MARKET INSIGHT

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THE PSYCHOLOGY OF INFLATION

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Inflation, the general increase in prices over time, is a key economic indicator that significantly influences financial markets and wealth management strategies. Beyond its economic implications, the psychology of inflation, i.e. how individuals and investors perceive and react to it, plays a crucial role in shaping financial decisions.

HOW INFLATION AFFECTS INDIVIDUALS

The impact of changing prices on an individual's psychology can vary. One significant effect is the perception of value.

As general price indices rise, the perceived value of money declines, leading to a sense of urgency to spend rather than save, as the purchasing power of cash erodes over time. This behaviour can push prices even higher as both consumer demand and spending increase.

Media coverage plays a significant role, as sensationalist headlines can reinforce this sentiment. Unstable prices also create uncertainty about future costs and economic stability, exacerbating anxiety among consumers and businesses, potentially leading to more conservative financial behaviours, such as postponing investments.

ANCHORING EXPECTATIONS AND CENTRAL BANK

Anchoring expectations refers to the trust businesses and consumers place in central banks to keep inflation stable. Future inflation expectations can influence current inflation: if businesses expect higher inflation, they may raise prices and workers may demand higher wages, leading to a self-fulfilling cycle. Conversely, low expectations can dampen actual inflation.

Thus, central bank credibility, forward guidance, and clear communication are essential. If market participants doubt central banks' commitment or receive ambiguous messages, expectations may become unanchored, making policy efforts ineffective.

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In the 1970s and 1980s, the USA faced severe inflation, with the Consumer Price Index (CPI) increases exceeding 13% YOY due to oil shocks, fiscal policies, and labour unions pushing for higher wages. To control this, interest rates were raised to nearly 20% in 1981, causing two severe recessions lasting nearly two years.

Comparing 2020-2024 to the 1980s, the inflation drivers differ: the 1980s were driven by supply-side shocks, while the 2020s saw demand-side factors, supply chain disruptions, and labour market tightness. The 1980s highlighted the importance of timely action and central bank credibility, a lesson current Federal Reserve members have applied with swift actions.

WHERE DO WE STAND?

In the US, recent economic data shows stabilizing inflation expectations, a slowing job market, slower wage growth, and improved productivity. The Fed is closely monitoring upcoming indicators. In Europe, inflation is more contained, with a significant decline to 2.7% from 7.1% a year ago. European consumers are less driven by stock market performance, so it should have limited impact on future demand and prices.

While some uncertainties remain, central banks have done a commendable job in containing price pressures. Inflation is perceived very differently among people: lower-income classes feel the pain more intensely than higher-income groups, though differences also arise within these classes depending on individual circumstances (homeowner versus renter, needing to borrow money soon, etc.).

Another human bias is that wage growth is perceived as deserved, while inflation is viewed as unfair. The impact of losing purchasing power is more painful than the gradual increase in wages over time, making inflation an intensified form of loss aversion bias. Given that the bulk of the pain from recent and quick price increases have been integrated by economic stakeholders, the comparison base is now higher, and future perceptions of inflation might then be less pronounced.

THE WEALTH MANAGEMENT IMPLICATIONS

Analysing inflation regime, including psychological factors, and correlation between asset classes is essential for effective wealth management and financial planning.

Inflation influences investor behaviour, asset prices, and market dynamics in complex ways. By recognizing these effects, integrating central bank moves, and implementing strategic adjustments, such as investing in inflation-protected securities, and favouring companies with strong pricing power with the ability to pass on higher costs to consumers, allows us to navigate these uncertain times more effectively.

Regularly reviewing and adjusting investment strategies ensures one remains aligned with clients' financial goals and risk tolerance.

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