



WILLIS INVESTMENT COUNSEL

Principled Investing

*JUST A THEORY*¹

September 20, 2022

WHAT MIGHT CHAIRMAN POWELL BE THINKING?

WIC's series *Just A Theory* is a way to frame a question or think about a problem. This second issue ponders what Federal Reserve Chairman Jerome Powell might be thinking regarding inflation and interest rates. Of course, we do not know what he is thinking or how he evaluates the current spike in inflation. Nor do we know how he thinks about interest rates as the antidote to the highest inflation rate in forty years. But it is instructive for us to think about what he might be thinking.

FORTY YEARS AGO

We begin this issue of *Just A Theory* by going back to 1980 (about the time WIC was formed and began managing client portfolios). At that time, the Federal Reserve Chairman was Paul Volcker – an imposing 6-foot 6-inch, cigar-smoking, economist who was a true public servant. He drew the ire of many Americans when his policies to bring inflation to heel caused the prime rate to reach 21%. He took an unconventional policy approach and showed extraordinary grit and discipline to tame inflation. Notably, Volcker did not bend to intense political or public opinion pressure. He did what it took to defeat inflation.

This brief description of Chairman Volcker is necessary to develop our theory because Chairman Powell has often said that he admires (perhaps reveres) his esteemed predecessor. It was not lost on me that recently Powell closed a very important speech in Jackson Hole, Wyoming by referencing Volcker. What really caught my eye was his final sentence, “We will *keep at it* until we are confident the job is done.” He was referring to the Fed’s plans to continue raising interest rates to fight inflation. That phrase “keep at it” happens to be the title of Paul Volcker’s autobiography. Might it be that Chairman Powell will draw fortitude and steadfastness from a man he might revere; might that give Powell the grit to raise interest rates higher, and keep rates at a high level for longer than most believe? Chairman Volcker is a legend – especially regarding his success breaking the back of inflation. Hold that thought.

¹ *Just A Theory* reflects my belief that with economic and investment decision-making we often know less than we think we do. We often fail to accept the limitations of our analysis, we are over-confident, and sometimes fall into epistemic arrogance. This memo uses the word and concept of *theory* in the non-scientific sense. That is, it uses *theory* more as a means to frame one’s thinking than the more scientific testable-hypothesis-theory framework.

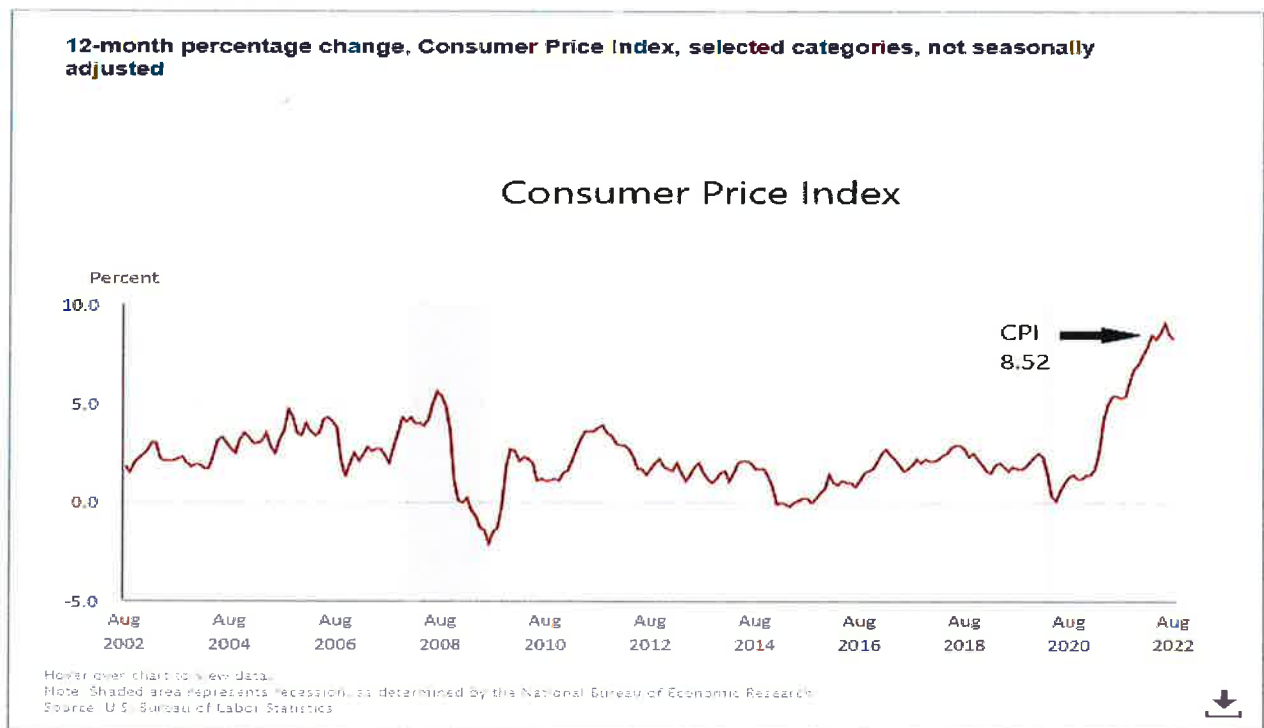
NO ONE WANTS TO BE FOOLED TWICE; CERTAINLY NOT THREE TIMES

The Federal Reserve has a very difficult, almost impossible responsibility. The Fed has no choice but to make ongoing forecasts of many unforecastable factors. That's hard to do, damn hard. WIC fully appreciates that impossible task and, therefore, the following should not be taken as our being critical or judgmental. We are not Monday-morning-quarterbacking. We are just wondering what Chairman Powell might be thinking.

Last September, again in Wyoming, the Federal Reserve went to great lengths to announce a new way of thinking about inflation and interest rates. Part of the new philosophy that was announced, the new set of beliefs, the new modus operandi, was a belief that the Federal Reserve should be more tolerant when inflation runs above the Fed's stated 2% target. Overly-simplified, the new philosophy somewhat espoused a notion that inflation was no longer a major economic problem. *Fooled once?*

Then, within a few months of that Wyoming announcement, inflation began to rise – noticeably so. Chairman Powell, the Federal Reserve, and many economists began using a new term to explain the surprise rise in inflation – *transitory*. We were told not to worry; this unexpected rise in inflation would be a temporary matter caused by the pandemic after-shocks. Once the supply chain issues, logistic issues, labor shortages, and surge in pent-up consumer demand normalized, then inflation would settle down. That is, the price increases would be *transitory*, short-lived. *Fooled again?*

But they weren't transitory. Spring rolled around and the Russia-Ukraine war and China covid lock-down further exacerbated inflation. Month after month, inflation increased to very worrisome levels. The following graph shows inflation may be more than transitory:



It's not just a U.S. problem. Over the last twelve months, inflation has increased at an alarming rate across the developed economies (per the weekly economic tables in the back of *The Economist*):

Netherlands	10.80%
Great Britain	10.10%
EuroZone	8.01%
Germany	8.00%
Canada	7.00%
India	7.00%
Australia	6.10%
France	6.00%
South Korea	5.50%
China	2.40%
Japan	2.20%

Arguably, inflation is now the #1 economic problem for the U.S. and probably for the major economies. What if Chairman Powell misjudges the severity of this spike in inflation? What if he under-estimates how entrenched the perception of inflation has become? What if he under-estimates *expected* inflation and the prescription needed to reverse this inflation trend? What if he does not have Volcker's grit, resolve, and perseverance? *Would that be the third strike?*

PSYCHOLOGY

For those who have been clients for many years, there will be no surprise that we close with psychology. Here are a few guesses about Jerome Powell the man (again, we do not and cannot know him):

- Like all humans, he probably has an ego
- Like all humans, he wants to be respected and considered skilled and successful
- Certainly, he does not want to go down in history as the Fed chairman who lost control of inflation and who caused the Federal Reserve to lose its all-important credibility
- Chairman Powell is not a PhD economist; he may not be dogmatic; meaning he may be more adroit at changing his mind (and tactics) when circumstances change
- He likely does not want to be remembered as the Fed Chairman who missed it thrice
- His hero (my word) – Chairman Volcker – was resolute and “kept at it”

When I think (speculate) about Jerome Powell the man, and think about human nature, I conclude – yes, it's *Just A Theory* – that he will not ignore the lessons of history and he will follow Paul Volcker's example.

Two weeks ago in Wyoming, did Chairman Powell conclude his widely anticipated and closely examined speech (he knew it would be closely examined) in the following manner to send a crystal-clear message (underline is mine)?:

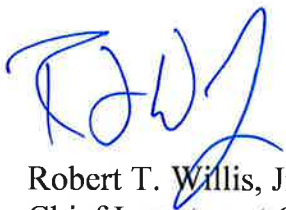
That brings me to the third lesson, which is that we must keep at it until the job is done. History shows that the employment costs of bringing down inflation are likely to increase with delay, as high inflation becomes more entrenched in wage and price setting. The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years. A lengthy period of very restrictive monetary policy was ultimately needed to stem the high inflation and start the process of getting inflation down to the low and stable levels that were the norm until the spring of last year. Our aim is to avoid that outcome by acting with resolve now. These lessons are guiding us as we use our tools to bring inflation down. We are taking forceful and rapid steps to moderate demand so that it comes into better alignment with supply, and to keep inflation expectations anchored. We will keep at it until we are confident the job is done.

Chairman Powell could not have been more explicit – history will guide him; reining in inflation *expectations* will be a high priority; and he will keep at it until inflation is back under control. Here is our theory – Powell is saying he plans to follow the Volcker playbook. If so, interest rates will probably be raised to higher levels than many believe; and rates will remain at high levels longer than many believe. Powell will keep at it; he will not retreat as Volcker’s predecessor did.

But why *just a theory*? Because of the following enduring principles that we hold dear, it cannot be anything more:

There are two kinds of forecasters: those who don’t know, and those who don’t know they don’t know. John Kenneth Galbraith.

It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so. Mark Twain.



Robert T. Willis, Jr., CFA
Chief Investment Officer