

U.S. Daily Directions: October 16, 2007, NY Edition

Today: Paulson speaks regarding the economic outlook as well as the housing and mortgage markets. The homebuilders' index for October is expected to decline to a record low of 19. Industrial production is expected to have risen 0.1% in September, the lowest rate of growth since May and consistent with a moderation in Q3.

Overnight: Treasuries have rallied and the curve steepened on rising anxiety on a broad range of issues. The Hang Sang index dropped 1.98% as a Chinese stock regulator warned of growing market risk and rumors circulated that the PBoC is planning a de facto tightening by draining excess liquidity from smaller financial institutions. The FX carry trade got hammered, with the yen gaining against all major currencies. And crude oil and gold traded to new records due to ongoing concerns regarding Turkey and Iraq. Bernanke used his speech to detail the recent events and repeat the Fed stance. This leaves the markets and Fed at the same uneasy stand-off as throughout most of the past year, with the Fed data-dependent and the markets pricing in easing (and effectively easing for the Fed).

Asset Commentary/Assessment:

Treasuries: Yields started out Monday rising due to the Empire Manufacturing report, but reversed course as the Citigroup news weighed on equities, and then stabilized along with equities. Our trading desks went long 2yr notes at 5.28% on the rationale that the market will vacillate regarding pricing in an October Fed ease. Currently, the market prices a 68% chance of the Fed holding steady at the October meeting.

MBS: Monday, mortgages couldn't maintain last week's momentum and followed swaps wider to the close. MBS opened up modestly tighter vs the curve, but lack of overseas demand, profit taking from \$ mgrs and >\$1bb in originator selling proved more than enough to push spreads wider vs the curve. Mortgages ended the day ~ 1 to 1+ wider vs the treasury curve and ~+ wider vs swaps. Servicer up-in-coupon trades helped 6's outperform the stack. The FN 6 fly now looks slightly rich, and our trading desk looks to establish shorts closer to 20/32nds around current dollars. Specified activity remains fairly robust with 10/20 and 40yr collateral pay-backs much tighter over the last month. Better CMO buying in the collateral today took out a fair amount of Gold 10/20 collateral and should leave a strong bid for production going forward.

Swaps: Spreads moved 1.5 bps wider in the long end yesterday, with 2s moving tighter by 0.75bps as the spread curve continues to steepen out. Paying interest came from speculation of reduced bank issuance after the announcement of the creation of a fund by 3 major banks that will ultimately support the ABCP market. This potentially would prevent the need for the banks to provide liquidity back-stops. Further deterioration in the ABX market also brought in paying interest.

Agencies: The callable trading session Monday started slowly as the early sell off in treasuries was accompanied by tighter oas spreads and lower vol. Many buyers were left watching as the market rebounded and finished the day close to opening levels. Secondary callables continue to provide the best outright value to customers with less restriction on what structures they can hold. Also, as we have been mentioning over the past few weeks, as FN and FMC continue not to issue less than one year locks, investors must seek such structures in the secondary market. Our favorite bond being the FN 5.55's of 5/12 offered at a slight premium to par, but providing more than enough yield pick up over new issue levels both on a ytc and a ytm basis. Regarding bullets, 2/3yr agencies remained firm as 5/10yr paper leaked 2-2.5bps wider on very light volume. Tomorrow FNMA will price 4 Billion 5yrs (price talk has moved to +46 are to 5yr notes) On the curve.

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