

Nigeria Strategy Report

H1 2019

Domestic Economy and Policy Environment

Monetary Policy: *Maintaining the Narrative*

Executive Summary

In our H2 18 strategy outlook, we outlined our expectation for a halt in the downtrend in OMO rates as apprehension towards budding system liquidity and capital reversal threatens FX stability. Over the second half of the year, the apex bank had to grapple with significant system liquidity over the period and contend with capital reversals over the same period. For context, OMO maturities over H2 (₦9.3 trillion) were 116% higher compared to H1 18. In response to the higher maturity and its attendant impact on the naira, the CBN towards the latter part of the year was forced to increase its liquidity squeeze over the period and raise the OMO rates. Accordingly, interbank rates tracked higher particularly in the last quarter of the year with both OBB and Overnight rates climbing higher to 14.79% (+5.9pps) and 16.06% (+6.3pps).

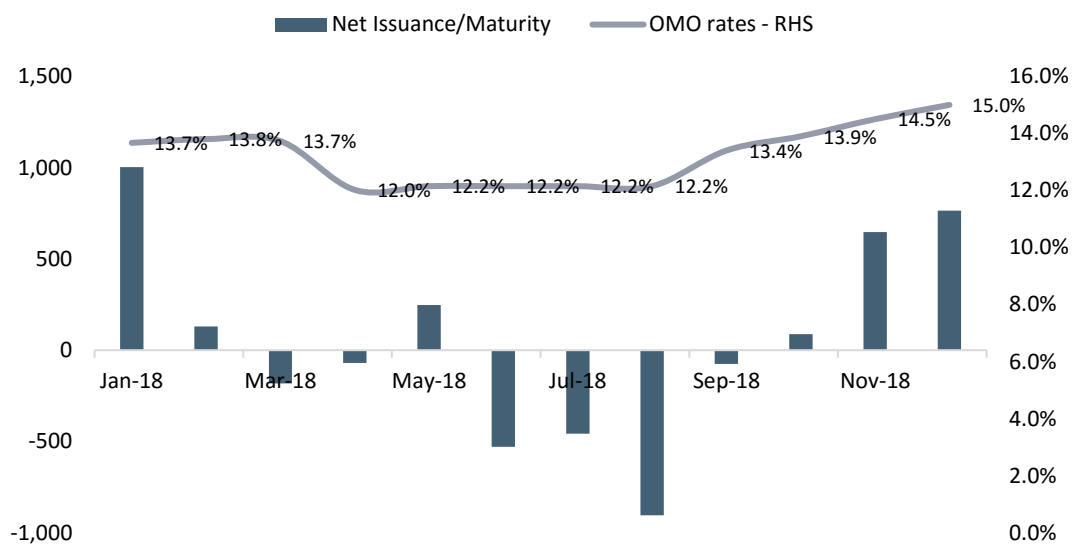
Going into 2019, despite our expectation for inflationary and currency pressure towards the latter part of the year, we believe the CBN will stick to keeping its benchmark rate unchanged as the monetary authority will continue to balance between economic growth and price stability.

Irrespective, as a sign of showing monetary tightness to rein the uptick in inflation over the second half of the year and attract FPIs, we believe the CBN will opt for an increase in the marginal clearing rate at its OMO auctions. To add, the apex bank is set to contend with an elevated liquidity profile over 2019. Specifically, a total of ₦16.0 trillion is expected to mature in the year with a larger chunk to mature in H2 19. Consequently, we believe the CBN will adopt a tough stance in combating the excessive liquidity from the system. Ultimately, we expect the CBN to jack up rates at its OMO auctions over H2 19 where the pressures are expected to surface. Particularly, we expect OMO rates to average 13.7% over H1 19 and go higher to 14.7% over H2 19. Furthermore, the tenure of the present CBN governor in June 2019 signals a no change policy as a new governor would be wary to move the needle while assessing economy growth and price stability over the second half of the year. On the same thought, if the present governor is re-appointed, we do not anticipate any change to his current stance.

In this report, we look at the major themes that dominated monetary policies in Nigeria over 2018 and delineate our outlook for CBN's monetary stance over 2019.

Monetary authority bows to mounting pressures

In our H2 18 strategy outlook, we outlined our expectation for a halt in the downtrend in OMO rates as apprehension towards budding system liquidity and capital reversal threatens FX stability. Over the second half of the year, our views largely played out. The apex bank had to grapple with significant system liquidity over the period and contend with capital reversals over the same period. For context, OMO maturities over H2 (₦9.3 trillion) were 116% higher compared to H1 18. In response to the higher maturity and its attendant impact on the naira, the CBN towards the latter part of the year was forced to increase its liquidity squeeze over the period. Accordingly, interbank rates tracked higher particularly in the last quarter of the year with both OBB and Overnight rates climbing higher to 14.79% (+5.9pps) and 16.06% (+6.3pps).

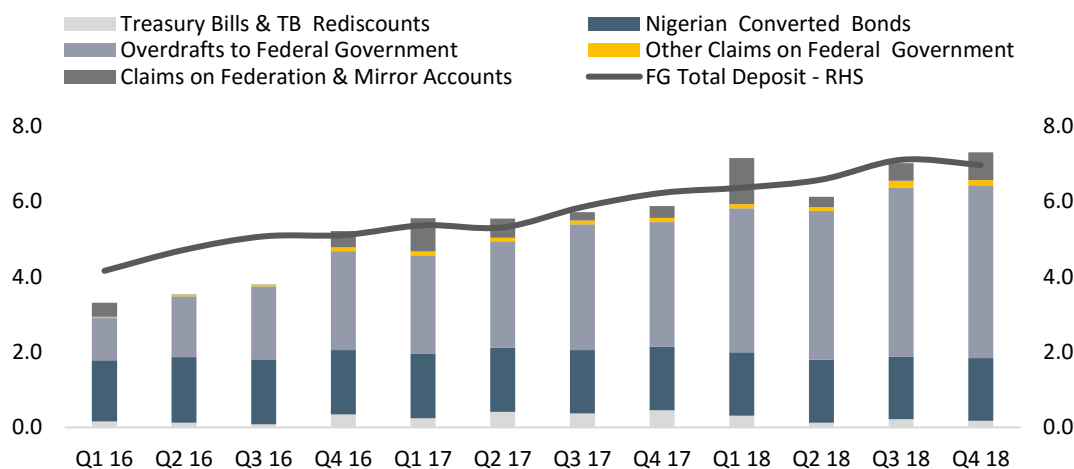
Figure 1: OMO net issuance/maturity vs OMO rates

Source: CBN, FMDQ, ARM Research

Looking out how the series of events played out. To start with, the CBN extended its tolerance for naira liquidity into Q3 2018 largely due to dissipating inflation pressure and stability in the naira. Particularly, the CBN net repaid ₦1.4 trillion over the period with clearing rates higher by 50bps only on average. Interestingly, after seven consecutive months of net repayment, the CBN turned into a hawkish stance over the last quarter. Importantly, the CBN jacked up OMO issuance in Q4 18, net issuing ₦1.5 trillion due to significant system liquidity coming from higher OMO maturity and increased FAAC allocation. Further reflecting the CBN's non-tolerance for the high liquidity in the system, the apex bank issued stabilization securities in December following a scrawny level of subscription from investors.

CBN shows no respite to funding FG

At a time higher oil price was expected to provide a slow down or even a decline in CBN financing to the FG, the outcome was contrary as CBN claims on the FG continued to expand. For context, CBN's funding to the FG increased significantly by ₦1.2 trillion over the end of H1 18 to October 2018. The increase reflected higher overdrafts to the FG and also claims on Federation and mirror account which both expanded by ₦640 billion and ₦469 billion respectively neutering the slight moderation in CBN holding of FG bonds (-0.6% to ₦1.67 trillion). To our mind, we believe the increase explains the lower borrowings by the FG following the refinancing of matured bills via \$2.5 billion from Eurobond issuance. The resultant effect saw the FG fail to net issue Treasury bills for 7 consecutive months. On the other hand, FG deposits with the CBN increased by ₦869 billion to ₦6.97 trillion over the same period. Despite the increase, FG deposit with the CBN tracked lower relative to CBN financing to the FG.

Figure 2: CBN Claims on FG (₦trillion)

Source: CBN, ARM Research

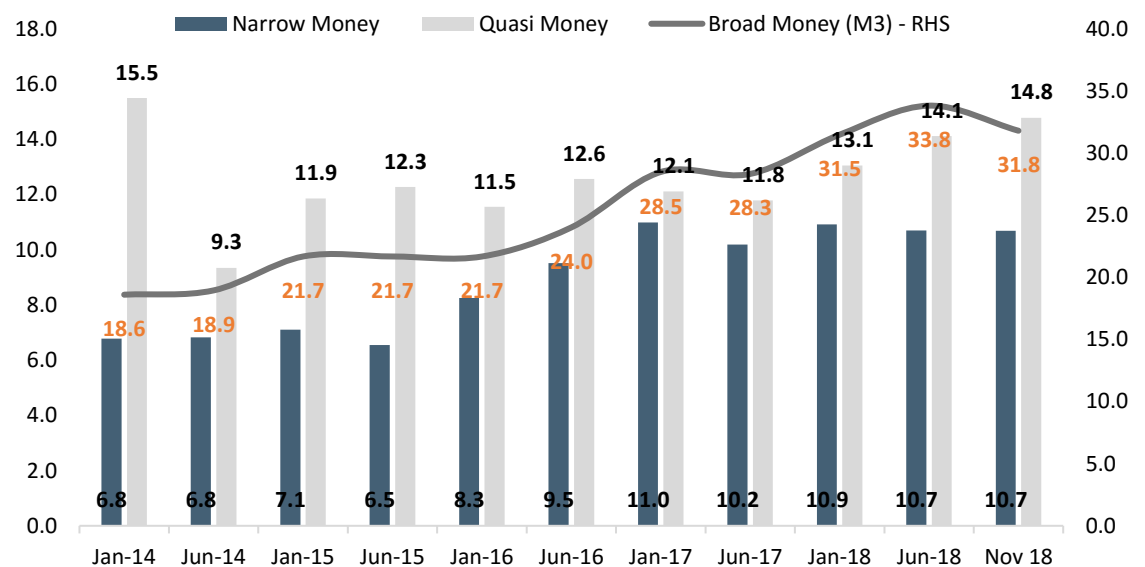
Monetary aggregates dominated by CBN's hawkish stance

Over the first nine-months of 2018, the Central Bank of Nigeria (CBN) was less apprehensive with growing liquidity as broad money expanded by 4.7%. The strong appetite for paper supply largely hinged on the stability in FX as well as moderating trend in inflation reading over the period. However, going into the last quarter of the year, the CBN switched to a tightening stance which was reflective in the sluggish growth in broad money (M2) over the period (+0.7%). In our view, the weak growth of broad money (M2) reflected higher OMO issuance and the resumption of the one-year OMO as the CBN was concerned about pressure

on the naira due to massive system liquidity over the period as well as the impact of capital reversal. Despite the weak growth over Q4 18, faster growth in the previous quarters drove broad money higher by 5.5% over 2018 (H2 18: 2.6%), lagging CBN's target of 10.48% for 2018. Elsewhere, after recording a growth of 8.5% in H1 18, broader money aggregate (M3)¹ took a descent path over H2 18 moderating 6.0%.

Growth in quasi money over H2 18 largely reflected higher time and savings deposit (+4.7%) by commercial banks (₦14.5 trillion), which we think was due to the depreciation of the NIFEX from ₦340/\$1 in Jun-18 to ₦361/\$1 in Nov-18 as 56% of the expansion in deposit stemmed from foreign currency deposit. Then, broader money (M3) however narrowed over the period largely due to a plunge in CBN Bills held by non-bank institutions (-6.0%).

Figure 3: Money Supply trend (₦'trillion)



Source: CBN, ARM Research

On the asset side, growth in net domestic credit (NDC) turned positive (+3.9%) over H2 18 largely driven by a combination of higher lending to the FG and credit to the private sector. Growth in credit to private sector largely mirrored a slight pickup in lending by commercial banks which is in tandem to the recovery in economy growth. For clarity, commercial banks' lending to the private sector remained depressed over 2017 (-1.9%) and into 2018 (-3.6%)² as banks were cautious to creating risk assets due to fragile state of the economy. On the other hand, higher credit to the FG

¹ In July 2018, the CBN introduced a revised and seasonally adjusted monetary aggregate (M3), which is intended to capture liquidity outside the banking system or better still, CBN bills held by non-bank institutions

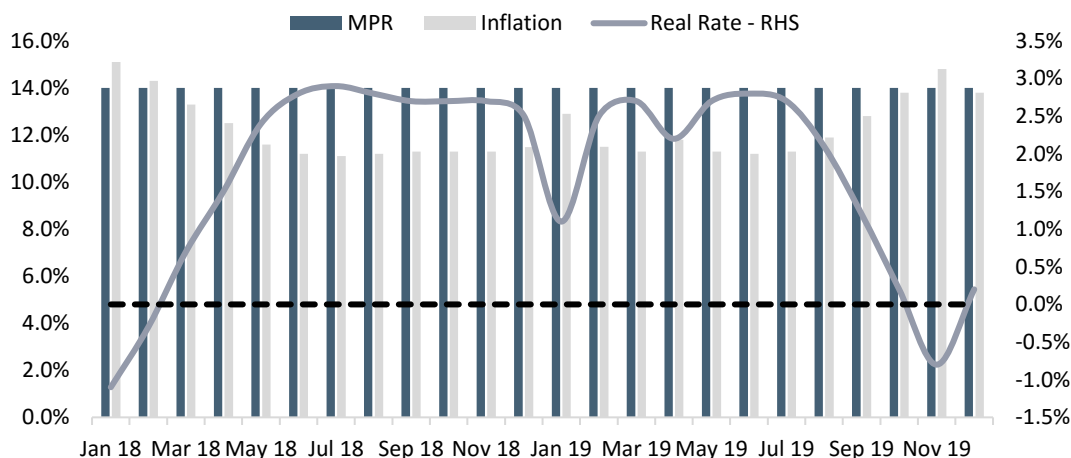
² H1 2018

reflected lower domestic borrowings. Overall, monetary aggregates were influenced by the confluence of capital reversals and elevated system liquidity over the period.

Maintaining the Narrative

Going into 2019, the movement in inflation reading and FX stability will continue to dictate monetary authority body signal. We expect increased FX demand across the markets, together with depressed outlook on autonomous flows to result into a drawdown in the FX reserve (-10.9% YoY to \$38.5 billion). While this suggest a comfortable position for the apex bank and the naira, we believe the distorted interplay of demand and supply at the IEW and the increased demand at same would drive short term volatility in rates and an eventual adjustment to ₦397.61/\$ to ₦401.50/\$ (8-10% down-leg from current NAFEX rate of ₦362.00/\$ at the end of December 2018). Furthermore, headline inflation is expected to average 12.4% (2018: 12.1%) hinged on our expectation of concerns on currency and PMS in the latter part of H2 19. Precisely, we project inflation over the first half to print at 11.67% and tick higher to 13.07% over H2 19 as currency pressure bites harder and PMS hike kicks in. Thus, we see real rate turning negative at the last quarter – particularly in November.

Figure 4: MPR vs Inflation and real rate

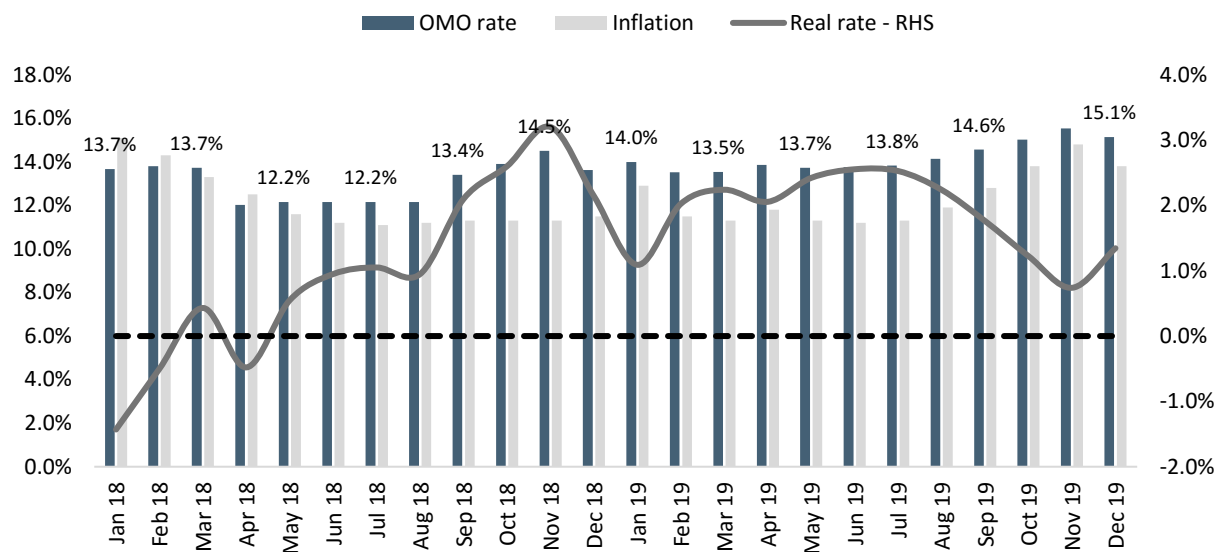


Source: Bloomberg, NBS, ARM Research

Despite our expectation for real rate to contract towards the end of the year, we believe the CBN will hold on to the current MPR rate as the monetary authority will continue to balance between growth and price stability. Irrespective, as a sign of showing monetary tightness to rein the uptick in inflation over the second half of the year and attract FPIs, we believe the CBN will opt for an increase in the marginal clearing rate at its OMO auctions. To add, the apex bank is set to contend with an elevated liquidity profile over 2019. Specifically, a total of ₦16.0 trillion is expected to mature in the year split into ₦12.8 trillion OMO bill,

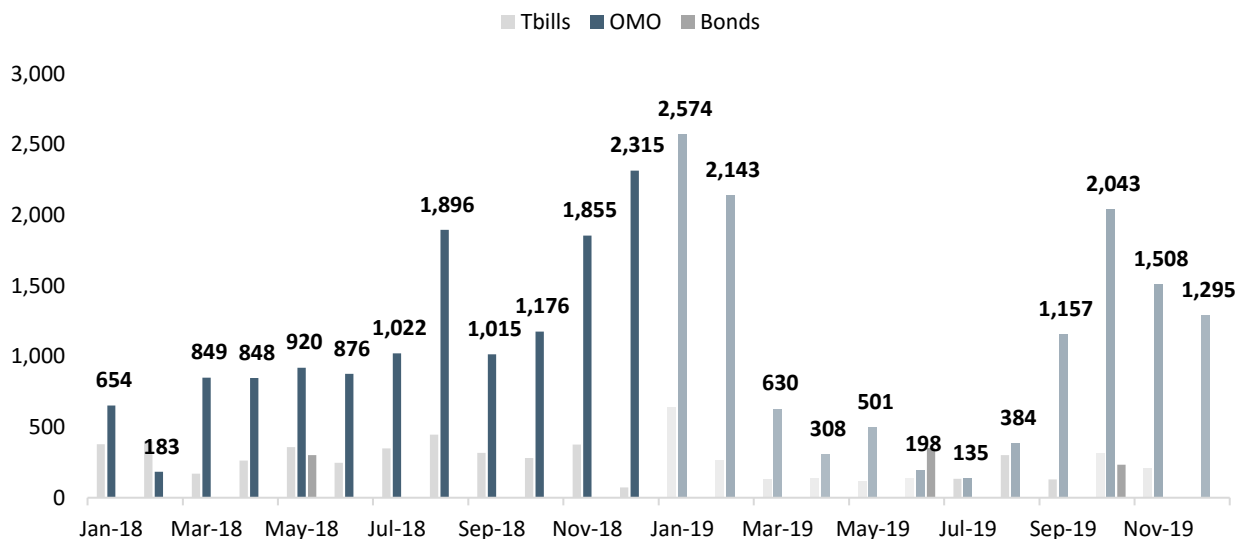
₦2.5 trillion T-Bills and ₦585 billion bond papers with a larger chunk to mature in H2 19. Consequently, we believe the CBN will adopt a tough stance in combating the excessive liquidity from the system in order to avoid speculation on the naira and keep rates attractive to FPIs. Ultimately, we expect the CBN to jack up rates at its OMO auctions over H2 19 where the pressures are expected to surface. Particularly, we expect OMO rates to average 13.7% over H1 19 and go higher to 14.7% over H2 19.

Figure 5: OMO rate vs Inflation and real rate



Source: FMDQ, NBS, ARM Research

Figure 6: Maturity Profile (₦'billion)



Source: FMDQ, ARM Research

Will the monetary authority succumb to an MPR hike?

Having outlaid our expectations for an uptick in inflation reading and pressure on the currency as major threats to the monetary authority goal, we went further to assess voting patterns of MPC members in the last three MPC meetings and possibility of a change in body language given the tenure expiration of the CBN governor in June 2019.

In the meetings prior to the July MPC meeting, virtually all the members voted to keep benchmark rates unchanged as they all opted to thread the needle on the back of economy growth and price stability. Following expectations of elevated system liquidity and inflationary pressure, we saw some members vote to hike rates in MPC meetings held in July and September. Going into 2019, we however believe the concerns highlighted are not as mammoth compared to what we saw in periods inflationary and FX pressure was more evident and yet, the MPR was left unchanged.

Elsewhere, given the tenure end of the CBN governor in June 2019, we believe a new governor would be wary to move the needle while assessing economy growth and price stability over the second half of the year. On the other hand, if the present governor is re-appointed, we don't anticipate any change to his current stance.

Table 1: Voting trend of MPC Members

MPC Members	Jul-18			Sep-18			Nov-18		
	Reduce	Hold	Hike	Reduce	Hold	Hike	Reduce	Hold	Hike
Mr. Godwin I. Emefiele		✓			✓			✓	
Mr Adebayo A. Adelabu									
Alade, Sarah O.									
Barau, Suleiman									
GARBA, ABDUL-GANIYU									
Dr. Okwu J. Nnanna			50 bps		✓			✓	
Salami Adedoyin									
Uche Chibuike									
Yahaya Shehu									
Prof. Dahiru Hassan Balami		✓				25 bps		✓	
Mrs. Aisha N. Ahmad			25 bps		✓			✓	
Mr. Edward L. Adamu		✓			✓			✓	
Prof. Festus Adeola Adenikinju								✓	
Dr. Robert Chikwedu									
Asogwa		✓			✓			✓	
Dr. Aliyu Rafindadi Sanusi			50 bps			25 bps		✓	
Adenikinju Adeola Festus		✓				25 bps			
Isa-Dutse Mahmoud		✓			✓			✓	
Obadan Mike Idiah		✓			✓			✓	
Shonubi Folashodun A.								✓	

Source: CBN, ARM Research

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