Heartwood Investment Management

10 February 2017

Investment Insight

Weekly Insight

Inflation risks are rising, but not unduly

As deflation worries have abated, attention is now shifting to inflation and the potential problems it can cause. In particular, there are concerns about the constraining effects on household consumption, due to a fall in real incomes, as well as the prospect of higher borrowing costs.

Both headline inflation measures and inflation expectations have accelerated since last summer, with the US election result shifting the focus to a reflationary environment, driven by a pro-growth agenda of corporate tax cuts and infrastructure spending. Moreover, as the US economy reaches full employment, more focus is being placed on tighter labour market conditions and the upward pressure this places on wages.

While acknowledging that risks have increased around the inflation outlook, our view remains that energy price effects on headline inflation measures are likely to be transitory; we believe the longer-term inflation outlook remains benign by historical standards. Core inflation is likely to drift higher - but not to levels that historically have impacted capital markets - given that, among other things, ageing demographics and technological advancements are likely to contain any material wage pressures.

Over recent months we have witnessed the evolution of central bank thinking from ultra-accommodative to a more balanced tone. The US Federal Reserve is further along in its efforts to normalise monetary policy and is expected to raise interest rates at least twice this year, maintaining a gradual approach to tightening. The European Central Bank has also signalled its intention to step back from markets by trimming its current purchase programme, while the Bank of Japan has favoured controlling the short-end of the yield curve through its asset purchases. Arguably, the most difficult task falls to the Bank of England. Having shifted to a neutral stance in November, UK policymakers need to find equilibrium between protecting the longer term growth outlook in a climate of business uncertainty against taming the undesirable effects of inflation, particularly as import prices are likely to rise. Central banks are alert to inflation risks, but there is not yet any reason to believe that there will be an abrupt shift from the measured approach that they continue to take towards policy adjustment.

A reflationary environment supports our short duration view

In an environment where headline inflation and market implied inflation expectations are likely to continue to rise in the near term, together with stronger global growth prospects and central banks looking to normalise interest rates, we would expect to see developed sovereign bond yields drift higher. We have maintained a long-standing short duration position and recent data appears to have reinforced our more cautious view on interest rate markets. We will look to find value in those areas of the fixed income market that will benefit from an improving global economy, such as less duration sensitive high yield credit and emerging market sovereign debt.

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Clear Thinking

Contact

To find out more about the Heartwood strategies, visit our website or contact your local representative.

Important Information

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