MERISTEM

Ahead of MPC

May 2020

Committee Set for Crucial Third Meeting

…Parameters to Remain Unchanged

The Monetary Policy Committee (MPC) is scheduled to hold its third meeting of the year on the 28th of May 2020. The deliberations at the meeting are expected to focus on analyzing the recent developments in the global economy in line with the existing monetary policy framework, while taking necessary steps to soften the impact of an economic downturn.

One of the major considerations at the meeting will be the assessment of COVID-19 impact on the global economy. Oil prices have taken a beating in recent months due to significantly reduced demand, along with supply side tensions. This poses a major threat to the country's fiscal and monetary stability due to the importance of oil prices to the domestic economy. Furthermore, global supply chain disruptions caused by the virus also pose dire consequences for local producers. We expect these deliberations to be on the front burner as the Committee seeks to proffer policy actions to mitigate their impact on the domestic economy.

Meanwhile, headline inflation has continued to soar, while the restrictions in economic activity due to the spread of the virus has hampered domestic growth. We expect these to be key considerations to the Committee, along with the dearth of liquidity in the FX markets.

With the above considerations in mind, we expect the MPC to keep policy parameters unchanged, while continuing its use of unconventional tools to achieve desired objectives.

International Economies and Developments

COVID-19 Sets the Global Economy on Edge

The IMF has forecasted a 3.00% YoY contraction in the global economy (much deeper than the 0.10% contraction recorded during the 2008 financial crisis) as the economic impact of the COVID-19 pandemic reverberates across the world. Interestingly, the IMF expects the advanced economies to be worst hit, with a projected contraction of 6.10%, compared to 1.00% in Emerging markets and 1.60% in Sub-Saharan Africa. In the United states, GDP contracted by 4.80% in Q1:2020 as the lockdown precipitated a slump in private consumption (-7.60%), with the rattled business environment inciting massive layoffs (20.5 million job losses in April). In its efforts to

mitigate the economic impact of lockdowns caused by the Pandemic, the Federal Open Market Committee (FOMC) at its April meeting stated its commitment to employ more quantitative easing mechanisms. It also maintained its target range for the federal funds rate between 0.00% - 0.25%. In tune with the Fed, the US Congress passed its fourth economic relief package totaling USD484.00bn in April, which was targeted at shoring up the Pay-check Protection Programme Fund and providing fund for hospitals

Events in the Euro Zone paint a similar picture, as recently released Q1:2020 GDP figures revealed the extent of the economic impact of the virus on the region. Real GDP contracted by 3.30% YoY, led by Spain (-4.10% YoY) and Italy (-4.80% YoY). The European Central Bank (ECB) reacted by lowering rates on its long-term liquidity auctions, whilst further stating its intention to ramp up its EUR750bn quantitative easing program. Elsewhere in the U.K, declining industrial production (-8.20% in March) and a halt in economic activity continue to weigh heavily on growth. Thus, the Bank of England (BoE) held its policy rate at 0.10% in its last meeting and pledged to continue its GBP200bn bond purchasing program aimed at providing liquidity to businesses in the region. In China, although real GDP contracted by 6.80% in Q1:2020, recent data point towards a gradual economic recovery as portions of its economy begin to reopen. Industrial output in April grew by 3.90% YoY (vs. -1.10% YoY in March), supported by a rebound in energy demand and manufacturing activities. However, retail sales remained downbeat, falling by 7.50% YoY

Monetary authorities around the world have sought to provide succor for their respective economies by utilizing alternative modes of stimulus, as traditional policy tools have proven ineffective in combating the economic effect of the virus. We therefore expect the Committee to tread the same path by keeping policy rates on hold, while channeling its various forms of monetary interventions to critical sectors of the economy.

Demand Problems Outweigh Output Cuts by OPEC+

The global oil market in 2020 so far has witnessed turbulent times due to the demand problem induced by the COVID-19 pandemic. Air travel was shut down, causing jet fuel sales to take a big hit, while lockdowns were imposed across the world leading to reduced use of automobiles and public transportation. OPEC recently cut its 2020 forecast for oil demand by 6.85MMbpd to 92.82MMbpd (vs. initial forecast of 99.67MMbpd), as it expects the reduced economic activity induced by the virus to weigh significantly on oil demand. In China, the impact of the lockdown on transportation and industrial fuel consumption resulted in a fall in the country's oil demand to 10.27MMbpd in Q1:2020 (vs 13.52MMbpd in Q4:2019). Furthermore, the price war between oil majors Russia and Saudi Arabia, precipitated an oversupply

situation in the market which caused a build-up of inventories and a shortage of storage capacity. As a result, Brent Crude and WTI fell to unprecedented lows of USD19.33 and -USD37.63 respectively in late April

OPEC+ and other oil producing nations including the US, returned to the negotiation table in April and agreed to a record output slash of 9.7MMbpd for May and June. The agreed cuts will then narrow to 7.7MMbpd from July to December 2020, and 5.8MMbpd from January 2021 through April 2022. This, along with the gradual easing of lockdowns around the world, spurred a positive rally in oil prices with Brent and WTI gaining 42.78% and 80.04% in May. However, despite this renewed optimism, uncertainties linger as the persistence of the pandemic poses a threat to global economic recovery. In China, while lockdowns were lifted in regions like Wuhan and the Hubei province, the Jilin province is poised for a lockdown – potentially suspending the activities of over 100 million people. The possibility of countries not adhering to their agreed production cuts is another factor to consider. While Nigeria is expected to cut production to 1.41MMbpd, as part of the joint effort to stabilize the global oil market, the country alongside other nations like Iraq are known to go beyond agreed limits.

On the domestic scene, Nigeria was forced to slash its official selling prices to as low as USD14.67pb in April, at the peak of the oil price war. Notwithstanding, the country still faced challenges clearing its inventory of unsold cargoes as other oil majors sold at even much deeper discounts. This pre-empted a revision of the 2020 budget oil benchmark from USD57pb eventually to USD25pb, while oil production benchmark was reduced to 1.94MMbpd. A positive development however was the downward revision of PMS prices from NGN145 per liter to NGN123.50 per liter in April by the PPRA, as the country gradually transitions towards a full deregulation of the downstream sector. This would ultimately eliminate under-recovery expenses and improve cost prudence.

With global oil prices expected to remain downbeat for much of 2020, the outlook for FX revenue from crude oil remains bearish. This poses a significant threat to exchange rate stability as foreign capital inflows have been virtually non-existent.

Domestic Macros

Lockdowns Expected to Stifle Economic Growth

The number of confirmed COVID-19 cases has risen to over 7000 as at 21st May 2020 since the announcement of the index case in February. Within that period, the Federal Government imposed a two-week lockdown on Lagos, Ogun, and Abuja,

which was then followed by another two-week extension, effectively shutting down the economy throughout April. On May 4th, lockdown restrictions were lifted and replaced with a curfew, gradually restarting economic activities.

Much of the GDP growth in 2019 was supported by improvements in both the oil and non-oil sectors of the economy. Growth in the oil sector was predominantly driven by stable production output and favourable prices while the non-oil sector benefited from the CBN's effort to channel credit to the real sector. Now, almost all the fundamentals which supported economic growth are being threatened as the COVID-19 manifests its far-reaching impact on the domestic environment.

The Nigerian manufacturing sector continues to grapple with the adverse effect of the COVID-19 on global supply chains and manufacturing activities. In March, the manufacturing PMI expanded at a much slower pace relative to February while the non-manufacturing PMI contracted for the first time in 34 consecutive months. The manufacturing PMI was reported at 51.1 index points (down from 58.3 index points in February 2020), while the non-manufacturing PMI settled at 49.2 index points (vs. 58.6 index points in February 2020). Although the CBN is yet to release its PMI report for April, we expect the nation-wide shutdown to weigh on manufacturing activities.

We expect the Committee to hold key parameters constant while focusing on implementing measures (such as the intervention funds) to boost real sector output and ease the recessionary impact of the Coronavirus on the economy.

Panic Buying and Higher Input Costs Trigger Inflationary Pressures

The Consumer Price Index (CPI) edged higher by 12.34% YoY for the eighth consecutive month in April 2020, representing an eight basis points (0.08%) increase from 12.26% in March. The upsurge in rate was driven by a combined rise recorded in both CPI sub-components.

The food sub-index increased for the 25th consecutive month to 15.03% YoY (vs. 14.98% in March 2020 YoY). The announcement of a lockdown in Lagos, Abuja and Ogun states triggered panic buying of food stuff and household consumables, thereby resulting in a spike in prices.

Similarly, core inflation showed a significant rise (+25bps MoM to 9.98%) as the impact of the illiquidity in the foreign exchange market and technical adjustment in FX rates weighed on manufacturers' input costs. Rise in the prices of medical services and pharmaceutical products amongst others, pressured the movement in the sub-index.

While price stabilization remains a key consideration for the Committee, we expect the current focus to be on stimulating economic activities, Hence, we expect the Committee to hold rates.

Widening Deficits and the Growth Imperative

The Nigerian economy has been fraught with overreliance on crude oil receipts, increasing the nation's susceptibility to oil price volatilities, and worsened by the absence of fiscal buffers to support growth. These fiscal vulnerabilities have only been accentuated by the COVID-19 pandemic with crude oil prices falling to decades low of below USD20pb. Thus, the Federal Government further revised its 2020 revenue projections downward in the light of this new reality. The revised budget which is subject to the approval of the National Assembly, holds the following key assumptions: Crude oil price of USD25pb (from USD57pb), crude oil production at 1.94mbpd (from 2.18mbpd) and an exchange rate of NGN360/USD (from NGN305/USD). Total expenditure was also reduced by 0.66% to NGN10.52trn while revenue projections were slashed by 38.72% to NGN5.16trn – a significant increase (146.33%) in budget deficit to NGN5.37trn. The FG further posits that the budget deficit would be financed through domestic borrowings and loans from multilateral organizations at concessionary rates. **In our opinion, an expanded budget deficit will further compound the heightened inflationary pressures in the economy, while crowding out private sector investments owing to the increasing (+193.18% to NGN850bn) domestic borrowing component of deficit financing.**

Meanwhile, the Federal Government has already embarked on a number of COVID-19 related spending including the establishment of a NGN500bn COVID-19 Crisis Intervention Fund. The government has taken receipt of the USD3.4bn International Monetary Fund (IMF) facility, aimed at providing Balance of Payment support particularly with regards to obtaining supplies for managing the COVID-19 pandemic in Nigeria. Furthermore, import duty and Value Added Tax waivers were recently granted for critical medical equipment and supplies. **While these are laudable steps taken to ensure the wellbeing of Nigerians, the economic consequences are nonetheless apparent especially as tax revenues are expected to fall significantly due to the slowdown in business activities. We therefore expect the MPC at the upcoming meeting to consider the widening mismatch of receipts to expenditures and its far-reaching implications for economic growth in the medium to long term.**

Politics and Security

The outbreak of COVID-19 and the Federal Government's efforts geared at managing the pandemic has relegated political differences to the backseat. Since the MPC last met in March, the number of confirmed cases has shot up from just 8 to over 7,000

(as at 21st May), including 211 deaths. Notable among those claimed by the raging virus is the former Chief of Staff to the president, Abba Kyari, who died in mid-April, prompting the appointment of Professor Ibrahim Gambari as the new Chief of Staff.

Also, in the wake of the outbreak of the pandemic in Nigeria, the two chambers of the National Assembly are in the process of deliberating the passage of the new infectious diseases bill. The bill which has scaled second reading in the house of representatives, aims to provide a legal backing to the management of infectious diseases and pandemics in the country. The introduction of the bill has however been trailed by controversy as critics are skeptical about the uncontrollable powers some provisions of the bill confers on the Nigeria Centre for Disease Control (NCDC) and what it would mean for fundamental human rights. On the other hand, supporters of the bill opine that the current law constrains the ability of both the Federal Government and the NCDC to proactively tackle infectious diseases and manage public health emergencies when they occur.

On the Security front, the Chief of Army Staff, Lt. Gen. Tukur Buratai, relocated fully to the North East to further oversee and coordinate the military troops in their fight against insurgency. Away from the North east, Lagos and Ogun states witnessed pockets of robberies across neighborhoods following the pronouncement of the lockdowns by the FG. To complement the efforts of the Police in dealing with this menace, residents of host communities resorted to establishing vigilante groups to protect their families and properties.

Due to the relative calm in the political space, we expect the committee's focus to be on security challenges plaguing the North and Middle belt regions and the implication for stability for the country's food supply and inflation.

Monetary Policy

The Nexus of Growth and Inflation

Following the hike in Cash Reserves Ratio (CRR) to 27.50% (from 22.50%) by the MPC in January 2020, Money Supply (M3) contracted marginally by 0.45% MoM to NGN34.14trn in February 2020. However, M2 expanded by 2.10% MoM to NGN29.73trn driven by growth across all its components with the exception Currency Outside Banks. Net Domestic Credit also increased by 2.37% MoM to NGN36.66trn supported by growth in credit to both Government and private sector.

The CBN has been unrelenting in its drive to improve the flow of credit to the real sector. Asides maintaining the Loan-to-Deposit ratio for Deposits Money Banks at 65%, the apex bank has also been aggressive in extending its balance sheet to provide credit to selected sectors of the economy particularly agriculture, manufacturing, and healthcare. Notably, CBN, in March 2020 announced a NGN1.10trn intervention fund to support local manufacturing and the health sector in COVID-19 related research and development.

While we appreciate the commitment of CBN to ensuring economic growth in spite of overwhelming constraints, we are concerned about the availability of willing and credit-worthy borrowers. A high default rate for banking sector risk assets will have damaging consequences for future (medium-to-long term) credit supply and hence economic growth. Furthermore, the attendant increase in money supply will compound existing inflationary pressures which CBN is mandated to keep in check.

Although inflationary concerns remain, maintaining support to the economy is paramount in the near-term. Thus, we expect the MPC to retain the CBN's credit stimulus to drive economic recovery while also weighing its impact on heightened inflationary pressures.

MPR vs. MMM rates

System liquidity remained elevated since the last MPC meeting. The Open Buy Back and Overnight rates decreased by 4.58% and 4.963% respectively, settling at an average rate of 1.71% as at May 21. The elevated system liquidity is largely attributed to the FAAC disbursement in April and May amounting to NGN780.93bn and NGN606.20bn respectively. In addition, there were OMO maturities worth NGN710.89mn in April 2020.

So far in April, the Nigerian Inter Bank Offer Rate (NIBOR) has recorded declines across all tenors, dragging the average NIBOR rate to 4.85%.

OMO bills worth NGN305.71bn is set to mature on the 29th of May, further strengthening system liquidity. In a bid to manage monetary inflation, we expect the increased system liquidity to be a key consideration for the MPC.

COVID-19 Impact Exacerbates Fall in FX Reserves

The Nigerian external reserve has been on a downward slide since last year, settling at USD35.75bn during the last meeting. Riding on the back of the COVID-induced supply glut, the fall in oil prices along with lower foreign remittances into the country threatened the CBN's ability to support the Naira. As a result, the Apex bank technically adjusted the local currency across the official windows to reflect current

market realities. The Naira was therefore devalued to NGN360/USD and NGN380/USD in the Interbank and I&E FX windows, respectively.

Despite this, the FX markets have remained largely illiquid which has caused the Naira to continue to weaken against the dollar, particularly in the parallel market rates where it currently trades at NGN460/USD. Albeit, the Interbank and I&E FX rates have remained relatively stable at around NGN361/USD and NGN386.50/USD levels respectively.

However, the external reserves position has recently turned a corner, pegging at USD35.67bn on the 20th of May 2020 from USD33.90bn on the 30th of April. We attribute this to the impact of the disbursement of the USD3.4bn IMF emergency facility to the CBN.

While there is a case to attract foreign investments by increasing the benchmark rate, we expect the Committee's decision to lean more towards the stimulation of the real sector. **With this perspective, we envisage that the MPC will adopt a wait and see approach and therefore hold rates at 13.50%.**

Fixed Income Environment and Outlook

The fixed income space has witnessed positive momentum since the last meeting. In the secondary market for T-Bills, there has been decline in yields across all tenors, settling average yields lower at 2.67% from 3.25% at the last meeting. The primary market for T-Bills have remained awash with liquidity, as stop rates have settled consistently below the 5.00% mark.

Likewise, in the secondary bonds market, there has been sustained bullish sentiment evinced by the decline in average bond yield by 81bps to 10.40%. In the primary market for bonds, strong investor participation reigned as the bond auctions held on the 20th of May, recorded oversubscriptions across offers. Bid to cover ratios thus pegged at 1.22x, 2.24x and 1.18x for the 12.75% FGN 2023, 12.50% FGN 2035, and 12.98% FGN 2050 instruments, respectively.

We opine that a rate cut would further suppress yields in the fixed income space, inducing capital flight. Nonetheless, we still expect strong investor participation in the fixed income market as liquidity levels remain robust.

Equities Market Performance and Outlook

Losses Taper as Bargain Hunting Persists

Buying pressures on quality names and dividend paying counters have resulted in a moderation in the YtD loss since the last MPC meeting. The YtD return improved to -

7.76% on 21st of May from -19.15% at the last meeting. Although Q1:2020 results were largely uninspiring, pockets of bargain hunting activities have been recorded on stocks that announced dividends.

Reflecting the weak investors' confidence, the Nigerian bourse saw a slump in the value of transactions as foreign participation declined to 41.33% in April from 45.37% in March 2020. In a similar vein, the NGN20.98bn FPI inflow recorded in April was offset by a NGN32.20bn outflow. On a sectoral basis, all sector indices have posted gains month to date, an improvement on the largely bearish month of March. However, sectoral year-to-date returns remain firmly in the red, save for the NSEIND and NSEINS10 indices.

In comparison with African counterparts, the NSEASI trails the South African (3.1%YtD) index as the best performing. However, valuations suggest that the Nigerian market appears to be undervalued trading at a PE of 7.7x- a significant discount to peers (frontier markets- 10.9x and emerging markets- 14.4x**). While macro conditions remain frail, positive market sentiments are expected on counters with significant upside potential and relatively impressive fundamentals. We, however, do not rule out the possibility of capital flights once the CBN resumes unrestrained supply of FX to foreign investors.**

On a Balance of Factors…

At the last meeting in March 2020, the MPC noted the unprecedented impacts of the COVID-19 pandemic on economic growth, with the emergent pressure in the FX market due to the crash in oil prices. The MPC however, acknowledged the measures put in place by the CBN to support private sector and SMEs were adequate to support domestic productivity and buoy aggregate demand.

In view of this, we posit that the MPC will maintain rates at the next meeting with focus on expediting the effectiveness of the various credit measures that have been put in place. More-so, we note the weakness of MPR as signaling tool in recent times, as the MPC has employed various unorthodox policies to stimulate economic growth. Therefore, we do not expect a deviation from the existing monetary policy stance at the next meeting.

Ultimately, we expect the Committee to:

Retain the MPR at its current level of 13.50%

- **Retain liquidity ratio at 30%**
- **Retain the asymmetric corridor at +200bps/-500bps**
- **Retain the CRR at 27.50%**

Contact Information

Brokerage and Retail Services

topeoludimu@meristemng.com (+234 905 569 0627)
abisoyeoludipe@meristemng.com (+234 708 000 7861)
contact@meristemng.com

Investment Banking/Corporate Finance

seunlijofi@meristemng.com (+234 808 536 5766)

Wealth Management

damilolahassan@meristemng.com (+234 803 613 9123)
www.meristemwealth.com
Tel: +234 01 738 9948

Registrars

martinaosague@meristemregistrars.com (+234 802 303 1783)
www.meristemregistrars.com
Tel: +23401-280 9250

Group Business Development

saheedbashir@mersitemng.com (+234 802 454 6575)
ifeomaogalue@meristemng.com (+234 802 394 2967)

Client Services

omosolapeakinpelu@meristemng.com (+234 803 694 3034)
blessingogwuche@meristemng.com (+234 806 738 5485)

Investment Research

ahmedjinad@meristemng.com (+234 809 187 8917)
research@meristemng.com

Corporate websites: www.meristemng.comwww.meristemwealth.comwww.meristemregistrars.com

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