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Sent: Wednesday, July 30, 2008 2:30 PM (GMT)
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Subject: Balance Sheet Observations
Attach: ole0.bmp;ole1.bmp

Kaushik

I am working on the balance sheet allocations. It is really a bottom-up process about who has sticky inventory. Obviously in the US it is Agencies, and in London it is Inflation. Pre-repo 105, the inflation book is not moving much (see graphs below-net is up, gross down about 20% from Q1). Since they have a gross long position against derivatives, one of my concerns is that we have paid on a large amount of inflation swaps vs buying TIPS. As you know, inflation swaps trade rich to "fair value". This fair value is really the cost of balance sheet, which has obviously gone up. Depending on how much we "PV'd" this fair value on the way into the trades, the reason we are not getting out of the TIPS inventory could be that we would have to unwind the inflation swap way wider than our marks, not because the bonds are hard to sell.

TIPS assets swaps in the US have widened about 25bps over the last year. If the average life of the 18b net long position we have is 7 years, that means we have lost about \$270mm, just on the widening. That assumes we did not PV any of the profits on the way in. If we Pv'd 1/2 the initial "fair value", then we have an additional problem of 127mm. Again, it is very similar to a Berm book. If you book to model value, the unwind can be expensive. If they cheapen in between, you have to take that loss as well.

Of course we could ride it out, but given Repo 105 is going away by Q4 that may not be an option.

Our repo 105 limit for global rates is 20b for Q3, down from 42b Q2. I am going to allocate 14b to london (down from 26b Q2), 4b to US (down from 13b Q2), and 2b asia (used 2.7 Q2). However, I am told no Repo 105 for Q4, so we need to investigate where we stand with inflation, as that could be a big issue for Q4. Looking at the "top users" of balance sheet globally, there are not many places we can reallocate balance sheet from if Repo 105 is gone for the inflation book.

I need to know what a reasonable target for the inflation book is for the end of Q3 and Q4 (without repo 105). Can you please touch base with Borut so that I can continue to work on the numbers. Only one month to go!

