Inflation: the good, the bad and the ugly

Global inflation is heating up. According to the International Monetary Fund, the global consumer price index (CPI) is expected to rise from its recent 2015 low of 2.8% to 3.5% in 2017 and then hover around this level for the next five years.

But AXA Investment Managers' head of macroeconomic research, Laurent Clavel, and the firm's senior fixed income portfolio manager, Jonathan Baltora, believe the cost of living could jump even higher before it eventually stabilises, primarily because central banks have deliberately kept interest rates down in a bid to help their respective countries cut their debts.

The three faces of inflation

For Clavel, there are three types of inflation - the good, the bad and the ugly.

Good inflation occurs when prices are rising in a controlled manner, allowing employers to increase employees' wages, which in turn boosts consumer confidence. It also helps individuals, companies and governments reduce their debt as the value of their borrowing falls in relation to their income.

This is why central banks usually set an inflation target of between 1% and 3%, as it helps prices to rise in a disciplined way. Central banks prefer not to let inflation run too much above 3% because this can lead to an economy overheating and result in a boom and bust scenario. As Clavel explained: "The more you let the economy overheat, the more damaging the eventual bust."

On the other hand, bad inflation destabilises and suppresses economic activity, as witnessed during the 1970s and 1980s, when the rate of price rises was subject to political interference rather than independent central bank control.

Supply shocks, such as the oil crisis of the 1970s, can also result in bad inflation as such a scenario can kill growth by eroding the value of income. More importantly, these situations are largely outside the control of central bankers. Clavel highlighted that inflation linked to oil supply can be particularly harsh on economies which are net importers, such as the US in the 1970s and Europe today.

Clavel explained that when inflation gets out of control it becomes ugly, as it drastically reduces the value of savings and eventually people's confidence in their currency. Very rapid price rises, or hyperinflation, makes money almost meaningless and this can have disastrous economic consequences - Zimbabwe suffered such a backdrop between the late 1990s and 2009, as did Germany in the 1930s. Inflation also gets ugly when it switches to deflation, an environment which Japan has endured for a very prolonged period.

The great moderation

Longer-term, there has been a strong shift from the 'bad' supply-induced inflation of the 1970s and 1980s, which stifled growth - to the 'good' demand-led inflation of the past 15 years - which has come from GDP growth.

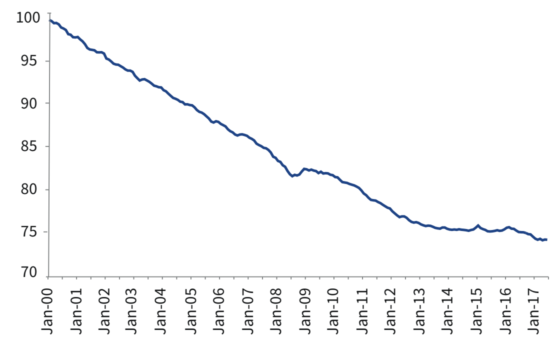
Inflation is also much lower and less volatile thanks to a phenomenon known as the great moderation. In the US, this was led by former US Federal Reserve chair, Paul Volcker, who pushed for a policy of re-anchoring inflation at a lower level. Other central bankers around the world subsequently followed a similar line.

"The current reflation will continue to be 'good' as it is not subject to political interference, and large supply shocks are unlikely," said Clavel. "This is supported by record low unemployment in countries like the US and Germany and better corporate performance and consumer consumption, all leading to increases in demand."

But even though it is good for the economy, investors must still protect against this rising inflation, warned Baltora. This is because, even if prices only rise by a small annual percentage, it can still lead to a large reduction in the real value of investments over time.

As the graphs shows, not hedging against inflation would have led to a 14% real loss in the 10 years to January 2017 or a 26% loss since 2000. This is despite the low, controlled inflation rates experienced throughout that period.

Not hedging inflation would have led to a 26% loss since 2000



Source: ECB and AXA IM Research, May 2017

Inflation solutions

To manage inflation, AXA Investment Managers is employing several strategies, including the use of inflation-linked bonds. These bonds can be seen as a trade-off between inflation risk and duration risk, but the maturity of the bonds makes a difference. For example, shorter maturity inflation-linked bonds are less sensitive to rates, and more so to inflation. Baltora said: "If you think interest rates will rise, then long-dated - for example 10-year-bonds - are problematic because they lock in low returns for 10 years. If you buy a bond with a duration of just two years, you can potentially access a higher return in two years' time."

However both long and short duration inflation-linked bonds offer different benefits and should be considered in the context of risk tolerance, investment horizon and outlook.

Baltora added that inflation-linked bonds are not the only solution - there are many other inflation protecting assets available, such as derivatives. But as with all investment strategies, expertise is required.

"You also need to consider timing and implementation of the strategies, which is different for each investor, according to their needs such as investment horizon and risk tolerance," said Baltora.

Baltora and Clavel said it pays to be prepared for all outcomes. But they reiterated that the most likely scenario is that good inflation will continue to create a benign environment for investors over the coming years, provided they have a well-adjusted portfolio.

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