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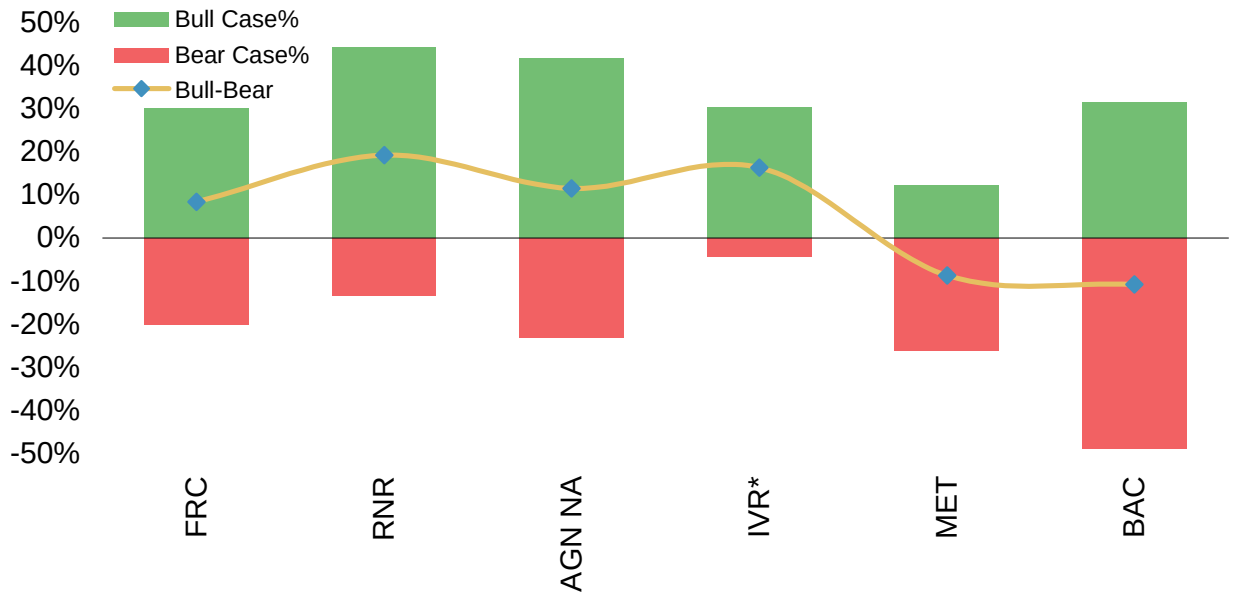
Rising Rate Beneficiaries

With 10 Year Treasury yields continuing to head higher amidst tapering fears, we've been focusing on equity market implications in search of stocks that could potentially benefit. While our US Interest Rate Strategist Matthew Hornbach suggests current levels imply that tapering occurs in September versus the MS expectation for December or later, there is precedence for the end of a QE program leading to significant volatility in rates, making ***Rising Rate Beneficiaries*** a theme worth exploring. Notably, at the end of QE1 measured from August 1, 2009 to January 31, 2010, 10-year yields ranged from 3.10 to 3.91%, and the end of QE2 measured from April 1, 2011 to September 30, 2011, 10-year yields ranged from 3.62% to 1.66%.

With this backdrop in mind, we've selected 6 ideas globally that are worth looking at for those wanting to play a rates move through equities. These include **MET**, **BAC**, **FRC**, **RNR**, **AGN NA**, and **IVR***. Separately, we highlight a derivatives trade on **AGNC**, which has seen an uptick in volatility following the rise in rates.

Criteria for inclusion on this list of ideas: 1) Overweight by Morgan Stanley Research, 2) Rising Rates Beneficial to Thesis 3) A favorable Risk/Reward based on our analysts' Bear vs. Bull case scenarios. We also took into account that not every rate rising environment is the same. Instead of undertaking a historical performance correlation analysis or looking at names that would benefit from a stronger economic environment (a common reason for a rise in rates), we tried to focus on names where a rise in rates had an actual impact on the underlying P&L.

Up/Downside % to Bull/Bear case



Ticker	Name	Sub-Sector	Last Price	Upside to Bull%	2013e P/B	Market Cap (MM / USD)	ADV Notional (MM / USD)	YTD % Move
MET	Metlife Inc.	Life Insurance	44.62	12.1%	0.74	48,859	320.6	36.0%
BAC	Bank of America	Banks	13.69	31.5%	0.56	147,529	1,712.1	18.0%
FRC	First Republic	Banks	37.50	33.4%	1.54	4,933	41.3	14.5%
RNR	RennaissanceRe	Reinsurance	86.70	44.2%	1.16	3,859	51.3	6.7%
AGN NA	AEGON	Life Insurance	€5.35	41.5%	0.46	€11,115	9.0	11.5%
IVR*	Invesco Mortgage	Mortgage REITs	19.18	30.3%	0.9	2,593	45.4	-2.5%

* Note rising rates have negative short-term implications for IVR, please see investment thesis below

Investment Theses for Beneficiaries:

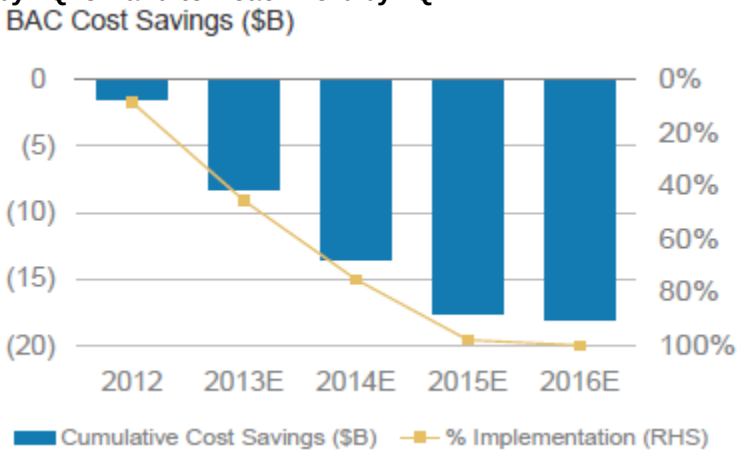
Metlife (MET) – For investors looking for an inexpensive means in which to play a rising interest rate scenario, Nigel Dally believes MetLife provides solid value with the stock's valuation remaining inexpensive both on an absolute and relative basis, and the company's annuity and life operations are very sensitive to interest rates. Additionally, MET's strategic initiatives further bolster returns while reducing risk and are not appropriately reflected in the current valuation, which at 7.8 times forward earnings, remains among the lowest in the industry.

MET is at a Discount to Peers on Price to NTM Earnings



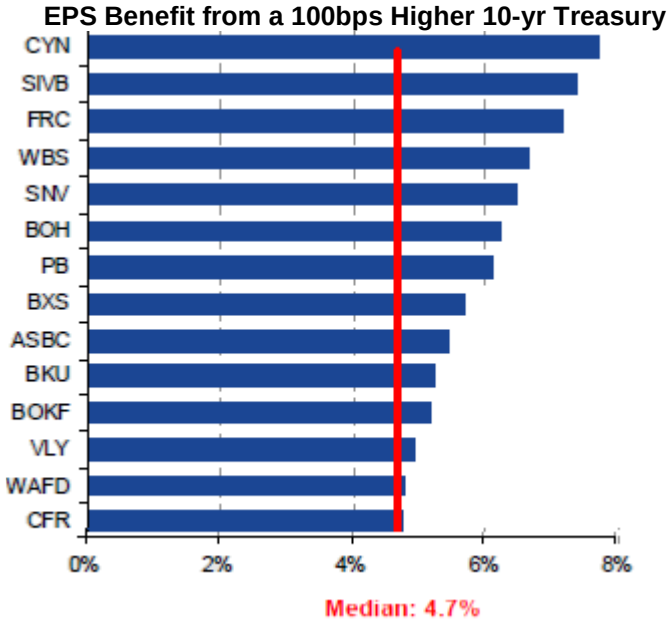
Bank of America (BAC) – According to Bank of America's 10Q, a 100bp hike in the 10 yr adds 11% to BAC's FY EPS. Betsy Graseck would view this as incremental to her bullish thesis, which is predicated on an earnings inflection point based on the convergence of visible cost cutting, the housing recovery driving mortgage originations, the reduction in legacy assets, and shrinking tail risks. Her 2014 $1.43 EPS est is 10% above consensus.. The next catalyst for shares is the final hearing on the Gibbs & Bruns consortium which begins today with a resolution likely in the next one to six months.

Expect BAC to Be 45% of the Way to Achieving $18B of Cost Savings by 4Q13…and to Reach 75% by 4Q14



First Republic (FRC) – Higher 10 yr yields would benefit midcap Bank EPS overall with the biggest impact occurring to banks with exposure to asset classes that are sensitive to a rise in the longer-end of the curve such as resi mortgages, commercial real estate and securities. Ken Zerbe estimates that a 100bp increase in the 10 yr yields over the course of the year would have a median benefit of 4.7% to 2013 EPS for his midcap bank universe, but the effect would be larger if the 100bp occurred immediately. Banks that benefit the most from higher LT rates include CYN (EW), SIVB (EW), and FRC (OW) (Chart below).

Overweight rated FRC is worth highlighting given that interest-earning assets compose 89% of assets with Residential 59%, CRE loans 18%, and securities 12%. First Republic is one of the fastest growing banks in Ken's coverage universe, with an attractive high- net-worth client base, a strong management team, and a reputation for excellent customer service. Given FRC is one of the few banks that can meaningfully grow core earnings in this environment he believes the shares will outperform the group.



AEGON (AGN NA) – Yesterday evening, David Andrich issued a positive Research Tactical Idea (RTI) on life insurance company AEGON (ADR: AEG) on the view that rising long-term US Treasury yields should reduce concerns around the impact of low yields on Aegon's balance sheet and bode well for sentiment. Notably, 69% of AEGON's 2013e earnings come from North America and the majority of earnings are derived from spread products. David is Overweight shares and sees Aegon generating over 25% of its market cap in FCF over the next three years. Aegon appears inexpensive based on its substantially discounted P/TBV of 0.5x 13e TBV, vs. peers at 2.1x. The next catalyst is Aegon's investor day on June 19 in London where he looks to gain further disclosure on capital generation and allocation.

RenaissanceRe (RNR) – P&C stocks do not stand to benefit as much as other sub-sectors within financials, but those that do are ones with short duration portfolios like OW rated RenaissanceRe. Investment income represents 40% of RNR's pre-tax income, and Greg Locraft continues to model low yields through 2014, so a rising rates would be a source of upside for RNR. RNR is a pure play in the high return property reinsurance marketplace, and is the market leader in the short−tail property catastrophe market with 20%+ ROE since inception in 1992. Valuation is attractive with shares trading on 1.16x Book Value vs. historical average of 1.6x.

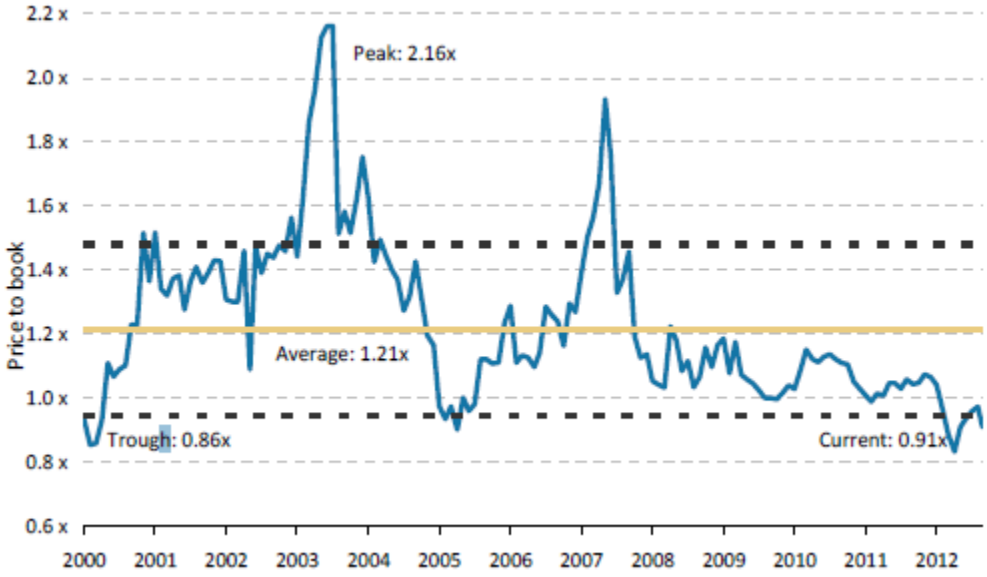
Invesco Mortgage Capital (IVR) – Cheryl Pate believes the recent sell-off in the Mortgage REIT space is overdone. Unlike the stocks listed above, higher rates actually hurts the book values of mortgage REITs, which have declined 2.9% Q/Q on average. However, the positive aspect of yields going up is that pricing on MBS is going down leading to stronger future earnings potential as the company reinvests. Cheryl also notes that hybrid mortgage REITs like IVR have hedges in place and exposure to more credit sensitive non-agency MBS which is levered to rising home prices. Following, she thinks IVR should be trading at a slight premium to book, yet it is currently trading below book at 0.90x 2013e P/B.

Highlighted Derivatives Idea (Blago Baychev, QDS)
AGNC Sep 23/28/31 Call Spread Collar – Agency Mortgage REIT AGNC has sold-off more than peers, down ~20% this month on concerns over rising rates and falling book values. AGNC's book value has declined 8.6% Q/Q, which is more than peers at ~2.9% Q/Q. However, a steepening curve and lower MBS prices also provides a better earnings outlook going forward because of more attractive reinvestment rates. With the stock trading near Cheryl's bear case of $26 and trading at 0.94 x 2013e P/B value there may be a tactical entry point in shares, although Cheryl remains Equal-Weight.

Our QDS team highlights that the implied vol on AGNC rose to the highest it has been in the past year (chart below) and skew has steepened. QDS likes selling vol and capturing upside through the **AGNC Sep 23/28/31 Call Spread Collar to collect 30c (indicative, 50 delta, ref 26.9).**

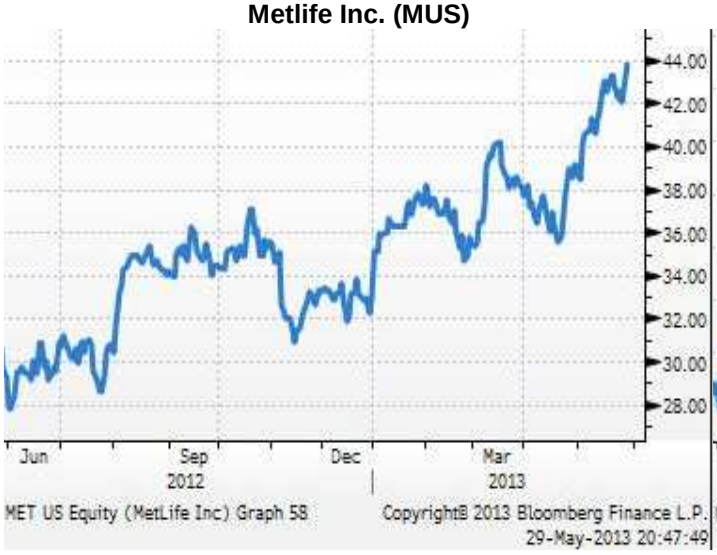


Agency REITS Price / Book

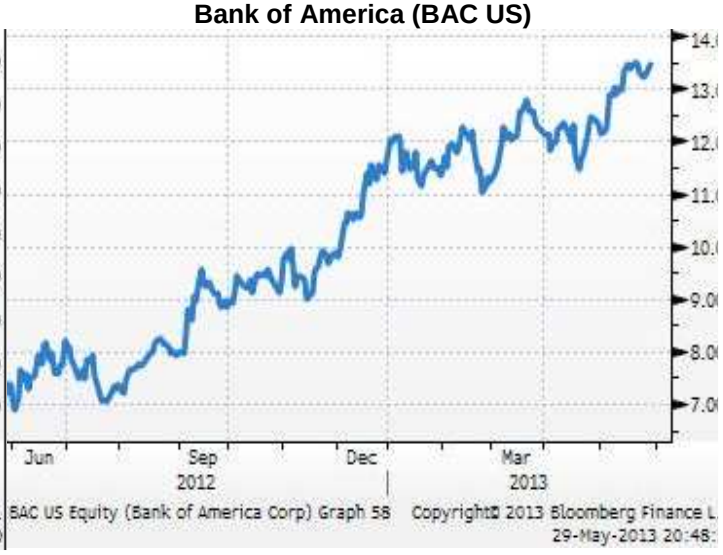


1 Year Price Performance:

Metlife Inc. (MUS)



Bank of America (BAC US)



First Republic (FRC US)



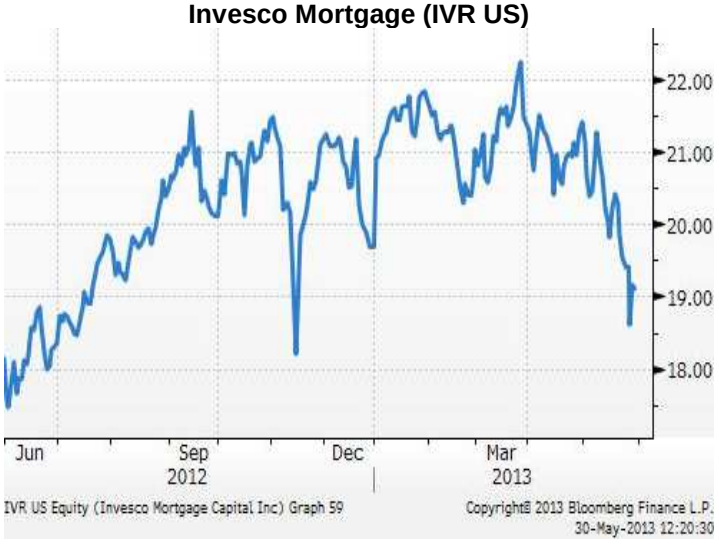
RenaissanceRe (RNR US)



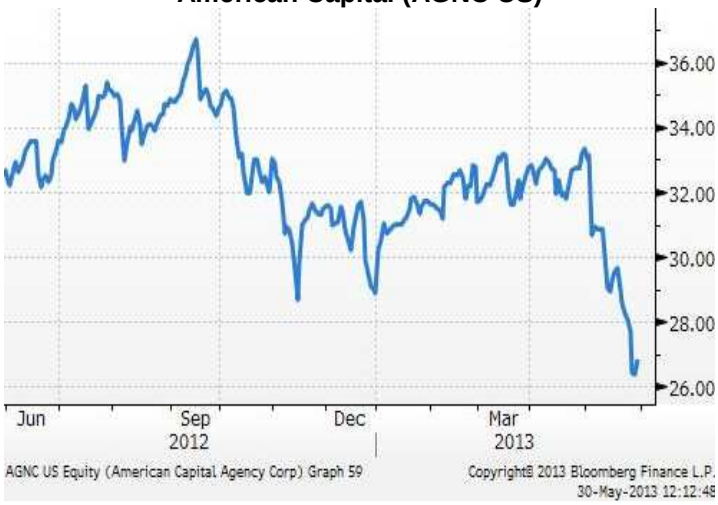
AEGON (AGN NA)



Invesco Mortgage (IVR US)



American Capital (AGNC US)



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Clients engaging in the execution structure known as Spreading should understand that Spreading may also entail substantial commissions, because it involves at least twice the number of contracts as a long or short position and because spreads are almost invariably closed out prior to expiration. Potential investors should be advised that the tax treatment applicable to spread transactions should be carefully reviewed prior to entering into any transaction. Also, it should be pointed out that while the investor who engages in spread transactions may be reducing risk, he is also reducing his profit potential. The risk/ reward ratio, hence, is an important consideration.

The risk of exercise in a spread position is the same as that in a short position. Certain investors may be able to anticipate exercise and execute a "rollover" transaction. However, should exercise occur, it would clearly mark the end of the spread position and thereby change the risk/reward ratio. Due to early assignments of the short side of the spread, what appears to be a limited risk spread may have more risk than initially perceived. An investor with a spread position in index options that is assigned an exercise is at risk for any adverse movement in the current level between the time the settlement value is determined on the date when the exercise notice is filed with OCC and the time when such investor sells or exercises the long leg of the spread. Other multiple-option strategies involving cash settled options, including combinations and straddles, present similar risk.