Decreasing inflation - what does it mean?

After a long period of minimal inflation, the UK experienced a surge in its inflation rate in 2021, reaching a peak of 11% in 2022. It was not alone - rates around the globe also rose quickly. Since its peak, the UK rate has fallen significantly to 4%, according to the latest figures from the Office for National Statistics. For over a year now, inflation has since been on a sustained downward trajectory.

But is falling inflation always a good thing? And what does it mean for investors?

When looking at the direction of inflation on portfolios, it is important to emphasise that a decreasing rate should not be misconstrued as deflation. At the moment, despite inflation's decline to 4%, prices are still rising. Furthermore, not only are they still rising, they're rising at a higher rate than the Bank of England (BOE) considers optimal. The BOE targets 2%, which it believes is necessary for economic growth.

Additionally, whilst inflation does currently appear to be decreasing, investors should be aware that potential upside risks remain. For instance, in the USA, continuing labour market pressures may cause inflation to be stickier than anticipated by much of the market. Moreover, geopolitical risks, such as current tensions in the Middle East, may impact global trade and supply chains - again keeping inflation higher for longer. Investors should be aware of these possibilities when making investment decisions.

Impacts of decreasing inflation

Still, with inflation currently decreasing, it's beneficial to know the impact of this downward trajectory and the knock-on effects on portfolios.

1. Stabilising prices

Decreasing inflation is often beneficial as it provides some sort of price stability. That's always better for businesses, which can struggle when costs escalate at an unaffordable rate. When prices are more stable, businesses also find it easier to strengthen profit margins and plan for the future. For investors, an improving backdrop for businesses means investments are more likely to grow.

2. Rate cuts

Turning to central banks, decreasing inflation makes it more likely that there will be rate cuts. Central banks will cut rates to stimulate economic activity. Again, for businesses, this is largely good news. Lower rates lead to more affordable investments, potentially enabling business growth. Lower interest rates also encourage more consumer spending and borrowing, further increasing economic activity. As a result of these factors, markets in general tend to respond positively to interest rate cuts.

3. Fixed income

For fixed income investors, lower rates shrink yields on existing bonds, benefiting those with a portion of their portfolio in this asset class.

4. Equities

Due to lower savings rates, investing in equities becomes a better way to achieve higher returns. Investors may find that dividend-paying stocks and income-generating strategies may become more attractive - particularly when compared to the current return on cash. Furthermore, in a lower inflation environment, dividend growth becomes a valuable avenue for enhancing returns. In addition, lower rates make it easier for companies to finance their growth.

Investing against decreasing inflation

All of the above impacts sound promising - particularly for investors who found the last couple of years a rollercoaster ride. But it's important not to get carried away. Despite news of decreasing inflation potentially causing a much-anticipated lowering of rates, it is still wise to take a considered, long-term view of the markets. In fact, at Square Mile, our investment philosophy is built upon the belief that taking a long-term view is a key factor in generating long-term returns.

Our belief is motivated by the need to drown out short-term noise, which can encourage misinformed decisions. Instead, taking a long-term view means we can better identify prospects with the best chances of outperforming. We only make tactical tilts when needed. It means we can be reactive to inflation and interest rate news as and when we feel appropriate.

Adopting this approach is particularly appropriate at the moment as, even though the path of inflation seems to be coming down on a global scale, its near-term numbers are volatile.

Finally, our philosophy is strengthened by actively seeking out investing in quality. With inflation proving to be unpredictable, it's essential to invest in quality companies that can be relied upon to be resilient, irrespective of the economic backdrop. Companies with strong balance sheets, for instance, are the ones that will be more able to navigate their way through uncertain times. We continually monitor our investments too, to ensure our picks remain up-to-date and relevant against the current environment - whether that be inflationary, deflationary or disinflationary.

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