Emefiele's re-appointment and macro ramifications

Emefiele gets presidential nod for continuity

Yesterday, President Muhammadu Buhari nominated the current governor of the Central Bank of Nigeria (CBN), Godwin Emefiele, for a second term in office. The president's nomination is subject to the confirmation of lawmakers, but we expect the approval phase to be relatively seamless in view of some visible achievements of the incumbent in the last 5 years. This wise, Emefiele is likely to become the first sitting CBN governor to be reappointed for a second term since the inception of the fourth republic in 1999. The last sitting governor to be reappointed was Alhaji Abdulkadir Ahmed, who served from 1982 to 1993.

Markets relish clarity on policy direction

Market reaction to the re-appointment was positive on the fixed income and currency fronts, evinced by the 15bps decline in yields across the bond curve and the increase in the I&E FX window turnover to a 9-day high of $367.2 million, with the NAFEX rate appreciating by 21 kobo to close at ₦360.88/$. Predictably, the re-appointment failed to buck the four-day losing streak in the equities market in today's session. In our view, the reaction in the fixed income and currency markets may have been driven by expectations of continuity of monetary policy going forward. In addition to this, Emefiele's largely hawkish posture in the last five years may have endeared him to some yield-chasing foreign and domestic portfolio managers, who largely switched to investment in Nigeria's short-term debt instruments amidst heightened global risk and low yield in developed markets. This was mostly obvious in 2018. To this point, we note that investments into money market instruments accounted for 50.4% of capital importation in 2018 (vs. 26.2% 14.1% in 2017) while flows into equity accounted for 21.1% of capital importation in the same period (vs. 37.8% in 2017). While the latest monetary policy twist (i.e. 50bps cut in the MPR) and gradual reduction of stop rates at recent OMO auctions are relatively dovish, we believe the spreads between Nigerian sovereign instruments and those of key developed markets are still attractive enough to entice some short term capital providers, barring significant shocks to oil price and domestic economic fundamentals.

What we expect in Emefiele's next term

We see the re-appointment of the governor as a presidential stamp of approval on the performance of the CBN and its monetary policy committee in the last five years. In line with market expectation, we are also of the view that the re-appointment could lead to continuity of the current policy direction, which still prioritises currency stability. Against this backdrop, we expect the following:

- Multiple exchange rate regime is likely to remain in place in the near term, with likelihood of gradual convergence. This convergence may see the Retail SMIS rate slowly move from the current N330/$ - N345/$ range to the N360/$ level. However, the official rate (primarily used to support PMS importation and for budget purposes) is likely to remain unchanged at c.N305/$ in the near term.

- CBN is also likely to continue its intervention in various FX markets to support liquidity, as the need arises. This position is strengthened by the increase in the portion of reserves available to defend the currency to c.$37.4 billion as at November 2018 (versus in $25.5 billion as at November 2017). We highlight that CBN's share of reserves may have risen above November 2018 levels, given the recovery in crude oil prices.

- FX ban on non-eligible items may likely be retained in the near term. We believe the CBN may be open to adding more items to its basket of restricted items to support domestic economic activities if the need arises.

- We expect continued Implementation of the intervention programs targeted at incentivizing growth in strategic sectors such as agriculture and manufacturing. We also believe that the implementation of the special CRR window to incentivize bank lending to select sectors may gain traction in Emefiele's second term in office.

Treasury yields are likely to slightly moderate

In our view, CBN's relatively looser grip on system liquidity and gradual reduction of stop rates at OMO auctions suggest that MPC's recent monetary policy twist may be extended in the coming months. The MPC is likely to reduce the MPR by a further 50-100bps by year end in a bid to support economic growth. It is our view that the policy rate only plays a signaling role in the country's monetary policy dynamics, with the CBN utilizing OMO instruments as its key policy tool for achieving price and exchange rate stability in recent years. Accordingly, we note that the yield on the 360-day OMO instrument has fallen by 30 bps to 14.02% since the last MPC meeting. With oil prices (YtD average: $65.8/bbl) and reserves ($44.8 billion) at favourable levels, we anticipate further moderation in yields through 2019.

However, the degree of yield moderation is likely to be capped by sticky inflationary pressures. As at April 2019, the inflation adjusted spread on the one-year T-Bill was 281bps compared to a median of 335bps for emerging market peers. We expect yields on the one-year instrument to settle around 250bps to 310bps above inflation, which translates to yields of 13.8% to 14.4%, considering the peculiarities pertinent to Nigeria that improves its relative attractiveness.

Current polices and the long term sustainable growth question

We believe that the current monetary policy priorities have positive implications for near term exchange rate stability; however, we are still concerned about the long-term ramifications for growth. The CBN governor's first tenure was characterized by declining investments in growth-inducing foreign direct investment (FDI) and a surge in investors' appetite for money market instruments. Precisely, annual FDI has hovered between $900 million and $1.3 billion since 2015, compared to $2.3 billion in 2014 when Emefiele was appointed. Current FDI inflows account for 0.2% of GDP, compared to 0.8% in 2014 and an average of 1.8% for Sub-Saharan Africa. The decline in FDI is in stark contrast to the surge in FPI flows, chasing money market instruments. Money market inflows rose from $1.0 billion in 2014 to $3.2 billion in 2017 and $8.5 billion in 2018. We believe that while hot money provides support for the FX and reserves, the flows are short term and susceptible to flight during periods of crude oil price decline, temporary domestic shocks, and other externalities. Foreign direct investment, however, is less fickle and provides support for long term sustainable growth. While fiscal policy has a great part to play in attracting FDI (more growth-focused reforms, strong structural frameworks, investment in infrastructure and amenities, etc.), we highlight that foreign investors have continued to express discomfort with the multiple exchange rate regime as well as the artificial elevation of the naira above its fair value (our calculations suggest a fair value of ₦395.71/$). We believe that a managed float that is closer to the fair value of the NGN would create a more conducive environment for long term investment.

We believe that continued divergence in the exchange rate from its true value will widen with the current trajectory, with IMF's inflation forecasts suggesting double digits reading until 2020. Further divergence will continue to dissuade long term investors as well as increase the downside risk of a forced devaluation akin to that of June 2016.

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