Morgan Stanley

INVESTMENT MANAGEMENT

Understanding Inflation

Inflation has jumped to a level we haven't seen in 40 years. Here's what that means, why it's happening now and how it can impact investors.

Inflation impacts all aspects of the economy. With war and energy shocks stacking on top of pandemic stimulus that was already driving up prices, inflation is on the rise. This has disrupted the markets and led investors to ask questions about inflation that haven't been asked in the developed world since the mid-1980s.

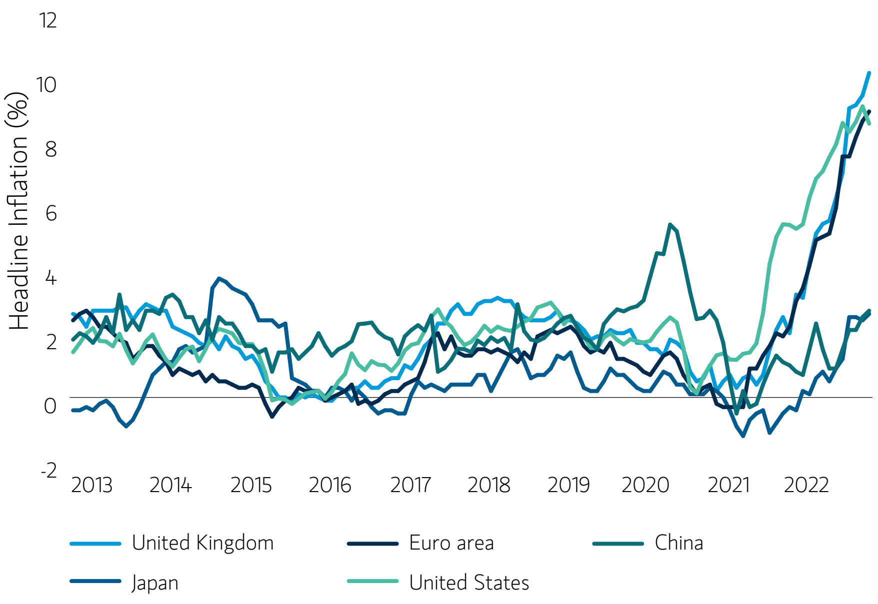
Background

Inflation is the rate at which the prices of goods and services are rising. Put another way, it's the rate at which the value of a currency is falling. It has been described as "too many dollars chasing too few goods."

While moderate inflation tends to be associated with economic growth—central banks target a rate of typically around 2%—high inflation can be a headwind for many investments.

Inflation Is Back to Levels Last Seen 40 Years Ago

The European Central Bank (ECB) has a 2% inflation target over the medium term.



The Harmonised Index of Consumer Prices (HICP) is a measure of inflation in the euro area.

The HICP tracks consumer price inflation based on the spending patterns of EU households.

It is "harmonised" because all EU countries follow the same methodology.

Source: Bloomberg, Inflation Monitor, as of July 31, 2022.

Types of Inflation

1

Cost-Push Inflation

is usually driven by an increase in production costs such as oil, energy, raw materials or wages.

2

Demand-Pull Inflation

grows out of demand for goods and services that exceeds the economy's production capacity, pulling prices up.

3

Built-In Inflation

is tied to market expectations. When workers expect a given level of inflation, they negotiate built-in wage increases. This type of inflation can be longer-lasting (sometimes called a "wage-price spiral").

Why Is Inflation Rising?

As with most perfect storms, there is more than one cause:

COVID Consequences

COVID-19 stopped the global economy, with 20 million workers losing jobs in the spring of 2020. Global governments and central banks responded with historic stimulus programs that turned a brief recession into a strong recovery, restored most of the lost jobs and pushed household net worth to record highs. But the side effect of that stimulus is inflation.

Pandemic Demand

During the pandemic, many consumers around the world wanted to buy goods that were not available, as supply chains got tangled by lockdowns, loss of workers and deglobalisation. The resulting pent-up demand pulled ahead of supply capacities.

War in Ukraine

Given both countries' roles in global energy and food production, Russia's invasion of Ukraine created a supply shock on top of energy prices that were already high due to the economic restart. This pushed up the volatile food and energy components of inflation and extended inflation's expected peak.

How Are Central Banks Responding?

With inflation hovering near 40-year highs and prices surging for groceries, energy and other household items, the number of central banks hiking rates has sharply increased. The pace of tightening is accelerating in several countries, with the Federal Reserve, Bank of Canada and Bank of England signaling they expect to continue to hike rates. The ECB recently lifted rates for the first time in over a decade.

Higher real rates on government debt has led to higher borrowing costs for consumers and businesses, which has contributed to a steep drop in equity prices around the world. There is a significant risk that inflation runs well above central bank targets over the next few years. Specifically, markets are signaling a high probability of inflation rates of over 3% persisting in coming years in the U.S., euro area and the U.K.

Central banks will have to tighten more aggressively if high inflation becomes entrenched. Faster tightening could trigger a significant rise in unemployment and further declines in risk asset prices. But restoring price stability is critical for sustained economic growth, and central banks must act to bring demand and supply into better balance. Bringing down inflation will require some pain, but moving too slowly could be much more costly.

Inflation impacts all aspects of the economy but not equally. While some assets tend to underperform when inflation is rising, others may be poised to benefit. Learn more about how to mitigate inflation risks at **morganstanley.com/im.**

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Diversification neither assures a profit nor guarantees against loss in a declining market.

There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in a portfolio.

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

A separately managed account may not be appropriate for all investors. Separate accounts managed according to the Strategy include a number of securities and will not necessarily track the performance of any index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.

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