The Stan Clark Financial Team's

PERSPECTIVES

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Asset Allocation

How inflation/deflation affects you (Part 2)

By Michael Chu, Investment Advisor

Last month, we discussed inflation and deflation: what they are, how they are measured and what they are used for. Now, in part two of our discussion, we will focus more on how inflation and deflation can affect you.

Inflation reduces the purchasing power of money. That means a dollar today will buy less in the future. If investors expect high amounts of inflation, then to compensate they will require higher rates of return.

For bonds, this means yields will increase as inflation expectations increase. For example, today 10-year bond yields are around 1.5%. And today's inflation expectations are quite moderate, around one percent. That implies a real rate of return of 0.5% (1.5% minus one percent). If inflation expectations were to increase, say to five percent, then bond yields would likely go to about six percent (five percent inflation plus 0.5% real). The effects of inflation on bond yields are pretty straightforward. But for stocks, it's more complicated.

Unlike bonds, stocks do not have a set payment schedule. Stock prices constantly change and are based on things like company earnings and dividends. Inflation might boost the price of goods sold, which implies more profits, but their costs will likely increase, too. Part of the increase in costs could be passed on to the consumer. But if a company cannot increase its revenue to compensate for the increase in costs, then its profits will decline.

Generally, stock and real assets, such as real estate, are thought of as good inflation hedges. That means their returns are usually at least at the rate of inflation.

Over the past 100 years, stocks have been, on average, a good hedge against inflation – meaning that stocks have provided growth in purchasing power. Stocks typically do well in periods of low and moderate inflation, and even sometimes in periods of high inflation. Stocks did not do well during severe inflation, as in the 1970s. But this was at a time when labour unions were very powerful and company profits could not keep up with inflation.

Deflation is the opposite of inflation. It is a general reduction in prices. Deflation is usually not good for the economy as people defer their purchases for lower prices down the road. Companies also delay new investments in machinery or buildings because they fear the prices of their goods will fall. This reduces consumer spending, and corporate investing will cause the economy to slow down. In turn, this is not great for profitability and tends to lead to lower stock returns. However, historically, while high deflation has usually been poor for stocks, mild deflation has not always resulted in poor stock returns.

Overall, stocks can be a good inflation hedge. And selecting good companies that can maintain their earnings during inflationary periods can add to that hedge. Our stock selection strategies monitor the earnings data to ensure we are in the stocks that have the best chance of doing well. We also diversify our stocks globally in order to reduce the risk of exposure of any one particular country's inflation volatility.

Michael Chu is an Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.

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Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca