ANNALY®
CAPITAL MANAGEMENT, INC.

MARKET COMMENTARY

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"2011 was a year in which the whims, actions and inactions of policymakers were a dominant driver of market activity and volatility."

Policy

Before the current crisis, participants in the marketplace generally would not consider the vote on raising the U.S. debt limit to be market moving, nor would they place much emphasis on the results of the latest sovereign debt auction in Italy or Portugal (no offense to those countries). The Spanish housing market and Greek tax collections were of purely provincial concern. Meetings between European heads of state were seen to be largely ceremonial, not transactional. Governments, whether democratic or autocratic, generally were in control of their citizenry. Central bankers didn't see themselves as firemen. Regulators and legislators took small steps to improve markets, not large actions that threatened to not only fix what was broken but break that which was working. America's was the triple-A risk-free rate.

This world no longer exists. 2011 was a year in which the whims, actions and inactions of policymakers were a dominant driver of market activity and volatility. In 2011, some $6.3 trillion in global stock market value was erased, with most of those losses coming in the second half of the year. European and Asian indexes were hit particularly hard, and the euro ended the year as the worst performing major currency.

By the end of the year, it was clear that the United States Treasury market—large, liquid and relatively safe—was the primary beneficiary of all of this turmoil. U.S. interest rates were driven to generational lows. Leading the way in this effort was the Federal Reserve (the Fed). No sooner had the American central bank completed its second round of quantitative easing (QE2) in June 2011 (in which it bought $600 billion of Treasurys and grew its balance sheet to $2.8 trillion), than only three months later it announced what has come to be known as Operation Twist (in which $400 billion of short-maturity Treasurys are sold and a similar amount of longer-term ones are purchased in a further attempt to suppress interest rates along the yield curve without growing the size of the balance sheet). When the European crisis deepened, the Fed reopened, expanded, and cheapened the dollar liquidity swap lines with several central banks amid tightness in dollar funding markets.

In short, prior to the crisis, the future could be counted on to generally follow the same path as the past, with governments and institutions playing their familiar roles. The uncertainty in the marketplace seems to reflect a perception that this belief no longer holds. Part of the problem is policymakers' penchant for kicking the can down the road (what Nouriel Roubini has called the "infuriating euphemism"). European policymakers have yet to fully confront the possibility that at least one and maybe more of their eurozone member nations are insolvent and that their union (and currency) lacks some

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critical mechanisms such as fiscal union and joint and several liability. The United States, no better, has let its crisis moment pass without taking serious steps towards fixing its structural fiscal deficits and unwieldy entitlement systems. Many suspect that China, with its social imbalances and mercantilist policies, will have its own day of reckoning in the future. The gloom of the market as we head into 2012 is that the can, so to speak, may not be kickable much longer. As if this weren't enough, policymakers have made headway in at least one respect—regulation. The looming catalysts of the enactment of the various pieces of the Dodd-Frank Act and Basel III are about to do nothing less than change the way in which our financial system operates.

The new year will start off with a bang. The European struggles will remain at the forefront of the market's immediate concerns—the test of more than €457 billion of eurozone government debt coming due in the first quarter. Beyond this, the market will grapple with more regulatory uncertainty and the spectacle of the pivotal U.S. election season. In this environment there will be both opportunity and despair, but it is hard to disagree with Christine Lagarde, head of the International Monetary Fund, who said recently, "There is no economy in the world, whether low-income countries, emerging markets, middle-income countries or super-advanced economies, that will be immune to the crisis that we see not only unfolding but escalating."

Economy

"If we could put words in Mr. Bernanke's mouth, we would say he is 'cautiously neutral.'"

At the press conference following the November 1-2 meeting of the FOMC, Federal Reserve Chairman Bernanke stated: "In short, while we still expect that economic activity and labor market conditions will improve gradually over time, the pace of progress is likely to be frustratingly slow." If we could put words in Mr. Bernanke's mouth, we would say he is "cautiously neutral."

Not a bad conclusion, actually. Though real GDP accelerated throughout 2011, the pace of growth was well below levels that typically mark a robust recovery: 0.4%, 1.3% and 1.8% in Q1, Q2 and Q3, respectively.

New housing starts averaged just over 600 thousand for 2011, well below the historical average of 1.5 million and previous troughs between 800 and 900 thousand. New home sales were just as bad, averaging around 300 thousand during the year, down over 75% from a bubble-time peak of near 1.4 million in 2005. Prices continue to drift lower. The S&P/Case-Shiller 20 city index was down 3.4% year-over-year in October, and has fallen in every month since April 2011 (seasonally adjusted). The CoreLogic index turned in a slightly worse performance, falling 3.9% year over year in October.

Inflation, one of the Fed's two mandates, is being watched very closely by the central bank. Headline CPI inflation accelerated throughout the year from below 2% to near 4% on the back of higher gasoline and food prices, and core CPI also accelerated from below 1% to 2.1% by November 2011. Inflation expectations, however, as measured by the TIPS 5-year breakeven, are telling a different story. After rising from around 1.7% at the start of 2011 to a high near 2.5% in May as QE2 was nearing its completion, expectations fell to 1.4% before the Fed announced Operation Twist. Expectations have stabilized, but have yet to move significantly higher, ending the year at 1.55%. This is a level that the FOMC would consider lower than its mandate, and it expressed appropriate concern in its December 13 statement: "The Committee also anticipates that inflation will settle, over coming quarters, at levels at or below those consistent with the Committee's dual mandate. However, the Committee will continue to pay close attention to the evolution of inflation and inflation expectations."

The second part of the dual mandate is the job market which, depending on your comparison year, turned in either relatively strong or relatively disappointing results. Compared to the job creation track record of the prior three years, 2011 was a change for the better. But compared to any other year of economic recovery, it was anemic.

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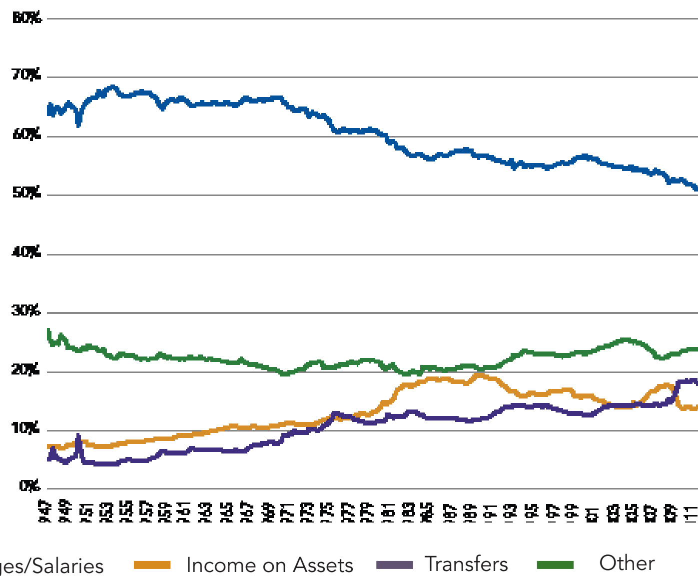
The widely-followed nonfarm payrolls averaged gains of only 137 thousand jobs per month during 2011, ranging from a high of 235 thousand in February to a low of 20 thousand in June. Gains in the household survey turned in a similar 131 thousand average for the year, but was much more volatile. The unemployment rate showed a continued downward trend, ending the year at 8.5% from 9.4% in the year-ago period. There were a few drivers of this decline: the number of unemployed workers fell by 1.3 million from last year, but more than 1.4 million people left the work force entirely. This pushed the participation rate down to 64.0% by the end of 2011, a level not seen since the recessionary period of the early 1980s. The labor force remained effectively flat for the year, but notably has not grown at all in the trailing four years. In fact, the trailing four-year growth rate dipped to -0.02% in December 2011; this is the first time since the labor force began being measured in 1948 that the 48-month growth rate has been negative. A stagnant labor force has important implications for potential GDP growth and inflation, among other things.

Furthermore, nominal per capita wage growth is also negative over the trailing four-year period, another unfortunate first for this 52-year old data series. If nominal wages have lagged this badly, real wages must be worse. This is certainly significant, as personal consumption expenditures (PCE) as a percentage of GDP has remained at its historic peak of 71%. PCE has shown continued strength despite slow/negative wage growth, but this isn't a new trend. Since 1980, PCE has grown at around a 6% nominal annual pace while personal income has grown at about 5.8% annualized. This gap looks small, but 20 basis points annualized over 30+ years becomes significant when you are dealing with trillions of dollars. Famously, falling savings rates, household debt growth, and wealth extraction from ripping equity and housing markets allowed consumption to outpace incomes, but these trends have stalled and reversed course in recent years. Increased government transfer payments have taken their place to support spending in recent years. Chart 1 below breaks out some notable components of personal income in search of underlying trends.

"Falling savings rates, household debt growth, and wealth extraction from ripping equity and housing markets allowed consumption to outpace incomes, but these trends have stalled and reversed course in recent years."

Chart 1: Components of Personal Income



Source: Bureau of Economic Analysis, Haver Analytics.

Chart 1 excludes payments for contributions to government social insurance, which are subtracted from personal income. The "other" bucket consists of proprietors' income, rental income, and supplements to wages and salaries such as employer contributions to social security and pensions. While this "other" bucket has stayed fairly constant as a percentage of total personal income over the past 60+ years, several other trends immediately stand out. From the 1940s into the mid-1970s, wages made up roughly 65% of personal income. They now account for roughly half. The categories that took this share are the aforementioned transfer receipts, as well as income on assets

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(interest income and dividends). The growth in government transfers seems to be secular (population growth and aging) and due to social security payments (31% of the total), Medicare (24%), and Medicaid (18%).

The importance of income from assets rose through the early 1980s and has been in decline ever since. Why? Lower interest rates and lower dividend yields, compounded most recently by a general decline in net worth. The owners of financial assets are clearly starved for income, and the Fed has promised that it will stay this way for some time to come, all along the yield curve. Chart 1 represents a worrisome headwind for the economy, as is the fact that the "growth" segment of personal income is dependent on government social programs (and our continued ability to fund them). Hopefully consumers have learned their lesson and won't resort to excessive borrowing to keep their consumption levels up.

Residential Mortgages

Even amid the volatility induced by European solvency and contagion fears, on a spread basis agency mortgaged-backed securities ended the quarter roughly where they began as investors sought the relative safety of high-quality, liquid fixed income assets. In addition, the fourth quarter of 2011 brought with it details of the re-vamped Homeowner Affordable Refinance Program, or "HARP 2.0." "HARP 1.0" was initiated to help homeowners avoid foreclosure, stabilize the country's housing market, and ultimately improve the economy by providing a competitive refinancing solution to borrowers who were experiencing hardship. While in theory the program was a feasible solution to the nation's housing problem, it failed to deliver: Amid lender representation and warranty concerns, inability to subordinate second liens, and loan-to-value (LTV) and mortgage origination capacity constraints, only slightly over 800 thousand borrowers were officially refinanced, far fewer than the hoped-for millions.

"It is important to note that these HARP 2.0 revisions are far from any kind of 'blanket' government refinance program."

HARP 2.0, announced on October 24, 2011, sought to ease the frictions associated with the original program. There were five key revisions to the original program: 1) eliminate mandatory Fannie/Freddie borrower risk-based fees for borrowers who refinanced into a shorter-term mortgage, 2) remove the 125% LTV cap, 3) waive certain lender representations and warranties, 4) eliminate the need for a new appraisal, and 5) extend the end date for HARP until December 31, 2013 for loans originated on or before May 31, 2009. While these revisions should certainly marginally help refinancing activity, it is important to note that these revisions are far from any kind of "blanket" government refinance program. In fact, the Federal Housing Finance Authority (FHFA) estimated that roughly 800,000 borrowers per year through 2013 may potentially refinance as a result of the changes, a far cry from the 14.7 million homeowners estimated to be underwater on their mortgages.

Despite the above mentioned revisions, there continue to be major frictions to refinance even the official target amount. First, as illustrated by Chart 2, provided by Nomura Securities, employment in the mortgage origination industry is off about 20% from January 2010, which in and of itself creates capacity constraints.

Second, as Nomura analysts pointed out in their "2012 Prepayment Outlook", HARP 2.0 did not "indicate any significant changes to underwriting standards or reps and warrants", two components believed to be the main drivers of HARP 2.0 speeds.

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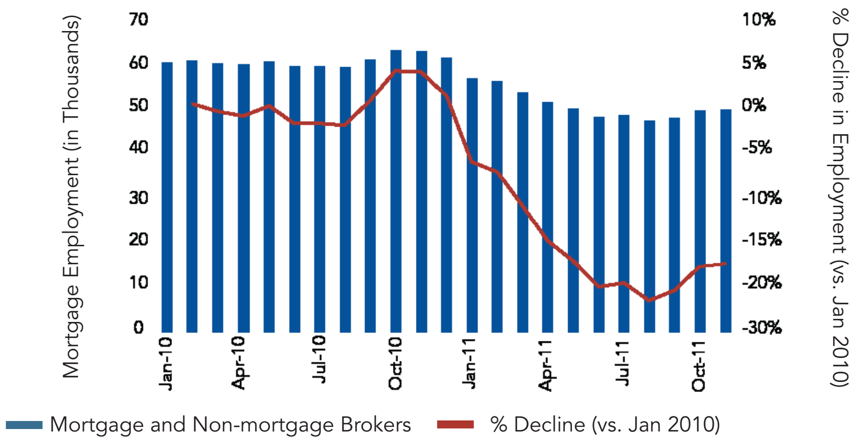
Chart 2: Employment in the Mortgage Origination Industry



Source: BLS, Nomura Securities International.

Commercial Mortgages

After two years of virtually no investment activity, commercial real estate participants entered 2011 more confident and poised to participate in a market revival. Their outlook was bolstered by the fact that CMBS spreads had grinded tighter since the summer of 2010. The favorable spread environment fostered a proliferation of conduit lending platforms. Lower financing costs coupled with pent up investor demand facilitated more transaction activity. And owners of properties sought to lock in historically attractive low long term rates provided the underlying property credit supported the financing. All signs pointed to a property recovery, albeit modest. All of this market momentum reversed during the summer of 2011 amidst increased volatility, and as "risk-off" became the mantra. Spreads widened and transaction quotes were pulled. As we enter 2012, macro themes—European debts, economic growth, job creation, etc.—overlap with the realization by investors that this incipient recovery may be limited to certain properties and markets.

"The one constant in the commercial real estate lending arena has been the life insurance

The one constant in the lending arena has been the life insurance companies. Bolstered by portfolios that emerged in relatively good shape following the Great Recession, an under-investment of commercial mortgages in the portfolios because of aggressive originations by conduit lenders, and value that is attractive relative to other fixed income instruments, life companies issued $60 billion of commitments. This trend should continue in 2012. We also expect to see renewed conduit lending activity, but enthusiasm for large loans and long warehouse holding periods are likely to be tempered by recent memory.

Given the low yields available in many fixed income products, investor appetite for real estate that exhibits relatively stable cash flows has remained strong. Investor preferences have and will remain focused on gateway cities subject to appropriate pricing. While opportunities for higher yields exist outside coastal and 24-hour cities, the risk-off mindset will likely keep capital flows choppy for these assets.

With interest rates remaining low for the foreseeable future and new product supply

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likely muted for almost all sectors, investors will continue to look for commercial real estate as an investment option to generate stable income with relatively high current rates of return.

Asset-backed Securities

Total volume of issuance increased sharply for asset-backed securities in the fourth quarter, particularly in October and November. In fact, November issuance ($18.7 billion) outpaced all other months of the year. According to J.P. Morgan, total public and private asset-backed issuance for the year ending 2011 was approximately $139 billion, which represents a 29% increase over total issuance in 2010.

Collateral performance remains strong in the benchmark credit cards, autos and utilities sectors of the market. Defaults in the credit card sector fell to pre-crisis levels while the average monthly payment rate (another measure of credit performance) rose well above 2010 levels. Excess spreads remained at near-record highs, providing investors with robust protection against credit losses. The auto and equipment sectors continued to see rating upgrades in subordinated tranches during the quarter in response to solid collateral performance and increases in credit enhancement/support.

Owing to sovereign credit concerns, during the quarter there was a pronounced bifurcation between the benchmark sectors and the off-the-run sectors such as retail cards, student loans and UK and Aussie mortgages. These latter sectors traded at a discount to the more liquid benchmark sectors. There was also strong demand in the primary/new issue market for these sectors, as many deals were upsized and/or driven by reverse inquiry.

"During the quarter there was a pronounced bifurcation between the benchmark sectors and the off-the-run sectors."

In general, the asset-backed sector delivered robust total returns in 2011, with the manufactured housing sector providing the best total return performance (10.82%), followed by the utility (5.36%), credit card (4.90%), home equity (3.63%), equipment (2.15%), and auto sectors (1.69%). Additionally, according to Merrill Lynch research, the only sectors that generated excess returns over the comparable Tresury benchmarks for the year were the asset-backed and commercial mortgage-backed sectors, with asset-backeds exhibiting less volatility than most other spread sectors.

In 2012, we expect to see a modest increase in issuance in the auto, equipment and some of the esoteric segments (timeshare, franchise, structured settlements, container leases, and aircraft) of the asset backed sector. Technicals are likely to remain favorable in the sector due to continued strong investor demand. The implementation of proposed securitization rules under the Dodd-Frank Act and other regulatory proposals remain the big wild cards; while these rules are unlikely to shut down the securitization markets they may ultimately increase the costs of issuance and slow new issue volume.

Corporate Credit

The same themes that underpinned the credit market as 2011 began were still in place as it came to an end. Fear of "Euro shock", coupled with forthcoming watershed changes in financial regulation and the 2012 U.S. elections, is likely to continue to contribute to choppy trading patterns, low conviction and heavy discounting of improving domestic conditions.

Last year is illustrative of the challenge of extrapolating too far into the future, and the resulting tendency to shorten investment time horizons. Risky assets posted very strong total returns in the first half notwithstanding tremors from the Japanese earthquake and

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Middle East unrest. Investors had cash to put to work and asset prices rose accordingly. The second half was unhinged by the re-emergence of Euro woes and the U.S. budget/debt limit debacle. These events were a boon to the Treasury market: The 10-year Treasury posted a spectacular 26.9% return in the second half, while financial bonds, high yield (HY), leveraged loans, the S&P 500 and Euro sovereign bonds posed negative returns (see table 1).

"The pricing of U.S. financial credit provides some insight into the direction of market risk and liquidity premiums."

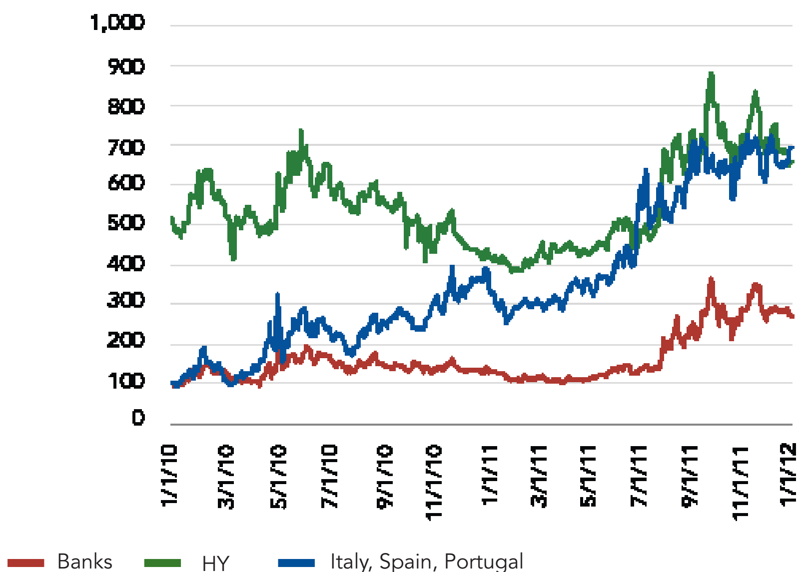
Table 1

	Annualized Returns-2011			Yields, %		
Market	1st Half	2nd Half	Full Yr	12/31/2010	12/30/2011	Chg, Bps
S&P 500	12.0%	-7.4%	2.1%			
US Broad	5.5%	9.8%	7.8%	2.92	2.04	-88
10-yr Trsy Note	6.5%	26.9%	17.1%	3.31	1.88	-143
Mortgages	5.7%	6.4%	6.1%	3.53	1.97	-156
IG Corporates	6.6%	8.2%	7.5%	4.09	3.87	-22
Industrial	6.6%	12.7%	9.9%	4.02	3.46	-57
Financial	6.6%	-1.0%	2.8%	4.16	4.67	52
HY Corps	9.9%	-1.1%	4.4%	7.60	8.41	81
CCC	11.1%	-13.1%	-1.4%	10.66	14.34	368
Leveraged Loans	5.2%	-2.1%	1.5%	6.40	6.70	30
CMBS	7.0%	5.2%	6.2%	4.10	3.62	-48
Euro Sovgs	15.4%	-17.6%	-1.8%	3.53	3.90	37
Japan Govts	1.2%	3.1%	2.2%	0.75	0.68	-7

Source: BAML, Bloomberg, LCD.

The pricing of U.S. financial credit provides some insight into the direction of market risk and liquidity premiums. If the "tail event" stemming from Europe is financial institution failure, it makes sense that U.S. bank credit default swaps (CDS) would be correlated to changes in perceptions about Euro stresses. Chart 3 shows how the correlation has increased starting last summer. Moreover, the U.S. government faces its own fiscal imbalances and the rating agencies have recently lowered the rating of a number of U.S. banks based on lower levels of perceived government support. A final factor to

Chart 3: 5-year Protection in the CDS Markets



Source: Bloomberg.

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consider is relative pricing: if the marginal buyer of fixed income is indeed a global asset allocator, it is important to look across markets as to the pricing of risk. As chart 3 shows, the single-B rated HY CDX index is trading at roughly the same level as the average CDS spread of Portugal (Ba2/BBB-), Spain (A1/AA-), and Italy (A2/A+).

Treasury/Rates

There were three main influences in the Treasury market that have worked to counteract each other. First, the somewhat better-than-expected economic numbers, which should have led to higher yields; second and third, the continued problems coming out of Europe and the commencement of Operation Twist, which helped drive down rates. These factors are responsible for the trendless market we have been experiencing since the fall, with the 10-year Treasury trading in a tight 35 basis point range for the last two months.

Auction sizes were steady during the quarter with a total of $501 billion in notes and bonds. The auction statistics were mixed, but overall demand for Treasurys remained strong. The 2-year, 3-year and 5-year Treasury notes continue to auction well and have seen the steadiest results. The 7-year saw solid demand in November but lackluster interest for both the October and December auctions. The 10-year saw mixed results as well with weaker than expected results for October and November but then very good demand in December. The 30-year auctions saw the widest swings in demand, with the December auction finishing with the highest bid-to-cover ratio since August 2000. (The bid-to-cover ratio is the number of bids received divided by the number of bids accepted and with December's reading at 3.05 it means the auction was more than 3 times oversubscribed.)

"There were three main influences in the Treasury market that have worked to counteract each other."

The Federal Reserve officially announced Operation Twist after its September 20-21 FOMC meeting. "To support a stronger economic recovery and to help ensure that inflation, over time, is at levels consistent with the dual mandate," the FOMC announced that it was going to extend the average maturity of its holdings of securities. "This program should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative." The idea of Operation Twist started to get priced into the market right around the time the debt ceiling issue was temporarily resolved in early August. As chart 4 below shows, the yield spread between the 3-year and the 30-year, the curve flattened significantly (~90 basis points) from early August up to the announcement on September 21st. But from when the first operation began on October 3rd through the end of the month, the curve actually steepened moderately.

Chart 4, as well as similar price action observed in the rally of the spring and summer of 2010 as the Fed hinted at QE2, illustrates that Fed transparency can result in market moves ahead of a Fed operation. This is worth watching in 2012. The minutes to the December 13, 2011, FOMC meeting, released January 3, 2012, described the Fed's intentions with regards to increasing the transparency and clarity of its public communications, including publishing the interest rate forecast built into each participant's economic forecast. As the Fed prepares to alter its communication policies, the market will continue to try to stay a step ahead.

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Chart 4: 3Yr vs. 30Yr Spread

Source: Bloomberg.

"This was a year of historic lows in interest rates, with Treasurys one of the best performing asset classes of 2011."

The Markets

The equity market ended the year essentially flat, rallying for the first half and fading in the second, with plenty of large daily swings. Commodities were down as a whole (-8% as measured by the CRB index), with precious metals and energy up for the year and industrial metals and grains mostly down. This was a year of historic lows in interest rates, with Treasurys one of the best performing asset classes of 2011. The 30-year moved from 4.33% to 2.89%, while the 10-year declined from 3.29% to 1.88%. Even the 2-year note, which started the year at a seemingly miniscule 60 basis points managed to shrink down to 24 basis points. The rally can be pinned partially on a relative scarcity of "safe" assets, particularly as the European sovereign debt crisis intensified.

QOQ	YOY				
	12/31/2011	9/30/2011	12/31/2010	% Change	% Change
Federal Reserve Funds	0.25%	0.25%	0.25%	0.0%	0.0%
2-year US Treasury	0.241%	0.245%	0.597%	-1.6%	-59.6%
10-year US Treasury	1.877%	1.916%	3.295.%	-2.0%	-43.0%
10-year JGB	0.988%	1.032%	1.128%	-4.3%	-12.4%
10-year euro	1.829%	1.887%	2.963%	-3.1%	-38.3%
10-year UK Gilt	1.977%	2.430%	3.396%	-18.6%	-41.8%
10-year Canada Treasury	1.941%	2.155%	3.122%	-9.9%	-37.8%
30 yr Conventional Mortgage	3.459%	3.490%	4.512%	-0.9%	-23.3%
Barclays US Corporate	3.76%	3.84%	4.03%	-2.1%	-6.7%
Dollar Index	80.18	78.55	79.03	2.1%	1.5%
Japanese Yen	76.91	77.06	81.12	-0.2%	-5.2%
S&P 500	1257.60	1131.42	1257.64	11.2%	0.0%
Nasdaq Composite	2605.15	2415.40	2652.87	7.9%	-1.8%
Gold $/oz *(nearby contract)*	$1,566.80	$1,620.40	$1,421.40	-3.3%	10.2%
Oil $/bbl *(nearby contract)*	$98.83	$79.20	$91.38	24.8%	8.2%
MBA Refi Index *(month end)*	3448.30	4019.00	2115.40	-14.2%	63.0%

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