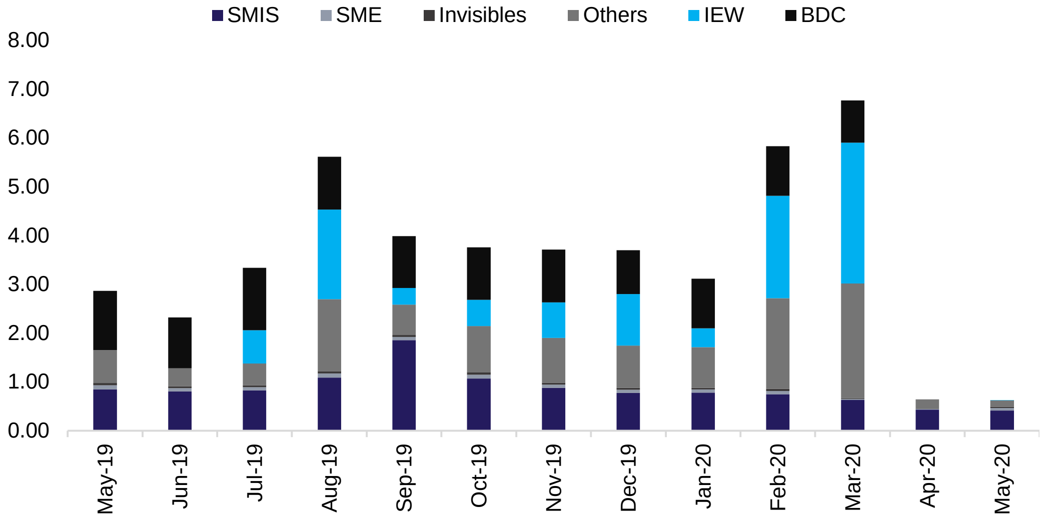
Monthly Economic Insights

Foreign Borrowings Offer Temporary Reprieve

After eleven months of consecutive depletion, the gross external reserves increased by $3.07 billion (April depletion $1.64 billion) in the month of May to adjusted level of $35.32 billion following the inflow of IMF facility and other official receipts. The accretion was further supported by absence of CBN sales at the IEW and minimal intervention sales across other segments. CBN sales to the SMEs, Invisibles and SMIS (retail and wholesale) windows totaled $490 million compared to $451 million in April as CBN rationing of dollars and DMBs lowering of bids to avoid unusual debits by CBN persists. Non-auction sales declined to just $133 million compared to $192 million in April, while no sale was recorded for BDCs as the apex bank is yet to resume sales.

Notwithstanding the gradual reopening of the economy amidst moderating fixed income yields, foreign inflows totaled $187 million compared to $163 million in April, dominated largely by foreign portfolio flows. On the hand, local supplies (ex-CBN) declined to $241 million (April: $360 million), following lower dollar sales by non-bank financial institutions. DMBs sold a total of $330 million during the month compared to purchases from clients of $392 million.

Figure 1: CBN Intervention Sales Across Markets



Source: FMDQ, NOVA Research

OTC FX futures market activity slowed in the month of May, with total value traded declining to $1.45 billion compared to $1.99 billion in April. Futures contract worth $2.51 billion matured on May 27. Compared to the rate at initiation of N360.8/$, the NAFEX rate on the settlement date averaged N389.7/$, indicating the apex bank closed the position with a loss of N72.6 billion compared to N37.9 billion loss on the April settlement.

The Month's Key Points

Other Readings

MPR Reduction Signals More Deliberate Measures Imminent, 28 May

MPC Preview: Economic Stability Regains Priority But Policy Options Still Limited, 27 May

Q1 2020 GDP Escapes Full Impact of Covid-19, Q2 Not So Lucky, 25 May

Supply Chains Disruption Becoming More Evident, 21 May

Monthly Oil Market Update, 14 May

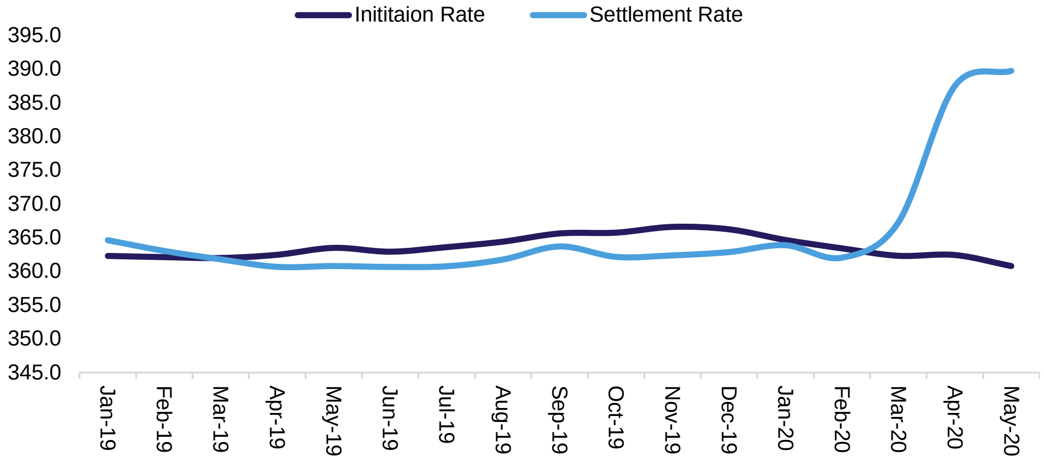
Monthly Economic Insights, 08 May

NOVA Research

Research@novambl.com

+234 1 280 4000

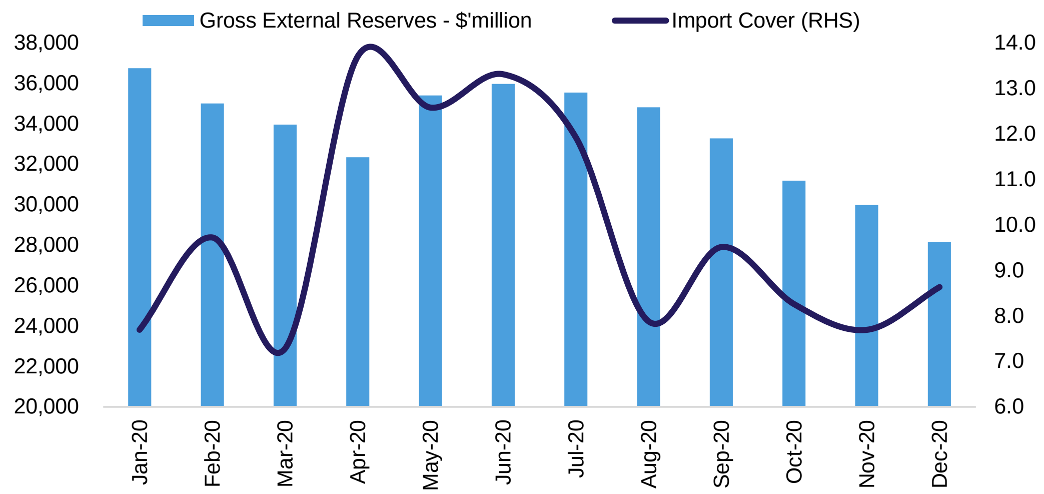
Figure 2: OTC FX Futures Contracts



Source: FMDQ, NOVA Research

In modelling the reserve position over the rest of the year, while we have adjusted expected oil inflows to reflect the modestly improving oil price and expected foreign borrowings, we expect paucity of FPI inflows over the rest of the year. The suspension of sales to BDCs by our estimate conserved about $2.0 billion between April and May, and an additional $1 billion in June as sales are expected to only resume as soon as international airports are opened. With the likely resumption of international flights in July, demand for services (especially Business and Personal travel allowances) and imports could further trigger a depletion in the reserve, albeit still marginal. Also, the recent fall in fixed income yields amidst fragile external position could propel exodus of FPI funds. Adjusting our modelled reserve level for the inflow of the remaining expected World Bank, AfDB and Islamic Development Bank borrowings of $2.11 billion, we estimate a year end reserve position of $28.2 billion ($26.1 billion at year end, excluding the borrowings), with our model suggesting further weakening of the NAFEX rate to N410/$. It is worthy of note that, due to the minimal activity at the IEW in April and May, we believe the portion of offshore holdings of maturing fixed income securities, estimated at $1.76 billion, is yet to be repatriated and could be rolled over to the rest of the year.

Figure 3: Forecast Gross External Reserves and Import Cover

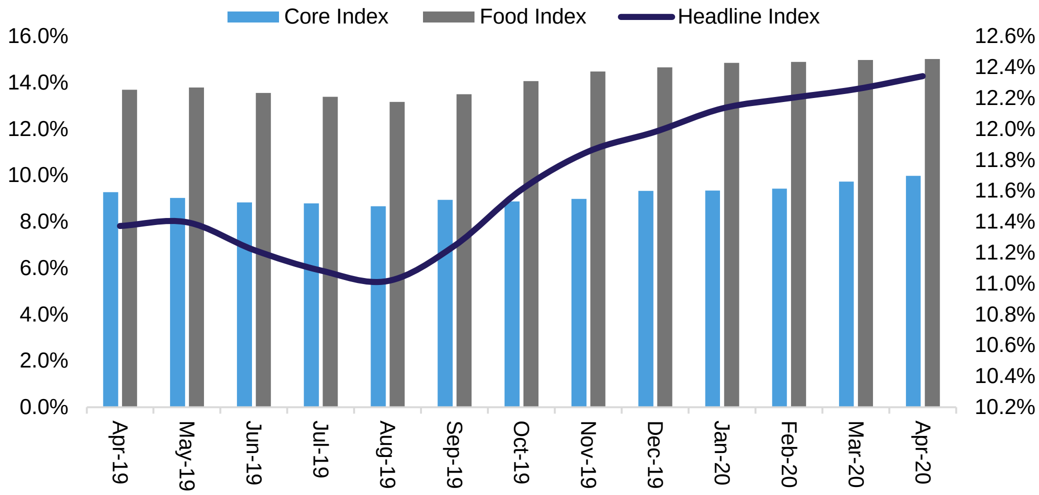


Source: NOVA Research Estimates

FX Depreciation and Social Distancing to Propel Inflation

The disruptive impact of the breakup in the supply chains (with transmission to scarce imported commodities and higher demand for local substitutes), the abrupt adjustment to the exchange rate and jump in prices of essential items (due to the lockdown) were largely evident in the inflation number released for the month of April. Month-on-month inflation was at a four month high of 1.02% MoM in April, coming above 0.84% MoM in March. Compared to the month of March, a much faster increase in food prices (+24bps to 1.18% MoM) and increase in the core index (+12bps to 0.93%MoM) contributed to the elevated price level during the month. For the food index, while prices of processed foods increased by 14bps to 1.74% MoM, prices of farm produce surged 25bps to 1.13% MoM, reflecting the impact of higher transportation costs for agricultural produce due to the restriction of movement. The expansion in the core index reflected increases in the Transport sub-index by 22bps to 0.97% MoM, Health (+23bp to 1.04% MoM), Clothing & Footwear (+9bps to 0.87% MoM) and HWEGF (+9bp to 0.69% MoM).

Figure 4: YoY Trend in Headline, Core and Food Inflation Trend

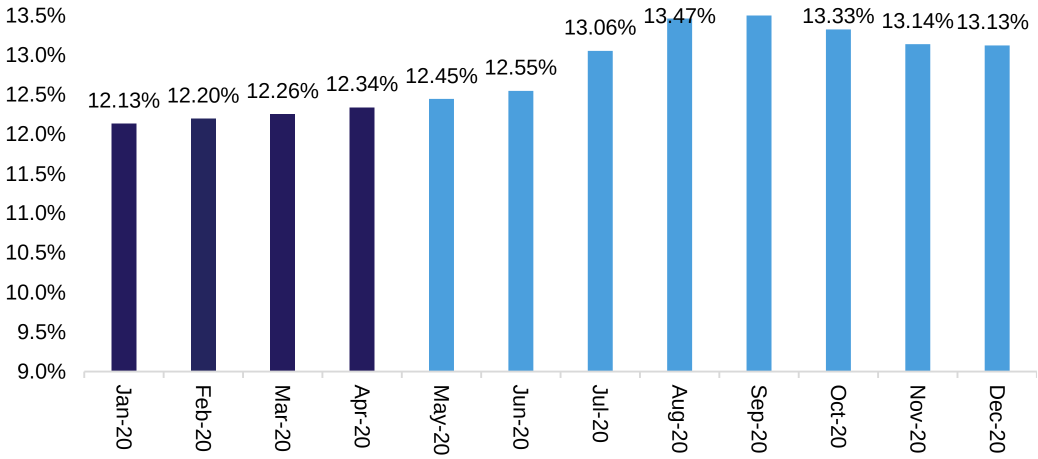


Source: NBS, NOVA Research

While the impact of the border closure continues to fade, the breakup in supply chain and higher transportation cost of both manufactured products and farm produce (due to the restriction of inter-state movements) have further triggered uptrend in YoY inflation. Headline inflation expanded by 12.34% YoY, coming ahead of March level of 12.26%. The expansion emanated from a much faster increase in the core index, which combined with a modest increase in the food index. The core index surged 25bps to 9.98% YoY, following increases in Furnishing (+14bps to 9.64%), Transport (+28bps to 9.78% YoY), Health (+27bps to 10.27% YoY) amongst others. The food index (+5bps to 15.03% YoY) reflected a better picture of the disruptions to manufacturing activities, with processed foods expanding 171bps to 14.7% YoY, with the impact muted by the decline in farm produce by 10bps to 15.07% YoY. Most of the increases in processed foods were attributed to higher prices of bread and cereal, and oil and fats. Relative to same period in the prior year, the food index is 132bps higher than the April 2019 level of 13.70% YoY while the core index increased by 70bps from 9.28% YoY in April 2019.

We see the trend in inflation in the month of May, mirroring similar patterns in April. While the government implemented a gradual reopening of the economy earlier in May, interstate travels is still restricted, resulting in higher prices of essential items. Also, with the impact of the Naira depreciation yet to have a material impact on prices of imported foods and other imported components due to delayed transmission (with MoM change in imported food prices 12-month average of 1.26%), we expect the impact to be more reflective in the month of May and for the rest of the year. All told, we expect the consumer price index to expand by 1.20% MoM, with headline YoY expanding to 12.44% YoY in May. We still allow our model to reflect the likely implementation of the higher electricity tariff in July, coupled with our expectation of persistent Naira volatility, elevated transportation cost due to social distancing policy and higher cost of essential items. All told, we expect average inflation rate for 2020 to settle at 12.8% on our base case.

Figure 5: Forecast 2020 inflation trend

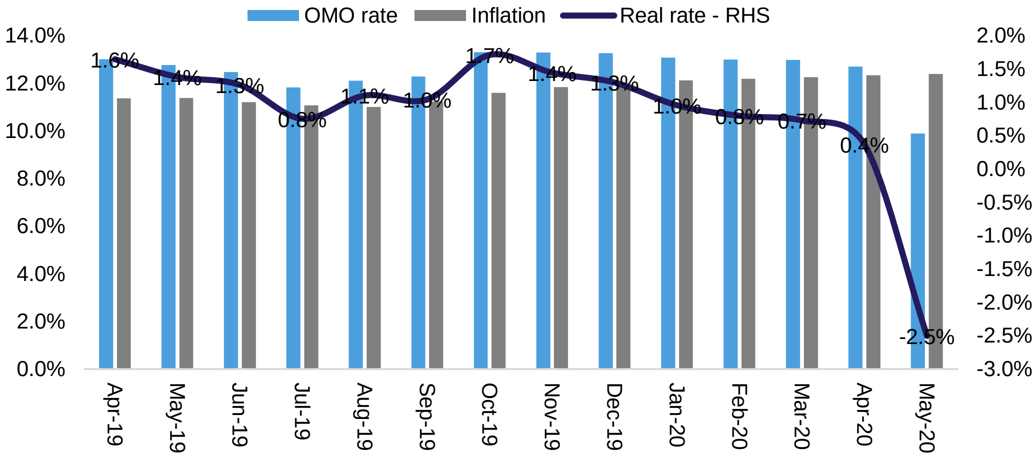


Source: NBS, NOVA Research Estimates

System Liquidity to Moderate Impact of Higher Borrowings and FX Pressure

Post the MPC meeting on May 28, the CBN delivered 281bps decline in the 1-year OMO stop rate to enter single digit at 9.9%. While it came as a surprise just like the cut in the MPR by 100bps, our channel checks revealed moral suasion on the part of the CBN to banks to bid at the lower rate. While the apex bank has refrained from conducting special OMO auction (stabilization securities), we understand the moral suasion to banks to bid at single digit rates, is similar to conducting a stabilization security. Beyond DMBs, as mentioned in the currency commentary, we estimate that ~$1.76 billion from offshore holdings of maturing fixed income securities are yet to be repatriated due to the minimal activity at the IEW in April and May. We believe the maturing offshore holdings which were not repatriated further compounded the already well lubricated liquidity in the system. Total fixed income maturity between April and May summed to N1.74 trillion, while total paper issuance (Treasury bills and Bonds) over the same period totaled N648 billion, compared with subscription and offered amounts of N1.14 trillion and N647 billion respectively.

Figure 6: Trend in Real Rate of Return

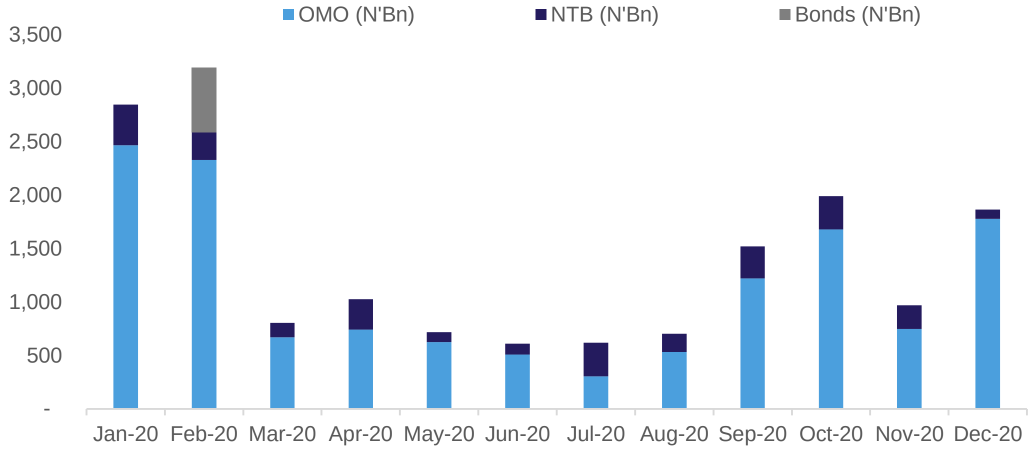


Source: CBN, NBS, NOVA Research

Going into the rest of the year, we believe the exchange rate pressure and higher government borrowings will dictate the trend in fixed income yields and primary market stop rates. However, the bountiful liquidity occasioned by the exclusion of corporates and individuals from OMO will further moderate the uptrend in yields that would have been occasioned by the FX pressure and higher borrowings. Also, delay in the repatriation of maturing offshore holdings of fixed income securities could further compound the liquidity pressure. Beyond maturing fixed income securities, PFAs placements with banks at the end of April totaled N1.52 trillion, which are exposed to ~200bps repricing following the contraction in OMO rates.

For OMO rates, given the delay in the repatriation of matured offshore holdings of fixed income instruments, we see the CBN adopting a soft approach to retain such funds. With the paucity of dollars for repatriation and limited avenue to attract FPI funds (due to the lower inflows to emerging markets), the apex bank might not be aggressive in raising OMO rates from current levels and could be more inclined to lower it further, with a strict directive to banks to either comply or get sterilized at zero. On a fundamental driven basis, the CBN should maintain or raise the OMO rates modestly from current levels, but the liquidity pressure will continue to constrain any upward movement.

Figure 7: Fixed Income Maturity Profile



Source: FMDQ, NOVA Research

For the Nigerian Treasury bills and Bonds, with PFAs and individuals largely dominating that segment with limited alternative and likely lower repricing of term deposits, we see the liquidity pressure further gravitating the stop rates lower. Recent events have showed the DMO/CBN intention to make the segment attractive, especially to foreign investors (as seen at the last two auctions), this could signify a gradual erosion of the large premium between NTB and OMO. With estimated FG paper issuance of N5.1 trillion over 2020 (N3.1 trillion between May and December) and maturing fixed income instruments of N4.2 trillion belonging to corporates and individuals, we see limited upside for NTB and bond stop rates from current levels of 3.1% and 11.2% on average respectively, with a downside risk for bonds closer to OMO current level of 9%.

In summary, we expect CBN to continue to pressure banks to drive OMO stop rates modestly lower, with 1-year stop rate likely to fall lower within the range of 8.5% - 9.5%. Bond rates could fall at the next auction due to demand pressure to 10.8% with a gradual convergence to OMO single digit rates. NTB 1-year stop rate could gravitate between 3% - 4%. Overall, we see average fixed income rates settling in the single digit region in the interim, with real return remaining negative over the rest of the year as inflation spirals.