Perspectives from the Multi-Manager People

Inflation on the up – should we be concerned?

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It's been one of the single biggest worries for policymakers, economists and financial markets for months, fuelling volatility in equities and rattling bond investors.

Inflation: how high will it go and how long will it last? While there has been clear evidence that, as measured by consumer prices, inflation has been on the up in recent months, we're not convinced that the increase will be sustained.

Indeed, with recently published data showing that the UK's GDP growth began to slow in May, it's tempting to argue that it won't be long before investors shift their focus again and start to fret that the recovery has run out of steam.

Why is inflation a concern?

It's undeniable that markets are worried. If inflation persists, it could spur the Bank of England (BoE) to lift interest rates to quell rampant economic growth. The concerns are not new, but investor unease is the highest it has been for around 15 years.

In broad-brush terms, rising inflation tends to be seen as bad news for markets. For equities, it can make it harder for companies to increase their earnings growth and, with bonds, it can make the securities that investors hold feel less valuable. If interest rates go up, it makes the returns available on newly issued bonds look more attractive.

Being selective matters

Within this, though, the performance of specific assets can vary dramatically, underscoring the importance of stock and fund selection. When inflation is low, as has been the case for more than a decade, the best returns have tended to be found in growth stocks, longer-term and fixed-rate bonds, for example. Assets that tend to do well when inflation is rising include so-called value stocks, whose intrinsic worth might not be recognised by the wide market, and alternative assets such as property funds and commodity funds that have a clear link to rising prices.

Understanding what's driven inflation higher

It has to be said that the experts are notoriously bad at predicting interest-rate moves, basing their forecasts, among other things, on their expectations for inflation, which are often awry.

More importantly, what underlies the recent concern is the extraordinary and prolonged period of intervention there has been by both governments and central banks worldwide.

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After the global financial crisis more than a decade ago, central banks stepped in, slashing interest rates to near-record lows and employing massive monetary stimulus programmes in a bid to kickstart growth.

The measures were meant to be temporary, enabling governments to return with their own fiscal policies against the backdrop of manageable inflation and normalised interest rates.

What happened instead was Covid, forcing governments to deploy an astonishing amount of fiscal firepower, extraordinarily quickly, as they moved to help businesses survive, prevent mass unemployment and head off seismic economic shocks.

That means we now have two enormous stimulus efforts running concurrently, and the worry is that growth surges, inflation rushes higher and, inevitably, interest rates go back up.

So how do we make sense of all this? Well, we know prices are rising: UK inflation was ahead of forecasts when it jumped to 2.5% in June – way ahead of the BoE's 2% target.

The pandemic caused a supply squeeze, which drove prices higher and led to a fall in demand. There is an argument that prices will fall once again when demand recovers.

A dramatic fall in the oil price, which can influence costs elsewhere, in March 2020 also means that the year-on-year comparison for the same period this year is against a low number. The effect of this should fall away as the months progress.

We believe higher inflation is temporary – but remain watchful

Both arguments favour the view that the recent rise in inflation is temporary.

There are complicating factors. A widespread recovery in the labour market, if it leads to a jump in wages, could cause a renewed bout of inflation driven by a rapid rise in demand for goods. Employees tend to spend their extra earnings, which increases the amount of money circulating in the economy and acts as a further inflationary pressure. This kind of inflation could be more prolonged.

It's nuanced, but now for us the argument that rising inflation levels are transitory is winning the day. We need to stay watchful, though, particularly for signs of a growing appetite to borrow among consumers, which could also push up prices over the longer term.

In this environment, the key for fund managers is to be flexible, and to be prepared to adapt the contents of their portfolios as and when the inflation data and the leading indicators change.