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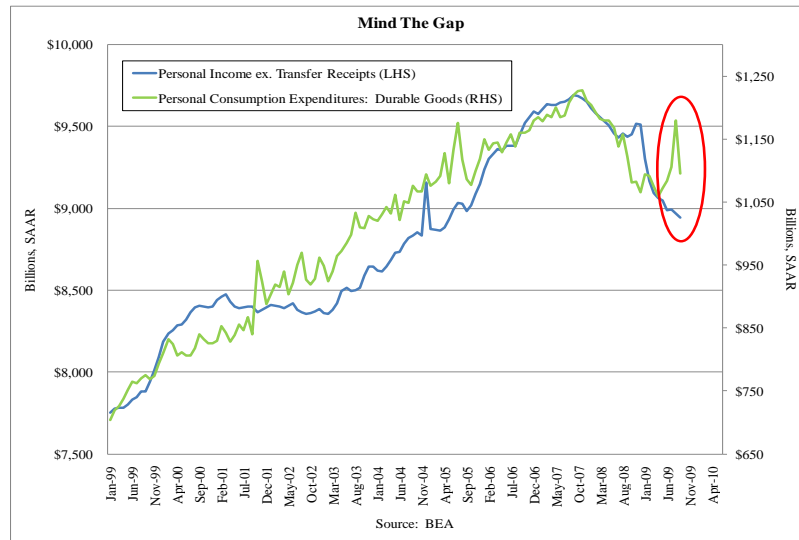
## The Economy

The preliminary estimate for 3<sup>rd</sup> quarter GDP was not negative. It came in at 3.5%, higher than expected and much better than the previous quarter's loss of -0.7%. The string of four consecutive negative readings, the first such string in the post-war era, has been broken. Is this the end of the recession? We won't know officially until the National Bureau of Economic Research says it is—after the fact—but many economists raced to mark the end of the worst contraction in America since, well, you know when. The stimulus put in place by the current administration worked, showing up in the expected areas. Private investment in residential real estate responded to incentives and added 0.53% to GDP growth. Motor vehicle output contributed 1.66% to GDP growth, accounting for nearly half (47%) of all economic growth in the quarter. For context, consider that the average contribution of vehicle output since 1980 has been an addition of 0.09% to average real GDP growth of 2.75%. We wanted economic growth, and the stimulus provided that growth. However, the point of Keynesian spending isn't just one quarter of growth. The point of the government's economic push is to "prime the pump," to get the economic fires roaring sustainably by throwing on some lighter fluid. In order to call the stimulus efforts a success, we now need the multiplier effect to kick in. Companies that are benefiting from artificial demand need to respond by increasing hours worked and then hiring more workers, creating new jobs and stimulating natural demand for goods and services.

Is that happening? The plunge in hours worked that began in 2008, a soft form of lost jobs, has not corrected itself as of the October reading (33.0 hours, tied for the record lowest reading), and new unemployment claims have remained stubbornly above the 500 thousand mark. The rate of job loss has slowed, but we are still losing jobs at a pace consistent with recessions, not recoveries. Third quarter corporate revenues and earnings are up quarter-to-quarter but down year-over-year, and bottom lines were helped by the trimming of headcounts and capital expenditures. Take a look at Alcoa. The aluminum producer always has the distinction of kicking off the official earnings season, and they certainly set the tone this time around. The company earned \$0.04 per share, down from \$0.37 last year but much better than the expected loss of \$0.09. In the last 5 quarters, the company has identified 22,000 jobs to cut, of which they have already completed 19,000. Although tough to estimate, management expects that 75% of these cuts are permanent. Capital expenditures are also being slashed, from \$3.4 billion in 2008 to an estimated \$850 million in 2010, a dramatic 75% drop.

Alcoa may be an extreme example, but it is not unique. Instead of investing in new projects and innovation, companies are cutting costs, [buying each other](#), [buying their own stock](#), or [just hoarding cash](#). As we said in our October 16 [blog post](#), we cannot shrink ourselves to prosperity. These are unsustainable one-shots.

Analyzing government data should be no different than analyzing corporate earnings, where exceptional one-time items are excluded. If the spending by Washington isn't having the desired multiplier effect, we should not extrapolate forward quarters like the most recent one. To analyze the quality of our nation's earnings, let's start with this observation: Personal spending drives GDP, and personal income drives personal spending, at least over the long term. Any divergence must correct itself over time. So how does personal income look? The graph below depicts monthly data for personal spending on durable goods (includes auto spending), one of the bigger drivers of GDP growth in the third quarter, versus personal income less transfer receipts (social security, unemployment benefits, etc.) for the last decade. We highlighted the months of the most recent quarter.



Notice the Cash For Clunkers spike in the middle of the quarter, and the subsequent reversion. We expect the decoupling of this relationship to end how most other decouplings end. GDP gains driven by personal consumption while incomes are falling, joblessness is rising, and credit availability is shrinking, just don't pass the common sense test (see Friday's 10.2% unemployment rate and the ghastly consumer credit figure, down \$14.8 billion from last month and \$125.8 billion from the peak in mid 2008). It's impossible to deny that the GDP data from this quarter are better, at least relative to how bad things were earlier in the year. Without the multiplier effect of the stimulus kicking in, however, we believe the third quarter 2009 GDP data could look like an accounting extraordinary item, a one-time event that quality-of-earnings analysts would disregard.

## The Residential Mortgage Market

Prepayment speeds in September (October release) on 30-year Fannie Mae fixed-rate pass-throughs declined 9% with aggregate speeds declining from 14.6 Constant Prepayment Rate (CPR) in August to 13.3 CPR in September. Across the coupon stack, 30-year FNMA 5.5s declined the most month-to-month, slowing 2 to 3 CPR. There was also a noticeable absence of Housing Affordable Modification Program-related buyouts in 30-year FNMA 6.5s and 7s, collateral that would be most affected by the program, as these coupons slowed by just 0.5 to 1.5 CPR month-to-month. Looking ahead, most dealers are expecting a 10% to 15% increase in speeds as HAMP-related buyouts offset normally seasonally slow speeds.

Market attention continues to focus on the possible effects of the end of the Federal Reserve's Agency MBS purchase program on March 31, 2010. Much of the commentary, including ours, has focused on the spread impact, but Bank of America recently put out a fine research piece outlining the duration impact of the Fed's MBS purchase program. The below tables, both provided by Bank of America, show the total duration change from December 2008 to September 2009 in just the 30-year Agency MBS universe, by coupon, as expressed in 10 year U.S. Treasury equivalents, as well as the corresponding total duration absorbed by the Fed's purchase program.

December-08			September-09			Duration Absorption of Fed Purchase Program		
	Bal(\$bb)	Tot. Dur		Bal(\$bb)	Tot. Dur		Bal(\$bb)	Tot. Dur
4.0s	1.5	0.7	4.0s	194.4	114.7	4.0s	151.9	89.6
4.5s	85.2	37.5	4.5s	648.9	285.5	4.5s	399.3	175.7
5.0s	763.4	244.3	5.0s	892.7	258.9	5.0s	210.1	60.9
5.5s	1290.2	283.8	5.5s	1100.4	209.1	5.5s	121.5	23.1
6.0s	929.1	130.1	6.0s	762.9	91.5	6.0s	11.7	1.4
6.5s	288.8	20.2	6.5s	244.7	14.7	6.5s	3.1	0.2
7.0s +	101.6	7.1	7.0s +	89.8	5.4	7.0s +	0	0
	<b>3,459.80</b>	<b>723.7</b>		<b>3,933.80</b>	<b>979.8</b>		<b>897.6</b>	<b>350.9</b>

Source: BOAML



As illustrated by the first two tables on the left, there has been roughly \$256 billion in 10-year equivalents added to the 30-year MBS universe from December 2008 to the end of September 2009. However, per the third table on the right, the Fed has absorbed roughly \$351 billion in 10-year equivalents from their purchase program resulting in a drain of \$95 billion in duration from the system. However, we observe that much of the added duration in the market has come in the 4% and 4.5% part of the coupon stack, which not coincidentally is also where the Fed had focused much of its buying—as part of its effort to keep primary mortgage rates below 5%. As for what the market will look like once the Fed steps aside, investors are thinking about how the market will absorb MBS duration, and how the less than sturdy housing market will react to reduced credit creation at lower rate levels. Only time will tell, but in the face of such uncertainty it is reasonable to conclude that there will be spread volatility in the months ahead.

## The Commercial Mortgage Market

October 2009 was the fourth month in which CMBS bonds could be submitted to the Fed for consideration under the TALF program. Under the program, an owner of CMBS presents his/her positions to the Fed for their consideration to provide financing. The administration of the program by the Fed is quite rigorous. Potential borrowers are screened for eligibility. Investment positions in CMBS must be well documented including that the prospective borrower owns the position and its basis. Readers can take comfort that this program will not provide fodder for headline stories of fraudulent applications. The bonds must all be rated 'AAA' and not be on a rating agency's watch list for potential downgrade. Below is a recap of CMBS presented under the legacy TALF program.

Month	CMBS Submitted (\$s MM)	Cusips Presented	Cusips Accepted	Acceptance Rate
July	\$668.9	36	35	97.2%
August	\$2,283.2	86	83	96.5%
September	\$1,402.0	59	59	100.0%
October	\$2,124.9	86	81	94.2%
<b>TO TAL</b>	<b>\$6,479.0</b>	<b>267</b>	<b>258</b>	<b>96.6%</b>

Source: NY Federal Reserve, BOAML

October was not only a busy month in terms of collateral submitted to the Fed, it also had the largest amount of bonds rejected. These rejections raised some eyebrows in the market. To start, given that the September submission was entirely accepted by the Fed, there was a certain confidence growing about the process and the bonds that could be submitted. Clearly, the market is still in a position to be surprised by the Fed, which does not provide guidance or color on its decisions. For example, is the Fed operating like any bank that lends money, concerned with portfolio composition and credit diversity? Or does it believe it has accomplished its objective to generate price appreciation of highly-rated CMBS by providing term, non-recourse financing to eligible TALF borrowers? A quick look at trading levels in the highly-rated CMBX tranches demonstrate it has.

In case you were traveling to Mars during the month, here is an update on StuyTown/Peter Cooper Village & Riverton Apartments: New York's Court of Appeals ruled that Tishman Speyer, the current owner of StuyTown, and its predecessor, Met Life, improperly deregulated apartments while they were contemporaneously receiving the J51 tax break from New York City. In layman's lingo, they were double-dipping, i.e., raising rents while lowering their personal tax bill. As we have commented upon previously, this will only exacerbate the dire financial situation at the property. On November 6, the loan was transferred to the special servicer "...to facilitate negotiations on a restructuring of the debt load," said a Tishman Speyer spokesman.

## The Corporate Credit Market

Improving credit fundamentals and "the love of yield" are reducing the level of volatility of credit relative to equity. Case in point: high yield bonds outperformed the Russell 2000 by a hefty 870 basis points in October. Corporate markets have enjoyed a steady stream of credit-friendly news flow. As a result, October marked the eighth consecutive month of positive total returns for corporate credit across all risk classes: investment grade, high yield, and loans. Near term, year-end risk positioning and macro-driven concerns about policy exits are likely to curb further spread narrowing. Given current pricing, the asset class simply has a more normal risk and return distribution than it did a year ago. The exception is the small to mid cap segment of the loan market, where legacy crisis headwinds persist.



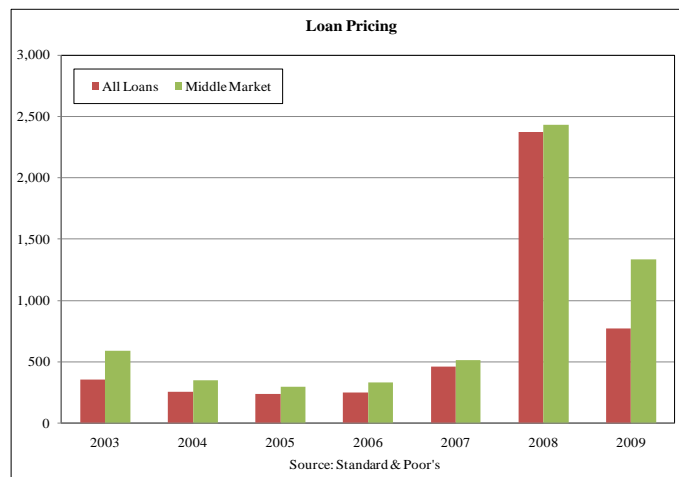
Fundamentally speaking, we learned a number of things last month. More banks will issue equity or sell off non-core assets. It's a tiresome theme but the actions ultimately support credit quality. The CIT Group saga finally came to an end in the form of a prepackaged bankruptcy. Senior bondholders will receive \$0.70 on the dollar and 92% of the new equity in the firm. Under the plan, CIT will emerge with \$10 billion less debt on its balance sheet and no debt maturities until 2013. Finally, the levered loan market was re-ignited by the several transactions: Warner Chilcott reportedly received nearly \$3 billion in orders for its \$1.95 billion term loan. Berkshire Hathaway purchased Burlington Northern Santa Fe. There were also deals announced for IMS Health, GenTek, Grocery Outlet, and Allison Health Care. Note that these days deals don't get done if financing is not a near certainty. Investors have cash and risk appetite to fund transactions and intermediaries are reducing their own risk by funding deals ahead of the actual close. The technicals for credit remain rooted in the unprecedented demand for fixed income, especially in lower quality. High yield garnered the strongest increase of net inflows this year of all fixed income sectors, based on AMG mutual fund flow data. Robust flows into the market signify ample public market liquidity, marking an inflection point in the default rate of around 12 ½%.

While there is activity, there is a hole in this virtuous cycle: size matters. Small- to mid-cap companies have not enjoyed the Fed-fueled liquidity like their larger cap counterparts because they are more dependent on banks for financing. The macro evidence lies in the Fed's own data, the Federal Reserve's Senior Loan Officer Opinion Survey. The net percent of banks tightening credit standards for C&I loans to small companies reached an all-time peak last September, and while off its peak, 14% of banks are still tightening standards. Likewise loan demand is contracting—a net of 36% are reporting weaker demand for C&I loans. Perhaps bankers aren't aware that may be because they are setting their pricing higher—43% of reporting banks are increasing spreads on loans versus their cost of funds.

There are three reasons why the private corporate lending market has not recovered like its public counterpart. First, premier specialty lenders, like GE Capital and CIT, have much smaller balance sheets to commit to the sector. GE Capital for example, while still writing new loans, is likely concentrated on its \$80 billion real estate portfolio. Second, banks are focused elsewhere. At least one large bank has exited the middle market business entirely. Many regional banks are also focused on the troubled real estate loans on their books and trying to preserve capital. Third, the new issue CLO machine, an important distribution channel, is shut down. Given that so many wounded triple-A buyers lie in the battleground of the structured credit space, it's unlikely a vibrant new issue market will emerge any time soon. In sum, credit to small and middle-sized firms has simply experienced more contagion from real estate and all of its derivatives than the rest of the corporate market.

Some of the residual fallout represents structural change, meaning there is no immediate solution to this hole in our virtuous credit cycle. In theory, relative pricing differentials point to new market entrants. In practice, this process is hindered by infrastructure requirements, market frictions, lack of depth in private markets, and lack of transparency that is characteristic of the sector.

There is a pricing differential between middle market secondary loans and the benchmark loan index. The graph below shows the average spread for a three-year middle market loan is currently 1,335 basis points, almost 600 basis points behind the aggregate index. Concurrently, middle market firms have aggressively cut costs. EBITDA has stabilized and Debt/EBITDA leverage has declined an impressive full turn since July, from 4.1x to 3.1x, according to S&P. It is reasonable to assume cost cutting efforts have partially been driven by concerns about access to affordable credit. Friday's jobs data show that the employment picture is still bleak. Large cap companies don't employ the lion's share of U.S. workers. Thus, we are left with the question: Who will give credit where credit is due?





## The Markets

The flip side of the weakening dollar was gold continuing its strong run in 2009. Rates stayed steady and stocks had a mild sell-off but remain up for the year. Let's see what happens in the rest of the year as investors take gains off the table.

	10/31/2009	8/31/2009	10/31/2008	MOM % change	YOY % change
<b>Fed Funds</b>	0.25%	0.25%	1.00%	0.0%	-75.0%
<b>2-year US Treasury</b>	0.893%	0.949%	1.552%	-5.9%	-42.5%
<b>10-year US Treasury</b>	3.385%	3.307%	3.955%	2.4%	-14.4%
<b>10-year JGB</b>	1.415%	1.301%	1.476%	8.8%	-4.1%
<b>10-year euro</b>	3.231%	3.220%	3.900%	0.3%	-17.2%
<b>10-year UK Gilt</b>	3.619%	3.592%	4.524%	0.8%	-20.0%
<b>10-year Canada Treasury</b>	3.423%	3.314%	3.759%	3.3%	-8.9%
<b>30 yr conventional mortgage</b>	4.708%	4.612%	6.301%	2.1%	-25.3%
<b>Dollar Index</b>	76.30	76.65	85.63	-0.5%	-10.9%
<b>Japanese Yen</b>	90.09	89.69	98.26	0.4%	-8.3%
<b>S&amp;P 500</b>	1036.19	1057.08	968.75	-2.0%	7.0%
<b>Nasdaq Composite</b>	2045.11	2122.42	1720.95	-3.6%	18.8%
<b>Gold \$/oz (nearby contract)</b>	\$1,040.40	\$1,008.00	\$718.20	3.2%	44.9%
<b>Oil \$/bbl (nearby contract)</b>	\$77.00	\$70.61	\$67.81	9.0%	13.6%
<b>MBA Refi Index (month end)</b>	2352.5	2857.3	1075.4	-17.7%	118.8%

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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