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## Welcome

It has been several months since I provided this welcome. As the Global Head of Equity and Corporate Bond Trading, I am focused on maximising the value of our clients' lending opportunities in the equity and bond markets. Our goal at Citi is to ensure that we offer a best-in-class product and remain dedicated to serving as thought leaders in the industry.

I am pleased to share with you that I had the pleasure of participating in a recent securities finance roundtable discussion at the U.S. Securities and Exchange Commission (SEC) in Washington, D.C. The purpose of the discussion was to provide the SEC with an overview of a number of topical issues in the industry. Among the items on which I was asked to share my expertise was the topic of accepting equities as a form of collateral.

Although equities are a permitted form of collateral for many lenders, US mutual funds are not currently permitted to accept equities as collateral. Equities offer a number of benefits as a form of collateral in a lending transaction. Among the positive attributes of accepting equities as collateral are the potential price correlation between loan and collateral, increased diversification in collateral options and robust pricing as an exchange-traded security. (It should be noted that equities as collateral are subject to the same risks as other equity holdings.)

I was also asked by the SEC to discuss proxy voting and whether a lending agent could facilitate voting by a lender on matters of interest. I was pleased to advise the SEC that at Citi we offer lenders the opportunity to customise their lending programme to take account of proxy requirements.

As a part of participating in the roundtable, I provided a position paper outlining investor protections that would be available in the structure of a lending programme at Citi. The SEC has archived the roundtable on their Web site. You may view a replay of my panel's discussion by using the link below. You may also review the position paper by clicking on "Statement" under my biography via the second link below.

[www.connectlive.com/events/secroundtable0909/](http://www.connectlive.com/events/secroundtable0909/)

[www.sec.gov/news/spotlight/shortsales/roundtable092909/roundtable092909bios.htm](http://www.sec.gov/news/spotlight/shortsales/roundtable092909/roundtable092909bios.htm)

I invite you to reach out to me ([patrick.m.avitabile@citi.com](mailto:patrick.m.avitabile@citi.com)) or your relationship manager if you would like to discuss any of the above in greater detail.

Taking a broader perspective, we can see in this edition of *Market Monitor* that market activity in recent months seems to reflect, if anything, that major economies are showing signs they are taking tentative steps forward, away from the recession, towards recovery. This may seem to confirm that, in these times, there's nothing more inevitable than gradualism. And yet, at Citi, continuing to put our expertise to work for our clients with unstinting commitment and resourcefulness, across markets and asset classes, is the least we can and will do.

## US equities

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

Securities-lending spreads across ten out of 12 analysed indices decreased during the week ending 25 September. The healthcare sector saw its spreads drop the most, at -46.6% or -4.5 basis points (bps) from the prior week. On the other side, DAX's spreads grew the most, by 43.1% (12.2 bps), during the same week.

Loan balances across nine out of 12 analysed indices fell during the week. Loan volume

in the financial sector decreased the most (-3.4%) compared to the prior week, while U.S. Treasuries' loan balances grew the most, at 1.6%.

The Dow and S&P 500 each jumped almost 15% in the third quarter, building on gains of 11 and 15%, respectively, in the April-to-June period. A seven-month rally has pushed the S&P 500 up 56% from a 12-year low in March and sent its price-to-earnings valuations this month to the highest levels since 2004.

### Active stocks

- Capstone Turbine Corp (CPST)
- First Solar Inc (FSLR)
- Buckle Inc (BKE)
- Evergreen Solar Inc (ESLR)
- Directv Group Inc (DTV)

<sup>1</sup> [www.bloomberg.com](http://www.bloomberg.com), accessed on 30 September 2009, and SunGard Financial System Validus Holding Ltd. (VR).

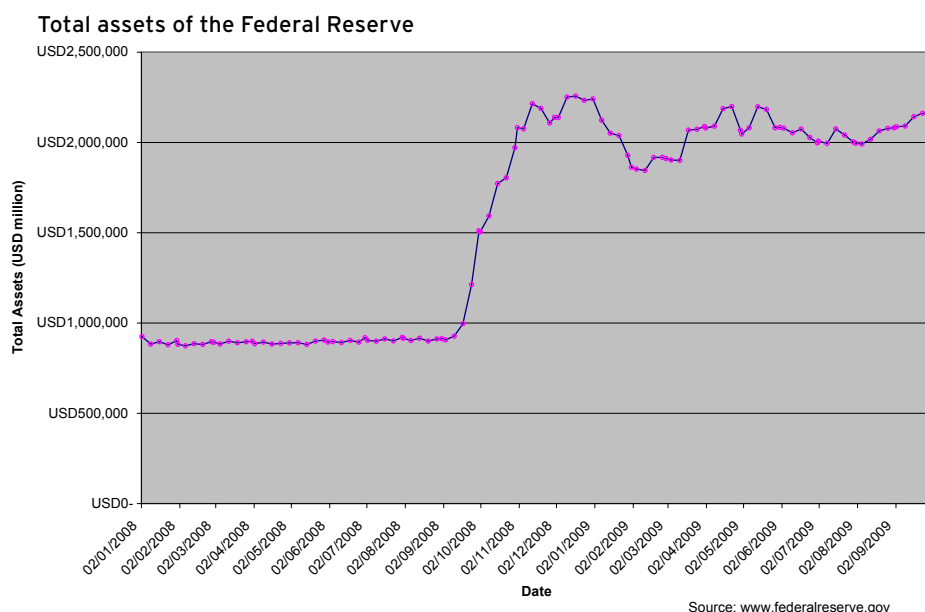
## US cash and money markets

Once again, as expected, the FOMC decided to keep the Federal Funds target in the range of 0.00% to 0.25%. The FOMC recognised some further strengthening of the US economy, but continued to express its view that there was still quite a bit of room for growth before inflation expectations could worsen.

Given that view and the acknowledgement that the employment situation continued to experience deterioration, the FOMC reiterated that its expected to keep the Federal Funds target rate at an extremely low level for an extended period of time.

The ultimate implications of the current monetary policy remain the big question in the market. There continues to be some angst with respect to the FRB's ability to exit smoothly from the current levels of accommodation.

Observers have noticed that the balance sheet of the FRB NY has risen from approximately USD900 billion in early 2008 to over USD2.1 trillion today (see graph), and is expected to reach USD2.5 trillion by year-end. That represents USD1.6 trillion that was created "out of thin air," and while there are no similar historic comparisons, even



much smaller monetary expansions in the past have led to a rapid growth in inflation.

The FRB continues to state that it has the necessary tools to effect a smooth exit from the accommodation without disrupting price stability.

One tool currently being considered is for the FRB NY to execute open market operations,

aimed at draining reserves from the system, with investors other than the primary dealers.

While it has not been decided yet, this could open up the possibility of securities lenders having the ability to execute reverse repurchase agreement investments with the FRB NY as the counterparty, which should provide a great degree of comfort for the most risk-averse cash-collateral takers.

## US corporate bonds

### Current news<sup>1</sup>

The cost to protect corporate bonds in the US from default climbed to the highest level in eight trading days as CIT Group Inc. faced a financing deadline and a report showed companies might be limiting their spending.

Credit swaps on the Markit CDX North America Investment-Grade Index, used to speculate on the creditworthiness of 125 companies in the US and Canada, or to protect against losses on their debt, rose 2.5 bps to a mid-price of 100 bps as of 12.12 in New York, according to Phoenix Partners Group.

The perception of credit deteriorated as CIT, the commercial lender, that has said it may be forced to file for bankruptcy protection, considered offers of financing, according to people familiar with the situation. A report released on 30 September showed a measure of US business activity unexpectedly shrank in September, indicating companies would be likely to limit spending.

Contracts on the Markit CDX North America Investment-Grade Index rose on 30 September to the highest level since 18 September, the last day before a new series started trading without CIT, Macy's Inc. and

other companies whose credit ratings were cut below investment grade, according to CMA. For the quarter, the index has declined about 31 bps.

### Issues in demand

- Accuride Corp (CUSIP 004398AE3)
- Wells Fargo Capital (CUSIP 94979D200)
- Cit Group Inc (CUSIP 125581AM0)
- Wash Mutual Inc (CUSIP 939322AX1)
- Boyd Gaming Corp (CUSIP 09689RAA7)

<sup>1</sup> www.bloomberg.com, accessed on 30 September 2009.

## US Treasury and agency

The most significant difference in the securities-lending and repo markets in September when compared to the summer months is the lack of "specials" trading in the on-the-run sector.

This phenomenon is confounding but very real. The repo market seems to be experiencing a lack of shorts. The prices of US Treasury issues were lower during the summer and conversely yields were higher. There has since been a rally that pushed the yield on the two-year from 1.30% on 7 August to 0.89% just after the quarter end on 1 October.

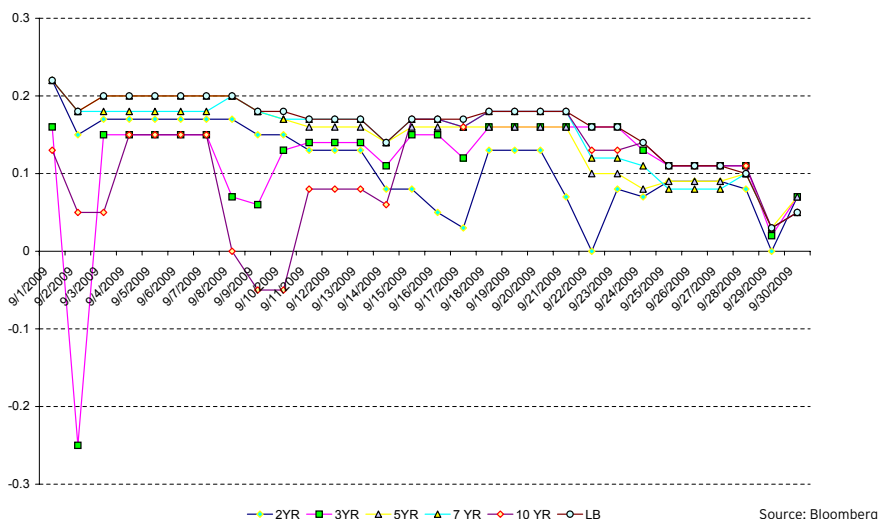
The longer-dated issues also rallied during that time frame. There seems to be reluctance in the dealer community to short Treasuries, which probably stems from the uncertainties regarding the timing of the Fed's pending exit strategies of the various quantitative easing programmes.

The Fed has announced it plans to continue buying assets through the end of March. Therefore, there doesn't seem to be a burning desire to short Treasuries at this point in the rate cycle.

One bright spot to the lack of specials is the fail problem, which was created a year ago due to the Lehman event, and which has been all but eliminated. We haven't experienced a fail due to issue scarcity in quite some time. The Fed has stated it plans to keep rates very low for the foreseeable future and the repo market is listening.

Treasury GC is trading at 0.27% all the way out to June 2010. There has since been a rally that pushed the yield on the 2-year from 1.30% on 7 August to 0.89% just after the quarter end on 1 October.

Current Treasury issues: open roll rates September 2009



## Asia-Pacific equities

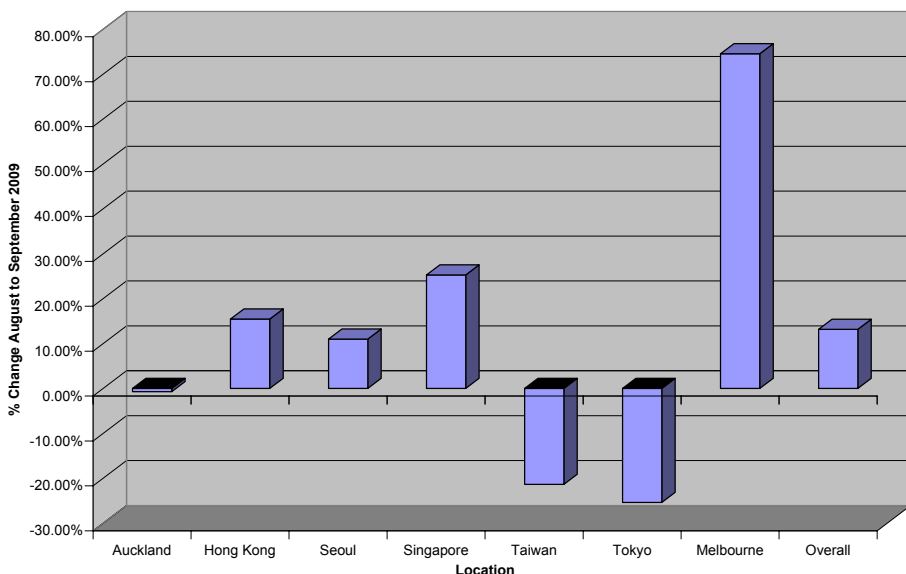
The overall balance is up over 13%. Following the strong demand in Australia, balance has increased 74%. Japan balance has dropped slightly to over 25%, as borrowers unwind positions with high dividend requirements before the September record date.

### China and Hong Kong

Economic recovery in China continues to outpace expectations with its investment-driven model. Domestic demand growth now has the support of the property sector, which contributed to a small pickup in broad investment growth despite

moderating state investment. Hong Kong Q2 09 real GDP fell less than anticipated to -3.8% year-on-year, and posted the first positive quarter-on-quarter growth after four quarters of recession. However, weak loan growth remains a drag to overall recovery. Uses of loans to almost all sectors remain in sharp decline, except property-related lending.

### Asia-Pacific balances



### Singapore

Recent data suggests that V-shaped recovery continued in Singapore. Industrial production bounced back with a strong 23% month-on-month increase, led by biomedical, and a 20% month-on-month jump in electronics production. FSSTI has jumped over 4% within the month, and on-loan balance has gone up over an impressive 25%.

### South Korea

The BOK has held policy rate at 2%, and BOK Governor Lee said that the Korean economy in general is improving and

inflationary pressure has currently eased. But the major concern will be increasing mortgage growth along with rising property prices aided by a historically low-level policy rate and abundant liquidity. Demand in Korea stays strong, and we have recorded a steady increase with a 10% jump.

#### Tight stock across the region

- Alibaba (B28Q940)
- Angang New Steel (6015644)
- China Shipping (B018L76)

- China State Construction (BOBM5T8)
- Country Garden (B1VNYN6)
- Daewoo Engineering (6344122)
- Daewoo International (6344274)
- Doosan Heavy (6211679)
- Genting International (6366795)
- Green Hospital (B05MTR0)
- Hanjin Shipping (6497071)
- Li Ning Co Ltd (B01JCK9)
- Maanshan Iron & Steel (6600879)

- Ncsoft (6264189)
- Oci Company (6497004)
- Olam International (B05Q3L)
- Samsung Heavy (6772217)
- Stx Shipbuilding (B130MM9)
- Yangzijiang Ship (B1VT035)
- Zte Corp (B04KP88)

## European equities

### Balances

Heightened confidence in the market and the usage of the Equilend trading system's "Auto Borrow" functionality has led to an increase in overall balances for European equities by 7% since September. Expectations that the global economy is on a recovery path have been growing as a result of European shares hitting an 11-month closing high for a second straight session during mid-month, powered by energy and financial stocks.

Major European stock markets could rise by as much as 25% by the end of the year, according to fund manager Barry Norris of Argonaut Capital Partners. He said: "Things have dramatically improved since the start of the year, and markets still have to go up another 25% to get back to the levels before Lehman Brothers' collapse. Most credit markets have recovered to pre-Lehman levels and it's logical that equity markets will do likewise." He also added: "I wouldn't be surprised if most major economies grew 3% to 4%. I wouldn't exclude the UK bouncing back very strongly either."

However, analysts are still debating whether there will be a V-shaped recovery or how sustainable the recovery will be.<sup>1</sup>

As a result of these events, the banks involved in stock lending remain upbeat, arguing that the worst has passed and some of those that recoiled from lending stock at the peak of the crisis are once more playing ball.

Those that temporarily suspended lending have returned to lending programmes and a high proportion of those that exited have now returned. But not all the changes in train in the depths of the crisis are likely to be erased so quickly. According to some experts in the industry, the level of focus from beneficial owners on oversight of their lending programmes has "just exploded", and lenders' escalated desire to customise their activities to meet their own unique requirements and risk parameters is going to be an ongoing trend.<sup>2</sup>

### News

A raft of macro-economic data boosted investors' belief that the worst of the economic downturn was over, but analysts said the market has risen too far too fast and could pause for a short period before starting its forward march again.

The FTSEurofirst 300 index of top European shares ended 0.5% higher at 1,011.26 points, rising for the ninth

session in ten. The index, up 21% in 2009, has jumped 57% since hitting a record low in March this year. It is up 19% this quarter and on track to post the index's strongest quarterly performance in almost a decade, but is still down about 38% from a near seven-year high touched in mid-2007.

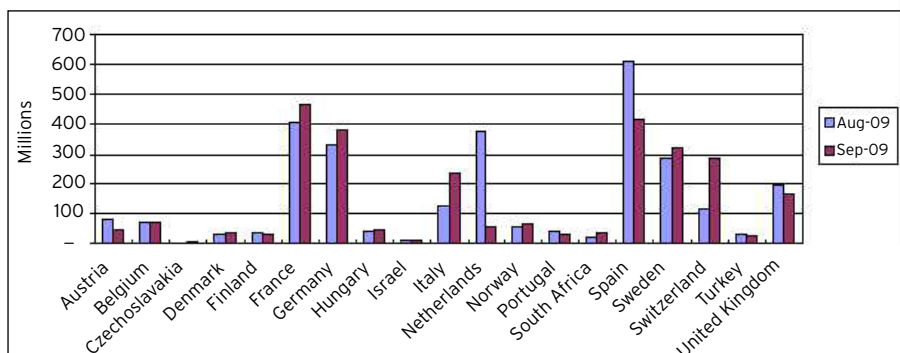
"We are moving into a period of stronger economic growth and there are tangible signs we are coming out of the recession. You have got companies going into this period of growth in a leaner and meaner shape. That's a pretty powerful mix of positivity," said Equity Strategist Henk Potts at Barclays Stockbrokers. "The current rally is unsustainable but there is every indication that we can at least hold on to these gains in the short term – be a little bit more cautious," he added.

"We've saw panic selling last winter. Now we're seeing panic buying. Investors who have been 'underweight' on equities now worry about missing the big rally," said Jean-Marie Mercadal, CIO of OFI Asset Management in Paris. "But the easy part of the rebound is done. Stocks still have room to grow, probably 20% over the next six months, but it's not going to be automatic. People will have to do stock picking."

### Active stocks

- Immofinanz (IIA AV)
- Swedbank (SWEDA SS)
- Volkswagen (VOW GR)
- HeidelbergCement (HEI GR)
- Aviva (AV LN)
- Yell Group (YELL LN)
- Barratt Developments (BDEV LN)

### European equities on-loan balances



<sup>1</sup> www.citywire.co.uk, accessed on 3 September 2009

<sup>2</sup> www.FT.com, "Securities Lending is Back but Looks Different," by Steve Johnson, 13 September 2009.

<sup>3</sup> Reuters, 17 September 2009.

## European government bonds

Balance sheets remain very tight in 2009, resulting in a fall in European government GC balances through September, as borrowers reduced positions in the run-up to quarter-end. Loan volumes were also impacted by the drop in spread (to just 2 bps) between Greek/Italian government debt collateral and AAA European government debt.

No gilts yielded value this month, the Cheapest-To-Deliver (CTD) Bond in September's Futures Contract was the mammoth UKT4 1/2 03/07/19 (GB00B39R3F84) of which over GBP26 billion has been issued since its launch in September 2008. This issue will also feature as the CTD Bond in December's contract. Pressure continues to mount

on GC spreads and balances against DBV as a result of the lack of spread between issues with broker-dealers searching for alternative ways to fund their gilt positions. To this end, borrowers have purchased Explicit Government Guaranteed Bonds (EGGB), which they are keen to pledge as collateral against gilt loans.

## European money markets

Economic data continues to point to a Eurozone economic recovery. European consumer spending rose for the first time in more than a year in the second quarter and exports fell at a slower pace. Both consumer and industrial confidence is showing signs of improving as government

efforts to encourage spending and fight the economic slump gain traction.

However fears remain that rising unemployment, currently at 10%, and forecast to reach 11.5% in 2010, could still stall the recovery. With this in mind the European Central Bank kept rates

unchanged in its monthly meeting and signaled that it was in no rush to withdraw its emergency stimulus measures, despite raising its economic forecast for this year and next. It now predicts a contraction in 2009 of 4.1%, from 4.6% and growth in 2010 of 0.2% from a contraction of 0.3%.

For further information, please contact your Citi representative.

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