



Dec 2008

Credit crunch goes on to 2009.

A vicious circle between credit crunch and falling asset prices dominated investment markets in 2008. It has led to severe loss in a variety of risky assets ranging from equities, corporate bond, commodities to high yield currencies and properties.

The vicious circle started with declines in US housing market. Sub-prime related assets sunk with falling US property prices. It led to billion dollar write-offs for banks, mortgage lenders and investment banks. Huge write-offs severely damaged their capital base. Strangled by diminished capital base, they could only trim down their balance sheet and cut back on lending. Financing became a headache for investors. For those who were investing with leverage, they were forced to exit their positions. Assets prices dropped as a result. The problem had not only affected the property market, but also the stock market, bonds, commodities and currencies. Falling asset prices in turn led to further write-offs for financial institutions. So, a vicious circle was set up and it went on and on.

But, the tightening of bank credit or asset prices decline were nothing new. Why the financial market failed to stop the vicious circle?

We think that it was attributable to the 2 conditions below.

1. High leverage in financial system – After years of low interest rate and easy credit conditions, nearly all kinds of financial institutions e.g. government sponsored mortgage securities issuers, investment banks, mortgage lenders, got used to employing high leverage to boost profitability. Many of them were operating at 30-40 times leverage. Pushing the leverage ratio to the extreme meant that there was no room for error. A small decline in asset prices could wipe out their equity totally and made them technically bankrupt.

2. Complex financial products hinder risk assessment - Explosive development of collateralized debt obligation (CDO) and credit default swap (CDS) added to the difficulty to deal with the credit crunch. CDO is effective a bundle of different bonds. Still, the composition was not clearly disclosed sometimes. Estimating the potential losses and exposure to poison assets became impossible. For CDS, it was traded in over the counter market of which regulation was minimal. Exposure and potential losses for individual companies was just unknown. Facing so much uncertainty, financial institutions could not assess the financial health of each other. As a result, inter-bank lending market was frozen. It pushed the troubled companies further to edge of bankruptcy.

The problem got more serious with time. Finally, Lehman Brothers filed for bankruptcy in September after the Fed rejected its call for bail out. The fall of Lehman Brothers shocked the entire world. Global financial system was paralyzed as investor flight to treasuries bonds and cash for safety. It left the governments with no choice but intervened by injecting capital to banks to avoid the meltdown of global financial system.

Now, the capital bases of major financial institutions were replenished. And, they had removed some bad assets from their balance sheet. Investment market also calmed down.

But, we think that de-leverage and credit crunch is not going to end anytime soon. It will continue to weigh on investment market in the beginning of 2009. Thus, we remain cautious about stock markets. Investors still need to wait patiently for recovery of economy and stock markets.

US: Negative

Over the month of November, DJIA dropped by 5.32%, S&P 500 lost 7.48% and NASDAQ plunged down by 10.77%. Financial Secretary Henry Paulson agreed to tap the TARP for USD 19 billion aids to GM and Chrysler. The first USD 350 billion approved by Congress was depleted in 2 months time. In return, he stopped the bankruptcy problem for US financial institutions and gave the equities market a break from panic selling. However, the real economy is still firmly in a downtrend. Worsening job market conditions is weighing on personal loans quality. There shall be more write-offs for US financials and credit crunch has yet come to an end. So, we think the rise in stock markets in recent day is just a rebound but not a long lasting rally.

EU: Negative

DAX slumped by 6.39%, CAC dropped by 6.48% and FTSE100 fell by 2.44%. European market also made a rebound after the bankruptcy crisis came to an end. But, looking ahead, they will also be affected by economic recession and continued credit crunch. Again, we remain negative on European market and expect them to stay under pressure in early 2009.

Japan: Negative

The Nikkei average had a slight loss of 0.75%. Recent market changes showed again that Japan is in a very passive position in many ways. First, Japanese Yen rose sharply as global central trimmed interest rate aggressively. But, BOJ had very little to do as it had adopted zero interest rate policy years ago. Besides, Japanese trade conditions is experiencing significant downturn as external demand wanes. In November, Japan reported trade deficit for the second months in a row. Still, there is nothing it can do again. So, we think the chance for Japanese economy to recover before external conditions improve is slim. We also remain cautious about Japanese equities market.

China: Negative

Last month, HSCEI climbed back 9.02%. Chinese mainland stock market rebound on news about government policies to stimulate growth. Hong Kong listed Chinese enterprises rebound strongly also. HSCEI bounce back up nearly 100%. But, we need to reiterate the stock market is still in bear market. Investors are advised to wait for pullback to accumulate assets.

Hong Kong: Negative

HSI ended the month of November unchanged at around 13,900. Our opinion for Hong Kong market is just the same as above. Investors better accumulate when market retreat.

Emerging Markets: Negative

Emerging markets stabilized as US market calmed down. They just followed the movements in major market. It was truly no matter for export-reliant Asian markets or commodities rich Brazil and Russia.

Bonds: Neutral

The Fed trimmed US policy rate to nearly nothing. But, the trend of global interest rate cut shall go on. Europe and UK shall lower their interest rate further to boost economy. So, high-grade government bond can still rise further. For corporate bonds, the risk premium climbed back to level unseen after the Great Depression. It may represent interesting opportunities for investment in 2009. But the twist here is to avoid losses related to bankruptcy.

Commodities: Slightly positive

Gold went back up as investors speculated on interest rate cuts by Fed. It came back above USD 800/ounce again. Still, de-leveraging and closure of hedge fund still have more to go. They will bring along more capital flow to USD. Thus, we expect more consolidation for gold prices before it can benefit from weaker USD.

Hedge funds: Slightly negative

Hedge funds had another down month. HFRX Global Hedge Fund Index fell 3.04 percent in November. Misfortune for alternative Investment did not come to an end. In December, former NASDAQ Chairman Bernard Madoff admitted that his investment company was a "Ponzi" scheme. According to Madoff, the amount involved in the fault case would be close to USD 500 billion. More losses for hedge funds shall be revealed and the wave of hedge fund closure should have some way to go.

Advices for investors

The vicious circle between credit crunch and falling asset price dominated 2008. Finally, it turned into a financial tsunami in Sep. Now, government aids helped to calm the market down and bankruptcy crisis for financial companies subsided.

But, global stock and property markets are still in a downtrend. The banking industry shall see more losses from mortgage related assets and worsening personal loans portfolio. Their ability and willingness to lend are still at risk. Therefore, we expect the credit crunch to continue into 2009.

The investment market is still expected to be under pressure. What investors can do is continue to accumulate when market is low and wait patiently for the economy and the stock market to recover.

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