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A Guide to Inflation ... Your Questions Answered

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As of April 2022, American consumers are paying 8.5% more for everyday goods than they were a year ago. That's the highest rate of price increases in more than 40 years. In the UK, the year-on-year increase in prices is at 6.2% – again the highest rate in decades*.

Introduction

Inflation is being experienced all around the world as prices of food, fuel, electricity, and many other items that make up our routine shopping are going up fast.
This marks a distinct change. In recent memory, inflation in most developed economies has been low.
So what's changed, and what does it mean for investors?

What is Inflation?

Inflation describes a change in prices. Where official consumer inflation statistics are provided on a national basis (such as the figures for the US or UK above) they are usually calculated by governments. They work out price changes by tracking a basket of commonly-bought items. These will include food and drink, clothing, footwear, transport and energy costs, for example.

If the inflation rate is being reported as at 5% year-on-year, it means that prices in general are 5% higher than they were this time last year.

From 5p to 50p in five decades: real-life price rise of a pint of milk

In January 1971 the average price for a pint of milk in the UK was just five pence. It remained roughly that level until 1975, after which it crept up gradually to just under 40p in the 1990s. The steepest increases have come recently. In April 2021 a pint of milk cost 42p. In March 2022, that reached 50p: a 19% increase in under a year. (Source: ONS)

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What causes Inflation?

Inflation has several potential causes. Economists talk of two main types: "cost push" or "demand pull". If the costs of producing goods and services rise, consumers face increased prices for end-products: this is "cost push".

But prices can also rise where there is more demand for something than there is capacity to supply it: this is "demand pull".

Today's inflation is being driven mostly by cost pushes. Energy is a component in most goods and services, and when as now its price rises, producers will need to pass on the cost.

Supply disruption in China and elsewhere, caused by the Covid pandemic, had a similar effect: the supply of components, consumer electronics and auto parts fell, causing their prices to rise.

Why is too much inflation seen as a problem?

Hurting savers: how the value cash erodes away

Even low inflation eats away at the purchasing power of cash. In the 21 years since 2000 UK inflation has averaged 2.1%, according to the Bank of England. That's a small number compared to the current inflation rate of over 6%. But £10,000 put in a box in the year 2000 would have shrunk to just £4,639 by the end of 2021.

The most obvious danger of inflation is that if prices rise faster than incomes, people can afford to buy fewer goods and services. This can mean a fall in standard of living. In practice inflation's negative effects are more subtle, impacting different groups in different ways, and having a broader destabilizing effect on societies.

These are just some of the negative effects of inflation:

- Inflation is hardest for those on fixed incomes such as pensioners
- It destroys the value of cash and discourages saving
- It can lead to workers demanding higher wages, creating "wage-price spiral" of further inflation
- It can increase the cost of borrowing, adding to financial pressures on households and businesses
- Because future costs are hard to plan for, it can deter businesses from investing
- It can reduce the value of a currency against other currencies, making imports more costly
- It can add to government costs and borrowing, as more provision may need to be made for pensions and other spending
- In the worst cases, countries suffering from high inflation have to abandon their local currency and adopt the currency of a more stable nation. This happened in Zimbabwe after hyperinflation in 2008 forced the country to use the US dollar.

What is the link between inflation and interest rates?

Inflation and interest rates are closely tied. This is because interest rates are the key tool used by countries' central banks (such as the US' Federal Reserve or the UK's Bank of England) to control inflation.

How does it work?

Most central banks are tasked with keeping inflation below an agreed level (say 2%). When inflation is rising, central banks raise interest rates as their way of controlling it.

Higher interest rates lead to higher borrowing costs and in turn less spending. This can dampen inflation. The opposite is also true: if inflation is low and an economy too slow, central banks might cut interest rates in order to stimulate more borrowing and more spending.

If that's INflation, what about DEflation and STAGflation?

Inflation describes a widespread rise in prices. Deflation is the opposite: it describes a period when prices fall.
As with inflation, too much deflation is unwanted. Falling prices can lead to deferred spending and investing, withdrawing demand from the economy and weakening growth.
Stagflation describes an unusual set of circumstances when prices are high or rising, but at the same time economic growth is weak or falling. This is what many economies may be facing in 2022.

Inflation lessons from history

There are parallels between events today and in the 1970s. Back then, oil shocks pushed up the price of oil which triggered higher inflation. In the US, inflation rose to 14.8% by 1979.**

In the 1970s central banks were slow to act, partly because raising interest rates is not a popular move. Instead they hoped the mere fact that goods and services were getting more expensive would stop people spending.

In fact the opposite happened. Consumers spent more because they expected prices to continue rising, which only made prices rise even further.

Eventually policymakers turned to interest rates. In the US, for instance, new Federal Reserve Chairman Paul Volker raised interest rates from 10% in 1979 to nearly 18% in 1980.

This time around, policymakers are far more ready to use interest rates to tame inflation, not least because central banks are now independent. Our economists think it's unlikely we'll experience the same levels of runaway inflation as we did in the 70s and 80s, but that we'll have to go through a period of painful adjustment that'll include higher unemployment and slower economic growth in order to get back to a more stable inflation situation.

Inflation snapshots: the double-digit years

You spent £1,000 in 1970. How much would you need to spend ten years later (1980) to buy the same quantity of goods? £3,608 (13.7%)

You spent £1,000 in 1975. How much would you need to spend five years later (1980) to buy the same quantity of goods? £1,967 (14.4%)

You spent £1,000 in 1979. How much would you need to spend one year later (1980) to buy the same quantity of goods? £1,180 (18%).

Source: Bank of England

Practical ways investors can limit the harm of inflation

Consumers can guard against rising prices by fixing certain outgoings, such as energy bills, loans and mortgages.
But what about their savings and investments?
As our examples show, cash performs poorly in times when prices are rising.
Shares in companies tend to hold their value better than cash: but their ability to weather inflation varies according to a range of factors.
Recent Schroders' research looked back in history to see how stocks in certain sectors performed during periods of stagflation – as we may be facing in 2022 – when inflation is higher than average, but when economic growth is slowing.

It concluded that:
- Shares in defensive companies (those selling essential products and services, such as electricity or staple household goods) tend to hold up better
- The best-performing stock market sectors during periods of stagflation*** were utilities, consumer staples and real estate

Diversification is another key defence during periods of inflation, with a well-managed portfolio being exposed to a range of asset classes. So alongside your holdings in company shares (as above) you may benefit from exposure to commodities, such as gold, property and other alternative assets including private assets (investments not listed on public markets).

Some investments – such as inflation-linked bonds – are explicitly designed to pay out in relation to inflation. However, demand for these investments grows during inflationary periods and so can push up their prices.

*US Bureau of Labor Statistics – March 2022
*UK's ONS – March 2022
**US Bureau of Labor Statistics
*** From 1995 to December 2021.
Source: Schroders Economics and Strategic Research Unit.

Is it appropriate still to use, for example, an inflation figure of 3% when planning?

Generally, and for most clients, when we plan, the timeframe we are considering span 20 years plus (often 40 years), so it is important to consider what inflation has been doing over a similar period. Of course, cashflow models are long-term illustrations of one potential financial future and are subject to many changes which is why we consider them as a 'living tool' and not static one-off planning events. Over the last 30 years, the Retail Price Index (RPI) has been a volatile beast, moving from lows of -1.6% to the recent highs of 2022. Therefore, we can look at the rolling average to gain longer term view – this view shows this long-term average at about 3%.

It takes a goodly amount of time, when considering a 30-year timeframe and accounting for the regular changes that occur, to move the average rate up or down. For example, it would roughly take 60 months if inflation remained at current levels to move this rolling 30-year average from 3% to 4%!

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