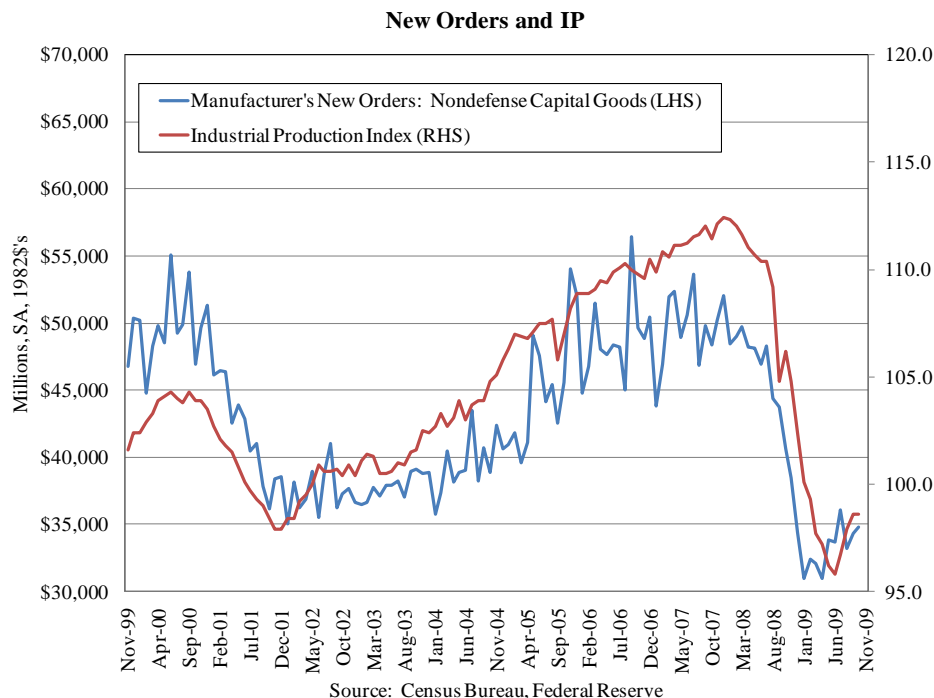




- **The Economy:** *Still looking for the building blocks of recovery*
- **The Residential Mortgage Market:** *The analysis of involuntary prepayments*
- **The Commercial Mortgage Market:** *The halting steps of rebirth of CMBS recovery*
- **The Corporate Credit Market:** *Trends and themes in corporate credit from the BOAML conference*
- **The Markets:** *The weak dollar pays dividends for dollar-based investors*

## The Economy

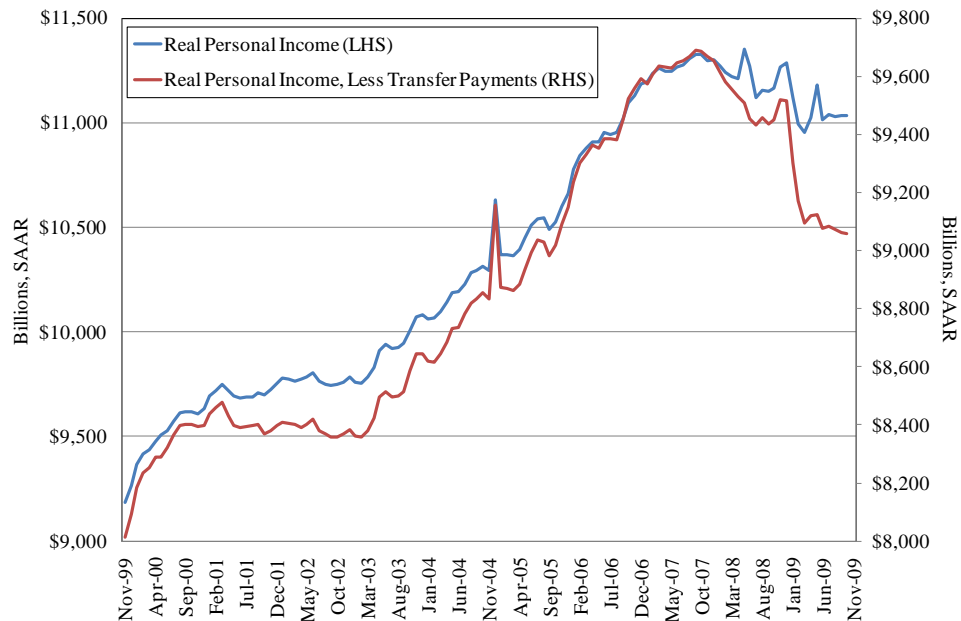
The economic data released in the month of November could be categorized as mixed. Business inventories continue to fall, as well as consumer credit outstanding. Consumer confidence bumps along at a depressed level. Initial jobless claims show signs of stabilizing, while the jobless stay unemployed for longer. Third quarter GDP was revised down to 2.8% from the initial 3.5%, thanks to moderation from the first reading in virtually every category. The non-manufacturing ISM Index ticked back into contractionary territory by the end of the month. The manufacturing sector, the target of much of the stimulus so far, seems to be taking the growth lead, albeit “growth from a lower base.” The two lines in the graph below are representative of the dramatic fall-off in the manufacturing sector.



Manufacturers' new orders of non-defense capital goods (shown here at a seasonally adjusted annualized rate) is a component of the Conference Board's index of leading indicators; industrial production is a coincident indicator. The third quarter bounce in GDP growth was helped by the beginning of an upturn, but new orders are still below the recessionary levels of roughly eight years ago. Perhaps a clue to why this is so can be found in the following chart.



Widening Disparity



Source: BEA

One of the inputs that the National Bureau of Economic Research uses to judge our location in the business cycle is real personal income less transfer payments (i.e., entitlements like social security and unemployment benefits). Real personal income including transfer payments (the blue line) and real personal income less transfer payments (the red line) are both still falling, but the government support has never been stronger, making the disparity between the two wider than ever. Transfer payments now stand at an all-time high of 18% of real personal income. Sustainable growth in new orders and industrial production needs top line revenue growth, which needs income growth.

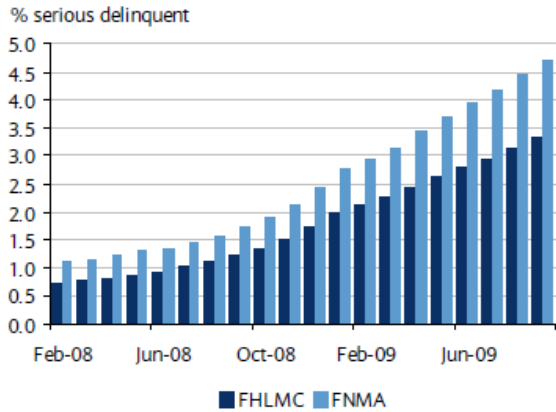
Fortunately, job losses slowed dramatically in November according to the Bureau of Labor Statistics (only a loss of 11,000 versus losses of over 100,000 in the previous month), but less dramatically according to ADP (-169,000 versus -195,000 in the previous month). The unemployment rate fell to 10% in November from 10.2% in the previous month. While these encouraging numbers could be a sign that the healing process is further along than many believe, it would be nice to see a reversal in the continually-falling labor force participation rate, which is now 65.0% (down from over 66% in 2008 and a peak of 67.3% in early 2000). In the recent month, 98,000 workers left the labor force (those that are employed plus those that are unemployed but looking for work) and, at 153.9 million, it currently stands at roughly the same level as 4<sup>th</sup> quarter 2007/1<sup>st</sup> quarter 2008.

## The Residential Mortgage Market

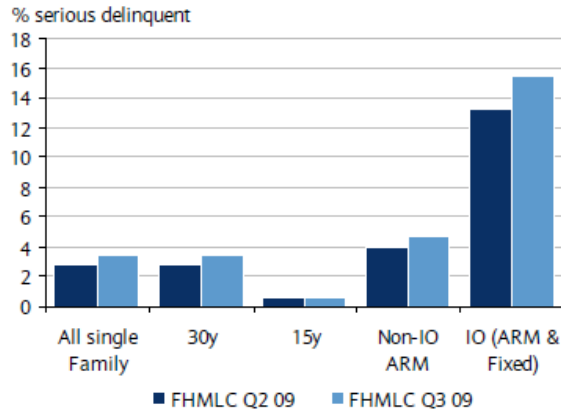
Prepayments speeds in October (November release) on 30 year FNMA fixed rate mortgage-backed securities increased 18% month over month. Evidence of assistance program buyouts was strong, as speeds on credit-impaired collateral with high loan-to-values (LTVs), or low FICO scores, steadily continued to ramp. This trend is expected to continue as most dealers are estimating speeds to increase on Home Affordable Modification Program (HAMP) related modifications going forward. MBS investors can reasonably expect 15-20% month-over-month increases in prepayment speeds for the next several months.

Low rates and HAMP-related modifications may not be the only drivers of prepayment behavior going forward. Under their current charters, both Fannie Mae and Freddie Mac are required to buy out loans that are 24 months or more delinquent from the MBS trust—such a buyout would result in a prepayment. Many delinquent loans are nearing their two-year anniversary: Should MBS investors be concerned about this technical factor?

There is no question that delinquencies on loans underlying Fannie Mae and Freddie Mac MBS are increasing along with the rest of the mortgage market. The graphs below, provided by Barclays Capital, illustrate both the steady ramp as well as the delinquency breakdown by product:



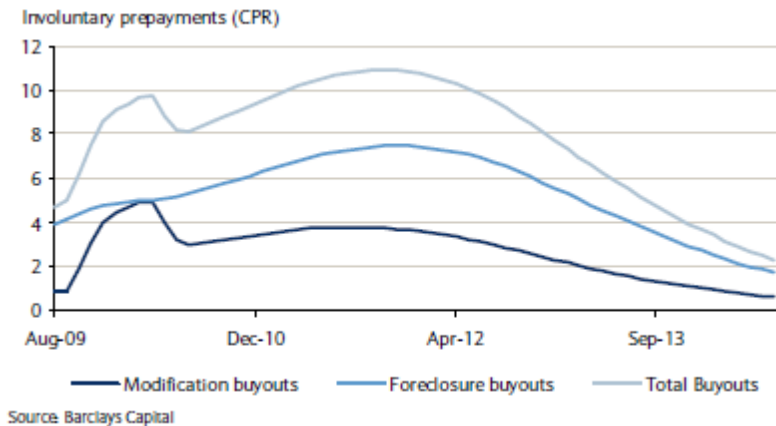
Note: 90-day delinquencies by loan count. Source: FNMA, FHLMC, Barclays Capital



Note: 90-day delinquency rate by loan count. Source: FHLMC, Barclays Capital

There are exceptions to the 24-month buyout rule, including any loans that are in a repayment plan, pursuing a short sale or “deed-in-lieu of foreclosure,” or in any stage of foreclosure. Furthermore, FNMA’s servicing guidelines requires that the “foreclosure process be started when a loan is 105 days delinquent unless it is being evaluated for loss mitigation” according to Barclays Capital. These exceptions to the 24-month buyout rules suggest that buyouts from loans that are 24 months or more delinquent will not be a serious driver of prepayments going forward.

While rate-related “voluntary prepayments” will always be a factor going forward, prepayment behavior at the margin will likely be driven by “involuntary prepayments”—initially by HAMP-related modifications followed eventually by foreclosures, both of which look like prepayments to the Agency MBS investor. Barclays estimates that the initial modification-induced spike in speeds should peak in first quarter 2010, with the second wave of foreclosure-led prepays cresting in late 2011 through early 2012. See the graph below. Given the current housing market, this may be a conservative scenario.



Source Barclays Capital

## The Commercial Mortgage Market

The long-awaited \$400 million Developers Diversified Realty Corporation (DDR) CMBS transaction was priced on November, 16, 2009, the first transaction to be issued with the AAA securities eligible for financing under the Federal Reserve’s new issue TALF program. Demand for the transaction was strong, evidenced by the lowering of levels from the initial marketing phase to final pricing. For example, the lowest-rated or ‘A’ class representing a cumulative LTV of 51.7% and debt yield (net operating income/debt, a measure of debt service) of 16.5%, respectively, was eventually priced to a yield of 6.25% from initial indications of 8.5% to 9.5%. The new issue TALF eligible AAA class totaling \$324 million was ‘price talked’ at Swaps+175 to 200 basis points (bps). The class ended up priced at S+140 bps for a yield of 3.81%. Curiously, only \$72 million of the AAA securities were presented to the Federal Reserve for financing under the TALF program. The final pricing provided a very favorable all-in execution for DDR of 4.20%.



This was the first true CMBS transaction to hit the market since June 2008. Underwriting and loan structure returned to metrics that should enable the investors to realize both a return on and return of their investments on a timely basis. Aside from utilizing current cash flows and valuation metrics that resulted in a low LTV and substantial borrower equity, the transaction incorporated several lender-friendly structures. Since the AAAs were TALF eligible, the Fed has appointed an operating advisor to oversee everything.

Speculation was rampant as to why the transaction took so long to get to market since it became known during the summer. Investors suspected the Fed may have been the clog because it was the first transaction undergoing new issue TALF scrutiny. While there could be some validity to that position, remember that the stated objective of the new issue TALF program was to restart the multi-borrower CMBS market. This transaction, while conservatively underwritten and structurally clean, was nevertheless a single-borrower transaction and therefore carried the sole default risk of DDR. Perhaps the single borrower bankruptcy of GGP (see [our April 2009 commentary](#)) was weighing on the Fed's mind.

Whether this transaction will jumpstart the CMBS multi-borrower origination machine is a leap for many of the participants. We would argue it has a way to go because investors want to focus on more simple transactions initially. Single borrower deals such as DDR fit that description. As for multi-borrower originations, there are still serious concerns, as we update below.

The credit crisis exposed many faults in the CMBS machine including aggressive and shoddy underwriting by originators, lax approval and oversight by the rating agencies, and non-alignment of interests between senior certificate holders and special servicers (see [our March 2009 commentary](#)). However the one fundamental flaw to the entire process was that no one had any 'skin-in-the-game,' or ongoing financial interest. The most subordinate investor with real equity, or B-piece buyer, not the mortgage originator, decided what collateral would ultimately be securitized. Unfortunately, the proliferation of CDOs and REMICs cashed out the equity of these B-piece buyers and eliminated the last party that should have had 'skin-in-the-game.'

The Financial Stability Improvement Act of 2009 is the current administration's effort to rewrite the financial system. A component of the bill was the requirement that issuers/originators of all asset-backed securities retain a nominal interest of 10% in the transactions they originated and securitized. In November 2009, the House Financial Services Committee voted unanimously to approve an amendment that reduces the maximum retention requirement from 10% to 5%. After much lobbying, the amendment was later customized to reduce the retention requirement for CMBS transactions to zero.

Unfortunately, this modification, coupled with renewed investor appetite for risk, will likely again prove to be the undoing of the revived CMBS market. All of the major contributors to the mortgage origination process will be incentivized to do larger volumes with weaker investor protections. Their reward for success is short-term, while the assets they create are long term. Wouldn't it be best if the underwriter/originator/sponsor stayed along for the ride?

## The Corporate Credit Market

A bottom-up analysis of the U.S. corporate landscape underscores the significant de-risking of the sector over the past year. Many themes apply to the behavior of corporate management teams, the most pervasive being the acute focus on liability management. The result is likely to be a significantly lower level of adverse macroeconomic volatility from the sector in 2010.

In early December, Bank of America Merrill Lynch held its annual High Yield Issuer conference. The conference was a two-day event with 145 high yield corporate issuers presenting and over 1,500 people in attendance (versus 350 in 2008). This month we highlight the key takeaways from the conference:

- The more leveraged part of the U.S. corporate sector is operating under a "lean and mean" business model. In general firms are managing to "cash flow" rather than growth.
- Many companies have reduced capital expenditures (cap-ex) to maintenance levels. Very few are budgeting higher cap-ex in 2010 and some still had cuts planned.
- Most companies noted job cuts as part of expense management strategy. While there were no indications more where planned, no one expressed hiring intentions for 2010.
- Despite building good liquidity positions in the downturn, management teams expressed that "balance sheet management" remains a key focus. Most were very pleased by the recovery in capital markets and had successfully engaged in "liability management strategies" in 2009.
- With respect to the macro landscape, "lack of visibility rather than doom and gloom" characterizes the general psyche of the group. Corporations have greatly reduced operating and financial risk. The 2<sup>nd</sup> half of 2010 is when most firms expect to see top line growth.



- Some boom-cycle LBOs are performing, while others are just surviving. Basically, the non-cyclical strong free cash flow firms have delevered whereas the cyclical names are managing liquidity risk. One question for 2010 will be the extent to which private equity firms monetize investments with IPOs or special dividends.
- Profitability vs. market share was a big theme. While many firms were focused on gaining market share in the downturn, there now appears to be sticker shock associated with further cannibalizing margins with price cuts. Firms in higher margin industries were much more likely to protect revenue and market share with cost cuts.
- What a difference a year makes: no company expressed lack of credit availability as an impediment to conducting business. There were some interesting undercurrents. Hertz is transiting its fleet away from GM and Ford product to Toyota, Nissan, BMW and Mercedes in part because they get better rates on ABS financing if the underlying manufacturer has an investment grade credit profile. Likewise, Ford Motor Credit expects to rely on the ABS market for most of its 2010 financing given the pricing differential between triple-A ABS and its B3/B- rated unsecured debt. They also highlighted credit performance (average FICO 715, 60+ delinquencies of just 20-25 bps) and low leverage (7.7:1 vs. norm of 11.5:1).
- The recovery of an “investment grade” rating was not a near-term goal of many of the issuers that fell to junk status in the downturn. Some expressed apathy towards the rating agencies, but felt that a high yield rating did not have an overly punitive impact on their business and access to credit. While some view that they should operate within the investment grade context, none expressed any urgency of getting the designation.
- No surprise, the most pessimistic firms were those in real estate related enterprises such as building products and rental equipment. Federal stimulus was cited as only a minor help to this space. Refiners were also very concerned about “Cap and Trade.” One even said that if they could not pass the higher cost along to consumers, a Cap and Trade policy would put them “out of business.”

## The Markets

Rates fell across the board in November. The dollar fell, and virtually anything denominated in dollars rose, like stocks, gold and oil. This bears watching.

	11/30/2009	10/30/2009	11/30/2008	MOM % change	YOY % change
<b>Fed Funds</b>	0.25%	0.25%	1.00%	0.0%	-75.0%
<b>2-year US Treasury</b>	0.667%	0.893%	0.985%	-25.3%	-32.3%
<b>10-year US Treasury</b>	3.200%	3.385%	2.922%	-5.5%	9.5%
<b>10-year JGB</b>	1.266%	1.415%	1.399%	-10.5%	-9.5%
<b>10-year euro</b>	3.159%	3.231%	3.258%	-2.2%	-3.0%
<b>10-year UK Gilt</b>	3.523%	3.619%	3.768%	-2.7%	-6.5%
<b>10-year Canada Treasury</b>	3.223%	3.423%	3.324%	-5.8%	-3.0%
<b>30 yr conventional mortgage</b>	4.339%	4.708%	5.091%	-7.8%	-14.8%
<b>Dollar Index</b>	74.88	76.30	86.52	-1.9%	-13.5%
<b>Japanese Yen</b>	86.31	90.09	95.57	-4.2%	-9.7%
<b>S&amp;P 500</b>	1095.63	1036.19	896.24	5.7%	22.2%
<b>Nasdaq Composite</b>	2144.60	2045.11	1535.57	4.9%	39.7%
<b>Gold \$/oz (nearby contract)</b>	\$1,181.10	\$1,040.40	\$816.20	13.5%	44.7%
<b>Oil \$/bbl (nearby contract)</b>	\$77.28	\$77.00	\$54.43	0.4%	42.0%
<b>MBA Refi Index (month end)</b>	2866.4	2693.7	3802.8	6.4%	-24.6%

Source: Bloomberg; Japanese Yen quote is the London feed

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