Post #14 on Inflation. Deflation scare is around the corner: hints from the commodity markets. Date 2023-12-27

The economic developments over the last year compelled me to write this post, as we are going to enter a deflation period of what I have previously termed the "inflation rollercoaster", which started in March 2020 with the pandemic policy response. After the massive monetary stimulus beginning in March 2020, we warned that inflation was coming, while in our inflation post#11 on the 30th May 2023[1] we warned that deflation was ahead of us, starting to be noticeable in Q1 2024. We are now at the verge of deflation re-surfacing as a "danger" for economic activity, and we'll show in this post that commodity prices are already showing those signs.

1. The context.

As I've discussed in the second edition of my book[2], the unprecedented expansion of money that was a coordinated economic response to the government lockdowns enacted in March/April 2020 was bound to set loose the inflation genie. During 2020 and until mid-2021, inflation seemed to be under control but since then it has exploded. I warned that the inflation that started mid-2021 was not a temporary phenomenon, and did not originate from problems in global supply chains, but was in essence a monetary phenomenon and also a result of the pent-up demand from the pandemic lockdowns that led to record savings by households[3]. Like a coiled spring, the economy rebounded sharply with supply chains struggling to keep up.

To control inflation "at any cost", the Fed embarked in a policy of quantitative tightening (by reducing its balance sheet) as well as an aggressive series of rate rises from 0.25% to 0.5% in March 2022, to 5.25% to 5.50% in July 2023. The result of the policy actions by the Fed led to an unprecedented drop in the money supply, as measured by the M2 aggregate. As we discussed in our previous post #11[4], with these policy actions the Fed would engineer the coming economic slowdown and deflation scare. We suspect that Q1-2024 will see a change in public perceptions and economists' language, turning from inflation to deflation. How policymakers will act once deflation scares emerge is unclear at this moment as the Fed is still committed to combatting inflation at present. In this post we'll show that we already see the early signs of disinflation in the commodity markets.

2. Subdued oil markets.

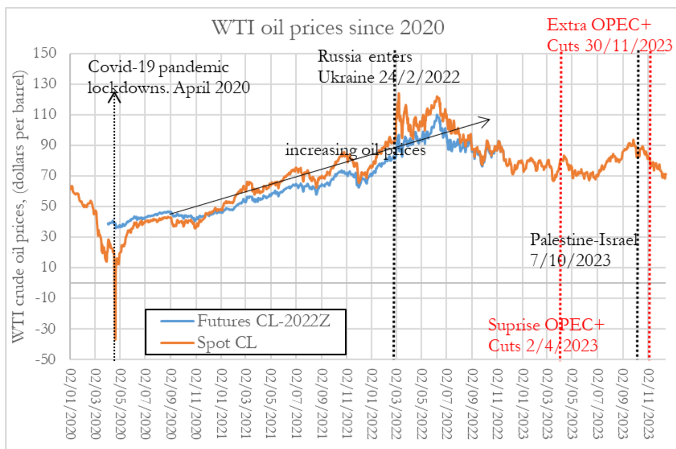

Figure 1 - Evolution of WTI crude oil prices since 2020

[1] https://www.linkedin.com/posts/carlos-alegria-b68878a_post-11-inflation-roller-coaster-deflation-activity-7069787263160770560-vucJ?utm_source=share&utm_medium=member_desktop
[2] http://www.cyclesdebtanddemographics.com/
[3] https://phinancetechnologies.com/content/2022-05-28%20Inflation%20LinkedIn%20Post-3.pdf
[4] https://phinancetechnologies.com/content/2023-5-30%20-%20LinkedIn%20Post-11-%20Inflation%20Update%20-%20V2.pdf.

The evolution of the WTI oil price in 2023 points towards low demand with no signs of inflation despite the conflict in Ukraine, with western countries imposing oil and gas embargoes on Russia. In our view, the likely cause of subdued oil prices stems from the housing crisis and economic slowdown in China, and the impact of the European sanctions on Russia which is leading to Germany entering a recession. Additionally, as we've discussed in a previous post, our ECIs (Early Cycle Indicators) show that the US economy is poised to enter a recession in the coming months[5]. The decline in economic activity will put further downward pressure on prices.

The outlook for subdued global demand and weak forward outlook were the reasons why the OPEC nations announced a surprise cut in oil production by 1.66 million barrels per day (mbd), following their meeting on the 3rd April 2023[6], which added to their previous agreed cut of 2 mbd. Furthermore, at their meeting on the 30th November 2023, OPEC+ announced additional voluntary cuts of 2.2 mbd.[7] Even those substantial cuts in oil production did not have an impact on oil prices as we can observe in Figure 1.

Oil prices versus gasoline retail prices:

Retail gasoline prices (prices at the pump) appear to be abnormally high, which is one of the reasons for inflation in other goods. However, with the weakness in oil prices we observe from Figure 1, how can we make sense of the stubbornly high prices at the pump?

Usually, retail gasoline prices are highly correlated with oil prices. Using a simple linear model, we've inferred gasoline retail prices from WTI oil prices and compare them with EIA gasoline prices, as shown in Figure 2. We observe that since 2021 there is a wider spread between EIA gasoline prices and the inferred prices, with retail prices being about 0.5$ to 1$ higher than expected. We suspect that "green" regulations and carbon policies could be the main causes for the spread.

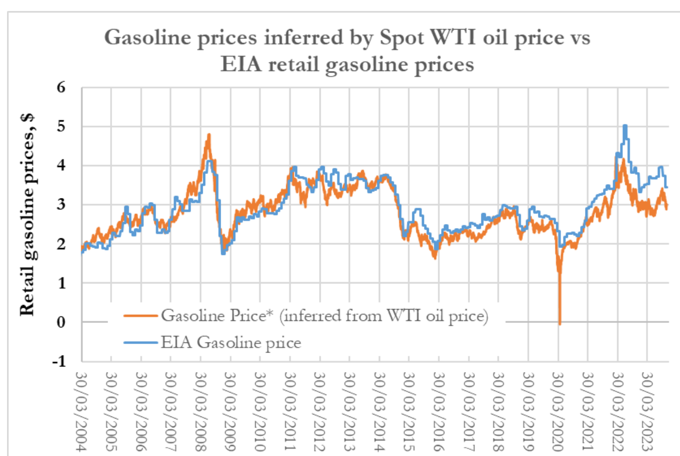

Figure 2 - WTI Inferred gasoline prices versus EIA gasoline prices.

The longer-term perspective:

When adjusting the oil price for inflation, the picture is even starker and oil prices are very low at current levels of $70 per barrel, as shown in Figure 3. At $70, the oil price is at its long-term average level since 1983, corresponding to a value of about $20 in 1983. For comparison, in 2008 real oil prices reached more than $60 per barrel. The equivalent level of oil prices today would be $210 per barrel.

[5] https://phinancetechnologies.com/content/2022-12-5%20-%20LinkedIn%20Post-9%20V1%20-%20Incoming%20US%20recession%20-%20December%20Update.pdf
[6] https://www.reuters.com/business/energy/why-is-opec-cutting-oil-output-2023-04-03/
[7] https://www.opec.org/opec_web/en/press_room/7267.htm

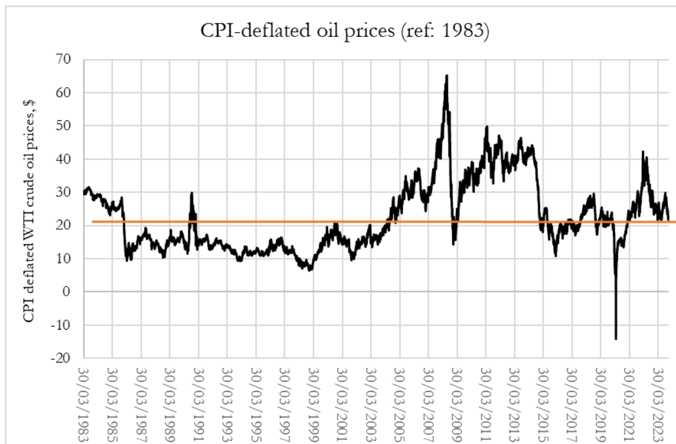

Figure 3 – Inflation-adjusted oil prices: ref: 1983.

3. Subdued agricultural prices.

Trends in wheat prices show a similar pattern to those of oil prices seen before, as shown in Figure 4. Wheat prices rose significantly from mid-2020 to 2022, likely due to the monetary stimulus that started in 2020 and the economic recovery in 2021. Wheat prices jumped substantially with the start of the Ukraine-Russia conflict as both Ukraine and Russia are major grain exporters. The situation was accentuated with the Western nations' sanctions on Russian products and by Russia being the world's top producer of fertilisers.

After the initial concerns, wheat prices normalised by July 2022 and since then have been on a downward path. As with oil prices, we believe that the weakness in wheat prices is due to the economic slowdown in China (from its ongoing housing crisis) and Europe (from the backfiring of the Russian sanctions), and also from the tightening of monetary policy from 2022. The weakness in wheat prices goes contrary to the large increases in retail prices for food and is another sign of deflationary forces at action.

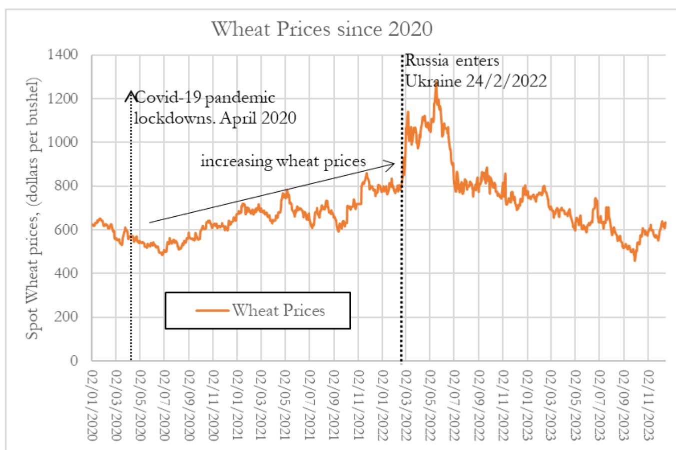

Figure 4 – Evolution of spot wheat prices since 2020. Source: CSI data.

3. Subdued lumber prices.

Lumber prices went through a wild rollercoaster from 2020, as shown in Figure 5. The 2020 pandemic lockdowns led to an initial drop in lumber prices but subsequent explosive rise as the economy rebounded aggressively and supply chain disruptions constrained supply. From mid-2022 however, lumber prices have been on a steady decline and currently are at values similar to those of 2019.

It should be noted that these values are nominal and not adjusted for inflation. Low lumber prices point to weakness in the real estate market where it is used in single-family homes, flooring and home furnishings.

Consequently, lumber prices are pointing to subdued demand and are another sign of deflationary forces at play.

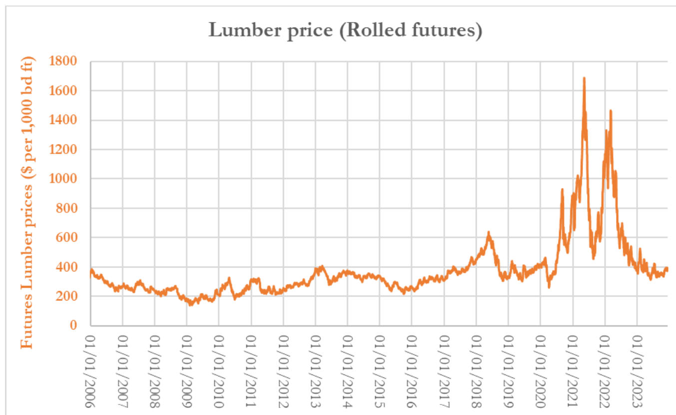

Figure 5 – Futures lumber prices (near contract) – spliced series. Source: CSI data and Phinance Technologies.

4. What to expect going forward

As I've stated in previous posts, inflation is a monetary phenomenon.

The yearly drop in M2 that we're currently experiencing is almost as extreme as the prior rise from March 2020 to 2022. This is likely to lead to significant economic dislocations, which have already been picked up by our ECIs. The draining of liquidity from the financial system is putting a squeeze on the real economy, which has been kept alive by large government deficits.

As the Fed has a dual mandate of full employment and stable prices (with an inflation target around 2%), we believe that the Fed will keep a tight monetary policy stance for longer, as hinted in their latest FOMC meeting[8].

As we've mentioned in a previous post[9], we believe that the unemployment rate is artificially low due to the substantial rise in disabilities and lost worktime in 2021 and 2022, which in our estimates is lowering the unemployment rate by about 0.7%. This means that the Fed might be slow in reversing its policy stance based upon the unemployment rate.

The above analysis of oil, wheat and lumber prices, that shows declining commodity prices in 2023, hints of underlying deflationary forces in action. We expect to see these trends surface into the real economy and retail prices in 2024. We expect deflation to be clear by Q1-2024 and that it will remain a worry for policymakers throughout 2024.

It will be interesting to observe how policymakers will respond to the first signs of low inflation in 2024 (that is, CPI changes drop below 0%). We suspect that the Fed will attribute those first low readings to seasonal effects or an outlier. This will be reinforced by the stubbornly low unemployment rate. Once the Fed wakes up to the new reality, it will probably be at a time when substantial damage is done to the real economy and the Fed will be "forced" to act decisively.

We are still uncertain as to what this "decisive action" will entail, but we suspect that a new round of QE with the introduction of CBDCs and universal basic income is awaiting us.

Thank you for reading. I hope this post helped clear up the noise instead of adding to it.

[8] The Fed hinted that policy decisions will be data-driven with an eye on the labour markets and inflation and further rate rises could be possible if inflation persists.
https://www.federalreserve.gov/monetarypolicy/fomcpresconf20231213.htm

[9] https://www.linkedin.com/posts/carlos-alegria-b68878a_post-10-us-economy-the-flavour-of-the-activity-7049481327900864514-YfB7