U.S. Daily Directions: August 28, 2007, Asia Edition

Day ahead: Data risk today encompasses home prices, consumer confidence, manufacturing and the Fed minutes. S&P/CaseShiller home prices for 20 metropolitan areas are expected to have declined 3.3%y/y during June, a new low for the data set. During Q1, the 10-metropolitan area index dropped 1.4%y/y, the lowest rate since March 1991. Consumer confidence for August is expected to have dropped from 112.6 to 104.0, below the modest uptrend in place since 2004. The Richmond Fed manufacturing index is expected to have dropped in August from 4 to 2, holding above zero after the consistent negative prints from Dec'07 through May. Finally, the minutes of the Fed's Aug 7 FOMC meeting will be released, but subsequent financial market turmoil will render the observations largely irrelevant.

Overnight: The flight-to-quality unwind continued, with the yields on bills rising sharply (1-mo +46.0bp) and yields for notes and bonds falling. The decline in note and bond yields might also have been helped by the ECB's Trichet stating that ECB tightening was not pre-committed and that his "strong vigilance" statement of Aug 2 occurred prior to recent market volatility. As part of the ongoing "readjustment of risk", Home Depot agreed to sell its supply division to Bain Carlyle for a reduced $8.5bn; the bad news was that the terms of the deal had to be "sweetened", but the good news was that the deal got done at all. The German banking system showed further vulnerability to the sub-prime crisis, as Landesbank Baden-Wuerttemberg, the largest state-owned bank, agreed to buy troubled Landesbank Sachsen Girozentrale. In the US, existing home sales for July fell less than expected (-0.2%m/m), but the 5.75mm rate remains a low since 2002, the median price fell 0.6%y/y, and the months supply rose to a new record of 9.6, all suggesting that the housing slowdown will continue to weigh on personal consumption for the next several quarters.

Asset Commentary/Assessment:

Eurodollars: **Yields higher, '07-'08 curve inverted.** Futures yields fell 4-8bp along most of the curve, particularly in the '08 contracts, and the Dec'07-'08 curve inverted 1.5bp to 21.0bp. The futures market now prices in a 70% chance of an ease at the Sep meeting.

Treasuries: **Notes/Bonds: yields lower on flight to quality unwind.** The 2yr yield fell to close at 4.205%, although the trend remains upward since the mid-Aug low of 3.948%. The 10yr yield fell to close at 4.563%, its lowest close since March. The 2s10s curve opened flatter, but then steepened, likely on a correction from the 24bp flattening of the prior several sessions.

Swaps: **Spreads tracked equities / spread steepening.** The spread market traded in a relatively tight range and tracked the movement in equities. The repo and bill market has continued to cheapen up, and with 2- and 5-year tsy supply on tap this week, front-end spreads tightened the most despite the steepening of the curve. The notable theme today was interest to put on spread steepeners (or profit taking of flattening positions).

Mortgages: **Basis too tight?** The basis ceded to the treasury rally and closed the day wider after 4 consecutive days of outperformance. 30yr 5.5's and 6's closed ~1 to 1+/32nds wider vs Treasuries. Despite the basis tightening during the last few trading days, remittance reports were weak, rolls in the 30yr market are soft implying issues still exist with dealer balance sheets and uncertainty over a Fed cut, world subprime exposure and the state of the economy still looms large over the market. These considerations should be negative for the basis. With the basis already coming close to 20bps from the wides, the risk/reward seems biased towards the short side.

Agencies: **Tighter spreads / light volume.** New Issue Callable volume remained light, typical of a holiday-shortened week. Only a handful of negotiated issues were executed today, totaling $100mm. Despite good two-way flow in secondary callables, a strong bid existed all day, with continued demand for Farm Credit paper and renewed demand for longer paper with some lockout. Lackluster bullet trading allowed spreads to grind tighter in line with swap spreads.

RBC Capital Markets

RATES STRATEGY | RESEARCH

T.J. Marta
+1.212.858.6077
Tj.marta@rbccm.com

All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.