Central bankers around the world are paid to find ways of stimulating global growth. They are entrusted with the authority to responsibly manipulate our economies in pursuit of growth and are given various levers to pull in order to achieve this goal. The most common of these levers is the ability to change our interest rates. Reducing interest rates makes borrowing cheaper and stimulates investment. Increasing rates makes investors more reluctant to borrow more expensive money and helps to cool overheating growth. However, when rates are already at close to zero or indeed negative (i.e. you pay an annual charge for saving money), this most important of levers no longer works – rates can go no lower. It's then that our central bankers are forced to design new tools to do the job that interest rate manipulation can no longer perform – please welcome 'Quantitative Easing' (QE) to the global stage.

We've written more than enough about QE over the years to focus on it in this piece but suffice it to say that printing (creating) vast amounts of new money and using that to buy up bonds and other assets has become the "go to" lever of choice for global central banks desperately searching for ways to kick-start growth. Devaluation of one's currency is another such tool – artificially lowering the value of your own currency so that your goods and services are cheaper for foreigners to buy, thereby increasing demand and boosting growth for your own, now cheaper products. However, devaluation is seen as a desperate, last resort measure when all else fails. Witness the panic when China devalued in August last year and again in January 2016. Investors smell fear and desperation and head for the hills.

As we have covered this ground many times before, our focus this month is instead on the potential by-product of pulling all of these different levers – inflation (the increasing price of goods and services). Our central banks love and hate inflation in equal measure. There is constant talk of achieving our "inflation target" and when inflation is unexpectedly low this can cause havoc in financial markets. Inflation is good because it shows that people are prepared to spend more money than they were before on the same things - demand goes up whilst supply stays the same - and this is typically a sign that there is confidence and growth in the economy. Inflation also helps to reduce the debt burden of governments and consumers. If you borrow £100,000 to buy a house, when you actually pay it back in 20 years, that £100,000 is worth less because inflation will have eroded its value. The same applies to governments that borrow now – they want inflation to have devalued that debt by the time they pay it back.

Yet ironically for the very same reason too much inflation can be very bad for an economy. Uncontrollably rising prices destroys the value of money and forces consumers to spend their savings on things that they don't want to just because that money won't be worth the same amount tomorrow.

History is littered with horror stories of 'hyperinflation', from wheel-barrows full of cash used to buy loaves of bread in post-war Germany to the worthless Zimbabwean currency causing panic (in November 2008 Zimbabwean inflation was an estimated 79,600,000,000% per month).

Every central banker's utopian dream is high growth with a little, but not too much, inflation. Dubbed the 'goldilocks economy' this is an economic environment that is not so hot that it causes excess inflation but yet not so cold that it causes a recession. Every central banker's worst nightmare is stagnant growth combined with hyperinflation - the dreaded "stagflation".

So central banks have a difficult task. They have all of these levers to pull that enable them to kick-start growth but pull the lever too hard and the machine overheats and eventually falls apart.

What, then, of the reality facing us since the global recession in 2007-2008 when we saw deflation and negative growth around the world? Since then ultra-low interest rates have helped to stimulate growth and some inflation but there have been many potholes along the way that have slowed our progress.

Have central banks done enough to stimulate inflation and have investors properly considered the outlook for inflation in the developed world?

Firstly, let's consider how inflation is measured in the UK. We have two important measures of inflation - Consumer Price Index (CPI) and Retail Price Index (RPI). CPI is the most commonly used metric now as it is most comparable with other countries' measures of inflation. CPI measures how much the price of a basket of goods and services has changed over a given time period. This basket is made up of common goods and services that are purchased by the general public and is updated regularly to reflect current consumer spending patterns. For example, digital TV services like Netflix are now included in CPI whereas Satnav Systems are being removed - the perfect example of changing consumer demand.

RPI has been deemed largely obsolete as a result of concerns with its methodology, however it is still used to determine the inflationary element of Index-Linked Gilts. It does also have the benefit of reflecting price moves associated with housing costs.

The most recent CPI basket is detailed below:

Good/Service	CPI Weight (%)
Food and non-alcoholic beverages	11
Alcohol and tobacco	4.3
Clothing and footwear	7
Housing and household services	12.8
Furniture and household goods	5.9
Health	2.5
Transport	14.9
Communication	3.1
Recreation and culture	14.7
Education	2.6
Restaurants and hotels	12.1
Miscellaneous goods and services	9.1

Certain components of the index will clearly have a larger impact on inflation than others and the collapse of the oil price over the last year has been a major drag on global inflation. This has a large bearing on several components within CPI, as the oil price has a 'trickle down' effect on constituents such as transport and recreation. As we will comment on later, the falling oil price is very important when considering future inflation prospects.

Wages also have a direct impact on inflation no matter what components are contained in a country's basket of goods and services. If unemployment is high and wage growth is low then it is unlikely that we would see inflation accelerate because consumer purchasing power would decrease. This relationship was reflected in what became known as the Phillips curve, originally published in the 1950's by British Economist, AW Phillips:

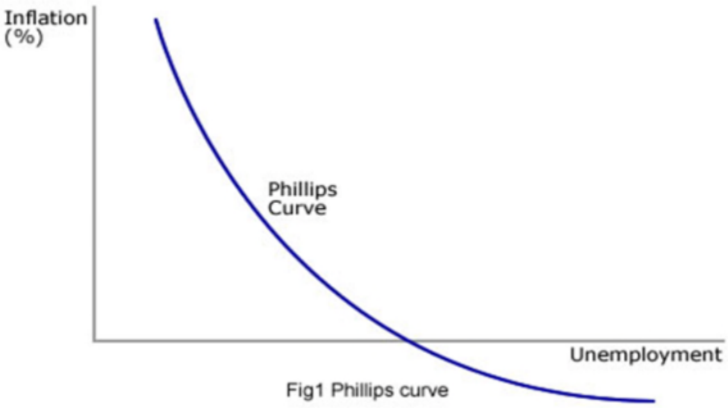


Fig1 Phillips curve

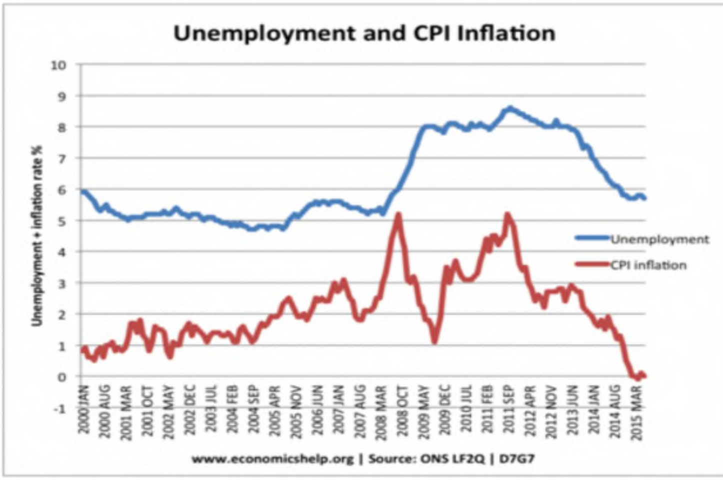
Current situation

Protection against inflation is a hot topic, as the US has started to creep closer to its target rate of 2%. There is still significant divergence in other economies around the world however, most notably in the Eurozone which is battling with deflation and still in the middle of a massive QE programme. Japan is also struggling to generate inflation, although the Bank of Japan is committed to boosting the economy by utilising every economic tool at their disposal. They have also implemented an explicit 2% inflation target, having endured a decade of deflation.

Both the Japanese and European economies have seen the very positive impact of QE in the UK and US and we remain encouraged by their continuing support for this approach.

At the moment UK inflation is lagging behind the Bank of England's target of 2%, but much of the rest of the economic data is positive. Since 2011 there has been a breakdown in correlation between unemployment and inflation, with unemployment close to record lows but both inflation and wage growth stagnating.

Unemployment is close to record lows and wages are rising ….



…..but inflation hasn't responded….yet.

Outlook

Investors seem to recognise that inflation in the long term (10 years or more) will start to increase, yet support for inflation in the short term (2-4 years) is underwhelming. As such there may be an opportunity to exploit mispricing in short dated inflation-linked investments in the US and UK, even pricing in the possibility of Brexit, which incidentally we feel is improbable.

As mentioned above, oil prices have a disproportionate impact on inflation measures and we've seen supply driven oil prices increase materially from their low point, yet this isn't properly reflected in investors' expectations for future inflation. This may be about to change as over the past week petrol prices have risen on average by 3.4p a litre.

It is not all about the oil price though as we feel that the US and UK economies are relatively well placed to grow and that with employment reaching full capacity, wage inflation may well increase over the coming years. This should spell good news for investors in short dated inflation related investments.

With this in mind, what securities are available to buy in order to reflect this position?

Historically when looking to protect the real value of capital from inflation we have considered a range of investments including a basket of commodities, equities and real estate. However, at this juncture it is our belief that there is more of an opportunity to exploit short term changes and as such would favour index linked bonds.

Index linked bonds (or linkers) are similar to traditional government bonds as they pay a coupon and will be redeemed for a value at maturity. The difference is that both the redemption value and the interest payments on an index-linked bond are adjusted for inflation whereas a conventional government bond pays a rate of return fixed at outset.

The key consideration when investing in index-linked securities is the 'breakeven rate'. In simple terms this is the rate at which the market values the returns on offer from a conventional government bond the same as the returns expected from an inflation-linked bond. If the market is correct about inflation assumptions then overall returns on the two bonds remain identical however this relies on correct expectations of what inflation might be in the future and investors often under/ overestimate future inflation, as it is not yet known what inflation will be in the future.

If inflation ends up being higher than expected during the life of the bond then the inflation-linked bond will give a higher return and if inflation is lower than expected then the nominal bond outperforms.

Importantly, the periods of lowest correlation between the two types of bond (i.e. mispricing of inflation) have often coincided with times of economic uncertainty and market stress like we are currently experiencing. As above, we believe that investors currently underestimate inflation in the short-term and this therefore presents an opportunity.

There are many investments available to investors wishing to exploit these short term anomalies, including UK index-linked gilts and US inflation-linked treasuries (TIPS are a $1.6trn asset class – big business in the US).

We believe that the UK and the US markets are best considered for this investment theme. Having analysed the market for the most suitable investment fund to reflect these views, we will now be considering inflation-linked securities for client portfolios over the coming weeks.