

Securities Finance Market Monitor

Issue 23, for the Quarter Ending March 31, 2004

Money Markets Recap

Employment data remains a focus of the FED

In a continuation of what appears to be a well-rooted trend, the month began with a very benign employment situation report and a correlated market rally. Immediately following the report of a 21K gain in payrolls, versus a survey consensus of 125K, the 2 year note spread narrowed to 1.50% from 1.75%. It remained in a fairly narrow trading range for much of the month and then rose up to about 1.65% at month end. This was the result of strong consumer confidence numbers along with some comments by FOMC members that the employment numbers are due to improve dramatically and that the FRB might be willing to react once they do. At it's March 18th meeting, the Committee once again took no action with regard to any change in policy, and except for a little bit of language tweaking with regard to the employment outlook, issued a statement very much the same as the previous one. It has become abundantly clear that the employment data is the key stimulus to a policy change, and the policy makers seem confident that that data is going to show marked improvement in the near future. Although they continue to state that inflation should not be a problem over the course of the next 3-9 months, there is no reason to believe that the FOMC will remain accommodative throughout that period. We continue to believe that the Committee is somewhat anxious to begin to move to a more neutral position, and that any confirmation of a pickup in job growth will trigger a move to a higher Federal Funds target rate. Despite a consensus that this will not occur until late 2004 or even early 2005, we believe that it is possible for a policy change to occur as early as mid year. On that basis, and given the small amount of yield enhancement offered by the short-term yield curve, we will manage the cash collateral investment portfolios in a very cautious manner.

One other note of interest, and as a follow up to what was discussed in last month's commentary, is that the U.S. Senate has begun to debate a bill that would strengthen the regulation of Fannie Mae and Freddie Mac, the two largest U.S. mortgage finance companies. The new law would create a supervisor with the power to alter the GSE's capital requirements, reject new lines of business, and put the companies in receivership or sell off their assets, should they become insolvent. The initial consensus is that in its current form, there is little chance that this bill would be brought to a vote, and in fact, any debate is likely to be postponed until after the elections and a new Congress is installed in January 2005.

US Government Markets Commentary

UST/Agency loan balances increase slightly

US Government on-loan balances Moved very little from the month of February. The 1.2% increase in loan activity is the combined effects of continued anxiety regarding the Middle East, apparent shifting demand by foreign central banks for US Treasuries as well as US economic concerns. As a result demand, has remained steady while desk rates drift between 94-97 bps for general collateral. Several US Treasury Cusips traded special at various times throughout the month namely; 912828BZ2 and 912828BU3.

US Government Issues Trading Special

For charts above and below: Source: Citibank, N.A. March 2004.

Cusip	Maturity	Spread Range (bps)		Market Commentary
		Low	High	
912828FM5	5/15/1930	85	100	Supply/Demand
912828BV1	1/15/2009	80	100	On the run Treasury
912828BR0	11/15/2013	25	50	On the run Treasury
9128276N7	11/15/2005	40	80	Supply/Demand
912828BR0	11/15/2013	25	50	On the run Treasury

US Equity/Bond Markets Commentary

Equity lending specials increase in volume

Issuance of investment grade and high yield debt climbed to \$240 billion in the first quarter from \$206 billion in 2003's first quarter, according to Thomson Financial, as companies took advantage of lower borrowing costs. Investment-grade sales rose to \$198.3 billion from \$183.3 billion in the first quarter from the same year-ago period while high-yield issuance nearly doubled at \$41.5 billion from \$22.8 billion from last year's first quarter

The benchmark Russell 2000 index gained 6 percent for the quarter, compared with 4.8 percent for the Standard & Poor's Midcap index and 1.3 percent for the S&P 500 index. Nasdaq fell 0.46 percent, but the broader Standard & Poor's 500 average rose 1.29 percent.

Equity and corporate lending continue to benefit from the lower interest rate environment and renewed confidence in M&A and the positive prospects for underwriting. Issues trading special has remained unchanged while loan priced in the 80-90 bps range increased significantly to 31% of all outstanding loans.

Specials Lending Activity

Corporate Equity

Q-Logic, Inc., lowered its quarterly outlook due to a decline in expected orders for computer networking equipment. Shares of QLogic, which makes computer storage equipment, fell \$9.69, or 22.7 percent, to \$33.00.

Interstate Bakeries Corp.- shares slumped after the company suspended its dividend to save cash. Shares of Interstate, which makes Twinkies cupcakes and Wonder bread, gave up \$1.30, or 10.3 percent, to \$11.37 after announcing the move, which comes amid an industry-wide slowdown in bread sales as more people try low-carbohydrate diets.

Circuit City, whose lower expenses helped its earnings gain despite a lackluster sales rise, added 60 cents, or 5.6 percent, to \$11.30. It also announced a \$284 million purchase of a Canadian rival InterTan, as it looks to battle Best Buy, which also owns a Canadian electronics chain.

Non-US Equity

Telefonica Moviles (4695532), at mid month were in talks to buy Bellsouth, stock was suspended. Early trading levels ranged between 2.75% and 2.35% fee.

Invensys (0807041) has said to be in talks with bankers to agree a £500 million rescue share issue (thought to be a rights issue). The securities that had been on loan prior to the announcement were re-priced at a range of 24 to 30bps.

Bayer Hypo (4325419) announced a capital increase (rights issue), also at the same time they have announced a dividend will not be paid in 2004, this has prompted the domestic funds to start lending which has kept the loan fee level between 35 bps and 50 bps.

FYI – Securities Finance Terminology

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.

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 payment 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.

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