OCTOBER 6, 2021

Investment Strategy Commentary: The Energy Challenge

As energy prices climb and temperatures fall, our views on inflation and growth are put to the test. Find out how the spike impacts our outlook.

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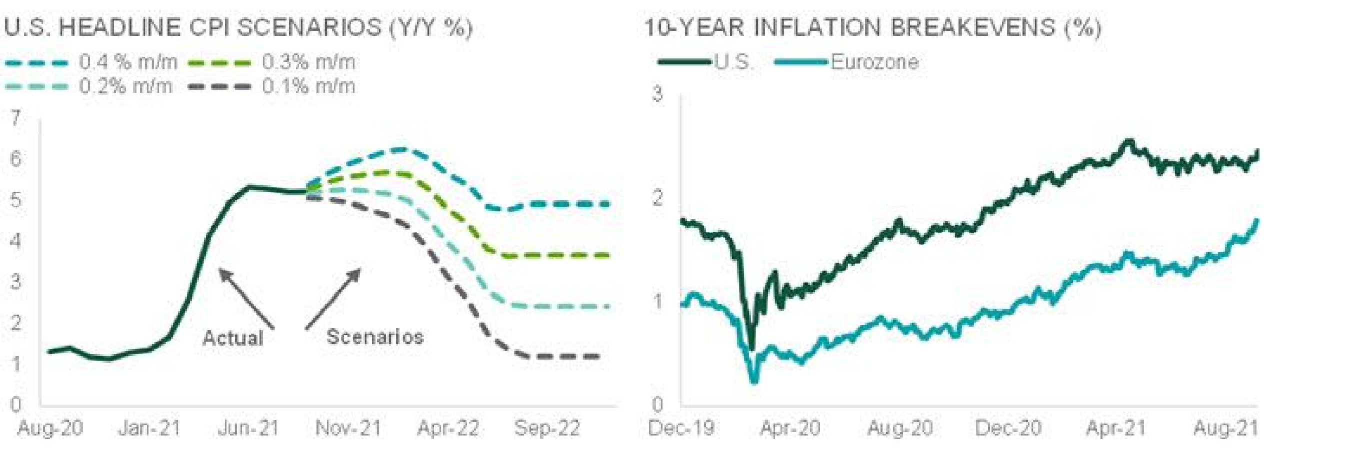
Energy prices have moved sharply higher over the last six months, with natural gas at the forefront. A combination of factors is behind the surge: a rebound in global demand, energy companies ranking capital discipline over production, lower power from wind farms, lower gas production due to maintenance challenges and lower storage levels due to a cold spring. Even more, swing producers like Russia are currently unwilling to deliver more than contractually obligated. With winter fast approaching, worries about potential shortages have created an unusually large and prolonged price surge. This poses a challenge to our inflation and growth outlook.

The INFLATION IMPACT

One of the drivers of our transitory inflation view is the expectation that the base level effect from a rise in energy prices from the depths of the pandemic to today will fade away in 2022. As a reminder, the price of a barrel of Brent crude oil fell to roughly $20 in April 2020 and has since risen to roughly $80 today. And even though energy only has a 9.5% weight in the Eurozone Consumer Price Index (CPI) basket, and 7.2% in the U.S., these big price swings dragged inflation down meaningfully in 2020 and up in 2021. In fact, half of the Eurozone's latest 3.4% year-over-year (y/y) rise in CPI came from energy alone, and for the U.S. it was roughly a third. However, we do not expect energy prices to keep rising at the pace of the last twelve months, so their impact on overall inflation should fade in 2022, bringing headline CPI down notably. The challenge the latest rise in energy prices poses is that the timeline for that base level effect to kick in is being extended further into 2022. Financial markets have so far been sanguine about this 'transitory for longer' period. Inflation expectations have increased only a little bit in the U.S. and Eurozone and are still at modest levels.

EXHIBIT 1: KEEPING UP WITH TODAY'S INFLATION

To maintain today's high inflation rates, prices would need to repeatedly increase 0.4% m/m. Investors assign a low probability to this.



Source: Northern Trust Asset Management, Refinitiv, Bloomberg; m/m = month-over-month. Left: historical data from 8/31/2020 through 8/31/2021; scenarios through 12/31/2022. Right: inflation breakeven rates from 12/31/2019 through 10/5/2021.

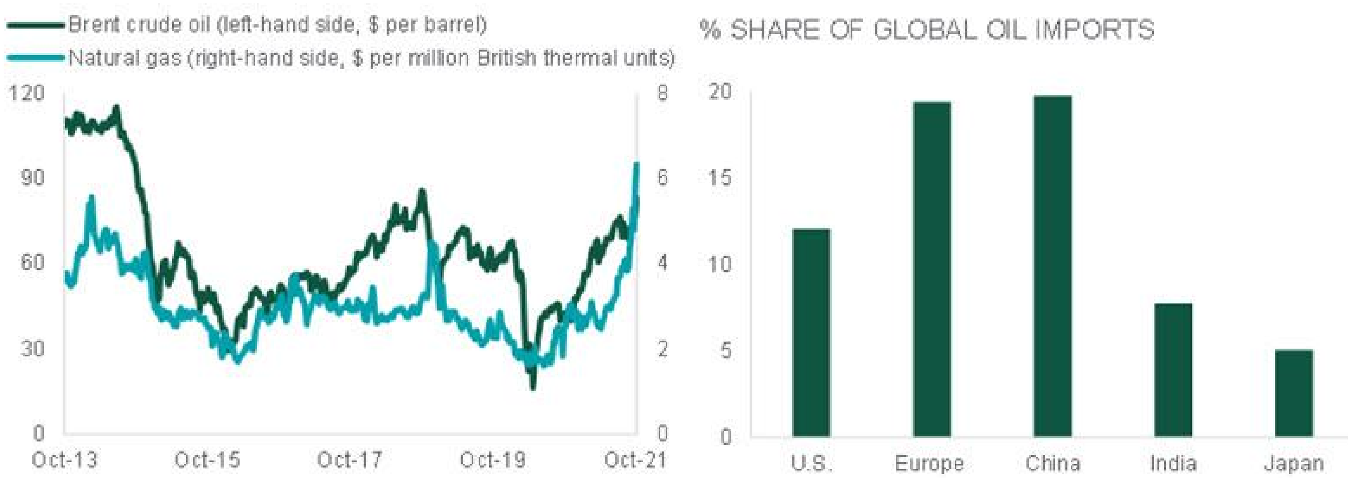
THE GROWTH IMPACT

The negative impact of higher energy prices on economic activity manifests through headwinds to consumers and producers. Consumers have to divert disposable income from other places to pay for more expensive energy. Producers face higher input costs depending on how much energy they need to manufacture their goods or deliver their services. That being said, it is important to recognize that in the U.S., household energy represents only 3.4% of CPI and roughly 3% of disposable personal income. Consumer spending has become less vulnerable to oil shocks over the past decade. With today's elevated consumer savings levels, the impact of rising energy prices on consumer spending may be even less noticeable. As for producers, for the vast majority energy is only a small part of their cost base relative to, for instance, labor. Only in very specific industries like the production of fertilizer, chemicals, metals and cement is the negative economic impact substantial. Altogether, this means that as a base case we don't expect the energy price surge to derail the economic recovery.

Of course, there is also a risk case. If we get a particularly cold winter and none of the other factors behind the price surge improve we could see actual energy shortages. If that were to occur, it would induce shutdowns across meaningful parts of the economy and the economic recovery would be dealt a severe blow. But it should be clear that seasonally colder weather is not here yet, and countries will likely take action to mitigate the impact under this scenario (see next section).

EXHIBIT 2: RISING PRICES, CONTAINED ECONOMIC IMPACT

Barring broad outages, we expect a manageable global growth impact from rising energy prices.



Source: Northern Trust Asset Management, BP Statistical Review (2020), Refinitiv. Energy price data from 10/1/2013 through 10/5/2021.

The POLICY RESPONSE

We expect policymakers will aim to ease economic headwinds in regions where rising energy prices are a drag. For example, China, which was running very low on coal, has started to take mitigating action by restarting coal imports from Australia. We expect other countries to follow suit, whether it's by providing financial support or pressuring Russia and the rest of OPEC+ to ease the shortages.

We noted that inflation expectations are still at modest levels. That could come under strain if higher energy prices trigger a hawkish change in monetary policy. So far central banks have shrugged off rising energy prices. Their approach may change if they see it triggering a rolling wave of price increases in other parts of the economy. For us, this is a risk case but not a base case. Central banks are well aware that tighter monetary policy is not going to bring down energy prices that are driven by idiosyncratic factors. Nor will they ignore economic headwinds from higher energy prices.

CONCLUSION: TRANSITORY INFLATION FOR LONGER, MODEST GROWTH HEADWIND

The latest surge in energy prices means transitory inflation will endure longer. But, beyond the first quarter of 2022 we still expect inflation to come down and for central banks to recognize this. Current natural gas market dislocations are serious and the outlook depends on difficult-to-predict factors such as the degree of colder weather and the willingness of Russia to boost production. If the rumors are true that Russia is using this price surge to get the new Nord Stream 2 pipeline operational more quickly, a deal to boost output could be struck. And with natural gas prices now reaching the equivalent of an oil price of more than $200 a barrel, substitution efforts should ramp up.

The growth outlook for energy-importing economies like the Eurozone, U.K., Japan, China and India has worsened somewhat. Higher energy prices will weigh on these non-U.S. consumers and producers alike. However, the impact should not be exaggerated. Energy is a relatively small part of the consumption basket and the total price of production. And hedges in the form of long-term energy contracts are softening the blow. Only in very specific industries is the impact material. Policymaker support should also help mitigate the fallout. We remain constructive on global economic growth.

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