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INVESTMENT MANAGEMENT

An Inside Look at Interest Rates

"Where are rates going?" This is one of the most common questions I hear in client meetings. It's no wonder. Financial headlines report on the Federal Reserve's interest rate policy on a seemingly never-ending basis: There's a headline when the Fed might hike, a headline covering what pundits think, a headline when the Fed actually makes a move. It never seems to end.

So I thought it would be worth it to hit pause and look closer at what happens when the Fed changes its interest rate policy, what that means for the economy overall, and how all of this relates to your financial plan.

A bit about banking

To understand interest rate policy, it's important to understand a few basic things about our banking system.

Banks are legally required by law to have a certain amount of customer money on hand, or in reserve, each night. Because banks don't generate revenue on reserves, they tend to keep as close to the minimum as possible. Sometimes, this means they dip below the required amount.

To remedy this, banks lend money amongst themselves in the form of overnight loans. They charge each other interest on these loans, and the Federal Reserve determines what that rate should be. It bases this target rate, known as the federal funds rate, on its assessment of the economy. More specifically, the Fed looks at inflation and employment data (more on that later).

When the Fed increases rates, it's more expensive for banks to borrow money, which sets off a domino-style series of events. A bank might want to keep more money on reserve to avoid borrowing from another bank overnight and paying a higher federal funds rate. That same bank might need more incentive, in the form of higher rates, to lend to businesses seeking finances or consumers seeking mortgages. And so, rates go up throughout the economy. That same bank, still concerned with keeping enough cash on hand to avoid too much overnight borrowing, might also impose stricter standards on the money it lends out, so it's more likely to be repaid.

The converse is also true. When the federal funds rate goes down, banks don't have to worry as much about keeping cash on hand and may be more willing to lend money to consumers. They may even loosen lending standards or offer better terms to borrowers.

When the Fed makes big moves in interest rate policy, whether it's a series of rate hikes or a period of cuts, the changes ripple throughout the economy.

Interest rates and inflation

Interest rates are closely linked to inflation, and that's by design. As the United States' Central Bank, the Federal Reserve has a dual mandate. In other words, it's tasked with taking care of two primary things: inflation and jobs. The goal is to keep prices stable while keeping Americans employed. While the Fed also looks at the overall economy (in the form of GDP reports) as well as global business (like supply chains), geopolitics (like wars or trade negotiations), and market factors (like energy costs), they do so as part of their mandate to monitor inflation and jobs.

How much the Fed focuses on a particular issue largely depends on current events. For instance, during and after the Great Financial Crisis, the Fed focused primarily on jobs. In doing so, they lowered the funds rate to essentially zero, with the goal of incentivizing banks to lend to companies, and for those companies to hire.

The risk with this type of policy is that it can cause inflation. We won't go too far into the why of it, but economists have been watching closely for inflation since the Great Recession and in the historically low-interest-rate environment that followed. For years, those concerns were overplayed—inflation stayed around 2-3% per year, which is in line with historical averages.

COVID-19 changed that dynamic.

The T word: Transitory

The pandemic caused huge shifts in the global economy. Since COVID-19 affected areas of the world in unique ways at different rates, the shifts to things like supply chains were hard to predict or quantify. Prices for goods increased to reflect these changes.

At the same time, consumer demands changed drastically, as more people stayed home. This impacted supply and demand in different ways. For instance, as more people stayed home from work, the price of gasoline fell dramatically. Meanwhile, costs for other goods jumped.

When the Federal Reserve looked at those price changes, however, the bank decided that the moves were likely temporary—a reaction to the pandemic that would normalize. The word the Fed uses for this is transitory, as in "inflation is transitory."

However, as the pandemic started to stabilize and the economy reopened, inflation stuck around. As a result, the Federal Reserve planned a cycle of interest rate increases in an attempt to get inflation under control.

If you were around in the 90s, it might seem strange that the Fed is now indicating what it's likely to do ahead of time. Prior to the Financial Crisis, the Central Bank rarely signaled what it would do ahead of time. During the upheaval of 2008, however, the Fed began signaling its intentions to avoid shocking markets.

How rate changes impact markets and the economy

These days, this signaling can create some complexity in markets. Traders tend to react one way on the anticipation of an event, and another when it happens, and it can get confusing and hard to predict. That's one reason we suggest steering clear of headlines and avoiding active trading or trying to time the market. For long-term investors, these fluctuations and shocks don't matter much. That's especially true if you have a financial plan in place.

When it comes to the economy, interest rates have a more straightforward impact than with markets. However, it can still take time for that impact to be felt by regular folks.
It can take time for a higher funds rate to domino out, and longer still for something like higher credit card rates to impact how much consumers shop. Ultimately, less shopping means less demand means lower prices. But this cycle can take some six to 12 months.

(Note: If you're paying your credit card off every month, rate changes won't affect you. However, if you carry credit card debt, the interest rate is likely variable, and your payments may increase.)

If you have any questions about how interest rate changes might affect your financial plan or investments, we can discuss at our next check-in. And if you're interest in reading more about inflation, we wrote an explainer for you last month.