



- **The Economy:** *Not quite the fireworks of March, but July was a stealthily devastating month*
- **The Mortgage Market:** *Technicals for mortgage-backed securities are improving*
- **The Markets:** *Stop the presses—rates are down and the dollar is up!*

The Economy

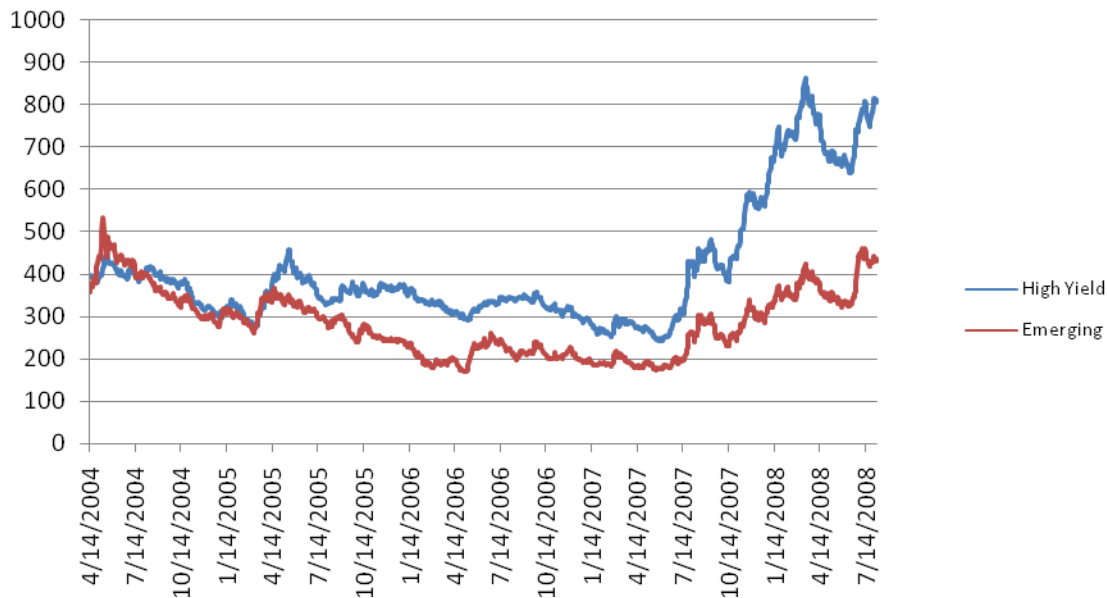
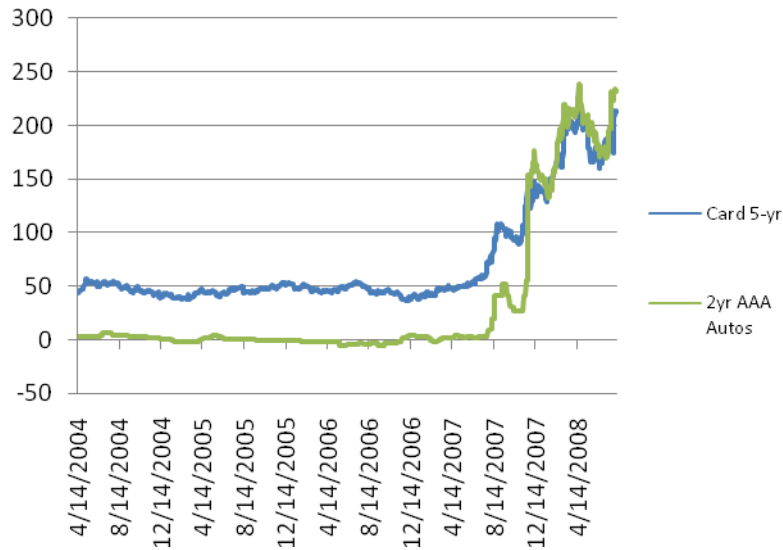
When the books are written about the great housing and sub-prime collapse, August 2007 and March 2008, of course, will get their own chapters. But July 2008 may have been the most stealthily devastating month of the whole saga thus far.

From a policy perspective, we watched with astonishment as the normally slow moving Congressional bureaucracy leaped into action to restore market faith in the ability of Fannie Mae and Freddie Mac to fulfill their charters at a time when it is most needed. The culmination of the month's policy events was the July 30th signing into law of The Housing and Economic Recovery Act of 2008. The sweeping new legislation is designed to bolster the economically vital housing market from both ends of the mortgage finance cycle—the borrower and the lender. (We wrote contemporaneous commentaries on these developments: see our July 14 note on policy announcements regarding Fannie Mae and Freddie Mac http://www.annaly.com/Note_July_2008.pdf, and our August 5 note on the Housing and Economic Recovery Act of 2008, <http://www.annaly.com/NHERA2008.pdf>.) As challenging as it may be to predict exactly how the Act will help the current situation, suffice it to say it will likely fall short of its economic and housing recovery goals. But the Act did validate the market's conviction in the federal government's implied financial backing of Fannie Mae and Freddie Mac. It is hard to overstate how critical this was towards edging closer to a solution. As Mike Farrell, CEO of Annaly said in his second quarter earnings call remarks (<http://www.annaly.com/mikeopenQ208.pdf>), "With the ongoing stress in the real estate sector claiming more and more banking entities, the GSEs, along with the FDIC, are positioned to be the new Resolution Trust Corporations."

From an economic perspective, the statistics released during the month did little to dissuade the belief that the US economy is likely in a recession. The jobs picture continues to be weak as evidenced by the rising unemployment rate and initial and continuing jobless claims, and falling non-farm payrolls (on August 1, the Labor Department announced the 7th consecutive month of job losses). Car and truck sales slid to the slowest pace since 1993, which was the time of the last consumer-led recession in the US. Housing and home prices show no signs of bottoming. In a sign of just how little confidence homebuilders have in the future of their markets, Larry Sorsby, CFO of Hovnanian Enterprises, said the company is essentially out of the spec building business and won't start building a new home until they have a contract to sell it. "We don't build them and hope they come," he said.

On July 31, the Bureau of Economic Analysis released its advance estimate of second quarter GDP. The real gross domestic product in the US grew 1.9%, which owed much of its strength to the one-shot effects of the fiscal stimulus checks (consumer spending grew at an annual rate of 1.5% in the quarter, mostly in non-durable goods purchases), exports (thanks to the weak dollar), government spending and a much lower-than-expected deflator. Imports fell sharply, inventories dropped, residential investment expenditures fell for the 10th straight quarter and capital spending fell for the second straight quarter. Also included in the release were revisions to prior quarters, including a downgrading of the fourth quarter of 2007 from +0.6% to -0.2%. Economist Asha Bangalore of Northern Trust summed it up succinctly: "The details of the GDP report point to significant weakness in the economy. Against this backdrop and financial market fragility, the Fed would only exacerbate the economic situation by raising the federal funds rate in haste."

From a market perspective, the most significant event was the announcement on July 29 that Merrill Lynch sold off CDOs at a fifth of their face value of over \$30 billion, and raised \$8.5 billion in new capital. The sale of assets, while painful to Merrill, does manage to eliminate some of the uncertainty related to future losses. In the long run, this will be healthy for the company, which is an important participant in the financial markets. As the first large-scale transaction of this type, however, the asset sales raise many questions about the exposures at other firms (would other firms follow?) and about the true mark-to-market value of financial assets in general. The accumulation of news in July, culminating in the price discovery on Merrill's CDO assets, put tremendous pressure on all but the most plain vanilla parts of the Treasury and Agency securities markets. We spend a lot of time focusing on the mortgage market (non-Agency mortgage-backed securities and Agency CMOs were hit hard in July), but the graphs below demonstrate that credit spreads are widening across the credit spectrum, including credit card and auto loan asset-backed and high-yield and emerging market debt.



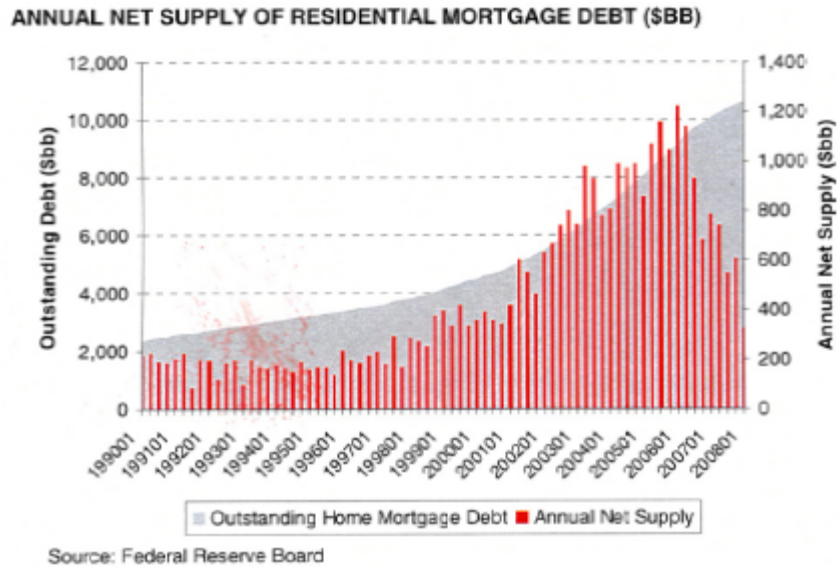
The Mortgage Market

Prepayment speeds in June (July release) declined 15% with aggregate prepayments on 30-year FNMA collateral falling to 8.9 CPR from 10.3 CPR. The slowdown in June came on the heels of the dramatic 21% decrease in May during what should be the peak in seasonal housing turnover. Prepayment speeds should only continue to grind slower for the foreseeable future as the housing market potentially softens even further. Richard Syron, CEO of Freddie Mac, estimates that the housing market is “far from stabilizing”: If the MBA Refinance Index is any harbinger for the housing market he may be correct, for the index hit a low not seen since 2000 on August 1. It is not just the weak housing market that is causing refinancing activity to dry up. According to JP Morgan, mortgage borrowing rates are so high that over 90% of the Agency borrower universe has “moved outside of the refinancing window.”

With the combination of slower speeds and lower origination volumes, coupled with the numerous benefits afforded Agency MBS from the Housing and Economic Recovery Act of 2008, mortgage-backed securities should have strong technical support in the marketplace. There has been a virtual standstill in new origination amid continuing demand from GSEs, banks, foreign and domestic money managers and convexity/servicer hedgers. According to Bank of America, despite the market’s preoccupation with bank write-downs and capital needs, domestic bank holdings of MBS rose by a \$91 billion year to date as of June 11, 2008.



To put these numbers in perspective, banks absorbed one third of the net new supply in MBS market since the beginning of 2008 (net issuance is defined as originations plus pay downs). In the graph below, courtesy of Bank of America, note the dropoff in 2008 net issuances:



Within the Agency space, the fact that origination of hybrid ARMs is slowing is somewhat counter-intuitive. The current steep yield curve is attractive to potential ARM borrowers from both a purchase and refinancing perspective—on August 6 the no-point 30-year mortgage rate stood at 6.57% versus 6.07% for a 5/1 hybrid ARM. Bank of America estimates that net issuance in ARMs will shrink to only \$4 billion in 2008, or roughly 10% of total originations, versus 35% of originations in 2004 and 2005, 25% in 2006 and 15% in 2007. Why the decline? Hybrids are typically seen as affordability products, which may not be as critical with home prices down, and borrowers and lenders may prefer the certainty of a 30-year fixed rate.

The Markets

In July, confounding received wisdom, global government interest rates fell despite inflation fears. Oil and gold slipped and the dollar strengthened. Refinancing activity continues to fall as mortgage rates stay stubbornly high and housing values keep falling.

	7/31/2008	6/30/2008	7/31/2007	MOM % change	YOY % change
Fed Funds	2.00%	2.00%	5.25%	0.0%	-61.9%
2-year US Treasury	2.512%	2.620%	4.522%	-4.1%	-44.4%
10-year US Treasury	3.948%	3.971%	4.741%	-0.6%	-16.7%
10-year JGB	1.539%	1.601%	1.800%	-3.9%	-14.5%
10-year euro	4.355%	4.621%	4.347%	-5.8%	0.2%
10-year UK Gilt	4.806%	5.130%	5.209%	-6.3%	-7.7%
10-year Canada Treasury	3.701%	3.734%	4.534%	-0.9%	-18.4%
30 yr conventional mortgage	6.280%	6.157%	6.598%	2.0%	-4.8%
Dollar Index	73.23	72.46	80.77	1.1%	-9.3%
Japanese Yen	107.98	106.19	119.22	1.7%	-9.4%
S&P 500	1267.38	1280.00	1455.27	-1.0%	-12.9%
Nasdaq Composite	2325.55	2292.98	2545.57	1.4%	-8.6%
Gold \$/oz (nearby contract)	\$913.90	\$928.30	\$666.90	-1.6%	37.0%
Oil \$/bbl (nearby contract)	\$124.08	\$140.00	\$78.21	-11.4%	58.6%
MBA Refi Index (month end)	1074.4	1269.2	1724.2	-15.3%	-37.7%

Source: Bloomberg; Japanese Yen quote is the London feed



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