Bolton Insight

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Understanding a Fed Rate Cut

With the Federal Reserve Board of Governors' (The Fed) recent decision to further cut interest rates, we would like to take the opportunity to shed light on what it means when the Fed cuts rates, why the rates are cut and the importance of understanding the potential impacts of this decision.

What does it mean when the Fed cuts interest rates?
When the Fed cuts interest rates they are lowering the fed funds target rate. This is the rate banks charge each other when lending money overnight to meet the federal reserve requirement. This is important because a number of other interest rates utilize the target rate as a reference point. One of the most significant rates influenced is the prime rate, or the rate that banks charge their best customers.

Why does the Fed cut rates?
The Fed has a few tools at its disposal in order to enact monetary policy: open market operations (the buying and selling of securities to increase or decrease money supply), the discount rate (interest rate charged between banks), reserve requirements (controls the amount banks can lend), and interest on reserve balances (eliminates the opportunity cost that banks incur by not investing required reserves in interest-bearing assets*) . When the Fed cuts rates, the objective is to stabilize prices (control inflation) and stimulate economic growth; as lowering finance costs can spur businesses and consumers to invest as well as borrow.

What are the potential impacts of this decision?
Some of the positive impacts from lowering interest rates are:

- Lower borrowing rates for both consumers and businesses. This will incentivize consumers to spend and businesses to invest in projects thus injecting capital into the economy. This infusion of capital will typically spur growth in the economy and the markets.

Notable negative impacts that could occur are:

- If rates are too low, they can spur excessive growth which can lead to inflation and the loss of purchasing power.
- Low rates can lead investors to take on more risk than normal as they look for yield.
- Retirees living off interest payments could look to cut spending to avoid tapping into principal. As Baby Boomers transition into retirement, a cut in spending along with an increasing retiree population could have an impact on the overall economy.

If the Fed, interest rates or any other topic is a concern or of interest to your investment committees or plan participants, please feel free to reach out to us at (410) 547-0500 or by contacting your Bolton consultant.

** Source:* ***https://www.newyorkfed.org/***