

# Discussion of "Fed Funds Futures and the Federal Reserve"

Peter N Smith

University of York

September 2011

- Federal Funds Futures have short maturities - up to 6 months
- So are they less risky?
- Risk premium zero or small?
- Paper shows that the risk premium counter-cyclical and not that small.

# Nature of the risk premium

- Piazzesi and Swanson showed it to be clearly counter-cyclical

# Nature of the risk premium

- Piazzesi and Swanson showed it to be clearly counter-cyclical
- Cycle from recession dummy, non-farm payroll and corporate bond spread

# Nature of the risk premium

- Piazzesi and Swanson showed it to be clearly counter-cyclical
- Cycle from recession dummy, non-farm payroll and corporate bond spread
- Also showed the excess return to be predictable

- Complicated structure of term structure and credit risk
- Novel term structure model that copes with discreteness
- Latent affine factors including the liquidity factor that arises from the LIBOR rates
- Interpretation of  $z$  as a macro factor by correlation with the ADS index - maybe not just macro?

- Model fits well and unbiased target rate forecasts
- (Counter) cyclical uncertainty raises risk premium
- Liquidity not just from LIBOR rates

- Spreads between futures rates and LIBOR very similar to TED spread

- Spreads between futures rates and LIBOR very similar to TED spread
- According to Acharya, Amihud and Bharath (2010) TED spread a very significant predictor of moving into a high stress, bond market illiquidity regime.

- Spreads between futures rates and LIBOR very similar to TED spread
- According to Acharya, Amihud and Bharath (2010) TED spread a very significant predictor of moving into a high stress, bond market illiquidity regime.
- Other significant determinants include: equity market volatility and the Aruoba, Diebold and Scotti business conditions index.

- Spreads between futures rates and LIBOR very similar to TED spread
- According to Acharya, Amihud and Bharath (2010) TED spread a very significant predictor of moving into a high stress, bond market illiquidity regime.
- Other significant determinants include: equity market volatility and the Aruoba, Diebold and Scotti business conditions index.
- More on the TED spread in the paper by Hans Dewachter and Leonardo Lania later on today.

# Liquidity Premium on a big scale

Can the model cope with the LIBOR spreads seen during the financial crisis period?

Model also facing the difficulty of the zero lower bound for interest rates

# Fed Funds Target and Effective Rates and LIBOR 3 months

