

Securities Finance Market Monitor

Issue 21, for the month ending September 30, 2003

Money Markets Recap

September Money Markets remain quiet

As it has been stated in this column for at least the past two months, there is very little change or expected change in the short end of the money market yield curve, where most of the cash collateral investment process takes place. For example, the 1-month LIBOR rate was unchanged at 1.12% for the entire month. The 2-month LIBOR rate was 1.13% for virtually the entire month, and the 3 month LIBOR rate was within 1 basis point of 1.14% for the entire month except for the last two days when it increased to a whopping 1.16%.

Does this mean that all of fixed income was this stable? The answer is a resounding "NO". The weak employment report early in the month created a rally in the medium and long end of the market. The 2-year US Treasury note rallied from a yield of over 2.00% at the start of the month to 1.48% by month end, with most of that drop coming within the two days after the release of the above mentioned employment situation report. The 10-year note fared just as well; decreasing by 67 basis points to end the month below 4.00% once again. Could this mean that another Fed easing is imminent? If so, barring a geopolitical event, it would be a long way off. The rally could also be partly explained by a significant drop in the value of the US dollar versus the yen and euro. There appeared to be some intervention in the market with those central banks buying dollars, and it is possible that the banks purchased a significant amount of US Treasury securities with the dollars that had been purchased.

The statement that followed the September 16th meeting of the FOMC was little changed from the previous meeting, except for the recognition that there was some weakness in the labor market. The next meeting is not until very late in October, and there is currently little or no expectation that either the monetary policy or balance of risk statements will be changed at that time. The Fed continues to state that policy can remain accommodative for a considerable amount of time before any action would be required. Therefore we will continue to take advantage of what little flexibility the short-term yield curve offers for our cash collateral investment portfolios.

US Government Markets Commentary

UST/Agency activity slows after volatile month

As US Treasuries have gained steadily for six weeks despite plenty of upbeat economic news, a variety of speculators have tried to short-sell Treasuries on hopes the rally had run its course. But so far they have been foiled and have had to repurchase bonds to get out of those bad wagers, helping push up prices. Often a big

base of short-sellers is a reverse indicator and suggests Treasuries have better days ahead. Data in September showed speculative short-sellers still outnumbered buyers in the Chicago bond futures pits, though the size of their positions was trimmed down.

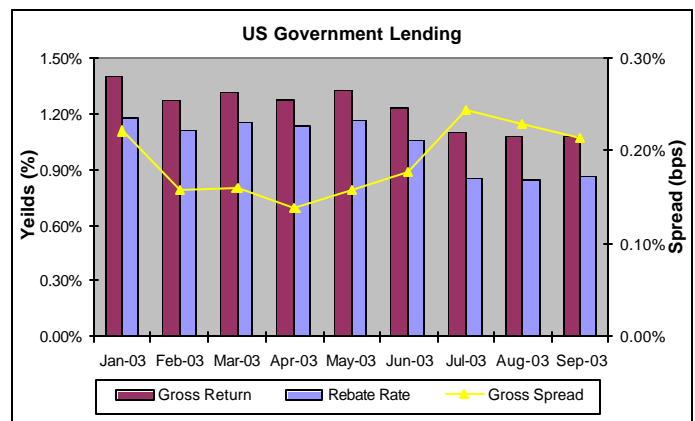
Some traders believe the market has more room to rise, with stocks looking shaky, the technical picture positive, and mortgage portfolios perhaps soon needing to buy Treasuries as a hedge against lower rates.

The lending portfolios have witnessed an increase in borrower demand as a result of the second quarter short bets increased. The third quarter saw an unwinding of those bets as borrower shorts reversed. The reverse is reflected in lower spreads (see the chart below).

US Government Issues Trading Special

		Spread Range (bps)		Market Commentary
		Low	High	
Fannie MTN	(Euro)	20	50	Credit Arbitrage
US T-Notes	11/15/06	80	100	On the run Treasury
US T-Notes	02/15/12	80	100	Strong borrower demand

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

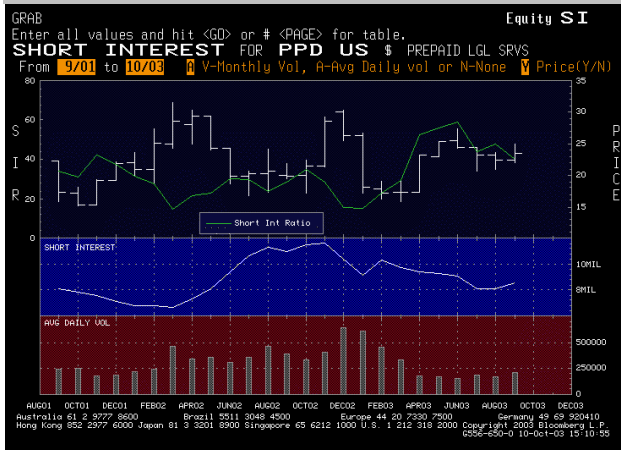


US Equity/Bond Markets Commentary

Equity lending activity comes back to life

The US equity markets finally showed signs of life in the second quarter of 2003. The S&P 500 Index rose only 2.2% for the quarter, but more importantly, confidence in the NASDAQ has broader implications for stronger growth in 2004. The technology sector has been somewhat revitalized and there are actually whispers of increased M&A activity.

Specials Lending Activity



Short Interest Ratio for Pre-Paid Legal Svcs. Inc. Source: Bloomberg

Corporate Equity

Teco Energy - Going through a major restructuring that includes employee lay-offs and plant closings. Also announced loss for the first half and reduced its dividend.

Cell Therapeutics - Biotech company has a cancer drug under R&D. Announcement about the drug's effectiveness caused 13% increase in one day during September, adding to 83% gain this year.

United Global Inc.- International provider of broadband communications. Late August Liberty Media gained the majority ownership of the company, by capturing 75% of its common stock, and 96% of the voting power, trading @ 25 bps.

Corporate Bonds

Northwest Airlines - Senior Notes: Distressed security facing typical Airline industry hardships. A basic short , currently trading @ 25bps

Non-US Equity

Koyo Seiko (6473) - With September record date over brokers are starting to refinance with domestic stock from October onwards. In an effort to maintain borrow positions rates are coming down to 2.5% fee.

Furukawa Electric (5801) - Rumors of a possible new CB issue lead brokers scrambling for stock. Stock traded up to 2.5% fee on the back of this speculation.

Anritsu (6754) - Rates are coming down from a high of 10% to 5% for this Convertible Bond related name as September record date passes. Brokers are refinancing expensive borrows with callable stock.

Air France (4916039) and KLM (5786491) - Announced a major European merger which will rival British Airways as the largest European airliner. Stock in Air France is trading around 5% fee.

Jenoptik (5470556) - Announced that they it will raise cash by issuing €175 million of debt. Trading at 1% fee with a re-rate in the small cap name. A lack of liquidity in this issue among lenders is contributing to demand and higher spreads.

FYI – Securities Finance Terminology

Convertible bond arbitrage. Convertible bonds are debt instruments issued by corporations with the embedded option that they can be converted into a predetermined number of shares (conversion ratio) at the discretion of the bondholder. An arbitrage opportunity occurs when there is a discrepancy in the price of the equity security and its convertible component. If the stock price increases up to the point at which the options are “in the money” and the market value of the bond is lower than the current value of the shares for which the bond can be exchanged (market conversion value), a positive spread can be obtained by buying the bond and converting it immediately. To protect against a decline in stock prices, the bondholder can borrow and sell the securities.

Index arbitrage. There is an arbitrage opportunity using index futures contracts and securities borrowing if, at a given moment, an investor can lock in a profit by simultaneously borrowing the securities underlying the index, selling them, investing the proceeds until maturity at the risk-free rate, and buying back the securities underlying the index by taking a long position in an index futures contract. A profit is locked in since the amount that will be received from the investment is greater than the futures price paid for the index. Portfolio managers who trade large indexed portfolios often favor this strategy.

Reverse Arbitrage. A riskless transaction consisting of the short sale of a security, the purchase of a call, and the writing of a put. If the value of the security increases, the call is exercised to negate the short sale. If the value of the security decreases, the put will be exercised by the holder and the received security will negate the short sale.

Basket. A group of several securities created for the purpose of simultaneous buying and selling. Baskets often play a role in index arbitrage, program trading and hedging.

Citibank Securities Finance Contacts:

Alejandro Berney	US	1-212-657-1075
Thad Garrison	US	1-212-657-4032
Linda Kearney	UK	44-207-500-5411
Paul O'Brien	HK	852-2868-7347

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