Inflation: Forgotten But Not Gone

A topic that traditionally has been toward the front-of-mind with respect to investor decision-making that has lost prominence in recent years is inflation.

Inflation may seem like an odd topic to bring up. Over much of the last decade, price pressures have been benign and have regularly undershot targets set by central banks. It is also reasonable to mention the current laundry list of issues is more important. With that said, inflation still carries significant implications for investors with a long time horizon, especially those with substantial exposures to the bond market – just because something may not be front and center does not mean that it is irrelevant.

In the most general definition, inflation is the broad-based increase in prices within an economy and serves as a gauge of changes in purchasing power over time. For example, if inflation is running at a 2% average annual rate, it means that one unit of the domestic currency is able to purchase 2% less than it could a year ago – this may sound small, but over the course of a decade 2% inflation means that a dollar now would be worth only 81 cents in ten years' time.

Inflation is in and of itself a fairly benign financial force, provided it does its work gradually. Incremental pricing power means companies can charge more for goods, which in turn means they can pay their employees more, which increases their present purchasing power. However, while a gradual rate of inflation is an economic good, a runaway rate of inflation has proven to be an economic disaster.

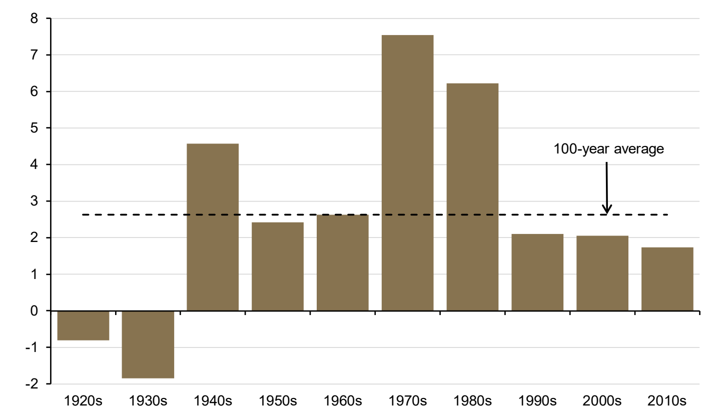
This is the reason that the management of inflation is one of the key objectives of central banks – as stewards of their domestic currencies, monetary authorities try to keep the rise in prices low, stable and predictable so that there can be reasonable confidence that money will hold its value over time.

In this way, central banks support people in making spending and investing decisions, and encourage long-term investment that supports economic growth. Moreover, by keeping inflation low, stable and predictable (this last point is key as it drives expectations), the "inflation premium" required by investors is lower since there is a greater assurance that purchasing power will not be at significant risk of being impaired over the term of a security – and a lower inflation premium helps to keep the costs of capital lower, incentivizing businesses to invest and create jobs to help grow the economy.

Inflation over the last century, which has included a World War and the Great Depression among other significant events, has averaged just under 3% –several decades featured well below average rates, but many exhibited far more destructive above-trend rates.

Inflation can currently be characterized as low and given the experience of the moderating price pressures of the last three decades it would be easy to assume that these rates are a new normal.

Canadian Consumer Price Inflation by Decade
(annualized percent)



Source: Statistics Canada, Guardian Capital

With that in mind, investors could be well served to keep an eye on inflation inputs. While it is the case that stock markets have all but recovered from this global pandemic, the underlying economy has not, and the pent up demand of tens of millions of workers returning to work could produce price pressures above today's levels.

The potential for an increase in inflation, even a modest rise, carries material implications for investors since it means an erosion of the "real" value of any investment that is made and held for any period of time. This is even more pertinent given that, thanks to the substantial degree of market intervention from central banks, the interest rates currently on offer in the bond market offer effectively no protection from inflation – in fact, the yield on inflation-protected "real return bonds" is negative across all maturities, suggesting that investors are locking in a loss of purchasing power of their invested capital for the foreseeable future.

So while it may well seem as though concerns about inflation can be forgotten given everything else going on at current, they most certainly are not gone and are still important for those hoping to reap the fruits of their investment decisions down the road. Investors should be aware that inflation is like the brown spots on a banana, by the time the signs are obvious, the fruit has over-ripened.