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MONTHLY COMMENTARY

FEBRUARY 2009

Released March 10, 2009

- **The Economy:** *Economic weakness intensifies; banks look for tangible equity*
- **The Residential Mortgage Market:** *Prepayment speeds increase; future still uncertain*
- **The Commercial Mortgage Market:** *Two case studies of poor CRE lending*
- **The Markets:** *Dividends get slashed, stocks fall*

The Economy

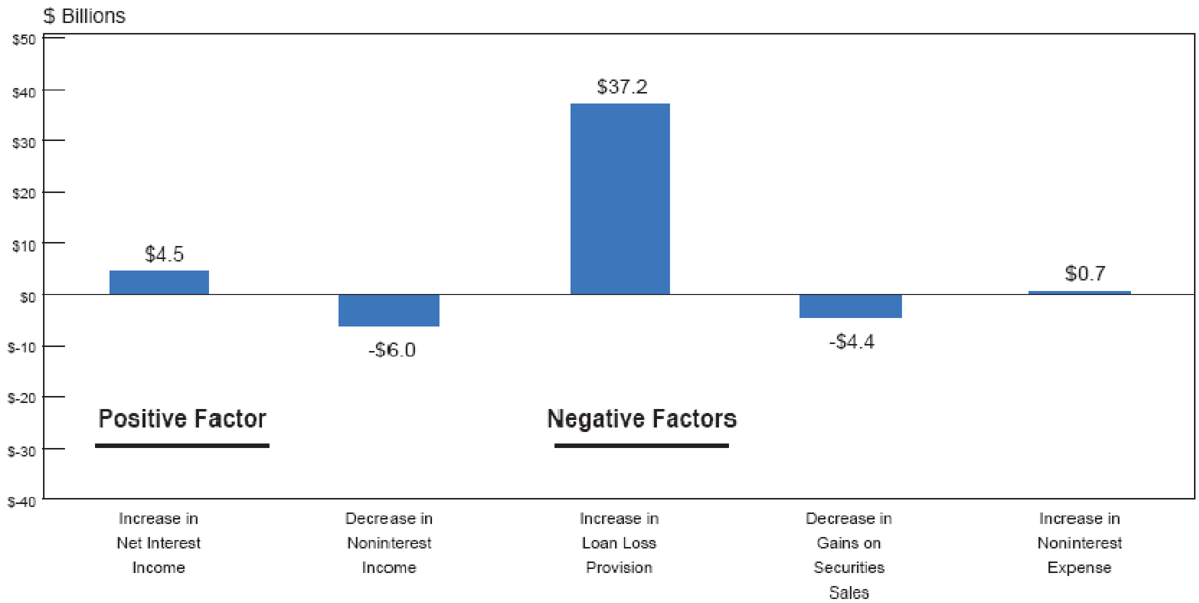
The economic rout intensified in February, with bad data releases on housing, jobs and consumption, and equity markets continuing to take back years of gains. The revised estimate of 4th quarter GDP growth came in worse than anticipated at a negative 6.2% annualized rate, the worst since first quarter 1982. The number of initial jobless claims has stayed above 600 thousand for five straight weeks, and continuing claims rose over the 5 million mark for the first time ever (measurement began in 1967). The economy has now lost 4.4 million jobs since January 2008, 2.6 million jobs in the past four months alone. To give a sense of how deep and sharp these losses are, in the 17 months of consecutive job losses from August 1981 to December 1982, the economy lost 2.8 million jobs. US auto sales (cars and light trucks of all manufacturers) plummeted to a 9.1 million seasonally adjusted annual rate, down 40% year-over-year. Manufacturing activity is running at just 72% of capacity, a level of slack exceeded to the downside only by the 70.9% level in December 1982. Housing starts, permits, and sales all got even worse. Housing starts are starkly weak, reflecting the oversupply in the market. In January just 466 thousand houses were started (at a seasonally adjusted annual rate), the fourth month in a row that a new all-time low has been set and a decline of almost 80% from the recent peak in January 2006 when homebuilders were cranking up at a 2.27 million annual rate. Home prices have now declined by 27% from their peak in the summer of 2006 (using the S&P/Case-Shiller 20 MSA composite index).

Not coincidentally, February was also the month in which the Obama Administration launched its multi-pronged attack on the problem. The main thrusts of the attack are to fix the economy (with the stimulus package and a budget with trillions in deficit spending), the housing market (the Housing Affordability and Stability Plan) and the country's banking system (the Capital Assistance Program). We are not economic forecasters, but we think our country's ills will get worse before they get better; the business cycle must be allowed to run its course and boom must be followed by bust. A great boom like the debt-bubble boom of 2002-2007 must be followed by an equally great bust like we are in right now. The Administration should not make the mistake of trying to prevent that from happening, or else it risks a repetition of the lost decade of Japan or, worse, causing a new bubble with the cure. The best that the Administration should hope to do is avoid the kind of collapses along the way that would make recovery impossible.

To that end, the banks were a focus in February. The S&P 500 finished down 11% for the month, with the KBW bank index falling more than 15% and money center banks collapsing to ridiculous lows, as the market discounted the probability of nationalization. Contributing to these concerns is the new-found appreciation for bank TCE, or Tangible Common Equity. After a laser-like focus on Tier 1 capital, bank regulators' preferred metric, the shift in attention to the stricter TCE ratio marks an important change. The differences between these two capital adequacy measures are stark. Tier 1 uses a fairly loose definition of equity capital that includes some questionable items: "equity-like" hybrid securities, deferred tax assets (DTAs), and other intangibles. Also, unrealized losses in available-for-sale securities are not included, effectively inflating the ratio. The denominator of this ratio is risk-weighted assets, calculated by a formula that gives varying weights to asset classes based on their perceived risk.

The TCE ratio is a much simpler measure of capital adequacy, although much more demanding. This metric divides tangible common equity by total tangible assets. Preferred stock and hybrid securities and intangibles like goodwill and DTAs are excluded. Unrealized mark-to-market losses are included. Total tangible assets are not risk-weighted. Clearly, the TCE ratio is the more conservative measure of bank balance sheet health, and it will also be the more onerous method if it is the focus of the government stress tests that are a part of the new Capital Assistance Program (CAP). Details of the CAP have been discussed elsewhere ad nauseum so we won't delve into it here, but in brief, bank capital will be stressed under a base case and a more severe scenario, and those banks that are found wanting will have access to government-provided "contingent common equity." Which ratio will be used to determine capital adequacy is unknown, but the CAP seems to be leaning toward TCE. One piece of evidence for this bias is the following quote from a Treasury white paper on the CAP (http://www.treas.gov/press/releases/reports/tg40_capwhitepaper.pdf) that defends the conversion of government capital injections from preferred equity to common equity: "Market participants pay particular attention to common equity as a measure of health in stressed environments, and regulators have long believed that common equity should be the dominant component of a banking organization's highest quality forms of capital."

In any event, the largest banks in the US have razor thin TCE ratios. According to SNL, the median TCE ratio for publicly-traded banks and thrifts with assets greater than $1 billion is in the neighborhood of 6.5%. The biggest banks are even lower. And there is a lot of headwind for the banks, as illustrated in the graph below from the recently released FDIC quarterly banking profile. The graph shows that the negative factors contributing to profitability in the fourth quarter of 2008 vs the fourth quarter of 2007 far outweigh the positive:



In the fourth quarter of 2008, FDIC-insured commercial banks and thrifts lost $26.2 billion, the first time since the fourth quarter of 1990 that the industry posted an aggregate loss, with one out of three banks reporting a loss. Banks still have work to do on loan loss reserves. Even after more than doubling loan loss provisions from the fourth quarter of 2007 to $69.3 billion, our nation's banks still found their aggregate coverage ratio (loan loss reserves as % of non-current loans) declined to a 16-year low of 75% (typically this number is above 160% in healthier times). Until banks get ahead of their loan loss reserve deficiencies, they will not be able to enjoy the positive effects of the steep yield curve that Ben Bernanke has engineered for them.

The Residential Mortgage Market

The market is closely watching prepayment speeds to gauge the effects of policy decisions that are clearly designed to instigate a refinancing wave. Prepayment speeds in February (March release) did come in faster month over month amid lower rates and potential increased capacity. The aggregate 30 year Fannie Mae prepayment speed rose 34% to 23.1% constant prepayment rate (CPR) from 17.2% CPR. Speeds for 30 year Fannie Mae 6.5s and 7s were slower on average than 5s through 6s due to likely credit impaired profiles for higher coupon borrowers. Looking ahead, most dealers are anticipating a moderate increase in speeds in the near term due to increased day count coupled with increased seasonality, with perhaps a more dramatic increase by May or June on the relaxation of mortgage insurance requirements and LTV guidelines. However, there is a minority view that is predicting speeds to decline 10% to 20% next month due to the back-up in mortgage rates in late January and February. Borrowers may be waiting for a better entry point.

While prepayments will be driven in the immediate term by mortgage rate movements and credit factors, in the longer run the dominant determinant of the marginal prepayment will be the success of the Housing Affordability and Stability Plan. We published our initial thoughts on the HASP last month ("The Impact (and Advisability) of the Homeowner Affordability and Stability Plan" http://www.annaly.com/impactfeb09.pdf), in which we concluded that the program will likely fall short of the hoped-for results and that prepayment speeds will therefore come in more slowly than expectations based solely on rate-related refinanceability. Among the reasons we listed were frictions associated with industry administrative capacity and credit availability, borrower documentation and credit history, little opportunity for equity withdrawal, and significant Fannie Mae and Freddie Mac guarantee fees. The only update to this analysis is based on news from last week, when the Administration released more details on the mechanics of the program, particularly the loan modification component, and Freddie Mac announced that it was significantly reducing its guarantee fees. The Administration's update contained little that addressed the frictions above, but the Freddie Mac announcement was meaningful. In brief, Freddie Mac has waived loan level pricing adjustments that would typically scale higher for lower FICO scores and higher LTVs, as well as removing the lender's obligation to make representations and warranties about the value of the borrower's house. These changes (which we assume Fannie Mae will have to match in the weeks ahead) will reduce some of the frictions that would otherwise reduce prepayment speeds. These changes notwithstanding, we believe that the market will see some sustained increase in speeds but not the type of peak speeds witnessed in the 2003 refinancing boom.

The Commercial Mortgage Market

For the last few years of the bull market, commercial real estate lending had taken a 'Field of Dreams' approach. Instead of "If you build it, they will come," the mantra was "If you finance it, it will perform." In the short run this has clearly been the case: In January the aggregate default rate for CMBS was only 1.1%. Storm clouds are on the horizon, though, as we believe that some of the very optimistic underwriting pro formas will not materialize. Two transactions in our hometown of New York, Stuyvesant Town/Peter Cooper Village (Stuy Town) and the Riverton, illustrate how these business models will lead to disaster for the lenders.

Stuy Town and the Riverton are two large scale, middle income housing projects that contained a number of rent-stabilized units. They were never the sort of properties that made commercial real estate finance headlines until the properties passed into private hands. The new owners' strategy, the foundation of the debt's feasibility, was to convert these rent-stabilized units into de-regulated units and then raise all units to market rents.

To acquire Stuy Town in November 2006, the buyer (Tishman Speyer) needed debt financing of $4.4 billion at a weighted coupon of 6.38%. Annual debt service was $280.7 million. At closing, 73% of the units were rent-stabilized and the property generated net cash flow (NCF) of approximately $112.2 million, which translates to a 2.1% cap rate at acquisition. The annual debt service shortfall of $168 million would be supported by various reserves totalling $640 million funded at closing. NCF was projected to grow to $334 million by 2010 through annual conversion and market rent growth rates of 11% and 8%, respectively. Although cash flow has suffered because of higher expenses and smaller increases in market rents, the rating agencies downgraded the CMBS backed by this mortgage primarily because the new owners could not convert as many units as planned. Historical conversion rates have typically been in the 6% range, nowhere near the assumption used for Stuy Town. Naturally, they have remained in the single-digit range since closing. Is this surprising? It wouldn't have been if anyone had bothered to speak with Rose Associates, the property manager from 2002 until April 2007. It would appear that the lenders and rating agencies failed their due diligence on this assumption.

Although the Riverton employed a similar business strategy to Stuy Town, the $250 million of non-recourse financing proceeds completed in December 2006 actually retired existing indebtedness of $114 million and allowed the owners, Stellar Management and Rock Point Group, to cash out some equity. Reserves of $38 million for capital expenditures and $19 million for annual debt service shortfalls were funded at closing. The balance, $79 million, was distributed to the owners. When the deal closed, the Riverton was already over 50 years old and had only 55 fair market units out of a total of 1,230 apartments. By 2012, the owners projected that 650 of the complex's apartments would be converted to fair market units, an increase of 595 from closing. By July 2008, the property had only converted 128 units, more than 100 behind schedule. Anyone who thought this through at the beginning should have clearly seen that the conversion assumptions were unrealistic.

Stuy Town and the Riverton may be unique properties, but they are emblematic of the bull market mindset. Both are confronting debt default as debt service reserves have been burned through and net cash flows haven't grown. Market events like these will weigh on the market in the coming months, which will hurt legacy portfolios already reeling from market softness but open up terrific investment opportunities for lenders and buyers with fresh capital. Ultimately, we are hopeful that in this next investment cycle investors, lenders and rating agencies will remember what used to be the primary rule of commercial real estate underwriting: the only income to underwrite is the current income of the project.

The Markets

Global stock markets continue to decline, as the discounting mechanism factors in weaker growth outlook and corporations slash dividends. In 2008, 61 companies in the S&P 500 cut their dividends a combined $40.6 billion. Just two months into 2009, that number has already been beaten, as 33 companies have cut an additional $40.8 billion in dividends. Banks are leading the capital preservation effort; financials now account for less than 11% of the index's dividend income, down from a peak of 30%. At the current rate, dividend income is expected to fall 23% in 2009, which would make it the biggest decline since 1938. The dividend yield on the S&P 500 is now 3.6%, higher than the 30-year Treasury.

	2/28/2009	1/31/2009	2/29/2008	MOM % change	YOY % change
Fed Funds	0.25%	0.25%	3.00%	0.0%	-91.7%
2-year US Treasury	0.974%	0.950%	1.620%	2.5%	-39.9%
10-year US Treasury	3.015%	2.842%	3.511%	6.1%	-14.1%
10-year JGB	1.280%	1.297%	1.365%	-1.3%	-6.2%
10-year euro	3.112%	3.296%	3.891%	-5.6%	-20.0%
10-year UK Gilt	3.623%	3.704%	4.469%	-2.2%	-18.9%
10-year Canada Treasury	3.131%	3.050%	3.640%	2.7%	-14.0%
30 yr conventional mortgage	4.759%	4.724%	5.728%	0.7%	-16.9%
Dollar Index	88.01	85.99	73.71	2.3%	19.4%
Japanese Yen	97.96	89.93	104.21	8.9%	-6.0%
S&P 500	735.09	825.88	1330.63	-11.0%	-44.8%
Nasdaq Composite	1377.84	1476.42	2271.48	-6.7%	-39.3%
Gold $/oz (nearby contract)	$942.50	$927.30	$975.00	1.6%	-3.3%
Oil $/bbl (nearby contract)	$44.76	$41.68	$101.84	7.4%	-56.0%
MBA Refi Index (month end)	3063.4	3906.3	2569.0	-21.6%	19.2%

Source: Bloomberg; Japanese Yen quote is the London feed

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