

The British disease: inflation spikes higher

By Tom Stevenson, 20 January 2010

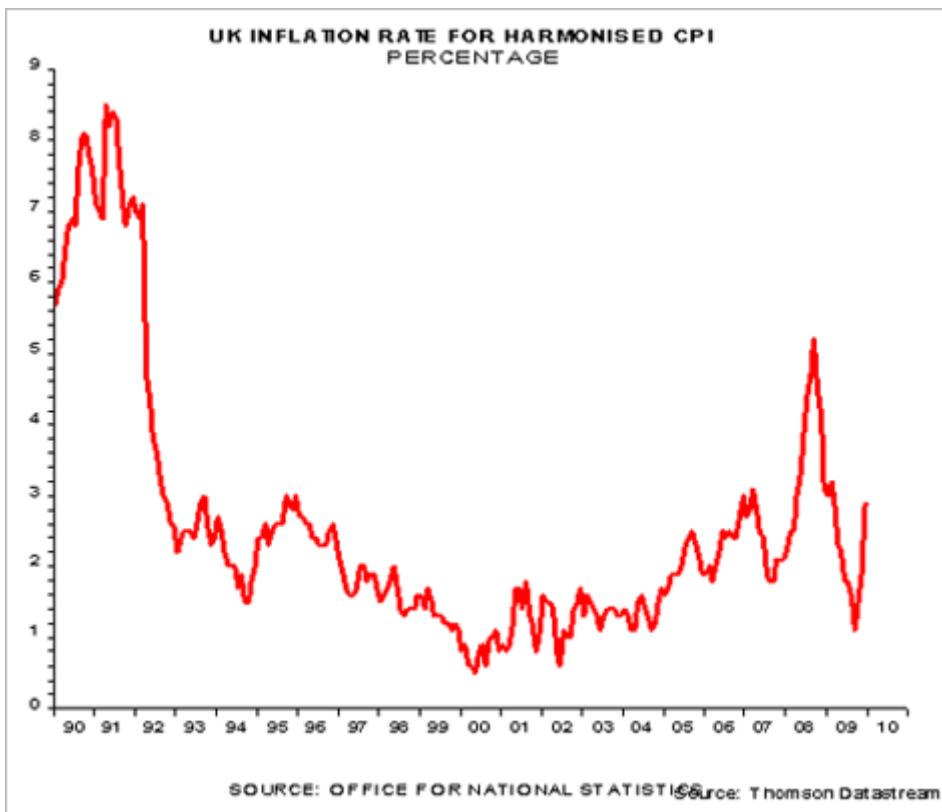
We just can't seem to get a grip on rising prices. But could this week's inflation shock be just a short-term blip?

This week's inflation report gave investors an unwelcome shock. The 2.9% reading for the consumer prices index (CPI) in December was quite a bit higher than expectations (2.6%) and considerably worse than the November rate of just 1.9%.

As the chart shows, inflation has become more volatile than in the 15 years or so before the financial crisis so a big jump in prices is potentially cause for concern.



"This week's inflation report gave investors an unwelcome shock." Tom Stevenson



To be fair, no-one was particularly surprised that inflation rose on the month. You only had to look at the period against which prices were being compared last year to realise that there was going to be some kind of increase.

At the end of 2008, in the thick of the financial crisis, retailers were slashing prices so they didn't end up with stacks of unsold inventory after Christmas, the government had just reduced VAT from 17.5% to 15% and the oil price had fallen hard, bringing petrol prices down in its wake.

You can see what impact that had on inflation and why the government felt able to take interest rates to rock bottom levels. From such a starting point, any sort of recovery was going to look a bit inflationary.

Bank relaxedThe minutes of the Bank of England's latest monetary policy committee meeting, which were published today, showed that the authorities were not surprised and, moreover, that they were not concerned.

They said that "inflation in the short term would be further above target than the committee had previously expected" but would "fall below the (2.0%) target for a period once the various near-term price-level shocks to inflation had worked through".

That was why the Bank left interest rates unchanged at its January meeting and why it is widely expected they will do the same at next month's meeting too.

The Bank may remain relatively relaxed about inflation but prices are nonetheless a concern. The consumer price index has been higher than economists have expected for most of the past couple of years.

There are probably a couple of reasons for this. The fall in the value of the pound has pushed up the cost of imports which feeds through into higher inflation. Also, there is probably less slack, or spare capacity, in the economy than expected. If some productive capacity has been lost for ever then output could remain lower than before the crisis without the beneficial side-effect of contained prices.

ImplicationsWhy does this matter to investors? A couple of reasons. First, inflation is a problem for savers and investors because over time it erodes the value of portfolios and means you have to save harder or achieve better returns from your investments to maintain your purchasing power.

The second reason why rising prices are a concern is that they are the trigger for monetary tightening, or higher interest rates. While you might welcome these if you have large amounts of money on deposit, rising rates are bad news for equity and bond markets because they raise the return that investors demand on their investments, which can only be achieved by a fall in their price.

I think the market's attention has probably shifted from whether to when interest rates start to head up but I still don't expect any move until the second half of the year and even then the tightening will be relatively modest until it is quite clear that recovery is well set.

It is possible that the Bank is right to look through this spike in the inflation rate. Indeed, with unemployment high, taxes set to rise and a reversal of some of last year's stimulus measures underway (the VAT cut and the housing stamp duty holiday, for example), inflation could be heading lower before long.

UncertaintyAs ever, there is plenty of uncertainty about the future path of both inflation and interest rates, so covering all the bases is the sensible approach. There are several ways to insure your portfolio against rising prices, the most obvious of which is to own financial assets that have been expressly designed to offer protection against inflation - inflation-linked bonds for example.

Other ways to achieve the same end are to own assets that tend to perform well in periods of higher inflation. Property is one. Others include commodities like oil and gold.

The best way to deal with uncertainty, however, is not to put all your eggs in one basket. Remember, if inflation does fall away again and deflation rears its ugly head then government bonds would have a resurgence. So a well-diversified portfolio is the best protection.

Whichever way things go, inflation will not be far from the headlines this year.

Note the value of an investment and the income from it can go down as well as up, so you may get less than you invested. The ideas and conclusions in this column are the author's own and do not necessarily reflect the views of Fidelity's portfolio managers. They are for general interest only and should not be taken as investment advice or as an invitation to purchase or sell any specific security. Past performance is not a guide to what may happen in the future. Investments in small and emerging markets can be more volatile than more established markets. For funds that invest in overseas markets, changes in currency exchange rates may affect the value of your investment.