RATELAB
MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

A Year-end Letter to Dept of Treasury IV

Dear Messrs. Henry Paulson, Ben Bernanke, and Tim Geithner:

This would be my fourth, and final for the year, open letter to the leaders of the US Financial System. Although unacknowledged, I greatly appreciate you taking my notions to heart. To remind you of my past suggestions:

On August 22, 2008: I warned of the need to remove the "Bifurcation of Risk" inherent in the GSE structure and predicted that you would act to take effective control sometime after the Political Conventions but before the October 1 start of the new fiscal year. You were quick on this one acting on the Sunday after the conventions.

On August 27, 2008: I urged you to Buy $500bn FN/FH 5.5s funded by issuing $500bn Treasury 5 year notes. This took a bit longer, but you made up for that in size when you announced on November 25 that you would purchase up to $600bn Agency securities.

On September 10, 2008: I outlined your "Rules of the Road":

1) Add liquidity to the Residential Mortgage Market;
2) Lower the Primary Mortgage Interest Rate;
3) Accomplish this without benefiting the "Fat Cats" [moral hazard].

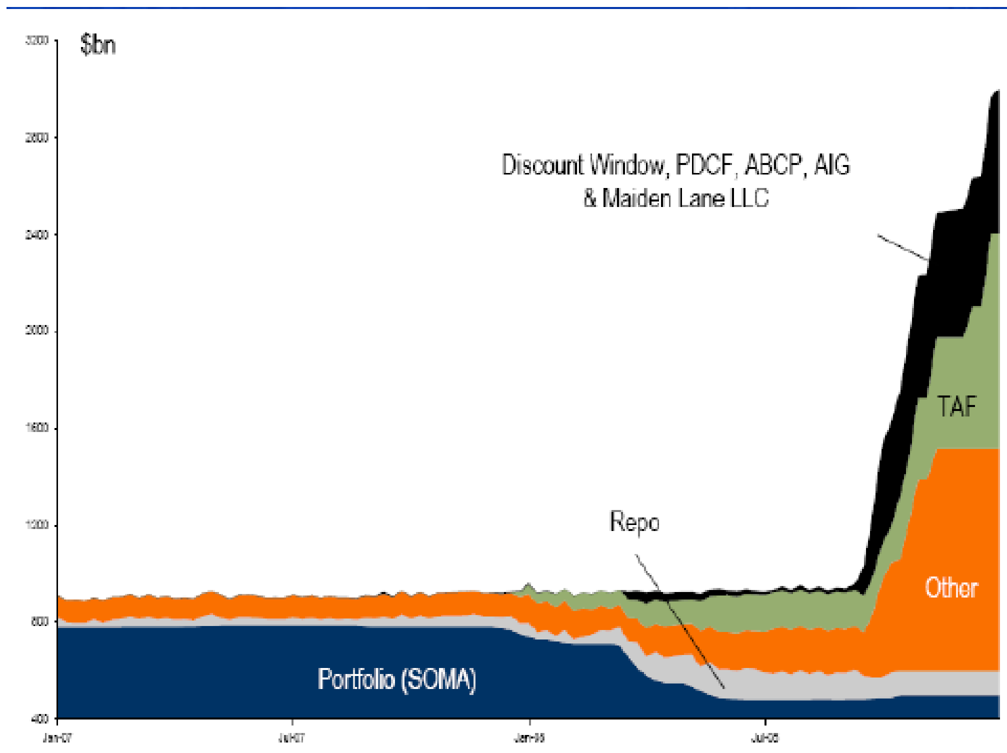
Let's see – buying $600bn adds liquidity, the Secondary Par MBS rate has declined from 5.24% to a current 4.22%, and the "Fat Cats" on Wall Street are almost uniformly receiving no bonuses this year. That works !!

On September 12 and 18, 2008: We recommended that you:

1) Re-instate the "Naked Short" rule;
2) Demand disclosure of positions in Derivative Indices (ABX, CMBX, etc);
3) Lower risk weighted capital for GSE/MBS obligations;
4) Reclassify some AFS assets to Held-to-Maturity;
5) Heavily regulate/supervise the Rating Agencies;
6) Massively increase the scope of FDIC insurance.

Most importantly, we urged you to become **the Balance Sheet of last resort.**

On this, you are exceeding even our expectations. The chart below extrapolates the distribution of all the announced "Alphabet Plans". **If these Plans are all executed on schedule, the FED's Balance Sheet will exceed $3 Trillion by January of 2009.**



As per the others on the list, you have taken actions that address many of these, although the decision to reject even a short-term modification to mark-to-market accounting needs to be reviewed.

So what do we recommend going forward ?

1) Slightly alter the $600bn "MBS buy program". The size is fine, and whether you fund it at the FED via "fiat accounting" or at the Treasury via bond issuance is irrelevant. However, **instead of buying already issued FN/FH MBS, you should instead purchase Prime non-agency (Jumbo) Fixed-rate bonds.** These are some of the bonds that are clogging up bank balance sheets. Not only are they generally "money good", but also these borrowers generally did NOT take advantage of the system during The Bubble. Moreover, these borrowers are the well employed who could buy a house if given "fair market" mortgage financing. Furthermore, **it adds direct help to US borrowers while reducing the possibility that non-domestic MBS holders will use the facility to sell their MBS bond holdings.**

2) End this nonsense about cutting rates and focus on "Effective Quantitative Easing". **As we have shouted since the start, this is NOT a price problem, it is a trust problem.** Bear Stearns did not go under because they could not borrow money at 15%; they went down because they could not borrow money at any price. Furthermore, **cutting rates below 1% will just cause greater damage to the already fragile Money Market system.** At a 1% short-term rate, Money Market funds can offer a slightly positive yield while charging the necessary fees to run their operations. If short-term rates dip below here, Money Market operators may be squeezed to take irrational actions since their fee structure could be greater than the return on their assets. Moreover, a zero-rate money market fund may force consumers to act irrationally. This needs to be avoided.

3) "Effective Quantitative Easing". This means you should NOT buy Treasuries, especially long-term Treasuries. The only entity that can finance anywhere near the Treasury rate is the USGovernment. As such, lowering that rate offers no help to the markets. Additionally, the recent massive flattening of the Yield Curve (and the inversion of long-dated swap spreads) is a direct result of your "FED Speak" of quantitative easing. That drove panic stricken Pension Funds and Insurance Cos to "receive fixed" lest their already injured Asset::Liability situation worsen more. To the contrary, you need to be issuing, in great size, long-term Treasuries while purchasing the Prime fixed-rate bonds mentioned above. **You need to steepen the Treasury/Swap Yield Curves while flattening the Credit/MBS Yield Curves.**

4) **Massive and coordinated regulation is required for Credit Derivatives.** This must include: a) Clearing and maintaining trades on a central exchange to reduce counter-party risk; b) Higher and standardized margining costs, similar to those required for Equities; c) Position limits, similar to CFTC Commodity limits; d) Insurance Licensing requirements for some products; e) And maybe even the elimination of some products, specifically Municipal Credit Default swaps. In the current illiquid market, some small trades are significantly re-pricing the debt for large and important financing deals.

5) Some sort of **short-term modification of Mark-to-Market accounting rules for regulated financial institutions.** There is no question that we are in middle of a capital reducing "death spiral". The standard FED medicine of steepening the Yield Curve so that Financial Firms can "earn out" the problems over a few years is being thwarted by the need to continuously sell assets to maintain capital ratios. This problem was the initial motivation for TARP. *As much as "short-term Socialism" is presently required to save "long-term Capitalism", we need a short-term "time-out" of some MTM rules until we can stabilize the capital base of the overall financial system.*

6) As noted in the introduction, USGovernment related actions have reduced the Secondary MBS Rate by over 100bps. However, this reduction must now be transmitted to the Primary markets. To do this, **the GSEs need to revise their rules to allow for a "super-charged" Streamlined ReFinance Program.** FN/FH already have ReFinance programs on their books, but they need to be modified to allow for Par-for-Par ReFinancing even if the LTV has risen above 80% or if the homeowner's income has declined. Since the GSEs already have the risk on their books, lowering the mortgage rate of these loans can only help them from a credit perspective. The only loser will be the owner of the premium priced MBS bonds. It is the anticipation of such actions that have contributed to the compression of the coupon stack.

7) The Government needs to enact a truly **massive fiscal stimulus plan, something on the order of $700 billion (5% of GDP).** Frankly this topic is probably a bit above my pay grade, but the Government needs to meet Brass with Brass. Although this spending will not reach the economy for quite a while as the planning for deployment of infrastructure dollars will take time, the shock value of the sheer size will be helpful for confidence.

Summary Concepts:

From the early stages of this crisis, I have been comparing the situation as similar to the period of 1989 to 1992 (as opposed to 1998 or 2002).
[See RateLab – *"We are going to Party like it's 1991"* August 17, 2007]

However, the more appropriate comparison may now be to Sweden or Japan of that same era. Both of those countries experienced a massive national housing/banking crash. The only question now is do we follow the Swedish or the Japanese path ?

Many economists argue that we may be on a path similar to Japan because they could not find a way to break the deflationary spiral. On this point I strongly disagree. It is not that Japan COULD NOT create inflation, but rather they DID NOT create inflation. **In a nutshell, they just did not try hard enough.** They were slow to act early on and when they finally did, they did not act forcefully enough to cleanse the banking sector. Compare their actions to those of Sweden who took much more aggressive action in their banking system.

Closer to home, FDR depreciated the USDollar by 40% in 1933/4 via use of the Gold Window. Combined with WPA fiscal action, inflation subsequently changed course from -10.3% in 1932, to -5.1% in 1933, to +3.4% in 1934. **(YES – the FED/Government can create inflation !!)** The main reason we did NOT come out of the depression in the later 1930s is that the USGovernment lost its nerve in 1937 and raised taxes and cut spending.

We are in fiat currency system. As such, as Bernanke detailed in his November 21, 2002 speech (The Helicopter Ben one), deflation can be stopped if enough force is applied. We need to apply this force via the channels I have described above. We still have a harsh recession to work through, but with enough nerve and intelligence, this too will pass.

Happy Holidays to you and your families.
Best Regards,

Harley S. Bassman

PS: As a reminder, this letter solely represents my personal opinion

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