RATELAB
MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

Top-Line Inflation Minus EVERYTHING is Zero

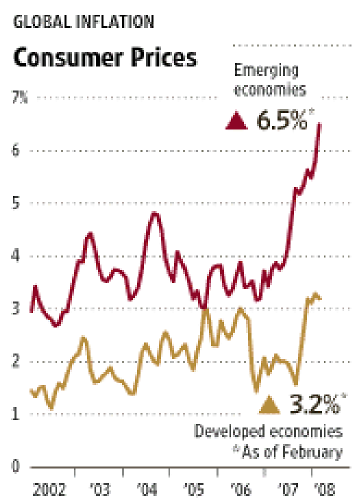
Rising Commodity Prices Cast Shadow World-Wide

Steel, Power Firms Battle Pricey Coal, Stunting Japan

By KENNETH MAXWELL and HIROYUKI KACHI
April 10, 2008; Page B4

TOKYO -- As raw-material suppliers continue to flex their pricing muscles, Japanese steel and power companies agreed to **pay two to three times more** for the coal they need to make their core products.

STICKER SHOCK: Rising costs of food and fuel have prompted protests around the developing world, including this clash Monday in Egypt.



Source: International Monetary Fund

This story, detailed in last Thursday's Wall Street Journal, cannot make our case any clearer: Fiat Currency around the globe is in trouble. And most certainly, lenders will soon be demanding longer-term debt returns greater than inflation.

Background:

It is certainly true that the last nine months have been stressful for all participants in the Debt Markets. And the recent price action makes it clear that everyone has been more interested in *"return of principal"* rather than *"return on principal"*. But at some point, rationality must return. Real money investors, such as ERISA and Insurance Cos., must invest at Rates of Return greater than Inflation if they are to cover their long-term obligations. Moreover, even Hedge Funds must create a Gross Return (before the two and twenty) north of six percent if they are to at least outperform Libor on a Net Return basis !!! As such, a USTreasury Ten Year rate of 3.50% will simply not cut it when Top-Line USDollar Inflation is 3.40%.

How much panic is too much.....?

The UST 2yr rate is currently at 1.78% while the UST 10yr is at 3.50%. Using that Two year rate as a discount value, the Forward Rate for the implied Eight year tail is about 4.00%. Put another way, an investor could buy the current Ten year at 3.50% to lock-in that return over the total investment horizon or he could buy the current Two year at 1.78% and hope that he could buy an Eight year Treasury in two years at 4.00% to be indifferent between the two investment paths.

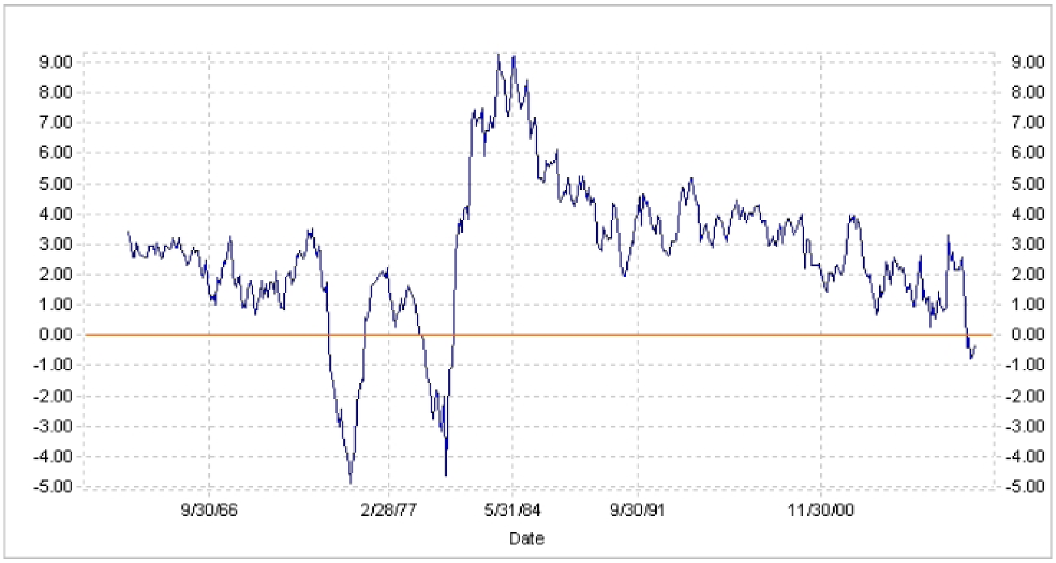
As much as many see no end in sight to the credit crisis, we must beg to differ. The FED's actions last month quickly halved mezzanine credit spreads and reduced Implied Volatility by 15% to 30% across the entire expiry grid. Two more years of FED action and Financial Institution de-leveraging will certainly place the world close to the end of this drama.

Since most economic and regulatory cycles are completed within two to three years, one has to ask what set of outcomes are implied by a 3.50% Ten year rate. The Conventional Wisdom that would justify the current rate structure:

1) A massive FED easing that takes the Funds rate to 1.0% or lower;
2) A consumer led US economic downturn that significantly reduces inflation;
3) The FED cannot maintain the plumbing of the Global Financial system; or
4) Another bubble (Commodities?) violently implodes.

Markets can remain irrational longer than one can stay solvent:

Tsy10yr Rate minus Spot Top-Line CPI



As the shorts can affirm from the "NASDAQ 5000 Internet Bubble", periods of insanity can extend well beyond the ability of the naysayers to remain solvent. Yet this too must pass and eventually the markets will return to rationality. The chart above is simply the yield on the Treasury Ten Year note minus the change in Spot Top-Line CPI. And while one certainly would be correct in pointing out that the former is forward looking while the latter is a vision from the rear-view mirror, one can easily see that this difference has not been below zero since Gerald Ford was passing out "WIN" buttons. (Non-Geezers can look this up.)

Furthermore, the "End of the World" premium built into Treasuries seems to have slackened as even weaker economic data since the BSC "takedown" has been unable to reduce rates below their March 14 lows. In fact, there is now a foot race between a weaker economy and the not too distant date when the Paulson-Pelosi stimulus package limits the widening of the output gap and starts to exert upward pressures on Inflation.

So what are we saying: *Prudent fiduciaries must soon reduce their holdings of negative Real Yield Securities.* We propose that the "Ponzi Scheme" that is also known as the USTreasury market will unravel. A Treasury Ten year rate of 3.50% can only be profitable in the long term if the US economy enters a serious recession accompanied by a huge reduction in CPI. But the FED has already shown its hand; They have many non-traditional tools that will all be used to support the system. And these tools almost all involve vastly expanding their balance sheet. (That is called INFLATION !!)

Recommendations:

In a nutshell, we believe the Curve will steepen, but slowly, since *the FED has clipped the wings of the Rates distribution.* This is why Implied Volatility on Rates has declined so much in recent weeks. As measured by the MOVE index, Implied Volatility has declined by about 25% from the mid-170s to the low-130s. (Still at the upper end of the long-term range.) This is also why Agency MBS have done so well. But since MBS still carry a lot of baggage, we prefer to focus on pure Rates strategies that have no embedded credit risk.

Conditional Steepeners:

Sell 417mm 2y- 2y atm Payers at 122bps
Buy 100mm 2y-10y atm Payers at 481bps
Strike = 96bps (60bp better than today's spot of 156bp)
Take-out ~~ $277,000

Sell 813mm 2y- 2y atm Payers at 122bps
Buy 100mm 2y-30y atm Payers at 813bps
Strike = 118bps (92bp better than today's spot of 210bp)
Take-out ~~ $1,788,000

Libor Range Notes:

Issuer:	Rabobank (Aaa/AAA)
Tenor:	10 years Non-Call 6 months (& callable quarterly thereafter)
Coupon:	**a) 5.80% for the days 0.00% <= 6m$Libor <= 7.00%**
	b) 7.10% for the days 0.00% <= 6m$Libor <= 6.00%
	paid quarterly 30/360
Price:	100.00%

Non-Inversion Note:

Issuer:	Rabobank (Aaa/AAA)
Tenor:	10 years Non-Call 6 months (& callable quarterly thereafter)
Coupon:	**7.50% for the days (CMS 30yr - CMS 10yr) >= 0.00%**
	paid quarterly 30/360
Price:	100.00%

ML US Rates Strategy
April 15, 2008