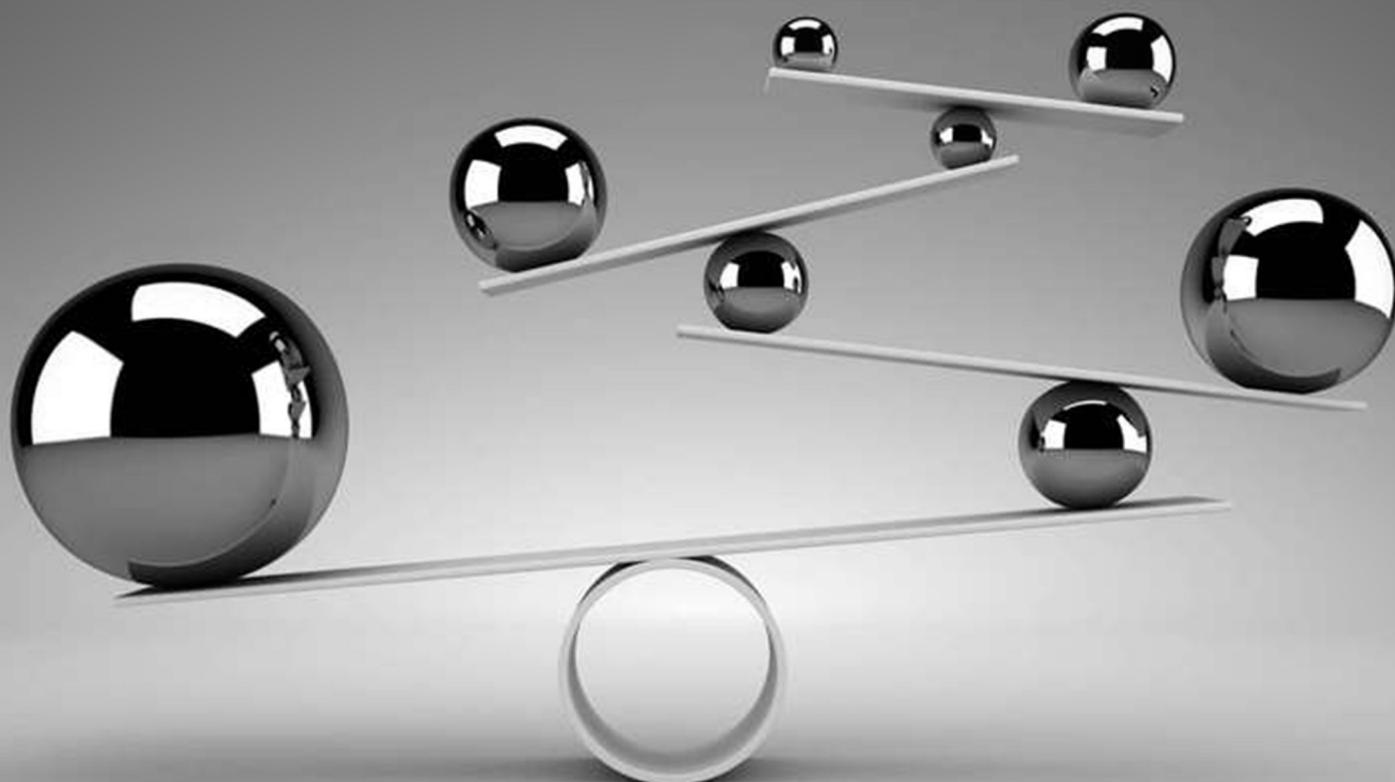




CARDINALSTONE



2023 Outlook

BALANCING THE LEVERS

January 2023



Executive Summary

The troika of potential monetary policy changes, China's reopening, and recession angst could be critical to investment decision-making in 2023. Across some key markets, a second recession in three years appears likely, given the composite effects of demand-stifling strategies to stem inflation worries engineered by supply-side triggers. Having fanned the prevalent recession risks vis-à-vis rate hikes, global central banks remain unlikely to orchestrate rate cuts hurriedly. To this end, this report posits a more gradual temperance in the pace of interest rate increases or cessation of rate hikes in the second half of 2023, with support accruing from high-base effects and moderating supply-side issues. Elsewhere, the reopening of the Chinese economy portends a double-edged sword—raising hopes for brighter supply chain dynamics while potentially capping the scope for energy price moderation. Yet, it is likely to have a net-positive effect on the global economic outlook, with a knock-on effect on the urgency to reduce rates.

For Nigeria, the growth outlook could be materially influenced by the sustained traction in tech-led services and an impending paradigm shift in the oil sector. To wit, the imminent onboarding of the Dangote Refinery could translate into a key upside risk, helping to unlock new policy frontiers and abate perennial FX woes. Nonetheless, the picture is beclouded by sociopolitical and policy uncertainties stoked by the coming February general elections. Would the emergent president seek to bite the bullet and make strategically important decisions despite the risks of near-term backlash? Or would he be swayed by the need to endear himself to the populace with unsustainable subsidies and other social interventions? Against this backdrop, this report assumes that 2023 will be mostly transitional and gradual, with strategic priorities of the new administration likely to be more pronounced in 2024.

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Contents

Introduction

Executive Summary	2
Contents	3

Global Economy

Tough year ahead	4
Inflation peaking; central banks could taper rate hikes	6

Domestic Economic and Political Environment

Economic growth to remain stable in 2023	7
Fiscal position in 2023: A year of reforms?	10
Monetary policy: Inflation and currency in focus	13

Disclosures 16



Global Economy

Recession worries linger

In 2022, inflation evoked synchronized monetary policy action, which was unparalleled since the 1970s and raised questions over a potential deterioration of the global economy. A rollover into 2023 is widely expected, with the IMF prevising that up to one-third of economies may slip into recession.

European countries are projected to suffer the largest churn on account of geopolitical stressors, while a resilient labour market could help the US avert a deep dive. Moreso, the world continues to monitor

developments in Southeast Asia, particularly as China reimagines its zero Covid stance and Japan rethinks its monetary policy.

While the reopening of the Chinese economy may boost industrial activity, the resurgent wave of Covid-19 infections poses a risk. Despite this, potential softening of global inflationary pressures could prompt slower pace of tightening in 2023.



Tough year ahead

2022 was a turbulent year for financial markets, with global economic considerations anchored by multidecade-high inflation, aggressive monetary tightening, and weaknesses in China induced by zero-Covid policies & slump in the property market. Accordingly, business and consumer confidence were negatively impacted.

In the U.S, Fed policies cascaded into dwindling housing demand owing to elevated mortgage pricing, which subdued the construction industry and drove weaker growth expectations for 2023. Notwithstanding the resemblance to the 2008 crisis, risk measures suggest a relatively lower possibility of a housing-led recession. Furthermore, the U.S. unemployment rate of 3.5% – one of the lowest levels since the 1970s – provides some comfort that a deep recession might be avoided in 2023.

The European economy appears more prone to a recession in 2023, as the IMF estimated that half of the 19 European countries are already in or at a high risk of recession primarily due to the potential impacts of the

the Russian-Ukraine war on energy supply.

Moving on to the Orient, the Chinese economy faces a different challenge, having faced erstwhile pressures from rigorous enforcement of Covid-19 restrictions and a beleaguered property market. To contextualize the latter, we note that real estate is the country's traditional growth engine, accounting for 20.0% of the GDP. The prolonged crisis in the space continues to create encumbrances in the financial sector. Nevertheless, the restrictive Covid policy seems to be easing, as mainland China opened transportation routes to Hong Kong and ended mandatory quarantines for incoming travellers.

Overall, IMF forecasts a decline in global growth from 6.0% in 2021 to 3.2% and 2.7% in 2022 and 2023, respectively. The 2023 projection, if it pans out, would be the weakest growth since 2001, save for the outturns induced by the global financial crisis of 2008 and the acute phase of the COVID-19 pandemic in 2020.

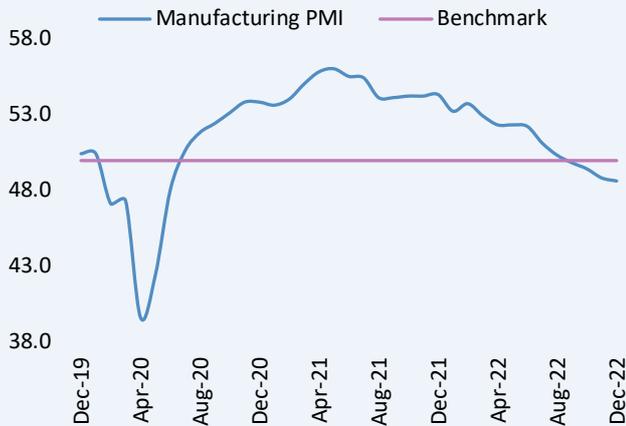
Figure 1: Recession risk and heightened market volatility

Real GDP Growth (%)	2018	2019	2020	2021	2022F	2023F
Advanced Economies	2.3	1.7	-4.4	5.2	2.4	1.1
United States	2.9	2.3	-3.4	5.7	1.6	1.0
Euro Area	1.8	1.6	-6.1	5.2	3.1	0.5
Germany	1.0	1.1	-3.7	2.6	1.5	-0.3
France	1.8	1.9	-7.9	6.8	2.5	0.7
Italy	0.9	0.5	-9.0	6.7	3.2	-0.2
Spain	2.3	2.1	-10.8	5.1	4.3	1.2
United Kingdom	1.7	1.7	-9.3	7.4	3.6	0.3
Japan	0.6	-0.4	-4.6	1.7	1.7	1.6
EM and Developing Economies	4.6	3.6	-1.9	6.6	3.7	3.7
Sub-Saharan Africa	3.3	3.2	-1.6	4.7	3.6	3.7

Source: IMF, CardinalStone Research

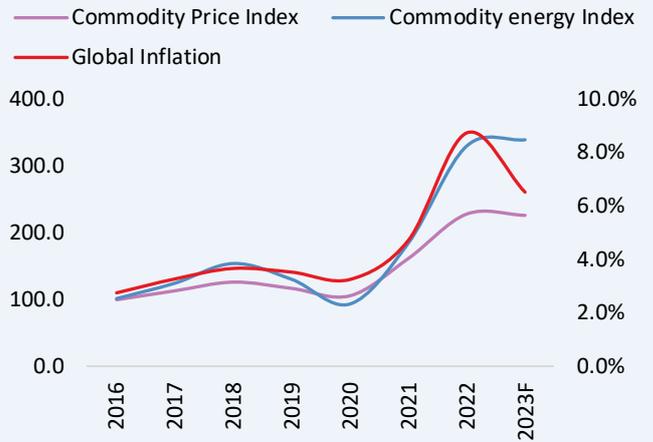


Figure 2: PMI data indicates a potential slowdown in global economic activities



Source: Bloomberg, CardinalStone Research

Figure 3: Global inflation is poised to moderate in 2023, which could lead to a slower pace of rate hikes



Source: IMF, CardinalStone Research

Inflation peaking; central banks could taper rate hikes

Monetary authorities raised interest rates in 2022 in a synchronicity not seen in the last five decades. Yet, the policy rate actions seem ineffectual in bringing the mostly supply-side-driven inflation down to desirable levels. In 2023, global inflation could touch its peak, largely due to a possible high base effect. Furthermore, supply chain disruptions are gradually disappearing, with shipment activities improving and cost declining. For context, Baltic Exchange Dry Index¹ fell by 31.7% in 2022. Also, while the gradual re-opening of the Chinese economy could serve as a tailwind to industrial activities and reduce supply constraints in 2023, the resurgent wave of Covid infections poses a downside risk. Nonetheless, an expected softening of inflationary triggers could spur a slower pace of rate hikes or discontinuation of monetary tightening in 2023.

Figure 4: Baltic Exchange Dry Index indicates that supply chain disruptions are waning



Source: Bloomberg, CardinalStone Research

1. The Baltic Dry Index (BDI) is an index of average prices paid for the transport of dry bulk materials across more than 20 routes



Domestic Economy

Economic growth to remain stable in 2023

Domestic growth seems to have found a new course. Post-pandemic output holds steady at c.3.0%, aided by a robust outturn in the services sector, which masked lingering weaknesses in oil GDP.

We expect services to be the cornerstone for growth in 2023, profiting from data-led growth in ICT and the positive pass-through of improved cross-border activities in the trade sector. In addition to the expected positive contribution from services, our 2023 growth outlook also reflects (1) a likely improvement in the oil production dynamic, (2) enhanced consolidated refining capacity, and (3) the impact of climate change. Juggling the abovementioned factors resulted in our growth projection of 3.2% in 2023, with

estimated oil and non-oil sector outturns at 7.4% and 3.0%, respectively.

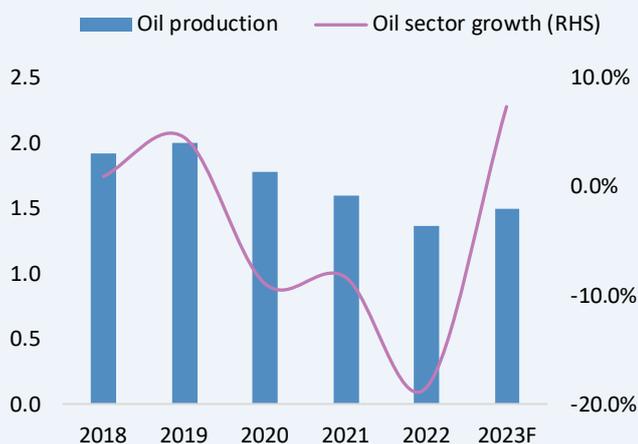
With few weeks to the general elections, the economic outlook remains uncertain. Would the emergent president seek to bite the bullet and make strategically important decisions despite the risks of near-term backlash? Or would he be swayed by the need to endear himself to the populace with unsustainable subsidies and social interventions? This report assumes that 2023 will be mostly transitional and gradual, with strategic priorities of the new administration likely to be more pronounced in 2024.



A recovery in the oil sector may be in the offing in 2023

Nigeria's crude oil production touched a decade-low of 1.0mbpd in 2022, reflecting oil theft, low investment, and significant leakages associated with poor maintenance. In our view, oil production will likely improve in 2023, aided by increasing pipeline surveillance and the ongoing clampdown on oil theft. In addition, the 2 biggest oil export terminals in Nigeria – Forcados and Bonny oil Terminals – which were shut down for most of 2022, have begun operation and export. Consequently, we project oil production to an average of 1.5mbpd in 2023, with a corresponding oil sector growth of 7.4%.

Figure 5: Oil sector to return to growth in 2023

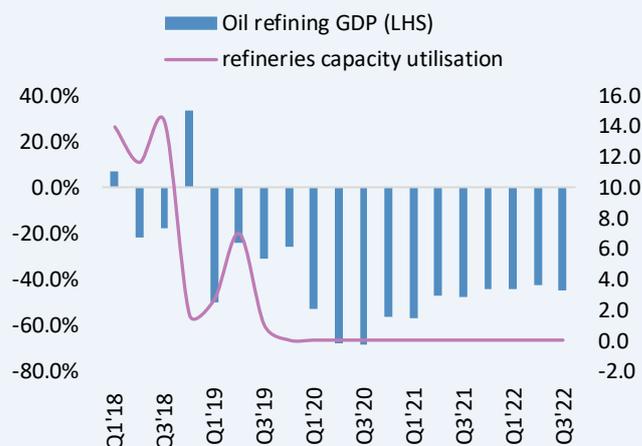


Source: NUPRC, NBS, CardinalStone Research

Hope for oil refining and potential manufacturing tailwinds

Nigeria has 4 oil refineries, with a total capacity of 420,000 bpd. However, all the refineries have been shut down since 2019 due to essential rehabilitation work. This explains why the oil refining GDP (a sub-component of the manufacturing sector) has recorded an average contraction of 46.8% over the last 4 years. With the Port Harcourt (210,000bpd) and Kaduna (110,000bpd) refineries projected to become active in H1'23, coupled with the anticipated operationalisation of the Dangote refinery, we see scope for an improvement in the manufacturing sector.

Figure 6: Nigeria's refineries capacity utilisation at zero % since 2019



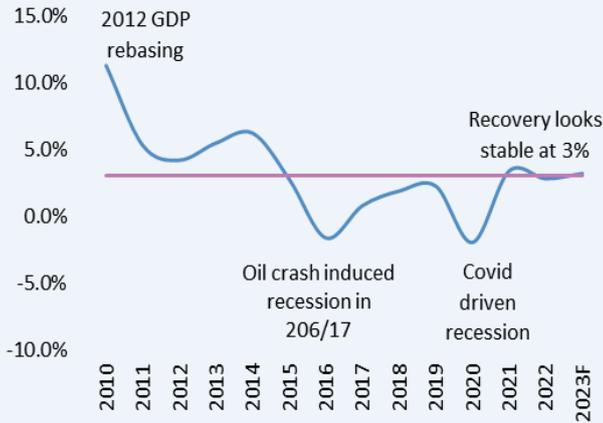
Source: NNPC, NBS, CardinalStone Research

Climate change: Headwinds to the agriculture sector in 2023

The above-average rainfall across Nigeria, and the subsequent release of water from dams, led to widespread flooding in over 30 states in 2022. With over 637,000 hectares of cropland submerged, the resulting food scarcity is expected to extend into H1'23. Furthermore, the National Emergency Management Agency has warned that the flood incidences could worsen in 2023, suggesting likely headwinds to Agric GDP. Consequently, we forecast Agric sector growth to remain sub-optimal at 1.9% in 2023. However, if Nigeria participates in the IMF's newly created food shock window, c.\$1.7 billion in funding could be unlocked for onward deployment to productive activities in the sector. The contingent financing is provided to member countries with urgent balance of payment needs due to acute food insecurity, a sharp increase in their food import bill, or a shock to their cereal exports.



Figure 7: Growth to settle at 3.2% in 2023



Source: NBS, CardinalStone Research

Figure 8: Nigeria's GDP growth to remain below those of a few oil-exporting economies

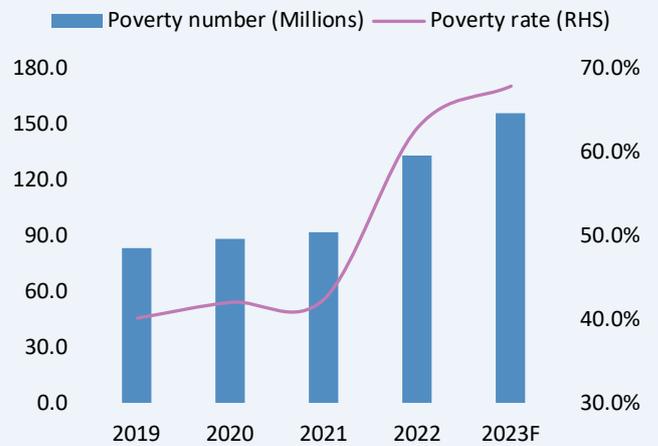


Source: IMF, CardinalStone Research

Economic inequity fuelled by lack of inclusive growth

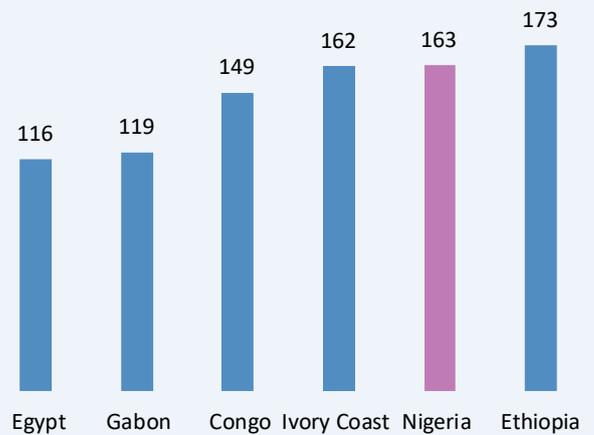
Nigeria's economic growth remains uneven and lacks inclusiveness, with notable socioeconomic disparities. For context, the recently-released statistics indicated that Nigeria is one of the poorest nations globally, with 63.0% of its entire population below the poverty line. Further analysis revealed that 80.0% of the poor Nigerians live in rural areas characterised by large numbers of dependents, limited access to infrastructure, and weak education.

Figure 9: About 63.0% of Nigerians live below the poverty line



Source: NBS, CardinalStone Research

Figure 10: Nigeria ranks 163rd out of 191 countries in UN Human Development Index (HDI)



Source: UN, CardinalStone Research



2023: A year of fiscal reforms?

Nigeria's fiscal space was largely eroded in 2022, with oil revenue materially underperforming, on account of expensive subsidy payments and lower-than-expected oil production. Conversely, tax revenue outstripped government estimates by 23.3%, profiting from improved internal and cross-border economic activities. By our estimates, the fiscal deficit for 2022 may have reached N7.0 trillion (c.3.5% of the GDP).

Analysing the 2023 budget

In 2023, the Federal Government expects a record fiscal deficit of N11.3 trillion (c.5.0% of GDP), as revenue mobilisation remains a major constraint.

Per our earlier fiscal update, we expressed concerns over the State's perennial inability to achieve revenue projections, given leakages and low institutional accountability.

Nevertheless, we find comfort in projected oil revenues, as the budget benchmark crude oil price of \$75.0bbl appears reasonable, considering the weaker global demand outlook amid fears of recession. Given the traction observed over the last 5 years, wherein government tax revenue lagged projected by c.10.0%, we see latitude for c.N2.3 trillion in tax revenue in the current fiscal year. On the net, we project the budgetary deficit to settle higher at N12.3 trillion (5.5% of GDP).

Figure 11: Nigeria's deficit may reach 5.5% of GDP in 2023

Fiscal balances 2023 (N trillion)	Budgeted	Bull case	Base case	Bear case
Total Expenditure	-21.8	-19.8	-21.2	-22.1
Recurrent non-debt	-8.3	-7.9	-8.3	-9.2
Debt service	-6.3	-6.3	-7.3	-7.6
Capital expenditure	-4.2	-3.0	-2.6	-2.3
Others	-3.0	-2.6	-3.0	-3.0
Total Revenue	10.5	10.1	8.9	6.1
Oil	2.2	3.5	3.1	0.8
Tax revenue	2.4	2.4	2.3	2.1
Others	5.8	4.1	3.5	3.2
Fiscal Deficit	-11.3	-9.7	-12.3	-16.0
Fiscal Deficit (% of GDP)	-5.0%	-4.3%	-5.5%	-7.1%

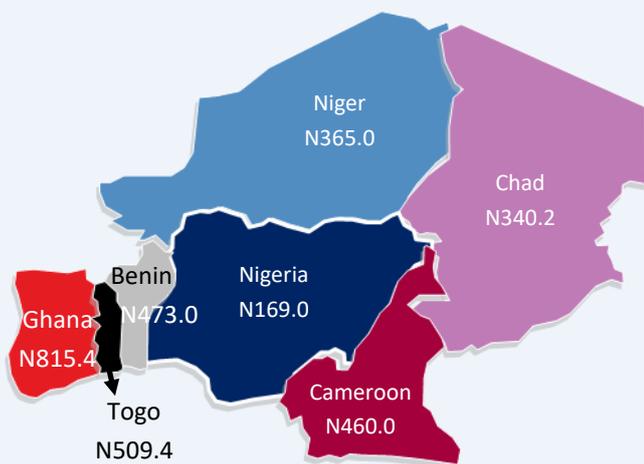
Source: Budget Office, CardinalStone Research



Subsidy removal: If Kenya, why not Nigeria?

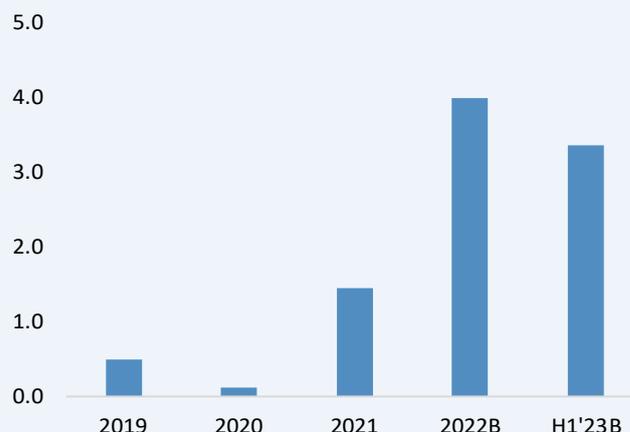
The lack of a market-reflective energy pricing mechanism has blotted government spending, with over N5.5 trillion expended on PMS subsidy in the last 2 years. In recognition of this burden, there have been increasing signals of a possible end to the price-control era, with the government making provisions for only six months of subsidy payments in 2023. To our minds, with c.72.0% of its gross oil revenue spent on subsidies, we think that the Nigerian government can mirror the action of Kenya, whose newly elected president eliminated energy subsidies in 2022. The absence of subsidies could save Nigeria over N4.0 trillion, which can be redirected to essential spending. However, given the politically sensitive nature of the issue, the government could adopt a staggered approach to subsidy removal (i.e. an initial 30-40% adjustment in 2023) to reduce the risk of significant public backlash. By IMF estimates, a 40% increase in PMS price could reduce the disposable income of rich households and decrease the country's income inequality (measured by the GINI coefficient) by 0.25ppt.

Figure 12: Nigeria's low PMS pricing sharply contrast with those of neighboring countries



Source: Global Petrol Prices, CardinalStone Research

Figure 13: Nigeria's subsidy payment (N' trillion)



Source: Budget office, Ministry of Finance, CardinalStone Research

Nigeria's debt trajectory remains biased to the upside

Over the medium term, sovereign debt will likely remain on the rise, with IMF projecting debt-to-GDP to touch 38.2% in 2023 and grow steadily to 43.8% by 2027. Although Nigeria's debt-to-GDP is below the sustainability threshold of 70.0% of GDP, its trajectory remains a major concern and requires fiscal reform measures to tame.

Figure 14: Nigeria's debt remains on the rise. Any cause for concern?



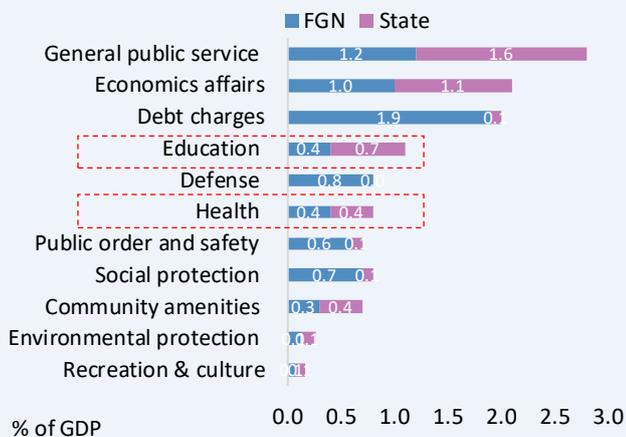
Source: DMO, IMF, CardinalStone Research



Is Nigerian government spending enough?

In Nigeria, fiscal space has largely been constrained by recurrent expenditures such as debt servicing and personnel costs, which accounts for 60.0% of total government spending. The World Bank estimated Nigeria's gross expenditure at c.12.0% of GDP between 2015 and 2021, significantly lower than the global average of c.30.0%. The same institution estimated that at the current rate of expenditure allocation, it would take the country about 300 years to bridge its infrastructure deficit. In addition, it appears the limited fiscal space has masked social spending in Nigeria compared to similar countries. For example, in 2021, with Covid still ravaging the economy, Nigerians received just \$15 worth of public health services² – 3.7x lower than the \$55.0 received in Indonesia. Hence, there is a need for fiscal reforms to bolster revenue and create space for growth-enhancing measures and social spending.

Figure 15: Government's social spending is relatively low



Source: World Bank, CardinalStone research

2. This includes health care investments, salaries to health personnel, and procurement of medication



Monetary policy: Inflation and currency in focus

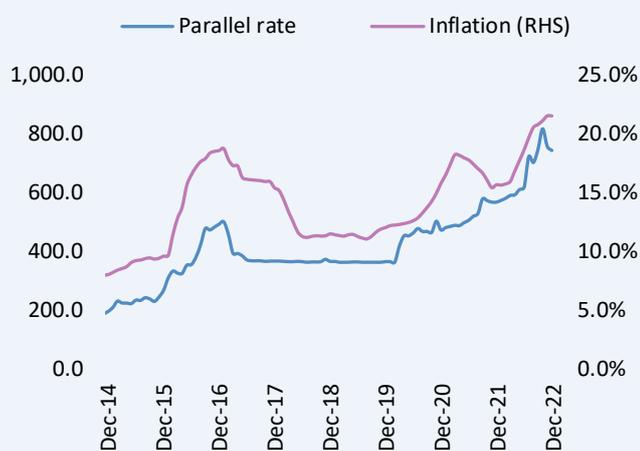
The CBN was intolerant of high system liquidity in 2022, adjusting the policy rate four times by a cumulative 400bps to an all-time high of 16.5%. Notwithstanding, inflation rallied to a 17-year high of 21.5% in November 2022, reflecting supply-side factors like lingering structural issues, persistent insecurity, and flooding in food-producing regions. In 2023, we see three major price triggers: relentless currency pressures, PMS price adjustment, and climate change.

First, we note that the naira has depreciated by an average of 4.0-6.0% over the last 5 years, a trend expected to continue in 2023. We project the official rate to devalue to N500/\$ in 2023, with the parallel market set to remain at a premium to the official rate on the impact of election-related activities and unmet demand from official sources.

Secondly, the stressed fiscal position of the government could lead to a partial removal of the PMS subsidy. We project a 40.0% increase in PMS retail price to N230/litre, which will impact both the core and food baskets of CPI through transport cost and HWEGF pressures.

Lastly, the 2022 flooding incidence was the most severe on record. The Nigeria Emergency Management Agency (NEMA) estimates that over 2.4 million people were displaced, while about 637,000 farmland hectares were submerged. Consequently, the climate-related shock could fuel food scarcity in early 2023, forcing food prices higher. Thus, we expect inflation to soar in the first half of the year before moderating slightly in H2'22 due to a high-base effect. We project headline inflation to average 18.6% in 2023, marginally lower than 18.7% in 2022. Consequently, we expect monetary responses to remain hawkish in the first half of 2023. However, the base effect-induced inflation moderation in H2'23 should provide some legroom for the CBN to stand pat on the interest rate.

Figure 16: Inflation and parallel market rates strongly correlate



Source: NBS, CardinalStone Research



FX pressures to persist in 2023

In 2022, average monthly net flows through the CBN settled at a negative \$81.0 million (vs 2021: +\$321.9 million), as a significant dip in crude oil production constrained the accretive movement of higher crude oil prices. Adding an extra layer of pressure on the market, foreign inflows were tepid in the review period on global risk-off sentiments, FX repatriation concerns and the absence of market reflective exchange rate. Moreover, FX demand was exacerbated by pre-election spending, increasing Japa syndrome, and heightened currency speculation. Consequently, CBN’s foreign reserves slumped by \$3.4 billion to \$37.1 billion as of December 2022.

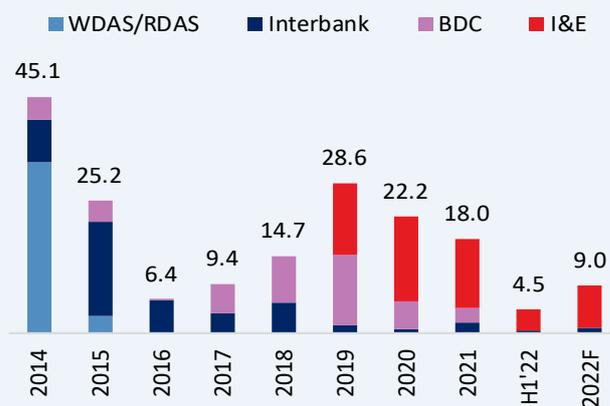
The limited FX inflows also curtailed the magnitude of FX supply, as average CBN monthly sales across the FX strata currently stand at \$1.4 billion, lower than the 3-year average of c.\$2.0 billion. Hence, the widened disequilibrium in demand and supply drove the parallel market premium to an all-time high in 2022.

We project the naira to weaken to ₦500/\$ in 2023

The naira has depreciated by an average of 4-6% over the last 5 years. We expect this trend to extend into 2023. In line with FMDQ’s 1-year forward rate, the official rate could weaken to ₦500/\$ by 2023.

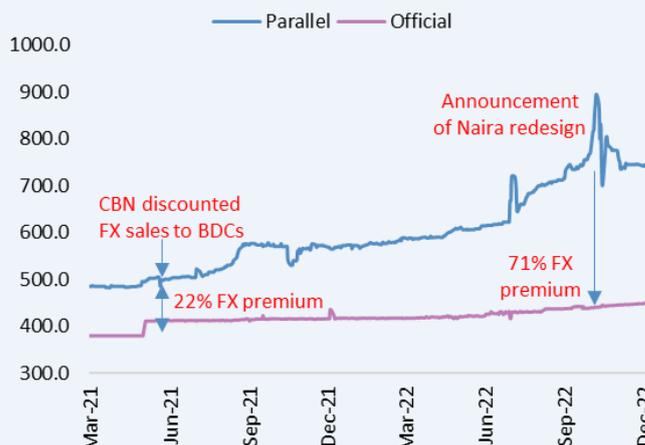
Upside risks to our FX outlook include the potential operationalisation of Dangote Refinery and a higher-than-expected-resurgence in crude oil production. Both factors could lead to a reduction in parallel market premium.

Figure 17: CBN continues to reduce the size of F.X. intervention



Source: NBS, CBN, CardinalStone Research

Figure 18: Parallel market rate remains elevated



Source: CBN, CardinalStone Research



Figure 19: Economic summary table

Nigeria Economic Indicators	2017	2018	2019	2020	2021	2022E	2023F
National income and prices (%)							
Real GDP	0.8%	1.9%	2.3%	-1.9%	3.4%	3.0%	3.2%
Oil and Gas GDP	4.7%	1.0%	4.6%	-8.9%	-8.3%	-18.5%	7.4%
Non-oil GDP	0.5%	2.0%	2.1%	-1.3%	4.4%	4.8%	3.5%
Production of crude oil (million barrels per day)	1.89	1.93	2.01	1.78	1.60	1.35	1.50
Total investment (% of GDP)	15.5%	19.8%	25.4%	27.5%	33.8%	17.9%	16.2%
Gross national savings (% of GDP)	18.9%	21.3%	22.2%	23.5%	33.4%	17.7%	15.5%
Consumer price index (annual average)	16.5%	12.1%	11.4%	13.3%	17.0%	18.6%	18.5%
External sector (\$'billion)							
Current account balance	12.7	6.3	-14.6	-17.0	-1.8	-1.0	-3.7
Current account balance (% of GDP)	3.4%	1.5%	-3.3%	-4.0%	-0.4%	-0.2%	-0.7%
Fiscal indicators (N'billion)							
Total revenue	2.6	3.6	4.1	4.4	6.1	7.1	8.9
Total expenditure	-6.5	-7.5	-8.3	-10.9	-13.0	-14.0	-21.2
Fiscal deficit	-3.8	-3.9	-4.2	-6.5	-6.9	-6.9	-12.3
Fiscal deficit (% of GDP)	-4.1%	-4.2%	-4.5%	-5.6%	-5.0%	-4.0%	-5.5%
Policy rates and FX indicators							
I&E window rate (Year-end)	306.1	307.0	307.0	410.3	435.0	461.0	500.0
MPR (Year-end)	14.0%	14.0%	13.5%	11.5%	11.5%	16.5%	17.5%
FX exchange reserves	39.4	42.6	38.1	36.8	40.5	37.1	36.0

Source: CBN, NBS, FMDQ, CardinalStone Research



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