

"Operation Twist"

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Trying to spur the economy, the Federal Reserve announced a plan on Wednesday to reduce borrowing costs for businesses and consumers. "Operation Twist", as the plan is aptly called, is a widely expected stimulus move reviving a policy from the 1960s. The policy involves selling \$400 billion in short-term Treasuries in exchange for the same amount of longer-term bonds, starting in October and ending in June 2012. Although the move does not mean the Fed will pump additional money into the economy, it is designed to lower yields on long-term bonds, while offering minimal adjustment to short-term rates.

This announcement is intended to make borrowing even cheaper for consumers, businesses and municipalities. "This program should put downward pressure on long-term interest rates and help make broader financial conditions more accommodative," the Fed said in a statement issued after an extended two-day meeting in Washington. In theory, lower long-term capital costs should filter through the system in the form of cheaper (and more plentiful) credit. In addition, financial institutions are finally lending more. The FDIC reported that in the second quarter, "total loans and leases at insured institutions rose by \$64.4 billion (0.9%) during the quarter." This rise is essentially the first quarterly increase since the second quarter of 2008.

However, this latest effort by the Fed to jolt the economy has been met by much skepticism. Immediately following the announcement, the markets began to sell off. By end of the day's trading session, the S&P 500 was down 2.94%, while the Dow lost 2.49%, and the NASDAQ was off 2.01%. Wall Street was not the only one to show their dissent. On Monday, Congressional Republican leaders took the unusual step of sending a letter to the Fed chairman, Ben Bernanke, urging him to avoid further stimulus action. Even within the Fed, three regional bank presidents dissented against the decision, the same three who also dissented in August.

The reason for concern is that lower interest rates alone cannot counteract other forces, such as massive lay-offs every month, a poor job market, or a lack of wages increase. Even with interest rates low, many are skeptical that those who really need the reduced rates will be able to receive them. In recent years, lower interest rates have generally allowed people who are already able to borrow do so at lower rates. Homeowners who have a lot of home equity and are current on their mortgages may be given an opportunity to refinance. Rarely have lower rates led to the extension of credit to people who possess a critical need. If a home is underwater, it is very difficult to refinance, regardless of how low rates go.

While “Operation Twist” was highlighted by the \$400 billion exchange in bonds, the Fed is also trying to help homeowners specifically. It was announced that the Fed will take the proceeds from maturing mortgage-backed securities (MBS) and agency debt, and will buy more agency MBS, rather than Treasuries. This could help further push mortgage rates down.

TPI will continue to follow “Operation Twist” very closely. We are cautiously optimistic that this effort will keep interest rates low and lead to additional lending. However, the impact on our nation’s unemployment and consumer demand remains to be seen. Please do not hesitate to contact us if you have any questions or comments.