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Welcome

It's a new year and, like the newly elected President Obama's theme for his administration, it is unquestionably the beginning of an era of change in the political arena, financial industry and world economy. In almost every aspect of our professional life, we will be faced with new challenges that will require us to examine, validate and, in some cases, restructure how we conduct our business.

Recently, I attended IMN's 15th Annual Beneficial Owners International Securities Lending and Repo Summit held in Scottsdale, Arizona. I was pleased to see the tremendous turnout by the beneficial owner global community. The key focus and message from beneficial owners around the world was that of "opportunity" and "risk mitigation". In 2008, the market turmoil and unprecedented market events caused beneficial owners to review their existing securities lending programmes. The question confronting many lenders now is: how should a lender continue to participate in a securities lending programme in order to take advantage of the securities lending revenue opportunities in a changing environment? The response I have heard from many beneficial owners is simple: let's get back to basics, re-educate, understand the risks and risk mitigants in lending, and participate in a securities lending programme that can respond quickly to changes in market conditions.

At Citi, our customised, flexible approach allows our lending clients to design securities lending programmes that are totally transparent to them and meets their programme objectives. While maximising yield is important, our priority is to help our lenders preserve principal while maintaining liquidity, and we are committed to working with our clients to help them find their appropriate risk-reward balance. Citi's global footprint with a network of branches in over 100 markets is the cornerstone of our securities lending programme that allows us to react quickly to legal and regulatory developments around the world.

Citi remains committed to lenders around the globe and endeavours to provide securities lending solutions designed to address your securities lending requirements.

US equities¹

News

After posting one of the worst yearly declines in US stock market history, the New Year started off with one of the worst January performances in recent history. The Standard and Poor's (S&P) and the Dow were both down over 8.50 per cent on the month. Mid-month, stocks rebounded from a two-month low, led by financials, on the speculation that a plan from President Obama would shore up banks. Economically

sensitive industrial and consumer stocks continued to drag on the market following more rounds of tepid profit announcements.

Active stocks

- Carmax (KMX)
- Dillards (DDS)
- Fortress (FIG)
- Ford (F)
- Under Armour (UA)

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

¹ www.bloomberg.com, Wall Street Journal (WSJ) and Dow Jones Newswires accessed on/consulted 20 and 21 January 2009 and 1 February 2009.

US cash and money markets²

The outlook for growth in the US economy continued a dismal trend in January with an early release from the Bureau of Labor Statistics indicating that 524,000 more non-farm jobs were lost during December.

Manufacturing and housing data for December were equally grim. Conditions in the short-term fixed-income market showed some signs of improvement, with

the 3-month LIBOR rate falling sharply in the first half of January from above 1.40 to below 1.10 per cent.

Front-end liquidity pushed the 1 month LIBOR rate down about 8 basis points (bps) to 0.33 per cent in mid month, but the improvement was given back by month-end as the credit story around the large global banks continued to deteriorate.

Issuance of TLGP paper in the 2- and 3-year maturity range continued to expand, with a total issuance at month-end of about USD175 billion. On 7 January, the FRB NY announced changes to the Money Market Investor Funding Facility (MMIFF). One of the important changes was the expansion of eligibility to participate in the facility. Since its inception on 24 November 2008, the

facility has served as a source of liquidity only for Money Market Funds that complied with S.E.C rule 2a-7, by providing funding to certain special-purpose vehicles that would then use the money to purchase highly rated short-term instruments from the eligible funds.

The eligibility was expanded to include US-based securities lending cash collateral investment funds, separately managed portfolios and accounts (securities lenders),

as well as other types of investors who operated similarly to money-market mutual funds. It should be noted that in the seven weeks of operation before the expansion, the USD600 billion facility had never been utilised and, despite the expansion of eligible participants, there continues to be USD0 of utilisation of the liquidity provided by this facility.

The primary reason that the MMIFF remains untapped is that the improved market

conditions have resulted in ample short-term liquidity in the restrictive number of issuers associated with the programme. In addition, execution of transactions under this facility is a bit more complex than most of the other liquidity facilities implemented by the various governmental entities.

² www.bloomberg.com, accessed on 3 February 2009.

US corporate bonds³

Current news

Towards the end of the month, sales of high-yield bonds surged to USD1.83 billion, the biggest weekly total since July, as companies took advantage of a six-week market rally to refinance debt.

The high-yield market showed signs of life after the worst year for issuance in

at least a decade. Corporate bond sales this year total USD135.7 billion, compared with USD99.4 billion during the same period of 2008.

Issues in demand

- Brookstone (CUSIP 114535AB3)
- Mohegan Tribal Gaming (CUSIP 608328AP5)

- Yankee Acquisition (CUSIP 984756AD8)
- Six Flags (CUSIP 83001PAF6)
- Blockbuster (CUSIP 093679AC2)

³ www.bloomberg.com, accessed on 23 and 31 January 2009.

US Treasury and agency

The US government continues its mission of increasing the supply of treasury securities. The treasury is planning to reintroduce the 7-year note for the first time since 1993. The 7-year will be a monthly issue similar to the 2- and the 5-year. The size of the issue has yet to be announced.

As the supply of new treasury issuance continues to increase, the spread between general collateral (GC) and Fed funds continues to decrease. The combination of an extremely low Fed funds target and increased treasury supply has created an

inverted spread between the Fed funds open rate and overnight treasury GC financing.

The repo market continues to be nearly devoid of "specials". The 5-year note was the only treasury with scarcity value. The issue traded with a negative rebate throughout most of the January. Some treasury bills traded close to 0 per cent; however, most all the other treasury and agency issues traded at or close to GC. It seems as though the liquidity facilities provided by the Federal Reserve have given the repo market a sense of calm.

The flight-to-quality trade seems to have levelled off, delivery "fails" have continued to improve, Fed funds continue to open at the high-end of the range and fears of another Bear Stearns or Lehman occurrence appear to have mostly been quelled.

The Federal Open Market Committee (FOMC) decided to keep the Fed funds "range" of 0.25 per cent to 0.00 per cent, unchanged during the 28 January meeting. The next meeting is on 17 March. The futures are not pricing in a significant percentage of a move away from the current range.

Asia-Pacific equities

Global recession asserts significant negative impact on Asian economies and markets, the rapid cooling Asian economies and negative surprises of production and export data have escalated recession concerns around the region. Economies with larger domestic markets and greater policy flexibility, such as China and India, are still performing relatively better.

China

Economic weakness continued to intensify in China, as recession deepened in neighbouring emerging economies as

well as far-flung developed markets. But aggressive monetary easing is producing some results in broad liquidity, and the eventual end of severe destocking offers some hopes for a near-term production rebound. But the destocking process may have run its course in some areas, such as raw materials. Though demand is unlikely to stage a durable recovery any time soon, production could still stabilise once firms are back to just-in-time inventories, even in the absence of restocking. Government officials have recently made comments

to this effect. Aggressive cuts in policy interest rates and reserve requirements, coupled with easier lending rules, have resulted in a surge in liquidity and credit growth.

India

Despite India being largely a domestic-oriented economy with domestic savings playing a key role in financing its growth story, the dramatic change in the macro-environment has taken its toll on the economy. The synchronised global recession is likely to have repercussions for exports, investments and consumption, due to the knock-on effects on IT and real estate.

Singapore

The current recession was largely led by manufacturing, while services had held up relatively well in the past six months as manufacturing declined. A large part of the services slowdown is related to the lagged slowdown in the regional economies. The importance of Malaysia and Indonesia in support of Singapore's transport, logistics and wholesale trade sector should not be underestimated. The one sector of the economy that still appears to be holding up relatively well is construction. However, the recession is already causing a sharp fall in private sector demand, measured through contracts awarded, though this slack in private sector demand is being taken up by the public sector.

Hong Kong

Retail sales data improved in the recent figures as shoppers take advantages of the discount sales and tourist arrivals recover during the Christmas and Chinese New Year holidays. However, recession worries will likely keep consumers and homebuyers cautious in spending and home-purchase decisions. Due to a strong Hong Kong dollar, the Hong Kong Monetary Authority (HKMA) can cut the policy rate and pump liquidity into banks to push down interbank rates. The lower cost of funds should enable banks to keep the prime rate at a record low of 5 per cent.

Korea

The Bank Of Korea (BOK) cut policy rates to 2.50 per cent in January, and is expected to end its easing cycle at around 2.00 per cent.

BOK's cautious stance now suggests that unconventional policy actions such as a zero-interest-rate policy or quantitative easing are not likely in Korea. The government increased the size of fiscal stimulus packages from W33 trillion to W35.6 trillion upon finalising its 2009 budget.

Taiwan

The economy appeared to be entering a serious recession as all components declined sharply. The legislators have passed the 2009 budget with expenditure increasing 5.70 per cent and revenues up just 0.30 per cent, resulting in a budget deficit of TWD157.5 billion. The legislator also passed a special budget of TWD500 billion to spend in four years. The Central Bank of China cut rates by 50 bps in January to bring the discount rate to 1.50 per cent.

European equities

Overall balance was down by 13 per cent since December. This is due to market conditions and falling market prices.

News

The ban on short selling in UK Financial companies expired on Friday 16 January 2009. The amended provisions governing the short-selling disclosure obligation take effect at the same time. The amended disclosure obligation is set to expire on 30 June 2009. The reporting obligations under the suspicious transaction-reporting regime remain unchanged, but these evidential provisions describe a behavior that, in the opinion of the FSA, constitutes market abuse.

Chancellor of the Exchequer Alistair Darling suggested he may have to scale back predictions of economic recovery later this year, acknowledging that Britain's recession is deeper than expected. "We did expect there to be a significant downturn in this last period and indeed we have seen that," Darling said in London today. "It is undoubtedly sharper than many people believed, partly because you have seen industrial production go down because of exports."

The economy contracted at its fastest pace since 1980 in the fourth quarter, pushing the UK into recession. The pound dropped to a 23-year low against the dollar, and stocks touched a two-month low. Darling predicted in November that the economy would begin to recover in the second half of this year. Darling and Prime Minister Gordon

Brown said they were working to revive the economy and that the elements for recovery are already in place. The comments were aimed at reassuring investors and voters, who appear to be switching their support to David Cameron's Conservative Party. "We're fighting this recession with every weapon at our disposal," Brown said on BBC Radio 4 today. "We are building the foundation stones of a recovery plan."⁴

European stocks climbed for a second week, as speculation that government stimulus packages and interest-rate cuts would revive the global economy overshadowed concern that earnings would deteriorate.

European Aeronautic, Defence and Space Company led gains among companies that got more than 20 per cent of sales from North America.

Volkswagen AG jumped 9.60 per cent after Porsche SE boosted its stake in Europe's largest carmaker.

Next Plc, the UK's second-biggest clothes retailer, advanced 8.00 per cent after maintaining its full-year profit forecast.

The Dow Jones Stoxx 600 Index added 1.60 per cent to 207.82, completing the first back-to-back weekly gains since July. The gauge has rebounded 14.00 per cent since 21 November on speculation that then US President-elect Barack Obama would revive the world's biggest economy with USD775 billion of tax cuts and spending, while

policy makers lowered interest rates to combat the biggest financial crisis since the Great Depression. "It's a classic January rally," said Jacques Porta, a fund manager at Ofi Patrimoine in Paris, which oversees about USD615 million. "There's a lot of cash in the market. Risk aversion has diminished. We've had a big confidence crisis. The new president will restore confidence."⁵

Active stocks

Event-driven names

- Xstrata (XTA LN)
- Cookson (CKSN LN)
- Workspace Group (WKP LN)
- Wolseley (WOS LN)
- Barclays (BARC LN)
- CIE Generale (GA FP)
- Volkswagen (VOW GR)
- Hypo Real Estate (HRX GY)
- Wavecome (AVM FP)
- Swedbank (SWEDA SS)
- ASM Intl (ASM NA)
- EDF (EDF FP)

Directional names

- Rolls Royce (RR/ LN)
- Hermes (RMS FP)
- Q Cell (QCE GR)
- Bang and Olufsen (BOB DC)

⁴ www.bloomberg.com, accessed on 23 January 2009.

⁵ www.bloomberg.com, accessed on 10 January 2009.

European government bonds⁶

While European government GC balances remained stable through January, we continue to see pressure on levels as broker-dealer balance-sheet restrictions require them to focus on haircuts and the collateral they pledge against their loans. Several competitors have removed their haircut requirements in an attempt to maintain cash balances for their funds, and others have reopened more diverse triparty sets. Opportunities in the fixed-income lending market have become polarised as the demand for GC against high-grade collateral (govt GC) has almost entirely dissipated, while any kind of collateral

upgrade (for the borrower) has become even more highly sought after.

Members of the Monetary Policy Committee (MPC) agreed to cut interest rates by a further 50 bps in January, bringing the base rate to an historic low of 1.50 per cent. They are widely expected to cut rates by an additional 50 bps in February, which is reflected in current term bids for GC.

The STG market still offers good spread opportunities with the 3-month Sterling Overnight Inter-bank Average Rate (SONIA) at around 0.70 per cent, while LIBOR remains relatively high at 2.11 per cent.

These two levels typically indicate where borrowers will bid for GC and where issuers offer interest on borrowed cash.

With regards to non-cash activity, we have seen an increase in demand to pledge the Bank of England's weekly bill as collateral against regular gilts. Whilst there is little incremental spread, the trade does offer value as non-cash GC loan positions remain under pressure. Just the UKT 5 09/07/14 (GB0031829509) traded at special levels through January, moving to around 25 bps for a short period.

⁶ www.bloomberg.com, accessed on 6 February 2009.

European money markets⁷

Economic data continues to highlight the plight of the Eurozone economy. Unemployment has risen to 8.00 per cent and both consumer and industrial confidence have fallen to their lowest levels on record, as the region faces its worst recession since World War II.

The inflation rate continues to fall, easing the way for the European Central Bank to cut rates a further 50 bps at its January meeting. The market anticipates further cuts, although a pause is expected at the February meeting.

Individual member countries have continued to announce measures to support their banks and unlock lending, both interbank and to the wider economy. The Euro Interbank Offered Rate has fallen to its lowest level since May 2006.

⁷ www.bloomberg.com, accessed on 4 February 2009.

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