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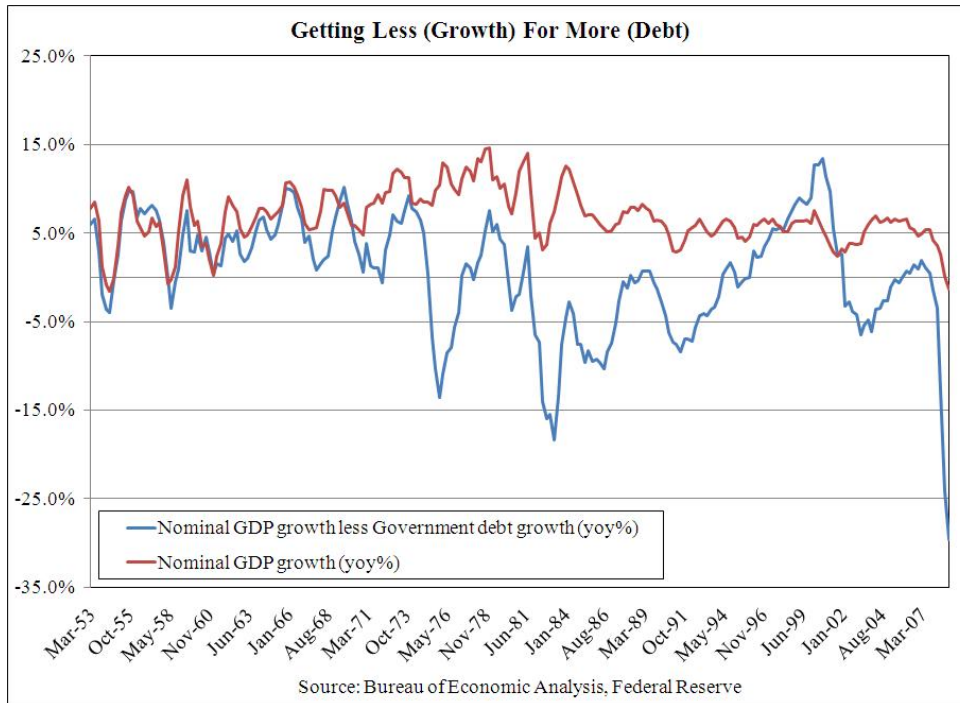
The Economy

Much of the economic data from August confirmed the continuation of the second derivative recovery—a decline in the rate of decline. More importantly, evidence surfaced that certain aspects of the government’s stimulus plan are working as hoped. First, the National Case-Shiller index of home prices rose 2.9% in the second quarter, marking the first quarter-over-quarter increase since mid-2006. Certainly part of what is helping stabilize home prices is the \$8,000 first time homebuyer credit, a gift from the Housing and Economic Recovery Act of 2008. In a recent webinar given by the National Association of Realtors, the trade group discussed the results of a member survey given during August. The NAR asked its members a number of questions about first-time homebuyers from the period between February and August. The first interesting point that jumped out was that fully 10% of NAR members who responded had no business at all to report during this period. According to the remaining agents, 51% of first-time buyers made purchases because of the tax credit.

Second, car sales jumped substantially in August, to an annual rate of 14.1 million units from 11.3 million in July and only 9.7 million in June. The 700,000 or so cars sold through the Car Allowance Rebate System, more popularly known as Cash for Clunkers, accounts for much of the marginal increase from June to August. The program began officially in July, and by the end of the month had exhausted its initial \$1 billion allocation. Congress dropped another \$2 billion into the program, which ran until August 24. The amount of the credit varied depending on the vehicles traded in and purchased, but was between \$3,500 and \$4,000. U.S. Transportation Secretary Ray LaHood beamed in a press release: “Manufacturing plants have added shifts and recalled workers. Moribund showrooms were brought back to life and consumers bought fuel efficient cars that will save them money and improve the environment.” The program appears to be responsible for driving auto sales in recent months, but questions remain about the stickiness of any increase in manufacturing and sales activity.

Both of these programs are Keynesian classics, designed specifically to get money spent that would otherwise have been saved for future consumption. They are also part of the impetus behind the \$184 billion in note and bond sales by the Treasury during August. Think of it this way: the increase that we experienced in home and auto sales have been doubly debt-financed. Not only did consumers take out mortgages and auto loans to make their purchases, the US government also levered up to fund the incentive programs that enticed them to buy in the first place.

In the past, we’ve talked about the relationship between debt growth and GDP growth, and the law of diminishing returns over time. At last measurement, it took the U.S. \$3.73 in total credit market debt to drive every \$1 of GDP. During a 20-year period from the late 1950s through the late 1970s, this measure moved in a fairly narrow range between roughly \$1.40 and \$1.55 per dollar of GDP. Programs like Cash for Clunkers and the first-time homebuyer credit is the paradigm of how the government is now sharing the debt load with the consumer. During the last credit boom, growth was consumer-driven. The graph below shows a time series that connects GDP growth and government debt growth. It tracks nominal year-over-year GDP growth versus nominal GDP growth minus nominal government debt growth. As of the latest data point, GDP growth was -1.4% and government debt growth was +28.3%, making the difference -29.7%. This particular spread tends to widen during recessions, but the gap right now is by far the largest since 1953.



The Residential Mortgage Market

Prepayment speeds for July (August release) declined 21% month-over-month. Driven by higher mortgage rates and a lower Refinancing Index, aggregate 30-year conventional prepayment rates slowed by 5% Constant Prepayment Rate; Fannie Mae 30-year pools came in at 18.2 CPR and Freddie Macs came in at 19.3 CPR. The declines were led by lower coupon 5s and 5.5s, while super premium 6.5s and 7s increased slightly. Looking ahead, August speeds should decline by 10% to 20% on two fewer collection days and speeds starting to fully reflect the decline in the Refinancing Index since early June.

On August 13, the Federal Open Market Committee announced that they would “buy up to \$300 billion of Treasury securities by autumn,” essentially giving the time frame for their exit from the Treasury purchase program. However, there was no guidance given on the exit strategy for the Term Asset Backed Securities Loan Facility (TALF) or the FDIC’s Temporary Liquidity Guarantee Program (TLGP), which are set to expire at year end and October respectively, nor on the Federal Reserve’s MBS purchase program. On August 17 the Fed and Treasury announced that they approved an extension to the TALF for newly issued ABS and legacy CMBS through March 31, 2010. The Fed commented on the extension: “Conditions in financial markets have improved considerably in recent months. Nonetheless, the markets for asset-backed securities (ABS) backed by consumer and business loans and for commercial mortgaged-backed securities (CMBS) are still impaired and seem likely to remain so for some time.”

We maintain our view that the Fed will gradually wind down their MBS purchase program over the end of 2009 and beginning of 2010 so as to mitigate any dramatic spread widening. Goldman Sachs recently issued a research report, the summation of which is below, which we feel adequately makes a strong case for how the government will resolve both the TALF and TLGP, both important components of the government’s overall credit restoration program and ultimately important to every MBS investor.

TALF is likely to be extended for three reasons:

- The looming commercial real estate problem has the Fed focused on bank balance sheets. Since the TALF for CMBS should have direct and indirect benefits in this regard, policymakers will be unlikely to terminate the tool that is currently available to them to deal with the issue.
- The Treasury’s Public Private Investment Partnership (PPIP) is another potential tool, but it is unproven and delayed. A successful PPIP could justify winding down TALF, but TALF still provides support to a wide range of securities.
- There does not seem to be political support to end the program.



TLGP is unlikely to be extended for two reasons:

- At its launch, the TLGP was wildly successful in re-starting the credit lifeblood of financial institutions in late 2008 and early 2009. Since then, demand for FDIC guaranteed debt has waned and the amount outstanding has not increased since April.
- Any TLGP debt that is issued from here on would likely come from only the riskiest institutions. Thus the FDIC would likely have to increase any fees in order to match the increased risk that the FDIC would assume by extending it. The better option would be to shut it down.

At the time of the writing of this commentary, the FDIC Board approved the phase out of the TLGP by October 31 and “will seek comment on whether a temporary emergency facility should be left in place for six months after the expiration of the current program.” FDIC Chairman Sheila Blair commented on the announcement: “The TLGP has been very effective at helping financial institutions bridge the uncertainty and dysfunction that plagued our credit markets last fall. As domestic credit and liquidity markets appear to be normalizing and the number of entities utilizing the Debt Guarantee Program has decreased, now is an important time to make clear our intent to end the program.”

The Markets

In a quiet month (quite a difference from the volatility of August 2007 and 2008), bonds rallied as markets discounted more economic challenges going forward, but stocks felt otherwise and continued to rise. Gold and oil were flat.

	8/31/2009	7/31/2009	8/31/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	2.00%	0.0%	-87.5%
2-year US Treasury	0.972%	1.115%	2.371%	-12.8%	-59.0%
10-year US Treasury	3.399%	3.481%	3.813%	-2.4%	-10.9%
10-year JGB	1.310%	1.419%	1.415%	-7.7%	-7.4%
10-year euro	3.257%	3.300%	4.176%	-1.3%	-22.0%
10-year UK Gilt	3.556%	3.801%	4.480%	-6.4%	-20.6%
10-year Canada Treasury	3.375%	3.459%	3.534%	-2.4%	-4.5%
30 yr conventional mortgage	4.840%	4.915%	6.053%	-1.5%	-20.0%
Dollar Index	78.17	78.35	77.38	-0.2%	1.0%
Japanese Yen	92.83	94.68	108.78	-2.0%	-14.7%
S&P 500	1020.62	987.48	1282.83	3.4%	-20.4%
Nasdaq Composite	2009.06	1978.50	2367.52	1.5%	-15.1%
Gold \$/oz (nearby contract)	\$952.20	\$953.70	\$831.20	-0.2%	14.6%
Oil \$/bbl (nearby contract)	\$69.96	\$69.45	\$115.46	0.7%	-39.4%
MBA Refi Index (month end)	2164.1	1996.7	1059.7	8.4%	104.2%

Source: Bloomberg; Japanese Yen quote is the London feed

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