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MONTHLY COMMENTARY

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- **The Economy:** *2006 was a year of transition, but 2007 visibility is cloudy*
- **The Mortgage Market:** *Prepays decline; measuring refinanceability in the market*
- **The Markets:** *Stocks were up, bonds and the dollar were down in 2006*

The Economy

If our regular monthly commentaries follow any "formula," it is that we supply a concise analytical perspective to what we believe to be the salient economic and market events of the month, for the mortgage market and for the market as a whole. Whether it is housing starts vs. construction jobs, inflation's relationship to economic growth, or the correlation between the ISM data and GDP, we try to use the past to guide our expectations for the future which, after all, is what matters most to investors. But when we prepare our commentary for December we've always felt compelled by the convention of the calendar to take a broader perspective.

This year is no different. That said, we have no chief economist who pronounces an official company interest rate or economic forecast that is included in published surveys or serves as a single input into a portfolio management model. Rather, what we have is the judgment of seasoned investment professionals who have spent their careers watching the economy and the markets. As managers of interest rate risk, we have learned that our long-term investors are best served if we evaluate and position our portfolios for a wide range of possible outcomes, and not take a directional bet that will pay off in only one outcome. When we evaluate a security for purchase (or sale), we run it and the portfolio through a host of interest rate scenarios—up and down shocks, curve steepeners and flatteners, and different vectors over different time horizons—and base our investment decisions on the relative values obtained through this analysis. We may have a point of view, based on observations similar to what follows in this commentary, but our portfolio decisions are more agnostic.

2006 was a year of transitions: From Greenspan to Bernanke, from Fed Funds tightening to rates on hold, from Snow to Paulson, from Republican to Democratic control of Congress, from Koizumi to Abe, from BoJ quantitative easing to raising rates, from Rumsfeld to Gates, from a commodities boom to commodities bust, from a roaring US national housing market to a splintered, collapsing market and the beginnings of credit underperformance. It was a year of tight risk spreads and frenetic M&A activity, mega-sized deals and huge liquidity flows into private equity, emerging markets and US financial assets. In December, the data painted a general picture of a weakening economy and subsiding inflationary pressures. Durable goods orders were weak, thanks to autos; the ISM manufacturing index had its first sub-50 print since April 2003; the weakening housing market data revealed high inventories and lower sales prices; the final revision to third quarter GDP was lower than expected; and core inflation data continued to show that price pressure in the economy is easing. Both core CPI and core PCE showed no change from the prior month. On a year-over-year basis, core PCE, the Fed's favored measure of inflation, registered a 2.2% increase, down from 2.4% in the prior month.

The inflation data came out after the Fed met on December 12 and decided to maintain the Federal Funds rate at 5.25%. The Fed kept its accompanying statement virtually unchanged, except to indicate that the housing market was showing "substantial" cooling but that inflation was still perceived to be a risk. According to the minutes, "many participants judged that economic activity in the second half of the year was probably a touch softer than had been expected…," but at the same time "nearly all participants viewed core inflation as uncomfortably high." No real change there. If there was anything new in the Fed's outlook it was the suggestion that it expected the economy to have a little slack and that housing "was likely to damp economic growth in the near term." Interestingly, one participant at the meeting favored putting an even more balanced view in the FOMC statement that included the possibility of an ease as well as a tightening.

Since the Fed isn't tipping its hand, we are looking for signs in the statistics. Before we see an ease, we will likely need a few of the following trends to develop:

- **Inflation**: Core PCE should have to fall to a year-over-year increase lower than the current 2.2% run rate. The Fed has always maintained that its comfort zone is 1% to 2%. While this isn't an inflation target per se, the Fed would probably continue its hawkish stance until inflation gets within the comfort zone. If they didn't, we'd likely see greater inflation

expectations built in the long end of the yield curve. That said, with energy and other commodities prices generally declining, and with below average economic growth, we would expect the late cycle trend of disinflation to continue.

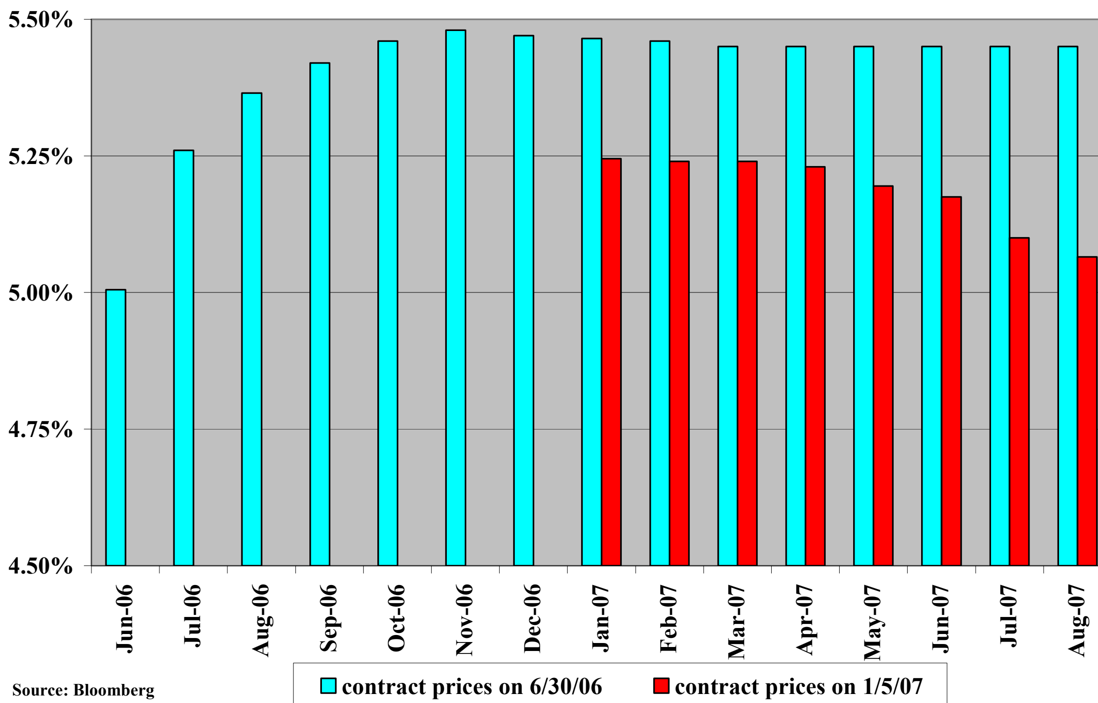
- **Manufacturing**: We believe that ISM manufacturing will have to fall and stay below 50, and that factory capacity utilization will have to decline. The ISM manufacturing survey is a good coincident indicator of cyclical turns in the economy. For November it came in at 49.5, but the December print was 51.4. Although this level of activity is not very powerful, factory activity has proved to be fairly resilient to an outright decline. Weakness here would resonate that a cyclical turn was at hand.

- **Employment**: Both job growth and the unemployment rate are still at levels that indicate a tight job market. But we believe the slowing housing market will start having a more pronounced effect during the first half of 2007, as the lagged effect of the collapse in housing starts begins to filter through to other related industries. The employment data for December released on January 5 shows that while the manufacturing and construction sectors continue to contract, the service sector of the economy is still strong.

- **Housing**: The Fed has signaled that it is concerned about housing weakness having broader effects on economic growth. We believe this is a valid concern because housing has played such a pivotal role in economic growth over the past half-decade. We see the potential to turn a soft landing into a hard one due to the combination of falling prices, reduced home equity extraction, slower residential construction activity, declining consumption of housing and housing related goods and services and eventual credit market effects of worsening credit performance for the marginal borrower. In the latest in an ever-lengthening line of these types of announcements, Lennar Corp., the fourth-largest US homebuilder, posted its first quarterly loss in at least a decade due to declining profits on home sales and a large land investment write-off. “Market conditions continued to weaken during the fourth quarter and we have not yet seen tangible evidence of a market recovery,” said CEO Stuart Miller. Subprime mortgage lenders continue to hit the headlines, too. Ownit Mortgage, an independent subprime lender that relied on Wall Street for financing, had to file for Chapter 11 bankruptcy protection in December when defaults rose and its lenders shut off their credit. “This is going to end badly” for the industry, CEO William Dallas told the LA Times. In the first business day of the new year, another subprime lender, Mortgage Lenders Network USA, stopped making new loans. Executive Vice President James Pedrick told Bloomberg News, “The economics of this market are not good, and it deals with the performance of loans, and to a lesser extent the value of homes.”

- **Consumer**: The American consumer is the workhorse of the US economy, if not the global economy, and thus receives a deserved amount of attention from the Fed. Spending activity is largely a secondary effect to many of the items above: People will spend if they are working, and they will spend more because of the wealth effect that comes with increases in home equity and gains in the stock market, by borrowing against these assets or otherwise shifting savings dollars into spending dollars. While this may or may not be a harbinger of things to come in 2007, surely the Fed will notice that same-store sales rose just 3.1% in December, making this year's holiday season the slowest in two years.

There are still question marks in the minds of many on the direction these and other variables will take in 2007. Most concede that housing will take a bite out of economic growth going forward, but opinions differ on the extent of the damage. Some believe the broader US and global economy is resilient enough to withstand the housing slump and avoid recession. Others say that monetary policy is still too accommodative and should cause elevated inflation pressures. According to the December survey of over 70 economists conducted by Bloomberg, the median forecast for GDP growth for 2007 is 2.5%, Fed Funds will be at 4.75% by year-end 2007, and the 10-year Treasury will be at 4.80%. The persistent inversion of the yield curve tells us something about growth and inflation expectations and for its part, the Fed Funds futures market thinks there is an 80% chance that the first cut will come by August.



Other externalities that could affect the economy and the markets in 2007 include US trade polices toward China, the performance of the dollar and its effect on the trade deficit and foreign investors' demand for US financial assets. We also cannot discount the threat of an eruption of geopolitical instability coming from Iraq, Iran, North Korea, Israel and Palestine, any of a number of rogue terrorist outfits or somewhere totally unexpected. It is a world filled with the risk of many possible outcomes, but one thing we do know for sure is that risk is currently seemingly priced out of the market. Risk premia are low for risky assets, whether it is emerging markets debt, junk bonds, subprime mortgages or even common stocks. Lawrence Summers, former secretary of the Treasury, wrote recently in the Financial Times that the "new year will begin with the greatest divergence for a generation between the general view of global risks as reflected by conventional wisdom and the risks as priced in the financial markets." Some may take comfort in the fact that the market seems to be unworried about these various risks, he says, but "historically, the moments of greatest complacency have been the moments of greatest danger." If we were to allow ourselves one outright prediction for 2007, it is that this risk pricing cannot be sustained.

The Mortgage Market

Mortgage prepayment speeds for November (released in December) decreased in line with dealer expectations. Despite a 50bp rally in mortgages since August, prepayments on premium coupon (6.5%) mortgages have not increased in any significant way, suggesting that the weak housing market is starting to have an impact on the refinancing profile of recent originations. Also noteworthy is that hybrid ARMs, despite a recent decline in speeds, continue to pay significantly faster than their fixed rate counterparts. Looking forward, we can expect December speeds to remain flat to down slightly. In January we can also expect speeds to remain fairly flat, however there may be a slight pickup due to lower mortgage rates and increase in day count, while the reverse should hold true for February.

The common themes in 2006 in the mortgage market—a slowing of the U.S. housing market, deterioration in credit quality leading to credit events, and the "refinanceability" of the overall mortgage market given current mortgage rates—will also dominate in 2007. On this last point, with the 30yr mortgage rate ending the year roughly at 6.18%, the question that should be on every mortgage-backed security investor's mind is "How far do mortgage rates have to fall to generate a significant refinancing wave?" We touched on this subject in September's Commentary but it is worth delving into again with the Fed on pause. UBS defines marginally refinanceable (rate sufficiently attractive to make a borrower even think about refinancing) when there is a 20 bps differential between the rate paid by the borrower and the new mortgage rate available, and it defines fully refinanceable when this

differential is 50 bps. So how refinanceable is the mortgage market? The market is roughly as refinanceable as it was when we spoke about this subject in September and the 30 year mortgage rate was at 6.31%. Currently only 18% is marginally refinanceable and 11% is fully refinanceable. For the mortgage market to get to the levels of 2003 when virtually 100% of the market was fully refinanceable, mortgage rates would have to rally to 4.75% from the current rate of 6.18%, (or about a 2.93% 10-year).

The Markets

This month we show year-end data points for each of the past three years to show a somewhat longer-term trend. 2006 was a good year to be in US stocks, but not long duration fixed income. Note the relatively tight range of long-duration fixed income yields over the past two years, and how long rates in the US are among the highest of the G-7. Commodities had a much better 2005 than 2006. The dollar had a strong 2005, and a weak 2006. Gold and oil, both commodities that are denominated in dollars, had much different years, which may tell us something about their respective ability as a store of value. Refis are up from December of 2004, but they are marginally lower than two years ago, reflecting the rangebound nature of long interest rates.

	31-Dec-06	31-Dec-05	31-Dec-04	05-06 YOY % change	04-05 YOY % change
Federal Funds Rate	5.25%	4.25%	2.25%	23.5%	88.9%
2-year US Treasury	4.812%	4.404%	3.069%	9.3%	43.5%
10-year US Treasury	4.704%	4.393%	4.220%	7.1%	4.1%
10-year JGB	1.685%	1.480%	1.441%	13.9%	2.7%
10-year euro	3.948%	3.309%	3.682%	19.3%	-10.1%
10-year UK Gilt	4.741%	4.100%	4.537%	15.6%	-9.6%
10-year Canadian govts	4.086%	3.979%	4.306%	2.7%	-7.6%
30 yr conventional mortgage	6.14%	6.06%	5.53%	1.3%	9.6%
Dollar Index	83.65	91.17	80.85	-8.2%	12.8%
Japanese Yen	119.07	117.97	102.50	0.9%	15.1%
S&P 500	1418.30	1248.29	1211.92	13.6%	3.0%
Nasdaq Composite	2415.29	2205.32	2175.44	9.5%	1.4%
Gold $/oz (nearby contract)	$638.00	$518.90	$438.40	23.0%	18.4%
Oil $/bbl (nearby contract)	$61.05	$61.04	$43.45	0.0%	40.5%
MBA Refi Index (month-end value)	1640.4	1363.2	1701.3	20.3%	-19.9%

Source: Bloomberg; Japanese Yen quote is the London feed

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