RATES STRATEGY | RESEARCH

September 21, 2007

U.S. Directions

Fixed Income Strategy

Keys next week

** Home prices, home sales, Construction spending*
** Durable goods orders, Richmond Fed index, Chicago PMI*
** Personal income / spending, confidence*
** PCE inflation*

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Sector	View	Specific Comments
Notes/bond yields	Neutral to negative	Data next week will likely prove bond-friendly, and quarter end could cause asset manager problems to come to light. Against these influences, 2yr and 5yr auctions could allow for underperformance in those tenors.
Curve	Steeper	Our 5s30s steepener has gained ground given the Fed easing as the short end is weighed by expectations of further cuts and the long end rises due to inflation concerns.
Swap spreads	Neutral	Spreads have tightened appreciably, but might be at levels consistent with the much-anticipated re-pricing of risk. Further normalization of the financial markets could allow for tightening, but sporadic negative news regarding ongoing sub-prime fallout will provide volatility.
Agencies	Constructive on spread	Activity is rising as the financial markets normalize, and investors are pushing out the curve. We see value out the curve and for cushion paper.
Mortgages	Negative bias on the basis.	The bid has returned for MBS, causing the basis to tighten from the extreme levels of the August crisis. The basis is fully valued to a bit tight. Separately, look to scale into up-in-coupon (6s vs 5.5s) positions

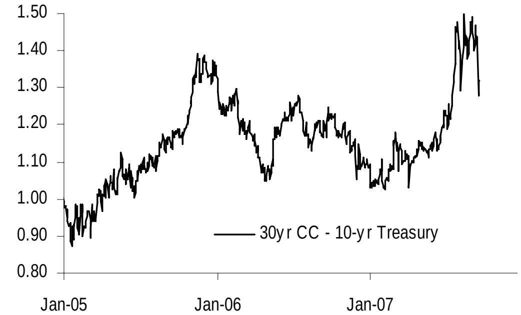
Trade Recommendations

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) ** Take Profit **

Entry (31 Aug 07)	Current (21 Sep-07)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
N/A	N/A	N/A	N/A	N/A	+$718,750	+$913,750

The Fed easing allowed the basis to tighten more than 13bp at one point this week, adding to the 7bp of tightening this position had already profited. Most of the correction has occurred, and we are taking profit and going neutral the basis.

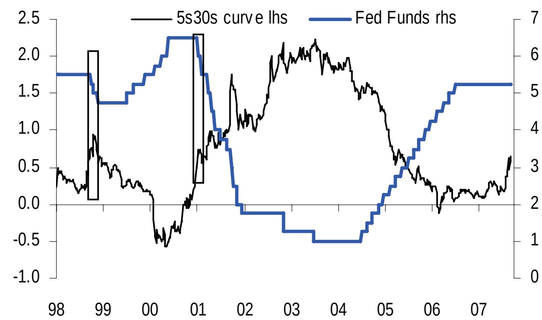


Source: RBC Capital Markets, Inc.

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

Entry (13 Sep 07)	Current (21 Sep-07)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
57bp	60bp	80bp	45bp	-1bp/3mo	+6bp	+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.

Fed Funds on a knife's edge

Financial markets out of intensive care, but not hospital

The Fed surprised markets this week with a 50bp cut and a statement reflecting a data-dependent stance. The Fed's rationale for the cut indicated its hand had been forced by the financial markets and not economic fundamentals, as evidenced by the language that the action was intended to "forestall … adverse effects on the broader economy that might arise from the disruptions in financial markets". Financial markets had begun "unseizing" prior to the Fed Funds rate cut in response to the discount window rate cut, the liquidity injections, and the relaxation of collateral requirements. The stock market had regained more than 50% of its losses since July, 2-yr swap spreads had retreated almost 20bp from their crisis peak, and the 10-yr agency spread had fallen back almost 15bp to the low since July. But when the Fed met, not all markets were improving, as the spread of LIBOR over the Fed Funds target had spiked higher to 57bp on Sep 7, and the spread of AAA long-term debt had leaked wider to more than 95bp. Furthermore, the asset-backed commercial paper market continued to implode, having fallen by $228bn, or 19%, as of Sep 12, and markets were jittery regarding the upcoming earnings reports from major US banks. The Fed Funds rate cuts precipitated further "normalization" of financial markets. The Dow Jones has risen approximately 400 points and stands only about 250 points below its record high 14021. Fixed income spreads have generally tightened: 2-year swap spread -7bp, AAA-rated long-term corporate debt -14bp, 10-year agencies -5bp, 30-mortgages -13bp, and even 90-day asset-backed commercial paper less 3-month Libor -59bp. Additionally, corporate issuance surged, with some deals oversubscribed and others moving at a discount to Libor. Some problems remain, particularly the spread of 1-month Libor over the Fed Funds target, which remains abnormally elevated at 39bp (the long-term average is 15bp). Perhaps time and disclosure will allow market participants to feel more comfortable as to where "the bodies are buried" and allow even more normalization, as happened when four major US banks reported mixed Q3 earnings results.

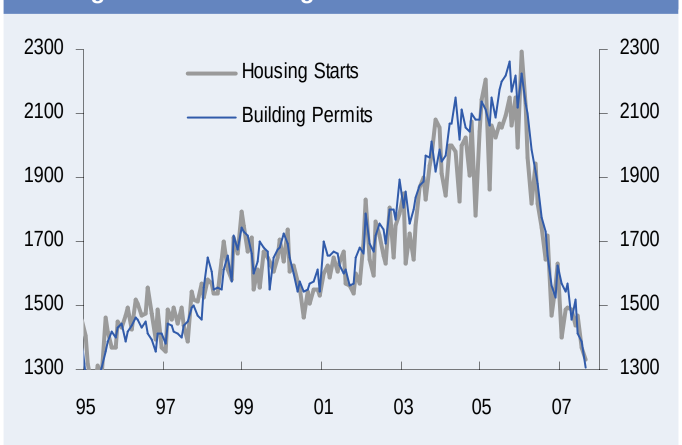
Growth remains an immediate risk

We wrote last week that the economy remained at stall speed, vulnerable to risks, and that a Fed ease was required to ensure a soft landing. The data this week confirm that view. Housing starts and building permits both fell to new multi-year lows and indicate further weight on GDP growth from falling residential investment. The leading indicators index fell 0.6%m/m in August, weighed in part by financial market turmoil and rising jobless claims. The Empire manufacturing survey fell more than expected to 14.7 (consensus 18.0, prior 25.1), back towards the bottom of the range it had largely maintained since mid-2005. However, the Philadelphia Fed survey rebounded more than expected (10.9, consensus 2.6, prior 0.0) to the top of its range since mid-2005, and jobless claims, which began to rise worrisomely in August, have retreated. Concerns persist, particularly regarding adjustable rate mortgage resets, foreclosures, and declining job creation. However, our base case view is that these threats are modest, especially with the extra "power" the Fed ease has pulled in for the economic jetliner. Unfortunately, in providing stimulus, the Fed has increased the chance it overshoots the runway (ignites inflation).

But inflation looms in the background

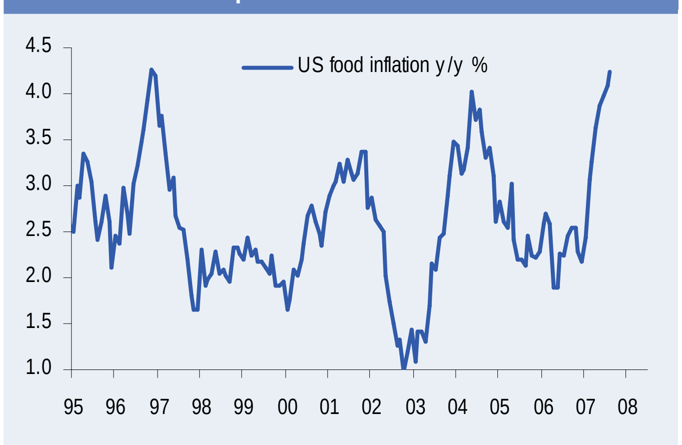
The liquidity conditions and inflation pressures the Fed had fixated on as have not abated. Overall PPI and CPI both fell m/m during Aug, but the declines derived from falling gasoline prices, a trend not likely to continue given oil is now trading over $80/bl. Furthermore, core PPI y/y remains at 2.2%, and the rise from 0.8% in Jul'06 suggests inflation pressures will persist into next year. Food inflation has risen to 4.24%y/y, among the highest rates since 1991, in part due to record prices for wheat. Finally, the weakening US dollar, which has fallen to a record low versus the euro, represents inflationary pressures, and Bernanke stressed this point during testimony to Congress when he equated price stability with dollar stability. Gold has surged above $730/oz, and the 5yr, 5yr forward breakeven yield for TIPS has risen above 2.60%, among the highest levels attained since 1997.

Housing continues to weigh …



Sources: National Assoc. of Homebuilders, Census Bureau

… even as inflation pressures mount

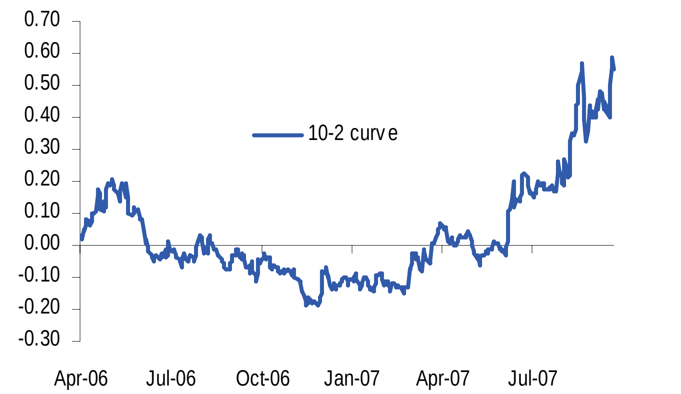


Sources: Bureau of Labor Statistics

Treasuries: Weaker and Steeper

The week behind. Weaker and steeper. The Fed's surprise 50bp cut to the Fed Funds rate gave further impetus to the weakening of Treasuries and also caused the curve to steepen sharply (2s10s +16bp, 5s30s +8bp), as the long end underperformed. The short-end yields are rising because the Fed cut was perceived to represent at least a partial cure for the dislocation in short-term borrowing. However, markets remain convinced the Fed will need to tighten further, as the futures market prices in a 40% chance of a another 25bp of easing and a 53% chance of another 50bp of easing, and these expectations are capping the rise in the short-term yields. At the same time, inflation concerns stemming from the weak dollar and rising prices in food, gold and oil are pushing the long end higher. The price action accelerated as technical positions flipped and convexity selling developed. On Friday, the curve retraced a bit, with some accounts taking profits and others initiating flatteners ahead of potential long-end buying by pension funds and short-end weakness expected due to next week's auctions. The economic data was mixed, with the Empire survey surprising on the downside, but the Philly Fed survey surprising on the upside. The leading indicator report surprised on the downside but against an upward revision to the prior. Overall PPI and CPI surprised on the downside due to falling gasoline prices, although spiking oil should reverse that trend. Core CPI remains elevated, and the rise in core PPI during the past year suggests continued price pressures through mid-2008. Housing data remain weak, with the homebuilders' index falling to tie the record low from 1991, and housing starts and permits making new multi-year lows.

Ongoing inflation pressures + Fed ease = steeper curve



Source: Bloomberg

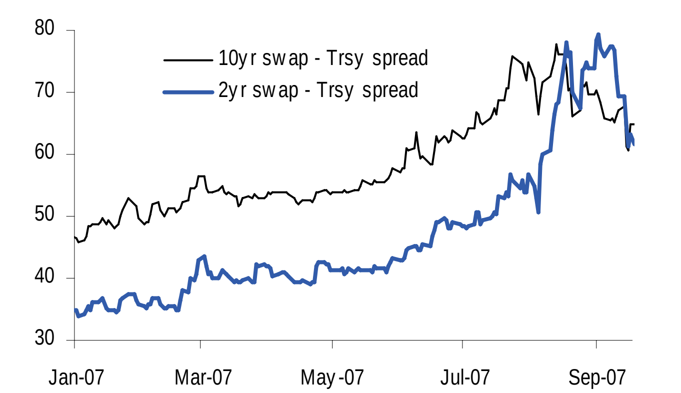
The week ahead. Heavy data and Treasury supply. The housing data, prices and sales, are expected show continued deterioration in the market, durable goods orders and construction are both expected to contract. The activity surveys are expected to show a mixed picture (Richmond lower, Chicago higher), while personal income and personal spending are both expected to remain fairly robust. Finally, core PCE inflation is expected to tick lower to 1.8%, a low since Feb'04. Price action could also be impacted by the Treasury's auction of 2yr and 5yr notes. We retain our strategic 5s30s steepening position, although profit taking, pension buying in the long-end, and the 5yr supply next week could provide better levels at which to enter the position.

Swaps: Tightening not a one-way street

Week behind: Spreads collapse. Spreads, which had already begun to tighten from the August wides, tightened further in the wake of the Fed ease. The 2-year spread came under particular pressure, as the Fed move allowed Libor to fall and was generally perceived as a more effective remedy for the short-end dislocations. However, the move retraced a bit later in the week, as the dark side of the Fed ease, downward pressure on an already weak dollar, sparked fears of an all-out dollar route, and an asset manager had to unload MBS inventory.

Week ahead: Tightening not a one-way street. While spreads are now back to pre-August crisis highs, they remain relatively elevated. The question now is whether they can tighten more as the financial crisis continues to resolve, or whether the "reassessment of risk" will keep them near current levels. Additional widening pressure will result from the occasional "blow ups" among asset managers that are forced to liquidate assets as part of the ongoing resolution of the financial crisis.

Spreads tighter, curve dis-inverts



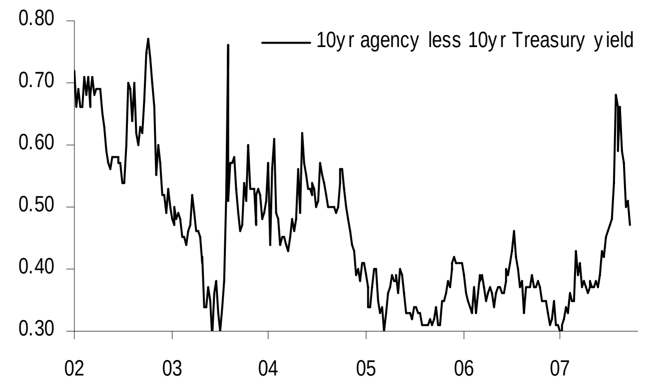
Source: Bloomberg

Agencies: Bid into month-end

Spreads are only 0.36bp tighter on Friday than Monday night, belying the volatile week in which the 10yr spread had tightened as much as 7.9bp. The Fed ease caused bonds with 5.50% coupons to be snatched up, and now investors are facing the sticker shock of 4% coupons. This, along with low funding needs, has kept issuance light. Cushion paper became popular after the ease, particularly as the curve steepened. Foreign flows were strong for much of the week, as European and Asian accounts bought in the 5- and 7-year buckets. Generally, volumes, which had begun to revive pre-Fed cut, are rising towards relatively healthy levels.

Spreads could tighten further in light of not only light issuance, but also because accounts are being flooded with redemptions and so are cash-rich. We see value out the curve and in cushion bonds and expect the bid to remain into month-end.

Agency spreads stabilize after retracement



Source: RBC Capital Markets, Inc.

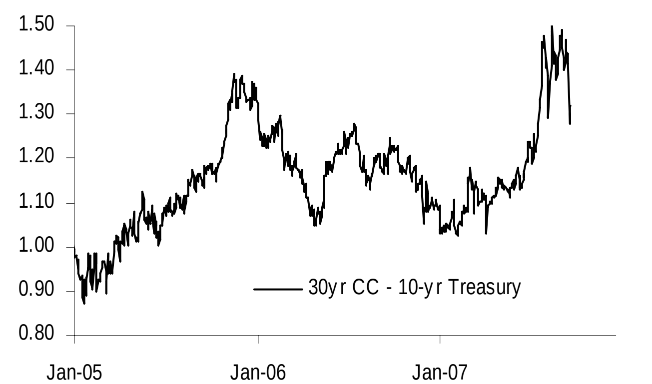
Mortgage-backed securities: Negative bias on the basis

The Fed ease caused the basis to collapse as much as 13bp during the week back towards 128bp, a low since July. However, the sell-off in Treasuries eventually elicited massive convexity selling by servicers, halting the move tighter. Bid lists had been trading a bit better in September, and interest increased post-Fed cut. Asian buyers have re-entered the market on the sell-off, buying especially 6 coupon non-deliverables.

Recommendations / Opportunities:

1) Buy FNMA 6's vs Treasuries. Take profit See page 2.
2) The 18bp tightening in the basis since the height of the August liquidity crisis appears to constitute a move to fair value, or perhaps even a bit tight. We would look sell the basis on any tightening.
3) For a short-term play, 15s appear cheap to 30s.
4) Look to scale into up-in-coupon 6s vs 5.5s.

Basis has collapsed to realistic levels



Source: RBC Capital Markets, Inc.

Key Data Risks Next Week

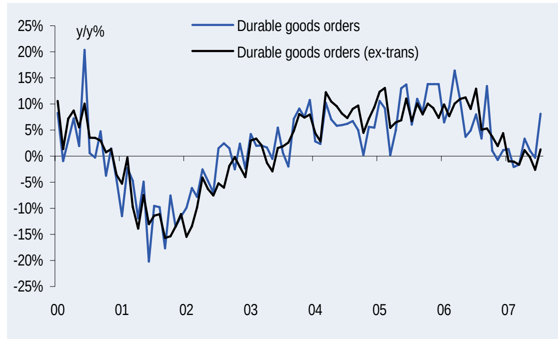
Rishi Sondhi (RBC Financial Group) and TJ Marta

US Durable Goods Orders / Durables (ex-trans)

Period:	Wed, Sep 26	RBC:	Consensus:	Previous:
Aug	08:30EDT/13:30BST	-3.0%/NA	-3.0%/-0.6%	5.9%/3.7%

Comment: Declines in aircraft orders, manufacturing industrial production and the new orders index in the ISM manufacturing point to a drop in durable goods orders during August. Despite the expected weakness, orders were likely still up 6.1% relative to a year ago, and thanks to a sizzling July, should be an annualized 20.7% higher so far in Q3 relative to the second quarter average. Thus, the data will still be consistent with our forecast that investment activity picked up in Q3.

Market Impact: Moderate. A volatile number, ex-trans surprises of 1.2ppt or more are associated significantly with price action. Markets should also focus on the "Main Street" orders (non-defense, ex-air), which on a m/m trend (6mo mvg avg) basis have managed to rebound to a moderate 0.7% after the weak Q4'06-Q1'07 period.



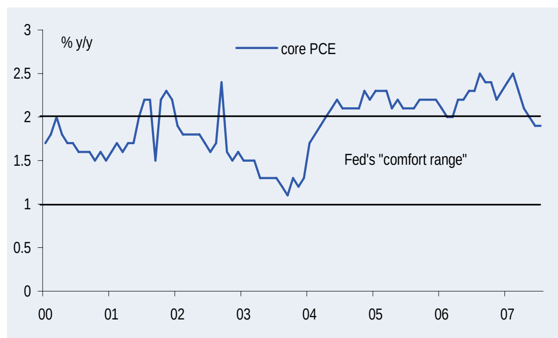
Source: Datastream

US Core PCE

Period:	Fri, Sep 28	RBC:	Consensus:	Previous:
Aug	08:30EDT/13:30BST	1.9%	1.8%	1.9%

Comment: Although hours worked was flat and employment declined slightly, we still anticipate that personal income was able to advance 0.4% in August, on the basis of indications of higher wage growth. Personal spending probably advanced by 0.4% buoyed by a robust increase in unit vehicle sales, though a decline in control (ex auto, building materials and garden equipment supply stores) retail sales argues against a larger increase. While the retail sales report was disappointing in August, it is still consistent with a 0.3% gain in real PCE which, after July's 0.3% gain, would put spending up an annualized 2.0% above the Q2 average. This would be consistent with our forecast that spending reaccelerated from Q2's 1.4% pace. The core PCE deflator, the Fed's preferred inflation measure, was likely up 0.2% leaving the year-over-year rate of growth at 1.9% which is at the upper end of the Fed's perceived "comfort zone"

Market Impact: Major. A downside surprise would cause market participants, already dubious regarding the Fed's infatuation with inflation, to try to price in greater Fed easing (to address growth risks) and also less inflation risks, allowing yields to shift lower along the curve.



Data / Event Risk Calendar

Day/date	Time (EDT)	Release/Event	RBC	Market	Prior	Comment
Mon / Sep 24	09:00	Fed's Fisher: Higher education				
Tue / Sep 25	09:00	S&P/CaseShiller home prices y/y (Jul)	-	--4.0%	--3.5%	Increasing weight on consumer
	10:00	Consumer confidence (Sep)	105.3	104.5	105.0	Remains near post-9/11 high
	10:00	Richmond Fed mfg index (Sep)	-	-	7	Had rebounded from H1 contraction
	10:00	Existing home sales (Aug)	5.47mm	5.50mm	5.75mm	New low since 2002
	17:00	ABC consumer confidence (Sep 23)	-	5	-15	Rebounding from crisis low in Aug
	17:30	Fed's Plosser: Economy, productivity				Believed rate cut unnecessary on Sep 9
Wed / Sep 26	07:00	MBA mortgage applications (Sep 21)	-	-	2.4%	Potential rebound from summer lull
	08:30	Fed's Poole speaks to small business owners				Unconvinced recession lies ahead
	08:30	Dur goods orders tot, ex-trans (Aug)	-3.0%, -	-2.0%, -0.4%	5.9%, 3.7%	Still recovering from H2 trough
Thu / Sep 27	08:30	Initial jobless claims (Sep 22)	-	315K	311K	Still benign
	08:30	GDP (Q2 F)	3.6%	3.8%	4.0%	Slight downward revision
	10:00	New home sales (Aug)	830K	830K	870K	Stabilization near low since 2001
	10:40	Fed's Evans: Globalization				
	17:30	Fed's Mishkin: Domestic Prices				Has recently focused more on growth risks
Fri / Sep 28	08:30	Personal income, spending m/m (Aug)	0.4%, 0.4%	0.4%, 0.4%	0.5%, 0.4%	Spending stable at moderate pace
	08:30	PCE core deflator m/m, y/y (Aug)	0.2%, 1.9%	0.2%, 1.8%	0.1%, 1.9%	1.8% would be low since Feb'04
	09:45	Chicago PMI (Sep)	-	53.2	53.8	Stable at moderately expansionary pace
	10:00	Construction spending m/m (Aug)	-	0.0%	-0.4%	Trend remains up from Q2'06 trough
	10:00	U. Mich confidence (Sep F)	-	84.0	83.8	At lower end of range since 9/11
	10:00	NAPM – Milwaukee (Sep)	-	-	63.0	Robust after H1 slowdown
	10:00	Fed's Lockhart: economic outlook				Retails sales strength offsets softening jobs
	10:15	Fed's Yellen: behavioral economics				Has noted significant downward pressure
	13:00	Fed's Poole: central banking				Unconvinced recession lies ahead
	13:15	Fed's Mishkin: globalization and systemic risk				See economic risks – Fed will act as needed

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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