May 26, 2010

The Honorable Bill Lockyer
Treasurer
State of California
915 Capitol Mall
Room 110
Sacramento, CA 95814

<u>State of California CDS</u>

Dear Treasurer Lockyer:

Citigroup Inc. and Citigroup Global Markets Inc. (together, "Citi") hereby respond to your May 5, 2010 letter to Vikram Pandit, seeking certain information relating to trading activity concerning State of California credit default swaps ("CDS"). Citi reserves the right to supplement or amend this response in the event that additional relevant information is discovered.

Citi Support for the State of California

As stated in my letter to your office, dated April 13, 2010, Citi is one of the largest municipal securities market makers with the largest portfolio of municipal securities of any commercial or investment banking firm. In addition, as previously discussed and as set forth below, Citi provides tremendous support to the State of California ("State" or "California"):

- Citi maintains a $14 billion tax-exempt municipal bond portfolio, $2 billion of which is attributable to State issuers.
- Citi offered and approved over $5 billion of loans to the State in 2009, which consisted of a $1 billion cashflow loan in April 2009 to assist the State in meeting its cashflow needs through the end of the FY2008-09 fiscal year and $4 billion of short-term loans in August 2009 to help repay IOUs and provide cashflow financing.
- Citi committed over $800 million of balance sheet capital in support of California to purchase and/or underwrite unsold State general obligation bonds over the past year. In particular, as senior manager for the State's October 2009 general obligation bond issue, Citi purchased $175 million of unsold bonds. Had Citi not purchases the unsold bonds, the State's bonds would have had to carry dramatically higher interest rates to be successfully placed with end-buyers.
- Citi currently has $700 million in outstanding letters of credit in support of the State's general obligation debt (all of which were provided to the State in 2009), more than any other U.S. commercial or investment banking firm.
- Citi was the only major, national financial institution that continued to accept, honor and cash IOUs issued by the State throughout the challenging events of this past summer.

- Citi worked closely with your Office to develop and execute the Housing Bond Private Placement Option Program, which is intended to restart lending for low and moderate-income housing development in California, as mandated by the State's voters under Propositions 1C and 46.

- As Joint Bookrunner for the State's recent $3.4 billion Federally Taxable General Obligation and Build America Bond ("BABs") offering, Citi marketed California's BABs in 29 countries and helped generate over $10 billion of interest in the State's offering in order to help the State lower its borrowing costs.

State of California Question #1

Please provide additional details about your firm's proprietary trading of State CDS from January 1, 2007 to present. Your answer should include:

a. *The gross notional amount of State CDS traded.*

b. *The three highest net notional amounts outstanding in State CDS at any time during this period. The answer should specify the dates on which the three highest net notional amounts were outstanding, and whether the net notional positions were long credit protection positions or short credit protection positions.*

c. *A list of all time periods during which your firm held net long credit protection positions, and the amount of the net long credit protection during each identified time period.*

d. *The net notional amount of your firm's current position and whether the net position is short credit protection or long credit protection.*

Citi Response

During the relevant period, Citi entered into two proprietary trades involving State CDS: (a) buying $5 million of protection on 11/20/09; and (b) selling $5 million of protection on 2/17/10 (which closed out the purchase in (a)). These trades were not conducted by or through, or with knowledge of, Citi's Municipal Securities Division.

State of California Question #2

If the answer to Question No. 1 indicates your firm, on a proprietary trading basis, took a net long credit protection position at any time, please explain why your firm considers that action appropriate, given that your firm represents California in the marketing of its State GO bonds and is employed by California taxpayers to sell those bonds.

Citi Response

Citi engaged in only two proprietary CDS trades, the latter of which closed out a trade made two months earlier. These two trades are dwarfed by Citi's constant and sizeable exposure to the credit of the State of California.

State of California Request #3

Regardless of the answer to Question No. 1, what are your firm's future plans with respect to taking, on a proprietary trading basis, net long credit protection positions on State CDS?

Citi Response

Even considering proposed legislation that might affect proprietary trading at certain financial institutions, Citi does not currently have a plan with respect to proprietary trading of State CDS. Citi will, however, continue to act as a significant supporter of the State of California.

State of California Question #4

For the period from January 1, 2007 to present, please provide information about the extent to which counterparties to your firm's market-making trades of State CDS entered into the CDS in order to take a speculative position on State CDS spreads. Your answer should:

a. *Provide the aggregate total notional amount of all speculative credit protection positions; the aggregate total notional amount of speculative long credit protection positions; and the aggregate total notional amount of speculative short credit protection positions.*

b. *Identify by type, not name (e.g. dealers, banks, insurance companies, hedge funds, etc.) clients that have taken speculative credit protection positions on State CDS*

c. *For <u>each</u> category of client identified in response to (b), provide: the total number of all speculative credit protection positions and aggregate total notional amount of all speculative credit protection positions; the total number of speculative short credit protection positions and total notional amount of those positions; total number of speculative long credit protection positions and total notional amount of those positions; and the time periods for which the speculative short credit protection positions and speculative long credit protection positions were held open.*

If your firm cannot provide all the information requested by Question 4 (a), (b) or (c), please answer to the best of your firm's ability. Also, please fully explain the reasons your firm cannot provide all the information requested. And please explain the conditions, including changes in internal or external procedures or restrictions, which would give your firm the ability to provide all the information requested.

Citi Response

Although Citi makes markets for its customers in State CDS, it does not possess knowledge about whether or not its counterparties enter into such transactions in order to take speculative positions on State CDS spreads. Furthermore, most (if not all) customers trade their CDS portfolios on an aggregate basis, with multiple counterparties, and may be initiating, unwinding, or offsetting a speculative position or a hedging position. Such trades may be executed in consideration of other State, non-State, or even non-US positions in a variety of instruments, including CDS, bonds, or loans. It is also important to note that, over time, Citi's market-making trading in State CDS always finds its way back to zero, which illustrates that for every buyer of protection, there are parties willing to assume exposure to the State.

State of California Question #5

For the period from January 1, 2007 to present, please provide detailed information about any instances in which your firm recommended that clients take speculative long or short credit protection positions on State CDS. Unless your firm already has provided such documents, please provide copies of all research prepared by your firm and distributed to clients regarding municipal CDS generally and State CDS specifically.

Citi Response

Citi has not identified any research in which it recommended that clients take speculative long or short credit protection positions on State CDS. Enclosed please find documents with the stamps CITI 000001 - CITI 000017; these are the research pieces described in Citi's April 13, 2010 response.

State of California Question #6

For the period from January 1, 2007 to present, please provide the following information about income your firm received for market-making trades of State CDS: aggregate income for all trades; total income for trades of State CDS that hedged a specific, identified credit exposure to the State; and total income for trades of State CDS in which the counterparties took a speculative position on the State's credit.

Citi Response

Citi is unable to identify specific revenue and expenses attributable to State CDS. Citi views its risks, revenues and expenses on an aggregate portfolio basis that spans customers, counterparties, and asset classes.

State of California Question #7

If the answer to Question No. 4 indicates your firm engaged in market-making for clients who took speculative long credit protection positions, please explain why your firm considers that action appropriate, given that your firm represents California in the marketing of its State GO bonds and is employed by taxpayers to sell those bonds.

Citi Response

Please see the answer to Question #4 above.

State of California Question #8

Regardless of the answer to Question No. 4, what are your firm's future plans with respect to making markets for clients who want to take speculative long credit protection positions on State CDS, i.e. clients who want to bet against the State's bonds?

Citi Response

Please see the answer to Question #4 above.

State of California Question #9

Does your firm believe California taxpayers benefit from speculative trading of State CDS? Please explain your answer. If your answer is yes, please tell us how any perceived benefit could outweigh the potential financial harm speculative trading could inflict on taxpayers.

Citi Response

We believe taxpayers benefit from CDS trading because it expands the demand for State bonds, both tax-exempt and taxable. A CDS contract, in its simplest form, enables one set of investors to reduce their credit exposure to the State while simultaneously enabling other investors to increase credit exposure to the State. CDS trading in corporate and sovereign names is generally viewed as enhancing market liquidity, which widens investor distribution and, as a result, decreases borrowing costs. Regardless of the suggested positive benefits of CDS trading, it is difficult to conclude that State CDS trading, given the relatively small observed volume and in relationship to the existing state indebtedness, has had any discernable effect.

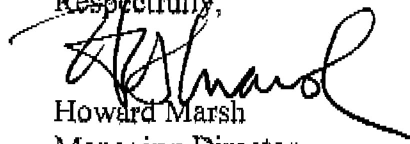
* * * *

Citi is providing the information contained in this letter, and the enclosed documents, in response to, and in cooperation with your request. Accordingly, Citi respectfully requests that the materials produced herein, together with this letter, be accorded confidential treatment under any and all applicable rules and statutory provisions, including Cal. Gov't Code §§ 6254, 11180.5 and 11183, as well as any and all common-law rules, regulations, practices, procedures, privileges and protections.

* * * *

If you have any questions or require any additional information, please contact me at (212) 723-5373.

Respectfully,



Howard Marsh
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*CONFIDENTIAL TREATMENT
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Uncovering Investment Opportunities. January 18, 2008

Municipal Products
TRADING DESK ANALYTICS

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Municipal Credit Default Swap Update

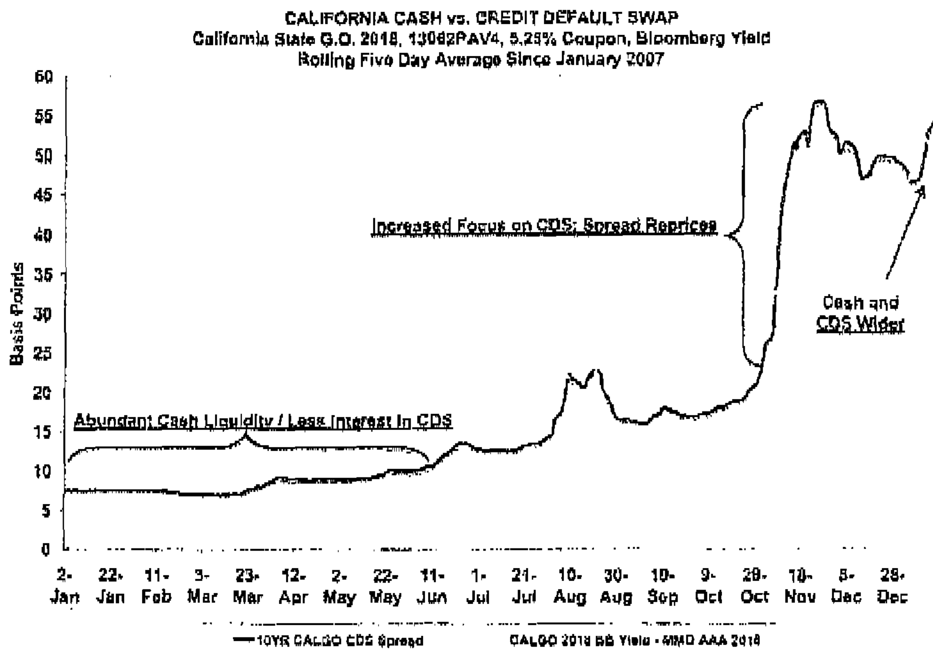
California CDS and Cash Spreads

Market Situation

The return of credit spreads to the Municipal Market has lead to increased interest in the Cash versus CDS basis. California State G.O. is one of the Municipal Market's most prolific issuers and one of the most actively traded credits in municipal CDS. Since November of 2007, credit default swaps have been trading closer to comparative credit spreads in the cash market.

During the first half of 2007, 10YR CALGO CDS averaged 9bps while 10YR CALGO Cash traded at 26bps over the AAA MMD scale. Over the past two months, however, the spreads have averaged 51bps and 44bps, respectively. We see this as an opportunity for investors to evaluate their view on the fiscal state of California while determining how strong of a leading indicator CDS may (or may not) represent for Cash.

Historical Spreads From January 2007



Points of Consideration:

- The current 10YR CDS spread of 57bps implies a cumulative 25% chance of default for the State General Obligation Credit using an 80% recovery level.

- The state of California has over $40bn in G.O. debt outstanding[1], $141 billion dollar annual budget[2], a GDP[3] equal to France's and A1/A+/A+ credits ratings from Moody's, S&P and Fitch.

1 http://www.sco.ca.gov/ard/cafr/cafr06.pdf , Page 20
2 http://www.census.gov/govs/www/statetax06.html
3 http://www.bea.gov/regional/gsp/

Citigroup Global Markets Municipal Securities Division
Proprietary Trading and Derivatives Group

Investors should be aware that this is a product of the trading desk and should not be confused with research. Please review disclosures on the final page of this publication for additional important information.

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See Disclosure Appendix A1 for the Analyst Certification and Other Disclosures.

UNITED STATES
PRIVATE CLIENT
INVESTMENT STRATEGY

DECEMBER 12, 2008

Municipal Market Comment

UNITED STATES

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New York

Yields in the Muni Market Have Been Pushed to Unsustainable Extremes

- The municipal bond market is not alone in experiencing distended yields and prices, in an environment where normal capital market processes simply aren't working.
- Nevertheless, we believe that the steepening of the muni yield curve and the widening of credit spreads in the muni market reflect extreme and unsustainable patterns.
- Reasons include the lack of institutional demand, the lack of a reasonable bid side on paper that investors need to sell, muni fund outflows, and limited channels of distribution to the now-all-important direct retail sector.
- It would also appear that heavy December selling by high-yield funds has caused an "accordion effect," whereby massive increases in yields on lower rated paper have pulled yield spreads on everything else rated below triple-A wider as well.
- These patterns have been compounded by severe, and in our view, unwarranted fears regarding the potential for defaults in the muni market, stemming from a number of sources, including the large size of projected state and local budgetary shortfalls.
- In our view, investors should recognize that the states have substantial resources to deal with these pressures, and that ultimately the Federal government will provide support in specific, identifiable forms if needed.
- Painfully low short-term rates and a growing US savings rate will also help the muni market recover.

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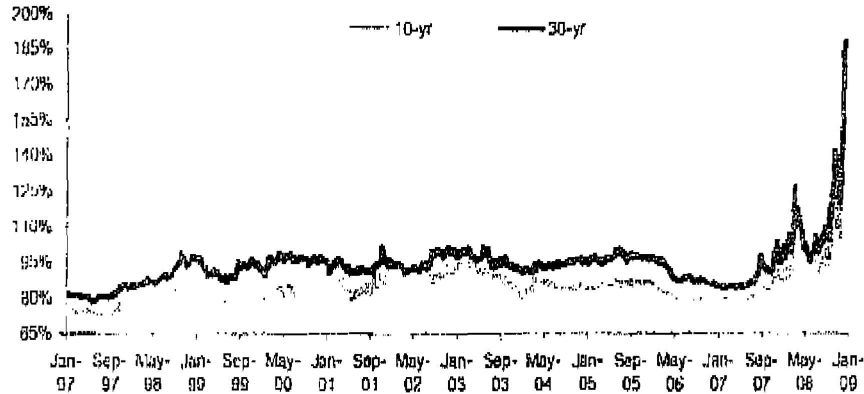
Mostly good news for investors

The muni market isn't working very well.

A very dramatic recent increase in slope credit spreads and sector spreads

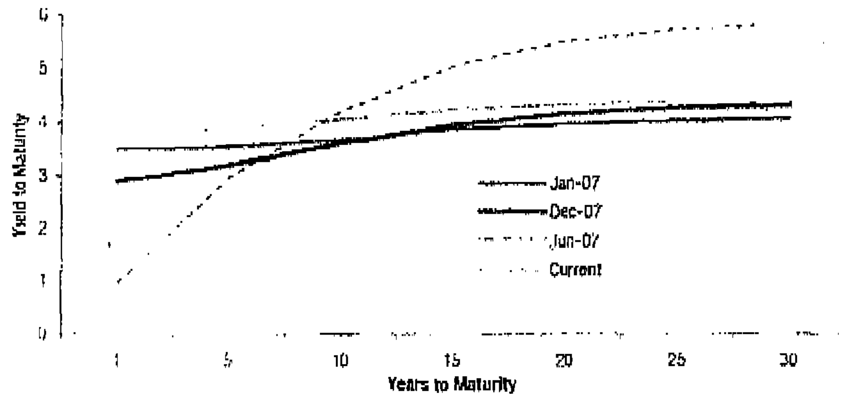
These are strange and challenging times, indeed, in the municipal bond market. By every possible measure, yield levels have become distended, with the slope of the yield curve, credit spreads all at record levels. Ten and 30-year muni yields as a percentage of ten and 30-year Treasury yields have more than doubled since early 2007, to levels where the comparison no longer makes much sense. (Figure 1). The yield curve has continued to steepen, with long-term yields moving higher even as short term yields keep declining and will go a lot lower still, we expect. (Figure 2). Credit spreads have widened sharply over a very short time period: in 30-year maturities, the AAA-Baa spread in 30-year maturities has widened from 87 basis points on September 30 2008 to 210 basis points at present, (Figure 3). On 10-year maturities, it has widened from 153 basis points to 239 basis points.

Figure 1. Ten- and 30-year Munis as a Percentage of Treasuries, Jan-97 to Dec 08



Muni Market Data Line, CGI

Figure 2. AAA Municipal Yield Curves, Jan 07, Dec 07, Jun 07 and Current



Source: Muni Market Data

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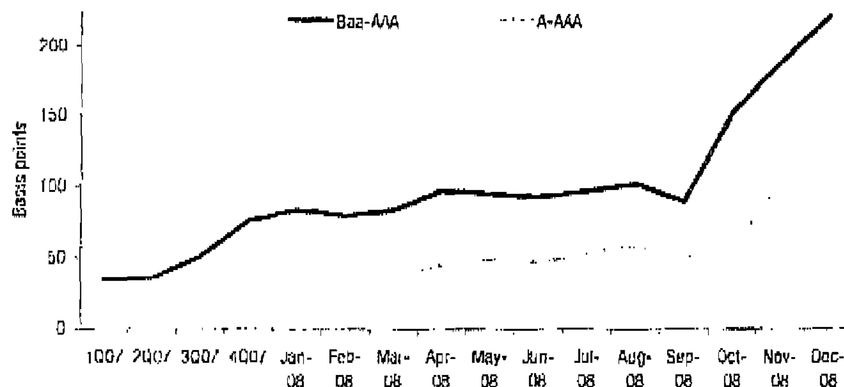
It is also important to note that AAA-A spreads began to widen sharply around that time as well. The 30-year AAA-A spread was 47 basis points on Sept. 30; now it is 111 basis points. In the 10 year range, the spread has moved from 67 basis points to 123 basis points. What has happened, for reasons we discuss below, is that the wall dividing perceived "good" credits from perceived "weak" credits has moved from the A/BAA "divide" up to the AA/A divide, (Figure 3). There are a number of reasons for this shift, which we discuss below.

Figure 3. AAA-BAA and AAA-A Credit Spreads 1Q 07 to present



Source: Muni Market Data Line, Citi

The case for investing now

In our view the case for investing now can be divided into at least the following arguments:

Institutional demand has virtually disappeared

1. A SUPPLY/DEMAND IMBALANCE HAS PUSHED YIELD LEVELS TO EXTREMES. There is a severe supply/demand imbalance in the muni market. Institutional demand has virtually disappeared, with leverage/hedged positions having been cut to perhaps 10% of peak levels, bond funds facing heavy outflows, and property and casualty insurers having very limited capacity. This supply/demand imbalance has inexorably pushed yields higher and yield spreads wider, particularly in the aftermath of the Lehman Bankruptcy in mid-September.

2. Demand from direct retail has not yet been sufficient to clear the market without much higher yields, yield spreads and a steeper slope. While individual investors have been heavy purchasers of munis, they tend to be cautious regarding maturity, credit rating and sector. Demand has been extremely strong inside 10 years, but on longer maturities, it has been strong at times and weak at others. At the same time, holders of muni bond funds have been net sellers, and the pace of fund outflows picked up again this week. Weekly reporting muni funds lost $1.073 billion in assets this week, the worst outflows since October, according to AMG Data Services. This is only slightly less than they lost in the past 3 weeks combined. The High Yield Fund sector lost $318 million, the second poor week in a row after losing $421 million last week, on a base only 15% as big as the all weekly funds category. The high yield funds are likely to see further outflows as

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their performance continues to lag: according to AMG, since 9/10, the average high yield fund has lost roughly 30% in market value. Pressures on flows on the high-grade funds also tend to be self-reinforcing during periods of rising interest rates, as yields on bonds purchased directly move higher, performance on funds turns negative, and reported yields do not rise nearly as rapidly as they do on bonds purchased directly.

Very dramatic outflows from bond funds

Heavy selling by high-yield funds pushes yields to distended levels

3 Heavy selling by high-yield funds has pushed yields in so-called high-yield sectors to extremely distended levels. This is true even in strong credits such as double-A hospitals and double-A state housing issues, which are only called "high yield" because they yield considerably more than straight GOs and essential service revenue bonds, and are thus included in high yield funds and traded on high yield desks (when they are traded at all). This pattern, we believe, has caused an "accordion effect": as yields on weaker or higher-yielding sectors are pushed sharply wider, it puts pressure on the next highest yielding paper, and the paper next to that, and so on. As a consequence, yield spreads in all sectors are pushed wider in comparison with the triple-A yield curve.

Credit fears have expanded far beyond actual risks, in our view.

4 Overly severe credit fears have compounded this process. This "accordion effect" has also been magnified by widespread, palpable fears regarding credit quality in the municipal bond market. Once again, we believe that these fears are greatly overstated, for a variety of reasons. To be sure, state and local governments are facing projected massive budget shortfalls, for fiscal years 20089 and 2010. The projections could get even more severe as the downward cycle in the US economy becomes more extreme than those in existing budget projections. And, the rating agencies have begun to send warnings to states in a couple of cases, with S and P cutting California's short-term rating to SP-2 from SP-1, and putting it's A+ long-term rating on Creditwatch for a downgrade. S and P has also put the state of Illinois on Creditwatch for a downgrade, from the double-A level. Fitch changed Florida's AA+ rating outlook to negative.

Nevertheless, we expect that actual payment defaults in the investment grade muni market will be extremely limited, although downgrades will occur and "headline risk" will tend to keep many investors nervous. . We believe that there is a widespread misunderstanding of:

- The nature of municipal credits and credit risks
- The very strong likelihood that the Federal government will step in to prevent widespread defaults, if needed.
- The fact that, unlike corporate and/or structured taxable credit defaults, recoveries in the limited cases of muni defaults tend to be very high, or even 100% in the cases of general obligation credits.

In our view, however, there have already been a number of misleading or inaccurate headlines that have added to the confusion. One piece on December 10 on a popular website was entitled "43 states in financial trouble," subtitled: "The recession has most states unable to cover expenses, according to the Center on Budget and Policy Priorities, and states should expect tough times ahead." The heading and subheading were, in our view, both misleading. The headline came from a report that was already two months old, and was discussing state BUDGETARY pressures, not an inability to balance their budgets. In a process that will inevitably be excruciating to watch at times, we expect all of the states to ultimately balance their budgets.

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through a combination of spending cuts, tax hikes, use of exiting rainy day funds, and federal support.

The new Administration has strong incentives to help avoid meltdowns at the state and local level as it attempts to restart economic growth.

This latter point bears further discussion. The new incoming Administration is committed to fiscal stimulus as a way to help restart the economy. Without that stimulus, the mighty struggles of the Fed and the Treasury to support the capital markets might be insufficient. However-- and this is a key point, we think--the efforts at the Federal level WILL FAIL if state and local governments are forced to cut too deeply, and lose access to the municipal markets for needed projects. So, ultimately, after the States are impelled to show at least a reasonable amount of restraint, the federal government WILL, we expect, provide help in a number of ways, including infrastructure grants, block grants that can be used more flexibly and grants that can be used to replace spending on unfunded mandates such as Medicaid. In an environment where the federal government needs to stimulate the economy, keeping states from being forced to take steps that are rapidly and severely restraining will become absolutely essential, in our view. The bottom line is that 49 of the 50 states have a balanced budget requirement in their constitution (all except Vermont), and with varying degrees of pain and temporary measures we expect them to meet that standard.

Prices in the muni credit default market bear no reasonable relationship to actual risks.

We also note that pricing in the thinly traded and poorly understood market for municipal credit default swaps has, quite literally, gone haywire. 5-year State of California CDS protection is being quoted around 480 basis points. That's wider than Turkey at 413bps. With a very conservative recovery assumption of 50% for California, their 5YR level implies approximately a 40% chance of default. This pricing has nothing in common with actual risks, in our opinion. A similar observation can be made regarding the relatively new muni default swap index.

The 5-year MCDX Series 11 is trading around 340 basis points for a basket of 50 credits. For a buyer to break even at this level, issuers reflecting roughly one third of the portfolio would have to default, with a 50% recovery rate. In our view, these prices bear no relationship to real risks whatsoever, we include these examples because comments about the default swap market are being taken by some investors and members of the financial press as somehow being based on sophisticated analysis of default risk, rather than what it is: a new, thinly traded market where prices can be pushed to extremes by a handful of buyers or sellers.

Sidebar below: Limited defaults and high recoveries in cases of default remain the most likely outcome.

To be sure, pressures at the local level will also be severe, in some cases more so, specifically where subprime housing concentration is the worst. Some defaults at this level are likely to occur. Even here, though, attempts from the state and Federal level to avoid a disruption of governmental activity are extremely likely, and the case for high recoveries of principal on the limited number of defaults remains strong. Clearly, what we have described here is not what the muni market yield relationship suggests, with triple-B GOs yielding more than 200 basis points more than triple-A, and with highly rated credits in sectors such as double-A hospitals yielding roughly 220 basis points more than triple-A GOs. In our view, these yield spreads are reflective of a market in distress, not of the likelihood of defaults or the potential for recoveries of principal.

Thin and erratic trading and pricing has also hurt

5 Thin and erratic trading patterns and pricing have compounded these concerns. As discussed in last week's MMC, trading in the muni market remains extremely

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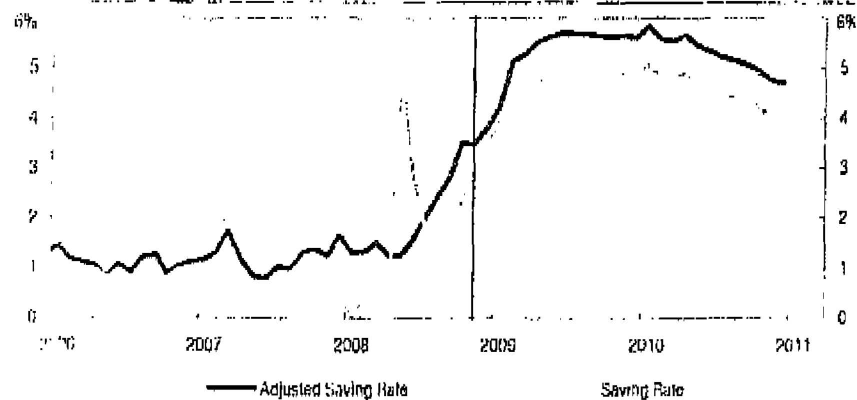
than, and pricing is particularly weak right now on the bid side. This is causing severe consternation among investors who see pricing on bonds they recently bought being significantly lower than their purchase price. The problem is, the pricing services price off the bid side of the market, and the bid side is under assault right now from selling pressures, lack of balance sheet support by Wall Street, and year-end concerns whereby many of the limited number of potential institutional buyers have closed their books. In our view, investors should recognize that the painfully weak bid side often reflected in statement prices does not reflect what bonds are worth to them as buy-and-hold investments. Indeed, right now the dichotomy is probably greater than at any prior time since the New York City crisis in the mid-70s.

Figure 4. Official Savings Rate and Savings Rate Adjusted for Temporary Shocks, 2005-Dec10F



Source: Bureau of Economic Analysis and Citi

All of the above is in the market, so what does 2009 have in store?

On the one hand, the muni market will remain under pressure from an ongoing heavy calendar of deals, many of which were delayed during the fourth quarter market disruptions. On the other hand there is a rather lengthy list of reasons to believe that the muni market will do better during the New Year, heavy supply notwithstanding. These include:

Some total return buyers from outside the muni "space" are likely to return

1 The return of at least some crossover buyers, who will be attracted buy the impressive total return opportunities to be had as the muni market normalizes. The will be attracted, in particular, by the fact that the credit concerns are NOT as severe as in the corporate sector, in our view.

More than $8.5 trillion in the personal sector with paltry or zero yields

2 The continued collapse in short-term rates, with the Fed pulling Fed Funds to zero, and short-term Treasuries providing zero returns. It is important to note that at the end of the third quarter, the personal sector held $8.5 billion in short-term assets: CDs, money market funds, and money market accounts. An additional large amount is in short treasuries. With yield so low, and yields in the muni market so enticing, we expect more cash to be moved out along the yield curve.

3 Investors will come to recognize that state budgetary crises are NOT the same as debt crises. This understanding, we believe, will become stronger as the Federal Government takes steps to assure that state and local patterns do not render its

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fiscal stimulus measures ineffective, and also takes steps to support favored activities such as infrastructure, health care and education.

4 The US savings rate is set to move sharply higher according to our economists. See figure #4, which shows the US savings rate. As consumers at all levels reduce spending relative to disposable income, the level of savings will grow. That savings will need to go somewhere; will it simply add to the massive amount of assets currently lying fallow at zero returns? Some of it, we are confident, will not.

Rates on munis have ample room to fall, even if Treasury yields ultimately rebound

5 Our economists believe that long-term treasury will stay low by historical standards for a number of years, at the very least. Even when and if they do rebound, they--and we--believe that there is ample room for bonds trading at a spread to Treasuries to rally even as Treasury yields increase. That case certainly applies to munis specifically.

What to do now

Insofar as what to do now, we simply repeat our message from last week, and then add a couple of points.

Not a propitious time to sell existing holdings

Our first message is simply to avoid selling into this messy, weak market environment if you can afford to wait until after year-end. The second message is to move out along the yield curve to take advantage off the extreme slope. The third message is to look at high-quality sectors where the yield increase has become severe, such as AA hospitals and AA housing, and other upper medium quality paper. Finally, for investors who are seeking equity-like (or better) total returns, we believe that properly selected paper in the higher yielding reaches of the muni market now provide some truly impressive opportunities. We note that, in our commentary, we have generally avoided recommending this paper. In our view, it has now become so compellingly cheap that it should be considered, even if only for a modest proportion of a total portfolio.

Even traditional buy-and-hold investors should consider total return opportunities at current levels

In addition, we note that investors should for the first time in many years, be considering total return opportunities over a 1-2 year period in the muni market. As the market normalizes, properly selected munis should provide equity-like returns plus high tax-free income. For this purpose, we particularly like long maturity, medium quality discounts, including bonds selling below the de minimus discount under the Accrued Market Discount tax. If the market rallies, these bonds in particular could jump in value as the move in price back above the de minimus amount, which is 1/4 point for each whole year to maturity.

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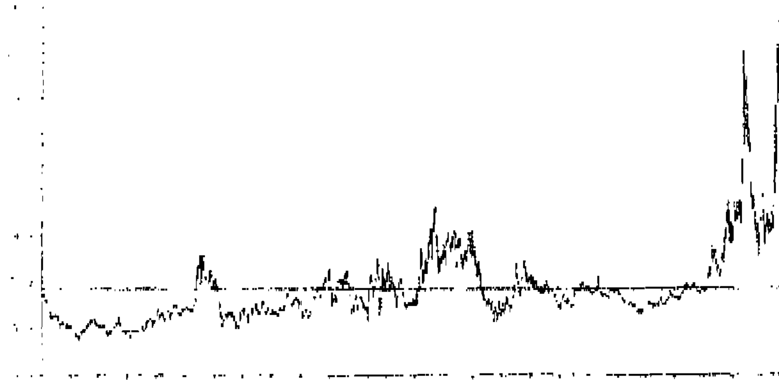
Figure 5 Five-Year Munis as a Pct of Five-Year Treasuries, Jan 96-Dec 08



Source: ... Thomson Financial/MMD and Citi

Figure 6 Ten-Year Munis as a Pct of Ten-Year Treasuries, Jan 96-Dec 08

Sources: ... Thomson Financial/MMD and Citi.

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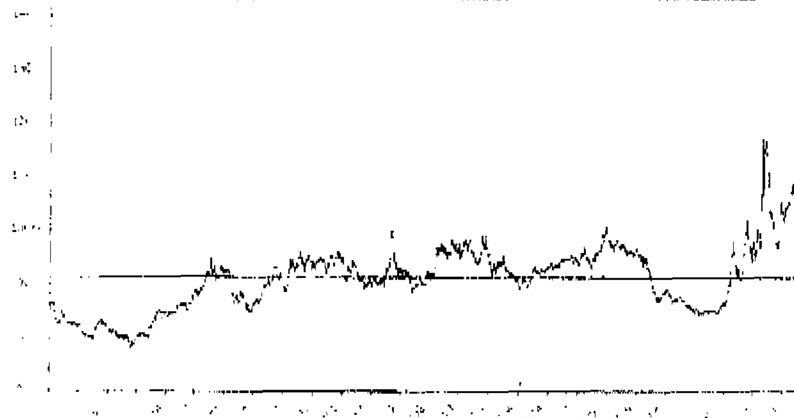
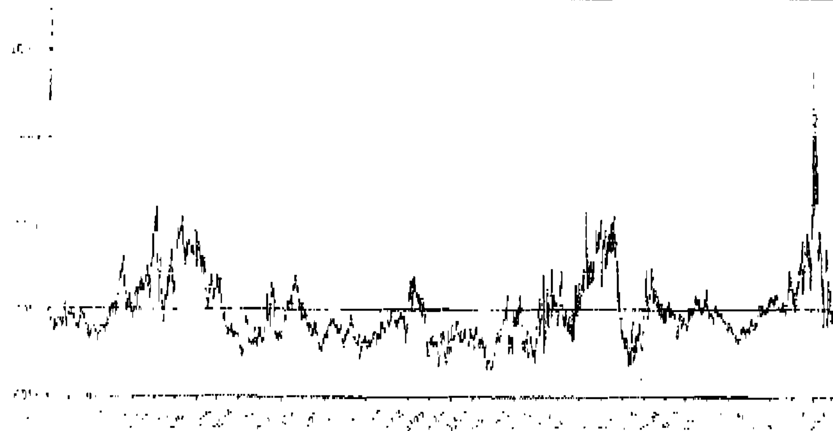
Figure 7. 30-Year Munis as a Pct of 30-Year Treasuries, Jan 96-Dec 08



Sources: Yield Book®, Thomson Financial/MMD and Citi.

Figure 8. Five-Year Munis as a Pct of Five-Year LIBOR, Jan 90-Dec 08



Sources: Yield Book®, Thomson Financial and Citi

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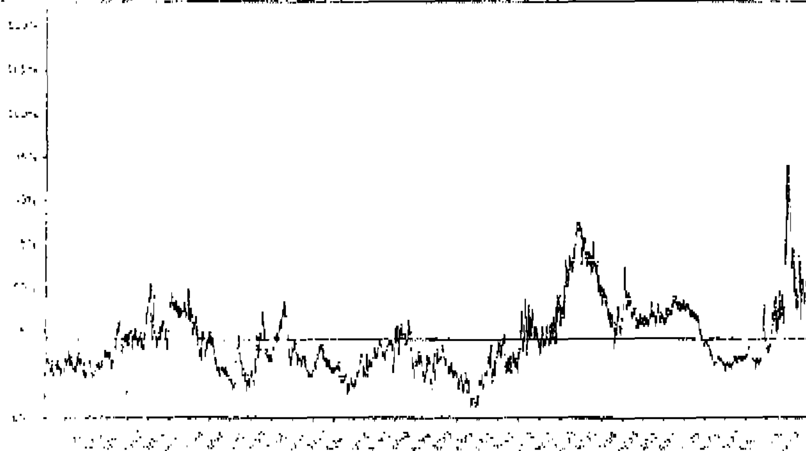
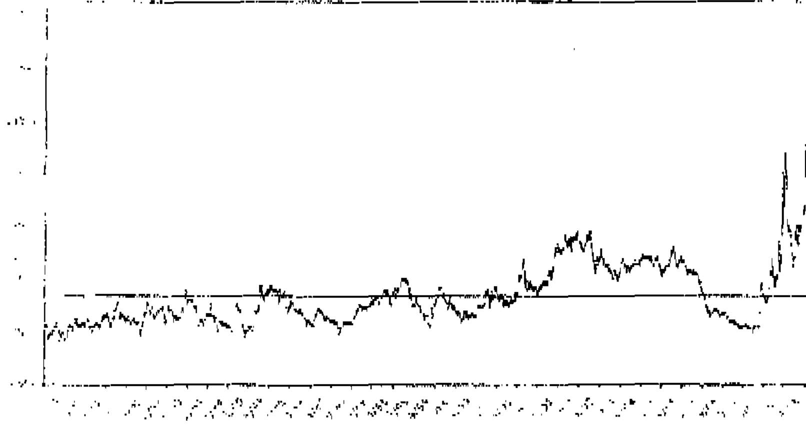
Figure 9. Ten-Year Munis as a Pct of Ten-Year LIBOR, Jan 90-Dec 08



Source: Yield Book[®], Thomson Financial and Citi

Figure 10. 30-Year Munis as a Pct of 30-Year LIBOR, Jan 90-Dec 08



Source: Yield Book[®], Thomson Financial and Citi

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Figure 11. Figure 12. December 2008

Monday	Tuesday	Wednesday	Thursday	Friday
8 Auction 3 & 6 Mth. Bills $54.0B	9 Small Business Survey Pending Home Sales Auction 1 Mth. Bill	10 Wholesale Inventories Sep -0.4% Oct -1.1% Federal Budget Balance Nov 07 -$98.2B Nov 08 -$164.4B Auction 3-Yr Note: $28.0B	11 Jobless Claims 12/6 573 Thous International Trade Balance Sep -$56.6B Oct -$57.2B Import Price Index Total / ExPetro Oct -5.4% -0.9% Nov -6.7% -1.8% Auction 10-Yr. Note: $16.0B	12 Retail Sales Total / ExAuto Oct -2.9% -2.4% Nov -1.8% -1.6% Producer Price Index Total / ExF&E Oct -2.8% 0.4% Nov -2.2% 0.1% Business Inventories Sep -0.4% Oct -0.6% Reuters/Michigan Sentiment NovF 55.3 DecP 59.1
15 Auction 3 & 6 Mth. Bills $54.0B(E) Empire State Manufacturing Nov 25.4% Dec Industrial Prod. & Cap. Util Oct 1.3% 76.4% Nov(E) 1.0% 75.5% Housing Market Index Nov 9 Dec FOMC Meeting	16 Consumer Price Index Total / ExF&E Oct -1.0% -0.1% Nov(E) [illegible] 0.2% Housing Starts and Permits Oct 791K 730K Nov(E) 760K 700K Real Earnings (Nov) FOMC Meeting Auction 1 Mth. Bill	17 Current Account Balance 2Q 08 -$183.1B 3Q 08(E) -$185.0B	18 Jobless Claims 12/13 600 Thous(E) Leading Indicators Oct -0.9% Nov(E) -0.1% Philly Outlook Survey Nov -39.3% Dec(E) -45.0% Ann. 2-Year Note: $37.0B(E) Ann. 5-Year Note: $27.0B(E)	19
22 Auction 3 & 6 Mth. Bills $54.0B(E) Auction 2-Yr. Note: $37.0B(E)	23 GDP & Chain Price Index 3Q 08P -0.5% 4.2% 3Q 08F(E) Corporate Profits (3QF) New Home Sales Oct 433K Nov(E) Existing Home Sales Oct 4.98M Nov(E) Reuters/Michigan Sentiment DecP 59.1 DecF(E) OFHEO Auction 1 Mth. Bill Auction 5-Yr. Note: $27.0B(E)	24 Jobless Claims 12/20 Durable Goods Orders Total / ExTrans Oct -6.2% -4.4% Nov(E) Pers. Inc. and Consumption Oct 0.3% -1.0% Nov(E)	25 **Christmas Day** **NYSE Holiday** **Federal Gov't Holiday**	26
29 Auction 3 & 6 Mth. Bills $54.0B(E)	30 NAPM Chicago PMI / Prices Nov 33.8 50.7 Dec(E) Consumer Confidence Nov 44.9 Dec(E) Farm Prices (Dec) S&P/CaseShiller (Oct) Auction 1 Mth. Bill	31 Jobless Claims 12/27 Ann. 10-Yr TIPS: $8.0B(E)	January 1 **New Year's Day** **NYSE Holiday** **Federal Gov't Holiday**	2 ISM Manufacturing PMI / Prices Nov 36.2 25.5 Dec(E)

(E) Indicates Citigroup estimate (A) Advance (P) Preliminary (F) Final (NCH) Unchanged, (R) Revised.
Contributor: Kathy Lamies

Disclosure Appendix A1

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TRADING DESK STRATEGY

US Municipal Bonds
Trade Idea

December 16th, 2008

Patrick Brett
(212) 723-7104

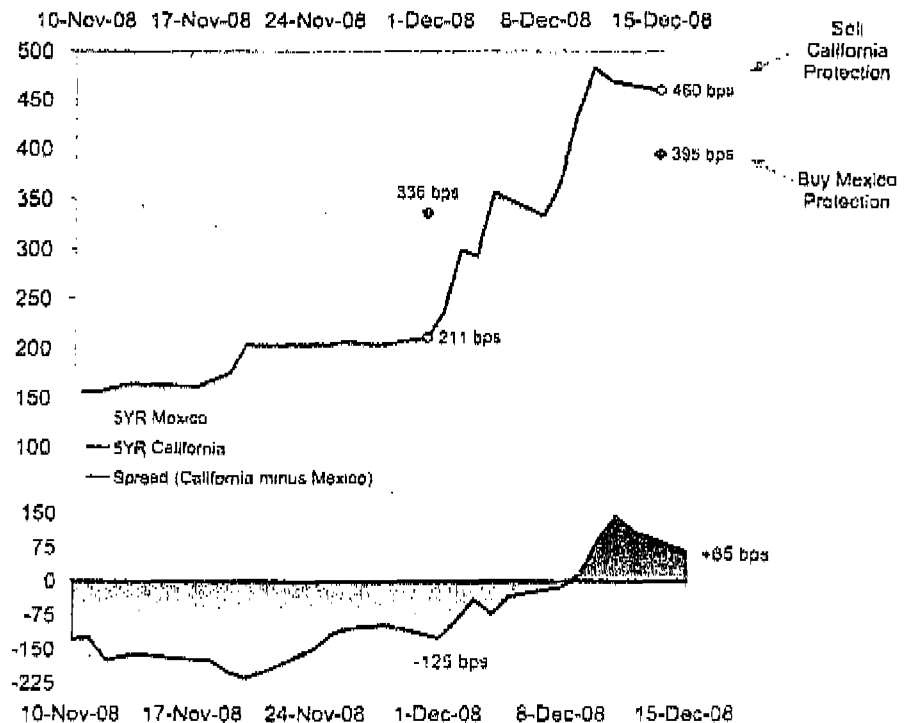
Sell California Protection vs Mexico at Positive Basis

Market Situation: The cost of insuring California's debt has risen sharply in recent days and for the first time is more expensive than insuring Mexico's debt (*see figure 1*). The widening appears to have come as headlines of California's growing budget deficit prompted significant speculative paying interest. Despite California's budget issues, this move is overdone in our view. Both California and Mexico are contending with the effects of the US-lead economic slowdown, but California would appear to retain significantly more financial flexibility than its southern neighbor (*see Table 1*). Well over two years into the US housing correction, California still produces six-times the GDP per capita of Mexico, and has one-fifth the public-sector debt burden (as a % of GDP). Additionally, California is expected to be a large beneficiary of President-elect Obama's forthcoming $500B+ stimulus bill, and should enjoy additional Federal support if market disruptions limit its capital market access. Needless to say, Mexico will not be a recipient of the upcoming US Government stimulus.

Table 1. Comparison of Key Financial Indicators

	GDP (2007)		Public Sector Debt		Deficit	
Issuer	Total	per Capita	Total	As % of GDP	2009 Est.	As % of GDP
California	$1,812B[2]	$48,243[4]	$57.6B[5]	3%	$14.8B[7]	0.8%
Mexico	$893B[3]	$8,482[3]	$134.2B[6]	15%	$16B[8]	1.6%

Figure 1. 5Yr State of California CDS vs Mexico (top) and Spread (bottom) – Past Five Weeks[1]



[1]Source: CMA and Markit [2]US Bureau of Economic Research [3]World Bank [4]2007 Population estimate from State of California [5]Sept 2008 General Obligation Debt Outstanding from State [6]2Q08 World Bank, Gross External Public Sector Debt Position [7]Governor of California Dec 10th [8]Reuters Nov12th

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