

Worrying about inflation

By Tom Stevenson, 29 July 2009

What investors should be thinking and doing about the possibility of resurgent inflation.

Inflation, what inflation? In most countries around the world, people will look at the consumer prices data and think that a more significant concern at the moment is falling not rising prices. A lower oil price since last year's peak, industrial overcapacity in recession-hit economies and a consequent lack of pressure on wages mean there is a plausible case to be made for deflation and not inflation.

However, in most countries prices continue to rise (albeit modestly) despite the worst economic downturn since the Great Depression. This suggests that there remains an inflationary bias to the global economy. Investors need to consider how likely a return of inflation is and what they should do to protect their finances against such an outcome.



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An important consideration with inflation is that the statistics are backward looking. They tell us what prices have been doing not what they will do in the future. This is unhelpful for an investor for whom the only decisions that matter are to do with what is about to happen.

Arguably there are better indicators of inflationary pressures in the economy, including the prices of commodities which have a history of maintaining their value in periods of rising prices. Gold and oil, for example, have both experienced marked price rises since the worst of the financial crisis last autumn. Other indicators of the inflation threat include the yield on government bonds, which has risen over the same period. There are no real warning signs flashing here but perhaps some straws in the wind.

Why should inflation return?

People who worry about rising prices tend to focus on a famous definition of inflation from the late economist Milton Friedman. He said that "inflation is always and everywhere a monetary phenomenon". He also described inflation in layman's terms as "too much money chasing too few goods and services".

Friedman's theory suggests that prices will rise if the amount of money in the financial system increases or if the money in the system changes hands more quickly or a combination of both. Translated into today's environment this explains why inflation has not yet taken off but also why it remains a threat.

Inflation has not yet taken off because while there has been a massive increase in the amount of money in the system, thanks to governments' stimulus measures such as quantitative easing, that money continues in the main to sit idle. This is because the banks who control all the new money that has been printed are reluctant to put it to work in the form of loans. They remain nervous about their own financial health and are hoarding it in case the economy takes another turn for the worse.

However, the explosion in the amount of money available represents a real potential threat to price stability, the

inflation worriers believe, because when confidence returns and the banks start to lend once more Friedman's equation will lead inevitably to renewed inflation.

The key to whether such an increase in the "velocity" of money really does lead to inflation depends on a number of factors. The first of these is how quickly the authorities are able to withdraw the punchbowl of excess liquidity. In theory they can move swiftly to mop up excess reserves in the banking system and sell off the long-term bonds that they have acquired in their bid to kick-start the economy. In practice this return to normality may be harder to achieve.

During the Great Depression, and again in Japan in the 1990s, governments moved too quickly to withdraw liquidity and the economy nosedived just when everyone hoped recovery was imminent. The political pressure not to repeat this mistake will be enormous. Moreover, the political temptation to tolerate a little bit of inflation in order to reduce the burden of the massive amounts of debt that governments have taken on during the financial crisis should not be disregarded.

Another key factor will be the general health of the economy. There is currently plenty of slack in the system and excess capacity and unemployment will depress prices and wages for some time to come. This is a very different situation from the 1970s when a wage-price spiral became self-reinforcing. Perhaps more likely is localised inflation within areas of the economy where resources are scarce relative to demand such as in commodities.

How to invest in an inflationary environment?

Broadly there are two ways to protect an investment portfolio from inflation. The first is to gain an exposure to real assets that can be expected to maintain their value even if financial assets depreciate. These include commodities such as oil and gold, commercial real estate and infrastructure projects. Shares in companies that produce or invest in these real assets could also be attractive in a mildly inflationary environment although high inflation tends to be bad news for equities.

A second approach is to own some financial assets which are expressly designed to offer protection against rising prices. Inflation-linked bonds fit this category.

No-one knows if or when inflation will return or how serious a problem it will be. This means that a well-diversified portfolio still makes sense, one that recognises the possibility that inflation could surprise with its ferocity or be overwhelmed by the prevailing deflationary forces still dominating the economy. However, from today's low levels of inflation the odds are surely stacked towards rising rather than falling prices. Forewarned is forearmed.

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