

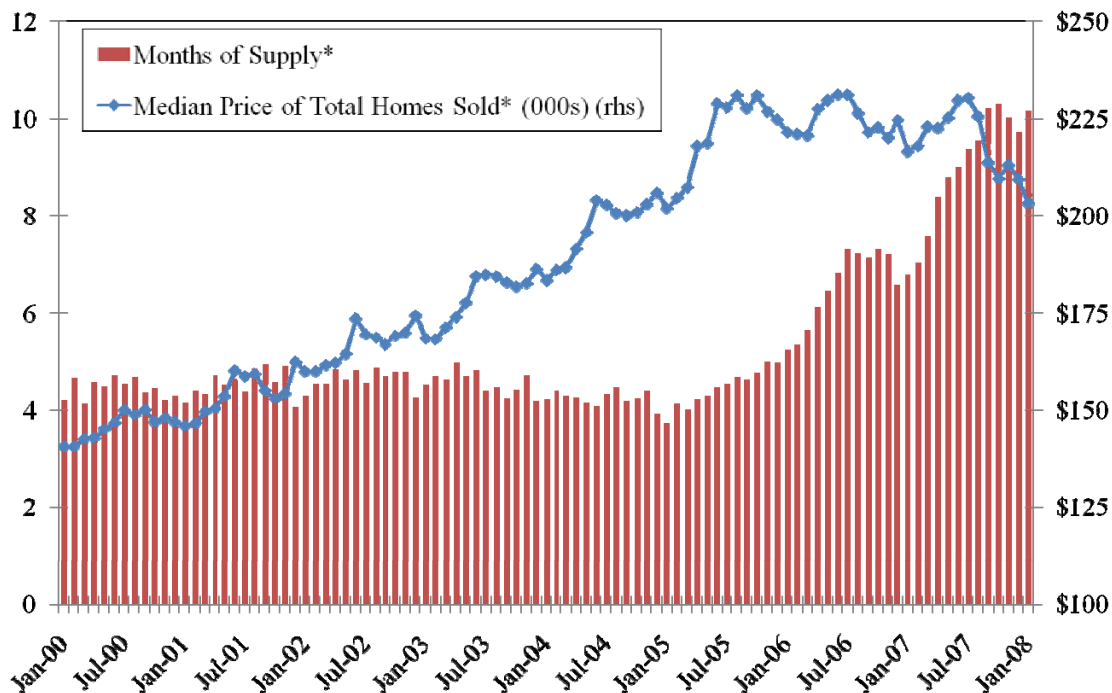


- **The Economy:** *How close is the Fed to tightening? Not very...*
- **The Mortgage Market:** *Mortgage refinancing and origination activity slows further*
- **The Markets:** *Yields rise worldwide on inflation fears*

The Economy

In May, the market kept one wary eye on the aftermath of the liquidity dislocation in March and the other on inflation. Contributing to the concern was hawkish talk from various Fed speakers, as well as oil prices, which rose from \$113 to \$127 per barrel during the month (now well over \$130). Rates rose across the yield curve. The minutes to the April 29-30 Federal Open Market Committee meeting, released May 21, reveal that the members were uneasy about rising commodity prices and their possible transmission to general consumer prices. “[T]he increase in crude oil prices to record levels, together with rapid increases in food and import prices in recent months, was likely to put upward pressure on inflation over the next few quarters,” the minutes reported. “Several participants reported that business contacts had expressed growing concerns about the increase in their input costs and that there were signs that an increasing number of firms were seeking to pass on these higher costs to their customers in the form of higher prices.” As a result of their growing concern over inflation, “most members” of the committee considered the decision to lower the Fed Funds target rate by 25 basis points (bp) to be a “close call.” Of the 10 members of the FOMC, two (Fisher and Plosser) voted against the cut.

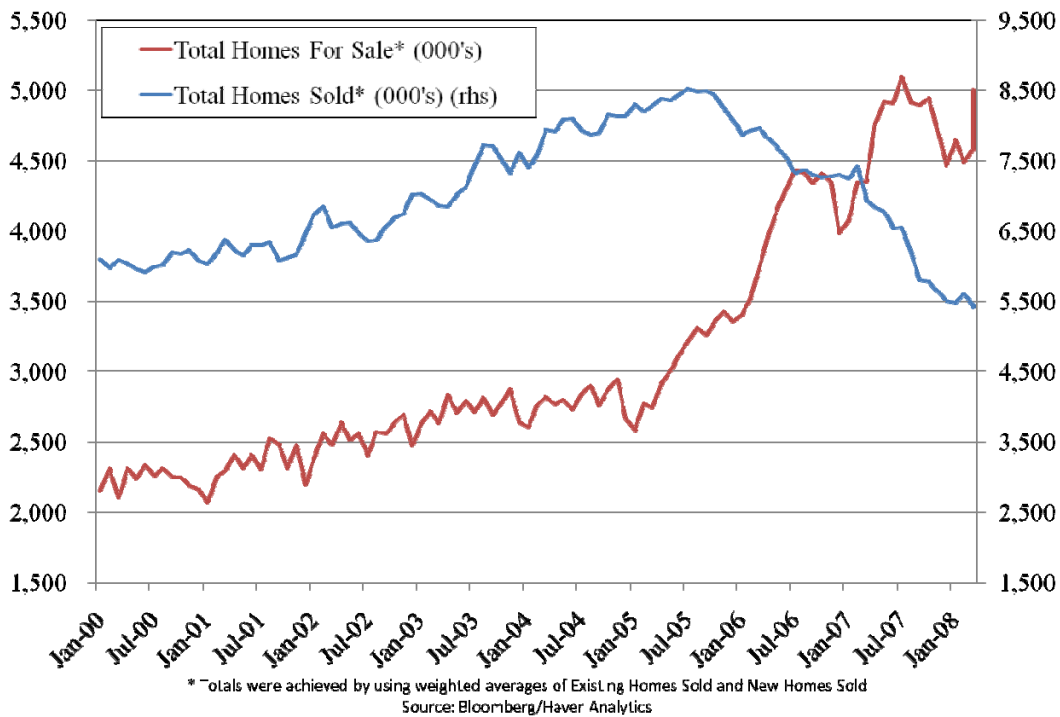
This statement begs a question: Given their concerns over inflation, if the FOMC’s decision to reduce the Fed Funds target rate by 25 bp was indeed a close call, how close a call is it for them to start raising rates? It’s a question we heard a lot on our recent road show. [Annaly priced a secondary offering on May 13th—ed.] For what it’s worth, the Fed Funds futures market is now discounting a 68% chance of a 25 basis point hike in the Fed Funds rate by the end of 2008. We don’t make interest rate forecasts, but we believe that there are a number of crosscurrents in the economy and the financial markets that will not only stay the Fed’s hand for some time but also serve to moderate inflation. First, the housing market still has a ways to go before it finds a bottom. Very simply, there are still far too many homes on the market and far too few buyers. At least at current prices.



* Totals were achieved by using weighted averages of Existing Homes Sold and New Homes Sold
Source: Bloomberg/Haver Analytics



The graph below spells out the supply/demand imbalance. It's perhaps a familiar story by this point in the housing cycle, but anyone hoping for a bottoming anytime soon is, we believe, whistling past the graveyard. Two points to make on the graph below: First, of the number of new and existing homes for sale, approximately 5 million, over 2 million of them are empty. And this is before the full brunt of foreclosed houses hits the market. The Mortgage Bankers Association (MBA) reported last week that an all-time high of 2.47% of all mortgage loans are in the foreclosure process at the end of the first quarter, meaning another 1.1 million homes of the 45.2 million homes with mortgages outstanding will likely be hitting the market. Moreover, the MBA reported that on a seasonally adjusted basis 6.35% of all residential mortgage loans outstanding were delinquent (and not yet in foreclosure) at the end of the quarter, another all-time high. If the rule of thumb that one-third of delinquent loans go all the way to foreclosure, this could mean another million or so homes on the market. We would also suggest that the delinquency rate will continue to get worse before it gets better. Second, lest anyone draw the wrong conclusion from the numbers on the two Y-axes below, the organizations that report new home sales (the Census Bureau) and existing home sales (National Association of Realtors) report them on an annualized basis. So, *actual* new and existing home sales in the month of April did not total 5.5 million, they totaled one-twelfth of that, or 458 thousand.



In other words, without a significant capitulation on the part of home sellers, or a significant ramping up of mortgage credit availability, or outright destruction of housing supply—none of which is likely to happen soon, particularly if the Fed decides to raise rates—home prices will continue to be challenged for quite some time. This will continue to put pressure on household net worth, which brings us to the second crosscurrent the Fed should be following—the health of the consumer. The Federal Reserve released its quarterly flow of funds data this week and it showed that household net worth fell by \$1.7 trillion in the first quarter of 2008—the decline was expected, but the size of the decline was over 3 times the decline in the fourth quarter of 2007. The \$2.2 trillion in lost net worth over the last two quarters is larger than the stock-market-crash-induced loss in net worth in 2000 (-\$651 billion), 2001 (-\$1 trillion) and in 2002 (-\$1.6 trillion). Unfortunately, the fundamentals in the housing market only point to a continuation of the current trend of falling prices (the Case-Shiller Index declined 14.4% in March on a year-to-year basis). Economist Asha Bangalore of Northern Trust reads these data and asks, “Does the sharp drop in net worth of households in the first quarter suggest we may be underestimating the likely weakness in consumer spending in the quarters ahead?” This cannot bode well for consumption which, as we all know, accounts for 70% of US GDP and about 20% of global GDP.

The third crosscurrent for the Fed to watch is the capital position of financial institutions. Financials indexes are trading at or below the mid-March Bear Stearns lows (see the S&P Financial Sector ETF, ticker XLF). Banks and brokers have been making some headway towards repairing their balance sheets, but there is more wood to chop. Fed Vice Chairman Donald Kohn spoke disapprovingly about banks’ loan loss reserves in a recent speech: “[D]espite higher provisioning during the past several quarters,” he said, “coverage of nonperforming loans by loan loss reserves has not kept pace with growth in problem assets and bank holding companies may likely face the need to further bolster loan loss reserves.” He also calls for additional capital injections and dividend cuts. Complicating matters for financial institutions will be evaluating the counterparty risk of the



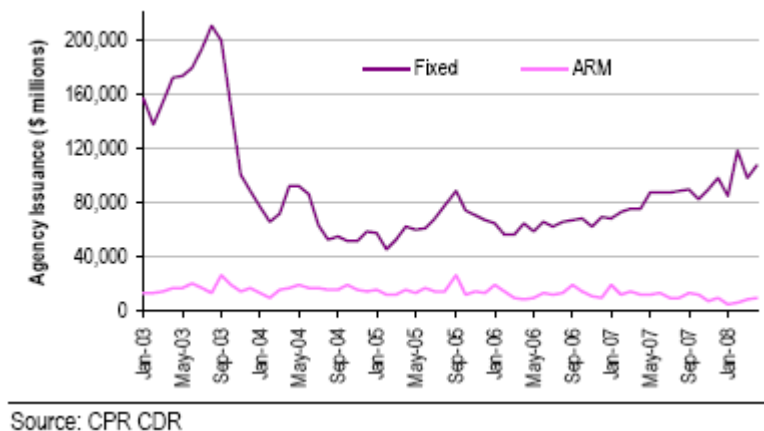
downgrades of the leading monoline bond insurers, MBIA and Ambac. Clearly the Fed will have to continue to a) keep their liquidity facilities in place in order to avoid another Bear Stearns-type event and b) make it possible for banks to grow their way out of their problems through the increased retained earnings that arise from a favorably steep yield curve.

Of course, we could be wrong. Certainly the Fed could surprise us and follow through on its inflation rhetoric. The hawkish stance of the ECB will not make the Fed's decision process any easier, particularly as Ben Bernanke has begun to tread into territory unbecoming a Fed Chairman by expressing concern over the inflationary effects of the weak dollar. But we conclude with three more observations about inflation and rates. First, the largest single component of the CPI and PCE indexes is housing, calculated primarily based on rental rates. We believe that at least some portion of the huge oversupply of available homes for sale could be turned into rental properties, which should temper the rise in that component of CPI. Second, with the May data released last week, non-farm payrolls have now fallen for five straight months, and the unemployment rate jumped to 5.5%. The Fed typically does not raise rates unless the jobs picture is improving, not deteriorating. Third, higher oil prices may end up having the same demand-constraining deflationary effect as higher short-term interest rates. Auto sales have been suffering, particularly among the higher margin trucks and SUVs that Detroit has favored. Airlines have begun mothballing less efficient planes and reducing routes. And consumer behavior is changing. "This summer, high gasoline prices appear to be dampening Americans' intent to travel," said Robert Sinclair Jr., a spokesman for the American Automobile Association. "If a trend toward higher gas prices and fewer travelers were to continue, it could eventually impact travel-dependent companies that provide employment opportunities and tax revenues in almost every city and town in America."

The Mortgage Market

April prepayment speeds (May release) came in slower from the flat to modest increases dealers were estimating, as seasonality and day count were trumped by home price depreciation and tighter underwriting standards. Prepayment speeds on the aggregate 30 year Fannie Mae universe decreased 8%, although new production has experienced yet another pickup on a percentage basis. For instance, prepayments on 30 year FNMA 6s of 2008 increased 22% month-over-month, from 6 to 8 CPR, due to the fact that the fresher documentation on these newer loans makes them easier to refinance. As this phenomenon accounts for just a small fraction of the FNMA universe, looking ahead we can expect that the continuing deterioration in the housing market should lead to flat to decreasing month-over-month speeds. The most recent Mortgage Bankers Association Refinancing Index clearly demonstrates the impending prepayment slowdown: the May 30th print was a 25% decrease from the prior week, a 21% decrease from the prior month, and a 52 week low.

While credit conditions have improved slightly we are not expecting a return to the easy credit available to non-conforming borrowers in 2004 through 2007, which means that any growth in the mortgage market will come in Agency MBS issuance. With the non-Agency market almost extinct, UBS estimates that Agency MBS accounts for 94% of all origination in Q1 2008. Overwhelmingly, as the graph below illustrates, Agency issuance is still largely fixed-rate. (The graph below also shows the fall-off in Agency issuance after the refinancing wave of 2003 and the growth in non-Agency issuance.)



Adjustable-rate mortgage (ARM) origination should remain flat going forward. The inability to refinance ARMs before the first coupon reset into new ARMs and the generally slow housing market will provide strong technical support for all ARM product. Total Agency MBS issuance should also get a boost from Ginnie Mae paper, as meeting the FHA/VA underwriting standards of Ginnie Mae may be the only financing alternative for high LTV borrowers. Even though most analysts estimate that Ginnie Mae issuance should remain elevated for the foreseeable future, the fact remains that the current environment will be challenging for all borrowers. UBS estimates that overall Agency MBS issuance should be flat to decreasing in 2008.



The Markets

In May, oil continued to soar, and resulting fears of inflation drove yields higher across the curve and across most geographical boundaries. The Refi Index plunged.

	5/31/2008	4/30/2008	5/31/2007	MOM % change	YOY % change
Fed Funds	2.00%	2.00%	5.25%	0.0%	-61.9%
2-year US Treasury	2.645%	2.258%	4.912%	17.1%	-46.2%
10-year US Treasury	4.061%	3.730%	4.890%	8.9%	-17.0%
10-year JGB	1.759%	1.585%	1.753%	11.0%	0.3%
10-year euro	4.405%	4.123%	4.422%	6.8%	-0.4%
10-year UK Gilt	4.986%	4.670%	5.255%	6.8%	-5.1%
10-year Canada Treasury	3.711%	3.588%	4.490%	3.4%	-17.3%
30 yr conventional mortgage	6.017%	5.795%	6.366%	3.8%	-5.5%
Dollar Index	72.88	72.51	82.30	0.5%	-11.4%
Japanese Yen	105.52	104.37	121.81	1.1%	-13.4%
S&P 500	1400.38	1385.59	1530.62	1.1%	-8.5%
Nasdaq Composite	2522.66	2412.80	2604.52	4.6%	-3.1%
Gold \$/oz (nearby contract)	\$887.30	\$865.10	\$661.00	2.6%	34.2%
Oil \$/bbl (nearby contract)	\$127.35	\$113.46	\$64.01	12.2%	99.0%
MBA Refi Index (month end)	1496.1	1905.2	1874.6	-21.5%	-20.2%

Source: Bloomberg; Japanese Yen quote is the London feed

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