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MONTHLY COMMENTARY

JULY 2007
Released August 8, 2007

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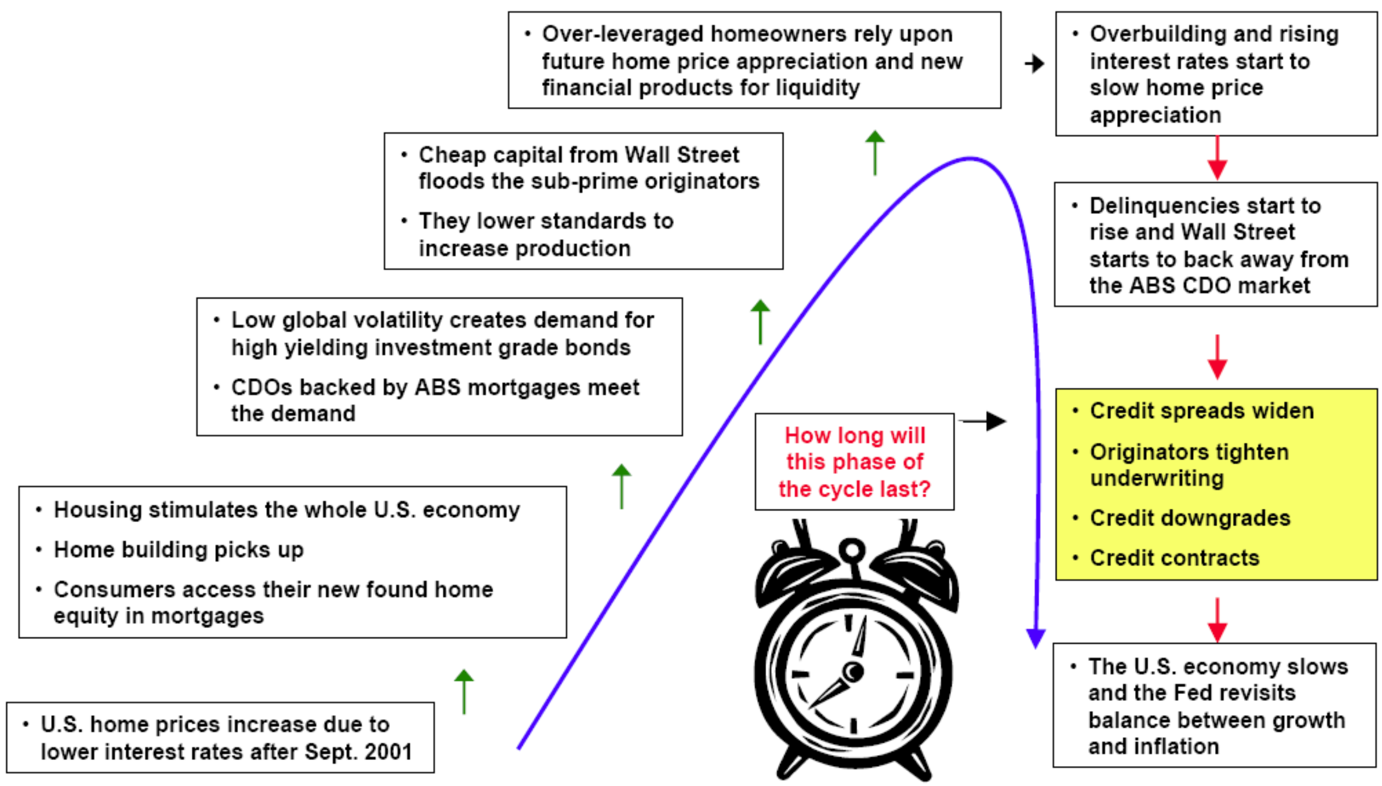
The Economy

A commentary that covers the month of July (and the first week of August) 2007 runs the risk of getting bogged down in detail. It was indeed an eventful month, and looking at the extreme turmoil in the credit and equity markets without context is like trying to understand the Grand Canyon by examining a piece of sandstone at the bottom. We need perspective. We'll start with the graphic below, which is our conception of the relationship between monetary policy, the mortgage market, the housing market and the US economy. As we have said in different venues and through different media, the story of the US economy since the tech-stock debacle of 2000 and the terrorist attacks of September 11, 2001 has been the story of easy money helping to drive up house values. Everything is rosy during the positive, virtuous phase of the housing cycle: The Federal Reserve lowers interest rates to an "emergency" level, mortgage rates decline making more houses more affordable for more people, which drives demand and prices for housing. Liquidity flows into the mortgage sector as credit performance remains strong. The economy picks up steam as houses get built and employment in housing and housing-related industries picks up. The consumer feels wealthy, keeps trading up in house and refinancing to extract equity and increase consumption. Everybody is a winner during the early phase of the housing cycle.



With business cycles, the risk is that they go on for too long, that the positive momentum turns into an irrational boom. Mistakes get made and the inevitable bust is all the more painful. In the case of the housing cycle, mistakes occurred because the cheap and plentiful credit for borrowers got less cheap as the Fed, watching all this, raised the Fed Funds rate 425% from June 2004 to June 2006. All participants in the market, however, kept it going: Returns were attractive, the ratings agencies were blessing the structures, and credit was performing. The demand for mortgage product through the CDO and securitization mechanism was too lucrative for mortgage originators and structured products packagers to pass up. But house prices *and* rates were going up while incomes weren't going up (as much), so the mortgage originators took matters into their own hands. They originated "affordability loans" that had low up-front rates or no principal amortization or negative amortization. More and more, they stopped asking for documentation, required less equity downpayment and compromised the appraisal process in order to create the raw loans, exposing both the lenders and the borrowers to greater risk.

The positive, virtuous part of the cycle reached the exhausted stage in 2006, as home prices continued to rise but housing affordability was problematic. As a whole, the mortgages originated in 2006 were so poorly underwritten that their credit performance deteriorated almost immediately. There are many stories of borrowers who couldn't make even their first or second payment. At that point, the vicious, negative part of the cycle began as the affordability of houses was at a low while the supply of homes was peaking. This spelled trouble for not only home prices but also for the credit performance of the riskier borrowers. Starting last summer, the homebuilders began to report weaker results, increased cancellations, stagnant home selling prices and asset writedowns. Homes for resale stayed on the market longer. The more marginal mortgage originators started to go out of business as they ran out of liquidity. The toll of failing smaller subprime mortgage originators continued through the fall, but the big warning signal to the market that the cycle had turned hit in February/March 2007. This is when New Century, at the time one of the largest subprime lenders in the country, ran into credit and liquidity issues and went into bankruptcy in an astonishingly swift downturn. By one measure of market perception, the ABX index of subprime mortgage-backed securities, credit spreads blew out, and warehouse funding for new CDO issuance began to dry up. The housing market has continued to deteriorate, as virtually every measure of activity—whether it is permits, housing starts, new and existing home sales or the National Association of Home Builders sentiment index—is tanking. Mortgage delinquency and default rates are rising—for all types of credits—and foreclosure activity is spiking.

Knowing what we know about the continuum of the housing cycle—the big picture—we can make better sense of the events of the last month. We can also take a guess at what will happen next. In our graphic, we believe the bullet points in the yellow box describe where we are: The vicious part of the cycle is playing out and the problems of the housing and subprime markets are no longer contained to just a few bad actors in lending and homebuilding. Housing prices are flat to down in virtually every part of the country, which spells problems for credit, homebuilder and lender performance. Credit spreads are widening, making it more expensive for all borrowers, not just subprime mortgage borrowers. Mortgage credit is getting harder to come by, as many surviving firms are either raising rates on certain products or getting out of the subprime and Alt-A lending markets entirely. Not only has the ABX continued to widen, but spreads on high-yield bonds have risen, too, to 428 basis points over Treasuries, the highest in two years. Sponsors of new LBO and M&A deals are finding it more difficult to consummate them. As one measure of the market, Blackstone, the pre-eminent private equity firm in the country (if not the world), went public on June 22 at $31 per share, and by August 6 had fallen to $24 as investors lowered expectations of future deal activity. Moody's and S&P began to downgrade the worst residential mortgage-backed securities—mostly 2006 vintage—in what should be viewed not only as a reflection of worsening credit trends but also a tacit acknowledgement that the ratings agencies were wrong to have rated them so highly in the first place.

Implied by the bullets in the yellow box are that these items are having consequences all over. US stocks have been on a roller coaster with many deep plunges, as investors re-appraise risk in the system. Railroads, chemical producers, car companies, retail chains and insurance companies are citing the fallout from subprime and housing for their own weak performance. Investors are getting hit hard. There has been a flight to quality in the bond market as any security with any credit risk has fallen in market value. And if those securities are financed, then the margin calls are becoming an issue. After all, it was mark-to-market that killed the Bear Stearns Asset Management funds, United Capital, American Home Mortgage, Caliber, severely wounded Australia's Basis Capital, Germany's IKB, Sowood and C-BASS and cost Warren Spector of Bear Stearns his job. The credit markets have lost confidence in anything that has credit risk.

So what is next? The next box on our graphic suggests that at some point all of this combines to prompt the Federal Reserve to use monetary policy tools in order to help alleviate the economic, credit and liquidity problems. But the timing is uncertain. The only numbers the Bernanke Fed seems to care about are the unemployment rate and inflation. It might be too hard to explain, even to a central banker, that the biggest threat to the economy at this point in time isn't something conventional like inflation, or profit growth, or job weakness, but rather the downside of financial over-exuberance. The paradox here is that in its official statements the Fed says core inflation isn't contained when it appears to be, but it also insists that the effects of the housing/subprime meltdown are contained when they appear not to be. Indeed, after its rate-setting meeting on August 7 the Federal Reserve acknowledged that the markets have been volatile, credit is getting tighter and that the downside risks to growth have increased, but it still maintained that inflation remains its "predominant policy concern."

One thing we do know is this: The highest point on the entire yield curve is the Fed Funds rate. The market is trying to tell the Fed something.

The Mortgage Market

Prepayment speeds in June (July release date) came in 8% lower with the aggregate CPR on 30-year FNMA collateral at 10.9% versus 11.9% in May. Typically there is a seasonal peak in speeds in the June/July period however, as Bear Stearns reports, the market is experiencing the slowest aggregate 30-year prepayment speeds since December of 2000. The largest declines in speeds were on recent vintage higher coupons; for instance, speeds on 2005 FNMA 6's declined 13% while 2005 5's only declined 4%, which may be further proof that the housing market is weakening. Looking ahead, speeds are estimated to continue a trend of flat to 5% monthly decreases throughout the remainder of the summer, setting up for a potential slowdown in speeds in September. We are in a historically slow period, and there are four fewer business days in September than in August, which is one of the slowest paying months of the year with the onset of the school season. Treasuries rallied at the end of July, which makes it difficult to accurately predict the estimated slowdown in September, but offsetting that is tightening credit standards, flat to down home price appreciation and a widening in mortgage spreads.

The widening in mortgage spreads brings up an important concept of prepayment behavior—that prepayment speeds can come in slower than anticipated in a bond rally due to spread widening. As the Treasury market has rallied since the end of June, mortgage spreads have widened as investors have re-assessed the value of the call option embedded in mortgages. Thus, the table below shows how the price and yield on the 2-year and 10-year Treasury have changed over the course of the last year and the last month, compared to Agency mortgage product, subprime and corporates. MBS spreads have been fairly stable from July 2006 through June of 2007 as the Treasury market has also remained fairly stable, and so have their dollar prices. The ABX widened considerably, resulting in a 40% decline in value, while the Lehman investment grade corporate Index has declined about 7/32 in price. In the July rally, spreads have widened on all sectors, although for different reasons and to a different extent. The ABX and both high-grade and high-yield corporate spreads have widened due to credit concerns and, despite the rally in rates, declined in price (significantly, in the case of the ABX). Agency fixed-rate and adjustable-rate mortgage-backed securities, while improving slightly in price during the rally because of their positive duration, nevertheless underperformed Treasuries because the MBS investor has required higher compensation for being short the call option embedded in mortgages in a falling rate environment. Many analysts believe that the underperformance is overdone, because tighter underwriting standards, slowing HPA and spread widening should temper prepayments. Perhaps the market has begun to agree with the analysts, because since the end of July mortgages have tightened back in to Treasuries by several basis points.

The Flight to Quality

	7/31/2006		6/28/2007		7/31/2007	
	Yield	**$ Px**	**Yield**	**$ Px**	**Yield**	**$ Px**
2-yr Treasury	4.95%	99-12+	4.94%	99-13	4.52%	100-6+
10-yr Treasury	4.98%	96-8	5.10%	95-9	4.74%	98-4+
	Spread	**$ Px**	**Spread**	**$ Px**	**Spread**	**$ Px**
Agency Fixed-rate MBS [1]	114	99-12+	117	98-31+	142	99-05+
Agency ARMs [2]	72	100-28+	79	100-21+	115	100-28
ABX 2006-2 BBB- [3]	227	100.5	1787	60.8	2592	40.7
Investment Grade Corporates [4]	95	100.22	97	99.96	126	99.70
High Yield Corporates [5]	322	96.12	292	98.42	413	94.17

[1] 30 yr FNCL 6%, actual spread over Treasuries
[2] 6% 5/1 Agency hybrid, spread over the zero volatility curve
[3] ABX 2006 BBB- spread over LIBOR
[4] Lehman Corporate Index, actual spread over Treasuries
[5] Lehman High Yield Index, actual spread over Treasuries

The Markets

In July, stocks fell on credit and economic concerns. Global yields came off their highs. Oil continued its surge and gold rallied. The dollar weakened against a basket of global currencies.

	7/31/2007	6/30/2007	7/31/2006	MOM % change	YOY % change
Fed Funds	5.25%	5.25%	5.25%	0.0%	0.0%
2-year US Treasury	4.522%	4.862%	4.954%	-7.0%	-8.7%
10-year US Treasury	4.741%	5.026%	4.981%	-5.7%	-4.8%
10-year JGB	1.800%	1.879%	1.929%	-4.2%	-6.7%
10-year euro	4.347%	4.574%	3.921%	-5.0%	10.9%
10-year UK Gilt	5.209%	5.463%	4.605%	-4.6%	13.1%
10-year Canada Treasury	4.534%	4.555%	4.314%	-0.5%	5.1%
30 yr conventional mortgage	6.60%	6.61%	6.52%	-0.1%	1.2%
Dollar Index	80.77	81.92	85.30	-1.4%	-5.3%
Japanese Yen	119.22	123.26	114.63	-3.3%	4.0%
S&P 500	1455.27	1503.35	1276.66	-3.2%	14.0%
Nasdaq Composite	2546.27	2603.23	2091.47	-2.2%	21.7%
Gold $/oz (nearby contract)	$666.90	$650.90	$634.20	2.5%	5.2%
Oil $/bbl (nearby contract)	$78.21	$70.68	$74.40	10.7%	5.1%
MBA Refi Index (month end)	1724.1	1687.2	1417.2	2.2%	21.7%

Source: Bloomberg; Japanese Yen quote is the London feed

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