MERISTEM

Macroeconomic Update

MPC Monitor | November 2022

MPC Retains Hawkish Stance

.... Tightens Monetary Policy Rate Further

The Monetary Policy Committee (MPC) held its last two-day policy meeting on the 21st and 22nd of November 2022, where it **raised the Monetary Policy Rate (MPR) by 100bps to 16.50% from 15.50%** while holding other parameters constant- **Cash Reserve Ratio (CRR) at 32.50% and Liquidity ratio at 30.00%**. We note that all Committee members voted in favour of a rate hike: 9 members voted 100bps, and 2 members voted 50bps.

The Committee considered the several macroeconomic headwinds impacting global growth, notably the lingering war in Ukraine, China's zero COVID-19 policy, the looming food crisis, supply chain bottlenecks, rising global inflationary pressures and the normalization of monetary policy in the advanced economies. The Committee, thus, noted that the spillover effect associated with the several uncertainties remained heightened, increasing the likelihood of a recession, especially in emerging and developing economies.

On the domestic front, the Committee considered the output growth sustained in Q2:2022 and expects this momentum to persist, given the rebound in economic activities. The Committee also noted the consistent uptick in headline inflation, which increased to 21.09% in October 2022 from 20.77% in September 2022. However, the MoM headline inflation declined to 1.24% from 1.36% in September 2022, which the Committee considered as a reasonable progress of its previous monetary policy rate hikes.

The Committee's decision to raise the MPR reflects its full commitment to aggressively achieve moderation in price level in the near term. In our view, the immediate effects of the decision would be higher borrowing cost and increased fixed income yield. However, we think that the effect on the equities market will be muted as we consider the market to have fully priced in the possibility of a rate

Committee's Considerations

The Committee was concerned with the rising inflationary pressures both the globally and domestically with Nigeria's inflation rate at 21.09% in October 2022. It highlighted the major drivers of the higher inflation in Nigeria as higher energy prices, recent flooding in major food producing states, lingering insecurity challenges, high transport cost and scarcity of Premium Motor Spirit. It also noted that broad money supply grew further in October: M2 money aggregate has risen by 4.25% since May 2022 when the rate hike cycle commenced to NGN50.58trn in October 2022.

The Committee however appraised the efficacy of its decisions to raise the policy rate at its previous meetings, concluding that the desired effect of price stability is gradually being achieved as month-on-month (MoM) inflation rate continues to decline. In particular, MoM headline inflation declined by its third straight time in October 2022.

Attributing the weakness in the global economy to the various headwinds upsetting economic recovery (such as high energy prices, supply chain bottlenecks), the Committee noted that domestic output growth has remained positive on the back of the continued support from fiscal and monetary policy. It however urged both authorities to not lose sight of the common policy goals of price stability and economic growth.

The MPC also highlighted the sustained decline in the equities market which reflected the rotation of funds to the fixed income market and investor apathy towards Nigerian equities due to increased inflationary pressures, tightening external financial conditions and increased political risk in the country.

Additionally, the Committee expressed concern over the significant decline in external reserves (gross reserves declined by 1.34% MoM between September and October to USD36.87bn). Thus, it encouraged the apex bank to sustain its drive at boosting non-oil exports to augment external reserves as an alternative to oil revenue which remain laggard.

Key Decisions:

- Raised the MPR by 100bps to 16.50%
- Retained the CRR at 32.50%
- Retained liquidity ratio at 30.00%
- Retained the asymmetric corridor at +100bps/-700bps around the MPR

Anticipated Impacts

The Banking Sector:

Net Interest Margin to Increase

As we have always reiterated, the banking sector is expected to benefit from the MPR hike through higher lending rate. Notably, the previous cumulative MPR hike of 400bps (since May) has led to an increase in average lending rates by c. 48bps. While this seems slow especially when compared with the MPR which is more than 8x higher, lending rates are relatively sticky and do not experience dramatic jumps. However, it is important to note that net domestic credit has since increased by 12.34% between May and October 2022 to NGN63.48trn. This presents an avenue for more interest income flows to banks. Similarly, the expected higher yield on investment securities following the aggressiveness of the MPC will also contribute to increased interest income.

On the flip side, interest expense will also experience an uptick following the successive hike in the MPR, as it takes its reference from the benchmark rate.

However, we think that there would be a relatively smaller rise in interest expense compared to interest income as over half of the banking industry funding comes from low-cost sources.

Banks' asset yield is thus, expected to rise faster than their funding cost. Thus, on a net basis, we expect to see a significant improvement in banks' net interest margin in their 2022FY financial results. The banks that would benefit most would be those who are able to accumulate cheap funding and are able to aggressively grow their interest earning assets base.

The Real Sector:

Q4:2022 Growth to be Significantly Weighed Down

Although there has been no new data regarding Purchasing Managers' Index (PMI) readings from the CBN since its August figure of 47.20pts, market musings point to slowdown of economic activities. A direct impact of the successive MPR raise is higher borrowing cost which is a deterrent for additional borrowings for investment purposes. This, coupled with other prevailing macroeconomic headwinds such as high cost of inputs, would deliver a lower supply of outputs. While the various fund interventions of the CBN in the agricultural, healthcare, and other real sectors are commendable, at best, they only partly address the supply-side. The demand-side is still left worse-off as high inflation depresses real household disposable income. In fact, the International Monetary Fund (IMF) recently revised its growth forecast for Nigeria downward to 3.00% (vs. a previous estimate of 3.20%).

Bearing in mind the lag associated with monetary policy transmission, we expect the cumulative MPR hikes to cause a significant deceleration of output in Q4:2022. Moreover, the unresolved headwinds would also leave a dent on output growth. While the recent reopening of major pipelines is expected to increase crude oil production, we do not expect this to significantly counteract the effect of the MPR hike on overall output growth.

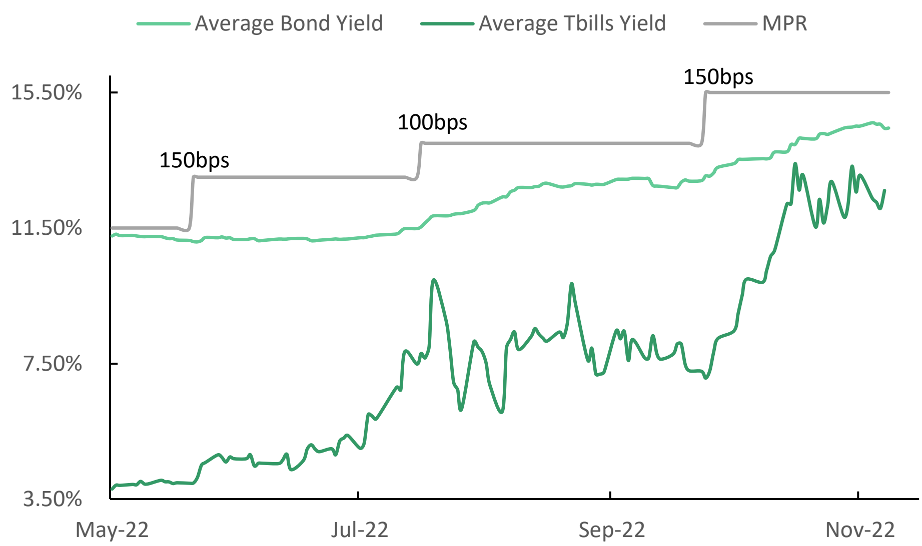
The Fixed Income Market:

Yields to Sustain Uptrend

Since the first-rate hike in May, fixed income instruments, especially treasury securities, have enjoyed tremendous patronage from both risk-tolerant and risk-averse investors. There has been a steady rotation of funds to the primary market auctions (PMA), as investors seek to bridge the gap between their returns and the high inflation rate. Between mid-May (prior to the first MPR hike) and mid-November (date of latest PMAs), average Treasury bills' rate and bond yield have risen by c. 636bps (to 9.51%) and c. 356bps (to 15.38%), respectively. Unfulfilled demands for higher rates at the PMAs have also found their way to the secondary market with average TBills and bond yields rising by 811bps and 333bps within the same period.

The additional increase in the MPR by 100bps is expected to prompt further uptick in stop rates at the PMAs in the foreseeable future. While occasional increase in system liquidity from FAAC allocation and coupon payments could cause instantaneous moderation in yield, the continuous government borrowing from the local fixed income market would ultimately keep yield elevated. Moreso, higher borrowing costs in the international debt market and the Government's need to finance NGN8.80trn of its 2023 budget deficit through borrowings jointly point to higher borrowing from the local market. We expect the same forces to hold yields high in the secondary market.

Chart 2: Average Bond and Treasury Bills Yield



Source: *Bloomberg, FMDQ, Meristem Research*

The Equities Market:

Rate Hike Already Priced in: Muted Impact Expected

The equities market has continued to record bouts of sell offs since the last Monetary Policy committee meeting in September, as investors take position for higher yields in the fixed income market. However, while the **NGXASI** lost in September (-1.61% MtD), and October (-10.58% MoM *representing the highest monthly decline in equities returns since March 2020*), there has been increased buying activities in the market so far in November (2.49% MtD as of November 22,2022).

Save for the Ghanaian equities market (Price-to-Earnings, PE ratio of 4.83x), the Nigerian equities market (PE ratio: 6.21x) is relatively undervalued compared with its peers: Egypt (8.10x), Kenya (6.86x), South Africa (10.08x) and Emerging markets (10.57x). We also opine that the market has already fully priced in and ridden out the effects of the rate hikes and as such, this current rate hike will have little to no effect on the equities market. Rather, we posit that a rebound is imminent. The major downside risk to this projection, however, is the likelihood of investors making fewer long term investment decisions in the build up to the 2023 elections.

While we see room for gradual rebound in the equities market, the expectation of higher yields in the fixed income market portends a major downside risk. We also opine that the upswing of tickers in the financial services sector has potential to spread across other sectors. Additionally, the cheap valuation of stocks across sectors presents an attractive entry opportunity, especially for long-term investors.

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