

U.S. Daily Directions: October 15, 2007, NY Edition

Today: The Empire Manufacturing Survey for October is expected to have slipped to 13.1, still within the range in place since mid'05, but a low since the weak period in Q2'07. After hours, Bernanke speaks in NY regarding the economy. The key data risks for the remainder of the week include the Beige Book, Philly Fed, industrial production, CPI, homebuilders' index, housing starts and building permits. The activity indicators (surveys, production, Beige Book) are more important currently because CPI will not be a worry if the economy sinks into recession, and lousy housing data is not news. Market risk emanates from financial company earnings reports and any potential fallout from Moody's CDO downgrades (e.g.: real money investors liquidating assets they discover no longer meet their investment mandate).

Overnight: Treasuries remained unchanged, although yields/curves globally moved higher/flatter. The financial market issues continue to evolve, although the markets seem content to focus on the positive – that the situation is moving forward, rather than the negative of the problems continuing to morph into new issues. Citigroup, BoA and JPMorgan Chase are close to reaching an agreement to establish a Master Liquidity Enhancement Conduit [MLEC] totaling \$75bn to buy other SIV's assets and preventing those other SIVs from having to unload assets at fire-sale prices. The fire sale could result from SIVs attempting to restructure as much as \$320bn because as commercial paper comes due, they will not be able to refinance due to investor concerns regarding subprime assets in the SIVs. The MLEC will not buy subprime assets. This process allows for an orderly restructuring of SIV assets in which subprime assets are finally isolated and quarantined. Around London's midday, Citigroup reported a Q3 57% drop in profits in the wake of \$6bn of fixed income losses, although the earnings per share of 47c did beat analysts' estimates of 44c.

Asset Commentary/Assessment:

Treasuries: Friday, yields spiked after the strong retail sales and overall PPI prints. The price action partially reversed later in the morning after the ABX indexes sold off in reaction to Moody's downgrade of \$33.4bn in subprime-related bonds. Later in the day, yields reversed again, rising along with firming equities. Throughout the day, the curve flattening trades dominated the price action.

MBS: Mortgages started off Friday tighter on better domestic based buying in 6's and overseas buying in 6.5's. 30yrs traded most of the morning ~3 to 4 tighter vs the treasury curve and ~1+ to 2 tighter vs 10 yr HRs. Continued light volume out of the originator community has helped keep the tightener alive in MBS over the last few trading days. The curve was crushed after the economic data and closed the session ~6bps flatter 2/10's. Despite the flatter curve, up-in-coupon managed to hang in and outperform by the end of the day. Post-3:00 MBS faded off their tights as swaps spreads widened and a rumored large seller hit the market bringing MBS 2 to 3/32nds off their tights. 30yr 5.5's closed the day ~1+ wider vs the 10yr and 6's unched.

Swaps: Despite the Libors dropping again Friday swap spreads reversed out and closed at the wides of the day. Spreads opened up and traded tighter for the bulk of the trading day. It was not until the bond market started to trade heavy in the afternoon off the back of some large paying in the belly of the yield curve. Once again the swap spread curve steepened as 2 yr spreads continue to see better receiving. The yield curve flattened today as the Treasury curve weighed on the swap curve and pressured the whole curve flatter. We continue to like the receive position but are cautious of rumblings in the ABX market, where more trouble may be brewing.

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