

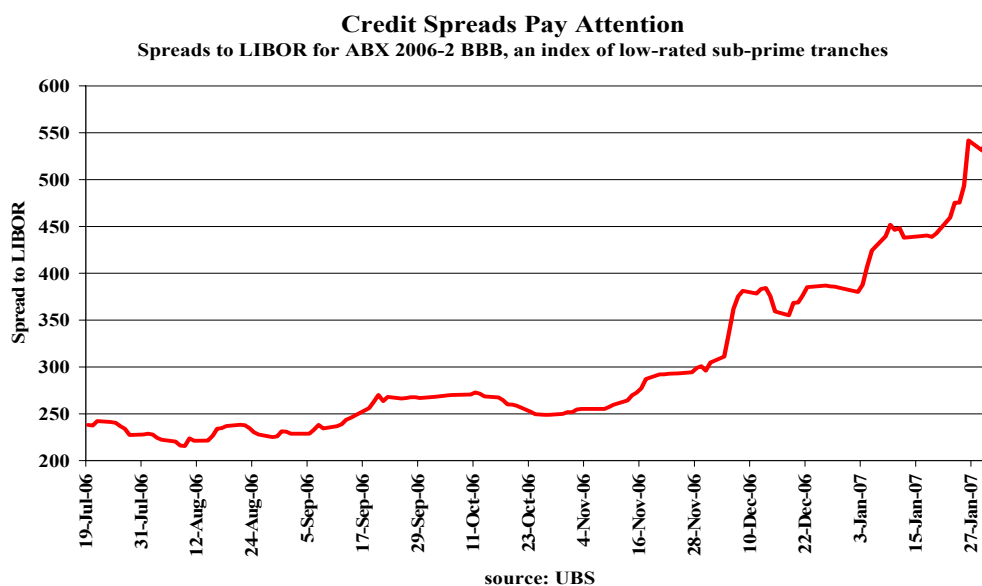


- **The Mortgage Market:** *Prepays speed up; examining activity in sub-prime mortgages*
- **The Economy:** *The Fed looks to stay on hold, watching and waiting for definitive data*
- **The Markets:** *Stocks and bonds react to the Fed on hold; oil falls*

The Mortgage Market

Prepayment speeds came in approximately 5% to 10% faster than dealer expectations for December (January reporting period). With the stable interest rate environment and slow seasonal turnover during November to December, speeds had been estimated to decline 5-10% for the month of December but, according to V.S. Srinivasan of Bear Stearns, faster speeds are occurring as sellers are discounting home prices to move unsold inventory. This phenomenon, however, is likely to abate: “Through the summer of 2006, sellers generally remained firm on asking prices and existing home sales declined sharply. More recently, we have seen a decline in regional home price indices, suggesting that sellers are more flexible on price. As the housing market goes through this price discovery process we are likely to see some rebound in home sales. Longer term, the level of housing turnover and cash-out refinancing activity is driven by the rate of home price appreciation.” Looking ahead, in January the Street expects speeds to remain fairly flat, with the chance of a slight pickup due to lower mortgage rates and an increase in day count; the reverse should hold true for February.

Although our strategy involves the use of the highest credit quality assets—US Government Agency mortgage-backed securities—we can’t help but notice developments in the sub-prime corner of the mortgage market. The race to acquire sub-prime mortgage originators by investment banks began in July of last year when Deutsche Bank purchased MortgageIT. In the remaining months of 2006, Morgan Stanley, Merrill Lynch, and Bear Stearns all followed suit with their acquisitions of Saxon Capital, First Franklin, and Encore Credit Corporation, respectively. And just recently, Bank of America and Countrywide Financial have held discussions about an alliance that would create the largest mortgage-lending group in the United States. The reasoning behind the latest surge in acquisitions is that banks want to build up the volume of loans that they can pool and sell to investors through the process of securitization. While perhaps a viable long-term strategy, we have to wonder about the timing of these acquisitions given where we are in the credit cycle. The ABX index, which is a benchmark of different tranches and vintages of sub-prime loans, has been widening lately, reflecting investor sentiment that credit quality will worsen. According to Markit, the firm that calculates the index, a number of the bonds underlying the index have suffered interest shortfalls due to rising delinquencies. As a result, it appears that the market is pricing in a substantial risk in the foreseeable future for the sub-prime mortgage market.





The Economy

The headline event of January was the decision by the Fed to hold rates steady for now the fifth straight meeting. The decision by the Fed was not unexpected. In the environment in which we now find ourselves, where the bond market has a pretty good handle on what's inside the mind of Ben Bernanke and his colleagues, and where the Fed tries diligently to communicate with the market, by the time the FOMC meets, its decision is mostly a ratification of expectations. In other words, there are few surprises in the market, at least when it comes to monetary policy.

Let us be more precise. The market's handle on Fed policy is proportional to the time until the next meeting. Its forecasting ability gets better the closer it gets. Thus for the month and half since the December 20th meeting, the market was quite twitchy and volatile as each piece of new economic data was released. By the time the Fed got around to deciding to do nothing, the picture of the economy—from manufacturing to housing to inflation—was decidedly mixed.

The data of the last week of the month is a good indication of the ambivalence of the data. The sentiment of the manufacturing sector as measured by the Institute of Supply Management at last count was 49.3—anything below 50 is contractionary and now two out of the last three months were below 50. The housing market is still weak by virtually every measure. New and existing home sales are down year-over-year and prices are flat-to-down in most metropolitan areas around the country. The news from the public homebuilders is an absolute disaster, with most reporting no expectations for improvement in 2007. WCI Communities, a Florida-based homebuilder, reported that in the 4th quarter they had more order cancellations than new sales. Lennar, the nation's fourth-largest homebuilder, reported that its order backlog at the end of the 4th Q was 40% lower than the prior year, which typically means that sales, which closely track backlogs, will be down about the same amount. The Case/Schiller home price index of 20 major markets was up only 1.7% year over year, the lowest on record. Credit performance in many mortgage sectors is suffering along with the slowdown in home prices as borrowers can't refinance out of a jam as easily. Inflationary pressures are easing, as December core PCE, the favored inflation index of the Fed, showed a year over year increase of 2.2%, down from recent cyclical high of 2.4% and just outside of the Fed's comfort zone. The employment data released on February 2 was modestly below expectations, with non-farm payrolls rising just 111 thousand in the month (as opposed to expected 150 thousand) and the unemployment rate ticking up from 4.5% to 4.6%.

In past commentaries we have described our view that the weakness in housing and credit should spill over into other areas of the market. We still hold that view, and most of the market shares it to some degree. The Fed itself, in its releases and speeches, has also reflected its concerns over these areas. However, definitive recessionary-type data has not yet surfaced. Most obviously, the preliminary estimate of fourth quarter GDP came in at 3.5%. Unless and until the Fed sees sustainable weakness in economic growth, we would expect the Fed to continue to stay on hold. In February we may get more clarity on the Fed's position on the growth vs. inflation debate in Chairman Bernanke's semi-annual testimony before Congress and the release of the minutes to the last FOMC meeting.

The Markets

In January, in the US bonds fell and stocks rose as each market factored in the possibility of the Fed staying on hold for a bit longer. Oil has cooled off, while gold stays strong.



	31-Jan-07	31-Dec-06	31-Jan-06	MOM % change	YOY % change
Federal Funds Rate	5.25%	5.25%	4.50%	0.0%	16.7%
2-year US Treasury	4.921%	4.812%	4.520%	2.3%	8.9%
10-year US Treasury	4.810%	4.704%	4.517%	2.3%	6.5%
10-year JGB	1.704%	1.685%	1.570%	1.1%	8.5%
10-year euro	4.100%	3.948%	3.468%	3.9%	18.2%
10-year UK Gilt	4.976%	4.741%	4.150%	5.0%	19.9%
10-year Canadian govts	4.177%	4.086%	4.166%	2.2%	0.3%
30 yr conventional mortgage	6.30%	6.14%	6.09%	2.6%	3.4%
Dollar Index	84.60	83.65	88.96	1.1%	-4.9%
Japanese Yen	120.91	119.07	116.85	1.5%	3.5%
S&P 500	1438.24	1418.30	1280.08	1.4%	12.4%
Nasdaq Composite	2463.93	2415.29	2305.82	2.0%	6.9%
Gold \$/oz (nearby contract)	\$652.00	\$638.00	\$570.80	2.2%	14.2%
Oil \$/bbl (nearby contract)	\$58.14	\$61.05	\$67.92	-4.8%	-14.4%
MBA Refi Index (month-end value)	1940.2	1640.4	1747.2	18.3%	11.0%

Source: Bloomberg; Japanese Yen quote is the London feed

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