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Economic Report | Monthly Update

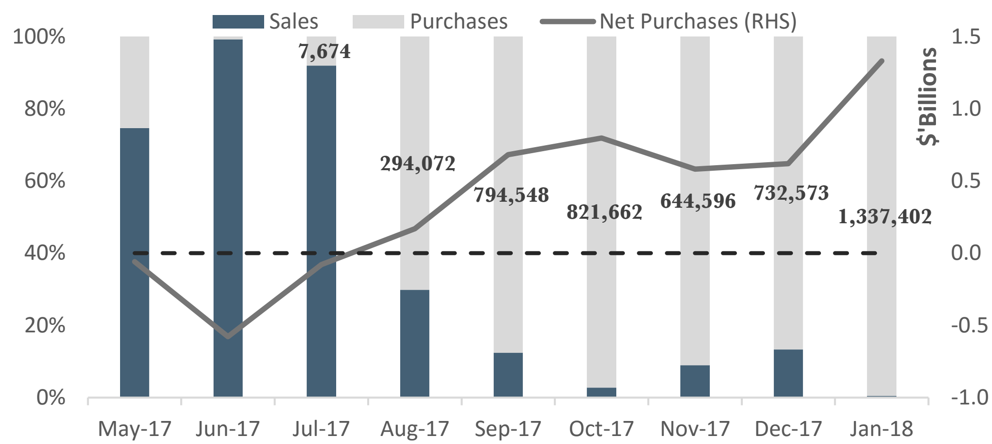
Economic Update – January 2018

Proactive or Defensive CBN?

In the month of January, daily average turnover at the Investors and Exporters Window (IEW) touched an all-time high of $274million, 35% higher MoM with a total of ~$6.1 billion sold. Notably, although the CBN has been a net buyer in the market since August 2017, (~$569 million average net purchase from August – December 2017), the apex bank mopped up sizable dollar flows in the month of January – net purchase of $1.3 billion. Basically, supply in the IEW has consistently outpaced demand, providing the CBN with scope to shore up its external reserves. As at 31st January 2018, the apex bank reserves grew by +5% MoM to $40.7 billion. In our view, the CBN is taking pre-emptive measures for any expected outflows stemming from global monetary policy normalisation and domestic political risk. However, this observation begs the question on why the excess supply has yet to force a noteworthy appreciation in the naira, especially when the CBN accounted for ~22% of transactions in the window. Is the CBN trading off between an appreciation in the value of the naira for currency stability over 2018?

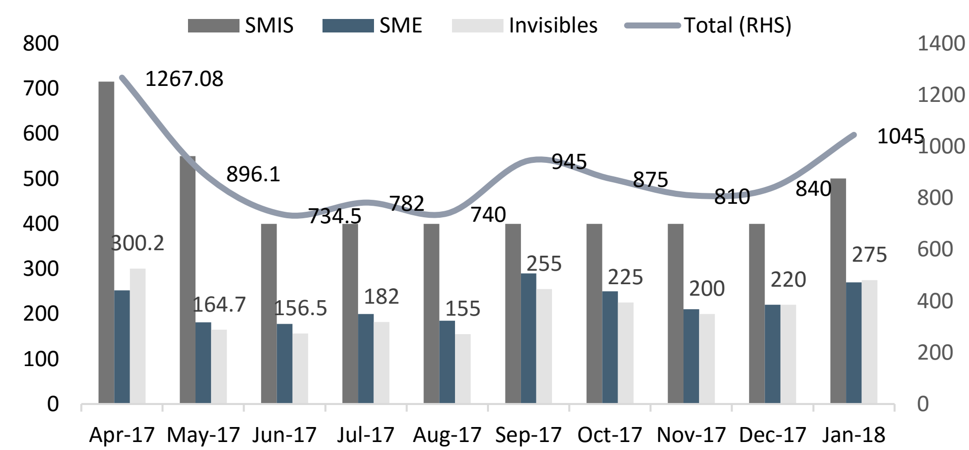
Further analysis into trading activities in the market reveal increased dollar inflows as client sales to the I&E Window jumped 27% to $2.3billion while member (dealing banks) purchases declined 19% to $848 million – indicating increased FX liquidity in the window. The CBN also increased sales across other segments of the market in a bid to close market spread. Precisely, the apex bank increased its sales to Wholesale, retail SMEs and invisibles' market by 25% to $1 billion.

Figure 1: CBN Activity at the IEW ($'000) vs. Balance ($'billion)



Source: FMDQ, ARM Research *Data estimated using monthly avg. exchange rate at the IEW*

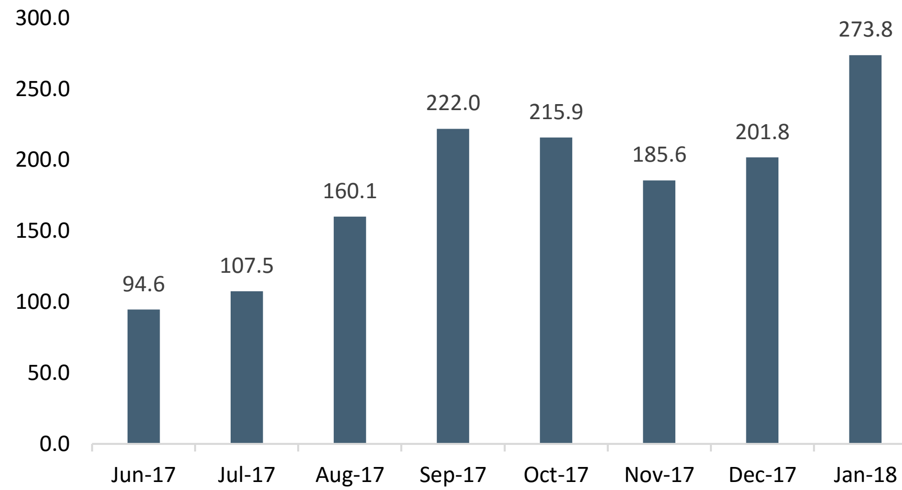
Figure 2: CBN Monthly FX Intervention to other market ($'million)



Source: FMDQ, ARM Research

Over the rest of the year, we do not see any shock to the currency as our analysis reveal the expected monthly oil and non-oil inflow as well as the current build-up of the country's reserve puts the apex bank in a better position to defend the naira. Underpinning our view is a scenario analysis carried out on the potential impact of a capital flight from the fixed income market as we believe foreign investors will remain attracted to the equity market. We look at maturing bills for the rest of the year and assume foreign investors hold back from rolling over their maturing bills because of expectations of lower return and election risk. Furthermore, on the basis that foreign investors hold 30-50% maturing instruments, we overlay the expected outflow with our expectations on oil and non-inflow for the rest of the year. For us, despite the higher outflow in May 2018 due to the maturing bond worth ₦302 billion ($838 million) – the current build up in reserve ($40 billion) as well as the move by CBN to take up the excess FX supply at the I & E window takes out thought of a depreciation in the currency.

Figure 3: Avg. IEW FX Intervention ($'million)



Source: FMDQ, ARM Research

Table 1: Scenario Analysis on expected outflows vs. CBN intervention

$'million	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18
Oil Inflow	1,500	1,800	1,300	1,200	1,200	2,200	1,500	1,100	1,100	1,600
Non-Oil Inflow	2,700	2,300	1,800	2,300	2,100	2,100	2,200	2,100	2,100	2,100
Total Inflow	**4,200**	**4,100**	**3,100**	**3,500**	**3,300**	**4,300**	**3,700**	**3,200**	**3,200**	**3,700**
Outflow										
Scenario 1: 30%	324	1,186	1,305	1,521	1,046	1,142	1,513	1,036	761	425
Scenario 2: 40%	432	1,581	1,740	2,028	1,394	1,523	2,017	1,382	1,015	567
Scenario 3: 50%	540	1,976	2,175	2,535	1,743	1,904	2,521	1,727	1,269	709
Net Inflow/(Outflow)										
Scenario 1	**3,876**	**2,914**	**1,795**	**1,979**	**2,254**	**3,158**	**2,187**	**2,164**	**2,439**	**3,275**
Scenario 2	**3,768**	**2,519**	**1,360**	**1,472**	**1,906**	**2,777**	**1,683**	**1,818**	**2,185**	**3,133**
Scenario 3	**3,660**	**2,124**	**925**	**965**	**1,557**	**2,396**	**1,179**	**1,473**	**1,931**	**2,991**

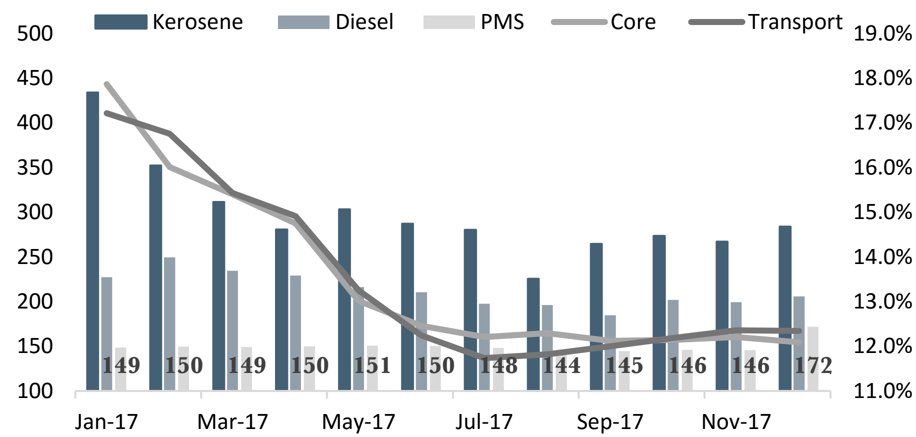
'Invisible hand' will magnify Inflation downtrend

First off, it is fascinating that in the month of December 2017, despite increases in key energy and transport prices relative to Nov-17 and Dec-16, core inflation moderated by 12bps to 12.1% YoY (-26bps to 0.51% MoM). According to the NBS, the deceleration was underpinned by declines in Alcoholic Beverage, Tobacco and Kola, Clothing and Footwear, and HWEGF divisions—which altogether account for 41% of the core basket.

Elsewhere, food inflation declined at its fastest pace since March 2013 by 89bps to 19.42% YoY (-30bps to 0.58% MoM) reflecting FX liquidity feedthrough to imported food even as FEWSNET noted the presence of elevated household stocks and market supplies after the main harvest. The latter likely offset demand pressures for farm produce and positively impacted on prices (-10bps to 0.69% MoM). Overall, Nigeria's CPI declined to a 19-month low of 15.37% YoY, 53bps lower than the prior month.

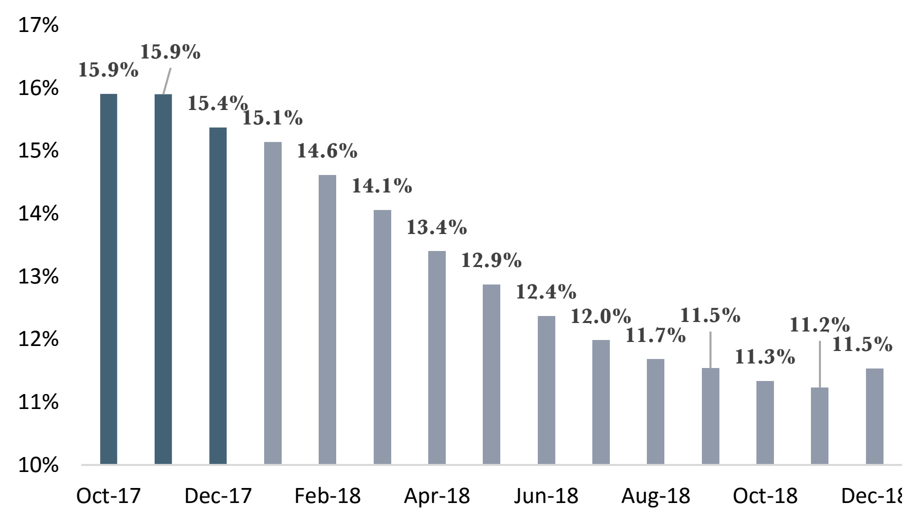
Over the first quarter of 2018, higher crude oil prices guide to possibility of higher energy prices which portends sizable downside risk to inflationary pressures. Nevertheless, we think energy prices will be managed for most part of 2018. To be specific, either political or economic induced, we are quite firm on the backdoor subvention to keep petrol prices stable with the NNPC remaining the sole importer of petrol. Consequently, we expect various spurts of fuel scarcity might resurface in the period as oil marketers protest unfavourable PMS prices. Nevertheless, the waning impact of currency-induced jump in food prices which posed a high base over 2017 suggests a downtrend in the CPI over the period. Tying all this together, we project mean YoY core inflation of 15.14% in January (Q1 18 average: 14.6% YoY).

Figure 4: Avg. energy prices (₦/litre) vs. Core & Transport Inflation (% YoY)



Source: NBS, ARM Research

Figure 5: Inflation rate – Actual and Forecast (YoY)



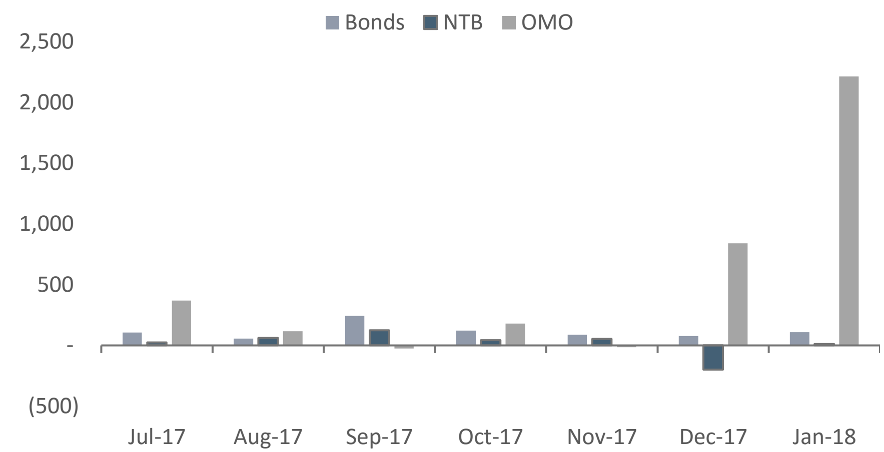
Source: NBS, ARM Research

Will the CBN sustain the liquidity strain?

The fixed income market is not dissimilar when it comes to the mighty hand of Jacob. In the last two months, the apex bank has intensified its OMO issuances in a bid to strain the liquidity impact of lower fiscal issuances, higher FAAC allocation (+8% MoM to ₦655 billion) and several coupon payments from FGN and state bonds (~₦88 billion). For context, in the month of December, given the inflows of ₦198 billion from payment of maturing bills via Eurobond Issuance and subdued bond issuance (₦86 billion vs. avg. of ₦117 billion in H2 2017), the CBN net-issued ₦919 billion (November: net maturity of ₦14 billion).

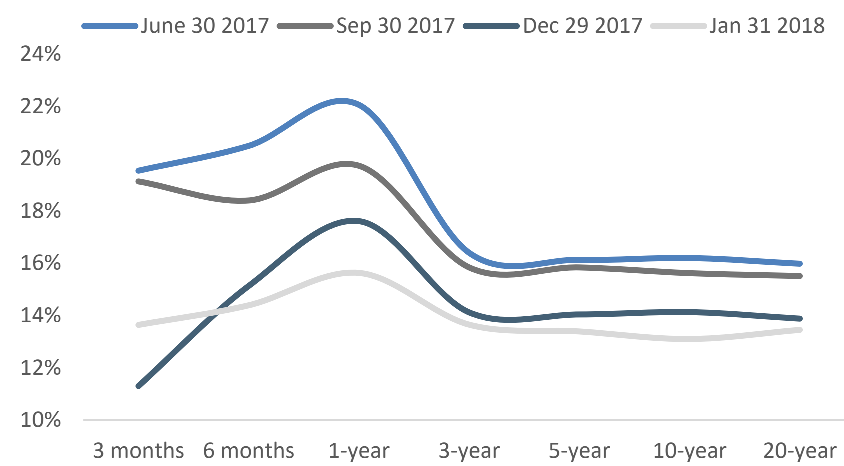
Similarly, in January, the apex bank net-issued ₦2.2 trillion via OMO, the highest monthly issuance on record, alongside net NTB issuance of ₦12.68 billion and bond auction of ₦110 billion. The foregoing reflects the CBN's quest to mop up system liquidity stemming from higher FAAC allocation (+8% MoM to ₦655 billion) and coupon payments from FGN and state bonds (~₦88 billion). Irrespective, in response to faster than expected drop in headline inflation (-53bps to 15.37% in December) CBN reduced its average stop rate at the OMO auction by 20bps to 13.67%. Contrariwise, average treasury bills yield inched higher by 15bps MoM to 14.48%. Elsewhere, although marginal rates tracked higher at the bond auction (+22bps MoM to 13.44%) on the back of higher issuance relative to prior month, average bond yields dipped 70bps to 13.41%. The decline in yields largely reflects the higher subscription level at the bond auction (bid to cover of 1.84x vs Q4 17 average of 1.36x) forcing investors to fill-up unmet bids at the secondary market. Overall, naira yield curve dipped a further 29bps to 13.94%.

Figure 6: Net OMO, net NTB and bond issuances (₦'millions)



Source: FMDQ, ARM Research

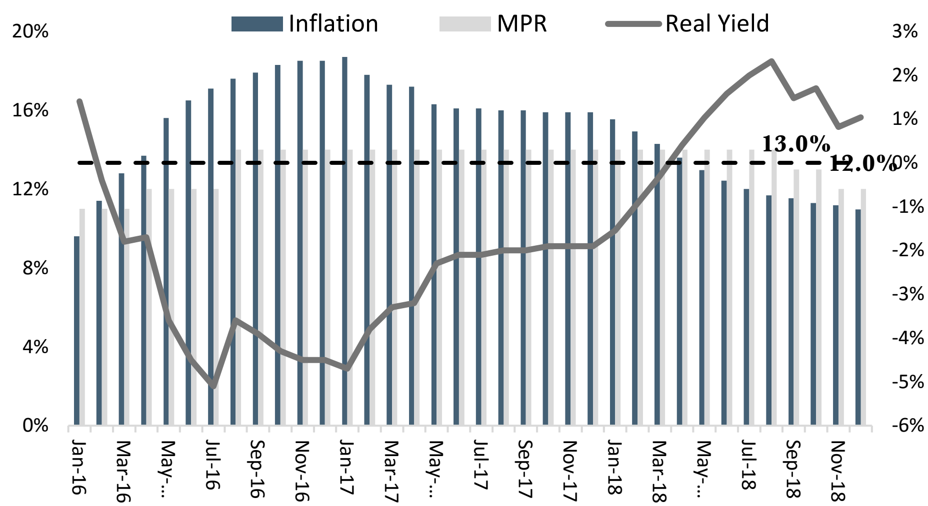
Figure 7: Movement in the naira yield curve



Source: FMDQ, ARM Research

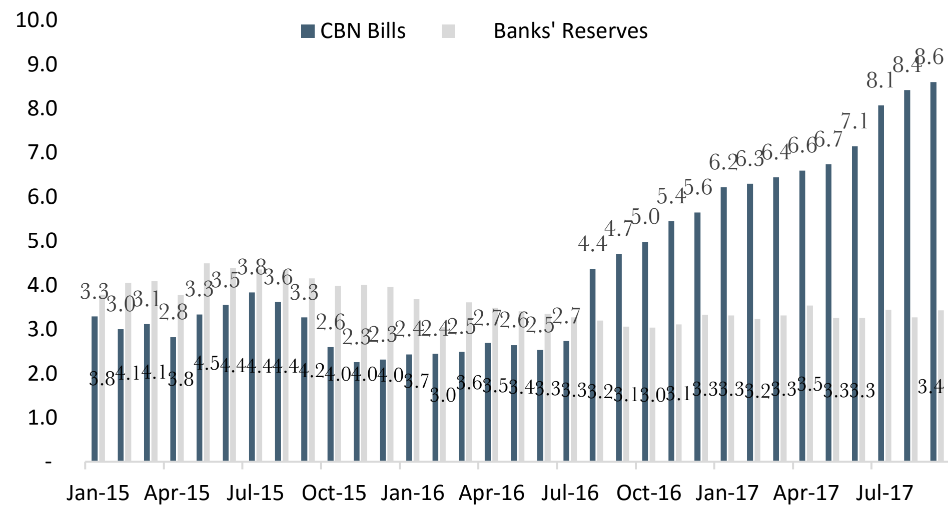
Going forward, monetary policy looks set to grapple with an elevated liquidity profile for NTBs, OMOs and bonds over 2018, and a pertinent question is whether the CBN will sustain the aggressive liquidity mop up. On the surface, with an expected drop in inflation and currency stability, the apex bank should be less concerned about the elevated liquidity levels in 2018. However, from a proactive stance, excess naira liquidity may direct flows to the I&E window, thus putting some pressure on the naira. Claiming the CBN may be defensive to achieving a stable naira at an 'equilibrium' rate, then the elevated liquidity level may be a concern for the apex bank. On this note, it is safe to say the CBN is likely to sustain its aggressive mop-up of liquidity in the near term albeit at lower rates, till farther out when an expected positive real yield will remove the justification to remain hawkish. At that point, we expect a cut in MPR ushered by a drop in OMO issuances and stop rates. However, should the risk of sizable capital flight materialize, the MPC will be faced with a conundrum of monetary easing in the face of FX concerns. Should this fear materialize, we are of the view that the CBN may switch its liquidity management tools from OMO issuances to a possible hike in CRR.

Figure 8: MPR vs. Inflation and real yield (2017 and 2018)



Source: CBN, NBS, ARM Research

Figure 9: CBN bills vs. Required Reserve (₦' trillion)



Source: CBN, ARM Research

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