



Watson French

INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT



PRESS RELEASE January 2011

Stephen Watson, managing director of Watson French, the Truro-based independent financial planning and investment management company, offers some tips on protecting capital from the effects of rising inflation.

At a recent meeting of city economists it was agreed the foremost economic threat for the UK in 2011 was inflation, and if this week's 3.7% figure is anything to go by, they were right. But it was also agreed the next major threat was deflation, which goes to show that forecasting is a perilous activity!

We could experience deflation in the UK in 2011, but there is no certainty in this.

Although not intended, Government deficit reduction policies will reduce consumer demand for goods and services.

On the other hand, monetary policy looks set to remain loose, with interest rates unlikely to rise by much in 2011 if at all. Such policies are intended to stimulate consumer demand.

There are two key factors that suggest it is unwise to ignore the prospect of a significant hike in the rate of inflation in the UK in the next three years.

First, we can see that some economies have not experienced recession. Various countries are enjoying good levels of growth. As a consequence we in the UK are experiencing rising costs for various goods and services we import. This is inflationary.

Second is the present phase in the UK economic cycle. With a bit of luck we will avoid a double dip. Interest rates are at record low levels and likely to remain so for

the foreseeable future. This will eventually lead to a full UK economic recovery, which in itself is inflationary.

Someone once said that inflation is like jumping off the Empire State Building. The sensation is great as long as you keep going!

The reality is that inflation devalues money. Your pound buys less.

This is particularly destructive for retired people on fixed incomes and needing extra returns from their savings.

At this phase of an economic cycle it is unusual to experience significantly higher rates of inflation over the record low base rate of interest. These circumstances are difficult, particularly for the retired who may need to increase the income from their savings to meet rising costs.

The South West has the highest proportion of retired people in the country, and for this reason a rise in inflation will have a bigger impact here.

It is vital that steps are taken to protect savings from inflationary threats over the medium term. Apart from rainy day money, leaving savings in cash accounts over the medium term is not the answer. It seldom is of course, but particularly not at this time.

There are a couple of investment funds that specifically target inflation as an investment return and in my estimation are worth consideration.

Aegon Inflation Linked Fund and M&G Index Linked Corporate Bond Fund aim to match inflation as an investment return. Consider also an Exchange Traded Fund that tracks the UK Government Inflation Linked Bond Index.

Investing a proportion of savings in this combination of funds is likely to offer the potential to protect capital from the effects of rising inflation, and is an option that we have been exploring with many of our clients who want to guard against erosion of capital.

It is not a high investment risk. The main threat to these investments is deflation. However, if we experience this the Bank of England is likely to engage in another round of quantitative easing, which is inflationary.

Present rates of inflation remain stubbornly high and this is disturbing if you consider that we have recently emerged from the nastiest recession since 1932.

For me the question to ask is this: will we experience deflation before we experience rising inflation? That is a tough call, but in many respects it doesn't matter because any action taken to tackle deflation will by its nature be inflationary. So I believe inflation is inevitable if the UK economy is to recover, and probable as a consequence of global growth even if the UK remains in the doldrums.

That is why investment funds that target inflation will continue to look attractive in the medium term.