HOUSE VIEW

JEROME POWELL AND THE FOOL IN THE SHOWER

BancaMarch

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If you have ever been scalded while enjoying a peaceful shower, you will know how tricky it is to adjust the water flow to reach the ideal temperature. Tweaking the heat too quickly and too much not only makes it far more likely that you will burn yourself, but also forces you to correct that decision immediately with cold water, sending you into a constant cycle of temperature swings that can turn your shower into one of the worst moments of the day. This metaphor of the fool in the shower was used by Milton Friedman to warn of the dangers of an overly aggressive or overly reactive monetary policy, and how a central bank that tries to adjust the economy too quickly can end up doing more harm than good.The Nobel Prize winner's argument is that decisions on policies designed to steer the course of the economy should be implemented slowly and in an orderly manner, rather than acting in haste.

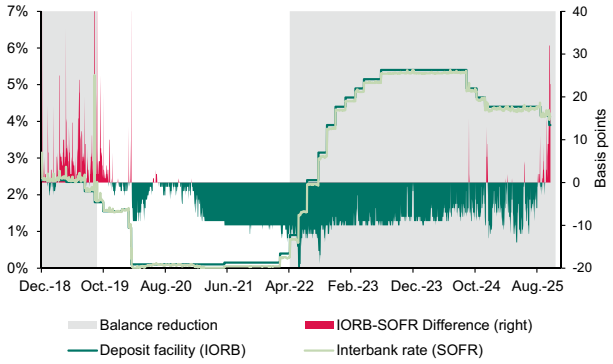
The Chair of the Federal Reserve, who is anything but a fool, is fully aware of this issue. Over recent months, in the final stretch of his term, he has demonstrated broad judgement by ignoring the constant threats from Donald Trump and his Administration urging him to slash interest rates drastically.

Powell prefers a measured approach and has long been planning a gradual withdrawal of stimulus, adapting it to the slowdown in the labour market and inflation at 3%. He began cutting rates in September 2024 and, after a pause in the first nine months of the year, has resumed reductions that now total 150 bps and put the FED's lower bound at 3.75%. He has reached an average pace of cuts of 10 bps per month compared with the typical recessionary cycle, in which reductions take place at an average of 96 bps per month.

In addition, from December quantitative tightening will end and the Federal Reserve will stop reducing its balance sheet: a monetary tightening measure that has been in place since mid-2022 and which, in GDP terms, has returned the balance sheet to pre-pandemic levels, reducing it by 14 p.p., giving the monetary authority ammunition for potential future difficulties.

1. SOFR MINUS FED DEPOSIT FACILITY

Sources: Bloomberg, Federal Reserve and Banca March



This decision, which has so far gone largely unnoticed by the markets, is being taken now because of the sharp fall in bank reserves held at the Fed, which are at a five-year low – standing at 3 trillion dollars – and because of the liquidity strains seen in recent weeks.

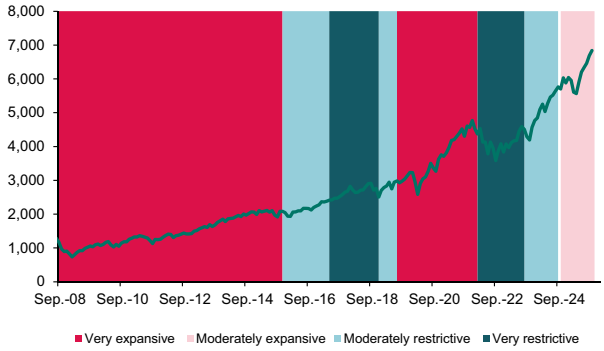
SOFR – the reference rate between financial institutions for overnight loans secured by Treasury bills – has even traded above the IORB – the interest rate paid on bank reserves at the Fed – when normally and logically the opposite should be the case.

In practice, 40 billion dollars will no longer be withdrawn from the financial system each month. This will take place under a new framework by which the Fed will offset 35 billion in maturing MBS – mortgage-backed securities – with Treasury bonds, adopting for the first time since late 2017 a neutral balance-sheet policy.

As shown in Chart 2, the combination of this measure and the renewed rate cuts implemented by the Fed in September is good news for risk assets.

2. S&P 500 PERFORMANCE BASED ON FED REGIMES (*)

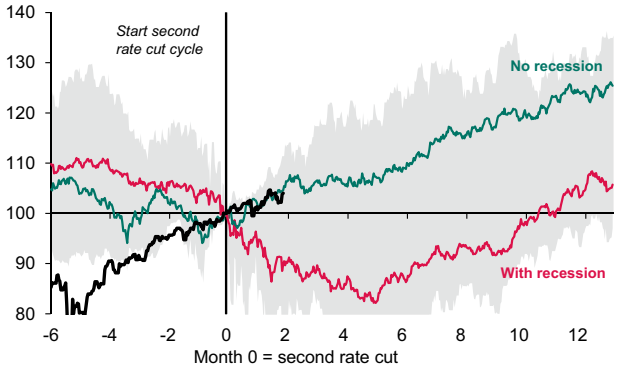
Sources: Bloomberg, Federal Reserve and Banca March



Regime	Definition	Average annualised return S&P 500
Very expansive	Falling rates and rising balance	13%
Moderately expansive	**Falling rates**	**17%**
Moderately restrictive	Rising rates	20%
Highly restrictive	Rising rates and shrinking balance	3%

3. THE S&P 500 POSTS POSITIVE 12-MONTH RETURNS AFTER RATE CUTS RESUME

Sources: Bloomberg and Banca March



Second cycle of drops: 1981, 1985, 1990, 1998, 2002, 2008 and 2020.

It is also essential to bear in mind that, although it is true that rate cuts are unusual in late-cycle phases – since 1980 this has only happened in 1985 and 1998 – the average historical return over the following 12 months is typically +25% – see Chart 3.

In short, and returning to Friedman, lukewarm water is better than water that is too hot, and it is wiser to go slowly and safely to avoid getting burned.

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