

Nigeria Strategy Report

H1 2020

Domestic Economy and Markets

Inflation set for a double whammy in 2020!

Executive Summary

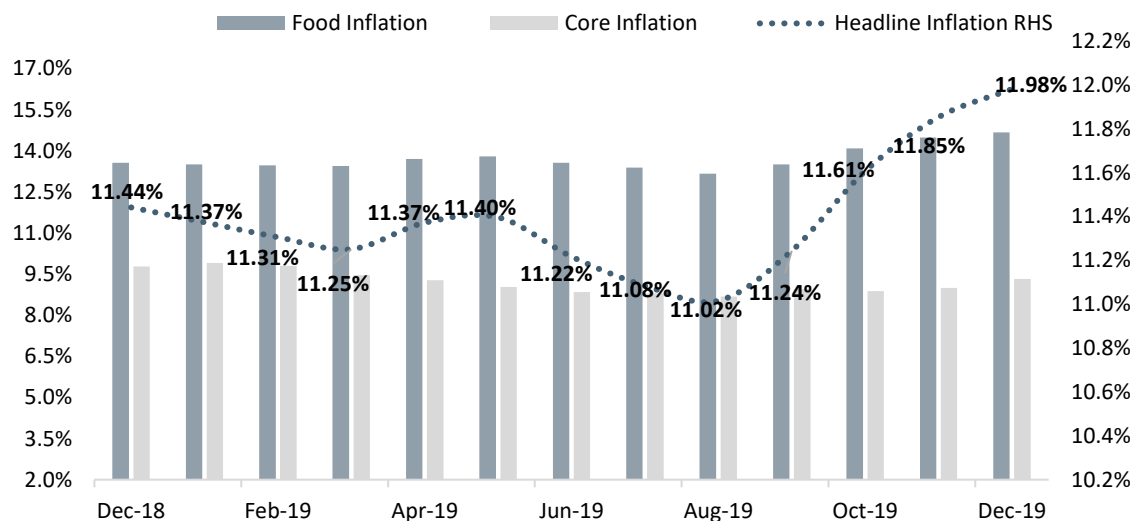
In our H2 19 NSR, we postulated that inflation would edge southwards hinged mostly on abating food prices and core inflation. Precisely, we expected that docile flooding in farming areas, curtailed tensions in the North, improved market supplies as well as fixed PMS prices by the government would anchor declines in headline inflation. While these factors came to fruition in July and August, with both food and core prices moderating - the tide turned in September. Towards the latter part of August, FG announced a formal closure of the Nigerian borders in a bid to curb smuggling of illicit items into the country. Consequently, the influx of food products like rice, vegetable oil, frozen foods, etc, into the country was adversely impacted – thereby sending food prices higher. Against this backdrop, food inflation ascended 30bps to 13.88% over H2 19, transcending a 45bps decline in core inflation to 8.94% over similar period. On that note, headline inflation ticked 14bps higher to average 11.46% over the second half of 2019, relative to H1 2019 – with average inflation for the year 2019 printing at 11.40%.

In this report, we focus on the major themes that steered consumer prices over H2 19 and delineate our outlook for inflation over 2020.

In setting our view on inflation over 2020, we analyse possible shocks to the CPI - highlighting our views on currency, hike in electricity tariff, increase in VAT (value added tax), lingering impact of the border closure and removal of petrol subsidy. For us, the hike in electricity tariff would drive upward pressure on core prices as we see no hike in petrol prices and expect currency to remain relatively stable this year. Elsewhere, we believe food inflation would trend higher in 2020 relative to 2019 as the ongoing border closure and VAT increase (from 5% to 7.5%) would keep food prices at elevated levels. That said, we project an average inflation rate of 13.8% YoY (2019: 11.40% YoY) and a MoM inflation of 1.07% (2019: 0.95% MoM) which serves as our base case scenario.

H2 2019 Inflation: Food pressures sends headline inflation skywards

In our H2 19 NSR, we postulated that inflation would edge southwards hinged mostly on abating food prices and core inflation. Precisely, we expected that docile flooding in farming areas, curtailed tensions in the North, improved market supplies as well as fixed PMS prices by the government would anchor declines in headline inflation. While these factors came to fruition in July and August, with both food and core prices moderating - the tide turned in September. Towards the latter part of August, FG announced a formal closure of the Nigerian borders in a bid to curb smuggling of illicit items into the country. Consequently, the influx of food products like rice, vegetable oil, frozen foods, etc., into the country was adversely impacted – thereby sending food prices higher. Against this backdrop, food inflation ascended 30bps to 13.88% over H2 19, transcending a 45bps decline in core inflation to 8.94% over similar period. On that note, headline inflation ticked 14bps higher to average 11.46% over the second half of 2019, relative to H1 2019 – with average inflation for the year 2019 printing at 11.40%.

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

Source: NBS, ARM Research

Food inflation: Border closure changed the narrative

July and August 2019 witnessed declines food inflation spurred by favourable green harvest conditions in the south fused with reduced bandit attacks in the North. According to FEWSNET, enhanced market supplies owing to favourable green harvest season¹, drove moderation in food

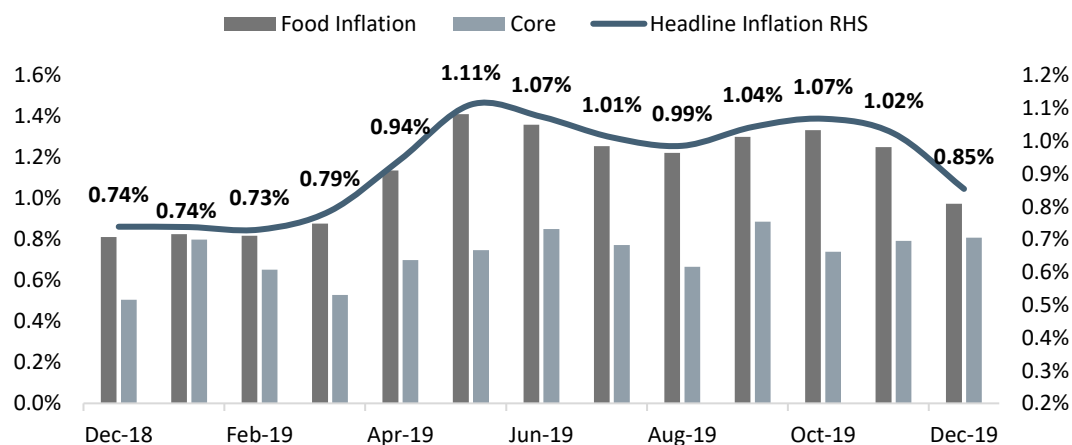
¹ Green harvest spans from June to September in southern Nigeria.

prices over the period. However, the narrative changed in September as the impact of border closure reared its head in CPI numbers. For context, the President ordered the shutdown of Nigeria's land border on August 20th in a bid to tackle incessant smuggling of goods in and out of the country. Consequently, prices of imported commodities such as rice (+24%), vegetable oil (+4%, as opposed to moderation in prices in earlier months), frozen Chicken (+10%) and other commodities rose significantly between August and November 2019 due to limited supplies, according to NBS. These watered down the impact of main season harvest² on food prices which should have driven prices lower. Against this backdrop, average food inflation ticked 30bps higher relative to H1 2019, printing at 13.88% over H2 2019.

Stable PMS prices keeps core inflation curtailed

On the contrary, core inflation sank 45bps to average 8.94% YoY over the second half of the year, as stable energy prices kept core numbers at bay. This largely reflects the government's efforts to maintain petrol prices at ₦145/litre. To emphasize, Petrol prices averaged ₦145.5/litre in H2 2019 (average H2 18: ₦146.9, H1 19: ₦145.4). Notably, tamed petrol price muted increases in deregulated products including diesel (+5.85% YoY to ₦226.6/litre) and Kerosene (+8.61% YoY to ₦320/litre). Unsurprisingly, the pass-through impact of lower PMS prices was echoed in Transport division, moderating by 32bps to 9.25%. Furthermore, declines across other key core components including Clothing (-19bps YoY to 9.81%), Furnishing (-34bps YoY to 9.13%), Health (-28bps to 9.29% YoY), Education (-66bps to 8.68% YoY), and Restaurant (-53bps to 8.21% YoY) outstripped 23bps uptick in HWEGF (7.47% YoY).

Figure 2: Historical MoM Core, Food and Headline inflation



Source: NBS, ARM Research

² Main season harvest begins in October

On a MoM basis, average inflation advanced 10bps to 1% MoM, bulk of which emanated from the hike in food inflation. Specifically, food inflation tracked higher by 15bps to an average reading of 1.22% MoM. Notably, after two consecutive declines in July (-10bps to 1.26% MoM) and August (-3bps to 1.22%), food inflation rose sharply in September (+8bps to 1.30% MoM) coinciding with elevated food prices following the closure of Nigeria land borders. The pace of expansion in food inflation slowed in October (+3bps to 1.33% MoM) and subsequently declined in November (-8bps to 1.25% MoM) and December (-28bps to 0.97% MoM) as the impact of the border closure gradually faded. Pressures in food inflation during this period reflected in farm produce (+14bps to 1.25%) and processed food (+26bps to 0.92%) over H2 2019. Furthermore, imported food inflation rose +3bps to 1.26% over H2 2019 which we believe is not unrelated to the mild increase in global food prices⁵ by 160bps over H2 2019 relative to the first half.

On the other hand, average core inflation ticked 6bps to 0.78% mirroring increases in energy prices over H2 19. Precisely, average PMS and kerosene prices ticked 4bps and 298bps higher MoM, outweighing the 27bps decline in diesel prices. Accordingly, all major sub-indices saw a 1bps to 6bps expansion, save for alcoholic & Beverage index which moderated 3bps during the period under review.

Inflation set for a double whammy in 2020!

In setting our view on inflation over 2020, we analyse possible shocks to the CPI - highlighting our views on currency, hike in electricity tariff, increase in VAT (value added tax)⁶, border closure and removal of petrol subsidy. On core inflation, plausible risks center around currency, electricity tariff increases and the removal of petrol subsidy. Starting out with our views on currency, the apex bank governor reiterated his stance to support the naira in as much as crude oil price remains above \$50 and FX reserves above \$30 billion. For us, we expect crude oil price to average at c.\$61⁷ this year and still see reserves above \$30 billion over 2020, closing the year at \$31 billion⁸. Therefore, we foresee relative stability over 2020.

Next is the electricity tariff. After various deliberation with the FG, NERC released an updated MYTO⁹ review on January 3rd, 2020. We recall MYTO requires a bi-annual minor review to key assumptions and major review every five years, and 2015 was the last time it was reviewed, wherein average tariffs shot up by 58%. The call for a review comes on the back of changes to key macro

⁵ FAO food price index which measures global food prices.

⁶ a consumption tax levied on products at every point of sale where value has been added

⁷ See our Report: Crude oil ([*NSR H1 2020 Excerpts - Crude Oil - Tug of War; the Bears Win*](#))

⁸ See our report: Currency ([*NSR H1 2020 Excerpts - Currency - How long can the CBN keep Up*](#))

⁹ Multi-year tariff order

assumptions such as Nigeria and U.S inflation, currency and generation cost, relative to 2015. According to the publication, allowable tariffs across the eleven DISCOs is estimated at an average of ₦31.05/kwh – which translates to a 23% hike. Though FG has refuted claims of a plausible hike in the near term, we believe the increment should be expected anytime from April as indicated in the NERC publication. For us, we foresee and modelled its implementation for April 2020 in line with what was published by NERC.

Table 1: End-User Allowed Tariffs Review Assumptions for all Discos (₦/kWh)

DISCOs	2015	2016	2017	2018	2019	2020E
Yola	26.9	26.8	26.8	26.8	26.8	26.8
Port Harcourt	24.6	29	33.8	33.8	33.8	33.8
Kano	24.3	27.1	30.1	30.1	30.1	30.1
Kaduna	22.8	30.3	30.3	30.3	30.3	30.3
Ikeja	22.8	27.3	27.3	27.3	27.3	27.3
Ibadan	26.9	28.3	30.6	30.6	30.6	30.6
Enugu	24.6	31.1	35.3	35.3	35.3	35.3
Eko	25.2	28.3	28.3	28.3	28.3	28.3
Benin	25.9	26.75	32.5	32.5	32.5	32.5
Jos	28.2	30.9	33.8	33.8	33.8	33.8
Abuja	25.9	32.3	32.7	32.7	32.7	32.7
Average Tariff	25.28	28.92	31.05	31.05	31.05	31.05

Source: NERC, ARM Research

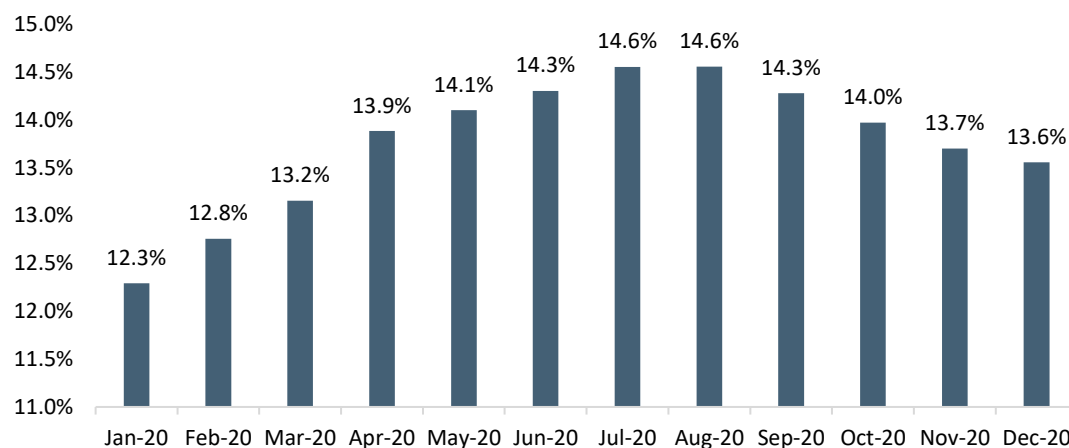
Meanwhile, for PMS prices, using the PPPRA template with our forecast for crude oil price at \$61, the expected open market price for PMS should be ₦178.5/litre. Going by our estimates, the cost of subsidizing a litre of petrol would be ~₦34 with petrol prices fixed at ₦145/litre, implying higher cost incurred by the government. However, the Nigerian government remains unreceptive to adjusting the PPPRA template such that it reflects current market conditions. Barring any hike in petrol prices, the electricity tariff increase should drive an upward pressure on core prices. Hence, we project an upward trajectory on housing, water, electricity, gas and other fuel (HWEGF) component of core inflation, which is expected to have a pass-through effect on cost of production and consequently higher core prices.

Elsewhere, we believe food inflation would trend higher in 2020 relative to 2019 as the ongoing border closure would keep food prices at elevated levels. Although the closure of the border was earlier extended till January 31st, 2020, recent developments suggests uncertainty

regarding the reopening date. Precisely, the Nigerian government gave a tinge that reopening of the land borders would be hinged on strict compliance to regional trade agreements of ECOWAS by neighbouring countries – specifically Benin Republic and Niger. Part of the conditions include strict adherence to the rule of origin for imports – a criteria needed to determine the national source of a product. Hence, goods produced in ECOWAS member states must be in majority, while goods produced outside the region should have an added value above 30% by an ECOWAS country. Furthermore, imported goods are expected to go through proper channels while all warehouses within a certain distance from the Nigerian borders should be dismantled. For us, we expect the government stand its ground on the implementation of the aforementioned conditions, given its impact on the Nigerian farmers and the economy. Elsewhere, VAT was increased from 5% to 7.5% after approval on the 11th of September 2019 by the Federal Executive Council. The new rate is expected to take effect from 1st of February 2020 with the aim of the generating more revenues for the government. We expect this new development to put more pressure on commodity prices going forward. That said, we see scope for elevated food prices in 2020 relative to 2019.

On that note, the lingering impact of Nigerian land border closure and increase in electricity tariff, informs our projection of higher inflation rates from January to August 2020. We expect inflation to abate from September 2020 owing to the high base from the prior year. That said, we project an average inflation rate of 13.8% YoY (2019: 11.40% YoY) and a MoM inflation of 1.07% (2019: 1.0% MoM) which serves as our base case scenario.

Figure 3: Monthly headline inflation forecast for Jan to Dec 2020 (Base)

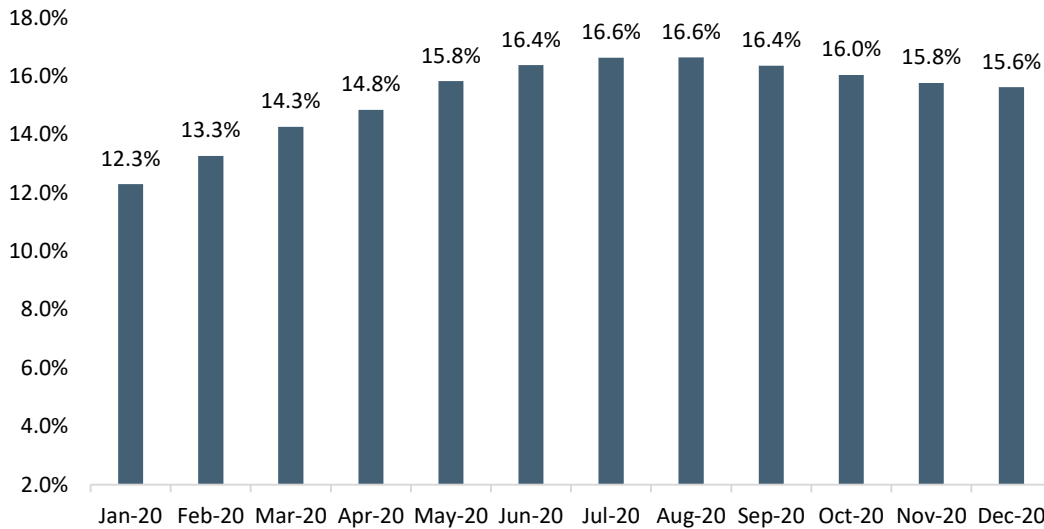


Source: ARM Research

On the downside, the pace of expansion to inflation could be aggravated by a sudden hike to petrol prices and significant currency depreciation. Summing up the impact of these shocks guides to higher

inflationary pressures over 2020 and consequently informs our bear case estimate of 15.3% YoY and 1.22% MoM.

Figure 4: Monthly headline inflation forecast for Jan – Dec 2020 (Bear)



Source: ARM Research

Where will yields go?

While the expectation of an upward movement in inflation should ordinarily call for an increase in FI yields, increased focus on FX casts a doubt to that school of thought. For us, the need to maintain the feat achieved in keeping naira stable at ₦360/\$ level since 2017, takes away the attention from Inflationary and liquidity pressures. We recall the CBN restricted the participation in OMO market to only FPI and banks in October, leaving liquidity levels of ₦3.6 trillion to chase the available FI instruments. With 70% of this liquidity¹¹ being restrained from chasing dollar, we see moderate concerns for FX and increased demand for the limited domestic paper supply. Hence, if the OMO market remains restricted to foreign investors, we anticipate relatively lower fixed income yields this year.

¹¹ The 70% belongs to pension funds and are strictly restricted from the FX market.

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