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A Commentary by Harley Bassman:

THE CONVEXITY MAVEN

Value Concepts from the Credit Suisse Trading Desk
December 7, 2011

"The 2012 Stocking Stuffers"

(A Model Portfolio)

Not to sound like a broken record, but I must remind you that there are only two avenues out of a "Debt Crisis": Default or Inflation. And contrary to the rating agencies too little too late attempt at an MBS mea culpa, the US Government simply cannot default since they can print unlimited US Dollars to legally pay off their debts. As such, **if the only solution remaining is inflation, we will have Inflation**; The only question is whether it takes six months or six years.

Recall also that the two most powerful stewards of our economy are both highly motivated to solve our problems, and thus create Inflation. Mr. Bernanke is widely regarded as the world's expert on the Depression. As such, he will do <u>whatever it takes</u> to not repeat those errors. He detailed as much in his November 21, 2002 speech entitled, *"Deflation: Making sure 'It' does not happen here"*. This is the speech where Mr. Bernanke earned the moniker "Helicopter

Ben" when he quoted Milton Friedman's comments on Inflation. More critically, this is where he closed his remarks by saying, "…Japan's deflation problem is real and serious; but, in my view, political constraints, rather than a lack of policy instruments, explain why its deflation has persisted for as long as it has."

As per our other Economic steward, President Obama, well, let's just say that one does not become president because of a deeply ingrained sense of modesty. No president wants to be remembered as the second coming of Herbert Hoover, consequently, President Obama will do whatever it takes to firm up the economy to ensure a successful re-election campaign in 2012.

So it is clear that the FED, with the help of the US Government, is going to engineer some type of Inflation to reduce the value of both our Private and Public Debt. To think otherwise involves violating the number one rule of investing: "Don't fight the FED."

As a preview, let me summarize this year's stocking stuffers. I hate US Treasuries and I love US Mega-Cap Equities. I also like "risk on" assets whose underlying exposure will be balmed by Inflation and a continuation of the FED increasing its balance sheet.

Since an aging demographic in the G-7 countries is mostly paralyzed with respect to adjusting their portfolios, the heavy lifting for asset re-alignment will fall upon the non-Western USD/EUR/Yen Sovereign Debt buyers who at some point must take actions that will defend their long-term Purchasing Power. Over the course of time, Asian Central Banks and other SWFs will need to re-allocate to assets in such a fashion that they can retain "real" value.

Since this process might not be imminent, portfolios need to be structured to tolerate long lead times. Outright Rate shorts or short-term option (gamma) longs will "bleed" too quickly to be maintained.

Of greatest import, entry level is not your key decision point, it is sizing; There may be significant mark to market volatility on any of these investments.

With the table set and our caveats delineated, here is our 2012 Model Portfolio.

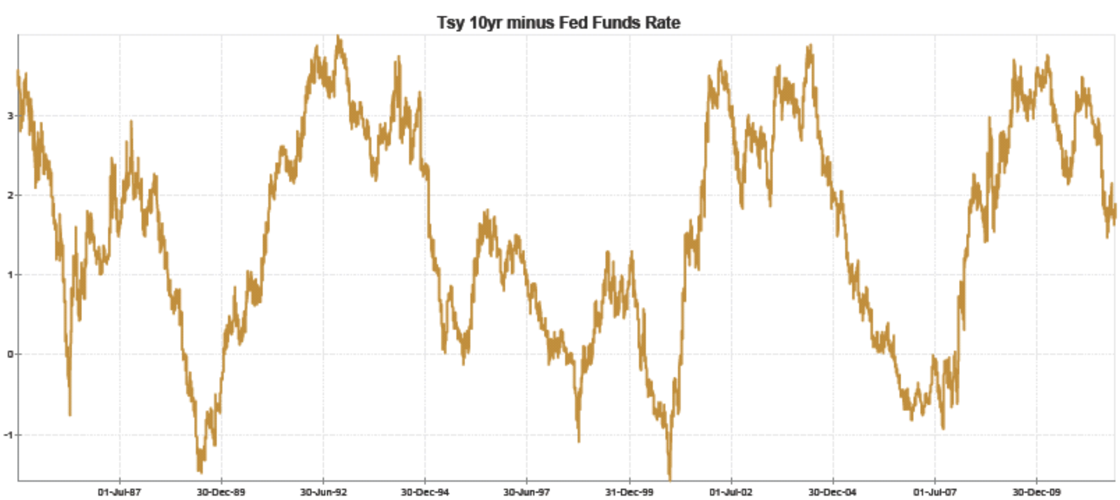
Buy 10yr-10yr 5.0% vs. Sell 3y-10yr 4.0% Payer Swaptions

One might expect to pay a heavy toll to be short Rates and long Convexity in a steep Curve / high Volatility world. So it is truly anomalous to be able to garner such a risk profile in a manner that is "analytically" flat carry. As detailed in the –purple table- on the next page, a ten year into ten year payer swaption struck at 5.00% exhibits little price decay over the first three years. The mid market opening price of 426bps only slightly declines to 410bps (Column 6) three year hence when computed using the standard "roll down" methodology.

1 Expiry	2 ATM Vol	3 OTM Vol	4 Fwd Rate	5 Strike Yield	6 Payer Price
2y	109nv	134nv	2.80%	5.00%	100bp
3y	109	127	3.06%	5.00%	193
4y	108	123	3.24%	5.00%	278
5y	107	120	3.33%	5.00%	345
6y	105	116	3.37%	5.00%	385
7y	103	113	3.37%	5.00%	410
8y	101	110	3.35%	5.00%	422
9y	98	107	3.32%	5.00%	427
10y	96	105	3.28%	5.00%	426

While this trade by itself might well qualify as a stand-alone winner, we like the idea of funding much of the purchase price via the sale of a three year into ten year payer swaption struck at 4.00%. This package was available for a net cost of less than one point somewhat prior to this publication.

The critical notion here is that the FED has "promised" to keep their Funds rate near zero until well into 2013. And since the –gold line- Fed Funds to Tsy10yr spread has historically not breached 395bps, it seems unlikely that the 4.00% strike will be breached anytime soon. By the time it does, enough decay will have occurred to offset most other adverse outcomes. And even in a worst case scenario, the trade is not short "notional" convexity, i.e. you are not short more options than you are long. In our best case outcome, the shorter expiry option expires and you own the seven year tail at a low price. By that time, the FED's inflation magic should be working and yields will be on their way north.



Source: Credit Suisse Locus

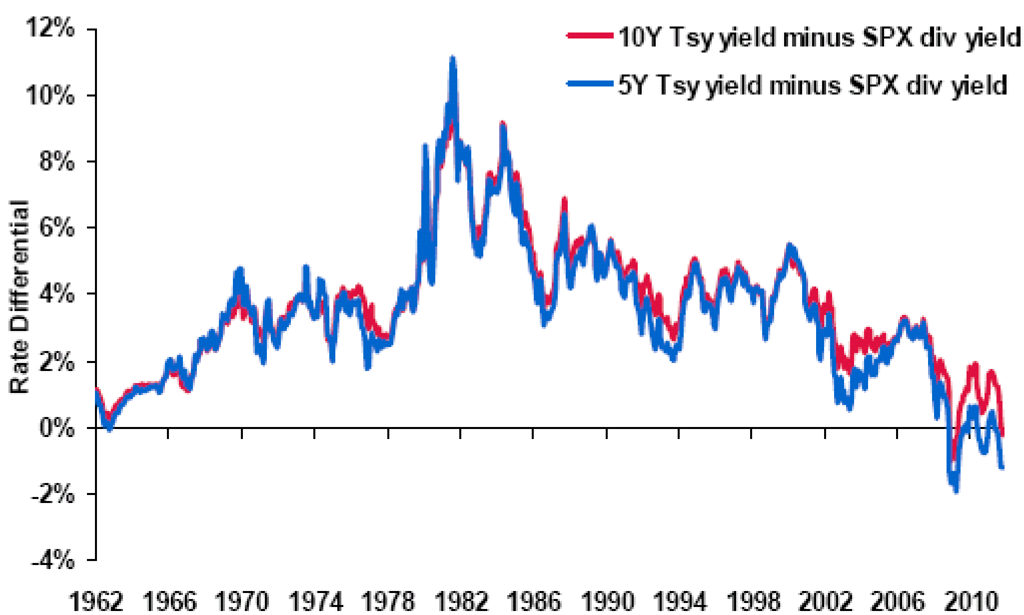
While this trade is mathematically short gamma, and initially long duration, the Greeks bleed towards neutrality over time. **This is our best Rates trade** since the net positive carry will offset most of the short-term fluctuations. Most importantly, it enables us to be short the market in the medium-term future without paying away all the profits in theta or roll down.

Buy Long-dated Risk Reversals on Mega-Cap Equities

Let me state this straight up: I hate US Treasuries and I like "Big Oil", "Big Pharm" and "Big Tobacco". While I cannot recommend specific stocks, I can tell you that the ones I love have P/Es of 10 to 12, sport Dividends of 2.5% to 3.5%, and have core businesses that are either based upon "hard assets" or are protected by hefty economic barriers to entry.

However, I am not so bold as to just buy Equities outright, I would like to have the wind at my back to give myself a little protection. As such, let's take advantage of the unintended consequences of Uncle Ben's zero rate policy.

The chart below details an event that last happened during the Eisenhower administration. Here, the –blue line- is the Five-year Treasury rate minus the S&P dividend yield while the –red line- is the Treasury Ten-year rate minus the same.



Source: Credit Suisse

While not shown, the last time these Rates inverted was 1959. The interesting consequence here is that the Forward S&P price is now lower than the spot S&P price. As with bond contracts or MBS, this is not a prediction of future but rather the simple math of discounting cash-flows.

Source: Credit Suisse

The other unintended consequence of the FED's aggressive policy is that not only has long-dated S&P Implied Volatility increased, but also the –blue line- put versus call skew has expanded. This has been driven by the hedging demands of regulated Insurance companies and other long-liability managers.

Here is a sample trade idea:

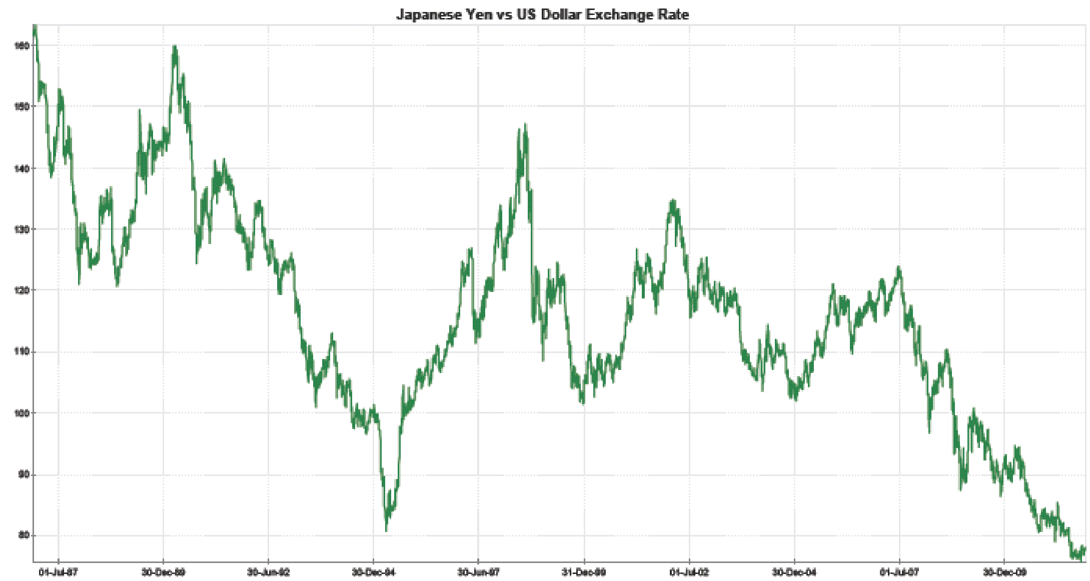
With the Spot S&P at 1250:
Buy 1 unit S&P strike = 1400 call, expiry January 2014 @ 100 (12% otm)
Sell 1 unit S&P strike = 950 put, expiry January 2014 @ 100 (24% otm)

While optically impressive, it is truly simple bond math that creates the value proposition. Because of the yield differential, the forward S&P is 4% lower at 1200. Overlay a 33% put over call Implied Volatility differential (32% vs 24%) and a trade is born. Similar opportunities exist for active single names. Want to lever up this idea? You can go out to ten years forward on an OTC basis.

Buy Long-Dated Call Options on USD versus JPY

There are those who say that the FED cannot produce inflation. They then point to Japan as their (only) example. To this I can only respond (as Uncle Ben did in

2002) that the MOF has just not tried hard enough. But this too will pass. At some point a Debt to GDP ratio of over 220% and the oldest demographic in the G-7 will sap the strength of the Yen and ricochet JGB rates away from the zero boundary.



Source: Credit Suisse Locus

Unfortunately for many investors, this economic reality is moving at a glacial pace and many overzealous traders have been carried off the field for being too early on the most well advertised trade in the Liquid Rates markets.

The main reason the –green line- JPY has strengthened and JGB rates have remained low is the Japan, unlike other countries, has self-funded their deficit. Be it risk aversion or monetary patriotism, it seems likely that as the generation that rebuilt post-war Japan retires, the deficit chickens must come home to roost.

While buying options is usually expensive, the still significant rate differential cheapens the cost significantly. For while the Spot rate is 77ish, the ten year forward rate is only 62ish. As such, one can buy a 100.00 strike call with a ten year expiry for not much more than five points.

I would remind you that the JPY last touched 100 less than two years ago. Moreover, this exchange rate was above the 105 “breakeven” level as recently as September 2008. Ten years is a long time. This is a fine way to wager that deficits do matter.

Buy Brazilian Local Currency Bonds

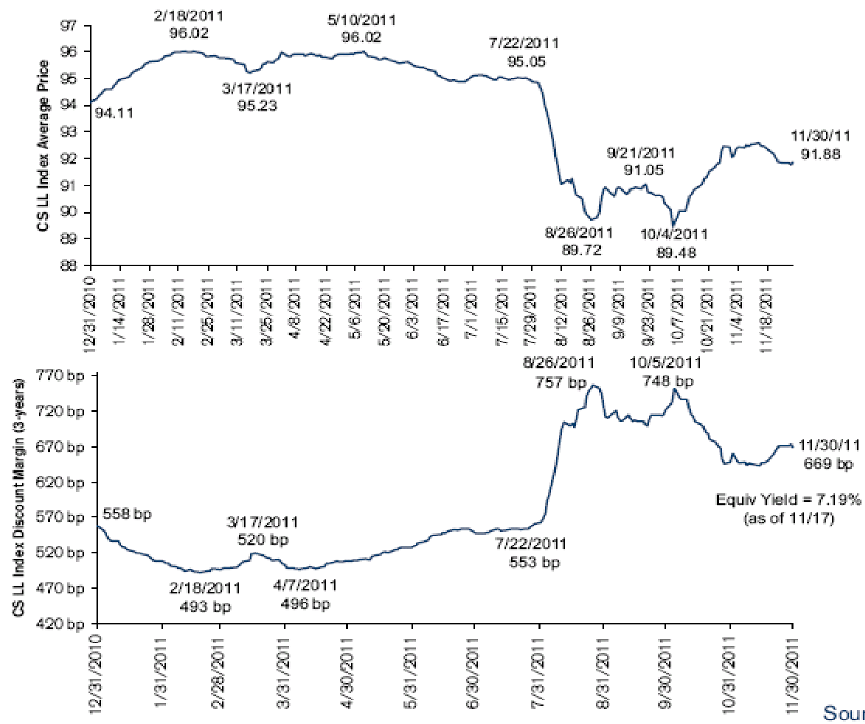
While it is certainly not cheap to live in Brazil, the price of a McDonalds Big Mac has declined from $6.12 last July to $5.13 recently. This makes investing in Brazilian local currency bonds all the better.

As a Monetarist and an Inflationista, I want to diversify away from the USD. However, the other G-7 countries, except Canada, have similar problems and will seek out similar solutions (Inflation!). Most of the other "high coupon" countries have a Currency risk I do not want. However, Brazil is a "hard asset" country with high local yields. Institutions can set up on shore accounts (and pay the IOF tax) to buy local currency notes or buy less liquid Global bonds off shore; small fry can buy Structured Notes issued by financial firms that "pass through" the coupon.

The main risk is currency devaluation; however, with “net” yields in the 8% to 9% range, one can absorb some serious depreciation versus similar maturity USD bonds. This is a great Diversification bet, size it accordingly and assume a minimum two year hold period.

Invest in a Diversified Portfolio of US Leveraged Loans

CS Leveraged Loan Index YTD Price and Discount Margin



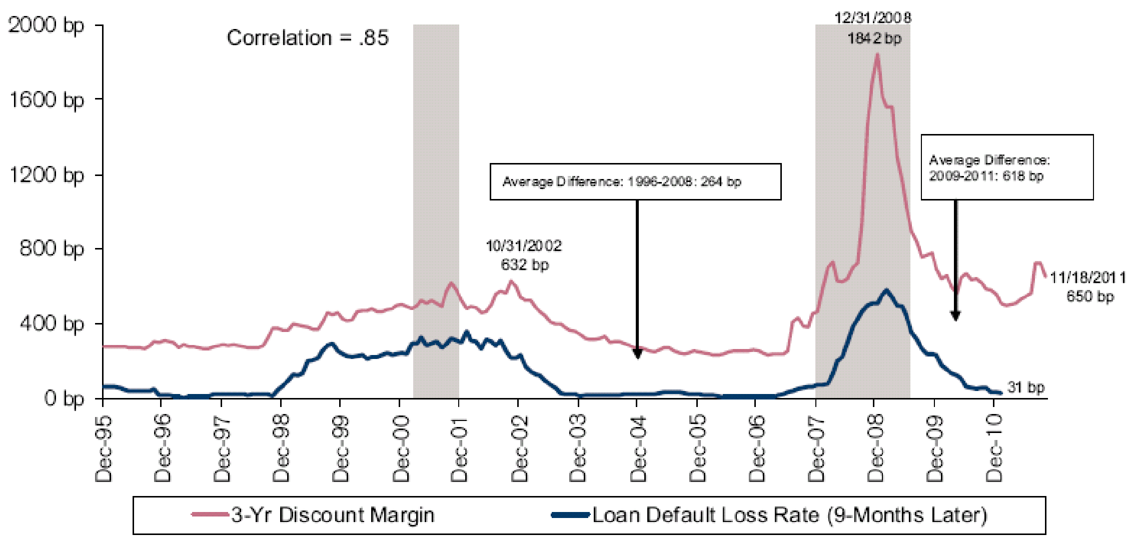
Source: Credit Suisse

The story line that Italy and Spain may roll off the map and the Euro may replace the Weimar Mark as decorative wallpaper has opened the "risk off" floodgates across a number of Credit Markets. One of the most unfounded liquidations has occurred in the "Top of the Capital Structure" Leveraged Loan (Senior Bank Debt) market. Preceding is our most recent chart of both the CS Dollar Price Index and the Discount Margin Spread over the past twelve months.

However the more interesting chart is below. Here, the -red line- is the Discount Margin traced back to 1995 placed over the –blue line- Loan Default Loss Rate. Notice how the spread between the two lines is at a gap only exceeded during the Lehman induced selling panic of late 2008. I guess one could stipulate that a Europe spinning out of control would drag down the US economy and significantly increase domestic defaults. However, the FED has made it abundantly clear that they will do whatever is necessary to defend against that scenario, including taking the (unilateral?) step of flooding the European banking system with USD financing.

Taking advantage of this opportunity is not such a simple task since one cannot buy an Index to gain exposure and a broadly diversified portfolio is required to absorb the unpredictable (yet inevitable) default losses. That said, those of you already involved in this market should certainly increase your exposure. For the small fry investor, there are numerous listed Closed-End Funds that presently trade at a discount to NAV.

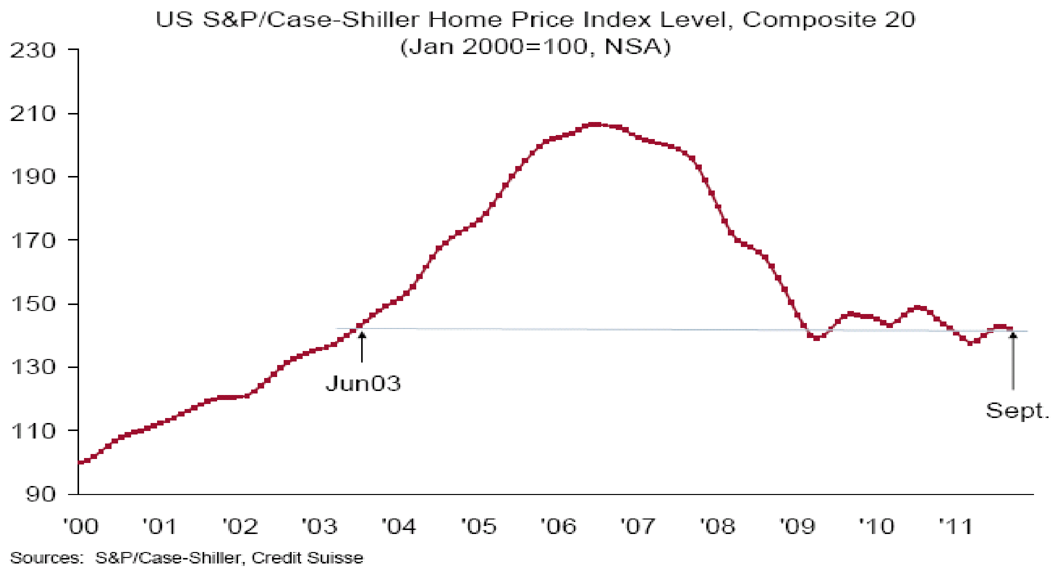
Leveraged Loan Default Loss Rate vs. 3-Yr Discount Margin: 1986 – Oct 2011

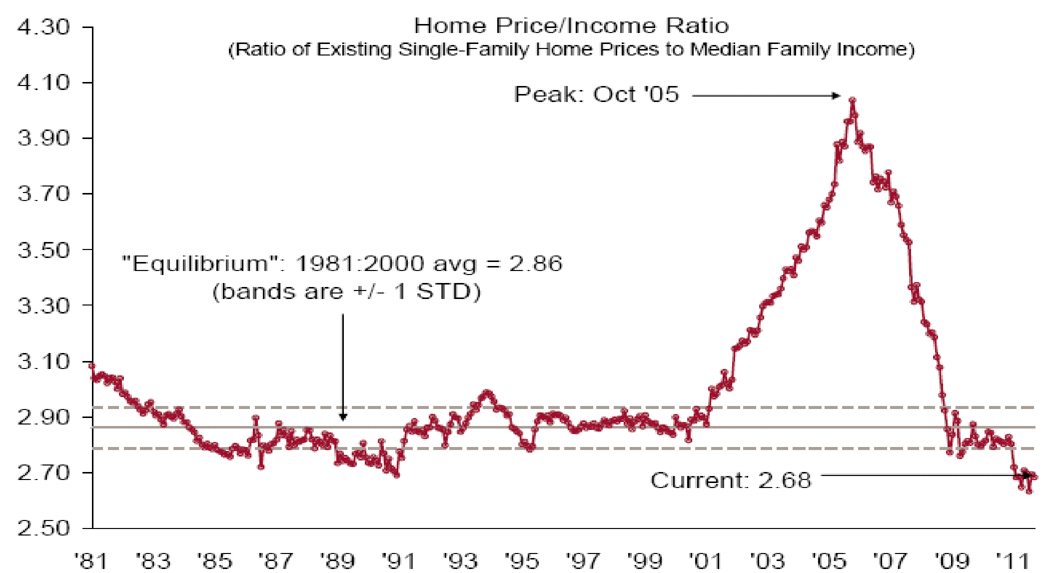


Source: Credit Suisse

Buy (Quasi) Distressed Mortgage Bonds

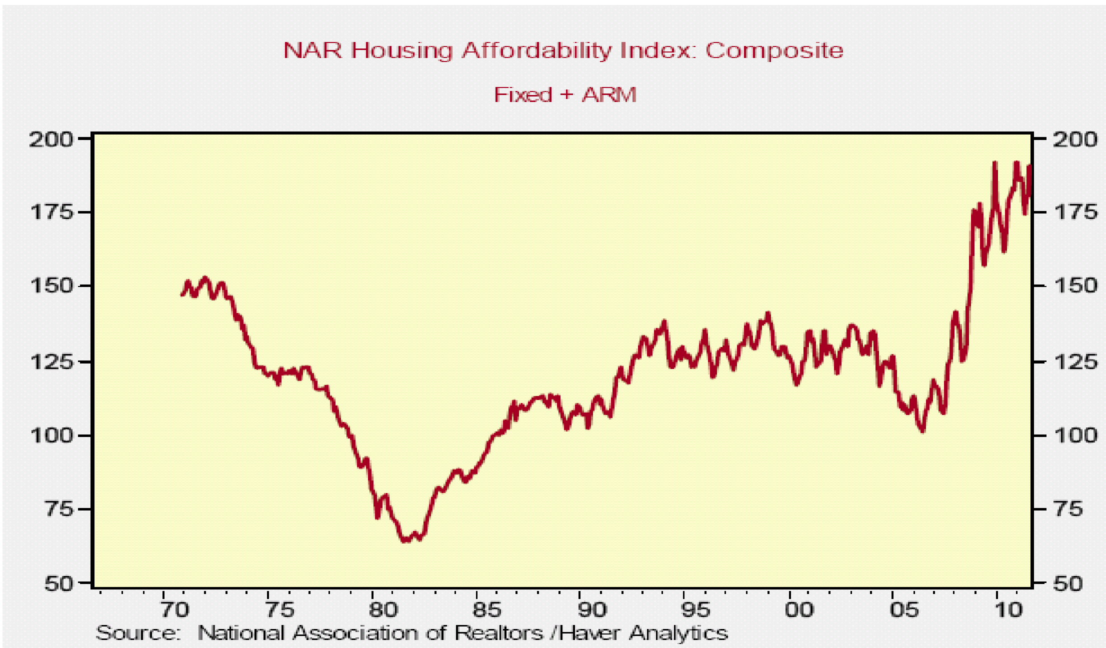
Has there ever been a knife that has fallen so hard that it has cut all comers who have tried to catch it? With respect to the housing market over the past few years, it is hard to top. Despite massive Government action to place a floor under home prices, it seems that two new houses come up for sale for every one that is sold. Nonetheless, the risk/reward matrix currently available motivates us to (once again) recommend an endeavor into professional "javelin catching" and we urge you to consider the purchase of select Clean Alt-A and Senior Pay Option ARM bonds. The former sport a loss adjusted yield in the range of 10% to 11% while the latter yield 12% to 13%.



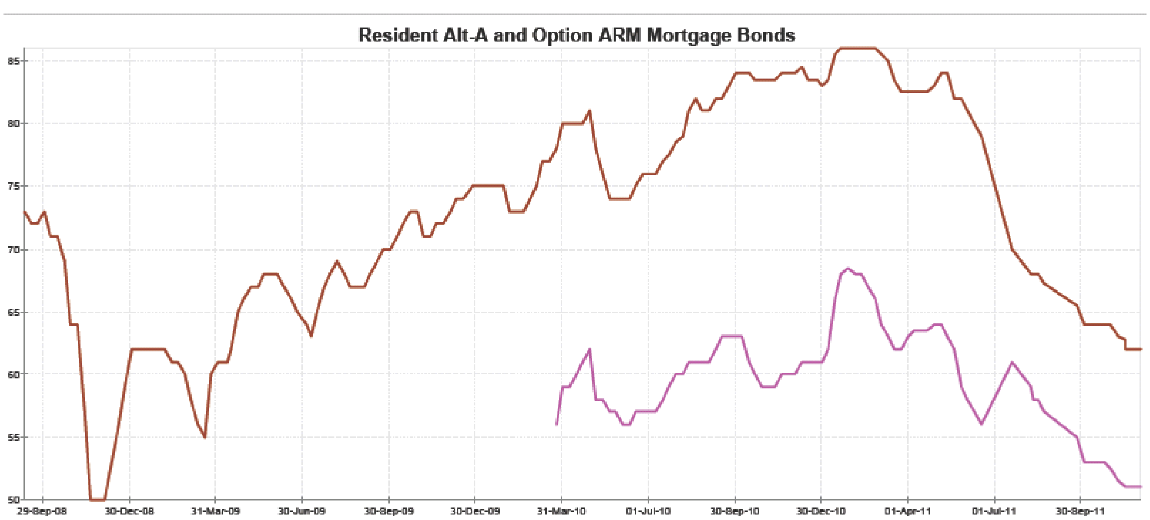


Source: NAR, Census, Credit Suisse

On the previous page, the standard Case-Schiller Index chart tells the sad story that although residential home prices have declined tremendously from the apex, they are still above the hundred year trend. However, once one adjusts for the level of Income and Interest rates, housing has never been more affordable. (Please see the next charts preceding and below.)



This is a fine segue to our recommendations. In the chart below, the –ochre line- is the dollar price of Clean Alt-A bonds while the –pink line- charts the price of Pay Option ARMs. Similar to the prices for Levered Loans in the last section, the late summer "risk off" trade took no prisoners anywhere in the credit markets. These loss adjusted double digit yields are a fine portfolio addition.



Source: Credit Suisse Locus

Buy Mongolia

This is a much harder trade now than when I first suggested it last year. Nonetheless, Mongolia is hard on the border of China where fewer than three million people occupy a mineral rich geography that is almost four times larger than California. The Mongolian Stock exchange recently engaged the London Stock exchange (LSE) to help manage and modernize their operations. Moreover, many in the political class are Western educated and are desirous for managed development.

You can allocate funds to specialized managers who have a solid local organization. For those who prefer a little risk in their morning coffee, there are a number of Canadian listed companies that have claims upon Mongolian mineral assets.

GOLD should still be in your portfolio.........

To some people, Gold is a "Ponzi Scheme" not too far removed from the nineteenth floor of the Lipstick building. There is little industrial use for the yellow metal and the Shake Shack in Madison Square Park will not accept a one gram sliver for a dozen cheeseburgers.

That said, Gold is down 10% from its mid-summer high as forced liquidations occurred to fund year-end redemptions. (How else to explain Gold's recent positive correlation to Equities?) This suggests that a "heads I win, tails you lose" situation is cooking in Gold for the year ahead. If Europe does jump off the rails, Gold will almost certainly rise as a safe haven. The alternative would necessarily be a successfully coordinated G-7 balance sheet inflation. The systematic printing of fiat Western currency can only be bullish for hard assets, the most liquid of which is Gold.

Similar to the manner in which we gained exposure to Equities, we would recommend the use of options to express our view. One year Implied Volatility is running well above Realized with a relatively flat put vs. call skew, as such, a "Quiet Bull" structure would be superior to a "risk reversal".

Spot Gold = $1,650/oz

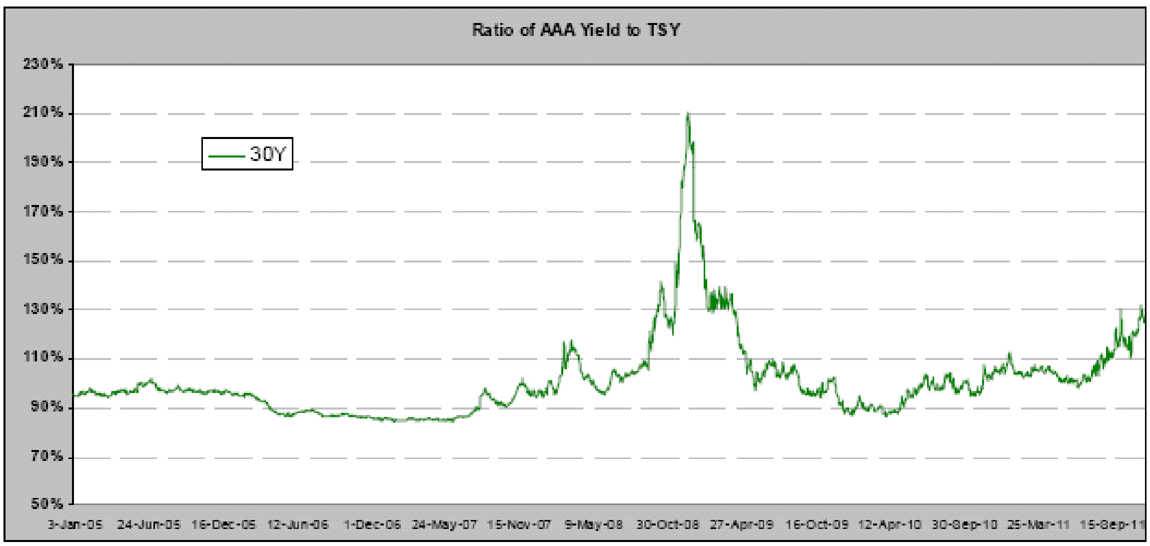
Buy 1 unit	GOLD	call option	strike = $1,650	Expiry December 2012
Sell 1 unit	GOLD	call option	strike = $2,000	Expiry December 2012
Sell 1 unit	GOLD	put option	strike= $1,450	Expiry December 2012

This package should be close to costless.

A Diverse Portfolio of Longer-dated Municipal Bonds

Despite the best efforts of the Tea Party, I can assure you that taxes will be on the rise over the near term. And while it is possible that the tax advantaged status of Municipal Bonds might be reduced, a complete phase out is unlikely.

The –green line- below charts the yield ratio of AAA Municipals vs. Treasuries. Notwithstanding the storyline that the current ratio was only exceeded during the Lehman panic, we would direct you towards mid-maturity (15yr to 20yr) uninsured bonds rated AA- to A+.



Source: Bloomberg/Credit Suisse

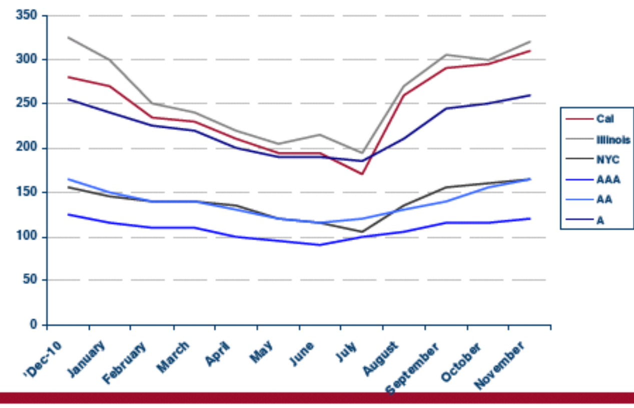
Since the tax advantage in regular Municipal Bonds is wasted on most ERISA and Insurance investors, you should consider Taxable Build America Bonds (BABs) as an alternative path to the sector. As detailed in the table/chart on the following page, the relative value proposition is presently at its greatest.

There are basically two risks with this idea. One is default risk, which can be reduced via diversification. The second is Duration risk. The offset here is that Muni's have a significant negative spread correlation to Treasury rates. Regular Muni's rates are sticky because the marginal buyer (retail investors) has rock solid "yield bogeys". As such, longer-term Muni bonds will simply not trade below 4% on the downside and will start to compress at 5% on the upside. Taxable Muni's (BABs) are in many respects a levered measure of confidence in the political class. This tends to improve as the economy expands and rates rise. A beautiful "pairs" trade would be to purchase longer-dated maturity Muni's in combination with the 10y into 10yr payers described earlier in this Commentary.

➢ Long-dated Spread to Treasury

	Dec '10	January	February	March	April	May	June	July	August	September	October	November
Cal	280	270	235	230	210	195	195	170	260	290	295	310
Illinois	325	300	250	240	220	205	215	195	270	305	300	320
NYC	155	145	140	140	135	120	115	105	135	155	160	165

	Dec '10	January	February	March	April	May	June	July	August	September	October	November
AAA	125	115	110	110	100	95	90	100	105	115	115	120
AA	165	150	140	140	130	120	115	120	130	140	155	165
A	255	240	225	220	200	190	190	185	210	245	250	260



A Summary

Ultimately, you either believe that our policy makers can create inflation or not. The Deflationists (and you know who you are) think that we are headed down a path similar to that of Japan. Their critical evidence being our inability to create Inflation (so far) despite the FED's best efforts. The clear retort is two fold. As noted earlier, Mr. Bernanke believes that Japan simply did not try hard enough as they were hampered by political concerns. Second, and more important, Inflation cannot occur overnight. The Inflation of the 1970's was not the product of Nixon's decision to collapse the Bretton Woods agreement and abandon the Gold standard in 1971, but rather the "Guns and Butter" spending by President Johnson in the 1960's as he simultaneously funded both his "Great Society" programs and the Vietnam war.

A Final Note: While we do not charge you directly for our Comments, we would consider it proper etiquette to allow Credit Suisse to be engaged in executing our ideas. If you presently have CS coverage, please call your Sales Representative to further discuss our thoughts. If you do not have coverage, please allow us to start that process. Our traders are fully engaged in most Global markets and we can transact at competitive prices. If you value these Commentaries, be respectful and act accordingly.

I look forward to discussing these ideas with you in the near future.

Happy 2012

Harley S. Bassman
Credit Suisse US Rates Trading
December 7, 2011

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