U.S. Daily Directions: October 23, 2007, NY Edition

Tuesday: The Richmond Fed manufacturing index is expected to moderate from 14, among the series' highs, to 8, in the middle of the range since mid-'04. Paulson will speak regarding the developing economic ties between China and the US.

Overnight: **The world's ok – today.** Overnight, stocks rallied, bonds fell, and the FX carry trade came back in style, but the Fed's Evans fretted about the markets' temper tantrum last week. Equities rose on better-than-expected earnings in for not only Apple in the US, but also Schneider, and China Mobile. Bonds generally fell, partly on equity gains, partly on falling corporate bond risk (as measured by credit-default swaps), and partly on concern regarding inflation in the Euro area. In FX, the investors ploughed back into the carry trade, with the USD and JPY lagging the other major currencies. The Fed's Evans made no protest against the 25bp cut priced in by the market for the Oct31 cut. He spoke in the paradigm of risk management, citing the need to protect against the high cost/ low probability of the risks from housing on the slowdown and the need to entertain the uncertainties in financial market conditions. Despite the cheery tone overnight, rumors that Merrill might announce worse-than-expected losses continue to lurk in the background, and such a report could send markets back into a tailspin.

Asset Commentary/Assessment:

Eurodollars: After pricing in as much as a 98% of an Oct31 ease last Friday, the market reduced the bet to as low as 78% today before settling at an 86% chance. Additionally, futures price in by yearend a 70% chance of an ease to 4.25%. As to the October meeting, given the obvious and significant skew of the market and the Fed's attempt to remain transparent and avoid surprising, or punishing, the market, failure of Fed rhetoric to guide the market away from its current pricing suggests increasing risk of the Fed easing next week.

Treasuries: With no new data the market was left to follow stocks. There was some good selling in 2yr on the open at 3.75%. 5yr was able to give up 5 bpts on 2yr/5yr/30yr butterfly. Auction concessions loom large for the 5yr Tip tomorrow, 2yr on Wednesday and 5yr on Thursday. The 5yr should continue to cheapen further in front of supply. Today's supply announcement had 20 bil 2yr(2 bil more than expected) and 13bil 5yr.

Swaps: In fairly quiet trading, spreads tightened, particularly closer in the curve. The move derives from the continued decline in Libor as well as receiving price action on any widening. The 10yr spread remains range-bound. We remain cautious at this juncture: respect the short-term ranges and continue to capitalize on opportunities to receive intraday on any widening due to "tape bombs".

MBS: MBS started the day tightening along with swap spreads. 5.5s tightened more than 6s, as the 2s10s flattened during the morning. By mid-day, MBS hovered at the tights on strong direction (tightening) bias from investors. The down-in-coupon, with 5.5s constituting the largest share of both originator supply and buying. Into mid-afternoon, MBS held in against Treasuries, with 5.5s and 6s ~2 – 3 tighter vs the curve. Discounts were continuing to lead the stack, although 5s began to show some signs of weakness as the roll started to fade slightly.

T.J. Marta
+1.212.858.6077
Tj.marta@rbccm.com

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