GW&K
INVESTMENT MANAGEMENT

# GLOBAL PERSPECTIVES

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## ENERGY MATTERS

HIGHLIGHTS

- The spike in energy prices following Russia's invasion of Ukraine has been an unwelcome source of upward pressure on U.S. and global inflation.
- Higher energy prices represent an important wild card for the near-term U.S. inflation and growth outlook since the Fed is clearly prepared to risk recession to curb inflation.
- But energy prices do not drive inflation in a fundamental sense. A normalization of U.S. monetary and fiscal policy is likely to curb overall inflation regardless of energy market trends.

# ENERGY MATTERS

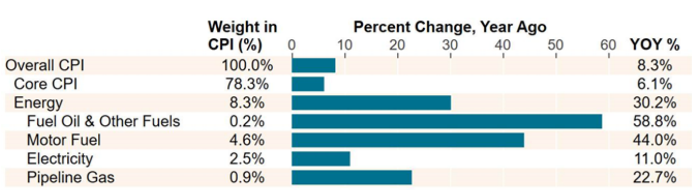
## ENERGY PRICES HAVE BEEN A KEY DRIVER OF RECENT INFLATION PRESSURES

The spike in oil and natural gas prices following Russia's invasion of Ukraine has been an unwelcome source of upward pressure on U.S. and global inflation. Since mid-February, just before Russia's invasion, the prices of Brent crude oil and NYMEX natural gas have surged by 20% and 93% respectively. This has resulted in higher gasoline, fuel oil, and pipeline gas prices throughout the U.S. economy, with the highly visible price of unleaded gas having risen above $4 a gallon in every state for the first time ever by mid-May.

Energy is an important component of America's Consumer Price Index (CPI), representing 8.3% of the weight of the CPI as of April 2022. But energy has recently been punching above its weight as a statistical driver of overall CPI inflation. For example, with the energy component of the CPI up by 30.2% for the year through April, it has accounted for about one-quarter of the 8.3% year-on-year rise in the CPI over the same period **(Chart 1)**. So far in 2022, the energy impact on inflation has been even more pronounced, with the energy component accounting for about one-third of the 9.5% annualized rate of change in the overall CPI.

### CHART 1

### Energy Costs Have Been a Key Driver of U.S. CPI Inflation Over the Year Through April 2022




Source: GW&K Investment Management, BLS, and Macrobond

*Energy prices account for about 8% of the CPI, but have accounted for about one quarter of the overall 8.3% year-on-year increase in the CPI in the year through April 2022.*

Many economists and market participants believe that America's headline inflation rate peaked in March when the CPI rose by 8.5% from a year earlier. Reasons for optimism that inflation pressures will ease in coming quarters include expectations that overall growth will slow in response to the restrictive impact of higher interest rates and a stronger U.S. dollar. That may reduce excess demand pressures in both the labor market and in many markets for goods and services, which should see supply-side improvements as supply-chain disruptions abate and labor-force participation improves.

Moreover, there should soon be favorable "base effects" on annual inflation comparisons. That's because April, May, and June of 2021 saw the fastest pace of core CPI price gains in nearly 50 years thanks to notable gains in durable goods' prices and especially used car prices. If month-on-month price increases moderate in coming months as expected, year-on-year inflation will naturally begin to look more modest relative to the abnormally heated conditions of a year ago. Based on such considerations, Bloomberg's latest survey of economists has the consensus outlook for year-on-year overall CPI inflation easing to the 4.0%–4.5% range by early 2023 and to around 2.5% by the second half of 2023.

## ENERGY PRICES ARE A KEY WILD CARD FOR INFLATION AND GROWTH

The optimistic consensus for peak inflation also appears consistent with consensus forecasts by oil analysts that crude oil prices have peaked as well. For example, Bloomberg's survey of oil analysts shows the median analyst expects the price of Brent crude oil to fall from an average price in May of $112 a barrel to an average of $90 a barrel next year. Crude oil futures are a bit less optimistic, but still put the price of Brent crude at an average of about $95 per barrel next year, down about 15% from its recent range **(Chart 2)**. Of course, both analysts' forecasts and what is priced into futures markets need to be taken with a large grain of salt. The fundamental backdrop remains highly uncertain. On the one hand, further energy supply disruptions associated with the Russia-Ukraine war could easily push prices higher. On the other hand, higher interest rates, tighter financial conditions, and U.S. dollar strength have the potential to drive prices lower.

## CHART 2

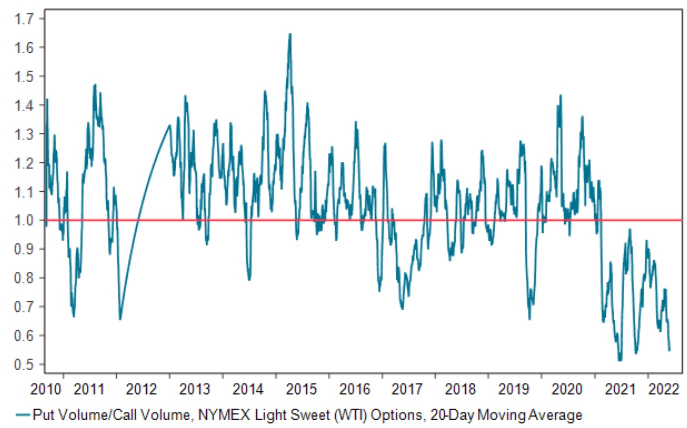
### Brent Crude Oil Actuals vs. Market Expectations as of May 31 of Each Year


Note: Shaded areas denote NBER recession periods.
Source: GW&K Investment Management, NBER, and Macrobond

*After a brief spike above $130 a barrel, Brent crude oil futures have recently traded around the $112 a barrel level and discount a decline of 15% to an average level of $95 a barrel in 2023.*

## CHART 3

### Oil Derivatives See Price Risk Skewed to the Upside: WTI Crude Oil Put/Call Ratio




Source: GW&K Investment Management and Macrobond

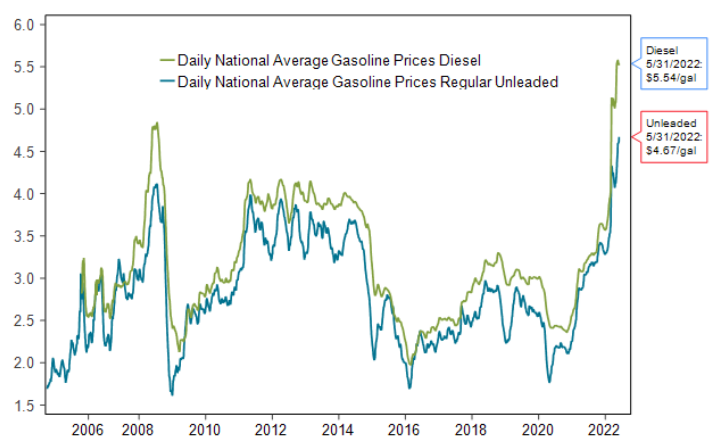
*The put-call ratio for WTI crude oil options has only been lower than it is now about 1% of the time since 2010, implying that near-term risk to oil prices is to the upside. Blame geopolitics.*

Year-ahead forecast errors of plus or minus 20% tend to be the norm when it comes to oil prices. Also, it's worth noting that the oil derivatives market recently has been heavily skewed toward investors protecting themselves against the risk of higher oil prices. That is seen in an extremely low put-to-call ratio for NYMEX West Texas Intermediate (WTI) crude oil options, with the ratio having been lower only 1% of the time since 2010 **(Chart 3)**. This suggests that the near-term risk to oil prices is to the upside against a highly unsettled geopolitical backdrop.

And while the price of crude oil can often be viewed as a good barometer for whether oil consumers are facing an "oil shock," the energy situation is further complicated by very low fuel inventories and very limited spare refining capacity. That has created a near-vertical ascent in the price of fuels like diesel and unleaded gasoline, which have increased in the year to date by 55% and 42% respectively **(Chart 4)**.

## CHART 4

### Soaring Prices for Diesel Fuel and Gasoline Reflect Low Inventories and Refining Capacity




Source: GW&K Investment Management and Macrobond

*Diesel fuel is up 55% for the year to date while unleaded gasoline is up 42%, as strong demand has collided with very low fuel inventories and extremely limited refining capacity.*

Here's the issue, as explained by Bloomberg's commodity expert:

> "Right now, the traditional relationship between crude and refined products is broken. WTI is anchored around $100–$110 a barrel, suggesting that — in barrel terms — gasoline, diesel, and jet fuel prices shouldn't be much higher, once you add the average refining margin.
>
> In reality, they are a lot more expensive. Take jet fuel: in New York harbor, a key hub, it's changing hands at the equivalent to $275 per barrel. Diesel isn't far away, at about $175 a barrel. And gasoline is about $155 a barrel. Those are wholesale prices, before you add taxes and marketing margins.
>
> What's changed? Refining margins have exploded. And that means energy inflation is far stronger than it appears."[1]

Now consider the potential for oil demand to grow as we enter the summer driving season against a backdrop of extremely low fuel inventories. And also consider the potential for global oil demand to increase as China starts to reopen from its extreme zero-Covid lockdowns. Using these assumptions, some oil analysts believe that prices at the pump could continue to soar in coming months.[2]

## HIGHER ENERGY PRICES WOULD PROMPT MORE AGGRESSIVE FED TIGHTENING

That's a risk, not a certainty, but what would continuing upward pressure on energy prices mean for the Fed?

Fed Chair Jerome Powell addressed that question in a mid-May interview when he emphasized that "this is not a time for tremendously nuanced readings of inflation." In perhaps his most hawkish comments to date, he made the following pointed comments at a *Wall Street Journal* live event:[3]

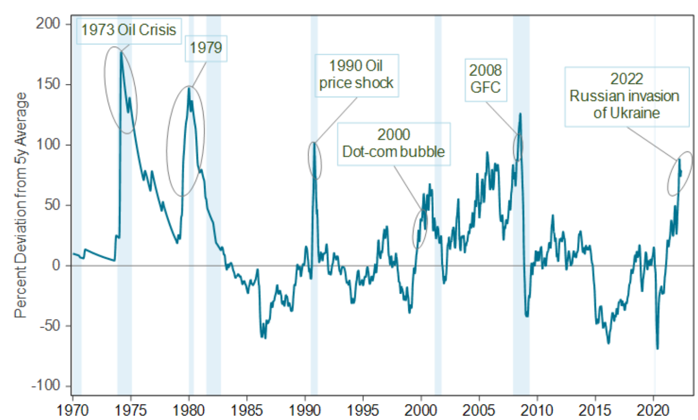
> "What we need to see is inflation coming down in a clear and convincing way, and we're going to continue to keep pushing until we see that. If that involves moving past broadly understood levels of 'neutral,' we won't hesitate at all to do that."

Former Fed Chair Ben Bernanke gave a speech in 2004 on the topic of how central banks should respond to energy shocks.[4] The gist of his view is that the starting point of inflation and growth should determine how to respond to an oil shock. When inflation is already high, he argued, tighter monetary policy should be viewed as "an investment in future economic stability." Bernanke's speech highlighted recessions that began in 1973 and 1981 as "unfortunate side effects" that followed Fed rate hikes aimed at containing the inflationary effects of oil shocks.

Chair Powell and many of his colleagues are borrowing from Bernanke's playbook, making it clear that they are willing to take the risk of an economic recession resulting from tighter monetary policy. A look at previous oil price shocks, measured by periods when oil prices exceeded their long-term moving average by a wide margin, shows that recessions have tended to precede or coincide with oil price shocks **(Chart 5)**. As Bernanke noted, tight Fed policy typically played a starring role during those recession periods.

### CHART 5

### Recessions Have Tended to Precede or Coincide with Oil Price Shocks




Note: Shaded areas denote NBER recession periods.
Source: GW&K Investment Management and Macrobond

*Large surges in oil prices relative to long-term price trends have often preceded or coincided with U.S. recessions, although tight Fed policy to curb inflation was usually a key factor triggering the recessions.*

1 Javier Blas, "Sorry, But for You Oil Trades at $250 a Barrel," Bloomberg Opinion, May 9, 2022
2 "Gas Prices Are Headed 'Substantially Higher' Says Goldman Sachs' Jeff Currie," CNBC Interview, May 9, 2022
3 Matthew Boesler and Craig Torres, "Powell Vows Hikes Until 'Clear and Convincing' Cooling in Prices, May 17, 2022
4 Ben S. Bernanke, "Oil and the Economy," Federal Reserve Board, October 21, 2004

In short, the energy shock the U.S. economy has already experienced has created near-term inflation pressures while also cutting the outlook for real economic growth. And the effect on growth tends to come through two important channels. First, higher energy prices act like a tax on consumers, draining their purchasing power and lowering their ability to spend on discretionary consumer purchases. Second, they lead to more aggressive monetary tightening by the Fed aimed at curbing the inflationary effects.

## OIL SHOCK OR NOT, THE FED IS LIKELY TO CURB INFLATION

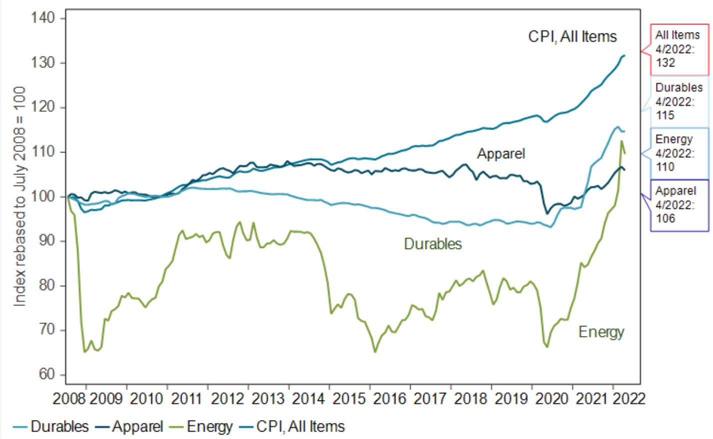
As we noted earlier, higher energy prices have recently been a key driver of inflation from a pure arithmetic standpoint. But that does not mean that they will continue to be a key driver of inflation from a fundamental standpoint. If energy prices go up while aggregate demand trends are under control, it simply means that some other prices need to go down.

This would be true even if there is an upward bias to energy prices in coming years due to structural underinvestment in the energy sector related to capital discipline or the regulatory environment. If aggregate demand is well controlled, higher energy prices simply imply a change in the relative price of energy. That differs from a process of escalating prices on an economy-wide and persistent basis.

To illustrate that energy prices have not been a persistent fundamental driver of inflation, consider the trajectory of the energy component of the CPI from July 2008 to April 2022 **(Chart 6)**. Over that long period, the energy component increased by only 10% (or 0.7% at an annual rate). In contrast, the overall CPI gained 32% (or 2.0% at an annual rate). Some components of the CPI, like durable goods prices and apparel prices, fell for most of that period, while many other service prices rose by even more than the overall CPI. The relative price of energy fell versus the overall CPI during that period. So it was clear that energy prices were not the key driver of CPI inflation over the long term.[5]

### CHART 6

### Energy Has NOT Driven Inflation Since Oil Prices Peaked in Mid-2008




Source: GW&K Investment Management and Macrobond

*Energy prices have not driven overall U.S. inflation over long time periods. For example, since mid-2008, the energy component of the CPI is up only 10% compared to a gain in the overall CPI of 32%.*

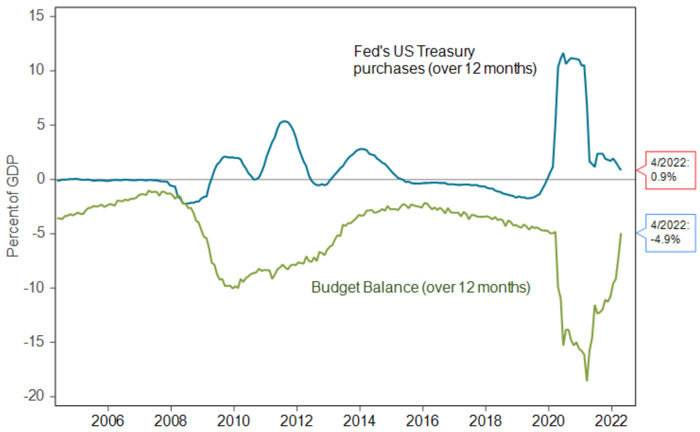
We would point to monetary and fiscal policy, as controlled by the Fed and the U.S. Congress, as being far more important fundamental drivers of inflation. From that perspective, the extraordinary burst of inflation the U.S. has experienced recently can be traced to the emergency "wartime finance" monetary and fiscal policies put in place in 2020 and 2021 in response to the pandemic.

As we have discussed previously, more than $5 trillion of fiscal spending (about 25% of GDP) was authorized from March 2020 through March 2021. And most of this spending was effectively financed through comparably sized Fed purchases of U.S. Treasury securities **(Chart 7)**. That experiment with Modern Monetary Theory (MMT) initially kept interest rates extremely low. It was also associated with a 40% increase in the U.S. M2 money supply over a two-year period, as stimulus checks, PPP loans, and other large spending initiatives were rapidly deposited into bank accounts.

5 Pierre Lemieux, "Confusion about Energy Prices and Inflation," www.EconLib.org, May 17, 2022

### CHART 7

### MMT, RIP? The Fed Is No Longer Financing Nearly All of America's Federal Budget Deficits




Source: GW&K Investment Management, Federal Reserve, U.S. Treasury, and Macrobond

*Similar to "wartime finance" episodes from WWI and WWII, huge government deficit financing was effectively financed by Fed purchases of U.S. Treasuries. These emergency measures have now ceased.*

With the benefit of hindsight, it perhaps should not be surprising that "wartime finance" resulted in a burst of inflation as has happened during other periods of wartime finance in the U.S. But along with an improving health situation, monetary and fiscal policy are now clearly normalizing. The budget deficit has shrunk from a peak of 18.6% of GDP in the 12 months prior to March 2021 to 4.9% of GDP in the latest twelve months. Moreover, the Fed has ceased buying U.S. Treasury securities and is now set to shrink its balance sheet. Broad money growth is also decelerating, with M2 growing at an annual rate of only 6.2% in the first quarter of this year after many quarters of double-digit annualized growth — following a remarkable "peak pandemic" rate of 65.3% annualized growth in the second quarter of 2020.

Regardless of near-term energy market trends, we think the normalization of U.S. monetary and fiscal policy is likely to be the decisive factor that will curb inflation pressures in coming quarters. It remains to be seen how aggressive the Fed will need to be to bring inflation back under control, but we would not bet against either its ability or determination to do so.

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