



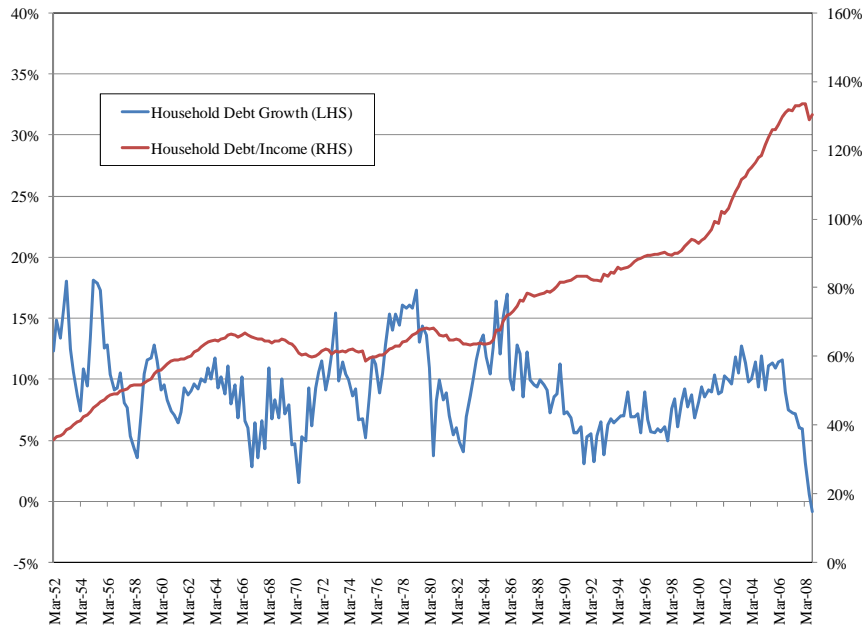
- **The Economy:** *The Fed goes to the toolbox as rates approach zero*
- **The Residential Mortgage Market:** *Handicapping prepayment speeds gets complicated*
- **The Commercial Mortgage Market:** *Commercial real estate should feel sting of poor jobs picture*
- **The Markets:** *2008 was the year to own Treasuries, and sell everything else*

## The Economy

In prior commentaries, we have often referred to the speech that Ben Bernanke delivered in the waning weeks of 2002 that set the intellectual stage for the Greenspan Federal Reserve to lower the Fed Funds rate to 1%. In the speech, “Deflation: Making Sure ‘It’ Doesn’t Happen Here” (<http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm>), Bernanke laid out the central banker’s toolbox of unconventional options to stave off deflation in the event interest rates neared zero. As it turned out, the deflation that so spooked the Fed never materialized, rates were held at 1% and the toolbox was never opened. With the conclusion of the FOMC’s two-day rate-setting meeting in December and the announcement that the Federal Funds rate is being reduced to a target range of 0% to 0.25%, it is safe to say that the toolbox is now wide open and virtually all the tools are being used to fight recession-induced deflation and market instability.

With this 75 basis point reduction in the Fed Funds rate, the Fed is essentially abandoning its traditional agent for monetary policy and looking at the Japanese model for guidance. After all, there can effectively be no further cuts of the Federal Funds rate from here, and the FOMC said that conditions “are likely to warrant exceptionally low levels of the Federal Funds rate for some time.” With its announcement of the Term Asset-Backed Securities Loan Facility and the announcement (and, as of January 5, 2009, implementation) of its intent to purchase up to \$600 billion of US Agency debt and mortgage-backed securities, the Fed is now committed to, as it said in the FOMC statement, “consider ways of using its balance sheet to further support credit markets and economic activity.” Moreover, we believe Bernanke is signaling to the new Obama Administration that they have a friend at 20<sup>th</sup> Street and Constitution Avenue. In principle, we agree that very weak and still-deteriorating market and economic conditions demand aggressive and decisive action of the kind that the Fed is undertaking. However, we believe that Newton’s Third Law of Motion—to every action there is always an equal and opposite reaction—applies in economics as well. The tools being deployed by the Fed (and the Treasury, and the forthcoming gargantuan economic stimulus package) constitute such stupendously massive actions that we remain vigilant in watching for whatever the equal and opposite unintended consequences of all of these decisions will be.

The economic data keep getting worse, as jobs continue to be cut, consumers continue to cut back and the US economy slows to a crawl. The ISM manufacturing survey for December came in at 32.4, the lowest since June 1980, with notable declines in employment and prices paid sub-indexes. Two data points from the 3<sup>rd</sup> quarter flow of funds data (released in December) jumped off the page: American households experienced their first-ever decrease in overall debt, as well as the largest decrease in net worth ever recorded. We suspect that these two facts are not unrelated. In fact, the average consumer is experiencing the same problems as the banking sector—falling asset values and steady (or increasing) liabilities. When one considers that the level of debt that the household is carrying still stands very near record levels, things could certainly get worse from here.



Source: Federal Reserve, Haver Analytics

It appears that the American consumer has officially joined the global deleveraging party. We are beginning to see the knock-on effects of reduced consumer spending already. The *Wall Street Journal* reported that up to 26% of all retailers may need to file for Chapter 11 bankruptcy in the very near future. November auto sales data showed that car manufacturers are selling the same number of cars today as in 1982. If the consumer is shrinking, those industries that serve the consumer must also shrink, it seems. What's worse is that in order to bring the ratio of debt to income back to only 100%, household debt levels would have to fall by about **\$3.2 trillion**. The drop in the 3<sup>rd</sup> quarter was *only* \$29.3 billion. The 4<sup>th</sup> quarter is likely to show a further drop, clearly not good news for an economy famously driven by consumer spending. It should surprise no one that the Conference Board Consumer Confidence Index hit an all-time low of 38.0 in December.

## The Residential Mortgage Market

November prepayment speeds (December release) declined by approximately 25% to 8.3 CPR from 11.0 CPR for the aggregate Fannie Mae 30-year conforming universe. This decline was largely due to four fewer business days and slightly higher mortgage rates during the month. In general, overall reported speeds were 1CPR to 2 CPR slower than anticipated. Looking ahead, and despite tame November speeds, most dealers are still anticipating dramatic increases of up to 150% for December speeds amid the new Agency loan modification plan announced by the FHFA in November and the recently announced plans by the Federal Reserve to purchase \$500 billion in MBS by June 2009. Interestingly, according to Credit Suisse, for every \$1.00 in paydown in November there was about \$1.98 in new originations, up from the rough pace of \$1.78 in originations for every \$1.00 in paydown during the third quarter of 2008. Could this mean that originations are being driven by new home sales instead of refinancing activity and that the expected great refi tsunami of 2009 won't materialize? With new home sales down 35% year-over-year, a resurgent home purchase market is unlikely. All other things being equal, what is more likely to drive this ratio going forward is the prepayment increases from the Streamlined Modification Program (SMP) and the Fed trying to drive mortgage rates to 4.5% (or less) through buying up to \$500 billion (or more) in fixed rate agency MBS by June 2009.

But all things are not equal, and prepayment analysis is challenging. As stated in last month's commentary, the goal of the SMP is to improve the affordability of seriously delinquent loans, defined as 90+ days past due, by bringing the borrower's monthly debt-to-income ratio to a minimum of 38% of their monthly gross income through either rate reduction, term extension or principal forbearance. However, this pool of 90+ day delinquent agency loans is relatively small; Barclays Capital estimates it at roughly 1.6% (\$71 billion) of the \$4.4 trillion Fannie/Freddie Agency guaranteed loan portfolio, so the SMP should have a relatively marginal effect on prepayment speeds. And it is easy to see how the Treasury buying program of fixed rate agency MBS could have far greater implications for speeds than the SMP, as roughly 80% of the Agency MBS universe is estimated to be currently refinancable (including the massive 5.5% coupon, which accounts for 38% of the Agency MBS universe). It is difficult to imagine a 2003-style refi wave unless mortgage underwriting standards are also relaxed in tandem with policy decisions, however, given the greatly diminished cash-out refinancing activity due to home price depreciation, tougher documentation



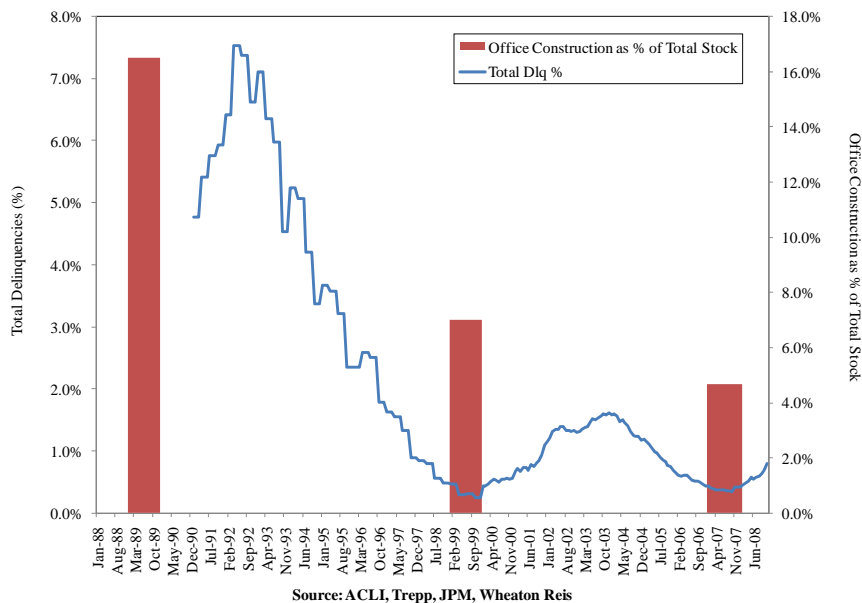
requirements, more honest appraisals, no competitively priced “affordability” alternatives a la hybrids circa 2003, substantial mortgage insurance hurdles facing most borrowers and high LTV-based delivery fees still in place. Time will tell.

What is certain though is that MBS investors can expect a dramatic outperformance of MBS in the immediate future relative to Treasuries given the relative short timeframe of the MBS buying program. On the first day of trading of the program, Agency MBS closed up about half a point on the day. The current coupon has now tightened about 60 basis points versus Treasuries in just one week. If origination continues to be light, this trend should continue. MBS outperformance could potentially be even more exaggerated if investors start to demand more yield than what is available in Treasuries.

## The Commercial Mortgage Market

Commercial real estate continues to gather its share of the headlines, all negative. Commercial mortgage delinquency rates currently measured by the CMBS market have been rising steadily for the last three months, but we note the absolute level of the current delinquency rate of less than 1% pales in comparison to the double digit rates of the early 1990s.

Real estate professionals believe that unbridled development is the primary cause of the rise of commercial mortgage delinquencies because it can lead to spikes in property vacancy rates. But we are less certain. To test that proposition, in the following graph we superimposed on the commercial mortgage delinquency rate three bars representing the amount of new office construction delivered for the years that have been designated as the beginning of a recession. (Note: We have presented only the office sector amounts, but the other segments of commercial real estate delivered space behave similarly).



There are two observations to note. First, the absolute amount of new space being built and delivered has been declining. Second, the peak-to-trough decline of the commercial mortgage delinquency rate was less following the 2001-02 recession (three years) than after the 1990-91 recession (eight years).

Delivery of space is only one variable affecting delinquency rates. Let's review what causes a commercial mortgage to become delinquent. Simply put, delinquency is the result of financial stress on a property. Now, assuming the stress is not a result of a property being Madoffed, what is the chief cause of such financial pressure? There are any numbers of reasons but the lack of tenants, directly and indirectly, is the most significant factor. And if there are fewer tenants, it is most likely the result of fewer jobs in the market. According to our research, there is a 0.82 correlation between the number of the top 100 metropolitan statistical areas that are reporting job losses and a subsequent increase in mortgage delinquencies. Simply, fewer jobs mean fewer tenants and fewer tenants means less rent generated to pay the mortgage.

So supply is a factor, but right now job losses are driving negative credit performance of commercial mortgages. Since the start of the recession in December 2007 approximately 1.9 million jobs have been shed. In the first eight months of the year, the average



monthly nonfarm payroll decline was 108,000, but more recently the average has increased to 262,000. Not coincidentally, delinquencies of commercial mortgages have begun to rise sharply. In the last three months, the delinquency rate for mortgages in the CMBS universe have risen nearly 40% to 80 basis points.

The bad news relating to the job market heralds bad news for commercial mortgages. Employment, or more precisely the lack thereof, has a strong and consistent correlation to the financial stress exhibited by commercial mortgages. All signs indicate that corporate downsizings will continue to outpace corporate expansions, at least for the foreseeable future. The result will be more financial stress on commercial properties with a corresponding increase in commercial loan defaults.

## The Markets

Markets wrapped up an exhausting and mostly money-losing year in December. For 2008, investment grade bonds had their worst year ever, the CRB commodities index lost 35%, also its worst year ever. Except for the depression year of 1931, the S&P 500 had its worst year ever. On the other hand, rates collapsed, making Treasuries the best performer. 30-year Treasuries had a total return of 41.2% for the year, its best year ever. Our only prediction: 2009 will be different.

	12/31/2008	11/30/2008	12/31/2007	MOM % change	YOY % change
<b>Fed Funds</b>	0.25%	1.00%	4.25%	-75.0%	-94.1%
<b>2-year US Treasury</b>	0.768%	0.985%	3.051%	-22.0%	-74.8%
<b>10-year US Treasury</b>	2.214%	2.922%	4.025%	-24.2%	-45.0%
<b>10-year JGB</b>	1.174%	1.399%	1.510%	-16.1%	-22.3%
<b>10-year euro</b>	2.951%	3.258%	4.331%	-9.4%	-31.9%
<b>10-year UK Gilt</b>	3.020%	3.768%	4.508%	-19.9%	-33.0%
<b>10-year Canada Treasury</b>	2.684%	3.324%	3.990%	-19.3%	-32.7%
<b>30 yr conventional mortgage</b>	4.283%	5.091%	5.921%	-15.9%	-27.7%
<b>Dollar Index</b>	81.31	86.52	76.70	-6.0%	6.0%
<b>Japanese Yen</b>	90.79	95.57	111.79	-5.0%	-18.8%
<b>S&amp;P 500</b>	903.25	896.24	1468.36	0.8%	-38.5%
<b>Nasdaq Composite</b>	1577.03	1535.57	2652.28	2.7%	-40.5%
<b>Gold \$/oz (nearby contract)</b>	\$884.30	\$816.20	\$838.00	8.3%	5.5%
<b>Oil \$/bbl (nearby contract)</b>	\$44.60	\$54.43	\$95.98	-18.1%	-53.5%
<b>MBA Refi Index (month end)</b>	6733.8	3802.8	1620.9	77.1%	315.4%

Source: Bloomberg; Japanese Yen quote is the London feed

FIDAC (An Annaly Company)  
1211 Avenue of the Americas  
Suite 2902  
New York, NY 10036  
Tel: 212-696-0100 · Fax: 212-696-9809  
www.annaly.com



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