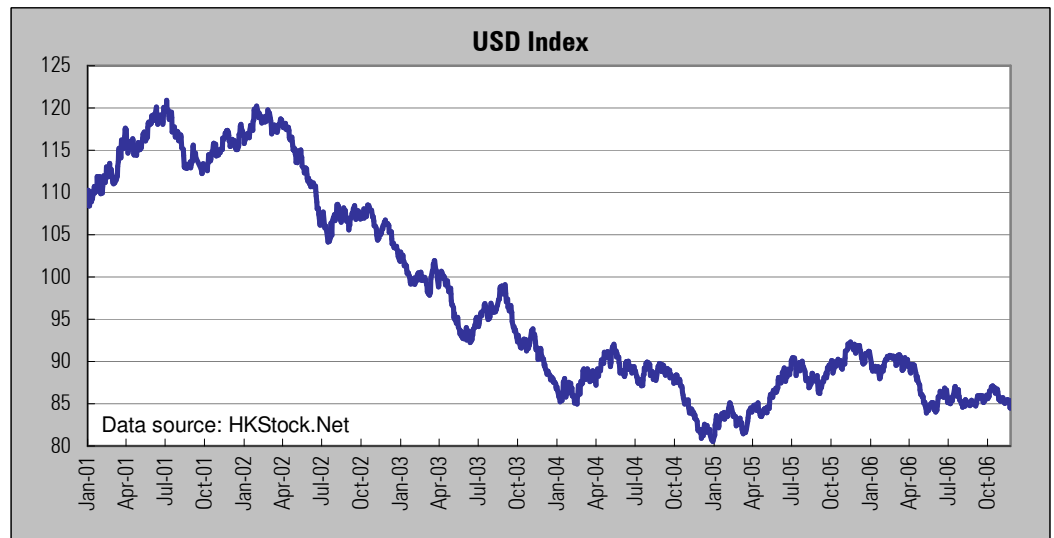




Dec 2006

The weakness of USD

The USD dollar is no doubt the most widely traded and most influential currency in the world. The change in value of it does not only affect trade flow, but also the financial markets.



Look at the chart of USD Index above, we can see the value of the dollar sank in the last 5 years. Still, at the right hand side, there is a flat tail indicating the value of USD stabilized since early 2005. So, what is coming for USD and what are the investment opportunities hidden behind?

Let's look at the situation from a long term as well as short term perspective.

The structural and long-term factor affecting USD are the twin deficit of US, which have been ballooning since 1990s. So far, the outflow of the dollars is largely recycled to US through purchase of Treasuries Notes by foreign governments, especially the Asian countries. It had provided support to the USD. But, the dominance of US dollar as a foreign reserve currency is facing severe challenge. First of all, the Euro has been in use for 6 years. Investors' confidence on it has built up throughout these years. The central banks now have one more competitive alternative for the choice of foreign reserve currency. Secondly, the cross border trade among emerging countries, especially Asian countries has risen a lot. As a result, they need to diversify their foreign exchange reserve in response to the change in trade pattern.

For the near term, the interest rate movement also weighs on the dollar. The Fed has broken the series of continuous rate hike in Aug 2006. On the other hand, the ECB is still adding to the interest rate. So, the advantage in yield is declining for the USD. It is eroding the attractiveness of holding the dollar. Moreover, the market expectation for next movement at Fed is a rate cut in 2007. Expected rate cut becomes a catalyst for renewed weakness in USD recently.

To sum up, the structural problems are still in place and a short term catalyst in form expected rate cut is seen. So, we believe the USD shall demonstrate weakness in the coming future.

So what kind of assets shall benefit from weaker USD? Euro and gold are the obvious beneficiaries. High yield currencies such as Sterling and Australian dollars are also good choices.

US: Neutral

US took the lead among major markets in November. DJIA gone up 1.17%, S&P 500 rose 1.65% while NASDAQ added 2.75%. Economic data released in the month reinforced the expectation for soft landing, which should be beneficial to the near term performance of the equities market. The 3Q GDP growth statistic was revised upward from initial figure of 1.6% to 2.2%. It was more supportive for the case of expected soft landing. Moreover, the moderation in inflation continued as oil price fell. The headline inflation number for October was 1.3% and the core PCE was 2.7%. Both of them were lower than the figure for September. The easing of inflation could reduce the pressure for the Fed to lift the interest rate.

EU: Neutral

European market fell behind US. CAC and FTSE had the first monthly drop since June, down 0.62% and 1.31% respectively. DAX registered a small gain of 0.64%. 3Q GDP growth for both Germany and France went down, German economy expanded 0.6% from last quarter while France was just at par. Still, the business sentiment was strong and unemployment conditions continued to improve. We believe Europe would still maintain the growth trend.

Japan: Neutral

NIKKEI continued with the sideway move and the index was down by 0.76%. 3Q GDP suggests that the economic expansion went on, the growth rose to 2.0% on an annual basis. Still, domestic demand demonstrated weakness. Household spending continued with the downward trend and dropped by 2% in October, it is the tenth consecutive monthly decline. It results in worries about the susceptibility of Japanese economy to changes in external environment.

China: Neutral

Eye catching performance is seen for HSCEI, the index jumped 14.2%. The financial stocks were the strong drivers while other stocks picked up in the last month. Although the fundamental is still strong for China, many of the stocks are no longer attractively priced after the recent rally. We would not suggest investors to add further to their Chinese holdings at current market level.

Hong Kong: Neutral

HSI climbed by 3.47% in the month, it was the sixth consecutive month of rising market. The index closed at 18,960.48, 24.7% higher than the bottom seen in June. Higher volatility in the month end suggests the market is heading toward short term adjustment.

Emerging Markets: Slightly Positive

Emerging markets continued with the strong run, Brazil Bovspa index was up 6.79% and breached 40,000 points after the president election ended last month. Russia RTS index jumped 10.1% as oil prices rebound. In the month, Russia reached agreement with US on its accession to WTO. It should further strengthen the long term economic and investment prospect for the country.

Bonds: Slightly positive

Despite the upward revision in headline growth rate for US, Treasuries bond yield failed to rebound. The market is still expecting further slowdown and rate cuts. 10 year Treasuries bonds yield dipped through 4.5% lately. In connection with expected rate cut, USD declined. It makes us prefer non-US bonds.

Commodities: Slightly positive

Helped by weaker USD, gold rose 6.88% in November. Crude oil future price was also up by 7.01%. Renewed weakness in USD has driven up gold price. It demonstrated

the case for investing in gold to hedge against lower USD again.

Hedge funds: Slightly positive

HFRX index went up by 1.85% in October, bringing the YTD return to 9.09%. By strategy, merger arbitrage strategy was again the leader. Emerging market came second and event driven ranked the third. The return for the top 3 were 2.59%, 2.38% and 2.31% respectively.

Advices for investors

The weakness of USD shall continue as the market expectation for interest rate cut is strengthened by slower growth and weak US housing markets. To take advantage of it, investors may invest in commodities e.g. gold, Euro or other high interest currencies such as Sterling, Australian dollars.

For adventurous investors, investment in commodities is a way to take advantage of the renewed weakness in USD.

For conservative investors, high yield currencies such as Euro, GBP would be good choices. Also, bond holding could be employed to take advantage of expected interest rate cut while avoid excessive volatility.

For investors who are investing in China funds, we would advice more caution rather than further adding to the position at current price level.

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