



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

### **The Goldfish is Dead, Senator**

About 12 years ago, I purchased two goldfish for my two kids, aged 8 and 6 at the time, to help relieve their desire for a family pet. One Friday night, coming home to a house emptied by soccer and baseball commitments, I peered into the tank and saw that one of the fish had died, apparently in a hostile confrontation with the other, bigger fish. Frantically, I weighed the options. Do I report the murder, or do I try to find a very similar replacement fish? Eager to protect my son's feelings, I held a quick burial at sea (flushing sound in background) and rushed out to the local F.W. Woolworth's (yesterday's Wal-Mart) in search of a body double. I successfully found a near twin, packed it up in a water-filled sandwich bag and rushed home to keep the lie alive so that I wouldn't have to break the news about the death.

About four days later, the scene repeated itself. Clearly, the larger fish was a Black Widow goldfish, killing all comers. This time, though, Woolworth's wasn't open late that night. Reality set in. The truth was now self evident and had to be disclosed. I steeled myself to tell my kids the news. Quietly, they listened to the report of the untimely death of his fish. My son looked at me with a straight face and said, "Dad, I don't think the fish that died is my fish, it looked different than when I first got it. What happened to the other fish?" Well! Accusations flew, verdicts were delivered, and the marauding Black Widow was imprisoned in a solitary tank for life (which was at least three months, if I remember correctly).

I am reminded of this story when I think of the past five year's housing market and Ben Bernanke's recent Humphrey-Hawkins testimony to Congress. Like my son, I really wanted him to 'fess up: Disclose the truth, tell it plainly and with all the certainty of a knowledgeable professional. The statement should have read something like this:

"Senators, at the end of the tech bubble, there was a rush to safety with the capital that was left in the consumer's pockets that was directed towards residential housing. As the economy slowed during 2000 the nesting urge took over and people invested in their homes at a tax advantaged rate. In the late winter of 2000, the energy crisis in California was shutting off one of the world's main engines of growth, so my predecessor began to lower interest rates to slow the rate of descent.

"Then 9/11 happened. When those airplanes hit their targets, the peacetime economy stopped altogether with one exception: that nesting urge accelerated and we opened up the door for more house for less money as we lowered interest rates to generational lows. Consumers began piling on the liquidity that was being provided for their largest, most tax-efficient asset, and they started improving them, trading them and speculating in them like never before. Eager to fill the ever-growing needs of housing leverage, lenders lowered underwriting standards, lending terms and conditions. New 'affordability products' became the mainstream. Borrowers stretched their limits, builders scooped up land to be ahead of the curve, appraisers lost track of what sensible valuations were, just because prices moved too quickly. Commodities breached their top end of the past twenty years as marginal global growth created a competitive spike in needed building materials being provided. Taxes at the Federal level were cut, providing more buying power to the behemoth. Interest rates have stayed low, as investors, we believe, have mistaken liquidity for credit quality. Debt restructuring using buyouts and derivatives has plastered a remarkably benign-looking face on what is now a sharply deteriorating skeleton.



“The world has been feeding off of this build-out, and it has been making the cardinal business mistake of maximizing capacity for and concentrating risk on basically one major customer—the US consumer. Fifty percent of all US jobs post-9/11 are daisy chained to housing. China and the correlated emerging markets’ growth have been tied to our consumer’s willingness to use debt to maintain lifestyle. This all ended in the summer of 2005. The government statistics that measure this were diluted by the unfortunate effects of multiple hurricanes hitting the Gulf Coast last August. So, even as professional investors knew that the housing bubble was bursting, we Central Bankers mistook statistical anomalies littered with hurricane-related effects for productive economic growth and kept on raising interest rates, which has been proven ineffectual, instead of letting free markets dictate outcomes. As we sit here this morning, companies in the United States are reporting their earnings. Consumers have stopped buying houses, cars, boats, and computers. Banks are scrambling to maintain their deposit bases. Credit card companies have stopped growing. Mortgage originators are laying off their employees from the housing boom and reducing their exposure to mortgage loans.

“The bubble that we successfully migrated from technology to housing is breaking again. This time the consequences for our domestic and the international economies are much broader than the breaking of a mere tech bubble. We are witnessing the first deflationary bubble burst in nearly four generations. The next bubble, I believe, will be in cash and mattress stuffing. The next discussions will not be about ‘return on capital’ as it will be ‘return of capital’. Our domestic deficits have been sentenced to solitary confinement at the price of lenders controlling our currency.

“Senator, the first bubble died six years ago. We replaced it with another one called housing. After months of analysis, we are now understanding that this bubble died in 2005.”

Son, those goldfish are dead. They were devoured by the Black Widow of government deficit spending, enabled by an accommodative Fed, financed by a hungry mortgage industry, led by decades of Congressional inability to deal with the financial realities of running this unique country. Woolworth’s is not open late tonight, and we have no choice but to tell you the truth. It was fun while it lasted.

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