ANNALY®

Macro & Market Musings

Key Findings

- The U.S. economy has continued to perform admirably, with recent economic data suggesting that growth may have even accelerated in recent months. This resilience comes amid a weaker labor market, as revisions have shifted the pace of hiring meaningfully below estimates seen at the beginning of the summer.
- Financial markets remained strong, supported by solid economic performance, healthy corporate earnings, interest rates that moved lower on the prospects of easier monetary policy, and optimism around AI and other emerging technologies.
- Agency mortgage-backed securities ("MBS") also delivered strong performance in both August and September, benefitting from declining interest rate volatility, strong demand, and wide spreads relative to comparable products at the beginning of the period.

The U.S. Economy

The end of the summer has brought cooling temperatures, strong financial markets performance, and data releases that have offered a surprising twist to the economic narrative. Upward revisions to Q2 GDP, along with better-than-expected spending and income reports for July and August, suggest that the U.S. economy remains resilient, even as signs of a weaker labor market emerge. Inflation remains above the Federal Reserve's ("Fed") target, and while the impact of tariffs on prices has been uneven and less immediate than expected, it remains a key concern for policymakers.

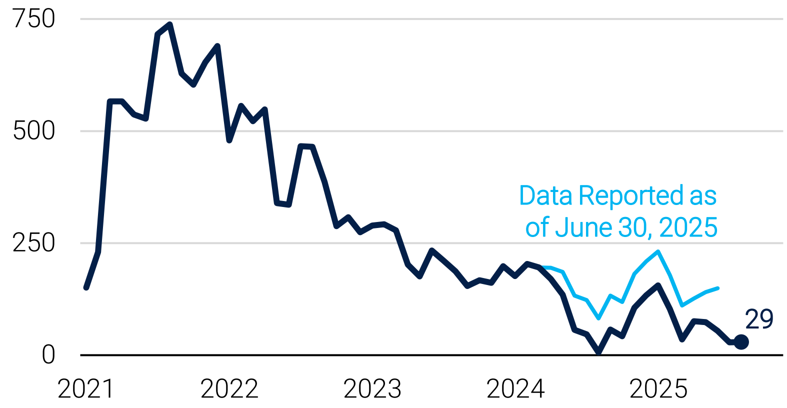
Labor Market

Despite the labor market continuing to display signs of a meaningful slowdown, it remains best characterized as a "no hire, no fire" market. On the one hand, according to the Bureau of Labor Statistics ("BLS"), businesses added an underwhelming 22,000 jobs in August, the fourth consecutive month of weaker-than-expected job growth that capped a sluggish summer for job creation. Net revisions were once again negative, which brought the 3-month average payroll gains to just 29,000. In addition, the BLS' preliminary benchmark revision suggested that job growth from April 2024 to March 2025 was running at less than half the previously estimated pace *(see panel 1)*. This lowered the average monthly pace of growth for that period to 73,000 from 149,000.[1] While these revisions do not necessarily reflect the pace of jobs growth since March, it does reveal that hiring was much weaker heading into 2025 than initially thought.

Panel 1:

Hiring Has Moderated Meaningfully

Non-Farm Payrolls Growth, 3-month MA, '000



On the other hand, the number of people filing for unemployment insurance remains low, with initial jobless claims consistently running in the low-to-mid 200,000s level – little changed from earlier this year. Meanwhile, the job openings rate fell to a new cycle low of 4.3% in August, leaving fewer than one available job per unemployed worker. Altogether, softer hiring and fewer job openings indicate that payroll growth may continue to run below the "breakeven" pace, even without a pick-up in layoffs. This dynamic is likely to put upward pressure on the unemployment rate, which gradually ticked up to 4.3% as of August.(2) That said, stricter immigration policy and enforcement under the current Administration suggests that the current "breakeven" rate of employment growth is likely much lower than in recent years.(3) It remains to be seen, however, whether the current pace of job creation is high enough to keep the unemployment rate anchored at historically low levels.

Economic Growth

According to revised estimates from the Bureau of Economic Analysis ("BEA"), U.S. economic activity is on stronger footing than previously thought. Second quarter GDP was upwardly revised to a 3.8% seasonally adjusted annualized growth rate ("SAAR") driven by robust consumer services spending and business fixed investment ("BFI"). Specifically, services consumption more than doubled from 1.2% to 2.6% SAAR in the latest release. BFI also saw a notable upward revision, rising from 5.7% to 7.3% SAAR, with AI-related investment contributing most of the gain. Additionally, real final sales to private domestic purchasers, a broader measure of underlying aggregate demand, improved to 2.9% SAAR – a full percentage point higher than the prior estimate and more in line with historical averages.

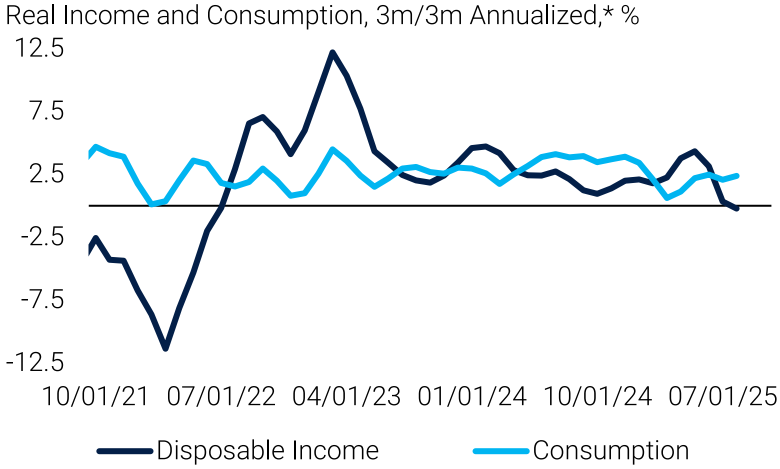
In addition, the BEA's August Personal Consumption Expenditures ("PCE") report showed that consumer spending rose 0.6% month-over month ("mom"), an increase above expectations that marked the highest monthly gain since March. On an inflation-adjusted basis, consumption rose 0.4% mom, with notable strength in discretionary purchases. Overall, the spending and income report signals that tariff-induced uncertainty has not yet weighed on consumers. Even with slower growth in disposable income, spending has remained solid *(see panel 2)*. At the same time, the savings rate has fallen to its lowest level this year, highlighting aggregate consumption appears heavily reliant on higher income households benefitting from surging asset values and lower income households dipping into their savings. Going forward, we would expect consumption to remain supportive of economic growth so long as wages and asset valuations hold up. Should either take a hit, consumers are likely to slow spending growth.

Inflation

On the prices front, tariff-related inflation pressures have been uneven and overall lower-than-expected. Despite a firm consumer price index ("CPI") August print, the Fed's preferred inflation gauge was somewhat muted, with core PCE rising 0.23% mom and remaining at 2.9% year-over-year ("yoy"). As shown by the unchanged annual rate, the inflation trend has leveled off above the Fed's 2% target. However, since reaching 2.6% yoy in April, it has begun to trend upward – driven in part, as [we expected](), by rising goods prices that slowly but surely have started to show some passthrough from tariffs. For example, based on the August CPI report, core commodities gained 0.3% mom – the largest monthly increase since January. Separately, food prices jumped 0.4% mom driven by elevated meat, fruit, and vegetable prices – the highest gain since January 2023. Contrary to our expectations, however, services inflation has been elevated the last two months and is not providing the expected offset. For instance, core services in the August CPI report rose 0.35% mom. Highlighting the forecasting challenges, over the last couple of months, a different mix of higher-than-expected shelter,(4) transportation, and medical care inflation has driven the firmness seen in core services inflation. Given the volatility in the monthly data, it remains unclear whether the recent prints signal a sustained upward trend or whether they represent temporary noise.

Panel 2:

Healthy Consumption Keeps the Economy Humming



* "3m/3m annualized" refers to the annualized change in the average of the latest three months of data and the three months prior to that, in turn replicating the way U.S. gross domestic product data is traditionally reported.

Financial Markets

Financial markets mirrored the economic resilience with a stellar performance in August and September. The strength was largely fueled by expectations of easier monetary policy, [muted concerns about the debt outlook](), lower volatility, and optimism for innovative technologies – most notably the adoption of artificial intelligence. The S&P 500 registered thirteen new all-time highs over the two months, while interest rates moved lower, led by short-term yields.

Monetary Policy

Softer hiring data and meaningful downward revisions to the employment picture have raised concerns about more persistent weakness in the labor market. In response, the Fed cut interest rates for the first time this year at its September Federal Open Market Committee ("FOMC") meeting. Fed Chair Powell indicated the FOMC is comfortable with "risk management" cuts, as growing risks to the labor market suggest monetary policy is more restrictive than previously thought. However, Powell stopped short of endorsing the prolonged rate cutting cycle currently priced into markets, arguing that there is no risk-free path forward and signaling a cautious and measured approach to future rate decisions.

Powell's stance also reflects broader uncertainty within the FOMC itself. While Powell emphasized the need for flexibility amid rising risks, the divergence in views among FOMC members has become increasingly pronounced. This growing split centers on how aggressively the Fed should ease rates in the near term to balance its dual mandate of maximum employment and price stability. Some members view the labor market weakness as acute and favor faster and more substantial cuts, while others favor a measured approach as they are predominantly concerned about higher inflation and the potential de-anchoring of inflation expectations. This is best reflected in the uncharacteristically wide range of 2025 interest rate forecasts in the Summary of Economic Projections ("SEP"), which showed a range of 1.5% across individual forecasts. It marks the widest range of current year forecasts for any September SEP, a forecast that tends to exhibit a higher degree of certainty given that there is only one quarter left in the year.

Fixed Income Markets and Volatility

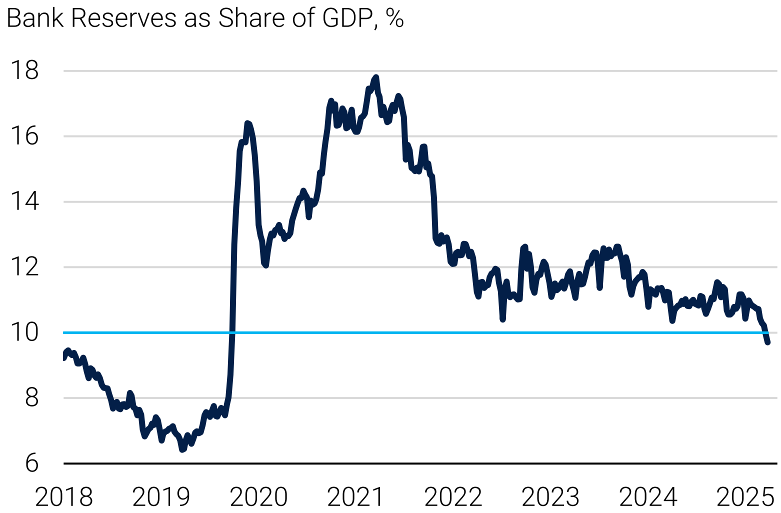
Treasury yields moved lower by up to 35 basis points ("bps") over the two-month period since July 31, 2025, with short-term yields declining more than long-term yields, in turn steepening the yield curve. The decline in Treasury yields was largely driven by the repricing of the path of the Federal Funds rate, with Secured Overnight Financing Rate ("SOFR") Futures pricing nearly one additional 25 bp rate cut by the end of 2026 than on July 31st. Inflation breakevens are little changed over the same period. Of note, U.S. interest rates moved in the opposite direction of most other developed market government bond yields, which generally saw higher yields, in large part due to growing concerns over the debt outlook in these economies.

Front-end markets have been in focus in September as SOFR averaged the highest rate within the Federal Funds target range in six years, signaling rising pressure in funding markets. This was reinforced by a marginal uptick in the Effective Federal Funds Rate. This pressure was largely anticipated, driven by the Fed's ongoing quantitative tightening, reduced usage of the Reverse Repo Facility, and the Treasury General Account rebuild over the past two months – all contributing to a sharp decline in bank reserves. According to the Fed's H4.1 report, reserve balances have fallen for ten consecutive weeks through September 24th, totaling a decline of $396 billion over the period. Current reserves stand at approximately $3.0 trillion, or about 10% of nominal GDP – a level increasingly viewed as shifting reserves from "abundant" to merely "ample" *(see panel 3)*. While quantitative tightening is expected to continue in the coming months, funding markets are likely to see greater price discovery, and the Fed will closely monitor how much further balance sheet reduction can proceed. For now, the process remains orderly, and facilities designed to mitigate front-end volatility – such as the Standing Repo Facility – have seen limited usage.

Financial market volatility has continued to decline in equities and, more importantly for MBS investors, in interest rates. While the reasons for the decline in market-implied volatility are widely debated, the most striking aspect has been the continued decline in realized volatility, or the limited actual daily move in interest rates. Early in the year, markets experienced sharp moves – particularly around the April tariff announcements – and interest

Panel 3:

Bank Reserves Fall Below 10% for the First Time Post-Pandemic



rate volatility remained elevated. This was in line with levels seen in recent years, which were marked by several exogenous shocks, including the Fed's series of 75 bp rate hikes, the March 2023 banking crisis, and the duration buyer strike in the fall of 2023. Since then, conditions have calmed, as markets have adapted to the economic data and the Fed's patient stance – both of which have mostly signaled "business as usual" – at least until recently.

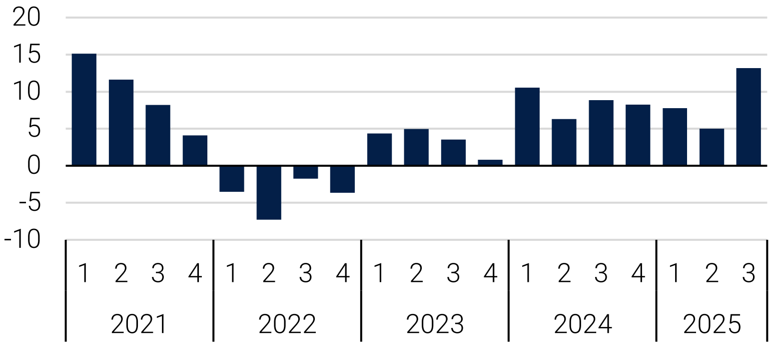
Risk Assets and Agency MBS Spreads

Buoyed by the robust macroeconomic backdrop described earlier, risk assets enjoyed continued strong performance over the past two months. According to S&P Dow Jones Index data, with nearly all companies having reported, S&P 500 operating earnings per share rose 9.7% in Q2 2025 yoy – a stronger-than-expected performance heading into the earnings season. Meanwhile, operating margins continued to run above five-year averages at 12.5%, suggesting that profitability remains healthy. Looking ahead, forward earnings growth expectations remain elevated, with annual operating earnings per share expected to grow 17.0% over the next year.

Agency MBS also performed well in August and September, with the Bloomberg U.S. MBS Index showing excess returns of 0.47% and 0.35% in the two months, respectively. The strong MBS returns were driven by the decline in interest rate volatility and robust demand from a broad set of investors including money managers and mortgage REITs. Inflows into mutual funds and ETFs have been running at the strongest quarterly average since the first quarter of 2021 according to Investment Company Institute data *(see panel 4)*. Speculation has also increased around the potential for a buyer of last resort. In recent months, there has been considerable discussion about the role of the government sponsored enterprises ("GSEs") and whether the Fed might adjust its MBS reinvestment policy.

Panel 4:
Bond Fund Flows Have Picked Up

Average Weekly Taxable Bond & ETF Flows by Quarter, $ billion



With the Administration's focus on housing and efforts to lower mortgage rates, market participants have pointed out that the GSEs potentially have room to increase their retained portfolios under current caps, potentially by as much as $240 billion combined.[5] However, several major questions remain. For one, the GSEs have indicated that its regulator prefers them to maintain portfolios significantly below the current caps, suggesting FHFA would need to change its guidance. Moreover, the GSEs have little cash-on-hand to increase retained portfolio holdings. More meaningful increases to the retained portfolios would require the GSEs to grow their short-term agency debt issuance, which would have to trade at attractive spread levels to government debt to make the trade economical. Finally, perhaps the biggest argument for the GSEs expanding their retained portfolios is their potential role to act as a backstop during periods of mortgage spread volatility, contributing to more stable spreads over time. This would require the GSEs to maintain sufficient portfolio capacity to step in during times of dislocation, though it remains unclear how much capacity is needed and how a backstop would work in practice.

A second point of speculation has been whether the Fed could change its portfolio management strategy and reinvest Agency MBS portfolio runoff back into the sector. Such a move could significantly reduce the net supply of Agency MBS – nearly halving the amount of MBS securities that must be absorbed by private market participants. However, current Fed officials have been outspoken about their preference to return to a Treasury-only portfolio. Additionally, many Fed members have generally advocated for a smaller balance sheet. We therefore remain skeptical that the Fed would resume MBS purchases – except in the case of a significant market disruption, like the situation seen in March 2020.

Disclaimer

Endnotes

1. *Of note, this benchmark revisions estimate will be revised again and over the past 5 years the subsequent revisions have averaged a +118,000 correction. In our view, a sign that the BLS and other federal statistical agencies require additional funding to improve and modernize their capabilities.*
2. *Given the ongoing government shutdown, we expect that the September Employment Report will be delayed.*
3. *Assuming a constant participation rate, we estimate that the breakeven hiring rate has likely declined from ~250,000 per month from 2022 to 2023 when immigration was running at 3 million per year to ~50,000 per month when immigration is running at 500,000 (current CBO estimate for the next three years).*
4. *August's monthly gain in shelter inflation was driven by certain medium-sized cities, which may be indicative of more imputations taken place at the BLS given funding cuts than actual trend changes.*
5. *The PSPA mandated portfolio limit is currently $450 billion combined across the two GSEs. The aggregate portfolio holdings of Fannie Mae and Freddie Mac are $206.9 billion as of August 2025.*