September 21, 2011

Economics Group

Special Commentary

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"Operation Twist" Gets Underway

As many analysts had expected, the Federal Reserve embarked upon "Operation Twist" today.[1] That is, the Fed announced that by June 30, 2012 it will purchase $400 billion worth of U.S. Treasury securities with maturities of 6 to 30 years. It will also sell an equal amount of securities with maturities of less than 3 years. The Fed's intent is to bring down long-term interest rates even further and, hopefully, to spur more borrowing. The Fed's action seems to have had the desired effect, at least initially, with the yield on the 10-year Treasury security down about 6 bps in the immediate aftermath of the announcement. (As of this writing, the yield has dropped to 1.88 percent, the lowest rate in decades.) The yield on the 30-year Treasury security, the so-called "long bond," was down about 15 bps. In contrast, the 2-year government bond yield edged up a few basis points.

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Most long-term mortgage rates are based on a spread over the 10-year government bond. The Fed's increased purchases of longer-dated Treasury securities will have little effect on mortgage rates if spreads widen. The Fed currently holds about $1 trillion worth of agency debt (i.e., the debt obligations of Fannie Mae and Freddie Mac) and mortgage-backed securities on its balance sheet (Figure 1). To help ensure that mortgage spreads do not widen, the Fed also announced that it will reinvest the principal proceeds of maturing agency debt and mortgage-backed securities in other mortgage-backed securities. By increasing its purchases of mortgage-backed securities, the Fed hopes to reduce mortgage rates.

Figure 1

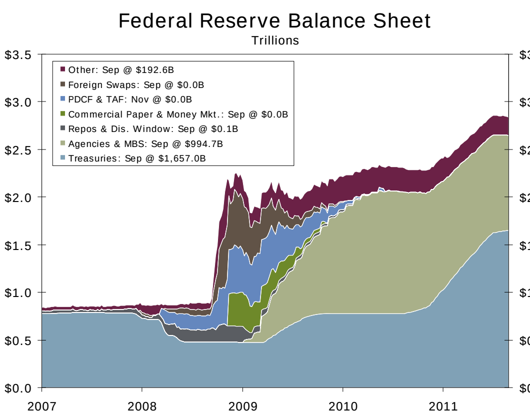
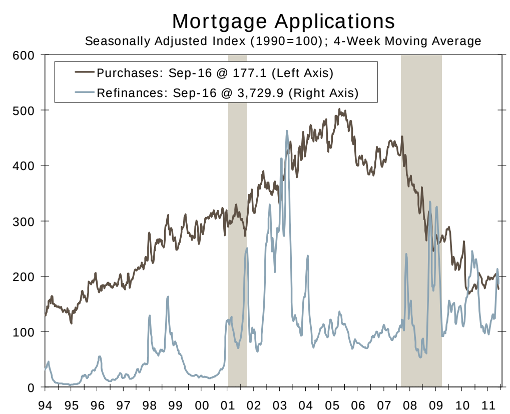


Figure 2



Source: Federal Reserve Board, Mortgage Bankers Association and Wells Fargo Securities, LLC

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[1] **"Operation Twist" gets its name from a similar program that the Fed enacted in the early 1960s when it bought long-dated Treasury securities and sold short-dated securities. By selling at the short end of the yield curve and buying at the long end, the yield curve flattens, or is "twisted."**

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In our view, however, the problem is not that long-term interest rates, especially mortgage rates, are too high. Indeed, the interest rate on the 30-year fixed rate mortgage is only about 4 percent at present, the lowest rate in decades. Rather, the problem is that credit remains very tight and many homeowners are "underwater," preventing them from refinancing at very attractive rates. Despite historically low rates, mortgage applications for purchase remain depressed (Figure 2). Applications for refinancing have ticked up in recent weeks, but much less than what would be expected given today's historically low rates.

The Fed long ago ran out of conventional "ammunition."

Therefore, we do not believe that "Operation Twist" will be the silver bullet that is needed to solve all the economy's problems. We do not mean to criticize the Fed for its actions today. The Fed long ago ran out of conventional "ammunition." That is, the FOMC cut the fed funds rate to essentially zero percent in December 2008, the level where the fed funds rate remains today. If the Fed could cut its main policy rate even further, it clearly would. However, the lower bound of zero percent is preventing the Fed from undertaking further conventional stimulus. The Fed is in uncharted territory at present, and it is doing all it can to help the struggling economy get back on its feet via unconventional policy actions.

Could the Fed do more? Arguably, the FOMC could authorize another round of quantitative easing (QE). However, the efficacy of further QE is unknown, and the policy is seen as controversial, certainly outside of the Fed and arguably within the Fed as well. As they did at the last policy meeting, at which the FOMC said that it would keep the fed funds rate at "exceptionally low levels...at least through mid-2013," three FOMC members voted against today's decision because "they did not support additional policy accommodation at this time." QE3 could eventually occur. However, we think that the bar for further QE is relatively high. Only if inflation recedes significantly over the next few months and/or the economy appears to be rolling back into recession do we think that a critical mass of Fed policymakers will support another round of QE.

We do not expect the Fed's actions today to have a significantly stimulative effect on the economy.

As noted above, we do not expect the Fed's actions today to have a significantly stimulative effect on the economy. The Fed's actions may help on the margin, but we project that the economy will continue to muddle along at a subpar pace over the next year or two. As we have written previously, it is hard to get a strong recovery underway if, as we expect, residential construction remains depressed. In addition, continued de-leveraging by consumers likely will exert headwinds on growth in personal consumption expenditures. Therefore, we forecast that real GDP growth will remain sluggish despite the best efforts by the Fed.[2]

[2] **See our *Monthly Economic Outlook* for our macroeconomic forecasts and our *Housing Data Wrap-Up* for our views on the housing market. Both publications are posted at www.wellsfargo.com/economics.**

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