THREE ON THURSDAY

First Trust

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August 8, 2024

The Federal Reserve (Fed), by switching from a scarce reserve model to an abundant reserve model, has completely taken over the short-term interest rate marketplace. What this means is that the markets are not necessarily focused on economic data itself but are trying to figure out what Jerome Powell and the Fed think about the data. In this week's edition of "Three on Thursday," we look at dramatic changes experienced across markets in the U.S. and overseas as expectations evolve about what the Fed (and other central banks) will do. Uncertainty and shifting perspectives about policy changes have led to some severe market volatility. For a more detailed analysis, refer to the three charts below.

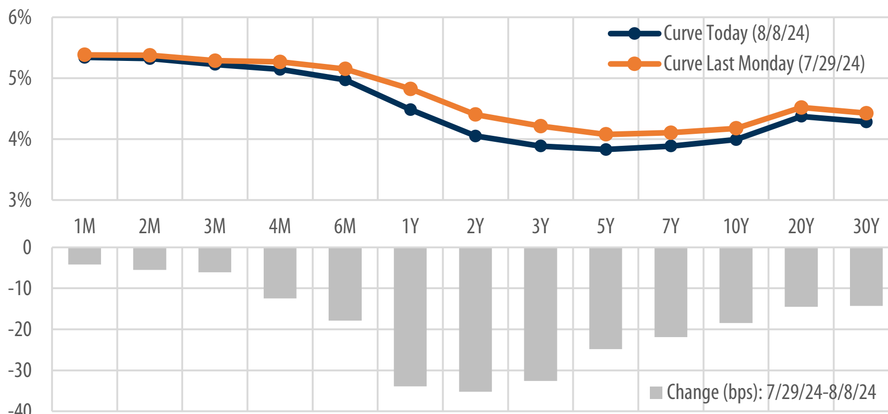
Market Implied Probabilities for Federal Funds Rate

FOMC Meeting Dates	Federal Funds Rate Range (bps) 350-375	375-400	400-425	425-450	450-475	475-500	500-525	525-550	Implied Meeting Outcome
9/18/2024	0.00%	0.00%	0.00%	0.00%	0.00%	**72.00%**	28.00%	0.00%	50 bps cut
11/7/2024	0.00%	0.00%	0.00%	22.40%	**58.30%**	19.30%	0.00%	0.00%	25 bps cut
12/18/2024	0.00%	6.50%	32.60%	**47.10%**	13.90%	0.00%	0.00%	0.00%	25 bps cut

Source: CME Group, First Trust Advisors. Probabilities implied by 30-Day Fed Funds futures pricing data. Estimates as of 8/8/24. Orange highlighted cell represents projected Federal Funds Rate at that meeting date

The CME FedWatch Tool is a widely utilized resource that offers insights into market expectations for changes in U.S. monetary policy, particularly regarding the Fed's target interest rate. This tool calculates the probability of Federal Open Market Committee (FOMC) rate changes for upcoming meetings by analyzing pricing data from 30-Day Fed Funds futures contracts traded on the Chicago Mercantile Exchange (CME). Last Monday, the market anticipated three rate cuts totaling 75 basis points (bps) by the end of the year. However, the market now expects three rate cuts totaling 100 bps, starting with a 50 bps cut at the Fed's next meeting in September.

U.S. Treasury Yield Curve



Source: Bloomberg, First Trust Advisors. Data from 7/29/24 - 8/8/24.

Throughout this year, we've emphasized the importance of extending the duration (lengthening the average maturity) of bond holdings. A common question is: why do this when cash yields over 5% are readily available? Why not wait until short-term yields start to decline? The key reason is that yields, especially in the current artificial environment influenced by the Fed, can change rapidly. For example, as recession fears resurfaced late last week, the yield curve shifted significantly. The two-year Treasury yield dropped by 35 bps since last Monday, while the five-year and ten-year Treasury yields fell by 25 bps and 18 bps, respectively.

JPY USD Spot Exchange Rate

Source: Bloomberg, First Trust Advisors. Daily data from 1/2/23 - 8/7/24.

A significant dislocation has occurred in the Japanese yen (JPY) carry trade. This popular strategy involves investors borrowing yen at Japan's low interest rates and investing the funds in higher-yielding assets or currencies. Profits are generated from the difference between the low interest paid on yen loans and the higher returns from investments. However, this strategy is unraveling as the Bank of Japan continues to raise rates while the U.S. appears poised to cut rates. Lower yields in the U.S. bond market, combined with higher short-term rates in Japan and a 5% appreciation of the yen since last Monday, have triggered widespread margin calls. This has forced the unwinding of carry trades, exerting additional upward pressure on the yen, which in turn will likely lead to further margin calls.

This report was prepared by First Trust Advisors L.P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.