U.S. Daily Directions: September 10, 2007, NY Edition

Day ahead: Monday provides little data risk, with only consumer credit due out. Economists expect July credit moderated to $8.4bn, consistent with the slight uptrend in place since 2002. Data for the week is also light. with retail sales the only tier one release. However, the tepid 0.2%m/m consensus for ex-auto sales does little to change the perception of a consumer weighed by slowing housing and now jobs markets. Fedspeak includes Lockhart and Mishkin (US economic outlook), Yellen ("A View from the Federal Reserve"), Fisher (US/Mexico/border economies), and Bernanke (global imbalances).

Overnight: Treasuries yields failed to rebound after Friday's rout. Asian yields collapsed as a follow on to Friday's US session. 1-wk Libor fixed at 5.6925%, falling for the 4th consecutive session to a low since Aug 29. Markets are focused on CP rolls this and next week, as $140bn come due by the end of next week, $60bn of which lies in conduits. However, the case for the Fed to ease is not being made easier price developments, as the prices for oil and gold, at $76.23/bl and $704.80/oz, respectively, are once again testing record highs, and the CRB has rebounded 4.4% since mid-August. Nevertheless, RBC believes the Fed needs to cut the Fed Funds rate 50bp on or before Sep18. The Bank has been stating that the strong economy would be able to withstand the buffets of the credit crisis, but the weak payrolls report and mediocre other indicators suggest the economy is not so strong after all. If the Fed does not address the current financial/growth problems decisively, it will not have to worry about inflation down the road.

Asset Commentary/Assessment:

Eurodollars: **Yields rebound overnight, especially near term.** Overnight, yields rebounded, particularly for the '07 contracts (5-6bp). The options market prices in only a 2.5% chance the Fed fails to cut rates, and a 60% of more than 25bp.

Treasuries: **Notes/Bonds: yields break out lower.** Friday, yields crashed through technical supports and look to have established a breakout lower. The move was precipitated by the payrolls report but gained a life of its own on the technical break and then convexity buying. Our trading desk retains its 2s10s steepener and added to the position today on the view the 2yr will outperform more as the Fed eases.

Swaps: The weaker than consensus NFP caused spreads to tighten as players raised the bets on a Sep18 Fed rate cut on the belief that the impending rate cuts will fuel improvements in the credit markets. As the day wore on it was apparent that there was a pretty heavy round of convexity receiving as 10yr rates caused to curve to flatten nearly 5 bps from it's steepest levels of the day.

Mortgages: The rally in treasuries induced a convexity bid in MBS that had 5.5's at one point 14/32nds tighter vs 10yr HRs. Massive buying by servicers outright in 5's and 5.5's as well as moving down in coupon out of 6's and 6.5's led discounts to outperform the stack. However, by the end of the day mortgages gave back much of their out performance fading into the close with 5.5's giving up ~10/32nds from their tights. 30yr 5.5's closed only 4 tighter vs 10yr, basically unchanged vs the steeper treasury curve and 3 wider vs swaps. The early price action seemed to have been overdone and fast money moved back up in coupon taking advantage of the compression of the 6.5/5.5 swap. One thing to take away is that the convexity bid is back and could lead to further outperformance of mortgage spreads if we continue reach new lows in rates.

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.