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Economic Commentary

Odds of a Fed Rate Cut Not 100%

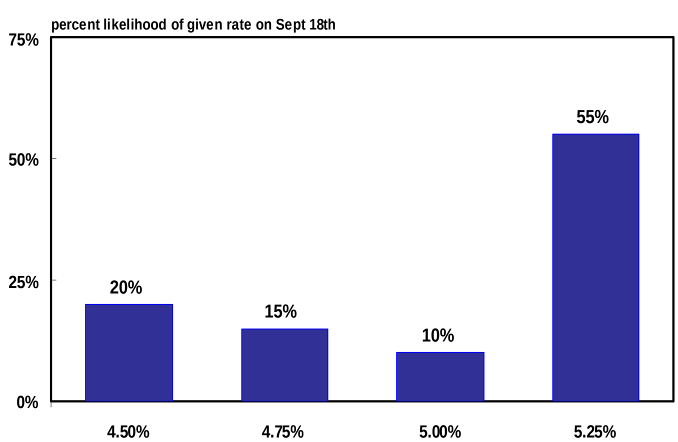
The word on the street last Friday was that the federal funds futures market was pricing in a 100% chance of a rate cut by September. But the price of the fed funds futures contract represents a weighted-average of all the potential outcomes in the months ahead, it is not a point forecast.

As a result, suggesting the market was 100% certain the federal funds rate would be 5% in September was a misinterpretation. The 5% federal funds rate expected was a combination of a variety of different forecasts. Some investors thought the economy was crashing and expected many rate cuts in the months ahead, while others (like First Trust) believed the economy would remain in good shape and the Fed would not cut rates at all.

The options market for federal funds futures showed this more clearly, providing a more textured view of what investors expected.

As the chart below shows, on Friday, options on September federal fund futures were suggesting a 20% chance of 4.5% rate, a 15% chance of a 4.75% rate, a 10% chance of a 5% rate, and a 55% chance of a 5.25% rate.

Expected Federal Funds Rate on Sept. 18th 2007



Source: Bloomberg / First Trust Advisors www.FTAdvisors.com

The weighted average of these figures shows that the numbers from the options market were completely consistent with the futures market yield of 5%.

$$
\begin{aligned}
5.00\% = \; & .20 \times 4.50\% \\
+ \; & .15 \times 4.75\% \\
+ \; & .10 \times 5.00\% \\
+ \; & .55 \times 5.25\%
\end{aligned}
$$

The important thing to realize is that according to the numbers from the options market, the odds of *any* rate cut at all – be it 25, 50, or 75 points – totaled only 45%. On the other hand, 55% of all market participants in the options markets last Friday thought a rate cut was unlikely.

What investors were saying on Friday was that the Fed was more likely to stand pat than cut rates. However, because many market participants believed the economy was in real trouble, some were also saying that if the Fed did cut rates it was likely to cut them multiple times rather than only once.

Let's take an extreme example to better illustrate this point. If 90% of investors expected no rate cut, but the other 10% thought the Fed would cut the funds rate to 2.75%, the average investor would expect a 5% federal funds rate in September. In this example, some would say there was a 100% chance of a rate cut when, in fact, there was only a small minority expecting rate cuts at all.

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