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The Angola *kwanza* trade - getting in on the peace dividend

- *Africa's 2nd largest oil producer is currently enjoying an export-driven boom, achieving an estimated growth rate of 19.5% in 2006.*
- *The monetary authorities are now consolidating a post-war stabilization effort that has slashed inflation to 12.39%, from triple-digit levels 5 years ago.*
- *The combination of high nominal rates, external and fiscal surpluses and sizeable foreign reserves creates an emphatically bullish outlook for the Angola* Kwanza *- and an opportunity for money-market returns of 20%+.*

Overview

Located in Southern Africa, where it is bordered by the Atlantic Ocean (west) and the republics of Democratic Congo (north), Zambia (east) and Namibia (south), the Republic of Angola is the third largest country in Africa. Its territory covers 481,354 sq. mi - approximately equal to the combined areas of Texas, California and New York; or, alternatively of France, Germany and Italy.

- Angola has a total population of only 14 million[1], of whom an estimated 4 million live in the capital, Luanda.
- Like its northern neighbor Angola enjoys abundant reserves of petroleum, diamonds, iron ore, phosphates, copper, gold, bauxite and uranium.
- Oil is by far the most important of these commodities[2], accounting for more than 80% of both export earnings and government revenues and almost 50% of GDP. The 2006 estimate for nominal GDP is US$44.1 billion.

Political background

Angola achieved independence from Portugal in 1975 after a 15-year liberation war waged by combatants from three rival liberation movements[3].

- During the ensuing civil war that lasted for the next 27 years, an estimated 1.5 million lives were lost; 4 million people displaced and the bulk of the country's infrastructure destroyed.

The civil war finally ended in April 2002[4].

- Parliamentary elections are scheduled for September'08 when all 220 seats in the unicameral National Assembly[5] will be on the ballot. This will be Angola's first democratic contest since 1992.
- Presidential elections are to be held in 2009.
- Given the advantages of incumbency, the favorable backdrop of a booming economy, and the fragmented opposition, the most likely outcome is for the ruling MPLA to retain its absolute parliamentary majority and for Jose dos Santos to be re-elected to the presidency.

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[1] Approximately one tenth of the population of Nigeria, a country only three quarters of Angola's size. Due to the skewed pattern of income distribution the per capita/GDP statistic for Angola (US$3,065) is somewhat misleading.

[2] Angola is the 2nd largest oil producer in Africa, with a current daily output of 1.6 million bbd, projected to hit 2 million bbd in 2008.

[3] Movimento Popular para a Liberação de Angola (MPLA), União para a Independência Total de Angola (UNITA) and Frente Nacional para a Liberação de Angola (FNLA).

[4] Shortly after the death in combat of UNITA 's leader, Jonas Savimbi.

[5] Allocation of seats: MPLA 129, UNITA 70, Partido de Renovação Social (PRS) 6, FNLA 5, Partido Liberal Democrático (PLD) 3, Other 7.

RECENT ECONOMIC DEVELOPMENTS

The post-war reconstruction phase began just as the oil price rally kicked into high gear[6]. The combination of rising production and sharply higher prices has fuelled a surge in national output, as illustrated in the accompanying chart.

⇨ In 2006 real GDP grew by 19.5%, capping a 5-year expansion averaging 13.6% annually[7] - one of Africa's fastest growth rates.

⇨ The acute fiscal situation soon stabilized, as the surge in oil tax receipts pushed the overall budget balance[8] from a deficit of 11.4% in 2001 to a surplus of 3.2% in 2006[9].

⇨ Over the same period, rising export revenues drove the current account from a deficit of 14.1% in 2001 to an 8.8% surplus in 2006, while foreign reserves ballooned to $9.3 billion – a 12-fold increase from their level 5 years earlier.

The table along-side provides a snapshot of this turn-around.

FOCUS ON STABILIZATION

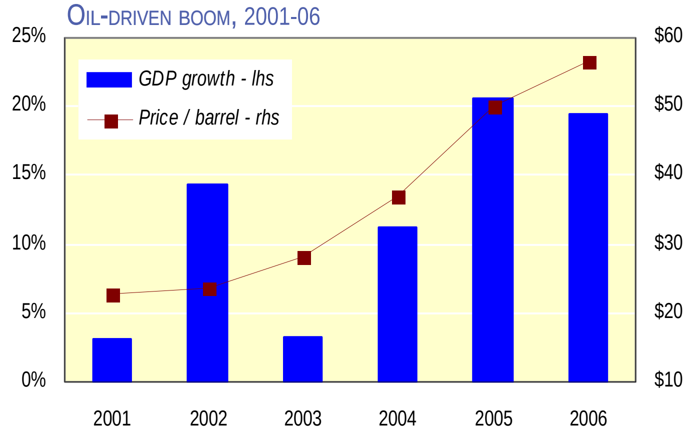
As the chart below illustrates, three distinct stages can be observed in Angola's post-war stabilization effort.

❶ The initial phase followed a relatively orthodox strategy that relied on a combination of open market operations at high real interest rates and modest fiscal reforms. However, with the *kwanza* still depreciating by 45.24% during 2002[10], inflation remained a hostage to cost-push pressures and ended the year at 105.6%[11].

❷ The authorities changed tack in early 2003, when they allowed nominal interest rates to drop by 81 percentage points in the space of 3 months. This stimulative gamble was quickly abandoned, as inflation immediately accelerated to more than 110% (y/y).

❸ In August 03[12], the authorities switched to a *de facto* exchange-rate anchor under which the central bank began to intervene in the foreign exchange market systematically, supplying as much hard currency as was demanded.

OIL-DRIVEN BOOM, 2001-06



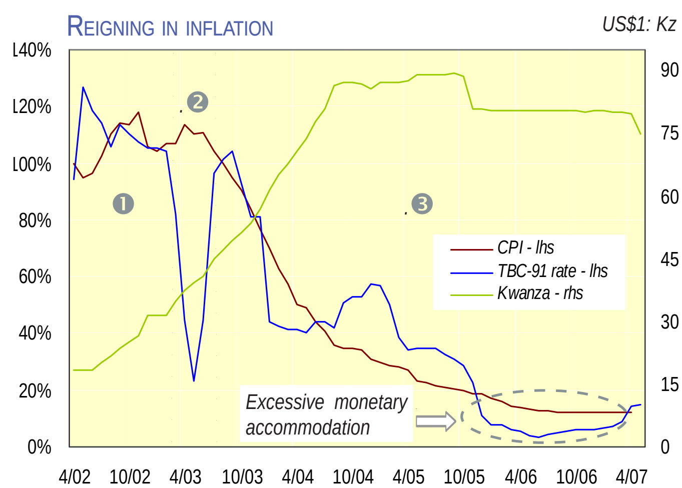
Sources: IMF; Banco Nacional de Angola.

SUMMARY ECONOMIC INDICATORS, 2001-06

Item	2001	2002	2003	2004	2005	2006E
GDP[a] ($bn)	8,936	11,386	13,956	19,800	32,810	44,103
Δ GDP	3.1%	14.4%	3.3%	11.2%	20.6%	19.5%
Debt/GDP	81.3%	82.4%	73.1%	54.5%	32.6%	37.7%
Curr Acc ($bn)	-1,329	-150	-720	1,324	4,100	3,870
C/A balance	-14.9%	-2.7%	-5.2%	3.5%	12.9%	8.8%
Reserves (bn)	732	399	800	2,034	4,147	9,331
Import cover[b]	2.1	0.9	1.9	3.2	4.2	7.5
Fiscal bal.[c]	-11.4%	-8.9%	-6.4%	-1.6%	6.8%	3.2%
Inflation	116.1%	105.6%	76.6%	31.0%	18.5%	12.2%
FX rate (US$)	32.00	57.09	78.48	85.99	80.79	80.19

Sources: IMF, Banco Nacional de Angola; Ministério das Finanças.
[a] i.e. Nominal GDP; [b] In months; [c] On a commitments basis.

REIGNING IN INFLATION



Sources: Banco Nacional de Angola; Bloomberg.

[6] i.e. following the brief pull-back between late 2001 and early 2002.
[7] This was almost three times faster than the 4.7% rate Angola had achieved during the preceding 5-year period (i.e.1997-2001).
[8] On a commitment basis.
[9] The fiscal surplus had actually peaked a year earlier at 6.8%.
[10] Essentially a repeat of the 47.24% devaluation during 2001.
[11] Only marginally lower than the 2001 rate of 116.1%.

■ Too much of a good thing

Although frowned upon by the IMF, the results of the "hard *kwanza*" regime have been spectacular. As illustrated, inflation began to ratchet down as soon as the initiative was launched and by September '05 had breached the psychologically important barrier of 20% y/y.

⇨ With the CPI decelerating, domestic interest rates began to drop even faster as the improving fiscal picture reduced the government's financing requirements. Between July and December '05, the real interest rate plunged from +10.6% to -6.1%. It was to remain at this level or worse until the second half of 2006, as the accompanying chart shows.

⇨ The mounting flows of largely unsterilized oil receipts magnified the impact of these accommodative conditions. As a result, M2 growth exploded, with the y/y rate of expansion peaking at 80.3%[12] in June 2006.

⇨ While 2006 ended with y/y inflation at a superficially benign 12.24%[13], there were alarming signs in the month/month data. During November and December alone, the CPI had jumped by a cumulative 3.5% -after posting increases of below 1% for 10 consecutive months.

■ Taking away the punch-bowl …

The central bank reacted to these warning signals by pushing nominal rates from 6.37% to 9.00%[14] over the first quarter, while more than doubling the scale of its open market operations.

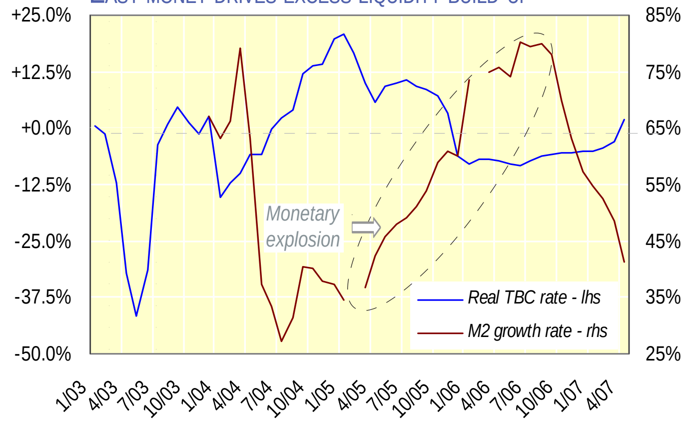
When the March 31st data established that the measures taken had been insufficient to mop up the excess liquidity[15], the authorities moved aggressively on three parallel fronts:

❶ The reserve requirement for banks was increased by a factor of 50%[16].

❷ The average float at the weekly auctions for *Titulos do Banco Central* (TBCs)[17] was increased from Kz 3 billion to Kz 8 billion[18], while the benchmark 91-day interest rate was hiked by more than 500 b.p. – to 14.28% - in the space of two weeks.

❸ The *kwanza* was revalued by 6.65%[19] against the US$ - i.e. from 79.739 to 74.767 – in the space of 10 days.

Easy money drives excess liquidity build-up



Sources: Banco Nacional de Angola

■ … Creates unique opportunity

Given the high nominal interest rates; the fiscal and external surpluses and Angola's sizeable foreign reserves, the stars are in almost perfect alignment from an investor perspective. Specifically, they point to an opportunity to capture a **double-digit yield with the added kicker of currency appreciation.**

★ **Trade recommendation**

❶ Buy the Angola *kwanza* at 79.00 and invest proceeds in 91-day TBCs, currently yielding 15%.

❷ At maturity, reinvest the proceeds into a 1-year instrument yielding approximately the same rate.

❸ Upon redemption - i.e T+455 - convert the proceeds[20] into US$ at 71.00 and repatriate, for a **total return of** 25.72% - equivalent to **20.16% on an annual basis** *(see Table over-leaf)*.

[12] When the nominal rate on the benchmark 91-day bill had fallen to an all-time low of 3.23%, with the 28 and 63-day bills yielding 0.75% and 2.55%, respectively.
[13] i.e. down from 18.53% in 2005, but still overshooting the 2006 target of 10%.
[14] Equivalent to the FOMC hiking the Fed funds rate by 220 b.p. to 7.46%
[15] Although M2 growth had eased moderately - to 48.57% - inflation was hovering near 12.40% and poised to move higher.
[16] Although the mandatory reserve remained at 15% of credit assets, the minimum [non-interest bearing] cash component thereof was raised from 5% to 7.5%.
[17] i.e. Central Bank bills, the primary instrument of monetary policy.
[18] i.e. from US$ 40 mm. to US$107 mm.
[19] The move was implicitly sanctioned by the IMF which had urged the Angolan authorities "not to resist some further nominal appreciation of the *Kwanza*". [Source: IMF PIN No. 06/133, Nov. 15, 2006]
[20] Government securities are exempt from all taxes.

■ … ASSUMPTIONS & RATIONALE

⇨ INTEREST-RATES

The BNA signals its policy intentions by moving the yield on the 91-day TBC to the level targeted and then allows the market to bid up rates for other maturities accordingly.

- As can be seen from the gradual flattening of the yield curve, as illustrated below, the 182- and 364-day rates have been moving steadbly towards the clearly identified target of 15%, where we expect them to settle.

- In private conversation the BNA has made it clear that the measures recently introduced to absorb excess liquidity are "to be given several months"[21] to take effect - providing ample justification for our 91-day forward rate assumption of a 1-year rate at 15%.

⇨ EXCHANGE RATE

In a rapidly growing economy, boasting a solid surplus on both its external and fiscal accounts, a hike in domestic rates will tend to produce a nominal currency appreciation - with a corresponding loss of domestic competitiveness.

- Yet, the authorities in Luanda have stated that they regard the risk of an inflationary spike as far more significant than the abstract threat of "Dutch" disease[21]. This supports our base-line assumption of a further 5.58% nominal appreciation over the next 15 months to US$=Kz71.00.

- As demonstrated in November 2005[22], the authorities are clearly willing to go beyond the passive acceptance of a nominal appreciation in pursuit of price stability. On the basis of this precedent and the statement quoted above, we actually expect to see the *kwanza* trading at 67.27[23] by August 2008 – an appreciation of 11.50% from current levels.

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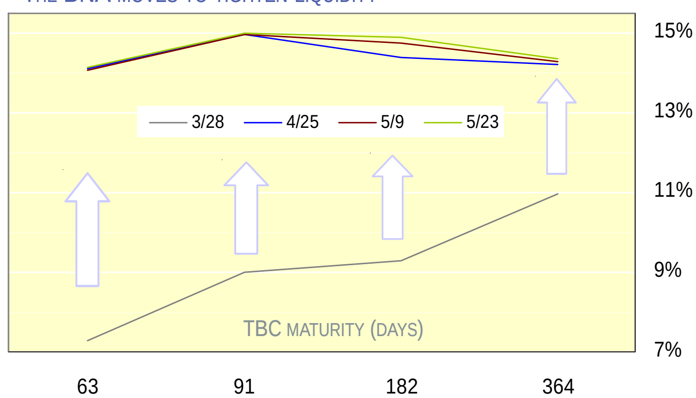
[21] Discussion between Rhombus Advisors and the BNA on 5/07/07.
[22] Over the 17 trading days through November 15, 2005 the *Kwanza* was revalued by10.76%.
[23] As illustrated, expected returns highly sensitive to the forward exchange-rate assumption. The projections shown assume a relatively conservative rate of 71.00.

TRANSACTION SUMMARY

ASSUMPTIONS			
Principal	$10,000,000	1st settlement	5/30/07
FX rate$_{spot}$	74.964	Reinvestment	8/29/07
Kz proceeds	749,640,000	TBC-364 $_{91d, forward}$	15.00%
TBC-91 rate	15.00%	FX rate $_{455d, forward}$	71.00

EXECUTION	
No. of TBC-91 units	775,000
Px / unit	965.7553
Purchase px	748,460,381
Redemption value	775,000,000
No. of TBC-364 units	892,600
Px / unit	869.5652
Purchase px	776,173,913
Redemption value	892,600,000
US$ equiv	$12,571,831
PERFORMANCE	
Holding period return	25.72%
Annual return	20.15%

THE BNA MOVES TO TIGHTEN LIQUIDITY



Source:Banco Nacional de Angola.

EXCHANGE-RATE SENSITIVITY OF RETURNS