

25 January 2018

Nigeria Strategy Report – H1 2018 Excerpts

Domestic Economy and Markets

Inflation has peaked, but downside risks remain

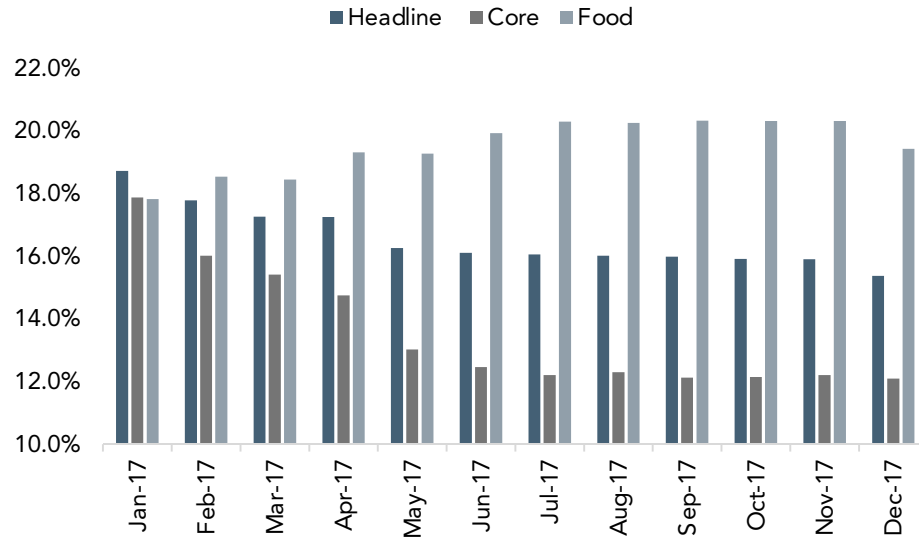
Our analysis suggests that although base effects provide scope for a sizeable downside in CPI, structural bottlenecks from elevated transportation costs should limit scale of moderation in inflation. Summing up developments across both core and food inflation sub-components and adjusting for their respective weightings in the CPI basket, we project mean headline inflation to hover around 12.7% YoY over 2018 (2017: 16.55%)

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In our H2 17 outlook, we identified the absence of currency shocks, lower energy prices and the resulting downtrend in transport inflation as central to inflation trajectory in the second half of the year. Precisely, we noted that subdued movements in MoM PMS prices and declining diesel prices will portend a reversion in transport inflation from elevated levels which will cascade to a downtrend in food and core inflation. Indeed, our view panned out with headline inflation declining by 135bps to average 15.87% YoY over H2 17. However, the scale of the impact relative to our expectations was subdued by the impact of flooding across key farming communities as well as elevated cost of transportation. Consequently, food inflation expanded 127bps over H2 17 to 19.42% YoY while core inflation dipped 274 bps to average 12.18% YoY over H2 17 with education, Housing, Water, Electricity and other Gases and Fuel (HWEGF) and transport inflation as the key drivers. The latter two divisions recorded sharp YoY declines in July following the NNPC's strategic decision to crash nationwide diesel prices by 42% in late June.

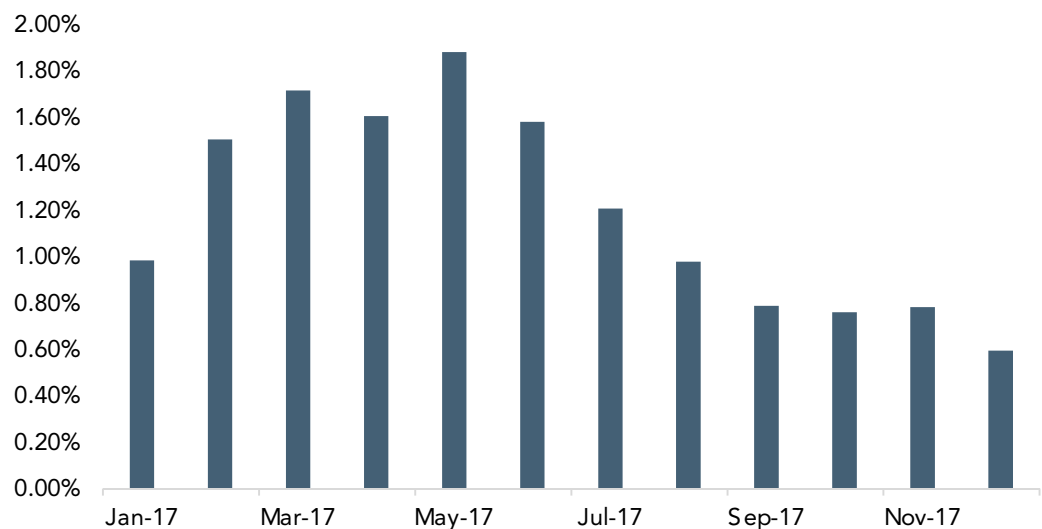
Figure 1: Historical YoY headline, food, and core inflation readings



Source: NBS, ARM Research

In the review period, MoM headline inflation trended lower (-70bps to 0.59% MoM) underpinned by decelerations in food (-104bps to 0.58% MoM) and core inflation (-32bps to 0.51% MoM). On the former, decelerations reflected higher food output in the harvest months which dampened the scale of inflationary pressures. Switching to the core basket, ebbing pressures captured the absence of fresh supply shocks and gains from FX liquidity pass-through.

Figure 2: Historical MoM Headline Inflation Readings



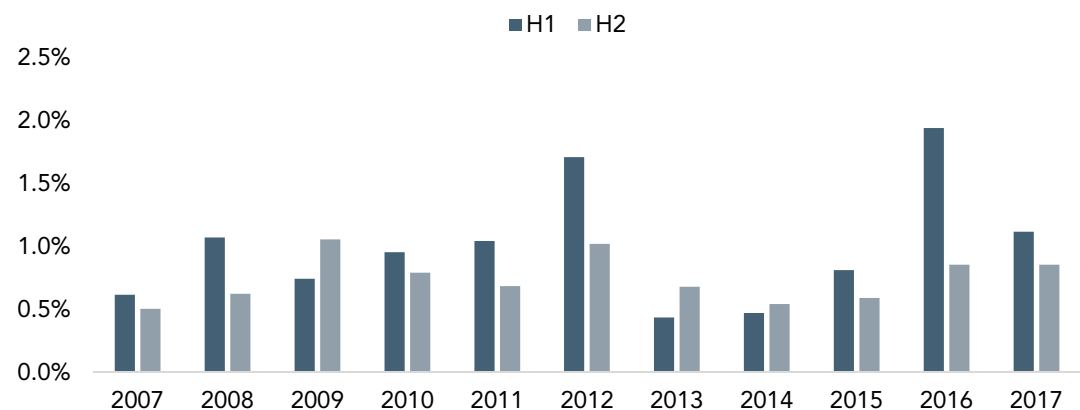
Source: NBS, ARM Research

Confined energy prices underpin benign core pressure

Consolidating gains from H1 17, core inflation continued a declining trend over the second half of the year retreating 274bps to average 12.18% YoY. The moderation largely emanated from the HWEGF and transport divisions which comprise 43% of the core basket (average H1 17: 58% of total). In our view, the impact of lower diesel and petrol prices as well as steep deceleration in energy inflation relative to the corresponding period of 2016¹ supported the decline in the HWEGF division. Against this backdrop of lower energy prices, transport inflation also declined over the review period (H2 17 average: -2.90pps to 12.07% YoY). To a lesser extent, lower education inflation (8% of core) also contributed to the downtrend in core inflation contracting 5.58pps to average 12.62% YoY over H2 17.

Over the second half of the year, MoM readings averaged 0.80% (vs H1 17: 1.11% MoM) as underlying drivers of the upward spiral receded, reflecting absence of fresh supply shocks and gains from FX liquidity pass-through. Disaggregating the core division by its sub-components, HWEGF component, which accounts for 21% of the basket, receded over H2 17 (average: -38bps to 0.48% MoM) relative to H1 17 (-2bps to 0.86% MoM). Similarly, average MoM inflation reading across all sub-components of core inflation decelerated over H2 17 with the sharpest decline in the energy division (-51bps to 0.55% MoM).

Figure 3: MoM H1 and H2 Core Inflation



Source: NBS, ARM Research

¹ average H2 17: -10.8pps to 10.40% YoY, H1 17: -10.0pps to 21.2% YoY

Elevated transport costs wind up food inflation

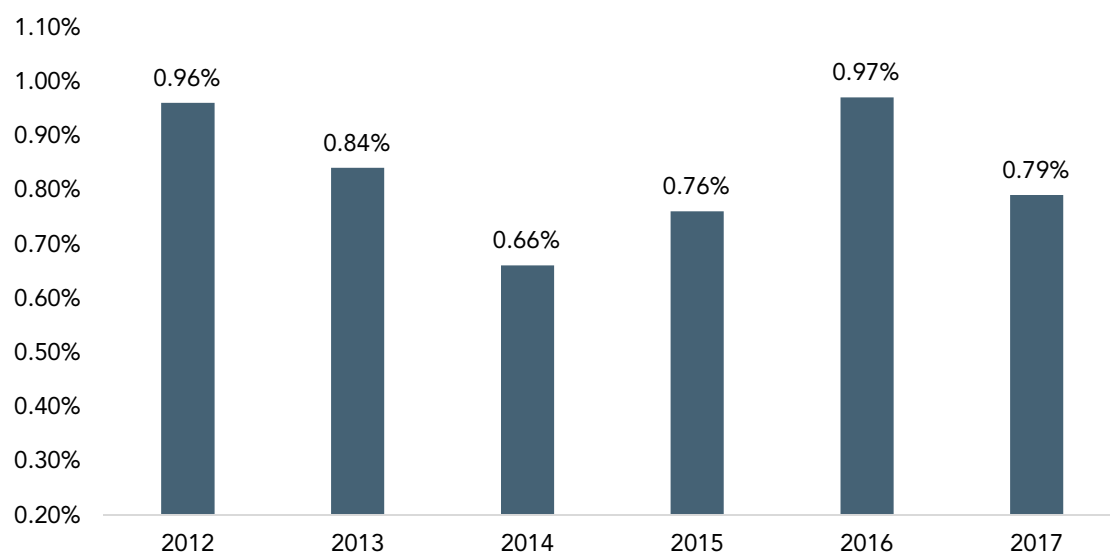
In a departure from trend over the first half of the year, YoY food inflation inched higher over H2 17 by 127bps to average 20.15%. Precisely, pressures from farm produce (avg: +25bps to 20.14% YoY) and processed food (avg: +1233bps to 20.40% YoY) offset FX-liquidity induced gains on imported food (avg: -238bps to 15.06% YoY). In our view, subsisting pressures on food inflation largely reflected the impact of flooding in key agrarian states which moderated pass-through of the harvest season. Elsewhere, although YoY transport inflation moderated in H2 17 (avg: -290bps to 12.07% YoY), it remained sizably higher than trend levels (5-year average: 9.4% YoY) to keep the cost of transportation elevated. According to the NBS, pressures on the transport front reflected the high cost of car/truck maintenance which neutered gains from lower diesel and PMS prices.

Despite receding shocks from cross-border demand on MoM food inflation, pressures on food inflation subsisted with average MoM food inflation between September till November at 0.86%. Commencing June till October, MoM food inflation decelerated in each consecutive month touching its lowest level of 0.85% MoM in October. We link October's MoM reading to sizeable declines in the prices of locally-produced grains on the back of elevated post-harvest market sales. Precisely, the descent largely reflected receding pressures on farm produce (H2 17 average: -114bps to 0.91% MoM) underpinned by higher food supplies in the main harvest season while imported food inflation contracted marginally (-3bps to 1.22% MoM) mirroring gains from improved FX liquidity. However, MoM food inflation inched higher in November (+3bps to 0.88% MoM) as pressures resurfaced on farm food inflation (+4bps to 0.79% MoM) alongside subsisting pressures on processed food inflation (+12bps to 1.91% MoM). We link these pressures to the impact of sticky transport inflation — a fallout of higher cost of transportation (avg. bus journey: intracity: +7.5% MoM, intercity: +14.8% MoM) as well as ramp-up in the demand for cereals and other food produce against the impending December festive season.

Nevertheless, these pressures were short-lived as food inflation recorded its sharpest decline in December (-30bps to 0.58% MoM) despite the festive season and PMS scarcity (+17.7% MoM) which prevailed in the month. In particular, December's MoM reading printed at its lowest level in over 10 years.

According to FEWSNET reports, moderation in food prices likely stemmed from the presence of elevated household stocks and market supplies after the main harvest which eased demand pressures on farm produce and positively impacted on prices.

Figure 4: Average MoM food inflation over main harvests



Source: NBS, ARM Research

Transport inflation to dictate headline trajectory over 2018

In setting out our view on inflation over 2018, currency, though indirect, remains central. Going into 2018, we expect a relatively stable naira—albeit marginal decline—across all FX windows driven by higher accretion in the CBN’s FX reserves which should mitigate capital flight and demand pressures over the forecast period. Against this backdrop, we narrow the scope of potential shocks on core inflation in the forthcoming year to higher electricity tariffs, rising energy prices and elevated cost of transportation. On the former, the Nigerian Electricity Regulatory Commission (NERC) is currently awaiting approval from the FG on its proposition to raise electricity tariffs by 61.5% to capture current indicators in the pricing template used in the MYTO². Nevertheless, as expected, the impending electricity tariff adjustment has been met with stiff opposition from the populace³. Thus, against the backdrop of a tightly contested election campaign in 2019,

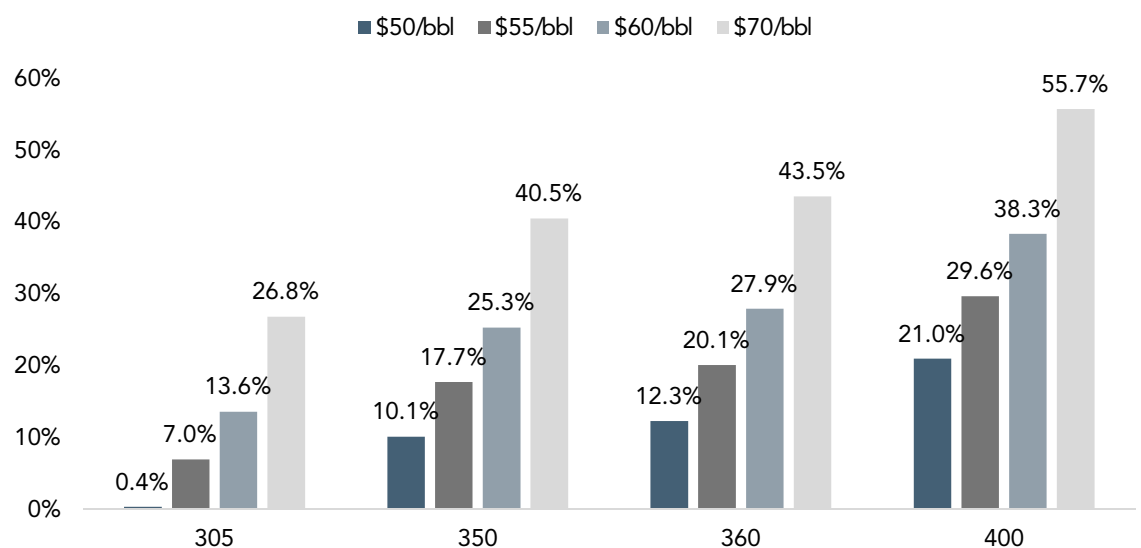
² For instance, the current electricity tariff template assumes an exchange rate of N197/\$ compared to the official exchange rate of N305/\$.

³ Recall, the unpopularity of hikes in electricity tariff accounted for a 7-year delay before the implementation of the MYTO 2 tariff arrangements that underpinned the last increase in February 2016

weak consumer purchasing power as well as high unemployment rate, we hold the view that the probability of implementing higher electricity tariffs in 2018 is extremely slim.

Elsewhere, rising crude oil prices (average 2017: \$58 vs 2016: \$45) guides to a potential increase in the pump price of PMS which has veered way off projections used in the PPPRA pricing template (\$34.50). As it stands, using the PPPRA pricing template, the current landing cost of PMS is N164.7, a 14% premium to the selling cost of fuel. As in past precedence, given the strong relationship between PMS and core CPI, higher PMS prices as well as Diesel prices could likely fuel fresh inflationary pressures in 2018. Nevertheless, we hold the view that PMS and diesel prices will be equally managed in 2018 to quell political uprising and garner political popularity against the impending 2019 elections.

Figure 5: Changes in PMS prices for different crude price and USDNGN assumptions

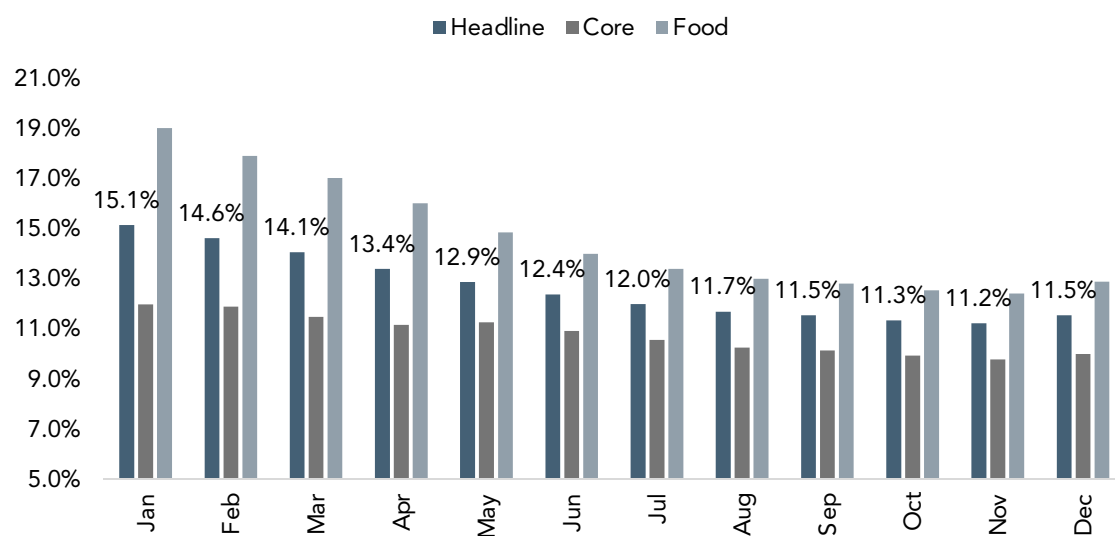


Source: ARM Research

For PMS, we envisage that NNPC will continue to provide implicit subsidy for imports with the resulting implication that various spurts of fuel scarcity might resurface in 2018 as oil marketers protest current PMS prices against the backdrop of higher global crude oil prices. Given the foregoing, we expect transport inflation to hover at currently elevated levels and tying this all together, we project mean YoY core inflation of 10.7% in 2018 (H1 18 average: 11.5% YoY).

Switching to food inflation, the waning impact of currency-induced jump in food prices which posed a high base over H1 17 suggests a moderation for food inflation in 2018. First off, FEWSNET reports that farmers responded favourably to the elevated domestic prices with aggregate production of major cereals⁴ (such as maize, millet, rice, and sorghum) higher than historical levels to drive moderation in prices⁵. In a similar thread, barring the occurrence of flooding activities, we expect to witness a steeper descent in food inflation over the harvest season. On the downside, the scale of the decline in food inflation will be tapered by structural bottlenecks in transportation costs. Overall, our analysis suggests that while base effects fuels CPI downside, structural bottlenecks from elevated transportation costs should limit scale of moderation in inflation. Summing up developments across both core and food inflation sub-components and adjusting for their respective weightings in the CPI basket, we project mean headline inflation to hover around 12.7% YoY over 2018 (2017: 16.55%) while we have also assumed a bull and bear case for inflation of 11.6% YoY and 15.3% YoY respectively over 2018.

Figure 6: Inflation forecast for Jan-Dec 18 (Headline, Core and Food)

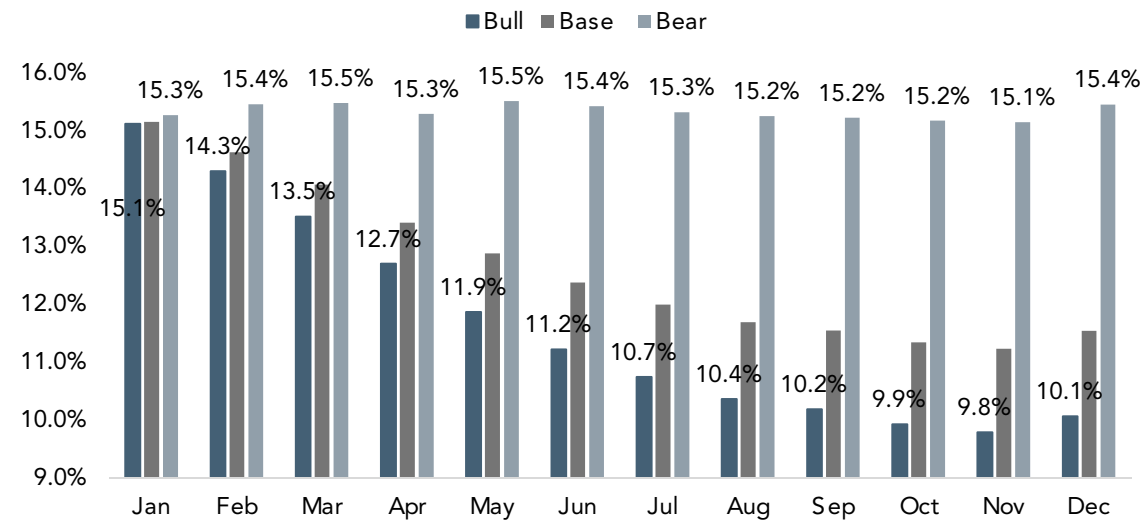


Source: ARM Research

⁴ According to FEWSNET, cereal production is 9% higher compared to last year, and 12% compared to the five-year average levels.

⁵ Prices for maize and other staple cereals are lower compared to the same period of last year.

Figure 7: Inflation forecast for Jan-Dec 18 (Bull, Base and Bear)



Source: ARM Research

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