RATELAB

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the BAS/ML Trading Desk
August 26, 2009

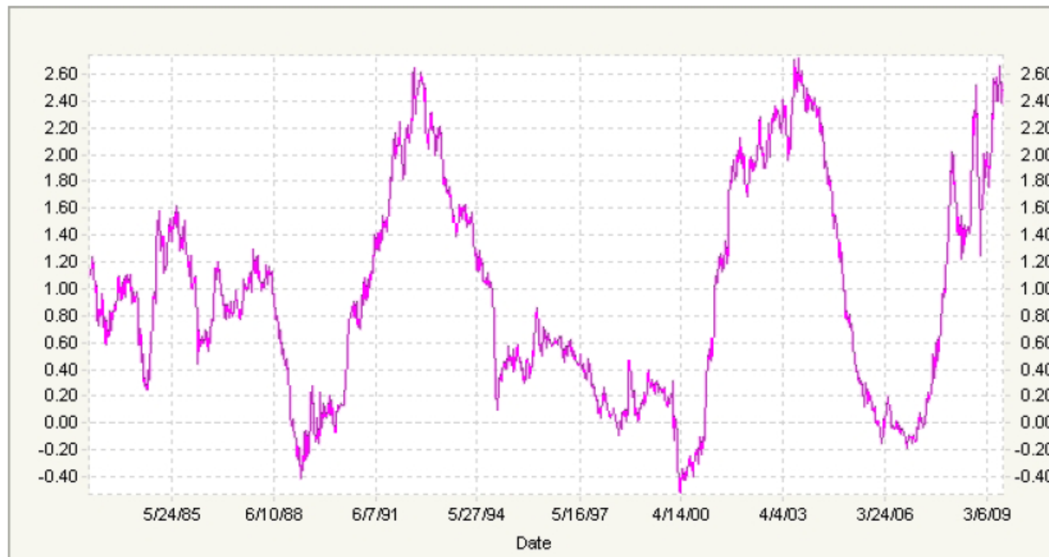
"Long Live the King (Bernanke)"

1272 French - 1422 English

The implications of another four years of a Bernanke FED

We at the RateLab have long been fans of Ben Bernanke, as such, we are cheered that politics did not trump competence and Bernanke was officially nominated for another four year term as Chairman of the FED. What follows is a linear thought process of what this means for the markets.

Tsy10yr rate minus Tsy2yr rate



All charts, unless otherwise noted, are sourced from BAC/MER data

One of our bedrock beliefs here at the RateLab is that: *"It is never different this time".* Yeah, yeah, yeah, each repeat has a slightly different flavor, but the core truth is always the same. Just as the Imperial Palace in Tokyo was not worth more than all California real estate in 1989 and Amazon.com could not sell every

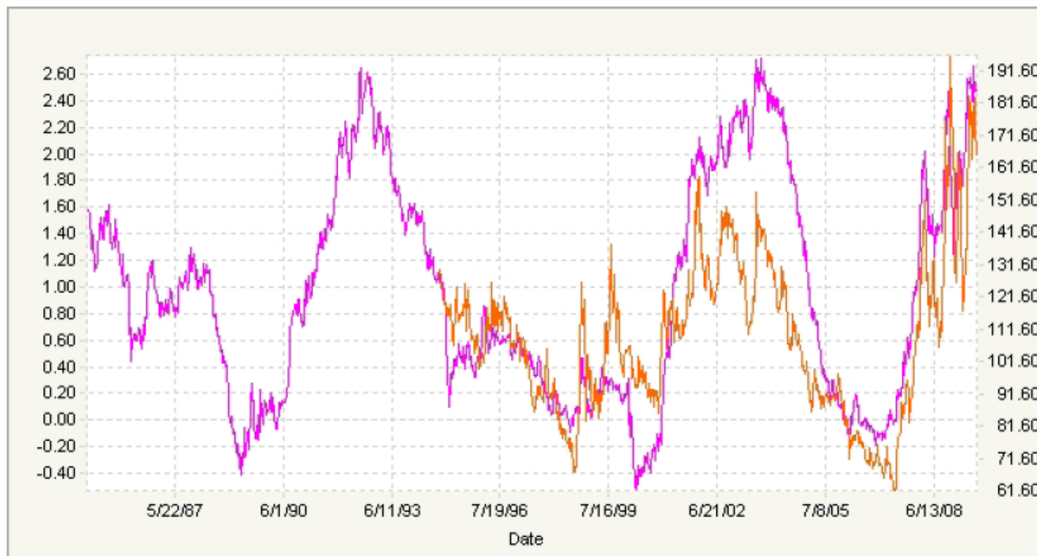
book in the world (as implied by its P/E ratio), so the current financial crisis will follow a familiar path as the illness passes out of the system.

As seen by –the pink line- above, steepening the Curve via massive cuts in the Funds rate has always been Plan A for the FED; and this time is no different. We fully expect to the FED to keep its word and maintain the Funds rate at a low level for an extended period of time. Critically, as the world's expert on the Great Depression, Bernanke will not repeat the error the FED made in 1937 (or Japan did in 2000) and remove the stimulus too soon. But "not too soon" does not mean forever. As shown, the 1991 recession brought on a 32 month period where the T2s vs. T10s slope was greater than 150bps. Similarly, the 2001 recession saw a 36 month period of steepness greater than 150bps. Presently, our curve expanded beyond 150bps in February 2008. As such, one might expect our curve to stay steeper than 150bps until at least late 2010 or early 2011. However, we suspect the "reds" and "greens" are a bit too optimistic on the economy and that the curve stays steep for a tad longer than past experience.

Another risk vector that is at an extreme is Implied Volatility. The –orange line- below is the Implied Normal Volatility for the benchmark 6m into 10yr swaption. Notice that even when the "World Was Ending" in 1998, 2001, and 2003, this measure barely breached 145Nvol or 9bps a day. Over the last three months, this Implied Volatility has averaged 175Nvol or 11bps a day. That is almost 3 standard deviations above its 15 year average of 108 Nvol. As the market becomes more comfortable that Bernanke intends to follow through on his advertized plan, all but the very shortest expiry options will decline in Volatility.

We have often detailed that there is an extremely strong correlation of Curve shape to Implied Volatility. Below, our same –pink line- representing the shape of the T10s minus the T2s curve is overlaid on top of the same –orange line-, the Implied Normal Volatility of a 6m into 10y swaption. While our anticipated steep Curve shape will keep Volatility from crashing back to the lows, it is also clear that Implied Volatility can easily decline by 20% and still be within the bands of its historical relationship. As such we recommend creating trades that mimic selling six month to two year expiries on "belly tails".

Pink - left - Tsy10yr rate minus Tsy2yr rate
Orange - right - 6m into 10yr Implied Nvol



Where the FED has placed its greatest effort, it has seen its greatest success. We are of course speaking of the MBS market. The FED has committed to buy $1.25 Trillion Agency MBS bonds. That will be close to one third of the entire market and maybe 90% of total Gross production for 2009. This is an unprecedented occurrence. Many money managers anticipate a huge widening of MBS spreads come November as the program starts to wind down. However, this notion tosses "efficient markets" onto its head. The total size, start-date and end-date have all been well advertized, as such, markets will adjust slowly over time. There will NOT be a sharp 50bps widening on the day the program finally ends. As shown by the –green line- below, this process may very well have already occurred. The nominal spread of the Par MBS rate vs. the Sw10yr rate closed at 72bps. The 13 year average for this spread is also 72bps. It seems likely the market has already adjusted.

Joining Duration (the Curve) and Convexity (Implied Volatility) as the third risk vector is Credit (Default). Once again it seems as if Bernanke has removed the exogenous panic in the markets and placed us on course to experience a regular recession. As seen by the –maroon line- below, the asset-swapped credit spread of the BAC/MER US Corporate Master index has fallen back to levels reached during previous periods of risk aversion. Although we do not yet know the full extent of the economic downturn, it seems certain that the "panic premium" has been removed and now only the fundamental risk remains.

Bernanke is a declared Republican and there is no question that Summers (an Obama favorite) desired the job. Yet Bernanke was re-nominated for a plethora of reasons, not the least of which is that he has fully explained his plan and changing mid-stream could produce only downside for the Administration. If it works, it was Bernanke's plan, if it does not, it would be Obama's/Summers'/etc's fault.

But this is the key notion. We do know the plan in broad strokes. Bernanke, unlike Greenspan speaks, in clear English. He has given lengthy interviews, including a star turn on 60 Minutes at the height of the crisis. It is for this reason that all markets should slowly become more stable.

Volatility is clearly 20% too high. At these levels, there is no natural buyer, only speculators. An MBS Servicer that buys Volatility as a hedge is just locking in a zero revenue stream since the theta/decay will absorb all the profits. It is better to self-insure and delta hedge and hope your skill can make some money. Locking in a zero P/L is certainly a *one-way ticket to Palookaville*. The problem here is that the traditional sellers, Hedge Funds and Wall Street prop desks, have been temporarily sidelined with lower risk limits.

Par MBS bonds may have an "average" +72bps Nominal spread to Sw10yr, but their Libor-OAS is still negative. Obviously, this market has figured it out. Take Implied Volatility down by 20% and the Par OAS will move from -7bps to +13bps. That calculates to one point in price on a 5 Dv01 bond or 20bps. This sound about right.

We love forward starting Yield Curve options. The Sw2 vs. Sw10 spread is presently about 230bps. It is projected via forwards to be 140ish in one year and 80ish in two years. As detailed previously, those sound about right for a standard recession. However, since we think this one might be a tad worse, buying an option on this spread is a fine way to limit your risk in case the world recovers more quickly. Best of all, this position "rolls positively" on both the Curve and the Volatility surface.

Of course, we cannot produce a RateLab without beating the drums for our favorite trade: **CMM vs. 10CMS.** With the spot spread presently at 77bps, the six month forward spread is about 55bps and the one year forward spread is about 45bps. Any entry below 50bps will be a winner. [See **RateLab – "Nessie, Yetti and CMM"** February 12, 2009]

Finally, we repeat our other Mantra: *"Since the only solution is Inflation, there will be Inflation."* Although Bernanke has NOT mentioned this, a mild, controlled inflation is certainly in the plan. It is how you pay down debt in real terms with nominal dollars. Bernanke is well aware of this concern; this is precisely why he spends so much time explaining how he will be vigilant enough to remove the stimulus before we become Weimar Germany or Zimbabwe. Consequently, we still absolutely love **buying 10yr into 10yr payer swaptions.** [See **RateLab – "The Positive Carry Hedge"** October 31, 2008]

Pay 4 points for a 6.00% strike.

Harley S. Bassman
BAS/ML US Trading Desk Rates Strategy
August 26, 2009

Important Note to Investors

The above commentary has been created by the Rates Strategy Group of Banc of America Securities LLC (BAS) for informational purposes only and is not a product of the BAS or Merrill Lynch, Pierce, Fenner & Smith (ML) Research Department. Any opinions expressed in this commentary are those of the author who is a member of the Rates Strategy Group and may differ from the opinions expressed by the BAS or ML Research Department. This commentary is not a recommendation or an offer or solicitation for the purchase or sale of any security mentioned herein, nor does it constitute investment advice. BAS, ML, their affiliates and their respective officers, directors, partners and employees, including persons involved in the preparation of this commentary, may from time to time maintain a long or short position in, or purchase or sell as market-makers or advisors, brokers or commercial and/or investment bankers in relation to the securities (or related securities, financial products, options, warrants, rights or derivatives), of companies mentioned in this document or be represented on the board of such companies. BAS or ML may have underwritten securities for or otherwise have an investment banking relationship with, companies referenced in this document. The information contained herein is as of the date referenced and BAS and ML does not undertake any obligation to update or correct such information. BAS and ML has obtained all market prices, data and other information from sources believed to be reliable, although its accuracy and completeness cannot be guaranteed. Such information is subject to change without notice. None of BAS, ML, or any of their affiliates or any officer or employee of BAS or ML or any of their affiliates accepts any liability whatsoever for any direct, indirect or consequential damages or losses from any use of the information contained in this document.

Please refer to this website for BAS Equity Research Reports: http://www.bankofamerica.com/index.cfm?page=corp