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Welcome

Citigroup is proud to announce the opening of its fourth International trading centre in Australia. Extending our live trading presence beyond Hong Kong, the UK and the U.S. further positions Citigroup to capitalise on lending opportunities for our clients. Our local capability in Australia includes the expansion of our multi-currency platform to include Australian dollar cash investment for same day, on-shore transactions.

Citigroup's trading focus for 2007 is two-fold, to continue to develop global, cross border trading strategies that are structured to maximize the return to our client's lendable inventory in existing markets and to identify trading opportunities in emerging markets. Citigroup is proud to announce the addition of Turkey to its extensive list of lending markets.

Automation and efficiency in trading are paramount to our global trading strategy. To maximize portfolio utilization Citigroup has enrolled Equilend to supplement the production of loan transactions in its integrated, global trading centers. Equilend's primary feature is to automatically create loans of securities by matching our client's inventory against borrower demand. To date we have successfully implemented Equilend in the U.S. and are in the process of rolling it out in Europe and Asia.

U.S. equities

Our US desk in New York saw that in March overall average balances were up 2.91 per cent for the month, with average specials in demand up 38.01 per cent.

News

A flight from risk at the end of February resulted in a more than 3.00 per cent drop in the broad stock market. After a nearly 9.00 per cent decline in the Chinese stock market and a much weaker-than-expected US durable-goods-orders report, traders became more focused on former Federal Reserve Chairman Alan Greenspan's comments that alluded to the increased potential for a recession later this year.¹

The Dow started March on a down note, falling almost 2.00 per cent to 12,076 points, the second-worst percentage drop for the year. The market started off moderately lower on concerns of a sub-prime lender faltering, weaker-than-expected-retail sales and concerns about the resiliency of the consumer. The market then sold off sharply as The Mortgage Banker's Association published a report showing increased delinquency rates on sub-prime mortgages.²

The market settled down mid-March despite an unexpectedly high Producer Price Index (PPI) number, as merger enthusiasm and sub-prime fears faded.³

The Dow ended the month down, with weak data on housing and consumer confidence providing downward pressure. The Standard & Poor's (S&P)/Case-Schiller home-price index fell to 107.2 points in March, with levels in the 10-city composite not seen since January 1994. The consumer confidence number fell to 107.2 in March, the first decline in five months.⁴

Active stocks

- Shares of American Home (AHM)
- Mannatech (MTEX)
- Indymac Bancorp (NDE)
- Take Two (TTWO)
- Zoltek (ZOLT)

Sectors in demand included: autos and exchange-traded funds. Some drivers of this demand included: asset valuations, downgrades, commodity prices and supply issues.

¹ Source: Bloomberg L.P., 2 March 2007.

² Sources: Bloomberg L.P., 13, 14 March 2007; Wall Street Journal (WSJ) 13, 14 March 2007.

³ Sources: Bloomberg L.P., 15 March 2007; WSJ, 15 March 2007.

⁴ Sources: Bloomberg L.P., 27, 30 March 2007; WSJ, 27, 30 March 2007; Reuters, 27, 30 March 2007.

U.S. treasury and agency

Citi's US Treasury and agency desk in New York saw overall balances increase by approximately USD2 billion during March. The overnight financing market for both treasuries and agencies was, once again, extremely heavy. General collateral (GC) averaged above the Fed funds target of 5.25 per cent for both markets. Fortunately, there were several off-the-run issues that traded at a premium, which enabled the desk to capture increased spreads for select specific issues on both open and term.

The current (CT) ten-year note was an issue that was able to sustain significant spreads throughout March, averaging approximately 100 basis points (bps). The CT five-year note and long bond both averaged just 30 bps.

The quarter-end, which is typically a time when treasuries are in high demand, turned out to be relatively expensive. In mid March, the "turn" (29 March to 2 April) was priced to trade at 4.90 per cent. At that time, the desk was able to trade term collateral to mid April, thereby exploiting the perceived quarter-end treasury shortage. Early April is typically a time of expensive funding due to a large quantity of cash-management bills.

U.S. corporate bonds

In March, our US desk in New York saw overall average balances were down 0.43 per cent for the month, while average special balances were up 2.52 per cent.

News

The Republic of Panama sold USD450 million of US-dollar-denominated bonds, which will mature in 2036. This is a reopening of the issue, increasing the total outstanding to USD1.83 billion. The bonds were first sold at a 230 bps spread to Treasuries. The new securities were priced at a spread of 163.5 bps.⁵

Risk premiums on investment-grade corporate bonds rose to their highest levels in over three months, as concern grew over the increasing level of delinquencies by sub-prime borrowers and the slowing effects it may have on the economy. Former Federal Reserve Chairman Alan Greenspan said in a speech on 15 March that he anticipated sub-prime defaults would spread to the economy overall, particularly if home prices tumbled.⁶

Jamaica sold USD350 million of US-dollar-denominated bonds maturing in 2039. This sale comes amid a rebound in emerging-market bonds that has been fuelled by gains in global equity markets. This suggests that investor demand is picking up for emerging-market securities after last month's rout. The yield is approximately 346 bps over similar maturity US Treasuries.⁷

Issues in demand

- Umbrella (CUSIP 904201AA8)
- Georgia Gulf (CUSIP 373200AN4)
- NTK Holdings (CUSIP 62941EAB7)
- Jamaica 22s (CUSIP 470160AQ5)
- Veny 34s (CUSIP 922646BL7)

⁵ Source: Bloomberg L.P., 22 March 2007.

⁶ Source: Bloomberg L.P., 19 March 2007.

⁷ Source: Bloomberg L.P., 8 March 2007.

U.S. cash and money markets

The markets traded fairly benignly during the first half of the month as they awaited the outcome of the Federal Open Market Committee (FOMC) meeting on 21 March 2007. While, as expected, the FOMC did not change the current Federal funds target rate of 5.25 per cent, they did mildly shock the market with an adjustment to the language in the statement that followed the meeting; and that indicated a step towards a more neutral bias on monetary policy. Although the FOMC reiterated its concern that inflation might fail to satisfactorily moderate, it stated that "future policy adjustments" rather than "the extent and timing of additional firming" would depend on incoming information.

Markets initially rallied after the announcement, but soon realised that any actual change in policy would not occur in the near future, and the longer end of the

curve actually sold during the later part of the month. The improvement in the short end of the curve was enough to move Eurodollar and Federal funds futures to the point where options were exercised on callable one-year money-market instruments that had been issued three months earlier.

There was significant participation in these instruments at the 5.40 per cent level, including purchases made for our clients' cash-collateral investment portfolios.

As the issues got called, a roll into a similar security would require the investor to surrender 5 to 7 bps in return. We are currently evaluating the relative value of such trades, and will be watching the market closely for directional guidance.

U.S. issuance and credit

With the continuing headlines centered on the US sub-prime asset-backed securities (ABS) market, we have taken steps to prevent a possible trickle-down effect from the broader US sub-prime mortgage market to the short-term investment market. As a precaution, we have restricted the purchase of various asset-backed commercial paper (ABCP) and collateralised debt obligations (CDO) programmes, both of which have various layers of sub-prime loans imbedded in their structures. We estimate that these programmes encompass roughly 5.00 to 6.00 per cent of the USD1-trillion ABCP market.⁸

The global credit cycle remained relatively strong, as various financial institutions experienced a ratings upgrade during March 2007. A majority of the upgrades have been fuelled by a new Moody's Joint

Default Analysis study that has lifted individual ratings of some banking institutions two to three notches above their previous ratings. This study, since recanted in late March 2007, will cause a large proportion of ratings to revert to their previous levels.⁹

In addition to the ABCP and CDO programmes, Citi placed Deutsche Post Bank and its US subsidiary PB Finance Delaware on hold, based on lower overall earnings, a spike in leverage and a decline in gross margins. Our action preceded an announcement by S&P that they were putting this name on negative credit watch. A potential ratings downgrade is very possible in the near future.

⁸ Source: www.federalreserve.gov, March 2007.

⁹ Source: www.moodys.com, March 2007.

European money markets

After the European Central Bank (ECB) meeting on 8 March, the EUR refinancing rate was raised to 3.75 per cent on 14 March. Since then, rates stayed static between 3.78 and 3.83 per cent, with a slight spike over the quarter-end up to a high of 3.87 per cent.

Data coming out of Europe still supports the ECB's tightening bias, with the effect of the VAT-hike on German private consumption being the only real unknown at present. Market consensus expects a further tightening of the refinance rate within the next three months.

European equities

During March, our European desk in London saw overall balances were up by 18 per cent. This was a result of structured termed GC trades and a buoyant market through the European dividend season.

Overseas demand prompts market growth¹⁰

Strong growth in the UK financial services sector has continued, helped by the highest level of overseas demand in almost eight years, according to the 70th Financial Services Survey published in March by the Confederation of British Industry (CBI) and PricewaterhouseCoopers LLP.

Business volume growth was lifted by an increase in demand from overseas customers, with a balance of 21 per cent reporting a rise in foreign demand over the past three months, the highest since June 1998 (23 per cent). Similarly, respondents reporting those business levels with overseas customers to be "above normal" hit a balance of 12 per cent, the highest since September 1999 (22 per cent).

Demand was strong across all UK customer bases: business from private individuals, financial institutions and industrial and commercial companies all grew more rapidly in the last quarter, and exceeded expectations.

Results by sector:

Banking

Business volumes grew strongly this quarter, and are forecast to accelerate further on the back of strengthening demand from private individuals. Bankers' investment plans are bullish for the year ahead, with planned IT expenditure, the strongest since December 1998.

Securities trading

Securities traders saw acceleration in both the value of incomes and volume of business, with the latter regarded as above normal and well spread across customer categories. Profits advanced smartly despite rising total costs, but their growth is set to slow down next quarter when business volumes are forecast to be slightly lower.

Fund management

Fund managers had a very strong quarter, with domestic and particularly overseas business well "above normal". The strong growth in volumes was also well spread by customer category.

News

Active stocks

Relative value and merger-and-acquisition news

- A3TV (A3TV SM)
- Endesa (ELE SM)
- Banco Popolare Di Verona (BPVN IM)
- Iberdrola (IBE SM)

Directional and convertible bond news

- Tiscali (TIS IM)
- Conergy (CGY GR)
- Premier (PRE GR)
- Option (OPTI BB)

Sectors and markets in demand included: Spanish utilities, exchange-traded funds, Real-Estate Investment Trusts, South Africa and emerging markets.

¹⁰ Source: ISF Magazine, March 2007.

Asia-Pacific equities¹¹

Our Asia-Pacific desk in Hong noted that Asian markets experienced a choppy ride in March, following a global decline sparked by the mainland's biggest one drop in a decade. However, with no clear signs of fundamental strength or weakness, the market recovery was interrupted by conflicting data.

Japanese industrial production logged its biggest month-on-month decline in three years, which added jitters about the economic outlook in early March. However, this was in contrast to data released mid-March showing an economy expanding 5.50 per cent in the fourth quarter, the fastest pace in three years. The Bank of Japan, on 20 March, kept interest rates at 0.50 per cent, but stated rising land prices and currency rates were among the factors that could affect monetary policy, giving no indication of the timing of the next rate increase.

China, in contrast, raised its interest rates on the 19 March, continuing a policy of trying to remove excess liquidity from the market. There was little immediate impact, with both Hong Kong and Shanghai markets rising.

New Zealand is also facing raising inflation and increased its interest rates for the first time in more than a year, warning further rises might be needed to prevent unsustainable economic rebound. This makes it one of the highest rates in the developed world at 7.50 per cent. Interest rates in Australia, widely anticipated to rise to 6.50 per cent, were kept steady by the Reserve Bank, though the dollar did reach AUD0.80. Australian merger-and-acquisitions activity continued with the Bank of Queensland offering AUD2.4 billion cash and stock by rival Bendigo Bank. Singapore Power Ltd and Babcock & Brown Ltd agreed to buy Alinta Ltd for AUD7.4 billion to gain the assets of Australia's biggest owner of

pipelines and electricity networks. This pushed the AS51 Index to almost 6,000 points.

Thailand continued its economic uncertainty when the finance minister resigned, just days after another top economic official quit, having been at the job only for a few weeks. The Central Government stated it does not have immediate plans to lift tough capital controls imposed in December. It went on further to reaffirm that they would not be removed until the baht was stable and no loopholes remained for speculation.

¹¹ Source: Bloomberg L.P., March 2007.

Client solutions update

Citi is pleased to announce that it has implemented a US-committed repo-financing programme that allows custody clients of Citibank N.A. New York to obtain committed USD liquidity, secured by fixed-income assets held at Citibank.

Citi's collateral-management system (CCMP) is being implemented in seven new European markets: Austria, Belgium, the Netherlands, Portugal, Spain, Sweden and Switzerland. This complements existing collateral-management capabilities for direct-custody clients in France, Germany,

Italy and the United Kingdom, and supports these clients' collateral-management requirements in areas such as secured financing (e.g. tri-party repo), securities lending, GCM securities margin obligations and derivatives margining. Further plans to extend CCMP connectivity into Asia and Eastern Europe will be announced in future issues.

European government bonds

European government GC balances increased through March as the European equity dividend season begins to peak with broker-dealers using fixed-income assets to finance these positions. We also noted increased demand for Spanish, Italian and Greek government debt, where paper is predominantly held domestically. These markets remain relatively illiquid.

Just one gilt special through the month, with volatility in the UKT 5 03/07/08 (GB0031734154), which jumped between GC and 50 bps throughout the month.

The Monetary Policy Committee (MPC) held rates in March, with LIBOR levels suggesting the market anticipated a (25 bps) hike at the next meeting in April despite a resounding 8-1 vote in favour of holding rates in March (1 vote actually calling for a cut). In a similar pattern to last month, sentiment appears to have swung back towards the bank holding rates again in April, so recent volatility looks set to continue in the short-term market.

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