

## **Fed Rate Policy – How to Gauge Market Expectations**

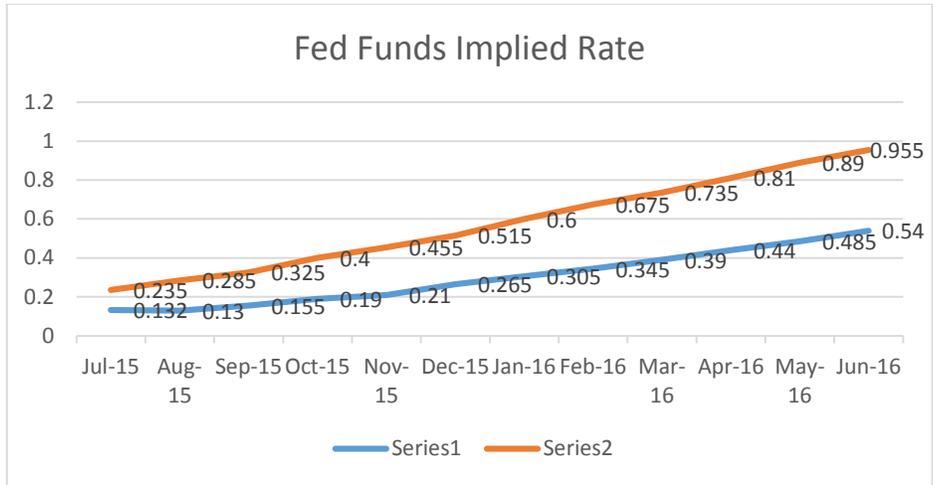
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After more than seven years of pursuing a nearly zero interest policy, the Fed is increasingly more likely to begin movement toward interest rate normalization through hikes in the Fed Funds target rate. Insight into the market's expectations of the timing and degree of Fed policy changes is often quite important to its participants. From the financial advisor looking for guidance on portfolio diversification to the money manager analyzing floating rate exposure, Fed interest rate policy changes have a great impact. Often it is difficult to discern the market's sentiment through gleaning the FOMC's forward policy guidance or competing interests' commentary; however, one can gather clues of rate policy expectations by observing the CBOT's Fed Funds futures forward curve.

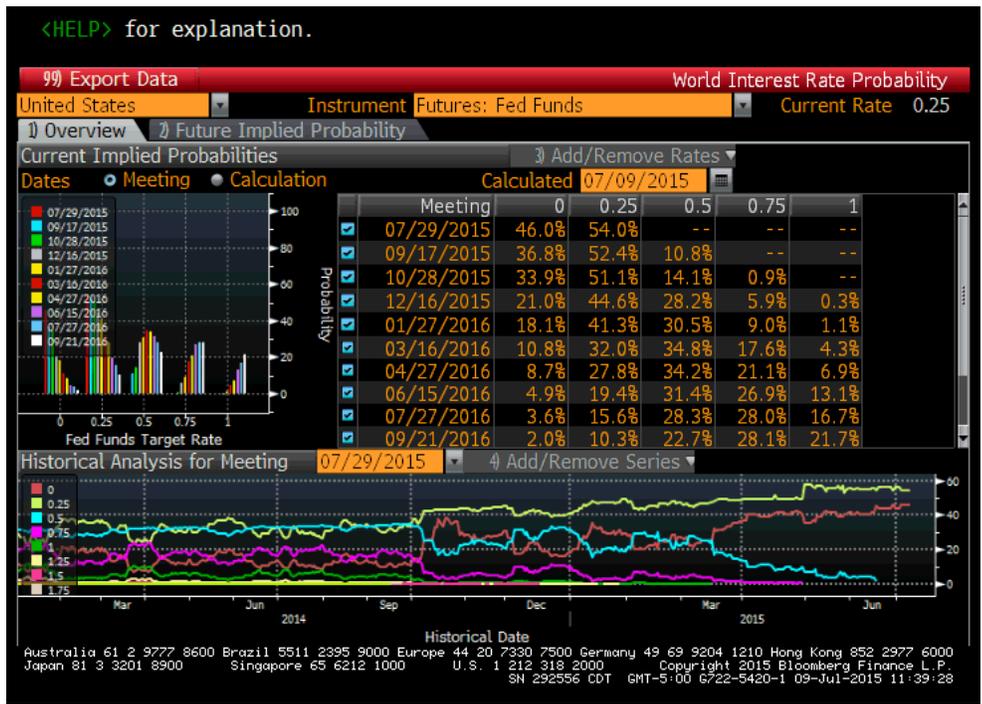
Launched in December of 1988, the CBOT created Fed Funds futures to provide a hedging and speculative tool for traders that directly correlates to interbank trading of excess reserves. Unlike other short term interest rate futures that settle the spot (front) month against a single fixed reference rate and date (e.g. Eurodollars settle versus 3 month LIBOR on a fixed mid-month date), CBOT fed funds futures settlement is based on a simple average of the published daily fed funds effective rate. As the spot month begins, fed funds futures trade as a forward rate and then look back to the average funds rate for the balance of the spot month's trading.

During FOMC meeting months, the daily effective fed funds average can be compared against the pre-meeting futures price. If there is any premium/discount in the futures price, it will provide an indication of the potential rate change impact to the fed funds average for the balance of the spot month, post-meeting. Forward months that have an FOMC meeting will price rate shift expectations in a similar, though easier, fashion. Take the Fed's target funds rate as the expected average funds rate for the days prior to the FOMC meeting, then compare the futures price difference averaged to the balance of the month. Easiest yet are forward months with no FOMC meeting. Simply take the Fed's target rate versus the futures implied rate (100 – FF price), and you can then quickly eyeball expected rate changes.

Historical changes in the market's view of economic strength and potential Fed rate policy response can be derived through comparing similar fed funds futures forward curves at different points in time. Below is a graph of the 1 year curve today (blue line) versus a curve of the same futures contracts 6 months ago. We can see that the start of this year came with expectations of a robust economy producing aggressive Fed hike activity becoming muted over time as actual growth was less than earlier forecasts.



Even though it may seem a bit complicated at first, by understanding the design characteristics of Fed Fund futures one can see their usefulness in depicting market expectations of upcoming FOMC interest rate policy shifts. Luckily, there are some real-time vendor tools that take most of the work out of the process. Below is a Bloomberg screenshot showing the probability of rate hikes at upcoming policy meetings as forecasted by Fed Fund futures forward curves. In your Bloomberg, use WIRP<go>



Also, you can use the link below to call up the CME Group's Fed Funds Probability monitor.

[http://www.cmegroup.com/trading/interest-rates/fed-funds.html?utm\\_source=direct&utm\\_medium=print&utm\\_campaign=CTA-Intelligence-advert](http://www.cmegroup.com/trading/interest-rates/fed-funds.html?utm_source=direct&utm_medium=print&utm_campaign=CTA-Intelligence-advert)

As we approached FOMC meetings in the third and fourth quarters, use these insights into Fed Fund futures and their related tool to view the market's changing expectations of upcoming hikes.

[http://www.cmegroup.com/trading/interest-rates/fed-funds.html?utm\\_source=direct&utm\\_medium=print&utm\\_campaign=CTA-Intelligence-advert](http://www.cmegroup.com/trading/interest-rates/fed-funds.html?utm_source=direct&utm_medium=print&utm_campaign=CTA-Intelligence-advert)

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