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## Welcome

The default of Lehman was almost six months ago and the markets continue to be volatile. Despite the volatility, there are still opportunities for lenders in the fixed income space, especially as spreads continue to be wide.

Throughout this market turmoil, it has been very important to work with clients to address their concerns and provide information to support their decisions. This, I believe, is where Citi's approach to agency lending has proved very beneficial. The client's ability to individually select their cash collateral programme enables lenders to alter their programme at any time to suit their current investment strategy.

There are a number of industry developments attempting to define a risk/reward ratio to enable participants to compare returns against a calculated risk formula. These initiatives are gaining more ground as lenders seek to have a more mathematical approach to the risks involved in their lending programmes. I expect that there will be more on this subject in the coming months, but in the mean time please do not hesitate to talk to your Citi representative if you have questions about this or any other securities finance-related subject.

## US equities

### News<sup>1</sup>

Wall Street ended yet another unforgiving month with a steep loss. The Dow lost 11.7 per cent in February, which was its worst monthly loss since 1933, when it fell 15.6 per cent, and its sixth straight monthly drop. The Dow, at its lowest point since 1 May 1997, is down more than 50 per cent from its record high of 14,164 reached in October of 2007. The Standard and Poor's (S&P) 500 index fell 11 per cent for the month. It was the second-worst February for the index, topped

only by an 18.4 per cent decline in 1933. The S&P 500 Index broke its November 21 trading low of 741, which happened during the peak of the credit crisis. It finished the month at its lowest level since 18 December 1996.

### Active stocks

- Amrep (AXR)
- Cabela's (CAB)
- HNI Corp (HNI)
- Overstock (OSTK)

- Valence (VLNC)

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

<sup>1</sup> www.bloomberg.com, accessed on 27 February 2009.

## US cash and money markets<sup>2</sup>

Short-term interest rates inched higher across the money-market yield curve during February as bank credit continued to experience a significant amount of stress.

The one-month Libor rate increased about 9 basis points (bps) and the one-year Libor rate increased by about 15 bps. Repo rates moved up as well, though by a lesser degree.

Under normal circumstances, an increase in rates might be a signal of higher policy rates in the near future. However, there is

no consensus that a higher federal funds target rate is anywhere in the offing.

Managing cash collateral investments continues to be about identifying relative value. As a result of the massive amount of liquidity added to the system by the Federal Reserve and foreign central banks, and the reluctance for banks to extend maturities on inter-bank lending, the money-market yield curve has remained relatively steep and offers compelling value beyond three-month maturities.

Swap spreads continue to tighten; however, US Agency and TLGP floaters in the one- to two-year maturity range also offer compelling returns when compared to the historic funding costs for highly liquid lendable assets.

<sup>2</sup> www.bloomberg.com, accessed on 5 March 2009.

## US corporate bonds<sup>3</sup>

### Current news

Just as investors were gaining confidence in the credit-market recovery, corporate bonds fell last month for the first time since October as the US recession deepened. While markets improved since the collapse of Lehman Brothers Holdings Inc. in September, yields on corporate bonds relative to government

rates were widening at the fastest pace since November and are still almost five times what they were before the credit crisis began in July 2007. Late in the month, Federal Reserve Chairman Ben Bernanke told lawmakers that a thaw in credit is critical to an economic recovery in 2010.

### Issues in demand

- GS Mortgage (CUSIP 36246LAE1)
- MGM Mirage (CUSIP 552953BD2)
- NTK Holdings (CUSIP 62941EAB7)
- Freescale (CUSIP 35687MAP2)
- Ply Gem Industries (CUSIP 729416AG2)

<sup>3</sup> www.bloomberg.com, accessed on 3 March 2009.

## US Treasury and agency

The supply of US Treasury notes continues to increase. As supply increases, spreads are decreasing.

A positive aspect of the increase in treasury supply is the fail-to-deliver dilemma, which, at one time plaguing the repo market, has greatly diminished.

A negative aspect of the increased supply is that nearly all US Treasury issues trade at or close to the general collateral (GC) level. Moreover, GC is trading above the high end of the Fed funds target range of 0.25 per

cent to 0.00 per cent. Treasury GC averaged 0.32 per cent throughout February.

Prior to this current surge of supply, there were occasional spot days when Treasury GC would trade above Fed funds such as quarter-end, year-end, corporate tax days and refunding day. These spike days were the exception.

Now the exception has become the rule and it looks like there is no end in sight. The Fed funds futures are not significantly pricing in an increase to the overnight Fed funds rate

for the remainder of 2009. However, US Treasury GC trades at 0.35 per cent to 30 June. This equates to 10 bps higher than the Fed's target rate of 0.25 per cent.

Again, this can be directly attributed to the increase in supply.

The market will settle 73 billion (ICAP Wrightson) in 2-, 5- and 7-year notes settling in early March, adding further to the supply.

The FOMC meets again on 18 March.

Fed Fund futures are indicating no change to the current range.

## Asia-Pacific equities

The rapidity, severity and almost uniformity of the downturn in exports and manufacturing production across Asia has been nothing short of astounding.

Countries that have been particularly hard hit are the more open economies with very large export share-to-GDP ratio (Singapore, Hong Kong and Malaysia), where exports have a high domestic value added (Korea and Taiwan) and where net exports had been large contributors to real GDP growth in lieu of weak domestic demand in the recent years (Taiwan and Thailand).

The broad approach in the region in the initial phase of the slowdown started with aggressive monetary easing; some central banks have now moved towards quantitative easing.

### China

Recent data shows a soft landing in China, but many domestic and external challenges remain. Early signs of a production rebound emerged, as severe de-stocking eases and stats-driven investment picks up pace. Strong credit growth reduced the urgency for rate cuts. But given deflation, rising real-interest rates may reverse

some of the effects of monetary easing. Authorities are weighing new policies to boost spending, including consumption coupons. Policymakers are pushing forward acquisitions of foreign natural resources assets, while reiterating intent to continue capital market reform. This could have important implications for cross-border investment flows and currency value.

### India

With the WPI currently at 3.9 per cent from around 13 per cent levels in August 2008, RBI expects inflation to fall below 3 per cent by end March 2009 from 7 per cent earlier. RBI stated that inflation could fall below 3 per cent in the short-run due to high base effect. The slowdown in loan growth continues on cautious bank lending. Buoyant deposit growth bodes well for the government's borrowing programme. The expected deflationary trend will aid a further 10 to 150 bps reduction in policy rates.

### Singapore

The export contraction is probably undergoing its most intense phase in Q1 09, but may start to improve marginally from Q2 or Q3 at the latest. Manufacturing

aside, other externally oriented services such as tourism, re-exports, wholesale trade, transport and logistics are likely to plummet as regional trade slows. Lending indicators do not yet show conclusive signs of recovery.

### Hong Kong

Q4 08 real GDP declined by 2.5 per cent year-on-year, indicative of the impact of a deepening recession. The jobless rate accelerated to 4.6 per cent from November 2008 to January 2009, with employment falling by 14.3 thousand from last month. The 2009/10 budget announced several one-off measures to help households, which included a 50 per cent salaries tax-reduction for 2008/09 income of a maximum HKD6,000 and a 20 per cent reduction for public housing/land rental for three months. The budget also focused on measures to create jobs, further education opportunities and preserve employment. The financial secretary expects the Hong Kong government to run fiscal deficit for the next five years.

## European equities

Overall balances were down by 5 per cent since January. This is due to market conditions and falling market prices.

### News

#### European Stocks Drop, Led by Lloyds, RBS, and US Futures Retreat<sup>4</sup>

European stocks fell, led by banks and raw-material companies, as Lloyds Banking Group Plc failed to announce an agreement on a government asset insurance programme and as metals dropped. Asian shares rose, while US futures dropped. Lloyds and Royal Bank of Scotland Group Plc slumped more than 14 per cent. Norsk Hydro ASA slid 6 per cent as Goldman Sachs Group Inc. recommended selling the shares and as copper declined Europe's Dow Jones Stoxx 600 Index fell for the fifth time in six days, decreasing 2.7 per cent to 171.45 at 12.44 p.m. in London. The regional gauge lost 10 per cent this month, the sixth straight decline, as companies from Anglo American Plc to Cie. De Saint-Gobain SA posted disappointing results and the economic crisis in Eastern Europe deepened.

"The economy and the solidity of companies is the main concern," said Peter Braendle, who oversees USD50 billion at Swisscanto Asset Management in Zürich. "Commodity prices show the economy is on a retreat, demand is not stabilising and prices are coming under pressure. Sentiment is very pessimistic." The MSCI Asia Pacific Index advanced 1 per cent today, helping the regional gauge trim its biggest decline for a start to a year since 1990, as Nintendo Co. climbed.

#### Barclays Results Help Lift FTSE<sup>5</sup>

Barclays led the risers, up 10.9 per cent to 116.2p, after its annual results beat consensus forecasts and management provided more clarity on its balance sheet.

Hammerson moved 9 per cent higher to 432.75p on confirmation it would raise GBP584 million by issuing shares at 150p apiece.

Ahead of results on Thursday, British Land gained 10.2 per cent to 501p after selling half its stake in the Meadow Hall Shopping Centre in Sheffield for GBP587.7 million.

Retailer DSG International lost 3.8 per cent to 25.25p on reports it was looking at a rights issue.

Numis analysts said a cash call was "sensible contingency planning should trading deteriorate, asset disposals disappoint and the banks prove unsupportive . . . Nevertheless, we expect the market to be less enthusiastic about the prospect of a DSG rescue-right than for retailers struggling predominantly as a result of an inappropriate capital structure," it said.

Other indebted companies dominated the loser board amid talk of a major "cash box" placing in the pipeline for this week. By setting up a separate "cash box" vehicle, firms can issue up to 15 per cent of share capital without offering pre-emption rights to all investors.

Yell faded 4.2 per cent to 45.25p following last week's profit warning, while GKN was down 4.1 per cent to 93.5p and William Hill lost 3.3 per cent to 256.5p.

But Travis Perkins rose 1.1 per cent to 383.75p ahead of results on Thursday. "While we don't expect a big miss on 2008 numbers, we do see significant risk to 2009 consensus estimates," said Morgan Stanley. "In addition, the results are likely to reignite the debate over the balance sheet, without a long-term solution being finalised."

Chaucer, the Lloyd's insurer currently negotiating a nil-premium merger with Novae, rose 11.8 per cent to 45p after saying it had received a number of other approaches. Brit Insurance was said to be among the firms to have approached Chaucer. Brit was 0.4 per cent better at 217.75p, while Novae gained 2.6 per cent to 320p. ITE Group was up 8.9 per cent at

70.5p after Dresdner Kleinwort said the exhibition firm should be able to protect a 5.8p dividend. "The near-term road may well prove rocky but we feel there is enough comfort in the shares to cope with this," it said.

Michael Page led recruitment companies lower by 3.3 per cent to 240p on data showing a sharp deterioration in the French temporary staffing market. Last year France provided nearly a fifth of Page's profit, and was its most resilient market outside Latin America.

Arm Holdings was down 4.5 per cent to 95.25p after Goldman Sachs said the chip designer's 2009 revenue forecast looked too optimistic.

Software maker Misys lost 2.9 per cent to 126.25p on reports that US senators would cut a USD2 billion subsidy for electronic health records from the US economic stimulus plan.

### Active stocks

#### Event-driven names

- Norwegian Energy Co. ASA (NOR NO)
- Q-Cells (QCE GR)
- Renewable Energy (REC NO)
- SAS Group AB (SAS SS)
- Det Norske Ojjeselskap ASA (DETNOR NO)

#### Directional names

- British Land Co (BLND LN)
- Peter Hambro (POG LN)
- Land Securities (LAND LN)
- Swedbank (SWEDA SS)
- Lafarge SA
- Xstrata (XTA LN)
- William Hill Plc (WMH LN)
- Banco Sabadell (SAB SM)
- Prisa (PRS SM)
- Gas Natural (GAS SM)
- Liberty (LII LN)

<sup>4</sup> www.bloomberg.com, accessed on 27 February 2009.

<sup>5</sup> *The Financial Times*, 9 February 2009.

## European government bonds

European Government GC balances fell across the board as de-leveraging and balance sheet restrictions continue to take effect in Europe. The spread between termed GC loans and cash reinvested in the Money Markets narrowed by almost 20 bps as LIBOR fell (3month) and the European Central Bank (ECB) held rates at 2 per cent as expected.

No Gilt specials this month, with growing pressure on GC balances. GC bids had been moving back towards Sterling Overnight Interbank Average Rate (SONIA) levels (historical benchmark for STG GC rates) over the past few months, however this trend reversed in February as The Bank of England cut rates by another 50 per cent to 1 per cent, another record low in the

institution's 315-year history. In addition the Bank also signalled plans to purchase private assets; the so-called quantitative easing policy looks like it may be taking shape. It's difficult to say how this will affect the Gilt repo market, suffice to say a reduction in supply would be welcomed given the huge issuance of UK Government Debt of late.

## European money markets<sup>6</sup>

As expected, the ECB kept rates on hold in February. But, with inflation close to its lowest level in 10 years and the global financial crisis continuing to undermine consumer confidence and curtail spending, the ECB is expected to cut rates further over the coming months.

Europe's governments have so far committed USD1.5 trillion in bank aid and USD250 billion in economic-stimulus packages, swelling budget deficits in some countries, creating fears about those countries' ability to meet their debt obligations.

Fears are escalating over Eastern Europe's ability to withstand the financial crisis, plummeting equity markets, and concerns about the temptation for protectionism dominate the market.

<sup>6</sup> www.bloomberg.com, accessed on 5 March 2009.

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