

## Securities Finance Market Monitor

Issue 25, for the Month Ending May 31, 2004

### Money Markets Recap

#### The FED sets the tone for future rate hikes

As expected, on May 4th the FOMC shifted its risk assessment to clear neutrality regarding inflation. In addition the FOMC removed the reference to being "patient" as it referred to the removal of policy accommodation. Although the Committee did not announce a rate hike at the meeting, they made it quite clear that a change in policy was in the works. "At this juncture, with inflation low and resource use slack, the Committee believes that policy accommodation can be removed at a pace that is likely to be measured." The market interpretation of this statement appears to be that the Fed is willing to be reactive as opposed to preemptive, at least for the time being. Given the strength of the recent employment reports as well as a string of other favorable economic data releases, a consensus that the first shift in short-term rates will occur at the June 30th meeting of the FOMC has emerged. The Federal Funds Futures market has confirmed this consensus by fully pricing in a 25 basis point rate hike in the July contract. The market further indicates a series of meetings resulting in basis 25 basis point increases for remainder of 2004. Given the climate of the market going into the FOMC meeting, money markets produced a puzzling reaction. The yield on the 2-year UST note dramatically increased 35 basis points, reaching a new recent high of 2.65%. However, trading prices settled back to normal trading ranges shortly thereafter.

At this point, in relation to cash collateral investment portfolios, we must be cautious of a market that is potentially more bearish than the current forward price data indicates. In the current environment, our approach will be to evaluate investments with the expectation of a 25 basis point increase on June 30th and another increase later into the year. By default, this will probably lead to a shortening of effective duration in most of the portfolios as this pricing model will be outside of the market norm.

It is possible that selective purchases will fit the risk /return model and be added to the portfolio, resulting in a pick up in yield associated with the higher rates of return for these investments. We will continue to carefully evaluate investment opportunities that are perceived to add such value to the portfolios, while meeting our clients' customized risk parameters.

### US Government Markets Commentary

#### On-loan balances keep pace with Fed activity

We continue to see an increase in custody holdings of US Treasuries by many Central Bank lenders. The securities

lending portfolios have increased their US Treasury balances by 11.5%. This may be explained by the 14.1% increase in US Treasury assets purchased by foreign Central Banks from the US Federal Reserve since January 2004.

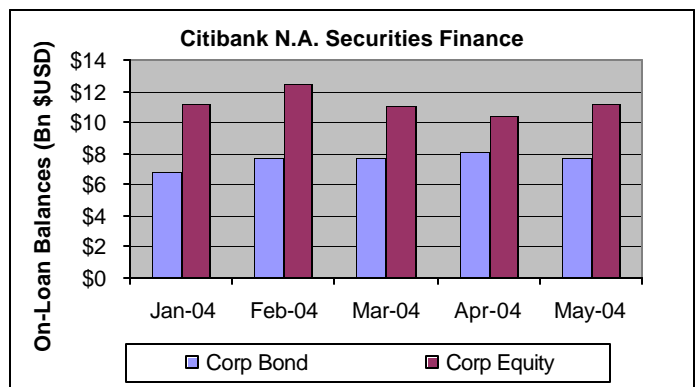
US Government securities on-loan balances rose 4.1% for the month of May. This increase reflects the continuing frenzied activity surrounding the current 2 year-notes and other select issues. The increase also reflects a more targeted effort to offer brokers US Agency securities at competitive lending rates ensuring optimization of our client's portfolios. On average, the US Treasury portfolio traded at 12 basis points below Fed Funds, or 88 bps. This remains relatively unchanged from the month before. Three issues in particular traded fairly even throughout the month, adding nearly \$200MM to existing client on-loan balances: 9128828CF5, 9128828CH1, 9128828CJ7.

### US Equity/Bond Markets Commentary

#### Inflation fears keep equity/bond markets fragile

The equity markets "wobble but they don't fall down" may be an apt phrase for analyzing the current environment for equities and corporate securities. The NASDAQ rebounded 3.47% for the month of May after retreating nearly 5% in the previous two months. Both the S&P and the DJIA posted very static returns. This relative calm may be deceiving. The markets have reacted to economic and geopolitical events, inching back and forth with little directional consensus. The upcoming summer months may only provide more of the same.

On-loan balances for US equities increased slightly in May as the Energy, Biotech, and Healthcare sector continue to provide a steady supply of specials to the market. The volume of "deep specials" on-loan (securities that have a negative rebate) has increased 5.1% vs. the prior month. One possible explanation may be that traders may be constructing specific arbitrage strategies around the looming interest rate increase in June. If the hike does not come to pass, expect the volume of specials to drop noticeably in July.



## Specials Lending Activity

### Corporate Equity

**Krispy Kreme Doughnuts Inc.** stock fell 33.96% during the month of May. The recent trend of low-carbohydrate diets is the chief reason behind this decline. In addition, Krispy Kreme attributes the fall to their pending sale of Montana Mills Bread Co.

While trying to avoid bankruptcy, **Delta Airlines** stock has fallen 35.1% since March. The company attributes part of their financial difficulty to pilot costs, as their pilots are paid 1.5 times higher than the industry average. Delta and the Air Line Pilots Association union are currently negotiating pilot pay cuts.

The past 23 months show a recent trend of investors eager to sell shares of **News Corp.** Investors may view the competitive and unstable entertainment atmosphere of News Corp.'s business as a risky investment. The company is also associated with relatively new and high-risk companies such as **Sky Italia** and **Tivo**, whose stock fell 15% on June 7.

### Non-US Equity

**Draka (4280132)** plans to issue €150 million worth of new shares. This trade was shown to brokers at total spread of 2.50% for this small-cap security.

**Storm Energy Ltd.** reported it had agreed to be acquired by **Harvest Energy Trust** in a cash and debt deal worth C\$189 million. The companies reported that Harvest Energy, a trust fund listed on the Toronto Stock Exchange, will buy all of the outstanding shares of Calgary-based Storm for C\$189 million, including assumed debt worth C\$64 million.

**Fukuoka City Bank (8539) & Nishi-Nippon Bank (8327)** - Stock prices rose in response to positive merger news. Brokers borrowed stock for directional trades with lending fees as high as 175 basis points.

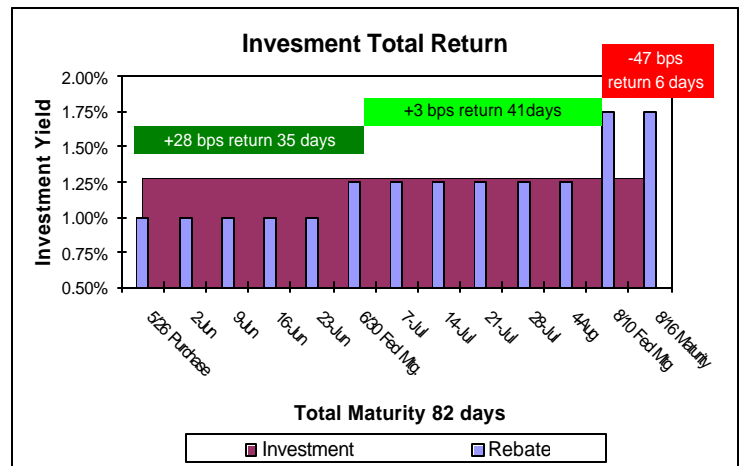
Lending activity has also picked up in Australia as more risk arbitrage opportunities have emerged in the Australian equity market, including names like **Lend Lease**, **Tabcorp**, and **Perpetual**.

## FYI - Collateral Reinvestment Strategies

In safekeeping assets for our clients, we believe it is extremely important to provide complete transparency to our securities clients participating in our reinvestment program. One component of our overall strategy is to manage interest risks while selecting investments that can add incremental earnings for our clients on a total return basis.

These investment purchases provide "front loaded" revenue to the Securities Lending program.

Take the following example. An investment is purchased on May 26th and matures on August 16th. Assume that we are always willing to invest at a premium of 10 basis points above the Federal Funds target rate. Given our model and the current Fed Funds rate of 1% we would require a 1.10% yield for the first 35 days (May 26 until the June 30 meeting), a 1.35% yield for the next 41 days (June 30 until the August 10 meeting), and a 1.85% yield for the last 6 days. The "breakeven" rate for this trade would be 1.281%. Therefore, an investment that was offered at rate equal to or better than 1.281% would be an attractive purchase. If interest rates moved in line with the model, then for the first 35 days the investment would carry a premium of 28.1 basis points above the Federal Funds target rate (which can be used as a proxy for rebate rates). For the next 41 days the premium would drop to 3.1 basis points. For the last 6 days, the investment rate would be 47 basis points below the target rate. Clearly, this demonstrates how such an investment maintains a positive spread throughout most of its investment period. This positive spread far outweighs the brief negative spread at the end of the investment period. This "total return" approach to collateral reinvestment supports our overall value-at-risk strategy. This strategy is one of many collateral investment approaches used to manage the risk/return component of collateral management.



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