U.S. Daily Directions: December 3, 2007, NY Edition

Today: **ISM, Policyspeak.** The manufacturing ISM represents the data risk for today. The market expects a modest drop from 50.9 to 50.7, with activity mushing ever closer to stalling into contractionary territory. The Fed's Rosengren speaks about subprime mortgage developments, Paulson will speak at a housing conference, and Yellen will speaks about the US economic and policy outlook. Other key data for the week includes the non-manufacturing ISM, expected to slip from 55.8 to 55.0, non-farm payrolls, expected to rise a weak 70K, as well as the ADP employment report, ICSC chain store sales, U Mich confidence, and consumer credit.

Overnight: **Libor sets higher, Berry article, Moody's in process of cutting SIV ratings.** The one-month rose almost 1bp to 5.24563%, while the 3mo rose almost a bp to 5.14063%. 1-mo Pound Libor spiked 62.375bp to 6.715%, reflecting liquidity concerns over yearend. John Berry wrote that a Fed rate cut in Dec depends on the evolution of Libor rates, as tighter lending could cause real economic problems. That logic underlies RBC's call for a Fed cut in Dec. Bloomberg reports that Moody's is preparing to lower ratings on as much as $105bn of SIV debt, which would constitute the largest sub-prime-related credit rating cuts to date. Some cuts have already taken place and other decisions will be made this week.

Asset Commentary/Assessment:

Eurodollars: **Yields mostly lower overnight**, falling more in the farther out contracts (ie: -4bp Dec'09), but actually for the Dec'07 contract (+2bp to 4.865%). The strip suggests a trough in the Fed Funds rate around 3.25% by Dec'08. The futures market prices the odds for a 25bp ease in Dec at 100% and those for a 50bp ease at 38%. The odds of a move to 4% or lower by Mar'08 are 95%.

Treasuries: **Yields choppy, mixed, curve flatter.** Yields gyrated overnight, opening higher in Asia but falling steadily throughout that session, and then rebounding through the European morning. The 2yr yield is back above 3% (3.019%), and it continues its consolidation of the past 6 sessions. The 10yr yield also continues its stabilization, which began last week. Our 2s30s position fell 2.6bp to 136bp, still up from the 121bp entry. Our target on the position is 146bp (recent high) with a stop of 116bp (just below recent low). A worsening of financial conditions and the premium for short-dated Treasuries as collateral over yearend will allow the curve to steepen back towards the recent highs.

Swaps: **Overnight, spreads mixed.** 2yr +0.4bp, 10yr: -1.3bp. Friday, spreads widened, then retraced. Spreads opened up better bid with the larger than expected rise in Libors. 10s traded as high as 69.5 before drifting lower throughout the day. Issuance and a hangover from convexity receiving activity are the likely reasons for the tightening, and any renewed liquidity/credit fears could cause spreads to widen again.

MBS: Friday, the basis started out wider on the jump in Libor. Fast and real money net sold vs rates, taking some gains from the last couple days of tightening. Despite a decent rally in rates, mortgages tightened into the afternoon moving from 6/32 wider to the treasury curve to 5/32 tighter on FN 5.5's by the end of the day. Servicer-related buying led the convexity grab and helped fuel another round of short covering in the market. With vol relatively unched on the day and mortgages tighter to swaps, levels look very rich considering the uncertainty that remains in the market.

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