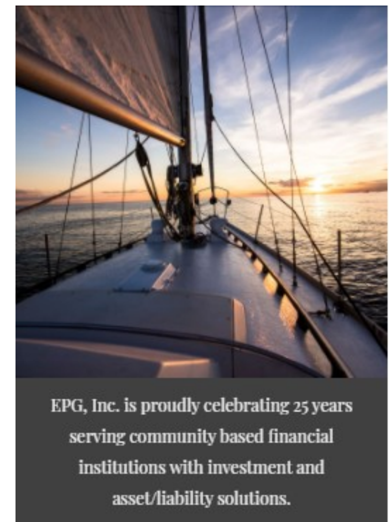
Will the Fed Cap Long-Term Rates?

Since the beginning of 2021, the 10-year Treasury note has risen by about 70 basis points in yield. This rapid rise in rates has created high volatility across bond and equity markets, and as such, it is fair to question if and how the Federal Reserve may intervene to keep long-term rates low.

We know the Fed plans to keep its policy rate near-zero through 2023, as reiterated by Chairman Jerome Powell at last week's FOMC meeting. All estimates indicate the Fed is also unlikely to signal QE tapering until the pandemic does not pose a threat to the economic outlook, and the Fed is expected to continue asset purchases at $120 billion per month through the end of 2021. However, investors' expectations for continued fiscal stimulus and rising inflation have driven long-term yields higher.

If the Fed decides that long rates have risen too far, too quickly, a measure in its toolkit is to reinstate "Operation Twist." First enacted following the 2008 Financial Crisis, Operation Twist is an extension in maturities for the Fed's bond purchase program. The Fed would not increase the total dollars in bond purchases but would reallocate some purchases of short-dated Treasuries to longer-dated Treasuries. Since bond yields fall as prices rise, a massive influx in central bank purchases of long-term Treasuries would surely lower the 10-year yield. Unlike quantitative easing, Operation Twist does not expand the Fed's balance sheet, so it is viewed as a less aggressive monetary policy tool. In short, by undertaking this strategy, the Fed would increase its holdings of long-term Treasuries while reducing its ownership of short-term Treasury bills. Should the Fed decide to pursue this measure, it would not be the first central bank to cap long-term rates in 2021. This month, the Reserve Bank of Australia purchased $4 billion of long-term bonds in a day, sending Australia's 10-year yield lower by 25 basis points and proving that such measures prove effective in today's financial climate.

The likelihood of central bank intervention is unclear, as Chairman Powell did acknowledge that the recent rise in yields is"notable." However, he alluded that this is not a concern currently, stating that he would only be concerned if an uptick in rates caused "disorderly conditions in markets or persistent tightening in financial conditions" that threatened the Fed's dual mandate of full employment and price stability. An announcement of Operation Twist or a similar program would likely come at the next FOMC meeting on April 28. Leading up to this meeting, it will be worth watching how long-term bond yields react to upcoming economic data.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