

## U.S. Daily Directions: September 17, 2007, NY Edition

**Day ahead:** For Monday, data risk is confined to the Empire manufacturing report, which the market expects to have fallen from 25.1 to 18.0, near the bottom of the range in place most of the time since 2003. For the rest of the week, the FOMC represents the key risk, followed by earnings reports by major US banks. We expect the Fed to cut the Fed's Fund rate, and given their reaction so far to the crisis and data, they are more likely to cut only 25bp than 50bp. Such a move would likely disappoint markets, as the futures market currently prices a 58% chance that the Fed eases 50bp and only a 42% chance they cut 25bp. The Fed will also likely cut the discount rate at least 25bp, and given the increase in bank borrowing during the past week, bringing the rate down to the same level as the funds target would likely help increase liquidity. Volatility will also stem from bank earnings, as Lehman Brothers, Morgan Stanley, Bear Stearns, and Goldman Sachs all report. Merrill Lynch, which warned Friday that subprime issues continued to represent a risk for their operations, reports earnings in October. Plenty of other data risk exists: Bernanke's testimony to Congress, CPI, PPI, Philly Fed and Empire manufacturing surveys, the housebuilders' index, housing starts and building permits.

**Overnight:** Treasuries stabilized and 1-month LIBOR collapsed another 11bp to 5.50%, around the level at which LIBOR stabilized after the initial crisis in mid-Aug. The apparent easing of the crisis comes despite a rally in European bonds, as depositors made a run on the UK bank, Northern Rock, taking out roughly 8% of all retail deposits as of Saturday. Equities indexes are generally down, universally so in Europe, on concerns about the banking system. China's Deputy central banker Wu Xiaoling stated overnight that China's current policy was to rebalance the economy, particularly the unsustainable savings rate and excess use of resources. The US's Paulson and France's Fin Min Lagarde agreed that China's exchange rate was fundamentally undervalued relative to the US dollar and euro. Europe's trade deficit with China jumped 22% to a record in H1'07, at least partly due to the strength of the euro.

### Asset Commentary/Assessment:

**Treasuries:** Yields have consolidated after re-establishing their pre-payrolls levels on signs that the short-term funding market is normalizing. The market currently prices in a 58% chance of a 50bp ease and a 42% chance of a 25bp ease, suggesting volatility no matter what the Fed does.

**Swaps:** Spreads overnight are stable to almost 1bp tighter farther out the curve. The spread curve continues to steepen out dramatically with 2s30s moving 11bp late last week. The weaker-than-expected retail sales number Friday initially brought in buying but was met with a wall of selling and yields ended the day close to flat on the day.

**Mortgages:** Mortgages continued their run Friday, outperforming treasuries and swaps for a third straight day. Mortgages caught a early bid from money manager buying and overseas buying of Gold 6's. There was close to 2bb in originator selling in the morning that was easily placed and had little effect on budging the tightener as 30yrs hung around ~1 to 2 tighter vs the curve for the majority of the day. 15yr allocations went out with little surprises, however sep/oct rolls continued to firm up till their close as buyers took advantage of the cheap arbitrage. Specified collateral in general continued to see better buying as the overall tone in the market has improved over the last couple days and spread product across sectors has seen more participation.

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