

U.S. Daily Directions: January 2, 2007, US Edition

- Day ahead:** **FOMC minutes, PMI, construction spending, vehicle sales.** The FOMC minutes will show the degree to which the Fed was concerned with the real economy versus the ongoing financial market crisis. It also may shed light on what many consider to be the clumsy handling of the rate cut on Dec11 followed by the auction announcement the following day. The manufacturing PMI for Dec is expected to have moderated from 50.8 to 50.5, suggesting this sector of the economy continues to move forward just above stall speed. Construction spending is expected to have fallen 0.4% m/m in Nov, the 2nd consecutive decline. Vehicle sales and same store sales will also be reported. The ICSC has already reported its chain store sales rose 2.3%/y, consistent with the tepid, stable, roughly 2.1-3.1% range in place throughout H2'07.
- Overnight:** **Real estate problems meeting global liquidity.** Centro Properties, the Aussie owner of 700 U.S. shopping malls, put itself on sale due to difficulties in meeting an A\$3.9 bn debt refinance obligation. The stock has collapsed 86% in 2 days. Sanford Bernstein reports it expects Q4 asset writedowns of \$12bn at Citi, \$1bn at JPMorgan and \$5.5bn at BoA. Global liquidity will likely move in, especially at the distressed prices being offered. The FT reported that the Kuwaiti Investment Authority, like its sovereign wealth fund peers, not to mention private investors like Warren Buffett, is looking for bargains in the wake of the US subprime debacle.

Asset Commentary/Assessment:

- Eurodollars:** Overnight, yields were mixed, with '08 contract yields slightly higher but '09 contract yields slightly lower. The strip suggests a trough in the Fed Funds rate below 3.25% by Dec'08 – Mar'09. As of Dec 31, the futures priced in a 92% chance of a 25bp ease in January and a 61% chance of a second 25bp ease in March. We believe the Fed will ease twice in Q1 to further combat risks emanating from the financial market turmoil.
- Treasuries:** Overnight, volume was light due to the Japanese holiday, and so the electronic market led to only modest declines. With the yearend liquidity concerns behind us, the curve is likely to take its cue from economic data. Continued moderation in growth figures and deterioration in employment figures will allow the curve to steepen. We continue to look for an opportunity to enter steepening trades. The 2s30s curve has drifted slightly higher in the past two weeks and has moved above 140bp, while the 2s10s curve has drifted higher to 99.34bp in recent sessions.
- Swaps:** We enter the new year to start with a tightening bias, particularly in the front end, as a yearend crisis was averted. The 2yr spread is up 1bp so far today to 76.3 and support from consolidation in the past several session lies around 75bp. The 10yr spread is down 0.65bp so far today and has drifted slightly lower in recent sessions. Heavy corporate issuance later in the month could dominate price action in coming weeks.

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