RateLab

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

An Open Letter to Dept of Treasury

Dear Mr. Henry Paulson

By now I assume you have read my most recent RateLab where I describe an outline for resolving the GSE situation. It involves using Government action to prod market forces to add liquidity to the MBS market. However, if you would prefer a more DIRECT route that would allow you to stick to your stated "Plan A", I urge you to:

Have the Treasury: **Buy $500bn FN/H 5.5s vs. Issue $500bn T5yrs.**

I am quite serious. This action would:
1) Create $500bn of balance sheet for the MBS market;
2) Meaningfully lower MBS rates;
3) Reduce MTM losses for all Financial Institutions;
4) Earn the Government $13bn annually in Net Interest Margin.

Since the Government is already on the hook for all FN/H liabilities, why rely on indirect methods that are negative carry when you can directly address the main problems of limited Balance Sheet and Impaired Capital Ratios. Lower MBS rates will produce all the ancillary benefits I described plus limit unwanted "equity" exposure.

On a separate note, I hope you consider the likely offer to remain Treasury Secretary into the next administration. Your strong mid-West ethic certainly encourages you to finish the job.

Best Regards,
Harley S. Bassman
August 27, 2008