

Macro Keys

The imminent inflation increase

Economics & Macro Strategy

Global

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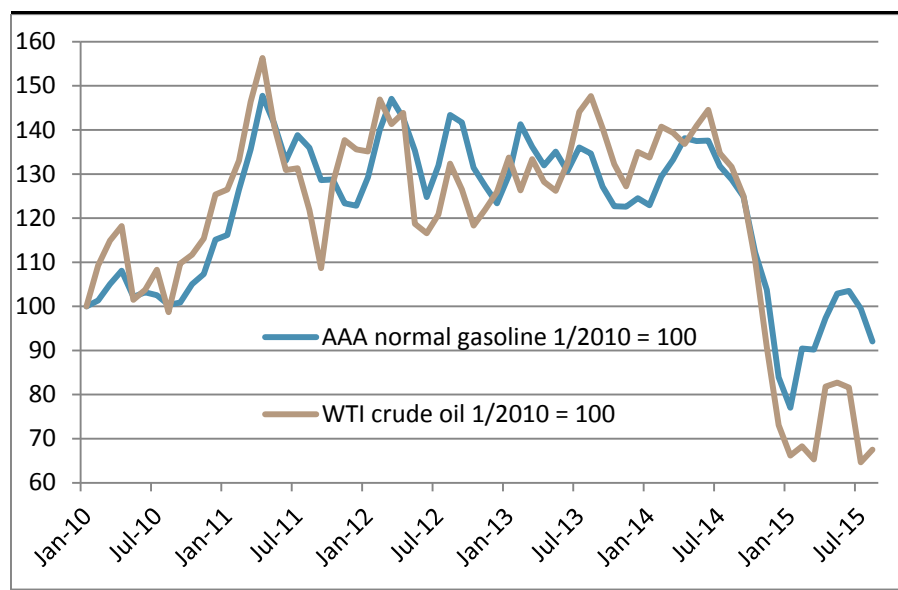
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Headline inflation is about to take a significant step up in most of the world's major economies. Oil prices started their precipitous decline in October 2014, continuing until January 2015. This means that the effect of lower oil prices on consumer price inflation will exert progressively less of a drag on the year-over-year headline consumer price inflation rate from the October 2015 data onward. This base effect is, in theory, well understood – although economists long ago came to understand that financial market participants do not necessarily have the rationality that is automatically conferred with the granting of an economics degree. It is possible that a deflation psychology lingers in markets today in irrational response to oil base effects.

Stop being crude – US crude oil versus retail oil prices (rebased)



Source: UBS, Haver Analytics

At the risk of making an obvious point, the fall in crude oil prices is not all there is to the impact of oil on consumer price inflation. Retail oil prices (those which matter to consumers) are not crude. The level of a national currency against the dollar will impact local currency oil prices. For some countries this has been a mitigating factor to disinflationary pressures. In addition, some governments (especially in emerging markets) have used the low oil price as an opportunity to reduce consumer oil subsidies.

These arguments cannot hold in the United States, and yet, as the previous chart shows, US gasoline prices have fallen notably less than crude oil prices. The issue here is primarily labour costs (and to a lesser extent taxes).

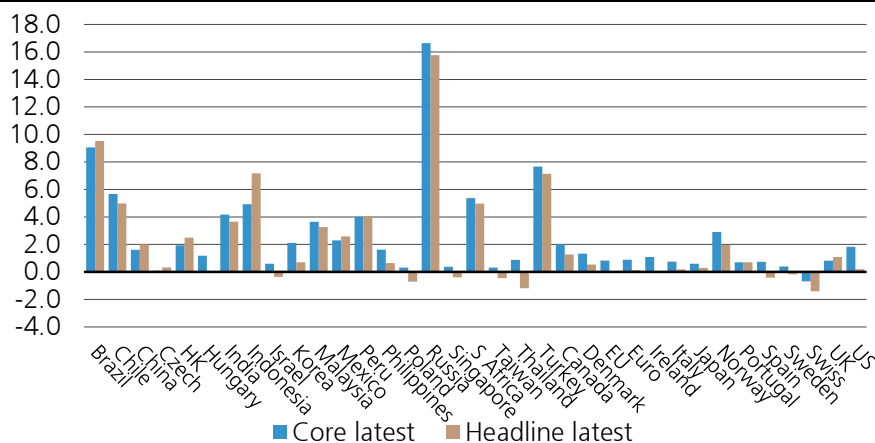
Around 60% of US consumer price inflation is driven by US domestic labour costs. For oil, the labour component is less than that but crude oil contributes only around half of the price of gasoline. A recent rise in labour costs across the oil processing and distribution chain means that gasoline prices are 15% above their lows already and set to rise further in year-over-year terms as the oil base effect disappears.

So where is inflation likely to go? A quick guide is to consider the core inflation rate – inflation excluding food and energy. As disinflationary oil base effects fade, headline and core inflation rates should converge.

It is worth stressing that the ending oil base effects will *also* raise core inflation rates (albeit with a lag). Consumer price inflation excluding food and energy does not exclude energy (it does not exclude food either). The energy component of core inflation is embedded into other prices. US core CPI was recently held in check by lower air fares. An air fare is roughly 40% energy costs: lower energy costs drive air fares lower, which drive core CPI lower. The US core inflation basket contains around a weight of about 4% for embedded oil prices, and for other countries this number lies somewhere between 3% and 4%.

Nonetheless as a rule of thumb, core inflation is a reasonable indication of where headline inflation is likely to head. All but five of the thirty-five major countries that provide monthly core consumer price data currently have core consumer prices in excess of headline consumer prices, and the average difference between yoy headline and core inflation is 0.8%. Allowing for embedded energy costs (which will also lose base effects) a gradual increase in headline inflation rates of around 1% seems a reasonable estimation of how headline inflation rates are likely to adjust into the first quarter of 2016.

Latest CPI and CPI ex food and energy rates, % yoy



Source: UBS, Haver Analytics

Will this increase in inflation impact consumer inflation expectations? This is unlikely. Consumer inflation expectations are disproportionately influenced by high-frequency purchases like energy. However, consumers tend to have very short-term memories when it comes to price behaviour. A typical motorist is unlikely to compare the price they pay for gasoline today against the price that they paid for gasoline a year ago. The typical motorist will compare the price they pay for gasoline today against the price they paid for gasoline a week ago.

It is also worth noting that core inflation pressures have been exhibiting some modest increases, which have been perhaps hidden from investor view beneath the relative price shift of the oil market. Two-thirds of the world's major economies have seen their core inflation rates rise since October 2014, by an average of 0.4% (ignoring Russia, as an inflation outlier). The fading of the oil base effect between October and January may bring this trend to somewhat greater prominence.

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