Standard Life Investments

Weekly Economic Briefing
Global Overview

Price shocks and policy

24 June 2014

After a period of unusual calm in global oil markets, the benchmark ICE Brent oil spot price spiked to just under $116 per barrel late last week, its highest level since September last year. The trigger was the deteriorating political situation in Iraq, with the militant Islamic group ISIS gaining territory in the north of the country. At around 3 million barrels per day, Iraq is currently the second largest oil producer in OPEC, so any significant disruptions to supply in the region would have severe consequences for oil prices and hence the global economy. Fortunately, most of Iraq's oil is produced in the south of the country, where the Shia majority remains in power. Therefore, a major oil price shock seems unlikely for now.

If oil prices stabilise at current levels, the impact on the global economy will be modest. There will be some short-term upward pressure on consumer prices, but economic growth is unlikely to take much of a hit - the latest empirical evidence suggests that oil prices have to push through multi-year highs before significantly affecting consumers' behaviour. This is because the composition of private spending has already adjusted to previous price spikes. However, what would happen if Iraq's oil were to go offline? Then the impact would be severe. Energy analysts think that the loss of Iraqi oil could be enough to send Brent prices through $150 per barrel, which would be more than $20 per barrel higher than their post-crisis peak (see chart 1). Consumer price inflation rates in many developed countries would more than double, eating into consumers' purchasing power and causing them to cut spending on discretionary items. Oil exporters would of course do well, as their terms of trade improve. However, that would not be enough to offset weaker growth in importing countries so global growth would soften. The reactions of policymakers to an oil shock could differ substantially. The Fed would probably look through the temporary rise in inflation and instead worry more about the negative impact on the economy. It could even signal that policy would stay looser for longer. Judging on past form, the ECB may not be so accommodative. Meanwhile, central banks in emerging markets where high inflation is already entrenched would possibly be forced to tighten policy.

Chart 1: Oil prices have been remarkably stable

Source: Datastream (as of 20 June 2014)

Contributors

Authors:
Jeremy Lawson
James McCann
Govinda Finn
Kieran Curtis

Editors:
Jeremy Lawson
Rachel Forshaw

Chart Editor:
Craig Hoyda

Contact:
Jeremy Lawson,
Chief Economist
jeremy_lawson@standardlife.com

US

Dovish, for now

As expected, the Federal Open Market Committee (FOMC) decided to taper its asset purchases by another $10 billion (bn) per month, which will reduce the monthly flow to $35bn per month. At this rate, the asset purchase programme will end in either October or December. The language used in the statement was also much as expected. The Committee focused on the rebound in activity in recent months and continued to emphasise that unemployment remains elevated while inflation is running below their long-run objective. There were few surprises in the projection materials either. Growth forecasts were marked down for 2014 to take into account the decline in activity in Q1, but the Committee left the 2015 and 2016 forecasts untouched. They also marginally revised down the forecast for potential growth. At the same time, unemployment forecasts were marked down slightly in 2014 from 6.2% to 6.05%, as FOMC members continue to be surprised at how quickly labour underutilisation is declining (see chart 2). Given recent consumer price trends, it was somewhat more surprising to see the Committee's median projection for core PCE inflation nudged up by only 0.05 percentage points (ppts) to 1.55%. **While core PCE inflation is currently just 1.4%, all other measures of underlying consumer price inflation are already running above the Federal Reserve's end-year projections** (see chart 3). Our view is that, in the coming months, the Committee will have to further revise its unemployment rate forecasts down and inflation forecasts up.

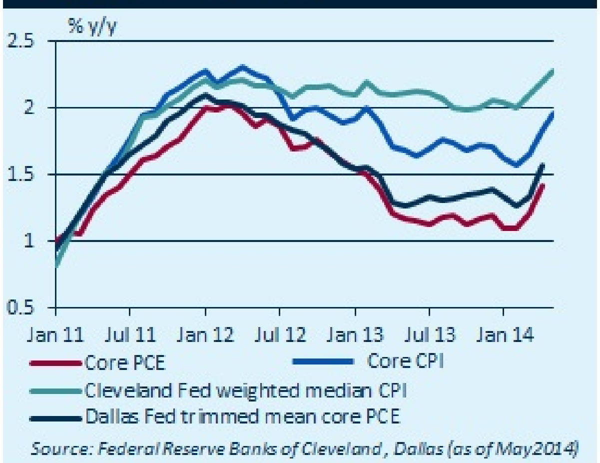
Given the modest revisions to the expected path of unemployment and inflation, the median federal funds rate projection for the end of 2015 increased slightly to 1.125%, while the median projection for the end of 2016 was increased to 2.5% from 2.25%. Meanwhile, the FOMC's median forecast for the terminal rate fell to 3.75%, consistent with increasing pessimism on the Committee about potential growth. **Market expectations for Yellen's press conference to be on the hawkish side were not realised.** No concessions to the recent uptick in core inflation were made and she was silent on any changes to the Fed's exit principles. Yellen also signalled that she was currently unperturbed about current financial market conditions. With the benefit of hindsight, a dovish press conference was to be expected. The Committee still views the first rate rise as being some time off and Yellen would have been conscious of the potential for the revisions to the unemployment, inflation and fed funds forecasts to be interpreted hawkishly. She is in no hurry to signal otherwise - at least for now.

Investors still seem to be hearing only what they want to hear, as equities and bonds both rallied following the dovish press conference. Indeed, despite another upward revision to the FOMC's projected path of tightening, markets are still pricing in a more gradual path. Something has to give. Either the bond market will be proved right and the Fed will have to change its projections, or markets will need to re-price. Given our own forecasts for growth, unemployment and inflation, we think the latter is more likely. That said, the re-pricing may not be imminent – at least while Yellen is content to send out dovish messages during her press conferences and market participants are happy to take her word for it.

Chart 2: Getting unemployment wrong

Source: Federal Reserve (as of June 2014)

Chart 3: Inflation rising?



Source: Federal Reserve Banks of Cleveland, Dallas (as of May 2014)