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NEWS & VIEWS

OCTOBER 30, 2007

Michael Farrell, Chairman of Annaly, delivered opening remarks to the company's 2007 third quarter earnings call. We reprint those remarks below:

Seduced by a Super Model

On October 15th, 2007, Federal Reserve Chairman Ben Bernanke addressed the Economics Club of New York. After his prepared remarks, the Chairman took a question from Henry Kaufman, who wanted to know what kind of information he would like to receive from the risk takers who were both lenders and borrowers in the structured markets. Bernanke thought for a moment and then replied, with an air of resignation in his voice, "I'd like to know what those damn things are worth." The thousand or so participants in the New York Hilton ballroom thundered their applause.

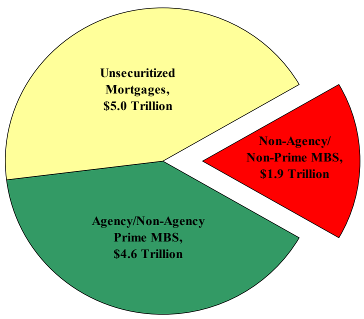
Numbers can be seductive. They can speak breathlessly in low, hushed tones of certainty, make loud cries of success, or whisper of potential opportunities. Many people love numbers because they seem to have a final, conclusive nature about them. They seem so solid, so predictable. They are the basis of every relationship in the universe. Human beings have always sought to quantify, compare, analyze, study and reach definitive conclusions with numbers. Indeed, the famous adage, 'Numbers don't lie," summarizes much of what motivates and ultimately satisfies us.

We are about to explain to you why numbers are not always what they seem to be, even when they add up.

Financial engineering, to boil it down to its essence, is applying assumptions to numbers to arrive at conclusions. For instance, in the case of collateralized debt obligations: If house prices always gain an average of 5% per year then the over-collateralization of mortgage cash flows will provide support for the cash flows of the structured, tranched debt. AAA assets are assumed to be protected with cash flows from lower tranches, which are protected by risk-takers who would receive any excess cash flow in exchange for taking equity risk. Certainly, in deals that have billions of dollars of assets in them, mathematically at least, these cash flows provide outcomes which give comfort to investors in all of the different levels of the CDO capital structure—AAA, AA, etc. Structurers, traders, rating agencies, regulators, investors all became enamored with the same super modeling techniques at the same time. The profiles sculpted by this financial engineering were alluring. The affair lasted longer and was more passionate then many skeptics could believe. But what happens if the key assumption—home price appreciation—the single criteria by which all of these cash flows are vetted is not a valid assumption. When all of this occurs, and the affair ends at every level, you don't get the summer of love. Essentially, you get the summer of 2007.

Now, here are some more numbers to explore to define the scope and scale of the problem. Those of you who have listened to these calls and watched our media and commentary releases understand that we have sought to compare the current dislocations in credit not to 1998, but rather to 1989. This was the last real estate-related crisis in the United States. History records that the vehicle by which the Federal government repaired that asset flood, The Resolution Trust Corporation, cost the US economy approximately $400 billion, which was equal to nearly 6% of Gross Domestic Product. Fast-forward to the 21st century, we would submit the following statistics. The mortgage market is an $11 trillion dollar market. Over the past several years the market expanded dramatically into sub-prime, alternative A loans going from almost nothing to the point where sub-prime and Alt-A securitized mortgages total $1.9 trillion. Effectively, just for this segment of the market, availability of credit has been shut off by the capital markets and, indeed, is now suspected by regulatory bodies of being a predatory lending practice. Therefore, there are no products available for these borrowers, even if they CAN and HAVE performed on their loans. The existing inventory of homes for sale is already at a nine month clearing rate, and there are more than 5 million homes for sale. More math: 5 million multiplied by $250,000 equals $1.2 trillion of inventory to be moved. Based on these numbers, we would submit that the size of the entire problem is in the neighborhood of $2 trillion, or equal to about 15% of current GDP. Even if we are wrong by 50%, it is 7.5% of GDP, still larger relative to the economy than it was in the early 1990's. There is a pie chart below outlining these figures. This is important to understand for our investors because it speaks to the probable outcome for the size and direction of the number one expense of our company, the cost of borrowed funds. In 1989 the Treasury curve was essentially flat, with an 8.5% rate all across the maturity range. In response to the ongoing crisis in the real estate market, the Fed lowered interest rates on the front end from 8.5% to eventually 3%. A similar move today would infer a financing rate of approximately 2%, from a peak of 5.25%.

How Much is at Risk?



Mortgage Crisis, Today

$1.9 Trillion
$13 Trillion Nominal GDP **= 15% of GDP**

RTC Crisis, early 90s

$369 Billion
$5.8 Trillion Nominal GDP **= 6% of GDP**

Today, the ultimate vision that must be dealt with is that the largest asset in most Americans' lives, their home, is dropping in price, while the cost of financing their largest liability, their mortgage, is rising. When we survey the world from our corner of the credit markets, and view the disruptions that are happening globally, we assemble all of the pieces of the puzzle and come to one logical conclusion: We are witnessing the piercing of a worldwide debt bubble. The central banks of the world are simultaneously being forced to shift fronts from being inflation fighters to fighters of the evil that dare not speak its name….deflation. Or to use the words of Ben Bernanke, "I'd like to know what those damn things are worth". This is the definitive statement in a deflationary environment.

Michael A.J. Farrell
Chairman, CEO and President of Annaly Capital Management, Inc.
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