


Risk of Global Stagflation




Amid the slowdown of global economy, inflation alarm bells are ringing in financial markets as soaring energy and commodity prices, along with the revival of companies' pricing power. Investors are already nervous about an economic downturn. According to IHT, markets grow uneasy about heavy doses of monetary easing and mounting inflation pressures from soaring raw material and food prices. In a sign that inflation expectations are going up, 10-year U.S. break-even rates - the difference between yields on inflation-protected securities and conventional bonds - have risen to 2.34% from a January low of 2.04%. Core consumer inflation in the United States rose more in January than it has in any month since June 2006, while inflation in France reached its highest level in 11 years and input price inflation in Switzerland surged to an 18-year peak. Output prices in the euro zone, which has 15

members, are at their highest since March 2007 as companies raise prices to pass on high raw material costs. The ongoing salary negotiation for around two million public-sector workers in Germany, the euro zone's biggest economy, was also a catalyst. Wage negotiations for around 550,000 chemicals-sector employees are also set to start in some parts of Germany. The inflation outlook is more disturbing in emerging markets. In China, for example, inflation rate was at 7.1% yoy in January, an 11-year high, while prices are rising at a record pace in some Gulf countries, according to IHT. On the other hand, the fragile economy in the US might become worse ahead. Even though the central bank cut short-term interest rates twice in January, in part to stabilize the housing market, investors remained so worried about the

the longer-term outlook that mortgage rates have edged up steadily in the past few weeks. Apparently, more cuts could very well be needed. The concern about inflation has prompted traders to almost drop expectations for euro-zone interest rate cuts in the first half of 2008. They are also scaling back how far the Fed can reduce rates. This certainly cast doubts over the stimulus from interest rate cuts of two and a quarter percentage points in the United States since September, and a planned \$150 billion government package of tax breaks and spending. As a matter of fact, some economists have argued that the world economy is so close to full capacity, limiting Fed's further action. In fact, we are falling into a dilemma of slowing growth with rising price. 

Microscope

Many people are feeling 1970's stagflation. Even as economic growth sags, oil and gasoline prices are surging to new heights. Gold is on the rise, along with the prices of basic commodities like wheat and steel. With the credit markets in disarray from the collapse of the housing bubble, the sustained weakness in sentiment might hinder economic recovery. Stagflation occurs when there is a decline production and a rise unemployment, with inflation. The most common explanation for stagflation revolves around a decrease in aggregate supply. An increase in resource costs causes firms to either cut back production, raise prices, or both. The cut back in production causes higher levels of unemployment, while higher costs are pushing prices up. Currently, higher resource costs can be caused partially by declining productivity, excessive regulation and natural disasters. During the 1970's, for example, OPEC cut back oil production and raised the international price of oil. Inflation reached double-digit levels, averaging just over 10% per year in the 1970's. Levels of production fell, and both unemployment and prices climbed. 

MARKET BRIEFING


YTD % (local curr)

US DJ	12,381 (-6.7%)
Nasdaq	2,303 (-13.2%)
Euro Stoxx 50	3,737 (-13.9%)
HSI	23,305 (-16.2%)
Japan NK225	13,500 (-11.8%)
China Shanghai Composite	4,370 (-16.9%)
Singapore	3,048 (-12.0%)
India BSE30	17,349 (-14.5%)
Brazil BOVESPA	64,608 (+1.1%)
Aus All Ord	5,644 (-12.1%)
US-10yr Bond	Yield 3.69%


As at 22/02/08

Insight: "Fight Against Inflation"

There is a conventional wisdom of investing in the stock market and the importance of portfolio diversification. But during the period of inflation or even stagflation, have you ever considered investing in gold to act as hedging tool? While stocks tend to perform extra well during periods of political and economic stability, due to its intrinsic value gold tends to be more desirable and perform better during periods of bank turmoil, falling interest rates, and times of political crisis or war. In addition, gold has been regarded and used throughout history. Gold price hit a new record high price recently. Had you purchased one ounce of

pure gold on Jan. 21, 1980, you would have paid over \$847 for it; in 1980 dollars, or, according to the Wall Street Journal, an astounding \$2,268.6 in inflation adjusted 2008 dollars. Therefore if you had sold on Jan. 28, 2008, the one ounce of pure gold, which you purchased on January 21, 1980, you would have lost in 2008 dollars the sum of \$2,268.6 minus \$927.1, which equals \$1341.5. Therefore, buying the real thing to hedge inflation may not be the most effective way. Another roundabout way to invest in gold is to buy stock in a company that mines gold. Besides benefiting from the rising gold prices, investors might get extra profit margin from profitable mining operations. Certainly, to avoid the risk of single investment, mutual funds could offer exposure as well as some semblance of diversification. 

A-Z Financial Tools

Mortgage pass-through security is a major type of mortgage-backed security, which is created when one or more mortgage holders form a collection of mortgages and sells shares or participation certificates in the pool. The cash flow from the collateral pool is passed through to the security holder as monthly payments of principal, interest, and prepayments. 



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