



- **The Economy:** *Mr. Market lifts his head out of the rubble*
- **The Mortgage Market:** *Mortgage refinancing speeds to be held down by price declines, lack of credit*
- **The Markets:** *Go figure: the Fed cuts again, and the dollar rallies*

The Economy

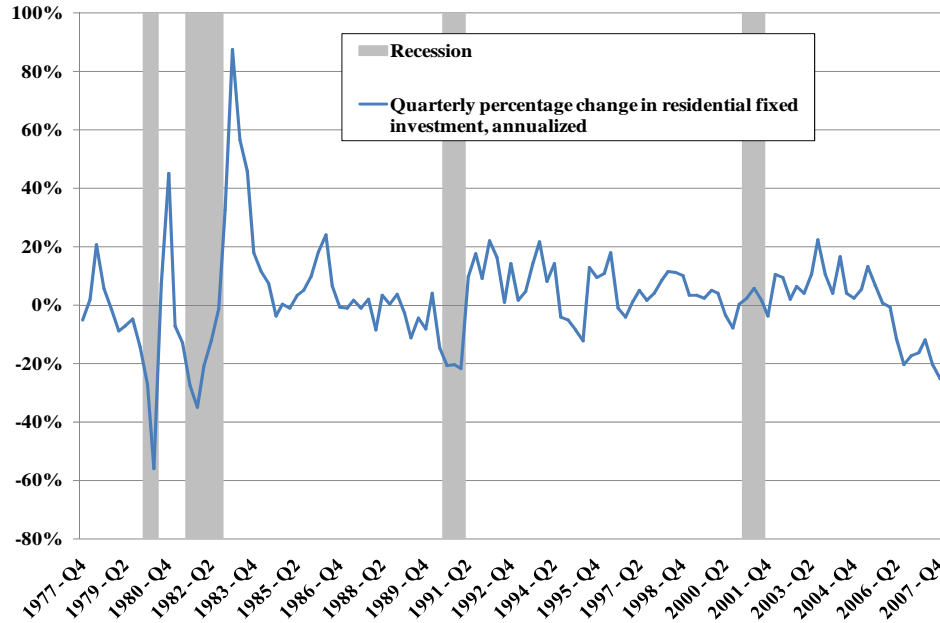
“My fellow citizens, let no one doubt that this is a difficult and dangerous effort on which we have set out.... But the greatest danger of all would be to do nothing. The path we have chosen for the present is full of hazards, as all paths are; but it is the one most consistent with our character and courage as a nation and our commitments around the world.”

--John F. Kennedy, October 22, 1962

April was the month when bruised and battered participants in the financial markets pulled themselves out of March’s rubble and checked to see if they were intact. If March was the month of action, then April was the month for second-guessing and explaining. On April 3, extraordinary testimony was delivered to the Senate Banking Committee by the principal actors in the drama of the prior month, including Fed Chairman Ben Bernanke, New York Fed President Timothy Geithner, Robert Steel of the Department of Treasury, and the CEOs of Bear Stearns and JP Morgan. They tried to explain to the assembled Senators, indeed the whole world, why and how the events of March came to pass and why and how they collectively arranged a take-over of Bear Stearns, opened the discount window to a broader group of borrowers and asset classes, coordinated liquidity measures with other central banks, expanded the buying power of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and cut rates another 75 basis points. In the fullness of time, books will be written about March 2008, and the tone will be akin to that reserved for crises such as the Cuban Missile Crisis, when the world was on the brink of nuclear war. Indeed, Mr. Geithner gave a detailed and frank play-by-play of how the world was pulled from the edge of financial collapse. He said: “The most important risk [of the credit crisis] is systemic: if this dynamic continues unabated, the result would be a greater probability of widespread insolvencies, severe and protracted damage to the financial system and, ultimately, to the economy as a whole. This is not theoretical risk, and it is not something that the market can solve on its own. It carries the risk of significant damage to economic activity. Absent a forceful policy response, the consequences would be lower incomes for working families, higher borrowing costs for housing, education, and the expenses of everyday life, lower value of retirement savings and rising unemployment.”

We don’t know if the Senators fully grasped the gravity of what they were hearing (although our guess is that most of them didn’t), because Mr. Geithner was talking about derivative contracts, flaws in the securitization model and interconnected counterparty risk, not missiles. But the risk of doing nothing is the same as it was in October 1962. For us, we believe the Federal Reserve, Treasury and OFHEO did what needed to be done to prevent a failure of the financial infrastructure. From the evidence, their actions are bearing fruit. Markets are more stable, credit spreads—while still wide—have come in since the widest points in March, and frozen parts of the market are starting to show signs of activity. Small-sized securitizations are taking place and asset values in certain structured products have at least stopped going down. Credit default swaps have tightened cheaper. Even the US dollar strengthened during April.

While the financial markets have stabilized for now, we believe that it is unlikely a harbinger of improvement in the US economy. That game is likely still in the early innings. The preliminary estimate for first quarter GDP was released at the end of the month, and it came in at 0.6%. The market was generally cheered by this result, as it was slightly above expectations of +0.5%, but an examination of the components of growth reveals that underneath the headline number lies fairly significant weakness. After backing out inventory building (+0.81%), the weak-dollar induced increase in net exports (+0.22%), and government spending-related growth (+0.39%), what is left—domestic private sector consumption demand—declined almost 1 percent (-0.82% to be exact). Combined spending on durables and nondurable goods fell at a 3% annual rate. Furthermore, residential fixed investment fell for the ninth consecutive quarter, but the latest drop of 26.6% was the largest in the series, and biggest drop in over 25 years.



source: BLS

The other big economic data point that cheered stock bulls was the relatively mild loss of jobs in the month of April. Non-farm payrolls, which had been expected to decline by 75 thousand, instead fell “only” 20 thousand, and the unemployment rate dropped slightly from 5.1% to 5.0%. Again, behind the headline were recessionary signals. Economist David Rosenberg of Merrill Lynch pointed them out: Wages fell 0.3% in the month (certainly not an inflationary data point); it is taking longer for the unemployed to find work (the average duration of unemployment lengthened from 16.2 weeks to 16.9 weeks); people typically take on more than one job in a recession, and last month the number of “multiple jobholders” rose 2.6% or 195 thousand; the length of the average workweek fell 0.3% in the month, which Rosenberg says is “the equivalent of 400,000 job cuts”.

We don't expect that the few bright spots in the US economy will be able to offset the drag of the housing market, not just from poor mortgage credit performance, homeowners' inability to extract equity or the reduction in housing-related economic activity, but also from the negative wealth effect that occurs when home prices decline—now 25% annualized over the last 3 months. Car sales have plummeted to an annual rate of 14.4 million, the lowest level since the late 1990s. Yes, checks from the US government should be arriving in Americans' mailboxes starting the next several months, but it remains to be seen how they will be used... our guess is the money will more likely be spent paying down a credit card bill than on a new car.

What does this mean for monetary policy and interest rates? Probably a steep curve for a while, although higher long-term rates will likely depress the housing market and mortgage origination business for as long as mortgage rates stay above 6%. For us, we agree with the conclusion of Economist Jan Hatzius of Goldman Sachs. “[M]arket expectations that the Federal Reserve will start to reverse its rate cuts in late 2008 or early 2009 are misplaced. Indeed, renewed rate cuts are much more likely over the next year than a turn toward hikes. In our view, the Fed is unlikely to tighten policy anew until both home prices and the unemployment rate have stopped deteriorating. This, in our view is unlikely before the second half of 2009, and our best guess is that the first rate hike will not come until early 2010.”

The Mortgage Market

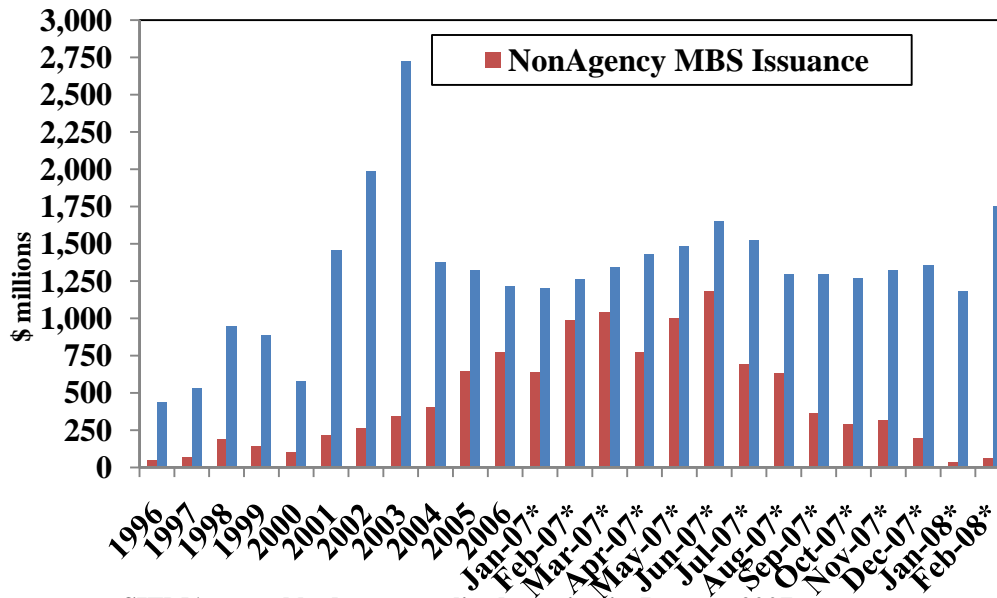
Prepayment speeds for March (April release) dropped 7% on the aggregate to 14.4 CPR from 15.5 CPR in February. Refinancing activity plunged in mid-to-late February because of the turmoil in the fixed-income markets and the resulting rise in mortgage rates. Prime mortgages with low LTV and high FICO credit scores prepaid much faster than collateral with credit impairment, and the gap could potentially go wider as credit-impaired borrowers find it increasingly difficult to refinance.

A deteriorating housing market and tighter lending standards should offset seasonal increases in refinancing activity heading into the historically fast-prepaying summer months. Slower speeds have long been our prepayment stance as readers of this commentary are well aware, which should continue due to the combination of declining home values, a general tightening of lending standards and a virtually non-existent non-agency market. The Federal Reserve, in its latest quarterly survey of senior loan officers shows an across the board tightening of credit availability: over 60% said they were tightening standards on prime residential mortgages. In addition, about 50% of domestic banks said they were tightening terms on home equity lines of credit,



an important source of home equity extraction, because “declines in the value of the collateral significantly below the appraised values” as well as “increased defaults of material obligations under loan agreements.”

Mortgage-backed securities origination has also dropped off in tandem with home prices. The bar chart below illustrates the dramatic decrease in non-Agency MBS issuance over the past year. The red bars are a pretty good picture of the inflating mortgage bubble—and its ultimate popping.



source: SIFMA; monthly data annualized starting in January 2007

This leads us into our third and final point which will be the primary driver of slower speeds going forward, tightening lending standards. The Federal Reserve recently reported that 70% of banks increased loan rates over their cost of funds for commercial and industrial borrowing, a 25% increase over their January 2008 survey. If borrowers are unable to obtain financing, sellers will be unable to sell, which will drive down home prices, origination and ultimately MBS speeds.

The Markets

In April, the Fed cut the Fed Funds rate by another 25 basis points to 2%. The dollar strengthened, albeit from a lower level, and gold eased. Stocks were up and bonds were down.

	4/30/2008	3/31/2008	4/30/2007	MOM % change	YOY % change
Fed Funds	2.00%	2.25%	5.25%	-11.1%	-61.9%
2-year US Treasury	2.258%	1.586%	4.595%	42.4%	-50.9%
10-year US Treasury	3.730%	3.411%	4.624%	9.4%	-19.3%
10-year JGB	1.585%	1.285%	1.660%	23.3%	-4.5%
10-year euro	4.123%	3.899%	4.154%	5.7%	-0.7%
10-year UK Gilt	4.670%	4.348%	5.043%	7.4%	-7.4%
10-year Canada Treasury	3.588%	3.440%	4.154%	4.3%	-13.6%
30 yr conventional mortgage	5.795%	5.587%	6.146%	3.7%	-5.7%
Dollar Index	72.51	71.80	81.45	1.0%	-11.0%
Japanese Yen	104.37	99.86	119.38	4.5%	-12.6%
S&P 500	1385.59	1322.70	1482.37	4.8%	-6.5%
Nasdaq Composite	2412.80	2279.10	2525.09	5.9%	-4.4%
Gold \$/oz (nearby contract)	\$865.10	\$916.20	\$683.50	-5.6%	26.6%
Oil \$/bbl (nearby contract)	\$113.46	\$101.58	\$65.71	11.7%	72.7%
MBA Refi Index (month end)	1905.2	2636.0	2015.8	-27.7%	5.5%

Source: Bloomberg; Japanese Yen quote is the London feed



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