US Macroeconomics

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Downstream Inflation Spillovers

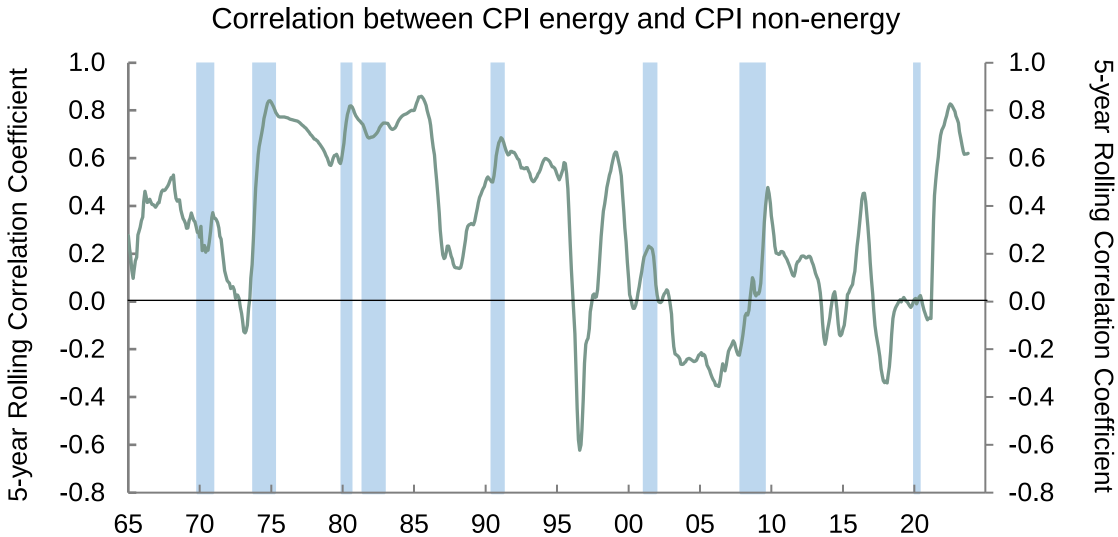
Oil and gas prices are down sharply from their respective June and August 2022 highs. In the case of oil, its recent decline has been particularly dramatic as it has occurred despite the Middle East conflict. Clearly, the oil market is more worried about weakening demand (US recession?) than the potential for supply disruptions associated with widening Middle East strife. The price of West Texas Intermediate crude is down over 20% in the last two months to around $73 per barrel. Remember oil prices were well under $50 per barrel as recently as December 2020.

While the drop in oil prices will lead directly to a lower headline inflation rate and lower inflation expectations, the decline is also likely to weigh on the non-energy portion of inflation. Consequently, this will allow the Fed to pivot away from a restrictive policy stance over the next year, possibly as soon as this coming March. Why are falling oil prices likely to weigh on the non-energy portion of the consumer price index (CPI)? Because the correlation between energy and non-energy prices has been unusually high over the last few years.

In the chart below, **we show the five-year rolling correlation coefficient between the year-over-year change in CPI energy prices versus CPI excluding energy**. The correlation was relatively low from 1965 until late 1973 when OPEC placed an embargo of oil exports to the US. The correlation coefficient stayed high until the mid-1980s when it plunged in lagged response to excessively tight monetary policy leading to a big drop in inflation expectations.

Until recently, there has been little evidence of higher energy costs feeding into other parts of the CPI. There was a modest increase in the correlation in the late 1990s following the US economic boom, but it was short-lived, and non-energy CPI prices remained relatively low. The situation changed in 2021 when soaring oil and gas prices led to spillover effects elsewhere in the economy. Both energy and non-energy prices increased sharply at the same time.

With the US potentially on the cusp of recession, today's high correlation between energy and non-energy prices means that a drop in the former should help push the latter lower. No doubt this will be welcome news for the Fed, which recently concluded its most aggressive monetary policy tightening cycle in at least four decades.



Sources: BLS, Haver, SMBC Nikko

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