

## On loan activity

**Government Bonds**

- U.S. ↓
- European ↑

**Corporate Bonds**

- U.S. ↑
- European □

**Global Equities**

- U.S. ↑
- European ↓
- Asian ↑

Key: ↑ Up ↓ Down □ No change

## U.S. Treasury and Agency

In August, our U.S. Treasury desk in New York saw a month of compressed spreads in the U.S. Treasury and agency repo markets. The Federal Reserve significantly increased the four-week bills issuance each week throughout the month. This excess of extra collateral resulted in higher-rate pressure on overnight treasuries, which in turn reduced spreads. The average spread between overnight Treasury financing and open fed funds was just two bps. The average spread between the same two indices throughout all of 2006 is eight bps. Overnight agency financing was a flat average.

The only current Treasury issue that traded special throughout August was the ten-year note, which averaged 100 bps. The shorts in the five-year never seemed to take hold with the paper averaging 30 bps spread to funds. The twos, threes and long bonds all averaged about ten bps. The term repo markets are pricing at approximately a 25 per cent chance of a 25 bps tightening during the FOMC meeting in September.

## U.S. cash and money markets

Market sentiment shifts in July was followed by a major shift in monetary policy in August. A soft employment report early in the month catalysed a broad consensus in the market that the Federal Open Market Committee (FOMC) would not raise short-term interest rates another 25 basis points (bps) when it met on 8 August.

The FOMC took the market's lead and after 17 consecutive rate hikes going back to June 2004, policymakers allowed the fed funds target rate to remain at 5.25 per cent. In the FOMC's statement to the public, they reiterated that inflation risks continued to be running at an uncomfortable level, and that future action, if necessary, would be data-driven. One FOMC member actually dissented with the majority in favor of another immediate rate hike. While the minutes of the meeting<sup>1</sup>, released three weeks later on 29 Aug 2006, indicate that it was a "close call" in voting to leave rates

unchanged, they also show that there was concern over the slowing of the economy and that the Committee might be willing to accept a bit more inflation to keep economic growth on track. Our U.S. cash desk saw the market continue to rally strongly after the release of the minutes.

For August as a whole: the three-month LIBOR rate decreased by about ten bps to 5.40 per cent; the one-year rate decreased by 17 basis points to 5.42 per cent; the two-year U.S. Treasury yield decreased by 25 bps to 4.77 per cent; and the U.S. ten-year note yield decreased by 26 bps to 4.74 per cent. As reported last month, we had already begun to add fixed-rate duration to the cash-collateral investment portfolios and continued to do so early on in the month, shortly after the rate decision. We will continue to evaluate investment opportunities in light of market conditions, and add value to the investment portfolios wherever possible.

<sup>1</sup>Source: Federal Reserve Bank of New York website.

## U.S. corporate bonds

In August our U.S. desk in New York saw average balances up 4.9 per cent for the month, while average special balances were down 18.4 per cent.

Earlier in August, we saw that five-year credit default swaps on Ford's Credit unit had narrowed 15 bps after speculation that it was launching a strategic review of its operations. This was confirmed mid-month with an announcement<sup>2</sup> that its restructuring plan would be accelerated. Rival General Motor's finance unit (GMAC) narrowed five bps with the news. Ford Motor Credit bonds due on 25 January 2007 (CUSIP 345397TX1) traded as low as 4.75 per cent but most dealers are looking for them in the cheaper 5.00 to 5.15 per cent range.

Convertible bonds have been rallying recently after speculation that The National Association of Insurance Commissioners (NAIC) may reverse a previous decision that discouraged this type of investment by insurance companies. A change in this policy,

by classifying this as debt or preferred stock (instead of common stock), would make these convertibles cheaper to own due to the lower reserve requirements for bond investments. This issue will be discussed at the NAIC's 9 September meeting in St. Louis.

### Issues in demand from Citigroup's U.S. desk

- There was a tender on Newpage (CUSIP 651715AD6) of 10 per cent due on 1 May 2012, and (CUSIP 651715AF1) 12 per cent due on 1 May 2013. There has been some demand for untendered shares at 3.5 per cent.
- Untendered shares of Lockheed Martin (CUSIP 539830AK5) of 8.5 per cent due on 1 December 2029 were in demand, bid at 0 per cent. Expiration date was 25 August 2006.
- General Motors' 8.375 per cent bond, due on 15 July 2033 (CUSIP 370442BT1), which has traded as low as 1 per cent, has been backing up to the 2 per cent level.

<sup>2</sup>Source: Dow Jones News 9 August 2006.

## U.S. equities

In August our US desk in New York saw overall average balances up 2.6 per cent for the month with average specials in demand down 16.6 per cent.

The FOMC left rates unchanged which were mostly priced in prior to the meeting on 8 August 2006. Our U.S. desk saw stocks initially rallied but gave up all of the gains as investors digested the comments that were released after the meeting. The Federal Reserve Bank (FRB) left the door open for future increases, but reiterated that such would be data-dependant.

Higher oil prices; with BP's closing of the Alaskan Prudhoe Bay's oilfield for repairs (the largest in the U.S.), the foiled terror plot, geo-political concerns, and some earnings releases all dragged on the market. We saw smaller gains in the core Producer Price Index (PPI) and a decline in the core Consumer

Price Index (CPI) that pushed equity markets higher as this gave the data-dependant FRB more reason to stay on hold for the near future. For most of August, the September futures market contract of the fed was only pricing at a ten per cent probability that the FOMC would tighten by 25 bps at the 20 September meeting.

### Active stocks<sup>3</sup>

- UAL Corp (UAUA) traded as low as 0 per cent after a convertible-bond deal was announced backed up to between 4.5 and 5.1 per cent.
- Fidelity National (FNT) traded as low as -7 per cent, ahead of proxy on 11 August 2006.
- Corus (CORS) remained tight. With short interest over 50 per cent of float, there is heavy demand in repo with shares trading as low as 0 per cent backing up to 1.75 per cent recently.

- GM preferred stock (GXM) traded as low as 3.5 per cent, ahead of record on 15 August 2006.
- Greenhill (GHL) traded 2 to 3 per cent ahead of record date 23 August 2006.
- New York Times (NYT) traded as low as 4 per cent, ahead of record date for dividend on 1 September 2006.

We saw the following sectors in demand: 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.

<sup>3</sup>Source: Bloomberg L.P. August 2006.

## European equities

Our European Equity desk in London saw overall, average balances were down 1.5 per cent for the month.

Hedge funds may start taking greater risks if returns decrease, making them a bigger gamble for securities firms acting as brokers, The Financial Times (FT) stated in its "Lex" column. According to the FT, Brokers may start to compete on margin requirements, as well as price and services, if hedge-fund performance declines. Goldman Sachs Group Inc., Morgan Stanley and Bear Stearns Companies Inc. were the largest brokers to hedge funds. Competition has increased, but the complex information that technology and services hedge funds require, such as stock lending, limits the number of rivals.

### Active stocks<sup>4</sup>

#### Relative-value and merger-and-acquisition news

- Intesa (BIN IM) potential merger with Sanpaulo: levels still general collateral (GC).
- Abertis Infrastructures (ABE SM), with a USD14.7 billion planned takeover of Autostrade SpA, levelled at 3 to 3.5 per cent.

- Mobilcom (MOB GR) has settled its legal dispute with Freenet CEO Gerhard Schmid, and levelled at 1 per cent.
- AEM (AEM IM), which may speed up merger talks with ASM Brescia (the merging of the two would create a company worth in the region of EUR6 billion), levelled at 50 bps.
- Tui (TUI AG), whose share price rose on speculation that the world's biggest shipping company A.P. Moeller-Maersk may make a takeover bid, levelled at 1 to 2 per cent.

### Directional (long/short)

- Conergy's (CGY GR) increased supply from their competitors has helped share price to drop by its biggest amount for two months. The company is now looking to buy a silicon producer to reduce costs. Shares have been trading at around 1 per cent.
- Getronics' (GTN NA) stock has fallen 57 per cent this year, making it the worst performer on the AEX index. As a result, there are widespread fears over the company's ability to reduce its borrowings. Levels at two to 2.5 per cent.

- Premiere AG (PRE GR) reported a second-quarter net loss of EUR8 million (USD178 million), compared with a profit of EUR6.7 million a year earlier. It levelled at two to 2.5 per cent.
- Singulus (SNG GR) reported a second-quarter net loss of EUR2.4 million (USD3.1 million), compared with a profit of EUR500,000 a year earlier. It levelled at three to five per cent.
- Tiscali (TIS AM) expected to sell its German & Dutch business to finance Internet TV services in the U.K. It levelled at seven to 7.5 per cent.

### Convertible-bond news from Citigroup

- Club Med's (CU FP) last level traded was at around 7 per cent.
- Hagemeyer's (HGM NA) last level traded was at around 1 per cent.

Sectors and markets that we saw in demand included: airlines, exchange-traded funds (ETFs) and REITs/South Africa and emerging markets. This was due to asset valuations, downgrades and supply issues.

<sup>4</sup>Source: Bloomberg L.P. August 2006.

## European government bonds

Our bond desk in London saw a stagnant month for European government bonds, with only a couple of issues attracting a few basis points of incremental spread above GC. Both DBR 3.25 per cent 7/15 (DE0001135283) and DBR 1/16 3.50 per cent (DE0001135291) are deliverable (DBR 7/15 is the cheapest-to-deliver issue) in the September ten-year Bund-Future. As such, they have more potential for value in the repo market as traders capitalise on an increase in market flow through this period. We noted bids of around 25 to 30 bps to lock in positions until settlement date (11 September 2006).

Also quiet in the gilt market with the 8/15 (0888154) as the only issue with any incremental value, which was seven basis points through GC, a few ticks off last month. Again we have seen periods of collateral shortage resulting in poor returns in short-dated (overnight, tomorrow or next-day and spot-next) DBV. Conversely, we have seen a premium for unsecured lending through the same period.

## European money markets

The European Central Bank raised rates to 3 per cent at their 3 August meeting and kept rates unchanged at the 11 August meeting. Euro short-term rates remained steady during the month, apart from a few bps drop-off at the end of August due to the end of the refinance period. Our London desk saw how strong domestic demand continued to spur European growth numbers. As a result, the futures market is now reflecting a further increase of 25 bps before the end of the year and another 25 bps increase in the first quarter of next year.

## Asia-Pacific equities

Our Asia desk in Hong Kong saw overall balances up 27.69 per cent from USD3.95 billion to USD5 billion in Asian markets for the month ending 31 August 2006. Asia balances on UK increased from USD3.1 billion to USD3.4 billion while balances in U.S. went from USD855 million to USD1.6 billion.

### Japan

Our Asia desk saw that in Japan the Nikkei was up 4.5 per cent for the month, closing at 16,140.76 on 31 August, primarily on news from the U.S. early in the month where the Fed suspended raising interest rates at its 8 August meeting for the first time since 2001, alleviating inflation concerns. Further gains were prevented by other market factors, such as concern about the nation's growth after consumer prices rose less than expected for the month, and Sony's major recall of rechargeable batteries for notebook computers by both Dell and Apple.

### Japan

#### Open additional<sup>5</sup>

○ Awa Bank	(8388)	10,000,000
○ Komori	(6349)	1,900,000
○ Matsushita Elec	(6752)	40,951,000
○ Yamaha	(7951)	2,576,000
○ Fuyo General	(8424)	2,650,000
○ Aloka	(7704)	2,500,000

### Shorts

		Total shorts	Ratio of 30-day trading volume
○ Kumagai Gumi	(1861)	18,000,000	23 days
○ Isuzu Motor	(7202)	175,000,000	20 days
○ Sanyo Electric	(6764)	210,000,000	18 days

### Australia

Australia was held to only a 2.69 per cent increase<sup>5</sup> when its central bank increased interest rates to a five-and-a-half year high early in the month and said inflation would likely breach its forecast this year adding to speculation that more increases would probably follow.

### China

The Hang Seng index ended the highest in a month at 17,392 as lower crude-oil prices eased cost concerns for oil refiners, but it was held in check to a mere 2.84 per cent increase as stocks fell for metals producers on the concern that lower prices for copper and gold would hurt earnings.

### Taiwan

Discussions moving towards T+2 have been renewed, as reported by Citigroup's market reports, though details still remain unclear. If implemented, it would reduce settlement and systemic risk for investors.

### India

According to media reports, the technical committee of the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI) are expected to discuss the proposal to permit institutional investors to short-sell.

### Active stocks<sup>6</sup>

Highest revenue earners:

### Japan

○ Mitsubishi Motor	(6598446)
○ Isuzu Motors	(6467104)
○ Sanyo Electric	(6776769)
○ Matsui Securities	(6373892)
○ Haseko Corp	(6414401)
○ Tokyu Construction	(6689351)
○ Softbank	(6770620)
○ Kawasaki Kisen	(6484686)

### Hong Kong

○ Bank of China	(B154564)
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### Australia

○ Brambles	(6120009)
○ Rio Tinto	(62201303)
○ BHP Billinton	(6144690)

Demand for both Japanese and Australian equities is expected to increase dramatically over the next couple of weeks, ahead of September's record date dividend season.

<sup>5</sup>Source: Bloomberg L.P. August 2006.

<sup>6</sup>Source: Citigroup's Securities Lending Platform August 2006.

# Product development

Citigroup currently lend in 30 markets and in September will be extending our securities lending markets to include South Africa. Expansion into further emerging markets are also planned to include the Czech Republic, Hungary and Turkey later this year.

Due to rate rises we are beginning to see a demand for Japanese government bonds. We are presently conducting a feasibility analysis.

For further information, please contact your Citigroup representative

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## Global Transaction Services

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