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U.S. Investment Grade Bonds Will Outperform Cash Under 'Operation Twist'

By David Nowakowski and Prajakta Bhide

- The US$400 billion maturity extension in the implementation of 'Operation Twist' is in line with our expectations, and addresses some of the shortcomings of QE2. While research around the 1961 Operation Twist indicates a modest impact from the program, the Treasury then concentrated its new issuance in shorter maturities, which is not the case today. The decision to reinvest the runoff on the mortgage-backed securities (MBS) holdings into MBS rather than Treasurys in September was a positive signal.
- It is too late to position for the impact of Operation Twist, which should push up yields in the front end and push them down in the long end, although practically, since the Fed also preceded the market operation with a strong commitment to ZIRP, the short end will be pinned down as well.
- The current risk-averse environment, in which liquidity-preference dominates fundamentals, has caused spreads to be wide even on sound, cash-flow positive, liquidity-rich companies. At some point, risk-aversion, benign inflation and Fed intervention should cease, at which point the long-end of the yield curve will be restored to more normal levels; spreads should come down but yields could rise to a precrisis level of 6.5-7.5%.
- Operation Twist is finite and new quantitative easing (QE) or other unorthodox innovations will occur; we expect to see yields falling thanks to lower UST rates, but longer-term spreads widening relative to short-term spreads.
- Investment grade (IG) bonds of high-quality companies and relatively short/medium maturities will far outperform cash and be less subject to negative real yields and financial repression.

Maturity Extension Rather Than Balance Sheet Increase

At the September Federal Open Market Committee meeting, the Fed opted for an extension of the maturity of its balance sheet, without increasing the size of the balance sheet: "Operation Twist." The Fed indicated that US$400 billion in longer-maturity securities (in the six- to 30-year range) would be purchased by June 2012, via the sale of security holdings with maturities less than three years. At the same time, the Fed also announced that it would maintain the size of its agency debt and MBS portfolio at current levels, instead of reinvesting the runoff in long-term Treasurys.

Twist Priced In

Operation Twist should now be fully priced into the markets, as the initial announcement has sunk in and the program is already underway, although it may be expanded. It is too late to position for its impact. Taken at face value, the scheme should (or already should have) pushed up yields in the front end and pushed them down in the long end, although practically, since the Fed also preceded the market operation with a commitment to ZIRP, the short end will be pinned down as well. In terms of economic effects, Fed Chairman Ben Bernanke has claimed that the degree of monetary easing should be on the order of a 50-bps rate cut in normal times—this may be optimistic, as we explain below, but in any case it is not a paradigm change, in RGE's view.

NEW YORK - 95 Morton Street, 6th Floor, New York, NY 10014 | TEL: 212 645 0010 | FAX: 212 645 0023 | americas@roubini.com
LONDON - 174-177 High Holborn, 7th Floor, London WC1V 7AA | TEL: 44 207 420 2800 | FAX: 44 207 836 5362 | europe@roubini.com | asia@roubini.com

With respect to corporates, then, we would expect to see yields falling thanks to lower UST rates, but longer-term spreads to widen relative to short-term spreads. This is exactly the kind of flattening we've already seen. If anything, one should expect that Operation Twist is finite and new QE or other unorthodox innovations will occur.

The current environment is one in which risk-aversion and liquidity-preference dominate fundamentals, which has caused spreads to be wide even on sound, cash-flow positive, liquidity-rich companies. Unless the U.S. follows the path of Japan, at some point, risk-aversion, benign inflation and Fed intervention will cease, at which point the long end of the yield curve will be restored to more normal levels; spreads should come down but yields could rise to a pre-crisis level of 6.5-7.5%.

For a risk-averse investor, the conclusions are clear: IG bonds of high-quality companies and relatively short/medium maturities will far outperform cash and be less subject to negative real yields and financial repression, though they will also give less gains in case of further intervention, an economic rebound that is non-inflationary, or a slow grind into Japanese-style stagnation and ultra-low yield and tight spread environment.

Figure 1: Barcap IG Corporate Intermediate and Long Yields (%)

Source: Bloomberg, RGE

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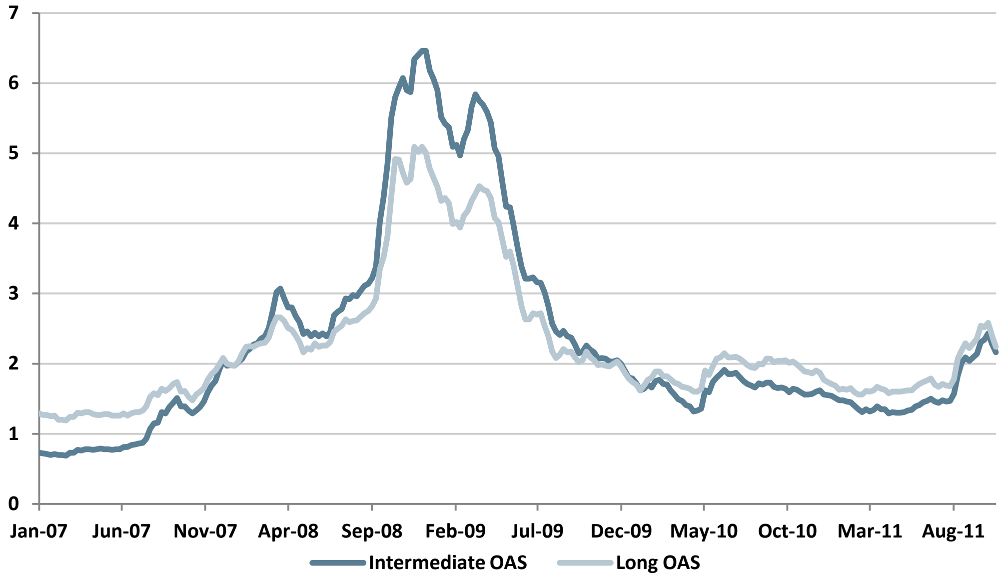
Figure 2: Barcap IG Corporate Intermediate and Long (option-adjusted spreads)



Source: Bloomberg, RGE

Let's Twist Again: Macroeconomic Impact

The purchases of longer-term maturities will be completed by the end of June 2012, and will be distributed as follows:

Figure 3: Distribution of Treasury Purchases Under Operation Twist

6-8 Years	8-10 Years	10-20 Years	20-30 Years	TIPS 6-30 Years
32%	32%	4%	29%	3%

Source: Federal Reserve Bank of New York

The choice of a maturity extension rather than a balance sheet expansion is in line with our viewpoint, and the size of the program—about 4% of total outstanding Treasurys—was also in line our expectations. To compare, the 1961 Operation Twist represented 4.7% of total outstanding Treasury debt, while QE2 represented 7.0%.

While as a share of total outstanding Treasurys, Operation Twist is smaller than QE2, attempting to increase the average maturity of the Fed's balance sheet addresses the key criticism of QE2: that QE2 purchases were of intermediate-term bonds and did little to counter the lengthening maturity of new bond issuance by the Treasury. Throughout the QE2 period, the Treasury continued to issue long-term debt faster than the Fed was buying it. With the Fed's QE2 purchases limited to the 2.5-to-10-year maturity range, the average maturity of publicly held Treasury debt during the first three months of QE2 was higher than it had been in any month over the preceding two years. Research by Hamilton and Wu indicates that the effects of the combined actions by the Treasury and the Fed would be to increase rather than decrease long-term interest rates.

Research indicates that the effects of a policy like Operation Twist are modest. A 2010 paper by Eric Swanson of the San Francisco Fed notes that the original Operation Twist lowered the yield on long-term Treasurys by about

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15 bps and that corporate bond yields were lower by only a few basis points. However, it is important to note that the 1961 endeavor involved coordination between the Fed and Treasury regarding the maturity of new security issuance, in order to ensure the program's effectiveness—at least initially, the Treasury concentrated its new issuance on securities of shorter maturity. This is not the case today.

Under our baseline scenario of a U.S. recession, we expect still more QE (meaning an expansion of the Fed's balance sheet). However, we believe that any future QE—even one that is larger than QE2—will have a smaller effect on the real economy and asset prices in the absence of an accompanying fiscal boost. Given that the credit channel is impaired, we think the Fed needs to climb up the unconventional ladder (via purchases of assets other than Treasurys) to keep policy effective and avoid the growing perception of policy pushing on a string. Unfortunately, we see this outcome as very unlikely, but a deeper economic recession or a financial shock from the EZ would force the Fed to undertake unconventional easing. We note that the decision to reinvest the runoff on the MBS holdings into MBS rather than Treasurys in September was a positive signal, and the recent HARP reform may also meaningfully improve the monetary channel.

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