



- The Economy:** *Central Banks try to alleviate liquidity crisis*
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- The Markets:** *Stocks gyrate, rates fall, oil stays elevated*

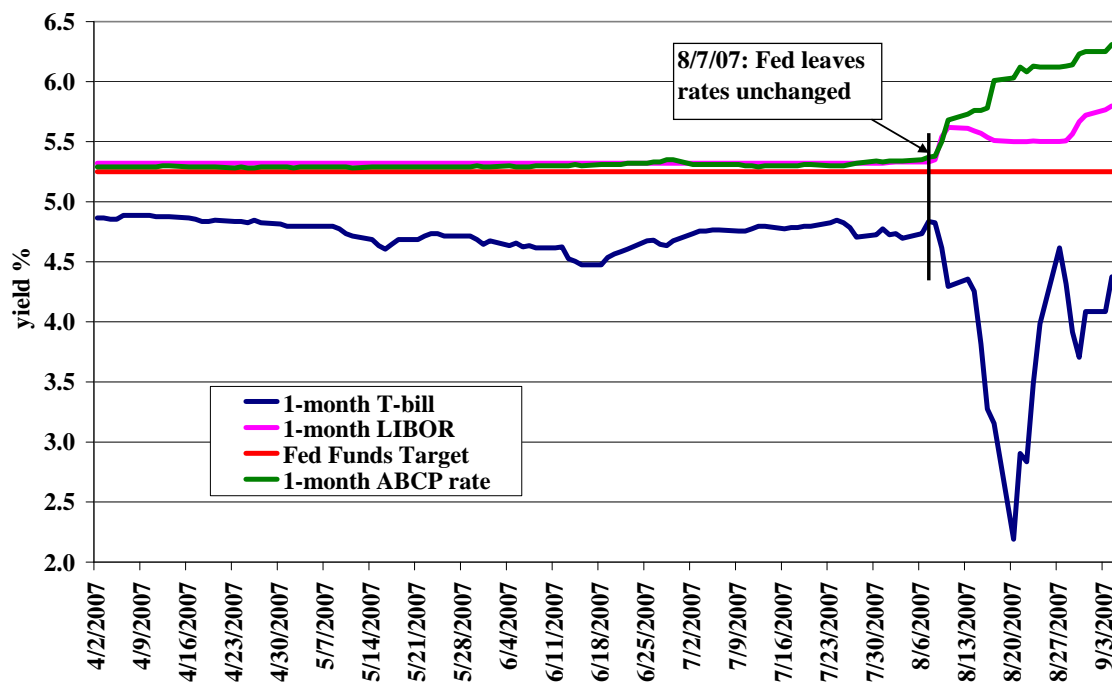
The Economy

There was a shift in sentiment in August.

Even though there is absolutely no risk of overstating the events of August and their ramifications for investors, we figure understatement was the better way to start our commentary. To us, the shift in sentiment was historic: short-term rates the world over went haywire, liquidity seized up in all but the risk-free corner of the credit markets (Treasuries and Agencies), money market funds refused redemptions, more mortgage finance companies blew up and major central banks made dramatic moves to try and address the situation. Like many in the markets, we'd never seen anything like it before.

We believe that the trauma of the month, foreshadowed by the volatility of July, began when the Fed decided on August 7 to hold rates steady. Brief anecdote: The son of one of our employees was in the office for the FOMC meeting on August 7, hoping to see the first Fed ease in over four years. (He is a unique child, destined to be a bond market geek.) When the Fed announced that it was not going to change monetary policy or its inflation-fighting bias, the disappointed boy said, "That's it? Nothing happened!" Wiser, older heads told him that in the right market conditions, doing nothing is doing something very significant. For indeed, after the Fed held pat on August 7, strange things started to happen in the financial markets. As the graph below illustrates, short-term interest rates, which had stayed highly correlated in a tight band for many months, diverged significantly. Investors abandoned the asset-backed commercial paper market due to uncertainty over the collateral and flew into the safety of T-bills. LIBOR rates soared as European banks struggled for liquidity. On September 5, 1-month LIBOR, which typically tracks Fed Funds, was at 5.81%, a spread of 56 basis points.

Interest rates part company



source: Bloomberg



Otherwise safe and sound institutions, some of them already rocked by difficulties in establishing asset values, got caught up in the situation. We can't list all the month's headlines, but there are several that stand out in our markets:

- On August 14, Thornburg Mortgage, Inc., a leading single-family prime residential mortgage lender focused principally on the jumbo segment of the adjustable-rate mortgage market, announced that it was delaying its dividend "in response to significant disruptions in the mortgage market which resulted in the sudden and unprecedented decline in the market prices" of its AAA-rated non-Agency mortgage securities and subsequent inability to finance in the repurchase market, the commercial paper market and the asset-backed securities market. Thornburg later disclosed that it had been forced to sell approximately \$20.5 billion in primarily AAA-rated non-Agency MBS.
- Also on August 14, Sentinel Management Group Inc., the Illinois-based cash-management firm, refused client withdrawals because, as it said in a letter, "We are concerned that we cannot meet any significant redemption requests without selling securities at deep discounts to their fair value and therefore causing unnecessary losses to our clients."
- A pair of German banks, SachsenLB and IKB Deutsche Industriebank, needed to be rescued due to imploding asset values.
- Countrywide Financial, the nation's largest mortgage originator, announced on August 16 that "secondary market demand for non-agency mortgage-backed securities has been disrupted in recent weeks. Along with reduced liquidity in the secondary market, funding liquidity for the mortgage industry has also become constrained." As a result, the company was forced to supplement its liquidity position by drawing down an \$11.5 billion credit facility and later selling a piece of itself to Bank of America at what can only be described as terms favorable to B of A.
- Carlyle Capital, a very highly-leveraged closed-end investment fund listed on the EuroNext, announced that it needed multiple capital injections from its sponsor, The Carlyle Group. Carlyle Capital invests in Agency MBS and, to a lesser extent, non-Agency MBS.
- Equity markets and credit risk markets were hit hard, and quantitative-based funds, notably two Goldman Sachs hedge funds, suffered significant losses through this volatility. The flabbergasted CFO of Goldman explained that the funds' performance was due to market moves of the type their models said would occur only once every 10,000 years or so but that, in fact, had happened several days in a row. Obviously, the model didn't work.

The market turmoil has been getting the attention of the world's central banks, with the European Central Bank, the Fed, the Bank of Japan and the Bank of Canada all adding liquidity through open market operations. Since August 9, they have collectively pumped more than \$400 billion into money markets. On August 10 the Fed put \$38 billion into the market, the single largest open market operation ever conducted by the Fed, including 9/11. More explicit was the Fed's move on August 17 to lower the discount rate by 50 basis points to 5.75%. In the accompanying statement, the Fed acknowledged that the market had indeed worsened since just 10 days before. "Financial market conditions have deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth going forward. In these circumstances, although recent data suggest that the economy has continued to expand at a moderate pace, the Federal Open Market Committee judges that the downside risks to growth have increased appreciably. The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets." Using the discount "window", the mechanism through which banks and others can borrow directly from the Fed, was intended to result in liquidity flowing into the market. However, this is still seen as a sign of weakness by financial institutions in the US, and the Fed had to provide encouragement in order for any firm to take advantage of the new, lower rate. While the four biggest US banks—JP Morgan Chase, Citigroup, Bank of America and Wachovia—borrowed \$500 million each, in our view these token moves had zero effect on the credit crunch.

One of the biggest concerns in the market today is the stress that is building in the banking and dealer systems. Most obviously is the concern over the mark-to-market effect of their own holdings of now-illiquid or underperforming securities. There is exposure to an estimated \$300 billion in buyout bridge loans and commitments that they either have to hold onto or sell at a loss. Perhaps most worrisome (as if that weren't worrisome enough) is the massive retrenchment in the commercial paper market. Recall that commercial paper (CP) is a short-term borrowing—maturing anywhere from overnight to up to a year—that is executed by corporations or that is backed by cash flows from asset-backed securities. Asset-backed commercial paper (ABCP) is the fastest growing segment of the commercial paper market, growing 85% from September 2004 through July 2007, compared with 47% and 38% for directly placed financial and non-financial CP respectively. The ABS behind the ABCP can be any type, residential or commercial real estate mortgage-backed securities or other forms of asset-backed paper. As of August 29, there was \$988 billion in total ABCP outstanding, comprising 50% of all commercial paper outstanding. Typically, the highest-rated CP is purchased by money market funds, short-duration bond funds and corporate treasurers, and rolled from maturity to maturity without any problem. In today's market, however, it has become a big problem to roll CP, particularly ABCP, as investors have become concerned about the credit quality of the underlying collateral, particularly those with sub-prime mortgage exposure. Since August 8, total CP outstanding has fallen \$298.2 billion, with ABCP accounting for \$216.2 billion of that total. At the same time, the one-month rate for top-rated ABCP has skyrocketed from 5.34% to 6.25%. The result of this is that worried ABCP investors have sought quality in the haven of T-bills (pushing down yields) and ABCP issuers have had to tap bank credit lines or



find other sources of financing. As a result of the banks taking on this paper, particularly in Europe, LIBOR rates have shot up due to inadequate liquidity as well as credit concerns. As Ted Wieseman, economist at Morgan Stanley told the FT, “Banks are unwilling to place longer term funds in the interbank market that would tie up balance sheet room that might be needed for customer obligations.” The result of this is that the best efforts (thus far) of the Fed and the ECB to inject liquidity into the system have been no better than the proverbial string-pushing.

In this environment, while several Fed officials have been talking very tough on monetary policy—St. Louis Fed President Poole infamously said that it would take a “calamity” for the Fed to change policy, just a day before it cut the discount rate—we believe that Chairman Bernanke’s speech at the Fed’s annual retreat to Jackson Hole, Wyoming, on August 31 brings us up to date on the current thinking of the Fed. Of particular interest to us was his comment that he, too, is concerned about recent market disruptions and is paying close attention to incoming data for guidance. He said: “[I]n light of recent financial developments, economic data bearing on past months or quarters may be less useful than usual for our forecasts of economic activity and inflation. Consequently, we will pay particularly close attention to the timeliest indicators, as well as information gleaned from our business and banking contacts around the country. Inevitably, the uncertainty surrounding the outlook will be greater than normal, presenting a challenge to policymakers to manage the risks to their growth and price stability objectives.”

Chairman Bernanke may have been alluding to the fact that the second quarter GDP revision came in at 4.0%, a number that he is now discounting. Indeed, according to the minutes of the August 7 FOMC meeting, the Fed has revised downward its GDP forecast for real GDP growth in the second half of 2007 and 2008. If he is paying attention to “the timeliest indicators”, we believe he is likely looking at jobless claims (which are trending upwards), retail and vehicle sales (weak), the ISM manufacturing survey (declining strength), the pending home sales index (plunged 12.2%), and non-farm payrolls (big drop in August). We are confident that the Fed will continue to be vigilant on this matter, for as Bernanke said elsewhere in his speech, “Well-functioning financial markets are essential for a prosperous economy.” The European Central Bank and the Bank of England have also pledged to keep a close eye on the European markets, particularly LIBOR.

In closing this section of our commentary, let us repeat what we said last month, that the market is telling the Fed something with the Fed Funds rate at the highest point on the yield curve. Now let us add that with 1-month LIBOR pushing 6%, the commercial paper market all but shut down to asset-backed issuers and T-bills going below 2%, the market is telling the central banks of the world something: Bring down the front end and steepen the yield curve. At the very least, that will help the banking system.

The Mortgage Market

Prepayment speeds decreased by 10% in July (August release) despite the fact that historically the summer months are the fastest paying months of the year. Overall payments on 30-year FNMA collateral came in at 9.7 CPR, down 1.2 CPR from June. However, even these speeds were elevated as some thirty year Fannie Mae 7% collateral experienced extremely fast prepayments due to a new program in which Fannie Mae will repurchase loans from the pool if the borrower is more than four months delinquent. Fannie Mae estimates that this program will be complete by September and speeds should return to normal. Prepayment speeds for Agency hybrid ARMs continued to pay flat to slower than expected. Looking ahead, we expect August speeds will be flat to slightly faster due to a two day bump in business days offset by a 20 basis point rise in mortgage rates.

Last month we touched on the subject of spread widening and its effect on mortgaged-backed securities. To quickly review, spreads on MBS typically widen in a bond market rally as investors demand more spread over Treasuries because of increased prepayment risk. However, depending on how much spreads widen prepayments may not increase as much as expected. In a bond market rally, such as we have experienced in August with the yield on the two year Treasury falling from 4.6 to 4.07 and the ten year Treasury falling from 4.79 to 4.51, an MBS should generally appreciate due to its positive duration. However, just as prepayments speeds can come in slower than anticipated in a bond market rally due to spread widening, prices on MBS can also appreciate less than anticipated in a bond market rally due to spread widening and their negative convexity. As an illustration, the table below sets forth representative prices moves for different Agency MBS of different coupons and the similar duration point on the Treasury yield curve on August 28:

<u>CPN</u>	<u>PX</u>	<u>Change</u>	<u>TSY-Curve</u>
4.5	93-02	+0-08	+0-23
5.0	95-20	+0-10	+0-23
5.5	98-09	+0-09	+0-23
6.0	100-14	+0-05	+0-11
6.5	102-01	+0-03	+0-11



Despite the substantial rally we experienced in Treasuries on the 28th, similar duration MBS failed to appreciate as much in the rally and underperformed Treasuries on the day. This is due not only to spread widening and the negative convexity profile of MBS, but also due to the flight to quality bid currently present in the market. Currently buyers are purchasing Treasuries and refraining from purchasing any asset that has a perceived greater risk as the long awaited “credit crunch” unfolds. This behavior is clearly visible in the price appreciation of the 5.5% relative to the price appreciation of a similar duration Treasury in the above table. Despite having a similar duration, 5.5’s underperformed Treasuries on the day by 14/32nds. Even within Agency MBS, some specific securities types have felt more pressure on values than others due to disruptions in liquidity.

The Markets

In August, government bonds around the world rallied. Stocks swung wildly during the month but finished in positive territory. Oil stayed over \$70.

	8/31/2007	7/31/2007	8/31/2006	MOM % change	YOY % change
Fed Funds	5.25%	5.25%	5.25%	0.0%	0.0%
2-year US Treasury	4.136%	4.522%	4.780%	-8.5%	-13.5%
10-year US Treasury	4.531%	4.741%	4.728%	-4.4%	-4.2%
10-year JGB	1.613%	1.800%	1.630%	-10.4%	-1.0%
10-year euro	4.242%	4.347%	3.760%	-2.4%	12.8%
10-year UK Gilt	5.036%	5.209%	4.516%	-3.3%	11.5%
10-year Canada Treasury	4.425%	4.534%	4.109%	-2.4%	7.7%
30 yr conventional mortgage	6.38%	6.60%	6.32%	-3.4%	0.9%
Dollar Index	80.79	80.77	85.05	0.0%	-5.0%
Japanese Yen	115.92	119.22	117.37	-2.8%	-1.2%
S&P 500	1473.99	1455.27	1303.82	1.3%	13.1%
Nasdaq Composite	2596.36	2546.27	2183.75	2.0%	18.9%
Gold \$/oz (nearby contract)	\$675.80	\$666.90	\$628.20	1.3%	7.6%
Oil \$/bbl (nearby contract)	\$74.04	\$78.21	\$70.26	-5.3%	5.4%
MBA Refi Index (month end)	1770.2	1724.1	1609.2	2.7%	10.0%

Source: Bloomberg; Japanese Yen quote is the London feed

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