Inflation and Risk Reduction

Inflationary cycles and economic downturns are typically viewed by marketers as value-seeking events not risk-reduction events. This time, however, inflation is spiking in a way that brings more risk not just less purchasing power. Inflation is presenting itself to consumers as a problem that is as much about risk reduction as value-seeking.

Value always matters during economic disruptions, but a cheap price does not necessarily remedy a bad risk. So, the response of marketers to the current—and likely, future—jump in prices must be more robust than simply pivoting to value. The primary focus must be on reducing risk.
Where does inflation stand?

Let’s begin by taking stock of where inflation stands and the specific things pushing it higher.

The Bureau of Labor Statistics (BLS) reported in January 2022 that the annual Consumer Price Index (CPI) for December 2021 was 7 percent NSA (not seasonally adjusted). This is the highest CPI reported since June 1982. Excluding the more volatile items of food and energy, the annual CPI-Core was 5.5 percent NSA. This is the highest CPI-Core reported since February 1991. The annual CPI for December 2020 was 1.4 percent and for December 2019 was 2.3 percent, so even excluding food and energy, prices in 2021 have been noticeably higher.

The CPI has been rising since it bottomed out in May 2020, early in the COVID-19 pandemic. But the CPI was not worrisome until it jumped from 2.6 percent in March 2021 to 4.2 percent in April. This caught people’s attention—with a subsequent spike in U.S. Google searches for “inflation”—because average inflation from 2010 to 2019 was only 1.78 percent.

But the average rate of inflation across all items is a muddy measure of exposure to rising prices. A detailed January BLS report showed that inflation during 2021 was up across the board but soaring in only a few sectors—primarily gasoline/energy and vehicles, both new and used, along with protein food. By contrast, inflation in 2020 was declining for energy and rising much more slowly than in 2021 for cars and trucks and protein.

Price increases in individual sectors need context. The BLS report also showed the distribution of consumer expenditures by sector. The biggest price increases year-over-year did not match up directly to the sectors with the greatest relative importance. This dispersion of inflation across several sectors of varying importance means myriad reasons, not just one, are behind the recent increase in inflation. There’s no easy answer to the question of whether inflation is being baked into the economy like the stagflation of the 1970s or if it is just a short-lived byproduct of restarting the economy.
Economists are always sharply divided over predictions about inflation, which has made for a long history of thumping miscalculations. During President Barack Obama’s first term, right-leaning economists voiced alarms that the Fed’s program of quantitative easing would trigger “currency debasement and inflation.” Nothing of the sort happened. In a similar vein, during President Joe Biden’s first year, left-leaning economists like Nobelist Paul Krugman insisted that any inflationary effects of the American Rescue Plan would be “transitory,” not a “deeper problem.” But now, Krugman, like others, is having second thoughts.

The criticism lodged about Biden’s stimulus programs (including prominent left-leaning economists like Larry Summers) is that these programs over-shot the output gap, thus triggering the current inflation as well as creating the potential for self-reinforcing inflationary expectations in the form of anticipatory product pricing, cost-of-living wage increases (some automatic), and more spending by consumers to buy now while prices are lower.

Those who argue that the current level of inflation is just a temporary blip point to rapidly diminishing spending reserves among consumers (i.e., no extra money means no extra demand) and breakneck efforts by logistics companies and manufacturers to unsnarl global supply chains.

The next thing to consider is the time horizon over which consumers may have to deal with inflation.

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The essence of the debate about inflation is the capacity of the economy. During downturns, economists and policymakers, with varying degrees of success, try to estimate the so-called output gap, or what the economy has the capacity to produce versus the level of demand. A gap exists when demand is lower than capacity. The objective of government stimulus is to close the gap by stimulating demand. Inflation occurs when stimulus pushes demand above the capacity of the economy resulting in too much money chasing too little supply.

What is likely to happen with inflation?
There are no definitive answers yet to these questions about the economy, but it is possible to get a better sense of what’s going on by looking at individual economic sectors.

Start with shelter. This is the biggest budget item for most households, covering mortgage payments and rent. In 2021, median home prices were the highest since 1999. This is due to a combination of the strongest sales since 2006, as reported by the National Association of Realtors, and the lowest number on record of homes for sale. The shortage of homes for sale has meant a parallel rise in rents. The reasons for the current spike in shelter prices go back to the financial crisis. Without getting into that detail, suffice it to say that it will take several years for housing inventory to catch up to demand, which means higher prices and rents for the immediate future. Shelter inflation has been exacerbated by people moving during the pandemic, but it is a long-standing structural problem unrelated to the pandemic. For the foreseeable future, it will continue to affect the sizable fraction of people buying a home each year as well as the larger fraction of renters.

Vehicles, new and used, have seen significant price increases because of a semiconductor shortage that has limited production. The shortage of new vehicles has shifted some portion of demand to used vehicles, which has pushed up those prices. Despite hope that the chip shortage would quickly sort itself out, a recent survey of chip suppliers and buyers conducted by the Department of Commerce documented a shortage that is severe, continuing and “alarming,” in the words of Commerce Secretary Gina Raimondo. Even the most optimistic experts expect it will be 2023 if not 2025 before supply catches up with demand, not to mention that future coronavirus outbreaks in China remain a threat to supply chain stability. But the situation is becoming more manageable as chipmakers ramp up production and automakers redesign cars to use fewer chips or more of the sorts of chips that are in plentiful supply. Vehicle inflation is a glitch caused by the pandemic, but it is going to last long enough that it will feel more structural than transitory.

Energy prices rose significantly during 2021. Almost nothing is more fraught with error than trying to predict oil prices. With that caveat in mind, recent near-term forecasts expect gasoline and energy prices to keep rising in 2022. Prices for most energy commodities have been trending up and are now above their peak in late October and early November 2021. Geopolitical uncertainty in areas like the Ukraine could add to price pressures, and ongoing truck driver shortages remain a supply chain challenge. On the other hand, price increases could be checked somewhat by an expected increase in global oil supply and a near-term slackening of global demand because of continuing restrictions to fight COVID.
Longer-term, the outlook is more favorable as green energy grows. Renewable sources will not completely displace fossil fuels anytime soon, but as they account for a growing percentage of supply, they will come online as a deflationary factor for energy prices. For the immediate future, though, energy prices will continue to put upward pressure on overall inflation.

Goods and services went in different directions during the pandemic. Quarantine lockdowns left consumers with no place to go and with extra money in hand from government support programs. So, people shifted their spending from services to goods, particularly durable goods. This is the opposite of what happens during a typical economic downturn, when consumers postpone the purchasing of many goods, especially durables.

Using January 2020 as a baseline month for comparison, personal consumption expenditures reported by the Bureau of Economic Analysis showed that spending on durable goods peaked in November 2020 at 34 percent higher, and remained over 20 percent higher in November 2021, the latest month of data available at the time of this writing. Spending on nondurable goods peaked in October 2021 at 14 percent higher. By contrast, since March 2020, spending on services has remained below its pre-pandemic January 2020 baseline.

Bottom-line, inflation is likely to persist during 2022 and probably longer. Some of the reasons for inflation pre-date the pandemic, but everything that happened during the pandemic exacerbated these ingoing issues while adding new pressure on prices.

The most recent tracking of consumer confidence by the Conference Board illustrates the complexity of what’s at work in the marketplace. Confidence is down in January 2022, with confidence in the future remaining well below perceptions of current conditions. Yet despite this dip in confidence, the share of consumers planning to purchase a vehicle rose to the highest level in six months, and buying intentions were up for several durable goods categories as well. Additionally, the share of consumers looking to buy a house over the next six months was the highest ever measured (for this tracking series that was begun after 2010). There is no waning of buying intentions in these data. Given current market conditions, this level of demand will keep pushing prices higher. Consumers seem to be buying ahead of the inflation they expect to see in months ahead, which is the kind of inflationary expectation that is hard to break.

The economy will eventually reset, but this transition will take time. In the meantime, whether inflation is transitory or structural, consumers are going to react to it, not wait it out, with a corresponding need for brands to respond accordingly.
How will consumers experience inflation?

Given where inflation stands and where it is likely to go, we can start to untangle how consumers will experience it and react to it, and thus what brands should do. Four things define the context of the current spike of inflation.

First and foremost, inflation is unfamiliar to people, which makes it particularly worrisome.

Consumers have not had to deal with high levels of inflation for two generations. Throughout most of the 1990s, inflation was below four percent. Inflation climbed above four percent only a few times during the 2000s run-up to the financial crisis. Prices plunged during the financial crisis, and although prices recovered, inflation stayed below three percent in the years prior to the pandemic, with only the exception of 2011.

It is no surprise, then, that inflation is getting people’s attention. A January 2022 U.S. MONITOR survey found that 11 percent mentioned inflation as the top thing they are thinking about as they look ahead to the next year. Gallup reported in November 2021 that 7 percent of Americans mentioned inflation as the most important problem facing the country, a level not seen for two decades. In Gallup’s September 2021 tracking it was only 1 percent, and 5 percent in October. Taken together (with cognizance of the difference in questions), the MONITOR and Gallup results show a steady ratcheting up of concerns. Indeed, in the MONITOR survey, one-third mentioned inflation as one of their top three concerns, second only to COVID and to the broad area of the economy, both mentioned by 41 percent as one of the top three. Given that many mentions of the economy are undoubtedly reflective of inflation, it is evident, even a few months in, that high inflation is already testing the resilience of consumers.

Measures of economic confidence reflect worries about inflation. In the early months of 2021, Gallup’s tracking showed a recovery of economic confidence. But the mid-year breakout of inflation sent economic confidence tumbling back to levels equivalent to the first couple of months of global COVID lockdowns. The University of Michigan tracking of consumer sentiment showed the same pattern— inflation expectations in particular, which are now at a level not seen since the early months of the recession triggered by the financial crisis.

Consumer concerns are echoed by business leaders. A Conference Board survey of Global CEOs conducted during October and November 2021 found 55 percent expecting higher prices through mid-2023 and beyond. Inflation was number two in their list of external threats to business, up from number 22 the year before. Inflation is just as unfamiliar to businesses as it is to consumers. Less than 40 percent of the CEOs in the Conference Board survey said that their companies are “well prepared” for an inflationary marketplace.

Top concerns when thinking about the next year of your life (Summary of rank 1-3)

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<th>Concern</th>
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<td>The economy</td>
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<td>COVID-19</td>
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<td>Inflation</td>
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Inflation is unfamiliar to people, which makes it particularly worrisome. Consumers have not had to deal with high levels of inflation for two generations.
In May 2020, the Centers for Disease Control (CDC) began a special biweekly tracking of the percentage of people reporting symptoms of anxiety or depression during the past week. The urgency of this tracking stemmed from concerns about mental health issues due to isolation during lockdowns and fears of COVID. Throughout 2020, the CDC tracked well over thirty percent of Americans reporting some level of anxiety and depression. Annual tracking in years past had found only five to eight percent. During 2021, the percentage dropped but remained above one-quarter.

It is important to keep these data in perspective. While anxiety and depression trended way up, suicides trended down. Unlike the financial crisis when suicides reversed a long-term decline and began trending up again, suicides went down during 2020, continuing a turnaround that began the year before. So, the unease and apprehension of the pandemic was not the sort of financial distress that pushes many people to the brink. This is because government support during the pandemic was generous and it came quickly, thus avoiding the punitive austerity policies of the financial crisis. While these support programs have seeded inflation, they have prevented the worst sorts of human consequences. In fact, even more than that, they have given people the ability to make positive changes in their lives.

**Inflation is piling on during a time of unprecedented levels of widespread anxiety.**

Bloomberg Economics published an estimate last October that people accumulated an aggregate excess savings of $2.5 trillion between the beginning of pandemic lockdowns in March 2020 and August 2021, just as inflation started ticking up. This is money that people were unable or unwilling to spend as well as government support that people banked. These excess savings benefitted people of all income levels, unlike the financial crisis. Emergency savings that dwindled just before the pandemic were back to normal afterwards. Most importantly, during late 2020 and early 2021, people had the financial wherewithal to rethink their priorities and to undertake changes in their lifestyles and careers.

The so-called Great Resignation has been funded by this windfall financial cushion. While people may have desired big changes after past downturns, they lacked the financial security to do so because most downturns hurt people’s pocketbooks. The pandemic was different, and the result is seen in more than quit rates and unfilled jobs. It is seen as well in the insistence on hybrid workstyles; in a jump in entrepreneurship; in geographic moves and relocations; and in changes to personal, family and online relationships. Inflation threatens the sense of security and insulation from financial risk that have emboldened people to make big decisions like these.

At this time in which many people have leaned into big changes in their lives, inflation has popped up as a peril that could penalize them at this vulnerable moment. Inflation has been rising faster than wage gains, so people find themselves with declining buying power even with more money. The annual Bankrate survey on financial security found in 2019 that only 16 percent thought their financial situation in 2020 would be worse. In the 2021 survey, 26 percent thought their financial situation in 2022 would be worse, and of those, 70 percent said it was because of inflation.

**Inflation is another disruption adding to the uncertainty facing consumers in the future.**

The clichéd 18- to 49-year-old consumers at the heart of the marketplace have come of age with a foundation of marketplace stability that will not be true of the future. The pandemic has brought into view the reality that disruptions, both bad and good, are the new normal. Marketplace discontinuities will be a feature of the future marketplace, not the exception.

The period from the mid-1980s to the beginning of the financial crisis is known to economists as the Great Moderation. It was a period when disruptions were less frequent and less volatile. But that period is in the rearview mirror. Since the turn of the 21st century, and especially since the end of the financial crisis, volatility and uncertainty have made a comeback. Looking ahead, disruptions abound: AI, blockchain, crypto, cybersecurity, the metaverse, climate change, green energy, biomedical breakthroughs, space exploration, political turmoil, geopolitical upheaval, omn commerce, mobile commerce, Gen Z, more pandemics and financial crises, and ever-increasing amounts of cheap capital ready to invest in disruption.

As things sit today, the marketplace is particularly exposed to disruptions. For example, the International Monetary Fund (IMF) warned late last year that the easing of global financial conditions after the financial crisis and during the pandemic was necessary to allow
“overly stretched asset valuations to persist,” but, unchecked, has the potential to “intensify financial vulnerabilities” to the point of a “deterioration in the underlying foundations of financial stability.” In other words, the marketplace continues to be secured by cheap money (i.e., low interest rates) from central banks, which threatens long-term stability. The concern that the IMF raised is now taking shape with strong signals from the U.S. Federal Reserve that it intends to raise interest rates several times during 2022 in an aggressive effort to take the air out of inflation.

Consumers are lurching along in the midst of this mounting volatility. Inflation adds to their broader sense of uncertainty. This is especially true given the long-running period of deflation that has been the consumer experience of the marketplace since the mid-1980s. Several factors have combined to keep prices down in years past. A couple of decades ago, a lot of attention was given to the so-called Walmart effect. Then it was the Amazon effect. Adding to that, economies of scale from technologies, robotics and global labor arbitrage have also been significant price deflators. This is the marketplace that has shaped the experiences of today’s generation of consumers, a marketplace that one financial expert described as “an era of Deflation, punctuated by occasional spasms of Inflation.” The uncertainty of whether or not the current spike of inflation is ‘occasional’ or long-lasting is yet more ambiguity piling in on consumers these days.

This is the context of inflation—unfamiliarity, anxiety, vulnerability, uncertainty. It adds up to inflation as a risk—an unknown, adding to apprehension, affecting people at their most vulnerable, amplifying uncertainty about the future. Consumers are reacting with risk reduction, not just with value-seeking.

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What should brands do?

With an understanding of the ways in which consumers are experiencing inflation, the key imperatives and opportunities for brands are clear.

Concerns about risk have grown dramatically during the pandemic. From 2015 to 2019, the percentage of consumers in the MONITOR survey agreeing that they “would be happy to take some risks for the chance to enjoy greater rewards” was between 52 and 54 percent every year. In April 2020, with the outbreak of COVID in the U.S., it plummeted to 37 percent and has remained well below half ever since (with one exception in April 2021, when it jumped back to 51 percent, prior to the Delta variant). In January 2022, it was 39 percent. Everything about this moment, which inflation is worsening, adds up to an experience of risk.

The brand imperative is simple: Take the risk out. And do so by focusing on losses.

This imperative does not mean ignoring value. It is just to say that in the context of this moment, the consumer experience of inflation is more about the risks inflation is creating than the value it is eroding. So, value-based tactics should be wrapped into an overarching strategy of addressing risk, especially the ways in which value-based tactics are communicated and offered to consumers.

One of the key things that researchers have discovered about risky decisions under conditions of uncertainty is that people evaluate the prospect of gains differently than the prospect of losses. Losses matter far more than gains. This stems from the fact that bad events affect people more profoundly than good events, to the point that people will opt for the certainty of smaller gains over the uncertainty of potentially larger gains if taking that chance for a larger gain means even a small chance of getting much less or nothing at all. Hence the brand imperative to take the risk out by focusing on losses.

Given the context of the current inflationary period, the better approach to value is to build it into a broader program of risk-reduction tactics designed to minimize or remedy losses.
The four elements that define the context of inflation also identify the broad set of losses that inflation means for consumers: Unfamiliarity—a loss of comfort. Anxiety—a loss of peace of mind. Vulnerability—a loss of security. Uncertainty—a loss of assurance.

These losses point to four things brands should do. None of these are new. They are just the priorities on which to double down in the current marketplace. More opportunistically, these are ways in which a premium remains possible even with inflation. Defaulting to discounting under the assumption that trading down is all that matters leaves value-building opportunities on the table. There is some premium of cost or loyalty that consumers are willing to pay for risk reduction.

1. The loss of comfort—Leverage equity and scale.

Conventional wisdom suggests that price matters more than brand equity or scale during a downturn. But with risk reduction more important than value-seeking, there is an opportunity to leverage brand power to restore reassurance.

The biggest cue people turn to, during good times and bad, is brand name. Kantar data show unambiguously that in the wake of disruptions consumers turn to the most familiar brands. With an unfamiliar future ahead—exacerbated by inflation—scale will best satisfy the need for comfort. Scale is also a comfort in a marketplace where supply chain breakdowns have steered the future away from large portfolios of micro-brands to more focused portfolios of macro brands. This is not to suggest that brands should abandon incremental strategies. It is only to recognize that disruption rewards bold moves to reassure consumers.

Not every brand can be the biggest, but smaller brands must act 'big' nevertheless. Conveying a 'small' image undermines the perception of stability that brands with a bigger footprint convert into familiarity and comfort. If a small brand lacks heritage or tradition, it must create it. If a small brand doesn’t resound with expertise and ruggedness, it must build it. If a small brand does not stand above the category, it must reinvent where it stands.

For all brands, it is critical to act in ways that will build a scaled presence aligned with consumers who are looking for comfort, reassurance and risk reduction.

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Defaulting to discounting under the assumption that trading down is all that matters leaves value-building opportunities on the table. There is some premium of cost or loyalty that consumers are willing to pay for risk reduction.
2. The loss of peace of mind—Deliver mental wellbeing.

Conventional wisdom recommends that brands stick to price during downturns. But the pandemic has put brands in a different light, one that is dimmed by anxiety yet also brightened by the opportunity to deliver equanimity and wellbeing.

The bigger challenge of the moment is one of mental health not consumer confidence. This will continue as COVID becomes an endemic facet of life. Consumers are at the breaking point of tolerance for things that add to stress and irritations, no matter how minor. Consumers want brands to eliminate frictions, to focus on constructive emotions, to champion affirming values, to police dysfunctional behaviors, to sustain an upbeat tone, to support causes aligned with positive missions, and to get behind programs that build community. Much of this goes beyond the traditional setting for brands, but with the blurring of lines between home, shopping, work, and leisure, commercial relationships have become part of everything, no longer siloed in transactional settings.

Health has become more than a separate service category, especially mental health. Instead, it is now regarded as an essential benefit of all categories and products. This is tied to the new multi-dimensional character of health as well as to growing evidence that lifestyles and workstyles affect health outcomes. People have learned that lots of things affect their health and deliver wellbeing. Increasingly, people see that health is a promise many brands and sectors can provide, not just the traditional healthcare system. The coronavirus pandemic has underlined the awareness that many things affect health. Everything has been implicated by the pandemic, proving that healthcare is a part of everything: Building designs matter for distancing and cleanliness. Behaviors and protective equipment, not just vaccines, provide protection. Foods, desk chairs, and home entertainment systems relieve stress and provide a sense of wellbeing.

The corollary parts of this are service and experiences. Brands should audit all points of contact for annoyances and evaluate performance relative to customer wellbeing not just internal efficiency. Customer service should re-envision itself as emotional support. Technology solutions for service and delivery should be augmented by empathetic, in-person support teams.
The loss of security—Deliver value-building solutions.

Conventional wisdom holds that consumers as a whole respond to downturns by trading down. Therefore, marketers should shift from building value to discounting value. The reality is more nuanced. Value solutions must be better crafted to avoid subtracting value. Kantar research has found that the ways in which people react during a financial squeeze is tied more to their in-going spending practices than to their spending power per se. Kneejerk discounting overlooks opportunities to build value while delivering affordable value solutions.

There are three sorts of spending practices, each of which requires a customized value-building solution. Cash Flow consumers live paycheck-to-paycheck. They practice coping, which makes them especially vulnerable to interruptions in income inflows. During downturns, they engage in ‘trading out,’ which means doing without or deferring and delaying. They need value solutions that will keep them in the market. They are hard-pressed to stock up, so value solutions must be designed for real-time swings in their finances. These are the consumers who benefitted the most from the Great Resignation and thus have the most to lose from inflation bringing it to a close.

Income Statement consumers have a steady, reliable income, along with some reserves. They practice budgeting. Even without financial disruptions their budgeting can be significantly affected by costs and carrying charges. During downturns, these consumers are managing the unreliability, not the disappearance, of income inflows, so they are ‘trading now’ to backstop their finances. These are the consumers who do the most substitution of cheaper brands, but they do so more for staying on budget than for chasing price. These consumers can be incentivized not to give up quality and convenience through substitution with value-building solutions that can be budgeted over time or across categories.

Balance Sheet consumers have more than enough income, assets and reserves to fund whatever they want or need. They are largely insulated from economic fluctuations, but they are exposed to the uncertainties of interest rates, political decisions and healthcare. Many are retirees. During downturns, these consumers are ‘trading back,’ or going back to budgeting rather than funding whatever spending they desire. These are the consumers whose spending declined the most during the depths of the pandemic as they quarantined their spending along with themselves. Value-building solutions should be designed to get these consumers back into the marketplace, not to redirect their spending away from what they continue to be able to afford.

Brand name products and services must not fall into the trap of discounting value during economic disruptions. Research has shown that share gains made by price brands during downturns are asymmetrical, which is to say that when the economy recovers, name brand products don’t recover all the market share they lost. Price brands retain some meaningful portion of the share gains they made, which steadily erodes the market position of name brand products over time. The best way for name brand products to thwart price brands is to sustain value-building marketing and to increase investment into “meaningful and significant” innovation.
Conventional wisdom treats consumers as independent agents in the marketplace, whose interests overlap the interests of brands only at the point of transaction. This means that whatever happens after the purchase, with limited exceptions or legal liability, is the responsibility of consumers alone. But it is exactly this kind of exposure that keeps consumers away from the marketplace during times of uncertainty. Brands can provide the assurance consumers need through value-building solutions that engage consumers as partners in managing risks.

Numerous studies have catalogued the dozens of things that consumers do when trying to take the risks out of choices they make. These activities fit broadly into two buckets—things to reduce the chances of facing a risk and things to reduce the consequences of being stricken by a risk. Consumers reduce the chances of facing a risk by gathering more information, particularly from friends and family, or by looking for cues that instill trust. Consumers reduce the consequences of a risk befalling them through warranties or support, and sometimes avoidance altogether.

Consumers want guarantees that the risky choices they make during times of uncertainty won’t expose them to even greater risks. More information is helpful, but the best guarantee is a warranty backstopping a reversal of fortune. There are several sorts of guarantees that brands can offer, from sharing risks with consumers to offloading risks to other companies to stipulations and requirements that minimize risks.

This was a common strategy during the financial crisis when the uncertainty of employment losses and income inflows was making many consumers hesitant about purchases they could afford but which entailed obligations they would be unable to afford if they lost their jobs. Warranties and guarantees provided the assurance that consumers needed, and doing so enabled these brands to grow and thrive during a time when most brands were struggling.

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Inflation is the next phase of the pandemic era. It will create risk for consumers. Brands must reduce it in order to keep consumers in the marketplace. Brands that measure up to this challenge by taking out the risk through a focus on losses will come through this wave of inflation stronger than ever and ready for a future that will require more innovation and creativity.
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