



Should we worry about global inflation?

John Stopford, Co-Head of Fixed Income at Investec Asset Management, discusses the potential for higher inflation, and how investors can protect their portfolios against such an outcome.

Back in 2002, Ben Bernanke outlined how central banks can print money to ease policy even when official interest rates have been cut to zero: “US dollars have value only to the extent that they are strictly limited in supply. But the US Government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many US dollars as it wishes at essentially no cost... We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.”

In the last six months, policymakers have been putting this idea into practice. Unfortunately, the printing press is a pretty blunt tool. Ultimately, the speed at which money circulates through an economy tends to vary over time and so calibrating the amount of new money needed to boost spending and inflation is an art not a science. The problem for central bankers is that if they do too little, they risk being overwhelmed by the deflationary forces present in the global economy but if they do too much they risk creating excessive inflation. To complicate matters further, their policy works with “long and variable lags”, making it impossible to identify the right amount of stimulus until after the fact.

The lesser of two evils?

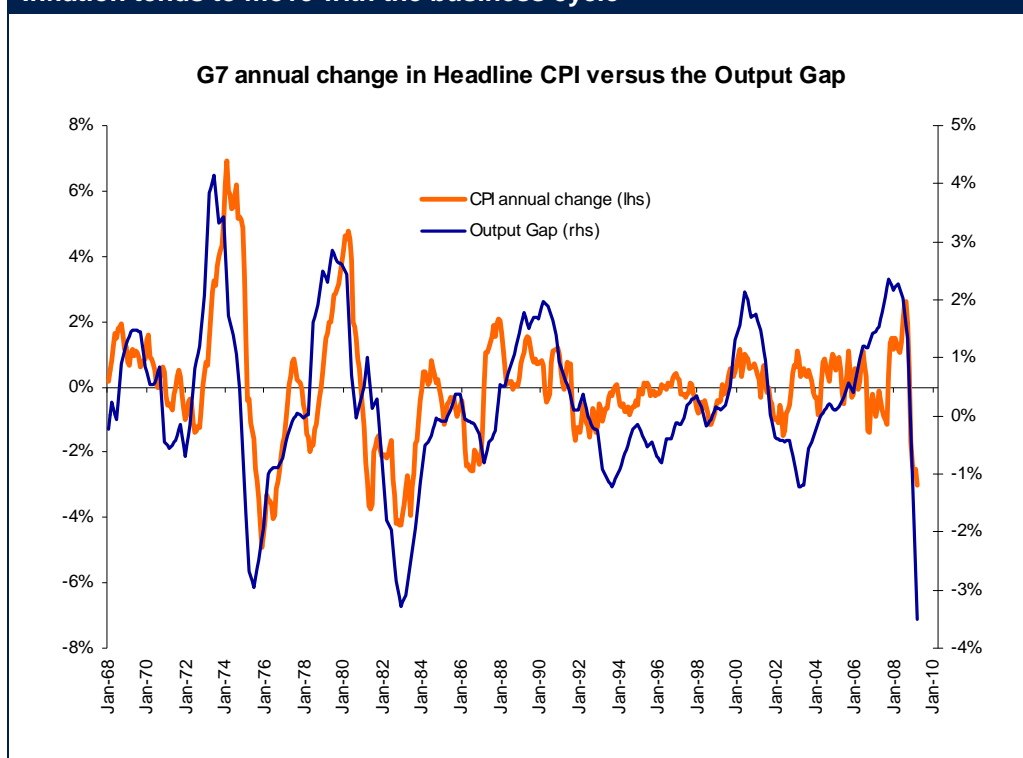
Perhaps reasonably, most central bankers are biased towards doing too much rather than too little. A little bit of inflation is seen as the lesser of two evils and has the advantage of being easier to reverse.

The history of paper currencies suggests this bias has always been there. Most policymakers equate price stability with measured inflation of about 2% and consumer prices have tended to rise persistently at varying rates since the 1930s when most countries abandoned the gold standard and took control of the printing presses. Against this backdrop some inflation appears inevitable. It is therefore just a question of when it will take off and how high it might go.

For individual currencies there is clearly some risk that attempts to debase their currency just enough to avoid deflation could undermine confidence sufficiently to cause a run on its value, leading to higher inflation. Aside from this, it seems unlikely that inflation will be a major issue for the next one to two years, especially given the amount of economic slack that has been created by the credit crisis. Even in the 1970s, inflation tended to decline after recessions and only rose later in business cycles when spare capacity was used up.

Out of the Ordinary™

Inflation tends to move with the business cycle



Source: Investec Asset Management, OECD

In time, however, cyclical pressures should begin to build. This may happen sooner in some sectors, such as commodities, where supply has tended to grow less quickly than demand over the last few decades. This makes it probable that headline inflation will recover faster than core inflation (which excludes food and energy costs). There is also evidence that the ability of economies to grow without creating inflation has been impaired by the rise in the cost of capital associated with the credit crunch and the impact this is having on investment. If this is so, even a moderate recovery could spark an acceleration in inflation. Unless central bankers react decisively to the early signs of inflation, there is a real risk that consumer prices could increase at a faster rate over the next decade than is currently priced into financial markets.

Where to invest to hedge inflation risk

Fortunately, there are a number of ways in which investors can hedge inflation risk. The evidence suggests that commodities and, less intuitively, cash deposits offer the best protection against a pick-up in inflation. The correlation between commodity price and inflation is obvious, but interest rates should also be expected to rise with inflation to encourage saving, and most central banks normally target a positive real interest rate.

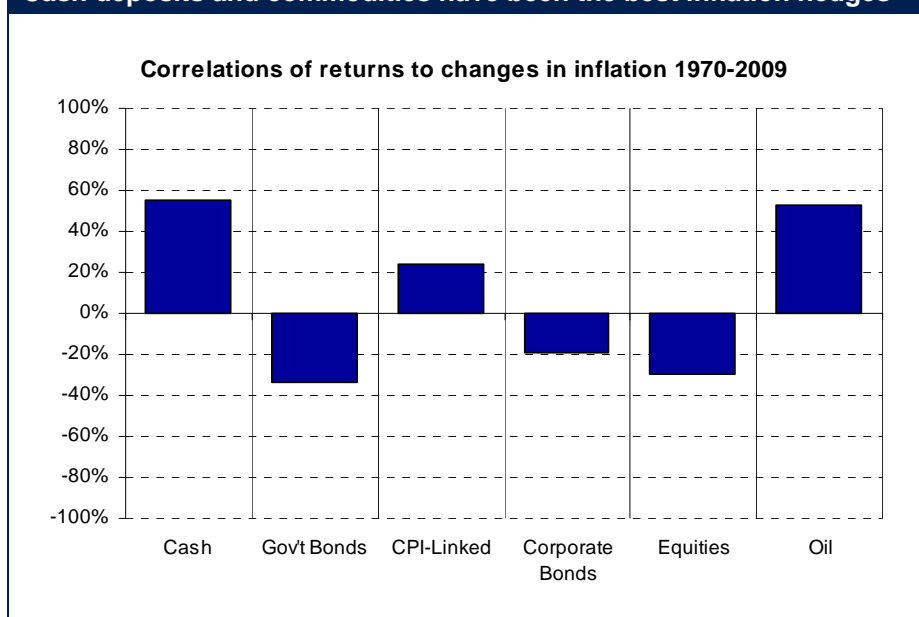
By contrast, equities, despite representing a claim on real assets, have historically been a poor hedge against inflation in the short term. Indeed one study¹ comes to the conclusion that, "to use common stocks as a hedge against inflation, one must sell them short." This finding reflects the inability of many companies to pass on rising costs to their customers, the negative impact of inflation on interest rates and growth and the inverse correlation between inflation and P/E multiples.

Perhaps not surprisingly, the shares of companies which can pass on higher prices to their customers, such as resource equities, work much better as a hedge against inflation than the shares of companies that cannot do so as easily.

It is well known that property has tended to be a more successful inflation hedge, but unfortunately tradable Real Estate Investment Trusts (REITs) behave more like equity than property during inflationary episodes.

¹ Zvie Bodie, 1976, "Common Stocks as a Hedge against Inflation", Journal of Finance, Vol. 31, No. 2.

Cash deposits and commodities have been the best inflation hedges



Source: Investec Asset Management

Surprisingly, the inflation hedging properties of inflation-linked bonds are also rather mixed. Despite being indexed to changes in consumer prices, swings in their real yields can have a more dominant impact on their returns, especially for longer-dated bonds. Inflation swaps, however, offer a more direct hedge.

Ultimately, the success of any inflation hedging strategy will depend not only on how different assets respond to a rise in consumer prices but also on whether the instruments chosen are appropriately valued. We would advocate a portfolio approach that balances the costs and hedging qualities of different asset classes. As the economic recovery gains traction, the threat from inflation will increase. Unless investors begin to take this into account, they run the risk that higher prices will start to eat away at the real value of their savings. For our part, we expect inflation protection to form an increasingly important element of our clients' portfolios over the next few years.

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For further information, please contact:

Investec Asset Management Asia Limited
Phone: +852 2861 6888
Email: investec.asia@investecmail.com
Website: www.investecassetmanagement.com

Notes to Editors

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