

April 18, 2008

U.S. Directions Fixed Income Strategy

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Sell UST 4.375% 2038 vs Canada 5% 2037
Buy 2yr and/or 10yr UST strangles – take profit
Qtr-end relative value play in Treasuries
Buy bullish spreads for either the Jun'08 or Jun'09 contracts - exit
Buy Jun'09 Eurodollar calls – initiate
Buy credit-impaired MBS vs generics
Buy whole loan, discount, agency ARMs

Keys to next week

- * Existing, new home sales
- * Durable goods orders, Richmond Fed Mfg index
- * U. Mich. confidence

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Sector	View	Specific Comments
Notes/bond yields	* Higher medium-term, but have come too high, too fast	Yields exploded higher this past week, decisively breaking higher. Inflation pressures, deleveraging, stop-loss unwinds, along with the increased supply of short-term notes have combined to force a decision break. Short-term yields could be further supported by the 2-yr and 5-yr note auctions next week. As a caution, the explosiveness of the move could lead to short-term retracements.
Curve	* Flatter	The sharp flattening of the curve has allowed it to breach technical support opening the way for more flattening. The Treasury auctions could add to the momentum.
Eurodollars	* Neutral – bullish bias * Buy Jun'09 calls	Should some financial meltdown, which the LIBOR spread suggests is imminent, actually occur, LIBOR could rise even further. On the other hand, prompt and decisive policy action to prevent a meltdown would prevent LIBOR from remaining elevated. Buying Jun'09 mid-curve calls takes advantage of the potential the LIBOR turns around and/or that the market backs away from calling for Fed hikes by mid-'09.
Swaps	* Neutral, biased tighter	The ECB and BoE are moving to confront obvious stresses in the system, and their action should be able to short circuit the crisis the market fears is brewing.
Mortgages	* Look to buy basis * Credit impairment	Medium-term, the basis still looks cheap. Long-term player look to add to tightening positions on pullbacks. Still like 15yr vs 30yr paper. Additionally, we see opportunities in low-FICO, negative HPA, moderately high LTV MBS.
Agencies	* Buy ARMs * High quality private label arms	Short-duration product remains in high demand. Agency ARMs appear attractive on an OAS basis and provide for better duration stability than 15/30 yr counterparts. High quality prime private label arms are gaining attention as markets recover from the shock of the credit crisis.

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 18)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
-30bp	-38.4	-45bp	-20bp	-	-15.5bp	-7.1bp

After nearly being stopped out last week, this trade has turned nicely with the sell-off in US Treasuries. We have moved the stop in to -45bp.

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

Trades to Consider

Buy UST 2yr and 10yr strangles – last week we suggested that clients buy strangles for either the 2yr or 10yr US Treasury notes. We got the expected breakout, and so would take profit on the positions.

Qtr-end relative value trade in Treasuries – The current 10yr note tends to cheapen on the curve going into quarter ends. Consequently, sell the current 10y 3.50% Feb18 versus the 4.50% May 17 and 9 Nov 18 (pick up 20/21bp). The carry to Jun30 is 1bp, leaving a breakeven of 19/20bp. The position also enjoys positive rolldown.

Buy bullish Eurodollar structures for Jun '08 and / or Jun '09 contracts – the unexpected widening of LIBOR has put these positions into negative territory. Fundamentally, we still believe the market is incorrectly pricing in Fed tightening, but we would look to express such a view via options.

Bullish Eurodollar options - Buy Mid-curve, May 16-expiry, Jun'09 Eurodollar calls. The 97.50 strike would cost 5.5 ticks. This position takes the view that the Jun'09 contract will benefit from some combination of decreased stress in the banking system alleviating LIBOR rates and the market taking out expected Fed hiking during H1'09 as the economic data in coming in weaker during the next few weeks.

Buy credit impaired MBS vs generics – credit-impaired MBS with relatively high LTVs, especially in negative HPA areas, should provide slower prepaes than generics.

Buy whole loan deep discount ARMs- The Jumbo conforming loan program should allow prime loans to refinance at better terms, particularly those looking to move away from the uncertainty of adjustable rate terms.

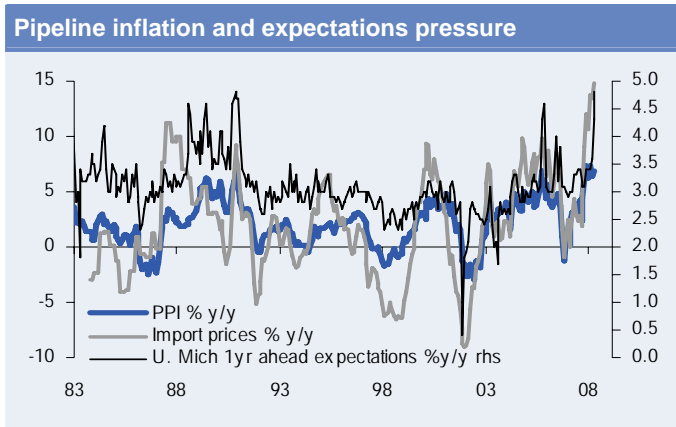
Inflation pressures natural for this part of cycle

Risks to Fed’s inflation outlook appears to be rising

The Fed has raised its core PCE inflation forecast for H1’08 “in response to elevated readings in recent months”. The overall PCE inflation rate was expected to “substantially exceed core PCE in 2008”. The Fed forecast further that headline and core PCE inflation would recede back towards previous forecasts only in 2009. The most recent FOMC minutes revealed the perception that inflation readings had been elevated, energy prices had spiked and that inflation expectations had risen. The Fed’s Beige book, prepared from information before April 7, observed ongoing price pressures, with manufacturers indicating the intention to raise selling prices. Certainly, subsequent developments have justified the concerns. Import prices during March surged to 14.8%/y/y, a record in data back to 1983. Overall PPI for March jumped to 6.9%/y/y, among the highest paces since the early 1980’s, while core PPI rose to 2.7%/y/y, among the highest rates since the early 1990’s. Overall CPI for March remained elevated at 4.0%/y/y, among the highest rates since 1991, and core CPI ticked up to 2.4%. Furthermore, the price of oil has traded a new record high over \$114/bl, and the 1-year-ahead inflation expectation from the University of Michigan confidence survey has jumped to 4.8%, tied for the highest level since the early 1980’s. Discounting the “headline” inflation numbers as overly volatile has become increasingly problematic. In the 1970’s and 1980’s, supply shock volatility for food and energy necessitated looking through the wild swings and focusing on the core rate of inflation. However, recently, overall inflation has been more demand-led, with the “volatility” not showing up as wild price swings so much as consistent upward pressure that is threatening to unhinge inflation expectations and cause core inflation to gravitate higher. With the threat of recession looming, fears are mounting that the Fed will lose control of inflation in trying to avert financial Armageddon and a hard landing for the economy.

Past recessions say not to worry just yet

Some comfort can be taken in the fact that the five recessions beginning with the 1973 recession show that inflation pressures persist for months into a recession. The median overall CPI rate rose for five

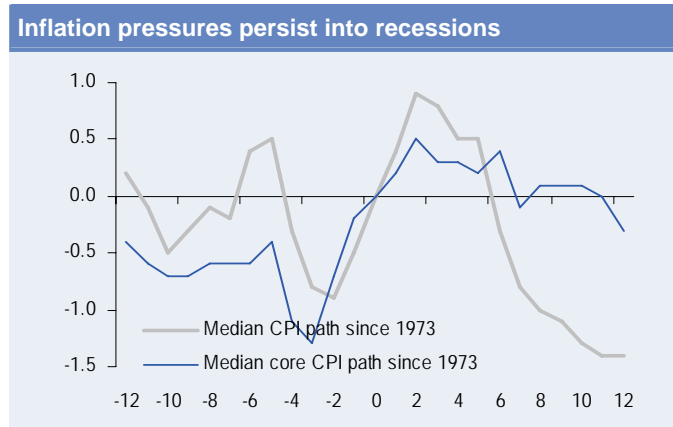


Sources: BLS, U. Mich

months into recessions and by as much as 0.9ppt. The median core inflation rate did not begin to head convincingly lower until a full year after a recession began and rose as much as 0.5ppt in the meantime. Assuming that a recession began in February (most recent CPI data), recent history suggests inflation could rise to 4.9% and remain higher than 4% until July. Additionally, it would not be abnormal for core CPI to remain at or above the 2.3% Feb print until Feb’09 and perhaps even reach 2.8% in the interim.

Look for choppy yield curve in coming months

Similar analysis of the 2yr and 10yr Treasury yields around the month that recessions have begun is less enlightening because the Fed began easing so quickly in 2007 in an attempt to short-circuit the financial crisis – or at least its spread to the real economy. However, one historical parallel to consider is the Q3’01-Q2’02 experience. Tax rebates in June’01 and the unwinding of the policy responses to the 9/11 attacks led to a temporary flattening of almost 70bp in the 2s30s curve. However, the temporary impetus of the tax rebate wore off and by April’02, the curve resumed a dirty steepening. In the current circumstances, the ongoing crisis has precipitated aggressive policy responses. As we wrote last week, the open market operations, in which a cumulative \$114bn of Treasury Bills and Notes were sold into the market, uncannily coincided with the recent 63bp flattening in 2s30s. The sales helped alleviate an intense demand for Treasuries in repo. The general collateral repo rate, which fell as low 20bp, normalized back to 2.00%, suggesting the policy response might be over for now and allowing for short-term yield curve steepening. However, the tax rebates in May could lead to further flattening as they did in Q3’01 to Q1’02. And just as in Q2’02, we expect the tax rebate stimulus will wear off, causing growth to sag back to a sub-trend rate in Q4’08, which will likely lead to further steepening. This steepening scenario would be helped especially should inflation begin to abate as in past recessions, allowing the market to focus on worries about growth prospects. From a positioning perspective, the precision required to thread this rapid requires nimble accounts, or the ability to ride out the volatility.



Source: BLS, NBER, RBC Capital Markets

Week Ahead: Data risk eases – house sales, durable goods, UST auctions

Housing sales remain depressed: Existing home sales for Mar are expected to have fallen 1.6%/m to 4.93mm, stagnating near the low of 4.89mm in data back to 1999. New home sales for Mar are expected to have fallen 1.0%/m to 585K, a new low since 1995.

Durable goods, Richmond Fed manufacturing index: The consensus expects that durable goods orders rose 0.1%/m overall and 0.6% ex-trans, a tepid rebound from the declines in Feb. The trend remains one of weakening, although outright recession is not indicated. The Richmond Fed index for April is expected to have fallen from 6 to 2; this index has

proved volatile in recent months. The final U. Mich. confidence survey for April is expected to show a slight uptick to 63.5 from 63.2, which was a low since 1982.

Treasury Auctions: The Treasury will announce the size of its 2- and 5-yr note auctions on Apr 21. The 2yr auction is expected to be \$25bn and the 5yr auction is expected to total \$15bn. These relatively large auctions could allow for further increases in short-end yields and flattening of the curve.

Treasuries: Something gave - somethings's gotta give (part II)

Last week, we noted that the yields for both the 2yr and 10yr Treasuries were trading tightening patterns that suggested a break out, and that is exactly what happened. The 10yr yield initiated the breakout on higher-than-expected PPI, and it subsequently broke not only the downtrend in place since Oct at 3.64%, but also the March high at 3.71%. It has even outpaced the upchannel in place since Mid-March (upper bound is 3.70% and is now testing the 76.4% retracement of the Feb-Mar decline at 3.80%. The next resistance would be 3.96%, the Feb high.

The 2yr yield broke above downtrend resistance a day later than the 10yr, and is testing upchannel resistance (and the Feb high) at 2.20%. A breach of 2.20% would open the way for a move to 2.42%, the Jan 25, post-SocGen high. The move higher in the 2yr yield is surprising perhaps only inasmuch as how long it took. Consider the relationship between the Fed Funds target rate and the 2yr yield. This curve has been inverted

since Jun'06. This 22 month inversion is much longer due in part to the Fed's long pause before easing and the safe-haven bid for short-term Treasuries stemming from the credit crunch. With the Fed supplying Treasuries to the market through the TSLF and open market operations, the safe-haven bid is being unwound. During the next week, short-end weakness in Treasuries could be exacerbated by 2- and 5yr auctions.

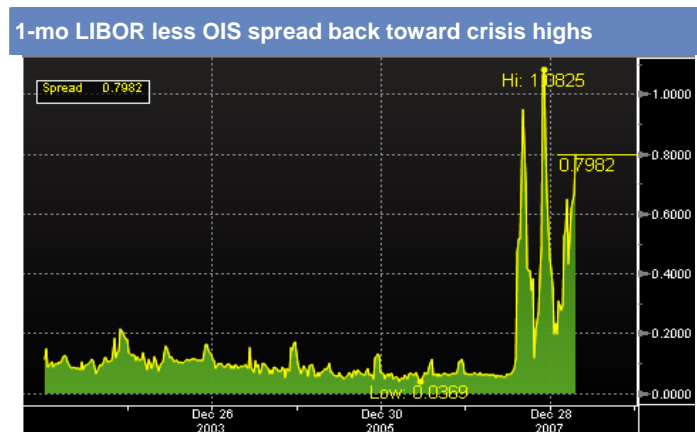
The curve has flattened massively, with 2s30s collapsing 22bp in the past week to 234bp. This reflects the increased bill and note supply, removal of safe-haven bid, deleveraging, stop-loss unwinds, and a perception that the Fed is very close to done easing due to rising inflation pressures. The curve has flattened below recent lows and the next technical support comes in at 220bp, the high during the SocGen crisis.

Eurodollars: What Crisis Lurks?

The media brought attention to a potential pricing issue in LIBOR early in the week that has precipitated a sharp widening in the spread of LIBOR over OIS. The spread at the one-month tenor has widened over 13bp during the week to 79.98bp, a high since last December. This spread has only been exceeded during the commercial paper meltdown of last August, when it reached 95bp, and the year end liquidity crunch early last December when it spiked to 110bp. For perspective, from 2002 to July'07, the median spread was only 8.4bp.

Speculation during the week centered on three potential crises that the spread might be pointing to. The first, pretty much disproved at this point by earnings reports, was that some major US bank would go to the brink of default. The second is concern that the UK banking system might be in severe distress given the problems in the UK housing/finance markets. The third is that the continental European banking system is in distress, more likely due to investments in US and/or UK mortgage derivatives. Actions by both the BoE and ECB give credence to fears regarding the European banking system, although the actions also provide solace that policymakers will avert a complete meltdown, just as the US did in March with the Bear Stearns incident. The BoE is implementing a UK version of the US's TSLF, in which the Bank will swap mortgage bonds for Gilts.

This will prevent banks from the same fate as Bear Stearns, which was unable to unload collateral taken due to failed margin calls. The ECB has announced a new \$15bn, 28-day, US\$ facility.

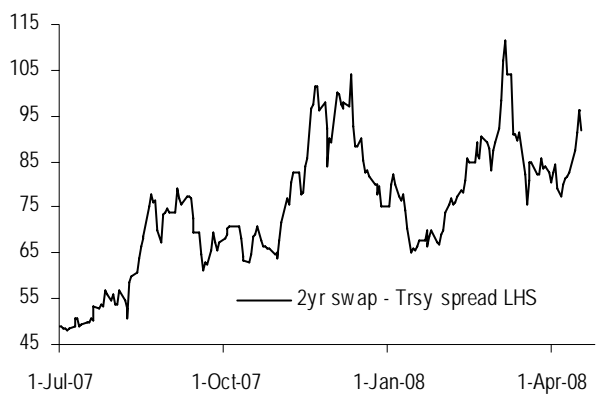


Source: Bloomberg

Swaps: CBs rallying to next crisis

Swap spreads started the week spiking wider on a growing sense of trouble in the banking system and then media reports that LIBOR was being misquoted to show less stress in the system. However, during the week, the BoE stated its intention to implement a UK version of the US's TSLF – swapping mortgage bonds for Gilts – to alleviate balance sheet problems for banks. Additionally, the ECB reported that it would institute a \$15bn US\$-denominated liquidity facility. It appears that central banks, having been slow to recognize the credit crisis and create and wield the tools to combat the crisis, have become more proficient at reacting to rising threats.

Have CBs short-circuited latest spike in swap spreads



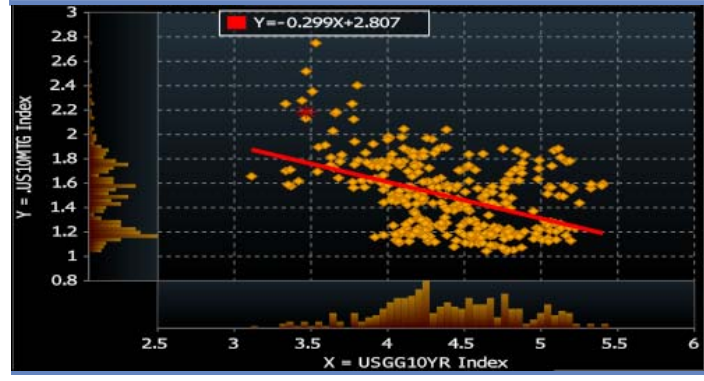
Source: Bloomberg

MBS: Credit impaired MBS positioning

The credit-impaired sector of 30yr 6% and 6.5% offers inexpensive call protection because loans in that sector experienced prepaids consistently slower than generics. Additional value can be found in geographic areas that are experiencing negative house price appreciation and for pools in which LTVs are high, but not excessively high. Where the LTV is near 90%, the prospect of negative house price appreciation represents an impediment to refinancing, but the roughly 10% equity provides a cushion against increased foreclosure rates. Consequently, we would look to purchase specified, impaired pools versus generics.

As to the basis, it has made a large round-trip during the week, widening as much as 11bp to Treasuries before reversing to close the week 3bp tighter. For long-term players, we would suggesting continuing to play the basis from the long side, entering positions on moves wider. At 215bp, the basis remains historically wide, and as the market continues to heal, the spread will continue to move in. Such a move will be further supported by our view that Treasury yields will continue to rise.

Easing of credit crisis and higher yields point to tighter spread



Source: Bloomberg

Agencies: GSE jumbo-conforming loans

The Economic Stimulus Act of 2008 established temporary increases to the GSE's conventional loan limits for 1st lien mortgage loans in high cost areas, as defined by HUD. FNMA will purchase jumbo-conforming mortgages secured by one-unit properties. The new loan limits will be 125% of the area median home price, not to exceed \$729,750, except in Alaska, Hawaii, Guam and the US Virgin Islands. In no area will the limit fall below the original \$417K. Our portfolio analytics group estimates that

40% of the currently outstanding jumbo loans will be eligible for this program.

The implementation of this program should lead to an acceleration of prepayment speeds as borrowers refinance. This should be especially true for ARMs, as the borrower moves to a more predictable fixed rate loan. Consequently, we would recommend purchasing whole loan, deep discount ARMs.

Data / Event Risk Calendar

Day/date	Time (EDT)	Release/Event	Market	Prior	Comment
Mon / Apr 21		No data/event risk			
Tue / Apr 22	10:00	Richmond Fed mfg index (Apr)		6	Holding up reasonably well – not indicative of recession
	10:00	Existing home sales (Mar)	4.95mm	5.03mm	Stabilizing at depressed pace
	17:00	ABC consumer confidence (Apr 20)		-39	Low since '93. Similar level to start of '90-'91 recession
Wed / Apr 23	07:00	MBA mortgage applications (Apr 18)		2.5%	
Thu / Apr 24	08:30	Initial jobless claims (Apr 19)	375K	372K	Pointing increasingly towards non-farm payroll losses
	08:30	Dur goods orders tot, ex-trans (Mar)	0.1%, 0.3%	-1.7%, -2.6%	Tepid rebound
	10:00	New home sales (Mar)	585K	590K	New low since 1995
Fri / Apr 25	10:00	U. Mich. confidence (Apr F)	64.3	63.2	Rebound from low since 1982

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

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