Macroeconomic Update

MPC Monitor | September 2022

MPC Tightens Policy Parameters

The Monetary Policy Committee (MPC) concluded its two-day policy meeting on the 27th of September 2022 where it raised the Monetary Policy Rate (MPR) by 150bps to 15.50% from 14.00%. Additionally, the Committee voted to raise the Cash Reserve Requirement (CRR) to 32.50% (from 27.50%), while other parameters were unanimously voted to be held constant. We note that all members of the committee voted in favour of a rate hike: 10 members voted 150bps, 1 member voted 100bps and another member voted 50bps.

The Committee reiterated its intention to achieve price stability in the economy, considering both domestic and external factors relevant for this objective. It considered the general adoption of a hawkish tone across major economies, persistent supply chain disruptions, and growing fears of a global recession.

On the domestic front, the Committee noted the sustained output growth in the second quarter while expressing concern about the contraction in production activities as Composite Purchasing Managers' Index (PMI) fell to 47.20 points in August 2022. The Committee also noted the continued uptrend in headline inflation rate which reached 20.52% in August from 15.60% in January 2022.

The decision to raise both the MPR and CRR further projects the Committee's aggressive hawkish stance. In our assessment, part of the direct impacts of the decision would be lower system liquidity, higher borrowing cost, and lower production activities. Fixed income yields are expected to go northward; thus, we advise investors to maintain short duration on fixed income instruments. For equities, the hawkish monetary policy stance is expected to aggravate the prevailing bearish sentiment.

Committee's Considerations

The Committee highlighted the high and rising inflation in the global economy, as well as the sluggish growth in both advanced and emerging economies. However, Nigeria has maintained a growth path which the MPC attributed to the support from the Central Bank of Nigeria (CBN) and the Federal Government. Nevertheless, the resultant inflationary pressure caused by such support was top-of-mind for the Committee in making its decision. Also, to sustain investors' confidence in the economy and ensure continued patronage from foreign investors, the Committee reiterated the importance of further engendering ease of doing business in the country.

Noting the conditions in the financial markets, the MPC attributed the bearish sentiment in the equities market to investors favoring USD-denominated assets, which give more attractive returns. For domestic fixed income instruments, however, the high inflation has left real returns negative, resulting in capital outflows. This has been further compounded by the series of rate hikes in advanced markets.

Thus, it was considered that the need to ensure price and monetary stability, in accordance with its mandate, should take precedence in reaching its decision. As such, the MPC considered that options to hold and loosen its policy rate would trigger further capital flights and would also be detrimental to the value of the Naira. It was, however, considered that a decision to reduce the pace of money supply growth further would achieve its stated mandates, while also making Naira-denominated assets relatively more attractive to investors.

Key Decisions:

- Raised the MPR by 150bps to 15.50%
- Increased CRR by 500bps to 32.50%
- Retained liquidity ratio at 30.00%
- Retained the asymmetric corridor at +100bps/-700bps around the MPR

Anticipated Impacts

The Banking Sector:

A Double-Edged Sword on Operational Metrics

Unsurprisingly, an effect of the two consecutive rate hikes in May (150bps) and July (100bps) has been higher prime and maximum lending rates (12.23% and 28.30% in August vs 11.96% and 27.37% in May 2022). Similarly, the yield on investment securities has also risen over the period: average Treasury Bills and Bond yields rose by 310bps and 194bps to 7.07% and 13.04% as of 27th of September (vs 3.97% and 11.10% as of 24th9/29/2022 of May). These, coupled with the recent reversal of interest rate on intervention loans to 9% from 5%, potentially put banks on a trajectory to generate interest income and asset yields.

On the other hand, the Committee's decision to increase the CRR by 500bps limits banks' credit creation ability. Hitherto, uncertainties in the macroeconomic environment have made it more challenging for banks to grow their loan books. For context, the industry's average loan book growth rate was 8.47% YtD in H1:2022 (vs 9.81% YtD in H1:2021). Also, the increased MPR indicates that banks' funding cost is expected to increase since the MPR serves as an anchor for the interest rate on deposits. Therefore, banks' interest expense is projected to rise, potentially leading to higher funding costs, which would, at least partly, counterbalance the projected increase in asset yield. The effect would be only a marginal improvement in the Net Interest Margin (NIM).

Overall, the Committee's decision is a double-edged sword for Nigerian banks bearing both positive and negative probable effects on financial performance in H2:2022. However, the H1:2022 results of our coverage banks show that most lenders are likely to have a good 2022FY financial performance still. Undoubtedly, the MPC's demand that banks meet the new CRR within a short notice period will test their short-term resilience. Nevertheless, any immediate short-term pressure will fizzle out in the medium term.

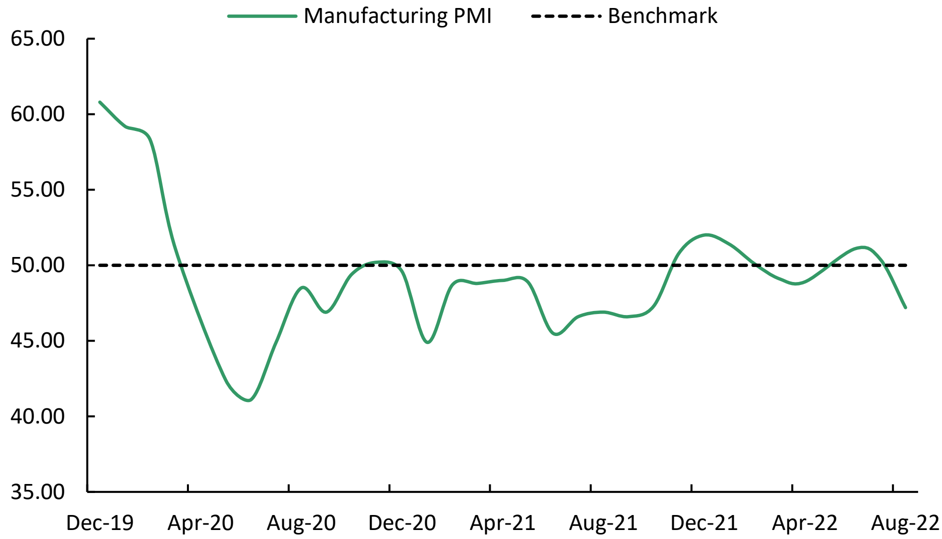
The Real Sector

Policy Decision to Weaken the Real Economic Growth

As referenced by the Committee, Nigeria's GDP has expanded in seven (7) straight quarters since Q4:2020. The latest data shows that GDP increased by 3.54% YoY in Q2:2022, buoyed by the manufacturing (+3.00% YoY), information and communication (+6.55% YoY), trade (+4.51% YoY), and agricultural (+1.20% YoY) sectors. However, the growth of the real sector moderated during the period: the agricultural and manufacturing sectors grew by 1.20% YoY and 3.00% YoY (vs. 1.30% YoY and 3.49% YoY in Q1:2021), respectively.

On a quarter-on-quarter basis, Nigeria's real GDP contracted by 0.37% in Q2:2022 (vs. -14.66% in Q1:2022). Furthermore, the trend in the Composite Purchasing Managers' Index (PMI) data shows a continued decline so far in Q3:2022. The index plunged substantially below the 50pts mark to 47.20pts in August, from 50.40pts and 51.90pts in July and June, respectively. While the downtrend can be attributed to the rising prices of manufacturing inputs, the aggressive monetary stance poses a threat to manufacturing activities through increased borrowing costs. The Committee's decision to further raise rates thus highlights a shift away from its erstwhile pro-growth stance, which was maintained until May 2022.

Chart 1: Trend of Manufacturing PMI (pts)



Source: *CBN, Meristem Research*

In our view, the Monetary Policy Committee's hawkish stance poses a downside risk to the real economy for the rest of the year. We expect the Committee's decision to hike rate to reduce new investments in the real sector, thereby slowing down economic activities. Thus, we expect lower production activities and employment in the remaining two quarters of the year. However, we expect the sustained intervention programs to marginally cushion the impact of tightening on the real sector.

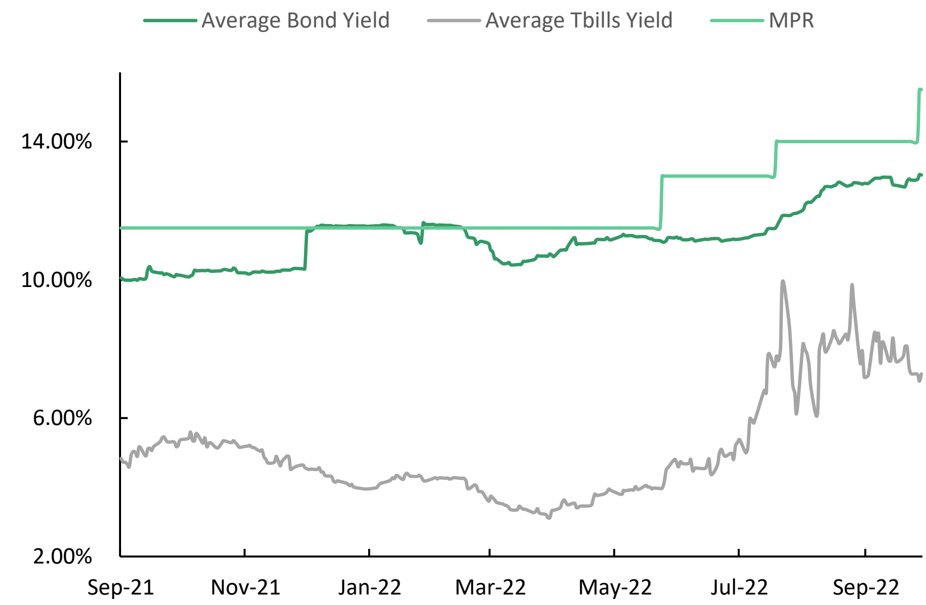
The Fixed Income Market:

Odds Remain in Favor of Risk-Free Assets

The fixed income market has been the preferred investment destination for investors since the MPC adopted a hawkish stance in May 2022. Investors have continued to price in further rate hikes and market risk; thus, fixed income instruments have remained relatively attractive compared to the equities market. For context, the stop rates across the trio instruments at the primary market auction (PMA) for treasury bills have been on an uptrend, increasing by an average of 437bps between the 25th of May and the 28th of September. In the secondary market, the average T-Bills and FGN Bond yields also increased to 7.07% and 13.04% as of the 28th of September (from 4.14% and 11.09%, respectively, on the 25th of May). We highlight that the gradual rotation of funds to the primary market due to increased stop rates at auctions has been the major contributor to the increase in yields in the secondary market.

Going forward, we expect the hike in the MPR to fuel a further uptick in stop rates at the PMAs and keep yields elevated in the secondary market. This outlook is further bolstered by the expectation of tighter system liquidity, following the Committee's decision to increase the CRR. Other factors projected to contribute to an uptick in yields are the high cost of borrowing in the international market, which makes the domestic market a more viable option to fund the FGN's budget deficit, and the high demand for a positive real rate of return amid surging inflation.

Chart 2: Average Bond and Treasury Bills Yield



Source: *Bloomberg, FMDQ, Meristem Research*

The Equities Market:

Equities Market to Take Further Beating

Bearish sentiments have dominated the local bourse since the MPC commenced its tightening cycle around mid-year. The decision of the Committee to adopt a hawkish stance in its May meeting (and the ensuing increase in fixed income yields) was accompanied by sell-offs in the equities market (which had reached its highest point in more than a decade). Expectedly, the risk-off sentiment caused a dip in activity levels in the equities market. Daily volume and market turnover averaged 196.83mn and NGN2.67bn, respectively, between June and September (vs. 350.08mn and NGN5.23bn during the first five months of the Year).

Thus, for the first time in six consecutive quarters, the All-Share Index recorded a negative return (-5.43% Qtd as of 29th September 2022), and the Year-to-date return declined to 14.63% (from 23.87% and 22.48% at the May and July meetings respectively). Across sectors, all indices recorded negative returns so far in

Q3:2022, with the industrial goods index being the worst performer (-17.61% Qtd).

While the market has recorded consecutive months of losses, the market PE (10.10x) remains above peers Ghana (5.23x), Egypt (6.70x), Kenya (6.80x) and South Africa (9.20x). However, the PE remains below the market's 3-year average PE of 11.42x and the Relative Strength Index of 38.23 implies that the market is approaching an oversold region.

With the most recent hike in MPR and CRR and the outlook of a further increase in fixed income rates, we do not expect to see any significant buying interest in **equities in the near term. We**, **however**, **note the likelihood of investors taking** a **position on presently undervalued tickers, especially in the financial services sector, due to the improved outlook for interest income. In our view, the cheap valuation of stocks across sectors also presents an attractive entry opportunity, especially for investors with a long-term investment horizon.**

Chart 3: NGX-ASI Trend (Pts)

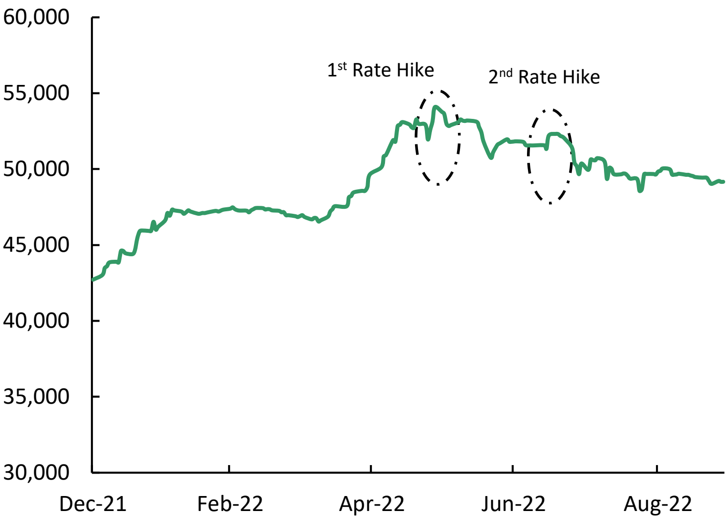
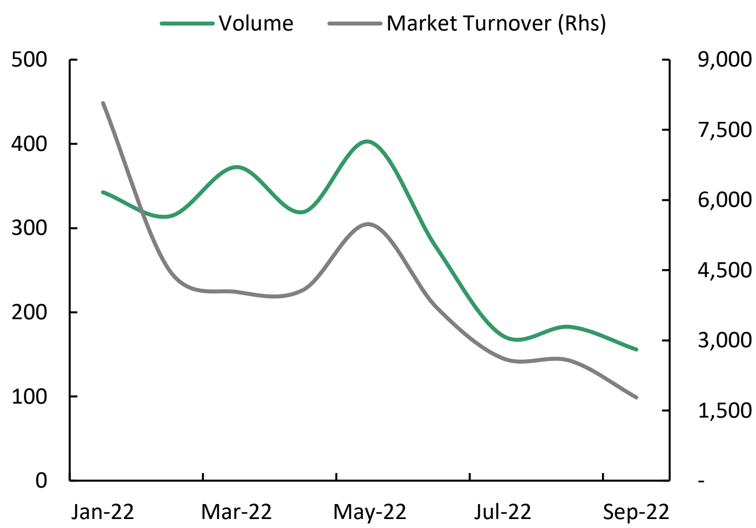


Chart 4: Average Daily Volume (mn) and Market Turnover (NGN'mn)



Source: Bloomberg, NGX, Meristem research

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