

Probability of Fed Action in 2007

April 4, 2007



By using the Fed Funds futures contracts it is possible to mathematically determine the probability that the market is placing on future Fed activity. The expectation of the Fed Funds rate on the expiration date of the futures contract can be determined by subtracting the contract price from 100. Given the market's expectation of rates on specific dates, the change implied on the FOMC meeting dates can be inferred by solving for the appropriate weighted average.

Fed Fund Futures Contract Expiration	Current Price
4/30/2007	5.2500%
5/31/2007	5.2400%
6/29/2007	5.2350%
7/31/2007	5.1950%
8/31/2007	5.1400%
9/28/2007	5.1000%
10/31/2007	5.0400%
11/30/2007	4.9550%
12/31/2007	4.8750%

With the recent increase in rates, the market has reduced the probability that the Fed will ease multiple times in 2007. In the chart below, we have outlined the implied Fed Funds target rates on the FOMC meeting dates. Using the changes implied between the scheduled FOMC meetings a probability can be assigned to a 25 basis point ease in any given period. We can also assess the cumulative probability that a 25 basis point ease will occur prior to a specific date. The probabilities are path dependent in that they are based on the expected Fed Funds rate at the prior meetings.

FOMC Meeting Dates	Implied Fed Funds Rate	Implied Change	Discrete Probability of Fed Action			Cumulative Probability
			-25bp	No Change	+25bp	
Current	5.25000%					
5/9/2007	5.23577%	1.42 bps	5.693%	94.307%	0%	5.693%
6/28/2007	5.21639%	1.94 bps	7.751%	92.249%	0%	13.444%
8/7/2007	5.11785%	9.85 bps	39.417%	60.583%	0%	52.861%
9/18/2007	5.06787%	5.00 bps	19.990%	80.010%	0%	72.851%
10/31/2007	4.95500%	11.29 bps	45.149%	54.851%	0%	118.000%
12/11/2007	4.83705%	11.79 bps	47.179%	52.821%	0%	165.179%

In analyzing the data above, the market does not begin assessing a large probability of an ease until August. On a cumulative basis, the market is assuming a 100% probability of a 25 basis point ease by the end of October.

Kensington Capital Advisors is a derivative advisory firm focused on assisting borrowers and users of derivative products in evaluating, pricing and executing hedge structures. As always, we welcome your questions and look forward to providing independent and expert advice.