

## The Fed Effect: Power, Politics, and Your Portfolio

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Since its founding more than a century ago, the Federal Reserve has been the subject of intense scrutiny. Economists, politicians and the financial press, among others, love to second-guess the central bank. Think of it as the financial world's version of Monday morning quarterbacking. Lately, President Trump has grabbed more than a few headlines for his efforts to [sway Fed policy](#).

Why all the fuss about the Fed? The central bank's decisions can have a major impact on the economy and the markets. It's one of the country's most powerful institutions, yet arguably one of the least understood. In this week's Markets in a Minute, we answer some basic questions about the Fed, touching on a few common misconceptions along the way.

### Why do we even need a Fed?

Before Congress established the Fed in 1913, the U.S. economy was much more volatile. The country experienced painful booms and busts. Bank runs and failures were not uncommon.

Without a central bank to stabilize the banking system, the country sometimes had to rely on private citizens to bail it out. Famed [financier J.P. Morgan](#) stepped in to help stabilize financial markets during several crises, including during the [Panic of 1907](#). The unemployment rate more than doubled the year following the panic, while the economy declined by 10%. This crisis rattled Wall Street and set off bank runs and ignited a reform movement that led to the creation of the Federal Reserve years later.

In the more than one hundred years since it's founding, the Fed has grown in complexity and importance such that today, reporters and investors alike hang on every spoken or written word of its leaders.

### What's the role of the modern Fed?

While the Federal Reserve was established initially to address the banking panics that had plagued the United States' economy, today its primary goal is to balance stable prices (ie limit inflation) with creating as many jobs as possible. In this balancing act, the Fed's role has evolved to become broader and more complicated than many realize.

### Federal Open Market Committee (FOMC)

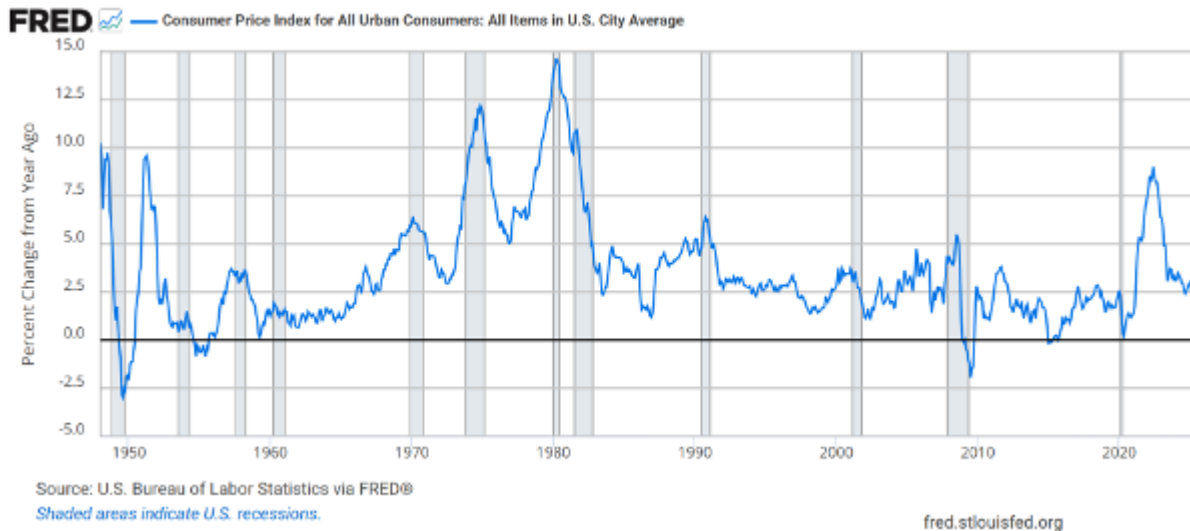
Most well-known is the Fed's setting of interest rates or, more specifically, the fed funds rate, the rate at which banks will lend to each other overnight. Rates are adjusted up and down in order to support the Fed's twin goals of taming inflation and promoting [full employment](#). For instance, if inflation is too high, policymakers at the Fed will raise interest rates. Conversely, if jobs are becoming harder to find and the number of unemployed is growing, they will lower rates.

### Board of Governors

Seven governors are appointed by the president with tenures of 14 years and staggered terms, designed to help protect the Federal Reserve from political influence. Together, they oversee the complex system that makes up the Fed and are ultimately responsible for helping to set interest rate policy and overseeing regional activities.

## Regional Reserve Banks

Twelve banks scattered around the country act as “banks for the bankers,” making it easier for commercial banks and the US government to do business. In addition, each of the regional banks has a staff of economists who research local, national and global economic issues, much of which is made available to the public. One resource you may have seen in these pages is the St. Louis Fed’s [FRED](#), a free online, searchable database of more than 800,000 economic indicators. See below for an example of what’s available.



While the Fed has a clearly designed set of roles, it can also innovate during times of stress to meet the needs of the moment. During the global financial crisis that began in 2008, for instance, the central bank’s initial efforts to respond didn’t pack enough of a punch. But it [kept trying new approaches](#), including making large purchases of assets that it normally doesn’t buy in an effort to support the battered mortgage and housing markets. Its drive to find solutions helped restore public confidence and buoy stocks.

Coming out of the global financial crisis, the Fed took on additional responsibilities in order to help forestall future crises. New duties included supervising banks and non-bank lenders, conducting annual stress tests for banks. In addition, the Office of Financial Stability Policy and Research was created within the Fed, which integrates economic research with supervisory policy to spot systemic risk earlier.

## Mortgage rates have been on the high side for several years. When the Fed cuts rates, will home buyers finally get some relief?

Not necessarily. Perhaps the biggest misconception about the Fed is that it controls all interest rates. The central bank directly controls only the [federal funds rate](#), the interest rate charged by banks to borrow from each other overnight. Changes in the fed funds rate influences other rates — in other words, the rates consumers pay on things like credit cards and auto loans. However, [mortgage](#) and other long-term rates are closely tied to the outlook for growth and inflation.

That said, it’s not hard to see why some people think the Fed controls mortgage rates. Mortgage rates often fall when the Fed cuts its policy rate in response to an economic slowdown, though this is not always the case. In fact, since the Fed started cutting rates in September 2024, the average 30-year mortgage rate has increased from around 6.2% to around 6.7%.

## With President Trump pressuring the Federal Reserve to cut interest rates, there’s been a lot of discussion about the Fed’s independence. What does that mean?

From its founding, the Federal Reserve system was designed to be insulated from political pressures. In addition to long and staggered terms for members of the board of governors, the central bank is decentralized through its 12 regional banks and it is self-funded, meaning it pays for its operations through interest and fees, remitting any surplus back to the US Treasury.

While the Fed is independent, though, it is still accountable to Congress. Congress sets goals for the Fed (ie maximum employment and stable prices), and Federal Reserve officials determine how to achieve those goals.

## Why does it matter that the Federal Reserve remains independent?

In theory, independence allows the Fed to focus on long-term economic goals, without being influenced by the day's political pressures or public sentiment. Many economists have argued that when a central bank is [independent](#), it can more easily promote low and [steady inflation](#).

Yet lowering rates to juice economic growth is tempting to politicians from both sides of the aisle. More jobs can mean more votes. Last year, for instance, Sen. Elizabeth Warren penned an [open letter](#) to the central bank calling on it to swiftly cut rates and arguing that its "delays" had threatened the economy and "left the Fed behind the curve."

As tempting as it may be, cutting rates preemptively — in other words, before clear signs of economic trouble — is risky. It may boost growth in the short term, while also stoking inflation over the medium- to long-term. History offers cautionary tales. In the early '70s, President Nixon put enormous pressure on the Fed to keep rates low in advance of his re-election campaign. Whether he succeeded is a matter of debate. But economists often blame preemptively lower short-term rates for contributing to the [Great Inflation](#) of the 1970s.

Remaining insulated from politics allows the Federal Reserve to make monetary and supervisory decisions based on economic realities rather than short-term political goals, which can distort policy and destabilize markets. The very belief that the Fed is committed to combatting inflation can help officials subdue price increases, even if higher rates are unpopular and sometimes painful.

## Why not cut rates at the first hint of trouble?

The central bank certainly isn't infallible. Even with its vast data resources, the Fed must make decisions based on incomplete or lagging indicators. Economic readings are often updated as more information becomes available, which means policymakers, investors and others must make real-time decisions based on imperfect snapshots.

Like its predecessors, today's Fed is facing some tough choices amid intense political pressure. Politics may create the noise, but the Fed's decisions send the signal investors can't afford to miss.

Invest wisely and live richly,  
Kara

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