U.S. Daily Directions: August 29, 2007, NY Edition

Day ahead: There is no data risk today. Headline risk will remain the key driver.

Overnight: In Asia, subprime risk provided the focus, with news at the close in NY of the possible liquidation of a $20bn commercial paper plan by Cheyne Capital, a London-based hedge fund. However, US stock index futures managed to gain overnight on the perception that Fed cuts are imminent, which would ease pressure on equities. Equities could get help in the medium- to long-term from the Chinese, as China has sold debt to establish a reserves fund that seek to invest the country's massive reserves in riskier assets. Treasury yields rose modestly, only partially retracing yesterday's large declines. However, 1-week Libor has begun rising again, fixing at 5.60%; it had spiked from 5.32% to over 6% on Aug 10 before settling back to 5.40%. Mortgage applications for Aug 24 fell 4.0%w/w, with the only category rising being fixed rate applications. On a y/y basis, applications for purchases, refi's and fixed rate mortgages are all up, but the increase is likely due at least partly to homeowners/buyers needing to apply with multiple lenders.

Asset Commentary/Assessment:

Eurodollars: **Yields higher, '07-'08 curve inverted.** Futures yields slipped further overnight, 1-1.5bp in the '08 and '09 contracts. The Dec'07-'08 curve has inverted 23.5bp. The futures market has increased its perception of a Fed cut in Sep to 72.5%.

Treasuries: **Notes/Bonds: yields lower, curve steeper.** Yesterday, the yield on the 6mo T-bill collapsed 41bp, leading declines of 14bp in the 2yr yield and 5bp in the 10yr. The price action reflected renewed sub-prime fallout concerns and followed widening credit spreads.

Swaps: **Spreads blow out.** After a one-day reprieve, volatility returned to the market with a vengeance yesterday as spreads blew out 2-5bps and the curve steepened out over 12bps between 2s and 30s. The market continues to gyrate around the front-end of the curve and should trade this way until there is more certainty of what the Fed is thinking -- information likely to be provided this Friday. Spreads had been pushed down almost 20bps from the wides in anticipation of a rebound in credit and a potentially heavy issuance calendar approaching. Potential for further widening exists.

Mortgages: **Mortgages lag.** Tuesday, mortgages couldn't keep up with treasuries and lagged the curve, underperforming ~10/32nds on the day. Versus swaps, the current coupon underperformed by ~4+/32nds. Mortgages reverted to widening mode as new tape bombs hit the market. Rolls continued to suffer, dropping another .25 to .375 across the stack. With higher dollars, stocks heading south, rolls collapsing, and Asia seemingly out the market, there is not much positive going for the basis in here.

Agencies: **Secondary callables get the action.** The majority of activity in callables remains in secondary land. As new issue spreads contracted 10-15bps over the last couple of sessions, many customers found much better value in the secondary market. Although we did see swap spreads and swaption vol push out today, the move lower in rates diminished any improvement in coupons levels. There was a strong bid in the market all day for secondary callables, particularly Farm Credit paper and longer paper with some lockout.

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