

## Securities Finance Market Monitor

Issue 26, for the Month Ending June 30, 2004

### Money Markets Recap

#### As expected, the FED raises rates to 1.25%

The last day of June, 2004 officially became the first day of a new era in monetary policy. The FOMC unanimously voted to increase short-term interest rates for the first time in over four years. The 25 basis point increase in the target Federal Funds rate to 1.25% was widely expected and was accompanied by a statement indicating that, unless there are clear signs that inflation is accelerating rapidly, we can expect a series of similar rate increases over the course of the next few quarters. While there was a point earlier in the month in which a combination of strong economic data and some commentary by policy officials led the market to believe that there was a possibility of a 50 basis point increase, that sentiment has since faded and the consensus now is that it would take significantly stronger data to get the Fed into a 1994 kind of mode.

Now that the increases have begun, where will they lead? The policy makers are extremely cautious when it comes to identifying a rate level in which accommodation has been removed, as it tends to be a moving target. If we assume that the accommodation will be removed over a period of 2 years, then we can interpolate from the Eurodollar Futures market that the neutral rate of Federal Funds should be about 4.00%. At this point the most significant risks for the plan of a measured pace to neutrality are an energy price based spike in the general inflation rate on the upside, and either a potential bursting of the "housing bubble" or another serious terrorist event on the downside. While we strongly believe that the Committee will continue to raise rates in small steps, we nevertheless must protect our investment portfolios from the shock that would occur in the event the FOMC takes stronger action.

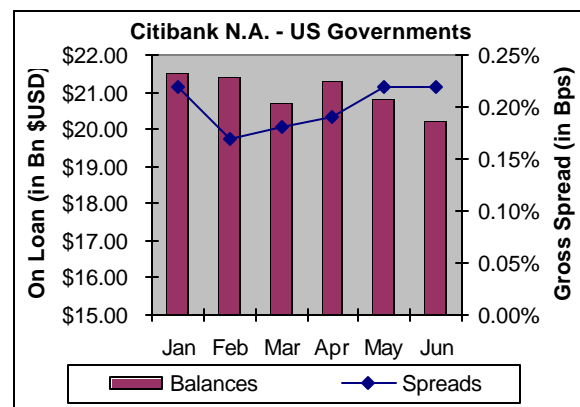
In that regard we shall invest only where the market is pricing in the appropriate amount of risk premium.

### US Government Markets Commentary

#### US Governments respond to Fed moves

As investors anticipated the well-telegraphed moves by the Fed, Broker/Dealers appeared to have repositioned their portfolios accordingly. Broker Dealers are faced with the logical concern that consumers will become more reluctant home buyers as mortgage rates rise. This concern obviously becomes ingrained in investor hedging strategies between Government and Agency securities. We will certainly keep this in mind when pricing loans which create value for our clients.

US Government securities on-loan balances remained relatively unchanged from the previous month, decreasing by an insignificant amount. Lending activity surrounding the current 2 year-notes saw slightly less demand as brokers/dealers did not increase their loan positions in June. Interestingly, with the increase in the Fed Funds target rate, one would expect an across-the-board increase in rebate rates for all issues. In reality only general collateral loans moved lock in step with rates. Some issues had little or no increase in rates. This is good news for lenders, as they may be able to earn additional spreads without taking additional collateral investment risk.



### US Equity/Bond Markets Commentary

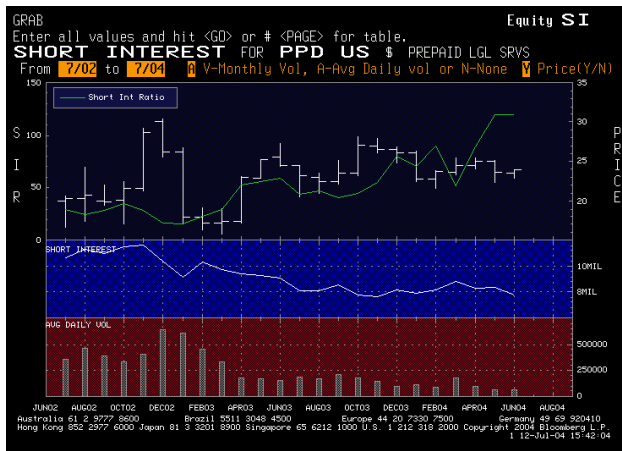
#### Fed move has modest impact on US Corporates

The equity markets continued their slow rise in June, posting positive returns for the past 2 months. The NASDAQ grew 3.07% for the month of June. The S&P Index rose 1.80%. The cumulative return for the year is a meager 2.64%. These are not the electrifying returns that investors have been waiting for. The bright side is that the worst days of the bear market are certainly over.

The volume of deep specials on-loan (securities that have a negative rebate) has declined slightly to 4.6% from 5.1% the prior month. This drop was anticipated as broker dealers repositioned their on-loan balances to align themselves with the new rising interest rate environment. On-loan balances declined slightly during the month. In addition, healthcare and technology continue to provide the largest source of lendable securities. As collateral reinvestment yields begin to rise, the profit margin for loans should increase at least in the short term. This may help to increase loan volumes in the coming months.

## Specials Lending Activity

### Corporate Equity



For all charts/graphs above and below: Source: Bloomberg, Citibank, N.A. June, 2004. Directly above, Short Interest Ratio for Pre Paid Legal Services, Inc.,

### Non-US Equity

**Altran (4907732)** has also announced a new €200 million convertible bond sale today. Again, it is quite illiquid, trading as high as a 3% fee.

**Skyepharma (0812357)** speculated to sell between £35 and £70 million worth of convertible bonds. General collateral went from a 0.25% to a 1% lending fee, with the majority of stock left on hold by borrowers.

**Centrica (0573438)** is expected to pay a special dividend. Brokers may swap the equity into a French counterparty. Brokers have expressed strong demand for this equity security.

**Scor (4797364)** has announced a new €180 mil lion convertible bond. Interest started around a 1% fee, but quickly rose to a 4% fee. Citibank lent between 3% and 3.5%. Most brokers are predicting a drop in rates after 1 week due to the lead manager showing stock to hedge funds at a 1.75% fee.

### FYI - Collateral Reinvestment Strategies

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 securities that have come into unusual demand in the repo or lending 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 security they own has fallen.

A security may also be in great demand because people need the issue to further their obligation 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. Assume that the rebate a lender would have to pay to borrow most government securities is 1.0%. Assume the securities lender can invest the cash collateral at 1.25%, thus the lender makes 0.25% on the transaction after paying the dealer the 1.0% rebate. Now assume an issue has gone special. The rebate on the special may be 0.60%, 40 basis points less than the rebate on general collateral. If the lender can invest the cash collateral at the same 1.25% 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. The rebate rate on specials can be 0% or even negative. Funds lucky enough to be holding a large inventory of the right securities 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, he 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. This would sharply increase the buyer's custody costs and make the repo much less profitable.

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