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FAB Macro Strategy

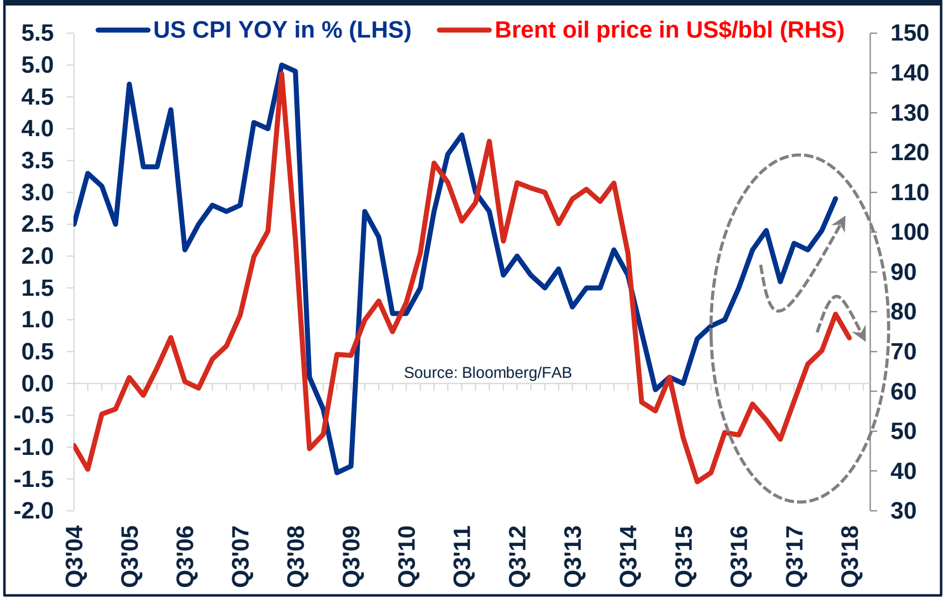
Exploring the correlation between oil and inflation

It makes sense that the direction of the price of oil has historically been viewed as correlated to underlying macroeconomic conditions. While it is all a question of relativity, generally speaking we could argue that a higher oil price would normally be associated with periods of economic expansion (for oil exporting economies) and vice-versa. We would suggest that oil price gyrations have symmetric effects on the economy.

Economic expansion should result in industrial productivity improvements and increased consumer demand. The implied resultant shift to the right of the aggregate demand curve in economic theory (with the short-term aggregate supply curve steady), should fuel asset price appreciation over time, in turn buoying commodity prices, including oil.

Therefore, by extension, given that improving economic growth metrics should tend to fuel inflationary pressures, so it can be shown that the oil price and inflation are intrinsically linked. Indeed, analysis of U.S. inflation data and the oil price over the past 13 years shows visible positive correlation.

US Inflation vs Brent Oil price



However, this positive correlation has weakened and turned negative over the past couple of months. We would conjecture that the breakdown in correlation between the two data series over the past month should be seen as a warning sign; either of a near-term reversal in economic growth optimism or renewed upside in the oil price. Both scenarios carry ramifications for MENA/GCC markets.

As per the above chart, with inflationary pressures remaining to the upside after years of loose central bank monetary policy and quantitative easing, the oil price has weakened with Brent crude dipping from a 2018 high of $79.80bbl in late May to around $73.50 currently. Arguably this divergence has been driven by independent, external, non-economic factors, with the question now being whether these will prove transitory or become more embedded.

For the time being, even as central banks begin the process of balance sheet normalization and the tightening of monetary policy from emergency levels of interest rates, inflationary pressure is being maintained by the residual effects of the prior years of financial repression. Moreover, the central banks' commitment to withdraw accommodation only at a 'measured' pace should also prove net accretive to near-term inflationary pressure, as they target their 'at or near to 2%' price growth target level.

Oil price volatility has been somewhat pronounced in recent months, driven primarily by the vagaries of OPEC/NOPEC's crude production quotas as well as certain geopolitical events. While production limits definitely contributed in helping to lift oil off the sub-$40bbl lows of late 2015 and early 2016, the recent relaxation – and varied market interpretations – of these quotas has now begun to weigh on prices somewhat.

Thus while we remain constructive in our longer term outlook for the price of the black stuff, we believe that the market for Brent has now probably established itself within a $60-$80bbl range for the time being. The anticipation of renewed sanctions on Iran over the coming months and reduced Venezuelan supply should continue to help support prices, whilst at the same time rising US shale production combined with some easing of the OPEC/NOPEC output limits should prevent a significant upside shift again, at least in the near term. (If you would like to read our more detailed outlook on the oil market please refer to my colleague Glenn Wepener's recent piece entitled; "Push & Pull").

Therefore, the 'truth' in the latest optical divergence between oil and inflation should probably lie somewhere in between the two on our chart. As suggested above, near-term upside in the oil price may be limited, and we expect (U.S.) inflationary pressures to ease as the Fed ratchets rates higher over the coming months.

The Fed presented an upbeat outlook for the U.S. economy in the latest policy statement from the FOMC and although the Fed Funds rate was left on hold this month, the Fed has effectively set itself up perfectly to raise rates (again) in September. The question then will be whether the Bank chooses to hike again by a further 25bps in December, followed by 1-2 additional interest rate increases next year.

With the ECB also in tapering/normalization mode and with the Bank of England having tightened monetary policy on August 2 for only the second time since 2007 (after the 25bp hike executed in December last year), we would anticipate a general dampening effect on inflation expectations as we head toward 2019 and a convergence bias with oil price movements.

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