MERITAS ADVISORS

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Insights

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A closer look at the Federal Funds Rate

Understanding the Federal Funds Rate

"The Fed is meeting to discuss interest rates" is a phrase that is used frequently in the media, typically surrounded by heated discussion of what effects the decision will have. But what exactly is this rate, how is it determined and what does it mean for the economy?

About the Federal Funds Rate

The Federal Funds Rate is set by the Federal Open Market Committee of the Federal Reserve (the FOMC) based on recent economic activity. The FOMC decides how much interest a depository (such as a bank, credit union, or other institution that holds tradable securities) charges on an overnight loan to another depository.

The Necessity of Intragovernmental Lending

Central banks are legally required to carry a minimum amount of capital at the end of the business day in order to ensure they can execute daily transactions. So if a bank or other depository has excess capital, they can lend it to another bank that may have a shortfall. This "overnight loan" is lent at a low interest rate set by the FOMC. To set this rate, the FOMC meets eight times per year, or approximately once every seven weeks, and considers recent economic and financial statistics to determine what the rate should be.

What the Rate Indicates

The Federal Funds Rate is reflective of the health of the US economy. If capital is more liquid in banks, the interest is higher. However, in times when money is harder to come by, the rates are lowered to make the money more liquid. Because the rate correlates with liquidity of capital, banks use this to determine their own short-term interest rates on deposits, credit cards, adjustable mortgages and other personal loans.

Historical Significance

In the 1980s, when inflation rates were high, the FOMC set aggressively higher overnight rates in order to combat soaring prices and lower liquidity. Conversely, after the great Recession of the mid-2000s, the FOMC set a low rate in order to stimulate liquidity of capital between banks.

The market at a glance

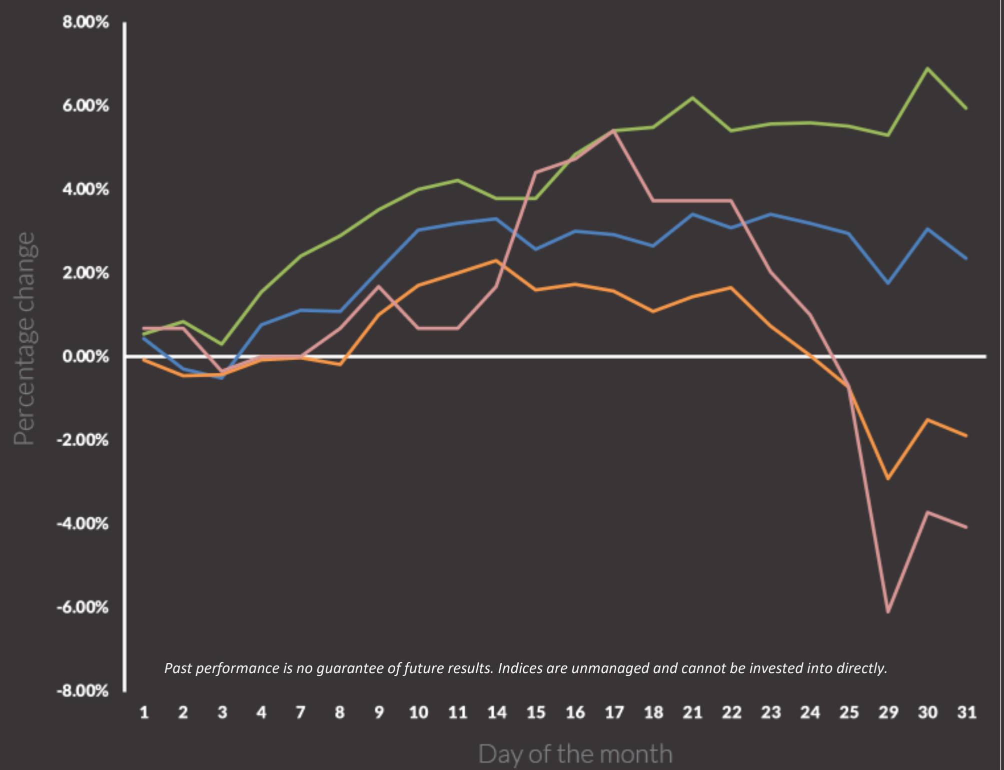
May

U.S. Large Cap
(S&P 500)
2,705.27 (2.36%) ▲

U.S. Mid/Small
(Russell 2000)
1,633.60 (5.96%) ▲

International Large
(NYSE International 100)
5,551.92 (-1.87%) ▼

U.S. Treasuries
(U.S. 10-year Treasury yield rate)
2.83 (-4.07%) ▼



The market in action

- After months of speculation and build-up, President Trump chose to withdraw the United States from the Iran nuclear deal. With the withdrawal, economic sanctions likely will again affect Iran's precious-metals and oil sectors.
- The Supreme Court of the United States effectively ended the prohibition on sports betting. The decision makes a key distinction allowing for states to enact their own regulations regarding sports betting. Before the decision, only the states of Delaware, Montana, Nevada, and Oregon had legal sports betting.
- PayPal agreed to purchase European FinTech startup iZettle AB for roughly $2.2 billion, an acquisition that would launch the digital-payment provider into hundreds of thousands of retailers around the world. This comes at a time when PayPal has begun to face encroaching competition from Wall Street-backed payment services like Zelle.
- Warren Buffett revealed that, after purchasing a massive 75 million shares of Apple stock in the first quarter, Berkshire Hathaway is set to make roughly $700 million this year in dividends from this Apple stock alone.
- May came to a close with more threats about tariffs. The United States stated its intentions to move forward with aluminum and steel tariffs on imports from Canada, Mexico, and the European Union. Canada and the European Union have both promised retaliatory tariffs of their own.

Reclaiming Charitable Deductions

You may remember that when the new tax law was debated, there was a lot of chatter around the possibility that Congress would totally eliminate the deduction for charitable contributions. That Republican-backed proposal never made it into the final Tax Cuts + Jobs Act, but in other ways the tax changes may wind up having a similar effect on many taxpayers.

How? By doubling the standard deduction, the Tax Code will greatly reduce the number of tax filers who itemize. Another part of the new law adds to the reduction in itemizing by capping the value of the deduction for state and local taxes at $10,000—far below what many taxpayers living in high-tax areas of the country will actually pay.

The result? In the past, roughly 30% of us were itemizers. That number is expected to drop to 10% by the time we start filing this year's taxes. Of course, if you don't itemize your deductions, you don't get to deduct your charitable contributions.

Some quick math shows how this works. Let's suppose a married couple plans to make $14,000 worth of charitable gifts this year. Their state and local tax deduction is capped at $10,000. Together, the two equal $24,000—which happens to be the same as the new standard deduction. They get no incremental deduction for their $14,000 of charitable gifts.

What to do? One way to overcome the impact of the new tax provisions is to bundle several years worth of charitable contributions into a single tax year, contributing the higher amount to a donor-advised fund rather than to the charities directly. If the same couple were to give two years worth of donations to a donor-advised fund, that would come to $28,000. Add in the $10,000 maximum deduction for state and local taxes, and suddenly it makes sense to itemize. The additional $14,000 results in a tax savings of about $5,180 for people in the 37% tax bracket.

Of course, if the couple were to bundle five or ten years worth of charitable contributions into the same tax year, that would further increase the value of the deduction, and they can happily take the standard deduction in the other years. Going forward, the money in the donor-advised fund can be contributed each year to charitable causes just as it had been before, in $14,000 annual increments. Meanwhile, the assets that remain in the fund are growing tax-free, creating additional charitable assets for future donations.

-Bob Veres

Sources:

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