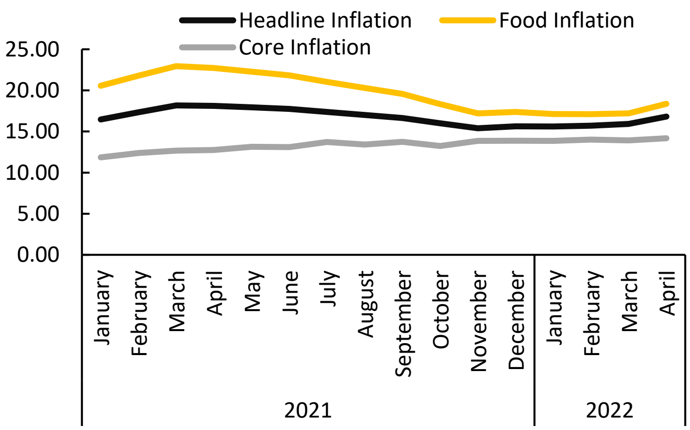
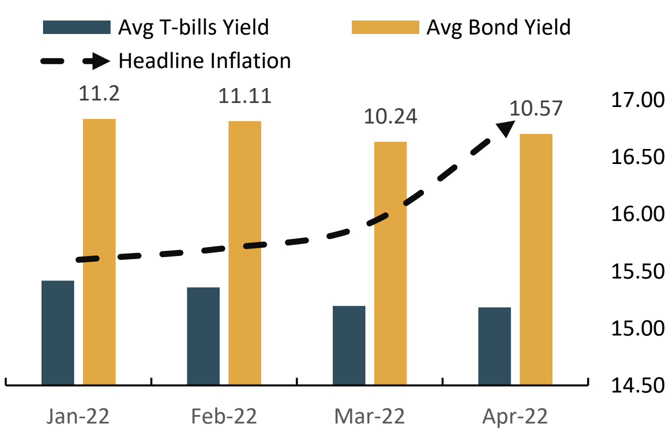
Macro-Economic Update | Inflation & Post-MPC Review

26 May 2022





Inflation Nudges Higher to 16.82%, Reaches Highest in Eight Months

Nigeria's headline inflation rate continued its upward trajectory in April, rising by 0.90% to 16.82% Y-o-Y. In the same vein, food and core inflation rose to historical highs, settling at 18.37% Y-o-Y and 14.18% respectively. On a month-on-month basis, however, headline inflation increased by modest 2bps from 1.74% to 1.76%.

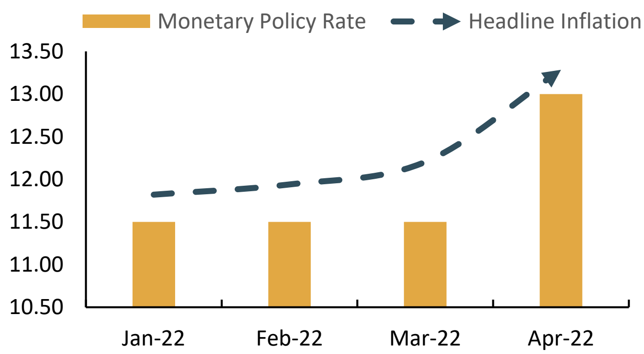
Data for April showed that food prices were higher than they were in March, reflected by the 2.00% M-o-M increase in prices. This surge was due to the rising cost of staples owing to the Ramadan and Easter festivities, as well as a slowdown in harvest season. Core inflation for April was also up 1.22% compared to last month's 0.98%, impacted by higher energy and transportation costs.

Asides the underlying structural issues surrounding inflation, it is worth pointing out that the significant rise in the year-on-year inflation figure was mainly due to base effects. Though the numbers continued to reveal that food inflation accounts for over 50% of headline inflation, the recent jump in April also showed that relative price increases in the core index is accelerating at a fast pace of 26bps to 14.18% Y-o-Y. As a result, the risk to the inflation outlook is tilted to the upside, due to pain points emanating from the lingering supply chain bottlenecks, insecurity concerns in food producing states, FX illiquidity, high energy prices, base effects among others. With this, we see inflation hitting 17.71% in May.

MPC Tightens Stance, Holds Key Policy Rate Constant

In a surprise move, the rate setting committee for Nigeria, the Monetary Policy Committee (MPC), voted to raise the monetary policy rate (MPR) for the first time in more than two years. The committee raised its key rate by 150bps from 11.50% to 13.00% at its third meeting of the year, citing its paramount need to rein in on inflation in line with the tightening cycle observed globally. However, it retained its other key policy parameters with Asymmetric corridor at +100bps/-700bps around the MPR, Liquidity ratio at 30%, and Cash Reserve Ratio (CRR) maintained at 27.50%.

In arriving at its decision, the committee gauged macroeconomic and financial market conditions in the global



and domestic economies, alongside an assessment of key risks in both environments for the rest of the year.

The committee acknowledged the robust GDP numbers of 3.11% Y-o-Y recorded in the first quarter, driven by non-oil sector growth of 6.08% Y-o-Y, even though the contraction in the oil sector persisted for the 10th consecutive quarter, reaching -26.04% Y-o-Y in the quarter. Growth was supported by the Agricultural (+3.16%), Manufacturing (+5.89%), Trade (+.54%), and ICT (+12.07%) sectors. With this, the CBN projects growth should reach 3.24% in 2022, despite pockets of macroeconomic vulnerabilities.

Though the committee stressed that the tightening stance would come at the expense of growth, it was of the view that rates on the development finance initiatives of the Bank should stay at 5% till March 2023, to continually support output growth.

The committee also noted that tightening should narrow the negative real interest rate, restore investor confidence, and moderate the speed of capital flow reversal, even as debt servicing cost will jump, thereby, adding to concerns surrounding debt sustainability.

On inflation, the committee alluded to the several supply side factors impacting inflationary pressures. According to the MPC, emerging evidence shows that money demand pressure is high and rising with a low probability of easing till after the 2023 general elections. We however remain of the opinion that a higher interest rate would do very little to slow down inflationary pressures or even attract foreign capital. This is because foreign investments have continued to thin out (worsened further by the government's unfavorable FX policies), and the reality that inflation is mostly supply driven. In other words, inflation is caused by increased commodity prices (which translates to higher costs of production and elevated prices of goods) rather than a demand-pull inflation which is triggered by increased demand.

Implication on Capital Markets

Equities: Given that foreign investor participation has dropped dramatically from 41.31% at the start of the year to 27.08% in April 2022, we do not expect major capital inflows that could fuel market volatility. Although, we expect price corrections in the market following the persistent uptick in stock prices. The market has returned over 11% in almost two months and 23% YtD. The rate hike could also trigger portfolio realignment inducing a reallocation of assets into fixed income market. Given how impressively the market has performed thus far, we believe stocks will lose pace in the coming months as investors assess the risk of a severe market correction. Respite could however come from positive corporate earnings, with investors cherry picking dividend paying stocks with attractive yields.

Fixed income: Following the decision to hike rates, we expect market rates would start to re-price higher, in the face of the government's higher spending plan. This should drive interest rates upwards, narrowing the negative real return gap for investors. This to us should improve returns on fixed income investments like mutual funds.

What does this mean for investors?

Fixed Income Mutual Funds: With the rate hike and the anticipated increase in domestic borrowing, we expect interest rates on fixed income instruments to increase, thus presenting a good investment opportunity in the fixed income mutual fund, where returns are expected to improve. Mutual funds, benchmarked against Treasury bills, tend to offer higher yields when compared to the current T-bills yield in the fixed income market, thus providing a better hedge against inflation. Investors should consider buying the Anchoria Fixed Income Fund which has returned 5.25% this year.

Dollar Denominated Investments: Generally, a higher interest rate should increase the value of a country's currency, though the multiple exchange rate systems run by the central bank creates uncertainty and unpredictability in the FX environment. Consequently, investing in dollar denominated assets provides a hedge against a plausible devaluation/depreciation of the currency while also offering investors a higher return potential (as rising interest rates boost return on dollar investments particularly in fixed income assets). Investors can consider the Anchoria Eurobond Linked Note designed to deliver high returns and hedge against foreign exchange risk.

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