July 31, 2018

Nigeria Strategy Report

H2 2018

Domestic Economy and Policy Environment

Nigerian Inflation: Approaching an Inflection point

Executive Summary

In our H1 18 strategy report, we projected a drop-in headline inflation, anchored on the blend of soft domestic food prices and base-effects (H1 17) with the scale of moderation trimmed by higher transport inflation – hinged on rising crude oil prices. Indeed, our view of a downturn in consumer prices panned out with headline inflation declining by 285bps over H1 18 to average 13.02% year-on-year (YoY). However, the scale of moderation was steeper than what we had envisaged, as NNPC stepped up its fuel imports over the period to support market supply and price – at ₦145/litre. Consequently, core inflation dipped 101bps to average 11.17% YoY over H2 17 while food inflation declined markedly by 451bps over the review period to 15.63% YoY with the sharp decrease resulting from the impact of favorable base effect and increased market supplies.

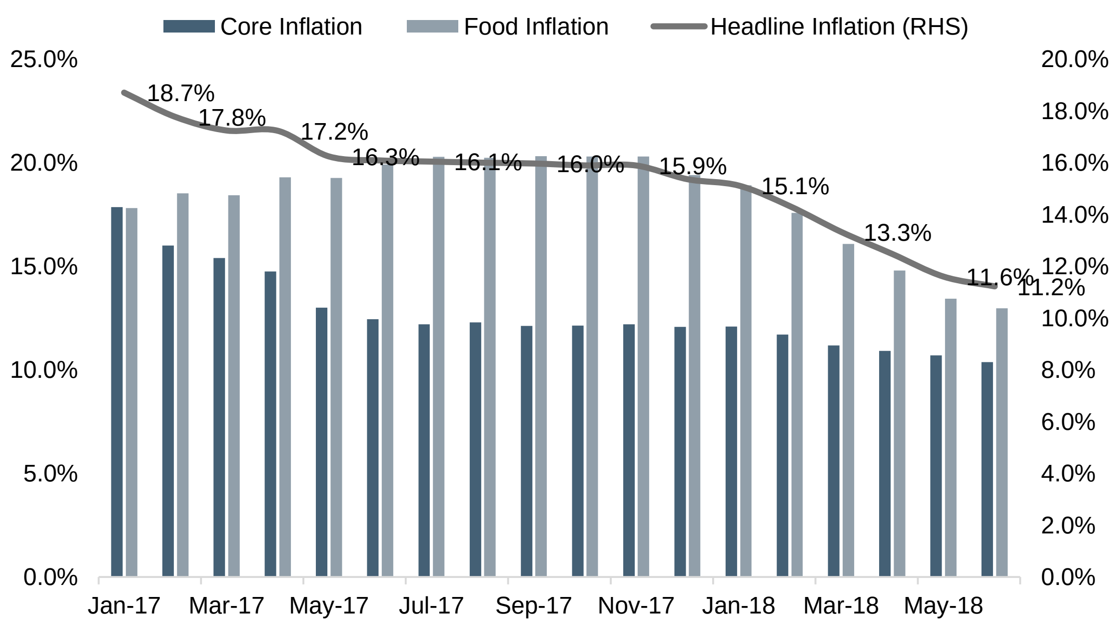
In this report, we look at the major themes that dominated the domestic environment, highlighting our views on the drivers of inflation over 2018

In terms of our outlook over the second half of the year, we considered currency and liquidity concerns over the rest of the year. On the currency front, we believe increased interventions from the CBN will keep the Naira stable in H2 18. With regard to liquidity, particularly from the implementation of the approved 2018 budget (₦9.12 trillion) and, most importantly, spending against the 2019 elections, we do not envisage any price pressure, taking a cue from precedents which shows muted pressures over H2 18 as well as in the months leading up to elections. Overall, our analysis suggests that while base effects although minimal would drive lower 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, we project mean headline inflation to hover around 12.04% YoY over 2018 (2017: 16.55%).

Headline inflation nose-dives over H1 2018, hits 28-month low

In our H1 18 strategy report, we projected a drop-in headline inflation with downside curtailed by elevated transport inflation. Precisely, our expectation of softer inflation was anchored on the blend of soft domestic food prices and base-effects (H1 17) with the scale of moderation trimmed by higher transport inflation, hinged on higher crude oil prices. Indeed, our view of a downturn in consumer prices panned out with headline inflation declining by 285bps over H1 18 to average 13.02% year-on-year (YoY). However, the scale of moderation was steeper than what we had envisaged. To be precise, due to rising crude oil prices, we had expected independent marketers' inability to import fuel to give rise to episodes of fuel scarcity which would pressure PMS price. However, in a bid to boost supply, NNPC stepped up its fuel imports over the period thus supporting price at regulated level of ₦145/litre. Consequently, core inflation dipped 101bps to average 11.17% YoY over H2 17 with the decline stemming from the HWEGF[1], education and clothing divisions. In the review period, food inflation declined markedly by 451bps to 15.63% YoY with the sharp decrease resulting from the impact of favorable base effect and increased market supplies.

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

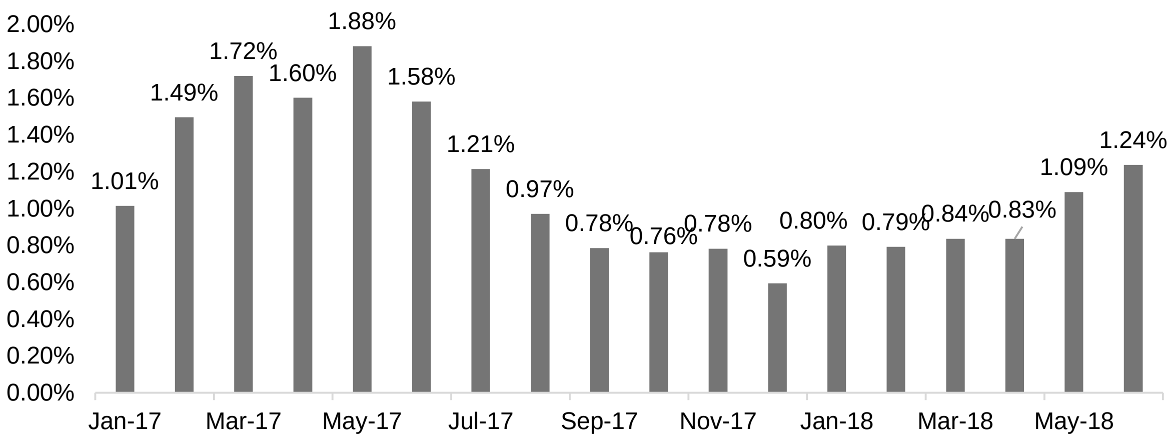


Source: National Bureau of Statistics

[1] Housing, Water, Electricity and other Gases and Fuel

Irrespective of the softer inflation YoY, Month-on-Month (MoM) headline inflation trended slightly higher, albeit modestly (+8bps to 0.93% MoM) underpinned by increases in food (+10bps to 1.07% MoM) and core inflation (+6bps to 0.86% MoM). On the former, the increase reflected pressures in the last two months of the first half stemming from tightened market supplies associated with the lean season which coincided with increased demand due to Ramadan. The combined impact of the above dampened gains achieved in earlier months from improved market supplies pass-through. Switching to the core basket, the uptick in MoM inflation (+6bps to 0.86%) captured the presence of supply shocks, particularly from higher PMS prices at the start of the year.

Figure 2: Historical MoM headline inflation



Source: National Bureau of Statistics

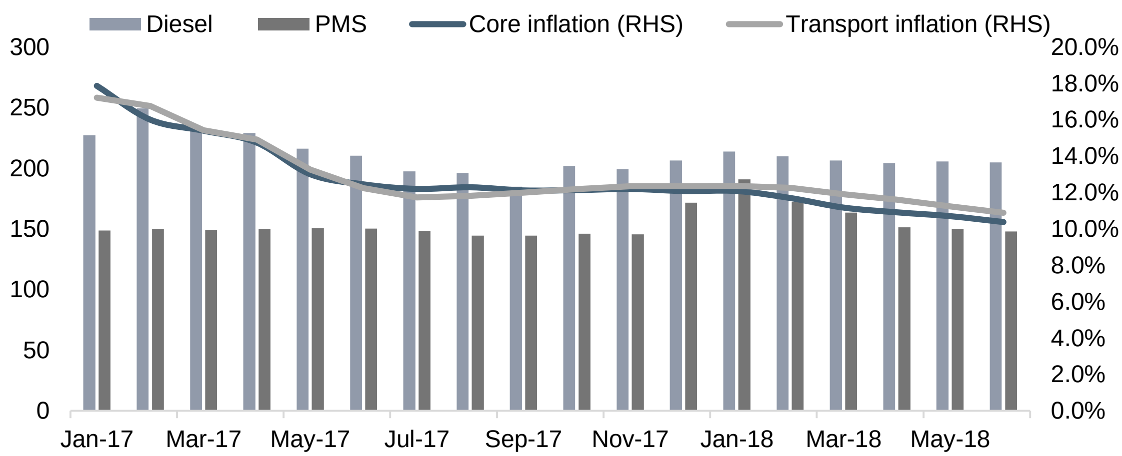
Lower diesel prices underpin moderation in YoY core reading

Extending gains from H2 17, core inflation continued its declining trend over the first half of the year, receding 101bps to average 11.17% YoY. The moderation largely emanated from clothing (-253bps to 13.06%) and HWEGF (-129bps to 7.5%) divisions – which jointly account for 46% of the core basket. On the latter, the steep deceleration over the period reflected lower diesel prices[2] (-8.9% YoY to ₦207.52/litre) relative to H1 17. We recall that over H2 17 diesel prices fell over 40% nationwide following key strategic interventions by the NNPC including improvement in the supply of the product and remodeling of the product distribution channels to address sufficiency issues across the country. Against this backdrop of lower diesel price, YoY transport inflation declined over the review period (H1 18 average: -0.36ppts to 11.71%).

[2] According to data provided by the National Bureau of Statistics

On clothing inflation, the division moderated 253bps to average 13.06% over H1 18. In our view, the sharp decline reflects the pass-through of currency gains and improved dollar availability over the review period.

Figure 3: Average energy prices (₦/litre) versus core & transport inflation



Source: National Bureau of Statistics

Bucking the decelerating trend in H2 17, MoM core reading over H1 18 rose 6bps to average 0.86% (vs. H2 17: 0.80% MoM) above mean H1 MoM core (avg: H1 13: 0.43%; H1 14: 0.47%; H1 15: 0.81%) in pre-shock years[3], indicating unrelenting price pressures in the core basket. In the review period specifically, consumer prices in the core basket were pressured by jumps in the HWEGF (+19bps) and ABTK[4] (+18bps) divisions. Starting off with HWEGF, the increase stemmed from higher PMS prices which prevailed at the start of the year (+8.4% to ₦162.7/litre on average over H1 18) owing to bouts of nationwide fuel scarcity over the first two months of the year, leading PMS to rise to a high of ₦190.9/liter in January 2018 with negative pass-through to transport inflation (+6bps). Over to ABTK inflation, the increase reflected the impact of gradual alcohol beverage increases since the commencement of the year alongside the June implementation of the new excise tariff structure on alcohol beverages and tobacco which led affected manufacturers to hike product prices by ~9% on average.

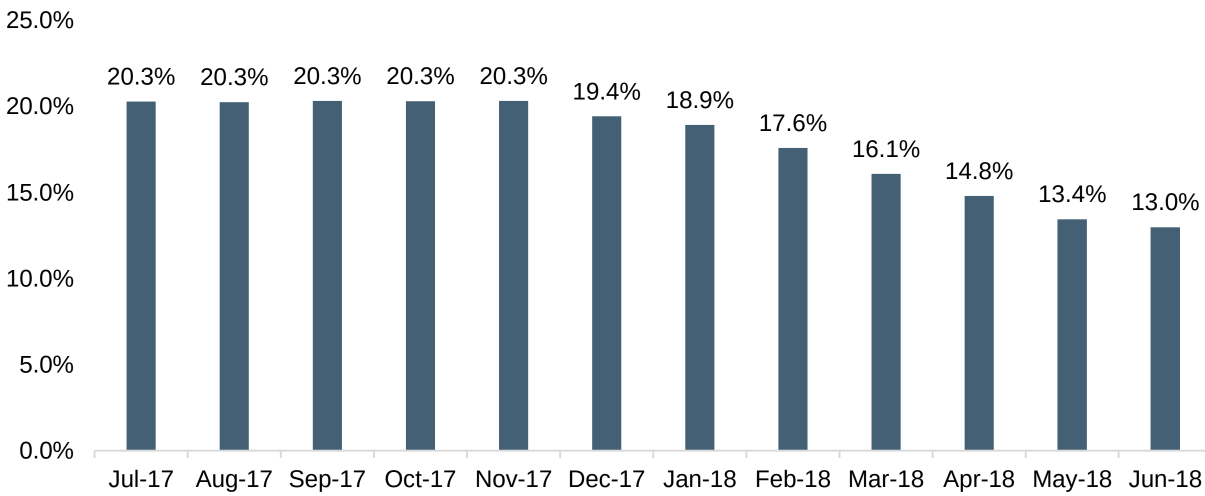
Food Inflation bows to the drum of base-effects

In a departure from trend in the second half of the 2017, YoY food inflation slumped by 451bps to average 15.63% in H1 18. Precisely, ebbing price pressures on farm produce (avg: -498bps to 15.16% YoY) offset mild uptick in processed food (avg: +47bps to 20.87% YoY).

[3] Excludes shock years of 2016 and 2017 where consumer prices were pressured by PMS price & electricity hikes as well as currency depreciation
[4] Alcoholic, Beverage, Tobacco and Kola

In our view, the retreating YoY food inflation largely reflected improved market supplies from bumper harvest during the peak[5] and dry[6] season harvest. Reflecting this, grain prices came in below H1 17 levels – thus presenting a high base for food inflation. To track back, H1 17 food prices were pressured by limited market supplies following increased export demand for grains – a fallout of currency depreciation which made grains cheaper relative to neighboring countries. Elsewhere, YoY imported food inflation inched up 95bps over H1 18 to 16.02% despite stable exchange rate over the same period. We link the increase to higher global food prices as FAO food index increased 2.7% over H1 18.

Figure 4: Historical YoY food inflation



Source: National Bureau of Statistics

Elsewhere, average MoM food inflation was higher 10bps to 1.07% with the average above pre-shock years (avg: H1 13: 0.73%; H1 14: 0.81%; H1 15: 0.94%). For us, with the average skewed by higher MoM food inflation in May (+1.33%) and June (+1.57%), the sizeable MoM reading in the above-mentioned months was in part due to the lean season wherein limited harvest resulting in low food stocks. Also, increased consumer demand during the Ramadan[7] season played a part towards the rise in domestic food prices. According to FEWS NET[8], depleting stocks, Ramadan season as well as industrial demand led staple prices to increase in those months.

[5] October – December
[6] January – March
[7] Commenced 16th May and ended 14th June
[8] Famine Early Warning Systems Network

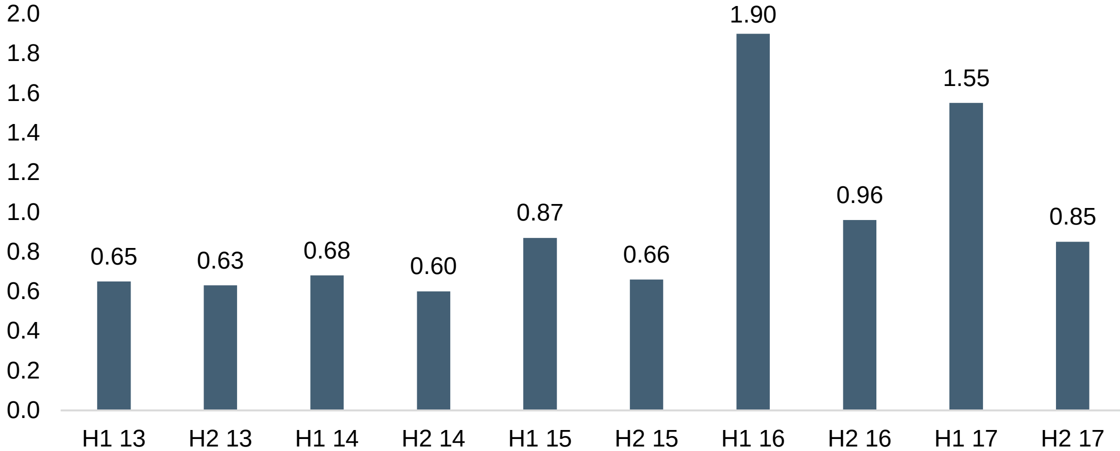
Moreover, they attributed higher food prices to a shift in household consumption from imported rice to locally produced cereals, thus pressuring local supply and prices of cereals. Owing to this, farm produce over the last two months of the first half averaged 1.35%, 50bps and 44bps higher than 0.85% and 0.91% in 4M 18 and H2 17.

Additionally, we link higher food prices in May and June to higher transportation costs (avg: 0.90% vs 0.85% in preceding months) with our channel checks revealing that manufacturers and distributors faced higher transportation costs in recent months likely due to road deterioration from the rainy season which might have reduced availability of trucks.

CPI will trend lower over H2 18, but moderation tapered by transport inflation

In framing our outlook on inflation over the second half of the year, we begin with currency which in our view is fundamental as it has both direct and indirect feed through to both the food and core components of inflation. In this regard, despite expected intermittent shocks to the naira owing to capital flight ahead of the 2019 elections, increased interventions from the CBN – supported by the sturdy reserve – guides to currency stability over H2 18. Next, we consider imminent liquidity concerns from the implementation of the approved 2018 budget (₦9.12 trillion) and, most importantly, spending against the 2019 elections. While increased liquidity should ordinarily translate to increased money in the hands of individuals and boost aggregate demand with a knock-on-effect on consumer prices, we believe this isn't the case in Nigeria. Our view is premised on findings that average MoM inflation in H2 (when budget is typically approved) have always trended lower than H1. Precisely, over the last 5-years (excluding 2016 and 2017 where H1 MoM readings were impacted by supply shocks), H2 MoM inflation was on average 10bps lower than H1 MoM inflation indicating that Nigeria's inflation isn't demand pull. In fact, we posit that the country's inflation is largely cost push noting years like 2016 where prices were impacted by hikes in electricity tariff and PMS, and 2017 where currency depreciation pressured food prices. In a similar fashion, having tracked back to years before elections, our findings reveal moderated MoM inflation over the second half, also indicating muted impact of pre-election spend on consumer prices.

Figure 5: Historical average MoM in H1 and H2

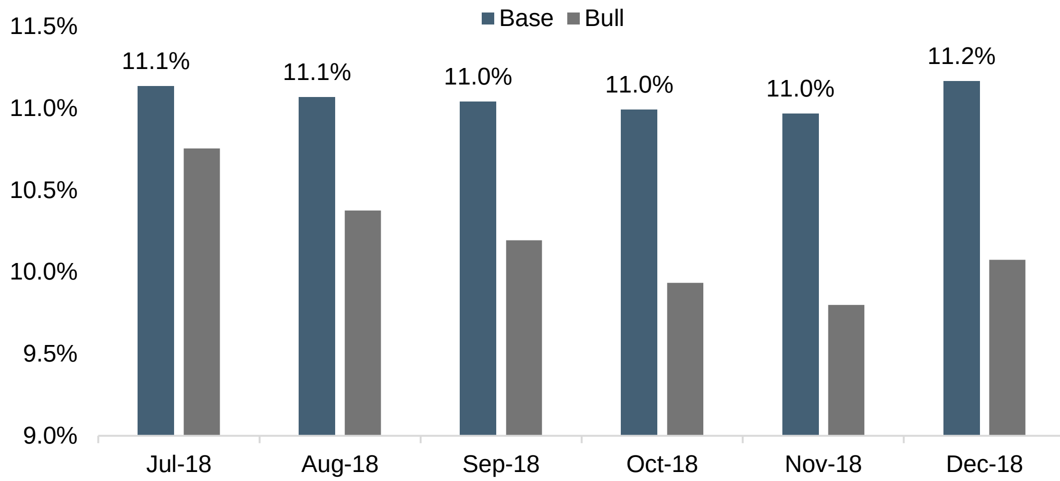


Source: National Bureau of Statistics

Against this backdrop, we narrow our scope of potential shocks to consumer prices over H2 18 to potential hikes in electricity tariff and PMS prices. However, we retain our view that any upward revisions will be considered after the 2019 elections as the incumbent would want to gather popularity against the upcoming election. Particularly for PMS, given higher crude oil prices, we envisage that NNPC will continue to intervene through increased imports which should stem incidences of fuel scarcity and keep the price of PMS stable at current levels.

Switching to food inflation, the high base effects that drove sharp moderations in YoY food inflation is expected to dissipate over the second half hence, indicating tamer moderation for food inflation over H2 18. In terms of MoM inflation, with the current lean season subsisting till October, we expect depleting food stocks to leave prices high in the interim. However, the main harvest is expected to commence in October which should bolster household stocks and support food prices. According to FEWSNET, main harvests in Q4 would boost household stocks and consumption of own production with the resultant impact driving a decline in market dependence and decrease in market prices. Overall, barring the occurrence of flooding activities, we expect a decline in food inflation over H2 18. On the downside, the scale of the decline in food inflation will be tapered by structural bottlenecks in transportation costs from road deterioration due to the rains which would limit the number of available trucks. Overall, our analysis suggests that while base effects although minimal would drive lower 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, we project mean headline inflation to hover around 12.04% YoY over 2018 (2017: 16.55%).

Figure 6: YoY inflation forecasts (Jun – Dec 2018)



Source: National Bureau of Statistics

Inflation risk more evident in H1 2019

Farther out into 2019 after the elections, with higher crude oil prices, we expect the clamour for PMS hikes and even higher electricity tariff to get louder which, if implemented, would pressure consumer prices both in the core and food basket and keep the headline reading on an upward trajectory. On PMS, as it stands, using the PPPRA[9] pricing template, the current landing cost of PMS is ₦173.18/ litre, a 19% premium to the selling cost of fuel. Using our crude oil estimate of $65/bbl. over H1 19, and exchange rate of ₦305/$ we estimate a landing cost of PMS at ₦155.92/litre, which is at a 7.5% premium, indicating the likelihood of a PMS price hike in 2019. Moreover, perusing through the financials of NNPC reveal that the state petroleum company lost an average of ₦138 billion (crude oil price averaged $67.4/bbl.) over Q1 18 in its effort to import fuel at current market levels and sell to marketers at a discount of ₦139/litre. Given expected higher losses as crude oil prices rises and the attendant impact of lower remittances to the federation account, we believe the government will have no choice but to hike the price of PMS. As in the past, there is a strong relationship between PMS and core CPI thus, higher PMS prices could likely fuel fresh inflationary pressures in 2019. Nevertheless, we do not think any upward revision would occur in H1 19 given that the new president would be inaugurated late May and a June price action will be too early.

[9] Petroleum Products Pricing Regulatory Agency

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

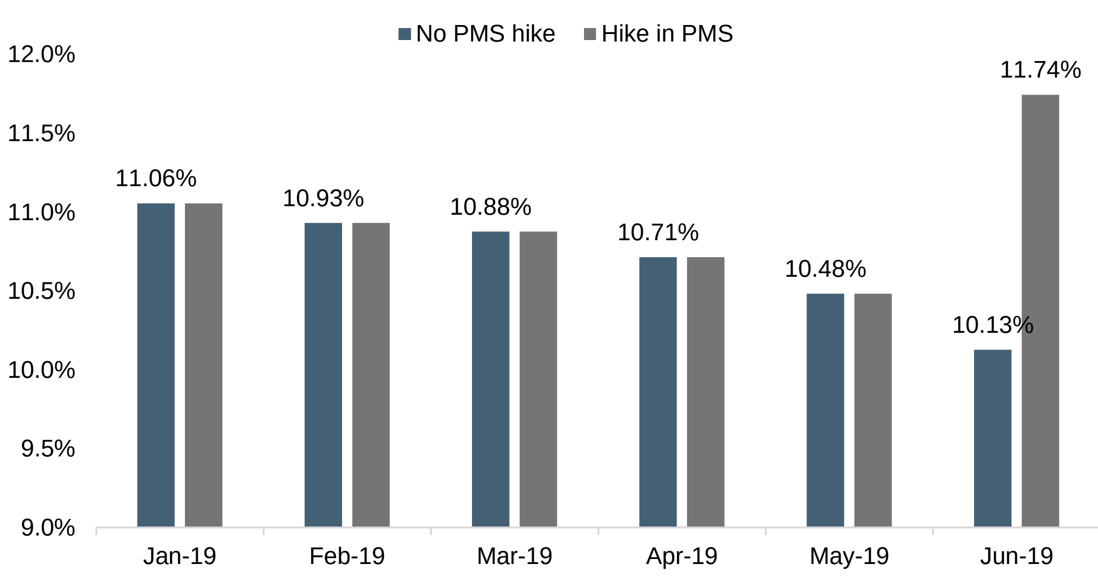
Table 1: Increases in PMS Price for different crude oil price and USDNGN assumptions

Scenarios	305	350	360	400
$50/bbl	-5.7%	0.3%	7.4%	17.0%
$55/bbl	0.9%	7.4%	15.2%	25.6%
$60/bbl	7.5%	14.6%	23.0%	34.3%
$70/bbl	14.1%	21.7%	30.8%	43.0%

Source: ARM Research

Moving over to electricity tariff, 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 MYTO. However, with many electricity consumers not metered, raising electricity tariffs would mean higher bills for the few adequately metered consumers. Given this, we expect the proposition to be met with opposition and view an upward review as unlikely over 2019.

Figure 7: YoY inflation forecast (Jan – Jun 2019)



Source: NBS, ARM Research

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