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Using the CME Group FedWatch tool to anticipate rate hikes

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Unless you've been living in an abandoned mine outside of Idaho Springs without television or radio, you've probably heard mention of the Sept. 17 Federal Reserve Board meeting. It was arguably the most highly anticipated Fed meeting in half a decade. It had looked as though the Fed would finally move off its near-zero target federal funds rate; however, the Fed stayed its course and kept the federal funds target rate at 0.0 to 0.25 percent. With all but one of the members voting against an increase in the target range, the Fed told the financial markets it still wants to see improvement in the domestic and global economies before raising rates. The lone dissenter, Jeffrey Lacker of the Richmond Fed, voted to raise the target rate by 25 basis points. So why did the Fed hold off raising rates and how does this affect the debt markets?

For the past few months, every positive bit of economic news has been met with a conflicting statistic or trend that casts doubts on the strength of the recovery. Improvements in household spending, business fixed investment and the housing sector were offset by a softening in net exports caused by a strengthening dollar. An improving labor market with solid job gains and declining unemployment has consistently been discarded when you consider that ordinary wage gains have remained nonexistent for the better half of a decade. A report from the National Employment Law Project indicates wages have effectively fallen since 2009 when taking inflation into account.

Next, the Fed stressed significant concern over the lack of inflation. The Fed utilizes the Personal Consumption Expenditures price index as its inflation measurement, and PCE grew at an annualized 1.24 percent in July, far below the Fed's objective of 2 percent. Projections from the recent meeting estimated the country will not achieve the targeted 2 percent until 2018, which was a full year later than the projection made in June.

Finally, there are still concerns over the state of the global economy. Gross domestic product in Eurozone countries has grown at 1.7 percent annually; however, the European Central Bank is currently undergoing its own €60 billion-a-month bond-buying program and research shows China's exports fell 8.3 percent in July while its factory activity fell to a 6 ½-year low in August. The fact that Janet Yellen mentioned "China" six times in her press conference and the word "global" an additional 10 times shows the Fed had the global economy in mind when it went into its meeting on Sept. 16.

So how did the Fed's decision affect the commercial debt markets and what should we expect moving forward? In the lead up to the Fed's announcement, the yield on the 10-Year U.S. Treasury note, one of commercial lending's main benchmark rates, peaked at 2.28 percent. Many people with whom I spoke feared Treasury rates would spike if the Fed announced a fed funds rate hike. One should realize that the probability of a rate increase was already priced into the pre-announcement 10-Year U.S. Treasury note yield of 2.28 percent.

The efficient-market hypothesis maintains that market efficiencies in the stock market cause existing share prices to incorporate and reflect all relevant information. For example, when looking at the yield of the 10-Year U.S. Treasury note before and after the Fed's announcement, we can see that the market already was pricing in the probability of a rate increase. The morning of the September Fed meeting, pricing of Fed funds futures on the Chicago Mercantile Exchange put the probability of a hike at 28 percent.

A simple back-of-the-envelope calculation indicates that if the markets predicted a 28 percent chance of a 25 basis-point rate hike, there was approximately a 7 bps premium already priced into the 10-Year U.S. Treasury note. When the Fed announced it would not raise its target rate, the yield on the 10-Year U.S. Treasury note dropped to 2.2 percent (down about 8 bps, so pretty close). Had the Fed announced it was raising its target rate 25 bps, one can imagine we would have seen yields increase approximately 15 bps. The CME Group FedWatch tool is not an exact science, but utilizing it can help individuals anticipate the Fed's movements and better forecast changes to the yield on 10-Year U.S. Treasury note related to the fed funds rate.

Going into the September meeting, the CME probability of a rate increase at the Fed's Dec. 15-16 meeting was 64 percent. Quickly after Yellen's press conference, the probability dropped to 42 percent. If the EMH is correct and the markets gradually factor this information into the yield, we will see yields on the 10-Year U.S. Treasury note increase somewhere between 10 to 16 bps between now and the December meeting. It should be noted that the Fed is meeting at the end of October and the probability of a rate increase in October is 11 percent, so there likely will be minimal effect on the yield of the 10-Year U.S. Treasury note in the weeks leading up to the meeting.

No matter what occurs at the next Fed meetings, the last sentence of the FOMC'S Sept. 17 statement is interesting, "The committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the committee views as normal in the longer run." This phrase provides indication that Fed isn't going to be in a hurry to raise rates, even after its economic metrics are achieved. How the market incorporates this information into fed funds futures in the run-up to the next Fed meeting in December remains to be seen.▲