

U.S. Daily Directions: November 16, 2007, NY Edition

Today: **Industrial production.** Economists expect that Oct industrial production rose a modest 0.1% m/m, which would cause the capacity utilization rate to slip to a still reasonably tight 82.0. TIC flows are also reported. Fed speak includes Kroszner speaking about the economic outlook (he has been fairly candid about the poor state of the subprime market) and Lockhart talking about the Southeast economy.

Overnight: **Gloomy mood continues.** Non-US equities and yields generally fell as yesterday's US tape bombs reverberated. Financial equities led the way, with Belgian bank Dexia reporting disappointing earnings and Mizuho pacing the retreat in Asian equities. Credit default swaps on European corporate debt spiked to a three month high. The BoJ's Muto warned the financial strife could hurt Japan's economy.

Asset Commentary/Assessment:

Eurodollars: **Yields slightly changed/mixed.** The strip suggests a trough in the Fed Funds rate below 3.75% in H2'08. The futures market prices in the chance for a 25bp ease in Dec at 94% and the odds of a move to 4% or lower by Mar'08 at 87%.

Treasuries: **Yields slightly higher overnight.** Yesterday, after a brief rebound in the morning, yields fell sharply on a flood of negative news regarding the health of financial firms. The 2yr yield closed below not only the Friday low of 3.384% but also technical resistance from the Jun'05 low (3.41%) and the pre-9/11 low (3.443%). Technical support now lies at 3.29-30%, highs in Nov and Dec '01. The 10-yr yield fell below the 4.20% level that had been under pressure since Friday. Our 5s30s steepener (established at 84bp, 130bp target, 65bp stop-loss) spiked to 85.28bp.

Swaps: **Yesterday, the market traded violently** as participants assess the damage of the credit meltdown, a barrage of negative headlines and a fresh short base were forced to cover. Front-end spreads broke out to new highs as 2yrs approached 85bps. With Libors moving higher there are concerns as to what type of pressure there will be on funds going into year-end. There will likely be pressure on balance sheets and this may involve liquidation of assets. Also, after the dealers and banks have reported their write-downs there are questions as to where the remaining paper lies and this could lead to more significant hits. This will likely be the next shoe to drop. Spreads in general were better behaved than they have been in prior flight-to-quality episodes. 10yr spreads moved out less than 2bps on the day, indicating that swap spreads may not be the hedge of choice for credit books.

MBS: **Back to crisis mode** as spreads blew out again yesterday. Mortgages hovered around 1 wider to swaps most of the day however as the flight to quality gained steam, mortgages moved wider to both treasuries and swaps and ended the day ~7+ wider to the treasury curve and ~3+ wider to the swap curve. Nominal spreads are back near the wides vs 5/10 treasury, currently sitting around 82//. Additionally, balance sheet funding continues to be a major issue and rolls in MBS space over the DEC/JAN period continue to be pushed lower implying north of 5.10% funding levels. Nominal spreads are back near the wides vs 5/10 treasury currently sitting around 182//.

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