U.S. Daily Directions: July 19, 2007, NY Edition

Day ahead: The Philly Fed manufacturing survey is expected to moderate to 13.5 from June's spike, although the Empire Survey defied similar expectations earlier this week. Initial jobless claims are expected to remain at a tight 311K, and the leading indicators for June are expected to have dropped 0.1%m/m, leaving a slight uptrend from early in the year intact. Additionally, the minutes of the FOMC June 28 meeting will be released. Finally, the Fed's Moskow will speak about global interdependence.

Overnight: China reported exceedingly strong GDP (11.9%) and inflation (4.4%), while India's Finance Minister stated that continued demand and inflation in his country and China necessitated his bank's tight monetary policy. This adds to RBC's theme of the global liquidity glut and inflation that has central banks globally tightening and could eventually draw the Fed into the battle. Treasuries are slightly weaker coming into the open.

***Asset Assessment*:**

Eurodollars: **Curve: m-t inverted.** Yesterday, the Dec'07/Dec'08 curve flattened 6.0bp to -14.0bp. The curve is likely to trade flat to negative (possibly –40bp) as the market anticipates Fed easing due the effects of the CDO crisis, ARMs resets, and higher borrowing costs generally as credit spreads widen.

Treasuries: **Notes/Bonds: increasing pressure for lower yields.** The 10yr yield failed to breach support at 5.00% for the third time in a month, but the wedge formation the price action is forming suggests that the pressure for a break is building. The 2yr yield is trading similarly, with increasing pressure building on 4.80-4.81% support.

Curve: neutral to steeper. The 2s10s curve steepened yesterday 0.5bp to 17.8bp. The curve appears to have settled into a 15bp-23bp range since the structural steepening in early-June, but news of increasing sub-prime fallout and the moderation of the economy from the Q2 surge could cause steepening as Fed easing gets priced in.

Mortgages: **Sell basis on strength.** Spreads widened up to ~4 wider vs treasuries and 2 wider vs swaps during the morning bond rally. However by the end of the day after both the abx and equities mounted a comeback, the basis came in and closed only 1/32 wider vs treasuries and in-line to swaps. Real and fast money added the basis around the wides of the day, mostly in the 5.5 and 6 coupons. We remain slightly negative on spreads as subprime/headline risk will likely remain. We would look sell into strength and continue to be biased towards up-in-coupon within the stack.

Swaps: **Will follow credit spreads.** Another volatile day but with the lack of significant new information the market continues to trade within the range of the past month and be driven by the movement in the equity/CDS markets. Spreads started out 1.5bps wider on the flight to quality but ended the day wider by only 0.5bp as equities and CDS indices rebounded into the close.

Agencies: **Callables: Volume resumes.** Secondary callable trading volume resumed across the curve as if accounts were finally ready to put some money to work, in spite of all the headline news. Spreads and vol widened out slightly today in line with swaps. Secondary paper looks attractive compared to the new issues that are printing.. Unfortunately for accounts looking for bids, there is still a lot of paper in the hands of dealers, so the bid/ask has widened. As the market settles down, that spread will return to normal levels.

Bullets: 2-3yr paper good value. Spreads widened. Agencies bullets continue to track swaps and finished 1-1.5bps wider vrs treasuries in light screen volume. Freddie Mac announced a two-tranche 3/10yr reference note package scheduled to price Friday for settlement Monday.

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