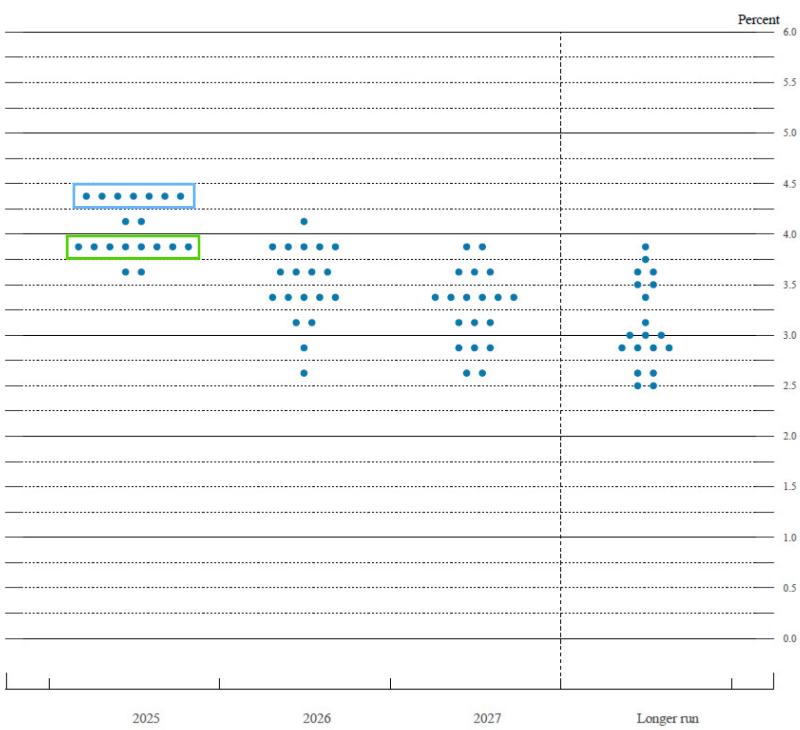
AEGON INSIGHTS

The Fed's theta trade

In options pricing, theta is the time factor—specifically, it represents time decay of the option price and that time decay accelerates as it approaches expiration. We mention this because if you look at the Federal Reserve's "dot plot" of policy rate forecasts, the market is essentially trying guestimate how fast that time decay will be. Does it accelerate into the Fed's September meeting? Or is there enough theta to get into 2026?

Comparing the 2025 dots to the 2026 dots, it's clear that all Federal Open Market Committee members see the path of policy rates moving lower, the only difference is the time it takes to get there. But the board members are split between exactly how much time is needed for this re-start of interest-rate cuts to happen: Almost half see no cuts in 2025, while the other half that sees two cuts. Fast forward to 2026 and all see cuts, with the majority finally seeing two or more.

Federal Reserve "dot plot" map



Source: Federal Reserve Board, Summary of Economic Projections, June 18, 2025.

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Ironically, this “theta game” gets all the focus from market participants and economists, which is understandable, given the economic consequences of high funding costs. But what is arguably more important from a forecasting perspective is in the “long-run” column on the right. What is the ultimate neutral rate of interest?

If a 10-year Treasury can be thought of as the average short-term interest rate over a 10-year period plus a term premium, then the long-term Fed target is pretty important.

Compare that to the “theta game.” If short rates were to fall to 3.0%, but one path of quarterly cuts starts in the third quarter of 2025 and the other path starts in the first quarter of 2026, the difference over a decade is measured in single-digit basis points. What really matters is where that end destination is. Currently, the range of the long-term dots (the destination) is 2.5% to 4.0%. That’s a pretty wide range, which gives the green light for volatility if the market changes its views on which end is in vogue.

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