MERISTEM

Ahead of MPC

November 2023

Committee Set to Hold its Fifth Meeting in 2023

…New Administration Expected to Focus on Price Stability

The Monetary Policy Committee (MPC) is expected to meet for the fifth time this year, on the 20th and 21st of November. Having had ample time to famililiarise itself with past and present economic events and decisions, it is anticipated that the Committee will carefully consider both global and domestic events in deciding its next monetary policy direction. Also, given that this represents the Committee's first outing since appointment, significant attention would be drawn to the Committee's decision as this would further entrentch its preferred policy direction.

We expect key considerations at the meeting to include disinflation trends in advanced economies, global monetary authorities consideration, slowdown in oil price movements, and the possible ripple effects of China's housing crisis and its slower demand on the global stage.

On the domestic scene, the continued uptrend in headline inflation, stemming from the impact of the devaluation of the naira on general price level, remains a focal point for the Committee's considerations. Additionally, factors poised to shape the Committee's decision include system liquidity and ongoing fluctuations in the foreign exchange market.

Given that inflationary pressures remain persistent and are expected to rise further, we expect the Committee to raise the policy rate by another 25-50bps to 19.00% - 19.25%, while holding other policy parameters unchanged. Also, given the need to align the monetary policy rate with market interest rates, we do no think a HOLD stance would be considered at this time as market rates are currently on the rise.

International Economies and Developments

The Benefits of Sustained Efforts Against Persistent Inflation

From their significantly higher numbers at the start of the year, inflationary pressures across global markets have declined significantly. In October 2023, headline inflation in the US, UK and Euro-area declined to 3.20%, 2.10% and 2.90% respectively (from 6.40%, 8.80% and 8.50% in January 2023). Thus, since the start of the Q3:2023, global monetary action has begun to shift towards an accommodative stance as major monetary policy authorities began to pause their pace of consecutive rate hikes. The Fed, Bank of England (BoE) and European Central Bank (ECB) all opted to hold their policy rates at their last meetings, highlighting the general moderation in inflation expectations across these economies.

Economic growth expectation was also adjusted for the US on the back of the economy's continuous resilience (expanded by 4.90% in Q3:2023 vs 2.60% in Q3:2022) and strong consumer & government spending despite The Fed's aggressive pace of rate which began in 2022. The International Monetary Fund (IMF) revised its 2023 growth forecast for the United States (2.10% from 1.80%) and United Kingdom (0.50% from 0.40%). The organization, however, maintained a gloomy outlook for the Euro area forecasting a 2023 growth rate of 0.70% vs 0.90% on the back of divergence in growth across economies in the region (France- 0.10%, Spain- 0.30%, Belgium- 0.50%, and Germany- -0.10%).

Elsewhere in the Asian region, China continues to face challenges in its property market, prompting the IMF's downward revision for its 2023 economic growth forecast to 5.00% from 5.20%). Despite the People's Bank of China (PBOC) lowering its banks' reserve requirement ratio (RRR) twice this year to enhance liquidity for economic recovery, the property sector remained unresponsive as new home prices declined for the fourth consecutive month in October by 0.10% to 0.30% MoM in October. However, the Chinese government plans to allocate around 1.00trn Yuan (USD137.22bn) in low-cost financing to support urbanization and affordable housing programs in the last quarter of 2023. We believe these expansionary efforts will assist in revitalizing its economy.

Adjustments in the Oil Market

In its latest November report, the Organization of Petroleum Exporting Countries (OPEC+) revised its global crude oil demand forecast upwards to 2.50 million barrels per day (mbpd) for the rest of 2023 (previously pegged at 2.40 mbpd). This upward revision is credited to the stronger-than-anticipated growth observed in non-OECD countries. In addition, the surge in China's crude imports by 240,000 barrels per day (bpd) in October and anticipated increased crude imports by India in Q4:2023 were factored into the revision of global demand. Meanwhile, on the supply front, the US remained the major contributor as a non-OPEC supplier, consistently boosting its liquid supply to exceed 12.50mbp monthly since January 2023. Consequently, the OPEC+ revised non-OPEC supply upwards by 1.80mbpd to 67.60mbpd for 2023FY, with additional support volumes from Brazil, Kazakhstan, Norway and Mexico. **Despite the voluntary supply cuts and the less impressive supply volumes from OPEC-11, the volumes from non-OPEC suppliers are expected to keep supply steady for the rest of 2023.**

Also, following the shift in the expected impact of the eastern region crisis and the Israel-Hamas conflict, the average Brent crude price declined from USD88.70pb in October to USD77.64pb as of November 16th. **We expect the Committee to consider the recent rebalancing in the oil market at its upcoming meeting as oil prices are expected to continue their downward trend in the near term, driven by anticipated low demand, leading to a surplus market until the beginning of 2024.**

Domestic Macros

Government Initiatives to Boost Oil Production

The Bretton Woods twin organizations (The World Bank and IMF) both revised their growth expectations for Nigeria downwards to 2.90% in 2023 on the back of the sustained depreciation of the Naira and lower-than-optimal production volumes in the oil and gas sector. This is largely in line with our projection of a 2.94% economic growth (compared to 3.10% in 2022) as we also factor in the expected slowdown in consumer spending and economic activities due to the recent fiscal policy reforms (petrol subsidy removal exchange-rate devaluation),

However, the National Upstream Petroleum Regulatory Commission (NUPRC) reported a marginal increase in Nigeria's crude oil production for October (+0.30% MoM) to 1.35mbpd, securing Nigeria's position as OPEC+'s top African oil producer for the month. Government initiatives addressing security concerns in oil-producing regions and heightened surveillance measures contributed to this rise in production volumes. Still, we maintain our low expectation for the oil sector in 2023 on the back of significantly low volumes recorded earlier in the year.

Looking forward to the long term (2024 and beyond), we expect that the federal government's efforts, including introducing the Nembe oil grade to the global market, resolving the PENGASSAN strike, and intensifying surveillance against oil theft, to enhance oil production. Additionally, recent developments in the oil and gas sector, such as Nigeria's USD533.00mn memorandum of understanding with Saudi Arabia, the ongoing USD2.80bn Ajaokuta–Kaduna–Kano gas pipeline project by Oilserve Limited, and the anticipated commencement of operations at the Dangote oil refinery by December 2023, will be significant drivers for improvements in the country's oil and gas sector in the mid to long term.

Capital Inflow Falls to a Six-Year Low

In Q2:2023, Nigeria's total capital inflow fell by 32.90% YoY and 9.04% QoQ, settling at USD1.03bn. This decline was primarily driven by substantial decreases in foreign direct investment (-41.54% YoY) and portfolio investment (-85.89% YoY). Notably, the banking sector's contribution to total capital inflow contracted, dropping to 18.89% in Q2:2023 from 26.89% in Q1:2023 and 39.21% in the full year of 2022. Furthermore, the oil and gas sector recorded zero capital inflow in Q2:2023. In our opinion, these respective declines are attributable to the challenging macroeconomic landscape in the country- high inflation, foreign exchange (FX) illiquidity, and sluggish economic growth. These factors have in turn diminished Nigeria's appeal to foreign investors.

We anticipate that the Committee will consider the need to attract Foreign Direct Investments (FDIs) and Foreign Portfolio Investments (FPIs) into the economy. This factor

becomes especially crucial considering the persistent rise in inflation, leading to a negative real rate of return, and underscores the necessity for offering competitive rates on securities to allure foreign investors and foster economic growth.

Inflation Reaches an 18-year-high in October 2023

As the National Bureau of Statistics (NBS) reported, the country's headline inflation rose for the tenth consecutive time in 2023 to 27.33% YoY—its highest level in eighteen years, up from 26.72% in September 2023. Simultaneous increases in both the food and core indices drove this upswing. The food index climbed to 31.52% YoY, influenced by factors such as inadequate storage infrastructure in the food sector, insecurity in food-producing regions, and rising fuel prices (which impacted the transportation cost of agricultural products and resulted in a general escalation in food prices). Additionally, the core index peaked at 22.58% YoY in October, compared to 21.84% in September 2023. This is attributable to the ongoing depreciation of the Naira in both the official (33.97%) and parallel (31.00%) markets during the month, affecting the prices of import-dependent items like clothing, fabrics, and motor vehicles.

Given the sustained inflationary pressures, we expect the monetary policy committee to prioritize maintaining price stability in the economy and sustain its previous pace of rate hikes, as there are no apparent signs of inflation abating in the near term.

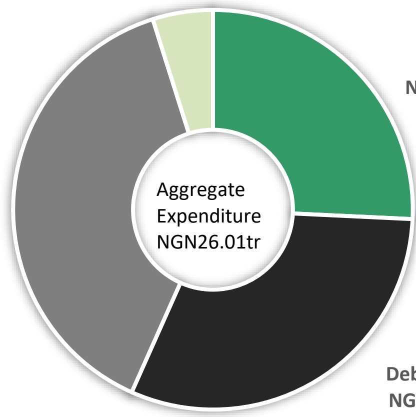
Fiscal Policy

Future Prospects and Challenges in Fiscal Management

Since the last MPC meeting, the fiscal policy scene has been rife with activity. The Federal Government proposed a NGN26.01trn budget for the 2024 fiscal year (+4.78%) from the previous year's NGN24.82trn (combined with the supplementary budgets), out of which NGN16.96trn would be funded by revenue while the budget deficit stands at NGN9.05trn. The budget is hinged upon certain assumptions, including an estimated oil price of USD73.96/pb, an exchange rate of NGN700.00/USD, inflation rate of 21.40%, and an estimated oil output of 1.78mbpd.

A review of the budgetary performance for the first seven months of 2023 shows relative progress compared to previous years. On the revenue side, c.81% (NGN5.19trn) of the pro-rated target of NGN6.44trn had been achieved, mainly anchored on taxation and other non-oil revenue. Meanwhile, expenditure remained within the 2023 fiscal year budget framework, totaling NGN8.60trn by July 2023. This accounted for 65.09% of the pro-rated target for the initial seven months and 37.97% of the annual budget at NGN13.21trn and NGN22.65trn, respectively. We expect the Committee to consider the expected performance by end of 2023 during its upcoming meeting

Chart 1: Federal Government's Proposed 2024 Budget



***Source**: Budget Office of The Federation, Meristem Research*

Anticipated Heightened Reliance on Debt

Concerns persist regarding the country's revenue underperformance and the insufficient contributions to the sinking fund (for financing future government debt obligations). For context, the budget performance shows zero contributions to the fund for the first seven months of 2023. This raises the possibility of increased reliance on debt to bridge the government's budget deficit, potentially resulting in amplified financing through Ways and Means and other debt sources. This also further entrenches apprehensions about its debt sustainability, especially considering the expected further depreciation of the Naira (evinced by the exchange rate at NGN841.14/USD on the NAFEM window as of November 16, 2023) and higher debt servicing costs. We posit that an increase in policy rate could further exacerbate the government's debt expenses.

Monetary Policy

Monetary Loop - Appreciation to Fluctuations

Since the last meeting in July, the Nigerian monetary authority has undertaken numerous measures to stabilize the exchange rate and manage liquidity in the financial system. This includes clearing c.10% of the existing backlogs of matured Non-Deliverable Forwards (NDF) leading to a temporal appreciation of the Naira by c.22% and c.10% on both official and non-official windows. While this is positive, we consider it insufficient to address the FX volatility prompted by the supply-demand gap.

Furthermore, the CBN issued Open Market Operation (OMO) bills worth NGN150bn in August for the first time in 2023 and subsequently, on October 30 and November 1 to

raise a cumulative of NGN650bn. Owing to these liquidity tightening measures, system liquidity tightened as both Open Buy Back (OPR) and Overnight (O/N) rates increased to 22.21% and 22.92% (from 14.00% and 14.86% as at the last MPC meeting). The NGN2.00bn maximum limit on Standing Deposit Facility by banks was also lifted to encourage banks increase deposits with the Apex bank.

In our Half year 2023 outlook, we considered the possibility of the monetary authority employing other tools like OMO auctions to control liquidity and enforce its mandate of price stability. We posit that this would become more frequent as the need to attract foreign capital remains a focal point for the Committee. A major concern for foreign investors has however included the lack of signaling effect between the Monetary policy rate and rates in the fixed income market. Thus, we expect the Committee to consider this need while deciding its next policy direction. We also expect that this will incentivize the Committee to raise the policy rate further.

Fixed Income Environment and Outlook

The fixed-income market sustained a predominantly bearish trend during the period, chiefly influenced by the CBN's continued use of unconventional tools to influence market liquidity. Specifically, the CBN rolled out two Open Market Operation bills on October 30 and November 1, with the average stop rates printing at 15.25% and 15.36%, respectively (vs. 12.49% at the first auction in August), coupled with multiple CRR debits during the period. The apex bank also lifted the NGN2.00bn ceiling on the Standing Deposit Facility (SDF), thus encouraging commercial banks to place more idle funds with the CBN at the SDF rate (15.75%). These activities cumulatively drove market liquidity lower, from NGN815.79bn (post-MPC meeting) to NGN209.36bn as of 14th November.

Consequently, at the last Primary Market Auctions (PMA) for T-Bills, the average stop rate on the trio instruments increased to 11.58% (from 9.33% at the previous auction in October). Similarly, the average marginal rate at the last FGN bond PMA increased to 17.13% (vs. 15.61% in October). The secondary market also mirrored the activities of the primary market as average T-Bills yield spiked to a high of 13.30% as of November 9 as investors sold off on existing instruments in anticipation of higher rates at subsequent PMAs, gleaning from the OMO auction results. Similarly, average bond yields rose to 15.79% as of November 16 (vs. 14.44% in September).

Drawing insights from the actions of the CBN and its evident liquidity management strategy, we expect yields on treasury instruments to stay elevated in the near term, underscoring the monetary authority's intention to make treasury rates more attractive and better reflect macroeconomic realities. Additionally, we highlight the heightened investors' demand for higher rates to compensate for the deteriorating economic conditions and the negative real rate of return on treasury instruments as the inflation rate trends upward. Thus, we expect the MPC committee to consider the aforementioned factors in its decision at the forthcoming meeting.

Equities Market Performance and Outlook

Attaining New Peaks Amidst Economic Adversities

While the local bourse has traded sideways since the committee last met on 25th of July, the predominant mood in the market has remained positive (as has been the case since the start of the year). During the period, the broad market index further gained 7.77%, settling at a historic high of 71,112.99pts as of November 17, 2023. Relatively, the return of the Nigerian equities market (+38.75% YtD) continues to dwarf the frontier (+1.50% YtD), emerging (+2.71% YtD) and developed markets (+6.97% YtD).

Several factors influenced the market direction during this period, including earnings releases (both H1:2023 and 9M:2023), subsequent dividend declarations and corporate actions. Notable buying activities were observed in financial services companies (banks and insurance), as they outperformed expectations. Conversely, consumer goods and telecoms stocks experienced sell-offs due to lower-than-expected earnings. On corporate actions, the proposed merger of **DANGSUGAR** and **NASCON**, as well as the announced premium buyout prices from **PZ** and **GLAXOSMITH**, spurred investors' interest, leading the stocks to rally during the period. The market also welcomed new listings - **VFDGROUP** (an investment firm) and **MECURE** (a pharmaceutical company), further contributing to the deepening of the Nigerian equities market.

Notwithstanding the stellar market performance, foreign investors remained hesitant of entering the Nigerian equities market majorly due to the lingering foreign exchange crises. Data from the NGX indicates a jump in outflow of funds by foreign investors (remaining above NGN20.00bn for three consecutive months since the last MPC meeting).

Furthermore, the Nigerian stock market witnessed notable reclassifications by FTSE Russell and MSCI to unclassified market and standalone market status, respectively. The market's response to these reclassifications was relatively subdued; however, they likely contributed to investors adopting a more cautious trading approach, evident in a significant reduction in activity levels during the review period. In October, both volume and value traded reached a six-month low of 7.05bn units and NGN148.03bn, respectively.

In contrast to equities markets in advanced economies, the impact of previous monetary policy hikes by the MPC has remained subdued in the local bourse. The MPC decisions have been largely anticipated by investors and thus already factored into their positions. Nevertheless, we highlight that the occurrence of an unexpected decision by the MPC may prompt a negative reaction from investors. Ultimately, our outlook for the market in the remaining months of the year remains mixed, though leaning towards a positive trajectory.

On a Balance of Factors…

We expect the Committee to:

- **Raise the MPR by 50bps to 19.25%**
- **Retain liquidity ratio at 30%**
- **Retain the asymmetric corridor at +100bps/-300bps**
- **Retain the CRR at 32.50%**

Contact Information

Brokerage and Retail Services

topeoludimu@meristemng.com	(+234 905 569 0627)
adaezeonyemachi@meristemng.com	(+234 808 369 0213)
contact@meristemng.com	

Investment Banking/Corporate Finance

rasakisalawu@meristemng.com	(+234 806 022 9889)
davidadu@meristemng.com	(+234 810 940 4836)

Wealth Management

funmilolaadekola-daramola@meristemng.com	(+234 805 498 4522)
crmwealth@meristemng.com	
Tel: +234 01 738 9948	

Registrars

oluseyiowoturo@meristemregistrars.com	(+234 802 321 0561)
www.meristemregistrars.com	
Tel: +23401-280 9250	

Trust Services

damilolahassan@meristemng.com	(+234 803 613 9123)
trustees@meristemng.com	

Finance

olasokomubo@meristemfinance.com	(+234 803 324 7996)
matthewawotundun@meristemfinance.com	(+234 802 390 6249)

Group Business Development

sulaimanadedokun@mersitemng.com	(+234 803 301 3331)
ifeomaanyanwu@meristemng.com	(+234 802 394 2967)
info@meristemng.com	

Client Services

adefemitaiwo@meristemng.com	(+234 803 694 3034)
brandandcomms@meristemng.com	

Investment Research

praiseihansekhien@meristemng.com	(+234 817 007 1512)
research@meristemng.com	

Corporate websites: www.meristemng.com www.meristemwealth.com www.meristemregistrars.com

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