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Surprise Halloween Scare on Tap from the Fed?

By Matthew Krupski (Oct 27)

Next week, the U.S. Federal Open Market Committee has a scheduled meeting to discuss monetary policy and determine interest rate policy going forward. With the meeting scheduled for October 31st -November 1st, should investors be wary of a Halloween trick from the Fed, or will they be rewarded with a treat?

At their last scheduled meeting in September, the FOMC announced that the Federal Reserve would begin trimming its $4.5 trillion balance sheet, choosing to limit some of the reinvestment of the principal of their bond holdings as they mature. Additionally, the committee left the target for its benchmark interest rate, the Fed Funds rate, unchanged at 1%-1.25%. At the meeting it also released its expectations of future rate hikes, which revealed that the majority of members expected one additional quarter point rate hike this year, three in 2018 and two more in 2019.

With those expectations laid out by the Fed, the market has reacted with skepticism. The Fed Funds futures markets are a quick and easy way to evaluate market expectations of future short term interest rates going forward. The average implied interest rate over the contract month of a Fed Funds future is simply 100 less the futures price. As you can see from the table below, the market does not believe that there will be a rush to raise rates in the future.

Fed Funds Future	Price	Implied Rate	Fed Estimate
Oct-17	98.84	1.16%	1.16%
Nov-17	98.84	1.16%	
Dec-17	98.725	1.28%	
Mar-18	98.59	1.41%	
Jun-18	98.455	1.55%	
Sep-18	98.41	1.59%	
Dec-18	98.305	1.69%	2.13%
Mar-19	98.24	1.76%	
Jun-19	98.18	1.82%	
Sep-19	98.13	1.87%	
Dec-19	98.09	1.91%	2.88%

Prices for the November 2017 contract reflect an implied Fed Funds rate of 1.16%, which is smack dab in the middle of the current target range. This implies that there are virtually zero expectations for a fed funds rate hike next week.

One important note to remember when analyzing Fed Funds futures prices is that the final settlement price for Fed funds futures contracts is the average Federal Funds rate over the course of the month. On December 13th of this year there is another FOMC meeting. If the committee leaves rates alone next week and then hikes its target range at the December meeting, the final settlement of the contract will reflect the first week and a half of lower rates averaged with the remainder of the month at the higher target rate.

There are many questions as to whether the FOMC's expectations for future rate hikes will be accurate. Chief among them will be who will be the next FOMC chair and how will their philosophy of policy decisions differ from Chair Yellen (Yellen's term expires in February of 2018). While the chair is important, it should be remembered that decisions are made by committee, so deviations from current expectations may be difficult to implement. Traders that are confident in the FOMC's ability to forecast future rate hikes should consider taking short positions in Fed Funds futures, as current rate expectations implied by the markets are below what the Fed estimates. Traders who think there is a chance of a rate hike at next week's meeting should sell November 2017 Fed funds futures in particular, as a 25 basis point hike in the target range could yield a 25 tick winner in the November future. As always, however, remember that futures and options trading is a risky endeavor and should not be attempted without first consulting a professional.

Please call me at 312.242.7978 or via email at matthew.krupski@archerfinancials.com with any questions or comments on these markets. Thank you.