Rediscover Fed Funds

30-DAY FED FUND FUTURES AND OPTIONS ON FUTURES

**Improving Economic Conditions**

Top-line economic numbers depicting the state of the U.S. economy suggest that there are valid reasons to be optimistic – with the unemployment rate at 6.2% and core inflation in the form of the PCE at 1.5%.* The ongoing strength, variable but enduring, of the U.S. economy has led many market participants to believe that a rate hike from the Federal Reserve will be coming sooner rather than later compared to any previous promises and market expectations of mid-2015. It is necessary to caveat that the Fed looks at a plethora of labor market data to make their decisions.

Adding a caveat of heightened food inflation stemming from weather conditions (well out of the Fed’s control), we expect inflation and then core inflation to edge even higher than expected.

Overall, if trends continue, PCE will be above the Fed’s 2.0% target in December 2014, and the unemployment rate will be trending well towards 5.5%.

**Where Are We in the Rate Cycle?**

Tapering of Quantitative Easing, which can be viewed as the elimination of monetary easing, continues, and the only thing standing between now and the first rate hike is unexpectedly weak economic data or the onset of strong international headwinds.

Tapering is on course to end in October, with the FOMC committee members judging that “the economy had sufficient underlying strength to support ongoing improvements in labor market conditions and a return of inflation towards the Committee’s longer run 2% objective” at the July 28 FOMC meeting.

Even more telling is that a prominent, rule-based monetary policy actualized by a OLS regression equation currently implies a Fed Fund Rate (FFR) of 77 bps when run using current values of 6.2% unemployment rate and 1.48% for year over year core inflation. However, changing those values to a 5.5% unemployment rate and 1.8% for core inflation – reasonable numbers which the U.S. economy could attain within a matter of months – the model forecasts a FFR of 2.4%, as the chart shows.

---

*Data as of July 2014.
What Is the Fed Funds Futures Market Implying about Rates?

Rate expectations as conveyed through the futures market are also suggestive. The Implied Effective Federal Funds Rates (EFFR), based on where FF futures contracts have been trading, spiked in numerous contract maturities in May 2013, the likely effects of then Chairman Bernanke’s announcement of the coming tapering of QE. We saw a significant spike again in the implied rate in August 2013, with the release of strong employment numbers. With these spikes continuing since June of last year, expectations for a rate hike have grown.

What Is the FOMC Communicating to the Marketplace?

The FOMC had made clear to market participants that the Federal Funds rate will be a pivotal part of implementing monetary policy moving forward. The continued relevance of the Fed Funds rate means it may be time to take another look at Fed Fund futures.

Quoting the June 17th-18th FOMC minutes:
“...Most participants thought that the federal funds rate should continue to play a role in the Committee’s operating framework and communications during normalization, with many of them indicating a preference for continuing to announce a target range.”
Rediscovering the CME Fed Fund Complex

Under the current economic conditions, and with projections of tightening within the one-year mark, activity in the FF futures complex has already begun to pick up.

- Prior to the onset of zero interest rate policy (ZIRP) in the U.S., CME Fed Fund futures and options averaged 120,000+ contracts per day.
- Fed Fund futures rebounded recently, averaging nearly 58,500 contracts per day for the week ended July 11, 2014.
- On July 10, Fed Funds futures traded 103,751 contracts.
- In 2014, Fed Funds ADVs are up 24%, averaging 22,964 contracts daily (through July 31, 2014).
- Similarly, Eur躲ollar futures are up 18% YTD, and Eurodollar options are up 52% YTD.

A similar story of expectations of an earlier rate increase is also playing out in the Eurodollar space, with hedge funds running a huge short bet in the front-end of the curve.
Futures trading is not suitable for all investors, and involves the risk of loss. Futures are a leveraged investment, and because only a percentage of a contract’s value is required to trade, it is possible to lose more than the amount of money deposited for a futures position. Therefore, traders should only use funds that they can afford to lose without affecting their lifestyles. And only a portion of those funds should be devoted to any one trade because they cannot expect to profit on every trade. All references to options refer to options on futures. Any research views expressed are those of the individual author and do not necessarily represent the views of the CME Group or its affiliates.

CME Group is a trademark of CME Group Inc. The Globe Logo, CME, Globex and Chicago Mercantile Exchange are trademarks of Chicago Mercantile Exchange Inc. All other trademarks are the property of their respective owners.

The information within this brochure has been compiled by CME Group for general purposes only. CME Group assumes no responsibility for any errors or omissions. Additionally, all examples in this presentation are hypothetical situations, used for explanation purposes only, and should not be considered investment advice or the results of actual market experience.

For more information, visit cmegroup.com/ir or contact a member of the Interest Rates team at interestrates@cmegroup.com.

What is the CFTC’s Commitment of Traders Report Telling Us About Market Expectations?

The CFTC’s Commitment of Traders report shows that the net short open interest positions in Eurodollars held by Leveraged Money have increased significantly since end of 2013 – rising to 1.4 million positions, which is 11% of all of Eurodollar O.I. Tellingly, leveraged investors have initiated a net short exposure for the first time since the financial crisis.

What Tools Are Available to Help You?

CME Group FedWatch Tool (cmegroup.com/fedwatch) lets you quickly gauge the market’s expectations of potential changes to the Fed Funds target rate, based on actual Fed Fund Futures pricing.

CFTC Commitment of Traders Tool on Interest Rate Futures (cmegroup.com/ircot) is an interactive tool that can be used to understand positions of various customer segments, by product.