

October 19, 2007

# U.S. Directions

## Fixed Income Strategy

### Keys next week

- \* Durable goods, Richmond mfg index
- \* New, existing home sales
- \* Consumer confidence

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Buy UST 4.125% Aug 2012 vs UST 5% May 2037

Buy Dwarf 5% 15s vs FNMA 5.5% 30s

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New issue 5nc2 Berm semi-annual structure

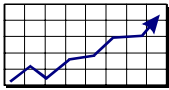
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Sector	View	Specific Comments
Notes/bond yields	Neutral to positive	The 2yr yield has failed at 4.20% resistance and collapsed to 3.80%, testing the Aug low. The 10yr yield failed at 4.70% and has retraced sharply to almost exactly a 76.4% Fibonacci level (4.3960%). Holds of these levels would indicate potential for short-term rebounds.
Curve	Neutral	Our 5s30s steepener gained sharply with the deterioration in market sentiment during the week. At 65bp, it has retraced 76.4% of its range since late-Aug. The 2s10s curve has similarly steepened, as at 58bp, it has recovered 76.4% of its flattening from late-Sep. Failure to steepen further suggests short-term downside.
Swap spreads	Receive on widening	“Tape bombs” and market reaction will drive spreads. Decline in Libor makes significant, sustained widening unlikely.
Agencies	Buy new issue 5nc2 Berm semi-annual	This structure has moved from 4bp rich to 3bp cheap relative to fair value in the past week, and the risk is for it to outperform.
Mortgages	Up in coupon	On page 6, we show how to enhance the up-in-coupon trade by using premium coupons.



## Trade Recommendations

Note all costs of carry are calculated over 3-months at inception unless otherwise stated

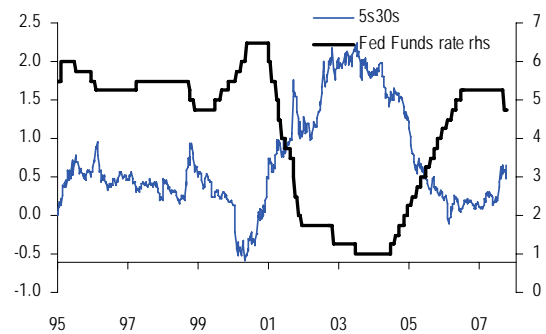
Profit/losses are calculated relative to the last edition of U.S. Directions

Trades priced at noon EST

### Buy 5-yr UST 4.125% Aug 2012 vs. 30-yr UST 5% May 2037

Entry (13 Sep 07)	Current (19 Oct-07)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
57bp	65bp	80bp	45bp	-1bp/3mo	+14bp	+8bp

We entered a 5s30s steepener at 57bp with a target of 80bp and a stop-loss of 45bp. In 1995, 1998 and 2001, curve steepening was accompanied by steepening of the 5s30s curve. Further steepening will occur due to concerns about inflation, especially in light of the recent Fed easing, and also due to expectations of Fed easing.

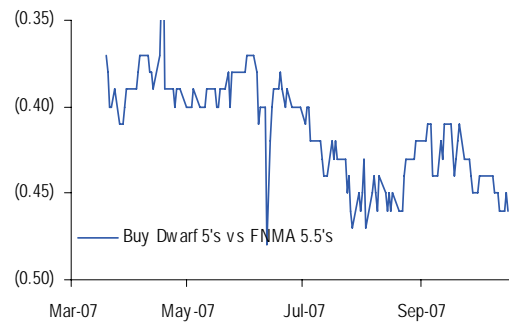


Source: RBC Capital Markets, Inc.

### Buy Dwarf 5% versus FNMA 5.5% 30yrs

Entry (28 Sep 07)	Current (19 Oct-07)	Target	Stop-loss	Carry	Weekly P&L	Cumulative P&L
N/A	N/A	N/A	N/A	N/A	-\$175,000	-\$75,000

We entered a position to buy Dwarf 5%'s versus FNMA 5.5%'s on a duration-weighted basis. The position expresses a short basis and curve steepening bias that should benefit from rising anxiety regarding the financial market and economic outlooks. The trade performed poorly this week due to convexity buying, but the fundamental view holds.



Source: RBC Capital Markets, Inc.

## Of SIVs and CDOs – Why we should worry

TJ Marta

### The MLEC Super-SIV – Not all it’s cracked up to be

The week started out on a positive note, with news that Citigroup, Bank of America and JPMorgan Chase had entered into an agreement to establish a Master Liquidity Enhancement Conduit (MLEC). The details regarding this arrangement remain tentative, but they do suggest a coordinated attempt to deal with the SIV problem. That problem is that SIVs are only partially backed by banks and, therefore, have come under severe pressure to liquidate assets as a result of investor aversion to SIV senior debt. This aversion stems from the depressed prices of the SIVs’ collateral; the SIV universe has recently declined from approximately \$400bn to \$320bn. The MLEC would act as a liquidity provider by allowing SIVs to exchange maturing notes for notes still collateralized by the SIV, but now also fully backed by the MLEC’s liquidity support. Proponents hope that this liquidity backstop, which is foreseen as totaling \$100bn, will forestall another round of collapsing asset prices as CP comes due for refinance. Additionally, the support for the SIV asset prices could help mitigate losses banks and CP investors eventually realize. There are downsides to the proposed MLEC. Free market critics decry the agreement as a bailout of banks, particularly Citigroup, which ran approximately 25% of the SIV volume. Additionally, many perceive the plan as simply a way to delay the final day of reckoning for banks and CP investors. Perhaps the most immediate concern is that the myriad details to implement this structure are far from ironed out and so another couple months could easily pass with a non-functioning market. This means that during November, when another large round of SIV refinancing comes due, financial markets could experience another round of financial dislocation. Indeed, on Thursday, a bank circulated notice of a public sale of \$2.8bn of assets thought to be from a SIV. The bidding for the assets is to be accepted during a 4-day period beginning Oct 29.

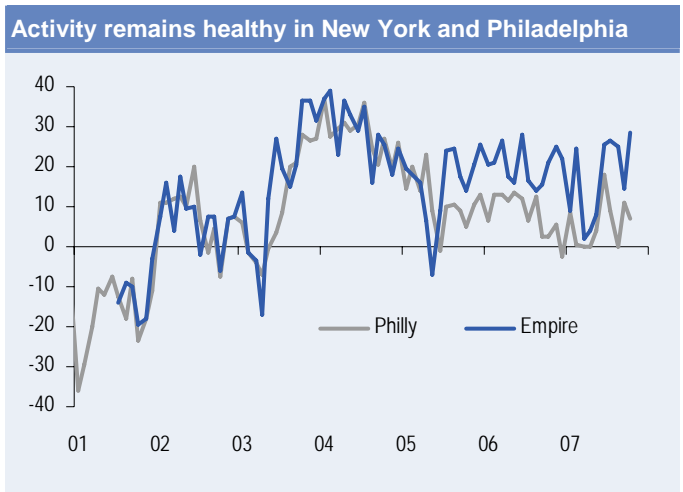
### CDO downgrades coming

S&P downgraded 1713 classes of RMBS backed by 1<sup>st</sup>-lien subprime

mortgage loans, 1<sup>st</sup>-lien Alt-A mortgage loans, and 2<sup>nd</sup>-lien mortgage loans issued in the first six months of 2007. 39 AAA-rated securities were downgraded. The original par value of the downgraded securities was \$23.35bn. The market has likely already discounted the downgrades due to the massive sell-off in asset prices since July. However, the downgrades could now force CDO’s to sell assets or suffer downgrading themselves. To the extent CDO’s get downgraded, real money investors could be forced to sell those assets, leading to further price declines.

### Fed remains more uncertain than does market

While the fixed income market has hunkered down once again into capital preservation mode and priced in a 92% chance of a FOMC ease Oct 31, the Fed appears less certain regarding the outlook. The Beige Book documented the moderation of growth in the economy most economists expect during Q4. The report noted the depth of the housing weakness and the expected ongoing drag from it. This observation was corroborated by data during the week. The homebuilders’ index for October fell more than expected, from 20 to 18 (consensus 19), a new record low, and although the outlook for future sales held steady at 26, the traffic index fell to 15, a new record low. Housing starts plummeted to 1191K, a low since 1992. But, as the Beige Book noted, the effect on the overall economy continues to appear limited. The Empire manufacturing survey surprised the market, unexpectedly rising (28.8, consensus 13.1, prior 14.7) to its highest level since July’04. The Philly Fed index dropped to 6.8, about the middle of the 0-13 range since mid-’05. The leading indicators for Sep rebounded 0.3%/m after the 0.8% collapse in August, and the trend continues to suggest a stabilization, and perhaps even recovery, from H2’06. Jobless claims did rise more than expected, but at 337K, they remain historically muted. At this stage, an October ease will likely emanate from another round of financial dislocation in financial markets rather than fundamental economic data.



Sources: Philadelphia and New York Feds



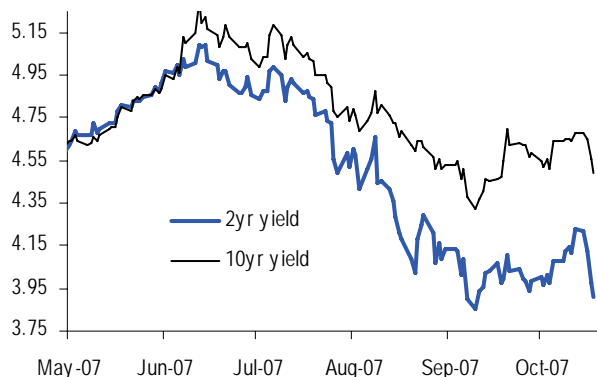
Sources: Bloomberg

## Treasuries: Pricing for doom and gloom

TJ Marta

**The week behind. Yields collapse / curve steepens.** On Monday, yields reached their highest since August Monday as the market seemed comfortable with the notion that they were finally seeing the “bodies” (earnings write-downs) and that the situation was not so dire as feared. Additionally, major US banks had reached an agreement to provide liquidity to the ailing SIV market. From a fundamental perspective, the Empire Survey surprised to the upside, rising to a 3-yr high. However, the market psychology shifted suddenly to an extremely negative outlook, causing yields to collapse violently. Concerns regarding the credit environment, geopolitics and the economy mounted. Perceptions of the MLEC (“super SIV”) fell from the initial hope that it would provide a panacea to suspicions it represented only a bank bailout or just prolonging the final day of reckoning. Late in the week, one bank issued a notice of public sale of assets and a SIV announced it might not be able to repay debt. Several banks reported disappointing earnings, and equities sagged. The US dollar fell to new lows, allowing oil to surge to a new record high above \$90/bl. Part of the surge in oil derived from the motion by Turkey’s parliament to approve military action in Iraq. The US economic fundamental data also turned negative, with industrial production, the homebuilders’ index, housing starts, building permits, initial jobless claims, leading indicators, and Philly Fed all surprising on the downside. Yields and the curve are ending the week testing significant technical levels. The 2yr yield, at 3.80% is testing the Aug low, while the 10yr yield, at 4.40%, is testing the 76.4% retracement level (4.396%) of the rise from the Aug low. The 2s10s and 5s30s curves, at 58 and 64bp, respectively, are both testing 76.4% retracements of recent highs.

Yields collapse, curve steepens



Source: Bloomberg

**The week ahead. Little data to confirm/soothe worries.** From a data perspective, the upcoming week will provide little for markets to consider before the following week’s FOMC meeting. Existing and new home sales for Sep are expected to have dropped, reinforcing the already dismal housing outlook. The Richmond Fed survey, reported Tuesday, is expected to retrace back into the middle of its range since 2002. Sep durable goods are expected to have partially rebounded from hard drops in Aug. FedSpeak includes Mishkin, Kroszner, and Evans. Trading during the week will derive from SIV headlines and technical analysis, with the above mentioned levels acting as inflection points.

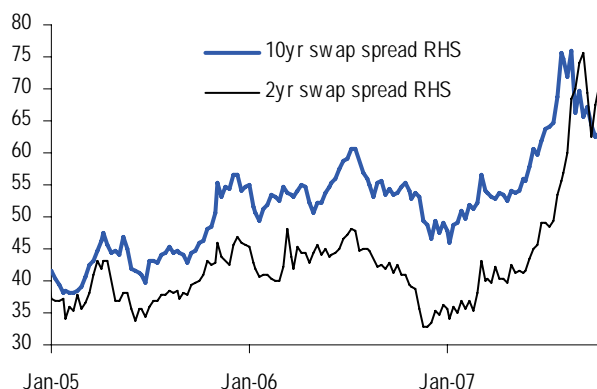
## Swap Spreads – Tail of two spreads

TJ Marta

**Week behind: Short spread wider on rising anxiety.** The 2-yr spread widened, recovering almost all of the prior week’s tightening, as fears about SIV’s, conduits, sub-prime, bank earnings and investors’ performances all resurfaced. One key difference from August is that Libor fell (1-month yield down 11bp), whereas during August, the yield spiked by 50bp. In contrast, the 10yr spread remained range bound in a 1.5bp range, held in check partly by mortgage-related receiving.

**Week ahead: Headline risks, receive on widening.** “Tape bombs” and market reaction could cause volatility during the next week. However, with Libor falling, significant, sustained widening is unlikely, and so we would look to receive in the event of any widening.

Short-end wider / spread curve flatter

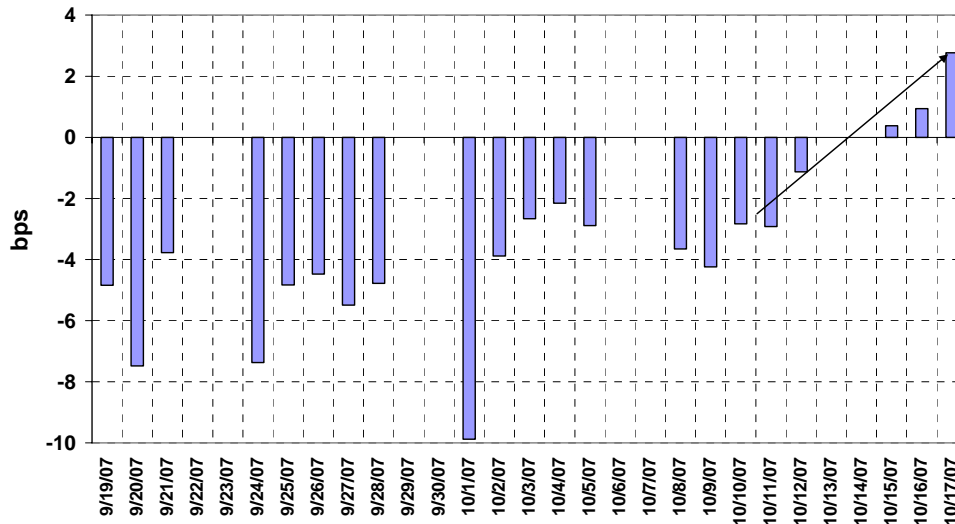


Source: Bloomberg

## Agencies: New Issue 5nc2 Berm semi-annual structure

Kirill Krylov

**5nc2 Berm New Issue Callable Agency Spreads To 5-year  
Treasury: Actual vs. "Creation" Model**  
(spreads as a function of slope of the curve, level of rates and volatility)



- ❖ The graph illustrates the difference between the actual spread on the 5nc2 Berm new issue callable structures and the model-predicted level of spreads. The model runs a regression of the historical time series of spreads vs. the level of rates, volatility and the shape of the curve.
- ❖ During the last week the actual spread flipped from 4 bps rich to the model to 3 bps cheap. (from 76 to 84).
- ❖ According to our relative value model, 5nc2 Berm new issue is one of the only 5 structures that can be currently printed cheap to the "creation" model.
- ❖ RBC CM printed a 5nc2 Berm with a semi-annual call @ 84 bps / 5yr, with OAD 3.13, OAC -0.52
- ❖ YTC pick to bullets 61 bps, YTM pick to 33 bps; yield pick to a bullet with the same duration +45 bps.

## Mortgage-backed securities: Up-in-coupon with 30yr 10/20 IO 6.5%

Kirill Krylov

The up-in-coupon strategy has been exploited by a large segment of MBS investors. Fundamentally, this strategy still works as higher coupons tend to have lower FICO scores and higher % of credit-constrained borrowers, while most prepayment models do not fully factor in the impact of the recent tightening in lending standards. However, we see this trade getting too crowded and believe that it should be modified to reflect unique characteristics of premium coupons.

The 10/20 IO segment is expected to prepay on average ~1.3 times faster than TBA 6.5%. While this trade looks compelling “as is”, we expect a greater OAS compensation for “non-deliverability” of the 10/20 IO sector. In the last 18 months 10/20 IO speeds have proved considerably slower than those of TBA 6.5%. The average (adjusted for extreme values) prepayment speed multiplier for 2007 is ~75% - nowhere near the projected multiplier of 130% implied by the YB prepayment model. If one assumes that speed ratios seen during the last 6 months persist, the expected life speed for 10/20 IO 6.5% pools should be in the ~14-17 CPR range, equating to ~approximately 55% of the YB prepayment model. Consequently, the swap looks more attractive:

- ❖ 41 bps pick in yield
- ❖ 28 bps pick in LOAS
- ❖ ~30% improvement in convexity

Even after the adjustment to slow 10/20 IO speeds the speeds appear very conservative. The last 6 months new production 10/20 IO 6.5% pools have been printing @ 8-11 CPR range, while @ 55% of the YB model, the 1mo projected speed is 25 CPR and 3-month CPR is 24. Given the recent tightening in lending standard, we see no reason for a doubling in the recent speeds.

As investors are selecting an appropriate 10/20 IO candidate, we suggest focusing on pools with added protection. We love Geo story in 10/20 IO pools as investors typically are not charged for GEO composition that has experienced a negative HPA. For our analysis, we employed Geo concentration in CA and FL. An up-in-coupon trade employing the above considerations, we obtain the following attributes:

- ❖ 25 bps pick in yield
- ❖ 24 bps pick in LOAS
- ❖ ~20% improvement in convexity

Exhibit 2: Coupon Distribution (Par in MM) for 10 / 20 Interest Only 30-year MBS

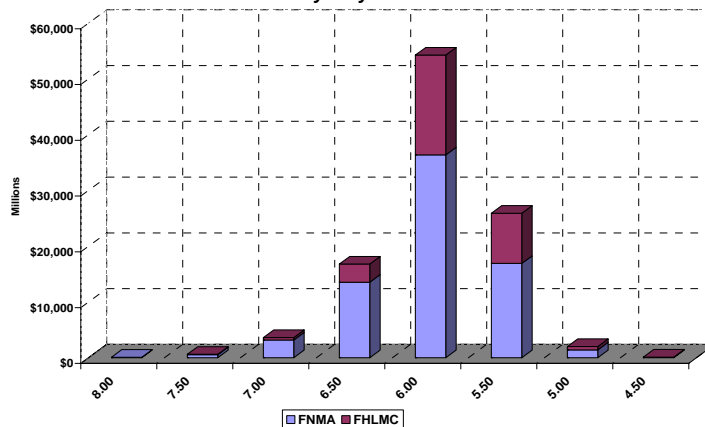
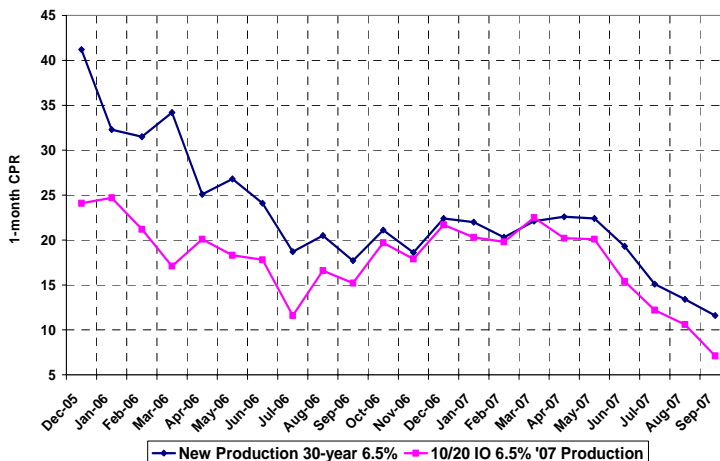


Exhibit 4: Historical CPR: 10/20 IO 6.5% New Production Vs. New Production 6.5%



## Key Data Risks Next Week

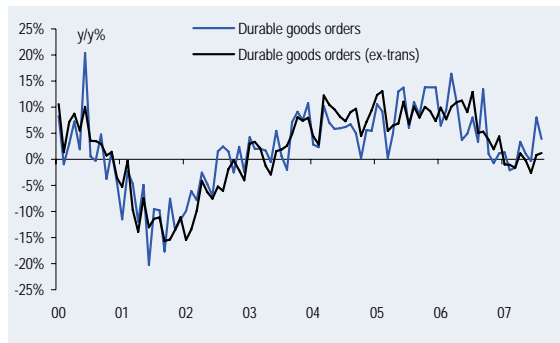
Paul Ferley (RBC Financial Group) and TJ Marta

### US Durable Goods Orders / Durable Goods Orders (ex-trans)

<b>Period:</b>	<b>Thu, Oct 25</b>	<b>RBC:</b>	<b>Consensus:</b>	<b>Previous:</b>
Sep	08:30EDT/13:30BST	2.0%/	1.5%/0.7%	-4.9%/-1.8%

**Comment:** Durable goods orders likely advanced 2.0% in September, fueled by a gain in transportation sector orders, in-line with an increase in orders at Boeing. Excluding the transportation sector, a much more subdued gain is likely, in-line with a drop in the new orders index in the ISM survey. After surging in the second quarter, both non-defense capital goods, core orders and core shipments were both substantially weaker over the July/August period pointing to slowing M&E spending in Q3. We anticipate that M&E spending will be relatively soft in the second half of the year reflecting tighter credit conditions.

**Market Impact:** Moderate. A volatile number, ex-trans surprises of 1.2ppt or more are associated significantly with price action. An upside surprise would be consistent with the Fed on hold in October and cause the curve to bear flatten, while a downside surprise might lead to bull steepening on the view that Fed easing is more imminent.



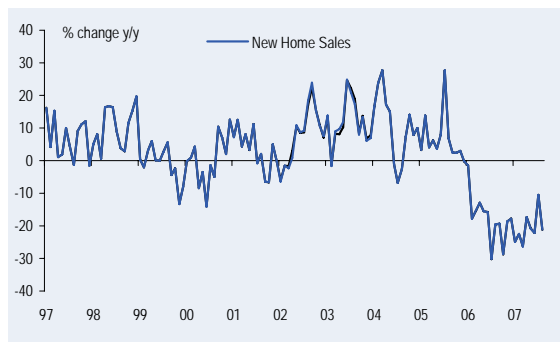
Source: Bloomberg

### US New Home Sales

<b>Period:</b>	<b>Thu, Oct 25</b>	<b>RBC:</b>	<b>Consensus:</b>	<b>Previous:</b>
Sep	10:00EDT/15:00BST	765K	775K	795K

**Comment:** New home sales likely fell 3.8% to an annualized 765K units in September, in-line with a drop in the current sales component of the NAHB housing market index. A 1.9% decline in the MBA purchase applications index also argues for a drop. In August, sales fell an outsized 8.3%, partly reflecting the effects of the credit crunch and we expect the crunch to have weighed on sales in September as well. Over the July-September period, sales were likely an annualized 24.4% below their Q2 average and 43% percent below their July 2005 peak. In Q2, sales increased, on average, for the first time in seven quarters. However, the onset of the credit tightening has led to a renewed downward trend in new home sales. Inventories in the sector remain highly elevated relative to the pace of sales, as evidenced by the months' supply measure currently sitting at 8.2 months. With an elevated level of inventories, prices are likely to fall further going forward. In August prices were down 7.5% on a year-over-year basis.

**Market Impact:** Moderate. A worse-than-expected deterioration would cause a further downgrade of the outlook for housing and cause the market to price in more Fed easing. A better-than-expected report, even a rise, is unlikely to cause a sea-change in the market's perception about poor state of the housing market.



Source: Bloomberg

## Data / Event Risk Calendar

Day/date	Time (EDT)	Release/Event	RBC	Market	Prior	Comment
Mon / Oct 22	08:15	Fed's Kroszner: financial markets				
	19:00	Fed's Evans: economic outlook				
Tue / Oct 23	10:00	Richmond Fed mfg index (Oct)	-	-	14	In upper end of range since 2004
	17:00	ABC consumer confidence (Oct 21)	-	-	-13	Stable after August crash
Wed / Oct 24	07:00	MBA mortgage applications (Oct 19)	-	-	0.7%	Application growth rising after slow summer
	10:00	Existing home sales (Sep)	5.15mm	5.29mm	5.50mm	Low since 2001.
	16:15	Fed's Mishkin: financial instability				
Thu / Oct 25	08:30	Initial jobless claims (Oct 20)	-	-	337K	Market fears beginning of uptrend
	08:30	Dur goods orders tot, ex-trans(Sep)	2.0%, -	1.5%, 0.7%	-4.9%, -1.8%	Q3 looks to show rebound
	09:00	Fed's consumer advisory council: mortgage rules				
	10:00	New home sales (Sep)	765K	775K	795K	Low since 1997.
Fri / Oct 26	10:00	U. Mich. confidence (Oct F)	-	82.3	82.0	Near the lows of range since 2001.

## Economic and Financial Market Forecasts

	Quarterly												Annual		
	Q106	Q206	Q306	Q406	Q107	Q207	Q307	Q407	Q108	Q208	Q308	Q408	2006	2007	2008
Real GDP q/q saar	5.6	2.6	2.0	2.5	0.6	3.8	2.9	2.0	2.3	2.6	2.8	2.9	2.0	2.0	2.6
Consumer Prices y/y	3.7	4.0	3.4	1.9	2.4	2.7	2.3	3.6	3.3	2.4	2.5	2.7	2.8	2.8	2.7
Core CPI y/y	2.1	2.4	2.8	2.7	2.6	2.3	2.1	2.1	2.1	2.2	2.3	2.4	2.3	2.3	2.2
Fed Funds Rate (e.o.p.)	4.75	5.25	5.25	5.25	5.25	5.25	4.75	4.50	4.50	4.50	4.50	5.00	4.50	4.50	5.00
2-year yields (e.o.p.)	4.82	5.15	4.68	4.82	4.60	4.93	3.94	4.15	4.25	4.55	5.10	5.25	4.15	4.15	5.10
10-year yields (e.o.p.)	5.85	5.14	4.63	4.72	4.65	5.03	4.53	4.65	4.75	4.95	5.25	5.35	4.65	4.65	5.35

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