

U.S. Daily Directions: October 30, 2007, NY Edition

- Today:** Greg Ip published a WSJ article (page A2) arguing the Fed cut "isn't a sure thing", echoing a similarly-themed Beckner article last week. We believe the downside risks to the economy, fragile financial markets and market expectations will lead the Fed to ease 25bp. The S&P/Case Shiller house price index for 20 metropolitan areas is expected to have fallen 4.2%/y in August, which highlights the potential for consumer retrenchment due to declining borrowing potential and a negative wealth effect. Consumer confidence (Conference Board measure) is expected to have declined further in August from 99.8 to 99.0, a new low since the aftermath of Hurricane Katrina. UBS will formally announce earnings. The company has already confirmed that its Q3 loss will register approximately US\$516-688mm and warned that Q4 results could deteriorate from the initial positive readings.
- Overnight:** UBS announced an as-expected loss of \$711mm for Q3 due to the write downs associated with the US mortgage market. Worse, it suggested that it also post a loss in Q4. Equities generally fell overnight on poor earnings reports. Despite falling equities, bond yields generally rose. European yields received help from the German unemployment report (-40K, consensus -30K). Gold and oil have both corrected from yesterday's highs, while the US dollar managed to gain against most major currencies.

Asset Commentary/Assessment:

- Eurodollars:** Futures yields rose 1-4bp in the '08 and '09 contracts. The contract strip implies an expectation that the Fed Funds rate might fall to 4.00-4.25% in H2'08. The amount of easing priced for Oct 31 moderated: 98% of a 25bp ease and a 2% chance of no change. We believe the Fed cuts 25bp this week.
- Treasuries:** Overnight, yields rose and the curve flattened in the aftermath of the Ip article. Yesterday, yields started the session higher, but then turned and fell steadily through most of the session. The 2yr yield ended 1.6bp higher, while the 10yr yield closed down 2.5bp. The curve flattened, with the 2s10s falling 4bp and the 5s30s falling 3bp. Both curves are failing near recent highs, likely as traders book profit ahead of the FOMC, and reinforcing ranges in place since August.
- Swaps:** The paying that resulted from ABX selling on Friday unwound itself Monday as spreads tightened in about 1.25bps across the curve. The ABX market continued to trade heavy, but with equities and credit generally trading well, receivers were around in anticipation of issuance. Activity was light and unwinding of well-populated steepening trades ahead of the Fed and economic data pushed the curve flatter by over 5bps between 2s/30s. Libors continue to drop more than anticipated and should keep a lid on front-end spreads. At one point today 2s10s spread of spreads approached zero but the steepening trade has been well advertised and as a result pushed down to end the day at -1.75. Our trading desk believes this position offers short-term value closer to -4.
- MBS:** Yesterday, the basis tightened as Treasuries rallied. 30yr 5.5's and 6's moved ~3+ tighter to 10yrs and 4+ tighter vs the curve. Demand continued for up-in-coupon trades in both 15yr and 30yrs as accounts look for longer-term gains on these positions. Specified activity was relatively muted, with few bid lists and some interest in lower loan balance premiums.

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