



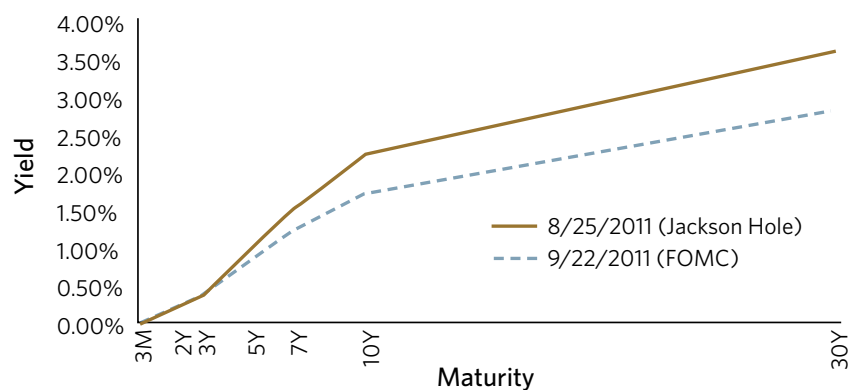
The Fed's Expected Move:

Operation Twist II

Wednesday's announcement by the Federal Reserve's Open Market Committee (FOMC) had been widely anticipated since the late August Economic Policy Symposium in Jackson Hole. "Operation Twist" is designed to place downward pressure on long term interest rates in order to spur refinancing in the housing markets, and perhaps lure investors back into risky investments. Corporate bonds, mortgage-backed securities, and equities could possibly experience a resurgence. For CIS's short duration strategies however, the announcement is virtually a non-event, since short term interest rates are widely expected to remain near zero.

The last time the Fed took a similar action was in 1961, when it managed to lower long-term rates by only 0.15 of a percentage point. According to some economists, Wednesday's announcement will have the same effect. The key action proposed is to sell \$400 billion of short-dated bonds and buy the same amount of long-dated. The action will definitely change the make-up of the Fed's bond portfolio and the immediate effect was evident. According to a Reuters report, the difference between 2- and 10-year yields stood at 157 basis points on Thursday, down sharply from 204 basis points in mid-August, the point at which the markets gradually began to anticipate further monetary easing.

A Flatter U.S. Treasury Yield Curve



Source: Bloomberg



The committee also stated it would now reinvest maturing principal payments from its holdings of agency debt and agency mortgage-backed securities (MBS) back into agency MBS. These had previously been reinvested into new U.S. Treasury holdings. The intent is to push down mortgage rates with particular force.

However, the long term effect of the FOMC's announcement seems cloudy at best. The Fed's action will, of course, flatten the yield curve, the intent being to bring down long term interest rates. It's hoped that this action will also spur refinancing in the mortgage markets, helping to revive the sagging

new housing market, which still faces competition from a glut of foreclosed properties.

But the immediate reaction of the markets did nothing to instill confidence. The general view seems to be that the markets had anticipated the move and had already priced it into the yield curve. As to the two key economic areas still dragging—housing and unemployment—the announcement offered no immediate relief. There had been hope that the move would be larger (\$400B was at the low end of the expectation scale), and the FOMC's pessimistic statement on the general state of the economy seemed

to precipitate equal gloom in the markets. ("Growth remains slow. Recent indicators point to continuing weakness in overall labor market conditions and the unemployment rate remains elevated," read the statement.)

At the same time, the Fed continues to see inflation remaining tame, an outlook that provides policy room if future adjustments need to be made. The FOMC still have some tools available. Interest on Excess Reserves (IOER), for instance, is still on the table. Should that come into play, there will be a definite impact on short duration instruments. But for now, it's "wait and see."

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