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Systemic risk eased, market is still volatile.

The shock in financial markets started by the fall of Lehman Brothers and other US financials was not reaching a conclusion. On the contrary, it spread to Europe. Almost at once, Belgium Fortis, Hypo Real Estate from Germany and B&B in UK announced that they were facing bankruptcy crisis. The bad news triggered another round of panic selling in global financial markets. Besides, the interbank lending market was frozen as banks lost confidence in financial stability of each other. The disruption to interbank lending market did no good, but added to the liquidity problem and pushed the banks toward the brink of bankruptcy. Unless the problem is solved quickly, a vicious circle could be set up and threaten the stability of our financial system. Worried about the systemic risk, investors sold risky financial assets and poured their money into short-term US Treasuries bonds for maximum safety.

European government announced some plans to tackle the problems and stabilize the market. UK became the role model this time. It had broken the convention for governments to wait for banks to ask for help and proposed to inject capital to British banks. Besides, it offered full guarantee for bank savings so as to maintain depositors confidence. Moreover, it has taken the initiatives to guarantee interbank borrowings to revitalize interbank lending. Now, US, Germany and France all followed its steps and announced plans to inject capital to the banks.

In the last week, interbank lending rates in nearly every country slid. It was a signal for improvements in the market and that was good news to companies and investor. Still, continuous easing of the interbank lending and the extension of return of credit availability to corporate borrowing is needed for the systemic risk to subside. It is still too early to call now.

For investors, diversification did not help to reduce system risk. In addition, market volatility rose substantially in recent months. The most effective way to reduce risk under the current market condition is to limit exposure to risky assets. Thereby, we could only advise investors to trim down the holdings in commodities related assets and park the capital in money market fund or high-grade bond funds.

Other than lump sum investment, we have also suggested investors to start accumulation assets with regular investments. In Sep, most of the equities markets had hit the entry level for our scheme. In other words, the suggestions for accumulation had become effective. Here, we must say that investors need not rush in to put large lump sum into the market at once. You better accumulate regularly so that you can benefit from dollar cost averaging to keep purchase cost low. Besides, we would like to remind you that the fundamental conditions for equities market is still not good and it may go further down. Thereby, investors would need to accumulate patiently and consistently to take advantage from next equities bull market.

US: Negative

In September 2008, DJIA dropped 6.00%, NASDAQ lost 12.05%, S&P 500 plunged by 9.21%. Bankruptcy crisis spare to Europe and short-term borrowing market stalled, they pushed US equities market further down. Even though the interbank lending market eased slightly, equities market shall remain under pressure as fundamental conditions was still worsening. So, let's have a check for the fundamentals of US. We will look at the housing market, job market and data for manufacturing and services industries. For US housing market, S&P Case/Shiller Home Price Index reported a 16% yoy decline in July. Job market was also deteriorating. In Sep 2008, non-farm payrolls data showed that it had lost 159,000 jobs. It lifted the accumulated number of job lost in 2008 to 760,000. In the same

month, ISM manufacturing purchasing manager index fell to 43.5 and it was the poorest figure since 2001. Besides, the non-manufacturing business activity index stood at 50.2, merely above the borderline for expansion and contraction at 50 points. Put all the numbers together, they showed that the US economy is still heading down. Given the poor economic background, it is unlikely corporate earnings and equities market will do well.

EU: Negative

Last month, DAX slumped by 9.21%, CAC declined by 11.56% and FTSE100 fell by 13.02%. Europe became the focus of financial markets again. European government injected capital to banks in their own country and raised the protection limit for bank deposits. Their actions helped the market calmed down a bit and interbank lending rates returned to lower levels. However, if we look at the European economic data, it was just as bad as those for US. The economic sentiment indicator for EU extended the downtrend in the last 12 months, it went down to 85.2 in September 2008. It demonstrated a poor expectation for European economy prospect. The labour market and industrial output data were not good either. Unemployment rate in EU rose slightly from 6.8% in April to 6.9% in August while industrial output had reported a yoy decline 4 months in a row. So, European market is not expected to do well either.

Japan: Negative

NIKKEI declined by 13.87%. Japan economy had also declined. Tankan survey showed that both manufacturing and services industries had contracted. In the 3rd quarter of the year, the manufacturing index had dropped to -16, following the contraction in the 2nd quarter. For service industry, the figure was -16 and it was the 6th consecutive quarter of contraction.

China: Negative

HSCEI dropped 22.4% in September. The Chinese government introduced more policies to stimulate economic growth. New measures adopted includes cutting down transaction cost for property purchases, uplifting the margin ratio for mortgage loans and increasing export tax rebate and so on. However, problem like declining export demand, bankruptcy of corporate and negative wealth effect due to the decline in property and stock market are causing damage to the Chinese economy. It is unlikely that the policy initiatives can help to revert the downtrend in mainland economy or the stock market.

Hong Kong: Negative

HSI lost 15.27% last month. Hong Kong had always been very sensitive to changes in global market environment. Our stock market did not escape the global sell-off. For our financial system, HKMA followed the initiatives in Europe and US to enhance the mechanism for providing capital to banks and offer 100% guarantee for bank deposits.

Emerging Markets: Negative

Argentina is the cause of concerns recently, the country is in debt problem. Argentine government took over private pension plan in country, it was the second time in the last 20 years. In 1991, it stopped payment to national debt shortly after the private pension plan was seized. Investors feared that it was the prelude for sovereign debt default. If it comes true, it could trigger more fund outflow and hurt emerging markets further.

Bonds: Neutral

As mentioned in the market commentary, investors tended to keep their assets in short-term US Treasuries issues recently. Yield on 3-months US T-bills had once dipped to 0.5%, holding these issues to maturity effectively gave investors no return. The only motive to purchase them was for the safety of invested capital. Once the market stabilize, investors may pull out their money from these issues and push down their market price. It makes money market funds a very competitive alternative to the short-term T-bills. Thereby, we suggest that besides high-grade bond, money market fund is another viable option for protecting capital.

Commodities: Slightly positive

Last month, we put forward our forecast for USD to come under pressure as US government needed to raise capital to support the market bail out plan. But, systemic risk escalated as bankruptcy crisis spread out to Europe. Investors pulled money out of risky assets classes including commodities and park it into short-term T-bills. The capital flow helped USD to extend the rise started in mid-July. Commodities declined in value as investors seek shelter and USD continued to go up. For crude oil, the drop was more substantial as investors worried about recession. Here, we would advise investors to reduce their exposure to direct commodities investments to no more than 20-30% of their total portfolio.

Hedge funds: Neutral

Hedge fund performance was very bad in September. HFRX Global Hedge Fund Index dropped 6.9%, making the YTD lost to 11.61%. The environment had become difficult for hedge funds to make profit as ban on short-selling on stocks is adopted in many countries. Also, the disruption in lending market makes borrowing more difficult for hedge funds. So, investors are suggested to stick to alternative investment funds with low gearing and less reliance on short selling.

Advices for investors

Though that the decline of interbank lending rate showed confidence among banks recovered a bit, we would say investors should observe for a while to determine if the systemic risk has subsided. Conditions that we would like to see interbank lending rate to approach policy rates and stabilize at low level. Also, lending to companies need to be resumed.

For now, we suggest investors to offload the commodities related investment which we recommended before and keep the exposure to these investment no more than 20-30% of the total portfolio. For regular savings, most of the equities market had already reached our reference entry level. Investors are advised to stick to the plan and continue accumulating equities market funds.

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