



*Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2007 first quarter earnings call. We reprint those remarks below:*

### **The New Dust Bowl**

In John Steinbeck's time, The Grapes of Wrath had a special meaning. It is a novel about the destruction of a way of life in the farming communities throughout Agricultural America in the 1930s, a condition created by an unprecedented drought, which followed an unprecedented boom for farm land, real estate, from favorable financial and environmental elements.

In reading the recent headlines about the distress in the mortgage market, it is easy to relate the events and circumstances of the two time periods. But we don't have to go so far back in history to understand the effects of setbacks in real estate valuation and lending standards to try to piece together the near term outlook for monetary policy.

In 1991, the dollar weighted value of US Gross Domestic Product was about \$7 trillion. During this time frame, the US experienced a real estate recession that was estimated to cost about \$300 billion in losses. This event led to the creation of a special government agency, The Resolution Trust Corporation, and very nearly brought several money center banks throughout the country to their collective knees. The weight of this repricing of values and the clearance of these inventories leaned on US economic growth for three years, and during this period we experienced a very steep yield curve of about 400 basis points. It was during this era that Sam Zell accumulated the portfolio of properties that became the centerpieces of Equity Office Properties.

A key factor leading to these problems was the dilution of underwriting standards caused by deregulation of the Savings and Loan industry during the late 1980s. As the pocketbooks of government-insured deposits at the thrifts were set loose on the real estate and high yield markets, riskier and riskier assets were underwritten and acquired to attain higher and higher rates of return. This drive of innovations in finance to satisfy the need for higher yielding returns was the blueprint for the eventual bankruptcy of Orange County California in 1994.

Now, flash forward to today. Deregulation, in the form of unregulated lending companies, has once again led to the dilution of credit underwriting standards and this time it has been compounded at least three times over in the financially reengineered capital markets. Today's economy is about \$11 trillion in weighted GDP dollars, or about 61% bigger than 1991's economy, according to the BEA. The sub-prime mortgage sector's estimated size is approximately 15% of the entire \$10 trillion residential mortgage market. If the current underwriting problems are only contained to about 25% of all of these loans, as many people believe, then the estimated size of the problem is approximately \$375 billion dollars in size or at least 25% bigger than 1991's problem. So the economy is bigger, but so is the problem, even assuming it is confined to just 25% of the \$1.5 trillion of sub-prime underwritings. For what it's worth, we think the problem is bigger than 25%. \$50 billion in market capitalization has already been lost and very few if any debt downgrades have taken place.

This leads to the debate about risk sharing and how far will the Fed go in order to cure the problem. If 1990-92 is an example, they took Fed Funds down from about 8.5% to 3% and left it there for at least two years, a decline of about 65%. In today's terms, the same percentage decline would bring the Fed Funds rate from 5.25% to about 2%. The ten year yield remained sticky during that period and basically went to about 7% from 8.5%. Today, that might imply a ten year rate of 4% or so.

To some, the shape of that yield curve may appear to be enough to help repair the damage created by the bubble-like conditions of the debt and derivatives market over the past six years. I would submit that this will not be the relatively quick three or four year fix that characterized the real estate recovery of the early 1990s. I think it is important to reflect instead on the Japanese experience of the last 20 years. Here, we see that the effects of a widespread



valuation problem in real estate spilled over into the equity markets and subsequently into the debt markets. The reaction of the Bank of Japan was to lower interest rates in a futile, 'pushing on a string' attempt to stimulate domestic demand and cure the banking system. This is an island empire that is 146,000 square miles in size—slightly smaller than the state of California. The United States is 3,537,000 square miles in contrast. With all of the risk parameters now being reinstated into the mortgage underwriting arena, it should be clear that the markets are now doing the heavy lifting for the Federal Reserve. Risk premiums will stay wide for some time to come as the markets attempt to get their arms around the problem. The Fed's attempts to restart the growth engine will not have the same effect as last time; it will take longer and the damage will be wider than either the RTC mop-up in 1991 or the tech bubble bust in 2000.

There is a great amount of discussion about how the 'real economy' is not being affected by the significant challenges in the energy market, the housing sector, the global war on terrorism and the myriad other micro and macro problems that exist in this vast \$11 trillion economy. I think this is nonsense. There isn't a more widely-held asset class for Americans than housing. We have almost 70% home ownership in this country; Germany, by contrast, has 43%. There is a daisy chain of job creation linked to housing that represents jobs that cannot be outsourced to any other country: Architects, realtors, builders, masons, plumbers, carpenters, lawyers, title searchers, lawn maintenance crews, financiers, just to name a few. This is a reflection of the real economy across the US, not just the manufacturing sector being hollowed out in the mid-west. To paraphrase 1992 Presidential candidate Ross Perot: "That sucking sound you hear is jobs being pulled away from the US via trade agreements and retrenchment in the financial services sector."

John Steinbeck's final metaphor in the Grapes of Wrath is the image of the migrant farmer's prayers being answered as rain finally relieves the drought condition. As the novel comes to a close, however, they are building a platform on top of their dilapidated car to save themselves from the subsequent flood that is spilling over from the river. Ben Bernanke has already identified the foreclosure problem as a "tidal wave" ready to happen. It is just beginning to happen, and at a time when employment has been statistically characterized as healthy. This should be a point of concern for the capital markets. Another Fed official has described the unoccupied housing developments across the country as "the new ghost towns". One difference is that our generation will be building our rafts on top of imported cars, not Fords. When you add it all up, it sounds a lot like the "new dust bowl" to me. I think Tom Joad would agree.

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