

- **The Economy:** *Less bad is not the same thing as good, and we have the graphs to prove it*
- **The Residential Mortgage Market:** *At least one driver of faster prepayment speeds*
- **The Commercial Mortgage Market:** *The General Growth Properties bankruptcy: a knotty problem*
- **The Markets:** *Stocks have another good month*

The Economy

The market is on the lookout for “green shoots,” for any signs of improvement in the steep decline in economic activity in the United States. In an environment like this, less bad is the new good, at least according to the stock market which has enjoyed two strong months in a row. Even Ben Bernanke is hedging his bets. In testimony before the Congressional Joint Economic Committee, he said: “The U.S. economy has contracted sharply since last autumn, with real gross domestic product having dropped at an annual rate of more than 6 percent in the fourth quarter of 2008 and the first quarter of this year. Among the enormous costs of the downturn is the loss of some 5 million payroll jobs over the past 15 months. The most recent information on the labor market—the number of new and continuing claims for unemployment insurance through late April—suggests that we are likely to see further sizable job losses and increased unemployment in coming months. However, the recent data also suggest that the pace of contraction may be slowing, and they include some tentative signs that final demand, especially demand by households, may be stabilizing.” Call him cautiously pessimistic.

This is what passes for “green shoots”: The Case-Shiller 20-city home price index fell 1.9% in February after a 2.2% drop in January, and year-over-year the index fell 18.6% versus the 19% decline in the prior month. It’s not worse, but it’s still bad. Existing single-family home sales dropped another 2.8% in March to an annualized 4.10 million homes, which means that sales are now in a relatively tight range of 4.06 to 4.25 million over the last five months. Economists suggest that this may mean a bottoming is being established. But the median sales price is still down over 11% year over year, and months of supply stubbornly remains at the elevated level of 9.3 months. Construction spending rose for the first time in six months in March by 0.3%, beating expectations of a decline of 1.6%, and pending home sales rose 3.2%, the first back-to-back monthly gains in a year. In the non-farm payrolls number released this morning, the loss of 539,000 jobs is being characterized as a sign that the economy is stabilizing, because it was fewer than the forecast loss of 600,000. In the graphs below, the longer-term view of a few of these green shoots shows little to cheer about.

Construction spending 2003-2009

Total Nonfarm Payrolls 1980-2009



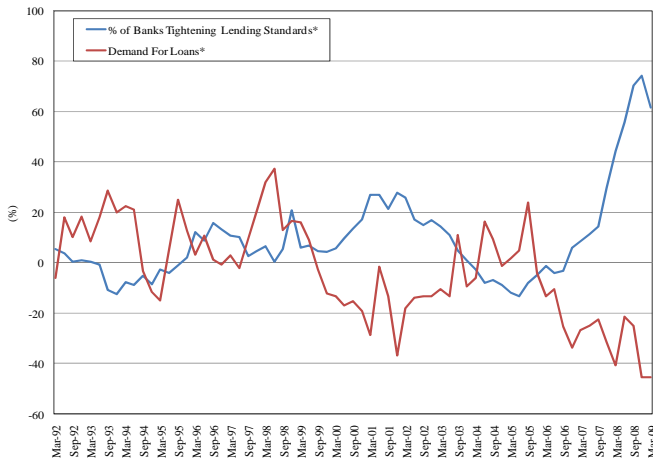
Source: Bloomberg

Do we see shoots of spring in the economy? Do we view the U.S. economy as a half-full glass or a half-empty glass? Our answer is that we see it as a glass that is twice as large as it should be. Our economy and our national balance sheet have been bulked up by the steroids of credit, and we are now witnessing what happens when we stop taking our steroids. The deflation in housing and many financial assets is occurring in the context of leveraged balance sheets. And nature abhors a balance sheet that doesn't balance. The highly anticipated stress tests of the 19 largest bank holding companies were designed to address this balance sheet

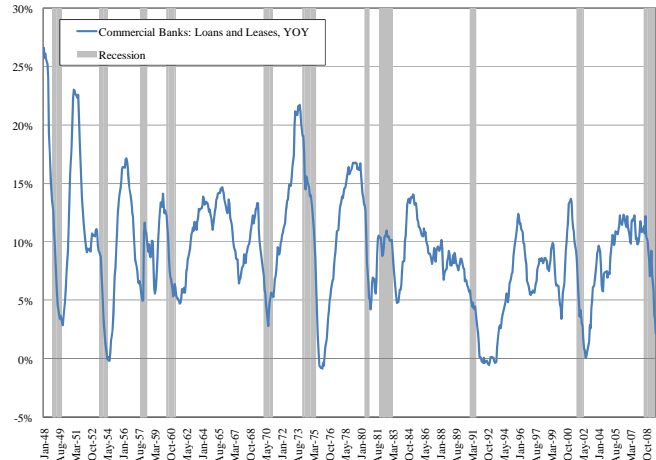


imbalance by measuring “how much of an additional capital buffer, if any, each institution would need to establish today to ensure that it would have sufficient capital if the economy weakens more than expected.” The headline results of the stress tests (found in their entirety at the [Fed’s website](#)) are that 10 of the 19 participating bank holding companies will need to raise an additional \$74.6 billion in capital in order to prepare for what the Federal Reserve called “more adverse” economic conditions and loss rate scenarios. Bank of America Corp, Wells Fargo & Co. and Citigroup Inc. lead the way, needing to raise new capital of \$33.9 billion, \$13.7 billion and \$5.5 billion, respectively, over the next six months. There will be debates over the reasonableness of the loss assumptions used in the “more adverse” case (for what it’s worth, we think the government’s adverse case may be optimistic) and the methods by which the weaker banks will raise that capital, but the bigger question is this: Will it spark more lending? The following two graphs speak to that. The first, which is an update of the bank lending officers’ survey, shows that more lending activity is probably unlikely for now, and the second shows that without increased lending activity our economy will likely stay recessionary.

% Banks Tightening Lending Standards vs. Loan Demand



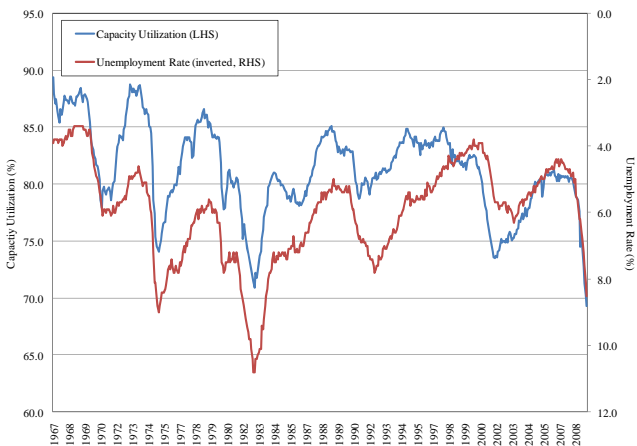
YOY % Change in Loans and Leases



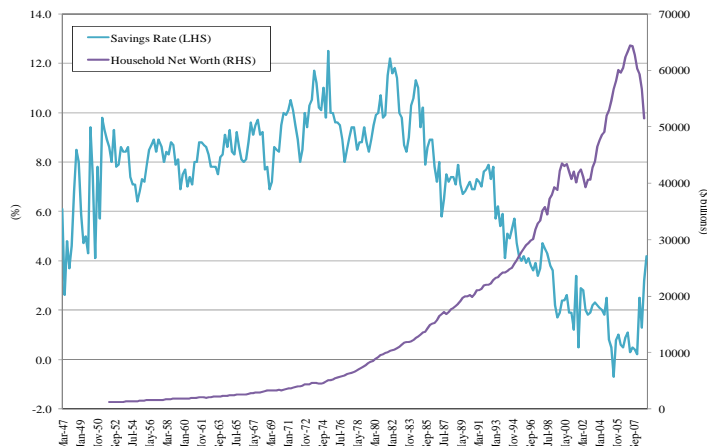
Sources: Haver Analytics; Federal Reserve; FDIC

The only way out of a mess like this is to take more steroids, i.e., inflate the assets again, reduce the debt, or inject new capital. Without it, these banks would be insolvent. We believe the government, in its alphabet soup of programs, has staved off collapse in the financial system by attempting to do all three. But because our country’s growth has largely been driven by credit creation over the last several decades our economy is also larger than it should be. Cory Booker, mayor of Newark, NJ, put it this way: “New Jersey will go bankrupt in 10 to 20 years because we cannot afford our employees as a state... we have more government per person than we need.” The two graphs below tell a story of what happens when an economy shrinks back down after the steroids stop. It will be a painful process, despite the “green shoots.”

Cap U vs Unemployment (inverted) from 1967



Savings Rate vs Household Net Worth from 1947



Sources: Federal Reserve, BEA

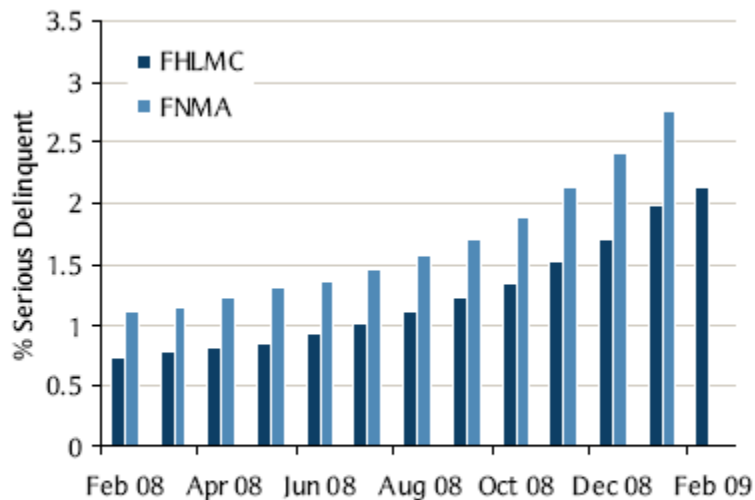


The Residential Mortgage Market

Prepayment speeds for March (April release) were essentially flat month over month, with 30-year FNMA collateral paying 21 CPR. Looking ahead, most dealers are anticipating a 15% to 25% increase for April speeds as a result of additional Treasury related mortgage-backed securities (MBS) buying, the corresponding multi-decade low on 30-year mortgage rates of 4.625% in April, as well as increased seasonality.

We have discussed in [prior commentaries](#) some of the reasons why prepayment speeds may be slower than those of the refinancing boom of 2003 (link directly to last month's commentary [here](#)), but there is a technical development that may actually help make them faster. It relates to Fannie Mae and Freddie Mac policies on buying delinquent loans out of the loan pools backing Agency mortgage-backed securities.

Fannie Mae and Freddie Mac are, for the most part, required to buy any individual loan that is modified due to delinquency out of a loan pool. Such a purchase results in a prepayment. Prior to December 2007 Fannie Mae and Freddie Mac typically purchased all loans that were 120 days delinquent out of a pool, whether they were modified or not. In 2008, in an effort to preserve capital, the two GSE's changed their policies to only purchase delinquent loans out of the pool if they meet one of four qualifications: 1) they are more than 24 months overdue, 2) a foreclosure sale has happened, 3) the loans have been modified, 4) the cost of carrying the loan (principal and interest advances) exceeds that of a buyout. This servicing change significantly reduced delinquency related prepayments in 2008, a period which Barclays Capital estimates loans were defaulting at "near historically high speeds". Additionally, shortly after they were taken into conservatorship the agencies implemented a moratorium on foreclosures in accordance with the Streamline Modification Program (SMP) and Home Affordable Modification Program (HAMP). Barclays further believes this moratorium added to the significant increase in the number of seriously delinquent loans (at least 90 days past due) at the agencies over the past year, as demonstrated by the below graph.



Note: % delinquent in terms of loan count.

Source: Fannie Mae, Freddie Mac, Barclays Capital

This buildup in serious delinquencies, and the looming increase in loan modifications from government programs, should result in higher amounts of delinquency-related buyouts going forward. Barclays estimates that as these ramp up, it will add 9 to 10 CPR for recent vintage mortgages and should account for over 20% of prepayments over the next year, but like all aspects of trying to forecast prepayment speeds, this is hypothetical. It does not take into account real world issues such as the cost of capital for Fannie and Freddie and the changing events on the ground, so it remains to be seen how big the true effect of delinquency-related buyouts will be.

The Commercial Mortgage Market

Like an upset stomach that you know will lead to a messy outcome, rumblings continue in the commercial mortgage market. *Barron's* declared the commercial property market "The Other Shoe" on the cover of its May 4 edition, and the *Sunday New York Times* spilled several thousand words worth of ink on Lehman's real estate legacy. On Friday, May 1, the Fed announced that



newly issued commercial mortgage-backed securities (CMBS) would be included under the Term Asset-Backed Securities Loan Facility (TALF) program. Details are still sketchy, but there were two items we found noteworthy. First, the CMBS market sold off because the updated terms do not address legacy positions. Given that the Fed's primary objective under TALF is to jump start lending, the sell-off may have been premature. Second, there is uncertainty over which and how many rating agencies can rate a TALF-eligible CMBS. The market still needs more clarification.

The other big rumbling in the market in April was the bankruptcy filing of General Growth Properties, Inc. (GGP), the second largest regional shopping mall owner in the United States. GGP has been an unabashed user of leverage to finance its operations and growth. The majority of GGP's liabilities are mortgages that have been securitized through Special Purpose Entities (SPEs), with the remainder unsecured debt and non-securitized direct mortgage placements. New management of GGP, installed during the fourth quarter of 2008, filed the biggest real-estate bankruptcy in US history on April 16, 2009, a filing that included GGP, the operating company and debtor to the unsecured bondholders, as well as 158 of its individual property holdings (another eight individual properties were added on April 22, 2009). While there are many impacts, legal and financial, that are specific to the creditors of GGP, this month's commentary will spotlight some issues and the ramifications for the broader CMBS market.

The SPEs are not necessarily bankruptcy remote. Lessons were learned from the real-estate recession of the early 1990s. One was that you should know all of the creditor relationships of your borrower because non-performance of debt, especially if it was recourse, could force that borrower to seek the protections of a bankruptcy court. This could be especially irksome if your loan was performing and was the largest of that borrower's portfolio. To mitigate this risk, the developers of the CMBS market required that borrowing entities had to be through SPEs which were serviced by specific underlying properties and ostensibly bankruptcy remote. The bond investor, then, is solely focused on underwriting for those specific properties, and his due diligence should not, and most likely could not, encompass the borrower's total financial dealings. From a legal perspective, the purpose for the creation of the bankruptcy remote SPE was to prevent the consolidation of those properties in a Chapter 11 filing if they were performing. Wrong. This Chapter 11 filing is a clear signal that GGP's management desires to consolidate performing properties with non-performing properties in order to effectuate an overall debt restructuring that is most advantageous to GGP, but not necessarily to individual bond holders.

Of course, the court could reject or modify the Chapter 11 filing. But in the meantime, investors in GGP securitized mortgages have clearly been blindsided. A larger issue is the role of the SPE in other structured finance transactions. Just to name one, what will new investors require to insure their participation in the TALF program so they are not exposed to other financial stresses of a real estate borrower?

A lockbox is not always locked. Most loan documents of the GGP properties that were securitized required the tenants to remit their rent checks to a designated bank account, the so-called lockbox. All expenses of the subject property, including its debt service, are paid from that account. From GGP's filing, it appears that the tenants' rent checks were deposited in the lockbox for each individual property, but it didn't stay there. Instead, all cash collected was swept into a master cash account prior to liabilities being satisfied. Apparently all property-specific liabilities have been satisfied in GGP, but perhaps another chink in the armor of securitization was exposed. Namely, who oversees the lockbox to ensure that it is performing as anticipated? The rating agency? The servicer? The trustee? Did GGP adhere to the word of the document but not to its intent? Do others?

With each rumbling in the CMBS market, whether it is a Stuyvesant Town or a GGP, bond investors are getting affected in ways they neither imagined nor bargained for. Maybe this is the ultimate lesson of the downside of a bull market.

The Markets

Stocks rejoiced in April, perhaps because less bad is the new good when it comes to economic news. The yield curve steepened, but inflationary signals from gold and oil are not in evidence. The MBA Refinancing Index crested with the slight uptick in mortgage rates. Perhaps the Fed needs to try harder....

	4/30/2009	3/31/2009	4/30/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	2.00	0.0%	-87.5%
2-year US Treasury	0.903%	0.800%	2.258%	12.9%	-60.0%
10-year US Treasury	3.121%	2.665%	3.730%	17.1%	-16.3%



10-year JGB	1.432%	1.353%	1.585%	5.8%	-9.7%
10-year euro	3.178%	2.994%	4.123%	6.1%	-22.9%
10-year UK Gilt	3.501%	3.166%	4.670%	10.6%	-25.0%
10-year Canada Treasury	3.101%	2.782%	3.588%	11.5%	-13.6%
30 yr conventional mortgage	4.454%	4.307%	5.795%	3.4%	-23.1%
Dollar Index	84.61	85.43	72.51	-1.0%	16.7%
Japanese Yen	98.89	99.35	104.37	-0.5%	-5.3%
S&P 500	872.81	797.87	1385.59	9.4%	-37.0%
Nasdaq Composite	1717.30	1528.59	2412.80	12.3%	-28.8%
Gold \$/oz (nearby contract)	\$891.20	\$922.60	\$865.10	-3.4%	3.0%
Oil \$/bbl (nearby contract)	\$51.12	\$49.66	\$113.46	2.9%	-54.9%
MBA Refi Index (month end)	5108.2	6600.1	1905.2	-22.6%	168.1%

Source: Bloomberg; Japanese Yen quote is the London feed

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