Investment Insight
Innovation, inflation and interest rates

Morningstar Investment Management EMEA

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For Financial Advisers to use with their clients

Innovation, inflation and interest rates are dominating markets with AI attracting a surge of investor interest globally, while inflation has become more and more a UK focus. As usual the punch line for investors is whether asset prices already reflect what is most likely to happen, excessive pessimism or excessive optimism.

Will AI innovation curb inflation?

AI exemplifies the challenge facing investors when it comes to considering the impact of technological based innovation. How much value will be created and who will benefit most? Will it be the companies at the forefront of innovation, the inventors and commercializers of the technology? Will it be the suppliers that provide the major inputs including workers? Will it be all end users if productivity gains and new products and services mean lower prices? Will it bestow an advantage to special groups or regions? How important are all these considerations vs other factors that can impact business, such as the economic cycle, regulation, competition and the cost of capital?

Recent history is supportive of the idea that more and more of the value add from innovation is staying with dominant companies and is not being competed away as much as happened previously. This could continue if companies can continue to acquire emerging companies that derive the next wave of innovation and there are no restrictive actions from regulators and governments. Investors already appear to have made up their mind that any company with the potential to benefit from AI will - judging by surging share prices that have propelled the US market this year, explosions of interest in AI on search engines and the rush to launch AI themed investments, including funds and ETFs.

The long history of universal and broadly applicable innovation - such as the steam engine, electricity, automobiles and computing - shows that picking winners amongst the initial innovators and enablers has proved far more difficult, as periods of rapid change erode competitive advantages quickly for most. Caution is warranted on pricing in the best case for companies currently at the forefront or tagged as part of the AI theme. Low inflation has instead been one of the more persistent impacts, as productivity and competition increase.

UK Bonds back in the frame

Right now, for UK investors any promise of lower inflation from AI seems a long way away. UK annual core inflation increased month on month to 7.1%, despite global inflationary pressures easing and US annual core inflation dropping to 4.8% in June. This has caused a repricing that leaves UK bond markets ranking highly in our global analysis, for the first time in many years. A central bank under pressure to quell inflation, and expectations of further rate rises, while global inflationary pressures ease, led us to switch some of our US for UK bond exposure recently.

Overall, we are maintaining broadly diversified portfolios with a mix of attractively valued more cyclical opportunities and more defensive investments that provide diversification in scenarios less favourable for our preferred investments.

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