

On loan activity

**Government Bonds**

- U.S. □
- European ↑

**Corporate Bonds**

- U.S. ↑
- European ↑

**Global Equities**

- U.S. ↑
- European ↑
- Asian ↑

Key: ↑ Up ↓ Down □ No change

## U.S. equities

Our U.S. desk in New York saw overall average balances up 0.36 per cent for the month with average specials in demand up 2.76 per cent.

With tame Producer Price Index (PPI) numbers and oil prices falling to as low as USD60 a barrel, the Dow rallied this month and at times it traded within points of the all-time intraday high set in January 2000. Strong consumer confidence numbers, stronger-than-expected new home sales for August and positive news on some Dow components also helped push the market higher. This was all despite weaker durable goods and Gross Domestic Product (GDP) numbers, a negative Philadelphia Fed manufacturing number, continued concerns over the strength of the economy and the ongoing potential for inflationary pressures.<sup>4</sup>

**Active stocks**

- Building Material (BMHC) traded as low as 1.00 per cent ahead of record date on 22 September 2006.

- Fidelity National (FNT) traded as low as negative 10.00 per cent ahead of record date for dividend on 14 September 2006.
- Corus (CORS) remained tight. With short interest over 50.00 per cent of float, there was heavy demand in repo with shares trading as low as 0 per cent.
- 1st Marblehead (FMD) traded as low as 2.00 per cent ahead of record date on 18 September 2006.
- PW Eagle (PWEI) traded as low as negative 12.00 per cent ahead of record date 2 October 2006.
- New York Times (NYT) traded as low as 4.00 per cent ahead of record date for dividend on 1 September 2006.
- Asta (ASFI) traded as low as 4.50 per cent ahead of record date 29 September 2006.

Sectors in demand included: autos, ETF and REITs. Some drivers of this demand included: asset valuations, downgrades, interest-rate volatility, commodity prices and supply issues.

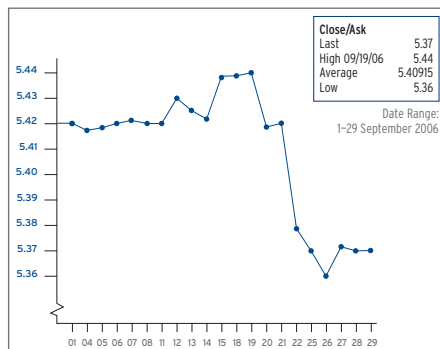
<sup>4</sup>Source: Bloomberg L.P./WSJ, 21, 27, 28 September 2006.

## U.S. cash and money markets

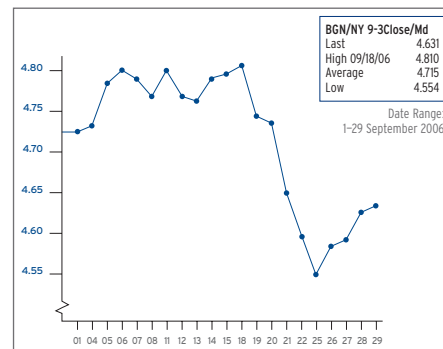
Our U.S. desk in New York saw that a combination of benign inflation data, reduced pressure on energy prices and weakness in the housing market led to a continued decline in interest rates across the LIBOR and Treasury curves. As seen in the adjacent Bloomberg charts, the six-month LIBOR rate decreased by seven bps, while the ten-year U.S. Treasury note decreased by 17 basis points (bps), having been down by as much as 25 bps.

While several market economists continue to express the view that the Federal Open Market Committee (FOMC) will continue to raise short-term rates at some point in the future, the charts illustrate traders had a different opinion. The fed funds futures chart highlights how the December fed funds contract reflected a change from a small probability of a rate hike to an equally small probability of a rate decrease. Our cash-collateral portfolio-management strategy is now based on the premise that there will be no further rate hikes this year.

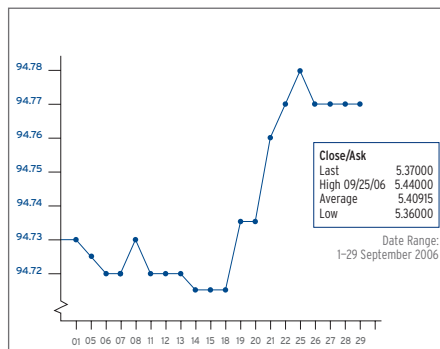
Six-month LIBOR, September 2006



10-year U.S. Treasury, September 2006



Fed funds futures, December 2006



## U.S. corporate bonds

In September our U.S. desk in New York saw overall average balances up 3.68 per cent for the month while average special balances were down 11.89 per cent.

Corporate bond spreads to treasuries have widened as the supply of securities has increased recently. According to a report on 28 August 2006, issued by analysts at the Bank of America, sales of investment-grade bonds could top USD80 billion in September, up over 25 per cent from August.<sup>1</sup>

Deutsche Bank is close to issuing Taiwan's first USD-denominated corporate bond. Issue size will be between USD200 and 500 million with an estimated yield between 4.60 and 5.00 per cent.<sup>2</sup>

General Motors Acceptance Corp may sell its first bonds in almost two years once the group of buyout firms purchases a stake in the financing unit of General Motors

later this year, according to Joanne Krell, a spokeswoman for GMAC in Detroit.<sup>3</sup>

### Issues in demand from Citigroup's U.S. desk

- WCI bonds (CUSIP 92923CAG9) 3.50 per cent due 5/01/2012 were in demand, bid at 4.25 per cent.
- Untendered shares of Philippines 14s (CUSIP 718286AU1) 8.25 per cent due 1/15/2014 were in demand, bid at 1.00 per cent.
- Lab Corp Convertible Preferred shares (CUSIP 50540RAC8) were in demand, ahead of a tender on 26 September 2006.
- Untendered shares of Philippines 25s (CUSIP 718286AP2) 10.63 per cent due 3 March 2025 were in demand, bid at 2.00 per cent.

<sup>1</sup>Source: Bloomberg L.P., 18 September 2006.

<sup>2</sup>Source: Bloomberg L.P., 27 September 2006.

<sup>3</sup>Source: Bloomberg L.P., 11 September 2006.

## U.S. issuance and credit

Our U.S. desk saw global credit trends remain relatively stable during September as no significant downgrades were issued. U.S. and foreign corporations are still benefiting from large cash balances despite the global economy's slower growth.

One notable upgrade was Citibank, N.A. which was upgraded to Aaa for long-term deposits and to A for financial strength (both ratings are at the top of their respective scales) by Moody's Investors

Services.<sup>5</sup> The rating agency sighted Citigroup's strong business segment diversity, customer base and a well-recognised brand as the rationale. Three other banks in the Citigroup family were also upgraded to Aaa for long-term deposits. Please visit [www.moodys.com](http://www.moodys.com) for more information on this press announcement.

<sup>5</sup>Source: Moody's Investors Services Press Release, 26 September 2006.

## U.S. treasury and agency

Our New York desk has reported that U.S. government balances for September were flat relative to August. The spread between overnight treasury financing and fed funds averaged just one basis point. Moreover, the spread between agency general collateral and fed funds was negative two bps. The dealer community acquired treasury collateral throughout the month by buying term in preparation of their need for treasury collateral over quarter-end. Ultimately, the street acquired a surplus of treasury collateral on term.

Dealer long positions of this nature can put an extraordinary amount of upward rate pressure on overnight treasury financing. Fortunately, we sold term into November

and December while rates were soft, which enabled our desk to enjoy wider spreads despite the rate pressure. The wider-than-expected treasury spreads we have come to expect over the quarter-end "turn" did materialise; however, not nearly to the degree that was priced into that market. Treasuries over the "turn" (29 September to 1 October) traded forward at 4.80/4.85 per cent throughout most of September but actually traded at 5.10 per cent backing up to 5.50 per cent on quarter-end.

The two current issues that traded the most special were the current ten-year and the current five-year. The tens averaged a spread to funds of 170 bps and the fives averaged 105 bps.

## Product development

We have seen the demand for emerging-market securities rise and this hot industry topic being discussed at securities finance industry conferences, in trade journals and at roundtables. In conjunction with growing client interest, we have continued to develop our capability in many of these markets.

"Synthetic lending" is closely linked with emerging markets as an alternative method of lending our client's portfolio. Often this form of lending is preferred where the market regulations do not permit a securities loan, or the rules and regulations are unclear as to what is and is not allowed. We have seen an increasing trend in the broker-dealer community to access/supply in the Taiwan market through alternative sources. Our recent roundtable event held in Amsterdam created a lot of interest and discussion on this topic. We will continue to keep our readers updated on future developments in this area.

### Market expansion

Earlier this year Citigroup was the first lending agent to complete a securities lending transaction in Taiwan, one of the hottest Asian emerging markets. Working closely with our clients and local capital markets, we have identified other emerging markets and, in response to demand, plan to offer lending capability in Hungary, the Czech Republic, Turkey and South Africa.

### Client events

We completed our second client roundtable in Amsterdam on 28 September 2006 (the first one was in Dublin, Ireland, in May). The conference focused on emerging markets, regulatory implications of MiFID and Basel II, with a session on synthetic lending structures.

Feedback was hugely positive with many attendees requesting more roundtable events and the inclusion of topics such as risk management and the impact of technology in securities finance. We will organise more roundtables in 2007, and would appreciate your suggestions on agenda items and possible locations.

# Asia-Pacific equities<sup>6</sup>

## Australia

On 7 September, our desk in Hong Kong noted from Bloomberg that Australian employment had climbed more than twice as much as expected in August. This is believed by the market to have exacerbated a worker shortage that may stoke wages and prompt the central bank to raise interest rates a third time this year. Takeover activity increased in Australia during the first three quarters of 2006 and the value of mergers and acquisitions (M&As) rose by 56 per cent to USD115 billion, largely due to the growing presence of private equity funds on the look out for takeover targets.

## Coles Myer

Kohlberg Kravis Roberts & Co. buyout group raised its takeover offer for Coles Myer to more than AUD18 billion (USD14 billion) to win control of Australia's second-largest retailer. However, news sources have expressed doubts that it will succeed when it was revealed that Kohlberg has not formally contacted Coles since 24 August 2006. The price ended up at a high of AUD14.69 up from AUD13.65 before dipping to end at AUD14.39.

## Brambles

At a General Meeting on the 9 November 2006, the shareholders of Brambles intend to vote on ending of the dual listing into an Australian-domiciled and -traded stock only.

## China

Our trading desk in Hong Kong saw that China reported the slowest growth in government and corporate spending this year, the strongest indication so far that a government clampdown on investment is starting to bite. Fixed-asset investment in towns and cities climbed 21.50 per cent from a year earlier, slowing from 27.40 per cent in July. The People's Bank of China sold on 12 September 2006 CNY120 billion (USD15 billion) of one-year Treasury Bills, the biggest issue since February 2006.

These sales are part of the banks efforts to reduce the amount of funds available for lending.

On 18 September 2006 the Shanghai Index gained around 9.70 per cent and the Shenzhen index gained 8.00 per cent, their biggest rise in three years. This was on speculation, without any particular evidence, that the government will begin merging B shares into Yuan-denominated A shares. The reason for this increase is that any increase in the Yuan makes B shares cheaper.

## Hong Kong

### Leonovo Group

The worlds third-largest personal-computer maker said it is prepared to cut prices in China as competitors such as Dell increased efforts to gain market share. The stock has declined 22.00 per cent this year, compared with the 15.00 per cent gain in the Hang Seng Index. Its fortunes were dealt a further blow when it was dropped from the Hang Seng Index on 11 September 2006.

## Japan

Nikkei shares initially fell during the first two weeks of September after U.S. labour costs rose more than expected, reviving concerns that U.S. interest rates will be increased to curb inflation. Copper and crude oil prices continued to decline amid concerns that there will be a fall in demand from the U.S. and China. Exporters were the hardest hit, such as Honda Motor Company. However, these declines were erased after China's Central Bank stated that economic growth would accelerate this year and U.S. consumer confidence rose more than expected, suggesting household spending will increase in the worlds largest economy.

Bank of Japan Board Member Atsushi Mizuno said policy makers remain committed to gradually raising interest rates even after signs that economic growth

has slowed and inflation was lower than economists had expected. Japanese bond yields fell to a six-month low after consumer prices rose less than expected. Wages declined for the first month in six and household spending has fallen every month this year. Japan's economic growth slowed to one per cent in the second quarter from 3.30 per cent in the first quarter.

## Sony

Shares of Sony Corporation, the world's biggest maker of video-game players, fell after the company halved its forecast for shipments of the Sony® PlayStation 3 this year, delaying its introduction in Europe by four months. Sony's stock has declined 7.30 per cent in the past six months compared with a 2.60 per cent gain in the benchmark Nikkei 225 Stock Average as of 6 September 2006. It is thought by the market that these falls were further exacerbated by recalls by laptop manufacturers such as Dell and Apple for Sony-manufactured batteries. Investors are unnerved about the final cost of mass recalls, as at this time there is no information available to confirm which manufacturers Sony sells its battery components to.

## Taiwan

### Benq Corp

Taiwan's largest cell-phone maker rose by their daily exchange limit on 29 September 2006 to a month high after the company announced it would halt further funding to German handset unit Siemens to stem losses.

## South Korea

In August 2006, South Korea's current account deficit widened to the largest level in four months as higher oil prices raised import costs and overseas holiday during the summer vacations.

<sup>6</sup>Source: Bloomberg L.P., September 2006.

# European government bonds

Our bond desk in London noted pressure in DBR five per cent 7/11 (DE0001135184) towards the end of this month as we approached settlement of the September Bund futures contracts. This bond traded as high as 100 bps in the final few days prior to settlement. They remain in demand, as they are the cheapest to

deliver (CTD) bond in the next contract (December 2006). The two-year contract OBL 3 1/2 08 #143 (DE0001141430) also tightened to around 90 bps.

Spanish Government paper traded at a slight premium over this month-end which is due to demand from local financial institutions.

A quiet month in the Gilt market with early speculation of special activity in 8/15 (0888154) failing to materialise. We have seen an increase in demand for term Gilt activity and have steadily increased balances throughout the month. However, financing these trades remains difficult, as collateral options are limited.

# European equities

Our European desk reported September's overall average balances were up 10.50 per cent for the month. This is primarily due to long-term general collateral (GC) trades structured during September.

## European five-year high<sup>7</sup>

Europeans' confidence in the economy unexpectedly increased to the highest in five years in September. European stocks also gained, as bids for Endesa SA & Iberdrola SA of Spain fanned more takeover speculation in a record year of M&As. Meanwhile, bid speculation lifted STMicroelectronics NV, while Schwarz Pharma AG & Fadesa Inmobiliaria SA led drug makers and property companies higher after receiving offers. Rio Tinto Group led the rebound in mining stocks, the worst performers this quarter after oil companies.

## Spain reconsiders energy industry laws<sup>7</sup>

El Economista has reported, citing comments by Spanish Economy Minister Pedro Solbes, that Spain is reconsidering

laws regulating the country's energy industry. The government needs to reflect various energy topics, especially tariffs and competition conditions in these potential changes to energy industry laws. The government's priority is to safeguard consumer interests.

## European hedge-fund industry now managing over USD400 billion<sup>8</sup>

According to the publication Global Custodian, the growth in overall industry assets, to USD401 billion at the end of June, represents an increase of 23 per cent from USD325 billion at the beginning of 2006 and of 44 per cent since June 2005 when total assets were USD280 billion.

The most rapid asset growth in recent months has been by the largest hedge-fund groups. At the end of June, the combined assets at the top 25 European hedge fund groups totaled almost USD180 billion or 44 per cent of the industry's total assets.

## Active stocks

### Relative value and M&A news<sup>9</sup>

- Intesa (BIN IM) merger with Sanpaulo.
- Abertis Infraestructuras (ABE SM) USD14.7 billion planned takeover of Autostrade SpA.
- Union Fenosa (UNF SM)/Iberdrola (IBE SM) planned merger. Spain may change its law allowing accounts, which own shares in both, to be able to vote on both boards to push through the merger.
- Gas Natural (GAS SM) planned takeover of Endesa (ELE SM), although GAS Natural will look to merge with Iberdrola and Union Fenosa should the Endesa bid fail.
- UCB (UCB BB): friendly takeover of Schwarz Pharma (SRZ GR).

### Directional (long/short)

- Antena 3 (A3TV SM) recorded its worst rating in 13 years in September.
- Conergy (CGY GR) received foreign orders worth EUR207.4 million (USD266.0 million) in September, pushing value of new contracts to full-year target.
- Premiere AG (PRE GR) reported a second-quarter net loss of EUR138.8 million (USD178.0 million).
- Singulus (SNG GR) reported a second-quarter net loss of EUR2.4 million (USD3.1 million).

### Convertible-bonds issued

- Club Med (CU FP)
- Hagemeyer (HGM NA)
- Karstadt (KAR GR)
- Sogecable (SGC SM)

### Sectors and markets in demand

Sectors and markets that we saw in demand included: Spanish utilities, Exchange-Traded Funds (ETF) and Real Estate Investment Trusts (REIT)/South Africa and emerging markets.

<sup>7</sup>Source: Bloomberg L.P., September 2006.

<sup>8</sup>Source: www.globalcustodian.com, September 2006.

<sup>9</sup>Source: Citigroup Global Capital Markets Equity Finance desk, September 2006.

# European money markets

Our European desk in London saw euro short-term rates traded in a narrow range during September (3.00 per cent to 3.04 per cent). All focus was on the almost-guaranteed 25-bps rate rise due on Tuesday 5 October and the potential timing of any more rises in November or December. The majority of the market

seems to be predicting another 25 bps rise in December. GBP short-term rates traded between 4.70 per cent and 4.90 per cent during the month. The market expectation of future rate rises is split with some predicting a 25 bps rise in October while other expect there to be a rise in November.

For further information, please contact your Citigroup representative

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