

Hike in MPR Anticipated, but Disappointing GDP Data may Restrain MPC.

Monetary Policy

At a time of fascinating developments in the domestic and external economy, the Monetary Policy Committee (MPC) is expected to hold its third meeting of the year on the 24th and 25th of May 2021. In the domestic economy, inflationary pressures cooled down in April despite lingering supply-side challenges. On the external front, risks to global economic growth remain roughly balanced despite emerging bumps that could undermine reflation trade and the commodity supercycle. For us, the timing of this meeting could not have been better given that the Q1-21 GDP report, which in our view will form an essential basis for the Committee's decision, will be released on 24th May. Considering past guidance from the Committee that its short-term objective is to support economic recovery, we believe the GDP report will enable the Committee to determine whether it should tweak policy tools to address the core mandate of price and exchange rate stability. In the event of a positive surprise (vs our expectation of 0.94% y/y), we see a strong possibility that most members will vote for a 50bps hike in the MPR. On the other hand, we think a tepid growth outturn will make the Committee hold off on interest rate hike at this meeting to enable economic growth to gain a foothold. Notwithstanding, we expect the underlying tone of the Committee to be hawkish given the still elevated domestic inflationary pressures and imbalances in the external sector.

Domestic Economy Averts a W-Shaped Traverse

Activities in the domestic economy started the year on a dull note given the resurgence in COVID-19 infection rates across the country, albeit it was in line with the second wave seen across the world. Since then, economic activities have improved albeit slowly, following (1) the continued reopening of the economy amidst the citizens' adaptation to changes brought by the pandemic, (2) optimism surrounding the administration of COVID-19 vaccines and (3) reeling impact of government support, particularly to the agricultural sector. Indeed, the manufacturing PMI improved by 3.8 points to 48.7 points in February (January: 44.9 points) while the non-manufacturing PMI jumped by 5.4 points to 48.7 points during the same period. Given that there was no major shock to the economy in March, we imagine that the manufacturing and non-manufacturing PMI would

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have increased above the 50-points benchmark. Besides, listed manufacturing companies' financial performance for Q1-21 showed improvement when compared with Q1-20, suggesting that the manufacturing sector might have exited three consecutive quarters of decline due to recovery in consumer demand amidst increased production runs.

Similarly, data from the OPEC's Monthly Oil Market Review (MOMR) showed that Nigeria's crude oil production volume (excluding condensates) increased by 0.5% m/m to 1.48mb/d in March (February: 1.47mb/d) in line with OPEC+ agreement to ease production cuts. **Overall, we forecast a GDP growth rate of 0.94% y/y in Q1-21 (Q4-20: +0.11% y/y) driven mainly by the non-oil sector. Accordingly, we believe sustained expansion in economic activities would bring comfort to the Committee that the economy has consolidated on the tepid recovery in Q4-20 (0.11% y/y), averting a W-shaped recovery.**

Figure 1: Trend in Manufacturing & Non-Manufacturing PMI

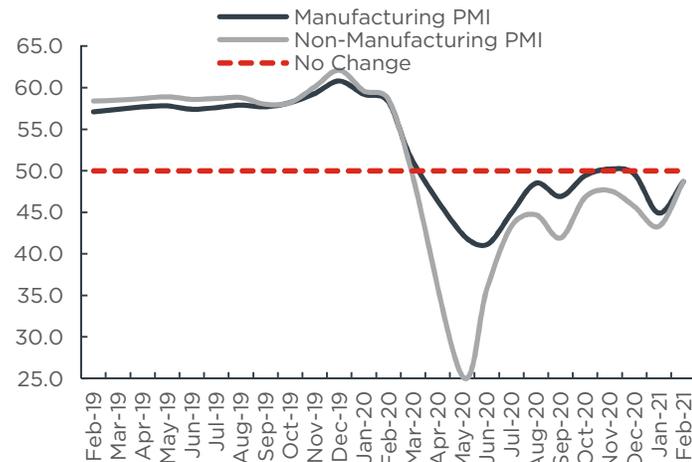
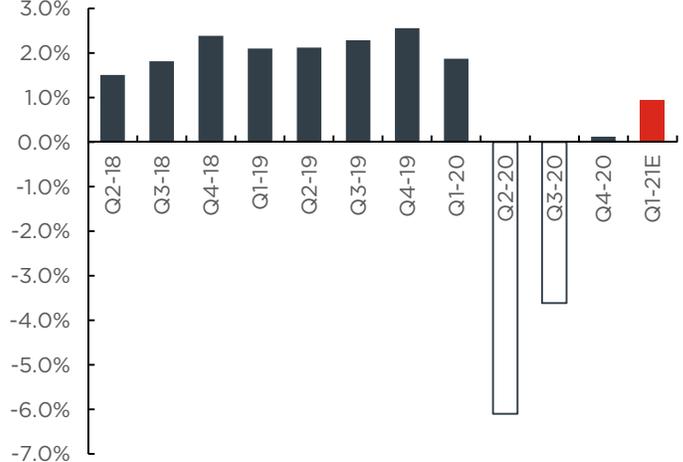


Figure 2: Trend in GDP Growth YoY



Source: CBN, NBS, Cordros Research

Inflation Risks Remain Elevated

Contrary to market expectations, domestic prices experienced disinflation for the first time since August 2019, when the FGN ordered the closure of the land borders. Pertinently, the headline inflation moderated by 5bps to 18.12% y/y in April, primarily driven by the slower rise in food prices (0.99% m/m vs March: 1.90% m/m) amidst a third consecutive month of decline in the core inflation (0.99% m/m vs March: 1.06% m/m). **The moderation in inflation in April is likely to spark a debate on whether it is transitory or a trend that will persist in the coming months. Our view is that the magnitude of the decline is too marginal to bring comfort to the Committee that the economy is beginning to experience disinflation.** In addition, the headline inflation is still materially above the upper band of the CBN's medium-term target of 6.00%-9.00%. Moreover, we believe members will be wary of the following risks that could potentially worsen inflationary pressures: (1) Repercussions of the persistent security challenges on the harvest season, (2) the growing prospect of the

removal of fuel subsidy and (3) possibility of an upward adjustment in electricity tariffs. Against this backdrop, we believe the Committee will feel the need to tighten monetary policy to nullify the indirect channels through which system liquidity amplifies inflationary pressures.

Figure 3: Trend in MPR and Inflation Rate

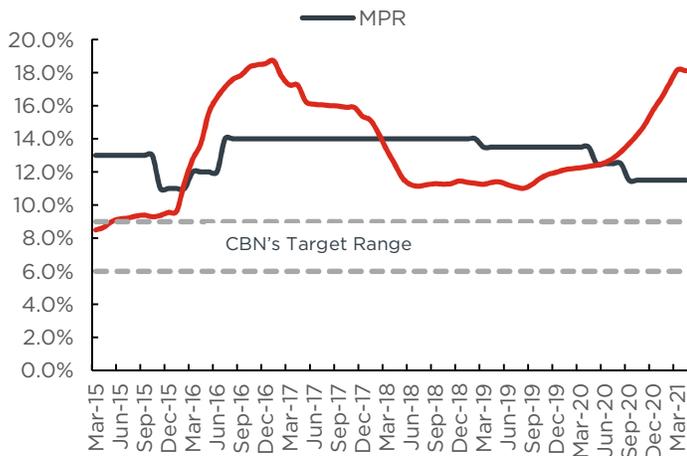
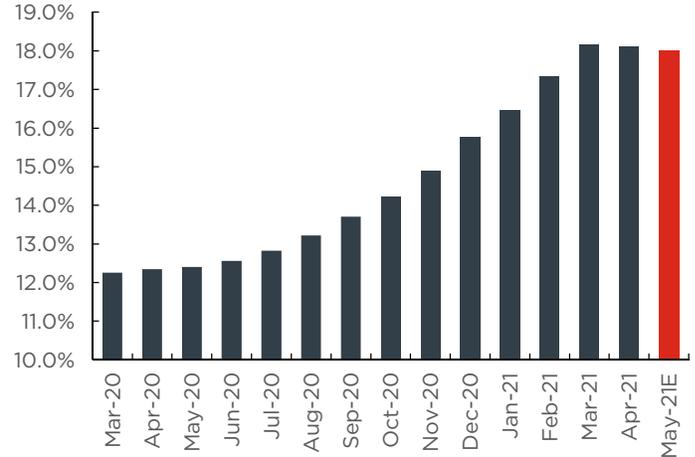


Figure 4: Headline Inflation – Historical and Forecast (y/y)



Source: NBS, Cordros Research

Reflation Trade Hangs on a Balance between Vaccination Efforts and Early Withdrawal of Loose Monetary Policy

While sustained vaccination efforts and reopening of economies have kept hopes of reflation trade intact, accelerating inflation in the U.S has prompted fears that the Fed might tighten monetary policy earlier than expected if prices continue rising. However, we note that the Fed has tried to allayed market concerns, noting that monetary policy will remain broadly accommodative until it sees "substantial progress" consistent with its full employment and price stability goals. Our view aligns with Fed officials given the idiosyncratic factors: (1) pent-up consumer demand arising from the reopening of the economy and fiscal stimulus, (2) shortage of chips affecting the price of used vehicles and, (3) high gasoline prices driving inflationary pressures. Consequently, we believe the Committee will have little worries about the possibility of capital flow reversals that will amplify exchange rate pressures at this meeting. Since the last meeting in March, oil prices have strengthened further, with Brent price rising by 1.9% to USD66.66/bbl. as of 19th May 2021 (March average: USD65.41/bbl.). Although surging cases of infection in India (the world's third-largest oil importer) have undermined hopes of a strong rebound in global demand for crude, this has been partly offset by a string of supply-side factors amidst optimism on the efficacy of COVID-19 vaccines. Key supply-side factors that have supported the oil market include (1) OPEC+ production cuts, (2) Saudi Arabia's decision to maintain its voluntary cut output of 1.0 mb/d, (3) Fuel supply shortages in the U.S following the Colonial Pipeline cyberattack. It is pertinent to highlight that supply is likely to increase, particularly if U.S and Iran reach a truce on the U.S.'s return to the Joint

Comprehensive Plan of Action on the Iranian nuclear program. We understand that talks are currently in progress, though a breakthrough is yet to be reached.

Notwithstanding, we think the global oil market will remain roughly balanced as demand continues to recover and OPEC+ retains its resolve to support the market. With an improving economic outlook for some of the world's biggest economies, we believe the Committee will express a more positive view on the overall health of the global economy compared to its March meeting. Accordingly, members will feel that commodity prices will continue to benefit from the cyclical upswing in economic activities, a development that bodes well for the FX reserves. We note that the gross FX reserve has decreased by USD195.50 million (-0.6%) since the last policy meeting to USD34.40 billion as of 18th May 2021. The decline in the FX reserves is tied to the increase in FX sales to FPIs and manufacturers to meet the growing demand for goods given the reopening of the economy. **That said, we remain optimistic that the (1) developments in the crude oil market and (2) expected Eurobond issuance would drive accretion to the FX reserves in the near term.**

Figure 5: FX Reserves (USD bn) & Exchange Rates (USD/NGN)

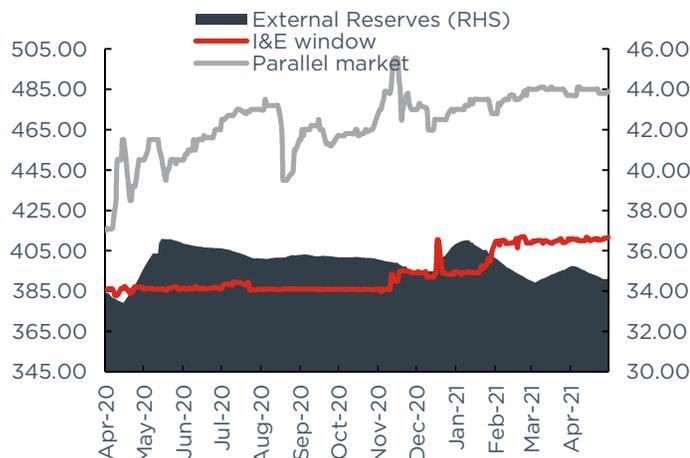
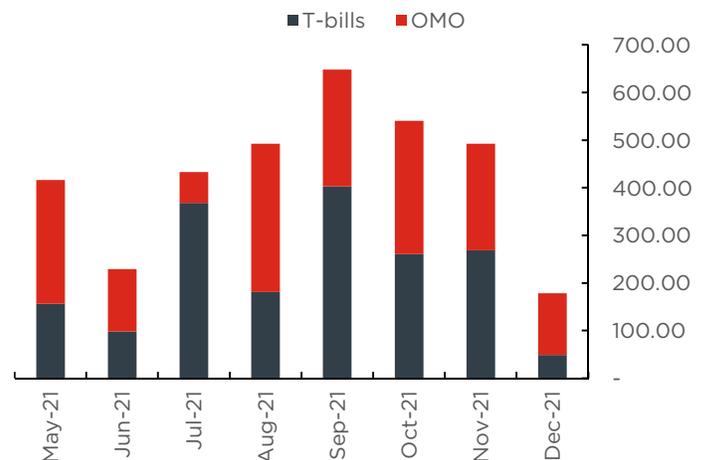


Figure 6: Maturity Profile (NGN billion)



Source: CBN, Cordros Research

Another Divergence in Voting Pattern, but the Hawks will come out Top

Like the March meeting where there was deviation in the voting pattern among members of the Committee, we anticipate there would be a similar outcome at this meeting. We believe the majority of the Committee will view that the MPC needs to align the MPR with prevailing rates in the market and focus on its primary mandate of price stability. **Our baseline expectation is that most members will vote for a 50bps hike in MPR. However, we do not rule out the possibility of a 100bps hike, particularly if the Q1-21 GDP numbers surprise positively.** We expect the underlying tone of the Committee to be hawkish given the still elevated domestic inflationary pressures and imbalances in the external sector. Overall, we expect the Committee will hike MPR by 50bps while keeping other monetary policy parameters unchanged.

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