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Research Paper No. 46: A review of the global and local securities markets in 2009

22 January 2010

Executive Summary

1. Worldwide stock markets extended losses in early 2009 amid the deepening of the global economic crisis, adverse economic outlook, worries over the capital conditions of financial institutions in the US and Europe and deleveraging activities in the stock markets. In response to the crisis, central banks lowered interest rates, injected cash into the banking systems and adopted loose monetary policies to stimulate their economies and support financial institutions and the stock markets. Given some early signs of economic recovery, worldwide equity markets surged on optimism over improving economic outlook and better corporate earnings in the fourth quarter. However, Dubai World's debt problems limited gains.
2. Among other factors, the performance of worldwide equity markets since April 2009 was mainly underpinned by capital inflow. As the global economy began to stabilise, investors' risk appetite revived and investment in riskier assets grew. In particular, falling interest rates and quantitative easing policies in the US caused a weakening of the US dollar and induced investors to adopt a US dollar carry trade strategy. In other words, investors borrowed US dollars and invested in higher-yield assets in Asia or other emerging markets for higher returns. The stock markets have rebounded strongly since April, as the US dollar weakened.
3. Improving economic conditions in Australia and Norway made them the first countries to raise interest rates after the financial crisis. The rate hikes were understandable, given surging commodity prices and the fact that both Australia and Norway are resource-rich countries. Nevertheless, it also heightened concerns that governments worldwide might start withdrawing stimulus measures and adopt tightened monetary policies in 2010 at the risk of slowing the pace of the global economic recovery.
4. In early 2009, the US and European markets started to slide and dropped to a trough in March hurt by adverse economic outlook, worries about the capital shortfall of financial institutions and bankruptcy of US automakers. The markets rebounded strongly afterwards and recouped the losses amid better corporate earnings, improving economic data and optimism over the global economic outlook. As at the end of 2009, the Dow, Nasdaq and S&P 500 had risen 19%, 44% and 24% respectively from their end-2008 levels.
5. During 2009, the Mainland market advanced on more economic stimulus measures. Solid earnings and strong economic data also lent support. Although concerns over possible monetary tightening trimmed gains, by the end of 2009, the Shanghai Composite Index had risen 80% from its end-2008 level.
6. During 2009, the Hong Kong market was initially clouded by uncertainties over the global economy and the health of US financial institutions. From late March however, the local market rebounded strongly amid optimism over the global economic recovery, additional stimulus plans in the Mainland and better corporate earnings. Strong capital inflows into the Hong Kong market also lent support. Properties stocks outperformed the benchmark indices on surging prices of luxury flats. As at the end of 2009, the HSI and the HSCEI had risen 52% and 62% respectively from their end-2008 levels.
7. Trading in both the cash and derivatives markets dropped compared to 2008. The average daily trading in the cash market dropped by 14%, while trading volume in futures and options dropped by 8%.
8. Short-selling activities fell in 2009 as the local equity market stabilised from the second quarter onwards. Short selling rose in absolute terms, but dropped relative to total market turnover during the second half of 2009. The average daily short selling was 5.3% of the total market turnover during the second half of 2009, compared to 5.7% in the first half of 2009 and 7.5% in the second half of 2008.
9. Initial Public Offering (IPO) activities were quiet in the first half of 2009, but became very active in the second half due to improving market sentiment. There were a total of 65 IPOs during

2009, raising a total of $244 billion[1]. This made Hong Kong the largest IPO centre in the world in 2009.

Performance of worldwide stock markets and economic conditions in 2009

10. Worldwide stock markets extended losses in early 2009 amid the deepening of the global economic crisis, adverse economic outlook, worries over the capital conditions of financial institutions in the US and Europe and deleveraging activities amid credit tightening and fund withdrawals by investors.

11. In response to the crisis, most governments and central banks launched various stimulus measures to stabilise their financial markets and stimulate their economies. In early March 2009, major benchmark indices were about 2% to 25% lower than their end-2008 levels. Central banks lowered interest rates, injected liquidity into the banking systems and adopted loose monetary policies to stimulate their economies and support financial institutions. Given some early signs of economic recovery, worldwide equity markets surged on optimism over improving economic outlook and better corporate earnings. As at the end of 2009, major benchmark indices were 19% to 87% higher than their end-2008 levels.

12. In late 2009, the Dubai Government sought to restructure the debt obligations of Dubai World and its subsidiary Nakheel and asked for a six-month delay in debt repayment. This dragged worldwide stock markets lower as some investors were concerned about the financial status of some creditor banks of Dubai World, including HSBC and Standard Chartered Bank. However, stock markets rebounded after the Abu Dhabi Government announced a US$10 billion bailout plan.

Performance of major stock markets

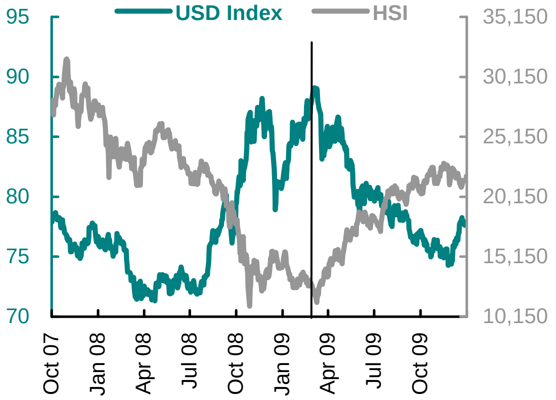
		Index level			% change		PE ratio	
		End-2009	Trough since 2008		from end-2008	from trough	End-2009	End-Jun 2008
HK	HSI	21,872.50	11,015.84	(Oct 08)	52.0%	98.6%	22.87	13.43
	HSCEI	12,794.13	4,990.08	(Oct 08)	62.1%	156.4%	20.48	15.43
China	Shanghai Comp	3,277.14	1,706.70	(Nov 08)	80.0%	92.0%	34.80	21.36
Japan	Nikkei 225	10,546.44	7,054.98	(Mar 09)	19.0%	49.5%	35.82	15.95
Australia	AOI	4,882.70	3,111.70	(Mar 09)	33.4%	56.9%	N/A	13.93
Taiwan	TWSE	8,188.11	4,089.93	(Nov 08)	78.3%	100.2%	N/A	12.74
Korea	KOSPI	1,682.77	938.75	(Oct 08)	49.7%	79.3%	23.10	13.00
Singapore	STI	2,897.62	1,456.95	(Mar09)	64.5%	98.9%	26.04	10.70
Thailand	SET	734.54	384.15	(Oct 08)	63.2%	91.2%	26.91	13.00
Malaysia	KLCI	1,272.78	829.41	(Oct 08)	45.2%	53.5%	22.41	12.75
Indonesia	JCI	2,534.36	1,111.39	(Oct 08)	87.0%	128.0%	30.57	14.96
Philippines	PCOMP	3,052.68	1,704.41	(Oct 08)	63.0%	79.1%	15.28	10.89
India	Nifty	5,201.05	2,524.20	(Oct 08)	75.8%	106.0%	23.42	13.94
Vietnam	VN	494.77	235.50	(Feb 09)	56.8%	110.1%	16.05	N/A
MSCI Asia Pacific Ex-Japan (USD)		416.54	200.36	(Nov08)	68.4%	107.9%	30.78	13.51
US	Dow	10,428.05	6,547.05	(Mar 09)	18.8%	59.3%	16.24	14.33
	Nasdaq	2,269.15	1,268.64	(Mar 09)	43.9%	78.9%	44.53	34.64
	S&P 500	1,115.10	676.53	(Mar 09)	23.5%	64.8%	24.28	21.20
UK	FTSE 100	5,412.88	3,512.09	(Mar 09)	22.1%	54.1%	61.47	11.18
Germany	DAX	5,957.43	3,666.41	(Mar 09)	23.8%	62.5%	60.24	12.06
France	CAC	3,936.33	2,519.29	(Mar 09)	22.3%	56.2%	16.70	11.23

Source: Bloomberg

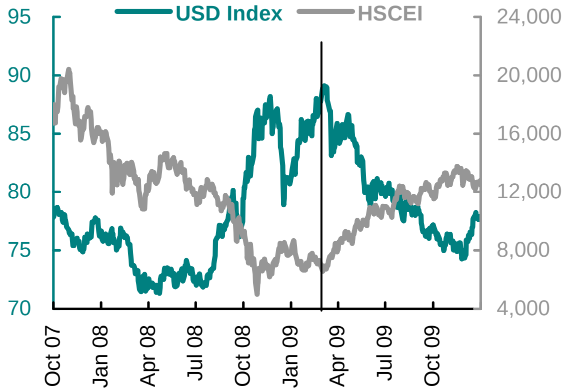
13. Among other factors, the strong performance of worldwide equity markets in 2009 was mainly underpinned by vast liquidity in the market. This was particularly true in the case of emerging

[1] Unless otherwise stated, figures given in the report are denominated in Hong Kong dollars.

markets. As the global economy began to stabilise, investors' risk appetite revived and they started investing in riskier assets. In particular, falling interest rates and quantitative easing policies in the US caused a weakening of the US dollar, and induced investors to adopt a US dollar carry trade strategy. Investors borrowed US dollars and invested in higher-yield assets in Asia or other emerging markets for higher returns. Stock markets have thus rebounded strongly since April, as the US dollar weakened.



US Dollar Index & HSI



US Dollar Index & HSCEI

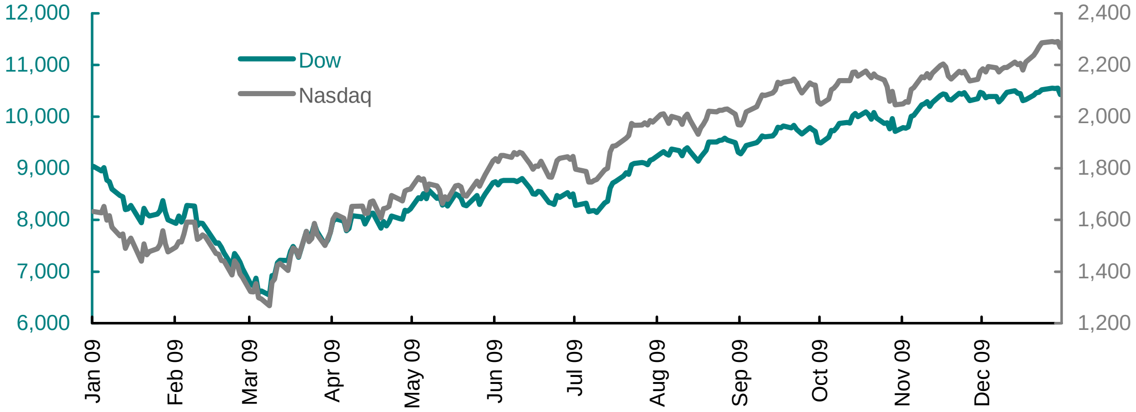
Sources: Bloomberg and SFC Research

14. Nevertheless, there are concerns that the economic recovery still seems preliminary at this stage. The rebound in the stock markets seems to be less associated with economic fundamentals but more due to the massive inflow of liquidity. Hence, if market sentiment changes or the global economy does not recover as expected, a sudden reversal of the current capital inflow, and consequently, a significant correction in asset prices could happen. Such a reversal might be triggered by:

- uncertainties about the exit policy of major central banks;
- uncertainties about the policies of emerging countries in dealing with capital inflow;
- change in investors' expectation about reviving economic conditions;
- an unwinding of the US dollar carry trade caused by US interest rate hikes or a rebound of the US dollar; or
- profit-taking activities due to overvaluation or a drop in risk appetite.

US

15. In early 2009, the US and European markets dropped to a trough hurt by adverse economic outlook, worries about the capital shortfall of financial institutions and the bankruptcy of US automakers. The markets rebounded strongly afterwards and recouped the losses amid better corporate earnings, improving economic data and optimism over the global economic outlook. As at the end of 2009, the Dow, Nasdaq and S&P 500 had risen by 19%, 44% and 24% respectively as compared to their end-2008 levels.

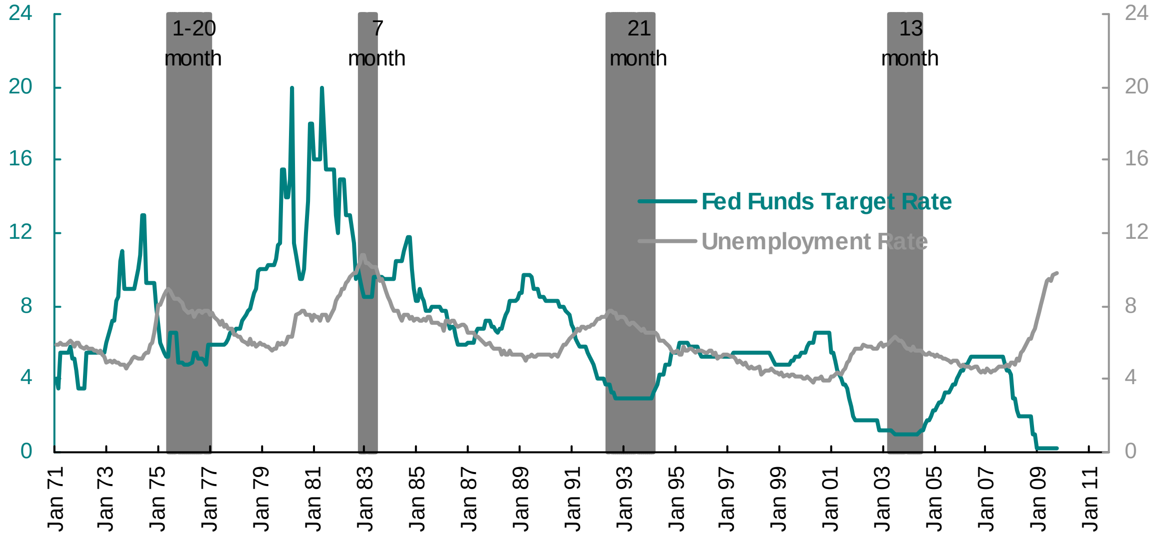


Performance of the Dow and Nasdaq

Source: Bloomberg

16. Despite some signs of recovery, mixed economic data indicated that the US economic outlook remained uncertain. Gross domestic product (GDP) growth in the US rose to 2.2% quarter on quarter (qoq) in the third quarter of 2009, ending a four-quarter long economic contraction. However, the GDP was still 2.6% lower than that of the third quarter of 2008. The unemployment rate rose to a 26-year high of 10.2% in October 2009. The Federal Reserve (Fed) reaffirmed in December that they would maintain low interest rates and a loose monetary policy until the economic growth becomes stable.

17. Since the 1970s, the US has experienced four major recessions and the unemployment rate has peaked four times. It is observed that, on average, the Fed starts raising the Fed Funds Target Rate 13 months after the unemployment rate has peaked. It follows that, in the current economic recession, if the unemployment rate reaches its peak in late 2009 or early 2010, the Fed Funds Target Rate would be raised by late 2010 or early 2011. However, there are also worries that the current loose monetary policy and record low interest rates may lead to another asset bubble. Therefore, it cannot be ruled out that the Fed may raise rates earlier than expected to prevent asset price bubbles.

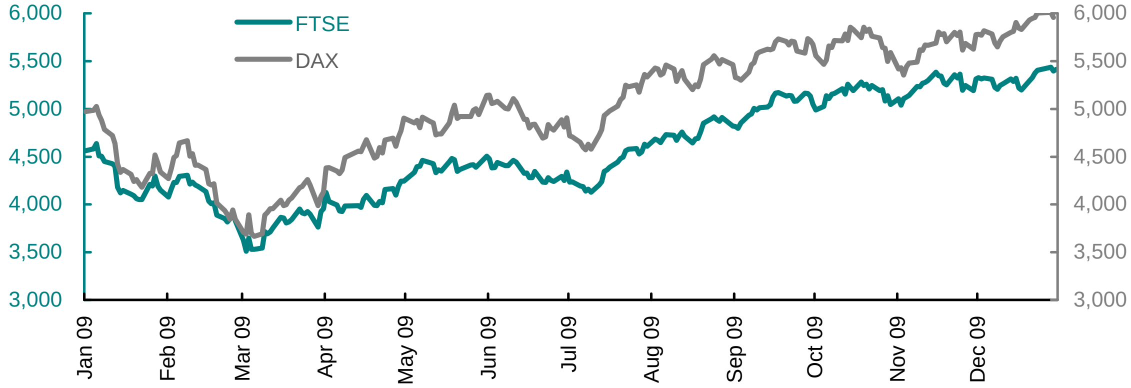


Fed Funds Target Rate and unemployment rate

Source: CEIC

Europe and Asia

18. European markets have also rebounded from their troughs in March. As at the end of 2009, the FTSE and CAC rose 22%, while DAX rose 24% as compared to their end-2008 levels.



Performance of the FTSE and DAX

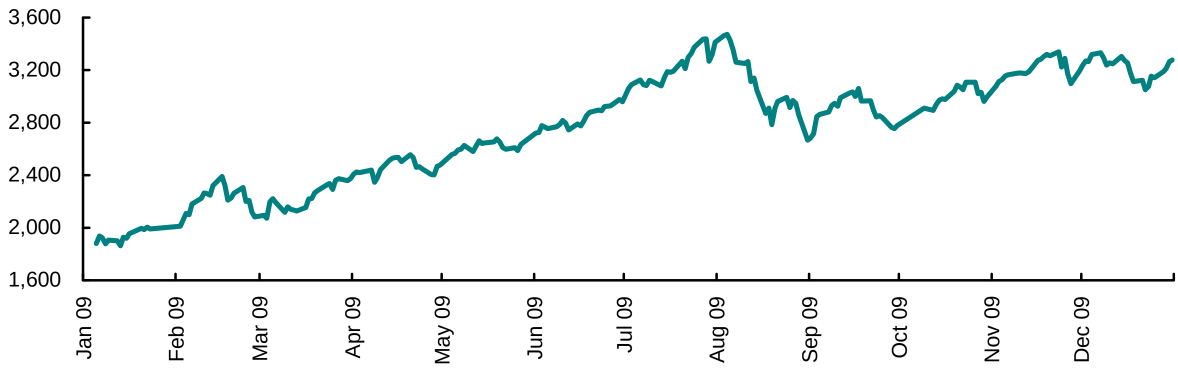
Source: Bloomberg

19. Following the declines in the US markets and amid falling exports, stock markets in Asia fell in the first quarter of 2009. The markets rebounded strongly afterwards on hopes of global economic recovery. During 2009, Asian markets rose, with gains ranging from 19% in Japan to 87% in Indonesia.

20. Improving economic conditions in Australia and Norway made them the first countries to raise interest rates after the financial crisis. Since October 2009, the Reserve Bank of Australia has raised its benchmark rate by a total of 75 bps to 3.75%, while the Central Bank of Norway has raised its benchmark rate by a total of 50 bps to 1.75%. Since they are resource-rich, both countries raised interest rates to accommodate surging commodity prices. However, their actions also heightened concerns that governments worldwide might start withdrawing stimulus measures and adopt tightened monetary policies in 2010 at the risk of slowing the pace of the global economic recovery.

Mainland

21. During 2009, the Mainland market advanced on more economic stimulus measures. Solid earnings and strong economic data also lent support. However, concerns over possible monetary tightening limited gains. By the end of 2009, the Shanghai Composite Index had risen 80% from its end-2008 level.



Shanghai Composite Index

Source: Bloomberg

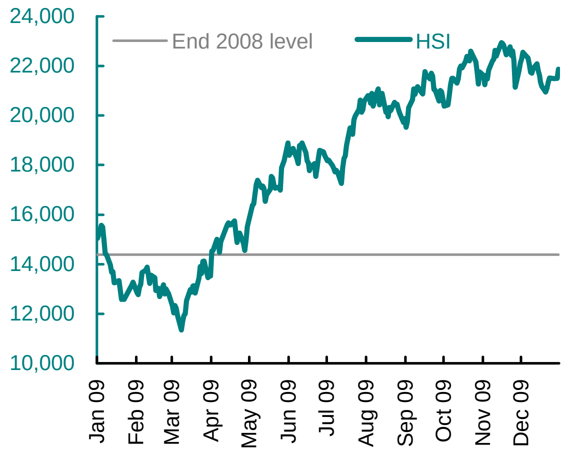
22. The global economic crisis also hurt the Mainland economy, but the impact was mitigated by several rounds of stimulus measures taken since late 2008 to support the growth of the economy and financial markets, including tax reforms and restructuring in 10 major industries. Increasing bank loans also supported growth. New loans in 2009 amounted to RMB 9.59 trillion, RMB 4.69 trillion more than the 2008 level. The declines in consumer prices and exports were slowing down, while GDP growth accelerated to 10.7% year on year (yoy) in the fourth quarter of 2009 from 6.1% (yoy) in the first quarter of 2009. The annual GDP growth rate was 8.7% in 2009, exceeding the annual target growth rate of 8%. However, this heightened concerns over more tightening measures ahead to curb overheating.

23. A new market segment, namely the ChiNext Board, commenced trading in Shenzhen on 30 October 2009 with 28 listings. All were well-received and posted strong debut performance, surging 106% from their IPO prices on average (individual gains ranged 76% to 210%). As at the end of 2009, 36 stocks were listed on the ChiNext Board. These stocks were, on average, 92% higher than their IPO prices (with individual stocks gaining 34% to 242% from their IPO prices). The PE ratios of these 36 stocks averaged 110 times by the end of 2009 (with individual PE ratios ranging from 70 times to 200 times). Trading in these stocks remained active, with an average daily turnover of RMB4.1 billion from 30 October to 31 December 2009, compared to the Shenzhen Main Board's turnover of about RMB70 billion and the Shanghai Main Board's turnover of about RMB161 billion during the same period.

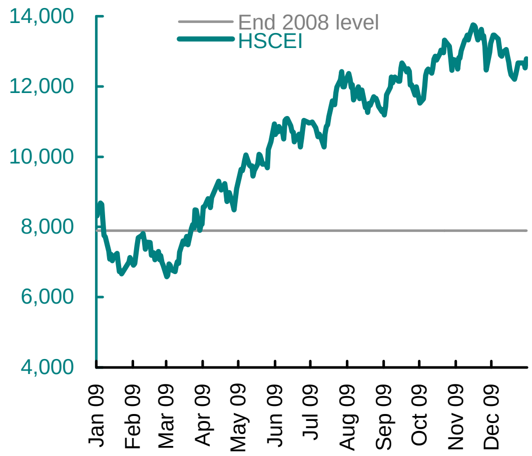
Hong Kong

24. During 2009, the Hong Kong market was initially clouded by uncertainties over the global economy and the health of financial institutions in the US. The HSI fell to a low of 11,344 on 9 March, dragged down by HSBC over concerns about its rights issue plan. Its share price once fell to a 10-year low of $33 on 9 March, but rebounded strongly after it went ex-rights and rose to $89.4 as at the end of 2009.

25. From late March however, the local market rebounded strongly amid optimism over the global economic recovery, additional stimulus plans in the Mainland and better corporate earnings. Strong capital inflow into the Hong Kong market also lent support. Properties stocks outperformed the benchmark indices on surging prices of luxury flats. The HSI rose to a 16-month high and once broke above the 23,000 level. As at the end of 2009, the HSI and the HSCEI had risen 52% and 62% respectively from their end-2008 levels.



Performance of the HSI



Performance of the HSCEI

Source: Bloomberg

Risks and uncertainties over the financial market and economic outlook

26. Despite stabilising economic conditions worldwide, recovery remains preliminary. The global economy is still clouded by uncertainties over the economic conditions and increasing unemployment in the US. The economies of some countries are improving, and oil prices and

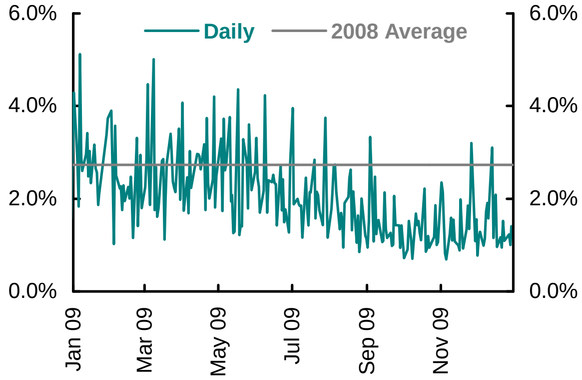
other commodities prices have rebounded strongly. If these trends continue, they may add inflationary pressure. The pace of economic recovery may also be affected if governments start to withdraw their stimulus measures and tighten monetary policies.

27. The surge in stock markets appears to be driven by ample liquidity, and not fully supported by economic fundamentals. Moreover, the movement of capital can easily be affected by market sentiment, a possible rate hike in the US or a rebound of the US dollar. If a large amount of capital is withdrawn, a significant correction in asset prices may take place. This, too, will affect the pace of economic recovery.

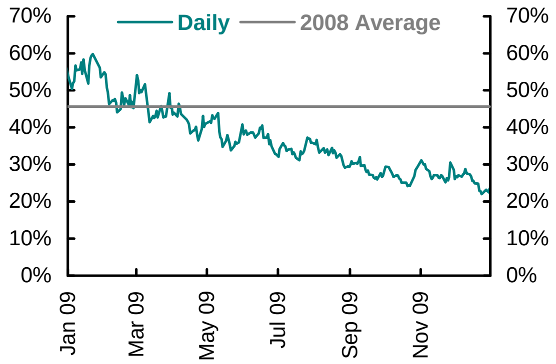
Major statistics of Hong Kong securities market in 2009

Volatility dropped in 2009

28. The intra-day volatility of the HSI dropped to an average of 2% during 2009 (2.7% in 2008 and 2.8% in 1998). The implied volatility of HSI options retreated steadily and was about 23.6% as at the end of 2009.



Intraday volatility of the HSI



Implied volatility of HSI Options

Remark:

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

Sources: Bloomberg and SFC Research

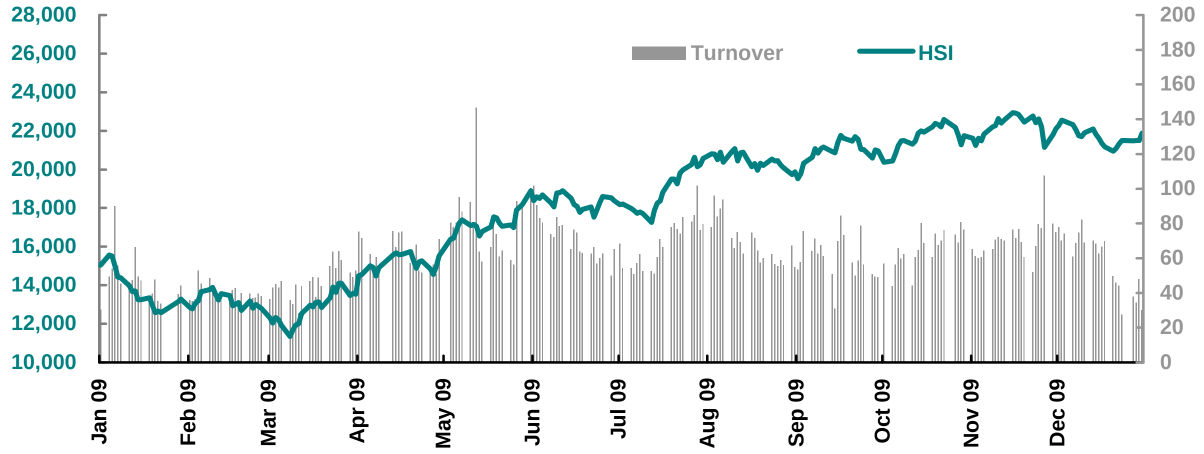
Trading activities in the local stock market

29. Trading activities in the local stock market were quiet in the first half of 2009, but became active in the second half due to improved sentiment and strong funds inflow. The average daily turnover amounted to $62 billion, 14% lower than the level of 2008 and 29% lower than the level of 2007. Mainland stocks remained the most actively traded stocks, and accounted for 46% of total market turnover. In comparison, trading of HSI stocks (excluding H shares and red chips) accounted for about 13% of total market turnover.

Average daily turnover ($ billion)

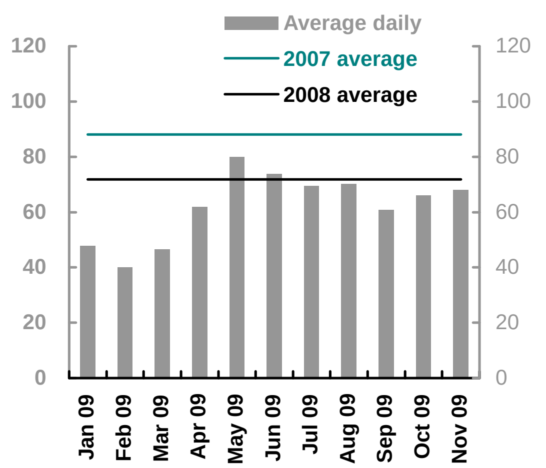
	2009	2008	2007	% change over	
				2008	2007
HSI (ex H shares & red chips)	7.9 (13%)	11.2 (16%)	12.1 (14%)	-30%	-35%
Mainland Stocks	28.5 (46%)	34.4 (48%)	42.7 (48%)	-17%	-33%
H shares	*20.8 (33%)*	*25.1 (35%)*	*31.6 (36%)*	*-17%*	*-34%*
Red chips	*7.8 (12%)*	*9.3 (13%)*	*11.1 (13%)*	*-17%*	*-30%*
Derivative Warrants	6.6 (11%)	14.0 (19%)	19.1 (22%)	-53%	-65%
CBBCs	6.7 (11%)	4.2 (6%)	0.3 (0.4%)	+59%	+2046%
Others	12.5 (20%)	8.2 (11%)	13.9 (16%)	+53%	-10%
Market Total	**62.3 (100%)**	**72.1 (100%)**	**88.1 (100%)**	**-14%**	**-29%**

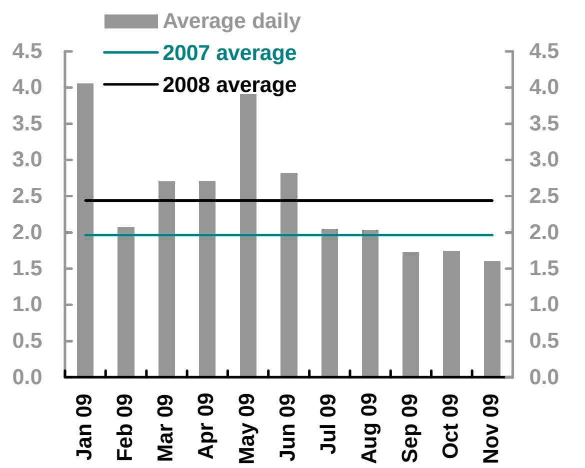
Sources: HKEx and SFC Research



HSI performance and market turnover ($ billion) (Jan 2009 – Dec 2009)

Source: SFC Research



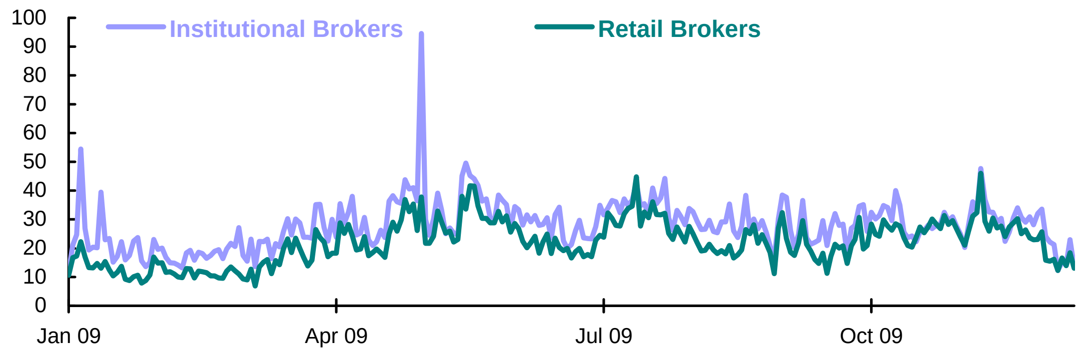


Trading value of the Hong Kong market ($ billion)

Trading volume of HSI constituent stocks (billion shares)

Source: Bloomberg

30. By broker type, the proportion of equity trading by institutional brokers decreased to 56% in 2009 (compared to 68% in 2008), while the proportion of retail brokers was 44% (compared to 32% in 2008).



Daily equities trading by broker type during 2009 ($ billion)

Source: SFC Research

Short-selling activities

31. Short selling was less active in 2009 as the local equity market became stable from March. Short selling rose in absolute terms, but dropped relative to total market turnover. Average daily short selling was $3,522 million or 5.3% of the total market turnover during the second half of 2009. The figures for the second half of 2008 and the first half of 2009 were $4,305 million (7.5%) and $3,333 million (5.7%) respectively.

IPO activities and performance

32. IPO activities were quiet in the first half of 2009, but became very active in the second half due to improving market sentiment. There were a total of 65 IPOs during 2009, raising a total of $244 billion, compared to 27 IPOs raising $66 billion in 2008, and 78 IPOs raising $292 billion in 2007. This made Hong Kong the largest IPO centre in the world in 2009. Mainland stocks (H shares and red chips) remained an important part of our IPO market, accounting for 48% of the total IPO funds raised in 2009.

33. Regarding the performance of these companies, 45 rose between 0.5% and 157%, two were flat and the remaining 18 dropped between 0.3% and 23% on debut. As at the end of 2009, 42 of them had gained between 0.8% and 261% from their IPO prices, two were flat and the remaining 21 dropped between 1.3% and 37%.

Exchange Traded Funds (ETFs)

34. The ETF market in Hong Kong continued to grow during 2009. The number of ETFs rose from 24 as at the end of 2008 to 43 as at end-2009. Their average daily turnover rose from $1.8 billion in 2008 to $2.0 billion in 2009. Its share of total market turnover continued to rise, accounting for 3.2% of the total market turnover in 2009, compared to 2.5% in 2008.

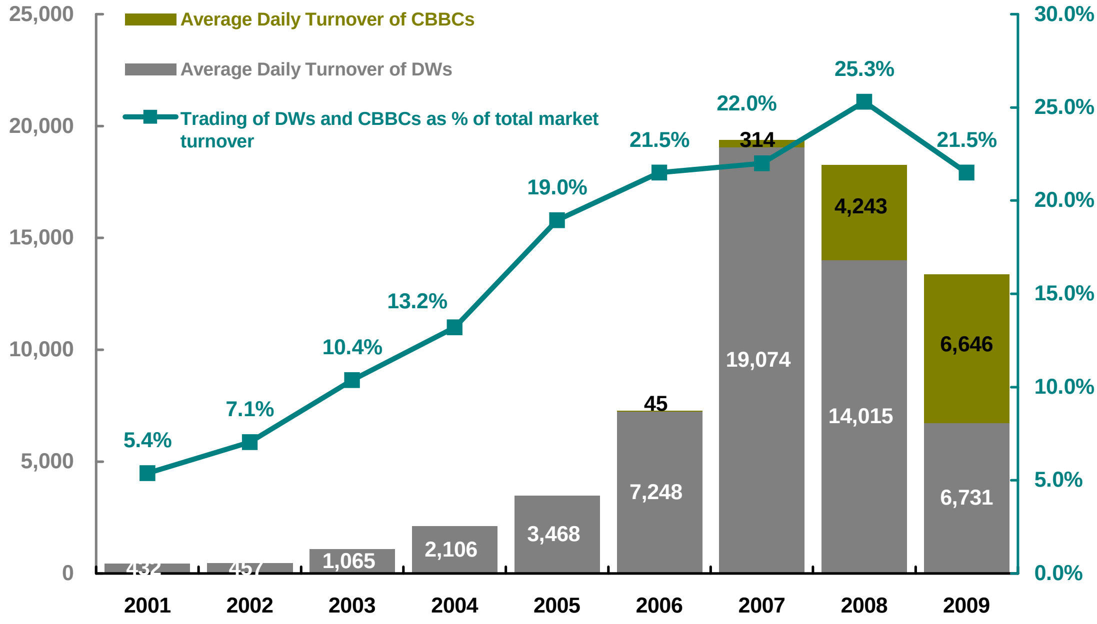
35. In August 2009, Hang Seng Index ETF (2833), Hang Seng H-Share Index ETF (2828) and W.I.S.E. CSI 300 China Tracker (2827) became the first Hong Kong ETFs to cross-list in Taiwan. In particular, W.I.S.E. CSI 300 China Tracker was the second most actively traded ETF in Taiwan. At the same time, Polaris Taiwan Top 50 Tracker Fund (3002) became the first cross-listed Taiwan ETF to trade in Hong Kong.

36. In November 2009, four A-share industry sector ETFs began trading in Hong Kong, making it the first market to offer Mainland A-share industry sector ETFs.

Derivative Warrants (DWs) and Callable Bull/Bear Contracts (CBBCs)

37. Trading in the DW market shrank while the CBBC market continued to grow during 2009. Trading of CBBCs has now surpassed trading of DWs. Turnover of DWs dropped to $6.6 billion (10.7% of total market turnover), compared to $14 billion (19.5%) in 2008.

38. The trading of CBBCs increased in both absolute terms and as a percentage of total market turnover. Trading of CBBCs rose to $6.7 billion (10.8% of total market turnover), compared to $4.2 billion (5.9%) in 2008.



Turnover of DWs and CBBCs ($ million)

Source: SFC Research

Exchange traded derivatives

39. Trading of futures products decreased during 2009. This was in line with trading in the cash market. Among futures products, HSI futures remained the most actively traded contract, accounting for nearly half of all futures trading. Its average daily trading volume decreased by 6%, compared to 2008. The second most actively traded futures were HSCEI futures, accounting for about one-third of all futures trading. Its trading volume decreased by 16%. As at the end of 2009, open interests in HSI and HSCEI futures were 68,456 and 74,324 respectively.

40. In the options market, trading declined slightly during 2009. Stock options remained the most actively traded options products, but their trading volume dropped 15%, compared to that of 2008. However, the trading volume of HSI and HSCEI options products rose.

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

		2009	2008	2007
Futures	HSI Futures	83,750	89,368	70,045
	Mini-HSI Futures	37,494	32,761	17,657
	H-shares Index Futures	50,077	59,428	44,271
	Mini H-shares Index Futures*	3,232	1,726	-
	Stock Futures	1,098	1,058	1,435
	3-Month HIBOR Futures	10	98	129
	Gold Futures**	27	62	-
	Other futures products***	1	4	34
	Total Futures	**175,690**	**184,505**	**133,571**
Options	HSI Options	21,686	15,723	30,531
	Mini-HSI Options	1,158	646	284
	H-shares Index Options	7,924	6,642	7,052
	Stock Options	191,676	225,074	187,686
	Other options products****	0	2	6
	Total Options	**222,445**	**248,087**	**225,559**
Total Futures and Options		**398,134**	**432,592**	**359,130**

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

Sources: HKEx and SFC Research