Conflicting Global Signals Complicate Fed Guessing Game

As Trade Digests Latest U.S., China Numbers, A Strong Debut for "Purple" Mid Curve Eurodollar Options

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MARCH 13, 2013

Improvement in the U.S. economy, reinforced by stronger-than-expected February jobs growth, has coincided with stepped-up investor interest in floating-rate notes amid expectations the Federal Reserve will eventually end its ultra-easy monetary policy.

The outlook for tighter monetary policy is supported by the rising spread between the on-the-run 5-Year Treasury yield and the June 2018 Eurodollar contract. The spread expanded from about 178 basis points to about 189 basis points from March 4-11.

Last week, the U.S. Labor Department provided fodder for the strengthening outlook when it reported the nation added a net 236,000 jobs during February, exceeding most estimates. Further, all but one major U.S. financial institution passed the Fed's so-called stress tests.

These dynamics influenced interest rate-based trading in recent days, contributing to a strong March 11 debut for CME Group's 5-Year "purple" Mid Curve Eurodollar options. About 22,200 of these contracts changed hands that day, comprising nearly 10% of overall Eurodollar options volume.

All of that Mid Curve options volume was in the June 2013 contract, which is linked to June 2018 futures.

Intriguing activity in CME Group's interest rate complex comes during a pivotal time for global investors and traders, who are faced with a complex brew of stronger U.S. data contrasting with signs of slowdown in China and lingering political and credit risk in the euro zone.

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Among other events this month, Chinese industrial production and retail sales figures were weaker than expected, while Fitch, the ratings agency, downgraded Italy's debt in the wake of the country's February elections.

Events overseas complicate efforts to get a handle on potential shifts in Fed policy in coming months. Investors likely will increasingly scrutinize statements generated from upcoming meetings of the Fed's policy arm, the Federal Open Market Committee.

FOMC meetings March 19-20 and April 30-May 1 may convey a mild change in the Fed's attitude. But the June 18-19 gathering has more potential to signaling policy change, as Fed Chairman Ben Bernanke and other central bankers will have a good read on labor market momentum and the impact of fiscal policy deep in the second quarter. **As a result, the June meeting could shape the outlook for policy in the second half of 2013.**

For more than four years, the Fed has held its benchmark short-term rate near zero amid efforts to mitigate the 2008 financial crisis and boost the economy out of recession. The Fed funds target range was cut to zero to 0.25% in December 2008, where it's held since.

But a look at CME Group's Eurodollar indicates traders see short-term rates moving higher by the first half of 2014. By June 2018, rates may be around 2.75%, based on today's Eurodollar levels for that period. The Fed funds target hasn't been at that level in early 2008.

Purple June Mid Curve Eurodollar options expire on June 14, just a few days prior to the FOMC meeting. These fundamental dynamics have mixed with technical factors influencing the June 2018 Eurodollar futures and related options.

The June 2018 contract held the February 4 low of 97.185 after working toward the bottom of the trading range that has been in place since May 2012. Ironically, February 4 was the low after the February 1 employment report and March 11 was the next trading day following the March 8 employment report.

Technically, traders may view a trio of old intraday highs in June 2018 Eurodollar futures – recorded around 97.10 between September 2011 and January 2012 - as potential chart support and pivotal to longer term price direction (June 2018 Eurodollars haven't traded below 97.10 since May 2012).

Additionally, a featured trade March 11 was buying of the out-of-the-money June 96.75-97.00 put spread (buying the 97.00 strike and selling the 96.75 strike), with about 11,000 such positions taken out.

This is conservative strategy aimed at capturing a small rise in short-term interest rates (a buyer would realize a profit if prices fell below 97.00, and gains would be capped below 96.75; profits would be limited to 25 basis points per unit, less the cost of the position).

In trading March 13, June 2013 Eurodollars settled at 99.71, compared with 99.675 at the end of last year. The June 2018 contract settled at 97.26, down from 97.675 at the end of last year.

The mixture of strengthening U.S. economic growth, healing U.S. financial conditions, and uncertainty over the pace of economic growth in China and the Eurozone may be benefiting the use of options to manage risk.

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