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FACTSHEET

Goldilocks economy

How to prepare your portfolio for inflation

Very low or very high inflation is damaging to the economy. The aim is usually to try and keep the Consumer Prices Index (CPI) at 2% in order to maintain a 'Goldilocks Economy' – not too hot, not too cold.

Over time, inflation can reduce the value of your savings because prices typically go up in the future. This is most noticeable with cash. Inflation is bad news for savers, as it erodes the purchasing power of their money. Low interest rates also don't help, as this makes it even harder to find returns that can keep pace with rising living costs. Higher inflation can also drive down the price of bonds. These become less attractive because you're locked in at interest rates that may not keep up with the cost of living in years to come.

OFFSET INFLATION LOSS

When you keep your money in the bank, you may earn interest, which balances out some of the effects of inflation. When inflation is high, banks typically pay higher interest rates. But once again, your savings may not grow fast enough to completely offset the inflation loss.

The UK's CPI measure of inflation tracks how the prices of hundreds of household items change over time, and there are several different factors that may create inflationary pressure in an economy.

STRONGER ECONOMIC GROWTH

Rising commodity prices can have a major impact, particularly higher oil prices, as this translates into steeper petrol costs for consumers. Stronger economic growth also pushes up inflation, as increasing demand for goods and services places pressure on supplies, which may in turn lead to companies raising their prices.

DETRIMENTAL PERFORMANCE IMPACT

The falling pound since Britain's vote to leave the EU contributes to higher inflation in the UK, as it makes the cost of importing goods from overseas more expensive.

The impact of inflation on investments depends on the investment type. For investments with a set annual return, such as regular bonds, inflation can have a detrimental impact on performance – since you earn the same interest payment each year, it can cut into your earnings.

IMPACT ON STOCKS AND SHARES

For stocks and shares or equities, inflation can have a mixed impact. Inflation is typically high when the economy is strong. Companies may be selling more, which could help their share price. However, companies will also pay more for wages and raw materials, which will impact on their value. Whether inflation will help or impact on a stock can depend on the performance of the company behind it.

On the other hand, precious metals like gold historically do well when inflation is high. As the value of the pound goes down, it costs more pounds to buy the same amount of gold.

INFLATION RISK INDEXATION

There are some investments that are indexed for inflation risk. They earn more when inflation goes up and less when inflation goes down, so your total earnings are more stable. Some bonds and annuities offer this feature for an additional cost.

Index-linked gilts are government bonds whose interest payments and value at redemption are adjusted for inflation. However, if they're sold before their maturity date, their market value can fall as well as rise and so may be more or less than the redemption value paid at the end of their terms. ■

PUTTING A STRONG INVESTMENT STRATEGY IN PLACE

Inflation is a market force that is impossible to completely avoid. But by planning for it and putting a strong investment strategy in place, you might be able to help minimise the impact of inflation on your savings and long-term financial plans. To discuss any concerns you may have, please contact us.

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