



Rate Cuts: What Are They and What Do They Mean for You?

Overview

In September, the Federal Reserve cut their Federal Funds Target Rate for the first time in 2025.¹ The target rate is adjusted to support the Federal Reserve's dual mandate policy of stable prices and maximum employment. Throughout 2025 the Federal Reserve has dealt with concerns about tariff inflation, a weakening labor market, and pressure from the White House to lower rates.² Amidst these factors, the Federal Reserve elected to cut by 25 basis points making the target rate range 4.00% to 4.25%.³ This cut ended a nine month pause since the last rate cut in December 2024 and many investors do not think it will be the last cut in 2025.⁴

The following section outlines the mechanics of a rate cut and what we believe to be the potential impact on current financial conditions and economic behavior.

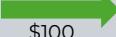
Understanding Rate Cut Mechanics

Every bank has a reserve requirement that they need to meet daily. This is the amount of cash that the Federal Reserve requires banks to store at the Federal Reserve in case of emergency. Like a high-yield savings account, the Federal Reserve will pay the banks interest on the money held at the Federal Reserve. For example, if a bank is required to have \$100 at the Federal Reserve, the bank will receive 5% interest for keeping their money there. This is known as Interest on Reserve Balances (IORB), and it serves as the floor rate for overnight lending.

Oftentimes, a bank will not have enough cash to meet its reserve requirement, so it must borrow from another bank overnight. Let's say Bank A is \$100 short of meeting its reserve requirement on any given day. Bank B has more than they need so they agree to give Bank A \$100 for the night. In exchange for the \$100 loan, Bank A will pay Bank B a 5.10% interest rate. This is known as the overnight lending rate.

If Bank B or any other bank does not want to lend to Bank A, the Federal Reserve will loan the necessary money to Bank A. In exchange for borrowing money, Bank A will pay an interest rate. This rate is called the discount rate, and it serves as the ceiling rate for overnight lending. The Federal Reserve may charge 5.25% interest in exchange for lending Bank A \$100. Note that this is a higher rate than the 5.10% that Bank B charged.

By combining the concepts of a reserve requirement, IORB, and a discount rate, you can understand how the Federal Reserve controls interest rates. By cutting the discount rate by 25 basis points, Bank B must charge 25 basis points less for lending their money to Bank A, or else Bank A will simply get a loan from the Federal Reserve at the discount rate. On the contrary, Bank B will not loan their money to Bank A for anything less than the Interest on Reserve Balances (IORB), because they have the option to make the IORB from the Federal Reserve.

Before Rate Cut Federal Reserve Target: 4.25% to 4.50%	After 25 Basis Point Rate Cut Federal Reserve Target: 4.00% to 4.25%
Interest on Reserve Balances (IORB): 4.25% Discount Rate: 4.50%	Interest on Reserve Balances (IORB): 4.00% Discount Rate: 4.25%
Bank A requests \$100 overnight loan from Bank B at a rate of 4.35%    Bank B accepts: They would choose to receive 4.35% rather than the 4.25% offered by the IORB	Bank A requests \$100 overnight loan from Bank B at a rate of 3.85%    Bank B Rejects: They would rather receive 4.00% by keeping their \$100 at the Federal Reserve
Bank A requests a \$100 overnight loan from Bank B at a rate of 4.15%    Bank B Rejects: Bank B can receive 4.25% by keeping their \$100 at the Federal Reserve	Bank A requests \$100 overnight loan from Bank B at a rate of 4.15%    Bank B Accepts: Now that the IORB fell to 4.00% it makes sense for Bank B to accept a rate of 4.15%

For Illustrative Purposes Only

¹ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20250917a.htm>

² <https://www.npr.org/2025/09/17/nx-s1-5539555/federal-reserve-interest-rates-inflation-jobs#:~:text=Scott%20Horsley-,Facing%20Trump's%20pressure%2C%20the%20Fed%20cuts%20rates,the%20first%20time%20this%20year&text=The%20Federal%20Reserve%20cut%20interest,pressure%20from%20the%20White%20House>

³ <https://www.forbes.com/advisor/investing/fed-funds-rate-history/>

⁴ <https://www.forbes.com/sites/simonmoore/2025/10/13/october-interest-rate-cut-broadly-expected-from-fed/>

How Do They Work?

As previously mentioned, the Federal Reserve has a dual mandate of maintaining stable prices and maximum employment. The Federal Reserve typically aims for an annual inflation rate of 2%. This level of inflation ensures that the economy is growing but there is not inflation to the point of a significant dollar devaluation.⁵ If the Fed thinks inflation is running too high, they tend to raise their target rate, and if it is too low, they tend to lower their target rate.

How does changing the target rate affect inflation and the job market? When the target rate is increased, banks charge their clients higher interest rates if they want to take out a loan. This causes loans to become less favorable and, therefore, businesses are more likely to delay expansion projects until interest rates are lowered. For example, a company may hold off on building a new factory if they are going to have to pay a high interest rate on the debt. Interest rates also influence hiring. If a company is delaying their new factory, then the construction workers, engineers, lawyers, etc., will no longer be hired for the planned project. The same goes for the employees that were going to be hired to work in the new factory. All the jobs that played a part in the new factory expansion are not only making less money, but they're also going to spend less money within the economy. Overall, higher interest rates slow economic activity. Therefore, the Federal Reserve may raise their target rate if they believe inflation is too high.

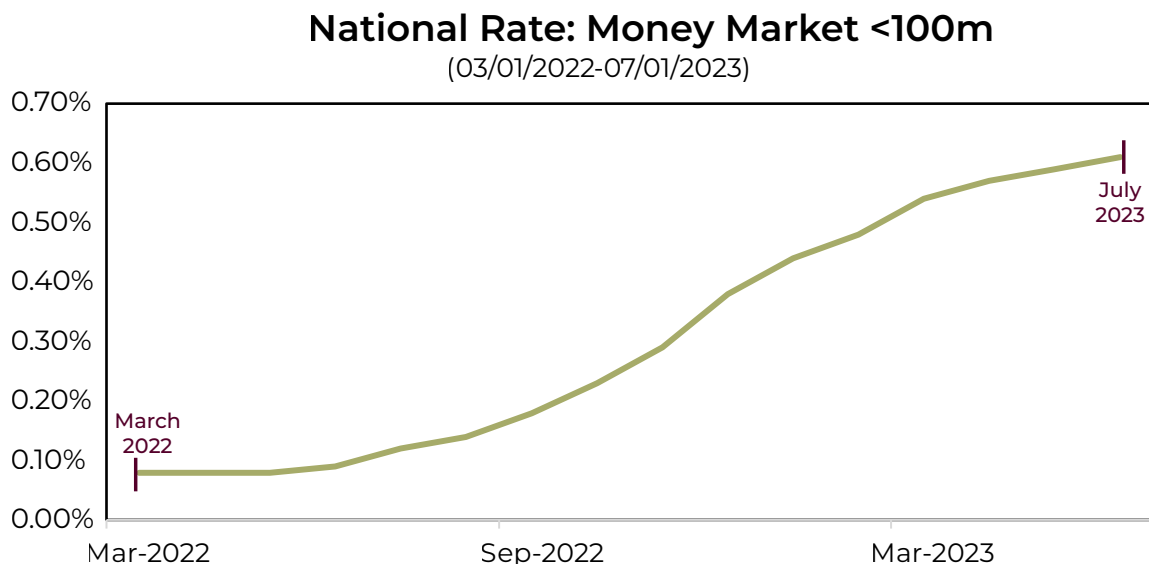
On the other hand, companies are more likely to start new projects and hire new employees if interest rates are low. This is because it is cheaper to get loans which makes it an attractive time to fund their expansion projects and grow their businesses. This leads to more economic expansion.

The Fed Target Rate and You

The Federal Reserve's target rate not only affects companies and their expansion projects. It also affects the standard consumer every single day. It can be broken down into three categories: loans, savings, and prices.

Loans: As we discussed earlier, rate cuts force banks to charge each other less for overnight lending. This allows banks to lower the interest rate charged on mortgage loans, automobile loans, and personal loans while still maintaining their profit margins. This allows the everyday consumer to have access to cheaper interest rates on new loans. They can also refinance existing loans at lower interest rates. The opposite is true when the target rate is hiked. Consumers are less likely to take on a new mortgage or buy a new car due to the higher rates. These effects contribute to a slowing economy.

Savings: Similarly, higher target rates also mean that banks are receiving more interest for their money held at the Federal Reserve due to the IORB. This allows banks to incentivize consumers by raising the interest rate that they pay consumers for deposits on their high-yield savings account. The chart below shows how the average money market deposit account added 0.54% Annual Percentage Yield (APY) from the first rate hike in March 2022 to the last rate hike in July 2023.⁶



This becomes a reason for consumers to simply hold cash and collect interest. The chart below shows how funds in money market accounts increased \$896.45 billion over the same period.⁷

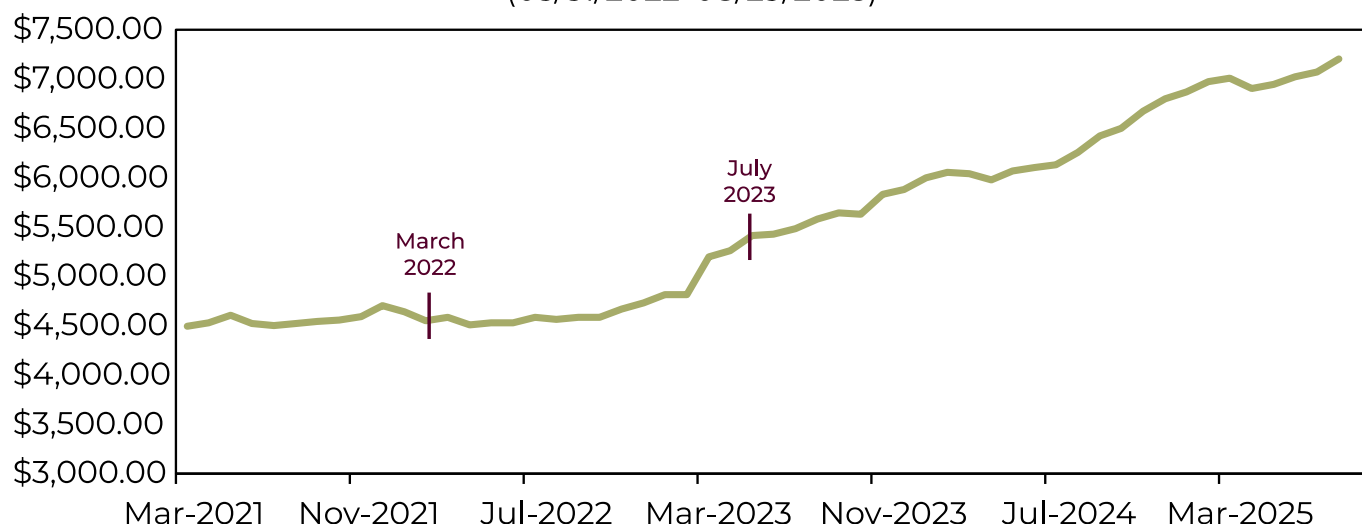
⁵ <https://www.federalreserve.gov/economy-at-a-glance-inflation-pce.htm>

⁶ <https://fred.stlouisfed.org/series/MMNDR#>

⁷ https://fred.stlouisfed.org/series/MMMFFAQ027S?utm_source=chatgpt.com#

Money Market Funds (in billions)

(03/31/2022- 08/29/2025)

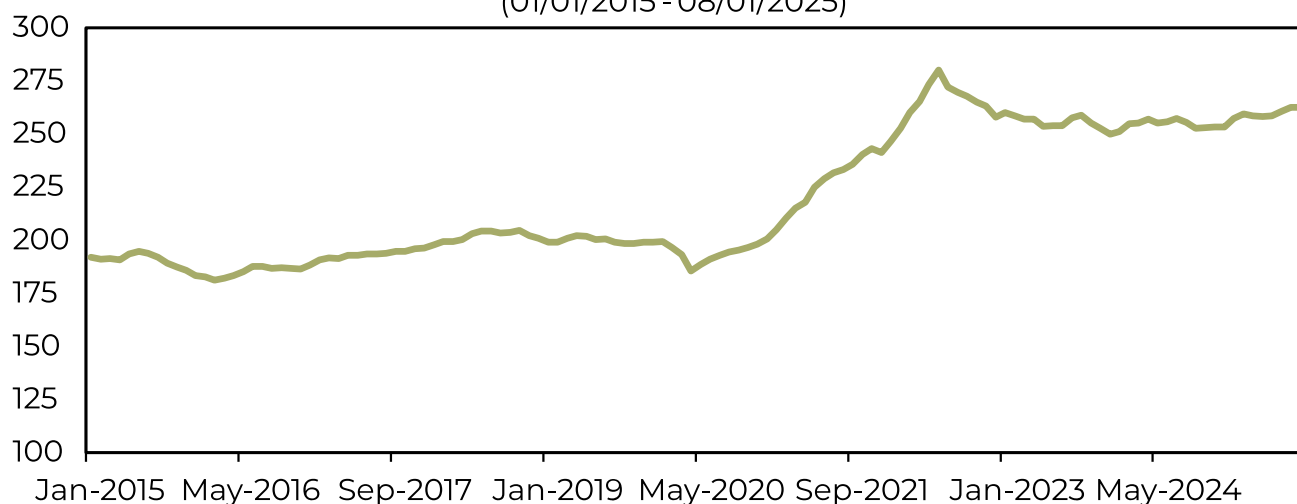


Today, the funds in money market accounts equal \$7.2 trillion, an all-time high. This may indicate that as yields on savings accounts rise, consumers become more content with keeping their money on the sidelines in a liquid savings account as opposed to spending. These reactions tend to assist the Federal Reserve in bringing down inflation and cooling the economy.

Prices: Prices are an outlier in terms of their relationship with interest rates because the effects are lagging and occur indirectly. Since consumers are more likely to save their money in a high-interest rate environment, producers have less room to raise their prices. This is evidenced in the figure below using the Producers Price Index (PPI) which measures the change in prices that businesses receive for the raw goods and services they sell. As you can see from the figure below, producers charged increasingly more throughout 2021 and 2022 but tapered off when the Federal Reserve started hiking rates in March 2022.⁸

Producer Price Index by Commodity: All Commodities

(01/01/2015 - 08/01/2025)



Producers were unable to continue charging higher prices because they did not believe consumers would be willing to pay, therefore reducing inflation.

⁸ <https://fred.stlouisfed.org/series/PPIACO>

From September 2024 to September 2025, the Federal Reserve has cut interest rates four times, totaling 1.25%.⁹ This is because worries about tariff-inflation have come down, the labor market is beginning to show signs of weakness, and the White House has been openly in favor of rate cuts. Rates are still elevated despite the recent rate cuts, and it will take time before the effects of recent cuts show up in economic data. However, the important thing for most investors is the Federal Reserve signaling the beginning of a rate-cutting cycle. At the last meeting, the Federal Reserve projected two more rate cuts in 2025 and one more in 2026.¹⁰ Although these projections are fluid, economists broadly expect recent and upcoming rate cuts to stimulate the economy over the next few years.¹¹

9 <https://tradingeconomics.com/united-states/interest-rate>

10 <https://fred.stlouisfed.org/series/FEDTARM>

11 <https://www.jpmorgan.com/insights/global-research/economy/fed-rate-cuts#:~:text=Looking%20ahead%2C%20J.P.%20Morgan%20Global,the%20cumulative%20amount%20of%20easing.>

Sources:

<https://www.forbes.com/advisor/investing/fed-funds-rate-history/> -> fed funds rate history

https://www.nerdwallet.com/article/banking/savings-rates-stay-strong-despite-dips?utm_source=chatgpt.com -> saying many MM accounts yielded 4%

<https://fred.stlouisfed.org/series/FEDTARM> -> fed cut forecast

<https://fred.stlouisfed.org/series/PPIACO> -> PPI chart

<https://fred.stlouisfed.org/series/MMNDR#> -> MM rate chart

https://fred.stlouisfed.org/series/MMMFFAQ027S?utm_source=chatgpt.com# -> MM deposits chart

<https://www.federalreserve.gov/economy-at-a-glance-inflation-pce.htm> -> fed 2% longrun



KARPUS
INVESTMENT
MANAGEMENT

Contacts

Information/Queries

183 Sully's Trail
Pittsford, New York 14534
Phone: 585 586 4680
Fax: 585 586 4315

Website

www.karpus.com

Important Notice

The opinions and analysis expressed in this document are those of Karpus Investment Management staff, are subject to change based on evolving market and economic conditions. While Karpus has used reasonable care to obtain information from reliable sources, no representations or warranties are made as to the accuracy, reliability or completeness of any third-party information presented herein. No responsibility can be accepted under any circumstances for errors of fact or omission. This is being provided for educational purposes only.