



- **The Economy:** *The market exhibits classic Prisoner's Dilemma behavior*
- **The Mortgage Market:** *Mortgages stabilize after furious policy activity*
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## The Economy

"Liquidity is confidence." So explained Fed Governor Kevin Warsh in a speech he gave a year ago, in March 2007. It is a general definition of a complex concept, but it nevertheless fairly well sums up the idea that market liquidity depends on participants' confidence in the behavior of others. "[P]owerful liquidity in the U.S. capital markets," he said, "is evidenced when the economic outcomes are believed to be benign. When the "tail" outcomes are either highly improbable or, at the very least, subject to reasonably precise measurement, the conditions are ripe for liquidity to be plentiful." And in March 2007, liquidity was indeed plentiful as market conditions supported a high degree of confidence. Risk premiums were low, M&A activity was strong, and the stocks of financial companies—the primary beneficiaries of liquidity—were strong.

That was then, this is now. The month of March 2008 and the quick collapse of Carlyle Capital, Thornburg Mortgage, Bear Stearns is a case study in the devastating consequences of confidence—and liquidity—leaving a market.

Market observers—both professionals and the man on the street (some of whom staged a protest in the lobby of Bear Stearns after its Fed-sponsored sale to JP Morgan Chase)—are scratching their heads to understand just how it came to be that liquidity got so constrained and spurred the most significant government intervention in the markets since Franklin Delano Roosevelt declared his bank holiday in 1933. The best way for us to think about it is in terms of the classical *prisoner's dilemma*, in which two suspects are arrested and placed in separate rooms to be interrogated by the police. Each prisoner has two choices: either accuse his friend or stay silent, with the following penalties: If both prisoners cooperate with each other and remain silent, they each get a reduced, 6-month jail sentence; if each betrays the other, they each get a 5-year sentence; if one betrays the other and the other remains silent, the betrayer is freed and the silent one gets sole blame for the crime and a 10-year sentence. What should the prisoners do? If each prisoner is only self-interested in minimizing his own jail term, they would betray each other. If one knew the other would remain silent, then he would betray in order to walk free, and if one was uncertain about what the other might do, then he still should betray in order to avoid the maximum sentence. In order for the prisoners to not betray each other, they have to have confidence that the other will cooperate and they both have to be willing to accept an outcome which does not maximize their self-interest.

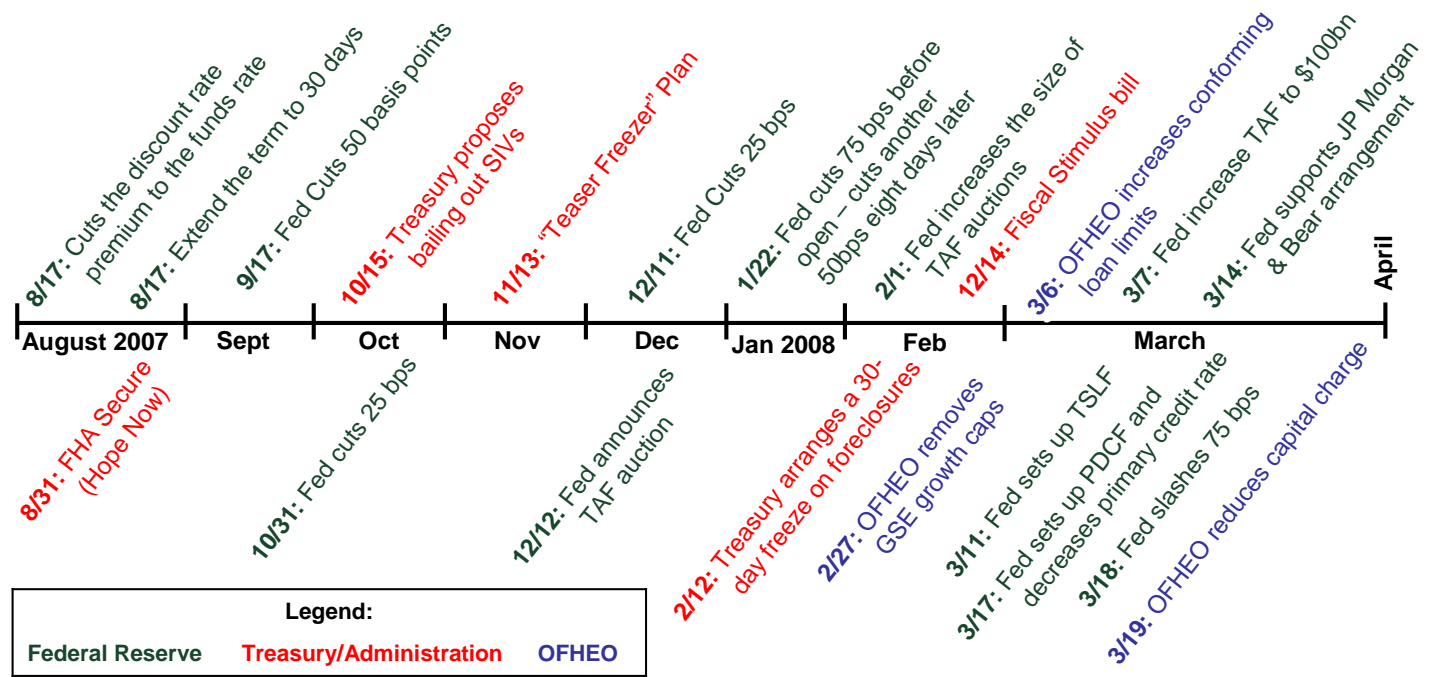
If liquidity is confidence, then we would add the concept that a liquid market is one in which all market participants—prisoners, if you will—are cooperating and have confidence in how they all will behave. Counterparties believe that each will perform on their contractual obligations, investors trust market values for assets, credit risk is quantifiable and priced correctly, and participants have confidence that what they buy or finance today can be sold or refinanced tomorrow on reasonably predictable terms and conditions. The conditions that prevailed in the financial markets in March 2008 were exactly the opposite of this state of affairs. The lack of trust and confidence in the marketplace was palpable, evidenced by 1) the fear of assets being dumped on the market by, among others, Thornburg, Carlyle, CDO liquidations and financial institutions stuffed to the gills with assets they didn't want to own, 2) blowing out of credit spreads, 3) the sharp rise in the price of credit default swaps for banks and broker-dealers, and 4) the ratcheting up of lenders' margin calls—through higher haircuts and lower market valuations—for all but the most liquid, plain vanilla and risk-free assets. Compounding the problem was the fact that many major market participants were contending with issues related to quarter-end.

Through their entirely self-interested behavior in March 2008, market participants essentially betrayed one another by racing to protect their own balance sheets and capital positions. They no longer had confidence in rational market behavior of their counterparties, or their counterparties' counterparties. In this case, betrayal didn't mean ratting out your colleague, it meant grabbing collateral before your competitor could, and the penalty for losing wasn't a prison term but getting stuck with assets they didn't want and couldn't sell. The speed with which this breakdown in confidence came to a boiling point was astonishingly quick and it indeed threatened the safety and soundness of the financial system. Ben Bernanke explained what happened, and why policymakers stepped in so aggressively, in testimony last week before Congress. "Pressures in short-term bank funding markets, which had abated somewhat beginning late last year, have increased once again. Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and increased the amount of collateral they required to back short-term security financing agreements. To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on security prices. Credit availability has also been restricted because some large



financial institutions... have reported substantial losses and writedowns, reducing their capital available to support increased lending. Some key securitization markets, including those for nonconforming mortgages, continue to function poorly if at all. These developments in financial markets—which themselves reflect, in part, greater concerns about housing and the economic outlook more generally—have weighed on real economic activity.”

With this background, the crisis at Bear Stearns took on added significance. “The sudden failure of Bear Stearns,” Bernanke continued, “likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company’s failure could also have cast doubt on the financial positions of some of Bear Stearns’ thousands of counterparties and perhaps of companies with similar businesses. Given the exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain.” The timeline below shows that with the unfolding of the crisis came an increase in the pace of policymakers’ actions.



To us, the actions of the Federal Reserve, the Treasury Department and OFHEO are designed to restore the market confidence that is the foundation of liquidity, particularly in the mortgage market. Specifically, their actions should help establish confidence on both the asset and the financing side of the market. With the increase in conforming loan limits and expansion of the buying capacity of Fannie Mae, Freddie Mac and the Federal Home Loan Banks, the mortgage market should see increased activity from a buyer of last resort (more on this below). By allowing primary dealers to access Federal Reserve lending programs (the first time non-depository institutions have been allowed to borrow from the Fed), the market now has a lender of last resort that it otherwise would not be able to access. The sum of all of these activities is that the federal government has placed a very visible hand into the free markets and become the market-maker of last resort, at least until market participants can once again have confidence in each other’s rational behavior.

Will all of these actions work? We don’t know how to answer that question, because it depends what the word “work” means in this context. If “work” means a reversion back to the markets as they are operated prior to March 2007, the answer is probably no. It is unlikely that we will again see the sins of 2001-2007, particularly the conflicted ratings and poor underwriting of the originate-to-distribute model of mortgage securitization. But if “work” means a prevention of a financial market meltdown, the answer is yes, and everyone in America is better off for it. This is not to say that the liquidity crunch is over—because it isn’t—or that the problems of financial institutions are behind them—because they’re not. Conditions have certainly improved since the first three weeks of March, but it is still an anxious market, and we believe that there are more writedowns and capital raises in the future for major financial institutions. We also believe that the US economy is in fairly weak condition. Thus we would not be surprised to see a continuation of the accommodative stance of policymakers and the institution of new liquidity-enhancing policies to continue for the foreseeable future. Cash is piling up in money market funds and bank deposits, just as money-market rates are falling. The tell-tale sign of recovery in the market will be when that cash begins to seek out greater returns.



## The Mortgage Market

Prepayment speeds for Agency mortgage-backed securities posted sharp increases in February (March release). Aggregate prepayments jumped approximately 70%, from 9.6 to 16.3 constant prepayment rate (“CPR”) on 30-year FNMA collateral, and from 9.0 to 15.4 CPR on FHLMC collateral. This increase was substantially more than the 15-20% month-over month increase the dealer community was anticipating and was a classic “rate lock” response to the nearly 70 basis point rally in mortgage rates that occurred in January. Despite the spike in speeds for February, from a historical perspective they are still relatively low given where long-term interest rates are. In 2003, when the 10 year Treasury was at a similar level, CPRs on Agency MBS were coming in at approximately 40% or higher. Speeds are slower today thanks to a lower coupon stack (most of the mortgage universe is now a lower coupon thanks to the refinancing wave of 2003), as well as the fact that increased transaction costs, as well as a slowing housing market, have tempered prepayments. This should continue throughout 2008, with further slowdowns expected in the latter half of 2008. According to Bear Stearns, prepayment models have still “not been fully calibrated” to the downside for the coming environment which is consistent with their previous statement that 2008 will be the “floor” from which all future prepayments models will be based. Looking ahead, March speeds (April release) are not expected to pick up substantially from where they are currently.

As discussed above, throughout the month of March, policymakers took several measures to try to improve the fractured credit markets outside of the 75 basis points ease in the Fed Funds Rate on March 18. On March 4 the Term Auction Facility (TAF) was initially expanded from \$40 billion to \$60 billion and then later to \$100 billion on March 7. While the TAF program did reduce the “stigma” of going to the discount window it still did not allow for a wide variety of collateral to be pledged and it was restricted to depository institutions. The TAF was then improved upon with the \$200bn Term Lending Securities Facility (TSLF) on March 11 which expanded the collateral the Fed would accept to include Federal Agency debt, Agency MBS and non-Agency AAA-rated private label residential MBS, and it expanded the availability of the facility to include primary dealers, ie, non-depository financial institutions. The Fed enhanced the TSLF by initiating the Primary Credit Dealer Facility (PCDF) on March 16 which further expanded the range of pledged collateral to include investment grade corporate debt, municipal securities and MBS and ABS. On March 19 OFHEO announced that the GSEs’ capital requirement would be reduced from 30% to 20%, which according to their release would “provide up to \$200 billion” in liquidity to the mortgage-backed securities market. Lastly, on March 24 the Federal Home Loan Banks passed a resolution allowing for the Home Loan banks to purchase up to 600% of their capital in MBS, an increase of 100% from their prior 300%. UBS estimates that the additional buying power brought about by the change in FHLB capital requirements is roughly \$76 billion. So has all of this added liquidity affected spreads on Agency MBS? In short, it has stabilized the market. On March 1<sup>st</sup> the spread on 30 year FNMA 6% was 309 basis points to the Treasury curve, it spiked to 431 basis points on March 6, and ended the month at 343 basis points.

## The Markets

In March, the Fed cut the Fed Funds rate by 75 basis points to 2.25%. The 2a/10s spread was unchanged. The dollar continued to show weakness, while gold also fell. Mortgage rates stayed range-bound, and so did the MBA Refi Index. Stocks were flat.

	3/31/2008	2/29/2008	3/31/2007	MOM % change	YOY % change
<b>Fed Funds</b>	2.25%	3.00%	5.25%	-25.0%	-57.1%
<b>2-year US Treasury</b>	1.586%	1.620%	4.579%	-2.1%	-65.4%
<b>10-year US Treasury</b>	3.411%	3.511%	4.646%	-2.8%	-26.6%
<b>10-year JGB</b>	1.285%	1.368%	1.659%	-6.1%	-22.5%
<b>10-year euro</b>	3.899%	3.891%	4.057%	0.2%	-3.9%
<b>10-year UK Gilt</b>	4.348%	4.469%	4.969%	-2.7%	-12.5%
<b>10-year Canada Treasury</b>	3.440%	3.640%	4.113%	-5.5%	-16.4%
<b>30 yr conventional mortgage</b>	5.587%	5.728%	6.118%	-2.5%	-8.7%
<b>Dollar Index</b>	71.80	73.71	82.93	-2.6%	-13.4%
<b>Japanese Yen</b>	99.86	104.21	117.59	-4.2%	-15.1%
<b>S&amp;P 500</b>	1322.70	1330.63	1420.86	-0.6%	-6.9%
<b>Nasdaq Composite</b>	2279.10	2271.48	2421.64	0.3%	-5.9%
<b>Gold \$/oz (nearby contract)</b>	\$916.20	\$975.00	\$663.00	-6.0%	38.2%
<b>Oil \$/bbl (nearby contract)</b>	\$101.58	\$101.84	\$65.87	-0.3%	54.2%
<b>MBA Refi Index (month end)</b>	2636.0	2569.0	2098.3	2.6%	25.6%

Source: Bloomberg; Japanese Yen quote is the London feed



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