

Securities Finance Market Monitor

Issue 34, for the Month Ending February 28, 2005

US Money Markets Commentary

FOMC increased the Fed Funds Rate 25bps

As expected on February 2nd, the FOMC increased the Federal Funds target rate by 25 basis points to 2.50%. The statement that accompanied the rate hike was almost unchanged from the statement issued in December and led the market to believe that there would be no change to process of removing monetary policy accommodation by the same amount at each meeting into the near future.

The employment data report that followed a couple of days later was fairly benign and there was very little market reaction following its release. The 6 month LIBOR rate improved by less than 1 basis point and soon thereafter continued to rise.

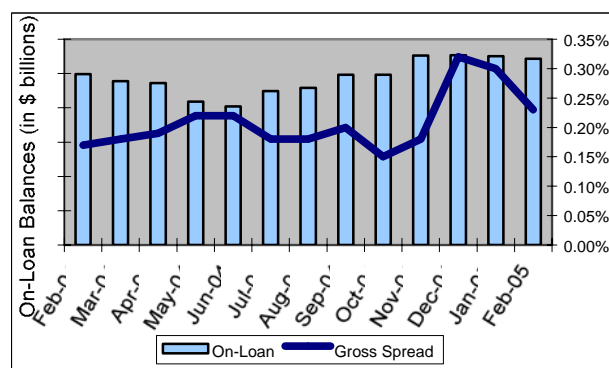
When Chairman Greenspan gave his semi-annual testimony on monetary policy in the middle of the month, the market reacted a bit more strongly. In his comments, the Chairman stated that "all told, the economy seems to have entered 2005 expanding at a reasonably good pace, with inflation and inflation expectations well anchored." He then went on to discuss in length the relationship between short-term and long-term rates, and how the present market was not reacting in a historical sense. "In this environment, long-term interest rates have trended lower in recent months even as the Federal Reserve has raised the level of the target federal funds rate by 150 basis points. This development contrasts with most experience, which suggests that, other things being equal, increasing short-term interest rates are normally accompanied by a rise in longer-term yields." He termed the relationship a "conundrum" and the markets reacted rather swiftly and strongly.

From that date until the end of the month the yield on the 2 year UST Note increased by almost 25 basis points and the 10 year Note increased by roughly the same amount. The data released throughout the remainder of the month was, for the most part, in line with expectations and the market tone remained slightly hawkish. We began to see a small amount of additional risk premiums being priced into the forward fed funds and Eurodollar futures contracts. Given that a lot can occur between FOMC meetings, we are maintaining our strategy of investing cash collateral only until the next expected rate hike, and then only if we are being rewarded for the expectation of higher rates plus an additional premium depending on the vehicle and credit. In that regard, we can expect to have a larger than normal amount of liquidity going into the meeting on March 22 and putting that liquidity to work until late April or early May.

US Treasury Markets Commentary

Spread decline in February; still high Y-o-Y

During the month of February we observed declining spreads as generally expected. However, even after the decline, as the graph below shows, the spreads are much higher compared the majority of 2004. On the other hand, on-loan balances remained at past levels. As the graph shows, balances have increased in the second half of 2004 and are preserving the levels.



As thoroughly discussed in the previous section of the letter, the markets are tuned in to the impact of the short-term rate decisions of the FOMC in March. FOMC will meet on March 22, followed by a meeting in May and then another meeting at the end of June.

During April, the Repo markets are expected to see some impact of the tax returns to the Treasury. April 15 is the deadline for filing tax returns and generally the treasury collects a good portion of returns around this date, which results in an increase of Treasury balances and a decrease in the supply of treasury securities in the market. Eventually, the impact can be a widening of the spreads around this deadline date.

On February 15th, the U.S. treasury issued a new 10-year note, therefore replacing the 912828DC1 with the new current 10, 912828DM9. The security was issued at 4.0% coupon. Shortly before the transition, DC1 traded highly special dipping close to 0 bps rebate.

Along with the new 10-year, the 2-year, 3-year and 5-year currents also got replaced. The new 2-year 912828DJ6 with 3.125% coupon replaced 912828DF4. The new 3-year 912828DK3 with 3.375% coupon replaced 912828AN0. The new 5-year 912828DL1 with 3.5% coupon replaced 912828DG2.

US Equity/Bond Markets Commentary

Equity Market

During the month of February, the S&P 500 and Dow Jones Industrial Average rose 2.1% and 2.9%, respectively. In contrast, the Nasdaq posted a negative return of 0.5%. Despite a surge in oil prices, hovering around \$52 per barrel in February, reports showed modest consumer spending.

Domestic Specials

Calpine Corp (Cusip 011544398), owner of power plants in 21 U.S. states, said it had a fourth-quarter net loss of \$172.8 million compared with net income of \$119.6 million during the prior year, including write-down of the value of oil and natural-gas reserves by \$200 million related to production areas in South Texas and the Gulf of Mexico off Louisiana.

Hitachi Zosen Corp (7004 JT), the shipbuilder and heavy machinery maker cut its full-year net income forecast to 1 billion yen from 5 billion yen.

International Specials

Euro Disney SCA (Sedol 4320878), CEO Andre Lacroix of Europe's biggest theme-park company told La Tribune in an interview that the company would need years to be able to post positive net income. In the 12 months ended in September, Euro Disney's net loss widened to 145.2 million euros from 58.3 million euros, its biggest annual loss in a decade.

FYI – Securities Finance Strategies

Convertible bond arbitrage. Convertible bonds are debt instruments issued by corporations with the embedded option that they can be converted into a predetermined number of shares (conversion ratio) at the discretion of the bondholder. An arbitrage opportunity occurs when there is a discrepancy in the price of the equity security and its convertible component. If the stock price increases up to the point at which the options are "in the money" and the market value of the bond is lower than the current value of the shares for which the bond can be exchanged (market conversion value), a positive spread can be obtained by buying the bond and converting it immediately. To protect against a decline in stock prices, the bondholder can borrow and sell the securities.

Index arbitrage. There is an arbitrage opportunity using index futures contracts and securities borrowing if, at a given moment, an investor can lock in a profit by simultaneously borrowing the securities underlying the

index, selling them, investing the proceeds until maturity at the risk-free rate, and buying back the securities underlying the index by taking a long position in an index futures contract. A profit is locked in since the amount that will be received from the investment is greater than the futures price paid for the index. Portfolio managers who trade large indexed portfolios often favor this strategy.

Tax arbitrage. As a result of tax policies, foreign holders of securities may be disadvantaged relative to firms in the local market over record date. In some jurisdictions, withholding taxes on dividends (or on realized gains, fees, price differential, etc.) on domestic securities traded in foreign markets are lower for local residents than for foreign residents. Local residents can therefore borrow domestic securities from a foreign lender and profit, as they will have to remit to the foreign lender only a portion of the dividends they earn. Changes to tax laws (for example in Australia and Germany) and harmonisation of taxation regimes have, however, reduced the opportunities to profit from such arbitrage strategies.

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