



Sep 2008

### **Rescue for financials, poison for the dollar.**

More financial companies fell in September. Lehman Brothers filed for Chapter 11 bankruptcy protection. AIG narrowly escaped the same fate and stayed afloat on a USD 85 billion bridging loans from US Treasury. Merrill Lynch also needed to merge with Bank of America. Bad news about the financial companies came one after another. US equities market slumped and set off panic selling around the world.

The panic sell ended with US government rescue plans for financial institutions. It is now seeking to establish a USD 700 billion company to purchase bad assets from financial companies. The plan stopped the panic selling and equities market rebound immediately.

But, everything comes at a cost. The rescue plan would probably lead to transfer of bad assets from financial companies to the US government. It would add to the budget deficit for the US government for years to come. Moreover, getting the money for the plan is another problem. After spending billions on bail out of Bear Stearn, Fannie Mae, Freddie Mac and AIG, the Treasury is already in an urgent need to raise capital to reinforce Fed's balance sheet. Now, they need billions more. So, it seems inevitable that the US government will need to borrow billions to finance the rescue plan.

The extra burden on already straddled US government finance caused concerns about the future of USD. It showed to investors that the USD rally did not have strong fundamental support. As a result, the dollar gave back gains in the last 2 months.

A weaker dollar becomes the catalyst for rise in commodities prices. Gold shot up by nearly 200 USD/ounce and crude oil rose back up to USD 100/barrel. The world's biggest gold ETF, SPDR Gold Trust gold holdings reached a new record last week. It showed that investment fund flowed back into commodities. As USD could face more pressure from rising US government debt, we maintain our positive view on commodities.

For equities markets, the government rescue action had helped to stop panic selling. However, it was no cure all for the fundamental problems e.g. a slowing housing market in US, credit crunch. This is not the end of the equities bear market. We reiterate that investors better consider entering equities market in phased approach to benefit from the current bear market conditions.

#### **US: Negative**

In Aug 2008, DJIA climbed 1.45%, S&P 500 rose 1.18% and NASDAQ went up by 1.80%. More financial institutions fell on asset write-offs and loss on derivatives products. Lehman Brother had no luck with its assets sales plans nor the effort to put itself up for sale. It ended up filing for bankruptcy. To avoid the same fate, Merrill Lynch sold itself to Bank of America and AIG accepted loans provided by US Treasuries on harsh conditions. Global equities market panicked as the bad news came. In response, US government stepped up the rescue action and planned to purchase problem assets from financial institutions. The rescue actions had stopped the landslide drop in equities market. However, it was not a solution to the fundamental problems e.g. declining housing market, credit crunch, negative growth in corporate earnings. So, we think it the equities market is making a short term rebound and it shall remain in down trend.

#### **EU: Negative**

DAX dropped by 0.88%, CAC rose by 2.05% and FTSE100 gained 4.15%. European countries also had a very serious slowdown. In 2Q2008, Eurozone reported a quarter on quarter GDP contraction. Exports for the region was hurt by slower external environment. European banks were also harmed by assets write-offs and they are also under pressure to

markets are also having poor fundamentals. We maintain that they are still in bear market.

#### **Japan: Negative**

NIKKEI declined by 2.27%. Japanese market was relatively less volatile during the market turmoil in September. But considering the fact that Japan was the among the first to enter the bear market and it had the biggest decline among developed markets, the relatively small drop did not indicator any merit for Japanese equities market.

#### **China: Negative**

HSCEI lost 6.73% last month. Chinese government stepped in to stop equities market slide. The government investment vehicle, China Investment Corporation had announced a plan to buy shares of ICBC, CCB and Bank of China from market. Government action helped to boost investors' confidence. But, again, it was not a quick fix for the structural problems. For China, they included economic slowdown on slower export and the massive amount of non-negotiable stocks entering the market. We do not expect the policy initiatives will toggle the downtrend in Chinese mainland equities market.

#### **Hong Kong: Negative**

HSI dropped 6.46% last month. Hong Kong market is still very much dominated by external environment. As both US and China market's rally was not convincing, Hong Kong market is also expected to stay in downtrend.

#### **Emerging Markets: Negative**

The big resources exports Brazil and Russia were able to fence off the general market decline early this year and subsequently reached new highs in the second quarter. But, the situation changed as resources prices since May. From that time on, Brazilian and Russian equities market index lost 30% and 50% respectively. It seemed that they are probably following the major markets into a bear market now. For Arcadia, it means these market are approaching the level that we would suggest investors to start accumulating.

#### **Bonds: Neutral**

For bonds, the policy rate trend is favourable as central banks are under pressure to keep rate low to help economy. For some high yield currencies, there is even some room to lower interest rate. Royal Bank of Australia in fact cut interest rate by 0.25% to 7% in September 2008. Still, risk premium for corporate bonds rise on more failures of financial institutions and exchange rate fluctuated violently in recent months. Thus, we think more conservative investors better stick with high-grade government bonds for higher safety.

#### **Commodities: Positive**

Massive rescue plan proposed by US government made investors worried about the future of USD. It drove investment fund flow to commodities. Gold and crude oil both benefited from it. Gold and crude oil jumped by more than 20% in the last 2 weeks. Besides the new rescue plan, the other rescue actions could also lead to further need for US government to raise debt. Example includes further capital injection to the Fannie Mae and Freddie Mac and potential capital need of FDIC. So, we expect the pressure on USD to continue and maintain our preference for commodities.

#### **Hedge funds: Neutral**

HFRX Global Hedge Fund Index dropped 1.28%. Among the strategy sub-index, HFRX merger arbitrage index was the only gainer. It rose 0.56%. The poor performers were HFRX Marco Index, HFRX Equity Market Neutral Index and HFRX Convertible Arbitrage Index. They declined 3.94%, 1.91% and 1.16% respectively.

#### **Advices for investors**

The US government rescue plan halted global panic selling for equities. However, it was no quick fix to the fundamental problems. Equities market shall remain in a downtrend. Although most of the equities market had already declined significantly, making lump sum investment now could still bring along high pressure to investors. We think that phased investment would be more appropriate for current bear market.

Besides, rescues action of US government shall result in higher national debt level. It shall pressure on USD and benefit commodities prices. We maintain our preference with direct commodities investments.

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