momentum

Inflation – the sleeping giant?

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global investment management

Executive summary

Inflation is a phenomenon which, over the long term, materially impacts the purchasing power of money. In an inflationary environment the nominal value of goods and services appreciates, resulting in the de facto devaluation of your currency – that is to say, in an inflationary environment, a pound spent today would buy less next year.

Modern economic theory suggests that inflation has a variety of possible causes, a number of which will be discussed in the pages that follow. At the outset it should be noted that it appears that the actions of central bankers over the past five years could have been uniquely designed to create an inflationary environment.

Traditional investment approaches often characterise risk simply in terms of volatility or falling short of a particular reference index's return. At Momentum Global Investment Management ('Momentum') we view the concept of risk more broadly. Looking forward, we believe that one of the greatest risks to investors is inflation. This comes at a time when an increasing number of investors are seeking out lower volatility investment solutions, after weathering a tumultuous decade in assets such as equities. These investment vehicles could be rendered ineffectual if inflation gains traction.

While inflation may be of only moderate interest for today's investors, looking to the future, Momentum believes that inflation will be a pivotal concern for tomorrow's pensioners. In a world where defined contribution pensions are the norm (meaning that investors themselves bear all the investment risk), increasing human longevity and a lack of awareness of the risks posed by inflation to long-term investors could have a severe impact on the next generation of pensioners. Consequently, at Momentum we believe that it is of the utmost importance for investors to take appropriate investment decisions today, with the aim of generating returns in excess of inflation over the medium to long term.

Momentum believes that by incorporating inflation expectations alongside a more traditional 'volatility-based' understanding of risk, investors can seek to maintain and grow their real purchasing power through time, whilst avoiding inappropriate levels of volatility.

Setting the scene – what causes inflation?

In economics, inflation is the rise of the price of goods and services in an economy over a period of time. As the general level of prices rises, a unit of currency (such as one pound) is able to purchase fewer goods and services. As a result, inflation causes the degradation of the purchasing power of money; a loss of value in *real* terms.

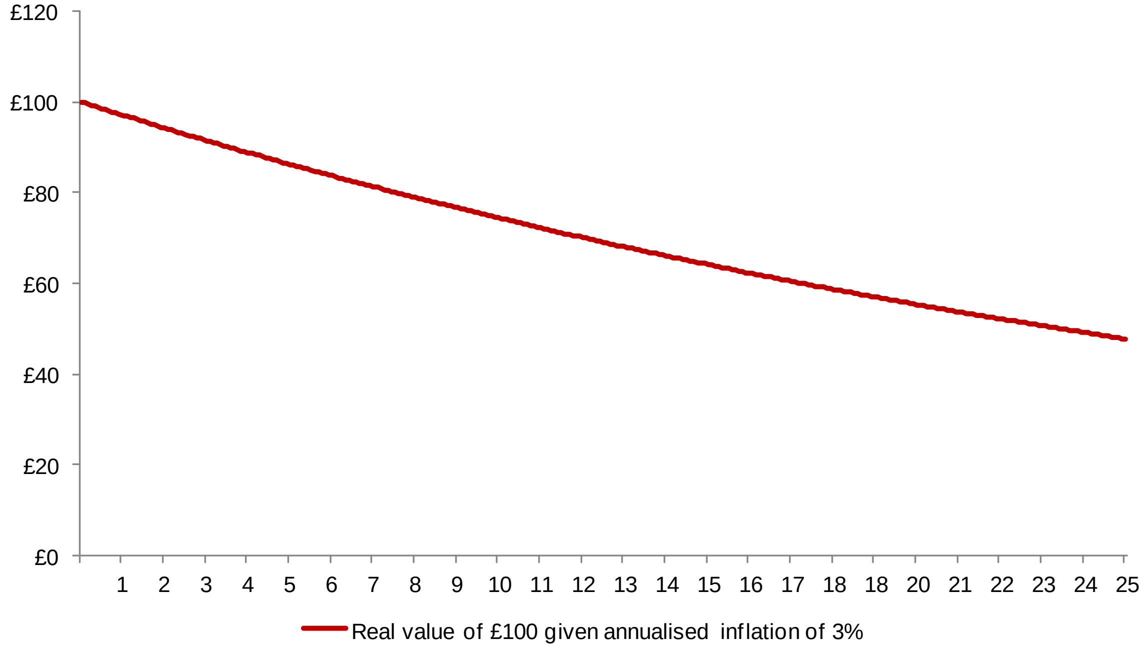
There are a number of different schools of thought with respect to how inflation comes to be seen in an economy. One hypothesis suggests that, ultimately, inflation is caused by too much money chasing a finite number of goods and services. Economic theory suggests that where demand outstrips supply the price of something is likely to rise as a result.

While the supply of goods and services is determined by tangible factors, the volume of money able to chase these goods and services is determined by the central bank, the Bank of England (BoE). The BoE is responsible for ensuring that the growth in the money supply is appropriate, such that inflation runs at somewhere close to the Bank's target rate. The BoE's role is greater than simply looking at today's prevailing conditions; it must also look out into the future and assess the longer term risks to inflation.

Regularly cited sources of inflation include changes in the supply of money, the 'velocity' of money and the level of real output. The velocity of money is how quickly money flows through the financial system. All else equal, an increase in the money supply or the velocity of money should translate to higher inflation. Thus far in the crisis, despite increases in the supply of money, the key dampener on inflation has been the fall in the velocity of money, with many entities choosing to hoard cheap money. One risk to bear in mind, therefore, is that as the velocity of money rises, inflationary pressures may be inadequately counteracted by a reduction in the money supply.

Setting the scene – the impact of inflation on savings

'Cash is king' has become a popular adage amongst investors. Where inflation is concerned, however, this is not necessarily the case. Following a difficult decade for equities, the number of investors making extensive use of cash has grown. The issue with cash – especially at present – is that while the volatility of these assets is zero in nominal terms (absent a truly value destroying incident such as a bank going bust) the returns are paltry. Consequently, investors using cash as a safe haven are particularly at risk from the erosive effects of inflation. The graph below demonstrates the impact of a 3% annual rate of inflation on a nominal starting value of £100. After twenty five years, the value of this cash has fallen to less than half its starting value in real terms, at £47.70. Furthermore, after only ten years the real value of this £100 is only £74.40, meaning a real loss of purchasing power of more than a quarter over a decade.



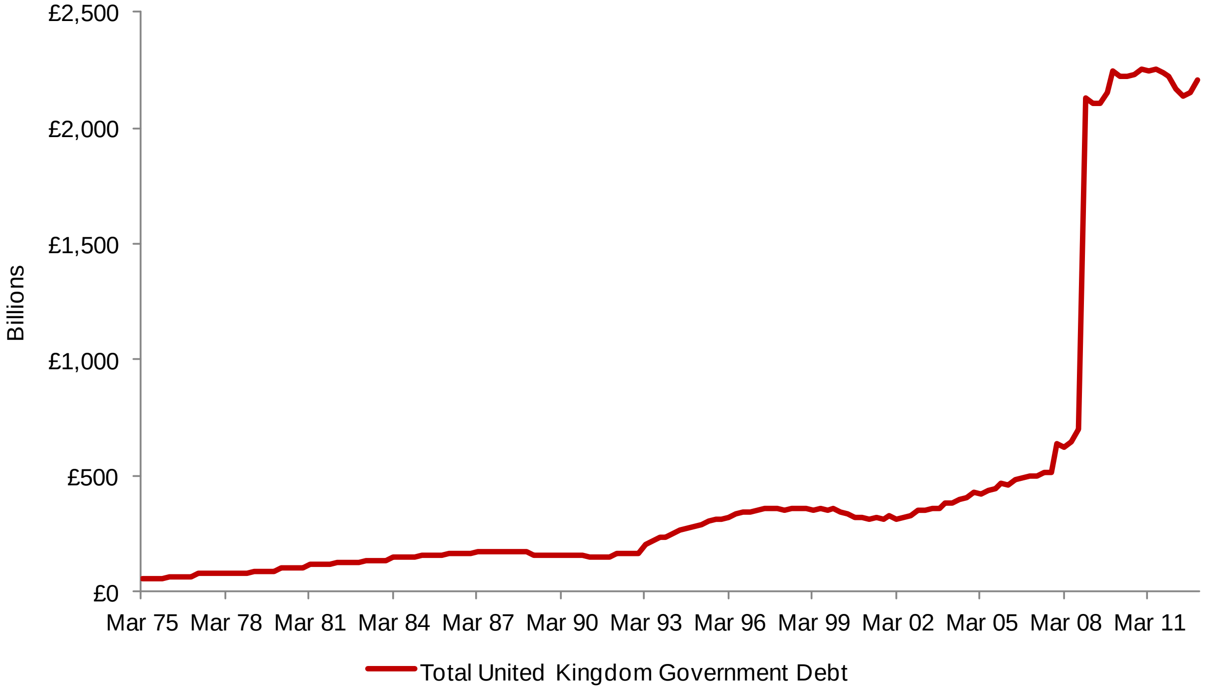
Source: Momentum, February 2013

The picture becomes bleaker as inflation rises. For example, if inflation were to run at 5% per annum instead of 3%, the real value of £100 ten years from now would be £61.30, and over 25 years it would be £29.40. Clearly the compounded impact of inflation is not something investors should take lightly.

The walls of money

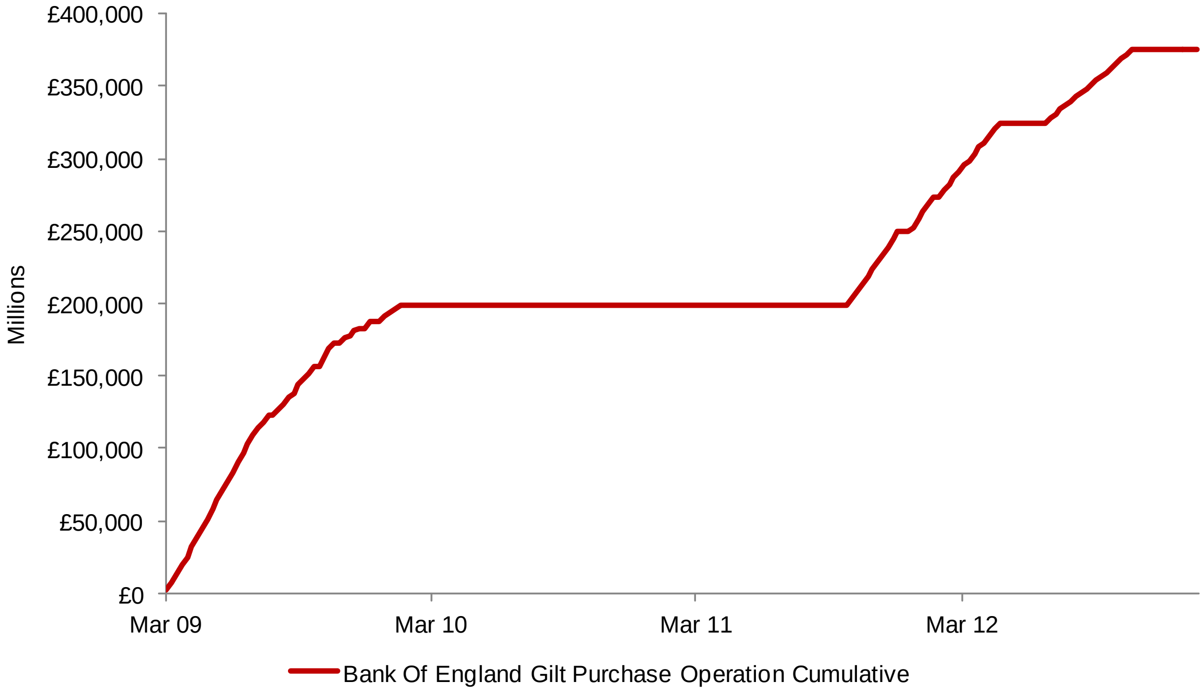
If the growth of a country's money supply poses an inflationary risk, then it is interesting to consider the events of the past five years. Policymakers in much of the developed world have been lauded by commentators for their willingness to 'throw money at the problem' of weak global growth. Central bankers have flooded the markets with 'walls of money' through both traditional and more unorthodox measures, which while successful at preventing a general economic malaise, may be creating greater longer term issues.

By way of example, the following chart shows the total outstanding debt of the UK government.



Source: Bloomberg, February 2013

These exceptional levels of government bond issuance are being supported by pensions and other similar 'liability driven' investors, many of whom are required by legislation to hold assets that match their liabilities, but this is only part of the story. The other major source of demand for government debt presently is in fact the BoE. The UK's central bank has purchased extraordinary amounts of gilts in order to keep interest rates low. In turn it is hoped that low benchmark interest rates will encourage investors to move into higher yielding assets, and make 'spread' products such as mortgages (which anchor to benchmark rates) easier to afford, at least in theory.



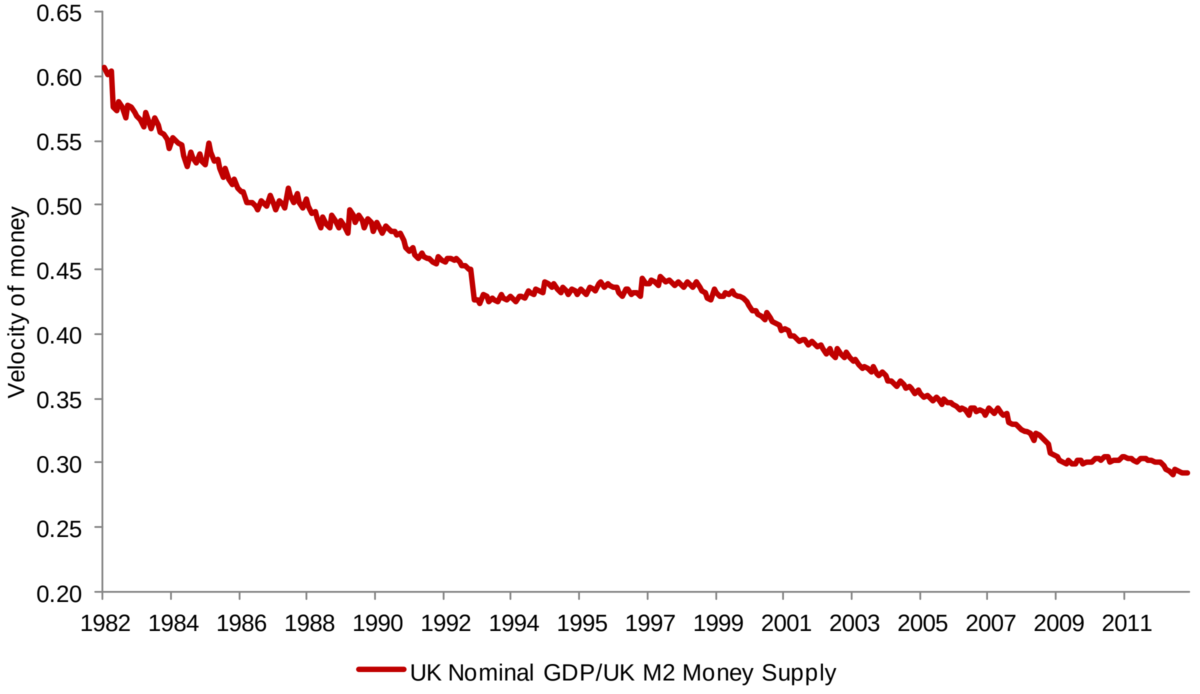
Source: Bloomberg, February 2013

The UK is certainly not alone amongst developed economies in pursuing this course of action. So far, this growth in the money supply has not materially affected the rate of inflation because the velocity of money is subdued i.e. its rate of transferral through the economy is low. Furthermore, inflation expectations remain muted. The next section deals with the risks to inflation that could be posed by these two ‘missing’ factors.

The missing pieces of the puzzle

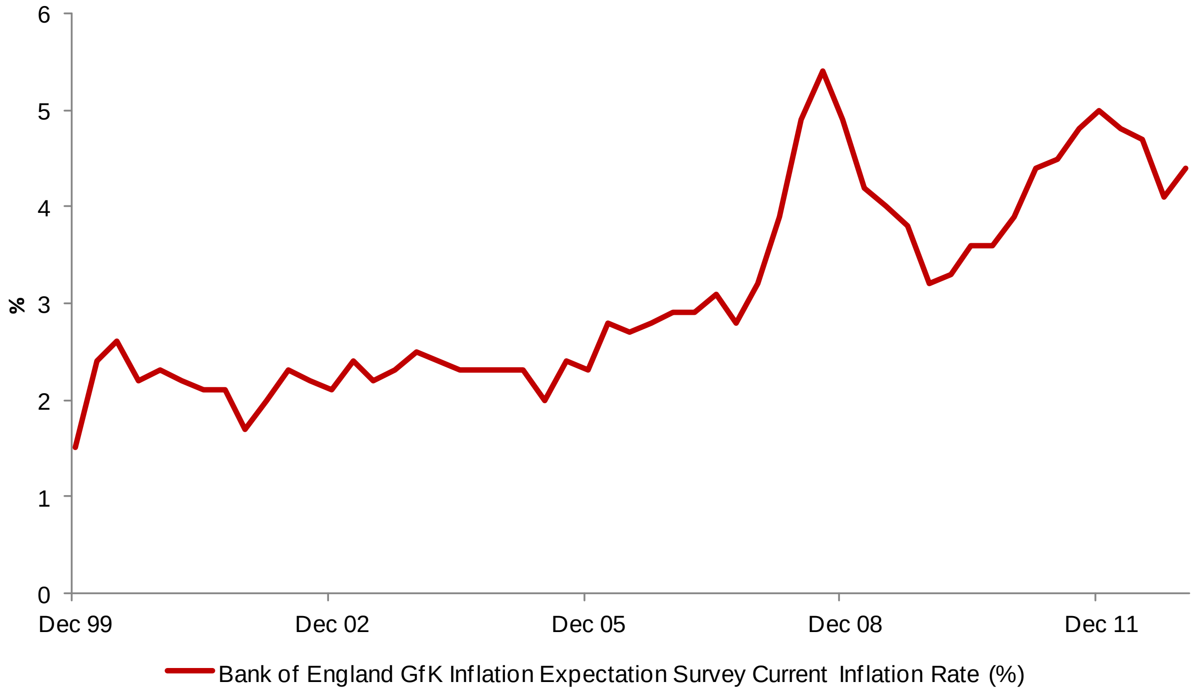
Given that the supply of money in the system has grown substantially and the economy is in many senses stable, the main factors seemingly holding back a significant rise in inflation are the low velocity of money, and the fact that inflation expectations still remain relatively contained.

As sentiment and business conditions improve, the likely path of velocity is upwards, and given the walls of money that have been put in place by central bankers around the globe, Momentum believes that even a moderate increase in this variable could have a material impact on inflation. Below is a chart that approximates how the UK's velocity of money has changed in recent years.



Source: Bloomberg, February 2013

The second missing piece of the puzzle is the level of inflation expectations. This is because inflation expectations are to an extent self fulfilling, and therefore provide an insight into future levels of actual inflation. For example, where few people expect inflation to be elevated, this would point towards a relatively benign inflationary environment in the near term.



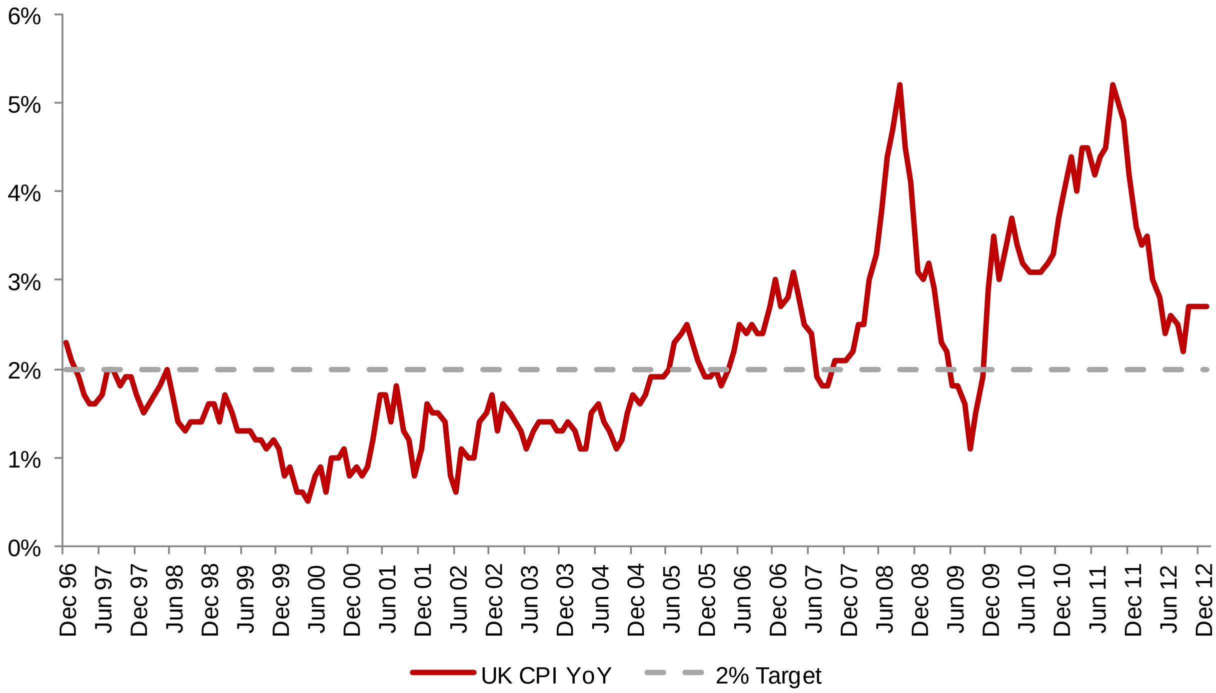
Source: Bloomberg, February 2013

It is clear from the graph above that inflation expectations have been drifting up over recent years and while the pre credit crisis years continue to represent the highs, present levels are not significantly below that peak. One dampener on inflation presently is the inability of many employees to pass through increased salary expectations into their actual remuneration packages. This is due to the relatively high level of unemployment, which reduces workers' bargaining power. As the unemployment rate falls, the opportunity for employees to negotiate wage increases will rise.

Forecasting a rise in inflation seems reasonable when one considers these factors, as well as the Bo E's relatively poor record of controlling inflation in the past.

The Bank of England's inflation targeting track record

Given the appearance of inflation above its target level, the onus is on the BoE to rein in the rate of price growth. Presently the CPI target is 2% per annum. The graph below demonstrates that the BoE has been only moderately successful at keeping inflation on target, and in recent years inflation has tended to surprise on the upside. If inflationary forces start to gather, what are the odds that the BoE will do better this time around?



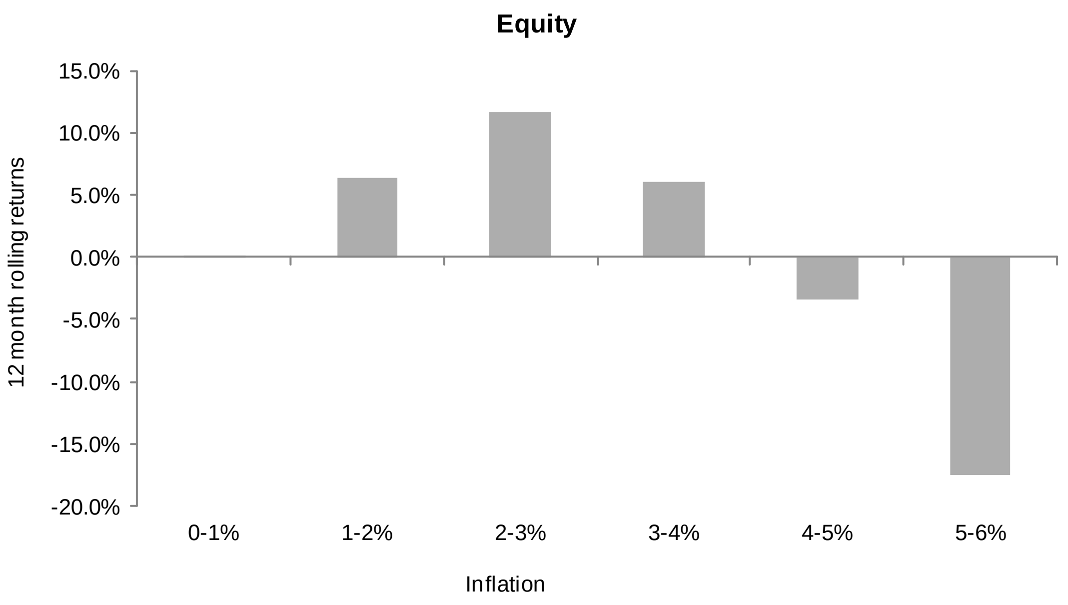
Source: Bloomberg, February 2013

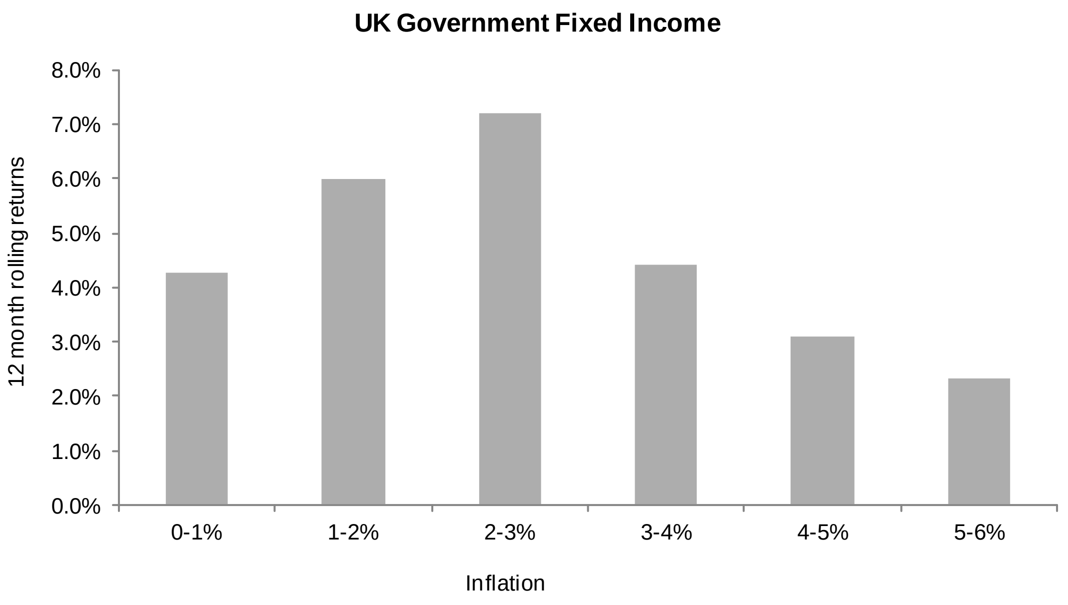
Over the period shown above, UK CPI has averaged 2.1%. Having said that, the levels of inflation observed recently are trending towards the target, despite the extraordinary lengths the Bank has gone to in order to pump liquidity into the system.

The BoE's poor track record of controlling inflation is something that the public are now wise to. Consequently, whilst inflation may be falling, people's expectations are for inflation to rise from here on in. Such an outcome would clearly impact the purchasing power of investors' assets, unless steps are taken to mitigate the impact of inflation on investment returns.

What inflation means for individual asset classes

While past performance can only ever offer a guide to the future, it is interesting to note how different asset classes behave under a range of inflationary scenarios in the charts that follow. Given the variety of potential outcomes the key is to employ a nimble asset allocation policy alongside an understanding of the importance of inflation for different assets' investment prospects. Below are chartered the average rolling twelve month returns of different asset classes in different inflationary environments of the past 20 years.





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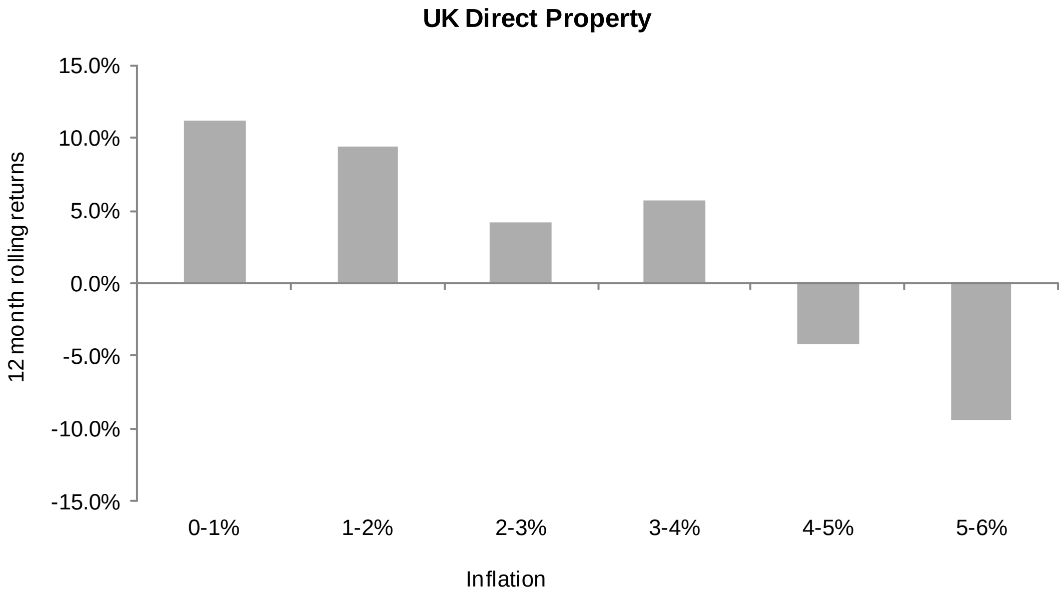

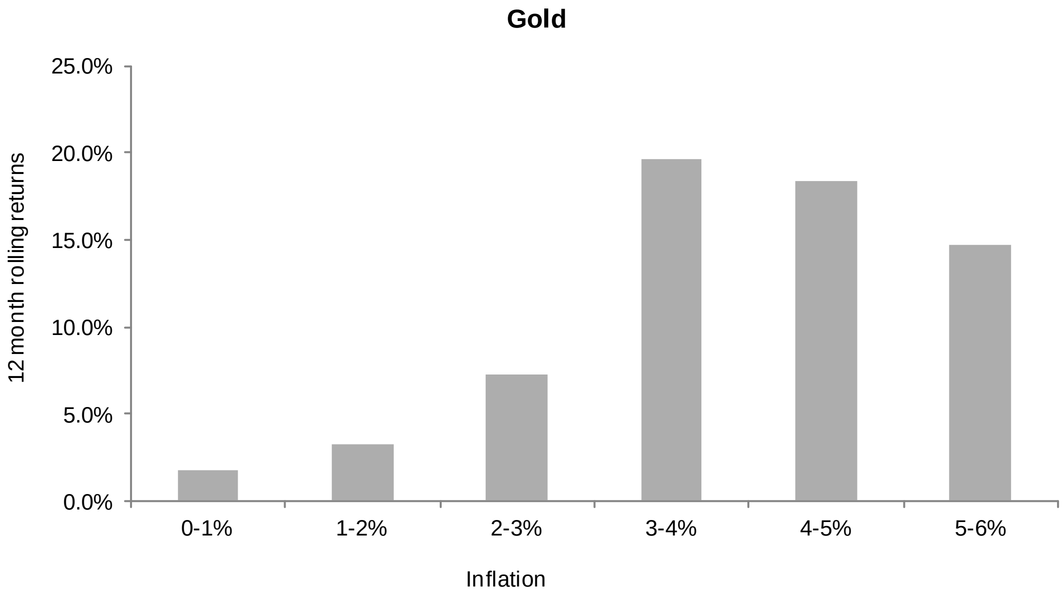

Source: Bloomberg, February 2013

It is clear from these charts that asset classes behave differently in response to a range of inflationary scenarios. This insight is key to the ongoing construction of portfolios for investors. Traditionally, investors worry predominantly about price volatility and while we continue to believe that this will be the preeminent driver of investor returns in the future, it is also clear that being able to adapt to different inflationary environments will be increasingly important. Therefore analysis undertaken by multi-asset investors should not end at valuation and volatility; it must also include a view on the likely path of inflation over the medium to long term. Finally it is worth bearing in mind that while bond returns look attractive in all inflationary scenarios, the graphs depict the returns of bond markets during a 20 year bull market. We do not anticipate this to be repeated.

Conclusion

As of today inflation is not considered to be a particular risk by many investors. The majority of investors continue to focus on the more immediate and obvious issues, such as the day to day price volatility of their investments, or the risk of a companies defaulting.

It is submitted that while these risks are clearly important, it is prudent to put in place a rigorous investment framework that also ensures adequate attention is paid to the erosive effects of inflation on investment returns over the long term. There is a risk that remaining sanguine on the outlook for inflation will leave investors out of pocket in the future.

It is imperative, therefore, that these competing risks are well balanced, and it is Momentum's belief that inflation targeting funds, incorporating a rigorous, valuation driven asset allocation process, will provide attractive real returns over the medium to longer term.

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