U.S. Daily Directions: September 11, 2007, NY Edition

Day ahead: Tuesday provides the last Fedspeak prior to the FOMC rate announcement Sep 18, and Bernanke will address the Bundesbank regarding global imbalances. Data reports consist of the Jul trade balance, expected to fall slightly to -$59.0bn, the IBD economic optimism index, which has not been above 50 since March, and the weekly chain store sales reports, which have remained at moderate levels.

Overnight: Treasury yields rebounded modestly overnight, as markets tried to digest the disparate Fedspeak from yesterday, which included Yellen assuring markets that the Fed shared their concerns about growth on one side, but Fisher haranguing markets as overly emotional. Even with the dire fears regarding growth and full employment, the Fed's inflation bogeyman continues to lurk. China – the great exporter of inflation in 2002 – reported 6.5%y/y inflation, a 10-year high. Global supply shocks to oil (Mexican pipeline explosions) and wheat (drought) have oil testing a record high and wheat trading at its record high. 1-month LIBOR fixed at 5.8031%, down 0.0031bp, while the 1-wk rate fixed at 5.62125%, down 7bp.

Asset Commentary/Assessment:

Eurodollars: **Yields mixed, curve inverts. '07 and the Jan'08 contracts y**ields rose 3-7bp, while yields for Mar'08 and beyond fell more as the tenor lengthened. The Dec'07-'08 spread has moved to –56bp, another record low for the spread.

Treasuries: **Notes/Bonds: yields continue break lower.** Yields tested lower in a sharp morning move on rumors of Asian buying as well as falling equities and news about massive commercial paper rolls in coming sessions. As equities rallied, yields also partially rebounded. The 2s10s curve flattened 1bp to 47bp, but the trend remains steeper, and our trading desk has a steepener position on.

Swaps: The spreads were mixed, with the 2-,3-,5- and 10-yr spreads tighter, but the 2-, and 7-yr spreads wider. The 2-yr spread widened to 77.5, back out near the 79.25 wide on Sep 5. The 10-yr spread continues to moderate, and has closed at its tightest level since July 13.

Mortgages: Mortgages traded wider most of the morning as last week's convexity buying failed to hangover into today's trading. At one point, MBS were ~2 wider vs the curve with little domestic flow and modest overseas buying. Mortgages climbed back by the afternoon as real money and convexity buyers resurfaced, pushing FN 5.5's to ~1+ tighter vs the treasury curve and in-line with swaps. We are finding it difficult to like the MBS market over the short term with OASs still relatively low and rolls continuing to trade through funding levels implying balance sheets issues that have yet to be resolved. The momentum has been pushing spreads tighter as servicers have added over the last couple of days, however without more domestic or overseas support it will be hard for MBS to sustain their recent run.

Agencies: Callable new issuance was light, with only five negotiated deals and one FFCB auction bond. Bank's funding needs in the FHLB system remain filled mainly via their DN program. This continues to cap short-lock paper and has helped the secondary market clean up much of the short-end paper. We like longer lock-out paper out the curve and expect to see more of this paper come to market soon to fill duration and yield bogies. Secondary callables saw light volume today to start off the week as the street continues to adjust to the abundance of premiums in the market. As you can see by the offerings of late, anything with short lock continues to widen as the market rallies and prices are limited to the upside. We continue to see demand for 2yr+ lockout and anticipate this continuing going forward as accounts seek yield.

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