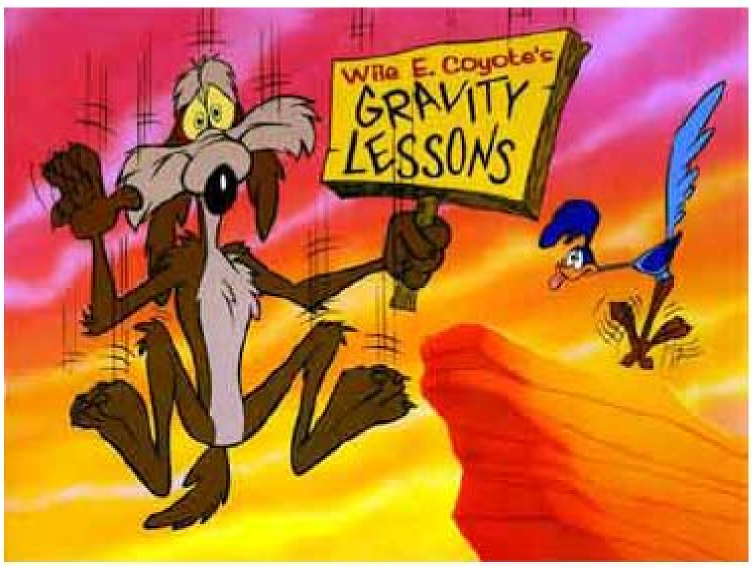
RATELAB

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the BAS/ML Trading Desk

Of Helicopters and Gravity



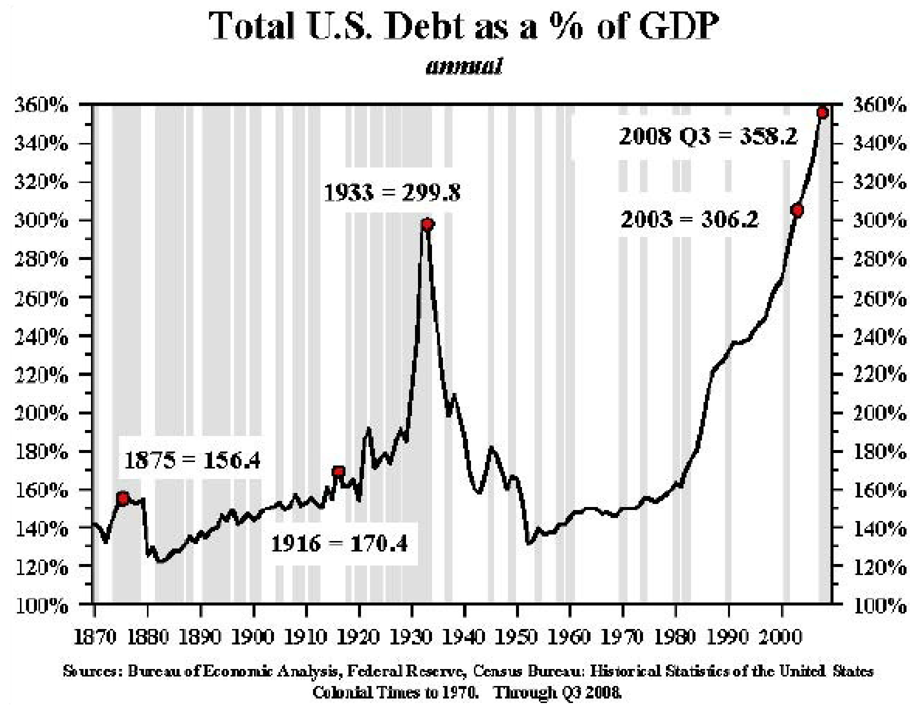
The chart on the next page should be familiar to all Financial Market participants. It details the massive expansion of Debt created in this country since the end of the last Great Recession (1982). Almost all large Financial debacles emanate from some sort of Debt/Leverage/Balance Sheet problem, and this one is no different.

The solutions that are available to resolve these problems tend to fall into two camps. The first was summarized by the US Treasury Secretary, Andrew Mellon, in 1929: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate……it will purge the rottenness out of the system". In a nutshell, the idea is to pay off the debt. Unfortunately, this prescription does not end well when the citizenry is armed with more than pitchforks and torches.

April 16, 2009

This leaves the only other solution: Inflation

The beauty of the Inflation solution (from the policy maker's standpoint) is that it quietly disperses a pernicious tax slowly across the entire populace to effectively socialize the losses that must be realized in aggregate at some point.



This method usually fails because the debtor nation tends to create its debt in one of the stronger "reserve currencies" yet they can only print their own local currency. Thus, the Inflation resolved Debt problem soon transmogrifies into a larger Currency problem.   This usually ends in tears for all involved.

The beauty of our Debt problem is that we have borrowed in USDollars and can also print USDollars. Since the Dollar is presently the only Reserve Currency in the world, this plan of printing Dollars to reduce/debase the outstanding Debt might actually work.

The naysayers, and there are many, insist that the FED cannot create Inflation. This is certainly not true. The Government can create Inflation; the only question is whether they have the political will to do so. Bernanke himself addressed this issue in his November 21, 2002 speech to the National Economics Club. This is where Bernanke earned the moniker of Helicopter Ben when he quoted Milton Friedman's notion of a "helicopter drop" of money.

Let's consider a few real life examples. In 1933-34, the USGovernment purchased (confiscated) the private gold holdings of the citizenry at $20.67/oz. (In fact, soon after this, it became illegal to privately own gold bullion.) After the gold was safely in Fort Knox, they devalued the USD by 40% via raising the price of gold to $35.00/oz. By the end of 1934, inflation was running at almost +4%, up from -10% in 1932 and -5% in 1933. The depression might have ended there had the Government not lost its nerve and raised taxes soon after.

Or consider Japan and their inability to end the "lost decade". The reality is that policy makers were slow to react on many fronts. From late in 1990 until early 1996, the Benchmark BOJ rate averaged 150bps HIGHER than the Japanese CPI rate. This certainly cannot be called aggressive policy. Moreover, when they did respond strongly, their actions were not sustained long enough. Economic growth or signs of inflation were often met with a premature reduction in stimulus.

Six Months or Six Years

The bottom line here is simple: If Inflation is the ONLY solution, then it will be the solution. The only question is when and for how long.

To tout my University of Chicago credentials, Monetary Policy does matter. Moreover, to quote Milton Friedman, "Inflation is always and everywhere a monetary phenomenon".

$$MV = PQ = GDP$$

As described above, the reason the massive FED injections of cash into the system has so far failed to increase GDP is that "Velocity" has been decreasing faster than "M" has been increasing. This is what created the urgency for the $800bn Fiscal stimulus plan. However, as soon as "V" stabilizes, Inflation will be off to the races.

What is our "house" view ?

Leaving at the top of his game, Wall Street's current Dr. Doom, our David Rosenberg, is forecasting a real GDP print in Q3 of +3.2%. (yes, that is Q3 of 2009 !!) This would certainly be bad news for all the bond bulls.

But one man's opinion is just that, so let's look at the larger picture.

In early 2008, Drs. Carmen M. Reinhart (University of Maryland) and Kenneth S. Rogoff (Harvard University) published a draft report titled: *"Is the 2007 U.S. Sub-Prime Financial Crisis So Different ? An International Historical Comparison"*

In it they detail how other countries that have faced seemingly similar situations have fared. They further sub-divide the data into a "Big 5" set that captures how the larger economies were impacted. Below are some of the Charts included in their report. [So T= 0 is late 2007]

With reference to the first chart, Figure 1, using Case-Schiller data (and projecting to T = 2), we are presently below the 2003 base Index level. As such, -the blue line- seems to have followed the average "Big 5" -green line- on a slightly accelerated basis. If one uses GSE data for comparison, then the housing market has to decline another 5% to 10% to reach parity.

Figure 1: Real Housing Prices and Banking Crises

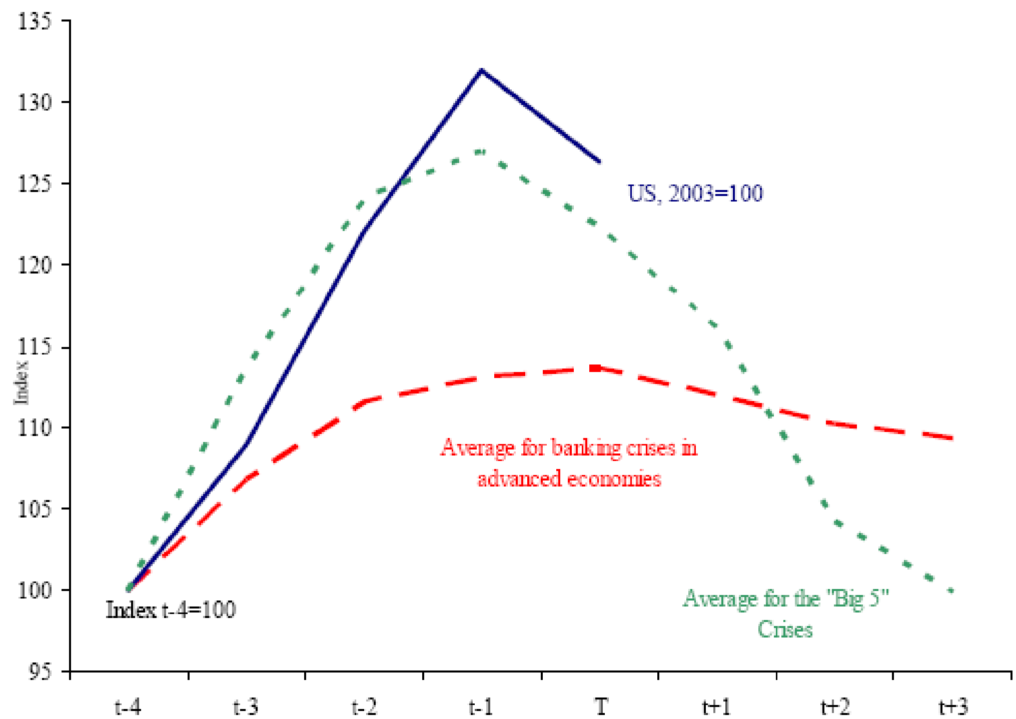
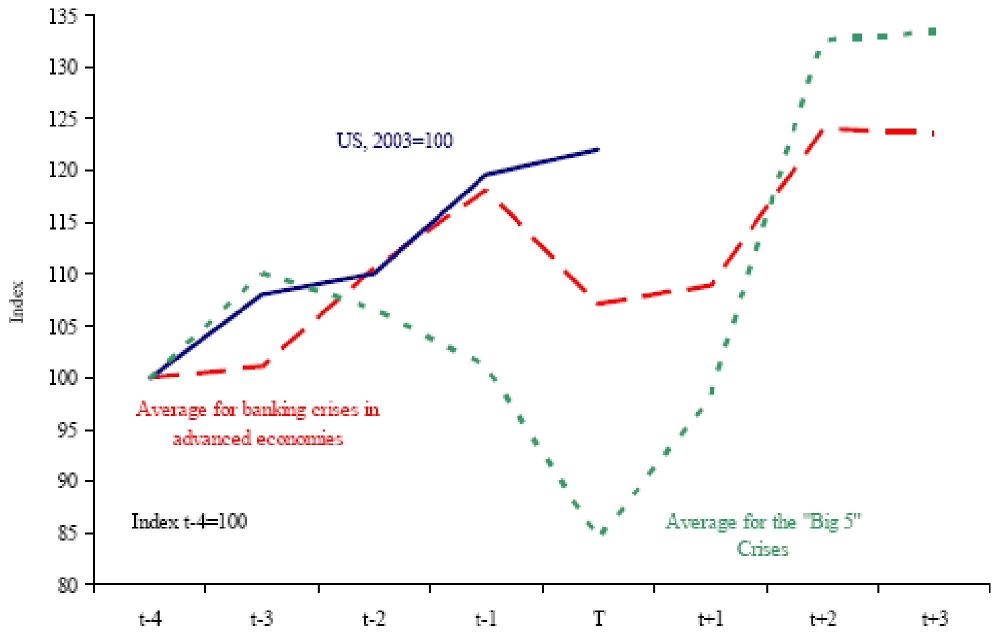


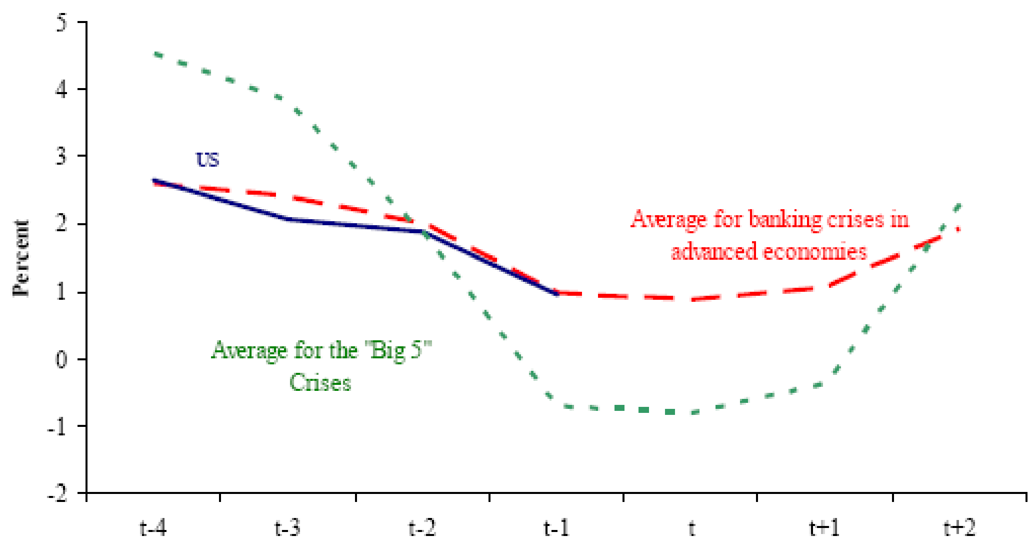
Figure 2 details the impact on the equity markets. Using either the Dow or the S&P 500 as index vectors, the (projected) –blue line- US market has already vastly exceeded the declines realized in the "Big 5" –green line-.

Figure 2: Real Equity Prices and Banking Crises



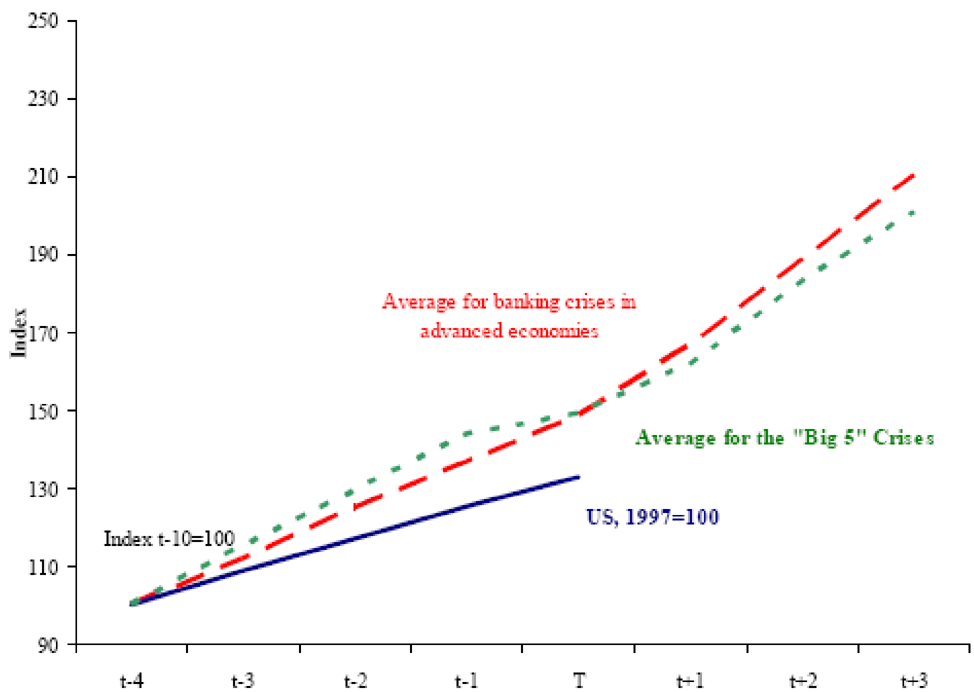
In Figure 4, depending upon how one annualizes our recent GDP data, it once again looks like the (projected) US –blue line- has exceeded the depths of the "Big 5" –green line-.

Figure 4: Real GDP Growth per Capita and Banking Crises (PPP basis)



As per our last chart, Figure 5, depending upon whether you believe the White House or the GAO projections for the forward looking deficits, the US –blue line- will be soon catching both the Average –red line- as well as the "Big 5" –green line-.

Figure 5: Public Debt and Banking Crises



Wherever you lie across the "state of fear" map, we will repeat that "this too will pass"; and maybe more comforting: Even the Great Depression ended !!!

And even if you are suspect of our official prediction of a +3.2% GDP in a few months, the cold reality is that we are nearing the end of the down cycle if we follow the history of similar events.

Never Discuss Religion or Politics in Polite Company

For arguments sake, let us stipulate the FED can create Inflation. So the question now becomes, does the Government have the will to do so ? Ignoring mom's advice from above, let's talk politics.

The Chairman of the FED, Ben Bernanke is one of the foremost experts on the Great Depression of the 1930s. He has written at great length about the policy errors that occurred previously which increased and extended the situation. It is doubtful he cares to repeat these errors. As such, protestations aside, he is likely to be slow to remove the stimulus.

Assistant Treasury Secretary Lawrence Summers was in high government office through most of the Japanese "lost decade". As above, it is doubtful he will support similar policy errors.

As for President Barack Obama, aside from his close ties to the University of Chicago, he is well aware of history. Great Presidents are not born, but rather they become "great" by successfully serving during exceedingly difficult times. Nobody recalls Calvin Coolidge who presided over the grand "Roaring 1920s", but we all know Abraham Lincoln and Franklin D. Roosevelt who stepped into office to face and successfully end the Civil War and the Great Depression.

I cannot assure you how this will all turn out, but I can state that the gentlemen above are fully aware of the great opportunities to lead and that they will do all that is within their power to not fail.

So if Inflation is the answer, then we will have Inflation. And once we have Inflation, it will not be removed too soon in order to assure success.

Like Wyle E. Coyote, the bond market has run off the cliff and has yet to look down. Hopefully the FED can ReFinance the MBS market before GDP bounces back later this year.

But in either case, our advice to the Bond Bulls: Don't look down !!

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April 16, 2009