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NEWS & VIEWS

JULY 30, 2009

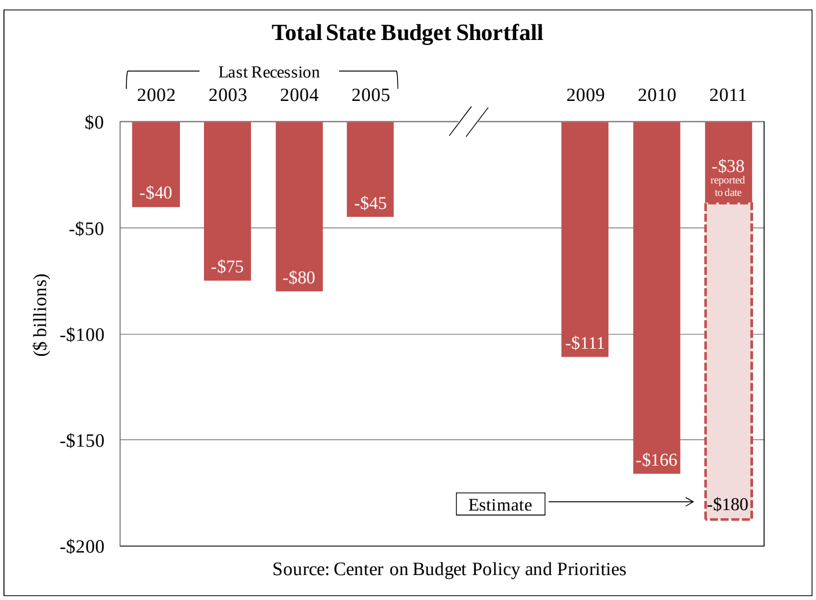
Michael Farrell, Chairman of Annaly, delivered opening remarks to the Company's 2009 second quarter earnings call. We reprint those remarks below:

Sherlock Holmes and the Mystery of the Green Shoots

In literature, it is difficult to find a protagonist more endearing, clever and flawed than Sherlock Holmes. Peerless in his attention to detail and his limitless powers of perception, what appears clear cut and evident to his trained senses bewilders those of lesser skills. His foil, Dr. Watson, his counterpart at Scotland Yard, the plodding Inspector Lestrade, and his arch enemy Professor Moriarty all wither in the face of Holmes' masterful powers of logic and deduction. That said, I believe even the formidable Mr. Holmes would have a problem figuring out the truth behind the current economic state of affairs.

First, Holmes would review the statistical evidence. There are those who argue that housing has bottomed because there has been a decline in the rate of decline. This belief is truly a leap of faith as long as large non-conforming loans from high FICO borrowers can still not be reliably funded, home prices asymptotically trend to liquidation levels and foreclosed homes dominate the sales market. Loan modifications have proven to be a feasting ground for the same mortgage underwriters that initiated the original loans, but unfortunately, the results are pretty much the same. Within 90 days, about half of the modified loans are once again delinquent.

Some have suggested that there are signs of life in the leading indicators and recent corporate earnings. Perhaps, but this ignores clues to the contrary. For example, the saga of distended state budgets plays out most tragically on California's stage, but California is not alone. According to the Center on Budget and Policy Priorities, the cumulative total of state budget deficits for fiscal 2009 will be $111 billion.



(Click chart above to be taken to corresponding blog post and enlarged chart)

California, which the New York Times has deemed to be "ungovernable" due to the splintering effects of special interests, represents a third of this projection by itself. At least 47 other states still face budget shortfalls, and the CBPP is looking for even deeper state budget deficits in the years ahead.

On July 2nd, the Bureau of Labor Statistics reported that the unemployment rate reached 9.5%. Vice President Biden, the Inspector Lestrade of the Executive branch, stated that the Obama Administration had 'misread the economy,' a startling admission since Candidate Obama campaigned with the message that the US economy was the worst since the Great Depression. And the massive amounts of stimulus that have been added to the economy have done little to improve the jobs picture.

American consumers are no longer a source of economic growth. Terrified by the reality of life changing events, they have acted predictably and begun to save discretionary income and any tax stimulus to rebuild their own safety net. We discussed this in our 2008 fourth quarter's earnings call report, "Just Save, Baby, Just Save." In fact, during May 2009, as the incentive checks were arriving into consumers' mailboxes from the government, they actually did NOT spend them, they put them into their savings accounts at extremely low rates of return and pushed the national savings rate up to a multi-year high of almost 7%. I applaud this move. As I said in February, it is the best course for America's long term financial health to self-fund our deficits via domestic savings. I believe that any follow-on stimulus packages will be subject to the same forces.

Our man Holmes still couldn't crack the case, so he went on the Internet. On YouTube he found an excerpt from an interview by the TV talk show host Phil Donahue with Nobel Laureate economist, Milton Friedman. Friedman is discussing concepts raised in his book Capitalism and Freedom, which advocates free enterprise solutions. To Holmes, Friedman's devastating smashing of the idea that any government intervention can lead to a strong society set forth an ideological framework for the current situation. (If you can, listen to the interview by clicking here (link will open in YouTube)). Scratching deeper, Holmes found a recent quote by Martin Feldstein, former head of the National Bureau of Economic Research and currently a professor at Harvard. When asked for his thoughts on second quarter GDP, he said, "We're going to see a temporary and substantial improvement." He continued, "I emphasize the words temporary and substantial."

Holmes then used his databases to draw conclusions from historical precedent. He discovered that as of the last reading, household borrowing fell for the first time since 1952. In June of 2008, the borrowing rate was a record of 133% of after tax income. In June of 2009, it fell to 128%. For an economy that is used to having the consumer represent 70% of its GDP, this does not bode well for the expenditures needed to lift the economy to trend growth. Corporate capital expenditures and employment will be constrained by lower than expected sales growth. At nearly 10%, unemployment is reaching a level not seen since the early 1980s. The thing most concerning Mr. Holmes is that the rise in savings so far is largely due to home mortgage debt being erased by home foreclosures, tax cuts and federal stimulus.

Going further into his research, Holmes uncovered a quote from the chairman of one of the largest banks in America in a *New York Times* story with the headline "… Bank Head Sees Credit Restoration and Recovery Nearing." The story reports: "The panic has passed, he declares, and we are moving from the period of emergency credit devices into a period where the basis of credit can be restored. There is a new hope in the world…" Intrigued by this missive exploring the light at the end of the tunnel, Holmes stopped reading and reached for his ever present smoking pipe when he realized that it was a quote from

Albert H. Wiggin, retiring chief of the Chase National Bank in an interview published on January 9th, 1933. Not only was this a historical precedent for a bank executive calling a bottom way too early, but it turns out that Wiggin was a scoundrel. The Pecora Commission investigation into the Wall Street crash uncovered that Wiggin had been shorting his own company's stock even as his firm and others were supporting the market via investment pools. These profits were protected from U.S. taxes because they were conducted in an off-shore trading corporation. Holmes, realizing that some things never change, put down his pipe and reached for his true comfort—a 7% solution in a hypodermic syringe.

At this point of the analysis, Dr. Watson assumed that the savings boost solved the credit crunch. Inspector Lestrade declared premature victory over the national municipal economic crisis and Professor Moriarty surrendered to the local tax authorities. Sherlock Holmes, on the other hand, had used his keen powers and solved the case.

But let us not forget that Mr. Holmes is actually a fictional character created by Sir Arthur Conan Doyle, and therefore his adventures and successes are all products of a spectacular imagination.

Just like the green shoots.

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