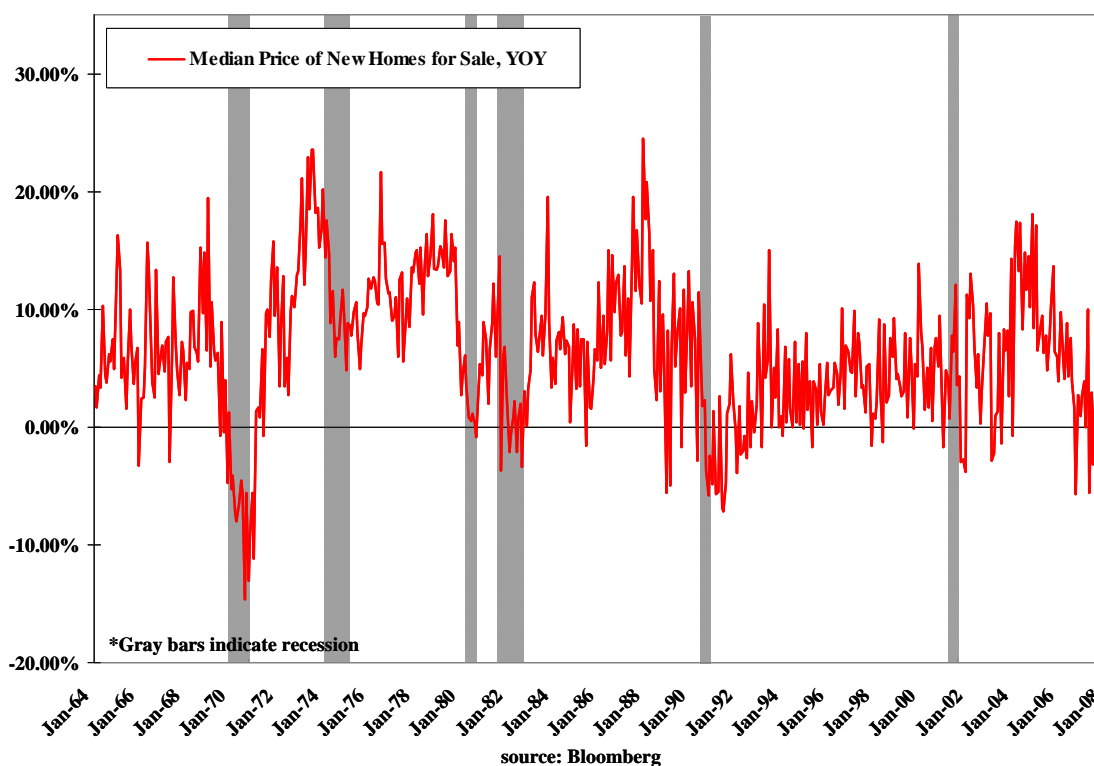




- The Economy:** *The Fed breaks out the worry beads*
- The Mortgage Market:** *Mortgage rates lag Treasuries*
- The Markets:** *Gold and oil surge, the curve steepens*

The Economy

In the month of February, economic news continued to support the notion that the economy is weakening. The job market stayed weak. Non-farm payrolls fell a revised 22 thousand, the first negative print since 2003. (Today's release was even worse: -63 thousand). Jobless claims continued to rise. The housing market showed no sign of bottoming. For both existing and new home sales, prices and sales declined, while inventories continued to rise. New home sales are down 35% year over year, and the median price of new homes has fallen 15.1%, the largest such drop on record. Industrial production muddled along with just a 0.1% increase in January, durable goods orders and ISM indexes were weak. The Federal Reserve published its updated forecast for the economy, in which it reduced its 2008 outlook for GDP growth and raised slightly its outlook for unemployment and inflation.



We had been waiting eagerly to read the minutes to the January 29-30 Federal Open Market Committee, released February 20, to get some insight into the Fed's decisive move to reduce the Fed Funds rate 125 basis points in two installments over an eight day span in January. Unsurprisingly, their decisions were driven by concern over the financial markets, particularly the impact of downgrades of the financial guarantors, and a credit crunch. "[P]articipants generally viewed financial markets as still vulnerable to additional economic and credit weakness. Some noted the especially worrisome possibility of an adverse feedback loop, that is, a situation in which a tightening of credit conditions could depress investment and consumer spending, which, in turn, could feed back to a further tightening of credit conditions."

Concern was also mounting for the overall health of the economy, although they still had faith in their ability to turn things around with a little bit of monetary and fiscal stimulus. "In their discussion of the economic situation and outlook, and in the projections that they had submitted for this meeting, participants noted that information received since the December meeting had been decidedly downbeat on balance. In particular, the drop in housing activity had intensified, factory output had weakened,



news on business investment had been soft, and conditions in labor markets appeared to have deteriorated. In addition, consumer confidence had remained low and business confidence appeared to have worsened.”

The Minutes reveal that they even after their move to ease a second time in eight days, the FOMC members were prepared to do even more than that which had already been done. “[M]ost members believed that a further significant easing in policy was warranted at this meeting to address the considerable worsening of the economic outlook since December as well as increased downside risks.... Still, with no signs of stabilization in the housing sector and with financial conditions not yet stabilized, the Committee agreed that downside risks to growth would remain even after this action.”

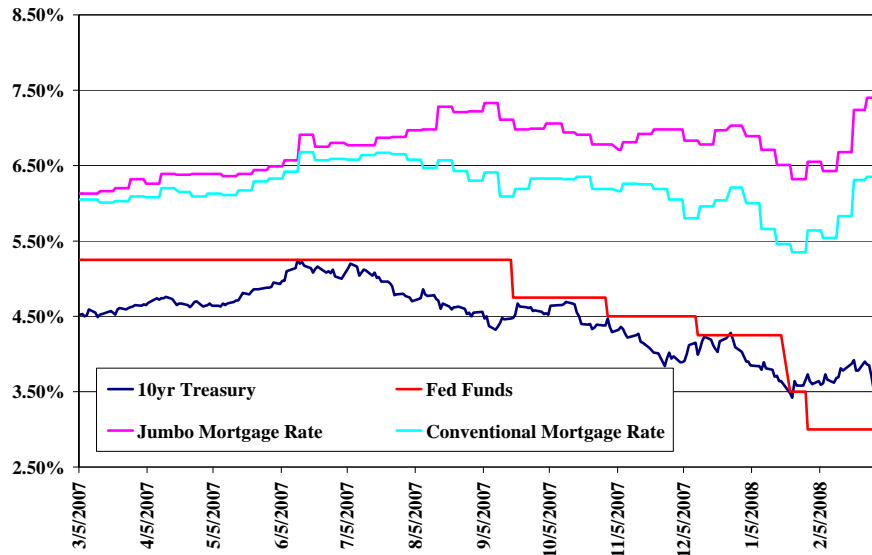
The Committee was right to be concerned, particularly about the financial markets, as volatility and anxiety abounded. Credit Suisse joined a long list of banks with pricing issues when it announced that it had \$2.85 billion in losses due to “pricing errors” made by traders. A sleepy neighborhood in the credit markets, the municipal auction rate debt market, made headlines after buyers stopped showing up to the auctions because of concerns over the monolines and credit risk. Several investment vehicles—such as KKR Financial Holdings, a Citigroup hedge fund, Peloton Partners, Thornburg Mortgage and Carlyle Capital Corp.—ran into serious challenges. The head of the Dubai sovereign wealth fund suggested in the press that Citigroup was going to need additional capital, even after it had received a capital injection of \$7.5 billion in November from Abu Dhabi and another \$14.5 billion in January. The monoline bond insurers were either downgraded (FGIC, SCA) or on the ropes (MBIA and Ambac). Storm clouds are brewing.

In this environment, we are reminded of a speech given by Ben Bernanke in November 2002 when he was still a Fed Governor. The speech, entitled “Deflation: Making Sure ‘It’ Doesn’t Happen Here,” laid out the rationale for lowering Fed Funds to an emergency rate in order to stave off deflation and its corrosive effects on the economy. The prescription, he said, could include bringing the target rates as low as possible, even zero. But beyond that, there are a variety of alternate tools it could use, including expanding the scale and menu of asset purchases, including Agency debt and MBS, making low interest-rate loans to banks or directly to the private sector (through the discount window, for example), working with fiscal policymakers, committing to holding short term rates at zero for a specified period (a la Japan), or establishing interest-rate ceilings on long-term Treasuries. As he concludes, even though these ideas are relatively unfamiliar, using them to prevent deflation is far preferable than having to cure it. “I hope to have persuaded you that the Federal Reserve and other economic policymakers would be far from helpless in the face of deflation, even should the federal funds rate hit its zero bound.” To us, even though he was talking about general price deflation, he could have been referring to the possible toolbox for fixing the asset deflation/deleveraging that is currently plaguing the financial markets. Today, the title of that speech would be “Deleveraging-induced economic depression: Making sure ‘it’ doesn’t happen here.”

The Mortgage Market

Prepayment speeds increased modestly in January (February release), primarily on recently originated loans. The increase in speeds in recent vintages is likely due to the fact that these loans have fresh documentation and are therefore easier to process. For example, prepayment speeds on 2006 vintage 30-year FNMA 5.5s and 6s were up 17% and 13% respectively, while speeds on 2005 vintage 5.5s declined 2% and 6s increased just 1% respectively. The difference was even more pronounced if you moved into the 2007 vintage, where 5.5s and 6s were up 33% and 34% respectively. In hybrid space speeds were similarly tame with premiums rising slightly by 5-10%.

As the graph below illustrates, in one short year the Fed has eased 125 basis points, the 10-year Treasury has rallied almost a point lower, yet rates on both conventional and jumbo mortgages are actually higher today than they were a year ago.



source: Bloomberg

How could this be? If today's conventional 30-year fixed-rate mortgages were at their historical norm of 180 to 200 bps over the 10-year Treasury, today's rates would imply that a conventional mortgage should be in the vicinity of 5.40% to 5.60%. However, such is not the case with the 30 year conventional mortgage rate at 6.24% as of March 4. The short answer is liquidity. Help, in the form of liquidity, may be on the way courtesy of the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO announced on February 27th that they will begin discussions with Fannie Mae and Freddie Mac's management on the "gradual decreasing" of the OFHEO mandated 30% capital requirement, thereby enabling Fannie to purchase more securities. Additionally, OFHEO also announced the increase the conforming loan limit to \$729,750 from its current \$417,000. Despite mortgages recently lagging Treasuries these changes in legislation should be long term positives for mortgages, and in the short term the MBS investor should appreciate the back up in mortgage rates and the resulting slower prepayment speeds.

The Markets

In February, gold and oil continued to jump. The dollar weakened further, the US yield curve steepened. Refinancing applications reversed course. Stocks fell amid uncertainty.

	2/29/2008	1/31/2008	2/28/2007	MOM % change	YOY % change
Fed Funds	3.00%	3.00%	5.25%	0.0%	-42.9%
2-year US Treasury	1.620%	2.097%	4.646%	-22.7%	-65.1%
10-year US Treasury	3.511%	3.595%	4.568%	-2.3%	-23.1%
10-year JGB	1.368%	1.452%	1.636%	-5.8%	-16.4%
10-year euro	3.891%	3.930%	3.957%	-1.0%	-1.7%
10-year UK Gilt	4.469%	4.477%	4.797%	-0.2%	-6.8%
10-year Canada Treasury	3.640%	3.878%	4.030%	-6.1%	-9.7%
30 yr conventional mortgage	5.728%	5.408%	6.070%	5.9%	-5.6%
Dollar Index	73.71	75.18	83.57	-1.9%	-11.8%
Japanese Yen	104.21	106.44	118.39	-2.1%	-12.0%
S&P 500	1330.63	1378.55	1406.82	-3.5%	-5.4%
Nasdaq Composite	2271.48	2389.86	2416.15	-5.0%	-6.0%
Gold \$/oz (nearby contract)	\$975.00	\$922.70	\$672.50	5.7%	45.0%
Oil \$/bbl (nearby contract)	\$101.84	\$91.75	\$61.79	11.0%	64.8%
MBA Refi Index (month end)	2569.0	5103.6	1943.5	-49.7%	32.2%

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.**