



- **The Economy:** *Don't fault Bernanke and Paulson for what they missed*
- **The Mortgage Market:** *Mortgage prepayment activity constrained*
- **The Markets:** *Classic flight to quality*

The Economy

That was then:

"I don't see [subprime mortgage market troubles] imposing a serious problem. I think it's going to be largely contained."—Henry Paulson, April 20, 2007.

"Importantly, we see no serious broader spillover to banks or thrift institutions from the problems in the subprime market; the troubled lenders, for the most part, have not been institutions with federally insured deposits....[W]e believe the effect of the troubles in the subprime sector on the broader housing market will likely be limited, and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."—Ben Bernanke, May 17, 2007.

This is now:

"These bad loans have created a chain reaction and last week our credit markets froze up—even some Main Street non-financial companies had trouble financing their normal business operations. If that situation were to persist, it would threaten all parts of our economy."—Henry Paulson, September 24, 2008.

"The downturn in the housing market has been a key factor underlying both the strained condition of financial markets and the slowdown of the broader economy. In the financial sphere, falling home prices and rising mortgage delinquencies have led to major losses at many financial institutions, losses only partially replaced by the raising of new capital....Despite the efforts of the Federal Reserve, the Treasury, and other agencies, global financial markets remain under extraordinary stress. Action by the Congress is urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy."—Ben Bernanke, September 24, 2008.

To call their earlier judgments on the mortgage and housing problem incorrect would be an understatement, but we shouldn't judge Messrs. Bernanke and Paulson too harshly. After all, in their current jobs they are not just the chief economist and chief banker for the country, they are also politicians and cheerleaders. They must carefully weigh their every word for its potential effect on world financial markets. And in any event, when taken on its face and in its narrowest scope, way back in 2007 the problem certainly seemed containable to most observers: subprime mortgages as a whole only total approximately \$1 trillion or 8% to 10% of all mortgages outstanding—and of that only about 25% or so may ultimately default—and direct housing and housing related jobs account for only a small fraction of the US economy.

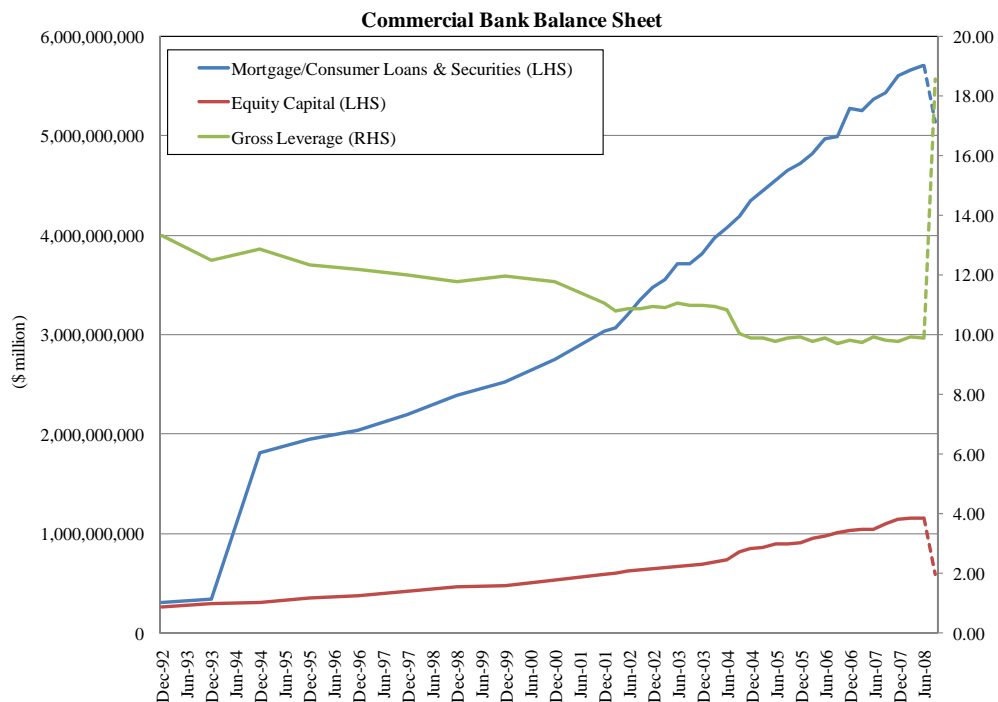
Besides, even bears like us who knew that this would all end very badly can't say that we foresaw many of the specifics of the denouement: venerable Bear Stearns and Lehman Brothers out of business; Fannie Mae and Freddie Mac in the government's conservatorship; AIG only alive because it was too big to fail; Bank of America acquire Merrill Lynch; Morgan Stanley and Goldman Sachs repudiate the bulge bracket investment-banking model and become bank holding companies; General Electric need to raise \$15 billion in new equity capital; California and Massachusetts ask for federal assistance; Congress pass in record time two landmark pieces of legislation—the Housing and Economic Recovery Act of 2008 and the Emergency Economic Stabilization Act of 2008; deposit insurance caps lifted both here and around the world; massive hedge fund losses; commodity prices plunging the most in 50 years; the Treasury guarantee money market funds; a country near bankruptcy (Iceland); and finance ministers and central bankers around the world pledge to do whatever was necessary to fix the problem. This is a long, terrifying list of events, and almost all of it occurred in the last 30 days.

So what did the experts and policymakers at every level miss when they were trying to convince the market that the subprime mortgage problem was "contained"? How did the US financial markets come to need a \$700 billion rescue, even after writedowns of over \$500 billion? They were missing the point—about what was being contained and where the container was. The problem wasn't just one specific asset class, it is all assets. And the problem isn't just assets, it is also liabilities. And the problem isn't just housing, it is all economic activities and the consumption that arises from it. And the problem isn't contained to just Wall Street balance sheets, it is in the daily business activities of every financial institution relying on the continued confidence of funding counterparties.



What market savants missed was nothing less than a decades-long gradual shift in the stability of the capitalist financial system, and the growing complexity of interstate and cross border interconnectedness of all financial institutions. Incrementally, we have seen financial institutions shift their funding base from more stable retail funding (like deposits) to less stable wholesale funding (like commercial paper) and shift their assets from diversified lending to more real-estate-related loans and securities. In 1991, banks obtained 72% of their funding from deposits and 12% from fed funds, repo and credit market debt; today 59% is in deposits and 19% is in wholesale funding. In 1994, banks had 33% of their assets in mortgage-related assets (real-estate loans and mortgage-backed securities); today, 41% is in mortgage-related assets. Moreover, in the last several years, we have also seen declining loan loss reserves as a percentage of loans and leases. Now banks are adding reserves in huge amounts, trying to keep pace with the credit trends. In the last year alone, banks have grown reserves 63% or \$46 billion, to \$118 billion—still under 2% of loans and leases. None of this happened overnight, but the progress of these developments reached a tipping point where the instabilities were revealed under market stress. September 2008, with its chain reaction of events, was the tipping point.

The paradox of the situation is that on a simple assets/equity basis, this country's commercial banking system looks about as healthy and well capitalized as it has ever been. Assets have been growing, and so has equity capital. According to FDIC data, at June 30, 2008, assets and equity capital on bank balance sheets stood at \$11.4 trillion and \$1.15 trillion, respectively, up 185% and 270% from 1994. Thus, gross leverage at June 30 stood at about 10:1, down from almost 14:1 in 1992. So what's wrong with this picture? While total assets grew 185% from 1994 to date, real-estate-related loans and securities grew 268% to \$3.7 trillion. Banks are finding out two things right now. First, they are having to finally confront the fact that their assets are not worth their carrying, or mark-to-market, values. The price discovery that is now in the market—from the Merrill Lynch sale of its mortgage securities portfolio, various bank sales (whole or partial sales), and the growing pace of CDO liquidations—is too pervasive to be ignored. The existence of the Troubled Asset Relief Program (TARP) is the capitulation that these assets are underwater and need to be removed from bank balance sheets. In the graph below, we did a pro forma 10% haircut on the value of just the mortgage and consumer loans and securities on the nation's bank balance sheets and its effect on equity capital and leverage (the dashed lines). That haircut of approximately \$570 billion would have the effect of jacking up leverage to over 18:1. Apply this haircut to the entire global financial system, and the reason for the widening crisis in global confidence comes clearer into focus.



Source: Haver Analytics, FDIC

Second, banks and others are suffering from their growing dependence on wholesale funding sources. The seizing up of the interbank credit markets and the short-term liquidity markets is exacerbating the asset problem. The spike in LIBOR and the drop in outstanding financial commercial paper is evidence of how quickly this can change. So while banks and other financial institutions are watching their asset values decline, they are also struggling to hold onto their wholesale funding. It's a vicious pincer-like seizing from both sides of the balance sheet, resulting in a deleveraging that threatens the solvency of the system. The starkest examples of this situation are from institutions like Lehman Brothers, which owned too much overvalued commercial real estate-related securities and found its wholesale funding drying up; AIG, which ultimately couldn't post required collateral on its massive and worsening credit default swap positions; or Washington Mutual, which fell victim to the fact that 80% of its assets



were in mortgage and mortgage-related loans and securities at a time when credit performance was enough to scare regulators and depositors.

The combination of the Fed's various liquidity programs and the TARP are designed to address both sides of the balance sheet problem. On the asset side, the TARP will constitute a very large, very well-financed and very discerning buyer of problematic assets from the financial system. Without the TARP, it is likely that the problem assets in the financial system would have to be rapidly sold into the market at significantly distressed prices or written down as other-than-temporarily impaired, ruining capital ratios and bankrupting many, many firms, large and small. On the liability side, by accepting virtually any collateral type from any financial institution (and by considering making uncollateralized loans, too), the Fed is truly resorting to becoming the lender of last resort to the financial system. And according to the latest data, the Fed's balance sheet (found on the H.4.1 form, released every Thursday) has been ballooned by loans. At October 2, 2008, total direct support through the Fed's various discount window mechanisms (other than the Term Auction Facility) totaled \$408 billion, up from \$262 billion in the prior week, and just \$24 billion four weeks prior. Of that \$408 billion, \$146 billion was in the Primary Dealer and Other Broker-Dealer Credit Facility, \$61 billion was to AIG, \$152 billion was to finance purchase of asset-backed commercial paper from money market mutual funds, and \$49 billion was in primary credit loans from the old-fashioned discount window. The surge in borrowing, not surprisingly, led to a huge increase in so-called excess reserves in the system. (By law, banks must hold a fraction of their deposits on reserve at the Fed or as cash in their vaults, upon which they received no interest.) With the passage of the TARP, the Fed will now be able to pay interest on reserves held by the Fed (but not vault cash). Without going into a lot of detail on this (gluttons for punishment can read a handy FAQ from the New York Fed at http://www.newyorkfed.org/markets/ior_faq.html) the ability to pay interest on excess reserves will allow the Fed to expand its balance sheet and provide liquidity almost without limit and without having to drive the Federal Funds rate to zero in the process.

We believe that with this two-pronged policy prescription, the asset cleanup can commence and liquidity providers can gain enough confidence to start flowing again. There is still major uncertainty about execution, particularly as it relates to the prices the TARP will pay for the assets—too low and the banks aren't that much better off, too high and it will squelch private capital demand for those kinds of assets. There also remains the uncertainty about whether the leadership being displayed by American policymakers in confronting the situation will be emulated by their European counterparts. Thus far, while the European Central Bank has proven to be very willing to offer liquidity outlets to its constituent financial institutions, the lack of coordinated government policy by the EU member states is not only frustrating any progress but also damaging the standing of the euro.

No, we can't fault Messrs. Bernanke and Paulson for not having more foresight or being more aggressive up to this point. Frankly, it is likely they would have been run out of town if they had come up with this story a year ago. Nevertheless, we believe that they have been appropriately aggressive in addressing the situation. And we have every confidence that they will continue to do battle. As Chairman Bernanke said last week, "We will continue to use all of the powers at our disposal to mitigate credit market disruptions and to foster a strong, vibrant economy." We would not be surprised that this also includes further rate cuts, that are justified by economic reasons. We believe their decisions will pay off. In the meantime the markets are in the unique position of being priced to disaster while policymakers are intent on averting that disaster.

The Mortgage Market

Prepayment speeds in August (September release) for conventional 30 year Fannie Mae collateral are at the lowest levels since 2000. At a 6.5% constant prepayment rate, speeds have decreased 14% from the prior month and 57% since February of this year. The decline in speeds is consistent with tighter credit, an uncertain housing market and a one day drop in day count. Looking ahead, most dealers are anticipating flat September (October release) speeds and are torn between either a substantial increase (50%) for October speeds or none at all. This divergence of opinion on October reflects the effect of the placement of Fannie Mae and Freddie Mac into federal conservatorship as well as the passage of the historic Emergency Economic Stabilization Act of 2008. We believe the three mitigating factors for speeds increasing or remaining tame going forward given this month's historic events are increased issuance of Treasury debt, decreased Agency guarantee fees and changes to policy and, lastly a lack of refinance efficiency.

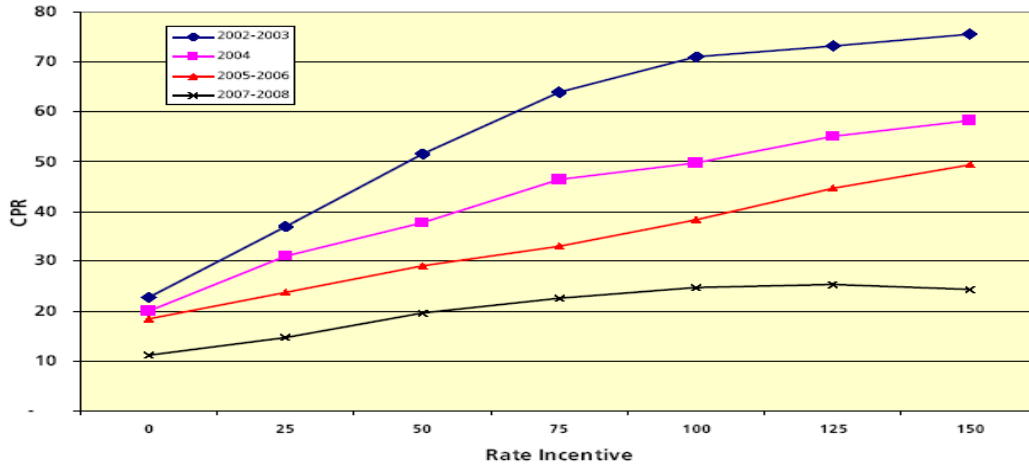
With an \$840 billion price-tag, the Emergency Economic Stabilization Act of 2008, which includes the TARP, is certainly a big number even by federal budget standards and will be largely paid for by the government debt. According to Morgan Stanley, before issuance plans are in place for the TARP there is \$245 billion in new Treasury coupon debt (2yr-30yr including TIPS) being issued in the fourth quarter versus \$144 billion maturing. This will add roughly \$101 billion to the system. The issuance of Treasuries, if accompanied by a sell-off, could temper prepayments.

Recently both Fannie and Freddie said that they will not increase fees on all loans purchased to 0.5 percent from the current 0.25 percent, as had been previously announced. Freddie commented that the changes would provide "some relief from the challenges



in the current market environment.” While on the surface this announcement may not seem significant it may lead to government changing Fannie and Freddie’s streamline refinance policy if it fails to provide relief. Under the current policy a new appraisal is not required for secondary residences and investor properties; should this be changed to include primary residences UBS estimates the effect on speeds could be dramatic.

As readers of this commentary are well aware, it has become increasingly difficult to refinance due to tighter credit standards. As demonstrated by the below graph (provided by UBS), holding collateral characteristics constant the 2007/2008 prepayment activity is relatively tame compared to that of previous observation periods with similar rate incentives. As a result of tighter credit, falling home values and the lack of affordability products, refinanceability has become less efficient and is likely to continue into the foreseeable future.



The Markets

In September, short Treasury rates plunged, credit spreads widened and stocks fell as investors fled to quality. Into October, volatility was massive over uncertainty regarding the passage of the TARP, rallying gold and the dollar, while oil fell.

	9/30/2008	8/31/2008	9/30/2007	MOM % change	YOY % change
Fed Funds	2.00%	2.00%	4.75%	0.0%	-57.9%
2-year US Treasury	1.964%	2.371%	3.988%	-17.2%	-50.8%
10-year US Treasury	3.825%	3.813%	4.588%	0.3%	-16.6%
10-year JGB	1.472%	1.415%	1.539%	4.0%	-4.4%
10-year euro	4.015%	4.176%	4.329%	-3.9%	-7.3%
10-year UK Gilt	4.449%	4.480%	5.011%	-0.7%	-11.2%
10-year Canada Treasury	3.757%	3.534%	4.344%	-6.3%	-13.5%
30 yr conventional mortgage	5.770%	6.053%	6.248%	-4.7%	-7.7%
Dollar Index	79.45	77.38	77.72	2.7%	2.2%
Japanese Yen	106.19	108.78	114.80	-2.4%	-7.5%
S&P 500	1166.36	1282.83	1526.75	-9.1%	-23.6%
Nasdaq Composite	2091.88	2367.52	2701.50	-11.6%	-22.6%
Gold \$/oz (nearby contract)	\$874.20	\$831.20	\$742.80	5.2%	17.7%
Oil \$/bbl (nearby contract)	\$100.64	\$115.46	\$81.66	-12.8%	23.2%
MBA Refi Index (month end)	1333.9	1059.7	1950.4	25.9%	-31.6%

Source: Bloomberg; Japanese Yen quote is the London feed



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