U.S. Daily Directions: November 2, 2007, NY Edition

Today: **Non-farms.** Non-farms are expected to have risen 84K in October, although the strong ADP report (106K) suggests upside risk. Average hourly earnings are expected to have risen 0.3%m/m, leaving the trend (12mma) at a robust 0.34%. The unemployment rate is expected to have remained stable at 4.7%. Factory orders for September are expected to have fallen 0.7%m/m.

Overnight: **Global markets follow yesterday's US panic.** Bond yields generally fell and equities, particularly in Asia, fell on renewed credit crisis concerns. Part of the fear has been spurred by a WSJ article reporting that Merrill Lynch and other banks might have entered into agreements with hedge funds that allowed the banks to delay recognizing mortgage-related losses. The stock price of Barclays fell as much as 8.2% on speculation that the company had approached the BoE for emergency funding. The US dollar has resumed its decline, losing against all but the yen overnight.

Asset Commentary/Assessment:

Eurodollars: Overnight, yields continued to slip, falling 2bp along most of the curve. Yesterday, yields collapsed as much as 12-15bp in the '08 and longer-term contracts. The strip now suggests a trough in the Fed Funds rate of 4.00% in H2'08. Despite Wednesday's FOMC statement, the market prices the odds for a 25bp ease in Dec at 60%.

Treasuries: Overnight, the 2yr yield dropped another 2bp, allowing the 2s10s curve to steepen another 2bp to 61bp. Thursday, yields tanked from the open through the ISM before stabilizing. The 2yr yield collapsed 18.9bp, and the 10yr yield collapsed 12.5bp. The yield charts for both posted key day down reversals, soundly rejecting the spike in yields after the FOMC statement Wednesday. A strong payrolls report would help yields hold above recent lows (3.69% 2yr, 4.30% 10yr), although mounting financial market problems should allow for an eventual breach to new lows. The 2s10s curve steepened 6bp, while the 5s30s curve steepened 4bp, and the mounting financial market problems should allow for further steepening.

Swaps: Overnight, the 2yr spread has tightened slightly (0.5bp), while the rests of the curve leaked wider. Yesterday, spreads blew out with the 2yr spread widening 4.9bp to 68.5bp, a high since Oct25. Downtrend technical resistance from the Oct high lies at 69.39bp. The 10yr spread widened 1.8bp to 65.5, a high since Oct22. 65.56bp has marked the top of the 10yr spread range since late-Sep.

MBS: Mortgages lagged the curve in Thursday's flight to quality. MBS started the morning ~1/32 weaker to the curve and slightly tighter to 10yrs, however progressed wider as the market continued to rally into the afternoon. Convexity buyers were largely absent with some down in coupon flows, however the street and money managers appetite for up in coupon and the ~5.5bps steeper yield curve led premiums to outperform the stack. Mortgages closed the day ~3+ wider to 10yrs HRs, ~5+ wider vs the treasury curve and 3+ wider vs the swap curve. There are still major issues lurking behind the curtains at many financial institutions and volatility in the market will continue to be in play into 08. The market uncertainty will keep MBS harder to hedge and with balance sheet issues making their way back into the market, illustrated by today's drop in the dollar roll market and spike in Libor, mortgages look less attractive from a carry standpoint. Mortgages are wide on a nominal spread basis but not necessarily attractive enough to step in at current valuations and considering the market outlook (funding, vol, etc). We maintain a negative bias on the basis and would continue to ride the up in coupon trade.

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