RBC Capital Markets

RATES STRATEGY | RESEARCH

July 13, 2007

U.S. Directions

Fixed Income Strategy

Keys next week

* Fed: Bernanke testifies, FOMC minutes
* Prices: CPI, PPI
* Housing: homebuilders' index, starts, permits
* Manufacturing: Empire, Philly surveys, industrial production

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Sector	View	Specific Comments
Eurodollars	Flatter	As the CDO repricing unfolds and with more evidence of moderation in both the Consumer and the overall economy, the market will likely trade torwards the easing side of flat for the eurodollars strip. By late year, we expect the curve will steepen.
Notes/bonds	Range – trade	Yields tested the bottom of likely ranges, marking them even more clearly: 4.79%-5.13% for the 2yr and 4.98%-5.32% for the 10yr.
Curve	Dirty steepen	The 2s10s curve has broken lower, but we believe continued concern about ARMs resets and CDO's, and the move in along the curve by Asian buyers could allow the curve to steepen further.
Swap spreads	Short-term tighter	With the initial shock of the CDO ratings past, spreads could tighten, which would allow issues delayed due to the recent surge to be brought to market.
Mortgages	Neutral the basis	We continue to believe that the basis could widen, but we have taken profit on our widening trade and will await a pullback before considering re-entering.
Agencies	Trading desk likes front end spreads	Agency spreads widened sharply before partially retracing during the week. We retain our long 15yr MBS vs 5yr agency.

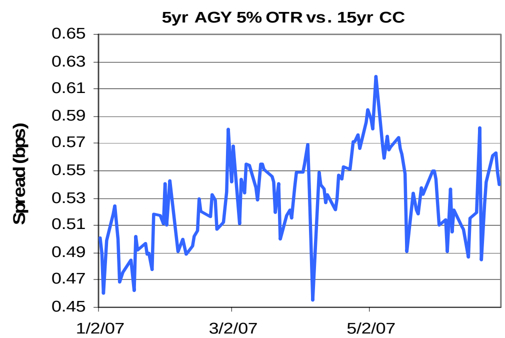
Trade Recommendations

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

Buy 15yr 5.0% MBS versus 5yr Agency 5.0% of Oct. 2011

Entry (08 Jun-07)	Current (13 Jul-07)	Target	Stop-loss	Carry	Cumulative P&L
+41.2 bps	+45.0 bps	+35.0 bps	+50.0 bps	-	$6,000

The trade moved in our favor last week as 5's received a minor bid due to specialness into the roll. We think this trade still makes sense given how cheap 15yr paper has gotten. We believe the 15yr sector, with its negative issuance, will catch a good bid going forward.

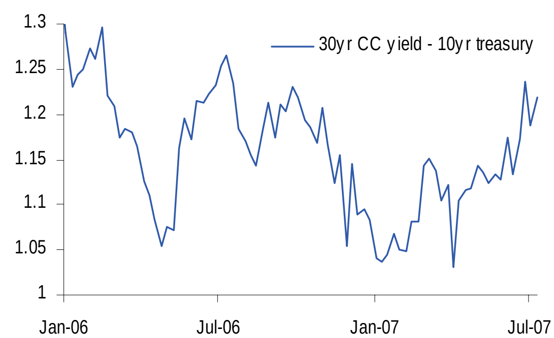


Source: RBC Capital Markets, Inc.

Buy 2yr, 5yr, and 10yr US Treasury versus 30yr 5.5% ** TARGET REACHED**

Entry (08 Jun-07)	Current (10 Jul-07)	Target	Stop-loss	Carry	Cumulative P&L
+1.149 bps	+1.25bps	+1.25 bps	+1.05 bps	-10,000	$121,000

This trade reached our target on July 10 and we have taken profit for a cumulative profit of $121,000.



Source: RBC Capital Markets, Inc.

Storm clouds gathering – but will it rain?

CDO crisis – heats up on cue

As expected, the CDO crisis heated up during the week. To start, an article appeared headlining that a major bank estimated the losses from subprime CDO's could reach $50bn. Then S&P put 612 US subprime RMBS classes totaling $7.4bn (corrected from the $12.1bn S&P originally reported) on negative watch. Moody's followed suit by actually downgrading 399 mortgage bonds worth $5bn. Both ratings firms indicated that they believed they had captured the bulk of the problem bonds that were issued in 2006 and that the issues were associated largely with only a handful of subprime lenders. Still at question are bonds originated in 2007, as well as the possibility that existing bonds could deteriorate further over time. The next step in this saga will be the impact on investors. Hedge funds that hold these securities should be feeling pressure from repo desks making margin calls and investors demanding redemptions, but there is so far no indication of such activity on a widespread basis. The "other shoe to drop" would likely be real money accounts that are forced to unload CDO's as the downgrades cause existing inventory to fall outside investment mandates. Within the next 30-90 days, the market will likely have figured out whether the CDO crisis creates a "LTCM-type" liquidity event or represents just another piece of wreckage in the housing correction, falling on the same heap as the residential construction pullback in H2'06 and sub-prime lender implosion in Q1'07. One interesting development that might mitigate the crisis is the possibility that China will increase its purchases of GNMA securities, a step that the US Dept of Housing and Urban Development has urged in a recent trip to China. Such an increased bid could help prevent a spillover into other MBS classes from CDO selling.

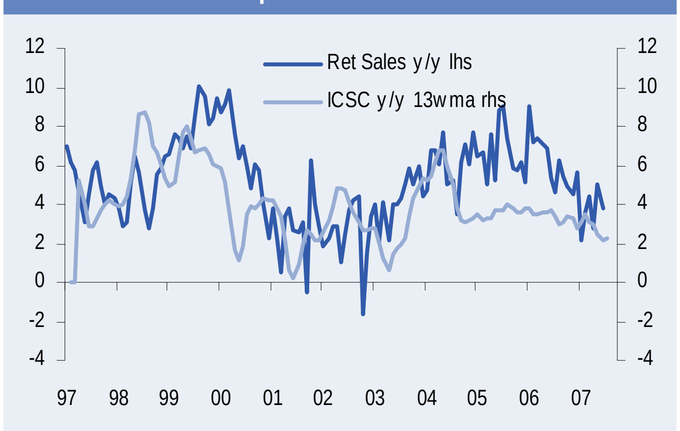
Consumer looking weak

Retail sales disappointed, falling 0.9%m/m overall and 0.4% ex-autos. Of the 14 sub-categories, eight fell, including motor vehicles, furniture, building materials. Same store sales were similarly disappointing. ICSC y/y sales, which rose 2.4%, are dipping toward the stall speed of 2.0%, and Redbook sales rose only 0.8%y/y, among the lowest growth rates since 2003. Consumers are likely feeling the squeeze of gasoline prices, which spiked from February through May, and rising ARMs resets could add to pressure on spending in coming months. Against this drag, other aspects of growth could support growth, as business investment remains robust and trade, an historical drag, could begin to add to growth because of the weak US dollar.

US policy mis-steps loom in trade and tax

Rumblings out of Washington indicate that if the consumers are still moving after the onslaught of stagnant house prices, spiking gas prices, rising mortgage costs, ARMs resets, and tightening lending standards as investors lick their wounds from CDO investments gone bad, Congress will ensure their demise by enacting protectionist laws and tax hikes. China's trade balance surged to another record surplus in June ($26.9bn) and is likely to rile US Congresspeople already lining up to enact protectionist legislation. Protectionist efforts are misguided. Calls for allowing the yuan to "float" could backfire if the Chinese also open their capital restrictions that prevent Chinese from investing overseas. Alternatively, a stronger yuan will increase US inflation and slow US personal consumption, a particularly dangerous combination in light of recent weak retail sales and persistent inflation pressures. As to taxes, Blackstone's IPO, and the clear realization that the funds profits would be taxed at only 15%, precipitated a legislative effort to raise the 15% capital gains tax for risk investing 20ppt to the 35% personal and corporate tax rate. Such a change would negatively impact the markets and economy in three ways. First, it would reduce the universe of entities private equity firms are willing to purchase (and the resulting beneficial corporate turnarounds) because of lower after-tax potential returns. Second, the lower after-tax returns would chill new investment in the stock market and could lead to lower equity prices and a negative wealth effect on already subdued consumers. Third, it would increase the cost to investors of reallocating money to new, better opportunities, leading to a sub-optimal allocation of capital.

Sales are near "stall speed"



Sources: Census Bureau, ICSC

Surging Chinese surplus has Congress seeing "red"

Sources: Chinese Customs General Administration

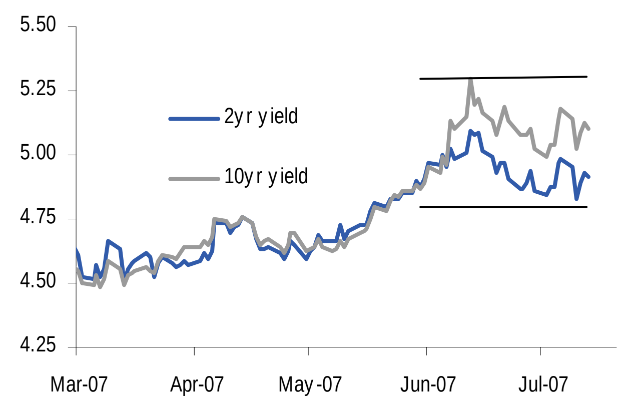
Treasuries: Confirming the range

Week behind: Defining the range. Treasuries started the week on a strong note, rallying on news that S&P was putting several billion dollars of RMBS classes on negative watch, Moody's was downgrading several billion dollars worth of MBS, and an article highlighting the downside risks to the economy stemming from wider credit spreads that would make borrowing more expensive. Treasuries tested recent highs on Tuesday as equities fell due to CDO concerns and spiking credit spreads, but failed at even higher levels Wednesday, when they finally retreated. Thursday saw a huge sell-off as equities rallied on better than expected sales by Walmart, and then Friday provided choppy price action from weak retail sales, but strong consumer confidence and business inventory gains.

Week ahead: Heavy Data risk. Bernanke testifies before Congress in his twice-yearly testimony, and he will likely come under severe fire for not preventing the subprime crisis. More important will be his defense of the Fed's hawkish stance despite core inflation falling in recent months and the Consumer starting to show signs of wear from high gas prices and the housing correction. The FOMC minutes will provide insight into the Fed's take on financial markets in light of the sub-prime mess, the sustainability of the rebound in business investment, the prospects for residential investment to stabilize, if not rebound, and the reasons for the Fed's suspicions about the sustainability of the recent decline in inflation. Price data will include both CPI (the core is expected to remain steady at 2.2%) and PPI (core expected steady at 1.6%). The housing data is not likely to provide much good news, with the homebuilders' index expected to remain at its low and starts and permits expected to continue at subdued rates. Finally, as to manufacturing, industrial production is expected to show a strong 0.5% rise for Jun that will support Q2 GDP growth, but the July Empire and Philly surveys are expected to moderate, consistent with our view that GDP growth, after an explosive Q2 rebound, will settle back towards trend.

Technicals: The key in coming weeks will be the ranges established. For the 10yr, this is 5.20% and 5.32% resistance and 4.98% support. For the 2yr, it is 5.01% and 5.13% resistance and 4.79% support.

Treasury yields have defined their range



Source: Bloomberg

Recommendations / Opportunities: Play the range with outright positions as yields reach either end of their ranges. Those comfortable with derivatives might consider a 1-by-2-by-1 swaption butterfly with a tenor of 1-3 months (period during which CDO/housing uncertainty will remain dominant) and struck to as to provide a maximum payout around the middle of the range. For instance, for the 10yr, sell 2x options struck at 5.15% and buy 1x options struck at both 5.00% and 5.30%.

Swaps: Spreads test multi-year highs

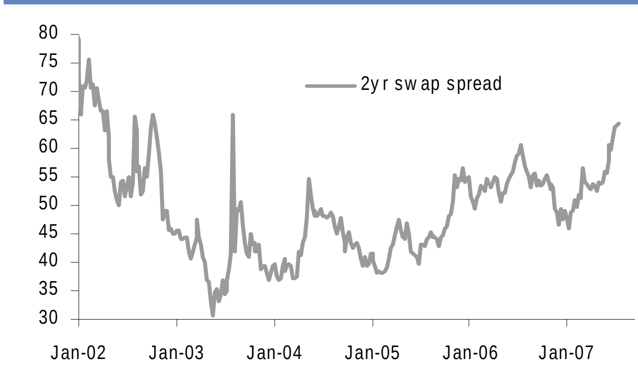
Over the week: Swap spreads widened on credit concerns during the week to the widest levels since 2003 but then tightened back to end the week nearly unchanged.

Risk: The major risk to spreads remains in the subprime space, as the rating agencies have finally sent chilling signals about upcoming downgrades on certain CDO tranches. A number of desks continue to be concerned about the "true" market value of the subprime loans they are holding in portfolio.

Outlook: Tighter spreads. The credit blowout pushed new issues on the shelf. With the initial shock of the CDO downgrades past, spreads could tighten, which will allow the delayed new issues to be brought to market.

Recommendations / Opportunities: Our swaps trading desk would consider implementing a 2s10s steepener in swaps should the Treasury 2s10s curve flatten to 15bp.

Swap spreads tested multi-year highs



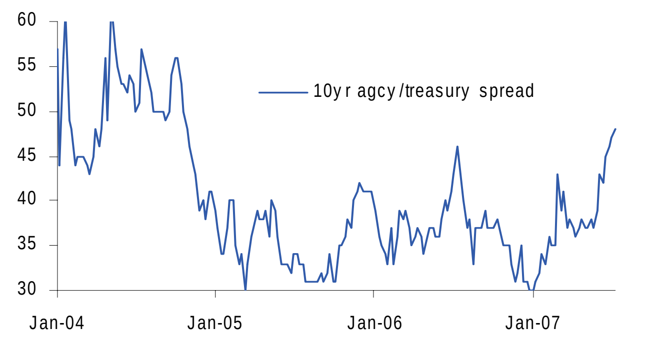
Source: Bloomberg

Agencies: Spreads to Treasuries test multi-year highs

Over the week: Agencies widened early in the week, with the 10-yr spread spiking to 51.4bp on Wednesday, a wide since 2004. Although the spread gradually tightened back to 48.4bp by weekend, the spread remains near its wide. The move derived from the CDO crisis and widening in corporate spreads.

Recommendations / Opportunities: Our trading desk continues to like front end spreads to Treasuries and believes that agencies have a little room to run vs. swaps. Our long 15yr MBS versus 5yr agency 5% of 10/2011 gained $6,000.00 during the week.

Spreads have trended wider



Source: RBC Capital Markets, Inc.

Mortgage-backed securities: Basis target reached

Over the week: Thirty-year nominal mortgage yields widened early in the week by as much as 10bp versus Treasuries on credit fears before subsiding to end the week wider by only 4bp. At 123bp, the spread remains near the widest in a year.

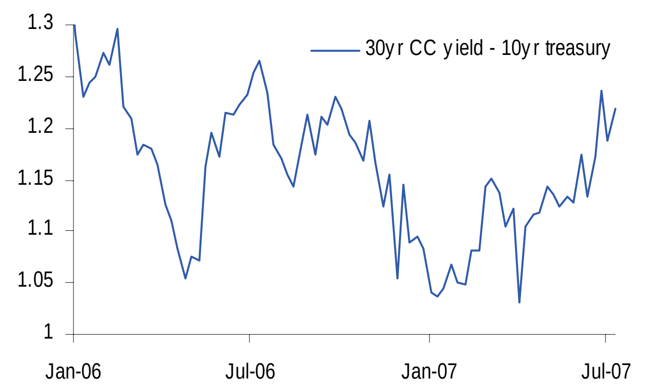
Recommendations / Opportunities:

Risk: Changes in the shape of the curve, increasing fixed-rate supply (declining adjustable-rate share), falling home prices, extension risk, and historically low volatility continue to be the major risks in the current environment. As rates and volatility drift higher, swap spreads could continue to widen as convexity sellers shorten the duration of their portfolios.

Banks & MM: We still like adding short sequentials backed by 10/20 IO collateral as a way of adding extension protection. We also like adding seasoned 15yrs.

Index Managers: We prefer 15yrs over 20 and 30yrs as a yield curve steepening, short duration, and lower vol exposure play for index managers.

The basis continues to leak wider



Source: RBC Capital Markets, Inc.

Model Portfolio: The spike wider allowed our short MBS vs Treasuries position to reach its 125bp target, and we closed the position for a $121,000 profit.

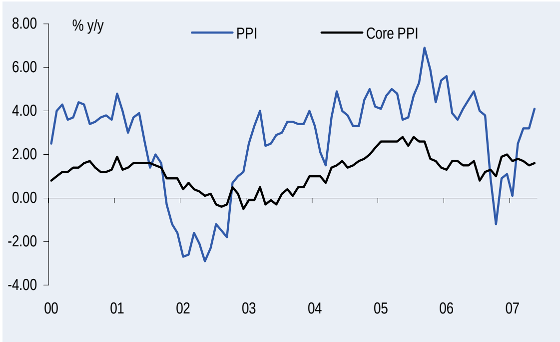
Key Data Risks Next Week

Rishi Sondhi (RBC Financial Group) and TJ Marta

US PPI / PPI (ex-food & energy)

Period:	Tue, Jul 17	RBC:	Consensus:	Previous:
Jun	08:30EDT/13:30BST	0.2%/0.1%	0.1%/0.2%	0.9%/0.2%

Comment: After surging in May, flat wholesale gasoline prices likely contributed to a moderation in the PPI in June. Food prices are expected to be up modestly after a small decline in May. Excluding food and energy, we anticipate a below-trend 0.1% gain, as past declines in intermediate goods and import prices start to have an impact. Stronger energy prices have caused the all-items PPI to heat up as of late with the index likely increasing at an ultra-hot 10.4% annualized pace in Q2. Given that producer prices do eventually feed into consumer prices with a lag, albeit a considerable one, such robust price gains in the PPI keep the upside risks to the inflation outlook very much alive meaning that vigilance will continue to be the order of the day for the Fed.



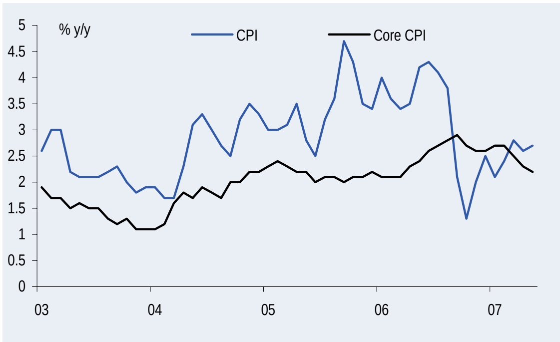
Source: Datastream

Market Impact:. Moderate. The PPI y/y tends to lead core CPI y/y by 12 months, and so it already suggests a temporary respite from inflation pressures during H2'07 before price inflation regains ground in 2008. A downside surprise might add to the relief from core PCE finally dropping to below 2.0%, while an upward surprise would add credence to the Fed's fear that current benign inflation might not be sustained.

US CPI / Core CPI

Period:	Wed, Jul 18	RBC:	Consensus:	Previous:
Jun	08:30EDT/13:30BST	0.1%/0.2%	0.2%/0.2%	0.7%/0.1%

Comment: Market focus will be the year-over-year core inflation reading which we anticipate will drift higher on the back firmer clothing prices. Owners' equivalent rent is expected to increase by 0.2% bringing the year-over-year rate to 3.3%, the slowest increase since May of last year. Our forecast is consistent with the core PCE deflator, the Fed's preferred inflation measure, holding near 2.0%, the upper end of the so-called comfort zone. Declining gasoline prices will serve to constrain growth in the all-items index, which we expect will be up 0.1% on the month and 2.5% relative to a year ago. Despite moderating core inflation, tight labour market conditions, elevated commodity prices and firm wage growth mean that upside inflation risks remain which increases the odds that the next move by the policy-makers will be a hike.



Source: Datastream

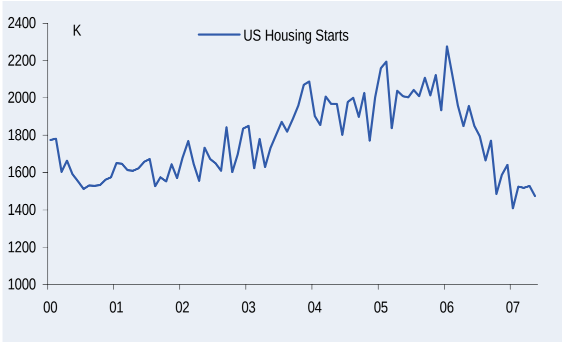
Market Impact: Major. An upside surprise on the core figure might dent the hopeful sentiment that gained ground after core PCE dropped to below 2.0%, but a downside surprise would add to the benign core PCE print.

US Housing Starts

Period:	Wed, Jul 18	RBC:	Consensus:	Previous:
Jun	08:30EDT/13:30BST	1460K	1450K	1474K

Comment: Another downturn in the NAHB housing market index coupled with weak permits in April/May (permits averaged a 1.4% decline over the period) points a decline in housing starts in June. To be sure, inventories remain elevated and sales remain depressed thereby lending credence to forecasts that the housing market will remain in recession for the remainder of the year (with the latest increase in mortgage rates likely to add to the pain). That said, starts were probably 5.5% above Q1's level in the second quarter, providing some optimism that the drag from the housing market may be starting to wane somewhat.

Market Impact: Moderate. The shock of the housing start crash has subsided. However, a break to a new low (1403K) could raise concern that the correction has more downside, while a surprise above 1600K might assure the market that the end of the debacle is in sight.



Source: Datastream

Monetary Policy Report to the Congress

Period:	Wed, Jul-18
Jul	10:00:EDT/15:00BST

Comment: Twice yearly the Fed Chairman is mandated to appear before committees of both the House and the Senate to report on the state of the US economy. The presentation this year is expected to focus on the predominant policy concern as cited by the Fed that "inflation will fail to moderate as expected." The annual rate of increase in the core CPI has trended down to 2.3% in May from a recent peak of 2.7% in February of this year. However, the Fed has indicated that despite this improvement "a sustained moderation in inflation pressures has yet to be convincingly demonstrated." The Fed's Congressional testimony will provide an opportunity to expand on what proof they are looking for to convince them that inflation does not pose a threat. The Fed will also have the opportunity to expand on conditions in the housing market where in the past they have indicated that adjustments are ongoing. The central bank could potentially comment on how long this adjustment will last and/or whether the weakness is spreading to other areas of the economy. In the Q&A session, which will follow the formal presentation, Bernanke will likely be grilled on the Fed's role in the current problems confronting the sub-prime mortgage market. Congress has become increasingly critical of the Fed for not providing greater oversight to lending in this area.

Market Impact: Significant. Markets might react positively to the most likely fireworks: Congress people pillorying Bernanke for the Fed's apparent failure to prevent the sub-prime mess. Against this market impact, a lucid defence of the Fed's hawkish stance in spite of the housing problems could cap Treasury gains.

FOMC Minutes

Period:	Thu, Jul-19
Jun 29th	14:00:EDT/19:00BST

Comment: On growth, the minutes are likely to show that participants were relatively more confident on their outlook for business investment after a wave of strong ISM, industrial production, and orders data received since the last meeting on May 9th. Housing market indicators remained mixed since the last meeting and a drop in builders' confidence as well the continued turbulence in the sub-prime mortgage market will likely be of concern. On inflation, the continued moderation PCE deflator did not cause a deviation from the policy makers hawkish bias as the June 28th statement indicated that "a sustained moderation in inflation pressures has yet to be convincingly demonstrated" with the minutes likely to show policy-makers continued concern over the tightness in labour markets and robust wage growth.

Market Impact: Significant. The market has difficulty making quick decisions while wading through the text of the minutes. The minutes' characterization of housing demand, the subprime market, business investment could provide market moving headlines.

Data / Event Risk Calendar

Day/date	Time (EDT)	Release/Event	RBC	Market	Prior	Comment
Mon / Jul 16	08:30	Jul Empire Manufacturing	-	17.0	25.8	Partial retracement from Jun spike
Tue / Jul 17	08:30	Jun PPI total, ex-F&E, m/m	0.2%, 0.1%	0.1%, 0.2%	0.9%, 0.2%	Pipeline pressures will keep Fed vigilant
	08:30	May TIC long-term flows	-	$70.0bn	$84.1bn	Steady uptrend since 1999 continues
	09:15	Jun industrial prod, capacity util. %	0.6, 81.7	0.4, 81.5	0.0, 81.3	More evidence of H2'06, Q1'07 trough
	10:00	Jul IBD/TIPP economic optimism	-	-	49.1	
	13:00	Jul NAHB homebuilders' index	-	28	28	No end in sight for builders
	13:00	Fed's Hoenig: US Economy				"Confident … economy will strengthen"
	17:00	Jul 15 ABC consumer confidence	-	-	-9	
Wed / Jul 18	07:00	Jul 13 MBA mortgage applications	-	-	1.1%	
	08:30	Jun CPI total, ex-F&E, m/m %	0.1, 0.2	0.2, 0.2	0.7, 0.1	Core y/y steady at elevated 2.2%
	08:30	Jun housing starts	1460K	1450K	1474K	Stabilizing at very low level
	08:30	Jun building permits	-	1480K	1520K	Also stabilizing at very low level
	10:00	Fed's Bernanke: twice-yearly testimony before House				Will be pilloried for sub-prime mess
Thu / Jul 19	08:30	Jul 14 initial jobless claims	-	-	308K	Remain subdued – labor market still tight
		Fed's Bernanke: twice-yearly testimony before Senate				Repeat of prior day
	10:00	Jun leading indicators	-	0.0%	0.3%	Trend suggests growth stabilizing at modest rate
	12:00	Jul Philadelphia Fed	-	12.0	18.0	Partial retracement from Jun spike
	12:30	Fed's Moskow: Global Interdependence				Noted global growth as supporting US yields
	14:00	Minutes of Jun 28 FOMC meeting				Look for impact of housing, tightening credit
Fri / Jul 20	10:30	Fed's Poole: subprime mortgages				Called subprime problems, "growing pains"

Economic and Financial Market Forecasts

	Quarterly												Annual		
	Q106	Q206	Q306	Q406	Q107	Q207	Q307	Q407	Q108	Q208	Q308	Q408	2006	2007	2008
Real GDP q/q saar	5.6	2.6	2.0	2.5	0.8	3.5	2.8	2.9	2.8	3.0	2.8	2.9	3.3	2.2	2.9
Consumer Prices y/y	3.7	4.0	3.4	1.9	2.4	2.7	2.6	3.6	3.4	2.7	2.5	2.5	3.2	2.8	2.8
Core CPI y/y	2.1	2.4	2.8	2.7	2.6	2.3	2.3	2.2	2.2	2.3	2.3	2.4	2.5	2.4	2.3
Fed Funds Rate (e.o.p.)	4.75	5.25	5.25	5.25	5.25	5.25	5.25	5.25	5.50	5.75	5.75	5.75	5.25	5.25	5.75
2-year yields (e.o.p.)	4.82	5.15	4.68	4.81	4.60	4.95	5.20	5.40	5.65	5.80	5.65	5.55	4.82	5.40	5.55
10-year yields (e.o.p.)	5.85	5.14	4.63	4.70	4.65	5.10	5.35	5.50	5.65	5.80	5.80	5.75	4.83	5.50	5.75

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