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Welcome

As Bob Dylan so appropriately stated, "For the times they are a-changin'." And the same sentiment can be shared within our industry. We witnessed unprecedented events: the collapse of Lehman Brothers and Washington Mutual; consolidations of Bear Stearns, Merrill Lynch and HBOS; restrictions on short selling in some markets or sectors; and finally global government intervention bolstering liquidity and stability preventing the economy from what policy makers saw as the beginning of a global meltdown. Now the future lies ahead of us, and change will be a predominant theme over the coming months, a change to the core basic fundamentals of the financial sector that will reshape the industry.

Daily change and conformity has been something that we, at Citi, have realised is part of the new world order. Our global team of professionals has been working diligently protecting the best interests of our clients and the integrity of our programmes. We have striven to be the best that we can be during these turbulent times by providing detailed reports to you each day. We have also maintained a high level of daily dialogue, via our global relationship management team, insuring that you were kept up to date on any developments occurring in the marketplace. We have stayed balanced and focused in these past few weeks and will remain that way as always. Citi has a long-term view and we will continue to offer top-quality service, delivering innovative solutions for an evolving market.

US equities¹

Average balances were flat for the month. There were unprecedented, historic events in the quarter's final month. Fannie Mae and Freddie Mac were taken over by the US government. Lehman Brothers went insolvent. Merrill Lynch & Co. was acquired. American International Group Inc. gave the government control of the company in return for a USD85 billion loan. Washington Mutual Inc. was seized by federal regulators and the bulk of its operations sold off.

The Dow Jones Industrial Average lost 4.4 per cent in the latest quarter and is down

23 per cent from its peak last October. The Standard & Poor's (S&P) 500-stock index is off 9 per cent from the end of June and down 26 per cent from its high. The Nasdaq Composite Index dropped 9.20 per cent in the third quarter and is 27 per cent below its multiyear high set last October.

This was certainly a bad quarter, but on a percentage basis it doesn't even break into the top-ten worst quarters for the S&P 500 and is only the 25th-worst quarter of all time for the Dow.

Active stocks

- Carmax (KMX)
- Fortress (FIG)
- Lululemon (LULU)
- Sears Holdings (SHLD)
- Zale Corp (ZLC)

Sectors in demand included: autos, sub-prime 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 on 22 and 24 September, and 1 October 2008; *Wall Street Journal* (WSJ), 22 and 24 September, and 1 October 2008.

Canada equities²

The S&P/Toronto Stock Exchange (TSX) Composite Index dropped 11.63 per cent during September on continued concern in the financial sector, and falling commodity prices. Volume spiked intra-month with 600 million shares trading hands on 18 September, a high for 2008.

The Canadian Securities Administrators (CSA) issued an overview of regulatory initiatives taken owing to current market events. Both the CSA and the Investment Industry Regulatory Organization of Canada (IIROC) are closely monitoring

global market events, and these measures indicate that Canadian regulators are proactively monitoring market activity and are prepared to take necessary action to prevent or curtail market disruption.

The CSA has taken the following actions

- Temporarily prohibited short selling in shares of certain financial sector issuers.
- Initiated a review of money market funds and other market participants to assess potential exposure to assets that are impaired or made illiquid.

- Created a special committee to recommend regulatory responses to aspects of the seizure of the non-bank sponsored asset-backed commercial paper (ABCP) market in Canada.
- Monitoring continuous disclosure by reporting issuers with a particular emphasis on the banking and financial services sector and highly leveraged reporting issuers.
- Monitoring, through IIROC, trading on the markets to assess if they continue to be fair and orderly and determine whether further steps should be taken.

- Collaborating with other Canadian regulatory authorities that oversee the Canadian financial industry to share information and coordinate actions.

Working closely with regulators around the world and actively monitoring international developments, the CSA is actively monitoring market events and is committed to protecting investors and market integrity.

The IIROC has taken, or is taking, the following actions

- Issued notices to the broker community in the handling of a short sale and specific guidance on the obligations of brokers in complying with the Temporary Order issued by the CSA.
- Increased surveillance of short-selling activity on Canadian marketplaces,

specifically in the securities of financial sector issuers that are not covered by the Temporary Order, closely monitoring regulatory capital position of all dealer member firms to assess the impact of current market conditions and in particular market volatility.

- Conducted a regulatory study and will be making recommendations concerning the manufacture and distribution by IIROC member firms of third-party ABCP in Canada.

The CSA, the council of the securities regulators of Canada's provinces and territories, coordinates and harmonises regulation for the Canadian capital markets. The IIROC is the national self-regulatory organisation that oversees all investment dealers and trading activity on debt and equity marketplaces in Canada.

Active stocks

- Thomson-Reuters Corp
- Uranium Participation Corp.
- Aurelian Resources Inc/Kinross Gold Corp
- Timminco Ltd
- Ballard Power Systems Inc
- Open Text Corp
- First Calgary Petroleum Ltd

² Citi Canada Market Watch via Canadian Securities Administrators (CSA); www.bloomberg.com, accessed on 2 October 2008.

US cash and money markets³

September 2008 will be remembered as one of the most eventful months in the history of the capital markets. It is difficult to even begin to discuss the various market events that took place and the effect that those events had on the short-term fixed-income markets.

During the first week of the month, the market concentration was on the deteriorating condition of Fannie Mae and Freddie Mac, the two large US Government Sponsored Enterprises (GSEs) that provided financing for roughly 50 per cent of the mortgage loans in the US. By the end of the first week, it was apparent that the two GSEs were going to need some kind of recapitalisation and that the capital was not available in the external markets.

In a stunning announcement on 6 September, the US Treasury Department announced that it was putting Fannie and Freddie into Conservatorship, and would purchase preferred shares in the companies to recapitalise them.

In addition, the Treasury Department issued an explicit guarantee on all senior obligations of the GSEs and on the Federal Home Loan Banks until December 2009.

The results of these actions were a significant tightening of spread between the GSE and US government debt.

During the second week of the month, the focus shifted toward the deteriorating condition of Lehman Brothers, who at the time was the fourth-largest investment bank in the US. Lehman's liquidity position and balance-sheet strength weakened significantly during the week, and by week's end it was clear that Lehman either needed to find a merger partner or declare bankruptcy. After all efforts to find a partner failed, Lehman Brothers Holdings Inc., as well several other Lehman legal entities, declared bankruptcy at midnight New York time on 14 September.

This event generated a "flight to quality" that to this date has not abated. This was further exacerbated by the near-bankruptcy

filing of the world's largest insurance company AIG, which was only saved by US government intervention, whereby the Federal Reserve gave the company a USD85 billion secured short-term loan.

The effect of all of this turmoil on market rates was astounding. Three-month LIBOR, which until the Lehman filing averaged just below 2.82 per cent, reached 4.05 per cent by the end of the month. At the same time, the rate on three-month US Treasury bills decreased from 1.72 per cent to 0.90 per cent, after reaching 0.00 per cent trading levels on some days.

³ www.bloomberg.com, accessed on 8 October 2008

US corporate bonds

Average balances were down 7.11 per cent for the month.

Trading in the corporate bond market has fallen over 30 per cent after averaging USD26 billion a day in the first eight months of 2007, according to Federal Reserve data on primary dealers.

The biggest bond dealers aren't committing as much cash to boost corporate-bond trading, partly owing to their efforts in shoring up their capital after the collapse of the sub-prime mortgage market spurred about USD511 billion of write-downs and losses. The decline in corporate-debt

trading is making these instruments less liquid. This is prompting fund managers to demand higher compensation to buy new bonds, driving up borrowing costs for companies, including American Express and Verizon, and reducing returns on existing securities. The corporate-bond market is at

its most illiquid since the collapse of Long-Term Capital Management a decade ago.⁴

Towards the end of the month, yields over benchmark rates on speculative-grade bonds rose 20 basis points (bps) to the highest level since November 2002. The gap between yields on junk bonds and US Treasuries widened to 987 bps. Yields over benchmark rates on investment-grade bonds

widened to a record 436 basis points.⁵

Corporate Bond sales so far this year total USD688 billion, compared with USD902 billion in the same period in 2007, Bloomberg data show.⁶

Issues in demand

- Brookstone (CUSIP 114535AB3)
- GM Corp (CUSIP 370442AZ8)

- Masonite (CUSIP 575379AE2)
- NTK Holdings (CUSIP 62941EAB7)
- Yankee Acquisition (CUSIP 984756AD8)

⁴ www.bloomberg.com, accessed on 10 September 2008.

⁵ www.bloomberg.com, accessed on 25 September 2008.

⁶ www.bloomberg.com, accessed on 25 September 2008.

US Treasury and agency

Tumultuous times have returned to the domestic fixed-income securities lending market. The US Treasuries and agencies have been experiencing an unprecedented lack-of-liquidity phenomenon, which has caused a record number of fails across many issues between the dealer community and securities-lending agents. This ongoing illiquidity is partially due to the decision made by some large holders of treasuries to temporarily withhold their securities from lending programmes. This supply of securities had been previously providing liquidity to the street. Each additional large US Treasury holder that chooses to "box" (hold back from the street) their securities further exacerbates the deepening dearth of treasuries.

The average spread between treasury general collateral (GC) and Fed funds open averaged 74 bps for the month. The spread for 30 September (quarter-end) was 630 bps. Treasury GC averaged 0.70 per cent while Fed funds opened at 7 per cent and traded down to 0 late in the day. It was very difficult to finance over the quarter-end. The dealer community has become extremely balance-sheet sensitive during their statement days. Quarter-end markets have become very expensive. Very few dealers will bid for issues and the dealers that will bid will charge a premium for the use of their balance sheet.

The Fed opted to keep the Fed funds rate unchanged at 2 per cent during

the 16 September Federal Open Market Committee (FOMC) meeting despite the fact that the Fed funds futures had a 50 bps ease priced in for that meeting. As of 6 October, the futures are pricing in at 40 per cent chance of a 50 bps ease and 60 per cent chance of a 75 bps ease during the 29 October FOMC meeting. Moreover, there has been speculation from the street that the Fed might not wait until 29 October to ease and that the Fed might do an inter-meeting move well in advance of 29 October.

Asia-Pacific equities

Asia-Pacific

The global economy is experiencing significant stress, the US growth is likely to reach trough before recovering modestly, and the EU and Japan already entered negative economic growth. The central banks have cut rates by 50 bps all across the countries, and the Australian Reserve Bank cutting rates by 100 bps. The threat of a US recession will likely dominate the near-term outlook for Asian economics and markets. Downward risk to US growth increased substantially and that could add pressures on Asian economies. Inflation is another key for the outlook, given high food and energy costs, with slowing growth, tightening liquidity and falling commodity prices, inflation probably already peaked or are peaking across the region.

China

The government should continue the past economic policies, and the monetary

policy focus has shifted to protecting growth, as inflation recedes. Monetary tightening has probably ended, giving way to micro-adjustments to fine tune growth, but broad-based easing remains unlikely. China should become a major player in the global capital markets, but its own financial system and exchange rate policy remain challenges. China's economy is showing a greater level of fatigue, industrial output fell to 12.80 per cent year-on-year in August, as broadly slower activity was exacerbated by Olympic restrictions and power shortages. The Consumer Purchasing Index (CPI) fell to 4.90 per cent last month as food prices retreated faster than expected, retail sales remained strong, but auto and furniture are under significant pressure. The People's Bank of China (PBOC) cut lending rates and reduced reserve requirement for small banks to alleviate difficulties in selected areas of the economy.

Hong Kong

Hong Kong's interest-rate cutting cycle ended as banks have hiked mortgage rates by 25 to 50 bps and may further raise lending and deposit rate. The financial sector continues to gain strongly from fund-raising by Chinese firms and China's overseas investment. However, Chinese capital outflows have lost momentum, while fund-raising in Hong Kong declines amid the global market crisis. The local financial market would only pick up after the global market becomes steady. New fiscal measures totalling HKD11 billion has been announced to help households cope with rising inflation. The budget had already planned to give households HKD35 billion in tax concessions, social welfare and subsidies. The financial industry is expected to enter a low growth era as credit growth and investment in global markets become sluggish after the latest crisis. In the near term, the economy will be receiving support from the government

payments, subsidies and tax cuts that should boost consumption. Asset prices are reflecting a gloomier economic outlook. Stock prices started to plunge in late 2007, and house prices have fallen more rapidly in recent weeks. Inflation seems have to peaked. The Government has been reducing rent, electricity and transportation costs for household, headline CPI is likely to be lower than 4 per cent. The economic slowdown is easing domestic inflation pressure, while the USD's rebound and lower food and energy would cut Hong Kong's import prices.

Korea

The contrast between emerging market-driven export booms and oil-driven weakness in domestic demand should persist in 2008. Inflation likely to stay

above Bank of Korea's (BOK) target range until the end of this year due to a commodity price rally, weak Won and rising inflation expectations. BOK raised policy rates by 25 bps to contain inflation expectations, while the government would implement fiscal easing such as tax cuts and a supplementary budget.

Singapore

The GDP forecast has dropped significantly from 2.8 per cent down to 2.5 per cent due to a protracted export slump and slowdown in domestic demand. Softening real income growth could curb domestic demand in tandem with failing external demand. Domestic funding conditions may be tightening, as suggested by a recent rise in interest rates. A slowdown in hiring and potential retrenchments from the growth

deceleration are expected to be moderate, with all Asia still seen as a growth region, job losses, especially in the financial sector may be capped. Inflation moderated to 6.40 per cent in August and will likely slow further to 5.00 per cent before failing more, as the effect of the growth slowdown and lower commodity prices kick in. The Monetary Authority of Singapore is expected to ease monetary policy in the near future by shifting to a zero percent appreciation bias. Fiscal policy may kick in and cushion the slowdown through government fee reduction and other measures to cut business costs.

European equities⁷

Average balances were down by 1 per cent. This is due to market uncertainty.

This month we saw the demise of two of the world's biggest investment banks. Lehman Brothers filed for bankruptcy, Barclays Capital purchased its North American Investment Banking and Capital Markets businesses for USD1.75 billion. Merrill Lynch merged with Bank of America in an all-stock deal valued at USD50 billion. Towards the end of the month, Fortis became the largest European firm to be bailed out in the crisis; governments in Belgium, the Netherlands and Luxembourg spent EUR11.2 billion (USD16.3 billion) in rescuing the lender. Hypo Real Estate, Germany's second-biggest commercial-property lender, got a EUR35 billion loan guarantee to fend off insolvency.

The collapse of Lehman Brothers Holdings Inc. and Washington Mutual Inc. has set off new troubles and the recent freeze in short-term debt markets has only compounded the problem. European stock markets continued to slide as energy stocks tumbled

on the falling price of oil. The UK Financial Services Authority (FSA) and European authorities have announced a temporary emergency action to prohibit short selling in financial companies to protect the integrity and quality of the securities market and strengthen investor confidence.

Citi has published a comprehensive list of restrictions that temporarily prohibit any person from effecting a short sale in the publicly traded securities of certain financial entities. For additional information, please refer to the CDS Market Guide at <https://securities.citidirect.com> or contact your Citi securities finance representative.

Active stocks

Relative-value and M&A news

- Inbev NV (INB BB)
- Continental/Schaeffler (KG)
- Natixis SA's (KN FP)

Directional and convertible bond news

- Anglo Irish Bank Corp (ANGL LN)

- Banco Pastor (PAS SM)
- Barratt Developments (BDEV LN)
- Alliance & Leicester (AL/ LN)
- Marine Harvest (MHG NO)
- Banco Popular Espanol (POP SM)
- Bradford & Bingley (BB/ LN)
- Pages Jaunes (PAJ FP)
- Bang & Olufsen (BOB DC)
- Gestevison (TL5 SM)

Sectors and markets in demand included bank and housing sectors.

European government bonds

Uncertainty within global financial markets intensified during September, highlighted with the demise of Lehman Brothers. This signalled a swift end to the Investment Banking model that relied heavily on leveraged financing to operate.

Merrill Lynch sought refuge with Bank of America, while Goldman Sachs and Morgan Stanley gained "banking" status, receiving immediate Fed backing. Liquidity within the credit markets virtually dried up with LIBOR (EUR 3-month) increasing by over

30 bps to 5.27 per cent during the latter part of the month.

Overall euro government balances decreased through the month as some investors limited their bond lending/cash

⁷ www.bloomberg.com, accessed on 25 September 2008.

reinvestment programme guidelines. But demand for GC remained high with plenty of opportunities to enhance yields on the cash reinvestment book. There were no European government specials in September.

The gilt market yielded a couple of specials this month with the UKT 4 03/07/09 (GB0032785924) and UKT4 1/4 03/07/11

(GB00BOLNX641) squeezing up to 125 bps towards the end of the month. These bonds have been short in the street for some time becoming more difficult to locate as lenders recalled gilts from loan. General collateral (GC) bids continued to drift above Sterling Over Night Interbank Average (SONIA) levels (the historical benchmark

for sterling [STG] GC rates), as the Bank of England's Special Liquidity System (SLS) has left the street awash with GC. In the same period, however, LIBOR (STG 3-month) has risen by over 60 bps, again providing good opportunity for reinvesting in the short term.

European money markets

Economic data has taken a back seat to the financial market disruption set off by the Lehman bankruptcy. During the weeks that have followed, Europe has witnessed several bank takeovers, governments stepping in to bailout banks and, in the case of Ireland, a complete guarantee of bank deposits and debt for two years. However, to date the European leaders have resisted

calls to adopt a more coordinated rescue mechanism similar to that which the US Congress marginally passed.

The result has been a drying-up of liquidity. Investors are only prepared to invest in very short-dated bank securities and the euro LIBOR, the rate at which banks lend to each other, has risen 32 bps during the month as banks hoard cash.

As the financial crisis has intensified, the outlook for the euro zone economy has deteriorated. Unemployment is rising and consumer sentiment is waning even as oil prices decline. The market expectation is that the European Central Bank will be forced to cut interest rates aggressively prior to year-end.

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