



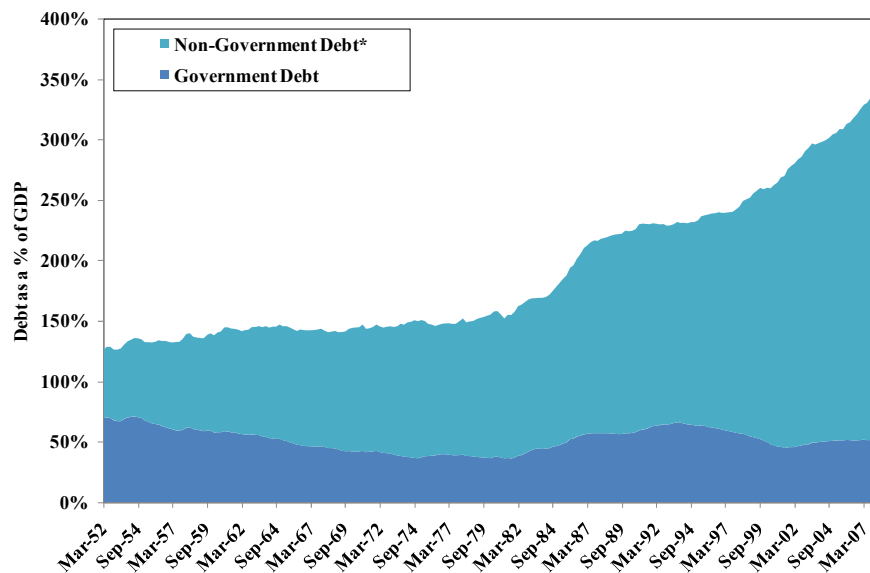
*Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2008 third quarter earnings call. We reprint those remarks below:*

### **It's contained, it's decoupled, it's only notional**

It is different this time.

Surveying the wreckage of the capital markets battlefield, it appears as though, as Thomas Friedman said in his book, the world is flat. More aptly, the world has been flattened.

It is being flattened by the weight of government borrowing throughout the globe being brought to incredible levels as measured by percentage of GDP. This is a continuation of the 'crowding out' effect we spoke about in the 2007 4<sup>th</sup> quarter's earnings call. As we reported on that call, in the post World War II economy, U.S. government debt—federal, state and local—accounted for 55.1% of the total debt outstanding in the US. At the end of 2007, government debt represented 15.7%, while non-government debt represented 84.3%. As I said at the time, "We would be on watch for much, much deeper government deficits and a surge in government debt issuance going forward." With the borrowing need growing from all of the takeovers, the TARP and other guarantees and liquidity programs, analysts are now coming to a similar conclusion. Current estimates are for a \$1 trillion deficit next fiscal year and up to \$2 trillion in net new federal government borrowing. If these estimates are correct, and we think they will be, then US Government borrowing in fiscal 2009 will amount to a staggering 13% of currently projected Gross Domestic Product (even more when you factor in state and local government deficit spending). In comparison, fiscal year 2008 estimates equaled \$770 billion and 5% of GDP. For those of you, who may not have heard this before from us in previous NLY releases and commentaries, let me reiterate: This is NOT contained from the real economy.



\* Non-government debt includes household debt, financial debt, and non-financial debt  
Source: Federal Reserve

In our earlier calls this year we were questioned as to the vulnerability of global markets. Our ongoing reply was that the overwhelming story for the second half of 2008 would be the softening of international monetary rates while the world's wealthiest consumer economy slowed its growth due to reduced access to credit and the decline in asset valuations. It's happening. As I packed my son off to London for a semester abroad in late August, I purchased



100 pounds for about two hundred US dollars. At this writing, I could have reduced that amount to about \$150. As a twenty year old junior finance major in London, he texted me about customers lining up outside of UK banks to withdraw money and deposit it into Irish banks who had just had their deposits guaranteed by the Bank of Ireland. Remember when the supermodel Giselde demanded to be paid in Euros? That was probably about the time that the Euro was about 1.6 to the dollar. Winston Churchill best summed up the American spirit in the following statement: “Americans can always be counted upon to do the right thing, after they have exhausted all the alternatives.” Having exhausted the alternatives, we believe the Federal Reserve and the Treasury are doing the right things. The ECB now needs to do the same: Validate its constitution, act as one currency and fix their regional problems in a coordinated fashion. In the words of Dr. Neal Soss of Credit Suisse, Europe needs an Alexander Hamilton.

If this is a decoupling, then it is apparent that the Euro has been decoupled from the desire of the ECB to fight the last war, inflation, instead of the current war, asset deflation.

Lastly, we discuss the issue of \$64 trillion in notional value of a deregulated insurance industry that grew from the desire to have modern risk management tools give investors the bizarre notion that they were hedging their risk by transferring it to all elements of the financial industry. Defenders of this innovation argued that the market’s astronomical growth was only notional in value and that the net number would have much less effect on the market. They were wrong. The first, second and third tier effects of liquidations was enough to take out money market funds, large insurance companies and small countries. The unwinding of the credit default swaps market started a powerful daisy chain of events that crushed Ambac and MBIA, led Fannie Mae and Freddie Mac into conservatorship, forced Merrill Lynch to sell its near-worthless CDO holdings at 22 cents on the dollar, and cast Lehman and AIG to their ignoble fates. In CDOs, credit default swaps were not used to provide protection against credit risk so much as they were used to synthetically go long a cash asset that didn’t exist in sufficient size. At FIDAC, we have auctioned billions in credit default swap positions in our CDO liquidation business, and what we have learned is that the carnage we are witnessing now would have been much more contained, to use that overworked word, without CDS. The definition of notional value is a derivative’s value at the spot price. The spot price and the liquidity needed to support it could not hold these positions together. That is what insurance is supposed to do; it is not supposed to create a flock of black swan events.

Three phrases not to be forgotten: it’s contained, it’s decoupled and it’s only notional.

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*October 30, 2008*

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