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MONTHLY COMMENTARY

NOVEMBER 2006

Released December 7, 2006

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The Mortgage Market

Mortgage prepayment speeds for October (released in November) increased 11%, in line with expectations, due to a slight uptick in seasonality, lower mortgage rates and despite a decrease in day count. As the year winds down, seasonal factors will be the main drivers of prepays. With the impending poor weather and school in session, market estimates are for a modest slowdown in speeds in November by roughly 6-8%, December by 7-9%, and January by 10-11%. While the MBA Refinance Index has increased since the end of October, dealers are predicting that strong seasonality will offset recent lower rates.

The Democrats took control of both the House and the Senate in the recent mid-term elections, and mortgage investors have begun to ask how this might affect GSE portfolio limits going forward. The short answer is that there should be little, if any, change to GSE portfolio limits. There will likely be headlines on the subject, so it is worth a quick review of the debate. Republicans have been trying to pass legislation for the past two years that would allow a new regulator to place strict caps on the size of Fannie Mae and Freddie Mac mortgage portfolios. They argue that the companies have had poor oversight and gotten so large that they pose a systemic risk to the economy. Democrats countered that they support a stronger regulator but do not see any gain in setting GSE portfolio limits. The Bush Administration is left with only four credible options for dealing with GSE reform with a Democratic Congress: accept a bill without caps, veto a bill supported by the Democrats, pursue its objectives through a regulatory strategy, or hold up the legislation. It is unlikely that the President, who has used his veto power only once in the six years he has been in office, will veto a Democrat sponsored bill. At the same time, many believe that the Administration leadership does not have the same passion for this issue as it used to. Also unlikely is that Republicans will force the Treasury Department to limit the GSE's debt issuance; doing so would effectively cap their portfolios without bipartisan support. Limiting GSE debt issuance could disrupt the already fragile housing market; the Bush administration would not want to take responsibility for that. The most likely outcome, then, is for nothing to happen.

Evidence of the softening in the housing market can be found in the recently released 2007 conforming loan limit for single family mortgages purchased by Fannie Mae and Freddie Mac. The conforming loan limits are set based on the October-to-October change in the average house price in the monthly index kept by the Federal Housing Finance Board. Despite the fact that the index fell 0.16% over the period, the conforming loan limit for 2007 was held unchanged at $417,000, versus an increase of 15.9% in 2006. Prior to this year's decrease in the index, the average annual increase in the FHFB index over the previous five years was 8.8%.

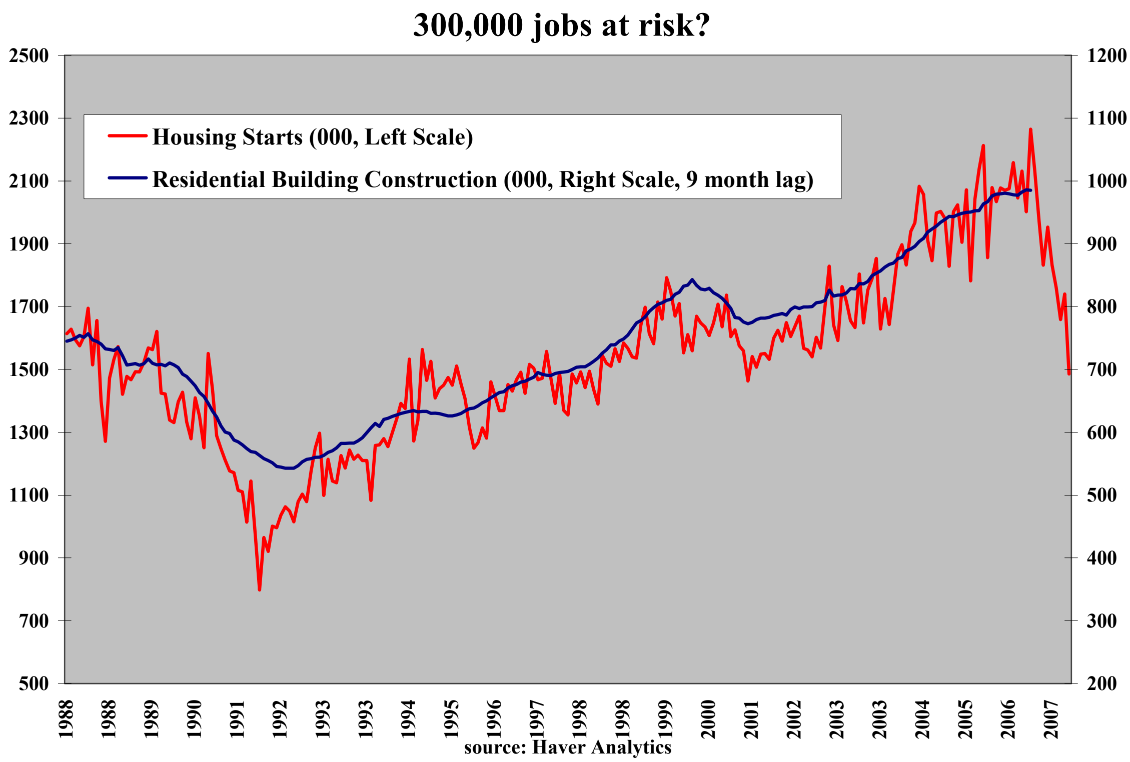
The Economy

Broad themes came into closer focus during the month of November. The first theme is the almost universal hawkishness coming out of the Federal Reserve, even as the economy clearly shows signs of slowing down. The minutes to the last FOMC meeting revealed anxiety over price stability: "All meeting participants expressed concern about the outlook for inflation." Even Kevin Warsh, the rarely-heard-from Fed governor, kept to the script in a recent speech. "Inflation," he said, "though down somewhat from its level earlier this year, remains uncomfortably elevated…There remain, I believe, clear upside risks to that inflation outlook."

We expect nothing less from the Fed—tough talk about inflation while watching the economy and formulating monetary policy. The monthly economic statistics, however, were mostly bond-friendly. This brings us to our second theme, signs that inflation is perhaps cresting. The Fed's Beige Book, indicated that growth remained "moderate" in most Federal Reserve Districts with notable weaknesses in industries related to autos and home-building. Price pressures were described as "moderating" for energy and home-building products. This observation was supported by the CPI, PPI and PCE data released during November. Core PPI and core CPI both came in lower than expected, while core PCE held steady for the month, with a year-over-year increase of 2.4%. The three-month annualized rate of core CPI inflation, which Chairman Bernanke has often cited in speeches, fell for the fifth consecutive month to 2.3% from 2.7%. Robert DiClemente, chief US economist at Citigroup, called the CPI data "the first sign, the first proof, that the outlook for inflation is improving."

The third theme is housing. The housing sector continues to sink, and its effects on the broader economy are becoming noticeable. New home sales and existing home sales were weak. While year-over-year median prices for both new and existing home sales declined—existing homes traded at a median price 3.5% below the year-ago level, the biggest drop on record—inventory levels for both increased. Clearly housing has not discovered a market clearing price. Housing starts fell 14.6% to 1.486 million rate, compared to expectations of 1.68 million, the lowest level since July 2000. Building permits fell 6.3% to a 1.535 million annual rate, the lowest since 1997. While this decline may help clear out excess inventory, there is still a lot of wood to chop. Without exception, homebuilders in the US reported declining revenues and new orders. For example, Beazer Homes said profit dropped 44% and orders fell 58% in its September quarter. It also took a land writedown. Toll Brothers saw orders collapse by 56% in its October quarter, and will also take land writedowns. Toll Brothers also said 37% of contracts signed during the quarter were cancelled, an increase from 18% in the prior quarter. "Nobody wants to buy something that will cost less two weeks or two months from now," said CEO Robert Toll. (Remember that new home inventory numbers do not factor in cancelled sales contracts. Thus the new homes supply number of 7.0 months is probably understated.)

The housing start numbers are important to watch because of their close correlation to construction jobs. The graph below shows the tight correlation between housing starts lagged by 9 months and residential construction jobs. If history is a guide, we would expect to see a downturn in construction jobs beginning in the first quarter of 2007.



Another broad theme developing in the market involves the recent weakness of the US dollar. During November, the dollar fell 3.8% and 3.1% against the Euro and the British pound, respectively. Investors around the world voted with their wallets against the dollar as the weak data is signaling that the Fed's next move could be to ease. In a world of competing fiat currencies, monetary policy is an important driver of value as a country that is tightening generally would have a stronger currency than one that is easing. From our perspective, we think it highly unlikely that the Fed will take dollar weakness into account when formulating monetary policy as the dollar is more appropriately the watch of Henry Paulson and the Department of Treasury. As for Paulson, he repeated the mantra of his predecessors: "A strong dollar is clearly in our nation's best interest." While Paulson may be officially talking the talk, unofficially Washington is probably not too upset about the weaker dollar. Clearly a weaker dollar would help shrink the approximately $800 billion (annualized) trade deficit, although it remains to be seen how trade balances work if a European shopper comes to New York to buy goods made in China. Which brings us to the December 14 trip to China that Paulson is leading. In his entourage will be five cabinet members and Ben Bernanke. The nominal purpose of the trip is to discuss a wide range of economic and trade issues, but uppermost on everyone's mind will be to continue to make the case for China to allow its currency to float more freely versus the dollar. To us, Paulson & Co. can talk until they are blue in the face, because the Chinese have no incentive to do anything but act in their own self-interest. This means that they would not want to jeopardize their own export business or the value of their vast dollar-denominated holdings by strengthening their currency.

The weakness of the dollar begs a larger question: To what extent is the dollar at risk of losing its position as the world's leading reserve currency? If monetary authorities around the world were to reduce their holdings of the dollar, that would have significant ramifications for the US and global financial markets. The Bank for International Settlements recently published a paper on this subject, "The Euro as a reserve currency: a challenge to the pre-eminence of the US dollar?" (October 2006). http://www.bis.org/publ/work218.htm . Not to worry, say the authors. Despite the growth in the liquidity and breadth of the Euro markets, it has not had a significant effect on the levels of reserve holdings of the dollar. According to the paper's authors, "The US dollar has maintained its place as the dominant reserve currency, supported perhaps by the edge that dollar financial markets still have over Euro markets in terms of size, credit quality and liquidity, as well as inertia in the use of international currencies."

We leave the last word this month to Nobel laureate Milton Friedman, the nonpareil champion of monetarism and free markets, who died on November 16. In this era of low risk premia and abundant liquidity, it is perhaps this simple aphorism he popularized that all investors and investment managers would be wise to remember: "There is no such thing as a free lunch."

The Markets

In November, interest rates in the US fell and the dollar weakened against other currencies as well as gold and oil. Stocks continue to price in a soft landing.

	30-Nov-06	31-Oct-06	30-Nov-05	MOM % change	YOY % change
Federal Funds Rate	5.25%	5.25%	4.00%	0.0%	31.3%
2-year US Treasury	4.613%	4.697%	4.411%	-1.8%	4.6%
10-year US Treasury	4.460%	4.600%	4.486%	-3.0%	-0.6%
10-year JGB	1.655%	1.720%	1.440%	-3.8%	14.9%
10-year euro	3.695%	3.741%	3.456%	-1.2%	6.9%
10-year UK Gilt	4.513%	4.511%	4.231%	0.0%	6.7%
10-year Canadian govts	3.903%	4.026%	4.060%	-3.1%	-3.9%
30 yr conventional mortgage	6.03%	6.21%	6.15%	-2.9%	-2.0%
Dollar Index	82.95	85.32	91.57	-2.8%	-9.4%
Japanese Yen	115.73	116.71	119.76	-0.8%	-3.4%
S&P 500	1400.63	1377.94	1249.48	1.6%	12.1%
Nasdaq Composite	2431.77	2366.71	2232.82	2.7%	8.9%
Gold $/oz (nearby contract)	$646.90	$606.80	$494.60	6.6%	30.8%
Oil $/bbl (nearby contract)	$63.13	$58.73	$57.32	7.5%	10.1%
MBA Refi Index (month-end value)	1749.6	1709.2	1484.3	2.4%	17.9%

Source: Bloomberg; Japanese Yen quote is the London feed

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