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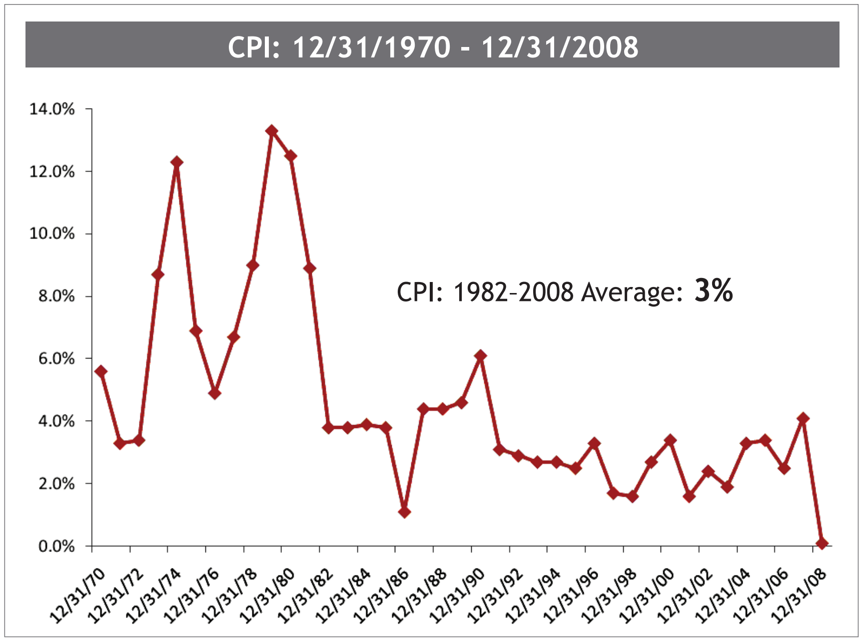
INFLATION FOLLOWING A RECESSION

By Craig T. Callahan, DBA, Founder and President | *June 9, 2009*

Ever since the inflation jolt of the late 1970s, investors have worried about higher rates of inflation returning. Yet, since 1982 inflation, as measured by the Consumer Price Index (CPI), has averaged a very moderate and tolerable 3% per year.

Today again, we hear concerns raised because of the monetary and fiscal stimulus being thrown at the economy. With this in mind, we looked into previous recessions and their impact on future inflation. It appears to us that recessions have a powerful dampening effect on inflation.



Data Source: Bloomberg

For each of the previous four recessions, 1974, 1982, 1991 and 2001, we computed the average change in the CPI for the two years before the recession. Even though recessions do not match exactly with calendar years, we measured CPI change for those periods. Next, we computed the average rate of change in the CPI for the next four years. Finally, we compared the two-year pre-recession average with the four-year post average to compute the percentage reduction in CPI.

For example, for 1972 and 1973, inflation averaged 10.50% per year. For the four-year period of 1974 through 1977, inflation averaged 6.91% per year. Thus, the recession reduced the rate of inflation by 34.2% for a substantial period of four years. On average over those four recessions, there was a 41.1% reduction in the inflation rate for the next four years. The largest percentage reduction was in the 1982 recession, which was the worst recession of these four with unemployment reaching 11%.

For 2006 and 2007, the inflation rate averaged 3.32%. Past performance is no guarantee of future results and no one can predict what the figures will be, but if the CPI was reduced by 41.1%, inflation would average only 1.96% per year for 2008 through 2011.

CPI BEFORE AND AFTER A RECESSION

	1974	1982	1991	2001	Average	2008
CPI Previous Two Years	10.50%	10.67%	4.59%	3.04%	7.20%	3.32%
CPI Subsequent Four years	6.91%	3.85%	2.72%	2.27%	3.93%	**1.96%***
% Reduction in CPI	-34.2%	-63.9%	-40.8%	-25.3%	-41.1%	

Percentages based on entire two- and four-year periods. **Based on a reduction of 41.1% during the period. Source: Bloomberg*

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SUMMARY While there are obvious negative consequences of recession, one positive aspect seems to be the repeated ability to reduce inflation significantly over a four year period. We can only guess at the reasons. Perhaps workers become more docile in their wage demands. They may prefer job security and not want to risk that security by demanding higher wages. Perhaps coming out of a recession, businesses try to regain market share rather than raise prices. They may choose not to raise prices in an attempt to take business away from competitors. Other explanations could involve capacity utilization or buyer's abilities to secure favorable long term contracts during recessions. For example, during the summer of 2009, imagine the favorable contract you could negotiate to buy lumber or other building products over the next four years. It would seem you could structure a contract that would avoid price increases. Whatever the reason, we believe, based on past recessions, inflation should remain controlled for a few years.

From late May 2008 through late May 2009, the money supply as measured by M1 and M2 grew 18% and 8% respectively. These rates are much greater than normal. Also, the Government enacted a larger fiscal stimulus package than has been seen before. Under some circumstances, such as full employment and full capacity utilization, the combination of these monetary and fiscal acts could be inflationary. However, our research on inflation and recessions suggests that there may be a three to four year window to jolt the economy and not suffer higher inflation. In other words, we believe that given the excess capacity and high unemployment, we may see a fairly forgiving setting.

Past performance does not guarantee future results.

Opinions and forecasts are subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security, industry, or sector.

The Consumer Price Index (CPI) is the primary indicator of U.S. inflation and is used to make cost-of-living adjustments to billions of dollars in benefit payments.

M1 is one measure of the money supply that includes all coins, currency held by the public, traveler's checks, checking account balances, NOW accounts, automatic transfer service accounts, and balances in credit unions. M2 is a measure of total money supply. M2 includes everything in M1 and also savings and other time deposits.

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