Arcadia Market Commentary

Jan 2009

Consolidation, no quick recovery in 2009.

Investment market turned upside down in 2008. Japanese Yen and USD, which were the underdogs in the previous years, became the lonely few to make a profit. On the contrary, stocks, commodities and high yield currencies experienced a free fall in value. In hindsight, taking conservative stance was obviously the right move for investors. So, will the situation change in 2009?

Our view is that credit crunch will continued to plague global financial system while the downturn of real economy will only add to the problem. Thus, it is still not time for aggressive investment. Rather asset accumulation in small step is more appropriate.

Asset-write off is still a headache for global financial system. Banks in US and Europe are still strangled by huge amount of bad asset. Latest earning announcement showed that major financial institutions including Bank of America, Citigroup, Royal Bank of Scotland and Deutsche Bank all suffered billion dollars write-off in the last quarter of 2008. Bank of America and Royal Bank of Scotland are forced to ask the government for more capital to keep them from bankrupt. While maintaining sufficient capital is still a challenge, the ability and willingness for banks to lend remains limited. Credit crunch will likely continue into 2009.

Besides, the real economy started turning down last year. Now, Europe, US and Japan have all fallen into recession. Poor business environment and severe setback in job market hurt corporate and individual. Default rate for corporate and personal loans are rising. Loans losses shall hit the bank system and threaten their survival. In other words, the second wave of the financial crisis is coming. It is expected to hurt stock market.

However, there are also some desirable changes. Governments from developed and developing world realized the severity of the financial crisis and economic recession. They are aggressively raising government expenditure to make up for part of the losses in demand. Still, it just comes a bit too late as fiscal policy usually needs 6-9 months to take effect. Moreover, corporate and individual spending are 2 important building blocks for the economy. Boosting government expenditure alone is not enough to reverse the downtrend in economy as well as the stock market.

All in all, the financial crisis is not over yet. The banks are still suffering from asset write-off and loans losses. The problem of credit crunch and a lack of liquidity will continue to beset investment market. Thereby, we think that the chance for stock market to make lasting rally is slim. There will only be short rebounds. We suggest investors to add to their equities investment step by step.

US: Negative

Dec 2008, DJIA slid by 0.60%, S&P500 rose by 0.78% and NASDAQ rose 2.71%. Earning reports for 4Q2008 showed that declining asset value remained a problem for financial institutions. Citigroup lost USD 8.29 billion and Bank of America also had a quarterly loss of USD 1.8 billion. Huge losses showed that US banking industry. is still in critical condition. Though that government aids helped to keep them from bankrupt, it does not mean the credit cycle will return to normal anytime soon. Looking into the future, US banking industry will face the losses related to increasing default on corporate and personal loans. Estimation by Goldman Sachs shows the loss will be as high as USD 2,000 billion. It will probably lead to another round of financial crisis and hurt equities market performance. US market will likely test previous low in coming months.

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EU: Negative

DAX went up by 3.01%, CAC lowered by 1.35% while FTSE100 was up by 3.41%. Banks in Europe were also reporting substantial losses also. Similar to Bank of America, Royal Bank of Scotland could do nothing but asking for more capital from government to stay afloat. In addition, the problem of corporate and personal loans losses will also hit European banks. Thereby, European equities market is also expected to drop together with US market.

Japan: Negative

Nikkei 225 index moved up by 3.29%. Japanese economy and stock market had not given us any surprise for long. The currency, Japanese Yen, is what concerned us. The reason is Japanese Yen has been driven up by capital seeking for safety. It can be taken as an indicator of risk appetite. Recently, it had crossed the 90 Yen to 1 USD mark. It meant risk appetite is low in the market.

China: Negative

Last month, HSCEI gained another 9.49%. Chinese GDP growth contracted to 6.9% in 4Q2008. Besides, exports which used to growth at double digits also dropped in the last 2 months. The economic data echoed with the profit warnings issued in recent month to show that business environment in the mainland is turning sour. The Chinese companies did not escape the impact of global economic slowdown. Their share prices also weakened again despite strong rebound was seen in previous month.

Hong Kong: Negative

Hang Seng Index also made a 3.60% gain last month. Hong Kong stock market fall again after a brief rebound started in Nov 2008. Sale of Chinese banks tocks by foreign strategic partners and rumors about the need for HSBC to replenish capital became the catalyst for the decline. Although Hang Seng Index rebound 40% strong since Oct 2008, it is not wise to expect Hong Kong market to fend off deteriorating business conditions in US and China

Emerging Markets: Negative

Last year, most of the asset losses suffered by financial institutions were related to collateralized debt obligations and sub-prime mortgages. Since theses products were not popular among banks and financial companies in emerging markets, their loss was not serious. For them, the challenge was capital flight. But, this year, the problem spread to loans losses from traditional lending e.g. corporate loans, personal loans and mortgage loans. Their suffering will likely be bigger than last year and emerging market will still be suffering from the financial crisis.

Bonds: Neutral

Government bonds yield of major economies fall to historical low as investors seek for safe heaven. Yield on 20 years or 30 years long term US Treasuries bonds dropped to around 2.0-2.5%. In other words, the price of the bonds shot up. In the last 2-3 months, it went up to USD 130 or even USD 140 for each USD 100 dollar face value of bonds. The sudden jump in Treasuries bonds was partly explained by aggressive rate cuts and declining concerns about inflation. But, at the same time, the yield spread between government bonds and corporate debt or high yield bond rose also. It showed that flight to safety was another important force behind. If the market sentiment continues to be cautious and risk appetite remains low, the long-term government bond may go even higher. But, we do not suggest investors to chase in at current price level. Cash is a safer alternative for individual investors.

Commodities: Slightly positive

Gold price is still moving sideway. It is now hovering around USD 800-900 pre ounce. For crude oil, it started a rebound in recent days. We noticed that near-term contract prices for WTI was by far lower than longer-term contracts. The spread was once higher than 10% between Jan and Feb contracts, which was very unusual in crude oil market. The reason behind was that oil storage was fully loaded and WTI contract buyers were unable to handle the oil to be delivered on settlement. As a result, they were forced to settle their long positions. Force selling drove down near-term contract prices. The unusually wide spread is starting to attract investors into the market. We think that crude oil had been very oversold and now investors are coming back, the rebound in crude oil price may go on.

Hedge funds: Slightly negative

Full year performance for hedge funds in 2008 were published. As a whole, it was far from satisfactory. HFRX Global Hedge Fund Index lost 23.25%. Among the strategy sub-indices, HFRX Marco Index and HFRX Merger Arbitrage Index were the gainers. They had gone up 5.61% and 3.69% respectively. But, several other sub-indices lost more than 20%. The big losers were HFRX Convertible Arbitrage Index. HFRX Relative Value Arbitrage Index and HFRX Distressed Security Index. At the moment, many hedge funds manager are still having difficulty to meet redemption request as their holdings lacked liquidity. The liquidity problem is expected to obscure hedge fund operation and performance in 2009.

Advices for investors

Asset write-down and credit crunch are still very acute problem for our financial system. At the same time, weakening economy will add to the trouble. Thus, global economy and equities market are expected to remain weak before the fundamental problem improves. But, as investors, battered asset prices meant bargain-hunting opportunity for us. Thus, we reiterate that investors can start accumulating assets in small steps.

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