Should investors worry more about inflation or deflation?

The short answer is that there is no substitute for constant vigilance. Investors should track macro-economic conditions which is the economy as a whole and emerging trends therein to inform their investment decisions.

A more nuanced approach to the question should, however, distinguish between cyclical and structural inflation/deflation.

Cyclical bouts of inflation or deflation occur due to temporary supply-demand imbalances as a result of short-term supply-demand changes caused by external shocks e.g. the forest fires in Russia in 2010 that destroyed the wheat crop, prompting a ban on wheat exports from that country.

Structural changes in inflation or deflation are more durable, under-pinned by fundamental changes in supply-demand dynamics e.g. the shrinking acreage of cultivable land globally due to urbanisation (supply constraints) combined with rising consumption (population growth, rising prosperity levels, urbanisation). These are multi-decade trends that unfold over the long term.

Investors should also distinguish between internal and externally-driven inflation pressures within an economy. For example, recent rises in UK inflation have resulted from pound sterling weakness, one-off VAT increase and rising commodity prices.

Genuine internally-driven inflationary pressures are more dangerous, arising from a fundamental supply-demand mismatch within an economy.

Symptoms of internal inflationary pressures are:

1. Excessive credit growth
2. Excessive and debt-fuelled consumer spending
3. Excessive real asset (property) price inflation
4. Wage pressures in collective bargaining

Note: The wage-price spiral suggests that rising wages increase disposable income, thus raising the demand for goods and causing prices to rise.

As we know, none of these has been particularly strong within the UK economy lately. The upward trend we have noticed in inflation is, therefore, likely to be externally-driven.

These distinctions are important because they inform investors' views on likely direction of interest rates and monetary policy. Externally- driven inflation, for example, is unlikely to be controlled by interest rate increases.

Investors must also identify the inflation number of most relevance to them. For some, it could be Consumer Price Inflation (CPI), for others, Retail Price Inflation (RPI). Yet other investors could have an altogether different relevant inflation figure – the increase in their personal cost of living. Making this determination is useful because it helps investors formulate an investment objective in terms of a long-term investment returns target.

That said, conflicting signals from financial markets make it tricky to clearly determine which is the greater threat – inflation or deflation? Historically low government bond yields suggest that deflation is the immediate short-term threat. However, prices of assets like gold and index-linked government debt – proxies of inflation expectations – suggest that the longer-term threat of inflation is very much alive in investors' minds.

As always, the preferred approach to investment planning in such uncertain times is a renewed focus on the three d's: discipline, diversification and dynamic asset allocation. Over the short-term, with deflation the greater worry, commodities are unlikely to perform strongly and this expectation should perhaps be reflected in appropriately cautious allocation to this asset class. Over the longer-term, with inflation the greater threat and non-indexed government debt unlikely to perform as strongly as it has done recently, a cautious allocation to that asset class would perhaps be the appropriate response.