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Ashmore

The quintessential Nigerian distribution problem

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Nigeria's central bank has taken decisive action in response to lower oil prices, but the Executive and state governors still have a battle ahead over who bears the brunt of the adjustment. As such, Nigeria's challenges mirror the situation faced by other oil exporters the world over following the recent drop in oil prices. We also discuss political developments in Ukraine, the new economic team in Brazil and the first round of the election in Tunisia. Additionally, we provide updates on the latest developments in South Korea, The Philippines, Thailand, Mexico, China, Taiwan, Singapore, Russia, Turkey, India, Mongolia and Eastern Europe. Finally, we discuss the factors behind the move in oil prices.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	990	–	-1.96%
MSCI EM Small Cap	1,015	–	-1.69%
MSCI FM	630	–	-1.80%
GBI EM GD	6.19%	–	-0.71%
EM FX spot	–	–	-1.12%
ELMI+	3.55%	–	-0.11%
EMBI GD	5.28%	301 bps	0.20%
EMBI GD IG	4.27%	196 bps	0.33%
EMBI GD HY	7.42%	531 bps	-0.04%
CEMBI BD	5.21%	318 bps	0.16%
CEMBI BD HG	4.30%	225 bps	0.23%
CEMBI BD HY	7.18%	517 bps	-0.01%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2068	0.24%
VIX Index	13.33	3.33%
5 year UST	1.49%	-12 bps
7 year UST	1.89%	-12 bps
10 year UST	2.18%	-13 bps
US HY	6.49%	-0.11%
European HY	5.01%	0.41%
EURUSD	1.2476	0.39%
USDJPY	118.43	0.02%
Brent	68.88	-11.80%
Copper	307.00	-2.43%
Gold	1175.67	-1.82%

Additional benchmark performance data is provided at the end of this document.

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- **Nigeria:** The central bank in Nigeria wasted no time in adjusting to the recent decline in world oil prices. Its response was textbook perfect, a fact not lost on the IMF, which quickly came out to applaud the central bank's actions. When any country experiences an external shock – such as deteriorating terms of trade – it must adjust both externally and domestically; a failure to reduce domestic demand would render the external adjustment ineffective as the level of consumption of imported goods would still be excessive relative to the country's export capacity. Nigeria raised policy rates by 100bps to 13% and increased reserve ratios on private bank deposits by 5% to 20%. In addition it devalued the NGN from 155 to 168 and widened the trading band for NGN from +/-3% to +/-5%.

Despite the central bank's laudable actions, the outlook for NGN remains challenging due to two problems. Oil prices are still under considerable pressure and fiscal pressures are rising as Nigeria heads towards elections on 14 February 2015. Historically, the Nigerian government has budgeted with oil prices substantially below market prices. This has enabled the central government to accumulate significant surpluses into its 'excess crude account'. These surpluses have then been distributed rather less formally to state governors in what is generally regarded as the central mechanism whereby the Executive buys political support. Thus, in 2014 the government budgeted with an oil price of USD 79 per barrel, while the actual oil price year to date has averaged around USD 96 per barrel. With output close to 2m bpd the excess crude account therefore ought to have accumulated about USD 12.5bn, but in fact it has only accumulated about USD 1.1bn. This implies that state governors have 'charged' the Executive about USD 11.4bn for their support this year.

Net-net, Nigeria typically ends up spending most of its oil revenue in any given year, which is why it must adjust every time oil prices change – and, to its credit, does so. So where does it stand ahead of elections next year?

Needless to say, the 'price' for support from state governors typically rises around election time. There is no set formula. President Jonathan has so far avoided a challenger within his own party and the opposition has also failed, so far, to produce a challenger. All else even this should reduce the price. But a food fight is still unavoidable. Central to the bargaining game is the 2015 budget oil price, because this determines the initial distribution of resources between central government and the states. The government has proposed a budget price of USD 73 per barrel, but at current prices (roughly USD 69 per barrel) the excess crude account would actually be drained by about USD 2.9bn in 2015. It is doubtful that Nigeria's high spending state governors would accept pay cut of this size in 2015, so the battle is on. Pick your poison: 'impoverishment for Nigeria's state governors, a major deficit on the part of the central government, a sharp drop in reserves, or a

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meaningfully lower NGN? The silver-lining is that Nigeria has approximately USD 36bn of reserves meaning that the Dollar deficit for next year can comfortably be covered by current reserves in most scenarios. For this reason, we do not see default as a major threat. Even so, the quintessential Nigerian oil rent distribution problem is likely to weigh on the NGN for some time, in our view. The 2015 Budget is finalised in February next year, roughly at the same time as the election.

- Ukraine: The economy has been shrinking and the currency has been under pressure as Ukraine undergoes adjustment. FX intervention by the central bank caused a large fall in international reserves in October. The currency has now stabilised somewhat but renewed FX weakness could create significant pressure on the balance of payments if poorly managed by the central bank. Quick disbursement of IMF loans is required to restore confidence that the programme is on track and financial support is forthcoming. The parliamentary elections allowed for the creation of a pro-Poroshenko coalition and with the re-appointment of Prime Minister Yatsenyuk the government will now shortly re-start discussions with the IMF. The IMF was in Kyiv for a technical mission in November, and will likely return soon. Our base case is that these discussions are concluded in time for the IMF to disburse the next USD 2.8bn tranche of the programme early next year. The programme also makes provisions for another four tranches of USD 2bn each next year, taking the total IMF financial package to USD 10.8bn. Once in place, domestic political stability and the success of domestic economic reform take centre stage; progress will attract a broader set of bilateral lenders such as the US and the EU, who have every interest to see Ukraine through this difficult period. Private sector financing could follow too, potentially in size if Ukraine is seen to have turned a corner. The cease-fire with the separatists has fizzled out for now, though new talks between Putin and Poroshenko are a positive sign. The conflict in the Donbas is disruptive economically and a point of contention between various factions of the governing coalition: Ukraine's nationalist movements could make it harder for President Poroshenko to focus on the domestic economic agenda and to arrive at a negotiated solution with Russia, for example.

- Brazil: Former Treasurer Joaquim Levy was appointed finance minister last week while Nelson Barbosa was appointed to head up the planning ministry. Alexandre Tombini was re-confirmed as central bank president. These are important positive developments that will ultimately translate into a recovery in business confidence and better fiscal performance after the disastrous management of the public finances under former finance minister Guido Mantega. Levy wasted no time announcing a medium-term fiscal framework involving fiscal adjustment, stabilisation and a decline in the level of public debt. Initially the primary surplus target will be 1.2% for 2015 and at least 2% for 2016 and 2017. Tombini's initial comments after his re-appointment were hawkish, suggesting that monetary policy will also be employed to pull Brazil back to orthodoxy.

We think Joaquim Levy and team will be successful. Levy's three year rolling fiscal program is exactly the right way to go forward. One of the big problems in Brazil over the past few years under Mantega's stewardship was that the fiscal accounts became far more discretionary and pro-cyclical. The result was not just a worsening overall fiscal stance, but also less efficient public spending. A medium term fiscal plan will allow Brazil to gently return to the right path by prioritising spending and revenue mobilisation in a rational way, while at the same time beginning to meet overall fiscal targets rather than missing them. The targets are credible. Taking a broader perspective, Brazil faces three problems: Loss of confidence in policy makers; fiscal deterioration; and structural impediments to achieving a higher trend growth rate. Levy and team should fix the first two of these problems but, although we believe they will succeed in bringing Brazil back to its present potential growth rate, they will struggle to lift Brazil to a higher trend growth rate.Raising the country's trend growth rate further would take a far more radical shift at the top of Brazilian politics. Brazil remains 'the France of South America', meaning a country with strong cultural preferences for a big heavy interventionist state.

In a sign of things to come the government last week vetoed one of Mantega's most regressive fiscal measures, namely the discretionary re-allocation of excess tax revenues towards financing tax exemptions in particular sectors of the economy. This measure ensured that fiscal surpluses were spent rather than saved, making public spending both more discretionary and pro-cyclical. The decision to rescind this measure is therefore an important positive. In October, Brazil recorded a primary fiscal surplus for the first time in five months. The improvement was mainly due to one-off items rather than the start of a broader fiscal adjustment, but we think more sustained improvement in the public finances is coming. Brazil grew only 0.1% in Q3.

- Tunisia: Tunisia's presidential election will go to a run-off in December after no candidate secured an overall majority in the first round of voting. Only six percentage points separated the two frontrunners, Beji Caid Sebsi, the leader of the centrist Nidaa Tounes ('Tunisian Call') and Moncef Marzouki, a former dissident. Tunisia is transitioning to a pluralistic political system and is hailed as the only success story among a wave of uprisings in 2011 across the Arab world. The attempt at democratic transition in Egypt, Libya, Syria and Yemen failed. The experience of transition from dictatorship in EM after the collapse of the Cold War in 1989 suggests that the process can easily take a decade, because it takes time to identify and develop home-grown political institutions. In the meantime, old political figures mix with the new in serious power struggles. In the case of Tunisia, the old is promoting a message of a strong and stable state, while the new offers a mix of religion and politics and guarding the original objectives of the 2011 revolution. Economic transition will be key to success and keeping younger voters involved. Unemployment is now around 15% and the government expects real GDP to grow between 2.3% and 2.5% this year, well below an initial forecast of 4.5%. Annual growth averaged about 4.4%

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in the 10 years through 2010. However, the direction of travel is encouraging. In July, the government cut fuel subsidies by 6.3% in order to cut its budget deficit. It also imposed new taxes and allowed the currency to depreciate in order to rebuild foreign reserves. The run-off election is expected to be a close call. At this point, odds marginally favour the leader of the Nidaa Tounes party.

Snippets:

- Korea: The current account surplus rose to USD 9bn in October from USD 7.4bn in September and USD 7.2bn in August. This is driven by increasing exports, despite heavy currency manipulation by Japan, a close competitor in a number of sectors. The capital account was unchanged at a deficit of USD 7.1bn. November's exports were down 1.9% yoy versus +1.8% yoy expected. While imports were also weaker than expected (-4.0% yoy versus -2.2% expected) resulting in a lower than expected trade surplus (USD 5.6bn versus USD 6.2bn expected) on a working-day-adjusted basis exports actually rose 2.4% yoy in November versus 2.3% yoy in October and 1.3% yoy in September. The other driver of the current account is softer domestic demand. Industrial production and PMI in October 2014 weakened more than expected. We think Korea's economy will face continuing pressure from Japan to which the correct policy response is to increase domestic productivity; the associated reforms typically slow growth temporarily.
- The Philippines: Real GDP growth in Q3 was 5.3%, which was significantly lower than the 6.5% yoy print expected by the market. However, the main culprit was government spending, while private consumption and investment spending actually both accelerated meaningfully over the quarter (5% qoq seasonally adjusted annual rate (saar) and 23% qoq saar, respectively). Government spending contracted at a rate of 10.5% qoq saar due to underspending. Under execution of capital spending is one of the perennial problems faced by EM governments, including the Philippines. Spending is often lumpy and almost always behind schedule. Still, with extremely healthy dynamics of GDP in the private economy one way to think about the under-performance in Q3 is that growth has been stored up for future quarters when planned capex spending eventually comes on line.
- Thailand: Exports picked up at a faster than expected pace in October. Exports rose 4.1% yoy versus 0.5% yoy expected. At the same time, imports declined 5.2% yoy, so the trade surplus improved sharply. Much of this improvement is due to lower oil prices, which is beneficial to the vast majority of EM countries. Domestic demand is picking up, but production is still lagging, partly due to delays in capex spending by the government. Inflation was 1.26% yoy in November versus 1.3% yoy expected and 1.48% yoy last.
- Mexico: Mexico recorded a trade surplus of USD 143m in October in sharp contrast to expectations of a USD 750m deficit. Exports rose strongly, particularly to the US, while imports also increased, albeit more sluggishly. Mexico renewed its USD 70bn flexible credit line (FCL) with the IMF. The FCL has never been used but is a low opportunity cost alternative to accumulating excessive FX reserves.
- China: China followed last week's policy easing with another technical easing move this week when they cut the two-week repo rate by 20bps to 3.2%. This is largely a technical move, which was expected by the market. Industrial production declined 2.1% yoy in October. China's slowdown is caused by deep reforms, which will ensure that China can continue to grow for decades to come. The temporary weakness in activity makes for compelling opportunities in the Chinese government bond market, in our view. We note in passing that China used the opportunity created by lower oil prices to raise consumption taxes on petroleum products. Manufacturing PMI was softer than expected at 50.3 (versus 50.5) HSBC's PMI manufacturing index – which claims to be more representative of small and medium sized enterprises – was unchanged from last month at 50. Meanwhile, the Chinese government put forward proposals to introduce a deposit insurance scheme for banks. This suggests that China is undeterred in moving forward with financial liberalisation. The measures are broad and include gradual opening of the capital account, internationalisation of the CNY, liberalisation of interest rates, moving local governments from bank to bond financing, establishment of municipal yield curves and developing a domestic mutual fund industry.
- Taiwan: The opposition DPP party made strong gains in local elections at the expense of the ruling KMT party. KMT supports closer ties to China. The next parliamentary and presidential elections are scheduled for 2016. November PMI declined to 51.4 from 52 in October.
- Singapore: The economy grew more than twice as fast as expected in Q3. Growth was 3.1% qoq, while analysts had expected only 1.5% qoq growth. What did everyone get wrong? First, manufacturing was stronger than expected. Second, construction activity picked up faster than expected. Most importantly, however, imports declined 8.4% qoq saar. The slowdown in consumption boosted net exports, which transfer directly into the GDP number.
- Russia: State banks VTB and Gazprombank have reportedly requested RUB 250bn and RUB 100bn in loans from Russia's National Welfare Fund (NWF). Both banks are sanctioned by the US and EU. Russia has considerable scope for meeting the financing needs of its state-owned banks despite the sanctions regime. A RUB denominated loan to, say, Gazprombank, would require the NWF – whose assets are in Dollars – to sell the equivalent amount of Dollars to the central bank in exchange for RUB, which are then extended to Gazprombank as a loan. Hence, the NWF's dollars simply move to the central bank with no overall impact on

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Russia's overall stock of Dollar assets. Domestically, the loan to Gazprombank would represent monetary easing since the central bank has printed RUB in order to buy the Dollars from NWF. A poll by Levada showed that only 14% of Russians see EU/US sanctions as a serious problem. PMI in Russia picked up strongly in November. The index rose to 51.7 from 50.3 in October.

- Turkey: The trade deficit in October narrowed more than the market expected. At USD 6.3bn, the deficit narrowed USD 1.2bn compared to last year and was USD 0.3bn narrower than expected. The outperformance was driven almost exclusively by exports, but it is likely that the trade balance will improve further in coming months due to lower global oil prices. November PMI rose to 52.2 from 51.5 in October.

- India: Real GDP expanded by 5.3% yoy in the third quarter, which was faster than the market had expected (5.1% yoy). We expect stronger growth in India next year. Only a year after India was labelled a 'Fragile Five' country by Morgan Stanley the Sensex stock market index has clocked up 39% return for investors, while the yield on India's 10 year government bond is down by more than 1% since April. Clearly, the widely held view that India was in terminal decline was somewhat wide of the mark. The election of a new more dynamic government has certainly helped sentiment but we never saw India as a fragile 'basket case' in the first place. Real GDP growth during India's 'recession' never dropped below 4.5% yoy, while FX reserves never fell below USD 275bn, even at the height of last year's 'Taper Tantrum'. In India, we continue to see opportunities in fixed income as the RBI cuts rates amidst declining inflation rates. As yields decline, the odds shorten that the USD 760bn domestic bond market is opened to foreign investors, in our view. This means that the technical bid for bonds should not only put a ceiling on yields, but also possibly lower the floor even further. The Reserve Bank of India relaxed restrictions on gold imports and PMI picked up strongly in November to 53.3 from 51.6 in October.

- Mongolia: The opposition party MPP has joined the ruling Democrat Party to form a National Unity coalition government. This marginally improves chances of an agreement with mining companies to develop the country's vast mineral wealth.

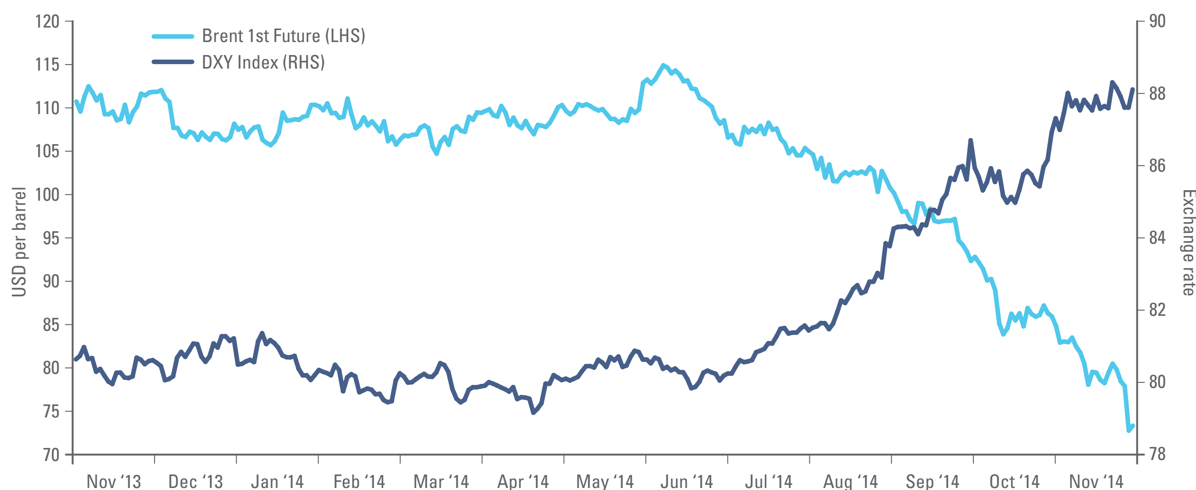
- Eastern Europe: Manufacturing is picking up pace in Eastern Europe. PMIs rose more than expected in Poland, Czech Republic and Hungary. The PMIs are well above 50, which points to economic expansion.

Global backdrop

Oil prices dropped nearly 10% following the decision by OPEC not to cut production from current levels of about 30m barrels per day (equivalent to just under 1/3 of global supply). Our view is that the oil market has not changed as dramatically as recent price action would imply. Inventories have risen over the past few months, partly due to shale production in the US and elsewhere. As the US became less reliant on imported oil, the likes of Venezuela and Nigeria had to look for alternative markets, increasing global inventories.

As such, the size of the move in oil now goes well beyond a normal inventory correction. There is an element of price discovery here. In addition to the inventory situation, the move in oil prices is related to developments in currency markets. It is curious how the drop in oil coincided almost perfectly with the rise in the Dollar index as the chart below illustrates. And global oil demand and supply did not suddenly change dramatically at the end of June 2014. Concerns about German growth, pessimism about China, the correction in US equities as a reaction to an expected Fed policy change along with and the IMF's concerns about global growth impacted sentiment. Markets have, however exaggerated the real threats to global growth, particularly as they pertain to Chinese and German growth prospects. EM will grow faster next year as will the US, in our view. As global growth recovers inventories should decline, which should support oil prices (lower prices stimulate demand and discourage supply).

Fig 1: **DXY dollar index and Brent crude oil**



Source: Bloomberg.

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Global backdrop

Why should currencies be part of the oil story? Recall that the world's largest consensus trade – to be long US dollars – has dominated global currency markets at least since 2011. Over this period, markets have accumulated ever more USD through a series of consensus trades with relatively weak fundamental groundings, but strong emotional appeals. The first trade in this series was the Eurozone debt crisis, which involved buying USD against EUR. When ECB President Mario Draghi killed this trade in 2012 it was replaced by 'Abenomics I', which saw the market buy USD against JPY. When this trade ran out of steam the long-Dollar trade moved on to EM, where currencies were sold against USD in the so-called Taper Tantrum of 2013. So far, in 2014, the search for something to short against the Dollar became more febrile: in June's 'Tightening Tantrum' the USD was bought against virtually every other currency in the world. This trade then quickly gave way to 'Abenomics II' – selling JPY against the USD to front-run portfolio changes in the enormous Japanese government pension fund (GPIF).

Probably because it is becoming increasingly difficult to find currencies that are genuinely expensive relative to the Dollar the long-Dollar trade now appears to have leapt to commodities, which are the closest proxies to currencies. Lower commodity prices will justify further Dollar accumulation, particularly against oil currencies. Indeed, it would be unsurprising if the trade did not soon move onto other commodities too. Gold fell sharply after Swiss voters rejected a proposal to boost gold reserves. As we have argued extensively, the accumulation of Dollars is building up technical imbalances that are likely to backfire when the US begins to experience inflation. By then, markets are likely to be 'limit-long' Dollars against...well...almost everything. This is extremely dangerous – see *"The big bad imbalance: EM FX vs. US dollar positioning,"* Market Commentary, April 2014.

In other global news:

US data releases surprised both to the upside and downside in the past week. Unfortunately, the main upside was in to backwards-looking data, while the main downside surprises related to more recent events. This suggests that the US economy is slowing into year-end, raising the prospect of another Q1 growth disappointment. Q3 GDP was revised up to 3.9% qoq from 3.5% (3.2% qoq net of defence spending). Consumer spending in particular was revised higher in Q3, although this was partly due to the decline in oil prices. Subsequent data releases were less bullish. Services PMI declined from 57.1 to 56.3, a full point below expectations. Dallas Fed was unchanged from October and the Chicago Fed's national manufacturing activity index declined to 0.14 from September's 0.29 (itself revised lower from 0.47). Then followed softer than expected house prices (Case Schiller and FHFA), lower consumer confidence, weak Richmond Fed, sharply falling mortgage applications, soft durable goods orders, rising claims for unemployment benefit, disappointing October personal consumer income and spending, underwhelming Chicago PMI, and a soft consumer confidence number. Pending home sales and new home sales also weakened. Only the Milwaukee ISM number rose. Black Friday sales disappointed as the National Retail Federation recorded an 11% yoy fall in sales.

Across the pond, in Europe, sentiment was little changed. The market is still baying for sovereign QE from the ECB in December to keep the Dollar rally going a little bit longer, but we think odds of a move by the ECB this year are low. Sovereign QE is the ECB's main defence against rising US rates and as such ought to be kept in reserve. Inflation is soft in Europe, but the economic data is not as bad as perceptions would imply. German unemployment dropped to 6.6% in November versus 6.7% expected, while consumer confidence rose. Retail sales were also stronger than expected. On the other hand, German PMI weakened from 51.4 in October to 49.5 in November. Bank lending to the non-bank private sector in the Eurozone is now rising, albeit marginally (household lending is rising, but corporate lending is still declining). Political risks are rising in both Greece and Spain as we approach 2015; the market clearly eyes an opportunity to resurrect the Eurozone debt crisis trade. A plan by EU President Juncker to revive investment was quickly dismissed as marginal for the growth outlook of Europe. The EUR 300bn plan (a) requires EUR 284bn of private sector co-financing; (b) project identification is at a very early stage; and (c) it is unclear if the projects would perform better than whatever projects they crowd out.

Finally, Moody's downgraded Japan's sovereign credit rating one notch from AAA3 to A1 with stable outlook on rising uncertainty about the government's ability to achieve its deficit target. Moody's is now in line with Fitch, though Fitch has Japan on negative outlook. S&P rates Japan one notch above both Fitch and Moody's, but with a negative outlook.

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Global backdrop

Emerging Markets	Year to date	1 year	3 years	5 years
MSCI EM	2.7%	1.4%	5.6%	3.9%
MSCI EM Small Cap	4.1%	3.7%	8.6%	5.2%
MSCI FM	11.1%	13.6%	14.5%	8.4%
S&P 500	13.97%	16.85%	20.94%	15.96%
GBI EM GD	0.22%	-0.33%	1.63%	3.82%
ELMI+	-3.66%	-3.86%	0.52%	-0.05%
EM spot FX	-8.48%	-9.38%	NA	NA
EMBI GD	9.97%	10.27%	7.55%	7.98%
EMBI GD IG	10.87%	10.73%	6.09%	6.76%
EMBI GD HY	8.43%	9.63%	9.97%	9.82%
5 year UST	3.98%	2.38%	1.36%	3.23%
7 year UST	7.26%	5.21%	2.26%	4.70%
10 year UST	11.90%	9.80%	3.59%	5.90%
CEMBI BD	7.02%	7.15%	7.18%	7.15%
CEMBI BD HG	8.18%	8.05%	6.63%	6.82%
CEMBI BD HY	4.60%	5.30%	8.75%	8.30%
US HY	3.92%	4.58%	10.08%	10.45%
European HY	5.81%	6.83%	16.05%	12.71%
Barclays Agg	1.28%	0.68%	1.19%	2.00%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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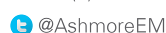
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