September 2011

Fidelity 富達 WORLDWIDE INVESTMENT

Market Perspective

Implication of the US "Operation Twist" and other latest actions

On 21 September 2011, the US Federal Reserve announced a $400 billion stimulus program known as 'operation twist' – a bold attempt to drive down long-term interest rates and boost the flagging US economy. But will the Fed's actions be enough to stave off recession?

Markets are unconvinced and, with one eye still on the unresolved European debt malaise, markets have reacted negatively to the announcement and the Fed's bleak assessment of the economic outlook. This piece outlines the Fed's latest actions and considers the implications for investors.

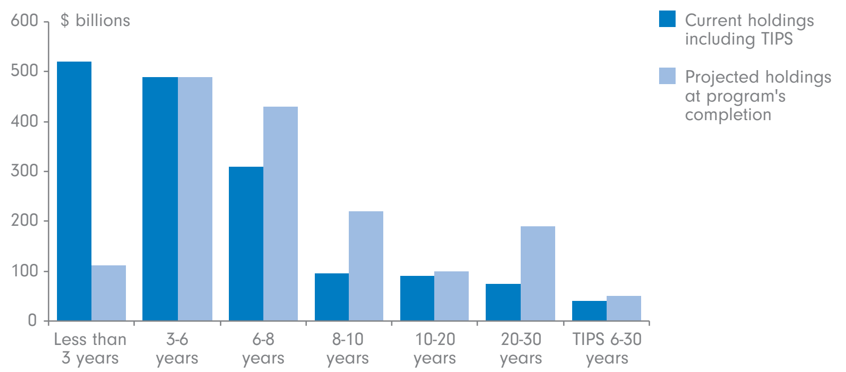
What is 'operation twist'?

The Fed now owns $1.65 billion of US government bonds after two rounds of quantitative easing, when it bought more US debt to inject liquidity into the economy.

However, the US economy is stalling and the Fed is not yet planning more asset purchases which would expand its balance sheet. The bonds it already owns will mature at different times – between one and 30 years. The Fed plans to sell some of its short-dated bonds in order to buy longer-dated issues. This will be a net stimulus to the economy and support financial markets, without expanding the Fed's balance sheet.

It is hoped that operation twist will depress the yields on longer-dated bonds, in theory flattening the yield curve – 30% of the purchases will be in the 20- to 30-year range. The Fed wants to encourage banks to make longer-term loans, such as mortgages to home buyers and loans for small businesses. The Federal Open Market Committee (they set interest rates and control money supply growth) made a statement that further unorthodox stimulus is also under consideration.

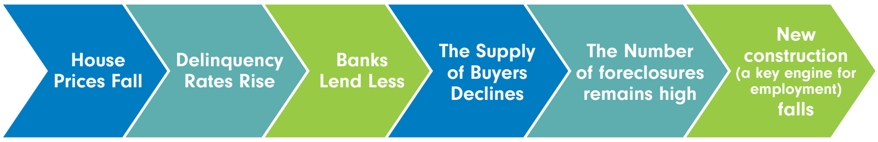
Distribution of the Fed's holdings by maturity



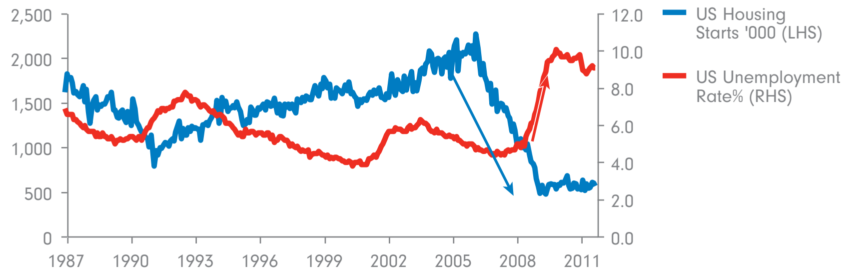
Source: WSJ estimates based on Federal Reserve Bank of New York data and published statements.
Doesn't take into account rollovers of maturing debt or how the natural maturing of debt would change the distribution.

Implications for US housing

In addition to 'Operation Twist', the Fed surprised markets by saying it will reinvest the payments from the maturing mortgage backed securities it owns back into similar securities to support the mortgage market. The Fed's intention here is to boost the housing sector and, in turn, the broader economy. The Fed recognises that a modest decline in house prices can be self-reinforcing.



US Housing starts and the unemployment rate (%)



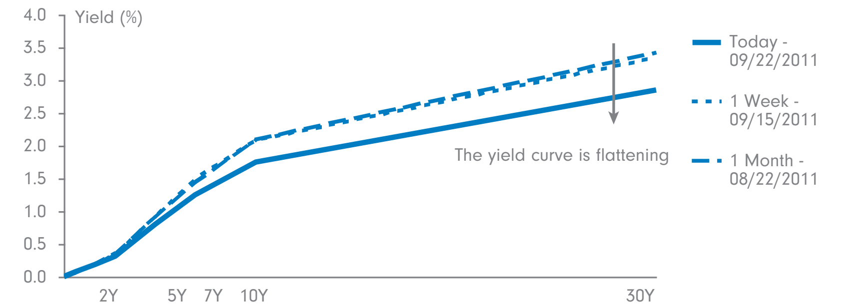
Source: Datastream, 22.09.2011

It is the bigger picture that is worrying markets: the eurozone debt crisis, the possibility of a US recession and hard landing in China – the Fed's latest action won't provide a solution to these issues. It is not a gamechanger.

How have markets reacted?

Equity markets reacted negatively to the Fed's gloomy outlook for the US economy which talked of "significant downside risks"; this has been accompanied by a sharp downward revision of global growth in a recent IMF report. 10-year Treasury notes have largely priced in the Fed's latest actions, but yields on 30-year Treasuries fell below 3.0% from 3.2% at the start of the week.

US Treasury Yields since the end of August – big action in the 30 year



Source: Bloomberg, 22.09.2011

Implications for investors

This latest action from the Fed offers mores support to bonds than equities. Equity investors should not panic given a very gloomy outlook has already been significantly priced into shares. Indeed, there is value to be found if patient investors are willing to stomach a little short-term volatility and take a long-term view. Allocating to high-quality, high-yielding shares could help weather the current storm and deliver good total returns. Equity yields are now extremely attractive.

Last but not least, the diversification benefits offered by multi-asset investing should serve investors well, whilst smart tactical decisions can help to protect investors' capital.