

## U.S. Daily Directions: October 22, 2007, NY Edition

**Monday:** Monday holds no data risk. The Fed's Evans (voter) will speak after hours regarding the economic outlook. Evans heads the Chicago Fed, which dissented from the decision to cut the discount rate 50bp on Sep 18, arguing instead for a 25bp cut. Data during the remainder of the week include the Richmond Fed manufacturing index (expected to moderate back to the middle of its range since 2004), durable goods orders (expected to rebound), new and existing homes sales (expected to plummet further), and consumer confidence (expected to hold steady at a moderate pace). Fed speak, other than Evans', will include Mishkin speaking regarding financial instability.

**Overnight:** The G7 finance ministers and central bankers opined that fallout from the US housing slump would sap global economic growth. Additionally, the statement ratcheted up pressure for the yuan to appreciate. Consequently, global equity markets fell sharply, global bond markets rallied, and the FX carry trade unwound. The Fed's Mishkin noted that despite the potential for rising energy and food prices to unhinge inflation expectations, core inflation appeared controlled. He also indicated that a stabilization of energy prices, even at high levels, would reduce inflationary pressure. Cutting against a completely benign view of inflation is that economists expect that China's economy surged 11.5% in Q3.

### Asset Commentary/Assessment:

**Treasuries:** Overnight, yields continued to fall in line with equities. The 2yr yield has now broken below the Aug low, and the 10yr has broken below 76.4% support, and the futures market now prices in a 92% chance of a Fed ease at the Oct meeting and a 98.4% of at least 25bp of easing (73.6% chance of 50bp easing) by yearend.

**Swaps:** Spreads started the session tighter, but widened as equities header lower from their open. Interestingly the widening is occurring out the curve. As a sign of the choppy trading, this morning the 10 year note traded right around the 3:30pm levels with the convexity grab, and 10 year swap spreads were in at 63.25. Spreads are now 1.5 wider from those levels with the last trade in tens 64.75.

**MBS:** Friday, mortgages finally gave up to the rally in the treasury market. For most of the morning, mortgages kept up in spread to slightly tighter vs rates. However, after what seemed like round 3 of a global credit meltdown that brought stocks down -360pts in the afternoon on the anniversary of Black Monday, the convexity bid for mortgage duration turned over to fast and real money selling of the MBS basis. 30yr mortgages ended the day ~8/32nds wider vs the curve and ~5 wider vs 10yr HRs. Mortgages had room to give as the last couple rounds of convexity buying left MBS looking rich vs the curve and in terms of LOAS. Mortgages look less likely to follow rates lower if we continue to rally and a sell-off may bring about a round of originator selling. We are short term negative on the basis in here and would look to sell strength if it arises. One thing to note is rolls have moved higher, duration adjusted, and are now implying another FED ease with roll implied CPRs for 5.5's and 6's close to ~4.60%. Could be a short term sell as despite an ease on the horizon, it would more than likely occur as a result of tighter lending environments and balance sheet constraints.

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