

## Inflation is the enemy

- How did we get here?
- What is the impact?
- Where do we go from here?

Markets and major economies are in a state of uncertainty in the context of rising inflation, rising interest rates and a risk to economic growth. How did we get here? What is the impact? Where do we go from here?

### How did we get here?

The COVID pandemic's lockdowns triggered a sudden stop to the global economy. To limit structural scarring from this "switch off", governments deployed unprecedented levels of financial support to help businesses and individuals while the economy was on "pause". As a result, government debt soared to levels not seen since WW2. The objective of this support was to ensure businesses could still function once the economy restarted, and thereby minimise the longer-term risk to growth.

As the pandemic passed, and vaccination rates increased, governments have had to wean economies off this financial life support and figure out how to pay off all that borrowing. Rising taxes (2021 budget) was the first step to affect the cost of living, but at that time, higher taxes were seen as manageable given that consumer finances were generally in good shape after a year of staying at home and not spending.

Since that budget, the rising risk of inflation, has threatened additional upward pressure on the cost of living.

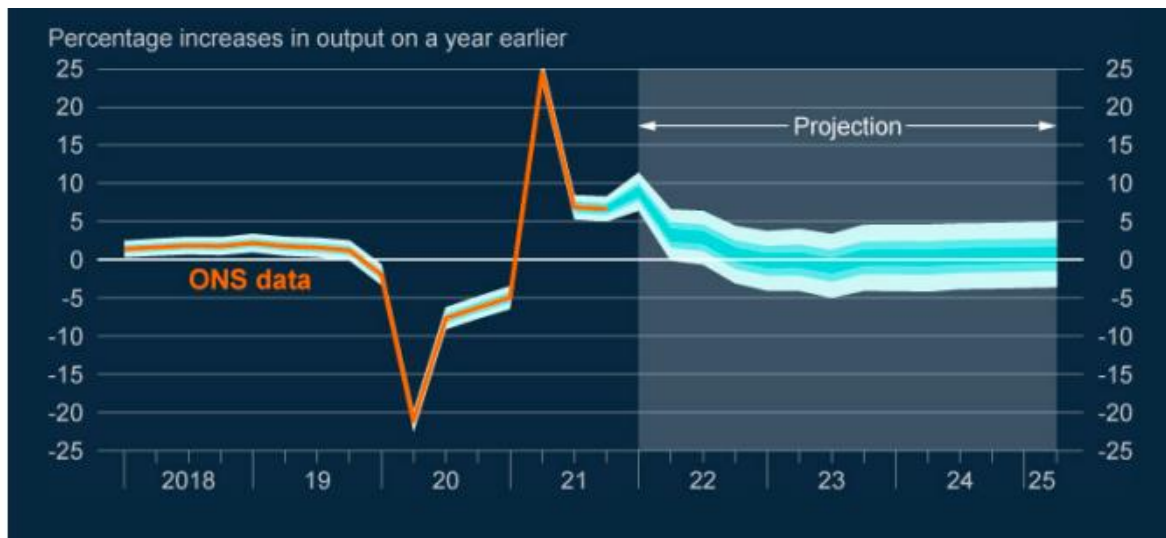
### What is the impact?

To understand the impact, it's worth considering the three key macro drivers of market returns: growth, inflation and interest rates.

### Growth

The growth rebound following Covid lockdowns was a function of the economic restart and a low base effect. However, the prospect of rising rates, rising inflation and declining business and consumer confidence means that businesses and consumers may reduce activity, creating a risk to growth.

Fig.1. GDP growth projection, based on market-implied interest rates



Source: Bank of England, May 2022

## Inflation

We are now experiencing inflation that is more reflective of external factors (energy costs), than of an economy running hot. This means that the Bank of England may be more accommodative regarding factors that are out of its control.

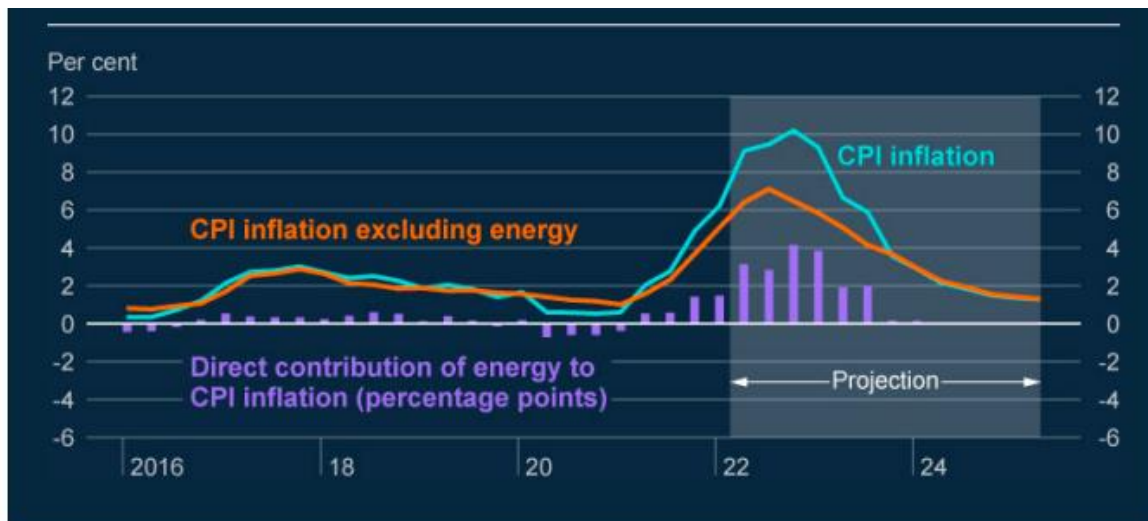
The outbreak of inflation can be broken down into three stages

- Firstly, the rapidity of the economic restart in late 2020/early 2021 led to global supply chain disruption. This was the start of inflationary pressure and was expected to be "transitory".
- Secondly, this pent-up demand also pushed up global energy prices through 2021, exacerbated by geopolitical tension around Russia/Ukraine which led to reduced gas supply to Europe and pipeline negotiations.
- Finally, when war broke out and Russia invaded Ukraine, supply disruption and sanctions on Russian exports meant that the costs of key exports – wheat, sunflower oil, fertilizers, and precious metals – all soared. Energy prices also soared owing to further supply disruption and redirection (Russian gas exports are not yet sanctioned). This means that the "inflation problem" will last at least as long as the tragic Russia/Ukraine war.

The combination of the above means widespread supply-side price inflation across energy, raw materials and input costs. Unlike money supply, these inflationary pressures are outside of Central Banks' control.

Looking at the Bank of England’s forecasts, the assumption is that inflation will moderate after a temporary elevation resulting from the increase in energy costs. We think this is optimistic, in part because of how they model energy costs, which builds in a transitory base effect<sup>1</sup>.

*Fig.2. CPI inflation and CPI inflation excluding energy*



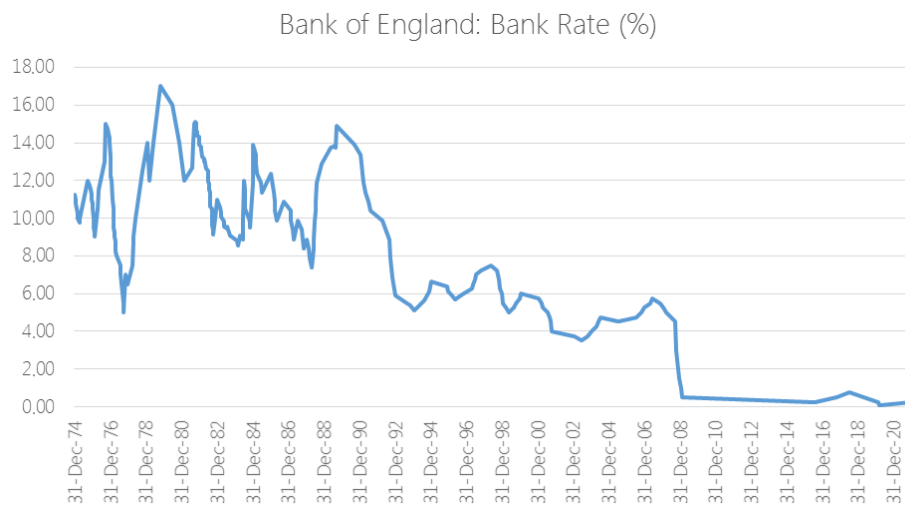
Source: Bank of England, May 2022

### Interest Rates

With respect to interest rates, we have lived in an “easy money” era since the Global Financial Crisis (2008), with interest rates that have been near zero. This was to ease financial pressure on governments, banks and households alike, but has also had the effect of supporting asset prices.

<sup>1</sup> The BoE methodology extrapolates a 6-month forward curve into the future that creates a transitory base effect which will always see any energy spike “washing through”, rather than persisting through, inflation figures. Any steepening (upside risk) of the forward curve, or weakening of GBP/USD rate would automatically render that assumption inaccurate. As energy prices are more volatile, the BoE’s inflation forecasting will also be volatile.

Fig.3. Bank of England Bank Rate from Dec-74



Source: Elston research, Bank of England data

This has been a great era for asset owners (who can borrow more cheaply and earn higher return on risk assets). It has also made investing look easy - all risk assets (even highly speculative ones, such as cryptocurrency) have delivered returns. This has begun to change as interest rates and borrowing costs go up. The rising cost of borrowing for those investing on margin, and the draining of liquidity (Quantitative Tightening) by Central Banks could see material dislocations in “frothy” asset classes (highly valued technology stocks, cryptocurrency, speculative assets).

### Where to go from here?

The slew of disturbing political and economic news is understandably impacting risk appetite for investors and managers alike. However, this is where staying the course – but adapting to the context – is important. There are three reasons why:

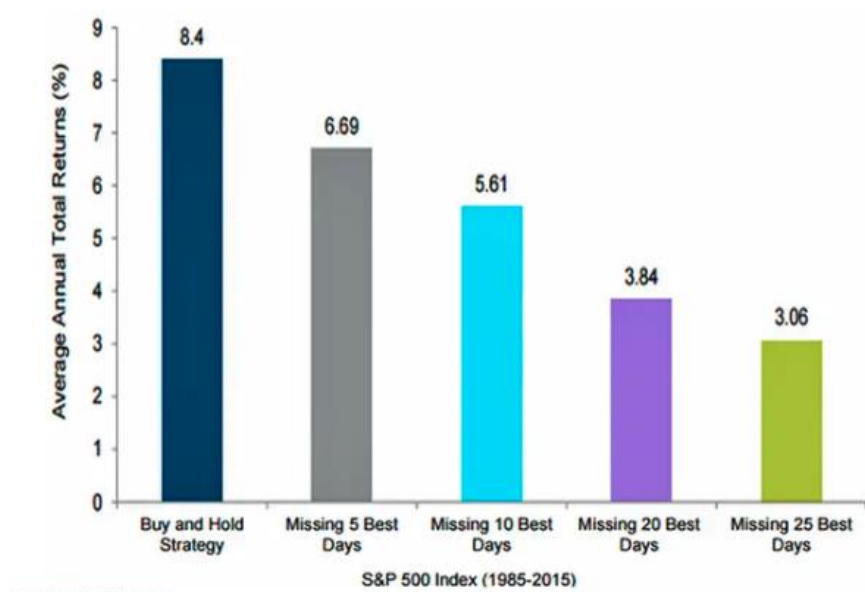
1. Time in the market, not timing the market, delivers returns
2. Take a perspective on long-term returns vs episodic crises
3. Risk is not just about volatility – it’s about inflation and time too

We explore each of these in turn.

### Time in the market, not timing the market

Trying to time the market to buy before good days and sell before bad ones is impossible. Staying invested is critical, to capture all the “good days” that drive returns. But that means accepting some bad ones too. Studies show how “time in the market” achieves a better outcome than “timing the market”. Not being invested for the best days, can materially diminish returns profile over time. So while it can be uncomfortable, it is better to stay invested.

Fig.4. Impact on annualised returns from missing "best" days



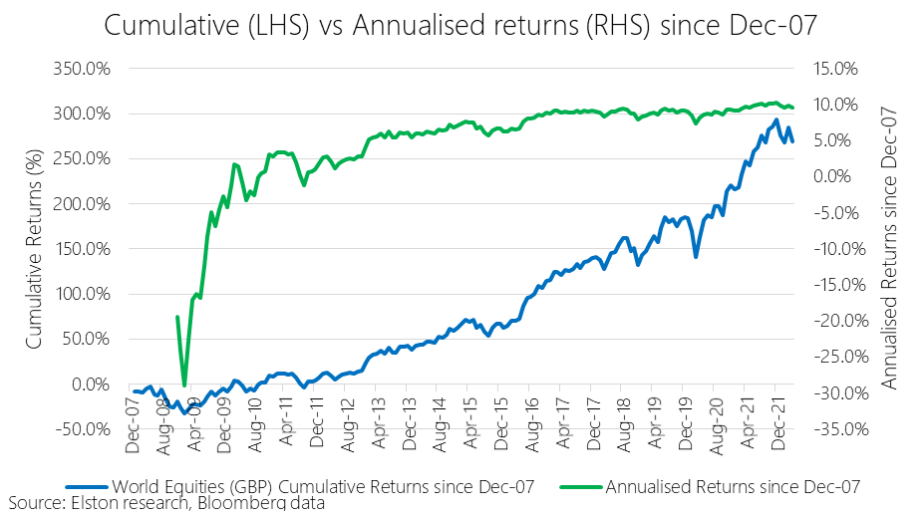
Source: Business Insider, returns in USD terms

### Gaining perspective: the long-term

It is never pleasant to see negative returns as investors have done this year or over the last 6 months. But it is important to put things in perspective. If we look at stock market returns since December 2007 – thereby capturing the financial crisis, the Eurozone crisis, the taper tantrum, Brexit, Covid and now war - cumulative returns have been strong. and Annualised returns, while lower from December levels, still represent 267% cumulative and 9.5% per annum annualised since Dec-07, as at end April.

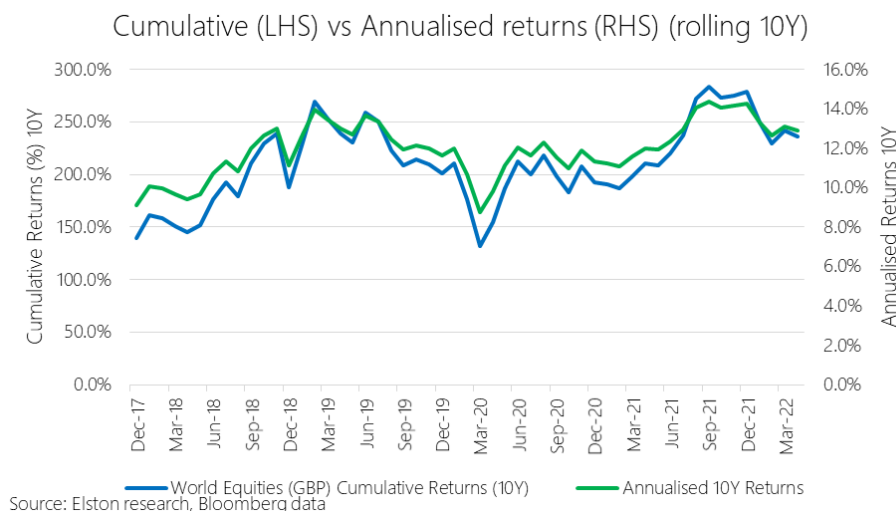
Investors have been well rewarded for taking risk.

Fig.5. Cumulative and annualised returns since Dec-07



Looking at the last 10 years only, cumulative returns are 236% and annualised returns are 12.9%, as at end April.

Fig.6. Cumulative and annualised returns (rolling 10 years)



This shows two things: firstly the power of long-term compounding – short-term market declines should be considered in the context of long-term growth. Secondly, investors should take the long view on riding out crises. That doesn't mean ignoring them: adapting to them is key. But the underlying objective should be to remain invested for a given risk profile and time horizon. This helps to stay on track with a broader financial plan.

### Risk is not just about volatility – it's about inflation and time too

It's important to consider "risk" in a broader sense: not just investment risk, but inflation risk too, in the context of time. The difference is outlined below.

Investment risk, often measured in volatility, is the flip-side of returns. So in a benign market environment, when things are going well, volatility is your friend – you receive a reward for the risk taken. But in a malign market environment, when things are getting difficult, volatility is your foe – you receive a negative return for the risk taken.

Higher risk assets such as equities may appear "risky" (volatile) and will fluctuate. However, in an inflationary regime, they are "safer" than cash over the medium- to long-term.

By contrast, lower risk assets such as cash may appear "safe" and not fluctuate, in an inflationary regime, cash is "high risk" over the medium- to long-term as its purchasing power is destroyed by inflation.

Fig.7. Illustration of relationship between risk and time during a higher inflation regime

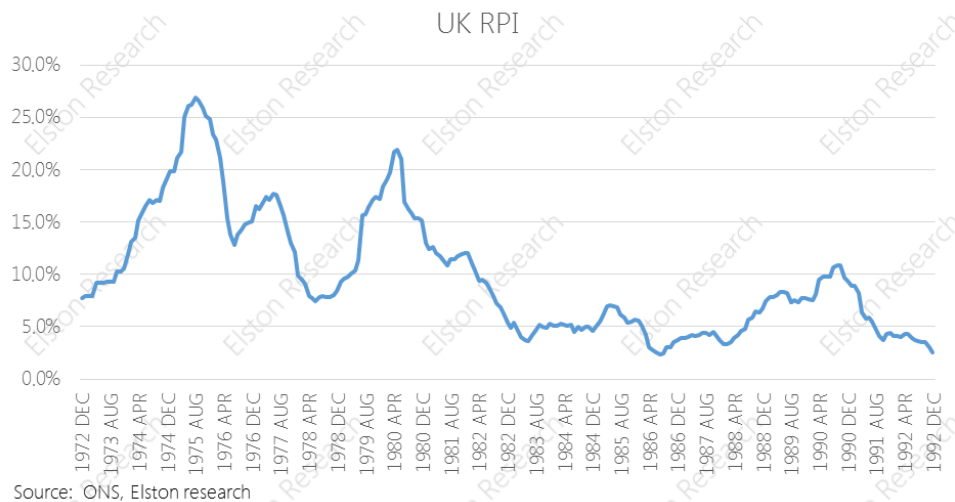
	Short-term	Long-term
Cash	Lower risk	Higher risk
Equities	Higher risk	Lower risk

Source: Elston research, for illustration only

In this respect, understanding the difference between investment risk (volatility) and inflation risk (loss of purchasing power) over time is key.

By way of illustration, we look at the relative performance of equities and cash during a high UK inflationary regime for the 20 year period from Dec-72 to Dec-92<sup>2</sup>.

*Fig.8. UK Retail Price Inflation rate Dec-72 to Dec-92*



Navigating asset allocation is the greatest challenge during an inflationary regime so we look at two extreme alternatives – a 100% allocation to equities, and a 100% allocation to cash<sup>3</sup>.

The charts below contrast the performance differential between £100 invested in Dec-72 for the following 5, 10 and 20 years.

Whilst equities are “visibly” risky (volatile), they can preserve capital in real terms over time. By contrast, cash is visibly “stable”, but cannot preserve capital in real terms over time. The longer the timeframe, the more extreme the difference. We look at the results over 5, 10 and 20 years from December 1972.

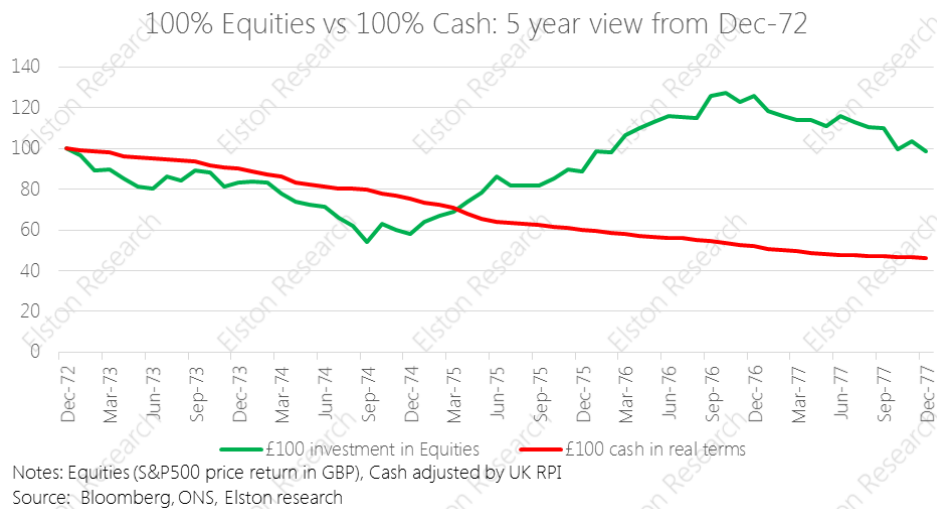
On a 5-year view from December 1972, an allocation to equities delivered a price return of -1.3% (-0.3% annualised), ensuring preservation of purchasing power in a high-inflation regime. Cash meanwhile lost -54% of its purchasing power (14.2% average annualised inflation).

Granted, equities underperformed cash initially when the inflation shock kicked in, but thereafter were able to preserve capital in real terms.

<sup>2</sup> We use the UK Retail Price Index as a continuous time series available at that time

<sup>3</sup> For equities, we use S&P 500 price return in GBP terms for continuous time series data and reflecting our “global equity bias” view (and FTSE 100 launch date was 1984). Use of a total return index (unavailable) would reflect value of dividends reinvested. In the meantime, the price return index (which assumes dividends paid out and not reinvested) is a more conservative measure. For cash, we assume notional cash on a non-interest bearing account (similar to platform accounts and to illustrate nominal values).

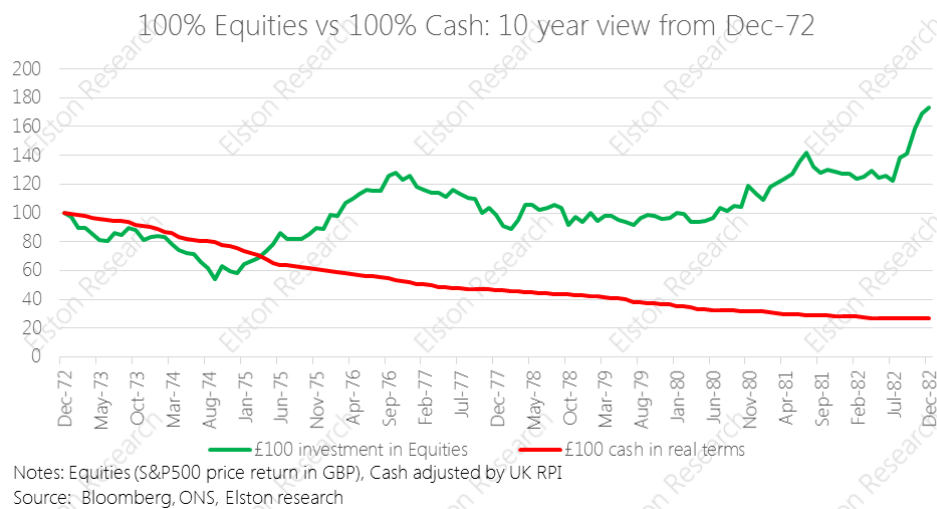
Fig.9. Equities vs Cash: 5 year view from Dec-72



On a 10 year view from December 1972, an allocation to equities delivered a price return of +72.9% (+5.6% annualised), ensuring capital growth in a high-inflation regime. Cash meanwhile lost -73% of its purchasing power (12.4% average annualised inflation).

This shows the importance of being invested over the medium- to long-term.

Fig.10. Equities vs Cash: 10 year view from Dec-72

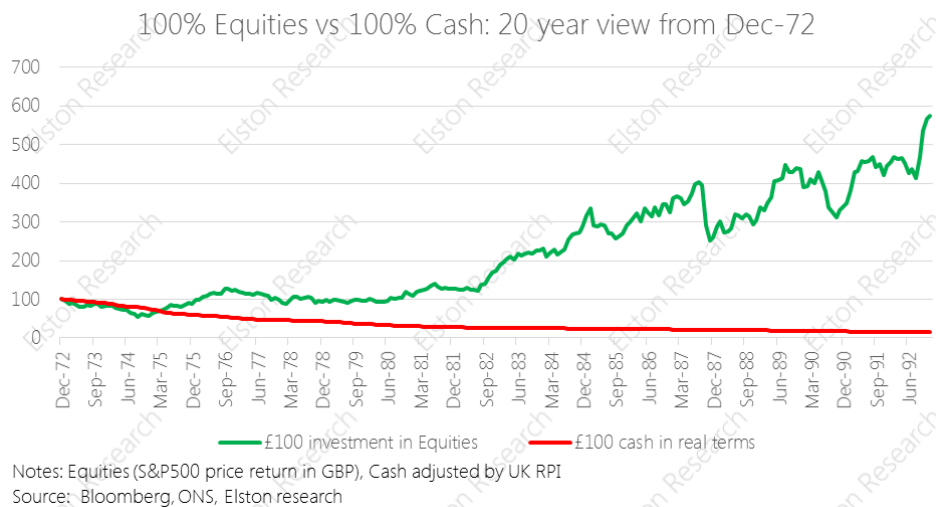


On a 20 year view from December 1972, an allocation to equities delivered a price return of +473.7% (+9.1% annualised), ensuring capital growth in a high-inflation regime. Cash meanwhile lost -84% of its purchasing power (8.8% average annualised inflation).

This is consistent with the oft-cited focus on the importance of “long-term” investment returns.



Fig.11. Equities vs Cash: 10 year view from Dec-72



## Summary

Weathering near-term losses in a portfolio is painful, and as humans we are “asymmetrically loss averse” – a lost £1 gives more pain, than a gained £1 gives pleasure. But it’s worth remembering the findings from this research:

1. The merits of staying invested to capture the “best” days (as well as the worst, unfortunately).
2. The power of compounding on invested capital over the long-term is more powerful than the impact of short-term crises
3. Fear drives us to seek “safe” assets but cash is not a safe asset in an inflationary regime

This does not mean do nothing. We think there are a number of steps that can and should be taken to [adapt portfolios for inflation](#).

Firstly, focus on traditional “value”-style equities with near-term earnings, which are less “frothy” than growth-style equities with distant earnings and where valuations can be stretched;

Secondly, incorporating real assets exposure for inflation proofing by “owning the problem” – and being a beneficiary of rising rents, tariffs, commodities and rates.

Thirdly, reducing bond duration (sensitivity to rising rates) as well as reducing bond exposure overall, because by definition fixed interest can’t keep pace with inflation rates in excess of bond yields. Bond “real” (inflation-adjusted) yields are negative, meaning they are a guarantee to lose money in real terms.

These types of adjustment are prudent to introduce a level of inflation resilience into portfolios relative to their respective risk-return profile.

Finally, while having sufficient cash on account to fund expenditures is critical, having surplus cash uninvested is a “false safety” in inflationary times. The 1970s taught us that, and investors can adapt accordingly.



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