

Global Securities Finance *Market Monitor*

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>> Money Markets Recap

September 2005 was certainly the most interesting month that the short-term fixed income markets had experienced in quite some time. The rally across the yield curve that took place during the last few days of August, which had been in reaction to the possible effects of hurricane Katrina on the U.S. economy, came to an abrupt end in the first few days of September, and then reversed itself quite severely. The market quickly took on the view that the storm would not be a major drag on economic growth, but that the potential disruption of energy supplies from the region might create additional pressure on inflation. The yield on the 2 year UST note, which had spiked down 30 basis points during the last 3 days of August to a yield of about 3.70%, began a dramatic rise, and ended the month at almost 4.35%. The federal funds futures contracts, which had gone from pricing in a 100% probability of a rate hike at the September 20th FOMC meeting to a 50% probability during the last couple of days of August, reversed itself, and by mid month the 100% probability was back. The volatility was opportunistic for the lending program, in that we found value in the term lending market during the rally and remained cautious on the investment side.

>> Euroland Update

Euro-area data confirmed indications that business sentiment has been little affected (at least so far) by higher oil prices in Q3. Consumers remain downbeat. The flash estimate of euro-area HICP inflation showed an increase to 2.5% YY in September, from 2.2% in August. This was a bit less than was feared after poor German and Spanish data, but still slightly above consensus, and the highest inflation rate in 16 months. While no split of the flash estimate is available, oil prices probably were key to the acceleration in the headline rate. Against this backdrop, the ECB probably will continue to suggest that the next rate move will be up but will show no urgency to act soon. The market view is that the ECB will tolerate above-target headline inflation, as long as the recovery is not secured and underlying price pressure are contained but will start the tightening cycle in the first half of next year.

>> United Kingdom Market Update

This week's data showed that many of the main themes in the interest rate debate: consumer confidence is weak, the labor market has loosened, household savings rates are rising - but rising petrol prices and rising headline inflation also are lifting household expectations from the record low seen early this year. In the market view, the current level of inflation expectations will not stop the MPC cutting rates at some stage in coming months. In both 2001 and 2003, household inflation expectations also briefly rose as base rates fell. On those occasions, the increases in inflation expectations were temporary and in any case did not prevent the MPC cutting again. Many suspect that the same will happen this time - and indeed, the latest reading on household inflation expectations is lower than those seen when the MPC started to cut rates in 2001 and 2003. Real economic growth is weaker now as well, and unemployment rising more sharply. Nevertheless, the BoE Governor has stated his anxiety over the risk that high headline CPI will create a lasting rise in household inflation expectations. Moreover, the next round of CPI data (for September) will probably show a further rise in inflation. This rise in inflation expectations may be used as an argument against a rate cut in November, making it a very close call as to whether the next rate cut is in November or Q1.

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