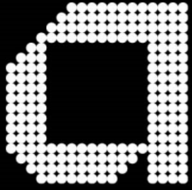


Research Institute - Insight

17 March 2023

6:06 minute read

#Global / #Inflation / #Asset prices

For professional and institutional investors only – not to be further circulated. In Switzerland for qualified investors only.

Inflation watch: reopening, recession and oil

Following the fall in commodity prices amid financial sector volatility, China's reopening and still-strong US activity may provide a supportive backdrop for prices over the coming months. However, the start of a US recession will ultimately more than offset the China boost.

Key Takeaways

- Commodity prices have whipsawed year to date over optimism around China's reopening recovery, concerns over US monetary tightening and most recently turbulence in bank stocks.
- The consequences of China reopening for commodity markets are not as clear as the initial market reaction signalled.
- The service-led composition of growth favours oil prices over metals in the coming months.
- Pent-up demand for travel will likely boost demand for transport fuel from Q2 onwards. However, the upside will be limited as China built up fuel inventories during lockdowns.
- A rotation away from manufacturing demand for naphtha and LPG toward transport fuels will also limit the overall boost to energy demand.
- We do not expect the positive impact of domestic and international travel on oil prices to be sustained, as our outlook for a US recession will eventually outweigh the boost from China.
- The net effect of divergent growth is likely to be lower prices. Following an initial undershoot, we are conditioning our global inflation forecasts on Brent settling around $70 pb by mid-2024.
- Overall, the decline in energy prices will prove disinflationary, due to base effects following the fuel price surge triggered through the pandemic and war alongside our expected oil price path.

Commodity prices buffeted by sentiment

Until this week, commodity prices had fluctuated within a fairly narrow range as investors tried to navigate the impact of China reopening and fears of a US recession.

The turmoil in banking stocks following the collapse of Silicon Valley Bank (SVB) and troubles at Credit Suisse Group triggered a sharp selloff across risk assets and pushed Brent to the lowest close seen in over a year.

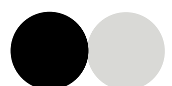
Tightening financial conditions pose a significant downside risk for energy prices, however, support lines for troubled institutions have helped stabilise markets. Meanwhile discussions between Saudi Arabia and Russian oil chiefs and the commitment to price stability helped calm oil traders.

The next OPEC+ meeting is scheduled for April 3rd, and the group is likely to look through the recent turmoil. As and when there is clarity over the outlook for the bank sector, commodity investor focus is likely to return to China's reopening vs. US recession debate.

Service-led rebound in China is likely to support oil rather than metals over the near term

The reopening of China's economy following two years of intermittent lockdowns was met with a fairly diverse response across commodity markets. Iron ore rallied sharply on expectations of a rapid rebound in demand and prices have remained elevated, while copper and aluminum swiftly lost steam.

Meanwhile in energy markets, following an initial surge in oil prices, the rally swiftly faltered as US recession concerns dominated price action.



While China remains the world's largest importer of iron ore, and a key consumer of industrial metals more broadly, the ongoing strength of this market will depend heavily on the outlook for manufacturing and infrastructure spending.

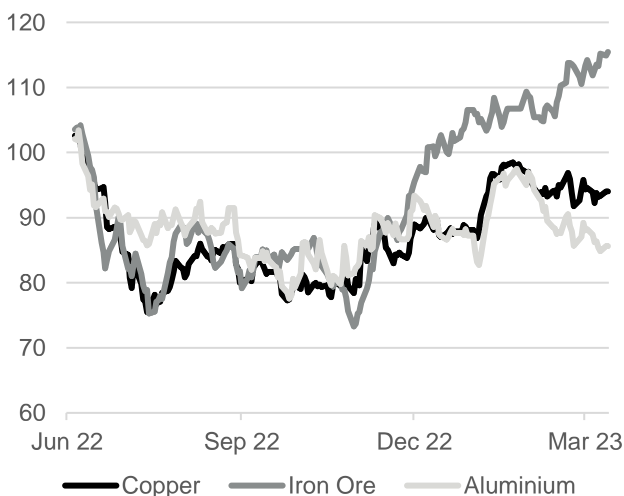
The latest PMI data and our proprietary activity index are already improving in line with our call for a a 'V'-shaped recovery. Our 2023 forecasts are above consensus, predicting China will be the fastest growing major economy this year. (See our Insight note *Rebounding consumption to drive China's GDP growth in 2023*)

However, the composition of growth favours oil prices over industrial metals. We expect China's reopening rebound to be oriented towards the service sector as domestic and international travel recovers. The recent recovery in subway traffic and internal movement point to a more consumption- and travel-orientated rebound.

Over the past year, China's copper demand was hit by weakness in construction and electronic products and the severe investment contraction in real estate. The multi-year rebalancing of the real estate sector will likely continue to dampen industrial demand.

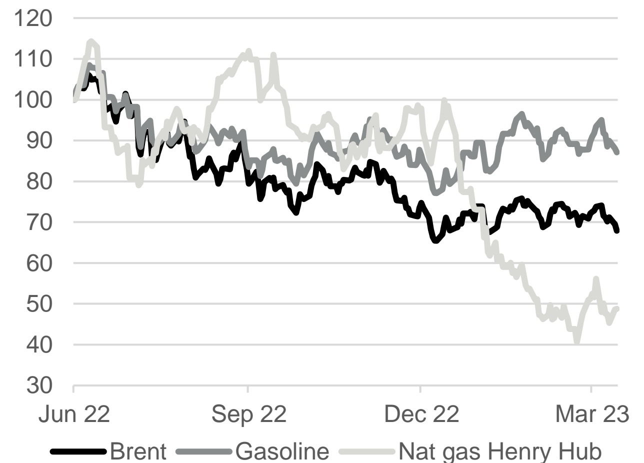
Meanwhile, it is not clear that local governments will boost infrastructure spending given fiscal concerns and the relatively cautious 5% growth target set by the central government.

Figure 1: Iron ore rebounded on expectations of China's reopening fueling steel production …



Note: Index=100 Jun 2022
Source: abrdn, March 2023

Figure 2: … meanwhile the oil price response has been more measured



Note: Index=100 Jun 2022
Source: abrdn, March 2023

Recent negatives for oil, but Q2 could see a boost

Warmer winter weather, rising inventories of crude and distillates, Europe's success in rebuilding gas storage, and most recently the turmoil in the banking sector have all contributed to lower energy prices in recent months.

China built up inventories of oil and coal during later stages of the pandemic. Energy security has been a key motivation for China and major coal-mining areas were not heavily impacted by lockdowns. This allowed for an increase in production and a surge in domestic mine supply.

China also had access to low-cost Russian crude oil and domestic refiners were able to take advantage of global crack spreads for diesel and gasoline. China is a major marginal refining region with the potential to have a sizeable impact on the supply of petroleum products.

However, China's pent-up demand could be unleashed in the coming months in a similar fashion to the US and EU during 2021.

This would likely occur in two stages: firstly in domestic travel, which is primarily pushing up demand for transport fuels such as diesel and gasoline; secondly, through international travel, which is likely to recover more slowly but benefits jet fuel demand.

Overall, this should provide some support for Brent during Q2 as travel numbers recover. But accounting for the differences between industrial and travel use, the overall increase in oil price may be limited to the 10-15% range.

A rotation in China's fuel demand may cap the overall impact on oil prices

During the pandemic, in 2021 and 2022, naptha and LPG demand were the strongest drivers of oil demand growth, while transport fuel demand was low. Global demand for Chinese goods was strong during this period and supported China's naptha and LPG consumption.

As the global economy slows, this consumption pattern should rotate. China's fuel needs may be determined more by domestic travel needs than industrial production.

IEA data shows that industrial end use accounts for over 50% of global oil demand. Although transport makes up the bulk of demand, around 40% of global transport fuel use is linked to freight and industrial growth.

Recession outlook likely offset any boost from Chinese demand by Q4

Our overall outlook for the global economy is for below-trend global growth despite our expectation of a sharp rebound in China (See our Global Economic Outlook). Figure 3 illustrates the net impact of this growth divergence through a stylised illustration of supply and demand for oil.

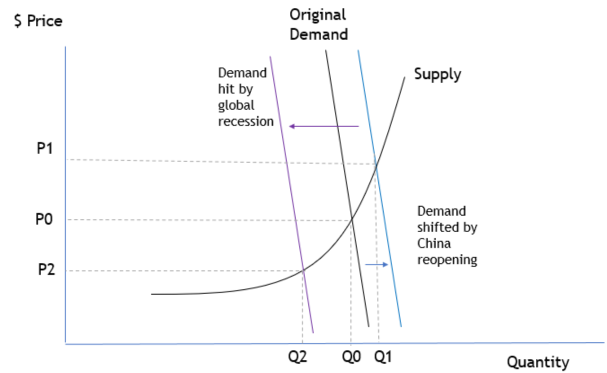
While we expect China's reopening to boost oil demand over the near term, we do not expect the price impact to be sustained.

Monetary tightening is expected to push the US into a recession later this year, with growth spillovers dragging many other economies along with it.

Meanwhile, rising rates led to turbulence in bank stocks following the collapse of SVB. Associated contagion fears reverberated through to commodity prices. While we do not expect this turbulence to be sustained as the failure of SVB should not trigger a systemic crisis, it nonetheless signals a path toward the recession we are expecting. The net effect of divergent growth is likely to be lower prices by the end of the year.

Following an intial undershoot, we are conditioning our global inflation forecasts on a path for Brent that settles around an average of $70 pb by mid 2024, slightly higher than our previous expectation of $65 pb.

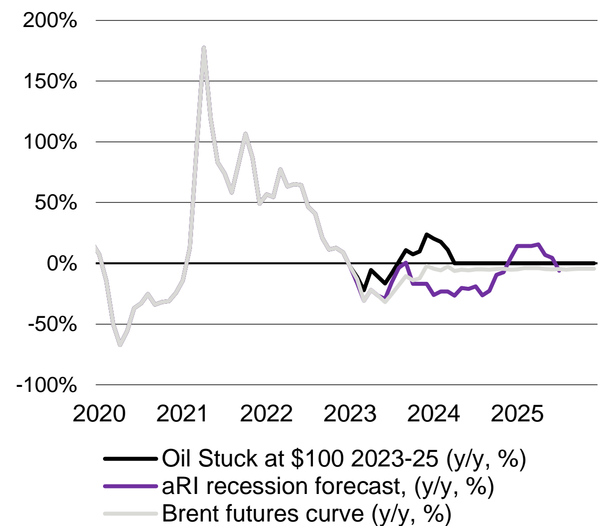
Figure 3: Oil price supply and demand balance – China's reopening to be offset by US recession



Source: abrdn, March 2023

The impact of energy prices on headline inflation is likely to come from strong negative base effects following the pandemic and war-related energy price surge. Our expected oil price path exacerbates these negative base effects.

Figure 4: Base effects from oil prices will contribute to disinflation despite the China boost



Source: Haver, Bloomberg, abrdn, March 2023

Figure 4 compares the outlook for oil prices under three scenarios. The first one simply follows the pricing signalled in the futures market. The second shows the abrdn Research Institute outlook including the impact of our recession forecast in purple. The final one assumes that Brent reaches $100 and remains stuck there, which still shows that the overall impact on the energy component within CPI measures will swiftly unwind.

Supply outlook remains tight but largely as expected and priced in

The supply outlook for energy remains broadly unchanged from Q4, with tight global oil supplies ahead. OPEC cuts may stay in place at least for the first half of the year.

Much of the growth in supply for this year is expected to come from non-OPEC producers such as US, Brazil, Norway and Canada.

The impact of G7 price caps on Russian crude oil ($60 pb), diesel and refined petroleum products ($100 pb) are expected to be limited as the prices are set at a relatively high level, and the main customers such as China and India are unlikely to comply.

Russia's recent announcement to cut oil production by 500k barrels per day in retaliation to the G7-led sanctions and price caps had a limited impact on prices. Russia was already facing challenges sustaining output following technology sanctions, making it difficult for Russian firms to access key equipment for maintenance.

There are also incentives for Russian firms to reduce international crude sales and instead refine into diesel given the price cap structure. The production cuts seemed largely in line with market expectations.

Investment implications

- Even as bank-stock-related volatility subsides, spillovers from China reopening may not be as exciting as initially signalled in the commodity market reaction.
- China's fuel inventories built during the zero-Covid era and will limit some near-term upside.
- China's fuel demand will likely rotate away from naptha and LPG, driven by global demand for goods towards transport fuels, meaning that overall energy demand may not increase as much as the growth surge itself might indicate.
- Nonetheless, pent-up demand for travel will likely boost fuel demand around Q2, and we have conditioned our inflation forecasts on Brent rising to $95. There are substantial near term risks considering the tightening of financial conditions following the deterioration in risk sentiment around banking sector.
- Ultimately, the onset of the US recession is expected to offset any demand boost from China, pushing energy prices lower. Following an undershoot as the global economy bottoms out, we use Brent settling around $70 by mid 2024 in our global inflation forecasts.

Author

Sree Kochugovindan

Important Information

For professional and Institutional Investors only – not to be further circulated. In Switzerland for qualified investors only.

Any data contained herein which is attributed to a third party ("Third Party Data") is the property of (a) third party supplier(s) (the "Owner") and is licensed for use by abrdn**. Third Party Data may not be copied or distributed. Third Party Data is provided "as is" and is not warranted to be accurate, complete or timely. To the extent permitted by applicable law, none of the Owner, abrdn** or any other third party (including any third party involved in providing and/or compiling Third Party Data) shall have any liability for Third Party Data or for any use made of Third Party Data. Neither the Owner nor any other third party sponsors, endorses or promotes any fund or product to which Third Party Data relates. **abrdn means the relevant member of abrdn group, being abrdn plc together with its subsidiaries, subsidiary undertakings and associated companies (whether direct or indirect) from time to time.

The information contained herein is intended to be of general interest only and does not constitute legal or tax advice. abrdn does not warrant the accuracy, adequacy or completeness of the information and materials contained in this document and expressly disclaims liability for errors or omissions in such information and materials. abrdn reserves the right to make changes and corrections to its opinions expressed in this document at any time, without notice.

Some of the information in this document may contain projections or other forward-looking statements regarding future events or future financial performance of countries, markets or companies. These statements are only predictions and actual events or results may differ materially. The reader must make his/her own assessment of the relevance, accuracy and adequacy of the information contained in this document, and make such independent investigations as he/she may consider necessary or appropriate for the purpose of such assessment.

Any opinion or estimate contained in this document is made on a general basis and is not to be relied on by the reader as advice. Neither abrdn nor any of its agents have given any consideration to nor have they made any investigation of the investment objectives, financial situation or particular need of the reader, any specific person or group of persons. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the reader, any person or group of persons acting on any information, opinion or estimate contained in this document.

This communication constitutes marketing, and is available in the following countries/regions and issued by the respective abrdn group members detailed below. abrdn group comprises abrdn plc and its subsidiaries:

(entities as at 28 November 2022)

United Kingdom (UK)

abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated in the UK by the Financial Conduct Authority.

Europe[1] , Middle East and Africa

[1] In EU/EEA for Professional Investors, in Switzerland for Qualified Investors - not authorised for distribution to retail investors in these regions

Belgium, Cyprus, Denmark, Finland, France, Gibraltar, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, and Sweden: Produced by abrdn Investment Management Limited which is registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL and authorised and regulated by the Financial Conduct Authority in the UK. Unless otherwise indicated, this content refers only to the market views, analysis and investment capabilities of the foregoing entity as at the date of publication. Issued by abrdn Investments Ireland Limited. Registered in Republic of Ireland (Company No.621721) at 2-4 Merrion Row, Dublin D02 WP23. Regulated by the Central Bank of Ireland. **Austria, Germany**: abrdn Investment Management Limited registered in Scotland (SC123321) at 1 George Street, Edinburgh EH2 2LL. Authorised and regulated by the Financial Conduct Authority in the UK. **Switzerland**: abrdn Investments Switzerland AG. Registered in Switzerland (CHE-114.943.983) at Schweizergasse 14, 8001 Zürich. **Abu Dhabi Global Market ("ADGM")**: Aberdeen Asset Middle East Limited, 6th floor, Al Khatem Tower, Abu Dhabi Global Market Square, Al Maryah Island, P.O. Box 764605, Abu Dhabi, United Arab Emirates. Regulated by the ADGM Financial Services Regulatory Authority. For Professional Clients and Market Counterparties only. **South Africa**: abrdn Investments Limited ("abrdnIL"). Registered in Scotland (SC108419) at 10 Queen's Terrace, Aberdeen AB10 1XL. abrdnIL is not a registered Financial Service Provider and is exempt from the Financial Advisory And Intermediary Services Act, 2002. abrdnIL operates in South Africa under an exemption granted by the Financial Sector Conduct Authority (FSCA FAIS Notice 3 of 2022) and can render financial services to the classes of clients specified therein.
GB-150323-189532-1