



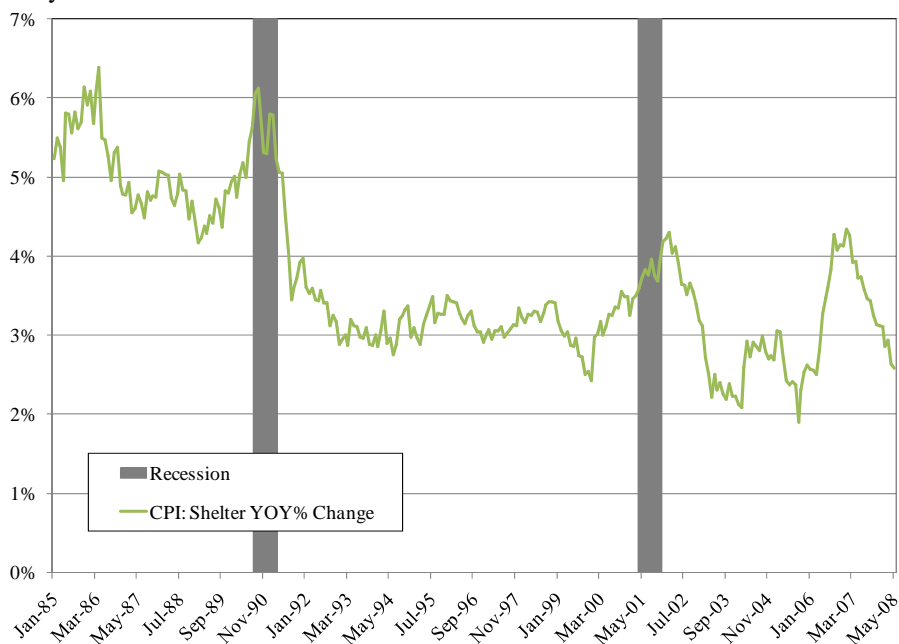
- **The Economy:** *The Fed is in a pickle*
- **The Mortgage Market:** *Fannie and Freddie hullabaloo*
- **The Markets:** *The Fed stays on hold, the ECB does not*

The Economy

On June 25 the Federal Reserve concluded its two-day FOMC meeting by announcing a pause in its current rate-cutting campaign. The accompanying statement explained that the Fed Funds rate was being held at 2% because while “downside risks to growth remain... upside risks to inflation and inflation expectations have increased.” As risks to growth, the central bankers specifically mentioned soft labor markets, stressed-out financial markets, the credit crunch, the housing “contraction” and high energy prices, while citing elevated energy and other commodity prices contributing to heightened inflation expectations.

By the time the Fed announced its decision, it was widely expected. But over the course of the month the market was exhibiting a tendency to change its mind. At the beginning of June, the Fed Funds futures market was discounting a 50% chance of the Fed raising 25 basis points (bp) at the September 16 meeting, and the two-year Treasury yielded 2.65%. By June 16, with Fed speakers seemingly competing with each other to see who could talk tougher on inflation, the market was pricing in a 100% chance of a 25 bp hike and a 36% chance of a 50 bp hike at the same meeting, and the two-year Treasury plunged in price to yield over 3%. But by month’s end, the market had reconsidered, and put the odds of a 25 bp hike at 52%. (After the weak employment report on July 3, those odds have since slipped to 38%.) The two-year recovered to end the month about where it started.

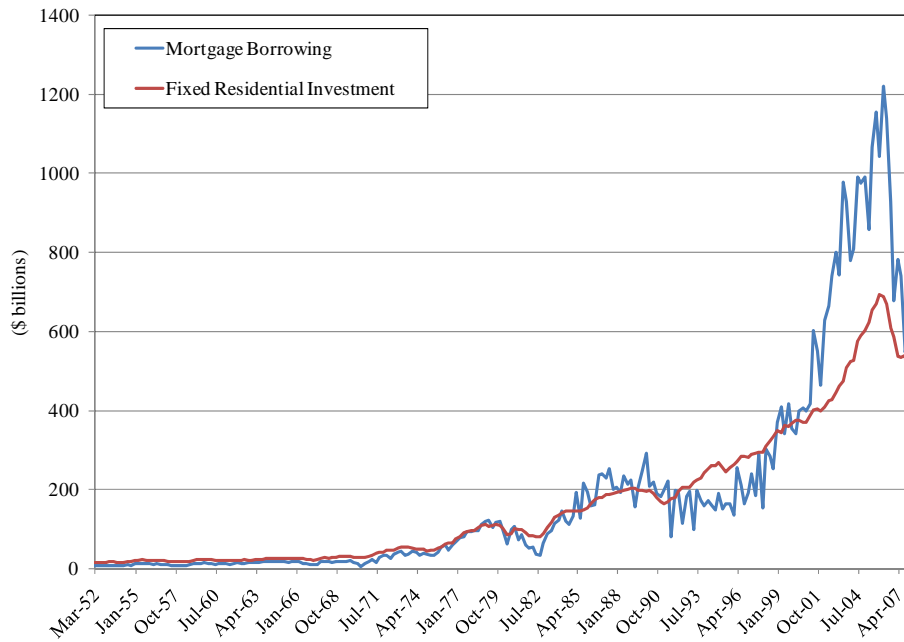
Like the Fed, the financial markets are trying to figure out which monster—weak growth or inflation—is more worrisome. Certainly, with oil making itself at home over \$140/barrel, gold approaching \$1000/ounce, and corn burning up the market, not to mention the weak dollar driving up import prices, it is clear that inflation is worthy of concern. We are just not ready to concede the point. First, if inflation is always and everywhere a monetary phenomenon, the monetary data don’t seem to support the notion that the Fed is accommodative and thus stoking inflation, the 2% Fed Funds rate notwithstanding. For example, the year-over-year growth in the monetary base (the sum of bank reserves and currency) was growing at just 1.4% year-over-year through June, monetary aggregate growth is still in the low single digits, and commercial bank credit—loans and investments—is actually shrinking. Second, looking at the CPI measure of the prices of goods and services, which is where inflation hits the wallet, the downturn in the housing market is likely to be a significant deflationary driver. Economist Seamus Smyth of Goldman Sachs estimates that over one million homes that had originally been intended to be owner-occupied have been transitioned to rental units. As the graph below shows, shelter costs are falling in price, and are likely to continue to fall, thanks to oversupply in the rental market. At 40% of core, the largest single component of the CPI basket is shelter (primarily rent and owner’s equivalent rent), thus according to Smyth this transition “acts as a substantial brake on overall US inflation.”



Source: Bureau of Labor Statistics/Haver Analytics

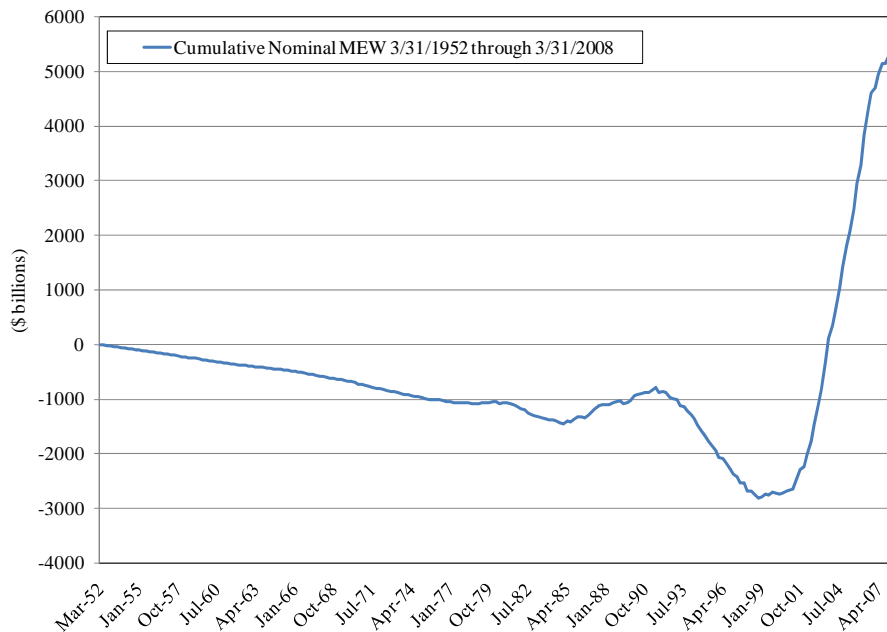


Weak economic growth will also have a mitigating effect on the demand side of the economy, particularly from the consumer. In this particular business/economic cycle, it is once again housing that will play a large role in this turn. This isn't a unique observation, but we constantly gain new insight from the data. Consider the graph below, which illustrates the two components of the broadest definition of mortgage equity extraction—mortgage borrowings and residential fixed investment. Very simply, all other things being equal mortgage borrowing represents an extraction of equity, and residential fixed investment represents an equity investment in housing. The time series illustrates that for much of the second half of the twentieth century, investment in the housing stock was matched by the equity extraction through mortgage technology. In other words, dollars into housing roughly matched dollars out. That all began to change in 2001. Indeed, even though the housing mania led to massive amounts of new homebuilding and improvements in existing units, this activity was far outpaced by mortgage credit creation.



Source: Federal Reserve/Haver Analytics

The graph below puts the scale of this equity investment/extraction in eye-popping cumulative historical perspective.



Source: Federal Reserve/Haver Analytics



From 1952 to 2001, homeowners invested a net cumulative \$2.6 trillion into their homes. Between 2001 and 2007, American homeowners changed course and extracted a phenomenal \$8 trillion in equity. These are nominal numbers, and they do not account for rising housing values. For example, in 2001, at the beginning of the Great Equity Extraction, American homeowners had \$6.7 trillion in equity in their homes, which were valued at \$11.6 trillion—a loan to value of 42%. By the end of 2007, American homeowners had \$9.5 trillion in equity in their homes, which were now valued at \$19.7 trillion—a loan to value of 51%. In what was probably the greatest period of national home price appreciation in American history, it is ironic that our collective household equity actually shrank. Anyway, the bigger question in the aftermath of the housing debacle is what can replace that \$8 trillion in extracted equity that Americans have been using to maintain their lifestyles? We can't think of an adequate answer. In the first quarter of 2008, for the first time since 2000, fixed residential expenditures exceeded mortgage borrowing.

The Federal Reserve is in a pickle. It is using its megaphone to battle inflation because it would rather not use its rate-setting tool while the prospects for the economy are so weak. The financial markets are still anxiety-ridden, too. An innocuous piece of sell-side research by analysts at Lehman caused a significant run on financial stocks (more on that below) and prompted Fed Chairman Bernanke to declare that the Fed is considering extending the duration of primary dealer liquidity facilities into 2009. Despite the strong evidence supporting a continuation of current monetary policy, it runs the risk of losing its credibility as an inflation-fighter, however, if it doesn't follow up its tough talk with some action. The European Central Bank, which tacked on another 25 bp to its benchmark rate on July 3, is adding pressure; the euro has appreciated 85% against the dollar since 2001. Yes, the Federal Reserve is in a pickle.

The Mortgage Market

May prepayment speeds (June release) on the aggregate 30-year Fannie Mae universe decreased 21%, substantially below most dealer expectations, from a CPR of 13 to a CPR of 10.3. Despite the fact that newer mortgage originations have been experiencing the most dramatic pickup in speeds as loans with fresher documentation are easier to refinance in this increasingly credit constrained environment, this was not the case for May. Speeds on newer mortgages decreased in May as the majority were potentially refinanced in January and February of this year. Instead, there was a pickup in prepayments for more seasoned loans which may be attributed, according to Bank of America, to seasonality. Going forward most prepayment analysts expect stronger summer seasonality to be overcome by the continuing deterioration in the housing and credit markets and we can expect flat to decreasing month over month speeds.

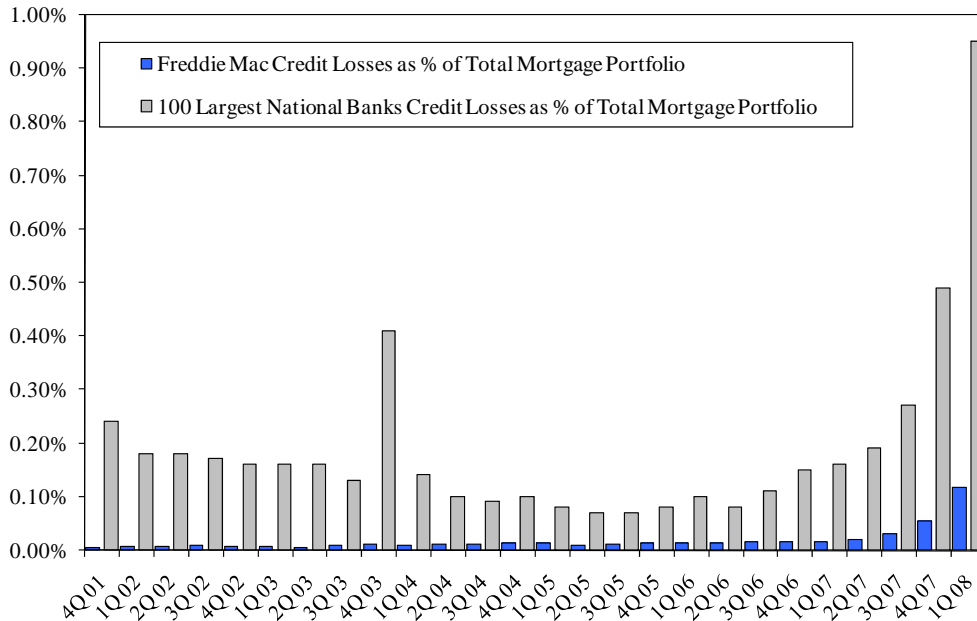
Despite the fact that this commentary is designed to cover the events of June 2008, we would be remiss if we did not address the one-day crisis of confidence that occurred on July 7, causing Fannie Mae and Freddie Mac share prices to suffer intra-day declines of 25% and 32%, respectively, and spreads of Agency MBS to Treasuries to widen by approximately 7 basis points. The spark to this firestorm was a report by Lehman analyst Bruce Harting, who was speculating on the hypothetical effect on Fannie Mae and Freddie Mac if a new accounting proposal were enacted. Very generally, the proposed change to accounting rule FAS 140 would require certain off-balance sheet securitization structures, such as mortgage-backed securities for institutions like Fannie Mae and Freddie Mac, to be consolidated on-balance sheet. According to Harting, the effect of this change, if taken at face value, would leave Fannie Mae and Freddie Mac undercapitalized even though it would not change in any way its current economic situation. Harting went on to observe that it was both unlikely and unnecessary for this change to take effect. Thus, while the market fixated on the hypothetical capital needed by Fannie and Freddie in the unlikely event that the proposed change to FAS 140 were enacted and enforced, the second half of Harting's report, in which he opined on why this could never happen, was virtually ignored. This section of it bears repeating:

“While GSE foes may have argued as recently as a year ago that the GSEs are not essential to maintaining liquidity in the mortgage market, we suspect there are few that would contend that today. The GSEs have proven themselves to be the buyer of last resort, providing a bid for mortgages when a broad-based buyers' strike threatened to paralyze the markets. It's easier to lose sight of the significance of this bid when the demand from other buyers for mortgages is so strong, but the GSEs are the only buyer with the mission of providing liquidity to the mortgage market, so they are the only buyer that is there precisely when the market most needs it. Even at times when the market is functioning normally, it's the GSE guaranty that is essential to the liquidity of MBS by bringing in a much larger pool of money to invest in MBS than we could expect to see if investors had to worry about the credit risk in addition to the prepayment and interest rate risk. The greater liquidity translates into lower funding costs, which are passed on to consumers in the form of lower mortgage rates. In addition to being essential to maintaining liquidity in the mortgage market, the GSEs play an equally important role setting a standard for responsible underwriting that is essential to a healthy mortgage market. Over the last few years, as the private label securitization market share overtook the GSEs, lending standards began to diverge from the GSEs' historical discipline (i.e. lower documentation requirements and more layered risk), leading to the meltdown in credit performance that is occurring in non-conforming loans. To preserve a sustainable mortgage market, it still seems essential to us that the GSEs continue to play a central role imposing discipline over lending



standards. Finally, it's important to point out that the GSEs guaranty a combined \$4 trillion of MBS (a very large segment of the credit markets), so we believe any threat of GSE failure could trigger a meltdown in credit markets that would make the movements in credit markets that we've seen over the last year look like a modest hiccup. Needless to say, the impact of a dislocation of that order could cause serious harm to the global economy."

The next day, July 8, James Lockhart, director of OFHEO, the GSEs' regulator, made a statement that reiterated OFHEO's determination that Fannie Mae and Freddie Mac were adequately capitalized. Moreover, he said, "An accounting principle should not drive a capital decision by a regulator." Cooler heads prevailed in the market, and Fannie Mae and Freddie Mac shares rallied and Agency MBS outperformed Treasuries. To illustrate Harting's point on the GSEs' underwriting discipline, the graph below compares Freddie Mac's credit losses over the past several years to that of the nation's commercial banks.



Source: Freddie Mac, Federal Reserve

The Markets

In June, oil and gold continued their strong performance. The Fed stayed on hold but the ECB did not. Mortgage rates continued to stay elevated relative to Treasuries and the Refi Index went lower. Stocks were down. Hedge funds posted their worst first-half performance since 1990.

	6/30/2008	5/31/2008	6/30/2007	MOM % change	YOY % change
Fed Funds	2.00%	2.00%	5.25%	0.0%	-61.9%
2-year US Treasury	2.620%	2.645%	4.862%	-0.9%	-46.1%
10-year US Treasury	3.971%	4.061%	5.026%	-2.2%	-21.0%
10-year JGB	1.601%	1.759%	1.879%	-9.0%	-14.8%
10-year euro	4.621%	4.405%	4.574%	4.9%	1.0%
10-year UK Gilt	5.130%	4.986%	5.463%	2.9%	-6.1%
10-year Canada Treasury	3.734%	3.711%	4.555%	0.6%	-18.0%
30 yr conventional mortgage	6.157%	6.017%	6.607%	2.3%	-6.8%
Dollar Index	72.46	72.88	81.92	-0.6%	-11.5%
Japanese Yen	106.19	105.52	123.26	0.6%	-13.8%
S&P 500	1280.00	1400.38	1503.35	-8.6%	-14.9%
Nasdaq Composite	2292.98	2522.66	2603.23	-9.1%	-11.9%
Gold \$/oz (nearby contract)	\$928.30	\$887.30	\$650.90	4.6%	42.6%
Oil \$/bbl (nearby contract)	\$140.00	\$127.35	\$70.68	9.9%	98.1%
MBA Refi Index (month end)	1269.2	1496.1	1687.2	-15.2%	-24.8%

Source: Bloomberg; Japanese Yen quote is the London feed



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