



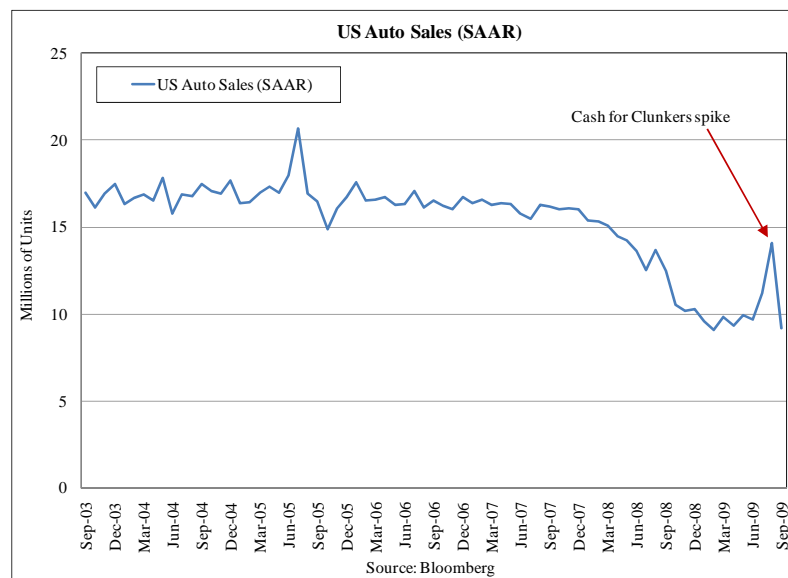
- **The Economy:** *A year after the crisis flash point, problems remain*
- **The Residential Mortgage Market:** *The ramifications of September 23rd*
- **The Commercial Mortgage Market:** *CMBX tightens; StuyTown and the Riverton update*
- **The Corporate Credit Market:** *We roll out our corporate credit observations*
- **The Markets:** *All markets rise, the dollar falls*

The Economy

It's been one year since the near-collapse of the global financial system. Re-reading our [contemporaneous commentary](#) reminds us how far we've come since that eventful month: "[E]ven bears like us who knew that this would all end very badly can't say that we foresaw many of the specifics of the denouement: venerable Bear Stearns and Lehman Brothers out of business; Fannie Mae and Freddie Mac in the government's conservatorship; AIG only alive because it was too big to fail; Bank of America acquire Merrill Lynch; Morgan Stanley and Goldman Sachs repudiate the bulge bracket investment-banking model and become bank holding companies; General Electric need to raise \$15 billion in new equity capital; California and Massachusetts ask for federal assistance; Congress pass in record time two landmark pieces of legislation—the Housing and Economic Recovery Act of 2008 and the Emergency Economic Stabilization Act of 2008; deposit insurance caps lifted both here and around the world; massive hedge fund losses; commodity prices plunging the most in 50 years; the Treasury guarantee money market funds; a country near bankruptcy (Iceland); and finance ministers and central bankers around the world pledge to do whatever was necessary to fix the problem. This is a long, terrifying list of events, and almost all of it occurred in the last 30 days."

We've come a long way since then. The efforts of government policy makers have been directed at improving market liquidity and staving off an economic depression. It's safe to say that these efforts have worked, at least for the short term. We're not so sure about the long-term. We believe that the exit strategy from the government support programs could prove to be more destabilizing than the events that brought them on.

For example, we addressed the Cash for Clunkers in our last commentary—a perfect microcosm of government market intervention. One month after its expiration, the program is now available for a post-mortem. Vehicle sales, after popping to an annualized rate of 11.25 million and 14.09 million in July and August, respectively, fell back to 9.20 million in September.

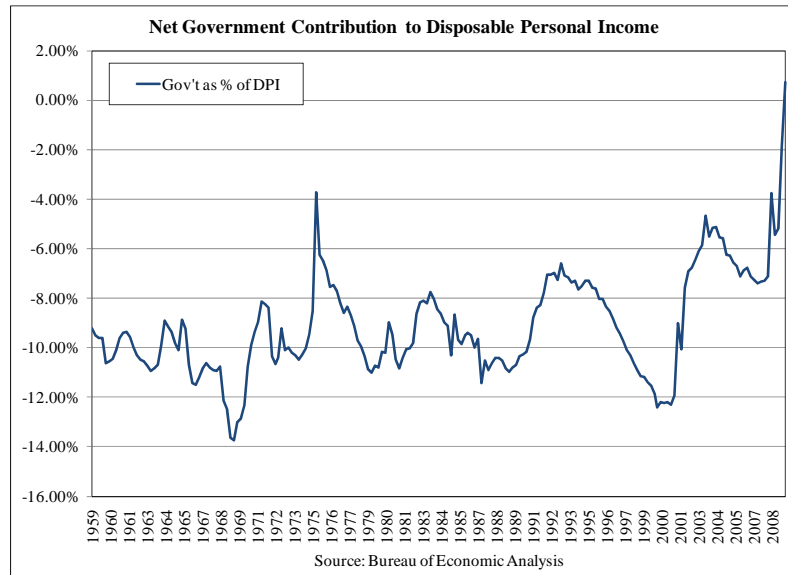


The conclusion? It was a one-off trade of current consumption at the expense of future consumption. While it may provide a bump to third quarter GDP, Cash for Clunkers had virtually zero long-term benefit and will likely hurt future car sales. We would



wager that the \$8,000 first-time homebuyer credit, set to expire November 30, 2009, will have the same transient effect. The National Association of Realtors estimates that 30% of recent activity has been due to this credit, and they and others are doing some heavy lobbying to have it extended beyond its deadline. See the link on NAR's website titled ["Call for Action"](#) which beckons realtors to write their legislators; thus far 142,810 have called on their congressman to extend the credit, because "Otherwise, uncertainty will return and the market might again be frozen—possibly as soon as October." In a similar vein, there is a proposal coming from Capitol Hill that would give employers tax credits for creating new jobs. The credit would reduce the payroll tax paid by companies for new employees for up to two years. Bill Rys of the National Federation of Independent Business told the New York Times why he thought this was a bad idea: "Why would a business hire a new worker? They're hiring because they need to do work. Unless you have work to do, it's still an expense."

Stimulus programs are a match in search of something flammable. But the graph below shows that the government is also just giving money directly to the people. For the first time since measurements began, the government has been a net contributor to disposable personal income. We calculate this as income received from transfer payments (social security, unemployment, etc), less payments into these programs and taxes paid on income. The Government giveth....what happens when it taketh away?



The Residential Mortgage Market

Driven by continued slowing in refinancing activity and two fewer business days, aggregate 30-year FNMA conventional prepayment speeds fell by 4 CPR in August (September release) to 14.2 CPR. There was a modest increase in higher coupon credit-impaired 30-year FNMA 6.5s and 7s, which may be a harbinger of faster speeds on super premiums thanks to Housing Affordability Modification Program-related buyouts. Looking ahead, most dealers' expectations are for tamer speeds over the next few months with September speeds flat to 10% higher than August.

There were two major announcements during the month of September that relate to mortgage spreads, both of which occurred on September 23rd. On the morning of September 23rd, Vanguard announced it was changing the index tracked by 12 bond funds to exclude mortgage-backed securities held by the U.S. government. With the Federal Reserve purchasing close to \$1 trillion in MBS under their purchase program they have dramatically reduced the universe of Agency MBS available to bond fund managers, many of whom aim to achieve an excess return over an index, thus making any index difficult to track let alone beat. A "float adjusted" index, stated Gus Sauter, Vanguard's Chief Investment Officer, "more accurately represent an investor's opportunities in a particular market." While this reclassification will help index-tracking managers beat their benchmarks, the shift in benchmarks is likely to have only a minor effect on spreads, because bond managers' buying habits won't change very much. Barclays Capital estimates that the Fed currently owns 90% of the outstanding 4% coupon and 80% of the 4.5% coupon.

Later that day, the FOMC announced that it "will gradually slow the pace of MBS purchases in order to promote a smooth transition in markets and anticipates that they will be executed by the end of the first quarter of 2010." As Bank of America research summarized, the recent Fed statement is unquestionably a positive for MBS for three reasons:



1. The Fed will buy all of the \$1.25 trillion authorized under the program, easing concerns that they will buy less than the committed amount.
2. If the Fed wishes to achieve their target of completing the program by the end of the first quarter of 2010 they will have to purchase \$70 billion a month, or roughly 70% of total origination.
3. By extending their buying program to the end of March 2010 and pledging a gradual wind down, the Fed has avoided a potentially dramatic sell off in both the MBS and Treasury market via duration coming into the market.

Positive technicals will continue to follow agency MBS through 2009 and into 2010. There is still uncertainty about market conditions beyond March 2010, but it is likely there will be wider spreads.

The Commercial Mortgage Market

There has been a sharp rally across the board in the CMBX, the groups of indices that are made up of 25 transactions of CMBS that were issued from 2005 to 2008. Overall, CMBX prices rallied approximately 5 to 15 points during September.

On September 15, new guidelines issued by the Treasury and the IRS gave more flexibility to special servicers to modify commercial mortgage loans with borrowers. Under the new guidelines, a special servicer could be more proactive in discussions with borrowers dealing with potential problems versus waiting until the loan is practically in default. Proactive discussions about imminent commercial mortgage defaults can have the impact of softening the outcome by mitigating and delaying losses. While the benefits of a modification are singularly enjoyed by the borrower, bondholders in the structure may be affected differently. These divergent interests of the bondholders were previously described in our March 2009 Commentary.

Given that the rally affected indices whose underlying mortgages were created during the most notorious periods for egregious underwriting practices, only certain mortgages from those vintages will benefit from proactive involvement by special servicers. Those properties must have some visible economic viability to be considered for a modification. It is our opinion that many loans funded during this period, particularly 2007/08, are significantly under water and any modification which lacks a debt forgiveness covenant will have little, if any, effect on the future performance for that loan. Given our view, we were a little surprised at the breadth of the rally.

So while new guidelines may have been a catalyst for some of the mid-month rally, prices were rallying before and after the announcement. Part of the reason is simply supply and demand. J.P. Morgan reports that the net supply of securitization securities relative to Treasuries for the first time since 2000 was negative in 2008, not surprisingly, by \$384 billion. For the seven months ending July 31, 2009, the deficit of investable securitization securities was \$704 billion. On the demand side, retail inflows into bond funds since mid-March 2009 have been 10 times as strong as equity fund flows. And while U.S. corporate issuance has remained unabated with September 2009 weighing in at \$152 billion, the busiest September on record, spreads have still tightened (see the Corporate Credit commentary below). Clearly, with wind coming out of the sails for corporate performance, investors have been searching for other investable product. Coupling that interest with price support programs such as TALF and PPIP, it is not surprising that CMBS prices have been rallying in concert.

StuyTown/ Peter Cooper Village & Riverton Apartment Updates: In our February 2009 Commentary, we introduced readers to the dubious underwriting standards for loans to these two closely-watched projects. Below are updates to their financial situations.

The September remittance report for StuyTown indicates that only \$33.6 million remains of the initial funded interest reserve of \$400 million. Approximately \$16.0 million was funded during September for debt service shortfalls. Given the math, StuyTown will default before year end without either a significant modification or an infusion of equity. Additionally, on September 11, lawyers representing both the landlord and the tenants made oral arguments to the State of New York Court of Appeals, the State's highest court. The argument centered on the ability of landlords to move apartments to market rents if the property benefited from the J-51 tax program. The ruling is expected in six weeks and the settlement could total \$200 million. Obviously, if the landlord loses, the decision will add to the financial burden of the property.

In September, the Riverton was appraised at \$108 million versus an original value of about \$340 million and first mortgage of \$225 million. While this does not translate into an immediate loss for the trust, it does give a pretty good indication that the ultimate loss severity will be in excess of 50%. This severity does not account for the \$25 million of mezzanine debt subordinate to the first mortgage which is worthless.



The Corporate Credit Market

The credit market continued its pattern of delivering “non-normal returns” in September. In the table below, we show monthly and 2009 YTD performance. Last year’s unprecedented events, which drove valuations to historic extremes, set the table for 2009’s strong performance. Even high grade corporate bonds, at 18.3%, have generated “equity like” double-digit returns. This is one trend that, unfortunately, has its bounds. The math is simple: the erosion of those sizable early-year yields equate to a lower rate of performance potential from the asset class. Looking forward, credit returns are likely to have more normal risk-return profiles.

How much more upside?				
<u>Sector</u>	<u>Yield</u> <u>12/31/08</u>	<u>Yield</u> <u>9/30/09</u>	<u>September</u> <u>Total Return</u>	<u>YTD</u> <u>Total Return</u>
Investment Grade	7.83	4.98	2.00	18.30
Financials	8.53	5.56	2.76	16.38
Nonfinancials	7.43	4.66	1.59	20.11
BBBs	9.67	5.77	2.42	28.60
High Yield	19.57	10.21	5.98	48.54
BB	14.63	8.03	4.42	38.84
B	18.15	9.80	4.95	40.86
CCC	31.08	14.53	10.15	78.28
Loans	n/a	n/a	3.30	48.40
10-yr Treasury	2.25	3.31	1.07	-6.34

Source: BAC-ML and Morgan Stanley

Arguably, much remains “non-normal” about the macroeconomic landscape. At best, forces ranging from global competition, interventionist governments, impending regulation, to demographics cloud the long-term visibility of the economic trajectory. Concurrently, at the microeconomic level, firm behavior is adhering to a normal cycle. Specifically, a classic, near text-book perfect credit recovery process is in full swing. Firms are: 1) engaging in restructuring efforts to boost cash flow and improve liquidity; 2) managing leverage with free cash flow, asset sales and new equity; and 3) right-sizing industry capacity (lower cap-ex, M&A, etc.) in the pursuit of margins.

The massive corporate new issue calendar presents an excellent example of how corporations are exploiting both the low rate backdrop and the market’s improved risk appetite. The lion’s share of supply is earmarked for debt management. (See our September 29 [blog post](#) on this point.) In fact, according to the Fed’s Flow of Funds, nonfinancial firm debt has declined over the past year. Likewise, for this group, the cash-to-asset ratio has returned to 1950’s era highs. For now, maturity extension helps mitigate liquidity risk in the corporate market. Another sign of the return to normal is that the recent actions of high yield companies to re-finance bank debt with senior unsecured debt means that capital structures are becoming less “upside down” than they were in the days of rampant issuance of LBOs, CLOs, and Total Rate of Return Swaps.

Firms continue to sell noncore assets and raise equity. In September, these actions were evident in REITs, Basic Industries, and Financials. Non U.S. banks either issued equity or announced plans to raise equity. U.S. financial institutions sold assets and announced plans to repay government funds. Another sign of deleveraging is the financing gap for nonfinancial firms. The ratio of capital spending to internal funds is now below 1. It’s also important to recognize the short-comings of basic metrics around cycle turns. For example, last 12 months leverage – which currently stands at a cycle high — is likely to be biased by depressed Q4-2008 and Q1-2009 EBITDA.

Mergers emerged as a more dominant theme in September. At this stage, it is premature to conclude that recent events presage “merger mania” given that deals have been concentrated in the Consumer Products and Pharmaceutical sectors. Nonetheless, the



“normal cycle” is in its nascent stages: weak expectations for top line growth will continue to incent free cash flow generation and firms will use mergers to take-out excess capacity, engage in bolt-on acquisitions, or transform business models. The strong will buy the weak. In time, lean cost structures and lower capacity will drive margin growth.

In sum, if one is looking for normal, they will find it in corporates. Unlike consumers, non-financial firms abstained from the millennium’s debt party. Hence, the 2009 rally in corporate credit market is commensurate with the behavior of firms that are managing balance sheets and operational risk with great care. The challenge now is presented by slimmer valuations and low yields. As a result, we expect that total returns for high yield will become more correlated to equity and investment grade total returns will become more correlated to interest rates. Now that’s normal.

The Markets

In an amazing display of market correlation, in September bonds, stocks, gold and oil all rallied. All the while the dollar was slipping. These markets should talk to each other.

	9/30/2009	8/31/2009	9/30/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	2.00%	0.0%	-87.5%
2-year US Treasury	0.949%	0.972%	1.964%	-2.4%	-51.7%
10-year US Treasury	3.307%	3.399%	3.825%	-2.7%	-13.5%
10-year JGB	1.301%	1.310%	1.472%	-0.7%	-11.6%
10-year euro	3.220%	3.257%	4.015%	-1.1%	-19.8%
10-year UK Gilt	3.592%	3.556%	4.449%	1.0%	-19.3%
10-year Canada Treasury	3.314%	3.375%	3.757%	-1.8%	-11.8%
30 yr conventional mortgage	4.612%	4.840%	5.770%	-4.7%	-20.1%
Dollar Index	76.65	78.17	79.45	-1.9%	-3.5%
Japanese Yen	89.69	92.83	106.19	-3.4%	-15.5%
S&P 500	1057.08	1020.62	1166.36	3.6%	-9.4%
Nasdaq Composite	2122.42	2009.06	2091.88	5.6%	1.5%
Gold \$/oz (nearby contract)	\$1,008.00	\$952.20	\$874.20	5.9%	15.3%
Oil \$/bbl (nearby contract)	\$70.61	\$69.96	\$100.64	0.9%	-29.8%
MBA Refi Index (month end)	2857.3	2164.1	1333.9	32.0%	114.2%

Source: Bloomberg; Japanese Yen quote is the London feed

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