MERISTEM

Ahead of MPC

May 2023

Committee Set to Hold its Third Meeting in 2023

…Expected to Raise Rates by 50bps

The Monetary Policy Committee (MPC) is scheduled to meet for the third time this year on the 22nd and 23rd of May 2023. Here, we highlight the notable global and domestic events that we expect the deliberations at the meeting to revolve around, in line with the existing monetary policy framework.

A major consideration at the meeting would be the most recent round of rate hikes by major monetary authorities - The US Federal Reserve, European Central Bank (ECB) and Bank of England (BoE). We also expect the Committee to take note of the moderation in oil prices due to lower economic growth expectations. A prelude to this was the International Monetary Fund's (IMF) downward revision of 2023 and 2024 global growth forecast in its April 2023 World Economic Outlook. Furthermore, some members of the OPEC+ recently announced a voluntary oil output cut.

On the domestic scene, headline inflation has maintained its upwards trajectory, peaking at of 22.22% YoY in April 2023. Also, broad money supply has increased consistently, and capital inflows have remained low. We also expect the recent securitization of Ways and Means financing to be appraised by the Committee.

With the above considerations in mind, we expect the MPC to increase the benchmark rate by 50bps, while keeping all other parameters unchanged.

International Economies and Developments

Persistent Contractionary Measures Cloud Growth Prospect

New concerns are emerging over the growth prospects of the global economy. This has led the International Monetary Fund (IMF) to reduce its 2023 global growth forecast to 2.80% (vs. 2.90% in January) citing sustained rate hikes, recent global financial turmoil, and higher-than-usual debt levels. Reflecting these concerns, advanced economies had weaker economic output in Q1:2023. The U.S.A. reported 1.10% YoY GDP growth (down from 2.60% in Q4:2022), while the Eurozone recorded 1.30% (down from 1.70% in Q4:2022). Elsewhere, the Chinese economy grew by 4.50%, largely driven by a surge in consumer spending.

Efforts to tame Inflation in the global economy persist as most countries still grapple with high food and energy prices due to supply chain disruptions which have lingered since 2022. Thus, monetary policymakers have maintained contractionary measures, as inflation remains above target, albeit declining. The US Federal Reserve, in May, hiked the Fed Funds rate for the 10th consecutive time by 25bps to a range of 5.00% - 5.25%, bringing the policy rate above the country's inflation of 4.90%. Similarly, the European Central Bank (ECB) took a less aggressive stance in May when the bank hiked rates by only 25bps, informed by slowing economic activity concerns, as the Eurozone recorded marginal growth in Q1:2023. Recent inflation data proved the efficacy of the rate hikes, however, the possibility of a breach in Russia's black sea grain deal poses a downside risk.

Oil Price Weakens Amidst Precautionary Oil Cuts

As a precautionary measure to support oil prices, OPEC+ announced an additional oil cut of 1.16mbpd, bringing the total to 3.66mbpd. The supplementary reduction is expected to take effect in May with the participating countries being Moscow, Iraq, the UAE, Algeria, and Kuwait. Oil prices rallied following the announcement: Brent crude and West Texas Intermediate (WTI) rose by 8.36% (to USD85.84/bbl.) and 6.24% (USD80.4/bbl.) respectively. However, the recently released China trade data for April 2023 signalled weak oil demand of 10.36mbpd, down by 16.00% MoM and 1.40% YoY. This contributed to a fall in oil prices, with Brent crude and WTI currently hovering around c. USD75/bbl and USD72/bbl respectively.

Domestic Macros

Domestic Economy Sustains Growth Trajectory

In the domestic economy, output growth was sustained at a temperate pace. According to data released by the National Bureau of Statistics (NBS), Real GDP expanded by 3.10% in 2022. Q4:2022 standalone saw a 3.52% YoY growth (vs 3.85% in Q4:2021 and 2.25% growth in Q3:2022), marking the ninth consecutive quarter of growth since the country's exit from recession in 2020. The enhanced performance was bolstered by growth in the non-oil sector (+4.44% YoY) which contributed 95.66% to GDP in Q4:2022. The growth was supported by improvement in Information & Communication (+10.3% YoY), Agricultural (+2.05% YoY), Trade (+4.54% YoY), Manufacturing (+2.83% YoY), Finance and Insurance (+11.61% YoY) and Real estate (+2.78% YoY) sectors. These sectoral expansions evince the impact of the Central Bank of Nigeria (CBN)'s various interventions to stimulate economic activities across the real sector (the agricultural, manufacturing and services sectors).

In Q4:2022, Nigeria's oil sector experienced positive developments in oil production. The average production increased from 1.20mbpd in Q3:2022 to 1.34mbpd. These improvements were a result of implementing stricter measures against crude oil theft and conducting necessary repairs on major pipelines. However, despite the increase in production, the sector still recorded a negative growth rate of 13.38% YoY in Q4:2022. Nevertheless, this represents a recovery for the sector compared to the previous quarter, which had a growth rate of -22.67%. It is worth noting that the contribution of the oil sector to Nigeria's overall GDP decreased to 4.34% in Q4:2022, down from 5.66% in

Q3:2022 and 5.19% in Q4:2021.
Shifting focus to Q1:2023, Nigeria's oil production saw further improvement, averaging 1.52mbpd. This increase in output can be attributed to higher production levels from the Forcados and Bonny oil terminals.
We anticipate economic growth to slow down in Q1:2023 on the back of the cash crunch debacle which reduced economic activities between February and March 2023.

Inflation Continues an Upward Trend

Price levels in the domestic economy rose to the highest level since September 2005 in April 2023 as headline inflation increased to 22.22% YoY (from 22.04% in March 2023). The uptick was largely driven by increase in both the food and core indices. We view the sustained structural challenges of poor agricultural production, festivity-linked stock piling, increase in money supply, insecurity challenges in Nigeria's agricultural hubs and FX scarcity as factors maintaining the uptrend. We note that the month-on-month headline inflation rate (1.91%MoM), represents the highest since May 2016 (which was characterized with incidences of fuel scarcity and dollar unavailability. In our April 2023 inflation report, we highlighted factors that impacted the inflation index for the month and discussed our expectations going forward.
We expect the committee to consider the sustained uptick in headline inflation (despite the committee's aggressive monetary policy actions). Thus, we anticipate a continuation in the current monetary policy hawkish tone.

Fiscal Authorities Move to Improve Revenue

The recent discuss regarding Nigeria's fiscal measures are centered on the lag in oil production with the resultant dwindling oil revenue, the planned removal of fuel subsidy, as well as the recent introduction of new set of taxes. This is amid the recent securitization of the NGN22.67trn Ways and Means which has a negative impact on the country's key fiscal ratios – *particularly the debt-to-GDP ratio (currently at 34.60%)* – and could lead to further rating downgrade but should reduce debt service obligations. In any case, the eventual removal of the fuel subsidy will reduce the burden of an arguably unproductive spending from the Government.

Meanwhile, unofficial data reveals that the Federation Accounts Allocation Committee (FAAC) revenue shared amongst the government tiers declined by 1.11% MoM to NGN714.63bn in March. This can be partly attributed to low oil receipt which came from twin factors: lower oil production (-2.92% MoM to 1.31mbpd) and low monthly average oil price (-5.18% MoM to c. USD79.21). This is likely to worsen in April as oil production further dropped by 21.26% to below 1.00mbpd, a result of the 13-day strike action by the Petroleum and Natural Gas Senior Staff Association of Nigeria (PENGASSAN).

Efforts to increase other streams of government revenue have however been implemented, the newly approved fiscal policy measures (FPM) instituted a new set of excise duties on alcoholic beverages, wines and spirits ranging from 20% to 100% higher than the previously applicable rates. Also, a new green tax has been imposed on single use plastics (SUPs) at the rate of 10%, and an import adjustment tax imposed on some categories of cars. Given the inelastic nature of demand in the consumer staples sector, we expect this new set of taxes on alcoholic beverages to further exert pressure on inflation as consumers are likely to bear the brunt of the excise duties.

Conversations about the possible removal of fuel subsidy has also remained front burner in recent times. The 2023 budget only provides for the payment up till June 2023 and the current administration has made an agreement with the World bank for the disbursement of an USD800.00mn facility to vulnerable families who would be most affected. While the removal is expected to increase inflationary pressures (through higher petrol pump price), it should reduce unproductive spending typically embedded in the budget.

In its next meeting we expect MPC to consider these fiscal activities in deciding monetary policy direction

Chart 1: Debt-to-GDP ratio

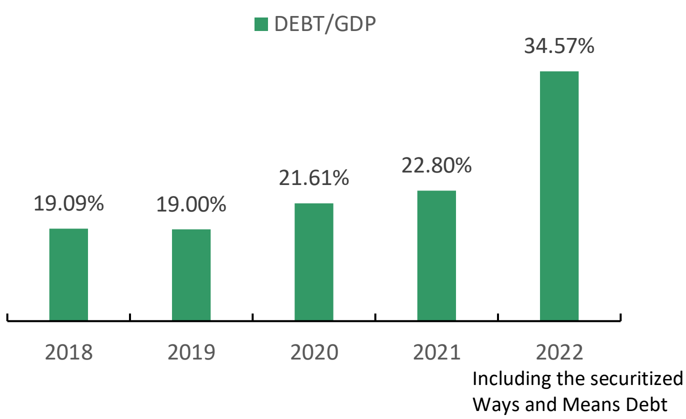
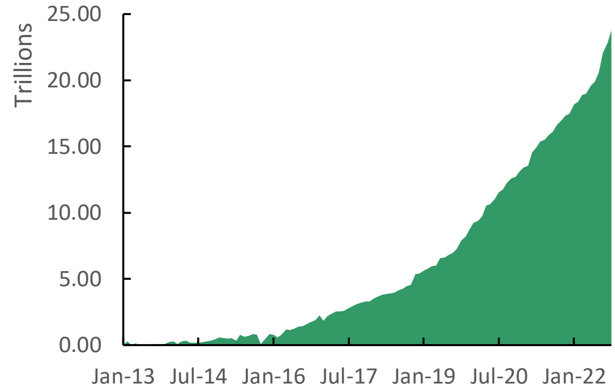


Chart 2: Ways and Means Trend



Source: DMO, CBN, Meristem Research

Lingering Political and Insecurity Issues…

The political scene has been awash with activities in 2023 given its significance as a transition year for major governmental positions. Following the Presidential election in February, at least 5 court cases challenging the outcome of the elections have been filed. Amongst them is the Labour Party's petition against the Independent National Electoral Commission (INEC) which is scheduled to be held on May 17th, 2023. Preparations of the inauguration of the current President-elect, Bola Ahmed Tinubu on May 29, 2023, are however ongoing. On the security front, the insecurity situation remains largely unabated as reports of kidnapping and banditry have continued to linger. These events have continued to pressure the food production and supply chain, as some of the affected states are considered major food producing states, leading to further rise in food prices.

We expect the Committee to appraise the potential impact of the change in government and persisting security challenges on rising inflation during its May 2023 meeting.

Monetary Policy

Currency Outside Banking System Spikes After Court-Ordered Policy Reversal

Despite the CBN's efforts to mop up excess liquidity in the system, broad money supply (M3) continues to rise, reaching a record high of NGN54.63trn (4.75% YtD increase) in March 2023. However, the increase was primarily driven by the spike in net foreign assets fuelled by higher foreign asset holdings of the CBN and a decline in foreign claims on other depository corporations. Net domestic assets also grew marginally by 1.54% to NGN48.64trn in the same period.

We recall that in December 2022, a humongous NGN2.57trn (or 85.29% of the currency in circulation) was outside the banking system. This has historically weakened the effectiveness of inflationary control measures. To curtail this, the CBN introduced the cash swap and Naira redesign policy which immediately lowered the currency outside banks to NGN792.18bn (or 57.14%) in January 2023. Unsurprisingly, we have observed a reversal in this trend as currency outside banks spiked to NGN1.45trn, reverting to 85.86% of currency in circulation in March 2023. This can be attributed to the reinstatement of the old Naira notes as legal tender until December 2023 by the Supreme court. We expect this increase to persist in the near term as old Naira notes are re-released into circulation, which could pose new threat to the efficacy of monetary policy decisions.

Low FX Liquidity Weakens Exchange Rate

Nigeria's external reserves balance has continued to decline (-5.24% Ytd) and currently stands USD35.24bn. This is reflective of the reduced accretion from the oil sector revenue which is a key FX inflow to the reserves. Despite improved oil production IN Q4:2022, output still falls below the budgeted target of 1.69mbpd. The strike action by the Petroleum and Natural Gas Senior Staff Association of Nigeria (PENGASSAN) coupled with multiple pipeline explosions aided the contraction in oil production. Consequently, FX market turnover in April 2023 fell by 17.01% (USD95.60bn vs USD111.87bn in February 2023) due to lower supply of FX to the market. However, the CBN has been making strong efforts to improve inflow through the RT200 programme which has recorded a USD1.70bn inflow in Q1:2023 from non-oil export and "Naira 4 dollar" scheme which rewards recipients of FX received through official channels.

Meanwhile, the official exchange rate has also been on a downward trend as the Naira depreciated on the I&E window and stood at NGN463.09/USD in April (from NGN461.64/USD in February 2023) with a Ytd decline of 3.24% (NGN448.55/USD in December 2022). However, the parallel market rate has been quite stable, hovering around NGN740.00/USD premised on reduced speculation activities in the market. We expect the MPC to consider the current FX illiquidity and its impact on the economy.

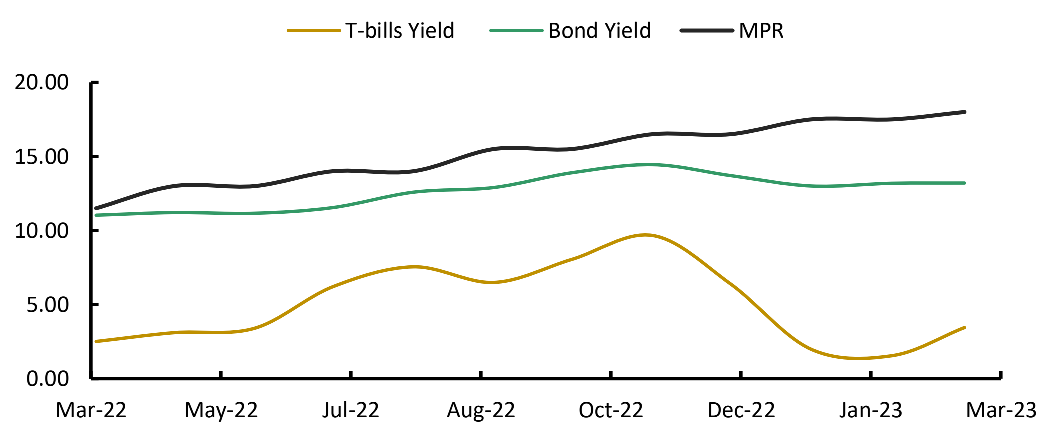
Fixed Income Environment and Outlook

Dissociation between MPR Hikes and Treasuries Yields

The general expectation in an environment of increasing interest rates is higher yields, especially on short-dated instruments. However, this has not been the story in the Nigerian fixed income market since the MPC embarked on its hiking spree in May 2022. We have observed a growing margin and disconnect between the monetary policy rate and yields on fixed income instruments. In our view, system liquidity has been the major driver of rates in both the primary and secondary markets. As such, it is perceived that this has been a helpful tool for the Government to manage its borrowing costs.

For investors in the T-bills auction, the 364-Day instrument remains a favourite note evinced by the high subscription level. In fact, in the last four auctions since the March meeting, the 364-Day instruments have seen a total subscription of NGN2.00trn (c.95.86% of the total subscription). As a result, the instrument has seen the largest drop in yields (8.99% as of May 10 auction vs 14.74% at the March 29 auction).

Chart 3: Average T-Bills Yield, Average Bond Yield and Monetary Policy Rate (MPR)

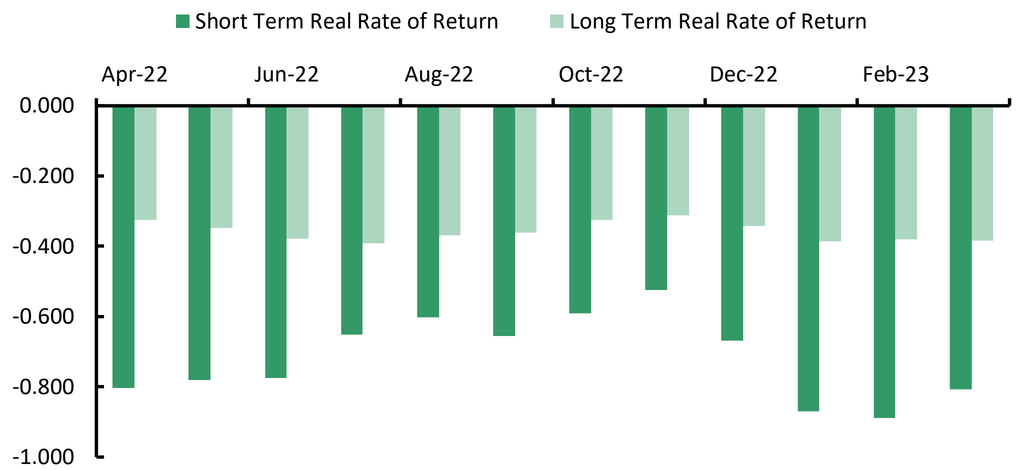


Source: *CBN, NBS, FMDQ, Meristem Research*

Realities surrounding the Real Rate of Return on Nigeria's Treasuries

Despite the accumulated 650bps MPR hike, the real rate of return on treasury instruments has remained negative due to the relentless inflationary pressures that have plagued the country. Furthermore, the margin has stayed relatively wider for short-dated instruments compared to long-tenor notes, underscoring the Government's interest in long-dated bonds to manage its borrowing cost more efficiently. The persistence of negative real rates and the Government's preference for long-dated bonds reflect the complex dynamics at play in the Nigerian fixed-income market. Balancing inflationary pressures, interest rates, and debt management remains a crucial objective to achieve.

Chart 4: Real Rate of Return on Nigeria's Treasuries



Source: *FMDQ, NBS, Meristem Research*

As we have analysed earlier, a balance between curbing the high inflation rate, interest rates and debt management appears essential.

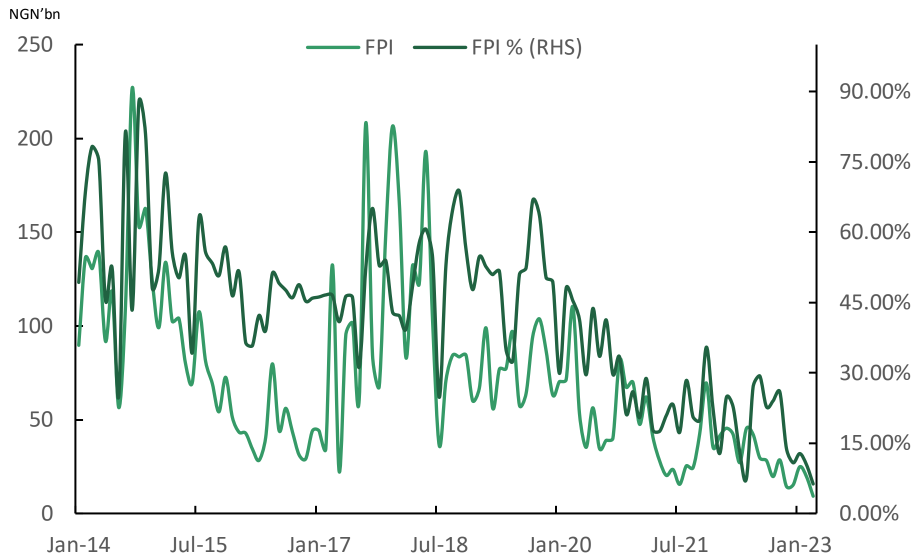
Foreign Participation on the NGX at a Decade Low

The local bourse has been predominantly bearish since the MPC last met in March. The All-Share Index shed 4.47% MoM in April and has lost 4.53% cumulatively since the last meeting to settle at 52,419.33 as of the 16th of May. Consequently, the Year-to-Date return of the index has declined to 2.28% (from 7.13% at the last meeting). The bearish mood in the market reflects broad based profit taking activities despite impressive Q1:2023 results that were released during the period. Furthermore, sell-offs on certain large caps in April – **AIRTELAFRI** (-15.48% MoM), **NB** (-13.15% MoM) and **MTNN** (-4.71% MoM) contributed to the dip.

Activity level in April was largely boosted by buying interest on **TRANSCORP** (5.42bn units) and **ACCESSCORP** (1.82bn units) both of which contributed 68.95% to the total volume traded during the month (10.50bn units of shares). For context, Femi Otedola recently acquired a significant portion of **TRANSCORP**'s shares (2.25 billion units), which he eventually sold. **ACCESSCORP**, on the other hand, has recently seen increased activity due to higher-than-expected dividend declarations (NGN1.30), improved Q1:2023 earnings, and notable corporate actions. These positive developments showcased the company's strong performance and strategic initiatives.

The level of foreign participation in the market remained worrisome. As per the most recent foreign portfolio investment report by the NGX, the value of foreign participation in the market in March was NGN9.19bn (6.29% of total market activity). This represented the lowest participation level by foreign investors in a decade (both in terms of Naira-value and contribution).

Chart 5: **FPI Participation on the NGX (2014-2023)**



Source: *NGX, Meristem Research*

Five of the seven sectoral indices we track recorded a decline in April, while only the Consumer Goods and Insurance indices – **NGXCNSMRGDS** (+4.75% MoM) and **NGXINS** (+3.87% MoM) appreciated. The gain on the Consumer Goods index was propped by the performance of **BUAFOODS** (+11.76% MoM) and **DANGSUGAR** (+14.71% MoM), while the performance of the insurance sector index is attributable to buying interest on **MANSARD** (+24.74% MoM), **NEM** (+4.71% MoM) and **WAPIC** (+5.00% MoM).

In terms of returns, the Nigerian equities market (1.88% YtD) trails its African peers - Ghana (11.34% YtD), Egypt (18.30% YtD), South Africa (7.13% YtD)- except for Kenya (-26.59% YtD). However, the market valuation (PE – 9.3x) indicates that the market trades at a premium relative to the peers – Ghana (3.8x), Egypt (9.2x), Kenya (4.8x) - except South Africa (10.8x).

We expect the MPC to consider the recent selloffs in the equities market and investors' concerns about economic growth in reaching its decision. However, the broadly positive corporate performance despite previous rate hikes should signal tenacity of corporates to the committee.

On a Balance of Factors…

Ultimately, we expect the Committee to:

- **Raise the MPR by 50bps to 18.50%**
- **Retain liquidity ratio at 30%**
- **Retain the asymmetric corridor at +100bps/-700bps**
- **Retain the CRR at 32.50%**

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