



Gareth Mitchell
European Head of
Fixed Income Lending
& Cash Re-Investment

Welcome

With January 2008 behind us, the global debt markets have now been through probably one of the most turbulent six months in some time. The joint efforts of the major central banks adding liquidity and, in some cases, reducing rates, coupled with the transparency offered by banks and financial institutions publishing their year-end accounts, have led to the reduction of very large spreads between government general collateral (GC) and LIBOR in January, still much wider than pre-July 2007 levels.

In Europe, Citi has continued to invest in both our people and technology as our cash balances have grown. The last year saw our cash balances grow by over 100 per cent in both EUR and GBP currencies. We continue to monitor opportunities for additional yield return and to offer these to clients in order for them to determine if such opportunities are suitable in light of their specific objectives and risk/return model.

We have a few initiatives underway at present, including Dublin-based AAA/AA cash funds and Asian domestic bond lending. We will keep you informed of the progress of these and other initiatives during the year.

US equities

Overall average balances were down 8.43 per cent for the month.

News

Early in the month, worries that soured mortgage bets and weak consumer spending could lead to a broader economic slowdown pushed major market benchmarks to their lowest levels since last spring. The Dow was down 5.1 per cent in 2008's first five trading days – a key period often considered an important harbinger for the market's fate for the rest of the year. The blue-chip average has fallen 11 per cent from its early October record of 14,164.53, the traditional definition of a correction. Stocks rallied over the next few days due to the increased hopes of investors for a sharp cut in the central bank's interest-rate targets. This hope is partly due to remarks by Ben Bernanke, Federal Reserve Chairman, said, "In light of recent changes in the outlook for and the risks to growth, additional policy easing may well be necessary." This was corroborated by committee officials, who spoke of standing "ready to take substantive additional action as needed to support growth."¹

After a surprise rate cut by the Fed late in the month, another rate cut at the scheduled meeting of 30 January 2008

and news of a possible bailout of insurers by New York regulators, the Dow rallied from a YTD low of 11,971 on Tuesday 22 January, a decline of over 9.7 per cent for the year, closing at 12,650 at month-end. The financial sector led the way in the wake of reports that New York state regulators were meeting with Wall Street firms to discuss ways to stabilise the troubled bond-insurance industry.²

Active stocks

- St Joe Co **JOE**
- MBIA Inc **MBI**
- Gramercy Capital **GKK**
- Cree Inc **CREE**
- Asta Funding **ASFI**

Sectors in demand included: autos, subprime lenders and Exchange Traded Funds (ETFs). Some drivers of this demand included: asset valuations, downgrades, commodity prices and supply issues.

¹ www.bloomberg.com, accessed 8-11 January 2008; The Wall Street Journal (WSJ), 8-11 January 2008

² www.bloomberg.com, accessed 23-25, 31 January 2008; WSJ, 23-25, 31 January 2008

European money markets

January saw further evidence of weakness in the euro region's economy, the service sector grew at its slowest pace in more than four years and retail sales dropped the most since 1995, signalling that the region's economy may follow the slump in the US.

Despite the evidence, the European Central Bank (ECB) policy makers have maintained their rhetoric that the euro economy is strong enough to cope and that inflation concerns prevent them from following the Federal Reserve's aggressive rate action.

Liquidity has returned to the market, driving three-month euro LIBOR down a further 30 basis points (bps); however, credit concerns persist, resulting in those banks seeking to access the floating-rate note market issuing at from +20 to +40 bps in the one- to two-year part of the curve.

² Equity Finance Desk, Citi Global Markets Limited, January 2008

US cash and money markets

The fixed-income markets experienced a historic change in the level of short-term rates as the Federal Open Market Committee (FOMC or the Committee) slashed the Federal funds target rate by 125 bps in the span of eight days.

The month began with a rather benign employment situation report, indicating that the US economy added only 18,000 jobs in the month of December.¹ On 10 January, speaking in Washington, D.C., Chairman Bernanke recognised the growing downside risks to economic growth and stated that “the Fed is prepared to act in a decisive and timely manner in order to counter any adverse dynamics that might threaten economic or financial stability” and that he and the Committee are

prepared to take “substantive additional action as needed to support growth and to provide adequate insurance against downside risks.”²

His comments opened the door for an inter-meeting rate cut and the market immediately priced in the strong probability that the target would be cut by at least 75 bps before the FOMC meeting on the 30 January.

On 21 January, the FOMC, in response to further deterioration in financial conditions, called an emergency meeting and voted to cut the Fed funds target rate by 75 bps to 3.50 per cent. This cut was announced and immediately implemented at 08.20 on the morning of 22 January. In the statement that accompanied the inter-meeting cut, the Committee clearly

indicated that further cuts were likely. The Federal funds futures markets reacted by pricing in a near 100 per cent probability of an additional 50 bps cut at the 30 January meeting. That probability was realised when, in fact, the FOMC did cut the target rate to three per cent on that date, and stated that the downside risks to growth were still prevalent. Investors who maintained fixed-rate duration in their portfolios are now being rewarded by the aggressive rate cuts. The benefits are expected to continue if rates decline, which many believe they will.

¹ US Economic and Market Daily, Citi FI Direct (<https://fidirect.citigroup.com>), 4 January 2008

² www.federalreserve.gov/newsevents/speech/bernanke20080110a.htm, accessed 10 January 2008

US corporate bonds

Overall average balances were down 1.31 per cent for the month.

News

Early in the month, the perceived risk of companies defaulting on their debt rose after a US manufacturing index (the Institute for Supply Management’s factory index) shrank by the largest amount in almost five years – from 50.8 in November to 47.7 in December – stoking concerns that the economy was headed towards a recession.

The Markit CDX North America Investment Grade Index, a benchmark for the cost of protecting debt from default, rose 3.25 bps to 81.75 bps as of 1 February 2008, the highest in a month, according to Deutsche Bank AG.

The credit-default swap index, which rises as investor confidence erodes, has climbed 37 bps in the past 12 weeks amid concerns that plunging home prices and rising mortgage defaults would push the economy into a recession.

A gauge of confidence in the high-yield market, the Markit LCDX Series 9 Index, fell by a quarter point to 96.95, according to Goldman Sachs Group Inc. The index, which falls as investor sentiment worsens, has dropped 3.5 per cent since 15 October 2007.¹ Bank sales of bonds signalled funding conditions were improving for US and European lenders. According to Bank of America Corp., Deutsche Bank and Wachovia are among firms who raised more than USD17 billion by selling extendable notes after the market for floating-rate

securities with variable maturities shut down in August. Extendable bonds give investors the option to extend the maturity date at set intervals and can be held by short-term money-market funds. Covered bonds, the main source of funding for home lenders, are guaranteed by the banks that issue the debt.²

Issues in demand

- Korea Dev Bank (CUSIP 500630BP2)
- MBIA Insurance (CUSIP 55276GAA3)
- Freescale (CUSIP 35687MAP2)
- KB Home (CUSIP 48666KAM1)
- Countrywide Home (CUSIP 22237LHE5)

¹ www.bloomberg.com, accessed 1 February 2008

² www.bloomberg.com, accessed 9 February 2008

US Treasury and agency

January was a month of extreme volatility for US government and agency lending. The month started with wide spreads that were residual from the softness in overnight financing over the year-end turn. The market backed up for about two weeks and treasury overnights traded much closer to the Fed funds target. It

appeared as though the US treasury spread-to-funds was going to normalise. However, on 22 January the Fed implemented an unexpected inter-meeting 75-bps cut of the Fed funds rate to 3.50 per cent. This surprise move proved to be disconcerting to the financial markets and spurred a flight to the safety

resulting in strong demand for US Treasury collateral.

Overnight treasuries proceeded to trade below 2.25 per cent in the following days reducing the average to below two per cent. As the deadline for the next FOMC announcement neared (30 January) there was increasing uncertainty in the Repo

marketing. Ultimately, the Fed eased rates by another 50 bps on 30 January, lowering the Fed funds rates to three per cent.

Presently, the futures market is pricing in 100 per cent of another 25-bps ease in the Fed funds rate and 66 per cent of a 50-bps ease during the 18 March FOMC meeting. The Repo market remains

skittish at the notion of another inter-meeting move occurring prior to the March meeting.¹

All the on-the-run treasuries traded at a premium throughout the month. The average spreads were as follows:

- CT2Y: 85 bps
- CT3Y: 90 bps
- CT5Y: 147 bps
- CT10Y: 155 bps
- CTLB: 70 bps

¹ www.bloomberg.com, accessed on 31 January 2008

Asia-Pacific equities¹

Australia and New Zealand

The Australian economy continues to perform well. Recent data highlighted strong momentum at year-end, most notably in the labour market. Sound fundamentals in the banking and housing sectors stand in contrast to developments in the major industrial economies. In New Zealand, the data continues to point to strong retail sales and persistent inflation, with an unambiguously high fourth-quarter Consumer Price Index (CPI), which was above Reserve Bank of New Zealand (RBNZ) estimates.

Japan

The next rate hike by the Bank of Japan (BoJ) is expected to be delayed until the end of 2008. Continued uncertainties surrounding the US economy and global financial markets, combined with ambiguity regarding the virtuous cycle of the domestic economy, will likely continue to dissuade the BoJ from raising policy rates until after the release of its October economic outlook. Long-term interest rates will probably rise.

Regional

A US recession will likely dominate the near-term outlook for Asian markets. Inflation is another key risk for the outlook, given high food and energy costs, abundant liquidity and booming asset markets. Inflation rates already exceed official targets in China, Singapore, Taiwan and Vietnam, where tightening policies are likely to continue. Capital flows will probably become more of a two-way street, further support asset prices and add pressure on currencies. Risks of asset-price bubbles and erratic policy reactions are high, but currencies such as the peso, rupee and Singapore dollar should outperform.

China

Key risks include a US recession and trade protectionism. External surpluses should shrink as shares of GDP, but the investment share may rise further. Policy rate hikes tightened credit, and quickened currency appreciation will help contain inflation and asset prices. Overvalued asset markets and hasty liberalisation of the capital account could pose serious risks to the economy.

Hong Kong

Falling interest rates due to bank interest-rate cuts and rising inflation will likely boost domestic demand and the property market. Inflation has risen more rapidly amid robust consumption and higher import prices. The financial sector continues to gain strongly from fund-raising by Chinese firms and China's overseas investment. Chinese capital outflows have lost momentum, but should pick up after the global financial market becomes steady. Weak market sentiment has delayed the listing of Chinese firms. Tax cuts and public spending hikes should boost domestic demand. With the 2007-08 fiscal surplus likely to hit a record high, the government could cut taxes and increase public spending.

Korea

Commodity-producing emerging-market countries should continue to be the major driving force of Korea's export growth. Exports to overall emerging-market countries continued to be strong, though there were signs of a slowdown in high-tech exports. Strength in consumption should continue, and investment should also recover under a new president. Weakness in consumption can be ascribed to higher oil prices. Tightening financial conditions would be negative for the investment outlook, while the new administration confirms its "pro-business" stance. The Bank of Korea will likely maintain a neutral policy stance with the help of stable

inflation within the target range. Rising concern about the US growth outlook made the bank more "dovish" despite the rising headline inflation, which led to an impressive rally in the bond market.

Singapore

Manufacturing will likely slow further while financial services have likely peaked. Key concerns are a US recession and inflation. CPI inflation could average five per cent in 2008, up from around two per cent in 2007. Upward revisions in Housing Development Board (HDB) values; higher rent, food and fuel prices; wage pressures and lower interest rates are fuelling inflation pressure. Sharp deterioration in the US growth outlook suggests that the Monetary Authority of Singapore (MAS) will tolerate an inflation overshoot in the first half and stay on hold.

Taiwan

Closer ties with China's economy should boost the domestic economy and financial markets. Higher interest rates will help deter capital outflows, but would be negative for domestic housing markets. Slower tech demand may pose near-term risks, but a continued upbeat outlook should support the economy on a longer-term horizon.

Thailand

A weak coalition running the government may not be poised to push for a strong policy agenda. Muddling through politics would prioritise political compromises, thus prolonging the investment drag to growth. Weak net exports in the first quarter of 2008 would raise the urgency of easing rates. Fiscal deficit spending should increase to cushion headwinds for growth in the first half of 2008.

¹ "Asia Economic Outlook and Strategy", 28 January 2008 issue; "Global Economic Outlook and Strategy", 25 January 2008

Client-solutions update

On 20 December 2007, the Securities and Exchange Board of India (SEBI) announced a broad framework for securities lending and borrowing, and short-selling.

Subsequently The Clearing Corporation of the National Stock Exchange (NSE) and the Clearing House of the Bombay Stock Exchange (BSE) have both announced their Securities Lending and Borrowing (SLB) schemes. Essentially, this amounts to an exchange-based model founded on a discussion paper from 2004 that is unlikely to change in the short term. With Citi's established presence in this market as a direct custodian, we are well placed to lobby for continued reform to work towards a bilateral securities-lending framework as seen in mature markets. In brief the main points are:

- Loans are for a fixed seven-day tenor, which neither party can recall before or hold longer, as no rollover is allowed. (This may be extended once the scheme is launched and the market stabilises.)
- Naked shorts are not allowed
- Collateral is defined as local currency held by the clearing houses.
- Securities lending and borrowing contracts are non-negotiable and executed under local law
- Loan rates are to be determined by the stock exchanges.
- Lenders' available securities have to be ring-fenced as lendable. (The client's custodian takes over the obligation to deliver.)
- SLB transactions can take place only in dematerialised securities available for trading in the futures and options segment of the NSE and the BSE. The National Securities Clearing Corporation Limited (NSCCL), the Clearing Corporation of the National Stock Exchange (NSE) and BOI Shareholding Limited, which runs the clearing house of the Bombay Stock Exchange (BSE), will announce the list of eligible securities from time to time.

The market-wide position limits for SLB transactions is 10 per cent of the free-float capital of the company in terms of number of shares.

European equities

Overall balances have increased by three per cent for the month. This is due to increased term date trading.

Active stocks

Relative value and merger and acquisition news¹

- Rexel (RXL FP)
- Hagemeyer (HGM NA)
- Banca Popolare (BPM IM)
- Sacyr Vallehermoso (SYV SM)
- Sabadell (SAB SM)
- Randstad (RAND NA)
- Carlsberg (CALRB DC)

Directional and convertible bond news

- IKB Deutsche (IKB GR)
- Alliance & Leic (QIA GR)
- Brad & Bingley (BB LN)
- Northern Rock (CGY GR)
- Tiscali (TIS IM)
- Bca Mps (BMPS IM)
- Metrovacesa SA (MVC SM)

Sectors and markets in demand included: ETFs and emerging markets.

¹ Equity Finance Desk, Citi Global Markets Limited, January 2008

For further information, please contact your Citi representative.

Contacts



USA, New York

Laurie Zeppieri

Tel: +1 212 657 1075

Email: laurie.zeppieri@citi.com



Europe, London

Brian Staunton

Tel: +44 (0) 20 7500 5411

Email: brian.staunton@citi.com



Asia, Hong Kong

Larry Komo

Tel: +65 6328 5377

Email: lawrence.komo@citi.com

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