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Inflation-proofing your portfolio

One of the biggest threats to the health of your investments

The coronavirus (COVID-19) pandemic has had a dramatic effect on the global economy. Around the world, economic activity has dried up. Fewer consumers are buying and fewer companies are investing.

If you take the view that inflation will go up in the long term, it is worth considering whether your savings and investments could be affected. After all, you need your investments, and the income from them, to keep pace with inflation to maintain the value of your buying power.

INFLATION OVER THE PAST DECADE

When we think about concerns over inflation today, we have to consider how the world looked immediately before the coronavirus pandemic, as well as our wider experience with inflation over the past decade.

In the run-up to the COVID-19 pandemic, things were actually pretty quiet on the inflation front. In fact, you could argue that policymakers were more worried about inflation being too low, or persistently low, rather than any return to the 1970s.

DECLINE IN DEMAND ACROSS THE ECONOMY

There are a number of factors driving down inflation at the moment. The social lockdown to help combat the spread of the virus is seeing us having to stay at home, meaning we have generally been spending less, which has led to a decline in demand across the economy. As elsewhere around the world, we have also been driving and travelling far less.

In addition, the price of oil has been a historic bellwether for the health of the global economy. The effect of lower oil prices feeding into lower costs of production for a wide range of goods will also push down inflation.

SPENDING COULD DRIVE INFLATION HIGHER

Despite unprecedented support from the UK Government to help workers and businesses, job security and consumer confidence has collapsed. Economic uncertainty and the threat of unemployment have left many less willing to spend

and businesses less willing to invest in capital.

Unless the damage done to the economy ends up lasting, it's likely we'll see a pick-up in spending once there is some resumption of normality. Depending on how much demand is pent up, and how willing consumers and businesses are to part with their savings when we start to emerge from the crisis, the rise in spending could drive inflation higher.

OTHER POSSIBLE INFLATIONARY PRESSURES

Over the long term, there are worries about other possible inflationary pressures. Prices can also go up because there is less supply of products. The ongoing situation caused by the crisis is seeing significant disruption to trade, and some companies going out of business. This could also have the effect of constraining the supply of goods and competition in the global economy, contributing to higher prices at checkouts.

Due to the heightened degree of uncertainty in global markets, it is difficult to forecast the outlook for inflation with any certainty. Nonetheless, it is worth considering the possibility that inflation may rise to levels that have historically been more 'normal'.

INCLUDING SOME PROTECTION AGAINST INFLATION

Investors may not be overly concerned in the short term about inflation, but a diversified portfolio should always include some protection against inflation, whether through holding shares in companies that have the ability to raise their prices over time, or more direct inflation-protecting assets such as inflation-linked bonds. Exposure to inflation-protecting assets should be seen as part of normal portfolio allocation, rather than as a response to the threat of higher inflation.

Inflation poses a threat to investors because it chips away at real savings and investment returns.

Most investors aim to increase their long-term purchasing power. Inflation puts this goal at risk because investment returns must first keep up with the rate of inflation in order to increase real purchasing power. ■

TAKE STEPS TO COMBAT INFLATION

Inflation might be beyond your control, but that doesn't mean you can't take actions to help preserve your investments and savings from its effects. To discuss this further or for more information, please contact us.

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