U.S. Daily Directions: January 10, 2007, NY Edition

Day ahead: **Bernanke, Hoenig, Light data.** Bernanke (13:00 NYT) highlights Thursday's schedule, and he is likely echo the relatively dovish rhetoric from most of the recent Fed speakers. Hoenig also speaks regarding the economic outlook. The data remains light. Initial jobless claims are expected to have risen to 340K – worrisome, but not yet consistent with aggregate payrolls losses. Wholesale inventories for Nov are expected to have risen 0.4%, still consistent with the downtrend in place since early 2006. The Dec ICSC chain store sales are not forecast, but the pace has trended downward since mid-'06 and registered 3.5%y/y in Nov. Analysts citing anecdotal evidence suggest the Dec number will weaken.

Overnight: **More negative banking news.** Moody's reported it might downgrade Freddie Mac because loan losses could prove worse than expected. Capital One lowered its profits forecast for 2007 by 20% due to provisions for deteriorating home equity and other consumer lending. The negative outlook for the consumer was corroborated by ChangeWave Research's consumer survey for Jan 2-8, which suggests a consumer recession in coming months as consumer retrench due to rising costs. More mixed is news that Merrill and Citi are both reported to have approached foreign investors for injections of capital. Merrill is reportedly seeking $3-4bn from the Middle East, while Citi is asking for as much as $10bn from Middle East and Asian sources. The negative aspect is that the banks' plights continue to worsen. The positive spin is that global liquidity exists - at the right price - to prevent outright collapse.

Asset Commentary/Assessment:

Eurodollars: Yields fell 2.5-7.5bp along the curve. The strip suggests a trough in the Fed Funds rate below 3.00% by Dec'08 and Mar'09. Should the downside risks to the economy play out and a recession develops, yields could go lower than even the futures anticipate, as during and after the 1990-91 and 2001 recession, the real Fed Funds rate moved to negative territory. Assuming core CPI of 2-2.5%, Fed Funds could conceivably be dropped to 2% or below. The futures price in not only a 100% chance of a 25bp ease in January, but also a 78% chance of a 50bp ease. The lack of Fed rhetoric arguing against market sentiment suggests that a 50bp Jan ease is increasingly likely.

Treasuries: Yields fell through most the day, weighed by negative headlines. However, they managed a strong rebound late in the session as equities staged a comeback. The 2yr yield continues to test new multi-year lows although we'd note that in trading as low as 2.655% today, it only marginally pierced Fibonacci support at 2.668% (61.8% retracement of the 420bp rise in yields from 2003 to 2006). The 10yr yield finally managed to breached the Nov low of 3.794%, trading as low as 3.756%, although these declines might need to consolidate before further declines can be established. Our 5s30s position reached a high of 124bp before retreating. Our trading desk has taken profit, and will look to re-enter on a pullback to 116bp, but the strategy team is in the position for the long haul and retains the 150bp target.

MBS: Mortgages opened up slightly better. 30yr 6's led the stack for the majority of the day and hung around ~1+ to 2/32nds tighter to treasuries. Both 6's and 6.5's outperformed the stack on more up in coupon relative value buying. Originator auctions occurred, primarily in 40yr and 10/20 collateral, and levels in this sector went to new tights with levels coming in ~1 to 2/32nds. The sector has been on fire over the last few days due to CMO related demand and real money buyers. With the compression in the coupon stack, the price for 40yrs over their 50bps lower TBA counterparts looks very cheap (ie 40yr 5.5's only 10/32nds higher than FN 5's and 40yr 6's only ~14/32nds above FN 5.5s). This product carries a longer duration however it has yet to be significantly priced into the market and pay-(up) levels continue to look extremely cheap.

T.J. Marta
+1.212.858.6077
Tj.marta@rbccm.com

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