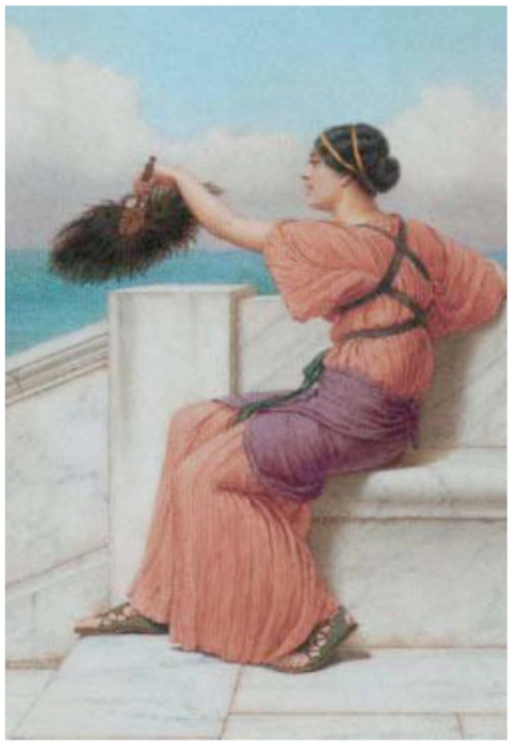
RateLab

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the BAS/ML Trading Desk
January 4, 2010

"A Farewell to RateLab"



With this issue, the RateLab will be going on an indefinite hiatus. As such, we wish to thank you for your patient support over these past three extraordinary years. Could there ever have been a better time to publish a wide-ranging real time strategy/commentary on the Bond Markets ?

But before we sign off, I would like to expand upon the few big thoughts that I have acquired during my 25+ years in mainstream Wall Street. Aside from an expanding waistline and a receding hairline, many years on a trading desk have revealed a few truths. Let's use a real life story as an introduction.

A number of years ago I left a yummy freshly made sandwich on the kitchen table. As I turned my back to take a drink from the refrigerator, the dog jumped up and grabbed the sandwich. Enraged, I turned to chase down the beast (with my sandwich in her teeth) and teach her a painful lesson. My wife grabbed my arm and stopped me in my tracks by sternly telling me: "Dear, what did you expect, she is just a dog !"

So looking back at the financial Tsunami that almost collapsed Western Civilization, how can we honestly say that we were surprised by these events ?

When Credit Rating Agencies are paid by the issuing firms, what did we expect ?

When Companies with a bifurcated business structure had the gains go to private shareholders while the losses would be shared with the Government, what did we expect ?

When the average person (not a "Prime" borrower) was offered the opportunity to buy a private home for their family at a low interest rate with no requirement to provide financial documentation, what did we expect ?

When the Directors of Public Companies are hired by and serve at the pleasure of the Senior Managers they are supposed to be supervising, what did we expect ?

When Senior Financial Managers are compensated relative to short-term financial performance, what did we expect ?

Let me be perfectly clear, I am not calling anybody a dog, nor am I passing judgment upon any of those mentioned above. What I am saying is that given a carrot and stick situation, most people will reach for the carrot. When presented with a particular set of rules, people will act in the manner that optimizes their personal circumstances. *So the answer to the question of how to avoid a repeat of the recent past is not to ask people to act against their nature but rather to create a set of rules where the participants improve their lot by reaching for the proper carrot.*

A corollary to the above is the notion that everybody acts rationally from their own point of view. Let's take a truly outlandish example to make the point. The serial killer is finally captured and is taken to the police station. The disturbed detectives ask him why he did it ? The psychotic killer calmly replies: "The voices told me to do it, what would you have done ?"

When professional investors were liquidating Senior bank loans, short-maturity High Grade Credits and Convertible bonds at silly prices, it was never a vote on the credit worthiness of the issuer; it was a panic driven effort to keep their jobs.

Similarly, when the FED cut rates to zero, the subsequent rally in stocks and bonds was not driven by a massive revision of the credit and economic outlook, but rather a necessity to keep their jobs. After all, who is going to pay a money manager to earn the T-Bill rate of Zero ? These actions are both rational and reasonable under the circumstances and I can assure you I have done the same many times. [This is one reason I have survived so long.] Just do not confuse selling at the bottom as a comment on value; it is often just a career enhancing strategy if done in a limited manner.

Greenspan's error in judgment, conceived from his Ayn Rand based view of the World, was not that people would act in their own self-interest (they do), but rather that removing all the rules was a required pre-condition for this to occur. It is not a mutually exclusive situation where you can only have personal freedom/responsibility with no rules. On the contrary, real freedom is the ability to act on your own within the confines of the rules. *Without a set of rules, there cannot be a game, only chaos*. Hopefully, the new Financial regulations being discussed will focus upon creating rules that motivate behavior that benefits the public good as opposed to focusing on micro-managing the actions of the individual. This concept is certainly the basis for the old saying: "Good fences make good neighbors".

I have frequently noted that: "It is never different this time". This idea seems to have provoked much consternation among some RateLab readers. Judging from the general tone and flavor of these comments, it seems likely that these respondents have not yet reached "geezer-hood".

The core reason we had a Tulip craze preceding a Dot-Com panic followed by a Housing boom is that they all involve markets made up of transactions created by humans. These are not events driven by computers or other inert beings making dispassionate decisions. It is precisely the emotions unique to mankind that create these obviously, ex post, disastrous situations. And because the general range of human emotion does not change much over time, the vicious swings from greed to fear, in the end, is as consistent as the movement of the tides. Unfortunately, because the length of this emotional wave is longer than the average Wall Street career, most people are not around long enough to notice.

While we may not be "doing God's work", we are also not Moneychangers at the Gate. We are the grease that allows the real production of commerce to function efficiently. Despite the actions of the few who harmed the system, we should be proud of our careers in Finance. Making money for your clients, and yourselves, is nothing to be ashamed of as long as it is done with honor and character. As my bosses declared at the start of my career: "Do not take actions that you would be ashamed to have posted on the front page of the New York Times."

So what is our final trade idea ? Not much has changed. The next few years will be broadly similar in nature our last Real Estate induced financial crisis from 1989 to 1994. The massive liquidity the FED and the US Government has injected into the system will need to be removed. Only the timing will be uncertain. They removed it too quickly in 1994 and too slowly in 2004. The trick to outperforming your peers will be in choosing which way they execute "The Drain" this time.

A careful reading of the speech Bernanke gave in Japan (May 31, 2003) indicates that he will probably choose the slower path to ensure that the US does not have another lost decade. As such, short the market via long-dated payer spreads and ladders should be a winner. And while MBS can remain rich well past the end date of the FED's Quantitative Easing program, there are many other ways to create a superior risk/return profile. As such, MBS will underperform other asset classes.

Although RateLab will cease publication, I shall still be sending out comments and recommendations via email. I will also continue to "eat my own cooking" via my proprietary trading book. I am open to receive your calls (both internal and external) and I expect to be on the road for some number of weeks per year.

This will be a great year for Interest Rate trading; Full speed ahead.

Harley S. Bassman
BAS/ML US Trading Desk Rates Strategy
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