

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. equities

Our U.S. desk in New York saw overall average balances up 12.34 per cent for the month with average specials in demand up 10.74 per cent.

Earlier in October, Federal Reserve Bank Chairman Ben Bernanke made remarks concerning the sinking housing market and the negative effects it will have on the economy for the remainder of this year. Stocks on the Dow Jones Index rallied on the remarks, which resulted in the expectation of lower rates next year and the sending of the Dow Jones Industrial Average Index into new territory, breaking the 12,000 mark mid October.

Signs of higher core prices in Consumer Price Index (CPI) and Producer Price Index (PPI) numbers reignited inflation concerns and took out most of the ease that was previously priced in the fed funds futures contracts. At month end, with record closes of 12 out of the last 22 sessions, the Dow Jones took somewhat of a breather as a weaker-than-expected Gross Domestic Product (GDP) number renewed concern about the slowdown in the economy.¹

Active stocks

- Level 3 (LVL3), traded as low as 5.00 per cent after rumours of a merger.
- CBRE Realty (CBF), a new Initial Public Offering (IPO), was in demand and bid at 0.25 per cent.
- Odyssey (ORH), was in demand bid at negative 5.50 per cent.
- Bare Escentuals (BARE), a new IPO, was in demand and bid at negative 5.00 per cent.
- Idenix Pharmaceutical (IDIX), was in demand and bid as low as negative 2.00 per cent.
- Shutterfly (SFLY), a new IPO, was in demand and bid at negative 2.00 per cent.
- Commerce (CBH) traded as low as 1.50 per cent ahead of record date for dividend on 4 October 2006.

Sectors in demand in October included: autos, Exchange-Traded Funds (ETF) and Real Estate Investment Trusts (REIT). Some drivers of this demand included: asset valuations, downgrades, interest-rate volatility, commodity prices as well as supply issues.

¹ Source: Bloomberg L.P., October 2006; Wall Street Journal, 5, 20, 27, 31 October 2006.

U.S. cash and money markets

Our U.S. desk in New York saw that the front end of the money-market yield curve remained fairly static during the month as the market consensus for an economic "soft landing" and no change in monetary policy remained in place.

The three-month LIBOR rate showed little volatility, with a high for the month of 5.38 per cent and a low of 5.37 per cent.² Inflation data as seen in the PPI release was mixed at 17 October. The overall inflation rate decreased by 1.30 per cent for the month as reflected in the sharp drop in energy prices. With the energy price component removed, the PPI was up well above expectations at +0.60 per cent.

U.S. equity prices continued to advance following the news of good earnings reports and steady long-term interest rates. The Dow Jones Industrial Average hit several

records and exceeded the 12,000-level for the first time ever on 19 October 2006. As expected, the Federal Open Market Committee (FOMC) held the fed funds target rate at 5.25 per cent at its meeting on 25 October. The statement following the meeting was relatively unchanged from the previous meeting, although the reference to energy prices as adding to the potential for sustained inflation was removed. Despite the overall bias towards higher inflation risks, the market completely discounts any possibility of a future interest-rate hike, and has priced in an increasing probability for a rate cut sometime in the first half of 2007.

Citigroup has continued to extend the duration of its cash-collateral investment portfolios in expectation of stable or falling interest rates at some time in the future.

² Source: Bloomberg L.P., October 2006.

U.S. corporate bonds

In October our U.S. desk in New York saw overall average balances up 0.38 per cent for the month while average special balances were down 6.23 per cent.

Standard & Poor's placed Ford's B senior unsecured debt on CreditWatch with "negative implications". Bonds (CUSIP 345397TX1) 6.50 per cent due 25 January 2007 and bonds (CUSIP 345370CA6) 6.50 per cent due 25 January 2007 had both increased in demand from the news, trading at 4.50 per cent and 5.00 per cent, respectively.³

According to Standard & Poor's, corporations in the U.S. have default rates at a record low level of 1.44 per cent, partly due to plenty of liquidity, private equity money, leveraged loans, and synthetic demand.⁴

Issues in demand from our U.S. desk

- Century bonds (CUSIP 156503AG9): 11.00 per cent due 1 May 2012 traded as low as 0.75 per cent.
- Abitibi bonds (CUSIP 003669AJ7): 8.37 per cent due 1 April 2015 bid at 3.00 per cent.
- General Motors Corp bonds (CUSIP 370442BT1): 8.37 per cent due 15 July 2033 were in demand and bid at 4.00 per cent.
- Turkey 30s bonds (CUSIP 900123AL4): 11.87 per cent due 15 May 2030 traded at 2.50 per cent.
- Movie Gallery bonds (CUSIP 624581AB0): 11.00 per cent due 1 May 2012 bid at negative 2.50 per cent.

³ Source: Bloomberg L.P., 26 October 2006.

⁴ Source: Bloomberg L.P., 2 October 2006.

U.S. issuance and credit

The U.S. asset-backed commercial paper (ABCP) market reached an important milestone during the month of October; outstandings topped the USD1 trillion mark, now accounting for roughly 59 per cent of all U.S. commercial paper outstandings.

Global credit trends remained relatively stable as a few upgrades were reported. Among them, Swedbank AB was upgraded to A+ (from A) by Standard & Poor's credit ratings. According to Standard & Poor's, the higher rating reflects "the strengthening of the group's management of risks in the Baltic operations following the integration of Hansabank" as well as "the sustained improvement in financial performance in the past three years".⁵

In addition, Fitch upgraded Sumitomo Mitsui Banking Corporation to A from A-, based on "profitability of its core banking business and the improving quality of its assets and capital".⁶

Standard & Poor's lowered the long-term sovereign credit ratings of the Republic of Italy to A+ (from AA-). In addition, Fitch ratings lowered the AA ratings to AA-. Despite the sovereign downgrade, all Italian domiciled banks on our approved reinvestment list have been affirmed. The sovereign downgrade reflects the rising budget deficit and the slow reaction by the new Italian government to spur growth.

⁵ Source: www.standardandpoors.com, October 2006.

⁶ Source: www.fitchratings.com, October 2006.

Product development

There has been much discussion about the changing regulatory environment, and the Markets in Financial Instruments Directive (MiFID), also known as Investment Services Directive 2 (ISD2), will potentially have an impact on the Securities Finance industry. MiFID is a major part of the European Union's Financial Services Action Plan (FSAP), which is designed to create an integrated and homogeneous financial services market in the European Union. Under the present regulations, securities lending is exempt from best-execution rules; however, MiFID proposes to include them in future. The International Securities

Lending Association (ISLA) have produced a response to the Financial Services Authority's (FSA) recent consultation on best execution under MiFID. In future newsletters, we will update on this initiative; but, in the interim, if you are interested to see the response from the FSA, please email one of the contacts mentioned at the end of this newsletter or log on to the ISLA website at: www.isla.co.uk/current_issues.asp#issues17.

We will keep you up to date on this important initiative that will potentially have an impact on our industry as soon as we have the response back from the FSA.

U.S. treasury and agency

In October our U.S. desk in New York saw U.S. treasury and agency balances were flat relative to September. However, the spread between overnight financing and fed funds continued to compress. For October, there was little to no spread between overnight treasury financing and fed funds, both of which averaged 5.26 per cent. Moreover, the average spread for general collateral (GC) agencies fell to negative three basis points (bps), averaging 5.29 per cent.

There have been fewer off-the-run treasury issues that have been trading at a premium. When an issue has little to no intrinsic value, it becomes GC. GC loans are financing trades, which by definition have minimal spreads. As of late, the government lending/repo market is experiencing a time where fewer issues are trading special. As the number of issues with intrinsic value decreases, conversely the number of issues trading as GC grows. Therefore, spreads decrease on an overall basis. The term treasury markets indicate that narrow spreads may continue in the near term with a brief respite for the year-end turn.

The only current treasury issue that traded special was the ten-year note, which averaged approximately 70 bps. The five-year note was mildly special, averaging just 15 bps.

There were recent market reports of a Securities and Exchange Commission (SEC) investigation of two primary dealers that allegedly attempted to reduce the supply of certain treasury securities with the intent of creating profits by trading the bonds to other dealers at favourable rates. Repo market participants have suggested that this scrutiny has cooled repo activity by reducing bond shortages. The knock-on effect has been a reduction of issues trading special in the market.⁷

⁷ Source: Wall Street Journal, 6 November 2006.

Asia-Pacific equities⁸

Australia

The Australian ASX Index continued to gain during October. The month started at a level 5,178.80 points, hitting a low of 5,142.00 points on the 4 October 2006 before rebounding to end at 5,384.40 points in October – an overall gain of 3.97 per cent.

BHP Billinton, the worlds biggest mining company, and Rio Tinto Group, the mineral, mining and processing company's trading activity, gained pace after prices of metals including zinc and copper climbed. St.George Bank, the nation's fifth largest bank, lifted lenders higher after reporting record second-half profit, beating analyst estimates.

Brambles (6120009) continues to be an arbitrage player between the London traded stock (BIL LN) and the local (BIL AU). However, at the general meeting held in November 2006, there will be a vote to bring an end to the dual listing of the stock.

Telstra (6087289) – the government, on 22 October, sold AUD4 billion of stock in Telstra, through stockbrokers and financial planers, completing the first part of its total AUD8 billion sale of its current holdings.

Top five highest fee earners

○ Boulder Steel	(6110572)
○ Brambles Inds	(6120009)
○ Bligh Oil & Minerals	(6106485)
○ Fortsecue Metals	(6086253)
○ Senetas	(6269571)

Hong Kong

The Hong Kong HIS index continued rise from 17,606.53 points to 18,324.35 points at month end, an overall 4.07 per cent increase for October. Shares of Hong Kong-listed Chinese companies including China Mobile Limited climbed as the yuan strengthened. Airlines also improved, as in the example of China Southern Co. Ltd., which has 84 per cent of its debt in USD.

Industrial & Commercial Bank of China, the largest lender in China, saw its shares surge on their debut and biggest-ever IPO, increasing its market value by about USD23 billion to make it the world's fifth-largest bank.

Top five highest fee earners

○ Shanghai Real Estate	(6201830)
○ China Everbright	(6455143)
○ ICBC	(B1G1QD8)
○ Tsingtao Brewery	(6905808)
○ F.E. Consortium	(6331555)

Japan

The Japanese market started at 16,254.09 points and then headed for a high on 26 October of 16,811.60 points before slipping to end at 16,399.39 points. On 26 October, the government announced lower-than-expected consumer prices, which may delay interest-rate increases by the Bank of Japan. Stocks fell back in the later half of the month as the number of exporters fell after concerns over the outlook of the economy.

Index changes announced for November-end inclusion

○ Daiwa System	(8939)
○ Maruka Machiner	(7594)
○ Nissui Pharm	(4550)
○ Zecs	(8913)

Top five highest fee earners

○ Privee Zurich	(6720)
○ PIA	(4337)
○ Tobishima Corp	(1805)
○ Eneserve Corp	(6519)
○ Invoice	(9448)

South Korea

The South Korean 100 share blue-chip KRX started at 2,840.15 points and then dropped to a low of 2,746.74 points on 9 October before rebounding marginally over the later half of October to 2,826.73 points. The drop was primarily the result of the news that North Korea had successfully tested a nuclear weapon. Their policy fundamentals returned over the course of the month as China denounced the test. North Korea confirmed it would return to diplomatic talks on its nuclear weapons programme.

Top five highest fee earners

○ Hankuk Paper	(6408578)
○ Ottogi Corp	(6658373)
○ Hanmi Pham	(6146083)
○ Woongjin Thinkbig	(6172505)
○ Keangnam Ent	(6490898)

⁸ Source: Bloomberg L.P., October 2006.

European money markets

Our European desk in London noted the European Central Bank continued tightening policy by raising interest rates by 25 bps on 5 October 2006 (effective 11 October 2006). This was fully priced in by most of the market. The market also forecasts the next rise will be on 7 December 2006. Following the 5 October rise, Euro short-term rates traded in a narrow range between 3.30 per cent and 3.34 per cent.

GBP short-term rates traded between 4.75 per cent and 4.90 per cent during the month. The market fully expects the Monetary Policy Committee (MPC) to increase interest rates by 25 bps on 9 November and then a further 25 bps in the first quarter of 2007.

European government bonds

Our European bond desk in London noted very little special activity through the month; however, European Government GC balances increased as we extended investments down the curve and took advantage of continued borrower demand for termed euro paper. This trade worked particularly well with broker-dealers financing repo and European commercial paper (ECP) through a single desk, allowing us to raise cash through GC repo and purchase ECP from their inventory.

We also continue to see strong demand for Spanish government bonds over the month end.

The gilt market saw a quiet month with the 8/15 (0888154) briefly reaching 15 bps during the last week of the month.

We have again seen periods of collateral shortage resulting in poor returns in short-dated (overnight, tomorrow or next-day and spot-next) Delivery by Value (DBV). However, we have seen greater value in outright certificate of deposits and ECP purchases as the market fully expects a 25 bps rate hike when the Monetary Policy Committee (MPC) meets next week, resulting in better yields for clients with wider collateral parameters.

European equities

Our European desk in London saw overall average balances up nine per cent for October. This was mainly a result of structured long-term GC trades.

The UK, Europe's second-biggest economy, grew faster than expected in the third quarter of 2006, stoking speculation that the Bank of England needs to raise interest rates more than once to quell inflation. Growth accelerated to an annual 2.80 per cent, the quickest pace in two years, as reported by the London office for National Statistics.⁹

Rising house prices, record employment and a recovery in manufacturing have pulled the economy back from a slowdown in 2005. Rates on futures contracts rose after the report from the Office for National Statistics based in London, as investors increased their stakes in the prediction that the central bank would increase rates to 5.00 per cent in November with another rise planned early next year.

Confidence in the European economy rose to a five-year high in October and inflation slowed as declining oil prices increased the spending power of consumers and companies.¹⁰

October has been very busy with increased merger and acquisition (M&A) news as detailed below.

Active stocks

Relative value and M&A news¹¹

- Schneider agreed to purchase American Power for USD6.1 billion.
- UCB BB embarked on a friendly takeover of Schwarz AG for EUR4.4 billion.
- Union Fenosa/Iberdrola anticipated merger.
- Catlin agreed to buy Wellington Underwriting PLC for GBP591 million.
- Popolare Verona agreed to acquire BPI for EUR8.2 billion.
- Intek Spa agreed to buy GIM SPA to create an industrial holding company.
- Meinl will sell up to EUR774 million in new shares to fund its international expansions.
- Volkswagen AG bought a 15.1 per cent stake in MAN AG (MAN GR).
- Alleanze AG announced capital increase for agreed merger of RAS Holdings.

Directional (long/short)

- Antena 3 recorded its worst rating in 13 years in September, with a recorded rating of 18 per cent, its worst since May 1993.
- Premiere AG reported a second-quarter net loss of EUR138.8 million (USD178 million).
- Sacyr Vallhermoso volatile stock in thin supply.
- Option continues to be a major recall name.

Convertible bonds issued

- Tandberg Data, a global supplier and manufacturer of professional tape-information storage products.
- Karstadt, a retailer, and Sogecable, a digital TV group.

Sectors and markets in demand

Sectors and markets we saw in demand included: spanish utilities, ETFs, REITs, South Africa emerging markets.

^{9, 10} Source: Bloomberg L.P., October 2006.

¹¹ Source: Citigroup Global Capital Markets Equity Finance Desk, October 2006.

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