U.S. Daily Directions: January 12, 2007, NY Edition

Day ahead: **Earnings, retail sales, PPI, Empire.** Retail sales for Dec are expected to have remained unchanged overall, but to have slipped 0.1%m/m ex-autos. The forecasts reflect giveback from very strong November prints, but also call into question the sustainability of the November strength with consumers still weighed by high food and energy prices and falling house values. PPI is expected to have risen 0.2%m/m both overall and ex-F&E. Overall PPI is expected to have slipped y/y to 7.1%, which would still be the second highest reading since 1981. The Empire manufacturing survey for Jan is expected to have slipped to 10.0, near the bottom of its range since 2003 as the economy emerged from the recession.

Overnight: **Citi, Merrill infusion.** Citi has reported a Q4 loss of $9.83bn, or $1.99/sh. It made $18.1bn in pre-tax writedowns, in the upper range of analysts' estimates, but below the $24bn rumor yesterday. Citi cut its dividend from $0.54/sh to $0.32/sh, or 40%, not as bad as feared. Consequently, our equity traders tell us the futures rose in response. **HOWEVER,** as of Dec31, the bank's **exposure to ABS and CDO's registered $29.3bn, suggesting potential further losses**. An additional $12.5bn via private placement was raised, but reports have surfaced indicating that China and Citi have reached an impasse regarding a proposed capital infusion by the China development bank, and this indicates there might be a limit to foreign liquidity for distressed Western banks. In a sign we've not yet reached the limit of foreign "strong hands", Merrill has reached an agreement with Mizuho, the Korean Investment Corp, and Kuwait Investment Authority for $6.6bn in preferred stock.

Asset Commentary/Assessment:

Eurodollars: **Yields lower, curve flatter.** The short yields fell another 1bp overnight, but moreso farther out the curve (Mar 11 yield -5bp). As of yesterday's close, the **futures price in not only a 50bp cut by the Jan meeting, but a 50% chance of a 75bp cut**. The strip suggests a trough in the Fed Funds rate around 2.75% by Dec'08 and Mar'09, and we believe this yield could go lower as economic data weakens and negative financial news continues to come out.

Treasuries: **Overnight, yields choppy – curve flatter.** Yields chopped around, falling in Asia, stabilizing in Europe, and now falling on the Citi news. Overnight, our 5s30s position slipped further to 130.5bp. We retain our 200bp target on this position with a trailing stop-loss of 110bp.

Swaps: **Yesterday, spreads tighter, especially at front end.** Spreads generally tightened with the 2yr collapsing 5.2bp and the 10yr coming in only 1.5bp. The 2yr spread closed at 65.2bp, a low since early November, and indication that the massive liquidity provided, particularly by the Fed and ECB, has helped unfreeze funding markets. The 10yr spread closed at 58.70, a low since Jun'07. The apparent success of the emergency easing by central banks means that the market will be better able to withstand the ongoing trauma of price discovery. However, we note that the losses will continue to mount in coming weeks and quarters.

MBS: **Yesterday,** mortgages opened up strong as front end Libor reset ~20bps lower. Carry is back in the market and where better to be than mortgages with what investors expect will be a much less robust refi environment than past easing cycles. Mortgages opened up ~2 tighter, and was propped further on little originator supply and overseas demand in both 5.5's and 6's. FN 5.5's got to ~5/32nds tighter to the treasury curve and ~3+ tighter vs swaps before sellers came to market and pushed spreads off their tights. FN 6.5's seemed to know no boundaries today as they moved one for one with FN 6's in the rally. Despite mid to upper 103 dollar prices, 6.5's have done very well over the last several trading days, although they are being helped by less supply and potentially slower prepays (better convexity). Discounts did catch a bid on some servicer related demand and managed to outperform the stack. By the end of the day the 30yr current coupon closed ~3/32nds tighter to treasuries and in-line to swaps.

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