

U.S. Daily Directions: March 10, 2008, US Edition

Today: **Light day: Wholesale inventories.** Wholesale inventories for Jan are expected to have risen 0.5%*m/m*, above the 0.4% *l-t* average and recessionary levels. The key data for the week are CPI and retail sales, which are going to paint a picture of a low-grade stagflation bug. CPI is expected to remain elevated (4.3% overall, 2.4% core), while sales are expected to rise only 0.2%*m/m*, below the 0.4% *l-t* average. Fed speak this week includes Kroszner (risk management) and Bernanke (homeownership).

Overnight: **Systemic risks in spotlight.** Press over the weekend highlighted the stresses impacting all around the financial system. Barron's highlighted the potential that FNMA's situation is far more dire than the accounting statements would indicate. The hedge fund industry is reported in crisis due to margin calls, with 6 funds totaling \$5.4bn being forced to at least partially liquidate since Feb 15. The liquidation is putting pressure on the banking system, with one report indicating banking capital could fall in excess of \$300bn as a result. The Carlyle Group has reported it believes banks have liquidated collateral backing \$5bn of indebtedness and that it is negotiating with lenders to avoid similar liquidations for another \$16bn of debt. Euribor spiked another 5.6bp to 4.56%, a high since Jan, and indicative of rising pressures in the European banking system.

Asset Commentary/Assessment:

Eurodollars: **Overnight, yields mostly lower, curve flatter.** Yields fell along most of the curve, as much as 8bp for the Sep'09 contract. The market has lowered the potential trough for the Fed Funds rate to approximately 1.75% by the Sep'08 meeting. As to the Mar meeting, it has priced in a 75bp ease and a 4% chance of a 100bp ease. Both views are more dovish than our base case (50bp ease in Mar and a trough of 2.00%), but they do reflect our risk scenario.

Treasuries: **Overnight, yields lower, curve flatter.** Yields drifted lower in Asia before rising in Europe. The 2yr yield is down less than 1bp at 1.51%, as solid support at 1.50% continues to hold. The 10yr yield is off 2.1bp to 3.51%, with 3.50% representing support. Our 2s30s steepener (entry 268bp, trailing stop at 275bp, target of 350bp) slipped 3bp to 300bp.

Swaps: **Opening tighter.** Spreads are opening about 2bp tighter across the curve. We have seen better receiving in the 5- to 10yr part of the curve. Spreads remain at the mercy of MBS, with potential "deleveraging" against Fed TAF and repo operations providing ongoing volatility.

MBS: **Friday reversal.** MBS managed to tighten Friday after putting in their worst week since 1986. The reversal came in the wake of news that the Fed would increase the Treasury Auction Facility to \$100bn and begin ramping up a repo facility that could reach \$100bn. The basis provides very good value, but only for investors who can look through potential near-term volatility.

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