Fixed Income Outlook Q3/Q4 '21

27 Sep. 21

The fiscal to the fore

Not for the first time, thanks due to the oil price

The rebound in the global economy has come to Nigeria's rescue and delivered a firmer oil price. The unprecedented discipline of OPEC+ in restoring supply at a measured pace has played its part. Along with the allocation of SDRs and the chase after yield by foreign portfolio investors, this made for a successful Eurobond issue this month. Prospects for domestic growth and market-friendly reform are dull but the decent external balance sheet resonated with investors.

Huge supply of FGN naira paper for the market

Fiscal matters remain the principal macroeconomic driver of the fixed income market. The FGN's stance is expansionary, which means a large supply of new paper for the DMO to sell. It has a record domestic funding target this year, which is 40% higher than 2020's. It is on track to hit the target due to the steady bid by the domestic non-bank institutions, the predominant players.

No change in the CBN's position on fx

The CBN has done the easy part on the wish list of the multilaterals by scrapping the preferential official fx rate and moving to effective unification. However, it has not bought into "market-determined" rates because it likes to guide and manage. Better prospects for the oil price and reserves are on its side, and our take is that the monetary authorities will get by with a few small adjustments.

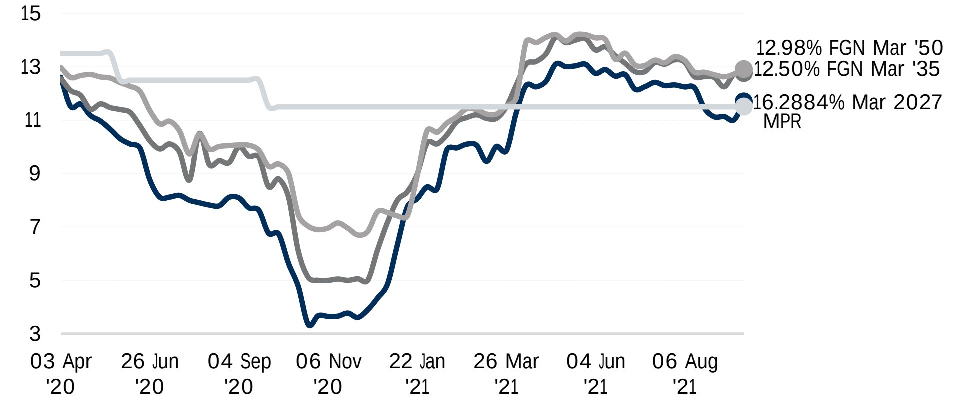
A temptation for the MPC to raise rates

Inflation is now on a downward track. We think that the committee will revert to gentle tightening to help it on its way next year once the foundations for growth are more secure.

FGN bond yields to tread water

FGN bond yields have recovered this year in response to the huge deficit financing requirement. The gap may well rise above the level in the 2021 budget, which would be funded outside the market. The DMO can count on steady institutional demand at auction. We see yields in the mid-curve stable with a small bias to the downside in a range of 10.50% to 11.50% in the quarter ahead.

FGN bond yields and the MPR (%)



Source: FMDQ, FBNQuest Capital Research

Gregory Kronsten
E-mail: gregory.kronsten@fbnquest.com
Tel: +44 7979 235 127

Tunde Abidoye
E-mail: tunde.abidoye@fbnquest.com
Tel: +234 703 005 7836

Olayinka Onikanni
E-mail: olayinka.onikanni@fbnquest.com
Tel: +234 816 779 9234

Team
E-mail: research@fbnquest.com
Tel: +234 708 065 3174

Global and domestic backdrop

No escaping the pandemic

COVID-19 continues to hang over the global economy, although the sequence of events differs across jurisdictions. China took the first significant hit in January '20 and made the first exit in macroeconomic terms. Most advanced economies followed in March/April. Unlike previous recent viruses such as SARS, no country has been spared. Western states have generally been hit at least twice.

A slow start to vaccination, domestically

Vaccines have reached developing states under the COVAX initiative, which is led by the World Health Organization and Gavi (the public-private health alliance). These supplies are being supplemented by transfers from the stocks of G7 members. As of this month, Nigeria has received eight million doses of vaccines within the initiative, and is scheduled to receive a total of 84 million in all. The official aim is vaccination of about 70 % of the adult population in 2022, and the current record is 1.9% (4.0 million Nigerians). With one exception (South Africa) fatalities in Africa have lagged the rest of the world by a considerable margin due in good measure to the lower age profile. The other costs have been heavy, however.

Strong rebound for the global economy

The latest *World Economic Outlook* (WEO) from the IMF, released in July, has the global economy recovering this year by 6.0%, the US by 7.0%, the Eurozone by 4.6%, and Japan by 2.8%. It has a strong rebound of 8.1% for China alongside 9.5% for India. For 2022, the WEO has global growth of 4.9%, in which emerging market and developing economies (5.2%) outpace the recovery of the advanced economies (4.4%). The next WEO is due next month. It may well reflect the consensus that the very different pace of vaccinations means uneven growth across borders.

Central economic indicators **Year-end December**

	2019	2020	2021F	2022F
Real growth (in per cent)	2.3	-1.9	2.9	2.8
CPI (in per cent; y/y Dec)	12.0	15.7	15.8	13.1
Monetary policy rate (%; year-end)	13.5	11.5	11.5	12.5
Current account/GDP (in per cent)	-4.3	-1.2	0.2	-0.4
Bonny Light (end-period spot; USD/b)	67	52	73	76
Bonny Light (average spot; USD/b)	66	44	68	73
Official fx reserves (in USD bn)	39	35	40	43
N/USD (NAFEX; end-period)	365	410	420	440
N/USD (NAFEX; average)	362	382	412	430

Sources: CBN, NBS, Bloomberg; FBNQuest Capital Research

The FOMC last met on 21 and 22 September. In line with market expectations, it made no change to either its benchmark (Fed funds) rate of 0.0% to 0.25% or its USD120bn monthly bond-buying programme. The committee's signals, however, had moved since the meeting in June. Its message is that we should now expect a tightening of its stance a little sooner.

The Fed may start to trim the bond-buying programme by the end of this year if "progress continues as broadly expected" towards the twin goals of average inflation of 2% and maximum employment. Jerome Powell, the Fed chair, said after the meeting that the step (taper) could be taken at the time of the next meeting (in November).

Committee members now see core inflation at 3.7% this year and 2.3% in 2022. The latest data from the Bureau of Labour Statistics for August suggest that inflation peaked the previous month (at 5.4% y/y) for the broad headline measure. We should note that the monetary authorities' adjustment of the inflation target to an average basis in August 2020 gives them a little more flexibility.

As for employment, the number of job opening increased by 749.000 to a record 10.9 million in July. Labour market surveys show about one million new jobs created in both June and July, with a sharp fall to 235,000 in August linked perhaps to a pick-up in COVID infections. The background to the "progress" is the recovery in the economy, which grew by 6.5% on an annualized basis in Q2. Output has returned to its pre-COVID level.

US output back to 2019 level

Once the programme has been wound up, the Fed moves to rate hikes. The consensus among officials polled is at least three increases in both 2023 and 2024. Nine of the 18 officials present expect the first hike before end-2022.

Rate hikes by the Fed coming!

The ECB is also preparing to adjust its stance. After the latest meeting of its governing council in early September it indicated that it would move to a "moderately lower pace" in its EUR1.85trn pandemic emergency purchase programme (PEPP) from the EUR80bn monthly level seen since March. In its own language this is not tapering but "recalibrating"of the programme, which runs until March 2022. The ECB also operates its regular asset purchase programme, which is not affected by the ECB's announcement.

A ECB taper yet not a taper

As in the US, inflation in the eurozone is running ahead of the target of 2.0% y/y. The harmonized index hit 3.0% in August although the ECB attributes the rise to one-off factors such as energy process and sees inflation back below the target in 2023. Its medium-term reference scenario has raised the possibility of monetary tightening as soon as 2023 although most analysts see such a step several years down the road. The benchmark rates are currently -0.5% for deposits and zero for refinancing.

Patience for normalization in the Eurozone

China posted spectacular growth of 18.3% y/y in Q1 '21 on base effects, followed by 7.9% in Q2. The official target for the year is at least 6.0%, which looks attainable despite concerns about the indebtedness of the real estate sector. Some slowing in the economy is discernible from the July data release that showed growth in retail sales and industrial production growth at 8.5% y/y and 6.4% respectively. There are well-placed calls to loosen fiscal and monetary policy: the authorities, however, have to take into account the reality that some sectors are overleveraged. Companies are not routinely rescued to avoid default.

Robust growth in China yet slowing

In addition to being the largest global buyer of crude oil, China is the leading importer from Nigeria and a sizeable investor, both in the FGN's infrastructure projects and in the local private sector. Signals from the Biden administration in the US point to a tougher stance with China, which, at the worst, might lead to additional sanctions that have a negative impact on third parties through trade and investment.

Pick-up in US-Chinese tensions

US official rates at almost zero are naturally welcome in Nigeria. A reasonable external balance sheet underpins the Nigerian credit story, and after several false starts the FGN tapped the Eurobond market this month to raise USD4bn from orders said to exceed USD12bn. Foreign portfolio investors (FPIs) are chasing yield, which they can only secure by taking a little more credit risk than previously. These favourable conditions for issuance are not permanent, given the signals from the Fed and elsewhere.

FGN's timely Eurobond success

Since the diversification of the economy is still at an early stage, the largest single determinant of Nigeria's prospects is still its oil revenue. Following a scare at the peak of the COVID-driven market turmoil in April 2020, the price has steadily recovered. The successful vaccination programmes in most advanced economies and the easing of restrictions have together given a substantial boost to demand for crude. The spot price of UK Brent crossed the USD60/b threshold in early February and the USD70/b threshold in early June.

Welcome recovery in the oil price

A demonstration of relative and unprecedented discipline by OPEC+ has been the principal driver. A minority of members have produced above quota but this has been more than outweighed by voluntary cuts by Saudi. The alliance between Russia and Saudi has broadly held even if the latter has had to indulge the former on occasions.

Based upon OPEC+ discipline

It imposed draconian cuts on all members in April 2020, and has since slowly restored their quotas. By January the aggregate quota reduction had been cut to 7.2 million barrels per day (mbpd) and to 5.0mbpd by this month. The intention is to release an additional 400,000 b/d onto the market each month. Monthly ministerial meetings review quotas and compliance.

Crude demand nearing pre-COVID level

Global demand peaked at 100.0mbpd in 2019 and crashed by up to one third at the peak of COVID-19 in April last year. The latest forecast from the International Energy Agency has demand recovering to 96.2mbpd this year and 99.4mbpd in 2022. OPEC has slightly higher forecasts.

The price is also underpinned by rising pressures on US shale oil producers. We can now see that the industry has a rather higher breakeven point than its public relations advisors indicated.

Price support from Middle East issues, too

As always, the geopolitical risks are unpredictable. A tougher negotiating stance by the Biden presidency than many (including ourselves) had anticipated suggests that a new deal on Iran's nuclear intentions and Western sanctions will prove a formidable challenge. Given our above take on the industry and our conviction that the negative dividend for the industry from climate change will be felt far beyond our forecast horizon, we see an average price for Bonny Light of USD68/b this year and USD73/b in 2022. This compares with an actual of USD44/b in 2020. Our unchanged forecasts probably err on the conservative side.

The Achilles heel again exposed

A series of slumps in the oil price, the most recent in March/April 2020, has exposed Nigeria's failure to diversify its economy away from oil and accumulate sizeable fiscal buffers in preparation for external shocks. We are revisiting familiar territory as the exchange-rate regime comes under severe pressure and the CBN is resolved to sit it out.

The CBN experimented with additional fx windows in March/April 2017. In addition to its then official/preferential rate (of NGN379), it operates a number of other markets for different end-users. The best known is the investors and exporters (I&E) window, also known as NAFEX (now NGN413).

A successful experiment for three years

For close to three years, this unfashionable experiment (or "heterodox" in the CBN's parlance) exceeded expectations. FPIs returned to local debt markets in large numbers, and helped to push reserves up to USD45.1bn in May 2019.

The sequence that followed is predictable: a crash in the oil price amid the emergence of COVID-19, exits by FPIs and then the freezing of NAFEX by the CBN. In March 2020 it adjusted the preferential rate from NGN307 to NGN361, and guided the rate on NAFEX to NGN380. The CBN stopped supplying the window until late August 2020, since which time it has made small amounts available. The result has been a pipeline of delayed FPI repatriations and other external payments, estimated at +/- USD3bn.

Until an oil price crash in March 2020

The CBN's game plan is to resist devaluation unless there is no alternative, make small adjustments in the hope of holding the line, and deploy administrative measures. President Muhammadu Buhari and Godwin Emefiele, the CBN governor who began a second term in June 2019, are firm advocates of this strategy. The CBN has made a large step towards the unification of rates, which it belatedly acknowledged in May, but has serious doubts about another call from the multilateral agencies (for a single "market-clearing" rate).

Resistance to "market-clearing" rates

Monetary and exchange-rate policy

The CBN's mission is to deliver price and financial system stability, and promote sustainable economic development. In line with this remit and influenced by Nigeria's sizeable import requirement, the CBN and the monetary policy committee (MPC) have sought to counter pressure on interest rates and inflation by managing the naira exchange rate. This has been apparent most recently in 2008-09, in the three devaluations of 2014-16 and and in the many tweaks of policy since March 2020.

The mission of price stability for the CBN

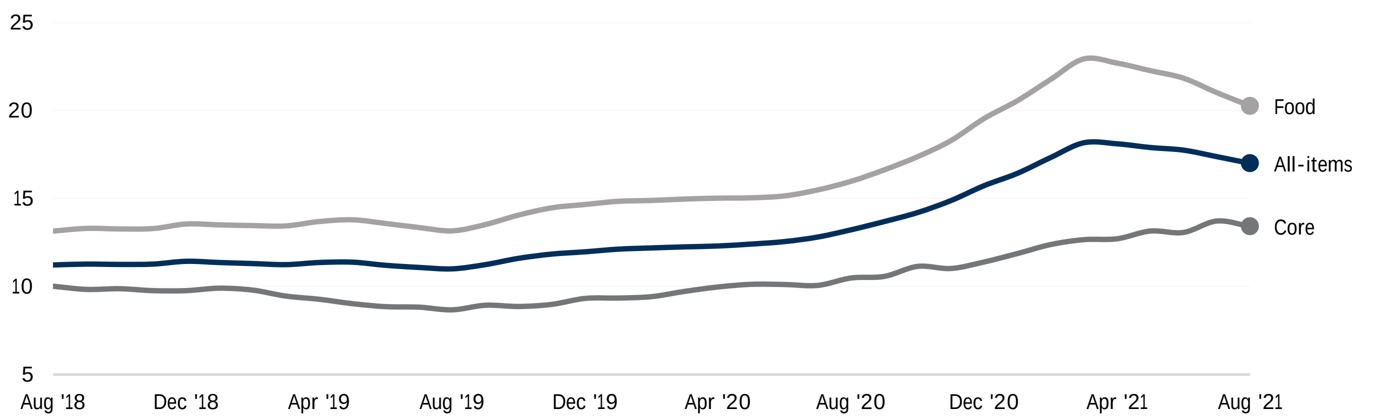
Cumulative turnover on NAFEX amounts to USD207bn since its launch in April 2017 (although this figure includes both sides of trades). The window operates on a 'willing buyer, willing seller' basis. The largest suppliers to this window pre-COVID were the FPIs. The CBN accumulates reserves when the offshore players are buyers of naira securities and usually supplies fx at the window when they exit.

NAFEX a winner when fx supply was regular

Since the CBN website started to show the NAFEX rate and the governor confirmed that all official transactions were being transacted at this rate in late May, there has been a pick-up in its supply to the market. They still fall well short of demand, however, and have limited impact on the pipeline. There has also been some supply from FPIs, albeit on a modest scale.

Now the window for official transactions

Consumer price inflation (% chg y/y)



Sources: Nigeria Bureau of Statistics (NBS); FBNQuest Capital Research

Headline inflation has posted five small declines to 17.0% y/y in August after a steady rise that began in September 2019 . The increases were initially the result of the closure of land borders, rising insecurity and assorted other constraints beyond the influence of monetary olicy. Nigeria's lockdown in Q2 '20 then added to the inflationary pressures. The data compiler (the NBS) has noted that some of the highest non-food price increases have been for pharmaceuticals and hospital services, both due to the lockdown.

Inflation stubbornly high in the high teens…

Before the closure in August 2019 we were already above the CBN's reference range of between 6.0% and 9.0% y/y for the headline measure due to sticky food price inflation. Poor infrastructure, irregular access to inputs for farmers, the rise in VAT in February 2020 and adverse weather conditions are among the other constraints.

…and well above the central bank's reference range

The CBN's position and that of the MPC, with which we sympathise, are that these supply-side factors are the responsibility of the FGN and beyond its control. Also, the range is not a formal target. Inflation would surely have settled within the range when we consider the squeezed condition of household demand, had it not been for these constraints. Other than the last quarter (an anomaly), GDP has not grown in per head terms y/y since Q3 '15. We have the headline measure at 15.8% y/y at end-year and 13.1% at end-2022.

Supply-side factors to blame according to CBN/MPC

Inflation may remain far above the range but this did not stop the MPC from making surprising policy rate cuts of 100bps in May '20 and another 100bps in September. We expected neither. The cuts were unexpected because they came at a time of accelerating inflation. The reasons for the acceleration may have been supply-side and not monetary, yet the CBN's primary mission is still maintaining price stability.

Surprise cuts back in May 2020

The cuts were also unexpected because of the 'disconnect' between the monetary policy rate and those in the market for the real economy, including yields on FGN paper. It (the disconnect) stems from the existence of a large unbanked informal economy.

Disconnect between monetary policy and real economy

With central banks and committees across the world easing in 2020 in response to the virus's economic impact, we might have expected that the MPC would want to make similar statements. The tide has turned among policymakers in the larger EMs, and our hunch is that the MPC will adopt a classic stance against inflation with two token small rate hikes, beginning in H1 '22. Until that point, the committee's communiques are in danger of becoming repetitive, stressing the successful reach of the CBN's development finance.

Expect some modest increases in rates in 2022

Another driver of monetary policy has been the wish of the CBN/MPC to keep FPIs invested in naira-denominated securities, and so bolster reserves and underpin the naira exchange rate. This was successful after the fx reforms in 2017 because they were then comfortable with the workings of NAFEX, if not its transparency. The policy rate was not the driver.

NAFEX bolstered FPI investments in naira-denominated instruments

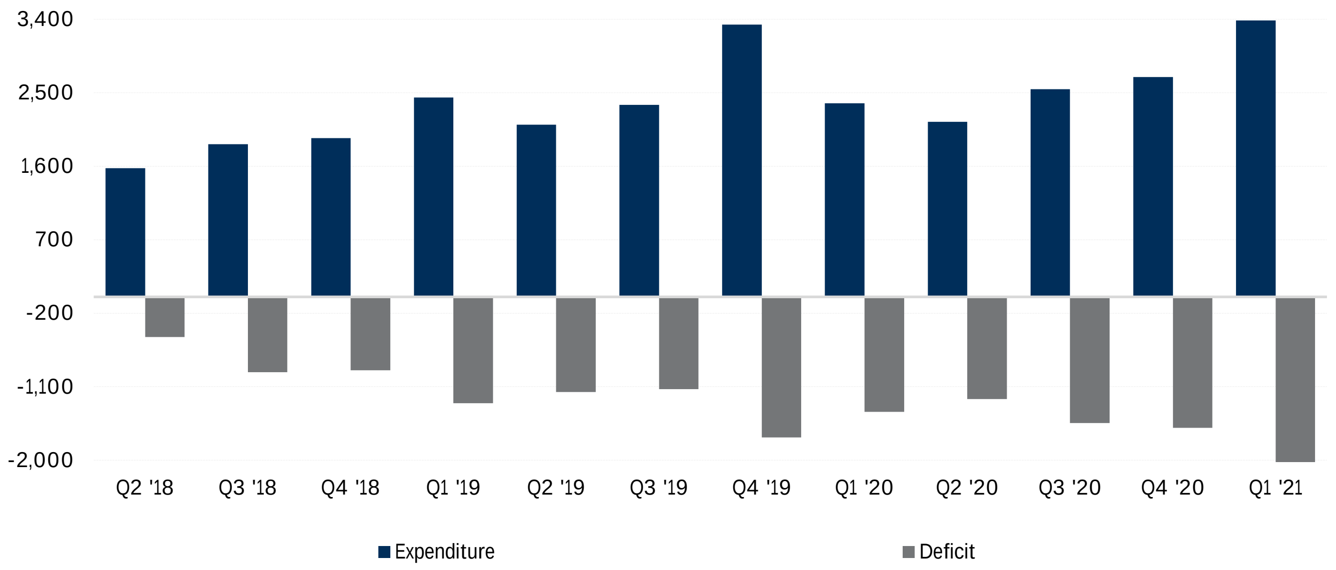
Fiscal policy

Fiscal performance has been characterised by a very low tax take relative to the size of the economy, inadequate allocations for capital spending, unproductive recurrent expenditure, and a mounting burden of domestic debt service.

The FGN deficit is capped at 3% of GDP by the Fiscal Responsibility Act (FRA) of 2007. The investor presentation for the recent Eurobond roadshow shows that the ceiling was breached in 2020, with a deficit equivalent to 4.0%. (The story of the general government deficit, which is tracked by the IMF, the ratings agencies and others, is less rosy.)

Another issue is that a large proportion of recurrent spending by the three tiers of government (federal, state and local) is unproductive. Gross revenue collected in the federation account (before distribution to the three tiers) declined by 3% y/y in 2020, to NGN9.4trn (USD24.5bn). The oil element was 16% lower at NGN4.4trn on lower production and prices. Non-oil revenue rose from a very low base by 13% to N5.0trn.

FGN fiscal operations (NGN bn)



Sources: CBN; FBNQuest Capital Research

Poorest revenue collection globally

The total collected in 2020 was equivalent to just 6.1% of GDP. This ratio is pitifully low for a major oil producer and a lower-middle-income country. According to the World Bank, it is the lowest anywhere. The oil majors will disagree but this tells us that the increase in the tax take in the Petroleum Industry Act, signed off by Buhari in August, is warranted. The ratio also highlights the authorities' challenge to persuade Nigerian taxpayers to meet their obligations after several decades of non-compliance. A plausible medium-term target should be closer to 20% in our view.

And therefore low FGN spending/GDP

Low revenue collection limits public spending, notably on the infrastructure, and therefore the government's ability to drive growth. The current administration has consistently maintained an expansionary fiscal stance since 2015 to overcome these hurdles and has enjoyed some modest success in pushing up non-oil revenue collection and capital releases, both from a low base.

Expansionary budgets to compensate

The 2021 FGN budget is a continuation of the stance. Its outlines (including the NGN980bn supplementary) are retained revenue of NGN8.12trn, spending of NGN14.57trn and a deficit of NGN6.45trn, equivalent to 4.5% of GDP and therefore another breach of the FRA 2007. Most striking (and most ambitious) in terms of the outturn for 2020 are the 106% and 186% projected increases for revenue and capital spending.

On the investor call for the roadshow, the Budget Office gave a signal that the FGN would allow an overshoot on its deficit this year rather than cut planned spending. Under this

A hint about overshooting on the deficit

scenario the assumption is an underperformance on revenue. We struggle to see how collection can be doubled (when there is no talk of tax rate rises and growth in this year of recovery will remain below 3%).

In the case of a revenue shortfall

If we take the Budget Office's signal at face value, we are looking at another steep rise in borrowing with a sizeable impact on naira debt prices/yields. We see a compromise of sorts ahead: an increase_in capital items on last year's NGN1.74trn but well short of the NGN4.98trn budget.

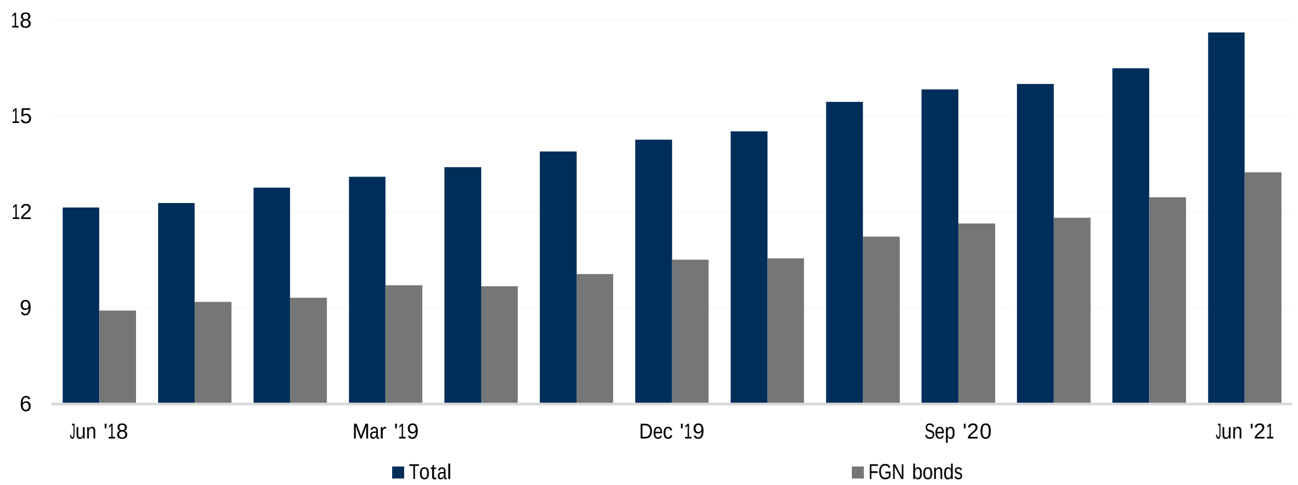
DMO on target domestically

The deficit before the supplementary was to be funded by the DMO from the market (NGN4.68trn divided equally between domestic and external sources), multilateral loans (NGN710bn) and unnamed asset sales. The DMO is well on target for domestic funding and has raised NGN1.65trn equivalent from the Eurobond sale. We are less confident about the FGN securing the projected multilateral loans due to conditionality and its making the asset sales.

Rising unfunded deficits

When the deficit is not covered by financing set out in the budget, it becomes unfunded (ie borrowed from the CBN in the form of ways and means advances, for which securitization has been proposed by the DMO). These advances amounted to NGN3.27trn in 2019 and NGN4.54trn in 2020.

FGN domestic debt (NGN trn)

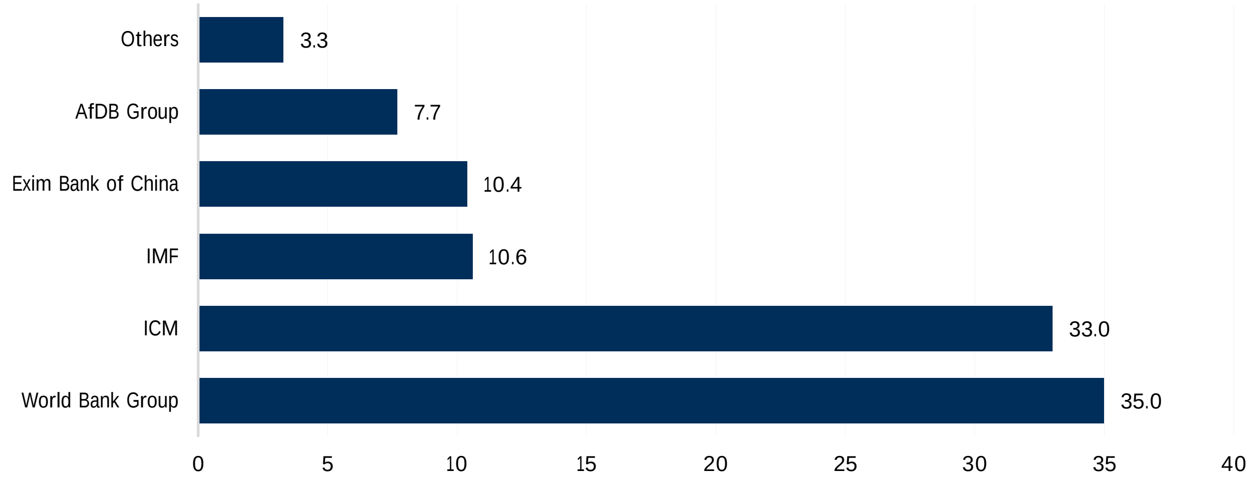


Source: DMO, FBNQuest Capital Research

FGN domestic debt in Q2 '21 amounted to NGN17.6trn, equivalent to just 10.9% of GDP. Issuance, notably of FGN bonds, has soared as the DMO races to meet its domestic funding target for the year (see above). The investor call put public debt at 21.6% of GDP in 2020. This measure covers the oblilgations of the FGN and state governments, both domestic and external. The ratio compares very favourably with Nigeria's EM peers. The presentation cited figures, sourced from the IMF, of 69% for Kenya, 77% for South Africa and 90% for Egypt.

For the fullest measure, we must add: the obligations of the NNPC and other public bodies such as AMCON; and federal debts up to a ceiling of NGN2.7trn to contractors and other private-sector parties which the finance ministry is in the process of securitizing (promissory notes of NGN800bn are currently outstanding). Our estimate of these additional debt categories would push up the burden to a maximum 30% of GDP. It does not allow for the FGN's ways and means advances. This conforms with established convention.

Public external debt by lender group, Mar 2021 (% shares)



Source: DMO, FBNQuest Capital Research

Good headroom within new debt ceiling

The DMO published a new medium-term debt strategy this year, and raised the ceiling for its measure of public debt/GDP from 25% to 40%. This leaves ample headroom for the proposed securitization of the advances and other new obligations. The new ceiling still compares very favourably with peers.

Market dynamics

Limits to liquidity in bond markets

The first point to make about the bond market is that it is shallow. At any one point, there is unlikely to be significant liquidity in more than eight FGN bond issues. The market gained a little more depth from the inclusion of selected FGN bonds in the JP Morgan indices of local currency government debt in emerging markets from October '12 to October '15.

For state government and corporate issues, liquidity is so limited that two-way prices are not generally available. The hold-to-maturity mindset prevails.

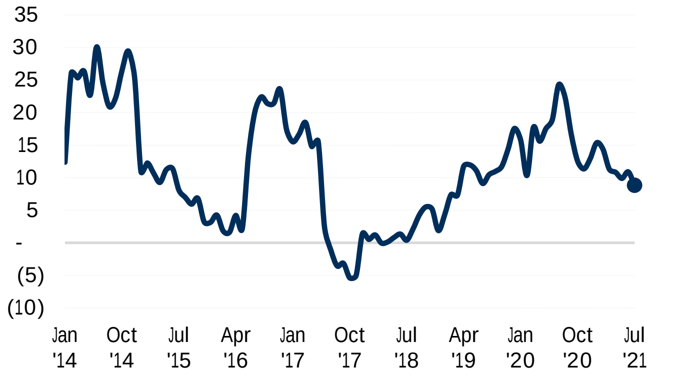
Monthly FAAC disbursements

In addition to the CBN's regular fx interventions, an important driver of the market is the liquidity provided by the monthly disbursement from the Federation Account Allocation Committee (FAAC) to the three tiers. (The FGN's share, however, is paid directly into the TSA.) The disbursement has traditionally been announced on the second Friday of the month from the previous month's revenues, and made the following week.

Far too low for states'needs

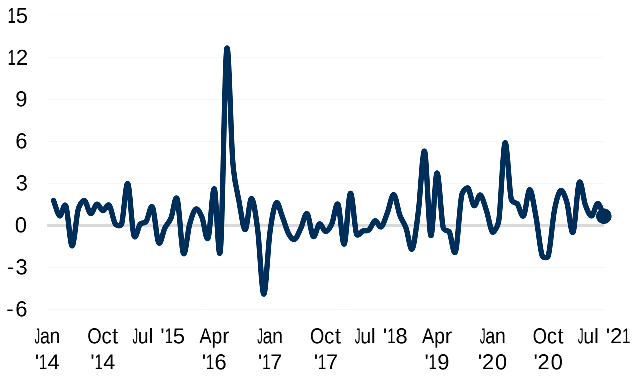
The payouts have held up better than expected when we recall the crash in the oil price in March/April 2020 and the economy's contraction in Q2 and Q3 '20. That said, they are far too low to meet the spending obligations of most state governments, which led to several debt relief packages from the FGN in the first Buhari term (2015-19). More packages will be required if the majority of states are to become fiscally viable. A few states, led by Lagos, are on a sound footing because of their ability to generate internal revenue.

Net claims on the private sector (excl FGN; % chg y/y)



Source: CBN, FBNQuest Capital Research

Net claims on the private sector (excl FGN; % chg m/m)



Source: CBN, FBNQuest Capital Research

Three investor groups have dominated holdings of FGN debt: the pension fund administrators (PFAs), the deposit money banks (DMBs) and the FPIs. The PFAs manage assets totalling NGN12.8trn (USD31.1bn) according to the latest figures (July 2021) and growing by up to 15% per year in naira terms. The potential for expansion is enormous, given that the regulated industry only dates from 2004 and that its coverage of the formal economy is limited. A micro pension to provide for the self-employed and SMEs is now available. The take-up has been slow, however.

Pivotal position of PFAs in debt markets

Two CBN circulars have influenced the market strategy of the local banks. The first from October 2019 ruled that domestic non-bank investors could no longer take part in the CBN's open market operations (OMO), which are essentially its issuance of short-term bills for liquidity management purposes. This cirular ruled out the PFAs, for example, but not the FPIs or the DMBs. The second circular set a minimum loan-to-deposit ratio (LDR) for local banks of 60%, subsequently raised to 65% as of end-December '19. The penalties for non-compliance are severe.

CBN pressure on banks to boost loan books

The CBN has long been pushing for a sizeable increase in private-sector credit extension, which remains below 20% of GDP and helps to explain the 'disconnect' we earlier mentioned. Data collated by the CBN showed double-digit increases y/y in net claims on the private sector from August '19 to April. The rate of growth has since slowed, however, which may mean that some banks have reached the threshold. We cannot be definitive because the data series covers the recapitalised Bank of Industry and other state-owned development banks, and the sizeable credit interventions by the CBN as well as the DMBs.

And its own sizeable development finance

When excluded from the trade in OMO bills, the PFAs initially bought heavily into the market for NTBs (Nigerian T-bills). These yields promptly crashed to low single-digit levels for all three benchmarks and the PFAs turned their attention to NTBs.

Banks' comfort with large FGN paper holdings

FGN debt currently yields 10.50% to 13.00% for the bonds (other than the very short end), and between 4.50% and 7.50% for our benchmark NTBs (Nigerian T-bills). It is a safer investment for a bank than a loan to a customer paying +/- 20% with the credit risk attached. It also requires much less management time. The DMBs (and bank analysts) fear that larger loan books bring higher NPLs.

The real economy's maximum lending rate has moved little despite the MPC's two rate cuts in 2020. The DMBs must maintain attractive net interest margins due to high cost bases, and most customers have little bargaining power on rates. This undermines the textbook argument that monetary easing will significantly boost growth via credit extension. It also helps to explain why the MPC has voted for an unchanged stance at all its meetings this year. The increase in loan books is the result of the CBN's regulation rather than monetary policy.

The disconnect with real economy rates

The FPIs were sizeable buyers of FGN debt in H2 '17 and H1 '18 as they became comfortable with NAFEX. There was another brief surge in Q1 '19. There has since been a rush for the door marked exit due to worries over the global economy and the impact of COVID, notably the crash in the oil price in March/April '20 and the resulting bottlenecks in the fx market. Some FPIs are caught in the pipeline awaiting the repatriation of their sale proceeds.

Mass exit by FPIs and the pipeline

The returns on FGN paper are again healthy for the FPIs and among the highest in EM. Yet this selling point is outweighed by the loss of exchange-rate stability and the irregular functioning of the NAFEX window.

Our final point on market dynamics is to highlight the (shrinking) gaps in the maturity profile of FGN bond issuance. The DMO routinely issues new benchmarks. For its 20-year instruments, first issued in 2010, it found a ready market in the PFAs, which can match long-term liabilities with assets. It has since pushed out final maturity to 30 years.

Few gaps in the bond maturity profile

Market direction

Interbank rates fluctuate considerably due to the CBN's fx transactions and OMOs as well as the monthly FAAC distributions.

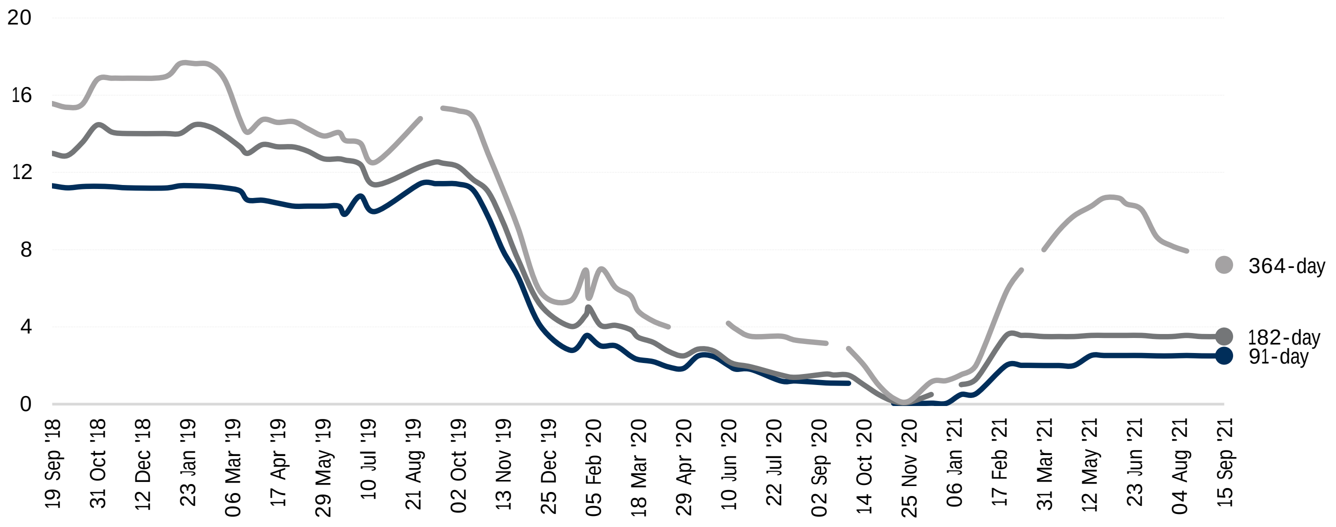
As for the direction of rates in FGN debt markets, our thinking is that: tightening by the US Federal Reserve will start in early 2023; domestic headline inflation will stand at 15.8% y/y at end-year and 13.1% one year later; the FGN will maintain its expansionary fiscal agenda; the FGN deficit will continue to grow beyond the ceiling set in the FRA 2007, given the spending agenda and the FGN's challenges in boosting revenue collection; the asset allocation of the PFAs will remain focussed on FGN paper; the MPC will revert to orthodoxy with token rate hikes to counter inflation in 2022; and the monetary authorities, buoyed by the strong recovery in the oil price, the general allocation of SDRs by the IMF and the successful Eurobond issuance, will muddle through on the naira exchange rate with some small adjustments when they can no longer be avoided.

Drivers of our take on market diorection

The most recent trend in FGN bond yields has been a widening of about 600bps across the curve in mid-curve since end-2020. The widening was greater three months ago. The trend has been similar for NTBs. (Our chart below has broken lines where the CBN has not sold all three tenors.) We can now say that the crashing of yields in Q4 '20 was an aberration, for which the CBN was partly responsible due to its circulars and market strategy. The FPIs have broadly vacated the space, and market direction has been guided by the increasing supply of new paper. Normal service has been resumed. The DMO raised a record NGN1.67trn from the sale (gross) of FGN bonds in 2020, almost double the previous year, and has been set a still higher funding target for this year.

Record bond issuance by the DMO

True yields at NTB auctions (%)



Source: FMDQ, FBNQuest Capital Research

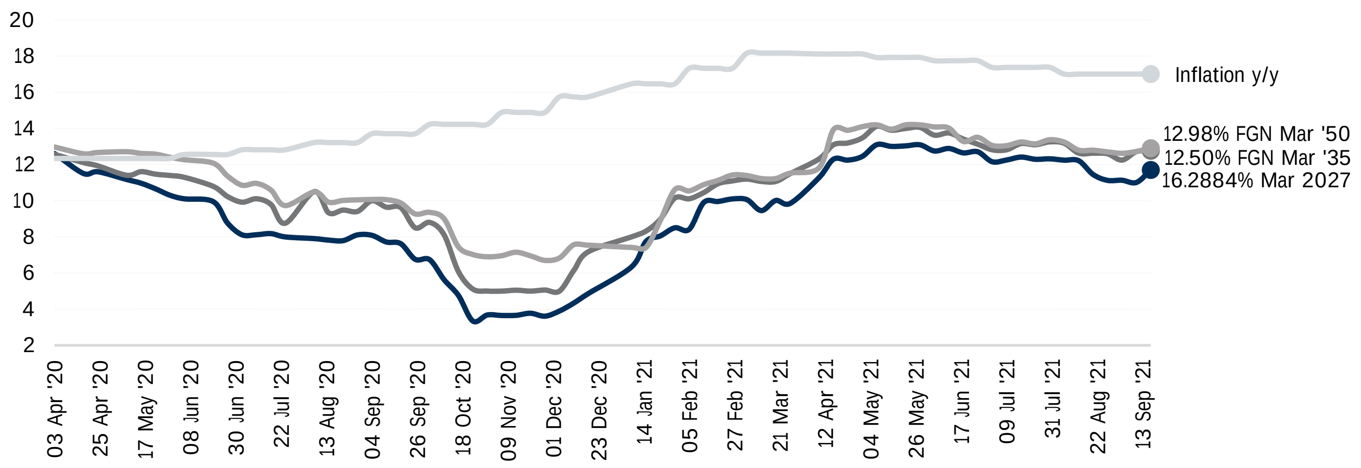
Growing appetite of PFAs for paper

On the demand side, the appetite of the PFAs for the bonds has continued to grow. Under amended pension legislation, they now have several more investment alternatives, but the bonds are by far their preferred play: 59.9% of total AUM in July, compared with 57.0% one year earlier.

And long-term concerns over equities

Over the same period, the share of domestic equities has picked up a little from 4.6% to 6.7%. The noted development in the fixed-income market in Q4 '20 was the likely driver. Equities' share is very low compared to peer markets such as Kenya (about 15%). A combination of earlier negative experiences with equities, weak GDP growth prospects and the absence of urgent macro and structural reforms is surely to blame.

FGN bond yields & CPI y/y (%)



Source: FMDQ, FBNQuest Capital Research

Our take for the next three months is that FGN bonds yields will tread water with a modest downward bias, and settle within a range of 10.50% to 11.50%. The record supply of new paper underpins our view. The PFAs and other domestic institutions will dominate the bid. The FPIs will generally sit on the sidelines.

Recent reports

Report	Contact email
FI-FX Daily Watch 27 Sept '21	research@fbnquest.com
Good Morning Nigeria 27 Sept '21	research@fbnquest.com
FI-FX Daily Watch 24 Sept '21	research@fbnquest.com
Good Morning Nigeria 24 Sept '21	research@fbnquest.com
FBNQuest Capital International Breweries Q2 '21 results review	research@fbnquest.com
FI-FX Daily Watch 23 Sept '21	research@fbnquest.com
FBNQuest Capital Fidelity Bank Q2 '21 results review	research@fbnquest.com
Good Morning Nigeria 23 Sept '21	research@fbnquest.com
FI-FX Daily Watch 22 Sept '21	research@fbnquest.com
Good Morning Nigeria 22 Sept '21	research@fbnquest.com

Updated: 27 Sep 21

FBNQuest Research Team			
Head, Macroeconomic and Fixed Income Research	Gregory Kronsten	+44 7979 235 127 +234 816 348 1463	gregory.kronsten@fbnquest.com
Head, Equity research (Banks and Telecom)	Tunde Abidoye	+234 703 005 7836	tunde.abidoye@fbnquest.com
Senior Vice President	Uwadiae Osadiaye, CFA	+234 703 305 7541	uwadiae.osadiaye@fbnquest.com
Associate	Abiola Gbemisola	+234 814 045 3731	abiola.gbemisola@fbnquest.com
Macroeconomic and Fixed Income Research Analyst	Olayinka Onikanni	+234 816 779 9234	olayinka.onikanni@fbnquest.com
Head, Equities	Olubunmi Asaolu, CFA	+44 7812 915 835 +234 805 209 7023	bunmi.asaolu@fbnquest.com

Trading Team			
Associate	Omotola Imafidon	+234 706 418 9858	omotola.imafidon@fbnquestmb.com
Associate	Clement Adaba	+234 906 292 7733	clement.adaba@fbnquestmb.com
Analyst	Ekanem James	+234 903 885 9453	ekanem.james@fbnquestmb.com
Officer	Abiola Oladosu	+234 708 8465 107	abiola.oladosu@fbnquestmb.com

Corporate Broking Team			
MD, FBNQuest Securities	Fiona Ahimie	+234 706 820 0244	fiona.ahimie@fbnquestmb.com
Associate	Abiodun Adedotun	+234 906 292 7735	abiodun.adedotun@fbnquestmb.com

Support Team			
Associate	Taiwo Ahmed	+234 806 313 6774	taiwo.ahmed@fbnquestmb.com
Analyst	Adewale Raji	+234 808 310 4180	adewale.raji@fbnquesttmb.com
Analyst	Michael Dada	+234 813 167 5242	michael.dada@fbnquestmb.com

Disclaimers and disclosures

FBNQuest Capital, FBNQuest Securities, their affiliates, directors and employees may engage in corporate finance activities and provide advisory and sponsoring broker services to some of the issuers mentioned in this Report and any other issuer.

	Ownership (5% or more of issuers securities) Yes	No
FBNQuest Analyst		X
FBNQuest or its subsidiaries		X

Certification by each of the authors of this Report:

The analyst certifies that the views expressed in this document are an accurate representation of the analyst's personal opinions on the stock or sector as covered and reported on by the analyst herein. The analyst furthermore certifies that no part of the analyst's compensation was, is or will be related, directly or indirectly, to the specific recommendations or views as expressed in this document.

The information and any opinions expressed in this Report do not constitute an offer, or an invitation to make an offer, to buy or sell any securities or any options, futures or other derivatives related to such securities.

General Nigeria listed equities rating system

Rating	General Equities
OUTPERFORM	The analyst expects the stock to outperform the Nigerian Stock Exchange (NSE) All Share Index over the next 12 months or the specified investment horizon.
NEUTRAL	The analyst expects the stock to perform in line with the NSE All Share Index over the next 12 months or the specified investment horizon.
UNDERPERFORM	The analyst expects the stock to underperform the NSE All Share Index over the next 12 months or the specified investment horizon.
NOT RATED	The rating and price target are currently suspended to comply with regulations or firm policies such as when FBNQuest Capital is acting as an adviser in a merger or transaction which involves the company whose rating has been suspended or due to reasons that limit the ability of the analysts to provide forecasts for the company in question.
BENCHMARK	The Nigerian Stock Exchange All Share Index.
PRICE TARGETS	Price targets reflect in part the analyst's estimates for the company's earnings. The achievement of any price target may be impeded by general market and macroeconomic trends, and by other risks related to the company or the market, and may not occur if the company's earnings fall short of estimates.
ASSET ALLOCATION	The recommended weighting for equities, cash and fixed income instrument is based on a number of metrics and does not relate to a particular size change in one variable.

Rating distribution for Nigeria listed equities rating

As at 27 Sep. 21 Recommendation	Total FBNQuest Count	% of Total
Outperform	12	52.2
Neutral	6	26.1
Underperform	5	21.7
Total	**23**	**100.0**

Notice to US Investors:

Rule 15a6 Disclosure

This Report was prepared, approved, published, and distributed by **FBNQuest Capital Limited**, a company located outside of the United States (the "**Foreign Counterparty**"). Avior Capital Markets US LLC ("**Avior US**"), a US registered broker-dealer, distributes this Report in the US on behalf of the Foreign Counterparty. Only major U.S. institutional investors (as defined in Rule 15a-6 under the US Securities Exchange Act of 1934 (the "**Exchange Act**") may receive this Report under the exemption in Rule 15a-6. A US institutional investor must effect any transaction in the securities described in this Report through Avior US.

Neither the Report nor any analyst who prepared or approved the Report is subject to US legal requirements or the Financial Industry Regulatory Authority, Inc. ("**FINRA**") or other US regulatory requirements concerning research reports or research analysts. The Foreign Counterparty is not a registered broker-dealer under the Exchange Act nor is it a member of the Financial Industry Regulatory Authority, Inc., or any other US self-regulatory organisation.

Analyst Certification

In connection with the companies or securities that; each analyst identified in this Report certifies that:

The views expressed on the subject companies and securities in this Report reflect their personal views

No part of his or her compensation was, is or will be directly or indirectly dependent on the specific recommendations or views expressed in this Report.

Note that:

The Foreign Counterparty is the employer of the research analyst(s) responsible for the content of this Report, and

Research analysts preparing this Report are resident outside the United States and are not associated persons of any US regulated broker-dealer. Therefore, the analyst(s) are not subject to supervision by a US broker-dealer and are not required to satisfy the regulatory licensing requirements of FINRA or required to otherwise comply with US rules or regulations regarding, among other things, communications with a subject company, public appearances and trading securities held by a research analyst account.

Important US Regulatory Disclosures on Subject Companies

Analysts of the Foreign Counterparty produced this material solely for informational purposes and the use of the intended recipient. No person may reproduce, this Report under any circumstances. No person may copy or make this Report available to any other person other than the intended recipient.

Avior US distributes this Report in the United States of America. The Foreign Counterparty distributes this Report elsewhere in the world. This document is not an offer, or invitation by or on behalf of Avior US, the Foreign Counterparty, their affiliates, or any other person, to buy or sell any security.

Avior US and the Foreign Counterparty and their affiliates obtained the information contained herein from published information and other sources, which Avior US and the Foreign Counterparty and their affiliates reasonably consider to be reliable.

Avior US and the Foreign Counterparty accept no liability or responsibility whatsoever for the accuracy or completeness of any such information. All estimates, expressions of opinion and other subjective judgments contained herein are valid as of the date of this document. Avior US assumes responsibility for the Report content with regards to research distributed in the US.

Neither Avior US nor the Foreign Counterparty has managed or co-managed a public offering of securities for the subject company in the past 12 months, have not received compensation for investment banking services from the subject company in the past 12 months and do not expect to receive and does not intend to seek compensation for investment banking services from the subject company in the next three months. Avior US and the Foreign Counterparty have not owned any class of equity securities of the subject company. There are no other actual, material conflicts of interest of Avior US and the Foreign Counterparty at the time of the publication of this Report. As of the publication of this Report, Avior US nor the Foreign Counterparty makes a market in the subject securities.

Avior US and its affiliates, to the fullest extent permissible by law, accept no liability of any nature whatsoever for any claims, damages or losses arising from, or in connection with, the contents of this Report or the use, reliance, publication, distribution, dissemination, disclosure, alteration or reproduction of this Report, or any views or recommendations recorded therein.

Avior Capital Markets US LLC is a FINRA registered broker-dealer (CRD # 172595) formed for that purpose in the State of Delaware with its principal office at 733 Third Avenue, New York, New York 10017.

FBNQuest Capital Limited is a subsidiary of FBN Holdings Plc regulated by the Securities and Exchange Commission in Nigeria (SEC). Its registered address is 16 Keffi Street, Off Awolowo Road, S .W. Ikoyi, Lagos, Nigeria.

FBNQuest Securities Limited is a subsidiary of FBNQuest Merchant Bank Limited, regulated by the Securities and Exchange Commission in Nigeria (SEC). Its registered address is 16 Keffi Street, Off Awolowo Road, S .W. Ikoyi, Lagos, Nigeria.