



**Barry Winter,**  
Managing Director,  
North American Head  
of Fixed Income Trading  
and Cash Investments.

## Welcome

Despite the confluence of liquidity that the US and European Central Banks (ECBs) have provided, many sectors of the credit markets continue to exhibit a high degree of stress. One market that seems to be an oasis of calm in the current credit storm, however, is the market for United States Treasury securities. In spite of its enormity, at over USD9 trillion, the US Treasury securities market remains one of the most liquid in the world.

The recent decrease in the value of the US dollar in foreign-exchange markets does not appear to have dampened the appetite of foreign investors for US government debt. Foreign ownership of US public debt has increased by over six per cent during the past six months to USD2.35 trillion.

Strong demand in the securities-finance market has rewarded lenders of US Treasury securities with historically high spreads and associated revenue. Of course, past performance is not a guarantee of continued performance at these levels. Citi would welcome the chance to discuss your holdings and opportunities in this very important market sector.

## US equities

Overall average balances were up 2.88 per cent for the month.

### News

Early in the month, a much weaker-than-expected reading on the service sector sent stocks down again as investors faced up to the likelihood of a consumer-led recession. The Dow made sporadic gains over the month, but floundered with the market as recession fears continue to impact on expectations.<sup>1</sup>

At the mid-month stage, the mood was downbeat. Economic news continued to suggest there was a pending recession. Consumer confidence fell to a 16-year low and the Federal Reserve reported that its general business-conditions index tumbled to -11.72, falling below zero for the first time since May 2005, down from a reading of 9.03 in January. The index was well below the median forecast of 6.5 in a Dow Jones Newswires survey.<sup>2</sup>

In economic news late at the end of the month, the National Association of Realtors reported that sales of existing homes had fallen at an annual rate of 0.4 per cent in January while the median home price was down 4.6 per cent in the US. Although these drops hardly represent good news for the economy, they did,

however, exceed analysts' already dismal expectations. Together with a small dose of corporate deal-making, this was enough to lift investor's spirits as the Dow gained over 2.5 per cent for the first three days of the final week of trading for the month. The Dow sold off the last few trading days of the month as investor enthusiasm evaporated amid a succession of downbeat corporate news and mixed economic data. The Dow closed 3.03 per cent down for the month.<sup>3</sup>

### Active stocks

- First Commonwealth FCF
- Lee Enterprises LEE
- La-z-boy LZB
- Surmodics SRDX
- Franklin Electric FELE

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.

<sup>1</sup> www.bloomberg.com, accessed on 5, 8 February 2008; *The Wall Street Journal (WSJ)*, 5, 8 February 2008.

<sup>2</sup> www.bloomberg.com, accessed on 11, 13, 15 February 2008; *WSJ*, 11, 13, 15 February 2008.

<sup>3</sup> www.bloomberg.com, accessed on 25-29 February 2008; *WSJ*, 25-29 February 2008.

## US issuance and credit

We are continuing to experience a weak credit environment as evidenced through bank earnings declines and credit downgrades. These actions stem from the mortgage and subsequent liquidity crisis that have continued to blight the markets. Since the beginning of 2007, major banking entities have compiled asset write-downs and have reported losses in excess of USD150 billion. There have been reports in the media that losses related to the credit markets could eventually exceed USD500 billion.

For the month of February, some highlighted downgrades included Société Générale. Standard & Poor's lowered the long-term rating to AA- from AA.<sup>1</sup> Another notable downgrade was Swedish Housing Finance, falling to A1 from Aa3 by Moody's.<sup>2</sup> A noteworthy upgrade, Banco Bilbao Vizcaya Argentaria, had its long-term rating upgraded to AA from AA- by Standard and Poor's.<sup>3</sup>

<sup>1</sup> www.ratingsdirect.com, accessed on 4 March 2008.

<sup>2</sup> www.moody's.com, accessed on 5 March 2008.

<sup>3</sup> www.ratingsdirect.com, accessed on 4 March 2008.

## US cash and money markets

Having recognised the risks to economic growth generated by tight credit conditions, the Federal Open Market Committee (FOMC) lowered the Fed funds target rate by 50 basis points (bps) to three per cent on 30 January. With no FOMC meeting scheduled in February, the monetary policy board made it clear it would continue to act in a timely manner if financial market conditions continued to worsen.

The weak employment-situation report early in the month did nothing to reverse the trend and the sharp decline in the service sector output. The report on 5 February provided more fodder for the interest-rate bulls. Yields on the two- and five-year notes

decreased by 14 and 13 bps, respectively, after the release of the non-manufacturing ISM survey.<sup>1</sup>

The options on Fed funds futures markets priced in at a greater-than-100-per-cent probability that the target rate would be reduced by an additional 50 bps at the 18 March FOMC meeting. That reading could be interpreted as either another inter-meeting ease or a 75 bps ease on the meeting date. The inflation data reported during the month was anything but benign, and the term "stagflation" (a condition of accelerating inflation but in a stagnant economy) suddenly appeared prominently in the media. Any ideas that this would dampen the

easing scenario were quickly erased when, on 27 February, in testimony to the House Financial Services Committee, Chairman Bernanke stated that the Fed would be "carefully evaluating incoming information bearing on the economic outlook and act in a timely manner as needed to support growth and to provide adequate insurance against downside risks."<sup>2</sup>

<sup>1</sup> US Economic and Market Daily, Citi FI Direct (<https://fi.direct.citigroup.com>), 5 February 2008.

<sup>2</sup> [www.bloomberg.com](http://www.bloomberg.com), accessed on 27 February 2008, in "Bernanke signals Fed prepared to lower rate again" by Craig Torres and Scott Lanman.

## US corporate bonds

Overall average balances were up 26.53 per cent for the month.

### Current news

Early in the month, Nasdaq Stock Market Inc. and Man Group Plc unit MF Global Ltd were among borrowers seeking to raise at least USD43.3 billion in bonds in the US, according to data compiled by Bloomberg. Sales so far this year total USD127.8 billion, compared with USD124.3 billion in 2007.<sup>1</sup>

Later in the month, Honeywell International Inc, sold USD600 million of five-year notes and USD900 million of ten-year bonds in its largest debt sale in a single day. The notes and bonds priced to yield 147 bps more than US Treasuries of similar maturity. The debt was rated A2 by Moody's, an equivalent "A" by Standard & Poor's. In March 2007, Honeywell sold USD400 million of ten-year bonds that priced to yield 77 bps more than Treasuries of similar maturity.<sup>2</sup>

### Issues in demand

- Univision (CUSIP 904201AA8)
- Realogy (CUSIP 75605EAT7)
- Abitibi (CUSIP 003924AA5)
- Perkins Family Restaurants (CUSIP 761253AD5)
- Claire's Stores (CUSIP 179584AC1)

<sup>1</sup> [www.bloomberg.com](http://www.bloomberg.com), accessed on 8 February 2008.

<sup>2</sup> [www.bloomberg.com](http://www.bloomberg.com), accessed on 26 February 2008; *WSJ*, 26 February 2008.

## US Treasury and agency

The strong demand for Treasury collateral, which we have become accustomed to lately, continued throughout the month of February. The month started out on the heels of a 50 bps reduction in the Fed funds rate on 30 January. Then US Treasury Global Custody General Collateral (GC) spread-to-funds proceeded to average over 40 bps throughout the month. These wide spreads, which now seem to have become commonplace, will eventually, begin to narrow. Historically, the US Treasury GC spread to Fed funds for the month of February is as follows:

### US Treasury GC spread-to-funds (bps)

- Feb 2005: 1
- Feb 2006: 4
- Feb 2007: 1
- Feb 2008: 40

The market is obviously still in the midst of the same turmoil that drove the spreads to wider-than-normal averages. We continually monitor trends to see when or if the market will return to some semblance of normalcy. The demand for treasuries was further exacerbated by the off-cycle quarter-end of four large primary dealers on 29 February. This quarter-end effect drives up the demand for treasury collateral, which markedly widens spreads as month-end approaches. The result of this quarter-end effect widened the spread for Treasury GC to 114 bps on 29 February.

All US Treasury on-the-run issues traded with strong demand throughout the month. The spreads were as follows:

### Spread in bps

- CT 2-year: 61
- CT 3-year: 58
- CT 5-year: 190
- CT10-year: 134
- CT long bond: 54

The FOMC did not meet in February. The next meeting is 18 March. The term repo market was pricing in at least a 50 bps reduction in the Fed funds rate for the March meeting.

## Asia-Pacific equities<sup>1</sup>

### Regional

Inflation is another key risk for the outlook, given high food and energy costs, abundant liquidity and booming asset markets. Asian currencies are not following the weakening dollar, in part because aggregate trade data look more robust than expected.

### Japan

Continued uncertainties surrounding the US economy and global financial markets, combine with ambiguity regarding domestic growth prospects. Economic growth is likely to remain a trend in 2008. The next Bank of Japan rate-hike likely will be delayed until around year-end, as uncertainties surrounding the global outlook have increased.

### Australia

The Reserve Bank of Australia's underlying inflation measures accelerated further in the fourth quarter, unemployment fell to a new low of 4.1 per cent in January and credit provided by banks has continued to grow briskly. Moreover, leads guides, such as job vacancies, have remained at high levels despite a sharp drop in business confidence. In addition, higher contract prices for iron ore and most likely coal will help boost Australia's terms of trade by a further 5 per cent this year. With inflation continuing to rise, measures of monetary policy, such as the real cash rate, remain only slightly above neutral levels, even though the nominal cash rate is high.

### China

Key risks include inflation, US recession and trade protectionism. External surpluses should shrink as shares of GDP, but investment may rise further should China become a major player in the global capital markets, though its own financial system and exchange-rate policy remain challenges. The A-share market had corrected by about one-third from its peak. Overvalued asset markets and hasty liberalisation of the capital account could pose serious risks to the economy.

### Hong Kong

Falling real interest rates, due to bank interest-rate cuts and rising inflation, will likely boost domestic demand and the property market. 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 market becomes steady.

### India

A deteriorating global macro environment and higher interest rates are expected to cause a slowdown in growth during 2009 to 8.3 per cent. Structural changes in the economy, coupled with the impact of the sixth Pay Commission on consumption are positive. Moreover, corporates are not as leveraged as in the past, which means that they would only have a minor impact on investment. Risks are both global (a

worsening recession, subcontinent risks) and domestic (infra-development, a talent shortage).

### Korea

Commodity-producing emerging-market countries should continue to be the major driving forces in Korea's export growth. Export growth continued to be strong in January and was led as much by European as oil-producing countries or areas like the Middle East and Russia. Consumer goods sales declined again, though retail sales showed signs of rebounding. Facility and construction investment extended the recent recovery.

### Singapore

Consumer Price Index (CPI) inflation could average five per cent in 2008, up from around two per cent in 2007. Upward revisions in Housing Development Board values; higher rent, food and fuel prices; wage pressures; and lower interest rates are fuelling inflation pressure

### 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.

<sup>1</sup> "Asia Economic Outlook and Strategy (Growth and Inflation Risks)", *Global Economic Outlook and Strategy*, 28 February 2008.

## European equities

Overall balances have increased by 18 per cent for the month. This is due to increased longer-term trading.

### News

"European Stocks Drop for Fourth Month on Concern Earnings Growth Will Slow"<sup>1</sup>

European stocks fell, completing their fourth straight month of declines, as investor concern deepened over slower economic growth and the chance that this could curb earnings further. The Dow Jones Stoxx 600 Index dropped to 318.95 in London. The gauge has fallen 13 per cent this year on the apprehension that the collapse of US subprime mortgages and a slowdown in the world's largest economy

would hurt global profit growth. "Some earnings have showed uncertainty and that hasn't been reassuring," said Benoit de Broissia, who helps oversee USD6.1 billion at Richelieu Finance in Paris. "The market is focused on companies' outlooks and the message of a lack of visibility."

### Active stocks

#### Relative-value and M&A news<sup>2</sup>

- TomTom (TOM2 NA)
- 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)
- Tiscali TIS IM)
- Bca Mps (BMPS IM)
- Metrovacesa SA (MVC SM)

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

<sup>1</sup> www.bloomberg.com, accessed on 1 March 2008.

<sup>2</sup> Equity Finance Desk, Citi Global Markets Limited, February 2008.

## European government bonds

Demand for European government GC increased and balances rose this month as borrowers continued to source high-grade collateral. Spreads continued to drop at the start of the month, following the trend from January, but had fully recovered and were in fact slightly up by the end of February.

We saw interest in DBR3 3/4 01/04/17 (DE0001135317), the Cheapest-To-Deliver bond in March's 10yr Bund contract, which moved to 10-15 bps during the last week of the month.

The gilt market yielded a couple of specials this month, most notably the UKT 4 09/07/16 (GB00BOV3WX43), which traded up to 100 bps for several days during the latter part of February, before falling back to GC by the end of the month. Interest turned to the UKT8 3/4 08/25/17 (GB0008931148), which moved to 10 bps.

Despite a cut in interest rates by 25 bps to 5.25 per cent, and strong signals from MPC members that further cuts could follow (most analysis suggesting a 8

May decision), LIBOR levels in the short end actually moved up by around 20 bps (three-month LIBOR) through the month. Last month's return to some sort of normalcy appears to have been short lived as the global credit squeeze continues to bite, indicating that spreads are here to stay for a little longer.

## European money markets

Economic data throughout the month provided further evidence of weakness in the euro-region's economy, manufacturing showed signs of weakening as both domestic and foreign demand faltered. However, while the projection of inflation for the year continues to be revised upward (to 2.8 per cent this year, an increase of

80 bps from six months ago), the ECB is unlikely to consider a cut in rates, until it sees signs of this trend reversing.

For the market, economic data has taken a back seat to the renewed concerns regarding credit markets, further bank write-downs and hedge-fund collapses. Monoline concerns have ensured that

cash has once again become king. The spread between inter-bank lending rates and the ECB repo rate has reversed the tightening we saw in January, widening back out to 40 bps.

For further information, please contact your Citi representative.

### Contacts



USA, New York

**Laurie Zeppieri**

Tel: +1 212 657 1075

Email: [laurie.zeppieri@citi.com](mailto:laurie.zeppieri@citi.com)



Europe, London

**Brian Staunton**

Tel: +44 (0) 20 7500 5411

Email: [brian.staunton@citi.com](mailto:brian.staunton@citi.com)



Asia, Hong Kong

**Larry Komo**

Tel: +65 6328 5377

Email: [lawrence.komo@citi.com](mailto:lawrence.komo@citi.com)

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