INVESTOR

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Inflation – How it erodes the value of your money

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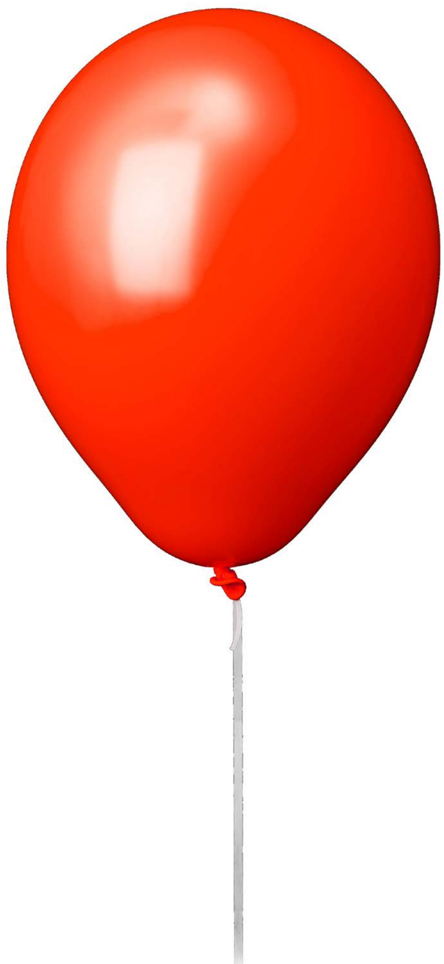

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We all know the feeling of going to the supermarket or DIY store and realising our paycheck isn't stretching as far as it used to - that is inflation.

Inflation is a persistent rise in the average cost of goods and services over time. Inflation decreases the purchasing power of your pound or euro.

A little bit of inflation is a good thing. That's because it shows the economy is growing: prices of products and services generally go up because there is rising demand for them. That in turn prompts manufacturers and providers to increase supply, which can lead to more jobs, higher wages and then even more demand.

Inflation is measured by the Consumer Price Index (CPI) – which compares the change over time in the price of a basket of commonly used goods and services. The price of one item going up isn't inflation, but the price of the basket going up over time is.

For the past few decades, inflation hasn't been a significant problem in the UK and Europe. Both the UK Bank of England (BoE) and the European Central Bank (ECB) have a goal to keep inflation in their countries at around 2% a year.

But worries about higher inflation in the future are growing. Inflation generally comes from three sources:

- **Demand-pull inflation** – this is generally caused by a strong economy
- **Cost-push inflation** – this may come from rising wages, or the cost of energy or materials
- **Easy-money policies** – when central banks try to boost the economy by lowering borrowing costs or increasing the money supply

As the global COVID-19 pandemic is brought under control, many observers worry that all those sources of inflation are now at play.

For most of the past year and a half, the UK and Europe were in various stages of lockdown in which certain sectors were shuttered or activities limited. The savings ratio has skyrocketed - in the UK, the personal savings rate in Q1 2021 was 19.9% of disposable income compared to 8.9% in Q1 2020[1], just before the first wave of lockdown was imposed.

In Europe, the data suggests the same phenomenon. In Q1 2021, savings rate was 21.5%, versus 16.8% in Q1 2020[2].

Now that services are reopening (think haircuts, manicures and movies!) and other activities are normalising, some of those savings are going to be put to use. Just think about all the things you missed doing during the lockdowns and you can see how there is a risk of **demand-pull inflation**.

Anyone who has recently tried to renovate a home, build a new patio deck, buy a used car or even fill up their car's petrol tank has a sense of the potential for **cost-push inflation**. But it's not just input costs that have risen – wages have too, especially in the UK[3]. As well, unemployment rates have been declining in 2021 as the economy revives.

Most importantly, however, have been the **easy-money policies** in both countries as authorities worked to keep the economy afloat during the pandemic. Interest rates have been held at record lows and the money supply has increased through both asset purchases by the central banks and huge fiscal stimulus: the wage support to individuals, grants to small businesses, tax credits and other measures that were introduced throughout the pandemic. As normal activities resume, this stimulus could provoke much higher inflation in the future unless the central banks raise interest rates or other actions are taken.

What does this mean for your investments?

Inflation has the same impact on your portfolio as it does on your pocketbook. Let's say your investments returned 9% last year. That's pretty good, but if inflation was 2% then your real return falls to 7%. And if there's a bad year in the markets and your returns are negative, inflation will take a bite out of those returns as well, increasing the magnitude of the loss.

When inflation rises due to an overheating economy, interest rates often do as well. Higher rates have a different impact on different assets.

Fixed income: Rising inflation may nip at the returns of fixed-income assets, such as government gilts and corporate bonds, which pay fixed interest rates. This is because inflation negatively impacts the real level of income from bonds (yield minus inflation). If inflation rises higher than a bond's interest rate, the real return of the bond will fall below zero.

Equities: Rising interest rates can increase borrowing costs for companies, eating into their profit margins. Some equities offer more protection against inflation

[1] https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/dgd8/ukea
[2] https://ec.europa.eu/eurostat/databrowser/view/teina500/default/table?lang=en
[3] https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/averageweeklyearningsingreatbritain/march2021

than others: demand for some goods remains strong even when companies pass on price increases to customers. People will always buy toilet paper, shampoo and toothpaste, for example. They'll keep paying their phone bill, although they may not upgrade their device.

Real Assets: Their unique characteristics mean they can provide investors with an income stream that is generally protected from the impact of rising inflation over time.

Infrastructure

- Most infrastructure assets have an explicit link to inflation through regulation, concession agreements or contracts. This is often because many infrastructure assets have monopoly-like competitive positions (such as ports, airports, electrical generating stations) and rising prices don't have a substantial impact on demand.

Real estate

- Real estate revenues can be adjusted higher through contract renewals, providing some protection against inflationary pressures. As well, rising prices also affect the construction of new buildings, thereby increasing the value of existing buildings.

Commodities

- The prices of commodities such as gold and oil typically rise when inflation accelerates. They also tend to move in an inverse relationship to the U.S. dollar, so an expected weakening in the dollar should raise the price of commodities.

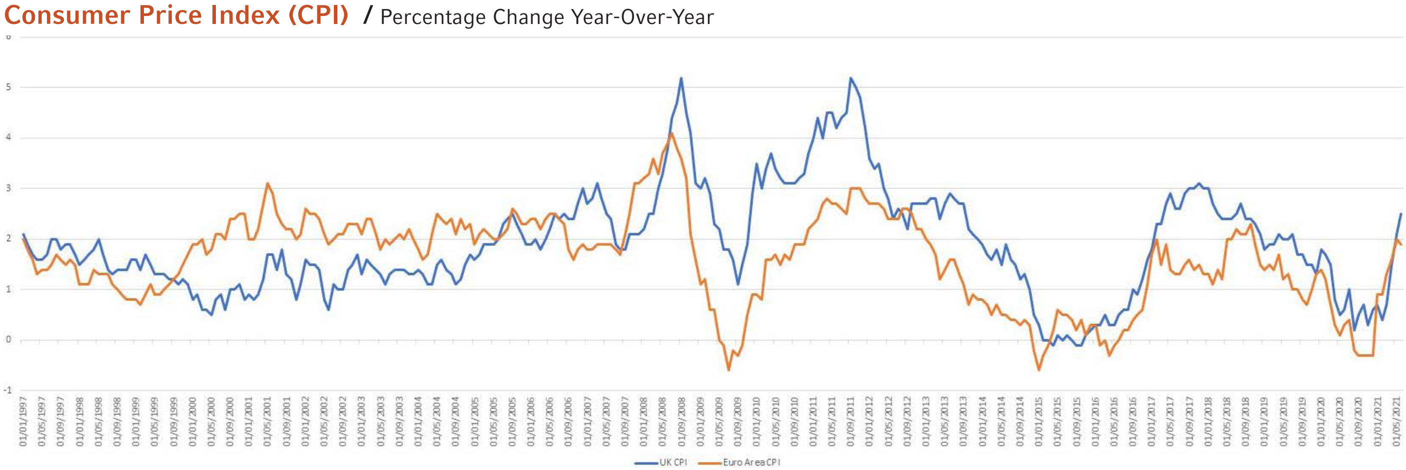
The best solution to the problem of possible – but not certain – inflation is to remain diversified with a broad selection of asset classes across geographies, industries, market capitalisation and styles.

Equities remain an important part of any portfolio no matter the economic environment because of the growth potential they provide. As well, earnings and dividends have traditionally been good hedges against inflation over the long term. Diversifying globally may be helpful as different regions experience inflation differently.

Fixed income remains necessary to offset the risk from the equities portion. While some fixed income assets such as government bonds may pay yields below inflation, moving to shorter-duration instruments may be an appropriate strategy. Since bond yields tend to rise with inflation (and prices fall), holding shorter-term bonds allows you to reinvest your cash flows at higher rates over a shorter time period.

While inflation risks are rising, we aren't likely to see a sharp spike as was seen during the 1970s oil embargo, since both the BoE and ECB are committed to their inflation goals. Still, the outlook is uncertain and therefore it may be prudent to prepare for higher inflation.

Consumer Price Index (CPI) / Percentage Change Year-Over-Year



Source: Bloomberg. UK EU harmonised CPI figure not seasonally adjusted. EU harmonised CPI, not seasonally adjusted. Data as at 01 May 2021.

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