

Central Bank update: Let's do the twist

Economic research note

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- The Federal Reserve has announced 'Operation Twist' with the aim of extending the average maturity of its holdings and placing downward pressure on longer-term interest rates.
- The US bond market reacted immediately to the announcement; however, the equity market remains concerned about the downside risks to US economic growth and also European sovereign debt problems.
- Operation Twist will face headwinds in assisting the US economy given low consumer confidence and structural issues facing the US housing market.
- However there are few other options for further stimulus in the US given ongoing political debate over fiscal policy.
- Going forward central banks globally will have to continue to implement unconventional monetary measures to help support a stronger economic recovery.

Federal Reserve - Operation Twist

On Wednesday, the Federal Open Market Committee (FOMC) announced it had decided to extend the average maturity of its holdings of securities. This was widely expected by financial markets. The aim of this program is to "put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative". This has been called 'Operation Twist' within financial markets after a similar program was introduced in 1961.

The FOMC has also reiterated its commitment to keep the target range for the federal funds rate at 0 to 0.25% as per the August meeting, given low rates of resource utilisation and a subdued outlook for inflation over the medium term.

Operation Twist was introduced as the Federal Reserve reassessed its economic outlook with a more pessimistic outlook requiring assistance to promote a stronger recovery. Chairman Bernanke noted that "there are significant downside risks to the economic outlook, including strains in global financial markets".

Operation Twist will involve the Fed selling US\$400bn of Treasury securities with maturities less than 3 years, and buying US\$400bn of Treasury Securities with a maturity greater than 6 years, out to 30 years. Note the overall size of the US balance sheet will remain constant with this new initiative. To date, the Federal Reserve's balance sheet had been concentrated in 1 – 5 year securities with 30% of holdings in this bracket.

The below table shows the exact maturity allocation of Operation Twist.

Maturity buckets

6 – 8 years	32%
8 – 10 years	32%
10-20 years	4%
20 – 30 years	29%
Treasury Inflation Indexed Securities	3%

Source: Federal Reserve Bank of New York



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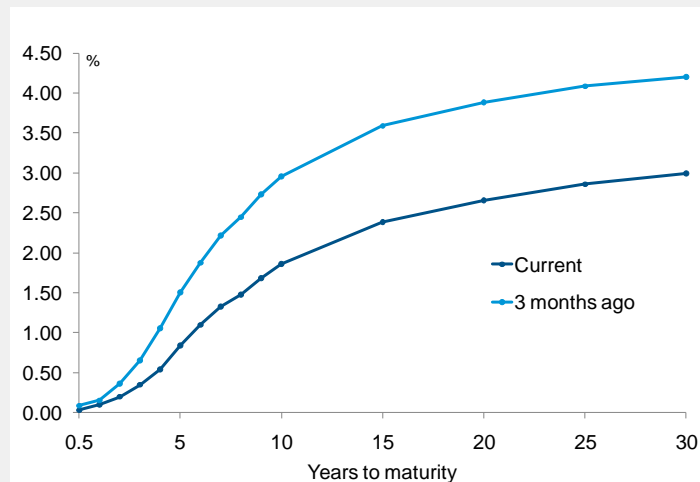
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The surprise for markets was the large allocation to the long end of the maturity profile, the 20 – 30 year bucket. This is an important support for the weak US housing market, with mortgage rates still largely determined by 30-year rates. The hope is lower mortgage rates should encourage new buyers into the housing market. However given low consumer confidence and the political environment in the US, this assumption looks challenged.

The bond market reacted immediately to the announcement, with a large fall in yields at the long end of the US Treasury curve, particularly 30-year yields. 30-year Treasuries yields fell below 3% for the first time since December 2008. As recently as February 2011 the yield was 4.77%. The below chart shows the yield curve has continued to shift down and flatten in the US. Equity markets sold off given the more benign US economic outlook.

US sovereign yield curve



Source: Bloomberg

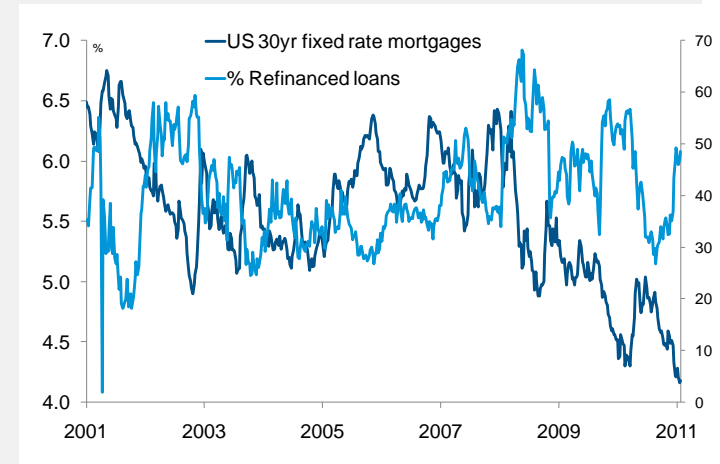
Further support for the housing market included the announcement that “the Committee will now reinvest principal payments from its holdings of agency debt and agency mortgage-backed-securities in agency mortgage-backed-securities”, rather than Treasuries. The aim of this is to prevent a widening of mortgage rates compared to Treasury yields.

The FOMC clearly believes that some of the weakness in the US economy, the so called ‘stall speed’ is still due to problems in the US housing market and the negative wealth impacts this has created. The actions today are an attempt to address this. However, there are several issues that could prove to be a headwind for improvements in the housing market and the overall US economy.

There are reports that refinancing activity has been restricted due to tight lending standards. As the chart below shows, refinancing activity has been relatively low despite the fall in mortgage rates; with refinancing activity significantly lower than 2008 despite the much lower mortgage rate. Only US households with a high credit score are seemingly able to refinance. Also refinancing is not available if a household owes more on the house

than its official value. Last counts estimated that around 30% of homeowners were in this position.

US 30-year mortgage rate and refinancing activity



Source: Bloomberg

There remained three dissenters on the FOMC from the August meeting who did not support additional policy accommodation. The dissent is focussed on the reference to the commitment to keep rates on hold till mid-2013. In the previous meeting, reasons against supporting further stimulus included that more monetary stimulus was expected to have limited impact given the structural changes underway in the US economy. One of the dissenters was also concerned that the implementation of further stimulus looked to respond to market volatility rather than underlying weakness given that since November 2010 (when QE2 was announced) unemployment had fallen and inflation had risen.

Will Operation Twist work?

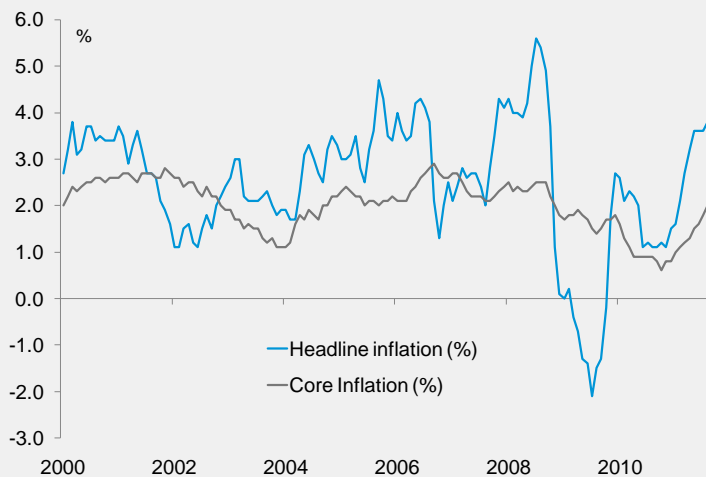
The effectiveness of Operation Twist and lower longer term interest rates depends on improvement of the transmission mechanism of monetary policy in the US. While longer term US Treasury yields have fallen, it is unlikely to fully translate into lower mortgage rates, freeing up household cash flow and encouraging spending.

Given the reluctance of households to borrow and the inability to refinance, only a small impact is likely. On the corporate side, large cash balances are held and demand for corporate credit is lower as a result. The biggest constraint for corporates and therefore improvements in the labour market remain a lack of confidence which is being hampered by ongoing political debate about fiscal policy.

Inflation also remains an issue in the US. As the chart below shows headline inflation has risen to 3.8% and core inflation to 2% as at 31 August 2011. For the long end of the yield curve to remain anchored at a lower rate, inflation expectations must remain low. This will depend on the ability of the Fed to retain credibility over long term inflation expectations. This could constrain further stimulus measures by the Federal

Reserve. Although at this stage the Fed believes inflation pressures have moderated.

US – annual headline and core inflation (%)



Source: Bloomberg

If further monetary stimulus is required by the Federal Reserve, there are still some options available. The balance sheet could be expanded from its current \$US2.84tr in a QE3 program, the interest rate on excess reserves could be reduced or further communication tools could be used, for example setting specific guidance on the unemployment rate before interest rates would be lifted.

However there are few other options outside of monetary policy for further stimulus in the US given ongoing political uncertainty over fiscal policy. Going forward, central banks globally will have to continue to implement unconventional monetary measures to continue to promote economic recovery.

Bank of England

In another nod to further unconventional measures, the Bank of England (BoE) also revealed in minutes released of the early September meeting that they had explored a range of possible tools to loosen monetary conditions - similar to those executed by the US.

The BOE discussed resuming the asset purchase program, changing the maturity profile of assets held on balance sheet and providing explicit guidance on the future path of the Bank Rate. While the BOE decided to leave rates on hold at 0.5%, most members thought it was likely that additional asset purchases would be warranted at some point to loosen monetary policy.

The BOE acknowledged that global growth was likely to be weaker than previously thought, with further fiscal consolidation measures expected to weigh on growth further. Increased uncertainty in financial markets and continuing sovereign debt concerns were also contributing to falling confidence and weaker growth globally.

The BOE also expressed concern over the difficulties European and UK banks could face in obtaining sufficient funding – should current conditions persist. Domestic indicators continued to show weakness in employment, consumer spending, the housing sector and exports. The committee judged there had been little change to their near-term inflation outlook, but downside risks to inflation had clearly increased. Unlike the Federal Reserve, there is currently one member voting for further asset purchases and at this stage appears less dissent for further stimulus at the next meeting.

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