Paul McCarville, Principal, Clarus Investment Solutions

Inflation and Financial Planning

INFLATION is front-page news these days, having reached levels not seen in many peoples' lifetime. With the Euro area annual rate reaching 7.5% in March, it is a multiple of the rates embedded in most financial plans. If anything like these levels were sustained, even for a few years, they would wreak havoc with those plans - and many investment portfolios. An assumption of 2% would have been very well grounded; it is (and has been for many years), the rate generally targeted by central banks. Indeed, inflation in the euro area has been substantially biased to the downside of 2%. **See graph below.**

Recently, the market-implied forecast of German inflation over the next ten years (10-Year Breakeven Inflation[1]) has risen sharply and now stands at 2.9%. All other things being equal – and accepting that inflation in Ireland will not be the same as that in Germany - inflation at this level would be a readily supportable assumption. **See graph opposite.**

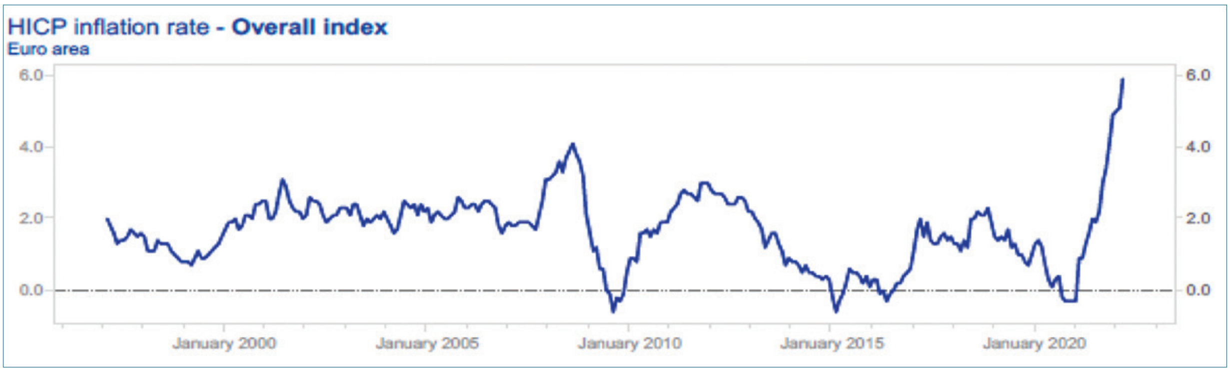
The upsurge in inflation has come in tandem with the post-Covid recovery in activity. Consumer demand is exceptionally strong, thanks to the combination of policy stimulus and accumulated savings during lockdown periods. However, supply in many sectors remains constricted by the effects of Covid and other factors such as prolonged under-investment in new capacity. More recently, the war in Ukraine and sanctions on Russia have triggered further price spikes in fuel, grain, fertiliser and other commodities.

Those arguing that inflation will soon subside to much lower levels cite the fact that supply-side constraints will ease, and they point out the possibility of favourable base effects from the reversal of some of the recent commodity price spikes. Taking a longer-term view, they also remind us of the structurally disinflationary impact of ongoing technological progress and innovation.

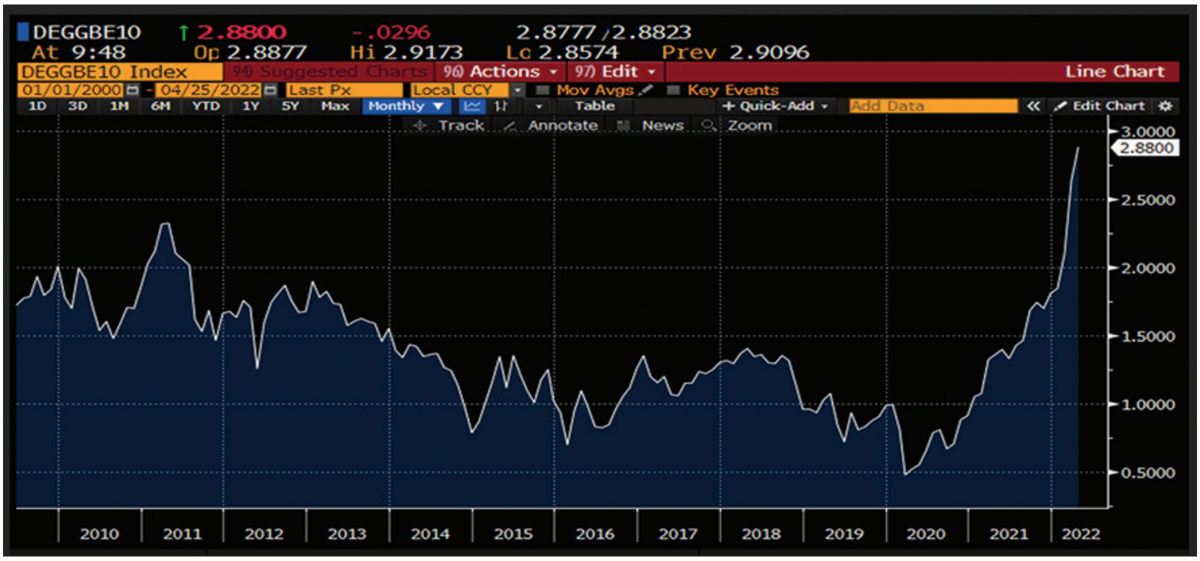
In and of themselves, those arguments are credible. But if inflation is to moderate soon and a wage/price spiral to be avoided, workers will need to accept pay increases which fail to keep pace with their cost of living, especially after any increases have been taxed. How realistic is this level of restraint at a time of full employment in most of the developed world? What degree of leverage do the negotiating parties have? Should an inflationary mindset gain a foothold, the consensus expectations around inflation will be substantially wrong over the near term and would take a lot longer to rein in.

Whatever the near term holds - clearly highly uncertain - what about the long term? One of the major factors which drove inflation down was globalisation and it seems to many that this factor may have run its course - if not be about to reverse. Covid substantially changed thinking about the relative importance of price and the security of supply, something the invasion of Ukraine will clearly accelerate. And a potentially major new factor has also entered the longer-term picture; the truly extraordinary amount of investment which will have to be made to address climate change. Of course, these factors may not turn out to have a big impact on inflation and they could be overwhelmed by others - that we know of, or which emerge. (Who had a pandemic in mind in late 2019?)

Taking an even higher-level view on inflation, the rise of populism in much of the developed world is likely to see further printing of money /more borrowing - which will be on top of debt levels generally associated with war-time. History shows that inflation and financial repression (keeping interest rates below inflation) have often been associated with the resolution of debt problems. The rise of cryptocurrency is in no small part due to a growing lack of confidence in conventional money and monetary policy.



Source: https://www.ecb.europa.eu/



So, all told, it might be prudent to model future outcomes using an inflation rate somewhat higher than 2%. Or use 2% as the base assumption but also stress-test them using a higher rate.

What about the near term? Especially for clients in ARFs it may be worth looking under the bonnet of their funds and taking a fresh look at assumptions in relation to rates of return. Funds at lower risk levels and funds which are not well diversified are likely to have substantial holdings of bonds, few if any of which are inflation-linked. Somebody once quipped that "inflation is Kryptonite for bonds" and we have already seen bonds generate significant losses; should inflation stay elevated, further losses will arise. Against a backdrop where 2.5% was routinely used as the projected rate of return for bonds until March 2021 – since when a rate of 1% is the de facto standard – it may be worth re-visiting and revising projected ARF outcomes. In terms of the investments themselves, the action that can be taken is to prefer funds which hold less nominal bonds and tap a wider range of asset classes, for example, property, commodities, infrastructure and inflation-linked bonds. Such funds are likely to be more resilient to inflation.

Inflation has been a non-issue for so long that it has been badly overlooked until the recent wake-up call. It is an extremely pernicious phenomenon; the purchasing power lost through an inflation surge is rarely if ever recovered. Its return has important implications for a number of aspects of the work of Financial Brokers.

[1]Breakeven inflation is inferred from the difference between nominal and inflation-linked sovereign bond yields; it is the future inflation rate at which the two bonds would provide the same real return.

Quilter Cheviot Europe boosts its Dublin office with triple hire

QUILTER Cheviot Europe (QCE), the Irish subsidiary of discretionary wealth manager Quilter Cheviot, has announced that it has made three significant hires to expand its team, with an investment manager and two financial planners joining the Dublin office.

William McDonald joins as an investment manager, having previously held senior roles with Appian Asset Management and Cannacord Genuity. He will report into Donnacha Fox, Chief Investment Officer at QCE.

Patrick Good and Tom O'Dea join QCE from Kennelly Tax Advisers (KTA) and PwC respectively to boost QCE's financial planning proposition, following the hire of Andrew Fahy as Head of Financial Planning in early 2022. Patrick and Tom will report into Andrew.

The three hires will help QCE to evolve its integrated investment management and financial planning offering to clients in Ireland and Europe, as well as reinforcing the support we provide to the external intermediary community. QCE expects to continue expanding its team in Ireland to support its growth ambitions.

Brian Weber, Chief Executive at Quilter Cheviot Europe, said: "We are delighted to be reinforcing our investment management team with William's appointment. He has a fantastic reputation in the market, and will have an important role in helping us to drive growth in 2022 and beyond.

"Clients are increasingly looking for a modern-day wealth management offering, which goes well beyond just investment management, and Patrick and Tom will be integral in helping us to evolve the services we can offer clients.

"We want to be able to offer a holistic service to our clients, which combines financial advice with investment management, while also fostering our existing intermediary relationships. All three of these hires help us to do this, and I look forward to them all contributing to the continuing success and growth of the business."