Securities Finance *Market Monitor*

Issue 28, for the Month Ending August 31, 2004

Money Markets Recap

Fed raises rates and signals more to come

Having officially entered the new era of rising short-term interest rates on June 30th of this year, it now has become the focus of the market to determine when and by how much will they be increased again. The party line remains "at a pace that is likely to be measured", and had been interpreted to mean 25 basis points at each meeting of the FOMC for the foreseeable future. Therefore, as we entered August, all eyes were on the outcome of the FOMC meeting on the 10th of the month. Before reaching that date, a very benign employment situation report caused a bit of concern that the June increase might have been a "one and done" affair. The yield on the 2-year UST note plunged an astounding 40 basis points after the release of the report and even though it gave back close to half of that move over the next couple of days, it ended the month near its low point of about 2.40%. When, in fact, the policymakers did implement the 25 basis point increase in the Federal Funds target rate to 1.50%, it became abundantly clear that it would take a dramatic slowdown in economic activity in order to back them off the program. Some weak economic data reports throughout the balance of the month gave a little more rise to the theory that rates might not be raised again in late September, with futures markets indicating only a 75% probability. This put a huge crimp in the front end of the money market curve as investors such as ourselves could not afford to place investments that did not fully price in a 25 point September hike. While we experienced an anticipated and planned increase in liquidity in our portfolios going into the August meeting date, it appears as though that will be even more severe going into the September meeting. We are only one small part of a market that is in a similar reaction mode, so we will probably see some downward pressure on overnight rates as we approach the meeting date due to all of the pent up liquidity in the market. We will then hope to put the excess liquidity back into the market as soon as possible once the new rate structure has been put in place

US Government Markets Commentary

Agency issuance decreases as housing slows

Daily trading volume of Treasuries by primary dealers averaged $501 billion during the first half of 2004, up 19 percent form the same period last year. Demand for Treasury securities continues to be affected by geopolitical risk, strong demand from non-US investors, and strong rates of return.

Long-term debt issuance by federal agencies totalled $589 billion in the second quarter 2004, down 13% from the first quarter. As mortgage originations start to slow federal agencies have pulled away from issuing new debt.

Fannie Mae announced in July that it would not issue benchmark agencies. The Federal Home Loan Bank System and other federal agencies experienced substantial decreases in new issuance activity.

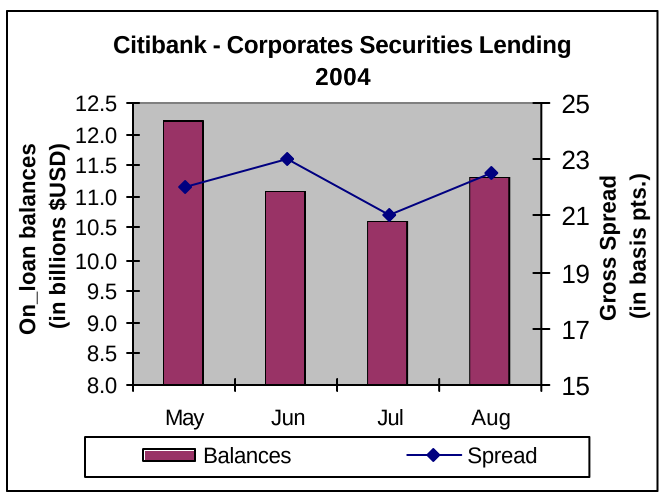
US Treasury ban balances have increased 12% since June. Spreads decreased by 18% reflecting the gradual shift in Treasury pricing towards less special Treasuries. This is consistent with the large Treasury supply in the market and less demand by non-US holders of Treasury debt. There are several possible explanations for the diminished repo/securities lending activity. Less hedging of US Treasuries vs. Agencies due to the cooling housing market. Also, the many large brokers prepare for August 31st financial reporting deadlines by reducing their lending balances.

US Equity/Bond Markets Commentary

Google sparks investor interest, but markets fall

The NASDAQ fell 2.61% for August. This has left the NASDAQ with a cumulative 6 month return of -9.36%. While we are well beyond the technology bubble that wreaked havoc on the equity markets, 2004 cannot be seen as a return to anything resembling a bull market. The S&P 500, which has seen less volatility, advanced 0.23% in August. The cumulative performance thus far for the S&P is -.56%. This cumulative return is a sharp contrast to the monthly double-digit returns of years past.

While the launch of the Google IPO was the biggest equity story for the year, let alone August, this offering did little to signal a return to more active equity lending. Once again the energy, healthcare, and technology sectors continued to hold the largest share of securities on-loan. For August spreads remained in the range of 17-22 basis points on average. As interest rates rise we would expect the rate of bond issuance to fall slightly. This may have a direct impact on the volume of lending specials in the lending market.



Specials Lending Activity

US Bond/Equity

XM Satellite (XMSR) – continues to trade special @ 7.25% fee. For the 6 months ended 6/30/04, revenue totalled $95.9M, up from $31.4M. Net loss applicable to Common stock rose 18% to $340.7M. Results reflect an increased number of subscribers, offset by higher royalty expenses.

Aksys, Ltd. (AKSY) provides hemodialysis products and services for patients suffering from chronic kidney failure. For the 6 months ended 6/30/04, revenues totaled $1.2M, up from $404K. Net loss rose 35% to $13.4M. Revenues reflect an increased number of dialysis systems sold and higher service and supplies revenue. Higher loss reflects increased legal and consulting costs related to the Durus litigation.

Non-US Bond/Equity

France
Brokers have expressed interest in a new convertible bond issue for **France Telecom (5176177).** This security is very liquid in the marketplace. The lending fee for a liquid new issue typically trades in a range of 18-25 bps fee.

United Kingdom
Arm Holdings (0059585) has offered $9.60 per share for a buyout of Artisan in a straight cash deal. There has been mild interest in the name.

Laird Group (0500522) has agreed to pay $194.4 million in cash and stock to buy Centurion Wireless Tech. This security maintains mild liquidity in the marketplace. As a relatively strong merger arbitrage trade, this security has been lent with a fee of 150 basis points.

International Power (0632016) has issued a rights offering to raise £290 million. Brokers have expressed some interest in this loan. While lending activity has been modest, activity is expected to increase in the days ahead.

FYI – Does Size Really Matter?

Yes, when it comes to yachts, but not necessarily for asset portfolios that engage in securities lending. There are several factors that come into play when considering the lending viability of assets, and market value is only one component. For securities lending there is no rule of thumb as to what is a true minimum asset size required to engage in securities lending. There are, however, some useful rules and business concepts to consider when evaluating a portfolio.

The first question to be addressed is, what constitutes a minimum revenue target considering the legal and operational risks and complexities involved? In most cases, portfolios that are able to generate $50,000 in gross revenues is a good minimum staring point. Again while this is not a requirement, due to the operational costs involved, this may be a good rule of thumb to consider.

Once a minimum revenue target is established, then you can review your portfolio for the types of assets that will be made available for lending. Most lending agents would agree that large positions of US Government "On the Run" (recently issued) benchmark Treasury securities are the most attractive for lending. Mid-cap equities of both domestic and international securities can be very profitable to lend. Currently, Convertible bonds are in strong demand from borrowers. Other assets classes such as US Agencies, international securities, CMO's and a variety of other assets can be lent as well.

The next aspect to consider is the choice of investment guidelines. Citibank's lending program is focused on the preservation of a client's principal with incremental income secondary. That said, clients still have a wide variety of options that can result in investment yields of 5 to 50bps above Fed Funds.

Thus, when these two components; portfolio asset class selection and collateral investment guidelines are optimal; a $500 million portfolio could theoretically earn as much as a $5 billion portfolio depending on the asset mix and the collateral investment parameters chosen!

So maybe size does not really matter after all.

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