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Crisis as Opportunity
Naija beckons

★ *Following last week's package of measures to defend the exchange rate Nigerian money-market rates have jumped to 15.88%, 17.39% and 19.35% (for 3, 6 and 12 months, respectively) – very attractive levels in terms of both absolute and real return.*

★ *The level of 159/160 at which the Naira is now consolidating, and that the authorities have demonstrated a determination and ability to defend, is another attraction.*

★ *RECOMMENDATION:* ***Buy 6-month Treasury instrument at 17.39%, aiming to re-invest proceeds at 16.50%, for a 12-month total return of 15.26% in USD.***

Background

Over the last six weeks the Nigerian Naira has come *under sustained pressure, losing as much as 6.1% at its low point, and exhibiting an annualized daily volatility of 17.34%*[1].

The *currency is managed*, via a twice-weekly schedule of foreign-exchange (WDAS) auctions that the Central Bank (CBN) conducts *with a target rate of 150 ±3% to the USD*. The success of this regime has relied from the outset upon CBN's willingness to satisfy forex demand.

The most obvious threat to this currency regime has been excess Naira liquidity resulting from the expansionary monetary and fiscal policies that the Nigerian authorities chose to maintain - in spite of the economy's rapid recovery from the successive economic shocks of 2008-09[2].

Anatomy of the Crisis

■ *FGN bond market as harbinger*

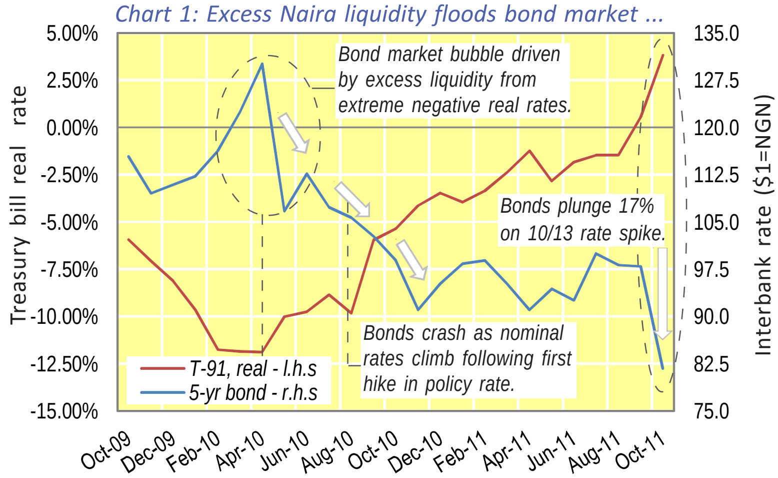
Initially, this excess liquidity flowed into the domestic bond market where it fueled a price bubble that peaked in April 2010, as illustrated in Chart 1[3]. That month, with inflation running at 15.02%, the Federal Government was able to sell *20-year bonds at a nominal yield of 7.24%*.

The bond-market bubble burst when the monetary authorities finally increased the policy rate that September[4] and nominal yields began rising across the curve. *By November, 5-year bond prices were down 30% from their peak*.

■ *Liquidity floods into forex market*

Under the circumstances the torrent of Naira liquidity still flooding the financial system was bound to seek a fresh outlet. In fact, as Chart 2 shows[5], demand for USD began to surge almost as soon as the bond-market rout bottomed out that November. By May 2011 the value of the Naira had fallen by 3.5% on the interbank market, while the official rate (determined at the WDAS auctions) was less than N1 above its -3% floor.

Chart 1: Excess Naira liquidity floods bond market ...



[1] The corresponding figures for the period Jan-Jun 2011 were -3.47% and 5.63%.
[2] Despite the halving of oil revenues in 2008 real GDP growth for the year was 7%. In 2009 the economy shrugged off the near-collapse of the banking system to post a growth rate of 8.5%.
[3] Chart 1 plots the month-end price of a constant-maturity 5-year FGN bond vs. the inflation-adjusted T-bill rate, for the period Oct. '09 to date. Sources: Central Bank of Nigeria; Debt Management Office.
[4] Although the move was only 25 b.p., from the previous level of 6%, it was the first increase in the policy rate for almost 2 years.

■ *Declining forex offer stokes demand*

Significantly, this depreciation had occurred despite the CBN's determined efforts to satisfy demand, at considerable cost to the country's external reserves. *As at May 31st, these stood at US$ 32.08 billion – equivalent to 6.6 months of imports*. However this was slightly below the figure for December 31st, despite buoyant oil prices and production levels that, *ceteris paribus*, ought to have produced a significant accretion to the reserves.

The authorities' concern with the non-accretion of reserves[6] became apparent over the summer, when supply was repeatedly allowed to fall short of demand at the forex auctions. Predictably, *such restraint on the part of the CBN was seen as rationing and simply stoked demand even further, sparking a run on the Naira*, as shown in Chart 3[7].

The run on the currency turned into a stampede at the end of September when two successive auctions were not only heavily oversubscribed but produced *clearing rates below the official floor of 154.50*[8].

CBN switches to offense

■ *Aggressive policy measures …*

Any *questions about the CBN's commitment to its Naira policy have been dispelled by its decisive action over the last two weeks*. At an emergency session convened on October 10 the Monetary Policy Committee (MPC) affirmed its determination to defend the official exchange-rate and announced a series of measures designed to mop up excess liquidity, viz.:

- 275 b.p. hike in policy rate to 12% p.a.;
- cash reserve ratio raised to 8% of total assets;
- limit on net open FX positions (NOP) slashed from 5% of equity to 1%.

Chart 2: … then switches to FX market

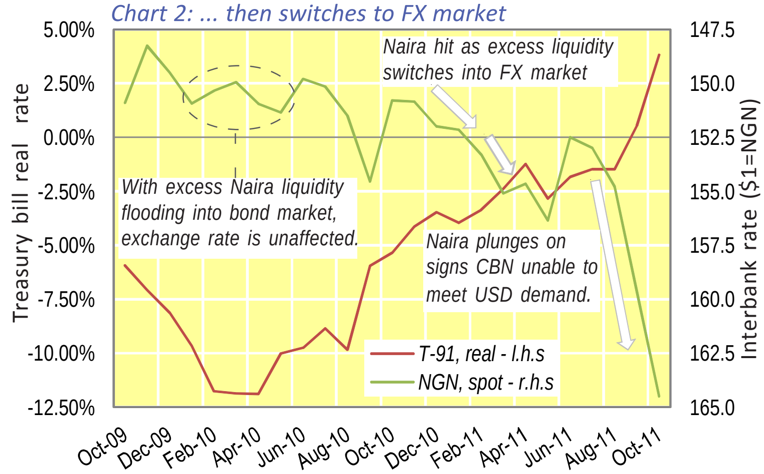


Chart 3: Supply & demand dynamics of forex market

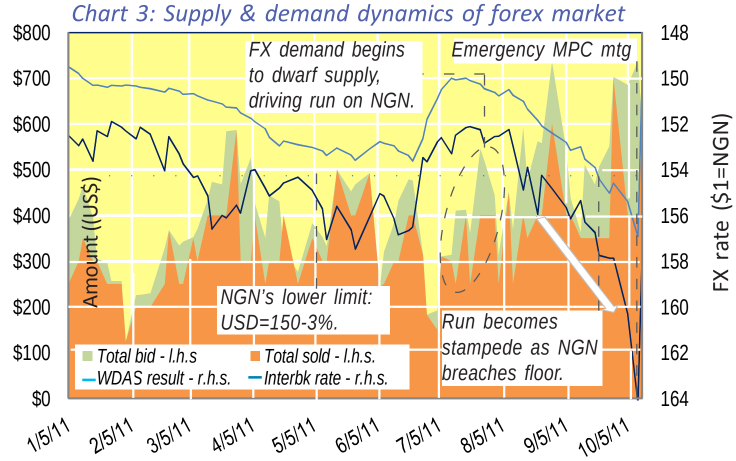
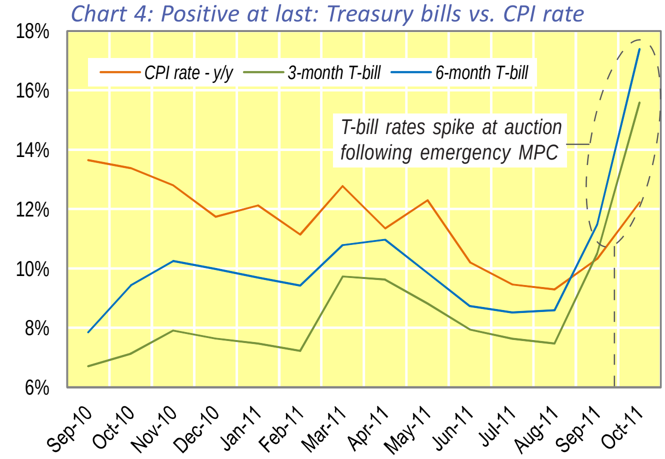


Chart 4: Positive at last: Treasury bills vs. CPI rate



■ *… Produce immediate results*

At last week's Treasury's bill auction, yields *jumped an average of 589 b.p. to 15.58%, 17.39% and 19.35%* (for 3, 6 and 12 months, respectively), in response to the aggressive tigthtening measures announced three days earlier.

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[5] Chart 2 plots Naira's month-end close on the interbank market vs. the inflation-adjusted T-bill rate, for the period Oct. '09 to date. Sources: Bloomberg; Central Bank of Nigeria.

[6] In late June, CBN announced two measures clearly aimed at offsetting the steady depletion of its reserves. (i) in a bid to attract portfolio inflows, offshore investors were declared eligible to purchase Treasury bills; (ii) a weekly limit of USD 250,000 was imposed upon the quantity of forex that Bureaux de change were authorized to purchase from depository banks. (This measure was reversed the following month.)

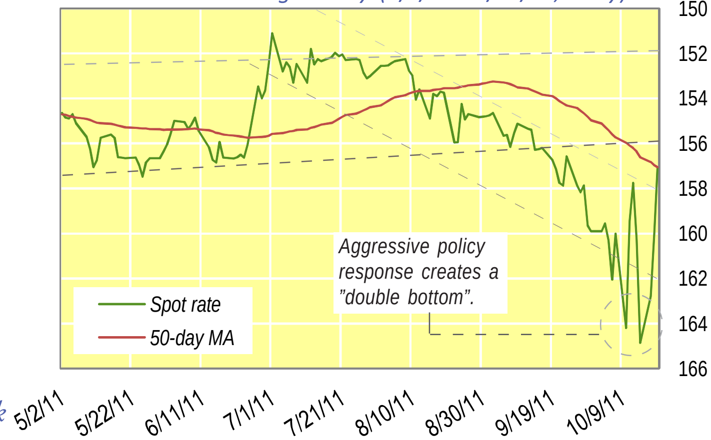
[7] Chart 3 graphs the results of WDAS auctions held year to date. Source: CBN.

[8] i.e. USD=150 -3%.

Meanwhile, the art of open-market operations (OMO) has been elevated to a whole new level. On more than one occasion during the last week, *CBN has unilaterally debited cash from banks' CBN accounts and credited them with OMO bills*[9].

In concert, the foregoing measures have achieved the desired result of draining the pool of Naira liquidity available to bid for USD. *At both this week's forex auctions demand averaged a mere USD 281 million*[10], producing a clearing rate of USD1=149.5 on each occasion.

Chart 5: Naira trading history (5/2/11-10/19/11, daily)



The *Naira has rallied just as strongly in the interbank market* - from a low of 164.85 on October 14 to the October 21 close of 159. More broadly, the currency has staged a clear break-out from the strong downward channel it entered in early August, as Chart 5 shows[11].

It is worth pointing out that the depletion of Naira liquidity is only part of the story behind the Naira's dramatic recovery. *Intervention by the CBN* – both through moral suasion and direct intervention - *has been a significant contributing factor*[12].

New policy creates a compelling opportunity

For the fixed-income investor this new environment presents an almost ideal opportunity, with *short-term real yields at approximately 630 b.p.*[13] *and the Naira consolidating at post-correction levels* that the monetary authorities have demonstrated a willingness and ability to defend[14].

- *Recommendation*

Investors should take advantage of the CBN's recent dispensation permitting offshore investment in Treasury bills[15], and position *the 6-month maturity which offers a compelling combination of short-term exposure, absolute yield and real return.*

- *Execution*

❶ Sell USD for NGN at prevailing spot rate of 159;

❷ Buy 6-month Treasury bills at current rate of 17.39% pa.;

❸ At maturity, re-invest NGN proceeds in second 6-month bill at an assumed rate of 16.50% p.a.[16].

❹ At maturity, convert NGN proceeds to USD at assumed rate of 162.24[17] for a total return of 15.26%, as shown alongside.

Assumptions	
Investment	US$10,000,0000
Spot FX rate	N159.00
T-182 rate, spot	17.39%
T-182 rate, fwd	16.50%
'Fwd' FX rate	N162.24

Date	Step	Proceeds
T+0	Sell USD	$9,954,445
T+0	Invest proceeds	N1,582,756,755
T+182	Redemption proceeds	N1,720,000,000
T+182	Invest proceeds	N1,720,000,000
T+364	Redemption proceeds	N1,861,511,679
T+364	Convert to USD	$11,473,468
T+364	Total return	15.26%

[9] This has been in addition to the more conventional sale of OMO bills by auction.
[10] Whereas the weekly average from the beginning of September through October 10 had been running at USD 541 million.
[11] Chart 5 plots the Naira's daily closing price and 50-day moving average, with major trading channels, for the period indicated. Source: Bloomberg.
[12] For example, after closing at 162.7 on 10/18, the market rallied to 160 at its opening the next day on rumors that CBN was poised to intervene. The intervention materialized the next day when CBN announced an unscheduled WDAS auction for USD 200 million.
[13] As shown in Chart 4, the nominal yields on Treasury bills have lagged inflation by as much as 550 b.p. in the last year.
[14] Indeed, there are indications that interest rates are poised to move even higher in the near term. This week, CBN placed N58 billion in O.M.O. bills for 55 days at a yield of 17%.
[15] By copy of CBN circular # TED/FEM/ FPC/GEN/OI/009 of 6/21/2011.
[16] This seems quite realistic, given the CBN's evident determination to keep monetary conditions tight.
[17] 'Forward' rate assumes an additional 2% depreciation in the interbank Naira exchange-rate from current levels.

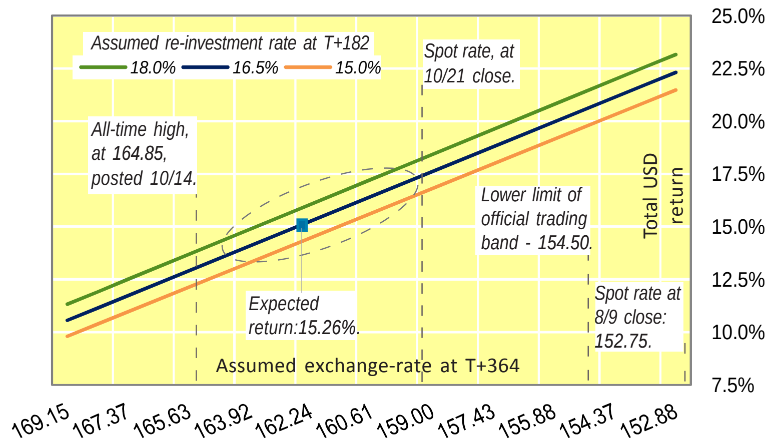
Risk Analysis

■ *Methodology*

The chart alongside graphs the sensitivity of the trade's performance to the two key variables on which it is dependent:

- the *interest rate* at which proceeds from the initial position can be re-invested for a further 182-days; three scenarios are considered - a base case of 16.5% and a bull and bear case of 18.5% and 15%, respectively.
- the *exchange rate* at which the aggregate Naira proceeds can be converted to USD upon the final maturity (i.e. at T+364), for repatriation; the range of outcomes modeled extends from a 6% devaluation to a 4% appreciation[18] in the Naira.

Chart 6: Trade's sensitivity to interest-rate & FX assumptions



■ *Highlights*

❶ *If the Naira were to stabilize* ***at the current exchange-rate of 159, the expected return under our central interest-rate assumption would be 17.61%***.

❷ ***The trade manages to deliver a total return of almost 10% under our most bearish assumptions*** – *i.e. a 182-day T-bill rate (six months forward) of 15%*[19] *and a 'terminal' exchange rate of 169.15.*

❸ *Under the 16.5%*[20] *interest-rate assumption,* ***the break-even exchange-rate is 187****, a devaluation of 14.975% from the Naira's current level.*

[18] This range is deliberately conservative: the -6% level corresponds to an exchange rate of 169.15 (i.e. 2.54% weaker than the currency's all-time low), whereas a 4% appreciation from current levels would put the currency at 152.88, which is marginally weaker than its 8/9/11 close.

[19] A devaluation of this magnitude would almost certainly be accompanied by a major spike in interest rates – arguably on the same scale as the 500 b.p. experienced last week.

[20] A devaluation of this magnitude would almost certainly be accompanied by an even more dramatic spike in interest rates than experienced last week.