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The Economy

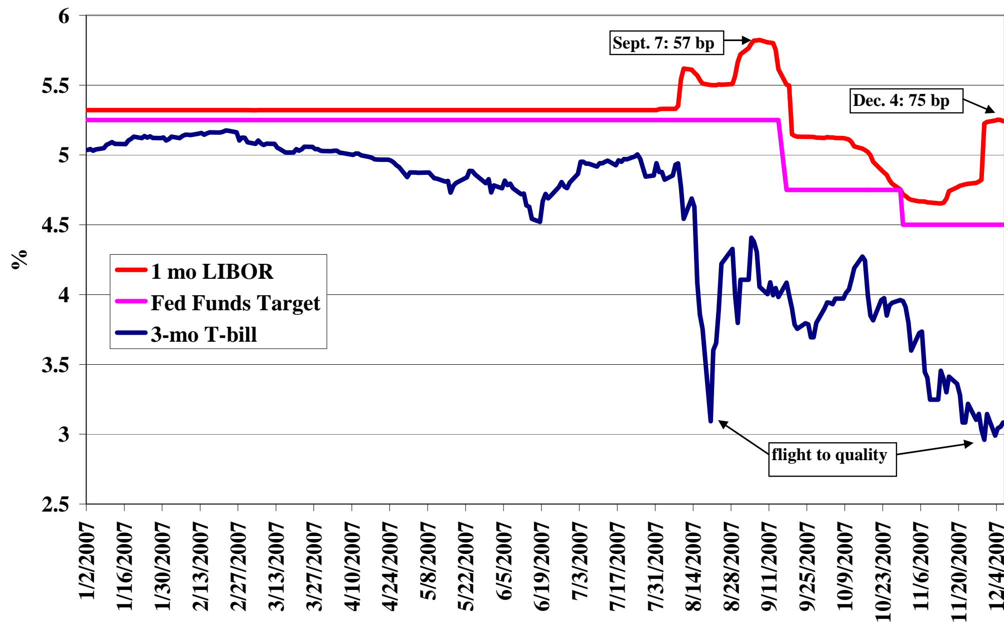
Of the many questions in the market today—"Who will fund the proposed Super SIV?"; "Which sub-prime borrowers will be affected by the Paulson-sponsored loan modification scheme?"; "Will loan limits for conforming loans be lifted?"; "Will the Fed combine liquidity measures with a rate cut next week?"—dwarfing them all is "Will any of it matter?" To borrow a well-worn phrase, we have the growing sense that all of this is just rearranging the deck chairs on the Titanic. To us, the dominant issue in the financial markets today isn't what regulators and legislators will or won't do to "fix" the problem, the item of most concern is the capital adequacy of borrowers of all kinds—particularly individuals, financial institutions, governmental entities.

Think about it: While central bankers around the world are dithering about whether their favorite government-endorsed measure of consumer prices is over or under their preferred target, we are witnessing massive asset deflation at two of the largest cohorts of borrowers. The assets collateralizing the borrowings of financial institutions and homeowners are falling in value. Financial institutions have now written down a total of $70 billion thus far, a fraction of the estimated amount of writedowns to come. Home prices continue to decline—in October the median price of a new single-family home declined 13.6% year-over-year, the largest drop since July 1970, while the median price of an existing single-family home fell 6.3% from a year ago, the largest decline ever according to Northern Trust.

It's not just asset deflation that's worrisome. Compounding the problem for banks and dealers is that while they are writing down some assets, they are having to absorb others, such as the massive amounts of off-balance sheet contingent claims (ie, backstops, liquidity puts and bailouts of broken SIVs and orphaned asset-backed commercial paper programs) coming on balance sheet. Adding further stress is rating agency downgrades as well as the mark-to-market requirements of fiscal year-end; for many large institutions the amount of assets marked using Level 3 accounting (ie, marked using management assumptions instead of market prices or observable inputs) exceeds their shareholders' equity. Compounding the problem for many homeowners is that they face the unexpected paradox of unaffordable coupon resets on their affordability loans. Asset quality and capital adequacy is paramount to surviving today's market.

The stagnant-to-rising cost of borrowings during a Fed easing cycle is one sign of the stress in the credit markets. On August 1, the spread between 1-month LIBOR and the Federal Funds target rate was 7 bp. Since then, the Federal Reserve has lowered rates 75 basis points from 5.25% to 4.5%, while 1-month LIBOR has barely budged from 5.32% to about 5.25%, widening the spread to 75 bp—the widest outside of the Y2K anomaly. This spread widening is also evident in euro and sterling markets. Not only is this problematic for the interbank lending market, but many different types of corporate and mortgage loans are indexed to these term funding rates. ***The Fed may be easing, but for many borrowers it just doesn't matter.*** Just as dramatic is the rising cost of capital for even the too-big-to-fail financial institutions: Fannie Mae and Freddie Mac have to pay in the mid-8% range on their preferreds, and Citigroup issued $7.5 billion in preferred that carried an 11% coupon—we can't remember the last time Citi paid 11% on a preferred issue.

August redux--LIBOR/Fed Funds spread gets even wider



source: Bloomberg

The speech delivered on November 28 by Donald Kohn, vice chairman of the Federal Reserve, was perhaps the first indication that the Fed is aware of the problem. He spoke at length about bank balance sheets and the ineffectiveness of lowering the Fed Funds rate: "The underlying causes of the persistence of relatively wide-term funding spreads are not yet clear. Several factors probably have been contributing. One may be potential counterparty risk while the ultimate size and location of credit losses on subprime mortgages and other lending are yet to be determined. Another probably is balance sheet risk or capital risk—that is, caution about retaining greater control over the size of balance sheets and capital ratios given uncertainty about the ultimate demands for bank credit to meet liquidity backstop and other obligations. Favoring overnight or very short-term loans to other depositories and limiting term loans give banks the flexibility to reduce one type of asset if others grow or to reduce the entire size of the balance sheet to maintain capital leverage ratios if losses unexpectedly subtract from capital. Finally, banks may be worried about access to liquidity in turbulent markets. Such a concern would lead to increased demands and reduced supplies of term funding, which would put upward pressure on rates." His comments, which raised hopes of a cut on December 11, were enough to spark a 331 point rally in the Dow Industrials.

All this said, we don't think the US economy is the Titanic heading for an iceberg. Rather, it is an ocean liner listing under its heavy debt load. (We're going to keep going with this metaphor, so indulge us.) As every sailor knows, if your boat is sinking, you have to plug the hole and start bailing. The hole-plugging has begun in earnest, beginning with Bear Stearns selling 10% of itself to Citic Securities; Countrywide, Citigroup, Fannie Mae and Freddie Mac each bolstering their capital position with high-coupon preferred offerings; and bond insurer CIFG Guaranty getting a $1.5 billion capital infusion from Natixis, its French parent. We expect to see more of the same in the weeks and months ahead, especially as non-Agency MBS and CDO ratings downgrades continue. In particular, the leading monoline bond insurers, MBIA and AMBAC, will likely need capital infusions in order to protect their imperiled triple-A ratings. The bailing has also begun, but it, too, has a ways to go. As discussed above, about $70 billion has already been written off, but UBS mortgage analysts estimate potential sub-prime losses of $394 billion, and Goldman Sachs economists estimate that at least half of that is on the balance sheets of financial institutions. So, the super SIV, the sub-prime loan rescue plan and another 25 or 50 basis points by the Fed, if they happen, may help lighten the load a little. This combination—taking the writedowns, increasing capital positions, steeper yield curve, regulatory relief—should help right the ship and repair financial institutions, eventually, but we believe it will take a lot more time to muddle through the housing inventory overhang.

In the meantime, the stock market is behaving as if the solution is at hand and it will once again be the beneficiary of leveraged investors, like private equity deals and flush hedge funds. That is an unlikely outcome in our opinion, at least in the short and medium term. Wall Street may not have a long memory, but it won't soon forget the consequences of poor underwriting standards, wanton securitization and lax ratings protocols. One other thing that the stock market should heed is the greater global

economy. It has been suggested that economic growth abroad and the concomitant benefits of a stronger export business (thank you, weak dollar) will help offset the drag from the current situation. On that point, note that the Bank of Canada and the Bank of England both cut their overnight lending rates in the last week. While the European Central Bank held rates steady at their most recent meeting, we wouldn't be surprised to see a rate cut soon. Note as well a comment from a recent report from China's commerce ministry, which stated that the biggest risk to Chinese economic growth next year was the squeeze on the consumer from the spreading US sub-prime debacle. "If demand in the US drops further," the report said, "Chinese exporters will be devastated by a rapid and continuous fall in orders." Exports account for a third of economic growth in China.

The Mortgage Market

Prepayment speeds on 30-year FNMA collateral increased 14%, or 1 CPR, for October (November reporting period). This fairly significant increase in speeds can be attributed to both day-count, with October having three additional business days than September, as well as a 20 basis point drop in mortgage rates since the beginning of September. However, even given the uptick in speeds experienced in October, prepayments are still substantially lower on the year. FNMA 5.5s and 6s, which collectively represent roughly 64% of the outstanding 30-year fixed-rate FNMA universe, are slower by 31% and 45% from January's actual speeds. Looking ahead, even with the strong rally in Treasuries since mid-October, November prepayment speeds should decrease by roughly 10% due to slower prepayments during the holiday season, home price depreciation and tighter underwriting standards.

November has been a very interesting month for the GSEs, and therefore for every Agency MBS investor. Fannie Mae returned to timely release of its financial results with its September quarterly filing, and reported higher credit-related expenses. This announcement was followed by Freddie Mac's announcement on November 20th that they realized actual credit losses of $126 million and a cumulative loss of $2 billion in the third quarter. Freddie Mac further announced that they would be raising capital in the "very near term" and slashing their common dividend by 50% if necessary. (See our "Note on Freddie Mac Following Release of its 3rd Quarter Results" on our website at www.annaly.com.) Freddie Mac achieved all three goals by issuing $6 billion of preferred stock on November 29 and by cutting its quarterly common dividend in half. Fannie Mae followed suit on December 6 with a $7 billion preferred offering and a 30% cut in its dividend. Fannie and Freddie stock prices suffered through all this, cut in half during the month and rebounding slightly after the Freddie deal was announced. Agency MBS, on the other hand, showed little of same volatility although they continued to underperform Treasuries.

With all the focus on the sub-prime rescue plan outlined by the Bush administration, it is worth reminding investors that Fannie Mae and Freddie Mac have always had the ability to purchase (and remove) from their pools, at par plus accrued interest, any loans that are four or more consecutive months delinquent, thereby making the MBS investor whole. Practically speaking, from the investor's point of view it looks like a prepayment. Fannie or Freddie will then modify and "cure" these loans after either the borrower pays their arrears, refinances the loan, or sells the home. Servicers of non-Agency mortgage-backed securities have also had the ability to modify delinquent loans, subject to certain limits. These modifications are quite different from those being proposed by the current administration. Under the "Hope Now" plan, mortgage servicers would agree to freeze current interest rates for five years on sub-prime loans originated between January 2005 and July 2007 with rate resets due from January 2008 through July 2010. Eligible under the plan would be borrowers with credit scores below 660, no more than 3% equity in their homes and who were either current or no more than 60 days delinquent. It is estimated that only 12% of the sub-prime universe will benefit from the plan, or about 240,000 borrowers, which shouldn't have much of an effect on cumulative losses. Barclays estimates that cumulative defaults would be reduced by 0.6%, "which is not much relief when losses could reach 13% to 15%." There are many other details still to be worked out on the plan, as well as assessments of potential unintended consequences of such government intervention into a free market, but we believe the most important effect of the plan is not an economic palliative but a confidence-boost to a shaken market.

The Markets

In November, short rates plunged and stocks fell. Mortgage rates remain elevated relative to Treasury rates. The dollar stabilized and oils and gold came down from recent highs.

	11/30/2007	10/31/2007	11/30/2007	MOM % change	YOY % change
Fed Funds	4.50%	4.50%	5.25%	0.0%	-14.3%
2-year US Treasury	2.999%	3.949%	4.613%	-24.1%	-35.0%
10-year US Treasury	3.940%	4.473%	4.460%	-11.9%	-11.7%
10-year JGB	1.478%	1.610%	1.655%	-8.2%	-10.7%
10-year euro	4.126%	4.239%	3.695%	-2.7%	11.7%
10-year UK Gilt	4.637%	4.928%	4.513%	-5.9%	2.7%
10-year Canada Treasury	3.982%	4.307%	3.903%	-7.5%	2.0%
30 yr conventional mortgage	5.83%	6.07%	6.03%	-4.0%	-3.3%
Dollar Index	76.15	76.48	82.95	-0.4%	-8.2%
Japanese Yen	110.87	115.18	115.73	-3.7%	-4.2%
S&P 500	1481.14	1549.38	1400.63	-4.4%	5.7%
Nasdaq Composite	2660.96	2859.12	2431.77	-6.9%	9.4%
Gold $/oz (nearby contract)	$782.20	$795.30	$646.90	-1.6%	20.9%
Oil $/bbl (nearby contract)	$88.71	$94.53	$63.13	-6.2%	40.5%
MBA Refi Index (month end)	2761.3	2249.0	1749.6	22.8%	57.8%

Source: Bloomberg; Japanese Yen quote is the London feed

FIDAC (An Annaly Company)
1211 Avenue of the Americas
Suite 2902
New York, NY 10036
Tel: 212-696-0100 · Fax: 212:696-9809
www.annaly.com

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