RBC Capital Markets

RATES STRATEGY | RESEARCH

July 20, 2007

U.S. Directions

Fixed Income Strategy

Keys next week
*Q2 Advanced GDP
* Housing: existing, new home sales
* Manufacturing: durable goods, Richmond Fed
* Fed: Beige Book

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Buy 6.5% MBS vs. 5.5% MBS	Buy 10yr agencies vs. swaps

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Sector	View	Specific Comments
Eurodollars	More inverted	Especially given Bernanke's acknowledgement that the housing correction could weigh on growth, signs of moderation in growth from the Q2 surge as well as mounting wreckage from the CDO crisis will cause the curve will invert further. Buy Dec'07 vs Dec'08 with a target of –39bp.
Notes/bonds	Rising pressure for a break lower in yields	Yields are testing the bottom of likely ranges, and the descending wedge price pattern for yields that is forming suggests increasing likelihood of a break lower in yields
Curve	Dirty steepen	Rising concern regarding CDO's, the likely pressure on the Consumer from rising ARMS resets, and the move in along the curve by Asian buyers could allow the curve to steepen further. We would look to enter a 5s30s steepener on a pullback to 18bp with a target of 27bp and a stop of 14bp.
Swap spreads	Don't fight the widening	The deteriorating credit conditions will likely accelerate in coming days - perhaps weeks. We do not expect new issuance to resume until the dust settles.
Mortgages	Sell the basis into strength	We recommend moving up in coupon and have entered a short 5.5% vs. 6.5% coupon in 30yr MBS. We also believe the basis will continue to widen and suggest selling the basis into any strength.
Agencies	Bullish relative to spread product	We recommend buying agencies versus swaps at the 10-yr tenor and also believe that agencies 3yrs and in offer particular value relative to other spread product.

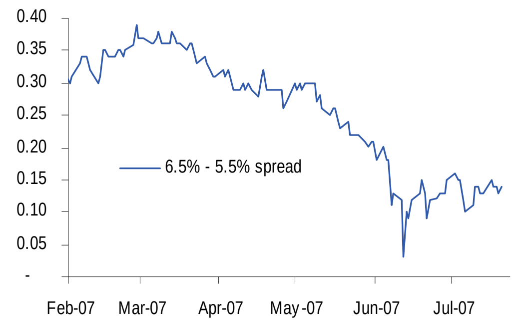
Trade Recommendations

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

Up-in-coupon: Buy 6.5% 30-yr coupons versus 5.5% 30-yr coupons

Entry (16 Jul-07)	Current (20 Jul-07)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
14.7 bps	14.6 bps	6bp	18bp	-	-$9,375	-$9,375

The slowing housing market will entail continued slowing of house price appreciation. Consequently, prepay speeds will generally slow, which will allow premium coupon MBS to carry better. Models have yet to adapt to this market dynamic.

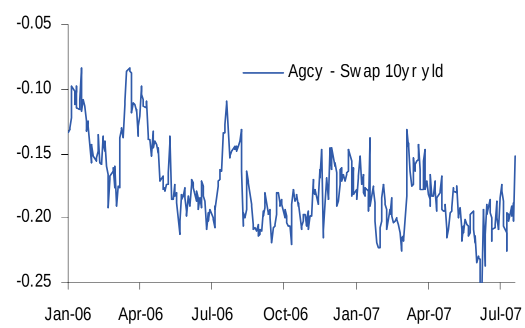


Source: RBC Capital Markets, Inc.

Buy FHLMC 5.5% Aug 2017 vs 10yr US Swap

Entry (20 Jul-07)	Current (20 Jul-07)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
-16bps	-16bpbps	-21bp	-14p	-	-	-

Agencies significantly underperformed swaps in the past week, as the Agcy – Swap 10yr spread narrowed from –25.6bp on June 8 to –16bp today. We believe that given the deteriorating credit environment, agencies should outperform other spread product as part of the flight to quality move.



Source: RBC Capital Markets, Inc.

Trades Under Consideration

5s30s Treasury steepener: The CDO crisis will continue to deepen as more hedge funds run into trouble and broaden as funds worldwide take hits. Additionally, downgrades of CDOs will likely mount, and downgrades will cause real money investors to have to unload CDOs that no longer meet their investment mandate. At the same time, US economic indicators will begin to slow from the torrid Q2 pace, a development markets will likely fear is the beginning of an economic downtrend - not just a benign moderation. These considerations will likely lead markets to begin to increasingly anticipate Fed easing, which should lead the front end of the curve to outperform the long end.

Relative value Treasury trade: The T4 2/15s are +8bp to 5's and 10's, the cheapest this area has been in quite some time, probably due to the recent rise in market volatility. The fact is though, 5yrs and 10yrs become off the runs within a couple weeks and will lose the liquidity premium that is embedded in them. The curve rolldown on this trade is also quite positive, as the T4.25 11/14 vs 4.5 3/12 and 4.625 2/17 is currently trading at 2bp (6bp diff to this trade).The repo can be locked to 8/15 or 9/4 at a cost of 1bp to 8/15 and 1.75 bp to 9/4. We believe the risk on this trade is very low and look to capture 3-4bp to the 9/4 date.

CDO worries gather steam

CDO crisis becomes a credit event

Bear Stearns finally confirmed rumors by publicly announcing that its two hedge funds that were experiencing sub-prime problems had lost almost their entire equity, despite the fact that they had invested in AAA CDOs. Confirming suspicions that CDO paper might create problems globally, an Australian hedge fund was reported to have limited redemption requests in order to maintain enough liquidity to survive its drawdown due to CDO exposure. S&P cut the ratings of AAA bonds from 12 CDO's to as low as A+, the ratings of 3 AAA securities from a second-mortgage deal to BBB, and warned that it might lower ratings for securities in another 8 CDO's. Moody's warned that it might cut the ratings for bonds backed by Alt A (one credit step above sub-prime) mortgages. In his testimony before Congress, Fed Chairman Bernanke suggested that CDO-related losses could reach a rather daunting $50-100bn. Lenders, which had taken huge casualties at the beginning of the year, remain susceptible, as two companies this week were asked by the NYSE to comment on "corporate developments" in light of "unusual market activity". Nor are banks immune, with USBankcorp falling short of earnings expectations. These developments have had a significant impact on the markets. The ABX indexes, which track home equity-backed securities, melted down, with the BBB- reaching as low as 48. BBB industrial 10yr credit spreads blew out as much as 11bp from the prior week, while the 10yr swap spreads widened to 67.30bp, a new high since 2003. Treasuries rallied on a safe haven bid, with the 10yr yield testing back below 5.00%. Finally, the heady days of LBOs appear to have stalled rather abruptly. Buyouts for Chrysler and Alliance totaling $40bn have met pushback from investors, an ominous development considering the backlogs of $220bn in deals in the U.S. pipeline.

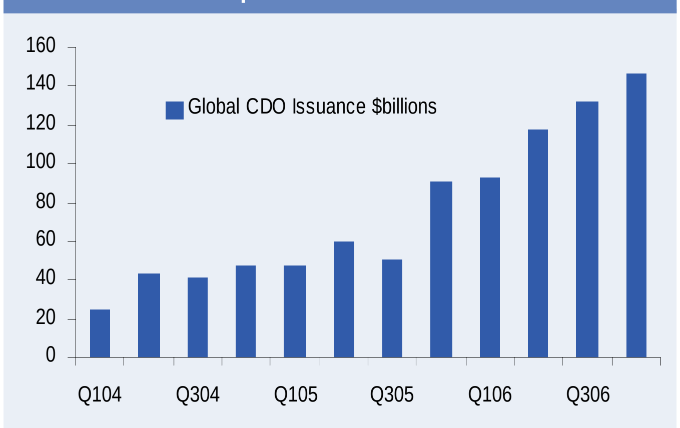
But all is not necessarily lost

The Bear Stearns experience does not necessarily represent the fate of all or even many hedge funds. Many hedge funds utilize longer-term financing that will prevent credit lines from being pulled before the markets stabilize, and many hedge funds have more effectively diversified and hedged their exposures. The $50-$100bn in losses estimated by Bernanke represent only 0.4% of the total US bond market, suggesting the overall market could absorb the stinging losses in one sector. Credit spreads have widened, but remain near historic lows, with the BBB industrial 10yr spread near lows last observed in 1997. The 10yr swap spread, while at the highs since 2003, has not yet spiked as it did during the LTCM crisis: 24bp the week of Aug 21, 1998. While fears of another LTCM crisis are understandable, global liquidity remains at a high level relative to 1998. In 1998, international FX reserves were rising only 3.3%y/y, but rose 20% in April. The liquidity sloshing around suggests sparks from the CDO blow-ups will fail to ignite panics in other assets. First, the liquidity will allow investors to bail out or pick off flagging hedge funds, as happened to the energy fund Amaranth last year. Second, the FX reserves represent "war chests" for many emerging market countries, and so the sell-off in CDO assets is unlikely to spread there. Another sign of an LCTM event would be an unwinding of the carry trade. However, the Japanese yen has lost ground against every single major currency year-to-date, while the Swiss franc, the other currency often associated with carry trades, has lost ground to every major currency but the yen. The Banking system appears sound. Many of the larger banks reporting earnings showed ongoing strength, as Citigroup, Merrill, Bank of America, State Street, and JPMorgan beat expectations, and these results came even as BoA, JPMorgan and Well Fargo increased reserves to cover potential defaults.

Things will get worse before better

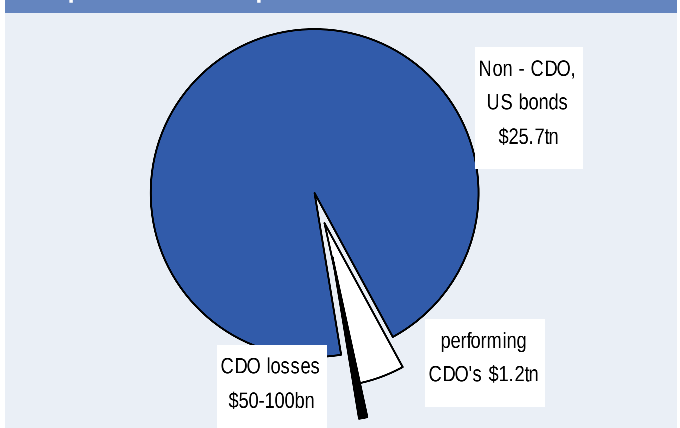
The storm will likely last the next few months. More hedge funds will likely come under increasing pressure from both margin calls and investor redemption demands. Additionally, as Moodys and S&P downgrade more CDOs, real money investors will be forced to liquidate positions. In turn, this selling will cause even more hedge funds to come under pressure.

CDO Issuance has spiked but …



Sources: SIFMA

… expected losses represent a sliver of the bond market



Sources: SIFMA, Fed

Treasuries: CDO hysteria – more downward pressure on yields

Week behind: Credit hysteria. Treasury price action largely ignored economic data. Instead, it ricocheted around with earnings estimates and CDO news and rumors. On net, the negative news outweighed, causing the price action in yields to grind lower in a wedge formation that would suggest a rising potential for yields to break below recent ranges. The 10yr yield has fallen from the top half of its 4.98%-5.20% range during the past month to test the 4.98% support. The 2yr yield is similarly grinding in a wedge pattern towards 4.79% support. The "push" needed to shove yields through support would likely come from some critical mass of poor economic data that would tie into Bernanke's admission that housing could last longer than originally thought or another spate of CDO downgrades, hedge fund blowups, or real money accounts involuntarily selling CDO's that no longer meet their investment mandates.

Week ahead: CDO Risk, GDP. In coming sessions, price action will likely continue to be dominated by headline risk from CDO's, and as the troubles of UK funds and now an Australian fund indicate, these headlines could occur outside the US time zones. The key data event next week is Q2 GDP, and though largely historical, it will serve notice as to just how strongly the economy was able to rebound from the Q1 near-stall. Housing data will consist of new and existing homes sales, which are expected to show only tentative signs of stabilization. Manufacturing data will be comprised of durable goods orders, for which we expect a strong print, and the Richmond Fed survey, expected to be steady after troughing early in the year.

Wedge pattern: suggests increased potential for break lower

Source: Bloomberg

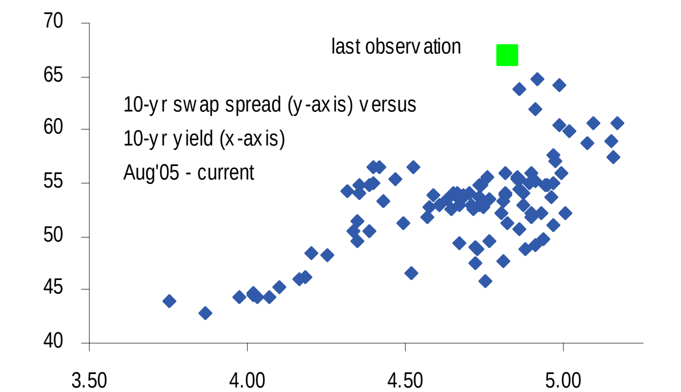
Recommendations / Opportunities: A hold of yield support on a closing basis might allow for another run higher into the range for a short-term play with stop-losses well-defined just below today's lows. A hold below the yield support levels suggests that a psychological "tipping point" has occurred and that the market is putting Fed easing back into play. With that development, position for further downside in yields. This can be accomplished by the 5s30s curve steepener we suggested Thursday or a eurodollar flattener via the Dec'07-Dec'08 contracts.

Swaps: Renewed fears cause new wides for spreads

Week behind: Early in the week, swap spreads held in, widening only slightly versus Treasuries despite the meltdown in the ABX index. However, the onslaught of credit downgrades/warnings, hedge fund trouble, rumors of real money, non-US accounts suffering losses, and – just to add spice - a story about the scrambling of British jets to counter a potential incursion by Russian bombers allowed spreads to widen to their highest level since 2003. Issuance deals that had been pulled the prior week due to the spiking in spreads, never got put back on the table. Additionally, the market easily absorbed all of the little receiving interest.

Week ahead: Wider. Despite Treasuries closing above resistance and likely to rally further, the deteriorating credit environment will probably allow spreads to continue wider until the unease in the market runs its course. We do not expect new issues to come to the table until the market settles down.

Swap spreads spiking on flight to quality price action



Source: Bloomberg

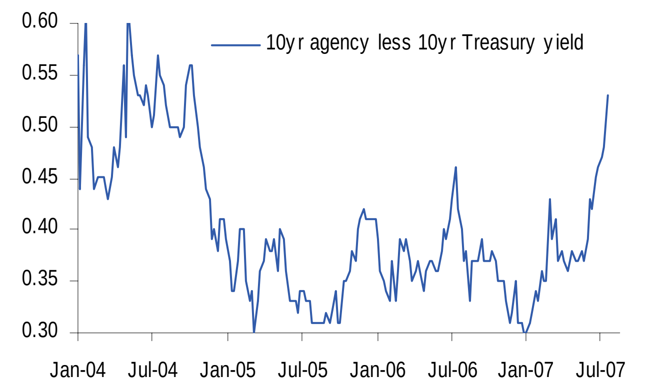
Agencies: Will outperform other spread product

Over the week: **Spreads widened.** Agency spreads widened versus Treasurys all along the curve, to among the widest since 2002. Further, the agencies have narrowed to –16 versus swaps. The new Freddie deals were priced this morning at +51 to 10's and 36.5 to 3's are now trading 2bps weaker vrs tsy's and 1/2bp richer vrs swaps.

Week ahead: Issuance for the month is complete. We are bullish the spread versus Treasuries into month end.

Recommendations / Opportunities: Our trading desk continues to favor short-end agencies relative to other spread product as investors seek refuge from deteriorating credit conditions. Additionally, we have recommended going long 10yr agencies versus swaps on the view that Agencies' underperformance during the past week was counterintuitive to the chaotic situation and will correct in coming sessions.

Spreads have broken to high since 2004



Source: RBC Capital Markets, Inc.

Mortgage-backed securities: Sell basis into strength

Over the week: **Basis widening.** Mortgages underperformed Treasuries, agencies and swaps, with the spread versus the 10yr Treasury spiking 10.5bp to 132bp, a high since February. While many are looking on the current situation as a LTCM redux, the current situation has not yet approached that magnitude. In 1988, the spread to the 10yr Treasury blew out 55bp over the course of 10 weeks.

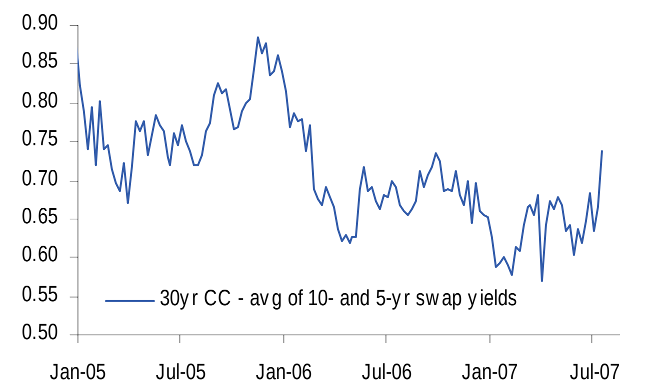
Week ahead: Sell basis on any strength. MBS will likely continue to underperform, and the trading desk looks to sell the basis into any strength and maintain a short core bias.

Recommendations / Opportunities:

1) Move up in coupon: For those anticipating a slowing housing market and slowing prepay speeds, consider adjusting portfolios with up-in-coupon trades. We have formally recommended shorting 5.5%s versus 6.5%s.

2) Seasoned discount notes: With house prices beginning to falter, many homeowners with equity in their current property might seize the opportunity to try to upgrade to a more expensive home before rates head even higher. This could cause the speeds for seasoned discount MBS to rise and the return to outperform.

The basis has spiked to wide since Feb'06



Source: RBC Capital Markets, Inc.

Key Data Risks Next Week

Rishi Sondhi (RBC Financial Group) and TJ Marta

US Beige Book

Period:	Wed, Jul-25
Jul	14:00:EDT/19:00BST

Comment: In the Beige Book, the districts are likely to highlight that weakness in the construction and real estate industries persists but to remain upbeat on the outlook for business spending in line with the firming in the regional ISM surveys. The weaker US dollar and strong foreign demand are also likely to be cited as positive factors for the growth outlook. However, the recent slackening in retail activity will likely be noted although only in the context of a slowdown after a period of very robust growth. Once again, labour shortages and rising prices for food and energy products are expected to be mentioned indicating that underlying price pressures persist.

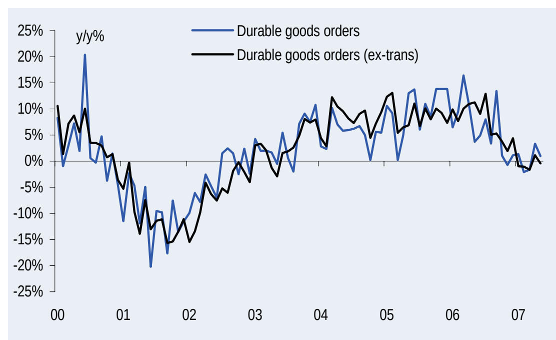
Market Impact: Modest. The Beige Book, while of interest to economists, is too long, balanced and in-depth to provide market-moving sound bites. Attention should be paid to perceptions about the housing correction, especially in light of Bernanke's mention of it as a source of risk in his recent Congressional testimony.

US Durable Goods / Durable Goods ex-transportation

Period:	Thu, Jul 26	RBC:	Consensus:	Previous:
Jun	08:30EDT/13:30BST	2.5%/NA	1.7%/0.5%	-2.4%/-0.4%

Comment: Business M&E spending accelerated in Q2. Orders are expected to have increased for the fourth month in the past five as business investment continued to recover from the sharp slowing in late 2006. Our forecast assumes a full recovery in transportation orders in June in line with the rebound reported by Boeing while the broad-based increase in industrial production in June and rising new orders ISM index for manufacturing point to firmer ex-transportation orders.

Market Impact: Moderate. A volatile number, ex-trans surprises of 1.2ppt or more are associated significantly with price action. Markets should also focus on the "Main Street" orders (non-defense, ex-air), which after trending sharply lower during 2006 on a y/y basis have stabilized at a pace consistent with the slowdown in 1998.



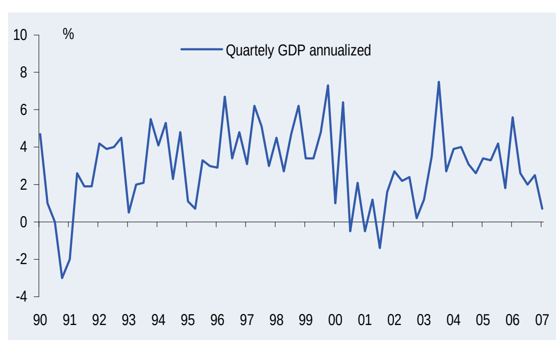
Source: Datastream

US GDP

Period:	Fri, Jul 27	RBC:	Consensus:	Previous:
Q2 annualized	08:30EDT/13:30BST	3.5%	3.2%	0.7%

Comment: The economy accelerated in Q2, and RBC forecasts real GDP grew 3.5%. Both net exports and inventories, which dragged on growth in Q1, supported the expansion in the second quarter, supplemented by increased business spending on capital goods and non-residential structures. Consumer spending is forecast to have slowed following two quarters of very strong spending growth. The data will confirm the Fed's view that the U.S. economy expanded at a moderate pace in the first half of 2007 with the second quarter improvement taking up the slack from the soft showing in Q1.

Market Impact: Major. Although historical, the market will react to misses in the estimate. The report could cause yields and the curve to move within or even test recent ranges, but because of its historical nature, it is unlikely cause a major break.



Source: Datastream

Data / Event Risk Calendar

Day/date	Time (EDT)	Release/Event	RBC	Market	Prior	Comment
Mon / Jul 23	-	No data/events scheduled				
Tue / Jul 24	09:00	Fed's Mishkin: Globalization				Recently took China to task for export policy
	10:00	Richmond Fed mfg survey (Jul)	-	4	4	Late-'06 – early'07 appears to have been trough
	17:30	Fed's Poole: energy and the economy				Has not recently addressed this topic
Wed / Jul 25	10:00	Existing home sales m//m (Jun)	5.95mm	5.89mm	5.99mm	Sag to yet another low since 2003
	14:00	Fed's Beige Book				Moderating consumer, stronger business, inflation
	16:45	Fed's Geithner: global integration				Has urged Asia to develop domestic demand
Thu / Jul 26	08:30	Durable goods tot,ex-trans m/m %(Jun)	2.5, -	1.5, 0.4	-2.4, -0.4	Volatile - Q2 has rebounded after weak H2'06, Q1'07
	10:00	New home sales (Jun)	900K	900K	915K	Stabilization continues after 16-month collapse
Fri / Jul 27	08:30	GDP (Q2 A)	3.5%	3.2%	0.7%	Above-trend growth will settle down in H2
		Personal consumption (Q2 A)	-	1.6	4.2%	Near stall speed after very strong Q1
		Core PCE (Q2 A)	-	1.5	2.4%	Forward-looking Fed will remain vigilant
		U. Mich confidence (Jul F)	-	91.5	92.4	Still reasonably robust – Consumer not wilting

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	4.93	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	5.06	5.35	5.50	5.65	5.80	5.80	5.75	4.83	5.50	5.75

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