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Nigeria Strategy Report – H1 2018 Excerpts

Domestic Economy and Markets

Monetary Policy: Dialing back on monetary tightening

Over H1 2018, we think the CBN will opt for a sustained moderation in the marginal clearing rate at its OMO auctions as well as lower OMO issuances as the way of signalling lower rates while keeping the appearance of policy tightening. In any case, the apex bank must grapple with a sizable maturity profile over H1 2018, which as we observed in December 2017, rendered impotent the impact of any net OMO issuances leading rates lower. Farther out, where we expect a downtrend in inflation, we think the monetary authority will cut rates to close the year at 12% for the MPR.

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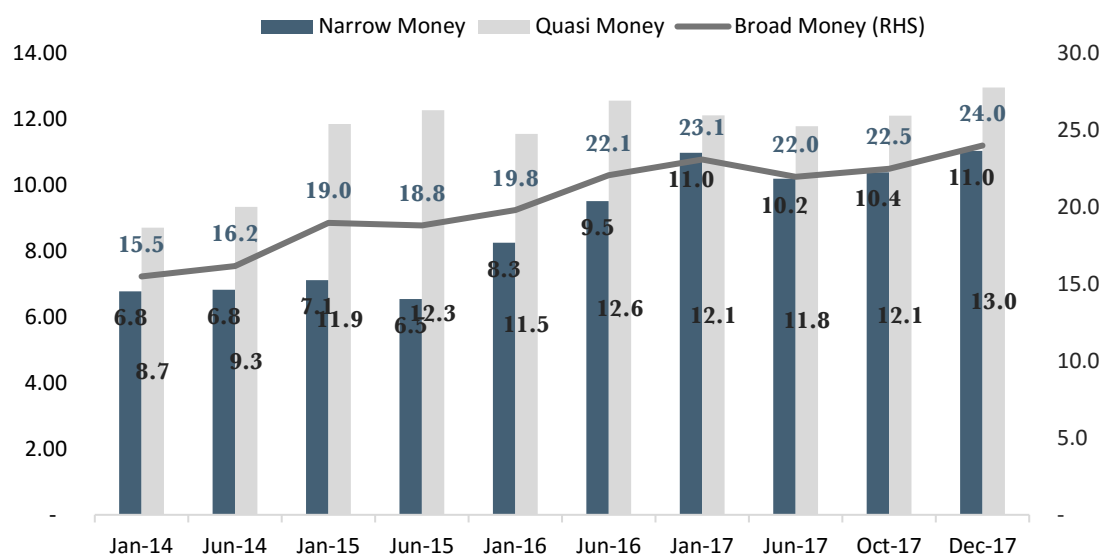
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Hawkish monetary policy stance drives weak growth in monetary aggregates in 2017

Over 2017, in its quest to stave off further speculation in the naira, the CBN adopted a hawkish posture curbing naira liquidity via daily OMO auctions. However, as concerns over naira volatility receded underpinned by improvements in the current account and FX reserves, the CBN lowered discount rates at OMO sales thereby signalling monetary easing. Precisely, aggressive tightening in the first half of 2017 drove a contraction in net domestic assets (NDA) which was evident on both broad (H1:-14.7% annualized) and narrow (H1: -21% annualized) measures of money supply. Nevertheless, following the switch towards an accommodative policy over Q4 2017, growth in monetary aggregates helped unwind the cutbacks from tightening with M2 posting 1.2% growth over 2017 while M1 contracted only 3.2%. Overall, the growth performance fell well below the CBN targets of 10.3% for 2017.

Looking at the drivers of movement over H2 2017, broad money (M2) expanded to ₦24 trillion (18.4% annualized) with quasi money and narrow money expanding 19% and 16% on an annualized basis. The expansion in narrow money (M1) emanated from demand deposit (+6.2%) even as currency outside the banking system expanded by 20% over the period. The expansion in demand deposits reflected higher private sector deposits at the CBN (+2.0% to ₦2.6 trillion) which neutered the impact of lower deposit by commercial banks and merchant banks. In our view, higher private sector deposit with CBN, which substantially emerged from other financial institutions, reflected the need to lock-in on attractive rates at the OMO which led to reallocation of funds from DMBs into the more attractive CBN's fixed income instruments.

Figure 1: Growth rate in money supply constituents



Source: CBN, ARM Research

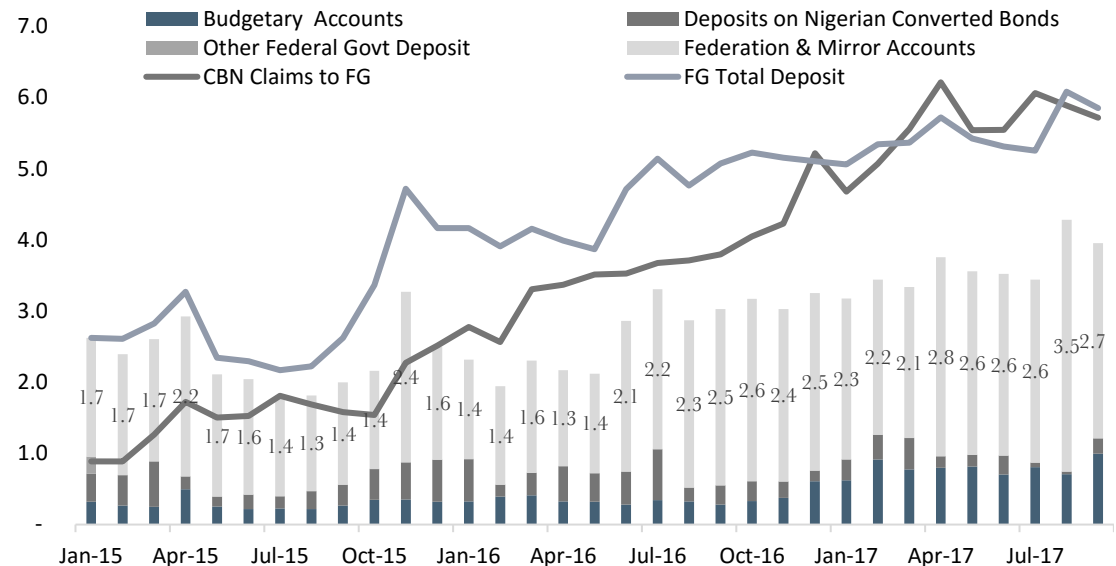
Growth in quasi money reflected an expansion in time and savings deposits (+3% to ₦11.9 trillion) stemming from higher deposit by commercial banks (₦11.6 trillion) and merchant banks (₦200 billion). Given the decline in foreign currency deposits (-3.3% to ₦4.0 trillion), the overall expansion in time and savings deposit over H2 17 largely stemmed from expansion in naira denominated deposits (+3.1% to ₦7.6 trillion) as impact of currency appreciation encouraged a switch from foreign currency deposits to naira denominated deposits. More so, improvement in system liquidity also mirrored higher receipts from FAAC inflows and lower issuances in the period.

On the asset side, net domestic credit (NDC) declined by 5% from the end of H1 2017 underpinned by a 32% cutback in credit to the government (₦3.6 trillion) despite a slight expansion in credit to the private sector (+1.4% to ₦22.3 trillion). Parsing through provided breakdowns, the decline in government lending mostly emanated from CBN's claims to FG which pulled back over ₦332 billion even as claims from commercial banks were only modestly higher (+70bps to ₦4.86 trillion). The pullback in CBN's financing reflected deceleration in mirror account (-57% to ₦219 billion), Treasury bills (-10.3% to ₦351.9 billion), and a slight moderation in bonds (-80bps to ₦1.68 trillion). The combined effect of these more than offset a 18% jump in overdrafts to ₦3.34 trillion. Overall, monetary aggregates were influenced by the confluence of currency stability, loose monetary policies as well as moderation in the size of government borrowings.

...as CBN 'back-door' funding cools off

In a clear divergence from prior period where the CBN financing to the FG expanded rapidly and created discourse and concern in the market, the improved revenue picture for the FG led to moderation in the apex bank's exposure to the fiscal authority. Specifically, after rising by 107% over 2016 on the back of sharp expansion in Treasury bills (242%) and overdrafts (49%), CBN claims to FG expanded more modestly over 2017 by 9.6% largely driven by a slower pace of increase in Treasury bills (7.6%) and overdrafts (27%). Most of the expansion occurred in the H1 2017 wherein revenue picture remained subdued with modest recovery. More importantly, FG's deposit with the CBN also expanded by 15% over 2017 to ₦5.9 trillion, reflecting increase in the federation & mirror account (+10% to ₦2.8 trillion) and budgetary account (+63% to ₦994 billion). Consequently, FG deposit with the CBN currently surpasses CBN claims to the FG, which from the surface is a breather to previously publicized concern. Overall, the expansion in banking sector liquidity and lowering of short-term rates (via lower OMO sales & lower T-bill rates) alongside lower backdoor FGN financing, suggest an easing posture by the monetary authority.

Figure 2: CBN claims to FG vs. FG deposit with CBN (Components)



Source: CBN, ARM Research

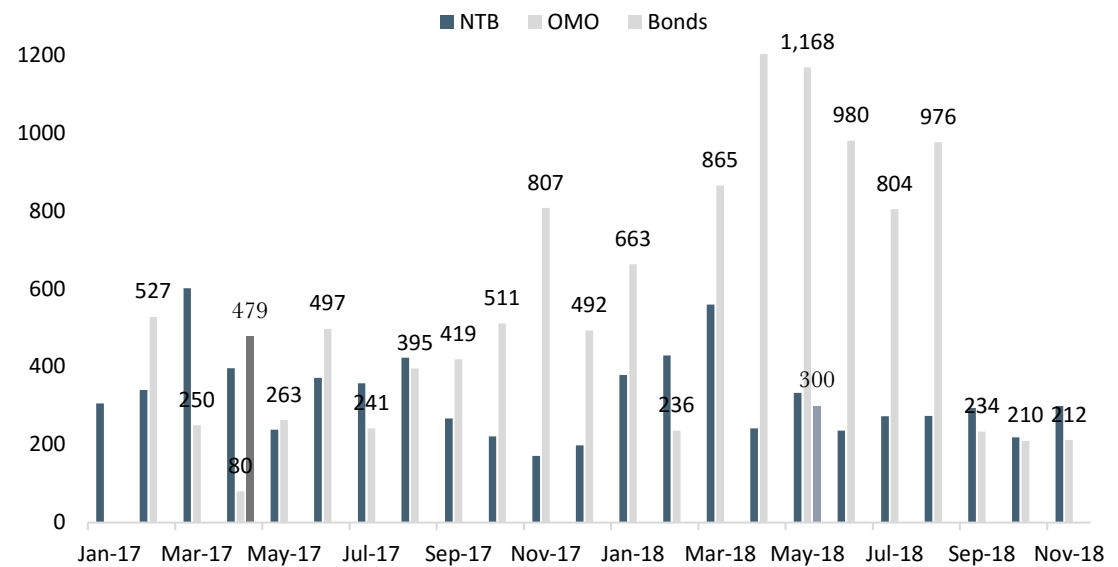
How will the apex bank manage impending liquidity?

Over 2018, monetary policy looks set to grapple with elevated system liquidity from maturing bills and bonds. Specifically, with a total of ₦6.6 trillion from maturing OMO bills, ₦2.6 trillion maturing Treasury bills, and ~₦300 billion from maturing bonds, the question in our minds is if the apex bank will be comfortable with the elevated liquidity levels or focus on sterilizing this liquidity via higher OMO issuances. In framing our outlook, we assume that fiscal authorities stick with plans of refinancing of maturing treasury bills via Eurobond Issuance of \$3 billion. The balance of \$2.5 billion which equates to ~₦900 billion is just 35% of the overall maturity of ₦2.6 trillion and we assume the FG rolls over the balance of ₦1.7 trillion. Consequently, the CBN will potentially have to grapple with a liquidity profile in the region of ₦7.8 trillion. To our minds, with lower justification to finance the FG and grow its asset base, we think the CBN will be under less pressure to increase its liabilities at high rates. More so, the macroeconomic picture has improved particularly the currency picture, and thus signals less pressure from the CBN to mop-up impending liquidity.

On balance, we think the CBN will at best rollover its maturing bills while leaving the system liquid from maturing treasury bills and bonds. Irrespective, any possible shock on

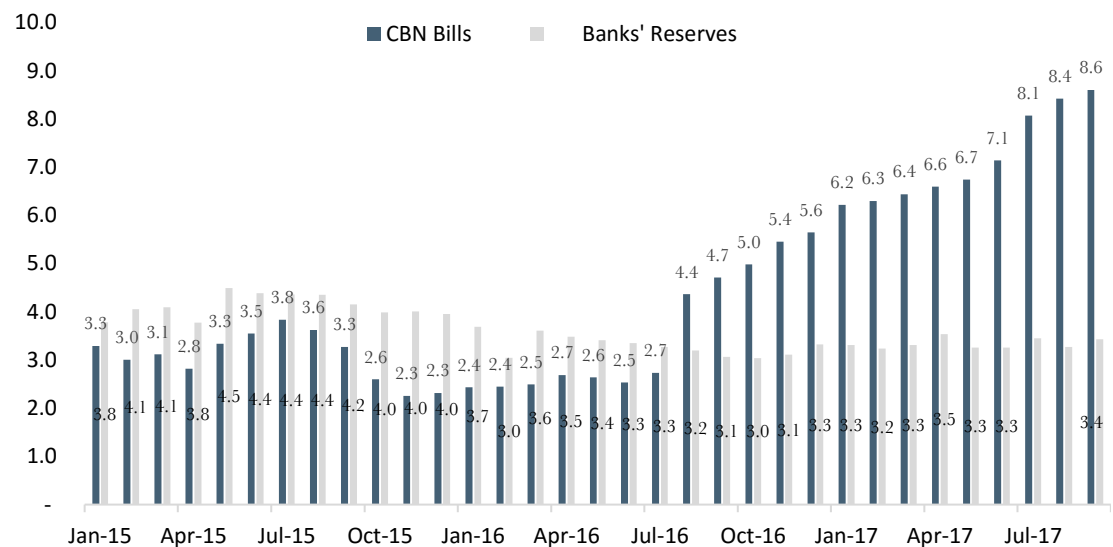
inflation from higher PMS prices may force the CBN to hike the CRR in a bid to rein in on inflationary pressure.

Figure 3: Monthly OMO, NTB and Bond maturity (2018)



Source: FMDQ, ARM Research

Figure 4: CBN Outstanding bills vs. Required Reserve (₦ trillion)

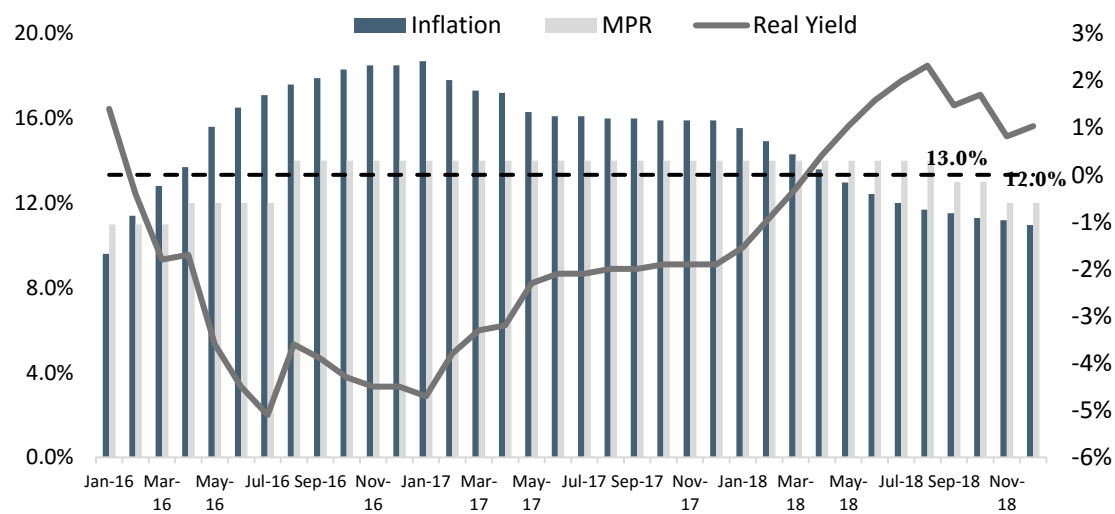


Source: CBN, ARM Research

Naira stability and subdued inflation underpin dovish rate outlook

Going into 2018, with no expected supply shocks, we expect a downtrend in inflation. Thus, the removal of the textbook cause for monetary tightening should permit the CBN to resort towards policy accommodation. Furthermore, we expect a relatively stable naira across all FX windows – driven by higher accretion in the CBN's FX reserves – which should neuter the impact of capital flight and demand pressures over the forecast period. Thus, we see increased prospects for easing as real yields expand in 2018. Irrespective, over H1 2018, we think the CBN will opt for a sustained moderation in the marginal clearing rate at its OMO auctions as well as lower OMO issuances as the way of signalling lower rates while keeping the appearance of policy tightening. In any case, the apex bank must grapple with a sizable maturity profile over H1 2018, which as we observed in December 2017, rendered impotent the impact of any net OMO issuances leading rates lower. Farther out, where we expect a downtrend in inflation, we think the monetary authority will cut rates to close the year at 12% for the MPR.

Figure 5: MPR vs. Inflation and real yield (2017 and 2018)



Source: NBS, CBN, ARM Research

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