ANNALY® CAPITAL MANAGEMENT, INC.

MARKET COMMENTARY

IN THIS ISSUE

Economy

There was a marked deterioration of economic indicators in the second quarter, followed by downgrades of current and future quarterly GDP estimates by the Federal Reserve (the Fed) and private forecasters. The Citigroup Surprise index for the US, which measures the variance of economic data from their estimates, experienced its largest swing since the 2008 crisis, moving from near +100 to near -100 (see chart 4). Fed manufacturing surveys from Philadelphia to Dallas to Chicago showed large declines in activity. The ISM manufacturing survey surprised to the upside, but this was driven almost exclusively by an increase in inventories. The ISM non-manufacturing survey declined, indicating a slowing of service sector growth. Real personal income and spending weakened and retail sales disappointed.

Hiring managers also became more risk averse during the quarter. Initial jobless claims spent all but one week in the quarter above the 400 thousand mark, indicating a still sluggish job market. Nonfarm payrolls saw continuous deterioration throughout the second quarter. Headline jobs fell from +217 thousand in April to only +25 thousand and +18 thousand in May and June, respectively. The unemployment rate increased from 9.0% to 9.2% over the same time period. In June the household survey showed a fall of 445 thousand jobs, which makes the number of people employed essentially unchanged from June 2010 (139.3 million from 139.1 million last year). The number of people working in full-time jobs is actually down slightly from June 2010. The June 2011 report was unambiguously bad (labor force and participation rate down, hourly earnings down, work week down, temp workers down, average duration of unemployment up, etc) and a big disappointment for those hoping that the poor May report was a single hiccup in an otherwise strengthening recovery. What we saw was a serious loss of momentum in the economy.

Much like the failed prediction of the Rapture on May 21, 2011, the end of the second round of Quantitative Easing (QE2) did not mark the end of the world for the Treasury market, though it did remove a powerful support for asset prices in general. Equity prices were effectively flat for the quarter while Treasuries rallied. Home prices continued to sink, and commodities also weakened. Much of the current "soft patch" in economic activity and asset prices is being blamed on lingering effects from the Japanese earthquake/tsunami/nuclear crisis, high gas and food prices, and, more recently, the ongoing sovereign debt crisis in peripheral Europe.

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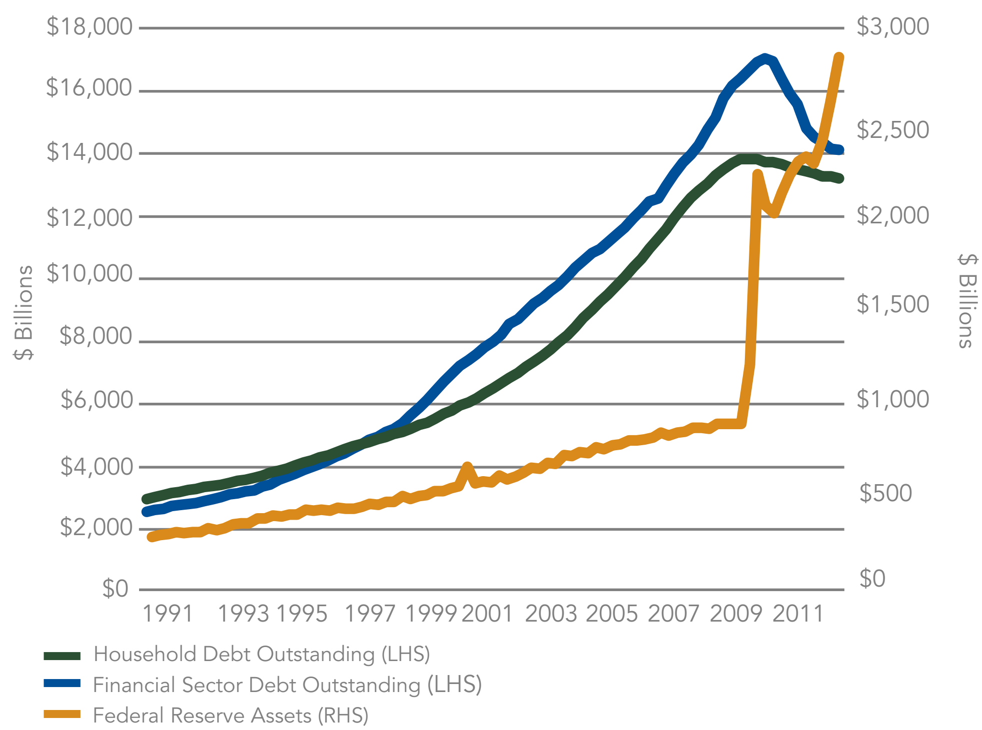
It isn't only in peripheral Europe where we find long-term structural problems. We find ourselves in the midst of another global cycle of debt growth and debt restructuring, much like past ones, but this time driven by heavy central bank "management" of interest rates and asset prices. The financial and household sectors saw the fastest growth in their debt outstanding of any sector during the last 30 years. These are the two largest segments of the economy, and their ongoing balance sheet contractions should be a headwind to economic growth for some time. This has been a kind of default/restructuring story as well, but with a twist: the full effect of this deleveraging hasn't been felt because governmental balance sheets have stepped in to soften the blow. Since 2008, household debt has fallen by over $600 billion and financial sector debt is down by a whopping $3.0 trillion. In the same time period, the balance sheet of the Federal Reserve has grown by $2.0 trillion.

"It is no wonder that when the Fed ends a round of QE, we see slouching economic data and falling inflation expectation."

Chart 1: The Fed to the Rescue



Source: Federal Reserve

It is no wonder that when the Fed ends QE2, we see slouching economic data and falling inflation expectations. The Fed and Treasury are not natural buyers and holders of household and financial sector obligations, so the restructuring will need to continue into its next phase: the re-privatization of risk. The markets will eventually need to learn to price risk correctly, in an environment of positive real interest rates and little to no government support of asset prices. We suspect that the transition to the next stage of restructuring in the US, and the eventual restructuring of the debt built up by European peripherals, Brazilian households, and Chinese local governments will not be without pain.

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Residential Mortgage Market

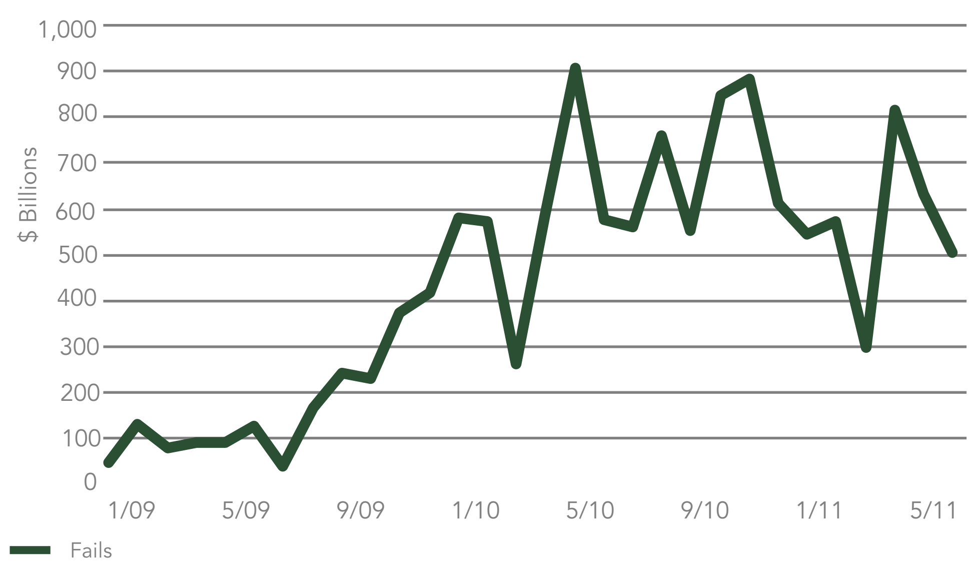
Prepayment speeds continue to be stagnant in a housing market still far from recovered. March, April and May speeds (April, May and June release) were flat, down 13% and up 15% respectively. Recent data as reported by CoreLogic suggests there are 1.7 million units in the "shadow" inventory, or five months worth of supply, on top of the 2 million loans that are more than 50% underwater. Given the sheer size of "unrefinanceable" loans, coupled with new mandatory additional loan-level pricing increases on all Fannie Mae/Freddie Mac refinances by FICO/LTV combination, it appears refinancing activity will continue to have the wind in its face.

Macro issues dominated the financial markets throughout the quarter, led by concerns over sovereign debt and the looming end of QE2. However as the quarter came to a close, and austerity measures by Greece were passed and the end of QE2 came and went, volatility gradually abated and the US Treasury market performed well while spreads on Agency mortgage-backed securities ended the quarter roughly where they began. Risky assets have underperformed throughout this period of uncertainty, but the market continues to bid well for high quality liquid assets.

In the second quarter, the Treasury Market Practices Group will be recommending a "fails" charge trading practice for the Agency mortgage market of 2% minus the Federal Funds daily effective rate beginning February 1st, 2012. A "fail" occurs when one counterparty is unable to make delivery of a specified security to another on the originally agreed upon settlement date. Since the implementation of the first round of quantitative easing, the volume of system-wide Agency fails has ballooned as demand dramatically increased and supply waned, as illustrated by chart 2:

"Since the implementation of the first round of quantitative easing, the volume of system-wide Agency fails have ballooned as demand dramatically increased and supply waned, as illustrated in Chart 2."

Chart 2: Outstanding Fails Since QE1



Source: NY Fed

A "fails charge", or penalty, is meant to correct this potentially systemic problem. Counterparties should seek to "clean-up" existing fails to avoid paying the penalty.

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Commercial Mortgage Market

Sixteen multi-borrower or conduit pool transactions have closed since June 2010 in a renaissance that is being called CMBS 2.0. The deals total $19.9 billion and are collateralized by 719 loans. While welcomed as a sign of market recovery, this activity is also viewed with suspicion by a market burned by the recent credit crisis. Specifically, has CMBS 2.0 been helped by eroding underwriting standards?

The short answer is no. Looking first at the aggregate composition, transaction sizes ranged from $717 million to $2.2 billion. The average loan size was $27.8 million. By comparison, the average loan size in the pre-crisis benchmark GSMS 2007-GG10 ("GG10") pool, comprised of 202 loans totaling $7.6 billion, was $37.6 million. While the loan size was obviously larger in GG10, it should be noted that the 10 largest loans in GG10 comprised 43% of the pool. Under CMBS 2.0, the top ten loans now comprise 62% of the pool on average. While there may be 'lumpiness' in the pool, the relatively smaller pool sizes and the fact that the transactions are issued under Reg. 144A provide investors ample opportunity for due diligence.

The property types financed under CMBS 2.0 were initially retail, office and industrial. Towards the end of 2010, multi-family and lodging collateral were added to the pools. The most significant concern raised by investors has been that the pools have been weighted towards retail. While the exposure to retail is north of 50%--clearly higher than the 30% average observed during the 2000 to 2008 vintages—retail performed relatively well with the second lowest historical delinquency rate of 7.75%.

"Has CMBS 2.0 been helped by eroding underwriting standards? The short answer is no."

To review the underwriting, we'll focus on debt service coverage ("DSC") and debt yields. Overall the CMBS 2.0 pools have an average DSC of 1.70x. While there was some pressure on the average during early 2011, recent debt service coverage levels have returned to or above the average. These levels far surpass the 1.31x DSC of GG10. We calculated debt yield based on net cash flow rather than net operating income, a more conservative approach since it incorporates some contribution to capital expenditures. Debt yields are still attractive for both debt and equity.

In summary, CMBS 2.0 appears well underwritten and clearly should outperform when compared to the 2005-2007 vintages. And although we have noted some minor slippages, the transactions are still structured with subordination levels that approximate amounts observed with the 2003 vintage which should provide sufficient credit support.

Asset-Backed Market

Despite concerns about the sovereign debt crisis, the strength of the domestic economy, unresolved regulatory reform and structural changes in securitization, the asset-backed market has rebounded sharply from the crisis period of 2008, 2009 and 2010. According to statistics provided by J.P. Morgan, total US public and private issuance through the second quarter of 2011 is $67 billion, which is 15% higher than the $58 billion in total issuance during the first half of 2010. This increase has mostly been driven by issuance in the auto, credit card and global RMBS segments, although several deals representing the more esoteric asset classes (railcars, container leases and servicer advances) have also come to market.

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"A major theme in the more traditional market segments is that collateral performance continues to improve and technical trends remain favorable, with demand exceeding supply."

Table 1: U.S. ABS Supply By Sector ($bn)

	2006	2007	2008	2009	2010	YTD 2011
Credit Cards	**66**	**90**	**65**	**47**	**7**	**5.4**
Bank/Change	64	83	63	32	5	3.8
Retail	2	7	2	15	3	1.6
Autos	**85**	**65**	**37**	**56**	**54**	**29.0**
Prime Loan	50	35	33	38	32	14.3
Subprime Loan	25	19	3	3	9	8.2
Lease	7	7	1	8	8	4.6
Fleet	1	1		5	3	1.9
Motorcycle/Truck	2	3		2	2	
Student Loans	**66**	**52**	**28**	**19**	**19**	**10.8**
FFELP	51	43	28	10	13	10.3
Private Credit	15	9	0.1	9	6	0.6
Equipment	8	7	3	7	5	4.0
Global RMBS	**67**	**53**	**5**		**7**	**8.6**
Other	35	32	4	11	15	9.2
Floorplan	12	8		4	7	4.0
Miscellaneous	23	24	4	7	8	5.1
Total ABS	**327**	**299**	**142**	**140**	**106**	**67.0**
%144 A	20%	22%	14%	41%	47%	47%
% Floating Rate	69%	78%	66%	45%	35%	43%

Source: JP Morgan Chase; IFR; Bloomberg

A major theme in the more traditional market segments (credit card, autos and equipment) is that collateral performance continues to improve and technical trends remain favorable, with demand exceeding supply. Bank credit card trusts continue to report strong performance with lower chargeoffs and delinquencies and higher excess spread. The bank credit card segment has benefitted from a strong technical bid due to a lack of new issuance and a flight to quality trade particularly during the last quarter. Through June, there has been only $3.8 billion of bank credit card issuance as the banks have funded credit card receivables more cheaply through deposits rather than through securitization. Investor interest in credit card securities is evident as J.P. Morgan issued two deals this year that were driven by reverse inquiry.

In contrast to credit cards, total issuance in the auto segment through June is $29 billion. Deals are frequently oversubscribed, launch at tighter levels than initial price guidance, and are often upsized to accommodate the strong interest. Demand has been particularly strong in the subordinated tranches from investors looking for incremental yield. Collateral performance continues to improve. For example, the Manheim Used Vehicle Index hit a record high in May, reflecting improving resale values on repossessed cars. This has helped to limit losses in the auto trusts.

Similarly, the equipment sector has also enjoyed strong demand. Issuance through the end of June is $4 billion, which is 60% higher than the $2.5 billion issued during the first half of 2010. Collateral performance has been strong, particularly in the agricultural segment. The additional supply has been met with very solid demand as evidenced by a $200 million upsize in a recent deal.

Due to strong collateral performance, stable quality ratings, and attractive yields relative to like-rated alternatives, the asset-backed market should continue to provide attractive investment opportunities for those willing to do their homework.

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Corporate Credit Market

Micro and macro are once again at odds. This type of backdrop generally serves as a source of frustration for corporate credit investors, who prefer the "cleaner" micro-level analysis. The dichotomy also served as a key source of volatility for credit in the first half of the year, which was broken into two distinct parts. In the first, material optimism due to tax cut extensions, QE2 stimulus, and continued robust earnings buoyed credit. In the second, weak housing, tepid growth, and Europe sovereign woes weighed on credit. Despite the volatility, credit across all segments managed to post respectable returns.

Technically speaking the first half was an excellent time for credit. Demand for the lower risk segments of credit —investment grade corporate bonds and leveraged loans—remains brisk coming off the first half. Net mutual fund inflows for each have been $24 billion and $35 billion YTD, respectively. On the loan side, permanent capital vehicles have returned: 14 new collateralized loan obligations (CLOs) came to market totaling $6.5 billion; Business Development Companies (BDCs) raised $2.8 billion of proceeds in 22 separate public equity offerings; and we count at least two new closed-end loan funds. Despite a record-size weekly outflow in June, high yield bond fund flows have stabilized. Investors want to be long risk: According to Morgan's Stanley's 6 July 2011 Global Credit Survey, 45% of US investors expect to add credit risk over the next three months. This compares to 29% in the last survey.

"Technically speaking the first half was an excellent time for credit."

Supply set new records year-to-date. While debt refinancing remains the primary use of proceeds, companies are finding alternative uses at the strongest pace since the credit crisis. In investment grade bond issuance, debt-financed M&A and share repurchase programs are taking a larger share of supply. Likewise, in leveraged finance, dividend recaps, capital expenditures, and M&A are at the highest share since the crisis. As a result, leverage loans outstanding has stopped declining and net bond supply trends— as measured by the par value of Bank of America/Merrill Lynch's Investment Grade and High Yield bond index— are picking up. Par debt outstanding is up $303 billion this year, which compares to a $229 billion rise in 2010.

At the same time, corporate credit spreads are outperforming on a relative basis. The credit ratings of European peripheral sovereign debt are falling like dominos. Recently, Portugal was downgraded to double-B at S&P, and Moody's put double-A Italy on CreditWatch negative and downgraded Ireland to double-B. Compared to these sovereigns, credit risk in the US looks relatively benign, with excellent liquidity, cash flow and asset leverage. In chart 3 we compare High Yield to the average spreads of the peripheral sovereign credits (with and without Greece).

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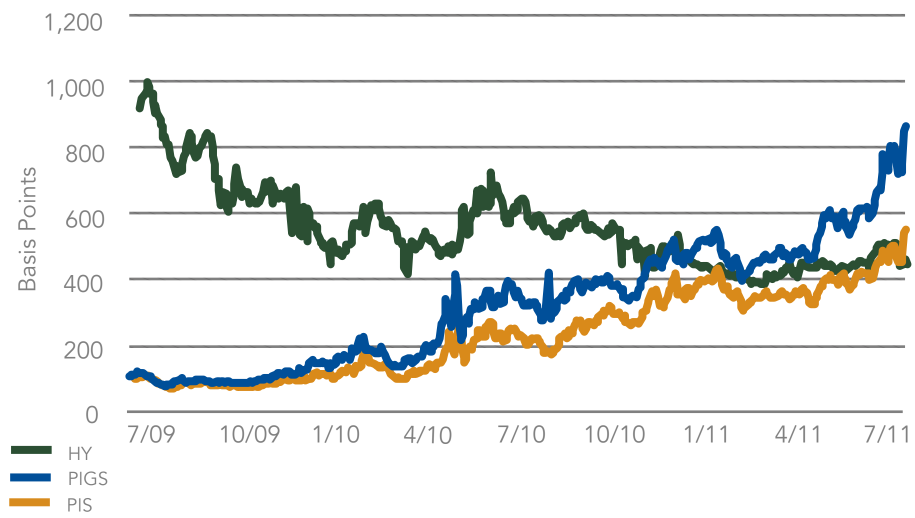
Chart 3: High Yield vs. Peripheral Sovereigns, 5-yr CDS



Source: Bloomberg

Treasury/Rates Market

The second quarter brought quite an about-face in the Treasury market. From the early part of April until the latter part of June we saw a nearly straight line rally in yields to the tune of 100 basis points (bps), only to give back a decent portion of those gains in the last week of the quarter. When all was said and done, 2-year Treasurys were 42 bps lower in yield or richer, 5-year Treasurys were 64 bps richer, 10-year Treasurys were 35 bps richer, and 30-years were just 15 bps richer. The theme of the quarter was downside economic surprise with a healthy dose of European sovereign debt woes.

Chart 4 plots the Citi US Economic Surprise Index and demonstrates the magnitude of the drop historically. The Index tracks cumulative degrees of upward and downward surprises in US economic releases weighted both to relative significance and timeliness. The peak to trough drop was on par with that of the 2008 crisis itself. Ultimately, economic data disappointed like clockwork relative to economists' expectations. Some of this can be attributed to supply chain disruptions as a result of the Japanese earthquake and effects of higher energy prices with unrest in the Middle East and North Africa, but the point is clear – it was an ugly second quarter, at least compared to what many expected.

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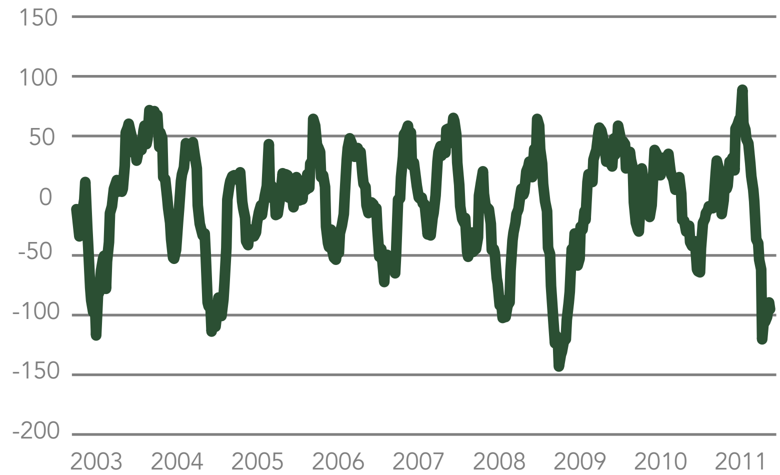
Chart 4: Citi US Economic Surprise Index



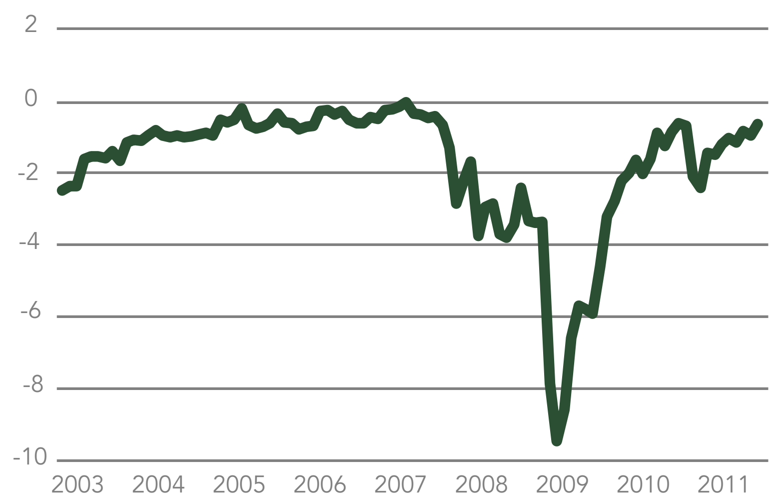
Source: Bloomberg

During the second quarter, the Treasury auctioned $517 billion in nominal notes and bonds. The auctions for April and May were mixed: The consecutive 2-, 5-, and 7-year auctions at the end of May all came to market fairly strongly, but the tone of the auctions soured in June as 5 of the 6 auctions priced cheap to market levels when bids were submitted.

With the end of quarter also came the well-advertised end of QE2 (excepting the reinvestment of paydowns and maturities to keep the Fed's portfolio stable). While the debate remains alive about the effects and benefits of QE, and in this case the impact on Treasury yields, the impact on broader financial conditions seems hard to dispute. Shown in chart 5 is the Bloomberg US Financial Conditions index. This index is a barometer composed of fixed income yields, yield curve spreads, credit spreads, and equities. While the direct impact of QE on rates is perhaps inconclusive, the impact of both phases of QE are fairly obvious when looking at broader financial markets, as the Fed's desired substitution effects were very much in play.

"While the debate remains alive about the effects and benefits of QE, the impact on broader financial conditions seems hard to dispute."

Chart 5: Bloomberg US Financial Conditions Index



Source: Bloomberg

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The Markets

The second quarter brought a massive rally in global interest rates as a flight to quality was sparked by valid concerns over the viability of Greece and the euro. Stocks held virtually unchanged for the quarter, but remained significantly higher than year-ago levels. Gold and oil rallied, probably less a reflection of inflationary concerns than a vote on the dollar, which is down 13.6% over the last year versus a basket of currencies.

	6/30/2011	3/31/2011	6/30/2010	QOQ % Change	YOY % Change
Federal Reserve Funds	0.25%	0.25%	0.25%	0.0%	0.0%
2-year US Treasury	0.460%	0.825%	0.605%	-44.2%	-24.0%
10-year US Treasury	3.161%	3.472%	2.933%	-9.0%	7.8%
10-year JGB	1.140%	1.260%	1.091%	-9.5%	4.5%
10-year euro	3.025%	3.354%	2.577%	-9.8%	17.4%
10-year UK Gilt	3.380%	3.689%	3.355%	-8.4%	0.7%
10-year Canada Treasury	3.110%	3.350%	3.081%	-7.2%	0.9%
30 yr Conventional Mortgage	4.313%	4.587%	4.119%	-6.0%	4.7%
Barclays US Corporate	3.84%	4.08%	4.23%	-5.9%	-9.2%
Dollar Index	74.30	75.86	86.02	-2.0%	-13.6%
Japanese Yen	80.56	82.83	88.58	-2.7%	-9.1%
S&P 500	1320.64	1325.83	1030.71	-0.4%	28.1%
Nasdaq Composite	2773.52	2781.07	2109.24	-0.3%	31.5%
Gold $/oz *(nearby contract)*	$1,502.80	$1,438.90	$1,245.90	4.4%	20.6%
Oil $/bbl *(nearby contract)*	$95.42	$106.72	$75.63	-10.6%	26.2%
MBA Refi Index *(month end)*	2604.40	2222.50	3613.10	17.2%	-27.9%

Source: Bloomberg; Barclays

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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