

Fed Cuts Should Lower Borrowing Costs, Right? Well, Maybe.

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I have been writing about inflation and the deterioration in the U.S. labor market since the beginning of the year. Recent revisions to jobs data suggest the labor market may be worse than we initially thought. This paired with relatively high but stable inflation data gives the Fed some cover for rate cuts. Markets widely anticipate the Fed will cut its short-term target rate (the Fed Funds Rate) by 25 to 50 basis points today.

This should stimulate economic growth, right? In theory, lower short-term rates should flow through to borrowers in the form of lower rates on things like mortgages and car loans, and that additional lending and borrowing should set off a multiplier effect.

Maybe—but in the real world, things don't always work out the way they do in an economics textbook. For example, **during the last round of Fed rate cuts between September and December 2024, the Fed cut rates by a full percentage point (100 basis points). Over that period, 10-year and 30-year Treasury rates actually *increased* by nearly as much as the cuts (88 and 75 basis points, respectively), as fiscal uncertainties and inflation fears drove rates higher.**

FRED — Federal Funds Target Range - Upper Limit (left)
 - - - Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis (right)
 - - - Market Yield on U.S. Treasury Securities at 30-Year Constant Maturity, Quoted on an Investment Basis (right)



During the last rate cut cycle, longer-term rates increased by nearly as much as the Fed rate cuts.

Source: Board of Governors of the Federal Reserve System (US) via FRED®

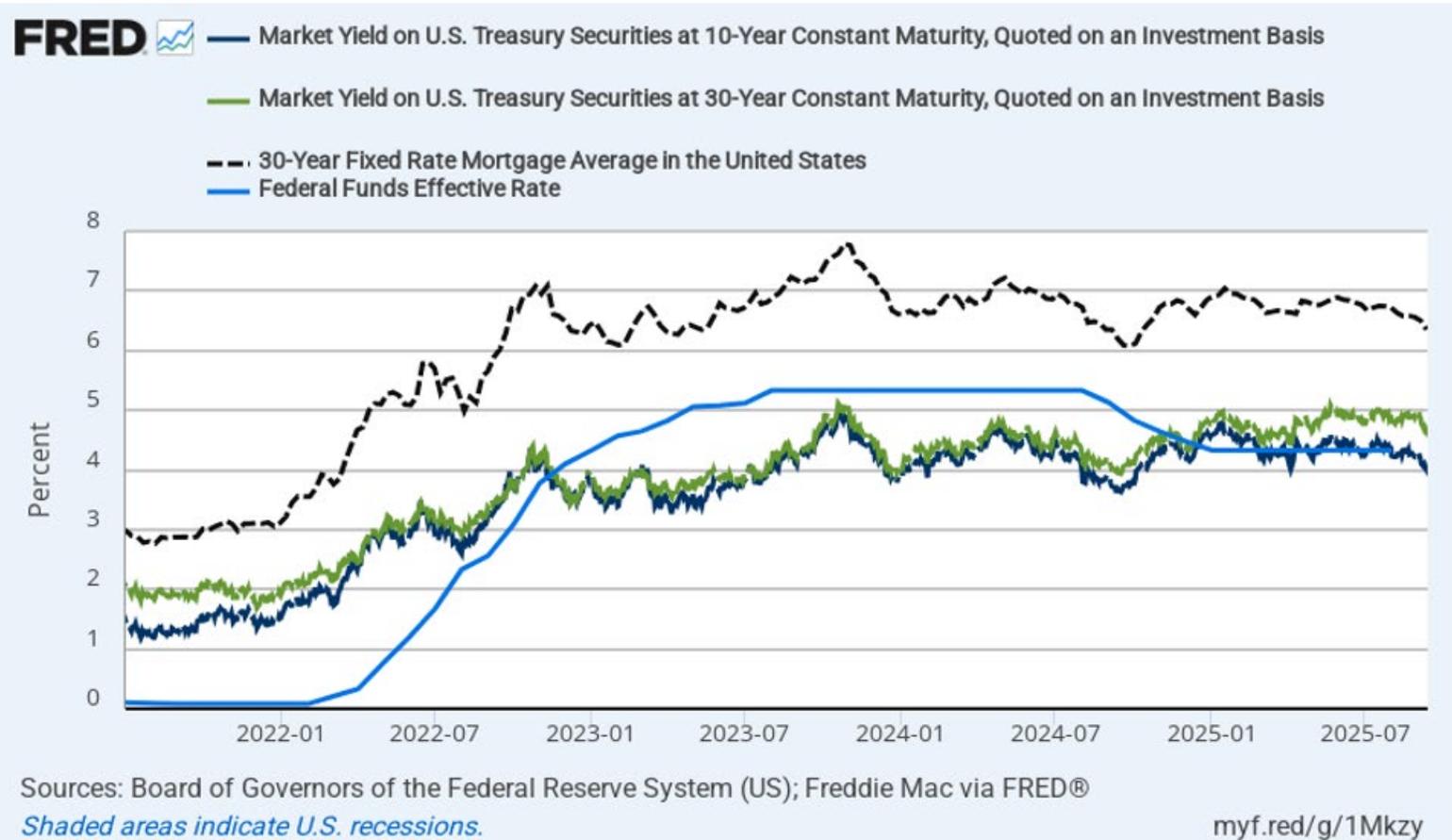
Shaded areas indicate U.S. recessions.

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This is important because rates on consumer debt (mortgages and car loans for example) tend to be correlated more with longer-term rates, which tend to be impacted more by longer-term macroeconomic forces and expectations for the future (see the graph, below).

The Fed is right to be concerned about the labor market and is probably right to start using the tools at its disposal to stimulate growth. **Recently, however—despite the expectation of rate cuts—longer-term yields have again been rising for the reasons noted above.**

It's possible the Fed cuts won't translate immediately into cheaper borrowing, as rising long-term yields drag borrowing costs up with them. If continued cuts fail to stimulate growth as intended, the Fed will be left with its recession playbook (namely, quantitative easing) if it wants to bring down longer-term rates.



Sources: Board of Governors of the Federal Reserve System (US); Freddie Mac via FRED®

Shaded areas indicate U.S. recessions.

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