

## **Inflation might be increasing in the next year – how will assets behave if prices begin to rise?**

There is an urban myth doing the rounds that the Bank of England is only printing new £50 notes because it's the quickest way to put more money into circulation. Whilst there is probably little truth in the rumour it does illustrate how desperate the Government is to kick start the economy. The Treasury has been reported as considering a further fiscal stimulus, Mervyn King is urging caution because the extra cash could trigger an increase in inflation. Certainly, governments have put more money into the global economy than was imaginable even two years ago and the effects of so much more cash being created have yet to be felt.

The primary function of the Bank of England is to control inflation and the only tool the Bank of England has at its disposal is adjusting interest rates. If inflation increases, the Bank of England will increase interest rates. We believe that the return of higher inflation is not a given, but we are preparing our portfolios for its possible return and adjusting some allocations accordingly.

Despite the concerns over inflation, a general point to make is that inflation is a better problem than deflation. Our opinion is that deflation is more “priced in” to assets than inflation, so an inflation scare could cause investors more losses if they hold the wrong assets.

Our ideas for how assets will behave in an inflationary environment are:

### **Good Assets:**

#### Index-linked gilts (ILGs)

- Current yields are around 1% plus actual inflation (or rather RPI, which is currently 0%), so ILGs are not exactly high yielding but should really be seen as an inflation protected alternative to cash, especially at shorter durations
- If you worry about stagflation – high inflation plus low growth – ILGs could also be attractive as it is unlikely equities for example, would do well in this environment

#### Equities

- Equities are a ‘real’ asset so should be inflation protected
- They are also significantly more liquid than property, for example
- Their upside potential depends on the underlying economy: stagflation would be bad for equities, inflation with growth would be good
- The problem is where to invest – a UK focus will protect against UK specific inflation worries; a global portfolio will offer a more diversified approach

#### Commodities

- Commodities are, by the global nature of their supply and demand, more exposed to global growth/inflation than UK specific issues and are therefore a good diversifier
- Specifically the performance of oil, industrial metals and potentially agriculture will depend on global growth rates

#### Distressed credit

- Values on distressed credit are typically driven by the expected recovery on the underlying assets: these could be properties (e.g. if you invest in distressed mortgages) or companies (e.g. leveraged loans)
- The definition of distressed might be bonds trading at 60% of face value or less. The likelihood of recovering par (ie the full 100% owed) or close to it rises with inflation. This should offer good real returns whatever the inflationary environment

#### Property

- As with equities, property is a 'real' asset and so traditionally is a natural inflation
- However, illiquidity remains a problem
- Residential property is likely to be a better bet in the near term as Government policies will promote lending in this area due to its obvious economic (and political) value
- Commercial property returns are likely to be held back by a slow recovery in lending as banks struggle to rebuild their balance sheets

#### **Bad Assets:**

##### Cash

- Cash is an obvious loser as inflation increases, since its relative value falls, despite the increase in interest rates

##### Gilts

- Gilts normally have fixed yields and maturities. Therefore as inflation and interest rates rise, these yields become less competitive and the price will fall
- Gilts with shorter durations offer more protection since inflation is unlikely to take off this year

##### High grade credit

- Again, corporate bonds with shorter durations offer more protection. However, lower risk credit is currently a higher yielding alternative to cash, so they will take pain if inflation comes as spreads reverse
- Riskier credit offers more protection, but is unlikely to offer true protection unless it is distressed (as described above)

#### **Not sure:**

##### Gold

- If you are **very** bearish this is probably a good investment
- Likely to do well irrespective of the inflationary environment if the global financial crisis takes another leg down and "western", developed countries start defaulting (e.g. Ireland, Greece, Portugal etc. even all the way up to the UK)
- At IPS Capital we are not this bearish so we remain uncommitted to gold

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