17 December 2019 **Economic Research**

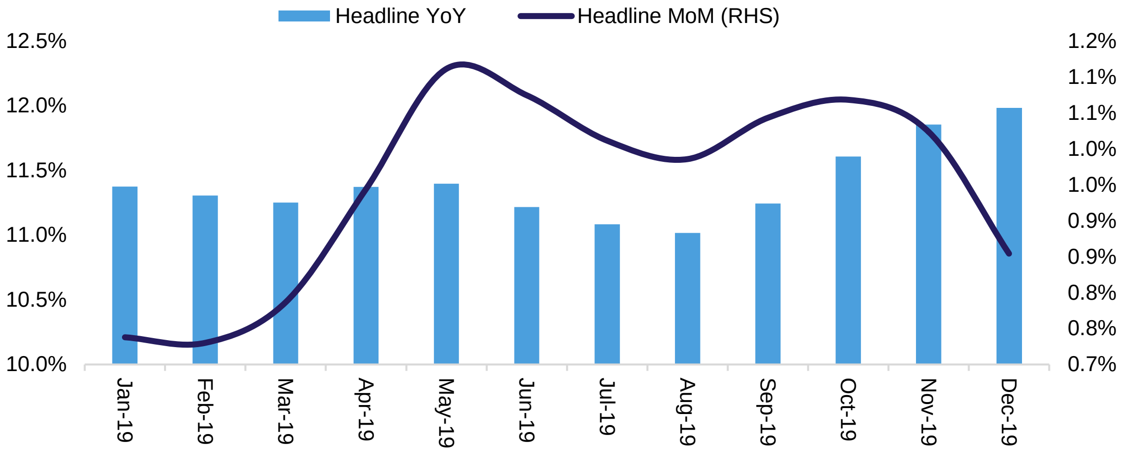
Economic Commentary

Month-on-month inflation expands at a slower pace in December

- Headline inflation ticked up by 13bps to 11.98% year-over-year (YoY) in December
- Core price index grew by 34bps to 9.33% YoY
- Food price index grew by 18bps to 14.67% YoY

Inflation data released by the National Bureau of Statistics this morning showed that consumer prices rose by 0.85% MoM in December, marking the slowest MoM change in nine months. The lower than expected MoM number largely mirrored a second consecutive slowdown in food inflation by 29bps to 0.97% MoM (due to the fading impact of the border closure), which more than offset the increase in the core basket. The core basket expanded for the second consecutive month by 2bps to 0.81% MoM, which reflects MoM increases in average diesel, cooking gas and kerosene prices by 2.10%, 0.92% and 0.96% to N229.81/litre, N2,018.68/5kg cylinder and N320.59/litre respectively.

Figure 1: Inflation Trend over 2019: YoY and MoM



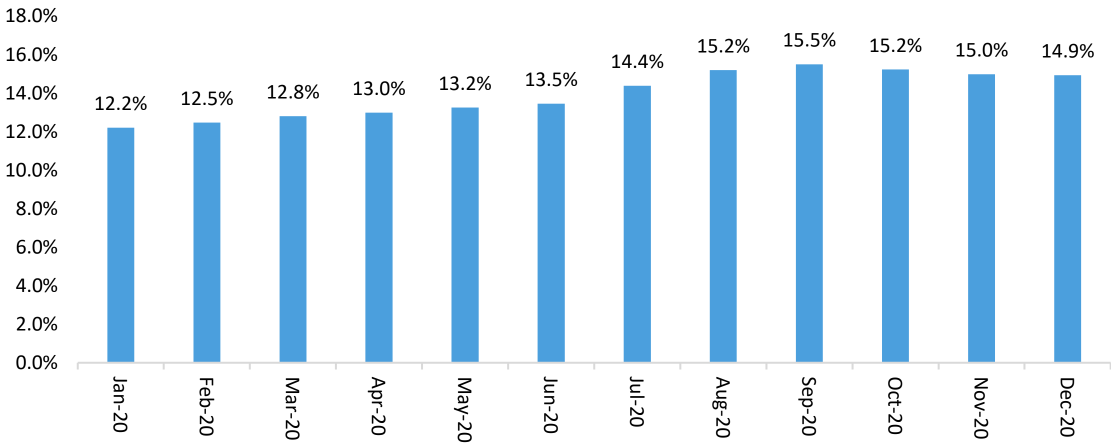
Source: NBS, NOVA Research

On a YoY basis, headline inflation expanded by 11.98% from 11.85% in November 2019, with headline inflation in 2019 averaging 11.39% (5bps higher than 11.34% average as at November) compared to 12.15% average in 2018. Much of the expansion over the past four months stemmed from the feedthrough of the land border closure on food prices, which more than outweighed the onset of the main harvest season, with food prices expanding 18bps to 14.67% YoY from 14.48% in November. The impact of the higher foods prices is further compounded by increase in the core index for the second consecutive month by 33bps to 9.32%YoY compared to 8.99% in November.

Overlaying the twelve-month average rate on average fixed income yield of 7.11% and the closing rate of the 364-Day NTB at last week's auction of 5.09%, translates to negative real return of 487bps and 689bps respectively. We believe the level of real return and the somewhat illiquidity at the OMO space will continue to constrain the rate of FPI inflows into the country and a further depletion in the FX reserve.

Going into 2020, we believe the catalyst of inflation will not be so far from what we witnessed in 2016 when the MYTO review took effect in February and an upward adjustment to the pump price of PMS in May. While we do not see an abrupt change in the pump price of PMS in 2020 (even with the PPPRA template suggesting open market price of N172.73), our channel checks reveal that the proposed increase in MYTO tariff would kick off in the second half of 2020, with the increase in VAT rate from 5% to 7.5% expected to take effect starting February 1, 2020. The MYTO tariff alongside our expectation of slight depreciation in the Naira early next year (and more noticeable depreciation in the second half) suggests much more pressure on inflation over the year. While the direction of the border closure is yet to be determined, we believe it will be resolved earlier in the year and assume muted impact post Q1 inflation numbers. Accordingly, we estimate expansion in average inflation rate in 2020 to settle at 14.1% on our base case.

Figure 2: Forecast 2020 inflation trend



Source: NBS, NOVA Research

Our broad expectation of an uptick in inflation over 2020, could inform a change in the direction of monetary policy. While economic growth has been the anchor for monetary policy over 2019, (which was supported by the softened inflationary trend and FX stability), we believe further depletion in the FX reserve (down $4.4 billion in 2019 to $38.1 billion) and expected uptick in inflation guides to upward adjustment in the monetary policy rate in 2020. However, before a change in the MPR rate, we do not rule out some form of administrative measures to limit the rate of FX depletion. In our view, we believe the apex bank will adjust the NTB primary market rate upward to attract FPI flows. In all and from a portfolio allocation standpoint, we believe a tactical medium-term position in treasury assets will accumulate mark-to-market gains going into 2020.