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Prepare for the Recovery rally

IN BRIEF

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- The external environment continues to deteriorate as the U.S. battles inflation, Europe faces an energy crisis, and China contends with the outbreak of the omicron BA.2 variant, leading to a surge in risk aversion.

- Following the loss of external market access in the shadow of the Russia-Ukraine war, the prevailing view seems to be that Ghana's fiscal health will deteriorate further before it recovers.

- While we think the consensus view is reasonable, today's market levels suggest there is not enough alpha in being bearish or negative on Ghana.

- Consider that while today's market winners took a bearish position twelve months earlier, tomorrow's winners belong to those who prepare for a recovery.

- It is easy to say that markets move in cycles and work themselves out in time, but it takes a lot of courage and conviction to live through them.

- Take heed to the words of Winston Churchill: "If you are going through Hell, keep walking."

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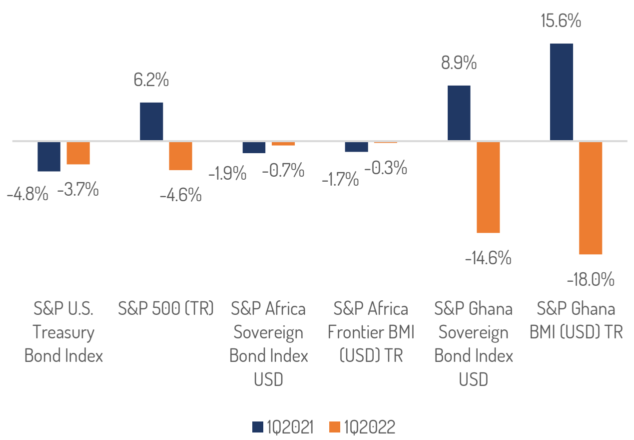
There can be no denying that the first three months of the year were tough. Who would have conceived that, as the global pandemic slowly loosened its hold on the planet, the possibility of World War III would loom to take its place in unsettling global markets?

Quarterly performance of selected financial markets



Source: Standard & Poor's

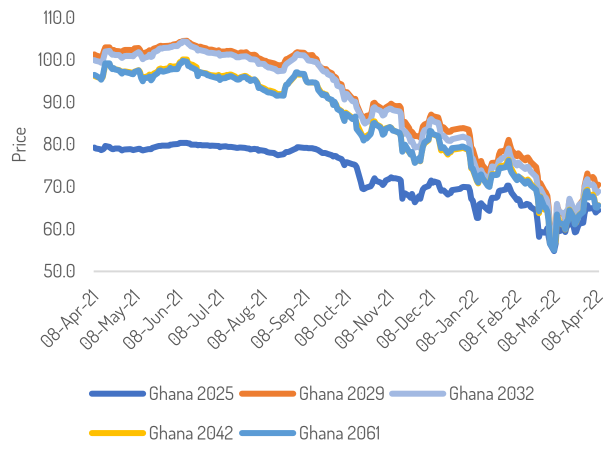
Amid the geopolitical risk, hawkish global monetary environment, and local fiscal uncertainty combining to stoke fear in the Ghanaian market, it could possibly be viewed as incongruous to talk about preparing for a recovery rally.

Following the loss of external market access in the shadow of the recent Russia-Ukraine war, the prevailing view seems to be that Ghana's fiscal health will deteriorate further before it recovers. While we think the consensus view is reasonable, today's market levels suggest there is not enough alpha in being bearish or negative on Ghana. Consider that while today's market winners took a bearish position twelve months earlier, tomorrow's winners belong to those who prepare for a recovery.

A review of the last three months shows everything that could go wrong for a weaker credit, like Ghana, happened

First, the country's 2022 budget moved from being rejected to being approved by the nation's quorum-fighting parliament. A credit downgrade from single B to triple C by Moodys followed the fisticuffs in the local parliament, plummeting the country's Eurobond prices by ~12.4% in 1Q2022. The downgrade effectively shut external market doors to Ghana, raising doubts about the country's local currency.

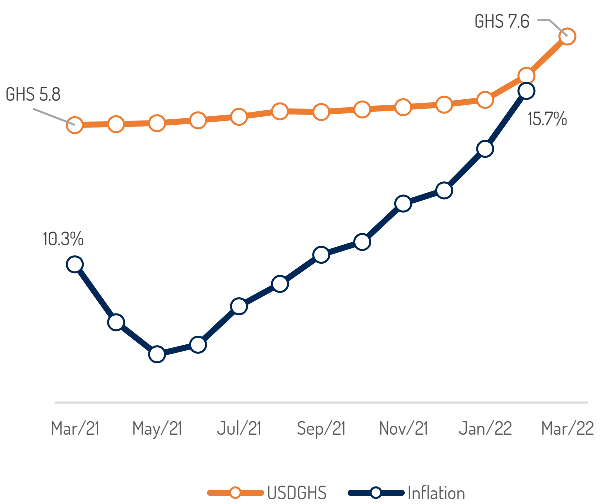
Ghana Eurobonds: Price evolution



Source: Bloomberg

Amid the loss of external market access, Ghana's parliament passed the central government's proposed electronic tax levy in the last week of the 1Q2022, four months after the fiscal budget was read in November 2021, with the minority party in parliament contesting this decision at the nation's apex court. This internal chaos served as the backdrop to the fallout of the Ukraine war, which has energised inflationary pressures as both currency depreciation and the oil price uptick erase disposable income in Ghana, further raising social and political tension. Can it get worse than what we have seen so far?

USDGHS vs. Inflation

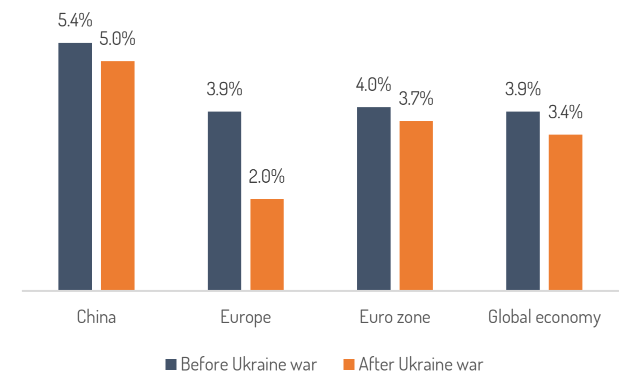


Source: Bloomberg

In a world of worry, global monetary tightening amid heightened uncertainty adds yet more concern

The external environment continues to deteriorate as the U.S. battles inflation, Europe faces an energy crisis, and China contends with the outbreak of the omicron BA.2 variant, leading to a surge in risk aversion. In our view, global monetary tightening within this environment exacerbates the downside risks to economic growth.

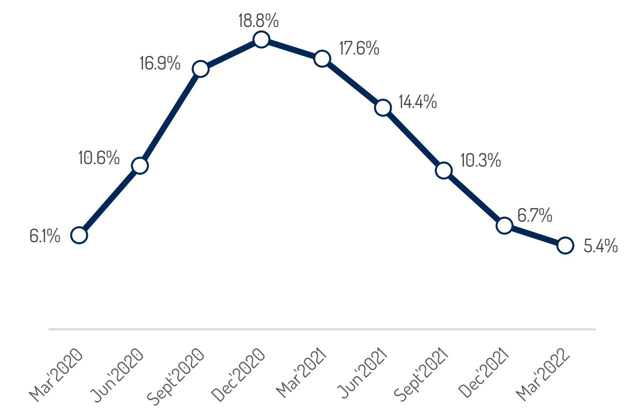
Growth rate projection: Before and after the Ukraine war



Source: Economic intelligence report

Another layer of concern to policymakers in Ghana is the monetary tightening that is fuelling a sharp fall in global money supply growth. This has led to portfolio outflow from the local rates market, raising reasonable doubt about the country's domestic financing target of GHS27.9bn (5.6% of GDP). So far, Ghana has raised GHS 22.1bn out of a target of GHS 24.5bn for 1Q2022. Out of the GHS 22.1bn raised, GHS 3.8bn (13.6% of domestic financing target) represents new issuances, leaving a clear funding gap in the country's fiscal operations. The longer the geopolitical tension remains elevated, the deeper that problem will become.

Growth in global money supply: Year-on Year



Source: Bloomberg

Local currency Treasury bonds purchased and sold by offshore investors; (GHS'bn)

Source: Central Securities Depository, Ghana

Like many other weaker credits, rising inflation adds to Ghana's debt worries. This means the cost of credit for both the private sector and the sovereign will increase, intensifying debt vulnerabilities. The challenge with Ghana is that the country does not have policy space to absorb the impact of the Russia-Ukraine war.

This could raise social-political pressures amid the country's near-hung parliament and scarring from the pandemic that was already impacting millions of households and businesses. Whichever way you look at it, the war has backed Ghana into a tighter corner and makes for thought-provoking reading on the next policy steps for the country.

Bank of Ghana maintains its credible monetary policy stance

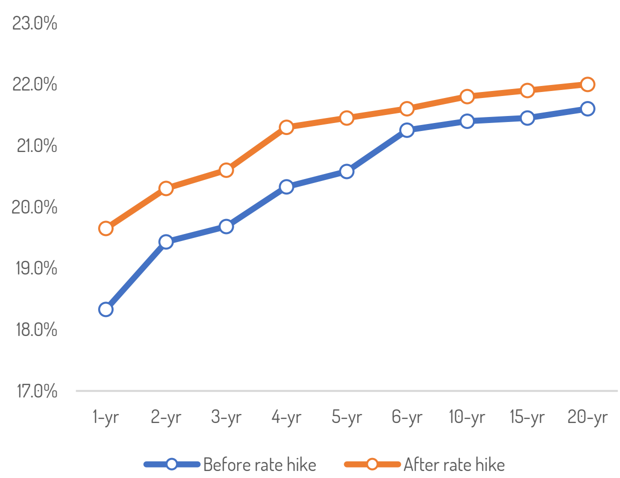
While there are growing reasonable doubts about the country's fiscal stance, investors cannot say the same about the central bank.

The Bank of Ghana, in a surprise move, deployed its twin tool of price and quantity in response to inflationary pressures, highlighting the extent of the fallout of the war on the cost of living in Ghana. On the pricing side, the central bank increased its policy rates by 250bps, the highest rate hike since 2018.

As if this was not enough, the Bank of Ghana also increased its cash reserve requirement from 8% to 10%, for banks that did not pay dividends, and to 12%, for banks that paid dividends. In our estimation, the increase in reserves could suck ~GHS 2.5bn from the market and thus leave less cash in the banking system for speculative activities.

While this provides temporary relief to the local currency, the hike in policy rate has spiked local yields as banks sell bonds to raise cash to meet the new reserve requirement. Having deployed price and quantity tools simultaneously, the local central bank has fewer tools available if inflation persists. Hence, much a lot depends on the fiscal side of the Ghanaian equation.

Local yield curve



Source: Insights desk

Fiscal Policy picks an unhappy middle stance as both markets and populace jostle for Government's attention

One of the fallouts of the pandemic is the competing interest between markets and citizens. Following the debt pile resulting from the pandemic, the market is demanding fiscal tightening, especially from weaker credits like Ghana, while the populace is pushing back on the rollback of budgetary support. The war has only heightened the tension between the three players: government, markets, and citizens.

Against this backdrop, the central government in Ghana announced a cabinet retreat to discuss the fallouts of the war. Gauging from the market reaction, investors expected either a pivot on the country's we-won't-go-for an IMF program stance or aggressive expenditure cuts, while the citizens were looking for a cutback on petroleum taxes to cushion individuals against rising fuel prices.

Following the 10% cut on discretionary expenditure in addition to the 20% cut in January and the 15 pesewas reduction in petroleum prices, both parties were not happy with the outcome of the much-publicised cabinet retreat. In addition to spending cuts amounting to GHS 3.5bn (2.6% of 2022 of budgeted expenditure) and raising new tax handles, the Minister of Finance announced the country's intention to raise USD 2bn from syndicated loans.

Details, however, remain sketchy as this year's fiscal budget indicates "*a planned international financing programme to raise at least USD 750 million with an option to increase it by a further USD 750 million for budget support and liability management*".

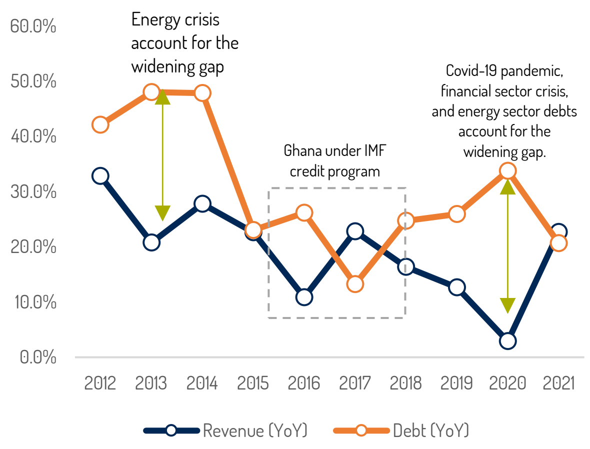
Why should you prepare for a recovery rally amid the country's fiscal hassle?

We believe that Ghana's fiscal position has hit rock bottom or is closer to rock bottom now than twelve months earlier.

The only way out is recovery — and recovery always comes with its pains: IMF credit program, homegrown solutions, or a combination. Ghana's debt has reached a tipping point amid structural rigidity surrounding its resource envelope and how much it can afford.

We therefore expect borrowing to stay elevated, owing to high debt-rollover needs, fiscal policy normalisation challenges posed by the pandemic, currency depreciation, high inflation, and polarised social and political landscapes. Following this, we expect Ghana to actively seek the support of multilateral agencies in some shape or form to give a bite to its homegrown solutions of cutting back on expenditure and raising new tax handles.

Growth rate (YoY): Revenue Vs. Debt



Source: Bloomberg, Bank of Ghana, Ministry of Finance

Until external support is secured, the wall of fear built against Ghana will remain, at least for the 1H2022, opening opportunities for investors with courage and local insights.

We believe fear brings opportunity

As contrarian money managers, we see markets as a pendulum moving from one end to another. Presently, we are closer to the fear end of the pendulum where uncertainty is high, so much so that no one wants to take a risk, opening bargains for contrarian investors. Despite this, our approach is different for each asset class.

Go short on Eurobonds and long on local currency bonds

Government austerity measures and a new revenue stream (E-levy) present short to medium-term measures to improve the country's fiscal situation. However, we do not anticipate local yields to decline this quarter. We are more likely to see the full effect of the new policy measures in 3Q2022 when the market will have data to measure the strength of government's home-grown solutions to the country's fiscal challenges.

We prefer to position at the mid to long-end of the curve with most focus on 2027 to 2032 papers. However, we will need at least a real spread of 600bps to compensate for this duration.

Compared to the local currency bonds, Ghana's Eurobonds are more vulnerable to rate hikes by major central banks, and this could cap capital gains. Thus, it makes sense to hold early maturity Ghana Eurobonds at steep discounts and gradually crystallize gains as the prices firm.

Local pension funds will support a recovery on the Accra bourse

Given the current local and global headwinds, it is very difficult to find value in Ghana's liquidity-thin stock market. We expect the bearish run to continue in the 2Q2022 for local equities as fear continues to weigh sway over risk. However, things could change if Ghanaian pensions embrace the new pensions guidelines which require a bit more tilt to risky assets. Given that value remains scarce on the market, we maintain our preference for MTN and a few well-governed market leaders in the financial space.

Easier said than done...

It is easy to say that markets move in cycles and work themselves out in time, but it takes a lot of courage and conviction to live through them.

Take heed to the words of Winston Churchill: "If you are going through Hell, keep walking."

For this reason, it is critical to work with a money manager who can tailor your portfolio to your risk tolerances. This can help you stay confident and be the contrarian who is not paralysed by, but rather take advantage of the opportunity in fear.

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