On January 31, the Federal Open Market Committee (FOMC) voted to raise the target level of the federal funds rate 25 basis points (bp) to 4.50%. Since the FOMC initiated its tightening cycle in June 2004, the target level has increased 3.5 percentage points. The inflation-adjusted fed funds rate now stands more than 300 bp above its low in June 2004. The measured upward pattern of rate hikes is consistent with the FOMC’s stated intention of gradually removing monetary accommodation in order to avoid inflationary pressures.

In recent months, however, FOMC meeting minutes reveal that many members believe that the target is at or approaching its neutral level, which suggests that the pattern of rate hikes may be nearing an end. Nevertheless, the FOMC’s January 31 policy statement release said that “some further policy firming may be needed.” Market participants have heard the message clearly. Federal funds futures indicate that by August the fed funds rate will plateau near 5%.

Options on fed funds futures indicate that the FOMC will almost certainly raise the rate another 25 bp at its next meeting in late March. Moreover, since the January meeting, implied probabilities based on options prices have indicated a better-than-even chance that the fed funds rate will reach 5% by May.

Relatively stable prices in futures and options markets signal that the market expects policy continuity from the FOMC as Chairman Bernanke takes over. His testimony on February 15 and 16, including his remark that “the inverted yield curve is not signaling a (continued on next page)
slowdown,” had no perceptible effect on market expectations; neither did the minutes released on February 21.

Implied yields derived from Eurodollar futures provide a measure of expected policy actions over a longer period. These yields often overpredict the federal funds rate and, like most forecasts, become less accurate as they predict farther into the future. Near-term Eurodollar futures also suggest that the current round of tightening is not over yet.

The U.S. Treasury yield curve flattened further in February and is even inverted in some ranges. For example, on the day after the January 31 FOMC meeting, the 10-year Treasury bond was 5 bp lower than the one-year Treasury note. By the end of February, the inversion had increased to 13 bp.

In the past, yield curve inversions often foreshadowed recessions, but this is not necessarily the case today. In recent years, the FOMC has enjoyed enhanced credibility for maintaining price stability. As a consequence, transitory inflation pressures—such as those associated with the recent surge in energy prices—no longer affect long-term inflation expectations as they did in the 1970s and 1980s. During economic expansions, on the other hand, inflationary pressures still tend to boost short-term inflation expectations. Because interest rates reflect inflation expectations over their corresponding terms, inflation shocks temporarily boost short-term rates relative to long-term rates, while the economy continues to grow. Hence, yield curves may be less informative now than they were in recent history.