# Will COVID-19 Cause Deflation to Show Up?

*First time in 60 years that core CPI has dropped for 3 consecutive months*

On June 10, 2020, the Department of Labor released CPI numbers for May and there was a chorus singing deflationary tunes for the rest of the week. Will the chorus get louder over the coming months or lose its voice in the heat of the summer?

The U.S. Bureau of Labor Statistics reported that:

- The Consumer Price Index for All Urban Consumers declined 0.1% in May on a seasonally adjusted basis after falling 0.8% in April
- Over the last 12 months, the all items index increased 0.1% before seasonal adjustment

Further, it was reported that:

“Declines in the indexes for motor vehicle insurance, energy, and apparel more than offset increases in food and shelter indexes to result in the monthly decrease in the seasonally adjusted all items index. The gasoline index declined 3.5 percent in May, leading to a 1.8-percent decline in the energy index. The food index, in contrast, increased 0.7 percent in May as the index for food at home rose 1.0 percent.

The index for all items less food and energy fell 0.1 percent in May, its third consecutive monthly decline. This is the first time this index has ever declined in three consecutive months. Along with motor vehicle insurance and apparel, the indexes for airline fares and used cars and trucks declined in May. The indexes for shelter, recreation, medical care, household furnishings and operations, and new vehicles all increased.”

This data adds another worry to any economic recovery – whether it’s U-shaped, V-shaped or doesn’t take any shape at all – as deflation is now a real possibility. In fact, this is the first time in over 60 years that core CPI has dropped for three consecutive months.

## Deflation Definition and History

In simple terms, deflation is defined as a decrease in the general level of prices for goods and services. Inflation, on the other hand, is an increase in the general level of prices for goods and services.

The most recent deflationary period in our history was during the Great Recession, which lasted from December 2007 to June 2009. During the Great Recession, commodity prices dropped – especially oil – and many worried that this would prolong the recession, lead to higher unemployment and lead to falling stock prices.

## What Deflation Means to You

So how does deflation affect you? Sure, we might all like to pay less for goods and services next year, but the underlying issues of deflation are troubling. Here is generally what happens during deflationary periods:

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Falling prices can lead to companies slowing down their production (think manufacturing), which might then lead to layoffs and salary reductions. More layoffs and reduced salaries then lead to less consumer spending, which then pushes companies to slow production even more, which then leads to more layoffs, less production, more layoffs and so on and so on.

## Calculating Deflation & Inflation

Every month, the Bureau of Labor Statistics, part of the Department of Labor, calculates indices that measure deflation and inflation:

- **Consumer Price Index** – A measure of price changes in consumer goods and services such as gasoline, food, clothing and automobiles. The CPI measures price change from the perspective of the purchaser.

- **Producer Price Indexes** – A family of indexes that measure the average change over time in selling prices by domestic producers of goods and services. PPIs measure price change from the perspective of the seller.

Why is the Consumer Price Index so important? Well, for those receiving Social Security payments, a version of the CPI is used to calculate cost of living increases, for example.


## Deflation in the Price of Gas

Meanwhile, we are currently experiencing big deflation in the price of gasoline, because as of June 15th, a gallon of gas has decreased by 59 cents from a year ago, according to AAA. But gasoline only makes up about 3% of the total CPI calculation, so that's a positive.

Further, it appears that gasoline is trending up, as since June 15th, the average price has risen seven cents in a week and 24 cents over the past month.

The truth is that there are consequences born from the coronavirus and resulting actions taken by the federal government and the Federal Reserve that are difficult to predict. If we fast forward to when economies begin to reopen, it stands to reason that production will be negatively impacted for quite some time as the recently unemployed slowly rejoin the workforce.

Further, whether there is a surge in demand from consumers and businesses, encouraged by historically low interest rates, remains to be seen. But the risk that we see slower economic output as prices fall – the very definition of deflation – is very real.

## What Investors Really Need to Remember

Financial advisors preach that it is imperative that your long-term retirement strategies account for inflation – not deflation – because it makes sense to prepare for a decrease in the purchasing power of your dollar over time. And many financial advisors will suggest you assume inflation to be about 3% – its historical average.

If you're wrong and we find that the inflation rate for the next 25 years turns out to be 2%, then the purchasing power of your retirement savings will be more, not less.

And it's generally best to be on the side of caution.

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