archititas

SPOTLIGHT **ON…**

Inflation

The pandemic has led to far greater cooperation between governments and central banks. Governments can borrow and spend, in the knowledge that they won't put pressure on the interest rates because central banks will stop that from happening. This has resulted in a powerful stimulant to the global economy.

At the same time industrial firms, service companies and consumers are all reporting more optimism in the future. This cooperation and these positive sentiment indicators all suggest that the global economy is on the way to repair but it also means that inflation could be on the rise.

Here we ask what is inflation, why does inflation happen what does it mean for your investments?

WHAT IS INFLATION? (AND DEFLATION)

Inflation is a sustained upward movement of prices for goods and services in an economy. Or too much money chasing too few goods. Think overall prices—not the price of a single good. According to this logic, if a central bank prints too much money, or makes it very easy to borrow money, by keeping interest rates low then prices will rise.

The other side of the coin to inflation is deflation. A condition that economists fear. When the prices of goods and services fall. And because deflation expectations make consumers wait for future lower prices, this reduces demand and slows growth.

THE INFLATION RATE

The inflation rate is generally estimated using the consumer price index (CPI). It is defined as the change in the prices of a basket of goods and services that are typically purchased by specific groups of households. Inflation is measured in terms of the annual growth rate with a breakdown for food, energy and total excluding food and energy.

AN INFLATION TARGET

To avoid extremes of inflation (like deflation), most central banks try to keep it around 2%. To stop inflation rising they can increase interest rates, making it more expensive for everyone to borrow money, which slows the economy and lowers inflation. Or provides room for central banks to cut in the event of a recession.

WHAT ARE THE CAUSES?

There are four main reasons:

1

An increase in demand:
When demand outpaces the supply of goods and services. Often when an economy is in recovery and the unemployment rates are falling.

2

An increase in costs:
Hikes in production costs from increases in the prices of commodities such as oil and food, or natural disasters.

3

An increase in the money supply:
If the total value of money available in an economy increases. This has an upward burden on prices.

4

Inflation expectations:
Inflation expectations can also lead to a hike in the prices of goods and services through wage demands.

EFFECTS OF INFLATION ON INVESTMENTS

Most people understand that inflation increases the price of their groceries or decreases the value of the money in their wallet. And over time, it can take a bite out of your investment returns.

Inflation's influence on select asset classes 1990 – 2020

US large-cap stocks	↗
Developed market stocks	↓
Emerging market stocks	↓
Investment grade bonds	↓
Inflation-linked bonds	↗
Property	↑
Commodities	↑

↑ Strong positive
↗ Positive
↓ Strong negative

HOW TO DEFEND YOUR PORTFOLIO AGAINST INFLATION

Although, inflation might be beyond your control. There is one technique in an investment portfolio that can help to address the threat of inflation to help preserve your investments and savings from its effects. This is diversifying your portfolio through asset allocation.

For example, investors might increase asset classes such as commodities, property and inflation-linked bonds, with a careful selection of equity assets and decrease bonds and cash.

Importantly, diversifying your portfolio may help you shield your money against inflation, although it doesn't guarantee protection against losses.

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