Research Institute - Insight

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#Global / #Inflation / #Asset prices

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Is global disinflation under threat from commodity shocks?

Global headline inflation pressures have eased as base effects dragged the contribution of food and fuel to inflation lower. However, a resurgence in energy prices and the increasing risk of El Niño weather patterns caution against thinking inflation risks have decidedly ebbed. While these trends are unlikely to derail the improvement in inflation, they could slow the pace of disinflation.

Key Takeaways

- Global headline inflation has eased year to date, but a resurgence in energy prices and the threat to food prices from El Niño weather patterns threatens this disinflationary trend.
- Tighter energy supply, a recovery in Asian travel demand, and the resilience of the US economy could keep oil prices higher and lead to spikes in LNG prices.
- Meanwhile, agricultural prices face three threats: political risks in Europe, El Niño weather patterns, and disruptions to supply driven by policy responses to the first two.
- Although workarounds have been found to reduce the impact of the Russia-Ukraine war on food supply, El Niño-related disruptions could lead to sudden bouts of food price inflation.
- While these commodity price risks are unlikely to reverse the course of global disinflation, they could delay easing cycles, particularly in emerging markets more vulnerable to such shocks.

Helpful commodity base effects under threat

Pandemic-related shocks to demand and supply resulted in a sharp rebound in global commodity prices through 2021. This was further exacerbated by Russia's invasion of Ukraine in early 2022 providing another shock to global commodity markets.

The effects of these surges are still evident in elevated global headline inflation numbers. But favourable base effects have begun to take hold, helping to cool global headline inflation (see Figure 1). However, risks are emerging that could disrupt this process and lead global inflation to remain higher for longer.

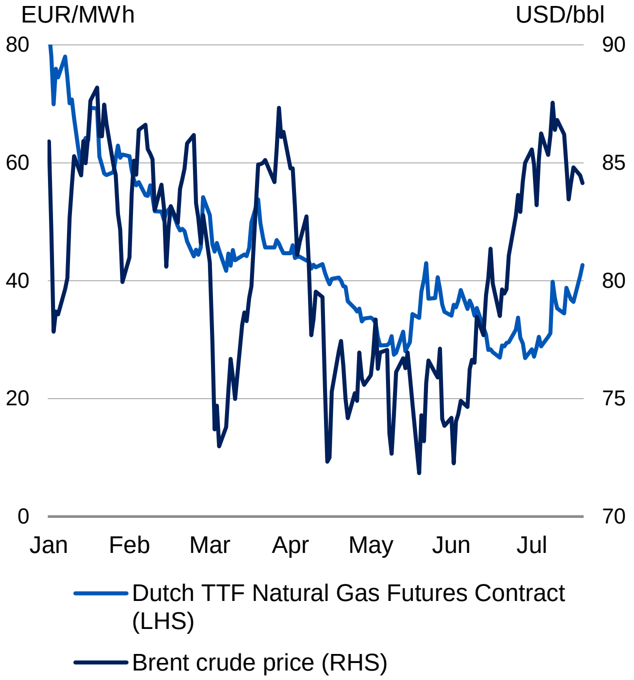
Figure 1: Commodity base effects driving inflation

Source: Haver, abrdn, August 2023

Tighter energy supply backdrop

Global energy supply is tight. Most recently, the threat of industrial action at Australian liquefied natural gas (LNG) export terminals triggered a spike across global LNG benchmarks, including Dutch TTF prices (see Figure 2). Australia's Wheatstone and Gorgon LNG facilities contribute almost 10% to global LNG supply, with potential spillovers across the energy complex.

Figure 2: Energy prices have been rising again



Source: Bloomberg, abrdn, August 2023

A drop in shipments would further tighten markets ahead of the high demand during the Northern Hemisphere winter. That said, given the importance of the facilities, and progress in talks, prolonged strikes are unlikely.

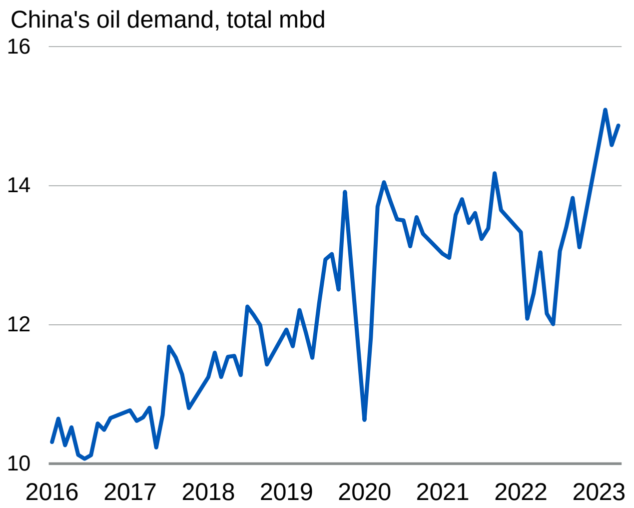
The crude oil rally started as early as June, supported by a combination of market deficit and positive economic sentiment. Moreover, Saudi Arabia implemented supply cuts of 1 mbd in July and August, leaving its oil supply at 9 mbd during this period. These cuts were extended into September.

Over the past year, OPEC+ production cut announcements have not been a major driver of oil prices. But combined with resilient US economic data and growing optimism about the possibility of a soft landing, they have helped keep the market tight and support prices.

Asia has driven the recent recovery in oil demand

The outlook for China is also a key driver for energy prices. China's oil demand is currently at or near all-time highs according to Bloomberg estimates (see Figure 3), with crude oil, LNG and coal imports all sharply higher year to date.

Figure 3: Chinese oil demand supporting prices



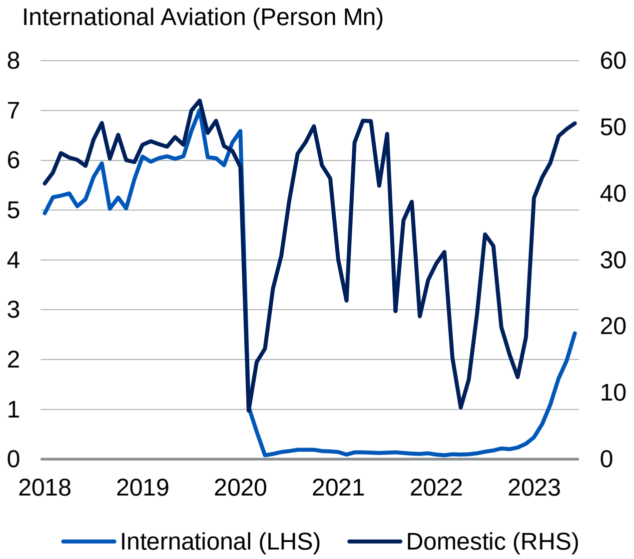
Source: Bloomberg, abrdn, August 2023.

Note: Total apparent Chinese oil demand is the combination of oil processing volume and net import of refined petroleum oil.

More recently, Chinese goods trade data, industry and real estate disappointed. As such the strength in energy demand from stock building in oil and coal cannot be relied upon to sustain the energy price rally.

However, travel related demand for fuel is likely to remain strong. We had previously flagged the potential for summer holiday travel to support jet fuel and diesel demand. Domestic air travel in China has recovered to pre-pandemic levels and international travel is making a steady recovery (see Figure 4). Leading indicators point to a continued pick-up in international travel over the summer months.

Figure 4: Chinese tourism recovery still underway



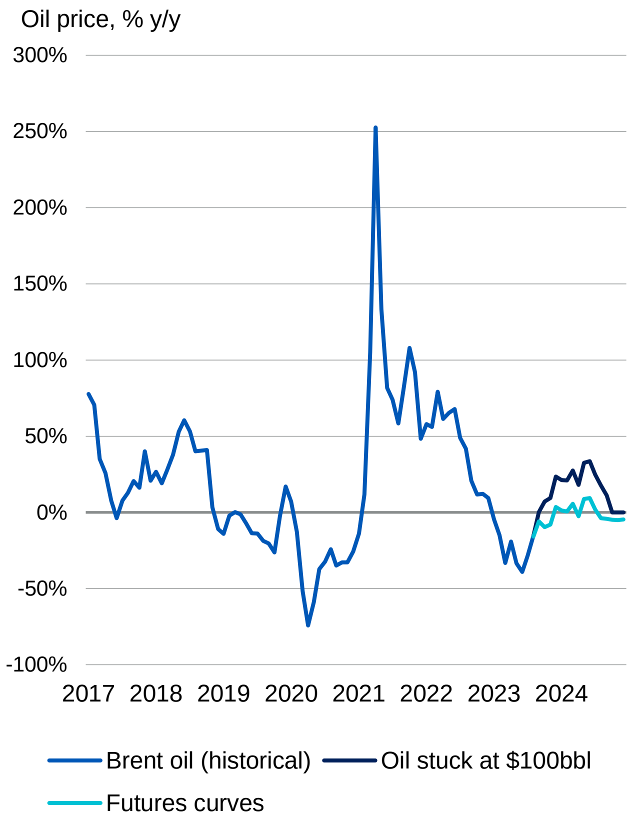
Source: Haver, abrdn, August 2023

Moreover, the recent relaxation of visa rules for business travel and the removal of restrictions on Chinese group travel will likely help support international travel over the coming months. And a new agreement between the US and China is set to increase round-trip flights from 12 to 24 per week starting October 29. Admittedly, services between US and China had averaged 340 per week prior to the pandemic so the absolute level is still very subdued.

Bringing this all together, we expect any further LNG price spikes to be limited and most likely temporary, but a higher range for crude prices ($80-90/bbl) may persist through the summer travel season.

Relative to the negative commodity price base effects during 2023, the inflationary impact of this is likely to be quite limited, although it could slow the pace of disinflation (see Figure 5) and the return to target-consistent inflation.

Figure 5: Higher oil prices won't derail, but may slow disinflation trend



Source: Haver, abrdn, August 2023

Political risks return to haunt agriculture prices

Agriculture prices had stabilised this year following a turbulent period in response to the pandemic and Russia's invasion of Ukraine. However, concerns around supply disruptions have risen again in recent months.

In particular, since the launch of the Ukrainian counter offensive in June, Black Sea transit routes for agricultural commodities have become increasingly exposed to the conflict. Russia has withdrawn from the U.N.-brokered Black Sea grain deal, which allowed grain to leave blockaded Ukrainian ports and has thus far shown little interest in rejoining.

Russia's withdrawal from the deal is not hugely significant in and of itself. The deal had been functioning poorly in the months before its collapse and the majority of Ukrainian grain is now transported overland via European 'solidarity lanes'.

However, with both sides now escalating the scope of the conflict, tail risks to grain supply are growing. Russia has increasingly targeted Ukrainian grain storage and export infrastructures along the Black Sea and the Danube, which have increased in importance as export routes.

Ukraine declared the waters around Russia's Black Sea ports a "war risk area" from August 23 "until further notice." The zone includes major Russian ports like Novorossiysk, Anapa, Gelendzhik, Tuapse, Sochi and Taman. Ukraine recently conducted a drone strike on an oil tanker near Novorossiysk, signalling that it is willing to target Russian exports in retaliation.

In July, 59 million barrels of crude – a third of overall exports – were shipped from Novorossiysk. 32 million barrels went to EU countries. The port also handles diesel, gasoil and naphtha as well as grain. It is also where the Caspian Pipeline Consortium oil conduit terminates, which brings up to 1.3 mbd of oil from Kazakhstan.

Meanwhile, broader European politics presents a further risk. In April concerns over falling prices for domestic grain led Poland, Slovakia, Romania, Bulgaria and Hungary to pressure the European Commission to introduce a temporary ban on the import of Ukrainian grain in exchange for member states allowing grain to be transported through their countries. The ban is due to expire on 15 September. Poland in particular is pushing for an extension, and the upcoming Polish election on October 15 means the ruling PiS government is keen to retain the support of farmers, making compromise unlikely.

All member states will have to agree on any extension to the current import controls. This is likely, as the most affected member states have already stated they will request a renewal. Other member states, including France, have criticised the arrangement, which they argue gives special treatment to member states willing to ignore EU regulations. Poland, however, has stated that it will not lift the import ban even if the restrictions are lifted, a move which would violate EU law. Failure to agree an extension to the current arrangement would risk disrupting the movement of grains through European solidarity lanes.

El Niño risks ahead for food inflation

El Niño occurs every two to seven years when the sea surface temperatures warm above average, and air pressure drops over large parts of the Pacific Ocean.

Figure 6 shows significant El Niño episodes can push food prices higher. The NOAA Oceanic Niño index is the official indicator for monitoring climate patterns. 1.5 degrees Celsius or larger increases in this indicator have been associated with strong El Niño events. These have happened once or twice a decade since the 1950s, most recently in 2009 to 2010 and 2015 to 2016. Risks are elevated this year, as climate scientists have warned of a particularly strong El Niño event developing.

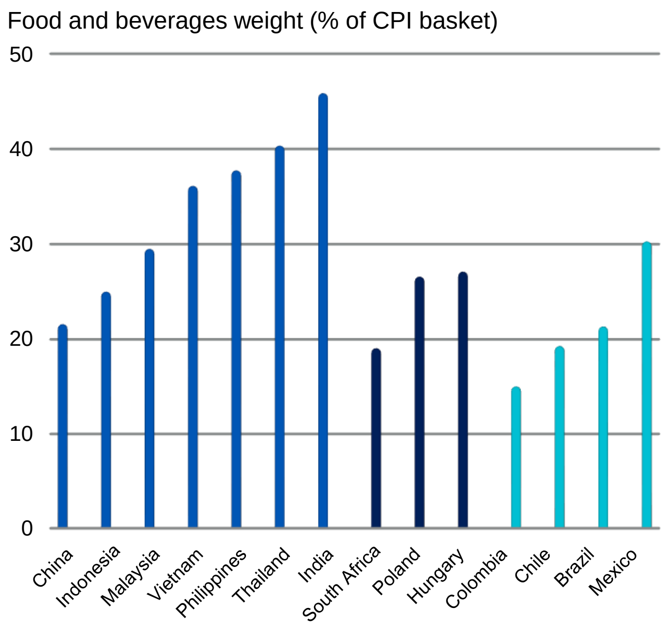
In 2009-2019, El Niño and La Niña effects, alongside growing demand from EMs, contributed to higher food inflation. However, falling oil prices helped ease transport, fertiliser, and production costs, offsetting the El Niño impact.

There are potentially strong repercussions in agricultural production across Latin America and emerging Asia. In particular, India is vulnerable to an El Niño shock, given agriculture makes up 18% of its economic output and 42% of employment – higher than other major EMs.

Food is a larger share of emerging market consumer price index baskets relative to more developed markets. Reported inflation in India, Mexico, Philippines, Thailand and Vietnam is particularly vulnerable to a sharp rise in food prices given the weight in CPI baskets (see Figure 7). The use of price caps, export bans and stockpiles often form part of the policy response to food price spikes. Such measures can reduce the impact on domestic food prices or smooth some of the price increase over a longer period, helping to reduce pressure on households.

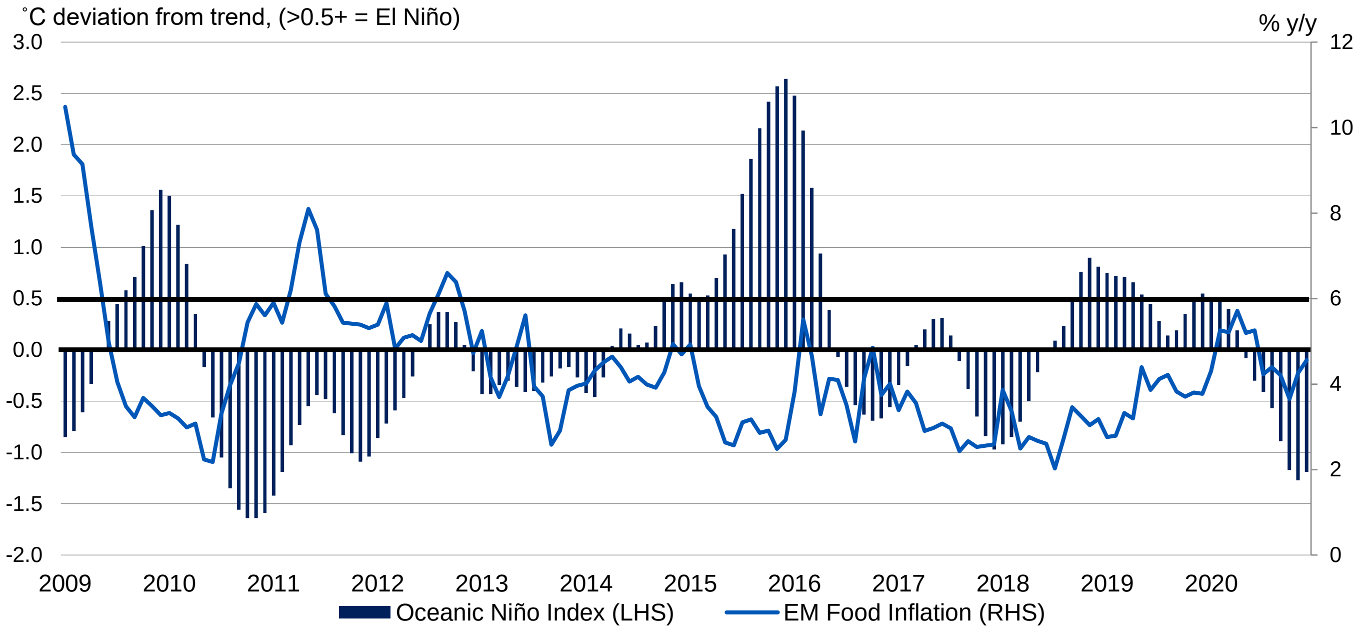
India has already extended restrictions on wheat exports, as well as bans on rice and sugar exports to combat recent food inflation. The impact has already been seen in Thai rice prices, which have risen in response to tighter supply. In contrast, Brazil's strong crop harvest in the first half of 2023 has helped to cool domestic food prices and increase agricultural exports.

Figure 7: Some EMs more vulnerable to food inflation



Source: Haver, CEIC, abrdn, August 2023

Figure 6: Significant El Niño events can drive food inflation but other factors can prove an offset

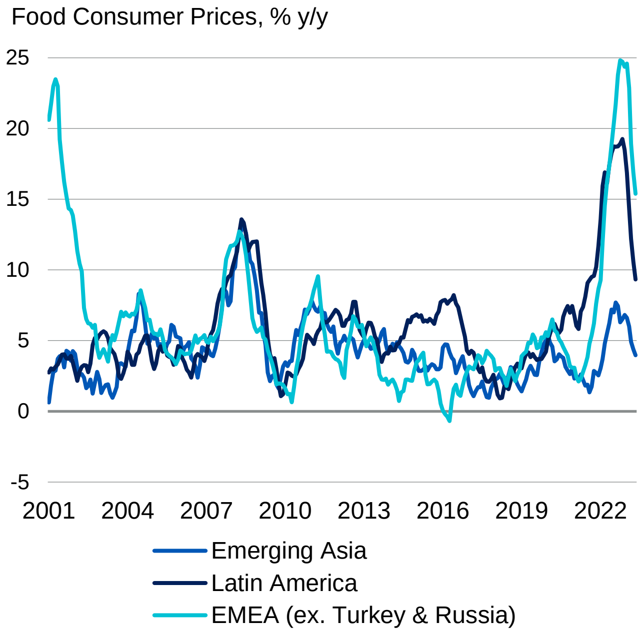


Source: Haver, Climate.gov, abrdn, August 2023

Food inflation could delay EM rate cuts

As such, the threat from El Niño will vary by market. Food prices are already elevated and disinflationary pressures following the surge in prices in 2022 will be strong (see Figure 8).

Figure 8: Food disinflation could slow



Source: Haver, abrdn, August 2023

EM central banks hiked aggressively in response to the surge in inflation during 2022 and only the most aggressive hikers (such as Brazil, Chile and Hungary) have begun easing cycles as inflationary pressures have receded.

As such, we do not expect further hikes in the event of food prices spikes. But central banks, particularly in emerging Asia and LatAm, could potentially delay easing cycles and cut less than markets have priced.

For example, the Philippines and Mexico are two markets where rate cuts are expected before the end of the year but are both vulnerable to food inflation. The Philippines' reliance on food imports and high CPI weighting for food could delay rate cuts. In Mexico, food inflation spills into core inflation measures and could have a large effect on overall inflation than suggested by the headline basket weighting for food.

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