



- **The Mortgage Market:** *Prepays dropped 9% due to lower day count in February*
- **The Economy:** *The Fed changes its tune, slightly*
- **The Markets:** *Stocks and bonds look for direction; oil rises*

The Mortgage Market

February speeds, released in March, dropped 9% to an aggregate 9.5 CPR, the lowest speed since December of 2000. The slowdown was attributed to a two-day decrease in day count as well as a backup in mortgage rates that occurred in January. Looking ahead we can expect March speeds to come in 25% to 33% faster, due to a three-day increase over February. April speeds are estimated to come in flat, and May speeds should increase 5% to 10% due to seasonality coupled with a one-day increase in day count.

Has the sub-prime credit meltdown affected the origination business? The very short answer to that question is ‘yes’. Mortgage originators are likely to continue to experience difficulty, with potentially far-reaching repercussions. As you can see from the chart below (provided by UBS), the mortgage origination business is currently a very unprofitable business, quite a change from just one short year ago:

	Early 2006	Early 2007
Origination Cost	101.50	102.00
Price of Loan Sales	102.50	98.50
Profit (Loss)	1.00	(3.50)
Less EPDs	0.20	2.10
Net Profit (Loss) per \$100	0.80	(5.60)

Source: UBS Calculations

In 2005-2006 the gross profit on sub-prime loan origination was 100 basis points. The only other cost to the originator is that which is associated with Early Payment Defaults, or EPD. In the event of an EPD, in which the borrower misses the first payment of the loan, the loan can be “put back” to the originator by the buyer. The originator will then resell the loan. In 2005-2006, that resale was typically at a 10% loss (i.e., selling the loan at 90 cents on the dollar), and 2% of all sub-prime loans were EPD; these therefore cost the originator 20 basis points per \$100 in loan origination. However the economics of that business model have changed dramatically. Today, approximately 6% of all sub-prime loans are characterized as EPD, and the loss rate is now 35% per loan, for a cost to the originator of 2.10%. As shown above, sub-prime origination now generates a net **loss** of 560 basis points instead of an 80 basis point profit. This is not sustainable. It is no wonder, then, that some Street estimates are looking for the volume of sub-prime origination in 2007 to be almost half that of 2006.

How will this impact the broader economy? Clearly this spells a credit contraction to a key sector of the housing market. Beyond that, though, there are a lot of jobs associated with housing that may be at risk. For example, according to Countrywide Financial (one of the larger originators), approximately 32,000 of their 55,000 full-time employees are dedicated solely to “loan production.” With lower origination volume, we believe there is likely to be some excess capacity. Moreover, there are the job losses related to the over 40 sub-prime originators that have gone out of business. On April 2, New Century Financial declared bankruptcy and announced that 3,200 of its employees would be fired immediately. As we have discussed before, housing-related industries have been a major driver of employment since 2001. As layoffs in mortgage lending as well as construction and other housing-related jobs increase, the broader employment picture should weaken resulting in slower economic growth.

The Economy

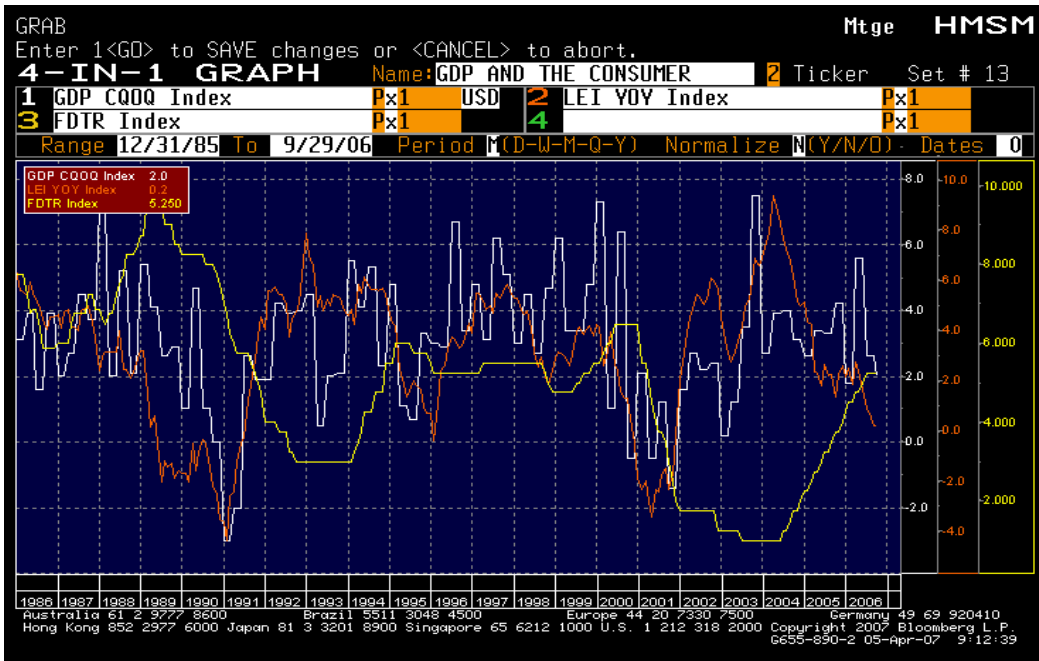
As we thought it might, the FOMC kept the Federal Funds rate steady after its two-day meeting concluded on March 21, while making several substantive language changes to its statement. In general, the form and structure of the statements are fairly similar meeting to meeting, so that side-by-side comparisons help illuminate (or allow us to project) the evolution in the Fed’s monetary policy perspective. Here’s what we mean: In the text to the January 31 statement, the Fed wrote: “Recent indicators have suggested somewhat firmer economic growth, and some tentative signs of stabilization have appeared in the housing market.” In the March 21 statement, that sentence was changed to read: “Recent indicators have been mixed and the adjustment in the housing sector is ongoing.” Thus, the Fed reversed itself not only on economic growth (“firmer” to “mixed”) but also on the housing market (“stabilization” to “adjustment”). The Fed repeated its warning on inflationary pressures and the possibility that tight resource utilization might make it worse, but added a more worrying note—that its “predominant policy concern remains the risk that inflation will fail to moderate as expected.”



In the final paragraph, the so-called balance of risks paragraph, the Fed made another significant change. In its January 31 statement, it said, “The extent and timing of any additional firming that may be needed to address those risks will depend” on incoming data. However, in the March 21 statement the Fed changed that language to read, “Future policy adjustments will depend” on the incoming data.

To the fevered women and men who sit, alert, in front of their Bloomberg terminals waiting to parse the Fed’s every utterance, this last change made all the difference in the world. “Firming” implies that the Fed’s bias will be towards tightening, while “adjustments” implies that the Fed has no bias toward whether the next move will be to tighten or to ease. The bond market took this author’s alteration to mean that the Fed, while not quite neutral, nevertheless opened the door to move into easing mode once the data confirm that the economy is in danger of slowing further. We don’t disagree. With this newly communicative and transparent Fed, we find it more likely that such a shift in language would be followed by an easing rather than a tightening.

The next question, of course, is when. On this, we have no crystal ball and remind readers that we do not take a “bet” with our portfolios on the direction of rates. Our view, however, is that it will be sooner rather than later if the data continue their current trends. First, the housing market is indeed continuing to weaken. Existing home sales were up an unexpected 3.9% in February, but year-over year prices declined and months of supply—a measure of how long it would take to sell all of the homes available for sale at the current sales pace—still rose, to 6.7 months. And while we hate to mention weather as a factor, it is probable that the existing homes that sold in February likely went to contract during the much warmer month of January. The more forward-looking new home sales number, which measures not closings but contracts, unexpectedly fell 3.9% in February to the lowest rate since August 2000. (Could the colder February have anything to do with it? We think not, as each of the prior four months were also revised downward.) With the decline in sales, the months of supply of new homes for sale rose to 8.1 months, the highest since January 1991. Second, without strong home price appreciation, credit performance will likely continue to deteriorate. Third, inflation is under control. Core CPI rose 0.2% in February, keeping the same 2.7% year-over-year pace as January. However, as Maury Harris, chief economist at UBS points out, “the pace has slowed to 2.2% at an annual rate over the past six months from 3.3% annualized during the previous six months.” Harris goes on to point out that excluding shelter (with the unreliably high component of owners equivalent rent—see our October 2006 Monthly Commentary for a more complete explanation of this), core prices have slowed to a 0.9% annual rate over the last six months, down from 2.2% in the prior six months. Fourth, the Conference Board’s Index of Leading Indicators dropped 0.5% in February, making it now nine out of the last twelve months that the leading index has been flat to declining. Not an encouraging signal.



Last month we discussed how the academic community was re-evaluating the concept of Non-Accelerating Inflation Rate of Unemployment. Goldman Sachs’ Economic Research Group put out a paper in March that suggested that NAIRU had dropped to below 5%, which “suggests that Fed officials may have a bit more leeway to keep unemployment temporarily low at a time when the debacle in housing threatens to spill over into the economy at large.” Adding to this trend in challenging economic orthodoxy



in order to rationalize the Fed not tightening was Fed Governor Frederic S. Mishkin. In a speech entitled “Inflation Dynamics,” Mishkin builds the case that inflation is less persistent than it has been in the past, less responsive to fluctuations in resource utilization and less susceptible to supply and demand. Just as importantly, the legacy of Paul Volcker’s aggressively disinflationary monetary policy is that inflationary expectations are well-grounded and low. There are a couple of policy implications for these observations. We’ve all been guided to understand that the Fed’s “comfort zone” for inflation is 1% to 2%, but Mishkin argues that in the current environment, the Fed will have to adjust the high end of that range. “I think that we can be reasonably optimistic that core PCE inflation will gradually drift down from its latest twelve-month reading of 2-1/4 percent...”, he said. “Looking to the medium term, I am less optimistic about the prospects for core PCE inflation to move much below 2 percent in the absence of a determined effort by monetary policy.” There is a measure economists call “sacrifice ratio”, which measures the number of years the unemployment rate has to stay 1% above the natural rate in order to lower inflation by 1%. Today, the sacrifice ratio is now 40% longer than it was 20 years ago, which means “a given increase in inflation will be more costly to wring out of the system.” Mr. Bernanke, please take note.

The Markets

In March, the 2-year/10-year curve disinverted as the short end rallied and the long end sold off. Stocks were up, and oil increased over \$4 per barrel because of political tensions in the Middle East.

	3/31/2007	2/28/2007	3/31/2006	MOM % change	YOY % Change
Fed Funds	5.25	5.25	4.75	0.0%	10.5%
2-year US Treasury	4.579%	4.646%	4.820%	-1.4%	-5.0%
10-year US Treasury	4.646%	4.568%	4.849%	1.7%	-4.2%
10-year JGB	1.659%	1.636%	1.780%	1.4%	-6.8%
10-year euro	4.057%	3.957%	3.772%	2.5%	7.6%
10-year UK Gilt	4.969%	4.797%	4.398%	3.6%	13.0%
10-year Canada Treasury	4.113%	4.030%	4.262%	2.1%	-3.5%
30 yr conventional mortgage	6.12%	6.07%	6.35%	0.8%	-3.7%
Dollar Index	82.93	83.57	89.73	-0.8%	-7.6%
Japanese Yen	117.59	118.39	117.5	-0.7%	0.1%
S&P 500	1420.86	1406.82	1294.83	1.0%	9.7%
Nasdaq Composite	2421.64	2416.15	2339.79	0.2%	3.5%
Gold \$/oz (nearby contract)	\$663.00	\$672.50	\$581.80	-1.4%	14.0%
Oil \$/bbl (nearby contract)	\$65.87	\$61.79	\$66.63	6.6%	-1.1%
MBA Refi Index (month end)	2098.3	1943.5	1640.8	8.0%	27.9%

Source: Bloomberg; Japanese Yen quote is the London feed

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