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How investors can beat 'stagflation'

By Bob Campion
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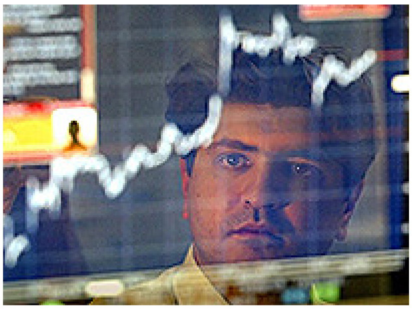
Experts have been talking about the prospect of 'stagflation' after it was revealed that the UK economy ground to a halt at the end of last year.


Stagflation: How to get your investing strategy right

Green shoots of recovery have emerged since, but the spectre of slow growth versus high inflation remains.

We take a look at what it means for savers and investors – and how you can beat it.

What is stagflation?

Stagflation is the double whammy of high inflation and poor economic growth.

Last month it was revealed the UK economy shrank by 0.5% in the last quarter of 2010 – quite a shock after a year of consistent growth.

The official figures sparked concerns that a 'double dip' recession could be on the cards – although these have since receded. But the CBI insists the UK faces a bleak year of 'anaemic and sluggish' growth.

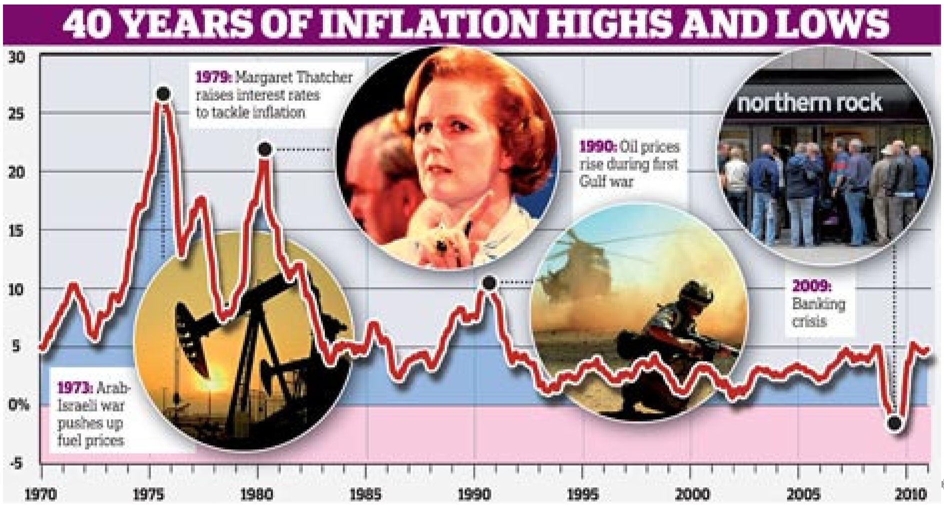
At the same time, however, inflation is rising. CPI inflation is now at 3.7% when the Bank of England's target is to keep it below 2%.

The UK saw short periods during 2008 and 2009 when the economy dipped at same time that CPI inflation was above 2%. And there have been other recent bursts of mild stagflation too, between 2000-2003 for instance.

But the period that is frequently referred to is the 1970s when an oil crisis caused rampant inflation across the world, which in turn triggered job losses and caused businesses in the UK to suffer. That was stagflation proper – a prolonged period of hyper inflation (reaching 25% in 1975 in UK) during a recession (in this case the economy shrank from 1973 to 1975.)

Our current predicament may seem tame by comparison to the 1970s – some have called it 'stagflation-lite' - but there are parallels. The main similarity is the influence of oil, which is once more driving inflation up around the world, recently rising over the $100 a barrel mark and putting the price of unleaded petrol on the forecourt at £1.28 a litre.

Political instability in Egypt and the Middle East means oil could get even more expensive. On top of that, if the data from the end of the year is correct and not just a blip caused by the bad weather, we could well be at the start of the dreaded 'double dip' recession.



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How to beat it

If inflation takes off, the Bank of England will struggle to rein it in because raising interest rates in an attempt to curb inflation will only damage our fragile economy – and vice versa: catch-22.

Savers would suffer, even if interest rates rise, as inflation eats away at their money. The only real way to beat stagflation is to invest, taking risk with your money in the hope of beating inflation – and with the economy suffering, that will be a tough challenge.

- ***Equities***

Patrick Connolly, certified financial planner with AWD Chase de Vere, believes shares that pay good dividends will be the key to success.

'Income stocks have been left behind in the last couple of years and are more attractively valued than growth stocks,' he says. 'And if we go through a period of stagflation then traditional equity income stocks are better placed to profit.'

Connolly's picks for the UK are the Neptune Income and Artemis Income funds. Royal Dutch Shell, AstraZeneca and Vodafone were among the biggest dividend payers in 2010 and financial planner Francis Klonowski favours such blue chip stocks, recommending Henderson's low cost City of London Investment Trust which boasts 44 years of rising annual dividends.

Good quality overseas income funds are harder to find, but the Newton Global Higher Income is worth a look. Connolly also tips US equities due to a $600bn quantitative easing programme which is likely to boost shares, at least in the short term. Here, Connolly favours the JPM US fund, Neptune US Opportunities and for large cap he would go passive with the L&G US Index Fund.

- ***Bonds***

Fixed income is not attractive when inflation is rising, but diversification is always wise. Opting for higher risk bonds would be the best strategy during stagflation, and Connolly suggests the Fidelity Strategic Bond fund and L&G Dynamic Bond. In the high yield sector the M&G High Yield Corporate Bond and Threadneedle High Yield Corporate bond would be worth considering.

Alternatively, index-linked bond funds are the safest way to keep pace with inflation. Index-linked bonds are expensive when inflation is at moderate levels, but the best place to be if inflation starts rising over 5% and towards double-digits.

The Insight UK Index-linked Bond fund has been one of the best performers in the last three years, while the M&G Index Linked Bond and L&G Index-linked Gilt Fund are stable and reliable. The iShares Barclays Capital £ Index-linked Gilts Exchange Traded Fund does much the same job with total costs of just 0.25%.

- ***Commodities***

In the past commodities have proved the best investments in stagflation: they returned 50% from April 1973 to December 1974 while stock markets lost 31%, and they outperformed equities in milder periods of stagflation as well, according to Fidelity International.

Some fear the same is not true today and that the commodities market is starting to overheat, but seasoned financial adviser Jonathan Davis of Jonathan Davis Wealth Management believes commodities are the only sensible place to be in a stagflationary environment. With the global population growing faster than the supply of raw materials he believes agriculture in particular looks attractive, although the market as a whole could be choppy in the short term.

Davis points to the Marlborough ETF Commodity Fund as the best place to start as it has a broad range of commodities investments. For those more experienced or adventurous he recommends the Ruffer Baker Steel Gold Fund, which invests in small and mid-cap gold and precious metals mining companies. And for those prepared to focus attention on farming there is the Eclectica Agriculture Fund which invests in agriculture-related equities.

Beating high inflation when the economy is stalling will be a tough ask for any investor. The only real solution is to be prepared take a risk, investing in companies that can still make money despite the conditions, wherever they are in the world.