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## The Economy

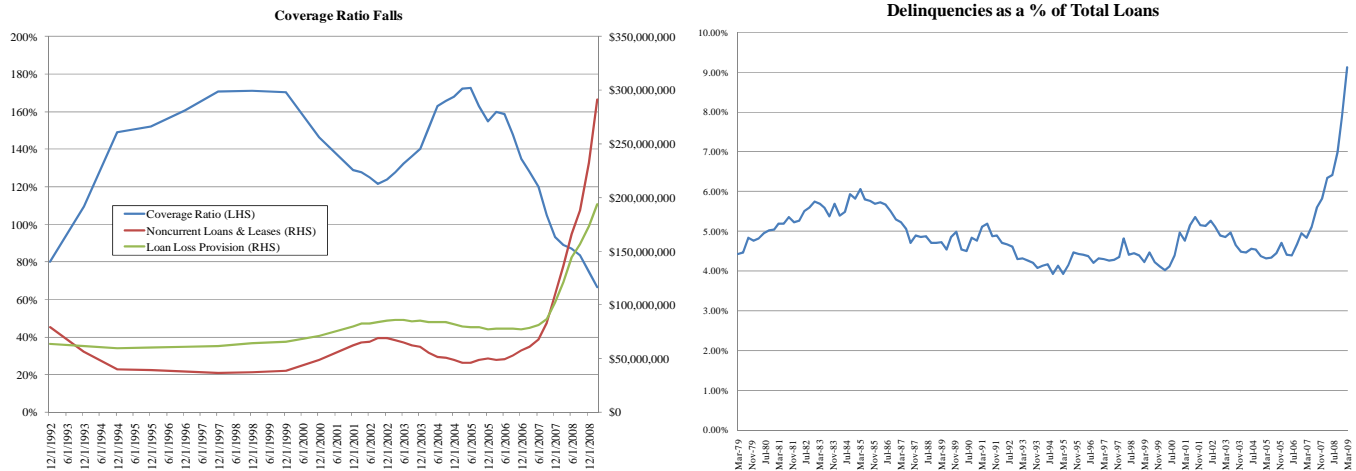
The bond market selloff that has been ongoing since the beginning of the year accelerated in May. The reasons are many: fears of oversupply (to the point that equity markets are beginning to react to news of how well Treasury auctions are received), gossip about the U.S. losing its AAA rating, concern that the Federal Reserve would choose to not defend a particular interest rate level with their Treasury buying program, headlines about Asians selling their dollar assets, convexity trading (more on that below) and, not least, a growing frenzy over inflation prospects.

We are currently experiencing deflation, with year-over-year CPI down 0.7%, so the real yield on the 10-year Treasury is well north of 4%. Despite this fact, the burden of proof clearly rests upon the deflation crowd, of which we have been a member. The reasons that we feel deflation is the war we are fighting now and for the foreseeable future are many and varied, but can be quickly summed up by the following statement: We have a deleveraging consumer and a struggling banking sector. That we have an overleveraged consumer should be beyond debate, and we've spoken at length on this in the past. Annaly CEO Michael Farrell is [on record](#) calling for the national savings rate to hit 15% as part of the household balance sheet restoration project.

Notwithstanding the stress test results of the Supervisory Capital Assessment Program—that showed only 10 of the 19 test subjects had to take capital-raising actions—banks in the US are ailing. Reading the results of the stress test, it appears that if the situation plays out how the Fed modeled the “more adverse scenario case,” most of the 19 banks will have *less* capital at the end of 2010 than they had at the end of 2008. For instance, Capital One Financial is estimated to take \$13.4 billion in estimated losses in 2009 and 2010, and will have only \$9 billion in resources other than capital to absorb these losses. Capital One was not required to raise capital. Regardless of whether investors consider this to be well capitalized, one thing remains true: If banks have shrinking capital, they cannot expand their lending activities. Just as in the consumer's case, deleveraging and protecting capital are not inflationary. As for the massive amount of money that has been thrown at this crisis, much of it has simply gone to fill the hole left by capital destruction in the financial sector.

We would argue the capital hole is still being dug. In the FDIC's most recent quarterly report on the banks (the title of which has an upbeat spin: “FDIC-Insured Institutions Earned \$7.6 Billion in the First Quarter of 2009”), news on the collective balance sheet of the industry was dour. Noncurrent loans (that is, non-accruing loans and loans past due 90 days or more) rose 25.5% in the first quarter to \$291 billion from \$232 billion just one quarter ago. Those looking for a moderation in the pace of deterioration will not find it in this data series. The 25.5% increase is accelerating over the past two quarters (23.8% in Q42008 and 12.8% in Q32008). As a percentage of total loans, the noncurrent rate rose to 3.8% from 2.9% last quarter, which is as bad as it got during the early 1990s. Despite these credit trends, the banks are still behind the curve. The coverage ratio at our nation's banks (reserve for losses/noncurrent loans) fell to 66% at March 31, 2009 from 75% at December 31, 2008 and 93% at the end of 2007. (The ratio stood at 160% at March 31, 2006.) If reserves had been increased by enough to maintain a 75% coverage ratio, the banks should have added another \$24 billion to reserves. This would have turned the \$7.6 billion profit into a \$16.8 billion *loss* for the quarter.

The day after the FDIC release, the Mortgage Bankers Association confirmed this trend with their first quarter national mortgage delinquency survey. There is no second derivative improvement to be found here either, as the seasonally adjusted delinquency rate of 9.12% is the highest since the MBA started keeping records in 1972. Also, the delinquency rate only includes late loans (30-days or more), but not loans in foreclosure. In the first quarter, the percentage of loans in foreclosure was 3.85%, an increase of 55 basis points from the prior quarter and 138 basis points from a year ago. Both the overall percentage and the quarter-to-quarter increase are records. The combined percentage of loans in foreclosure and at least one payment late is 12.07%, another record.



Sources: FDIC, Mortgage Bankers Association

As bad as the headline numbers are, the underlying trends are just as disturbing. Delinquencies on subprime mortgage loans rose to 24.95% from 21.88% in the fourth quarter of 2008, which should surprise no one. However, prime loan delinquencies rose to 6.06% from 5.06% one quarter ago, a significant and disconcerting increase from a group of borrowers that had previously been holding up much better. The percentage of loans in foreclosure increased 61 basis points to 2.49% for prime loans, and 63 basis points to 14.34% for subprime loans. The chief economist for the MBA, Jay Brinkman, was understandably downbeat. "Looking forward, it does not appear the level of mortgage defaults will begin to fall until after the employment situation begins to improve. MBA's forecast, a view now shared by the Federal Reserve and others, is that the unemployment rate will not hit its peak until mid-2010. Since changes in mortgage performance lag changes in the level of employment, it is unlikely we will see much of an improvement until after that."

Two other notable data points have been spotted in the field (thanks, Fred Hickey): The International Air Transport Association reported a 21.7% year-over-year drop in cargo demand, the fifth consecutive month of 20%-plus year-over-year declines. "We have not yet seen any signs that recovery is imminent," said Giovanni Bisignani, IATA's CEO. The American Trucking Associations reports that tonnages shipped in April fell 13.2% from the prior year, the worst year-over-year fall in the current cycle and the largest drop in thirteen years. (In March, tonnages fell 12.2% year-over-year.) ATA Chief Economist Bob Costello said the second derivative (the change in the rate of change) is getting worse. "While most key economic indicators are decreasing at a slower rate, the year-over-year contractions in truck tonnage accelerated because businesses are right-sizing their inventories, which means fewer truck shipments."

We believe there is indeed a connection between what is happening in credit, what is happening at the banks, what is happening in the economy and what may happen in inflation down the road. For the last word on inflation, we'll leave it to the Mortgage Bankers Association economic forecast. For what it's worth, the MBA is calling for consumer price changes of -0.2%, 0.9% and 0.8% for Q42008 to Q42009, 2010 and 2011, respectively. Nowadays, the MBA's perspective is worth a lot.

## The Residential Mortgage Market

Prepayment speeds for April (May release) remained relatively benign despite concerns of a modification and rate-induced refinance wave. On the aggregate, 30-year FNMA collateral prepaid at 22.1 Constant Prepayment Rate, compared to 22.2 CPR the previous month. Any collateral that was impaired or challenged in some way, such as credit-impaired, interest-only or 40-year mortgages, high loan-to-value loans, etc., prepaid substantially slower than their conforming cohorts due to their barriers to refinancability even under the various government loan refinancing programs and incentives. Looking ahead, most dealers are anticipating anywhere from flat to a 20% increase in speeds month-over-month. The divergence of opinion comes from the questions on whether capacity constraints have eased on mortgage originators enough to get new loans processed, and the effect of higher mortgage rates.

As discussed above, there was a dramatic sell-off in Treasuries towards the end of May and into early June. The yield on the 10-year Treasury closed below 3% as recently as April 27, hit 3.461% at May 29 and as of June 8 had risen to the 3.90% range. This despite the fact that new data points were hardly inflationary. A logical explanation for this would be convexity-related hedging.



In a general bond market sell-off, the duration (or price sensitivity to changes in interest rates) of a portfolio that held MBS would extend due to the decreased refinance incentive brought about by higher rates. In this instance, a portfolio manager would seek to offset this extension. One way to do so is by “selling duration,” or selling Treasuries. MBS related hedging now appears to be leading Treasuries instead of Treasuries leading MBS. The markets experienced a similarly dramatic uneconomic sell-off in mid 2003 related to convexity hedging. Fed Funds were equally low; however the 10-year Treasury sold off from 3.11% on June 13, 2003 to 4.56% on August 13, 2003, a huge jump. This time around, the convexity-related hedging may be even worse than the experience of mid-2003 if the much anticipated refinance wave fails to materialize. In other words, we are likely to continue to see a steep yield curve, thanks in large part to portfolio managers simply doing their jobs.

## The Commercial Mortgage Market

While negative credit issues continue to steadily bombard the commercial real estate sector, other forces—namely the government and the rating agencies—contributed to significant price volatility in CMBS, both positive and negative.

The Term Asset-Backed Securities Loan Facility (“TALF”) program was expanded on May 1 to include CMBS. Initially, price movement was negligible because legacy assets were not included. Then on May 19, the Federal Reserve Bank announced the inclusion of legacy CMBS with certain eligibility requirements, including that the securities “...be rated AAA by two agencies *and have no rating below AAA*” (emphasis ours). This announcement triggered price rallies in CMBS by as much as 10 points for super senior bonds. However, many of these gains were reversed on May 26 when Standard & Poor’s requested responses by June 2 to a Request for Comment (“RFC”) on proposed changes to its methodology and assumptions for rating U.S. CMBS. Within the RFC, S&P indicated that approximately 25%, 60% and 90% of the most senior tranches of the 2005, 2006 and 2007 vintages, respectively, could be downgraded. Consequently, many CMBS would now carry a rating *below AAA* and be ineligible for TALF. On May 28, after considerable negative reaction from the market, S&P extended its deadline of the RFC to June 9. Price declines were reversed slightly as investors took this as a sign that a more favorable resolution may be forthcoming. Investors’ hopes were dashed as S&P released a report on June 4, revising upwards that 50%, 85% and 95% of most senior tranches of the 2005, 2006 and 2007 vintages, respectively, could be downgraded due to its proposed rating changes. Let’s look a little closer at two areas that S&P is adjusting in its methodology: valuation and rental revenue.

As we have said in previous commentaries (see November 2008), leverage extended during 2004–2008 generated excess valuations ranging from 30% to 40%. As the prices gained momentum, excess valuations and leverage increased. For example, the now infamous Stuyvesant Town transaction, securitized in early 2007 with a 2% cap rate, is projected to default during the second half of 2009. Revaluing this property using 2008 cash flow and cap rates ranging from 6% to 6.5% (and that is generous) results in a loss of \$700 million to \$900 million of senior debt. However, if the property were to be financed by a new third party lender, that lender would commit funds to no more than 65% of the new value. The total loss to the senior debt holders would be \$1.5 billion to \$1.6 billion. Given the fact that total subordination through the ‘AAA’ rated AJ class totals \$1.6 billion, it seems a good bet that the super seniors will be downgraded.

A second area where S&P has drawn criticism revolves around how the agency intends to stress the rental income of a property. S&P wants to start with the lower of current or market rents, and then decrease rents a further 6% to 30% depending upon property type. Analysts feel this is draconian. However, Blockbuster Inc., Zale Corp, Pier 1 Imports and Starbucks Corp. are requesting rent reductions and concessions on existing space. Starbucks is reportedly requesting rent reductions of up to 25%. Again, it sounds like S&P may not be too far out of the base path.

Unquestionably, a resolution of the legacy CMBS assets is imperative to jump starting the lending effort. The inclusion by TALF was a step in the right direction. But some market participants were outraged that S&P chose now to consider changing their ratings methodology to a more conservative, yet more realistic, posture. While the initial ratings for these transactions were moronic and the agencies were maligned for not reacting quickly to the subprime disaster, we think there is merit in their revised methodology. Thus far the Federal Reserve has given no indication of how or whether the TALF program will be adjusted if the downgrades are enacted.

## The Markets

Stocks continued to climb a wall of perceived confidence, even as bonds took a dive and gold surged. The refi index got sawed in half from the prior month as mortgage rates rose. Should be an interesting summer.



	5/31/2009	4/30/2009	5/31/2008	MOM % change	YOY % change
<b>Fed Funds</b>	0.25%	0.25%	2.00%	0.0%	-87.5%
<b>2-year US Treasury</b>	0.919%	0.903%	2.645%	1.8%	-65.3%
<b>10-year US Treasury</b>	3.461%	3.121%	4.061%	10.9%	-14.8%
<b>10-year JGB</b>	1.490%	1.432%	1.759%	4.1%	-15.3%
<b>10-year euro</b>	3.589%	3.178%	4.405%	12.9%	-18.5%
<b>10-year UK Gilt</b>	3.747%	3.501%	4.986%	7.0%	-24.8%
<b>10-year Canada Treasury</b>	3.385%	3.101%	3.711%	9.2%	-8.8%
<b>30 yr conventional mortgage</b>	5.020%	4.454%	6.017%	12.7%	-16.6%
<b>Dollar Index</b>	79.23	84.61	72.88	-6.4%	8.7%
<b>Japanese Yen</b>	95.59	98.89	105.52	-3.3%	-9.4%
<b>S&amp;P 500</b>	919.14	872.81	1400.38	5.3%	-34.4%
<b>Nasdaq Composite</b>	1774.33	1717.30	2522.66	3.3%	-29.7%
<b>Gold \$/oz (nearby contract)</b>	\$978.80	\$891.20	\$887.30	9.8%	10.3%
<b>Oil \$/bbl (nearby contract)</b>	\$66.31	\$51.12	\$127.35	29.7%	-47.9%
<b>MBA Refi Index (month end)</b>	2953.6	5108.2	1905.2	-42.2%	55.0%

Source: Bloomberg; Japanese Yen quote is the London feed

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