



# Economic Flash!

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**Peter Buchanan (416) 594-7354**  
**Emanuella Enejajor (416) 956-6527**

## ***Time to Twist Again***

Digging into the annals of monetary history, the Fed validated market expectations today for a new “twist-style” initiative. In a bid to further lower long term rates, the Fed announced that it will sell securities from its Treasury holdings with a maturity of 3 years or less to the tune of \$400 billion, purchasing a comparable amount in the 6 years plus part of the curve. The operation, expected to be completed by June 2012, is at the upper end of the market’s expectations.

Beyond the move to extend the term of the Fed’s near-\$3 trillion portfolio, the Committee also focused its attention on the still-ailing mortgage market. The Fed will now re-invest principal payments from its holdings of agency debt and agency mortgage backed securities into agency MBS, rather than into Treasuries as done previously. The Committee, for now, has decided not to proceed with another easing option discussed by Bernanke earlier—an increase in the rate paid on excess reserves held at the Fed. Although that move could potentially reduce incentives to park cash with the Fed, given how low rates are, the impact would be only marginal.

Additionally, the FOMC reinforced its earlier expectations that the target for the funds rate will remain in the 0-¼% range through the middle of 2013, based on continuing anticipated “low rates of resource utilization and a subdued outlook for inflation over the medium-run.” On the inflation side, the statement reiterated earlier concerns that that rate will “settle over the coming quarters at levels at or below those consistent with the Committee’s dual mandate”.

Although no new quantitative projections are provided, the language on the economic side remains cautious, much as in the August statement. The Committee once again took note of appreciable downside risks to the outlook, adding the words “strains in global financial markets” although some “pickup” in growth is expected over coming quarters. The cautious economic tone and continuing concerns about too weak inflation going forward leaves the door open for another round of QE, if conditions deteriorate further rather than pick up as the Fed currently anticipates.

As at the August meeting, the motion was opposed by Fisher, Kocherlakota and Plosser who do not support additional policy stimulus at this time.

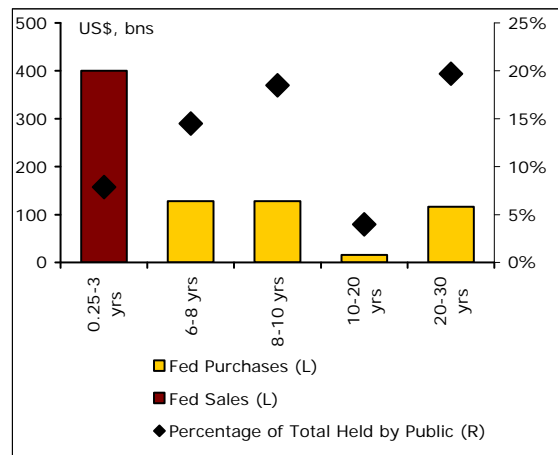
## Economic/Market Implications

Treasuries at the long end rallied as a result of the announcement, with the size of the program coming in above what many had been expecting. In particular, the impact on 30 years was pronounced, as the details of the anticipated distribution of Treasury purchases suggest a measurable impact on that sector of the curve (Chart 1).

Equity markets initially held up, but lost appreciable ground later, given the still-downbeat outlook expressed by the Fed and acknowledgement of downside risks to the economy. Indeed, a modest decline in longer-term rates won't provide a strong lift to activity. A bigger lift from lower yields would come if the US was able to liberate underwater mortgage borrowers (now standing around 30%). With monetary policy reaching its effective limits, attention will continue to turn to steps that can be taken on the fiscal side to keep the economy afloat next year.

Overall, today's announcement, though slightly above what the market had been anticipating, should not provide more than a marginal boost to growth. If the US economy indeed avoids a recession next year, bond yields should rise both here in Canada and south of the border. But the timing of higher US Treasury yields will likely be pushed off due to operation twist—boosting the yield advantage of Canadas.

Chart 1-  
Operation Twist: the Details



Source: NY Fed, Bloomberg, CIBC

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