Feb 2007

A twist in the market

In January, we had seen vigorous moves in many markets e.g. USD dollar, US treasuries bonds, Yen, crude oil and Hong Kong stock market.

Among them, we believe the move of USD and US Treasuries bonds would be the most influential because any movement in them could trigger massive fund flow across different markets.

In the month, USD turned up against Euro, GBP and Yen. The driving force behind was a change in market expectation for future Fed rate movement. Previously, the market was expecting rate cut as early as March, but now the consensus seems to be no change at least in first half of 2007.

The shift in market expectation was attributed to strong economic data in the US and worries about inflation being more stubborn that the Fed expected. So, was it a warranted change?

We think that there is not sufficient evidence to revise the expectation for rate cut in 2007.

First of all, inflation risk is contained with oil prices dropped more than 20% in the last quarter of 2006 and wages in US was still rising moderately. Thereby, we would say inflation risk is still contained and easing. In fact, the core personal consumption expenditure remained at 2.3% in Dec 2006. The low and easing pressure from inflation is favourable for monetary easing.

Secondly, it is said that the US economy is holding up strongly with the first estimates of Q4 2006 GDP growth at 3.5% annualized. Also, the housing market shown some signs of improvement with new homes sales rose in the last 3 months. But, compare to Dec 2005 the number was more than 10% lower. The downward trend is still obvious on annual basis. So, the moderation in housing market is continuing and it is going to pressure on growth. Therefore, despite the strong Q42006 data, we still believe the economy will continue to slow down.

In sum, we believe both economic growth and inflation to moderate over the year. We would stick to our expectation for weaker USD to benefit European currencies as well as commodities. But, one thing we must say is that the new economic data is in fact less supportive for rate cuts and we will closely watch the upcoming information.

US: Slightly positive

US equities market moved up in the first month of 2007, DJIA was up by 1.27% and ended the month with a record high at 12,621.69, S&P 500 gained 0.73%and NASDAQ climbed by 2.01%. Q4 2006 reported strong GDP growth at 3.5%. Moreover, the core personal consumption index remained stable at 2.3% in Dec 2006. Good growth and low inflation pressure meant that the Goldilock situation continued. It had kept the Fed from adjusting the interest rate in Jan 2007. The ‘not too hot’ and ‘not too cold’ condition is expected to help the stock market.

EU: Slightly positive

European market also moved up in general. DAX made 2.91% and CAC went up 1.20% while FTSE edged down by 0.03%. Employment conditions continued to improve. In Dec 2006, France reported 8.6% unemployment which is the lowest in 5 years and the figure for Germany also fell to 9.6%. Strong job market is expected to help easing the impact of higher German VAT on recovery of European consumption. On balance, we remain

optimistic about the outlook for European markets.

Japan: Neutral

Japanese equities market was helped by weaker Yen. NIKKEI gained for the second consecutive month and ended January with 0.91% return. The Bank of Japan surprised the market by holding the interest rate at 0.25% for another month. It had dashed on hopes for yield for holding the Yen to rise and the Yen fell below 120 against US dollar and approached 160 against Euro. Although the weakness in Yen had helped the stock market, it had yet to break the peak set in 2006 and the market remained in consolidation range.

China: Negative

Investors are advised to exit China funds as the risk of adjustment is high. HSCEI jumped to 10,766.08 on 3 Jan 2007 and then fell to 9,602.40 in the last trading day. It was down 7.13% over the month and 10.81% off the peak. Last month, we stated that stock prices of the Chinese enterprise were driven by optimistic atmosphere. This month, we saw the market sentiment harmed by negative news e.g. Central government banned bank loans for stock investment, speech of Chinese officials to cool down the equities market. We believe many of the stocks are over-priced and sharp correction can easily occur. Thereby, we suggest investors to sell China funds.

Hong Kong: Negative

HSI reached another all time high at 20,821.05 at month begin, but then fell hard to finished the month with a mere 0.71% gain. Liquidity in the market spread out from Chinese mainland enterprises to some local companies e.g. Properties stocks and local banks. Still, we believe the liquidity driven run is focused on Chinese companies. Any adjustment for them would have significant impact on Hong Kong market. So, we suggest investors to exit together with China funds.

Emerging Markets: Slightly positive

Despite the volatility demonstrated in the month begin, we did not see any significant fundamental changes in emerging markets. Over the month, Russia RTS lost 4.11% while Brazil BOVESPA gained 0.38%. Although the decline in Russia RTS was not small, we saw the market recovered with oil prices rebound in early Feb. Overall, we are still optimistic on the emerging markets while attention should be paid to change in risk appetite and commodities prices.

Bonds: Neutral

Market expectation for rate cuts by the Fed was dashed by strong economic data. As a result, US Treasuries yield rose for another month. We believe the speculation about future Fed rate movement will continue and result in volatility in bond market. Still, we believe the Fed would probably keep interest rate unchanged in near future and we would probably see the Treasuries yield moving in range in near term.

Commodities: Slightly positive

Crude oil started the year with a dip, but it recovered strongly and bounced back to close the month above USD 58 / barrel. Gold also moved up to USD 650 / ounce. Overall, both oil and gold are still in consolidation phase.

Hedge funds: Positive

In 2006, hedge funds made good return in general. All sub-indices of HFRI but HFRI Marco Index made double digit return. HFRI Emerging Market index was the top performer, which rose 24.29%. Below are the return for different sub-indices.

HFRI Index	Dec 2006	Full year 2006
HFRI Emerging Markets (Total) Index	3.47%	24.29%
HFRI Distressed Securities Index	1.60%	15.80%
HFRI Merger Arbitrage Index	1.27%	15.67%
HFRI Event Driven Index	1.75%	15.30%

HFRI Index	Dec 2006	Full year 2006
HFRI Relative Value Arbitrage Index	1.58%	12.38%
HFRI Convertible Arbitrage Index	1.18%	12.17%
HFRI Equity Hedge Index	1.53%	11.47%
HFRI Macro Index	1.62%	8.54%

Data source: Hedge Fund Research

Advices for investors

For Hong Kong and China market, we would suggest investors to exit. The reason behind is that the short-term rally started in 3Q2006 has already driven up the stock prices far above the fair value. Recent turmoil suggests the run may be close to an end. The risk of correction has become very high.

In the month, we had seen markets fluctuation resulted from speculation about Fed rate movement. We believe the situation will continue as more economic data is released. Still, the Fed shall likely keep interest rate unchanged in near future. Given such a situation, we believe hedge funds with low volatility would be good for conservative investors. On the other hand, more aggressive investors may accumulate commodities related assets when they show temporary weakness.

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