



- **The Economy:** *Looking back, looking forward; Remembering the Panic of 1907*
- **The Mortgage Market:** *Setting a new floor on prepayment speeds; The Year of the Hybrid*
- **The Markets:** *Oil and gold continue their run; stocks are flat; the Fed eases again*

## The Economy

As is our wont, standing at the turn of the calendar we pause for a look back at the past year and a peek at the possibilities ahead. We believe that if you took a vote of financial market participants (sorry, we have elections on the brain during this presidential primary season), the leading candidate for 2007 sentiments would be “Thank goodness it’s over.” Indeed, the sequence of events of the past 12 months traumatized institutions and people in many ways: Experienced hedge fund managers were carried out; ratings agencies reversed their ratings on scores of newly-originated securities in record time; home prices slid and mortgage availability shut down which forced multitudes into foreclosure, credit was literally shut off overnight for many otherwise creditworthy borrowers with cash-flowing assets; staid municipal funds suffered heavy losses; jobs were lost at the highest and lowest levels of financial institutions; a few money market funds suspended redemptions; asset values and market capitalizations suffered huge writedowns; short-term funding rates went haywire; and central banks stepped in with aggressive liquidity schemes and, at least in the case of the Federal Reserve, rate cuts. By some counts we have seen over \$100 billion in asset writedowns, over 100 companies out of business, and \$500 billion in stock market wealth lost. It was an annus horribilus for many.

We’d like to think that we saw this coming, but that would be overstating our prescience. What we did right was maintain our conviction that the mortgage debt bubble and the resulting ballooning of home values would turn out badly for anyone and anything exposed to the housing industry (broadly defined) and credit risk, but we couldn’t predict the actual sequence of events, the exact magnitude of pain suffered by affected individuals and firms, or the specific policy responses. The realization that 2007 was one for the history books has prompted anyone with market experience to try to identify a historical precedent that might provide some kind of clue to the future. We can see different aspects of 2007 echoing several episodes from the past: The inflating and bursting of the housing and mortgage debt bubbles is but the latest stop in the movement of asset bubbles from the oil patch in the mid-80s to commercial real estate in the early 1990s to tech stocks in the late 1990s; the nascent consumer-led slowdown is similar to that experienced in the early 1990s; the growing government intervention seems to be on the path to an RTC-type bailout; and the wrenching liquidity crisis reminds us of Y2K and the days, weeks and months following the Long Term Capital Management blowup.

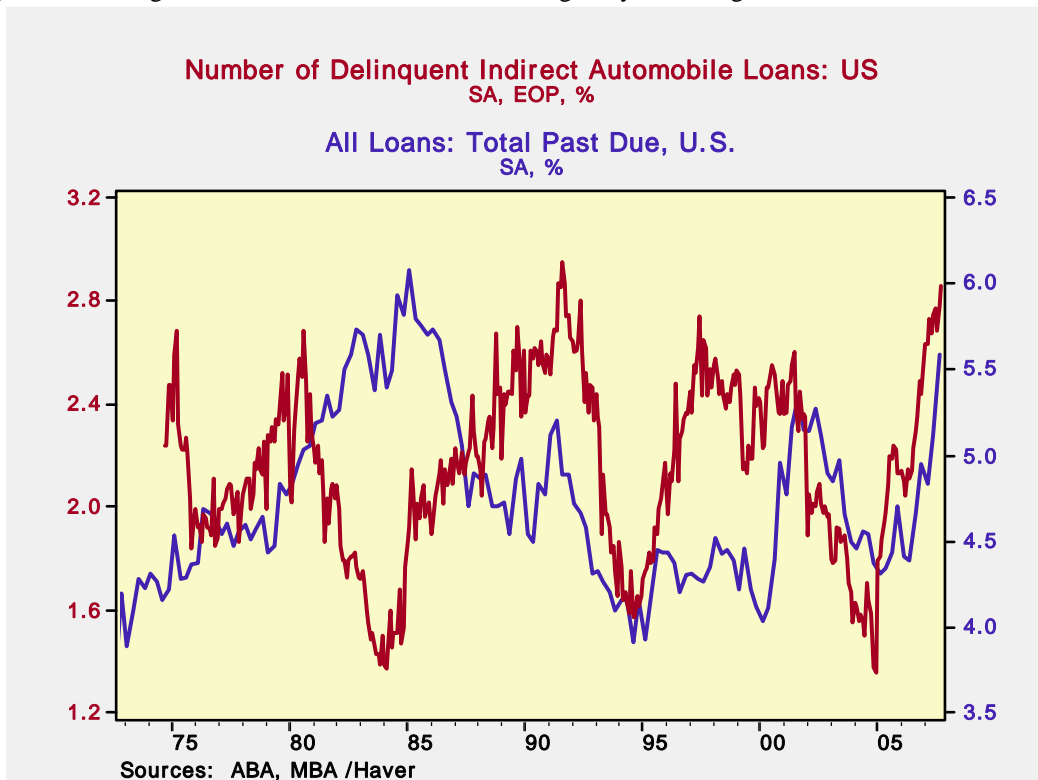
Perhaps the best historical lesson can be drawn from the Panic of 1907, which included all of the above—the inflation of leveraged assets followed by unmet margin calls when their value declined, bank runs, and a crushing liquidity squeeze. Granted, we did not use our own personal experience for this memory, instead relying on the excellent book by Robert F. Bruner and Sean D. Carr, [The Panic of 2007: Lessons Learned from the Market’s Perfect Storm](#) (Wiley, 2007). In it, the authors explained the foundation for a market crisis: “The recounting of the events of 1907 suggests that the storm gathers as follows. It begins with a highly complex financial system, whose very complexity makes it difficult for anyone to know what might be going wrong; by definition, the multiple parts of the financial system are linked, which means that trouble in one institution, city, or region can travel easily and quickly to others. Buoyant growth in the economy makes the financial system more fragile, in part due to the demand for capital and in part due to the tendency of some institutions to take on more risk than is prudent.” Sounds familiar. It is remarkable that the characteristics that seemed so unique to 2007 were actually encountered over a century ago. Back then the complexities and linkages were in connected banks and a cumbersome global gold standard. Today they are derivatives and securitization. Rather than reducing risk, these instruments seduced investors into taking on more risk—and paying for it later.

The astonishing part of the 2007 story is that someone who should have known his history better was cheerleading the virtues of complexity. This was Alan Greenspan in a 2003 speech: “The use of a growing array of derivatives and the related application of more sophisticated methods for measuring and managing risk are key factors underpinning the enhanced resilience of our largest financial intermediaries. Derivatives have permitted financial risks to be unbundled in ways that have facilitated both their measurement and their management....As a result, not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient. Individual institutions’ portfolios have become better diversified. Furthermore, risk is more widely dispersed, both within the banking system and among other types of intermediaries and institutional investors.” We would have added “...to a point.” We suggest that the “unbundling” of risk lauded (and left unchecked) by Greenspan gave rise to a “tendency of some institutions to take on more risk than is prudent.” It reduced or removed accountability, made it impossible to quantify risk and, through the socialization of risk, actually put more institutions in harm’s way. Unfortunately for Wall Street, the wisdom of prudence is too easily forgotten in bull markets.



In the hope that there is any lesson to be learned about how to avoid another Panic of 1907 or Crisis of 2007, it would be wise to remember the words of J.P. Morgan, testifying in the 1912 Pujo hearings (that, among other things, ultimately led to the creation of the Federal Reserve). He was asked whether he would extend a loan to a man based on the value of his assets or on his character. “[H]e gets it on his character...Because a man I do not trust could not get money from me on all the bonds in Christendom.”

As challenging as 2007 was, we don't have high hopes for much improvement next year. We expect that 2008 will look like 2007 in many ways. It is likely that rates will be volatile, the Fed will be attentive and aggressive, and the trends that were set in motion in the second half of the year will continue. Credit spreads will stay wide for all risk product, and equities will be lackluster (for 2007, the Dow Jones Industrials Index was up 6.4%, but it fell 4.5% in the 4<sup>th</sup> quarter). Credit performance for residential and commercial mortgages, credit cards and auto loans should continue to worsen as the economy slows. The graph below shows the rising percentage of all residential mortgage loans and dealer-financed auto loans that are delinquent. Moody's recently forecast that corporate default rates would quadruple this year and possibly increase ten-fold if the US economy heads into a recession. This will likely lead to a continuation of chargeoffs, writedowns and increased loan loss provisions. Financial institutions already struggling with valuing illiquid asset-backed securities and CDOs will have to contend with not just actual credit losses but also continued ratings downgrades. Moody's has already downgraded 50% of the subprime mortgage-backed securities it rated in 2006, including an astonishing 97% of those securities that were originally rated single-A or below.



Going into the new year, economic indicators show continuing weakness. The US economy should continue to suffer as the overbuilt and over-priced housing market finds a clearing level and the mortgage bubble deflates. In particular, the ISM Manufacturing Index unexpectedly dropped to 47.7, the lowest since April 2003. Durable goods orders fell short of expectations. The housing data—from housing starts, building permits, new and existing home sales and prices—continued to show weakness but with still a ways to go to clear excess inventory. The employment picture is turning worse, with nonfarm payrolls growth almost non-existent, the unemployment rate leaping from 4.7% to 5%, and jobless claims data stubbornly remaining at elevated levels.

The economy is probably already in or on its way to a recession, and the factors that are contributing to this weakness are already in motion. We will be watching several things to help us understand the extent and duration of the downturn. First, the vigor of the fiscal and monetary policy responses. The Bush Administration is already talking about tax cuts, and there is now louder chatter for lifting the conforming loan limit to enable Fannie Mae and Freddie Mac to play a greater role in the mortgage finance cycle. Should the Fed continue to use its powers to prevent a recession, it will likely continue to cut short term rates and provide liquidity to the market through a continuation of the TAF auctions. Goldman Sachs economists now forecast that the Fed will cut another 50 basis points by the January 30 FOMC meeting, and bring the Fed Funds rate to 3% by mid-year. This brings us to the



second item: inflation and the dollar. As every schoolboy knows, inflation is always and everywhere a monetary phenomenon, so to the extent the Fed expands the monetary aggregates as a byproduct of their pump-priming efforts, inflation may become an issue. This is before we even talk about the rising price of oil and food and raw commodities. The dollar had a rough 2007, falling 8.3% versus a basket of major currencies as the Fed lowered rates, but we believe that as the rest of the world starts to feel the effects of the US slowdown, their central banks will join the Fed in lowering rates. Third, the American consumer, which accounts for 70% of US GDP and 20% of global GDP, will likely be constrained going forward particularly as the mortgage equity withdrawal mechanism gets harder to access. We still have not seen significant consumer pull-back during this cycle and will be watching for signs of that retrenchment. Fourth, we will be watching the health and behavior of financial institutions. The stress in the financial system structure that was evidenced by the spike in Libor and the contraction in credit has been tempered somewhat but it is not over. We expect to see more writedowns, writeoffs, layoffs and retrenchment. This is painful but ultimately healthy for the institutions, provided they continue to access new sources of equity capital and can improve profitability through a steeper yield curve.

## The Mortgage Market

November prepayment speeds (December release) were on average 8% slower than October with 30yr FNMA 7s leading the way, off 30% to 50%. Speeds on the 2006 vintage 7s came in this month at 14% to 15% CPR, or roughly where 30yr FNMA 6s were printing in January of this year. Fannie commented in October that it intended to “smooth” out the impact of future buyout activity in 7s. Speeds in the Agency hybrid ARM universe came in about 4% slower this month, with the premium and short reset space slowing down even more substantially. For instance, 6.5% 5/1 ARMs (where the coupon is fixed at 6.5% for the first 5 years and then resets annually based on the then current reference rate) originated in 2006 had a CPR of 9.9% this month, off 43% from the prior month, whereas 2006 6% 10/1s ARMs had a CPR of 8.4%, off just 13%. This illustrates the point that affordability product borrowers are being locked out of refinancing since the shorter reset/higher coupon space should be paying substantially faster than longer reset/lower coupon.

Looking ahead to December (January release), prepayment speeds should be flat as the slow holiday seasonality offsets the substantial rally in rates we have seen since our last commentary. According to Bear Stearns, despite relatively low long-term rates, “extraordinary housing conditions combined with structural changes to the underwriting process” should result in record slow prepayment speeds in 2008 through 2009, so slow in fact that they believe it will set the “calibration floor” for the benchmark prepayment models in the future.

Slowing speeds, at least when securities are purchased at a premium, are obviously a strong technical advantage for MBS, and the performance of Agency hybrids benefited in 2007 from slowing speeds. Also helping Agency hybrids in 2008 should be limited supply due to lower levels of issuance. The table below, provided by UBS Research, clearly shows the sharp fall off in Agency hybrid issuance since 2004:

Year	Gross Issuance (\$billions)				Net Issuance (\$billions)			
	Fixed	ARM	Total	%ARM	Fixed	ARM	Total	%ARM
2003	1,712	187	1,899	10%	326	91	417	22%
2004	711	167	879	19%	7	75	82	92%
2005	704	171	876	20%	118	63	181	35%
2006	679	150	830	18%	258	50	308	16%
2007-11M	820	137	956	14%	429	44	474	9%

In the table above, gross issuance is the total volume issued, and net is after paydowns and refinancing. Interestingly, in 2004, Agency ARM's accounted for 19% of gross issuance and 92% of net issuance, meaning that folks were refinancing from fixed-rate into adjustable-rate loans. The decline in Agency hybrid issuance is due to two factors. First is the convergence of 30-year conventional fixed mortgage rates with that of hybrid rates. When that happens, the borrower is left with very little rate incentive to take out an adjustable rate mortgage over a fixed. Today, the 30-year fixed-rate conventional mortgage rate was 6.07%, while a 5/1 hybrid ARM stood a mere 29 bps lower at 5.78%. Second, increased credit underwriting by the agencies, and the mortgage insurance companies that provide additional credit enhancement for agency loans, have and should continue to weed out unqualified borrowers. For example, Fannie and Freddie have both announced that they will lower the loan-to-value cap by 5% for programs in areas with sharply negative home price depreciation in addition to raising their upfront delivery charges on mortgages with high LTVs and low credit scores. Mortgage insurers are also tightening credit standards. Triad announced it would no longer write policies with > 90% LTV's in states that have rapidly declining home prices, PMI will no longer write mortgage insurance for borrowers with credit scores < 620 and LTV > 95%, and MGIC will no longer insure loans when income and assets are not fully documented. Indeed it may be that 2008 will be the Year of the Hybrid instead of the Year of the Rat.



## The Markets

In December, the Fed eased another 25 basis points (as did the Bank of England). Stocks were flat. Mortgage rates remain elevated relative to Treasury rates. Gold and oil finished the year powerfully, with gold now flirting with \$850/ounce and oil with \$100/barrel.

	12/31/2007	11/30/2007	12/31/2006	MOM % change	YOY % change
<b>Fed Funds</b>	4.25%	4.50%	5.25%	-5.6%	-19.0%
<b>2-year US Treasury</b>	3.051%	2.999%	4.812%	1.7%	-36.6%
<b>10-year US Treasury</b>	4.025%	3.940%	4.704%	2.2%	-14.4%
<b>10-year JGB</b>	1.510%	1.478%	1.685%	2.2%	-10.4%
<b>10-year euro</b>	4.331%	4.126%	3.948%	5.0%	9.7%
<b>10-year UK Gilt</b>	4.508%	4.637%	4.741%	-2.8%	-4.9%
<b>10-year Canada Treasury</b>	3.990%	3.982%	4.086%	0.2%	-2.3%
<b>30 yr conventional mortgage</b>	5.92%	5.83%	6.14%	1.5%	-3.5%
<b>Dollar Index</b>	76.70	76.15	83.65	0.7%	-8.3%
<b>Japanese Yen</b>	111.79	110.87	119.07	0.8%	-6.1%
<b>S&amp;P 500</b>	1468.36	1481.14	1418.30	-0.9%	3.5%
<b>Nasdaq Composite</b>	2652.28	2660.96	2415.29	-0.3%	9.8%
<b>Gold \$/oz (nearby contract)</b>	\$838.00	\$782.20	\$638.00	7.1%	31.3%
<b>Oil \$/bbl (nearby contract)</b>	\$95.98	\$88.71	\$61.05	8.2%	57.2%
<b>MBA Refi Index (month end)</b>	1620.9	2761.3	1640.4	-41.3%	-1.2%

Source: Bloomberg; Japanese Yen quote is the London feed

FIDAC (An Annaly Company)  
1211 Avenue of the Americas  
Suite 2902  
New York, NY 10036  
Tel: 212-696-0100 · Fax: 212:696-9809  
www.annaly.com



This commentary is neither an offer to sell, nor a solicitation of an offer to buy, any securities of Annaly Capital Management, Inc. (“Annaly”), FIDAC or any other company. Such an offer can only be made by a properly authorized offering document, which enumerates the fees, expenses, and risks associated with investing in this strategy, including the loss of some or all principal. All information contained herein is obtained from sources believed to be accurate and reliable. However, such information is presented “as is” without warranty of any kind, and we make no representation or warranty, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. While we have attempted to make the information current at the time of its release, it may well be or become outdated, stale or otherwise subject to a variety of legal qualifications by the time you actually read it. No representation is made that we will or are likely to achieve results comparable to those shown if results are shown. Results for the fund, if shown, include dividends (when appropriate) and are net of fees. ©2008 by Annaly Capital Management, Inc./FIDAC. **All rights reserved. No part of this commentary may be reproduced in any form and/or any medium, without express written permission.**