MARKET FACTS

March 27, 1998
A Historical Look At The Markets

Volume 3, No. 6 | Last Commentary: February 9, 1998

BIANCO RESEARCH L.L.C.
An Arbor Research & Trading, Inc. Affiliate
1000 HART ROAD, BARRINGTON, IL 60010, Phone (800) 876-1825
James A. Bianco CMT,
(847) 304-1511,
jbianco@BiancoResearch.com, www.BiancoResearch.com

Why The Fed Funds Contract Matters

"Federal funds rate futures are one of the things the Federal Reserve looks at as it attempts to measure market expectations of monetary policy, but they are not a dependable indicator, according to research recently conducted at the Federal Reserve Bank of St. Louis." – Market News Service, March 27, 1998

This morning, Market News Service ran the above story (by Steven K. Beckner). It quotes a recently published report by the St. Louis Federal Reserve suggesting that the federal funds futures contract is "not a dependable indicator." The story goes on to explain the inherent biases in the contract that makes using it as a gauge of market expectations "tricky." Fair enough.

We looked on the St. Louis Fed's web site for the latest copy of the "Review." It has not been posted yet. So, until we read the original article, we do not feel it fair to comment further on the specifics of it.

However, as the following tables show, ***we still believe that the Fed funds futures contract is an excellent indicator of Fed policy.***

The MNS story says the study goes back to the inception of the fed funds contract in 1988. We agree that over its lifetime, this contract has a spotty record. However, since the Fed started openly disclosing policy immediately after its FOMC meeting in 1994, it has been an excellent tool. This is why the following tables start in 1994.

We believe that the excellent record of "market expectation" tools such as the MMS survey and the fed funds futures contract is no accident. Since the bond market plunged in 1994, which was triggered in part by an unexpected February 1994 shift in Fed policy, the last thing the FOMC wants is a surprise. Therefore, they purposely "telegraph" all their intentions. But don't take our word for it. From the August 20, 1996 FOMC minutes:

> *"One concern was that policy tightening at this point might generate an excessive reaction in the financial markets, both because it was generally* ***not expected*** *[our emphasis] and because it would represent a change in policy direction that might lead to* ***expectations*** *[our emphasis] of further policy tightening."*

Its not that the market has gotten smarter rather, the Fed makes it intentions very clear ahead of time.

Currently both the MMS survey and the fed funds futures contract are expecting no move next Tuesday. When they are wrong, it has more often been when the consensus expects the Fed to move and it doesn't. What is rare is when the consensus expects no change and the Fed moves (its only happened once in the last 33 meetings – 12/18/95). So, despite the MNS story, we believe these tools are valid and suggest that next Tuesday should be a non-event.

The MMS Survey
The Fed Watchers Are Rarely Wrong

FOMC Meeting	Current Funds Rate	Funds Rate Forecast The Week Before *The Current* FOMC Meeting[1]	Correct?	Funds Rate Forecast The Week Before The *Current* FOMC Meeting For The *Next* Meeting (6 Wks later)[1]	Correct?
2/3/94	3.00	Unchanged	**No**	Higher	Yes
3/21/94	3.25	Higher	Yes	Higher	Yes
5/16/94	3.75	Higher	Yes	Higher	**No**
7/5/94	4.25	Unchanged	Yes	Higher	Yes
8/15/94	4.25	Higher	Yes	Higher	**No**
9/26/94	4.75	Unchanged	Yes	Higher	Yes
11/14/94	4.75	Higher	Yes	Higher	**No**
12/19/94	5.50	Unchanged	Yes	Higher	Yes
1/31/95	5.50	Higher	Yes	Higher	**No**
3/27/95	6.00	Unchanged	Yes	Unchanged	Yes
5/22/95	6.00	Unchanged	Yes	Unchanged	Yes
7/5/95	6.00	Unchanged	**No**	Down	**No**
8/21/95	5.75	Unchanged	Yes	Unchanged	Yes
9/25/95	5.75	Unchanged	Yes	Down	**No**
11/14/95	5.75	Unchanged	Yes	Down	**No**
12/18/95	5.75	Unchanged	**No**	Down	Yes
1/30/96	5.50	Down	Yes	Down	**No**
3/25/96	5.25	Unchanged	Yes	Unchanged	Yes
5/20/96	5.25	Unchanged	Yes	Unchanged	Yes
7/2/96	5.25	Unchanged	Yes	Unchanged	Yes
8/20/96	5.25	Unchanged	Yes	Unchanged	Yes
9/24/96	5.25	Higher	**No**	Higher	**No**
11/13/96	5.25	Unchanged	Yes	Unchanged	Yes
12/17/96	5.25	Unchanged	Yes	Unchanged	Yes
2/4/97	5.25	Unchanged	Yes	Unchanged	**No**
3/25/97	5.50	Higher	Yes	Higher	**No**
5/20/97	5.50	Higher	**No**	Higher	**No**
7/2/97	5.50	Unchanged	Yes	Unchanged	Yes
8/19/97	5.50	Unchanged	Yes	Higher	**No**
9/30/97	5.50	Unchanged	Yes	Higher	**No**
11/12/97	5.50	Unchanged	Yes	Higher	**No**
12/16/97	5.50	Unchanged	Yes	Higher	**No**
2/4/98	5.50	Unchanged	Yes	Unchanged	***????***
3/31/98	***????***	***Unchanged***	***????***	***Unchanged***	***????***
% Correct			**88%**		**52%**

1 = MMS International weekly survey reflecting what the median result was expecting.
Source: Logical Information Machines, Chicago IL

The Fed Funds Futures Contract
Much Better Than Random

The Friday Before The FOMC Meeting	Targeted Fed Funds Rate	Fed Funds Futures Close	Implied Rate	Chg. From The Target Rate	Odds Of A 25 Bps Move?[1]	Consensus Expecting A Move?[2]	The FOMC Moved The Funds Rate?	Was The Consensus Correct?
1/28/94	3.00	96.95	3.05	0.05	20%	No	0.25	**No**
3/18/94	3.25	96.39	3.61	0.36	144%	Yes	0.50	Yes
5/13/94	3.75	95.73	4.27	0.52	208%	Yes	0.50	Yes
7/1/94	4.25	95.31	4.69	0.44	176%	Yes	0.00	**No**
8/12/94	4.25	95.34	4.66	0.41	164%	Yes	0.50	Yes
9/23/94	4.75	95.01	4.99	0.24	96%	Yes	0.00	**No**
11/11/94	4.75	94.41	5.59	0.84	336%	Yes	0.75	Yes
12/16/94	5.50	94.10	5.90	0.40	160%	Yes	0.00	**No**
1/27/95	5.50	94.05	5.95	0.45	180%	Yes	0.50	Yes
3/24/95	6.00	93.97	6.03	0.03	12%	No	0.00	Yes
5/19/95	6.00	94.01	5.99	-0.01	4%	No	0.00	Yes
6/30/95	6.00	94.10	5.90	-0.10	40%	No	-0.25	**No**
8/18/95	5.75	94.28	5.72	-0.03	12%	No	0.00	Yes
9/22/95	5.75	94.31	5.69	-0.06	24%	No	0.00	Yes
11/10/95	5.75	94.28	5.72	-0.03	12%	No	0.00	Yes
12/15/95	5.75	94.37	5.63	-0.12	48%	No	-0.25	**No**
1/26/96	5.50	94.63	5.37	-0.13	52%	Yes	-0.25	Yes
3/22/96	5.25	94.74	5.26	0.01	4%	No	0.00	Yes
5/17/96	5.25	94.71	5.29	0.04	16%	No	0.00	Yes
6/28/96	5.25	94.69	5.31	0.06	24%	No	0.00	Yes
8/16/96	5.25	94.68	5.32	0.07	28%	No	0.00	Yes
9/20/96	5.25	94.58	5.42	0.17	68%	Yes	0.00	**No**
11/8/96	5.25	94.68	5.32	0.07	28%	No	0.00	Yes
12/13/96	5.25	94.64	5.36	0.11	44%	No	0.00	Yes
1/31/97	5.25	94.70	5.30	0.05	20%	No	0.00	Yes
3/21/97	5.25	94.54	5.46	0.21	84%	Yes	0.25	Yes
5/16/97	5.50	94.39	5.61	0.11	44%	No	0.00	Yes
6/27/97	5.50	94.46	5.54	0.04	16%	No	0.00	Yes
8/15/97	5.50	94.47	5.53	0.03	12%	No	0.00	Yes
9/26/97	5.50	94.47	5.53	0.03	12%	No	0.00	Yes
11/7/97	5.50	94.41	5.59	0.09	36%	No	0.00	Yes
12/12/97	5.50	94.41	5.59	0.09	36%	No	0.00	Yes
1/30/98	5.50	94.50	5.50	0.00	0.00	No	0.00	Yes
3/27/98	***????***	***94.48***	***5.52***	***0.02***	***8%***	***No***	***????***	***????***
Bat. Avg.								**79%**

1 = The chance of a 25 basis point move.
2 = The chance of a 25 basis points is greater than 50%
Source: Logical Information Machines, Chicago IL