



MARKET COMMENTARY

THIS ISSUE

- > **WASHINGTON WATCH**
Housing policy trial balloons
- > **ECONOMY**
Inflation expectation in focus, but watch wages
- > **RESIDENTIAL MORTGAGE MARKET**
The Agency market shows resilience
- > **COMMERCIAL MORTGAGE MARKET**
A review of a regulatory proposal
- > **CORPORATE CREDIT MARKET**
Cash-rich companies: A side-effect of QE2
- > **TREASURY/RATES MARKET**
A volatile rates market; the futures market changes its mind...often
- > **MARKETS**
The tracks of QE2 continue...rates and stocks rise, gold rises, the dollar shrinks

Washington Watch

The first quarter of 2011 may not have had the fireworks of the third quarter of 2008, but it certainly ranks among the more eventful for markets, the economy and policy. Regional events around the world had global consequences, as Japan suffered a terrible earthquake, tsunami and nuclear crisis; European peripheral sovereign credit concerns reemerged, with yields on Greek, Irish, Portuguese and even Spanish debt reaching new highs amid a slew of rating Agency downgrades; and several countries in the Middle East and North Africa erupted in revolution and protest, toppling governments and instigating civil turmoil. Oil prices responded by rising to over \$100/barrel, currency values fluctuated and commodity prices rose.

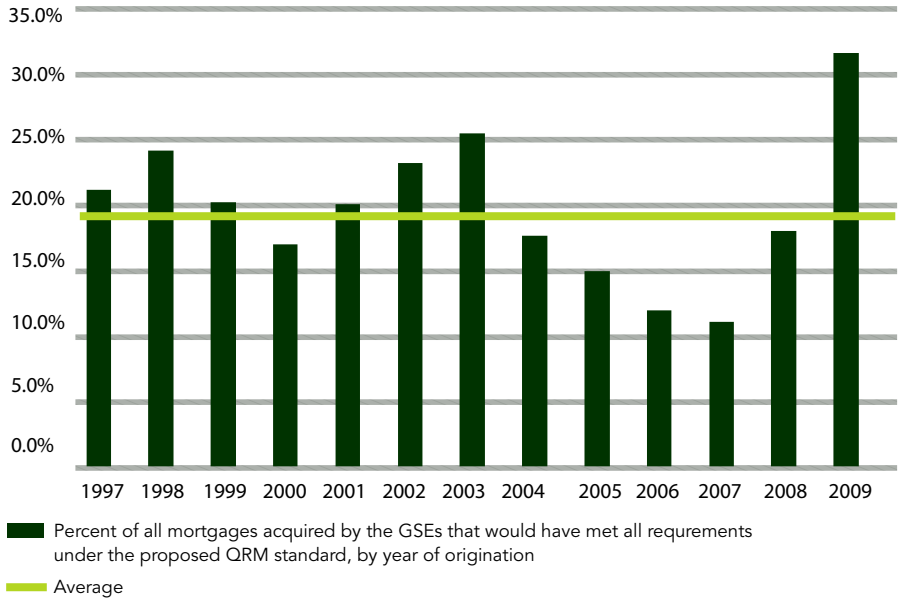
Overlaying these events was the execution of a second round of large-scale asset purchases (otherwise known as Quantitative Easing 2 or QE2) by the Federal Reserve—and the resulting positive portfolio channel effects in financial markets—as well as the extraordinary budgetary imbalances at every level of government in America. On this last point, the partisan wrangling and brinkmanship over the deficit at the Federal level brought the government to within an hour of a shutdown. These developments in Washington will continue to be on the radar screen for market participants in the quarters ahead. (There will be more partisan bickering in the debt limit debate. Treasury has said it will run out of money by May 16 at the latest, and Congress is taking the last two weeks of April off....so expect this to also go down to the wire.)

But life is what happens to you while you are making other plans (as John Lennon famously said), and in the case of policymakers the other plans include a raft of activity related to our nation's system of housing finance. First, in February the US Treasury Department released its white paper on housing finance reform. "Reforming America's Housing Finance Market" was a summary document that had some basic thoughts on the short term (ie, lowering the conforming loan limit for the Government Sponsored Enterprises) and reducing the government's role in housing finance, but contained little by way of prescriptions for the timing and direction for long-term reform of the housing finance system. Instead, it offered three alternative directions for reform while expressing no preference for any of them. That said, the white paper was unequivocal in the government's support for any current and future guarantee obligations of Fannie Mae and Freddie Mac.

Continued on next page >

Second, in March, regulators, as required by the Dodd-Frank Act, proposed rules on the definition of a Qualified Residential Mortgage (QRM). In brief, securitizers of QRM will be exempt from a requirement to retain 5% of the credit risk. In the process of defining QRM—currently set at maximum loan-to-value of 80% with standardized debt-to-income and product requirements—regulators are essentially trying to align the economic interests of the parties to a securitization. As this effort to find the right balance between credit availability and credit risk is tantamount to mortgage credit rationing (those borrowers who fall within and outside the QRM rules will likely have differently priced mortgages), we expect to see a lot of discussion on this topic going forward. As it is currently written, only about 20% of the Fannie Mae and Freddie Mac pool of borrowers were underwritten to QRM guidelines (see Chart 1). The rule will likely not be finalized until this summer at the earliest.

Chart 1: A Narrow QRM Bucket



As it is currently written, only about 20% of the Fannie Mae and Freddie Mac pool of borrowers were underwritten to QRM guidelines (see Chart 1).

Source: FHFA

Third, the House Financial Services Committee, now led by the Republican majority, began to follow through on its ambitions to tighten the government’s grip on Fannie Mae and Freddie Mac and introduced eight different bills to do so. Fannie Mae and Freddie Mac are still operating in conservatorship and receiving government funding for their losses in order to maintain positive net worth. Collectively, the bills mostly codify some of the ideas and themes from the Treasury’s white paper; it is likely there will be more bills forthcoming from the Committee as it considers a legislative framework around the Treasury’s white paper proposals.

In sum, there will likely be more headlines, rulemaking and proposals with regard to housing finance policy going forward. However, with the backdrop of a still-weak housing market and a fractious political environment, not to mention other systemically important issues to consider, we expect little traction on finding a consensus anytime soon.

Continued on next page >

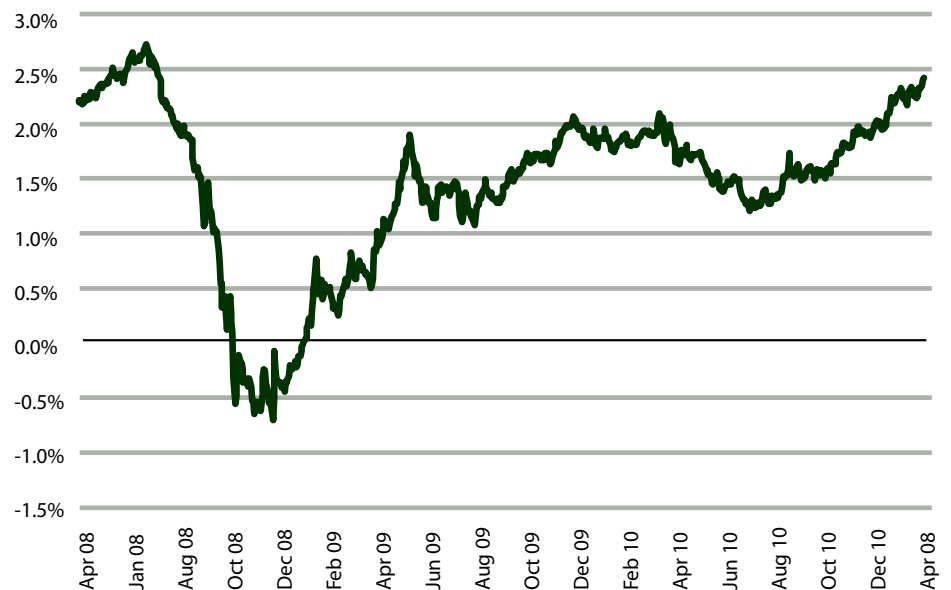
The Economy

As discussed above, the first quarter had more than its fair share of geopolitical and geological disasters, but the markets were resilient and mostly took these events in stride.

Behind each of these crises was a central bank somewhere providing support for risk assets: The ECB is supporting the Euro sovereign debt market, the Bank of Japan has pumped an unprecedented amount of cash into their markets nearly overnight, and the entire G7 contributed to holding the Yen down.

Here in the US, the Federal Reserve (the Fed) continues its \$600 billion large scale asset purchase program which is supporting bond and equity markets alike. The obvious worry is that this brand of monetary policy could stoke inflation. Beyond record gold prices, certain measures of inflation expectations have moved up recently. Chart 2 shows the 5-year breakeven inflation rate as expected by the TIPS market.

Chart 2: 5 Year TIPS Breakeven Inflation Rate



Source: Bloomberg

Despite its relatively low levels, the trend is not the Fed's friend in this case, and some members of the FOMC seem to have noticed. In fact, several governors have taken the discussion of monetary policy to the public stage in recent weeks and the lively internal debate over the future of QE2 and monetary policy is spilling out through the various channels of FedSpeak. This is confusing but is healthy; few things are more dangerous than an intellectual consensus.

Based on the Fed's preferred measure of Core PCE, inflation has yet to show itself in any meaningful way, and the committee expects it to remain so. Even if you drive and eat, headline CPI is currently 2.1% and the index only just broke through its July 2008 high in January of 2011 (meaning that its 2.5 year growth rate is essentially zero). However, recent commodity price action suggests that it may not remain so benign. Chairman Bernanke calls this inflation transitory, but Wal-Mart CEO Bill Simon disagrees: "Every single retailer has and is paying more for the items they sell, and retailers will be passing some of these costs along.

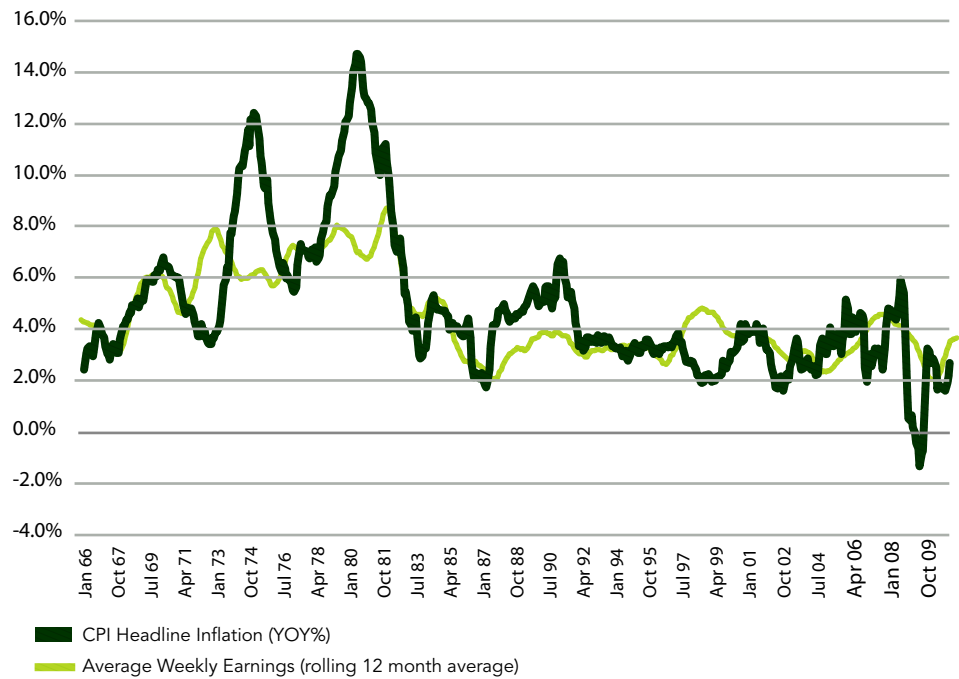
Continued on next page >

Except for fuel costs, U.S. consumers haven't seen much in the way of inflation for almost a decade, so a broad-based increase in prices will be unprecedented in recent memory." He goes on to say, "No retailer is going to be able to wish this new cost reality away."

Inflation worriers also look at excess reserves held at the Fed as being the dry tinder that will combust into an inflationary pyre. Under the money multiplier theory, banks will sharply increase credit creation and thus inflation when it puts those reserves out into the economy. Jan Hatzius of Goldman Sachs differs on this point. "[M]ost bank loans have long been primarily funded from sources other than deposits subject to minimum reserve requirements," he wrote. "This means that bank lending was not constrained by the availability of reserves even prior to the increase in excess reserves. Relieving a non-existent constraint cannot be important for credit creation or inflation."

Another salve to inflationists is that wage growth has remained well behaved in recent months, as Chart 3 illustrates:

Chart 3: Inflation vs. Wage Growth



Source: BLS, Haver Analytics

Weekly earnings growth has stayed relatively well anchored to below 3% in recent months. While this is not a positive outcome for American households, a breakout in inflation while wage growth is so low would be a truly unique event in our short economic history. Nevertheless, we are staying tuned to measures of inflation expectations.

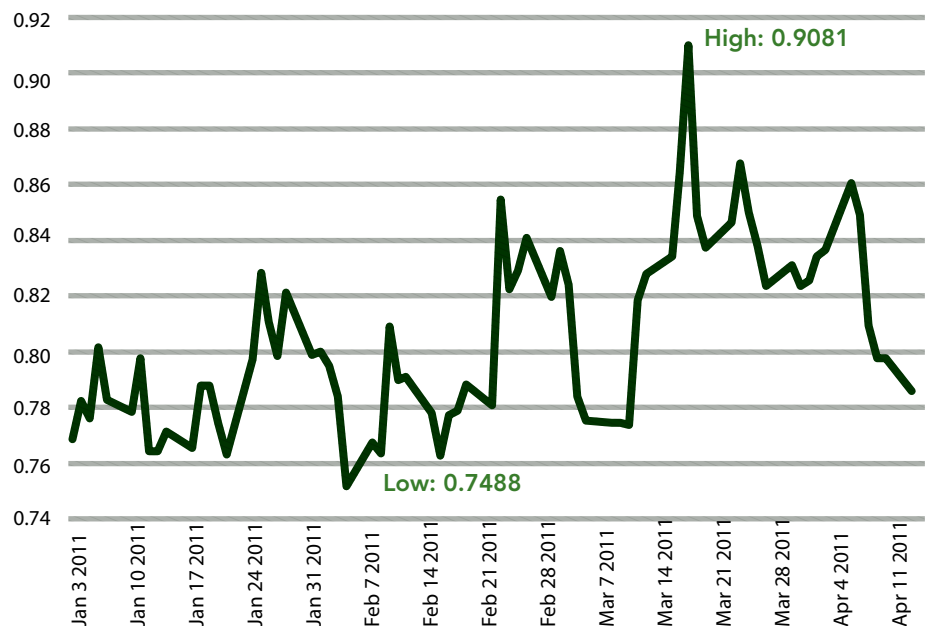
Continued on next page >

The Residential Mortgage Market

Amidst the various potentially market-moving headlines during the quarter, Agency mortgage-backed securities proved to be resilient. As illustrated in Chart 4, any widening of the spread between the par-coupon mortgage and the yield on the 10 year U.S. Treasury was short-lived.

In the mortgage market, market participants react to any new headline with an estimate of its effects on prepayment speeds and convexity. The contents of the Treasury's white paper were generally in line with market expectations, and were thus ultimately a non-event, although participants focused on the potential ramifications of lower conforming loan limits and higher guarantee fees. The second significant headline this quarter was related to FHFA extending Homeowner's Affordable Refinance Program, or HARP. HARP was an initiative by the Obama administration designed to assist in lowering homeowner's mortgage payments via rate reduction or principal forbearance. The program was scheduled to expire on June 30, 2011; however, on March 11 it was extended by one year with minor changes. A HARP-induced acceleration in prepayment speeds has long been a concern of mortgage investors since the implementation of the program, yet HARP has been largely unsuccessful to date: of the 6.3 million refinances since the program's inception only 564 thousand, or 9%, can be attributed to HARP refinances. Thus the market largely shrugged this off as well.

Chart 4: Spread Between Current Coupon Mortgage and 10-yr Treasury



Source: Bloomberg

Mortgage spreads narrowed even after the March 21 announcement by the Treasury that it would begin winding down its portfolio of approximately \$142 billion of Agency mortgage-backed securities at a rate of \$10 billion per month. The tightening can be attributed to basic technical factors. The Treasury's portfolio is still considered relatively small, and net issuance continues to remain low.

Continued on next page >

The Commercial Mortgage Market

The release of the notice of potential rulemaking on qualified commercial real estate mortgages gave the market a case study in the possible ramifications of legislation.

For months, commercial mortgage-backed securities (CMBS) participants lobbied Congress and regulators to permit the B-piece or equity tranche investors to satisfy the 5% risk retention requirement for newly issued transactions, the theory being that the B-piece buyer is the retainer of risk. Ultimately, the proposed rule contained this provision. The requirement could be satisfied provided the buyer paid in cash for the bottom horizontal position, and the buyer had to perform a credit review of each asset in the pool. There were a few other provisions added to the rule, including a requirement for transparency for the B-piece buyer, disclosure of the purchase price for the securities and limitations on selling and transferring the risk.

Much like in the residential space, the purpose of these requirements is to create a long-term alignment between the issuers and their product. Indeed, if the proposals described herein had been in effect during 2005-2007 we believe there would have been much less speculative CMBS created. Thanks in large part to the CDO machine, a B-piece investor could immediately transfer its acquisition and, by extension, the risk to the non-recourse finance vehicle. The cash proceeds from the CDO would nearly eclipse any investment by the B-piece investor, and enable B-piece investors to transfer the risk, thus circumventing the intent of the proposals. Interestingly, very few commercial mortgages originated over the past few years would qualify under the “qualifying” category, so the B-piece investor solution was welcomed by the market.

The problem is that regulators added a new directive to the risk retention language that caught the market by surprise. The provision would require the funding of a “premium capture cash reserve account,” in which an issuer who sells CMBS for more than the par value of the transaction—essentially the profit in the transaction—pays those excess proceeds into a reserve account that serves as a first loss piece subordinate to the B-piece. This account would prevent issuers from immediately monetizing the profit created through issuance of interest-only securities (IOs). Analysts at JP Morgan put it this way: “[T]he introduction of the premium capture cash reserve account makes the economics of issuing CMBS infeasible using traditional structures. Furthermore, if enacted, the likely second-order effect would be that pricing across the capital structure would change to such a great extent that B-piece buyers may no longer be interested in participating.”

Risk retention regulations for the securitization market are clearly necessary. But while the intent of this regulation is to create long term alignment, this provision could have unintended consequences. It is still early days in the comment period on the proposed rules and this is one provision that will likely be reviewed.

Risk retention regulations for the securitization market are clearly necessary. But while the intent of this regulation is to create long term alignment, this provision could have unintended consequences.

Continued on next page >

The Corporate Credit Market

Not only has QE2 helped support financial asset prices, but as the central bank takes out Treasury bond float, corporate issuers have stepped up to fill the void. Since QE2 commenced, supply has been robust across the sub-sectors of investment grade, high yield and leveraged loans at record lows in yields. Hence, the Fed's effort to propagate the virtuous cycle of liquidity has had a quantifiable result: improved free cash flow of corporate America.

The low return on cash continues to support demand for fixed income assets, and in credit demand creates supply. High yield issuers sold a record amount of bonds in Q1-2011, a massive \$107 billion, or nearly 9% of the market size. Further up the capital structure, leveraged loan origination also improved dramatically from 2010, thanks to deep bids from CLO managers and funds. At \$137 billion, first quarter loan new issue volume grew a hefty 216% year-over-year. In investment grade, the multi-tranche, multi-billion dollar industrial issuer propelled overall index-eligible gross supply to \$210 billion, up 12% year-over-year. Investment-grade financial issuers, in contrast, reduced new issue activity by 2% year-over-year.

The use of proceeds for the majority of speculative grade new issuers remains debt refinancing. While the old trend of high-yield bond tenders continues, a new trend emerged in the first quarter. Loan issuers began to aggressively call loans and refinance them at much tighter spreads and LIBOR floors (the market's prepayment rate is 39% vs. 15% in 2010). For leveraged companies, the resulting decline in interest expense can have a meaningful impact on free cash flow. Arguably, this is the kind of positive feedback loop on Bernanke's wish list. "Easy money" has yet to transmit into excessive leverage: the institutional loan market has contracted 2% this year, while the amount of high yield and investment grade bonds outstanding are up 3% and 4%, respectively. Low rates and the debt recycling machine are among the biggest fundamental positives supporting the corporate sector. Moreover, firms continue to deleverage balance sheets, albeit at a slower pace than any point in the current expansion. Balance sheet liquidity remains strong as evidenced by termed-out debt capital structures and extreme cash balances. While margins have likely peaked for the cycle, higher top line growth can support higher levels of future EBITDA. While a couple of name-brand companies recently filed Chapter 11 bankruptcies, the driver was technological obsolescence. More broadly, S&P estimates a mere 1.9% corporate default rate at year-end.

As far as corporations are concerned there is another component of the "liquidity story" that underscores the change in the post credit-crisis landscape. Corporate cash balances remain near record levels. One reason is that firms have become less reliant on banks for revolving lines of credit and commercial paper back stops. Non-financial commercial paper outstanding is just \$108 billion for U.S. companies. Casually, one might expect a "return to normal" with such robust capital markets. However, under Basel III, banks will be required to hold liquid assets against unfunded commitments. One CEO avowed that as a result his bank would ration credit and charge higher prices. So, the high "liquidity" on corporate balance sheets may not be transitory but a more or less permanent feature of their funding strategy.

As far as corporations are concerned there is another component of the "liquidity story" that underscores the change in the post credit-crisis landscape. Corporate cash balances remain near record levels.

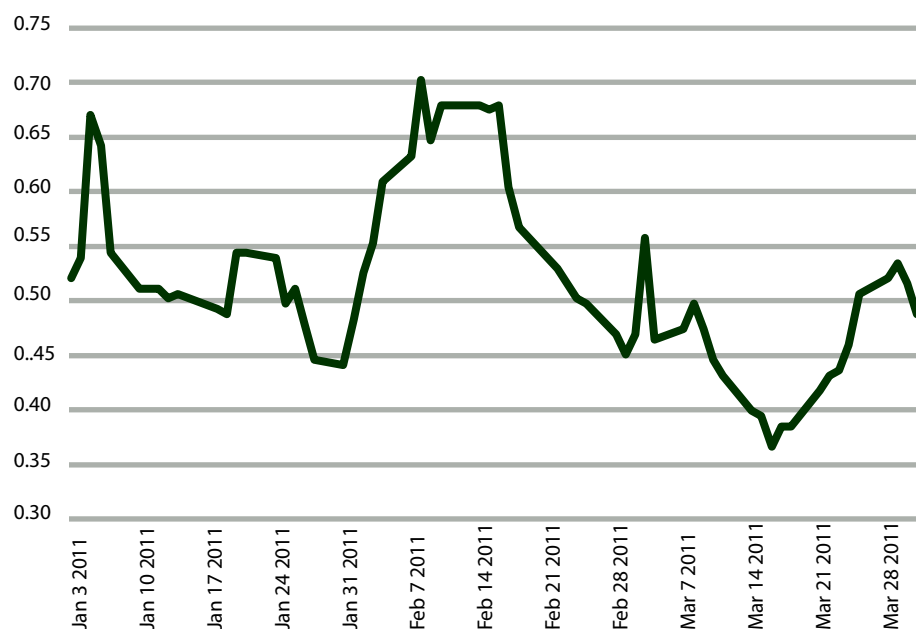
Continued on next page >

The Treasury/Rates Market

The events of the first quarter were the main drivers of the price action in the Treasury market. Yields on 10-year Treasuries traded in a relatively tight trading range even though equities have continued to march higher. Yields reached their peak in early February heading into and shortly after the release of the January unemployment report, but the 3.75% level brought in the buyers as tensions in the Middle East and North Africa (MENA) became more prevalent. The rally continued into mid March as the radiation fears out of Japan caused whatever shorts were left in the market to capitulate around the 3.15% level.

Auction sizes were steady for the quarter. There was a total of \$501 billion of new nominal issuance, but results varied across the curve. January saw good demand for the entire curve during the auctions except for the 30-year as the market needed a slightly higher yield to take down \$13 billion of longer term bonds. In February we saw similar results but the one outlier was the 5-year where weak demand from end users caused a higher than expected rate. March was an interesting month on the auction front as results from the first round of auctions early in the month differed greatly than the second round at the end of the month. The 3-year, 10-year and 30-year were all well received and demand statistics were strong. Toward month end, however, the 2-year auction surprised many when the auction rate results came cheaper than where the issue was trading at the auction deadline. That was the first time that had happened in almost a year and caused the market to sell off. The 5-year and 7-year both followed suit with higher auction rate results than expected as bidders demanded higher yields. The results helped Treasuries extend their 9-day losing streak into month end.

Chart 5: March '12 Fed Funds Future Contract



Continued on next page >

Fedspeak ratcheted up in the first quarter, from both hawks and doves, adding to the volatility around market expectations for when the Fed will move the target rate. The best gauge for these expectations is to look at the Fed Funds futures contract. If we look at the March 2012 contract which is cash settled a year from now using the 30-day average of the overnight Fed Funds rate for that month, we see that on Jan 1st of this year the market fully expected the Fed Funds rate to be at .50% (see Chart 5). Rate expectations reached a high in early to mid February after economic data started to show some promise for the economy and the hawkish language first started, but as the MENA unrest escalated and the Japan news first hit, the market made an about face and priced out the majority of the tightening. The hawkish tone from some of the Fed Governors then started to pick up more steam as we headed into the end of March and the 25 basis point hike was priced back into the market. This time series is notoriously volatile the further away from the contract date. In the meantime, market participants will cut through the headlines and the rhetoric and stay focused on what is important—the economic data and inflation expectations.

The Markets

10 year Treasury yields were volatile, but finished the quarter only a little higher than where they began. The S&P 500 rose 5.4% during the quarter, lagging the small cap Russell 2000 index which rose 7.9%. These are the best quarterly returns since the late 1990s tech bubble. Commodities followed suit, with cotton up 49.2%, crude oil up 16.8% and corn up 9.5%. Silver was up an impressive 21.8% while gold swung to a -8% loss before making a comeback to finish the quarter just slightly in the green. There were some impressive currency moves during the quarter, particularly in the Japanese Yen. Following the earthquake, the Yen rocketed to under 77 to the dollar from near 82 only a few days before. An immediate G7 intervention sent it quickly back to 81 and the Yen finished the month around 83 to the dollar (it subsequently breached 85).

The S&P 500 rose 5.4% during the quarter, lagging the small cap Russell 2000 index which rose 7.9%. These are the best quarterly returns since the late 1990s tech bubble.

	3/31/2011	12/31/2010	3/31/2010	MOM % Change	YOY % Change
Federal Reserve Funds	0.25%	0.25%	0.25%	0.0%	0.0%
2-year US Treasury	0.825%	0.597%	1.020%	38.2%	-19.1%
10-year US Treasury	3.472%	3.295%	3.828%	5.4%	-9.3%
10-year JGB	1.260%	1.128%	1.400%	11.7	-10.0%
10-year euro	3.354%	2.963%	3.092%	13.2%	8.5%
10-year UK Gilt	3.689%	3.396%	3.939%	8.6%	-6.3%
10-year Canada Treasury	3.350%	3.122%	3.569%	7.3%	-6.1%
30 yr Conventional Mortgage	4.587%	.512%	4.839%	1.7%	-5.2%
Barclays US Corporate	4.08%	4.03%	4.49%	1.2	-9.1%
Dollar Index	75.86	79.03	81.07	-4.0%	-6.4%
Japanese Yen	82.83	81.12	93.44	2.1%	-11.4%
S&P 500	1325.83	1257.64	1169.43	5.4%	13.4%
Nasdaq Composite	2781.07	2652.87	2397.96	4.8%	16.0%
Gold \$/oz (nearby contract)	\$1,438.90	\$1,421.40	\$1,113.30	1.2%	29.2%
Oil \$/bbl (nearby contract)	\$106.72	\$91.38	\$83.76	16.8%	27.4%
MBA Refi Index (month end)	2222.50	2115.40	2707.80	5.1%	-17.9%

This commentary is neither an offer to sell, nor a solicitation of an offer to buy, any securities of Annaly Capital Management, Inc. ("Annaly"), FIDAC or any other company. Such an offer can only be made by a properly authorized offering document, which enumerates the fees, expenses, and risks associated with investing in this strategy, including the loss of some or all principal. All information contained herein is obtained from sources believed to be accurate and reliable. However, such information is presented "as is" without warranty of any kind, and we make no representation or warranty, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use. While we have attempted to make the information current at the time of its release, it may well be or become outdated, stale or otherwise subject to a variety of legal qualifications by the time you actually read it. No representation is made that we will or are likely to achieve results comparable to those shown if results are shown. ©2010 by Annaly Capital Management, Inc./FIDAC. All rights reserved. No part of this commentary may be reproduced in any form and/or any medium, without our express written permission.



ANNALY[®]
CAPITAL MANAGEMENT, INC.

1211 Avenue of the Americas
Suite 2902
New York, NY 10036

Tel: 212-696-0100
Fax: 212-696-9809

www.annaly.com