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Welcome

We enter the New Year in a challenging market environment characterised by exceptional market volatility and liquidity concerns on a global scale, which will certainly continue to have an impact on the market place in the New Year. For your review, the commentary in this issue highlights a number of factors that will present an ongoing challenge to the market.

We look forward to working closely with our clients and assisting in repositioning and managing cash and collateral risk in the current environment. In the context of these financial conditions -- and as we work together to make 2008 the best year ever for our clients -- we have identified four overriding initiatives that will maximise our financial reach and strength in the marketplace and support your continued success.

Investment in infrastructure

Citi's technological prowess is a major competitive advantage for us. As a prime example, this year we will continue to enhance our securities-finance reporting capabilities via CitiDirect® for Securities. This gives full transparency of our Securities Finance programme to our customers in an automated and flexible manner (clients can receive reports via email and customise them to their individual needs, for example).

Focus on efficiency

Improved efficiency delivers bottom-line benefits both to our clients and to us. In 2008 we will make our business more efficient with the use of Equilend to process equity and fixed-income securities transactions on a global basis. By standardising, centralising and automating front-and back-office processes, the Equilend platform measurably increases efficiency for the industry and all market participants.

New markets

As we did in 2006 and 2007, we will continue to invest in new lending markets, creating greater opportunities for our lenders to earn additional revenue. This strategy plays directly to one of our market-leading strengths: our proprietary global network. This year we expect to see significant prospects in India, Malaysia, Russia and Poland, and, as ever, we want to be at the forefront of this development.

Commitment to client service

Beyond question, our performance in the marketplace depends on our continued commitment to client service. This year we will considerably enhance the client experience and bolster our competitive position as thought leaders and industry experts, as we expand our formal knowledge-transfer programmes of customer roundtables, seminars and service reviews.

I look forward to our continued partnership in 2008 as we navigate the market together.

US equities

Overall average balances were up 6.06 per cent for the month.

News

The Dow started lower early in December 2007 as credit tensions continued to linger over the market. Major financial stocks declined as JPMorgan Chase cut its estimates for the sector's fiscal fourth quarter and 2008, citing weaker fixed-income projections and a modest slowdown in advisory revenue growth. They also expect write-downs of fixed-income inventory and a slowdown in mergers and acquisitions (M&A) and origination activity to negatively impact results for all brokers.¹

A day after a rate cut that disappointed investors who had been hoping for more dramatic steps to improve liquidity, the Federal Reserve (Fed) announced further steps to ease the credit crunch, causing stocks to jump. The Fed said it would create a new "term auction facility" under which it would lend at least USD40 billion or more in four separate auctions starting in mid December 2007. Moreover, the loan rates will be well below the rate charged on direct loans from the Fed's discount window. At the same time, the European Central Bank (ECB), Bank of England, Bank of Canada and Swiss National Bank announced similar measures. Following the

announcement, stocks declined steadily with higher import prices, oil over USD90 a barrel and a higher-than-expected Consumer Price Index (CPI) figure, igniting inflation concerns once again.²

Investors, late in December 2007 continued to fret about the economy. Most analysts already expect growth in the fourth quarter and early 2008 to be meagre, so any shortfall from the consensus could mean economic contraction or even a recession, which is traditionally defined as two straight quarters of falling output.³

Active stocks

- Gramercy Capital GKK
- Frontier Financial FTBK
- First Horizon FHN
- Ambac Inc ABK
- Verasun VSE

Sectors in demand included: autos, subprime lenders and Exchange-Traded Funds (ETFs). Some drivers of this demand included: asset valuations, downgrades, commodity prices and supply issues.

¹ Bloomberg L.P., at www.bloomberg.com, accessed on 3-7 December 2007; Wall Street Journal (WSJ), 3-7 December 2007

² www.bloomberg.com, accessed on 10-14 December 2007

³ www.bloomberg.com, accessed on 17-21 December 2007

US cash and money markets

As expected, the Federal Open Market Committee (FOMC) reduced the Federal Funds target rate by 25 basis points (bps) from 4.50 per cent to 4.25 per cent on 11 December. At the same time they also reduced the discount rate by 25 bps to 4.75 per cent, leaving the 50 bps discount-rate "penalty" in place. The immediate reaction to the move was one of disappointment, as the major US equity indexes declined sharply after the rate announcement. In contrast, yields on US Treasury securities rallied significantly across the entire yield curve, with the yields on the two- and five-year notes declining by 25 bps.¹ Traders in both the fixed-income and the equities markets were obviously hoping for a larger cut in the target rate, a removal, or partial removal, of the discount-rate penalty, a more dovish post-meeting statement or some kind of combination of the three. The statement did make some reference to further easing by saying that the FOMC would "continue to assess the

effects of financial and other developments on economic prospects."²

Year-end liquidity and market conditions were another key concern for the market during the month. Turn-of-the-year bank deposits traded as high as 10 per cent for AA-rated banks.³ On 12 December, in response to what appeared to be unwelcomed tight liquidity conditions, the Federal Reserve Board of Governors announced plans to establish a Term Auction Facility (TAF) from which they could provide temporary liquidity to any depository institution that would be judged to be in "generally sound financial condition" by their local Federal Reserve Bank (FRB). While all advances under the TAF will be collateralised, the FRB will accept the wide variety of collateral that can be used to secure loans from the discount window. "By allowing the Federal Reserve to inject term funds through a broader range of counterparties and

against a broader range of collateral than open-market operations, this facility could help promote the efficient dissemination of liquidity when the unsecured intra-bank markets are under stress."⁴

In addition to the establishment of the TAF, the FRB announced that there would be two auctions of USD20 billion each during December, followed by two additional auctions (amounts to be determined) in January.

¹ U.S. Economic and Market Daily (accessed via Fixed Income Direct, at <https://fidirect.citigroup.com>), 11 December 2007

² Federal Reserve, at www.federalreserve.gov/monetarypolicy/fomc.htm#calendars, accessed on 4 January 2007

³ ICAP Capital Markets Inc., at <http://www.icap.com/markets.aspx>, accessed on 4 January 2007

⁴ www.federalreserve.gov/newsevents/press/monetary/20071212a.htm, accessed on 4 January 2007

US corporate bonds

Overall average balances were down 8.27 per cent for the month.

News

According to a report by Moody's Investors Service, US corporate defaults will probably quadruple in 2009 after the number of companies that lost their investment-grade credit ratings rose at the fastest pace since 2003. Moody's predicts companies will default on 4.7 per cent of their bonds in 2008 as the economy slows down, up from one per cent this year. Corporate bonds returned 3.08 per cent in 2007, less than the rate of inflation, as subprime-related losses drove to the

relative safety of government debt, according to data compiled by Merrill Lynch & Co. Standard and Poor's says companies that are cut to speculative grade fail to pay their debt on time at almost twice the rate of those that were never investment grade.¹

This has been the worst year for corporate debt, compared to government securities, since 2000, according to Merrill Lynch & Co. Downgrades are accelerating across America. Moody's reduced the ratings of 389 corporate issues this quarter, compared with 150 upgrades, according to data compiled by Bloomberg. The gap was the biggest since the first quarter of 2003.

Corporate bond sales for 2007 totalled USD1.16 trillion, up from USD1.09 trillion a year earlier.

Issues in demand

- Claire's Stores (CUSIP 179584AA5)
- Advanced Micro Devices (CUSIP 007903AJ6)
- K Hovnanian (CUSIP 442488BA9)
- Masonite (CUSIP 575379AE2)
- Beazer (CUSIP 07556QAQ8)

¹ www.bloomberg.com, accessed on 18 December 2007.

US Treasury and agency

The demand for safe collateral continued throughout December. The spreads for US Treasury general collateral (GC) to the Fed Funds Open Index widened to 46 bps for the month. In addition, the fact that "treasury general collateral" seemed to trade special, very few specific issues traded at the GC level. Most treasuries issues held significant intrinsic value in the repo market throughout December, especially as year-end drew near. On typical year-ends, collateral tends to leave the street because some accounts are precluded from having their securities on loan due to balance sheet restrictions. During this time, many loans

and repos are closed across all dealers and securities lenders. The treasuries leave the street and return to the box (custodian). This reduction of available collateral exacerbates the shortage of treasuries, and spreads continue to increase. This theory held true for the 2007 year-end. On 31 December, overnight treasury collateral averaged 1.85 per cent. Over 140 specific issues traded lower than 1.85 per cent, which markedly widened spreads for our overall portfolio.

The current treasury notes all traded as "special" throughout December. Their spread to Fed Funds was as follows:

Issue	Average spread (bps)
• CT 2-year	80
• CT 3-year	75
• CT 5-year	185
• CT 10-year	165
• CT long bond	60

The FOMC reduced the Fed Funds rate to 4.25 per cent on 11 December. As of this writing, the Fed Funds futures market is pricing in 100 per cent probability of a 25 bps reduction in the Fed Funds rate during the 30 January meeting and a 36 per cent chance of a 50 bps reduction.

¹ www.bloomberg.com, accessed on 18 December 2007.

Asia-Pacific equities ¹

Australia and New Zealand

Exports are expected to pick up, reflecting healthy economic growth among Australia's major trading partners, despite the weaker outlook in the US and Japan. The resilience abroad mainly reflects the strength of emerging economies. As a result, Australia's terms of trade could increase marginally in 2008, driven by coal, iron, ore, gold and soft commodities. In addition, fiscal easing could add to domestic demand and help boost the economy's productive capacity.

Economic growth in New Zealand is expected to slow to two per cent. The slowdown is expected to come from the lagged impact of the Reserve Bank of New Zealand's policy-tightening and from the elevated NZD. The housing market has clearly shown signs of deceleration in prices and activity, although the labour market remains very tight with the unemployment rate at generational lows.

Japan

As the US slowdown broadens from housing to consumer spending and business investment, economies with US trade connections are also expected to slow moderately. Japan's overall export growth is expected to decline during 2008. Private domestic demand will probably remain on a modest uptrend, but downside risks have also increased.

Employment has started to show tentative signs of deceleration this summer, partly due to declining headcounts at small firms.

The government has introduced a more stringent review of building profit applications in June 2007. This delayed many construction projects in 2007. Moreover, it may have hampered growth slightly in 2007, before pushing it up in early 2008.

Regional

Despite the subprime fallout in the US, Asian economic activities remain strong around the turn of the year. Inflation rates already exceed official targets in China, Singapore, Taiwan and Vietnam, where tightening policies are likely to continue.

China

Key risks include a US recession and trade protectionism. External surpluses should shrink as shares of GDP, but the investment share may rise further. Policy rate-hikes, tightened credit and quickened currency appreciation will help contain inflation and asset prices. Overvalued asset markets and hasty liberalisation of the capital account could pose serious risks to the economy.

Hong Kong

Banks will follow the US Fed to cut interest rates, but strong domestic demand and increasing capacity utilisation should add inflation pressure. Inflows of Chinese funds will continue, and Chinese firms will continue to list on the Hong Kong stock exchange. Rising public revenue will enable the government to cut taxes and increase spending.

Korea

Exports to emerging-market countries, who are leading a recent boom in heavy industry exports, surged to 17.4 per cent in 2007 (11.90 per cent in 2000). Household consumption growth reached five per cent, but construction and facility investments were sluggish in the third quarter of 2007. Headline inflation jumped from 2.3 per cent to three per cent in October, but the Bank of Korea maintained a neutral stance with an emphasis on external uncertainties.

Singapore

Structural changes, income-tax cuts, a more liberal immigration policy, more diversified growth engines and integrated resorts have lifted GDP prospects. The likelihood of more property measures has fallen since the scrapping of the deferred-payment scheme, higher property taxes and development charges. CPI inflation will likely breach five per cent in first quarter of 2008, given a sharp adjustment in imputed rent and risking fuel and food prices.

Taiwan

Closer ties with China's economy will boost the domestic economy and financial markets. Higher interest rates will help deter capital outflows while negatively affecting the domestic housing market. Slower technology demand may pose downside risks in the near term, but a continued upbeat outlook will support the economy in the long run.

Thailand

The policy agenda, not just having elections, would be crucial for the return of investor confidence. The removal of regulatory bottlenecks, such as the 30 per cent unremunerated deposits on short-term capital flows, would comprise a positive signal for investors.

The government's decision to accommodate price adjustments on regulated commodities and recent transport fare-hikes effectively ends the rate-cutting cycle. Subdued demand pressures and the strong currency effect would probably help to temper the risk of an inflation upturn in 2008.

It is thought that the newly elected government may be prone to hiking infrastructure spending to elevate growth and accelerate investment.

"Stress and Resilience", 21 November 2007; "Asia Economic Prospects 2008", 26 November 2007.

Client-solutions update

In our securities-lending operations in Dublin, we have recently been focusing on ways to streamline and improve the dividend processing attributed to the securities-lending product. Historically, this area of processing has encompassed a high element of manual effort internally within the broker-dealer/custodian network. In preparation for the forthcoming dividend season, we are working with the market borrowers to migrate to industry vendor applications, such as Equilend, and improve the reconciliation of these dividends.

As an industry-recognised service provider, Equilend provides the reconciliation platforms for counterparties who lend to each other to identify differences quickly and easily thereby eliminating potential risk around differing transaction details, particularly dividend tax rates. In preparation

for the forthcoming dividend season, we are working closely with select counterparties, during the first quarter of 2008, in order to go live before the end of March.

In addition to Equilend, we are also focusing our efforts on the PIRUM product and in particular the contract-compare functionality that benefits lenders and borrowers by providing a reconciliation platform based on trade feeds from the counterparties' front-end trading systems. We are currently working with key market counterparties to improve our matching rates for stock-loan transactions.

Our objective is to go live with the contract-compare functionality within PIRUM by the end of February 2008. This will allow for faster resolution of transactional differences between borrowers and our lending counterparts and improve

the matching and settlement process.

The International Securities Lending Association (ISLA) Executive Board approved a statement of market guidance for manufactured income collection. Circulated in its final version on 19 December 2007, the document is a result of discussions at the Operations Market Best Practice Committee of ISLA and outlines the best-practice measures for the securities-lending community and common income-collection issues that affect borrowers and lenders, including discrepancies on share amount, dividend rate, tax rate and delays in payment.

This guidance makes a number of recommendations to improve income collection, such as the use of contract-compare and dividend-compare vendors to reduce discrepancies.

European equities

Overall balances were down 15.5 per cent on the month. This is due to brokers conscious of running long positions throughout 2007 year-end.

News

Fifth year of great returns for UK pension funds¹

The average UK pension fund achieved an estimated return of 6.8 per cent in 2007, the fifth consecutive year of positive investment performance after the slump at the beginning of the decade.

Over the three years to 31 December 2007, UK pension funds achieved an estimated weighted average return of 11.4 per cent per annum. Funds outpaced inflation during this period, and achieved an estimated real rate of return of 7.9 per cent, against the retail prices index (RPI). Real returns were even better over a five-year period when pension funds returned

12.1 per cent, outperforming inflation by 8.8 per cent.

"Despite the market volatility and the turnaround in the property market during 2007, pension funds ended the year with a positive result, adding to the good returns of prior years." Commented Alan Wilcock, Performance and Risk Analytics Manager at BNY Mellon Asset Servicing.

Property struggled during 2007, returning an estimated -2.6 per cent. The last time the sector saw a negative annual return was in 1992. By contrast, both cash and UK bonds provided positive returns of 5.6 per cent and 5.3 per cent, respectively. However, all were outperformed by UK Index-Linked Gilts, which provided the highest non-equity return of 8.5 per cent.

There were some very strong performances in the equity markets, particularly in emerging markets, with 37 per cent, and Pacific ex-

Japan equities up 34.2 per cent. Canadian and Europe ex-UK equities also achieved double-digit returns of 28.8 per cent and 15.3 per cent, respectively. The only equity sector that failed to achieve a positive return over the year was Japanese equities, which returned -6.5 per cent. UK equities, the single biggest asset class for pension-fund investment, returned 5.3 per cent over the year.

Active stocks

Relative-value and M&A news²

- Gaz De France (GAZ FP)
- Hypo Real Estate (HRX GR)
- Rexel (RXL FP)
- Hagemeyer (HGM NA)
- Banca Popolare (BPM IM)
- Sacyr Vallehermoso (SYV SM)
- Sabadell (SAB SM)
- Randstad (RAND NA)

Directional and convertible-bond news

- IKB Deutsche (IKB GR)
- Alliance & Leic (QIA GR)
- Brad & Bingley (BB LN)
- Northen Trust (CGY GR)

- Tiscali (TIS IM)
- Option (OPTI BB)
- Metrovacesa SA (MVC SM)
- Solon (S001 GR)

Sectors in demand included: ETFs and emerging markets.

¹ www.isfmagazine.com, accessed on 3 January 2008

² Equity Finance Desk, Citigroup Global Capital Market's Limited (CGML), December 2007

European government bonds

Euro government balances tailed off during December as firms reigned in their balance-sheet exposure over the year-end. LIBOR climbed to 4.95 per cent (95 bps above the benchmark rate) in one month, exacerbated by the year-end factor. However, the ECB, in an orchestrated manoeuvre with other leading central banks, injected some EUR350 billion in short-term cash to cover the turn, resulting in LIBOR falling by around 50 bps. While this appeared to ease pressure in the depot market, we continued to experience volatility in the secured market with overnight offers ranging by up to 50 bps from borrower to borrower, presumably depending on their own funding requirements.

In the same joint central bank action, the Bank of England added GBP10 billion in three months' liquidity while significantly increasing the range of eligible collateral. Earlier in the month, the Bank had also cut its benchmark interest rate by 25 bps to 5.5 per cent as it attempted to wrestle LIBOR back to some sort of normality and give relief to the UK's burgeoning debt mountain and stuttering housing market.

With regards to gilt specials, we re-rated UKT 4 09/07/16 (GB00BOV3WX43) up to 80 bps for the first week of December 2007. We also continued to see a demand for sub 10-year bonds and maintained our GC levels of 8 to 12 bps.

European money markets

Economic headwinds, which included a strong euro, expensive oil and food, weak foreign demand and ongoing credit-market problems all contributed to a weaker economic outlook during the month.

The spread between inter-bank lending rates and the ECB repo rate continued to widen as year-end liquidity concerns hampered the market further. That was until the ECB turned on the "liquidity tap" by adding USD500 billion of cash for two weeks over the year-end at 4.21 per cent. The move had the desired effect as three-month LIBOR fell 25 bps during the rest of the month and cash over the turn of the year traded softly.

For further information, please contact your Citi representative.

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