September Commentary

Cutting Out Sweets and Hitting the Gym

Last month, the Federal Open Market Committee (FOMC) cut the overnight lending target rate. There was a lot of conjecture about whether the policy-making arm of the Federal Reserve would cut the rate by 25 basis points (0.25%) or 50 basis points (0.50%). As you already know, Fed officials decided on the latter for their first move of numerous expected cuts in the near future. This 0.50% cut took the upper range of the overnight rate from 5.50% to 5.00%. But what does this all mean? And on the other side, what doesn't this rate cut do? It might be worth noting that many people don't fully understand what it means when the Fed cuts rates.

Let's take a quick look at what it does: A rate cut by the FOMC means it reduces the upper limit of the interest rate range where they want financial firms to lend to one another for one business day. In other words, cutting the overnight interest rate lowers the cost of overnight cash and borrowing in the banking system.

However, to the chagrin of many consumers, here is what cutting the overnight lending rate doesn't do, at least DIRECTLY: lower new purchase mortgage rates, change the yield to maturities of U.S. Treasury debt securities, alter existing fixed-rate loans, or affect the interest rate spreads between corporate, municipal, and Treasury securities. The operative word in the previous sentence is "directly." Lowering the overnight lending rate doesn't directly affect many things people believe or hope it will. While there is no arguing that cutting the overnight lending rate will have an impact on lending and consumer behavior moving forward, that five-year car loan you took out at 7.0% will remain 7.0%. The interest rate on your existing 15- or 30-year fixed-rate mortgage won't change. The coupon on bonds is still the same coupon on bonds, at least for most of them. If you live in such a neighborhood, the neighborhood loan shark couldn't care less what the Fed did or does in the future. So, if this is the case, why does anyone care if the Fed cuts the overnight rate? The reason is that a lot of debt is of the variable rate variety—meaning the interest rate on that loan fluctuates off a predetermined benchmark or index. Nearly all of this debt is closely tied to the Fed's overnight rate and not directly tethered to the rate but darn-near close enough. For example, the prime lending rate (Prime), the benchmark rate banks charge clients with good credit, has been 3.0% above the overnight lending rate for decades. However, the Fed doesn't directly adjust Prime, and banks aren't required to reset their rate because the overnight lending rate moves one way or another, but all do.

However, here is some good news! If you have a personal loan or credit card tied to Prime, your interest rate, or cost of money, went down a little last month. That's right, it fell by 0.50%. That slight decrease is much better than a sharp stick in the eye, but just about everything is. Here is an example: Imagine you have a $10,000 balance on some revolving debt at Prime. Before September 18, your annual interest rate was 8.50% (3.00% plus 5.50%). When you woke up on the 19th, the rate had fallen to 8.00%, and the annual interest expense had dropped from $850 to $800. That works out to a cost savings of slightly more than $4/month. While this example is just for debt tied to Prime, some banks use other floating rate indices, though the story remains the same directionally. Currently, borrowers with $10,000 in revolving debt will save anywhere from $3-5/month, thanks to the Federal Reserve. If that sounds like a great big "nothing burger," the first rate cut in an easing cycle normally is in the near term. A not-so-ginormous single-digit savings each month? This sum amounts to the cost of one of those puny [double cheeseburgers](#) at McDonald's—the burger with only 3.2 ounces of beef despite the formidable name. And, in my humble opinion, is an actual nothing burger!

I will assert the 0.50% cut won't tremendously affect consumer behavior for the first several months. No doubt it was necessary and will help, but conventional wisdom says it will take nine to 15 months, or even longer, for the economy to feel the full impact of a change in the overnight rate. By then, the FOMC will likely have made a few more cuts. Collectively, this will have a sort of cartoon-like snowball rolling down a mountain effect and will grow more significant as it travels further downhill.

Follow along for a minute longer and imagine a doctor has a morbidly obese patient and tells them they need to lose a large amount of weight over the next 18 months. With a couple of minor changes to their diet, the patient starts to lose some weight. After three months of cutting out alcohol, sugary treats, and fried food, they are down 50 lbs. By anyone's definition, that is a massive step in the right direction and worthy of kudos. However, the patient is still morbidly obese and needs to lose more. Because the patient has found some relief in their joints, they begin walking, gradually increasing the distance each day. After another three months, they have lost 75 lbs, inching ever closer to their goal weight. You guessed it, despite the enormous strides and admirable progress, they still have more to do. Next, they add weight training to their exercise regimen and start hitting the gym. Since muscle burns more calories than fat, the excess weight starts to melt from their body, their physical stamina dramatically increases, and the change in their appearance becomes increasingly apparent. With consistency and commitment as their mantra, some added tweaks to their diet, a few more steps each day, and increased weight training, they can reach the doctor's prescribed goal in the stated time. The purpose of this analogy was to illustrate the following: Last month, the FOMC effectively took sweets, fried foods, and soft drinks out of our diet. While this is just the first step in the journey to better economic health, everyone is counting on the Fed to make more changes in turning the economy in a more favorable direction.

"The journey of a thousand miles begins with one step."
— Chinese philosopher Lao Tzu

Thus far, the equity markets have responded positively to the FOMC's widely expected action. While it hasn't been the wild, euphoric rally many people expected, the markets are buoyant since the rate cut announcement, and positive is always better than the alternative. In truth, despite being a 0.50% cut instead of 0.25%, I would contend the Fed's recent action was somewhat anti-climactic. You know, like Christmas morning after all the presents have been opened. Do you remember the scene in "[A Christmas Story](#)" when Ralphie's dad quizzically asks, "Didn't I get a tie this year?" That about sums up what happened last month.

In the end, the Fed gave us the first of what should prove to be several rate cuts in this easing cycle. Each will build on the previous one until the cuts create the previously mentioned financial snowball. Instead of an interest savings of $4.17/month, it could eventually be as high as $20 or more on that $10,000 loan. Just imagine a loan balance of $250,000, which isn't out of the ordinary for things like Home Equity Lines of Credit. How does saving $520/month sound if the FOMC cuts the overnight rate by 2.50%? That's when it gets fun, and you see meaningful economic impact. Until then, it will be sneaking up on us in a good way if the FOMC is able to stay committed and consistent in the pursuit of better economic health.

Until next month—

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