

Money Markets Recap

The power of "Fedspeak" was made demonstratively clear when looking at how longer term interest rates have behaved since Fed Chairman Greenspan labeled the relationship between short-term and long-term rates a "conundrum", given the rising rate environment. Since that statement in mid February, the UST 10 year note yield has backed up from around 4.00% to over 4.60%, a level not seen since last July, just after the FOMC began raising the federal funds target rate. Fueling the backup in rates across the yield curve was economic data that seemed to indicate that the U.S. economy's growth trend was firmly entrenched, and inflation data that indicated that, while not yet out of hand, there appeared to be some clear risks on the upside. This point was driven into the market when after raising the federal funds target to 2.75% as expected at the March 22nd meeting of the FOMC, the statement issued by the committee contained some new language alluding to higher inflation risks. "Though longer-term inflations expectations remain well contained, pressures on inflation have picked up in recent months and pricing power is more evident." While the "measured" language remained in their statement, the market became a bit more hawkish on rates and some additional risk premium was being priced into the fed funds and other financial futures contracts. The June fed funds contract traded as high as 3.09% shortly after the FOMC meeting date, indicating about a 30% chance that the next increase, due on May 3rd, might be a 50 basis point move. We have taken a very conservative stance with regard to cash collateral investments, given the current market environment, and are remaining very short with regard to new purchases, unless we receive value for an anticipated steeper rise in short-term rates.

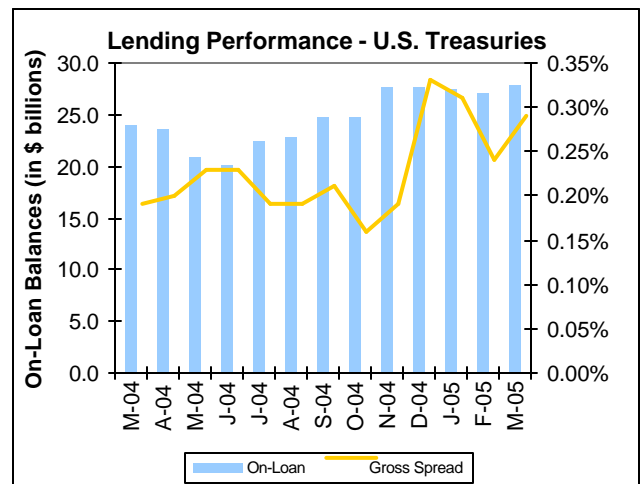
US Government Markets Commentary

March is generally an active month in the lending market. There are multiple reasons for this activity, which in a nutshell is the result of various driving forces, i.e. dealers, investors and U.S. Treasury.

During February and March the U.S. Treasury's expenditures increase due to the tax refund activity and the treasury increases issuance of short-term instruments such as cash management bills. The treasury also anticipates that these short-term liabilities can easily be paid off on and after April 15<sup>th</sup>, when tax receipts begin flowing in. Therefore, during February and beginning of March, the issuance of short term paper increases the supply of paper in the market, which in turn would result in the narrowing of the spread between repo and Fed Funds Rate. However, in March, other forces act on the repo

market, counteracting the increased supply of securities.

March constitutes the end of the first quarter and activity by the U.S. treasury dealers and investors generally increase in a manner that diminishes the supply of securities. This phenomenon is more evident towards the end of the month. At the end of the quarter, the amount of collateral in the market is diminished mainly because various institutions pull securities back from the market, in order to dress-up their balance sheets. So at the end of the March, this action had two impacts. First, as we approached month-end, we observed a widening of the spread between the specific issues to the general collateral repo rate. Second, as we reached the month-end, the spread of repo to fed funds rate widened out.



The two dynamics explained above had a canceling effect at the beginning of March however, towards the end of the month we observed that the impact of the window-dressing weighed heavier and resulted in a widening of the spread - between the Fed Funds and repo.

This spread between Fed Funds Rate and the repo rate is a slightly different measure than the *gross spread* displayed in the graph above. The *gross spread* is the difference between the investment rate and the rebate rate on loans. However both spreads are closely correlated. As we observe in the graph, the *gross spread* has improved in March relative to February, mainly driven by the month-end widening of the spread.

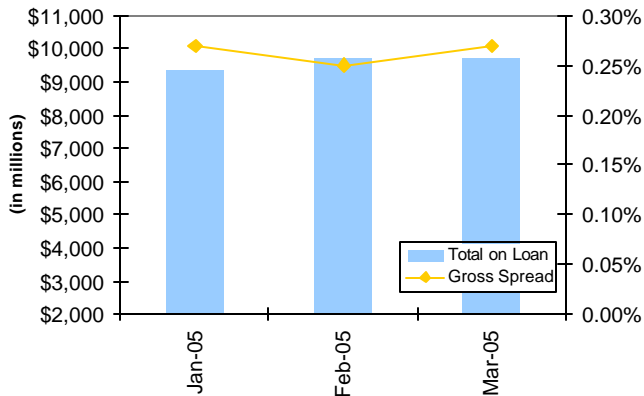
Also driving the specials market was the U.S. treasury futures contracts that were due to expire on March 31<sup>st</sup>. The cheapest-to-deliver against the 10-year contract; 9128277L0 (4.875 2/12) traded south of 100 basis points for most of the month, averaging as low as 30bps on days at the end of the month. Second cheapest-to-deliver was the 912828AJ9 which also traded special averaging 167

bps for the month and falling as low as 60bps towards the end of the month.

## US Equity/Bond Markets Commentary

### Equity Market

The S&P 500 index dropped 2.5 percent in the three months leading to March 31, and the Dow Jones Industrial Average fell for the fourth straight week on concerns that the Fed may accelerate interest-rate increases and the price of crude oil which hovered nearly \$58 a barrel towards the end of March. A Department of Labor report showed that employers added 110,000 workers to payrolls



in March, highlighting sluggish employment growth. Asian stocks fell amid government reports suggesting lower economic growth for the region. Towards the end of March, Japan's Ministry of Economy, Trade and Industry said in February industrial production fell 2.1% on a seasonally adjusted basis. The Morgan Stanley Capital International Asia-Pacific Index, which tracks more than 900 stocks, lost 0.7 percent to 100.34 during the last week of March.

### Domestic Specials

**Cooper Tire & Rubber Co.** (CTB US) In mid-March, the second-biggest tiremaker said a strike halted production at its Texarkana, Arkansas plant after the company and the United Steelworkers union failed to agree on a new contract. The company reported on February 16th that fourth-quarter profit fell fifty-eight percent as sales of its tires slowed and costs for materials such as rubber increased. (1)

**Audible Inc.** (ADBL US) The provider of audio books on the Internet on February 15 said it would not meet operating-margin targets this year and will increase spending. In March, the company announced that it identified \$190,000 of additional expenses, primarily related to its retail customer incentive programs. As a result, the Company's 2004 net income before preferred stock charges is approximately \$2.0 million. (2)

## FYI – Contractual Default Provisions

All securities lending agency programs are bound by legal provisions that are meant to identify risks and define the rights and remedies of the three primary parties (lender, agent, and borrower) to a lending transaction. Issues related to counterparty insolvency, security interest in collateral and loaned securities, as well as lender indemnification, if clearly defined, can substantially mitigate lending risks for all parties involved. While there have been attempts within the industry to standardize lending agreements, this has been successful mostly on the agent-borrower side. Securities lending agreements between the agent-lender are typically customized to each relationship. Counterparty insolvency and loaned security default are the primary concerns of most lending participants. While counterparty insolvency has much greater consequences, loan default due to the broker's non-delivery of a loaned security is by far a more common occurrence that requires coordination of operations and different short-term risk mitigation techniques.

In instances where there is an act of loaned security default by the borrower as defined by a securities lending agreement, there are several remedies that the agent, acting on behalf of the lender, can take to ensure your account is made whole and your contractual rights are enforced.

The first step in the process regards the date of the loaned security default (the post-settlement period). The agent can leverage its relationship with the borrower in question to expeditiously return the security in question. At the same time, the agent can utilize financial leverage with the broker by reducing the rebate rate to zero. This means that the full interest earned on the collateral invested for the loaned security is credited to the lender and/or the agent. The effect of this adjustment is to ensure the lender and/or the lending agent is reimbursed for any compensation claims or custodial charges relating to any failed trades. Reducing the rebate to zero also reduces the profitability of the trade for the broker; a further incentive to return the securities to the lender's custodian.

The second alternative in the event of loaned security default is to initiate buy-in proceedings. To initiate a buy-in, the securities lending agent enters the open market directly to secure a price. The broker is then notified of the trading price. Following the notification, the collateral is then used to purchase the securities in the open market. Any incidental costs of the transaction would be borne by the borrower.

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