



COMMENTARY

News and Views Behind the Economy and Mortgage Backed Securities Market

Fall 2004

Never a Dull Moment in the Bond Market

Annaly Mortgage Management, Inc. owns and manages a portfolio of mortgage-backed securities. Our principal business objective is to generate net income for the distribution to our shareholders from the spread between the interest income on our mortgage-backed securities and the costs of borrowing to finance their acquisition.

FIDAC is a wholly owned subsidiary of Annaly and a registered investment advisor that manages off-shore and on-shore unregistered investment funds for a wide variety of clients around the world.

Annaly and FIDAC manage over \$30B in assets. Headquartered in New York City the firm consists of 32 professional and support staff. We focus on keeping our operating costs low which adds to shareholder return.

Annaly, a mortgage real estate investment trust, is an NYSE-listed company and trades under the symbol NLY.

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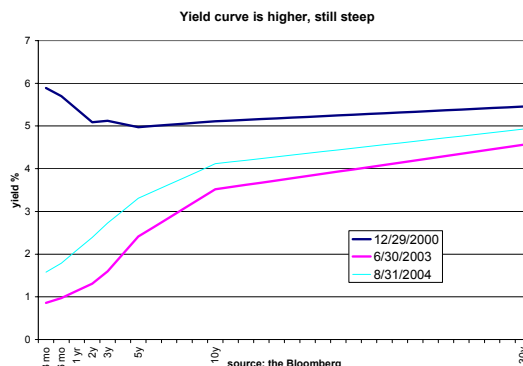
Over the past 12 months, the bond market has adjusted its expectations from a) the probability of deflation and accommodative monetary policy to b) the probability of inflation and restrictive monetary policy to c) somewhere in the middle. In 2002 and 2003 the Federal Reserve raised alarms about the specter of deflation and promised to take whatever measures were necessary to ward it off. By 2004, satisfied that the deflation beast had been held at bay, the Fed began its tightening cycle.

On June 30, 2003, the Fed had just cut the Fed Funds rate to 1% and rates across the curve were low as the markets had subdued expectations for inflation and economic growth. A little over a year later, expectations had changed along with the Fed's tune—the first rate hike in four years—and interest rates were higher. (It is always interesting to note how rates change over a longer time span and over different economic environments. As the great bull market in stocks was about to end and the Fed was still in tightening mode, interest rates were significantly higher and the yield curve was significantly flatter.)

Interestingly, while rates are higher, the result of this adjustment of expectations hasn't really changed the shape of the yield curve, which is the term structure of interest rates. In October 2002, we published "A Case for a Steep Yield Curve" (available on our website). The thesis we set forth is that the yield curve was steep, would remain steep and would likely get steeper because of fundamental reasons: the US economy was weak, the US was operating with a budget deficit and debt levels were rising.

Looking at the market environment today, while much has changed, the yield curve is still steep. In October 2002, the 2-year/10-year spread was 191 basis points and the Fed Funds/10-year spread was 185 basis points. As of September 10, 2004, the 2s/10s spread was 171 basis points and Funds/10s was 269 basis points. Thus, even through the first two tightenings by the Fed on June 30 and August 10, the yield curve has stayed steep. Even after an (expected) additional raise of 25 bp on September 21, the yield curve will likely stay relatively steep. (For comparison purposes, from 1962 to date, the average spread between the 1-year and the 10-year is 86 basis points. Today that spread is approximately 217 basis points.)

The view on the yield curve is a critical one for managers like us who generate returns for investors from the spread between the yield on our assets and our cost of funds. Certainly there have been many critical market events over the intervening months that have affected returns, not the least of which were the refinancing





Dear Fellow Investor,

The Fall of 2004 finds all investors searching for clues about the future. Our team has put together this *Economic & Market Commentary* in the hope that it will help in that effort, particularly as it relates to what makes our strategy tick: The return potential that is available from managing interest rate risk and the unpredictability of cash flows from mortgage-backed securities. In future issues we hope to revisit these points as well as touch on specific economic and market-related threats and opportunities.

For markets in general, from where we sit the immediate future looks a lot like the immediate past. In the US, this means tremendous uncertainty about the direction of the economy and monetary policy, the potential dangers of the twin deficits, the outcome of the upcoming presidential election and the ever-present threats to our homeland security. Around the world, this means the future course of global capital flows, the volatility in the oil market and the sustainability of both the recovery in Japan and the impressive growth in China.

If the past is a guide, then, the return outlook for virtually every investment category is dismal. Except for commodity-based investments, it is difficult to find any strategy that has generated better than meager returns for the year to date. Bonds had a strong August, but otherwise returns have been weak in the face of tighter monetary conditions. Credit-sensitive investments carry increased risk in a higher rate environment. US stocks have generally delivered weak total returns so far in 2004. Fixed income and equity returns also have been weak around the world, whether investing in local currency or in US dollars.

In investment strategies that rely on capital gains for the bulk of the total return calculus, prospective returns may be pressured. One of the key observations in this *Commentary* is that investment strategies—like ours—that depend on income for total return deserve a place in investors’ portfolios. It makes me think that the investment industry needs to initiate a new asset allocation category just for income.

We welcome your comments and look forward to working with you in the future.

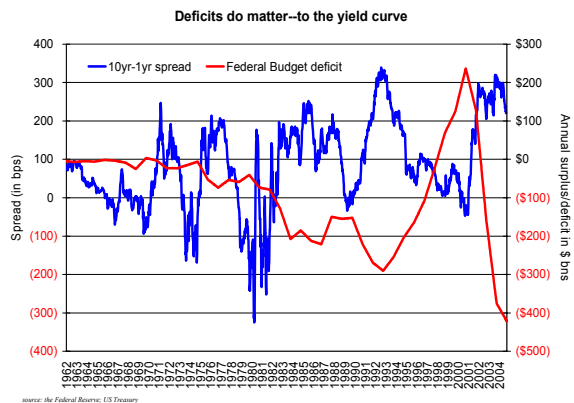
Best regards,

Michael A.J. Farrell
Chairman, CEO and President

waves of 2003 and 2004 and the volatility of bond prices, but the shape of the yield curve remains a critical component of our basic business model so we take this opportunity to again look ahead. In the Fall of 2004, we see many of the same elements at work that we bullet-pointed almost two years ago, as well as a few others, that support the conclusion that the yield curve will stay steep going forward.

First among these is the state of the federal finances. We examined the shape of the yield curve against the federal budget going back to 1962. During periods of deeper deficits, such as the 1980s, the early 1990s and today, the yield curve, as measured by the 1-year/10-year spread, was generally steeper than the historical average. By contrast, when the government budget was in surplus, as it was in the mid-to-late 1990s, the curve was flat to inverted. The latest estimate for

the deficit for the current fiscal year ending September 2004 is \$422 billion—not as much as previously estimated, but still a record level and an increase of \$47 billion over the prior year.



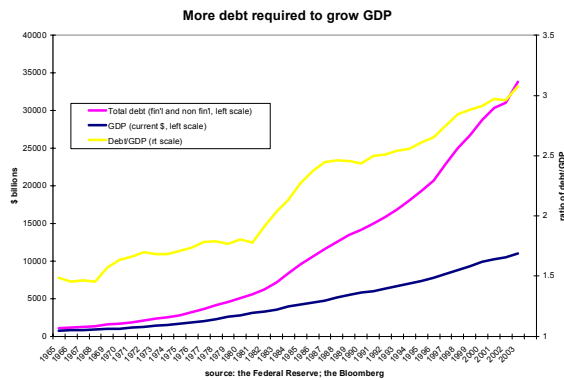
Fed Chairman Alan Greenspan has been talking about this issue for years, arguing that pernicious deficits pose a threat to the capital formation



process (read: higher rates). In his September testimony before the House Budget Committee he lamented the pressures on the federal budget from future Social Security demands. “With the baby boomers starting to retire in a few years and health spending continuing to soar, our budget position will almost surely deteriorate substantially in coming years if current policies remain in place.”

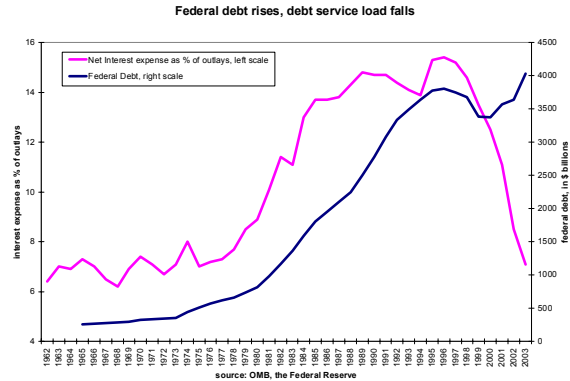
In his earlier February testimony, he elaborated on the potential effects of deep budget deficits. “Under a range of reasonably plausible assumptions about spending and taxes, we could be in a situation in the decades ahead in which rapid increases in the unified budget deficit set in motion a dynamic in which large deficits result in ever-growing interest payments that augment deficits in future years. The resulting rise in the federal debt could drain funds away from private capital formation and thus, over time, slow the growth of living standards.”

Indeed, the growth of the federal debt load has been substantial. In order to grow GDP, it now takes a much greater contribution from borrowing. Every dollar of debt produces less and less GDP every year. Until the 1980s, the ratio of total domestic debt to GDP was less than 1.7:1; in other words, it took \$1.70 of debt to create \$1 of GDP. In October 2002, generating \$1 in GDP required \$2.89 in total debt. Today it takes \$3.08. If the following graph were a picture of a corporate debt issuer and not the United States of America, it would be downgraded.

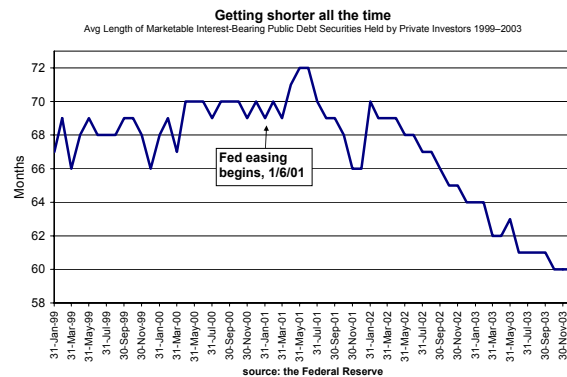


Meanwhile, even as the federal debt has increased by 6% between 1996 and 2003, the debt service burden during that same period has been

cut in half, from 15.4% of all government expenses in 1996 to 7.1% in 2003.



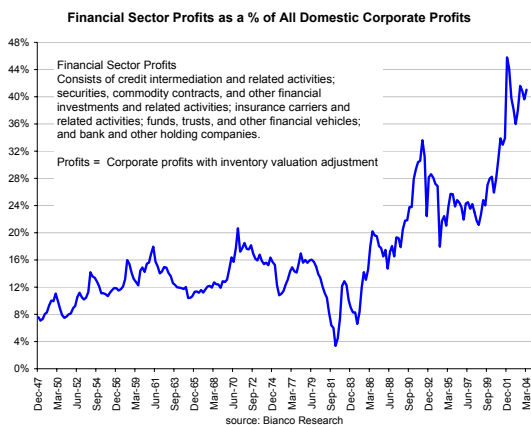
Clearly the decline in rates since the mid-90s has played a role in this evolution, but another reason for it is that the Treasury has “rolled down the curve” and shortened the average maturity of the federal debt, thereby exposing the government to a situation where rising rates will pose greater budgetary threats. (Perhaps contrary to good liability management: shouldn’t a rational firm lengthen maturities as rates fall?) In short, the budget deficit isn’t likely to be helped by higher interest rates.



We also see two technical reasons why the curve stays positively sloped. The first reason has been pointed out by Jim Bianco of Bianco Research. He points out that 37% of the S&P 500 and 40% of corporate profits in the US are generated by financial service companies, and that these are generally institutions for which profitability closely correlates with the shape of the yield curve. “When discussing the impact of interest rates on the stock market,” he wrote, “most analysts look for relationships between the level of interest rates and the overall level of the stock



market. Many of them conclude that no relationship exists and the recent rise in rates, and any expected rise, is “no big deal” for stocks. In reality interest rates do have a significant effect on the stock market. One has to look in the right place. That place is a two-dimensional measure of the yield curve (swap spreads) and the relative performance of financial stocks. Financial stocks are the dominant sector of the equity market. They are the largest component of the S&P 500 in terms of market capitalization and earnings. Anything that influences these stocks should influence the overall stock market.” As the Federal Reserve deliberates over its monetary policy decisions, it must keep the trade-off in mind: Raise rates too fast and potentially kill the yield curve and thus the engine of 40% of the country’s profit potential, or raise rates too slowly and potentially allow inflation to get out of control. Another reason to be “measured.”



The other technical point to keep an eye on is the demand for dollar-based investments by foreign investors. The pervasive globalization of the capital markets, the outsized US current account deficit, the hegemony of the US dollar as a global reserve currency, and the substantial global ownership of dollar-based financial assets and hard assets has created a situation where our markets are influenced by foreign investors. The ownership position of foreign investors of US assets is substantial and growing. Non-US investors own over 40% of outstanding marketable Treasury debt, up from 20% a decade ago. Over \$5 trillion in Treasuries, Agencies, corporate debt and equities are owned by foreign investors. The US current account deficit for the June quarter was \$166 billion, and \$572 billion over the last

four quarters. In other words, in the United States we consume more than we produce, and to meet the demand, we import more than we export. We pay for these imported products by borrowing money from the people who make them in other countries. James Grant, editor of Grant’s Interest Rate Observer, has called it “the biggest vendor-financing scheme in the history of lending and borrowing.” To finance this deficit, we receive investment dollars (i.e. we borrow) from foreigners—approximately \$1.5 billion a day—in the form of financial assets like Treasuries, Agencies, corporate bonds and stocks.

Theoretically, this pace of foreign investment could continue indefinitely. But here is the critical point: Any lessening of appetite by foreign investors would drive market yields higher. What could do that? One would be a weaker dollar, which by definition means that it buys less, which puts upward pressure on prices, and the inflationary pressure changes expectations for credit market participants, driving long-term interest rates up. A declining dollar makes our exports more attractive to foreign consumers, but it hurts the value of dollar-based assets, which ultimately repels foreign investors and makes it more expensive to finance the federal budget deficit and the current account deficit. A second could be a stronger competing currency, like the euro or yen. We think that it is unlikely that another currency can take the place of the dollar, but it can certainly take market share as a reserve currency which, at the margin, could affect the dollar.

We still have many caveats to our outlook: Geopolitical risk, lack of viable alternative investment options, a significant decline in economic activity, the vestigial threat of deflation from the capacity overbuilding during the bubble, the opposite threat of inflation picking up from overly accommodative monetary policy, a change in fiscal policy after the election. And there is always China to consider: Whatever the Chinese are buying is inflating, and whatever the Chinese are selling is deflating. The United States is on the other side of both of those trades. We mention these caveats because like any forecast, there are many factors that are beyond control.



While a steep yield curve is optimal for our strategy, our management team has operated successfully through a variety of yield curves and interest rate environments. ♦

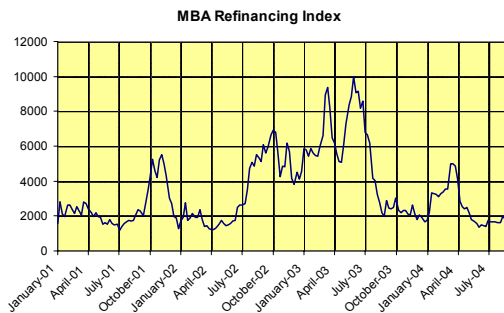
Mortgage Market Update

The mortgage market, forever dynamic, is in a much different place this summer compared to the summer of 2003. Last summer the mortgage market was in a tizzy with record prepayments for MBS securities due to a massive refinancing wave and record low 30 year mortgage rates. Currently, with the refinancing wave behind us, the market, while always worried about refinancing, is more focused on supply dynamics and how economic trends will affect the mortgage market going forward. To see this, let's compare some of the statistics from Summer of 2003 with what has been going on recently and explore their impact on the average mortgage-backed security investor.

MBA Refinancing Index and FHLMC Primary Mortgage Market Survey Commitment rate:

Summer 2003: Off a record high in May 2003 of almost 10,000, the refi index averaged 5612 for the summer. The refinancing wave, although slowing, was still in full bloom with the FHLMC commitment rate reaching a record low of 5.21% in the middle of June.

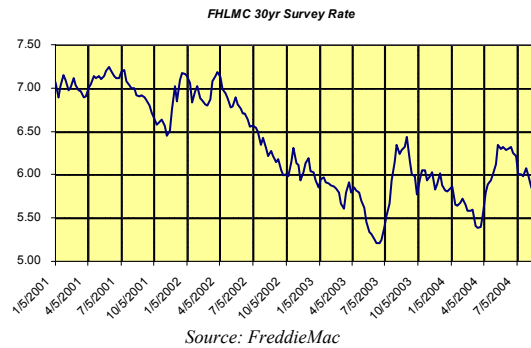
Summer 2004: Despite a brief refi wave in the Spring 2004, higher lending rates reduced the incentive to refinance. The index averaged 1636 and the FHLMC commitment rate averaged 6.07% from June through the end of August.



Source: Mortgage Bankers Association

Implications for Mortgage Investor: Mortgage refinancing is expected to continue its decline if interest rates move upwards, which should de-

crease amortization expense. Yet with current mortgage rates closer to 6.0%, episodes of elevated refinancing levels are possible.

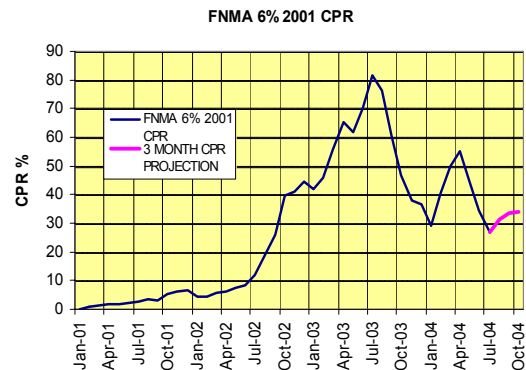


Source: FreddieMac

FNMA 30yr 6.0% 2001 CPR:

Summer 2003: Prepayment speeds for this widely-held security, after ramping up for 6 straight months, reached an all time high of 81.5% cpr in June, 2003. Mortgage market players continue to expect elevated prepayments throughout the summer and seek prepayment protection by being selective about the characteristics of each pool.

Summer 2004: Prepayment speeds reached levels not seen since 2002 as they slow to 27% cpr.



Source: Bloomberg

Implications for Mortgage Investor: While trending lower over the summer, further declines are not expected throughout the fall as lending rates have decreased in the face of economic uncertainty. Mortgage market players also wonder how the stellar housing market and the presence of alternative mortgage financing products will affect prepayments going forward.

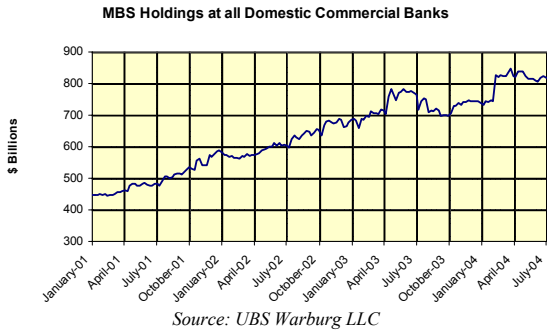
MBS Holdings at all Commercial Banks:

Summer 2003: Bank holdings of MBS remain



elevated as decreasing interest rates, increased prepayments, depressed commercial & industrial loan demand and a steep yield curve keep them net buyers of mortgage related assets.

Summer 2004: MBS bank holdings climb to higher levels compared to 2003 as demand remains strong. Even though the yield curve has flattened, it remains historically steep and demand for C & I loans has yet to be realized.



Implications for Mortgage Investor: The current Fed tightening cycle has prompted some concerns that banks will taper their demand for mortgage related assets, thus putting pressure on spreads. However, the expected measured pace of the rise in interest rates has kept demand

strong for short duration MBS products as banks wait for the opportunity to employ capital at higher yields. Overall, mortgage related assets remain well bid as any concerns of heavy bank selling has been put off into the future.

National Association of Realtors Housing Affordability Index:

Summer 2003: Housing affordability averages 138.26 while the median sale price on a existing single family home continues to rise. This number suggests that the median family income is 138.26% of the amount necessary to purchase a home at the median price. Low mortgage rates keep purchasing activity robust.

Summer 2004: The last post in July 2004 indicated a drop in affordability relative to summer 2003. Yet at 126.1 housing remains quite affordable despite increased borrowing rates.

Implications for Mortgage Investor: If rates continue to rise, affordability should continue to trend downwards. This could result in decreased originations of new mortgage backed securities. With decreased supply, competition for mortgage related assets could increase. All else

National Association of Realtors Housing Affordability Index

		Median Priced Existing Single-Family Home	Monthly Mortgage Rate*	Monthly Payment P & I	Payment as a % of Income	Median Family Income	Median Qualifying Income**	Affordability Indexes		
Year	Month	Family Home	Rate*	Payment	of Income	Income	Income**	Composite	Fixed	ARM
2001		147,800	7.03	789	18.4	51,407	37,872	135.7	135.7	145.5
2002		158,100	6.55	804	18.5	52,103	38,592	135.0	132.7	148.3
2003		170,000	5.74	793	17.8	53,463	38,064	140.5	127.6	142.6
2004	Jan	170,200	5.70	790	17.4	54,395	37,920	143.4	139.6	155.2
	Feb	168,100	5.74	784	17.3	54,517	37,632	144.9	142.3	157.1
	Mar	174,000	5.48	789	17.3	54,639	37,872	144.3	139.2	158.1
	Apr	177,100	5.42	797	17.5	54,761	38,256	143.1	138	156.1
	May	182,400	5.77	853	18.7	54,884	41,232	134.0	128.5	144.9
	June r	191,000	6.01	917	20.0	55,006	44,016	125.0	119.9	133.7
	July p	191,300	5.93	911	19.8	55,128	43,728	126.1	121.7	134.0
								This Month	Month Ago	Year Ago
	Northeast	216,100	5.88	1023	20.1	61,125	49,104	124.5	123.1	139.7
	Midwest	157,200	5.96	751	15.6	57,785	36,048	160.3	161.2	177.9
	South	176,800	6.00	848	20.3	50,165	40,704	123.2	120.6	134.7
	West	275,900	5.85	1302	28.0	55,836	62,496	89.3	89.3	108.2

*Effective rate on loans closed on existing homes - Federal Housing Finance Board

**Based on a 25% qualifying ratio for monthly housing expense to gross monthly income with a 20% down payment.

p Preliminary r Revised

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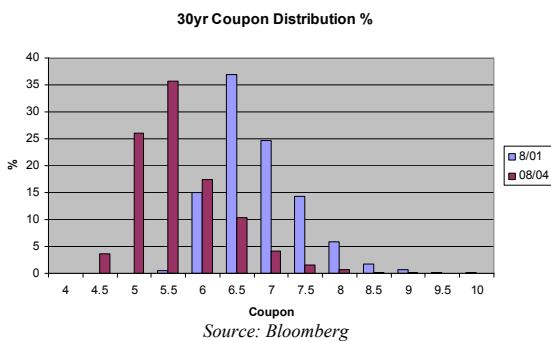
equal, this would be a positive for spreads. However, to date housing market activity has remained robust with existing home sales in June and July posting well above prior year's numbers as the impact of higher interest rates has been somewhat offset by alternative mortgage loan products. Thus, the supply picture for mortgage based securities remains unclear heading into the fall.

Mortgage Market Coupon Distribution:

Summer 2003: The 30yr market is comprised mostly of 5.5% and 6.0% coupon bonds. At one point, close to 90% of the 30-year fixed rate universe had an incentive to refinance.

Summer 2004: As a result of the 2003 refinancing wave the coupon stack has shifted toward lower coupons, namely 5.0% and 5.5%.

Implications for Mortgage Investor: Currently, roughly 40% of the 30-year fixed rate universe has an incentive to refinance. If interest rates resume an upward trend, prepayment risk, while still a concern, will be more muted as investors wrestle with the extension risk concerns and supply dynamics. However, the concentration of the MBS coupon stack makes any large rally in interest rates a concern as a substantial portion of borrowers would have incentive to refinance.

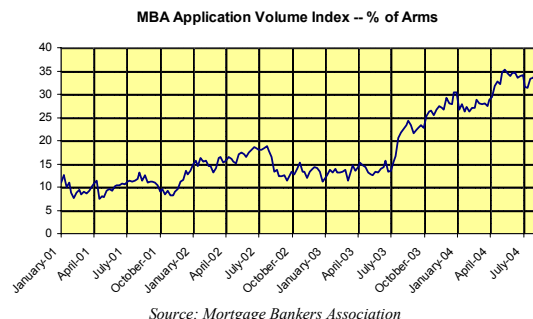


Increasing Levels of ARM Activity:

Clearly, the mortgage market universe has changed from last summer, especially in terms of the prepayment landscape. Yet the future path of mortgages and prepayments is never clear. Among the many things affecting the mortgage market, the most noteworthy of late is the strong re-emergence and acceptance of alternative mortgage lending products such as hybrid ARMS. Currently 32.1% of the applications for mortgage borrowings, as measured by the Mort-

gage Bankers Association, are for ARM-based mortgage products. This percentage has exhibited an upward trend for sometime now as ARM-based products have become more and more accepted by the average consumer. Part of the reason for this is the continued steepness of the mortgage borrowing rate curve. For example, a homebuyer can borrow \$200,000 at a fixed rate for 30yrs at 5.875% or utilize a hybrid arm whereby they borrow for a fixed rate for 5 years at 5.125% and then have an adjustable rate based on a spread over some index thereafter for 25 more years. This results in lower payments for at least 5 years that add up to close to \$5700 in savings. Of course these savings come at the risk of higher rates during the adjustable period. However, if a borrower's horizon is less than the 5 year fixed rate portion of the loan such a product may make financial sense. Thus, a borrower who is currently in a 30yr fixed rate loan still has incentive to refinance if they look at alternative loan products like hybrid arms. This of course influences mortgage-backed securities' prepayment rates as borrowers utilize fixed-to-ARM refinancing and ARM-to-ARM refinancing to lower their monthly payments and possibly cash in on any built up home price appreciation.

We would expect such activity to continue as long as an incentive is present and could result in pockets of unusually fast prepayment rates for mortgages with little or no traditionally measured rate incentive to refinance. Further, as more of these types of products are created the supply of them will increase in the MBS market, which potentially puts pressures on spreads in the near term as the supply is digested. We saw some of this spread widening early in the summer but it has since been reversed as more market players have become intrigued by the unique investment opportunities these securities can present. ♦





Annaly & FIDAC **IN CASE YOU MISSED IT.....**

News.....

- **The Annaly/FIDAC merger was approved by the shareholders and became effective on June 4, 2004. FIDAC is a fee-based management business with a global distribution reach. It will operate as a wholly-owned taxable REIT subsidiary.**
- **E. Wayne Nordberg was elected as a class II Director at the latest Annaly annual meeting. Mr. Nordberg is a Senior Director at the investment management firm of Ingalls & Synder LLC and sits on the board of directors of PetroQuest Energy, Inc. serving as Chairman of the compensation committee.**
- **Annaly declared a Preferred Dividend of \$0.47 for shareholders of record as of June 01, 2004, payable on June 30, 2004.**
- **Annaly declared a 2nd quarter dividend of \$0.48 for shareholders of record as of July 2, 2004 payable on July 28, 2004.**
- **On July 23rd Annaly reported net income for the quarter ending June 30, 2004 of \$63,835,000 or \$0.52 basic earnings per common share.**
- **Mike Farrell, Chairman, CEO and President, is often interviewed by media outlets on a variety of investment topics. Visit our website at www.annaly.com or www.fidacadvisors.com for the most recent interviews.**