

U.S. Daily Directions: July 23, 2007, Asia Edition

There will be no US Daily Directions Tuesday or Wednesday of next week

Day ahead: There is no data/event risk scheduled for Monday.

Friday: A bloody day. Bonds rallied on rumors of non-US banks running into problems due to sub-prime exposure, a retreat in stocks after high profile earnings misses, S&P downgrading European CDO ratings (not sub-prime-backed), strength in bunds, a scramble of British fighters in response to a flight of Russian bombers, and even news of a rocket launcher found in New Jersey.

Asset Assessment:

Eurodollars: **Curve: inverted.** The Dec'07/Dec'08 curve inverted Friday 3.0bp to -16.0bp. We advocate positions taking the view that this curve could trade as low as -39bp 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 crashed through support at 5.00%, living up to the warning the wedge formation in the price action provided. This break suggests a significant shift in market psychology that the CDO crisis is a serious event that could require Fed easing. Resistance for the 10yr is now 4.98-5.00%, while support comes in at 4.89-4.90% (downtrending channel and former resistance in January. The 2yr yield is trading similarly, with resistance now at 4.79% and support at 4.73% (downtrend channel) and 4.67-8% (former support in April and resistance in March).

Curve: steeper. RBC just missed getting put into the 5s30s steepener trade (18.0bp entry level) and so can claim only a moral victory on the subsequent steepening that occurred, as we had stated in part, due to news of increasing sub-prime fallout.

Mortgages: **Sell basis on strength.** Mortgage spreads blew out on today's flight to quality to bid. At the height of the rally mortgages were ~6 wider vs to treasuries and 3 wider vs swaps. Mortgages were able to recover some by the end of the day and closed ~4 wider vs treasuries and ~1 wider vs swaps. Mortgages may look cheap from a nominal spread basis, however days like today remind you how hard it is to fight the trend. Unlike the LTCM event in 98, the move in spreads has been more gradual. However it doesn't look like its over as we continue to see more headline risk regarding subprime across the international financial community. We will continue to look to sell strength in spreads for the time being, and maintain a core short bias.

Swaps: **Range trade.** The negative correlation of spreads to rates was quite clear today with swap yields lower by 4-6bps and spreads wider by 2bps. The swap market is currently obsessed with the performance of credit markets and as a result, 10yr spreads are at their 4-year highs. All the flows that we saw were payers, and there was a noticeable absence of any type of receiving interest from the mortgage community. The curve finally steepened out on today's move and a light data calendar next week and potentially grim weekend press should keep the curve well bid.

Agencies: **Callables: Favor secondaries over new issues.** The rally took away any interest in underwriting callables today. Many dealers remain on the sidelines due to a lack of end user interest in new issues. Secondary spreads waffled as the market rallied today. The recent spread widening is developing a solid base and will hold and eventually tighten in. We have recommended buying 10yr agencies vs 10yr swaps. Secondaries continue to look attractive versus new issues.

Bullets: 2-3yr paper good value. The new Freddie deals that 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. Customer flows have been very light, The question remains, when will the underweight real money accounts add agency exposure vrs treasuries? The patient investor will be rewarded with a juicy spread and cheaper entry level vrs libor.

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