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Worried about China A share drops and higher yield?

In recent days, we had seen 2 factors causing significant movements in equities markets. First, the drop of Chinese equities market. Second, the sharp rise in yields for the sovereign bonds of major countries.

The fall in Chinese stock market was triggered by a series of monetary and policies measures to cool down the stock market by Chinese central government. In the month of May, the Peoples Bank of China raised the savings and lending interest rate, the required reserve ratio. Later stamp duties for securities transactions was also lifted. The series of action sent to the market strong message that the government did not want to see the equities market to shot up vigorously. Finally, at the end of the month, Chinese stock markets response by declining by more than 15%.

Still, the decline was limited to Chinese equities market. The reason behind was that Chinese stock market had been very much closed to outside world. Investors cannot freely move their money between China and other markets. Thereby, a slump in Chinese market did not trigger investors to pull out from other markets.

Given the close nature of Chinese stock markets, it is likely that the slump in it would have significant impact on other markets.

The rising bond yields may have been less noticed. Still, the importance of it should not be underestimated.

10 years US Treasuries bond yield had rose from the low of 4.5% in March to 5.0% lately and that of 10 years German bunds gone up to 4.5% from 3.9% in March. Higher bond yields indicated changing market expectation on future Fed rate movement and the hopes for rate cuts had dissipated. It had led to a sharp adjustment in equities markets.

Since US economy is slowing significantly on weak housing market, we still think that the Fed is unlikely to raise rate soon to avoid further pressure on housing market. Moreover, liquidity is still ample as indicated by strong M&A market. So, the recent fall is regarded as another short term adjustment. We remain optimistic on equities market performance.

However, the trend of bond yield still worth a lot of attention as a continuous period of rising yield can gradually result in contraction of credits and draw on liquidity. We do not expect the conditions to turn sour quickly, but it is a major risk to the market.

Here, we would like to restate that liquidity condition is still favourable and we are optimistic on equities market performance despite possibility for near term adjustment.

Let's look at the markets now.

US: Neutral

In month of May, DJIA gone up 4.32%, S&P 500 gained 3.25%, NASDAQ rose 3.13%. Market focus had shifted away from economic data as they were generally in line with market expectations. On the other hand, M&A activities had been the catalyst for further upside. Active M&A market indicated the liquidity conditions was still favourable. However, Treasuries bond yield rose on changing expectations for future course of interest rate and more countries tried to diversify reserve assets away from USD. Higher bond yield hasd triggered a fall in US equities market lately, which we believe would be another short term adjustment.

EU: Slightly positive

European markets had continued with the strong rally. DAX jumped another 6.40%, CAC up 2.42% and FTSE100 gained 2.50%. Economic data had been very positive again. Q12007 GDP data again pointed to the continuous expansion of European economies. Still, the European equities market declined near the end of the month. We regard it as a normal adjustment after the superior run in the last 2 months.

Japan: Neutral

Japan market moved up also. NIKKEI went up by 2.73%. But, a weaker Yen further trimmed return to foreign investors. As BOJ remained on hold for further rate hike, the Japanese Yen continued to stay weak. It had now gone down to 122 to 1 USD. As global market turned down recently, Japanese equities market is not expected to do well either.

China: Positive

HSCEI shot up by 7.02% in May. The Chinese stock markets started an adjustment while H shares were unaffected. In fact, the H shares of dual listed companies were having large discount compare to A shares right before the adjustment. The lower price and more reasonable valuations had become the cushion for investors of H shares. Given the valuation of the Chinese enterprise is reasonable and market interest in China is still high, we remain optimistic on stocks of Chinese enterprises.

Hong Kong: Positive

HSI remained slow in May with 1.55% upside. However, Hong Kong market had been immune to the slump in Chinese stock markets at the month end. In fact, the red hot Chinese stock market had led to a expansion of QDII quota. Although the immediate impact is small, capital inflow from China is expected to benefit Hong Kong market in longer term.

Emerging Markets: Slightly Positive

Latin America and Asian markets performed well. Brazil BOVESPA index gained 6.77%, Korea KOSPI had a superior run and up 10.29% and Singapore Strait Times Index also up 4.46%. On the other hand, Russian market had been weak. Russian RTS lost 10.89% in the month. Russia market was clouded by political uncertainty linked to the presidential election in Mar 2008 and weak oil prices. Although crude oil prices strengthened slightly in recent days, the political uncertainties remained. With strong economic growth and fast growing domestic demand, we think Russia is a potential buy if political conditions become clearer in the coming months.

Bonds: Neutral

Yield on prime countries e.g. US and Germany sovereign bond rose. Part of the reason was the market expectation for US interest rate swung back to rate hike again. But, we think that it is unlikely to happen as US economy continued to slow and threat of inflation is still not serious. Another cause was the diversification of reserve asset away from US Treasuries bonds. The higher yield would probably weight on the Treasuries and thus other bonds issues.

Commodities: Slightly positive

Little changes were seen for crude oil and gold prices. Gold prices went down 2.85% and crude oil prices dropped 2.51% over the month.

Hedge funds: Neutral

As the equities market turned up again in April, hedge fund performance in general benefited also. Given a strong equities market, arbitrage strategies fell behind those directional strategies. The top performers were HFRI Emerging Market (Total) Index, HFRI Equity Hedge Index and HFRI Marco Index. They gained 3.08%, 2.08% and 2.06% respectively.

Advises to investors

Global economic development brought no surprise to the market and liquidity conditions is still favourable. Thereby, we remain optimistic on equities markets.

However, quickly rising US Treasuries bond yield is causing pressure to the equities market and near term adjustment may come.

Under such conditions, we would recommend investors to keep their asset in markets that has consolidated for some time e.g. Hong Kong market, Chinese stocks listed in Hong Kong and natural resources. Aggressive investors may consider adding to their equities market holdings if correction comes.

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**Arcadia Financial Services (Asia) Ltd
Arcadia Asset Management (Asia) Ltd
1402-1403, Tower 1, Times Square, Causeway Bay, Hong Kong
Tel: (852) 2114 8488 Fax: (852) 2111 0777**