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Research Paper No. 47: Half Yearly Review of the Global and Local Securities Markets

20 July 2010

Executive Summary

1. Following rallies in 2009, major stock markets extended gains during the first quarter of 2010 on upbeat corporate earnings and better-than-expected economic data. However, stock markets around the globe were later clouded by heightening worries over sovereign debt problems in Europe.
2. The European sovereign debt problems were triggered by the worsening fiscal and financial conditions of some European countries such as Portugal, Ireland, Italy, Greece and Spain (PIIGS), which had large budget deficits and high levels of government debts. Although the Eurozone finance ministers and the International Monetary Fund (IMF) announced bailout plans for these countries, investors still were worried that the structural problems in the PIIGS countries would not be resolved soon. Tightening fiscal measures to reduce their fiscal deficits may also hurt the growth prospects of these countries, and it is likely therefore that global stock markets will continue to be affected by developments in the Eurozone. Moreover, uncertainty remains as to how the sovereign debt problems may impact the balance sheets or earnings of European financial institutions. Any downgrading of institutions by credit rating agencies may also impact stock markets.
3. As at the end of June 2010, the Dow, Nasdaq and S&P had dropped by 6.3%, 7.0% and 7.6% respectively from their end-2009 levels. Over the same period, the FTSE and CAC had dropped 9.2% and 12.5%, while the DAX rose 0.1%. Stock markets in the PIIGS countries retreated and dropped by 3.2 to 34.7%.
4. The performance of Asian markets was mixed amid sovereign debt problems in Europe, geopolitical tensions in the Korean peninsula and political uncertainties in the region, eg, conflicts in Thailand, and leadership change in Japan. During the first half of 2010, performance of benchmark indices in Asia ranged from a loss of 11.4% in Australia to a gain of 15.0% in Indonesia.
5. In the Mainland, markets retreated on worries over more tightening monetary measures to cool down the property market. As at the end of June 2010, the Shanghai Composite Index had dropped by 26.8% from its end 2009 level, reaching a 15-month low.
6. The Hong Kong market retreated amid worries over tightening measures in the Mainland and sovereign debt problems in Europe. As at the end of June 2010, the Hang Seng Index (HSI) and the Hang Seng China Enterprises Index (HSCEI) had dropped by 8.0% and 10.4% respectively.
7. Trading in our derivatives market increased from January to June 2010, while trading in our cash market was stable. Compared to the second half of 2009, the average daily trading in the cash market fell slightly by 3.4%, while trading in futures and options rose by 4.8% and 25.4% respectively.

Performance of worldwide stock markets and economic conditions in the first half of 2010

8. After the rallies in 2009, major stock markets extended gains during the first quarter of 2010 on upbeat corporate earnings and better-than-expected economic data. However, stock markets around the globe were later clouded by heightening worries over sovereign debt problems in Europe. The bailout of Greece by the European Union (EU) and the IMF could not ease investors' concerns that the sovereign debt problems in Europe might spread to other countries. This may dampen global economic recovery and add pressure on the credit market.

Debt crisis in Europe

Sovereign debt problems of European countries

9. The European sovereign debt problems first came under the spotlight when Iceland became bankrupt during the financial crisis in 2008. Investors started to become concerned about the

fiscal and financial conditions of other European countries, namely, Portugal, Ireland, Italy, Greece and Spain. These countries, which eventually came to be known by the acronym PIIGS, had large budget deficits and high levels of government debts. In late 2009, the sovereign debt problem re-surfaced following news of Dubai World's financial difficulties. Later, in the first quarter of 2010, fears intensified as news spread about Greece's difficulties in re-financing its debt. The potential impact of sovereign debt problems on worldwide capital markets thus began to unfold.

10. Since the beginning of the last decade, Greece has suffered from heavy budget deficits and high levels of government debt.

    (a) Greece's budget deficit was 13.6% of its gross domestic product (GDP) in 2009. Other PIIGS countries had budget deficits that ranged from 5.3% to 14.3% of their GDP in 2009.

    (b) Greece's government debt was about 115% of its GDP in 2009, one of the highest in the Eurozone. The Bank for International Settlements (BIS) forecasted that Greece's government debt might rise to 130% of its GDP by 2011. Meanwhile, other PIIGS countries had government debts that ranged from 59.3% to 123.6% of their GDP in 2009.

    (c) In Greece, the nominal wage growth has increased faster than its productivity growth. Spain, Portugal and Italy also have similar structural problems.

    (d) In addition, due to a drop in the competitiveness of its industries, Greece has been running high current account deficits for some years. In 2009, its current account deficit was 11.2% of its GDP. The corresponding deficit for other PIIGS countries ranged from 2.9% to 10.1% in the same year.

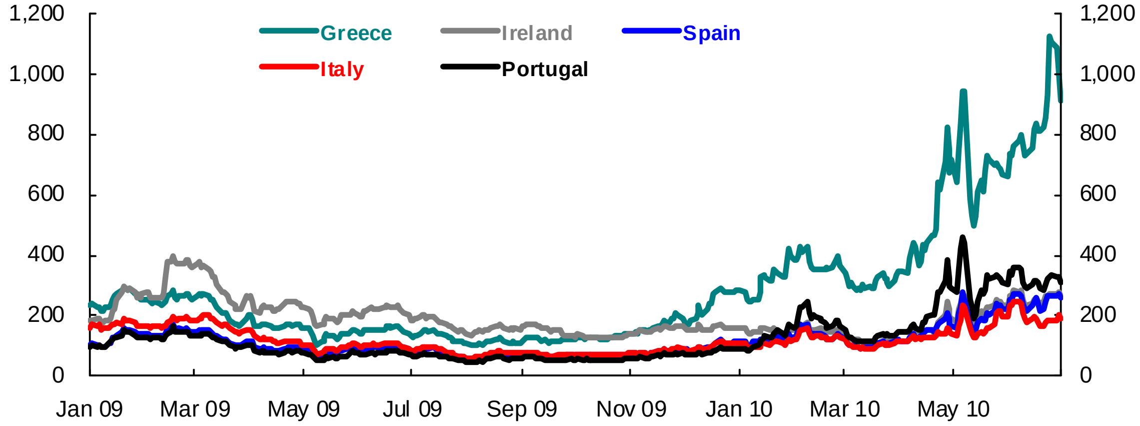
11. With Greece's weakening economic conditions, financial markets grew increasingly concerned about its repayment capability. Investors' attention was first drawn to the fiscal situation in Greece in October 2009 when it announced a significantly higher-than-expected budget deficit for 2009. Credit rating agencies then began to review their ratings for Greece. The worsening situation triggered S&P to downgrade Greece's sovereign debt rating to non-investment grade.

    (a) The rating was downgraded to BBB+ from A- on 16 Dec 2009.

    (b) It was further downgraded by three notches to BB+ (non-investment grade) from BBB+ on 27 April 2010.

    (c) S&P also downgraded both Portugal (from A+ to A-) and Spain (from AA+ to AA).

12. As investors became increasingly concerned about the repayment capability of Greece and the contagion effect on other countries, the credit default swap (CDS) spreads of the PIIGS countries shot up.



CDS spreads of Major European countries

Source: Bloomberg

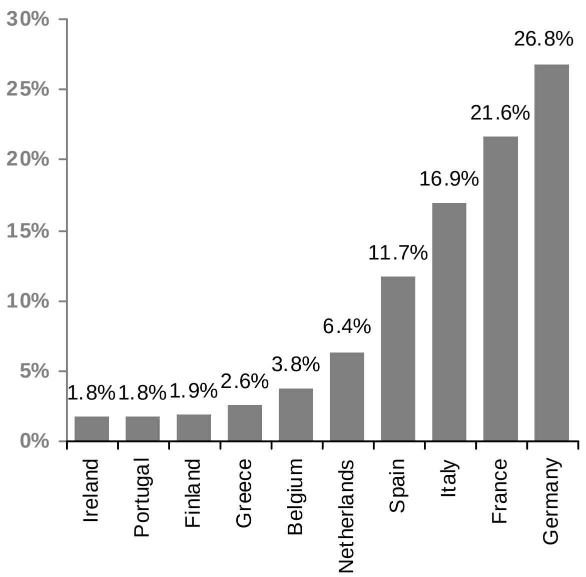
13. The Eurozone finance ministers and the IMF announced a three-year package of financial support worth €110 billion on 2 May 2010 and a rescue fund worth €720 billion on 9 May 2010.

In addition, the European Central Bank agreed to buy Eurozone government debt if needed. However, investors still were worried that the structural problems in Greece and other PIIGS countries would not be resolved soon even with the EU and IMF rescue plans. Moreover, the sovereign debt problems in Europe might eventually spread to other countries. The euro once weakened to about €1.18/USD, the lowest level since April 2006.

14. Greece, Spain and Portugal also announced several tightening fiscal measures, including tax reforms and wage cuts in the public sector, to reduce their fiscal deficits. Although these measures helped restore investor confidence in financial markets, there were also concerns that they might hurt the growth prospects of these countries, and eventually affect exports from China and other Asian countries.

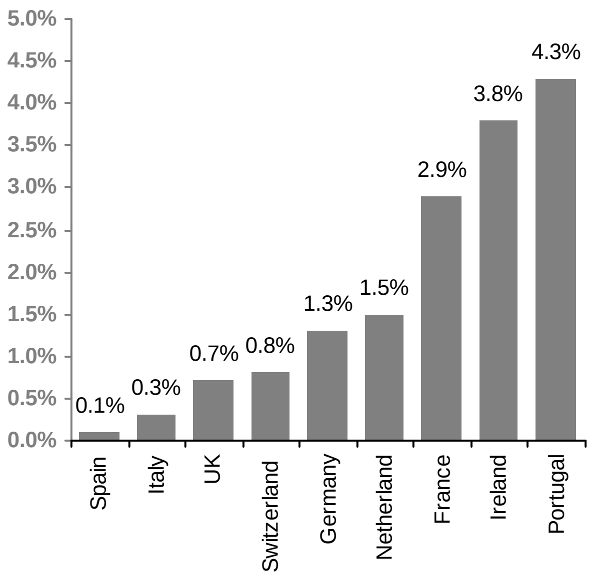
Potential problems of European banks

15. Concerns also surfaced that some European banks might be affected by the worsening economic situation in the PIIGS countries, as European banks tended to hold more European government bonds. If these countries were to restructure their debts, it would lower the value of their bonds, and thus adversely affect the financial health of banks holding those bonds. For instance, according to the BIS, the exposure of Portuguese banks to Greece debt accounted for 4.3% of Portugal's GDP while that of Irish banks accounted for 3.8% of its GDP.



GDP size as % of Eurozone GDP (2009)

Source: Eurostat



Banks' exposure to Greece (% of GDP) (December 2009)

Source: BIS Consolidated Bank Statistics, Haver

16. As discussed in more details in the paragraphs below, the crisis in Europe reverberated across major stock markets. Gains made earlier in the year were erased, and concerns about the situation worsening remain.

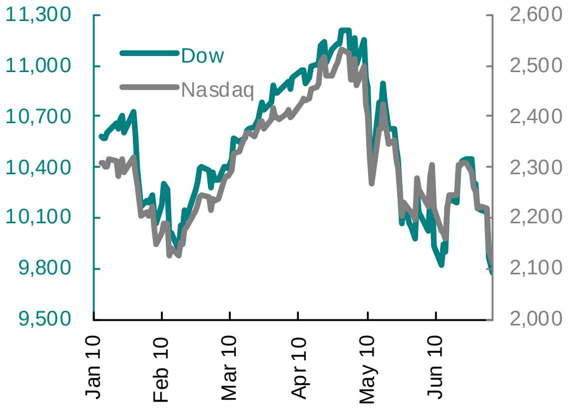
Performance of major stock markets

		End-Jun 2010 Index level	% change From end-2009	PE ratios End-2009	PE ratios End-Jun 2010
Hong Kong and Mainland					
HK	-HSI	20,128.99	-8.0%	19.57	14.55
	-HSCEI	11,466.24	-10.4%	16.38	14.23
China	-Shanghai Comp	2,398.37	-26.8%	28.78	17.83
	-Shenzhen Comp	945.29	-21.3%	44.12	30.81
Asia					
Japan	-Nikkei 225	9,382.64	-11.0%	35.82	27.79
Australia	-AOI	4,324.80	-11.4%	N/A	33.15
Taiwan	-TWSE	7,329.37	-10.5%	N/A	17.11
Korea	-KOSPI	1,698.29	0.9%	23.10	11.75
Singapore	-STI	2,835.51	-2.1%	26.04	13.23
Thailand	-SET	797.31	8.5%	26.91	12.37
Malaysia	-KLCI	1,314.02	3.2%	22.41	16.91
Indonesia	-JCI	2,913.68	15.0%	30.57	28.98
Philippines	-PCOMP	3,372.71	10.5%	15.28	11.45
India	-Nifty	5,312.50	2.1%	23.42	18.66
Vietnam	-VN	507.14	2.5%	11.78	11.22
MSCI Asia Pacific Ex-Japan		382.01	-8.3%	30.78	16.69
US					
US	-Dow	9,774.02	-6.3%	16.24	13.65
	-Nasdaq	2,109.24	-7.0%	44.53	26.53
	-S&P	1,030.71	-7.6%	24.28	14.92
Europe					
UK	-FTSE100	4,916.87	-9.2%	17.78	13.32
Germany	-DAX	5,965.52	0.1%	60.24	14.79
France	-CAC	3,442.89	-12.5%	15.66	13.09
PIIGS					
Portugal	-PSI20	7,065.65	-16.5%	14.66	11.65
Italy	-FTSEMIB	19,311.75	-16.9%	30.68	13.09
Ireland	-ISEQ	2,878.67	-3.2%	N/A	N/A
Greece	-ASE	1,434.22	-34.7%	11.96	9.56
Spain	-IBEX	9,263.40	-22.4%	12.93	9.92

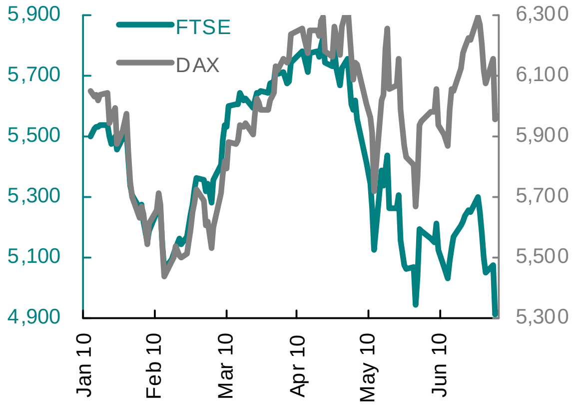
Source: Bloomberg

The United States (US)

17. In early 2010, the US markets initially advanced amid positive corporate earnings and economic data. However, gains were later erased as concerns over sovereign debt problems in Europe heightened. As at the end of June 2010, the Dow, Nasdaq and S&P had dropped by 6.3%, 7% and 7.6% respectively as compared to their end-2009 levels. It is likely that the US markets will continue to be affected by developments in the Eurozone.



Performance of the Dow and Nasdaq



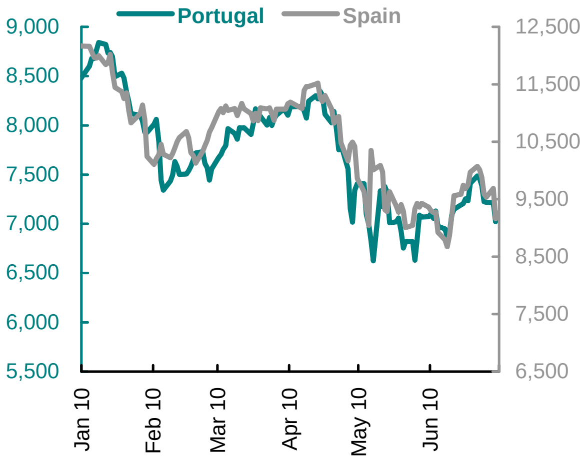
Performance of the FTSE and DAX

Source: Bloomberg

Europe

18. Similarly in Europe, major markets also advanced initially, but gains were later erased amid concerns about possible spread of the sovereign debt problems. At the same time, however, European governments' policy initiatives to discuss and introduce new regulatory measures to tackle the market turmoil might also have an impact on market performance. For instance, after Germany banned naked short selling in selected financial stocks and Eurozone government bonds on 18 May, the DAX dropped 2.7% as it added to investors' anxiety about policy disarray in Europe. During the first half of 2010, the FTSE and CAC dropped by 9.2% and 12.5%, while the DAX rose 0.1%.

19. Stock markets in the PIIGS countries retreated. During the first half of 2010, the benchmark indices of these markets dropped by 3.2% to 34.7%. As at the end of June 2010, the Greek market dropped 50.5% from its high level in October 2009.



Performance of Portuguese and Spanish markets

Performance of Greek market

Source: Bloomberg

Asia

20. The performance of stock markets in Asia was mixed as investors fears grew amid slower economic recovery in the US and the sovereign debt problems in Europe. Regional stock markets were also hurt by geopolitical tension in the Korean peninsula and political uncertainties in the region, eg, conflicts in Thailand and leadership change in Japan. From January to June 2010, performance of benchmark indices in Asia ranged from a loss of 11.4% in Australia to a gain of 15.0% in Indonesia.

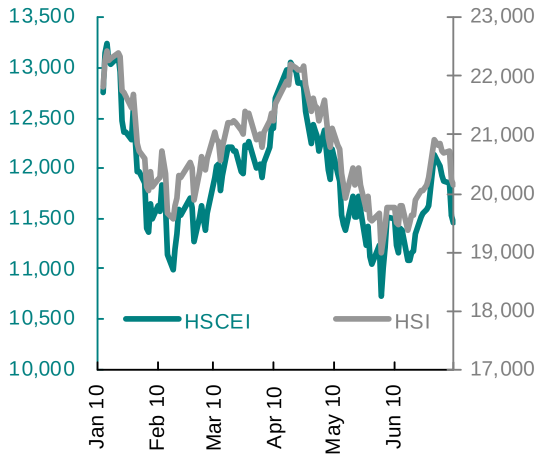
Mainland

21. From January to June 2010, the Mainland market retreated after a series of cooling measures in the property market and tightening regulations in the banking sector. These included increases in reserve requirement ratios, tighter regulations governing mortgage approvals and pre-sale of development projects and reforms in the property tax regime. Investors stayed on the sidelines as they worried about further tightening measures. Policy uncertainties in the Mainland and a shift in investors' perception on the market outlook also had an impact on the stock markets. As at the end of June 2010, the Shanghai Composite Index had dropped by 26.8% from its end-2009 level, reaching a 15-month low of 2,398.

Hong Kong

22. The Hong Kong market rose initially on optimism over corporate earnings and growth prospects of the Mainland economy. The market retreated later amid worries over tightening measures in the Mainland to cool down the property market. The sovereign debt problem in Europe also dampened investor sentiment. As at the end of June 2010, the HSI and the HSCEI had dropped by 8% and 10.4% respectively from their end-2009 levels.

Performance of the Shanghai Composite Index

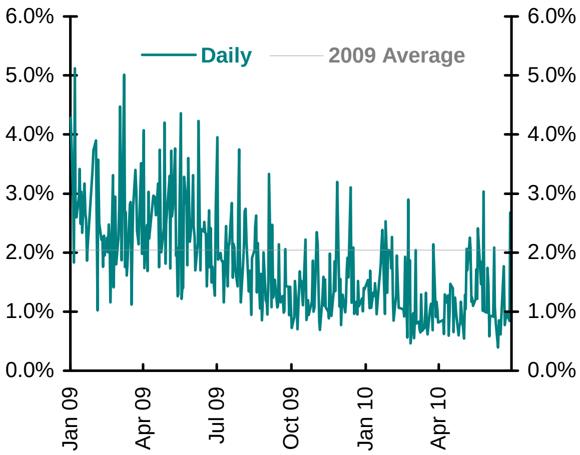


Performance of the HSI and HSCEI

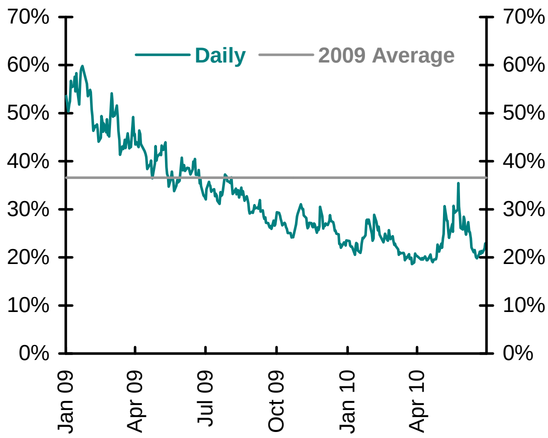
Source: Bloomberg

Volatility dropped in 2010

23. The intra-day volatility of the HSI dropped to an average of 1.3% from January to June 2010. (It was 2% in 2009 and 2.7% in 2008.) The implied volatility of HSI options retreated steadily and was about 23% by the end of June 2010.



Intraday volatility of the HSI



Implied volatility of HSI Options

Remark:

$$\text{Intraday Volatility} = \frac{\text{(Day High – Day Low)}}{0.5 \times \text{(Day High + Day Low)}}$$

Source: Bloomberg

Risks and uncertainties over the financial market and economic outlook

24. It is likely that the global stock markets will continue to be affected by developments in the Eurozone. As many European countries have tightened fiscal spending, this may further hurt the growth prospects of the Eurozone. Exports from China and other Asian countries may also eventually be affected. In addition, any downgrading of institutions by credit rating agencies may also dampen investor sentiment and hurt the stock markets.

Activities of various securities market segments in Hong Kong

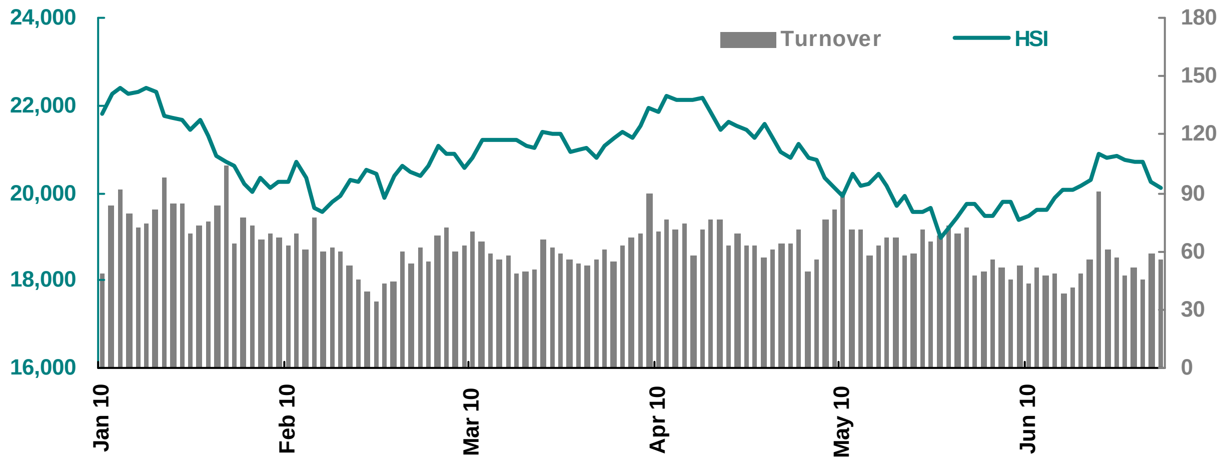
Trading in the local stock market

25. Trading activity in the local stock market was moderate during the first half of 2010. The average daily turnover amounted to $64 billion[1], about the same level as in the second half of 2009, but 9% higher than the level in the first half of 2009. Trading activities became sluggish in June 2010 when the average daily turnover dropped to about $50 billion.

Average daily turnover ($ billion)

	1H 2010	2H 2009	1H 2009	% change over	
				2H 2009	1H 2009
HSI (ex H shares & red chips)	7.9 (12%)	7.7 (12%)	8.0 (14%)	+2%	-2%
Mainland Stocks	26.1 (41%)	29.1 (44%)	27.9 (48%)	-10%	-6%
H-shares	*18.6 (29%)*	*20.7 (31%)*	*20.9 (36%)*	*-10%*	*-11%*
Red chips	*7.6 (12%)*	*8.5 (13%)*	*7.1 (12%)*	*-10%*	*+7%*
Derivative Warrants	9.3 (15%)	7.2 (11%)	6.0 (10%)	+29%	+55%
CBBCs	4.9 (8%)	6.7 (10%)	6.8 (12%)	-27%	-28%
Others	15.6 (24%)	15.4 (23%)	9.5 (16%)	+2%	+63%
Market total	**63.8 (100%)**	**66.1 (100%)**	**58.3 (100%)**	**-3%**	**+9%**

Sources: HKEx and SFC Research



HSI performance and market turnover ($ billion) (Jan – Jun 2010)

Source: SFC Research

26. The proportion of equity trading by institutional brokers was 58% in the first half of 2010, compared to 58% the same time last year and 55% in the second half of 2009. The proportion for retail brokers was 42%, same as the year-ago level and 3% less than the 45% level of the second half of 2009.

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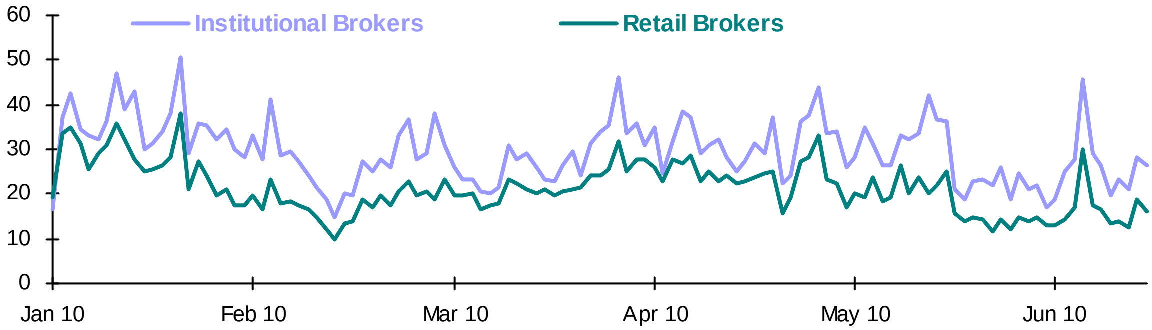
1 Unless otherwise specified, currencies given in the report are denominated in Hong Kong dollars.



Daily equities trading by broker type from January to June 2010 ($ billion)

Source: SFC research

Short selling

27. Short selling became active during the first half of 2010, rising in both absolute terms and relative terms to total market turnover. The average daily short selling was $4.4 billion, or 6.9% of the total market turnover during the first half of 2010. The figures for the first half and second half of 2009 were $3.3 billion (5.7%) and $3.5 billion (5.3%) respectively.

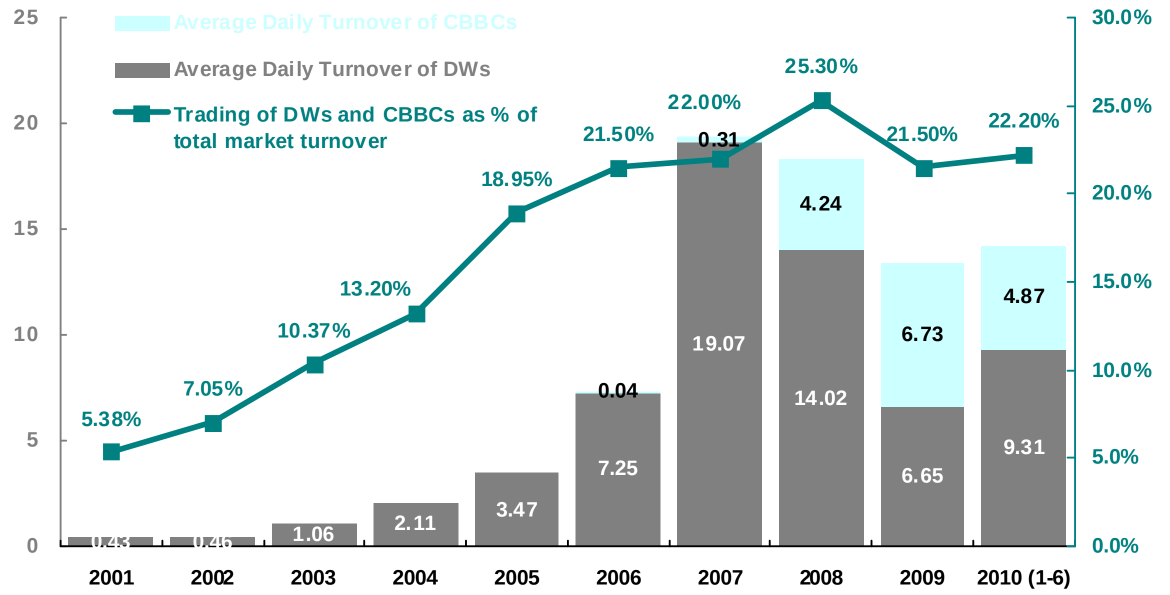
Exchange-traded funds (ETFs)

28. The number of ETFs rose from 43 as at the end of 2009 to 62 as at the end of June 2010. During the first half of 2010, their average daily turnover was $2 billion (or 3.2% of total market turnover), compared to $2.3 billion (or 3.4 % of total turnover) for the first half of 2009 and $1.7 billion (or 3 %) for the second half.

Derivative warrants (DWs) and callable bull/bear contracts (CBBCs)

29. Trading in DWs increased in both absolute terms and as a percentage of total market turnover during the first half of 2010. It rose to $9.3 billion (14.6 % of total market turnover) during that period, compared to $6 billion (10.3%) in the first half of 2009 and $7.2 billion (11%) in the second half.

30. By contrast, trading in CBBCs decreased in both absolute terms and as a percentage of total market turnover during the first half of 2010. It decreased to $4.9 billion (7.6% of total market turnover), compared to $6.8 billion (11.6%) in the first half of 2009 and $6.7 billion (10.1%) in the second half.



Turnover of DWs and CBBCs ($ billion)

Source: SFC research

Exchange-traded derivatives

31. Trading in futures products increased in the first half of 2010. Among futures products, HSI futures remained the most actively-traded product, accounting for nearly half of all futures trading. Its average daily trading volume increased by 5% from the second half of 2009. The second most actively traded futures contract was the HSCEI futures. Its trading volume increased by 14.6% and accounted for about one-fifth of all futures trading. As at 30 June 2010, open interests in HSI and HSCEI futures were 77,070 and 89,089 contracts respectively.

32. In the options market, trading also rose in the first half of 2010. Stock options remained the most actively-traded options product and its trading volume rose by 25% from the second half of 2009. The trading volume of the HSI options products rose strongly by 29% while that of the HSCEI surged 31%.

Derivatives' average daily trading volume by product type (contracts)

		1H 2010	2H 2009	1H 2009
Futures	HSI Futures	84,001	79,887	87,788
	Mini-HSI Futures	34,724	36,321	38,721
	HSCEI Futures	51,147	45,304	55,068
	Mini-HSCEI Futures	3,619	3,507	2,944
	Stock Futures	597	1,033	1,166
	3-Month HIBOR Futures	5	4	17
	Gold Futures	21	29	26
	Other futures products*	0	0	1
	Total futures	**174,114**	**166,085**	**185,731**
Options	HSI Options	30,981	23,937	19,334
	Mini-HSI Options	1,595	1,208	1,105
	HSCEI Options	10,946	8,367	7,460
	Stock Options	221,512	177,895	206,084
	Other options products**	4	N/A	N/A
	Total options	**265,037**	**211,407**	**233,984**
Total futures and options		**439,151**	**377,493**	**419,714**

Remark: * One-Month HIBOR Futures and Three-year Exchange Fund Note Futures
** Flexible Hang Seng Index Options and Flexible H-shares Index Options
^ The average daily trading volume is based on the available trading days after product launch

Sources: HKEx and SFC Research