Daily U.S. Market Commentary for Monday, March 19, 2012

Treasuries put in a round trip by late morning in U.S. trading, with buying seen in the early Eurozone session offset by subsequent selling early in the U.S. session. 10s ended the U.S. session on Friday near 2.30% and they did not stray far from that level in the Asian Monday session. However, early in the Eurozone session, buyers were out in force, taking 10s to 2.26% and keeping them there into U.S. trading. In the absence of any top-tier economic data in the U.S. today (the March Homebuilder's Survey came in unchanged at 28), and with U.S. equity markets not making any major move in the early going, U.S. Treasury market participants were sellers of 10s, taking the yield back to 2.30% and then to a 2.33% intraday high before buyers came in mid-morning to take 10s back to 2.30% and unchanged levels by noon.

4-week bills were announced at $40 bln, unchanged for 6 weeks now, but bills are now moving into pay-downs and we expect offering cuts to happen as soon as this Thursday with the announcements of 3s and 6s. Cuts in 4s could occur as soon as next Monday. The normal 3s and 6s auctions today came at the same or just slightly elevated rates, but covers fell sharply, perhaps as some short end participants moved out the curve. We provide details below.

Meanwhile, equity markets opened a bit weaker, but soon found buyers and pushed into positive territory. Gains were limited until late morning buying took averages higher. There was another plateau in prices in afternoon trading, but Treasuries were not trading on the day's fundamentals, the technicals, or equity markets, reaching higher yields across the curve in steady selling in afternoon trading. From an unchanged 2.30% at noon, 10s saw selling throughout the afternoon, reaching 2.35% by mid-afternoon, and going into the final hour of trading before the future's close, 10s were at 2.38-9%, within striking distance of the October 28 2.42% recent high.

However, the belly also continues to trade poorly, even after a 14 bp cheapening in 5s on the 2/5/10s butterfly last week. We remarked on Friday that "*the 2s/5s/10s butterfly moved from +56 bp to +42 bp. This move entailed 5s moving from being rich to the curve to being cheap to the curve, because the 2 year yield did not move much relative to 5s and 10s.* Now with 2s/5s/7s announced on Thursday and 5 buy-backs this week, two at the long end, we look for the belly of the curve to continue to trade poorly relative to 2s/10s.

The underperformance in the belly of the curve is one reason why some analysts continue to see the current sell-off as a "game-changer", but it actually merely represents a stable 2-year relative to 5s and 10s. Normally, when long rates are seen to be rising, participants move to the belly of the curve, as the bond math favors the short end when prices are falling, but the best total return comes in the belly as the higher coupon income generally offsets the better bond math in the short end. Thus, an outperforming belly is generally a sign of players expecting higher long end yields. The belly has been expensive to 2s/10s up until recently, and subsequently long end yields have risen, supporting the claim that an outperforming belly is a sign that players expect higher long end yields. However, now that the belly is underperforming and is cheap to 2s/10s, this is likely no longer a sign of a "game-changing" situation and that higher yields are here to stay; rather it may be signaling that the long end sell-off is now due to end temporarily, and that players are selling the belly to extend out. Of course, it may also be the case that players are shifting into the short end or even bills, but as we report today, 3s and 6s saw substantially less tenders today, so it is unlikely that players are moving to the short end. It may be that players long the belly are moving into cash, and looking to see if the long end sell-off begins to reverse, especially with 5 buying operations this week from the Fed. Our guess is that long end yields will be lower by the Friday close than they are going out today. The sell-off has moved very far very fast, and these moves tend to be at least partially reversed. We do agree that the trend this year will be to higher long end yields, but this trend move is likely to come with considerable volatility with risk-on, risk-off trading continuing to be the nature of the price action in Treasuries this year.

At 3:30 p.m., 2s had traded between 0.33% and 0.38%, ending at 0.38%, +2.0 bp, while 10s had traded between 2.26% and 2.39%, ending near 2.38%, +8.1 bp. This price action pushed 2s/10s to near +193.7 bp on Monday in *bearish steepening*.

Recent price action in 2s and 10s:

Date	2s	10s	Spread	Price Action
03/15	0.359	2.294	193.5 bp	***mixed steepening***
03/15	0.362	2.279	191.7	***mixed steepening***
03/14	0.386	2.269	188.2	***bearish steepening***
03/13	0.346	2.126	178.0	***bearish steepening***
03/12	0.322	2.033	171.1	***bearish steepening***
03/09	0.318	2.028	171.0	***bearish steepening***
03/08	0.306	2.012	170.7	***bearish steepening***
03/07	0.302	1.976	167.4	***bearish steepening***
03/06	0.278	1.943	166.5	***bullish flattening***
03/05	0.294	2.010	171.7	***bearish steepening***

Fed's Operation Twist

The Fed was in today with a buying operation, the 76th of the maturity extension program. In this operation, the Fed bought $5.106 bln with $13.426 bln offered, for a good 2.63 cover. The maturity range was 05/15/20 to 02/15/22, targeting 8s-10s. The Fed bought 2 securities in size, $2.535 bln of the 3.625s of 02/15/21 (which is the Feb 2011 10-year, $67.585 bln outstanding, the Fed holding 13.1% of this issue before the operation), and $1.432 bln of the 3.125s of 05/15/21 (which is the May 2011 10-year, $66.000 bln outstanding, the Fed holding 28.9% of this issue before the operation). In 34 sell operations, the total is $250.669 bln, with a $7.373 average and 62.7% (just over 5/8ths) of the $400 bln target now reached. In 76 buy operations, the total is $249.403 bln, with a $3.282 average and 62.4% of the $400 bln target now reached.

Auctions

BILLS: The Treasury auctioned 3s and 6s today at **9.5 bp** (after 9.5 bp, 8.0 bp, 11.5 bp, 8.5 bp, 9.5 bp, 8.0 bp, and 5.0 bp previously) and **15.0 bp** (after 14.5 bp, 13.0 bp, 14.5 bp, 12.5 bp, 13.0 bp, 10.0 bp, and 7.5 bp previously). The 3-month bill cover was well lower at 4.30, after 4.83, 4.41, 4.24, 4.33, 4.31, 4.63, and 4.56, on unchanged issuance and $17.6 bln in lower tenders. The 6-month bill cover is also well lower at 4.42, after 5.10, 4.54, 4.32, 4.43, 4.36, 4.76, and 4.78, on unchanged issuance and $20.4 bln in lower tenders. In 3s, the indirect bid was 28.9% after a high 51.8%, while for 6s, it was 24.4% after 25.9%. The direct for 3s was 9.7%, after 5.8%, while for 6s, it was 8.5% after 5.3%.

BILLS: The Treasury announced 4s at **$40 bln,** for the 6th week at that level. We said a few weeks ago (and it was our original call to start the year) that we think 4s could go to a $40 bln high, and our best guess for an initial increase had been at the 1/31 or 02/07 auction. The Treasury increased 4s three times to our objective, and the Treasury is now likely done for the quarter in 4s. Reductions in bills could come as early as this Thursday for 3s and 6s, and next Monday for 4s.

MFR End-of-Session Tables
{MRCC 19 <GO>} Treasuries
{MRCC 20 <GO>} Agencies
{MRCC 21 <GO>} Corporates
{MRCC 22 <GO>} Major Equity Indices

MFR U.S. Economic Commentary for March 19, 2012

PREVIEW OF UPCOMING U.S. ECONOMIC DATA & KEY EVENTS

Tuesday sees February **housing starts** (estimates are centered on little change from January's 699K unit seasonally adjusted annual rate), and a **10:00 AM (NY time) Senate Banking Committee confirmation hearing on the nominations of Jeremy Stein and Jerome Powell to the Board of Governors of the Federal Reserve**.

Wednesday provides **9:30 AM (NY time) testimony by Fed Chairman Bernanke and Treasury Secretary Geithner on the European debt crisis**, and February **existing home sales** (the median forecast calls for a small gain to a 4.61M unit seasonally adjusted annual rate from the 4.57M units recorded in January).

Thursday brings **initial unemployment claims** for the week ended March 17 (forecasts are centered on little change from a previous 351K), the February Conference Board **leading indicator index** (the median forecast calls for a 0.6% m/m rise), and a **10-year TIPS auction**.

Friday delivers February **new home sales**, which are generally expected to rise modestly to about a 325K unit seasonally adjusted annual rate from the 321K posted in January.

HOMEBUILDER INDEX STEADY IN MARCH

The National Association of Homebuilders' Housing Market Index was reported at 28 in March, which was unchanged from the downward revised February tally (which had originally been reported at 29, and was adjusted lower even though none of the three sub-indices were revised). The median forecast for March was 30, so the result was below what was generally expected. Earlier outcomes were 25 in January, 21 in December, 19 in November, 17 in October, 14 in September, 15 in August, 15 in July, 15 in July, 13 in June, 16 in May, 16 in April, 17 in March, 16 in February, and 16 in January of 2011.

The cumulative 14-point gain reported in the six months to March has lifted this index to well above the all-time low of 13 that was reached in June. These recent results would seem, therefore, to point to significant gains over the near term in single-family housing starts. The next few months will be critical in determining to what degree homebuilders follow their more optimistic talk with action.

While some improvement in starts seems likely, we continue to believe that the massive supply overhang of existing homes will present brutal competition to the new home market for the foreseeable future, and therefore it is unlikely that single family housing starts will make sharp gains from current rates anytime soon.

The diffusion index for the present condition of single-family sales was 29 in March after 30 in February, 25 in January, 22 in December, 20 in November, 17 in October, 14 in September, 15 in August, 15 in July, 13 in June, 15 in May, 15 in April, 17 in March, 17 in February, and 15 in January of 2011.

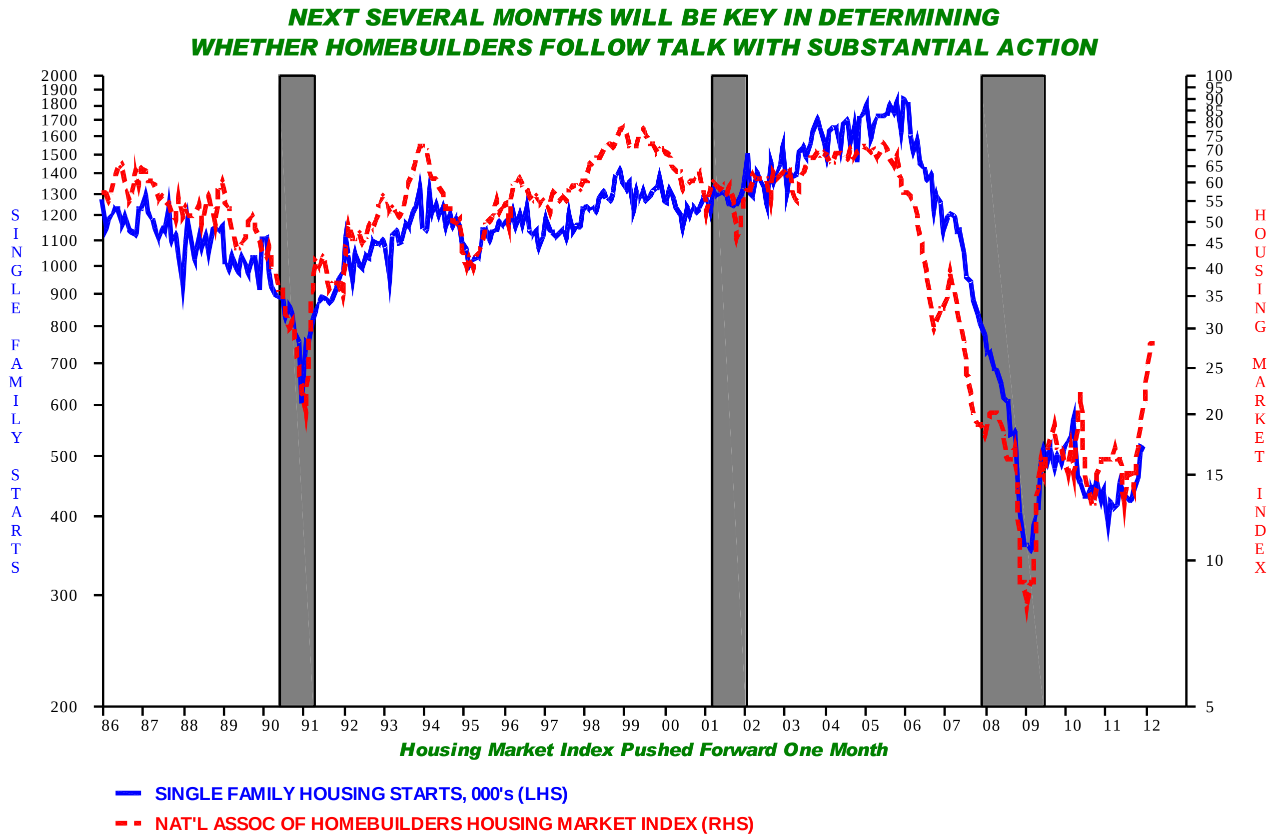
The diffusion index for the outlook for single-family sales over the next 6 months was 36 in March after 34 in February, 29 in January, 26 in December, 25 in November, 23 in October, 17 in September, 19 in August, 21 in July, 15 in June, 19 in May, 22 in April, 26 in March, 25 in February, and 24 in January of 2011.

The diffusion index for prospective buyers traffic was 22 in March after 22 in February, 21 in January, 18 in December, 15 in November, 14 in October, 11 in September, 13 in August, 12 in July 12 in June, 14 in May, 13 in April, 12 in March, 12 in February, and 12 in January of 2011.

Homebuilder Survey Housing Market Index Summary Table

	March 2012	Feb. 2012	Jan. 2012	Dec. 2011	Nov. 2011	Oct. 2011
	Index					
Housing Market Index	**28**	**28**	**25**	**21**	**19**	**17**
Single family sales: Present	29	30	25	22	20	17
Single family sales: Future	36	34	29	26	25	23
Prospective Buyers Traffic	22	22	21	18	15	14
	Prospective Buyers Traffic in New Homes					
Regional HMI Northeast	25	20	23	14	16	14
Regional HMI Midwest	32	30	24	23	24	15
Regional HMI South	27	25	28	25	21	19
Regional HMI West	33	43	21	16	15	21
Builder Respondents	403	389	466	477	479	508

NOTE: The HMI and components are seasonally adjusted. Future refers to starts in next six months. (Table Courtesy of Bloomberg)



MFR International Commentary for March 19, 2012

TODAY'S INTERNATIONAL MARKET ACTIVITY

Markets are looking for some direction after the recent rally in global equity markets. There was no economic data of significance today. In fact, the first significant international data comes with the flash March EC PMIs on Thursday. Equity markets have been mixed today. The MSCI Asia Pacific index was up just a fraction as declines in China property prices and a stronger JPY dampened investor enthusiasm. Europe's Stoxx 600 fell as much as 0.6% in early trading and remained in the red virtually all session. Consumer goods, industrials and utilities were the biggest losers and overwhelmed the gains posted by telecom, tech and health care. The index closed down 0.1%. The S&P 500 has outperformed today, thanks in part to more favorable news out of Apple. Financials, tech, basic materials and oil/gas were the strongest performers - all 10 of the major industry groups are higher. The index is up about 0.6%, near the highs of the session. Japan is closed tonight for the Vernal Equinox holiday and the RBA meeting minutes will be among the few bits of economic news. Further consolidation is anticipated.

Upside pressure on oil prices could become a damper on equities. After dipping lower in early European trading, crude and metal prices have moved higher on prospects of improving US demand and on-going tensions with Iran. West Texas Intermediate closed on Friday at $107.06

and had seen a low of $106.55 before the US market got going today. It is currently trading at the $107.88 level and Brent is at $125.70, up from its session low of $124.82. Diminishing inventories provides support for copper prices, gaining 0.8% to the $390-91 level. While on the topic of oil and fuel prices, China announced that it was hiking retail gasoline and diesel fuel prices 6-7% immediately. This is likely this news to raise new concerns about domestic demand and slowing growth and damp China and Hong Kong equity markets.

Despite the lack of any major economic data, the USD index spiked lower in the US morning session after key technical levels for the CHF and EUR were breached. The DXY index had been going sideways in narrow trading until just after 10am NYT when it dived from the 79.85 level to a low of 79.35. As noted, the major moves were in the CHF (+0.5%), EUR (0.5%) and CAD (+0.5%). The EUR went from 1.3150 to 1.3266 and is currently trading at the 1.3238 level. It remains to be seen if the stronger EUR tone will be sustained.

There have been comments by the IMF raising concerns about the limited scope for error in Greece's implementation of its economic/reform program. The country has a reputation for its falling short on deliverables. PIMCO has also said that it sees Portugal as being the next Greece. That it will require additional financial support. It is interesting to note that Portugal government bond yields declined further today despite the bad press. The 10yr yield was down 9bp to 13.56% and the 2yr down 31bp to 12.41%. Italy's 10yr was down 2bp to 4.84% and 2yr up 25bp to 2.30%. Spain's 10yr was basically flat at 5.20% and 2yr down 2bp at 2.37%. The German 10yr benchmark was up about 0.5bp to 2.06% (range 2%-2.06%) and the UK 10yr down 1.5bp to 2.43%. The US 10yr has been up 9bp to 2.38%, the highest yield since the beginning of November.

The JPY has gone from near the top of the G10 relative strength profile to the bottom along with the USD. The yen is trading currently at the 83.42 level, little changed from Friday's close at 83.43. The range today has been 83.02-83.57. Keep in mind that last week's weakest level was 84.18. Again, Japan is closed for a market holiday tomorrow so we anticipate the JPY will hold these levels through the overnight session.

PREVIEW OF UPCOMING KEY INT'L ECONOMIC DATA & EVENTS

Tuesday will be dominated by February inflation measures --Germany's February PPI and UK February CPI. The recent run up in energy prices will put upside pressure on the monthly changes, but the annual rates are expected to continue to ease gradually. German PPI is seen up 0.5% mom but easing to 3.2% yoy from 3.4% in January. The UK CPI is seen up 0.4% mom and 3.3% yoy against -0.5% mom and +3.6% yoy in January. Core CPI is seen easing to 2.3% yoy from 2.6%. The BoE's medium-term target is 2% yoy but the BoE does not expect the annual rate to get down to that level until 2013. These releases are not expected to have a major market impact. Any upside pressure on bond yields that may have resulted will have been offset by the backup in government bond yields last week.

Wednesday has the UK at center stage. The Bank of England will publish its minutes of the March 7-8 MPC meeting and finance minister George Osborne will present the new budget. The BoE left its policy rate unchanged at 0.50% and its asset purchases program at 325B pounds. The bond purchases are expected to take another two months to complete, so it is unlikely that there was any detailed discussion of adding to the program at the March meeting. It is expected the vote will be unanimous in favor of leaving the policy rate unchanged. No surprises are expected. No change is likely to be a modest positive for the GBP.

Thursday has the heaviest data schedule. It begins in Asia with Japan's February trade data. In Europe, the flash estimates of the EC March manufacturing and services PMIs will be followed by UK February retail sales and EC January industrial orders. Finally, Canada's January retail sales concludes the releases.

The market has been more sensitive to Japan's deteriorating external balance of payments. Analysts are expecting a deficit of Y120B in February, down from the Y1.48T in January. The recovering supply chain and weaker JPY will help exports. The increased energy bill following last year's nuclear disaster will contribute to the strong gain in imports. The currency has become more sensitive to the balance of payments data and a larger than expected trade deficit could result in added selling pressure on the JPY.

With investors focused again on economic fundamentals, the modest improvement expected in the flash EC manufacturing and services PMIs will add to investor confidence in improving global growth. The data will again highlight the relative strength of the German economy relative to the overall EC. Germany's manufacturing and services PMIs are expected to improve modestly, with manufacturing rising to 51.0 from 50.2 and services to 53.1 from 52.8. These will add to the evidence suggesting Germany will avoid recession this year. The EC measures however will remain below the 50 grow-contract threshold, reflecting the drag being exerted by the likes of Greece, Portugal, Spain and Italy. The EC flash manufacturing PMI is expected to rise to 49.5 from 49.0 and the services PMI to 49.2 from 48.8. These will produce a flash composite March PMI of 49.7 vs 49.3. This result is consistent with a modest contraction in Q1.

EC January industrial orders are expected to decline 2.0% mom after the stronger than expected 3.5% mom gain in December. The weakness in overall orders comes through in the 3.1% decline year-on-year. The 2.7% decline in January German factory orders suggests a weak reading. The combination of these orders data and the sub-50 PMIs will add to investor expectations of weak performance in the first half of the year. This will keep a lid on the EUR.

UK February retail sales will provide added evidence of Europe's relative weakness relative to growth prospects in the US and Asia. Headline sales are expected to slip 0.5% mom after the stronger than expected 0.9% increase in January. Price discounting has been holding up spending activity in recent months, but this is expected to fade and with it new sales. Higher gas prices will also be a factor in higher sales. When gasoline is excluded, sales are expected to be down 0.5% mom and up 2.3% yoy. After the larger than expected increase in February's jobless and weaker earnings growth, the prospect for household spending is looking gloomy for the first half of 2012.

Canada's January retail sales data are expected to post a strong 1.8% mom rebound from the 0.2% contraction in headline sales in December. Increases in auto and gasoline related sales will account for the bulk of the increase, but excluding these elements, sales are still expected to be up 0.4% mom in contrast to being flat in December.

Friday starts with China's flash March HSBC manufacturing PMI and concludes with Canada's February CPI. China's February HSBC manufacturing reading was 49.7 and markets will be sensitive to any significant decline from here. After the government announced its 2012 growth target at 7.5%, down from 8.0%, a further erosion of the PMI is going to feed fears of more sluggish China demand, putting a damper on equity and commodity prices.

Canada's February CPI data are expected to be a bit hotter than in January. Higher fuel prices will contribute to the 0.5% mom gain in headline CPI, lifting the annual rate to 2.7% from 2.5% the previous month. The Bank of Canada core measure is expected be up 0.3% mom and 2.2% yoy, also up slightly from January. In its statement following the March 8 policy meeting, the BoC noted that inflation was trending higher than previously expected. The policy statement was generally more hawkish and these firm CPI data will reinforce that tone. This report will keep a upside bias to government bond yields and the CAD.