

Global Securities Finance Market Monitor

Issue 38, for the Month Ending June 30, 2005

>> Money Markets Recap

The market was fairly quiet for the month of June and continued to price in a June 30th, 25 basis point increase in the federal funds target rate. Neither the economic data releases nor any commentary given by FOMC members, including Chairman Greenspan, indicated anything but the fact that the pattern of 25 basis point short-term rate hikes would continue for at least the next few meeting periods. Fed fund futures contracts did not necessarily support this point of view. Although the August contract priced in the probability of the first hike at greater than 90%, the September contract indicated on average only a 22% probability of an additional 25 points on Sep. 20th. Some concern continued to be echoed about the housing market, and the potential for a catastrophic bursting of the "housing bubble". Much of the discussion centered around the fact that the banks continue to support the growth in the housing market by offering interest only, and other "exotic" types of loans, and that the proliferation of this type of lending could lead to significant problems in the future. Crude oil also continued to attract attention with a mid month breaching of the \$60 level creating a rather sharp 300 point sell off of the Dow Jones Industrial Average. The bond markets initially rallied in conjunction with the sell off in the equities market, but soon gave back ground to higher rates. We will continue to evaluate the market expectations against our views, and invest cash collateral only where we feel that we are being fairly rewarded against the most likely outcomes.

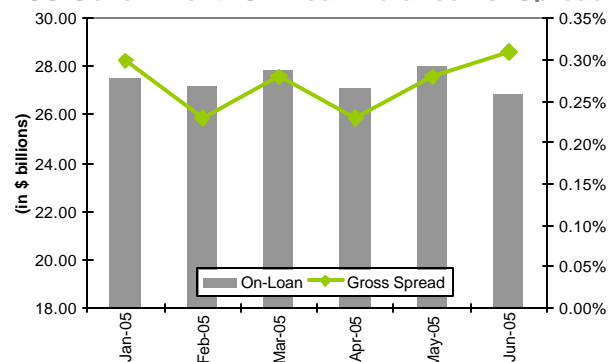
>> US Government Markets Commentary

The spread between the Fed Funds rate and the Repo Rate is a crucial part of the beneficial owners' securities lending revenue. For those lenders who choose to reinvest their lending cash collateral only in U.S. Treasuries, the spread has little impact on the revenues generated. In this case it is only the intrinsic value of the security on loan – typically quantified by the difference between the effective

Fed Funds rate and the rebate rate from lending – which provides revenue. However, for those accounts which permit investments based off the Fed funds rate (e.g. Time Deposits, Commercial Paper), the widening of this spread can greatly enhance both revenues and the portfolio utilization rate.

Historically, June marks the month when the Fed Funds to Repo spread narrows dramatically from the prior month highs. This is especially true in those periods where the U.S. budget deficits are large and growing. To be sure, the spread did narrow in the early part of the month to 2-3 basis points. However, from the midpoint of June the benchmark averaged nearly 8 basis points. The weekly U.S. T-bill auctions continued to provide no net new issuance, reflecting a better Treasury cash flow and signifying a change in the underlying U.S. internal deficit. Moreover, the 8 basis point spread was also carried by the quarter-end effect where U.S. government securities become particularly attractive from a securities lending perspective.

US Government: On-Loan Balance vs. Spread



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 May as general collateral repo rates widened from the quarter-end effects as the June trends took effect.

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The issue which was most in demand during June was the 4.875% 2/15/12 (9128277L0). As has been previously mentioned in this report, this issue is the most deliverable against the June futures contract. During the month spreads in excess of 280 basis points were common. Going forward, we expect this issue to trade only a few basis points below the repo rate. In another development, "short" coupons seemed to be catching a bid in the lending market as the spreads on these issues to other instruments widened. Unfortunately, the issuance of these securities was too large to thwart any attempts to gain larger spreads.

>> Equity/Bond Markets Commentary

US Equity/Bond Markets

The Dow Jones Industrial Average ended the month at 10274.97, down 1.8% from the previous month. Month end S&P 500 Index remained at the same level as beginning of the month. Oil price hit a 22-year high of \$60.54 per barrel hindering the stock markets. But the small-cap stocks performed well, soaring 3.86% in June.

International Equity/Bond Markets

The international equity markets, on the contrary to the US markets, were doing pretty well in June. Major European markets went up, led by FTSE which was up 3% from end of May level. DAX (up 2.8%) and SMI (up 2.0%) followed the same trend. Asian Pacific markets also finished the month high, Nikki moved up 2.7% while Hang Seng ended June 2.4% higher than May.

Domestic Specials

Novastar Financial Inc. (NFI), a specialty finance company that originates, purchases, invests in, and services residential nonconforming loans in the United States. Directional short trade in June.

Netflix Inc. (NFLX), operates as an online movie rental subscription service provider in the United States. Directional short trade in June.

International Specials

Versatel (Netherlands, 5731532) Continued demand throughout the month of June due to re-hedging positions for the convertible bond, as well as interest from the event driven funds on a possible takeover offer from Belgacom.

Unipol (Italy, 5107832) Demand increased as the story of their potential bid for BNL (5528604) came into focus.

Karstadt (Germany, 5786565) Heavy directional interest in June.

>> FYI – Lending Terms

Two terms that a participant in the government lending or reverse market will frequently hear are "specials" and "general collateral."

"Specials" are securities that have come into unusual demand in the repo or lending market. A security may come into demand when several dealers begin to short the issue, i.e. sell more of the issue than they own and must deliver by borrowing with the expectation of being able to buy it outright at a later time when the price has fallen. A security may also become "special" because borrowers need the issue to better their obligation to deliver a specific issue on a certain date under futures contracts. The use of certain issues in hedging derivative securities also creates demand.

"General collateral" includes any security that is not special. A dealer is willing to accept general collateral on a repo as long as the collateral consists of government securities, whichever particular government securities are delivered is irrelevant.

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