equilibrium asset management

Stagflation

Inflation continues to go through the roof with RPI hitting 5.1% this month.

"Don't worry," says the Bank of England, "it's only food and petrol and gas and electricity, it's not core inflation."

This sort of statement quite rightly gets under people's skin. What can be more core than the items which sustain us, keep us warm, and get us to and from our places of work?!

What economists mean by core inflation is generally the sort of stuff that could get ingrained into the system. For example, wages have seen little or no inflation. Wage inflation means people have more money to spend pushing up other prices, which in turn pushes up wage inflation. This isn't happening. Yet.

The Bank of England and many others feel that most of the factors pushing up the inflation figures are temporary. Food and fuel price rises worldwide have been exacerbated by a fall in the value of the pound. Anything we import costs more as a result.

Unless these items continue to grow at the same rate, and Sterling falls at the same rate (which it hasn't been doing for some time), these factors should drop out of the calculations. Likewise, the VAT rise causes a temporary rise in inflation numbers.

Whilst the simple maths means that inflation should fall back later in the year, it is this fall back that we think could be temporary.

Take the oil price. Oil is a finite resource, it's becoming harder to get out of the ground from harder to reach places, and it's more and more in demand from emerging economies. Likewise, food prices are rising as those emerging markets demand more of a Western diet. We think those inflationary forces are here to stay.

One thing we are seeing is that people's expectations of future inflation are rising. This can actually contribute to rising inflation, since this makes wage rises more likely. Despite high unemployment, there are shortages of skilled workers in many industries.

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Stagflation

Stagflation: "A condition of slow economic growth and relatively high unemployment - a time of stagnation - accompanied by a rise in prices, or inflation."

Stagflation is a dirty word for economists. No one really wants to mention it, but to us it seems distinctly possible.

Most economists agree that we are going to have relatively low growth for some time, unemployment is undoubtedly high and may rise further due to public sector cuts. Therefore, if inflation remains high we think stagflation is distinctly possible.

Who Normally Benefits From Inflation?

A reasonable amount of inflation is fine provided economic growth is also high. Some people can even benefit from it.

Higher growth usually means rising equity prices, property prices, and wage inflation, which can compensate most people for increased prices.

Mortgage holders do well in most normal inflationary periods, as the real value of the mortgage becomes much lower in proportion to both the house value, and their income.

In addition, the government would probably welcome relatively high inflation, which may help to solve our national debt problems.

Who Suffers From Inflation?

Those on fixed incomes suffer in an inflationary environment, as the real value of their income decreases year on year.

This often affects pensioners. Even people with index linked pensions are affected as the inflation linking is capped. In addition, the real cost of inflation for pensioners is often higher than the official RPI or CPI figures.

Everyone's personal inflation rate is different. You can calculate your own rate by using an online calculator provided by the BBC at:
http://www.bbc.co.uk/news/business-11331052

Who Suffers in Stagflation?

If we get low growth as well as inflation, then it becomes much more difficult for everyone.

Without the growth that leads to higher incomes and higher asset prices, the amount of money in people's pockets reduces.

Lenders suffer in stagflation, as not only does the amount they are owed reduce in real terms, but people's ability to repay debts. Whilst punishing the banks sounds a great idea, this has an impact on the wider economy.

This can all become a vicious circle with growth being low for a number of years.

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What Next?

With lower growth, inflation HAS to be kept down otherwise it will become a real issue.

If inflation can be kept to more manageable levels, then GDP will rise as the published numbers are calculated AFTER inflation. If inflation falls and nominal growth stays the same, real GDP will go up by default.

Interest rates will have to rise sooner or later. In theory, this should increase the value of the pound and therefore lower the cost of imports. Whether this will work is a matter for continued debate.

Interest rate rises are controversial, since in themselves they can reduce growth and can actually increase inflation in the short term. However, there are very few alternative courses of action for policymakers.

In the meantime, we should be thankful that we have some high quality international businesses based in the UK. These well capitalised businesses make money from all around the world, where growth is continuing at pace.

We believe it is still possible to make money ahead of inflation, particularly from equities in these sorts of companies. However, there is no doubt that it is much more difficult to find compelling opportunities now than it has been for some time.

Whilst we have concerns about the economic future, we should remember how far we've come in the past two years. We no longer fear the collapse of the entire financial system.

Since March 2009 virtually every asset class has risen fairly substantially and, whilst the picture remains unclear, there are still reasons to be positive.

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Market Views | March 2011

General Economic Overview

GDP growth is expected to remain muted but will recover from last quarter's negative result. Inflation may remain well above the Bank of England target for some time, and potentially could be a concern in the long term.

Interest rates will have to rise this year but will remain relatively low to try and stimulate economic growth. Raising interest rates would have little impact on inflation, which is mainly being driven by commodity prices and the VAT rise.

If our scores below turned out to be correct, our balanced asset allocation could return around 7.1% over the next 18 months compared to our long term assumption of 7.6% pa.

Asset class key

+	positive	+5	strongly positive
-	negative	-5	strongly negative
=	neutral (normal behaviour)		

	Outlook
Equity Markets Equities look decent value based on current earnings. However, earnings continue to be revised upwards and if projections are correct there is the potential for some good growth. We remain overweight "alternative equity" giving exposure to equity returns but with some downside protection. We believe that high quality, well capitalised companies should outperform, as they have not seen the same growth as poorer quality stocks.	+1
Fixed Interest We are concerned about the risks of investing in pure fixed interest. Given our views on inflation and interest rates, returns on fixed rate bonds are likely to be much lower than they have been of late whilst the risk of losses is increased. However, we believe there is value in inflation linked, variable interest rate, and some high yield bonds.	-4
Commercial Property The rental yield on the commercial property index remains very attractive relative to other asset classes. However, we are expecting little capital movement and possibly some small capital losses over 18 months. Property funds are gradually reducing their high cash levels, which has been a drag on returns. This should improve total returns.	-2
Residential Property We believe prices could fall or remain flat over 18 months, well below our 5% pa average assumption.	-5
Cash With interest rates remaining at record lows, returns on cash are as low as they have ever been. Rates will remain below average for some time.	-5

These represent Equilibrium's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take action without speaking to your adviser.