U.S. Daily Directions: August 5, 2008, NY Edition

Recommendation	Date	Theme
Buy low MLB, HLB, low FICO 20yr 6%	Jul 7	Historically low value allows capture of "free convexity"
UST: 2s30s steepener	Jul 2	Market's focus is shifting to growth concerns
Agcy: Buy 3nc6m 1x	Jul 1	Cheapest value in the callable agency market
Aug 97.00/97.25 euro$ call spread	Jun 19	Market will abandon view that Fed hikes by Sep
MBS: GNMA LLB vs conventional LLB	Jun 10	Better convexity at lower price

Overnight: **Developed / EM market split.** Overnight data highlighted how the policy headwinds will roll through the global economy - from the US to UK, to Europe and then Asia, with EM policymakers fighting inflation while financial disintermediation and flagging growth become more dominant for developed economy policymakers. Ongoing problems in the UK were highlighted by reports showing that manufacturing production shrank for a 4^{th}-consecutive month (-0.5%m/m) in June, while the services PMI for July remained in contractionary territory at 47.4. Developing growth problems in Europe were evidenced as retail sales there collapsed 3.1%y/y in June, the biggest drop since at least 1995 with consumers squeezed by higher food and energy costs. In Australia, the RBA signaled an easing bias, and RBC now forecasts that easing will commence at the latest in Q4. However, in EM countries, inflation fighting is the focus. The central bank of Indonesia raised rates for a fourth straight meeting to tame inflation running at the fastest pace in almost two years, while in the Philippines, inflation accelerated to 16-year high, increasing pressure on the central bank to raise interest rates for a third month in August.

Day ahead: **FOMC, services ISM.** The Fed is widely expected to leave the target Fed Funds rates unchanged at 2.00%, and so the statement and the dissents will provide the price risk. Relative to the June statement, this one might shift a bit to the dovish side, as the prior one mentioned rising commodity prices, and these have subsequently fallen. However, yesterday's PCE deflator report could elicit an expression concern regarding that measure. As to growth, the statement will likely retain the observation about "some firming in household spending". Characterizations of the financial markets as "under consider stress" and credit conditions as "tight" will likely be retained. Finally, there will likely be at least one dissenter, as subsequent developments are not likely to have changed the mind of Richard Fisher, the hawkish dissenter at the June meeting. Stern and/or Plosser could also "rebel" based on their recent, hawkish rhetoric. Separately, the market expects the July services ISM rebounded modestly from 48.2 to 48.7, a weak and border-line recessionary reading.

Asset Commentary/Assessment:

Eurodollars: **Overnight, yields narrowly lower for most of curve.** Yields slipped 1.0-1.5bp along most the curve. The market prices the odds of no Fed move today to 92.0%, and increased the odds the Fed will be on hold through yearend to 36.6%. We retain the view that the Fed will not hike rates by yearend, and our long eurodollar position - a 97.00/97.25 call spread on the Aug options contracts – stands at 17.25bp (entry at 6.5bp).

Treasuries: **Overnight, yields narrowly mixed, curve flatter.** Yields remained in a narrow range ahead of the FOMC, slipping in Asia before rebounding in Europe. The 2yr yield is down 0.8bp to 2.52%. The 10yr is unchanged at 3.96%, having rebounded off Fibonacci support at 3.92% (61.8% retracement of move higher during H2 of July). Our 2s30s steepening position flattened 0.3bp to 205.6bp, continuing near the low end of the uptrend in place since mid-June (support off the lows lies at 200). We have moved up our stop-loss position to the entry level of 189.4bp.

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