

Investment Alerts Archive

Operation Twist?

Operation Twist and its impact on the U.S. Economy

On 21st September 2011, the Federal Reserve announced that they would be using "Operation Twist" to spur the U.S. economy that is stalling and on the verge of sliding back into recession. How can Operation Twist achieve this? Or, the more important question is, will Operation Twist succeed?

The Fed's objective of having Operation Twist is to boost the U.S. economy by reducing interest rates on longer-term loans, like mortgages and business loans, thereby lowering borrowing cost for business and consumers and eventually leading to extra cash for higher spending. With the lower interest rates, home purchases and refinancing activities as well as purchases of other "big-ticket" items are supposed to increase. The low government bond yield is also supposed to cause investors to seek higher-risk investment assets in order to get higher yield. However, market participants are generally sceptical about how successful it would be with concerns that the lower lending activity is a result of other fundamental economic and regulatory conditions rather than interest rates. The high unemployment rate also means that consumers may not have the ability to spend more. Thus, even with lower interest rates, businesses and consumers are unlikely to borrow more or increase spending as their confidence in the economy is low. As a result, even though the move was widely expected, investors interpreted the announcement as a sign that the Fed is running out of good policy options, thereby causing the market to tumble.

What is Operation Twist?

Operation Twist is a monetary policy program used by the Federal Reserve which aims to buy and sell U.S. government securities to lower yields on long-term bonds while having little change to short-term rates. The program was first seen 50 years ago in 1961 where the intent was to flatten the yield curve, thereby promoting capital inflows and lifting the dollar. The desired outcome is to bring down interest rates on long-term loans like mortgages and business loans, thereby providing incentives for consumers and companies to borrow and spend. From October 2011 to June 2012, the Fed would be selling a total of \$400 billion in short-term Treasuries in exchange for the same amount of longer-term bonds. The early results of Operation Twist showed a "Visual Success" as yields rose on the short end and sink on the long end, with 30-year Treasury bond yield dropping 17 basis points (refer to Figure 1).

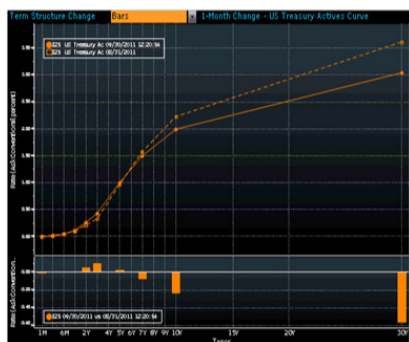


Figure 1: Change in Term Structure Curve of US Treasury Actives; Source: Bloomberg

For the Investor

With the current uncertainty in the market, what should investors do? Diversification is even more crucial now so as to reduce investors' risk exposure by having exposure to different asset classes.

Investments into bonds or bond funds could help in reducing elements of risk together. With lower yields on long-term government securities, long-term corporate bond yields are likely to follow suit, thereby resulting an increase in corporate bond prices (which are inversely related to bond yields). At the same time, in a low interest rate environment, bond investors could still receive regular income stream from the coupon payments. However, credit risk on issuers of the bonds should be taken into consideration to ensure that investors are taking on risk which they are aware of. Investors who want to diversify across various bonds can consider bond funds like Templeton Global Total Return Fund or Pimco Total Return Fund.

Investors can also consider using alternative investment strategies like Man AHL Trend. The fund can hold both long and short positions and has exposure to a wide array of asset classes, thus portfolio diversification may be achieved.

Please contact your Premier Relationship Managers for more information on investment suitability and risk of the funds.

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