The implications of inflation

By Simon Marsh and Rachel Winter

The war in Ukraine and tragic human cost is uppermost in everyone's minds at present and will undoubtedly add further uncertainty to the stock market. Even before the Russian invasion, energy prices were surging leading to a debate about how to invest over the long term to beat inflation.

A decade of very low inflation

After ten years of low rates, inflation is now a global issue, with the UK seeing the Consumer Prices Index (CPI) rise by 5.5% in the 12 months to January 2022. Germany's rate stands at around 4.9% and is particularly striking after a period of deflation not too long ago. The rate in the United States is currently around 7.5%.

Is this transitory?

According to Bank of England figures[1], in Q3 2021, countries in the G7 provided 8% more goods when compared with Q4 2019, prior to the pandemic, indicating a substantial spike in demand for goods. As the economy has reopened, the demand for goods and hence this part of inflation, is notably subsiding.

Looking at shipping costs[2], there was a huge increase in 2020 when lockdown started and also in 2021 when the tanker, Ever Given, blocked the Suez Canal – contributory factors to inflation which have now lowered considerably.

However, there are parts of inflation that could potentially persist for longer – such as wage increases, which can't be easily reversed. In the US, wage growth stands at 5.68% and is contributing to higher inflation, but in real terms, wages are falling which could in turn contribute to further inflationary pressures.

How will central banks respond?

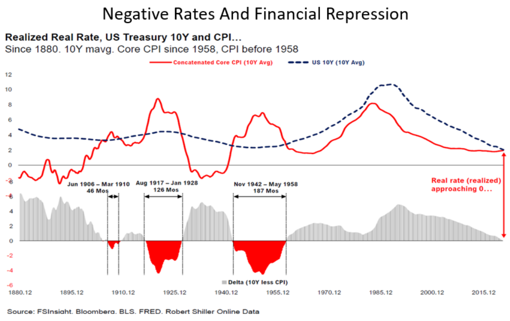
In the US there are calls from bankers and market commentators for significant rises in interest rates to bring inflation back in line; the same dynamics are occurring in Europe and the UK. However central banks need to be careful not to derail economic growth. Historically, the market has rarely predicted rate rises correctly. The level of Base Rate is important for the market as it essentially reduces the value assigned to future cash flows and is a major factor in valuing the equity market. Our view, based on historical evidence and before the situation in Ukraine, is that we may now be at the point of maximum interest rate pessimism.

History tells a story

For savers and investors, this chart is important. It depicts the rolling ten year moving average yield on the US ten-year treasury – the benchmark bond – in relation to US inflation or Core CPI.

The chart shows that there are extended periods of time where the inflation rate runs ahead of the return on the 10-year bonds or the cash equivalent. These periods are shown by the red 'icebergs'.

Such periods happened after World War I and World War II, following a build-up of war debt



and when inflation was allowed to run above the returns available on cash, effectively to inflate away the debt.

The chart shows that we are at the point where rates cross over again. The issue for savers and investors is how this will impact the real value of capital.

Putting aside the atrocities in Ukraine, COVID was our war equivalent from an economic perspective, with governments running up large debts that need to be paid back and the easiest way to achieve that is to let inflation run ahead of the returns obtainable on cash or bonds.

How do equities fare in periods of high inflation?

Other than in periods of deflation, or where inflation runs consistently ahead of 6% for an extended period, equities have performed well. Our view is that inflation over the next five years is likely to be higher than the previous five years.

What should investors do?

Inflation is rising, but we've still got interest rates at very low levels, so that means that anyone holding their money in cash is going to be losing money in real terms. The key question all savers and investors should be asking is whether they are taking enough risk to beat inflation.

Our three-pot approach

We suggest keeping between three- and six-months expenditure in an easily accessible rainy-day account. Then a second pot to cover foreseeable calls on capital over the next couple of years. Over and above these pots are your lifetime savings, where you can try to beat inflation – all dependent on your time horizon, age and of course, your attitude to risk.

When looking at investing in equities, there are certain types that tend to perform better in periods of high inflation or high interest rates. We perceive it as more of a stock pickers market currently and favour companies with significant pricing power such as software and technology.

If you favour not having 100% of your portfolio in stocks and shares you could consider bonds and commercial property funds to benefit from some inflation protection. For example, commercial property funds investing in logistics warehouses have the potential to provide an investor with capital growth from a property that increases in value over time, as well as rental payments which are likely to rise with inflation.

1 Bank of England
2 Baltic Dry Index

This is a fast-moving situation and if you'd like to discuss this with one of our investment team please email us.

This article is designed to throw an everyday lens on some of the issues being discussed and debated by investors across the world; it is not research, so please do not interpret it as a recommendation for your personal investments. Capital at risk.

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