Fundamentals

20 June 2022

Economic insights | Strategy Sub-Saharan Africa

Not in the same boat

IN BRIEF

- Just when we thought the global economy was getting back on its feet from the pandemic knockout, new risks have emerged – constituting flies in the ointment.
- The biggest curveball thrown to emerging and developed markets so far this year has been the European conflict that is fanning uncontrollably-high consumer prices.
- Markets finally got the long-anticipated interest rate hike from the United States (US) Federal Reserve Bank (Fed). This, along with a strong dollar, has resulted in a declining global risk appetite – to the detriment of emerging market economies.
- However, Sub-Saharan Africa's (SSA) emerging economies may be in the same storm, but not in the same boat.
- How the SSA's emerging economies have been impacted and how they have been responding has depended largely on their domestic economic circumstances and levels of resilience.
- For some emerging SSA economies, soaring commodity and energy prices have been a boon (e.g. South Africa), while for others, they are a new headwind (e.g. Ghana). For another group of economies, the gains from the commodity price shock are being eroded by inefficient subsidies (e.g. Nigeria) – making a nonsense of the commodity windfall.
- The deterioration of the SSA's economic fundamentals in 2022 is inevitable, and the region's markets are already pricing in the associated sovereign risks.
- But bear markets quite often price assets rather irrationally - pushing prices beyond where fundamentals warrant; and widespread market pessimism serves up bargain purchases at dirt cheap prices.

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As the world economy begins to recover from the impact of COVID-19, in sub-Saharan Africa (SSA), new threats have emerged. Besides debt risks that were already heightened pre-pandemic, a war, energy shock and the United States (US) Federal Reserve's (Fed) pivot on monetary policy have hit SSA economies in 1H2022. Sovereign fiscal profiles have worsened and with investors refocusing on economic fundamentals, SSA debt sustainability has become a major concern.

Huge fiscal deficits amid restricted access to foreign capital markets have increased concerns about refinancing risks and the potential for significant deterioration in the value of SSA currencies. Consequently, even though the region may not appear to be heading for another default event, markets have begun to price in the elevated risks.

Therefore, we interrogate the macroeconomic fundamentals of selected sub-Saharan African countries to determine if the outlook is as gloomy as envisaged and if investors are overcompensating for the perceived risks.

- **Inflation, a much bigger deal than COVID-19.** The European war doubled-down on pre-existing risks – supply chain disruption, commodities price shock fanning domestic inflationary pressures, and the emboldening of central bank hawks. These are poised to have a much bigger impact on SSA economies than the COVID-19 endemic. Yes, there is still COVID-19 and the rate of full vaccination in Africa (17.6%) remains below the global average (61.2%). However, we are of the opinion that the impact of the virus on SSA economies will be less significant than it was in 2020 and 2021.

  Our opinion is driven by two assumptions: 1) Scientists have gained a better understanding of the virus and how to mitigate its impact 2) the world is gradually beginning to contend with the fact that, the virus itself will settle into a seasonal type of flu that will be around for a long time. In effect, we are unlikely to see the mass lockdowns which triggered contractions in several SSA economies.

- **Commodities rally, two sides of the coin.** Regional governments are left with a decision to tip the balancing scale between financial risks and inflation. There is no gainsaying that the SSA has benefitted from the commodities rally, given its status as a commodities export region. The not-so-pleasant other side of the coin is the prevalence of unsustainable consumption subsidies that is constituting a cancer to government purses as they are predominantly financed by borrowing, and the inflationary impact of higher-priced commodities.

  Although, subsidy funding could put a lid on the build-up of inflationary pressure, large subsidy bills could erode the gains from the commodities windfall - especially in countries like Nigeria where reform plans have been shelved to preserve political appeal ahead of the polls. The pro-subsidy stance of many SSA governments, coupled with a potential depreciation in SSA currencies on account of QE[1] tapering, suggests further pain ahead with regards to debt sustainability over the next 12 months.

- **Local currencies will weaken, but Eurobonds offer a decent hedge**. Overall, we have a negative bias on SSA currencies but currently see significant upside in Ghanaian Eurobonds, where the market appears to have overcompensated for fiscal weakness and refinancing risk due to QE[1] tapering. Unlike Nigeria with its policy quagmire, a swing in global sentiment in favour of risk - if fears of a global recession are entrenched - could reverse the sour appetite for Ghanaian papers and by extension, Cedi weakness.

  Our negative outlook for SSA currencies, however, stem from our concerns about the region's long-term growth due to some structural shifts such as a growing debt pile, vulnerable fiscal policies, weak productivity, and growing political risk. The local currencies of countries like Ghana - on account of its fiscal weakness -, and Nigeria - whose business environment is characterised by anti-market policies - are likely to be worse hit.

- **Debt forgiveness is a stretch, but default is unlikely.** Ghana, Nigeria and South Africa are not likely to encounter a default event in the near term despite the potential for further deterioration in their debt sustainability ratios, and the non-existent chance of immediate debt relief. While the massive dislocations caused by the COVID-19 pandemic provided justification for some kind of debt jubilee for SSA countries, Africa's experience with debt resolution has historically been disorderly and protracted. For example, the Heavily Indebted Poor Countries (HIPC) initiative took more than a decade to be implemented. There are also ongoing, long-lasting litigations with external creditors over the debt of Angola, Republic of Congo, and Mozambique. Consequently, we do not see any form of debt relief in the immediate term.

- **Playing the market.** Out of the abundance of caution, we recommend a marketweight allocation to Nigeria - despite the bullish outlook for crude oil prices in the near term. Our recommendation is hinged on heightened fiscal uncertainty that continues to dull the appeal of the Western heavyweight. However, South Africa is riding on the wave of improved fiscal ratios – on account of its GDP rebasing exercise and outperforming revenues-, and we therefore recommend an overweight allocation as long as the prevailing balance of risks persist. For Ghana, our overweight allocation is based on the fact that bonds are now dirt cheap, and the country is unlikely to default on its obligations because it is now willing to take support from the International Monetary Fund (IMF) when push comes to shove.

Nigeria

Batten down the hatches

Nigeria has seen better days, no thanks to heightened policy uncertainties and weak hydrocarbon revenues. For a country whose initial economic conditions were already strained pre-pandemic, its vulnerabilities have been further magnified by the pandemic's economic consequences.

We recommend that you remain MARKETWEIGHT Nigeria over the next 12 months due to the current multidimensional crisis -shrinking fiscal space and the general loss in investor confidence owing to policy inconsistency -, and the anticipated liquidity play in the fixed income market.

- **Crude oil prices remain optimistic but production shortfalls to weaken fiscals further.** In our opinion, the persistence of Nigeria's crude oil production shortfall is likely to worsen the budget deficit to around 4.7% of GDP in 2022, amid economic stagnation and last-minute infrastructure spend to garner public approval ahead of the polls. The pandemic triggered an unprecedented price shock in the oil industry that has resulted in further deterioration in Nigeria's fiscal imbalances and continues to put pressure on its external health.

  While the OPEC+ production quota arrangement to re-balance the global oil market has helped prop up oil prices to over USD 100 per barrel, oil production shortfalls due to sabotage within the country's oil industry and other factors, such as low investments and the COVID-19 pandemic continues to hurt the Nigerian government's financial coffers. Consequently, Nigeria's oil revenue declined from USD 12.2bn in 2019 to USD 9.8bn in 2021 despite the 10% increase in crude oil prices within the same period. In effect, the country has recorded a widening of its budget deficit to 4.2% of GDP in 2021 from 3.3% of GDP in 2019.

  This trend of crude oil production shortfalls has persisted in 2022 as the World Bank, in its bi-annual Commodity Markets Outlook, confirmed that Nigeria had the largest shortfall among oil-producing countries in 1Q-2022 with a shortfall of 500,000 barrels per day. This reinforces our expectation of a wider budget deficit for 2022.

- **FX draught likely to get worse in 2022.** A cocktail of lower oil earnings due to production shortfalls, capital flight due to political noise in the runup to the general elections, and inadequate structural reforms will cause the naira to lose some more steam in 2022. In addition to the limited potential to earn foreign exchange (FX) by trading its hydrocarbons, the country's incoherent policy environment has resulted in a dollar draught in a segmented FX market that has come under a lot of scrutiny by foreign multilateral and private creditors.

  The FX management regime is characterised by multiple exchange rates, access restrictions, and capital controls. This, together with significant uncertainty regarding FX liquidity in the wider business environment is constraining other sources of FX inflow, including foreign direct investments (FDIs) and foreign portfolio investments (FPIs). In our opinion, we struggle to see the situation improving in 2022.

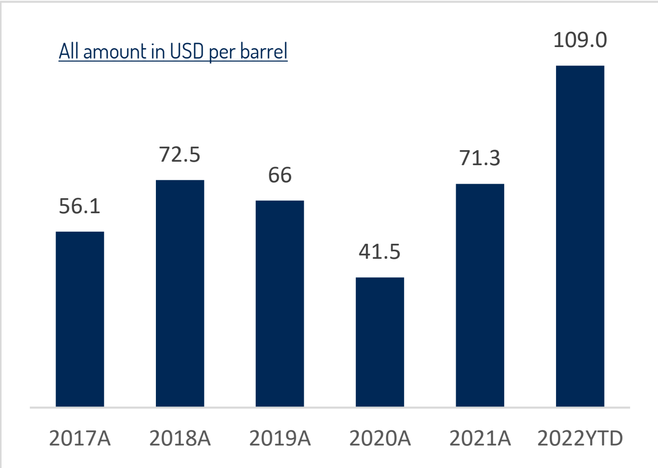
- **Nigeria has been technically shut out of the Eurobonds market.** With Eurobonds costing a pretty penny during this bout of global risk aversion, Nigeria's access to the international debt market has been cut short. The overhang from an increasing debt stock that continues to put upwards pressure on the country's debt-service-to-revenue ratio - with oil revenue hanging in the balance - is keeping the country's borrowing costs elevated. Therefore, the earlier proposed USD 950mn Eurobond supply has been shelved due to unfavourable pricing conditions in the international market. Both the mid and long tenor papers are currently yielding 13% in the secondary market, including the 7-year paper that was issued at 8.4% in March.

  Amid concerns of a potential debt overhang, Nigeria remains poised to borrow its way out of the existing multidimensional crisis and shrinking fiscal space. Out of its planned USD 6.1bn Eurobond sale from last year, around USD 5.3bn has been raised so far amid healthy investor appetite - with the last tranche (USD 1.25bn) raised in March. But borrowing costs have already worsened. The last sale was about two percentage points more expensive than a similar debt issued six months earlier, and any new issues will attract an even steeper cost. Therefore, near term taps of the international capital market are unlikely if prevailing market conditions deteriorate.

- **Tapering to see about 100-150bp adjustment in yields, but better risk-adjusted returns exist elsewhere.** From current levels, local yields could rise by another 100-150bp on account of QE tapering, global investors de-risking, robust bonds supply from the government and lower liquidity profile to support borrowing levels. However, long-dated papers yielding around 14% excites the markets, triggering a short-lived rally till yields are back to 12% levels. While the prospect of upward yield adjustments may offer a good entry point for Nigerian treasuries, we see better discounts in Ghana - especially if prevailing global financial conditions backtrack.

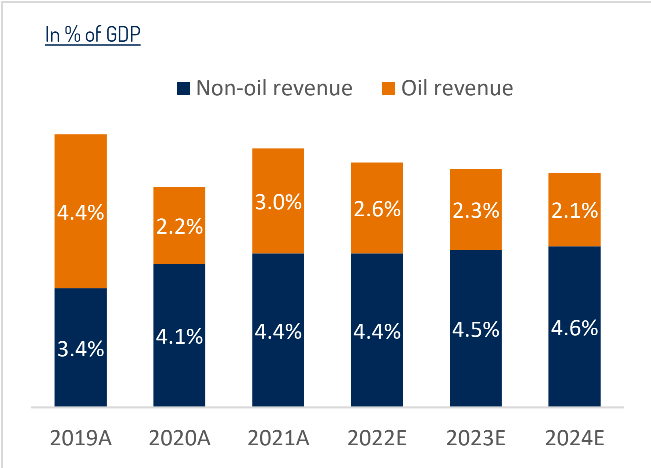
Gallery

Evolution of bonny light crude oil price



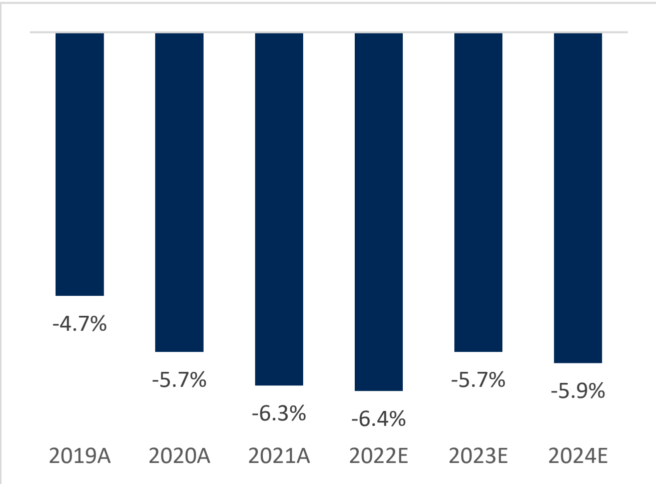
Source: Bloomberg

Revenue split



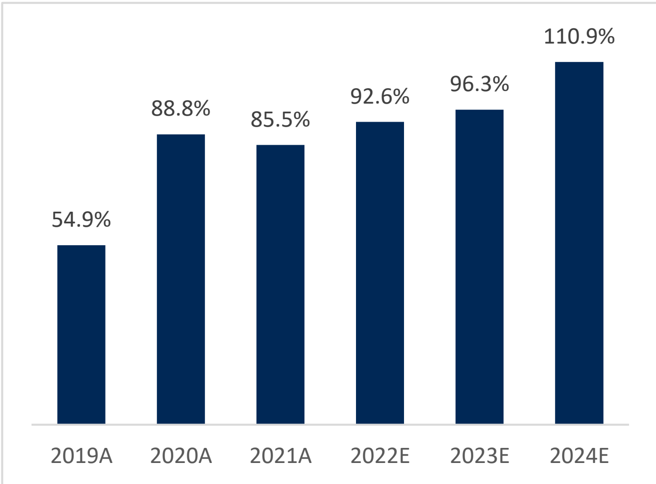
Source: IMF

Evolution of budget deficit/surplus



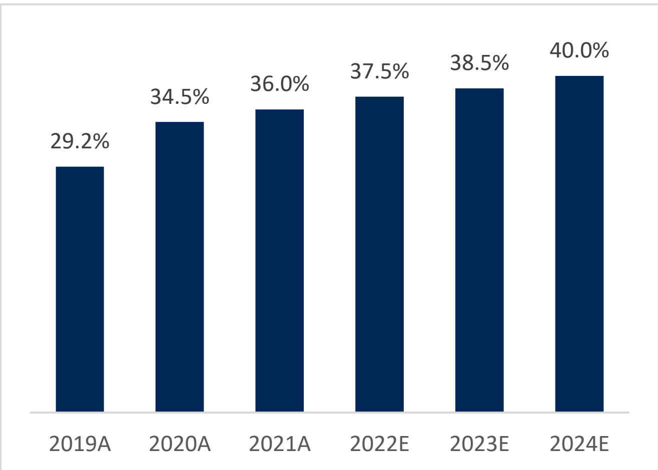
Source: IMF

Evolution of debt to revenue



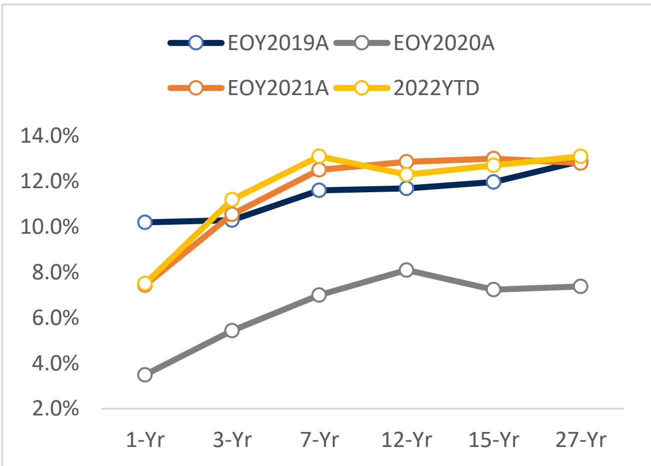
Source: IMF

Evolution of debt to GDP



Source: IMF

Nigerian Eurobond yield curve



Source: Bloomberg

Ghana

A day late, a dollar short

In 2017, Ghana had just emerged from an IMF programme and was the posterchild of SSA. The country's GDP was growing at an average of 6.9% y/y, the budget deficit had been halved from -10.2% of GDP in 2014 to -5.9% of GDP and the gross international reserves stood at USD 7.0bn (+19.6% y/y). Barely four years since this feat, the west-African nation is grappling with unsustainable debt levels and huge deficits owing to the triple whammy effect of a financial sector crisis, pandemic-induced revenue shortfalls, and high expenditure.

Following the controversial credit rating downgrade by Moody's at the start of the year, Ghana - who once sought to crawl from under its debt burden without support from the IMF - may not be turning its back on the multilateral lender completely. However, the government is still committed to implementing fiscal reforms that should improve the fiscal outlook in the near term. Although 1Q2022 fiscal outturn fell shy of its targets, we are optimistic about the fiscal outcomes from subsequent quarters following the kick-off of the electronic transaction levy implementation, as well as conscious efforts by the government to rein in spending.

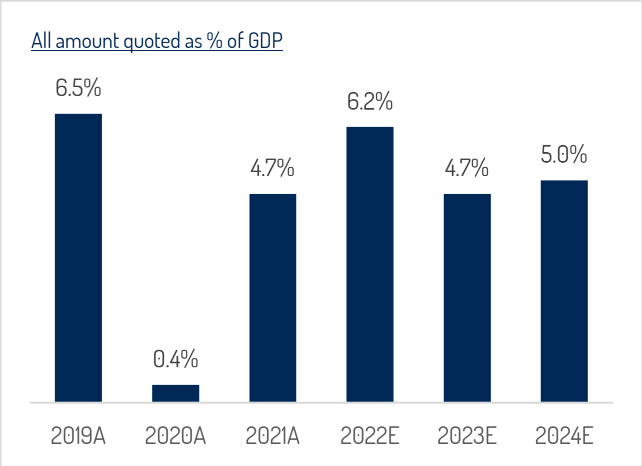
From a risk-reward perspective, we believe the market has overcompensated for Ghana's fragile macro backdrop and the country's need for an IMF bailout. Therefore, we recommend an OVERWEIGHT portfolio allocation for Ghanaian papers against the backdrop of optimistic fiscal fundamentals over the next 12 months and the possibility of help coming from the IMF should the government's efforts at self-retrospection go south.

- **Trading austerity for market confidence.** The GoG's austerity mode is likely to persist as it seeks to slash its budget to regain investors' trust, amid fiscal slippage risks. Under pressure to throw investors a bone, the GoG is pursuing a restrictive fiscal policy that will curb its expenditure growth. Although 1Q2022 fiscal numbers reveal that capital spending is bearing the brunt of this cutback, the overall impact on the GoG's debt burden could play out in its favour in the coming months. However, the GoG may need to hold back its reins of spending more tightly as fiscal slippage risks still exist. Against a target of -2.3% of GDP in 1Q2022, the outturn underperformed at -2.6% of GDP. Therefore, to fully regain market confidence, fiscal discipline will need to be intensified in the coming months.
- **Monetary policy to hold the reins of inflation.** Paying the price for high inflation, monetary policy is poised to continue being used as a tool to combat domestic inflationary pressures. In the course of the year, the MPC has reset the pandemic-support provided to help the economy stay afloat by increasing the MPR to 19%, the cash reserve ratio (CRR) to 12%, the capital conservation buffer (CCB) to 3%, making the minimum required capital adequacy ratio (CAR) 13%. In the face of the pass-through impact of the global monetary tightening cycle and commodity price shock on domestic inflation in Ghana, we see scope for more interest rate hikes from the BoG – albeit at a slower pace and/or smaller magnitude.
- **Local currency will weaken, so Eurobonds offer a good currency hedge.** The next 12 months could see the cedi weaken further, and exposure to Eurobonds and gold could cushion the impact of depreciation on portfolios - amid the global flight to certainty. In the context of accelerated US Fed taper, global policy normalisation, and domestic import pressures, the cedi is poised to take a further hit. Already, all three factors have resulted in a 14.4% YTD depletion of the external reserves to USD 8.3bn as of April 2022, a deterioration of the import cover to 3.7 months from 4.3 months in December 2021, and a 28.6% YTD depreciation of the local currency. As we do not expect domestic import pressure to abate in the near term and the US Fed is still on course to further tighten global financial conditions in the coming months, we believe these will take their toll on the cedi in the near term. The latter will crowd out Eurobond funding for vulnerable economies like Ghana, while the former will uphold local demand for the greenback. The above notwithstanding, we are of the view that current pricing of Ghanaian Eurobonds offer a good entry point for investors seeking to hedge the local currency.
- **Cashing in your chips?** Given the plethora of external shocks impacting SSA economies coupled with each economy's internal dynamics and policy responses, we still consider Ghana as the poster child of SSA. We hold the view that Ghanaian assets are now cut-price because investors have underpriced them due to elevated refinancing risks. Ghanaian papers trading at a steep discount to its SSA peers offers a good entry point for taking position. Alongside a more stable political clime, Ghana's strong growth outlook is also a positive catalyst for the mobilisation of domestic revenues in the near term.

  Although, continued inaccessibility of the international debt market and elevated fiscal slippage risks as taper tantrum 2.0 intensifies can raise investor anxiety for Ghanaian papers, the silver lining could come from two factors 1) short term relief from an IMF deal and 2) a return to easier global monetary policy if the global growth outlook bleakens further. The odds of one or both factors materialising sooner rather than later have increased in recent weeks, hence fanning our decision to maintain an overweight allocation on Ghanaian papers.

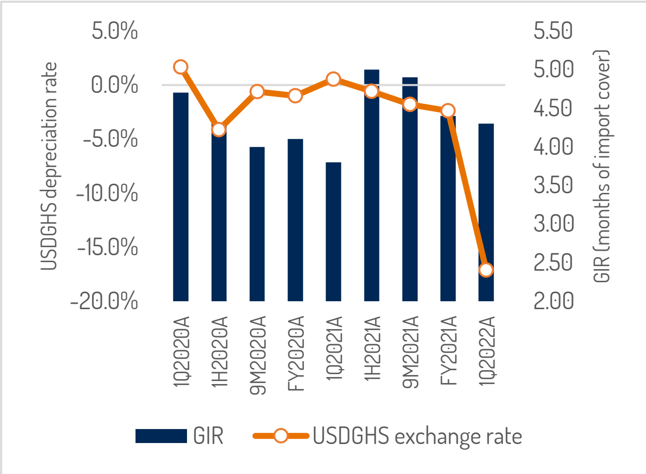
Gallery

Evolution of GDP growth rate



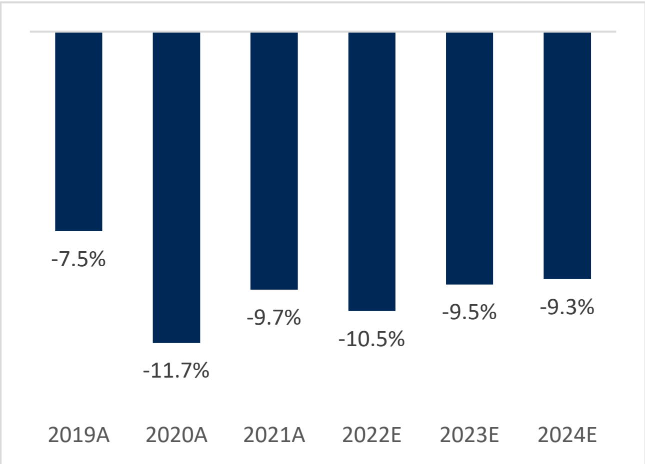
Source: IMF

Evolution of GIR vs Cedi performance



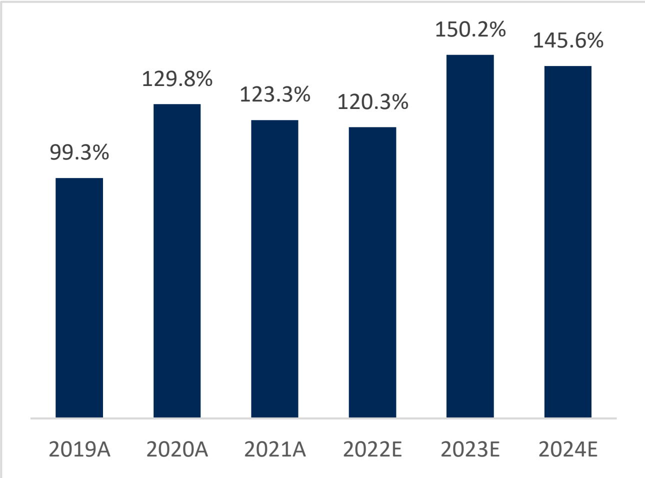
Source: BoG

Evolution of budget deficit/surplus



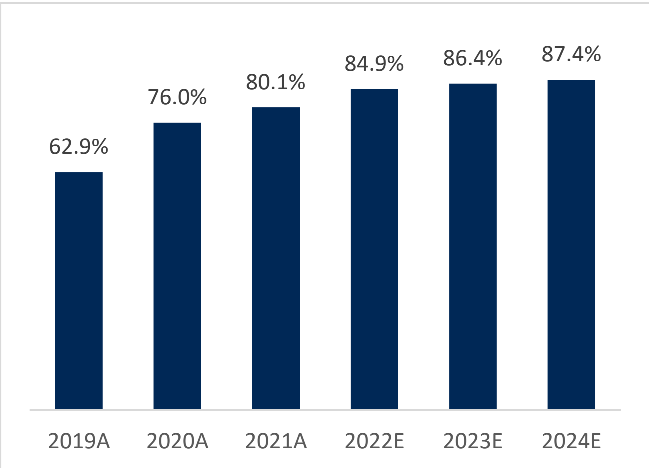
Source: IMF

Evolution of debt service-to-revenue



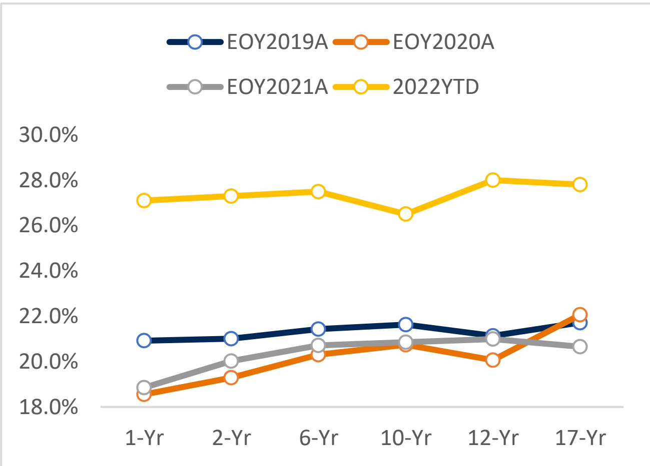
Source: IMF

Evolution of debt to GDP



Source: IMF

Ghana Eurobonds yield curve



Source: Bloomberg

South Africa

Pulling back from the brink

South Africa is a key strategic economic and political player in the Sothern Africa region. However, structural weaknesses, and the resulting low productivity, has weighed on the country's competitiveness for years despite its track record of sound economic management and its investor-friendly business environment. Incessant power blackouts – a result of public sector inefficiencies, and drought of investment and financing in the power sector for a long period - have been the bane of the economy's poor performance.

The country's fiscals had deteriorated steadily over the years due to the activation of state guarantees to state-owned-enterprises (SOEs) and a growing public sector wage bill. However, the surprisingly strong fiscal performance from the past two years and significant improvements to key GDP-based credit metrics - following the re-basing of national accounts – have improved fiscal indicators.

In the context of our expectation for the global and SSA economies, South African assets still have some upside due to sizzling commodity prices and a its relative "haven" status among emerging market peers, amid the ongoing global flux. Therefore, we are betting our bottom dollar on South African papers and recommend an OVERWEIGHT position.

- **Relatively less rand volatility anticipated, compared to SSA peers.** The Rand is poised to benefit from South Africa's commodity exporter status, early cycle rate hikes, and economic outlook upgrades by credit rating agencies. In a stroke of good luck, South Africa is in a unique position, having profited from the rise in commodity prices caused initially by COVID-19 supply disruptions and as a consequence of the Ukrainian conflict. Similarly, we have seen an increase in commodity prices improving South Africa's terms of trade (export prices over import prices) and relatively large surpluses on the current account from 2020 to date.

  These surpluses have contributed to the 6% accretion of gross external reserves from USD 54.9bn in December 2019 to USD 59.3bn in May 2022, and has also underpinned a relatively resilient local currency (ZAR) thus far. In addition to the favourable current account position from South Africa being a metals exporter, the ZAR could ride on the dulled appeal for Russian and Turkish assets going forward – among other positive domestic highlights that could bode well for foreign portfolio flows.

  However, the positive balance on the current account resulting from the mining windfall - despite being supportive of the Rand - is not large enough to shield South Africa from inflationary pressure in the near term. Inflationary pressures are poised to increase from last year's levels – breaching the midpoint of the South Africa Reserve Bank's (SARB) inflation target. Also, US Fed taper bets, elevated oil prices, and domestic encumbrances due to social unrest all pose downside risks to the ZAR in the near term.

- **Volatile interest rate outlook.** Economic and financial conditions are expected to remain more volatile in the near term. Over the next six months, inflationary pressures are likely to remain cost-driven, owing to increasing energy prices, as well as food prices caused by ongoing supply chain disruptions. The estimated average for 2022 is 5.3% y/y, up from 4.5% y/y in 2021.

  Hence, the SARB is likely to take a more hawkish stance – in the face of rising global and local inflation – and gradually increase the repo rate to 5.5% by the end of the year, to stem the pace of capital reversal, rein in local inflation, and deliver positive real returns to investors. Thus far in 2022, the repo rate has been raised by 100bps to 4.75%, and the yields on South Africa's near-term maturing (1-10 years) local bonds have risen by an average of 77bps YTD.

  The rally in global commodity prices, including oil, has meant higher imported fuel and food production costs for South Africa. As a result, the headline consumer inflation rate is expected to increase further towards the upper boundary of the central bank's inflation target range of 3% to 6% in 2022. Thus, the decision, statement, and tone are likely to strike a more hawkish note going forward, at the same time acknowledging a high degree of uncertainty. Electricity and other administered prices continue to present short- and medium-term risks to inflation, and by extension interest rates.

- **Improved fiscal flexibility.** Fiscal consolidation, improved revenue collection, and debt moderation have stopped South Africa's fiscal ship from heading straight into an iceberg, but the drawing of a line in the sand when it comes to the public sector wage bill is in the spotlight. Amid the improved fiscal outlook, near-term risks to South Africa stabilising its debt trajectory include continued support for cash-strapped state-owned companies (SOCs), a high public-sector wage bill, and growing social welfare needs.

  With the re-based national accounts capturing more of South Africa's economic value and revenues surprising to the upside - even though the economy's capacity to generate revenue and the level of economic development has not fundamentally changed – South Africa now enjoys some degree of fiscal flexibility. The GDP re-basing had a lowering effect on key credit metrics - including the ratio of public debt to GDP-, while the mining windfall, as well as steps to reduce spending, have raised the prospect that South Africa's National Treasury can stabilise its debt burden over the medium term. The FY2022/23 budget projections show government debt peaking at 75.1% of GDP FY2024/25 – from an initial projection of 78.1% of GDP, and a year earlier than previously expected. The consolidated budget deficit is also expected to narrow faster than previously anticipated.

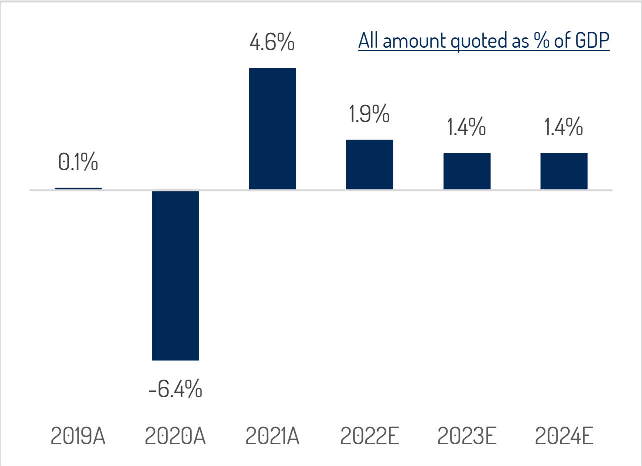
- **Antes up on South African assets.** While investors are panicking about the global interest-rate outlook, South Africa's sovereign risk premium has come down materially since the start of the Ukrainian conflict. The recent upgrades in South Africa's outlook by credit rating agencies also bodes well for Rand-denominated securities. Thus, South African assets are still relatively attractive compared to other emerging market alternatives.

  The new budget forecasts reduce the near-term risk that investor concerns about debt sustainability could lead to a further surge in borrowing costs in the context of global monetary tightening - implying a further slowdown in debt accumulation-, and the favourable position of external accounts could also help South Africa weather less supportive international financing conditions in the context of global QE tapering and interest rate hikes.

  While South Africa's foreign-currency debt is low, the high participation of non-residents in the local debt market - holding a 30% share - is still a source of exposure. However, the positive net balance from the Eurobond flows will provide a buffer for the Rand in the near term. The South African government raised USD 3bn in international markets - in a 2.4x oversubscribed auction, ahead of the redemption of the USD 1bn Eurobond in May. As a result, the Rand firmed up by 1.3% m/m in May despite pressures from interest rate hikes in the US and the Eurobond redemption. So, in the face of further global risk off episodes, we expect the Rand's resilience to persist with the commodities rally. Therefore, South African pension and mutual funds are going to make a tough call in deciding the degree of currency diversification that is suitable for their portfolios, even though the offshore limit in prudential rules has been reviewed upwards to 45%, from 30%.

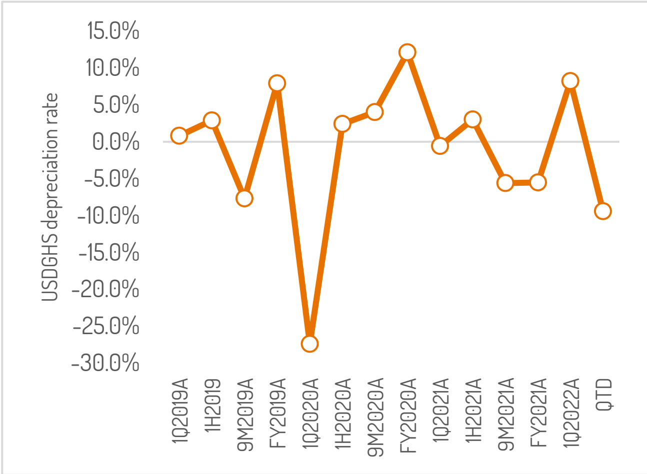
Gallery

Evolution of GDP growth rate



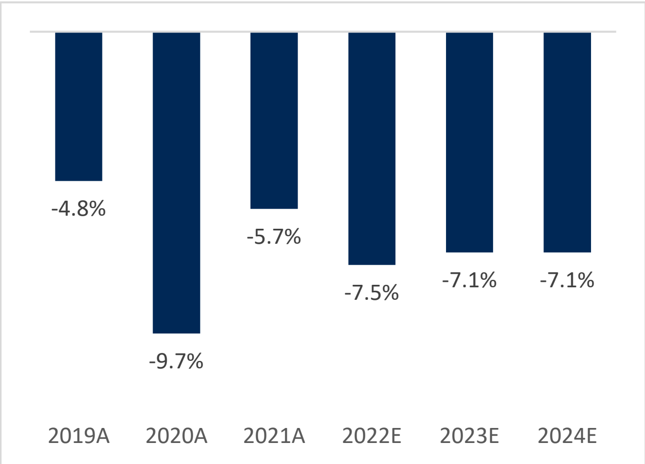
Source: IMF

Evolution of Rand performance



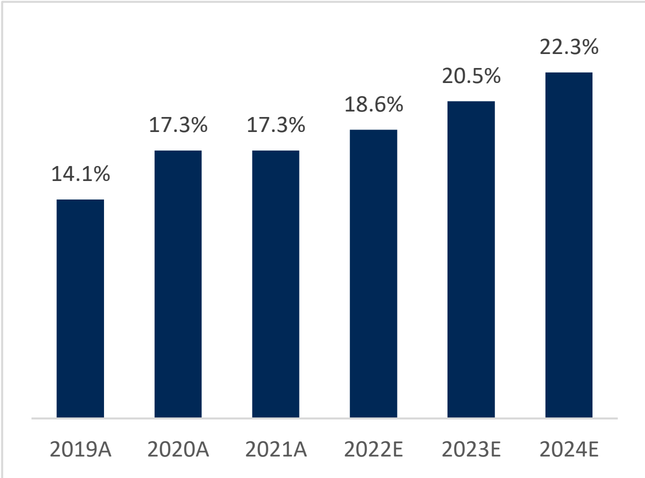
Source: Bloomberg

Evolution of budget deficit/surplus



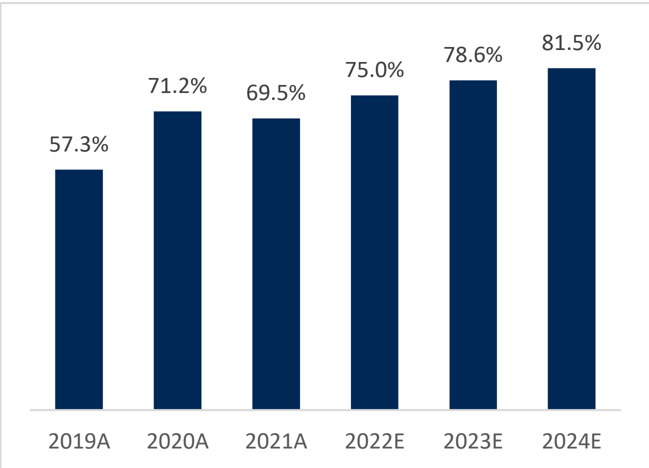
Source: IMF

Evolution of debt to revenue



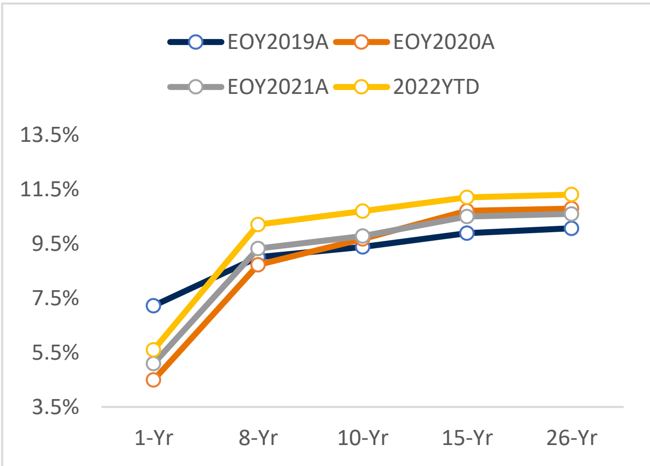
Source: IMF

Evolution of debt to GDP



Source: IMF

South Africa Eurobond yield curve



Source: Bloomberg

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