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Economics Group

Sarah House, Senior Economist
sarah.house@wellsfargo.com • (704) 410-3282
Shannon Seery, Economic Analyst
shannon.seery@wellsfargo.com • (704) 410-1681

Oil Is Back into the Inflation Fold

Outages at Saudi Arabian oil facilities after attacks this weekend have sent oil prices up sharply. The impact to inflation remains small at present, but if persistent it could further challenge real spending as tariffs take hold.

Saturday Night Fever

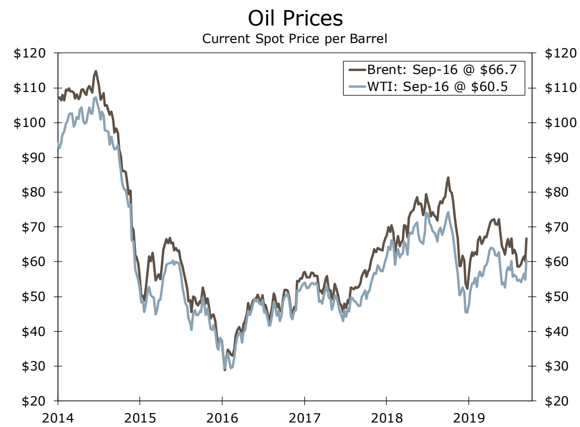
After a relatively calm summer for oil prices, attacks on Saudi Arabian production facilities over the weekend have brought oil back into the spotlight. Saudi Arabia produces about 12% of global oil output and often acts as a stabilizing force among OPEC's production. The weekend's attacks are estimated to have knocked off 5.7 million barrels-a-day of production, or about 5% of global production. While a meaningful share of the market, the outages caused by Saturday's attacks are small when compared to the oil shocks of the 1970s. At the time of the 1973-74 OPEC embargo, the block accounted for about half of global output, representing a much more sizeable shock to the market. Oil prices more than tripled over the 7-month embargo. Following the 1979 crisis, prices more than doubled.

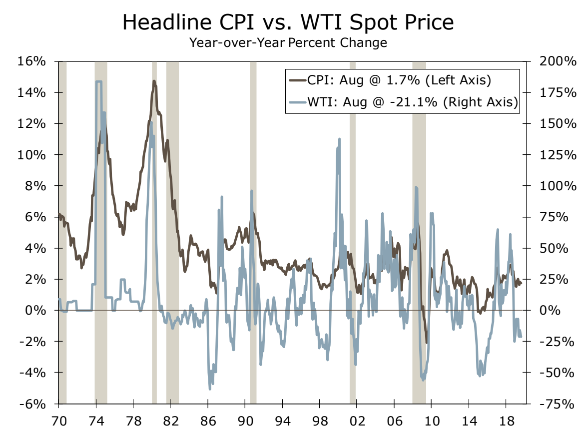
Details on when production might come back online are still light at this time, making it difficult for markets to fully price the impact of the outages on supply going forward. As of this writing, prices for Brent and WTI are both up a little over 10% from their Friday close. While a sharp "one-day" move, that merely puts prices back on par with this past spring's levels.

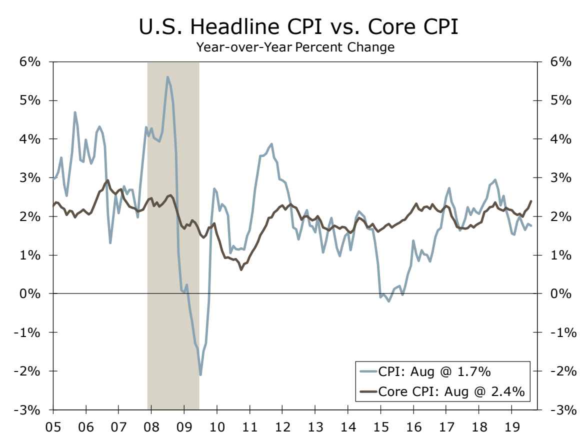
The direct impact to inflation would remain fairly small if oil prices continue to trade near current levels. Based on our model of the Consumer Price Index, a 10% increase in WTI prices is estimated to raise the year-over-year rate of inflation 0.1-0.2 percentage points. That bump would prove temporary as prices ease again after production comes back on line, all else equal. But of course, things are rarely ever equal. This weekend's event brings geopolitical risks for oil prices back to the forefront and raises the potential for prices to stay elevated even as production returns to normal.

If prices remain elevated for an extended period of time, either due to Saudi production taking a while to come back on line or the perception of risks around supply going forward, U.S. production could strengthen further. The impact to other segments of the U.S. economy, however, are less sanguine. While the impact to inflation looks rather small at present, it comes at a thorny time for manufacturers and consumers. Manufacturers reliant on inputs from China have borne the early brunt of the trade war, with many intermediate goods facing 30% tariffs. Producers face the additional costs of needing to reconfigure supply chains at a time when the trade-related disruptions are weighing on global demand and therefore sales.

Consumers have been spared in the early rounds of tariffs. However, there is increasingly less scope for companies to absorb tariffs as rates climb well into double-digits and more consumer goods from China are now directly exposed. As a result, consumers are now facing a dual hit to real spending power; tariffs are beginning to push up core inflation, while energy is no longer a source of disinflation. While not massive at the moment, these forces together create a hurdle for consumers carrying growth when capex spending struggles.







Source: Bloomberg LP, U.S. Department of Labor, IHS Markit and Wells Fargo Securities

Wells Fargo Securities Economics Group

Jay H. Bryson, Ph.D.	Acting Chief Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Macro Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Azhar Iqbal	Econometrician	(212) 214-2029	azhar.iqbal@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Macro Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Brendan McKenna	Macro Strategist	(212) 214-5637	brendan.mckenna@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Jen Licis	Economic Analyst	(704) 410-1309	jennifer.licis@wellsfargo.com
Hop Mathews	Economic Analyst	(704) 383-5312	hop.mathews@wellsfargo.com
Coren Burton	Administrative Assistant	(704) 410-6010	coren.burton@wellsfargo.com

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