



Twist and Shout?

More open-market activity may create bond fever

By Jim Reber

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ICBA Securities Factoid

Four members of ICBA's Executive Committee are also currently on the ICBA Securities board of directors: Cindy Blankenship, Jim MacPhee, Steve Gardner and Bill Loving.

Federal Reserve Chairman Ben Bernanke apparently wasn't kidding two years ago when he said the Fed was serious about supporting the fixed-income markets. The first and still most effective effort at creating some stability was "QE1," which was put into play between March 2009 and April 2010. It involved the purchase of more than \$1.75 trillion in Treasury and GSE securities in the open market and was successful in pushing down credit spreads, which were unnaturally high.

The oft-ridiculed QE2, which involved another, smaller round of Treasury purchases, concluded in mid-2011. Although the actual dollars involved were substantial (\$600 billion), and the investments were on the longer end of the maturity spectrum (up to 10 years), the interest rate curve remained stubbornly high. Which translates into high borrowing costs for beleaguered homeowners. Which translates into a moribund housing market. Which translates into an equally lame national economy.

At the conclusion of the Fed's meeting in September, it announced a third strategy, this

time specifically focused on bringing down long-term rates. "Operation Twist" has already affected community bank investment portfolios.

Let's take a look at this latest dance craze.

The Bernanke two-step

There are really two parts to Operation Twist. The first is the purchase of \$400 billion in Treasury securities. The novelty in this action is that it will be funded by the Fed *selling* a like amount of shorter Treasuries. Since no additional reserves will be added to the banking system, this strategy is considered "sterilized." However, as the average maturity will be increased by around seven years, the effect should be lower long-term rates.

The second part is the reinvestment of maturities and cash flows from agency debt already part of QE1 into longer-term mortgage-backed securities (MBS). It is expected that about \$125 billion will be invested in this manner. This should again be supportive of MBS prices.

Yield curve limbos down

The reaction by the market was immediate, dramatic and as hoped-for. Ten-year Treasuries saw their yields fall 15 basis points that day, which is an enormous one-day move. Although the slope of the Treasury curve from two to 10 years had already flattened nearly 100 basis points between late July and September, this move caused another 15 basis points of flattening.

MBS prices likewise rallied, with lower-coupon pools increasing the most. Another gauge of the impact of the announcement is that 30-year mortgage rates hit an all-time low on Sept. 29, at a rate of 4.01

percent. An investment manager already awash in cash may be wondering what the good news is.

Opportunity waitzes in

There are several reasons that this new phase can benefit community banks. For one, municipal spreads should widen out by year-end, as Operation Twist does not involve any state or local government debt. Also, the fourth quarter is when muni supply often floods the market. This can make bond swaps into munis advantageous.

Plus, even though mortgage yields may fall, many analysts think it'll be just too small of an impact to help the 22 percent of homeowners who are still underwater. This means that careful purchases of premium MBS can help maintain net interest margins. Spreads should widen out.

This should also buy some more time for floating rate SBA 7(a) pools to prepay slowly, which is beneficial to both current owners and potential investors. SBA pools have become increasing popular money-market alternatives, and they tend to prepay at slower speeds when the Fed Funds rate is low.

Finally, there is very little reason to expect prices of your current holdings to fall and plenty of reason

to expect them to rise, albeit modestly. Unrealized gains in the bond portfolio give a banker a lot of options.

Time to hustle

Community banks that need to make restructuring decisions in 2011 should do so—the sooner, the better. In normal circumstances, the liquidity in the bond market begins to dry up in early December as some banks and many broker/dealers attempt to

dress, legitimately, their year-end balance sheets.


This means that bid/ask spreads, which are a barometer of the liquidity of a market, will widen out, making the simultaneous purchase and sale of bonds less efficient. However, if outright buying is an option, there are usually year-end bargains. Operation Twist could usher in a new season of dancing with the stars—those being high-performing securities. **■**

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