



Worried about inflation?

The UK CPI measure of inflation rose to 4.4% in July thanks to record oil prices and food prices. Interest rates have already been cut to 5.00% and the Bank of England believes inflation will rise further. So should investors be worried?

Inflation is far below historic highs. In the late 1980s and early 1990s, monthly inflation figures were well above current levels – as high as 8.5% in April 1991. But many will remember the economic slump of the 1970s, triggered by double-digit inflation, and be nervous (source: www.statistics.gov.uk)

The recent peaks in inflation have come from rising energy costs plus higher prices for vegetables, furniture, and cigarettes. House prices and housing costs are also still ahead. However, the Bank of England's Monetary Policy Committee emphasises the longer term when determining the UK's interest-rate policy as it takes time for a change to take effect.

Data from the British Bankers Association (www.bba.org.uk, as at 10 March 08) shows that consumer credit card debt is finally falling – but still remains high at £64.1 billion and the Bank of England expects inflation to stay high for a while, before falling back towards 2% in 2009. However, there is less reason for concern than in the 1970s and early 1980s. The economic outlook is nervous but companies appear robust – investors should take heart from this benign macroeconomic backdrop. Even so, this does provide a timely reminder for investors to review and inflation-proof their portfolios.

Interest Rate Rises

If interest rates rise, one of the first concerns for many is their mortgage payment as variable mortgages tend to increase directly. Bond investments are also affected: as interest rates rise, bond prices go down in order to bring the rate of income they pay back in line. And changes in interest rates don't just affect individuals. An increase can affect companies as well as more profit is needed to pay higher borrowing costs, which can ultimately hit the share price. This can have a knock-on effect across your investment portfolio. However, if you remain clear about your long-term objectives, these short-term moves should not be seen as any cause for panic.



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The impact of falling houses prices

The housing market started to fall in the last quarter of 2007. There is now ongoing gloom among commentators about 2008 as statistics begin to confirm that the unprecedented multi-year boom in house prices is at an end. But while the housing market generates a lot of headlines, how important is it for the health of the economy?

The traditional argument has been that strong house prices generate a 'wealth effect', which gives people the confidence to spend money. Many homeowners have used this to their advantage by taking on additional borrowing or using equity release to help fund that spending. However, the big worry now is that if house prices fall too far, those that have taken on the extra debt already, or have bought very recently, could find themselves in negative equity. The Council of Mortgage Lenders has estimated that 23000 people are already there.

This matters because those people will stop spending – and this will knock profits in the corporate sector. If corporate profits begin to fade, jobs will be cut, which means people will have less money and spending will fall further and so on in a potential downward spiral.

Perhaps the economy is getting there. UK GDP hit zero for Q2 and some consider we are now already in recession. People are undoubtedly sitting on too much debt and some have run into difficulties, but the corporate sector overall is healthy and unemployment remains relatively low. Retailers reporting difficult conditions but here are highlights within the sector and interest rates remain on hold at 5%, despite rising inflation.

Of course, a decline in house prices is good news for some people – notably first time buyers, those moving to a bigger house or those buying a second home. They will have smaller debt repayments and more money to spend – assuming they can find a mortgage lender. However, depending on where you live, prices have risen between 150% and 200% in the last 10 years so there is scope for some falls without the economy being significantly affected.

Markets in turmoil

Investors are becoming increasingly concerned with market progress through 2008. We have now seen the collapse of the US sub-prime mortgage market, a prolonged credit crunch, the nationalisation of a UK bank, support the shore up two of the US's largest lenders and now the takeover of a Merrill Lynch and bankruptcy filing by investment bank Lehman Brothers. Speculation over the potential fallout continues to dominate and fears about the high oil and food prices have only helped to make matters worse.

Across the board, the credit crunch has led to an increase in the cost of borrowing, which has stalled mergers and acquisitions. Although many companies are in decent financial shape, some – particularly smaller companies – have found tighter credit conditions hard. This, coupled with the oil price, has led to the collapse of XL and also put Alitalia in the spotlight. Meanwhile, the end of the housing boom and predictions that prices could fall significantly, has hit consumer confidence and retailers are feeling the pinch.

As a result, sentiment among equity investors has taken a huge knock. Bad news dominates so, although there will still be some winners, selectivity and realistic expectations will be important. Markets remain volatile, but it is worth remembering that stockmarkets tend to be driven by irrational fear (and greed), not logic. The key is to stay calm, think long term, and be selective. In the words of Franklin D Roosevelt, "the only thing we have to fear is fear itself".