Citigroup® Global Transaction Services

Global Securities Finance *Market Monitor*

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>> December Fixed Income Outlook for 2006

December proved to be yet another month of steady economic growth, fairly strong employment growth, benign core inflation, and strength in the housing market. It therefore came as no surprise that at the December 13th FOMC meeting; the federal funds target rate was increased by 25 basis points to a new target level of 4.25%. This was the 8th increase of the year, and the 13th consecutive increase since the committee began raising rates in mid 2004. In total, the short-term interest rates have been adjusted upwards by 325 basis points, and all indications are that they will continue to be increased, although perhaps the pace of the increases may slow. There was a notable change in the statement language that accompanied the rate increase, in that the reference to "policy accommodation " was removed, indicating that some members might have felt that the level is approaching what might be considered "neutral". However the statement did state "further measured policy firming is likely to be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance." The full minutes of the meeting, which were released three weeks later, stated that the number of firming steps required in the future would not be large. That being said, all indications, including the pricing of the federal funds futures markets, indicate that an additional 25 basis point tightening will occur at the January 31st meeting, which will be the last for Chairman Greenspan. The cash market traded a bit erratically during the month, with the 2-year UST note bouncing between 4.35% and 4.45%. What was getting more attention was the curve flattening, as defined by the 2-year versus 10-year notes, which at one point inverted by about 1 basis point. While an inverted yield curve is usually the result of an economic slowdown, preceding a possible recession that does not seem to be the case here. What is more evident is that the long-term inflation expectations and premiums remain low as a result of the policy actions that have caused the short-term rates to rise.

In the securities finance market, expectations for December turned out to be a bit of a disappointment. December 2004 saw a significant widening of spread between UST rebate rates and other money market rates. While the widening was not really expected in the first half of the month, the period in 2005 traded extremely tight. For the first 15 days of 2004, the spread between UST general collateral and federal funds was about 5 basis points, and in the same period in 2005, it was about 1.5 basis points, with several days of inversion. In the period of December 15th to 21st, the spread widened to 10 basis points in 2004, but only half of that in 2005. From December 21st to the 28th, the spread in 2004 was about 13 basis points, while only about 6 in 2005. The spread expectation finally occurred during the last few days of the month, with the period of December 28th through the 31st showing a 33 basis point spread, which was equivalent to the spread in 2004. Because the year ended on a weekend, the boosted spread will carry into the first couple of days of January 2006.

The outlook for 2006 would appear to much the same as it was a year ago, with perhaps a bit of temperance. The US economy continues to be driven by consumer spending. Stock market wealth gains, multiple tax cuts, and home equity extraction have each taken a turn in propping up the consumer during the current growth period. Clearly the housing boom and the spending that it has fueled are considered to be unsustainable. Exotic mortgages and speculation have created a likely bubble in certain areas, and could result in a strong downturn. It is probably more likely that, as long as GDP growth remains healthy, the housing market will not collapse, but should certainly flatten out. Core measures of inflation remain at the higher end of the 1% to 2% that has been recommended by the incoming FRB Chairman, Ben Bernanke, and will have to be closely watched. It is certainly expected that the long cycle of interest rate hikes will come to an end sometime in 2006, but expectations are that the federal funds target rate will reach at least 5% before that occurs, and that such a level will probably be reached in the first half, if not the first quarter of the year.

>> US Government Markets Commentary

The Repo market for the month of December started with anticipation of a tightening at the December 13th FOMC meeting along with an expected treasury collateral shortage for the days leading up to and including year-end. The Federal Reserve did the expected and raised the Funds rate by 25 basis points to 4.25%. However, the treasury collateral shortage prior to year-end failed to materialize much to the surprise of many who positioned themselves for its occurrence. In late November and early December, the treasury Repo market was pricing in a 15 basis point spread to funds from December 15 to year-end (Dec 30). The actual spread was only 8 basis points. The "turn" Market, which was the 4 days from Dec 30 to Feb 2, traded very close to expectations at 3.65%. Funds opened at the fed target rate of 4.25% on year-end, which resulted in an overnight treasury financing/funds spread of 60 basis points for the 4-day turn.

The current issue with the most value was the long bond, which averaged 3.00% for December. Also, the 10-year note averaged 3.20%, and the 2-year note averaged 3.50%.

As of this writing, the fed funds futures market is very nearly pricing in a 100 percent chance of another 25 basis point tightening at the next FOMC meeting on Jan 31st and 70% for another 25 at the March 28th meeting.

>> Equity/Bond Markets Commentary

US Equity/Bond Markets

In 2005, devastating hurricanes in the southern states played a major role in affecting US markets as millions of Americans were displaced from their homes. Hurricane Katrina is the costliest natural disaster to strike the US. In December, the US market also experienced a 0.1% drop in the Consumer Price Index. Declines in the price of clothing, energy, and transportation offset increases in prices of education, food, and shelter.[1]

International Equity/Bond Markets

The Dow Jones adjusted its Emerging Markets Index, World Index, and Asia/Pacific South Index to reflect a 75% restriction on foreign investments by the government of Taiwan. Such changes to investment guidelines increase Taiwan's weighing by free-float market capitalization.[2]

Auto sales in Europe ultimately declined in December 2005 and for the entire year of 2005, contributing to decreasing share prices for European automakers. British, German, French, and Italian automakers saw declines in sales especially in Eastern Europe while Toyota showed gains of over 3% in its European auto sales. Rising oil prices have been labeled as a contributing factor to declines in automobile sales.[3]

Domestic Specials

Chipmos Tech (IMOS): independent provider for semiconductor services and assembly in Japan, Taiwan, and US. [4] Short interest percentage increased 168.1% between October 15 and November 15.

Leapfrog Enterprises (LF): leader in development of technology-based learning products. Products are available in six languages in twenty-five countries.[5] LF was found on November NYSE list of top losers with a price loss of 5.8%.

International Specials

Germany:

1 http://money.cnn.com/2006/01/18/news/economy/cpi.reut/index.htm. Accessed 18 January 18, 2006.

2 http://www.djindexes.com. Accessed 17 January 2006.
3 Reuters: India. Accessed 17 January 2006.
4 www.shareholder.com. Accessed 17 January 2006.
5 www.leapfroginvestors.com. Accessed 17 January 2006.

Strong interest in the big three German dividend stocks that pay in January with levels bid up over last year's fees.

- 5727973 Siemens (SIE)
- 5636927 Thyssen (TKA)
- 7101069 Porsche (POR3)

Canada:

Continued interest in Fairfax Financial, a financial services holding company that conducts operations in property, casualty, life insurance and reinsurance due to effects of 2005 hurricanes. They recently deferred paying their creditors and issued more bonds to raise cash. As a consequence, it's been in demand by hedge funds as a huge short.
Rates traded up to 20.0% fee on this name.

- 2566351 Fairfax Financial (FFH/SV CN)
- 2974374 SFK Pulp Fund (SFK-U CN)

>> FYI – Lending Terms

Repo and Reverse:

Frequently confused, reverses and repos both involve the transfer of securities and cash. A repo typically occurs when a dealer takes cash and gives securities. Conversely, a reverse occurs when the dealer takes securities and gives cash.[6]

General Collateral and Specials:

Specials are securities that come into "unusual demand" in the market. Often securities gain demand when dealers short the issue and have to cover their position. Specials command a premium in the market. General collateral is collateral that consists of government securities that are not specials.[7]

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[6] Souder, Frank. Securities Lending. Greenwich, CT: 1994

[7] Souder, Frank.