

U.S. Daily Directions: August 28, 2007, NY 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 during June, a new low for the data set. During Q1, the 10-metropolitan area index dropped 1.4%/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: Concerns regarding subprime returned overnight, causing equities to fall and the Japanese yen to appreciate in anticipation that carry trades would be unwound. German business confidence fell to 105.8, a 10-month low in August after an increase in the cost of credit clouded the outlook for economic growth. On the positive side, Bloomberg reports several real money investors are advising clients to re-enter risk assets that have been unfairly punished in the recent credit event. Whether the current calm marks the end of the hysteria or just a brief lull before another shoe drops remains to be seen.

Asset Commentary/Assessment:

Eurodollars: **Yields higher, '07-'08 curve inverted.** Yesterday, 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 yesterday 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 yesterday 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 yesterday 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 yesterday, 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.

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.

The information contained in this report has been compiled by RBC Capital Markets ("RBC CM") from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC CM, its affiliates or any other person as to its accuracy, completeness or correctness. RBC Capital Markets is a business name used by subsidiaries of the Royal Bank of Canada including RBC Dominion Securities Inc., RBC Dominion Securities Corp., RBC Dain Rauscher Inc., Royal Bank of Canada Europe Limited and Royal Bank of Canada – Sydney Branch. All opinions and estimates contained in this report constitute RBC CM's judgement as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation of an offer to buy any securities. RBC CM and its affiliates may have an investment banking or other relationship with some or all of the issuers mentioned herein and may trade in any of the securities mentioned herein either for their own account or the accounts of their customers. Accordingly, the entities constituting RBC CM or their affiliates may at any time have a long or short position in any such security or option thereon. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. This material is prepared for general circulation to clients and does not have regard to the particular circumstances or needs of any specific person who may read it. **To the full extent permitted by law neither RBC CM or any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior consent of RBC CM.** The entities comprising RBC Capital Markets are wholly owned subsidiaries of the Royal Bank of Canada and are members of the RBC Financial Group. **Additional information is available on request.**

To U.S. Residents:

This publication has been approved by RBC Dominion Securities Corp. ("RBCDS Corp.") and RBC Dain Rauscher Inc. ("RBC DRI"), both of which are U.S. registered broker-dealers, which accept responsibility for this report and its dissemination in the United States. Any U.S. recipient of this report that is not a registered broker-dealer or a bank acting in a broker or dealer capacity and that wishes further information regarding, or to effect any transaction in, any of the securities discussed in this report, should contact and place orders with RBCDS Corp. or RBC DRI.

To Canadian Residents:

This publication has been approved by RBC Dominion Securities Inc. Any Canadian recipient of this report that is not a Designated Institution in Ontario, an Accredited Investor in British Columbia or Alberta or a Sophisticated Purchaser in Quebec (or similar permitted purchaser in any other province) and that wishes further information regarding, or to effect any transaction in, any of the securities discussed in this report should contact and place orders with RBC Dominion Securities Inc., which, without in any way limiting the foregoing, accepts responsibility for this report and its dissemination in Canada.

To U.K. Residents:

This publication has been approved by Royal Bank of Canada Europe Limited ("RBCEL") which is regulated by Financial Services Authority ("FSA"), in connection with its distribution in the United Kingdom. This material is not for distribution in the United Kingdom to private customers, as defined under the rules of the FSA. RBCEL accepts responsibility for this report and its dissemination in the United Kingdom.

To Persons Receiving This Advice In Australia:

This material has been distributed in Australia by Royal Bank of Canada -Sydney Branch (ABN 86 076 940 880). This material has been prepared for general circulation and does not take into account the objectives, financial situation or needs of any recipient. Accordingly, any recipient should, before acting on this material, consider the appropriateness of this material having regard to their objectives, financial situation and needs. If this material relates to the acquisition or possible acquisition of a particular financial product, a recipient in Australia should obtain any relevant disclosure document prepared in respect of that product and consider that document before making any decision about whether to acquire the product.