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What Does A Higher Fed Funds Target Mean For Investors?

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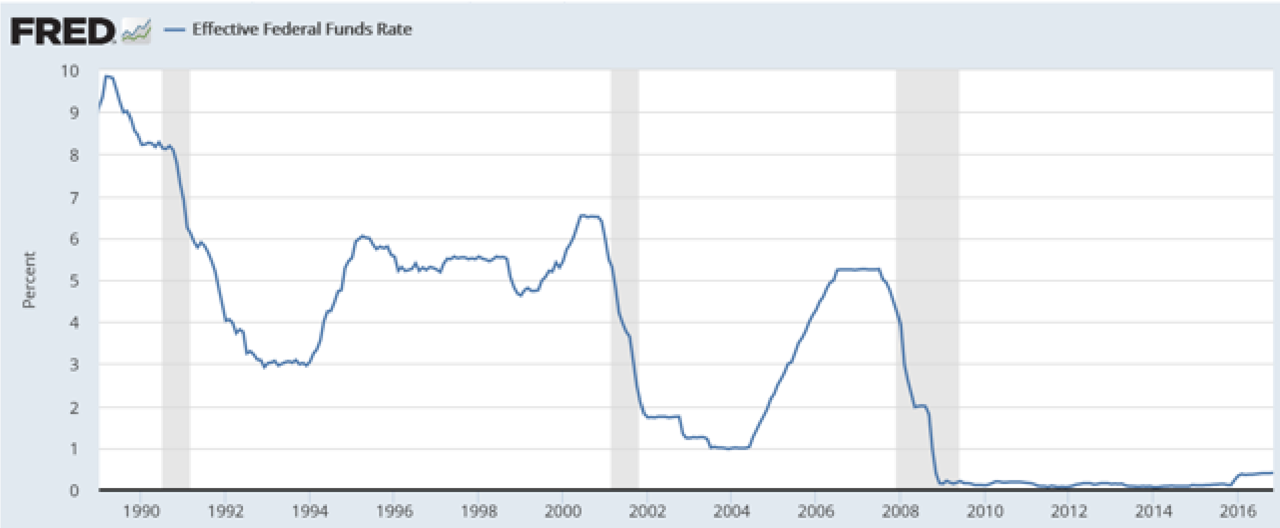
Summary

- FOMC is expected to raise its fed funds target 0.25%.
- Fed fund futures indicate that the FOMC may raise rates an additional 100 basis points by Nov. 2018.
- Bond prices have already dropped since Trump was elected, and they could continue to decline over the next two years.
- The new administration may try to lengthen the average maturity on federal debt.

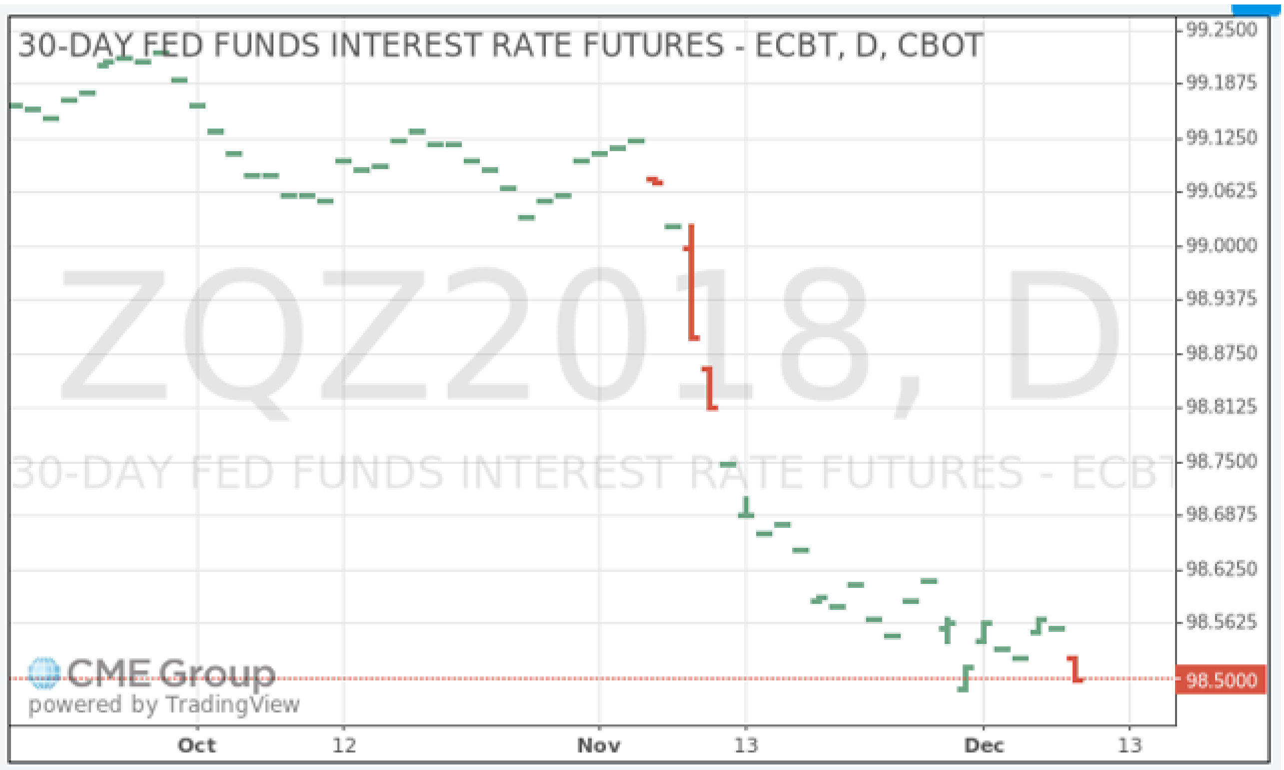
The Federal Reserve is expected to raise its target for the federal funds rate by 0.25% on Dec.14, which could be followed by additional increases in 2017 and 2018. Even long-term bond investors need to include the analysis of the fed funds rate in their investment strategy. Investors should sell their bond holdings or risk significant decline in the market value of their debt portfolio over the next two years. Already the 2.25% '46 bonds have dropped to 82.4141 from 95.8087 on Sept.16. That decline is equivalent to over six years of interest income gone.

The expected new target for fed funds is not a specific fixed rate, but is instead a range of 0.50-0.75%. The fed funds rates fluctuate during the day, and the N.Y. Fed trading desk adds or reduces liquidity to keep the rates within the targeted range. The closing trade was 0.41% on Dec.9. Even with the 0.25% increase, the current range remains at an extremely low level as seen by the below chart.



The future fed funds rates were already drifting higher prior to the election of Donald Trump because the economy was strengthening in the third quarter with 3.2% GDP growth, which was up from 1.4% growth in the second quarter. After the election, the market showed a dramatic increase in expected future fed funds rates.

December 2018 30-Day Fed Funds Futures

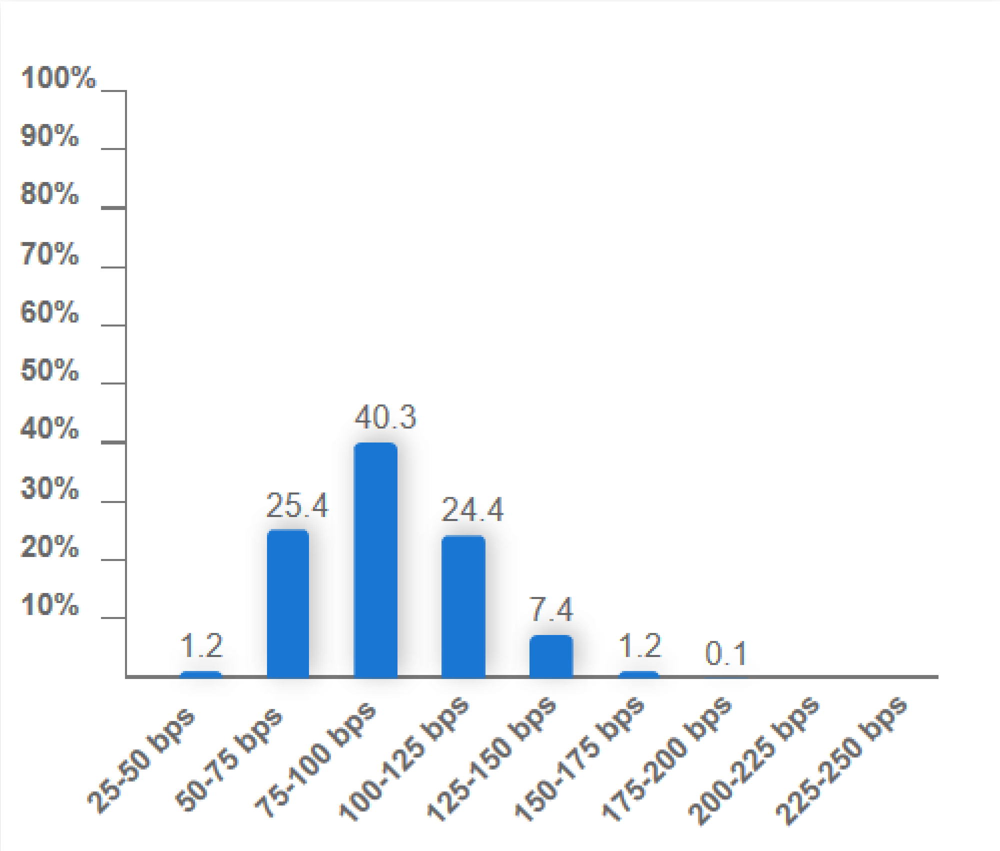


Usually any increase in the Fed's target range is set at its Federal Open Market Committee Meetings, but there have been special situations where the target was changed between meetings. These are the preliminary meeting dates for next year:

2017 FOMC Meetings	
Jan/Feb	31-1
March	14-15*
May	2-3
June	13-14*
July	25-26
September	19-20*
Oct/Nov	31-1
December	12-13*

Using fed funds futures, probabilities for target ranges can be estimated. There is a 73.4% probability that the fed funds target will be set higher at the Nov. 1, 2017, meeting than the expected 0.50-0.75% range set at this week's meeting using CME estimates.

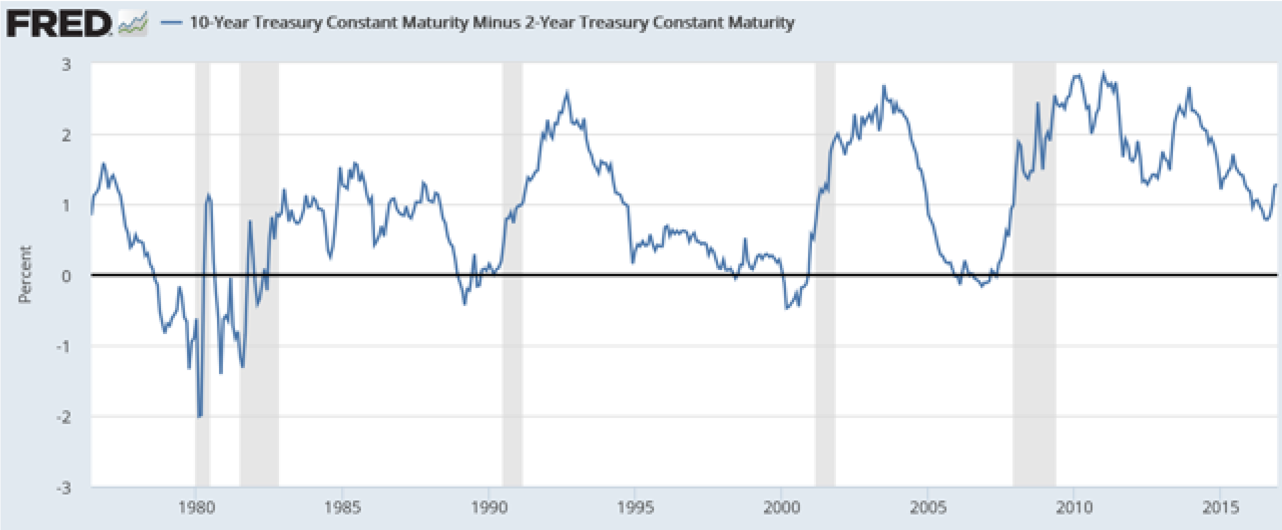
Meeting date: Wednesday, 1 Nov 2017



If fed funds rates are expected to rise over the next two years based on futures prices, how does this impact investors? The Nov. 2018 futures prices indicate that there could be a 100 basis point increase in the fed funds rate from the expected 0.50-0.75% target set this week. Does that also mean that other forms of debt will rise 100 basis points by Nov. 2018? Some say "no" because current debt prices reflect the same outlook of more robust economic growth under President Trump as he expands infrastructure spending and de-regulates businesses and is, therefore, already factored into fed funds futures and other forms of debt. I disagree. I do not think that the current longer-term credit market has not fully factored in strong economy in 2017 and 2018.

Adding 100 basis points to the yield on the 1.5% '26 notes would result in the prices dropping to 83.92 from the Dec. 9 price of 91.64. The price drop for the 2.25% '46 bonds is even more dramatic. Adding a 100 basis points would cause the bond price to drop to 67.61 from 82.41.

If fed funds are 1.50% in Nov. 2018, what should longer-term interest rates be? In theory, the "normal" yield curve should be sloping upward as yields on longer debt are higher than short-term debt. In reality the spreads between long-term debt and short-term debt is highly volatile. In addition to market conditions, these spreads are influenced by policies at the U.S. Treasury. The amount of debt issued by the government at various maturities causes changes in spreads along the yield curve.

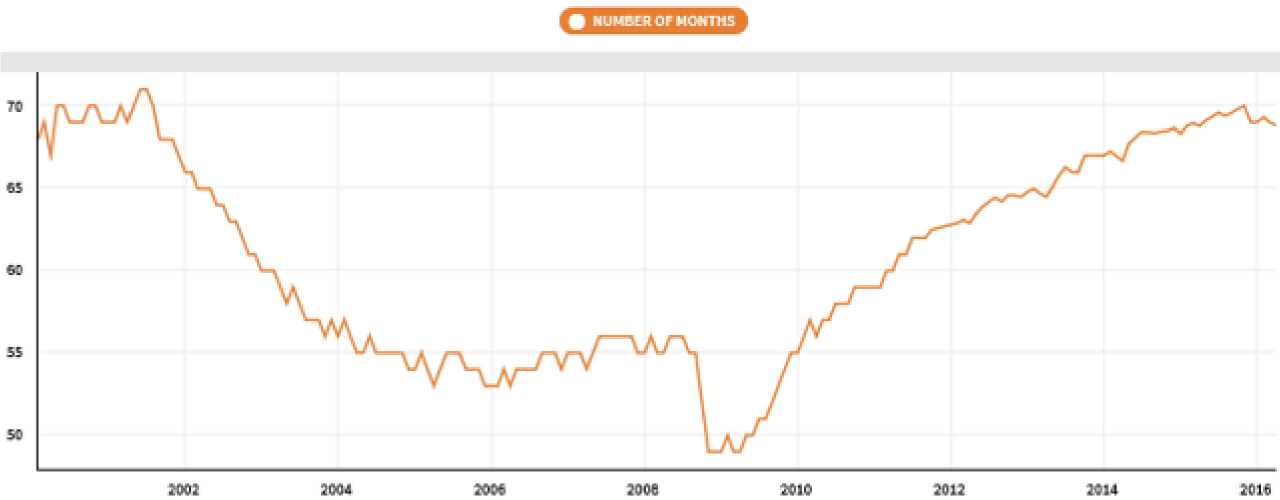


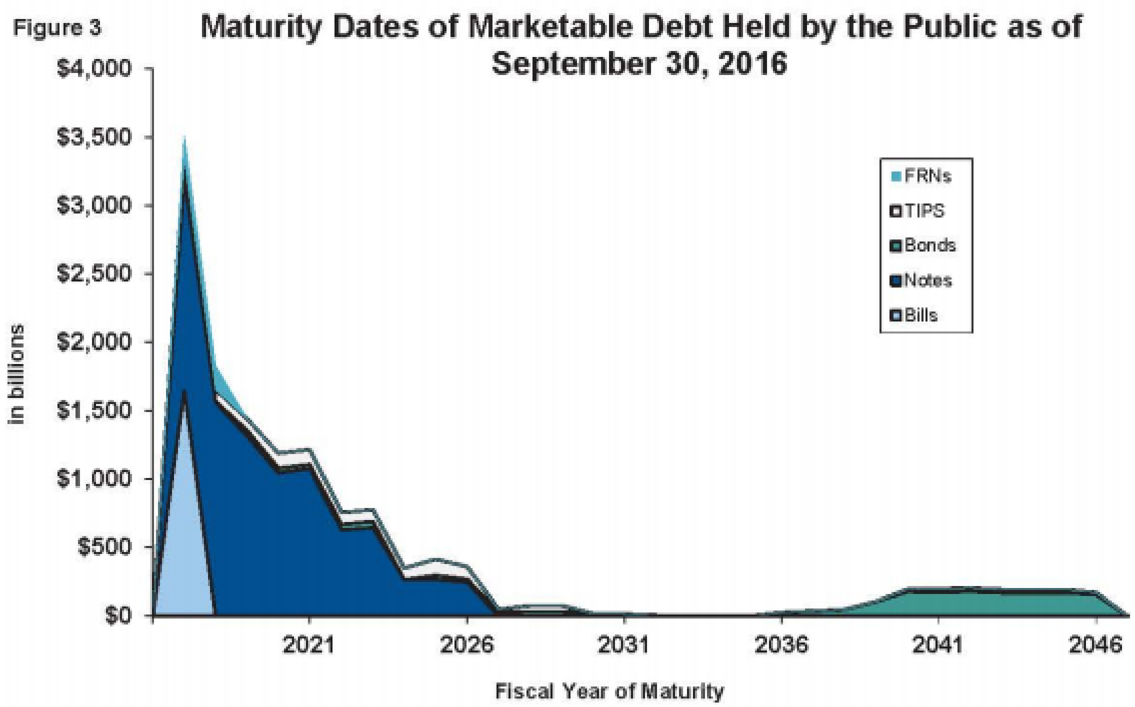
To get an interesting, but not really a scientific analysis, indication of possible interest rates on 10-year notes, I looked at historical rates the day after the FOMC set 1.50% as its new target rate. On Oct. 8, 2008, the target was reduced to 1.50% from 2.0% and the 10-year rate was 3.72%. Aug. 11, 2004, the target was increased to 1.50% from 1.25% and the 10-year rate was 4.30%. The last example did not move to 1.50%, but was reduced to 1.25% from 1.75% on Nov. 6, 2002, and the 10-year rate was 3.88%. Therefore, it is plausible that the 10-year note could be trading at a 3.75-4.0% yield in late 2018, based on current future prices for fed funds.

The U.S. Treasury is already extending the average maturity of the government's debt and could extend the average even further based on comments by Steven Mnuchin in a CNBC interview:

> "We'll look at potentially extending the maturity of the debt, because eventually we are going to have higher interest rates, and that's something that this country is going to need to deal with."

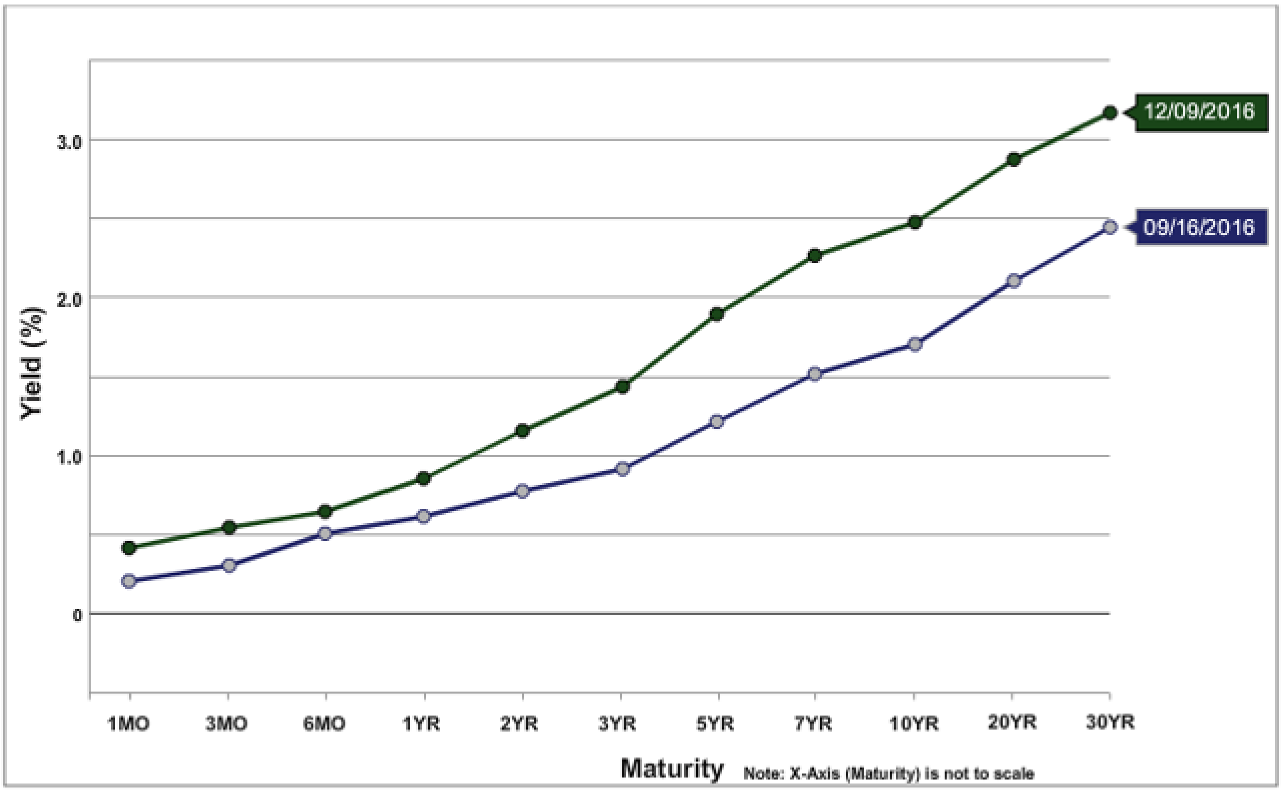
There is $7.969 trillion in Treasury debt maturing within the next four years. Refunding of this debt to longer maturities could put pressure on longer-term interest rates, but the actual rates would remain relatively low on a historical basis.





Source: GAO Report

The yield curve has shifted much higher since I wrote an article recommending investors to sell their bonds because Trump was going to win.



Conclusion

Interest rates have increased sharply since Trump was elected and fed funds futures indicate additional increases by the FOMC of its target ranges over the next two years of 100 basis points. These higher short-term rates would also mean higher long-term rates as the upward sloping yield curve moves higher. In addition, the new Treasury secretary has stated that he wants to extend the average maturity of federal debt, which could put pressure on longer-term yields.

I continue to recommend selling long-term debt and investors should consider selling other investments that trade mostly on their yields.

Disclosure: I am/we are short FED FUNDS FUTURES.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.