The Inflation Problem

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INFLATION WHICH for so long was not a huge concern for investors has made a resounding come back making headlines everywhere.

Data from the Central Bank indicates that inflation in Australia went up by 3.5% last year, it was the fastest annual increase in prices in years. While that sounds ominous, it is important to understand the underlying reason for this price rise.

High cost of fuel

The quarterly average price of unleaded 91 octane petrol was close to 165 cents in the December 2021 quarter, an increase of 6.6% from the previous year.

This is the highest it has been since the 2013 September quarter. The record-high prices for fuel resulted in higher transport and freight costs.

The higher fuel impacts the individuals and households directly as increased outlay for fuel. This also permeates through all other goods.

Building and Construction costs

The prices of building materials significantly increased resulting in higher costs of new houses and renovation costs. The cost of new homes has jumped up 4.2%.

The current inflation has already exceeded the Reserve Bank of Australia target two years down the line.

This is the reason why the increasing consensus is that the RBA will increase the interest rate following its next meeting.

However, most of the inflation is imported – fuel and the delayed building supplies interacting with the higher demand.

So, it remains to be seen what the RBA decides to do.

While it is good to understand what is happening with inflation and the impact on interest rates, the reality is that there is not much that we can do to impact the outcome.

Erik Mclean/unsplash

However, as investors where do the concerns around inflation leave you.

What should you be thinking of?

Inflation is an important but often overlooked element of investing. Most often the reason for saving today is to provide for being able to spend in the future. Keeping pace with inflation is critical to maintaining purchasing power.

As an investor, you may query if inflation impacts stock returns.

A look at the US market return from 1991 to 2021 shows there is no reliable correlation between periods of high or low inflation and US stock returns.

During the period under consideration, the inflation-adjusted average annualised return was 8.5%. What this does show is that stocks tend to outpace inflation over the long term – and this is critical for investors who are concerned that today's rising prices will make it harder to reach their financial goals.

Does the rise in prices signal the coming wave of broad and persistent inflation or just a temporary recovery in prices especially given the economic downturn following the pandemic? No one can say that for certain.

But future inflation along with many other factors such as increasing profits, war, natural disasters, etc. are all things considered by the market to arrive at market prices.

As economist Frank Knight observed, "willingness to bear uncertainty is the key reason investors have the opportunity to profit."

Given the diverse factors and dynamics influencing market movements, it is virtually impossible for every factor & outcome to have been taken into account, but the key variables & risk factors that can have a significant impact on you (including inflation for instance) should be considered at the portfolio design stage.

Thereafter, making changes to your portfolio in response to news headlines is not warranted. One of the best countermeasures for inflation is to ensure you have the appropriate level of growth assets in your portfolio.

And when all this discussion around inflation concerns you, remind yourself that your rationally constructed portfolio will allow you to stay ahead by simply remaining invested as this will help outpace inflation over the long term.