



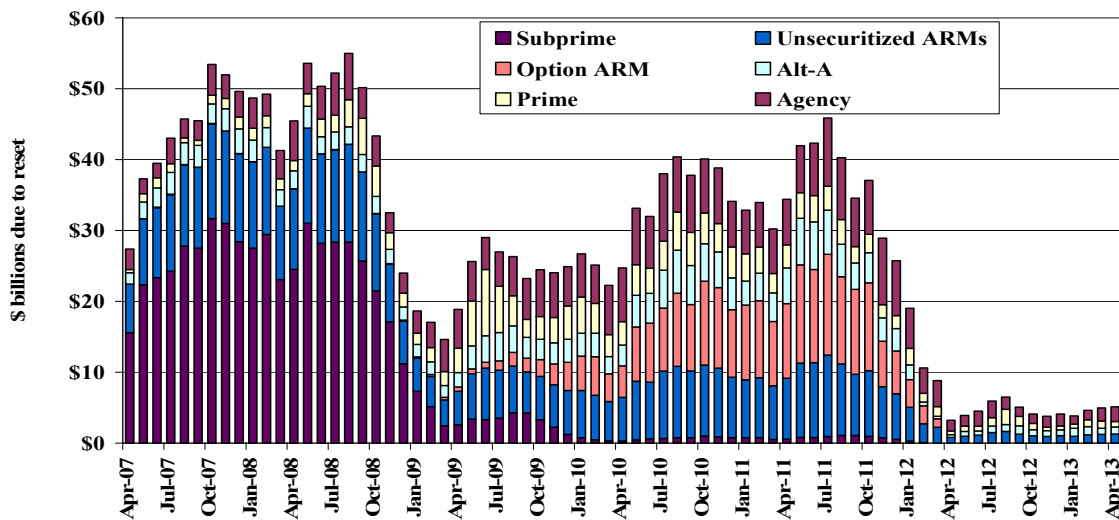
- **The Mortgage Market:** *Prepays increase less than expected; looking ahead to ARM resets*
- **The Economy:** *The Fed digests recent data: a change in bias to follow?*
- **The Markets:** *Stocks rally, bonds stay flat and the dollar weakens*

The Mortgage Market

Prepayment speeds in March (April release) picked up 17% from February, less than the 25% to 33% pickup dealers had predicted as a slowing housing market, tightening credit origination standards and slowing home price appreciation may be having an effect. Speeds are estimated to come in 5% to 10% faster for April as seasonality starts to get into full gear. The potential for faster prepayment speeds in April would be due to February's rally in rates, but this may be offset by the two business day decrease from March. May speeds are also estimated to increase by roughly 10% as the two-business day decrease is reversed, while June speeds should remain flat as day count offsets seasonality.

In last month's commentary we spoke of how early payment defaults, or EPDs, are making the sub-prime origination business unprofitable. The once-healthy spread that originators had been earning has evaporated as both the resale value of sub-prime mortgages have decreased, and EPDs are forcing more loans to be "put back" to the originator by the buyer as borrowers miss their first scheduled payments. While no hard data exists on the numbers of EPDs, it is believed by industry observers that they have risen from less than 1% of loans in 2005 to 6% to 8% in 2006. This rise in EPDs, and the associated losses to the originator, will likely lead to a reduction in the availability of credit. The graph below sets forth the schedule of ARM resets—by type of mortgage—in the US over the next several years. Credit Suisse estimates that close to \$1 trillion is due to reset by the end of 2008. Originators are unlikely to grant credit on the same basis once they've experienced a rise in EPDs and other credit problems related to the rate resets.

ARM resets: something to look forward to



source: Credit Suisse

There will still be discrimination based on credit score. Borrowers with FICO scores greater than or equal to 720 who chose "affordability" products over a traditional mortgage should be able to refinance prior to reset. The borrowers who had no choice but to take out an "affordability" product, however, will experience difficulty in refinancing due to originators being fearful of more EPDs and other problems. These borrowers could be stuck with substantially above-market interest rates that they can't afford to pay on mortgages secured by homes that have fallen in value. According to the Mortgage Foundation, roughly 1.1 million homeowners will lose their homes to foreclosure due to their mortgage resetting at a higher rate within the next 6-7 years. **To avoid any confusion, let us reiterate that this is a problem primarily for the sub-prime mortgage market, in which we do not participate.** Nevertheless, it could weigh heavily on the economy.



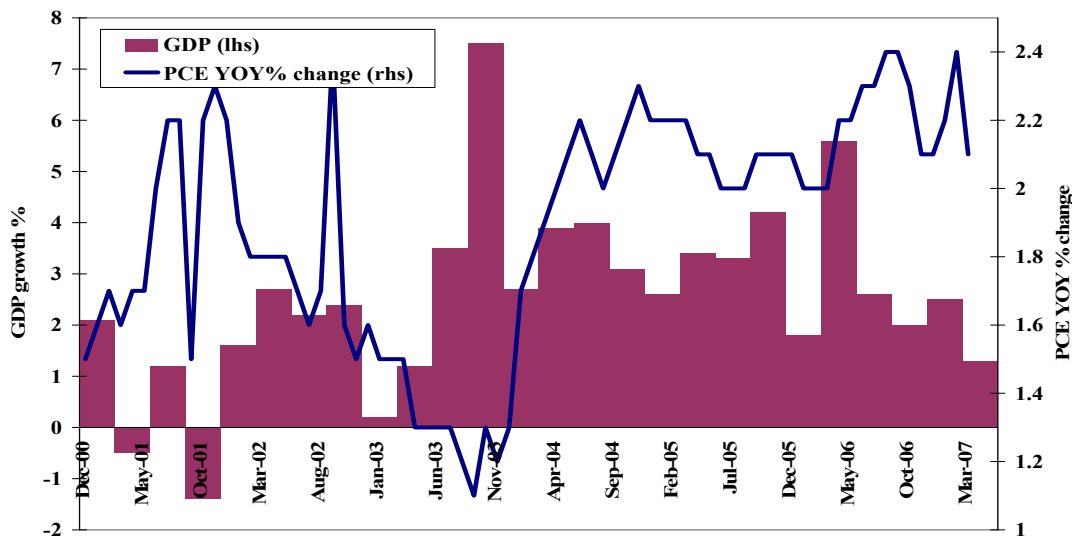
The Economy

Having reduced its monetary policy agenda to the balance between economic growth and inflation, the Federal Reserve has become a binary animal. Each data point that's released, whether it's a top tier economic statistic or a number of secondary importance, sets up the following question: Is the economy weak enough to merit an ease or is inflation high enough to keep the Fed on hold? Textbook macroeconomics argues that the demands of a strong economy would produce scarcities in various resources, be they workers, finished products or raw materials. These scarcities, that argument goes, would result in pricing pressures as the market bid up those resources that were in highest demand. Thus the Fed, prompted to address the problem by using its blunt policy instruments, would slow down the economy, reduce the demand for these resources and thereby relieve the price pressure. Conversely, if inflation were subdued by the slowing economy and the weakening demand for goods and services, the Fed would relax its monetary policy to encourage investment by lowering the cost of capital.

If only the world conformed to a textbook. For example, what is the Fed to do if scarcities exist in workers or goods, price pressures remain worrisome, but the economy is slowing incontrovertibly? That is the situation the Fed believes it currently confronts. In speech after speech, Fed officials directly acknowledge a slowdown in their economic growth forecast to below long-run potential but they still talk tough on inflation. The minutes to the March 20/21 Federal Open Market Committee meeting summed up this view best: “[A]dditional evidence of sluggish business investment and recent developments in the sub-prime mortgage market suggested that the downside risks relative to the expectation of moderate growth had increased in the weeks since the January FOMC meeting. At the same time, the prevailing level of inflation remained uncomfortably high, and the latest information cast some doubt on whether core inflation was on the expected downward path... [T]hat risk remained the Committee’s predominant concern.”

As it considers the course of monetary policy at its next rate-setting meeting on May 9, we believe that the FOMC will have room to change its view, to edge even closer to neutral. The evidence released since the last FOMC meeting shows that the growth trajectory in the United States has slowed even more and that core inflation is edging downward. On April 27, the Commerce Department reported its preliminary estimate for first quarter GDP. At an annualized rate of 1.3%, the economy grew at the slowest pace in four years and the fourth straight quarter of sub-3% growth. The employment report for the month of April, released Friday May 4, suggests that job growth is slowing. The Labor Department announced that the economy added 88,000 jobs during the month, smaller than estimated, and that the unemployment rate rose to 4.5% from 4.4%. Moreover, workers’ average hourly earnings rose just 0.2%, less than expected, and weekly hours worked also fell. Joseph LaVorgna, chief US economist at Deutschebank, said, “The current level of economic activity is consistent with an unemployment rate closer to 5%.”

GDP and inflation: both softening



sources: BEA

The inflation data released in April showed a moderation. Core CPI for March, released April 17, increased just 0.1% from the prior month, after gains of 0.3% in January and 0.2% in February. Year-over-year, core CPI has risen 2.5%, after gains of 2.67% in January and 2.71% in February. The Fed’s preferred measure of inflation, core PCE, released on April 30, was unchanged in March after an increase of 0.3% in February. Year-over-inflation measured 2.12%, down from the 2.38% gain in February. David Rosenberg, Merrill Lynch’s North American economist, points out that the trend could go lower. “In each of the next four months,” he writes, “the core PCE index will be coming off high year-earlier comparisons of 0.2% or more. That means that if the core PCE can manage to print a series of +0.1% results, it will be running at 1.6% year-over-year by August.”



There is always a mix of data to consider. The ISM manufacturing index came in unexpectedly strong in the month, signaling strength in the industrial economy. At 54.7, the index was the highest in a year and up from 50.9 in the prior month. We think the market would like to see some confirmation of the strength of this data. The bottom line after this month is that it seems fairly clear that the Fed won't be raising rates in the near future and, with a month or two more of evidence to support the growth and inflation data released for April, the odds of an ease will increase. Without the stimulative effect of an interest rate cut, the consumer will have to be the driver of growth. In the first quarter, it was the 3.8% increase in consumer spending that was the main support for the tepid 1.3% growth. But the momentum in real consumer spending is slowing, coming in at a decline of 0.2% in March. Thus, most economists expect consumer spending to come in softer in the second quarter, leading to another weak GDP result.

The Markets

In April, gold rallied with the weakening dollar, interest rates moved sideways and stocks rallied.

	4/30/2007	3/31/2007	4/30/2006	MOM % change	YOY % Change
Fed Funds	5.25%	5.25%	4.75%	0.0%	10.5%
2-year US Treasury	4.595%	4.579%	4.862%	0.3%	-5.5%
10-year US Treasury	4.624%	4.646%	5.053%	-0.5%	-8.5%
10-year JGB	1.660%	1.659%	1.930%	0.1%	-14.0%
10-year euro	4.154%	4.057%	3.953%	2.4%	5.1%
10-year UK Gilt	5.043%	4.969%	4.635%	1.5%	8.8%
10-year Canada Treasury	4.154%	4.113%	4.468%	1.0%	-7.0%
30 yr conventional mortgage	6.15%	6.12%	6.45%	0.5%	-4.7%
Dollar Index	81.45	82.93	86.11	-1.8%	-5.4%
Japanese Yen	119.38	117.59	113.81	1.5%	4.9%
S&P 500	1482.37	1420.86	1310.61	4.3%	13.1%
Nasdaq Composite	2525.09	2421.64	2322.57	4.3%	8.7%
Gold \$/oz (nearby contract)	\$683.50	\$663.00	\$654.50	3.1%	4.4%
Oil \$/bbl (nearby contract)	\$65.71	\$65.87	\$71.88	-0.2%	-8.6%
MBA Refi Index (month end)	2015.8	2098.3	1565.6	-3.9%	28.8%

Source: Bloomberg; Japanese Yen quote is the London feed

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