

Sticky Food Prices Limit Headline Inflation Moderation at 16.05% y/y.

Earlier today, the National Bureau of Statistics (NBS) released the Consumer Price Index (CPI) report for the month of July, showing that Nigeria's inflation rate increased by 16.05% y/y, 5 bps lower than the 16.10% recorded in June, marking the sixth successive y/y decline in the headline index. Broadly in line with our forecast, albeit 10 bps ahead of Bloomberg's compiled average estimate of 15.95%, the inflation figure is consistent with the sense that the base effect driven moderation expected at the beginning of the year has waned. Again, the fact that the headline index came above consensus, as has been the trend thus far this year, further corroborates the case that prices remain sticky downward. Good to mention, however, the month-on-month price increase of 1.21%, 37 bps lower than June's 1.58%, is the second consecutive m/m moderation recorded thus far in 2017, and the lowest since January (1.01%).

Figure 1: Headline Inflation and Components (y/y)

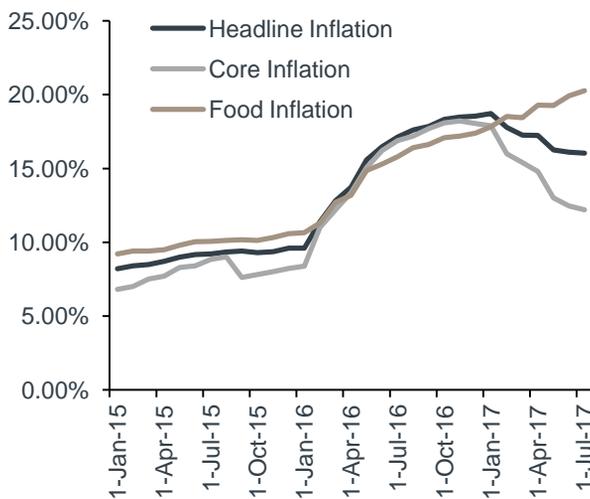
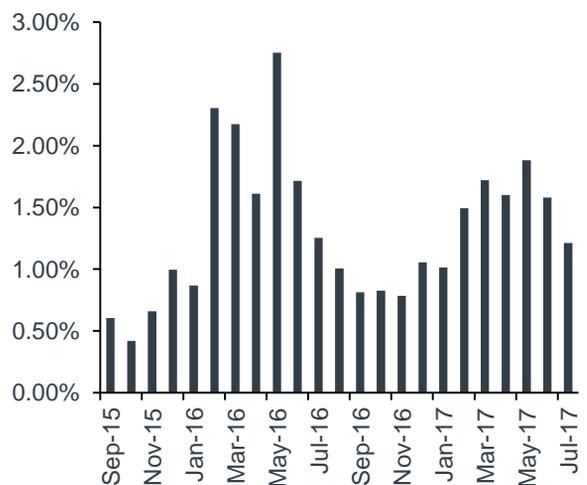


Figure 2: Headline Inflation (m/m trend)



Source: NBS, Cordros Research

On average, from end-2016 level, month-on-month inflation has increased by 1.50%, 22 bps higher than the 1.28% average recorded in the seven months to December 2016. While it may be argued that the persisting inflationary pressure again supports the central bank's Monetary Policy Committee's (MPC) case of holding the line on its policy stance, we think the Committee's subsequent decisions will largely be influenced by its considerations of inflation volatility and expectation, rather than inflation itself. As shown in a recent study by the apex bank, "Modelling Inflation Rate Volatility in Nigeria with Structural Breaks", inflation level in an economy may not really be what matters strictly but inflation volatility, and fiscal policies importantly affect the latter. The study guides that inflation only causes high inflation volatility only in a situation where monetary policy is dominated by fiscal policy and the government deficit cannot be predicted. That partly confirms the MPC's persistent call on the fiscal authority to pursue complementary policies that support fiscal-monetary policy harmony.

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Downplaying the likelihood of a rate hike, despite identified likely risks to banking system liquidity amid anticipated fiscal injections over H2-2017, the MPC clearly noted that additional tightening will widen the income gap, weigh down aggregate consumption, and further constrain credit to the real sector of the economy. Strengthening the case for a rate cut, on the other hand, a critical assessment of the Committee's considerations in its last meeting reveals that, unlike in May – where members expressed uncertainty around key economic activities particularly food production – expectation is for a robust harvest season capable of subduing the rate of price increase on the food component, which is expected to combine with continued moderation in core inflation to ease the pressure on the headline index. That said, we suspect a rate cut is unlikely to be earlier than November when output growth would have comfortably returned to the positive value, inflation rate would have decelerated close to the empirically established 10% - 12.5% threshold for Nigeria, and exchange rate stability would have been relatively consolidated.

Notably, consistent with observed trend this year, all classification of Individual Consumption by Purpose (COICOP) which aggregates the headline index increased during the month under review, with sizable price increases reported in the following major divisions: oil and fats, bread and cereals, meat, coffee, tea and cocoa, vegetables, fish, potatoes, yam and other tubers, and garments and clothing materials and other articles of clothing.

Food Index Pressure Persists

Food inflation increased by 20.28% y/y (vs. 19.91% in June), with the import component declining for the eighth consecutive month to hit a 17-month low of 14.08%. Meanwhile, m/m rate in this segment, at 1.52% (vs. June's 1.99%), continued the moderation it started in June, consistent with the 0.15% m/m drop in the average prices reportedly paid by households across various rural and urban markets and informal arrangements, according to the NBS Selected Food Price Watch for July, driven by notable declines in the prices of egg (-3.14%), bread (-1.90%), chicken (-1.30%), gari (-1.15%), and rice (-1.10%). Year-to-date, the food index has increased by 14.4%, compared to 11.6% same period last year.

Core Inflation Sustains Slower Rate of Increase

Core inflation increased at a slower pace for the eight consecutive month, rising by 12.20% in July, versus 12.50% in June, with the highest increases reported in clothing materials and articles of clothing, furniture and furnishing, books and stationary, medical services, glassware, tableware & household utensils, accommodation services and household textiles. On a m/m basis, prices rose at a slower rate in this segment at 1.00% (1.32% the previous month), benefitting from reported decreases of 0.3%, 2.36%, and 6.08% in average national prices of premium motor spirit, kerosene, and diesel to N145.9/litre, N280.49/litre, and N197.62/litre respectively.

Food Prices Remain Fundamental to Headline Inflation

Clearly, the direction of headline inflation for the rest of the year will be largely driven by food prices. Save for potential risk of negative surprises, specifically with regards foreign exchange, and the possible increase in electricity tariff, we expect continued moderation in the core component.

Drilling down events vis-à-vis food prices, results being reported in most areas vis-à-vis the dry season harvest are generally favourable. The raining season has commenced with near-normal timing and cumulative rainfall across most of the country, in line with earlier guidance for the rainy season through September/October for average to above-average cumulative precipitation. In its latest report, FEWS NET

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revealed that outside of the northeast, staple harvests that begin as late as October in northern areas are likely to be more robust than last year's, due to increased access to inputs as well as strong production incentives for farmers due to very high staple food prices, in addition to increased government funding and support. Granted, incidence of flooding has been reported in most parts of the country but not primarily on the back of unusually heavy downpour. More so, affected areas were largely residential not farmlands.

That said, for the rest of 2017, we maintain our position that except monthly inflation rate stays below the 1.5% average recorded since the beginning of the year, the likelihood of the headline index reaching 20% by December cannot be ruled out. To be specific, we forecast the headline inflation rate in 2017 to average 16.10% (bull case) or 17.73% (bear case).

Meanwhile, we look for the CPI recording a marginal decline to 16.03% y/y and 1.00% m/m in August.

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