RATELAB

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

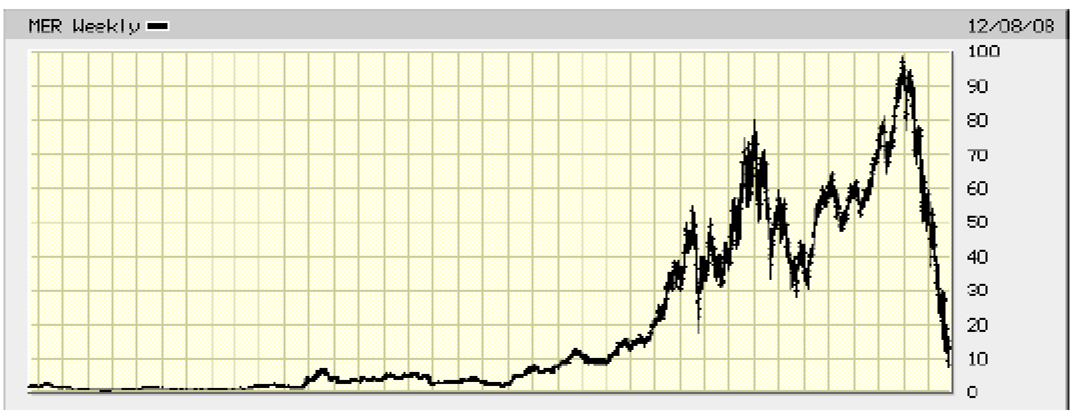
New Listing by Owner

Cave, Sleeps 6, Near a Stream

Ample supply of wild berries and small wildlife

Over the past year, we at the RateLab have repeatedly said that if *[such and such]* happened (please fill in the blank), we would have bigger problems to worry about. Well, as exemplified by our first chart below, *such and such* has happened in spades, and we now have bigger problems !!!

Merrill Lynch Weekly Chart



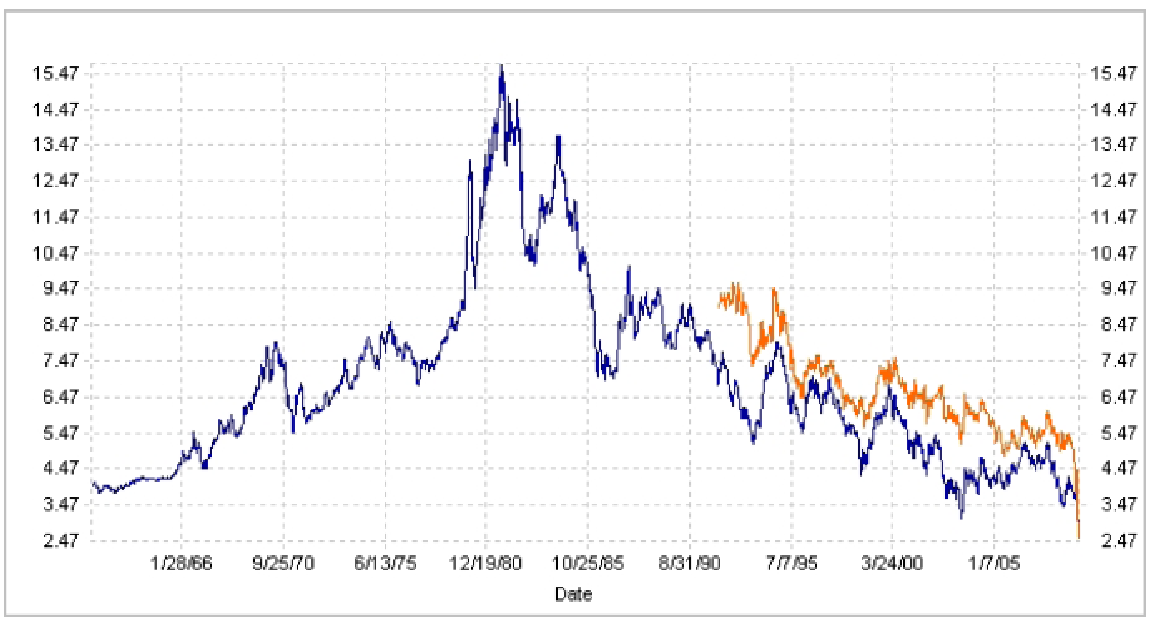
Furthermore, as alluded to in the title, we said that if *such and such* occurred, one should start to acquire canned goods and ammunition. (See RateLab – "Praise the Lord and Pass the Ammunition", April 3, 2008) All we can say now is "Yikes" !!

Below is a quick summary of what has occurred this year as a preamble to our annual year-end recommendation of "Holiday Stocking Stuffers".

A Little Fire Scarecrow ?

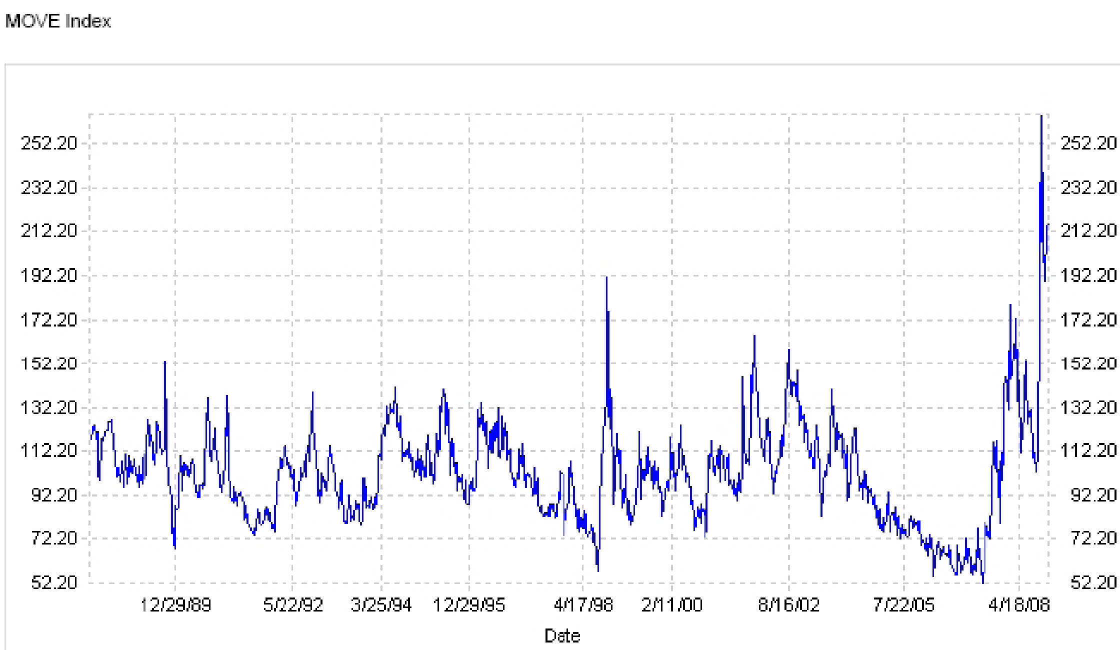
On December 5, The USTsy Ten Year touched 2.503% (after a 2.55% low yield close the previous day); That's the lowest yield since a 2.30ish% print in July 1954. As much shock value as this might create, it is small potatoes compared to the news that the Twenty Year Forward Ten Year Swap rate changed hands at 2.496%. As shown below, -the blue line- is the closing T10yr rate since 1962 while –the orange line- is the Forward Swap Rate. Of particular note is the fact that the last time the Tsy10yr nose-dived towards a 2%-handle, the Forward Swap Rate was barely below 5.50%. While the actuarial demand for duration from Pensions/Annuities and Insurance Cos combined with the hedging needs of Exotic Options dealers is understandable, this type of rate structure is preposterous even if we are headed for a 1930s style depression. The FED is going to engineer inflation since that is the ONLY solution. And although we can debate whether this will take six months or six years, it certainly will NOT take twenty years.

Blue - UST 10yr rate
Orange - Sw10yr rate 20 years Forward



Shake and Bake

We detailed in RateLab – "Implied Volatility: A Measure of Fear", October 7, 2008, that Implied Volatility had surpassed the LTCM induced 1998 highs and was approaching the October 1987 heights. Well, we can safely report that we exceeded those highs when the MOVE subsequently closed at 265. To contextualize, that's almost 17bps a day for a month or a terminal breakeven of +/- 62bps over the full month.



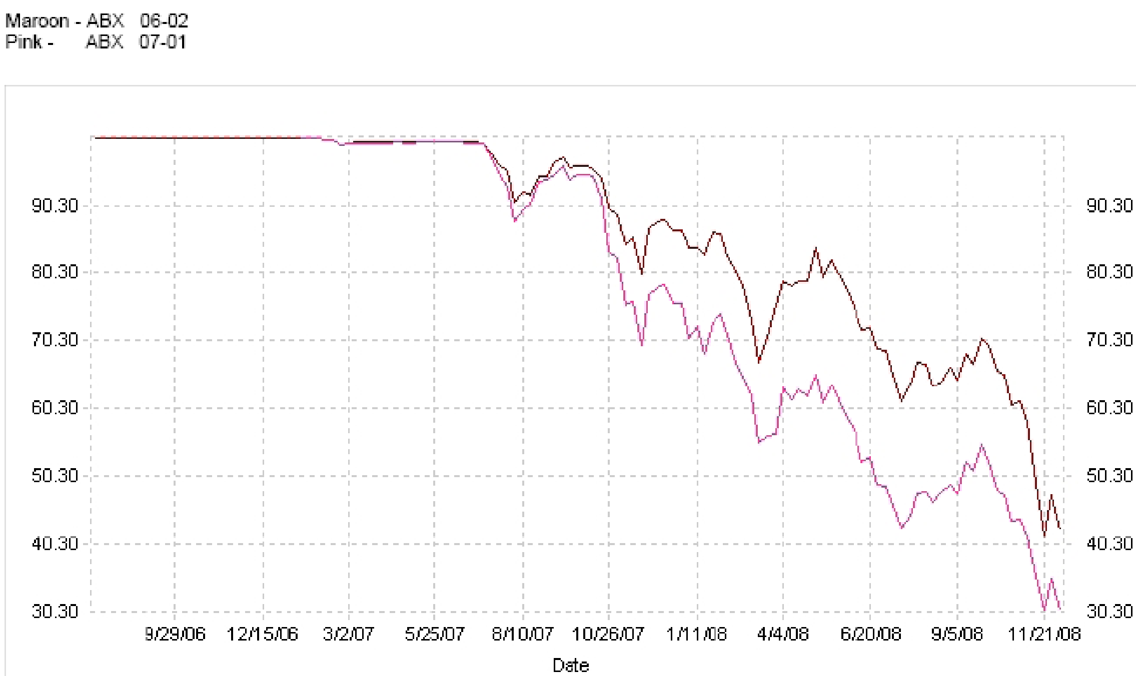
As much as the world is NOT going to calm down in the near term, we do want to stress the point that Implied Volatility will decline significantly if rates continue lower. First, lower rates will reduce the value of a straddle. Since rates cannot go below the "call/receiver" leg of the straddle must be worth less. This will lower the quoted Implied Volatility for an ATM straddle. Second, any further rally from here will induce MBS Servicer option selling as the IO/Servicing asset becomes positively convex. This is precisely what occurred in 2003.

What is Dirt Worth ??

In the chart below, -the maroon line- is the AAA ABX 06-02 index while the -pink line- is the AAA ABX 07-01 index. We must confess that we liked bonds linked to both of these indices 20 points higher, as detailed in RateLab – "Client 9, Area 51, Agent 86 and Other Stories You Just Cannot Make Up", March 14, 2008.

Unless we have done our math incorrectly, and ignoring the critical concept of the *time value of money,* at current prices of 45 and 33, a 100% default rate would require a loss severity of at least 65% and 74% respectively to cause a loss of principal investment. More realistically, at a 70% default rate, if every foreclosed loan incurred a complete loss, one could still recover their principal. I will note that this analysis also ignores the value of prepayments which can be substantial at these steep discount prices.

At these valuations, can't we just convert the property to agriculture and grow soybeans ?? How about single site wind-farming ?



The See-Through Office Building Returns

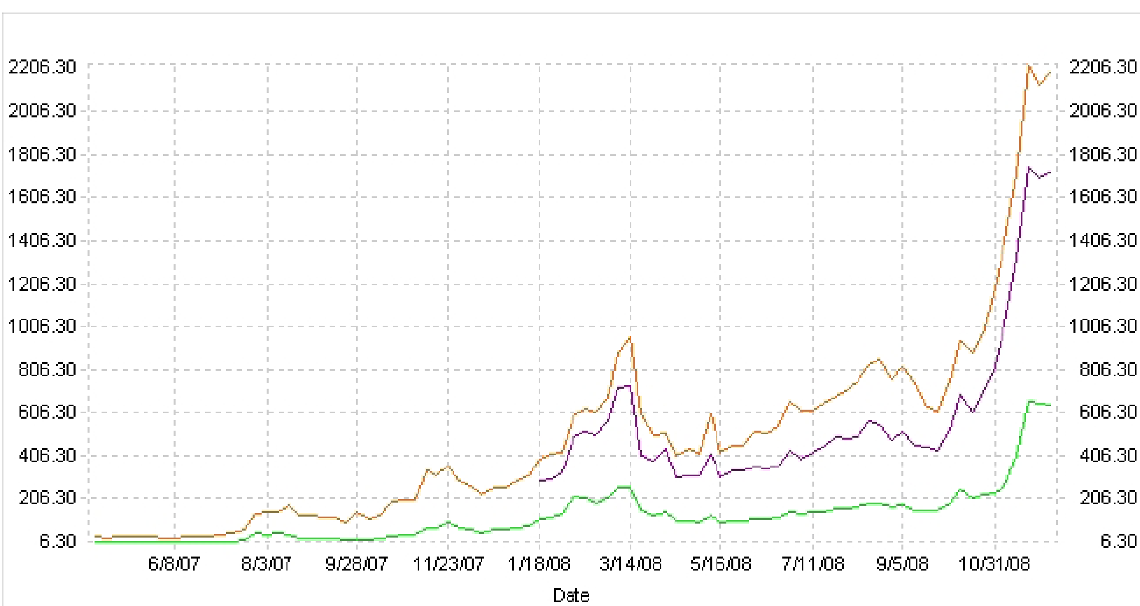
The last great Real-Estate collapse in the early 1990s saw the creation of the "see through" office, i.e., an all glass exterior with no tenants inside.

Let's check the bond math. In 2006, a prime commercial building has $12mm of cash-flow rent and a Capitalization Rate of 6%. This creates a $200mm value. A CMBS originator loans 70% or $140mm. Using a 30% subordination level, $98mm of Super Senior AAA bonds are created. Let's assume the cash-flow deteriorates to $9mm and the Cap Rate climbs to 9%. That would value the property at $100mm or down 50% from origination. Noting –the lime line- CMBX AAA 07-01 Index at 600bps and adding in the 500bps yield premium for cash bonds, your standard AAA Super Senior has a 13% yield and a dollar price in the low $60s, well below the theoretical value of the building.

Let's worst case this idea: Rents fall by 50% to $6mm and the Cap Rate rises to 10% creating a $60mm value for our office tower. You buy the Super Senior at 60ish with a 5 ¼ % coupon. You earn a cash-on-cash yield of about 8.5% (Swaps +550bps) for the remaining 8 years of the bond. And if the bond defaults, you own the building at $60mm, near its current value, down a full 70% from origination.

What am I missing here ?

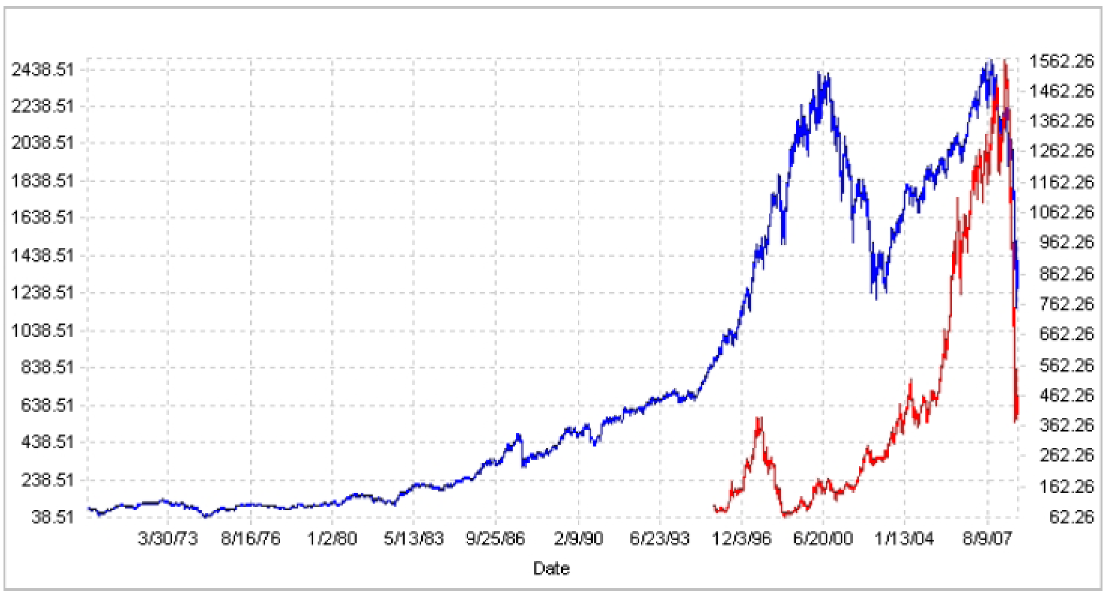
Green - CMBX 07 01 AAA
Purple - CMBX 07 01 AJ
Oranage - CMBX 07 01 AA



The Lost Decade

There is not much to add to this chart. All the value earned over the past ten years has been wiped out. Even the new and improved Russia, represented appropriately by –the red line- has shown that the theory of decoupling for the BRICs was just a lot of Wall Street blather.

Blue - S&P 500 index
Red - Russia RTS index



Although this is NOT news to many of you, we wanted to collect the broad story for the non-expert into a single RateLab as we prepare to ink out our annual list of Stocking Stuffers.

ML US Rates Strategy
December 9, 2008