MERISTEM

Ahead of MPC

March 2021

Committee Set to Hold its Second Meeting in 2021

… We Expect no Changes to Key Parameters

The Monetary Policy Committee (**MPC**) is scheduled to meet for the second time this year on the 22nd and 23rd of March 2021. We expect that the progress with global vaccination efforts, Nigeria's emergence from a recession in Q4:2020, spiraling inflation as well as developments in the financial markets would feature in the Committee's discussions. As this would be the Committee's first meeting since 2020FY GDP statistics were released in February, we look forward to an impact assessment of the Committee's efforts at supporting economic growth, and guidance on whether this would be sustained going forward.

On the international front, OPEC+ supply cuts and a soft recovery in demand have upheld oil prices – an otherwise positive development for Nigeria, apart from higher pump prices and the attendant inflationary impact. A higher oil price environment and progress with vaccination efforts are some of the bright spots in the global discourse.

On the domestic scene however, inflation has continued to soar, pressured mainly by a cocktail of structural bottlenecks. As a result, real rates of return continues to sit firmly in negative territory.

After carefully considering all the points above, we expect the MPC to keep policy parameters unchanged.

International Economies and Developments

IMF Forecasts Stronger Growth over 2021

The IMF, in its recent world economic outlook revised its 2021 growth projections up 0.3 percentage points to 5.5%. The IMF's projection hinges on the progress recorded with vaccination efforts globally, and the renewed commitment of governments and monetary authorities to sustain policy support as long as is needed. Already, the US Fed has opted to leave benchmark rates unchanged at between 0% - 0.25%, while carrying on with its Quantitative Easing program, despite concerns about inflation and the impact of the sizable USD1.9trn relief package. Its European counterpart, the European Central Bank (ECB) shares the same sentiment, agreeing at its last meeting to sustain its pandemic emergency purchase programme (PEPP).

On the second critical factor – vaccination, the suspension of the AstraZeneca vaccine in a growing number of European countries (including Germany, France, and Italy) casts a dark cloud on renewed optimism. The suspension of the use of AstraZeneca vaccines have been implemented as a precautionary measure, despite the WHO's recommendation for vaccinations to continue, due to concerns about blood clotting side effects. In our opinion, if this situation lingers, it has the capacity to reshape the battle against the coronavirus pandemic, pushing back the timeline for reaching herd immunity/and vaccinating a large number of the global population. Key among our considerations are that the AstraZeneca vaccines have the largest manufacturing capacity among all the other approved alternatives, an alliance with COVAX program to supply underserved countries, and logistical/distribution advantages with respect to required storage temperature.

We expect the Monetary Policy Committee to fully consider these developments before reaching its decision.

Recent Oil Price Rally to Boost FX Reserves

In March, OPEC revised its expectation for global oil demand in 2021 from 96.05mbpd to 96.27mbpd, with improved demand for transportation and industrial fuels, a steady rollout of vaccines and expectations of a ramp up in vaccination in the second half of the year as major tailwinds. This revised outlook comes as an improvement to an underwhelming 2020 where demand declined to 90.39mbpd following the COVID-19 scourge which saw many economies go into lockdowns. On the supply side, OPEC+ decision to maintain supply cut at 7.2mbpd in March, spurred a rally in oil prices to around USD69 per barrel. We note that the cartel's decision to retain production cuts implies Nigeria would continue to have lower production volumes – having achieved about 1.78mbpd in February 2021, compared to 2.07mbpd in Q1:2020 (prior to April's drastic supply cut).

Although we observe that the country's FX reserves have been on a downward trend for most of the year, we expect that a steady rise in crude oil prices and the gradual pick up of the global economy would eventually support FX accretion.

From a welfare point of view, rising crude oil prices ultimately suggests higher inflationary pressure arising from increased pump price of petrol. In March 2021, PPPRA released a pricing template that reflects expected PMS prices in relation to market trend. Expected PMS retail prices (upper band) amount to NGN212.61 per litre (vs. current prices at NGN167 per litre). If implemented, we expect inflation rate to tick up significantly due to the ripple effect of energy prices on the rest of the economy.

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At the upcoming MPC's meeting, we expect the current inflation environment to be a key consideration. However, we expect the committee to maintain the status quo, favouring its pro-growth stance.

Domestic Macros

Economy Exits Recession with 0.11%YoY Growth in Q4:2020

The latest GDP report published by the National Bureau of Statistics (NBS) showed that the Nigerian economy contracted by -1.92%YoY in 2020. However, real GDP in Q4:2020 was surprisingly higher at 0.11% YoY – marking an earlier than expected exit from the recession. The growth was reflective of the gradual pick-up in economic activities and a general improvement in business conditions in the quarter despite challenges posed by the aftermath of the End-SARS protests. Thus, non-oil GDP grew by 1.64%, led by significant expansion in the information and communication sector (+14.70%). Also, we acknowledge the impact of the CBN's direct lending program (Anchor Borrowers Program) on the agricultural sector. Access to low-interest credit, no doubt, aided the 3.42% YoY expansion (the fastest since Q1:2019) recorded in the agricultural sector. Meanwhile, the significantly lower crude oil output in Q4:2020 dragged oil GDP performance as it contracted significantly by 19.76% YoY. However, the outlook for the oil economy in Q1:2020 is positive given the slightly higher production quota of 1.5mbpd (vs 1.4mbpd previously) and higher oil prices in the quarter.

Manufacturing activities remained downbeat as high cost of input and weak consumer demand underscored the -1.51% YoY contraction in the sector. On the bright side, Stanbic IBTC PMI readings for February (52.0) suggests there has been mild improvements in manufacturing activities compared to the last two months in 2020 (November – 50.9, and December – 51.8). Purchasing activity also expanded as new orders, exports and output grew at a fast pace.

However, economic growth remains delicate as rising inflationary pressures, weakening consumer purchasing power, and currency devaluation concerns pose significant downside risks to growth expectations.

In arriving at its decision, we expect the Monetary Policy Committee to prioritize sustained economic growth ahead of the need to curb inflation.

Inflation Sustains Upward Momentum

Supply chain bottlenecks and other structural factors continue to exert upward pressure on general price levels. In February 2021, increases in both the core and food indices drove headline inflation to 17.33% (vs. 16.47% in January 2021), its highest level in 4years. We cannot deny the impact of the lingering insecurity issues in the food producing region, and more specifically, the Shasha crisis in Oyo state as well as the strike action by the Amalgamated Union of Foodstuff and Cattle Dealers of Nigeria (AUFCDN), on food inflation. Core inflation soared higher on the back of higher transport cost and healthcare services costs. Also, the further devaluation of the Naira continues to pose upside risk to inflation. Rate at the I&E FX window was devalued to NGN410/USD in February 2021 (from NGN400/USD) and there was a corresponding movement in parallel FX market rate a to NGN475/USD.

While the worsening inflationary pressure will be a key consideration of the committee, we expect the focus to be on consolidating the economic performance recorded in Q4:2020. Moreover, the committee have at several meetings acknowledged that the uptrend in inflation stems majorly from supply side bottle necks engendered by persisting structural factors such as infrastructural deficiencies, as well as security challenges in different parts of the country.

Muted Fiscal Activity with focus on the Finance Act 2020

Since the Monetary Policy Committee (MPC) last met in January 2021, majority of the fiscal policy developments have been offshoots of the Finance Act which was signed into law in December 2020. While some of the amendments in the new act have been applauded, others have attracted widespread criticism - top of this list being the empowerment of the Federal Government (FG) to borrow unclaimed dividends and dormant account balances as a special form of debt to support its finances. Despite growing opposition and being sued to court, the Federal Government has gone ahead with its plans.

Some of the other developments include the reduction of company minimum tax to 0.25% from 0.50% (applicable only on tax returns filed for years ending between 1st January 2020 and 31st December 2021), reduction of import duty on mass transit vehicles and trucks (from 35% to 10%), tractors (from 35% to 5%) and cars (from 30% to 5%). According to the Federal Government, this is expected to ease mounting pressure on transportation costs, and support companies still reeling from the adverse impact of the coronavirus pandemic.

The Federal Government (FG) formally unveiled the Infrastructure Corporation of Nigeria (InfraCo), an infrastructure focused company with initial seed capital of NGN1trn (sourced from the Central Bank of Nigeria, Nigeria Sovereign Investment

Authority, Africa Finance Corporation and other strategic partners). InfraCo is expected to focus on financing critical infrastructure projects within the country, with a view to plugging the gap in the nation's widening infrastructure deficit.

Politics and Security

Nigeria's political and security landscape has become even more heated over the last couple of months since the MPC held its last meeting. There have been several reports of farmer-herder clashes, kidnapping, armed banditry and even communal clashes occurring simultaneously in different parts of the country. Notable among these reports are the more recent kidnapping of 39 students in Kaduna state on 11th March (the third of such occurrence in 3 months). The unfortunate events have forced most schools in the region to shut down. Down in the South, communal clashes between the Hausa and Yoruba ethnic groups in Shasha, Oyo State which left three dead and scores injured have prompted the State Governor to deploy the police and other security agencies to dowse escalating tensions.

In response to the rising spate of insecurity across the country, President Muhammadu Buhari fired all four of his military service chiefs and appointed new service Chiefs in January 2021, while also reiterating his commitment to deal decisively with all forms of security challenges plaguing the country.

In its upcoming meeting, we expect the Committee to consider the impact of lingering security challenges in the North and Middle belt regions on the nation's food supply as food inflation continues to surge.

Monetary Policy

External Reserves and FX

Nigeria's FX reserve has fallen by a little over USD1.3bn since the start of the year, settling at USD34.63bn as of March 11th, 2021. A large portion of this decline was due to the repayment of USD500mn in maturing Eurobonds sometime in February. That aside, we consider the decline in the country's reserves despite a higher oil price environment to be due to OPEC+ production quotas which caps the gains of significantly higher oil prices. This, along with faltering USD remittances threatens the apex bank's ability to support the local currency. This has manifested in the FX market where the Naira has weakened against the dollar, exchanging at NGN409.75/USD at the I&E window as at March 17th, 2021.

The CBN recently launched the "Naira 4 Dollar scheme" with the hope of incentivising diaspora remittances and encouraging inflows by reducing the cost burden. The scheme offers a rebate of NGN5 for every USD1 remitted into the country. While the impact of this policy (which is set to run for 60 days ending in May 2021) remains to be seen, it is the hope of the CBN that this policy is able to drive remittances as observed in some Asian countries.

Fixed Income Environment and Outlook

Fixed income yields have generally reversed their direction since the Committee's last meeting in January, with both stop rates (at primary market auctions) and average T-bills and bond yields (secondary market rates) advancing from sub-2% and sub-7% levels to 2.72% and 9.26% as at March 2021. The treasury bill auction held on March 10th, 2021, stop rates were 2.00%, 3.50% and 6.50% for the 91-day, 182-day and 364-day instruments respectively. Investor participation has also firmed up, with bid to cover ratios reaching 4.17x on the 91day T-bills (vs. 1.85x at the auction preceding the January MPC meeting).

Corporate issuers (including **MTNN**, **FIDSON**, **NB, FIDELITYBK and UCAP**) have also tapped the debt market in Q1:2021, seeking to take full advantage of lower funding costs before a steeper climb in rates.

At T-bill PMA held yesterday, the 17th of March, stop rates once again were unchanged on the 91 and 182-day bills, while the 364-day bill rose by 50bps to 7.00%. This suggests slowing momentum and a possible end to rapidly rising stop rates. We expect rates would hover around current levels, and for investor participation to remain strong.

Equities Market Performance and Outlook

The Nigerian equities market sustained last year's bullish run for most of January, with the NSEASI gaining 5.32% over the course of the month. This performance was largely supported by expectations of stronger earnings, a recovery in economic activities and a depressed fixed income environment that attracted domestic institutional investors. As fixed income yields began to retrace higher in February, the allure of equities fizzled out, resulting in selloffs and six consecutive weeks of negative performance. The equities market closed in the red all through February (-6.16%) and has so far shed 2.71% in March (as at 16th March 2021), with Year to Date return sitting firmly in negative territory, at -3.85%. Per the Domestic and FPI report released by the NSE in January 2021, domestic players continue to dominate trading activity (c. 80% of total transactions), led by institutional investors (64%). This supports our position that the selloffs have been driven by institutional investors such as PFAs rerouting their funds to the fixed income market as yields push higher.

In comparison with its African counterparts, the NSEASI (-3.85% YtD) is the only negative performer in terms of year to date return (Egypt: 3.19%, Ghana: 14.83%, Kenya: 7.04% and South Africa: 1.87%). Valuations, on the other hand suggest that the Nigerian market currently trades at a lower PE multiple (relative to South Africa and Ghana) of 14.61x. This is also at a significant discount to both frontier (23.15x) and emerging markets (24.44x).

In the short to mid-term, we think the preference for fixed income instruments would continue to dampen equities performance, particularly against the backdrop of uninspiring macroeconomic conditions and a challenging operating environment.

On a Balance of Factors…

Ultimately, we expect the Committee to:

- **Retain the MPR at its current level of 11.50%**
- **Retain liquidity ratio at 30%**
- **Retain the asymmetric corridor at +100bps/-700bps**
- **Retain the CRR at 27.50%**

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