May 2024

The Tale of Transitory Inflation

CRAWFORD
INVESTMENT COUNSEL
Est. 1980

In the second half of 2022, when inflation reached levels not seen since the early 1980s, the question of whether or not it would be transitory was front of mind for economists and market commentators. There were two opposing viewpoints: transitory vs. persistent. The transitory camp believed that the bout of inflation was a result of short-term, Covid-related dislocations and would resolve quickly once the economy got back into balance. The persistent camp believed that price hikes had spread well beyond pandemic-affected areas and that they would persist well beyond the point at which the shorter-term disruptions were resolved.

The pandemic presented unprecedented circumstances and the authorities responded with unprecedented stimulus. This unprecedented stimulus created inflation that has recently been coming down in an impressive fashion. This is due, in part, to the Federal Reserve (Fed) tightening which began at the start of 2022. Inflation has come down without yet causing a recession, something many thought could not be achieved. So, the likelihood of a soft landing has increased.

As a result, some economists are now suggesting that inflation was in fact "transitory" and driven largely by supply disruptions and shifts in demand. Our goal with this piece is not to comment on this ongoing debate, but rather to take issue with the nomenclature being used. Transitory inflation is an academic categorization that refers to a temporary increase in the rate of inflation. However, after the "transitory" increase, inflation will return to a steady rate of growth. When we scrutinize this categorization in a more literal sense, we can make the argument that inflation is never really transitory. Let's start with some definitions:

> Transitory: Only for a short time (typically 6 months or less)
> Inflation: Decreased purchasing power of money

The problem with an academic categorization of transitory inflation is that it ignores the fact that the decreased purchasing power of money is not "only for a short time," unless we experience deflation, which is something nobody wants. When inflation raises the price of food or lodging, slower/lower inflation still increases the cost of living off of a higher base. In other words, high prices get "built in" when a bout of inflation occurs and "built on" when inflation returns to a more normal/lower level. While inflation might slow, or prices may stop rising at such a rapid rate, the original price hikes never go away. So, high inflation, such as we experienced, is only transitory if it reverses and therefore it is not "only for a short period of time," but rather permanent in nature. Slower price growth on top of seriously elevated prices in some areas can still feel like a lot of pressure on consumers and can add significantly to the cost of living.

The Tale of Transitory Inflation

Part of this is related to the way inflation is reported. There are two primary ways of looking at inflation: Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE). From there, many people choose to look at Core figures, which exclude food and energy. In other words, they basically ignore the very items that most influence consumer behavior and spending patterns. The inflation numbers that make headlines are reported on a year-over-year basis and demonstrate the change over the period. Just because the rate at which prices are rising has decreased from the previous year does not mean inflation has decreased. Rather, it means it has increased at a slower rate.

Today, we note that despite a strong economy with very low unemployment, measures of consumer sentiment and overall confidence levels are lower than one might expect. We have written about the psychology of inflation, and there is certainly a negative psychological aspect of inflation that influences consumer behavior and expectations. This mental accounting of the overall price of things we consume is at least partially why increases in the costs of goods and services evoke such a visceral response from consumers and business owners, not to mention the media.

Our objective with this article is to provide a different take on the inflation picture that reflects that the "damage has been done," even if we all feel better about the current rate of inflation. Prices are still much higher than they were before the inflationary period. We believe this is a viewpoint worth considering. Transitory inflation is a useful academic categorization, but it becomes less meaningful when interpreted in a more literal sense. Despite the inflationary situation present in the economy, we will continue to manage our investment strategies according to our long-held philosophy and discipline with the primary goal of creating successful outcomes for our investors.