



NAIJA UPDATE & TRADE IDEA

Optimistically predicted by Naija bulls, the post-election virtuous cycle – reduced FX pressure, fiscal consolidation, higher investment & accelerating growth – has failed to materialize. Instead, the period in question has witnessed *a significant deterioration in the country's fundamentals*:

- There has been a sharp deterioration in the security situation in the north-east of the country - particularly in Borno state, where the Islamist group known as *Boko Haram* has declared war upon both state and federal arms of government.
- FX demand has continued to outpace even the characteristically heavy levels seen in the run-up to April's elections and now routinely exceeds USD500 mm at the CBN's twice weekly WDAS auctions¹.
- The fiscal overshoot has gathered pace – provoking increasingly strident warnings from the frustrated monetary authorities. For the month of June, for example, the Federation Account Allocation Committee (FAAC) distributed a record N1.3 trillion among the three tiers of government.
- Although the CPI rate announced for June came in at 10.20%, no explanation was offered - and seasonal patterns offer no justification - for the sharp drop from May's 12.40% print². Certainly, the MPC appears to have drawn no comfort from the figures – pointing instead to the likely impact of the recent wage settlement between the Federal government and the National Labour Congress, as well as the prospect of AMCON³ injecting more than N1 trillion in additional liquidity into the system in the coming months.
- Local financial markets look vulnerable. Even with real interest rates still in negative territory, stock market remains in doldrums the under the weight of a bank recapitalization program that remains incomplete after multiple extensions.

With the policy rate still lagging the CPI by 145 b.p. after two consecutive rate increases and additional price pressures threatening, the Monetary Policy Committee remains in an aggressively tightening mode. *This portends a potentially significant yield back-up across the curve.*

¹ In early July the authorities hastily implemented two policy measures prompting a series of emergency measures each clearly aimed at alleviating the pressure on reserves: 1) the revocation of the mandatory 1-yr holding period for offshore investors in the domestic bond market; and 2) the introduction of a USD250,000 weekly limit on the quantity of FX that bureaux de change would be eligible to purchase from banks. The latter measure has since been rescinded.

² However observers will doubtless recall that after the Director-General of the National Bureau of Statistics was abruptly replaced in April one of the new incumbent's first steps was to rebase the CPI time series in a manner that produced a dramatic reduction in the rate reported for that month ...

³ i.e. Asset Management Corporation of Nigeria whose mandate is to purchase non-performing loans from distressed banks.

TRADE RECOMMENDATION

The current scenario is tailor-made for a bear steepener trade, with the benchmark 8-year FGN bond now yielding 11.05% versus 10.21% and 10.86% at the 3- and 6-year maturities, respectively.

ASSUMPTIONS:

1. The CPI rate increases by another 100 b.p. to 11.20% over the next 6 months.
2. The monetary policy rate is hiked by 125 b.p. to 10%, over the next 6 months.
3. Interest rates back up across the yield curve, with a pronounced steepening that widens the 3-8 year spread by 100 b.p. - i.e. from 74 b.p. to 175 b.p.

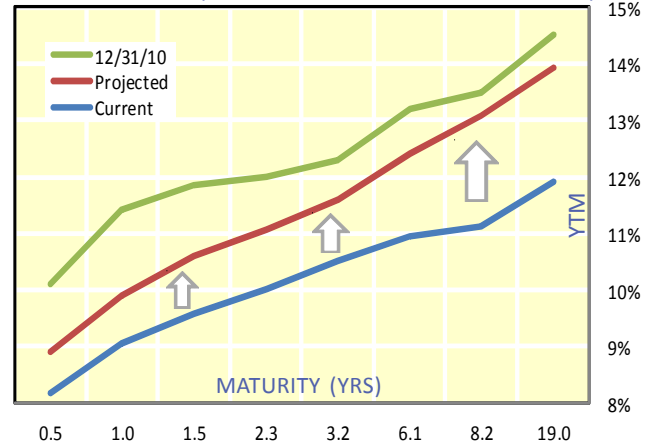
EXECUTION:

1. Sell FGN 7s of 2019 vs. FGN 91/4s of 2014:
 - ⇒ Sell short NGN 1.5 bn x FGN 7% of Oct. 2019 bid yield of 11.07%, for a total consideration of NGN 648,085,132.
 - ⇒ Buy NGN1.5 bn x FGN 91/4% of Sept. 2014 at offer yield of 10.38%, for a total consideration of NGN1,148,517,507.
 - ⇒ Net proceeds: -NGN500,432,375
2. Pay/receive semi-annual coupon payments of -NGN52,500 and NGN69,375, respectively - for net proceeds of NGN16,875.
3. Reverse the trade in 180 days:
 - ⇒ Buy in FGN 7s of 2019 at projected offer yield of 13.17% for a total consideration of NGN589,853,972.
 - ⇒ Sell FGN 91/4s of 2014 at projected bid yield of 11.48% for total proceeds of NGN1,159,093,918.
 - ⇒ Net proceeds: NGN579,289,890.

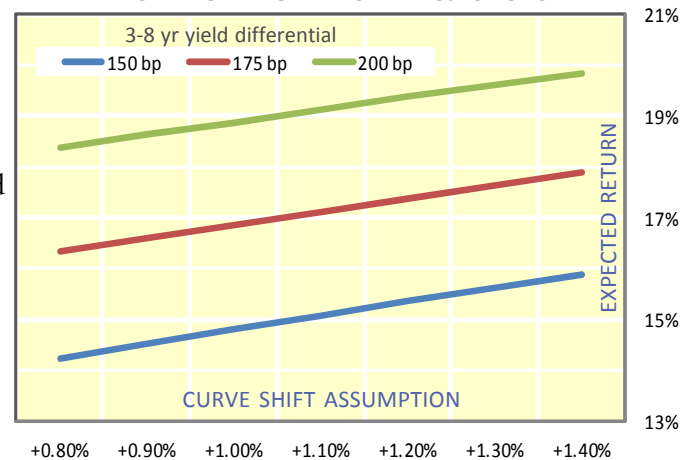
RESULTS:

- ★ Total net proceeds: NGN85,682,972
- ★ Holding-period return: +17.12%.

FGN YIELD CURVE (CURRENT, HISTORICAL & PROJECTED)



HOLDING-PERIOD RETURN PROJECTIONS



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