

INFLATION, THE INVISIBLE RISK

INFLATION: OUT OF SIGHT, OUT OF MIND?

"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

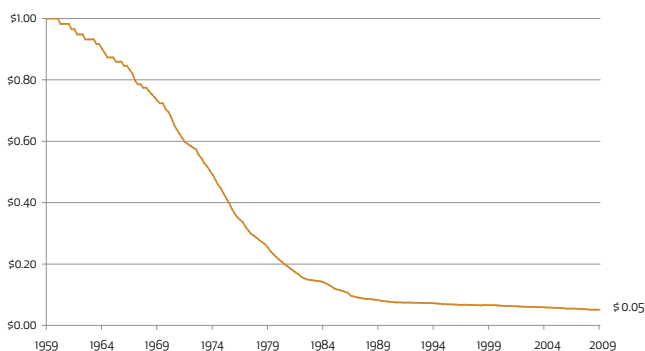
- Ronald Reagan, 40th President of the United States

The risk that inflation poses is easily overlooked. Unlike most risks that savers have to cope with, the effect of inflation is close to invisible. Its impact cannot be seen on a portfolio's current size or its returns. Instead, it eats away at the purchasing power of those savings.

The gradual process by which inflation erodes purchasing power further enhances its stealth. While the swings in investment markets grab attention and headlines, the gradual nature of inflation does not sell newspapers.

This does not mean that it should be ignored. In some respects this slow, relentless erosion is more dangerous than the erratic swings in investment markets. The variability in returns dished up by investment markets can be mitigated by time because the losses and gains eventually even out. But with inflation there are very few positive surprises as prices rarely fall. The impact of the gradual but relentless erosion does not reduce with time – quite the opposite, it increases.

DECLINING PURCHASING POWER OF \$1 IN NEW ZEALAND



Source: Bloomberg.

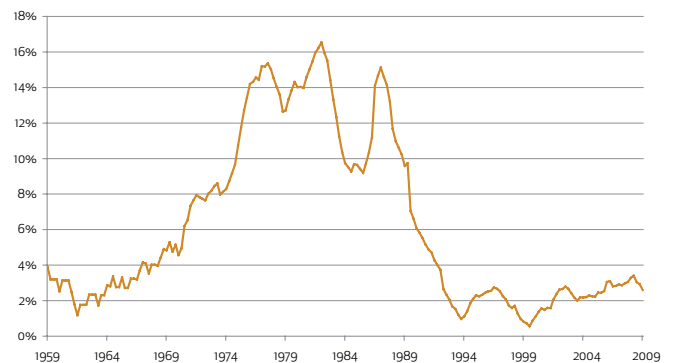
"Inflation is always and everywhere a monetary phenomenon."

- Milton Friedman and Anna Schwartz, A Monetary History of the United States 1867-1960

The cumulative effects of inflation are perhaps best illustrated by looking at the past 50 years. The accompanying chart shows the decline in the purchasing power of a dollar since 1959, which dropped to five cents by 2009. Over the past 50 years prices have increased by 2000%! For most of that period inflation was not grabbing the headlines, but it certainly had a major impact.

There are times when inflation is big news. This occurs during the relatively rare periods when prices skyrocket. The last period of note was the late 1970s and early 1980s. The accompanying chart illustrates the point that the rate of inflation can be a roller coaster ride. Monetary economists argue that the massive spike in prices during the 1970s and 1980s was at least, in part, a result of Keynesian economic policies (stating the obvious, the oil shocks also played their part). When these policies were replaced by Monetarist discipline, personified by Volker, who raised interest rates one week into the job (on a Saturday), inflation declined.

INFLATION RATE IN NEW ZEALAND



Source: Bloomberg

During these relatively infrequent periods when prices surge upwards, the danger and damage of inflation becomes more immediate and a lot of harm to a saver's spending power can be done over a relatively brief period.

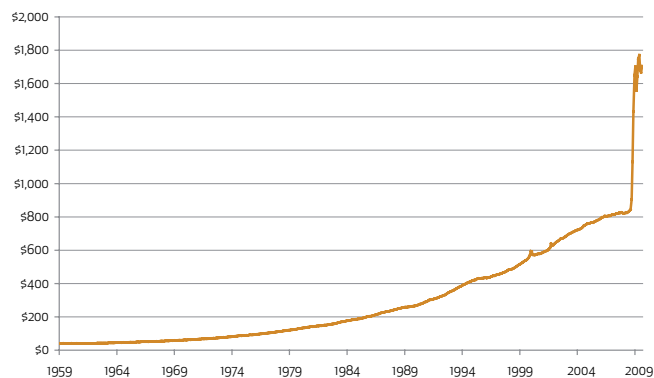
WHAT DOES THE FUTURE HOLD?

“Do not adjust your mind; there is a fault in reality.”

- Graffiti, New York 2009

The banking crisis would have turned into a credit crisis without the intervention of central banks. The Federal Reserve and the Bank of England led the charge by dropping interest rates to almost zero and expanding the monetary base, in effect printing money (economists call this ‘quantitative easing’). The accompanying chart illustrates the magnitude of this expansion in the United States.

US MONETARY BASE (IN US\$ BILLIONS)



Source: Bloomberg.

The importance of this expansion is made clear by the equation of exchange:

$$MV = PT$$

Where M represents the money supply; V represents the velocity of circulation; P represents the price level; and T represents the level of transactions. In 1963, Milton Friedman, a highly respected Nobel Prize winning author, and Anna Schwartz proved empirically that V/T was a constant ratio. Using the equation of exchange as the basis, this is empirical proof that increasing the money supply should lead to an increase in prices.

At the moment economic activity is subdued. Most economies are beginning to recover from the credit crisis but this recovery is relatively immature. Financial institutions are attempting to rebuild their balance sheets rather than lending some of their recently replenished

reserves. And thus, while the monetary base displayed in the chart above has skyrocketed, the money supply has not. As a result, the massive increase in the monetary base is not creating inflationary pressure.

In time, however, economies around the world will recover, confidence will rebound and financial institutions will lend some of their recently rebuilt reserves. When this occurs the explosion in the monetary base will feed through to the money supply and the danger is that this will create excessive inflation.

Central banks could of course react to the changing environment and reduce the monetary base, but this seems unlikely. History suggests that they will act too late or not at all. After all, it was central bankers’ low interest rate policies that enabled households to accumulate so much debt in the first place. According to some commentators this risk is heightened by indications that they intend waiting for clear signs of a recovery before acting. Furthermore, there has not been a clearly articulated strategy on how the monetary base will be reduced. Instead, they have suggested several options.

The risk of high, headline-grabbing inflation is real. The modest rate of inflation witnessed over the past couple of decades will at some point in our lifetime come abruptly to an end.

SUMMARY

Inflation does not have to be at eye-watering heights to do damage. Arguably the more sinister side of inflation is gradual, undetected erosion of purchasing power. And unlike other risks savers have to deal with, inflation rarely provides a positive surprise. This is important because time does not mitigate some of the risk of inflation, in fact it magnifies it.

While inflation could well be subdued for the next year or two, the increase in the monetary base will create inflationary pressure when economic confidence bounces back. This creates the risk of abnormally high inflation in a couple of year’s time, which will put the purchasing power of savings under considerable pressure. The bottom line, regardless of your view, is that inflation is a real risk even when it is not making the headlines.

When inflation hits, will your savings be protected?

One effect of low inflation over the past 20 years is that investment strategies frequently ignore the risk of inflation, or at least do not attach sufficient importance to this very real threat. NZ Funds' investment strategy, however, does address the risks associated with inflation through a needs category that is specifically tailored to counter this threat.

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