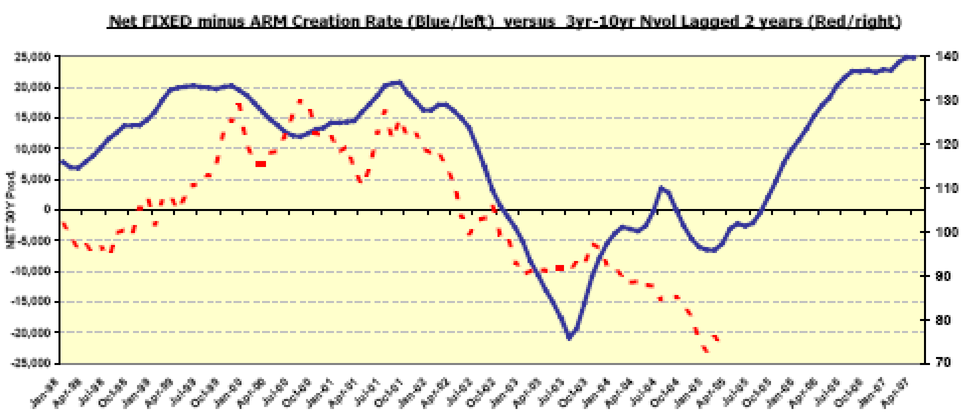
RateLab
MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

<u>The Elephant in the Corner: Who will buy MBS Duration?</u>

In our last RateLab, issued on May 15, 2007, we focused on the MASSIVE Volatility buying created by homeowners refinancing their resetting ARMs into Fixed-rate mortgages. (See chart below) As you may recall, the standard ARM will reset into a Floating 1yr CMT + 225bp, currently about 7.50%. Concurrently, a new Fixed-rate MBS can be created at a retail yield of about 6.25%. Although some homeowners may prefer to refinance into a new 5:1 ARM at 6.00%, we believe a high proportion of homeowners will forsake the 25bp advantage to lock in these relatively low long-term rates with the knowledge that they can always refinance again if rates decline in the future. We calculated the purchase of the embedded refinance option as the swaption Vega equivalent of homeowners buying $12 billion a-t-m 3yr-10yr straddles per month. But as we reflected in the glory of our cleverness, we noticed the elephant in the room, namely, the duration impact of the ARMs to Fixed-rate refinance was the bigger story. Below, we weave together a few recent datapoints that may describe the unimaginable:

A Big Brown Grizzly Bear may be looming on the horizon!



The Prologue:

Via near unanimous acclamation from Traders, Economists, and Policy Makers, whether bullish or bearish on the economy, all agree that there is a "conundrum" as to why longer-term USD interest rates are so low given the basic state of the world. The numbers generally bandied about suggest that the USD T10yr is 50bp to 100bp too low versus where it might otherwise be without the "conundrum". The "explanation", also generally agreed to by acclamation, is that the trade deficit from exporting nations is recycled through their Central Banks into US Treasuries, a sort of global "vendor finance". Although we will stipulate this to presently be true, the question is, can it continue indefinitely as a new paradigm?

The Proposition:

To richen the world's largest bond market by 50bp to 100bp requires a sustained and massive buying of USD securities. However, to reverse this process does NOT require the exporting Central Banks to sell a single bond; all that has to occur is a slight reduction in their buying. Since a market is NOT priced to value all the assets but ONLY to the value of the last asset exchanged, even a small reduction in purchases would reprice the entire asset class. Consequently, a small alteration in the recent supply::demand dynamic could quickly lead to a significant revaluation.

The Story....block by block:

The FED:

The most recent large decline in USD rates started in late June, 2006, just prior to the FED's August meeting where they indicated that the "hiking process" was to be paused. Central Banks led the charge to extend duration as the market believed that eases were in sight. This anticipation led to a severe Yield Curve inversion and its associated negative carry. <u>However, despite the market at times aggressively pricing in lower forward rates, the FED has NOT given any signal that eases are imminent</u>. We have almost expected a GHWB paraphrase from the FED: "Read my lips, no lower rates"! **Thus the creation of our RateLab catchphrase: The REDS versus the FED.** This message may finally be seeping into the market as even some of the largest money managers now concede that they may have been a bit premature. *Our opinion: The FED is on hold as long as the Dow is above 13,000 AND the Unemployment rate is below 4.75%.*

The Supply:

A key support for the lower rates parable is the diminishing supply of Treasury securities. In fact, strong tax receipts may even lead to net paydowns in Treasury securities this year. Past RateLabs have focused on seasonal net supply dynamics to anticipate near-term price action. *However, a new supplier of duration has emerged: The Fixed-rate MBS market.* Glancing at our first chart, or viewed in detail from our last RateLab, the MBS market is net creating over $25 billion Agency Fixed-rate bonds a month. That is roughly $11 billion in T10yr equivalents at today's Current Coupon OADuration.

The Demand:

We all can opine about cash levels, net market positions, and what trade "hurts the majority", but all of these issues have existed for the entirety of the "conundrum". What we need to identify is a secular change that will alter the last trade ticket from a buy to a sell; and we believe the WSJ article below is it!

China making a $3 billion direct investment in Blackstone is the first sign that exporting Central Banks will take action to diversify their holdings away from USD debt obligations. $3 billion is not much, but as noted at the outset, all we need is a slight change in the flow of funds to reverse the "conundrum".

WSJ.com THE WALL STREET JOURNAL. ONLINE

May 21, 2007

EUROLINKS DAILY VIEW

Blackstone Stake Is Just The Beginning for Beijing's Billions

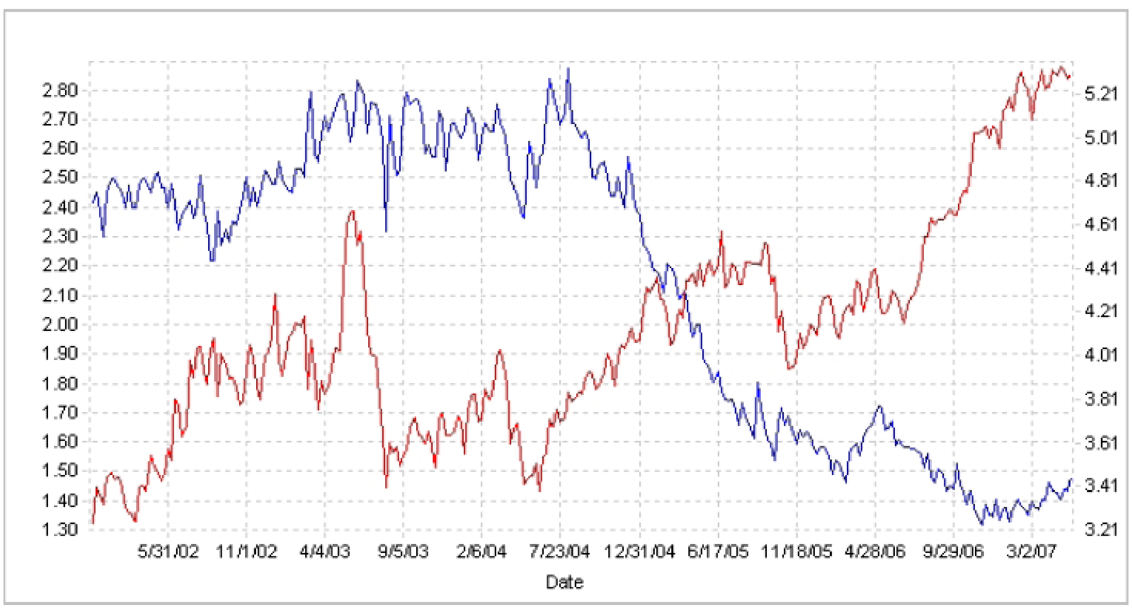
By MICHAEL CONNOLLY
May 21, 2007

China's move to take a $3 billion stake in U.S. private-equity giant Blackstone Group marks an unusually aggressive start to the country's long-anticipated campaign to diversify how it invests its massive $1.2 trillion foreign-exchange reserves. The deal is expected to be completed alongside Blackstone's announced $4 billion initial public offering of a 10% stake in the firm.

The Instability:

We will not bore you with yet another chart of Implied Volatility nearing the all-time lows for some number of eons. Instead, we will direct your attention below. The –Blue line- (right) is the Option Adjusted Duration (OAD) for the constant Current Coupon (par priced) 30 year MBS. Notice how the flattening of the Yield Curve combined with the reduction in Implied Volatility has reduced the OAD from 5.0 to 3.4. That is a lot of Duration that has mathematically vanished since late 2004. This Duration will return quickly upon a steepening of the Yield Curve. How quickly…..? The –red line- (left) is the Option Adjusted Convexity (OAC) for the constant Current Coupon (par priced) 30 year MBS. Notice how it has increased from the 1.80s to the 2.80s. This is a great measure of the instability of the duration of MBS. If rates were to rise in any sort of UNREASONABLE fashion (please note the sarcasm) such as above 5.00%, the MBS mart would lengthen by well over one hundred billion T10yr equivalents.

Comments:
Blue - right - OADuration FN Current Coupon MBS
Red - left - OAConvexity FN Current Coupon MBS (absolute value)



The Final Denouement:

We have no burning desire to predict the tops or bottoms in the rate markets. (Volatility, of course, is and entirely different matter.) And there is certainly a powerful story about a slackening consumer reigned in by a declining housing market. But as long as tight Spreads and an inverted Yield Curve enable the homeowner to refinance from a resetting ARM to a Fixed-rate MBS at over a 100bp difference, there will continue to be a huge supply of Duration to the market at a time when the largest buyers are diversifying to Equities, Commodities, etc.

Recommended Trades:

1) Buy FN 5.5 August 16/32 o-t-m puts @ 9/32

2) Buy FN 5.5 August half out puts
   + Sell FN 5.5 August 22/32 o-t-m calls; net pay 4/32

ML US Rates Strategy
May 23, 2007