RATELAB

MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

Holiday Stocking Stuffers – 2008

A Portfolio You Can Live With

Come this time every year, we at the RateLab publish a list of "Investments" that we think will do well. These tend NOT to be *nips to blips* RV trades, but rather longer term notions that capitalize upon either our strongly held themes or the *weak hands* of other traders. This year presents probably the best opportunities we have ever seen, namely because we have both a near certainty of opinion and *weak hands* that been nearly chopped off by the markets.

To repeat our Mantra:

1) Whatever MUST happen, WILL happen.
2) In a debt crisis, inflation is the ONLY solution.
3) The FED + USTreasury can create inflation.
4) As such, there WILL be Inflation.

What all of our ideas have in common:

1) Longer-term Government Interest Rates will rise as the major Global economies utilize massive fiscal and monetary policy to counter recession, de-levering, and deflation.
2) Hard assets, such as income producing property, fixed demand commodities (such as foodstuffs), and limited supply commodities (such as gold) will increase in nominal price as fiat currencies are over produced.
3) Money good assets that have been liquidated via "margin calls" to reduce leverage will increase in value as the Government's balance sheet absorbs assets.
4) The world is NOT going to end. Even the Great Depression only lasted eight years.

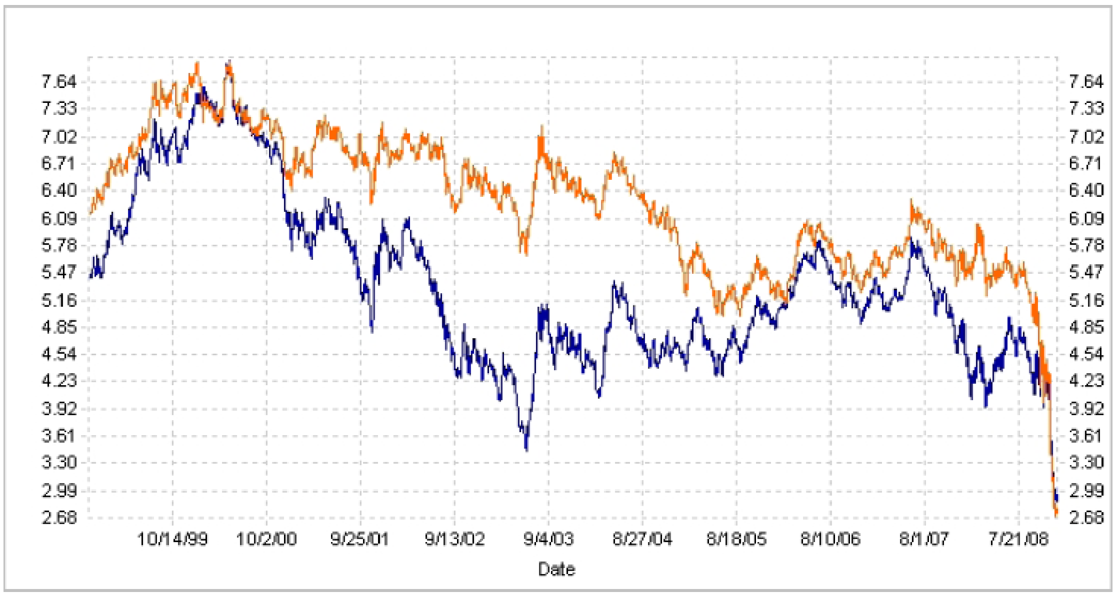
Finally, remember this: If you are reading this RateLab, your life is better than 98% of the rest of the world's population.

Pay Fixed (Sell) Long-dated Forward Interest Rates

Detailed in: *RateLab – "The Cave" December 9, 2008*

We can see how one might bet that various credit assets will all default and have no recovery value, but even the most grizzly bear cannot think receiving the Ten year rate Ten years from now at 2.75% is a good idea. Nonetheless, today's prices are just numbers dancing on a screen to various Asset/Liability and Exotic Risk hedgers. Presently, long-dated Forward Rates are BELOW Spot Rates. In the rare times in the past where this has occurred, the overall rates market is near its peak level, NOT at its all-time low.

Indigo - Spot Sw10yr rate
Orange - 10yr Forward Sw10yr rate



The Trade(s):

Pay Fixed (sell) the 10 year Forward 10yr Swap Rate at 2.75%
However, we may be too early on this trade and the MTM risk is certainly too great for us to tolerate in the current environment.

Instead:
Receive (Buy) 75mm Spot 10yr Swap Rate at 2.95%
Pay (Sell) 100mm 10 year Forward 10yr Swap Rate at 2.75%

This trade is presently Positive Carry, Flat Duration and Long the Curve. It is a great way to sell long-dated rates with greatly reduced MTM volatility.

Buy 10yr into 10yr 5.50% Payer (put) Swaptions

Detailed in: *RateLab – "The Positive Carry Hedge"* *October 31, 2008*
RateLab – "The Positive Carry Hedge 2" *November 3, 2008*

This trade enables one to be short the market and long convexity in a structure that rolls up the Rate and Volatility surfaces. Most importantly, because of the limited loss nature of options, you cannot be shaken out of the trade since your loss is limited to a few points over ten years.

The table below represents a theoretical mid-market pricing grid to demonstrate the "Roll-up" effect, it does NOT represent prices where a transaction could occur. Furthermore, you may notice that the Implied Volatilities and Skews are sharply higher than when we initially presented the concept. As such, we recommend that you execute either of the trades above and wait for an opportunity to "delta-swap" into swaptions when markets become more stable early next year.

1 Expiry	2 ATM Vol	3 OTM Vol	4 Fwd Rate	5 Strike Yield	6 Put Price	7 Strike Yield	8 Put Price
5yr	114	125	3.19%	5.94%	*175bp*	5.50%	*222bp*
7yr	101	112	3.03%	5.78%	*197bp*	5.50%	*222bp*
10yr	87	99	2.75%	5.50%	*205bp*	5.50%	*204bp*

Notes:
Spot = 2.97%
Mid-Market Levels

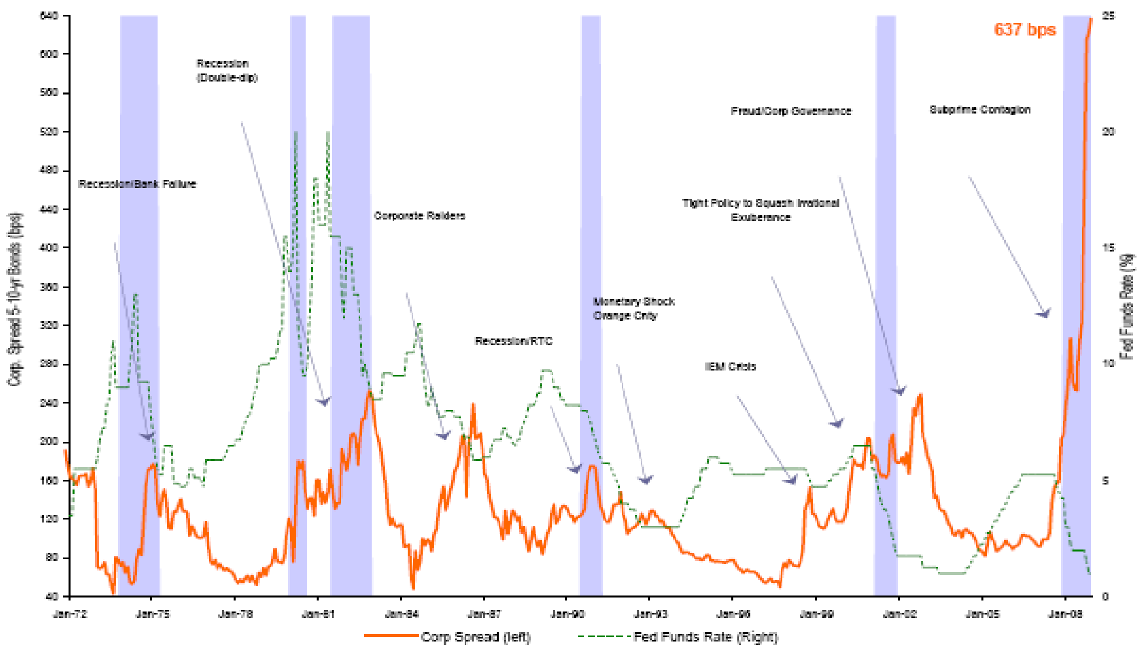
Buy Altria (Phillip Morris) 9.70% 11/10/18 cusip 02209sad

Offered at T10yr + 640bps - 103.85 for a 9.10% yield to maturity

I could go into great detail about debt coverage ratios and free cash-flow, but let's just cut to the chaff (yes, that is the correct usage). We have here a company that manufactures and markets a legally addictive product – their customers are almost totally price insensitive. Unless they can be dragged back to court by the plaintiff's bar, these bonds should be money good.

This bond at 9.1% yields 60bps more than the dividend on the common equity and is obviously higher in the capital structure. The deal came at T10yr +600bp and broke syndicate the next day at T10yr +575bps.

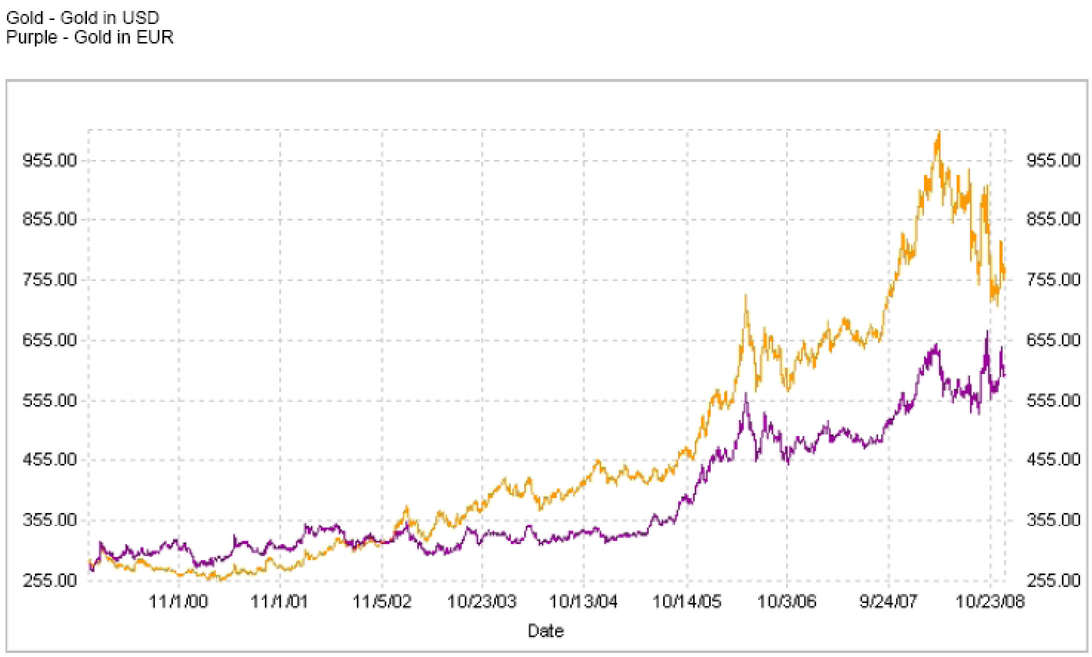
The brilliant chart below was compiled by our Mary Rooney. This bond is presently trading just slightly below the average of the Merrill Lynch 5yr-10yr OAS Corporate Bond Index (C6A0). This is a $3.1bn benchmark deal that will be relatively liquid (about a 10bps bid/offer) and transparent.



Buy Gold

Truth be told, we have NEVER been "gold bugs" at the RateLab. It's hard to store, has negative carry, and it's not quite fungible for canned goods in case of a real emergency. However, if the Global "printing presses" (aka Helicopters) start to crank out the cash in the quantities needed to staunch the current global de-levering, then Gold prices will rise substantially in the medium-term.

Buying Gold also has the added kicker of hedging out a global devaluation of the dollar. As shown below, -the gold line- is the price of Gold in USDollars while –the purple line- is the price of Gold in Euros. The recent global panic in equity markets has serendipitously given you an advantageous entry point for Gold. Gold peaked at about $1,000 earlier this year. The Commodities / Equities collapse this summer took Gold along for the ride. This is strange since Gold is NOT an economic activity based Commodity. The explanation can be found when one looks at the price of Gold in Euros - It has been quite stable. So the panic by the BRIC countries to grab dollars has temporarily crushed Gold in dollar terms. This is a huge buy opportunity since Helicopter Ben's plans include debasing the USDollar.



The Trade:

Sell	one unit	GLD	110	June 2010	call	}	
Buy	one unit	GLD	80	June 2010	call	}	a costless transaction
Sell	one unit	GLD	65	June 2010	put	}	

This structure is liquid and transparent. All trades utilize exchanged traded options on the GLD ETF (Exchange Traded Fund). The price of GLD is close to the price of spot Gold on a 10::1 basis. We like this particular structure, a variation on the ML Quiet Bull, because it has much less MTM volatility than a straight up Gold purchase. Please note, this trade is NOT for you if you think Gold will be shooting up to $2000 in the near-term. In this trade, your gain is capped at $300/oz.

The See-Through Office Building Returns

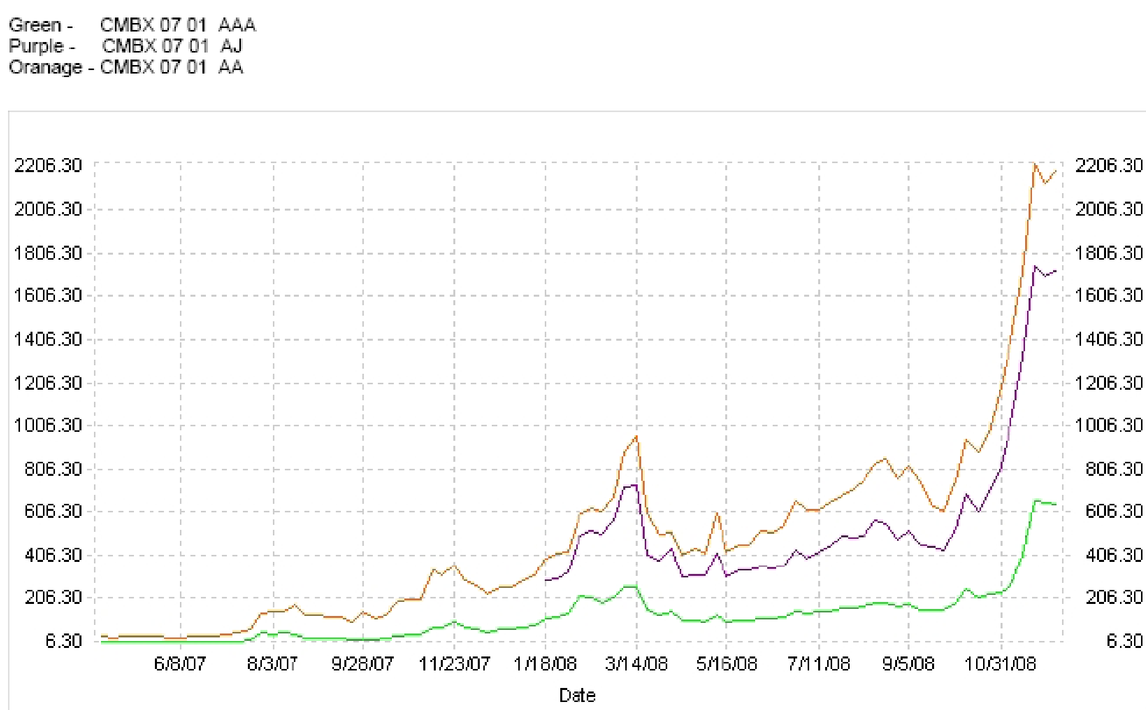
(From *RateLab – "The Cave" December 9, 2008*)

The last great Real-Estate collapse in the early 1990s saw the creation of the "see through" office, i.e., an all glass exterior with no tenants inside.

Let's check the bond math. In 2006, a prime commercial building has $12mm of cash-flow rent and a Capitalization Rate of 6%. This creates a $200mm value. A CMBS originator loans 70% or $140mm. Using a 30% subordination level, $98mm of Super Senior AAA bonds are created. Let's assume the cash-flow deteriorates to $9mm and the Cap Rate climbs to 9%. That would value the property at $100mm or down 50% from origination. Noting –the lime line- CMBX AAA 07-01 Index at 600bps and adding in the 500bps yield premium for cash bonds, your standard AAA Super Senior has a 13% yield and a dollar price in the low $60s, well below the theoretical value of the building.

Let's worst case this idea: Rents fall by 50% to $6mm and the Cap Rate rises to 10% creating a $60mm value for our office tower. You buy the Super Senior at 60ish with a 5 ¼ % coupon. You earn a cash-on-cash yield of about 8.5% (Swaps +550bps) for the remaining 8 years of the bond. And if the bond defaults, you own the building at $60mm, near its current value, down a full 70% from origination.

What am I missing here ?



The Trade:

MLCFC 2006-04

- Total Deal Size: $4.523bn;   Pricing Date: 12/01/2006
- Total Loans: 280;   Largest Loan: 8.5% (Multi-Family);   Largest 10: 32%
- LTV at issue: 72%

MLCFC 2006-04 Class "A3";   Cusip – 55312VAD0

- Class Size: $1,284bn; Subordination within Deal (attachment): 30%
- Coupon = 5.172%;   Maturity = 11/12/2016
- Recent Offer Price: 73-00 ~~~ 10.40%;   Swaps + 825bps

MLCFC 2006-04 Class "C";   Cusip - 55312VAN8

- Class Size: $79.2mm; Subordination within Deal (attachment): 9.6%
- Coupon = 5.324%;   Maturity = 12/12/2016
- Recent Offer Price: 18-00 ~~~ 41.5%;   Swaps + 3950bps

The Super Senior "A3" bond above is about 10 points higher than our example above, but markets are volatile and this deal is a particular beauty in terms of its size and diversity. You can certainly find other Super Senior bonds in the mid-60s at a 12ish% yield.

The Class "C" AA-rated bond is a curiosity. It is now basically an IO since if it survives more than three years, you cover your investment and own a lottery ticket on the implied default::recovery vector. I cannot even begin to analyze this bond since the pricing indicates the end of the world on a deal that presently has only 0.85% of the loan balance delinquent or in foreclosure and still has an aggregate Debt Service Coverage Ratio (DSCR) of 1.32x. Can this deal really go south in three years ??

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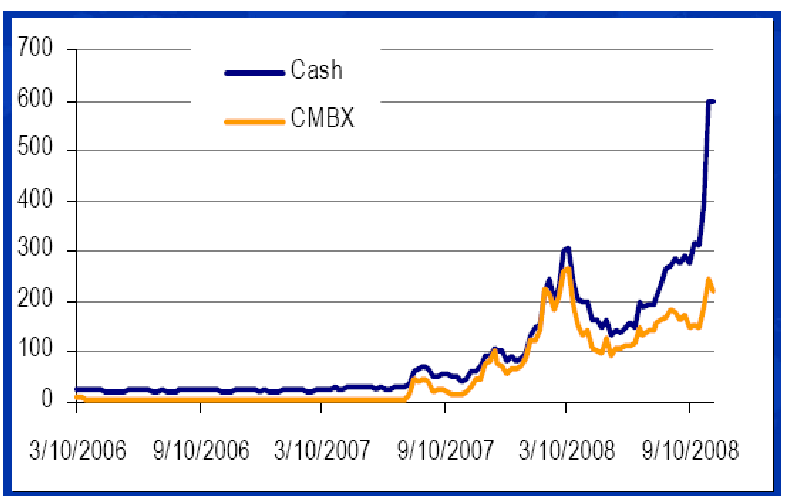


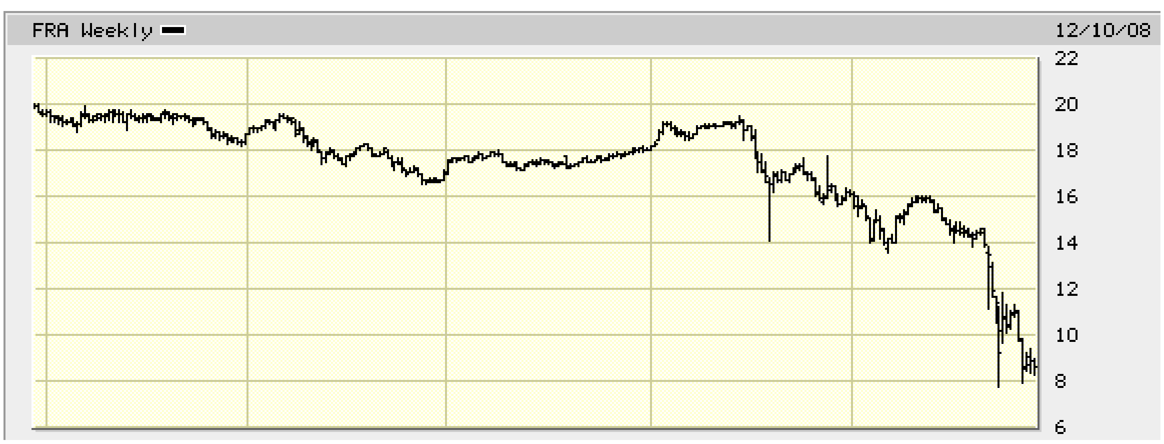
In any case, you certainly want to execute ANY CMBS trade in the cash market. The crushing panic of balance sheet de-levering seems to have hit the CMBS market the hardest. Look at the chart above. Although -the orange line- representing the CMBX index has leaped another 300bps since late September, the spread to cash is still hovering at nearly 500bp or about 22 points on a Super Senior ten year tranche.

Closed End Funds

Each time we think we have found the silliest possible price for a security, we open our eyes and find another. Let's look at three different classes of Closed End Funds.

Floating Rate Funds

BlackRock Floating Rate Income Strategies Fund – ticker FRA
Recent price of $8.40   NAV of $9.38   Discount of 10.4%
Current yield of 16.40%   Recent monthly dividend of $0.1148
Total assets of $365mm using $97mm (27%) leverage

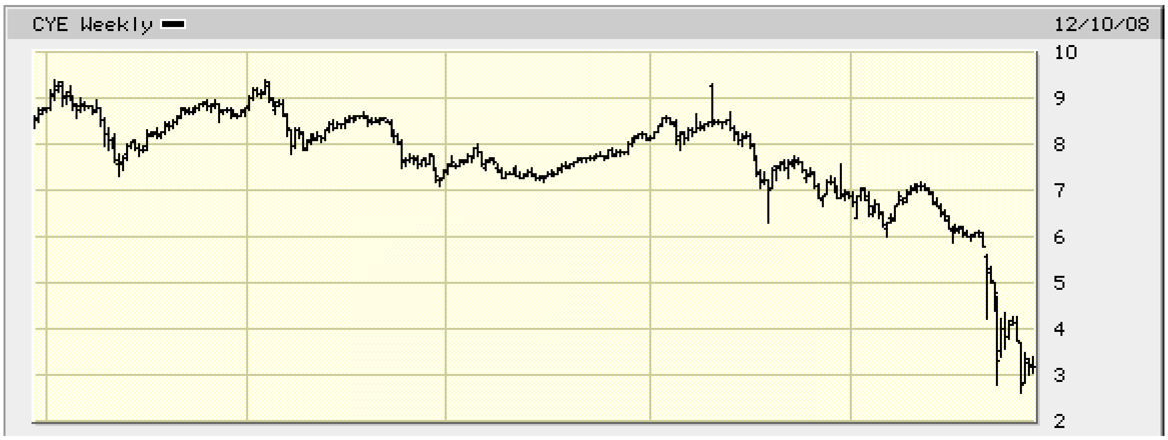


Similar Funds:

FRB – ($8.05 @ 16.9%) A sister fund that is similar in almost all aspects.
BHL – ($9.10 @ 14.8%) Also a BlackRock fund. This one has a defined maturity. However, it trades at a NAV premium of 8.5%
PFL - ($5.70 @ 21.6%) A Pimco fund. The BIG issue is that they have exceeded their leverage covenants and must buy back some ARPs. Trades at a 22% discount to NAV. Scary but interesting.

High Yield Corporate Funds

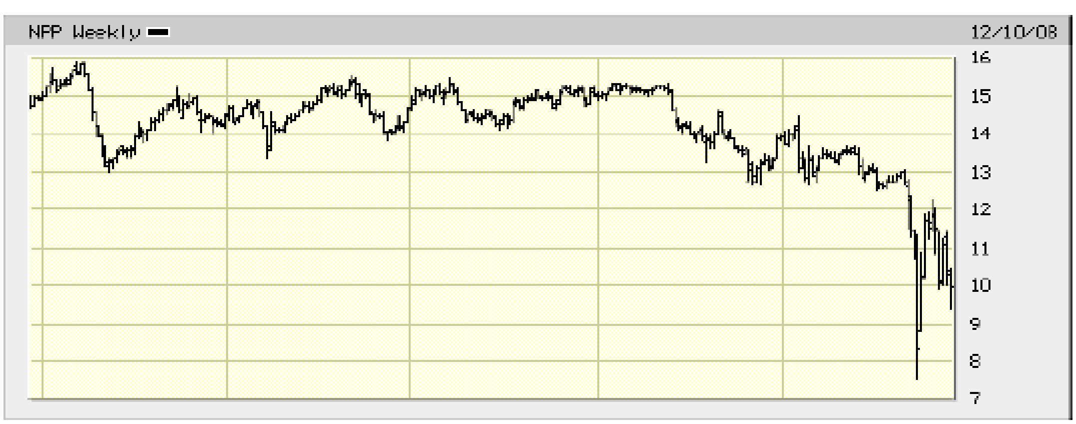
BlackRock Corporate High Yield Fund III– ticker CYE
Recent price of $3.12   NAV of $3.90   Discount of 20.0%
Current yield of 23.1%   Recent monthly dividend of $0.06
Total assets of $310mm using $71mm (23%) leverage



HYV – ($5.24 @ 22.9%) A sister fund in the same family, same managers.
PTY - ($8.31 @ 16.6%) A Pimco fund. Large market cap of $550mm

Municipal Bond Funds

Nuveen Performance Plus Municipal Fund– ticker NPP
Recent price of $9.41   NAV of $11.73   Discount of 19.7%
Current yield of 7.7%   Recent monthly dividend of $0.06
Total assets of $1.2bn using $440mm (36%) leverage



Municipal Bonds

Basically all Municipal Bonds are a great asset class to buy. Sure there are a few locations that are weak and should be avoided, but if CitiBank, AIG and GM are too big to fail, what does that mean for California or New York ?

New York City General Obligation bonds with a fifteen year maturity and a ten year call feature are presently trading at about 6.00%. For a resident taxpayer in the top bracket (of which there are now a lot fewer) that is equivalent to 11%.

But let's look at a real outlier:

New Jersey State Transportation Cusip – 646136wf
Zero coupon bond to mature on December 15, 2028
Price = $26.50 for a yield of 6.75%. Taxable equivalent = 10.40%

Compare that to:	Tsy20yr	@ 2.90%
	T20yr Zero	@ 3.50%
	Sw20yr	@ 2.85%
	Sw20yr Zero	@ 2.85%

Holiday Potpourri

Non-Agency Bonds – Including Prime Hybrids, Front-pay Option ARMs, and Alt-As located in "stable value" states. This is all about security selection; do NOT buy large pools at low dollar prices and hope for diversity. Many loans in CA, FL, AZ and NV may be money-bad at any price. Do your homework.

TYH and FVH futures contracts – The main liquidity providers for futures contracts have lost all balance sheet. In fact, they are all in risk reduction mode until at least next year. Moreover, fear of a mandated "negative repo" policy has sent futures contracts to absurd levels. If you have any Cash Treasuries in the four year to seven year sector, sell them versus futures and place the proceeds into 0% yield T-Bills. Pick up 200bps running.

Concluding Comments:

We are in the middle of a once in a lifetime experience. It is not at all clear that we have even reached the middle of the tunnel yet. If we are truly about to enter into a 1930s-type economic situation, any investment that is not cash under the mattress (or T-Bills at -0.01%) will be a short-term loser. The only investment idea that we can surely promise you is correct is diversification – because nobody knows for sure how or when this will end. Also make sure you have enough cash on hand, both professionally and personally, to enable you to avoid an untimely forced exit.

The coming horizon will be the era of Debt. Returns of 12% to 20% for securitized assets are vastly superior to the long-term (50 year) return on Equity.

How do we think this ends ? Even stipulating that Rosie is correct and we do not have inflation, as some point the Government's balance sheet will absorb the excess leverage of the private sector. Once that occurs, the selling will stop. After that, the free cash-flow from the Pension and Insurance universe will buy Debt instead of Equity since a 15% Debt investment will mathematically (and more assuredly) improve their actuarial liabilities.

Happy Holidays from the RateLab

Additional Disclosure Notes:

Representative mid-market prices for sometime during the week of December 8.

We at the RateLab may have positions in some of these recommendations both professionally and personally.

Please be sure these investment ideas are consistent with your investment horizon. Since these are "investments" and not "trades", the work-out time could certainly be measured in years.

ML US Rates Strategy
December 12, 2008