Bloomberg

Fed's 'Twist' Fails to Convince Investors Growth Will Follow

September 23, 2011, 12:23 AM EDT

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Sept. 23 (Bloomberg) -- The Federal Reserve's plan to buy longer-term Treasuries has succeeded in bringing down interest rates while not convincing investors the unorthodox monetary policy will strengthen economic growth.

Stocks fell for a second day yesterday as investors sought safe assets after the Fed announced it would shift $400 billion of its Treasury securities holdings into longer-term debt. Treasury 30-year bonds rallied, sending yields to the lowest level in almost three years. The Dow Jones Industrial Average had its biggest two-day loss since December 2008.

Chairman Ben S. Bernanke and his policy-making colleagues cited "significant downside risks" to the outlook in their Sept. 21 statement and announced a program that economists say will provide at most a small boost to the recovery. The Fed has not done an adequate job explaining to investors how the program will help, said Jerry Webman, chief economist at OppenheimerFunds Inc. in New York.

"It would be helpful if someone would lay out exactly the economic mechanism that gets us from yet lower interest rates to actual economic activity," said Webman, whose firm has $177 billion in assets under management. "Tell us why this is supposed to work because we're missing something here. The market is obviously missing something here."

The stock fall after the announcement of the Fed's policy known as "Operation Twist" contrasts with the reaction to the second round of quantitative easing, when the S&P 500 rose 24 percent from the day Bernanke first signaled the policy in August 2010 to its conclusion in June. That rise in equities helped strengthen the economy, Webman said.

Yields Decline

Yields on 30-year Treasuries declined to 2.8 percent yesterday in New York from 3.2 percent on Sept. 20. Stocks tumbled, with the Standard & Poor's 500 index falling 3.2 percent in New York to 1,129.56, following a 2.9 percent drop the day before. The Dow lost 3.5 percent to 10,733.83.

The Fed should instead put more pressure on fiscal authorities to revive growth and outline a clear policy strategy, including setting a target for inflation, said Greg Hess, a former Fed researcher.

"The Fed needs to be answering questions, or providing confidence out there that answers questions, not just creating new ones," said Hess, a professor and faculty dean at Claremont McKenna College in Claremont, California. "That's why I think the response is negative and that's why you're seeing volatility rise."

Stock Volatility

The Chicago Board Options Exchange Volatility Index, a benchmark measure of stock volatility known as the VIX, jumped 10.8 percent to 41.35 in New York yesterday, bringing its four- day increase to 33 percent.

"The downside risks stem from situations such as Europe, the tax law and so forth," said former St. Louis Fed President William Poole. "The Fed can't offset those. It is not within the realm of monetary policy."

Bernanke should instead devote an entire speech to other issues that are holding back the recovery, such as tax policy and regulations, and make clear that the Fed is powerless to deal with them, Poole said.

"For the Fed to be doing these things that are extremely unlikely to have much current impact, it damages the Fed's credibility," Poole, a senior fellow with the Cato Institute in Washington, said in a telephone interview.

Economists in a Bloomberg News survey before the Fed's meeting had low expectations for the action dubbed Operation Twist, with 61 percent saying the move would probably fail to reduce the 9.1 percent unemployment rate. Among those, 15 percent predicted it would be "somewhat harmful." None of the 42 economists in the survey said the move would be "very effective."

Home Loans

The central bank posted answers to "frequently asked questions" on its website, saying that the program should help lower costs for home loans, corporate bonds and other consumer and business lending. The plan "will provide additional stimulus to support the economic recovery but the effect is difficult to estimate precisely," the Fed said.

The central bank purchased $2.3 trillion in debt from December 2008 through June in two rounds of so-called quantitative easing aimed at lowering borrowing costs for companies and consumers with the benchmark interest rate already at zero. The Fed lowered its target interest rate to zero, also in December 2008, and in August it pledged to hold rates there through mid-2013.

Policy Options

With "Operation Twist" the Fed stopped short of some monetary policy options such as a third round of quantitative easing, a move seen as unlikely this year by 79 percent of economists in the Sept. 14-16 Bloomberg survey. Another option for the central bank comes from Chicago Fed President Charles Evans who supports tolerating a higher rate of inflation until unemployment falls below 7.5 percent.

Separately, the Fed released a study yesterday showing that low mortgage rates in 2009 and 2010 did not lead to as much home refinancing as anticipated, underscoring the difficulty in spurring economic growth through interest-rate reductions.

The housing market remains "depressed," in the FOMC's words, even after three years of low mortgage rates. New-home sales fell for the third straight month in July to an annual pace of 298,000, just above the record low pace of 278,000 sales in August 2010. The national average 30-year fixed-rate mortgage is at 4.09 percent, the lowest on record in a Freddie Mac index.

The central bank probably has limited expectations for the policy, Alan Blinder, a former Fed vice chairman, said in an interview yesterday on Bloomberg Television.

'Throwing Sticks'

Through Operation Twist, Bernanke is "throwing sticks and stones and pea-shooters and BB guns and whatever he's got at the weak economy in the effort to make marginal improvements," said Blinder, a professor at Princeton University. "I don't expect any miracles from it, and frankly neither do they."

Bernanke may have more success in spurring growth by signaling that interest rates will increase next year, which would get more people to borrow money now, said David Kelly, who helps oversee $408 billion as chief market strategist for JPMorgan Funds in New York.

"The public realizes that the Fed's action is completely incapable of helping the economy out," Kelly said of Operation Twist. "Ben Bernanke is at least trying to do the right thing. He just doesn't know what the right thing is."

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