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CAPITAL MANAGEMENT, INC.

MARKET COMMENTARY

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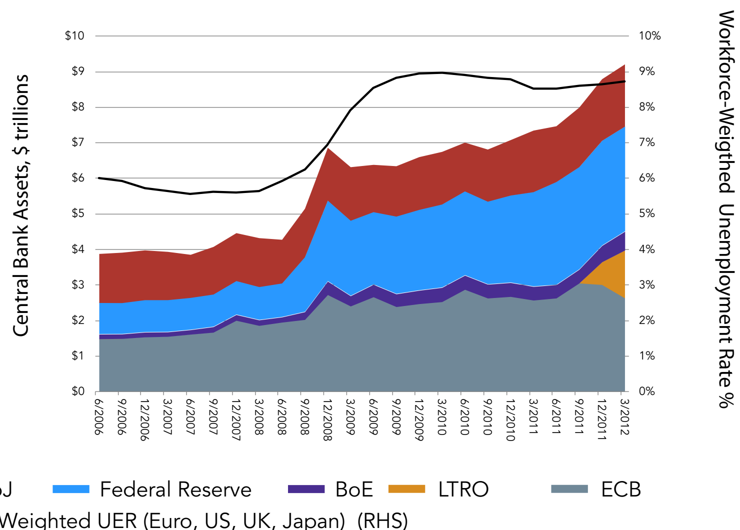
Policy

The first quarter of 2012, like the fourth quarter of 2011, was characterized primarily by heavy central bank activity. The Federal Reserve (Fed) continued with Operation Twist, which is currently scheduled to end in June 2012. The ECB completed its second tranche of Long-Term Refinancing Operations (LTRO) in February, and has provided €1 trillion ($1.3 trillion) of liquidity across both tranches. The Bank of England added an additional £50 billion ($80 billion) in February to its existing quantitative easing program, bringing it to a total of £325 ($520 billion). The Bank of Japan recently expanded its asset purchase program to ¥65 trillion ($784 billion) to be completed by the end of 2012, as well as upsizing its "Growth-Supporting Funding Facility" to ¥5.5 trillion ($66 billion) from ¥3.5 trillion.

All together, the four major central banks added over $300 billion of new assets in the first quarter of 2012, and $1.6 trillion over the last year. With financial conditions more stable, it appears that central bank balance sheets are deploying to jumpstart employment and other economic activity. The transmission mechanism of this lever, however, is not so simple, as Chart 1 demonstrates. Monetary policy is not a panacea, believes Fed Chairman Ben Bernanke, and without employing a counterfactual—"it

Chart 1: Major Central Banks: Total Assets vs. National Unemployment



Source: National central banks, Haver, Bloomberg, Eurostat, OECD, BLS.

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would have been much worse without it"—empirical evidence would seem to agree. (Looking at Chart 1, it is easy to see the attraction of the gold standard, or something like it, for governing monetary policy: with an objective, apolitical delimiter on central banks, such mind-boggling credit creation would not be possible.)

"We are mindful of the fact that politics will always be trumped by economics."

Time horizons get distorted in a crisis. When you're staring down the barrel of a gun, everything's immediate. Monetary policymakers stuck at the zero bound in the middle of a great deleveraging aren't much different: they try to fix the problem at hand but can't predict the long-term consequences of their actions. But "financial repression"—the concept that describes the central bank's role in a government's manipulation of the price, supply and demand of credit for its own purposes—comes chock full of political connotations which become more acute during this year of government elections/ transitions in Europe, China and the US.

People are not happy with the results: Riots in Spain and Greece, labor agitation in China and demoralized workers dropping out of the work force in America. Everywhere, it seems, governments are dealing with intractable structural deficits and rising levels of debt by either punishing their citizens for their own mismanagement (expensive social programs help win elections but can't go on forever) or kicking the can down the road. Neither solution is without consequences. Either the recession is magnified by severe austerity measures that won't work or demand is brought forward through government-supplied incentives, but in both cases the market never finds its clearing price. Skeptical market participants see this happening on a micro scale—think of "cash for clunkers" or the many government efforts to "fix" housing finance—as well as a macro one. Cautiously pessimistic about how this will all turn out, we are mindful of the fact that politics will always be trumped by economics.

Economy

The effect of central bank-fueled liquidity on financial markets has been obvious. The S&P 500 was up 12.6% in the first quarter, gold was up 6.7%, crude oil up 3.6%, gasoline futures were up 18.5%, and even the Barclays Aggregate Bond Index managed to gain 0.3%.

Less obvious were the effects of central bank activism on the US economy. Most of the incoming economic data have been mixed, but as we look at the Fed's headline performance as benchmarked by its dual mandate of stable prices and maximum employment, it seems the Chairman would have reason for satisfaction. The unemployment rate has steadily declined to 8.2% from near 10% as recently as late 2010. Employment has continued to grow, although the pace is slower than hoped and the trend was lower throughout the quarter: +275,000 in January, +240,000 in February, and +120,000 in March. Inflation as measured by the FOMC's preferred metric, the core PCE Index, has leveled out at around 1.9%. This is supported by inflation expectations, as measured by 5-year TIPS breakevens, of 2.05% at quarter end. These are about as close to 2%, the Fed's newly-minted inflation target, as one could ever hope to get. In any event, there seems to be a fair amount of dissent among the ranks. Chairman Bernanke was seen as dovish in his recent television interview, but this clashed with the March 13 FOMC meeting minutes which were viewed as hawkish by comparison. Several regional reserve bank presidents (including Williams, Lacker and Lockhart to name a few with voting power) recently gave speeches indicating that the bar for further easing is now higher. The debate comes down to the sustainability of recent growth in jobs and the economy, and the ability of monetary policy to fix problems like long-term unemployment.

In general, the momentum of economic outperformance that started 2012 has faded, at least as measured by the Citigroup Economic Surprise Index, which stood above 90 in early January before closing the quarter at 18.9. Notably weak was personal income, specifically real disposable personal income (RDPI), the kind that's available to spend after Uncle Sam takes his cut and inflation deducts its invisible tax. Through February

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2012, RDPI is up only 0.32% year-over-year. This is well below the already weak 1.8% pace in 2010 and the still weaker 1.3% 2011 gain. What is worse is that RDPI per capita has turned negative (down 0.4% year-over-year) and is stuck at 2006 levels. Call it a lost decade for household income growth. As Chart 2 shows, the only time the 5-year growth rate has been lower is 2009, but that was due to a spike in personal income in December 2004 driven by a one-time Microsoft dividend. On an organic basis, the trailing 5-year growth rate has never been lower. This suggests that total real disposable personal income growth will be driven by population growth, which is itself slowing versus historical trends (currently 0.73% versus an average north of 1% since 1970).

"Low interest rates drive a preference for current period consumption over future consumption."

Chart 2: Real Disposable Personal Income Per Capita

Source: Bureau of Economic Analysis, Haver Analytics.

Real personal consumption expenditures nevertheless plow ahead at the expense of the savings rate, which now stands at 3.7%. This is down from crisis-induced highs north of 6%. While this rate is above the 2.2% average of the debt binge years of 2005-2007, it is about half the historical average of 7% since 1959. Low interest rates drive a preference for current period consumption over future consumption, which is exactly what we are seeing in the monthly income and spending data. Perhaps this is what the Fed is aiming for with a 0% interest rate on savings?

Residential Mortgage Market

Mortgage spreads, as measured by the 30-year Fannie Mae current coupon minus the 10-year US Treasury, finished the quarter 8 basis points (bps) tighter than where it began. There was, however, volatility, as spreads ranged between 65 bps and 92 bps, primarily driven by the uncertainty in Europe and news on domestic mortgage issues.

On March 12, the United States along with multiple state attorneys general filed servicer settlements with Bank of America, JP Morgan Chase, Wells Fargo, Citibank, and Ally for approval in Federal Court. The total settlement was for $25 billion and will be allocated four ways: 1) $17 billion for credits towards principal reductions, forbearance, and costs to facilitate short sales, 2) $3 billion to refinance underwater borrowers current on their payments, 3) $1.5 billion to provide cash payments to borrowers who were foreclosed on between January 1, 2008 and December 31, 2011, and 4) $3.5 billion to pay states to fund consumer protection efforts. In addition the settlement cleared what has been a major impediment to refinancing over the past several years, the treatment of existing second-liens. Prior to the settlement, second lien holders (which were also in many cases the servicers themselves) were unwilling to subordinate their encumbrance, thus

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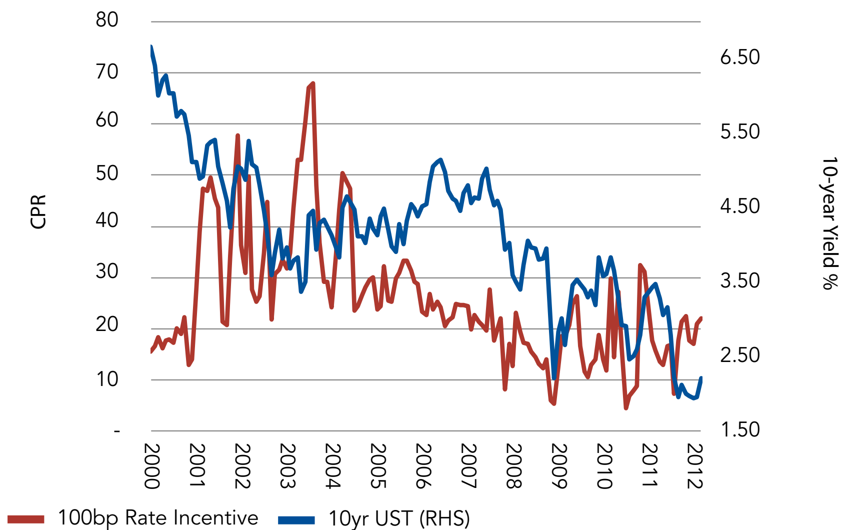
preventing a refinance of the first lien. Under the settlement, banks will be able to share losses on their second liens with first lien bondholders and receive credit toward the cash they pledge to spend in settlement. This change incentivizes banks to subordinate second liens and refinance first liens, as well as assists in the processing of foreclosures.

The dollar amounts of the settlement, in general, are small, but even so the impact needs to be put in context. From a historical perspective prepayments are tame relative to prevailing interest rates. Chart 3 illustrates historical prepayment speeds on mortgages with 100 basis points of rate incentive. The time series adds 100 bps to the 30-year Fannie Mae Current Coupon (which represents where current mortgages are being originated) and looks at the prepayment rate for mortgages at that rate level. For example, in March 2012 the current coupon was approximately 3%, and the prepayment speed on 4% mortgages was 22.1%. In contrast, in July 2003 the current coupon was approximately 6% and the prepayment speed on 7% coupons was 67.1%. What should be obvious from Chart 3 is that interest rates have never been lower and speeds on collateral with substantial rate incentive have rarely been slower, certainly prior to the credit crisis.

"From a historical perspective prepayments are tame relative to prevailing interest rates."

Chart 3: Historical In-the-Money Speeds



Source: Bloomberg.

Commercial Mortgage Market

The first quarter of 2012 saw a continuation of the global rally for many credit-sensitive asset classes. The legacy CMBS market has been no different, although there has been some differentiation up and down the credit stack and across vintages. For example, more seasoned vintages from 2005 and 2006 are anywhere from 5 to 12 bps tighter than bonds with less seasoning.

Moving down the capital stack requires more dexterity, as the key issue is which holder owns the fulcrum bond for the overall transaction, that is, the position that would enable the holder to either retain the Special Servicer designation for the entire transaction or gain the special servicing designation in the event they become the controlling class representative. A premium is embedded in the securities' pricing to account for the special servicing fees that could be realized. However, the buyer must determine the amount of time loans will remain specially serviced and generate fees versus when

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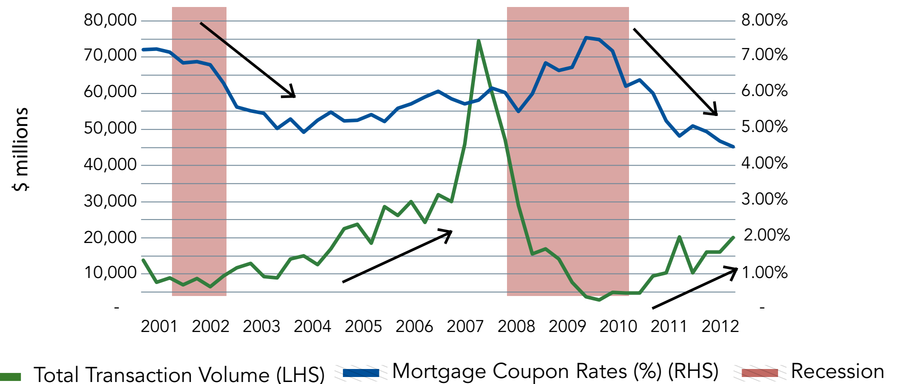
ultimate resolution of the loan will occur and its recoverability. Interestingly, many holders of these classes were insurance companies. While these firms, if they are still the holder, have little interest in being the controlling class representative, the premium does offer potential resale value beyond the potential credit performance of the underlying collateral.

Previously, we speculated that the rally in credit spreads, which in turn drives down the cost of financing, spurs transaction activity. In the chart below, we note that transaction activity has increased by over 327% since 2010 as mortgage coupons have dropped by approximately 168 bps. Reviewing data back to 2001, we can see that as mortgage coupons dropped following the recessions, transaction volume increased. Clearly, the benefits of cheap debt cannot be underestimated. However, the spike in transaction volumes during 2005-2007 is a reminder of how weakening underwriting standards can distort this relationship. The memory of the market is such that underwriting discipline has returned and remains in place, at least for now.

"The memory of the market is such that underwriting discipline has returned and remains in place, at least for now."

Chart 4: Mortgage Rates vs. Total Transaction Volume



Source: American Council of Life Insurers, Bloomberg.

The Asset-Backed Market

The asset-backed securities (ABS) market was extremely active during the first quarter as issuance ramped up sharply. According to J.P. Morgan, total new supply for the first quarter was $49.5 billion, an 89% increase over the first quarter of 2011. The increased supply came primarily from the auto segment but also included credit cards, global RMBS, equipment and "esoterics". The esoteric segment was particularly active this quarter, consisting of deals ranging from structured settlements and drug royalties to Domino's Pizza and servicer advances with no shortage of demand from yield-hungry investors. The only segment with a reduction in issuance was the student loan segment. It's not just issuers who have done well in ABS, but investors have as well. Demand was very strong: 26 deals were upsized by a total of $9.7 billion between announcement and pricing, and spreads in the consumer ABS segment rallied sharply during the quarter.

From a fundamental perspective, ABS is also performing well. Collateral backing the credit card, equipment and auto segments continues to improve. Fitch reported that cumulative net losses in the prime auto space hit a new low in February, but the same can't be said for subprime auto paper. While default rates for recent vintage (2010-

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2011) prime deals are at record lows, default rates in the subprime auto segment are worsening. S&P reported strong performance in the credit card sector, with improvement in most of the performance metrics (payment rate, delinquencies and charge-offs).

Overall, the ABS sector generated strong excess returns over the Barclays Aggregate for the quarter. Barclays reported that the excess returns for the ABS index was 1.20% for the first three months of 2012, with the AAA-rated credit card, auto and utility sectors earning excess returns of 1.23%, 1.18% and 1.16%, respectively. The home equity sector had an excess return of 3.95% for the quarter which eclipsed all other segments, while the manufactured housing segment had an equally impressive excess return of 1.70%.

Corporate Credit Market

"Several catalysts drove the outperformance of financials."

Financials were the star performer of the U.S. credit market last quarter. There are many reasons why this sector is so important, as its future direction will help set the stage for the overall corporate market's performance for the balance of the year. First, the sector is large, accounting for a third of market value and 41% of trading volume. Second, it is extremely high beta; for example, the three-year financial intermediate bond total return beta is a hefty 1.3x. Third, inasmuch as financial credit pricing is a proxy for the overall vigor of the financial system, it is arguably a driver of economy activity.

The markets have been on a fatigue-inducing round trip over the past several months. In the table below, we show returns, yields, and option-adjusted-spreads (OAS) across several fixed income sectors. On an annualized basis, investment grade financial bonds posted a spectacular annualized return of 19.4% in the first quarter, a reversal from a massive underperformance to investment grade non-financials in the second half of 2011. As Table 1 shows, financial bond returns have been as volatile as high yield, despite respective credit ratings of A2 and B1. The favorable interest rate backdrop supported all credit sectors; notice that while spreads are still wider than June of 2011, yields are not.

Table 1: Fixed Income Sector Returns

	Domestic Agg			HY All			IG-NonFinancials			IG-Financials			Mtge		
Period	TR[1]	Yield	OAS	TR[1]	Yield	OAS	TR[1]	Yield	OAS	TR[1]	Yield	OAS	TR[1]	Yield	OAS
Q1-2012	1.2%	2.02	57	20.6%	7.21	595	4.6%	3.32	162	19.4%	3.79	252	2.2%	2.29	40
H2-2011	10.0%	2.00	79	-1.1%	8.41	738	13.3%	3.47	203	-1.0%	4.67	364	6.4%	1.97	45
H1-2011	5.5%	2.70	52	9.9%	7.44	542	6.6%	3.87	142	6.6%	3.90	201	5.7%	3.27	35

(1) Annualized Total Return

Source: BAML Bond Indices.

Several catalysts drove the outperformance of financials. Foremost, the success of the ECB's LTRO in alleviating refinancing risk and funding pressures in the EU removed a significant near-term tail event. As noted above, banks reached a $25 billion foreclosure-gate settlement, thereby removing the uncertainty as to the size of the costs. The Fed's stress test generally went smoothly; those shown deficiently capitalized under a recession scenario were found so mainly because of premature plans to return capital to shareholders. Finally, the macroeconomic data have shown some improvement, particularly on the all-important jobs front.

Given this year's break-neck speed of spread and credit default swaps (CDS) tightening,

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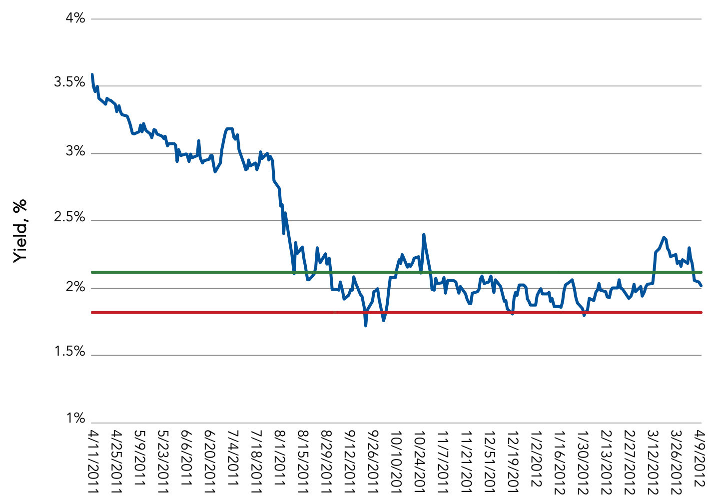
financial credit's risk/reward proposition is a lot less compelling than it was back in December. A popularly held belief is a more regulated and de-risked banking sector would propel financials to converge towards their tighter industrial counterparts. This thesis has yet to play out in a consistent manner. Credit ratings remain on a downward trend. Next month, Moody's is expected to complete its review of banks with global capital market operations. It's quite likely that a number of U.S. bank holding company ratings will migrate down to triple-B.

Treasury/Rates Market

In Treasuries, the first quarter was mostly range-bound. Shown in Chart 5 are 10-year yields over the past year, and it is clear that they have oscillated in a tight 30 bps window for most of the first quarter, which is where they were for much of the third and fourth quarters of 2011. The range ultimately broke with a move to higher yields in mid-March. Economic data showed reasonable health highlighted by the non-farm payrolls and a further drop in unemployment. Contagion from Europe simmered down as progress was made with the Greek sovereign debt resolution, although investors have certainly kept their guard up.

"The focus of the quarter can be boiled down to the market's evolving expectations for Federal Reserve policy."

Chart 5: US 10-Year Treasury Yield



Source: Bloomberg.

Auction sizes remained steady with $501 billion in issuance of nominal notes and bonds. The auctions proceeded without too much excitement, with reasonable demand. Broadly speaking 2-, 3-, and 10-year auctions were well supported while 5s, 7s, and 30s were more mixed.

The focus of the quarter can be boiled down to the market's evolving expectations for Federal Reserve policy with the coming expiry of Operation Twist. Despite some overall economic improvement and some less dovish Fed rhetoric, the market traded with reasonable confidence that the Fed would engineer a new phase of easing, either more Operation Twist or more balance sheet expansion. The game changed after the March 13 FOMC meeting where the Fed made clear that the onus is on the data (and arguably systemic risk from Europe) to justify additional policy action. Further, the Fed clarified that its commitment to near-zero rates is not iron clad, but is rather an expectation. While the Fed will maintain its enhanced balance sheet for the foreseeable future as well as its near-zero interest rate policy, the training wheels are off for the time being

as it relates to continued easy policy action from the Fed. The Fed is certainly mindful of the rise in rates but mostly in the context of broader financial conditions which are otherwise still healthy (stocks, credit spreads, etc). For now, other central banks have taking the baton to some extent, notably the ECB. As the quarter drew to a close and April brought some new data, the market was reminded that it is still too early to get too confident on any forecast for the future. Stay tuned.

This market commentary has been prepared by contributors from Annaly Capital Management, Inc. and its subsidiaries, Fixed Income Discount Advisory Company (FIDAC) and Merganser Capital Management, Inc. (Merganser).

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