



- **The Economy:** *The Fed eases for the first time in four years*
- **The Mortgage Market:** *Mortgage prepayments continue to slow*
- **The Markets:** *The dollar weakens, helping oil, gold*

The Economy

We don't break news in our monthly commentaries. So we are not telling readers anything they don't already know when we report that during the month of September the Federal Reserve decided to slash the Federal Funds target rate (as well as the discount rate) by 50 basis points, its first such cut in four years. Although the magnitude of the reduction was perhaps a surprise to some, the move itself was widely anticipated. According to the FOMC statement, the decision to cut was made because "tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally." By using its most visible and powerful tool, the Fed signaled that it no longer believed that the housing and mortgage problems are contained. "Today's action," the Fed continued, "is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time." It is clear from this, as well as the combined 100 basis point cut in the discount rate since August 17, that the Fed is worried.

Is their worry justified? Not all market observers think so. The editorial page of the *Wall Street Journal* thought that the decision was a risk to the Fed's credibility. "It is easy for a central bank to cut rates and ease money...[t]he harder task is being willing to tighten money amid the business and political criticism that inevitably follows." The *Financial Times* thought that Ben Bernanke showed his hand too early. "It...risks fuelling the belief that there is a 'Bernanke put'—and the Fed will always ride in to save the markets." After all, reasoned the *FT*, the economic data we have seen is weak but not disastrous.

Despite these and other criticisms, we think the Fed is right to be worried. Although the timing may be uncertain, the themes for the next several quarters in the market will be how the economy responds to the fallout from a deflating housing market, a punctured mortgage debt bubble and a stressed consumer. Timing, of course, is difficult to predict, but we believe these themes are still in their early stages of development. Clearly the housing market has a way to go before it hits bottom and shows any signs of life. The latest data points on new and existing home sales, housing starts and building permits, were all weak or less than expected. New home sales declined 8.3% to an annual pace of 795,000, the lowest level in more than seven years. The consensus estimates was for sales to come in at an 825,000 pace. The months of supply of new homes rose to 8.2 months. Existing home sales fell to a five-year low of 5.5 million on an annualized basis. The months of supply rose to a record 10 months. Housing starts fell to 1.331 million homes, the slowest in 12 years, and building permits, which is a harbinger of future construction activity, declined to 1.307 million annual pace, the slowest in five years. The home builders continue to report worsening earnings, writedowns and fire sale auctions. With so much supply on the market, one has to wonder why there is any building activity at all.

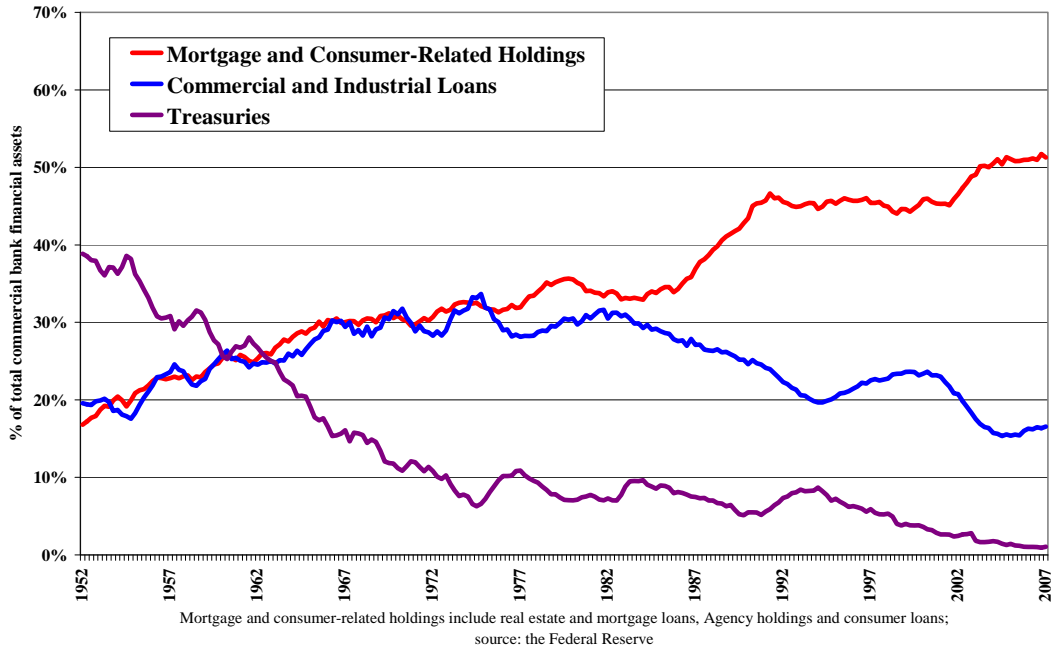
The slowdown in housing activity thus far has not helped bring supply and demand into balance. In order to do that, prices have to decline, the price to finance has to decline, and credit must be available. Thus far, these things have not happened. In fact, credit for anything that is not conforming or prime (in other words, eligible for purchase by Fannie Mae and Freddie Mac) has gotten harder to find and relatively more expensive. The difficulty for the non-Agency segment of the mortgage-backed securities market was the tip of the iceberg in the liquidity crunch of August, but we have to believe that the issue is still a concern for anyone holding the paper. Most notably, several financial institutions reported that their third quarter results would reflect the recent troubles. Merrill Lynch announced that it would report a loss for the third quarter as a result of over \$5 billion in writedowns; Washington Mutual reported that its third quarter earnings would be reduced by \$1.4 billion in writedowns and increased reserves; Lehman Brothers wrote down \$700 million on LBO financing and mortgages; UBS predicted its loss in the third quarter would reflect \$3.4 billion in writedowns of MBS holdings; Citigroup and Bear also reported significant writedowns. All told, at least nine major banks have now reported approximately \$21.8 billion in writedowns. This number will likely grow as writedowns and increases to loan loss provisions continue.

With this in mind, the graph below should be a timely illustration of a macro risk to the banking system. It depicts the changing face of bank balance sheets in the US since 1952, breaking down financial assets into three basic categories: Treasuries, commercial and industrial loans and mortgage and consumer-related holdings (including mortgages, consumer credit and Agency securities). In the 1950s, Treasuries dominated bank balance sheets but gradually fell until now they total approximately 1%. Commercial and industrial loans, the lifeblood of business growth, grew in share through the 1970s, but with the growth of the



securitization industry they have been overtaken on bank balance sheets. Yes, it's a picture of the evolution of the US economy, but it does raise some questions about vulnerability to a widespread downturn in the value of the collateral backing much of these assets, not to mention the worsening credit performance of significant portions of the borrowers. Perhaps most critical is the leverage on deposits in the US banking system. The deposit-to-asset ratio is a measure of balance sheet leverage, as deposits are a liability of a bank. The ratio has fallen from approximately 85% in 1973 (85 cents in deposits for every dollar of assets) to 62% at last count. The depositors of Northern Rock can sympathize.

Banks rely more on real estate and consumers



So what will the Fed do from here? It has kept its options open and remains dependent on incoming data to confirm the trends that were so worrisome to them in August and September. The FOMC statement concluded, "Developments in financial markets since the Committee's last regular meeting have increased the uncertainty surrounding the economic outlook. The Committee will continue to assess the effects of these and other developments on economic prospects and will act as needed to foster price stability and sustainable economic growth." By cutting 50 basis points rather than 25, we think that the Bernanke & Co. probably bought themselves a little more time to evaluate the data before deciding their next move. We'll continue to monitor the data along with them.

The Mortgage Market

Prepayment speeds continued to grind slower in August (September release) on 30-year fixed-rate mortgage-backed securities, coming in 5% to 9% slower than the prior month, across all vintages, versus dealer expectations of a flat to 5% increase. To drill down a little bit, a large portion of the slowdown can be attributed to FNMA 7% speeds, because of a two-month old Fannie Mae program to purchase (and therefore pay off) loans that were over 120 days delinquent. As a result, two months ago we saw a substantial increase in speeds in Fannie 7s, but last month these speeds slowed back down to July levels. It may be safe to assume that Fannie removed most, if not all, of those delinquent loans. Additionally, speeds slowed in Agency hybrid adjustable-rate mortgage-backed securities, for the third month in a row. Longer resets, specifically 10/1 hybrids, experienced the greatest declines. Looking ahead, we can expect both fixed-rate and adjustable-rate speeds to decline substantially yet again next month. In addition to the fact that we are in a generally slow period for speeds, September is historically one of the slowest paying months of the year due to the onset of the school season and a fewer number of business days.

In mortgage-related news the Office of Federal Housing Enterprise Oversight, the regulator of Fannie Mae and Freddie Mac, announced on September 19th that it will change how it calculates portfolio caps for the Agencies. Some highlights of the changes are that both Fannie Mae and Freddie Mac will have equal portfolio caps of \$735bn, currently \$727bn for FNMA and \$728 for FRE, both agencies will be allowed 2% annualized growth with no more than 0.5% realized per quarter (with Q4 '07 the exception with 1% growth allowed), and that OFHEO will require frequent reporting on market conditions, as well as monthly



reporting on sub-prime and lower credit borrowers and multi-family housing mortgages. The table below, courtesy of UBS research, illustrates the potential buying power of the Agencies under aggressive growth assumptions:

	7/31/07	July	Q3 07			Q4 07: 1% cap		
	Portfolio Size (UPB)	Specified Amount	Portfolio Limit	9/30/2007	Room	Portfolio Limit	12/31/2007	Room
FNMA	729.840	729.840	735.000	746.274	16.434	742.350	751.417	21.577
FRE	720.629	725.000	735.000	747.781	27.152	742.350	750.661	30.032
Total	1,450.469	1,454.840	1,470.000	1,494.055	43.586	1,484.700	1,502.078	51.609

Given market conditions, it is no wonder OFHEO is requiring monthly reporting of new purchases with a keen eye on sub-prime. OFHEO is walking a fine line of wanting to be a tough regulator but also wanting a smoothly functioning mortgage market. While the \$51.6 billion that becomes available to Fannie and Freddie under the new calculations could be an important source of demand on the margin, the impact on mortgage spreads remains to be seen.

The Markets

In September, markets remained volatile, as the US yield curve steepened. The US dollar weakened after the Fed lowered the Fed Funds rate. Gold and oil (both denominated in US dollars) soared.

	9/30/2007	8/31/2007	9/30/2006	MOM % change	YOY % change
	Fed Funds	4.75%	5.25%	5.25%	-9.5%
2-year US Treasury	3.988%	4.136%	4.687%	-3.6%	-14.9%
10-year US Treasury	4.588%	4.531%	4.630%	1.3%	-0.9%
10-year JGB	1.685%	1.613%	1.675%	4.5%	0.6%
10-year euro	4.329%	4.242%	3.709%	2.1%	16.7%
10-year UK Gilt	5.011%	5.036%	4.523%	-0.5%	10.8%
10-year Canada Treasury	4.344%	4.425%	4.001%	-1.8%	8.6%
30 yr conventional mortgage	6.25%	6.38%	6.17%	-2.0%	1.3%
Dollar Index	77.72	80.79	86.03	-3.8%	-9.7%
Japanese Yen	114.80	115.92	118.01	-1.0%	-2.7%
S&P 500	1526.75	1473.99	1335.85	3.6%	14.3%
Nasdaq Composite	2701.50	2596.36	2258.43	4.0%	19.6%
Gold \$/oz (nearby contract)	\$742.80	\$675.80	\$598.60	9.9%	24.1%
Oil \$/bbl (nearby contract)	\$81.66	\$74.04	\$62.91	10.3%	29.8%
MBA Refi Index (month end)	1950.4	1770.2	1970.8	10.2%	-1.0%

Source: Bloomberg; Japanese Yen quote is the London feed

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