ARE YOU READY FOR THE RETURN OF INFLATION?

Last year the Reserve Bank of New Zealand (RBNZ) started talking about the return of inflation to the 1% - 3% mandated range. After a decade of barely 1% inflation, how do we prepare for its inevitable rise?

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FOR MORE THAN A DECADE prices have been ground down by the enormous size and reach of Asian, in particular, Chinese, manufacturing giants. For many years China and Asia exported deflation to the western world as the price of consumer goods plummeted because of their vast manufacturing capability. This downward pressure on prices was also aided by Central Banks holding interest rates at historic lows, to aid recovery from the impact of the Global Financial Crisis (GFC) in 2008.

So how do we prepare for the return of inflation? While the Government and the RBNZ may have a targeted range of 1% - 3%, we need to remember that these things do not always go to plan, and the upper limit can be breached. Many people will remember the double-digit inflation that was rampant in the 70's and 80's. Inflation is a two-prong attack on prices, not only does the base price of the item rise but so does the amount of tax (GST) that is payable. Hence, one of the reasons governments are generally in favour of having a degree of inflation in their economy is that it increases the tax take.

Inflation is especially important to consider when planning for retirement because of the corrosive effect that rising inflation can have on some types of assets. Basically, the interest rate being offered is the price of money, i.e. if you have a mortgage and are paying 4.85% interest on your mortgage, that is the price of the money that you have borrowed. One of the main factors that determine the price of money is inflation. The RBNZ defines inflation as, "When average prices throughout the economy go up, that's inflation."

Inflation is a concern for people on a fixed income as they generally do not have the ability to increase their income to compensate for the increasing cost of living. People on a fixed income tend to seek "safer investments" for any funds that they may have available for investment. Traditionally, the so-called "safer investments" are those which pay interest, such as bank deposits, but they have no ability to provide any capital growth. A vicious spiral can be created as investors require more income to maintain their standard of living, but the net return (after tax) isn't keeping up with inflation, so some of the capital needs to be withdrawn. This means that there is now a smaller capital base to provide income and the spiral spins faster.

Volatility of the returns from some types of assets, shares and property, can be very disconcerting for retirees and people on a fixed income, but this needs to be balanced against the alternative, gradually depreciating cash investments. Real assets, which have the potential for capital growth, tend to do well during times of rising or high inflation but the returns are not linear like cash. As well as shares and property, investors have traditionally held gold as a hedge against inflation, but there are some factors to consider before racing out to buy gold, including the fact it doesn't produce any income (interest), it normally incurs a storage cost, and the price can be very volatile.

As inflation returns to our economy and those of the countries that we trade with, prices will start increasing. One item that has a big impact on prices is the price of oil, as the majority of consumable items are transported at some stage.

When evaluating any investment, we will need to start asking whether it produces a real return after tax and inflation. Not all investments will produce a real return, but it is still necessary to maintain a fully diversified investment portfolio that contains all asset classes. We still need some cash investments as it is very difficult to buy the weekly groceries with a safe full of gold bars.

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