Educational Update: Interest Rates

Interest rates have been a hot topic, with the President consistently complaining that rates are too high, and even suggesting we should have a rate of 1%.

The first thing investors should understand about interest rates is that the Federal Reserve Board (Fed) only sets the Fed Funds Rate, which is the very short term. The rest of the rates are set by the free market, based on expectations of future rates, as well as supply and demand. The most important rate for the economy is the ten-year rate, as mortgages are loosely based on that, and this is often considered the base risk-free rate for equity valuation. In general, when the Fed lowers rates, and particularly when it hints at lowering rates even further in the future, the whole curve will move down. It tends to be flatter when investors expect rates to stay low or fall and steeper when they expect rates to rise. Sometimes, future expectations can move opposite of the Fed's actions. Observe what happened between 9/16/24 and 1/14/25: the spread between the ten-year rate (set by the market) and the Fed Funds Rate went from -1.7% to 0.46%, a swing of 2.16%. This pushed the ten-year rate from 3.63% to 4.79%, even as the Fed cut rates by a full percentage point. Investors were concerned that the rate cut would revive inflation, forcing the Fed to raise rates higher than they were before the cut.

While inflation has been steadily falling for some time, it has remained above the Fed 2% target (which some people say should be 0%) for over four years. The primary effect of tariffs should be a one-time jump in prices for goods, and the US economy is more service—based, so that should not create problematic inflation. The secondary effect could be less trade, driving up prices, along with service industries needed to raise prices to pay people more to cover higher priced good. This all remains to be seen. The other open question is that of demand for an ever-increasing US debt. If investors fail to increase their purchases of US Treasuries at a rate that keeps up with the massive deficit spending, long-term rates would rise. This could happen due to de-dollarization, credit concerns, or other capital demands being more competitive.

I don't understand the argument for lower rates, other than it tends to pull growth forward, supercharging the economy until it overheats, and it reduces the Federal deficit. The latter seems a worthy cause, but it is at the expense of savers who rely on the interest income. Inflation is still above the target, employment is still strong, stock market valuations are near all-time highs, and so is real estate. The balance of risk still seems to be toward overheating the economy. As argued above, I'm skeptical that a lower Fed Funds would have the President's desired effect anyway. On the other hand, if politicians remove the independence of the Fed, they will inevitably wield the power of monetary policy to goose growth during their tenure at the expense of those who come later. This is already happening in a major way with Fiscal Policy, as we've seen the largest non-recession peacetime deficit spending in history lately, with no appetite for serious reductions. We will have to wait and see how the Trump-Powell drama unfolds, but investors would be wise to not put their hope in a presidential takeover of the Federal Reserve to create limitless wealth.