U.S. Daily Directions: June 10, 2008, NY Edition

Investment Recommendation	Recommendation Date	Theme
MBS: long seasoned 15-yr	Jun 5	Best short duration mortgage alternative to mitigate extension risk
MBS: long '05 vintage 30yr 5.5s	Jun 5	30yr, 5.5s from '05 have been prepaying faster than '03,'04 vintages
MBS: buy GEO / High-LTV	May 5	Prepayment speeds slowing in Florida
MBS: High LTV 30yr 6%	May 8	Lower speed multipliers = better convexity

Overnight: **Bernanke goes hawkish, "fixes" in BBA and CDS, rising FHA losses.** Bernanke ramped up his hawkish rhetoric, saying policymakers will "strongly resist" any surge in inflation expectations. He also opined that the risk of a "substantial downturn" had abated and downplayed the rise in unemployment reported last Friday. The BBA has announced it will tweak its Libor fixing process, adding more banks to the borrowing quote process and looking more closely at adding a second survey to reflect US trading hours. US regulators and banks are reported to have agreed to change the process for CDS to allow trades to settle at a clearing house. This move that should eliminate counter party risk should a major bank fail, as was the fear when Bear ran into trouble earlier this year. The FHA has announced it expects to lose $4.6bn due to unexpectedly high default rates on home loans.

Day ahead: **Trade balance, IBD economic optimism, Fedspeak.** RBC, as does the market, expects the trade deficit deteriorated in Apr from $58.2bn to $60.0bn due to the continued rise in commodity prices. Fedspeak derives from Mishkin (voter, moderating a conference) and Fisher (voting dissenter, monetary policy).

Asset Commentary/Assessment:

Eurodollars: **Overnight, pricing 2.50-2.75% by yearend.** Yields rose even further along most of the curve, as much as 21.5bp for the Sep09 contract. The Jun09 contract yield has spiked 66bp in two days. The market has now priced an 18% chance of a 25bp hike by the Fed on Jun25 as well as a 96.4% chance of some hike (centered on 50-75bp to 2.50-2.75%) by yearend.

Treasuries: **Overnight, massive bear flattener continued.** Yields jumped in Asian trading on Bernanke's hawkish talk before settling down and ranging in the European session. The 2yr yield is up 15.4bp (almost 50bp so far this week) to 2.86%, blowing through the recent high of 2.77% (May 29) and threatening to increase the upward momentum for the yield remains intact. The 10yr yield is up 4.1bp to 4.04%, still within the uptrending channel it has plied since March. The 2s30s curve flattened another 15bp (now 48bp this week) to 177bp, a new low since January 17 (before both Bear and SocGen crises) and actually accelerating the flattening trend in place since March.

Swaps: **Yesterday**, extreme moves across global markets continue in what remains clearly one of the most challenging markets in recent time. The European markets had been leading the move, but today the US market stood front and center with the 2/30 swap curve over 35bp flatter. The idea of CBs tightening while the banking industry scrambles for capital presents a precarious scenario on many fronts. The difficult thing about this trade in US space is it occurs with no real signs of a pick-up in the real economy, so the move in rates is running counter to what most believe will be the ultimate outcome. Unfortunately, moves like this tend to occur when they make the least sense and perhaps we are in one of those periods. So in general we are trying to stay nimble and tuned into global markets for short term direction. When the dust settles there's likely to be some good RV trades to look at.

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