

## Securities Finance Market Monitor

Issue 18, for the month ending January 31, 2003

### Money Markets Recap

#### Quiet month in January for Fed as 2003 begins

As was December, January was a fairly quiet month in the fixed income and money markets. Geopolitical concerns dominated the news headlines, such that any strong economic data which caused even slight backup in rates, were always quickly reversed as news that an armed conflict in Iraq was more and more imminent. Also in the news was the current administration pre-release of a fiscal stimulus package that would cost close to \$700 billion over the next 10 years, if enacted. One of the key components of the proposal is the elimination of taxes collected on dividend payments by U.S. corporations. The opposition political party immediately came out strongly against much of the Bush proposal, and while they are the minority, it appears as though the final stimulus package, if there is to be one, will have to be somewhat different that what was announced.

To no one's surprise at all, the FOMC voted to keep rates unchanged at its meeting on January 29th, and also voted to maintain the outlook for the economy as balanced. In their statement, they did make note that the spike in oil prices and other aspects of the geopolitical risks have restrained the level of growth in the economy, and that the markets expect these risks to be lifted in the near future, which would allow for the accommodative monetary policy and productivity growth to foster higher economic growth. This was clear "Fedspeak" for "we are not going to lower rates anymore unless we really, really have too!" It would appear as though as soon as the Iraq conflict is resolved, or quickly moving to resolution, the Fed can be expected to move into a mode in which they would soon thereafter find reason to erase some of the accommodation from the current short-term interest rates.

While some market watchers do not expect such action to take place until well into the second half of 2003, many investors have taken a more cautious stance and will not look to extend the duration of the cash collateral investment portfolios, given the current risk/reward value of doing such.

### US Government Markets Commentary

#### Higher volume returns to Government loans

Gross Coupon issuance in the treasury market rose 50.2% in 2002 versus 2001. The year 2002 saw the highest volume of issuance since 1996. The increase reflects the growth demand for treasuries as issues related to economic and geopolitical uncertainty.

The demand for lending of US Treasuries increased by 10% in January. This increase in demand was due in part

to the re-entry of insurance company lenders that typically recall securities over year-end for balance sheet and accounting concerns. The other factor is the "flight to quality" in the marketplace that has increased the need by borrowers of securities to avoid settlement failures.

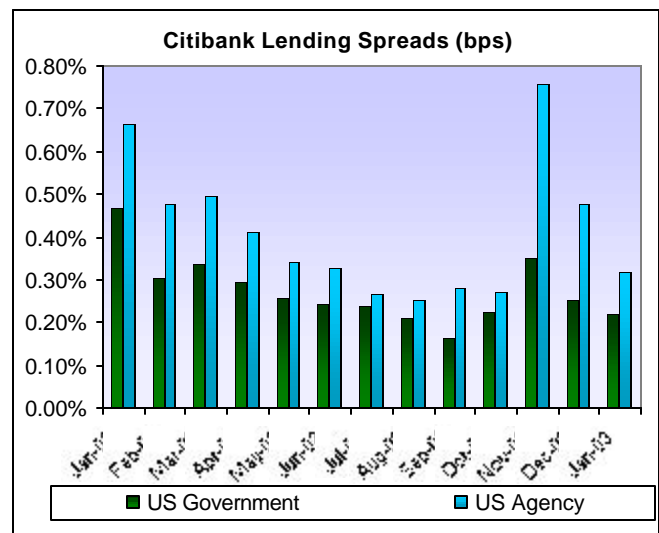
The US Agency Market has expanded due the one of the bright spots in the US economy: the housing market. The Federal Home Loan Bank issuance of debt increased by 52% in 2002. Fannie Mae's volume of new debt increased 18% in 2002.

US agency lending portfolios have witnessed increased volume of 10% in 2002. Interestingly, utilization has increased over 40%. As many investors have begun to express concern over the size of many quasi-governmental agencies, portfolio volume has declined. Specials which generate higher spreads have increased in volume as a result the portfolio reductions.

#### US Government Issues Trading Special

		Spread Range (bps)		Market Commentary
		Low	High	
Fannie MTN	(Euro)	200	250	Credit Arbitrage
US T-Notes	11/15/06	175	300	On the run Treasury
US T-Notes	02/15/12	250	300	Strong borrower demand

For charts above and below: Source: Citibank, N.A. January 2003 .



As seen above, in 2002 except for November when The Fed eased on rates, lending spreads declined throughout most of the year. The spread between US Government loans and US Agency loans narrowed to less than 5 basis point in August and widened immediately thereafter.

## Specials Lending Activity

### United States:

**Constellation Brands** (21036P108) agrees to buy **BRL Hardy**. At the time the deal was announced last week there was no interest. Now the market is seeing mild interest at gross fees of .75%. **Moore Corp Ltd** (615785102) agrees to buy **Wallace Computer Services**, strong interest with gross fees of .75% to 1%.

### Japan

**Tohoku Ricoh** (Q6427) to merge with **Ricoh Co.** (Q7752) - liquid stock and hence do not expect to trade above GC levels. **Fudow** (Q4209) to merge with **Mitsubishi Gas** (Q4182) - No liquidity in Q4209 while Q4182 is very liquid name which will not trade above General Collateral levels.

### Australia

**Challenger Int'l** (6187071) & **CPH INV** (6096144) – Recently announced a merger. No stock is available in CPH. (6764689) Southcorp Holdings - was suspended in trading pending the issue of an earnings outlooks statement. Brokers were looking to hold.

### United Kingdom

Still waiting on more news regarding the possible three-way bidding war for **Safeway's**; with **Morrison**, **Sainsburys** and **Walmart** all declaring interest in buying, although Morrison has been priced down at 50 bps in addition, Sainsbury's and Walmart have still yet to re-priced downward.

### France

**Sagem** (4074432) saw moderate loan demand activity. The company is offering to convert preferred shares to common stock at the rate of 6 common shares for 7 preferred shares, while offering a 20% premium over current pricing for the preferred shares. It has also suggested it will boost the common dividend payable this year by an unspecified amount.

## US Tax Proposal's impact on Sec Finance

Over the past few weeks we have been talking to market participants to reach a common viewpoint on the implications of the proposed dividend tax changes to the securities lending world .

The issue can be broken down in two parts.

The first one is the retroactivity of the tax changes. Some borrowers are concerned that lenders will retroactively claim them on dividends paid on loans for this year if proposed legislation is approved as presented. We are receiving requests to re-allocate loans from taxable accounts in favor of non-taxable accounts over a record date, if we are unable to comply the broker is closing out the loan.

Our mutual fund lenders feel that, based on the current agreements with the borrowers, they can not claim retroactively any loss of non-taxable benefit due to manufactured dividends of securities that were on-loan over record date. In essence, the borrower is obliged by contract to return any distribution - and not responsible for the tax consequences that the lender may have by lending or not lending those securities. Based on this view, our mutual fund lenders have instructed us to continue to lend and have agreed not to claim the borrowers for any retroactive loss of the tax benefit.

The second point is related to dividends of foreign companies that pay US federal taxes through their US subsidiaries. In the project as it stands, companies such as Daimler Chrysler could recognize a portion of their dividend as tax free for US shareholders.

Lenders, brokers and other market participants are of the opinion that even in large companies with a substantial US presence, the net benefit to shareholders would be so small that it is extremely unlikely that issuing companies would go through the effort of breaking up the dividend for purposes of passing the tax free portion to US shareholders.

In summary, as the project stands now, we have seen that market participants believe that if this is approved by Congress it will not have a retroactive impact on Securities Lending transactions, and after the fact only impact the lending of equities of US companies (we exclude ADR's from this definition). The impact to the market after approved might be a drop in demand dividend paying equity over record dates and year end of from taxable accounts in favor of non-taxable and foreign domiciled accounts.

In the meantime, our taxable mutual fund lenders are continuing to lend their securities. Their rationale is that incremental income they receive is in the best interest of the fund's shareholder's and the outcome of this project is still so uncertain that any decision on the securities lending program of the US equity portfolio will be taken after it becomes law.

We will keep you informed of the turn of events regarding this matter. In the meantime, we would like to know your opinion on this matter.

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