



Michael Farrell, Chairman of Annaly, delivered opening remarks to the Company's 2009 third quarter earnings call.

We reprint those remarks below:

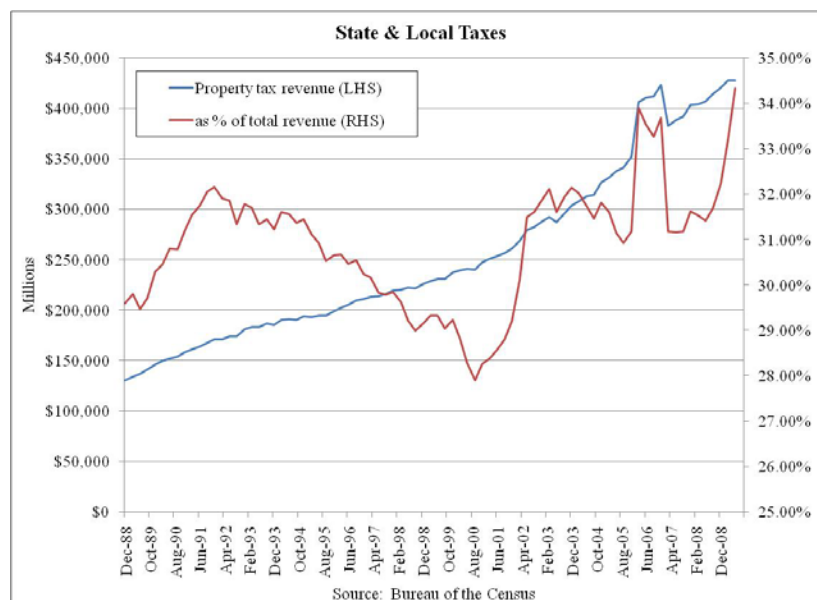
Central Planners Defend Dirt

There's a lot of curb appeal in restructuring a mortgage to keep voters in their homes. Politicians can puff out their chests and proclaim populist programs, reflect in the afterglow of the media radiance and then return to their districts armed for steely debates with otherwise unsatisfied constituents.

On the other hand, there is a lot less to be gained by those charged with America's financial well-being for supporting a high profile real estate developer or financier who got in over his head on an office building or a high end condominium complex or a resort. There would be little or no defense for that in a town hall meeting.

Given this fact set, let me explain the title of my comments today, "Central Planners Defend Dirt."

The simplest way to state our case is that all dirt is tied to some sort of taxable authority, in many cases multiple authorities. Valuations and property taxes make their way through the labyrinth of municipal, county, state and federal cash flows into the mostly leveraged debt service of those entities. When the tide is rising and carrying all boats—that is to say, when valuations on property, consumer incomes and access to credit are floating to higher and higher levels—there is a virtual bubble erupting right under our W-2 forms. The dirt on which we live, commute, travel and shop transforms itself into currency. Lenders lend at higher loan-to-value ratios, borrowers at all levels take some cash out with which to spend, reinvest and speculate, and taxation authorities adjust the rate of confiscation. As the graph below shows, property taxes now account for over one-third of state and local tax revenue, and herein is the problem of falling property prices.





As the downward spiral of falling valuation punctures the bubble, the weakest link in the chain goes first. Residential property speculators, sometimes also called homeowners or voters, adjust their lifestyles as their lenders take away home equity loans, raise lending rates and generally tighten credit, and as the economy slows, job losses compound the effect on all sides. Incomes drop, W-2 earners pay less income tax, consumption drops and the spiral picks up speed.

The most heavily leveraged towns and states, those that rely on the rising residential real estate tide to service their debt, are the first to report budget crises. California is the current poster child for this state of affairs, but they are not alone. As debt service commands a greater and greater share of the shrinking pie, services are cut, pensions are restructured and the spiral continues.

Realizing the risk to their own livelihood, the revenue bureaucrats in the Federal Government spring into action. Stimulus packages for shovel-ready projects are hastily legislated into existence. Tax credits for first-time home buyers, also called residential property speculators or voters, are shoved into the mix to slow the spiral. This step, however, cannibalizes the rental market and the hammering of the commercial and multi-family property market begins.

The point is clear. The pyramid game of municipal, state and federal taxation is in its death throes. The Treasury and the Federal Reserve are trying to juggle \$7 trillion in [debt](#), and over \$100 trillion in [unfunded liabilities](#) for Medicare and Social Security entitlements, not to mention the sums that are backing federal guarantees, that will have to be serviced by a \$14 trillion economy.

Time and time again, residents are raising their voices about being ‘taxed out.’ So much so that politicians from Arnold Schwarzenegger to Jon Corzine to David Patterson have actually been forced to verbalize this sentiment in their struggles to steady their respective ships of state. Federal agencies like the FDIC are looking to depositories to ante up early to help shore up the FDIC deposit insurance pool. The capital markets are going to be forced to invent ways to refinance this deflationary trend in municipal cash flows.

From my point of view the tax code is, for the first time in my life, ripe for a top to bottom restructuring. Even the most uninformed person in the US can infer that the personal tax rate for all of us is going up under the current system. Profitable corporations like energy companies are being targeted for ‘windfall taxes’ or reversals of tax credits. The homeowner’s mortgage interest deduction, capped at \$1 million in the Clinton administration will come under increasing fire from a Federal government determined to close every loophole and redistribute limited resources across its many obligations.

The general theme for investors to remember, during all of this disruption and transition, is that government central planners defend dirt. Japan has been trying to do it for twenty years. Let’s hope our bankers understand that we can’t afford to spend twenty years trying to disassemble that which is tearing the economy apart. The Japanese had the benefit of a huge domestic savings pool to lessen the downdraft of their spiral. But now their political and demographic systems are in complete disarray while the zombie banking system continues to stumble and stutter through the inevitable social changes needed there. Europe is no different. America does not have the luxury of waiting twenty years. We don’t have the cushion of national savings and we are starting at already high debt levels.



My advice to our central planners? First, reform the tax code to a simple domestic flat tax formula, so we can give our kids and grandkids a chance to prosper. Next, defend the dirt intelligently, not through taxing away the heat, light and water necessary to grow.

Last, and above all, never forget that *capitalism* is the arrangement under which individual freedom and opportunity will flourish.

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