PEAK THEORIES
RESEARCH
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The Weekly Peak

Operation Rebalance
One month after the announcement of Operation Twist, this balance sheet policy move seems nearly forgotten unlike the two controversial rounds of bond buying to precede it. Perhaps the Federal Reserve's most recent action has been put out of mind mainly due to the fact that it does not expand the Fed's bloated balance sheet as did QE1 and QE2 but simply shifts the contents of the Fed's portfolio, and thus takes away the debate about monetizing the debt.

Operation Twist may be worth remembering, however, considering that it could turn out to be a more **powerful policy tool** than quantitative easing as it potentially helps steer investors toward risk assets and away from safe-haven assets on the sly and something that could help to create the wrongly maligned **virtuous cycle** in the months ahead.

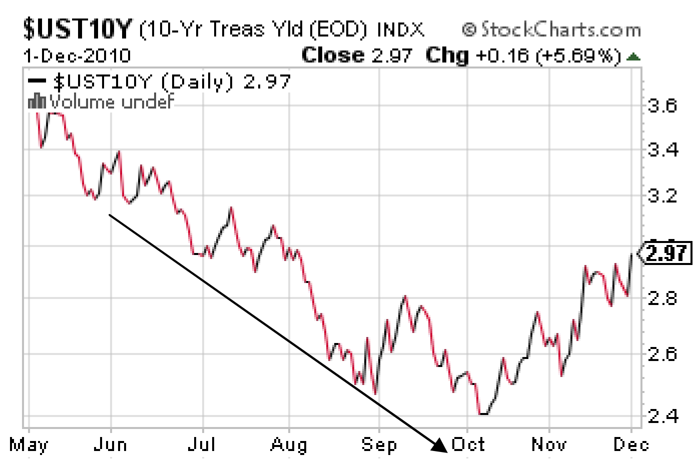
Such a possibility is far from a sure thing, but in looking at the charts of the 10- and 30-year yields, the S&P and gold, there's a strong chance that such a **rebalancing of investor portfolios** could happen on a collective level and something that would make this program a quiet success.

Interestingly, the most explicit goal of this $400 billion program to shift the Fed's portfolio toward long-term Treasurys and MBS was to lower long-term interest rates and something that was achieved by investor anticipation of this well-in-advance-telegraphed policy move along with the fearful uncertainties of August.

As can be seen below to the left, any investor who got in on the latest round of invest-in-what-the-government-is-about-to-invest-in did rather well with yield trading inverse to price.

Operation Twist and the 10-Year Yield

QE2 and the 10-Year Yield



Well worth noting is the fact that this is exactly what happened around QE2 with the 10-year yield hitting a low in that round of Fed policy known as communication three weeks in advance of the actual QE2 announcement and action as shown to the right.

Perhaps even more interesting, however, is that in looking at the chart of 10-year yield, it seems as though it may continue to trade in a similar manner to the months that followed QE2 as shown on the following page.

As can be seen below to the left, anticipation of QE2 brought interest rates down low with such a low serving as a springboard to launch the 10-year yield higher and its price lower as investors began to shift to risk assets and away from safe-haven assets.

QE2 and the 10-Year Yield

Operation Twist and the 10-Year Yield

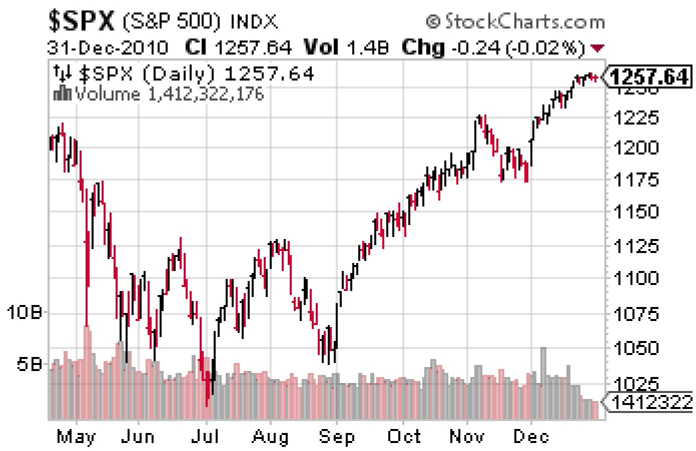
In looking at the marked up chart of the **10-year yield** today, it appears that it is likely to trade in a very similar manner with September's low appearing as a bottom that might help launch it back up to **3.0%** and relatively quickly even though such a potential move up may follow a few weeks of dicey sideways trading and presumably over the uncertainties around the euro-zone debt crisis.

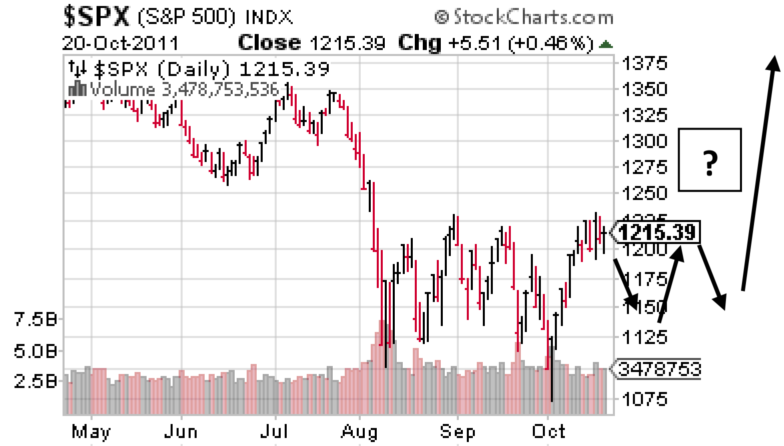
Such a potential pop in yield would be consistent with the other and less-focused-on goal of Operation Twist and that is to steer investors toward risk assets and particularly toward equities.

If this occurs and this means a rare 100 bps move in a month or so, it will probably signal that investors are lightening up on safe-haven assets such as Treasurys and the "safety" side of gold and silver and increasing positions in riskier assets such as equities.

In fact, when the charts of the 10-year yield are considered in combination with the charts of the 30-year yield, the S&P and gold, it seems that such a **rebalance might occur in the form of a later Q4 rally in risk** and one that could break the sideways trend that has dominated the equity markets for months now with the 30-year yield below supporting a shift from safety.

Turning to the risk side of the equation in the form of equities, note the similarities of the S&P today to its trading of about a year ago.



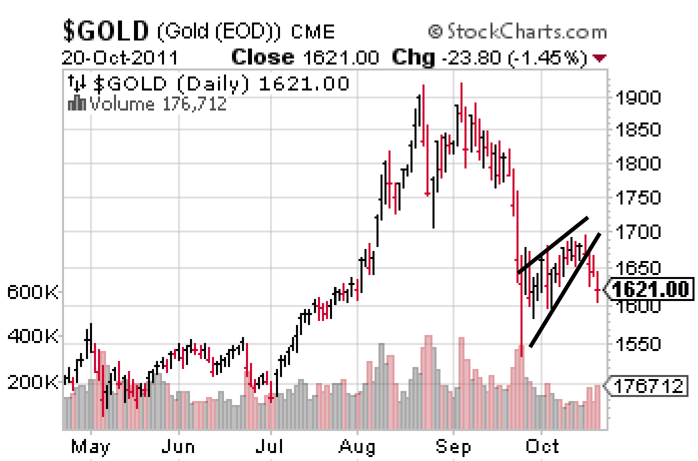


Specifically, it was a bullish Inverse Head and Shoulders pattern that carried the S&P 20% higher around this time last year and it seems a similar pattern may be setting up now even though the gains it might produce towards its target of 1375 are unlikely to begin until later this quarter after some volatile sideways trading in the weeks ahead.

In turn, should Treasury yields turn up from the Fed-created artificial low of September as the S&P starts to turn up, it will seem that Operation Twist will have herded investors toward risk assets even if such a potential herding is largely unnoticed due to the stealthier mechanisms of this balance sheet policy move.

Such a potential herding is even supported by the dual "passport" risk and safe-haven asset of gold also supports the possible rebalancing effect of Operation Twist considering that **gold is not a Fed-backed trade at this moment**.

Gold may regain the support of the Fed again in the future should the Federal Reserve embark on another round of bond-buying that should weaken the dollar and boost the status of this alternative currency, but at this time, the Fed is starting to support a stable or even strengthening dollar by selling the shorter-side of its portfolio and by making no commitments to another round of quantitative easing at this time.



It is for this reason that **gold has dropped nearly 15% since the announcement of Operation Twist** with the government no longer giving the great gold trade the green light.

It seems that investors may stick with that messaging in looking at the fulfilling and bearish Rising Wedge on the previous page that carries a target of $1,478 per ounce.

Should this bearish pattern fulfill, it suggests that gold is being ignored as a safe-haven status despite the events in Europe and as a risk asset as investors make the S&P – equities – the risk asset of choice right now as has been encouraged quietly by the Fed's September 21 policy move.

In summary, then, specific technical reasons to believe there may be a massive rebalance between risk and safety are as follows.

- The 10-year is showing a Rounding Bottom with a target of 3.0% and the 30-year yield a Double Bottom with a target of 3.8% with both patterns suggesting that investors will step away from safety with yield trading inverse to price.
- The S&P 500 is showing a possible Inverse Head and Shoulders pattern that requires a few right shoulders around 1120 before it might confirm at 1220 to take the S&P up toward its target of 1375 and something that supports the idea that investors will be moving back toward risk assets.
- Gold is showing a bearish Rising Wedge with a target of $1,478 per ounce that will help to show a formal reversal of gold's long-term uptrend and something that could continue if that target is hit with gold declining even more.

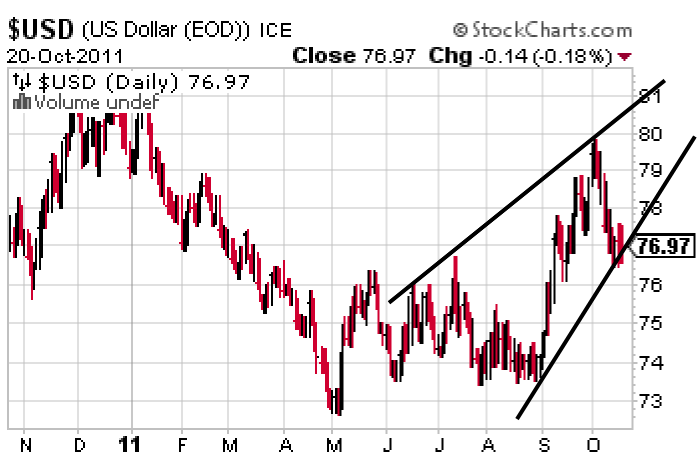
In turn, these chart patterns strongly suggest that after a bit more of sideways scuffle up and down in the weeks ahead around the euro-zone debt crisis and perhaps ISM and payrolls data in the US, investors as a collective may begin to rebalance portfolios by increasing exposure to risk assets and reducing exposure to safe-haven assets and something that may have been spurred by the Fed's rebalance of its own portfolio toward the perhaps relatively "riskier" MBS and longer-term Treasurys and away from the relatively "safety" short-term Treasurys.

Should the Fed be successful in steering investors toward riskier assets such as equities through such a balance sheet policy move, psychology and confidence may improve and could help to spur a virtuous cycle as a possibly rising stock market helps to spark spending, lending and borrowing and perhaps even hiring.

It is for all of these reasons that the Fed's recent balance sheet policy move may be best called **Operation Rebalance**.

Sam's Stash, Gold and the S&P

An interesting aspect of Operation Twist is the fact that it could serve to herd investors toward risk assets but without depending on a degraded dollar to do so.



Such a potential dynamic separates this balance sheet policy move from QE1 and QE2 with those latter two having had the effect of depressing the dollar as the Fed monetized the debt to the tune of more than $2 trillion.

In looking at the chart of the dollar index on the previous page, it is at an interesting crossroads right now as there is some small chance that the trading of the last few days may serve as a bearish appendage pattern that will take it lower, but the possibly greater likelihood is that it may trade into a very large Rising Wedge, or maybe it will be an even larger bottoming pattern, that could take it up toward or above 90 in the months ahead.

Should the dollar index rise to those levels as the S&P rises too, it suggests that the economic data is about stabilize if not improve and perhaps in part on the feedback loop of a potential and Fed-stimulated virtuous cycle.

In turn, it would mean that the Fed will have done the seemingly impossible through Operation Twist by boosting the buck and equities simultaneously and something that may set the stage for a genuine recovery.

Thank you for taking the time to read this week's piece and have wonderful weekend.

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