

July 11, 2008

U.S. Directions

Fixed Income Strategy

Investment / Trade Recommendations

Position	Theme
UST: 2s30s steepener	Market focus shifting from inflation to growth
Eurodollars: long Aug 97.00/97.25 call spread	Fed cannot hike imminently – as is priced
Agcies: Buy 3nc6m 1x	Best value in callable agencies
Swaps: Receive US 2yr, Pay Can 2yr	Can is not pricing enough turbulence
MBS: GNMA LLB/MLB/HLB vs conventional LLB/MLB/HLB	Better value for convexity
MBS: Buy seasoned 15-yr paper to mitigate extension risk	Mitigate extension risk
MBS: Buy '05 vintage 30yr 5.5s	Vintage '05s prepaying faster

Keys to next week

- * CPI, PPI
- * Bernanke testimony
- * Earnings for financials
- * Retail sales
- * Industrial production, Empire mfg survey, Philly Fed
- * Home builders' index, housing starts, bldg permits

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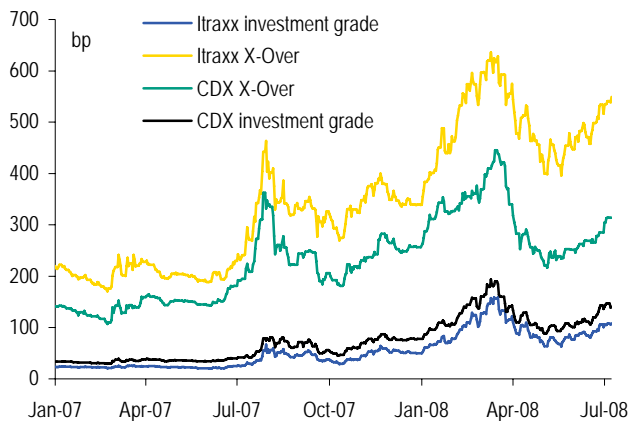
Sector	View	Specific Comments
Eurodollar yields	* Neutral	Next week, with inflation headlines likely to show new multi-year highs and retail sales likely elevated (if only temporarily due to tax rebates), yields are likely to hold steady or move higher. However, we look beyond this short term risk in retaining our eurodollar call spread trade based on the view that the Fed will not hike rates imminently.
Notes/bond yields	* Neutral – waiting for Bernanke	Yields could benefit from the CPI headlines and the relative inflation / growth risk assessment from Bernanke and/or the FOMC minutes next week. Bernanke will set the tone for coming weeks.
Curve	* Steepening bias	Data/event risk next week will test our steepening position, although we believe that our view will eventually win out.
Swap spreads	* Neutral	Spreads remain at the mercy of headlines, whether they relate to MBS, agencies or oil. The prospect that the GSEs are either ok or will be backstopped by the government is constructive, but the situation remains in flux.
MBS	* Like the basis	Policymakers appear either confident that the GSEs are well-capitalized or determined that the US government will backstop them. Either way, MBS should tighten relative to Treasuries.

Macro Comment - special thanks to Mark Chandler

Beware strangers bearing gifts

Fed Chairman Bernanke and Treasury Secretary Paulson were both stumping for pending changes in mortgage lending and financial regulation this week. The immediate focus of Chairman Bernanke's speech was on the likely extension of the Fed's emergency liquidity measures for dealers (notably the PDCF) into 2009 and financial shares rallied on the news. What received somewhat less focus was the "stick" that went with the carrot of added liquidity – increased regulation, the need to "increase the firms' capital and liquidity buffers" and more supervisory powers for the Fed. Also somewhat ominously, the Chairman talked about the possible role that the Treasury might play in the case of another financial firm bailout (let's hope that this was purely hypothetical). Collectively, these measures suggest financial firms will have to scratch and claw to earn a buck in the quarters (and years) ahead. It is possible that credit markets paid a bit more attention than equity markets to these longer-run implications as credit indices continued to widen.

Figure 1: No easy or early credit solution

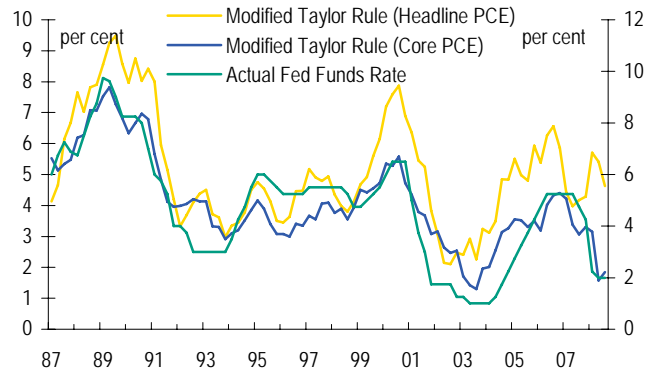


Source: Bloomberg

Justification awaits for Fed

Before shedding a tear for Wall Street, it is worth remembering that increased regulatory burden is only an issue for financial firms if costs cannot be passed along. In the short-run, this seems likely. Prices are likely to prove "sticky" as customers balk at posted rates for mortgages and loans that represent the "true" cost of intermediation. As the industry struggles to re-capitalize and re-price, the rate subsidy offered by the Fed in the form of increased liquidity provisions will continue to be required and so too will a more accommodative policy setting. One way to gauge the magnitude of this accommodation is to compare the actual Fed funds rate with one expected to prevail under "normal" economic conditions. Using a modified Taylor Rule (our version is one espoused by former St' Louis Fed President Poole as described in http://www.stlouisfed.org/news/speeches/2005/10_14_05.htm) the extra degree of accommodation is roughly 2½ pp be headline PCE inflation (though virtually zero if core PCE inflation was the true measure).

Figure 2: Fed greasing the wheels

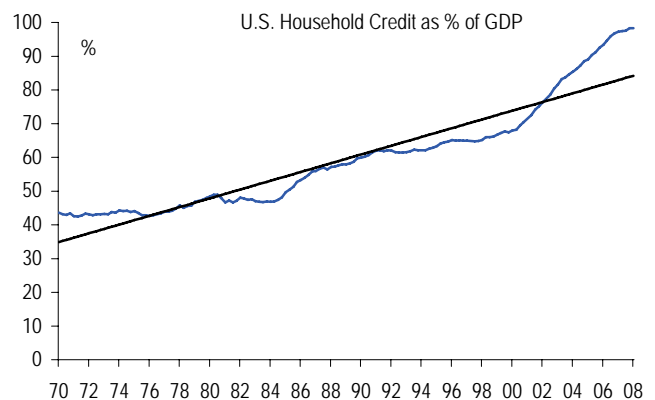


Source: Bloomberg, CBO, Department of Commerce, RBC calculations

Credit crunch means more than liquidity

As time goes on, we would expect to see the gap between the actual Fed funds rate and the predicted rate to narrow. The question becomes: "How does it adjust?" At least over the next year or so, we are looking for the adjustment to come through the calculated Taylor Rule rate rather than actual Fed actions – i.e. future inflation and growth trends will justify the current rate. The output gap (currently about 2% as judged by CBO estimates) is expected to widen further as growth holds below trend through mid-2009 and headline inflation (fingers crossed on the future course of energy prices) is expected to converge towards core inflation. One factor that should hold growth below trend is the impaired credit channel. While systemic risks may abate and wholesale, shorter-term funding spreads narrow, it seems reasonable to assume that retail spreads may remain historically wide and "credit rationing" by financial firms should slow credit growth back towards a more sustainable path (see Figure 3). Look for some aspects of this outlook to be reflected in next week's semi-annual monetary report to Congress. The Fed is likely to maintain a weak growth profile and, while projected headline inflation measures may rise, core inflation forecasts should hold relatively constant.

Figure 3: Back to trend



Source: Federal Reserve, RBC

Losing on all Three Fronts

To the extent the Fed is fighting a “three-front war” – growth, inflation, and financial system - this week was a poor one. The financial system credit bust continues to morph from a liquidity event - such as caused Bear Stearns’ demise – to a credit issue as losses mount. The inflation front continued to erupt with problematic data and shrill Fed speak. The growth data was light, although not particularly heartening, leaving markets to stew on the other two “fronts”.

Financial system to the edge of a new “brink”

We have characterized the financial system as a trauma patient being wheeled into an emergency room where the Fed is the Chief of Staff. And we have cautioned that although in managing the Bear Stearns implosion, the Fed successfully negotiated a cardiac arrest (liquidity crunch), the patient was still in danger of “bleeding out” (losses due to rising defaults). Last week, we suggested the volatile price action headed into quarter-end might be something more than just quarter end anxiety, and subsequent developments confirmed those worries.

Q3 opened with persistent and torrential MBS selling attributed alternatively to hedge fund liquidations and / or the liquidation of bank portfolios in the wake of recent takeovers. The spread of MBS over Treasuries spiked to 240bp, a high since the Bear Crisis. Hedge fund liquidation seems appropriate, given that hedge funds posted a net 0.75% loss in H1, the worst H1 since at least 1990. And the fixes provided by policymakers in the wake of the Bear Stearns implosion have apparently not eliminated the risk of more bank failures, with fears of at least one large bank continuing to cause declines in share prices. The S&P Diversified Bank Stock Index has plunged to its lowest level since 2000, while the S&P Investment Bank Index is testing the low since 2003. More broadly, the S&P formally entered a bear market. And on top of concerns about particular banks and hedge funds, the market is confronting an “unthinkable”, the default of one or more of the GSE’s. The market remains quite fearful of this possibility, overreacting to a research report considering the potential additional capital that would be required in the unlikely event an accounting rule was changed. Policymakers (OFHEO’s Lockhart and Treasury’s Paulson) have attempted to reassure markets the GSEs remain well-capitalized. These assurances attempted to counter the assertion of recently-retired Fed President William Poole, who went on record stating flatly that the GSEs were “insolvent” and in need of nationalization, but Bernanke’s call for both Freddie and Fannie to raise more capital undercut Lockhart’s and Paulson’s position.

Risk aversion is reentering the market. The spread of 3m Libor over 3-mo T-bills, which widened to 112bp going into quarter end, narrowed to below 100bp temporarily, but has widened again to 115.7bp. The repo rate for 5yr notes has dropped to 115bp. Perhaps more ominous is that the US dollar index has fallen to within 1.8% of its Post-Bretton Woods low (posted during the Bear Crisis) and Moody’s felt compelled to reaffirm the AAA rating of Treasuries.

Minor data haven’t changed our soft growth outlook

Pending home sales collapsed 4.7% m/m, although this was mitigated by an upward revision to the April gain (from 6.3% to 7.1%). Initial jobless claims fell much further than expected (to 346K, consensus 395K), although the report is suspect due to seasonality problems stemming from the July 4th holiday and seasonal auto plant closings. Chain stores sales for June surged 4.3%, but 2.4ppt of that came from WalMart sales, not exactly a glowing endorsement of consumer strength. Furthermore, the RBC / Change Wave consumer spending survey for July showed that consumers overwhelmingly expect to cut spending during the next three months, consistent with our expectation that consumer spending will slow considerably once the tax rebate checks are spent (likely by month end). Overall we retain the view that economic growth will slow towards the end of Q3 and into Q4 as consumers remain weighed by high prices, a soft job market, and declining wealth (house and equity prices).

Inflation – a more immediate concern

While we believe, as does the Fed, that inflation will begin to recede before year-end, it does continue to represent the most immediate risk. Oil has traded above \$147/bl on concerns about disruption in Brazil (strike), Nigeria (rebellion), and the Middle East (Israel / Iran). Import prices for Jun surged to 20.5%, yet another record in data going back to 1983. From the U. Michigan survey, 1-yr ahead inflation expectations jumped to 5.3%, a high since 1981, while the 5-yr ahead expectations remained elevated at 3.4%, the high since 1995. Not surprisingly, Fed rhetoric has grown increasingly hawkish. The Fed’s Yellen warned that headline inflation is “much higher than [she] would like” and that the Fed “will not allow” a wage spiral to develop. Kansas City Fed President Thomas Hoenig urged that the Fed should hike rates from their accommodative level “as quickly as possible”. Lacker maintained his hawkish bent, opining that withdrawing some... stimulus as ... risks diminish make eminent sense”.

The week ahead: Huge Risk – Inflation, Bernanke, Financial System

Next week entails extraordinary event risk. Inflation could take center stage for data, as overall PPI (Tue) is expected to show a further spike to 8.7%/y, a new record since 1981, and overall CPI (Wed) is expected to have jumped to 4.5%/y, the 2nd-highest print since 1991. Bernanke's testimony (Tue, Wed) and the FOMC minutes (Wed) are likely to reinforce recent rhetoric that the risks for growth have declined while those for inflation have risen (although Bernanke is unlikely to make any suggestion that would support the imminent rate hikes priced into the futures market). Additionally, several countries in Europe report CPI, which could cause the ECB to ratchet up hawkish rhetoric and put bonds generally under pressure.

The next biggest risk will be headline or "tape bomb" risk emanating from the earnings of numerous financial entities scheduled for the week (type "EVT <go> in Bloomberg) and the continued potential for dramatic developments regarding the perceived plight of the GSE's and at least one large US bank.

Other risk emanates from economic data regarding housing and growth. The homebuilders' index (Wed) is expected to remain stable at a record low, and housing starts and building permits (Thu) are expected to

remain depressed at or near the lows since 1991. Industrial production (Wed) is expected to have rebounded in June (0.1%/m), due to rebounds in auto production (end of auto parts strike) and utilities (from cool weather in May). The Empire Manufacturing (Tue) and Philly Fed (Thu) surveys are expected to have rebounded Jul from unexpected declines in Jun. Retail sales for Jun (Tue) are expected to remain strong (RBC: 0.7% overall, 1.2% ex-autos) although we believe these will falter once the tax rebate checks are spent (likely by end of July).

Rates – Defensive into data, take lead from Bernanke: Our strategic steepening bias and call for the Fed to be on hold at least through the summer and likely yearend will come under threat this week. Our trading desk cautions to remain defensive and wait for Bernanke to set the tone for markets. From a technical perspective, the 2yr yield appears to have found a base around 2.35% (lows in June and so far in July). The 10yr yield has support at the recent low of 3.78%, but is testing the upside of the sharp downtrend in place since mid-June. Our 2s30s steepener (entry 189.4bp, target 225, stop-loss 180) has support at 186bp (uptrend of June lows).

Data / Event Risk Calendar

Day/date	Time (EDT)	Release/Event	RBC	Market	Prior	Comment
Mon / Jul 14	10:00	Fed governors vote on mortgage rules				
Tue / Jul 15	08:30	PPI tot, ex-F&E m/m (Jun)	1.4%, 0.3%	1.4%, 0.3%	1.4%, 0.2%	8.7%yly overall would be record since 1981
	08:30	Retail sales tot, ex-autos (Jun)	0.7%, 1.2%	0.4%, 1.0%	1.0%, 1.2%	Continued support from tax rebates
	08:30	Empire mfg survey (Jul)	-	-7.3	-8.7	Rebound after surprise drop in Jun
	10:00	Bernanke testifies re Fed and the economy				Likely to stress finance and inflation over growth risks
	10:00	Business inventories (May)	0.6%	0.5%	0.5%	Moderate build
	15:30	Fed's Yellen (non-voter, stabilizing foreclosure-wracked communities)				
	17:00	ABC confidence (Jul 13)	-	-	-41	Recovering from record low in May
Wed / Jul 16	07:00	MBA mortgage applications (Jul 11)	-	-	7.5%	w/w changes positive, but y/y changes remain negative
	08:30	CPI tot, ex-F&E (Jun)	0.7%, 0.2%	0.7%, 0.2%	0.6%, 0.2%	Overall CPI up to 4.5%, 2 nd highest print since 1991
	09:00	TIC flows (May)	-	-	\$115.1bn	
	09:15	Ind prod, cap util (Jun)	0.2%, -	0.0%, 79.4%	-0.2%, 79.4%	Production remains very soft, but not clearly recessionary
	10:00	Bernanke repeats testimony				
	13:00	Homebuilders' index (Jul)	-	18	18	Stable at record low
	14:00	FOMC minutes of Jun meeting				
	14:00	Fed's Hoenig (non-voter, economy)				Has called for immediate rate hikes
Thu / Jul 17	08:30	Housing starts (Jun)	972K	965k	975k	New low since 1991
	08:30	Building permits (Jun)	-	970K	978K	Stabilizing near low since 1991
	08:30	Initial jobless claims	-	-	346K	Seasonal volatility due to summer auto plant closings
	08:30	Continuing jobless claims	-	-	3202K	High exceeded only in wake of recessions
	10:00	Philadelphia Fed (Jul)	-	-15.2	-17.1	Rebound after surprise drop in Jun
Fri / Jul 18		No scheduled data / event risk				

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	1.0	0.1	2.2	1.0	1.5	2.9	3.0	3.0	2.2	1.5	2.0
Consumer Prices y/y	2.4	2.7	2.3	4.0	4.1	4.2	4.1	3.7	3.2	2.2	2.2	2.2	2.9	4.0	2.4
Core CPI y/y	2.6	2.3	2.1	2.3	2.4	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.3	2.3	2.2
Fed Funds Rate (e.o.p.)	5.25	5.25	4.75	4.25	2.25	2.00	2.00	2.00	2.00	2.00	2.25	2.75	4.25	2.00	2.75
2-year yields (e.o.p.)	4.60	4.93	3.94	3.08	1.62	2.64	2.90	2.75	2.65	2.85	3.05	3.50	3.08	2.75	3.50
10-year yields (e.o.p.)	4.65	5.03	4.53	4.03	3.42	3.96	4.30	4.50	4.60	4.70	4.50	4.55	4.03	4.50	4.55
30-year yields (e.o.p.)	4.84	5.12	4.83	4.45	4.30	4.51	4.90	5.10	5.20	5.25	5.05	5.05	4.45	5.10	5.05

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

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