Operation Twist

How it May Impact Corporate Treasurers

Abstract

The almost comical sounding term "Operation Twist" has been creeping into the financial media since last December as Federal Reserve officials and market commentators discussed innovative ways to revive the stagnant economy. This phrase became a household name on September 21st, when the Federal Open Market Committee (FOMC) decided to simultaneously buy $400 billion of U.S. Treasury securities with maturities ranging from six to 30 years and sell an equal amount of securities with maturities of three years or less. While the effectiveness of this maneuver on the labor market remains a hot point of contention, its impact on short-term securities has been somewhat overlooked. We believe corporate treasurers may benefit from the "Twist" in the form of some yield relief, although the near- to medium-term yield outlook remains clouded.

Operation Twist 2.0

No, the Fed is not twisting arms to create jobs. Instead, Operation Twist refers to a tactic that the Federal Reserve has employed in the past with the goal of lowering long-term interest rates and spurring growth by influencing the shape of the term structure of interest rates, commonly known as the "yield curve." In this maneuver, the Fed buys long-dated Treasury notes and bonds while simultaneously selling short-dated Treasury bills and notes. By creating demand for the long-dated notes and bonds, the Fed hopes to push up prices, which, in turn, would lower the yields on the long-end of the yield curve. The opposite effect on the short-end of the yield curve would likely raise yields, hence the Twist.

Operation Twist is not a new concept. The Fed introduced Operation Twist in the early 1960s (when Chubby Checker and the dance known as The Twist were all the rage) to spur economic growth during an economic recession. Operation Twist was back in the spotlight in November 2002, after then Fed Governor Ben Bernanke mentioned the 1960s Fed move to combat the threat of deflation in a speech he delivered to the National Economists Club[1]. Governor Bernanke concluded that "academic opinion on the effectiveness of Operation Twist is divided;" remarks that earned him the nickname "Helicopter Ben." In any case, this episode was rather small in scale, did not involve an explicit announcement of target rates, and occurred when interest rates were not close to zero."

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Given this nearly forgotten piece of history, the recent Fed decision, dubbed by some as Quantitative Easing 2.5, actually is Operation Twist 2.0. The key difference, as Mr. Bernanke pointed out nine years ago, is that interest rates were much higher in the 1960s. Furthermore, Operation Twist 2.0 follows two consecutive rounds of quantitative easing, which has injected massive amounts of liquidity into the banking system. This is why sharp disagreement over the policy's effectiveness has been prevalent ever since the idea was floated last December[2].

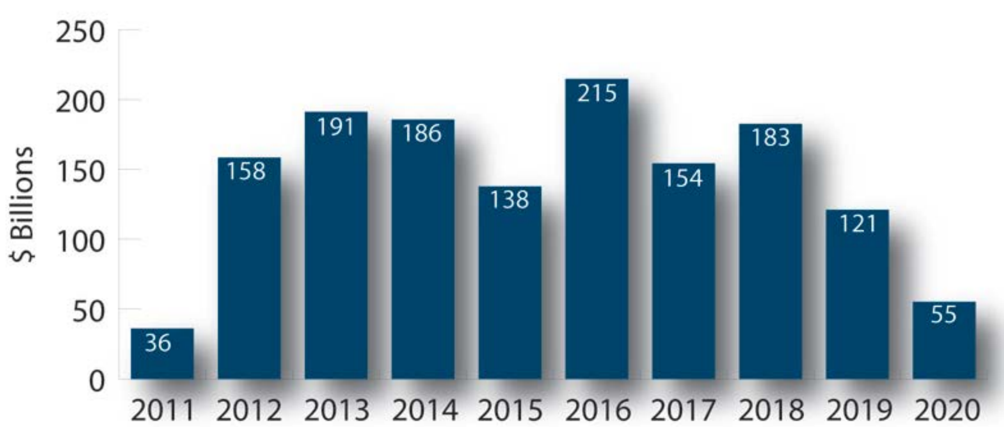
Impact on the Short-term Markets

The current market debate centers mostly on whether Operation Twist will succeed in bringing down long-term interest rates or if it will stimulate lending enough to encourage more hiring and consumer spending. As short-duration bond investors, our attention is focused on how this move may influence the front end of the yield curve and on yields of other types of cash instruments.

Intuitively, the execution of Operation Twist should result in some yield increases on the front end of the curve due to supply dynamics. According to the FOMC's press release, they intend to sell $400 billion of U.S. Treasury securities with remaining maturities of three years or less over the course of the next nine months[3]. This represents roughly 70% of the Treasury securities held by the central bank in the one- to three-year maturity range.

Compared to the $5.43 trillion of all outstanding public debt maturing within five years ($2.47 trillion maturing within one year and $2.96 trillion maturing between one and five years)[4], the $400 billion of Treasury sales scheduled under Operation Twist represents more than 7% of the outstanding Treasury securities in this maturity range. Due to the large percentage of outstanding Treasury debt being sold, a decline in price and, thus, a modest increase in short-term Treasury yields is expected. This may offer much needed relief in the severely overbought market for Treasury bills, which has seen consistent negative yields in recent months.

Figure 1: Federal Reserve System Open Market Account Maturity Distribution



Source: Federal Reserve SOMA Maturity Distribution as of 9/26/2011, Bloomberg.

Along with long-term Treasury rates, the Fed expects yields on home mortgages, corporate bonds and consumer loans to fall. Conversely, we expect yields on repurchase agreements, agency discount notes, corporate and financial commercial paper and other short-term notes to rise. It is difficult to gauge exactly how much short-term yields may rise, especially since the market is in a "risk off" mode of parking cash in government and other highly liquid short-term instruments. Market strategists estimated the probable rate impact of Operation Twist would range anywhere from 0.05% to 0.15%.

Since the start of the Fed's two-day policy meeting on September 21st through September 26th, the yield on the two-year Treasury note rose 0.07%. Yields on the three-month Treasury note, overnight repurchases agreements, and 30- to 90-day dealer-placed commercial paper debt were essentially unchanged during the same period.

Yield Outlook

Perhaps it is not surprising that yields on short-term securities, other than the two-year Treasury note, have not budged much in recent days. We think this trend will persist for the foreseeable future due to the Fed's strategy of keeping the Fed funds target rate "exceptionally low" through mid-2013. In its press release, the FOMC says its commitment "should help anchor short-term rates near current levels, suggesting that shorter-term Treasury rates should not be significantly affected by the maturity extension program." Absent clear signs of economic recovery and resolution of the sovereign crisis in Europe, outside investors may continue to crowd the space traditionally reserved for money market funds and corporate cash investors, putting downward pressure on short-term yields.

But not all is lost. As the upward movement in the two-year Treasury yield suggests, Operation Twist may be most effective in raising yields in the one to three year part of the yield curve, resulting in better yield opportunities. With the Fed anchoring a stable interest rate environment through at least mid-2013, maturities in the one to three year range may represent a sweet spot for corporate treasurers to capture attractive yields without undue concerns for duration risk. Of course, this duration extension strategy works only with a portfolio comprised of high-quality credits and government securities, which may be less susceptible to the ongoing credit concerns in the debt markets.

[1] See the Federal Reserve's website for the archived article of "Remarks by Governor Ben S. Bernanke before the national economists club" in Washing, D.C. on November 21, 2002.
http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm

[2] George Athanassakos, We've seen quantitative easing before – and it didn't work, Globe and Mail, December 20, 2010. http://www.theglobeandmail.com/globe-investor/investment-ideas/experts-podium/weve-seen-quantitative-easing-before-and-it-didnt-work/article1845137/

[3] See the Federal Reserve's website for the frequently asked questions on "Maturity Extension Program and Reinvestment Policy" updated on September 21, 2011. http://www.federalreserve.gov/monetarypolicy/maturityextensionprogram-faqs.htm

[4] See the Treasury Department's "Federal Debt" release document, Table FD-5 as of June 30, 2011. http://www.fms.treas.gov/bulletin/index.html