

# Global Securities Finance Market Monitor

Issue 37, for the Month Ending May 31, 2005

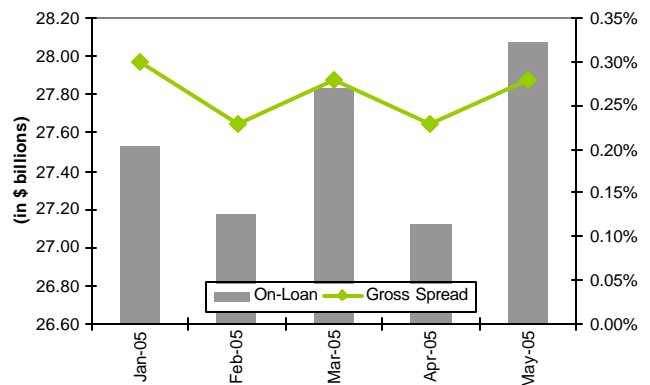
## >> Money Markets Recap

It came as no surprise when the Federal Open Market Committee raised the federal funds target rate by 25 basis points to 3.00% on May 3. While there was some hope for a change in the language that accompanied the rate hike, which may have indicated a willingness for the FOMC to forego future increases, the language remained pretty much intact. At the time, the federal funds futures market priced in about a 98% probability of a further 25 basis point hike when the committee next meets on June 30. It came as quite a surprise when on May 5, the Treasury Department announced the fact that they were considering reviving issuance of the 30 year bond. While the concept was not out of the mainstream, the timing was certainly surprising. The price of the 5.375% 02/15/31, which was the last long-bond issued, fell by over \$2 per \$100 on the news, resulting in an 11 basis point increase in yield. While the Treasury said only that they were considering its issuance, the market feels that a new 30 year bond will definitely be issued later this year. Between the rising deficits, the proposal to partially privatize Social Security, and the increasing demand by pensions for longer term assets, there is a lot of market support for a new long-bond, although with the expectation of only \$20-30 billion per year, it will be a drop in the bucket when compared to the overall bond market goes. A strong employment report at the end of the first week of May had the expected effect of a backup in short-end yields, with the 2 year note backing up over 20 basis points to reach the 3.75% level, but benign inflation reports which followed took all of the wind out of the sails of the bears and the yield dropped back close to the 3.55% level. While the July federal funds contract continued to fully price in the 25 basis point rate hike for June 30, the August contract reflected only a 76% probability that there would be an additional increase on August 9. In that regard, we are looking for investments which fully price in both increases in order to maximize value within the cash collateral investment portfolios.

## >> US Government Markets Commentary

As expected, the spread between the Federal Funds rate and the General Collateral U.S. Treasury Repo rate remained wide throughout the month of May. Typically the spread was between 8 and 10 basis points for the period. The greater than expected individual tax payments received in April allowed the Treasury to continue to retire maturing short term bills. Looking forward into June, we would expect

US Government: On-Loan Balance vs. Spread



these spreads to narrow in the first part of the month as the Treasury issues Cash Management bills of one and two week duration in order to fill the funding needs until the June 15th corporate tax payment.

The gross spread from a securities lending perspective is the difference between the investment rate and the rebate rate on loans. As observed in the graph, the gross spread increased from April as general collateral repo rates widened from the post-April 15th date.

On the specific issues front, the mid-month quarterly refunding brought about larger spreads (65-75 basis points) between the current 10-year note (912828DM9) and the general collateral rate. Additionally, the market speculation of a new 30-year issuance by the Treasury early next year, has given a repo bid to the existing 30-year bond (912810FP8). The issue has opened up to the 30 basis point range and bears watching in the months

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ahead. The most significant development in the specific issues market, however, was the large scale buying of two off the run 10-year notes, namely the 4.875% 2/15/12 and 4.375% 8/15/12. The former is the most deliverable against the 10-yr futures contract on June 30<sup>th</sup> and the later the cheapest to deliver against both the September and December contracts. As May came to a close, the 4.875% 2/15/12 was commanding spreads of 275 basis points!

## >> Equity/Bond Markets Commentary

### US Equity/Bond Markets

The downgrade of Ford Motor Corp. and General Motors Corp. corporate bonds had an immediate impact on the markets. The downgrade of GM bonds also meant that it would fall out of Lehman Brothers Holding Inc.'s benchmark investment-grade bond index, prompting some investors to sell. Towards the end of May, the University of Michigan's consumer sentiment index showed that confidence had fallen for the fifth straight month, the longest series in declines since 2002. The Dow Jones Industrial Average ended the month at 10467.48.

### International Equity/Bond Markets

Worries about European cooperation – namely the French rejection of the proposed European constitution – helped push the euro to \$1.2305 at month end, its lowest level against the dollar in almost eight months in late New York trading. European leaders must determine the most efficient path to manage the Euro despite the various member statuses and moreover signs of sinking confidence. In Germany, Europe's largest economy, the unemployment rate remained at 11.8% in May, while 10.2% in France. The dollar also hit a two-month low against the yen at 108.53.

### Domestic Specials

**Collins and Aikman Corp.** (CKCRQ), a maker of automotive interior systems, announced the departure of Chairman and Chief Executive David Stockman. Analysts consider that the downgrades of automakers GM and Ford had a direct impact on the company's foreseeable ability to generate net income.

**General Motors Corp.** (GMAC US), had its debt-rating cut to junk bond status by Fitch Ratings. It

downgraded the senior unsecured ratings of General Motors, GMAC and the majority of affiliated entities to BB+ from BBB-. The action reflects slowing NA sales of mid-size and large SUV products, increasing market volatility, and competition from foreign players Toyota and Honda.

### International Specials

**Lenovo Corp** (992 HK; 6218089 HK), the maker of personal computer products, received word that an e-mail circulated throughout Dell Inc., suggested that buying Lenovo's computers was a tacit endorsement of the Chinese government.

## >> FYI – Exclusive Lending Programs

The characteristics of commercial paper (CP) 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.

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