



- **The Mortgage Market:** *Prepays stay slow; evaluating extension risk*
- **The Economy:** *The Fed is unmoved, but it can't stay unmoved*
- **The Markets:** *Stocks move sideways amid bond market volatility*

The Mortgage Market

Prepayment speeds in May (June release date) remained relatively unchanged from April, even with a two business-day increase in day count and the expected pickup from seasonality. Looking ahead to June and July we can expect this trend in prepayment speeds to continue, which should further confirm that the U.S. housing market is softening. Also contributing to slowing prepayments in the immediate future is the roughly 40 basis point back-up in 10-year Treasury rates since the end of April.

As the 10-year Treasury sells off, every mortgage investor is thinking, "What is my extension risk?" Extension risk is simply the lengthening of a bond's duration when rates rise given an assumed slowdown in prepayment speeds. Due to this slowdown in the speed with which principal is returned, the mortgage investor has a reduced ability to capitalize on the investment opportunities in higher-yielding assets. Extension risk is refinancing risk's mirror image, and in an extreme market condition it can be just as much of a negative for the investor. The chart below (prepared by UBS) helps to quantify the level of extension/contraction risk present across the entire MBS universe:

	Duration							Duration Change						% Mkt Outstdg As of Jun- 07
	-200	-100	-50	unch	50	100	200	-100 to -200	-50 to -100	Unch to -50	Unch to +50	+50 to +100	+100 to +200	
30-yr FN														
4.50 & Below	2.41	5.55	6.26	6.62	6.86	7.02	7.13	-3.15	-0.71	-0.36	0.24	0.17	0.10	2.95
5.00	0.43	4.41	5.56	6.30	6.72	6.97	7.22	-3.98	-1.15	-0.75	0.42	0.25	0.26	24.89
5.50	-0.01	2.76	4.52	5.49	6.15	6.53	6.91	-2.76	-1.76	-0.97	0.67	0.38	0.38	38.11
6.00	0.23	0.94	2.95	4.47	5.31	5.91	6.50	-0.72	-2.01	-1.51	0.84	0.60	0.60	22.97
6.50	0.23	0.36	1.83	3.35	4.51	5.20	6.07	-0.13	-1.47	-1.52	1.16	0.69	0.87	8.04
7.00	0.22	0.42	1.36	2.53	3.70	4.56	5.59	-0.20	-0.94	-1.16	1.18	0.86	1.03	2.14
7.50 & Above	0.72	1.26	2.12	2.90	3.62	4.18	4.90	-0.54	-0.86	-0.78	0.72	0.56	0.72	0.90
Market														
6/07 Distribution	0.26	2.58	4.16	5.23	5.91	6.34	6.79	-2.32	-1.59	-1.07	0.68	0.43	0.45	

Source: UBS *Prices are as of the close on Monday, June 11, 2007. Duration calculations are from Yield Book.

The table illustrates that on June 11, 2007, the duration of the entire MBS universe was 5.23 years in the unchanged scenario. Should rates rise by 50 basis points, the duration would extend 0.68 years to 5.91 years. Conversely should rates decrease by 50 basis points, the duration of the MBS universe would contract 1.07 years to 4.16 years. Interestingly, we updated UBS's analysis using market data on July 3rd, when mortgage rates were higher. It shows that should rates decrease by 50 basis points from these higher levels, the mortgage universe will contract by 0.87 years, and should rates increase by 50 basis points the mortgage universe will extend by 0.58 years. This analysis shows that as rates rise, there is relatively less extension risk. This illustrates what we call the "beauty and the curse" of mortgage-backed securities: you receive capital to reinvest every month, but more than you want when you least need it, such as during a refinancing wave when yields are low, and less than you want when reinvestment is attractive at higher rates.

The Economy

As expected, the Federal Open Market Committee decided to hold the Federal Funds Target Rate steady at 5.25% on June 28. The accompanying statement is noteworthy for a few items: First, the Fed says that economic growth is expanding at a moderate pace and that housing has been a drag on growth. Second, the Fed acknowledges that core inflation has subsided (removing the word "elevated" that characterized inflation in the last two statements), but maintains its position that inflation remains its predominant policy concern because "a sustained moderation in inflation pressures has yet to be convincingly demonstrated." It does not elaborate on what it considers a convincing demonstration. For what it's worth, economists at Goldman Sachs think that the core

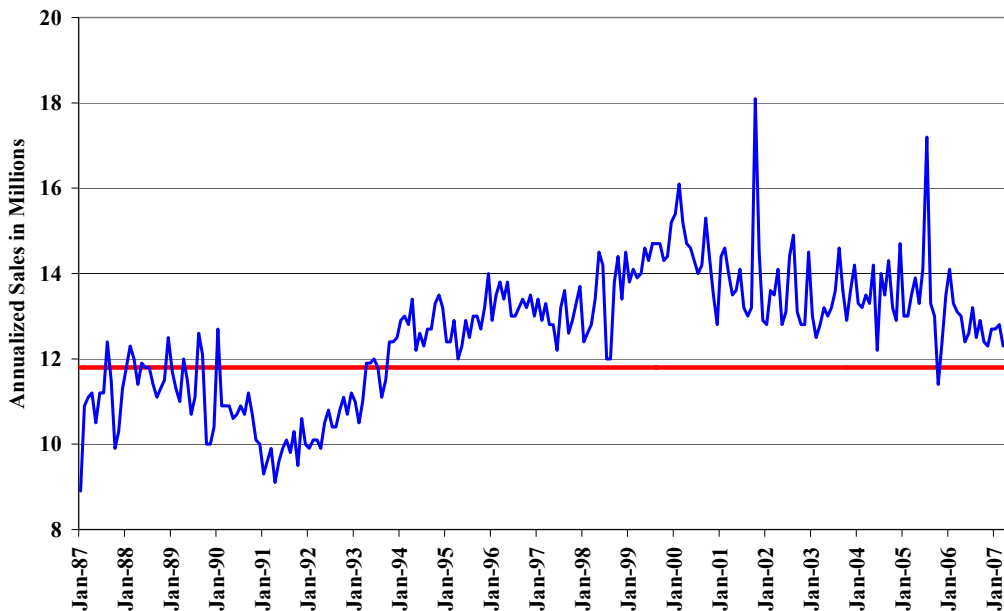


PCE inflation picture is pretty clear: “[R]ecent trends are quite promising. Annualized, the last three months translate into yearly inflation of 1.1%. In contrast to the FOMC, we see the evidence of sustained inflation moderation as fairly convincing.”

We read the FOMC statement to mean that the Fed believes growth is not yet weak enough to warrant an easing, nor does it believe that inflationary pressures are subsiding enough to stop being worried about it. Federal Reserve Bank of San Francisco President Janet Yellen referred to current policy as the best way to achieve the elusive goal of faster growth and slower inflation in the U.S. economy. “The virtues of this path,” she said in a recent speech, “are that it avoids exposing the economy to unnecessary risk of a downturn while, at the same time, it is likely to produce enough slack in goods and labor markets to relieve inflationary pressures.”

To judge by the Fed Funds futures market, the Fed is convinced this state of equilibrium will last for some time. We wonder about that assessment, as there are so many parts in an economy moving above and below trend. We will be very interested to see what we can learn about the deliberations of the FOMC when the minutes of the meeting are released in three weeks, because the Fed is, we believe, approaching a decision point. In recent months, the data on inflation, GDP growth, retail sales, durable goods orders, production and credit performance are showing weakness. There is some strength in the service sector, and in the jobs picture, where the unemployment rate is a low 4.5%. In addition, the housing market continues to deteriorate and weigh heavily on the consumer, as retailers are generally reporting weak numbers. The latest release on domestic auto sales—at 11.8 million units, the lowest since we were pulling out of the last consumer recession in 1993 (except for the post-Katrina month of September 2005)—should raise some concerns at the Fed. “Slowly but surely,” writes Paul Kasriel, chief economist of Northern Trust, “the tentacles of the housing recession are strangling the consumer.”

US domestic auto sales--a sign of consumption weakness



One more item for the Fed and the markets to continue to watch is the bond market and global interest rates. With the yield curve steepening, the bond market is doing the Fed’s job of reducing stimulus. “The Fed knows that it cannot keep the funds rate at ‘equilibrium’ continuously,” writes Lou Crandall, chief economist of Wrightson Associates. “It leaves the fine-tuning to the market.” Rising credit spreads and higher long-term interest rates will likely exacerbate the underlying weakness in the economy and credit performance.

Credit performance, indeed, is reverberating through the bond market. Recent headlines on the Bear Stearns Asset Management hedge funds, Caliber Global Investment Ltd and United Capital Markets are mainly about the difficulty in pricing an illiquid security that is experiencing these credit issues. The question that faces the general market is how widespread the holdings of these securities are, and what is the systemic fallout if there is an accurate mark to market which significantly reduces the value of the security. The Fed will likely have to address all of these issues with monetary policy decisions in the month ahead. For us, we are happy to sit on the sidelines with our high credit quality assets.



The Markets

In June, stocks were flat as global interest rates fluctuated. Oil rose on fresh supply concerns.

	6/30/2007	5/31/2007	6/30/2006	MOM % change	YOY % change
Fed Funds	5.25%	5.25%	5.25%	0.0%	0.0%
2-year US Treasury	4.862%	4.912%	5.154%	-1.0%	-5.7%
10-year US Treasury	5.026%	4.890%	5.138%	2.8%	-2.2%
10-year JGB	1.879%	1.753%	1.930%	7.2%	-2.6%
10-year euro	4.574%	4.422%	4.071%	3.4%	12.4%
10-year UK Gilt	5.463%	5.255%	4.710%	4.0%	16.0%
10-year Canada Treasury	4.555%	4.490%	4.584%	1.4%	-0.6%
30 yr conventional mortgage	6.61%	6.37%	6.75%	3.8%	-2.1%
Dollar Index	81.92	82.30	85.16	-0.5%	-3.8%
Japanese Yen	123.26	121.81	114.47	1.2%	7.7%
S&P 500	1503.35	1530.62	1270.20	-1.8%	18.4%
Nasdaq Composite	2603.23	2604.52	2172.09	0.0%	19.8%
Gold \$/oz (nearby contract)	\$650.90	\$661.00	\$616.00	-1.5%	5.7%
Oil \$/bbl (nearby contract)	\$70.68	\$64.01	\$73.93	10.4%	-4.4%
MBA Refi Index (month end)	1687.2	1874.6	1423.9	-10.0%	18.5%

Source: Bloomberg; Japanese Yen quote is the London feed

FIDAC (An Annaly Company)
1211 Ave of the Americas
Suite 2902
New York, NY 10036
Tel: 212-696-0100 · Fax: 212-696-9809
www.annaly.com



This commentary is neither an offer to sell, nor a solicitation of an offer to buy, any securities of Annaly Capital Management, Inc. (“Annaly”), FIDAC or any other company. Such an offer can only be made by a properly authorized offering document, which enumerates the fees, expenses, and risks associated with investing in this strategy, including the loss of some or all principal. All information contained herein is obtained from sources believed to be accurate and reliable. However, such information is presented “as is” without warranty of any kind, and we make no representation or warranty, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. While we have attempted to make the information current at the time of its release, it may well be or become outdated, stale or otherwise subject to a variety of legal qualifications by the time you actually read it. No representation is made that we will or are likely to achieve results comparable to those shown if results are shown. Results for the fund, if shown, include dividends (when appropriate) and are net of fees. ©2007 by Annaly Capital Management, Inc./FIDAC. **All rights reserved. No part of this commentary may be reproduced in any form and/or any medium, without express written permission.**