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### US housing declines, yet reasonable growth expected.

As the Fed predicted, the negative impact of slower housing market on overall economy had got more prominent. The first estimate of US GDP growth in 3Q2006 had come down to 1.6%. It was the smallest quarterly growth rate reported in last 3 years.

In the last 3 months, residential fixed investment dropped by 17.4% on annual basis. It was equivalent to a 1.1% drop in the headline GDP growth rate. Moreover, the housing market showed signs for further moderation. The number of new home sold continued with the down trend and median price of new home sold reported the biggest year-on-year decline in 35 years in September. Thereby, the housing sector shall remain the weakest link in US economy.

Wealth effect from housing market had been an important force to drive the growth in consumption in US. So, now that housing market moderates, does it mean that the US consumption market and thus overall economy heading toward an unavoidable recession?

We believe the conditions are more optimistic.

In fact, we also saw some good news in the GDP data. Despite that housing market had moderated, consumer spending managed to keep on expanding. It had gone up by 3.1% in the quarter. The growth was even better than that in 2Q2006. It was backed by a buoyant labour market. In September, the unemployment rate stayed low at 4.6% and real average hourly wages rose at the fastest pace in 5 years. Higher income provided strong support for consumer spending.

When we looked at the global economic conditions, we saw a healthier picture. In Europe, Germany and France had recently raised their forecast for economic growth. It demonstrated the fact that the economic performance in the region had been better than expectations. Moreover, spending power in emerging countries was expanding on rapid growth of middle class and rising income. Both factors should help to mitigate the impact of further slowdown of US economy.

In aggregate, we expect global economy to follow the steps of US to moderation. However, it is likely that the global economy shall be growing mildly and not falling into contraction.

Next, we will talk about our views on different markets and asset classes.

#### US: Neutral

US stock market extended the rally, which had started when the Fed paused with interest rate hike in August. DJIA hit a record new high in October and the index rose 3.43% in the month. S&P 500 rose by 0.16% and NASDAQ Composite went up by 4.7%. First estimate of 3Q2006 GDP growth was 1.6%. It was the lowest figure in 3 years. In the past 3 months, the drag of housing market on overall economy had got more prominent. Residential fixed investment decreased by 17.4% on annual basis, it was equivalent to a 1.1% cut to the headline GDP growth. Going forward, the conditions for housing market are still hardly optimistic. In September, the number and median price of new home sold both dropped on annual basis. The median price of new home sold fell 9.7% and the inventories of unsold homes stayed at historic high level. It indicated the pressure on real estate developers to cut price. Still, there was also some good news in the GDP data. Consumer spending showed resilience. It had expanded by 3.1%. The growth was in fact better than that reported in 2Q2006. The strong growth in consumption was backed by a buoyant labour market. Unemployment rate had been hold down in the range of 4.6-4.8%. In addition, real average hourly wages reported a 4% increase, which was the fastest since

2001. Healthy labour market is expected to help holding up wages growth and private consumption.

#### **EU: Neutral**

European market also continued to rise. In October, FTSE went up by 2.78%, DAX gained 4.16% and CAC rose 2.13%. Looking at the underlying economy, we see positive surprise in economic performance while inflation and interest rate are in line with expectations. Since May, ZEW index of economic sentiment continued to drop. It indicated a slowdown in German economic in the coming future. However, Germany had raised the economic growth forecast for 2006 and 2007. France had also adjusted the forecast for 3Q2006 GDP growth upward. It may suggest that the prospect is in fact better. Interest rate and inflation had been in line with expectations. For the monetary policy, ECB lifted the repo rate by 25bps to 3.25%. More, Eurozone inflation rate had dipped through 2% mark and fallen back to ECB policy target range.

#### **Japan: Neutral**

NIKKEI lagged behind other major markets in the month, but it still rose 1.69%. No major surprise or disappointment was seen. Monetary conditions remained accommodative. Bank of Japan had kept interest rate at 0.25%. Labour market statistics had turned sour slightly. In September, real wages index dropped 1.2% and unemployment rate went up 0.1% to 4.2%. Still, it did not mark a turnaround in the longer term trend for unemployment rate to decline which had been in place for 3 years.

#### **China: Slightly Positive**

Domestic consumption related stocks performed well. ICBC became listed in Hong Kong and Shanghai in the month. The financial sector lost a bit of steam right after the listing. On the other hand, fixed investment growth had slowed. The central government had not announced new austerity measures to cool the economy. Chinese mainland property stocks gained strength as worries about policy risk eased.

#### **Hong Kong: Neutral**

Hong Kong stock market was helped by the strength in Chinese mainland enterprise. HSI hit record new high, it reached 18,465.54 at the highest. Over the month, the index jumped by 4.45%. Still, after the rapid rally, we would not recommend adding to holding further.

#### **Emerging Markets: Neutral**

As the US economy moderated further, the downside risk for global economy had risen. It reduced the attractiveness of emerging market investment. Still, oil prices stabilized after sharp decline in September. It was beneficial to emerging markets with high oil exports e.g. Russia, Mexico. Moreover, Brazilian presidential election ended after the second round voting. Lula was granted a second term as predicted by poll results. In the year, Mexico and Brazil had both their presidential election settled down. Political risk in the region should have gone down.

#### **Bonds: Slightly positive**

Since the GDP growth figure fell short of forecast, the yield on 10 year Treasuries notes went down to 4.6% after the data is announced. Although the economy slowed further, it did not point to a rate cut in near future. It is because core PCE stayed about the Fed's target range between 1-2%. The interest rate shall stay at 5.25% for some time. It suggests the fluctuations in Treasuries bonds prices shall be small.

#### **Commodities: Slightly positive**

Commodities prices stabilized. Crude oil prices rebounded after OPEC announced a 1.2 million barrel reduction to daily production quota. It had once gone over USD 60/barrel. For Gold, it was helped by weakness in USD after the GDP report. Bullion price went up to over USD 600.ounce. Weakness in USD is expected to continue to support gold price.

**Hedge funds: Slightly positive**

Return on HFRI slid in September. The index was just up by 0.2% compared to 1.08% gain in August. Year to date, HFRI emerging market (Total) index was the best performing category index. It had gained 12.06%. HFRI merger arbitrage index came second with 9.82% return. The third place was HFRI distressed securities index and it rose 9.53%.

**Advices for investors**

US GDP growth was again below expectation. US housing market continued to slow down. But, consumer spending kept on growing and eased the pain with moderating housing market. Consumption was supported by rising wages. Strong European economic conditions and higher buying power in emerging markets could also help to reduce the impact of slowdown in US economy on global economic outlook.

For aggressive investors, we think commodities sector funds e.g. energy fund, gold fund offers profit opportunities. You may consider putting a small portion of your money in it. The investment can help to balance inflation risk and gold may gain on weaker USD.

For conservative investors, we believe maintaining a 10-15% allocation to bonds is appropriate.

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