Markets suggest that we may be nearing the first pause after federal funds rate increases of 25 points (bp) at each of 17 consecutive FOMC meetings. After the June 28–29 meeting, the rate stood at 5.25%, which represented an increase of 425 bp from the recent low of 1% in June 2004. The current tightening cycle has lasted longer than both the 1994 and the 2000 tightening cycles.

Participants in the federal funds options market currently place a probability of roughly 70% on maintaining the 5.25% target rate at the August meeting. A 25 bp increase has around a 30% probability. On July 19, the CPI release showed that core inflation (excluding food and energy) exceeded expectations by posting a 3.6% (annualized) increase. This would ordinarily have been expected to strengthen the probability of a rate hike, but the release coincided with the Semi-annual Monetary Policy Report to Congress, in which Federal Reserve Chairman Ben Bernanke stated, “FOMC participants project that the growth in economic activity should moderate to a pace close to that of the growth of potential both this year and next. Should that moderation occur as anticipated, it should help to limit inflation pressures over time.” On the whole, his statement signaled to futures market participants that a pause is more likely.

The probability of a pause at both the August and September meetings is roughly 70%; the probability of a 25 bp hike at one of these meetings is approximately 30%.

(continued on next page)
Monetary Policy (cont.)

Implied yields from Eurodollar futures gauge expected policy actions over a longer period. These futures suggest that there may be a pause in the short term before another increase of 50 bp. But the yields often overpredict the federal funds rate and, like most forecasts, become less accurate as they extend farther out.

Future policy rates, along with inflation expectations, help determine the yield curve. Parts of the yield curve are inverted. Rates more than six months out are uniformly lower than the six-month rate. To some, this inversion portends a slowdown in GDP. The spread compared to the three-month rate is not inverted, however. The Friday after the June FOMC meeting, the spread between the three-month and one-year rates was 25 bp; by July 21, that spread had decreased to 12 bp.

An inversion of the rates on the 10-year and one-year Treasury notes is considered one of the best recession predictors. On June 30, the Friday after the FOMC meeting, the 10-year Treasury note was 5 bp lower than the one-year note. By July 21, that spread had widened to –15 bp. The yield on the one-year Treasury note fell from 5.27 to 5.22 over the same period, and the 10-year note fell from 5.22 to 5.07.

The spread between safe and risky bonds is also thought to indicate current and future GDP. There have been slight upticks in the 10-year Treasury’s spreads with two indexes, the BBB (35 bp) and the AA (83 bp).