Stanbic IBTC Asset Management Limited
Quarterly Economic Review Q2:2016

ECONOMIC REVIEW

The Global GDP expanded 2.50% annually in line with analysts view that global economic activity is bottoming out and a likely acceleration is expected in the second half of the year. As it stands, the economic recovery in the United States remains firm on the back of resilient private consumption while the Chinese authorities have started to unwind its policy stimulus to reflate its economy. Moreover, the steady increase in commodity prices that has been observed since mid-January provides some relief for some battered emerging-market countries.

In an unprecedented vote on 23 June, the United Kingdom made a decision to exit the European Union ("Brexit"), thereby raising concerns regarding the future of the British economy. However, analyst are yet to ascertain the full economic impact of Brexit and the economy is expected to experience a prolonged period of uncertainty until new agreements are ratified. Prior to the Brexit, the British economy expanded 2.00% year-on-year in the first three months of 2016, lower than a 2.10% initial estimate and a 2.10% rise in the previous period. It is the weakest growth rate in three years, due to a slowdown in household consumption, exports and a fall in business investment.

The Euro Zone economy has shown resilience despite a number of external headwinds including the slowdown in emerging markets driven by firm domestic demand and financial market volatility at the start of the year. Eurozone's broad economy is expected to expand at a steady pace of 0.4% quarter-on-quarter in Q2. However, the effects of a number of tailwinds, mainly the benefits from low oil prices and the depreciated Euro, that have been driving the recovery will likely dissipate going forward. That said, the improving economy, along with a shift in attitudes in the face of an austerity-weary public in many nations, should continue to support a loose fiscal policy.

In the United States, the Gross Domestic Product (GDP) expanded 2.00% in the first quarter of 2016, same level recorded in the first quarter of 2015, while unemployment rate declined by 0.3% to 4.7% in May 2016 from 5.00% in April, (lowest reading since November 2007) relative to market expectations of 4.9%. Consumer prices in the United States went up 1% year-on-year in May 2016, slowing slightly from a 1.1% rise in April. Similarly, the Federal Reserve left the target range for its federal funds rate unchanged at 0.25% to 0.5% for the fourth time during its June 2016 meeting but signaled the possibility of raising short-term interest rates at their next meeting based on improved market conditions as indicated by the U.S Bureau of Economic Analysis.

In contrast, according to the National Bureau of Statistics of China, the Chinese economy slowed to an annual rate of 6.7% in the first quarter of 2016, compared to a 6.8% expansion in the previous period and in line with market expectations. While it is the weakest growth since the first quarter of 2009, fixed-asset investment (+10.70%), industrial output (+6.8%), retail sales (+10.5%) and new Yuan loans all increased more than estimated in March, suggesting the economy is accelerating.

At the home front, data released by the National Bureau of Statistics (NBS) shows that the nation's Gross Domestic Product (GDP) declined by 0.36% (year-on-year) in real terms in Q1 2016 representing the first contraction since June 2004. This was also lower by 2.47% from growth recorded in the preceding quarter and 4.32% lower than growth recorded in the corresponding quarter of 2015. This was as a result of decline in production output of 0.07mbpd compared to the production recorded for corresponding period in 2015. However, within the non-oil sector, activities such as crop production, Trade and Telecommunications & Information Services supported growth, but growth was weighed upon by slowdown in Manufacturing, Financial Institutions, and Real Estate.

Furthermore, the Consumer Price Index (CPI) which measures inflation recorded a relatively strong increase for the fourth consecutive month as the headline index increased to 15.60% (year-on-year) in May, roughly 1.9% higher than level recorded in April (13.70%). Inflation rose significantly due to the faster pace of increase across all divisions that contribute to the Headline index such as increase in electricity rates as well as other energy prices, imported foods and draw-down of inventories across the country. Imported food inflation in May rose to 18.60% (year-on-year) from 16.30% in April 2016. The Food sub-index increased to 14.90% (year-on-year) from 13.20% in April 2016. Also, the "All Items less Farm Produce" or Core sub-index, increased by 1.7% from 13.40% in April 2016 to 15.10% in May.

MARKET REVIEW

The Monetary Policy Committee ("MPC") of the Central Bank of Nigeria ("CBN") met on 23/24 of May 2016, the MPC, contrary to market expectation of a further tightening in monetary policy, in light of upward movement in inflation figures which printed at 15.60% in May 2016, decided to retain the Monetary Policy Rate (MPR) at 12.00% and the Cash Reserve Ratio (CRR) at 22.50% in order to spur growth. This was as a result of negative GDP growth rate of 0.36% reported for Q1 2016. In addition, the committee expressed concern over sustained pressure in the foreign exchange market and the necessity of implementing reforms by adopting a flexible exchange rate regime to engender flexibility and transparency in operation of the interbank foreign exchange market.

Also, the system was awash with liquidity for most part of the quarter with daily balances averaging ₦451.53 billion following OMO Treasury bill maturities, FAAC inflow and undisclosed amount as sovereign debt note & coupon payment. As such, the CBN conducted Open Market Operations (OMOs) intermittently causing Overnight and Open Buy Back rates in the money market to hover around 3.83% p.a. and 3.50% p.a. respectively during the quarter with interjectory spikes of circa 100 basis points (intraday) but closed the quarter at 4.00% and 5.00% respectively. However, following the pronouncement by the CBN on modalities of the new foreign exchange regime in June, the CBN conducted a special OMO at an unusual level of 13.50% (circa 250bps above market level) for a 364-day treasury bill.

In the Foreign Exchange (FX) market, the USD/NGN remained relatively flat and traded around ₦199.50 at the inter-bank for most part of Q2 2016. However, following the adoption of a flexible FX market, the CBN liberalized the naira by revising the guidelines for the operation of its FX market, with a view to introducing greater flexibility following which the USD/NGN moved higher, settling around ₦280- ₦285. The CBN also conducted a special Secondary Market Intervention Sales (SMIS) Retail auction to ease the flow of FX, where it sold a total of $4.02billion. During the Auction, the CBN sold $532million spot and $3.49billion in 1-3months forward (broken down as $0.697billion of 1-month, $1.22billion of 2-month and $1.57billion of 3-month forward) at a marginal rate of N280.00. According to the summary of the spot auction released by the CBN, the bid range was ₦197.00- ₦382.00.

In the equities market, the signing into law of the N6.06 trillion expansionary budget, partial deregulation of the petroleum sector, the Morgan Stanley Capital International's (MSCI) decision to retain Nigeria in its frontier index and implementation of the flexible exchange rate by the Central Bank of Nigeria ("CBN") formed the riding theme in the equities market during the quarter. These positive developments improved local and foreign investor's interest in the equities market as investors took position in select quality names particularly following the release of guidelines for CBN's flexible exchange rate policy which effectively devalued the Naira by 40%. Consequently, with the exception of April (0.96%), the equities market recorded positive performances of 10.41% & 6.96% in May and June respectively. Thus, returning 16.96% and 3.34% for the quarter and year to date respectively. Similarly, all sectorial indices recorded positive performances during the quarter with the exception of the Oil and Gas sector whose performance was marred by the upsurge of militant groups responsible for the vandalism of crude oil pipelines which impacted revenue lines for several upstream players in the sector.

OUTLOOK

Although the government is seeing improvement in unemployment and inflation figures, we opine that further hike in interest rate may be delayed by the US Fed in light of the sluggish growth on the global space. As such, the federal funds rate is likely to remain, for some time, as expressed in the communiqué released by the Federal Open Market Committee (FOMC) in June 2016. Also, the outcome of Brexit portends negative outcome for the global economy as investors seek safe heaven by selling off risky assets. Similarly, there are going concerns regarding the possibility of other European countries working towards similar referendum to leave the European Union, as this will increase uncertainty and volatility and further dampen growth figures for the global economy.

On the domestic scene, we expect the adoption of flexible exchange rate regime to further ease the constraint around foreign exchange market. The initial response will be a knee jerk reaction as foreign investors seeking to exit will first pull out to test the flexibility of the new FX market. However, we expect the market to subsequently ease as we begin to see inflow from offshore investments. Furthermore, we expect interest rate to continue to inch upwards as the Central Bank is constrained to tighten liquidity in a bid to support the flexible foreign exchange policy. We also expect inflation to increase at a decreasing rate in the coming quarter. This should also support the rise in interest rates as investors continue to push for real return on investment.

In addition, we posit that the flexible exchange rate framework will put further pressure on imported inflation and possibly further depress operating margins of companies with high dependency on foreign inputs or foreign loans. However, we expect that this policy should increase market participation particularly by foreign investors albeit gradually. Also, implementation of the budget is expected to reduce economic uncertainty and kick start the economy in H2 2016. Similarly, the FGN's efforts to resolve the Niger-Delta militancy issues and the expectation that MSCI would retain Nigeria in its MSCI Frontier Index when it makes its announcement in September 2016 should sustain renewed interest in the market. Based on the foregoing, we expect a positive performance for the equities market in Q3 2016.

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