BNY MELLON

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MACRO MORNING BRIEFING

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Diversifying Into African Growth

Sub-Saharan Frontier FX seeing renewed interest

- We expand coverage of frontier market currencies to sub-Saharan Africa
- KES and GHS flows have reached multi-year highs
- Nigeria one of the strongest markets for asset allocation year-to-date

Diversification and demographics, underpinned by real rates

Africa will likely be a centre of attention in coming days as results from what could be the most consequential election in South Africa since the end of apartheid come through. Over the past few weeks, we have observed notable shifts in asset flows for the country; to be sure, exposures have ebbed and flowed according to changes in polls. There is a pressing need for reform, but its realisation will depend on the make-up of the next government.

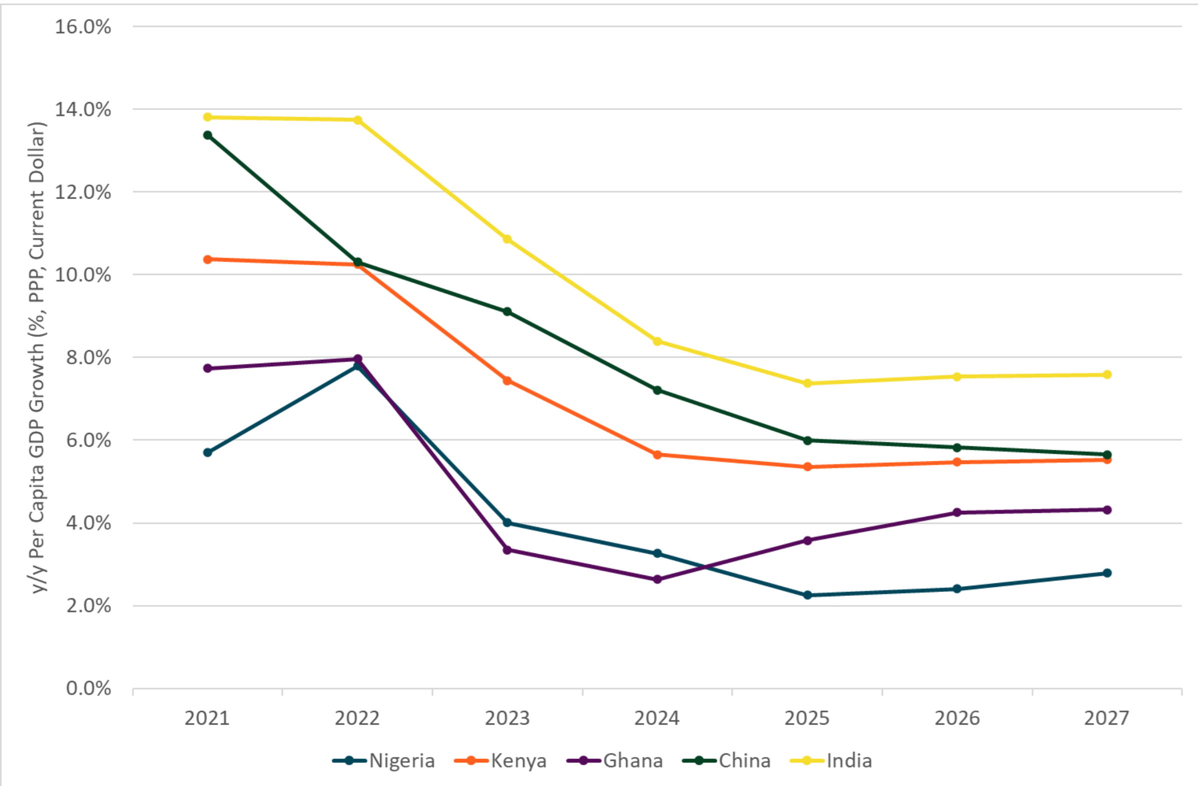
The importance of South African assets in global emerging market (EM) benchmarks is well-established. Irrespective of the election outcome, we see EM likely to continue to struggle in the near term due to the pressures arising from elevated dollar rates. The month-end move in yields has tightened financial conditions even further. Strong performance of EM assets due to heavy under-allocations has been one of our core themes of 2024, but it has been strongly challenged by a ‘higher for longer’ outlook for the Federal Reserve.

Nonetheless, the extent of over-positioning in US assets means that diversification needs are still in place. If EM is too exposed to dollar real yields, especially when much of EM itself is now going through an easing cycle ahead of the Fed, then opportunities will lie in economies which are similarly under-positioned, have even higher real rates, or are undergoing structural re-rating. In March, markets saw how devaluation and reform in Egypt pushed its bonds towards the top in iFlow. At present, something similar is happening to Turkey as reform credibility strengthens. Diversification is leading investors increasingly into frontier markets, to the extent that there is now sufficient data density within our custody transactions to generate viable time series. The region which is clearly outperforming on both an absolute and relative basis is sub-Saharan Africa (SSA).

In addition to existing data available for South Africa's rand (ZAR), we can now track developments in Nigeria's naira (NGN), Kenya's shilling (KES) and Ghana's cedi (GHS), after some degree of data smoothing of transactions. The long-term macro case for the region has always been clear, but it's no longer about simple resource plays. Investors are now acutely aware of global demographic pressures and SSA appears the only region which can maintain demographics as a positive driver of potential growth over the long term. However, there are many caveats to the story which have traditionally inhibited flows. On a practical level, South Africa’s financial infrastructure and general adherence to market-based price discovery is the exception on the continent. Elsewhere, capital and exchange controls have come and gone, and the lack of consistency can serve as a deterrent to long-term investors. Depth of capital markets is another factor, though we stress that all three countries have equity markets which are open to international investors.

As much as demographics can drive aggregate GDP growth, total factor productivity is lagging across the region and preventing countries from reaching their full growth potential. Based on the IMF’s current long-term forecasts, per capita GDP growth (in PPP terms) in Nigeria, Kenya and Ghana is still expected to lag China and India – whose corresponding growth rates are expected to continue declining. Ghana is the only country expected to register higher growth rates in the coming years (exhibit #1).

Exhibit #1: Expected Growth Rates: SSA3, China, India

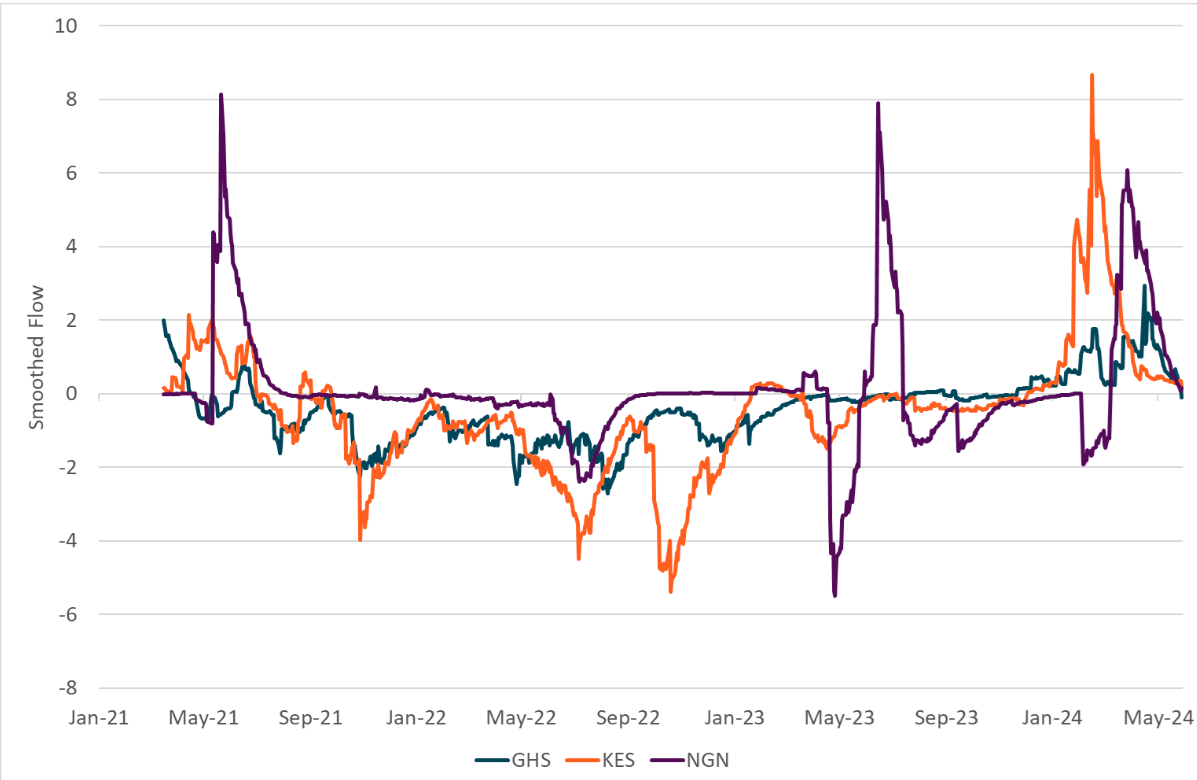


Source: IMF, BNY Mellon

Investors may cite the need for structural reforms before increasing allocations, but arguably foreign investment is needed in the first place to create fiscal and policy space to push through such reforms without generating excessive pressures on the population. Before the pandemic, multilateral aid and private- and sovereign-backed direct investment may have been the dominant drivers of the financial account in the past. In the current environment, high dollar rates and the need to conserve resources for domestic purposes (especially for China) means there will be greater reliance on portfolio flows. Realising reform is a sufficient condition for reallocations, especially if endorsements from ratings agencies are forthcoming, which we have seen in Nigeria. However, having firm central bank credibility through high nominal and real rates is also necessary. Probably to the surprise of asset allocators, frontier markets have generally held firm in that respect throughout the current Fed cycle.

Since the Fed peaked in July last year, Nigeria has raised rates by 600bp and Kenya by 250bp. Ghana cut by 100bp at the beginning of the year, but this was after a cumulative 15.5ppt in hikes between 2022 and 2023. Ghana's policy rate continues to stand at a region-high of 29% – around 400bp above the annualised inflation rate. The market is clearly still willing to reward hikes or high absolute rates, and we can see in exhibit #2 that KES, GHS and NGN have all performed very strongly year-to-date as a result.

Exhibit #2: SSA3 Smoothed* Currency Flow

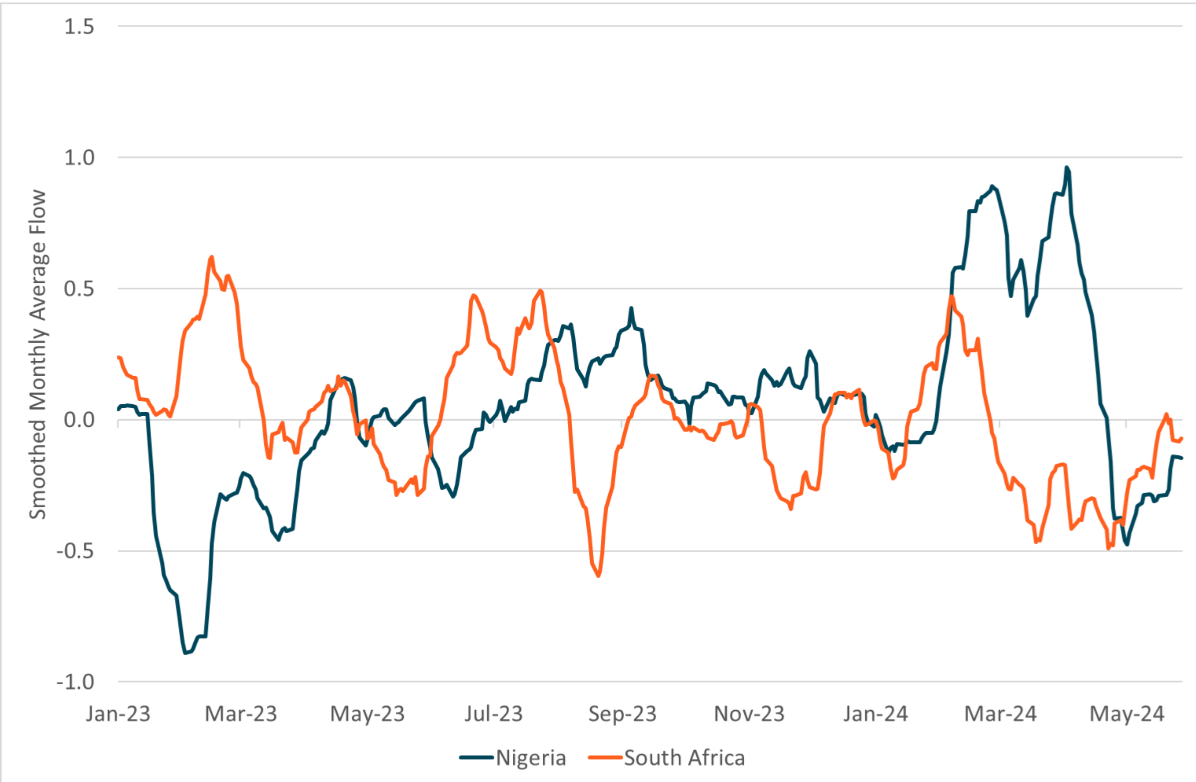


Source: BNY Mellon; *aggregating daily flows and applying Gaussian Moving Average (GMA) with a 65-day window and 20-day half-life

As the Fed's current outlook remains in flux but seems leaning towards 'higher for longer', flows into these currencies, as well as into the likes of EGP (even BRL), have tailed off. But no signs of liquidation for now indicates that the market is content to hold such 'frontier diversification'. The small size of these countries' capital markets also means that the tracking error impact will be manageable, even with outsized flows by historical standards. Nonetheless, to ensure the longevity of flows, reform credibility remains paramount.

While flows into Nigeria bonds peaked (exhibit #3), the reverse was taking place in South Africa bonds as polling pointed to an election outcome seen as 'market unfriendly'. We fully acknowledge that the allocation path will not be smooth and subject to various factors, but strengthening domestic reforms is the best defence against external shocks. Referring back to exhibit #2 again, it shows that GHS, KES and NGN faced strong outflows in 2022 due to the global interest rate shock and geopolitical turmoil.

Exhibit #3: Fixed Income Flow, Nigeria vs. South Africa

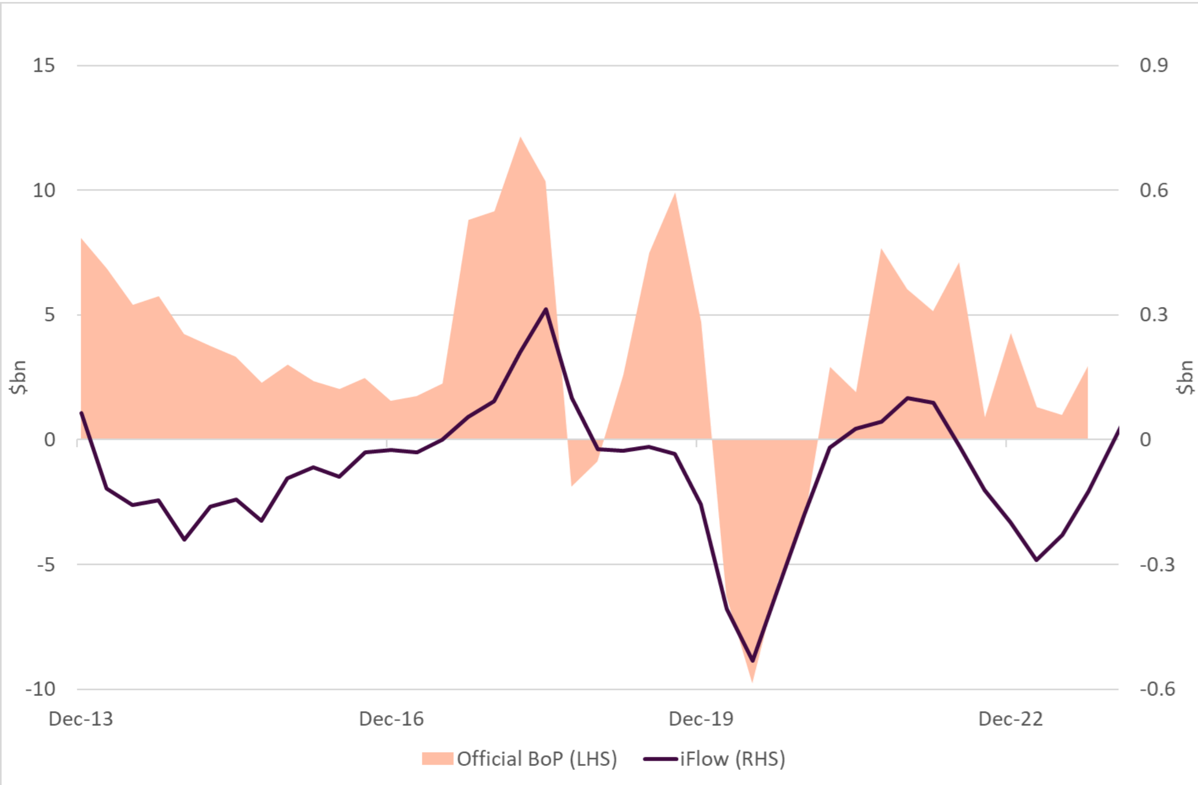


Source: BNY Mellon

Of these three economies, Nigeria is the largest in size and the only financial market for which we have strong enough transaction data in bonds to create an iFlow balance of payments proxy (exhibit #4). The investment cycles do match each other well and we can see that the last round of strong inflows was also during the immediate post-pandemic period when developed market rates converged to zero. Flow momentum has clearly fallen over the last two years and domestic stability is also a factor. But even the Fed's tightening cycle has not generated a period of net outflows in bonds over a four-quarter window, as of Q3 2023. Our data indicate that momentum has picked up further and we expect official data to reflect up to two further quarters of inflows.

If the Fed does begin easing in H2, in line with our expectations, we think the investment environment can only strengthen for Nigeria and other frontier markets. Maintaining high real rates and furthering reform agendas will help sub-Saharan Africa to continue standing out in a crowded field of diversification candidates across both emerging and frontier markets.

Exhibit #4: Nigeria Official Portfolio Flows* vs. iFlow Proxy



Source: BNY Mellon; *bonds only

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