

## “OPERATION TWIST”: A BABY STEP FOR AN OVER-LEVERAGED U.S. ECONOMY AMID DYSFUNCTIONAL GLOBAL MARKETS

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**As the curtain falls on the summer, we can only bid a heartfelt goodbye to a regrettable period. It is hard to remember another time when as many headwinds buffeted the nation. Forget the insufferable weather, which featured heat, rain, floods, overflowing rivers and, finally, a devastating hurricane. Mother Nature was only partly responsible for the havoc wreaked on the global economy and financial markets. Most of the blame goes to the planet’s politicians, who displayed the all-too-human traits of infighting, incompetent leadership, and self-interest to the detriment of the common good.**

The economic toll taken by the highly partisan and contentious battle over the debt-ceiling legislation is hard to quantify, but the damage to household and business psychology is clearly documented by the plunge in confidence measures over the summer. Likewise, the erratic and confused approach of European leaders towards the long-simmering sovereign debt crisis escalated to the boiling point and created an astonishing amount of volatility in the financial markets. There is an age-old adage that says uncertainty is the enemy of growth, and the political establishment delivered that in abundance.

With the economy limping into the summer, it certainly did not need an additional shock imposed by the captains of the ship. Indeed, it’s surprising that things did not turn out to be worse. Even so, August was a lost month, as the economy generated no growth in either jobs or retail sales. While that is when the economy came under the most intense pressure from the debt-ceiling debacle and the European debt crisis, the headwinds continued to hammer the financial markets and the economy in September, which is shaping up as another month of underperformance and heightened fears of recession. With fiscal policy immobilized by partisan politics and deficit concerns, the Fed is once again attempting to play the role of savior, resurrecting a version of “operation twist” from the early 1960s. Like the earlier dance craze that quickly fizzled, we don’t believe the current variation will gain traction. The economy is firmly on a course of slow growth at best or into recession at worst. Along the way, deflation risks will be rising and event risks loom everywhere.

### The Dark Side of Low Rates

On September 21, the Fed announced that it would be swapping \$400 billion of its short-term Treasury holdings out to 3 years for a similar amount of 6-30 year Treasuries over the next eight months. At the same time, it will reinvest the proceeds of maturing agency and mortgage-backed securities into other mortgage-backed securities, thus keeping its \$1-trillion portfolio of mortgage-related securities from shrinking. The goal of this so-called “operation twist” and the agency reinvestments is to nudge long-term rates, including mortgage rates, lower in an attempt to stimulate borrowing and

spending as well as to support the housing market. Another stated objective was to “help make broader financial conditions more accommodative”, a coded phrase that really means the Fed wants to boost stock prices (the so-called Bernanke put) as well, hoping for a positive wealth effect on consumption.

While bond rates slid after the announcement – and will likely decline further – a less understood fact is that the Fed’s low-interest rate policy is not an unambiguous growth stimulus. Collectively, households save more than they borrow, holding \$50 trillion in financial assets versus \$14 trillion in outstanding liabilities. Millions of families, particularly retirees, rely heavily on interest received on the fixed income portion of those assets to sustain living standards. As a result, they tend to spend a higher fraction of those funds than do households whose income is derived primarily from wages or other forms of investments, such as capital gains on stocks.

To the extent, therefore, that the purchasing power of fixed income households is curtailed, the Fed’s low-interest rate strategy may actually backfire by causing those consumers to reduce spending. Although it’s difficult to calculate the impact that reduced interest income has had on consumption, the dollars involved are not insignificant. Over the past three years, almost \$400 billion of interest income has been taken out of the spending stream. At their peak in 2008, financial assets were providing households with \$1.4 trillion in interest, accounting for 11.4 percent of total personal income. In July of this year, those metrics shriveled to a tad over \$1 trillion and 7.8 percent.

### **No Housing Rebound**

The reduction of interest income is only one of several critical offsets that is diluting the thrust of the Fed’s low-rate policy. The other key impediment is the comatose state of the housing industry. Historically, housing is the main growth driver during recoveries, as low mortgage rates and ample credit availability rev up home sales and building activity. But the housing sector has been a conspicuous no-show this time, pushed to the sidelines by the huge overhang of unsold homes, mounting foreclosures and sagging prices. Until the housing market works off the excesses built up during the prerecession bubble years, low mortgage rates will do little to crank up this traditional growth engine.

Indeed, the moribund housing market has also short-circuited another growth driver associated with low interest rates. Along with encouraging home sales and construction, homeowners traditionally respond to reduced mortgage rates by refinancing outstanding mortgage loans, slashing monthly payments in the process. This gives an immediate as well as a long-lasting boost to consumption by freeing up cash that would otherwise go to debt servicing. Alternatively, homeowners can cash out some home equity when they refinance, which provides them with an immediate injection of fresh cash for spending purposes. Such cash outs (as well as secondary mortgage loans) played a major role in boosting consumption during the 1990s and the middle years of the last decade.

The sharp decline in home values since 2006 has virtually cut off those extra sources of spendable funds. Against the backdrop of burgeoning mortgage debt prior to the housing bust, the slide in home prices has eviscerated the available equity that homeowners can borrow against or cash out. True, homeowners have whittled down their mortgage debt over the past three years but the total is still higher than it was five years ago, just prior to the housing meltdown. Meanwhile, residential property values have plunged by more than \$6.5 trillion since 2006, wiping out 53 percent of homeowners equity. Households’ equity stake in their homes has shriveled to 38.6 percent from nearly 60 percent five years ago. Lacking equity and in light of the continued slide in home prices that is facilitating ever-lower housing appraisals, risk-averse banks have sharply narrowed the refinancing window, despite the exaggerated hopes of the administration’s failed Home Affordable Refinance Program (HARP).

### **Deleveraging Persists**

While restrictive conditions in the mortgage market are clearly stifling refinancing activity as well as home sales, the demand side of the credit equation is causing at least as much of a drag on the U.S. economy. Despite some improvement, household balance sheets remain deeply tarnished by the housing bust and credit crisis of 2008. Total debt outstanding still totals a whopping 119.5 percent of disposable incomes, about 50 percent above its average since 1960 and well above the 90 percent average during the 1990s. This ratio needs to recede to at least 100 percent before households will feel comfortable with their debt burdens, a haircut that implies another \$2-trillion reduction from current debt levels.

To be sure, the haircut would be less if accelerated income growth and higher inflation enabled households to grow out of their obligations, as has often been the case in the past. But incomes have stagnated in the face of an extremely weak and competitive labor market that has been a constant throughout the recovery. The unemployment rate remains stuck above 9 percent and the underemployment rate above 16 percent, leaving workers with little bargaining power and even less job security. Rather than hiring, companies are sitting on a \$2.1-trillion mountain of liquid assets that they view as a lifeline in the event of another crisis. If this defensive strategy needed reinforcement, it was provided by the Fed's ominous concern expressed in its latest policy statement, which asserted, "...there are significant downside risks to the economic outlook, including strains in global financial markets."

Nor will inflation help borrowers grow out of their debts. The commodities-led climb in headline inflation during the spring has already been reversed. Oil, copper and industrial raw materials have all plunged in recent weeks in response to weakening global demand and mounting fears of a recession. At one point in the final week of September, the Dow Jones-UBS Commodity Index touched its lowest level in 2011. China and other major consumers of commodities among developing nations are experiencing growth slowdowns, corroborating the downward revision in the world growth outlook just issued by the International Monetary Fund. The IMF cut its 2012 global forecast by half-percent compared to its June estimate, shaving 0.9 percent from the U.S. and 0.5 percent from China, adding that the "downside risks are growing". The combination of slowing global growth, verging on recession in developed nations, and vast pools of unused labor as well as productive capacity is a recipe for deflation, not inflation; that, in turn, increases real debt burdens and reinforces the imperative of households to continue the deleveraging process.

### **Beware Unintended Consequences**

What's more, the Fed's latest efforts to promote lending through "operation twist" might have unintended consequences that will restrict rather than expand credit availability. By flattening the yield curve even more than what has already occurred in recent months, the profit incentive for banks to extend credit is correspondingly reduced. After all, any shrinkage of the gap between long and short rates reduces the opportunity of banks to leverage a positive yield curve. They clearly won't chase lower yields on mortgages – which are tied to 10- year Treasury yields – since those loans would generate a smaller return even as the risk associated with them remains high. Paradoxically, the Fed may be promoting a credit squeeze in the mortgage market, which is the polar opposite of its intention.

Meanwhile, the Federal government, state and local entities, corporations and sovereign issuers have all jumped on the deleveraging bandwagon. Hence, while the demand for quality assets in an uncertain global environment has increased, the supply of such assets is shrinking. Perhaps nothing is more emblematic of the evolving shortage as the Fed's lengthening of its Treasury holdings. The \$400-billion swap into long bonds will be soaking up virtually all of the Treasury's estimated longer coupon offerings for the fiscal year, leaving risk-averse investors scrambling for whatever's left over.

The looming supply shortage that will exacerbate downward pressures on bond yields will also put more of a squeeze on underfunded pension funds and life insurance companies, as their ability to generate sufficient returns to cover obligations is further diminished. That could well prod them into riskier assets, which would increase their vulnerability to potential event risks that are not far beneath the surface. Hedge funds are raising cash by offloading gold, their only profitable trade this year, in order meet heavy redemptions by clients who have become extremely wary of risky bets that haven't paid off. Banks, both here and overseas, are sitting on a mountain of loans that are worth less than their book value, refusing to write off losses to protect reported profits. At the same time, they are counterparties to untold trillions of dollars of derivatives written by offshore banks that are tied to near-defaulted sovereign debt. This lack of transparency is reminiscent of the zombie banks in Japan, whose hidden losses were also buried under accounting legerdemain condoned by the government.

With Japan still reeling from two "lost" decades, the comparison is more than apt. The sovereign debt crisis engulfing Europe is part and parcel of a systemically dysfunctional global financial market for which governments are neither willing nor capable of finding solutions. Instead, band-aids and temporary patches are applied to deep wounds that may staunch the bleeding for a while but are merely keeping the global economy on life support. We suspect that it will take another major crisis before world leaders are shocked into the reality of their errant ways. But the recent history of how governments have responded to crises is not an encouraging omen.



## RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

US Treasury Market (Barclays TSY Bellwethers)	Yields (%)			Total Return (%)	
	9/30/2010	6/30/2011	9/30/2011	Last Quarter (1)	Last Year (2)
6-mo. Bill	0.20	0.10	0.05	0.08	0.32
2-Yr. Note	0.43	0.46	0.24	0.51	1.30
5-Yr. Note	1.28	1.76	0.95	4.57	5.09
10-yr. Note	2.52	3.16	1.92	12.16	9.31
30-Yr. Note	3.69	4.37	2.91	31.07	19.89

Municipal Bonds	Yields (%)			Total Return (%)	
	9/30/2010	6/30/2011	9/30/2011	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	4.62	5.28	4.61	6.182	4.18
ML GO 22+ Index	4.31	4.96	4.32	6.474	5.62

Equities	Levels			US Dollar Terms (%)	
	9/30/2010	6/30/2011	9/30/2011	Last Quarter (1)	Last Year (2)
S&P 500	1,141.20	1,320.64	1,131.42	-13.87	1.13
DJIA	10,788.05	12,414.34	10,913.40	-11.50	3.82
Nikkei (Tokyo)	9,369.35	9,816.09	8,700.29	-10.74	-5.40

Commodities	Spot Rates			Percent Change (%)	
	9/30/2010	6/30/2011	9/30/2011	Last Quarter (1)	Last Year (2)
Gold COMEX Spot (\$ per oz)	1,308.35	1,500.35	1,623.97	8.24	24.12
CRB Future Com. Pr. Index*	286.86	338.05	298.15	-11.80	3.94
West Texas Intermediate Crude (\$ per bbl)	79.97	95.42	79.20	-17.00	-0.96

Currencies	US \$			Percent Change (%)	
	9/30/2010	6/30/2011	9/30/2011	Last Quarter (1)	Last Year (2)
Yen	83.53	80.56	77.06	4.34	7.75
Sterling	1.57	1.61	1.56	2.95	0.87
Euro	1.36	1.45	1.34	7.69	1.81

Foreign Bond Markets	Yields in Local Currency (%)			US Dollar Terms (%)	
	9/30/2010	6/30/2011	9/30/2011	Last Quarter (1)	Last Year (2)
3-mo. LIBOR DEM Fixing (3)	0.85	1.49	1.50	0.01	0.76
ML German 10-yr.+ Bond Index	2.85	3.61	2.56	8.52	5.20
3-mo. LIBOR Yen Fixing (3)	0.22	0.20	0.19	-0.05	-0.14
ML Japanese 10-yr+ Bond Index	1.53	1.75	1.62	7.62	10.01

Source: Bloomberg Financial Data

**Notes:** (1) Total returns for one quarter (2) Total returns for one year

(3) Quarterly and annual returns represent % change, not total return

\*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

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