

Securities Finance Market Monitor

Issue 24, for the Quarter Ending April 30, 2004

Money Markets Recap

Employment data surprises market watchers

The trend of early month benign employment reports followed by a significant market rally came to a screeching halt in April with the release of a very strong Bureau of Labor Statistics report. The release of the news that 308,000 jobs were created in the U.S. economy during March sent fixed income markets into a steep nosedive. The 2 year note yield immediately shot up 25 basis points and then just kept going, eventually rising well above the 2.00% level and ending the month at about 2.30%. It was much the same across the yield curve although the longer end did not rise as steeply. Much of the selling of the shorter end was part of curve flattening trades, and the 2 year note was sold so hard that it became a 0.00% special in the repo market as dealers scurried to borrow the issue.

Now the question becomes what happens next. FRB Chairman Greenspan was on Capitol Hill for a couple of days of testimony and indicated that although inflation is likely to remain well contained, he saw signs that "pricing power" was returning to the economy and deflation was now a non-issue or concern. He went on to state that the Fed "will act, as necessary, to ensure the maintenance of price stability." Of course what he is referring to is higher interest rates, it is only a matter of when. Clearly there was a change in the conventional wisdom regarding this subject, some of it almost comedic. For example on April 6th the chief U.S. economist for Goldman Sachs forecast "no tightening well into 2005." On April 15th, after some further strong data releases, the same economist wrote "We see Fed tightening as a distinct possibility this summer..."

It seems clear that at the next meeting of the FOMC, something is going to have to give, and the market is clearly looking for an indication via the FED language. Many FED watchers believed that the FOMC could, in fact, increase rates by 25 basis points at the next meeting. The policymakers could continue to state that they can be "patient in removing its policy accommodation" and add something to the effect that they may find it appropriate to adjust the degree of accommodation from time to time, and to do just that by increasing the Federal Funds target rate by 25 basis points. This would indicate to the market that they are serious about not falling far behind the curve with regard to inflation and would give them some time before elections to bring the rates further towards neutral.

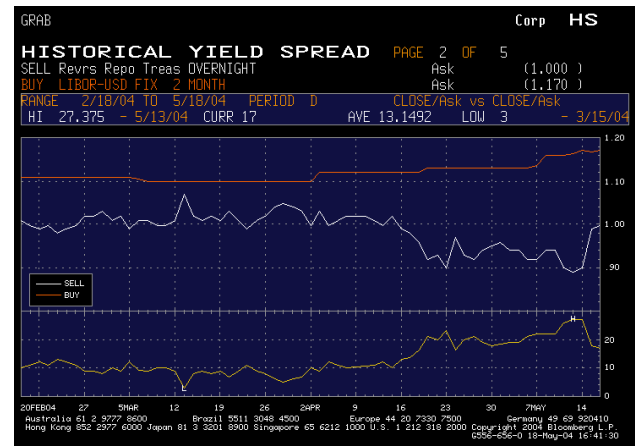
As a response to FED policy, our clients have maintained shorter durations for the management of their cash collateral reinvestment portfolios, in order to protect against a possible move to higher rates.

US Government Markets Commentary

US Treasury lending rises on economic news

US Government securities climbed, as expected due to seasonal demand created the market sell-off and by financing of tax receipts by the US Treasury and Money center banks. While this created some of the demand, the specials market really began to heat up as short dated US Treasury notes become the largest short trade in the market. One note in particular the 2yr. 1.50% 3/31/2006 CUSIP912828CD0 traded special for weeks at a 100bps fee, or zero rebate. The US Treasury market has remained vibrant as political and economic factors has kept debt issuance levels high, despite concerns that demand Asian central banks may decrease in the months ahead.

3-Month Libor vs. Overnight Reverse Repo



For charts above and below: Source: Bloomberg Citibank, N.A. April 2004.

US Equity/Bond Markets Commentary

A quiet start to the second quarter for Equities

As the equity markets continue to react to inflation fears, interest rate hikes, and continued global turmoil in the middle east, it does not appear that there will be any market rally the will add buoyancy to the lending markets.

Overall, on-loan balances for corporates and equities have not moved in any definite direction since the 4th quarter 2003. Mergers and acquisition activity has not grown as rapidly as was originally expected in the first quarter 2004. This may be a contributing factor in the overall flat utilization rates. Technology sector stocks and energy sector corporate bonds continue to represent 1 in 4 specials. Continued uncertainty about oil prices should keep energy sector bonds in demand by broker/dealers and hedge funds for the remainder of the second quarter.

Specials Lending Activity

Corporate Equity

Circuit City, whose lower expenses helped its earnings gain despite a lackluster sales rise, added 60 cents, or 5.6 percent, to \$11.30. It also announced a \$284 million purchase of a Canadian rival InterTan, as it looks to battle Best Buy, which also owns a Canadian electronics chain.

Shares of **Gillette Co.** fell more than 4 percent on mid-month on concerns that Chairman and Chief Executive James Kilts, the key driver behind the turnaround at the world's largest razor maker, will soon leave to take the top spot at Coca-Cola Co.

Kraft Foods Inc., the largest North American food company, announced first-quarter profit fell 33 percent, hurt by restructuring costs and higher marketing expenses. Kraft expects its earnings for the year to come in at the low end of a previously announced range of \$1.63 per share to \$1.70 per share. The forecast includes an impact of 30 cents per share from restructuring costs and asset impairment charges.

Non-US Equity

Storm Energy Ltd. reported it had agreed to be acquired by **Harvest Energy Trust** in a cash and debt deal worth C\$189 million. The companies said in a release that Harvest Energy, a trust fund listed on the Toronto Stock Exchange, will buy all of the outstanding shares of Calgary-based Storm for C\$189 million, including assumed debt worth C\$64 million.

Shinhan Financial offered to Buy shares of 18.9% stake of **Chohung Bank** it doesn't own. Shares traded as a result of this new with a 3% securities lending fee.

Westfield Trust - After yesterdays announcement of a merger between the Westfield's property trusts, the price surged 15% gaining 53cents creating directional interest with stock trading up to 1.5%fee.

Bayer Hypo (4325419) announced a capital increase (rights issue) , also at the same time they have announced a dividend will not be paid in 2004, this has prompted the domestic funds to start lending which has kept the loan fee level between 35 bps and 50 bps.

FYI - Basics of Commercial Paper

The characteristics of commercial paper vary from one country to the next, but some very general characteristics persist across markets. Typically, CP is a senior level unsecured short-term note. In the United States, CP maturities range between one and 270 days, averaging about 45 days. In other countries, the maturities often extend to 365 days and sometimes longer.

Commercial paper is an important, flexible source of short-term financing for the largest and most creditworthy

corporations worldwide, providing them with a low-cost alternative to bank loans. Within the parameters of a CP program, issuers are generally free to float new paper quickly and cheaply. The notes generally sell at a discount from par value and may be placed directly by issuers or, more frequently, indirectly through an intermediary.

Typically, large denominations and relaxed registration requirements (relative to the public bond markets) limit the appeal of CP to retail investors. Consequently, large sophisticated investors dominate the buy-side of the market. Major purchasers of commercial paper, including money market mutual funds, corporations, state and local governments, and commercial banks and their trust departments, generally hold funds as CP in anticipation of near-term outlays. As a rule, investors do not consider their CP holdings as risk capital.

Unlike corporate CP programs issued to finance inventories or manage cash flows, ABCP is issued by independent, bankruptcy-remote entities that invest in a wide variety of financial assets. These may consist of mortgages, credit card or other trade receivables, or other non-liquid assets. The notes are generally not matched to cash flows from the assets, and the issuer relies on issuing new notes or on third-party liquidity lines to repay maturing ABCP.

As with other structured finance transactions, a program administrator who is often the principal liquidity provider conducts management of ABCP programs. All ABCP programs are supported either fully or partially by one or more outside liquidity providers. Often the principal liquidity provider is a bank with experience in the direct funding of the assets that underlie the ABCP. The ABCP structure allows banks to move such funding operations off balance sheet and can provide significant cost saving as well.

More recently, banks have set up special purpose vehicles (SPV) with the sole purpose of providing liquidity to various ABCP programs.

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