

## Securities Finance Market Monitor

Issue 20, for the month ending April 30, 2003

### Money Markets Recap

#### The Fed is quiet, as nation prepares for conflict

Trading activities in all of the capital markets in the U.S., and for that matter the rest of the world, were dominated by news regarding the military conflict in Iraq. With the war in full swing for much of the month, each piece of significant news which indicated that the duration of the war might be short created a rally in the equities markets and a backup in the fixed income markets. By contrast, any news indicating that the war might be prolonged created a slide in equities and a rally in fixed income.

While this uncertainty created some increased volatility in the longer end of the U.S. yield curve, the front end of the curve remained fairly stable. With no meeting of the monetary policy board scheduled for the month, and no clear signal on what the U.S. economy might be doing once hostilities in Iraq ended, there was no expectation of any immediate change in short-term interest rates one way or the other.

Toward the end of the month, Chairman Greenspan gave testimony to the U.S. Congress, in which he reiterated that he expected the pace of growth in the economy to pick up in the second half of the year, but that risks to that occurring, as well as a slight risk of deflation remained in the picture, and that the Federal Reserve would be ready to take additional stimulative action, should it be required. The current consensus is that there will be no change in the Federal Funds target rate when the board meets on May 6th, but there is a chance that they might choose to reimplement a bias towards economic weakness. Based on Mr. Greenspan's testimony, and on the fact that some members of the board do not like the current policy of expressing a near-term outlook, the board might choose once again to refrain from making any statement with regard to forward looking economic conditions.

The U.S. Treasury formally announced their financing details for the May refunding, in which they initiated the reissuance of the 3-year note. It is expected that the note will be well-subscribed for, and that it will be in demand in the loan/repo market as well. In addition, they announced that they would increase the 5-year note issuance to a monthly schedule, and that they would double the 10-year note issuance to 8 times per year, with the reopening of each quarterly issue one month later. Over time, it is expected that this might weaken some of the "special" value that the 10-year note traditionally carries.

In all, \$58 billion of U.S. Government securities will be settling in mid-month, and only about \$2.5 billion will be maturing, thus adding significantly to the supply of paper in the market.

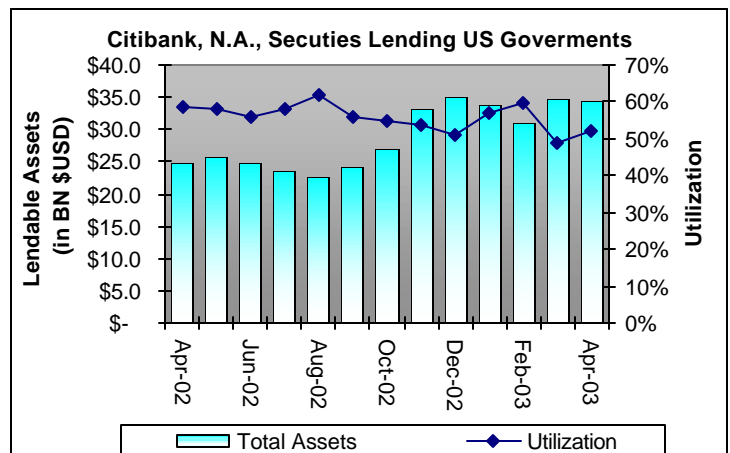
### US Government Markets Commentary

#### Higher volume returns to Government loans

The securities lending market has been realizing the typical seasonal widening of spread that comes after the April tax date; however, once that new supply hits the market, it is expected that spreads will normalize, or perhaps trade with abnormally tight for the foreseeable future.

#### US Government Issues Trading Special

		Spread Range (bps)		Market Commentary
		Low	High	
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: Source: Citibank, N.A. April, 2003.

### Specials Lending Activity

#### United States:

**XM Satellite (XMSR)**, a directional trade, still has demand at 7.25% fee. **Scansoft (SSFT)** saw a slight decline in short interest and has moved rates out of negative levels to a 1.25% fee. **Ryanair Hdgs (RYAAY)** has seen demand heating up recently, pushing fees up to the 75 - 100 bps range as the airline announced a planned acquisition at the end of January.

#### Japan

**Namco (9752) & Sega (7964)** are in merger talks. **Namco** is the more illiquid of the two with takers around the 3.5% fee level. **Hankyu Corp (9042)** –There is industry speculation of a Convertible Bond issuance.

Australia

**Westfields Trust (6956312)** stock has been halted from trading. Brokers are looking to hold stock pending further announcements.

United Kingdom

Lending activity for **P&O (0963590)**, has diminished now as P&O completed its merger with **Carnival Cruises (3121522)**. **Scottish & Newcastle (0783969)** have announced a bid to buy Bulmer, while selling their pub business to finance the purchase. Brokers are trying to hold shares at the moment until more news is known.

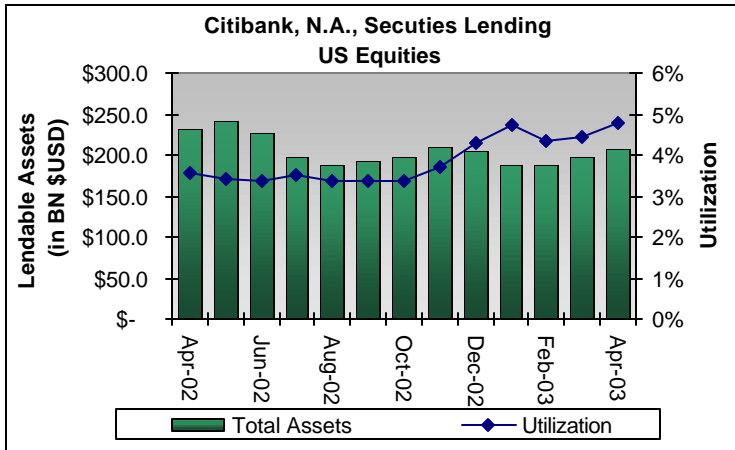
Singapore

**Neptune Orient (6628859)** Shares were suspended which sparked interest from Borrowers. In mid-April, news was announced that were selling a holding company to a Malaysian shipping company. Shares traded between a 1% - 1.50% fee.

The use of certain issues in hedging derivative securities also creates demand.

When many people are trying to borrow a specific security, that security "goes special," which is to say it begins to command a premium in the market. The premium takes the form of a lower interest rate or rebate paid on the cash collateral. Let us assume the rebate a lender would have to pay to borrow most government securities is 3.0%. Assume the securities lender can invest the cash collateral at 3.25%; thus, the lender makes 0.25% on the transaction after paying the dealer the 3.0% rebate. Let us now assume an issue has gone special. The rebate on the special may be 2.60%, 40 basis points less than the rebate on general collateral. If the lender can invest the cash collateral at the same 3.25% as above, the spread increases to 0.65%. Specials typically command a premium of 20 to 150 basis points. At times, however, the premiums can be much higher. At times the rebate rate on specials can be 0% or even negative! Funds lucky enough to be holding a large inventory of the right government bonds can see their earnings skyrocket.

General collateral includes any security that is not special. When a dealer is willing to accept general collateral on a repo, it is saying that as long as the collateral consists of government securities, whichever particular government securities are delivered is irrelevant. Some types of government securities are not considered acceptable general collateral. "Strips"-government securities where either the principal payments, or the interest payments have been removed, are examples. In addition, on a repo where the seller was going to deliver the collateral to the buyer's custodian, as opposed to a tri-party custody bank, the buyer would expect three to five issues of collateral for every \$100 million of repo. Buyers would get upset if the seller tried to deliver 20 or 30 pieces of collateral on a small repo. It would sharply increase the buyer's custody costs and make the repo much less profitable.



**FYI: General Collateral Defined**

Three terms that a participant in the government lending or reverse market will frequently hear are "general collateral" and "specials," or as specials are sometimes called, "specific issues." Specials are government securities that have come into unusual demand in the repo market. A security may come into demand when several dealers begin to short the issue, i.e., sell more of the issue than they own. The short sellers must deliver the security when a dealer is willing to accept the general issue they sold. They do this by borrowing or reversing the security, with the hope of being able to buy it outright at a later time when the price of a particular government security they own has fallen.

A security may also be in great demand because people need the issue to make good their obligations to deliver a specific issue on a certain date under futures contracts.

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