

May 2018 Inflation Report - The Bottom is Near

June 14, 2018



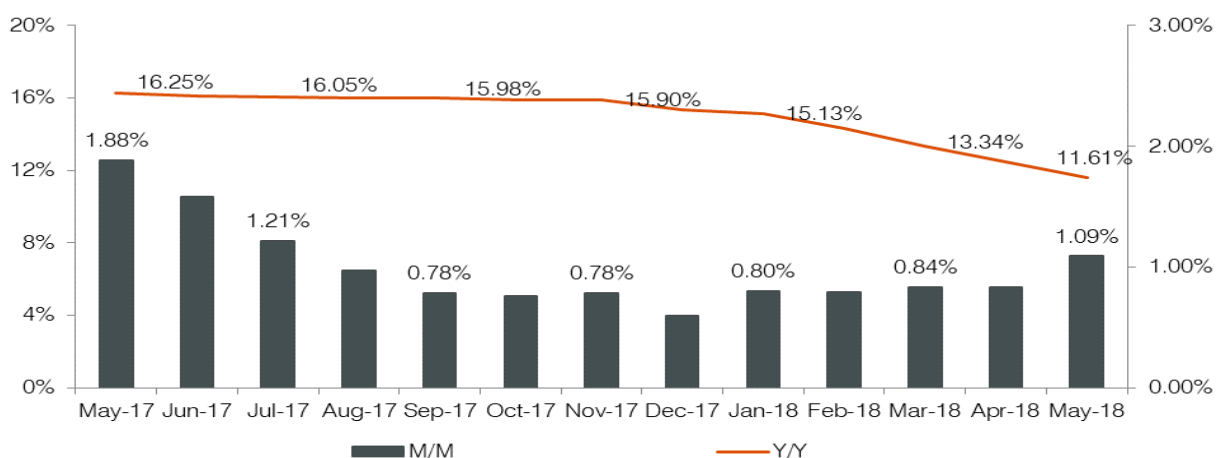
INVESTMENT ONE

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Yesterday, the Nigerian Bureau of Statistics released the Inflation Report for May 2018, which showed a further moderation in headline inflation to 11.61% year-on-year (y/y), slightly higher than our forecast (11.36%) and below the FG's benchmark target rate of 12.42% in the 2018 Budget of Consolidation.

The inflation figure for May was the lowest y/y increase in consumer prices in 27 months.

Headline Inflation Performance



Source: NBS, Investment One Financial Services Research.

We highlight that the reduction in headline inflation was mainly on the back of high base effect of H1 2017. This was more prominent on the Food Sub-Index (down 135bps to 3.45% y/y in May 2018), which has seen support from Federal Government's (FG) incentives to grow the Agricultural sector and stability in the Foreign Exchange (FX) markets.

We believe the significant drop in Food-Sub Index may not be unconnected with the high base effect of 2017, which may be prominent till the end of August 2018. Similarly, the slowdown in increase of food prices may have been supported by FG's incentives to improve the agricultural sector in a bid to diversify its revenues. This, as well as a relatively stable FX market compared to this time last year, may be partly responsible for the moderation in the rise of food prices. Moreover, the agricultural sector may have seen support from early rainfall as highlighted by the President of Cocoa Association of Nigeria, which should bode well for agricultural output in the near to medium term.

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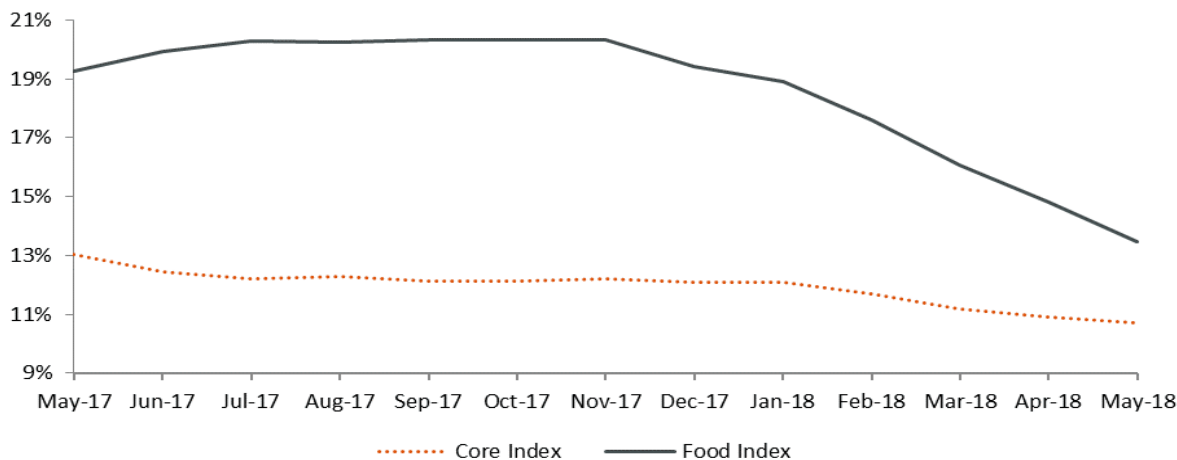
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Core and Food Sub-index Performance



Source: NBS, Investment One Research

Excess PMS Supply Supports Slowdown in Core-Sub Index

The Core-Sub Index moderated, albeit at a slower pace, by 22bps from April 2018, hitting its 29-month low at 10.70% y/y in May 2018.

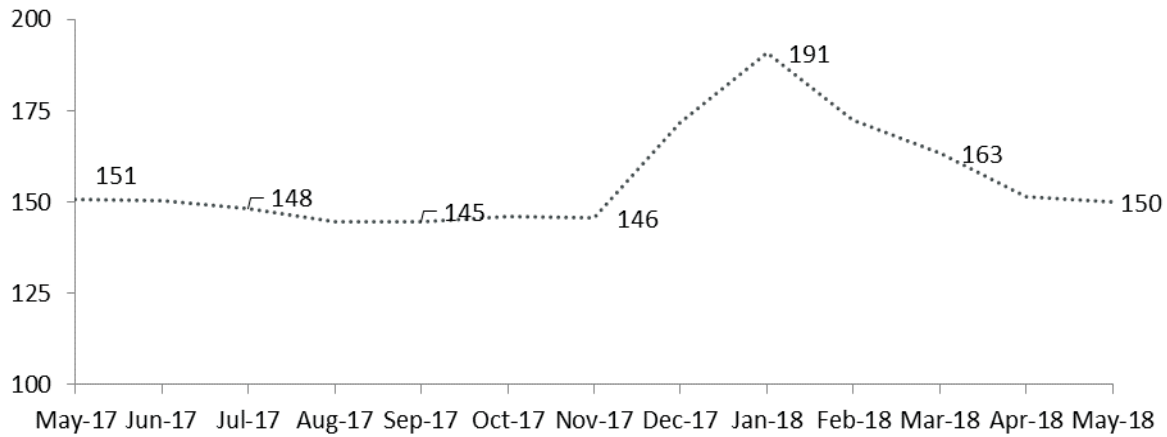
The slight reduction in Core-Sub Index y/y may have seen support from the slowdown in the increase of 'housing water, electricity, gas and other fuel' prices by 17bps to 7.04% y/y in May 2018.

In addition to this, the rise in the transport index slowed down to 11.25% y/y in May 2018 from 11.61% y/y in April 2018, which may have been indicative of a moderation in transport costs. This may have also contributed to the slower rise in inflation rate (y/y).

Furthermore, we highlight the 0.3% decrease in the average price paid by consumers for PMS in May 2018 from 1% increase in April 2018, as the FG had earlier announced the excess inventories of imported PMS, which had eroded the supply deficit that plagued the nation from last year, into early 2018. Petroleum Products Imports data from the NBS showed that 5.67billion litres of PMS was imported in Q1 2018, with the month of March recording the highest volumes pf PMS imported into the country at 4.41billion litres. That said, the average price of PMS decreased to NGN150.2 in May 2018, from NGN151.4 in April 2018.

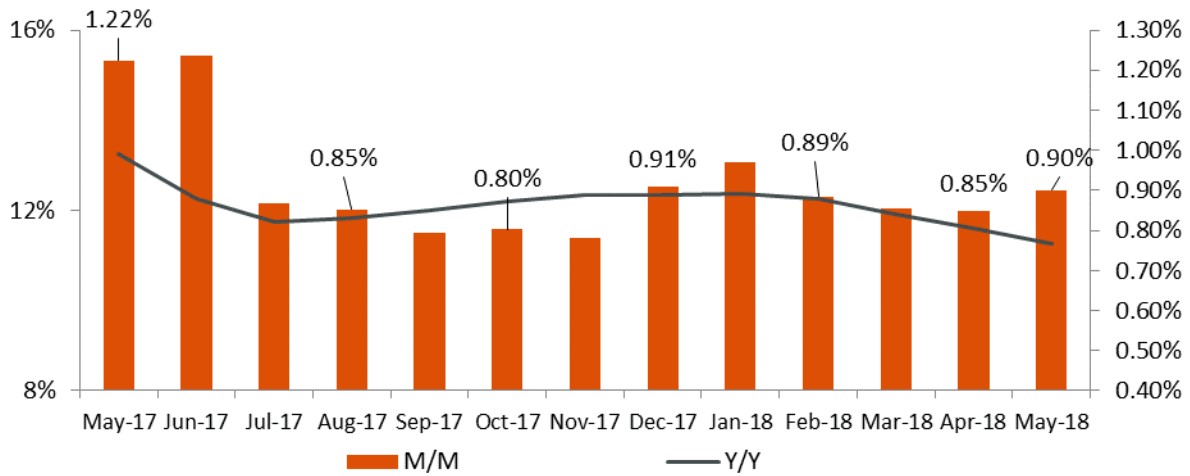


Average PMS Price Paid by Consumers



Source: NBS, Investment One Research

Transportation Sub-index Performance



Source: NBS, Investment One Research

However, imported food inflation remains sticky at 16.06% y/y, despite a stable foreign exchange rate. However, we have to highlight the global rising costs of inputs such as sorghum (+50.8% YTD), maize (+8.9% YTD) and cocoa (+26.9% YTD), which could have fed into the increased imported inflation m/m numbers, which came in at 1.22% m/m in May 2018, from 1.16% in April 2018.



High Base Effect Starting to Wither

However, contrary to the decreases recorded in the y/y numbers, we highlight the apparent increase in inflationary pressures as the Core sub index surged to 0.98% m/m in May 2018 vs 0.87% m/m in April in 2018 coupled with the change in the m/m increase in Food prices (1.33% m/m in May 2018, the highest m/m increase recorded since June 2017) was not as supportive of the slow increase in consumer prices in May 2018. The m/m surge in food prices were attributable to crops such as Potatoes, yam, cereals, meat etc. Most of which are obtained from the North Central region of the which has been subjected to attacks by herdsmen which could have affected output. Also, we highlight the impact of the Ramadan season on food prices, which tend to naturally spike during the period as Muslim Nigerians tend to rack up food supplies in their households. The core sub index saw increased m/m pressures in the 'housing water, electricity, gas and other fuel' prices which were up 11bps in May 2018 to 0.73%.



Implications

In our view, the moderation in the increase of consumer prices may be a positive for consumer sentiment, corporate performances and economic activities.

It could also increase the scope for the Monetary Policy Committee to cut its benchmark interest rate from 14% at the meeting next month (23rd – 24th July 2018). However, we highlight that if the CBN do not cut rates at the next meeting, chances of cutting rates grow slimmer towards the end of the year, as we saw the US Fed hike rates yesterday and also signal two more 2018 Set against this backdrop, the MPC would have little to leverage upon in cutting rates after July 2018.

However, given the recent increase in demand pressures on the Naira from travelers and pilgrims we saw the Central Bank of Nigeria (CBN) maintain its aggressive stance in tightening system liquidity to defend the local currency, going even further to bridge the gap between the multiple foreign exchange windows, by forcing BDCs to acquire USD20,000 thrice a month, at a rate of NGN357/USD.

The bullish sentiment in the secondary fixed income market and the apparent improvement in system liquidity (as both the OBB and Overnight rates remain heavily subdued) contributed to the yield on the one year Treasury bill moderating and showing signs of stability at 13% levels in recent auctions, from 14%-15% levels at the start of the year.

The CBN released the Q3 2018 calendar for NTB issuance which shows planned government borrowings at NGN1.1trillion set against maturities of the same amount with no redemptions. In simple terms, the FG borrowing is simply rolling over what is maturing which implies that on a net basis no fresh borrowings.

As such, we could see the Monetary Policy Rate reduced by 100bps to 13% at the end of the meeting next month as CBN attempts to loosen its tight monetary stance on the back of very much improved macroeconomic conditions.



Outlook

We maintain our view that the rate of increase in consumer prices in 2018 is likely to slow on the back of the high base effect, which may be more pronounced in the Food sub-index.

As such, we could see a more moderate fall in headline inflation in June 2018, towards 10.91%. The blunt decline could be driven by the moderate increase in the CPI in June 2017 (+1.58% m/m).

With the average price paid by consumers for PMS falling by about 0.8% m/m, to NGN150.02/litre in May 2018 from NGN151.4/litre, we opine that the decrease in price (-0.3% y/y in May 2018) poses an upside risk to the reduction in costs of transportation in June 2018.

Despite the stability in the local currency, which should be supportive of imported inflation, the continued unrest in the North, which contributed to the slowdown in activities in the Agriculture sector in 2017, remains a challenge as we have seen in the slowdown in growth recorded in Q1 2018 Agricultural sector GDP numbers (3.00% y/y in Q1 2018 vs 4.23% y/y in Q4 2017). This, as well as the lingering herdsmen attacks in different parts of the country, could pressure the Food sub-index in the near term.

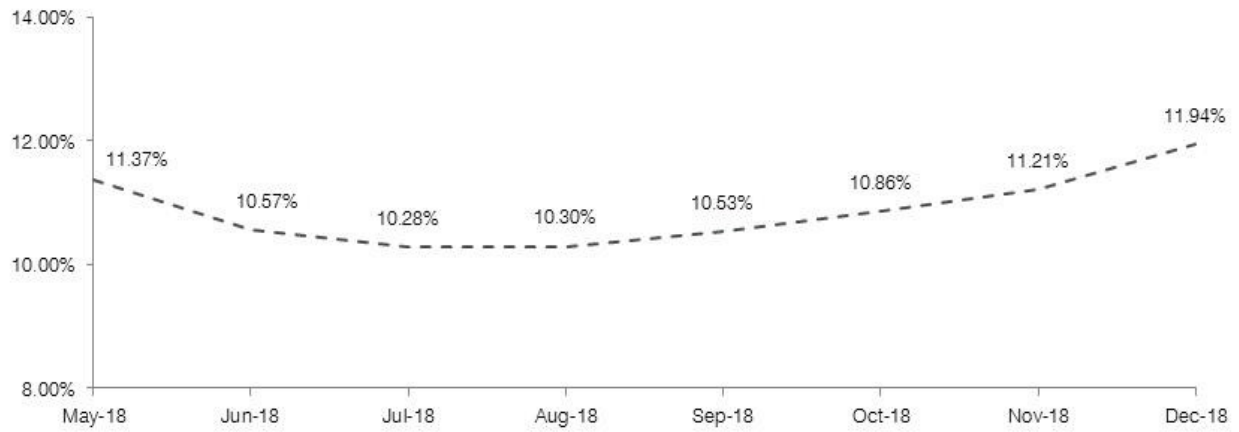
With this said, a resurgence of the scarcity of PMS and weak output in the Agricultural sector pose a downside risk to our forecast.

Furthermore, we highlight that the potential rise in minimum wage from N18,000 to N56,000 in Q3 2018, election spending and the passage of the 2018 budget in the near term could put inflationary pressure on the economy in H2 2018.

Nonetheless, our inflation projection for end of the year projection of 11.94%. Our end of the year estimate is in line with Central Bank of Nigeria's and Federal Government's targets of 11-12% while our projection is still well above the CBN's long term target range of 6-9%.



Inflation Outlook



Source: NBS, Investment One Research



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