

ARBOR RESEARCH & TRADING, INC.

US 800-876-1825 / 847-304-1560

UK 44-207-556-7309

Weekly Review – January 5, 2007 From our Trading Desk

Treasury Market

The prospect of a large Treasury market rally disappeared with the Friday report of a solid 167,000 increase in December payroll employment. With the housing market, construction sector, and manufacturing sector vulnerable to further contraction, a weak payroll report could have produced substantial downward revisions to GDP forecasts and a solid base for an extended Treasury market rally. The risk of a soft payroll number was increased with the Wednesday report of the ADP private sector payroll forecast of -40,000. The last time this forecast was negative was April 2003—a month that produced an actual payroll employment loss of 68,000 jobs. The strength in December payroll employment minimized the risk of cumulating weakness within the economy this quarter. The most reasonable scenario is that the FOMC will maintain its policy hold beyond its early May meeting. Whether the Fed eases or raises the federal funds rate in the second-half of this year will be determined by a complex mix of dynamics involving the housing market, real consumption spending, job creation, manufacturing activity levels, and the trend in core inflation. While the federal funds futures market continues to forecast a Fed ease later this year, very reasonable cases can be made that the funds rate will be 4½%, 6.0%, or unchanged at 5¼% at yearend.

There are tentative indications in the sales rate, selling price, and inventory level data that the housing market has begun to stabilize. The November pending home sales index was weaker than expected, however, and reinforced the consensus estimate that housing activity will trim about 1.0% from the GDP performance of this year. If overt sector weakness is confined to housing, the economy should hold in a 2.0% to 3.0% growth range through 2007. The dynamics of the manufacturing sector, business capital goods spending, and real consumption spending are powerful and assure that there is a high risk of error in trying to peg the GDP within a narrow 1.0% range. As of January 5, however, that is the general perception.

The trend in year-over-year core inflation has moderated since August—the core PCE price index easing to 2.2% from the cyclical high point of 2.4%. Additional favorable inflation news has been delivered by a 7.9% drop in the crude oil contract price during the first four trading days of 2007. Labor costs are more problematic. Year-over-year average hourly earnings reached 4.2% in November. This is the highest rate since February 2001 and compares to the cyclical low point of 1.6% during the deflation-risk period of February 2003. This upward trend may be mostly a benign reflection of strong productivity and compositional changes within the job market but it is a factor that argues strongly against a funds rate ease before, at the least, the May FOMC meeting.

The service sector of the economy is solid. Service sector employment has increased an average of 183,000 over the past six months while total payroll employment has increased an average of 161,000. The service sector contributes 80% of GDP and has seemingly yet to be impacted by the contraction of the housing sector and the serious slowdown of the manufacturing sector. The economy appears to be maintaining its fine balance and therefore is holding Treasury yields in a relatively tight trading range mode. For the week, the 2-year note rallied 5.4 bps to a yield level of 4.758%. The long bond rallied 7.3 bps to a yield level of 4.742%.

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TIPS Market

Falling energy markets do not enhance breakeven rates. Accordingly, TIPS underperformed nominals this week as oil reached \$55/bbl (down 7.9% this week). Multiple accounts sold TIPS this week and saddled street dealers with larger TIP positions. December's payroll report did provide some relief for the TIPS market. Breakevens seemed to stabilize and bounced a few bps after the payroll report. A new 10-year and 20-year TIP will be auctioned this month and sharpen the focus on the asset class. TIPS will certainly be marketed on their historically narrow breakeven rates and relatively attractive real rates. The energy markets should continue to dictate their value vs. nominals too. For the trading week, the 10-year TIP breakeven (7/16's) narrowed by 2.8 bps to 228.2 bps and the 20-year TIP breakeven (1/26's) narrowed 2.6 bps to 249.1 bps. The 10-year real rate (7/16's) decreased 3.2 bps to 2.376% and the 20-year TIP (1/26's) decreased 4.2 bps to 2.353%.

Agency Market **Issuance Calendar**

<u>Announced</u>	<u>Issuer</u>	<u>Ticker</u>	<u>Security Type</u>	<u>Size</u>	<u>Price</u>	<u>Bench</u>
1/2/07	Home Loan	FHLB	18mo Global Note	2BB	Par	2yr
1/3/07	Freddie Mac	FHLMC	7nc2yr Domestic Note	1BB	Par	5yr
1/4/07	Farm Credit	FFCB	10yr Domestic Note	1.5BB	+30	10yr
1/4/07	Home Loan	FHLB	2nc6mo Global Note	500MM	Par	2yr
1/5/07	Freddie Mac	FHLMC	3nc1yr Domestic Note	500MM	Par	3yr
1/5/07	Freddie Mac	FHLMC	5nc2yr Global Note	1BB	Par	5yr
1/5/07	Freddie Mac	FHLMC	10nc2yr Domestic Note	500MM	Par	10yr

Agency Spreads

Agency volume has picked up in the New Year despite the shortened trading week. Swap spreads tightened 1-2.5 bps across the curve with the 5, 10 and 30 year sectors trading at their 90-day narrows. Spreads across the curve were relatively quiet versus USTs but underperformed swaps. We have seen decent supply this week with most priced in the front-end but one deal worth mentioning is FFCB's 10-year Domestic Note. This issue trades +30 bps over the 10-year UST. Fannie Mae and Freddie Mac are both due to announce more supply next week.

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Active Swaps and Agencies

	Vs. UST			3 MONTH	
ISSUE	12/29/06	1/5/07	CHANGE	WIDE	NARROW
2YR SWAP	36.0	34.5	-1.5	48.0	33.5
3YR SWAP	37.0	36.0	-1.0	51.0	36.0
5YR SWAP	41.0	38.5	-2.5	57.0	38.5
10YR SWAP	48.5	46.5	-2.0	62.0	46.5
30YR SWAP	50.5	49.5	+0.5	64.0	49.5
2YR FNMA	22.5	20.0	-2.5	29.0	18.0
3YR FNMA	19.0	18.5	-0.5	33.0	18.5
5YR FNMA	24.5	22.5	-2.0	41.0	22.5
10YR FNMA	29.5	30.0	+0.05	46.0	29.5
30YR FNMA	37.0	36.5	-0.05	48.5	35.5
	Vs. SWAPS				
2YR FNMA	-13.5	-14.5	-1.0	-12.5	-21.0
3YR FNMA	-18.0	-17.5	+0.5	-16.0	-20.0
5YR FNMA	-16.5	-16.0	+0.05	-15.0	-18.5
10YR FNMA	-19.0	16.5	+2.5	-15.0	-20.5
30YR FNMA	-13.5	-13.0	+0.5	-12.5	-20.0

Corporate Market

Benchmark Indices

TKR	12/22/06	1/05/07	CHANGE	% CHANGE	INSTRUMENT
USFICORP (\$ billion)	6.955	10.37	+3.415	+49.10	CORPORATE SUPPLY
TYA (\$PX)	108-04+	107-28	-8.5/32	-0.25	10YR FUTURES
GT10 (%YLD)	4.624	4.648	-0.024	-0.052	10YR YIELD
LEH CORP (%YLD)	5.51	5.57	+0.06	+1.09	CORPORATE INDEX
SPX (\$PX)	1412	1408	-4	-0.28	S&P 500 INDEX
INDU (INDEX)	12358	12383	+25	+0.20	DOW JONES INDU AVG
CCMP (INDEX)	2404	2429	+25	+1.04	NASDAQ INDEX
VIX (%VOL)	11.33	10.05	-1.28	-11.30	VOLATILITY

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Select Investment Grade New Issues

<u>DATE</u>	<u>ISSUER</u>	<u>TKR</u>	<u>RATING</u>	<u>AMT</u>	<u>MAT</u>	<u>PRICING</u>	<u>NOTES</u>
1/04/07	Morgan Stanley	MS	Aa3/A+	2.75BB	10YR		
1/03/07	Goldman Sachs	GS	A1/A+	2.25BB	10YR	+96	
1/03/07	Donnelley & Sons	RRD	Baa2/BBB+	625MM	5YR	+100	
1/03/07	Donnelley & Sons	RRD	Baa2/BBB+	625MM	10YR	+157	

Credit Spreads

Primary issuance started 2007 much more quietly than expected. We heard rumors at the beginning of the week that January could see as much as \$70 billion, but so far we are significantly behind that pace and chatter regarding the forward calendar has been light.

Private equity concerns are at the forefront for many credit analysts and portfolio managers as we begin 2007. Rumors began to circulate Friday morning that Soros had taken an equity position in some higher grade retailers like JCP, KSS, TGT, among others, which pressured the sector 2-5 bps wider in 5-year CDS. HD, which saw CEO Nardelli resign Wednesday, came under particular pressure due to ongoing LBO fears. HD 5.40 3/16, which do not have change of control (COC) language, widened 23 basis points this week to +125/122. The issues with COC language only widened a basis point or so. Investors are also paying attention to those issuers with sub-prime mortgage exposure, like RESCAP. 5-year RESCAP CDS are 25 wider over the last month, while other entities in the sector have softened by 2-12 basis points, as accounts attempt to properly value the individual names.

Detroit's auto makers disappointed with December sales data. GM & F each declined 13% month-over-month, while TOYOTA gained 12%. The drop marked the lowest annual totals for GM since 1970 and the sixth annual decline in a row for F. GMAC bonds traded lower, more noticeably after Friday's treasury market sell-off. GMAC 8.00 11/31 closed \$114/114.25, down half a point. F bonds were little changed.

Rating Changes

Duke Capital	DUK	Upgraded to BBB+ by S&P 1/02/07.
UNOCAL	CVX	Upgraded to Aa2 by Moody's 1/03/07.
Snap-On Tools	SNA	Downgraded to A3 by Moody's 1/04/07.
Kinder Morgan Inc.	KMI	Downgraded to BB- by S&P 1/05/07.
Kinder Morgan Energy	KMP	Downgraded to BBB by S&P 1/05/07.

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From our London Office

Euro Benchmark Indices

INDICIES	12/29/06	1/05/07	CHANGE	% CHANGE	INSTRUMENT
€ SUPPLY (€ Billion)	0	13	13	1300%	EU NEW ISSUANCE (€)
RXU6 (€PX)	116.03	115.88	-0.15	-0.13%	10YR BUND FUTURES
GDBR10 (%YLD)	3.948	3.983	0.04	0.89%	10YR BUND YIELD
GUKG10 (%YLD)	4.741	4.80	0.06	1.24%	10YR GILT YIELD
UKX (INDEX)	6,220	6,222	2	0.03%	FTSE 100 INDEX
CAC (INDEX)	5,541	5,517	-24	-0.43%	CAC 40 INDEX
DAX (INDEX)	6,596	6,593	-3	-0.05%	DAX 30 INDEX

Euro New Issuance

DATE	ISSUER	ISSUE	MAT	SIZE	NOTES
1/3/07	Germany	DBR 3.75% 1/04/17	10YR	€7BB	TAP
1/4/07	France	FRTR 3.75% 4/25/17	10YR	€6BB	TAP

Issuance in the first half of January focuses mainly on the belly of the curve and longer, with Germany and France kicking off 10-year issues on Wednesday and Thursday for a combined €13 billion. Next week the pipeline is stacked with more than €20 billion, which includes: a new Greece 10-year benchmark, a tap in long Netherlands, a dual BTP tap, and a possible new 5-year Bono. Looking forward for 2007, overall EGB issuance is less than initial expectations as European countries revised funding requirements from their initial draft budgets which lowered estimates to €540 billion from €570 billion. Nearly a third of the year's issuance (€175 billion) is expected to price in the first quarter, €70 billion for January, €50 billion for February, and €55 billion in March.

The UST/DBR 10-year spread was active this week, trading as high as 78 bps and finishing at 70 bps late Friday. The spread gradually ground tighter throughout the week however it did gap to 65 bps immediately following the US employment report.

Euro linkers started the year with a down week as breakevens finished 3-5 bps tighter across the curve. The narrowing could have been much worse with the large sell off in crude. However linkers could not sustain the strength of the TIPS market and underperformed their American counterpart by 4-5 bps.

Credit markets ended the week virtually unchanged, in a low-volume to start the year, with many market participants still on holiday. The current index levels finished, Euro main 23.25/23.75 (0 bps), hi vol 46.00/46.50 (0 bps), x over 217.75/218.25 (0 bps).

New issuance as would be expected, has been minimal with no deals of any note coming to market, and expected to be similar next week. Flow wise, it would appear that investors are still positive on the market and long cash, and are simply waiting for attractive new issues to invest in. News wise, there has been little firm corporate news of note to report on this week.