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Debt bubble recedes

Last month, we said that a debt bubble was forming in high-grade government debt. US government issues shot up in prices, 20-30% rise. It did not only jeopardize the attractiveness for treasuries issues, but also could develop into another debt and become a new threat in investment market.

We are not suggesting that the rise in government bond prices lack fundamental support. In fact, rapid rate cuts and expectation for inflation to subside are supportive to bond prices. However, the abrupt price change was also driven by extreme risk aversion. Investment market was in complete chaos after Lehman Brother went under. Investors lost their confidence in every asset class other than government bonds. As a result, they rushed to debt issues of major countries e.g. US, Germany and UK. The abrupt capital flow pushed these issues to historical high.

In Jan 2009, US treasuries bond yield came back up. For example, the yield for 30 years Treasuries bond went up by 1% to 3.66%. It meant that the price for each USD 100 face value of it to fall 10% and stands at around USD 126 now.

We take the lower treasuries prices a positive change, especially for the interest rate sensitive longer maturity issues. The drop in government debt meant that Investors have calmed down a bit and they stopped fleeing to government bonds at any price. So now that the government bonds bubble is deflated. It meant that the risk to investment market recedes.

Still, on the other hand, we do not expect government bond yield to shot up. As stated before, the global economy is still heading to further slowdown and good prices has a higher pressure to drop than to rise. All theses point to low interest rate. So, the government bonds yield should remain low, especially for short-term Treasuries bills.

Lastly, the fall in treasuries bond issues could be temporary. The bonds bubble may come back when market become messy again. Tightening credit condition and global economic recession are still acute problems. Besides, the second wave of financial tsunami shall be triggered by higher losses from personal loans, corporate loans and mortgage portfolio. When the problems surfaces again, investors will likely seek for asylum for their money. The debt bubble will likely be re-inflated again.

US: Negative

DJIA dropped by 8.84%, S&P500 lost 8.57% and NASDAQ went down by 6.38% in Jan 2009. The new US President Obama is pushing forward for his plan for economic stimulation and rescuing the financial institutions. Although his proposal aroused disputes from Republican, the severity of the US economic problem made a stimulation plan necessary. Thus, it is very likely that the plan will finally be approved. But, we must reiterate here that the effect for government prop-up actions will not come out until 6-9 months later. It can stimulate a rebound in stock market for now, but not making a lasting up-trend.

EU: Negative

DAX lost by 5.65%, CAC lowered by 7.58% while FTSE100 fell by 6.42%. Spain, Portugal and Greece got the market attention. Their sovereign credit ratings were downgraded. Besides affecting themselves, it also has an impact on Euro. Investors worried that the restrictions of ECB on monetary policy of member countries is making them less effective in dealing with the crisis. As a result, it caused concerns about the Eurozone.

Japan: Negative

Last month, Nikkei 225 index lost 9.77%. We have always emphasized that dependence on exports is a weakness for Japanese economy and the stock market. It is confirmed by earnings forecasts by large Japanese corporations. Hitachi, Toshiba, Panasonic, NEC announced this year's profit forecast, they all expect to have billions dollars losses. We reiterate our negative view of Japan, and also that recovery of Japan economy and stock market will be slower than other major markets.

China: Negative

HSCEI gave back the gains in Dec 2008 and ended Jan 2009 with a 9.63% drop. The Chinese government announced more stimulation policies for the 10 selected industries. After automotive and steel industry, revitalization plan for textile, equipment manufacturing was just announced. Government policy help could to absorb the impact of global economic recession. But foreign direct investment and exports were major driving forces for Chinese economic growth. Thereby, we do not expect a decoupling in stock market or economy for China from global trends.

Hong Kong: Negative

Hang Seng Index also dropped by 7.71% last month. Hong Kong market has no significant changes. Our focus is on upcoming earnings reports. Since many Chinese enterprises has already issued profit warnings earlier, the market shall have no surprise to see poor performance for last year. However, the outlook for 2009 remains a wildcard. Pessimistic forecast by companies may cause renewed pressure on stock prices.

Emerging Markets: Negative

The Russian government is facing a difficult choice between currency devaluation and sharper economic slowdown. It did not lift interest rate quick and significantly to protect the sinking ruble. Instead, it resorted to lower the exchange rate in small steps in hope to relieve the selling pressure. But, it is sending a message to the market that the government failed to stabilize the currency again and again. It does no good but strengthen the expectations for lower exchange rate. Still, the problem with lifting interest rate quickly is that it will bring about sharper slowdown for the Russian economy, which is already plagued by capital flight and diminishing exports demand. So far, it seems the Russian government is having a difficult time to meet the challenge. Unless oil prices resumes an upward trend, the problem with ruble will continue to drag on Russia stock market.

Bonds: Neutral

US Treasuries yield moved up, we regard it as a positive change in market. Moreover, it means that the risk for formation and bursting of another bubble has receded.

Commodities: Slightly positive

US bonds dropped, investors switched to other assets for capital protection. Gold moved above USD 900/ounce again. But, the worries about inflation to climb and USD to collapse are pre-mature. We still expect gold to move in range between USD 800-900/ounce. For crude oil, it is consolidating at around USD 40/barrel.

Hedge funds: Slightly negative

HFRX Global Hedge Fund index gained 1.10% last month. The biggest losers last year became the ones to make highest rebound. HFRX convertible arbitrage index rose 5.90% and HFRX relative value arbitrage index made 2.33%. However, redemption gates are still in place for many hedge funds. It shows that liquidity of the underlying assets has not return to normal. Liquidity risk for investors is still high, so investors should only buy into these funds if you are willing and able to keep the money there until investment market recovers.

Advices for investors

Recently, government debt prices came down a bit. It means lower risk for the debt bubble to burst. But, the market conditions did not improve much. The stock market is still

making “see-saw” movement. Before the market can recover, the problem with assets write-down for the banks and credit contraction must be solved.

Our suggestion to investors is to continue accumulating assets with discipline and patience.

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