Monthly Economic Insights

Gone Deep Enough, Recovery Could Lengthen

Without any doubt, the contraction in GDP in Q2 is the deepest Nigeria has ever seen and more likely the worst we are going to see at least in 2020. Economic events post June relaxation of interstate movements have witnessed improvements albeit still below historical averages. Particularly, the informal sector seems to have gained some mojo with services available at full scale and operators largely pricing in the lost revenues over the period of interruptions. Irrespective, the level of income to participants in that sector has been materially hampered with a transmission to lower consumption and demand over the rest of the year, although an improvement from Q2. Also, while manufacturing activities is still being constrained by limited supply of foreign exchange, manufacturers have dominated alternative foreign exchange markets in a bid to continue operation with the hope of passing the cost to consumers. While the higher cost will have a feedthrough impact on demand due to the lower purchasing power, actual production of goods and services and distribution channels have seen significant improvement since the end of June.

Figure 1: Segments with Positive Outturn in Q2 2020 GDP

Segments	YoY Growth	Composition of Headline GDP
Crop Production	1.44%	21.97%
Livestock	2.26%	1.82%
Forestry	1.08%	0.32%
Fishing	5.68%	0.54%
Coal Mining	10.53%	0.02%
Chemical and Pharm	3.79%	0.25%
Motor Vehicles and Assembly	6.95%	0.05%
Water Supply, sewage, etc	5.71%	0.26%
Telecommunications	18.10%	14.30%
Broadcasting	8.78%	2.50%
Financial Institutions	28.41%	3.60%
Public administration	2.02%	2.36%
Health and Social services	1.89%	0.77%

Source: NBS, NOVA Research

Beyond the dark side of the Q2 GDP, the number presented some positive stories helped by the diversified structure of the economy (this is debatable in some corners and context). Firstly, relative to the quantum of contraction witnessed in other advanced economies which were in excess of 10% despite series of fiscal and monetary stimulus, the Nigeria Q2 numbers presented a much better story. While the comparison might differ due to annualized and direct year-over-year changes, the 5% QoQ, contraction in Nigeria

The Month's Key Points

- Gone Deep Enough, Recovery Could Lengthen
- CBN Planned Resumption of BDC Sales Narrowed Naira Undervaluation
- Consumer Prices to Succumb to Rising Energy Prices

Other Readings

Covid-19 Hurricane Makes Landfall as GDP Contracts 6.1% YoY in Q2 2020, August 24

Increase in Food Prices Delivered Another Jump in Headline Index, August 17

Employment Numbers Hit the Bottom, Unemployment Rate Rose to 27.1%, August 14

Monthly Oil Market Update – August 2020, August 14

Monthly Economic Insights – August 2020, August 11

NOVA Economic Outlook H2 2020 – A Contraction Like Never Before, July 16

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over Q2 compares favourably with 12.1%, 9.5%, 7.8%, 20.4% and 12.0% in EU, US, Japan, UK and Canada respectively. Also, compared with similar emerging market economies (who have published Q2 GDP) with related scale of Covid-19 cases and GDP size in dollar terms, Nigeria still fared better. Malaysia, Indonesia, Israel contracted by 17.1%, 5.3% and 7.8% respectively, with the South African economy forecast to contract 35% YoY in Q2 alone. However, the speed of recovery in Nigeria and the advanced economies is something to look out for. We believe it will be much faster in the latter given the series of support provided for businesses with even less casualty relative to Nigeria. Secondly, 13 industries (See figure 1 above) which account for about 49% of the GDP actually showed resilience, growing on average by 7.43% YoY (above growth threshold of 3%, which approximates Nigeria's annual average population growth in recent years).

As mentioned in our Q2 2020 GDP update (See report: Covid-19 Hurricane Makes Landfall as GDP Contracts 6.1% YoY in Q2 2020), while the headline GDP contraction of 6.1% YoY came in just below our forecast of 6.58%, following much slower rate of contraction in manufacturing, and crude oil, we are however surprised about the level of contraction in construction and trade. We have adjusted our model for the modest surprises in the Q2 numbers and improvement in manufacturing activities following the gradual reopening of the economy. Also, we incorporated expected lower oil production over Q3 due to compensatory cuts to meet up with the OPEC+ production deal, with implied oil production of 1.359mbpd (excluding condensates) in August and September, compared to average of 1.619mbpd (excluding condensates) in Q2. Notwithstanding our optimism, the negative surprises in Q2 more than outweighed the positives, which coupled with expected deeper cuts in oil production and high base in H2 19 (relative to H1 19) necessitated upward revision of our modelled contraction. We now expect Q3 GDP to contract by 4.4% YoY and 3.3% YoY in Q4, with a full year GDP contraction of 3.1% YoY on our base case.

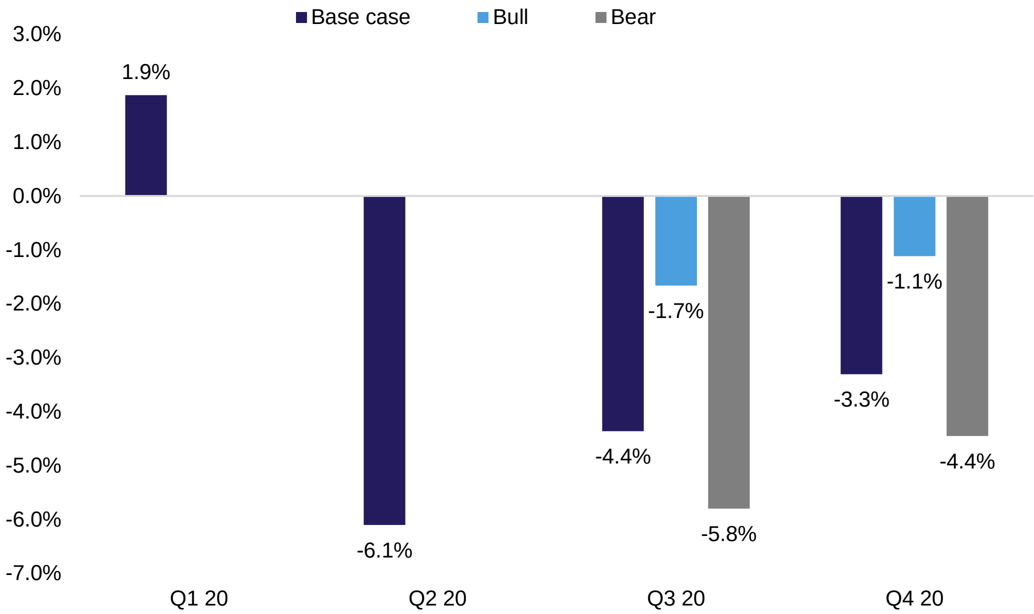
Figure 2: NOVA Research YoY GDP Growth Forecast (Baseline Scenario)

	Q1 19	Q2 19	Q3 19	Q4 19	Q1 20	Q2 20	Q3 20	Q4 20	FY 19	FY 20
Oil GDP										
Old	*-1.5%*	*7.2%*	*6.5%*	*6.4%*	*5.1%*	*-6.6%*	*-9.6%*	*-9.7%*	*4.41%*	*-6.1%*
New	***-1.5%***	***7.2%***	***6.5%***	***6.4%***	***5.1%***	***-6.6%***	***-10.6%***	***-8.5%***	***4.41%***	***-5.4%***
Non-Oil										
Old	*2.5%*	*1.6%*	*1.8%*	*2.3%*	*1.5%*	*-6.1%*	*-3.1%*	*-2.0%*	*2.06%*	*-2.6%*
New	***2.5%***	***1.6%***	***1.8%***	***2.3%***	***1.5%***	***-6.1%***	***-3.7%***	***-2.9%***	***2.06%***	***-2.8%***
Real GDP										
Old	*2.1%*	*2.1%*	*2.3%*	*2.6%*	*1.8%*	*-6.1%*	*-3.7%*	*-2.6%*	*2.30%*	*-2.9%*
New	***2.1%***	***2.1%***	***2.3%***	***2.6%***	***1.9%***	***-6.1%***	***-4.4%***	***-3.3%***	***2.30%***	***-3.1%***

Source: NBS, NOVA Research Estimates

Our most positive scenario assumes that both fiscal and monetary measures will be sufficient to provide a fast reboot to the economy, relaxation of Covid-19 related restrictions by the end of September and limited compliance with the OPEC+ cut with production averaging 1.493mbpd. As such, we expect Q3 GDP to contract by 1.7% YoY and 1.1% YoY in Q4, with a full year output contraction of 1.8% YoY. For the negative scenario, we assume that ongoing fiscal and monetary measures will be insufficient to provide necessary jolt for a fast restart of the economy. In this scenario, we expect a more telling impact of the second-round effects of the economic disruption in the form of massive layoffs in the formal sector, corporate defaults, tightening of financial conditions and weaker capital spending. We expect these effects to culminate into a much deeper Q3 GDP contraction of 5.8% YoY and 4.5% YoY in Q4, with a full year output contraction of 3.7% YoY. Note, a second wave from the resumption of international flights could lengthen the return to growth.

Figure 3: NOVA Research YoY GDP Growth Forecast Scenarios

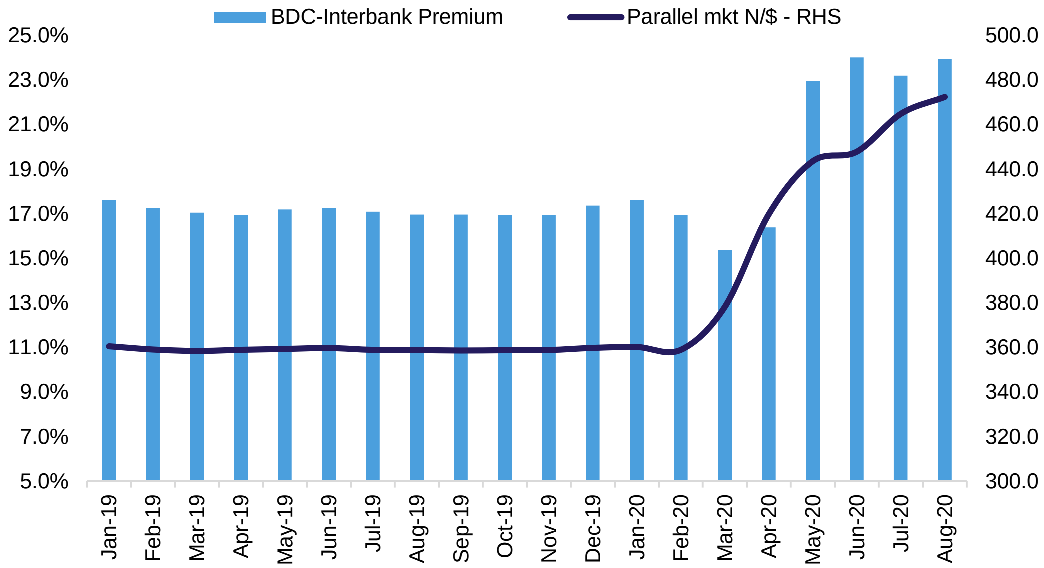


Source: NOVA Research Estimates

CBN Planned Resumption of BDC Sales Narrowed Naira Undervaluation

In the month of August, the apex bank lockdown on FX sales to BDC operators since April resulted in further widening of the BDC-Interbank premium to 24% (from 23.2% at the end of July) with the parallel market exchange rate rising to N472.4/$ (average for August). New demand necessitated by the reopening of the economy amidst rising speculative demand resulted in a rise premium in the month of August. Largely reflecting the extent of speculation in the BDC and Parallel market, following the circular on the 27th of August by the apex bank to resume sales to BDCs starting September 7th, rates at both the BDC and parallel market have appreciated 10.8% and 9.7% to N427.5/$ and N432.5/$ respectively. The sudden appreciation is not so much of a surprise to us, as we stated in our August Monthly Economic Insights that the rates at the parallel market at the end of July was a ~10% undervaluation, based on our fundamental value of the naira of between N427/$ and N430/$. Further to dispel speculation in the market, CBN recently abolished company/agent or third-party "Form M" payment in a bid to discourage over-invoicing.

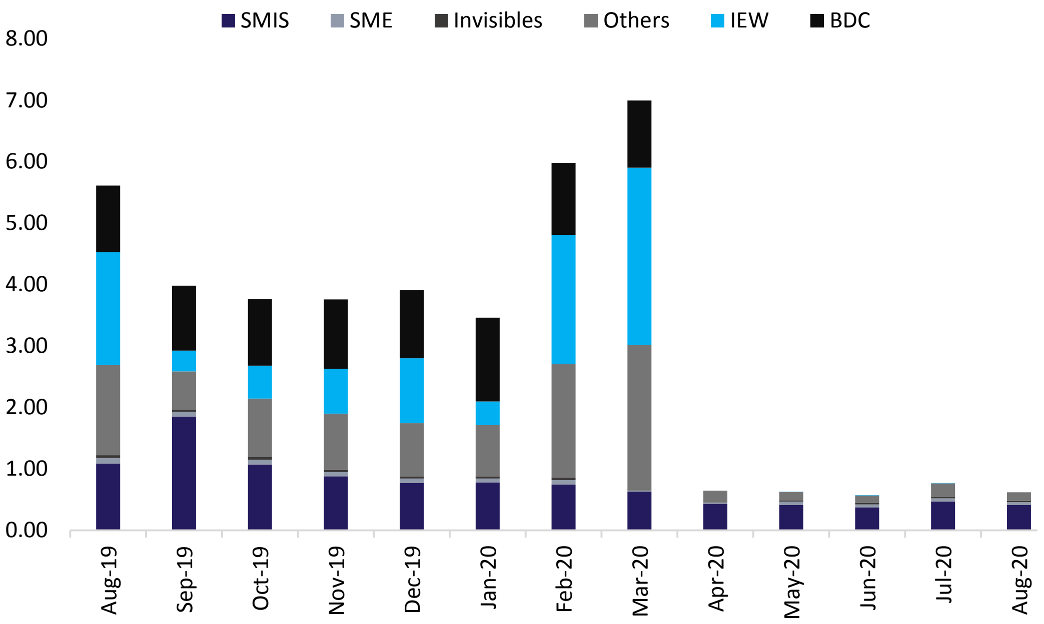
Figure 4: BDC-Interbank Premium and Parallel Market Rate



Source: CBN, FMDQ, Nova Research Estimates

In the month of August, CBN sales to the SMEs, Invisibles and SMIS (retail and wholesale) segments totalled $475 million compared to $547 million in July. Non-auction sales declined to just $143 million compared to $215 million in July, while no sale was recorded for BDCs. Foreign inflows totalled $65 million compared to $117 million in July, dominated largely by foreign direct flows of $36 million. Local supplies (ex-CBN) increased to $364 million (July: $458 million), following higher dollar sales by non-bank financial institutions. DMBs sold a total of $407 million during the month compared to purchases from clients of $440 million. With the sales at the SMIS, SME and other segments compared to the level of inflow, the gross external reserves depleted by $215 million (July depletion $321 million) in the month of August to adjusted level of $35.24 billion.

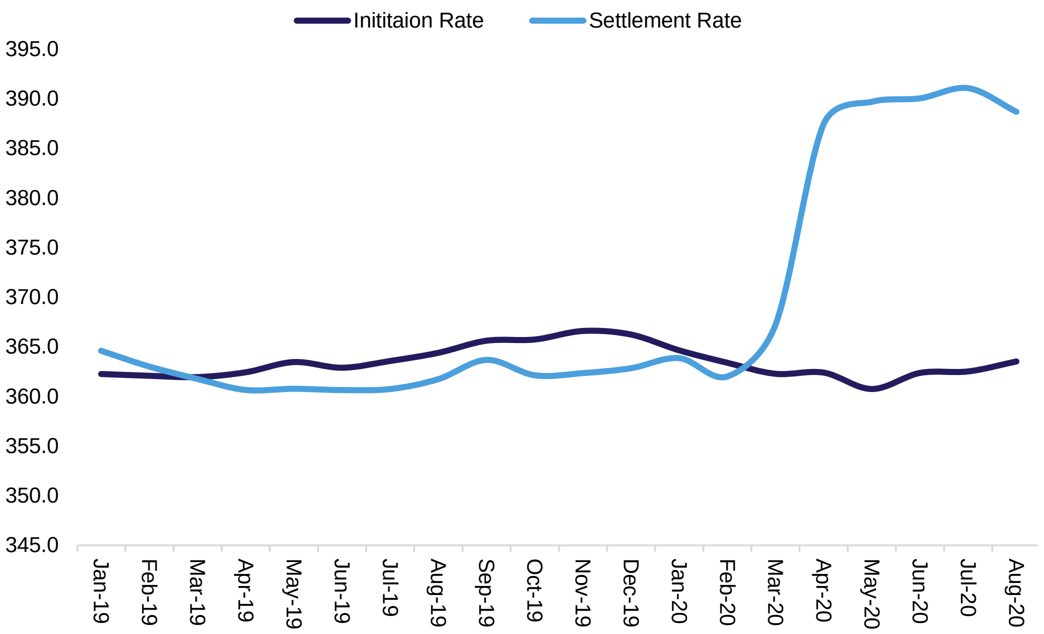
Figure 5: CBN intervention sales across markets



Source: FMDQ, Nova Research

OTC FX futures market activity improved in the month of August, with total value traded increasing to $1.29 billion compared to $860.8 million in July. Futures contract worth $1.58 billion matured on August 29. Compared to the rate at initiation of N363.5/$, the NAFEX rate on the settlement date averaged N388.7/$. Notwithstanding the minimal sales at other segments, the lower inflow from oil and paucity of FPI flows continues to put pressure on the gross external reserves. By our estimate, excluding the one-off inflow of the foreign borrowings and other official receipts, the gross external reserves will currently hover around $31.8 billion despite the absence of sales at the IEW and to BDCs.

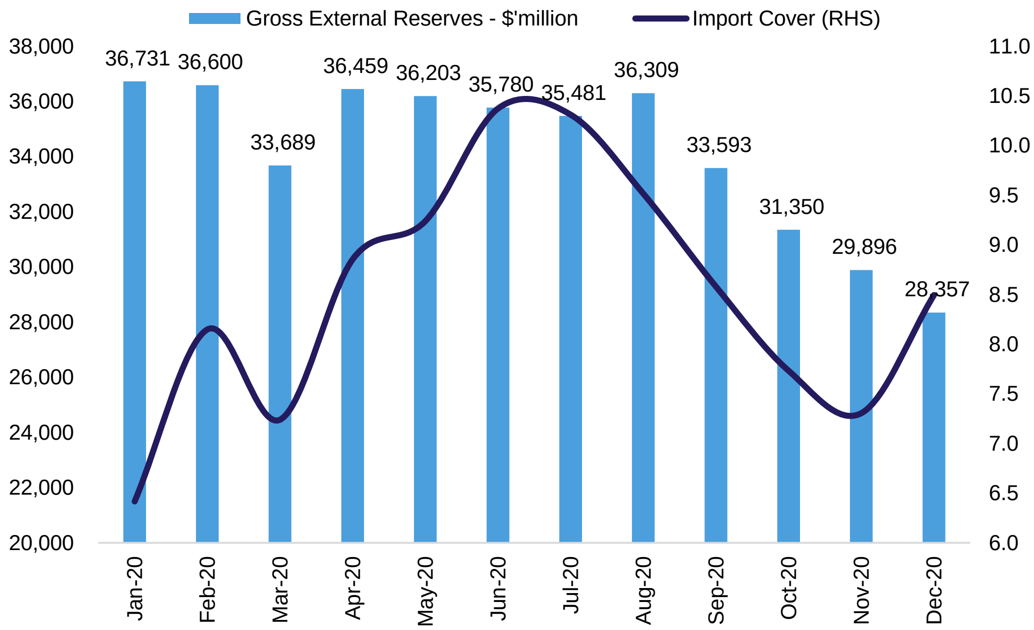
Figure 6: OTC FX Futures Contracts Initiation and Settlement Rate



Source: FMDQ, NOVA Research

As mentioned above, the apex bank is expected to resume sales to BDC operators starting September 7th, with initial sales per market of $10,000 per BDC twice a week. By our estimate, this should result in total monthly sales to BDCs of $295 million (compared to our earlier estimate of average of $550 million monthly). However, we expect a gradual increase month on month as activities pick up, with sales over the next four months totalling $2.1 billion. With the absence of sales at the IEW since April, we believe the portion of offshore holdings of maturing fixed income instruments estimated at $4.51 billion, is yet to be repatriated and could be rolled over to the rest of the year. Assuming 25% repatriation of backlog and maturing offshore holdings between September and December, even with resumption of sales to BDC and imports/services demand, the gross reserve could close the year at $31.0 billion on our best-case scenario. Our base scenario assumes that if 50% of the backlog and maturing offshore holdings are repatriated between September and December, the gross external reserves could end the year at $28.0 billion. Adjusting the reserve position for expected foreign borrowing of $2.11 billion, could result in a corresponding increase in both our base and best case scenarios. As we have always maintained, with limited inflows and reduced avenues to control outflows, unification of rates will have limited impact on the reserves. We believe an outright floating of the exchange rate with intermittent intervention to avoid unnecessary speculative attacks will have more meaningful impact. Based on our purchasing power parity model (PPP), the fundamental value of naira lies between N427/$ and $430/$ (~11% overvaluation from current NAFEX rate of N386/$).

Figure 7: Forecast Gross External Reserves and Import Cover (Base Case)

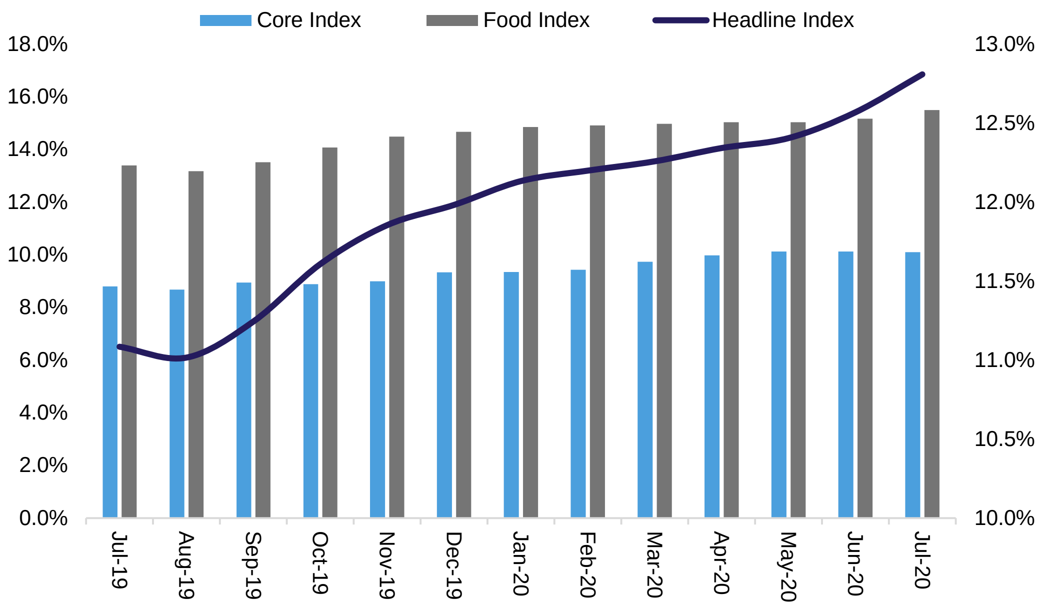


Source: CBN, NOVA Research Estimates

Consumer Prices to Succumb to Rising Energy Prices

The rate of growth in the month-on-month inflation over the last 3 months has been largely dictated by decline in market supplies, rising cost of transportation and FX pass-through to manufactured products. Notably, the increase in prices of diesel and PMS (following rising crude oil prices) are also contributing to upsurge in the prices of food items, especially farm produce. Particularly, average fare paid by commuters for bus journey intercity and within city increased MoM by 4.09% (+17.24% YoY) and 7.62% (+26.41% YoY) to N1,898.14 and N247.46 respectively in July 2020. Beyond the reduction in the maximum number of commuters per vehicle (due to social distancing measures), the higher transportation costs also reflect MoM increase in average prices of diesel and PMS by 0.03% (-0.23% YoY) and 11.44% (-0.97% YoY). Cumulatively, the transportation index rose 1.09% MoM in July and 10.8% YoY (June: 10.42% YoY and 1.04% MoM). While the impact of the higher transportation cost on the core index was muted, we reckon that it largely filtered into higher prices of farm produce, coupled with the shortfall in market supplies. For context, while the headline index expanded 1bps to 1.23% MoM in July, the headline index excluding farm produce contracted 11bps to 0.75% MoM and when further adjusted for energy related cost, the headline index fell 12bps in July (See report: Increase in Food Prices Delivered Another Jump in Headline Index).

Figure 8: YoY Trend in Headline, Core and Food Inflation Trend

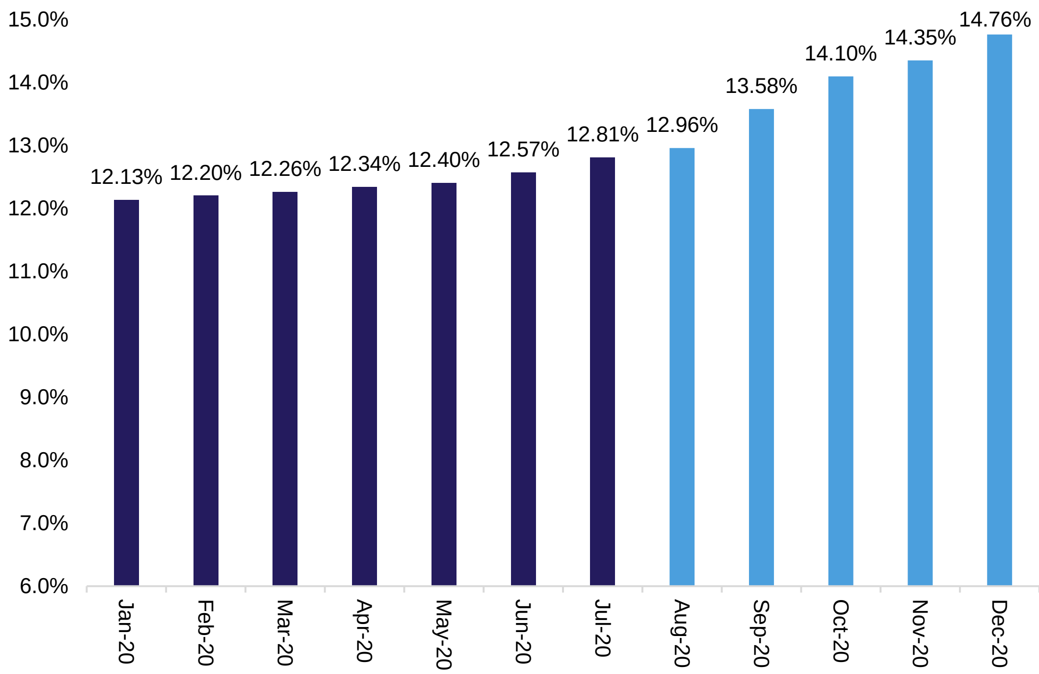


Source: NBS, NOVA Research

With the persisting higher prices of livestock (up 20% to 30% relative to the pre-COVID-19 period across most markets), staple foods (increased 65% to 120% between January and May), rising PMS price (+3.2% MoM) and FX pass-through to manufactured products, we expect inflation in the month of August to deliver same trend as in July. For the month of August, we expect the consumer price index to expand by 1.12% MoM, with headline YoY expanding to 12.96%.

Beyond August, recent upward adjustment in electricity prices and rising PMS/diesel prices due to increasing global crude oil prices will add more pressure to inflationary trend over the next couple of months. On electricity tariff, recall the implementation of the ~58% increase in February 2016 reverberated across industrial and consumer prices. The major shock area was the core index which incorporates Housing Water, Electricity, Gas and Other Fuel (HWEGF). By our estimate, the increase in electricity tariff effective September will result in ~89% increase, compared to ~58% increase in 2016. We see every room for the increase to more than supersede that of 2016 and look forward to the impact on HWEGF in the next couple of months. We see the impact on consumers in two fold, first to prepaid customers whose purchase of new units will automatically reflect the increase, and secondly to post-paid/estimated billing customers who will pay the cost of the energy increase in October. On PMS/Diesel price, compared to average PMS price of N148.2/litre in August, PMS price is expected to increase to N151.6/litre in September with further adjustment over the rest of the year as global oil prices adjust. Interestingly, the upward adjustment to PMS is still below our estimate of N160.8/litre and N165.9/litre using exchange rate of N361/$ and N379/$ respectively and average oil price of $44.5/barrel. The combined impact of increase in electricity tariff, rising diesel/PMS prices and lower than average harvest season will define new levels for inflation in the coming months. Adjusting our model for the above-mentioned pressures, we arrived at a base average inflation rate of 13.04% in 2020, compared to average of 11.41% in 2019.

Figure 9: Actual and Forecast 2020 Inflation Trend



Source: NBS, NOVA Research Estimates