Why You Should Be Worried About Inflation

Description

During the last decade, the world has faced the threat of deflation. This has been countered across the developed world by low interest rates and a policy of quantitative easing which has stimulated growth and boosted inflation.

Now, though, the prospects of deflation are falling rapidly and a new threat is emerging. The global economy could face relatively high levels of inflation in 2017 and beyond. And with growth prospects still limited, it could cause a quandary for policymakers across the world.

Higher inflation

A major reason why inflation could increase over the medium term is a shift in policy under the US President. Although there is no certainty as to what his policies will be, Donald Trump looks set to reduce taxes and increase spending. This will cause a widening of the budget deficit and lead to higher rates of inflation in the US.

Similarly, China is also experiencing higher levels of inflation which could get worse in the coming months. Higher commodity prices and rising wages mean that the cost of its manufactured goods is likely to rise in future. With countries across the globe being reliant on Chinese imports since it is the ‘workshop of the world’, global inflation expectations are moving higher.

The response

Theoretically, the response to higher rates of inflation is simple: put in place a more restrictive monetary policy. This will help to cool inflation, although it could take time to have an impact due to time lags.

However, the problem faced by Central Banks across the globe is that economic growth is relatively sluggish. This means that if interest rates are increased then it could have a negative impact on economic growth and lead to a period of stagflation. This is where inflation is relatively high, while economic growth stagnates.

Already, the US has started to increase interest rates. And with the UK and Eurozone experiencing currency weakness, they may be forced to have a higher than desired interest rate as the price level rises.

The impact on investors

As mentioned, rising inflation can cause higher interest rates, which in turn could mean slower economic growth. This clearly causes a major headache for investors, since it could lead to downgrades in earnings forecasts and a reduction in valuations and investor sentiment.

Some companies will be able to cope with higher inflation better than others, which is why it is crucial to seek out stocks with wide economic moats. For example, high levels of customer loyalty or stubbornly low cost bases relative to competitors could mean that the impact of inflation is less negative. Furthermore, a wide margin of safety and a yield which is well ahead of inflation could help stocks to perform better than their peers in future.

High inflation has caused economic turmoil on a number of occasions in the past. While it is not yet at challenging levels, there is the potential for it to move much higher. As such, it may be prudent to plan for its arrival later this year through buying good value stocks which can thrive in a very different global economy to that experienced over the last decade.

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