



- **The Mortgage Market:** *Mortgage activity slows; subprime credit performance worsens*
- **The Economy:** *The Federal Reserve's housing paradox*
- **The Markets:** *Rates take a round trip, oil loses steam*

The Mortgage Market

Mortgage prepayment speeds decreased about 10% in September (released in October) for fixed-rate and adjustable-rate mortgages primarily due to a three-day decrease in day count. Looking forward, speeds are expected to increase 10% to 15% in October due to an increase of 1.5 business days from September, lower mortgage rates, as well as the last of the seasonal upticks of 2006. Prepayments in November are expected to slow by 5% due to the holiday slowdown, which should offset lower mortgage rates, while December's should decrease by 10% for the same reasons. The Mortgage Bankers Association reported that US mortgage applications dropped 3% for the week ending October 25th, 11% lower than a year ago. In addition, the purchase index and the refinance index are down 1.8% and 4.5%, respectively, from a month ago. The purchase index, down 13% year-over-year, is at its lowest level in three years. To us, the fact that mortgage applications are much lower on a year-over-year basis while mortgage rates are essentially unchanged points to a clear slowdown in housing.

It seems that investors are starting to place their bets that the credit performance of residential mortgage borrowers is about to worsen, starting with the marginal credits in subprime mortgages. Lending standards were eased in recent years, as down payment requirements were dropped or shrank, credit and documentation processes were shortened, and payment terms were eased. Over the past decade roughly two million Americans have realized the American dream of home ownership through no-doc, interest-only, piggy-back or some other combination of subprime mortgage. Since 2002 companies such as Ameriquest Mortgage, New Century Financial and H&R Block's Option One mortgage unit made \$2.2 trillion in subprime loans. The increase in the U.S. homeownership has arguably been helped by this extension of easy credit: UBS research has found that subprime mortgage issuance is the most highly correlated variable to homeownership rates.

Easier credit standards inevitably lead to weaker credit performance. *The Wall Street Journal* points out that while just 1% of subprime loans made in 2003 were 60+ days delinquent by August of that year, almost 3% of subprime loans made in 2006 were 60+ days delinquent by August. The Mortgage Bankers Association also reported that delinquencies are on the rise. As a percentage of total loans outstanding, 12.24% of subprime ARMs are delinquent in the second quarter, up from 12.02% in the first quarter of 2006 and 10.04% in the second quarter of 2005. One measure of the market's attitude towards this possibility is going up: The cost of insuring against defaults in subprime mortgages is getting more expensive. Credit default swaps on \$1 million of moderately risky subprime-backed bonds (BBB) rose from \$21,500 in early August to \$25,000 at the end of October. In an environment such as this, high credit quality assets will likely outperform.

The Economy

October was a roller coaster month. The bond market did a round trip, as the two-year Treasury started the month at 4.687%, fell in price to yield 4.911% and ended the month at 4.697%, while the 10-year started the month at 4.63%, sold off to yield 4.83% and rallied back down to 4.60%. The market got a look at suspect employment data at the start and finish to the month, but most of the new information in between provided evidence of a slowing economy and moderating inflationary pressures. In the beginning of the month we got September non-farm payrolls—a weak headline number but strong backward-looking revisions—and at the end of the month we got the October employment data—below consensus, but with a much lower unemployment rate. Industrial production fell 0.6%, with most sectors showing softness, including appliances, autos, furniture, construction supplies and business and industrial equipment. Capacity utilization at America's factories fell from 82.5% to 81.9%. The Conference Board's Index of Leading Indicators now has a trend of 5 straight months of negative readings for its 6-months annualized change, which typically foretells a recession. The preliminary estimate of 3rd quarter GDP, released at the end of the month, came in at a lower-than-expected 1.6%. Residential housing construction fell 17.4% in the quarter, reflecting the collapse in the housing market. It was the biggest decline since the first quarter of 1991 and subtracted 1.12% from economic growth—its biggest drag on the economy since the 1982 recession.



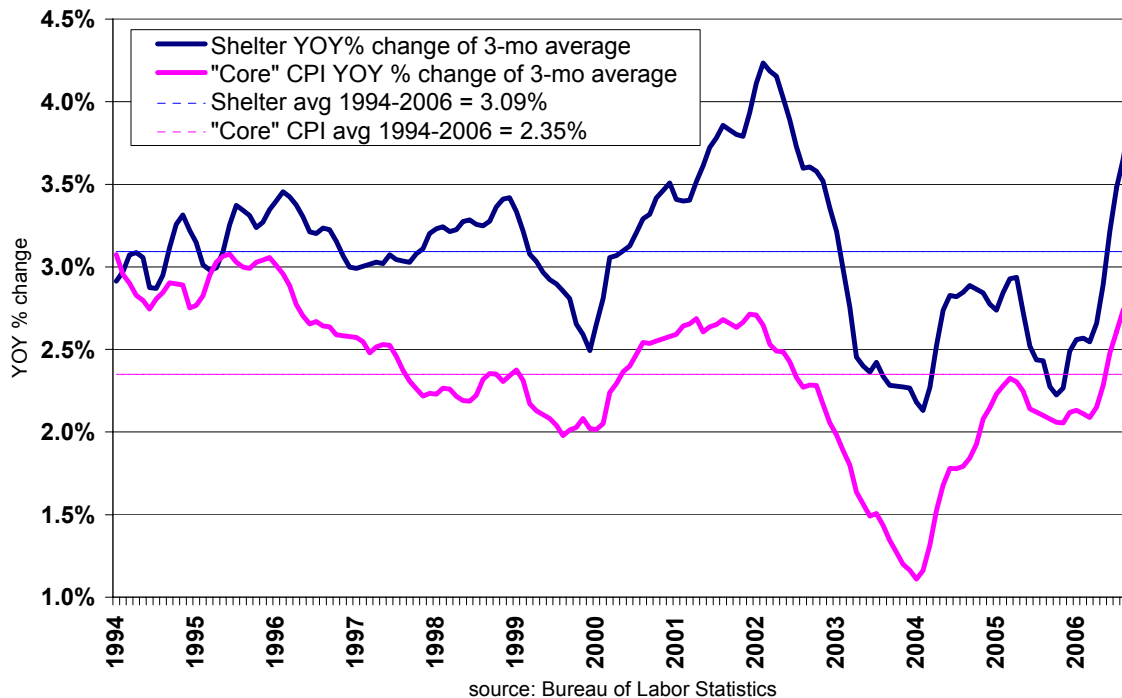
It is evident that economic growth is slowing. But in the balance of growth versus inflation the Fed remains more concerned about inflation. Recent speeches of Fed governors and presidents are uniformly on message, which goes something like this: “Inflation is a little higher than our comfort level, we expect slowing growth will fix it, but the Fed will not let inflation get out of control.” The minutes to the September 20 FOMC meeting (released October 19) expressed this lingering concern over price pressures:

Many meeting participants emphasized that they continued to be quite concerned about the outlook for inflation. Recent rates of core inflation, if they persisted, were seen as higher than consistent with price stability, and participants underscored the importance of ensuring a moderation in inflation. To be sure, very recent data on inflation suggested some improvement from the situation in the late spring, partly reflecting slower increases in owners’ equivalent rent. Also, the considerably lower level of energy prices of recent weeks, if sustained, would help reduce overall inflation and damp increases in core prices....To date, the available evidence indicated that inflation expectations remained contained—indeed, expectations of price increases for the next few years had fallen some as energy prices declined. Nonetheless, several participants worried that inflation expectations could rise and the Federal Reserve’s willingness to carry through on its intention to seek price stability could be called into question if cost and price pressures mounted or even if there was no moderation in core inflation.

This is a sobering view on inflation for anyone hoping for a quick move to easing from the Fed, but what interests us is the reference to owners’ equivalent rent (OER). We’ve all been educated about what the Bureau of Labor Statistics is up to with owners’ equivalent rent: In looking at the basket of goods and services the BLS measures in calculating CPI, it must put a number on what is, for most of us, the largest single item in our monthly personal budgets—shelter. Rents are trackable and indexable, but the cost of shelter for a homeowner is more difficult to measure. Thus not only is there a CPI shelter component called rent of primary residence, which measures the cost of renting a home, there is also one called owners’ equivalent rent of primary residence (OER). It imputes a cost of owning a home by calculating not the acquisition cost of a home but what an owner would have to pay if she were renting her own house from herself. Strangely enough, then, in the calculation of CPI both renting a house and owning a house are captured on the same rental equivalent basis. Together rent, OER and other shelter costs make up 41.7% of so-called core CPI, or CPI less food and energy. Given its size, it’s no surprise that changes in the cost of shelter drive core CPI. The graph below illustrates that when shelter costs are running above or below their long-term average, core CPI runs above or below its long-term average. (To help with the illustration, we smoothed the series by taking the three-month average for both time series, and we started the graph in 1994 when both were running at about the same year-over-year rate.)



Shelter costs drive core CPI



The news from the GDP report and the FOMC's focus on OER highlight the fact that housing is critical to both the growth story and the inflation story. The challenge for the Fed at this point in the economic cycle is that the demand for rentals, and therefore the pressure on rental rates that drives much of shelter costs, is inversely correlated with the housing market. When housing demand is strong, rental demand is weak, resulting in lower rents; when housing demand is weak, rental demand is strong, resulting in higher rents. The markets of the past few years demonstrate this point. When housing was booming during the 2002 to 2005 period, rises in rents were slowing and core CPI was low. The growth in shelter costs bottomticked in September 2005, which is just about when we believe the housing market in the US peaked. Ever since, housing has been in decline and shelter costs have been rising. Jim Bianco of Bianco Research summed up the Fed's paradox: "If housing continues to weaken, and shifts demand back to rentals, this might not only weaken growth, but keep core inflation moving higher."

As for the inflation numbers themselves, headline data during October showed outright declines due to falling energy prices, while core inflation moved sideways. However, the shorter-term trends in core inflation are declining. The annualized three-month change in both core PCE and core CPI were lower in the latest quarter than in the prior quarter. While the Fed waits and watches the inflation data and the growth data, we don't believe that these statistics—individually or as a group—are definitive enough in direction to cause the Federal Reserve to change from its current course at the next and last meeting of 2006 on December 12th.

The employment data are potentially troubling, but we're not prepared to make any conclusions based on these numbers. Non-farm payrolls rose just 92,000 in October, but the Bureau of Labor Statistics again made several large upward revisions. David Resler, chief economist of Nomura Securities International, doesn't trust the numbers. He said, "The BLS revised its first-reported job gain by nearly 100,000—from 51,000 to 148,000. Last month, the BLS revised its first-reported August gain from 128,000 to 188,000 and this month raised the August gain another 42,000 to 230,000.... Against the backdrop of such large revisions, it's hard to have much confidence in any inferences to be drawn from the reported data." One thing is for sure: construction and manufacturing continue to lose jobs while service industries, particularly health care, are driving whatever job growth there is.

The Markets

In October, interest rates in the US rose then fell to end virtually unchanged. Stocks were up, possibly in response to the outlook for an easier Fed. Oil prices fell and refinancing activity continued to decline.



	31-Oct-06	30-Sept-06	31-Oct-05	MOM % change	YOY % change
Federal Funds Rate	5.25%	5.25%	3.75%	0.0%	40.0%
2-year US Treasury	4.697%	4.687%	4.378%	0.2%	7.3%
10-year US Treasury	4.600%	4.630%	4.553%	-0.6%	1.0%
10-year JGB	1.720%	1.675%	1.554%	2.7%	10.7%
10-year euro	3.741%	3.709%	3.403%	0.9%	9.9%
10-year UK Gilt	4.511%	4.523%	4.335%	-0.3%	4.1%
10-year Canadian govts	4.026%	4.001%	4.167%	0.6%	-3.4%
30 yr conventional mortgage	6.21%	6.17%	6.13%	0.6%	1.3%
Dollar Index	85.23	86.03	90.07	-0.9%	-5.4%
Japanese Yen	116.71	118.01	116.44	-1.1%	0.2%
S&P 500	1377.94	1335.85	1207.01	3.2%	14.2%
Nasdaq Composite	2366.71	2258.43	2120.30	4.8%	11.6%
Gold \$/oz (nearby contract)	\$606.80	\$598.60	\$466.90	1.4%	30.0%
Oil \$/bbl (nearby contract)	\$58.73	\$62.91	\$59.76	-6.6%	-1.7%
MBA Refi Index (month-end value)	1709.2	1970.8	1862.8	-13.3%	-8.2%

Source: Bloomberg; Japanese Yen quote is the London feed

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