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Welcome

As 2007 draws to a close, we continue to look for new opportunities within the emerging-market space.

Recently in October 2007, Citi launched a securities-lending solution in Israel that has emphasised our dedicated first-in-market approach. In the space of a year, Citi has been successful in launching lending solutions in Taiwan, Hungary, the Czech Republic and Turkey. Initiatives for 2008 look promising as our focus turns to Russia, Greece, and Malaysia, though we have not lost sight of potential opportunities in Poland, India and China, which will possibly require specialised solutions that move away from a traditional stock borrow/loan route (unless regulations change to permit a standard securities loan).

Utilisation and spreads, furthermore, remain robust in this space. With average utilisation remaining above the forty percentile mark, and spreads trading higher than general collateral (GC), the entire market endeavours to make strides here. In a clear demonstration of the industry's commitment, the agenda for the annual International Securities Lending Association (ISLA) and Risk Management Association (RMA) conference in Prague was specifically focused on emerging markets and the route to market for securities lending. Please feel free to contact us for further information on the upcoming conference and securities finance solutions for emerging-market countries.

Markets in Financial Instruments Directive (MiFID)

Thursday 1 November was a red-letter day for the regulation of the activities of investment firms and markets in Europe. On that day, MiFID came into force across the 27 countries of the European Union and the three countries (Iceland, Liechtenstein and Norway) of the European Economic Area (EEA). MiFID replaces the Investment Services Directive (ISD), which established what is known as the passport regime under which a financial services firm in one European country could do business in another, either cross-border from its home jurisdiction or through branches. MiFID broadens the scope of the ISD and further harmonises the rules in Europe. Some of the key changes implemented by MiFID are that it:

- Eliminates the "concentration rules" under which each EEA nation could require trading in national securities on a national platform;
- Introduces new rules on client classification; and
- Harmonises the conduct of business rules applicable to financial services firms.

There is no consensus on whether securities lending, specifically, lies within MiFID's scope. Having taken external legal advice, Citi's Global Transaction Services has concluded that it falls outside the scope of MiFID. In effect, the introduction of MiFID makes negligible change to your existing securities-lending relationship with Citibank, N.A., London. Citi's analysis was based on the interpretation of a number of MiFID directives, including: MiFID Art. 4.1(5), which defines "execution of orders on behalf of clients" as "acting to conclude agreements to *buy or sell*" financial instruments; and the Implementing Directive, Art. 5, which excludes a "securities financing transaction" from the definition of a transaction as it is not a purchase or sale of a financial instrument. Furthermore, the nature of a securities-lending mandate is such that there is neither a receipt and transmission of orders nor an execution of orders on behalf of clients. We have appraised both our regulator in the UK (the Financial Services Authority) and the market trade association ISLA of our position.

Reinvestment of cash collateral by Citibank, N.A., London, however, does fall within the scope of a MiFID activity as it is treated as "Portfolio management".¹ Citi has put in place both a Best Execution policy and a Best Results policy, but fundamentally there will be continuing reliance on clients' cash reinvestment guidelines.

Global Transaction Services has completed its MiFID compliance project and letters were sent to existing clients while new clients will receive MiFID standard documentation. If you have any queries, please email Citi at gtsmifid.queries@citi.com or contact your Relationship Manager.

¹ See MiFID, Art. 4(9): managing portfolios in accordance with client mandates "on a discretionary client-by-client basis where such portfolios include one or more financial instruments", where a "financial instrument" includes transferable securities and money-market instruments but not time deposits or repos.

US equities

Overall average balances were down 3.04 per cent for the month.

News

Wall Street has been struggling to access the extent of damage from the credit-market downturn that began a couple of months ago. In early October, the major indices reached historical highs, as investors thought the fallout from the summer's turmoil might have been limited. But as the financials reported third-quarter earnings, many took big losses, showing that the crisis could take longer to resolve than previously thought.¹

At month-end, the Federal Reserve cut interest rates by a quarter point but later discouraged expectations of further cuts as energy prices and other inflationary threats surged. The stocks (the Dow) sold off after the Federal Reserve's statement, but then gradually recovered during the day, ending within 235 points from its record high set earlier in the month.²

Active stocks

- Surmodics (SRDX)
- Nutri System (NTRI)
- Freedom Holdings (FRH)
- Home Solutions (HSOA)
- Sulphco (SUF)

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 Bloomberg L.P. at www.bloomberg.com, accessed on 24 October 2007; *Wall Street Journal (WSJ)*, accessed on 24 October 2007.

² Bloomberg L.P. at www.bloomberg.com, accessed on 31 October 2007; *WSJ* accessed on 31 October 2007.

US cash and money markets

Focus on the market in October centred on whether and by how much the Federal Open Market Committee (FOMC) would reduce the Federal Funds target rate at its 31 October meeting. Housing data reported during the month continued to display weakness while inflation reports were in line with expectations. The "Fedspeak" offered by various voting and non-voting members seemed to indicate that the FOMC was

prepared to act in order to buffer against serious economic deterioration created by the turmoil in the credit and housing markets. On 31 October, the FOMC did reduce the target rate by 25 basis points (bps) to 4.50 per cent and the discount rate by 25 bps to 5.00 per cent. In doing so, the FOMC judged that, with 75 bps of easing now in place, the upside risk of an increase in inflation was roughly balanced with the

potential for an undesirable slowdown in economic growth. In its policy statement, the FOMC implied that further action might not be needed to keep economic expansion on track with low inflation. That said, the market immediately priced in a 25 per cent probability that there would be an additional rate cut at the 11 December meeting.

US corporate bonds

Overall average balances were down 3.16 per cent for the month.

News

US corporate bond sales this year are closing in on USD1 trillion, putting offerings on a pace to set a record as demand rebounds from a slump in July and August. Sales have picked up since the Federal Reserve lowered its benchmark interest rate on 18 September, the first cut since 2003. While high-yield sales slumped in August and September, investment-grade companies picked up the slack, setting

sales records in both months. Funding for mergers and acquisitions accounted for 38 per cent of the use of proceeds raised by both investment-grade and high-yield borrowers in the third quarter, down from 46 per cent in the second quarter, according to data compiled by Moody's.¹

IBM, the world's largest computer-services company, raised USD1.5 billion in a sale of five-year notes. The 5.05 per cent notes sold at a spread of 87 bps more than US Treasuries of similar maturity. Moody's Investors Service rates the new notes A1,

its fifth-highest level of investment grade, with Standard & Poor's (S&P) ranking them at an equivalent A+.²

Issues in demand

- Georgia Gulf (CUSIP 373200AT1)
- AMH Holdings (CUSIP 001706AB6)
- Six Flags (CUSIP 83001PAF6)
- Ply Gem Industries (CUSIP 729416AG2)
- Hawaiian Telecom (CUSIP 420029AD2)

¹ Bloomberg L.P. at www.bloomberg.com, accessed on 12 October 2007.

² Bloomberg L.P. at www.bloomberg.com, accessed on 17 October 2007.

US issuance and credit

The volatility in the global credit markets continued in October 2007. During the month, a myriad of negative rating actions were taken, thus reflecting the current market conditions. Merrill Lynch was downgraded by S&P to the long-term rating of A+ from AA- and the short-term rating of A-1 from A-1+.¹ S&P also lowered the long-term rating of UBS AG to AA from AA+.² Another downgrade reflective of

the weakening banking industry was the downgrade by Fitch of First Tennessee Bank to long-term A- from A.³

The overall commercial-paper issuance market rebounded from a 2007 low in September to USD1.905 trillion in October 2007, up from USD1.857 trillion. This modest increase is still off from the 2007 high of USD2.12 trillion in May 2007.⁴

¹ www.ratingsdirect.com, accessed on 24 October 2007.

² www.ratingsdirect.com, accessed on 1 October 2007.

³ www.fitchratings.com, accessed on 10 October 2007.

⁴ www.federalreserve.gov/releases/cp/outstandings.htm, accessed on 2 November 2007.

US Treasury and agency

The US Treasury and agency markets remained steady throughout October. Repo trading has returned to relative normality. The Treasury GC spread to Federal Funds for October dropped to 15 bps from 23 bps in September and 56 bps in August. However, this is up from a spread of zero bps in October 2006. Demand for off-the-run Treasury issues continued to be strong; however, the depth and breadth of the Treasury "specials" in October was

somewhat tempered when compared to August and September.

The current Treasury notes traded at a premium throughout the month with all issues averaging between 40 and 65 bps. The quarterly refunding will be November 15th at which time the Treasury will settle an estimated 13 billion new ten-year notes. The treasury also plans to reopen an estimated six billion of the current long bond at that time.

The Federal Reserve decided to reduce the funds rate to 5.50 per cent from 5.75 per cent during its 31 October FOMC meeting. Since then, the term Treasury GC markets have traded at 4.40 per cent for one month and 4.27 per cent to year-end. The early indication for GC over the "turn" (31 December 2007 to 2 January 2008) is 3.90/3.50 per cent. This wide spread should tighten-up as the turn approaches.

Asia-Pacific equities¹

Australia and New Zealand

The run of economic data in Australia continues to point to strong momentum in the economy. There are few signs of a material hit from the 25 August basis-point tightening and the turmoil in credit markets. The risks to the Australian inflation outlook, therefore, continue to build to the upside. The economy is growing above potential and key pressure points include rents, home-building costs, food, electricity and gasoline prices.

Japan

The Bank of Japan (BOJ) left its target for the overnight call rates unchanged at 0.5 per cent in October. BOJ published its semiannual economic outlook report at the end of October, but with surprisingly few changes from the previous April report. The central bankers did point to risk factors including the overseas economies and global financial markets, but they virtually maintained their base-case economic and price scenarios and assessments. Economic forecasts by policy board members have remained largely the same as in the previous report.

Regional

The evolution of the "Asian consensus" implies that Asian currencies as a group could show greater flexibility. Asian central banks may increasingly recycle surpluses within the region. A return of investment to emerging Asian economies outside China and India will support growth and help regional surpluses. Asian financial markets are becoming more "politics-proof and increasingly correlated with each other.

China

Despite continuous policy efforts, structural distortions deteriorated on faster growth of gross domestic product (GDP), investment, trade surplus and Consumer Price Index (CPI). Financial reforms and liberalisation continue, but rapidly growing

equity prices pose increasingly greater risk for the markets and economy.

Hong Kong

Interest rates are in a down-cycle, and Hong Kong Inter-bank Offer Rates (HIBOR) jumped as stock rallies boost demand for funds and bank liquidity tightens. Moreover, there have been mortgage-rate hikes by a selection of banks. The financial sector continues to gain strongly from fund-raising by Chinese firms and China's overseas investment. Inflows of Chinese funds through Qualified Domestic Institutional Investor (QDII) and grey channels are gathering momentum. Investors also expect China to implement a programme to let Chinese individual investors invest directly in Hong Kong's stock market. Renminbi (RMB) appreciation boosts Hong Kong's economy and the financial market, while the impact on inflation is likely to remain moderate. Inflation remains moderate despite faster RMB appreciation.

Korea

Rising interest rates and a weak housing market has slightly weakened domestic demand. Facility and construction investment was weak in September, while activity and sentiment indicators confirmed strength in consumption. Global expansion, high-tech recovery, a shipbuilding boom and strong demand from oil exporting countries continue to swell exports. And policy rates should be on hold at five per cent at least until year-end, as the Bank of Korea (BOK) maintains a neutral stance on monetary policy (BOK confirmed its balanced stance in September by skipping future guidance in policy statements).

Singapore

The 2007 GDP growth forecast was upgraded to eight per cent following a sharp rebound in manufacturing growth and robust service growth. There have

been limited spillover effects from the subprime crisis and slower US growth. The third-quarter GDP growth flash estimate came in at 9.4 per cent. Inflation forecasts for 2007 and 2008 have risen to 2.5 per cent and 3.0 per cent, respectively. The mounting inflationary pressure is due to rising residential rent, transport costs and a tighter labour market. The Monetary Authority of Singapore (MAS) highlighted in its October review that inflation might average 3.5 per cent in first half of 2008. The MAS tightened, and increased "slightly", the appreciation bias of the Singapore dollar Nominal Effective Exchange Rate (NEER) policy band.

Taiwan

A referendum for a UN bid increases tension across the Taiwan Strait as well as between Taipei and Washington. Consumer and investment spending could recover moderately. A stable job market and strong equity performance supports consumption. Corporate capital expenditure faces downside risks as global uncertainty increases.

Thailand

Recent resignations in Surayod's cabinet were probably a backlash from anti-Thaksin forces. Thaksin's opponents may be disgruntled with the treatment of Thaksin's remaining allies preparing for the coming elections. End of rate-cutting cycle as policy rate kept at 3.25 per cent. The government's decision to accommodate price adjustments on regulated commodities and recent transport fare hikes effectively ends the rate-cutting cycle. Currently the fiscal deficit is two per cent of GDP. An end-of-fiscal-year budget deficit of THB130 billion undershot the official target of THB146 billion for the year 2007.

¹ "Global Economic Outlook and Strategy" 18 October 2007; "Asia Economic Outlook and Strategy" 22 October 2007.

European equities

Overall balances were up 1.5 per cent on the month.

News

Citi completes its first securities-lending trade in Israeli securities¹

Citi Markets & Banking has become the first major international lending agent to complete a securities-lending transaction in Israeli securities. Citi worked with Israeli legal and tax specialists, as part of the due diligence process, to create an efficient and easy access to this market for foreign borrowers and lenders of securities.

"We are thrilled to offer offshore lending of Israeli securities to benefit our clients and the local Israeli market," said Brian Staunton, Managing Director, Securities Finance, Global Transaction Services, Citi.

Ralph Shaaya, Citi's Country Officer for Israel, said: "In line with our efforts to expose the Israeli market to international investors, Citi is looking to improve the access of foreign investors to the local market, enable additional liquidity resources and continue supporting the development of the local economy." Citi has offered securities clearing and settlement services in Israel since last year when Citi announced it would provide direct

custody and clearing (DCC) services to clients through the Tel Aviv Stock Exchange clearing house, making Citi the first foreign bank in Israel to offer DCC services to a large international client base.

European stocks decline after Group of Seven (G7) comments²

European stocks fell after the G7 finance ministers and central bankers said the rising cost of credit, record oil prices and the US housing slump would sap economic growth. Royal Bank of Scotland Group Plc paced losses by banks after Credit Suisse Group cut profit estimates for British lenders.

The Dow Jones STOXX 600 Index lost 1.3 per cent to 375.81 as of 4.30 p.m. in London, the lowest since 26 September, with all 18 industry groups falling except telecommunications companies.

The STOXX 50 slipped 1.1 per cent, and the EURO STOXX 50, a measure for the euro region, sank 1.3 per cent. "The market is concerned about a strong slowdown or a recession," said Salah Seddik, a fund manager at Richelieu Finance in Paris, which oversees USD5 billion. "The crisis in the credit markets is spilling into the general economy. It's time for the stock market to take a breath."

Active stocks

Relative value and merger and acquisition news³

- LSE (LSE LN)
- Gaz De France (GAZ FP)
- Hypo Real Estate (HRX GR)
- Carlsberg (CARLB DCI)
- Rexel (RXL FP)
- Hagemeyer (HGM NA)
- Banca Popolare (BPM IM)
- Sacyr Vallehermoso (SYV SM)

Directional and convertible-bond news

- Banca Italease (BIL IM)
- IKB Deutsche (IKB GR)
- Alliance & Leic (QIA GR)
- Brad & Bingley (BB LN)
- Northen Trust (CGY GR)
- Tiscali (TIS IM)
- Premier (PRE GR)
- Option (OPTI BB)
- Metrovacesa SA (MVC SM)

Sectors and markets in demand included: ETFs and emerging markets.

¹ www.isfmagazine.com, accessed on 30 October 2007.

² Bloomberg L.P. at www.bloomberg.com, accessed on 22 October 2007.

³ Equity Finance Desk, Citigroup Global Capital Market's Limited (CGML), October 2007.

European government bonds

European government balances increased through the month as demand for high-grade collateral continued. However, the spreads we have benefited from over the last few months have contracted as confidence has returned in the short-term interest-rate market. While three-month LIBOR has fallen to around 50 bps (from 75 bps in September), levels below two months are back to where they were prior to the credit crisis.

There has been little activity in the gilt market this month, with just UKT 4 09/07/16 (GBOOB0V3WX43) yielding incremental value trading up to 50 bps. In line with the European market, spreads between government GC and corporate debt have tightened in the short term, rising above 100 bps over the year end. This suggests the year-end could be quite a volatile period.

European money markets

European inflation accelerated to 2.6 per cent this month, a two-year high and more than economists had forecast. Rising oil and food prices, coupled with declining unemployment, is all adding to inflationary pressures. Meanwhile, confidence in the economy declined as the euro appreciated to a new record, making European exports less competitive. The European Central Bank (ECB) find itself in a quandary. Does it raise rates to fight inflation or follow the US and cut rates to fuel growth? It is widely expected that it will continue to do nothing.

The three-month inter-bank lending rate, while still high relative to the ECB repo rate, has fallen 18 bps during the month as market liquidity improved.

The desk has been able to maintain the increase in revenues from last month as the flight to quality continues and as spreads between our government bond and our non-government reverse repo and cash re-investment remain high.

Client-solutions update

Citi completed its 2007 programme of proprietary Securities Finance roundtables with a final event in Edinburgh, Scotland. A selection of high-profile industry experts discussed the current market place and how to expand and improve customer programmes.

The roundtable event covered many topical issues, from 130/30 to subprime and emerging markets, for example:

- 130/30: attraction, landscape and Undertakings for Collective Investments in Transferable Securities (UCITS) III.
- Emerging markets: what's next and where?
- Subprime: the detrimental effect on financing for broker-dealers.
- And the history and development of bond financing.

The roundtable ended with a discussion on current market developments, initiatives, MiFID and Basel II; but will recommence in early 2008 (with more details to come in a forthcoming edition of *Market Monitor*). We look forward to seeing you at one of these interactive sessions.

For further information, please contact your Citi representative.

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