Since the current round of monetary policy tightening began in late June 2004, the Federal Open Market Committee has increased the federal funds rate a total of 2.00%. This total increase is the result of eight rate hikes of 25 basis points (bp) at that and each subsequent meeting, including the most recent meeting on May 3.

Contracts in the options market for federal funds futures can be used to estimate the probabilities placed by market participants on a range of possible future values for the funds rate. These probabilities change frequently in response to Federal Reserve officials’ statements and important data releases.

For example, from March 29 to April 7, the probability associated with a 25 bp increase in the funds rate at the May meeting rose around 20 percentage points, while the probability of a 50 bp increase fell a similar amount. These movements reflected an unexpected increase in first-time jobless claims and a favorable March 31 data release that put February’s core PCE inflation at 1.6%. This news apparently convinced market participants that the Fed could stick to its “measured pace” of increases in the funds rate for the short term. Just before the May meeting, participants in the options market placed a probability of nearly 100% on a 25 bp increase in the federal funds rate.

Federal funds futures told a similar story. Participants almost fully priced in a 25 bp increase in the funds rate at the May meeting. Implied yields on eurodollar futures indicate expectations of further rate increases throughout this year and into 2006.