HYMANS ROBERTSON

Briefing note

What does heightened inflation mean for the LGPS?

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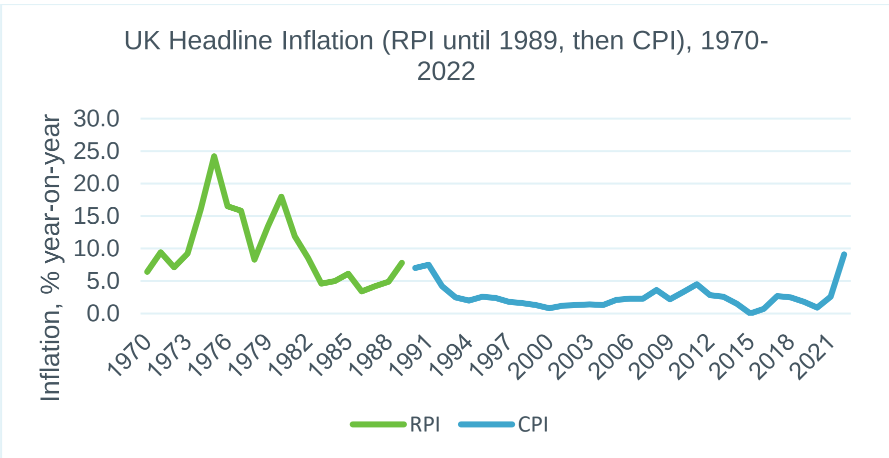
Key messages:

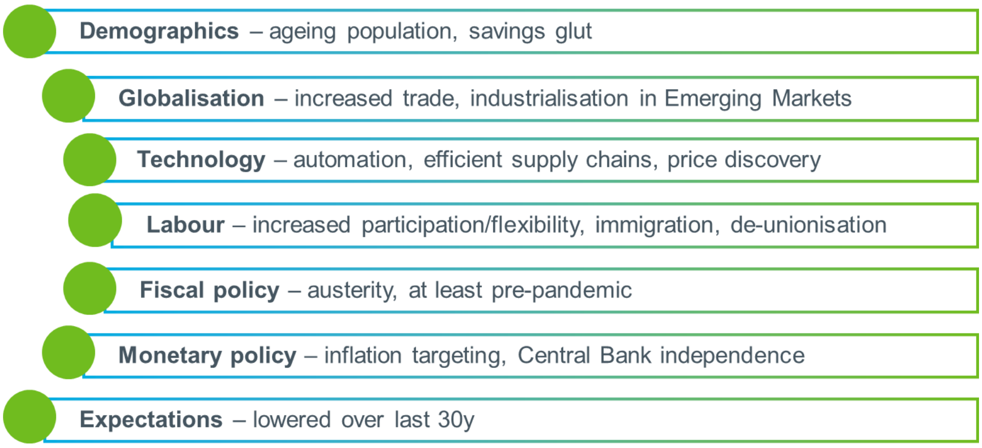
- Sustained, high inflation is a challenge for the LGPS. There have been some major changes in global economics that may keep inflation higher for longer.
- In order for LGPS investment strategies to earn a rate of return above inflation over the long term in today's market, some creativity is required.
- There are opportunities to gain greater protection, whilst maintaining returns, by investing in the underlying drivers of longer-term inflation.

Cast your mind back to the 1980s – the decade that brought the first personal computer, Chicken McNuggets and Channel Four. It's also the last time that UK inflation exceeded 10%.

For years, it looked like Western policymakers had inflation in check. Since 1997, the Bank of England has operated independently of the Treasury, with responsibility for keeping inflation low and stable. Although inflation has breached the Bank's 2% target on several occasions, it never reached double digits. That changed in October 2022, when UK CPI hit the heady heights of 11%.



A range of factors kept inflation low, including demographics, globalisation and technology, as shown below.

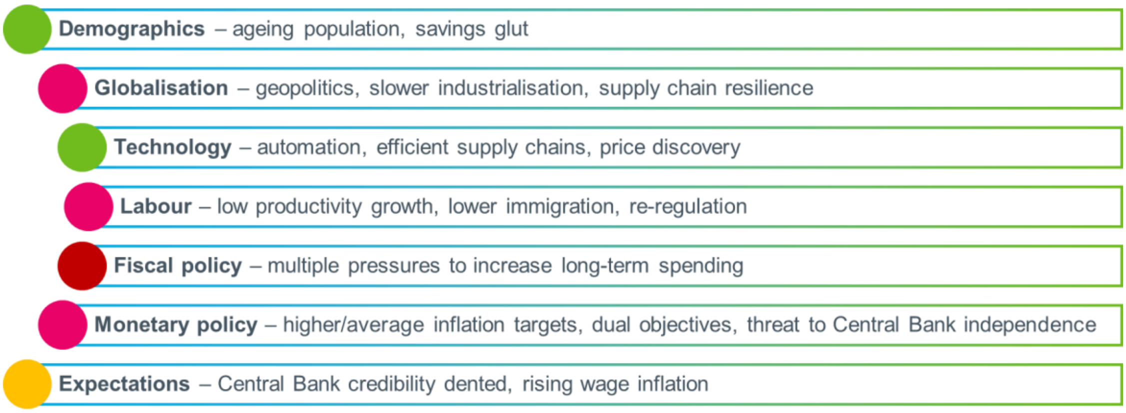


The tide turns

The current bout of inflation started to come through in late 2021. It was largely spurred by the reopening of the global economy after the Covid-19-induced lockdowns, which released pent-up demand suddenly into the market, far outstripping suppliers' ability to meet it. Of course, the response to the pandemic itself, including massive fiscal stimulus in the US and EU countries, had also played a part. Then, as investors expected these effects to dissipate, Russia invaded Ukraine, leading to a monumental increase in food and energy prices, and significantly higher inflation.

What's next?

The big question facing investors today is where inflation will go from here. Many will be hoping for a fast return to the recent years of very low inflation. However, a lot has changed, and this looks increasingly unlikely. We don't expect to see the runaway inflation that hallmarked the 1970s and 1980s, but nor is it likely to return to the very low levels of recent years. We envisage that inflation will fall back under control at a higher level than we've been used to, in the range of 3–4% pa. A range of economic conditions support structurally higher inflation, as you can see below.



A question for LGPS funds

We've always advised clients to build inflation protection into their investment strategies, but this will be an even greater consideration going forward. That means investing in assets that either provide some kind of explicit or implicit link to inflation in their returns, or are simply expected to produce long-term returns in excess of long-term inflation. Traditionally, this would point you to asset classes like index-linked gilts, infrastructure, property and equities. But is there a way to be more focused within your investments to gain that inflation protection?

Investing in the inflation drivers

As we've seen in the diagram above, economic factors are in a very different inflationary position than they were prior to 2021. While these present risks for the LGPS, driving higher benefit payments, they also present investment opportunities.

These opportunities can be realised by investing in the asset classes and companies that will see demand for their products or services rise due to these economic factors. For example, under the umbrella of fiscal policy, we expect that the UK government will further increase its spending on a wide variety of projects, such as defence, levelling up and decarbonisation. This presents opportunities to invest in the asset classes and companies that will benefit from this expenditure. The opportunities are abundant, but we set out a couple below.

Investing in decarbonisation

A prime example, and one that will tie in with the wider ambitions of the LGPS, is decarbonisation. The costs of decarbonising the economy are expected to be significant, and potentially inflationary. Funds can place their capital into a wide range of investments that will benefit from increased government spending and changing regulations. These include renewable energy infrastructure projects – not just generation, but transmission and storage too.

Similarly, sustainable equity funds invest in companies providing solutions to sustainability issues, including climate change. Other solutions are likely to include low-carbon transportation, low-carbon steel/cement, sustainable agriculture, water management, and biodiversity solutions. Such companies are potentially well placed to benefit from a push towards a greener economy by providing the products and services to enable a just transition.

It's worth noting, however, that the characteristic of being an inflation beneficiary doesn't automatically mean that an investment is a sound one that will translate into strong returns. Decarbonisation is such a monumental economic shift that some consider it to be the next industrial revolution. It will certainly spawn investment opportunities, but they won't all be high quality or attractively valued.

The scale of the opportunity may even lead to an oversupply of related products and services as businesses race for the potential profits from producing a successful solution. In the first industrial revolution, the birth of the passenger railway prompted a wave of speculation in companies set to benefit from the trend – a large number of which went bust with the lines never built. And who can forget the fall-out from the last industrial revolution, the dotcom bubble? There will doubtless be similar casualties in the transition to a low-carbon economy, but also the opportunity to invest in the climate equivalents of Google and Amazon, giving high-quality, successful active managers the opportunity to prove their worth.

Reshoring and increased investment

In terms of globalisation, the recent trend has been towards 'reshoring', when businesses relocate operations to their home country, a reversal from decades of offshoring. It's hoped that reshoring will stimulate local economic growth, and better insulate economies from geopolitical risks. However, offshoring became such a global phenomenon due to its lower costs, with reshoring expecting to reverse these savings, leading to inflationary pressures.

Again, there are opportunities to invest in areas that will benefit from this trend. Examples will include certain UK infrastructure and industrial properties, which are generally strong inflation hedges over the long term. In addition, these may also help with local investment requirements, if these materialise.

Conclusion

- As with anything involving investments, with new challenges come new opportunities.
- While inflation is creating significant challenges for the LGPS, there are opportunities among the drivers of higher inflation.
- These opportunities may provide funds with more direct protection against higher inflation, by investing in its beneficiaries.
- It's also possible to tie investment decisions into wider fund ambitions or requirements, such as climate change goals and local investment.