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The Fed paused and equities market started a mild rally.

Economic growth and interest rate moves have been the focus of the market in the last few months. Second quarter GDP reports of the three major economies confirm the view that the global economy is still strong while US has started to slow down. Moreover, we continue to see cautiousness among the central banks. Overall, neither the economy nor the monetary policies causes any surprise to the market and the market continues to recover from the decline earlier in the year.

In US, the Fed has paused in August and left the interest rate at 5.25%. It is now more concerned about the risk of a rapid economic slowdown than the threat of inflation. Consumption has moderated, but buoyant job market shall help to prevent a slump. So, we believe that the US economy is steering toward a soft landing. At the same time, market expectations for future interest rate movement now points to rate cuts as early as 1H2007. Anticipation of soft landing and lower rates eased the worries about abrupt economic slowdown. The US stock market climbed and treasuries yield fell. As the interest rate outlook becomes more favourable and treasuries bond yield stands at reasonable level of 4.5-5%, we think that the attractiveness of bonds investment has improved a lot.

Japan also reported slower economic growth in the second quarter. The annualized growth figure came down to 0.8% from 2.7%. Still, the decline could be attributed mainly to a drop in government spending while consumer spending and business investment had both accelerated. It demonstrates a shift from policy stimulated to market driven growth. Together with other structural changes e.g. return of inflation, rebound of banking lending, it indicates that the secular recovery is going on. In fact, the market shrugged off the weak headline growth figure and NIKKEI moved up by 4.4% in the month.

The picture is very different on the European Continent. Economic growth has accelerated in EU. Both Germany and France reported faster GDP growth in 2Q2006 compare to the previous quarter. ECB has lifted the benchmark interest rate by another 25bps to 3% as inflation stay over the target range of 1-2% and it is expected to lift the rate further. Higher interest rate, a strong Euro and rise in VAT in Germany starting Jan 2007 are dampening the prospect for the region. But, for the time being, EU is still offering more attractive growth opportunities compare to US.

Market with strong support for domestic demand is more favourable as US, the biggest consumer market, is expected to slow down further. Our pick is China, especially the financial sector.

Let's go through our views on individual market.

US: Neutral

The Fed paused at 5.25%. The policy focus had shifted from threat of inflation to risk of rapid slowdown. It had resulted in a change in the expectation about future interest rate. Now, the market is looking for rate cut next year. Treasuries bond yields declines. Underlying economy is showing more resilience than the GDP report suggests. In 2Q2006, consumer spending rose by 2.6% and the job market remained healthy with unemployment rate stood at 4.7% in Aug. Healthy job market shall lend support to consumer spending and ensure orderly moderation of the economy. In the month, the DJIA has risen by 2.4%, but it still lags behind other markets.

EU: Neutral

European stock markets continued to outperform US, CAC and DAX both run up by more

than 3% in August. Moreover, stronger momentum is seen in the region's economy. GDP growth rose from 0.6% in first quarter to 0.9% in second quarter for Euro zone. The two biggest economies Germany and France both reported faster growth compare to last quarter. Healthy growth and persistent inflation made the ECB to add another 25bps to the interest rate to make it 3%. Higher interest rate would further strengthen Euro, together with proposed increase in German VAT in Jan 2007, they are expected to weight on the economy and dampen the region's prospect later in the year.

Japan: Slightly Positive

Japanese market made the best monthly performance since May. NIKKEI was up by 4.4%. The country has started to escape from the reliance on government policy for growth. In 2Q2006, we saw some acceleration in the private sector to make up for the decline in the public sector spending. The economic growth report showed that government spending had dropped by 9.6% and dragged down the overall annualized growth rate to 0.8% from 2.5% in the first quarter. But, increase in consumer spending accelerated to 0.5% and that of capital spending also increased to 3.8%. In addition, other favourable secular trends remained firmly in place e.g. mild inflation, rises in bank lending. They were all indicators for continuous economic recovery. We believe the long-term prospect is good given the fundamentals of Japanese economy improves. Still, for the time being, it shall remain range bounded.

China: Positive

Sectors to benefit from domestic demand are more favourable. We have seen strong performance for the insurers in terms of profits and stock price. On the other hand, industrials and real estate sector are clouded by macro economic measures to curb over investment.

Hong Kong: Neutral

HSI has reached a new high for last 6 years. Local economy slowed while interim corporate profits had generally met market expectations. GDP growth of Hong Kong slowed to 5.2% in 2Q2006 due to sluggish export growth. However, the stock market is helped by ample liquidity and satisfactory corporate profits.

Emerging Markets: Slightly Positive

We reiterate the recommendation to stick with markets supported by strong fundamentals such as Brazil and Russia. For Brazil, policy continuity is a concern for investors as the presidential election will be held on 1 Oct. Voting intention polls results show that the current president Lula will probably be elected for a second term as he leads by more than 20% compare to the closest candidate.

Bonds: Slightly positive

The most aggressive monetary policy maker, the Fed, pauses finally. At the same time, BOJ demonstrates cautiousness in reversion of loose interest rate conditions. The only major central bank that keeps on raising interest rate is ECB. As a whole, the interest rate conditions have become clearer and more favourable for bonds investment.

Commodities: Slightly positive

The month had been quiet for commodities. Oil, gold and industrial metals all drifted slightly lower as a result of slower growth expectation. However, if no abrupt economic downturn occurs, the growing demand from emerging markets shall maintain a tight demand and supply balance and keep their prices at high levels.

Hedge funds: Neutral

Hedge funds in general has reverted the downward trend. Up to 30 August the HFRX global hedge fund indices rose by 0.67% in the month. By strategies, merger arbitrage and convertible arbitrage had extended the lead in the year. Merger arbitrage rose by 0.93% and convertible arbitrage added 0.99%. Year to date, they has made 7.48% and 5.86% respectively compare to 3.23% for the general global hedge fund index.

Advices for investors

Currently, global economy growth is healthy thanks to continuous recovery of EU and Japan. But US is slowing down and EU is going to face more challenges for its economy, we expect moderation in the global economy to come later in the year. Thereby, we believe countries with more internal strength to drive economic growth and corporate profits are more favourable than those that rely heavily on exports to the developed regions.

For more conservative, we believe the reasonable yield offered by US Treasuries bonds and the lower risk of interest rate hike make bonds investment more attractive.

For more adventurous investors, we believe China offer good investment opportunities as domestic demand is well supported by strong income growth, especially the financial sector.

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