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ASSET MANAGEMENT

History's lessons for a new era of Spikeflation

Trevor Greetham, Head of Multi Asset at Royal London Asset Management, discusses how the new era of 'Spikeflation' calls for diversification beyond stocks and bonds and a more active approach to tactical asset allocation.

Students of history see some troubling parallels with the past, both in the geopolitical sphere and in the field of economics. The Covid-19 pandemic marked a regime change for financial markets, shattering the low, stable inflation backdrop that had been in place since the early 1980s. We are now in a high and unstable inflation equilibrium, similar to the 1970s and the periods around the two World Wars. In common with these times, long-held beliefs around the balance of power in the world are being questioned almost on a daily basis. Profound structural changes leave us vulnerable to repeated price level shocks that central banks may be unable to prevent and unwilling to reverse. In our view, this new era calls for diversification beyond stocks and bonds, including inflation-hedges such as commodities in a multi asset portfolio. It also calls for a more active approach to tactical asset allocation, with shorter business cycles and more frequent bear markets in prospect.

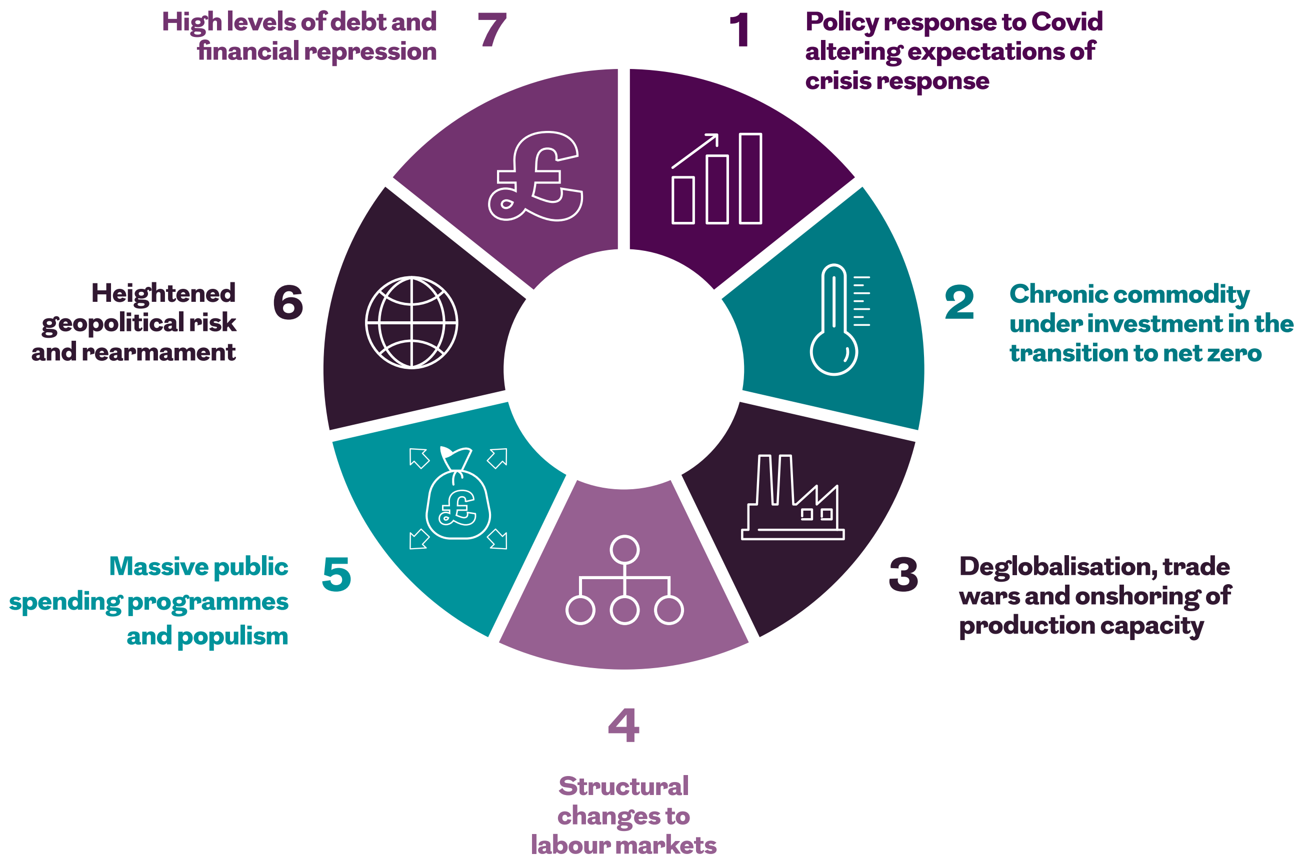
The pandemic marked a regime change

The initial impact of the pandemic was deflationary. Synchronised lockdowns brought economies to a sudden stop and inventories of raw materials and finished goods backed up in the system with alarming speed. In April 2020, for the first time in history, crude oil futures traded at a negative price – a barrel of oil was worth less than it would cost to store it. We warned of a more inflationary post-Covid recovery as policymakers were likely to err on the side of doing too much, rather than too little, to help consumers and businesses survive. As it transpired, wartime quantities of fiscal and monetary stimulus were left in a supply-constrained world economy long after the lockdowns were over. The resultant broad-based surge in prices was well under way when Russia invaded Ukraine, triggering sanctions and a further large increase in the cost of energy.

Year-on-year measures of inflation have since returned to a normal range, but this should offer little comfort. The cost of living remains elevated and further shocks are likely. Self-proclaimed 'Tariff Man' Donald Trump is back in the White House. To the dismay of allies and enemies alike, he has started a trade war reminiscent of the 1930s that could increase the cost of imports all over the world. Plans to expel undocumented workers threaten US labour shortages, raising the spectre of a wage-price spiral. A reduction in fossil fuel supply in the transition to net zero, rearmament in Europe, populism and the increasing risk of conflict with Russia or in the Middle East create their own inflation risks. Overshadowing everything, a series of economic hits – including the 2008 financial crisis, Brexit for the UK, and the pandemic itself – have left sovereign indebtedness very high. Governments have an incentive to let inflation overshoot to inflate away debt. It feels a lot like the 1970s (Figure 1).

For professional investors, not suitable for retail clients.

Figure 1: Structural drivers of Spikeflation



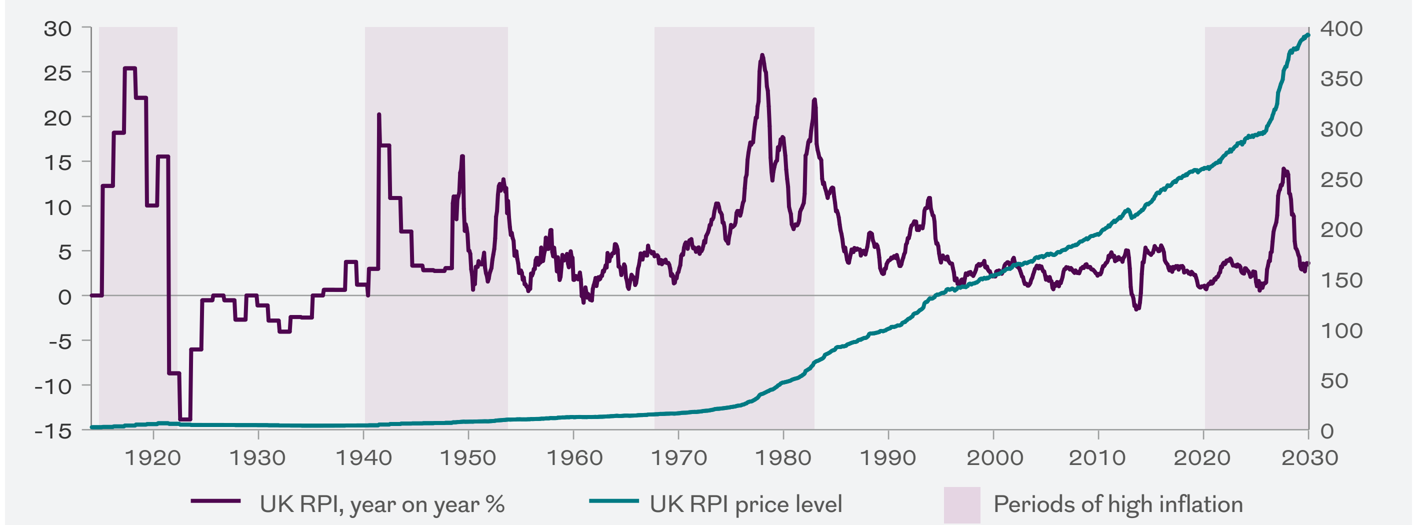
Source: RLAM. For illustrative purposes only.

History repeating itself

A period of low inflation punctuated by sudden price level shocks would be consistent with evidence from the historical record. For most of the last century, inflation has been well-behaved, if not negative, with UK retail prices rising by an average 1.9% a year. However, around the two World Wars and in the 1970s it was a very different story. Inflation averaged 9.8% a year over these periods, but it wasn't high all the time.

In fact, the measured annual rate fluctuated wildly with a series of pronounced spikes. On two occasions, late in the 1914-18 war and again after the OPEC oil embargo of 1973-4, it rose to more than 25%. Once a shock had been absorbed into the base of the calculation, it dropped back to the low single digits (Figures 2 & 3).

Figure 2: UK Retail Prices Index showing periods of high inflation



Source: Office for National Statistics. High inflation periods shaded. LSEG Datastream as at 15 January 2025.

Figure 3: High and low inflation regimes since 1915

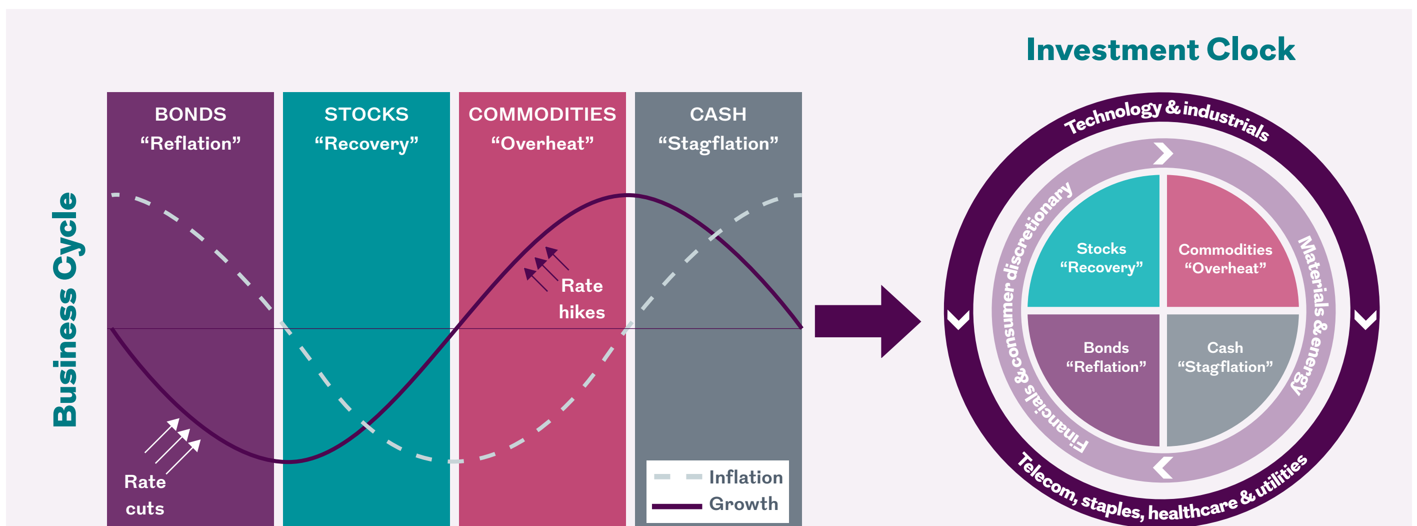
Period	Dates		Years	Price level change	Year on year RPI		
	Start	End			Low	Average	High
World War I	Jan 1915	Nov 1921	6.8	2.6 x	0.0%	14.9%	25.4%
Interwar years	Nov 1921	Oct 1939	17.9	0.7 x	-13.9%	-2.3%	3.8%
World War II	Oct 1939	Jun 1953	13.7	2.4 x	0.6%	6.7%	20.2%
Reconstruction	Jun 1953	Jul 1967	14.1	1.5 x	-0.8%	3.0%	8.3%
1970s	Jul 1967	Nov 1982	15.3	5.2 x	1.4%	11.4%	26.9%
Globalisation	Nov 1982	Apr 2020	37.4	3.5 x	-1.6%	3.4%	10.9%
Covid aftermath	Apr 2020		4.8	1.3 x	0.5%	6.3%	14.2%
Stable regime			69.5	3.6 x	-13.9%	1.9%	10.9%
Spikeflation			40.6	43.9 x	0.0%	9.8%	26.9%
Full period	**Jan 1915**	**Jan 2025**	**110.1**	**157.7 x**	**-13.9%**	**4.7%**	**26.9%**

Source: Retail Prices Index, Office for National Statistics. 'Spikeflation' periods shaded in grey, based on RLAM categorisation.

Few people alive today have prior experience of investing under these circumstances. In the four decades since 1980, inflation just wasn't an issue, barring a brief rise during the 1990/1 Gulf War. The fall of the Iron Curtain, China's transformation into the workshop of the world, rapid productivity growth and globalisation all helped to keep prices in check. One by one, developed economy central banks adopted inflation targets, creating the impression that high inflation was a thing of the past.

As it turns out, inflation targets often get suspended when a large price level shock hits. The UK Consumer Price Index is up a cumulative 25% since April 2020. If inflation had been in line with the official 2% target set by the Chancellor, it would have risen by less than 10%. Yes, the Bank of England raised base rates to bring inflation back down, but they and other central banks have absolutely no intention of reversing the overshoot. It's easier to apologise and let bygones be bygones. To do otherwise would entail engineering a deep and destabilising recession which would increase national debt – something their governments do not want to see.

Figure 4: The Investment Clock linking asset allocation to the business cycle



Historic asset class returns through business cycles

	Growth	Inflation	Bonds	Stocks	Commodities	Cash
Reflation	↓	↓	7.9%	-1.5%	-29.3%	2.6%
Recovery	↑	↓	4.1%	18.2%	-8.4%	1.1%
Overheat	↑	↑	-0.4%	8.9%	17.6%	-0.2%
Stagflation	↓	↑	-2.7%	-14.3%	37.1%	-1.1%
Average return			2.1%	7.0%	1.7%	0.6%

Stocks and bonds suffer in Stagflation

Commodities hedge Inflation

Past performance is not a guide to future performance.
Source: RLAM. Data based on an analysis of business cycles from April 1973 to January 2025. US dollar returns after inflation for US Treasuries, S&P 500, Goldman Sachs Commodity Index and US T Bills. For Illustrative purposes only.

Asset allocation and the business cycle

Historical analysis offers some suggestions as to how investors should respond to this new environment. The Investment Clock approach that guides our asset allocation is based on the idea that you can tell where you are in the global business cycle with the help of growth and inflation indicators. Looking at market returns since the mid-1970s, a pattern emerges (Figure 4).

Historically, government bonds do best when growth is weak and inflation is falling. Stocks do best when growth recovers, but inflation continues to fall. When inflation is rising, you've been better off in commodities. This holds especially true in years of stagflation, with 2022 a recent case in point. At these times neither stocks nor bonds have kept pace with inflation.

There's an important timing issue here. While stocks have beaten inflation handsomely over the long run, justifying the pride on place in most portfolios, they are not usually a good inflation hedge in the shorter term.

This is because valuation multiples tend to drop during inflationary periods like the 1970s, which has often offset the benefit from increased corporate earnings. It is when inflation drops again, and multiples expand, that the real money has been made, as we saw in the 1980s.

Broader diversification and a more active tactical approach

The first lesson of history during periods of Spikeflation is to diversify broadly, including inflation hedging assets such as commodities in a multi asset portfolio, and being more selective about bond exposure.

The second lesson of history is to be more tactical. According to the National Bureau of Economic Research, the average US business cycle since 1857 has been between four and five years in length, with three years of economic expansion and a year or two of contraction (Figure 5). Cycles in this environment could be even shorter.

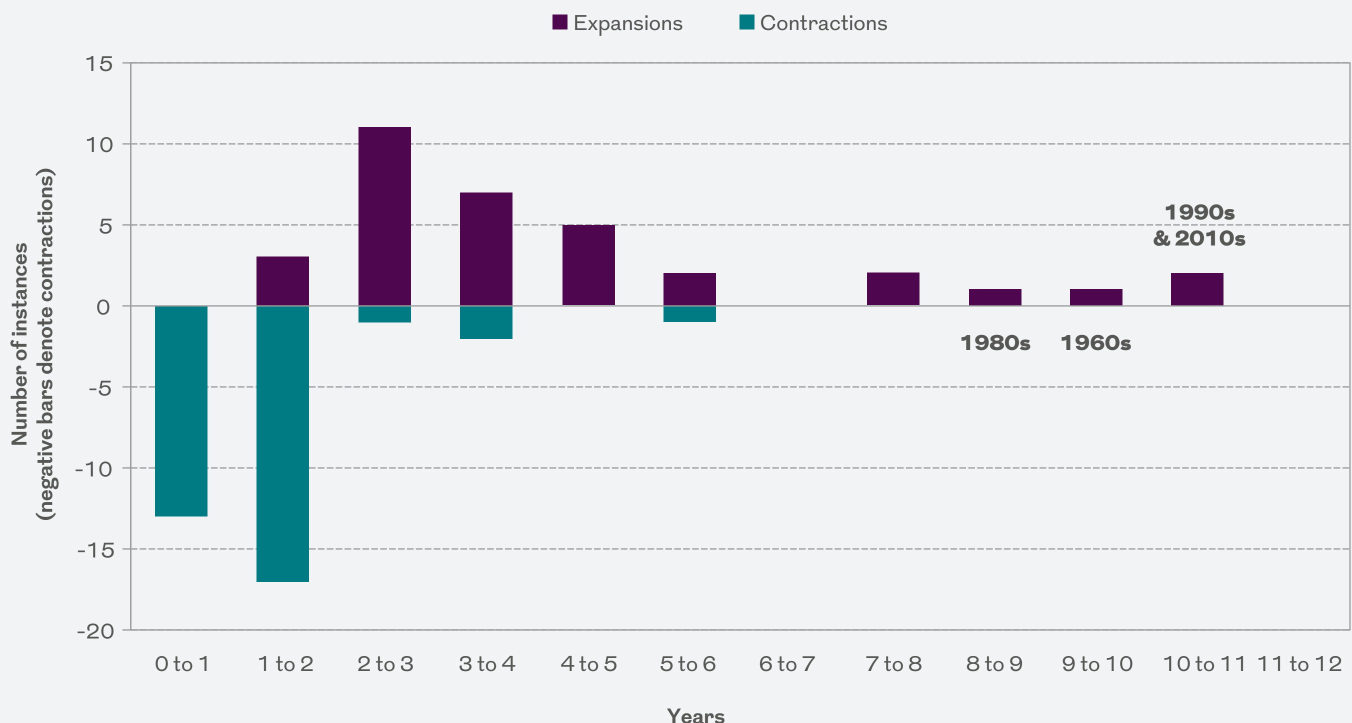
In periods of low and stable inflation we've seen some really long business cycles, with central banks willing and able to cut interest rates whenever needed to extend the cycle. Over the four disinflationary decades up to 2020, US economic expansions averaged around nine years.

The UK economy didn't suffer a recession in the dot com bust, so it enjoyed 17 years of uninterrupted growth between 1991 and 2008. Australia went one step further, also avoiding recession in the 2008 financial crisis. The 2020 pandemic ended a 28-year expansion. This isn't anything close to normal.

If low, stable inflation means above-average expansion lengths, the converse must also hold true. Periods of high and spiky inflation tend to see shorter business cycles, with central banks stepping in more frequently to hit the brakes. More frequent recessions mean more frequent equity bear markets. Adopting a buy and hold strategy is no longer enough for investors with a shorter time horizon, including those taking an income from their portfolio. We see a greater role for tactical asset allocation using models such as the Investment Clock, with a view to adding additional value as the business cycle evolves. Active volatility management can help to mitigate losses when recession strikes.

History never repeats itself exactly, but it can teach us some useful lessons. As philosopher George Santayana said, "Those who cannot remember the past are condemned to repeat it".

Figure 5: US business cycle expansion and contraction lengths since 1857



Source: National Bureau of Economic Research.

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Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

Efficient portfolio management (EPM) Techniques: The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

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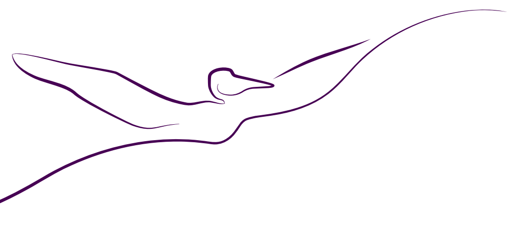

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