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Welcome

Reading the *Wall Street Journal* or *Financial Times* these days can seem like reading a Steven King novel – suspenseful and often scary. This unsettling period of market volatility is a good time to remind our clients how deeply engrained risk management is in our securities-lending business.

Our policies, controls and systems are designed to balance our clients' revenue-enhancement objectives with their level of risk tolerance. Our system allows us to control the investment guidelines by client and the compliance module of our cash reinvestment system controls all parameters on a pre-trade basis. Each of our borrowers is subject to an extensive credit analysis before being approved and independent credit-risk management is handled by a centralised team within Citi that has no management or economic ties to the securities-lending group.

Before launching a new lending market, we perform a comprehensive due diligence that includes, but is not limited to, a review of local regulations, settlement processes, corporate actions and local restrictions. On top of that, Citi has an extensive internal process, Audit and Risk Review, which scrutinises and tests our policies and procedures on a regular basis.

Our clients can rest assured that we are taking risk management at least as seriously as they do.

US equities

The Fed lowered its key rate by a quarter point to 2 per cent on 30 April. The small cut was widely anticipated by analysts, but the Fed's accompanying statement signalled rate cuts could be nearing an end. Early in the month, the Dow rose above 13,000 for the first time since 3 January. US stocks have erased almost half their losses since October, helped by seven interest-rate cuts and the central bank's USD951.2 billion injection into the financial system.¹

The Dow has moved in the opposite direction of oil recently. A series of announcements underscored the extent of how expensive energy is already proving to be a burden to companies. JetBlue Airways said, late in the month, that it would defer the purchase of

21 Airbus A320 aircraft by up to five years as it struggles with inflating fuel costs. Dow Chemical said that it would raise prices of all its products by up to 20 per cent effective 1 June, a move the company said was "essential" to mitigate the effects of raw-material costs. Towards month-end, stocks jumped on a sharp decline in crude-oil prices and a stronger GDP number, with financials leading the way. Some analysts believe that banks benefited from the economic data and a growing sense that the Fed will boost interest rates. Odds the Fed would raise rates in October jumped as high as 88 per cent after the release of the GDP data, according to Fed Funds futures. The Dow closed down over 1.42 per cent for the month.²

Active stocks

- Carmax **KMX**
- China Sunergy **CSUN**
- Netflix **NFLX**
- Fleetwood Enterprise **FLE**
- Blue Nile **NILE**

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 www.bloomberg.com, accessed on 30 April and 2 May 2008; *The Wall Street Journal (WSJ)*, accessed on 30 April and 2 May 2008.

² www.bloomberg.com, accessed on 28-30 May 2008; *WSJ*, accessed on 28-30 May 2008.

US cash and money markets

As expected, the Federal Open Market Committee (FOMC) reduced the Federal Funds target rate by 25 basis points (bps) to 2 per cent when they met on 30 April. Also, as expected, in the statement issued with the decision the Committee "tweaked" the language in order to represent a more neutral bias by removing the phrase

"However, downside risks to growth remain".¹ In the days and weeks following the rate-cut, the market became more and more convinced that rising inflation pressures would be enough to keep the FRB from implementing any further cuts. Federal Funds futures pricing indicates the probability of an unchanged target

on 25 June at greater than 90 per cent. LIBOR continued to be a contentious issue throughout the month of May.

The British Banker Association (BBA) announced that it was conducting a comprehensive review of the LIBOR setting process and that it would announce its results on 30 May. Intra-month, the indexes

were a bit choppy. Six-month LIBOR fell by 10 bps during the first week of the month, then rose by 16 bps by mid-month, gave it all back by 21 April and then ended the month near the highs.² The BBA concluded

its review and announced that it was not going to make any changes to the list of contributors to the USD, GBP and EUR LIBOR data; however, it would strengthen the oversight of the LIBOR setting process.³

¹ www.federalreserve.gov, accessed on 30 April 2008.

² www.bloomberg.com, accessed on 4 June 2008.

³ "BBA Avoids Changes to Libor as It Seeks to Strengthen Review", by Gavin Finch and Ben Livesey, www.bloomberg.com, accessed on 30 May 2008.

US corporate bonds

Overall average balances were up 6.19 per cent for the month.

News

Indonesia plans to sell USD1.5 billion of dollar-denominated debt in June. The government plans to sell debt with a maturity of 10 years or longer. Indonesia needs to sell the debt, its second dollar bond sale this year, to help plug a widening budget deficit. According to Finance Minister Sri Mulyani Indrawati, the deficit may widen

to as much as 2 per cent of GDP in 2008, on rising crude-oil prices, compared with a 1.7 per cent government forecast in August. Italy plans to sell USD2.5 billion of three-year global notes. The securities may yield 14 bps less than the midswap rate. Moody's Investors Service gave the new securities its third-highest rating of Aa2, while Standard & Poor's ranked them two steps lower at A+. Corporate bond sales so far this year total USD508.7 billion, compared with USD529.8 billion in 2007.¹

Issues in demand

- Countrywide (CUSIP 22237LHE5)
- Movie Gallery (CUSIP 624581AB0)
- Realogy (CUSIP 75605EAV2)
- NXP (CUSIP 62947QAG3)
- Ambac (CUSIP 023139AF5)

¹ www.bloomberg.com, accessed on 7, 28 and 30 May 2008.

US issuance and credit

May 2008 was a relatively quiet month on the credit front as the focus turned from the banking sector to the corporate sector. CIT Group Incorporated experienced a downgrade to its unsecured debt rating to Baa1 from A3 by Moody's. Additionally, Moody's has affirmed the

short-term P2 rating, but the long-term rating still remains under review for further downgrades.¹ The credit ratings of American International Group (AIG) experienced a downgrade to Aa3 from Aa2 from Moody's.² However, AIG's long-term ratings were removed from ratings watch

negative by Fitch and ratings watch negative by S&P.³ Both Fitch and S&P have rated AIG as AA-

¹ www.moody's.com, accessed on 29 May 2008.

² www.moody's.com, accessed on 22 May 2008.

³ www.fitchratings.com, accessed on 22 May 2008; www.ratingsdirect.com, accessed on 21 May 2008.

US treasury and agency

The US treasury and agency markets experienced another month of narrowing spreads. The Federal Reserve's liquidity facilities are doing an excellent job of providing liquidity to both banks and dealers. The origination of the TAF, PDCF and TSLF enabled the repo market to quickly move away from the frenzied trading environment experienced throughout the second half of 2007 and the first quarter of 2008.

Unfortunately, the liquidity added to restore market stability is continuing to wreak havoc on treasury spreads. The spread between treasury GC and Fed Funds averaged just 3 bps for May. The same spread for March, prior to both the PDCF and the TSLF, was 95 bps. This 92 bps reduction in intrinsic value for treasuries, combined with the drop in 1 month LIBOR

throughout May has created, and will continue to create, significant challenges for US treasury and agency spreads for the near future.

One month LIBOR traded at 2.80 in the beginning of May and gradually reduced to 2.45 on 30 May. Obviously, as LIBOR continues to fall, overall spreads will continue to narrow.

The current (on-the-run) US treasuries continued to trade at a premium throughout May.

The spreads were as follows:

- 2-year: 61 bps
- 3-year: 25 bps
- 5-year: 70 bps
- 10-year: 85 bps

The Fed settled 15 billion new 10-year notes and reopened 6 billion long bonds at the May 15 refunding.¹ The 10s averaged 0.66 per cent for the two weeks leading up to the refunding. However, the new 10s averaged just 1.77 per cent or 32 bps for the remaining two weeks after settlement. The current long bond averaged close to 2 per cent throughout May. The additional 6 billion of issuance increased the already abundant supply of the issue and pushed the average rate close to GC.

Currently, the fed funds futures market is not pricing in a move in either direction for the 25 June FOMC meeting. Moreover, throughout May, the market had been pricing in only a modest probability of a rate reduction of approximately 10 per cent.

¹ www.ny.frb.org, accessed in June 2008.

Asia-Pacific equities¹

Asia-Pacific

Asian central banks are facing a growth-inflation dilemma. Inflation rates are climbing higher as growth is moderate. The growth for Asian countries could be cut significantly as the oil prices are breaking the record. Growth of energy-intensive countries such as Indonesia, India, Malaysia and Thailand would suffer even more. The global economic downturn – possibly a recession – might help to moderate the upward pressure on commodities, including oil.

China

The Wenchuan earthquake in the Sichuan province is likely to affect the China's economy and policy, but only modestly at a national level. The Chinese government already estimated the total damage to 14,207 industrial firms in Sichuan, Chongqing and Gansu at RMB67 billion (about USD9.7 billion) and the total damaged assets, including infrastructure, housing and farm properties, could be RMB750 billion (USD108 billion) or 3\5 of China's GDP in 2007. However, reconstruction investment is likely to accelerate after such a disaster,

and would have some temporary affect on inflation and macroeconomic policies. Such investment would play an even more important role in driving China's growth in the next year or two. The Consumer Price Index rate has centred on 8.5 per cent over the last couple of months, and the effects of the earthquake likely kept it above 8 per cent in May. The improvement in the US near-term outlook may keep core inflation elevated.

Hong Kong

Under the broad-based economic boom, real GDP growth rose to 7.1 per cent year-on-year in Q1 08, up from 6.9 per cent in Q4 07. Despite weak US demand and financial turmoil, inflation pressure is mounting with robust consumer spending, rising business costs and higher import prices. The US Fed's pause in policy rate-cuts will limit the room for HIBOR declines and remove the chance for Hong Kong banks to cut the prime rate. Real interest may, however, edge down due to higher underlying inflation rate.

Korea

A sub-par growth throughout this year was seen, as the sluggish global economy

weighs on exports and the rise in inflation hurts consumption growth. But generally strong exports and weak domestic demand is expected. April exports surged 26.4 per cent year-on-year. Continued strength in emerging-market-bound exports dwarfed the relative weakness in G3-bound exports. Inflation will stay above the Bank of Korea's target range near the end of this year due to rallying commodity prices, a weak won and the expectation of rising inflation.

Singapore

GDP growth will likely slow further to 4.7 per cent in 2008, given the risk of a deeper and more protracted US recession. Construction and other services should provide some cushion, but supply bottlenecks could pose speed limits to growth, and the growth is expected to reduce by 3 per cent compared with last year. The Monetary Authority of Singapore (MAS) tightened monetary policy on 10 April with and upward re-centring of the SGD nominal effective exchange rate (NEER) by an estimated 1.6 percentage point.

¹ Citi Economic and Market Analysis, June 2008.

Client-solutions update

Citi held its third consecutive securities-finance roundtable event in Amsterdam and will host three further events this year, which are planned for Madrid, Dublin and possibly Luxembourg.

At each roundtable industry experts and market participants discuss trends, with particular emphasis placed upon current events, such as the credit crunch, sub-prime, synthetics in emerging markets and asset pooling, and how these affect lending programmes now and going forward. The following topics were presented and discussed during our Dutch roundtable:

International Equities

- Emerging markets.
- SWAPS and synthetic structures.
- Impact on your lending programme.

Fixed Income and Cash Re-Investment

- The impact of the credit crunch and liquidity crisis.
- How have the repo-bond lending markets reacted?
- How have clients reacted and was there any benefit?
- How long will the credit crunch last?

Pooling and Securities Finance

- Cross-jurisdictional pooling.
- How and why does this work?
- The benefits to clients.
- Development of the pooling product.

Securities Finance Market Update

- The lending market place
- The Impact of market events
- New market developments
- Basle II, Mifid and ALD

European equities

Overall balances have increased by 11.5 per cent for the month. This is due to increased term-trading.

News

ISLA roundup¹

Just in time for the year's biggest conference, the International Securities

Lending Association (ISLA) has made some important announcements. ISLA has published a consultation paper setting out a proposed model for agent-lender

disclosure in Europe. The proposed model will standardise the provision of information from agent lenders to borrowers of securities so that the borrowers can monitor their exposures to those underlying principals and calculate regulatory capital requirements under Basel II.

For UK-regulated firms, the Financial Services Authority has stated that borrowers should be receiving full information daily about their exposures at underlying principal level by 1 January 2010 at the latest.

ISLA's proposed model builds on the successful US model for agency-lending disclosure introduced in 2006. In particular, agent lenders should provide daily files (the same standardised files used in the US model) to borrowers detailing outstanding loans and the allocation of collateral delivered by the borrower according to the underlying principal lenders. Agent lenders should use the US credit approval process when informing borrowers that underlying principal lenders are joining or leaving their programme. Files should be routed through the same data transmission hub used in the US model, provided by the Depository Trust and Clearing Corporation (DTCC).

Some changes are proposed to the content of the standard files in order to meet European requirements, including adding reporting of agency repo transactions and facilitating reporting of agency reverse-repo transactions on an optional basis. ISLA is seeking comments on the proposed model by 31 May. The working group will then agree and publish an implementation timetable so that the model is operational ahead of the 1 January 2010 deadline.

In other ISLA news, the body has also published a draft-amended version of the Global Master Securities Lending Agreement (GMSLA) for public consultation. The GMSLA was originally published by ISLA in 2000 and has been adopted by many market participants in Europe and Asia to govern their securities-lending and borrowing activities. The main changes include a new obligation on a securities borrower to recall any non-cash collateral over an interest payment date provided it has delivered adequate alternative collateral. Failure to comply with this obligation is not an event of default. Failure to deliver equivalent securities or collateral is no longer a potential event of default, reflecting the view that such failures are usually for operational rather than credit reasons.

The set-off procedures following an event of default have been broadly harmonised with those in the GMRA. A "gross-up" requirement for tax deducted or withheld has been added in relation to all payments other than manufactured payments on collateral.

An addendum has been added, modelled on the similar addendum to the GMRA where agents wish to make agency loans on behalf of more than one principal and allocate collateral on a pro-rata basis among them (also known as a "collateral allocation letter").

An updated UK Tax Addendum has been added, covering both overseas securities and real-estate investment trust shares. ISLA is not proposing to publish standard tax addenda for any other jurisdictions at this time. Furthermore, ISLA has publicly welcomed the recent ruling in Australia by Judge Finkelstein in the case of *Beconwood vs ANZ Banking Group*. The judge rejected the claim by the

plaintiffs that securities-lending transactions should be re-characterised as secured loans. In this way, the judge confirmed the effectiveness of transfer of title to securities lent under industry-standard securities-lending agreements.

The concept of title transfer is fundamental to securities-lending and repo markets, as it is critical to the ability of the receiver of the securities to give good title to a third party to whom it may transfer those securities. This ruling will give further certainty to market participants that securities loans governed by agreements such as the GMSLA are legally robust.

Active stocks

Relative-value and M&A news

- TomTom (TOM2 NA)
- Hagemeyer (HGM NA)
- Banca Popolare (BPM IM)
- Sacyr Vallehermoso (SYV SM)
- Sabadell (SAB SM)
- Tui (TUI1 GY)

Directional and convertible bond news

- IKB Deutsche (IKB GR)
- Brad & Bingley (BB LN)
- Tiscali (TIS IM)
- Bca Mps (BMPS IM)
- Air Berlin (ABI GY)
- TeleAtlas (TA NA)
- Carlsberg (CARLB DC).
- Gestevisión (TL5 SM),

Sectors and markets in demand

included: ETFs and emerging markets.

¹ www.isfmagazine.com, accessed on 6 May 2008.

European government bonds

European government GC balances remained unchanged through May, with steady demand from broker-dealers. In the same period, LIBOR levels (3-month) increased by just 1 bp, providing good reinvestment opportunities.

Once again we saw no special activity during May, but demand for DBR3 3/4 01/04/17 (DE0001135317), DBR4 1/4 07/04/17 (DE0001135333) and DBR 4

01/04/18 (DE0001135341) continued to intensify, ahead of the June/Sept 10-year bund contract.

The gilt market yielded one major special this month, with the UKT 5 03/07/12 (GB0030468747), squeezing up to 40 bps by the middle of May, and eventually reaching 200 bps in the latter part of the month. GC bids slowly drifted above SONIA levels (general benchmark for STG

GC rates) as broker-dealers started to feel the pinch of half-year-end balance-sheet management. The BoEs Special Liquidity System (SLS) is also a likely factor in these drifting rates, as the market contemplates financing a potential injection of up to GBP50 billion's worth of new government debt. While LIBOR levels remain high, however, reinvestment opportunities remain in STG short-term money markets.

European money markets¹

Germany continues to defy the global economic downturn, gross domestic product (GDP) in the Eurozone's largest economy increased by 1.5 per cent in the first quarter - the fastest quarterly increase in 12 years. However, this strong growth contrasts sharply with other member countries, particularly Spain, which grew at just 0.3 per cent, its slowest quarterly pace in nearly 13 years. The contrast between the two countries presents the European

Central Bank (ECB) with a problem: do they dare hike interest rates to fight inflation (currently at 3.3 per cent, well above the target 2 per cent)? Such a move would be most unwelcome in some member countries and lead to inevitable conflict.

We continue to see evidence of issuers returning to the market. Notable deals include a EUR4 billion 2-year European medium-term note issued by ING and a Prime Residential Mortgage-Backed

Securities transaction issued by HBOS. The market has begun to price in the chance that German growth will sway the ECB to hike rates over the coming months, but this has been fairly spread neutral, with similar up-ticks in both general collateral and cash re-invest levels in the 3-month part of the curve.

¹ Equity Finance Desk, Citi Global Markets Limited, May 2008.

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