ANNALY® CAPITAL MANAGEMENT, INC.

MARKET COMMENTARY

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Washington/Sovereign Watch

Looking back at the third quarter of 2011, we are struck by how much markets and economic conditions are being driven by exogenous factors and not by the agents of economic and market activity.

There are examples large and small of how the invisible hand of economic activity is now firmly attached to the arm of an official policymaker of one kind or another. Whether you agree with it or not, the fact of the matter is that this activism or intrusion or extreme supervision, whatever you want to call it, is affecting the decisions of businesses and investors the world over.

Whatever the institution—American bodies such as the Federal Reserve, Congress, the Obama Administration or the SEC, foreign institutions such as the European Central Bank or European governments, or global entities such as the Basel Committee on Banking Supervision or the International Monetary Fund—we are witnessing the playing out of the battle between government and the marketplace for control of the economy that Daniel Yergin chronicled in "The Commanding Heights" (Simon and Schuster, 1999). This book (and the PBS documentary, which can be found here), described how for much of the 20th century, it was the state that had been winning the battle for economic control, and not until Margaret Thatcher and Ronald Reagan did market mechanisms begin to take over. In the aftermath of the credit crisis and Great Recession, and the complications of the European Monetary Union, the pendulum of history appears to be swinging back again.

Most would agree that the policy actions taken during the worst of the credit crisis were well-intended, necessary and effective at staving off a complete financial meltdown. Markets and businesses are now waiting and watching for these same governmental institutions to decide if they will lead, follow or get out of the way. Washington's battle over raising the debt limit, which resulted in a Standard & Poor's (S&P) downgrade, is just one example. Taken in isolation, the downgrade may not have moved the market (Chairman Ben Bernanke articulated this view in April when S&P placed the United States on credit watch: "S&P's action didn't really tell us anything. Everybody who reads the newspaper knows that the United States has a very serious long-term fiscal problem."), but the rating agency hit the nail on the head regarding policymakers: "The political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed."

"Markets and businesses are now waiting and watching for these same governmental institutions to decide if they will lead, follow or get out of the way."

The same kind of situation is playing out in Europe, where governments and euro-policymakers are struggling with the challenges of keeping their system together. The choice facing Greece and its euro-brethren is default, devalue or break-up, and policymakers seem to be intent on delaying that choice as long as possible. Default

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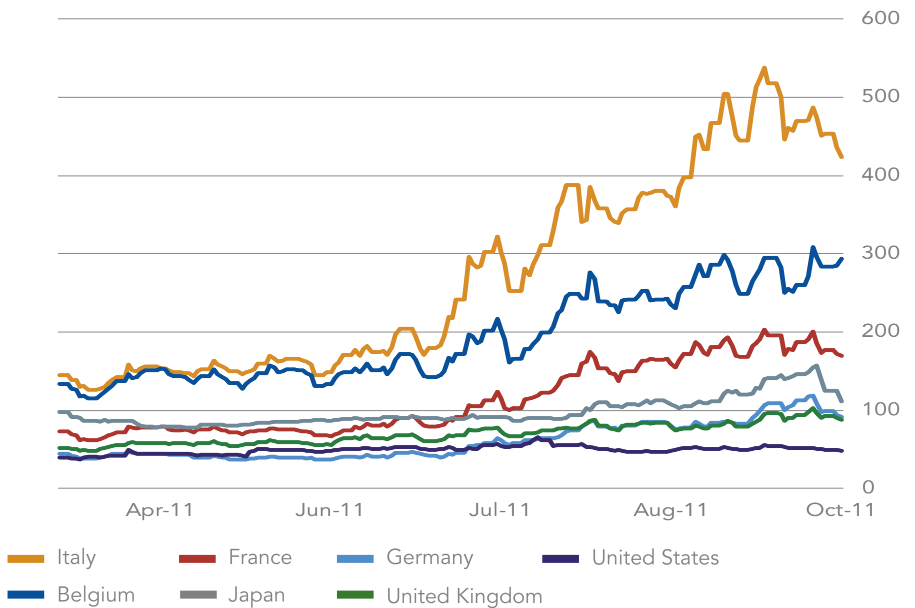
isn't so easy, given the exposures of European banks to each other's sovereign credits. Neither is devaluing the euro a palatable option. "The decision for a single currency was a path-breaking decision and therefore we'll defend it with all possible strength," Germany's Angela Merkel stated at a press conference this week, standing alongside France's Nicholas Sarkozy. As for breaking up the countries participating in the euro, Floyd Norris of the *New York Times* pointed out recently that "Legally, there is no way out. The euro was designed to be the Roach Motel of currencies. Once you enter, you can never leave. There is no provision for departure." Not to be outdone, the Federal Reserve and monetary policymakers all over the world continue to fight an economic war using war-time strategies, and other domestic regulatory bodies are pushing through aggressive regulation agendas for markets and market participants.

The end result of all of these and other machinations is euphemistically called "uncertainty." The rest of our commentary will explore the ways different markets have reacted to this uncertainty. In the meantime, the governments themselves are being re-rated, and not just by S&P, Moody's and Fitch. Chart 1 sets forth the cost of 5-year protection in the credit default swap (CDS) markets over the past six months through October 11 on a range of sovereign credits. (Greece is not shown due to scale: it last priced at 3075).

"The governments themselves are being re-rated, and not just by S&P, Moody's and Fitch."

Chart 1: 5-year Protection in the CDS Markets



Source: Bloomberg

The Economy

What caused the resurgence of risk aversion during the third quarter? European peripheral debt (and exposure to it by banks) was the headline story.

The KBW Bank Index finished the quarter down 26.5% due to worries about how the global banking sector would handle a default by Greece. The Federal Reserve (Fed) took a number of substantive actions during the quarter: It reinstated the dollar swap lines with the ECB and other central banks; through the communication channel, it put an explicit term on zero interest rates (2 years); and it announced what has been dubbed Operation Twist, a $400 billion plan to lengthen the duration of the Fed's portfolio without changing its size. Operation Twist won't begin until after the third quarter ends.

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About Operation Twist, Chairman Bernanke said: "We think this is a meaningful but not an enormous support to the economy. I think it provides some additional monetary accommodation; it should help somewhat on job creation and growth. It's particularly important now the economy is close, the recovery is close, to faltering." It seems that Bernanke is on target: Markets became nervous because the economy may be hitting or getting close to stall speed. The double-dip recession debate has begun (again) in earnest. The Economic Cycle Research Institute, which has gotten all of its recession calls right over the last 15 years, with no false alarms, says that its indicators signal that "if the United States isn't already in a recession now, it's about to enter one."

Expectations were so low that the September nonfarm payroll report was greeted with a sigh of relief. The headline of +103,000 jobs was better than expected, and came with considerable positive revisions to the previous two months. August was changed from zero to +57,000, and July was revised to +127,000 from +85,000. The revisions increased the number of jobs created in August and July by over 100%, and significantly changed the look of the recent trend. Reasonable skeptics might question the accuracy of data subject to such large revisions, but the market was pleased.

The trend may not be as ominous as it looked prior to the September revisions, but this level of job creation, while at least positive, likely won't be enough to keep the unemployment rate from rising. The headline U3 unemployment rate has been flat-lined right around the 9% level for much of the year after dipping as low as 8.8% in March 2011. The broader U6 measure (which includes marginally attached workers and those working part-time for economic reasons) is already very high at 16.5% and has been in an upward trend since its March 2011 low of 15.7%. What is driving the U6 higher says something about the quality of the jobs that are being created. Employment grew by 691,000 jobs in the third quarter (household survey), but within this, the number of people getting part-time jobs because that was all they could find rose 451,000.

"While lower-paying part-time jobs are indeed jobs, they are nothing to get excited about, especially for an economy that is 70% dependent on personal consumption expenditures."

Chart 2: Laborers Working Part-Time Because That's All They Could Find

Source: BLS, Haver

The recent spike could be related to a pickup in the rate of people rolling off of expiring extended unemployment benefits, but whatever the reason, these are not the kind of high-paying jobs that a thriving economy creates and is likely contributing to the stagnation of real wage growth. While lower-paying part-time jobs are indeed jobs, they are nothing to get excited about, especially for an economy that is 70% dependent on personal consumption expenditures.

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Residential Mortgage Market

As mentioned above, macro concerns and foreign and domestic sovereign risk issues continued to dominate the headlines throughout the third quarter of 2011. In the aggregate, high-quality, liquid fixed-income products appreciated in value throughout the quarter as investors sought relative safety amid the volatility. Agency mortgage-backed securities (MBS) were no exception, although spreads, as measured by the yield on the 30-year Current Coupon mortgage minus the 10-year Treasury, ended the quarter modestly higher than where they began.

In addition to the unusual market volatility, the third quarter also brought concerns of a blanket government refinance program. While the market was not given any explicit guidance from the Administration with respect to these plans, we believe any changes are most likely to come via the existing Home Affordable Refinance Program (HARP). Edward J. DeMarco, acting head of FHFA, said in a statement: "If there are frictions associated with the origination of HARP loans that can be eased while still achieving the program's intent of assisting borrowers and reducing credit risk for the Enterprises, we will seek to do so." These frictions will likely be eased for homeowners with loan-to-values (LTVs) in excess of 125% or who have loans originated prior to January 1, 2009. Additional changes that can be made are eliminating current mandatory Loan Level Pricing Assumptions and waiving existing legal representations and warrants. Analysts at Nomura Securities estimate that the worst case scenario for change in prepayment speeds as a result of these changes is relatively small.

Of potentially greater concern with respect to prepayment speeds is the effect of lower mortgage rates. For now, prepays are coming in faster than in prior quarters but still slower than expected. Chart 3 shows the refinancing speeds (calculated as the 1 month constant prepayment rate or CPR) on 2008 vintage Agency MBS of various coupons in the most recent month, September 2011, and the months of September and December 2010, when mortgage rates were higher. It appears that despite the possibility of upcoming policy initiatives and lower rates, the effect thus far on prepayment speeds has been muted except possibly at lower coupon levels.

"It appears that despite the possibility of upcoming policy initiatives and lower rates, the effect thus far on prepayment speeds has been muted except possibly at lower coupon levels."

Chart 3: Speeds on '08 Vintage Collateral

Source: Barclays Capital

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Commercial Mortgage Market

The third quarter of 2011 marked a return of volatility to the commercial mortgage-backed securities (CMBS) market. On the new issue front, spreads grinded tighter over the last 18 months until early July. At that point, both exogenous and endogenous events in the market injected volatility.

Outside forces, including the turmoil in the European markets, stock market gyrations and fears that economic growth may be slowing, contributed to both spread widening as well as a steepening of the credit curve. An endogenous event came courtesy of S&P. Chart 4 shows new issue pricing on super senior CMBS tranches as basis points (bps) spread to the comparable Treasury.

"In this enviornment, bargaining power favors the well-capitalized issuers and investors."

Chart 4: Super Senior CMBS spread to Treasury

Source: Commercial Real Estate Direct

On July 27, as Goldman Sachs and Citigroup were poised to settle a $1.5 billion CMBS pool that they had just priced, S&P published an advance notice of a change in their rating criteria. The effect of the notice of change was that S&P couldn't provide a rating on the deal, and since ratings were a condition of closing and settling the trades, the transaction had to be pulled from the market. Spreads widened on other S&P rated transactions on fears of potential downgrades arising from the new rating criteria. These fears proved to be unfounded. The issue ultimately narrowed to conflicts between debt service coverage methodology for loans of new issue CMBS versus loans in CMBS under surveillance, and there had been no marked deterioration in the credit performance of the previously rated transactions.

Despite the S&P uncertainty, the exogenous factors identified above were beginning to create significant pressure on the issuers. For example, there was pushback by investors to the AAA bonds being marketed with credit support of less than 15%. Goldman and Citigroup were able to rework the aborted transaction and issued AAA securities that were public with credit support of 30% —essentially a return to the super-senior format. Since then, all conduit transactions have featured a super senior class structure issued in a public securities format.

The Goldman/Citi/S&P confluence of events highlighted the inherent conflict that CMBS issuers encounter as they attempt to become viable again. Namely, issuers staff up to originate a significant amount of loans quickly to create a critical mass to securitize. Given that the pricing of mortgage coupons is relatively inelastic, a CMBS issuer cannot charge a borrower for his risk of warehousing loans and ultimately selling CMBS to investors. Their only choice is to create larger pools as quickly as possible

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and manage the credit enhancement levels or to better manage their warehousing risk. Investors made their concerns known, and their pushback happened to coincide with the S&P announcement.

The new issue CMBS market remains challenged. Opportunistic CMBS issuers will make loans but only when they can clearly get out quickly and profitably. In this environment, bargaining power favors the well-capitalized issuers and investors. As demonstrated by the Goldman/Citi transaction, CMBS investors are demanding quality in new offerings. After all, they theoretically live with the credit performance of the underlying mortgage assets much longer than the time it takes the issuers to originate and sell them.

Asset-Backed Market

While investor risk appetite in other markets may have toggled on and off like a light switch in response to each day's headlines, the core segments and benchmark issuers of the asset-backed sector (prime auto, bank credit card, rate reduction and equipment) continued to see steady issuance, strong demand and solid collateral performance.

According to statistics provided by J.P. Morgan, total U.S. public and private issuance during the third quarter was $34.3 billion with approximately 47% coming from the auto sector. September saw the highest monthly issuance this year with just over $18 billion in total supply. Total issuance in the asset-backed sector year-to-date is $101 billion, which exceeds total issuance during the first nine months of last year by approximately $15 billion. Demand continues to outstrip supply, with new issues frequently oversubscribed and launching at tighter spreads than initial price guidance.

"Defying conventional wisdom about the weak consumer, the fundamentals in the consumer asset-backed segments, particularly prime auto and credit cards, indicate improving credit trends."

Tiering by average life and issuer has been a consistent theme during much of the summer, and September was no exception. In the primary market, demand was particularly acute for short money market and one-year senior classes, while the last cash-flow classes have struggled a bit. Spreads on subordinated tranches of new-issue deals have come at considerable concessions to levels earlier in the year. Spreads on subordinated tranches in the secondary market have also widened during the quarter in response to increased risk aversion from institutional investors and a preference for greater liquidity as we move into year-end. The appetite for high quality short average-life classes is not surprising given the flat yield curve and heightened concerns about liquidity. In fact, spreads in the secondary market for short-duration benchmark issues have tightened to post-crisis lows. High dollar prices on seasoned high coupon asset-backed issues stoked demand for new-issue par-priced paper, which pressured new issue spreads tighter. Given the tight spreads on the benchmark sectors and issuers, more investors are moving into high-quality esoteric assets to pick up incremental yield.

Defying conventional wisdom about the weak consumer, the fundamentals in the consumer asset-backed segments, particularly prime auto and credit cards, indicate improving credit trends. While there was an uptick in delinquency and losses month-over-month in the auto segment, this was due to seasonal factors. However, losses and delinquencies remain low on an absolute level and are well below the peak levels reached during the crisis. The credit card sector saw continued improvement in collateral performance through the most recent reporting period, with most issuers reporting increases in monthly payment rates and decreases in charge-offs and late-stage delinquencies. Tighter underwriting standards in both the auto and credit card segments were the main catalyst behind the improvement in collateral performance. Moreover, high levels of credit enhancement in the core segments of the asset backed sector should protect investors against deterioration resulting from prolonged economic weakness.

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Corporate Credit Market

The aforementioned global macro issues resulted in a reversal of fortune for domestic corporate credit. Each market—investment grade, leveraged loan, and high yield—has experienced significant volatility over the past quarter.

In some segments, the price action is reminiscent of the not-so-distant U.S. credit crisis. As a result, fear and uncertainty have set the foundation of a poor technical backdrop, with low liquidity and choppy trading. While the Q3 earnings release cycle will provide much needed clarity about the impact of the deteriorating macroeconomic trajectory on firm fundamentals, it is likely to be overshadowed by future policy responses to sovereign debt woes.

Investment grade corporates have benefited from their high correlation to Treasurys. While wider spreads resulted in the worst excess return performance since the fourth quarter of 2008, lower yields produced total returns of 2.3% for the quarter and 5.6% for the year. Moreover, investment grade non-financial companies, thanks to their low-risk credit profiles and the "reach for yield," enjoyed deep access to the new issue market. New issue concessions were higher than normal, but low interest rates resulted in average 5-year and 10-year yields of just 2.5% and 4%, respectively. Policy measures such as Operation Twist and the Fed's communication of its commitment to low rates until 2013 gave way to a material outperformance of 10-year or longer corporates which posted a total return of 8.4% in the quarter.

Financials presented themselves as the cheap house in the good neighborhood. Their underperformance was the result of several concerns: third quarter trading losses, future mortgage liabilities, exposure to European sovereigns, a slower pace of investment banking business and credit rating agency downgrades. The widespread adoption of Counterparty Valuation Adjustment (CVA) in the immediate aftermath of Lehman Brothers, which led to a widening of CDS levels, has continued. Thus, it is hard to extrapolate whether the recent widening of CDS (see chart 5) is a result of the market's true view of solvency or simply model-driven behavior.

"It is hard to extrapolate whether the recent widening of bank CDS is a result of the market's true view of solvency or simply model-driven behavior."

Chart 5: US Bank 5-yr CDS, bps

Source: Bloomberg

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Moving further out on the risk curve, leveraged loans were affected by Fed policy in an unexpected way: Fund flows took a sharp reversal following the Fed's message of extended short-term rates. As a result, the attractiveness of LIBOR-based assets declined. By late August, the market had gotten so cheap that it was trading at similar asset-swapped yields to high-yield bonds, despite leveraged loans' seniority in the capital stack. By the end of the quarter, however, loans prices snapped back, closing the month at a 0.4% total rate of return vs. high yield's -3.6%. The loan market was helped by a couple multi-billion dollar repayments and new CLO-related funding. Moreover, banks still offer total rate of return facilities on loans, so hedge fund buying when loan dollar prices trade at generous discounts to par is one unreported source of loan demand.

The High Yield Index recently crossed the 10% yield threshold, after reaching a low of 6.70% this year. Cash market liquidity has dried up and the primary market has largely shut its doors as investors brace for heightened uncertainty. As would be expected, asset coverage and free cash flow are likely to decline in the recession scenario. However, liquidity presents a historic buffer to balance sheet health. Stay tuned for the outcome.

Treasury/Rates Market

The main theme of this quarter was the strong bull-flattening of the Treasury yield curve—where the curve flattens due to the long end rallying.

"After the events of the quarter, Eurodollar traders believe the Fed when they say that zero interest rate policy will hold through at least 2013."

From an asset class perspective the yield on the 30-year bond fell from 4.39% to 2.91% during the quarter and delivered a massive quarter-over-quarter return of 33%, one of the highest returns in history. In addition, the 2-year to 30-year yield spread flattened by 125 basis points, from approximately 392 basis points to 267 basis points.

Chart 6 shows the path of the 2s-30s spread in candle-stick chart form for each trading day in the quarter. (The candle-stick charts are similar to bar charts or line graphs, but they give much more information. One can tell intra-day activity from looking at them.)

Chart 6: Day-to-Day Volatility

Source: Bloomberg

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The beginning of the quarter was marked by European debt woes in the headlines. With uncertainty in the markets comes demand for more certain cash flows. However, that certainty was questioned as the debt-limit was hit by the Treasury and Congress reached an impasse, leading to the possibility of a US sovereign downgrade by S&P. As the debt-limit was lifted, the reach for duration began, compounded by multiple factors such as weakening economic numbers, anticipation of Fed policy, and demand from institutional investment accounts (observed through strong direct bids during the Treasury auctions). While the rating downgrade theoretically would have created a selling bias, it ultimately had little effect on the market demand for Treasury securities. The evidence of economic weakening and the September 21 FOMC announcement of Operation Twist continued the flattening trend.

Meanwhile, the changed perspective on indicative Fed policy can be seen in the Eurodollar future contract expiring in June 2013. After the events of the quarter, Eurodollar traders believe the Fed when they say that zero interest rate policy will hold through at least 2013: At the beginning of the quarter they expected 3-month LIBOR to be about 1.60% in June 2013; by the end of the quarter expectations had fallen to approximately 67 basis points.

Markets

We noted in our Q2 2011 commentary that the world did not end on June 30, 2011, when the Federal Reserve ended their second asset purchase program, nicknamed QE2 —but it didn't take long for its absence to be felt.

"The few winners for the third quarter were related to fear."

Equity markets in the US hit their high watermark for the quarter in late July and then fell precipitously. The S&P 500 lost 14.3% in the third quarter, and the Russell 2000 small cap index fell over 21% (erasing almost all of its gain since Chairman Bernanke's Jackson Hole speech in late August of 2010). Global equities performed poorly as well, with the MSCI World Index falling 16.5% during the quarter. Most commodities were lower as well: Crude oil, cotton and copper were down 18.4%, 15.5% and 26.7%, respectively. The few winners for the third quarter were related to fear (the VIX Index went from 16.5 to 43) and safety (the dollar index +5.8%, Gold +7.8%). The Treasury market was the most conspicuous beneficiary, with the 10-year rallying to 1.92% from 3.16% and the 30-year moving impressively below 3% by quarter end.

	9/30/2011	6/30/2011	9/30/2010	QOQ % Change	YOY % Change
Federal Reserve Funds	0.25%	0.25%	0.25%	0.0%	0.0%
2-year US Treasury	0.245%	0.460%	0.426%	-46.7%	-42.5%
10-year US Treasury	1.916%	3.161%	2.512%	-39.4%	-23.7%
10-year JGB	1.032%	1.140%	0.940%	-9.5%	9.8%
10-year euro	1.887%	3.025%	2.275%	-37.6%	-17.1%
10-year UK Gilt	2.430%	3.380%	2.950%	-28.1%	-17.6%
10-year Canada Treasury	2.155%	3.110%	2.758%	-30.7%	-21.9%
30 yr Conventional Mortgage	3.490%	4.313%	3.749%	-19.1%	-6.9%
Barclays US Corporate	3.84%	3.84%	3.63%	0.0%	5.8%
Dollar Index	78.55	74.30	78.72	5.7%	-0.2%
Japanese Yen	77.06	80.56	83.46	-4.3%	-7.7%
S&P 500	1131.42	1320.64	1141.20	-14.3%	-0.9%
Nasdaq Composite	2415.40	2773.52	2368.62	-12.9%	2.0%
Gold $/oz *(nearby contract)*	$ 1,620.40	$1,502.80	$1,307.80	7.8%	23.9%
Oil $/bbl *(nearby contract)*	$ 79.20	$95.42	$79.97	-17.0%	-1.0%
MBA Refi Index *(month end)*	4019.00	2604.40	4288.30	54.3%	-6.3%

Source: Bloomberg

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