



- **The Economy:** *Parsing GDP*
- **The Residential Mortgage Market:** *Scenarios for the end of market intervention*
- **The Commercial Mortgage Market:** *The Dickensian commercial mortgage market*
- **The Markets:** *Stocks were loved and bonds treaded water*

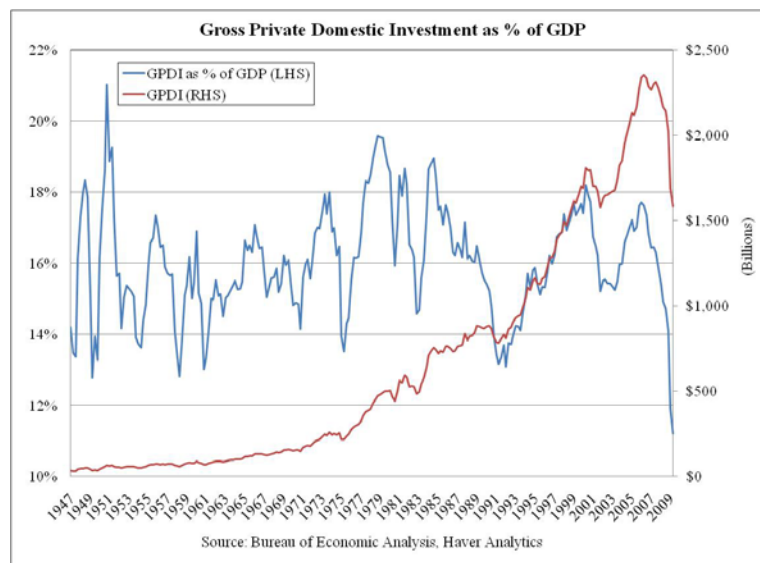
The Economy

*"I was not going to be the Federal Reserve Chairman who presided over the second Great Depression."
—Ben Bernanke, at the Town Hall meeting in Kansas City, July 26, 2009*

To judge by stocks in July, equity investors think Chairman Bernanke has succeeded. The S&P 500 finished the month more than 7% to the plus side, up about 45% from the lows of early March. That's an annualized 155% gain which, while formidable (and unsustainable), is eclipsed by the Hang Seng's 76% gain over the same period (over 300% annualized!). Recent gains in the Leading Indicators Index (positive for three months in a row for the first time since 2004) have been mostly driven by these ripping stock market returns and a steeper yield curve, neither of which we would classify as indicators of economic activity.

Last Friday's GDP release, however, while better than expected, had weak underpinnings. We won't go into details about the prior quarters' negative revisions, except to say that they took away 5.1 percentage points of GDP growth since the first quarter of 2008. That's fairly significant; nearly three quarters of a trillion dollars that was never there. The third quarter of 2008, during which Lehman Brothers collapsed, AIG was "rescued" and Fannie Mae and Freddie Mac were taken into federal custody, saw GDP revised from -0.5% to -2.7%. As for the second quarter of 2009, the -1.0% headline was helped by the GDP Price Index. This measure deflates nominal GDP to make it "real," and it came in at a scant 0.2% for the quarter versus expectations of 1.0%. If the price index came in at the expected 1.0%, the headline GDP result would have been -1.8%, worse than the expected -1.5%. Next, personal consumption expenditures (PCE) dropped 1.2% in the quarter, reversing the first quarter's positive print. Despite this drop, PCE as a percentage of GDP reached a new record of 70.6%. Looks like for now we are still depending on a frail consumer to drive the economy, but that won't be for the government's lack of trying. Not shockingly, government consumption and investment is ramping up. It added 1.12% to GDP, one of only two major components that contributed positively to GDP. The other is net exports, which was up only because exports were down less than imports.

Of course, GDP is backwards looking, but forward looking worriers like us are troubled with the continued shrinking of gross private domestic investment, pictured below in absolute terms and as a percentage of GDP. The drop-off has been precipitous, and the percentage of GDP has never been lower. Investment is defined as an outlay of capital with the expectation of future return, so what this means for the future is money not being put to work today will not generate GDP in the future.





The Residential Mortgage Market

Prepayment speeds for June (July release) on 30-year fixed Freddie Mac speeds increased a mild 2% on the aggregate. The majority of the increase can be attributed to 30-year 6% and 6.5% coupons, which experienced a 6% to 10% month-over-month increase versus a 3% month-over-month decrease in 4.5% and 5% coupons. It appears that Home Affordable Refinance Program (HARP), announced in early March, has had a muted, if any, effect on speeds. Barclay's estimates that roughly 40% of the balance of 30-year fixed-rate Freddie Mac 6.5s originated between 2000 and 2007 have an LTV between 80% to 105%, a bucket that should greatly benefit from HARP. However, this cohort has risen only 6-8 CPR since the April report, a clear sign of the many barriers to refinancing. Looking ahead, most dealers are anticipating a 10% to 20% decrease in July speeds as a result of the recent back-up in rates.

Through July, the Federal Reserve has purchased net \$702 billion under their MBS purchase program, or roughly 56% of the total \$1.25 trillion authorized. Every MBS investor is watching the possible effect on both interest rates and prepayments with the Fed's involvement in, and eventual exit from, the MBS market. Bank of America recently released a research report that suggested several different ways this could play out:

- Scenario #1: Fed continues to buy roughly \$20-25 billion a week for the remainder of 2009 irrespective of MBS and spread levels. With this option, the Fed will absorb another \$440-540 billion in MBS
- Scenario #2: Fed ramps up purchases in Q309 only to gradually slow down purchase to zero by December, thus meeting their \$1.25 trillion authorization and allowing for a smooth transition in early 2010
- Scenario #3: Fed maintains their buying of \$20-25 billion per week and gradually reduces their purchases to zero by December of 2009; under this option roughly \$200-300 billion of the capacity available in the program will not be used
- Scenario #4: Fed combines their MBS, debenture and Treasury purchase program to purchase a total of \$1.25 trillion in the combined securities, rather than the \$1.75 trillion authorized
- Scenario #5: Fed targets a current coupon MBS spread level and increases or decreases its MBS purchases based on spreads in the market even if it means not hitting the potential \$1.25 trillion purchase target

We would add a Scenario #6 to this list: The Fed stops all buying programs now. It is perhaps unlikely, but it's possible if the Fed is interpreting the green shoots to be the beginning of a trend. Regardless of whether the Fed chooses one of these options or something else, spread widening in MBS is a likely outcome. However, the ownership structure of the MBS market will have substantially shifted over the course of the past year from private hands that are more active traders to investors like the Fed, domestic banks and the GSEs, who do not play in short-term spread movements. This is a potentially positive technical for MBS regardless of the looming Fed exit.

The Commercial Mortgage Market

"It was the best of times, it was the worst of times..." Charles Dickens could have been talking about the divergent performance that the commercial mortgage-backed securities (CMBS) market and the direct real estate market have exhibited over the last year.

Less than twelve months ago, the securities market was hammering the prices of CMBS as liquidity dried up and prices ratcheted downward. Conversely, investors in and lenders to commercial real estate took comfort in low commercial mortgage defaults as well as the standard refrain, "We did not overbuild, so we will be OK." National Council of Real Estate Investment Fiduciaries (NCREIF) returns showed modest declines.

Fast forward to more recent events. The announcement of TALF eligibility for CMBS legacy assets on May 19 and the emergence of re-REMIC structuring applied to Super Senior CMBS provided catalysts for a positive price move. Confirmation of TALF-eligible CMBS was provided on July 16 with the Fed accepting 35 CUSIPs from 36 CMBS securities presented. Prices rallied in the securities markets depending on the vintage, the class in the structure and the specific deal itself.

So does the market feel the same way about the prospects for the buildings themselves? On Friday July 31, Property and Portfolio Research ("PPR") issued their Q209 forecast entitled "Keep Your Eyes Shut; It's Scary Out There." The picture painted by the report is not pretty. Vacancies have not peaked and occupancies have not hit bottom. This observation was confirmed through the



release of the Fed's beige book on July 29 reflecting data through July 20. All twelve districts reported that leasing of commercial real estate was either "slow" or "weak." Transactions are at a near standstill reflecting a combination of frozen capital markets and wide "bid/asks" in terms of pricing. Cushman & Wakefield Inc. reported that overall asking rental rates for prime Park Ave, NY office locations have dropped on average 35% to approximately \$76 psf. over the past 18 month. Contributing to the eroding rentals is a *fourfold* increase in sublet space.

The recent rally for the CMBS market has been driven by government programs and other technical factors. Fundamentals for the underlying real estate, however, continue to be negatively affected by the weak job market, reduced consumer consumption and slower household formation. All of these factors should continue to lead to overall repricing of commercial real estate. As PPR concluded, commercial real estate investing is finally getting back "to good old-fashioned cash flow-based returns."

The Markets

The seas were calm on the surface in July and the wind is about to shift, the question is in which direction? Stocks were loved and bonds treaded water. August is off to a rocky start for bonds, especially with the release of July's job number on August 7. Enjoy the end of summer!

	7/31/2009	6/30/2009	7/31/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	2.00%	0.0%	-87.5%
2-year US Treasury	1.115%	1.113%	2.512%	0.2%	-55.6%
10-year US Treasury	3.481%	3.535%	3.948%	-1.5%	-11.8%
10-year JGB	1.419%	1.359%	1.539%	4.4%	-7.8%
10-year euro	3.300%	3.386%	4.355%	-2.5%	-24.2%
10-year UK Gilt	3.801%	3.690%	4.806%	3.0%	-20.9%
10-year Canada Treasury	3.459%	3.364%	3.701%	2.8%	-6.5%
30 yr conventional mortgage	4.915%	4.936%	6.280%	-0.4%	-21.7%
Dollar Index	78.35	80.13	73.23	-2.2%	7.0%
Japanese Yen	94.63	96.32	107.98	-1.8%	-12.4%
S&P 500	987.48	919.32	1267.38	7.4%	-22.1%
Nasdaq Composite	1978.50	1835.04	2325.55	7.8%	-14.9%
Gold \$/oz (nearby contract)	\$953.70	\$927.40	\$913.90	2.8%	4.4%
Oil \$/bbl (nearby contract)	\$69.45	\$69.89	\$124.08	-0.6%	-44.0%
MBA Refi Index (month end)	1996.7	1482.2	1074.4	34.7%	85.8%

Source: Bloomberg; Japanese Yen quote is the London feed

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