



## MONTHLY FOCUS

**The Mortgage Market:** *Mortgage activity slows; Freddie Mac volunteers for a cap*

**The Economy:** *After 2 years and 17 meetings, the Fed stops, but others keep going*

**The Markets:** *Gold and oil stay elevated*

## The Mortgage Market

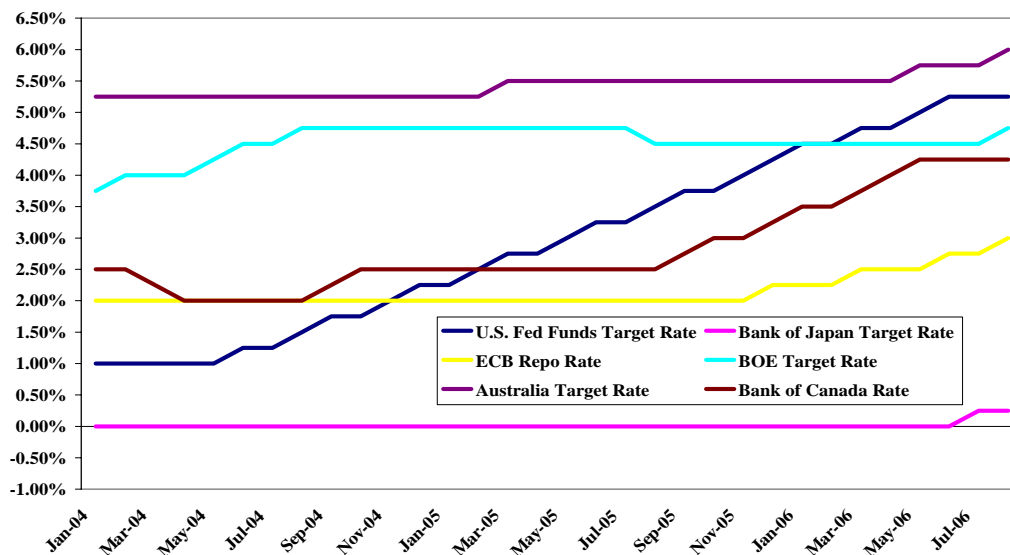
Mortgage prepayments were essentially unchanged in June (July reporting period), reflecting the offsetting impact of day count and strong seasonal turnover with increases in interest rates. The summer months will be primarily driven by day count, with July prepayments expected to drop 10-15% and August expected to bounce back 10-15%. In September a 3-day drop in the day count and weaker seasonal turnover should lead to a 10-15% drop in prepayments. U.S. mortgage applications fell to the lowest levels in more than four years as home purchases declined. The Mortgage Bankers Association said its seasonally adjusted index of mortgage applications and home purchases decreased 1.3% and 2.4%, respectively, for the week ended July 28.

On August 2, 2006, Freddie Mac and its regulator OFHEO announced that Freddie Mac voluntarily agreed to limit the growth of its mortgage portfolio to no more than 2% per year, starting July 1, 2006. This cap is similar to the one placed on Fannie Mae earlier this year. According to feedback from senior management at Freddie Mac, this does not impose additional limits on the types of mortgage products that Freddie Mac can buy and sell. Analysts speculate that this will have very little, if any, impact on the mortgage market. According to the *UBS Mortgage Strategist*, taking a different spin, Freddie Mac's announcement "might actually be a plus for the mortgage market, since it puts an end to the speculation that some sort of OFHEO-imposed limit on the Freddie Mac portfolio might be coming. In fact, Freddie Mac may very well have honored OFHEO's request to limit its growth because its cost of doing so is quite limited, given its main goal of getting GAAP-compliant by early next year."

## The Economy

If you are an observer of interest rates (like we are), the last month or so was like watching fireworks, with all the world's major central banks sending up rockets. The Bank of Canada, the People's Bank of China, the Bank of Japan, the Reserve Bank of Australia, the European Central Bank and the Bank of England all made momentous monetary policy decisions. In the Grand Finale, on August 8 the Federal Reserve decided to pause after 17 straight raises, ending, for now at least, the largest percentage increase in the Fed Funds rate over a two-year span since 1962. In all, 15 central banks around the world increased their cost of borrowing in the last month. It was quite a performance.

A central bank fireworks show



source: the Bloomberg

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- The PBOC, with second quarter GDP at 11.3% and its June trade surplus at a record \$14.5 billion, decided to raise the reserve requirements in order to slow down the staggering rate of fixed asset investment growth rather than take the less politically palatable option of raising short-term rates. (The Chinese overnight interbank rate is currently 2.48%.)
- The Bank of Japan's decision on July 14 to raise overnight lending rates for the first time in 6 years was controversial but highlighted the central bank's independence from political pressure. Toshihiko Fukui, the BoJ governor, called the rate rise "a delightful moment" for Japan, which has seen sustained economic growth and seven monthly increases in core price inflation since November.
- The Reserve Bank of Australia pushed rates up for the second consecutive meeting to 6%, now the highest overnight rate for any major economy. "The general strength of the global economy has been reflected in further increases in commodity prices since the start of the year," the bank announced on August 2. "These increases have been broadly based and are adding to the growth in Australia's national income and spending."
- The ECB's raise to 3% was expected, while the BoE's move was a surprise to the markets. Reacting to the strength in German employment data, and an inflation rate of 2.5% in the euro-zone, Jean-Claude Trichet, ECB president, said "a progressive withdrawal of monetary accommodation will be warranted."
- The Bank of England, which reduced rates to 4.5% just a year ago, sees things differently today. It said, "Against the background of firm growth, limited spare capacity, rapid growth of broad money and credit, and with inflation likely to remain above the target for some while, the Committee judged that an increase of 0.25 percentage points in the official Bank rate to 4.75% was necessary to bring CPI inflation back to the target in the medium term."
- Perhaps foreshadowing what was about to transpire for its neighbor to the south, the Canadian central bank on July 11 announced that it was keeping its overnight rate at 4.25%, the first pause after seven consecutive 25 bp increases. "With some anticipated moderation in U.S. growth," the central bank explained in its announcement, "combined with past interest rate and exchange rate increases, the Canadian economy is projected to return to its production capacity by the end of 2008."

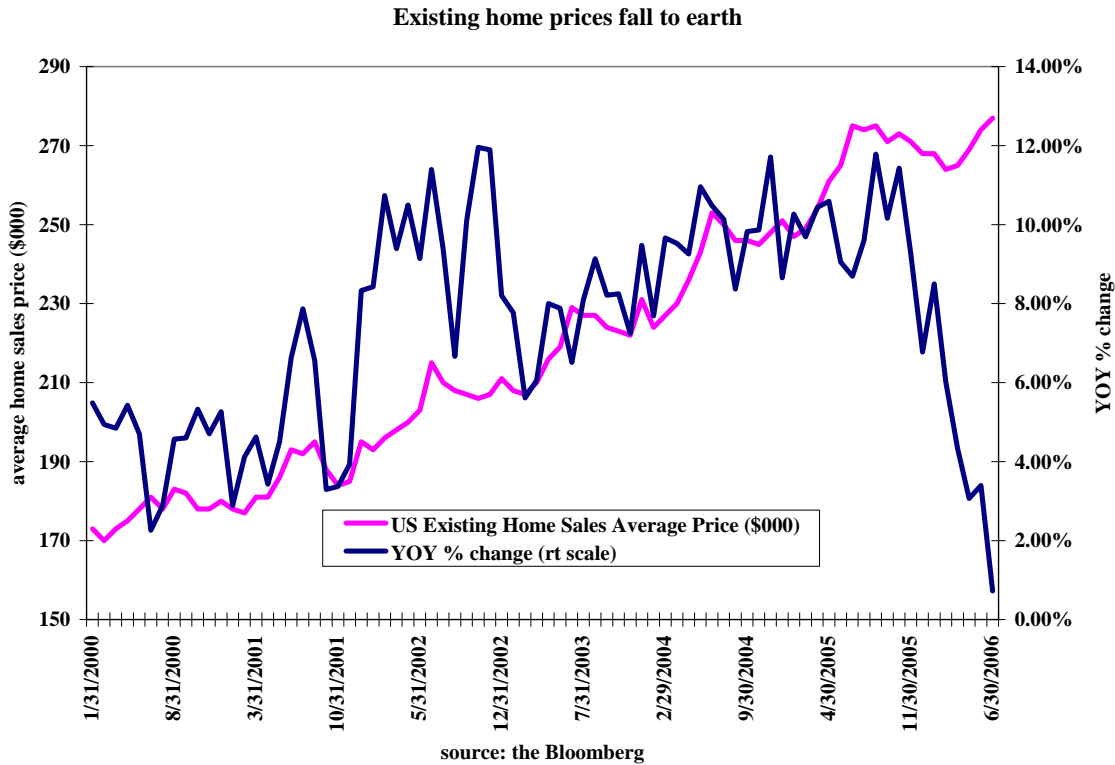
The Fed Funds futures market, normally a reliably accurate predictor of the upcoming meeting within 30 days of the date, had a probability of tightening as high as 65% as recently as July 18<sup>th</sup> (after PPI was released). The 2-year Treasury, the point on the curve that is most sensitive to Fed policy, peaked in yield on June 28 at 5.28% and, leading the Fed, had rallied to under 5% by month's end. A pair of headlines in the *Financial Times* summed up the vacillation of the markets. On July 29, following the release of the lower-than-expected estimate of 2.5% for second quarter GDP, the headline read: "Evidence of US slowdown backs hopes for rates pause." Just four days later, on August 2, following solid data on manufacturing activity in July from the Institute of Supply Management and a 2.4% reading on core PCE, the headline read: "New data prompt speculation that Fed will increase rates."

Which brings us to the Fed's decision on August 8. With the backdrop of the FOMC statement of June 29, the speeches of various Fed governors, the semiannual monetary policy testimony of Chairman Bernanke and the release of the minutes to the FOMC meeting, all of which drove the market to conclude that a pause in rate hikes was a possibility, not to mention the activities of central banks around the world, each data point released during the month of July was freighted with meaning. The economic statistics were consistent with the Fed's so-called 'balance of risks' view on economic conditions, i.e., the balance between inflationary risks and economic growth. The advance second quarter GDP estimate came in significantly below first quarter growth, the July employment report failed to meet expectations for now the fourth month in a row, and housing continuing its sharply weakening trends. At the same time, the inflation data were somewhat worrisome: The core PCE number for June, the Fed's preferred gauge of inflation, increased 2.4% year over year, the highest since April 1995. In addition, industrial production, capacity utilization and the ISM data also came in stronger than expected. Thus, the Fed's decision on August 8 can be explained: A pause, with an acknowledgement that "core inflation ha[s] been elevated in recent months," while "[e]conomic growth has moderated from its quite strong pace earlier this year." The statement stressed those factors that would help contain inflation, including "the cumulative effects of monetary policy actions", but concluded with a bias towards fighting inflation. "Nonetheless," the statement winds up, "the Committee judges that some inflation risks remain. The extent and timing of any additional firming that may be needed to address these risks will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information." In sum, the Fed has paused, hasn't ruled out further increases, but believes the slowing economy will likely moderate inflation pressures over time. Like the Fed, we will watch the incoming information to determine which way the balance may be tilting between growth and inflation.

Taken separately, each central bank is making rational, independent decisions based on the data before them and their expectations for economic activity in their home countries or regions. Taken together, however, we believe that these interest-rate events are a signal that *the world is going to look a lot different going forward than it has over the last several years*. (Mike Farrell, chairman of Annaly, published an ironic perspective on these conditions in "The Goldfish is Dead, Senator," found on our website at



[http://www.annaly.com/images/The%20Goldfish%20is%20Dead%202\\_.pdf](http://www.annaly.com/images/The%20Goldfish%20is%20Dead%202_.pdf).) Moreover, this profile would likely mean that return expectations for different investment classes will likely have to be adjusted downwards. Global growth is driven by US consumption, which is driven by the US consumer, who is driven by his or her ability to extract home equity through mortgage facilities; the world is going to have to find other engines of growth. To central bankers around the world, perhaps the most important piece of data that came out in July is that the price of the average existing home sold in the US was \$277,000, just 0.73% over the average a year ago. It is the slowest rate of YOY appreciation since the data have been kept.



## The Markets

Interest rates around the world are largely higher year-over-year. The dollar weakened. Gold and oil strengthened more.

	31-Jul-06	30-Jun-06	31-Jul-05	MOM % change	YOY % change
<b>Federal Funds Rate</b>	5.25%	5.25%	3.25%	0.0%	61.5%
<b>2-year US Treasury</b>	4.954%	5.154%	4.019%	-3.9%	23.3%
<b>10-year US Treasury</b>	4.981%	5.138%	4.278%	-3.1%	16.4%
<b>10-year JGB</b>	1.929%	1.930%	1.313%	-0.1%	46.9%
<b>10-year euro</b>	3.921%	4.071%	3.243%	-3.7%	20.9%
<b>10-year UK Gilt</b>	4.605%	4.710%	4.315%	-2.2%	6.7%
<b>10-year Canadian govts</b>	4.314%	4.584%	3.869%	-5.9%	11.5%
<b>30 yr conventional mortgage</b>	6.52%	6.75%	5.63%	-3.4%	15.8%
<b>Dollar Index</b>	85.30	85.16	89.35	0.2%	-4.5%
<b>Japanese Yen</b>	114.63	114.47	112.29	0.1%	2.1%
<b>S&amp;P 500</b>	1276.66	1270.20	1234.18	0.5%	3.4%
<b>Nasdaq Composite</b>	2091.47	2172.09	2184.83	-3.7%	-4.3%
<b>Gold \$/oz (nearby contract)</b>	\$634.20	\$616.00	\$429.90	3.0%	47.5%
<b>Oil \$/bbl (nearby contract)</b>	\$74.40	\$73.93	\$60.57	0.6%	22.8%
<b>MBA Refi Index (month-end value)</b>	1417.2	1356.0	2250.3	4.5%	-37.0%

Source: Bloomberg; Japanese Yen quote is the London feed

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