

# Nigeria Strategy Report

## H2 2019

### Domestic Economy and Markets

## Inflation: A tale of two seasons

### Executive Summary

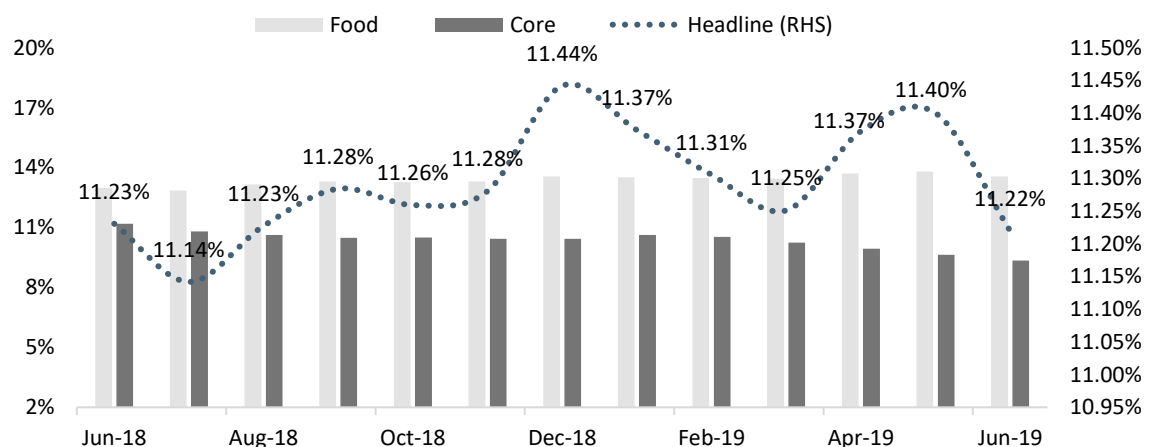
Consumer prices ticked up by 5bps to 11.32% over the first half of 2019, mirroring the conflict induced increase in food prices in Q2 19. For the first three months, inflation maintained a downward trajectory, followed by an unanticipated rise in farmers-herdsmen conflict which changed the inflationary trend in April and May. Eventually, the tide calmed in June as the anticipation of a favorable harvest season drove an increase in market supplies. Consequently, inflation declined in the month of June. Looking at the components, food inflation ticked up by 34bps to 13.58% YoY mirroring the telling impact of conflict in the north and seasonal increase in food prices. At the other end, the core basket maintained a downward trajectory, declining by 53bps to 9.39% following NNPC's drive to leave petrol prices unchanged at ₦145/litre.

Over the rest of the year, we foresee the current administration would retain its socialist modus operandi, limiting the downside risk to core inflation. That said, we shift our focus to heightened tensions in the north which took a toll on food inflation over the first half of the year. Continued efforts to resolve the tensed security condition in the Northern region and reduced risk of flooding relative to the prior year, limits the downside risk to food inflation in coming months. According to FEWSNET, markets are expected to remain well supplied during the lean season through September. Further amplifying the market supplies is the main harvest season which will begin in October with favorable harvest expected in the last two months of the year. That said, we expect average inflation rate to print at 11.2% YoY (2018: 12.2% YoY).

***In this report, we focus on the major themes that steered consumer prices over H1 19 and delineate our outlook for inflation over H2 2019.***

***H1 2019 Inflation: Consumer prices edged northwards.***

In our H1 19 NSR, we posited that the confluence of increased PMS prices and slight depreciation of the naira will dominate discussions on price level over 2019. Notably, while they anchored our inflation expectation, we stated that the pressure from PMS prices and currency depreciation will emanate largely in the second half of the year. As such, we expected of inflation trajectory over the first half of the year to reflect short term shocks emanating from intermittent festive related price increases. Not so far off, the first three months of 2019 saw downward inflationary trend. However, unanticipated rise in farmers-herdsmen conflict changed the smooth sailing in April and May – before settling in June. Accordingly, average inflation rate printed at 11.32% over the first half of 2019, which is 5bps higher than 11.27% average recorded over H2 18. As stated earlier, the uptick stemmed from a rise in food inflation by 34bps to 13.58% YoY, which outstripped the moderation observed in core inflation (H1 19: -53bps to 9.39%).

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

Source: CBN, ARM Research

***Waning food inflation bucked by heightened tensions in the North***

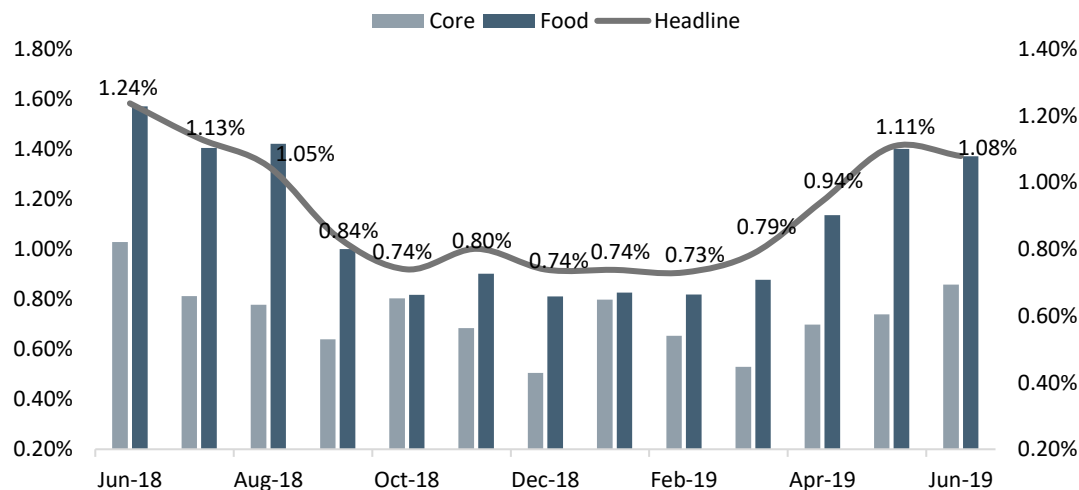
Consumer prices oscillated over the first half of the year, driven by a conflict induced movement in food inflation. To begin, food inflation kicked off on a soft note, moderating over the first three months of 2019 due to favorable planting conditions during the dry season harvest<sup>1</sup>. According to FEWSNET, farmers were engaged in harvest of rice, maize, vegetables and sugar cane, necessitating an average to above average harvest and low prices during the dry season. However, tensions between the armed bandits and farmers in the North coupled with Ramadan effect turned the tide, driving the ascent in food inflation for the month of April and May. Eventually, the tide calmed in the month of June with food inflation dipping by 22bps to 13.56% YoY. Though

<sup>1</sup> January, February and March

surprising, we believe the moderation was driven by increased supplies in the market. According to FEWSNET, normal onset of the rainy season with reduced risk of flooding lessened trade speculation, causing traders to release most of their stocks during the lean season. Likewise, we believe on-going discussions on a peace pact in the conflict affected areas calmed the tensions in the North, further reducing the pressure on food prices. Nonetheless, average food inflation ticked up over the first half of the year, printing at 13.58% – expanding by 34bps, when compared to the second half of 2018.

On the flipside, core inflation witnessed a slow down over the first half of the year – receding by 42bps to average 9.5% YoY. This was largely supported by NNPC's continued effort to keep petrol prices at ₦145/litre. Accordingly, PMS prices (10.62% to ₦145.5/litre over H1 19) remained lower relative to the prior year, overshadowing increases in kerosene (+10.3% YoY to ₦310/litre) and diesel (+9.7% YoY to ₦228/litre) prices. Against the backdrop of lower PMS price, YoY transport inflation declined by 105bps to 9.41% with attendant impact on HWEGF<sup>2</sup> – declined by 6bps to 7.25%. Also, moderation in clothing (-12bps), Furnishing (-43bps to 9.52%), Education (-41bps to 9.44%) and Health (-12bps to 9.62%) further contributed to the overall moderation in the core basket during the period under review.

**Figure 2: Historical MoM Core, Food and Headline inflation**



Source: NBS, ARM Research

Average month-on-month (MoM) inflation reading was benign over H1 19, expanding just 1bp to 0.9% stemming from both the core and food baskets. To begin, average food inflation edged up by 1bp to average at 0.75% in H1 19, skewed by the conflict induced increase in prices for the month of April and May. Specifically, price pressures were evident in farm

<sup>2</sup> Housing, Water, Electricity, Gas & other fuel

produce due to increased demand during the Ramadan season coupled with reduced farming activities following the tensed security situation in the north. Consequently, over the first six months, farm produce inflation expanded by 2bps to 1.11%. On the flipside, currency gains over the period left imported food inflation flat while prices of processed foods declined by 8bps. At the other end, average core inflation flatlined, reflecting the differing movement in energy prices. Month-on-month, movement in average petrol prices was flat overshadowing the 40bps expansion in diesel and 110bps increment in kerosene prices. Across the sub-indices, save for the HWEFG basket which expanded by 9bps, other key sub core indices either remained flat or dipped by 5bps.

### *Inflation to sustain its downward trajectory*

Over the rest of the year, we believe the current administration will retain its socialist modus operandi, limiting the downside risk to core inflation. That said we shift our focus to heightened tensions in the north which took a toll on food inflation over the first half of the year. To begin, we believe food inflation will sustain its downtrend over the rest of the year as the risk to higher prices centers on heightened tensions in the north and flooding in farming areas. To clarify, in a bid to resolve the tensed security situation in the north, FG approved the Rural Grazing Area (RUGA) settlement in May – a programme expected to put an end to the recurring conflict between nomadic herders and farmers. The project aims to place migrating pastoral families in an organized place with provision of adequate basic amenities such as schools, markets, veterinary clinics etc. across the 36 states.

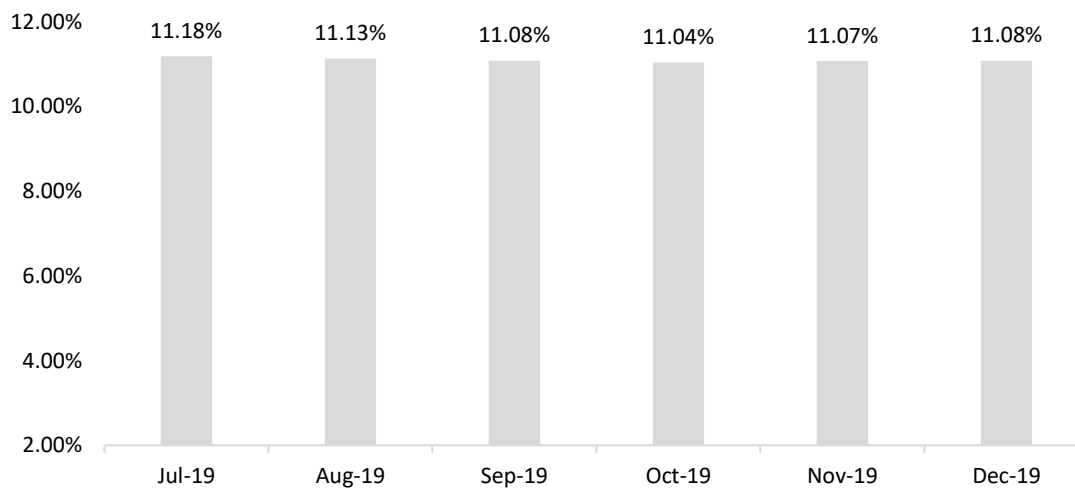
While 11 states<sup>3</sup> in the North have indicated interest thus far, there has been a lot of kickbacks from the southern and Western regions on fears of ethnic domination by the Northerners. Notwithstanding we are positive the government will not relent in its efforts to put an end to the rift between armed bandits and farmers, given its impact on the Agricultural sector. To add, asides indicating interest in RUGA settlement – Zamfara state government has taken a step further to engage in peace talks with the armed bandits. For us, while we do not expect the conflict to end abruptly, we foresee moderation in coming months. Elsewhere, recent annual flood outlook by Nigerian Hydrological Services Agency (NIHSA) revealed that an average level of flooding is anticipated across the country mainly between July and September, albeit the probable flood area will be lower than the previous year. According to FEWSNET, markets are expected to remain well supplied during the lean season through September - as traders continue to release their stocks. Further amplifying the market supplies is the main harvest expected to begin in October with favorable harvest expected in the last two months of the year.

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<sup>3</sup> They include Sokoto, Adamawa, Nasarawa, Kaduna, Kogi, Taraba, Kastina, Plateau, Kebbi, Zamfara and Niger states

On core inflation, the risk centers around increment in petrol price and currency depreciation. While we expect slight depreciation towards the end of 2019, an increment in PMS price seems improbable. To clarify, despite the calls for a review of the PPPRA template as global crude oil prices remain elevated – the government continue to subsidize the sale of PMS. Also, engagement with various stakeholders reveal the plausibility of its occurrence this year is very low – ruling out inflationary pressure borne out of higher petrol prices. Secondly, naira has remained largely stable since the start of the year helped by continued intervention by the apex bank, which is expected to persist. Albeit, we retain our view of a drop in its intensity as accretion to the reserves is expected drop due to lower oil receipts in the latter part of the year (Q4 19). That said, we expect slight depreciation to the naira, with muted impact on the core basket. Overall the impact of our adjustment translates to an average inflation rate of 11.2% YoY (2018: 12.2% YoY) which serves as our base case scenario.

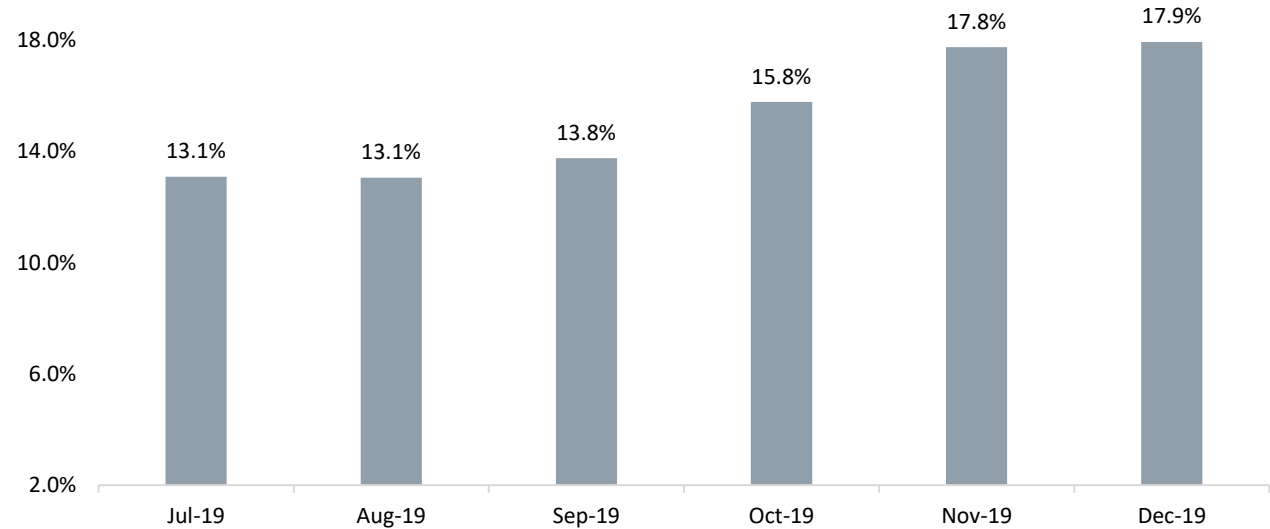
**Figure 3: Monthly inflation forecast for July to Dec 2019 (Base)**



Source: ARM Research

Downside to our forecast is a sudden hike in petrol prices, higher than expected, conflict and the inability of the government to resolve the kickbacks from the populace against RUGA settlement. The interplay of these factors could drive inflationary pressures in the second half of the year which guides our expectation of an uptick in the average inflation rate over 2019 to 13.3% which is our bear case scenario.

Figure 4: Monthly inflation forecast for July to Dec 2019 (Bear)



Source: ARM Research

**ARM Securities Contact**

Research	234 (1) 2701653	<b><u><a href="mailto:research@armsecurities.com.ng">research@armsecurities.com.ng</a></u></b>
Institutional Sales & Trading	234 (1) 448 8833	<b><u><a href="mailto:trading@armsecurities.com.ng">trading@armsecurities.com.ng</a></u></b>
Customer Service	234 (1) 4488282	<b><u><a href="mailto:customerservice@armsecurities.com.ng">customerservice@armsecurities.com.ng</a></u></b>

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