

US Economic Comment

Oil price weakness and the CPI

Economics

Americas

CPI still estimated at 2.2% (Q4/Q4) in 2016 but raised 0.3pt to 2.7% in 2017

UBS oil analysts cut their Brent oil price forecasts for the end of this year to \$49/bbl from \$60.00, cut the 2017 average to \$55.00 from \$70.00, and trimmed 2018 to \$70.00 from \$75.00. The lower prices reflect "weaker current prices & expectations that a recovery will be hindered until global inventories begin to drawdown in 2H16". Please see "Answers to the Most Frequently Asked Oil and Gas Questions", [LINK](#).

Our forecast for 2016 CPI is unchanged at 2.2% (Q4/Q4), close to the 2.1% pace for the core CPI. (We had marked to market along the way; y/y estimated CPI energy price changes are little different, but from a lower base.) However, for 2017, we now project a larger boost from energy, with headline CPI up 2.7% versus our earlier 2.4% forecast and versus a 2.3% core CPI. (Table below.)

How sensitive to oil prices are our CPI estimates?

We simulated high price and low oil price scenarios:

The low price scenario: Futures imply Brent oil prices at \$37.08 at the end of this year and at \$40.70 in 2017. These would trim 0.7 pct pt from our 2016 CPI inflation estimate, implying 1.6%/y/y in Q4. They would trim 0.3 pt from our 2017 estimate, implying 2.4% in Q4.

The high price scenario: We allow for a faster return to normalized prices—by mid-2017. UBS oil analysts put those longer-run normalized prices at \$75.00/bbl. This would add 0.3 pct pt to our 2016 CPI inflation estimate, implying 2.6%/y/y in Q4. It would add a further 0.1 pt to our 2017 estimate, implying 2.8%/y/y in Q4.

TIPS breakevens continue to underprice inflation

TIPS breakevens continue to underprice projected inflation by over 1% in annual terms in January 2017-and January 2018. Even in the low oil price scenario, TIPS breakevens underprice inflation by 0.5-0.8 pct pt. (More below.) Please see our CPI/TIPS modelling tool [LINK](#).

Oil sensitivity of UBS CPI estimates:

Relative to our estimates for 2.2% CPI inflation in 2016 (Q4/Q4) and 2.7% in 2017, oil futures markets imply ½ pt less boost to the CPI from oil this year and ¼ pt less next year. A faster return to "normalized" oil prices (\$75/bbl) would be consistent with inflation 0.3 pct pt faster this year and 0.1 pt faster next year.

	Low prices (based on futures)	UBS estimate	Higher prices (faster return to "normalized")
CPI (Q4/Q4 % ch)			
2016e	1.6%	2.2%	2.6%
2017e	2.4%	2.7%	2.8%
Brent (\$/bbl)			
2016e	\$33.95	\$42.50	\$51.37
2017e	\$40.70	\$55.00	\$72.43

Source: UBS estimates, Bloomberg

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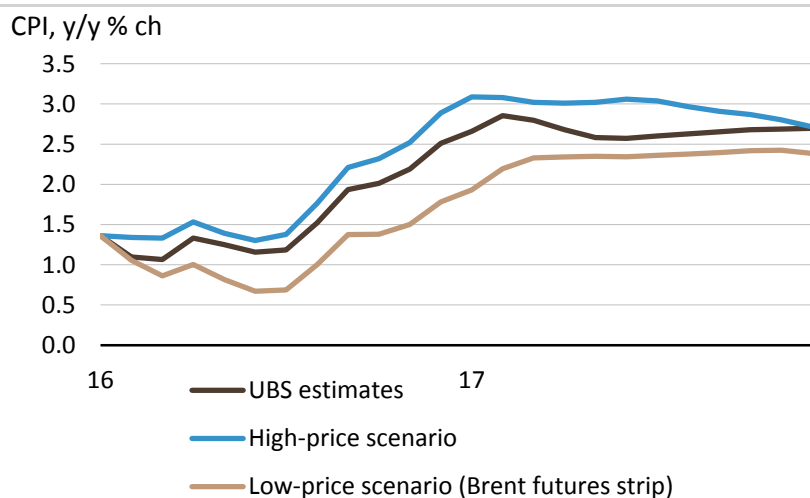
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Oil and gasoline prices and the CPI

Oil futures prices, if realized, would hold the CPI to below a 2% pace in 2016 but point to acceleration to a 2.4% y/y pace in 2017.

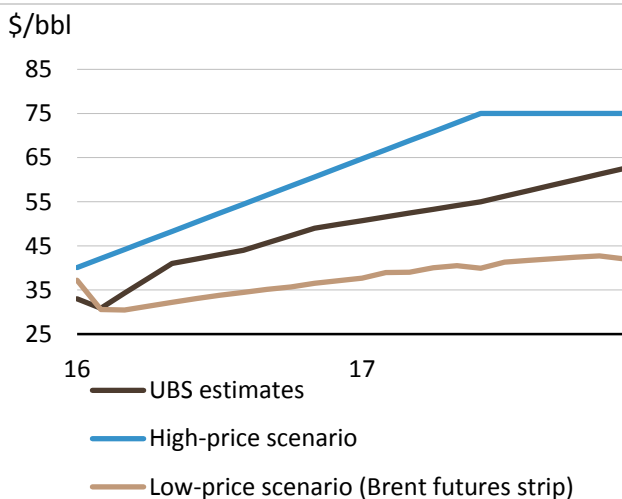
UBS estimates CPI up 2.2% in 2016 (Q4/Q4) and 2.7% in 2017.

Faster normalization of prices toward \$75/bbl would lift CPI inflation into the high 2% in 2016 & 2017.



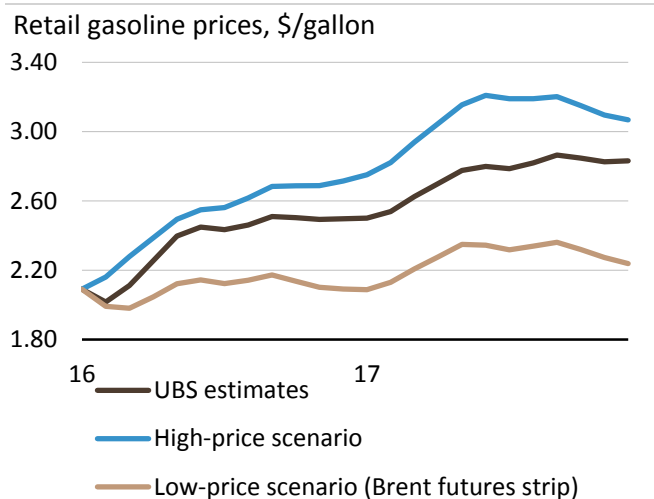
Source: UBS

Brent prices in our three scenarios



Source: UBS, Bloomberg

Estimated retail gasoline prices



Source: UBS, Energy Information Administration

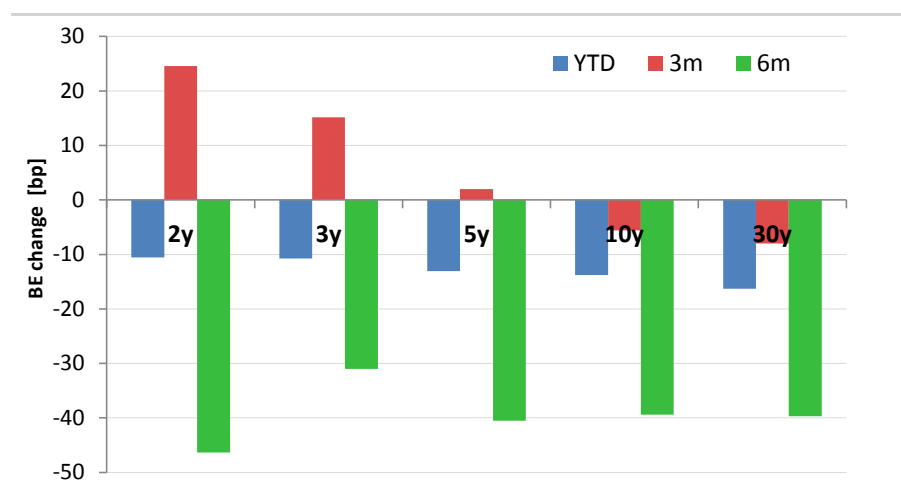
TIPS breakevens continue to underprice inflation

We have incorporated the updated CPI forecasts into our TIPS front-end breakevens interactive model ([LINK](#)). Breakevens continue to underprice projected inflation by over 1% in annual terms. The January 2017 TIPS BE implies 0.7% y/y inflation vs. our 2.1% January forecast while the January 2018 implies 1.0% vs. our 2.4% estimate.

BEs still undervalue inflation estimates even in the low oil price scenario. Plugging futures implied oil prices trims that gap to estimated inflation to a still large 0.5-0.8 pct pt range in the January 2017 to January 2018 period.

While BEs have declined by over 30bp since July 2015 following the sharp oil price drop that month, front-end BEs, such as the 2y and 3y, had been richening towards the end of 2015 (see chart). Investors began to anticipate fading of the low oil price base effect and the prospect of improving TIPS carry under the assumption of stabilization in oil prices. Notably, renewed declines in oil since late December have put BEs under pressure, and delayed the point when carry will start to turn positive by over a month, to March. Front-end BEs have been relatively resilient over this time, but could be prone to further declines if oil prices continue to slide.

TIPS breakeven changes per maturity, over 3 months, 6 months, and year-to-date



Source: Bloomberg and UBS

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