

March 7, 2008

# U.S. Directions Fixed Income Strategy

*Keys to the week*

- \* Retail sales
- \* CPI
- \* Confidence

**Trade Recommendations ..... 2**

Sell UST 5% May 2037 vs German 4% Jan 2018 ** trailing stop raised **
Buy FHLMC 2.875% Apr 2010 vs UST 2.125% Jan 2010 ** stopped out **
Buy UST 2.00% Feb 2010 vs UST 4.375% Feb 2038 ** target, stop raised **

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Sector	View	Specific Comments
Notes/bond yields	* Short-end lower – eventually * Long-end higher	The 2yr yield has continues to struggle to breach support at 1.50%. We believe that eventually some new impetus, either weaker economic and/or worse financial market news will allow the yield to move lower. The 10yr yield appears to have found similarly solid support at 3.50%, and rising price pressures will likely allow it to leak higher.
Curve	* Steeper	The curve has steepened massively as forced liquidations by hedge funds have hit the market, causing the short end to test new multi-year lows at the same time that inflation pressures are pushing the long end higher. We raised the target and stop on our 2s30s position to 350bp and 275bp, respectively.
Eurodollars	* Neutral	Eurodollars have priced an ease by Mar18 of at least 50bp and mostly likely 75bp. The market has also priced in a trough for the Fed Funds rate at or just below 1.75% by H2'08. These exceed our base case for easing (50bp in Mar and a trough of 2.00%), but they do both represent our "risk" scenarios, and so we would not fade the market.
Swaps	* Stand aside * Vol to remain high	Spreads remain at the mercy of MBS. While the Fed's repo and TAF announcement should help, the potential for the "deleveraging" to continue suggests wide spreads could widen further and high volatility will remain intact.
Agencies	* Short-term callables to tighten	Callable spreads have lagged the tightening in other spread product, and we expect short callable, one-time onlies to be in vogue in the coming week.
Mortgages	* Neutral basis	With the basis just off its wides since 1986, we believe it provides incredible value in the long-term. However, given the event risk looming over the market, we remain neutral. For long-term investors, up-in-coupon and seasoned discounts remain attractive.

## Trade Recommendations

Note all costs of carry are calculated over 3-months at inception unless otherwise stated

Profit/losses are calculated relative to the last edition of U.S. Directions, Trades priced at noon EST

### Sell UST 5% May 2037 vs German DBR 4% Jan 2018 \*\* trailing stop raised \*\*

Entry (Jan 18)	Close (Mar 6)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
-35.8bp	-76.0	-100bp	-55.0bp	-1.5bp	+16bp	+30.2bp

We have adjusted the trailing stop from -45bp to -55bp to protect more profit. The US has made it clear it intends to focus upon its growth concerns rather than its inflation fears - a strategy we suspect will result in the curve continuing to steepen but led bearishly by the long end. Supply-side concerns resulting from a likely pending fiscal support package also supports this scenario. The ECB is undergoing a dovish shift in line with recent market speculation and the distinctly more cautious nature of the European bank with regards to inflation arguably sees it offer somewhat of a safe haven in the context of global inflationary pressures and a markedly easier policy stance in the US.



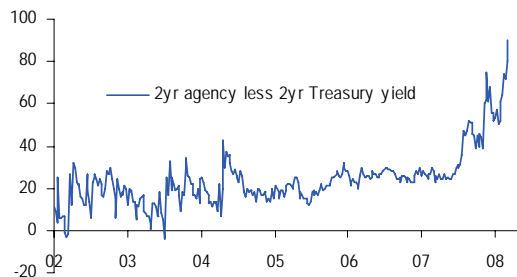
Source: RBC Capital Markets, Inc.

Trade: Sell UST5% 37s vs. DBR4% Jan 18s

### Buy FHLMC 2.875% Apr 2010 vs UST 2.125% Jan 2010 \*\* stop-loss triggered \*\*

Entry (Feb 21)	Close (Mar 4)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
+73bp	+81bp	+60bp	81bp	+4.3bp	-	-8bp

The Great De-leveraging swamped the agency market this week, taking the spread as wide as 90bp during the week. Ongoing forced selling by hedge funds could very lead this spread wider. For those able hold on through the volatility, we believe agencies offer good value.



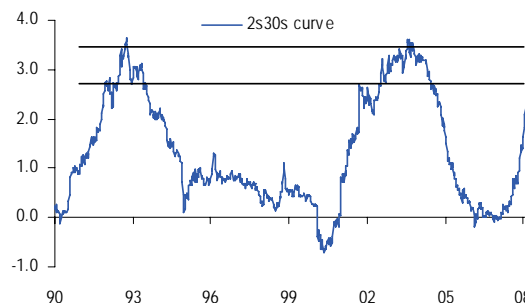
Source: RBC Capital Markets, Inc.

Trade: Buy FHLMC 2.875% Apr 2010 vs UST 2.125% Jan 2010

### Buy 2-yr UST 2.00% Feb 2010 vs. 30-yr UST 4.375% Feb 2038 \*\* Target, stop-loss raised \*\*

Entry (Feb 28)	Current (Mar 6)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
268bp	303bp	350bp	275bp	-6bp/3mo	+30bp	+35bp

This trade has reached our initial target of 300bp, but the economy continues to weaken and the financial crisis continues to worsen, suggesting that the curve is likely to reach 350bp, as it did in both the early '90's and early '00's. We have raised the target to 350bp and the trailing stop to 275bp.



Source: RBC Capital Markets, Inc.

Trade: Buy UST 2s versus UST 30s

## In the Grip of Doom

### Markets displaying massive stress

The 2-yr swap spread reached above 100bp again this week. This might not seem quite so extreme as the Nov and Dec wides, but taking into account that the 2yr yield is roughly 140bp lower than during late-'07, the spread has attained a historic wide. Mortgage yields widened to a record over Treasuries, and the ratio on the 30yr, AAA-rated municipal bond yield to the 30yr Treasury yield spiked to a record high 112.8%. Almost all of the ABX and CMBX indexes traded to all-time wides. The TED spread (3-mo LIBOR less T-Bill yield) spiked to 137bp, a wide since the SocGen rogue trader meltdown in January. The US dollar index traded to a new post-Bretton Woods low, and gold reached a new record high of \$989.54/oz. Oil traded to a record high of \$103.95/bl. But the tension was not confined to one-way price action. In one half-hour period on Tuesday, oil sold off \$4 and gold sold off over \$15 in a move rumored to be associated with hedge fund unwinding activity.

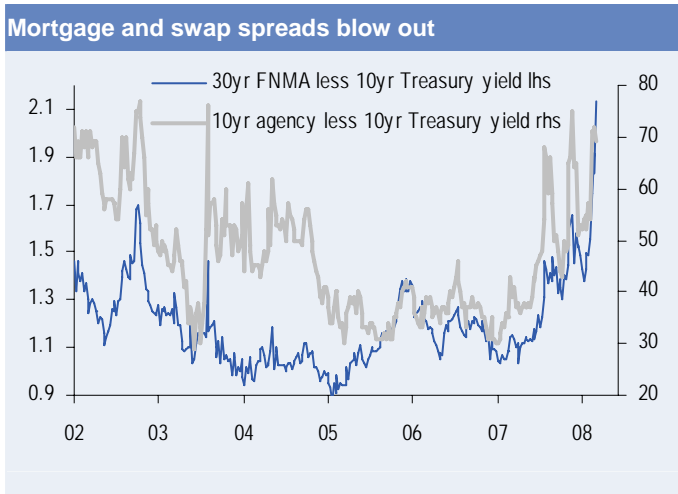
### Indiscriminate sideswiping of entities and processes

Fears of hedge fund failure and unwinds are not unfounded. Following the previous week's failure by the Peloton Partners' \$2bn ABS fund, Focus Capital, a \$1bn NY hedge fund, has been forced to liquidate; the surprising thing is that Focus, which lost 80% of its value, traded mid-cap Swiss stocks, not sub-prime-tainted structured products. The turmoil continues to hit more than just hedge funds. The auction rate securities process continues to deteriorate drastically, with 70% of auctions failing in February, double the fail rate in January, and these failures caused the index yield to almost double from 3.63% in Jan to 6.52% at the end of February. Student loans have been particularly hard-hit by the failures, and the Pennsylvania Higher Education Assistance Agency, the 2<sup>nd</sup>-largest seller of auction rate debt, announced it will stop making student loans. The increased funding costs have not only caused many municipalities to seek alternative financing, but in at least one case, that of Jefferson County, Alabama,

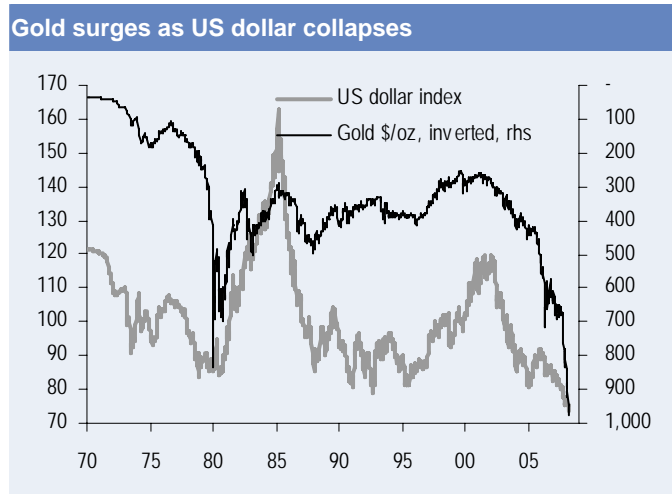
the increased costs have caused S&P to downgrade the municipality, a move that will ironically result in even higher borrowing costs and a greater drag on the local economy. Mortgage lenders found themselves again in the spotlight. Thornburg Mortgage stated that it had failed to meet \$270mm of margin calls. Countrywide noted in its annual SEC filing that it could not even "define" the "maximum obligation" in addition to the \$704mm loss posted in Q4 that resulted when non-reimbursement clauses of home equity trusts were triggered. The head of Dubai International Capital questioned not only Citigroup's ability to survive without further cash infusions, but also whether Middle East sources could provide enough support. Ambac remains in the news, with a "bailout" led by a consortium of banks turning out to be merely an equity issuance that the markets looked dimly on. The concern about the efficacy of the Ambac plan focuses on the ability/willingness of investors to continue to support Ambac as foreclosures mount and the CDO's that Ambac has insured come under even greater pressure.

### Policymakers painfully frank about the situation

While Treasury Secretary Paulson towed the party line in forecasting a growing economy, he conceded that growth had "slowed appreciably" and that risks were to the downside from high energy prices, the housing correction and financial market turmoil. A week after Bernanke indicated bank failures are likely, Don Kohn admitted that banks are facing "serious challenges" and "persistent pressure on earnings". Bernanke warned this week that the current housing downturn was worse than previous ones due to widespread negative equity, that home prices would fall further, that delinquencies and foreclosures would rise, and he recommended that banks respond vigorously, including reducing the principal balance of loans in certain cases. There is very little in the picture to suggest that the Fed will stop easing in the next few months, and we are raising the target on our 2s30s steepening position from 300 to 350bp and our trailing stop to 275bp.



Source: Bloomberg



Source: Bloomberg

## Week Ahead: Market risk and low-grade stagflation

**Event risk:** Event risk will likely remain the key driver of markets next week. There is a fear in the market that forced fund liquidation due to margin calls will gather steam, causing spreads to widen even beyond the current extreme levels. However, the Fed's enhanced repo and TAF facilities should provide at least some relief.

**Retail sales, CPI – more low-grade stagflation.** The key data this week will be the retail sales and CPI reports. Retail sales for Feb are expected to rise 0.3%/m/m overall, roughly consistent with the pace maintained during H2'07, and 0.2% ex-autos, consistent with the downtrend in place during H2'07. CPI for Fed is expected to rise 0.3%/m/m, which would

cause the y/y rate to rise to 4.4%, tied for the 2<sup>nd</sup>-highest pace since 1991. The core measure is expected to rise 0.2%/m/m, which would allow the y/y pace to tick lower from 2.5% to 2.4%, still an elevated level. Consumer confidence will be evidenced by the U. of Michigan and Investor Business Daily surveys. The IBD survey is expected to have fallen from 44.5 to 42.0, a new low since Hurricane Katrina, while the U. Mich. measure is expected to have fallen modestly from 70.8 to 70.4, a new low since 1992. Other data reports include the trade balance, wholesale inventories, business inventories, monthly budget statement and import prices.

## Treasuries: Volatile and steeper

Our 2s30s position reached our 300bp initial target much faster than anticipated, and so we have raised the target to 350bp and the trailing stop to 275bp (initial entry 268bp). We make this decision in light of the deteriorating financial market crisis, the likelihood it will worsen in coming weeks due forced liquidations by hedge funds and banks, the clear signal from non-farm payrolls that the economy is very close to – if not already in – recession and headed lower, and the fact that inflation pressures remain worrisomely intact, with the TIPS 10yr breakeven yield up 34bp since January to 2.54%.

At the short-end of the curve, the 2yr yield made a strong run to pierce 1.50% support, but is trading back above that level as of writing. That could prove an area around which the yield will consolidate until either the financial crisis abates, new resolutions are put in place, or takes a turn for the worse. The 10-year yield (3.566% as of writing) could only temporarily pierce short-term term at 3.50%. A breach of that would suggest moves towards 3.55% (76.4% retrace of Jan-Feb rise), and then 3.285% (Jan23 low). On the topside, resistance lies at 3.708% (Mar5 high) and the 3.956% (Jan high).

## Eurodollars: Pushing for 75bp ease on/before Mar 18

The futures market has sharply shifted its perception of Fed policy during the course of the week. Last week, the market priced in a 50bp ease and a 24% chance of a 75bp ease on or before Mar 18. Today, the market prices in a 98% chance of a 75bp ease by Mar 18. The factors weighing on the sentiment are numerous. The news that Jefferson County Alabama has been not only been downgraded due to higher borrowing costs, but that it has also run into problems funding its hedges, which have perversely lost money as Libor has fallen. The market perceives a surge of hedge fund liquidation, evidenced by rising bond bid lists being shopped and news of suspended trading for Carlyle Group's mortgage unit. The Fed's increase of the Treasury Auction Facility to \$100bn, an historic action, has done little to dent the perception the Fed will still need to cut rates sharply.

Part of the easing being priced by March reflects the potential for an intra-meeting ease. The close in the S&P500 on Thursday below the close of the SocGen meltdown close back in January suggests the potential for further equity, and thus consumer wealth, losses that the Fed might feel compelled to stem. Such a move runs the risks that 1) equity markets

ignore the easing, which would constitute to a great degree a no-confidence vote in the Fed and 2) that the Fed is running low in rate cut ammunition. Without an intrameeting cut, a 100bp cut appears extreme, although it could be justified on the view of continued deterioration of both the economy and the financial market with no cut cuts since Jan. Without more jawboning from the Fed (other than Fisher), the Fed will prove hard-pressed not to cut as markets price for fear of spurring another meltdown.

Farther out, the futures are implying a trough in the Fed Funds rate of 1.75% with a chance of 1.50%, which assuming core inflation of around 2.1%, implies a real Fed Funds rate of -35bp to -60bp, not unreasonably extreme when compared to the lows to which the Fed took the real rate in 1993 (-60bp) and 2001 (-97bp). We maintain our base case forecast that the Fed will ease only 50bp by Mar 18 and to a cyclical trough of 2.00%, but the markets are merely pricing our risk scenario of likely action should the historic developments in markets deteriorate further, and we won't try to fade the market.

## Swaps: Still at the mercy of MBS

Spreads spiked this week as MBS suffered their worst performance since 1986. The 2yr spread spiked to 112.56, a record, while the 10yr spread peaked at 92.75, a high since 2001, when the Federal budget was in balance and nominal yields were roughly 150bp higher. The Fed managed to break the escalating sense of doom by introducing the \$100bn, 28-day repo facility, in which the Fed will accept MBS as collateral, combined with the increased TAF facility. This has calmed the MBS market and allowed swap spreads to tighten in somewhat. While we are biased to receive the 2yr, the short-term volatility prevents any active positioning.

Vols are up 0.1-1.5 implied bp/day, led by gamma sector of shorter expirations, as can be expected given the whippy realized rates volatility. Many structures hit recent highs and even historical highs, like 3mo into 5y, which rose to 11.7 (high since Jul'03). Vols should slip from the current elevated levels on profit taking, but outright selling is unlikely to develop. Our bias remains to buy dips.

Two weeks ago we proposed a zero-cost trade from 2/20 of a 2y/5y bull steepener, which can now be exited at ~100k profit, as the recent move

All-time wides on 2yr spread



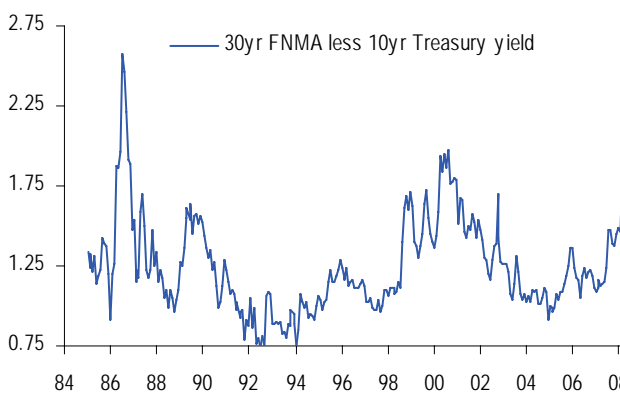
Source: Bloomberg

has front-loaded easing and what this trade was designed for. With 2y maybe getting to where it runs out of room, it might be a decent exit and re-assess point on this trade.

## MBS: A brave new world?

Up through Friday morning, MBS suffered the worst drubbing since 1986 as leveraged accounts were forced to liquidate in order to meet margin calls. By the close on Thursday, the spread on the 30yr FNMA over the 10yr Treasury had spiked 55bp from end of the previous week to 238bp, a high since 1986. However, the Fed's announcement that it will offer \$100bn in repo lines and accept MBS as collateral offers the potential to "change everything". Consequently, the FNMA – 10yr UST spread snapped in 12bp during Friday's session. The question of whether the repo lines and enhanced TAFs will prove enough remains open, as no one can quantify the effect of deleveraging that is sweeping through the opaque hedge fund world. The situation remains too uncertain for participants required to mark to market to be able to buy MBS, but the extreme wides still present excellent value to accounts with a long-term horizon and balance sheet capacity.

Worst performance since 1986



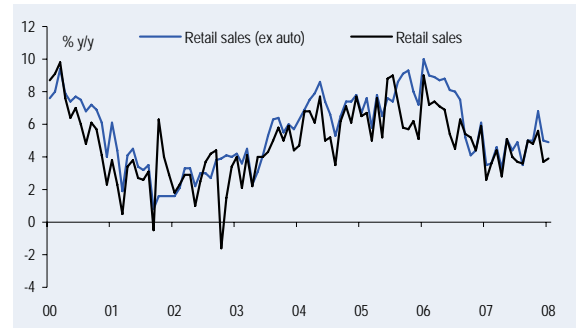
Source: Bloomberg

## Data Risk in Focus

### US Retail Sales / Retail Sales (ex-autos)

Period:	Thu, Mar 13	RBC:	Consensus:	Previous:
Feb	08:30EST/12:30GMT	0.2%/0.1%	0.3%/0.2%	0.3%/0.3%

**Comment:** Retail sales growth likely moderated to 0.2% in February from 0.3% the month prior. On the positive side, there was an estimated 1.3% gain in unit auto sales in February, thereby providing a modest boost to sales in the month. However, indications of weaker chain store sales coupled with a slight decline in gas prices (weighing on gasoline receipts) suggest that ex autos spending decelerated in February. Colder-than-normal temperatures may have provided a boost to seasonal sales. On a real basis, sales were likely flat in February, consistent with our forecast for a sharp deceleration in consumer spending in Q1. We expect consumer spending to soften significantly in the first six months of the year owing to a softening labour market and deteriorating household wealth. However, it will likely see a big boost in the second half of the year, as the fiscal stimulus package bolsters incomes and spending. For the year, we expect consumer spending growth to clock in at 1.7%, a deceleration from 2007's 2.9% pace.



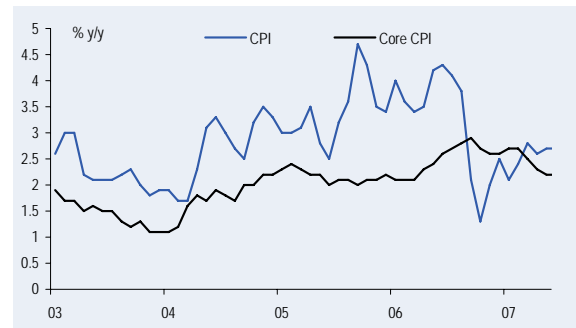
Source: Datastream

**Market Impact:** Major. A downside surprise for the market should allow short-end yields to test or reach new lows and the curve to steepen even further. An upside surprise will allow for a temporary bear flattening.

### US CPI / Core CPI

Period:	Fri, Mar-14	RBC:	Consensus:	Previous:
Feb	08:30EST/12:30GMT	0.2%/0.2%	0.3%/0.2%	0.4%/0.3%

**Comment:** We are expecting the core index to have advanced 0.2% in February, with support coming from medical care costs, which have been on an upward trend recently. Further upward pressure on the owner's equivalent rent component is likely, given its inverse relationship with still weak housing prices. In terms of the all-items index, we are also forecasting a 0.2% gain as a drop in gasoline prices was likely offset by increasing crude oil, natural gas, and food prices. On a year-over-year basis, we are expecting the all-items index to come in at 4.3%, which could pressure already increasing inflation expectations even higher. Year-over-year growth in the core index likely came in at 2.4%, slightly slower than January but higher than the 2.1% near-term lows seen in August and September of last year



Source: Datastream

**Market Impact:** Significant. This report could influence the long end of the curve. An upside surprise will provide renewed steepening impetus for the curve, as policy remains firmly fixed on combating the housing and credit crises.

## Data Risk Calendar

Day/date	Time (EDT)	Release/Event	RBC	Market	Prior	Comment
Mon / Mar 10	10:00	Wholesale inventories (Jan)	-	0.5%	1.1%	Remain relatively buoyant
Tue / Mar 11	08:30	Trade balance (Jan)	-\$57.8bn	-\$59.5bn	-\$58.8	Deficit continues to stabilize
	10:00	IBD/TIPP economic optimism (Mar)	-	42.0	44.5	This would be low since Hurricane Katrina
	17:00	ABC consumer confidence (Mar 9)	-	-	-34	Just off multi-year low
Wed / Mar 12	07:00	MBA mortgage applications (Mar 7)	-	-	3.0%	
	14:00	Budget statement (Feb)	-	-\$150bn	-\$120bn	Falling reviews putting pressure on budget
Thu / Mar 13	08:30	Import price index m/m (Feb)	-	0.8%	1.7%	Weak dollar adding to price pressures
	08:30	Retail sales tot, ex-autos m/m (Feb)	0.2%, 0.1%	0.2%, 0.2%	0.3%, 0.3%	Tepid and deteriorating pace
	08:30	Initial jobless claims (Mar 8)	-	355K	351K	Lower than the negative payrolls suggests
	10:00	Business inventories (Jan)	-	0.4%	0.6%	Modest pace
Fri / Mar 14	08:30	CPI tot, ex-F&E, y/y (Feb)	4.3%, 2.4%	4.2%, 2.4%	4.3%, 2.5%	Entrenched inflation remains a problem
	10:00	U. Mich. confidence (Mar P)	-	70.4	70.8	RBC CASH index points to downside risk

## Economic and Financial Market Forecasts

	Quarterly												Annual		
	Q106	Q206	Q306	Q406	Q107	Q207	Q307	Q407	Q108	Q208	Q308	Q408	2006	2007	2008
Real GDP q/q saar	5.6	2.6	2.0	2.5	0.6	3.8	4.9	0.6	0.0	-1.0	3.9	1.7	2.9	2.2	1.4
Consumer Prices y/y	3.7	4.0	3.4	1.9	2.4	2.7	2.3	4.0	3.6	2.2	2.5	2.5	3.2	2.9	2.7
Core CPI y/y	2.1	2.4	2.8	2.7	2.6	2.3	2.1	2.3	2.1	1.9	2.0	2.2	2.5	2.3	2.1
Fed Funds Rate (e.o.p.)	4.75	5.25	5.25	5.25	5.25	5.25	4.75	4.25	2.50	2.00	2.00	2.00	5.25	4.25	2.00
2-year yields (e.o.p.)	4.82	5.15	4.68	4.82	4.60	4.93	3.94	3.08	1.85	2.00	2.25	2.50	4.82	3.08	2.50
10-year yields (e.o.p.)	5.85	5.14	4.63	4.72	4.65	5.03	4.53	4.03	3.40	3.65	3.80	4.00	4.72	4.03	4.00

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