How global inflation is driving asset allocation

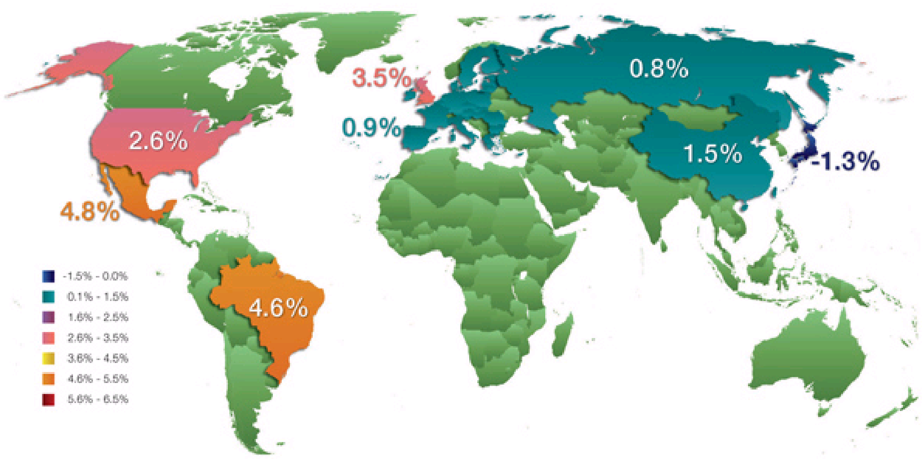
By Drazen Jorgic | 07:00:00 | 18 March 2010

The highly uncertain outlook on inflation is currently asset allocators' prime concern when making their investment decisions.

The Citywire Wealth Manager inflation heat map – comprising current Consumer Price Index (CPI) figures which are then contrasted to 2011 'year average' predictions provided by Capital Economics – underlines some of the changes that need to be taken into account.

The deflationary camp is keen to highlight the credit contraction and the deleveraging of banks and consumers, while the inflationists see money printing, stimulus packages and a possible currency crisis as the biggest hazards ahead.

CURRENT GLOBAL INFLATION 2010



SOURCE: Capital Economics

Colin McInnes, co-founder of discretionary wealth management firm Quartet Capital Partners, pinpoints inflation as the number one concern for his asset allocation committee.

Deflationary camp

McInnes says: 'It is massively important and the biggest driver of our asset allocation calls. We've been in the deflationary camp for quite some time.'

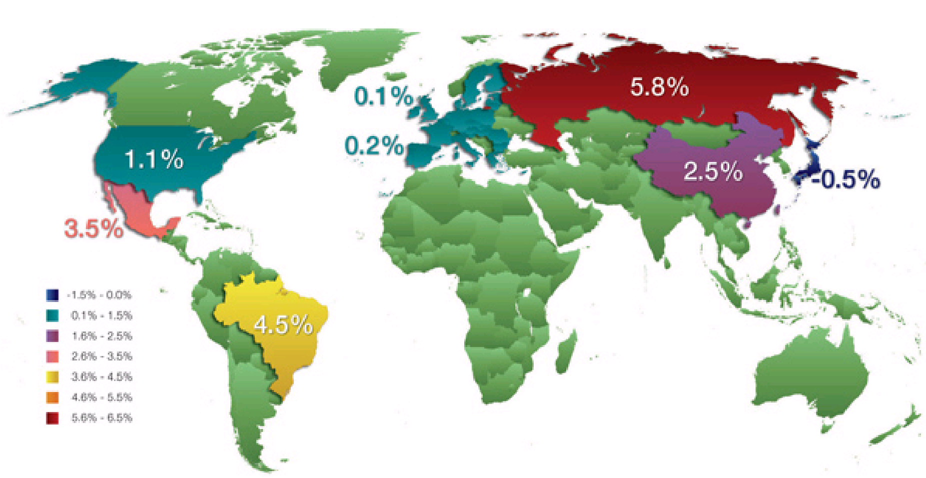
The latest CPI inflation figures for the UK and the US stand at 3.5% and 2.6%, but the predictions for 2011 suggest inflation should not be a problem, with the yearly average falling to 0.1% and 1.1%, respectively.

Likewise, eurozone inflation is likely to flirt with negative numbers as the CPI is predicted to fall from today's 0.9% to an average of 0.2% in 2011. Deflationary pressures are also tipped to prevail in Japan, where the year average inflation in 2011 is expected to come in at -0.5%.

For a deflationist like McInnes, the biggest asset allocation call in the fixed income space has seen him buy conventional fixed interest securities rather than taking the index-linked route.

However, he adds: 'We were concerned about long-term inflation so we reduced the duration of our fixed interest exposure from 12 years to two and a half years.'

CAPITAL ECONOMICS' YEAR AVERAGE INFLATION PREDICTION FOR 2011



SOURCE: Capital Economics

Tim Price, investment director at PFP Wealth, says the biggest problem is the lack of clarity. In the long term he believes governments will struggle to reduce their debt burden unless they inflate their way out, but in the short term he is siding with McInnes and leaning toward the deflationary camp.

He says: 'In the short run, whatever asset class you are looking at there has to be a focus on quality. You want to be in the best quality assets, whether it's corporate or government debt, though the same goes for equities.'

Gulf debt

With this ethos in mind, Price has been investing in the debt of genuinely wealthy Gulf states and some emerging Asian economies.

He adds: 'From an equity perspective, an environment of lower interest rates for longer would also be consistent with a gradual re-rating of high-quality, largely defensive stocks offering sustainable dividend yields hugely more attractive than the pitiful yields being offered from fundamentally discredited and generally deteriorating government bond markets.'

McInnes, meanwhile, says inflation is more likely to be an issue in emerging markets. He is keeping an eye on China's efforts to try to dampen asset bubbles, especially the talk about the renminbi currency peg to the dollar being dropped.

'That might well put a dampener on Bric inflation', McInnes adds.