FEDERAL FUNDS RATE EXPECTATIONS: IT'S OCTOBER 2014 ALL OVER AGAIN

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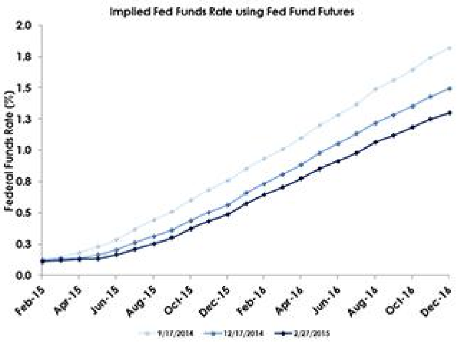
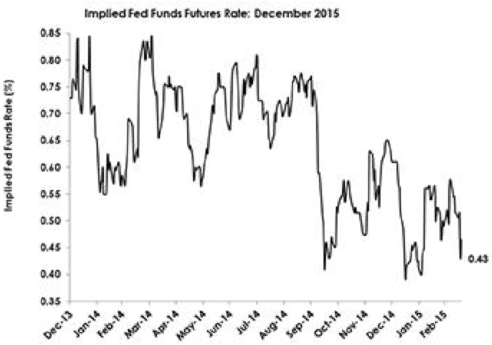
In a previous blog post, we expressed the view that a tug-of-war was under way between the market and the Federal Reserve (Fed) surrounding the timing of the first rate hike. After a series of stops and starts, comments from a variety of Fed speakers and a slight pickup in some U.S. economic data, the Fed took the opportunity to deliver a dovish surprise at its March 18 policy meeting.[1] In advance of Fed liftoff, we thought it would be interesting to examine how the market's expectations have evolved over time. In our view, the current positioning in the Fed Funds futures market does not seem consistent with other market indicators about a potential shift in Fed policy. Additionally, current market positioning may be vulnerable to upward surprises in the economic outlook, similar to moves we saw last October. **Setting the Stage** Below, the graph to the left shows the evolution of Fed Funds futures prices on days of Federal Open Market Committee announcements that include updates to staff economic projections. Over these last three meetings, the market has gradually reduced the pace of interest rate hikes and delayed the date of the Fed's first change in policy. At the most recent meeting, the staff projections showed meaningful downward revisions to the outlook. In the eyes of the market, the switch from time dependent to data dependent meant that rate hikes would likely occur later and at a slower pace. However, the graph to the right shows a much different view of the market's evolution. While it appears as though the Fed has gradually moved in the direction of the "lower for longer" camp, changes in market perceptions are much more volatile than the smooth downward adjustment that these three dates would suggest. **Evolution of Market Expectations** **Implied Fed Funds Rate Using Fed Funds Futures**





Source: Bloomberg, as of 2/28/15. Implied interest rates based on Fed Funds futures prices. Past performance is not indicative of future results.

However, what is most interesting about the market's recent reaction is that we have seen this exact market forecast before. On October 16, 2014, the shape of the Fed Funds futures curve was nearly identical to the market's current outlook.[2] In fact, as we show below, the results are within 2 basis points (bp) of one another all the way out through July 2016 (at which point the current market projections become even more bearish). **Implied Fed Funds Rate (%)**

	10/16/2014	3/18/2015	Difference
Mar-15	0.100	0.118	0.018
Apr-15	0.115	0.130	0.015
May-15	0.130	0.130	-
Jun-15	0.150	0.150	-
Jul-15	0.200	0.180	(0.020)
Aug-15	0.225	0.215	(0.010)
Sep-15	0.265	0.260	(0.005)
Oct-15	0.325	0.330	0.005
Nov-15	0.375	0.385	0.010
Dec-15	0.425	0.430	0.005
Jan-16	0.505	0.500	(0.005)
Feb-16	0.550	0.560	0.010
Mar-16	0.605	0.610	0.005
Apr-16	0.675	0.675	-
May-16	0.755	0.750	(0.005)
Jun-16	0.810	0.805	(0.005)
Jul-16	0.885	0.870	(0.015)
Aug-16	0.975	0.945	(0.030)
Sep-16	1.050	1.000	(0.050)
Oct-16	1.125	1.065	(0.060)
Nov-16	1.200	1.130	(0.070)
Dec-16	1.275	1.180	(0.095)

Source: Bloomberg, as of 3/18/15.

While it would be easy to write this off as coincidence, it's remarkable that other assets, notably U.S. stocks and bonds, have shown a dramatic divergence from this view. With many markets taking cues from the Fed, market prices appear inconsistent with the market moves over the last couple of weeks. Since October 16, the S&P 500 Index is up nearly 14%. U.S. U.S. 2- Year Treasury note yields have risen from 34 bp to 61 bp, and 10-Year rates have fallen from 2.16% to 1.93%. Interestingly, the five-year breakeven inflation rate is virtually the same for both periods (1.48% versus 1.52%).[1] While the dovish tilt in the market may ultimately prove correct, if we do regain economic momentum in key data releases in the coming weeks, the market is likely to react violently to such an upward change in expectations. This view is based on the fact that as we approach Fed tightening, the window for the market to react to such a change in policy becomes more constrained. If the Fed is going to hike rates two times before the end of the year, the futures market will need to adjust higher over a comparatively short amount of time. In our view, while recent data may have softened compared to expectations, we believe that the economy at large has shown some meaningful signs of improvement over the last five months. However, the market is still predicting the same bearish forecast as before. As a result, investors should recall the market reaction to stronger-than-anticipated weekly jobless claims on October 16, 2014.[4] Markets rallied dramatically as an upward surprise boosted Fed rate hike expectations. We believe that the market is underestimating the likelihood of a change in Fed policy in light of a potential uptick in economic momentum. As a result, investors should continue to reduce interest rate risk in advance of any potential change in market sentiment or economic indicators. [1]Source: Federal Reserve, 3/18/15. [2]As of 3/19/15. [3]Source: Bloomberg. [4]Source: Bloomberg.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Implied Fed Funds Rate : refers to the Federal Funds Target Rate implied by the daily trading values of the Fed Funds Futures.

Basis point : 1/100th of 1 percent.

WisdomTree Dynamic Bearish U.S. Equity Index : A rules-based long/short index that includes long equity positions or long U.S. Treasury positions and short equity positions. The Long Equity Index consists of approximately 100 U.S. large- and mid-capitalization stocks that meet Index eligibility requirements and have the best combined score based on fundamental growth and value signals. Stocks are weighted in the Long Equity Index according to their volatility characteristics. The Short Equity Index consists of short positions in the largest 500 U.S. companies, weighted by market capitalization, designed to act as a market risk hedge. The Index provides a dynamic allocation of exposure to the Long Equity Index ranging from 100% to 0% while employing a variable monthly hedge ratio ranging from 75% to 100% exposure to the Short Equity Index based on a quantitative rules-based market indicator that scores growth and value market signals. During times when the market indicator shows unattractive readings on valuation and growth characteristics, the Index can move to 100% exposure to the Long Treasury Index (and accordingly no exposure to the Long Equity Index).

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Floating Rate Treasury Note : a debt instrument issued by the U.S. government whose coupon payments are linked to the 13-week Treasury bill auction rate.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Break-even inflation rate : For a given bond maturity, for example five years, the interest rate on the five-year nominal bond minus the interest rate on the five-year inflation adjusted bond; meant to approximate expected inflation over that time frame, in this case five years.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.