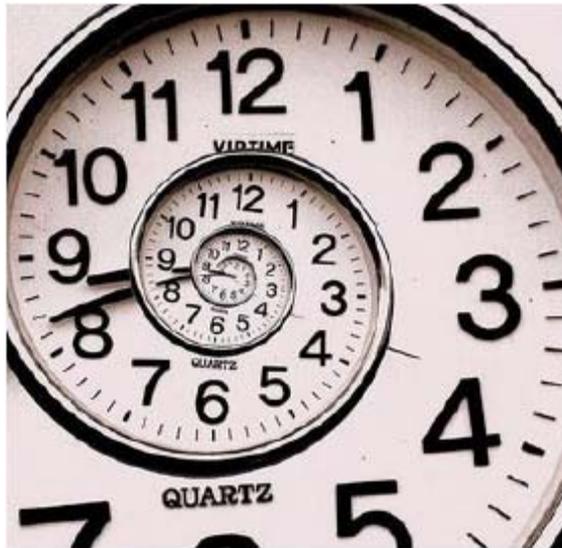


Time Heals All Wounds



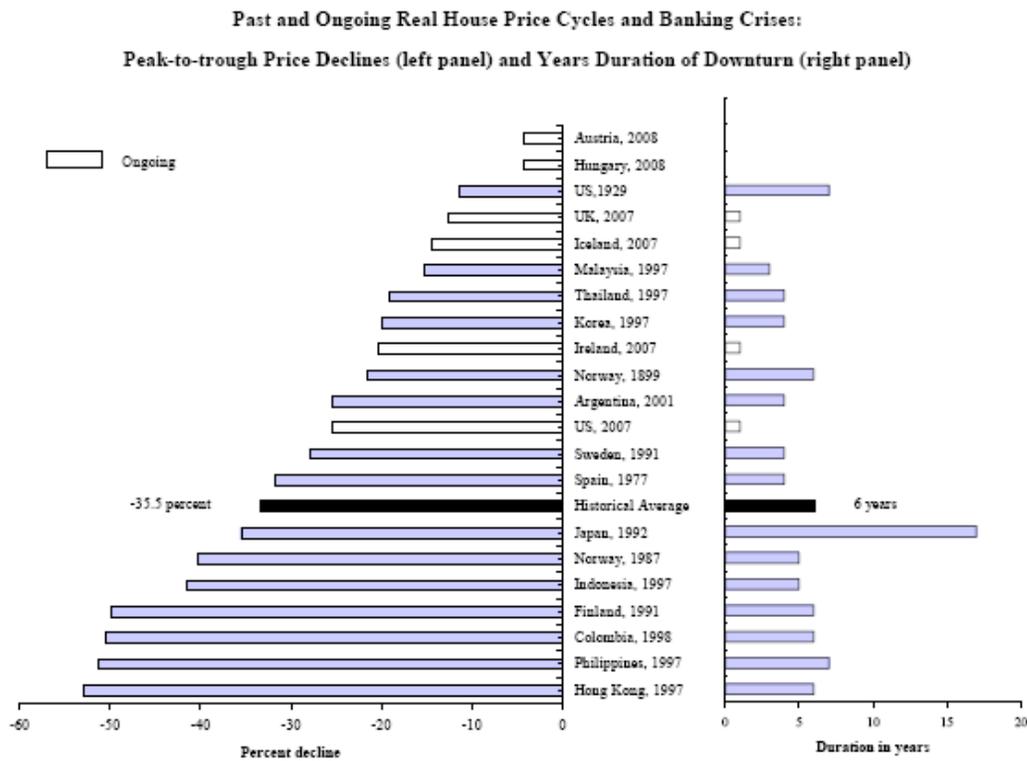
When the patient has a serious illness, the Doctor often does not specify the course or the length of the disease for that particular patient but rather describes the process relative to the many others who have faced a similar situation. So it is medical convention to quote "survival rates" as in: "Those with stage 2 such and such have a 70% five year survival rate".

And while we will remind you that your health is supremely more important than your portfolio, many market participants feel that the financial carnage that has occurred over the past eighteen months is something unique that has only happened to them. For better or worse, this is not the case. Financial history books are replete with the aftermath of asset bubbles being pricked. As such, maybe it makes sense to look at how severe and how long other financial fevers lasted before they broke.

As this RateLab is a follow on to our April 16, 2009 publication, "Of Helicopters and Gravity", so also is our main data source from Drs. Carmen M. Reinhart (University of Maryland) and Kenneth S. Rogoff (Harvard University). One year after their initial paper, they presented "The Aftermath of Financial Crises" to the American Economic Association on January 3, 2009. Here they look at the full range of 18 different countries that experienced a systemic financial crisis during the post-war period. For completeness, they also include the Norwegian crisis of 1899 as well as the 1929 U.S. experience.

Figure 1 measures the "Peak to Trough" of real housing prices. Although the US-2008 bar below shows a decline of about 28%, this does not reflect the further losses registered since this chart was created. The Case-Schiller Index is presently down 30% from the top, placing it quite close the 35.5% Historical Average.

Figure 1

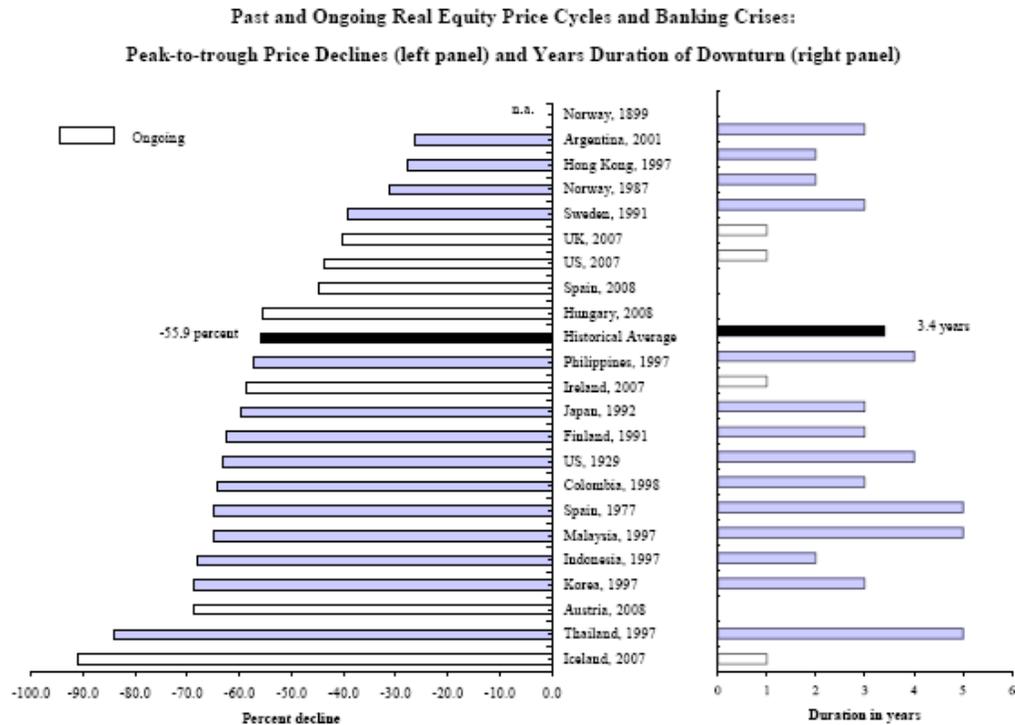


Sources: Reinhart and Rogoff (2008b) and sources cited therein.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes. Consumer price indices are used to deflate nominal house prices.

Figure 2 presents the Peak to Trough price decline of the major Equity market in each country. If we now include the March 2009 plunge in this chart, the Dow has experienced a 54.4% decline while the S&P has suffered a 57.7% Peak to Trough decline. Both of these tightly surround the average of 55.9%

Figure 2



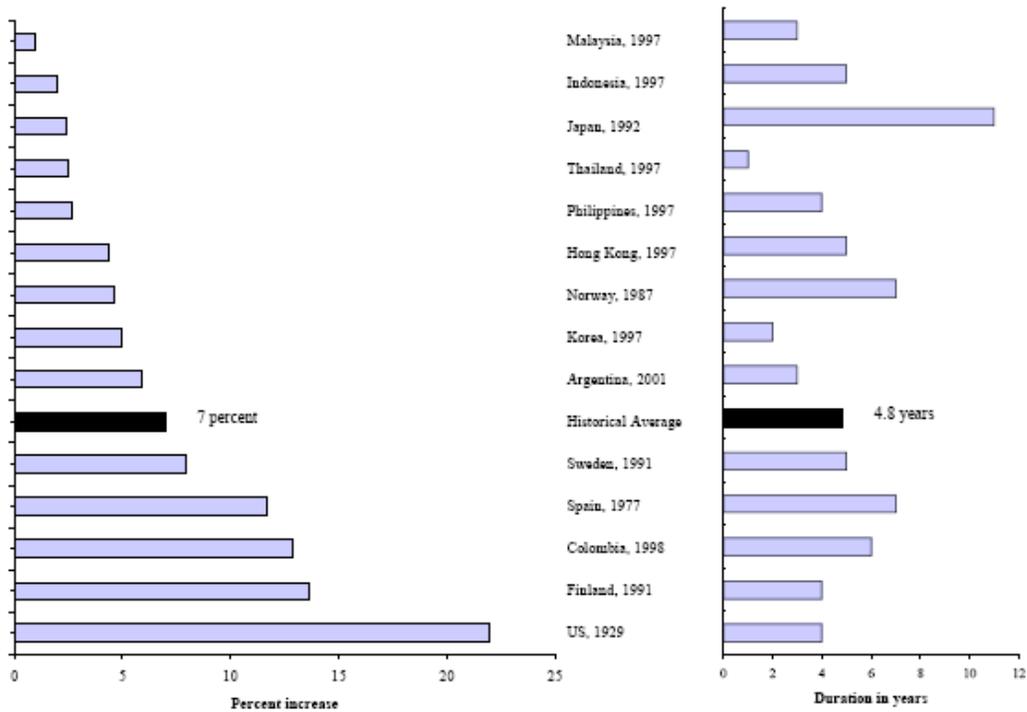
Sources: Reinhart and Rogoff (2008b) and sources cited therein.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included subject to data limitations. The historical average reported does not include ongoing crises episodes. Consumer price indices are used to deflate nominal equity prices.

On the next page, Figure 3 examines the impact a systemic financial crisis has upon Employment. Keeping in mind that Payrolls are a lagging indicator, we can input the BAC/ML view that Unemployment can rise to 10.4% in the fourth quarter of 2010 with an out of sample projection of a possible peak rate of 11.0% to occur in the second quarter of 2011. The National Seasonally Adjusted Unemployment rate bottomed at 4.4% in October 2006. The former metric would indicate a 6.0% rise over 4.25 years. Using the latter potential projection, Unemployment could peak up 6.6% from the bottom over the course of 4.75 years. Compare this to the Group average of a 7.0% increase over 4.80 years -- almost identical.

Figure 3

Past Unemployment Cycles and Banking Crises: Trough-to-peak
 Percent Increase in the Unemployment Rate (left panel) and Years Duration of Downturn (right panel)



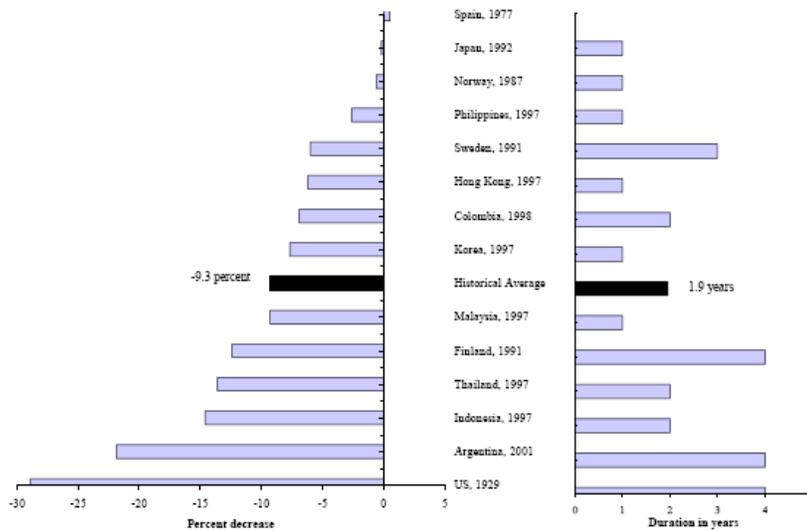
Sources: OECD, IMF, Historical Statistics of the United States (HSOUS), various country sources, and authors' calculations.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes.

Figure 4, on the next page, looks at the impact on Real GDP. This one is a bit trickier to analyze since the data can be so volatile. Using only Annual data, U.S. GDP peaked at 2.8% in September 2007 and will most likely bottom near -3% in the second quarter of this year. That would be a high to low change of 5.8% over 1.75 years. This is certainly light versus the Historical averages. However, using Quarterly data, we peaked at +4.8% in September 2007 and seemingly bottomed at -6.3% in December 2008. This was only 15 months, but the drawdown from the peak was 11.1%. Compare each of these views to the recorded Historical averages of a -9.3% change over 1.9 years.

Figure 4

Past Real Per Capita GDP Cycles and Banking Crises: Peak-to-trough
Percent Decline in Real GDP (left panel) and Years Duration of Downturn (right panel)



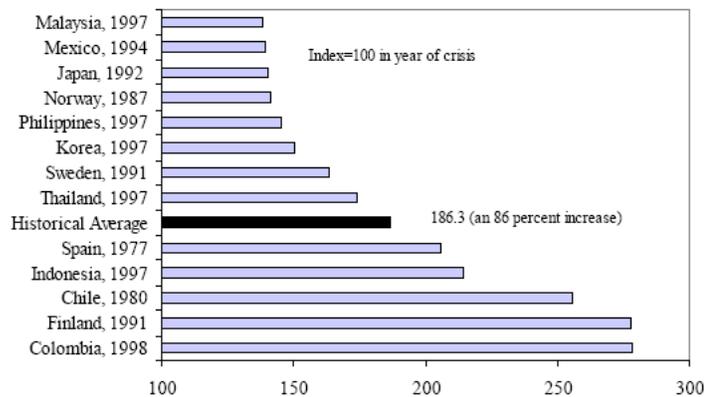
Sources: Total Economy Database (TED), Historical Statistics of the United States (HSOUS), and authors' calculations.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes. Total GDP, in millions of 1990 US\$ (converted at Geary Khamis PPPs) divided by midyear population.

Finally, figure 5 examines the expansion of public debt during the three years that follow a banking crisis. Since we are just at the start of the Debt expansion process, it is not clear where we will compare on this vector.

Figure 5

Cumulative increase in real public debt in the three years following the banking crisis



Sources: Reinhart and Rogoff (2008b) and sources cited therein.

Notes: Each banking crisis episode is identified by country and the beginning year of the crisis. Only major (systemic) banking crises episodes are included, subject to data limitations. The historical average reported does not include ongoing crises episodes, which are omitted altogether, as these crises begin in 2007 or later, and debt stock comparison here is with three years after the beginning of the banking crisis.

What is the key concept here ? It is that the bursting of the housing bubble that kicked off a systemic banking crisis in this country is NOT unique. Many other countries in the not too distant past, some of them with well developed and sophisticated Western economies, have experienced similar situations. And although utterly painful for the citizens at the time, those economies did recover.

Since we all presently reside in the eye of the storm, it can be quite difficult to dispassionately analyze our situation. But within the context of the average declines realized in both the Housing and Equity markets, it is possible that we have already traversed the worst. While we are certainly not Pollyannas, it is possible for a rigorously analytical view of the World to be something other than absolutely bearish.

We most likely have two more quarters of negative GDP, eight more quarters of increasing Unemployment, and housing prices will not meaningfully increase until at least 2012. But as always, the Financial markets will price in the turn well before the good news is realized.

What do we recommend:

- 1) Pay Fixed on long-dated forwards, such as the 10yr-10yr rate at 3.80%.
- 2) Buy 6% strike 10yr-10yr payers at 300bps up front.
- 3) Pay the one year forward CMM mortgage rate at 3.95%.
- 4) Buy ten year Hi-Grade Corporate bonds at a 6% handle.
- 5) Buy ten year NYCity G.O. Municipal bonds at a 5% handle.
- 6) Buy Closed-end funds of High yield or Senior bank debt at a discount.

Size these trades to be able to absorb at least a 10% drawdown in a month, and stick with the Mantras: "It is NOT different this time" and "This too will pass".

Harley S. Bassman
BAS/ML US Trading Desk Rates Strategy
April 21, 2009

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