

# Operation Twist.

The US economy is clearly weaker now than it was a year ago. Why then is the Fed's response to use weaker medicine (Operation Twist) than the previous rounds of QE? I can think of one reason; it has no other viable policies which are politically acceptable or that do not come with unacceptable side effects.

Operation Twist puzzles me a bit. Buying longer dated US treasuries while selling shorter dated ones is not full blown QE in that it doesn't really print money. Instead it is likely to flatten the dollar yield curve further and depress the cost of long term funding, assuming that the credit transmission system is functioning. But the curve was already flat and flattening even before the Fed's announcement. For the US treasury, OpTwist is effectively a refinancing exercise where it swaps short term debt for long term debt. For that, the treasury owes a debt of debt to the Fed. Yet why was the Fed needed to effect this given how well US treasuries are bid? The problems in the US economy lie elsewhere.

While the yield curve is quite flat, there is easily a good 50 – 100 basis points more of flattening that could occur. And 400 billion usd is not a small number. The easy trade is to front run the Fed and get ahead of the curve flattening further.

The trade in equities is harder to see. OpTwist is likely to increase the cheapness of equities relative to bonds and may provide some boost to equities but this is grasping at straws. The fundamental drivers of equities are likely to dominate any interest rate effects.

The gold trade is interesting. Gold has always been an inflation hedge and protection against the debasement of fiat currency. The previous round of quantitative easing had clear implications for currency as it was an outright debasement. The current nature of OpTwist is different. It lengthens duration but it does not actually inject more money into the system and is therefore not likely to translate into a direct substitution away from cash to gold. To the extent that gold may have priced in a more aggressive stimulus, it could have run ahead of itself and thus need to correct further than the already sharp decline to below 1600 seen in the past few days.