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Ahead of MPC

July 2023

Committee Set to Hold its Fourth Meeting in 2023

…No More than 50bps Hike Expected

The Monetary Policy Committee (MPC) is scheduled to hold its fourth meeting of the year on the 24th and 25th of July 2023. Just as in previous meetings, we expect the Committee to appraise happenings in both the global and domestic environment in reaching its decision. The Committee is expected to consider declining inflation across major advanced economies, sustained hawkish tone of monetary authorities across the world, developments in the oil market and the financial sector crisis of H1:2023.

On the domestic scene, headline inflation has maintained its upward trajectory, significant fiscal policy reforms (like fuel subsidy removal and tax reforms) are ongoing, while existing legacy issues in the agricultural sector persist. The Committee is also expected to consider the impact of these aforementioned issues in its upcoming meeting.

Other factors likely to influence the Committee’s decision include: the cost-of-living crisis, collapse of FX windows at the Investor's and Exporters Window and its implications for the country's currency value against the greenback. As a side note, we expect the ongoing administrative changes at the Apex bank to have an impact on the MPC's monetary policy decision.

While we maintain that a HOLD stance is not appropriate at this time, we also opine that the Committee's decision would swing between a decision to hold and utilise other monetary policy tools, or to increase the MPR further. After carefully considering all the points above, our view is that the MPC will be more tilted towards a 50bps increase in the monetary policy rate (MPR) to 19.00%.

International Economies and Developments

Pausing to Reflect: Is the End in Sight for the Hiking Cycle?

Global economic growth prospects are still a cause for concern due to continuous rate hikes, high debt levels, and the lingering effects of the global financial turmoil experienced in H1:2023. Nevertheless, the International Monetary Fund's (IMF) growth projection of 2.80% in its April economic report appears optimistic, considering the persisting economic challenges. Economic growth in the US and UK saw marginal improvements, with both countries experiencing growth rates of 2.00% and 0.10% in Q1:2023, compared to contractions of -1.30% and -1.10% in Q1:2022, respectively.

However, since the last MPC meeting in May, inflation numbers from advanced countries indicate the effectiveness of contractive measures taken by the central banks. Specifically, the UK's inflation rate fell by 80bps to 7.90% in June 2023, its

The lowest level since March 2022. The reduction is on the back of c.20% YoY drop in motor fuel prices. Similarly, the US inflation rate declined to a two-year low of 3.00% in June from 4.10% in May due to declines in prices of gas, groceries, and used cars. However, the inflation rate remains above the target level of 2.00%, and the unemployment rate continues to be elevated, with labor demand surpassing labor supply.

The previously highlighted threat to global inflation has become a reality as Russia declines to renew the black sea grain deal. Additionally, India, the world's largest exporter of rice (c.40.00% of global rice exports) has imposed a ban on the export of its non-basmati rice, in a bid to control rice prices in the country's domestic market. These developments may offset the positive impacts of effective global monetary policies, leading to anticipated repercussions on food prices by the end of 2023.

The Contracting Oil Market and Trends in Demand

The International Energy Agency (IEA) for the first time in 2023 revised its growth forecast for global oil demand downwards by 0.22 million barrels per day (mbpd) to 101.88mbpd (vs 102.10mbpd in 2022) for 2023. The revision is attributed to the persisting economic challenges and tightening monetary policies in both advanced and developing countries, all of which are contributors to the drags on global oil demand.

However, despite these challenges, global oil demand was anticipated to rise seasonally by 1.62mbpd from Q2:2023 to Q3:2023, reaching an average of 102.10mbpd for the entire year. China is expected to account for 70% of this increase in global oil demand, driven by a rise in petrochemical activities on its domestic front. On the other hand, oil consumption in the Organization for Economic Cooperation and Development (OECD) countries, especially Europe, remains sluggish due to the slowdown in industrial activities. The oil demand growth rate is projected to slow further by 1.10mbpd to 100.78mbpd in 2024, owing to a slow economic recovery, in addition to the adoption of electric vehicles and an upsurge in efficiency measures in vehicle fleets.

African countries have experienced a decline in oil imports in Q2:2023, evinced by the drop in oil demand to 4.32mbpd (from 4.69mbpd in Q1:2023) according to data from the Organization of Petroleum Exporting Countries (OPEC)'s June report. This decline is due to higher retail fuel prices after the removal of subsidies in countries like Nigeria and Ethiopia. The decline in oil production from Saudi Arabia and core OPEC+ members, along with output increases from other producers, has so far offset the production cuts implemented in November 2022. Not subjected to cuts due to sanctions, Iran has ramped up production to 3.01mbpd (from 2.48mbpd in October 2022) reaching a five-year high. Additionally, output has also recovered in Kazakhstan to 1.60mbpd and Nigeria to 1.24bpd (from 1.56mbpd and 1.18mbpd in May respectively).

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Domestic Macros

Growth to Improve Marginally

The National Bureau of Statistics (NBS) reported that real GDP growth in Q1:2023 declined to 2.31%YoY (vs 3.11% in Q1:2022). The services sector was the primary contributor to GDP for the quarter, accounting for 57.29%, followed by agriculture at 21.66% and the industrial sector at 21.05%. The slow growth experienced in Q1:2023 was largely attributed to the impact of the cash crunch on business activities, particularly in the non-oil sector. Following the suspension of the Naira redesign policy we expect an expansion in GDP for Q2:2023, specifically in the non-oil sector as business activities improved. For the oil sector, our outlook is positive as oil production for Q2:2023 reached an average of 1.14mbpd (vs 1.13mbpd in Q2:2022) despite the strike action by PENGASSAN, which affected oil production for April (1.00mbpd).

We highlight that the administration's policies targeted toward economic growth such as backward integration programs, value chain domestication, and bilateral investment agreements create opportunities for Foreign Direct Investments (FDIs). However, we do not anticipate an immediate impact of these growth-targeted policies in the near term. On the other hand, the removal of fuel subsidies and the consolidation of exchange rate windows into one is expected to result in higher costs for importing raw materials for manufacturers posing a threat to output growth.

Unyielding Inflation Poses Concern

In June 2023, headline inflation continued its upward trajectory, reaching 22.79% YoY (compared to 22.41% YoY in May 2023 and 18.60% YoY in June 2022). This increase can be attributed to the simultaneous increase in the food and core index to 25.25% YoY and 20.27% YoY (vs. 24.82% YoY and 20.06% YoY in May 2023), respectively. Moreover, the significant price hike of Premium Motor Spirit (PMS) following the removal of fuel subsidy by the government had a notable impact on transportation costs, further adding pressure to the overall prices of goods and services.

Given that the drivers of inflation remain present, we expect the committee to maintain its hawkish stance and hike the benchmark rate in the upcoming monetary policy meeting. Furthermore, the reflection of market realities of the exchange rate and the expiration of the black sea grain deal poses a notable upside risk to inflation.

Fiscal Reforms Take Centre Stage

Following the inauguration of President Bola Ahmed Tinubu's administration, fiscal policy reforms have largely been the major highlights of the macroeconomic environment. From the removal of petroleum subsidy, suspension of tax payments in the Finance Act till September 2023 (to align with National tax policy guidelines), Senate's approval of the USD800mn palliative focused loan, and the signing of the student loan act, the administration's activities signal a willingness to undertake economic growth-enhancing activities.

Data from the Nigerian Upstream Petroleum Regulatory Commission (NURPC) also indicates a recovery in the crude oil sector as oil production volume for June improved by 5.51% MoM to 1.25mbpd (vs 1.18mbpd in May 2023) on the back of activities undertaken to curb oil theft and pipeline vandalism in the country's oil-producing regions. Notably, news sources report that the Nigerian Army arrested suspects of illegal bunkering in Rivers state. We expect sustained improvement in production volume to support oil receipts, strengthen Nigeria's fiscal coffers, and improve FAAC allocation. Already, unofficial sources report that FAAC allocation in June shot up by 15.37% MoM to NGN907.05bntrn (from NGN786.16bn in May 2023).

We infer from these factors discussed above that the fiscal authority favors a pro-growth stance at this time. Thus, we expect the Committee to consider the potential impact of these actions on rising inflationary pressures in its upcoming meeting.

Cost of Living Crisis Sparks Fears of Socio-Political Unrest

Activities on the political scene have largely calmed following the inauguration of the new administration, while the focus has shifted to policy actions including the selection of cabinet members. Some court cases challenging the validity of the February elections have been closed (Enugu and Lagos) while others have continued to linger (the petition against President Tinubu’s win of 25% of the votes cast in the FCT).

Insecurity in the country has also heated up since the last MPC meeting on the back of reported cases of kidnappings and banditry in the Northern and Eastern regions of the country, specifically Kano, Plateau, Imo, and Enugu, amongst others. As the cost-of-living crisis deepens, we express concerns about jitters of potential protests erupting in the country which would result in a slowdown in economic activities. Thus, we expect the Committee to consider the impact of these challenges.

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Monetary Policy

Currency Soaring to Pre-Cash Redesign Levels

As we highlighted in our half year 2023 outlook, money supply statistics have largely been on the rise in 2023 as broad money supply expanded by 22.15% between January and June to NGN64.91trn. In line with this, following the resolution of the currency crisis that rocked the economy in Q1:2023, currency outside the banking system continue to increase, shooting up by 185.67% between January and June.

We also highlight the reduction in Cash Reserve Ratio (CRR) requirement for merchant banks from 32.50% to 10.00% to support economic growth activities including infrastructure development, real estate, and agriculture. These developments suggest a gradual shift from a contractionary to an expansionary monetary stance, we expect the Committee to consider the prevailing upside risks to inflation.

Since the last MPC, the CBN has undertaken major reforms in the FX market, collapsing all FX windows into one and re-introduction of the willing buyer–willing seller exchange. Following this, the currency was immediately devalued by 83.05% and the gap between official and parallel market rates narrowed. However, as we highlighted in our macroeconomic commentary on the FX policy, other actions such as increased FX supply and implementation, and relaxed restrictions on some banned items, would need to follow to encourage FX inflows into the country.

Data reveals that FX supply still remains low as the external reserve balance has also declined significantly since the last MPC meeting (-3.42%). We note the repayment of USD500mn Eurobonds which matured in July contributed to this decline. Thus, exchange rates across official and parallel channels have remained largely volatile at NGN768.16 and NGN860.00 as of 20th July 2023.

Overall, we expect the Committee's dilemma to be between the continuation of the current aggressive stance and consideration of the potential benefits of a rate HOLD.

Fixed Income Environment and Outlook

Treasury Yields Persists on Its Downward Course

Since the last MPC meeting, the dynamics in the Nigerian fixed-income market have been relatively positive. The primary driver of the upbeat mood witnessed during the period has been the implemented policy reforms. Nonetheless, interbank liquidity remained the significant determinant of treasury yield direction. This was fuelled by the removal of caps and floors on interbank placements. In fact, data from the CBN showed that the system liquidity stood at NGN540.21bn as of July 19, up from NGN382.73bn as of the last MPC meeting date. Additionally, the Overnight Policy Rate and Overnight Rate have been very volatile during the period, crashing to a year-low of 0.83% and 1.15% on July 5 (from 11.00% and 11.50% as of May 23), respectively.

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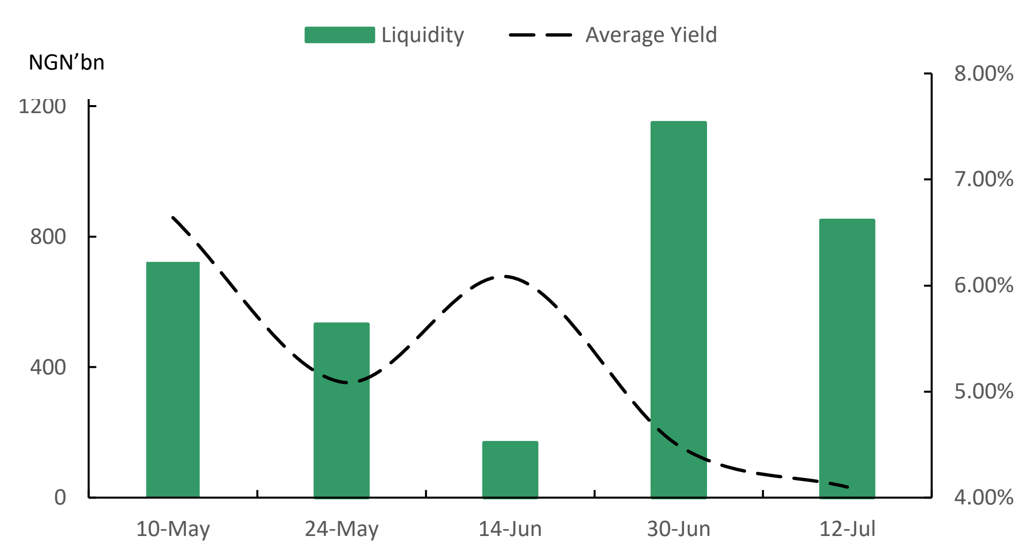
As we have previously highlighted, there has been a weak relationship between the MPR and treasury yields. This, combined with the robust system of liquidity, has continued to broaden the gap between inflation rate and treasury yields. Notwithstanding, investors in the domestic debt market have continued to take a position on these instruments despite the widening negative real return. For reference, at the last T-bills auction, the stop rate on the 91-Day, 182-Day, and 364-Day instruments were 2.86%, 3.50%, and 5.94% (vs 4.50%, 6.44%, and 8.99% as of May 23). Equally, the average marginal rate in the bond primary market declined to 13.63% in July (vs 15.12% in May). A similar trend was observed in the secondary market as average T-bills and bond yield fell by 285bps and 125bps to 3.80% and 12.75% as of July 19, respectively.

While lower treasury rates can be seen as a positive for the Federal Government in a bid to improve the nation's fiscal sustainability, we note that the adverse impact of the rising inflationary pressure continues to taper investors' real return. Thus, we expect the committee's decision to revolve around striking a balance between debt management and satisfying investors' demand for higher rates.

Chart 4: Liquidity and Average T-Bills Rate (May- July 2023)



Source: CBN, Meristem Research

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Equities Market and Outlook

Charting a Golden Course: Seeking New Highs

The Local bourse has maintained a strong bullish trend since the last MPC meeting on May 23rd, 2023. Consequently, the NGX-ASI has advanced by +20.79% since the last meeting to reach 63,930.72pts as of the 20th of July. The upbeat mood in the market was evinced by the activities level as total volume and value traded surged by 4.51% MoM and 28.78% MoM to 11.75bn units and NGN200.95bn, respectively as of June 2023. Furthermore, the market breadth at 3.96x reflected the prevailing upbeat mood in the market.

The optimism in the market was upheld by the investor's perception of the pro-market policy stance of President Bola Ahmed Tinubu's administration. Following the subsidy removal, and unification of FX windows into the I&E, amongst other policies, investors took bargain-hunting positions in some sectors that were considered to benefit from the policies particularly banking, and oil and gas. The positive sentiments filtered into other sectors across the board, consequently, all sectoral indices recorded ample returns - **NGXBNK** (+53.89% YtD), **NGXCNSMRGDS** (+49.28% YtD) **NGXOILGAS** (+84.15% YtD), **NGXINDUSTR** (+18.77% YtD), and **NGXINS** (+50.72% YtD) **MERI-AGRIC** (+54.74% YtD), safe for the Telecommunications index (-3.09% YtD) as of 20th of July.

Furthermore, foreign participation in the market improved in May 2023 (the latest available data) with FPI participation in the local bourse reaching NGN37.16bn (the highest level since June 2022). Also, there was a slowdown in FPI outflow compared to inflow, with the ratio of inflow to outflow reaching its 5-year best of 2.85x. We attribute this improvement to growing foreign investors' confidence in the policy direction, as it is expected to facilitate the ease of fund repatriation, FX flows, and contribute to economic growth.

From a valuation viewpoint, the Nigerian equities market is currently trading at a premium (P/E of 11.66x) relative to its African peers. Likewise in terms of returns, the local bourse has garnered the most (+24.74% YtD) outperforming other African markets - Ghana (+17.01% YtD), Egypt (+20.41% YtD), Kenya (-13.00% YtD), and South Africa (+5.75% YtD) as of 20th of July.

In the near term, we envisage that the overriding sentiments in the market will remain positive. Investors should continue to react favorably to policy changes by the new administration and thus, buying interests sustained. Also, H1:2023 earnings releases from corporates are expected to drive positive market performance.

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In any case, the market has been less responsive to any successive policy rate hikes. However, a misguided policy decision that causes a negative surprise could reverse the upbeat in the Nigerian equities market. Thus, we expect the MPC's stance to signal a well-anchored policy-setting framework rather than catch the market by a negative surprise.

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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