GLOBAL & LOCAL®

THE INVESTMENT EXPERTS

Why Should You Factor Inflation Into Your Investments?

Inflation and rising interest rates are the most common words of 2022, which undoubtedly have exacerbated some financial difficulties for many in South Africa and beyond. Indications point to the Monetary Policy Committee continuing to hike interest rates in the foreseeable future as a way to curtail rising inflation thus affecting and shaping both the saving and investment landscape.

With spiralling inflation, food prices and fuel costs among other basic necessities rise drastically thus affecting the cost of living thereby inducing socio-economic woes. While raising interest rates have a positive impact on fixed-income securities, they have a far-fetched unprecedented impact on equities, cost of borrowing and asset valuations. In an environment of high-interest rates and mounting inflation, investors are between a rock and a hard place when they seek ways to save and grow capital in real rate terms.

When interest rates are raised to match the rate of inflation, this creates both opportunities and challenges. As previously mentioned, investors may benefit from higher interest rates on their savings, money market, and fixed deposit accounts. Simultaneously, short-term rates and borrowing become more expensive, which means that individuals and businesses will pay a higher interest rate to finance a car loan, or monthly payments on credit cards and retail accounts will increase for individuals, and corporates will incur higher interest rate expense, affecting net revenue.

In the same vein, high inflation raises the prices of goods and services in an economy. Many people notice inflation when they go grocery shopping, for example, when they notice that bread and milk prices have risen. Investing during periods of high inflation can be more difficult because earnings and real value become more volatile and difficult to predict. Understanding how inflation affects investment returns and what to do with your investments during a period of high inflation can help you achieve long-term success.
In general investment returns comprise real and nominal rates depending on how the returns are calculated. When inflation is high, real rates of return are adjusted downward, while nominal rates are adjusted upward.

The graph below illustrates an example of the nominal and real rates of return and how they can impact your investment. This is based on a selected Balanced Fund over the past nine years.

From the above illustration, it can be seen that inflation impacts returns with the annualised nominal rates always above the real rate of returns.

Understanding the difference between nominal and real interest rates is important because it can inform investors about their purchasing power and true borrowing costs. As a result, it is critical to keep an eye on real rates because they provide a clear picture of how your investment has grown in real terms.

With that in mind comparing asset classes in real terms, equities have proven to outperform inflation over the long term, especially those stocks that have passed on inflation, therefore it is important to have some exposure to this asset class despite the present short-term volatilities.

In economics, the general rule is that the value of money today will not be equal to the same amount of money in the future. This is a central concept in finance theory that takes into account factors such as interest rates and inflation. It is also known as the time value of money.

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