FINANCE UPDATES

MARCH 2021

CAMPBELL & McCONNACHIE

chartered financial planners

COULD INFLATION BE ABOUT TO RETURN?

And might it be a problem for you in 2021?

We've all had enough on our plates over the last 12 months, without having to worry about things like inflation. But a surprise jump in December 2020 caused speculation as to whether it might surge when we properly come out of lockdown.

Although it sounds like a dry economic word, it has a real effect on all our lives. So let's examine what it is, how it can impact on savings, and what might happen based on the current situation.

WHAT IS INFLATION?

Inflation is the rate at which money loses value against goods or services, normally expressed as an annual percentage. When inflation rises, things become more expensive, more quickly.

While items becoming more expensive might sound like a bad thing, it's actually not when it happens gradually, and as long as wage rises keep pace with it. It encourages people to buy things sooner and facilitates companies giving pay rises. These usually spark economic growth.

For this reason, central banks often have a target of keeping inflation at around 2%. Problems can arise if it rises significantly beyond this or runs out of control.

In the UK, the main measure of inflation is the Consumer Prices Index including owner occupiers' housing costs (CPIH). In January 2021, the CPIH ticked up to 0.9% (from 0.8% in December 2020). Still well below the 2% target, but quite a surprise given the lockdown situation of recent times.

Inflation is used by the Government and some pension providers to set state benefit and pension rates, and it influences what the Bank of England does with its base rate of interest.

WHAT DOES IT MEAN FOR SAVERS?

If you are a cash saver, traditionally you could be protected against inflation to a degree by interest rates. If you could find an account with an interest rate that matched or exceeded inflation, your cash savings wouldn't lose value.

Following the Bank of England's lead with the base rate, high street bank interest rates tended to track inflation rates to an extent. However, after the shockwaves of the 2008 financial crash, interest rates have hovered just above 0%.

Inflation has also been low, but not as low as interest rates. What that means is interest rates have not served as much of a defence against inflation in protecting the value of savings.

It is not all about cash, though. There are other asset classes which tend to offer better protection against inflation, although it is important to understand that nothing is guaranteed to do so.

Shares are one such asset – after all, companies can normally raise share prices in an inflationary world. Gold is another asset class that people have turned to and there is property, too.

These all come with risks and rewards, so inflation is just one factor to consider when allocating your wealth in a portfolio.

CAN YOU BENEFIT FROM INFLATION?

People with accumulated wealth have to manage their portfolio to ensure it's not eroded by inflation. For borrowers, however, inflation can be their friend because it eats away at the value of their debt – how much they have to pay back.

People on fixed-rate mortgages can do well when inflation rises, as can governments on the money they borrow to fund spending and companies, too.

WHAT'S HAPPENING NOW?

The CPIH for January 2021 showed a small rise in inflation, but it is still well below the Bank of England's 2% target. Looking back over the past decade, CPIH has spent time over this target, but not in a sustained way.

Major headwinds like the pandemic and Brexit had seen the base rate cut to an historic low of 0.1%, and there has even been talk of it going into negative territory. But if inflation threatened to rise sharply, the Bank could address it by raising interest rates.

Nobody has a crystal ball, and there is an age-old split between analysts: some are convinced that inflation is coming and it will bring major trouble. Others are more relaxed and consider that it won't occur or won't be a problem.

Here is a flavour of the two sides of the debate at present.

The pessimistic view

A surge of consumer spending – as lockdown restrictions begin to ease and Brexit uncertainty dissipates – will mean demand massively outstrips supply. Producers won't be able to keep up and the law of supply and demand means that prices will rise.

This will be exacerbated by central bank quantitative easing policies, which have been pushing money through the system. This will eventually materialise as cheap loans, which further encourage consumers to spend. Inflation soars.

The optimistic view

Sure, there is pent-up demand in the economy as people have not been able to spend as they normally would during lockdown. And this will be released as the vaccination programme allows the UK to open back up again.

But many have suffered financially because of being furloughed or made redundant and simply cannot afford to splurge. Meanwhile, for those that do have money to burn, it is not a never-ending supply and spending will soon level out.

Neither the private nor the public sector is in a position to grant runaway wage rises, and with significantly higher unemployment than two years ago, there is no need to open up cheque books.

It's an employer's market. As companies regain confidence and face fewer restrictions, they will be able to increase output and ease inflationary pressure on pricing.

In this view, there's an inflationary bounce, but it will not be sustained and will not cause major problems.

POSITIONING A PORTFOLIO FOR INFLATION

Given the huge backwards step the UK economy took last year due to COVID-19, there is consensus that the rate of inflation will rise this year when the economy fully reopens. Debate is currently focusing on how much it will rise by and whether it will be a problem.

Many would agree that between 1% and 3% will be OK, but if it stays above 3% for a prolonged period of time, that would start to impact investment portfolios, and other areas of our lives.

To some extent, whether it will be a problem for you will depend on your circumstances. You may have your own views on that, or you may wish to discuss it with us.

Investment managers will always have a view on inflation which feeds into their holdings. For example, one might think the shift to online shopping will reduce demand for oil over the long term.

Their analysis behind this could be that instead of many people jumping in cars to hit shopping malls and high streets, one delivery driver can drop purchases to their doorstep. This eases pricing on other commodities, which are a significant cost base for many businesses, and helps to limit inflation.

In a further boon for such businesses, consumers have extra cash in their pockets from saved petrol money which they can spend on discretionary purchases.

The logic for the investment manager, taking into account these limiting factors on inflation, might be to invest more in consumer goods companies.

That, of course, is just one narrative but it goes to show how assessment of inflation can translate into investment decisions.

Contact us for a review of your financial plans.