



- **The Economy:** *It's official: The US is in a recession. Tell us something we don't know...*
- **The Residential Mortgage Market:** *Mortgage activity confronts loan modifications*
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- **The Markets:** *Rates, stocks and oil collapse from deflationary exhaustion*

## The Economy

In November, the Federal Reserve and Treasury continued attacking the credit crunch on multiple fronts. The Fed created yet another addition to the alphabet soup group: the Term Asset-Backed Securities Loan Facility (TALF). This \$200 billion facility was created to support the consumer loan market, including student loans, auto loans, credit cards, etc. The Fed also announced a program to purchase \$100 billion of direct GSE obligations and \$500 billion of Agency MBS “to reduce the cost and increase the availability of credit for the purchase of houses, which in turn should support housing markets and foster improved conditions in financial markets more generally.” The devil is in the details, but mortgage rates did indeed decline in November.

The never-ending bailout of AIG continued in November, with the purchase of \$40 billion of new preferred stock and two new lending facilities, one each for the company's RMBS and CDO positions. The big story of the month, however, was Citigroup. In a joint effort of the Fed, Treasury, and the FDIC, Citi received protection from losses on a pool of \$306 billion of troubled loans and securities (for a fee paid in preferred stock). Also, \$20 billion of new capital was injected into the bank via TARP funds, in exchange for more preferred stock. Unlike previous “bailout” plans, this one was especially kind to the common stock holders of Citigroup. Perhaps the government has realized that it won't be able to recapitalize the entire banking system on its own, and will need the help of the private market.

Also in November, the Business Cycle Dating Committee of the National Bureau of Economic Research made it official: The United States is in a recession, and it began in December of 2007. The informal definition of a recession is two consecutive quarters of negative GDP, but the NBER identifies “official” peaks and troughs of economic activity by studying reams of government data, focusing especially on measures of domestic production and employment. The committee weighed the available data and decided that the 73 month expansion that began in November 2001 ended in December 2007. Unfortunately, the NBER only works with a rear-view mirror; they make no prediction about when the trough will arrive.

Confirming NBER's declaration, the November economic data were dismal. The Fed's Beige Book began by reporting that “economic activity weakened across all Federal Reserve Districts.” There were some perverse bright spots: wage and price pressures have eased, and more retail discounting is seen as likely going forward. Also, in Minneapolis and Dallas, demand for bankruptcy services has increased. There is always a bull market somewhere.

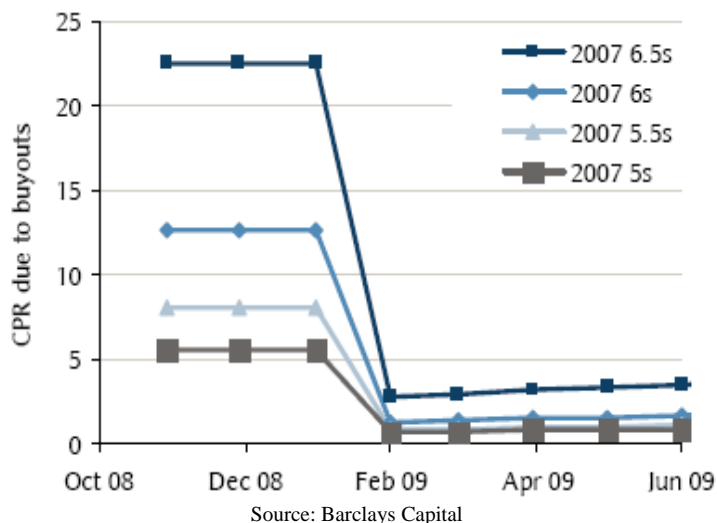
Other incoming data were no better. Initial jobless claims rose over 500,000 for the first time since September 2001. Nonfarm payrolls declined dramatically by 533,000, the biggest drop since 1974. Economists expected the unemployment rate to rise from 6.5% to 6.8%, but it “beat” estimates by only rising to 6.7%. The reason for the “miss” seems to be twofold. First, more people are working part time than ever before because of economic reasons. This measure is up 62% over the last year, and stands at its highest level since records began in 1955. If the hundreds of thousands of people in this group who switched reluctantly to part-time work during November are counted as “unemployed”, the unemployment rate would have been 7.1%. The second reason for the better-than-expected unemployment rate is linked to a disturbing data point that few were discussing in November: the pool of available labor shrank by 422,000 workers. The number of discouraged workers who left the labor force is up 25.6% month-over-month, and 74% year-over-year. Assuming that all of the people who left the workforce had stayed and remained unemployed, the unemployment rate would have been 6.9%.

Car sales, while certainly not expected to be stellar, were terrible. Ford led the way with the smallest drop, only 30.6%. GM's sales fell 41%, and Chrysler brought up the rear with a 47% decline. No wonder the car companies want a bailout. Christmas sales are off to a lukewarm start, too. Perhaps retailers are planning their own trip to Capitol Hill, hat in hand.



## The Residential Mortgage Market

October prepayment speeds (November release) on 30-year fixed rate Fannie Mae collateral came in at 7.8 constant prepayment rate, up 25% from September's 6.2 print. This increase was a relatively tame response to the 40 basis point drop in 30 year conforming mortgage rates from September to October. Looking ahead, most dealers are anticipating dramatic, 130%-150%, increases for December speeds amid the new Agency loan modification plan announced by the Federal Housing Finance Authority (FHFA) in November and the recently announced plans by Treasury to purchase \$500 billion in Agency MBS. On November 11<sup>th</sup> the FHFA announced a streamlined loan modification plan for both Fannie Mae and Freddie Mac. The goal of the plan was to improve the affordability of seriously delinquent loans, defined as 90+ days past due, through either rate reduction, term extension or principal forbearance to bring the borrower's monthly debt to income to a maximum of 38% of their monthly gross income. Barclay's Capital estimates that approximately 1.6%, or roughly \$71bn, of the combined \$4.4 trillion of Fannie Mae and Freddie Mac guaranteed portfolio is seriously delinquent. While not a substantial number, MBS investors should be aware of the impact the plan could have on prepayment speeds as well as the impact on the overall housing market. The below graph, prepared by Barclays Capital, shows the potential CPR spike for various coupons assuming the buyout of all delinquent loans under the plan are carried out within three months:



What becomes easily discernable from the above graph is that higher coupon paper could experience the greatest pickup in speeds under the plan, but it will drop back down. What is not easily discernable is the effect that the modification plan will have on the broader housing market. The number of loans that would actually qualify for modification represents a relatively small portion of the overall MBS universe. The plan, while well-intentioned perhaps, will only stave off a small amount of foreclosures and misses treating the larger problems of negative homeowner equity and impaired credit.

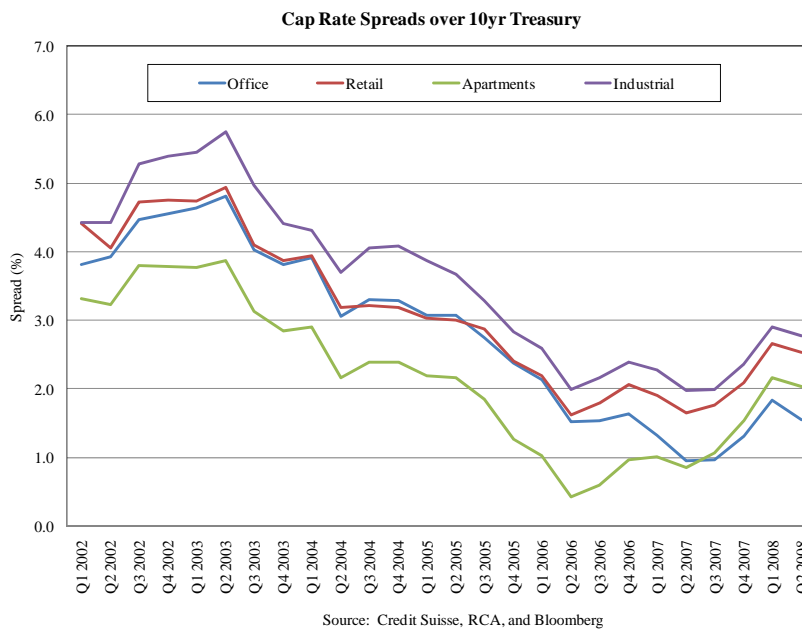
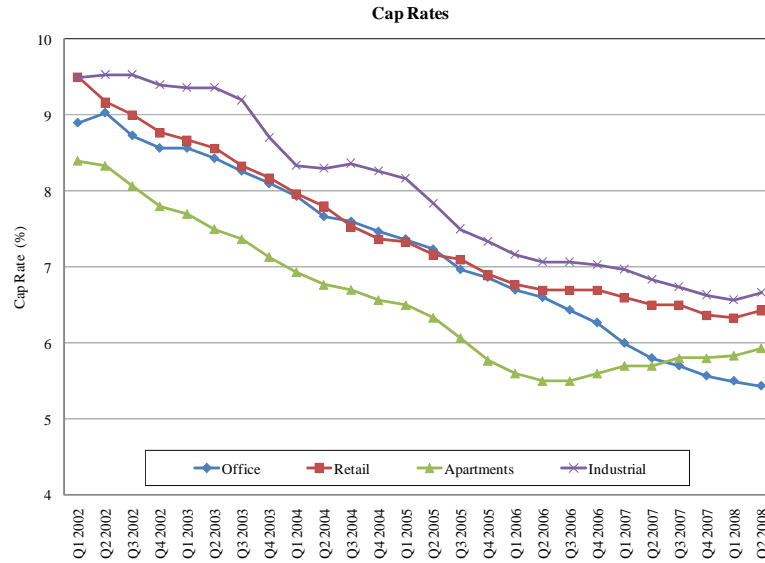
## The Commercial Mortgage Market

The eyes of the investment community have turned toward commercial real estate as the next domino to fall in the financial crisis. Let's start by saying upfront that we agree with the premise. The larger questions are how severe will the losses be and when will they be recognized?

Historically, before the recent era of cheap and reckless credit, cap rates on commercial properties generally traded in a range of 8.5% to 10%, translating to a spread of 325 basis points over 10-year Treasury yields. (Similar to the concept of a current yield, the cap rate is the ratio used to estimate the value of income producing properties. It is derived by dividing net operating income by the sales price.) The graphs below illustrate what happened next. Following the 2000-2002 recession and the significant drop in Treasury yields, cap rates rallied to a range of 6.5% to 8.5%. Also fueling the rally was a significant sector and asset rotation to hard assets, particularly real estate. Commencing in late 2004, a deluge of liquidity flooded the system and, frankly, trashed cap



rates. Cap rates dropped further to a range of 5% to 6.5% with the resultant spread narrowing to 100 to 150 basis points over 10-year Treasuries.



Cap rates are due for a correction, and we thus anticipate downward price revisions for commercial real estate generating loss severities of 30% to 40%. We draw our conclusion by comparing the leverage per unit on two samples of loans that were originated during 2002-2003 versus 2006-2007. Analysts at JP Morgan have also re-underwritten mortgage loans incorporating both a higher financing cost and less financing proceeds. Their conclusions also point to price declines of 35-40%.

The timing on loss recognition is a bit more difficult to determine. Contrary to the residential mortgage payment construct, the debt service for a commercial mortgage is not provided by the borrower/owner of the property but by the tenants. In addition, most debt structures are 5 and 10-year bullet term structures. Provided the tenants continue their payments, the borrower/owner can continue making his debt service payments and the mortgage will perform. In that case losses will manifest themselves upon refinancing.

In 2009, less than \$25 billion of commercial mortgages underlying commercial mortgage-backed securities (CMBS) will mature.



Although the lending markets are constrained, most of these mortgages are performing and were originated prior to the injection of additional leverage in the system. While there will be stress, these loans should exhibit minimal repricing. This situation will become worse going forward as newer loans come up for refinancing. In 2010, 45% of the loans maturing include approximately \$17 billion of 2005 originations. Loans maturing in 2011 and 2012 have similar contributions from 2006 and 2007 originations. We anticipate more losses as these latter vintages (2005-2007) enter the refinance pipeline. Of course, any loan that goes delinquent will be subject to a workout and, by definition, immediate repricing. Therefore the timing of any loss recognition for a loan will be a function of the underlying credit performance, the year of origination and, finally, the maturity date. Stay tuned.

## The Markets

In November, markets dropped in deflationary exhaustion. Stocks fell. Rates crashed to historic lows as markets piled into the safety of Treasuries. Oil continued its collapse. The 30-year mortgage rate finally budged, driving a pickup in refinancing applications. We'll see how many of those mortgages close.

	11/30/2008	10/31/2008	11/30/2007	MOM % change	YOY % change
<b>Fed Funds</b>	1.00%	1.00%	4.50%	0.0%	-77.8%
<b>2-year US Treasury</b>	0.985%	1.552%	2.999%	-36.5%	-67.2%
<b>10-year US Treasury</b>	2.922%	3.955%	3.940%	-26.1%	-25.8%
<b>10-year JGB</b>	1.399%	1.476%	1.478%	-5.2%	-5.3%
<b>10-year euro</b>	3.258%	3.900%	4.126%	-16.5%	-21.0%
<b>10-year UK Gilt</b>	3.768%	4.524%	4.637%	-16.7%	-18.7%
<b>10-year Canada Treasury</b>	3.324%	3.759%	3.982%	-11.6%	-16.5%
<b>30 yr conventional mortgage</b>	5.091%	6.301%	5.832%	-19.2%	-12.7%
<b>Dollar Index</b>	86.52	85.63	76.15	1.0%	13.6%
<b>Japanese Yen</b>	95.57	98.26	110.87	-2.7%	-13.8%
<b>S&amp;P 500</b>	896.24	968.75	1481.14	-7.5%	-39.5%
<b>Nasdaq Composite</b>	1535.57	1720.95	2660.96	-10.8%	-42.3%
<b>Gold \$/oz (nearby contract)</b>	\$816.20	\$718.20	\$782.20	13.6%	4.3%
<b>Oil \$/bbl (nearby contract)</b>	\$54.43	\$67.81	\$88.71	-19.7%	-38.6%
<b>MBA Refi Index (month end)</b>	3802.8	1075.4	2761.3	253.6%	37.7%

Source: Bloomberg; Japanese Yen quote is the London feed

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