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How worried should we be about inflation?

Now that the pandemic seems to be less of a longer term threat to global economic growth, the ugly spectre of much higher entrenched inflation is the dominant factor influencing markets and investor sentiment.

We all know that energy prices and supply chain issues have contributed towards higher inflation over the past few months, but looking further ahead, the bigger threat to an end to low global inflation lies with central bank policy.

In order to understand this fully, look at how the narrative has subtly changed: last year, the US Federal Reserve shifted its target to an ‘average’ rate of inflation of 2%, and also for such a rate to persist ‘for some time.’ It also altered its stance on full employment, and this means that it will not tighten policy until we see full employment.

Elsewhere, the European Central Bank has moved its own set of goalposts to a 2% target, as opposed to a previous aspiration of close to, but below 2%. Small turns of the dial perhaps, but with potentially long-lasting consequences.

In the UK, the Monetary Policy Committee is already displaying a greater divergence of opinion about tightening of policy than has been seen for several years, and Governor Andrew Bailey’s somewhat unsteady pointers to the market have not helped – the world we live in now calls him ‘an unreliable boyfriend’ – probably not the high esteem that he was hoping to be held in!

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The big question in the UK, of course, will be the extent to which the government forces bank policy to focus more on economic growth than inflation targets.

As we move ever closer to yet another general election, turning something of a blind eye to inflation in favour of growth will be increasingly attractive to the government. They need no reminding that inflation and low interest rates are pretty handy for those with debt to service or repay, and we all know whose debts are the largest these days. And the numbers are truly terrifying: a one percentage point increase in rates, taking us to a base rate of a mere 1.1%, adds £25bn a year to the government’s cost of servicing its debt.

There is also a knock-on effect on sterling, which has weakened against the US dollar. At the time of writing, sterling against the dollar is teetering on an important trading point of about $1.34; the ongoing hints from central banks will probably determine whether it can rebound from this level, or is set to move lower against the dollar.

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Predicting currencies is a mugs' game, but generally speaking betting against the dollar has proved to be an unwise move. From a global perspective, international investors reading about the UK's recent fuel shortages and another 'winter of discontent' with empty supermarket shelves at Christmas is unlikely to help the bigger picture.

So how worried should we be?

It may be too early to tell, but our own view is that some of the principal drivers of short-term inflation will be mainly transitory. Whether we are right or wrong, for many asset classes, including the stockmarket, some modest entrenched inflation should be a generally benign influence. However, barring a more deadly strain of Covid emerging, this question will dominate investor sentiment through 2022.

In the grand scheme of things, it needs to be remembered that we are still looking at relatively small changes to monetary policy and a scenario that sees inflation retreat to more manageable levels once current restrictive conditions normalise. Cash is also likely to remain an unappealing investment option going forward.

But the prospect of an end to an era of ultra-low borrowing plus rising costs will almost certainly increase the chance of raised market volatility – that should play more into the hands of those investors who have, and can utilise effectively, an active investment management style. Sitting on one's hands during this next phase of economic recovery is unlikely to be a rewarding experience.

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