RATELAB

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

Inflation is Always and Everywhere a Monetary Phenomenon

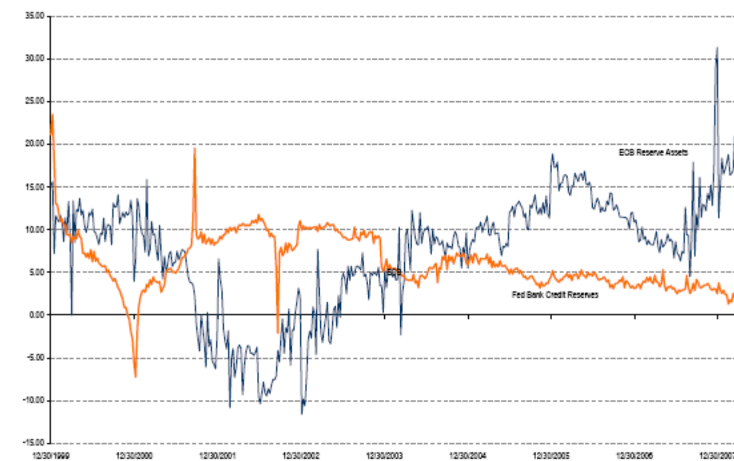
Milton Friedman

Plan "B" was Always the Answer:

After all the shouting and chest thumping is done, *today's Credit Crunch is NOT a price problem, but rather a trust problem*. Bear Stearn's problem was not that it couldn't afford to borrow, it was that there was no rate at which it could borrow !! As such, as soon as the FED implemented Plan "B" by opening the discount window and its balance sheet to the Investment Banks, all risk premiums declined dramatically. [It goes without saying that Plan "A" was cutting the Funds rate]

Now what degree of rate cutting was required to offset the decline in economic activity can be debated in a different forum, but the issue here is that the current rate is well below Top-line CPI, and consequently, it creates a negative Real Rate. We believe that the current FED Funds rate will add to inflationary pressures. Below are a few random thoughts that summarize our views.

Still Plenty of Arrows Left in the FED's Quiver:

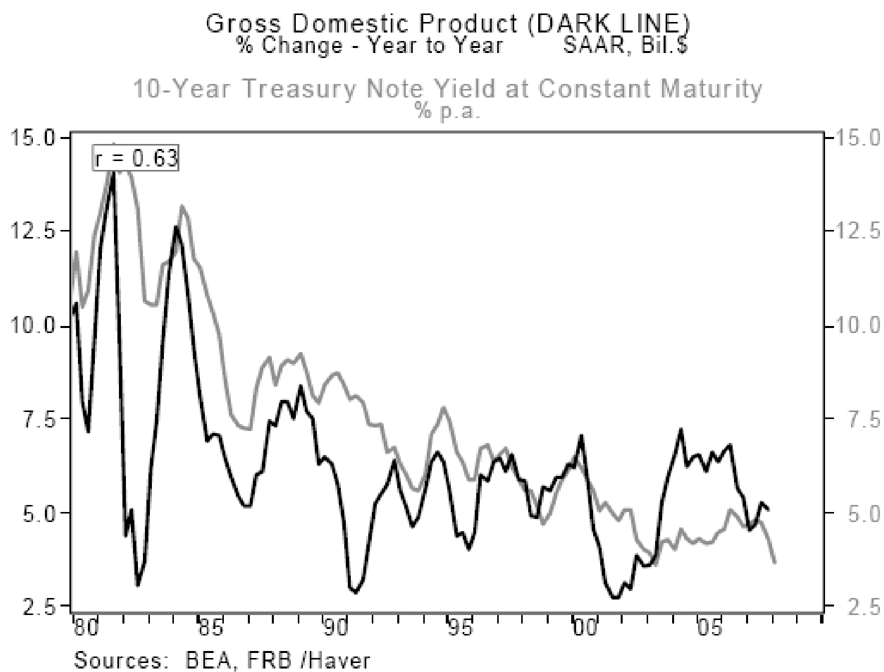


Both the FED and ECB have been injecting funds into the markets to add liquidity, and hopefully, stability. But while the ECB –the Orange line- has been expanding their balance sheet at a double digit pace, the FED –the Blue line- has been sterilizing their actions to maintain a relatively low 3.5% growth rate. How do their actions differ? The ECB has been directly buying securities for cash while the FED has been swapping MBS (and other assets) for Treasuries. Of the FED's ~$900bn balance sheet, ~$800bn was in the form of Treasuries last year. Presently, only ~$550bn is in now in Treasuries.

If the recent FED action is not enough to stabilize the credit markets, you can surely expect the FED to follow the ECB's lead and expand its balance sheet by directly purchasing Ultra High Grade MBS. (Passthroughs are the logical choice since the FED can insure the credit via backstopping the GSE's.) This is certainly a contributing factor to why MBS have performed so well recently.

A Recession in Name Only:

A recession is usually defined as two consecutive quarters of negative "REAL" GDP growth. However, we have not had a quarter of negative nominal growth since well before 1980.



The chart above is one of our favorites. (Even David Rosenberg loves this one; in fact, he is our source.) **-The dark line-** is the change in nominal GDP. –The grey line- is the constant maturity Treasury Ten Year yield. Notice how the lines have diverged recently. This is certainly a symptom of a market that is fearful that the economy will soon enter a recession. However, if inflation continues at its current pace, even a "Real" recession could create "Nominal" growth of over 4%. If this is the case, a 3.75% Treasury Ten Year rate is simply too low. And if the FED manages to avert a "Real" recession, then "Nominal" growth could be well over 5%. Since the FED will use all tactics to avoid a recession, especially in an election year, we believe the entire Treasury curve is too rich.

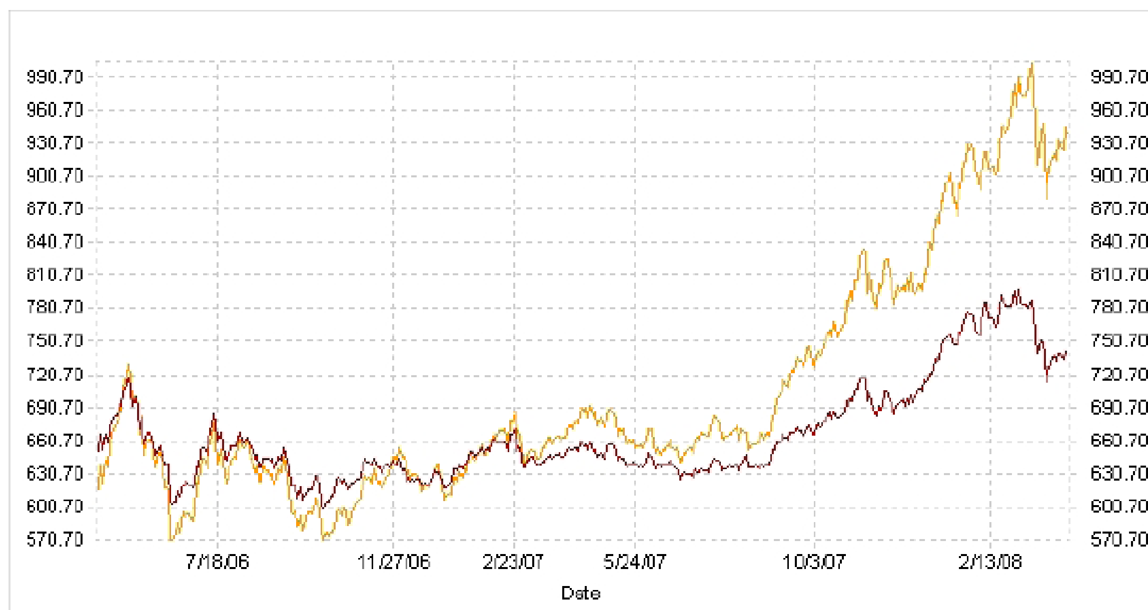
The Market Demands a Positive Real Return:

Investors demand a return that at least covers the depreciation of the currency, *also known as inflation*. In the chart below, borrowed from John Mauldin, **–the dark line-** is the Treasury Ten Year rate while –the grey line- is the long-term moving average of CPI. One can easily extrapolate where Ten Year rates are headed if CPI continues to clip along at nearly 4.0%

Now it has become de rigueur to comment that labor makes up +/-70% of the economy and that any sort of recession would reduce the pricing power of the American worker. However, much of the recent CPI stability has been driven by the "Great Moderation" of imported deflation from the BRIC economies. Unfortunately, trends have changed and the BRICs are now exporting inflation. As such, we believe the long decline in CPI is over and that all fiat currencies will experience a cyclical increase in inflation.

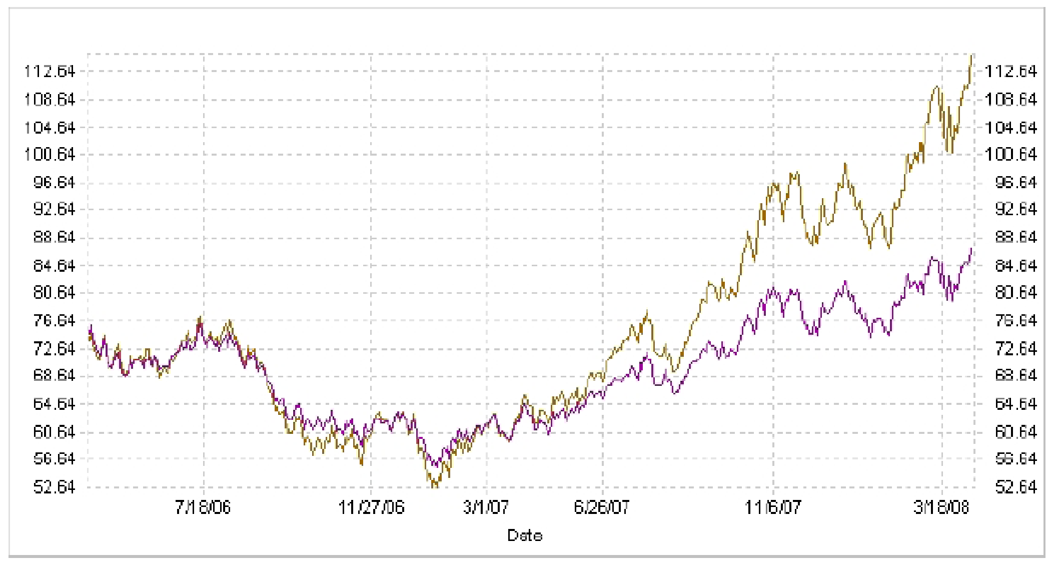
Speaking of Currency Depreciation:

Excessive relative inflation and currency depreciation are two sides of the same coin. As such, the recent talk of a commodity bubble may just be the release of air from the 1990s dollar bubble. Below are two charts that expand upon this point. –The gold line- is the price of spot gold quoted in dollars. –The burgundy line- is this price divided by the Euro/USD exchange rate. Notice that most of the recent increase is really just the depreciation of the USD since the price of gold is relatively stable when quoted in Euros.



The chart on the next page is nearly identical. Here, -the brown line- is the spot price of oil while -the magenta line- is the spot price divided by the Euro/USD exchange rate. Once again, most of the recent run up in spot oil can be accounted for via the depreciation of the USD.

Brown - Oil
Magenta - Oil in Scaled Euros



Pontification from the RateLab:

Notwithstanding the near-term credit crunch, the long-term remediation is clear for the towering Twin Deficits: The United States will repay China, et.al. with depreciated dollars. Since long-term exchange rates follow the path of the relative inflation rates between countries, controlled inflation is the solution. This also answers the question as to how the US consumer will repay the massive dollars borrowed over the past decade: A lower standard of living facilitated by a weaker dollar that provides less purchasing power abroad. As real money investors such as Pension and Insurance companies seek positive real returns to match their actuarial obligations, negative "Real Yield" Treasury rates must surely rise to market clearing levels.

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