



FIDAC FOCUS

The Mortgage Market: Day count becomes a factor in prepays; credit begins to unravel

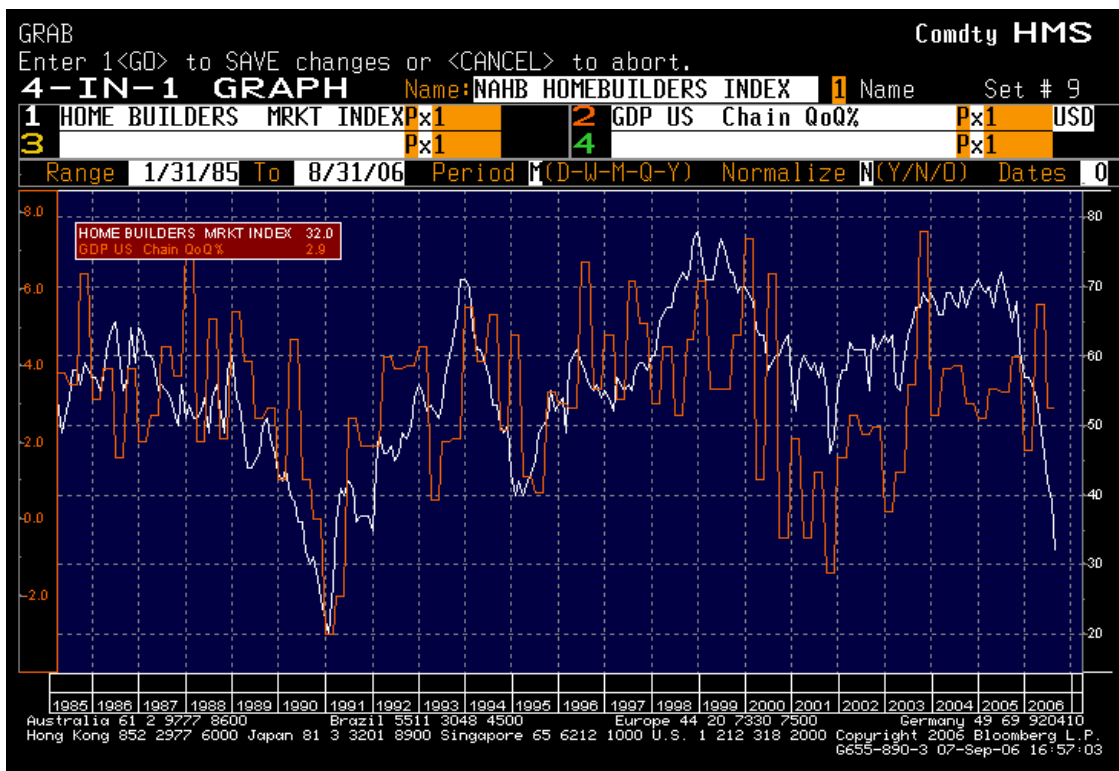
The Economy: The Fed pauses, with one dissent; the door remains open for more tightenings

The Markets: Rates decline and stocks rally with the pause

The Mortgage Market

Mortgage prepayments decreased 13% in July (August reporting period), primarily due to a two-day drop in day count. Looking ahead, August has the most business days of the year (23), three more than in July, so we should see a 10-15% pick up in prepayment speeds. September has a three-day drop in the day count and weaker seasonal home sales, which should reduce prepayments. The Mortgage Bankers Association (MBA) Refinance Index rose in August to 1609.2, but this rebound in applications was largely anticipated due to the recent rally in mortgage rates. The Refi Index declined 26% year-over-year. Within that same MBA survey, the Purchase Index declined from the prior month, reflecting the steady slowing of home sales. The Purchase Index is down about 20% from a year ago.

The slowing of the housing market is becoming more evident in the data. The Office of Federal Housing Enterprise Oversight, which is the regulator of Fannie Mae and Freddie Mac, just released home price appreciation data for the second quarter of 2006 which shows home prices appreciated just 1.17% in the quarter, the lowest quarterly rate of appreciation since the fourth quarter of 1999. The decline in the quarterly rate of appreciation over the past year is the sharpest decline since OFHEO began tracking the index in 1975. Not surprisingly, this decline in home price appreciation is spilling over into homebuilder confidence. The National Association of Homebuilders index of builder confidence fell for the seventh consecutive month in July to 32, the lowest level in 15 years. A reading under 50 suggests more survey participants are seeing “poor” economic conditions than “good” ones for home sales. The connection between homebuilder confidence and the economy is striking as illustrated in the graph below.



(Continued on page 2)



We are starting to see credit issues spring up in the mortgage market. For example H&R Block's mortgage unit (Option One) announced that it reserved \$61.3 million, or 19 cents a share, against "early payment defaults", which are loans that do not make even the first or second payment. Block said it tightened its loan-underwriting criteria and pricing guidelines, especially in parts of the Midwest and other regions where these early defaults have been the highest. Other subprime mortgage originators, including New Century and Impac, also reported worsening credit experience.

In a sign that credit is becoming a growth industry, RealtyTrac, a California-based company that publishes a national database of home foreclosures, has been listed as the 53rd fastest growing private company in the US by Inc. magazine. Foreclosures in the US were up 25% year over year in the second quarter. Commenting on why his company is growing, CEO James Saccacio said, "[W]e believe there will be increased opportunities to invest in foreclosures in 2006 and in 2007, when over a trillion dollars in adjustable-rate mortgages are expected to reset."

Not every lender will necessarily be prepared for these resets. The *Wall Street Journal* reported that Washington Mutual (WaMu), one of the biggest mortgage lenders in the US and a leading originator of so-called "option ARMs", made a startling confession in its annual filing with the SEC. WaMu disclosed that it had been improperly measuring some option ARM customers' debt-to-income ratios for 2004 and most of 2005. The company said that the qualifying interest rate at which lenders qualified for loans had not been adjusted upward as rates were rising. "In other words," said the WSJ, "the applications looked more credit-worthy than they really were."

The Economy

Economists, analysts and investment managers finally had something new to talk about last month as the Federal Reserve decided not to raise rates for the first time in 18 meetings. The attention of the market then turned to the data released after the August 8 decision to see if Ben Bernanke and the Federal Open Market Committee were correct to pause, and to get a handle on what might transpire at the next meeting on September 20. For the most part, Bernanke & Co. are looking smart right now. Since the FOMC meeting, we have seen further deterioration in the housing market (a decline in new and existing home sales, rising inventories of unsold homes, a sharp decline in home price appreciation, a fall-off in housing starts and building permits), consumer confidence waning, a weaker-than-expected upward revision to second quarter GDP, no upward surprises to the inflation data and slowing job growth. In addition, the Beige Book, which is the Fed's monthly survey of current business conditions, was not particularly robust—it showed that labor markets are generally steady, that despite some rising raw materials costs manufacturers are not passing these costs on, flat to decelerating retail sales, tepid consumer spending and national weakness in housing.

All of these data support current market expectations for monetary policy, the most tangible evidence of which is expectations for future rate hikes that is imputed by the Fed Funds futures market. On September 5, the Fed Funds futures market had only a minimal chance of the Fed Funds rate being raised to 5.5% at the September 20 meeting; as recently as July 9, the market put that probability at over 100%. (Moreover, the market is pricing in a better-than-average chance of a 5% Fed Funds rate in early 2007.)

Despite the relative certainty of the Fed Funds futures market, the Federal Reserve has left the door open for future rate hikes. The minutes to the August 8 FOMC meeting (released on August 29) were transparent in communicating the Fed's view of domestic economic growth. "The staff forecast prepared for this meeting," the minutes read, "indicated that real GDP growth would slow in the second half of 2006 and 2007, and to a lower rate than had been anticipated in the prior forecast." The minutes went on to give the reasons for the Fed's pessimism. "The slowdown in the housing market, the effects of higher energy prices on household purchasing power, the waning impetus of household wealth effects on consumer spending, and the effects of past policy tightening were expected to hold economic growth below potential over the next six quarters. Core consumer price inflation was projected to drop back somewhat later this year and next, mainly as the effects of higher energy and import prices abated."

Despite the rather unambiguous reduction of growth expectations on the part of the Fed, the minutes disclose that the decision to pause on August 8 was "a close call" because inflation is still elevated outside of the Fed's comfort range and that "additional firming could well be needed." The other side of the growth vs inflation debate was articulated by the one member of the FOMC who did not vote for a pause, Richmond Fed President Jeffrey Lacker. The minutes faithfully detail his reasoning. "Mr. Lacker dissented because he believed that further tightening was needed to bring inflation down more rapidly than would be the case if the policy rate were kept unchanged." While the rest of the voting members apparently believed that keeping policy unchanged "would allow the Committee to accumulate more information before judging whether additional firming would be necessary to foster the attainment of price stability over time," Mr. Lacker felt that based on his reading of the economy, growth "was unlikely to moderate by enough to bring core inflation down."



The challenge for policy makers is clear: Growth is slowing, but inflation is still a worry. If they raise rates further to stem inflationary tendencies in the economy, they will also raise the risk of pushing the economy into a recession. If they don't raise rates further, they run the risk of letting inflation get worse. The next few months will reveal whether Mr. Lacker or his colleagues are correct. For us, we believe that we are not out of the woods yet, but that ultimately the lagged effects of the prior tightenings and, much more importantly, the ripple effects of the rapidly deteriorating housing market, will ultimately be enough to slow down the economy and inflation.

The Markets

In August, interest rates around the world were lower, perhaps reflecting the slower growth that prompted the Federal Reserve to pause in its rate tightening policy. US stocks were up on the month and gold and oil slipped.

	31-Aug-06	31-Jul-06	31-Aug-05	MOM % change	YOY % change
Federal Funds Rate	5.25%	5.25%	3.50%	0.0%	50.0%
2-year US Treasury	4.780%	4.954%	3.815%	-3.5%	25.3%
10-year US Treasury	4.728%	4.981%	4.016%	-5.1%	17.7%
10-year JGB	1.630%	1.929%	1.349%	-15.5%	20.8%
10-year euro	3.760%	3.921%	3.100%	-4.1%	21.3%
10-year UK Gilt	4.516%	4.605%	4.159%	-1.9%	8.6%
10-year Canadian govts	4.109%	4.314%	3.789%	-4.8%	8.4%
30 yr conventional mortgage	6.32%	6.52%	5.61%	-3.1%	12.7%
Dollar Index	85.05	85.30	87.58	-0.3%	-2.9%
Japanese Yen	117.37	114.63	110.69	2.4%	6.0%
S&P 500	1303.82	1276.66	1220.33	2.1%	6.8%
Nasdaq Composite	2183.75	2091.47	2152.09	4.4%	1.5%
Gold \$/oz (nearby contract)	\$628.20	\$634.20	\$435.10	-0.9%	44.4%
Oil \$/bbl (nearby contract)	\$70.26	\$74.40	\$68.94	-5.6%	1.9%
MBA Refi Index (month-end value)	1609.2	1417.2	2187.8	13.5%	-26.4%

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. ©2006 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.