Fundamentals

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Macroeconomic update I Nigeria's JP Morgan downgrade

Fanning the flame

IN BRIEF

- Once again, Nigeria faces backlash from the international investing community because of its economic quandary.
- Aging infrastructure and lingering policy uncertainty continue to weigh on the performance of the country's oil sector – the crux of Nigeria's economic weaknesses.
- Unfortunately, this will rain on Nigeria's parade - given its large development spending needs -, as many of its sustainable financing channels are showing little-to-no prospects in the near term.
- As a result, Nigeria's balance of risks in the near term is skewed to the downside, portending dire implications for its fiscal profile, external sector health, and the wider economy.
- This, however, does not mean that Nigeria is completely hogwash.
- While the international investing community remains cautious around investing in Nigeria's debt securities, we believe that the risk of default in the near term is still low.
- However, the country's capacity to continue its borrowing spree has been impaired by increased government outgo in the future, and foreign investors will be demanding more premium to hold Nigeria's debt securities – especially Eurobonds.

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JP Morgan has reviewed its recommendation for Nigeria's sovereign papers, removing it from its "overweight" emerging market sovereign recommendations. The downgrade comes as Nigeria has been unable to make the most of the current oil price rally, which has benefitted other crude oil exporters. Against a worsening global risk backdrop, the downgrade portends a number of risks for Nigeria's economy in the near term.

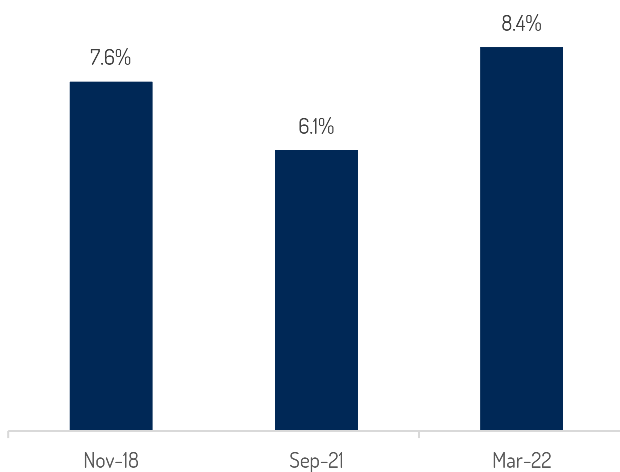
The soon-to-unfold unsavoury developments could range from costlier Eurobond outings – as the country mulls another USD 950m issuance, increased dependence on the local bonds market for government financing needs - thereby increasing the borrowing costs for local corporates, a widening of the gap between the official and unofficial exchange rates, which can prompt further naira weakness.

The Federal government's debt carrying capacity to weaken.

Weaker fiscal health is a no-brainer in the near term as Nigeria's market borrowings are poised to outpace revenue generation. This is alluded to by the recommendation downgrade as perpetual petrol subsidies rob the Nigerian government of financial resources that should accrue to it. Sadly, the subsidy bill is going to be worsened by the government's recent commitment to a three-month jet fuel subsidy to the country's aviation sector. All these points to more borrowing in the offing against the backdrop of a weak revenue-generating capacity, due to tax revenue leakages and oil production sabotage.

More expensive, short-term Eurobond issuances

Primary Market pricing for Nigeria's 7-year maturing Eurobond issues



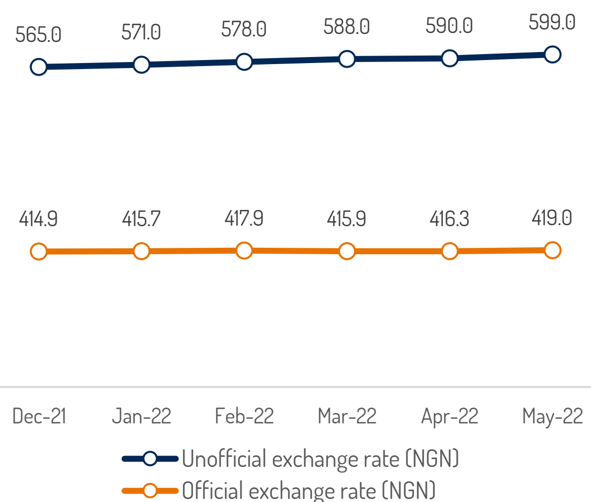
Source: Nigeria's Debt Management Office (DMO)

Due to its weakening fiscal profile and the sour global risk backdrop, the Nigerian government will have to pay more for its USD 950m proposed Eurobond issuance and possibly limit its issuance to short-term maturities (five to seven-year tenors). With more rate hikes on the table in 2022 from the United States Federal Reserve Bank, emerging and frontier markets (Nigeria inclusive) will be tapping the international market at higher rates of interest.

Also, JP Morgan's review decision thickens the dark cloud that has been cast over Nigeria's economy, and the government will have to pay a premium to entice investors to its upcoming dollar offerings. These market conditions will limit Nigeria's access to the short end of its Eurobond curve, where market pricing for its papers is still tolerable. Nigeria's five-year and seven-year dollar bonds currently yield between 10.6% and 11.4%, while the yields on papers maturing in 10 years or more are quoted at 12%.

Risk of further naira weakness still lingers

Nigeria's official and unofficial exchange rates

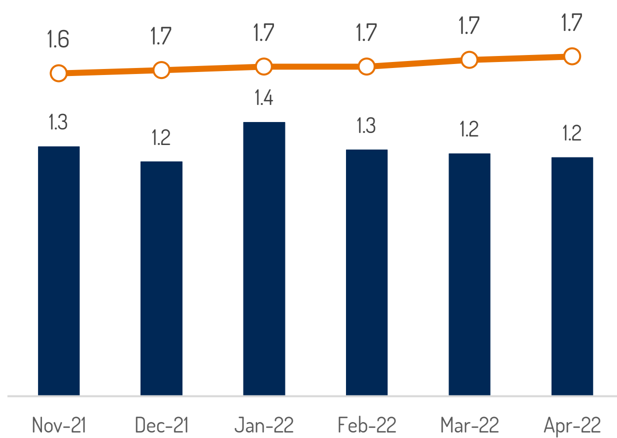


Source: FMDQ; Aboki Rates

In our opinion, pressure will continue to mount on the naira as Nigeria's huge local dollar demand - in the context of the central bank's current foreign exchange regime – continues to widen the exchange rate gap in its fragmented foreign exchange market. This leaves room for further unorthodox currency adjustments that will result in a weaker naira.

Also, aging infrastructure and lingering uncertainty in the country's oil sector - from bunkering, and subsidies – is counter-productive to the accretion of international reserves at a time when other sources of foreign exchange supply (foreign direct and portfolio investments, and remittances) are being constrained by the policy environment. Therefore, the naira is also likely to cave in due to the multifaceted hit to the Nigerian economy.

Nigeria's oil production vs OPEC quota (mbpd)



Source: OPEC

This is especially troubling because a weaker naira makes servicing dollar-denominated loans more onerous. The government and local corporates that borrowed in dollars may be put under further strain, worsening their ability to repay such credits if their earnings do not rise in lockstep as the naira weakens further against the dollar.

Local corporates at risk of the government's large domestic borrowing program

A large financing requirement and restricted access to the international debt market put the weight of government financing on the local debt market, where yields are currently repressed. As government securities are considered the safest debt instruments, the anticipated oversupply of government bonds in the local fixed income market can choke off investment spending by Nigerian corporates via increased cost of borrowing. This narrows the window of opportunity for Nigerian corporates to raise affordable funds, putting pressure on their future cash flows and limiting profitability as they try to navigate other headwinds such as supply chain bottlenecks, constrained credit access, and inflation.

Conclusion

Perception is everything, and the downgrade by JP Morgan serves as a note of caution to foreign investors who might be interested in Nigeria's sovereign credit. As the country's oil sector crisis deepens, its ability to service its obligations, especially foreign obligations, will be adversely impacted.

Although the cautionary note sends a negative signal to Nigeria's foreign portfolio investors, the risk of default in the near term is still low with gross reserves at USD 39bn. But the country's capacity to continue its borrowing spree has been impaired by increased government outgo in the future, and foreign investors will be demanding more premium to hold Nigeria's Eurobond securities.

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