U.S. Daily Directions: October 18, 2007, NY Edition

Today: Initial jobless claims are expected to remain benign, at 312K. The Philly Fed index for October is expected to fall from 10.9 to 7.0, the middle of the roughly zero to 13 range the index has plied since mid-'05. The Sep leading indicator is expected to have risen 0.3%m/m, partially rebounding from the 0.6% collapse in August; the trend in this indicator continues to show a troughing in the economy between H2'06 and Q1'07.

Overnight: Yields globally fell overnight, as the gloom of international credit concerns and potential Turkish military action weighed. The Fed's Hoenig expressed optimism regarding the US economy, specifically citing ongoing job and consumer spending growth as well the positive effect on exports of the weak dollar. However, he also expressed alertness regarding the risks posed by the housing slump.

Asset Commentary/Assessment:

Treasuries: Yields rallied at the very beginning of the session on the JPMorgan earnings report, but then cratered under the deluge of yield-negative news noted above. Late in the session, yields rebounded weakly along with equities. Yields are now testing the lows from late-Sep / early-Oct. The futures market rallied sharply, and now places the odds of an Oct 31 cut at 56%. Further deterioration could cause Treasury yields to test the August lows – and the Fed to ease in October.

Swaps: Spreads widened, particularly at the short end, with the 10yr spread widening 0.5bp but the 2yr spread widening 3.7bp. The 10yr spread has exhibited a relatively controlled grind higher in the past few sessions to close at the highest level (63.7bp) since September. In contrast, while the 2yr spread has spiked (closing at 66.63bp), it remains below the Oct high (72.63bp). Further deterioration in financial conditions will likely add to the widening move.

MBS: Mortgages moved wider after lower than expected housing starts led a flight to quality in rates. The uptick in vol, real and fast money selling of 5.5's in the morning, and credit concerns overtaking the market again all put pressure on the basis. MBS traded ~ 2 to 3 wider vs 10yr HRs, ~4/32 wider vs the steeper treasury yield curve and ~2+ wider vs swaps for most of the trading day. .By the afternoon MBS made a small comeback tightening in to only 1 wider vs 10yrs and ~3 wider vs the curve. Better buying in 5.5's from money managers helped bring spreads in post 3:00. Asia is still out of the market and they will need to re-evaluate as expectations of 4.80 10yrs are now a distant memory. With more uncertainty in the markets, vol headed higher and supply looming around the corner its hard to like in MBS in here. We continue to remain slightly negative on the basis but participating in MBS through up in coupon trades. Despite the steeper curve 15/30yrs have not found sponsorship and continue to lag the curve and vol.

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