

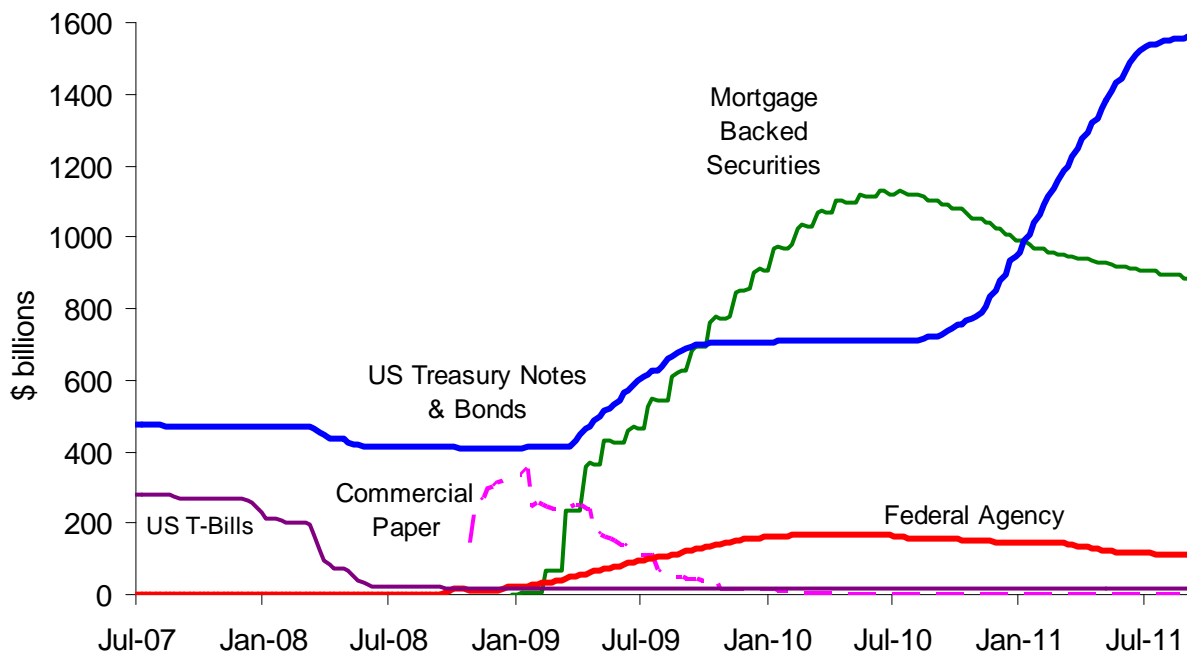
September 21, 2011

Drawn-Out Operation Twist

The Federal Open Market Committee adopted a drawn-out Operation Twist. The same three regional Fed Presidents dissented at this meeting as did at the previous meeting – Fisher, Plosser and Kocherlakota.

- The Fed cited more evidence of a weakening economy and global strains. We think this, more than its portfolio rebalancing, explains the decline in equities and in bond yields following the announcement.
- The FOMC decided to buy \$400 billion more in 6 to 30 year Treasury bonds, but will spread the purchases through June 2012. It will pay for them by selling Treasuries with maturities of up to 3 years.

Federal Reserve's Assets (last obs. September 14, 2011)

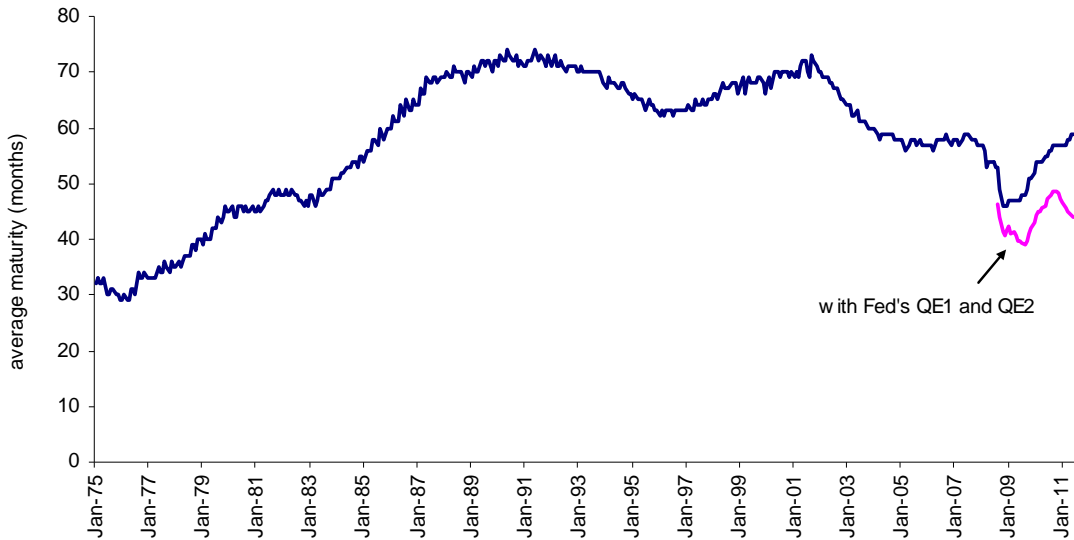


Source: Federal Reserve; Encima Global

- This will shorten the effective maturity of the U.S. national debt (the maturity of the consolidated Treasury and Fed holdings). Treasury has been gradually lengthening its

issuance. If continued, this will counteract some of the Fed's purchases, especially since the Fed is buying slowly.

Maturity of the Public Debt (June 2011)



Source: U.S. Treasury; Encima Global

- In addition, as the Fed's mortgage backed securities (conventional MBS guaranteed by Fannie and Freddie) the Fed will switch to reinvesting its maturing MBS in MBS rather than Treasuries.

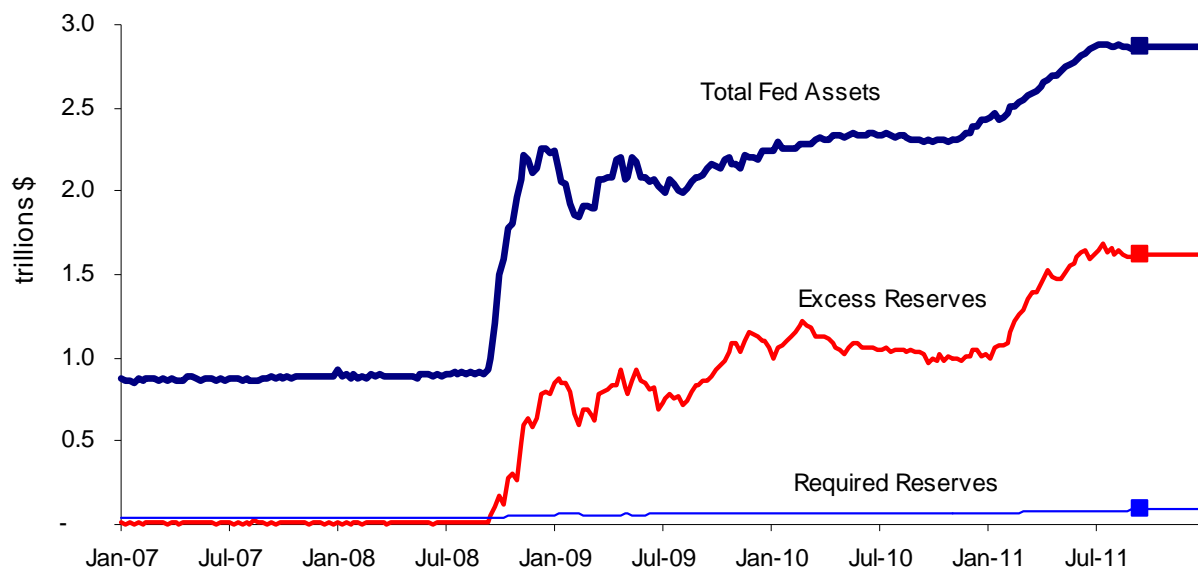
MBS minus 10 Year U.S. Treasury Yields (last obs. September 21, 2011)



Source: Bloomberg; Encima Global

- We think today's announcement means that the MBS line in the top graph will stop going down and that the Treasury bond line will stop going up. Within the Treasury bond line, the long-maturity portion will go up and the short-maturity portion down.
- In the graph below, we don't think total assets or excess reserves will change much as a result of the announcement. In effect, the Fed is running a leveraged SIV (structured investment vehicle), borrowing short-term at 25 basis points to finance long-term bonds yielding more. This is very profitable for the Fed as long as interest rates stay low. We expect the Fed to generate in excess of \$100 billion in profit per year under current policies, which it turns over to the Treasury Department less expenses. The cost is born by savers earning negative real interest rates.

Fed Total Assets and Reserves (last obs. September 14, 2011)



Source: Federal Reserve; Encima Global

Implications

- By expanding its purchases to MBS, the Fed is emphasizing the importance of mortgage rates in its policy. We don't think this change was priced into markets, and we expect it to push conventional MBS yields and, with a short lag, mortgage rates even lower.
- However, we think the FOMC's schedule for purchasing long-maturity Treasuries is slower than market expectations, dulling the impact. Though Treasury bond yields fell today after the announcement, we think this is mostly in response to the Fed's view of the economy, not the Fed's bond announcement.
- Bottom line: We don't expect today's announcements to affect the outlook. European developments are more important. They continue to be negative, with Italian bond yields rising again.

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