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## Welcome

The securities finance industry continues to grow at a very healthy rate despite the normal seasonal dip in outstanding loan volume over the summer months. Securities available for lending in August topped over USD14 trillion, equivalent to approximately USD3.5 trillion on loan, giving an average utilisation across all markets and asset classes of 20 per cent. Equities accounted for just over USD8 trillion and the rest was made up of bonds. Of particular note in Citi's programme is the success of the new markets we launched this year. Turkey was the most recent addition to our lending programme and we are still seeing very healthy returns for Turkish equities in the range of 320 basis points (bps).

Balances are relatively stable despite the current volatility in the credit markets. These events have put a greater demand for quality collateral so lenders have benefited from lending their Organisation for Economic Co-operation and Development (OECD) government debt at higher-than-normal rates.

## US equities

Overall average balances fell 11.29 per cent for the month with average specials in demand down 0.61 per cent.

### News

Early in the month, the market endeavoured to focus on economic fundamentals only to be set back again by volatility and credit market troubles as the Dow slid almost 200 points<sup>1</sup>.

The Chicago Board Options Exchange Volatility Index (VIX) jumped over 10 per cent to the highest level since February 2003. The higher readings in this index, which are derived from prices paid for Standard and Poor's (S&P) 500 Index options, indicate traders expect bigger share-price swings over the next 30 days. This measure, known as a gauge of investor fear, tends to increase as stocks fall<sup>2</sup>.

On 17 August, the Fed lowered the discount rate on loans<sup>3</sup> to banks by 50 bps, declaring that increased economic uncertainty posed risks for US business growth. To date, this has been the central bank's largest push to restore calm in the global financial markets, which have been roiled by a widening credit crisis. Stocks were solidly higher for the day<sup>4</sup>.

Late in August, the Conference Board's poll of consumer confidence fell to 105.0 from 112.6 in July, in part due to the month's financial-market turmoil. The Dow also lost ground. The index fell further as financial shares continued to deteriorate and investors weighed what released Fed minutes could signal about the future direction of interest rates. At the Central Bank's August meeting, interest rates were kept stable and a fairly hawkish assessment of inflation risks, then interpreted as a reluctance to cut the fed-funds rate, was delivered. While recent developments have made the minutes of the meeting somewhat outdated, policy makers acknowledged that market dislocations might force their hand.

The stock market's wild fluctuations continued as shares soared sharply, a day after suffering their worst decline in three weeks. Technology shares led this move upwards as investors sought safe harbours amid the credit-markets storm. Also helping this rally was the release of a letter from Fed Chairman Ben Bernanke to Senator Chuck Schumer, in which Mr Bernanke reiterated that policy makers were "prepared to act as needed" should the turmoil in the financial markets begin to harm the broader economy.

President Bush's plan to curb mortgage defaults and stem losses in the credit markets continued into month-end, led by financials. Despite the turmoil and volatility in the markets, the Dow finished modestly higher for the month<sup>5</sup>.

### Active stocks

- Fortress: FIG
- Redwood: RWT
- Private Bancorp: PVTB
- Amrep Corp: AXR
- Lululemon: LULU

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> Source: Bloomberg L.P. and Wall Street Journal (WSJ), 13 August 2007.

<sup>2</sup> Source: Bloomberg L.P. and Wall Street Journal (WSJ), 16 August 2007.

<sup>3</sup> Source: Bloomberg L.P. and Wall Street Journal (WSJ), 16 August 2007.

<sup>4</sup> Source: Bloomberg L.P. and Wall Street Journal (WSJ), 17 August 2007.

<sup>5</sup> Source: Bloomberg L.P. and Wall Street Journal (WSJ), 28-31 August 2007

## US cash and money markets

Yield curves across several sectors of the fixed-income markets experienced an unprecedented shift during the month. While it had been widely reported that risk premiums were historically low and credit spreads historically tight, the rapidity and force in which the market acted to adjust these conditions were astounding. One month LIBOR, a fairly benign benchmark rate, which indicates where banks would lend each other money on a short-term basis, had traded within 1 bps of 5.32 per cent for better than a year, until it started to move up slightly, early in the month. On 8 August, the rate was set at 5.35 per cent; however, on 9 August it jumped by 19 bps to 5.54 per cent and on August 10 was set at 5.62 per cent.

These rate movements were associated with a global liquidity squeeze that caused central banks around the world to inject cash into their respective markets. The ECB led the way with an injection of USD135 billion on 9 August, and the Federal Reserve Bank (FRB) followed on that day and the next by adding in excess of USD50 billion to the US system. While the intervention took some pressure off of the rates in the mid-month period, by month-end

credit conditions had worsened and the rate closed the month at 5.72 per cent, up 40 bps from the start, despite a greater-than-ever consensus that the Federal Open Market Committee (FOMC) would be forced to reduce the overnight fed-funds target rate when it met on 18 September.

A good portion of the liquidity in the market ran to the safe haven of short-term US Treasury securities and repurchase agreements collateralised by those same instruments. Three-month US T-bills traded below 3.70 per cent on 22 August, down from 4.88 per cent at the start of the month. Demand for Treasuries picked up tremendously in the securities finance market, and we experienced a couple of days in which the spread between overnight general collateral (GC) loans and one-month LIBOR reached almost 300 bps.

As the cash collateral investment portfolios experience a liquidity build-up through maturities or new loans, we will take advantage of the shift in the LIBOR curve by purchasing new assets and increasing the portfolio yield.

## US corporate bonds

Overall average balances were down 5.57 per cent for the month, while average special balances were up 22.12 per cent.

### Current news

Bear Stearns sold USD2.25 billion of notes at yields that approached those normally demanded of high-yield, high-risk companies as a result of its two failed hedge funds and the collapse of the subprime mortgage market.

The notes were sold at a spread of 245 bps more than similar maturity US Treasury notes—a premium that is four times as wide as that of a five-year note issued in January by Bear Stearns and 82 bps wider than that offered by BBB-rated companies, which are two steps above junk. Bear Stearns is currently rated A+ by S&P. The sale demonstrates Bear Stearns' ability to tap the credit markets for money, appeasing concerns that the company may be unable to raise capital<sup>6</sup>.

This year, companies have sold USD793.6 billion's worth of bonds, up from USD671.4 billion a year ago. This has been attributed to a revival in demand for long-term debt as borrowing costs soar for commercial paper (CP). In some cases, selling CP maturing in 30 days is more expensive than offering five-year debt. Issuers are facing the choice between uncertain financing in the CP market and more stable five-plus-year fixed-rate financing in the high-grade bond market at similar yields<sup>7</sup>.

American Express and Lincoln National Corporation are two of a plethora of companies that sold bonds to take advantage of this revival in demand for long-term debt as borrowing costs soar for CP.

Recently, so-called dealer placed CP with 30-day maturities and an A2 S&P rating yielded 6.06 per cent, according to Federal Reserve data.

By comparison, an A-rated company would have received a yield of 5.64 per cent for a five-year maturity debt issued by A-rated companies, based on Merrill Lynch and Co. indexes, while a BBB-rated borrower would have paid 6.14 per cent for the same five-year debt<sup>8</sup>.

### Issues in demand

- Dana (CUSIP 235811AK2)
- Cosan (CUSIP 22111YAA3)
- WCI (CUSIP 92923CAG9)
- Countrywide (CUSIP 22238HCV0)
- Graham Packaging (CUSIP 38470RAD3)

<sup>6</sup> Source: Bloomberg L.P., 7 August 2007.

<sup>7</sup> Source: Bloomberg L.P., 22 August 2007

<sup>8</sup> Source: Bloomberg L.P., 22 August 2007

## Client-solutions update

Citi's Securities Finance team is developing a cross-jurisdictional pooling capability to enable its clients to benefit from pooling and continue to earn lending revenue. It is now possible to split a pool of assets into separate identifiable pool participants who potentially have different cross-jurisdictional tax rates.

The concept of pooling is becoming increasingly popular with larger fund-management institutions. In aggregating the assets of underlying individual funds, there are a number of operational benefits, including brokerage (larger transactions, lower unit

costs), netting (greater assets within the pool enable net flows and reduced cost), administration (transaction-based charges reduced) and potentially lower custody fees.

There are also a number of qualitative benefits, including, for example, better operational control due to a consistent investment approach and more flexible product design.

We believe this provides our clients with a significant competitive advantage in a pooled custodial environment. Moreover, we can offer exclusives to multiple borrowers from a single account.

# Asia-Pacific equities<sup>9</sup>

## Balances for August 2007 over July 2007

- AUD +4.44%
- HKD +10.25%
- JPY +0.93%
- KRW -3.69
- NZD -8.30%
- SGD +18.65%
- THB +12.61%
- TWD +69.06%

## Regional

The evolution of the "Asia consensus" implies that Asian currencies, as a group, could show greater flexibility. Asian central banks may increasingly recycle regional surpluses. The return of investment to emerging Asian markets outside China and India will support growth and help regional surpluses. Such developments are assisted further by the fact that the Asian financial markets are becoming less susceptible to politics and increasingly correlated with each other.

## Australia and New Zealand

Australia has not escaped the contagion from the subprime turmoil in the United States. The share market is down around 6.00 per cent from its peak in July, and the AUD is down 10.00 per cent against the USD and 15.00 per cent against the yen. Corporate-bond spreads have widened by 30 to 35 bps from a base near 55 bps. Economic growth is expected to remain around trend, near 4.00 per cent, with the economy operating to close to full employment and full capacity.

To date, the company-reporting season has, on balance, produced some earnings surprises. Indeed, the main concern for the Reserve Bank of Australia (RBA) has been inflation, prompting the early 25 August bps tightening, taking cash to 6.50 per cent. Moreover, the RBA's rhetoric remains hawkish.

The mixed dataflows in New Zealand gives the Reserve Bank of New Zealand (RBNZ) time to assess the economic outlook through the lens of the current liquidity crisis. While the cash rate is expected to remain on hold at 8.25 per cent for quite some time, changes in soft home sales and consumer spending will cause a shift in market pricing, lowering cash rates within the next 12 months.

## Top stock Australia

Geodynamics (SEDOL 6546218)

## Top stock New Zealand

Tower Ltd (SEDOL 6174299)

## Japan

The Bank of Japan decided to leave policy rates unchanged at 0.50 per cent. The turbulence in the global financial markets and the increasing downside risk to the US economy are likely to have dissuaded policymakers from hiking interest rates. Governor Toshihiko Fukui showed his intention to closely monitor developments in the financial markets and their possible impact on real economic activities. Uncertainties surrounding the US economic outlook will persist for an extended period. We expect that the sharp appreciation of the yen will delay any rate hikes.

## Top stock

Privee Investment (SEDOL 6673547)

## China

Economic policies are likely to focus on rebalancing the investment and consumption gap between domestic and external demand. The central bank will probably continue to tighten liquidity, liberalise the capital account and allow greater exchange-rate flexibility. The post-World Trade Organisation (WTO) financial landscape will probably experience rapid change with increasing competition from foreign banks and foreign institutions.

## Hong Kong

Interest rates are in a down-cycle. The financial sector continues to gain strongly from fund-raising by Chinese firms and China's overseas investment. RMB appreciation boosts Hong Kong's economy and the financial market, while the impact on inflation is likely to remain moderate.

## Top stock

Dynasty Fine Wines (SEDOL B05M185)

## Korea

Domestic demand is dampened slightly by rising interest rates and the weak housing market. Exports are boosted by continued global expansion, high-tech recovery, a shipbuilding boom and strong demand from oil exporting countries. The Bank of Korea (BOK) extends its tightening stance throughout 2007 based on a favorable growth outlook and continued liquidity concerns.

## Top stock

Hyundai Autonet (SEDOL 6539036)

## Singapore

Second-quarter GDP growth came in above expectations at 8.60 per cent. Given a 2.00 per cent Goods and Services Tax (GST) hike (to 7 per cent) in July, inflationary pressures are increasing, causing an up-turn in residential rents and a tightening in the labor market. The high-end property market may be moderate given the financial turmoil. Property prices and transactions, particularly in the high-end market, may cool and rise at a more modest pace.

## Top stock

Hyflux (SEDOL 6320058)

## Taiwan

Upcoming elections may boost the short-term economic outlook. Presidential candidates from both the ruling and opposition parties are likely to take less extreme positions and be more pragmatic toward cross-strait relations. Consumer and investment spending could recover moderately. Stable labour markets and a resurging equity performance would support consumption. Corporate capital retrenchment could end on a sustained export and output expansion. Rising interest rates will help the NTD stabilise against carry-trade incentives and portfolio-capital outflows from domestic residents.

## Top stock

Asia Optical Co In (SEDOL 6295866)

## Thailand

Political risk premiums were lowered on the back of a 58.00 per cent approval rating of the plebiscite on the draft constitution. Lackluster private spending and lower inflation risk may have led to a policy bias for fast-tracking a recovery. Pass-through of a strong baht and lackluster demand accorded flexibility for a rate cut. There was a fiscal deficit of 2.00 per cent of GDP. The government's hefty overall cash deficits reflect a policy shift to increased fiscal spending. Lacking a stronger infrastructure component, the fiscal policy may not be as effective but it still complements policy-rate easing.

## Top stock

Bangkok Dusit Medi (SEDOL B013SQ9)

<sup>9</sup> Source: "Asia Economic Outlook and Strategy", Citi Global Equities Online, 24 August 2007

# US Treasury and agency

August's credit turmoil drove spreads for US Treasuries and agencies to their widest in recent memory. Meanwhile, a systemic flight to quality took treasury general collateral spreads to an unprecedented monthly average of 57 bps - there were at least two trading sessions when Treasury General Collateral (GC) traded in excess of 285 bps.

Sustained spreads of this magnitude are unique to the current credit situation. Spreads were not so wide during the flight to quality leading up to the 2003 invasion of Iraq, nor were they so wide during the days and weeks immediately following the

11 September 2001 terrorist attacks in the United States.

An incidental beneficiary in this rush to treasuries was agency GC. Overnight agencies typically trade within a basis point or two relative to fed funds. The average spread for August was 14 bps. Again, this is unprecedented and unique to this situation.

The current treasury issues were all in demand throughout the month. The spreads were as follows:

- Two-year: 75 bps
- Three-year: 70 bps
- Five-year: 75 bps

- 10-year: 125 bps
- Long bond: 65 bps

The term GC markets are pricing in two Fed eases for the remainder of this year: 25 bps during the 18 September meeting and another 25 bps for the 31 October meeting. There are alternative views to the easing school of thought. It's true that the credit turmoil is putting pressure on the housing market; however, without noticeable spill-over outside of real estate to the general economy, coupled with modest up-ticks in employment, the Fed's decision to ease becomes more difficult.

## European equities

Overall balances fell by 12 per cent for the month due to extreme market conditions.

### News

**London sees biggest stock market tumble in four years on 16 August 2007<sup>10</sup>.**

The London Stock Market suffered the biggest one-day fallout since March 2003, as investors fled risky assets. Other European markets also followed the US and Asia into negative territory, prompted by weak credit markets.

The FTSE 100 index closed at 5,858.9, falling below the 6,000 level and hitting its lowest levels since September 2006. Financial and mining stocks suffered the most. US stocks made some recovery later in the day.

In Europe, the pan-European DJ STOXX 600 closed down 3.60 per cent to 352.37, its fifth negative end in the last six sessions. France's CAC 40 fell 3.30 per cent to 5265.47, putting it down 5.00 per cent this year, while Germany's DAX 30 index slid 2.40 per cent to 7270.07.

The fall in equity follows several weeks of volatility and turbulence in global financial markets. With credit at the centre of the investor distress, a worry is that the inter-bank lending market isn't functioning normally. Even the largest banks are unwilling to lend to each other beyond the short term.

### Russia steps up to global repo standards<sup>11</sup>

The National Securities Market Association in Russia has introduced a repo model agreement that meets global repo standards and promotes the Russian market. Created in accordance with the

best international standards promoted by the International Capital Markets Association, while keeping within the Russian legislative environment, the agreement intends to improve market liquidity and open fresh avenues of access for Russian companies to repo trades.

This initial agreement has been signed between Gazprombank and Petrocommerce Bank, two leaders in the Russian repo market. A number of other Russian banks plan to sign up in the near future, according to Moscow Interbank Currency Exchange sources.

### Active stocks

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

- Endesa (ELE SM)Gaz De France (GAZ FP)
- Hypo Real Estate (HRX GR)
- Iberdrola (IBE SM)
- Banca Popolare (BPM IM)
- Sacyr Valleherm (SYV SM)

#### Directional and convertible-bond news

- Banca Italease (BIL IM)
- IKB Deutsche (IKB GR)
- Qiagen (QIA GR)
- Tiscali (TIS IM)
- Conergy (CGY GR)
- Premier (PRE GR)
- Option (OPTI BB)
- Metrovacesa SA (MVC SM)

Sectors and markets in demand included ETFs, Real Estate Investment Trusts (REITs) and emerging markets.

<sup>10</sup> Source: www.isfmagazine.com, accessed on 17 August 2007

<sup>11</sup> Source: www.isfmagazine.com, accessed on 15 August 2007

## European government bonds

The European Repo Market has reflected the flight to quality witnessed in other regions against the backdrop of a global credit crunch. While demand for European Government GC increased, spreads between government repo and tri-party have come under increased pressure. Conversely, the spread against lesser-quality assets has widened significantly as borrowers desperately attempt to upgrade their collateral.

There are no specials to speak of in the gilt market as firms focus on continued liquidity issues. As with other markets, the spread between government GC and lesser-quality assets has widened considerably, as has the spread between the Monetary Policy Committee (MPC) target rate and short-dated LIBOR rates. These conditions have benefited yields in funds able to reinvest down the credit curve (from government bonds).

As expected, MPC members maintained the interest rate at 5.75 per cent following last month's 25 bps hike. As the Interbank market almost grinds to a standstill beyond overnight, LIBOR rates have drifted to 50 bps (between one and three months ) above the current interest rate. However, despite few signs that consumers have seriously felt the MPC succession of rate hikes, inflation has dropped below the Bank's target rate of 2.00 per cent and the market is not expecting any further move next month, and possibly for the rest of the year.

**For further information, please contact your Citigroup representative.**

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