

May 30, 2008

U.S. Directions Fixed Income Strategy

Investment / Trade Recommendations 2

MBS: Buy GEO / High LTV

MBS: High LTV 30yr 6% for better convexity

Macro: Buy in May, go away 4

Treasuries: Recent bear flattening has historical precedent 5

Eurodollars: Libor report could salve market's nerves 5

Swaps: Spreads – some seasonality of their own 6

Calendar and forecasts 7

Keys to next week

* *Non-farms, unemployment, ADP employment*

* *ISM, mfg and services*

| Sector | View | Specific Comments |
|-------------------|--|--|
| Notes/bond yields | * Short-term looking for top * Medium-term lower | 2yr yield has crashed through 2.59% resistance (high during May) and is threatening 2.79% resistance (low from early December). A hold below 2.79% could allow for a retracement that would be consistent with both seasonals and our view that growth remains a bigger problem than inflation. The 10yr has broken above resistance at 3.96% (held as high through most of this year) and could threaten the 4.29-4.30% range (Dec high and Sep low). |
| Curve | * Short-term looking for bottom * Medium-term steepening bias | The curve continues to flatten, but the trajectory has moderated during May. This, in combination with our view that the yields could be establishing a top in coming sessions, leads us to believe the curve could put in a trough in the short-term. Note that in 2002, after the curve went through 5-month flattening post-9/11, it made its last close in March 2002 at 2.09 before beginning to steepen again. |
| Eurodollar yields | * Short-term higher * Medium-term lower | The market has overrun any trader that tried to establish a long position during recent sessions. Nevertheless, the pricing of hikes by yearend with so much uncertainty seems overdone, and perhaps some of this derives from Libor uncertainties. |
| Swaps | * Directional | Spreads appear to be highly directional. To the extent yields make further gains, the 10yr spread could reach 65-66bp, while a retracement in yields could cause the spread to fall back towards the high 50s. |
| Mortgages | * Neutral, but look buy the basis on any weakness | With yields rising, we expect convexity selling to provide further momentum. Should this develop and the basis widen significantly, we would look to buy the basis. We continue to like the up-in-coupon and believe this will continue should yields continue higher. |

Investment / 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

MBS: Buy GEO / High LTV

Summary:

The recent mortgage crisis is changing the prepayment landscape of the mortgage market. While investors are testing the validity of old prepayment stigmas, new stories are emerging as the real estate crises continues. In this publication, we have closely examined the recent changes in relative speeds of classic prepayment protection states (TX, NY). We have found that they offer less effective means of buying convexity, compared to Florida (the relative "newcomer" into the mix of "slow" states). Below, are the main findings of this study:

Conclusion #1

* During the last 6 months, Florida speeds slowed down a lot more relative to speeds in NY and TX (which offer less call protection due to a relatively strong HPA and employment growth in both states, especially TX). Aggregate prepayments in Florida slowed to ~40% of the overall speeds for all 30-yr 6% (1-12 WALA), while TX speed multiplier declined to 71% and that of NY to 67%.

Conclusion #2

* During the last 6 months, the high LTV cohort speed multiplier declined from 90% to 40%, suggesting that this is great story to overlay on top of the call protection offered by GEO stories. Florida offers the most efficient way of combining call protection characteristics of GEO with high LTV.

Conclusion #3

* While our examination of 6.5% universe produced results similar to those seen in the universe of 6s, we strongly favor exercising investment views on high LTV Florida pools in 6s as oppose to 6.5s, as call protection offered by 6% high LTV cohort in Florida is lot more pronounced. Lastly, we believe that the downward trend of speed multipliers for high LTV pools in Florida will continue due to the following reasons:

- * Continued decline in real estate prices in this state.
- * New GSE guidelines regarding declining market status will impose an additional barrier to refinance on many Florida borrowers.
- * New structure of G-fees introduced recently by GSE will serve as an additional deterrent for highly leveraged borrowers from exercising their prepayment option.

MBS: High LTV 30yr 6% provides better convexity

- * CPR on High LTV 6% slowed in April relative to Generic 6s (from multiplier of 58% in March, down to 49% in April).
- * This 9% decline in CPR multiplier for 6s is two times greater than LTV 6.5s
- * We believe that the convexity features of new high LTV 6s are undervalued.
- * We are concerned with increasing foreclosures, & therefore, suggesting to stay between 80% & 90% (Orig LTV) for pools originated in "high risk" states.

* Below, we show the most recent CPRs for high LTV 6% vs. generic 6% cohort:

| | Nov-07 | Dec-07 | Jan-08 | Feb-08 | Mar-08 | Apr-08 |
|-------------|--------|--------|--------|--------|--------|--------|
| High LTV 6% | 7.9 | 6.5 | 6.8 | 10.9 | 13.5 | 9.1 |
| Gen 6% | 8.2 | 10.5 | 13.2 | 22.3 | 22.8 | 18.5 |
| Multiplier | 0.96 | 0.62 | 0.52 | 0.49 | 0.58 | 0.49 |

Consider the comparative analysis of the high LTV 6% offered @ +0-5+ ticks /TBA

- * 34 bps yield pick up with 50% greater duration
- * 16 bps LOAS pick up with ~15 % improvement in convexity

| | Yld | LOAS | OAD | OAC | S-Dur | Vega | L-CPR | 1m-CPR | 1y-CPR |
|------------|------|------|------|-------|-------|-------|-------|--------|--------|
| Total Buy: | 5.51 | 26 | 3.60 | -2.89 | 4.93 | -0.27 | 11.0 | 0.8 | 1.9 |

| | | | | | | | | | |
|-------------|------|----|------|-------|------|-------|------|------|------|
| Total Sell: | 5.17 | 10 | 2.36 | -3.37 | 3.64 | -0.19 | 21.7 | 34.1 | 27.9 |
|-------------|------|----|------|-------|------|-------|------|------|------|

| | | | | | | | | | |
|------------|------|----|------|------|------|-------|-------|-------|-------|
| Swap Diff: | 0.34 | 16 | 1.24 | 0.48 | 1.29 | -0.08 | -10.7 | -33.3 | -26.0 |
|------------|------|----|------|------|------|-------|-------|-------|-------|

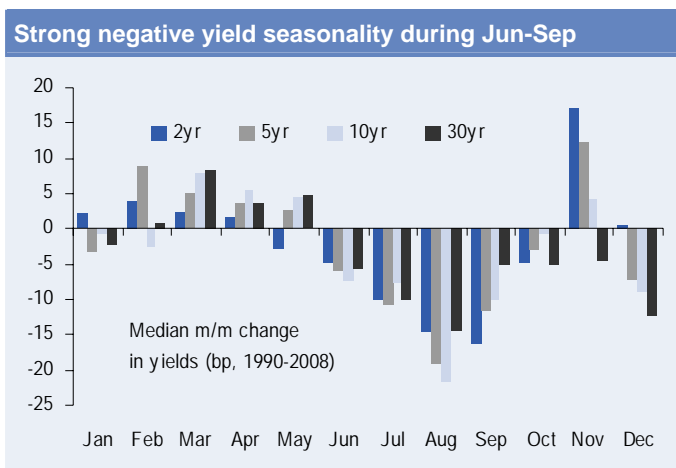
Buy in May, go away

“Buy in May, go away” generally works for bonds...

The old adage, “buy in May, go away”, is supported by seasonal tendencies for the months from June through September since 1990. The 2-year yield has tended to fall, with the median yield change for these months ranging from -4.8bp (June) to -16.2bp (Sep). Furthermore, the winning/losing trade ratio has ranged from 10:8 (month of July) to 13:5 (September). The yields for 5-year, 10-year and 30-year Treasuries all show consistently negative median yield changes, ranging from -5.1bp (30yr during September) to -21.6bp (10yr during August). They also show consistently skewed win/loss ratios, ranging from 10:8 (10yr during July) to 14:4 (5yr during September).

...and suggests butterfly and curve positions, too

The directional tendency for yields indicates potential butterfly positions. The 2,5,10 and 2,5,30 butterflies show the most consistent seasonality for the months from June to September since 1990. The 5-year note tends to outperform the 2-year and 10-year notes from June through September, with the winning/losing position ratio for these months ranging from 11:7 (July) to 13:5 (June and September) for a total gain of 219bp. The 5-year note also outperforms the 2-year note and 30-year bond, with the winning/losing trade ratio ranging from 10:8 (June) to 13:5 (September) for a total gain of 422bp. Curve trades also reflect a strong seasonality. The 10s30s steepener has exhibited a consistent steepening bias. Positions put on at the close of a prior month and held to the close of the next month would have yielded at total profit of 233bp, with winning trades in 46 of 72 months. The 2s30s curve shows a bias towards steepening during all four months, although it is much stronger in July (6.9bp median, steepening in 11 of 18 instances) and September (7.1bp median, steepening in 11 of 18 instances). Overall, this curve steepener would yield profits in 42 of 72 months for a total gain of 383bp. The 2s10s curve tends to show a significant bias towards flattening during June, Aug and Sept, interrupted by a steepening bias during July.



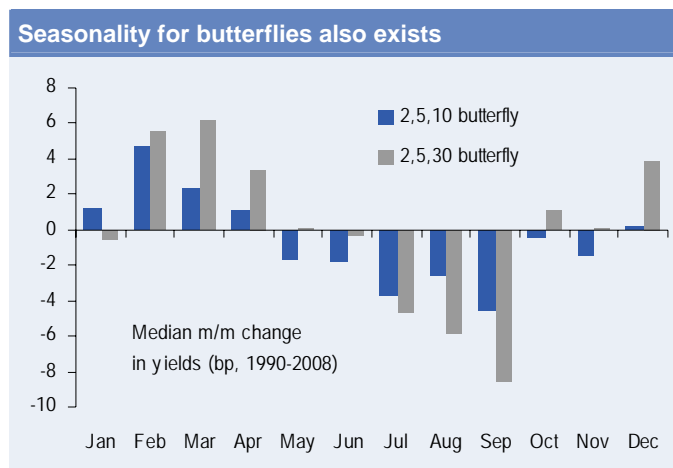
Sources: Bloomberg, RBC Capital Markets

Maybe 2008 is different...

The recent rise in yields suggests the market is providing very attractive levels at which to enter seasonal positions. Unfortunately, the price action has caused the 2yr yield to punch up above technical resistance at 2.59%, while the 10yr yield remains in an uptrending channel. And the fundamental backdrop and Fed rhetoric support the recent move higher. Inflation remains a significant problem. Most recently, core PPI rose 3.0%, a high since 1991, and the University of Michigan's poll for expected inflation 5 years ahead rose to 3.3%, a high since 1996. As to the Fed's second mandate, full employment, the picture looks moderately weak, but not so much as the market feared a few weeks back. Rather, recent Fed rhetoric suggests policymakers are content to let past easing work its way through the system, and that they are increasingly intent on the risks to inflation and reversing the accommodation that has been implemented. Other considerations suggest looking at 1980-1981 as a potential guide. The spread between overall and core CPI, at 1.6ppt, is near an extreme since the early 1980's, and RBC is calling for the economy to carve out a double-dip slowdown similar to the double-dip recession of 1980 and 1981. Consequently, despite massive changes in global markets, a look at the 1980-1981 period might provide a useful “stress test” for the seasonals.

... which would dampen the seasonal effect

In contrast to the seasonal tendency since 1990, in 1980 and 1981, the 2-year yield rose 3 of the 4 months of the June-September periods and ended the overall 4-month periods higher. The 5-year and 10-year yields similarly bucked the seasonal trend. The 2s30s and 10s30s curves both flattened during the June-Sept period of 1981. The 2s10s curve flattened in 1980 and barely steepened in 1981 (and only after a 50bp downdraft). The 2,5,30 butterfly was similarly unsuccessful. Using data for 1981, the 5yr underperformed in 3 of the four months and underperformed for the period as a whole. However, the 2,5,10 butterfly seemed to hold up, as the 5-year outperformed the 2s and 10s in three of the four months in both 1980 and 1981 and for the overall four-month periods.



Source: Bloomberg, RBC Capital Markets

Treasuries: Recent bear flattening has historical precedent

The 2 1/2 – month rebound in yields has the inflation hawks and bond bears declaring victory in their position the Fed is done easing and will begin hiking by yearend. While inflation readings and the price action are unnerving given our view that the Fed will need to continue to ease by late year, we take solace in historical precedent that shows we have seen this price action before. Since early March, the 2yr yield has jumped 134bp. This is greater than the 108bp rebound during the first 2 1/2 months of 1992, but still in keeping with the 138bp pop during the five months after 9/11. The 10yr yield has exhibited similar false rebounds. Since early March, the 10yr yield has risen 86bp. For comparison, note that in the first 2 1/2 months of 1992, the 10yr rose 100bp, and that in the wake of 9/11, the yield jumped 137bp.

The recent 2s30s yield curve flattening (99bp) does represent a more drastic move than in 1992 or 2001-2 (both times the curve flattened just under 70bp). Part of this likely reflects increased risk premium that was placed on the front end of the curve late last year and which is now being unwound. Part also likely derives from the Fed's permanent open market operations. The most recent operation was held on May 21, and of the

\$144bn of Treasuries sold since March, \$138bn has been 4yr or less in maturity. With these influences accounted for, and not likely to continue infinitely, they do not represent theme-changing factors for the medium-term.



Source: Bloomberg

Eurodollars: Libor report could salve market's nerves

We continue to disagree with the market's call for a Fed hike by yearend (82% chance of at least one hike priced in). However, the price action prevents one trying to fade the recurring sell-off's of the past several weeks, and our futures trading desk reports that traders attempting to establish long positions other than through options have been consistently "run over".

Part of the upward bias in yields has stemmed from worries about whether Libor is being underreported and what steps the BBA might take to correct the issue. As the original story broke in April, eurodollars sold off sharply, and the spread of Libor over OIS spiked to 85bp. In recent sessions, as the BBA report (due out at noon NYT time on Friday) has loomed, the market has reacted by pushing Libor higher, which has helped support Eurodollar yields. We do not believe the BBA report is going to enact dramatic changes that would further undermine the fragile market psyche. Rather, it will likely move to encourage banks to behave as they have for the years that Libor has worked. To the extent the credit crunch put banks in conflict between reporting true rates and avoiding being punished by the market for do so, the BBA might simply opt to allow the reporting to be anonymous. A more stringent option would be to require banks to substantiate that the reported rates were actually transacted. In any event, to the extent that banks stopped misrepresenting borrowing rates after the press broke the story in April (as price action would suggest), the report today could prove to be a "sell the rumor, buy the fact" situation.

From a fundamental perspective, the pricing in of hikes by yearend appears overdone. Too many variables (i.e. historic pace of rate cuts,

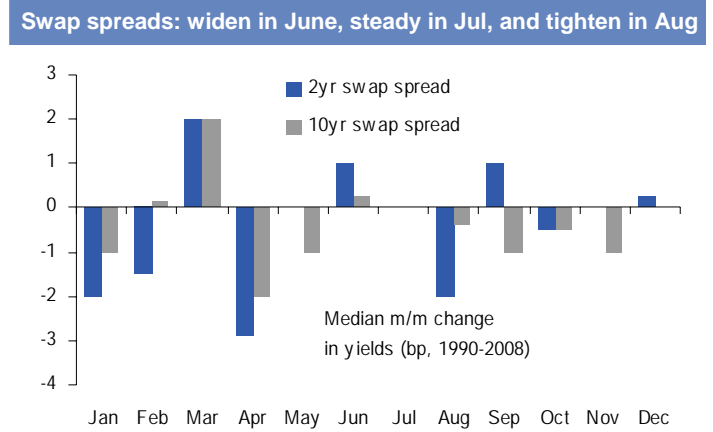


Source: Bloomberg

liquidity facilities, pressure on banks and investors from ongoing losses, tax rebates, presidential election, uncertainty of fiscal policies depending on election) remain in play for the Fed to be able to reverse course by yearend. Furthermore, as the "dust" settles in Q3, we believe that inflation will abate and the economy will show that it needs another couple rate cuts to keep it out of recession.

Swap spreads – Some seasonality of their own

Seasonality analysis similar to that for Treasury yields and the Treasury curve above indicate some seasonal factors to consider for swap spreads. For the 2-year spread, June shows a slight bias towards widening, but August and September really stand out. Spreads tend to tighten in August (13 out of 17 years for a median of 2.0bp and a maximum 13bp) and then loosen in September (12 out of 17 years for a median of 1.0bp and maximum 13bp). The 10yr spread shows seasonality only in June (widening 14 out of 17 years for a median 0.25bp, maximum 16bp). The 2s10s swap curve relative to the Treasury curve also displays seasonality in coming months, tending to steepen in June (13 of 18 years for a median 0.9bp and maximum 9bp) and August (12 of 18 years for a median 1.5bp and maximum 12.75bp), while flattening in September (13 of 19 years for a median 2.3bp and maximum 18bp).



Source: Bloomberg, RBC Capital Markets

Data / Event Risk Calendar

| Day/date | Time (EDT) | Release/Event | Market | Prior | Comment |
|-------------|------------|--|------------|------------|--|
| Mon / Jun 2 | 10:00 | ISM mfg (May) | 48.0 | 48.6 | Weak, but not recessionary |
| | 10:00 | Construction spending m/m (Apr) | -0.6% | -1.1% | Contract will continue into 2009 |
| | 12:20 | Fed's Lockhart (non-voter, economic outlook) | | | |
| Tue / Jun 3 | - | Total, dom vehicle sales mm (May) | 14.6, 11.0 | 14.4, 10.6 | Deteriorating trend is gathering momentum |
| | 09:00 | Bernanke (speaking in Europe) | | | |
| | 10:00 | Factory orders (Apr) | -0.1% | 1.3% | Weakening trend is developing |
| | 17:00 | ABC consumer confidence (Jun 1) | | | |
| Wed / Jun 4 | 07:00 | MBA mortgage applications (May 30) | | -4.6% | ARM / new purchase apps down y/y, fixed rate refs are up |
| | 07:30 | Challenger job cuts y/y (May) | | 27.4% | Uptrend exists, but the pace remains moderate |
| | 08:15 | ADP employment change (May) | -30K | +10K | Low since 2002, deteriorating trend is gathering steam |
| | 08:30 | Non-farm prod, unit labor costs (Q1F) | 2.5%, 2.0% | 2.2%, 2.2% | Labor costs remain very modest |
| | 10:00 | ISM non-mfg (May) | 51.0 | 52.0 | Deteriorating trend intact – not clearly recessionary |
| Thu / Jun 5 | 08:30 | Initial jobless claims (May 31) | | 372K | Still relatively moderate – not clearly recessionary |
| | 08:30 | Continuing jobless claims (May 24) | | 3104K | Consistent with level towards end of '01 recession |
| | 13:30 | ICSC chain store sales y/y (May) | | 3.6% | A moderation would confirm downtrend in place since 2006 |
| Fri / Jun 6 | 08:30 | Non-farm payrolls (May) | -55K | -20K | Losses more moderate than any recession since 1973 |
| | 08:30 | Unemployment rate (May) | 5.1% | 5.0% | Uptrend less steep than 1990 and 2001 recessions |
| | 08:30 | Average hourly earnings (May) | 3.4% | 3.4% | Earnings moderation consistent with 1990 and 2001 recessions |
| | 10:00 | Wholesale inventories (Apr) | 0.5% | -0.1% | Trend is lower, suggesting companies paring back |
| | 11:15 | Fed's Evans (non-voter, payment fraud) | | | |
| | 15:00 | Consumer credit (Apr) | \$6.9bn | \$15.3bn | Credit appears to be declining, suggesting lower consumption |

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 | 2.9 | 1.2 | 1.5 | 2.9 | 3.0 | 3.0 | 2.2 | 1.2 | 2.0 |
| Consumer Prices y/y | 2.4 | 2.7 | 2.3 | 4.0 | 4.0 | 3.0 | 3.2 | 2.9 | 2.7 | 2.4 | 2.2 | 2.1 | 2.9 | 3.3 | 2.3 |
| Core CPI y/y | 2.6 | 2.3 | 2.1 | 2.3 | 2.4 | 2.4 | 2.2 | 2.1 | 2.1 | 2.1 | 2.1 | 2.1 | 2.3 | 2.3 | 2.1 |
| Fed Funds Rate (e.o.p.) | 5.25 | 5.25 | 4.75 | 4.25 | 2.25 | 2.00 | 2.00 | 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 | 1.65 | 2.05 | 2.30 | 2.00 | 2.20 | 2.50 | 2.75 | 3.25 | 3.08 | 2.00 | 3.25 |
| 10-year yields (e.o.p.) | 4.65 | 5.03 | 4.53 | 4.03 | 3.42 | 3.60 | 3.75 | 3.75 | 4.00 | 4.25 | 4.50 | 4.75 | 4.03 | 3.75 | 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 ("RBCCEL") 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. RBCCEL 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.

Copyright © RBC Dain Rauscher Inc. 2003
Copyright © RBC Dominion Securities Inc. 2003
Copyright © RBC Dominion Securities Corp. 2003
Copyright © Royal Bank of Canada Europe Limited 2003
All rights reserved. Member CIPF