MERISTEM

Ahead of MPC

September 2020

MPC is Scheduled to Hold Fifth Meeting

… Key Parameters to Remain Unchanged

The Monetary Policy Committee (MPC) is scheduled to hold its fifth meeting of the year on the 21st of September 2020. We expect deliberations to revolve around events in the global and domestic space. The committee is expected to consider how the build-up to the US presidential elections is shaping the global economy. Being the first committee meeting since Q2:2020 statistics were released, we expect an impact assessment of the COVID-19 pandemic on the global and domestic economy.

On the international front, while oil prices have moved from lows experienced in March and April, the outlook remains fragile as concerns about demand and inventory levels have constrained oil prices from moving to more favorable levels. This, alongside threats of a second wave of COVID-19 infections in Europe, dampens hopes of a swift recovery. We expect these issues to be top of mind for the committee as they seek to position the economy for a fast recovery from the effects of the pandemic.

On the domestic scene, rising inflationary pressure triggered by constricted FX supply and rising food prices have further pushed real rates of return into the negative territory.

Having carefully considered the foregoing, we expect the MPC to keep policy parameters unchanged.

International Economies and Developments

Global Economy Seeks to Recover from COVID-19 Damage

The global economy still reels from the impact of the COVID-19 pandemic as it tries to rebound from the unprecedented crisis. The Organization for Economic Cooperation and Development (OECD) forecasts that global GDP will contract by 4.5% in 2020 while stating that the outlook remains uncertain. As a result of the lockdowns imposed in the first quarter of the year, sectors such as tourism and aviation still struggle as fears of a second wave threaten recovery.

Major economies like the United States and Eurozone are expected by the OECD to record GDP contraction by 3.8% and 7.9% respectively. Amidst the economic slowdown, monetary policies to help support the economy are being implemented as central banks have generally held an accommodative stance on interest rates. The US Fed has kept rates at near-zero as it has a target rate of 0% - 0.25%, which is to be

held till mid-2024. With inflation remaining below 2% for a significant part of the last decade, the Fed's new policy framework should allow the economy heat up as focus lies more on creating jobs and boosting the economy, rather than taming inflation surges. August data showed that US inflation rose for the third consecutive month, coming in at 1.3% (1% in July).

The US dollar has taken a hit from the impact of the lower interest rates as the country's assets became less attractive to investors. Adding to that is the slower economic projection, implying lower returns on debt instruments, equities and other assets. The tensions on the trading relations with its trading partners also set up US export levels for a poor outlook. Thus, investor uncertainty about the future of US trade relations has been a factor pressuring the dollar as well. The Dollar Index has lost 9.66% between March and the 18th of September 2020.

China is realizing more Foreign Direct Investment (FDI) as it went up by 18.7% in August, according to the Chinese government. The world's most populous nation appears to be ready for a V-shaped recovery from the COVID-19 pandemic, as a surge in credit activity of 29% from July to August was reported. Chinese banks' lending to households was up by 11%, while lending to business was up a significant 119%. This mirrors the growing confidence of investors in the Chinese economy. The nation is, however, not without its risks as there are still concerns regarding an increase in bad loans in the economy, trade tensions with the US and weaker overseas demand due to the pandemic. The OECD expects the Chinese economy to grow by 1.8% in 2020 – the only nation the body expects to avoid a contraction this year.

As the world's monetary authorities continue to support their respective economies by adopting an accommodative stance, as well as utilizing stimulus buffers, we, therefore, expect the Committee to tread the same path by keeping policy rates on hold.

Oil Market Still Reels from Demand Concerns

While the OPEC+ April agreements helped support the global oil market, concerns about demand and inventory levels have pinned oil prices from spurring to more favorable levels. Supply quota compliance from nations like Nigeria and Kazakhstan dampened the optimism in the market, thereby causing a bearish trail on crude oil prices. While the agreed May and June supply cuts of 9.7MMbpd was extended to July, this only had little effect on the oil market, as reports of newly imposed lockdowns in Europe and South America emerged.

With the leaders of the cartel stamping their feet and demanding higher compliance, the organization recorded a 97% adherence rate in August, thereby causing some positive sentiment to return to the market. The world's largest importer, China had

its economy up and running quickly and the UAE announced extra supply cuts to its Dubai crude. In addition, the fall of the US Dollar helped oil prices gain traction, while expectations of tropical storms in Louisiana and Texas restricting offshore production buffered the market. Crude oil traders, however, are still cautious amidst the rise in August US rig count and lower expectations for Chinese imports in 2020. OPEC projects an unprecedented 9.5MMbpd fall in global oil demand in 2020. This is based on the COVID-19 concerns, as well as bloated oil inventories.

In Nigeria, the Petroleum Products Pricing Regulatory Agency (PPPRA) continued to set the prices of Premium Motor Spirit (PMS) in Nigeria. the pump price per liter set by the PPPRA in May, June, July, August and September were NGN123.50, NGN121.50, NGN143.80, NGN138.62 and NGN151.56 respectively. Whilst this mechanism was a shift toward having a deregulated downstream industry, prices are still not liberated from the limitations of government regulation. Meanwhile, the NNPC maintained the monopoly of importing PMS.

Now that there are talks of deregulating the downstream sector in Nigeria, a realization of such would see Nigerians potentially paying more at the pump. This would mean a more cost reflective price at the filling stations, based on the realities of the market. This translates to an outlook of not only higher petrol prices, but higher costs of transportation, food, services and inflation levels.

While global oil prices are expected to remain pressured in 2020, this would continue to put a strain on FX reserves and exchange rate stability.

Domestic Macros

Activity Remain Sluggish Post Lockdown

In Q2:2020, the NBS reported negative GDP growth of 6.10% YoY and 5.04% QoQ as a result of the contraction witnessed in both the oil and non-oil sectors of the economy. To lessen the adverse impact of the pandemic, the CBN introduced series of interventions funds to the real sector and in its last meeting ,the MPC voted to cut the benchmark rate from 13.5% to 12.5%. On its part, the Federal Government has continued to ease lockdown restrictions thus far in the third quarter, as it attempts to fully reopen the economy and hasten the post-pandemic recovery.

Data suggests that economic activity is gradually picking up in some segments of the economy, as seen in CBN's August PMI readings. Although the manufacturing PMI for August (48.5pts) remains entrenched in the contractionary region, certain sub-sectors led by nonmetallic mineral products, cement, plastics, and rubber products have witnessed expansion. Also, we reckon that easier lockdown conditions have contributed to the tapering in contraction of new orders and non-manufacturing

activities when compared to April and May. However, we observed that production level remains pressured as many manufacturers are yet to swing back to pre-COVID activity level.

While we expect measures to support economic recovery to be a key consideration for the committee, we do not anticipate a rate cut as it will do little to stimulate economic growth at this time. Hence, we expect the committee to hold key parameters constant.

CPI Hits 29-months High

In August, the Consumer Price Index rose by 13.22% YoY, marking the highest inflation rate since March 2018 and 40bps higher than 12.82% recorded in July 2020. The rise in headline inflation was influenced by increases in both the food and core indices. In the period, the Food Index increased by 16.00% YoY (vs 15.48% in July 2020), driven mainly by the sustained land border closure and restrictions on FX access for crops and fertilizer importation. Also, low rainfall in August and flooding in Kebbi added further pressure to the upward momentum.

Similarly, the core sub-component of the index also rose by 10.52% YoY (vs 10.10% in July 2020) driven by increases in Airfares, Hospital services, Medical services, Pharmaceutical products, Road transport fares, amongst others.

Going forward, the hike in electricity tariff, coupled with the continued closure of the land borders and constricted FX supply are expected to impact costs of production and ultimately, prices of goods and services.

In navigating the double whammy of rising prices and weak economic activity, we expected the committee to maintain status quo as it puts faith in existing policy initiatives to ensure improved credit to the private sector and aggregate demand

Fiscal Sustenance Remain Pressured

The past few months have seen the federal government go back to the drawing board to reassess its fiscal position as shocks to the nation's major revenue source (oil) and the slow business environment stifle revenue generation. Data from the National Bureau of Statistics showed that FAAC disbursements to the three tiers of government dropped significantly by 10.76% from NGN606.20bn in May to NGN547.31bn in June. For the period, the sum of NGN219.80bn was disbursed to the federal government- 13.83% lower than NGN255.07bn received in May and 45.38% lower than the benchmark of NGN402.42bn. In light of the developments, the Federal Government further revised its 2020 revenue projections downward. The revised budget rests on assumptions of crude oil prices at USD25pb (from USD57pb), crude oil production at 1.94mbpd (from 2.18mbpd) and an exchange rate of

NGN360/USD (from NGN305/USD). Also, total expenditure was reduced by 0.66% to NGN10.52trn while revenue projections were dropped by 38.72% to NGN5.16trn – a significant increase (146.33%) in the budget deficit to NGN5.37trn .

Amidst the drop in revenue, the government is still saddled with the responsibility of supporting the economy through the crisis. Recently, the Federal Executive Council approved a NGN2.30trn stimulus package to ease the effect of the pandemic under its economic sustainability plan. The program is majorly intended to be funded from special accounts (NGN500bn), CBN structured lending (NGN1.1trillion) and external sources (NGN334 billion). Although, the Federal government has taken receipt of the USD3.4bn International Monetary Fund (IMF) facility, import duty waivers and value-added tax waivers (to ease medical supplies to combat the pandemic) constitute further pressure points for gross federally collected revenue. However, in a move to free up funds, the federal government have signaled further deregulation of the petroleum sector and more cost-reflective tariffs for electricity.

We expect the committee to consider the worsening fiscal imbalance in arriving at its decision. However, following better crude oil prices in Q3:2020 (compared to Q2:2020), we expect the committee to adopt a wait and see approach leaving key parameters unchanged.

Politics and Security

As the Edo state gubernatorial elections slated to hold on 19th September 2020 draws closer, both sides of the political divide have intensified campaign efforts to secure the support of the people. As expected, the atmosphere in the state is politically charged with widespread reports of shooting, violence and disruption of public peace during the electioneering campaign. While we do not rule out possible electoral conflicts, we expect the deployment of armed police by the Inspector General of Police to maintain order in the state.

Relations between Nigeria and her sister country, Ghana have come under strain, featuring in developments in the political landscape over the past months. Nigerian traders and businesses in Ghana have faced harassment as trade and diplomatic issues linger. The situation has escalated, requiring visits from both the Speaker of the House of Representatives, Femi Gbajabiamila and the Vice-President, Yemi Osinbajo at different occasions.

Also, of particular concern to Nigeria and indeed the entire West African bloc is the political situation in Mali following the coup d’état that took place in August and resignation of the country’s President - Ibrahim Boubacar Keita. The relatively porous borders in the sub-region means that any escalation in tensions can easily threaten the stability of neighboring countries.

On the Security front, little has changed domestically as reports of pockets of violence in the Northern part of the country continue to dominate headlines. Herdsmen-farmer clash, armed robbery and banditry, and kidnapping have reverberated across Southern Kaduna, Katsina, Borno, Nasarawa and other Northern states.

We expect the committee to consider the impact of the security challenges in the North and Middle belt regions on the nation's food supply.

Monetary Policy

Continued Interventions Spur Higher Private Sector Credit

According to the CBN's data, broad money supply (M3) grew by 5.88% to NGN32.82trn between end-2019 and July 2020 driven largely by growth across Net Foreign Assets (+31.58%) and Net Domestic Assets (+9.76%). Based on the apex bank's M3 growth guidance for 2020, significant headroom still exists for further growth in M3.

Unsurprisingly, Credit to Private Sector (CPS) increased 13.09% over the same period and was the major driver of Net Domestic Credit. The growth in the CPS is off the back of the CBN's drive to improve the flow of credit to the real sector of the economy through the banking sector.

To further boost spending and discourage savings, the CBN recently announced a reduction in savings deposit rate from 3.75% to 1.25% per annum. However, given the constraints facing, insecurity, inadequate storage and distribution facilities and FX illiquidity, the increase in money supply contributed to the inflationary pressures within the economy.

Given that heightened inflationary pressures are disadvantageous to real economic growth, an important consideration for the MPC at its next meeting is the fast-rising price levels, particularly food prices.

MPR vs. MMM rates

Since the last MPC meeting, system liquidity has remained robust supported by FAAC allocation disbursed in August (NGN676.40bn) and OMO maturities (NGN921bn so far in September). The combination of these factors crashed average interbank call rates by 617bps to 3.75% (vs. 9.92% as at 20th July 2020 when the MPC last met).

In line with the movement in average call rates, NIBOR has steadily declined across maturities to settle at 3.52% (vs. 7.88% as at 20th July 2020). We expect system liquidity to further strengthen as additional OMO maturities (c. NGN300bn) and August FAAC disbursements come in later this month.

Foreign Exchange Reserve Intervention Depleting Foreign Exchange Reserve

Nigeria's foreign exchange reserve has maintained the downtrend as recovering oil prices continue to weigh on FX earnings. Between the last MPC meeting and 16th of September 2020, reserves have declined by USD243mn to USD35.80bn. This decline also reflects the effect of the CBN's resumed intervention in the foreign exchange market amid recommencement of international travel.

Despite the CBN's intervention, the buildup of demand for FX by foreign investors remains a cause for concern. A situation that heralds danger for future foreign portfolio investments (FPI) as investor confidence remains downbeat, especially as the prospect for foreign exchange earnings remains downbeat for H2:2020.

While a case can be made for the Committee to raise the policy rate to attract forex inflow, especially given the current economic environment, we consider the need to support real sector growth amidst the lingering effect of the pandemic as too big a trade-off.

Fixed Income Environment and Outlook

The fixed income space has continued to witness positive momentum in the year as buying activities have dominated the treasury bill and bond space. In the most recent T-bills auction held on the 16th of September 2020, the bid to cover ratio pegged at 1.99x, 1.84x and 1.25x respectively across the 91-day, 182-day and 364-day instruments. This was in sync with activities at the last bond auction which witnessed oversubscription across all maturities, evidenced by bid-to-cover ratios (**12.50%JAN2026**:1.31x, **12.50%MAR2035**:1.22x, **9.80%JUL2045**:1.03x, and **12.98% MAR2050**: 2.86x) at the auction.

The secondary market has also witnessed its share of buying activities, as spillover demand from primary market activities made its way to the secondary market. The secondary bond yields as at 15th September 2020 had dipped by 42bps to 7.39% (vs. 7.81% as at 20th July 2020). Similarly, the T-bills secondary market posted a 38bps decline from 2.11% at the last MPC meeting to 1.73% on the 16th of September 2020.

We opine that a further cut in policy rate might disincentivize savings and up the assemblage of funds in the economy, hence, crashing rates further. The possibility of a rate hike in the wake of the 6.10% YoY GDP contraction in Q2:2020 is also bleak, given the stance of the MPC to prioritize supporting an economic rebound. Nonetheless, we do not expect any significant change within the space in the short to medium term.

Equities Market Performance and Outlook

A combination of bargain buying, and rotational trades sponsored by "not so gloomy" second-quarter results have largely supported the recovery in the equities market. From a negative 20.63% YTD return at the end of Q1 2020 (*due to the Covid-19 shock*), the market has slowly clawed back most of its losses (gaining 14.92% in Q2:2020 and 4.47% so far in Q3:2020), thus moderating YTD return to - 4.73% as at 18th September 2020.

The most recent data available on the NSE (July 2020) signals that domestic participation has largely dictated the direction of market performance, accounting for c. 66% of total transaction volume (vs. 34% on the part of foreign investors). We have reason to believe the trend has persisted through August and September supported by slower market momentum and decrease in average transaction volumes.

The NSE All-Share Index (-4.9% YtD) continues to trail its South African counterpart (-0.9% YtD) as the best performing index. As far as valuations go, sentiments around the Nigerian market has improved, as it currently trades at a PE of 9.0x (vs. 7.7x in May). However, the market still trades at a significant discount to its peers (Frontier Market - 17.3x and Emerging Market - 20.6x). Although macroeconomic conditions remain fragile, we expect investor interests on fundamentally sound counters with significant upside potential to sustain the market performance.

On a Balance of Factors…

At the last meeting in March 2020, the MPC saw the need to relax the key interest rate from 13.5% to 12.5% citing the need to further stimulate the economy for a faster recovery. The Committee also noted the deterioration of the manufacturing PMI in June 2020 to 41.10 index pts. (vs. May: 42.40 index pts.), and improvement in non-manufacturing PMI to 35.50 index pts. (vs. May: 25.30 index pts).

We expect the MPC to maintain rates at the next meeting as it puts faith in existing policy measures to achieve its aim of increased credit to the private sector and stimulate aggregate demand.

Ultimately, we expect the Committee to:

- **Retain the MPR at its current level of 12.50%**
- **Retain liquidity ratio at 30%**
- **Retain the asymmetric corridor at +200bps/-500bps**
- **Retain the CRR at 27.50%**

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