



**US Government Markets Commentary**

**FOMC does not meet on January, FFR at 2.25**

There was not much to get excited about in the short-term fixed income market during the first month of 2005. Economic data releases, "fed speak", and market activity all pointed directly towards an expected 25 basis point increase in the Federal Funds target rate to occur when the FOMC next meets on February 1st and 2nd. In the minutes of the December 14th meeting, which was the first of the new early releases, the Committee stated that "The current level of the real funds rate target remained below the level it most likely would need to reach to keep inflation stable and output at its potential." This clearly indicated that several more increases in the target rate are likely. Fueling the hawkish side of the market was the statement that "Some participants believed that the prolonged period of policy accommodation had generated a significant degree of liquidity that might be contributing to signs of potentially excessive risk-taking in financial markets..." While there was not quite the effect of the "irrational exuberance" statement from several years ago, the market nevertheless backed up a bit on the notion that the Fed might have to speed things up at some time in the future. There was clearly no permanent damage in the longer end of the market as 10 year notes and long bonds continued their resiliency to higher rates. The 2's-10's spread crossed below the 100 basis point mark early in the month, and continued to tighten, closing the month at about 85 points. The market appears to be split as to whether the curve flattening will continue, or whether the fundamentals for higher long-term rates will finally take hold and steepen the curve.

One thing for certain is that the wonderful spreads seen in the securities finance market in late December was going to dissipate. While there was some residual value early in the month, the general collateral trading levels returned to close to normal. We would expect that the U.S. Treasury general collateral to Fed Funds spread will continue to tighten modestly in February.

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**Spreads narrowing from December highs**

As the discussion above indicates, the dissipation of the wide spread between the general collateral repo rates and the federal funds rate, a.k.a spread, is very likely. The narrowing of the spread has a very direct impact on the government securities lending earnings. As the spread widens, the financing rate becomes lower than the investment rate, and the greater difference between the two rates leads to greater earnings.

Therefore January can be a less lucrative month in comparison to December, for the government securities lenders. However the spread is still wider than usual and as suggested above, it can be expected to narrow

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throughout the month of February. The specials activity has continued throughout January. The usual suspects; current 10-year DC1, long bond FP8, the second cheapest to deliver against the March 10 year futures contract AJ9, traded at low rebate levels for most of the month.

**US Equity/Bond Markets Commentary**

**Equity Market**

A strong voter turnout with limited violence in Iraq drove stocks up towards the month-end of January. The Dow Jones Industrial Average traded at 10489.94. Towards the end of January, Citigroup announced the sale of its Travelers Life and Annuity business, creating the largest life insurer in North America. Household names were in the spotlight in January and those included Procter and Gamble acquiring Gillette; SBC Communications acquiring AT&T; and MetLife and Citigroup.

**Domestic Specials**

**Tower Automotive Inc. (TWR)**, the largest maker of vehicle frames announced in January that it adversely impacted by the length of customer shutdowns over the holiday season. The shutdowns are reported to impact liquidity by approximately \$40 million during the first quarter of 2005. It also reported that it would use \$57 million of cash reserves in the first quarter because of disruptions in customer orders and payments.

**Interstate Bakeries (IBCIQ)** posted a loss of \$14.5 million for the four weeks ended December 11 and announced in January that the SEC issued a formal order of private investigation into the Company's manner for setting its workers' compensation reserves and other reserves.

**International Specials**

**Mazda Motor Corp.** (ISIN JP3868400007) Japan's fourth-largest carmaker, missed last year's 10 percent U.S. sales growth because it underestimated the demand for Mazda3 cars and offered fewer incentives. Mazda sold 76,080 Mazda3 sedans and hatchbacks in 2004 compared to 2,081 in 2003.

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