U.S. Daily Directions: October 17, 2007, NY Edition

Today: The key releases for Wednesday will be the Beige Book, housing starts/building permits and CPI. In the Beige Book, look for signs of spillover of the housing slowdown into the real economy and the assessment of financial markets. Both housing starts and building permits for September are expected to fall to new lows (1280K and 1285K, respectively), suggesting ongoing drag on GDP from residential investment. Core CPI for Sep is expected to remain steady at 2.1%y/y, consistent with core PCE in the upper reaches of the Fed's 1-2% comfort zone. The Fed's Hoenig speaks after hours regarding the economy and monetary policy.

Overnight: ABC consumer confidence held steady at -13, stabilizing after the August rout. In Asia, equities fell and Treasuries gained for two reasons. First, Japanese financial fell on concerns regarding the US subprime issue, and second, Indian equities fell after a regulator there proposed restrictions on investments favored by global hedge funds. The latter development caused further unwinding of currency carry trades.

Asset Commentary/Assessment:

Treasuries: Tuesday, yields steadied after falling in Europe, and then made new lows due to the fall in equities and the poor industrial production print before finally steadying. Our trading desk took advantage of the move to book profits on long positions in the 2yr and 5yr. The futures market has increased its view that the Fed will ease in October, from 32% yesterday to 38% this afternoon, and the Treasury market is likely to bounce around in a range as the market positions for the Oct 31 Fed decision.

Swaps: Spreads widened Tuesday 2bp to 64.8bp at the 2yr tenor but remained steady at 63.3bp at the 10yr tenor. Cynicism regarding the effectiveness of the Super-SIV proposed by Citi, JPMorgan and BoA, along with further losses for homebuilders and August TIC data that showed just how unhinged markets did (and can) become caused spreads along the curve to widen early in the session, but the 10yr spread retightened as yields fell while that for the 2yr continued to drift wider

Agencies: **Callables:** Secondary paper continues to shine, and is often 10 to 20 OAS wider than the new issue counterparts. Consequently, most new issues are relatively small in size. Agencies continue to experience solid demand overseas, as most accounts believe GSE debt will continue to richen verses current Libor levels. As vol has fallen over the last week, Bermuda calls in the secondary market look relatively more attractive, especially out the curve w/ good lockout. **Bullets:** Activity remained robust. FNMA priced a successful 5yr at +47.5 over 5yr notes & FHLB announced a new $3bn 10yr. The 10yr price talk is +47 to 10yr notes and is scheduled to price later in the week. The sector has cheapened substantially vs swaps over the last week (5-7bps in some issues). This deal should go very well, FHLB has not issued a 10yr since April, and the recent widening in swap spreads should entice overseas investors.

MBS: Mortgages widened out again, ending the day ~1 wider vs 10yr HRs and ~3 to 4 wider vs the curve. Supply weighed in quiet trading, as 2bb came out of originators. Asia remained quiet for a second day as rates failed to move higher to trigger their bogey levels. The uncertainty surrounding SIVs has put volatility back in play and should put pressure on MBS spreads for the time being. With uncertainty looming and supply concerns on the horizon we would rather be short than long MBS spreads, especially considering their outperformance last week. Discounts lagged the stack in today's treasury rally and curve steepener. Up-in-coupon remains a predominant theme in the market with specified collateral a way to leverage the slower prepayment story.

RATES STRATEGY | **RESEARCH**

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