

# Insights

## Demystifying Inflation

Speculation about rising inflation rates is a cause of concern for many investors. However, average global inflation appears to have settled in the 2.5% range, and is now close to what central bankers would agree approximates a definition of price stability in most parts of the world. Current levels of long-term interest rates suggest that investors believe that a manageable level of inflation is here to stay.

Although we are seeing more news about rising inflation in many economies due to high commodity prices (particularly oil), core inflation (inflation excluding food and energy due to their volatility) appears benign and higher energy prices have yet to trickle down to unit labor costs. Some signs, however, suggest that inflation concerns are stirring, particularly with respect to the US and China, two of the most significant engines of global growth. As we anticipate more inflation-related news on the horizon, this is an opportune time to go back to the basics of inflation.

### What Is Inflation and What Causes It?

Inflation is an overall global upward price trend of goods and services in an economy. It usually occurs in a period of economic growth when there are not enough “in-demand” products and services to meet the public’s need. Producers can, therefore, raise their prices, as spending outpaces the production of goods and services. The consequence is that the purchasing power of a currency declines over time. In extreme cases, this means that it becomes difficult for consumers and businesses to make plans for future purchases.

### How Is Inflation Measured?

The two most commonly used indices to measure inflation are:

- CPI, the Consumer Price Index, is the most commonly watched inflation index. This index reflects the retail prices of goods and services, including healthcare, housing and transportation. The CPI is used to adjust Social Security and other benefits. Europe looks to the European Harmonised Indices of Consumer Prices (HICP), which represents the most comparable measure of price change across countries.
- The GDP Deflator is a broad indicator of price changes for goods and services produced by the economy as a whole.

### How Can Inflation Be Controlled?

Central banks try to maintain a stable inflation rate by regulating the pace of economic activity, either by raising or lowering short-term interest rates.

Let’s look at a simple example that illustrates how central banks regulate the economy and the rate of inflation. If a car goes too fast there are two possibilities: the car could crash or the engine could burn out. Think of interest rates as the brake on a car, the economy as the engine and the central bank as the driver. If the car is going too fast (equivalent to a growing economy with accelerating inflation) the driver (central bank) could use the brake (rising interest rates) to slow down the car (economy). Conversely, if the car is not going fast enough, the driver (central bank) would not use the brake (decrease interest rates) to allow the car (economy) to go faster.

Central banks may lower interest rates by purchasing bonds and providing the bondholder with money to spend in the marketplace, thereby adding money into circulation. In addition, lowering rates encourages banks to borrow from the central banks and from each other, which also encourages businesses and consumers to borrow money, spend and invest. This chain of events helps to stimulate spending and overall economic activity.

If central banks want to raise rates in response to high inflationary concerns, they will take money out of circulation by selling bonds and reducing the money supply. Higher rates discourage banks, businesses and consumers from borrowing, spending and investing, and therefore serve to subdue economic activity.

### What Does Inflation Do to Investment Returns?

Inflation tends to erode the value of investment returns. Investments must therefore generate better performance to keep up with inflation and serve to increase the investor’s long-term purchasing power.

Inflation can particularly affect fixed-income returns, since investors usually rely upon this asset class to provide a stable and predictable income stream. Due to the static coupon on most fixed-income investments until their maturity, the actual return, and therefore, purchasing power, of the interest payments declines as inflation rises. Rising inflation usually brings along rising interest rates — either due to the market’s inflation expectations, or central banks’ attempts at controlling inflation. As a consequence, bond prices fall, which also impacts the total return of bonds.



## What Can Be Done to Protect Investments from Inflation?

Within the fixed-income universe, investors should consider securities that are linked to inflation's movements:

- Inflation-Protected Securities are mainly issued by federal governments; for example, Treasury Inflation-Protected Securities (TIPS) in the US, Index-Linked Gilts in the UK and Real Rate Bonds in Canada. IPS issuers can also be found within the private sector and other levels of government. Both the principal and interest payments of these securities adjust according to changes in the CPI.
- Floating rate notes are also positively correlated to inflation, since their coupons move in line with interest rates.

In the long term, stocks tend to be less impacted by rising inflation. Stocks are generally more resilient to the effects of inflation as revenue and earnings tend to increase in line with inflation, assuming that companies can pass on higher prices to consumers. However, the impact of rising interest rates on stocks partially mitigates their usefulness as an inflation hedge on a more short-term basis.

Overall, the best hedge against rising inflation is a well-diversified portfolio of fixed-income instruments, equities and alternative investments. Having a well thought out asset allocation strategy, and rebalancing portfolios on a regular basis, is the best way to ensure that one's wealth not only keeps pace with inflation, but grows over the long term.

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