

September 14, 2007

U.S. Directions

Fixed Income Strategy

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| Buy 6% 30yr FNMA vs Treasuries |
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| Buy UST 4.125% Aug 2012 vs UST 5% May 2037 |
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Keys next week

* FOMC,, Bernanke
testifies, Greenspan

* CPI, PPI

* Homebuilders' index,
housing starts, building
permits

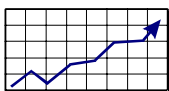
* Philly Fed, Empire
survey

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| Sector | View | Specific Comments |
|-------------------|--|--|
| Notes/bond yields | Neutral | Yields have rebounded to pre-payrolls levels. Massive event risk from the FOMC and bank earnings, along with several important data reports, will provide volatility |
| Curve | Steeper | We have entered a 5s30s steepener on the view that Fed easing will prompt steepening as the short end prices in easing. The long end could actually rise on increased inflation concerns |
| Swap spreads | Neutral | Spreads could tighten should Libor continue to fall, but the FOMC could cause widening, and hedge removal on disappointing issuance could add to widening pressure. |
| Agencies | Spread neutral short-term | Short end agencies have richened significantly versus swaps in recent weeks, causing issuance to fall off. A spread widening on poor bank earnings could prevent a buying opportunity. |
| Mortgages | Basis short-term neutral – curve steeper | Overseas accounts are buying, but domestic accounts remain leery about reentering the waters. We are neutral the basis given near-term event risk, but expect tightening further out. 15s should outperform 30s. |



Trade Recommendations

Note all costs of carry are calculated over 3-months at inception unless otherwise stated
 Profit/losses are calculated relative to the last edition of U.S. Directions
 Trades priced at noon EST

Buy 30-yr FNMA 6s vs Treasuries (duration weighted 5s and 10s)

| Entry (31 Aug 07) | Current (14 Sep-07) | Target | Stop-loss | Carry | Weekly P&L | Cumulative P&L |
|-------------------|---------------------|--------|-----------|-------|------------|----------------|
| N/A | N/A | N/A | N/A | N/A | -\$5,000 | +\$195,000 |

The basis reached its widest in the wake of the mid-Aug panic and has since made successively tighter wides. A retreat in Libor and a general feeling that the commercial paper market is “unfreezing” is helping spreads tighten. Additional tightening impetus could come as dealers, which have been liquidating inventories during the recent turmoil and have been constrained by balance sheet considerations going into fiscal yearend, begin rebuilding inventories during September.

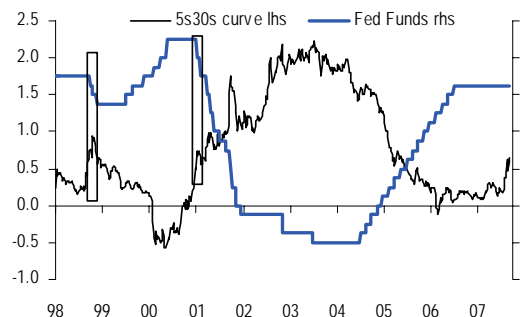


Source: RBC Capital Markets, Inc.

Buy 5-yr UST 4.125% Aug 2012 vs. 30-yr UST 5% May 2037

| Entry (13 Sep 07) | Current (14 Sep-07) | Target | Stop-loss | Carry | Weekly P&L | Cumulative P&L |
|-------------------|---------------------|--------|-----------|----------|------------|----------------|
| 57bp | 54bp | 80bp | 45bp | -1bp/3mo | -3bp | -3bp |

We have entered a 5s30s steepener at 57bp with a target of 80bp and a stop-loss of 45bp. In 1995, 1998 and 2001, curve steepening was accompanied by steepening of the 5s30s curve. The Fed will ease next week, at least by 25bp, if not 50bp. The Fed has initial indications that the economy is not creating enough jobs to absorb new entrants. Furthermore, personal consumption will likely deteriorate as consumers are weighed by ARMs resets, house price stagnation/decline, and leveling stock prices. Business activity is likely to stall as consumer demand wanes. Such developments could very well lead to further easing by the Fed at subsequent meetings.



Source: RBC Capital Markets, Inc.

Approaching stall speed – Fed needs to cut

The economy remains just above stall speed

To the extent that the US economy can be likened to a fully loaded jumbo jet, it is trundling in towards a landing at worryingly low speed. Retail sales ex-autos collapsed 0.4% m/m in August, although the number was depressed by weak gas station receipts (sales ex-gas rose 0.6% m/m). However, the trend in sales ex-autos appears down from a reasonably strong Q2. More recent data from weekly same store sales show moderate growth, as the ICSC chain store sales rose 2.9% y/y and Redbook sales rose 2.8% y/y, both above the 2.0% stall speed. Industrial production for Aug rose 0.2% m/m, down from an upwardly revised 0.5%, but still consistent with the healthy pace of growth generally in place since mid-2003. The payrolls report suggested that job growth is moderating to the extent that new work force entrants will not be absorbed into the labor force. Optimists note that initial jobless claims, at 319K, still do not indicate a historically unhealthy number of job cuts, thus suggesting a loss of momentum rather than an outright downturn. Furthermore, the job picture has been driven by losses in government, not necessarily a negative development for Libertarians. However, the pessimists counter that not only were jobs lost in Aug, the gains for June and July were revised lower, leaving the job gains below the 100K minimum thought necessary to maintain a stable job market for three consecutive months. Furthermore, while job losses occurred in construction during August, as would be expected, they also occurred in manufacturing, a surprisingly weak development given strong global growth and the weak dollar. Additionally, the household survey showed a massive 316K decline. We expect that GDP growth will moderate during H3 towards 2.2%, well below trend, but still a soft landing.

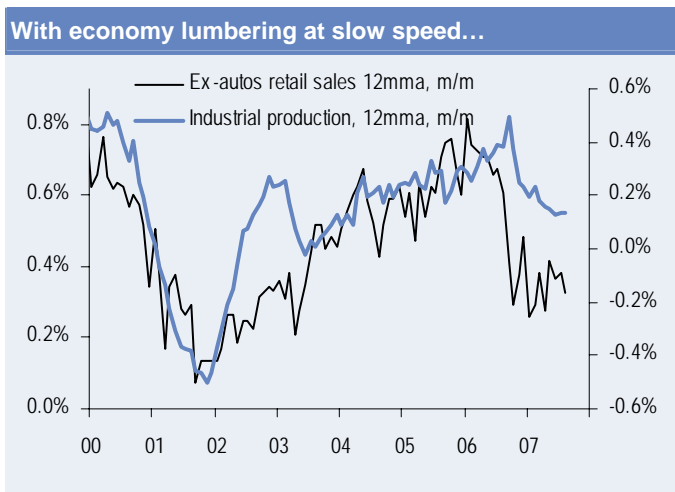
The downside risks remain

The problem with the soft landing scenario is that with growth moderating, any downdrafts or wind shears could turn the situation decidedly nasty in short order, and those risks are all too evident with the ongoing financial freeze-up. The long-term corporate bond spread

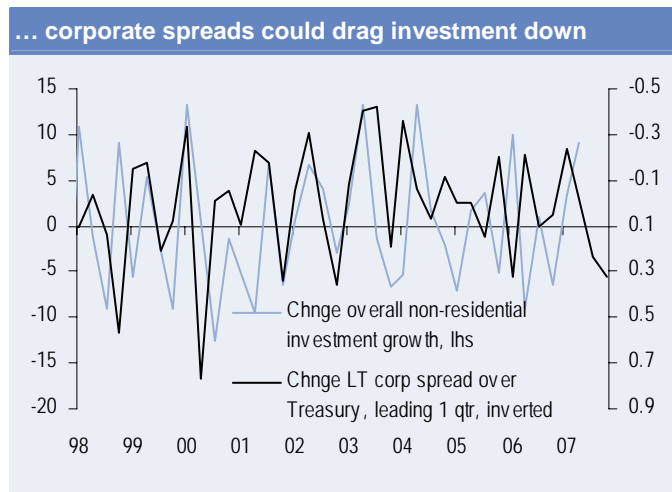
over Treasuries has spiked 46bp since July to a recent peak of 147bp, a high since 2003. Our trading desk suggests that new, pent-up issuance is pressuring spreads wider and that the situation could continue through yearend. The spike in rates represents a significant risk for business investment going forward. The consumer has taken a hit to their home values and will be further weighed by resets of ARM loans. However, so long as jobs remained strong, the damage to personal consumption should remain moderate. But now the jobs market has shown signs of softening.

Fed at least needs to cut 25bp

With the ongoing problems in the credit markets and now softening real economic data, the Fed has to ease the Fed Funds rate. To not do so would cause equities to sell-off, which would lead to corporate pullbacks and further consumer retrenchment, and this would require Fed easing. However, at that point, the Bank would be in a reactive, “behind-the-curve” stance. That said, enough is going “right” to suggest the Fed moves only gradually (25bp cut Sep 18). The unemployment rate remains at a tight 4.6%, and so some job losses could be viewed as a healthy untightening of a jobs market that threatens to cause higher inflation. And inflation pressures remain. China’s inflation has risen to a 10-yr high, the price of oil has closed above \$80/bbl, gold, at \$714/oz, is threatening the all-time high of \$730/oz, capacity utilization remains at a taut 82.2%, and inflation expectations, as expressed by the 5yr, 5yr forward TIPS breakeven yield, have risen to 2.51%, near the year’s high of 2.57% and the closing in on the decade-high of 2.66%. And the financial crisis shows ongoing signs of resolving itself. Banks, at first tentative to approach the Fed’s discount window, increased their borrowing by approximately \$6bn in the week ended Sep 12. Asset-backed commercial paper outstanding continues to fall, but the latest \$14bn decline was moderate and suggests the hysterical phase has passed. Additionally, the one-month LIBOR fixing rate, which had spiked to 5.82%, has retreated 20bp in the last week, suggesting an easing of banking concerns in Europe.



Sources: Federal Reserve, Census Bureau



Sources: Bureau of Economic Analysis, Moody’s, RBC Capital Markets

Treasuries: Yields recover from post-payrolls collapse

The week behind. What? Me worry? Yields completely recovered from their post-payrolls collapse. The reason is not so much fundamental, but rather financial and technical. The data this week provided a mixed assessment. Retail sales disappointed, with ex-auto sales falling 0.4%/m, a mitigating factor being that gas stations sales drove the decline – ex-gas, sales rose 0.6%. Industrial production rose a moderate 0.2%/m, but capacity utilization ticked higher to 82.2%. Initial jobless claims remained benign at 319K. The financial situation is broadly becoming livable, if not normal, and that has helped Treasuries sell-off – an unwind of previous flight to quality. 1-mo LIBOR fell 21bp, the commercial paper market continued contracting, but at a slower pace, and the 2-yr swap spread fell approximately 8bp. The Fed's discount window received some bank demand, with loans spiking \$6bn to the week ended Sep 12. The bad news is that banks require the liquidity, but the good news is that the Fed's easing measure – lowering the discount rate – is being accepted. One final positive sign that the crisis is at least progressing was that Countrywide was able to obtain \$12bn in financing.

The week ahead. Yes - worry. Next week, the FOMC represents the key risk, followed by earnings reports by major US banks. We expect the Fed to cut, 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 50pt and only a 42% chance they cut 25bp. Volatility will also stem from bank earnings, as Lehman Brothers, Morgan Stanley, Bear

Yields regain pre-payrolls levels



Source: Bloomberg

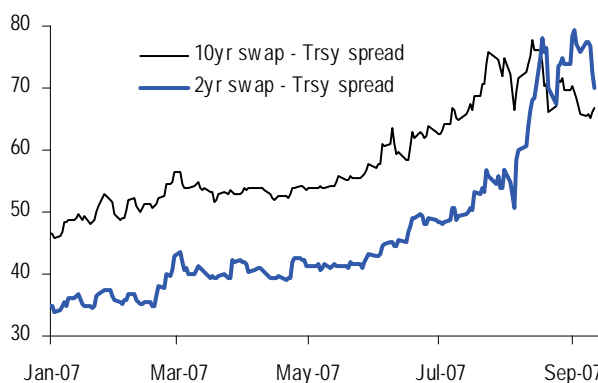
Stearns, and Goldman Sachs all report. Merrill Lynch, which warned Friday that subprime issues continued to represent a risk for its operations, reports earnings in October. Plenty of other data risk exists: Bernanke's testimony to Congress, CPI, PPI, Philly Fed and Empire manufacturing surveys, the housebuilders' index, housing starts and building permits. Finally, Alan Greenspan will be making the media circuit, marketing a new autobiography.

Swaps: Opposing forces to buffet spreads

Week behind: 2yr spread collapses. The 2yr spread finally began to tighten sharply late in the week as Libor fixings began to crash lower. Prior to that, the 2yr spread had blown out during the August crisis to match the 10yr spread and then remained elevated even as the 10yr spread settled back, reflecting the problems in the short-term borrowing markets. Spreads remain elevated relative to the recent past. From a longer-term perspective, the 10yr spread did widen to near-LTCM wides but has since retreated significantly. In contrast, the 2yr spread spiked above the LTCM wides and even near the 2000 peak, and it has not retreated appreciably relative to its long-term price action.

Week ahead: Opposing forces to buffet spreads. Continued declines in LIBOR fixings should allow spreads, particularly at the short end, to continue to tighten. However, the FOMC rate decision and statement will also have a major impact. Additionally, issuance has been a little less than anticipated, and so spreads could push wider as hedges are removed.

2yr spread collapsing back to where 10yr spread settled

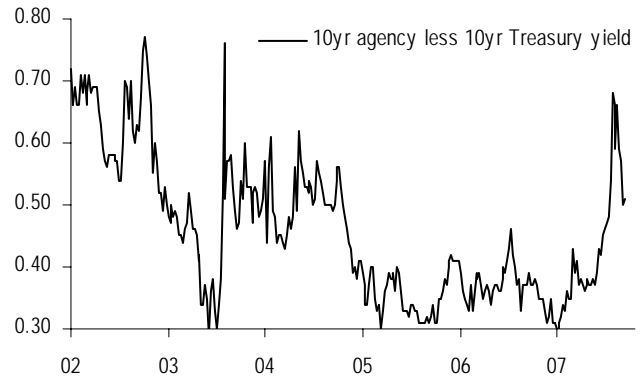


Source: Bloomberg

Agencies: Spread widening to present buying opportunity?

The short end of the agency curve has richened significantly versus swaps in recent weeks. Flows continue to improve, particularly in the front end. Investors have sought secondary callables that provide yield inside 5 years. The demand for 2-yr+ lockout paper remains steady and should continue, at least for the short term. A risk for next week is that spreads could widen on lousy bank earnings. Such a move could actually provide a buying opportunity, as the second reaction could be a flight to credit quality – and agencies.

Agency spreads stabilize after retracement

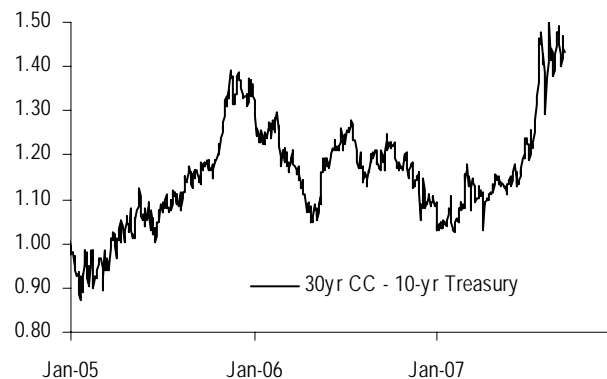


Source: RBC Capital Markets, Inc.

Mortgage-backed securities: Basis tighter – but short-term risk

The basis tested wider early in the before gradually tightening on Thursday and Friday. The price action has traced out two “lower highs” since the 1.5053 peak on Aug 16, suggesting that the worst of the crisis is over and the basis will tighten, perhaps gradually, as market conditions improve. Overseas accounts have actively bid for MBS, but domestic accounts have shown little proclivity to put money to work other than some sparse bottom-fishing for particularly cheap bonds. During the next week, the basis could prove volatile given the event and data risk. However, we believe it will tighten longer-term.

Basis is still faltering at multi-year highs



Source: RBC Capital Markets, Inc.

Recommendations / Opportunities: Buy FNMA 6's vs Treasuries.

See page 2. Additionally, we note that the 15yr 6s have not fully participated in the recent curve steepening and would look to establish positions in them, either alone or against 30-yr 5.5s.

Key Data Risks Next Week

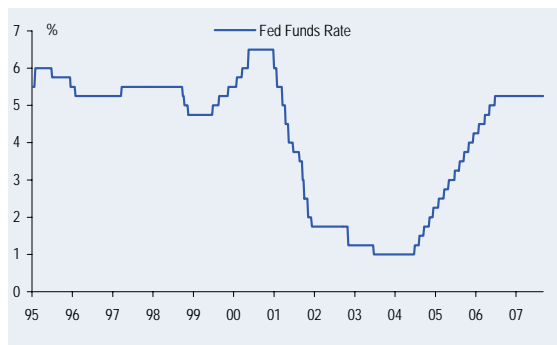
Rishi Sondhi (RBC Financial Group) and TJ Marta

FOMC Rate Decision

| | | | | |
|---|---|----------------------|----------------------------|---------------------------|
| Period: Sept 18 th | Tue, Sep 18 14:15EDT/19:15BST | RBC: 4.75% | Consensus: 5.00% | Previous: 5.25% |
|---|---|----------------------|----------------------------|---------------------------|

Comment: The Fed is widely expected to cut rates on September 18th. Fed officials have been holding their cards close to their chests acknowledging risks to the growth outlook but still maintaining that monetary policy should not be used to bail out imprudent risk-takers. The only voting member (outside of Bernanke) to speak since the release of the ugly August payroll data, Frederick Mishkin, stated that economic activity “could be affected more severely in other sectors should heightened uncertainty lead to a broader pullback in household and business spending. That scenario cannot, in my view, be ruled out, and I believe it poses an important downside risk to economic activity”. On balance, we think that conditions favour the Fed cutting the policy rate by 50 basis points next week to mitigate the downside risks to the economic outlook and to alleviate liquidity concerns in financial markets.

Market Impact: Major. The market appears priced for a 50bp cut, despite the economist consensus of a 25bp cut. Consequently, a cut of only 25bp would disappoint markets and lead to a sell-off. Such a sell-off would be mitigated to the extent the statement indicated further easing is likely.

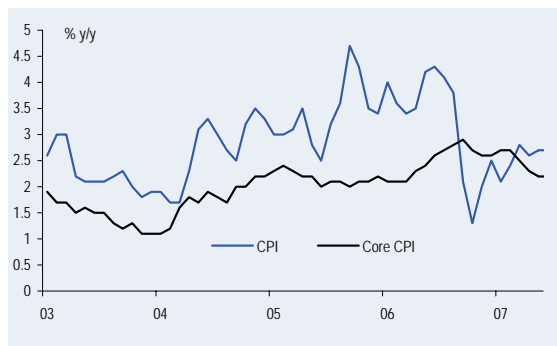


CPI / Core CPI

| | | | | |
|-----------------------|---|--------------------------|--------------------------------|-------------------------------|
| Period: Aug | Wed, Sep 19 08:30EDT/13:30BST | RBC: 2.0%/2.2% | Consensus: 2.2%/2.2% | Previous: 2.4%/2.2% |
|-----------------------|---|--------------------------|--------------------------------|-------------------------------|

Comment: A fall in gasoline prices likely led to a 0.1% decline in the CPI in August. Excluding food and energy, we anticipate that the index was up 0.2%, in-line with the recent trend, and with the upward pressure coming from owner’s equivalent rent as well as medical care costs. Downside risk to our forecast stems from the increased automotive incentives offered by some automotive companies. Year-over-year growth in the all-items index likely moderated to 2.0% from 2.4% in July. Growth in the all-items index is poised to accelerate in the coming months as the oil price-related declines of September and October of last year fall out of the year-over-year calculation. The year-over-year rate of increase should reach the 3.7% area in the fourth quarter of this year. Core inflation likely remained at 2.2% for the fourth straight month, supporting the view that the recent moderation in core inflation is “sustained”.

Market Impact: Significant. Given the market’s focus on growth and financial risks, reaction to this report might prove less than normal. An upside surprise on the core figure might blunt credit concerns - temporarily. A downside surprise would allow markets to focus more intently on the Fed’s ability to ease and ameliorate the credit crunch.



Data / Event Risk Calendar

| Day/date | Time (EDT) | Release/Event | RBC | Market | Prior | Comment |
|--------------|------------|--|-------------|--------------|--------------|---|
| Sun / Sep 16 | 19:00 | Greenspan speaks to CBS's "60 Minutes" television show | | | | Subprime problems exceeded expectation |
| Mon / Sep 17 | 07:00 | Greenspan speaks to NBC's "Today" show | | | | |
| | 08:30 | Empire manufacturing (Sep) | - | 20.0 | 25.1 | In 15-25 range in mostly place since '04 |
| Tue / Sep 18 | 08:30 | PPI total, ex-F&E, m/m (Aug) | -0.3%, 0.1% | -0.3%, 0.1% | 0.6%, 0.1% | Core PPI points to elevated core CPI in '08 |
| | 09:00 | Net long-term TIC flows (Jul) | | | \$120.9bn | Retracement likely from extreme level |
| | 13:00 | NAHB housing market index | | 20 | 22 | Falls to tie for record low (1991) |
| | 14:15 | FOMC rate decision | 4.75% | 5.00% | 5.25% | FOMC could resort to other means of easing |
| | 18:00 | ABC consumer confidence (Sep 16) | | | -17 | Stabilizing, but at low level |
| | 20:00 | Greenspan: autobiography, economy | | | | |
| Wed / Sep 19 | 07:00 | MBA mortgage applications (Sep 14) | | | 5.5% | |
| | 08:30 | CPI total, ex-F&E, m/m (Aug) | | 0.0%, 0.2% | 0.1%, 0.2% | Core CPI remains elevated |
| | 08:30 | Housing starts, building permits (Aug) | | 1355K, 1340K | 1381K, 1373K | Further deterioration in housing |
| | 19:00 | Greenspan: autobiography, economy | | | | |
| Thu / Sep 20 | 08:30 | Initial jobless claims (Sep 15) | | 325k | 319K | Remain subdued |
| | 10:00 | Bernanke testifies | | | | Insight into Fed's perception of risks |
| | 10:00 | Leading indicators (Aug) | | 0.0% | 0.4% | Continues hover near level requiring Fed ease |
| | 12:00 | Philadelphia Fed (Sep) | | 2.0 | 0.0 | Holding just above level requiring Fed ease |
| Fri / Sep 21 | 05:00 | Fed's Mishkin: monetary policy | | | | Risks exist, Fed will act as needed |
| | 08:45 | Fed's Plosser: opening remarks | | | | No media, no Q&A |
| | 13:00 | Fed's Warsh: Financial market developments | | | | Didn't see systemic risks back in July |

Economic and Financial Market Forecasts

| | Quarterly | | | | | | | | | | | | Annual | | |
|-------------------------|-----------|------|------|------|------|------|------|------|------|------|------|------|--------|------|------|
| | Q106 | Q206 | Q306 | Q406 | Q107 | Q207 | Q307 | Q407 | Q108 | Q208 | Q308 | Q408 | 2006 | 2007 | 2008 |
| Real GDP q/q saar | 5.6 | 2.6 | 2.0 | 2.5 | 0.8 | 4.0 | 2.6 | 2.5 | 2.8 | 3.0 | 2.8 | 2.9 | 2.9 | 2.2 | 2.9 |
| Consumer Prices y/y | 3.7 | 4.0 | 3.4 | 1.9 | 2.4 | 2.7 | 2.3 | 3.7 | 3.4 | 2.1 | 2.4 | 2.6 | 3.2 | 2.8 | 2.6 |
| Core CPI y/y | 2.1 | 2.4 | 2.8 | 2.7 | 2.6 | 2.3 | 2.3 | 2.2 | 2.2 | 2.3 | 2.3 | 2.4 | 2.5 | 2.3 | 2.3 |
| Fed Funds Rate (e.o.p.) | 4.75 | 5.25 | 5.25 | 5.25 | 5.25 | 5.25 | 4.75 | 4.75 | 4.75 | 5.25 | 5.50 | 5.50 | 5.25 | 5.25 | 5.50 |
| 2-year yields (e.o.p.) | 4.82 | 5.15 | 4.68 | 4.81 | 4.60 | 4.93 | 4.20 | 4.50 | 4.56 | 5.20 | 5.50 | 5.55 | 4.82 | 5.20 | 5.55 |
| 10-year yields (e.o.p.) | 5.85 | 5.14 | 4.63 | 4.72 | 4.65 | 5.06 | 4.75 | 4.85 | 5.00 | 5.30 | 5.60 | 5.75 | 4.72 | 5.35 | 5.75 |

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