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Sub prime mortgage to cause more fluctuation

US sub prime mortgages problem spilled out to financial markets. It had triggered steep fall in equities, bonds, commodities and also currency values.

So, what is sub prime mortgages and why it can trigger so much turbulence?

Sub prime mortgage is the mortgage loans granted to property buyers with poor credit record, with little requirement for income proof and some of them had high loans to equity ratio. In other words, the ability for the borrower to meet mortgage payment is doubtful. During the housing boom years, the borrower could easily sell the house and repay the loans when he/she had difficulty to pay the mortgage. However, the US housing market started to turn down in 2006. The easy way out by selling the property did not work anymore. So, the default rate for sub prime jumped.

Higher default rate had resulted in rapid deterioration in demand and the prices of mortgage backed securities backed by the sub prime mortgages. Investors who brought them with leverage incurred very substantial losses. Several hedge funds even went bankrupt. For those who were in need of cash, they were unable to locate a buyer for their mortgage backed securities. So, they could only sell other holdings at discounted prices. Thereby, the sell off spread out to other assets classes e.g. corporate bonds, equities. The result was a sharp turn down in near all financial assets including equities, high yield bonds and currencies.

What added to the problem was the size and scope of losses is very much unknown. One after one, hedge funds, mutual funds and banks reported that they were in trouble. With so much uncertainty lumped overhead, investors and lenders are unwilling to take risk. The sentiment in the market become sour and it reacted vigorously to bad news.

Currently, the impact of the sub prime mortgage problem is spreading and the full impact is still not known. It is likely that more financial institutions would report that they are in trouble. The bad news may trigger more fluctuations.

As investors, we would avoid investment in high yield bond and US and Europe financial sector. On the other hand, it could be an opportunity to bargain hunt on market with strong domestic demand and fundamentals e.g corporate earnings. China is a very viable choice.

US: Slightly negative

Sudden drop in the end of July had all the gains wiped out. DJIA dropped 1.47%, S&P 500 lost 3.20% and NASDAQ gave away 2.19%. Sub prime mortgage problem dominated the market. Uncertainty slumped over the market as the actual size and potential losses of sub prime related securities remained unknown. Financial and housing sector of US would likely suffer the most for the housing slowdown and sub prime mortgage defaults. Still, the sub prime mortgage was not a large part of the US housing market. It is not expected to derail the US economy from the path to soft landing.

EU: Neutral

European market also reported losses. DAX declined by 5.28%, CAC lost 5.02% and FTSE also down 3.75%. The negative impact of sub prime mortgage mess in US had spread to Europe. IKB from Germany and BNP Paribas asset backed securities funds were affected by the sub prime problem. Direct impact on economy from US sub prime problem is not expected, but the financial institutions may suffer from losses in their investment in sub prime related investment.

Japan: Neutral

Japanese stock market continued with the weak performance. NIKKEI declined by 4.90%. In the month, Japanese Yen approached 117 to the USD. Strong Yen further added to the market volatility as investors feared about unwinding of carry trade.

China: Positive

Despite the decline in the market, we did not see any changes in fundamental for China. The Chinese economy is still humming on, corporate earnings growth remain strong. Thereby, we believe Chinese stocks were still good buys especially when external turmoil triggered an adjustment in their prices.

Hong Kong: Positive

Same as Chinese stocks, no significant change in fundamental is seen. While on the other hand, corporate earnings were generally upbeat. Moreover, capital inflow from China is expected following the expansion of QDII quota announced in July 2007.

Emerging Markets: Neutral

General risk aversion rose in times of market turmoil. Emerging markets also seen big sell off. However, direct exposure for emerging market to US sub prime is in fact low. There is also no change to the strong fundamental for emerging markets. In the down turn, Latin America lost the most, while Eastern Europe and Asia also reported decline.

Bonds: Slightly negative

Demand for sub mortgage backed securities dried up. It had led to substantial losses for the investors. In fact, the credit quality of sub prime mortgage is deteriorating. Thereby, it would be difficult for the prices to recover soon. For other high yield bonds such as corporate bonds and emerging market sovereign bonds, their prices dropped as investors pared risky assets. But, high grade bond benefited from flight to quality as investors seek for safe heaven to park their money. 10 year US Treasuries yield came down from 5.2% to 4.8%. As investors were re-rating risk, it was very unfavourable for bonds with lower credit ratings.

Commodities: Slightly positive

Oil and gold prices were not severely affected. Oil price came down from around USD 78/barrel to around USD 70/barrel. Still, it was just in line with the seasonal movement seen in previous year as driving season and hurricane season coming to end in peace. For gold prices, it remained strong and stayed at around USD 670/ounce.

Hedge funds: Neutral

Hedge funds performance is not good in July. It suggested that the correlation of assets prices rose during vigorous market changes. Among all HFRX strategy sub indices, only HFRX Relative Value Arbitrage Index reported a gain of 1.65%. The big droppers were HFRX Macro Index declined 3.13% and HFRX Merger Arbitrage Index lost 2.14%.

Advices for investors

The sub prime problem is in fact a consequence of the slowdown in US housing market. As a quick rebound in the US housing market would be unlikely, it is unrealistic to expect the sub prime problem to go away soon. More financial institutions would likely report that they are facing liquidity problem or substantial losses from sub prime holdings. The market shall remain very volatile in the near term.

The deterioration in credit market had trigger a revaluation of risk and investors are asking for higher risk premium which negative impacted asset prices. This is unfavourable to low grade bonds.

We suggest investors shall avoid investment in high yield bond and financial sector. While on the other hand, bargain hunting in markets with strong fundamental is viable. China is a good choice.

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