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NEWS & VIEWS

NOVEMBER 2, 2006

Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2006 third quarter earnings call. We reprint those remarks below:

Two for the Price of One

As followers of the past several Annaly earnings calls are aware, we have observed that the target of the seventeen interest rate hikes that paused in June was the unrestrained and mostly unregulated underwriting, speculation and saturation of residential housing. The Federal Reserve certainly did not discuss this openly in the media and in its releases, as it began to lift interest rates from generational lows of 1%. Instead, their dialogue centered on the threat of inflation and overheated growth in the nation's gross domestic product. Trend growth in gross domestic product has typically been recognized by economists as a rate of 3% per year. Since June of 2004 through the second quarter of 2006, growth has averaged 3.4%. This is noteworthy to us here at NLY because, as noted in prior calls, we buy into the fact that housing has contributed at least 50% of all of the jobs created post 9/11, 70% of the growth in household wealth, and 50% of the improvement in GDP as interest rates began to move down dramatically.

The Federal Reserve has tried to wring out a number of excesses in the past two years as it changed the rate of financing by a whopping 425% from 1% to 5.25%. I think that the underlying theme in the markets today is that we are watching the destruction of two bubbles—one in mortgage underwriting and the second in commodities—for the price of one bear market in short term interest rates. In short, we got a 'twofer'.

The effect of Fed tightening on the housing market is now being well-documented in the media and our best thoughts on its effects on the credit markets are best summarized on two commentary pieces on our web site (www.annaly.com), one by Jay Diamond, and the other by Gary Gordon. In Gary's piece entitled "Housing-Why we expect a Hard Landing", the rush to the bottom in lending standards is outlined on page 8, where we learn that since 1998 the debt to income ratios have increased from 31% to 40% of originations, that low/no income/ asset verification loans for "Private Label" (non-agency loans) have skyrocketed from 24% to 62% of originations and that no/negative loan amortization loans have grown from 0% to 52% of originations. In a world where we had the first negative savings rate and negative wage growth since the 1930's, it makes sense that borrowers would seek to minimize their payments on their largest asset (also their largest liability) by the use of creative financing techniques. This was a target of the Federal Reserve policies, since these mortgages did NOT fall under the standards of FNMA, FHLMC and GNMA and were, instead, sourced by private label issuers. Jay summarizes our view on the interest rate cycle related to this once in a lifetime economic event. As he says, there has been a massive misallocation of capital into the housing market.

Not outlined on our website is the second bubble which has been burst, the commodities bubble. Interestingly enough, as we sit here today, roughly 60 days after the start of a liquidation theme in commodities hedge funds, the CRB index is roughly a mere 15% above where it was when the Fed began raising rates in the summer of 2004. Gone are the days of $3 gasoline prices and the arguments tied to the natural resource shortages in petroleum, natural gas and lumber. For the past two years, the Fed has been commenting on its amazement that higher energy prices had not worked their way into the larger economy, given the sizable global demand that this move inferred. The answer is, apparently, that the demand really wasn't there in the first place. The speculators were. And, like all relatively smaller markets, a lot of cash pushed into a position can cause a waterfall effect that spills over into related markets.

Now that these markets are correcting into their natural supply-demand curves, the members of the Fed will be scratching their collective heads again trying to figure out why this correction IS affecting the larger economy in a fundamental way. Enlightened people at the Fed will no doubt be questioning in retrospect whether or not they should have continued raising interest rates based on inflationary commodity scares as much as they did, when, in fact the CRB now seems to be implying a much more benign economic impact.

So here we are, almost two and half years after the Fed began to raise rates and surprise! The housing market finally relented to its fundamentals, as did the commodities market. So, how are these bubbles related? Apparently, they have been linked by the desire of lenders and speculators to add spread income to their core returns. That is, lenders have been growing the potential pool of borrowers by further introductions of new, affordable lending devices like option and teaser ARMs, negative and zero amortization loans. Pools of investment capital, both public and private, in search of yield, have been driving these credit spreads relentlessly tighter to their Treasury benchmarks—while simultaneously driving energy returns to multi-year highs.

Both conditions have one similarity—a misalignment of macro risk premiums. One in credit spreads the other in commodities. I believe that these two elements are linked in multiple ways, in many portfolios and are currently correcting back to defensive risk-based pricing. One is being driven by the reality check going on in the speculative bid in the commodities market and the other will be a reality check in the credit spread markets. The disconnect between what is happening in housing and mortgage credit performance and what currently is reflected in credit spreads is the next shoe to drop in the unwinding of these bubbles.

History will record that neither sector were negatively affected by central banking policies but by their independent fundamentals. Both commodities and credit spreads deteriorate against one common enemy—slower economic growth, both domestically and globally.

November 2, 2006
Michael A.J. Farrell
Chairman, CEO and President of Annaly Capital Management

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