The Inflation Divide

The inflation debate is polarising opinion over whether a generation of investors will experience a sustained period of rising prices for the first time. Guy Foster, our head of research, looks at the two sides.

For the current generation of investors, inflation is more of an annoyance than the economic tyrant of old. Prices rose by 10% a year on average between 1970 and 1990. Since then it has rarely nudged above 5%. Modest inflation of around 2% is considered the optimum state of affairs in order to encourage dynamism in the economy, although even those levels of inflation could be detrimental to savers at a time of record low interest rates.

Given the unprecedented stimulus that the global economy has received since the coronavirus crisis hit, the key debate among many economists and investors right now is whether these "whatever it takes" financial packages will ultimately stoke a sustained period of rising prices.

The sheer scale and speed of these stimulus packages implemented by central banks and governments across the world are undoubtedly significant. It is estimated that together they have committed almost $8tn to battle the pandemic. Here in the UK, government borrowing is at levels not seen since the Second World War, while in the US, the Federal Reserve (Fed) is expected to have implemented almost $4trn worth of packages by the end of the year.

To put the Fed's strategy into context, it took more than six years to phase in a similar amount of stimulus following the 2008 crisis.

Inflation or deflation?

The inflation debate is polarising opinion among economists.

One group sees the primary concern to be deflation. Conventional theory says that spare capacity (an economists' euphemism for unemployment) prevents companies from raising prices. It is only when there are shortages that prices really start to rise.

Other economists disagree. They argue that inflation is caused by an increase in the amount of money in circulation relative to the amount of goods and services being sold.

That seems intuitive, but – the deflationists object – the quantitative easing introduced in in the aftermath of the global financial crisis failed to provoke a resurgence in inflation.
Why should it be any different this time?

The explanations range from the healthier state of the banking system this time around, to the reversal of the globalisation trend. Global trade continued to expand up until 2018 but has been in decline since then. Could this be the trigger that reverses the thirty-year disinflationary trend?

While the long-term inflation prognosis divides opinion, there is more of a consensus on what will happen in the short-term. Deflationary pressures – where prices fall – are far more prevalent as economies grapple with the immediate consequences of the lockdown.

The sudden fall in global demand for oil, as the pandemic hit, triggered a sharp fall in the price of crude. Despite its recovery over the summer, the price of oil is still around a third lower than it was at the start of the year. Indeed, motorists returning to the roads in light of the easing restrictions are paying less for a tank of fuel today than they were before the lockdown began in March.

Other factors are likely to keep prices and wages depressed in the coming months. Fewer people are going to pubs, restaurants and shops, while fewer people are in work. In the UK, the number of workers on the payroll is falling and large numbers of jobs could be lost once the government's furlough scheme rolls away. A British Chambers of Commerce survey of 7,400 firms, suggests that nearly a third of businesses will look to cut jobs over the next three months1.

We do think inflation will come back in future years though. With the demand outlook very weak, companies are cutting whatever costs they can, including inventories and investment that would have supported their future growth. This will likely result in a period of higher inflation. In 2015 UK inflation went negative but just two years later it was above 3%, the threshold at which the governor of the Bank of England has to write to the Chancellor of the Exchequer to give an explanation.

With globalisation seeming to be in reverse we could see a more pronounced impact this time around.

Assessing the possible impact

Given the short-term signals point to a period of deflation, investors could be forgiven for asking why they need to be mindful of higher inflation now. Inflation, even at modest levels, can seriously reduce people's spending power.

Just as they have done for the best part of the past 40 years, Governments and central banks will look to keep inflation under control. However, as the short-term impacts of the pandemic unwind, they may tolerate inflation levels slightly above the current 2 per cent target rather than initiating inflation-prevention policies that could see economies go in retreat. Above-target inflation will also hasten the erosion of governments' vast debt mountains.

Assets left as cash with inflation running at 2 per cent a year for 20 years could result in a 33 per cent loss in 'real terms' (once inflation has been taken into account). Inflation running at 4 per cent a year will see the real value of cash fall by more than half. The predicament savers currently face is reinforced with interest rates set to stay low, and below the rate of inflation, for a prolonged period of time. Governments and central banks will be keen to keep rates down to give economies more room to recover – but this gives investors a challenge. With miserly deposit rates on offer, cash, while a safe haven in times of uncertainty, is one of the asset classes most vulnerable to inflation risk.

Considerations for investors

Investors looking to preserve the purchasing power of their wealth need to be prepared to take on some risk – and be comfortable seeing the value of their money fluctuate. This still leaves them the conundrum of where to invest in an environment that is not only uncertain but hints at the prospect of higher inflation further down the line.

The recent increased demand for inflation hedges such as precious metals and inflation-protected bonds suggest that many investors are already investing with higher inflation in mind. The gold price hit an all-time high approaching $2,000 an ounce in July, while inflation protected bond yields have been driven down to an all-time low (implying that higher inflation will be needed to make holding these worthwhile).

Demand for gold typically increases when, as is the case now, 'real' inflation-adjusted interest rates and government bond yields are low or negative. This helps explains gold's strong run since the stimulus packages were announced, but another precious metal that is often overlooked by investors is silver. While gold has recently reached an all-time high, silver is still around half its record high despite rising sharply during the pandemic.

Inflation-linked bonds give investors an opportunity to suffer lower interest payments now, on the basis that they will rise along with inflation (along with the eventual redemption payment too).

Meanwhile, equities have long been considered to have inherent inflation-protection characteristics and there are several studies that back up that assertion. For instance, Credit Suisse's latest yearbook shows that global equities have outstripped inflation by 5 per cent a year since 1900.

There are caveats to any such analysis as they examine at markets as a whole. Not all equities are the same and depending on the environment, some stocks will fare better than others. And, while inflation is not prevalent yet, the stock market would likely start to price in any impact on companies, whether positive or negative, long-before before it became a reality, rather than when any reality of higher inflation sets in.

The higher inflation debate will continue to simmer and while the latest generation of investors may not yet experience it at first hand just yet, they should bear it in mind when appraising their portfolios. They may need to step up the risk ladder to achieve their financial goals, aware that simply sitting on cash is risky too – even when inflation remains modest. It's why a pragmatic investment approach and a balanced, diversified strategy is as important as it has ever been.

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