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### China's deflation fight

China's consumer price index fell 1.6% in February from a year earlier, the first year on year drop in more than 6 years. The producer price index also dropped 4.5% from a year earlier, raising the threat of deflation as global recession deepens. We expect negative CPI could persist for the coming few months but we believe that China will avoid a prolonged period of deflation, mainly because of the aggressive monetary and fiscal stimulus policies introduced by the Chinese authorities.

Deflation is symptom of a weak economy and industrial overcapacity. Deflationary expectations often lead consumers to defer purchases, resulting in further downward price pressure.

To fight deflation and economic recession, the Chinese government has raised its spending, cut tax, increased export tax rebates and money supply. In the first two months this year, the total fixed investment was 30% higher in real terms than a year earlier, and investment in railways tripled. It is the quickest way for the government to boost domestic demand in the short run. The additional spending to improve education, healthcare and social welfare announced by premier Wen Jiabao, will encourage domestic consumption in longer run. To boost exports, the rate of export tax rebate for textiles and clothing was lifted further to 15% from 14%.

As for monetary policies, the People's Bank of China still has room to lower interest rate and the banks' required reserve ratio to fight the threat of deflation. The benchmark 1 year lending rate is 5.31%. However, in order to preserve the purchasing power of the yuan and to keep the currency's exchange rate stable, we expect that the PBOC will not cut rates aggressively this year.

The broad measure of money supply (M2) in February climbed 20.5% from a year earlier after growing 18.8% in January. The gain was the most since October 2003 as banks quadrupled lending from a year ago to help boost the economy. Chinese banks extended 1.07 trillion yuan worth of new yuan-denominated loans, up 827.3 billion yuan from a year ago. The growth in loans and money supply are inflationary in nature, which can ease the deflationary pressure.

On the other hand, the larger-than-usual fall in CPI last month was partially the result of the high base effects from the shifting Chinese New Year holidays and the snow storm last February. CPI should stabilize towards the third quarter as the lower base of 2008 takes effect. Declining values of raw materials, such as iron ore and crude oil, were largely responsible for the decline in China's consumer price index (CPI). Food prices, which make up about one-third of the index, also fell 1.9% in February. We think that the sharp falls in commodity prices are unlikely to continue, which can help ease the deflationary pressure.

The Chinese government had set an inflation target 4% for the year, which is difficult to achieve. However, we believe the policy maker has the ability and commitment to pursue additional policies and prevent deflationary expectations from getting entrenched.

#### U.S.

DJIA rose 7.7%, S&P500 went up 8.5% and NASDAQ jumped by 11% in last month. US market rallies on better than expected economic data. Durable goods order, new home sales, existing home sales, housing starts and building permits all jumped unexpectedly. We doubt the sustainability of these rebound and we cannot arrive at a conclusion that the economy is about to recover. Treasury Secretary Tim Geithner announced the long-awaited details on the financial repair plan "The Public-Private Investment Program for Legacy Assets". By bringing in private investors, the government hopes to jump-start market mechanisms to establish benchmark prices for these assets. We believe that it can help to stabilize the bank sector if the banks, private investors and Treasury agree on the prices of the legacy assets. However it takes time for the prices of these assets to rise and the economy to recover.

Gross domestic product contracted at a 6.3 percent annual rate from October to December, the weakest since 1982. Corporate earnings dropped 16.5 % from the prior quarter, the most since 1953. Meanwhile, the Non-farm payroll employment continued to fall sharply in February, which has declined by 2.6 million in the past 4 months. We expect that the employment situation will continue to worsen. Unless the unemployment rate rises to a peak, the economy has not yet bottomed and a sustained rally in the market cannot occur.

## EU

DAX moved up by 5.3%, CAC made 2.7% and FTSE100 recovered by 2.5% in March. The consumer prices of UK in February rose unexpectedly to 3.2% from a year earlier. It suggests the Bank of England might not do as much quantitative easing as expected and will need to withdraw much of the stimulus as soon as the crisis ends. The risk is that tightening policy so soon after the crisis ends will choke off a recovery. On the other hand, the German ZEW survey for March showed that analysts' expectations recovered slightly, albeit to a still very weak level. European banks were far trickier than the U.S. banks in terms of off balance sheet leverage, we therefore expect that the deleveraging process will run longer and the pace of recovery for EU will be much slower.

## Japan

Nikkei 225 ran up 10.4% in last month. The Japan's trade balance swung into surplus in February for the first time in 5 months, as a sharp fall in imports offset a record fall in exports for the month. Japan's export dived a record 49.4% in February from a year earlier. The slump in global demand and a strengthening yen have crushed Japan's exports. Since Japan's growth has still been far too dependent on exports, it faces a more painful adjustment.

## China

HSCEI and Shanghai SE A Share index jumped 16.9% and 13.9% respectively in March. There are some tentative signs of a recovery in domestic demand. China's purchasing managers' index strengthened for the third consecutive month and new bank loans have surged. Statistics, such as electricity use and car sales have also picked up. The country's vast domestic market, great consumer potential and healthy financial system would provide a solid back up for stable economic growth. Premier Wen Jiabao pledged that China is capable of launching a new stimulus package at any time. But, its 8% growth target in GDP is not easy to achieve.

## Hong Kong

HSI rose 5.5% in March. Unemployment rate in Hong Kong for the three months starting from December climbed to 5% from 4.6% for the three months starting from November. It is expected to rise even further as the tough times were not yet over in the labor market. China Mobile's net profit in 2008 rose about 30%, but still fell short of forecasts with an 11%. Meanwhile, PetroChina's net profit fell 22%. The decline is slightly larger than the analysts' forecast. Several large properties developments have trimmed their selling prices, which will translate into much lower property revaluation this year. Companies are still under pressure to cut their dividends due to the fall in earnings.

## Emerging Markets

RTS jumped 26.6%, Sensex gained 9.2% and Bovespa was up by 6.7%. Emerging-market stocks rose, with the global benchmark index poised for the biggest monthly gain since 1989. The EU leaders agreed at a summit in Brussels to double loans available to Eastern Europe to 50 billion euros and add 75 billion euros to the coffers of the International Monetary Fund. Investors speculate the U.S. economy is stabilizing and the government efforts aimed at unlocking credit markets and reviving economic growth will succeed.

## Bond

The Fed surprised the market with an aggressive announcement of its quantitative easing policy. It would buy up to \$300 billion of long-term U.S. Treasuries in the next 6 months and buy additional \$750 billion in mortgage backed securities guaranteed by Fannie Mac and Freddie Mac. The yield on the benchmark 10-year note fell the most since 1962 and tumbled to 2.53%. The 30-year bond's yield also tumbled to 3.55%. Clearly, the Fed's action is designed to boost Treasury prices and drive down their rates. The goal behind all the Fed's moves is to spur lending. More lending would boost spending by consumers, which would revive the economy.

### **Commodities**

We're not convinced gold can maintain its rally, at least in the short-term. The money supply is going to increase, but at the same time, money velocity decline. We expect that gold will trade between \$900 and \$1,000 USD per ounce as it takes 9 to 12 months for inflation to take effect. Meanwhile, WTI trades at around USD 30-60/barrel. With less drilling going on, we will soon start to see tighter output for oil. For now, lower oil demand is trumping stagnant supply. But when demand starts to recover, prices will take off.

### **Hedge funds**

HFRX Global Hedge Fund index lost 0.4% last month. Relative value strategies perform better, the convertible arbitrage index gained 2.2%. On the other hand, Equity hedge, event driven and global macro performance were worse.

### **Advices for investors**

Investors should continue accumulating funds in China and Emerging Markets with discipline and patience.

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