RBC Capital Markets

RATES STRATEGY | RESEARCH

April 10, 2008

U.S. Directions

Fixed Income Strategy

Keys to next week

* Fed's Beige Book
* Retail sales
* CPI, PPI
* Industrial production, Empire mfg, Philly Fed, Richmond Fed
* Homebuilders' index, housing starts, building permits
* Bank earnings

Sector	View	Specific Comments
Notes/bond yields	* Yields are consolidating and should break out	Price action in yields is consolidating and suggests either a break-out next week to either retest recent lows or resume the late-Mar uptrend. Given the extraordinary event risk next week, we explore purchasing futures strangles.
Curve	* Steer clear of competing, violent forces	The 1990-1 and 2001 recessions both lead to uneven, choppy steepening, similar to the violent retracement of the past four weeks. However, the Fed's open market operations and significant deleveraging have also played a large role, and the potential that they might continue makes us wary of steepening positions.
Eurodollars	* Bullish	Eurodollars have rallied in recent sessions, but still price in only approximately a 50% chance of a 50bp cut at the April meeting (our base case). Furthermore, the futures price in a trough in the Fed Funds of 1.75% in Q3 and a chance of tightening as early as Q1'09, in contrast to our call that the Fed will cut to 1.50% by June and will not tighten until H2'09. Consequently, our futures team has designed bullish eurodollar structures for the Jun'08 and Jun'09 contracts.
Swaps	* Range, unless yields break lower	The 2yr spread appears to have established a 75-85 range, although a break lower in Treasuries yields could occur along with a renewed spike in the spread. For the 10yr, a 60-70bp range also appears to be in place, with the same caveat regarding a potential breakout in yields.
Mortgages	* Look to buy basis * 15yr vs 30yr	Basis still looks cheap, and positive financing developments facilitate short-term players entering market. Look to re-enter tightening positions on pullbacks. We continue to believe 15yr paper is attractive relative to 30 yr paper, and have instituted a recommendation accordingly.

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 US 30s vs Canada 30s

Entry (Mar 19)	Close (Apr 10)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
-30bp	-22.9	-50bp	-20bp	-	-3.6bp	-7.1bp

This trade has been hammered by curve flattening in the US. Nevertheless, the fundamental backdrop remains in place, and we will ride the position through this downdraft.

This trade seeks to capitalize upon Canada's superior inflationary backdrop – the BoC being the only central bank we cover that is not concerned on the prices front while the Fed cuts rates aggressively in the face of lingering inflation concerns. The supply-side backdrop is also conducive for this trade with Canada likely posting healthy surpluses while the US budgetary shortfall looks set for a marked deterioration as the government pushes out a stimulus package worth close to 1.0% of GDP.

Trade: SellT4.375% 2038 vs CAN5% 2037

Buy FN Dwarf 4.5s vs FN 30yr 5s

Entry (Apr 10)	Close (Apr 10)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
N/A	N/A	N/A	N/A	-	-	-

We continue to see value in 15 year paper relative to 30 year and so are buying Dwarf 4.5s vs 30yr 5s. The one downside for this trade is that it has negative carry.

Trade Under Consideration

Buy bullish Eurodollar structures for Jun '08 and / or Jun '09 contracts – see page 4

Buy UST 2yr and 10yr strangles – see page 4

What's been bugging the yield curve?

Curve steepeners hazardous for your health

We have stated in past weeks that the "easy" money in curve steepeners was over, even by the standards of the early '90's and early '00's experiences, when the curve ended its steepening phases with less directional price action. However, the recent curve flattening can be traced to Fed open market operations, historic deleveraging, as well as a pullback from the Fed's extremely aggressive rate cuts, and these impacts make positioning for steepening dicey.

Fed balance sheet shift adding to flattening

The Fed has radically altered its balance sheet in recent months, and this process has also likely done much to flatten the curve. Analysis of the Fed's "Factors Affecting Reserve Balances" shows the Fed has sharply reduced its holdings of Treasury Bills from $277bn in August, before the crisis took hold, to $93bn by Apr 2. Additionally, the Fed reduced it's holdings of Treasury notes by $21bn. In exchange for the Treasuries, the Fed offered Term Auction Credit, repurchase agreements and other loans, but the key point for our purposes is that a potent amount of short-term paper hit the market in a short period. The yield curve flattening can be more specifically tied to permanent open market operations. Beginning on Mar 7, 2008, the Fed began a series of Treasury Bill and Note sales that totaled $114bn by April 2. Not coincidentally, the yield curve closed at its recent high (306bp) on March 6. The sales entailed mostly T-Bills ($71bn), but also included Notes with maturities as far out as 2012. The Fed still has more than $450bn of Notes and Bonds and $93bn of Bills on its balance sheet, so further sales could continue to pressure the curve. This possibility was given weight by news that the Fed was considering additional steps to mitigate the crisis that included having the Treasury auction securities for the Fed or allowing the Fed issue it's own debt.

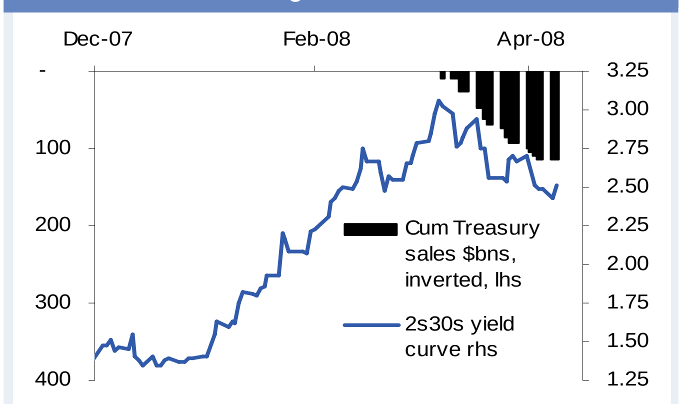
Deleveraging and safe haven unwinds drive flattening

Anecdotally, deleveraging and safe haven unwinds have driven much of the price action, and analysis of CFTC Commitment of Traders data supports this notion. Total non-commercial contracts, often associated with speculative activity, on the CBOT for the 2yr and 10yr Treasury futures have plummeted 643K from Feb 19 through Apr 1 to 1,125K, the largest drop on record. The open interest could fall even further, as prior to 2004, when the open interest began to accelerate sharply, the high had been only 500K contracts. The buildup and unwind of the safe-haven bid in the front end of the Treasury curve can be observed via the net long non-commercial position for the 2yr notes. In Aug'07, as the commercial paper market melted down, the net long rose to an exceptionally (till that point) high 48K contracts. In December, when the market began to fear a yearend liquidity crunch, the position spiked temporarily to 162K contracts. And it rebuilt to 74K in March as fears built around intensifying fears of a banking collapse. Subsequently, the net long has slipped back to 45K. Consequently, while these data help explain the past curve flattening, they also indicate the potential for further curve flattening.

Fundamental steepening support depends on view

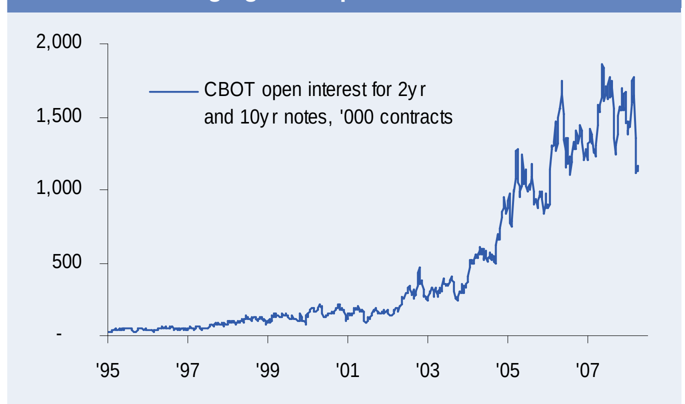
In the prior two US recessions, the yield curve steepened more than its recent high (~360bp vs. the recent 305bp). But this time the Fed has eased much more aggressively, prompting the curve to steepen much more quickly in the economic cycle. Even assuming the economy is determined to have entered recession in Jan'08, the curve was already at 222bp, in sharp contrast to the 56bp in Jul'90 and 126bp in Mar'01, the starting months for the last two recessions. Additionally, the real 2yr yield (nominal less core CPI) was already at -40bp by Jan'08, much lower than the 288bp in Jul'90 or 148bp in Mar'01. The Taylor Rule, as described by the St. Louis Fed in 2008, suggests that the Fed Funds rate should be above 4.0%, indicative of the Fed responding to a financial crisis rather than an economic slowdown. Consequently, it is possible that the government has "short-circuited" the economic downturn and the curve steepener. Alternatively, the recent 63bp of 2s30s flattening could be likened more to the 64bp flattening that occurred after the initial reaction to 9/11. Should the Fed's expressed fear that a protracted and severe downturn develop, the curve could reach new cyclical highs as the market prices in easing even below our base-case forecast of a 1.50% trough.

Fed Treasuries sales weigh on curve



Sources: Federal Reserve, Bloomberg

Extreme deleveraging – with potential for more



Source: CFTC, RBC Capital Markets

Week Ahead: Return of data risk - growth, inflation, housing, earnings

Growth to show weakness: Advance retail sales constitutes one of the bigger risks for the week, and while overall sales are expected to have been capped by autos, ex-auto sales are expected to be up 0.2%m/m, which is still only half the average pace since the start of 2007. The Empire manufacturing survey for April is expected to have rebounded to a still-recessionary -17 from the prior -22, which represented a record in data back to 2001. The Philly Fed is similarly expected to rebound modestly but remain at a recessionary level (from -17.4 to -15.0). Mar Industrial production is expected to fall for the 2nd month (-0.1%m/m), putting the trajectory for the time series into a steepening downtrend.

Prices to show ongoing pressures: Mar CPI is expected to rise 0.3%m/m overall and 0.2%m/m ex-F&E. These results would keep the overall rate at 4.0%, among the most worrisome rates since 1991, and cause the core rate to tick up to 2.4%, elevated, but still below the 2.9% registered in Sep'06. Mar PPI is expected to have jumped 0.7%m/m overall and to have risen 0.2% ex-F&E. The overall y/y rate would slip to 6.1%, which is still among the highest since the early 1980's, and the core rate would rise to 2.6%, among the highest since the early 1990's.

Housing still depressed: The Apr homebuilders' index for is expected to remain stable at 20, just off recent record lows and still indicative of a very depressed industry. Housing starts for March are expected to sag lower to 1025K, moving to retest the recent multi-year low of 1000K. Mar Building permits are expected to drop to 973K, a new low since 1991.

Fed: The Beige Book report will be released. Of particular concern will be potential further retrenchment by not only consumers but also businesses. Additionally, the ability of firms to pass on rising inflation pressures will provide insight into the likelihood of the Fed's expectation for inflation to eventually abate. Fedspeak includes Warsh (voter, economic policy), Yellen (non-voter, US outlook), Plosser (voting dissenter, goals and monetary policy), Kohn (voter, credit markets and banking), and Fisher (voting dissenter, global affairs).

Earnings: Many large banks report earnings next week. Of interest will be how the market reacts to the losses - whether it takes them in stride as part of the financial crisis evolution, or whether worse-than-expected results cause markets to price in more doom and gloom.

Treasuries: Something's gotta give

10-yr yield – price action suggests break – but which way?

Source: Bloomberg

Technical analysis – yields are coiling: The yields for both the 2yr and 10yr Treasuries are both trading tightening patterns that suggest a break next week, which makes intuitive sense given the extreme data risk during the period. Both yields have traded an uptrending channel since Mid-March, but both have also traded lower highs this past week. The downtrend of the highs appears to intersect the bottom of the uptrending channel early next week. For the 2yr yield, the current downtrend of the highs is at 1.84 and the uptrend of the channel is at 1.72. A breach to the upside would bring a retest of 1.985% (April high), followed by 2.20% (Feb high). In contrast, a breach to the downside would open the way for a test to 1.55 (April low) and 1.50% (psychological support). For the 10yr, a breach of the downtrend at 3.55% would allow for a retest of 3.60%, while a breach of the uptrending channel bottom at 3.45% would open the way for a move to 3.38% (Mar 31 low) and then 3.28% (Mar 17 low). To position for a potential break in either direction, our futures group suggests the following trade ideas. First, buy the 2yr, 106.75/107.75 strangle for May, which expires in two weeks and has a price of 0-08. Second, buy the 10yr, 116.5/119.5 strangle for May, which also expires in two weeks and costs 0-26.

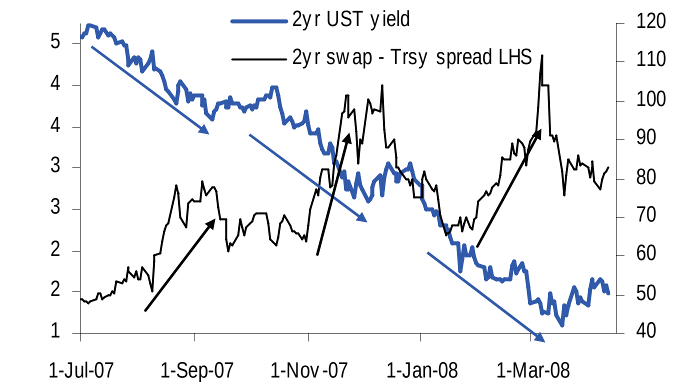
Eurodollars: Position for 1.50% Fed Funds

The futures market has moved a long way towards pricing in our base case view for the April meeting – that the Fed cuts 50bp. The market prices the odds of a 50bp cut at 52%, up from only 36% last week. Our futures desk had positioned clients well for this move early in the week by putting forward the idea to Buy June '08, 98.00/98.25 call spread, although there is still room left in the trade. Further out the curve, the market prices not only a less deep trough of 1.75% by Q3 (our base case is 1.50% in Q2) but also a faster return to Fed hiking (as early as Q1'09 versus our base case of no hiking until H2'09). To take advantage of this dichotomy in view, our futures desk proposes buying a Jun'09, 97.50/98.00 call spread and then selling the 97.00 put to cheapen the cost of the structure.

Swaps: Spreads range-bound – so long as yields are

The swaps market is showing the most tentative signs of life. Liquidity is by no means perfect, but deal flow does exist. The situation feels as if it is transforming from a financial liquidity crisis to a real economic downturn. The 2yr spread appears to have established a 75-85 range, although a break lower in Treasuries yields could occur along with a renewed spike in the spread. For the 10yr, a 60-70bp range also appears to be in place, with the same caveat regarding a potential breakout in yields.

Swap spread lagging MBS spread in tightening



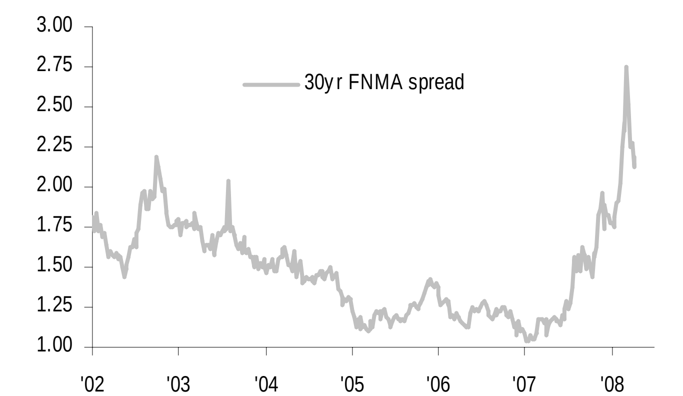
Source: Bloomberg

MBS: Basis still attractive long-term, Dwarf paper attractive

MBS widened 5bp this week versus Treasuries, and although they have tightened over 75bp to 218bp since reaching 293bp early in March, it remains wide on a historical basis, as since 2003, it has averaged 142bp relative to nominal Treasury yields. Consequently, further normalization could lead the spread to contract further towards 180bp. However, potential volatility next week could lead to short-term widening.

We have implemented a long FN Dwarf 4.5 vs FN 30yr 5s (see page 2).

MBS spread remains historically wide



Source: Bloomberg

Data / Event Risk Calendar

Day/date	Time (EDT)	Release/Event	Market	Prior	Comment
Mon / Apr 14	08:30	Retail sales, tot, ex-autos m/m (Mar)	0.1%, 0.2%	-0.6%, -0.2%	Modest rebound. Sales trend remains above recessionary pace
	10:00	Business inventories (Feb)	0.4%	0.8%	Buildup of inventories remains fairly benign
	14:30	Fed's Warsh (voter, economic policy forum)			
Tue / Apr 15	08:30	PPI tot, ex-F&E (Mar)	5.7%, 2.6%	6.4%, 2.4%	Core near highs since early 1990's
	08:30	Empire manufacturing survey (Apr)	-16.0	-22.2	Consistent with levels during 2001 recession
	09:00	TIC long-term flows (Feb)		$62.0bn	
	13:00	Homebuilders' index (Apr)	20	20	Stabilizing – near all-time lows
	17:00	ABC consumer confidence (Apr 13)		-34	Stabilizing near lows since 1993
Wed / Apr 16	07:00	MBA mortgage applications (Apr 11)		+5.4%	
	08:30	CPI tot, ex-F&E (Mar)	4.0%, 2.4%	4.0%, 2.3%	Overall near highs since 1980's. Core remains entrenched
	08:30	Housing starts, building permits (Mar)	1025K, 970K	1065K, 984K	Housing remains depressed
	09:15	Ind Prod, cap util (Mar)	-0.1%, 80.4%	-0.5%, 80.4%	2nd consecutive decline for production - trending lower
	11:45	Fed's Yellen (non-voter, US outlook)			Yellen has stated economy has "all but stalled"
	12:30	Fed's Plosser (voter, dissenter, goals and monetary policy)			Worried about inflation-fighting credibility
	14:00	Fed's Beige Book			Balancing growth, financial turmoil and inflation pressures
Thu / Apr 17	08:30	Initial jobless claims (Apr 12)		357K	Uptrend since Q3'07. Level consistent with early '01 recession
	08:30	Continuing jobless claims (Apr 5)		2940K	Consistent with mid-'01 recession level
	09:45	Fed's Kohn (voter, credit markets and banking)			Hasn't spoken publicly since Mar 7
	10:00	Philadelphia Fed (Apr)	-14.0	-17.4	Consistent with levels during 2001 recession
	10:00	Leading indicators (Mar)	0.1%	-0.3%	Trend is similar to recessions of '90-'91 and '01
Fri / Apr 18	08:30	Fed's Lacker (non-voter, liquidity and systemic risk)			No public comments since February
	08:30	Fed's Rosengren (non-voter, liquidity and systemic risk)			Said it's "too early" to call recession on Mar 28

Economic and Financial Market Forecasts

	Quarterly												Annual		
	Q107	Q207	Q307	Q407	Q108	Q208	Q308	Q408	Q109	Q209	Q309	Q409	2007	2008	2009
Real GDP q/q saar	0.6	3.8	4.9	0.6	0.0	-1.0	3.9	1.7	1.9	2.9	3.0	3.0	2.2	1.4	2.3
Consumer Prices y/y	2.4	2.7	2.3	4.0	3.6	2.2	2.5	2.5	2.4	2.4	2.5	2.3	2.9	2.7	2.4
Core CPI y/y	2.6	2.3	2.1	2.3	2.1	1.9	2.0	2.2	2.1	2.2	2.3	2.3	2.3	2.1	2.2
Fed Funds Rate (e.o.p.)	5.25	5.25	4.75	4.25	2.25	1.50	1.50	1.50	1.50	1.50	2.00	2.50	4.25	1.50	2.50
2-year yields (e.o.p.)	4.60	4.93	3.94	3.08	1.50	1.60	1.80	1.95	2.10	2.45	2.75	3.25	3.08	1.95	3.25
10-year yields (e.o.p.)	4.65	5.03	4.53	4.03	3.45	3.60	3.75	3.90	4.00	4.25	4.50	4.75	4.03	3.90	4.75

TJ Marta (New York)
+1 212 858 6077
tj.marta@rbccm.com

All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

The information contained in this report has been compiled by RBC Capital Markets ("RBC CM") from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC CM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC Capital Markets is a business name used by subsidiaries of the Royal Bank of Canada including RBC Dominion Securities Inc., RBC Dominion Securities Corp., RBC Dain Rauscher Inc., Royal Bank of Canada Europe Limited and Royal Bank of Canada – Sydney Branch. All opinions and estimates contained in this report constitute RBC CM's judgement as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation of an offer to buy any securities. RBC CM and its affiliates may have an investment banking or other relationship with some or all of the issuers mentioned herein and may trade in any of the securities mentioned herein either for their own account or the accounts of their customers. Accordingly, the entities constituting RBC CM or their affiliates may at any time have a long or short position in any such security or option thereon. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. This material is prepared for general circulation to clients and does not have regard to the particular circumstances or needs of any specific person who may read it. To the full extent permitted by law neither RBC CM or any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior consent of RBC CM. The entities comprising RBC Capital Markets are wholly owned subsidiaries of the Royal Bank of Canada and are members of the RBC Financial Group. **Additional information is available on request.**

To U.S. Residents:

This publication has been approved by RBC Dominion Securities Corp. ("RBCDS Corp.") and RBC Dain Rauscher Inc. ("RBC DRI"), both of which are U.S. registered broker-dealers, which accept responsibility for this report and its dissemination in the United States. Any U.S. recipient of this report that is not a registered broker-dealer or a bank acting in a broker or dealer capacity and that wishes further information regarding, or to effect any transaction in, any of the securities discussed in this report, should contact and place orders with RBCDS Corp. or RBC DRI.

To Canadian Residents:

This publication has been approved by RBC Dominion Securities Inc. Any Canadian recipient of this report that is not a Designated Institution in Ontario, an Accredited Investor in British Columbia or Alberta or a Sophisticated Purchaser in Quebec (or similar permitted purchaser in any other province) and that wishes further information regarding, or to effect any transaction in, any of the securities discussed in this report should contact and place orders with RBC Dominion Securities Inc., which, without in any way limiting the foregoing, accepts responsibility for this report and its dissemination in Canada.

To U.K. Residents:

This publication has been approved by Royal Bank of Canada Europe Limited ("RBCEL") which is regulated by Financial Services Authority ("FSA"), in connection with its distribution in the United Kingdom. This material is not for distribution in the United Kingdom to private customers, as defined under the rules of the FSA. RBCEL accepts responsibility for this report and its dissemination in the United Kingdom.

To Persons Receiving This Advice In Australia:

This material has been distributed in Australia by Royal Bank of Canada -Sydney Branch (ABN 86 076 940 880). This material has been prepared for general circulation and does not take into account the objectives, financial situation or needs of any recipient. Accordingly, any recipient should, before acting on this material, consider the appropriateness of this material having regard to their objectives, financial situation and needs. If this material relates to the acquisition or possible acquisition of a particular financial product, a recipient in Australia should obtain any relevant disclosure document prepared in respect of that product and consider that document before making any decision about whether to acquire the product.