

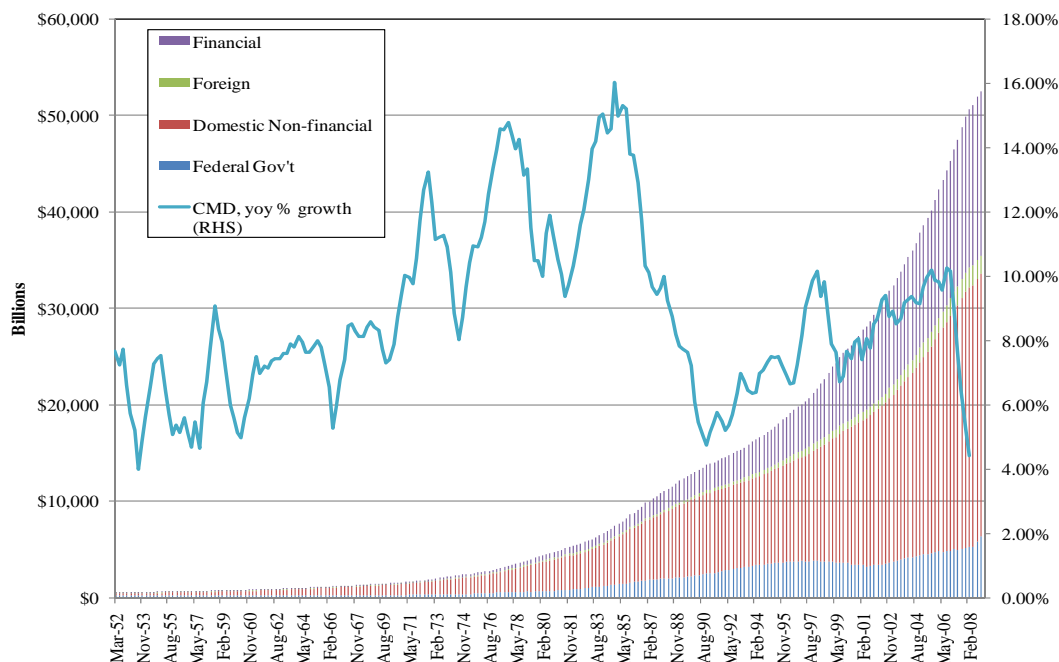


- **The Economy:** *What's bad for Six Flags is bad for America*
- **The Residential Mortgage Market:** *The low impact of 125% LTV refinancing*
- **The Commercial Mortgage Market:** *Re-REMICs come to CMBS*
- **The Markets:** *The MBA Refi Index gets sawed in half*

The Economy

The new poster child for excess leverage is the amusement park operator Six Flags Inc., which filed for Chapter 11 protection on June 13, 2009. To us, the bankruptcy is emblematic of what ails the nation. Typically, firms filing Chapter 11 line up debtor-in-possession loans to help provide working capital during the sometimes lengthy bankruptcy process. In the case of Six Flags, they don't need it. Earnings before interest, taxes, depreciation and amortization (EBITDA) has always covered interest payments, but as the ratio of total debt to total capital ramped up from roughly 60% at the turn of the century to over 100% at the time of the filing, precious little cash remained for operating the business after servicing the debt. It borrowed for growth and ended up with the wrong capital structure for this economic downturn. In other words, Six Flags would be fine *if it weren't for the debt!* Relieved of the burden of interest payments, the company estimates that it will have plenty of working capital. If only it were that easy for the U.S. consumer, state and local governments and the U.S. Treasury.

But it isn't so easy. Six Flags had \$2.4 billion in debt outstanding at the time of the filing, and while it won't be pleasant for those creditors, the world won't miss Six Flags (or its annoying but memorable TV commercials) when it's gone. On the other hand, the world is surely feeling the effects of a massive debt contraction in the U.S., even as the Federal Reserve and U.S. Treasury heroically step into the breach. According to the Federal Reserve flow of funds data, the whole domestic nonfinancial sector (household, consumer, non-financial corporate, farm and state and local government debt) has shrunk as a percentage of total credit market debt (CMD) from over 70% at its peak in the early 1970s, to just 50% of the total today. In dollar terms, this sector has now declined two quarters in a row; up until now, there had never been even one quarterly contraction. In this bucket are both mortgage debt and consumer credit. Mortgage debt outstanding has fallen over \$100 billion since its peak in the first quarter of 2008, and consumer credit has fallen in seven of the last eight months, the worst string since 1991. The domestic financial sector (ie, repo, financial corporate debt, etc.) now makes up over 30% of CMD outstanding, up from less than 3% back in the 1950s, but it contracted over \$70 billion during the 1st quarter (the first quarterly drop since 1975).





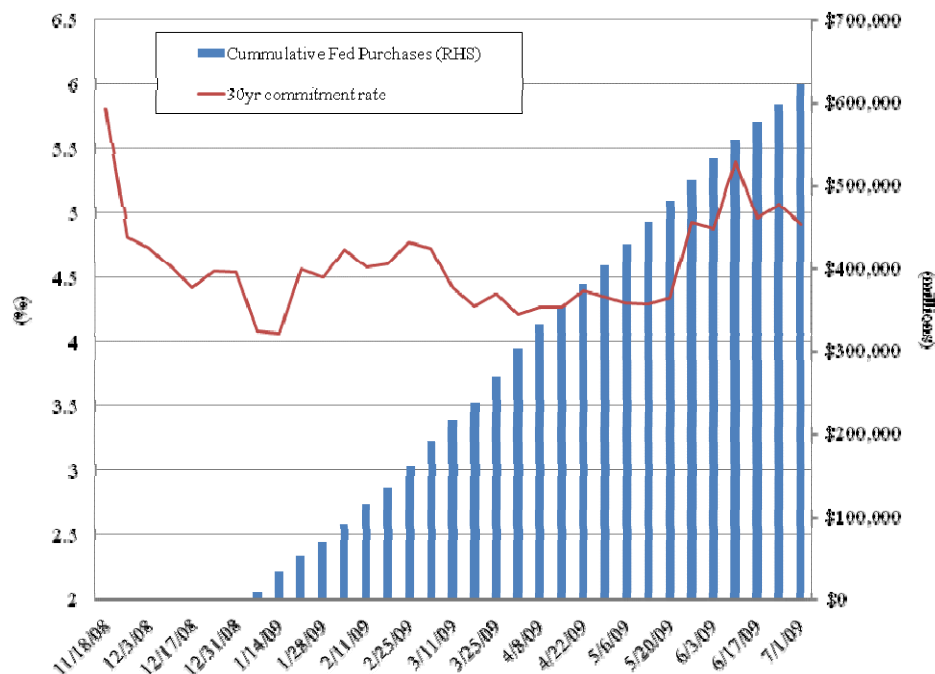
On an aggregate, economy-wide basis, can you call this deleveraging? Technically, no, because the staggering growth in federal government debt has so far made up for the contraction in other sectors (see the blue line above). But the U.S. government only accounts for 13% of CMD (down from nearly 45% after WWII). In the last three quarters alone, U.S. government debt has increased over 30%, or \$1.5 trillion. We are witnessing the deleveraging of the non-federal sector and the re-leveraging of the U.S. government. While we are uncertain about the government's ability to keep total CMD outstanding from falling (the latest YOY growth rate is the weakest in the time series), this much is clear: a negative print for CMD growth will be a bell-ringer. And stagnant debt growth will mean stagnant economic growth and a strong deflationary undertow.

On that last point, we have three observations to go along with the seemingly inflationary portent of a doubling of the Fed's balance sheet and the monetary base. First, it's been a step function, not a persistent trend. It took the Fed only 5 months to ramp the monetary base from \$840 billion to \$1.7 trillion, but for the last several months it has trended sideways or down. Second, not coincidentally, excess reserves at the Fed also increased by roughly \$800 billion over the same time. Those reserves are just sitting there, earning interest, not permeating the economy. Third, money supply growth (as measured by M2 or MZM), while higher than average, hasn't even broken the highs of 2001 and 2002. The mechanism by which the Fed generates money supply growth is being hampered by a financial system still in distress, and a consumer that lacks the willingness and ability to create new credit. It all makes one want to go take a roller coaster ride at Six Flags.

The Residential Mortgage Market

Prepayment speeds for May (June release) were largely unchanged month over month for 30-year Fannie 6s and 6.5s, while 30-year Fannie coupons of 5.5% and lower increased 10% to 20% in line with most estimates. Looking ahead, most dealers are anticipating a 10% to 20% decrease in speeds month over month due to the dramatic rise in mortgage rates observed in May.

The Administration's efforts to spark a refinancing wave are proving to be ineffective for a number of reasons. For one, housing values keep slipping. So on July 1, the Federal Housing Finance Agency authorized Fannie Mae and Freddie Mac to raise the Home Affordable Refinance Program LTV ceiling from the current 105% to 125%. While on the surface this may seem like a potential boom for future prepayment speeds, it most likely will end up only marginally affecting speeds. Goldman Sachs estimates that only 7% of the MBS universe lies in the 105% to 125% LTV bucket, while Bank of America similarly estimates it at 6% with the majority falling in the higher coupons that likely have some credit issues. In any event, these changes will no doubt take time for the GSEs and originators to implement so if there is any related increase in prepayments, they most likely would not flow through until the end of this year. But lest we forget, the Fed is over \$600 billion into its buying program of Agency MBS, and the 30-year Fannie Mae commitment rate has barely budged.





The Commercial Mortgage Market

As we reported in last month's commentary, S&P had sent seismic shock waves through the CMBS market by soliciting comments on proposed new ratings methodology. On June 26, S&P issued its report entitled "The Potential Magnitude of Rating Changes Resulting from Our U.S. CMBS Criteria Update." The rating agency also released a list of bonds it was placing on review for possible downgrade.

S&P added 1,586 tranches from 209 conduit deals to CreditWatch negative. These bonds are now added to the 1,982 tranches that the rating agency has currently watchlisted (negative, of course). Most of the actions were in line with the prevailing view that 2006-2008 CMBS vintages are suspect for their aggressive underwriting. This characterization was affirmed by the fact that approximately 73% of the classes rated 'AAA' from those years are now watchlisted. There was a negligible amount of watchlisted items prior to the 2004 vintage and none prior to the 2000 cohort.

While there was faint hope that S&P might back down from its position, we discounted that possibility due to accelerating credit concerns. First, 30+ day CMBS delinquency spiked to 4.11% from 2.75% largely due to the inclusion of the General Growth Properties (GGP) loans, which are now just paying interest-only. We generally focus on the 60+day delinquency rate as we believe it is more indicative of worsening credit trends, and this rate spiked by 40 basis points from the prior month to 2.49%. This metric will likely increase significantly next month once the GGP loans make their way through the system. Second, the latest Moody's/REAL commercial property index (CPPI) declined 8.6% for April 2009. This was the largest decline for any one month and represents declines of 25.3% for the last twelve months and 29.5% from the peak measured in October 2007.

Even with credit concerns mounting and S&P having watchlisted thousands of securities, a price rally in senior CMBS would have been the last thing investors would have guessed. However in mid-June, a structure more commonly observed in the non-agency RMBS market appeared on the scene—the re-REMIC (REMIC is short for Real Estate Mortgage Investment Conduit, which is a vehicle used to pool mortgage loans and issue mortgage-backed securities). In its simplest form, a re-REMIC is a resecuritization of a targeted bond into two classes, a senior and subordinate security. The senior bond should now be relatively stable and maintain its AAA rating since it benefits from both the subordination of the existing credit enhancement as well as the credit support provided by the subordinate bond. The senior bond obviously prices tighter than its subordinate counterpart yet still produces a respectable single digit yield. This product is attractive for institutions that are sensitive to ratings classifications while earning a significant spread versus other comparably rated spread products. The junior security will be attractive to financial vehicles such as hedge and opportunity funds who can withstand ratings volatility particularly given the security's higher yield. At last count there were six re-REMIC transactions that were listed in the market totaling approximately \$1.8 billion. But if prices of the senior CMBS that are the fodder for re-REMICs continue to rally, then the economics of the structure will get less attractive.

The Markets

June was mostly quiet from point to point, with some volatility in between. The MBA Refinancing Index was sawed in half in the month, reflecting the headwinds in the market—higher mortgage rates, reduced capacity, falling house values, lack of product choice, economic stagnation. And the year-over-year change in oil makes us realize how volatile the commodity is.

	6/30/2009	5/31/2009	6/30/2008	MOM % change	YOY % change
Fed Funds	0.25	0.25	2.00	0.0%	-87.5%
2-year US Treasury	1.113%	0.919%	2.620%	21.1%	-57.5%
10-year US Treasury	3.535%	3.461%	3.971%	2.1%	-11.0%
10-year JGB	1.359%	1.490%	1.601%	-8.8%	-15.1%
10-year euro	3.386%	3.589%	4.621%	-5.7%	-26.7%
10-year UK Gilt	3.690%	3.747%	5.130%	-1.5%	-28.1%
10-year Canada Treasury	3.364%	3.385%	3.734%	-0.6%	-9.9%
30 yr conventional mortgage	4.936%	5.020%	6.157%	-1.7%	-19.8%
Dollar Index	80.13	79.23	72.46	1.1%	10.6%



Japanese Yen	96.32	95.59	106.19	0.8%	-9.3%
S&P 500	919.32	919.14	1280.00	0.0%	-28.2%
Nasdaq Composite	1835.04	1774.33	2292.98	3.4%	-20.0%
Gold \$/oz (nearby contract)	\$927.40	\$978.80	\$928.30	-5.3%	-0.1%
Oil \$/bbl (nearby contract)	\$69.89	\$66.31	\$140.00	5.4%	-50.1%
MBA Refi Index (month end)	1482.2	2953.6	1269.2	-49.8%	16.8%

Source: Bloomberg; Japanese Yen quote is the London feed

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