

Securities Finance Market Monitor

Issue 32, for the Month Ending December 31, 2004

Money Markets Recap

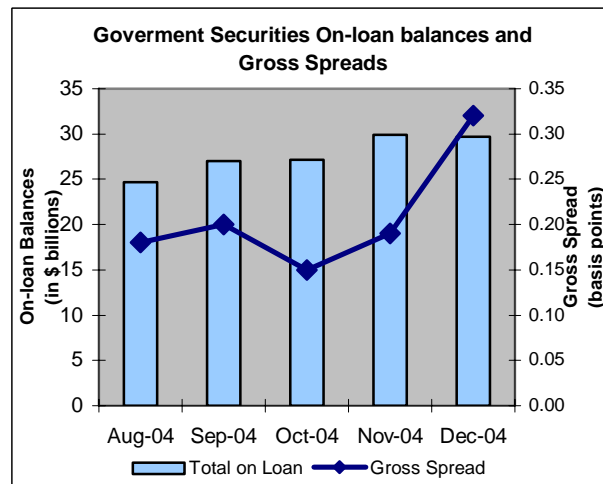
Although December began with a rather benign employment report, showing that payrolls had increased by only 112,000, the market saw no reason to change its consensus that there would be a 25 basis point increase in the Federal Funds target rate when the FOMC met on December 14th. In fact, that is exactly what occurred, and the statement following the announcement of the rate hike was very similar to the language in the previous meeting, with particular attention paid to the language that stated that the Committee felt that policy remained accommodative and that policy accommodation would continue to be "removed at a pace that is likely to be measured." The biggest surprise from the meeting of the FOMC was that they announced that they would begin to release the full minutes of the meetings at an accelerated pace, with the release now coming 3 weeks after the meeting, rather than the previous 45 day waiting period. The Committee felt that the market would better understand the current policy positions if they could get a greater sense of the discussions that occurred around it. This also served to build Chairman Greenspan's legacy of transparency, as he gets closer to his expected retirement in about 6 months. Erratic yields across the curve continued to rise with the 2 year UST note moving above the 3.00% level and bouncing off of 3.10% at the end of the month. The Treasury yield curve continued to flatten significantly as 2's-10's moved from around 135 basis points to about 113 basis points. Expectations are that it should continue to flatten in the near future and test the 100 basis point barrier fairly shortly.

The latter part of the month saw a tremendous demand in the securities finance market for UST collateral. Overnight general collateral, which topped out at about 2.25% on December 15th, tightened up to below 2.00% and, in fact, ended the month at about 1.70%, which was an incredible 55 basis points below the Federal Funds target rate. Other collateral types, such as Agency and Agency MBS held their spread to Fed Funds, and therefore portfolios across the board saw a significant widening of their earnings spread in the days leading to yearend. While the cause behind the demand for the UST was primarily "window dressing", there should be some residual value into the first half of January. After that we can expect spreads to normalize and perhaps run a bit tighter than normal during February.

US Government Markets

Throughout the month of December the U.S. government securities lending market was relatively active, reflecting year-end activities by financial institutions. The Federal Reserve increased rates once again on December 14th, and the general collateral financing rates in the repo markets remained wide relative to the Federal Funds

Rate, which is generally a good environment for the securities lenders.



As the graph above displays, the on-loan balances for the government securities have slightly decreased from the November level however, reflecting the number of specials that increased in December and the low GC repo rates, the gross spread increased significantly.

Treasury Specials- 912828BZ2, a.k.a. Feb-09, was the cheapest-to-deliver against the five-year futures contract, which expired December 31st. The Feb-09 traded deeply special throughout the month of December, dipping down as low as zero during the middle of the month. Towards the end of the month it averaged around 50 bps yielding nice lending spreads.

Throughout the month, we observed the 2-year current - 9128282DD9 - traded fairly special and at the end of the month the treasury issued a new 2-year, Cusip 912828DF4.

Additionally, the 5-year current 912828DB3 until December 15 traded special, leaving its place to the new 5-year current 912828DE7, which merged into special territory few days after issuance.

The 10-year current 912828DC1 and the long bond 912810FP8 also traded special throughout the month, averaging 1.31 and 1.83 respectively during a period when the Federal Funds Rate averaged 2.16.

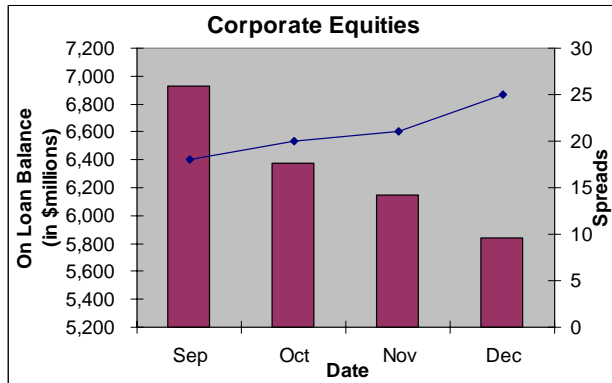
U.S. Equity

Among the U.S. equity securities that traded special in the month of November were:

NetFlix In. (NFLX): Shares of the stock have fallen some 70 percent since hitting an all-time high of \$39.77 in January 2004. Demand for its mail-order DVD rental service has declined, and increasing pressure is being felt

from popular cable and satellite services. Moreover, pressure mounted on NetFlix as Blockbuster Inc, the largest U.S. video-chain store, announced in December that it would stop charging late fees.

Securities Lending on-loan balances and spreads for corporate equities:



International Equity

JUJIYA CO LTD (Sedol 6479789): Daiei announced in December that it would sell 60 out of its 100 companies under a rehabilitation process that would be led by the government's corporate bailout agency, the Industrial Revitalization Corporation of Japan. Among the companies that are likely to be sold include Jujiya, the Japanese department store operator.

FYI – Securities Lending

If a lender recalls a loaned security from a borrower and the borrower is unable to return it within the lender requested timeline or the normal market practice, the lender may be forced to buy the securities in the open market to satisfy a pending transaction. The following describes the "buy-in" process and provides some framework of the transaction.

What is a notice to Buy-in?

When a fail occurs in the market, the broker to whom the securities were sold and/or the securities lending agent have the right to initiate a buy-in. The notice to buy-in is the formal notification to the responsible party that if they continue to fail on the delivery of the contracted shares from the original transaction, an additional transaction may take place (a "buy-in") and the costs may be passed along the failing party.

When to buy-in?

Communication between the lending agent and the borrowing broker, as well as between the owner of the security, their custodian and the counterparty on the trade are ongoing. As a result, the details of when a buy-in will occur by any party involved should be readily available. Once the intent is made known, all parties should be notified.

Buy-in practices are defined by securities regulations in most markets. If not mandated, a buy-in is at the discretion of the receiving party and can be initiated at any time after default. There are differences between a market buy-in on a sale and one on a failing loan return. The market buy-in process is regulated. To the extent that a borrower is in default as a result of not returning loaned shares, the agent lender can generally liquidate collateral and buy-in the securities at any time after default under the terms of the securities loan agreement between the agent and the borrower.

Why should you buy-in?

A buy-in should be executed to avoid a continuing sale fail. In some markets in the Far East, a buy-in is mandatory to eliminate sale fails and therefore the market will execute the buy-in. In other markets, a reasonable amount of time is usually given to the selling party to provide shares for settlement. Additional costs may be incurred for the failure to deliver the securities. Consideration should be given to executing a buy-in in an illiquid security as this may cause new exposures and may not resolve the original fail.

Who can buy-in?

- The receiving counterparty can initiate the buy-in to satisfy the failing sale.
- The borrower can initiate the buy-in and use the shares to return to the lender.
- The lenders can initiate a buy-in to avoid sale fails costs.
- The market can initiate a buy-in to eliminate a sale fail.

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