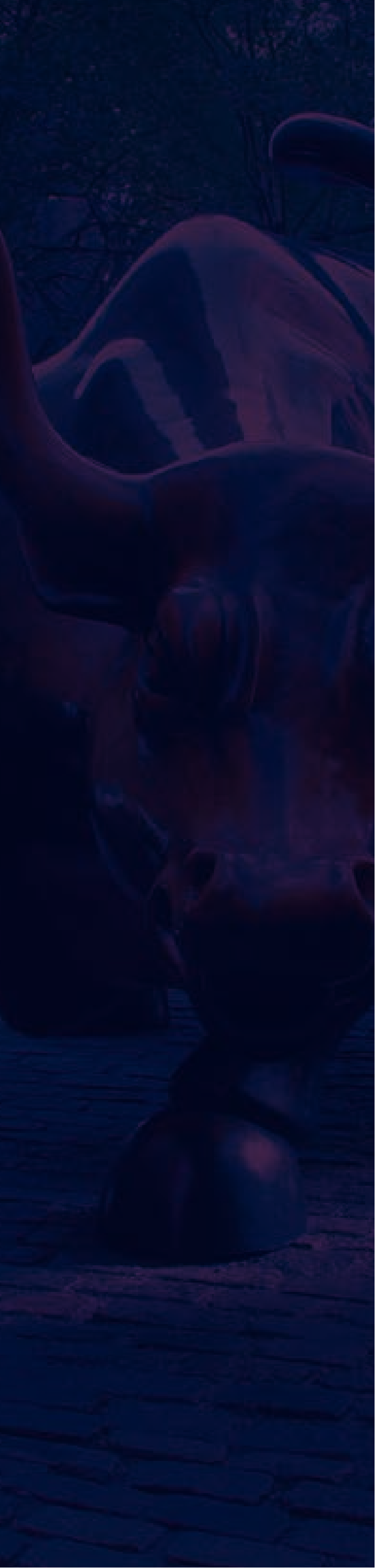

Turnaround Still Leaves More Room to Run

ARM INVESTMENT MANAGERS

A phenomenal year for the market

ANOTHER YEAR, another record breaker, pessimist can't cut a break. Scientist Albert Einstein got it right when he said, “In the middle of difficulty lies opportunity”. The investment climate in 2017 underscored the wisdom of the theoretical physicist. Some market watchers will no doubt have been surprised by this positive outcome. At the start of 2017, many investors (particularly domestic) feared that a combination of lower oil production and prices leading to dollar shortage, lower fiscal revenues, inflation, and sustained economic downturn would lead to financial market volatility and disappointing investment returns, but the year bucked this expectation. The domestic economy slowly turned the corner, thanks to the duo of higher crude oil prices and production, a reflection of relative peace in the Niger Delta region as well as strong compliance by OPEC and its allies to the production cut. On this basis, as well as a successful Eurobond Issuance, there was a strong rise in the nation’s reserve (+52% over 2017 to $38.7 billion). Consequently, the CBN raised its dollar sales towards the end of February, and created new FX windows—the Investor and Exporter window, invisibles, SME window and secondary market intervention sales (SMIS) for wholesale & retail—in some sort of tacit liberalisation. Against this backdrop, the premium between the interbank and parallel market contracted to a 20-month low at the end of June even as the once-elusive portfolio flows began to trickle in. On account of the improved dollar supply, naira appreciation at the parallel market, resilience in agricultural output, and the rebound in crude oil production, the economy slipped out of a 5-quarter long recession and has sustained a 2nd consecutive quarter of growth in Q3 2017 of 1.4% YoY. Furthermore, inflationary pressure started to moderate on the back of base effect from 2016 and lack of supply shocks over the year.

The market rattled to the news of an upturn in economic indicators with Equities market on a roller coaster to post ~42% return, after 3 consecutive years of downturn, following recovery in earnings and a more positive earnings outlook. On fixed income, given moderating inflationary pressure and FX market stability, the CBN signalled an inflection point policy wise, going by historical patterns even as the FG scaled back on domestic borrowings in favour of external financing. Average yield, however, expanded by 423bps over 2017 to 17.6%.

Through all the market traumas, investors prepared to weather short-term volatility have seen handsome returns. This was in sync with our views in the article: When it rains, it pours: the case for equity investment, where we noted that a better strategy during the turbulent times, when many are turning their backs on stocks, is to leverage on cheap equity investment valuations — a virtue seen only by a few at the time.

Table 1: Movement in key macro-economic variables

Key Economic Variables	2015	2016	2017
FX Reserves ($’million)	29,069	25,843	38,765
Average crude oil prices ($’bbl.)	53.6	45.1	54.7
Average Crude oil production (mbpd)	2.14	1.81	1.91 **
GDP (% YoY)	2.8%	-1.5%	0.6% **
All share Index Return	-17.4%	-6.2%	42.3%
Average Inflation (YoY)	9.0%	15.6%	16.6%
Average parallel rate (NGN)	222.79	381	394
Average Yields	12.97%	13.31%	17.54%
MPR	13%	12.8%	14%

Source: NSE, CBN, NBS, FMDQ, ARM Research

** Estimated

2018: Change, or more of the same?

> There is a general optimism that the year would be brighter than 2017 on account of steady crude production and uptrend in crude oil prices

GOING INTO 2018, there is a general optimism that the year would be brighter than 2017 on account of steady crude production and uptrend in crude oil prices which combined would drive further accretion in the nation's foreign reserves and fiscal revenues. This guides to currency stability, tamer inflation, and higher economic growth in 2018. Given this, it's certain that the recovery would be sustained into 2018. But the question remains whether it would feed through to an upbeat performance in our financial markets considering the risks that might likely playout during the year including election-eering, hike in fuel prices and increase in electricity tariffs. Of importance is electioneering, as any slightest indication of a likely change in leadership could dampen investor interest. However, we believe the excitement over growing reserves and improving economic growth will outweigh this concerns and drive activity, particularly for equities, at least in the first half of the year. In addition, despite the rally in equities in the prior year, our market remains undervalued when compared to emerging markets peers which should attract foreign investors with the stability in our currency ensuring this possibility.

In terms of where the value is, we see the financial sector, particularly tier 2 banks as one to be considered. Earnings recovery is expected for those banks in 2018 as the general macroeconomic environment improves. Also, compared to their peers, the banks are undervalued which informs our view of sizeable upside potential for the tier 2 banks. Moving over to consumer stocks, there is strong prospect for even better earnings in 2018 because of the improved dollar liquidity which bodes well for expansion in profit-ability margins, and lower interest rate would drive a moderation in interest expense. For the palm oil companies, we expect positive earnings growth in 2018 driven by a recovery in sales volume as we foresee subdued domestic prices over the year. For fixed income, the ongoing monetary easing, stability in currency and expected tamer inflation guides to lower yields on average in 2018 which would drive slower activities within the market.

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