ARE FED FUNDS FUTURES ALL THEY'RE CRACKED UP TO BE?

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It seems with each new day, Fed rate hike expectations are changing, with these outlooks being skewed toward more increases occurring in 2022 than previously thought. Arguably, the primary gauge for these rate hike expectations is Fed Funds Futures. Investors read it about every day: "Fed Funds Futures implied probability is looking for __ rate hikes." Fill in the blank. However, does anybody ever ask the question, how accurate has this yardstick been in predicting the actual outcome?

This blog post is not meant to be overly critical. Indeed, I am just as guilty of following Fed Funds Futures. There is no doubt it measures market sentiment, and as a result, it does provide some good guidance on Fed policy expectations. It is important to remember, though, that this market reflects what investors *think* the Fed will do, not what the Fed actually *does*.

So, let's go to the videotape and see what type of track record Fed Funds Futures have in predicting the actual outcome of rate hikes. The data only goes back to early 2015, but that should be good enough for our purposes because it includes the last 'stop and go' rate hike cycle. As a reminder, the Fed began the process in December 2015 and finished up in December 2018. I used February as the base month to coincide with where we are now on the calendar:

- In February 2015, the implied probability was looking for essentially two rate hikes for that calendar year, with a nearly 75% chance the first increase would occur in July
    - *The actual first rate hike came in December 2015 and was the only increase for that year*
- In February 2015, the implied probability was also looking for a total of five rate hikes to be implemented by the end of 2016
    - *The only other rate hike to occur was in December 2016 (so two total)*
- In February 2016, one rate hike was expected by the end of 2017
    - *Four increases actually took place between February 2016 and the end of 2017*
- In February 2018, the implied probability was looking for 2.7 rate hikes
    - *The Fed raised rates four times that calendar year*

Perhaps the most glaring discrepancy occurred back in November 2018, when Fed Funds Futures were pricing in 2.5 rate hikes by the end of 2019, but the Fed actually *cut* rates three times during the second half of the year.

Conclusion

Based on this sample, it becomes apparent that *today's Fed Funds Futures* may not actually be *tomorrow's actual Fed rate increases*. Let's go with what the Fed appears to have guided us to, and that lift-off is coming in March with the distinct possibility of a faster tightening pace. Against this backdrop, based on economic data thus far, the FOMC could be poised to front-load rate increases by hiking in March, May, June and July…

and don’t forget their balance sheet drawdown.

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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.

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.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Drawdowns : Periods of sustained negative trends of return.