



- **The Mortgage Market:** *Prepays speed up; sub-prime performance woes also seen in Alt-A*
- **The Economy:** *The Fed looks to stay on hold but...for how long*
- **The Markets:** *After a month of turbulence, stocks are down, bonds are up*

## The Mortgage Market

Prepayment speeds came in approximately 7% to 9% faster than dealer expectations for January (February reporting period). This can be attributed partially to a continuation of sellers discounting home prices to move unsold inventory. Historically speeds slow down 30% from January to February (March reporting period) because of a decrease in business days, and then speed up by a like amount in March because of warmer weather and an increase in business days. Dealers, however, are expecting only a 20% pickup in speeds in March; this call for speeds to come in below their historical average is based on the view that the housing market will continue to slow. Any pickup would likely reflect a further discounting of unsold homes in order to take advantage of the seasonal increase in buyers.

The credit problems in the sub-prime mortgage arena are starting to show up in the more creditworthy parts of the mortgage market. "Alt-A" loans, which fit on the credit spectrum someplace between "Prime" (borrowers having the least amount of credit risk) and sub-prime, are beginning to show some of the same performance problems exhibited by sub-prime loans. According to the UBS mortgage research team, the 2006 vintage of Alt-A loans is off to the worst credit performance of any in history. And there are a lot of these loans out there. A record \$400 billion Alt-A mortgages were originated in 2006, up from \$85 billion in 2003. While sub-prime loans accounted for approximately 24% of all mortgage originations in 2006, Alt-A was an additional 16%. As for structure, Alt-A borrowers in recent years have gravitated more to so-called option ARMs, in which they have the option to pay principal plus interest, interest only, or another amount of their choosing which may lead to negative amortization. Delinquencies on Alt-A originated loans are rising, but they are still substantially below those of sub-prime. Currently 2.4% are at least 60 days past due versus 10.5% of sub-prime. We believe it's only a matter of time before Alt-A loans start to exhibit similar performance deterioration as sub-prime loans.

## The Economy

It's a good thing there are only 28 days in February. It was a very active month in which incoming economic data and market-moving information led to a re-pricing of risk and a reevaluation of future expectations. While most of the month was spent treading water, the end of the month was an expensive reminder of how seemingly calm waters can be turbulent underneath. Perhaps it was still-trying-to-be-relevant Alan Greenspan discussing business cycles that got the market's attention: "When you get this far away from a recession," he said in a recent speech, "invariably forces build up for the next recession, and indeed we are beginning to see that sign." Maybe it was the one-day slide of 9% in the Chinese stock market that spooked everyone, or the Bank of Japan's decision to double its overnight benchmark rate to 0.50%. Perhaps it was more bad news from the subprime mortgage arena, such as the troubles reported by lenders large and small—HSBC, NovaStar, Countrywide, Accredited Home Lenders, JP Morgan, ResMae Mortgage, New Century. Maybe it was the growing realization that the housing market—as evidenced by faltering sales, drooping prices and stubbornly high inventories—may not have found a bottom yet. To us, it wasn't any one of these things to blame for the market correction. More likely, we think it was a growing realization by the marketplace that all of these things are connected. For many months now we have been discussing the lack of sufficient risk premia in the financial markets and the potential damage that a housing recession would have on the broader economy. Our point of view was, admittedly, probably more bearish than the consensus. The market gyrations of the last week of the month likely represent the wrenching change in sentiment that is driving the consensus closer to our point of view. The question as it relates to the financial markets is whether the Federal Reserve is taking notes. We think it is, and wouldn't be surprised to see a change in the balance of risks portion of the FOMC statement after its meeting on March 20/21.

Weighing on the market during the month was the fundamental weakness in much of the data. Even when the numbers seemed to show strength, the market was quick to dismiss it with undercutting circumstantial details. Industrial production started off the litany of missed expectations, when it showed a decline of -0.5% instead of the projected flat result. Factory capacity utilization also posted a greater-than-expected decline to 81.2%, now a full 1.2% below the cyclical high of 82.4% in August 2006. Durable goods orders came in weaker than expected, falling 7.8%. Aircraft orders accounted for much of that, but there was also a 6% drop in orders for non-defense, non-aircraft capital goods. Core CPI for January came in slightly higher than expected: A 0.3% month to month increase was slightly ahead of the expected 0.2%, but analysts were quick to point out that the increase was mostly due to transitory items. For example, 60% of the increase in core CPI during the month was due to a sharp 0.8% increase



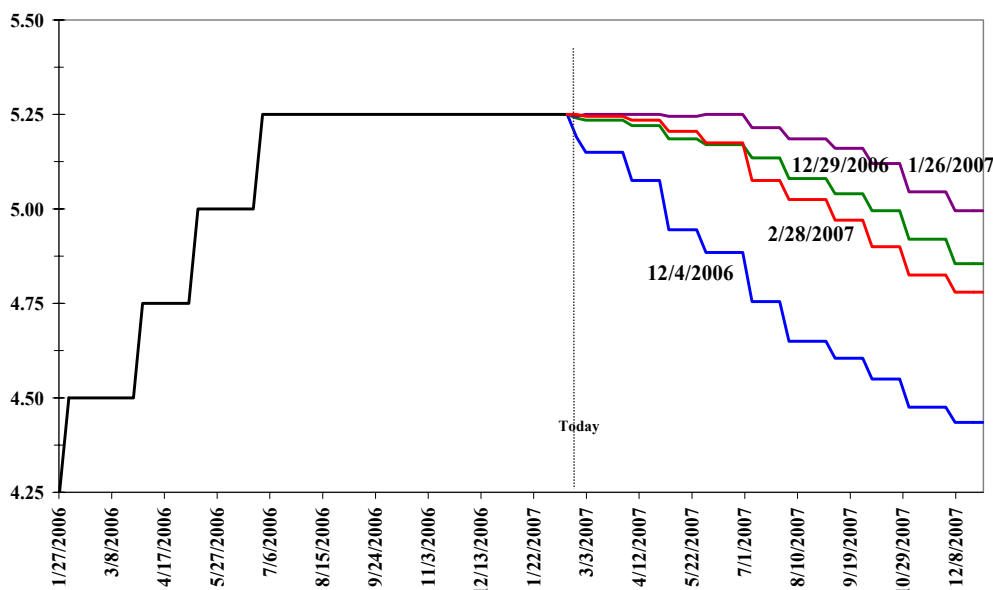
in medical care, a number which typically jumps in January as a number of government-set medical prices adjust on January 1<sup>st</sup>, and many pharmaceutical companies push through annual price increases in January. The personal income number for the month was up 1.0%, which was stronger than expected. However, more than half of that increase was due to January bonuses, bringing the “recurring” income number down to a much tamer 0.4%. GDP growth in the fourth quarter of 2006, previously estimated at 3.5%, was revised downward drastically to 2.2% thanks largely to slower drawdown of business inventories. Goldman Sachs estimates that first quarter GDP growth will rise just 2%.

The housing datapoint that was most troubling to those who have suggested that housing is bottoming was that new home sales fell by 16.6% to 937,000 on an annualized basis (excluding cancellations, which are still running at high levels). That result may have been exaggerated by weather patterns, but it was broadly based across the country—down 18.7% in the Northeast, 9.7% in the South, 8.1% in the Midwest and 37.4% in the West. The supply of new homes for sale rose to 6.8 months from 5.7 months in the prior month. Existing home sales rose, but so did the number of unsold homes, bringing the months of supply to 6.5 months. Building permits and housing starts fell to levels that are 28.4% and 37.8% lower than a year ago, respectively. The Case-Shiller data now show five straight months of price deflation. The main takeaway from the housing data is that the market is not clearing out the excess inventory. David Rosenberg, chief economist for North America for Merrill Lynch, summed it up nicely: “From our lens, the housing downturn is barely half over in duration and the deepest impact on employment has yet to come. Record unsold inventories point to further deflationary pressure and an inevitable—albeit lagged—impact on consumer spending as the savings rate reverses course.”

The Fed wasn’t giving much of a clue about its future intentions. Ben Bernanke delivered his semi-annual testimony before Congress and stuck to the script: The economy is slowing, but not too much, and the Fed will stay vigilant to do what is right in the event inflation gets out of hand. The minutes from the January FOMC meeting were released a few days later, and again there was no new ground. One point that has been puzzling analysts has been the seeming inconsistency between the Fed’s forecasts for unemployment and inflation. The Fed’s analysts are calling for unemployment to range between 4.5% and 4.75% this year and next, while inflation will decline from between 2% to 2.25% this year to between 1.75% and 2% next year. According to traditional Phillips Curve analysis, that unemployment rate is lower than the “non-accelerating inflation rate of unemployment” or Nairu. This suggests that the Fed may be showing flexibility in this view, that perhaps today’s relatively low unemployment rate need not be considered inflationary. One other bit of information that we Fed-watchers found interesting is a point Bernanke made during his Congressional testimony on the ramifications of a worsening subprime mortgage sector. It shows that Bernanke is definitely aware of the current problems. He said, “Several credible reports say that we are facing a tidal wave of defaults and foreclosures which could strip these families of their major, if not their only, source of wealth and long-term economic security.”

The graph below points out how much the Fed Funds futures market has shifted its thinking about the future path of monetary policy. It is now pricing in an over 80% chance of a rate cut at the June meeting.

**A round trip—the market now bets on a rate cut**



source: the Bloomberg



## The Markets

In February, US bonds rallied, stocks fell, mortgage rates declined, gold and oil rose. The rally in the bond market begins to point to an expectation that the Fed may be on hold in the short term but that an ease is on the table.

	2/28/2007	1/31/2007	2/28/2006	MOM % change	YOY % Change
<b>Federal Funds Rate</b>	5.25	5.25	4.50	0.0%	16.7%
<b>2-year US Treasury</b>	4.646%	4.921%	4.679%	-5.6%	-0.7%
<b>10-year US Treasury</b>	4.568%	4.810%	4.553%	-5.0%	0.3%
<b>10-year JGB</b>	1.636%	1.704%	1.595%	-4.0%	2.6%
<b>10-year euro</b>	3.957%	4.100%	3.490%	-3.5%	13.4%
<b>10-year UK Gilt</b>	4.797%	4.976%	4.190%	-3.6%	14.5%
<b>10-year Canadian govts</b>	4.030%	4.177%	4.126%	-3.5%	-2.3%
<b>30 yr conventional mortgage</b>	6.07%	6.30%	6.10%	-3.7%	-0.5%
<b>Dollar Index</b>	83.57	84.60	90.11	-1.2%	-7.3%
<b>Japanese Yen</b>	118.39	120.91	115.81	-2.1%	2.2%
<b>S&amp;P 500</b>	1406.82	1438.24	1280.66	-2.2%	9.9%
<b>Nasdaq Composite</b>	2416.15	2463.93	2281.39	-1.9%	5.9%
<b>Gold \$/oz (nearby contract)</b>	\$672.50	\$652.00	\$563.90	3.1%	19.3%
<b>Oil \$/bbl (nearby contract)</b>	\$61.79	\$58.14	\$61.41	6.3%	0.6%
<b>MBA Refi Index (month-end value)</b>	1943.5	1940.2	1573.5	0.2%	23.5%

Source: Bloomberg; Japanese Yen quote is the London feed

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