

On loan activity

Government Bonds

- U.S. ↑
- European □

Corporate Bonds

- U.S. ↑
- European □

Global Equities

- U.S. ↑
- European ↓
- Asian ↑

Key: ↑ Up ↓ Down □ No change

Merger and acquisition news

Mittal (5295254) and Arcelor (7281875): this merger has been going back and forth throughout July, with rates peaking at 15 per cent (Mittal) and 3.5 per cent (Arcelor).

Metrovacesa (5442685): shareholders had until 31 August to accept competing bids for a stake in Spain's largest real-estate business. Stock was trading at a 2.5-3 per cent fee.

Tui (5666292): CB/AP Moeller bid speculation - stock still remained very tight, levelling at around one per cent. It is historically a 50-75 bps trade.

U.S. corporate bonds

July saw a rise of 4.3 per cent for overall balances while specials balances were down 2.4 per cent.

Investment-grade bonds outperformed high-yield debt for the second month in a row. Some investors believed that a slowing economy would have a negative impact on earnings and increase the risk of defaults¹. Prices on credit-default swaps have risen over nine per cent in July.

The Philippine government sold USD-denominated debt by reissuing USD300m 10-year notes (CUSIP 718286BA4) and USD450m 25-year bonds (CUSIP 718286BB2) that settled on 1 August 2006.

The Federal Reserve Bank (FRB) Chairman Bernanke, in front of the Senate Banking Committee, claimed that although energy and other commodity prices remain a risk to the inflation outlook, the current economic slowdown would offset those risks. Markets took Bernanke's testimony as a sign that the FRB is less likely to raise rates higher at the next Federal Open Market Committee (FOMC) meeting on 8 August 2006.

Fed funds futures, towards the end of the July, were pricing with a 36 per cent probability of a further hike in August (Aug FF contract 94.68).

General Motors bonds have rallied since the company's fourth-largest investor (Kirk Kerkorian) proposed an alliance with Nissan Motor Corp. and Renault SA on 30 June 2006.

Issues in demand from our U.S. desk:

- Century Communications (156503AG9) traded as much as 425 basis points (bps) special as a directional trade.
- Untendered shares of Owens-Brockway (CUSIP 69073TAB9) traded as low as zero per cent since the tender expired on 11 July 2006.
- There was a partial call on Amkor Tech 10.5 per cent bonds due 1 May 2009 (CUSIP 031652AE0), 90 per cent call. Supply was taken off the street resulting in the bonds being extremely difficult to locate.

¹Source: Bloomberg, 27 July 2006.

U.S. Treasury and Agency update

From our U.S. Treasury desk in New York in July, the Treasury/Agency repo/lending market was quiet. The FRB meeting passed at the end of June, and the quarterly refunding will not arrive until August 2006. Many dealer desks were operating with skeleton staff due to summer vacations during July and August. There were, however, market details worth mentioning. The most surprising was the ongoing stronger-than-average demand for treasury collateral. Treasury overnight financing averaged 5.16 per cent throughout July. This equates to a nine-bps spread to the Fed funds' target of 5.25 per cent. This

spread was wide considering that the average year-to-date Treasury General Collateral (GC)/Fed funds spread is six bps. The disparity between treasuries and agencies was present again during July. Agency overnight GC financed at 5.27 per cent on average, two bps above the year-to-date average of the Fed funds flat.

The ten-year was the only current Treasury issue that traded at a premium. The tens averaged 4.65 per cent, a 60-bps spread to funds. Currently the Treasury term markets are pricing in a 36 per cent chance of a 25-bps tightening for the 8 August FOMC meeting.

U.S. equities

From our U.S. money-market desk, we saw overall balances up by 1.3 per cent for July, with specials in demand down 9.6 per cent.

There is a pension bill moving through Congress that would allow hedge funds to manage more pension-fund money. Most hedge funds currently limit the amount of pension-fund money they manage to 25 per cent of their total assets. If the hedge fund goes over this limit, it is subject to scrutiny and restrictions. Under this proposed bill, the ceiling would be lifted to 50 per cent if passed².

The Securities and Exchange Commission (SEC) could propose changes to Regulation SHO, a regulatory addition by the SEC, expanding and updating the restrictions placed on short-sale transactions. The updated regulations came into effect on 3 January 2005 and help to address several key issues in the short-sale market. The Regulation may propose to eliminate the grandfather provision that did not include securities that were not on the "threshold list" at the time of trade. The threshold list includes stocks in which sellers failed to deliver 10,000 shares or more in the past five trading days and the level of fails is a minimum of 0.5 per cent of the shares outstanding. Once a stock is on the list, the broker with new short positions has 13 days to close out any failed trades, reducing outstanding shorts on these stocks³.

Active stocks

- UAL Corp (UAUA) traded as low as zero per cent after a convertible-bond deal was announced. It traded negative in small amounts.
- Windstream was added to the S&P 500 on 12 July 2006, replacing Cooper Tire (CTB), which lost over 35 per cent of its market value this year alone. CTB's bid has recently been as low as -2.0 per cent.
- Corus (CORS) remained tight. With short interest over 50 per cent of float, there was heavy demand in repo with shares trading as low as zero per cent.
- Medicis Pharmaceuticals (MRX) traded as low as 4.25 per cent, ahead of record date 3 July 2006.
- Commerce Bancorp (CBH) traded as low as one per cent ahead of record date 5 July 2006.
- Central Europe (CEE) started trading as low as 0.75 per cent.
- Superior Industries (SUP) traded at -50 per cent.

Sectors in demand as seen by our desk included: autos, airlines, exchange-traded funds, and real-estate investment trusts (REITs). Some drivers of this demand included: asset valuations, downgrades, interest-rate uncertainty, commodity prices and supply issues.

²Source: Bloomberg, 28 July 2006.

³Source: The Wall Street Journal, 12 July 2006.

U.S. cash and money markets

Our U.S. cash desk saw a major shift in market sentiment during July. Early releases of economic data supported the trend towards higher interest rates. The inflation data released on the morning of 19 July was bearish and created a swift backup in short-term interest rates. The one-year EURO strip increased by around 11 bps to 5.77 per cent, which turned out to be the peak. Later that same morning, FRB Chairman Bernanke gave his semi-annual Humphrey-Hawkins testimony to the U.S. Congress, and his prepared statement indicated to the market that the FOMC would not need to increase the Fed funds' target rate at the 8 August meeting. The one-year strip not only took back the 11-bps increase, but

also fell by an additional ten bps. The probability of a 25-bps interest-rate hike at the August meeting, as indicated by the Fed funds futures market, decreased from over 80 per cent to around 60 per cent immediately after the testimony, and continued to decrease through the remainder of the month. By the end of July, it appeared there might be a real chance the FOMC would pause in its rate hikes, and this became a consideration in our management of the cash collateral investment portfolios. Duration was added to most of the large portfolios through the purchase of investments with maturities modestly longer than those investments that were maturing.

Asia and Pacific Rim equities

Australia

Our Asian desk in Hong Kong saw the Australian ASX index fall as concerns over raising interest rates, the world economy and commodity prices - which the Australian economy relies on - weighed on the market. Banks were hardest hit but recovered over the second half of July with National Australia Bank falling from AUD35.80 to AUD33.17 but recovering to AUD35.90.

The mining sector was hit with demand concerns and commodity prices. The merger of Oceana Gold (OGD), mining for gold in New Zealand with Climax Mining Ltd. through a share-offering, spurred interest. Fortescue (FMG), a mining company, planned to sell AUD1.9 billion of bonds in Australian dollars and euros.

Hong Kong

Most indexes faltered in the first half of the month on interest-rate concerns, as reported by our Asian desk, but they recovered strongly to finish at 16,971 bps at month end from 16,043 bps. This was the longest winning streak in five months, after a U.S. report showed growth more than halved in the second quarter, fuelled by speculations the Federal Reserve would end interest-rate increases. Property developers, including Henderson Land advanced, as investors bet Hong Kong's Central bank would also stop raising borrowing costs. Exporters, including Li & Fund Ltd and Yu Yuen, dropped, concerned cooling demand in the U.S. would impact sales.

Japan

Indicators showed a cooling U.S. economy in July. Combined with Japan's industrial production, climbing higher than expected, higher earnings from technology companies pushed the Nikkei to a 15,456.81-bps high.

Hokuetsu Paper Mills (3865) - target of an unsolicited JPY141 billion (USD1.25 billion) takeover offer by Oji (3861) - rejected an alliance with Oji, vowing to pursue a tie-up with Mitsubishi Corp to thwart the hostile bid. Nippon Paper (3893) unexpectedly announced it bought shares in Hokuetsu to block Oji's takeover 8.49 per cent. Hokuetsu's issuing new shares in a private placement to Mitsubishi (8058) in a poison-pill strategy to maintain its independence.

European money markets

We saw a quiet month in which the summer doldrums began early, probably due to the World Cup football tournament in Germany and the European Central Bank (ECB) hinting strongly of a rate hike at their 3 August meeting. Our money-market desk viewed the rate rise as obligatory, considering the mounting inflation risks and upbeat economic data coming out of Europe. Rates softened considerably in the last week of July ahead of the end of the reserve period and the aforementioned ECB meeting.

European Government Bond update

Generally our bond desk saw July as a quiet month in Euro Government Bonds with nothing trading special in the open book. We noted continued interest in Deutsche Bundes Republic 3.25 per cent 7/15 (DE0001135283). This issue is Cheapest to Deliver (CTD) in the September ten-year Bund-Future.

Central Bank month-end requirements on financial institutions in Spain saw an increase in demand for domestic government debt over month end. Demand was driven up further in July as it is the biggest coupon payment month in Spain. Coupon-paying issues

are not eligible as collateral with the Central Bank during this period. The next big coupon month will be January 2007.

The gilt market was also quiet with the 8/15 (0888154), the only issue with any incremental value -10 bps through GC. The July month end has seen a shortage of collateral, enabling Citigroup to lend more GC positions through the period. However, this shortage has had a negative impact on reinvestment levels in the short dates for Sterling (STG) deliverable by value (DBV), forcing us to look at alternative collateral solutions.

EU demand from directional-long/short trading

- Fiat (5748521): directional - levelled trading at 75 bps.
- GN Store (4501093): directional - sales made this name vary tight, levels moved as high as 45 per cent.
- Hagermeyer (5209073): convertible bond (CB)/directional - levelling between 75 bps and one per cent.
- Premier (b0662j4): directional - supply was still tight after recalls from the last week in July, levelling at two per cent
- Sacyr Vallehermoso (5504789): directional - shares traded up to five per cent
- Telecom Italia Media (5843642): directional - we have seen brokers scrambling to cover large recalls in the market, with levels at around ten per cent.
- Tiscali (5953529): directional - tight name for some time, levelling at seven per cent.
- TomTom (b08tzq9): directional - levelling at two per cent.

European equities

Our international desk in London has seen a quiet month in July, with most brokers taking the opportunity to refinance existing loans. Most deal names were directional, coupled with fund managers' activity on the sales side creating tighter shorts in the market.

iSHARES ETFS still dominated demand, although we have experienced some recalls of late.

The airlines as well as travel industry took a hit recently due to poor financial results.

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Product development update

Recognising the importance of customised reporting to our clients, Citigroup will be introducing a new and powerful reporting tool in the coming months. It will be a major paradigm shift from the current static, to the new dynamic, reporting system. The new reporting system will have an array of benefits including data flexibility, scheduling, customisation and quicker time to market for new reports. The reporting data will be updated six times a day, in place of the current once a day. An additional enhancement to our Asian clients will be the report availability at their end of day.

We are also looking at Brazil as a potential lending market. Rates to borrow are very attractive to lenders holding securities.

Global Transaction Services

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