



MANAGER'S FOCUS

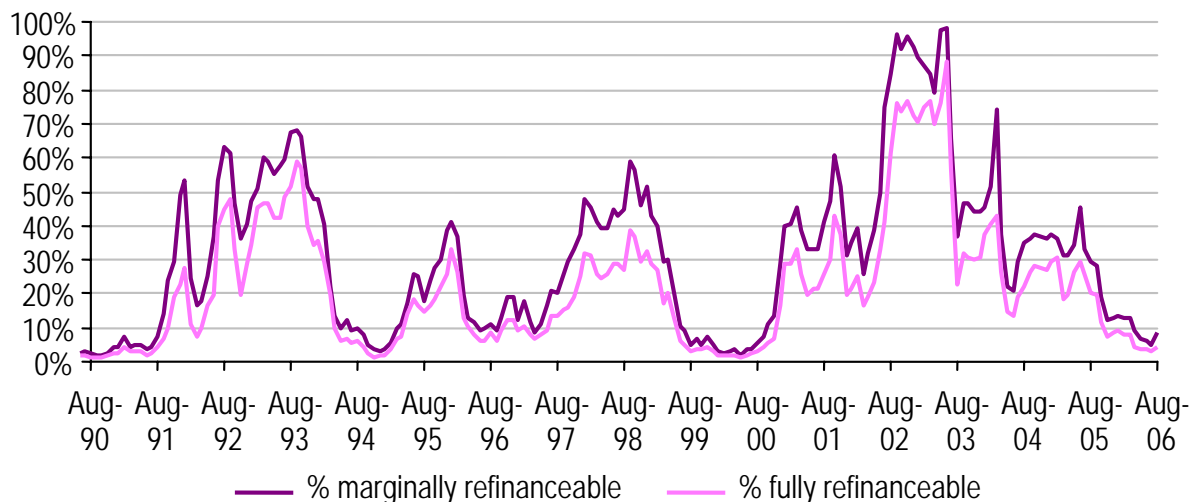
- **The Mortgage Market:** *Thinking about prepayment risk in the market*
- **The Economy:** *The Fed begins a new streak*
- **The Markets:** *Rates in the US fall, commodity prices drop*

The Mortgage Market

Mortgage prepayments increased 9% in August (September reporting period) mainly due to an increase in day count. While prepayments were in-line with expectations, they met the lower end of Street expectations, suggesting that the slowdown in housing is having an effect on refinancing. Looking forward, most dealers are expecting prepayments in September to decrease by 10-15% as day count drops by 3 days, yet some dealers are questioning whether the 20 basis point (bps) rally during August will have an impact on refinancing by homeowners. The Mortgage Bankers Association reported that US mortgage applications fell 4.9% during the week ended Sept 22; the Purchase and Refinance Indexes were also down week over week 5.5% and 4.1% respectively.

With the decline in long-term interest rates, mortgage rates slipped again in September. The 30-year mortgage rate fell to 6.31%, the lowest level since hitting a four year high of 6.80% on July 20, 2006. Market participants are beginning to ask: "How far do mortgage rates have to fall to generate a significant refi wave?" The academic answer is based on the likelihood of a borrower with a specific mortgage rate to refinance at a given interest rate. In mortgage-speak, this is called how "refinanceable" a mortgage is. 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 UBS defines those mortgages with 50 bps differential between the rate paid by the borrower and the new mortgage rate available as *fully refinanceable*. So how refinanceable is the mortgage market? The mortgage research team at UBS calculates that of the entire universe of Fannie Mae and Freddie Mac 30-year fixed rate collateral, currently only 18% is marginally refinanceable and 11% is fully refinanceable. In other words, at current rates mortgages with a coupon of at least 6.53% (or 17% of the market) are marginally refinanceable and mortgages with a coupon of at least 6.83% (or 10% of the market) are fully refinanceable. The graph below, which uses the 30-year Fannie Mae pass-through, illustrates how historically low these rates are.

% of Market (30-yr FNMA) that is Refinanceable



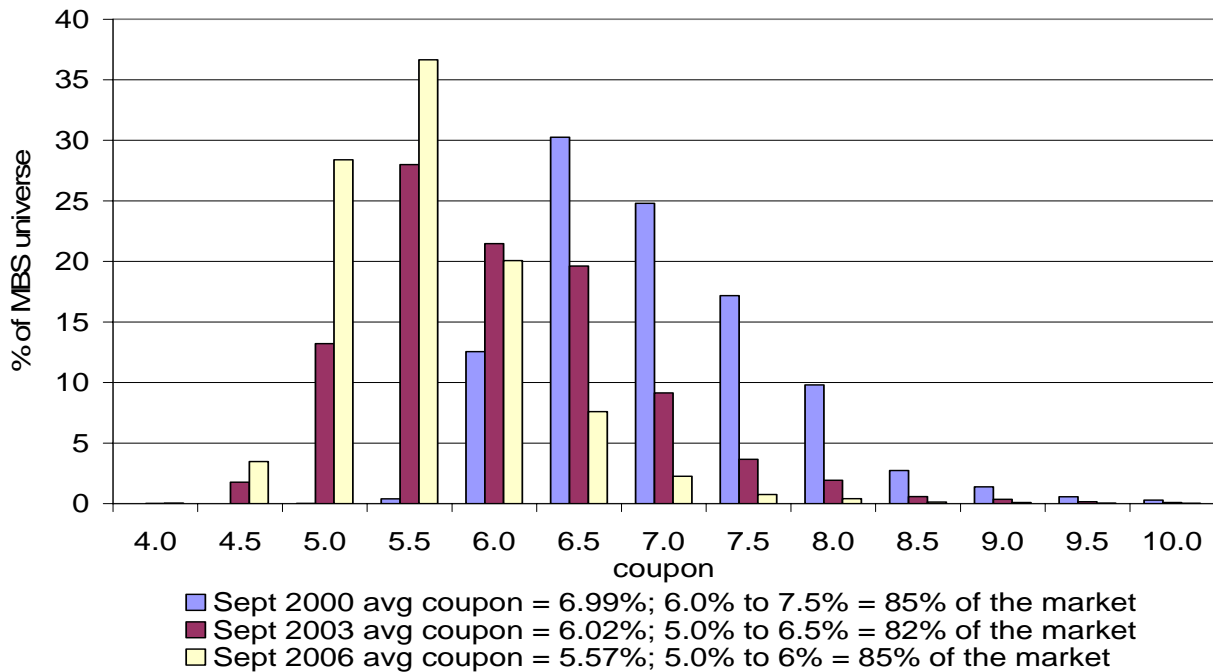
Source: UBS

How low must rates go in order for more of the mortgage market to become refinanceable? UBS calculates that if the mortgage market rates decline approximately 40 bps to 5.93% (roughly corresponding to a 4.13% 10-year Treasury yield), then 34% of the

mortgage market would be marginally refinable. If mortgage rates fell to a 5.69% (or about a 3.89% 10-year Treasury), then 58% of the mortgage market would be marginally refinable. For the mortgage market to get to the levels of 2003 when virtually 100% of the market was fully refinable, mortgage rates would have to rally to 4.73%, (or about a 2.93% 10-year). UBS also estimates that for each additional 10% of the mortgage market that becomes marginally refinable, prepayment rates rise by 4.8%.

A different way to look at the mortgage market with this in mind is to look at the coupon stack, or the distribution of coupons in the market. Since 2000, the average fixed-rate mortgage has moved down 142 basis points in average coupon to 5.57%, and it has gotten more concentrated as rates have stabilized at lower levels. Fully 37% of the market is at a 5.5% coupon, with 85% of the market spread over just three coupons; at prior snapshots in time the dispersion of coupons has been much greater.

Coupon stack moves down in rate through 6 years of refinancings



Source: UBS

Clearly a pickup in prepayment rates would accelerate as the larger segments of the coupon stack become refinable. In that instance, investors would have to contend with the reinvestment risk in a lower rate environment. Unlike the market going into the refi boom of 2003, however, today mortgage-backed securities are largely trading around or below par, suggesting that in general the income effect of increasing premium amortization will be lower in a falling rate environment.

The Economy

On September 20, for the second meeting in a row, the Federal Reserve failed to raise the target Federal Funds rate.

After a string of 17 consecutive rate hikes over two years, that's the only way to write about the Fed. It's kind of like when the New York Yankees lose 17 straight games and then win two straight, the sportswriters fall all over themselves trying to figure out if the team has finally figured out how to win games. The same is true for Fed-watchers, who have been flooding the airwaves, newspapers and our email inbox with their opinions on whether the Fed is establishing a new streak, and what will come next.

The arguments basically fall into the following two camps:

- On the one hand, the Fed will have to tighten again
 - Inflation is still an issue; Despite recent sell-off, energy price pressures remain high, and labor costs are rising

- Europe and Japan are raising rates, which puts pressure on the Fed to do likewise to help the dollar
- On the other hand, the next move by the Fed will be to ease
 - Commodity prices are falling, including energy
 - Inflation, while perhaps outside of the Fed's comfort zone, is a lagging indicator of economic strength
 - The lagged effects of 17 consecutive rate hikes have yet to be fully felt by the economy
 - The index of leading indicators has been signaling slower growth
 - Certain economic data, including manufacturing and employment, have been weaker
 - The housing market is collapsing, which is likely to have significant ramifications for the broader economy

For its part, the Fed has not expressed a bias towards either policy direction, despite the fact that it has paused for two consecutive meetings. It awaits evidence that would result in a more definitive view, and we will continue to do the same. Until that time, the market continues to try to anticipate the next move by the Fed. And as far as the market is concerned, it currently believes the next move by the Fed will be to ease. The yield curve is inverted by about 2 basis points between 2s and 10s, 35 basis points between 3-month T-bills and 10s, and 66 basis points between Fed Funds and 10s. The Fed Funds futures market is showing an 8% chance of the Fed easing to 5% after the Oct 25th FOMC meeting; for the Dec 12th meeting there is a 36% chance of the rates being eased to 5%, and for the Jan 31st meeting futures are showing a 58% chance for an ease to 5%.

The Markets

In September, interest rates in the US rallied and stocks were up in response to the outlook for an easier Fed. Gold and oil (in fact most commodities) fell during the month; perhaps the Amaranth blow-up revealed the role of hedge funds in the strength of commodities in general.

	30-Sept-06	31-Aug-06	30-Sept-05	MOM % change	YOY % change
Federal Funds Rate	5.25%	5.25%	3.75%	0.0%	40.0%
2-year US Treasury	4.687%	4.780%	4.169%	-1.9%	12.4%
10-year US Treasury	4.630%	4.728%	4.326%	-2.1%	7.0%
10-year JGB	1.675%	1.630%	1.484%	2.8%	12.9%
10-year euro	3.709%	3.760%	3.139%	-1.4%	18.2%
10-year UK Gilt	4.523%	4.516%	4.287%	0.2%	5.5%
10-year Canadian govts	4.001%	4.109%	3.968%	-2.6%	0.8%
30 yr conventional mortgage	6.17%	6.32%	5.83%	-2.4%	5.8%
Dollar Index	86.03	85.05	89.52	1.2%	-3.9%
Japanese Yen	118.01	117.37	113.56	0.5%	3.9%
S&P 500	1335.85	1303.82	1228.81	2.5%	8.7%
Nasdaq Composite	2258.43	2183.75	2151.69	3.4%	5.0%
Gold \$/oz (nearby contract)	\$598.60	\$628.20	\$469.00	-4.7%	27.6%
Oil \$/bbl (nearby contract)	\$62.91	\$70.26	\$66.24	-10.5%	-5.0%
MBA Refi Index (month-end value)	1970.8	1609.2	2107.4	22.5%	-6.5%

Source: Bloomberg; Japanese Yen quote is the London feed

Annaly/FIDAC
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 Mortgage 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 Mortgage 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.**