustaining monetary expansion, QQE (Quantitative and Qualitative Easing) and yield curve control for an extended period until it reaches inflation that sustainably exceeds 2.0%.

Turmoil in Global Financial Markets amidst Geopolitical Tensions

Following a bullish run in global markets in 2017, the year 2018 started with the same positive momentum until policy normalisation and trade concerns began to weigh on investor sentiment. In October, the IMF cut its global growth forecasts for 2018 and 2019 to 3.7% from an earlier projection of 3.9% for both years. This downgrade reflects a host of factors including the introduction of import tariffs between the United States and China and weaker performance in Britain, Japan and the euro area. Also, rising interest rates resulted in capital outflows in emerging markets, notably Argentina, Brazil, Turkey, South Africa, Indonesia and Mexico. Capital flow reversals weakened currencies, triggered volatility and tilted growth trajectories across Emerging and Frontier markets, especially for economies with current account deficits. In response, Emerging Markets (EMs) and Frontier Markets (FMs) raised policy rates to support their respective currencies and stem outflows.

However, concerns of weaker economic growth, geopolitical tensions and uncertainties surrounding trade disputes have seen sell-offs across equity markets, with the MSCI World, Emerging and Frontier Markets indices all posting negative returns in 2018. The MSCI World index which tracks performance of developed markets returned -10.4% regardless of strong growth in the US. The MSCI Emerging Markets index, which was the outperformer for 2017, posted a loss of 16.6% while the MSCI Frontier Markets was the worst performing index at a negative return of 16.8%.

Against the backdrop of expectation of further rate hikes and sustained monetary tightening in the US and other advanced markets in 2019, we anticipate continued volatility in emerging and frontier markets. Also, in Europe, Brexit and the EU-Italy fiscal standoff are poised to have significant effect on market performance in 2019.

Section Three

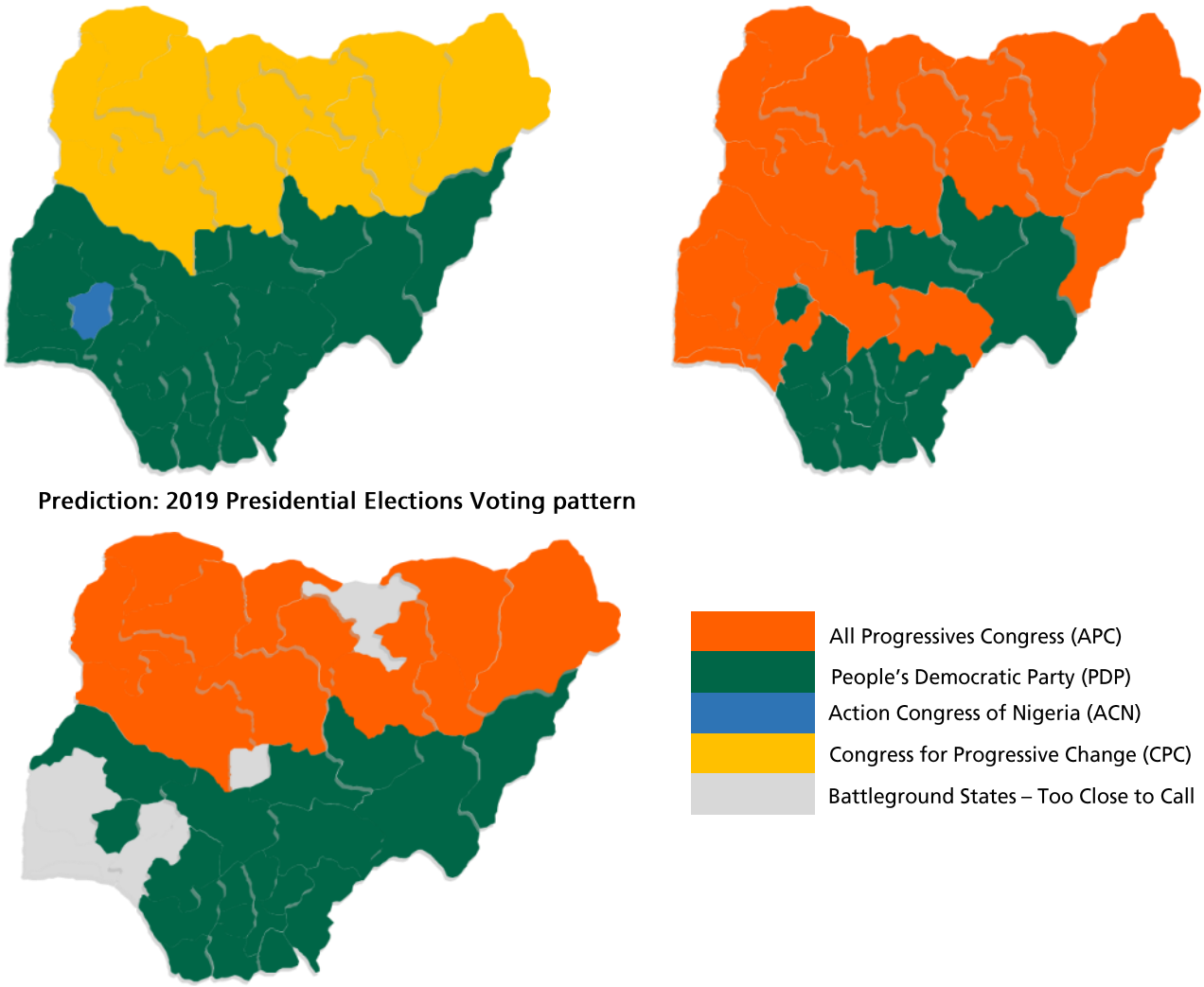
Domestic Macroeconomic Review and Outlook

2019 Elections: Politics Takes Centre-Stage

In many ways, our outlook for 2019 is dependent on the outcome of the general elections and the likely impact it will have on the overall economy. The presidential election will once again be a tight contest between the two leading political parties, similar to 2015 when President Buhari of the All Progressives Congress (APC) unseated President Jonathan and the People's Democratic Party (PDP) which had hitherto been in power for sixteen years. In 2015, anti-corruption, security and the economy were on the ballot. President Buhari was considered an honest politician who would fight corruption and a former army general capable of resolving Boko Haram insurgency as well as security issues in the Niger-Delta. Similarly, President Buhari received wide approval because he promised social interventions to reduce poverty. This was because despite robust growth under the PDP, inequality and poverty worsened.

Going into the 2019 elections, these issues are still on the ballot, but the larger part of the conversation has been focused on the economy. Growth has retreated to below long-term growth rate of 6-7%, just as unemployment & underemployment have worsened at 23.1% and 20.1% respectively in Q3:2018 (8.2% and 18.3% respectively in Q2:2015). According to a report by the Brookings Institution, Nigeria now has the highest number of poor people in the world – making Nigeria the world's poverty capital. Also, while security has improved slightly, the risk of instability is still elevated across regions. In the North-East, Boko-Haram continues to wreak havoc.

Chart 4: Presidential Voting Pattern (2011 & 2015)



Source: Afrinvest Research

In the South-East, secessionist agitations which have recently calmed down remain a latent risk, while conflict between farmers and herders has elevated insecurity in the Middle-Belt of the country. Meanwhile, the situation with cattle rustling in the North-West is yet to abate. In the Niger-Delta, a delicate pact has restored calm, but the situation remains precariously balanced.

Despite these challenges, which have continuously eroded support for President Buhari, the election is a close call. Although we observe that public opinion and alliances have shifted mostly in favour of the opposition, President Buhari remains popular. For instance, President's Buhari's approval rating dropped from 70.0% at the start of his tenure in June 2015 to 41.0% in May 2018, according to NOI (Ngozi Okonjo-Iweala) Polls. Nevertheless, Atiku Abubakar, a former Vice-President and the candidate of the PDP, is yet to fully reap the benefit of the opposition's waning influence as corruption allegations continue to hurt his popularity.

Looking at the likely pattern of voting in the elections, we observe that President Buhari's strong alliances with leaders in the South-West may help at the polls. However, the APC's influence in this region has thinned lately. As an example, the APC won the two state elections held in the region in 2018 but the margin of victory has significantly reduced as the party garnered less than 40.0% of the votes cast in the Osun State elections. In Ekiti State, the APC returned to power, but the margin of victory was also thin.

Furthermore, we have observed growing negative sentiments towards the candidacy of President Buhari. Hence, the South-West will be a battle ground region in 2019. In the Middle-Belt, President Buhari faces an uphill battle given extended conflicts which have destroyed livelihoods and communities. However, President Buhari's chances are most promising in the North-West and North-East, where he continues to attract a large following. We also expect Atiku to garner modest support in those regions given the PDP's strength in some states and being Atiku's place of birth. In the South-South and South-East, Atiku Abubakar has a strong advantage due to the popularity of the PDP and given that the Vice-Presidential candidate, Peter Obi, is from the South-East.

In chart 4 , we created maps showing the pattern of votes since 2011 and the potential outcome in 2019 based on the current situation across states.

Real GDP: An Improved but Sluggish Growth Expected in 2019

2018 was a year of two distinct paths for growth. But overall, the pace of growth remained slow and uneven, coming below the long-term growth rate of 6-7% and the pre-recession level of 2.8%. Real GDP growth came in at 1.9% in Q1:2018, below our estimate, due to a poor performance in the Service sector and a slower expansion in Agriculture. In Q2:2018, growth further moderated to 1.5% due to both a 5.0% contraction in oil output and a slump in Agriculture growth to 1.2% - the lowest in more than a decade. This slowdown in Agriculture output was due to the herder-farmer conflict in the Middle-Belt which led to the destruction of livestock and poor harvests of crops. The contraction in the Oil sector in Q2:2018 was mainly due to a reduction in output by 160,000b/d to 1.8mb/d. Elsewhere, growth was not broad-based as sectors such as Trade and Real estate remained weak due to fragile consumer spending. Meanwhile, Manufacturing growth was soft and volatile.

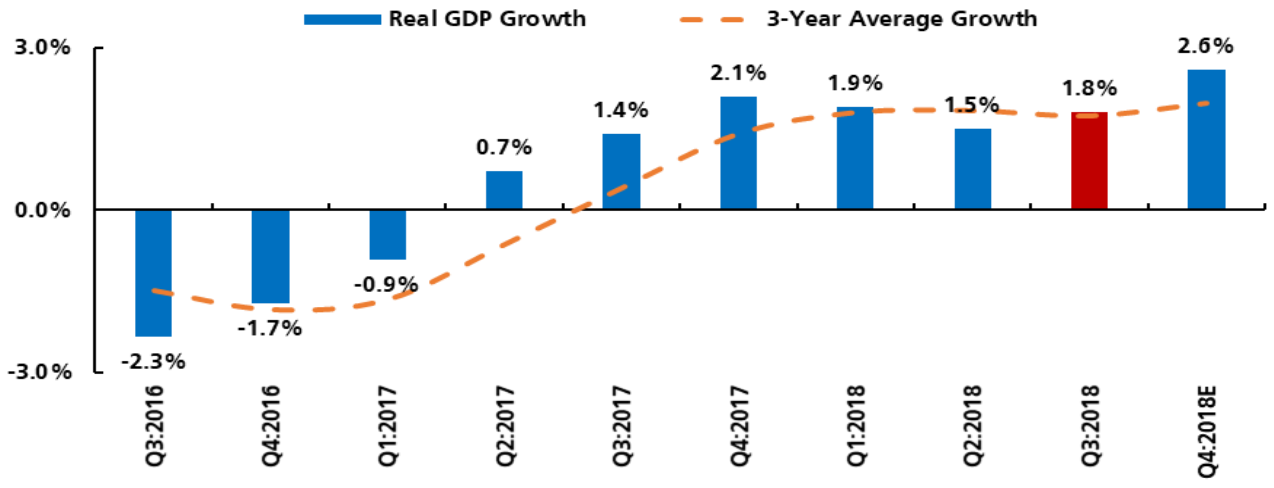
In Q3:2018, growth came in better at 1.8% but this was slower than the 2.1% we expected. Oil output contracted by 2.9% and agriculture growth remained weak at 1.9% in Q3:2018. This prompted a revision of our forecast of FY:2018 growth to 1.9% from 2.1%. To achieve this growth target, we believe the economy will expand by at least 2.6% in Q4:2018. We are optimistic that a strong festive season and better Agriculture output can push Nigeria past the finish line.

Our growth expectations in 2019 is somewhat linked to the outcome of the general elections. We modelled three scenarios to capture different effects:

1. the Base Case assumes that President Buhari wins the election and there is policy continuity.
2. the Optimistic Case is that regardless of the winner, the government implements reforms to attract investment.
3. the Pessimistic Case assumes that political risks intensify and lead to continued violence in the Middle -Belt, North-East and the Niger-Delta.

In our '**Base case**' for 2019, we do not expect a marked turnaround in the economy. We estimate that growth will improve to 2.5% from 1.9% in 2018 based on the expectation of improved oil GDP and sustained expansion in the non-oil sector. This forecast implies that with population growing at 2.6-3.0%, Nigerians are projected to remain poorer on the average in 2019.

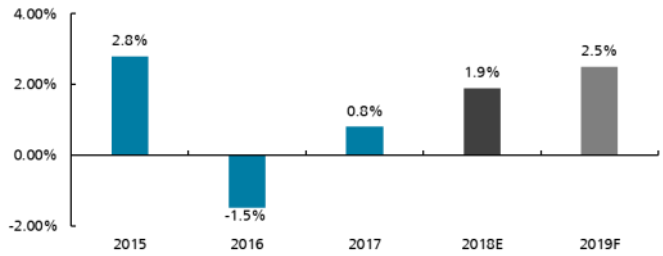
Chart 5: Quarterly Trends in Real GDP Growth



Source: NBS, Afrinvest Research

We believe this growth outcome will reflect a soft rebound in Agriculture, increased oil output and better performance in the Services and Manufacturing sectors. The downside risks remain the slower than expected recovery in Agriculture, oil prices below budget benchmark of US$60.0/bl and oil production at less than 2.0mb/d (including condensates).

Chart 6: Real GDP Growth (2015-2018E)



Source: NBS, Afrinvest Research

In our '**Pessimistic case**', we expect the impact of insecurity to be felt through lower agricultural and oil output. We assume that the decline in oil production will mirror the drop seen between Q2:2016 and Q3:2016. For agriculture, we expect growth to continue at its underwhelming pace of sub 2.0%. The combined impact of these will lead to a moderation in growth below 1.0%. Meanwhile, growth in the Services and Manufacturing sectors will weaken as lower oil exports and investment prompt an exchange rate depreciation. This will lead to high input costs for manufacturers and pricing adjustments will affect consumer purchasing power.

In our '**Optimistic case**', we expect reforms to set the pace for H2:2019. Most important is the removal of energy subsidies which will improve government revenues. We also expect increased private sector investments due to the liberalisation of the downstream Oil & Gas and Power sectors. Although this is likely to inflict pains in the short-term, gains will not be visible until the medium-term. Hence, while we forecast GDP to slightly expand at 2.7% in 2019, we expect a faster pace of growth in the medium-term. The main risks to our projections remain poor implementation of reforms and the lack of political will to follow-through on proposed plans.

Inflation Outlook: Power and Oil & Gas Reforms Pose Inflationary Risks

The direction of inflation was positive for most of 2018 as there was a deceleration to a 30-month low of 11.1% in July 2018 (January 2018: 15.1%). This disinflation was mainly driven by a high base and continued exchange rate stability. However, the streak turned for most of H2:2018 as inflation rose slightly due to a low base, although moderating food prices tempered the increase in headline inflation. We estimate monthly inflation to average 12.2% in 2018, an improvement over 16.5% in 2017.

In 2019, we expect inflation to remain elevated at double-digit levels, but we note that the inflation trajectory remains largely unclear for various reasons. The biggest downside risk we foresee is supply shocks. This will come from an adjustment of petrol and electricity prices as well as continued insecurity in the food planting Middle-Belt. In our opinion, the impact of the new minimum wage will be moderate as funding remains unclear due to weak government finances. This will likely cause implementation to suffer, especially at the sub-national level.

Based on the growth scenarios established in the section above, we use similar assumptions to model inflation.

In the 'base case', where we assume policies remain unchanged, we forecast inflation to moderate slightly to an average of 11.3% in 2019. In the 'optimistic case', where energy prices are finally adjusted and calm returns in troubled regions, we expect a significant spike in inflation to an average of 14.2%. We note that this is possible in H2:2019, which comes with less risk of losing votes and especially as electricity and petrol subsidies are untenable due to weak government finances. In the 'pessimistic case', which models high political risk, we expect a devaluation and weak agricultural output to push inflation closer to a monthly average above 15.0%.

External Balance: Oil Prices and Remittances Provide Support

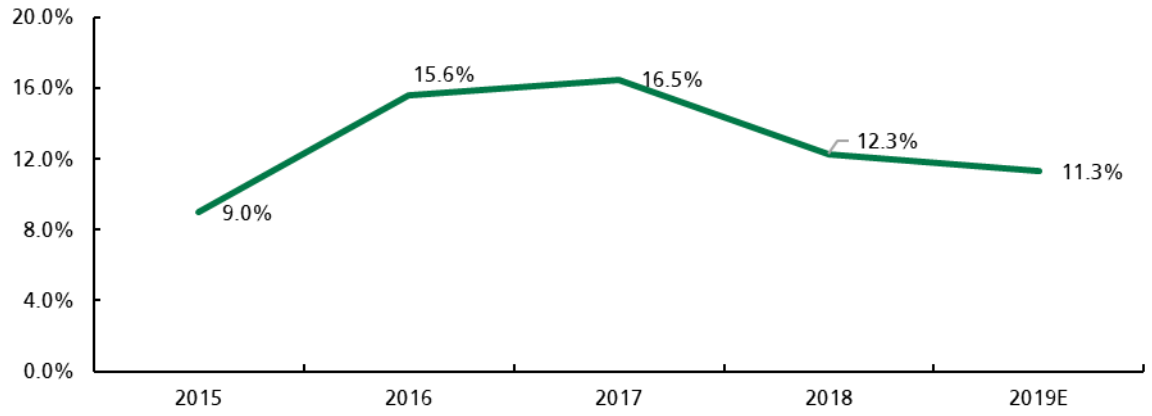
Nigeria's external balance was strong in H1:2018, sustaining its return to a positive territory since Q4:2016. The external balance also breached record highs during H1:2018 as the global environment was favourable. In Q1:2018, the current account balance stood at 1.5% of GDP. This improved to 4.4%of GDP in Q2:2018, the highest since Q1:2013. The current account surplus was supported by stronger exports which was driven by higher oil prices and production, and steady growth in remittances. Similarly, increasing capital flows provided support to Nigeria's external position. The exchange rate was pegged at N305.00/US$1.00 in the official window and there was a convergence in rates at the I&E window and parallel market to the range of N360.00-363.00/ US$1.00. However, cracks had started to appear in capital flows due to higher risks in emerging markets (EMs) and frontier markets (FMs) towards the end of H1:2018.

In H2:2018, the diverse headwinds we expected crystallised. Capital flow reversals intensified due to increasing interest rates in advanced economies which made EMs and FMs assets less attractive. Geo-political risks – the spat between Turkey and US as example – spurred a contagion which led to capital outflows in EMs and Frontier Markets (FMs). The broad implication of these headwinds were depreciations of currencies and negative external balances. South Africa, Turkey and Argentina recorded the deepest currency depreciations in EMs.

In Nigeria, the combination of weak capital flows and lower trade surplus in Q3:2018 led to external account pressures. The external reserves were hit hard as the CBN continued to intervene to support the exchange rate amid capital reversals. Between June and November 2018, the reserves declined to US$42.2bn from US$47.8bn. This was not helped by the slump in oil prices in November 2018 after a record rally in October. However, oil production at 2.1mb/d, based on the estimates of the Ministry of Petroleum Resources, offered reprieve. Thus, the exchange rate remained broadly stable at official markets, although a slight depreciation was recorded in the parallel market and the I&E window.

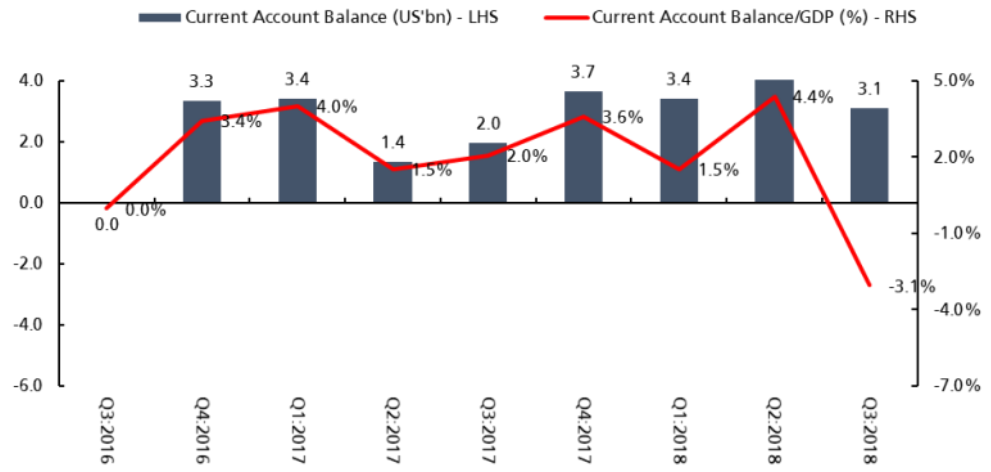
In 2019, we expect sustained positive current account balances due to stable remittances, expectation of stable oil production at around 2.1mb/d and stable oil prices at US$60.0. However, the current account balance to GDP is expected to slightly moderate due to slower growth in trade surplus. Post-2019 elections, we could see the return of investors as there is more clarity. This would support a much-improved external position. Also, fewer rate hikes by the US Fed would also support improved capital flows. However, weak economic prospects in the UK due to Brexit and the halt of monetary stimulus in the EU are major downside risks to capital inflows.

Chart 7: Average Monthly Inflation (2014-2018E)



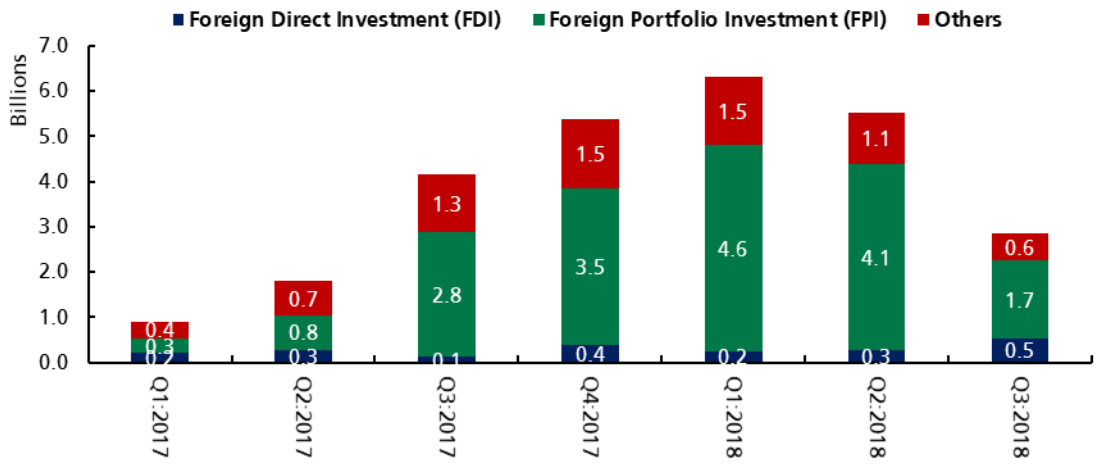
Source: Afrinvest Research

Chart 8: Current Account Balance (Q3:2016-Q3:2018)



Source: CBN, Afrinvest Research

Chart 9: Foreign Investment Trends (Q1:2017-Q3:2018)



Source: Afrinvest Research

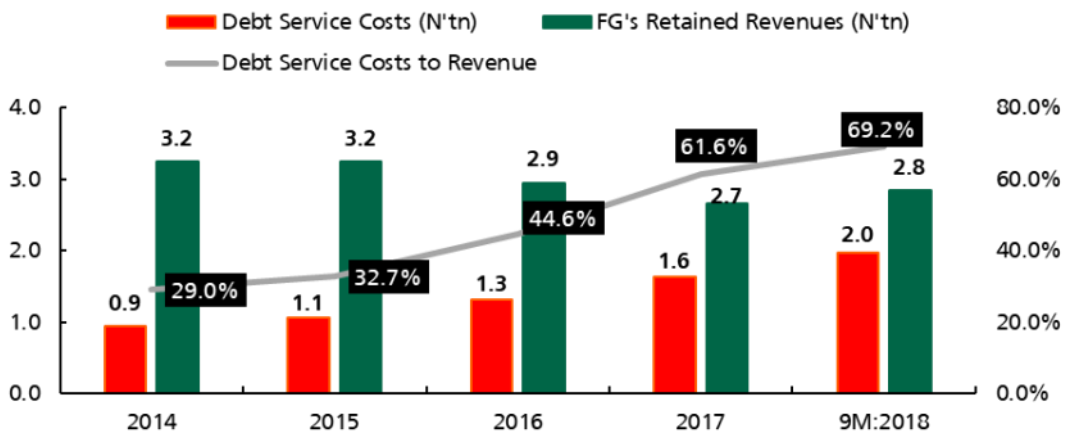
Fiscal 2017/2018 Budget Review and Analyses

2019 Budget: Projections Still Far from Prudent

The Federal Government (FG) plans to spend N8.8tn in 2019, slightly lower than the N9.1tn budgeted for 2018. We saw a surprise in the composition of spending which shows that the share of capital expenditure is lower at 23.1%, a departure from the average of 30.0% in the previous three budgets. Hence, non-debt recurrent expenditure is projected 15.0% higher at N4.0tn. This is perhaps driven by the need to accommodate fuel subsidies which are now finally budgeted and the imminent minimum wage increase. The decision to include fuel subsidies in the budget is laudable as it adds more transparency to the process. However, like we have mentioned in our previous notes, removing fuel subsidies could unlock more revenues which can be better spent on development by the FG. Debt service cost is projected to expand 6.3% to N2.1tn, representing 30.7% of projected revenues. This is far from being realistic if we consider that this ratio was above 60.0% in the last two years.

Revenues are also expected to moderate 2.7% to N6.9tn in 2019, reflecting lower projections for independent revenues and other revenues (asset sales and recovery) which offset the double-digit expansion in oil revenue and non-oil revenue from core sources (CIT, VAT and customs & excise duties). Based on the oil price assumption of US$60.0/b, oil production at 2.3mb/d and the exchange rate of N305.00/US$1.00, oil revenue is projected to increase 24.8% to N3.7tn (53.5% of total revenues). We believe that the oil price assumption is slightly optimistic as the current oil price is lower than estimated at US$58.6/b, while the OPEC+ output cut which was agreed in December 2018 would limit Nigeria's crude oil production

Chart 10: FG's Debt Servicing Costs

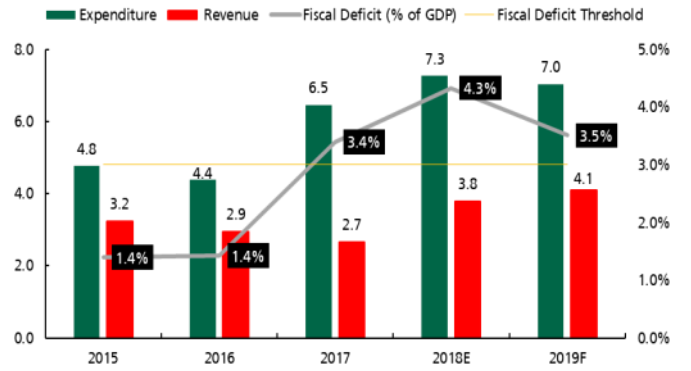


Source: DMO, Budget Office, Afrinvest Research

to around 2.1mb/d (including condensates). The exchange rate assumption remains short of the market rate of N360.00/US$1.00, indicating that there is room for adjustment and in turn more oil revenue in local currency. For non-oil revenue which is projected at N3.2tn (46.5% of total revenues), we see modest growth assumptions for CIT, customs and excise duties and VAT. However, the reduction in projected revenues mainly reflects fading optimism on the part of the FG on the contribution of independent revenues, asset sales and recoveries which are set lower at N1.9tn (27.4% of total revenues in 2019 vs 40.9% in 2018).

While lower projections for spending and revenues suggest that the FG is finally recognising its dire financial position and making adjustments, we believe the spending estimates are still far from prudent. Indeed, the fiscal position of the Federal Government has improved somewhat as total collected revenues of N2.8tn as at 9M:2018 is already above total revenues of N2.7tn collected in FY:2017. However, at the current run rate, estimated actual revenues of N3.8tn will fall short of 2018 projections by an estimated 47.1%. This means a likely expansion in the fiscal deficit to 2.9% of GDP, above the 1.8% projected for 2018. We expect this scenario to play out again in 2019 as non-oil revenue from non-core sources underperform. The fiscal deficit projected for 2019 is 4.8% lower at N1.9tn from the previous year, translating to 1.3% of GDP. But going by recent trends, we believe the fiscal deficit to GDP will remain closer to the 3.0% threshold set by the Fiscal Responsibility Act. Also, we have concerns around implementation as 2019 is an election year. Should the incumbent emerge, we expect budget implementation to proceed smoothly; otherwise, implementation will suffer due to a likely difference in priorities.

Chart 11: Projected Expenditure, Revenue and Fiscal Deficit (2015-2019F)



Source: Budget office, Afrinvest research

Reforming the Budgeting Cycle – A Constitutional Amendment Paramount to Drive Change

Nigeria's budgeting cycle is of concern as the Executive and Legislative struggle to restore the country to the constituted January to December fiscal year. Over the years, the fiscal year has been disrupted by the length of the budgeting cycle - the length of time between the ministerial call and the presidential assent – which in turn creates dire consequences for the implementation of capital projects.

While several reasons have been given for these delays, the cycle have primarily been lengthened by both the ministerial & Executive councils as well as the Legislative approval phase, with the latter being the major drag to the budget cycle. On the average, the budget cycle has historically been a 10-month period with the Legislative approval phase requiring 6 months of the total period. While the Executive has a definite period to assent to the bill, there is no defined period for the Legislative to consider and approve the budget, hence the period can be lengthened depending on the whims of the House.

Chart 12: Federal Government of Nigeria's Budget (2017-2019)

	Items	FY:2017 Approved Budget	FY:2017 Estimat-ed Actual	FY: 2018 Ap-proved Budget	FY:2018 Estimat-ed Actual	FY: 2019 Proposed Budget
Assumptions	GDP Growth (%)	1.5%	0.8%	3.5%	1.9%	3.0%
	Oil Production Volume (m/bpd)	2.20	1.86	2.30	1.99	2.30
	Average Budget price per Barrel (US $)	44.50	54.60	51.00	74.00	60.00
	Inflation Rate					10.0%
	Average Exchange Rate (N/US$)	305.00	305.00	305.00	305.00	305.00
Revenue	Oil & Gas Revenue	2,122.2	1,125.0	2,988.4	1,988.8	3,730.0
	Non-oil revenue	1,379.8	956.7	1,248.8	964.6	1,390.0
	Independent revenue	807.8	295.3	848.0	219.6	624.6
	Others	774.6	280.6	2,080.8	-	1,225.4
	Total FGN Retained revenue	**5,084.4**	**2,657.6**	**7,166.0**	**3,173.0**	**6,970.0**
Expenditure	Statutory Transfer	434.4	434.1	530.0	530.0	492.0
	Debt Service	1,841.4	1,636.9	2,014.0	2,106.2	2,140.0
	Sinking Fund	177.0	177.5	190	190	120.0
	Recurrent (Non-debt)	2,990.9	2,765.3	3,513.0	2,408.4	4,040.0
	Capital Expenditure	2,174.5	1,440.0	2,873.0	1,314.0	2,031.0
	Total Expenditure	7,618.2	6,453.7	9,120.0	6,548.6	8,830.0
	Fiscal Deficit (N'tn)	**2533.8**	**3,796.13**	**1,954.00**	**3,375.60**	**1,860.00**
Fiscal Deficit	Domestic Borrowing	1,488.0	1,337.6	N/A	755.19	N/A
	Foreign Borrowing	175.9	1,165.7	N/A	762.50	N/A
	Others	N/A	N/A	N/A	N/A	N/A
	Debt Service/Revenue Ratio	**32.7%**	**51.5%**	**28.1%**	**66.4%**	**30.7%**
	Deficit/GDP Ratio	-2.2%	3.2%	-1.8%	2.7%	1.3%

Source: Budget Office, Afrinvest Research

This has further been worsened by the power of the executive to spend the previous year's budget within the time limit of six months in a new fiscal year.

As noted earlier, the consequences on the economy are not far-fetched. The budget plays a key role in economic management and is an important fiscal tool through which the government influences the direction of the economy. Hence, a delay induces uncertainty among economic agents and leaves a shorter period for the effects of government spending to be absorbed by the economy. Empirical studies (A. Adeniran, S Bodunrin 2018 & Oke M 2013) show that budget delays could have a negative impact on economic growth.

The call for a reform is paramount, although in our opinion we believe the solution is creating a budget timeline for both ministerial, Executive and Legislative approval. Furthermore, we opine that the constitution should be amended to reflect a timeline that is binding. Nigeria can take a cue from other countries such as Chile which stipulates a definite time for the entire budget cycle, with significant consequences for legislative inaction.

Chart 13: Budget Presentation and Approval Timeline (2008-2018)

Year	Presentation	Signed
2008	8th Nov 2007	April 14th 2008
2009	2nd Dec 2008	March 10th 2009
2010	23rd Nov 2009	April 22nd 2010
2011	15th Dec 2010	May 27th 2011
2012	13th Dec 2011	April 13th 2012
2013	10th Oct 2012	February 26th 2013
2014	19th Dec 2013	May 24th 2014
2015	17th Dec 2014	May 19th 2015
2016	22nd Dec 2015	May 06th 2016
2017	14th Dec 2016	June 13th 2017
2018	7th Nov 2017	June 20th 2018

Source: Budget Office, Afrinvest Research

Reassessing FG's Debt Strategy Amid Rising Treasury Yields and Expectations of Lower Oil Prices

In 2016, the FG through the Debt Management Office (DMO) unveiled its debt management strategy from 2016 to 2019. In its strategy document, the DMO highlighted plans to reduce domestic borrowings to 60.0% of total debt while increasing the level of foreign borrowings to 40.0% to take advantage of cheaper interest rates. In 2016, outstanding local and foreign borrowings were 80.4% and 19.6% of total debt respectively.

The decision to reduce domestic debt was timely as the level and frequency of government borrowings drove market rates higher. The resultant effect was a rise in the cost of debt service and the crowding out of private sector players from the domestic market. Since 2017, the FG has implemented the new debt strategy by issuing more Eurobonds (US$10.2bn). This has driven foreign borrowings to an estimated 33.0% of total debt, with a corresponding decline in domestic borrowing to 67.0% (December 2018).

However, the downside risks to external borrowings are elevated. The recent policy normalisation by systemic central banks have begun to drive higher yield expectation on SSA Eurobond instruments as reflected in the pricing of Nigeria's last Eurobond sale in November 2018 (US$750m, 30-year tenor at 9.3% vs US$1.5bn 30-year tenor at 7.6% issued in November 2017). More so, expectations for higher exports remain constrained due to the possibility of low oil prices over the medium to long-term. The attendant implications for the country are heightened debt sustainability risks as debt to exports ratio weakens, and increased borrowing costs in the event of a currency devaluation.

We analysed FG's debt strategy by stress testing for export shocks and a devaluation based on historical trend. For export shocks, we assumed oil production at 2.0mb/d and lower oil prices at sub US$40.0/b due to market oversupply. Our analysis reveals that the capacity of the FG to cover obligations will deteriorate, especially as a quantum of Eurobond obligations fall due between 2021 and 2025. While we expect FG to meet its obligations due to the natural hedge provided by export earnings, the deterioration in debt sustainability indicators will raise the country's risk premium and make Nigeria's debt issuances more expensive. Also, assuming that a currency devaluation that mirrors mid-2014 to early 2015 occurs, the total cost of foreign debt - Eurobonds in particular – would outweigh local borrowings.

The implication is that resources which could be used to fund public services will be used to pay for debt, especially when the country has to repay the principal obligations and the cost of refinancing is high. Our analysis further reveals that if the FG intends to expand its foreign borrowings at cheaper cost, obtaining concessional funding from multilateral partners significantly lowers the risks brought by export shocks and currency devaluation.

Monetary Policy Review and Outlook

Exchange Rate to Breach Resistance Levels in 2019

The exchange rate stability which we anticipated was achieved for most of 2018. The official rate remained unchanged from N305.00/US$1.00, its level since September 2016. However, in the I&E window and parallel market, rates converged at N360.00/US$1.00. The current account balance to GDP which hit a five-year high of 4.4% in Q2:2018 supported exchange rate stability.

However, turbulence soon emerged in H2:2018 when investors retreated from emerging and frontier markets. In Nigeria, policy uncertainty as a result of the upcoming elections also made investors jittery. Consequently, increased FX demand led to depreciation in rates to N366.00/US$1.00 in the parallel market, with the rate at the I&E window also pressured. To support stability, the CBN responded by increasing the size and frequency of its intervention for BDCs.

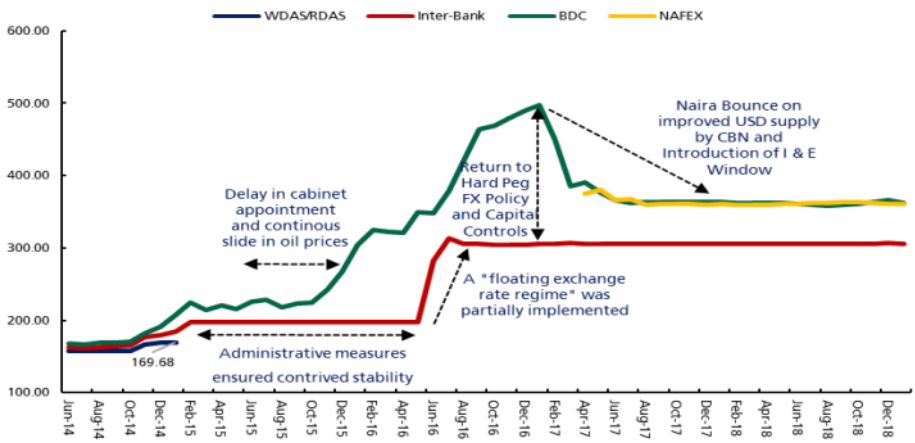
In 2019, the currency faces a downside risk. Foreign capital flows may remain constrained due to both political risk and elevated interest rate in advanced economies. This will heavily impact Nigeria's external position and weaken external reserves accretion. However, the CBN has guided towards a tight monetary policy stance which should help attract capital inflows. We also expect a stable current account surplus to support reserves accretion, if oil production remains steady at 2.1mb/d as expected, and oil prices remain above US$50.00/b. Overall, we believe the exchange rate will remain stable, especially in H1:2019, since the CBN has ample reserves for interventions. However, we note that pressures on the currency will intensify in H2:2019. Hence, we may see a depreciation in the currency to N401.00/US$1.00, mirroring the rate of 12-month non-deliverable forwards quoted on Bloomberg. We note that the likely emergence of a new CBN governor by mid-2018 may result in a new exchange rate policy.

Monetary Policy to Remain Tight in 2019

The monetary policy environment has remained tight since 2016 despite weak economic growth. While growth has stayed below population growth rate of 2.6% since 2016, inflation has remained elevated at double-digit – slowing to 12.2% monthly average in 2018 (2017: 16.5%). With price stability as objective, the MPC retained Monetary Policy Rate at 14.0% with a corridor of +2%/-5% in 2018, as well as Cash Reserve Ratio at 22.5% and liquidity ratio at 30.0% in 2018. We note that the need to attract and retain portfolio investment to support exchange rate stability also informs this policy stance.

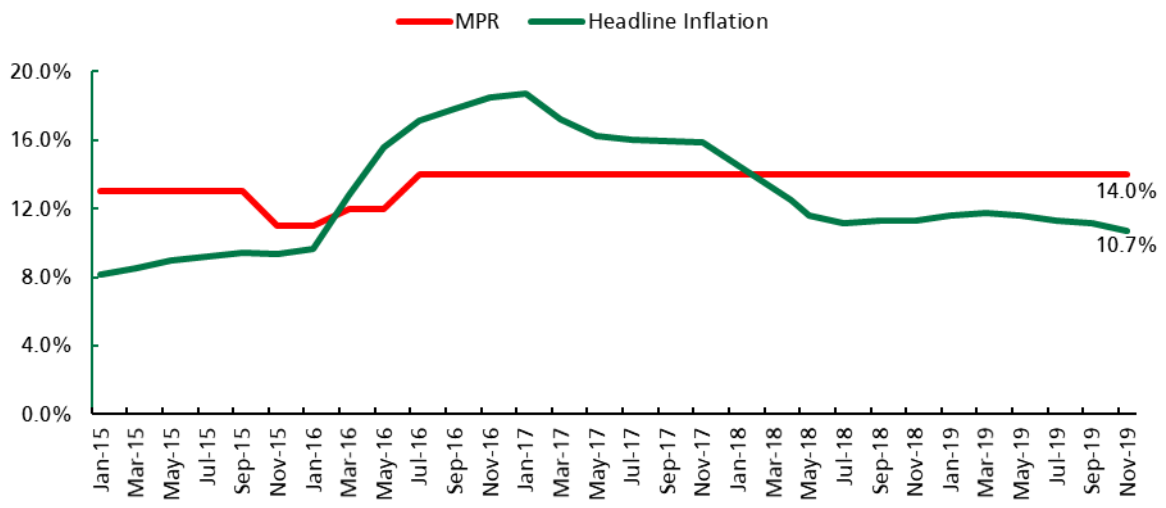
However, there is already a scope for easing and this has been the case since Q2:2018 but the MPR remained tight regardless. Indeed, the CBN gradually eased rates in the money market as yields collapsed from highs of 15.4% as at the end of 2017 to 11.6% as at the end of H1:2018. However, the real sector could not benefit as only large corporates who could issue commercial papers benefitted from CBN's relaxed stance. To support economic recovery, the CBN intensified its development finance role with intervention funds to the real sector.

Chart 14: Exchange Rates in Nigeria (2014-2018)



Source: CBN, Afrinvest Research

Chart 15: Monetary Policy and Headline Inflation Rates (2015-2019F)



Source: Afrinvest Research

For instance, in July 2018, the apex bank rolled out plans for a D-CRR regime and a corporate bond repurchase programme to enhance access to credit. The impact of these initiatives so far has been unclear due to lack of information. In our opinion, we do not expect both initiatives to move the needle as the SMEs which are the main driver of growth and employment will be shut out of the market.

Looking forward, the guidance offered by the Bank so far is that the restrictive monetary policy stance will remain in place for the early part of 2019. This is due to expected inflationary pressures from food shortages, fiscal spending and possible implementation of a new minimum wage of N30,000/month. In our view, food shortages and a devaluation in exchange rate are the biggest threats to inflation, as well as pricing adjustments for electricity and petrol. Thus, all scenarios point towards a double-digit inflation rate in 2019 and we expect the policy rate to remain tight. This will also be in line with the CBN's desire to support exchange rate stability through capital flows .

A New CBN Governor? How Monetary Policy Could Evolve

No CBN Governor has been retained after a first term of five years in the past twenty-five years. There is a chance that this would happen when Governor Emefiele's tenure lapses in June 2019. Hence, a change in leadership at the CBN may impact the policy choices of the Bank. However, looking at the past three administrations of the CBN, we do not expect a dramatic change in monetary policies. Nonetheless, there are areas in which policies could change. We analyse this along major considerations such as exchange rate and external reserves management, development finance and monetary policy targets.

Historically, CBN Governors have always shown a preference for a managed exchange rate. Exchange rates were often adjusted to reflect the balance between demand and supply of FX. However, until the introduction of the I&E FX Window, the current CBN Governor preferred a fixed exchange rate. This is still the situation in the official window where Naira has mostly been unchanged for more than two years at c. N305.00/US$1.00. The CBN continues to intervene in currency markets without adjusting the official rate. For a new CBN Governor, we may see a shift in the exchange rate regime towards a managed float. We do not see the possibility for a free float given the structure and vulnerability of Nigeria's external position as well as political considerations.

On the Apex bank's independence, we note that Investors' confidence has largely been affected by the influence of fiscal policymakers on the current CBN administration. The presidency continues to interfere in the administration of monetary policy through rhetoric favouring fixed exchange rates, although this is now to a lesser extent than during the FX crisis in 2016. It is unclear how this will evolve for the next five years given the possibility of a new president and CBN governor. However, we note that investors' confidence will remain downbeat without the

independence of the CBN.

We believe the overarching objective of the CBN will remain price stability as well as exchange rate stability. There are several means to achieve this, but we believe the CBN will continue to favour monetary targeting. The implication is that targets for money supply will be set every year to avoid excess liquidity that may drive inflation. This is slightly different from what is obtainable in advanced economies where inflation targeting is a popular tool. While the CBN has a 6-9% inflation target, it is secondary to money supply aggregates. We also believe that the need to attract and retain capital flows will ensure that the tight liquidity environment persists.

Development finance has always been part of the agenda of the CBN. We believe this is because the Bank is aware of the limits of monetary policy to spur growth in an inflationary environment. Hence, through cheap credit (c.9.0% interest rate), the Bank facilitates investments in the real sector to expand output. However, under Governor Emefiele, we have seen more creative methods to boost output in the real sector such as the D-CRR and the corporate bond repurchase programme. The reasons for these range from weak credit expansion by banks to import substitution; 42 items are currently not valid for FX while palm oil, cassava and rice production have been prioritised to receive funding support. With a new governor, there is a strong chance that this will be sustained. However, the spate of interventions and other causes of inefficiencies such as the list of items not valid for FX may be relaxed.

Money Supply Targets Ineffective in Ensuring Price Stability

Over the past five years, the CBN has kept its monetary policy targets at 10.0-15.0% increase in money supply. However, money supply aggregates have serially underperformed targets in all those years, except 2016. The expansion in money supply has mostly been driven by increases in quasi money as net domestic credit growth is moderate if not contracting. Despite this, inflation is still elevated at double-digit levels. We believe this is because inflation in Nigeria is driven by supply shocks rather than by an expansion in aggregate demand. The challenges facing inflation are outside the control of the CBN. Hence, this should force a rethink of the proper monetary policy strategy.

The OMO tool through which the CBN intervenes to manage system liquidity has caused more problems lately. The remarkably high discount rates of issuances, which is prompted by the desire to offer positive real returns to investors, have often led to excess liquidity at redemption. This cycle has been sustained for quite some time, at least since 2016. We believe the CBN should realise the bluntness of money supply aggregates to fight inflation given weak transmission of credit to the real sector and persistent supply shocks. As such, we expect that inflation rate will remain outside the targeted band of 6-9.0% for the fourth consecutive year in 2019.

Polity Review and Outlook

Security Tensions, Calls for Restructuring and Ethnic Agitations

Across Nigeria, political risks remain elevated and these continue to weigh on economic activities. Ahead of the 2019 elections, the political environment may heat up if latent security risks manifest. This may get even worse if the conduct of the elections is not free and fair. If this happens, there is a chance that insecurity would worsen across regions.

Beyond the elections, we believe the political risks across regions of the country will persist in 2019 due to the ineffective response of the Executive to the challenges of security. Despite improved security in the North-East, the early momentum that brought results between 2015 and 2016 has slowed considerably. Over the past two years, the gains have been limited and Boko-Haram continues to wage war. There are currently over 2 million displaced people in the North, with heavy concentration in Yobe, Borno and Adamawa. In the North-West cattle rustling remains a permanent feature and herder-farmer clashes in the Middle-Belt is still elevated. Secessionist agitations have also moderated in the South-East, but the sentiments are rife. In the Niger-Delta a peace pact with militants has ensured stability, but as history has shown over time, this is still a considerable risk. In the South-West, the desire for restructuring is not hard-fought. The implication of this is relative calm, although debates about the restructuring of the fiscal regime will continue to gain steam. Therefore, we expect the socio-political environment to remain heated in the face of latent risks to widespread insecurity which are elevated in all regions.

Post 2019 Elections: Synergy Between Legislature and Executive Key for Reforms

The 2019 general elections will be tightly contested at the state and federal levels. The campaign season kicked-off in November 2018 and ends some weeks to the elections. The implication is that the attention of economic

managers has shifted towards the elections rather than on economic policies. We also observe that tough reforms and decisions are being delayed until after the elections to retain political capital.

To better understand how the economy could evolve post-2019 elections we assume that regardless of the pattern of voting, the National Assembly will continue to be a battleground. Ideologically, there is no fundamental basis for distinguishing lawmakers in Nigeria, so we expect the Executive – regardless of the winner of the presidential elections – to continue to reach compromises to secure support. This will impact the passing of the budget as we have seen in previous years, and efforts to institute reforms and pass bills may be prolonged. An example in recent years is the electoral bill and the Petroleum Industry Bill (PIB).

Nonetheless, the pace of the economy will be dictated by the eventual winner, planned reforms and how fast they are able to execute them. Much of our considerations on this have been discussed above. To summarise, there is more clarity if the incumbent wins while the opposition may delay investments temporarily, at least until the proposed policies are clear and implementation is set in motion. In any case, better management of the relationship between the Executive and Legislature is a precondition for faster reforms and growth.

Section Four

Equities Market Review and Outlook

Equities Market Performance and Outlook… Leaving Value on the Table

The performance of the domestic bourse in 2018 was largely bearish as sustained sell offs dragged the benchmark index 17.8% southwards. The year began with optimism, riding on the positive wave of 2017 which was stoked by the launch of the Investors' & Exporters' (I&E) FX window, but this slowly dissipated from the tail end of January 2018. In January, the benchmark index rapidly accelerated to as high as 17.9% (19/01/2018) before the bearish run set in. The gains recorded at the start of the year were largely in line with our views on the performance of the market for 2018, although we expected a weaker performance for H2:2018 as jitters of the impending elections filtered in. However, the impact of the upcoming elections was somewhat underestimated as this was a major drawback to market performance in the year alongside increased policy normalisation in systemically important central banks.

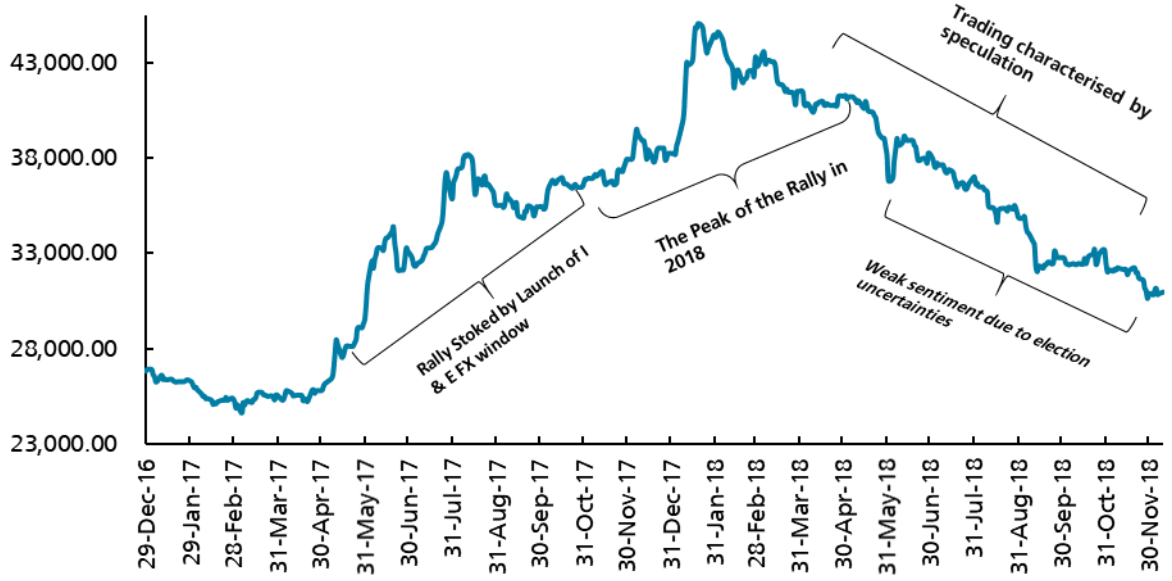
Historically, the performance of the Nigerian equities market has largely moved in lockstep with developments in the oil market, as foreign investors who often are the major players in the domestic market closely track the strength of the external reserves of emerging markets before investing. This focus on oil price and external reserves was evident between 2014 and 2016 as depressed oil prices took a toll on Nigeria's external reserves and weighed on investor sentiment. However, 2018 took a different turn as investor sentiment remained weak for the greater part of the year, despite rising oil prices (peaked at US$86.29/b on 03/10/2018) and stronger reserves (2018 high US$47.9bn on 10/5/2018). In spite of these positives, market performance was characterised by sell offs from February till year-end and the impact was reflected in participation dynamics. On the average, domestic investors accounted for 50.5% of transactions relative to 49.5% of foreign investors, while net value of transactions by foreign investors was negative as outflows (N513.5bn) surpassed inflows (N477.7bn). Furthermore, as foreign investors exited the market, domestic investors followed suit and as such the impact on the market was evident.

We note that sentiments towards emerging and frontier market assets, especially equities, was also impacted by policy normalisation from systemically important central banks of developed economies. However, we believe the major drawback for the Nigerian market was closely tied to the upcoming general elections. Therefore, in line with historical trend noticed in pre-election years, we expected significant sell-offs in the market, albeit in H2:2018. But the sell-offs began earlier than anticipated, consequent on global and domestic risk factors.

…Leaving Value on the Table

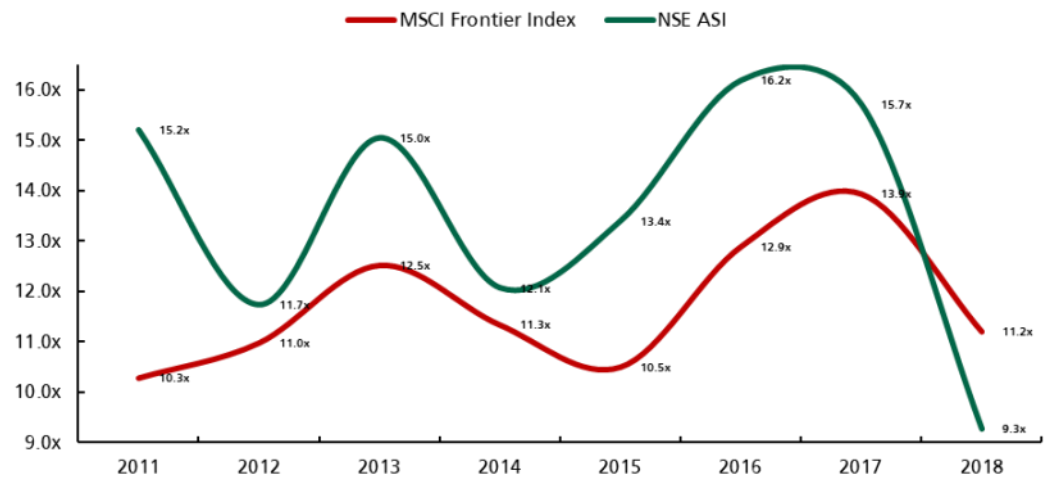
Our conviction is closely associated with the fact that whilst some companies recorded weaker financial performances in the year, a host of market bellwethers remained resilient. Yet, some stocks traded below fundamental valuation. The benchmark index traded at an average P/E of 9.3x in 2018, relative to a 5-year

Chart 16: Nigerian Equities Market Performance



Source: NSE, Afrinvest Research

Chart 17: P/E Multiple for NSE ASI vs MSCI Frontier Market Index



Source: Bloomberg, Afrinvest Research

historical average of 14.5x. This bucks the trend of the premium pricing the NSE ASI has enjoyed over the MSCI Frontier Market Index in the past 7 years. This undervaluation is more apparent when juxtaposed with peer markets; hence our view that investors may have left value on the table.

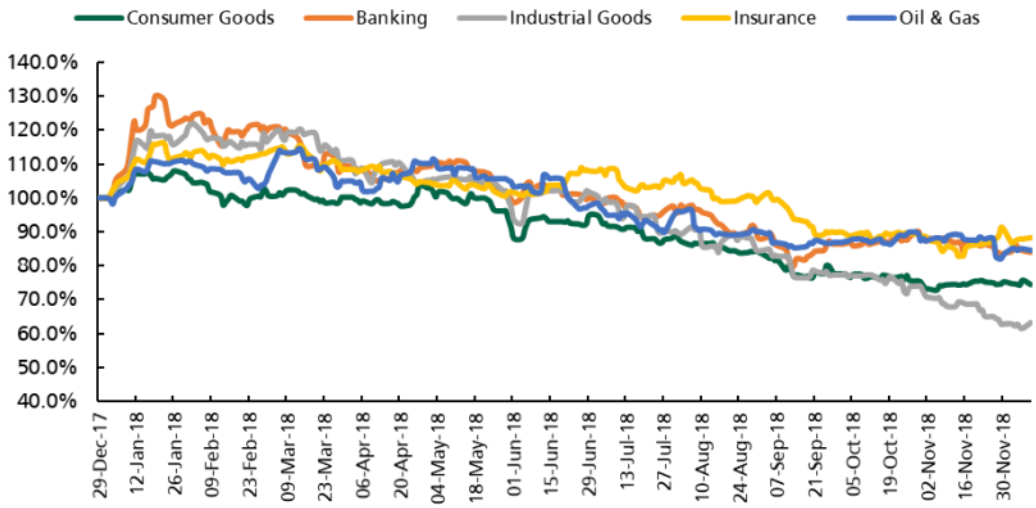
Sector Performance… Any Positives amidst Weaker Sentiment?

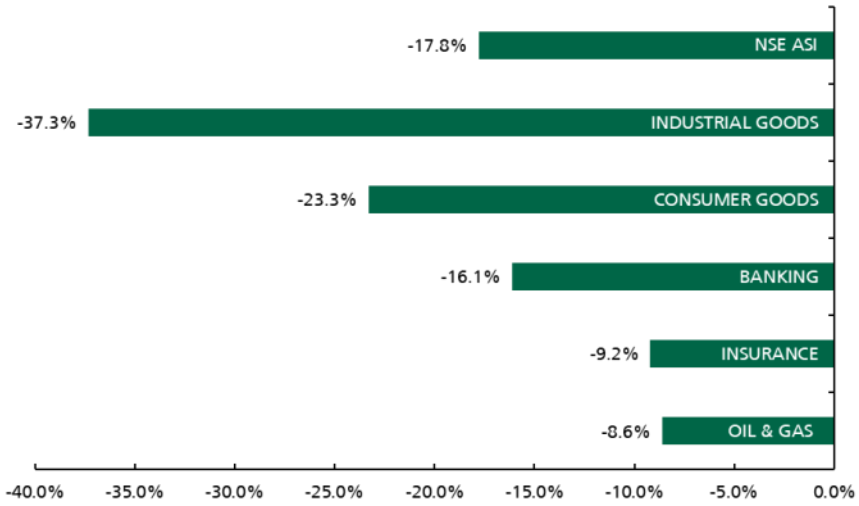
In line with the overall weak sentiment towards equities, sector performance of 2018 was in contrast to the positive performance of 2017 as all indices under our coverage trended lower.

The Industrial Goods index declined the most, falling 37.3% in the year. The negative performance of the index was largely due to sustained profit-taking as the index had earlier touched a year high of +18.2% in January. The poor performance was largely due to losses in DANGCEM (-17.5%) – the most capitalised stock on the exchange – and WAPCO (-72.3%), which was plagued by weaker financial performance in the year.

The Consumer Goods index followed, falling 23.3% in 2018 as weaker consumer spending pressured the earnings of the companies which make up the index. The brewing companies were the major drags to performance, with NIGERIAN BREWERIES (-36.6%) and GUINNESS (-23.4%) declining in the year. The weak sentiment towards these stocks was largely tied to the weaker financial performance, which was a result of softer consumer spending as well as imposition of higher tariffs on alcoholic products.

Chart 18: Sector Indices Performance in 2018





Source: Bloomberg, Afrinvest Research

In the same vein, activity on banking stocks continued to surpass other sectors, although selling pressure outweighed the buy sentiment as the NSE-Banking 10 index slid 16.1% southwards. Despite the positive results churned out by some of the banks, especially Tier-1 banks, the overall bearish sentiment in the market dragged the index as investors continued to exit positions. Accordingly, the dip in the performance was largely due to price declines in GUARANTY (-15.5%), ZENITH (-10.1%), UBA (-25.2%) and ACCESS (-34.9%).

The Insurance index trailed, falling 9.2% in 2018. Sentiment towards the insurance industry was boosted in the year following the announcement of a recapitalisation exercise by National Insurance Commission (NAICOM); however, this plan was eventually shelved. Despite gains recorded in CUSTODIAN (+45.2%) and NEM (+62.7%), the impact was offset by losses in MANSARD (-5.2%) and WAPIC (-16.0%).

Finally, the Oil & Gas index declined by 8.6% despite the price appreciation of SEPLAT, which inched 2.2% higher on the back of higher oil prices. Nevertheless, sustained sell pressures on TOTAL (-11.7%), OANDO (-16.5%) and MOBIL (-4.7%) netted off the impact of the gains.

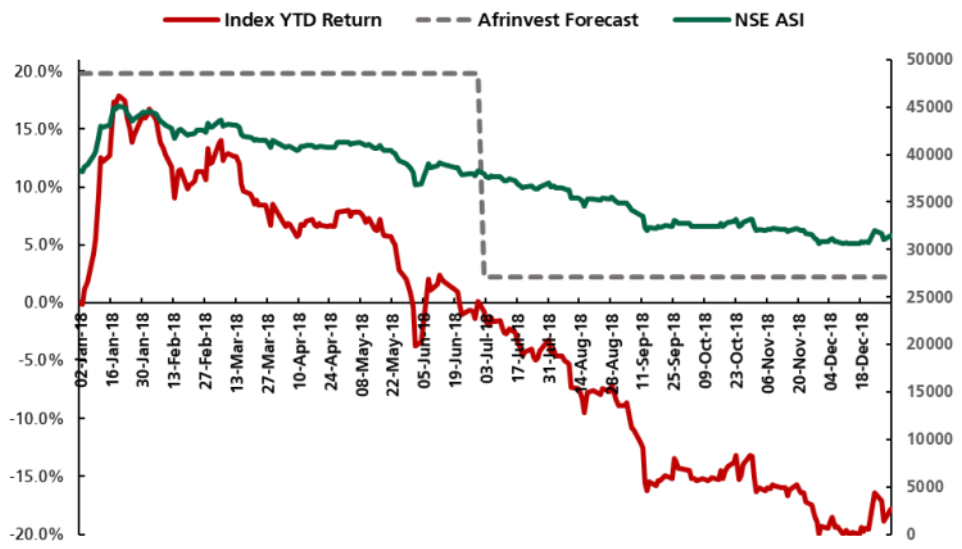
Notwithstanding the overall negative performance, we note that earlier in the year, each of these indices trended higher, before the rout on the domestic bourse started. The Banking, Industrial Goods, Consumer Goods, Insurance and Oil & Gas indices rose to as high as 30.2%, 21.9%, 8.0%, 15.4% and 14.4% respectively. Sectoral valuation across African markets suggests that there are rooms for positive upside potentials for Nigerian securities. Banking (4.2x), Consumer Goods (21.2x), Industrial Goods (9.4x), Insurance (4.0x) and Oil & Gas (3.9x) market valuations are currently at discount to African peers of 11.0x, 26.8x, 25.1x, 17.1x and 13.3x respectively; thus, presenting opportunity for value-seeking investors.

Our Scenario Analysis for 2019…Turning the Tide?

In our scenario analysis for 2018, we remained largely optimistic on the performance of the market, with our 3-scenarios (Bear: +7.7, Base: +19.8% and Bull: +32.7%) all pointing towards an appreciation of the benchmark index. In our H1:2018 review and H2:2018 outlook report, we adjusted our market forecast – Bear (+2.2%), Base (+10.0%) and Bull (+18.3%) – expecting a positive base case performance. However, actual market performance missed our forecast as the impact of uncertainties around the general elections and global capital flows dragged performance.

As we have reiterated, our 2019 crystal ball assumes that equities will remain unfavoured by investors until after elections, which wraps up in March 2019, when the effect of the negative sentiment is expected to dissipate. This makes calling the market herculean. Nonetheless, we modelled market return scenarios around expectations on domestic monetary and fiscal policy, possible election outcomes, momentum of economic growth, dynamics of funds flow and outlook on global growth with the possible effect on policy normalisation. Although we are positive on equities market performance post-elections, our expectation hinges on possible scenarios amidst the various risk factors envisaged for equity investing in 2019. We conceptualised three major possible outcomes that could play out irrespective of the winner of the presidential elections.

Chart 19: 2018 NSE ASI Return Relative to Afrinvest Forecast



Source: NSE, Afrinvest Research

1. ***Pessimistic Case:*** *Our pessimistic case with a probability of 40.0% envisions a less likely post-election violence characterised by slower than expected pace of economic growth in addition to negative signals in monetary policy management and increased pace of policy normalisation, especially from the Bank of England (BoE). We estimated that this scenario would necessitate at least 20.0% decline in market EPS and force P/E as low as 6.7x; hence, crystallising in 33.4% decline in the broader index by year end.*

2. ***Base Case:*** *In the event that status quo is maintained in major policy disposition with successful and violence-free elections, irrespective of the winner, this will result in a base case. Our scenario also envisages that the country maintains slow but steady economic growth path with fiscal and monetary policy conditions subsisting while current pace of global policy normalisation remains. In our analysis, this scenario would result in a 6.8% EPS growth with higher market P/E (11.4x) resulting in 42.0% market return. We believe the possibility of this occurrence is most plausible at 50.0%.*

3. ***Optimistic Case:*** *This is the least likely scenario in our view with a probability of 10.0%, given the current realities. We believe a change in monetary and fiscal policy to drive investments would improve macroeconomic fundamentals. This scenario would be most bullish for equities if combined with liberalisation of downstream oil and gas sector, new big listings on the NSE (including MTN) and weaker than expected global growth that could reverse the current course of policy normalisation. This we estimate would result in 15.0% growth in EPS with estimated market P/E at 15.2x and market return of 117.7%.*

Equities Market in 2019… All Bets Hinge on Election Outcomes

We opine that some of the expected drivers of market performance in 2018 still hold true, although we do not expect the impact to be seen until after the elections. Against this backdrop, we forecast market performance to strengthen in 2019 and we highlight some key themes that are anticipated to shape the market.

1. Post-Election Stability Leading to Return of Foreign Investors

Historically, foreign investors have been the major participants in the Nigerian equities market; however, in 2018, domestic investors contributed the bulk in terms of market activity. This was largely due to the exit of foreign investors from the domestic market as outflows stood at N605.5bn, relative to inflows of N553.5bn as at November 2018. In 2019, we expect foreign investors to return to the Nigerian market after the conclusion of the elections and as such anticipate an improvement in performance. Furthermore, given current pricing of the market, which we believe is attractive –even more attractive in dollar terms – we expect foreign investors to take advantage of this whilst domestic investors will react accordingly.

2. New listings

Given the sustained drive to increase product offerings in the market by regulators, coupled with the expected improvement in sentiment, we anticipate some new listings either by way of rights or Initial Public Offering

(IPO) in 2019. In the preceding year, several companies issued rights – MAYBAKER, LAFARGE and MUTUAL BENEFITS – while the only IPO was for Skyway Aviation Handling Company Plc (SAHCO), although there were broad expectations for the listing of MTN Nigeria (MTNN) shares on the Nigerian Stock Exchange; however, this plan was stalled and is now expected in 2019. Given the pedigree of MTNN, which is a subsidiary of the South African company MTN Group and the biggest telecommunications operator in Nigeria, a listing of this magnitude is expected to drive interest and activity in the market, as well as boost market capitalisation.

3. Corporates' Earnings Performance

In 2018, investor reaction to positive corporate earnings was weak given risk factors. However, we opine that following the conclusion of the elections, investors will place a premium on investment decisions based on fundamental analysis of companies as opposed to speculative trading. Hence, we believe that performance of corporates will be a major consideration in 2019. Our expectation for corporates' performances varies across sectors, with our optimistic expectations tilted towards the Banking sector, especially the Tier-1 players that have historically demonstrated resilience amidst tougher operating conditions. We also anticipate improved performances from Consumer Goods companies – as economic conditions improve – and Oil & Gas companies – as earnings are projected to be buoyed by increased oil production and prices.

4. Sustained improvement in Macroeconomic Indicators

We believe factors including oil prices, external reserves and FX liquidity will remain major considerations for investors in 2019 and the outlook on these indicators remain largely positive and should support market activity. As regards external reserves, increased oil production as well as higher oil prices resulted in sustained appreciation, with the reserves level expanding from US$38.8bn as at December 2017 to US$43.2bn in December 2018. Likewise, while oil prices moderated in Q4:2018, the broad outlook remains largely positive as OPEC+ take steps to keep prices elevated. Finally, FX liquidity which is another factor that investors will keenly consider in deciding to invest in Nigeria, shows no signs of being significantly pressured given the appreciable levels of reserves.

Chart 20: Afrinvest Equity Market Projection Scenarios 2019

Scenarios	EPS Growth Forecast	EPS Forecast	P/E (x) Forecast	2018 ASI	ASI Forecast	Overall Return	Probability of Occurrence	Remarks
Pessimistic Case	-20.00%	3,132.09	6.7	31,430.50	20,923.02	-33.4%	40.0%	• Post-election violence occurs • Slower than expected pace of growth • Negative signal from monetary policy management. • Increased pace of policy normalisation especially from BoE • Further misalignment in monetary policy results in market distortions and weakens investments.
Base Case	6.8%	4,182.90	11.4	31,430.50	44,632.25	42.0%	50.0%	• Successful, violence free elections • Slow and steady economic growth path • Fiscal policy direction remains on the current path • Monetary policy focus remains the same • Current pace of policy normalization is sustained.
Optimistic Case	15.0%	4,502.38	15.2	31,430.50	68,436.12	117.7%	10.0%	• Monetary policy changes drive increased investments • Improving economic fundamentals. • Removal of subsidies and liberalization of the downstream Oil & Gas sector • New listings on the NSE including MTN IPO • Weaker than expected global growth

Source: Afrinvest Research

Section Five

Fixed Income Review and Outlook

Fixed Income Market Review & Outlook

The fixed income market was quite volatile in 2018, similar to the previous year, even as the Monetary Policy Committee (MPC) opted to maintain the policy rate at 14.0% through the year. The Central Bank of Nigeria (CBN) maintained its tight monetary stance more vigorously as issues around weak global growth, heightened polity risk and higher interest rates in advanced economies which prompted capital flow reversals in developing markets came to the fore in 2018.

Consequently, the yield on both Treasury bills and bonds trended upwards in 2018, with the average yields on both instruments increasing by 1.2% and 0.4% Year-on-Year (Y-o-Y) respectively to settle at 15.3% and 15.2% in that order.

Yield Curve Inversion: A Recession Signal?

During a period of economy stress, we observe that the inversion of the Nigeria Sovereign yield curve has been a prominent feature. This occurred during the 2016 economic recession, with the yield curve only returning to normal in Q4:2017. However, in Q4:2018, we saw an inversion of the yield curve again as external and domestic headwinds resulted in a fragile external position. In our opinion, monetary distortions present in the market are behind the current shape of the curve, and we view the probability of economic distress in 2019 as low, although this view is very much dependent on how risk factors crystallise in Q1:2019.

From the direction of yields through the quarters in 2018, the volatility in the market is apparent, with the sharpest moves recorded at the short-end of the curve. This afforded investors the opportunity to record substantial gains in the year, as the CBN utilised policy levers to affect market yields and stem intensifying capital flow reversals precipitated by a combination of EMs and FMs market pressures and policy normalisation in systemically important central banks.

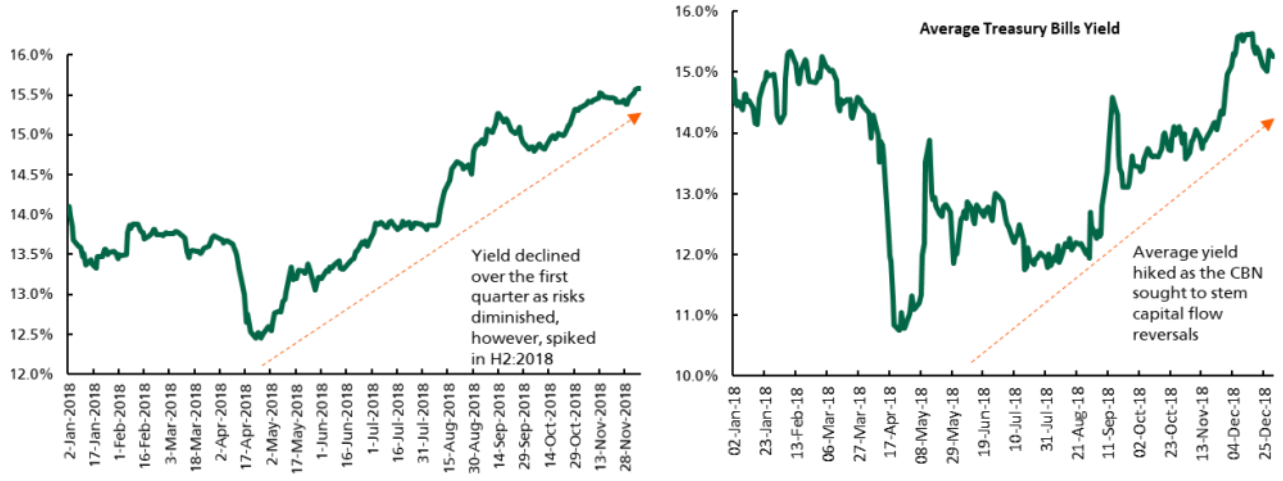
We expect the policy normalisation in the US and UK, as well as the EU's decision to end its asset purchase program in 2018, to continue to play a part in defining the narrative in 2019, given the expected impact on the direction of capital flows. Nonetheless, we do not expect a significantly different direction to monetary policy from what was witnessed in 2017, with the focus still on driving growth and maintaining price stability.

Tighter Monetary Stance Drove OMO Bill Issuances in 2018

For the second consecutive year, Open Market Operation (OMO) sales exceeded Primary Market Auction (PMA) sales, as the CBN sought to maintain price stability through the limitation of liquidity levels in the financial system. Consequently, OMO sales for the year were recorded at N16.6tn as compared with N3.4tn worth of Treasury bills sold at PMAs.

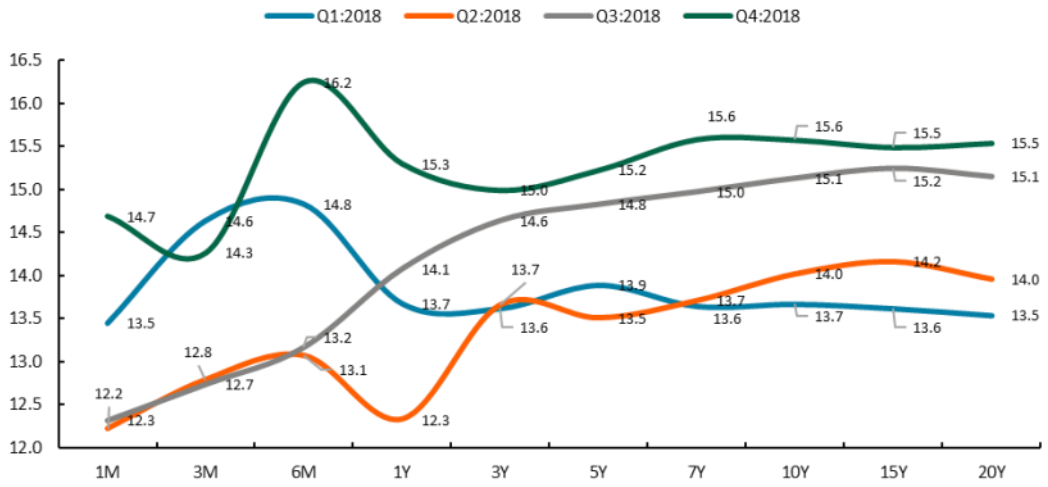
While in the earlier part of 2018, it seemed that the CBN was comfortable allowing maturing OMO bills enter the system, concerns about declining crude oil prices and pressured foreign exchange reserves resulted in the CBN mopping up excess liquidity in the system to forestall speculative FX position taking. The outstanding stock of OMO bills, with a short-term maturity cycle, should see this trend maintained for the majority of 2019 as risk factors persist.

Chart 22a-b: Treasury Bond and Treasury Bills Yields (2018)



Source: FMDQ, Bloomberg, Afrinvest Research

Chart 23 a-b: Nigerian Sovereign Yield Curve across Quarters



Source: FMDQ, Bloomberg, Afrinvest Research

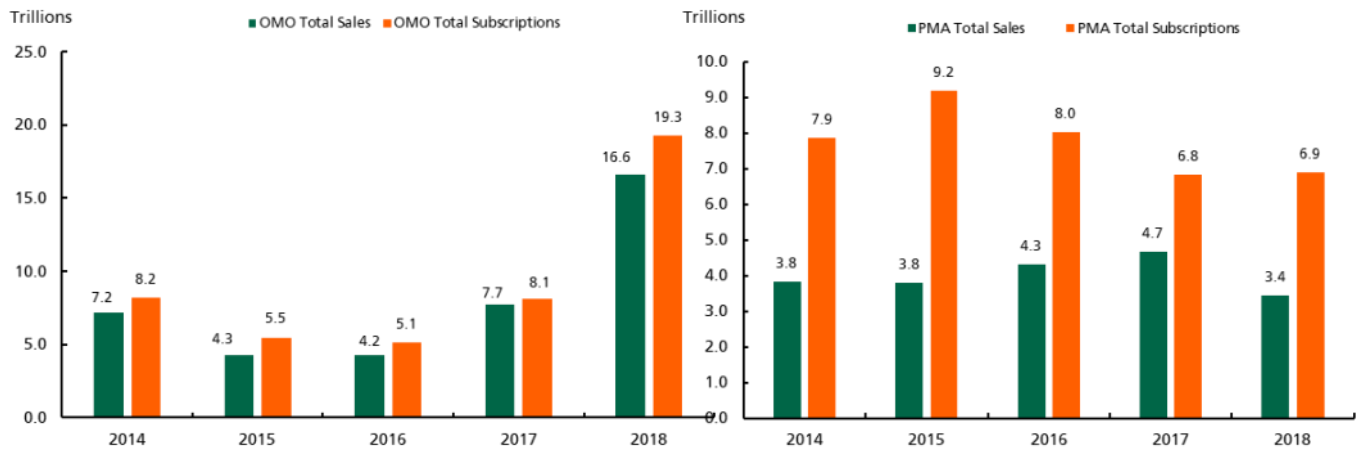
Bond Subscriptions and Sales Decline Significantly

Dissimilarly, the levels of sales of FGN Treasury bonds were relatively depressed in 2018, as the amount subscribed for and sold to investors at Primary Market Auctions (PMAs) declined by 44.1% and 30.5% Y-o-Y respectively. This was precipitated by the spike in Treasury Bills yields in H2:2018, which resulted in investors refocusing to the shorter end of the curve, given the measurably higher yields obtainable.

Also, in 2018, the FGN explored several long-term borrowing windows within the domestic market by extending issuances of FGN Savings Bonds by a further N2.6bn at monthly sales and issuing another N100.0bn Sukuk bond at a rental rate of 15.743% (in addition to N100.0bn issued in September 2017).

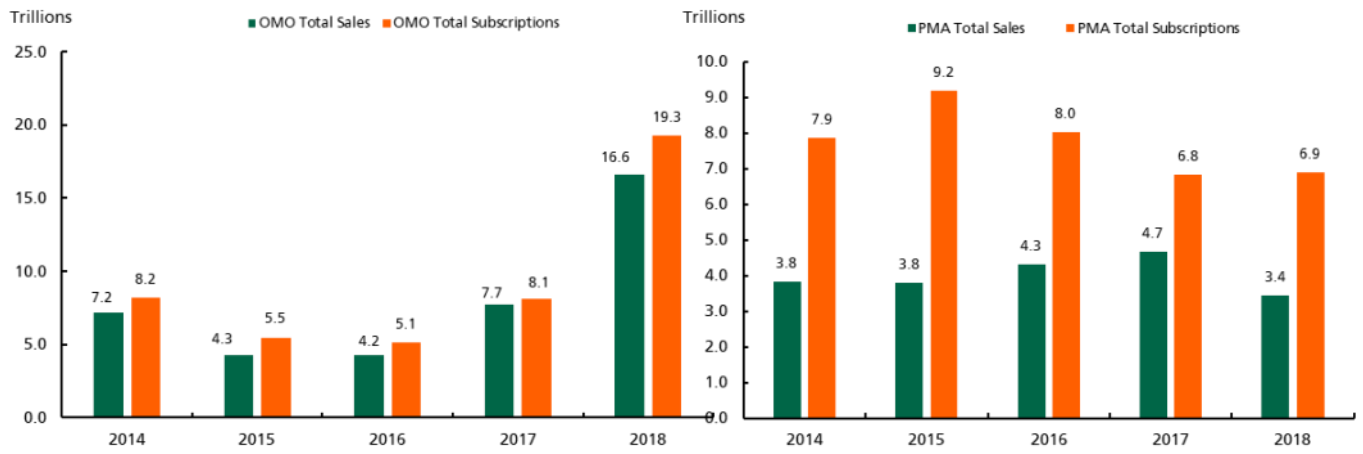
Notwithstanding, the activities in the Treasury Bonds market were generally tempered, with activities in the secondary market closely mirroring the PMA. In the secondary market, trades declined precipitously in the year as yields on Treasury Bills spiked. Trades in the FMDQ OTC market were recorded at N10.2tn (with approximately N5.1tn in transactions in each half of 2018). Contrastingly, Treasury bills trades settled at N69.1tn in 2018 (N32.3tn in H1:2018 and NGN36.8tn in the second half of 2018).

Chart 24 a-b: Total Subscriptions and Sales OMO and PMA (2014-2018)



Source: FMDQ, Bloomberg, Afrinvest Research

Chart 24 a-b: Total Subscriptions and Sales OMO and PMA (2014-2018)



Source: FMDQ, Bloomberg, Afrinvest Research

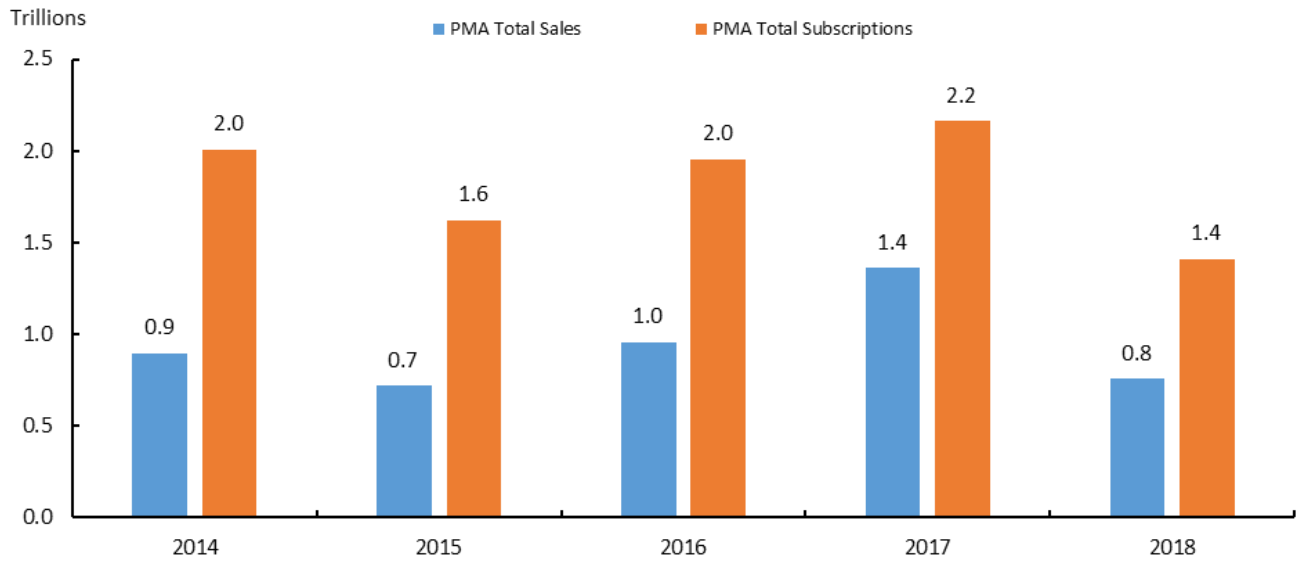
Eurobond Issuances Extended … Outstanding Debt Rises to US$11.2bn

In line with the drive from the Ministry of Finance to shift the country's debt strategy away from high cost local currency debt, there was an increased level of Eurobonds issuances in 2018, with US$5.4bn in instruments issued in 2018 across multiple tenors through 5 instruments. Consequently, the total Eurobonds increased to eleven instruments with an outstanding value of US$11.2bn.

These Sovereign issuances were issued at coupon rates ranging between 7.625% - 9.248%, which increased the average coupon on the country's debt to 7.522%, as the country's debt was repriced given factors discussed earlier (i.e. policy normalisation). Nigeria now has the largest stock of outstanding debt across SSA, with the next largest debt stock recorded for South Africa at US$6.6bn.

In the corporate Eurobonds space, activity was muted in the year, with only one Nigerian corporate issuing an instrument in 2018 - Seplat Petroleum Development Company. The company issued a 5-year instrument at a coupon rate of 9.25%.

Chart 25 a-b: Total Subscriptions and Sales at PMA Bond Auctions (2014-2018)



Source: Central Bank of Nigeria

Also, Guaranty Trust Bank Plc's 5-year Eurobond matured in the year, however, the bank decided against re-issuance noting limited opportunities for US Dollar business growth.

Crystal Ball Indicative of More Volatile Year, Presenting Trading Opportunities

The Nigerian economy is expected to remain on a tentative path of growth, just as monetary policy is expected to remain tight in the face of expected pressure. However, with risk factors such as policy normalisation in the US and UK and cessation of monetary easing in the EU, as well as soft issues such as the potential change of the CBN governor expected to crystallise in the year, we expect more volatility, that should allow investors position and ride the curve to boost income. Overall market yields on Treasury Bills and Bonds are anticipated to moderate by c.2.0% apiece to the range of 13.0-13.5% in 2018 with the yield curve transitioning back to steepness.

We expect yields to maintain an uptrend going towards the presidential elections which will be held in February 2019, with average yields on bonds and Treasury Bills forecasted to top out at the 16.0% level. Following the end of the elections, we anticipate a resurgence in capital inflows into the country, which should result in a moderation in yields as foreign investors take advantage of relatively high yields in the market. This expectation is however dependent on the peaceful transition of the new government, be it the incumbent or an opposition candidate. We highlight some of the revelations from our crystal ball below.

1. **Inflationary Pressure Could Buoy Rates:** Inflation had moderated in 2018, allowing headroom for a downward revision to the policy rate, however, given the tight monetary stance the MPC decided to hold. While we expect a tight monetary policy stance through 2019, we view the possibility of upside pressure on price levels in the event of the removal of petrol subsidies and adjustment of electricity tariff as fair. Consequently, we expect the CBN to utilise policy levers to ensure positive real rate of return.

2. **Short-term Yield Spike Provides Opportunity:** We expect short-term rates to continue an uptrend going towards the elections, before retracing through H2:2019. At current levels, yields on Treasury bills are still comparatively attractive, with the c.364-day instrument trading at a yield of 17.3% on the 31st of December 2018. This offers an opportunity to lock in attractive yield over the short-term and capital appreciation benefits as yields decline in H2:2018. However, given re-investment risk inherent in that strategy, we advise taking position and selling down before yields begin downtrend and investing in long-term bonds, which should still carry attractive yields, as we expect short-term rates to descend prior to yields on long tenor assets.

3. **Yields on Long-Term Instruments Optimal for Duration Play:** Given our expectation of a decline in yields, the bonds which will offer the largest gains will be higher modified duration bonds. These bonds are more sensitive to declines in yields and are estimated to gain the most per instrument for every percentage decline in the market yield. We expect to see increased activities in the bond space from investors seeking to ride yield downwards for the capital appreciation benefits and institutional fund managers, notably Pension Fund Managers who will seek to lock in high rates to match their Hold-to-Maturity strategies.

4. **Eurobonds Market Will Continue to Hold Trading Value:** The Eurobond market remained volatile in the year, as fundamentals of issuers changed. In the Sovereign Sub-Saharan Africa (SSA) Eurobonds market, issues bordering on frontier and emerging market contagion following economic pressures and currency losses saw Eurobond yields spike in 2018. While in the Nigeria corporate Eurobonds space, concerns regarding the banking sector, as well as changing fundamentals of specific corporates resulted in significant price movements during the year.
The Eurobonds market is quite active and given that the holders of assets are geographically diverse, the movements in assets prices are quite volatile depending on assessments regarding economic fundamentals and credit worthiness of issuers. Given our assessment that the market will be particularly volatile in 2019, opportunities to take advantage of the market will be significant.

5. **Real Sector Support Facility Will Drive Corporate Issuances:** The CBN instituted the RSSF through differentiated Cash Reserve Ratio (CRR) and Corporate bonds programme aimed at boosting credit extension to the real sector. While information on the level of adoption is unavailable, we anticipate increased utilisation from firms in 2019, especially given high market interest rates. This should be supported by the Federal Government's focus on foreign debt issuances which moderates the crowding out of corporate entities in the debt market.

Nigeria Sovereign Eurobonds				
Issue	Issue Date	Maturity Date	Coupon	Outstanding Value (USD m)
6.75 28 JAN 2021	28-Jan-11	28-Jan-21	6.750%	500.0
5.625 27 JUN 2022	27-Jun-17	27-Jun-22	5.625%	300.0
6.375 12 JUL 2023	12-Jul-13	12-Jul-23	6.375%	500.0
7.625 21 NOV 2025	21-Nov-18	21-Nov-25	7.625%	1,118.0
6.5 28 NOV 2027	28-Nov-17	28-Nov-27	6.500%	1,500.0
7.143 23 FEB 2030	23-Feb-18	23-Feb-30	7.143%	1,250.0
8.747 21 NOV 2031	29-Nov-18	21-Nov-31	8.747%	1,000.0
7.875 16 FEB 2032	16-Feb-17	16-Feb-32	7.875%	1,500.0
7.696 23 FEB 2038	23-Feb-18	23-Feb-38	7.696%	1,250.0
7.625 28 NOV 2047	21-Nov-17	28-Nov-47	7.625%	1,500.0
9.248 21 NOV 2049	21-Nov-18	21-Nov-49	9.248%	750.0
				11,168.0

Section Six

Alternative Asset Classes

Derivatives Market Review and Outlook

Derivative products for hedging against asset price volatility are gaining prominence in the Nigerian market. The CBN, since the introduction of I&E FX window and in partnership with the FMDQ, maintains several FX-based derivative products to enhance FX liquidity. Although there are no derivative products for hedging in the equities and fixed income spaces, few forward contracts track some commodities while through the facilitation of the CBN, forward, futures and swaps contracts track the trading of foreign exchange. The two major exchanges in Nigeria, NSE and FMDQ, continue to put measures and technology in place to commence the full trading of derivatives across the traditional asset classes, but operations are yet to begin. However, since the structuring of current FX derivatives exclude speculative traders that can help deepen and make the market more active, trading during 2018 was largely calm with soft activities around the naira settled OTC FX Futures market.

Forward and Futures Market

The value of FX forward contract sales has grown over the past two years due to increased Naira volatility and the CBN's FX reserves management strategy. Total turnover for money market derivatives as at November 2018 was slightly lower by 2.7% Y-o-Y at US$71.0m relative to FY:2017.

There are twelve different tenors of naira settled non-deliverable OTC FX futures contracts with combined total offer amount of US$12.0bn. Growing interest in these contracts has seen the total value of open contracts increase by US$1.6bn Y-o-Y as against a decline of US$336.3m in 2017. The May-2019 contract was the most subscribed in 2018 at US$723.4m with a close rate of N365.19/US$1.00

In 2019, we expect interest to further grow as foreign investors return to the market post-elections, although the naira-settled nature of the market remains a major drag to its development.

Options and Swaps

The launch of the options market in Nigeria has faced some setbacks since the scheduled launch date in 2018. The launch of the options trading platform now postponed to 2019, is expected to significantly shift the dynamics of the Nigerian financial market by further deepening the market. Options offer the holder the right, but not the obligation to execute a transaction at a pre-stated volume of an underlying asset at a given date as well as at an established rate. Similar to forwards and futures, asset classes including equities, bonds, interest rates, commodities, currencies etc. often serve as underlying assets in option contracts. Currently, from the schedule of corporate bonds listed on FMDQ, there are four securities issued with call options as shown in chart 29.

Chart 28: OTC Futures Contract as at Dec 2018

Contract Tenor (Month)	Contract	Settlement Date	Value of Open Contracts ($'mm)	Current Rate ($/N)
1	NGUS JAN 30 2018	30-Jan-19	515.09	364.59
2	NGUS FEB 27 2018	27-Feb-19	557.16	364.74
3	NGUS MAR 27 2018	27-Mar-19	423.56	364.89
4	NGUS APR 24 2018	24-Apr-19	245.74	365.04
5	NGUS MAY 29 2018	29-May-19	723.4	365.19
6	NGUS JUN 26 2018	26-Jun-19	262.66	365.34
7	NGUS JUL 24 2018	24-Jul-19	243.87	365.49
8	NGUS AUG 21 2018	21-Aug-19	277.97	365.64
9	NGUS SEP 18 2018	18-Sep-19	666.48	365.79
10	NGUS OCT 30 2018	30-Oct-19	318.62	365.94
11	NGUS NOV 27 2018	27-Nov-19	517.65	366.09
12	NGUS DEC 26 2018	24-Dec-19	20.15	366.24
Total			**4,772.35**	

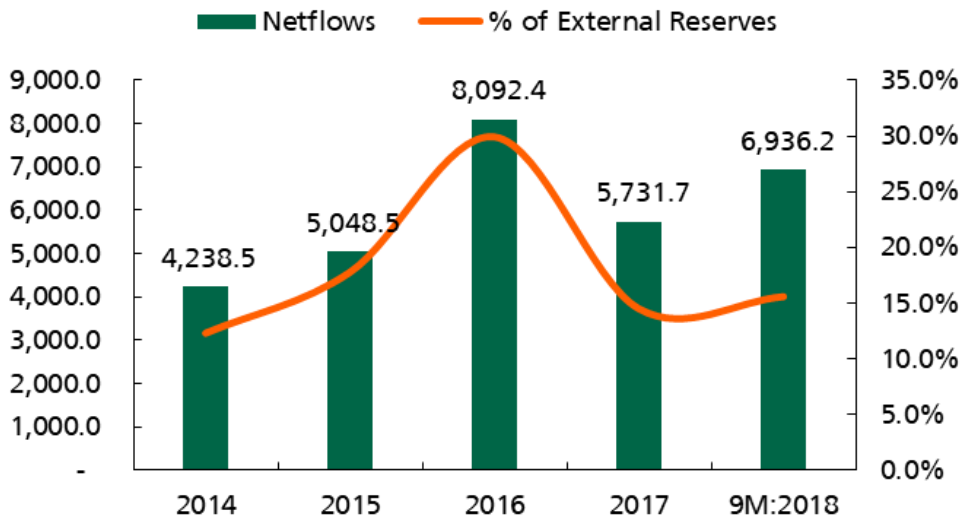
Source: FMDQ

Chart 29: Selected bonds with embedded options

Issuer	Maturity Date	Coupon (%)	Tenor (Years)	Option Type	Currency
UBA	30/12/2021	16.45	7	CALLABLE	Naira
Fidelity Bank	13/05/2022	16.48	7	CALLABLE	Naira
Access Bank	24/0612021	9.25	7	CALLABLE	USD
First Bank Nigeria	23/07/2021	8.00	7	CALLABLE	USD

Source: Bloomberg, Afrinvest Research

Chart 30: Swap Contract Net Flows



Source: CBN, Afrinvest Research

Inflows from currency swaps have seen significant improvement in value as total inflows spiked 68.5% from US$2.7bn in 9M:2017 to US$4.9bn (9M:2018). Net flows from swap contracts between DMBs and the apex bank accounted for 15.7% of the external reserves (US$44.3bn) as at 28/09/2018. Net flows stood at US$6.9bn as at 9M:2018, 6.6% lower than its value the same period in 2017.

Real Estate Review and Outlook… Performance Remains Weak

In 2018, the performance of the real estate sector remained weak as output growth continued to contract Y-o-Y, although at a decreasing pace. Increased activities across various sub-sectors of the industry – residential, retail, office, hospitality and industrial - rose slightly owing to improving consumer spending in these areas. According to Northcourt, residential and hospitality markets showed improved price stability and increased levels of activity due to higher disposable incomes and increased traffic to major cities such as Lagos and Abuja; while office and retail spaces struggled in the first half of the year due to high rental cost of Grade A offices and malls. Furthermore, prices of building materials trended downwards, rents stabilised, suspended projects were revived, and new projects commenced as foreign exchange rates remained fairly stable following elevated liquidity levels.

Chart 31: Cost of Building Materials

Description	H1:2017 (N)	H1:2018 (N)	Y-o-Y
Cement (50kg)	2,800	2,700	-3.6%
Sandcrete block (9 inch)	220	210	-4.5%
Aluminium Roofing Sheet (0.55m)	2,500	2,700	8.0%
Cables (6mm/Coil)	38,000	35,000	-7.9%
Coloured Emulsion Paint	12,000	5,500	-54.2%
Paving Stone 60mm (Local)	2,100	1,800	-14.3%
Harvey Roof Tiles	11,000	4,500	-59.1%
White Emulsion (Dulux)	28,000	30,370	8.5%
Twyford Complete Set WC	14,000	14,500	3.6%
Ariston Water Heater (Small)	28,000	25,000	-10.7%
13A Socket	1,200	1,500	25.0%
Distribution Board	45,000	48,000	6.7%

Source: Northcourt

High Risk and Elevated Rates dampen Mortgage Financing

Although mortgage financing is one of the most effective ways to reduce the housing deficit in Nigeria (assessed at 17 million units), the contribution of mortgage loans and advances to GDP remains low, estimated at 0.6% by the Nigerian Mortgage Refinancing Company (NMRC). According to Afrinvest's Banking Survey in 2018, poor information flow was one reason for the slow adoption of mortgages, in addition to the existing high interest rates. On the other hand, the slow adoption of the Model Mortgage Foreclosure Law (a legal mechanism that allows the lender take possession and sell the property in the event of a default) by majority of states coupled with double digit inflation supported the high interest rate offered by these institutions.

Furthermore, we analysed the performance of the NMRC - a vehicle created to close the gap between the capital market and mortgage lenders by refinancing loans – to assess the depth of mortgage refinancing through the company. As at FY:2017, the bank's refinanced loans marginally rose 2.5% Y-o-Y to N8.3bn from N8.1bn in FY:2016. Interestingly, investment in government securities accounted for 71.4% of total assets while total refinanced loans as at FY:2017 accounted for only 19.3% indicating the firm's sub-optimal refinancing activities. This trend further reflects the perceived high risk in the real estate sector as the NMRC elected to direct funds towards more attractive and less risky investment opportunities. Hence, this invariably compounds the funding challenge faced in the mortgage industry.

Outlook: Weak Growth to Persist despite Stakeholders Optimism

In line with trend, capital expenditure releases for the 2018 budget cycle are projected to buoy construction activities, impacting directly on the growth of the sector. Although positive, the improved but slow rate of growth in other sub sectors such as the hospitality, health, industrial and retail sectors may temper the overall expansion of the sector. Hence, we believe the contraction the sector witnessed in 2018 will continue to moderate and growth will remain weak in 2019. As regards mortgage financing, plans to recapitalise the Federal Mortgage Bank of Nigeria (FMBN) to strengthen its capacity are underway; however, we opine that this would be insufficient to drive increased mortgage activities in the year. Thus, we expect the long-standing funding constraint to remain.

Chart 31: Cost of Building Materials

NMRC FY: 2017 Result - Financial Highlights (NGN Billion)			
Statement of Comprehensive Income	**FY:2017**	**FY:2016**	**Y-o-Y Growth**
Gross Earnings	6.2	5.2	19.0%
Interest Income	6.1	5.2	18.8%
Interest Expense	(2.2)	(2.2)	0.9%
Net Interest income	4.0	3.0	31.5%
OPEX	(2.1)	(1.7)	22.8%
PBT	1.9	1.3	50.9%
Taxation	(.0)	(.0)	49.3%
PAT	1.9	1.2	66.4%
Per share data	**NMRC**		
Current Price	n/a		
EPS	2.1		
Ratios			
RoAE	18.8%		
RoAA	4.6%		
Net Interest Margin	9.5%		
Cost of Funds	9.5%		
Cost to Income	52.4%	56.1%	
Net Margin	31.3%	22.4%	
Statement of Financial Position	**FY:2017**	**FY:2016**	**% Growth**
Cash and Bank Balances	1.9	1.3	52.5%
Total Loans and advances (Mortgage refinance loans	8.2	8.1	1.5%
Financial Assets	31.8	29.4	8.1%
Total Assets	42.5	40.8	4.3%
Total Equity	11.7	8.6	36.0%
Placements with Banks	0.0	1.4	-100.0%
Total Borrowings	22.8	24.3	-6.0%
Total Liabilities	30.8	32.2	-4.2%

Source: Northcourt

Commodities Market Review and Outlook

Lower Sugar Production to Lift Prices in 2019

Sugar prices are expected to slightly recover in 2019/20 as the market tightens due to lower production in Brazil and the EU. This is clearly a departure from the previous two years when oversupply led to lower prices. Specifically, from a net surplus of around 20.6 million tonnes in 2017/18, the United States Department of Agriculture (USDA) is forecasting a net surplus of 9.1 million tonnes in 2018/19. This is mainly driven by sugar production which is estimated to contract by 4.5% to 185.9 million tonnes, reflecting lower output in Brazil and the EU. In Brazil, raw sugar output has competing uses in ethanol production and this is expected to weigh on supply. Lower yields due to ageing plantations also reduces the prospects of higher sugar supply in Brazil. In the EU, the removal of export and output quotas, which fuelled higher supply in the past year, is expected to have a lesser impact on supply balance in 2019. Lower production is expected in EU as farmers switch to wheat which is likely to offer better prices. However, Indian exports are expected to support sugar supply in the short-term as the government incentivises more production.

On the other hand, sugar demand is forecasted to increase 1.6% to 176.8 million tonnes as food and drinks companies reduce sugar content due to increased health consciousness. Government policies and health campaigns discouraging sugar consumption are also expected to hurt demand. However, the build-up in sugar stock due to oversupply in the past two years is likely to exert pressure on sugar prices.

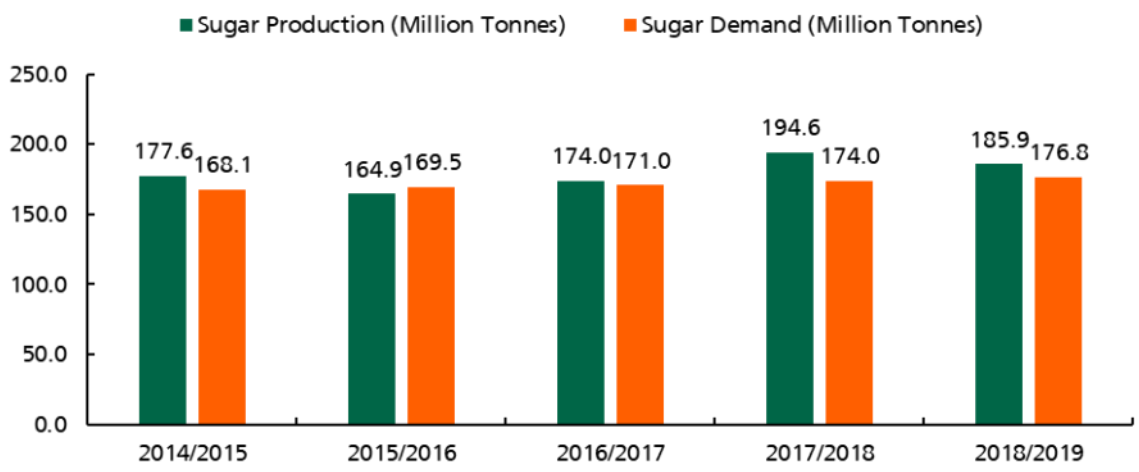
For sugar imports into Nigeria, the expectation of slightly higher sugar prices will result in increased input costs for foods and drinks manufacturers. This could worsen if there is a currency devaluation. Overall, both effects will lead to a moderation in the margins of manufacturers as intense competition may limit pass through to consumer prices.

Wheat Prices to Rise amid Tighter Global Supply in 2019

Based on the balance between demand and supply, higher wheat prices are expected in 2019. On one hand, global wheat production is expected to contract 3.9% to 733.4 million tonnes in 2018/19 from 763.1 million tonnes in 2017/18. The moderation in production is partly due to a drought which is expected to reduce harvest output in Australia by as much as 20.2% to 17.0 million tonnes. Lower output in the EU (-9.0%) and Russia (-17.6%) to 137.6 million tonnes and 70 .0 million tonnes respectively is also expected to affect global production. However, higher output in India, Canada, Argentina and the US are expected to marginally offset the decline in the aforementioned countries. On the demand side, wheat consumption is estimated to marginally expand 0.1% to 745.3 million tonnes in 2018/19 from 744.2 million tonnes in the previous year. A broad-based increase in wheat consumption is expected across countries, with the exception of Russia (-5.8%), the EU (-4.1%) and Indonesia (-3.8%) where deep contractions are expected. Hence, the global market is expected to suffer shortages which will induce higher prices. However, high global stock of wheat from the preceding period will weigh on prices.

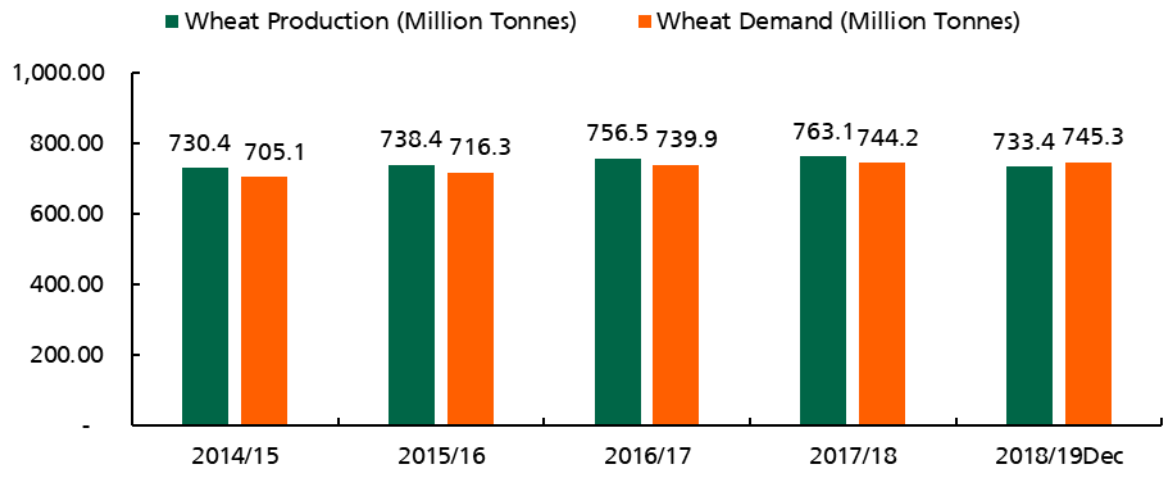
For food companies using wheat in Nigeria and which rely mostly on importation, increased wheat prices are negative as we expect higher input costs. This should ordinarily lead to a slight compression in gross margin for flour companies, but we expect them to pass it on to food companies at the end of the chain.

Chart 33: Global Production and Consumption of Sugar



Source: USDA, Afrinvest Research

Chart 34: Global Production and Consumption of Wheat



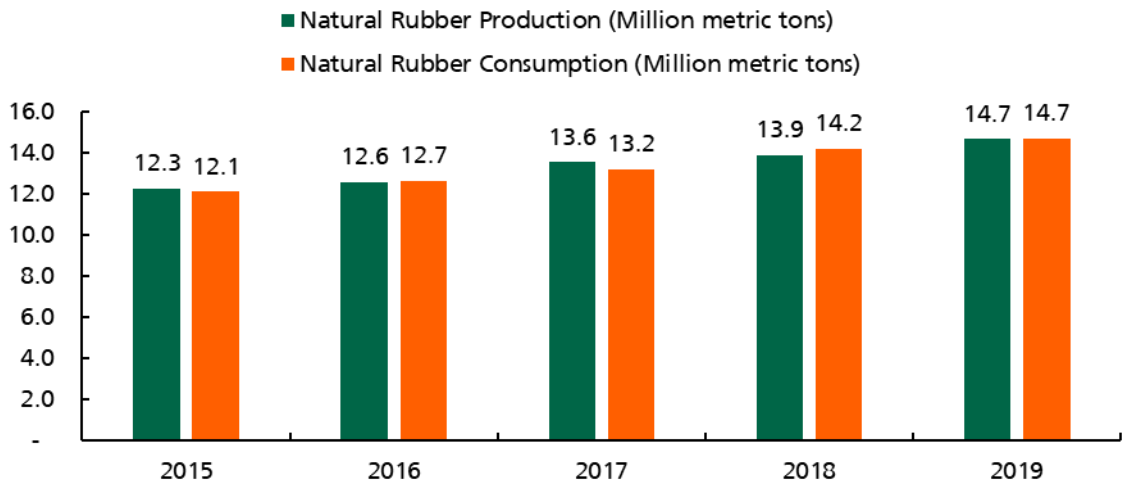
Source: USDA, Afrinvest Research

Tepid Demand to Restrain Natural Rubber Prices in 2019

The World Bank expects lower rubber prices in 2019 after a fall by as much as 20.0% in 2018. This is expected to reflect rising output in Thailand and Vietnam – which are the world's top suppliers of rubber – due to favourable weather. Hence, global rubber production is projected to increase 5.8% to 14.6 million tonnes in 2019. However, the International Rubber Study Group projects a slower 3.6% increase in rubber consumption to 14.7 million tonnes in 2019 (2018: 7.5% to 14.2 million tonnes). On the demand side, weakness in China is expected to put downward pressure on prices. As most of rubber production is used to manufacture tyres, an import duty levied on Chinese tyres by the US is expected to affect demand. Similarly, a projected moderation in tyre imports in the EU will also negatively impact rubber demand.

The persistent weakness in the price of natural rubber is expected to slightly weigh on the earnings of agriculture companies in Nigeria, especially Okomu Oil Plc.

Chart 35: Global Production and Consumption of Natural Rubber



Source: International Rubber Study Group, Afrinvest Research

Cocoa: Rising Demand to Support Prices

From the start of 2018 to May, the price of Cocoa rose by about 50.0% from US$1,800/t to US$2,800/t as low prices from 2017 stimulated demand. Prior to January 2018, Cocoa prices had declined significantly, hitting a 10-year low due to the more than favourable harvests in the 2016/17 season. Although prices softened in December 2018, the demand for Cocoa is expected to remain buoyant in 2019. Data from a Dutch Bank – ABN AMRO reveals that the consumption of cocoa in emerging countries has increased at a remarkably strong rate with China and Indonesia's cocoa imports growing at 16.0% and 2.0% respectively in 2018. This coupled with a stable demand for the commodity in Europe is expected to support demand and prices in 2019.

On the supply side, analysts forecast sufficient supply in the coming year as weather conditions in West Africa which houses the largest producers – Cote d'ivoire and Ghana – are anticipated to remain favourable. Furthermore, the International Cocoa Organization (ICCO) revealed that the number of stocks to grindings has declined due to the faster pace at which the number of grindings has increased compared to the pace of growth of inventories – a sign that less Cocoa powder may be available in the market resulting in an upward movement in prices.

While the direction of prices in 2019 is anticipated to move northwards, the downside risks include the influence of El-Nino on harvests as well as political instability in cocoa producing countries.

Crude Palm Oil (CPO): Lunar Year Festivities to Drive Prices Higher in Q1:2019

In 2018, several factors such as favourable weather conditions in the world's largest CPO producing countries – Malaysia and Indonesia, weaker demand which drove stock piles and anti-palm oil campaigns in the west resulted in CPO prices reaching multi year lows in 2018. As a result, forecasts for full year closing stock is projected to grow by 0.2 million tonnes to 2.9 million tonnes due to weaker exports according to commodity analyst in Malaysia.

While 2018 was characterized by low prices, anticipation for a rise in demand and an improvement in prices in Q1:2019 is building up due to China's lunar year festivities. Hence, exports are projected to increase while production improves due to higher yields on fresh fruit bunches. Furthermore, Indonesia's push for greater biodiesel consumption and the price differential between palm oil and its main substitute soybean oil (with the price of soybean oil higher than CPO) is expected to boost demand and prices for the former.

However, the direction of demand in Q2-Q4:2019 is unclear as the industry still lacks strong catalysts to support the upward trend in prices in this period. This, in addition to the faster pace of production relative to exports may keep supply above demand, weighing on prices in the period.

Section Eight

Investment Strategy for 2019

Investment Strategy for 2019

In search of Value

Developments within global and domestic markets cast doubts on investor optimism for optimal returns in an – expected to be keenly contested – election year. Whilst there is a clear case of undervaluation of Nigerian equities and a relatively higher yield environment compared to frontier and emerging market peers, we imagine that, in search of value, investor confidence will be laced with caution in 2019. Earlier in 2018, our investment strategy had envisioned an equities market driven by sound fundamentals in the first half but with price corrections in H2 while lower yield in the second half of 2018, after rising yield in H1, was forecast to inspire a bullish performance in the fixed income market.

Sadly, rising interest rates in the US and UK, coupled with anticipatory election apprehensions, compelled a bearish equity outing while sustained high yield environment, yet less active fixed income market, especially at the long end of the yield curve, delivered less desirable return. Again, as the markets refocus with renewed vigour in 2019, worries around the possible election outcomes, which could sustain recent bearish tone set since 2018, remain the greatest consideration for determining the most optimal strategy that will deliver alpha.

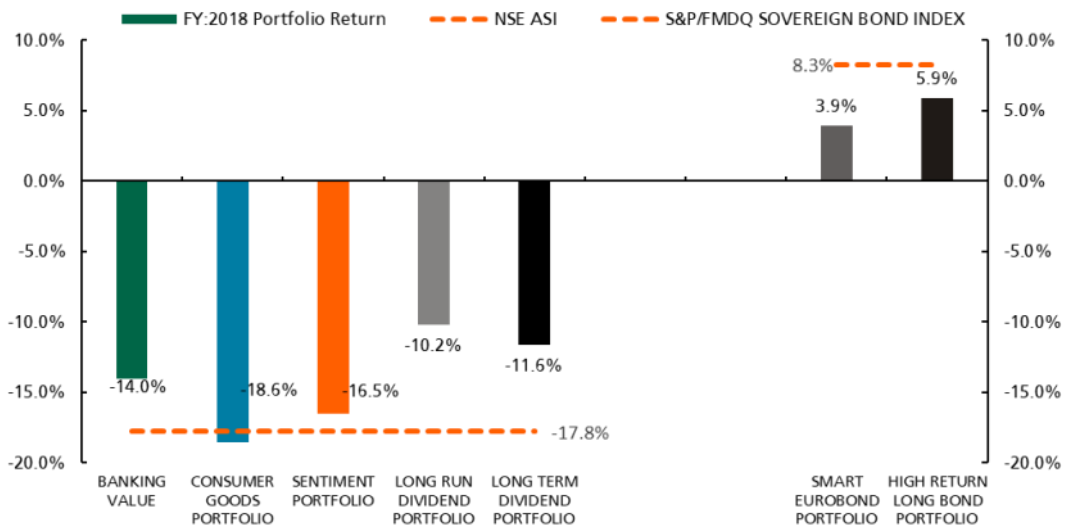
Hence, our strategy preaches significant overweight on the fixed income market for H1:2019 and a balance of play between equities and fixed income markets in H2:2019. Election concerns are projected to further drain equities market performance until a peaceful transition is achieved in May. Conditioned on other macro and market developments, this is anticipated to largely swing equity sentiment for unmatched bullish run. Yet, regardless of policy changes post elections, for as long as a successful government transition holds sway, the yield environment should moderate and swell fixed income assets by H2:2019.

Review of 2018 Strategy: "Recovery Investing amid Moderating Yields Supports a Fundamental Strategy"

Following our outlook for stable oil prices and a slow but steady growth of the economy, our expectations for the Nigerian financial market in 2018 was positive. We opined that gradual economic growth, improved fundamentals and the strong investor sentiment at the start of the year would be drivers of equity asset prices in the first half. Thus, we advised investors to adopt a mix of fundamental investing in equity and position at the long end of the yield curve following our expectation of a moderation in the interest rate environment.

However, the effect of policy normalisation in systemically important banks, notably the US Fed, coupled with pre-election fears, led to capital flow reversals by February 2018. The consistent outflow in foreign portfolio investments dragged the benchmark index to the negative region, as the All-share index lost 17.8% in 2018 while in the fixed income market, yields on

Chart 36: Afrinvest 2018 Strategy Portfolio Returns



Source: Afrinvest Research

short term instruments rose as the CBN sought to limit the impact of fund flow reversals.

As a result, our equity portfolios, though outperforming, mirrored the bearish performance of the broader market. On the fixed income side, our portfolios performed positively at the close of the year despite our strategy to focus on the longer end of the yield curve.

Fixed Income Strategy … Playing to Market Expectations

The strategy for 2019 was crafted to take advantage of the opportunities we see in the market. Our expectation of volatility in both the Sovereign Treasury Bonds and Eurobonds market means that we expect investors to have the opportunity to ride the curve to generate returns through the year. Also, investors with buy and hold strategies would also be able to take advantage of the anticipated spike in market yields. Given our assessments we propose three strategies for investors, listed below:

1. **Modified Duration – Bond Portfolio**
2. **Smart Eurobond Portfolio**
3. **Passive Bond Portfolio**

Modified Duration-Bond Portfolio

We expect the yield environment to moderate post-2019 general elections in H2:2019. Thus, our Modified Duration - Bond Portfolio is designed to leverage on expectations for the path of yields in 2019. Technically, this implies that bond prices are anticipated to rise given its inverse relationship with rates. We therefore recommend investing in long term bonds which we estimate will witness the largest price increases when yields decline. Consequently, we have selected four on-the-run sovereign bonds with modified durations between 3.8 – 5.9.

While we recommend bonds with higher modified durations, we acknowledge that investors at times have shorter tenor preferences and so we have recommendations in this line. Nonetheless, we note that all Bonds recommended are on-the-run and as such are quite liquid, and so offloading the instruments should not be problematic.

Smart Eurobond Portfolio

We are of the view that despite the normalisation of policy rates externally, emerging and frontier markets still present opportunity for optimal return. This assumption informs our "Smart Eurobond Portfolio" designed for trading to take advantage of the highly active Eurobond market. The portfolio comprises a selection of Sub-Saharan Africa (SSA) and corporate Eurobonds intended to take advantage of yield volatility.

Whilst we designed the portfolio to be actively traded to take advantage of market volatility, we recommend taking position in attractively priced instruments of issuers which we assess have good credit quality. Consequently, we have selected bonds with minimum Ask -yields of 7.7% with term-to-maturities not exceeding 5.0

Chart 37: Modified Duration-Bond Portfolio

Instrument	Issue Date	Coupon (%)	Maturity Date	TTM (yrs.)	Yield (%)	Closing Price	Modified Duration	Convexity	Change in Value (-1%)
13.53 23-MAR-	23/3/18	13.53	23/3/2025	6.23	15.54	92.12	3.84	207.45	96.61
16.2884 17-MAR-	17/3/17	16.29	17/3/2027	8.21	15.55	103.29	4.30	279.69	109.18
13.98 23-FEB-2028	23/2/18	13.98	23/2/2028	9.15	15.54	92.48	4.64	332.43	98.31
16.2499 18-APR-	18/4/17	16.2499	18/4/2037	18.30	15.24	106.11	5.88	620.97	115.64

Source: Afrinvest Research

Chart 38: Smart Eurobond Portfolio

Issuer	Maturity	Coupon	Bid-Price	Offer-Price	Bid-Yield	Offer-Yield
REPUBLIC OF GHANA	07-Aug-23	7.875	97.25	98.25	8.61	8.34
FIDELITY BANK	16-Oct-22	10.5	100.00	101.00	10.49	10.16
UBA	08-Jun-22	7.75	99.25	100.13	8	7.7
ZENITH BANK	30-May-22	7.375	99.38	100.13	7.58	7.33
SEPLAT PETROLEUM	01-Apr-23	9.25	99.00	100.50	9.54	9.06

Source: Afrinvest Research

Passive Bond Portfolio

The market for corporate and sub-national debt is oft ignored, given the crowding out effect of the Federal Government's activities in the debt market. We note that while the market is illiquid, the credit quality of many of the instruments are quite good and offer investors a path to generate above market returns. Our ''Passive Bond Portfolio'' is therefore constructed with the most credit worthy bonds which offer attractive yields, that investors with low liquidity needs can take advantage of. We therefore recommend this portfolio for passive investors with long term fund with a maximum tenor of 5 years for any constituent of the portfolio with an investment rating not less than 'BBB'.

Equities Market Strategy … In Search of Alpha

Our expectation is that the bearish sentiment for equities will be reversed in the year although cautious optimism is advised. Nonetheless, we believe there is a compelling investment case for value, growth and income stocks as the strategy is likely to deliver alpha in 2019.

1. **Value Portfolio**
2. **Growth Portfolio**
3. **Banking Quality Portfolio**
4. **Dividend Income Portfolio**

Value Portfolio

Based on our optimism for a rebound in the market post-elections, we created a portfolio constituted of undervalued stocks with strong earnings fundamentals. In screening our selection, we used a mix of fundamental and technical analyses – although tilting more towards fundamental analysis. Stocks with a 5-year positive return on equity (ROE) higher than industry's ROE, 5-year dividend yield above industry average as well as earnings yield above industry average in 4 of 8 quarters were selected. However, based on technical analysis, we made a case for UACN as the stock fell below industry average ROE (12.1%) but is currently trading close to its 1 year-low. Back testing this portfolio with the broader market, it moved in tandem with the benchmark index, outperforming the ASI in 3 of 5 years. As a result, we expect the portfolio to return positively when the market rebounds post-election.

Growth Portfolio

Our growth portfolio is recommended for long term investors with a preference for income generating equity assets in 2019. The portfolio tracks fundamentally justified stocks in our universe with a positive 5-year EPS CAGR, ROE above industry average in the last five years as well as a 5-year dividend yield above market average.

Chart 39: Passive Bond Portfolio

Issuer	Coupon (%)	Issue Date	Maturity Date	TTM (yrs.)	Yield (%)	Closing Price
FORTE OIL	17.5	02-Dec-16	02-Dec-21	1.79	16.82	100.93
UBA	16.45	30-Dec-14	30-Dec-21	3.00	16.00	101.03
FIDELITY BANK	16.48	13-May-15	13-May-22	3.37	16.05	101.02
UPDC	16	26-Apr-18	26-Apr-23	3.57	16.44	98.79

Source: Afrinvest Research

Chart 40: Screened Value Portfolio

	EARNINGS YIELD COUNT	5-YEAR AVERAGE DIVIDEND YIELD	5-YEAR AVERAGE ROE	WEIGHTING
GUARANTY	4	9.9%	28.4%	30.0%
ZENITH	8	6.9%	20.0%	27.0%
UBA	8	9.9%	19.1%	14.9%
ACCESS	8	9.1%	16.1%	12.2%
STANBIC	8	6.8%	22.4%	9.8%
UACN	8	6.9%	9.20%	6.1%

Source: Bloomberg, Afrinvest Research

Furthermore, we screened for a positive price to earnings growth (PEG) to make the final selection of stocks. Hence, **ACCESS**, **UBA**, **ZENITH**, **GUARANTY** and **DANGSUGAR** emerged as the final constituents. Our recommendation is for investors to take position in January ahead of FY:2018 corporate earnings releases and hold for a 12-month period so as to enjoy dividend payments as well as capital appreciation. Nevertheless, investors can hold till the anticipated market rally post-election before exiting. In a similar fashion, we back-tested the growth portfolio against the broader index. The portfolio outperformed the market in 2 of 5 years; hence we remain optimistic of its performance in 2019.

Banking Quality Portfolio

The performance of the banking sector in 2018 was dragged by the overall bearish sentiment of the local bourse as political agitations influenced market sentiment. This was despite the positive earnings posted by Nigerian banks (especially tier-1 players) as well as the relatively higher liquidity of banking sector stocks.

We maintained our banking quality portfolio from 2018 and retained the selection criteria – stocks with ROEs higher than industry average in at least 8 of the last 16 quarters or stocks that simultaneously meet our market value criteria of earnings yield, dividend yield and book value to price yield higher than industry average in at least 4 of the last 8 quarters. Lastly, we also screened for liquidity using average traded value ratio (ATVR) greater than 2.5%. The portfolio has outperformed the broader banking index in at least 4 in the last 5 years.

Chart 41: Growth Portfolio

STOCKS	ROE COUNT	BVP/P COUNT	EARNINGS YIELD COUNT	DIVIDEND YIELD COUNT	LIQUIDITY	WEIGHTING
GUARANTY	16	-	4	2	12.3%	30.0%
ZENITH	16	-	8	2	17.7%	30.0%
ACCESS	13	8	8	4	13.2%	15.3%
UBA	16	8	8	2	14.9%	14.9%
STANBIC	16	8	8	1	3.5%	9.8%

Chart 42: Banking Quality Portfolio

STOCKS	ROE COUNT	BVP/P COUNT	EARNINGS YIELD COUNT	DIVIDEND YIELD COUNT	LIQUIDITY	WEIGHTING
GUARANTY	16	-	4	2	12.3%	30.0%
ZENITH	16	-	8	2	17.7%	30.0%
ACCESS	13	8	8	4	13.2%	15.3%
UBA	16	8	8	2	14.9%	14.9%
STANBIC	16	8	8	1	3.5%	9.8%

Source: Bloomberg, Afrinvest Research

Chart 43: Dividend Income Portfolio

STOCKS	DIVIDEND PAYMENT COUNT	NET INCOME GROWTH COUNT	DIVIDEND YIELD COUNT	WEIGHTING
GUARANTY	5	6	6	20.0%
DANGSUGAR	5	5	6	20.0%
ZENITH	5	5	6	16.3%
UACN	5	4	5	12.2%
NASCON	5	4	5	7.0%
UBA	5	5	6	6.3%
UCAP	4	4	6	5.7%
CCNN	4	4	4	5.5%
ACCESS	5	4	6	3.0%
NEM	4	4	5	1.6%
FIDELITY	5	4	6	1.4%
STERLING	5	5	4	0.6%
FCMB	5	4	6	0.3%

Source: Bloomberg, Afrinvest Research

Dividend Income Portfolio

The Dividend Income Portfolio was developed for investors with a transient time horizon, especially the first three months in 2019 to position for 2018 final dividend payments. Selection conditions for this portfolio included fundamentally sound stocks with a minimum of 4 years dividend payment history, positive earnings growth and above market average dividend yield for a minimum of 4 of the previous 6 years. Qualified stocks were also screened for liquidity level with a minimum of 2.5% using the ATVR. We believe that optimum return can be derived from the portfolio based on an entry in January and exit following the post dividend declaration rally.

Section Eight

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Afrinvest (West Africa) Limited

About US

Afrinvest (West Africa) Limited ("Afrinvest" or the "Company") is a leading independent investment banking firm with a focus on West Africa and active in four principal areas: investment banking, securities trading, asset management, and investment research. The Company was originally founded in 1995 as Securities Transaction and Trust Company Limited ("SecTrust") which grew to become a respected research, brokerage and asset management firm. Afrinvest (West Africa) Limited is licensed by the Nigerian Securities and Exchange Commission ("SEC") as an issuing house and underwriter. We provide financial advisory services as well as innovative capital raising solutions to High Net-worth Individuals ("HNIs"), corporations, and governments. Afrinvest is a leading provider of research content on the Nigerian market as well as a leading adviser to blue chip companies across West Africa on M&A and international capital market transactions. The company maintains three offices in Lagos, Abuja and Port-Harcourt.

Afrinvest Securities Limited ("ASL") is licensed by the Nigerian SEC as a broker dealer and is authorized by the Nigerian Stock Exchange ("NSE") as a dealing member. ASL acts as a distribution channel for often exclusive investment products originated by Afrinvest and AAML as well as unique value secondary market trading opportunities in equity, debt, money market and currency instruments.

Afrinvest Asset Management Limited ("AAML") is licensed by the Nigerian SEC as a portfolio manager. AAML delivers world class asset management services to a range of mass affluent and high net worth individual clients. AAML offers investors direct professionally managed access to the Nigerian capital markets through equity focused, debt focused and hybrid unit trust investment schemes amongst which are the Nigeria International Debt Fund (NIDF), Afrinvest Equity Fund (AEF), Balance Growth Portfolio (BGP), Ethical Investment Portfolio (EIP) and Guaranteed Income Portfolio (GIP).

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