ABOUT INVESTING

What's that coming over the hill? Is it inflation?

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If the past year hasn't been unpredictable enough already, the prospect of rising inflation may now pose fresh questions for investor portfolios.

In the UK, inflation is expected to edge up towards the Bank of England's 2% target before summer 2021, before staying in that region for at least another year.[1] Elsewhere there are indications it could rise more rapidly. Much of the focus is on the US, where Congress approved a massive $1.9tn stimulus package in March that includes means-tested direct payments of up to $1,400 for millions of Americans, topped-up unemployment benefits and higher tax credits, among other measures.[2]

A return of consumer spending could drive inflation up

With more money in the pockets of consumers - bolstered by an estimated $1tn in savings that has mounted up during the pandemic[3] - there is potential for a big spike in spending as the US economy reopens and recovers. As demand rises, businesses would be expected to increase prices, driving inflation up as a result.

Larry Summers, the former US Treasury Secretary, warned in March that such large-scale stimulus 'will set off inflationary pressures of a kind we have not seen in a generation, with consequences for the value of the dollar and financial stability'.[4] Raised inflation expectations have contributed to a government bond sell-off in recent weeks, pushing up the yield on 10-year Treasuries (US government bonds) to its highest point in over a year.[5]

Not everyone predicts a spike in inflation. The US Federal Reserve has sought to play down the chances of a big uptick in prices and suggested that it feels relaxed about allowing inflation to overshoot its 2% target.[6]

Others are less sure. More than half of respondents to a survey in March by the US National Association of Business Economists believe inflation risk is at its highest in two decades.[7]

With higher manufacturing prices in China adding to inflationary pressures[8] and some economists pointing to the potential for rising prices across Europe[9] as the reopening of economies releases pent-up demand, investors and their advisers may need to be vigilant.

The ripple effect of increasing inflation

Inflation is unlikely to return to the high single figures last seen in the late 1980s and early 1990s, let alone the double-digit levels of the 1970s. But even a modest increase is eventually likely to see policymakers respond by raising interest rates, beginning to bring an end to a long period of very low borrowing costs.

Investor life stage can influence the effect of inflation

While advisers will naturally be monitoring portfolio returns compared to inflation, they will also be cognisant of the effect that higher prices can have on a client's wider financial situation, aside from investments.

For example, for advisers with clients who are nearing or are already in retirement, inflation can significantly erode the value of a retirement pot over time, especially if it is insufficiently invested in risk assets that are most likely to keep pace with rising prices. At the same time, retired households are typically more exposed to inflation than non-retired households, spending a higher proportion of their income on essential items such as food and utilities.[10]

Inflation is one of several factors that feed into cashflow planning assumptions and help shape the plans put in place for meeting client goals. So, as expectations rise of an upwards tick in inflation, advisers can play an invaluable role in helping their clients to review those plans to identify potential impacts and mitigation strategies.

Prices and positioning for investment portfolios

That extends to investment portfolios, given the implications of higher inflation and interest rates on markets and asset classes. Any suggestion of the economic environment beginning to move materially away from the low interest rate environment of the post-Global Financial Crisis era will inevitably influence the conversations that advisers have with clients, given the various opportunities and threats.

Economic cycles continue alongside market activity

Changes in the macro environment can be viewed through the prism of economic cycles. Markets began 2020 in the late stages of a bull market that had started in March 2009 during the Global Financial Crisis.[11] The pandemic, however, brought it to an abrupt end with global economic activity grinding to a virtual halt in the first half of 2020, with the International Monetary Fund (IMF) reporting an estimated 3.3% contraction in gross domestic product (GDP) for the year. [11] In April the IMF increased its global growth forecast from 5.3% to 6% in 2021 as economies begin to stabilise. The revision reflects additional fiscal support in some large economies, vaccine-powered recovery and the continued adaptation of economic activity.[12]

If inflation goes up it will likely reflect higher economic activity, indicating that the recession has bottomed out and a recovery is underway. Understanding the point we're at in the economic cycle can help both advisers and investors in allocating assets appropriately while taking inflation and interest rates into account.

Managing investor expectations

When expectations change and cycles move there can be pressure to take some sort of action.

If the global economy moves into recovery mode over the coming months and inflation ticks up there is a good case for positioning portfolios accordingly.

Yet portfolios that are already sufficiently diversified and regularly rebalanced should already be in a good place. In this case advisers may find their role is more one of reassuring clients that they are well positioned to ride out changes in appropriate portfolios that reflect their long-term goals, risk appetites and time horizons.

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[1] Bank of England – Bank Rate maintained at 0.1% - March 2021, 18/3/21
[2] CNN – Here's what's in Biden's $1.9 trillion economic rescue package, 15/1/21
[3] The New York Times – Inflation Fear Lurks, Even as Officials Say Not to Worry, 21/3/21
[4] The Washington Post – Opinion: The Biden stimulus is admirably ambitious. But it brings some big risks too, 4/2/21
[5] Today News Post – US 10-year Treasury yield hits highest level since last January, 2/4/21
[6] Reuters – Inflation not likely to hit Fed's target through 2022, Rosengren says, 17/2/21
[7] Marketwatch – Economists say inflation risks highest in two decades and could force Fed to raise interest rates in 2022, 22/3/21
[8] The Wall Street Journal – China, long a Source of Deflation, Starts Raising Prices for the World, 29/3/21
[9] The Guardian – Why is no-one in Europe talking about dangers of rising inflation, 24/3/21
[10] The Office for National Statistics – Household Costs Indices, UK: third preliminary estimates 2005 to 2019, 21/7/21
[11 and 12] The International Moneraty Fund – Transcript of April 2021 World Economic Outlook Press Briefing, 6/4/21

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