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## Welcome

As we pass the midpoint of the year, there has been a noticeable shift by our clients, in particular the Public Sector Group, whose Investment Guidelines are being brought into line with the rest of the market. Previous constraints prevented them from conducting securities lending.

We continue to educate and update our clients on the latest changes in securities lending by means of numerous roundtable events in Dublin, Milan and Amsterdam, and, more recently, a Public Sector Conference hosted by our management in Shanghai. Approximately 30 different central banks attended this event, including senior representatives from the Federal Reserve Bank (Fed). Many conference attendees were encouraged by Citi's ability to lend out assets irrespective of where they were held in custody.

For our business strategy of market expansion, our product experts continue to develop new markets for lending by undertaking rigorous due diligence. Our most recent market expansions enabled our clients to lend in Turkey and Israel. Both of these markets provide excellent opportunities for our clients.

As the markets develop, we continue to work with our clients to find the best possible solutions in financing their securities. Particular emphasis is now being placed on developing our Cash Reinvestment program, which continues to add revenue to the standard securities lending fees.

With some significant new business won this year that is already in the process of being implemented, we look forward to a productive second half of 2007.

## US equities

Average balances were up 4.11 per cent for the month with average specials in demand down 0.98 per cent.

### News

After the Dow Jones Index hit a record high early in June, it was a rollercoaster ride for the market mid-month. As US ten-year bond yields hit a five-year high, the Dow Jones Index sold off drastically over worries about rising inflation abroad and concerns that foreigners might curb their purchases of US bonds, which have been an important source of support for the market. This sell-off was reversed after strong retail sales and lower inflation numbers were announced.

Stabilisation in bond yields also contributed to the rally.<sup>1</sup>

The near-meltdown of two hedge funds at Bear Stearns late in the month underscored a growing fear on Wall Street that hard-to-trade investments might suddenly turn south and set off a broader market downturn. After some volatile trading sessions, the Dow Jones Index bounced back modestly.<sup>2</sup>

Stocks barely moved after the Fed kept short-term interest rates in place at 5.25 per cent. The Fed cited modest improvement in core inflation and moderate economic growth as the reasons for keeping rates unchanged.<sup>3</sup>

### Active Stocks

- Heelys (HLYS)
- Blackstone Group (BX)
- Greenhill (GHL)
- Fortress (FIG)
- Sadia (SDA)

Sectors in demand included: autos, sub-prime lenders and exchange-traded funds (ETFs). Some drivers of this demand included: asset valuations, downgrades, commodity prices and supply issues.

<sup>1</sup> Bloomberg L.P., Wall Street Journal (WSJ), 12, 13, 14 and 15 June 2007.

<sup>2</sup> Bloomberg L.P., WSJ, 25 and 26 June 2007.

<sup>3</sup> Bloomberg L.P., WSJ, 28 and 29 June 2007.

## US Treasury and agency

As a result of very favourable US Treasury supply-and-demand conditions, the month of June was one of unprecedented spreads for the US government desk. The repo market's appetite for treasuries seemed insatiable from the beginning of the month right up to month-end (quarter-end). For the full month, overnight general collateral (GC) averaged 5.06 per cent and Fed funds averaged 5.28 per cent. This equated to an unparalleled 22-bp average spread.

The June spreads can be broken down into

three different components: 1) prior to the Cash Management Bill (CMB) maturity, June 1-14, with 10 bps; 2) following the CMB maturity, June 15-28, with 25 bps; and 3) at quarter-end, 29 and 30 June, with 92 bps. Some of the reasons for this treasury-collateral shortage are attributed to: the maturity of USD39 billion of CMBs on 15 June, the temporary reduction in the issuance of four week bills by the Treasury and collateral being pulled from the street by entities that are precluded from having their securities outstanding over

quarter-end. These supply conditions are extremely conducive to lending, and an extraordinary number of issues traded as specials throughout the month.

The treasury term-collateral markets are indicating that these levels are unsustainable and that spreads will narrow in the near future. August is already trading at levels similar to May, with about a 12-bps spread between GC and Fed funds. Also, the term GC run is flat out to December 2007, implying that the Fed is on hold for the remainder of the year.

# US cash and money markets

The US fixed-income market experienced an extremely volatile month. Economic data released early in the month continued to indicate that growth was accelerating. The market reacted to the data by selling off across the yield curve and producing yields that had not been reached for several years. The two-year US Treasury (UST) note began the month with a yield of 4.96 per cent, but quickly climbed above the 5.00 per cent level, peaking at 5.08 around mid-month. That interest rate had not been seen since mid 2005. The ten-year UST note fared even worse, starting the month below 5.00 per cent, but then reaching an intraday high of 5.31 on June 12 before settling back to close at 5.25 that day. Those yields had not been available on ten-year notes since early 2002.

The severe sell-off certainly took the wind out of the sails of any market participants who thought that a rate cut was in the offing. The options on Fed funds futures markets shifted to reflect about an even probability between the next rate move being a cut or a hike. The shorter end of the market had also shifted to higher rates, and given our outlook that the Fed would be on

hold for quite some time, we extended the duration of most of the cash-collateral investment portfolios by purchasing fixed-rate instruments at the maturity limits permitted by the clients. These purchases were proven to be of excellent value as the market rallied during the second half of the month after reports of benign core inflation and potential spill-over effects from the sub-prime mortgage woes.

Yields returned to the same levels that they had been at the start of June and rallied even a bit further at month-end after the Federal Open Market Committee (FOMC) voted to hold the current Fed funds target rate at 5.25 per cent. In their statement that followed the meeting, the FOMC stated that, while its main concern continued to be higher inflation, the "elevated" levels that had been stated previously were now considered to have moderated. Having extended the duration and increased the yield of the cash-collateral investment portfolios, we will now continue to make relative value purchases in the shorter end of the money-market yield curve. This will enable clients to maximise their returns.

# US corporate bonds

## Balances

Average balances were down 10.10 per cent for the month while average special balances were up 7.98 per cent.

## Current News

Freddie Mac, one of the largest US mortgage finance companies, sold USD3 billion of its five-year notes at a higher yield premium than the last time it issued the same type of debt. The notes were priced to yield 5.519 per cent, or 36.5 basis points (bps) higher than similar maturity US Treasuries, 4 bps higher than the last time these were issued.<sup>4</sup>

In late June, investors rejected a USD3.6 billion buyout-related bond-and-loan deal by US Foodservice Inc, the nation's second-largest food distributor, which subsequently

pulled the bond offering and postponed plans to sell the loans. Also, Catalyst Paper, after citing "adverse" market conditions as the cause, scrapped a USD200 million bond offering. Bankers and investors have started to wonder whether these setbacks in the debt markets are signalling that the buyout boom is in jeopardy or just suffering a temporary shock.<sup>5</sup>

## Issues in Demand

- Blockbuster (CUSIP 093679AC2)
- Masonite (CUSIP 575379AE2)
- KB Home (CUSIP 48666KAM1)
- Alcoa (CUSIP 013817AK7)
- Leiner Health (CUSIP 52536PAE8)

<sup>4</sup> Bloomberg L.P., 13 June 2007.

<sup>5</sup> Bloomberg L.P., 28 June 2007.

# US issuance and credit

With the continued headlines surrounding the US sub-prime mortgage market, we have once again suspended purchases of certain asset-backed commercial paper (ABCP) programmes that consist of large concentrations of US sub-prime debt. This action is purely cautionary as we continue to monitor the market and any future developments.

The ABCP market continued its torrid pace of issuance as month-end levels eclipsed the USD1 trillion US dollar mark for the seventh consecutive month.<sup>6</sup> Furthermore, the 30 June 2007 outstanding represented a new record high at USD1.161 trillion, up from USD1.129 trillion in May 2007.<sup>7</sup>

The ratio of upgrades to downgrades affecting Citi's Approved List was equal in June 2007. Some of the upgrades included Sumitomo Trust and Banking Corp and Sumitomo Mitsui Bank, both upgraded to A+ long-term by Standard and Poor's (S&P).<sup>8</sup> Mellon Bank NA was upgraded to Aaa from Aa2 by Moody's.<sup>9</sup>

The two main downgrades for the month included the Bank of Montreal, downgraded by S&P to a long-term rating of A+ from AA- and a short-term rating of A-1 from A-1.<sup>10</sup> In unison, Harris Bank Corporation, a subsidiary, was also downgraded to the same ratings. The long- and short-term downgrade was directly attributed to the larger-than-expected loss from the Bank of Montreal's gas-trading derivative business.

<sup>6</sup> The Federal Reserve at [www.federalreserve.gov/releases/cp/outstandings.htm](http://www.federalreserve.gov/releases/cp/outstandings.htm), accessed on 03 July 2007.

<sup>7</sup> The Federal Reserve at [www.federalreserve.gov/releases/cp/outstandings.htm](http://www.federalreserve.gov/releases/cp/outstandings.htm), accessed on 03 July 2007.

<sup>8</sup> Standard & Poor's Ratings Direct® at [www.ratingsdirect.com](http://www.ratingsdirect.com), accessed on 03 July 2007.

<sup>9</sup> Moody's at [www.moodys.com](http://www.moodys.com), accessed on 03 July 2007.

<sup>10</sup> Standard & Poor's Ratings Direct® at [www.ratingsdirect.com](http://www.ratingsdirect.com), accessed on 03 July 2007.

# Asia-Pacific equities<sup>11</sup>

Our Asia-Pacific desk noted that the Australian economy grew last quarter at its fastest pace in more than three years, with the Australian Securities Exchange hitting new highs on the back of revenue expectations and merger activity. Australian employment increased four times as much as expected, worsening a labour shortage that might force the central banks to raise interest rates to ward off inflation. However, Australia's central bank chief stated on 14 June that there was time to monitor inflation before deciding whether or not to raise interest rates. Financial markets took the comments as lessening the chance of a rise in interest rates in the next few months, sending the dollar lower while bonds rallied.

Mergers and acquisitions on mainland China surged in the first half of 2007, making it the busiest start on record. The mainland's industrial output rebounded last month, growing 18.1 per cent year-on-year and strengthening the case for further economic tightening measures. However, more than 350 mainland companies saw their stocks drop by their 10 per cent daily limits on 25 May as worries about government triggered a dive in the mainland stock markets. Power-generation companies and property developers led the decline. Mainland stock markets hit a two-week low on 25 June after comments from the country's central bank chief fuelled fears about more interest-rate increases. With these comments coming on the back of China's Premier Wen Jiabao's indication that the government would make further efforts to cool the fastest-growing economy, foreign investors have become more bearish about the mainland A share market and are switching into Hong Kong-listed H shares for lower valuation.

The Hong Kong market, driven increasingly by the Chinese domestic market, increased dramatically, but volatility remained as central government considered measures to cool the economy. The mainland's trade surplus last month was up 73 per cent (USD22.45 billion) from a year earlier, a rise analysts described as astonishing and certain to increase the political pressure on Beijing. The Hong Kong stock market breached the 21,000-point level for the first time on 15 June, as laggard stocks, which are looking cheaper than their mainland equivalents, induced strong buying interest.

Japanese retail sales unexpectedly rose last month, signalling a slight recovery in personal consumption, while Japanese

core consumer prices fell slightly for a fourth consecutive month in June. The corporate-goods price index, which tracks trends in wholesale prices, rose 2.2 per cent from a year earlier. It was the thirty-ninth consecutive month of annual gains and the index hit 102.8 last month, the highest level since January 2000. The market data bolstered expectations for the Bank of Japan to raise interest rates as early as August.

The New Zealand dollar sat just above 75 cents on 12 June, as investors absorbed the Reserve Bank of New Zealand's unprecedented intervention on 11 June, which sent the currency tumbling about two per cent. The central bank said that it sold the currency, for the first time since it was floated in 1985 because the currency was at unjustifiable and exceptional levels.

The Taiwan share market rose 1.43 per cent on 25 June, pushing the benchmark to a new seven-year high, as liquidity-driven interest helped the market recover from a moderate decline during the special trading session on Saturday. The Taiwan dollar hit a five-month high yesterday after the central bank raised interest rates by a more-than-expected 25 bps. The move was aimed to discourage capital outflows.

Thailand's consumer confidence fell last month to the lowest level in five years as a court banned the nation's most popular political party and terrorist attacks worsened in its southern provinces. An index of consumer confidence dropped to 71.4 from 72.1 in April

## Australia

Balances in Australia were slightly down 0.05 per cent, with a combination of record date-depressing positions, while mergers and acquisitions increased borrows

### Tight Stocks

- GEODYNAMICS (SEDOL 6546218)
- QUEENSLAND COTTON (SEDOL 6714112)
- COPPERCO LIMITED (SEDOL 6151441)
- BOULDER STEEL (SEDOL 6110572)
- PROGEN INDUSTRIES LIMITED (SEDOL 6701437)

## Hong Kong

Balances in Hong Kong were slightly down 1.35 per cent as volatility increased, especially with H shares.

### Tight Stocks

- DYNASTY FINE WINES (SEDOL B05M185)

- CHINA EAST AIRLINE (SEDOL 6171375)
- GEELY AUTOMOBILE (SEDOL 6531827)
- MIRABELL INT (SEDOL 6581833)
- CHINA MINING RESOURCES GROUP (SEDOL 6369705)

## Japan

Balances in Japan were up 14.72 per cent month-on-month.

### Tight Stocks

- PRIVEE INVESTMENT (SEDOL 6673547)
- TOBISHIMA CORP (SEDOL 6893000)
- TOKYU CONST NPV (SEDOL 6689351)
- TOKYO KIKAI SEISAK (SEDOL 6895039)
- NIWS CO HQ LTD (SEDOL 6513784)

## New Zealand

Balances in New Zealand were down 25.06 per cent, as the tax season and financial year ended.

### Tight Stocks

- MEDIAWORKS NZ LTD (SEDOL B021MH1)
- TOWER LTD (SEDOL 6174299)
- MAINFREIGHT LTD (SEDOL 6603038)
- CONTACT ENERGY (SEDOL 6152529)
- FISHER and PAYKEL AP (SEDOL 6421791)

## Taiwan

Balances in Taiwan were up a modest 4.71 per cent month-on-month.

### Tight Stocks

- ASIA OPTICAL CO IN (SEDOL 6295866)
- PHOENIX PRECISION (SEDOL 6353957)
- SHIN KONG FINL HLD (SEDOL 6452586)
- SYNTEX TECH INTL (SEDOL 6868439)
- MERRY ELECTRONICS (SEDOL 6129749)

## Thailand

Balances in Thailand were up 359.14 per cent, as stock-lending markets stabilised after the impact of T+4 buy-in change.

### Tight Stocks

- BANGKOK DUSIT MEDI (SEDOL B013SQ9)
- AMATA CORP (SEDOL 6592943)
- LAND & HOUSES (SEDOL 6581930)
- THORESEN THAI AGEN (SEDOL 6561879)
- TISCO BANK (SEDOL 6365101)

<sup>11</sup> Bloomberg L.P., 12 June 2007.

# Client solutions update

During the first half of 2007, Citi held a series of securities finance roundtable events in Dublin, Milan and Amsterdam, with two more planned for autumn in Edinburgh and Stockholm. Industry experts and market participants discussed the future challenges and opportunities in the securities finance market. Presentations and discussions covered a range of topics, including:

## International Equities

- What drives demand?
- Emerging-Markets
- Way to market

## Fixed Income and Cash Reinvestment

- How has the landscape changed?
- Funding requirements
- Collateral flexibility

## Regulatory Changes

- MiFID
- BASEL II
- UCITS
- Pension funds

## Securities Finance Market Update

- Technology
- New markets
- Benchmarking

## Local Market Infrastructure

- Liquidity in the Italian market

Over sixty clients have participated in the sessions so far this year. Feedback from attendees has shown that the roundtable discussions are seen as a valuable tool for keeping abreast of the securities finance market, as well as providing the opportunity to network with other market participants.

If you would like to attend a securities finance roundtable event in your market, please contact one of the Citi representatives listed at the back of this newsletter.

## European equities

Overall balances fell by 3.00 per cent for June due to term trades unwinding.

### London Houses Top 14 European Hedge Funds<sup>12</sup>.

London is the preferred location by a long way for big European hedge funds. It is home to the continent's top 14 funds and 38 of the top 50, according to a survey by Alpha magazine.

The ranking of Europe's 50 biggest funds found that 85 per cent of the USD300 billion assets of the top 50 are held by funds based in London or with London-based owners, with the top 14 alone holding half the assets.

The biggest managers of single-strategy hedge funds were: Barclays Global Investors, with USD18.9 billion; Man Investments, with USD18.8 billion; and GLG Partners, with USD15.8 billion. The biggest non-British fund was ADI Gestion, in Paris, with USD7.2 billion, which climbed from 50th to 15th place in a year.

### European Shares Post Fourth Straight Quarterly Profit Gain On Growth, Dividends<sup>13</sup>.

European stock rose in June and posted a fourth straight quarterly advance, after reports in the US signalled the world's biggest economy will keep growing without stoking inflation. Oil companies rallied as crude prices rose to a 10-month high. Vodafone Group Plc paced gains by phone companies as investors bought shares that paid the highest dividends. The pan-European Dow Jones Stock 600 Index

added 0.3 per cent this week, taking quarterly gain to 5.2 per cent. The Dow Jones Stock 50 rose 0.6 per cent for the week, and the Euro Stock 50, a measure for the 13 countries using the euro, gained 0.2 per cent.

### Active Stocks

#### Relative Value and Merger-and-Acquisition News

- Cap Gemini (CAP FP)
- Banco Popolare Di Verona (BPVN IM)
- Iberdrola (IBE SM)
- Banco Popolare (IBE SM)
- Mapfre (MAP SM)

#### Directional & Convertible Bond News

- Altana (ALT GR)
- Qiagen (QIA GR)
- Tiscali (TIS IM)
- Conergy (CGY GR)
- Premier (PRE GR)
- Option (OPTI BB)
- Zardoya Otis (ZOT SM)
- Gaz De France (GAZ FP)
- Metrovacesa SA (MVC SM)

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

<sup>12</sup> ISF Magazine, June 2007.

<sup>13</sup> Bloomberg 30 June 2007.

## European money markets

As widely expected, the European Central Bank (ECB) voted to increase interest rates to four per cent at the beginning of June. Since then, the tri-party levels have remained at around the 4.03 per cent level, with a modest reduction near month-end as we approached the end of the most recent reserve period. This pressure, combined with several major US counterparties experiencing their half-year end, caused tri-party re-investment levels to dip as we approached the final few days of June.

ECB markets remained solid throughout, with a good supply of new paper over the month. Once again, returns on both one- and three-month commercial paper far outperformed tri-party returns, particularly in asset-backed and extendible issues.

The ECB meet once again early in July, and the market consensus is for no change. With no meeting scheduled for August due to the summer break, most market signals point to a further hike at the September gathering. Accordingly, we are seeing marked additional value in three-month paper over both one- and two-month issues.

# European government bonds

European government GC flows slowed down in June as the European equity dividend season finally drew to a close with just French and Italian equities paying through the month. Spanish equities also paid through June and will continue into July. However, these trades tend to be on a name-by-name basis rather than the large-basket activity witnessed in other European markets; hence the drop in demand for European government GC.

Several special issues dominated activity in the gilt market toward the early part of June, most notably the UK Treasury (GB0030468747) 5.00 per cent due 3 July

2012, which moved to a spread of 150 bps over GC. Meanwhile, UK Treasury (GB00BOV3WX43) 4.00 per cent due 7 September 2016, and UK Treasury (GB0032785924) 5.00 per cent due 7 March 2008 and 4.00 per cent due 7 March 2009 all remained well above GC through the month.

Towards the end of June, there was speculation that UKT (GB0008931148) 8.75 per cent due 25 August 2017 was getting squeezed into the settlement of the June ten-year gilt futures contract in which it was the cheapest to deliver issue. However, this did not materialise and the bond remained at GC.

STG LIBOR rates responded to dovish tones from various Bank of England Monetary Policy Committee members with one-month LIBOR almost fully pricing in a 50 bp hike for July's meeting by the end of June. However, with a few signals now emerging, which could indicate a slight cooling of the economy, it appears the Bank of England's succession of rate hikes over the last 12 months is starting to take effect and therefore making a 25 bp hike more likely. The STG cash market continues to yield good cash-reinvestment opportunities for our open book.

For further information, please contact your Citigroup representative.

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## Global Transaction Services

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