RateLab

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

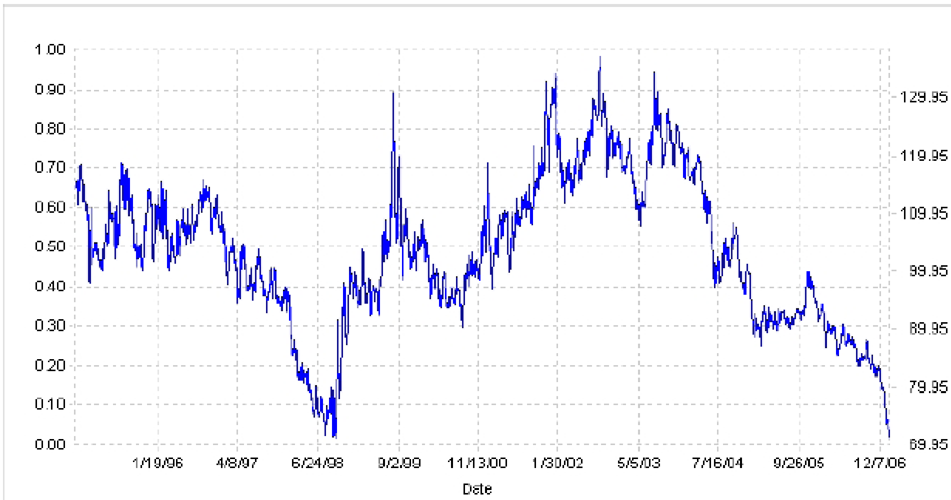
The Market will NOT PAY for Volatility protection…….
…….even with Implied Volatility at record lows;
….and it will NOT PAY for Credit protection…..
……even with High Yield spreads at record tights;
….and it will NOT PAY for Curve protection….
…….even with Correlations at record highs;
….so why will it PAY to own duration with unlimited risk ???

We believe in a broad based efficient market where “alpha” premiums across all risk vectors are correlated over a medium-term horizon. If this were NOT the case, market participants would engage in transactions to reap the rewards until risk parity resumed. Currently, investors seem to be acting incongruously as to how they allocate capital across the risk spectrum. This current RateLab looks to optimize investor portfolios to allow them to express their market views in the most efficient fashion.

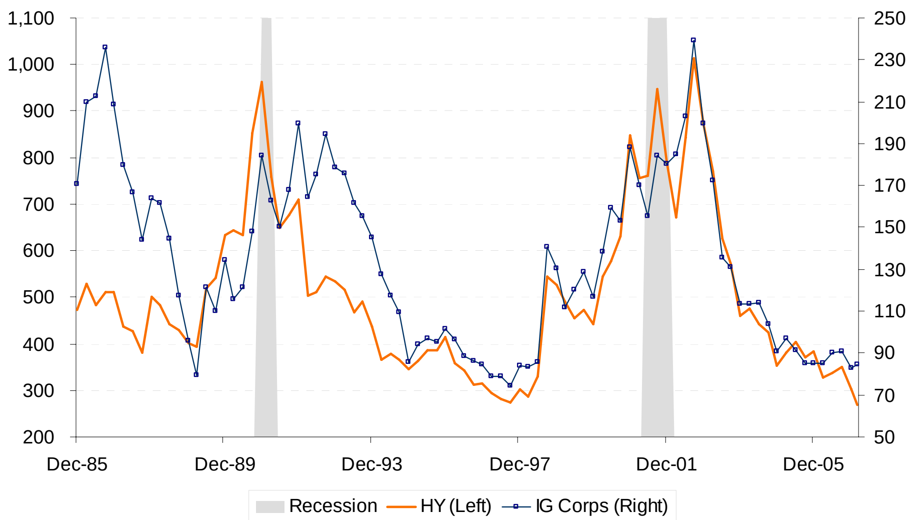
The Current Landscape:

The chart below of the Implied Normal Volatility for 3yr into 10yr swaptions shows that we have recently reached the all-time recorded lows, near 72 Nvol. Although there are many reasons for this steep decline, the primary one is the lack of demand for hedge products as manifest by the "reach for yield".

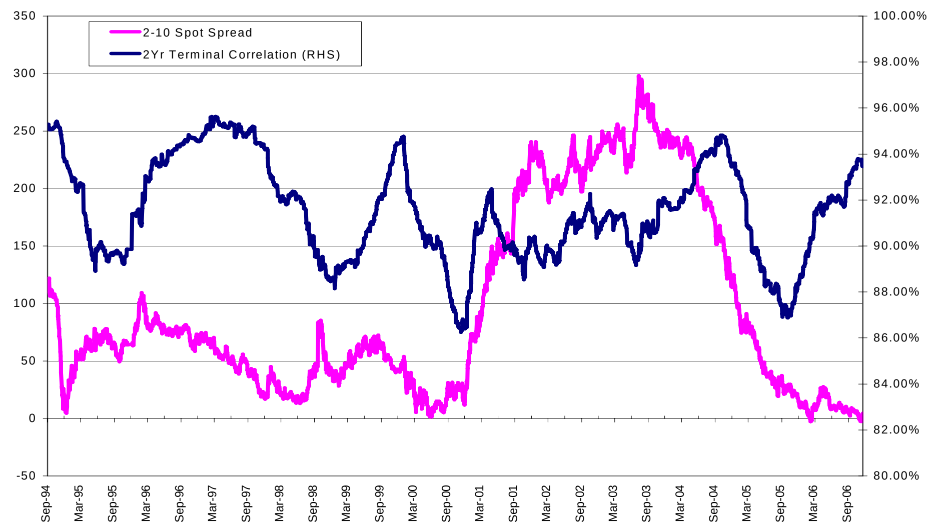
Comments:
Implied Normal Vol for 3y-10y



This chart shows another view of the same concept. It is the net spread of High Yield and Investment Grade Corporate bonds over US Treasury yields. Notice how the "reach for yield" has compressed spreads to near the all-time lows.



This final chart highlights two last concepts. The Pink –left– Line shows the shape of the yield curve as measured by the difference between the 2yr swap rate and the 10yr swap rate. One can think of it as a measure of the "alpha" for duration risk. The current flat curve implies that there is no nominal benefit to incurring additional risk via extending duration; in fact, there is a slight cost. The Blue –right- Line is a measure of the correlation between the 2yr swap rate and the 10yr swap rate. A high correlation is a symptom a seemingly low risk world.



The Conundrum:

So if the aggregate investment community's desire for yield is so great that they are <u>unwilling to purchase "performance insurance"</u> via the options market and <u>willing to absorb huge credit risk for minimal return</u> via the corporate bond market, **why are they willing to "give yield" to extend on the curve and accept an unlimited downside loss ??** Under current market conditions, investors are absorbing an opportunity cost of about $112,000 per 100mm per quarter to own off-the-run 10 year Treasuries instead of overnight repo. Although investors have the opportunity for large gains, they are also exposed to the risk of large unlimited losses. Why are investors willing to enter into such a situation ?? Many market participants believe the Fed will soon be easing and that all rates will be much lower in the near future. They are willing to pay this opportunity cost in order to gain upon the day rates experience a large decline. We have a superior proposition……

A Better Mousetrap:

We are NOT going to enter into a discussion of near-term FED policy or the merits of being long duration as a way to profit from imminent policy easing. What we will propose is that incurring negative carry to garner such exposure to lower rates is philosophically similar to buying call options. The anomaly here is why investors who would usually NEVER pay an option premium (and "give yield") to create a risk exposure of unlimited upside versus a fixed loss are all of a sudden willing, in effect, to PAY a similar premium via negative carry yet still be exposed to unlimited downside. Why not just invest in a cash vehicle and purchase some form of call option ?? Given the current rate structure and volatility surface, there are a number of ways to create a superior performance portfolio.

A Simple Trade Idea:

a) Move 10yr "bucket" Treasury exposure to repo
b) Buy 3 month european call options on the Tsy10yr;
   Strike 3 ½ points in-the-money @ 3 ½ points.

Result: Pick up 45bp running in net income; Unlimited participation to lower rates on a one for one basis; Limited downside if rates rise.

Specific pricing example:
Spotting the T 4.625% 2/17 at 98-20
Buy 100mm Euro Calls; Strike = 95-04 (3-16 in-the-money)
Expiry = May 14, 2007 (3 months)
Price = 3-16/32

Think about it…….

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