See the Disclosure Appendix for the Analyst Certification and Other Disclosures

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Hong Kong Financial Market Weekly

22 May 2007

Risks and Impacts of China's Stock Bubble

- **If China's stock bubble bursts, Hong Kong's financial industry will be affected, but signals for a burst of the Chinese stock bubble in the near term are not obvious**
- **A stock market crash in China could boost the flow of Chinese savings to overseas markets through the QDII scheme. China is also diversifying its foreign reserves. These two trends will boost Hong Kong's fund management industry, offsetting a decline in stock market activity**
- **The global economy and financial markets are favorable for Hong Kong, easing any potential setback from China. Hong Kong's financial industry will continue to grow, but the focus may shift from the stock market to the fund management sector**
- **Debt and money markets: HIBOR remains on an uptrend; spread with USD Libor narrowing**
- **HK dollar market: HKD at a record weak level against the USD**
- **Stock market: Stocks boosted by QDII rules; China tightening worries capped gains**
- **Data review: Economic slowdown likely temporary and to reverse in coming quarters**
- **Inflation dampened by government measures; underlying trend remains steady**

Interest and Exchange Rate Forecasts

	18 May	1-Month	3-Month	6-Month	12-Month
3-month Hibor (%)	4.43	4.45	4.45	4.30	4.35
5-year EFN Yield (%)	4.10	4.17	4.20	4.30	4.45
HKD/USD	7.8226	7.818	7.815	7.810	7.80

Source: Citi estimates, Reuters.

Hong Kong and US Week Ahead Calendar

Date	Region	Period	Topic	Citi Forecast	Market Forecast	Prior Report	2 Periods Ago
24 May	HK	--	HK Public Holiday (Buddha's Birthday)	--	--	--	--
24 May	US	May 19	Initial Jobless Claims (thousands)	300	303	293	298
24 May	US	Apr	Durable Goods Orders (% mom)	-0.8	0.9	3.7	2.3
24 May	US	Apr	New Home Sales (thousands)	890	860	858	836
25 May	US	Apr	Existing Home Sales (millions)	6.25	6.10	6.12	6.68

Source: Citi estimates, IDEAglobal, Bloomberg, Reuters.

Risks and Impacts of China's Stock Bubble

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Rising concerns about China's stock market bubble

Soaring prices of Chinese A shares have aroused concern about a forthcoming major correction and negative repercussions for Hong Kong. A few weeks ago, the governor of the People's Bank of China (PBOC), Zhou Xiaochuan, mentioned that China's stock market had already entered a bubble phase. Hong Kong tycoon Li Ka-shing also expressed worry about the high valuation of China's stock market. With P/E ratios of Shanghai and Shenzhen A shares at 53 and 49, respectively, in April, the risk of a correction triggered by monetary policy tightening should not be ignored. The PBOC has indeed increased efforts to cool China's economy and stock market. On May 18, the PBOC announced its second interest rate hike this year and a fifth rise in the bank reserve requirement ratio.

Although China's stock bubble burst will inevitably affect Hong Kong, the risk and impact should not be exaggerated. First, the risk is not yet dangerously high in the near term, in our view. Second, it could bring new opportunities for Hong Kong. Finally, a favorable global economy and financial market would ease the repercussion of a Chinese stock market crash on Hong Kong.

But no obvious sign of a Chinese stock bubble burst in the near term

While there are ample signs of a bubble in China's stock market, the signals of a burst in the near term are not obvious. A bubble could last for a long time before bursting. In December 1996, former Federal Reserve Chairman Alan Greenspan warned investors with his famous phrase *"irrational exuberance."* The US stock market rally, however, continued for nearly four more years before the dot-com bubble burst in 2000.

China's policy measures have so far been gradual and moderate. Real interest rates remain negative while excess liquidity still floods Chinese banks and the stock market even after the latest measures. At the current pace, it could take many months before bank deposit rates become high enough in real terms to dampen asset prices.

The renminbi savings and three-month time deposit rates are 0.72% and 2.07%, respectively, before a 20% tax rate, compared to an inflation rate of 3%.

China also has a chance to avoid an abrupt stock market crash, but a correction might still happen. The high profit growth of Chinese listed firm could lower P/E ratios to safe levels if stock prices stabilize. The challenge is to stabilize the market without causing an exodus of funds from the stock market. The recent expansion of China's QDII program to allow investors to invest in overseas equity markets through Hong Kong could channel funds away from the overheated Chinese stock market in an orderly and controlled manner.

Hong Kong will face some challenges...

Thanks to global investors' keen interest in Chinese H shares, Hong Kong's stock market became the third largest in the world by equity fund raising and the sixth largest by market capitalization. Stock market turnover also surged 85% in 2006, with 56% of trading in shares of Chinese firms. The massive fund-raising and trading of Chinese shares have injected a strong boost to Hong Kong's financial industry, which has become a major growth engine of the local economy.

If there is a major and long-lasting stock market correction in China, Hong Kong's financial industry will definitely suffer. A plunge in Chinese A-share prices could affect global investors' confidence in H shares. The IPOs and other fund-raising by Chinese firms in Hong Kong would decline significantly, as market demand for Chinese stocks fell. Real impacts on the businesses of companies listed on Hong Kong's stock market are also likely. Chinese firms with large investment portfolios of A shares will suffer a direct hit. A negative wealth effect on consumption and the property market in China due to a stock price slump also may affect Hong Kong listed companies with sizeable business operations in China.

...but the challenges are manageable...

The negative impacts should not be too great to affect Hong Kong's prosperity. Our optimism is based on a belief that a stock market crash would not undermine China's economic prospects. China suffered a stock market slump in 2001-05, but its economy continued to thrive.

Investors would return to Hong Kong after stock prices fell to attractive levels. For new listings, Chinese firms may be reluctant at first, but would soon accept lower prices. After all, it has greater need to raise funds in Hong Kong if the mainland stock markets are in a slump. For Hong Kong listed stocks, prices may drop initially after a Chinese stock market crash, but the decline should not be significant as Hong Kong's stock market is at a reasonable price level. The P/E ratios of Hang Seng and H-shares indexes are around 16 and 20, not significantly high compared to other major stock markets. The average P/E ratio of the US S&P 500 is, for example, around 18.

...and there are new opportunities

A stock market slump in China may speed up the flow of Chinese savings to overseas markets, providing opportunities for Hong Kong's fund management industry. As Chinese investors become aware of the need of diversification, their overseas investment through QDII would rise strongly. Banks and fund houses in Hong Kong will gain businesses[1], offsetting a decline in stock market activity.

China's diversification of its foreign reserves will also boost Hong Kong's fund management industry. As a first step, China's state investment agency has taken a US$3bn stake in a US private equity firm. According to an earlier report, China is going to allocate up to US$200bn of its foreign reserves to a state investment agency for investment in global financial markets. To compete for the enormous business from China, fund management firms would expand operations in Hong Kong, which is the best location for them to get deals and manage assets.

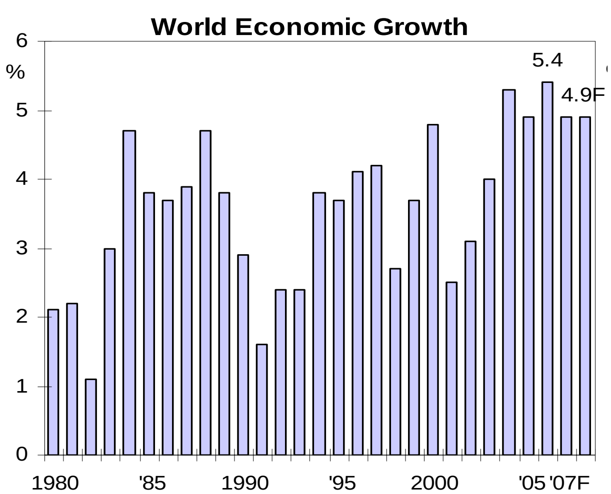
With the strong potential revenue from helping Chinese invest in the global market, Hong Kong's financial industry should continue to thrive in the scenario of a Chinese stock market crash. The focus is, however, likely to shift from the equity market to fund management.

Global liquidity keeps Hong Kong afloat

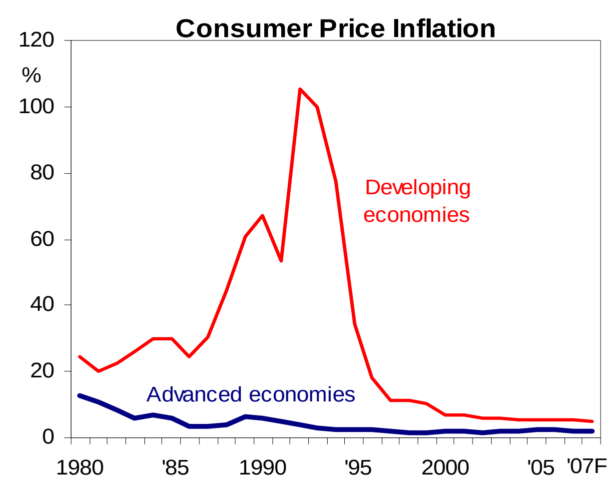
Further reasons for us to be optimistic about Hong Kong are its very favorable global economy and financial market. Hong Kong, alongside other major financial centers, is enjoying a global asset market rally.

The global rally is supported by robust world economic growth and low inflation. Global economic growth this year and in 2008 is likely to be only modestly below the three-decade high level in 2006. Meanwhile, inflation is under control worldwide and perhaps at the lowest level since World War II. Strong growth and low inflation are favorable for risky assets. We, therefore, see high risk appetite in the world financial market and rising prices of risky assets including equities, corporate bonds, commodity prices and high-yield currencies.

World Economy Growth at a 30-Year High



World Inflation at a Post-WWII Low Level

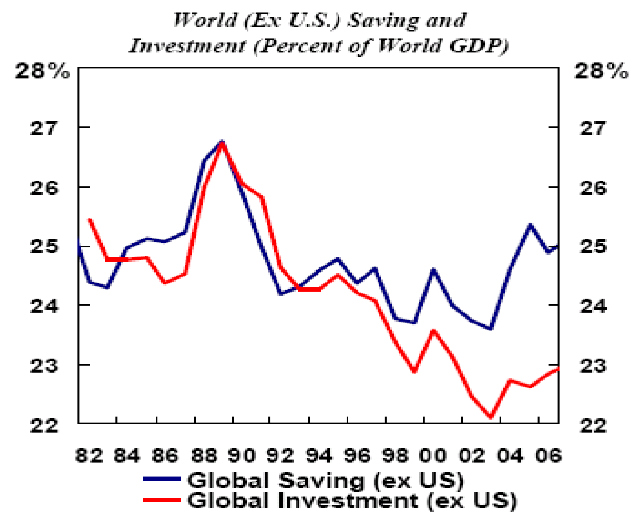


Source: IMF.

[1] Our HK Financial Market Weekly "China Expands QDII – A Boost for Hong Kong" dated May 14, 2007.

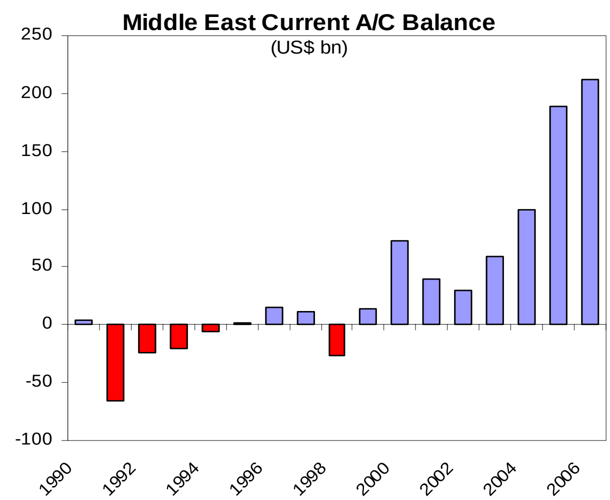
A surge in liquidity is also keeping the global financial market buoyant, providing benefits for Hong Kong's financial industry. World savings are rising strongly thanks to a lower inflation rate and the rising income of many emerging market economies. China, for example, has a savings ratio of 50%. Meanwhile, oil producers enjoyed massive export earnings in recent years due to the surge in oil prices. The current account surplus of Middle East countries surged to US$630bn in 2001-06, compared to a deficit of US$29bn in the 1990s. Petrol dollars have already become a major force in the global financial market in recent years. In coming years, we will see China's rising influence in the global financial market due to its soaring outward investment.

Rising World Savings Support Global Financial Markets



Source: Federal Reserve Board & Citi.

Soaring External Income of Middle East Countries



Source: IMF.

In this favorable global environment, Hong Kong's setback from a potential China stock market slump would likely be short-lived, in our view. Investors would soon return to Hong Kong again after asset prices become attractive. There would be also many new kinds of fund management business opportunities for Hong Kong. With its rule of law, world-class infrastructure, free and open market, and most important as a gateway to China, Hong Kong should continue to prosper as Asia's top fund management center. Hong Kong's role as a gateway to China in trade may be declining, but it is still the most important gateway for capital going into and out of China.

Debt and money markets

HIBOR remains on an uptrend; spread with USD Libor narrowing

Continuing their upward trend in recent weeks, Hong Kong dollar interbank offer rates (Hibor) were squeezed up during the week of May 18. Three-month Hibor inched up to another year-to-date high of around 4.43% on May 18. Overnight Hibor shot up to 4.61% from 3.82% the previous week. Some funds were tied up in IPO subscriptions.

Short-dated Hibors may ease mid-week as funds tied up in recent IPOs return to the interbank market after listings are completed. Meanwhile, three-month and longer dated Hibors are likely to continue their uptrend, as excess HKD liquidity continues to fall due to HKD/USD interest rate arbitrage trades, i.e. investors selling the HKD to buy the USD to earn higher interest. The three-month HIBOR/USD LIBOR spread stood at 98bps on May 18, sufficient to encourage interest rate arbitrage trades that would boost Hibor. We expect the three-month HIBOR to hover around to 4.4 - 4.5% in coming weeks.

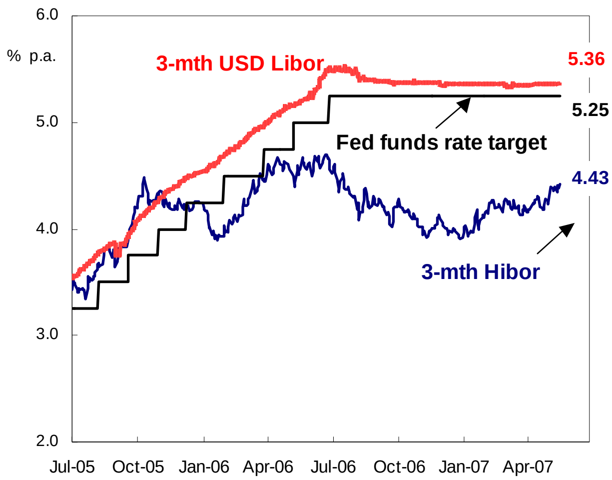
Upward pressure on Hibor may persist until the US Fed's expected 25bp interest rate cut in 3Q07 causes a decline in the USD LIBOR. As we have mentioned previously, this remains a close call. The recent trends of falling jobless claims, industrial production rebound and stronger consumer confidence suggest that the US economy is picking up after weak growth in 1Q07. The chance of an US interest rate cut has therefore declined. In addition, Fed Chairman Bernanke's confidence that the US subprime mortgage problem would have no major impact on the US economy also further reduces the chance of an interest rate cut.

EF note yields may edge up

Average Exchange Fund (EF) note yields were slightly lower during the week of May 18. Hong Kong EF note yields were affected by a two-year EF note tender, which took place on May 16. HK$1.0bn of two-year EF notes were tendered at an average yield of 3.94%. US Treasury yields rose at the long end, but were insufficient to lift EF note yields above last week's levels.

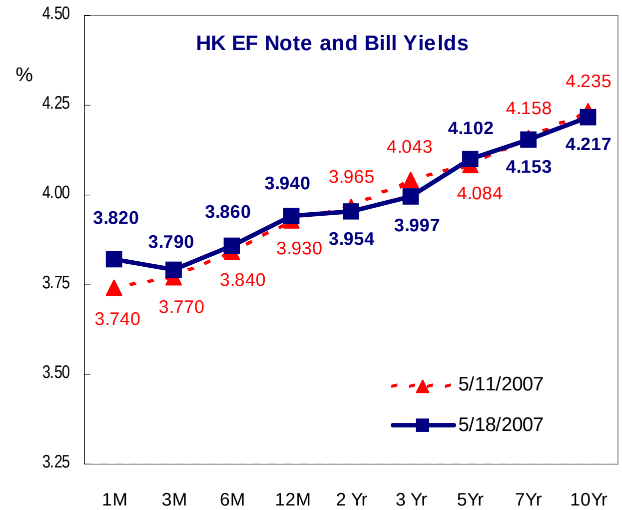
In the week ahead, there is no major data that would have a big impact on US Treasury yields and EF note yields. We expect some improvement in April's new and existing home sales, which may cause US Treasury note yields to edge up. US Treasury yields may remain on an upward trend, as funds leave the safe haven in the bond market to join the stock market rally. We expect Hong Kong EF note yields to follow the rise of their US counterparts, causing the HKD yield curve to steepen.

Three-Month Hibor Rose to the Highest YTD Level



Source: Reuters, HKMA.

HKD Yield Curve Little Changed



Source: Reuters, HKMA.

Money Market and Interest Rate Swaps

		18 May	11 May	27 Apr	Week ahead forecast
Bank Clearing Balance (HK$ Bils.)		1.452	1.275	1,265	Stable
3 Month HIBOR (%)		4.43	4.40	4.29	Higher
3 Month HIBOR Futures	Jun 07	95.75	95.77	95.75	Lower
	Sep 07	95.63	95.65	95.65	Lower
3-Month Exchange Fund Bill Yield (%)		3.79	3.77	3.78	Higher
3-Year Exchange Fund Note Yield (%)		3.997	4.043	4.00	Higher
5-Year Exchange Fund Note Yield (%)		4.102	4.084	4.11	Higher
10-Year Exchange Fund Note Yield (%)		4.217	4.235	4.28	Higher
1 Year Interest Rate Swap		4.39	4.35	4.33	Higher
3 Year Interest Rate Swap		4.44	4.37	4.39	Higher
5 Year Interest Rate Swap		4.54	4.46	4.50	Higher

Source: Citi, HKMA.

Hong Kong Dollar Bond Pricing

		18 May	
Issuer / Coupon / Maturity		**Offer Price**	**Offer Yield %**
1.	Commerz Bank 8.64% 9/7/10	112.018	4.62%
2.	DNB Nor Bank ASA 4.78% 11/18/08	100.517	4.49%
3.	HBOS 4.65% 1/19/2016	98.907	4.80%
4.	HKLINK Tranche B 3.60% 05/07/09	98.701	4.36%
5.	HKLINK Tranche C 4.28% 05/09/11	99.032	4.63%
6.	HKSAR Retail 3.38% 07/23/08	99.107	4.21%
7.	KBC 2.65% 8/29/07	99.546	4.41%

Source: Citi Treasury.

Recent HKD note issues

	Issuer	Size HK$mn	Coupon Rate	Payment Date	Maturity Date
1.	Bank of Ireland	1,000	4.4475%	25 May 2007	25 May 2009
2.	Bank of Nova Scotia	300	4.28%Q	29 May 2007	29 May 2009
3.	Soc Gen Australia	200	4.289%Q	25 May 2007	27 May 2008
4.	Export-Import Bank of Korea	300	3-mth Hibor +10bps	30 May 2007	30 May 2009
5.	IXIS Corp & Investment Bank	100	4.96%A	22 May 2007	22 May 2012
6.	Barclays Bank	200	6-mth Hibor+31bps Yr 1 capped at 4.85%, Yr 2: 5%, Yr 3: 5.25%, Yr 4: 5.5%, Yr 5: 5.75%	23 May 2007	23 May 2012
7.	Agricultural Bank of China	600	3-mth Hibor+12bps	28 May 2007	28 May 2010
8.	HK Mortgage Corp	550	0%	23 May 2007	23 May 2009
9.	HK Mortgage Corp	300	4.25%Q	21 May 2007	21 May 2009
10.	Barclays Bank	200	6-mth Hibor+33bps Yr 1 capped at 4.85%, Yr 2: 5%, Yr 3: 5.25%, Yr 4: 5.5%, Yr 5: 5.75%	17 May 2007	17 May 2012
11.	Westpac Corp	150	5.35% x no. of days 3-mth Libor is within range (Yr 1: 4.75-6%, Yr 2: 4.5-6.25%) over accrual period)	18 May 2007	18 May 2009
12.	Westpac Corp	150	6-mth Hibor+34.5bps Yr 1 capped at 4.85%, Yr 2: 5%, Yr 3: 5.25%, Yr 4: 5.5%, Yr 5: 5.75%	21 May 2007	21 May 2012
13.	Bank of Tokyo Mitsubishi UFJ HK	700	3-mth Hibor +6bps	17 May 2007	17 May 2010
14.	Commerzbank AG	100	4.4775%Q	17 May 2007	17 May 2010
15.	Commerzbank AG	100	4.485%Q	17 May 2007	17 May 2009
16.	Westpac Banking Corp	190	6-mth Hibor+34.5bps Yr 1 capped at 4.85%, Yr 2: 5%, Yr 3: 5.25%, Yr 4: 5.5%, Yr 5: 5.75%	21 May 2007	21 May 2012

Note: A= annual, SA= semi-annual, Q= quarterly, M= monthly. Source: Infroma Global Markets, Reuters.

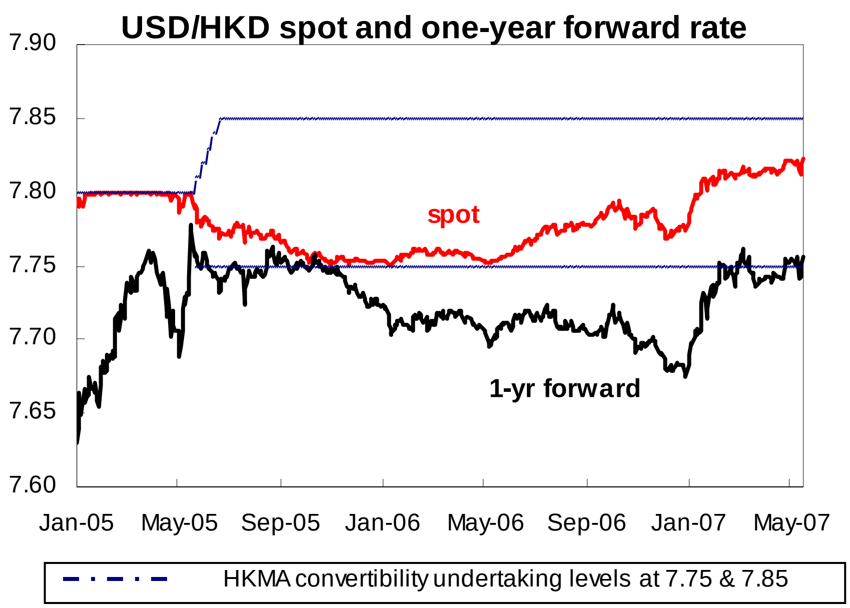
Hong Kong dollar market

HKD at a record weak level against the USD

The USD/HKD stayed below 7.82 during May 14-17, but weakened to a daily fixing level of 7.8226/USD - a new record weak level - on May 18. Interest rate arbitrage activities continued as the HKD/USD spread widened. The USD has also strengthened against major currencies following the release of some strong economic data. Moreover, commercial buying of the USD and end-of-week profit-taking in the local stock market added selling pressure to the HKD.

The HKD will likely remain weak against the USD. As HKD interest rates are likely to rise gradually but maintain a sizeable discount to their USD counterparts, selling pressure on the HKD will likely persist in the near future. We expect the USD/HKD to remain in a range of 7.815-7.82 over the next three months before strengthening to 7.81 in 4Q07E when there is likely to be a further narrowing of the USD/HKD interest rate spread.

USD/HKD Spot at Record Weak Level; Forward Rates Remain Stable



Source: Citi, Reuters.

In the forwards market, the one-year USD/HKD forward discount remained in our target range of 650-700pips. As the one-year HKD forward exchange rate is now inside the HKD trading band of 7.75-7.85/USD, pressure on a sharp decline in the forward discount should ease. Looking ahead, we expect a moderate narrowing in the USD/HKD forward discount as Hibors edge up gradually.

USD/HKD Spot and Forward Rates

	18 May	11 May	4 May	27 Apr	Week Ahead
Spot Rate	7.8226	7.8217	7.8206	7.8216	Range
6-month Forward (pips)	-375	-385	-390	-406	Narrow
1-year Forward (pips)	-663	-660	-659	-675	Narrow

Source: Reuters, Citi.

Stock market

Stocks boosted by QDII rules; China tightening worries capped gains

Boosted by new rules for the Qualified Domestic Institutional Investor (QDII) program, the Hang Seng Index (HSI) hit a new record high of 20,995 on May 17. Investors expect the local stock market to benefit from the new QDII rules, which allow mainland banks to invest in overseas stocks. Turnover surged to a daily average of HK$69.6bn during the week of May 18.

However, gains were capped on profit-taking and on concern about policy tightening in China. Blue chips fell across the board on May 18, tracking a decline in mainland-listed stocks. Property stocks in particular suffered. The Hang Seng Property Sub-Index, which originally gained 2.8% on May 17, closed the week only 1.2% higher respectively. The HSI gained 2.1% overall during the week of May 18 while H shares gained 4.5%. The People's Bank of China announced late on May 18 that it would widen the RMB/USD trading band to 0.5% above and below its central parity rate effective May 21, from the previous 0.3%. The PBOC also raised the one-year RMB lending rate by 18bps, the RMB deposit rate by 27bps, and the banks' reserve requirement ratio by 50bps.

Hang Seng Index Touched a New High

Source: Reuters, Citi.

H-Share Index Edging Higher

Source: Reuters, Citi.

Equity Market Indicators

Selected indicators / Week ended	18 May	11 May	4 May	27 Apr	20 Apr
Hang Seng Index	20,905	20,468	20,841	20,526	20,566
P/E Ratio	15.8	15.5	15.8	15.6	15.6
H-Share Index	10,859	10,392	10,384	10,141	10,179
P/E Ratio	20.0	19.2	19.2	19.7	19.8
Avg. daily turnover (HK$ Bils)	69.6	60.9	53.8	52.0	62.3

Source: HSI Services Limited.

Data review

Economic slowdown likely temporary and to reverse in coming quarters

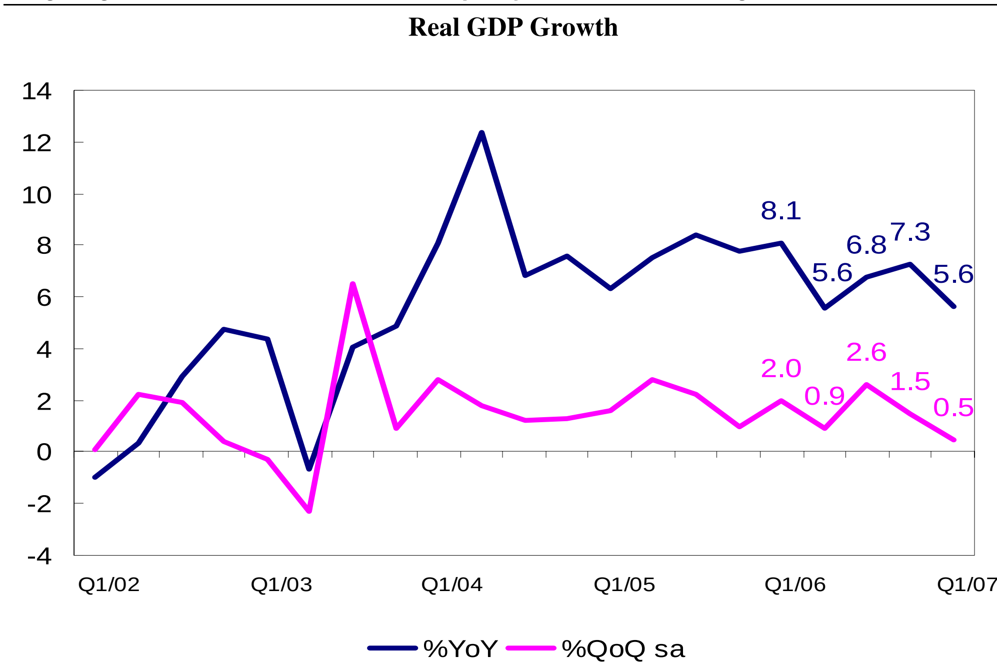
	1Q07	Citi Forecast	Market estimate	4Q06
Real GDP (yoy % change)	5.6	5.5	6.4	7.3
(QoQ s.a. growth %)	0.5	0.6	1.0	1.5

Source: HKSAR Government, Bloomberg, Reuters, IDEAglobal, Citi estimates

The decline in real GDP growth in 1Q07 due to weak investment and exports is in-line with our expectation. Real GDP growth fell to 5.6% yoy in 1Q07 from 7.3% in 4Q06, as investment growth plunged to 3.9% yoy (vs. 9.4% in 4Q06) while exports increased less rapidly by 8.2% (vs. 11.7% in 4Q06). Consumption and exports of services remained the main growth engines. Private consumption growth gained momentum and edged up to 5.6% (vs. 5.4% in 4Q06) as a robust job market boosted consumer confidence and spending power.

We think the weak investment is a temporary adjustment after the robust growth last year. With continued strong consumption, we expect the business sector to increase investment again in the coming months. Despite the slowdown in 1Q, we maintain our 6% economic growth forecast for 2007. In addition to investment recovery, the economy will likely receive a boost from consumer spending. The government's generous budget measures including property rates wavier, tax cuts and rebates should boost household disposable income and increase consumption growth momentum.

Hong Kong Economic Slowdown Should Be Temporary and Reverse in Coming Quarters



Source: HKSAR Government.

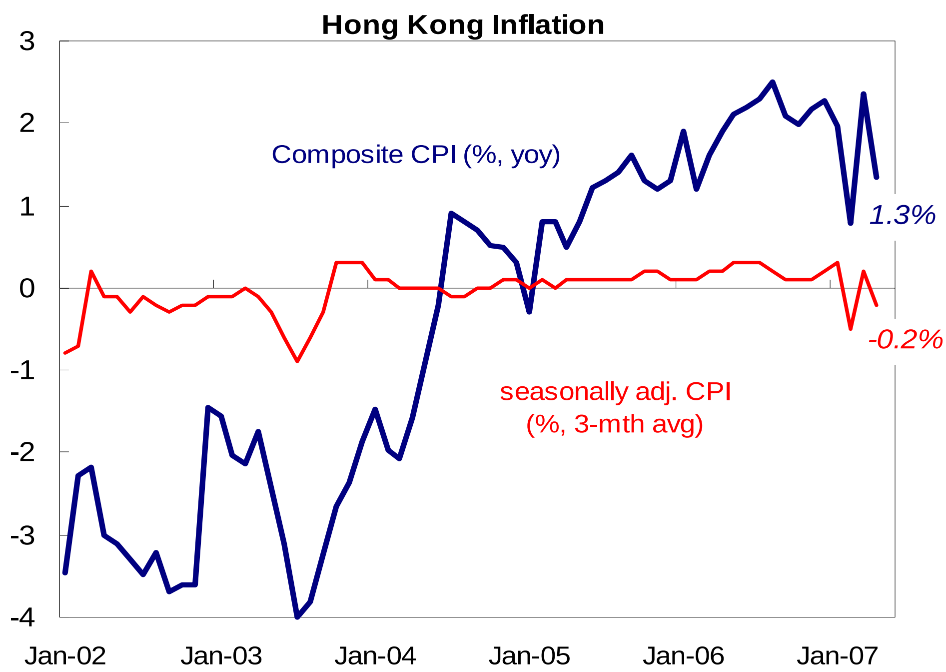
Inflation dampened by government measures; underlying trend remains steady

April 2007	Actual	Citi Forecast	Market estimate	Previous Data
Composite CPI (yoy % change)	1.3	1.0	2.1	2.4
(s.a. 3-month avg. % change)	-0.2	-0.4	—	0.2

Source: HKSAR Government, Bloomberg, Reuters, IDEAglobal, Citi estimates.

Inflation rate fell to 1.3% yoy in April due to distortion from the government's property rates concession. Without the distortion, the inflation rate should have remained stable at 2.4%. Retail price of consumer goods continued to rise by 1.9% yoy in April, only slightly weaker than a 2.0% rise yoy in March. Thanks to strong consumer spending, clothing and footwear prices were 4.1% higher than a year ago. Meanwhile, the rise in food prices moderated and Towngas charges declined. **POSITIVE:** The steady rise in non-housing consumer prices reflects retailers maintaining their pricing power amid rising import costs.

April Data Distorted; Hong Kong's Inflation Remains Steady



Source: HKSAR Government.

Disclosure Appendix

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