Arcadia Market Commentary

Oct 2006

Maintain a balance

In the August edition of our commentary, we started to suggest investors, especially for those who were more conservative, to make bonds part of their portfolio. The rationale was that the Fed rate hike cycle should be very close to the end and the Treasuries yield had reached reasonably attractive level at that time. Since then, we saw the yield on 10-year Treasuries bonds declined from around 5% to 4.6%.

The downward move of Treasuries yield suggests that the market expect the Fed to cut interest rate in the future, which implies an expectation for slower economic growth. The oddity is that the equity markets especially US, shrugged off the growth concern and resumed an upward run in the recent months.

So, are bonds investors or equity investors right?

We expect a soft landing for the US economy and no disastrous impact on global economic conditions. Still, the process and pace of moderation is subject to many uncertainties e.g. oil prices. Thereby, we believe maintaining a balance between risk and return is very important for the time being. On this basis, we would suggest investors to keep a 10-15% position in bonds.

Among different classes of bonds, we prefer high yield sovereign bonds. The asset class is in fact very diverse with lots of choices for issuing nations. Like emerging market equities, the selection of country can lead to very different results. Currently, the asset class as a whole has already run up a lot and risk premium over Treasuries has gone down to historic low level, staying below 200 bps. However, there are still some countries offering attractive yield and reasonable profit potential. An example is Indonesia, which is benefiting from declining inflation pressure. It allows the central bank to lower interest rate, which could positively affect bond prices.

Now, let's look at the updates about different markets.

US: Slightly positive

US market outperformed EU and Japan in the month. DJIA was up 2.54% and S&P 500 was up 2.11%. The market continued with the rally as the worries about further interest rate subsided. The housing market moderated more while retail sales was still growing in July and August, thus far we could say that the deceleration is orderly and concentrated to the real estate market.

EU: Neutral

European markets had also gone up. DAX led in the group with 2.46% upside, CAC was up 1.65% while FTSE100 went up 0.20%. For the moment, the economic condition is spectacular as shown by the German ZEW current situation index. The index continues with the rising trend, which has been in place for over 3 years. On the other hand, the index of economic sentiment, which is a leading indicator for German economy, falls to lowest level since 1999. It demonstrates the worries about impact of US slowdown and higher VAT to become effective next year.

Japan: Slightly Positive

NIKKEI had been flat in the month, edged down by 0.08%. Japanese economy continued to deliver positive signals. The business outlook survey shown improvement in all 3 segments of large, mid and small size companies in 3Q2006 compare to last quarter. On the political side, Shinzo Abe had taken over from Koizumi and became the new Prime Minister for Japan. Neither his appointment nor his choices for new cabinet member

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caused any major surprise to the market.

China: Positive

The market continued to enjoy strong momentum and good performance continued with financial stocks. Economical growth is still strong, the PBoC lifted the GDP growth forecast for this year to 10.5%. To take advantage from rising domestic demand remains the investment theme.

Hong Kong: Neutral

HSI continued with the strong run and reached 6 years new high in the month. Good performance spread from Chinese mainland related stocks to other stocks. But upside is still limited to large caps.

Emerging Markets: Neutral

Emerging markets had under-performed in the month. Performance is negatively affected by decrease in commodity prices. Russia RTS Index dropped by 6.14%. We expect further volatility for the near term. Still, the long term investment opportunities base on convergence to global economy and good economic growth potential is still valid.

Bonds: Slightly positive

Treasuries yield declined from the peak in the middle of the year. Yield on 10 year Treasuries dropped by as much as 60bps from 5.2%% to 4.6% level. It has lifted the price for the Treasuries issues. Still, further drop in Treasuries yield is expected to be limited. Among the bonds universe, emerging market sovereign bond provides a more attractive investment opportunities. Although the benefit from credit upgrade and decreasing yield spread have been done by large, there are still individual countries to benefit from improvement in domestic inflation environment and debt positions. For example, Brazil and Indonesia both are seeing inflation coming down and it allow the central bank to cut interest rate which would positively affect bond prices.

Commodities: Slightly positive

Sharp decline was seen for oil price. It was driven by high inventory level in US and dissipation of risk premium on the dispute between Iran and US and a quiet hurricane season. It has become the determining factor once again. London gold price gone down by 4.32% in the month. More consolidation should be the likely case for oil and commodity. Still, for longer term, weakening of US dollar shall provide support for commodities especially gold.

Hedge funds: Neutral

The asset class continued to deliver positive return. In the month, equity market neutral and convertible arbitrage were the out-performers. The HFRX equity market neutral index returned 1.32% and convertible arbitrage index made 1.04% return.

Advices for investors

The rise in developed countries equities market would likely continue, at least in the near term. Still, the pace of deceleration of US and its impact on global economy remains an important risk factor for investment markets. Thereby, balance between risk and return is our recommendation for both adventurous investors and conservative investors.

For more adventurous investors, China continues to offer good growth potential while developed countries equities market may also benefit from easing of inflation pressure in the near term. For the choice of bonds, high yield sovereign bonds provide selective investment opportunities.

For more conservative investors, keeping a portion of the portfolio in high grade bond may not add to performance a lot but it is certainty a prudent approach.

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