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RESEARCH METHODOLOGIES

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THE RECENT IMPACT OF EXTREMELY LOW INFLATIONARY RATES (DEFLATION) ON INVESTMENT LEVELS IN THE UK CAPITAL MARKET.

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Contents

Introduction

The drastic drop in the UK's inflation rate is an issue that has dominated the headlines in these past few weeks from the beginning of the year 2015. According to the BBC (2015) in a report published on February 17 the same year, consumer price index (CPI), which forms the main determinant of inflation stood at 0.3% (one of the lowest on record), from 0.5% following the continuous fall in fuel and energy prices. Ever since the early 1990's developed countries have targeted low and stable inflation rates as an economic policy to put inflation in check. This policy has itself proved worthy with most of these countries achieving their targets to the point of experiencing deflation.

This propelled my interest to carry out a research on how such a situation may impact investment levels in the UK capital market. Academic intellects who find themselves in the field of finance or economics have shown interest in this topic (if not exact, related). In the month of August 2006, a group of scholars from University of Glasgow, University of Stirling and Brunel Business School completed a research on "Stock Returns and Inflation: The Impact of Inflation Targeting" (Kontonikas, 2004). Meanwhile, some previously conducted empirical studies draw a distinct relationship between high, sustained rates of inflation and financial crisis; see Boyd et al (2001).

Another empirical research was conducted by (Shabani, 2010) on capital market Inflation theory in which he concludes with the development of a simple model to show this theory in the US capital market by using data spanning from the year 1964 to 2010. After estimating a quadratic relationship, the results supported the theory in that, the price levels of long term securities are dependent on the inflow of equity capital into the market.

Research Question

To what extent do inflationary rates affect the decision of capital market investors?

Sub-Questions

- What is the current inflation rate in the UK?
- What are some of the factors or forces that determine the rate of inflation in the UK?
- What does the research tell us about how inflationary rates affect capital market investment in the UK?
- Can there be a perfect rate of inflation?
- How are capital market investors affected?

Research Objectives

Objective 1: To identify the role of inflation in the UK capital market.

Objective 2: To examine how deflation has impacted the UK capital market over the years.

Objective 3: To carry out a primary research involving experts to express their views on capital market investment in the UK.

Objective 4: To evaluate the outcome of the entire research to reach some justifiable conclusions on the issue.

Objective 5: To know whether there are other factors aside inflationary/deflationary rates that affect capital market investment decisions.

Aim of the Research

The aim of this research is to determine what inflationary rate(s) in the UK is/are appropriate enough to promote capital investment.

Review of Related Literature

Introduction

This section covers the review of related studies on the effect of large class size on teaching and learning of business management. In this chapter, relevant literature was reviewed to acquire information on previous research on the topic. The review of related literature dwelt on the following topical areas;

1. Inflation
2. Deflation
3. Capital Market(s)
4. Investment and
5. The role of inflation/deflation in the UK capital Markets (the main argument)

Inflation

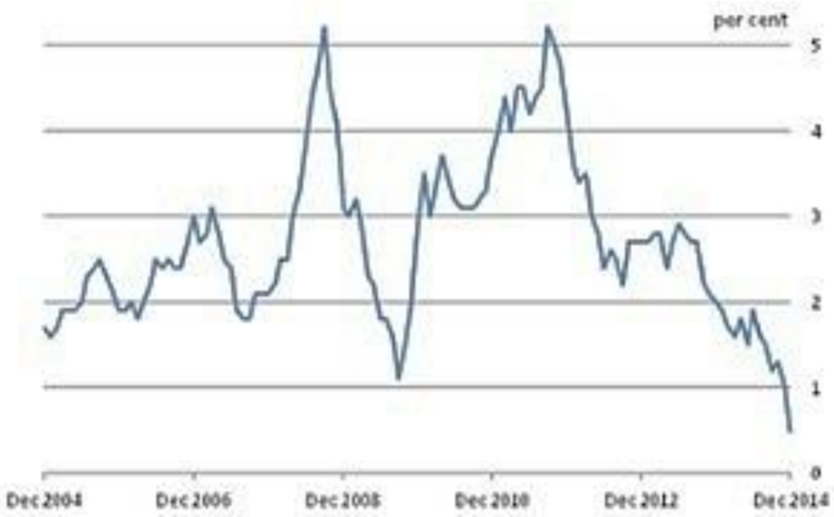
By inflation, there is a denotation in the rise of general prices in an economy as to whether they have been kept low or stable- a simultaneous target for arguably all governments in power.

These two factors are taken into consideration in order to make informative economic decisions by households, businesses and governments (Hinde, 2007).

In most developed countries, governments set targets for the *rate of inflation* of which the UK is no exemption; the Bank of England has a 2 percent target whereas interest rates are also adjusted to match up.

The facts of low and stable inflation rates as policy targets are more or less the same in the view of Economists- According to Nordhus (2010), inflation is a phenomenon of rising prices; and when the increase persists; consumers get confusedly led into making poor decisions on spending and investment. Nordhus (2010) goes ahead to state that macroeconomic policy has largely placed emphasis on low and stable inflation as a prime objective. Below is a chart that shows the rate of inflation in the UK from 2004 to 2014 on a 2 year interval.

Figure 1



Source: The Guardian (www.theguardian.com)

Deflation

The question is “*can there be a fall in general prices?”* Yes there can! Falling prices sound like something to cheer but today’s version is ruinous (Economist, 2015). The period of a general fall in prices particularly when it is accompanied by unemployment, reduction in productivity and trade is termed “*deflation*”. Due to these components, anti-inflationary policy makers prefer the term *“disinflation”* so as to reduce its severity when made mention of (Oxford, 2008). In theory, Calomiris, (2014) suggests that there is no obvious connection between deflation or disinflation today and changes in economic activity the near future.

Before we probe into the effects of extremely low inflation rates on capital market investment; it is only right to look at its associated harms from a general economic perspective. The governor of the Bank of England, Mark Carney, feels that falling energy prices are “unambiguously good” which is very true for the British Economy. Good in the sense that they contribute to price drops, however its long term effects can be detrimental. If prices are to rise at 2% p.a for instance, most shoppers may ignore their low accent. During periods of deflation, the depressing choices- delaying purchases/payments, hoarding cash do crop up amid lower energy bills, cheaper costs of inputs and consumables (Economist, 2015).

In a business report by the BBC on 25th March 2015, Robert Peston, an economic editor for the broadcasting corporation said for now, it’s good news for prices to be falling- because it increases spending, makes us feel a bit richer and our pounds go further, however if it goes on to become fully fledged deflation, it will be disturbing (Peston, 2015).When making investment decisions, Bloomberg, (2014) argues that most investors do not take into consideration the negative aspects of inflation and how their portfolios can be affected in the long term- a very unwise approach towards investment which is sometimes not the fault of investors but rather advisers, policy makers and economic conditions that sound and appear truly promising for the future.

Capital Market(s)

A capital market is a platform where the trading of long term debt instruments takes place. Long term meaning they yield returns or mature in a year or more. In recent times the capital markets are used for raising cash/money through bonds, stocks, shares and other investments (Harvey, 2011). In lay man terms, the capital market is simply a phrase used to describe the buying and selling of investment portfolios that grow in more than a year.

Investment

The word investment is a business term used to describe a risk taken by an individual (investor) or a group of people say a company in which money is spent (the risk) with the optimism of getting some returns (profits).

To the investor, the motivation is to increase wealth. Myles (2013), gave a definition which he refers to as "standard". He claims that investment is the sacrifice of a current consumption in order to gain increased consumption at a future date. Investment comes in two forms: financial or regular and falls under several market types including the money market, commodities market, capital market etc.

The role of inflation/deflation in the UK capital markets (the main argument)

With the above definitions and for the purpose of this research, we can consequently say that investing in a capital market is a venture that requires thorough market investigations on the part of the risk taker (investor) so as to make worthy decisions.

Inflationary and deflationary rates, which are more or less the central focal point of this research, must be taken into consideration before investment decisions are taken.

For instance, one can say inflation is good in the long term because it reduces debts on the part of the borrower and creates losses on the part of the lender- say the present value of £200 today will most likely diminish by about 5% to £190 in about a year or two depending on the severity of the inflationary rate in the country. This puts the investor/lender in a much better position with '*the toast butter side up'* .In the longer term however, and with constant rise in the price of general commodities, prices of assets increase vis-à-vis high returns.

On the other hand, deflation brings about a reduction in the price of assets alongside lower returns on capital employed. In spite of inflation control success between the late 90's and early 2000's, international capital markets experienced a swindle in stock returns which aroused the concern of policy makers and academics on the impacts of the real economy as well as the effects of inflation targeting. The pressures of inflationary and deflationary rates co-exist in today's market (Hewitt, 2012). Although governments have tried to mitigate the global financial system, this cash flow is yet to reach consumers to reduce the risks of inflation. However, there is a fear that central banks will fail to implement policies that will timely cut excessive inflation.

It is shown by Kontonikas and Loannidis (2005) that inflation targeting – an approach by governments, central banks and policy makers to control the rate of inflation by setting a particular target - with strong interest rate policies should mitigate capital market volatility. In contrast, the New Environmental hypothesis (NEH) argues that low inflationary rates in an economic environment are illusive in the sense that investors feel convicted of lowered costs of capital which rather leads to unsustainable financial imbalances within the country (See example Borio ad Lowe, 2002).

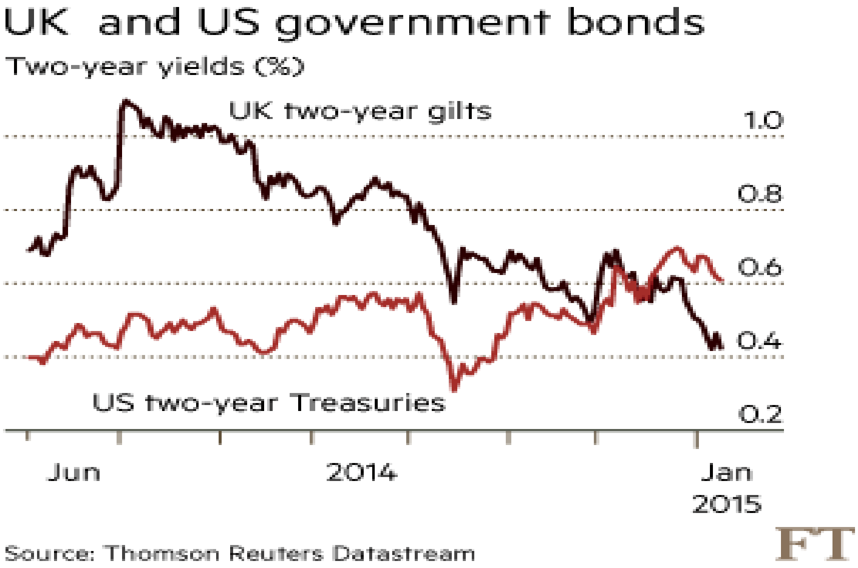
Empirically, the relationship that lies between inflation and economic activity is negative (Judson and Orphanides 1999) meaning that rising inflation rates lead to a fall in economic activity whereas dropping inflation rates yield good and positive economic activity although this empirical theory does not state how low the rates should be. If this is true, then inflation and deflation both have downsides as well as positive sides whether in the short or long term.

Deflation can more often lead to a surprise- a deflationary surprise is one that raises more concern and is most peculiar within the financial sector. It is the type of deflation that causes wealth to be transferred from debtors to creditors meaning that debtors will owe more whereas creditors will own more! This will in result have effects on the balance sheets of individuals and businesses. With regards to investment, cost of capital increases for debtors whilst the rate of return also increases for shareholders.

The United States of America, a nation that holds a place in the G7 together with the UK, share prices have been driven up by low interest rates. Interest rates and inflation are forces that move alike- one is adjusted to put the other in check. When inflation is galloping, the government/policy makers have to increase interest rates so people (especially lenders) don’t get affected. Conversely, when inflationary rates get extremely low, bank interest rates are lessened to balance things up.

Normalisation of interest rates by central banks has been long anticipated by investors in the UK. The benefits of high rates include rewarding savers and reducing excessive volatility in capital markets from the investor’s point of view whereas policy makers will regard it as a way of reducing risk levels (Moore E. & Mackenzie M., 2015)- the possible downside according to these two publishers of the Financial Times they claim is that; equity and bond markets have become too dependent on low interest rates from central banks and the US Federal Reserve.

Figure 2



In the same report, it is alleged that expectations have shifted considerably, and as it stands, expectations of the rate rise in the UK has been held to 2016, a point that is known to some in the US bond market.

A report published by Elliot (2015) an economics reporter for The Guardian said that falling inflation rates and the interest rate being put on hold by the government has seen the benchmark for borrowing cost plunging to an all time low. The fall in oil prices which saw the UK enter a period of deflation caused the yield or the interest rate on 10 year gilts touch 1.396% at one point- an all time low since the financial crisis in the eurozone in 2012 and the very first time in history it had below 1.4%. Indications from the US Federal Reserve and the Bank of England showing a further hold on interest rates also saw yield on UK gilts to drop.

Even though the debt yields in the UK were at low rates, they offered better returns than bonds in other competitive economies in the eurozone.

The low interest rates that currently exist in most developed countries like the US according to Foroohar (2015) have allowed companies to borrow money cheaply for use of short term gains.

As a result, corporate debt (excluding that of banks) has increased from $5.7 trillion (£3.83 trillion) in 2006 to a present figure of $7.4 trillion (£4.97trillion). A chunk of this money has been used for share buybacks, payment of dividends, company mergers and acquisition deals. The Office for Financial Research (OFR) reports that “although this has caused stock prices to bolster in the short run, it prevents investment in capital markets which will attract long term returns”.

In a 15 minute interraction with Dipesh Shah, director of Oakdale Financial Services (an associate partner practice of St. Jame’s Place Wealth Management), he made mention of the drastic fall in oil prices and as a matter of fact emphasised it is the main cause of the deep fall in the rate of inflation. He added that inflation is good because it erodes away debt over a period of time whilst deflaion is a bad phenomenom in the sense that it brings down the prices of assets, devalues equity, increases the value of debt, has a negative impact on savings and on investments. “Deflation doesn’t really hurt, its just part of the cycle. We have experienced inflation over a long period of time so a bit of deflation won’t be worrisome. If asset prices are falling over a long period of time it means we are getting poorer, the falling of asset prices has a bigger impact over the long term” - Shah (2015)

Continuous cringe in oil prices from the later part of 2015 impacted the UK inflation rates and consequently investment levels massively as Monaghan (2015) reports that business investment spending levels have dropped in 2014 at the fastest rate in six years by 1.4% ; this is due to a rather prolonged fall in oil and gas prices. In spite of the fall in business investments, general investment in the UK rose to 6.8% in 2014, the strongest year on year rise since 2007 according to the Office for Naitonal Statstics(ONS).

In conclusion, deflation according to some economists is a harmful practice to restoring an economy’s monetary sanity after a long period of inflation. This believe has been adopted by Mises and Rothbard who only agreed with Jean-Baptise Say- refer to Say (1880).

All arguments raised so far seem to be more in favour of deflation being a positive rather than negative factor as HÜLSMANN (2008) tells us that we should not be afraid of deflation, we should love it as much as our liberties.

Research Methodologies

This chapter touches on the research method that will be used in gathering information for the study. It discusses in detail the research design and population that will be applied, the sample and sampling procedure as well as the development of the research instrument. The description of data collection procedure and analysis for the research are also given.

Research Philosophy

The research approach applied to this study is the positivist approach. Due to the nature of the topic- which requires observation, statistical prove and realities as listed by Gill and Johnson (2010), the positivist approach allowed itself more than the other philosophies available to be employed for the completion of the study. According to Saunders et al (2012) the positivist approach to research is that the study is carried out in a value-free way as extensive as possible- this means that the boundries to the research are broader with this approach which makes way for collecting more information. It is often said that the researcher has a high propensity of using a well structured methodology so as to facilitate replication (Gill and Johnson, 2010).

Research Ethics

Ethics in its broadest sense, generally regarded as the principles of accepted human behaviour, is one of the issues that philosophers have sought to address with providing guidance to Arnold, (2002). The most common way of defining ethics according to Resnik, (2011) is “norms of conduct that distinguish between acceptable and unacceptable behaviour.

This research has and will be completed in adherance to disciplines that study standards of conduct. There is however a need to conduct this research by complying to ethical norms as Resnik, (2011) gives some reasons why it is important to do so. He says that first and foremost, it promotes the aim of the research, highlights the values that are relevant to team work like trust, fairness, mutual respect and accountability. Thirdly, ethical norms in most cases help to check that researchers can be held liable by the public, to create support from the public and finally to promote the norms and values of society such as satisfying social responsibility, health and safety, environmental awareness etc.

In view of the above listed factors to be considered, this research will further be conducted to ensure that authenticity, genuiness, practicability and norms are kept to satisfy the requirement of good research ethics.

Research Design

The research design for the study will be descriptive in nature. The objective of a descriptive research design as per Robson (2002:59) is to paint an accurate profile of people, situations or events. According to Polit & Hungler (1999), descriptive survey aims at describing, observing and documenting aspects of a situation as it occurs rather than explaining them.

It is also of importance to note that this design is appropriate when a researcher attempts to describe some aspects of a population by selecting unbiased sample of individual who are asked to complete questionnaires, interviews or tests. It is for this reason and more that I intend to use this method to help the reader understand, find and address the issues I have identified in the research questions. The results produced by this design can however be unreliable because some of the questions which are usually posed seek to delve into private/personal matters of the respondents and respondents may not be truthful about it (Fraenkel & Wallen, 2006). For instance *“how many new shares will you buy when the economy is witnessing a zero percent (0%) inflation rate?”* or *“how much worth of returns did you receive on your investment(s) when the market was volatile?”*

Population

This refers to the total number of units from which a sample group/unit will be selected. The survey population which will be used for this research will be investment companies, listed Public Limited Companies (PLC’s) and individual investors in and around the city of London. These target population groups have been selected because the matters of this research do pertain to them (see objective number 3).

Research and data collection organisations like the Office for National Statistics (ONS), Thomson Reuters, Ernst & Young etc. will not be left out of the population. These focus groups again are targeted for the sample size because they will be easily accessible in the UK where this research is being conducted. The total population will further be divided into stratums in each respective organization.

Sample and Sampling Procedures

A sample size of 50 investors and 10 companies will be selected using the simple random procedure. A table showing the recommended sample size (n) with population (N) and finite sizes developed by Krejcie & Morgan (1970) will be employed to determine the estimated sample size. According to the table and for the purpose of this research, the researcher will use an estimated population of N= 100 respondents and thus, a sample size goal of n=60 respondents.

The total population sample (n) serves as a representation of the total number of investors and chosen organizations in the UK. The simple random procedure was employed because every individual out of the sampling population had an equal chance of being selected. The method was also used to avoid discrimination against respondents being selected for the purpose of study

Research Instrument

The questionnaire and interview are the instruments that will be employed for the entire study. A questionnaire is a set of well-constructed and organised questions that are meant to provide answers to a particular study or research. Since the sample size is a relatively small and reasonable number, the questionnaires, after answered by the respondent will be recorded by the researcher.

By definition, an interview is a purpose-focused interaction amongst two people or more (Khan and Cannell 1957). Interviews can help collect genuine and valid data which are relevant to the research questions and objectives. The type of interview that will be used will be the structured interview which is also referred to as interviewer administered questionnaires (M. Saunders et al 2009).

Structured interviews are organised and predetermined in nature- the questions that are posed to the interviewee are planned before hand by the interviewer or the researcher (in the case of this study). Unlike the unstructured interview, structured interviews are used to gather quantifiable data and information- the main reason why it will be selected for this research. The two types of approaches used under the questionnaire administration and interview planning go hand in hand and will be preferably applied to this research as M. Saunders et al (2009) list the interviewer-administered questionnaires under both categories.

Research Limitations

This research will be limited to finance, investment and economics-related companies. Individuals who have a fair knowledge about these topics are also targeted to express their view point which does not give equal opportunity to individuals or corporate bodies. Some other limitations may include the possibility of being refused an interview or administering questionnaires, the accuracy of the sampling techniques, sources of gathering relevant information and the like.

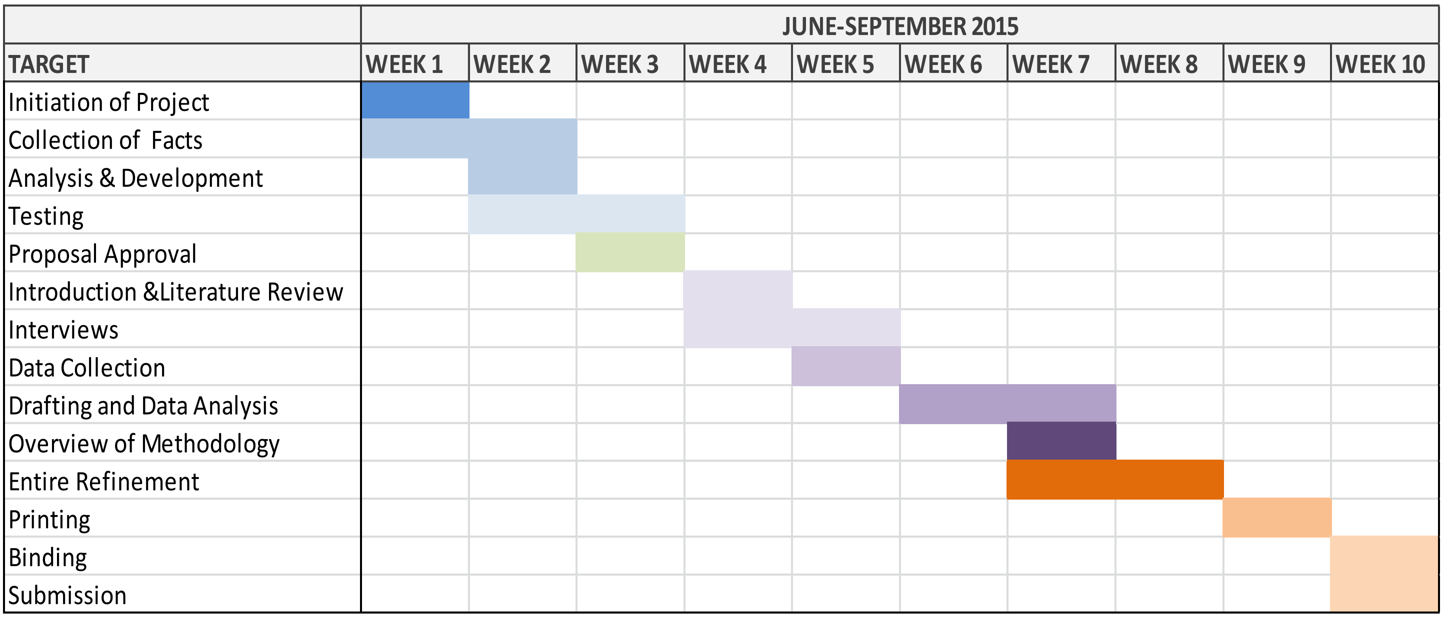
Data Collection Procedure

The researcher will personally administer the questionnaires and carry out the interview to the respondents at pre-arranged venues, especially within the office premises. Permission will thence be obtained from the heads of departments or designated people in charge by the use of an introductory letter which will be collected from the College (London School of Commerce). To obtain appropriate responses, the items will be crafted as much as possible to the level of the respondents and also enough time will be allowed to enable them have ample reasoning time to complete the questionnaire as well as the interview.

Data Analysis

The data that will be collected will be edited, coded and analysed via a computerised software known as Statistical Package for Service Solution (SPSS) – a Microsoft Windows program that is used to analyse data (large or small) to create tables and graphs for interpretation. The data will in turn be completed and presented in frequencies and percentage.

Gantt Chart



Conclusion

There are several other factors aside inflation/deflation that affect investment rates in the UK capital market. Factors like interest rates, stock market volatility, asset prices etc. From the review of related literature, it can be concluded that inflation and deflation both have their positive and negative effects on investment levels. All relevant sources sited give a clear understanding of linking the topical matters with practice.

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