CORONATION

2025 Year Ahead

Research | Nigeria

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Executive summary

Stability in 2025

2025 holds out the prospect of much more stable economic conditions than either 2023 or 2024. Since mid-2023 the monetary authorities and the Federal Government have implemented policies to tackle inflation and to stabilise the currency.

The effects of these policies have not been immediate. Inflation has risen from 28.20% year-on-year in November 2023 to 34.60% y/y in November 2024. The Naira, whose US dollar value fell 49.1% in 2023, has fallen by a further 41.0% in 2024, as of 27 December. The performance of such metrics demands patience from those suffering their effects.

Economic policies take time to work and their effects are cumulative. The Central Bank of Nigeria (CBN) has raised its policy rate by 875 basis points over the past 12 months to 27.50%. The 1-year T-bill yield in the secondary market has risen from 11.77% pa to around 26.00% over the same time. Measures have been taken to reverse the flow of unfunded loans from the CBN to the government.

The foreign exchange market is liberalised today though, as is the case with many currencies, the central bank regularly intervenes. The CBN has addressed the backlog of US dollar claims that hung over the market during 2023 and early 2024, and it has introduced a new trading system. Petroleum (PMS) subsidies were finally removed, effectively, in September 2024, though partial removal of subsidies was in evidence as early as June 2023.

The response of foreign portfolio investors has been positive, with over US$1.0bn in FPI recorded by the CBN in October and again in November. In early December the Federal Government of Nigeria raised US$2.2bn in Eurobonds.

What will be the cumulative effects of these developments in 2025? We start with an examination of inflation, which has been a destructive force for households and businesses. We conclude that there are good prospects for bringing it under control in 2025, though more so in the second half of the year than during the first. We go on to examine the outlook for the policy rate of the CBN, the yields of T-bills, the prospects for the Naira-denominated government bond market, and the exchange rate.

Key economic drivers for 2025 – forecast scenarios

	Naira / US dollar			Inflation			MPR rate			1-year T-bill yield		
	Now	Av* 2025f	Dec 25f	Now	Av* 2025f	Dec 25f	Now	Av* 2025f	Dec 25f	Now	Av* 2025f	Dec 25f
Optimistic	1,546.0	1,406.6	1,230.0	34.60%	26.50%	18.00%	27.50%	24.08%	18.00%	26.00%	21.46%	16.00%
Base Case	1,546.0	1,642.4	1,750.0	34.60%	30.42%	23.00%	27.50%	26.17%	24.00%	26.00%	23.38%	20.00%
Pessimistic	1,546.0	1,877.5	2,200.0	34.60%	35.00%	36.00%	27.50%	20.00%	12.00%	26.00%	17.17%	8.00%

*Sources: FMDQ, Bloomberg, Coronation Research *Average. NB Optimistic (65%), Base Case (25%) and Optimistic (10%) probabilities are derived from Coronation Research's overall prognosis for 2025. MPR rate = the Monetary Policy Rate of the Central Bank of Nigeria. The 1-year T-bill yield is that of the secondary market. The inflation rate given is for November 2024, year-on-year (34.60%). The exchange rate is that given by Bloomberg for close of business, 30 December 2024*

We have developed three sets of scenarios for Naira/US dollar, inflation, the Monetary Policy Rate and 1-year T-bill yields. Within our overall prognosis, and barring any unforeseen events during 2025, we assign a 65% probability to our base case scenario, a 25% probability to our optimistic scenario, and 10% probability to our pessimistic scenario.

Our base case scenario is built on our belief that the Federal Government and the CBN will continue to work hand-in-hand during 2025, advancing the stabilisation measures that were implemented in 2023 and 2024. Our optimistic scenario considers the effects of some drivers working out much better than our base case assumptions, in particular the possibility that CBN could actually bring about Naira appreciation in 2025. Our pessimistic scenario is built on a possible – we hope unlikely – reversal of the reform process and a return to the pro-growth policies in place before 2023, low policy rates and high inflation.

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Introduction. The World Bank report

The Nigeria Development Update reports a turnaround

Periodically the World Bank publishes a Nigeria Development Update. These updates are read by a long list of Nigeria's business partners and counter-parties and provide a reliable guide to the condition of public finances and economic conditions. The WB's summary descriptions of policy areas are: weak; semi-weak, average, semi-strong and strong.

World Bank Nigeria Development Update (NDU) – summary table

	NDU Dec-22	NDU Jun-23	NDU Dec-23	NDU Oct-24
(A) Monetary Policy				
Maintain tight monetary policy to lower inflation	Weak	Semi-weak	Average	Semi-strong
Avoid resorting to deficit monetization, including access to Ways & Means Advances	Weak	Weak	Semi-weak	Semi-strong
Improve balance sheet transparency	Weak	Semi-weak	Semi-weak	Average
(B) Fiscal Policy				
Eliminate PMS subsidy	Weak	Strong	Semi-weak	Semi-strong
Strengthen non-oil revenues	Weak	Semi-weak	Average	Average
Increase transparency of oil revenues	Weak	Weak	Weak	Weak
Phase out the FX subsidy	Weak	Semi-strong	Semi-weak	Strong
Reduce the cost of governance	Weak	Weak	Weak	Weak
('C) Foreign Exchange Policy				
Maintain a unified, market-reflective exchange rate	Weak	Semi-strong	Semi-weak	Strong
Concentrate FX transactions in the officail market	Weak	Average	Semi-weak	Semi-strong
(D) Trade Policy				
Reduce trade restrictions that increase prices and poverty	Weak	Weak	Semi-weak	Semi-weak
('E} Provide urgent relief to the population				
Scale up and provide relief to the population	Weak	Weak	Semi-weak	Average

Sources: World Bank, Coronation Research. NB This is Coronation Research's reproduction of the summary table given in the October 2024 edition of the World Bank's Nigeria Development Update (NDU). The original table uses colour coding for the World Bank's five descriptions with a key: Coronation Research has substituted the descriptions. Coronation Research has omitted, for the sake of brevity, the column giving the World Bank's 'Measures to sustain and deepen the reforms'. See worldbank.org

The October 2024 edition of the Nigerian Development Update describes, in our view, a turnaround in Nigeria's public finances in less than two years. These coincided with the election of new presidential administration in early 2023 and the implementation of policies to end the PMS subsidy (petroleum subsidy) and foreign exchange subsidy, as well as a concerted effort (more evident in 2024 than in 2023, in our view) to get inflation under control.

The largest gains have been made in monetary policy and in the reversal of ways and means loans (unfunded central bank loans to the government) where the World Bank's description has moved from weak to semi-strong. The elimination of petroleum subsidy has also improved from weak to semi-strong, while the phasing out of the FX subsidy has improved from weak to strong, as has the maintenance of a unified, market-reflective exchange rate.

Some areas of public finances continue to be described as weak, notably transparency of oil revenues and the cost of governance. And broad-based economic improvements, such as trade policy and relief to the population, while improving, are not improving as quickly as monetary policy, reversal of ways and means loans, petroleum subsidy and foreign exchange policy.

The World Bank and the international investor

The fact that Nigeria's strongest policy gains are in those areas benefiting public finances and financial markets is significant, we believe. This a scorecard that appeals to foreign portfolio investors, which place great importance on the reliability of the foreign exchange market, anti-inflationary monetary policy and the elimination of subsidies. We do not think it coincidental that October and November 2024 showed a sharp uptick in foreign portfolio investment.

In this report we make our own assessment of inflation, monetary policy, fixed income rates, foreign exchange and fiscal policy, yet one key driver is foreign portfolio investors' confidence and this, we believe, has been positively influenced by October's Nigeria Development Update.

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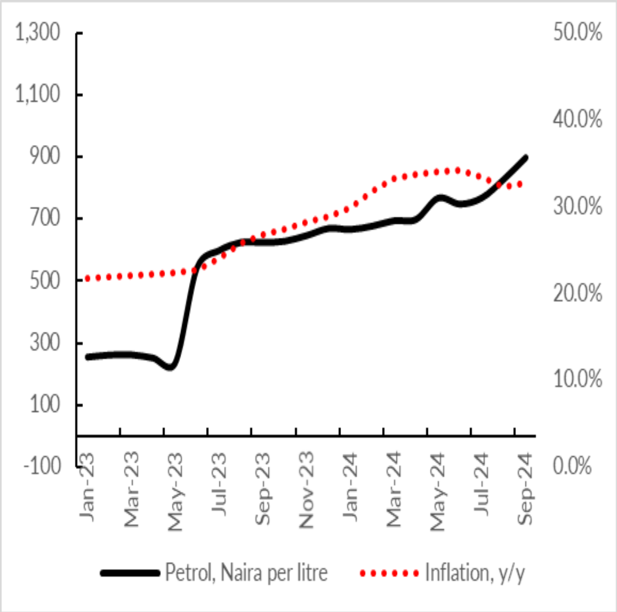
Inflation in 2025

Inflation has created manifold problems for Nigeria over the past five years, increasing from 11.85% year-on-year in November 2019 to 34.60% y/y in November 2024.

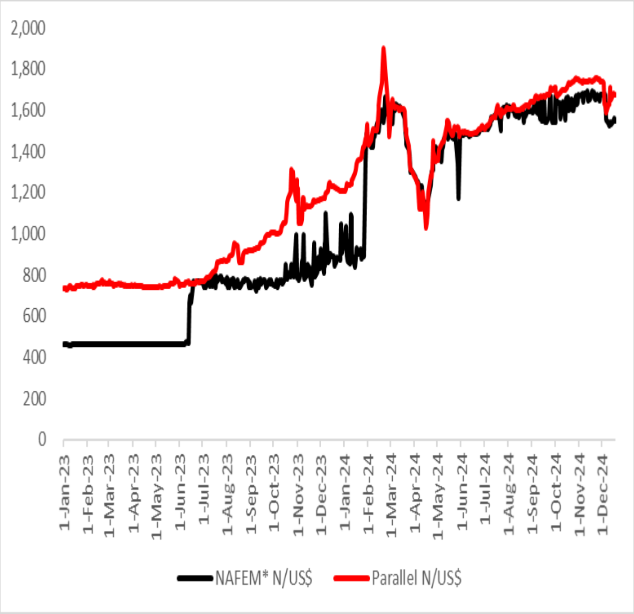
There are several causes of inflation. Some of them are difficult to quantify, such as insecurity that raises the costs of transporting goods along Nigeria's highways. Others can be quantified, notably rises in fuel prices and the creation of money through unfunded loans to the Federal Government by the CBN. Unfunded loans, that swell the amount of money in the economy without a corresponding rise in the volume of products and services, can be contrasted with funded loans such as T-bill issues, FGN bond issues and bank loans to the government.

Petrol prices, Naira/litre (left), and year-on-year inflation



Sources: NBS, Coronation Research

Naira/US dollar



*Sources: FMDQ, Bloomberg, Coronation Research *Previously known as the Importers and Exporters Window and the NAFEX market*

The CBN has a remit to reduce inflation. It does not have the means to improve security along Nigeria's highways, nor can it influence the price of fuel which is largely a function of subsidy withdrawal. It can, however, exert control over the supply of money into the economy by changing interest rates, imposing a cash reserve requirement (CRR) on the banks, and by reversing (ie funding) the flow of its unfunded loans (so-called ways and means loans) to the government.

In an economy such as Nigeria's, which can be characterised as having a low level of monetisation (for example, most households do not hold mortgages, most small and medium-sized entreprises are financed with savings rather than debt) it remains to be seen whether monetary controls can decisively break inflation. But these are the means at the disposal of the CBN, and we believe they will contribute to the decline of inflation during 2025.

Fuel Prices

Fuel prices will play an important role in inflation in 2025. Fuel prices rose rapidly in 2024 as government subsidies were withdrawn. The bad news is that increases in fuel prices feed through into the prices of almost any product or service one can think of, or any least all those involving energy and transportation.

The good news is that, with a total withdrawal of fuel prices in effect as of September 2024, there is not much – short of a significant rally in crude oil prices, or another significant devaluation in the Naira – that can make them rise again in 2025. Of course, the rise in fuel prices in September 2024 will put pressure on year-on-year inflation throughout the first nine months of 2025. But it is unlikely to make the year-on-year inflation measure worse after September 2025, so we may see a significant decline in inflation during the fourth quarter.

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Inflation in 2025

The currency and inflation

The Naira/US dollar exchange rate will also be key to inflation in 2025. The relationship between inflation and the exchange rate works both ways. Over long periods of time Naira inflation erodes the value of the Naira, and the Naira/US dollar exchange rate has to adjust for this (otherwise the Naira would be over-valued relative to the US dollar; Nigerian goods and services would be expensive in US dollar terms).

In the short-term Naira devaluation contributes to inflation. The prices of imported goods have to reflect their cost in US dollars, although imports are not a major component of the economy, so their impact is limited. The CBN, like many a central bank, therefore, has an anti-inflationary tool at its disposal if it is able to influence the exchange rate. Stabliising or even strengthening the Naira versus the US dollar has the potential to contain or even reverse the imported element of inflation.

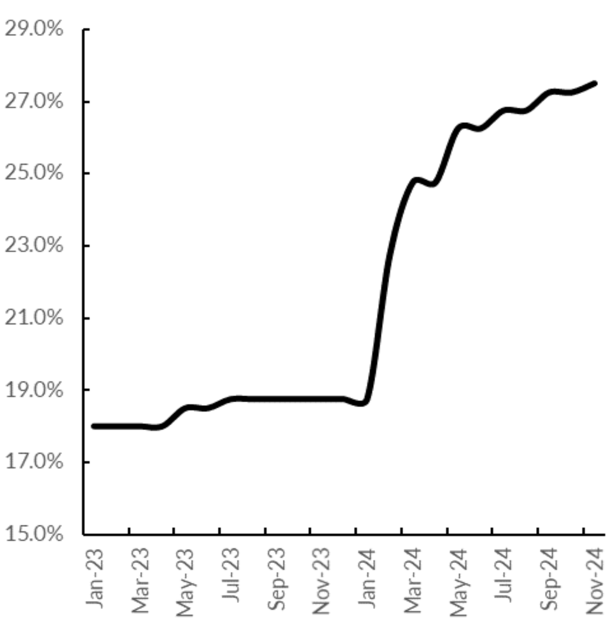
The good news is that recent months have seen a levelling off in the Naira/US dollar exchange rate. This has happened as foreign portfolio investment (FPI) has increased, with the CBN recording inflows of US$2.3bn during October and November combined. The foreign exchange reserves of the CBN are set to gain from the Federal Government of Nigeria's issue of US$2.2bn of Eurobonds in early December. The ability of the CBN to supply US dollars to the official foreign exchange market, the NAFEM market, is set to increase and, we believe, can moderate the decline of the US dollar value of the Naira to 11.7% over the year, to US$1/N1,750, which is our base case. It is even possible that the Naira could appreciate, which is our optimistic case.

Ways and means loans

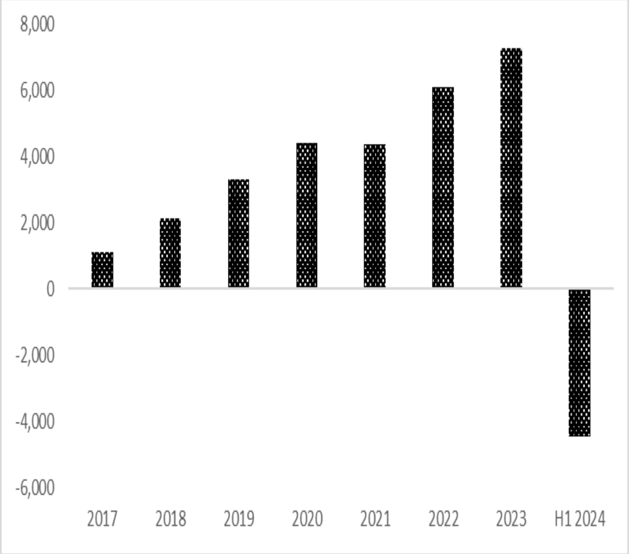
In his National Broadcast on Independence Day, 1 October, President Bola Ahmed Tinubu spoke about the repayment of 'ways and means debt' as a key milestone. Ways and means loans are not so much an obscure financial engineering technique as a problem the reform-minded administration wants to fix. Ways and means loans were initially designed to tide over short-term liquidity constraints experienced by the Federal Government, but during the six year 2018-23 swelled to become a mainstay of budget financing.

The problem is that ways and means loans are unfunded (pension funds, mutual funds and banks do not buy them in the same way in which they buy T-bills and FGN bonds) and are created by the CBN. They represent a net addition to money supply, and if the economy does not produce commensurately more goods and services, then inflation is the result.

CBN Monetary Policy Rate since 1 Jan 2023



Annual change* in Ways & Means loans, Naira billions



*Sources: Source: CBN, Coronation Research *This data has been adjusted to remove the N22.7 trillion securitisation of Ways & Means loans recorded in May/June 2023 as these have yet to be sold., Coronation Research*

In the first half of 2024 the issuance of ways and means loans went into reverse, with some N4.5 trillion removed. If this policy is continued (up-to-date information for the months after June 2024 is not currently available) then the second half of 2024 will have seen more Ways & Means loan removed. Continuation of the policy would, most importantly, prevent further expansion of money supply from this source.

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Inflation in 2025

Monetary Policy Rate, the Cash Reserve Requirement

In the next section we discuss monetary policy: here we note that the Monetary Policy Rate of the CBN has risen by 8.75 percentage points over the past 12 months to 27.50%. The cash reserve requirement of deposit-money banks stands at 50% and banks' access to emergency funds from the CBN is strongly discouraged by an asymmetric financing corridor of +500/-100 basis points. Liquidity conditions are designed to be tight.

At the same time, the banking sector has been required to raise fresh capital, with over N2.0 trillion raised in fresh equity during 2024. Although this creates capital buffers that will allow banks to expand their loan books, it also enables them to bear the risks borne by their customers in an environment of rising interest rates, in our view.

It is not easy to discern whether these measures, combined with the reversal of ways and means loans, have reduced money supply, or slowed down its growth. Data for money supply includes data for foreign currency deposits and therefore are influenced by the Naira's devaluation against the US dollar. What we can say is that these measures are clearly designed to hold back to the growth of money supply over and above what the economy can absorb.

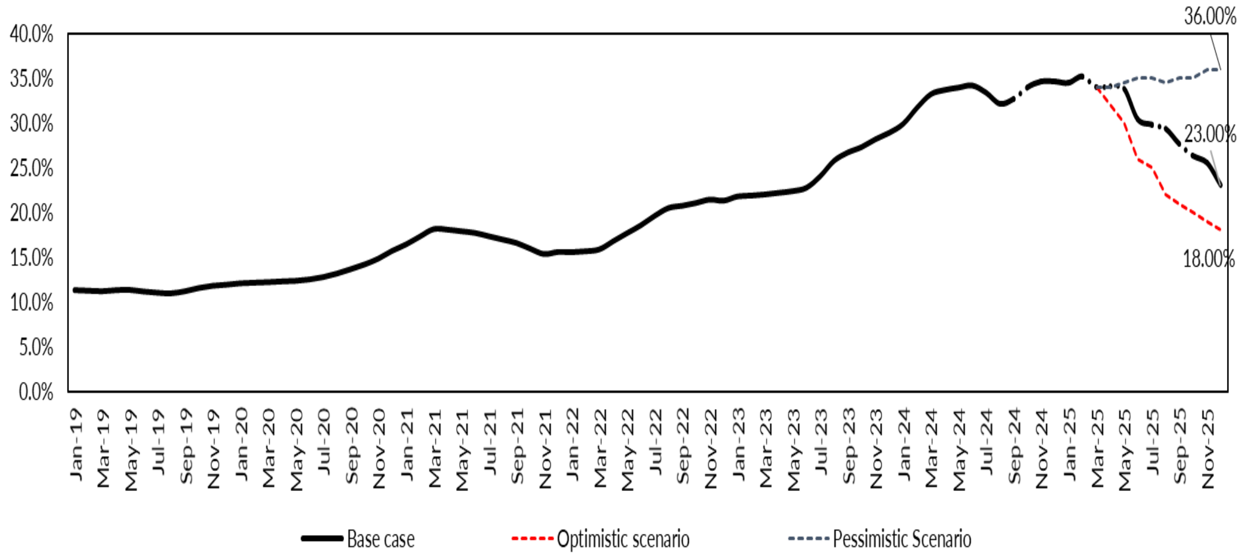
Scenarios for 2025

Our view is that the combination of these four factors (namely: a degree of stabilisation in fuel prices; a degree of stability in FX rates; reversal of ways and means loans; monetary policy) have the potential to reduce inflation in 2025. This is not to say that inflation will not increase during the first half of the year, due to year-on-year increase in fuel prices and currency depreciation that have happened already. But we think that the continuing application of policy by the CBN will bear fruit, particularly later in the year when the year-on-year comparison in terms of fuel prices and currency is likely to improve.

We have set out three scenarios for inflation in 2025.

Our base case (we have assigned it a 65% probability) for inflation in 2025 is that it will continue to rise during the first part of the year, moderate mid-year and then fall, with a sharp fall in Q4 2025. In this scenario we see inflation falling to 23.0% y/y by year-end (December). This scenario is consistent with the CBN being able to limit Naira/US dollar depreciation to 11.7% during 2025.

Annual inflation, y/y, starting in 2019, and forecasts for 2025



Source: National Bureau of Statistics, Coronation Research

Our optimistic scenario (25% probability) is for inflation to fall to 18.0% y/y by year-end 2025. This would be consistent with the CBN succeeding in a robust defense of the Naira versus the US dollar, with the Naira actually appreciating over the course of the year to some US$1/N1,230 by year-end (a 25.7% increase in the US dollar value of the Naira). Our pessimistic scenario (10% probability) sees a complete reversal of the current policies of the CBN. This would mean very steep cuts in interest rates (in the supposed interests of economic growth) and a weakening of the US dollar value of the Naira by 29.7%, with inflation rising to 36.0% by year-end .

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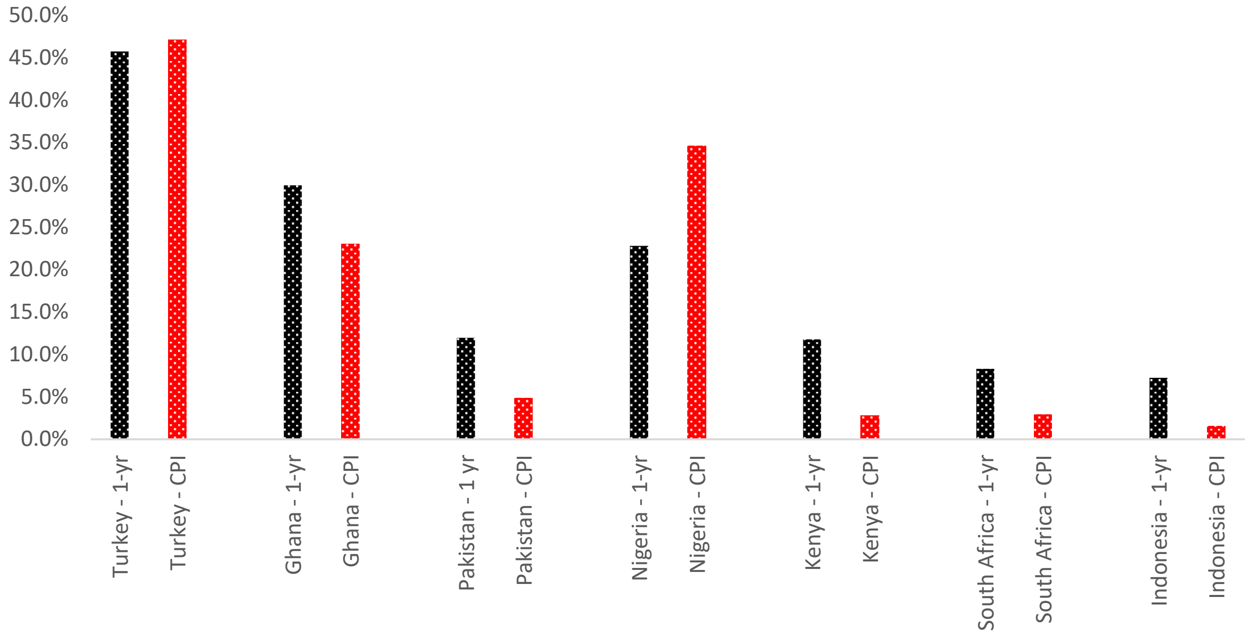
Monetary policy

As we have described above, Nigeria's monetary authorities are in the middle of a determined assault on inflation. We believe that Nigeria has a further six-to-nine months of inflation-targeting monetary policy ahead of it.

The obvious question about the CBN's monetary policy is: "Why doesn't the CBN raise interest rates to the level where they are above the level of inflation?" This would be the orthodox response to a rise in inflation and several other emerging market central banks follow it.

One-year local currency risk-free rates, and year-on-year inflation (CPI)

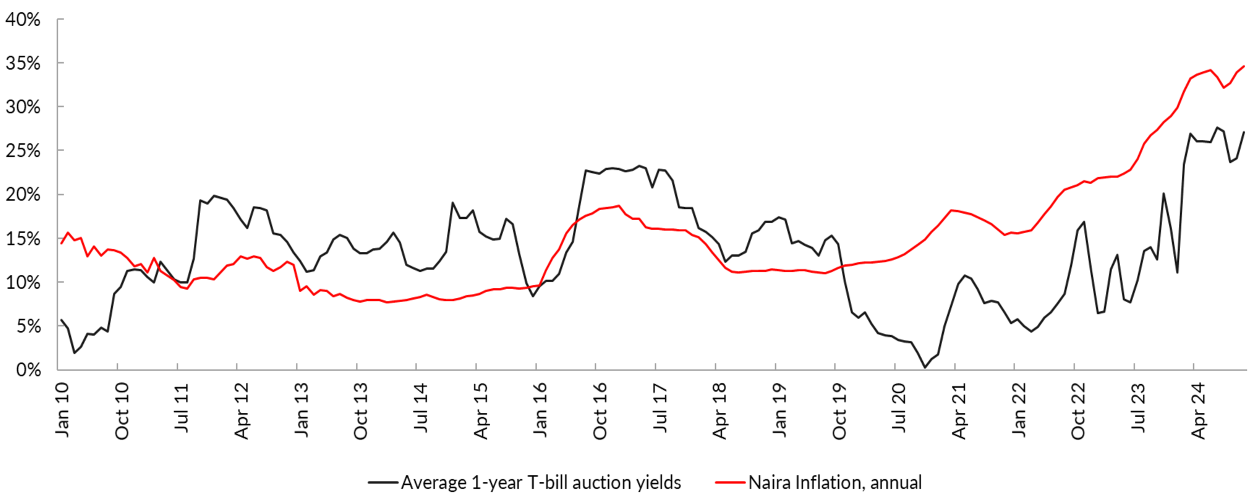


Source: Bloomberg, Coronation Research

The answer, in our view, is that it would prove too difficult for the Federal Government to pay the interest on its outstanding T-bills and FGN bonds if interest rates rose to a level higher than inflation. As things stand, the FGN's budget proposal sees the debt service cost rising 91% from N8.0 trillion (US$5.2bn) in 2024 to N15.4 trillion in 2025.

So, we term the CBN's policy a semi-orthodox approach to monetary policy, using a combination of the MPR, fairly high market interest rates, control over public-sector money supply and tight liquidity conditions for banks.

One-year local currency risk-free rates (T-bills), and year-on-year inflation (CPI), since January 2010



Source: CBN, FMDQ, NBS, Bloomberg, Coronation Research

The shortfall of 1-year risk-free (1-year T-bill) rates relative to inflation has existed since the third quarter of 2019. In the fourth quarter of 2019 the monetary authorities embarked on a pro-growth policy by engineering low market interest rates. Since Q3 2019 the spread of 1-year T-bill rates over inflation has been negative 972bps on average. Many economists would describe this as a subsidy for economic growth, though in the absence of rapid economic growth since 2019 one might also call it the principal cause of Nigerian inflation. Note how inflation, which trended in a range between 7.21% y/y and 18.72% y/y between 2010 and 2019, rose sharply from early 2020 onwards.

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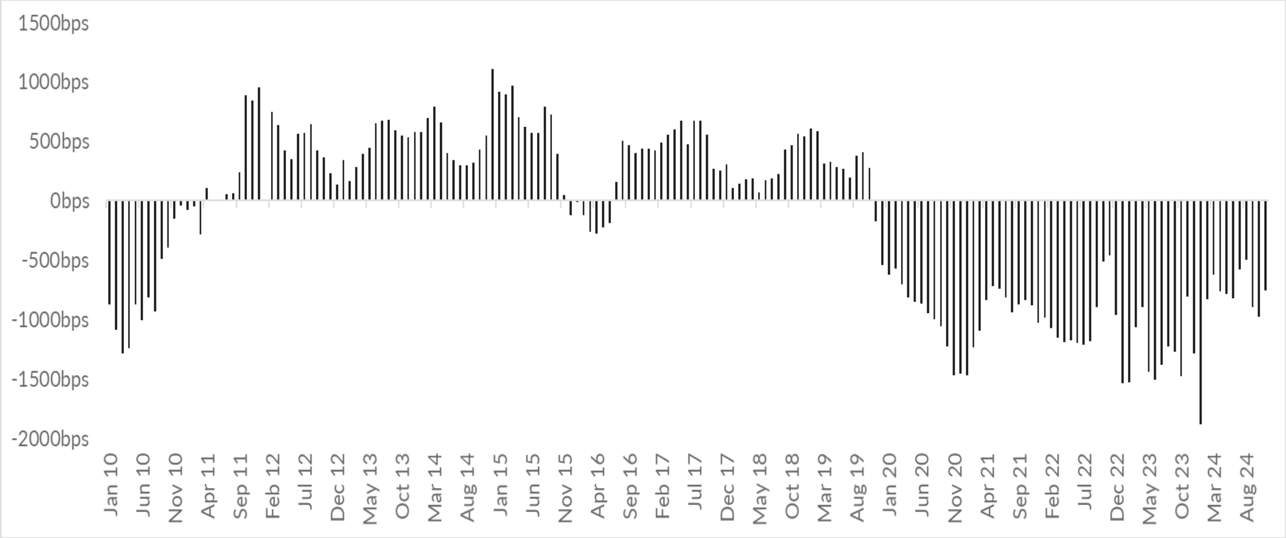
Monetary policy

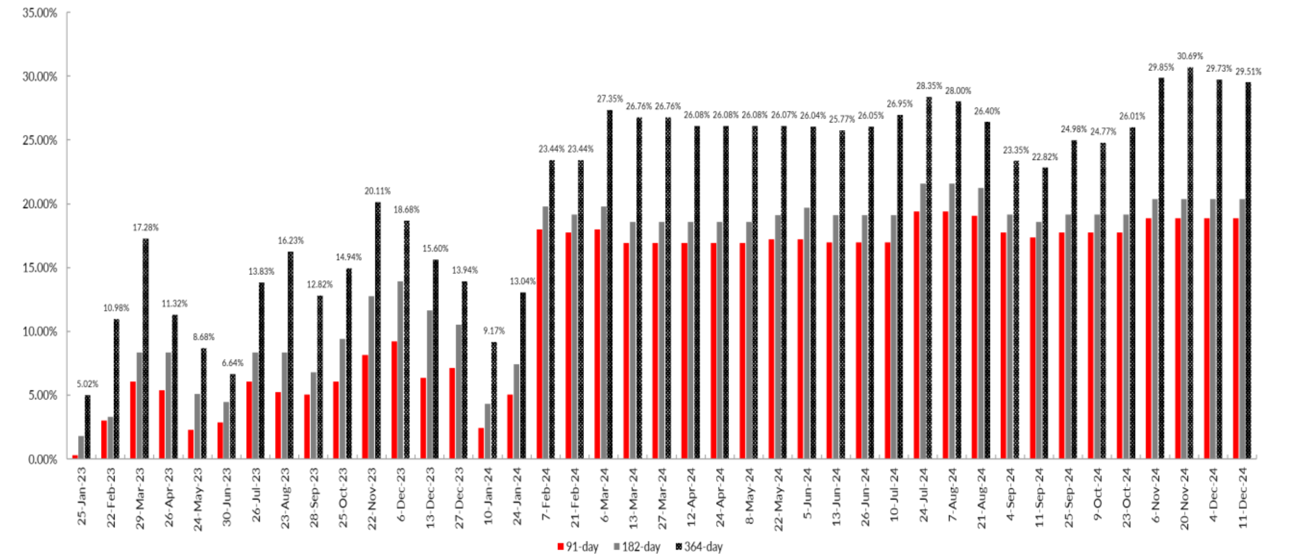
One-year local currency risk-free rates (T-bills) minus year-on-year inflation (CPI), since January 2010



Sources: CBN, FMDQ, Bloomberg, Coronation Research

The good news is that 2024 saw the CBN, which holds regular T-bill auctions and decides their yields, narrow the gap between 1-year T-bill rates and the rate of inflation. This has encouraged – to a degree – savers to hold money in T-bills and money market mutual funds.

One-year Treasury bill rates at auction, since January 2023



Source: CBN, FMDQ, Coronation Research

The key to this has been to keep T-bill auction rates high. With the exception of a few auctions at the beginning of 2024, the CBN has sold new 1-year T-bills at rates above 20.0% per annum, resulting in market interest rates well above what has been achieved during the period from 2020 to 2023. In December 2024 1-year T-bill yields at auction have been as high as 29.51% for the highest-yielding paper, while secondary market yields have traded in a range of 25.00% to 28.00%

Our view is that the CBN will continue with this policy well into 2025, given that such policies take time to have positive effects on inflation, particularly after such a long period (2020 – 2023) of loose monetary conditions. This may even mean that the CBN chooses a further, small, increment in the Monetary Policy Rate at its scheduled meeting in January 2025, perhaps 25 basis points. At any rate, our sense is that the CBN will continue with its current policy of sustaining high market interest rates until it is clear that inflation is beaten. We think that conclusive evidence of this will not be forthcoming until mid-2025. On this basis we can build some scenarios for monetary policy in 2025.

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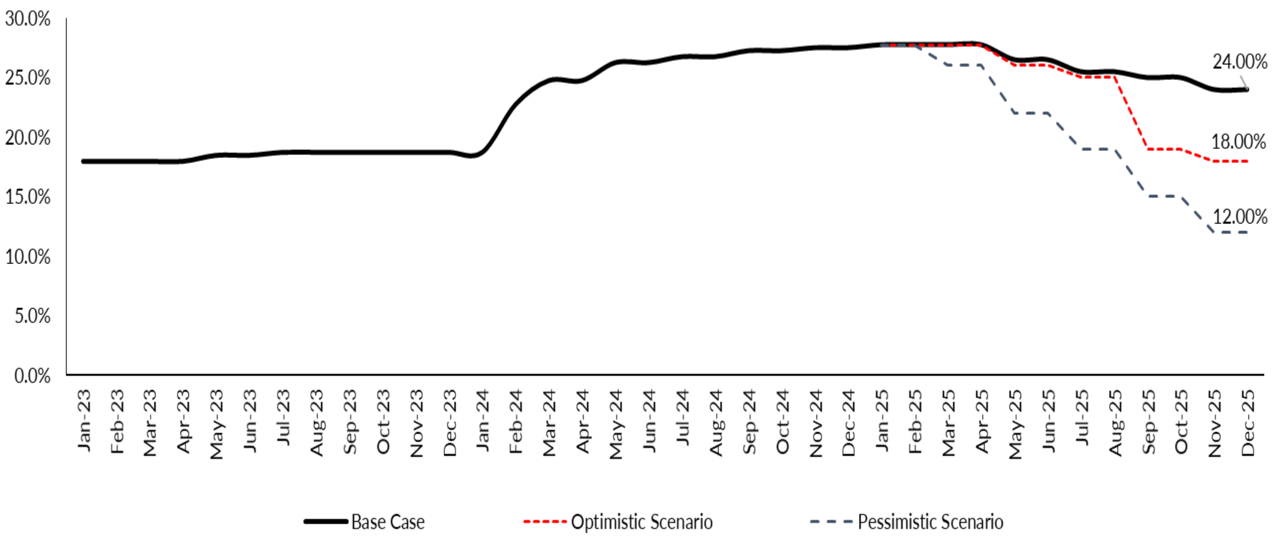
Monetary policy

Scenarios for 2025

We expect the CBN's monetary policy to remain tight going into 2025, with the possibility of small (25 basis point) rise in the MPR at the January and March meetings of the Monetary Policy Council (MPC). We doubt that the CBN will implement an inflation-plus Monetary Policy Rate in 2025 (or at least not until the very end of 2025) but we think that it will continue to use a high MPR rate in conjunction with market interest rates, combined with continued reversal of ways and means loans and tight liquidity conditions for banks.

The Monetary Policy Rate, starting in Jan 2023 and forecasts for 2025



Sources: CBN, Bloomberg, Coronation Research

Our opinion is that Nigerian inflation is likely to ease in the second half of 2025 and that this will give the CBN the justification to cut the MPR rate. Our base case (65% probability) is for the MPR to be cut to 24.00% by the end of 2025. Our optimistic scenario (25% probability), which supposes that the CBN will be able to bring about Naira appreciation against the US dollar in 2025, thereby contributing to a rapid fall in inflation, is that the MPR can be cut to 18.00% by year-end. In our pessimistic scenario (10% probability) we see the CBN abandoning its assault on inflation and cutting rates steeply in order to encourage growth. In this pessimistic scenario we see the MPR being cut to 12.0.% by year-end.

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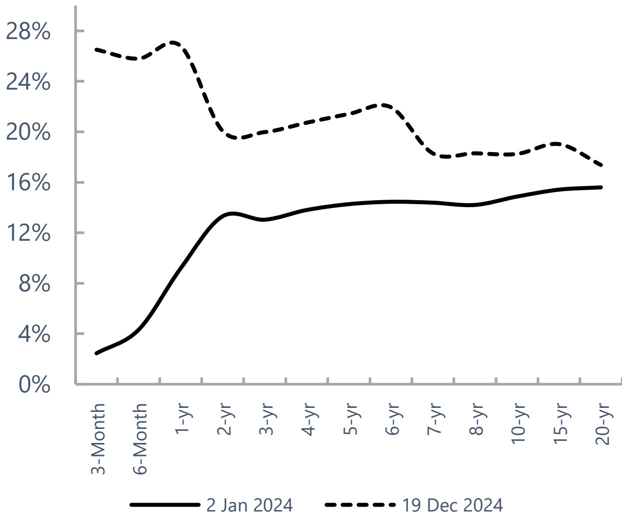
Naira fixed income

As we have seen, the CBN has ensured that T-bill rates in 2024 were much higher than in previous years, and that 1-year T-bill rates were generally above 20.00% per annum when sold at auction, reaching annual yields of 29.00% at auction by year-end.. The negative spread between risk-free rates and inflation narrowed during the year.

What you see is what you get

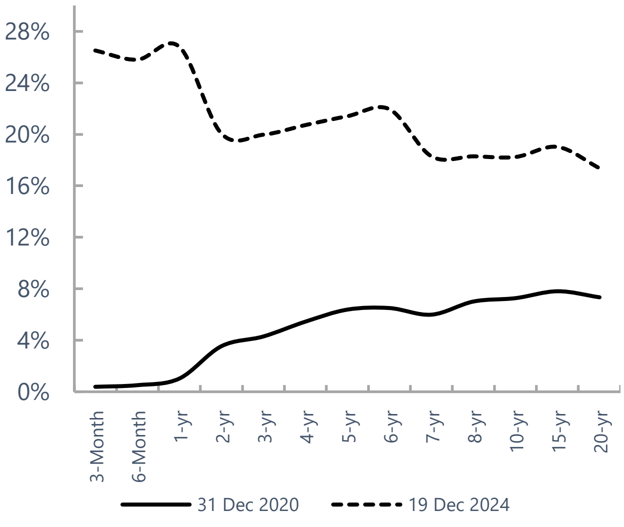
As the CBN simultaneously raised its Monetary Policy Rate and raised the yield of 1-year T-bills at auction, the MPR and 1-year T-bill rates began to match each other during 2024. Note that at the beginning of 2024 the 1-year T-bill rate in the secondary market was 11.77% pa while the MPR was 18.75%. By year-end the 1-year T-bill rate in the secondary market was close to 26.00% and the MPR was 27.50%. The proximity of the MPR and 1-year T-bill rates has the advantage, in our view, of presenting investors and other market participants with clarity. Nowadays, what you see from the CBN is what you get.

Nigeria Government T-bill and bond yield curve – over 1 year



Sources: FMDQ, Coronation Research

Nigeria Government T-bill and bond yield curve – over four years



Sources: FMDQ, Coronation Research

On several occasions in 2024 the CBN has issued its Open Market Operation bills (OMO bills) and it appears that recent months have seen an enthusiastic level of take-up of these by foreign portfolio investors (FPI). Stop rates (or discount rates) at auction for 1-year OMO bills have been as high as 23.98%, implying an annual yield of 31.54%.

Pain in the bond market, 2020-2024

Over a four-year period the Nigerian Government T-bill and bond yield curve has changed from an upward slope to a downward one, the latter sometimes known as yield curve inversion. Yield curve inversion is generally associated with an anti-inflationary stance by monetary authorities and sometimes linked to the onset of recession (which does not appear to be the case in Nigeria today).

As market interest rates have risen across all durations over the past four years, including 2024, mark-to-market prices of FGN bonds have fallen. Prices of the longest-dated bonds have been most susceptible. A sensible strategy for a bond fund has been to hold overweight positions in the short-dated durations least susceptible to mark-to-market price corrections as interest rates rise. Conversely, sponsors of registered Naira-denominated funds have been able to market the superior yields of these funds as rates have increased recently, a tactic used by those that do not highlight their mark-to-market results. Our sense is that the market is ready for mark-to-market reporting, which is the international standard, and will be more receptive to it if rates begin to fall – as we believe they will – during 2025.

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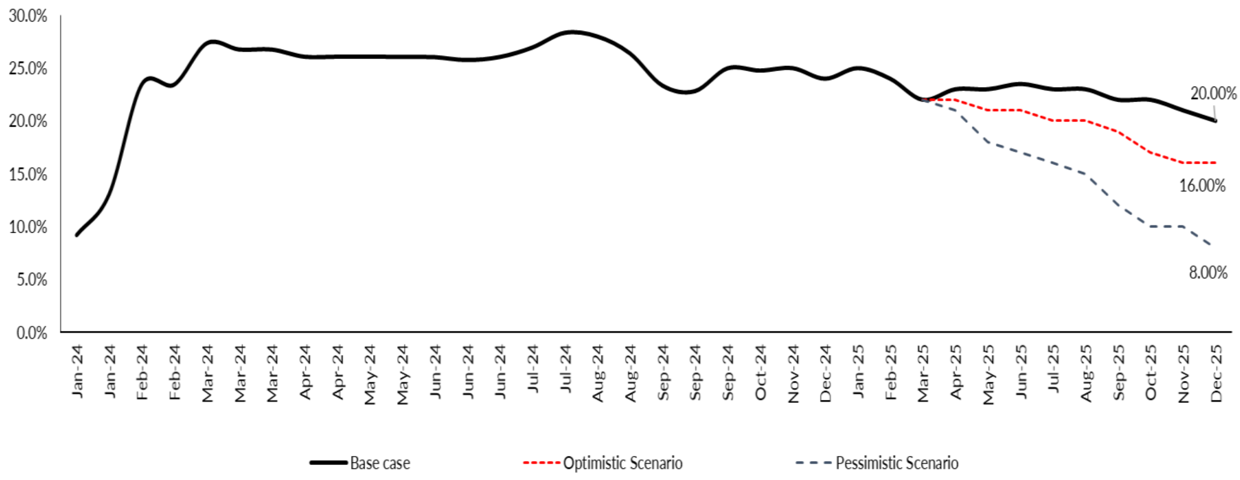
Naira fixed income

Scenarios for 2025

Now that the MPR and T-bill rates are broadly aligned, and assuming that the CBN intends them to move in step going forward, we can begin to forecast T-bill rates in 2025 in line with our inflation and MPR scenarios.

Our base case for 2025 (to which we assigned a 65% probability) that T-bill rates are set to be kept fairly high for at least the first half of 2025, with scope to cut T-bill auction rates in the second half of 2025 if it appears that inflation is being brought to heel. We think that the scope for these positive developments is likely to increase in Q4 as we believe the drivers of inflation are likely to weaken then. Our base case is for 1-year T-bill rates to be priced a little lower than the inflation rate, coming down to 20.00% by December 2025 .

1-year T-bill rates, starting in January 2024, and forecasts for 2025



Source: FMDQ, Bloomberg, Coronation Research

There is also a possibility (base case-related) that both the MPR and T-bill rates are kept a little higher than inflation, possibly in Q4 2025, which would mean that 1-year T-bill rates would be higher than inflation for the first time since 2019. This would have the potential to encourage Nigerian investors to make significant investments in money market mutual funds and fixed income (FGN bond) funds.

Our optimistic scenario (25% probability) is based on the Naira strengthening against the US dollar and a sharp fall in inflation (to 18.00% by year-end 2025), with 1-yr T-bills ending the year at some 16.00% pa. Our pessimistic scenario (10% probability) is that the CBN abandons its semi-orthodox approach, adopts a pro-growth monetary policy (with all the attendant risks to inflation) and allows T-bill rates to fall to 8.00% by the end of 2025.

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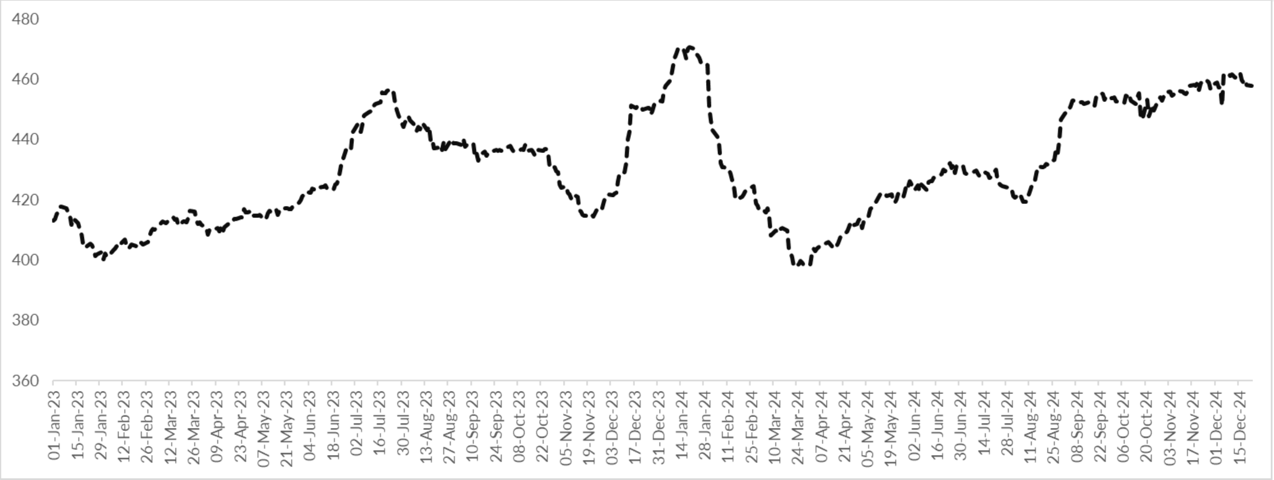
Naira Fixed Income

A bond market rally in 2025?

What are the prospects for the FGN Naira-denominated bond market in 2025? As we have seen, there was considerable pain in the bond market during the period from 2020 onwards, including 2024. Taking the Bloomberg Nigerian Local Currency Sovereign Absolute Return Index, which is based on a selection of medium and long-dated FGN bonds, recent returns have been poor. The index has returned just 10.8% in Naira over the past two years and a meagre 1.4%, mark-to-market, in 2024.

2025 could see a reversal in fortunes, in our opinion. If, as we expect, the monetary authorities succeed in bringing inflation under control as the year progresses, with the chances of this increasing in Q4 2025 in our view, then there will be scope for the MPR to be cut and T-bill rates to fall.

Bloomberg Nigeria Local Currency Sovereign Absolute Return Index, January 2023 to December 2024



Sources: Bloomberg, Coronation Research

If this happens then we would see a rally in the FGN bond market. While bond rates were going up in 2024 it made sense to cut exposure to long durations and to increase exposure to short durations. The reverse would be true if market interest rates start to fall in 2025 and risk-tolerant investors would buy long-dated FGN bonds.

Bond rallies are often associated with currency appreciation. If our optimistic scenario with regard to the Naira/US dollar exchange rate is realised, then this could itself point to a bond market rally. But, even if there is no actual Naira/US dollar appreciation in 2025, which is what our base case sets out, we believe that there would still be potential for a bond market rally if inflation is brought under control and the CBN is able to cut rates.

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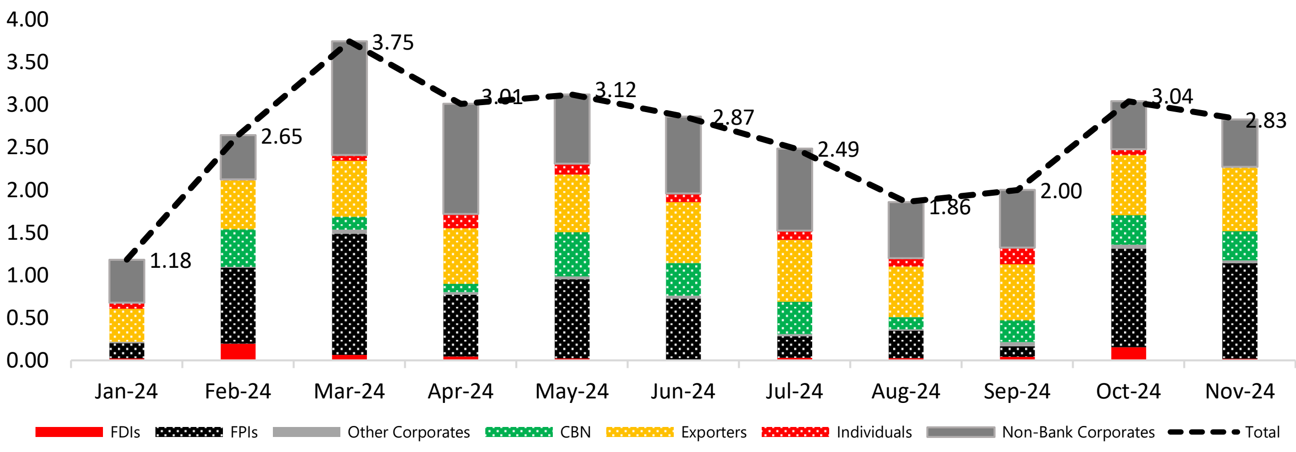
The exchange rate

A better year for the Naira

Pessimism regarding the Naira/US dollar exchange rate can be overdone. Although most years see the Naira depreciate against the US dollar (this is true over the past half century) there are years when it either stabilises or even appreciates. The behaviour of the parallel market Naira/US dollar rate in 2017 is an example of appreciation.

The fair value of the Naira against the US dollar is not the subject of this section. Fair values, which are generally derived from a calculation of inflation differentials between the US dollar and the Naira, and which were calculated in a range of N800 to N1,100 during 2023, were easily bypassed in 2023 when the US dollar value of the Naira fell 49.1% from US$1/N461.5 (0.22US cents) to US$1/N907.1 (0.11US cents), and again in 2024 when it fell 41.0% from US$1/N907.1 to US$1/N1,538.5 (US0.06 cents) on 27 December. We learned that what matters is not fair value but supply and demand.

Sources of monthly inflows of FX to the NAFEM market, US$ billions



Sources: Central Bank of Nigeria, Coronation Research

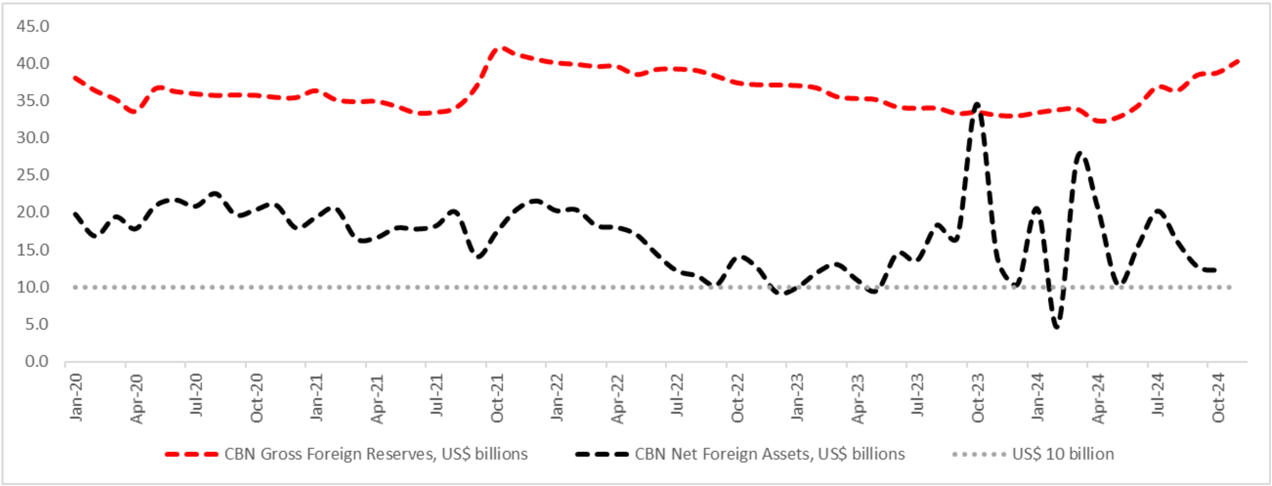
So, what is being done to supply US dollars to the Naira/US dollar market? The CBN gives regular breakdowns of the sources of supply of US dollars to the NAFEM market, as shown in the chart. (There is no such data for the parallel market.) The introduction of the Electronic Foreign Exchange Matching System (EFEMS) in November 2024 improved visibility in the NAFEM market and is likely stimulating flows.

The CBN's data show that its own supply of US dollars to the NAFEM market has been quite moderate in 2024, averaging some US$280 million per month up to the end of November. (By contrast the contribution of the CBN to the then NAFEX market reached as high as US$1.0bn per month during 2019.) The contribution from exporters has been quite consistent during 2024 at a monthly average of US$645m, while the contributions from foreign portfolio investment (FPI) has been volatile from month to month.

Foreign portfolio investors' contribution of US dollars to the NAFEM market was strong in March but declined thereafter. However, in October and November, and likely influenced by the upbeat report in the World Bank's Nigerian Development Update (NDU), FPI picked up again, reaching over US$1.0bn in each month.

Further evidence of foreign investors' interest in Nigerian debt instruments is suggested by the high level of participation in the CBN's auction of Open Market Operation (OMO) bills in December. These are typically purchased by foreign investors as well as by domestic banks. We think it possible that January and February 2025 will see a high level of purchases of Nigerian T-bills and OMO bills by foreign investors.

CBN Gross Reserves and CBN Net Foreign Assets, US$ billions



Sources: Central Bank of Nigeria, Bloomberg, Coronation Research

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The exchange rate

As foreign investors sell US dollars to purchase Naira-denominated T-bills and OMO bills we would expect the US dollar position of the Central Bank of Nigeria to improve. The published gross reserves of the CBN rose from US$32.7bn in mid-April 2024 to just over US$40.0bn in December. Yet this is a gross figures (as well as a three-month rolling average) that does not take into account the CBN's US dollar obligations.

Can the CBN supply more US dollars to the market?

A better idea of the CBN's position is given by its own data for its Net Foreign Assets. These can rise and fall quickly and have been particularly volatile since mid-2023. Our explanation is that the rise in Net Foreign Assets in mid-2023 was associated with the removal of petroleum (or PMS) subsidies (which turned out the be partial: full removal was not achieved until September 2024), and the removal of fuel subsidies saved the public sector significant sums of US dollars, causing the level of Net Foreign Assets to rise.

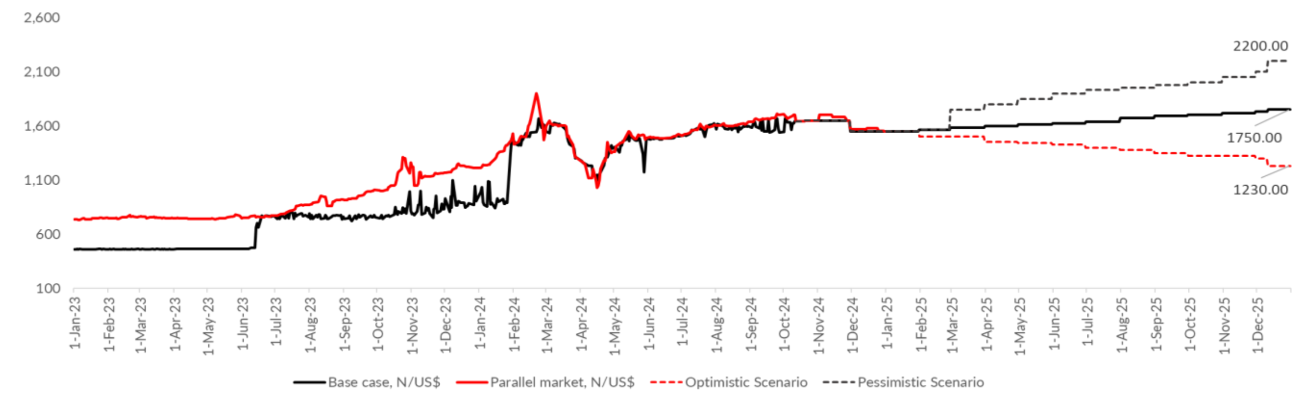
The CBN by then had already embarked on a policy of rectifying the backlog of US dollars due to foreign airlines, shipping companies, investors and other parties, a sum that was generally understood to be around US$7.0bn. The repayment of part of these sums would have caused the level of Net Foreign Assets to fall again. This process has been repeated several times. We believe that the bulk of the backlog has been cleared at the end of 2024.

Forecasting the level of the CBN's Net Foreign Assets is important, because it gives us an idea of how many US dollars the CBN has at its disposal in the event that it decides to increase the supply of US dollars to the NAFEM market in 2025. Its moderate supply of US dollars to the NAFEM market in 2024 suggests parsimony (we mark the US$10.0bn level as a possible lower tolerable limit of Net Foreign Assets in the chart on the previous page). In 2025, in an optimistic scenario, it could supply much more than in 2024, and cause the Naira to appreciate, with positive knock-on effects on imported inflation.

Forecasting the level of the CBN's Net Foreign Assets is also very difficult. We think that recent purchases of T-bills and OMO bills, together with the Federal Government of Nigeria's US$2.2bn issue of Eurobonds in early December 2024, have contributed significantly (data is published with several months' lag). Against this, one has to consider recent reports that the Nigerian National Petroleum Corporation owed US$6.2bn to its suppliers (for purchases of petroleum and other products) which presumably will inhibit the CBN from receiving the proceeds of the NNPC's earnings for a while. (More recent reports put the NNPC's outstanding bill at close to US$3.0bn.) Our sense is that the inflows of US dollars into the accounts of the CBN are improving, while the large obligations may not arise at the same rate as before. This opens up the possibility that the Net Foreign Asset position of the CBN may improve significantly in 2025.

Scenarios for 2025

Naira/US dollar in the NAFEM market, starting in January 2023 and with scenarios for 2025



Sources: CBN, FMDQ, Bloomberg, Coronation Research

Our base case scenario (65% probability) for the Naira/US dollar exchange rate in 2025 is for gentle Naira depreciation. This scenario is consistent with a continuation of tight monetary policy during 2025, though with some easing during the second half of the year as inflation is tamed. We see the US dollar value of the Naira falling by 11.7% over the course of the year to US$1/N1,750. A key feature of the base case scenario is that the yield of 1-year T-bills and of OMO bills would exceed the potential for Naira/US$ devaluation. This scenario would suggest holding such Naira-denominated securities rather than risk-free US-dollar denominated securities.

Our optimistic scenario (25% probability) has the US dollar value of the Naira actually appreciating by 25.7%, influenced by strong flows of both FPI and the CBN's US dollars into the NAFEM market, to US$1/N1,230 by year-end. Our pessimistic scenario is for a 29.7% fall in the US dollar value of the Naira to US$1/N2,200, consistent with an abandonment of tight monetary policy.

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Fiscal policy

The Federal Government's proposed budget for 2025 is 36.64% larger than 2024's budget, and this is a bigger increase than inflation (34.60% y/y). Revenues will not catch up, so the Ministry of Finance plans a 42% increase in the deficit, meaning that the government will increase it dependence on borrowing. Costs will be borne by consumers and companies directly, in the form of elevated taxes. And they will bear the cost indirectly by paying more for fuel (from October 2024 onwards) in place of receiving fuel subsidies. The price of reforming public finances is a high one.

Expenditure, Naira billions

Naira billions	2024 NASS* Approval + Amendment	2025 Budget Proposal	change
Statutory Transfer	1,743	4,259	144%
Debt Service	8,047	15,384	91%
Sinking Fund	224	430	92%
Recurrent (non-debt)	11,269	14,213	26%
Capital Expenditure (Exclusive of Transfers)	13,773	13,615	-1%
Total FGN Budget (including GOEs & Project-tied Loans)	35,056	47,901	37%

*Source: 2025-2027 Medium Term Expenditure Framework and Fiscal Strategy Paper, Budget Office of the Federation *National Assembly NB GOE stands for Government-Owned Enterprises*

It is tempting to think that government has exempted itself from the reform program by proposing an inflation-plus budget, but the first thing we notice about 2025's expenditure plan is the near-doubling of the Debt Service item (+91% y/y). This makes perfect sense because market interest rates have more than doubled this year and, we believe, the CBN will keep them high for at least the first part of 2025 as part of its fight against inflation. More debt will be required next year, too. Secondary-market 1-year T-bill yields, which we use as a guide to the government's cost of debt in Naira, began 2024 at 11.77% and are around 26.00% now.

The next thing we notice is the 26% increase in Recurrent (non-debt) expenditure, an increase lower than the rate of inflation. Certain regional funds will receive much more than this in the form of the Statutory Transfer. Capital Expenditure is to be kept essentially flat, which means a significant reduction in inflation-adjusted terms.

Revenue, Naira billions

Naira billions	2024 NASS Approval + Amendment	2025 Budget Proposal	change
Share of Oil Revenue	8,176	19,602	140%
Dividends	358	686	92%
Share of Minerals & Mining	5	15	240%
Share of Non-Oil Taxes	3,521	5,708	62%
NPTF Levy	0	2	n/a
Share of Electronic Money Transfer Levy*	24	32	31%
Share of oil price royalty	24	361	1393%
Revenue from GOEs**	4,854	4,070	-16%
GOEs operating surplus	(1,992)	(1,199)	-40%
Independent Revenue	2,692	3,465	29%
Draw-down from special levies accounts	300	300	0%
Signature Bonus	251	0	n/a
Recoveries + Asset + Fines	0	83	n/a
Grant and Donor Funding	686	711	4%
Education Tax (TETFUND)	700	990	41%
Additional Revenue to fund 2024 Budget	6,278	0	n/a
Amount available for FGN Budget (including GOEs)	25,877	34,826	35%

*Source: 2025-2027 Medium Term Expenditure Framework and Fiscal Strategy Paper, Budget Office of the Federation *Formerly known as Stamp Duty **Government-Owned Enterprises*

Revenues are not set to rise as fast as expenditure, with a 35% increase planned. The most obvious change is the Share of Oil Revenue which is planned to rise by 140%. Of course, if the government is not paying fuel subsidies, then net revenues from oil will rise considerably.

The government's annual deficit is planned to rise by 42% year-on-year, from N9.2 trillion to N13.1 trillion (US$8.5bn). This will require extra borrowing. This is not the typical initiative of a reform-minded administration although, as already noted, the rise in interest costs is the major source of the problem and it cannot be avoided if the CBN's interest rate regime is to continue. To an extent this allays fears of the 2025 budget being an inflationary budget as incremental debt service costs are to be transferred to savers, for the most part, in the form of pension funds, mutual funds and foreign investors.

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Fiscal policy

The government will need to lean heavily on the domestic T-bill and bond markets in 2025 as well as increasing its reliance on loans from commercial banks (which poses the problem of crowding-out of private-sector borrowing in 2025). The government will also be borrowing from supranational agencies such as the World Bank (which completed the second tranche of a US$1.5bn loan to Nigeria in November 2024), and from foreign investors in terms of sales of T-bills and other securities.

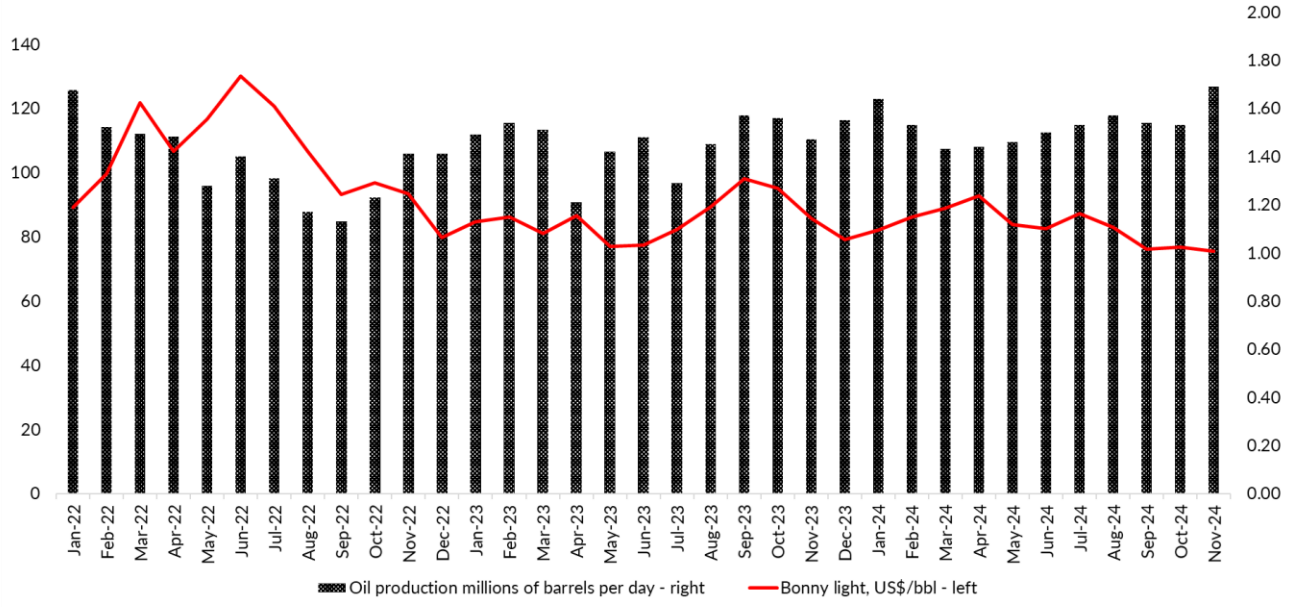
One significant factor in the government's favour is the fact that it is not itself a large player in the Nigerian economy. Unlike developed economies, where total government expenditure represents perhaps 35%-45% of GDP, the Nigerian government's expenditure in 2024, at N35.1 trillion (US$22.6bn), represents some 20% of nominal GDP. A sizeable percentage increase in the budget of a developed nation would have far higher inflationary effects than in a country like Nigeria, in our view.

The government's assumptions behind its 2025 proposed budget include an oil price of US$75.00/bbl, inflation at 15.9% and an exchange rate of US$1/N1,400. These resemble to some extent our optimistic scenarios for 2025 (albeit with an even lower inflation forecast). While we can call the government's assumptions optimistic, we cannot call them unreasonable, given our own forecasts.

The oil factor

As the proposed budget makes clear, oil revenues are to play a key role in 2025, and this brings into question the trend in oil prices and Nigerian oil production. The good news is that Nigerian oil production is trending upwards, likely as a result of the separation of onshore and shallow-water facilities, which tend to be owned by indigenous companies, from deep offshore facilities, where international oil companies (IOC) predominate. Oil production rose from an average of 1.38 million barrels per day (mbpd) in 2022 to 1.46mbpd in 2023 and averaged 1.53mbpd during the period January to November 2024. We believe similarly high levels can be produced in 2025.

Nigerian oil production, millions of barrels per day, and Bonny Light prices, US$/bbl



Sources: Nigerian Upstream Petroleum Regulatory Commission (NURPC), CBN, Bloomberg, Coronation Research

The bad news is that oil prices are trending downwards. The average price of Bonny Light was US$85.21 during 2023 but US$83.14/bbl during 2024, with October and November seeing an average price of US$76.07/bbl. We this number, or quite possibly a number a little above US$70.00/bbl, as representative of average prices during 2025, given the reversal of previous production cuts by OPEC members, the pro-oil production stance of the incoming Trump administration in the US, and a weak economic outlook for China. Nigeria may face a degree of challenge in attaining its budgeted oil revenues in 2025, in our view, though not to the extent that this would challenge the assumptions behind the forecast scenarios in this report.

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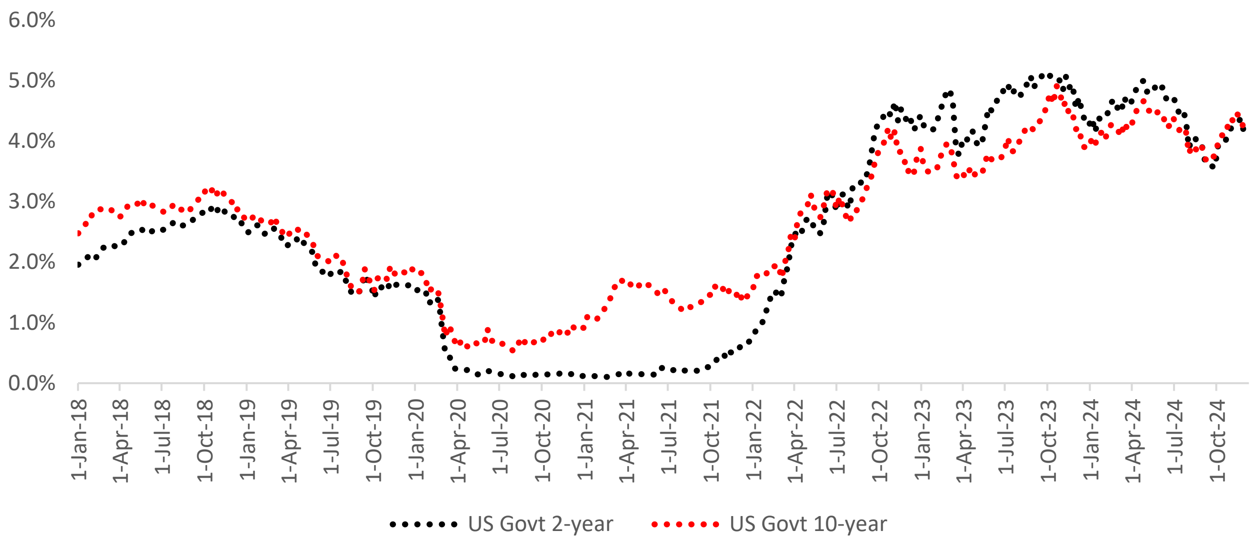
US dollar bond rates

Not everything is perfect with Nigeria's financial variables. In a perfect situation US interest rates would be low, with the yields of US government bonds at about 2.5% pa (as they were in 2018 and 2019). Low US interest rates would encourage international investors to borrow US dollars in order to invest in high-yielding Naira-denominated government securities (e.g. OMO bills, T-bills and FGN bonds). This was the key feature of the so-called carry trade that brought tens of billions of US dollars into Nigeria in past years.

US dollar risk-free rates since 1 Jan 2023



Sources: Bloomberg, Coronation Research

As things stand, we believe conditions are good enough. US government bond yields are low enough to make Naira-denominated yields appear attractive to risk-tolerant international investors: it is just that there would be more foreign investment (in OMO bills, T-bills and FGN bonds) if US rates were lower.

Our core view is that Nigeria is currently attractive to international investors. We believe that there is a high level of Foreign Portfolio Investment (FPI) coming it at the moment, evidenced by high levels of FPI that came into the NAFEM market during October and November and a large OMO bill auction in December. And we think there is a reasonable probability of significant flows (and by significant we mean over US$4.0bn over two months) during January and February 2025.

These have the potential, when combined with the US$2.2bn of Eurobonds issued by the FGN in December 2024, to swell both the gross foreign exchange reserves and the Net Foreign Assets of the Central Bank of Nigeria during the early part of 2025.

The US dollar. A store of value?

Why are US interest rates high in comparison with a few years ago, and how long will they stay this way? The answer lies in the generous fiscal response to the Covid-19 pandemic in 2020 and the fiscal stimulus of President Joe Biden's administration. These both increased US dollar liquidity without, necessarily, a corresponding rise in output.

Going forward, the incoming administration of President Donald Trump is committed to high tariffs on imports into the US and removing illegal immigrants (who supply the US economic with cheap labour). Both policies are inflationary, so US bond markets are pricing only moderate cuts in the Federal Funds target rate of 4.50% (we cite the upper limit of the range here) in 2025.

There are two significant consequences of this. If one believes that US inflation ultimately can be brought back close to the target of 2.0% pa, then risk-free US government bonds offer a store of value. This is why the US dollar is strong relative to emerging market currencies. Second, and because all US dollar-denominated Eurobonds are priced at a spread over US government bonds, the yields of Eurobonds of emerging market sovereign nations are also attractive. As mentioned above, this enabled Nigeria to issue US$2.2bn in Eurobonds in December.

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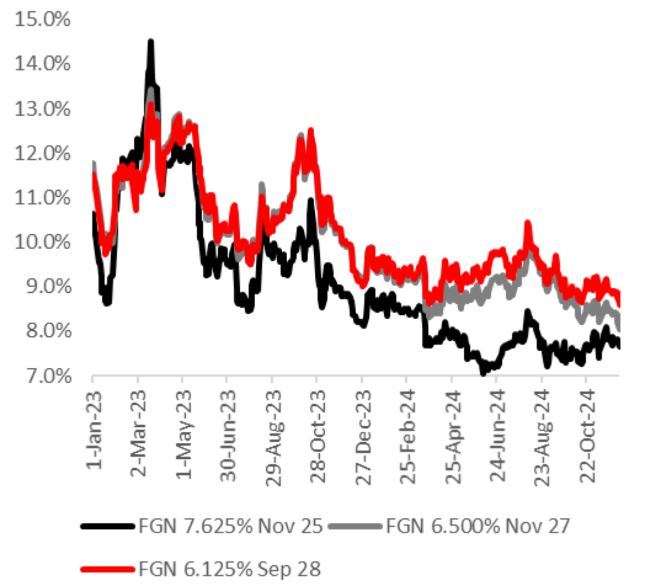
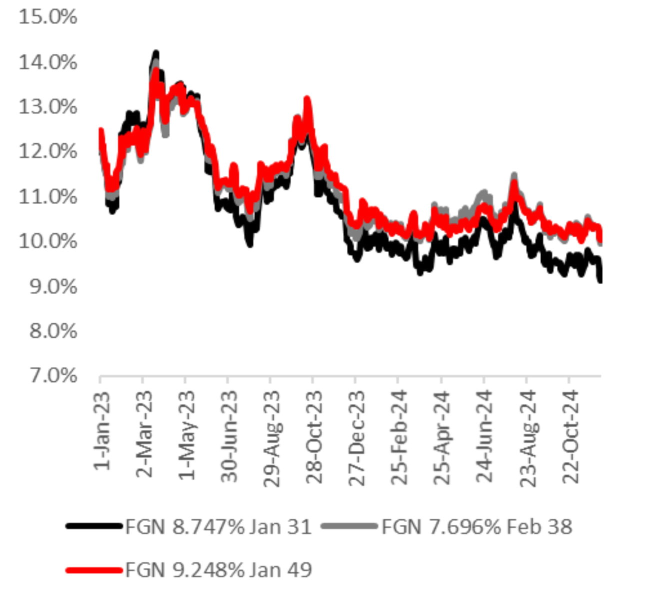
FGN Eurobonds

Nigeria's sovereign Eurobonds have been a success story throughout the turmoil of the past few years. Maturing Eurobonds have been paid back, yields have trended down. Early in December 2024, and after a long absence from the new issue market, the Federal Government of Nigeria issued two Eurobonds, a US$700m issue with a coupon of 9.625% maturing in 2031 and a US$1.4bn issue with a coupon of 10.375% maturing in 2034.

Selected FGN Eurobond yields, short-to-mid maturities



Selected FGN Eurobond yields, mid-to-long maturities



Sources: Bloomberg, Coronation Research

After the announcement of the government's reform program in late May 2023 investors became more enthusiastic about FGN Eurobonds, and yields trended down. In July and August 2024 yields moved back up again, a move which we attribute to several negative news items around that time, namely the announcement of an increase in the minimum wage, the announcement of a supplementary budget of N6.6 trillion for 2024, and a report from Fitch Ratings that took its rating of Dangote Industries from AA to B+.

After that, progress with the reform program, notably further raising of Naira interest rates and the removal of fuel subsidies in September, enthused the market again. Prices recovered, yields fell and the Debt Management Office of the Federal Government made its two issues in early December. The pricing of these issues, with the coupons at approximately 550 basis points above US Government bonds, was in line with earlier FGN issues, in our view.

We think that FGN Eurobonds represent good value for investors, though to keep risks low we prefer short durations to long ones. We favour the short-dated November 2025 bond with a mid-yield of 7.97% and the November 2027 bond with a mid-yield of 8.45%.

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Risks

External, global economic and policy risks

Risks to the forecast scenarios presented in this report are manifold. In essence, the preparation of these scenarios follows recent trends in economic, monetary and fiscal policies, and projects their possible effects onto exchange rates, inflation, the Monetary Policy Rate and 1-year T-bill yileds in 2025, assuming that these policies continue to be consistently applied. In fact, several factors could change their course.

External risk exists in the form of extraneous events (such as the Covid-19 pandemic in 2020) that could introduce factors that necessitate a change in economic, monetary or fiscal policy, or any combination of the three. Nigeria's public finances are susceptible to both oil prices and the levels of oil production in the country and a deterioration in either price or production could undermine the assumptions behind the forecast scenarios in this report. Nigeria's economy is also sensitive to prices of imported goods, including food commodities such as wheat.

The assumptions behind the forecast scenarios in this report depend on a positive outlook for global economic growth in 2025 and for moderate changes in global interest rates, US interest rates in particular. Any significant change in global growth as a result of unforeseen events, and a sharply upward movement in US interest rates, could affect the global investment flows on which Nigeria's public finances depend, and therefore undermine the assumptions behind our forecast scenarios.

The reform process in Nigeria's public finances has been in place since mid-2023, and in our opinion has gathered pace during 2024. As is the case with any country enacting far-reaching monetary reforms, there is typically a small group of central bank and government officials enacting reform relative to a large number of people who may feel the pinch from tight monetary policy. Political risk, as is the case with any country, is a factor to take into account. A change in the essential policies of Nigeria's reform program could undermine the assumptions made in this report and, for example, could increase the probability of our pessimistic scenarios being realised.

Nigeria's public finances depends on both domestic investors and international counterparties, notably supra-national agencies and private-sector investors, for continued investment. Their continued confidence is important to the success of the reform program in 2025 and forms an assumption underlying our forecast scenarios.

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