

Monetary Trends

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FOMC Decisions and Bond Market Uncertainty

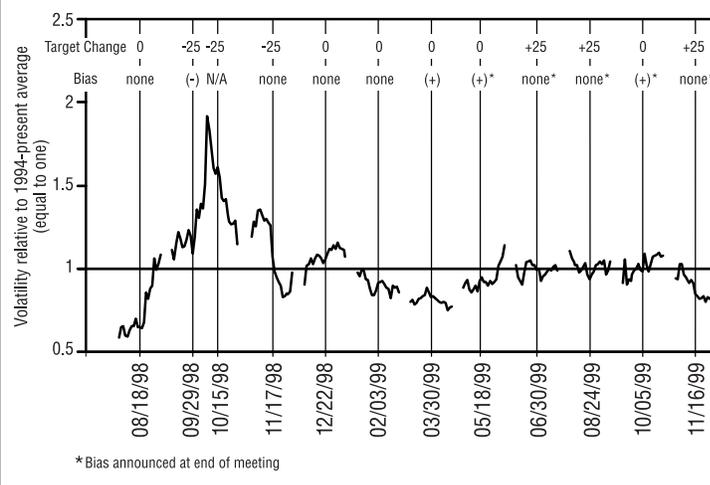
Monetary policy decisions by the Federal Open Market Committee (FOMC) affect market perceptions of the degree of uncertainty about the future course of interest rates. The FOMC influences expectations about interest rates most directly by changing its target for the federal funds rate and by announcing its bias with respect to possible future target changes. Because the FOMC tends to adjust the fed funds target rate in a series of increments, a single target change can induce relatively large revisions to market expectations. Furthermore, starting with its May 18, 1999, meeting, the FOMC has announced its adopted bias for possible future target changes at the conclusion of each meeting. Information about the bias might affect market uncertainty about the future course of interest rates. For example, a switch from a bias to tighten to a symmetric stance may lead bond market participants to believe that a series of interest-rate hikes has concluded or that the series will be more gradual.

To examine the relationship between FOMC decisions and bond market uncertainty, an index of bond yield volatility is useful because higher volatility reflects greater uncertainty about future bond yields. The Merrill Option Volatility Expectations (MOVE[®]) is one such measure that covers a wide range of maturities of Treasury bonds. Analysts estimate the implied volatilities corresponding to at-the-money options with one month to expiration on Treasury bonds with maturities of two, five, 10 and 30 years. These four implied volatilities are aggregated with weights determined by the approximate volume of options traded on each bond. Because a given term structure of interest rates maps onto a sequence of implied forward short-term rates (see page 11), uncertainty about the future behavior of bond yields is equivalent to uncertainty about the future course of short-term interest rates.

The accompanying chart shows the behavior of the MOVE bond volatility index for 10 business days before and after each FOMC meeting since August 1998, including the Oct. 15, 1998, conference call.¹ At the top of the chart, the change in the federal funds target rate and the FOMC's bias are noted for each meeting (+ for a bias toward future tightening and – for a bias toward easing). The 25-basis point cut in the fed funds target rate in November 1998—the third such move that autumn—clearly reduced bond market uncertainty, as markets were apparently convinced that the FOMC's actions were consistent with a continued calming of that autumn's financial market upset. Since May 1999, bond market uncertainty has tended to increase slightly when the FOMC announced a bias toward future tightening but did not change its target for the fed funds rate. On the other hand, none of the three 25-basis point increases in the funds target rate since June 1999 appreciably affected bond market uncertainty, perhaps because each was accompanied with an announced symmetric stance looking forward.

—Michael Dueker

FOMC Decisions and Expected Bond Yield Volatility



¹ Data provided by Merrill Lynch.