RBC Capital Markets

RATES STRATEGY | RESEARCH

August 10, 2007

# U.S. Directions

## Fixed Income Strategy

*The US Weekly Directions will next be published Aug 31*

Keys next week

* Retail sales
* CPI, PPI
* Industrial production, Philly Fed, Empire Mfg
* Homebuilders' index, housing starts/permits

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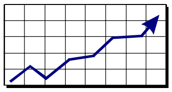
| Sector | View | Specific Comments |
|---|---|---|
| Eurodollars | Yields lower. '07-'08 curve steeper | The worsening of the credit crisis has caused the market to price in more aggressive easing in 2007, causing the '07-'08 curve to disinvert. To the extent sentiment for a crisis-induced LTCM-type easing builds, the curve could steepen. |
| Notes/bond yields | Yields – neutral, choppy | The headline risk from the ongoing credit crisis will keep yields pinned down and perhaps even cause them to test lower. However, the massive injection of liquidity by central banks globally appears to have damped the fire, which could support yields. |
| Curve | Neutral | The market might try to take it steeper on the belief the Fed will come the rescue with rate cuts, but we believe that the strong global economy and inflation pressures will cause the Fed to "ease" via repo operations and liberalization of collateral. |
| Swap spreads | Flatter curve, tighter at the front end | In light of concerted central bank intervention via short-term funding and not rate cuts, the front end spreads, which blew out in the past few sessions should come back in. |
| Agencies | Thin liquidity, but spreads too wide | Spreads are at multi-year wides with few willing to step in to buy. Gutsy investors can take this opportunity to obtain excellent value. |
| Mortgages | Buy up-in-coupon, non-deliverables; fade the basis | Value exists in non-deliverables, particularly 40yr paper and interest-only 6s and 6.5s. We still like the up-in-coupon trade (5.5s to 6.5s). Additionally, fade basis tightening – the crisis is not over. |



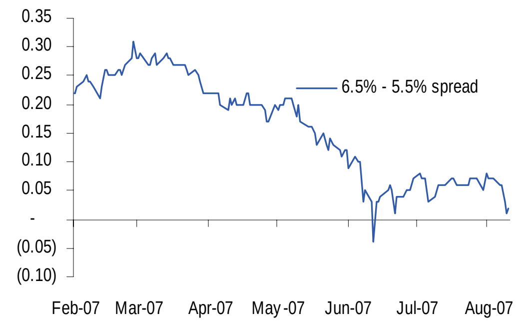
# Trade Recommendations

**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 FNMA coupons versus 5.5% 30-yr FNMA coupons **take profit**

| Entry (6 Jul-07) | Current (10 Aug-07) | Target | Stop-loss | Carry | Weekly P&L | Cumulative P&L |
|---|---|---|---|---|---|---|
| N/A | N/A | N/A | N/A | N/A | +$196,875 | +$233,125 |

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. We have taken profit on this position simply due to being out for a summer holiday. Our trading desk still supports this trade.

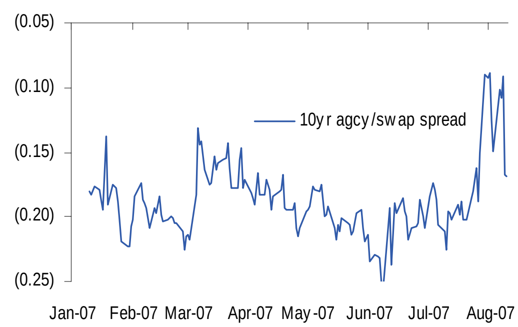



Source: RBC Capital Markets, Inc.

## Buy FHLMC 5.5% Aug 2017 vs 10yr US Swap ** cut position **

| Entry (20 Jul-07) | Current (10 Aug-07) | Target | Stop-loss | Carry | Weekly P&L | Cumulative P&L |
|---|---|---|---|---|---|---|
| -16bp | -16.9bp | -27bp | -8 | - | +4.9bp | +0.9bp |

Agencies have significantly underperformed swaps, as the Agcy – Swap 10yr spread narrowed from –25.6bp on June 8. We believe that given the deteriorating credit environment, agencies should outperform other spread product as part of the flight to quality move. We have cut out of this trade simply due to being out for a summer holiday. Our trading desk still supports this trade.




Source: RBC Capital Markets, Inc.

# Rock and a hard place

### Crisis of confidence could actually worsen

Commerce globally has seized due to a crisis of confidence. At the most basic level, parties no longer trust the valuation of each other's balance sheets. Losses in asset-backed securities used as collateral in short-term funding have caused at least a partial freeze up of the commercial paper pipeline. The European pipeline appears to be getting hit the hardest, which could reflect its smaller size. The US pipeline remains liquid at relatively normal levels for high credit entities. However, lower credit entities are being forced to borrow at very short tenors. The situation is not likely going to improve soon. Fear regarding counterparties' balance sheets stems from the complexity of some of the derivatives (sub-prime CDO's and covenant-lite corporate debt), as well as the uncertainty of the pricing of less exotic assets (mortgage-backed and agency securities are under pressure as dealers attempt to liquidate their inventories). The situation could very well worsen. The number of real money investors to gain media attention due to subprime losses is likely to grow, especially as CDO's actually begin to default. Hedge fund headline risk could mount substantially in coming sessions, as many funds are still arguing with dealers regarding July mark to markets, but their statements are due early next week. And next week is also a deadline for many fund investors to communicate to their desire to redeem investments.

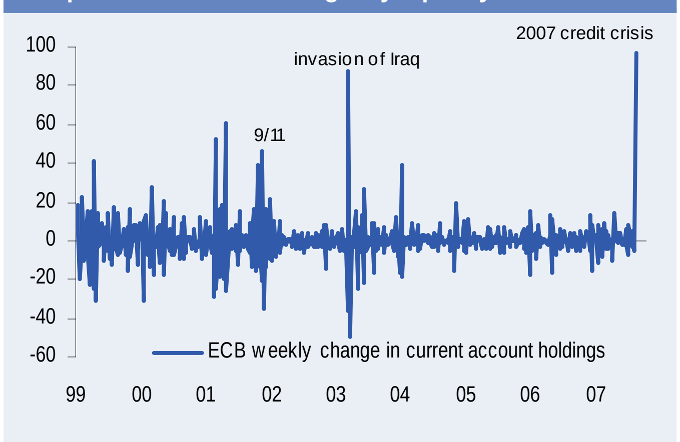
### But Inflation and the liquidity glut remain problems

China's trade surplus continues to balloon. It surged 67%y/y in July to $24.4bn, the second highest on record, indicating that the savings glut is alive and well. International FX reserves growth remains robust at 21.8%y/y, well above the 7.0% rate in April 1998, just before LTCM. Furthermore, the market expects that China's CPI, to be announced Monday, rose further in July to 4.6%, near the 2003 levels just above 5%. US import prices rose 2.8% in July, tied for a high since Aug'06, and suggestive of a rebound in pricing pressures due at least partly to the weak dollar. Next week, US July core CPI is expected to remain stable at an elevated 2.2%y/y and core PPI during July is expected to have risen 2.5%, which would constitute a high since Sep'05 and point to a resurgence of inflation pressures in 2008. In Australia, unemployment remains 4.4%, a multi-decade low, capacity utilization remains stretched, and confidence remains strong. Canada provides a similar picture. Unemployment has sunk to a 33-year low, core inflation is unlikely to recede to 2% until 2009, and activity generally remains firm.

### Inflicting a two-front war on central banks

The global central banks are left to fight a two-front war, with the credit crisis on one side requiring liquidity and the inflation/growth pressures on the other side requiring tightening. To combat real economic growth and inflation, the banks are employing a combination of rhetoric and rate hikes. The RBA hiked last week, the Fed retained its "tight-lite" bias, and the ECB employed the "vigilance" code word for an imminent hike. However, central banks also need to aggressively combat the liquidity freeze in the short term. They must assure markets that liquidity exists and will continue to be provided by central banks. The ECB has injected massive liquidity, causing the current account holdings to spike more than in the run-up to the invasion of Iraq or just after 9/11. The Fed has chosen more directed means, injecting more moderate amounts, but allowing a wider than usual range of collateral to be used. For instance, allowing mortgage backed securities to be used is not unheard of, but nor is it an everyday event. The provision of liquidity helps assure the financial community that central banks will keep the banking system afloat in these tenuous times, but it is of more limited help in causing commercial parties to trust each other's balance sheets. So long as the pricing of complex derivatives remains in doubt, the markets will continue to experience intermittent liquidity spasms. One potential mitigating force is the massive accumulation of sovereign wealth from trade surplus countries and the apparent tectonic shift in the willingness of governments to seek risk returns rather than the safety and liquidity of Treasuries.

**ECB provides historic emergency liquidity**




*Sources: ECB*

**But will this just exacerbate existing liquidity glut?**


*Sources: IMF, RBC Capital Markets*

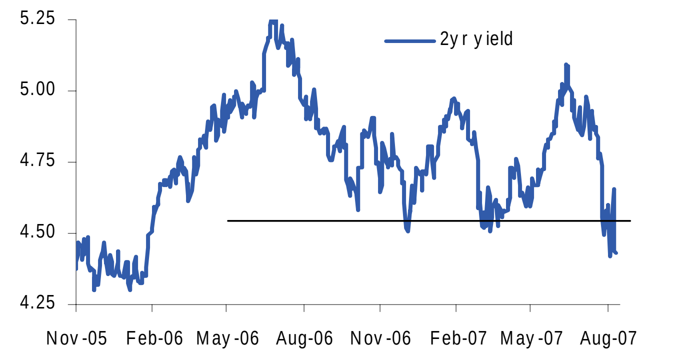
# Treasuries: Crisis of confidence

**Week behind: Steeper due to rising crisis.** The week started with an odd calm that all was well with the world, and so yields rose. No one really believed this, however, and when BNP Paribas announced two of its hedges were in trouble, the market reverted instantaneously to crisis/flight-to-quality mode. Yields crashed, particularly at the front end. The 2yr yield tested its lowest level since Jan'06 before stabilizing, while the 10yr yield failed to seriously test the recent 3-month low of 4.66%. The 2s10s curve steepened to 33.4bp, a high since Jul'05, as the market shifted to price in more than 50bp of Fed easing. Thursday's bond auction was poorly received, tailing 5.9bp. The markets ended the week in relative calm after central banks globally pumped more than $300bn of liquidity in two days.

**Week ahead: More turbulence ahead.** However, the problems are not over by a long shot. Headline risk for the upcoming week could increase. Hedge funds that have been wrangling with dealers over July mark to markets will finally report their July results. Additionally, some hedge fund investors will be placing redemption requests as the deadline for obtaining assets at Q3 quarter end arrives. Finally, one potential lurking risk is that more problems will surface in Europe, this concern being driven by the vast disparity of the ECB's massive liquidity injections relative to the more moderate reactions of both the Fed and BoJ.

Data risk is also significant. Retail sales are expected to show that personal consumption is rebounding after a tepid 1.3% rate in Q2. As to inflation pressures, core CPI is expected to remain at an elevated 2.2%y/y rate, while core PPI is expected to rise to 2.5%y/y a high since 2005 and strongly indicative of rising inflation pressures during 2008. US manufacturing will be highly visible due to the reports for industrial production, expected to evidence moderate, sustainable gains, as well as the Philly Fed and Empire manufacturing surveys, both expected to moderate back towards more sustainable levels. Finally, housing data will include the homebuilders' index, expected to fall to another multi-year low, and housing starts/ building permits, which are forecasted to exhibit ongoing stabilization at subdued rates.

**Funding crisis prompts test of new multi-year low for 2-yr yield**




*Source: Bloomberg*

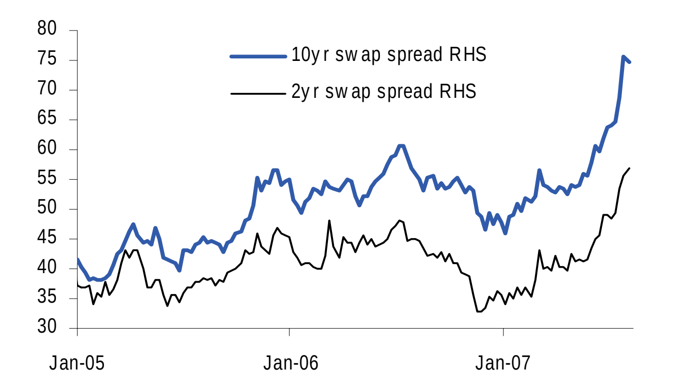
**Recommendations / Opportunities: Stay long the front-end, avoid the long-end.** The curve has steepened as far as it is likely to without the Fed signaling it is going to ease. Given the volatility, directional views are dangerous. Consequently, our trading desk advises to remain long at the front end of the curve, particularly the five year, and short the long end. Should the Fed actually ease, long yields would likely rise sharply due to inflation concerns.

# Swaps: The "next shoe" dropped

**Week behind: Blow out, especially at front end.** Last week we warned that the calm in markets would not likely last and that another shoe was likely to drop. This week's funding crisis caused markets to price imminent Fed easing, which caused the overall curve to steepen. The sharpness of this move caused spreads to trade with the curve move rather than with credits/equities, as in the previous week. Consequently, the front end spreads blew out, a move exacerbated by the sharp rise in Libor.

**Week ahead: Potential tightening.** With the acknowledgement of the credit issue by central banks globally and the willingness to aggressively provide liquidity, the situation could prove less volatile than the past few sessions. This could cause the yield curve to flatten a bit and spreads, especially those in the front end, to tighten up modestly.

**Spreads have blown out at an accelerating pace**




*Source: Bloomberg*

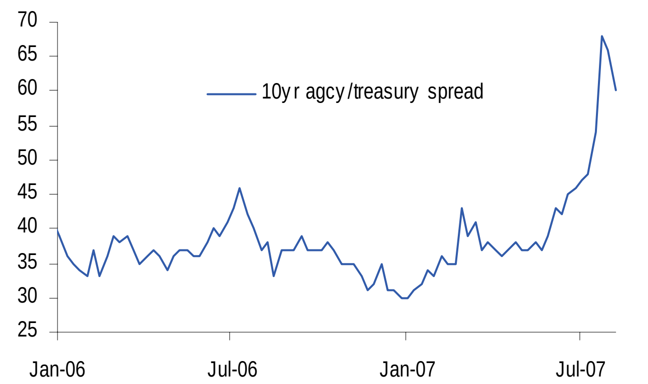
# Agencies: Thin liquidity breeds value/opportunity

**Over the week: Value building on continued thin liquidity.** Spreads ground tighter to their tights Wednesday, but Thursday's BNP tape bomb caused the spread to spike to the week's high before reversing on the concerted central bank intervention and ending the week near the tights. Liquidity remains very poor. Spreads remain near highs since 2002, providing excellent value for investors willing to come into the market with few other buyers and dealers willing to unload inventory. Some clients have started bottom-fishing the curve. For example, buying 15/6mo, 20nc1yr, and 30nc1yr paper.

**Week ahead: More paralysis.** Traders remain dubious that the liquidity that has been pumped into the system has permanently calmed the markets. More negative headlines will continue to roil markets, and the central bank community will likely be forced to re-enter with liquidity injections. The investor base remains paralyzed, unfortunately at the same time as the dealer community is trying desperately to reduce inventory.

**Recommendations / Opportunities: Long Agys vs credit, move in the curve.** We retain our recommendation to buy FHLMC 5.5 Aug 2017 vs 10yr swaps on the view that Agencies will outperform other spread product. Additionally, we advise looking for opportunities in putting small amounts to work, especially at the short end of the curve.

**Spreads have tightened – value remains vs other credits**




Source: RBC Capital Markets, Inc.

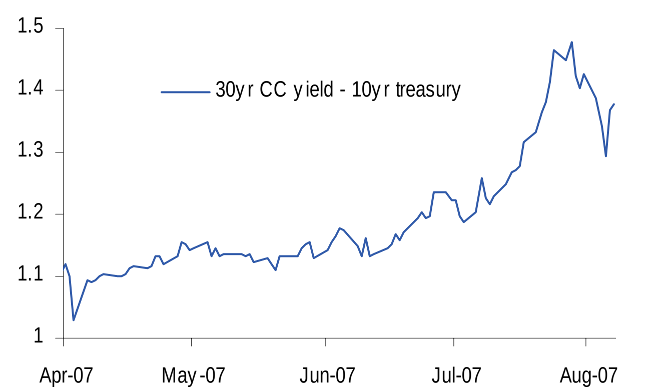
# Mortgage-backed securities: Value in non-deliverables, fade basis tightening

**Over the week: Tale of two weeks.** MBS spreads started the week tightening, moving in as much as 12bp through Wednesday. However, on Thursday, the BNP news caused the basis to blow out 8bp in Asia and European trading. The basis tightened in temporary in the US session on concerted ECB/Fed liquidity injections but re-widened later Thursday and then stabilized on Friday. Non-deliverables have cheapened too much due to the lack of liquidity. Up-in-coupon trades performed well due particularly to the curve steepening.

**Week ahead: More volatility ahead.** We expect continued funding problems to dog the markets and that the basis will trade in a choppy manner. We have a bias for the basis to widen. Additionally, we believe that non-deliverables will eventually outperform as liquidity returns to the system. Finally, up-in-coupon trades will continue to perform well due to the carry as the housing market and prepay speeds slow.

**Recommendations / Opportunities: Fade basis tightening, buy non-deliverables and up-in-coupons.** For trading accounts, fade any basis tightening, as any string of days of calm will likely be interrupting by negative headlines and volatility. Longer-term look to accumulate non-deliverables, particularly 40-yr paper and interest-only 6s and 6.5s, which have trade 24 and 20 back, respectively due to poor liquidity. Finally, we continue to like trading up-in-coupon from 5.5s to 6.5s.

**Basis tried to tighten – but credit crisis intervened**




*Source: RBC Capital Markets, Inc.*

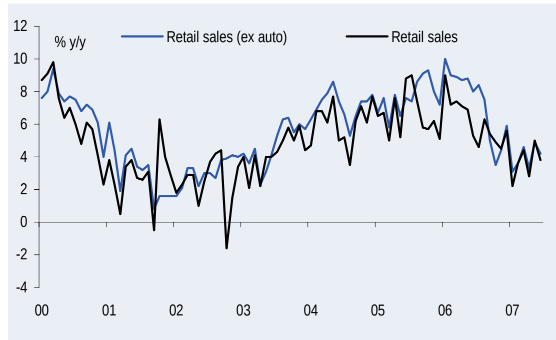
# Key Data Risks Next Week

*Rishi Sondhi (RBC Financial Group) and TJ Marta*

## US Retail Sales / Retail Sales ex-autos

| Period: | Mon, Aug 13 | RBC: | Consensus: | Previous: |
|---|---|---|---|---|
| Jul | 08:30EDT/13:30BST | 0.4%/0.5% | 0.2%/0.4% | 0.9%/-0.4% |

**Comment:** This report will be of keen interest as it will help illuminate whether or not consumer spending growth stabilized in Q3 after softening in the second quarter following marked strength at the start of the year. We forecast a 0.4% increase in retail sales, supported by increasing wages and consistent with indications of improving chain store sales, although declining gasoline prices (cutting into service station receipts) and a 0.8% drop in unit auto sales will weigh against a larger nominal increase. Excluding autos, sales likely advanced 0.5%. Relative to a year ago, sales were probably up 3.2%, consistent with moderate consumer spending growth. This report should ease some worries that spending growth is headed for a sustained downward trend under the weight of a weaker housing market and tightened financial market conditions.



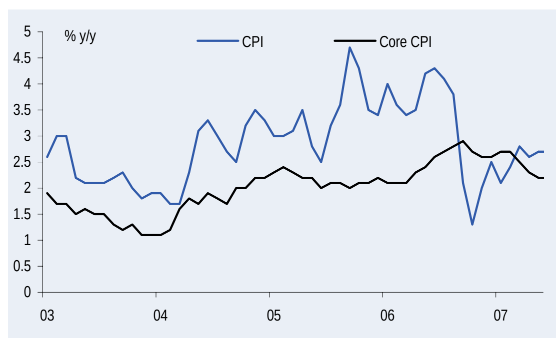

*Source: Datastream*

**Market Impact:** Major. An upside surprise might blunt the effect of the raging credit storm. A downside surprise might add to the perception that the consumer is already weakening due to gas prices and adjustable rate mortgage resets and will be all the more vulnerable to the recent tightening of liquidity conditions.

## US CPI

| Period: | Wed, Aug 15 | RBC: | Consensus: | Previous: |
|---|---|---|---|---|
| Jul | 08:30EDT/13:30BST | 2.4%/2.2% | 2.5%/2.2% | 2.7%/2.2% |

**Comment:** Increasing food prices likely contributed to a 0.1% increase in the consumer price index in July, though a decline in gasoline prices will temper the monthly gain. Excluding food and energy, prices were likely up 0.2% with support, coming from an increase owner's equivalent rent (estimated to be up 0.2%). We forecast a slight increase in apparel prices, and further support will probably come from medical care costs. On a year-over-year basis, all-items inflation likely moderated to 2.4% from 2.7% while the core index probably stayed at 2.2%. At 2.2%, the core inflation rate would be consistent with the core PCE deflator, the Fed's preferred inflation measure, remaining at the upper end of the Fed's so-called comfort zone. As well, with unit labor costs accelerating and the unemployment rate still lingering in inflationary territory, no cuts are likely from the central bank.




*Source: Datastream*

**Market Impact:** Major. An upside surprise on the core figure might blunt credit concerns - temporarily. A downside surprise would allow markets to focus more intently on the Fed's ability to ease and ameliorate the credit crunch.

## Data / Event Risk Calendar

| Day/date | Time (EDT) | Release/Event | RBC | Market | Prior | Comment |
|---|---|---|---|---|---|---|
| Mon / Aug 13 | 8:30 | Advance Retail Sales, Less Autos (Jul) | 0.4%, 0.5% | 0.2%, 0.4% | -0.9%, -0.4% | Decent start to Q3 after weak Q2 |
| Tue / Aug 14 | 8:30 | PPI, tot, Ex-F&E m/m (Jul) | 0.1%, 0.2% | 0.1%, 0.2% | -0.2%, 0.3% | Core PPI justifying Fed vigilance |
| | 8:30 | Trade balance (Jun) | -$61.5bn | -$61.0bn | -$60.0bn | Gradually deteriorating after 2006 rebound |
| | 10:00 | IBD/TIPP Economic Optimism (Aug) | - | - | 48.2 | Soft, but up from April trough of 45.5 |
| | 17:00 | ABC Consumer Confidence (Aug 12) | - | - | -9 | Consolidating after rebound from June trough |
| Wed / Aug 15 | 7:00 | MBA Mortgage Applications (Aug 10) | - | - | 8.1% | Still concerns about multiple applications |
| | 8:30 | CPI, tot, Ex-F&E m/m (Jul) | 0.1%, 0.2% | 0.2%, 0.2% | 0.2%, 0.2% | Suggests inflation near top of comfort zone |
| | 8:30 | Empire Manufacturing (Aug) | - | 18 | 26.5 | Moderation back to sustainable pace |
| | 9:00 | Net Long-term TIC Flows (Jun) | - | $62.5B | $126.1B | Mostly an FX impact |
| | 9:15 | Industrial Prod, Cap Utilization (Jul) | 0.3%, 81.8% | 0.3%, 81.8% | 0.5%, 81.7% | Remains moderate, sustainable |
| | 13:00 | NAHB Housing Market Index (Aug) | - | 23 | 24 | Potential new, multi-year low |
| Thu / Aug 16 | 8:30 | Initial Jobless Claims (Aug 11) | - | 313K | 316K | Job market remains tight |
| | 12:00 | Philadelphia Fed. (Aug) | - | 8.3 | 9.2 | Moderation back to sustainable pace |
| | 8:30 | Housing Starts, Building Permits (Jul) | 1410K, - | 1400K, 1405K | 1467K, 1406K | At best, a stabilization |
| Fri / Aug 17 | 10:00 | U. of Michigan Confidence (Aug P) | - | 88.3 | 90.4 | Rebound after H1 retrenchment still intact |

## 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 | 4.80 | 5.20 | 5.65 | 5.80 | 5.65 | 5.55 | 4.82 | 5.20 | 5.55 |
| 10-year yields (e.o.p.) | 5.85 | 5.14 | 4.63 | 4.72 | 4.65 | 5.06 | 5.10 | 5.35 | 5.65 | 5.80 | 5.80 | 5.75 | 4.72 | 5.35 | 5.75 |

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