Economic Analysis

Oil Prices and Inflation: What's Next for 2015?

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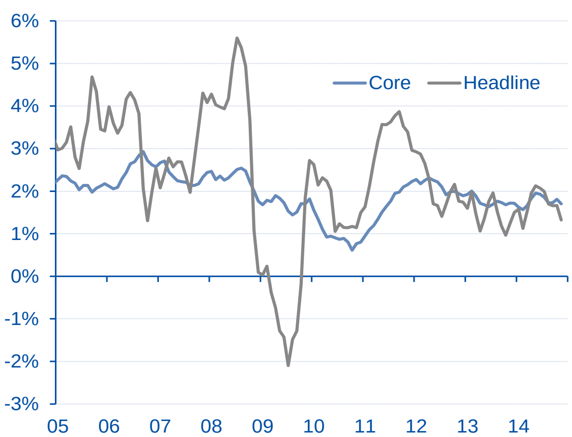
Downward Revision to Inflation Figures but Qualitative Assessment Unchanged

- **Oil prices weighed on CPI inflation in November for the fifth consecutive month, with headline and core CPI down to 1.3% and 1.7% YoY, respectively**
- **Headline and core CPI are expected to average 1.7% and 1.8%, respectively, in 2014**
- **Fed will certainly discuss falling inflation expectations but we do not expect any immediate change to projections for the timing of the first rate hike**

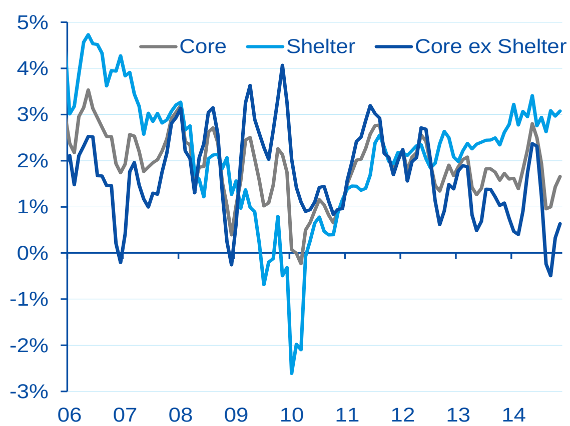
The ongoing decline in oil prices has been dominating economic news throughout the past few months, presenting an uncertain picture of how such deflationary movements will impact the global recovery. November's data mark the fifth consecutive month for oil price declines, with levels down nearly 30% since June. Data for December suggest an even bigger drop, with WTI prices approaching $55/barrel and marking a 47% decline since July 1st. Natural gas prices have also followed suit, taking a sharp downward turn in late November and early December. It is not surprising that this decline in energy prices is having a major impact on headline inflation, but it appears that the pass through to core prices has been relatively limited, at least on the services side. In November, headline CPI declined 0.3% following a flat reading in October, with the energy index down 3.8% to mark the largest monthly drop since the midst of the crisis in 2008. However, food inflation remained stable around the 0.2% monthly pace. Excluding food and energy, core inflation increased a modest 0.1% in November after increasing 0.2% in the previous month. The usual drivers are still at play, with shelter prices up nearly 0.3% and medical care services up 0.4% for the month. While prices for services have held steady, commodity prices (other than energy) are falling. Most notably, apparel prices have declined throughout the past four months, while transportation commodities have been down since September.

Chart 1
Headline and Core Inflation (YoY % Change)



Source: BLS & BBVA Research

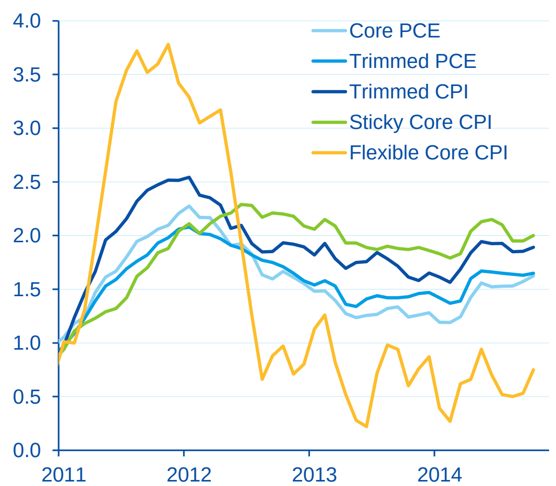
Chart 2
Core CPI and Shelter Inflation (QoQ SAAR % Change)



Source: BLS & BBVA Research

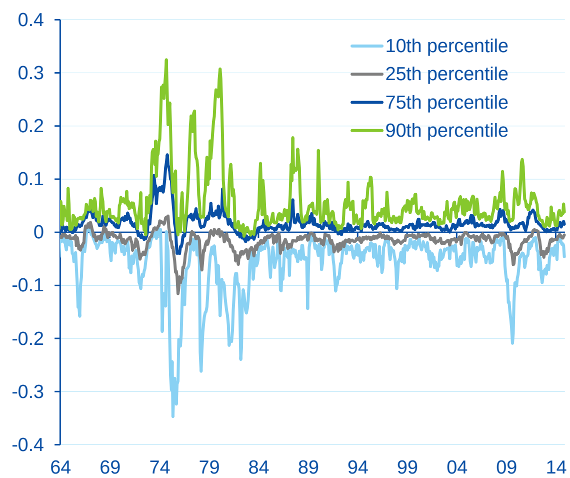
Compared to 12 months ago, the inflation message is clear: headline CPI has decelerated sharply to 1.3% YoY, while core CPI has remained more stable, dropping to only 1.7% in November. Expectations for the ongoing downward pressure on headline inflation prompted a slight revision to both our 2014 and 2015 inflation projections, although our qualitative assessment regarding the path of the inflation rate for the next few years has not changed. Headline CPI will average 1.7% in 2014, rising slightly to 2.0% in 2015. Core CPI will remain slightly higher, at 1.8% in 2014 and 2.1% in 2015. Although no one expected this drastic drop in oil prices, other factors related to inflation are in line with our projections set out earlier this year (see Should Low Inflation be a Concern?). The fact that low inflation in the U.S. is not always associated with slow growth hits close to home, with falling oil prices likely to have a positive impact on 2015 growth while at the same time weighing on inflation. Also, core services have been and will remain the principal contributor to the core inflation rate. Finally, the stabilization of the inflation rate at new historic lows is due to long-term economic structural changes, such as lower costs of production and labor-to-capital ratios driven by globalization and infiltration of technology. Nonetheless, a significant downward revision to our official oil price forecast would cause further adjustments to our overall inflation outlook.

Chart 3
Alternative Measures of Inflation (YoY % Change)



Source: BLS, BEA, FRB, & BBVA Research

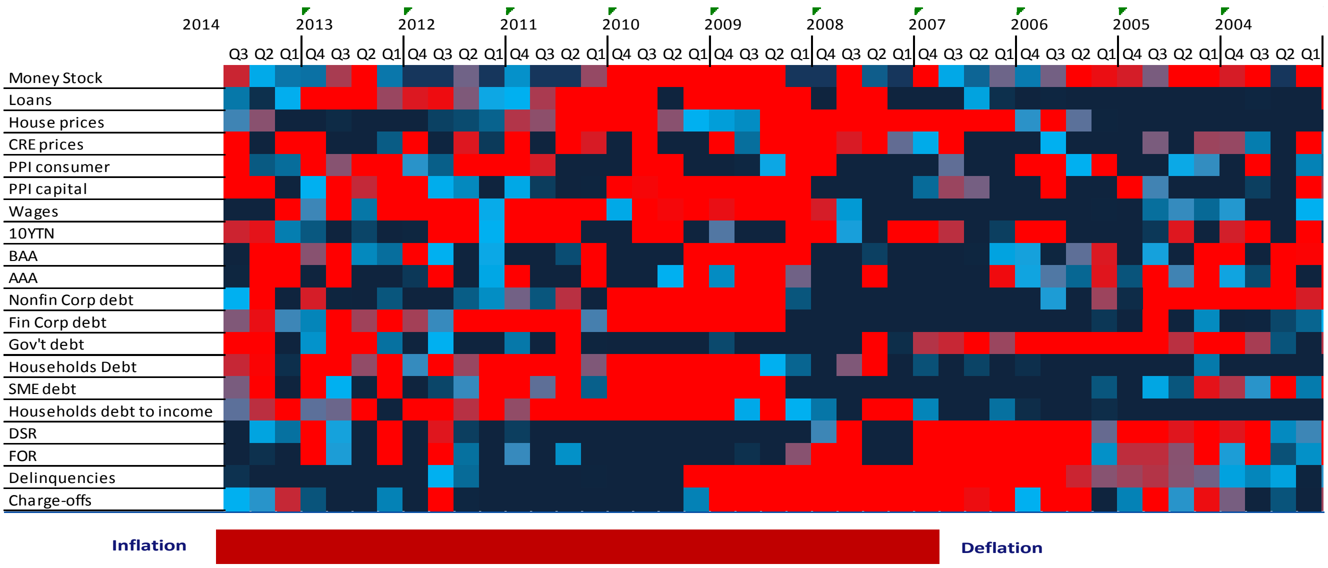
Chart 4
12-Month YoY Relative CPI Price Distribution (YoY % Change Less Year-Ago YoY % Change)



Source: BLS & BBVA Research

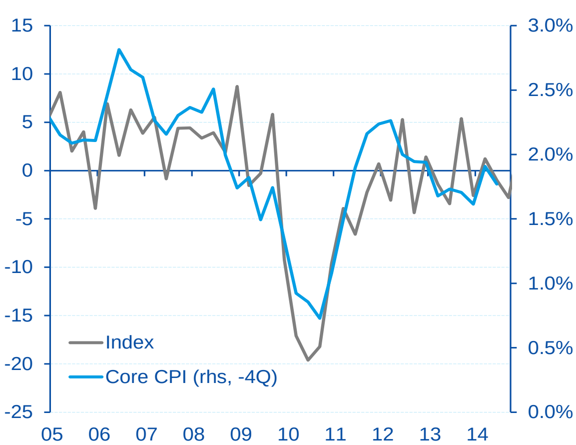
When it comes to the Fed, we expect that discussions will focus on falling inflation expectations and the fact that oil price declines may not be as transitory as originally predicted. However, at this point we do not expect that the FOMC will drastically shift their views on the appropriate timing for the first rate hike, and they will try to avoid implicitly delaying the timing from the current mid-2015 consensus date. Overall, the FOMC will view the favorable consumer and economy-wide growth environment coupled with only short-term transitory downward pressure on headline inflation as a positive scenario. Furthermore, despite continuous downward pressure on inflation, the monetary policy stance of several prominent FOMC members has not changed since the pre-September meeting, and they have shifted their attention beyond the timing of the federal funds rate liftoff (for more details, see our FOMC preview).

Chart 5
BBVA Research U.S. Inflation Heat Map



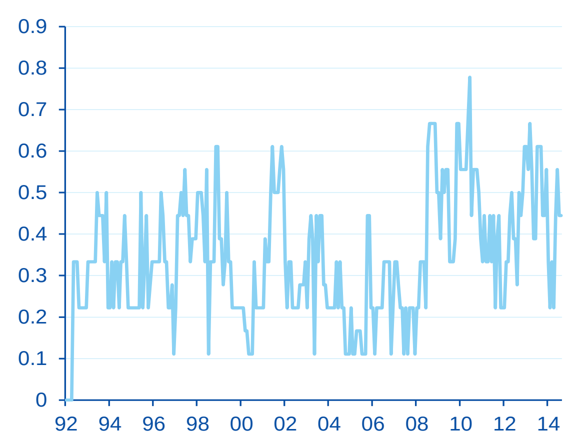
Source: BBVA Research & Haver Analytics

Chart 6
BBVA Research U.S. Inflation Risk Index (Higher Risk<0; Lower Risk>0)



Source: BBVA Research & Haver Analytics

Chart 7
Deflation Vulnerability Index (%)



Source: BBVA Research

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