

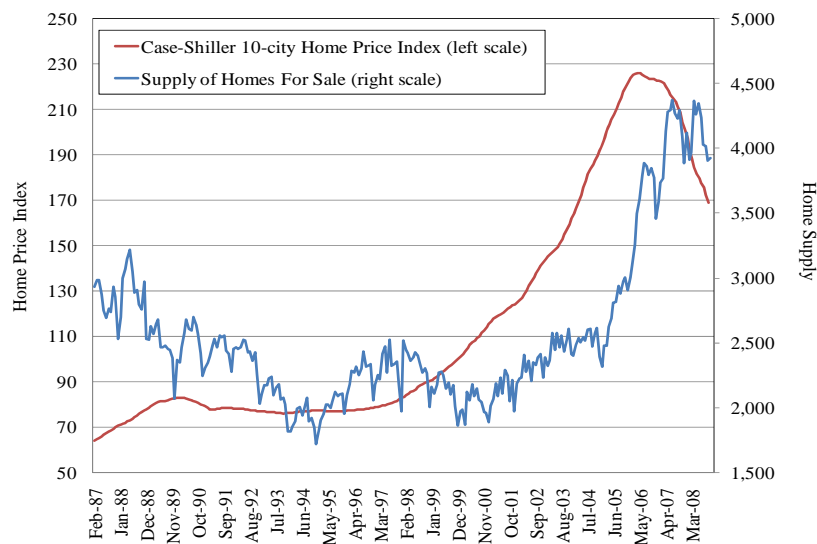


- **The Economy:** *The housing market has not seen a bottom, and none is in sight*
- **The Residential Mortgage Market:** *Prepayment speeds pick up, but from a very slow pace*
- **The Commercial Mortgage Market:** *A report from the CMSA*
- **The Markets:** *The market sobers up to economic policies; stocks fall, gold and bond yields rise*

The Economy

Data received in January on the state of the housing market remained downbeat. If you don't believe us, just ask a homebuilder. The National Association of Home Builders (NAHB) released its monthly builder sentiment index, which surveys the market outlook for those who build single family homes. Index values range between 1 and 100, with a reading above 50 indicating a positive outlook, and vice versa. The current reading of the index moved down a point to a new low of 8 (down from the bubble-time peak of 72 in June 2005). Maybe we are looking for blue skies wherever we can find them, but we are happy that the NAHB was even able to find enough builders to complete the survey.

Here's the conundrum: It seems that the falling price of homes and the cost to finance their acquisition simply aren't enough to drive housing market activity. The National Association Realtors Homebuyer Affordability Index takes into account the three variables that account for a purchaser's ability to buy a house—home prices, mortgage rates (on a 20% down payment fixed rate mortgage) and income. A 25% decline in the median home price and a sharp drop in the mortgage debt burden as a percentage of income have pushed the composite affordability index to an all-time high of 158.80, up from its all time low of 99.60 in July 2006. Nevertheless, at last report the months of supply of existing homes stayed stubbornly high at 9.3 months and supply of new homes hit an all-time high of 12.9 months. As the graph below demonstrates, inventory levels remain stuck.



Source: S&P, NAR, Haver Analytics

For as long as this overhang exists, pressure on prices will persist. There are about 4 million new and existing homes for sale and millions more due to hit from foreclosures. Homebuilders get the picture, which explains their lack of enthusiasm (and their call for stepped-up government support) and the fall in new housing starts: The latest total of 550,000 starts is around 35% below all previous troughs since measurement began in 1959. Prices are still only back to levels of 2003-4. Prices have another 15% or so to fall before they get to levels seen in January 2001, when the Alan Greenspan Fed started lowering rates in its last easing cycle. According to David Rosenberg at Merrill Lynch, such a decline would “double the number of people who are upside down on their mortgage from 13 million to 25 million,” which is half of the 51 million households with a mortgage.

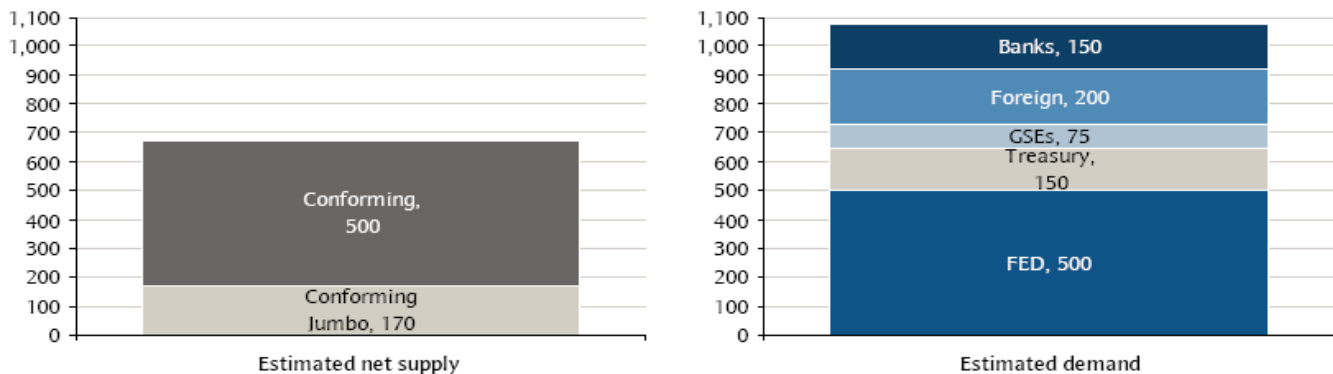


Given the current Fed Funds range of 0 to ¼ percent, Fed decision days now have a different kind of excitement around them. The meeting that concluded January 28th set the tone, as Bernanke and company reiterated that rates are likely to remain at “exceptionally low levels” for a while. Given that its primary policy tool (interest rates) has mostly lost its utility, the Fed has been digging deeper into the toolbox. They have already spent nearly \$70 billion on purchases of Agency MBS, along with language in the current statement saying that they stand ready to extend this program beyond the original \$500 billion if necessary. Markets took some comfort in the Fed’s acknowledgment that it is also considering outright purchases of long-dated Treasuries, but the yield curve only continues to steepen: The spread between Fed Funds (using 0.125%) and the 10-year currently stands at 287 basis points, up from 209 basis points at the beginning of the year. The massively heavy forward calendar of Treasury issuance along with mounting evidence that the economy keeps sinking (woeful auto sales, very weak retail sales and accelerating slack capacity in factories and workers) seems to be weighing on the market’s belief in United States Treasuries as a safe haven.

The Residential Mortgage Market

Breaking from our normal reporting calendar, we have two months of speeds to report in this commentary. Prepayment speeds in December (January release) increased 56% on the aggregate. While on the surface this increase may seem substantial it was large purely on a percentage basis coming off November’s record lows. As an example of how slow speeds are, Annaly Capital Management, in its just released fourth quarter earnings report, disclosed that the constant prepayment rate in its portfolio of mostly higher coupon Agency mortgage-backed securities declined to 10%—the second lowest in company history behind the first quarter of 2000. The market was watching January speeds carefully for signs that lower rates—which had caused a spike in the MBA Refinancing Index to 7414.1 in January—were flowing through to actual mortgage closings. Most dealers were anticipating that January speeds would be double that of December. Actual January speeds, released February 6, came in largely in line with dealer expectations, as prepayments on Fannie Mae 30 year fixed rate pass throughs spiked 124% in the January report. Again, while the increase may seem large on a percentage basis, the absolute level of speeds is relatively tame. For now, it would seem that very low mortgage rates have not sparked a refi wave similar to 2003. Going forward, analysts are expecting 20% month over month increases for February and March.

2008 was a challenging year for the MBS investor, but 2009 has the potential to be rewarding. The following chart, provided by Barclays Capital, illustrates their estimate for 2009 MBS estimated net supply and demand (in billions of dollars):



There are, however, two sides to this picture. First, as the chart demonstrates the technicals for MBS point to very good price support. On the other hand, the Federal government, through all of its many buying programs (including, we would argue, banks that are supported and directed by the government), is the main source of that demand. What is unclear to the market is how long the government will remain as the market’s largest buyer. The Federal Reserve’s \$500 billion buying program is supposed to run through June 2009. We will continue to monitor this situation.

The Commercial Mortgage Market

Our commentaries and conclusions are typically driven by data, but we also pay close attention to the sentiment of market participants. Thus we bring to you a quick report from the Commercial Mortgage Securities Association’s (“CMSA”) Investor Conference in South Beach from January 12-14. This conference, which is always held the second week of January, is attended by investors, investment banks, rating agencies and third party providers, and is a great venue for getting the direction and mood



of the industry. One indicator of the mood is attendance, and that indicator is decidedly gloomy—only 700 attendees this year, down from 1,300 a year ago. In general, the low attendance reflected a palpable sense of foreboding among the attendees as they await the inevitable tide of rising defaults and ponder the ramifications to their businesses. Here are our three main takeaways:

What Will the Special Servicer Do? Loan servicers will be in the hot seat in the coming years, and they will be faced with some big decisions related to the scarcity of capital for refinancing and the generally poor credit prospects. Any form of loan modification will generally come with some degree of pain for the borrower. For performing loans that are maturing, servicers see extensions for up to one year as the most likely scenario. It is hoped that the financing environment will be more favorable at that time, thereby creating a higher realized value for the loan rather than what the current environment would provide. In effect “servicers will become the lenders of last resort.” A second reason for utilizing this strategy is simply that the acceleration of problem loans may strain the resources of the servicers.

Investors, particularly investment grade, are concerned that the market will fall further next year and that their interests are best served by immediate action by the servicer. Current market stresses, however, expose a conflict that participants in CMBS have long fretted about. Specifically, do special servicers, who are also the subordinate note holders in the trust, truly act to maximize the net recovery proceeds on a net present value basis for all certificate holders?

Where Will the Money Come From? Two panels were devoted to examining the origination landscape as well as what new lenders may develop for the market since \$20 billion of CMBS is maturing in 2009. With capital scarce, portfolio lenders will focus on their existing relationships and investments. Any new financings will be underwritten at pre-boom leverage levels and cap rates similar to at least eight years ago and perhaps earlier. Conference attendees accepted the fact that the primary market for CMBS will be dormant for 2009 and most likely 2010.

Private equity was being touted as having the most flexibility. However, while panelists emphasized their desire to be first mortgage lenders and noted borrower’s attitudes becoming more realistic toward the new lending environment, the return requirements for their investment vehicles limits their capital for the sector. These return requirements (as well as those for asset classes across the investment spectrum) will have to ratchet downward, or values will continue to seek lower levels.

How to Fix the Sector? A group of investors who invest real money presented recommendations that they believe would stimulate the CMBS market. Suggestions included simplifying the structures by having fewer tranches, more access to detailed property information, underwriters maintaining some ongoing risk in the transaction and a compensation structure for the rating agencies predicated on the investment performance. While we applaud the desire for greater simplicity and transparency, we wonder if investors are really ready to abandon securitization as the appropriate structure to finance commercial real estate in favor of direct lending with its private negotiations and attendant reporting.

The Markets

The market continued to work through the many ramifications of global economic conditions and current monetary and fiscal policy in January. The yield curve steepened, gold rallied, stocks fell. In a mark of the greenback’s resiliency, it rallied against a basket of foreign currencies, but remained weak against the yen. Perhaps a Bank of Japan foreign exchange intervention is in our future. The MBA Refinancing Index spiked to 7414.10 mid month as mortgage rates plumbed new lows, but by the end of the month mortgage rates had risen again and application activity subsided.

	1/31/2009	12/31/2008	1/31/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	3.00%	0.0%	-91.7%
2-year US Treasury	0.950%	0.768%	2.097%	23.7%	-54.7%
10-year US Treasury	2.842%	2.214%	3.595%	28.4%	-20.9%
10-year JGB	1.297%	1.174%	1.440%	10.5%	-9.9%
10-year euro	3.296%	2.951%	3.930%	11.7%	-16.1%
10-year UK Gilt	3.704%	3.020%	4.477%	22.6%	-17.3%
10-year Canada Treasury	3.050%	2.684%	3.878%	13.6%	-21.4%
30 yr conventional mortgage	4.724%	4.283%	5.408%	10.3%	-12.6%
Dollar Index	85.99	81.31	75.18	5.8%	14.4%
Japanese Yen	89.93	90.79	106.44	-0.9%	-15.5%



S&P 500	825.88	903.25	1378.55	-8.6%	-40.1%
Nasdaq Composite	1476.42	1577.03	2389.86	-6.4%	-38.2%
Gold \$/oz (nearby contract)	\$927.30	\$884.30	\$922.70	4.9%	0.5%
Oil \$/bbl (nearby contract)	\$41.68	\$44.60	\$95.98	-6.5%	-56.6%
MBA Refi Index (month end)	3906.3	6733.8	5103.6	-42.0%	-23.5%

Source: Bloomberg; Japanese Yen quote is the London feed

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