17 July 2020 **Economic Research**

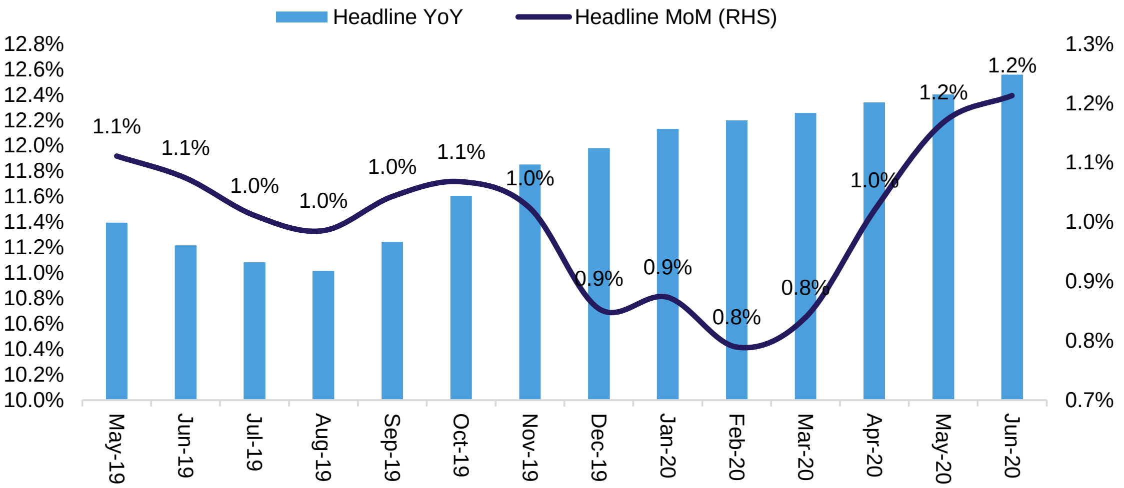
Economic Commentary

Decline in Market Supply Pushed Headline Index Higher

- Headline CPI ticked up by 15bps to 12.56% YoY, highest since April 2018
- Core inflation grew by 1bps to 10.13% YoY, highest since August 2018
- Food price index jumped 13bps to 15.18% YoY

The decline in market supplies occasioned by the restriction of interstate movement resulted in a spike in prices of staple foods and farm produce in the month of June. Accordingly, food inflation expanded month-on-month by 1.46% - the highest MoM increase in about 24 months. Largely, most of the increase in the food index emanated from higher prices of farm produce. For context, while the headline index expanded 5bps to 1.21% MoM in June, the headline index excluding farm produce contracted 2bps to 0.86% MoM and when further adjusted for energy related cost, the headline index fell 4bps in June. Surprisingly, while imported food increased by 2bps to 1.29% MoM, processed food prices contracted during the month. The decline in the core index by 2bps to 0.86% MoM is however surprising given modest increases in most constituents – HWEGF (+2bps to 0.74% MoM), clothing and footwear (+3bps to 0.90% MoM) and furnishings (+3bps to 0.84% MoM) – expanding during the month.

Figure 1: Inflation Trend: YoY and MoM



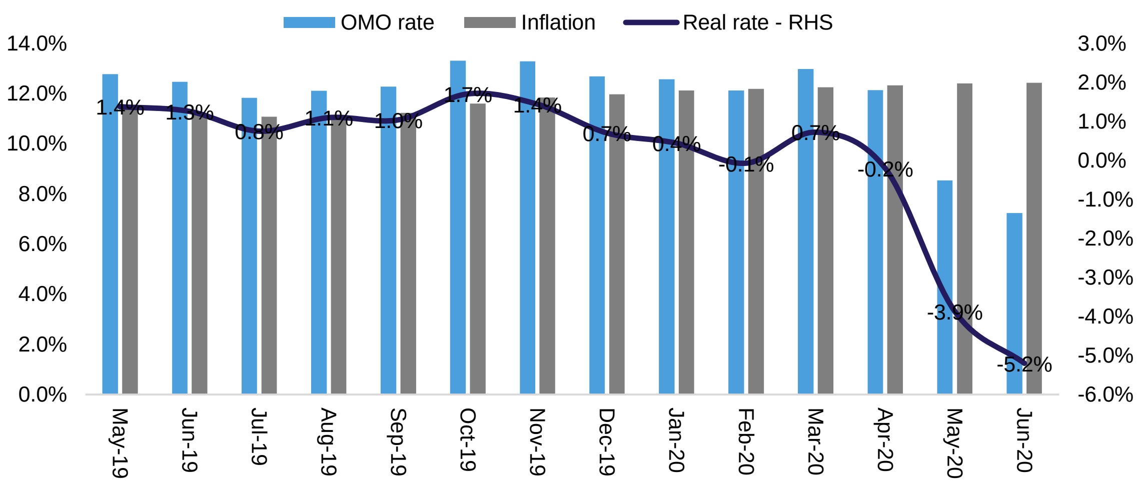
Source: NBS, NOVA Research

Perusing the numbers relative to the same period in the prior year, headline inflation expanded by 12.56%, coming ahead of May level of 12.40% YoY and our estimate of 12.52%. The expansion emanated from a much faster increase in the food index, which outweighed largely flat increase in the core index. The food index surged 13bps to 15.18% YoY, dominated by increases in prices of farm produce and stable prices. Similar to the MoM movements, excluding farm produce, the headline index would have been flat at 10.13% YoY. As mentioned above, the flat movement in the core index at 10.13% YoY negates the increases across constituents. Key components of the core basket expanded, starting with HWEGF (+10bps to 7.86% YoY), Transport (+33bps to

10.41% YoY), Communication (+19bps to 8.62%), Health (+42bps to 11.09% YoY), clothing (+10bps to 10.48% YoY), amongst others.

Dissecting the food basket, farm produce and imported food prices expanded 33bps and 4bps to 15.37% and 16.3% YoY respectively, to more than offset the 207bps decline in processed foods to 13% YoY. To us, the rising food prices is not so surprising. According to FEWSNET, livestock prices have increased by between 20 to 30% during the lockdown relative to the pre-COVID-19 period across most markets. Also, prices of staple foods (including maize, rice, millet, sorghum, and yams) are above the level in 2019 and the five-year average, as prices increased 65% to 120% between January and May. Relative to the same period in the prior year, the food index is 162bps higher than the June 2019 level of 13.56% YoY while the core index increased by 129bps from 8.84% YoY in June 2019. Overlaying the twelve-month average inflation rate on average fixed income yield of 6.52% and the closing rate of the 364-Day NTB at last week's auction of 3.39% translates to a negative real return of 735bps and 850bps respectively.

Figure 2: Trend in Real Rate of Return



Source: NBS, FMDQ, NOVA Research

Over the rest of the year, we believe the pressure on consumer prices will largely reflect the impact of the breakup in supply chains and volatility occasioned by the oscillating PMS price. With oil prices expected to average $41.5/barrel in the second half of the year, we estimate PMS average expected market price of N154/litre on official exchange rate of N361/$. If the unification of the official rate with the NAFEX rate takes practical effect over H2 with exchange rate of ~N387/$ expected market price could increase to N161/litre. While the impact of the border closure is expected to largely fade off in August, recent events have overtaking its impact. The combined effect of Naira depreciation and expected volatility occasioned by the market reflective PMS price will further add to the pressure on the core index over the rest of the year.