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Research Paper No. 45: Half Yearly Review of the Hong Kong Securities Market

17 July 2009

Executive Summary

1. The sharp economic downturn as a result of the financial crisis last year galvanised governments and central banks around the world, including the US, the Mainland and Hong Kong, into introducing various economic and financial stimulus packages. As it would take time for the impact of supportive measures to realise, economic data remained weak during the first half of 2009 but preliminary signs of stabilisation and recovery have emerged.

2. During the first half of 2009, most stock markets slid initially amid adverse global economic outlook and worries about the distressed assets and capital shortfall of financial institutions. Markets rebounded strongly afterwards on better-than-expected corporate earnings and optimism over economic recovery. Compared to the end-2008 levels, the US S&P500 rose 1.8% during the first half of 2009 whilst the Shanghai Composite Index surged 62.5% on expectation that the Mainland's economic recovery would outperform in terms of both pace and strength.

3. Tracking overseas markets, Hong Kong stocks also fell initially on uncertainties over the global economic performance and concerns about financial institutions in the US. The Hang Seng Index (HSI) and Hang Seng China Enterprise Index (HSCEI) dropped to this year's trough in early March. Later, markets rebounded strongly on optimism over global economic recovery amid signs of stabilisation in economies. In addition, strong capital inflow to the Hong Kong banking system and stock market also lifted the markets. During the first half of 2009, the HSI and the HSCEI rose 27.7% and 38.9% respectively from their end-2008 levels.

4. During the first half of 2009, the average daily turnover in the cash market rose slightly by 2% to $58.3 billion[1] compared to the second half of 2008. The average daily trading volume of the futures and options contracts dropped by 3.3% to 419,714 contracts. The turnover of short selling and derivative warrants (DWs) as well as initial public offerings (IPOs) shrank, but the growth in the exchange-traded funds (ETFs) and callable bull/bear contracts (CBBCs) markets remained solid.

5. Despite a strong rebound of the global stock markets, fundamental support to the recent surge in the stock markets has not been broad-based. Signs of economic recovery are emerging at best. The recent rally in the stock market seems to be underpinned by a strong capital inflow, but it should be noted that capital movements are known to be volatile and subject to sudden reversals. Meanwhile, if commodities prices continue to rebound, they may add inflationary pressures and undermine the easy monetary conditions necessary to support recovery. Investor sentiment will continue to be affected by global economic outlook and the financial health of corporations. In addition, a possible large-scale spread of the H1N1 flu and geopolitical risks may also pose uncertainties.

6. Since the trough in early March this year, major stock markets have rebounded some 30% – 60% until the end of June. However, it is worth noting that such strong rebound might not be uncommon following a crisis. Though history might not repeat itself, the experience of the 1929 Great Depression in the US suggests that stock markets could be volatile before reaching a genuine trough. As it is, a stock market rebound is not sustainable if it lacks fundamental support. Compared to the Great Depression, the responses of most governments in the current financial crisis have been much more decisive and prompt. However, whilst economies have shown early signs of stabilisation or recovery, concerns remain that the huge stimulus package and extensive supportive measures may lead to inflation and pressure on currencies. The policy challenge is to have appropriate exit strategies for the supportive measures so as not to undermine recovery and growth prospects. Investors should be reminded that the stock markets could remain volatile on the back of uncertainties over the sustainability of economic recovery and the stability of the financial markets.

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[1] Unless otherwise specified, the currency referred to in this report is the Hong Kong dollar.

Economic and financial conditions

7. The financial crisis and sharp economic slowdown which occurred in the latter part of 2008 galvanised many governments and central banks worldwide into introducing various measures to stabilise financial markets and to stimulate growth. These include interest rate cuts, quantitative easing, capital injection to financial institutions, tax cuts, etc.

8. In the US, the government introduced stimulus packages, such as a bundle of growth-stimulating measures costing US$787 billion and a US$700 billion Troubled Asset Relief Program to clear distressed assets at financial institutions. As it would take time for the impact of supportive measures to take hold, the US gross domestic product (GDP) still dropped 2.6% year on year in the first quarter of 2009 and the unemployment rate rose to 9.5% in June. Nevertheless, some economic indicators such as the housing and manufacturing data showed early signs of recovery. This buoyed investor expectations of a recovery by late 2009 or early 2010. In addition, the financial stimulus packages and the declaration of voluntary bankruptcy of major automakers eased uncertainties over the banking and auto sectors. Positive news also emerged from the stress test on 19 US-based banks, which showed that the capital shortfall at these banks was manageable.

9. On the Mainland, after launching the RMB4 trillion fiscal stimulus plan in November 2008, the government continued to introduce various policies to lay the ground for possible growth in the economy and financial markets. Tax reforms, industry restructuring, regulatory reforms and development of financial markets would all help enhance the competitiveness of different industries. During the first half of 2009, economic growth slowed due to the global recession. Exports dropped by 22% year on year in the first half of 2009 whilst GDP growth slowed to 6.1% in the first quarter and consumer prices declined for the first time in six years. Yet, some economic data, such as retail sales and manufacturing activities, stabilised or rebounded.

10. In Hong Kong, GDP fell 7.8% year on year in the first quarter of 2009. The SAR government also announced various supportive measures to lift the local economy, namely, infrastructure projects, tax rebates and loan guarantees. The Mainland government also helped support the Hong Kong economy and financial market through various initiatives, such as, the currency swap agreement, cross-border infrastructure projects, the broadening of renminbi bond issuance, strengthening of economic cooperation and tourism.

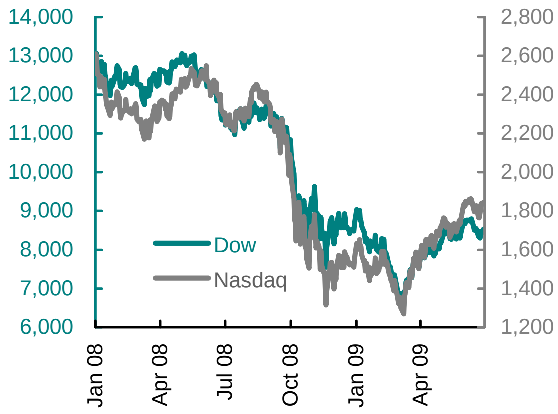
Performance of Worldwide Stock Markets

US/Europe

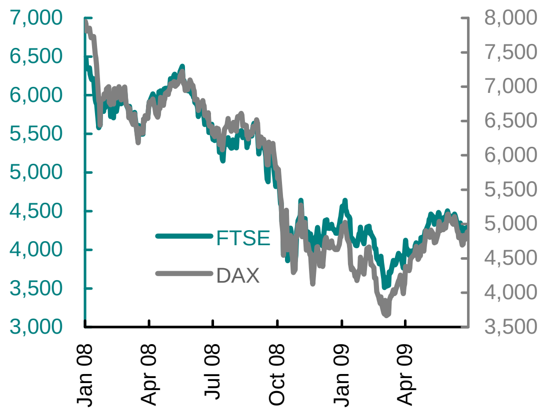
11. In early 2009, the US and European markets slid. Major benchmark indices reached their trough in early March on the back of adverse economic outlook and worries about distressed assets and capital shortfall of financial institutions. The liquidity problem and possible bankruptcy of US automakers also dampened investor sentiment. In early March, major benchmark indices were about 20% – 25% lower than the end-2008 levels.

12. Later, major banks and some corporations reported better-than-expected earnings. Investors cheered the results of the stress test of banks, and encouraging economic data also lent support. The spread of H1N1 flu appeared to have limited impact on stock markets. As of the end of June 2009, the Dow, S&P500 and Nasdaq rebounded 30% – 45% from the trough in early March. Compared to the end-2008 levels, S&P500 and Nasdaq rose 1.8% and 16.4% respectively whilst the Dow dropped 3.8%.

13. Following the rebound in the US, European markets also trimmed most of their earlier losses. By the end of June, the FTSE and CAC dropped 4.2% and 2.4% respectively whilst the DAX remained flat, compared to the end-2008 levels.



Performance of the Dow and Nasdaq



Performance of the FTSE and DAX

Source: Bloomberg

Performance of Major Stock Markets

		end-Jun 09	% change from end-2008 level		% change from end-Jun 2008 level		PE Ratio
		Index Level	in local currency	in USD	in local currency	in USD	end-Jun 09
HK	-HSI	18,378.73	27.7%	27.7%	-16.8%	-16.3%	15.25
	-HSCEI	10,962.61	38.9%	38.9%	-8.0%	-7.4%	17.03
China	-Shanghai Comp	2,959.36	62.5%	62.5%	8.2%	8.5%	29.88
Japan	-Nikkei 225	9,958.44	12.4%	5.7%	-26.1%	-18.6%	41.81
Australia	-AOI	3,947.80	7.9%	23.8%	-26.0%	-37.7%	32.52
Taiwan	-TWSE	6,432.16	40.1%	40.0%	-14.5%	-20.9%	60.43
Korea	-KOSPI	1,390.07	23.6%	22.2%	-17.0%	-31.8%	18.10
Singapore	-STI	2,333.14	32.4%	30.9%	-20.8%	-25.6%	12.24
Thailand	-SET	597.48	32.8%	35.4%	-22.3%	-23.7%	20.03
Malaysia	-KLCI	1,075.24	22.6%	20.8%	-9.4%	-15.9%	18.55
Indonesia	-JCI	2,026.78	49.5%	62.9%	-13.7%	-22.0%	23.29
Philippines	-PCOMP	2,437.99	30.2%	28.5%	-0.9%	-7.5%	14.43
India	-Nifty	4,291.10	45.0%	47.7%	6.2%	-4.6%	16.48
Vietnam	-VN	448.29	42.0%	39.5%	12.2%	6.2%	20.85
MSCI Asia Pacific Ex-Japan (USD)		323.84	-	30.9%	-	-24.7%	18.98
US	-Dow	8,447.00	-3.8%	-3.8%	-25.6%	-25.6%	11.16
	-Nasdaq	1,835.04	16.4%	16.4%	-20.0%	-20.0%	28.10
	-S&P	919.32	1.8%	1.8%	-28.2%	-28.2%	14.56
UK	-FTSE100	4,249.21	-4.2%	8.1%	-24.5%	-37.6%	9.94
Germany	-DAX	4,808.64	0.0%	0.4%	-25.1%	-33.3%	26.71
France	-CAC	3,140.44	-2.4%	-2.0%	-29.2%	-36.9%	11.13

Sources: Bloomberg and websites of various exchanges

Asia

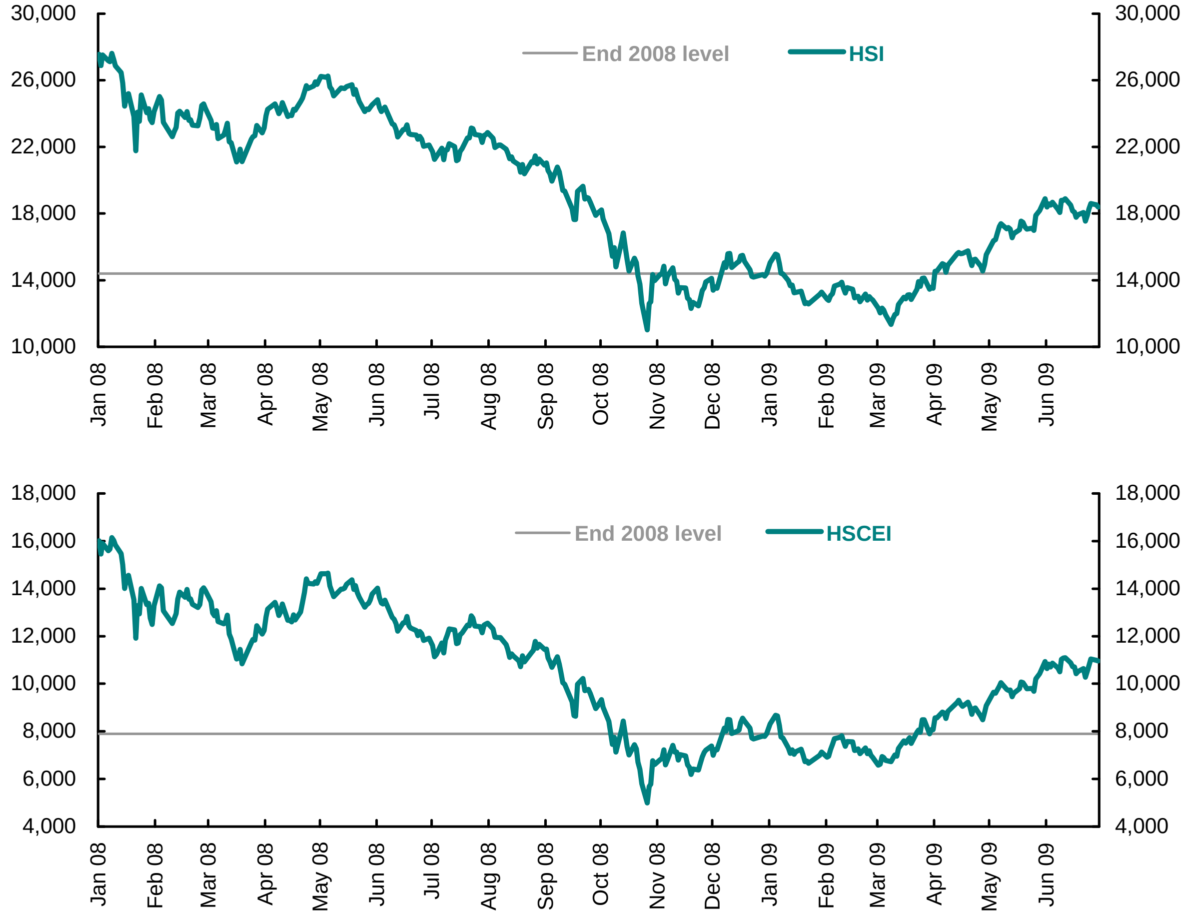
14. The performance of the stock markets in Asia was weak initially due to economic slowdown but later rebounded strongly on hopes of global economic recovery. During the first half of 2009, Asian markets advanced, with increases ranging from 7.9% in Australia to 49.5% in Indonesia (The performance of Mainland market will be discussed in the next section).

Mainland China

15. During the first half of 2009, the Mainland stock market was not much affected by slowing domestic economic growth amid the recession overseas. Despite the contraction in economic activities, the stock market advanced, buoyed by optimism over further economic stimuli. A total of RMB7.3 trillion in new loans have been made so far this year to boost consumption and infrastructure investment. This lifted hopes of sustainable economic growth in the Mainland. By the end of June of 2009, the Shanghai Composite Index rose 62.5% from the end-2008 level on expectation that the Mainland's economic recovery would outperform in terms of both pace and strength.

Hong Kong

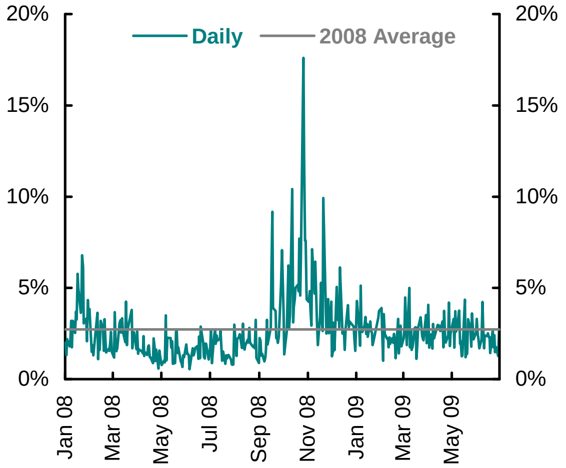
16. During the first half of 2009, the Hong Kong market was initially clouded by uncertainties over global economic performance and concerns about financial shares in the US. The HSI fell to a trough of 11,344 on 9 March. Since then, local market have rebounded strongly amid optimism over global economic recovery, additional stimulus plans on the Mainland and concerted international efforts in stabilising financial markets and stimulating economies worldwide. Local property stocks outperformed on hopes of an economic recovery. In addition, strong capital inflow to the Hong Kong banking system and stock market also helped bring about a rebound. As of the end of June 2009, the HSI and the HSCEI rose 27.7% and 38.9% respectively from the end-2008 levels.



Performance of the HSI and HSCEI (Jan 2008 – Jun 2009)

Source: Bloomberg

17. The intra-day volatility of the HSI during the first half of 2009 dropped slightly to an average of 2.5% from the 2.7% level of 2008. The implied volatility of the HSI options also retreated steadily to 32% as at end June 2009 from 56% at end-2008.



Intraday Volatility of the HSI

Implied Volatility of HSI Options

Remark:

$$\text{Intraday Volatility} = \frac{(\text{Day High} - \text{Day Low})}{0.5^*(\text{Day High} + \text{Day Low})}$$

Source: Bloomberg

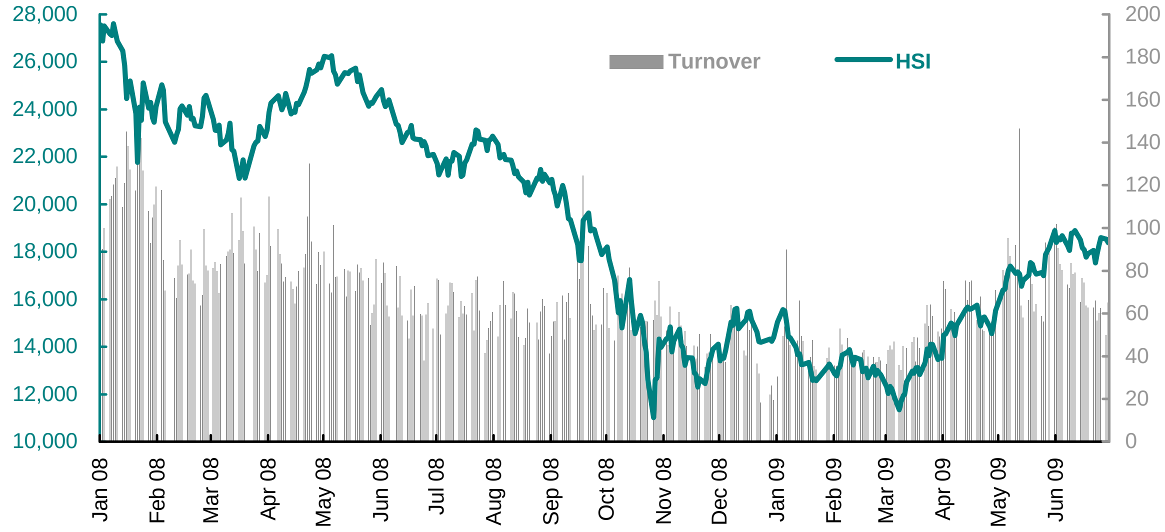
Trading activities in the local stock market

18. During the first half of 2009, trading activity in the local stock market was moderate. The average daily turnover amounted to $58.3 billion, 2% higher than the level for the second half of 2008 and 33% lower than the level for the first half of 2008. Locally-listed Mainland stocks remained the most actively traded, accounting for 48% of total market turnover. The trading of HSI stocks (excluding H-shares and red chips) was about 14% of the total.

Average Daily Turnover ($ billion)

	1H 2009	2H 2008	1H 2008	% change over	
				2H 2008	1H 2008
HSI (ex H shares & red chips)	8.0 (14%)	9.4 (16%)	13.1 (15%)	-14%	-39%
Mainland Stocks	27.9 (48%)	27.9 (49%)	41.0 (47%)	0%	-32%
H-shares	*20.9 (36%)*	*20.3 (36%)*	*29.9 (34%)*	3%	-30%
Red chips	*7.1 (12%)*	*7.6 (13%)*	*11.1 (13%)*	-7%	-36%
Derivative Warrants	6.0 (10%)	7.0 (12%)	21.2 (24%)	-14%	-72%
CBBCs	6.8 (12%)	6.3 (11%)	2.1 (2%)	8%	217%
Others	9.5 (16%)	6.6 (12%)	9.8 (11%)	45%	-2%
Market Total	**58.3 (100%)**	**57.2 (100%)**	**87.3 (100%)**	**2%**	**-33%**

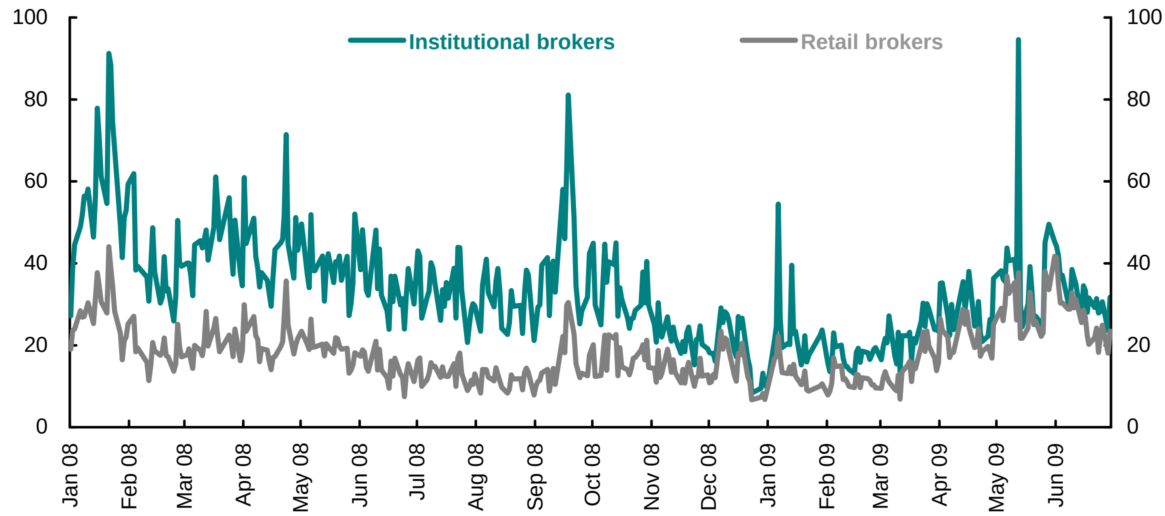
Sources: HKEx and SFC Research



HSI Performance and Market Turnover ($ billion) (Jan 2008 – Jun 2009)

Source: SFC Research

19. By broker type, the proportion of equity trading by institutional brokers decreased to 58% of the total during the first half of 2009 (compared to 68% in second half of 2008). The proportion of retail brokers rose in tandem to 42% from 32% in the same period.



Daily equities trading by broker type during Jan 2008 to Jun 2009 ($ billion)

Source: SFC Research

Short-selling activity

20. During the first half of 2009, short selling dropped in both absolute terms and relative to total market turnover. No concentration either at stock level or at broker level was observed. Short selling averaged $3,301 million daily or 5.6% of the total market turnover, compared to $4,305 million or 7.5% for the second half of 2008.

IPO activity and performance

21. Due to bearish sentiment in the equity market worldwide, IPO activities were sluggish initially during the first few months of 2009, but became more active in May and June. The local market launched 12 IPOs, raising a total of $17.4 billion in the first half of 2009, compared to 11 IPOs and $15.6 billion in the second half of 2008.

22. The performance of the 12 IPOs was mixed. On average, they rose 8.6% from their IPO prices on the first day of listing, with individual performance ranging from a loss of 11% to a gain of 39.2%. Subsequent performance was relatively more satisfactory. As of the end of June 2009, one of them was below its IPO price, whilst the other 11 traded above IPO prices. Their gain/loss ranged from -11.9% to +283.8%.

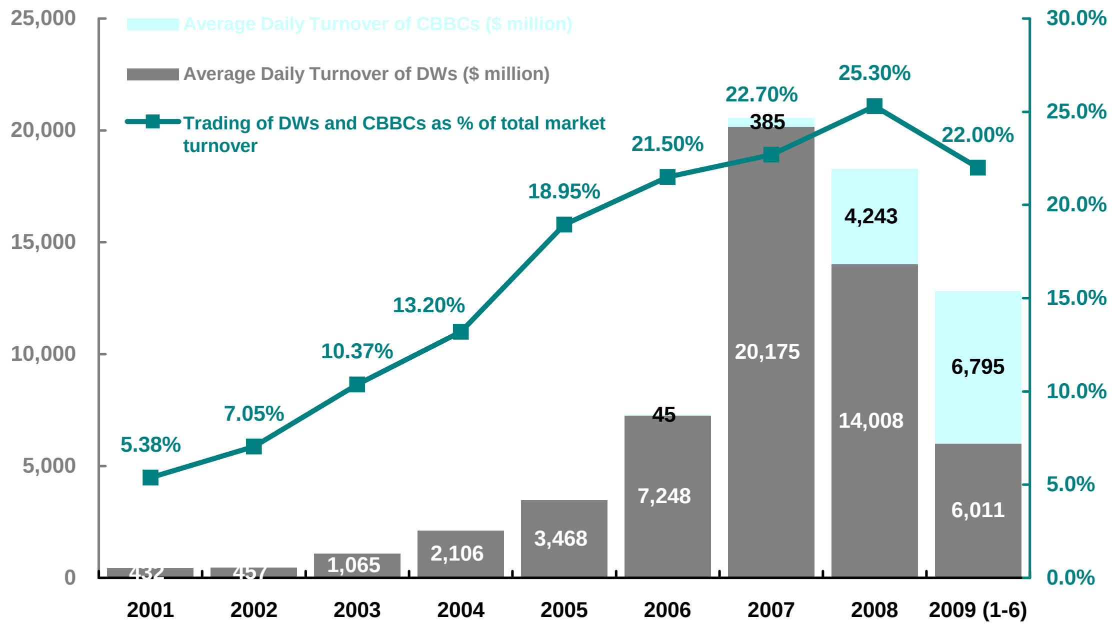
Exchange-traded funds

23. The ETF market in Hong Kong has continued to grow during 2009. The number of ETFs rose to 32 as of the end of June 2009 from 24 at the end of 2008. However, their average daily turnover dropped 15% to $1.7 billion during the first half of 2009 from $2 billion in the second half of 2008.

Derivative Warrants and Callable Bull/Bear Contracts

24. The trading in DWs shrank slightly. During the first half of 2009, the average daily turnover of DWs dropped to $6 billion, or 10.3% of total market turnover, from $7 billion (12.2%) in the second half of 2008.

25. The trading of CBBCs increased in both absolute terms and as a percentage of total market turnover. In the first half of 2009, the average daily turnover of CBBCs rose to $6.8 billion, or 11.6% of total market turnover, from $6.3 billion (11%) in the second half of 2008.



Turnover of Derivative Warrants and Callable Bull/Bear Contracts and the market share as percentage of total market turnover

Source: SFC Research

Exchange-traded derivatives

26. Trading of futures products decreased during the first half of 2009. Among futures products, HSI futures remained the most actively traded, accounting for nearly half of all futures trading. The average daily trading volume for HSI futures decreased by 7.1% from the second half of 2008. The second most actively traded futures were HSCEI futures, whose trading volume decreased by 12.5% and accounted for nearly one-third of all futures trading. Open interest of HSI and HSCEI futures also dropped to 79,772 contracts and 71,607 contracts respectively.

27. In the options market, trading declined slightly during the first half of 2009. Stock options remained the most actively traded among options products, but its trading volume dropped 2.6% compared to its volume for the second half of 2008. The trading volume of the HSI options rose, whilst that of the HSCEI option products dropped.

Average daily trading volume of derivatives by product type^ (contracts)

		1H 2009	2H 2008	1H 2008
Futures	HSI Futures	87,788	94,478	84,131
	Mini-HSI Futures	38,721	35,924	29,520
	HSCEI Futures	55,068	62,941	55,827
	Mini-HSCEI Futures*	2,944	2,022	1,133
	Hang Seng China H-Fin Index Futures#	N/A	N/A	0.08
	FTSE/Xinhua China 25 Index Futures##	N/A	0.03	0.29
	Stock Futures	1,166	1,393	714
	3-Month HIBOR Futures	17	79	117
	Gold Futures**	26	62	0
	Other futures products***	1	2	5
	Total Futures	**185,731**	**196,864**	**170,895**
Options	HSI Options	19,334	16,940	14,476
	Mini-HSI Options	1,105	837	450
	HSCEI Options	7,460	7,897	5,355
	FTSE/Xinhua China 25 Index Options###	N/A	0.01	3
	Stock Options	206,084	211,516	238,970
	Total Options	**233,984**	**237,191**	**259,254**
Total Futures and Options		**419,714**	**434,056**	**430,149**

Remark: * Mini-HSCEI Futures were launched on 31 March 2008
** Gold Futures were launched on 20 October 2008
*** One-Month HIBOR Futures and Three-year Exchange Fund Note Futures
^ The average daily trading volume was based on the available trading days after the product was launched
# The Hang Seng China H-Financials Index Futures were suspended on 24 December 2008
The FTSE/Xinhua China 25 Index Futures were suspended on 31 December 2008
The FTSE/Xinhua China 25 Index Options were suspended on 24 December 2008

Sources: HKEx and SFC Research

Uncertainties over the market and economic outlook

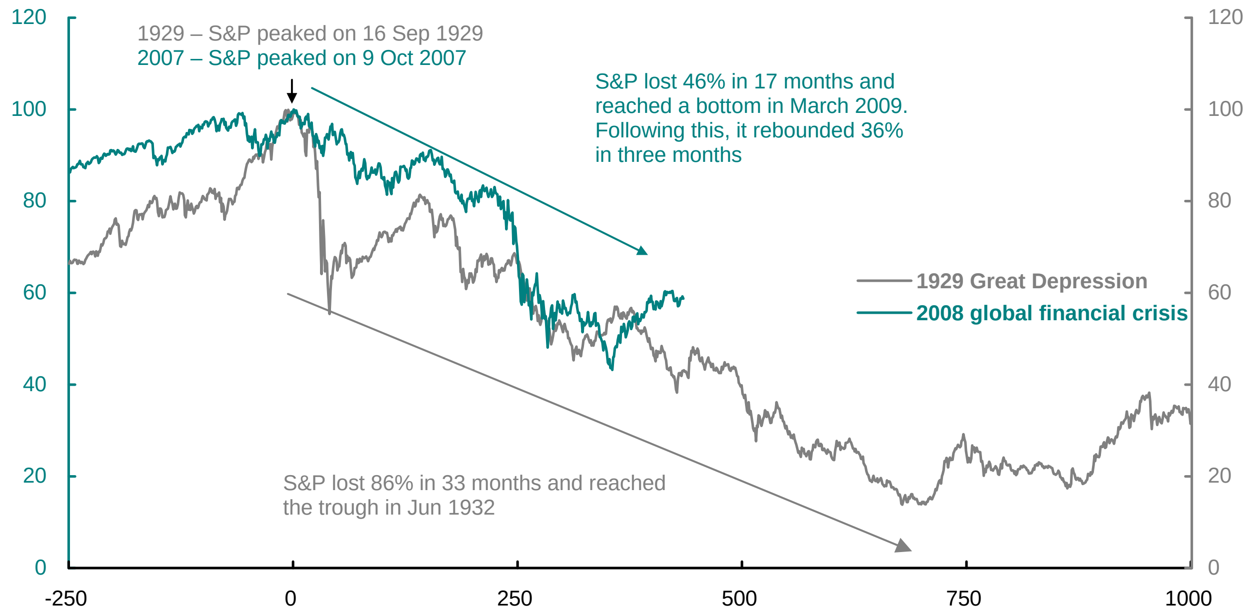
28. Despite a recent strong rebound of the global stock markets, fundamental support is not broad-based. Economic data show that the global economy is still shrinking and any signs of economic recovery still look tentative. The recent rally in the stock market seems to be underpinned by a strong capital inflow. It should be noted that capital movements are known to be volatile and subject to sudden reversals. Meanwhile, if commodity prices continue to rebound, they may add inflationary pressures and undermine the easy monetary conditions necessary to support recovery. Investor sentiment will continue to be affected by the global economic outlook and the financial health of corporations. In addition, a possible large scale spread of the H1N1 flu and geopolitical risks may also pose uncertainties.

Comparison between the current financial crisis and the Great Depression in 1929

29. The US and European stock markets rebounded some 30% – 60%. from their trough in March 2009 until end-June. Optimism picked up hopes of an economic recovery and the ample liquidity generated by the trillion dollars stimulus plans of worldwide governments. However, it is worth noting that during the 1929 Great Depression, the US stock markets also experienced similar rebounds after tumbling to an immediate bottom, but the markets subsequently experienced further corrections again before reaching the genuine trough. The bear run on the US stock market lasted for three years in the Great Depression.

30. The Great Depression shares a number of similarities with the current financial crisis. Before the Great Depression, investors were highly speculative, leveraged investment was common, and credit expanded rapidly prior to the stock market crash. In the current financial crisis, cheap credit after the burst of the tech bubble and the 911 incident inflated housing prices; financial institutions invested heavily in subprime mortgages whose collapse triggered the crisis. The losses were magnified by the complex and opaque derivative products and the high leverage of financial institutions. Eventually, many financial institutions were not able to withstand the losses and had to be rescued by governments.

31. Following the stock market crash in both crises, the credit market froze, leading to severe contractions in economic activities. There were waves of bank runs during the Great Depression. In the current financial crisis, commercial banks in the US and Europe were nationalised or bailed out by the governments. Deleveraging and the sale of assets at deep discounts were common in both crises.



Performance of S&P Index in both crises (Base = 100 when the index peaked)

Remark: Index peaked at t=0 and the X-axis denotes the number of trading days from the peak. The graph plots the performance of the index approximately 1 year before and 4 years after the peak
Source: SFC Research

32. In the Great Depression, the bear run of the stock market lasted for three years. The S&P500 dropped 86% from the peak in September 1929 to a trough in June 1932. During those three years, the stock markets experienced 12 major rebounds and consolidations until it reached the genuine trough. The S&P500 rose 12% - 46% in each rebound and dropped 25% - 61% in each consolidation. Therefore, compared to the rebounds during the Great Depression, the current 36% rebound of the S&P500 over a period of about three months was not particularly strong.

33. Nevertheless, it is also worth mentioning that the current economic and financial conditions are very different from the times of the Great Depression so the two crises are not strictly comparable.

(a) **Shorter business cycles nowadays** – Business cycles are much shorter now so the duration of the economic recession and the bear run of the stock market might be shorter compared to the Great Depression. According to the International Monetary Fund[2], economic recessions after financial crises lasted for an average duration of about seven quarters; the current US recession has lasted for six quarters (The US National Bureau of Economic Research affirmed that the recession started from the fourth quarter of 2007). Some optimistic investors expect the US economy to recover by late 2009 or early 2010. Thus the bear run in the stock market might not be as long as in the Great Depression.

(b) **Timing and magnitude of government support** – According to The McKinsey Quarterly[3], the duration and severity of a recession that resulted from a financial crisis depended on how governments responded and restored confidence. In the current financial crisis, governments have responded much faster than during the Great Depression. In this regard, the current recession could be shorter.

(i) In the Great Depression, the US government's support to the financial markets and economies was limited at the early stage; the stock market found its trough in June 1932. International cooperation was also limited due to political tensions, and protectionism among major countries certainly did not help.

(ii) During the current financial crisis, worldwide governments acted promptly to cut rates, increase money supply, bail out financial institutions and guarantee both deposits and loans to avoid widespread disruptions and dislocations in the functioning of financial markets and economies. Concerted international efforts to restore confidence and stabilise the financial system, the launching of stimulus packages to reduce the impact of recession, the introduction of financial reforms to strengthen the global financial, and rejection of trade protectionism are hallmarks of the current response. This has helped to stabilise economies and support recovery.

Implications from the previous crises and outlook

34. The impact of a major financial crisis on the economy depends on the timeliness and quality of policy responses. Failure to implement timely, decisive and appropriate policies to break the feedback loop could result in self-reinforcing negative spill-overs from the financial system to the economy and back to the financial system.

35. Compared to the 1929 Great Depression, the responses of most governments in the current financial crisis have been much more decisive and prompt. However, whilst economies have begun to show early signs of stabilisation or recovery, concerns remain that the huge stimulus and supportive measures may lead to inflation and pressure on currencies. The policy challenge is to have appropriate exit strategies for such measures so as not to undermine recovery and growth prospects. Investors should be reminded that the stock markets could remain volatile on the back of uncertainties over the sustainability of economic recovery and the stability of the financial markets.

36. The recent rally in stock markets should be taken with cautious optimism. Experience shows that during a bear run or a recession, stock markets could be volatile before reaching a genuine trough after the initial tumble. In this environment, a stock market rebound is not sustainable if it lacks fundamental support.

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2 "World Economic Outlook" , April 2009, IMF, page 114
3 "Financial crises, past and present", The McKinsey Quarterly, December 2008