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Despite US slowdown, global economy remains healthy.

The US department of Commerce reports a 2.5% GDP growth for 2Q2005. It is significantly lower than the 5.6% figure for the previous quarter. Looking at the details, we can see milder growth in consumer spending, declines in corporate investment and construction activities. The fears for slower housing market, rising interest rate and high energy cost to drag on consumption have turned into reality. Without stimulation such as low borrowing cost or inflating asset prices, it is unlikely that the consumption will turn up strongly again and drive the economic growth again. So, the US economy will probably lose steam in the rest of the year.

The immediate reaction of the market is quite positive, markets bounce on rising expectations for the Fed to halt the interest rate hike cycle. However, the longer-term risk is clearly a severe decline in global economic growth.

US will likely slow down, but the near term outlook for EU and Japan are much better. Japan is getting out of deflation. In June, the consumer price index has risen for 8 consecutive months and land price rises the first time in 9 years. It indicates that product and asset prices are turning up again. Corporate profits are no longer squeezed by continuously falling price. For the EU, business activities will likely remain buoyant. The purchasing manager index for both manufacturing and services industry reaches the high level since 2000 in June. As a whole, global economic expansion may slow. But, it shall remain healthy.

When we look at the market, it has already reacted to the fears for economic slowdown and retreated from the previous peaks. All the major markets find strong support in May and rebound since.

If the near term outlook for the global economy is fine, what's about individual market?

US: Neutral

Economic slowdown is finally reflected in statistical data. 2Q2006 GDP growth is 2.5%, which is substantially lower than the 5.6% in the previous quarter. At the moment, the market response is positive as slower economic growth may make the Fed more incline towards pausing the series of interest rate rise. Thereby, the market will likely continue to move sideways. But an important piece of information is that the core consumer expenditure index (PCE) has also risen to 2.9%. Inflation pressure is still high. It suggests that the Fed is still in the dilemma of keeping up the economic growth and reining in inflation pressure.

EU: Neutral

Purchasing manager index for both manufacturing and service industry (a leading indicator for economic conditions) continues to rise in June and it reaches the high level since year 2000. Therefore, EU is expected to continue with its economic recovery even if US is slowing down. But, the ECB is going to continue to raise interest rate, Germany may add to the Sales Tax in 2007 are casting doubts about the future of European markets.

Japan: Slightly Positive

The BOJ lifts the interest rate by 25 bps on 14 Jul. It marks the end of zero interest rate policy. Together with the gradual return of inflation, it makes the corner-stone for revival of Japanese economy. Japanese economy has removed some long existing drawbacks. It shall continue with its secular recovery despite slightly slower global environment. Looking at the stock market, we can see strong support at 14,000 level for NIKKEI which has been tested once and again in the last 2 months. While on the other hand, the JASDAQ and OTC market failed to keep up with the upward march. It demonstrated change in risk

appetite among investors. Thereby, we recommend investors to stick with large caps rather than their smaller counterparts for Japan market.

China: Positive

Performance of the Chinese companies is in line with general market. Expectations about RMB appreciation and growing domestic demand continue to attract investors' interest. Despite the restrictive measures implemented by Chinese government to cool down fixed asset investment, the economy continue to growth at 11.3% annual rate in 2Q2006 and expansion in fixed asset investment still stays at 29.6%. The government may response by stepping up the austerity policies, which is a major risk factor for the market.

Hong Kong: Neutral

Unexpected strength is seen in the market, as Hang Seng Index regains nearly all the loss grounds since global markets peaked in mid-May. Still, the price increase is concentrated in the blue chips while mid and small caps lagged behind.

Emerging Markets: Slightly Positive

After 3 years of strong performance in general, they are expected to show very some divergence in return. Investors should therefore be more selective. Countries with less favourable fundamental support such as Hungary, Turkey are not expected to repeat the spectacular return any time soon. Brazil and Russia are our choices as both countries enjoy large current account surplus and they shall continue to benefit from high commodities prices.

Bonds: Slightly positive

As the US government is more likely approaching the end of the rate rising cycle, it shall lend more strength to the bond market. On the other hand, ECB and BOJ are not yet done with their increase to interest rate. But the pace shall not be very fast and not to cause rapid decline in bond prices. Since investors demonstrate higher risk aversion, high quality bonds are more favourable instruments.

Commodities: Slightly positive

Basic supply and demand for petroleum remains tight and petroleum price is expected to stay at high level for some time. Moreover, political conflicts and natural disasters shall from time to time disrupt the supply. The risk of such event is driving up the risk premium in oil prices. Gold price should be helped by the weakening of USD as the Fed approaches the end of rate hike cycle.

Hedge funds: Neutral

General market condition has stabilized after the sharp fall in May and June. It makes the equities market more attractive than before and reduce the relative value for hedge funds in general.

Advices for investors

We believe global economy will remain robust despite US gradual slowdown. For US economy, we maintain the view that it is heading toward a soft landing. Thereby, the risk for another abrupt decline is low. The market is also not expected to see abrupt decline after the corrections in May and June. Interest rate hike cycle is yet to complete for most countries except US, central banks shall add to the interest rate cautiously. Still, short-term fluctuations may be seen in the market.

Facing a slow down in US economy, it is recommendable to seek for growth opportunities which are less dependent on external conditions for aggressive investors. China and Japan are our picks in this area.

For more conservative investors, adding back of bonds to the portfolio can help to enhance stability in asset values. High quality bond is the choice as risk aversion is getting higher among investors.

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