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## Welcome

While the US credit crisis continues to challenge global financial markets in Q1 of 2008, Asia remains home to some of the biggest securities lending opportunities in the world, as regulators in the region increasingly recognize how their capital markets can benefit from an efficient and effective securities lending market.

In this, we are seeing the results of years of active campaigning by the securities-lending industry, and this is firmly underscored by the success of the PASLA and RMA's (in association with ASLA) 5th Annual Securities Lending Conference held in Sydney on 4-7 March. The strong attendance across global and regional industry players in spite of the current market volatility demonstrated the industry's commitment to the region. The key themes touched on this year were: 1) transparency and liquidity in cash reinvestments; 2) increased need for secured financing alternatives for Asian securities; and 3) the opening of new markets across Asia.

While the first two items are closely related to the US credit market crisis, the opening of new markets is a continuing positive theme and is expected to gather pace this year. Malaysia looks set to introduce a bilateral over-the-counter (OTC) model (similar to Korea and Taiwan) providing market access to overseas investors.

The clarification around guidelines introduced last year by the Philippines will similarly provide an avenue for overseas investors to begin lending their Philippine equities. India regulators have approved the introduction of securities lending, and the market awaits detailed guidelines and clarifications from the Indian exchanges.

Citi, along with the key industry associations like PASLA (Pan Asia Securities Lending Association, a collective group of major industry players in Asia), will continue to help drive this process. Citi is an active member of PASLA and, on a personal note, I am honoured to be representing Citi as the PASLA chairman from this March. I look forward to representing the industry in 2008, and remain confident that we will have a number of new markets to introduce to your lending programmes shortly.

## Canada equities

On 23 April 2008, the Bank of Canada reduced its benchmark lending rate by half a percentage point, to 3 per cent, the fourth cut since early December when the rate stood at 4.50 per cent. Preceding the move, the Canadian dollar fell the most in five weeks after a government report showed retail sales unexpectedly declined in February. Canada's finance minister, Jim Flaherty, in an interview with Bloomberg Television in New York on 23 April, mentioned that central bankers "still have significant room to move if they decide to move further." Flaherty also said higher commodity prices have put "pressure" on the currency. In a statement on 22 April, The Bank of Canada said that "some further monetary stimulus will likely be required," and estimated that the Canada economy would grow 1.4 per cent this year, the lowest growth rate since 1992.

By Q3, Canadian banks will establish and adopt "leading practices for disclosure" by tweaking the way they disclose bank securities at mark-to-market values,

among other items, Flaherty told reporters on Monday 28 April after a meeting with regulators and the heads of the Canada's largest commercial banks. Flaherty stated that Canadian banks would improve certain disclosure practices as urged by the Group of Seven (G7) in its recent Financial Stability Forum report. Canada's six largest banks have collectively taken CND7.7 billion (USD7.6 billion) in write-downs for capital-markets-related issues over the past five quarters, according to RBC Capital Markets banking analyst Andre-Philippe Hardy.

In the equities market, the S&P/TSX Composite Index was volatile intra-month, rising 6.55 per cent over 14 trading sessions from 1 to 2 April, yet settled in on 30 April up roughly 3.7 per cent for the month. Leading the charge higher were several commodities producers. InterOil Corp., rallied after announcing a natural gas facility in Papua New Guinea. Norbord Inc., the Toronto-based lumber producer, gained ground after Chief Financial Officer Robin Lampard mentioned on a call with analysts

that the company is looking for potential acquisitions. As for equity finance, there is continued pressure on Thomson-Reuters following the 26 March merger of Thomson Corp. and Reuters Group Plc. Borrowers are looking to allocate stock to participate in the arbitrage between the Canada-listed equity and the UK-listed equity.<sup>1</sup>

### Active stocks

- InterOil Corp: **IOL CN**
- TSX Group: **X CN**
- Norbord Inc: **NBD CN**
- Synenco Energy: **SYN CN**
- Open Text Corp: **OTC CN**
- Crystallex International: **KRY CN**
- Gildan Activewear: **GIL CN**
- Torstar Corp: **TS/B CN**
- Inmet Mining: **IMN CN**
- UEX Corp: **UEX CN**

<sup>1</sup> www.bloomberg.com, accessed on 23, 28 April and 2 May 2008.

## US equities

Overall average balances were up 7.27 per cent for the month.

### News

Earlier in the month the Dow weakened as oil futures prices surged, weak consumer confidence numbers were reported, and some disappointing earnings results were announced, all putting downward pressure on stocks.<sup>1</sup>

The Dow took another hit later in the month as Bank of America issued a disappointing profit report that soured some of the earnings optimism that led to some of the previous rallies. This was short-lived, though, as the Dow made gains while investors ditched safer investments, including

Treasuries and gold, and bought financial and technology shares in reaction to news that the Federal Reserve might be nearing the end of a series of interest-rate cuts.<sup>2</sup>

The Fed lowered its key rate by a quarter point to two per cent. The result was a day-long stock rally that evaporated. The small cut was widely anticipated by analysts, but the Fed's accompanying statement was mixed. The Fed remained focused on signs of weakness and the economy at large, yet it also said in its statement that inflation remained a concern.<sup>3</sup>

### Active stocks

- Perdigaos **PDA**
- National City **NCC**

- Beacon Roofing Supply **BECN**
- Zoltek **OLT**
- Dillards **DDS**

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.

<sup>1</sup> www.bloomberg.com, accessed on 21, 22, 24, 25 April 2008; *Wall Street Journal (WSJ)*, accessed on 21, 22, 24, 25 April 2008.

<sup>2</sup> www.bloomberg.com, accessed on 21, 22, 24, 25 April 2008.

<sup>3</sup> www.bloomberg.com, accessed on 30 April 2008; *WSJ* accessed on 30 April 2008.

## US cash and money markets

Another weak employment report set the tone for the US short-term money markets early in the month. However, despite the Federal Funds Futures markets pricing in a high probability of an additional rate cut of 25 to 50 basis points (bps), a continuation of tight liquidity conditions kept pressure on the rates.

From 18 March, when the target rate was adjusted downward by 75 bps to 2.25 per cent, until and including month-end, Fed Funds were unable to open below 2.375 per cent and averaged 2.625 per cent. The unfriendly conditions in the inter-bank deposit market led to a major story development at mid-month. On 16 April, the *Wall Street Journal* published an article titled "Bankers Cast Doubt On Key Rate Amid Crisis" (by Carrick Mollenkamp), which stated that the benchmark London

Inter-bank Offered Rates, better known as LIBOR, were becoming unreliable. Widely considered an important money-market index, LIBOR is used to set interest rates on trillions of dollars of global assets and liabilities and did carry a low profile until recently. The LIBOR rates are set each day as a result of a survey of a number of banks by the British Bankers Association (BBA). The concern became that the banks did not want to report the actual rates that they were paying for short-term funding because they would not want the market to think that they were desperate for liquidity.

While no specific evidence emerged that banks were providing false information about borrowing rates, the BBA nevertheless decided to investigate the issue. A spokesman for the BBA stated: "We want to ensure that our rates are as

accurate as possible, so we are closely watching the rates the banks contribute. If it is deemed necessary, we will take action to preserve the reputation and standing in the market of our rates".

In a recent research report on potential problems with LIBOR, Scott Peng, an interest-rate strategist at Citi, stated: "the long-term psychological and economic impacts this could have on the financial markets are incalculable." Mr Peng estimated that if banks provided more accurate data on their borrowing costs, three-month LIBOR could be 30 bps higher. In fact, within two days of the *WSJ* article, three-month LIBOR had increased by about 20 bps and one-year LIBOR increased by about 50 bps in the wake of the story.

## US corporate bonds

Overall average balances were down 1.72 per cent for the month.

### News

Bondholder recovery rates are becoming more crucial as the US economy slows. Moody's Investors Service said recently that the number of companies at risk of running out of cash is the highest since at least October 2002. The amount of debt in Merrill Lynch & Co's US High Yield Distressed Index has swelled to USD206 billion from USD4.8 billion a year ago.

The index contains non-defaulted bonds with yields of 10 percentage points or more above Treasuries.

High yield bonds lost three per cent in Q1, the worst start to a year on record. However, it is making a recovery. April has been the best month for high-yield bonds in five years. Merrill's data shows corporate debt, rated CCC or less by S&P, returned 5.9 per cent compared with 4.2 per cent for all junk bonds. Junk bonds are rated below Baa3 by Moody's, and BBB- by S&P. Bond

sales so far this year total USD341 billion, compared with USD392.7 billion in 2007.<sup>1</sup>

### Issues in demand

- Indosat (CUSIP **45579NAA3**)
- Mohegan Tribal Gaming (CUSIP **608328AP5**)
- Yankee Acquisition (CUSIP **984756AD8**)
- Standard Pacific Corp (CUSIP **85375CAN1**)
- Univision (CUSIP **904201AA8**)

<sup>1</sup> www.bloomberg.com, accessed on 23, 30 April and 2 May 2008.

## US issuance and credit

The volatility in the credit market and the after-effects of bank asset write-downs continue to cause widespread rating fluctuations among some of the larger banks. In April 2008, after announcing further asset write-downs in its securitisation businesses, UBS experienced a one-notch long-term rating downgrade by Moody's, S&P and Fitch.<sup>1</sup>

Additionally, another downgrade due to the tenuous market conditions was the Bank of America Corporation. After earnings warnings and further credit write-downs, Moody's lowered the long-term rating to Aa2, from Aa1 on 21 April 2008.<sup>2</sup>

Other notable downgrades included Alliance and Leicester to A1 from Aa3 (Moody's long-term)<sup>3</sup> and the country ratings of the

Republic of Iceland, which experienced a one-notch downgrade to A from A+ by S&P.<sup>4</sup>

<sup>1</sup> www.moody's.com, www.ratingsdirect.com, www.fitchratings.com, all accessed 1 April 2008.

<sup>2</sup> www.moody's.com, accessed on 21 April 2008.

<sup>3</sup> www.moody's.com, accessed on 16 April 2008.

<sup>4</sup> www.ratingsdirect.com, accessed 17 April 2008.

## US Treasury and agency

Spreads have compressed considerably since the Federal Reserve enacted its various programmes to promote liquidity to banks and primary dealers. The spread between treasury and agency general collateral (GC) was two bps for April. This spread was 77 bps lower than the March spread of 79 bps. Moreover, the spread between Treasury general collateral and Fed Funds Open was 19 bps for April. This spread was 93 bps for March. The Fed remains committed to providing liquidity to the market for the foreseeable future. It is highly likely that spreads between Treasury GC and mortgage-backed securities (MBS)/agency GC will remain

tight for as long as the Fed's liquidity facilities are in place.

The current treasury issues were in strong demand throughout April. Each issue traded at a premium. The spreads in bps were as follows:

- CT 2-year: 65
- CT 3-year: 60
- CT 5-year: 145
- CT 10-year: 100
- CT long bond: 30

The May refunding is on Thursday 15 May. The Fed plans to issue 15 billion new 10-year notes and reopen six billion of the current long bond. Also, for the first time in seven

years, the Fed will resume issuing 52-week bills as budget deficits swell due to higher government spending and lower revenues in the sluggish economy. The first of their monthly auctions will be announced on 29 May and will be held on 3 June.

The Federal Open Market Committee (FOMC) meeting took place on 30 April. As expected, the Fed Funds rate was reduced 2.25 per cent to 2.00 per cent. As of this writing (1 May), the futures are pricing an 80 per cent chance of no move and 20 per cent chance of another 25 bps reduction in the Fed Funds rate during the 25 June FOMC meeting.

## Asia-Pacific equities<sup>1</sup>

### Asia-Pacific

Financial markets have stabilised in recent weeks as policymakers took action to contain downside risks. Inflation risks loom on the horizon but central banks have been cautious due to the risk of inhibiting future growth. Dividend payback for Asian banks is the shortest in 20 years.

### China

Government policies shifted to support equity markets after experiencing a recent market correction. The central bank took more tightening measures with elevated inflation. A recent hike in the reserve requirement to 15.5 per cent confirms the tightening bias of the monetary policy in the face of 11-year-high inflation.

### Hong Kong

Economic growth seemed to maintain robust six per cent year-on-year growth in Q1, but there are signs that the economy is slowing down. Lower appetite for risk

and liquidity contractions in the global financial market have led to capital outflows that have in turn caused a sharp stock-market correction. The jobless rate reversed its falling trend and rose to 3.4 per cent in March.

### India

Higher prices for basic metals and iron ore, alongside an uptrend in non-food articles and manufactured food products, led to a rise in inflation from 5.1 to 7.4 per cent. A recent 50-bps hike in Cash Reserve Ratio from 7.75 per cent to 8 per cent will remove USD4.5 billion in liquidity. The balance of payment for Q3 2008 indicated an overall surplus of USD26.7 billion.

### Korea

Negative signs, such as a rise in inventory in the high-tech sector, weakness in employment and slowing momentum in industrial production and investment, have appeared recently. On the other hand,

consumer-good sales picked up from a dip in the Q4 2007, and exports remained strong. Global food inflation led to a major increase in Korea's core inflation during the month of March.

### Singapore

On 10 April, the Monetary Authority of Singapore (MAS) tightened monetary policy with an upward re-centring of the SGD Nominal Effective Exchange Rate (NEER) by an estimated 1.5 per cent points. Non-oil domestic exports fell 5.9 per cent in March after two consecutive months of expansion. This represented the sharpest fall in 13 months. The recent budget abolished the estate duty and also included measures aiming to improve longer-term competitiveness.

### Taiwan

Gross domestic product (GDP) growth reached 5.7 per cent in 2007 and showed resilience in Q1 2008. This is due, in

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part, to export growth, which remained robust and continued to be a major driver. Inflation pressure remained high as headline Consumer Price Index (CPI) soared to 4.0 per cent year-on-year in March and 3.6 per cent year-on-year in Q1 2008 due in large part to high energy and commodity prices. The Central Bank of the Republic of China (CBC) raised the

discount rate for the fifteenth time to 3.5 per cent in March.

#### Vietnam

Real GDP growth slowed to 7.5 per cent in Q1 2008, down from 8.5 per cent in 2007. CPI was up 21 per cent year-on-year after averaging 16.4 per cent in Q1 2008. Food prices rose 33 per cent in the past year and are not showing any signs of slowing.

The government raises import duties on cars to 83 per cent and hinted at more hikes to come.

<sup>1</sup> Asia Economic Outlook and Strategy ("Dealing with Food Prices") Global Economic Outlook and Strategy, 29 April 2008.

## Client-solutions update

"Cash is king" is the familiar theme, especially in the world of securities lending. Securities Finance offers flexibility and alternatives for clients with respect to the investment of cash collateral. Citi is flexible in its approach to the ways in which clients can invest their cash collateral. Citi is amendable to working with clients to develop a cash-reinvestment approach that best suits their needs. Among the current options that Citi has in place with lenders are: 1) investing in various short-term investments according to client specific guidelines; 2) investing in mutual funds or other collective pool structures selected

by the client; 3) returning all or part of the cash collateral back to the client for their own management.

The first two approaches outlined above are the traditional structures and are generally rather standard from an operational perspective. The third alternative of providing the cash collateral to the lender for the lender to invest is a relatively recent offering. The rationale for this approach is being driven by an interest on the part of lenders that have experience with managing short-term cash to be more actively involved in the management of

their securities-lending cash collateral. This option may pose unique operational and technological considerations that Citi is well positioned to address. Citi has designed a variety of structures to address different client's' individual requirements for investing their cash collateral.

We welcome the opportunity to discuss our recent and future business enhancements. For further information, please refer to the contacts listed on the last page of *Market Monitor*.

## European equities

Overall balances have increased by 10 per cent for the month. This is due to increased longer term trading.

#### News

#### UK economy grows at the slowest pace since 2005 on credit-market turmoil<sup>1</sup>

The UK economy grew at the slowest pace since 2005 in Q1 as the seizure in credit markets hurt banks and falling house prices threatened consumer spending. Gross domestic product rose 0.4 per cent in the three months through March, the least since Q1 2005, the Office for National Statistics said. The result matched the median forecast of 35 economists in a Bloomberg News survey. The economy expanded 2.5 per cent from a year earlier. Financial services expanded at the slowest pace in five years as Royal Bank of Scotland Group plc and HSBC Holdings plc led writedowns among UK banks and added to global losses of almost USD309 billion. With the worst housing slowdown since 1992 adding to recession risks, the Bank of England has cut interest rates three times and tried to ease strains in the mortgage

market. "We expect the economy to slow, and that will dominate the outlook for inflation and lead to further cuts in interest rates in due course," said Merrill Lynch & Co economist Nick Bate, who used to work at the UK Treasury, in an interview on Bloomberg Television. "We're not looking for a recession. You can't rule it out."

#### AIMA strikes back at hedge-fund criticism<sup>2</sup>

The Alternative Investment Management Association (AIMA), the global hedge-fund industry association, notes that the hedge-fund industry is facing a renewed wave of unwarranted criticism at a time when many hedge-fund managers are doing what they set out to do: to deliver absolute returns for their investors during extreme market volatility and falling asset prices.

AIMA believes that the very practices recognised in the past as being part of the innovative nature of asset management (including hedge-fund management) - such as shorting, which is an accepted hedging and risk-management practice - are now

being singled out for unwarranted criticism in a number of quarters. AIMA is calling for hedge funds to be recognised for what they are: investment funds that offer investors access to a wide range of asset and investment strategies that can offer downside protection in difficult market conditions.

They continue to play a productive and liquidity-providing role across a range of markets, and are often the pioneers in new areas of finance that would not grow and flourish without them.

Florence Lombard, Chief Executive of the Alternative Investment Management Association, said: "Hedge funds are now considered part of the mainstream of the asset-management industry. They are widely recognised as productive investment vehicles by investors, including pension funds, and have an important role to play in the current market. They protect the value of portfolios with skills specific to them. Disappointingly, hedge funds are often made the focus of media attention when

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any suspicions of market irregularities arise. It is vital that the legitimate shorting of assets should not be confused with alleged market abuse by as yet unidentified players in the market."

Although some commentators were quick to accuse hedge funds of being contributors to the credit crisis when it began last year, subsequent developments have indicated that the causes of current difficulties in global capital markets lie at a fundamental level elsewhere.

#### Active stocks

Relative-value and M&A news<sup>3</sup>

- **TomTom** (TOM2 NA)
- **Hagemeyer** (HGM NA)
- **Banca Popolare** (BPM IM)
- **Sacyr Vallehermoso** (SYV SM)
- **Sabadell** (SAB SM)
- **Randstad** (RAND NA)
- **Monte Dei Paschi** (BMPS IM)

Directional and convertible bond news

- **IKB Deutsche** (IKB GR)
- **Alliance & Leic** (QIA GR)
- **Brad & Bingley** (BB LN)
- **Tiscali** (TIS IM)

- **Bca Mps** (BMPS IM)
- **Air Berlin** (ABI GY)
- **TeleAtlas** (TA NA)

Sectors and markets in demand included: ETFs and emerging markets.

<sup>1</sup> www.bloomberg.com, accessed on 26 April 2008.

<sup>2</sup> www.isfmagazine.com, accessed on 8 April 2008.

<sup>3</sup> Equity Finance Desk, Citi Global Markets Limited, April 2008.

## European government bonds

Demand for European government GC increased through April following the reduction in balances over the quarter end. In the same period, we saw LIBOR (3-month) levels creep up by around 10 bps, widening the spread between GG and cash. We saw no special activity through the month, but noted increased demand for DBR3 3/4 01/04/17 (DE0001135317), DBR4 1/4 07/04/17 (DE0001135333) and DBR 4 01/04/18 (DE0001135341), ahead of the June/Sept 10-year Bund Contract.

The gilt market yielded several specials again this month, including UKT 4 03/07/09 (GB0032785924) and UKT 4 09/07/16 (GB00BOV3WX43), which

traded up to 60 bps, while UKT 5 09/07/14 (GB0031829509), UKT4 1/4 03/07/11 (GB00BOLNX641) and UKT4 3/4 09/07/15 (GB0033280339) traded in the 10-15 bps range throughout the month.

Despite the Monetary Policy Committee (MPC) cutting rates a further 25 bps in April to 5 per cent and announcing terms of a GBP50-billion financing facility, LIBOR levels (3-month) have not corrected as aggressively as some had expected. In fact, the spread has effectively widened with LIBOR falling just 10 bps following the bank's 25 bps rate-cut. A healthy spread therefore remains for clients able to invest in the short-term money markets.

## European money markets

Economic data throughout the month continued to provide further evidence of weakness in the euro-region's economy, leading some economists to forecast a rate-cut in Q3. Rising oil and food prices, while inflationary, are also having a negative impact on growth. In the credit market, there are tentative signs of an improvement, credit default swaps are generally tightening and we are seeing more issuers coming to the market in both the financial and the asset-backed sectors. However, despite the European Central Bank's (ECB) efforts to add liquidity, spreads between inter-bank lending rates and the ECB repo rate have widened further.

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For further information, please contact your Citi representative.

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