Is Inflation on the Rise?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"By a continuing process of inflation, government can confiscate, secretly and unobserved, an important part of the wealth of their citizens" John Maynard Keynes

Outside of a few select emerging markets, inflation worries have been notable by their absence for financial market participants in recent years. Of the major global central banks, only the Bank of England is currently mildly embarrassed due to the specific influence of lapping the post Brexit referendum vote weak Pound period, which had a mechanical impact of raising import prices.

So, is all quiet on the inflation front? As with many matters in the investment world, when there is seemingly a collective memory lapse is just the time when you should be worrying about something.

If you look at the inflation numbers in the US, Eurozone or Japan, two aspects stand out. The first is that headline inflation rates, according to official forecasts, are not predicted to breach this year or next year the 2% level that each of the area's Central Banks regard as a minimum level of inflation control. The second is that rising commodity prices - especially oil prices - are causing some building inflationary pressures.

Particularly influential on this latter point is the fall in the value of the US dollar. With many commodities (both energy and agricultural/food) dollar-denominated, a fall in this exchange rate is usually supportive in turn of both higher demand (in particular from the emerging markets) and ultimately higher prices. And 'cost-plus inflation' that starts in raw materials, quietly and persistently can go up the product chain.

The role of China here is crucial. A simple summary of the last fifteen or twenty years would observe that the great cost and productivity strides in mainstream manufacturing that the country made during this period, effectively exported disinflation to the world. As China employs economic reform measures to encourage the growth both of the service sector and personal consumption levels, slowly but surely it is shifting away from low-cost manufacturing. Whilst other low-cost nations in south Asia, Central America and Africa will progressively take global manufacturing market share, they are unlikely to be individually or collectively as influential in keeping pricing so low. And given how cheap many emerging market currencies are currently trading on conventional foreign exchange valuation mechanisms (like purchasing power parity (PPP)) – at the risk of higher imported inflation into the largest developed markets in the world – this is a legitimate concern for the next few years.

As with many matters in the investment world, when there is seemingly a collective memory lapse is just the time when you should be worrying about something

The effect of such a shift may be starting to have a small impact in global fixed interest markets, where both short and medium duration yields have started to rise (i.e. bond prices have started to weaken). Clearly there are other influences at work here including the progressive ending of the global central bank stimulus and even recent solid levels of world economic growth, however, any burgeoning inflation story underpins this trend.

*An affiliate of Raymond James & Associates and Raymond James Financial Services

Country	Inflation rate %	Data point
Turkey	11.92%	Dec 2017
Mexico	6.63%	Nov 2017
India	4.88%	Nov 2017
Indonesia	3.61%	Dec 2017
United Kingdom	3.10%	Nov 2017
Brazil	2.80%	Nov 2017
Russia	2.50%	Dec 2017
United States	2.20%	Nov 2017
Canada	2.10%	Nov 2017
Australia	1.80%	Sep 2017
China	1.70%	Nov 2017
Germany	1.70%	Dec 2017
Euro Area	1.50%	Nov 2017

Source: Trading Economics

From an asset allocation and position selection perspective, investors generally would place a premium on assets with inflation protection capabilities, which tends to favour equities over conventional bonds and alternative assets such as gold versus cash. Additionally, there is the complex impact on borrowers who benefit from a higher price level but may face raised interest rates in the shorter-term. This could prove to be troublesome for a world where debt levels are still material in many countries.

Currently we are only in the early foothills of any inflation crisis but plausible macroeconomic eventualities, such as a lower US dollar and a continued shift of the Chinese economy, potentially is enough to induce a bigger concern. Time to run an inflation health check if you are an investor, fund manager or central bank board member.

KEY TAKEAWAYS:

- Worry when others do not appear to be worrying
- Central Banks are currently relaxed but watch the value of the US dollar
- Any burgeoning inflation story underpins the recent trend of higher bond yields
- Time to run an inflation health check on your investment selections

INVESTMENT STRATEGY COMMITTEE MEMBERS

Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

Andrew Adams, CFA, CMT, Senior Research Associate, Equity Research

Chris Bailey European Strategist, Raymond James Euro Equities*

Jennifer Bottalico, CFP®, CAIA®, Managing Director, Head of Product Solutions & Services (Alex. Brown)

Scott J. Brown, Ph.D. Chief Economist, Equity Research

Robert Burns, CFA, AIF® Vice President, Asset Management Services

James Camp, CFA Managing Director of Fixed Income, Eagle Asset Management*

Doug Drabik Senior Strategist, Fixed Income

J. Michael Gibbs Managing Director of Equity Portfolio & Technical Strategy

Nick Goetze Managing Director, Fixed Income Services

Peter Greenberger, CFA, CFP® Director, Mutual Fund & 529 Plan Product Management

Nicholas Lacy, CFA Chief Portfolio Strategist, Asset Management Services

Pavel Molchanov Senior Vice President, Energy Analyst, Equity Research

Kevin Pate, CAIA Vice President, Asset Management Services

Paul Puryear Director, Real Estate Research

Ted Ruddock Head of High Net Worth, Fixed Income Services

Jeffrey Saut Chief Investment Strategist, Equity Research

Scott Stolz, CFP® Senior Vice President, PCG Investment Products

Jennifer Suden, CFA, CAIA Director of Alternative Investments Research

Tom Thornton, CFA, CIPM Vice President, Asset Management Services

Anne B. Platt, AWMA®, AIF® – Committee Chair Vice President, Investment Strategy & Product Positioning, Wealth, Retirement & Portfolio Solutions

Kristin Byrnes – Committee Vice-Chair Senior Manager, Wealth, Retirement & Portfolio Solutions

DISCLOSURE

Issued by Raymond James Investment Services Limited (Raymond James). The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Past performance is not a reliable indicator of future results. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. The taxation associated with a security depends on the individual's personal circumstances and may be subject to change.

The information contained in this document is for general consideration only and any opinion or forecast constitutes our judgment as at the date of issue and is subject to change without notice. You should not take, or refrain from taking, action based on its content and no part of this document should be relied upon or construed as any form of advice or personal recommendation. The research and analysis in this document have been procured, and may have been acted upon, by Raymond James and connected companies for their own purposes, and the results are being made available to you on this understanding. Neither Raymond James nor any connected company accepts responsibility for any direct or indirect or consequential loss suffered by you or any other person as a result of your acting, or deciding not to act, in reliance upon such research and analysis. If you are unsure or need clarity upon any of the information covered in this document please contact your wealth manager.

APPROVED FOR CLIENT USE

RAYMOND JAMES®

Head Office Broadwalk House 5 Appold Street London EC2A 2AG
www.RaymondJames.uk.com