



Dec 2007

Hong Kong market reshuffling

Hong Kong stock market had attained very spectacular gains in 2007. Still, investors must have noticed the violent ups and downs during the year. In November, we had gone another sharp decline. Both HSI and HSCEI lost about 20% from previous peak in 3 weeks time.

So, what for now?

After the 20% drop, Hong Kong market had a rebound in December. During this period, the turnover reduced to about HKD 100 billion each day. Slower turnover indicated that both buying and selling forces were weak. Without strong forces to driving the market up or down, it is expected to go through more consolidation.

And where are the opportunities?

In December, we had seen kind of sector rotation. Several sectors, especially those that lagged behind in previous rally had a short run. They included the domestic property sector, the domestic banking sector, mainland coal sector and the mainland telecoms. Although their rallies were relatively short, they had still out-perform general market in recent days.

Is it time to get back to the market?

Yes, I think investors may get back in by phases. The market had already weathered the selling spree in November. The bottom formed with HSI at 25,000 and HSCEI at 15,500 shall be strong support. Also, liquidity condition is expected to improve with capital inflow related to QDII. Recently, IPO of new QDII funds had restarted and quotas were granted to the major Chinese insurers. In addition, the existing QDII funds will be re-opened soon. Part of the new money flowing out through QDII is expected to get into Hong Kong market.

What risk factors shall investors watch out for?

Risk factors came from the two forces driving Hong Kong economy, US and China. For US, the knock on effect of its housing slowdown may lead to lower consumption. If that happens, it shall pressure on our exports and industrial stocks. For China, the government is under pressure to fight inflation and excess liquidity. So, it is likely that the Chinese government will implement more macro austerity measures. That say, the target for the policies shall be tightening liquidity conditions and preventing assets prices running out of control. So, the banks and properties stocks are expected to suffer while domestic consumption sector are less likely the target.

Overall, we would say the selling pressure for Hong Kong market has been released through previous decline. Currently, the opportunities are with sector rotation. Moreover, expected capital inflow of QDII shall benefit Hong Kong market too. Investors may get back into Hong Kong/China market by phases.

US: Slightly negative

DJIA went down 4.01%, S&P 500 dropped 4.40% and NASDAQ lost 6.88%. US financial institutions, e.g. Merrill Lynch, Citigroup made additional write off to their investments in debt assets. It shown that the credit market problem was spreading further and it will lead to further pressure on stock market. On the other hand, the US government made several initiatives to ease the problem. They included joining hand with banks to offer low cost refinancing to home owners, freezing the interest charged on sub prime borrowers with good

credit record and injecting more cash to inter-bank market together with ECB and Swiss National Bank. The government initiatives became the supportive forces, which is counter acting sub prime related problem. As the two forces struggle, the US market shall continue to swing up and down.

EU: Neutral

European markets declined also. DAX retreated slightly by 1.85%, CAC declined by 3.03% and FTSE dropped 4.13%. European financial institutions also reported more losses related to sub prime problem. Credit Agricole brought back an SIV investing in sub prime related bonds and UBS write off another USD 10 billion of its asset. Just like US, it dragged on the stock markets. Looking at the fundamentals, the economic data became less rosy. Although the job market remained very buoyant, consumption in Europe weakened. As a whole, EU is expected to slow down in 2008. The biggest economy, Germany had already lowered its economic growth forecast for the coming year from 2% to 1.6%. In sum, the credit market shall remain tight and growth expectation is getting lower. So, the European stock markets are also expected to move sideways in near term.

Japan: Negative

NIKKEI went down by 4.23%. Japanese economic conditions also turned weaker as corporate investment declined. Corporate spending and exports were the major driving forces for Japanese economy. Now that corporate spending has started to weaken and exports is clouded by slower US economy, we do not have high hopes on Japanese market.

China: Slightly positive

HSCEI slumped 14.46% in November. There was some good news related to QDII. Recently, IPO of new QDII funds had restarted and the major Chinese insurers were granted QDII quotas. In addition, the existing QDII funds will be re-opened to subscriptions and redemptions. Part of the money qualified for QDII is expected to flow into Hong Kong market to take advantage of international investment or to tap on the spread in A and H share prices.

Hong Kong: Slightly positive

HSI lost 8.64% in November. The market had found good support after the decline in November. For now, the buying force is still not strong and sector rotation is the investment theme.

Emerging Markets: Slightly Positive

Strong recovery was again seen in emerging markets. Russia had weathered the recent turmoil very well compare to its counterparts. It had even hit a new high in December. In fact, there were some positive changes in the Russian market. Russian Duma election was held in early December. The results were very much expected. United Russia, the political party led by President Putin, won a landslide victory. It demonstrated the popularity of Putin among his people and he would have decisive influence on the Presidential election in next year. The candidate who had Putin on his side will probably be elected the next Russian President. It implies that a dramatic change in policy is unlikely. In other words, political risk is getting lower.

Bonds: Neutral

Bank of England joined the Fed to cut interest rate in December. It cut the UK policy rate by 0.25% to 5.50%. The Fed made the same move and US policy rate became 4.25%. Given a downward tendency in policy rates, high-grade bond price was expected to benefit. On the other hand, high yield bonds were negatively affected by higher yield spread. In our views, the return on high-grade bonds is too low to be attractive while the turmoil in credit market is still affecting high yield bonds. So, bonds remained unattractive compare to equity.

Commodities: Positive

USD strengthened some how recently. So, gold retreated slightly and it is now consolidating at around USD 800/ounce. Still, more interest rate cut is expected in US and

it is not easy for USD to return to strength. So, the fundamental is still supportive for gold.

Hedge funds: Neutral

November was not good for hedge fund either. Among the HFRX strategies index, only the HFRX Market Neutral Index made a positive return. It gained 0.15%. On the down side, HFRX Equity Hedge Index dropped 3.67%, HFRX Event Driven index lost 2.97% and HFRX

Advices for investors

Hong Kong stock market found support after the sharp fall in November. Now, the selling pressure is very much released. But, the buying force is weak too. Without strong buying or selling forces, the market shall consolidate further.

In the near term, sector rotation is where the investment opportunities lie with. Moreover, new DQII funds, allocation of quotas to insurers and re-opening of existing funds were expected to bring along capital inflow to Hong Kong market. Investors may get back in by phases.

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