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Beginning of more fluctuations

Equities market turned around in the last 2 days of February. The drawdown started on 27 Feb took away all the gains for many of the equities markets. On 27 Feb, the Shanghai A share index reported a 8.8% decline, the biggest single day decline, while the DJIA had dropped by 3.6% which was the largest drop in more than 3 years. Big decline was also seen in other markets such as equities markets around the world and commodities.

There were many views on what has initiated the global drawdown. Some believed it was the abrupt decline in Chinese market on Feb 27, some said comment made by former Fed Chairman Alan Greenspan about possible recession in US later in the year was the cause, while others attributed it to the strength of Yen to trigger fears about unwinding of carry trade.

Despite the differences in opinion about what had caused the decline. Consensus was seen in some important points. First of all, the recent fluctuations were believed to be another adjustment of the markets in the bull trend. They had nothing to do with deterioration in fundamental factors e.g. economic conditions, corporate earnings trends. Secondly, the fluctuations saw in recent days were just a beginning of more volatility for weeks to come. More downside may come in coming weeks.

As the recent turmoil may be just the start of more downside, we think investors better consider reducing their exposure to high beta market e.g. Asian markets, emerging countries equities markets. They may wait until the market becomes settled before entering into these market again.

So, was there any asset class boosted by the market turmoil? In fact, the drawdown triggered a flight to quality. US Treasuries issues gained as investors moved from equities market to safer investments. It demonstrated the defensive nature of the high grade bonds once again.

US: Neutral

US stock market gave back all the gains in the year. DJIA dropped by 2.80%, S&P 500 by 2.18% and NASDAQ by 1.94% in Feb. Sub-prime mortgage quality aroused concerns about US household debt problem. New Century, the third largest lender in sub-prime mortgage market reported that it is expected to suffer a loss in the last quarter of 2006. It had aroused concern about quality of US sub-prime mortgage. Still, Fed Chairman Ben Bernanke had responded by saying the trouble sub-prime mortgage shown no signs of spreading out to affect overall economy.

EU: Neutral

European markets followed US to go down. FTSE declined by 0.51%, DAX by 1.09% and CAC by 1.64%. Underlying economy continued to improve, according to German ZEW survey, both expectation and current condition index rose in Feb. The current condition index even reached an all time high of 70.9. However, in front of a global slide, the good economic data did not help.

Japan: Slightly negative

NIKKEI lost 0.63 points, which was less than 0.01% in the month. Japanese Yen turned strong at the month end. It had risen from 121 to the dollar to around 116. The climb in value of Yen not only negatively affected the Japanese stock market. It had also aroused attention about possible unwinding of carry trade. For the underlying economy, BOJ has lifted the interest rate by 0.25% to make it 0.5% in the month. However, the consumer price index reported later retreated to 0% level in Jan. It is expected to prevent the BOJ to add to the rate quickly.

China: Negative

Chinese stock market had become the market focus. On Feb 27, both Shanghai and Shenzhen stock market declined by over 8%. After that, equities markets around the world started a slump. For HSCEI, it dropped by 3.32%. It was the second consecutive monthly decline and it left the index down by 13.77% from the peak. The previous hot financial sectors became big losers with declines ranging from 20-30%.

Hong Kong: Negative

HSI retreated by 2.26% and dropped through 20,000 points level. Weakness in Chinese stocks continued to drag on the market. Moreover, poor performance from US business negatively impacted on the biggest index constituent, HSBC. As both Chinese and US market became under pressure, Hong Kong market shall demonstrated further weakness.

Emerging Markets: Slightly positive

Emerging markets reacted very vigorously to the global declines. Given that global equities markets may have further downside and emerging markets tended to follow developed market with magnified volatility, investors better consider reducing exposure to them. Over the month, Russia RTS gained by 0.83%. Brazil BOVESPA declined by 1.68%. The drop over the month may not seem significant. But, the decline in last 2 days was huge. Russia RTS lost 5.72% while Brazil BOVESPA declined by 5.01%. Besides Eastern Europe and Latin American markets, Asian markets also dropped sharply. In the last 2 days of Feb, India BSE declined 7.73%. Malaysia also dropped 6.80%.

Bonds: Slightly positive

Slump in equities market and commodities prices had triggered a flight to quality. High grade bond especially US Treasuries issues were the major gainers. The seek for safer assets is expected to last for some time and high grade bonds shall further benefit from it.

Commodities: Slightly positive

Gold had retreated together with other risky assets classes while crude oil prices stood at around 60 USD/barrel. Investors pared commodities holdings and went for more stable assets. Together with emerging markets, commodities may show short-term decline as global market fluctuates. Still, just like equities markets, we believe that the recent fluctuations were adjustment rather than start of a long term down market.

Hedge funds: Neutral

For Jan, hedge funds again made good return. HFRX Equity market neutral led the pack with 2.45%, HFRX merger arbitrage index made 2.13% and HFRX event driven index gained 2.11%. Still, as the market turned around in Feb. The environment became less favourable for hedge fund strategies with long bias such emerging market, equities long/short.

Advices for investors

Recent decline may be just the beginning of more market fluctuations for coming 2-3 months. Also, risk of carry trade unwinding is getting higher as Japanese Yen rise. Given the highly volatile and uncertain near term outlook, we think investors better consider reducing the holding in high beta markets e.g. Asian equities market, emerging countries equities markets.

High grade bonds may benefit from the flight to quality as market drawdown continues, money fund could also be the choices for parking if minimal risk is needed.

Still, one important point is the market turmoil is generally expected to be a short-term adjustment. Investors should be aware of chances to get into the market as it settles down.

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