SECURITIES AND FUTURES COMMISSION
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Research Paper No. 49: Half Yearly Review of the Global and Local Securities Markets

July 2011

Executive summary

1. The performance of major stock markets differed in the first half of 2011. While the United States (US) and European markets advanced amid upbeat economic data and hopes of an economic recovery in the US, the Mainland and Hong Kong markets fell on lingering worries about monetary tightening measures on the Mainland. The Japanese market also declined on concerns over the impact of the March earthquake and ensuing nuclear crisis.
2. In the US, stock markets advanced on the back of solid economic data and the extended low interest rate environment. There were signs of funds returning from emerging markets to developed markets. During the first half of 2011, the Dow, Nasdaq and S&P 500 rose 7.2%, 4.5% and 5% respectively.
3. In Europe, the markets initially rose on optimism over global economic growth and easing concerns over the sovereign debt problem. However, worries over the debt restructuring of Greece trimmed gains later on. During the review period, the FTSE, DAX and CAC rose 0.8%, 6.7% and 4.7% respectively.
4. In the Middle East and North Africa (MENA), political uncertainties dampened market sentiment. In particular, the Egyptian market fell 25%. Given uncertainties regarding the oil-producing markets in MENA, the oil price rose to a new high.
5. Within Asia, Japan was one of the worst-performing markets, declining by 4% during the review period. The market was hit by the massive 9-magnitude earthquake, the subsequent tsunami and radiation leakages.
6. The performance of stock markets in other Asian countries was mixed. In some markets, investors focused on the possible tightening measures to be imposed to curb inflation. During the first half of 2011, the performance of benchmark indices in Asia ranged from a loss of 10.8% in Vietnam to a gain of 5% in Indonesia.
7. In the Mainland, markets advanced in early 2011 on strong economic data and upbeat corporate earnings. However, most of the gains were erased after the Central Government launched a series of measures to contain inflation. In the first half of 2011, the Shanghai Composite Index fell 1.6%.
8. The Hong Kong markets rose initially amid optimism over a robust economic outlook and solid corporate earnings. Although the accommodative policies in the US boosted investor sentiment, the impact was offset by lingering concerns over further tightening measures in the Mainland and the European sovereign debt problem. In the first half of 2011, the Hang Seng Index (HSI) fell 2.8% and the Hang Seng China Enterprises Index (HSCEI) fell 0.9%.
9. Looking ahead, global stock markets probably will continue to be affected by monetary policies in the US and development of the European sovereign debt problem. Volatile commodity prices may add to inflation risks and impact stock markets while concerns over monetary tightening measures on the Mainland will also affect the market outlook in this region.
10. Trading in the derivatives market rose, while trading in the cash market was stable. Compared to the second half of 2010, the average daily trading in the cash market dropped slightly by 0.7%, while trading in futures and options rose by 9.3% and 9.2% respectively.

Performance of worldwide stock markets and economic conditions in the first half of 2011

11. In the first half of 2011, major stock markets in the US, Europe and Asia performed differently. The US and European markets advanced amid upbeat corporate earnings, solid economic data and accommodative monetary policies in the US. The Hong Kong market rose slightly on optimism over corporate earnings and positive business sentiment. However, the

Mainland market fell on lingering worries about tightening measures to tame inflation. The Japanese market also dropped on concerns over the impact of the earthquake and nuclear crisis.

Performance of major stock markets

US

12. In early 2011, the US markets rose. The extension of tax cuts and solid economic data lent support, while the US Federal Reserve's assurance of a loose monetary policy added further boost. Robust earnings and brokerage upgrades also improved market sentiment.

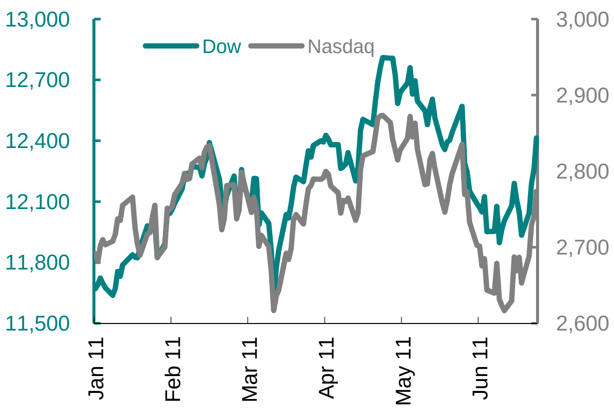
13. In March 2011, markets slid on worries over the political unrest in the MENA region, as well as the natural disaster in Japan. Yet, losses were quickly recouped on the back of upbeat corporate earnings and economic data.

14. Optimism over an accommodative monetary policy also lent support after the Federal Open Market Committee meeting in late April 2011. The Dow rose to a near three-year high, while Nasdaq hit a 10-year high in May. However, investor concerns over a possible downgrade of the US credit rating limited the upside.

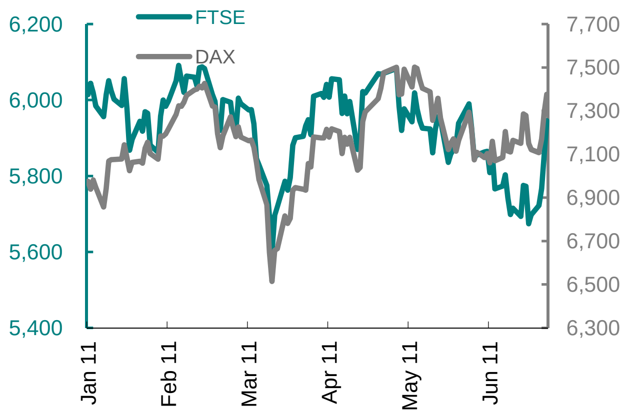
15. There were signs that funds might have returned from emerging markets to developed markets. After the financial crisis in 2008, emerging market economies were relatively resilient, attracting strong inflow of capital. This prompted tightening measures in the region. In early 2011 however, the outlook for economic growth in developed markets became more optimistic as a result of the loose monetary policy in these markets. This, coupled with concerns that tightening measures in emerging markets might slow down growth in the region, led to the re-allocation of funds from emerging markets to developed markets.

16. Commodity prices were volatile, affecting stock market performance. The Thomson Reuters/Jefferies CRB index of 19 major commodities rose 31% since 2010 to a peak of 370.6 in late April before seeing some correction. Among other factors, the rebound in the US dollar might have contributed to the correction. In addition, changes in demand from funds and big investors contributed to volatile commodity prices, which, in turn, affected the prices of resources stocks and inflation outlook, and hence the performance of global stock markets.

17. During the first half of 2011, the Dow, Nasdaq and S&P 500 rose 7.2%, 4.5% and 5% respectively. Developments in the quantitative easing (QE) programme will continue to affect market performance, whilst economic data will shed light on the economic outlook.



Performance of the Dow and Nasdaq



Performance of the FTSE and DAX

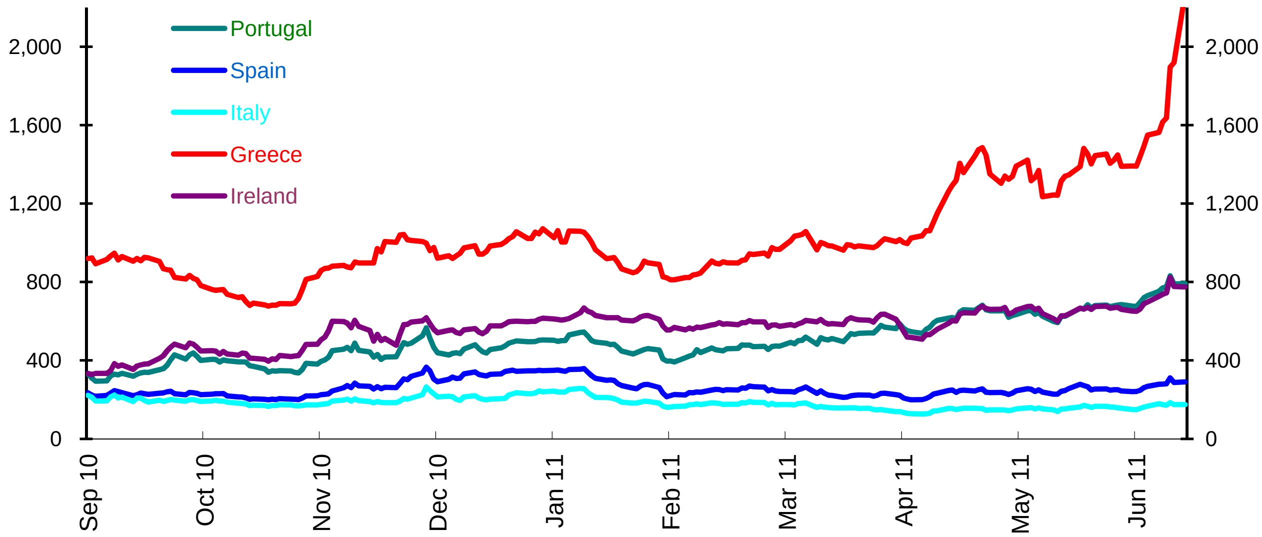
Source: Bloomberg

Performance of major stock markets

		30-Jun-11	% change		P/E Ratios on
		Index	YTD	in 2010	30-Jun-11
Hong Kong and Mainland					
Hong Kong	-HSI	22,398.1	-2.8%	5.3%	11.8
	-HSCEI	12,576.7	-0.9%	-0.8%	11.6
China	-Shanghai Comp	2,762.1	-1.6%	-14.3%	15.5
	-Shenzhen Comp	1,155.9	-10.5%	7.5%	30.4
Asia					
Japan	-Nikkei 225	9,816.1	-4.0%	-3.0%	18.0
Australia	-AOI	4,659.8	-3.9%	-0.7%	22.8
Taiwan	-TWSE	8,652.6	-3.6%	9.6%	15.3
Korea	-KOSPI	2,100.7	2.4%	21.9%	13.9
Singapore	-STI	3,120.4	-2.2%	10.1%	10.6
Thailand	-SET	1,041.5	0.8%	40.6%	13.3
Malaysia	-KLCI	1,579.1	4.0%	19.3%	16.8
Indonesia	-JCI	3,888.6	5.0%	46.1%	17.9
Philippines	-PCOMP	4,291.2	2.1%	37.6%	15.2
Vietnam	-VNINDEX	432.5	-10.8%	-2.0%	9.2
US					
US	-Dow	12,414.3	7.2%	11.0%	13.6
	-Nasdaq	2,773.5	4.5%	16.9%	23.5
	-S&P	1,320.6	5.0%	12.8%	15.0
Europe, PIIGS and Middle East					
UK	-FTSE100	5,945.7	0.8%	9.0%	14.2
Germany	-DAX	7,376.2	6.7%	16.1%	12.2
France	-CAC	3,982.2	4.7%	-3.3%	11.9
Portugal	-PSI20	7,323.8	-3.5%	-10.3%	11.6
Italy	-FTSEMIB	20,186.9	0.1%	-13.2%	12.8
Ireland	-ISEQ	2,953.3	2.4%	-3.0%	N/A
Greece	-ASE	1,279.1	-9.5%	-35.6%	N/A
Spain	-IBEX	10,359.9	5.1%	-17.4%	9.0
Hungary	-BUX	22,693.7	6.4%	0.5%	10.9
Other BRIC					
Brazil	-IBOV	62,403.6	-10.0%	1.0%	9.5
Russia	-MICEX	1,666.6	-1.3%	23.2%	7.8
India	-Nifty	5,647.4	-7.9%	17.9%	16.7
Egypt	-EGX	5,373.0	-24.8%	15.0%	17.6
Regional					
MSCI Asia Pacific Ex Japan		481.3	0.5%	15.0%	13.6
MSCI BRIC		533.0	-4.9%	5.0%	N/A
MSCI Emerging Europe		5,299.2	0.0%	16.3%	N/A
MSCI Latin America		4,463.6	-3.3%	12.1%	11.4

Europe

18. In early 2011, European markets advanced on optimism over global economic growth and easing concerns over the sovereign debt problem after an increase in the size of the eurozone rescue fund. Later however, gains were trimmed on worries over the debt restructuring for Greece and further downgrades in the credit ratings of Portugal, Italy, Ireland, Greece and Spain (PIIGS). In particular, the five-year credit default swap (CDS) spread of the Greek sovereign debt reached a fresh record-high towards end-June.



CDS spreads of PIIGS (bps)

Source: Bloomberg

19. In April 2011, the European Central Bank raised the benchmark interest rate by 25 bps to combat inflation. It was the first hike since the bankruptcy of the Lehman Brothers group in September 2008 and sparked worries over the possible start of a rate hike cycle.

20. In May 2011, concerns over the debt problems heightened. Standard & Poor's (S&P) downgraded Italy's rating outlook to negative. This added to concerns over the spread of the sovereign debt crisis to big nations. In June 2011, Greece's credit ratings were downgraded to non-investment grade.

21. In the first half of 2011, the FTSE, DAX and CAC rose 0.8%, 6.7% and 4.7% respectively. The performance of the PIIGS markets was mixed, ranging from a loss of 9.5% in Greece to a rise of 5.1% in Spain. The sovereign debt problem will continue to cloud market outlook.

MENA region

22. Early in the year, the stepping down of the ruler in Tunisia triggered political unrest in the MENA region, including Egypt, Libya and Yemen. Political uncertainties in Egypt led to temporary close of the stock market and banks, and the Egyptian stock market fell by 25% in the first half of 2011. Meanwhile, Libya, the third largest oil-producing country in Africa, has been in turmoil since mid-February 2011, despite military intervention by major Western countries. The oil price hit a new high of US$114 per barrel in April 2011. The violence in Yemen also affected investor sentiment. Lingering concerns over political unrest and geopolitical tensions in the MENA region will continue to affect oil prices and stock markets.

Asia

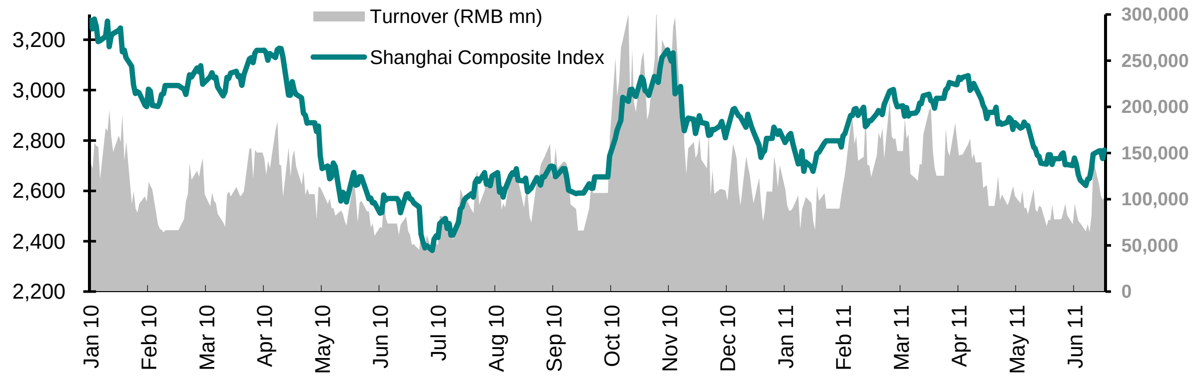
23. In Japan, the market was hit by a 9-magnitude earthquake in early March 2011. The subsequent tsunami and radiation leakages struck not only the country's economy but also stock markets worldwide. A stronger yen weighed on markets as well. To stabilise financial markets, the Bank of Japan injected liquidity into the banking system after the disasters. In addition, the Group of Seven intervened in the foreign exchange market to curb the yen's rally. Markets rebounded later as the nuclear crisis appeared to have stabilised. However, as long as the nuclear crisis remains unresolved, investors are likely to worry about its long-term impact on the economy.

24. Analysts estimated that economic losses stemming from the disasters might have accounted for about 6% of Japan's gross domestic product (GDP). Investors were concerned that the massive expenses for reconstruction would add pressure to the financial situation of the Japanese government. S&P revised the country's credit rating outlook to negative. The CDS spreads once rose to 118 bps from the pre-quake level of 78 bps and was at 91 bps as of end-June. Later, Moody's put Japan's credit rating under review for a possible downgrade. The development of the nuclear crisis will continue to cloud market outlook.

25. Meanwhile, the performance of stock markets in other Asian countries was mixed. Investors focused on possible tightening measures to be imposed to curb inflation. In the first half of 2011, the performance of benchmark indices in Asia ranged from a loss of 10.8% in Vietnam to a gain of 5% in Indonesia. Going forward, market sentiment is likely to be affected by possible tightening measures, which in turn, will impact economic growth and corporate earnings.

The Mainland

26. In early 2011, the Mainland markets rose on strong economic data and upbeat corporate earnings. However, most of the gains were erased later amid a series of tightening measures. The benchmark one-year deposit rate was raised twice by a total of 50 bps to 3.25%, while the bank reserve requirement ratio was raised six times to a record high of 21.5%. As at end-June 2011, the Shanghai Composite Index had fallen 1.6% from its end-2010 level.



Shanghai Composite Index

Source: Bloomberg

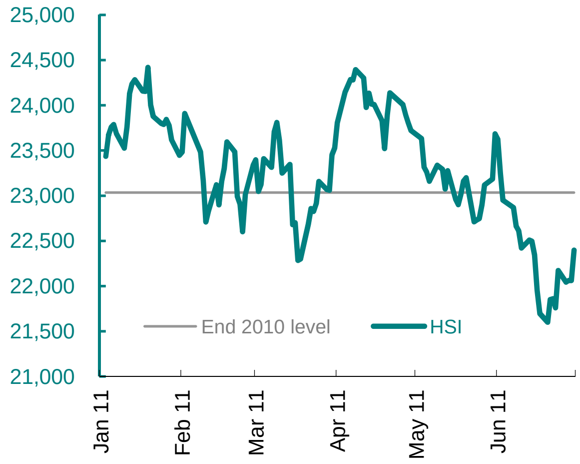
27. Economic growth in the Mainland was solid and stable although inflation risk was a major concern. GDP growth was 9.7% in the first quarter of 2011, compared to 9.8% in the previous quarter. However, consumer price inflation reached 5.5% in May 2011and rose to 6.4% in June, the highest level in three years.

28. The renminbi continued to strengthen in the first half of 2011, rising against the US dollar to a new high of 6.46 in June from 6.61 at end-2010. Meanwhile, the cumulative trade surplus fell to US$23 billion between January and May 2011, compared to US$35.4 billion during the same period in 2010. In addition to monetary tightening measures, the drought in Central and

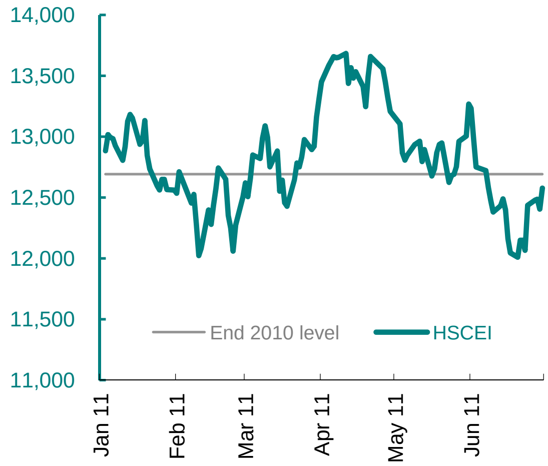
Southern China and the power shortage problem also had clouded the outlook on the Mainland's economy.

Hong Kong

29. The Hong Kong markets rose initially on optimism over the economic outlook and solid corporate earnings. However, the markets retreated in the aftermath of the natural disaster and the nuclear crisis in Japan in mid-March. The Hang Seng Index (HSI) once slid more than 1,000 points on 15 March 2011. Later, losses were trimmed on signs that the nuclear crisis had stabilised. Although accommodative policies in the US boosted investor sentiment, the impact was offset by lingering concerns over further tightening measures in the Mainland as well as the European sovereign debt problem. In the first half of 2011, the HSI and the HSCEI fell by 2.8% and 0.9% respectively.



Performance of the HSI



Performance of the HSCEI

Source: Bloomberg

30. On 29 April 2011, the first renminbi-denominated real estate investment trust (REIT), Hui Xian REIT, was listed on Hong Kong Exchanges and Clearing Ltd. From 29 April to 30 June 2011, the daily turnover of Hui Xian REIT averaged around RMB118 million ($142 million[1]). In volume terms, a daily average of 24.6 million units changed hands, accounting for 0.5% of the outstanding units of Hui Xian REIT.

31. On 18 May 2011, Hong Kong Mercantile Exchange Ltd commenced operation as a commodities futures market in Hong Kong, starting with the trading of US dollar-denominated gold futures contracts. The average daily turnover was some 2,300 contracts from its launch in May till end-June 2011.

Risks and uncertainties over the financial market and economic outlook

32. Global stock markets probably will continue to be affected by US monetary policy and the European sovereign debt problem. The end of the quantitative easing programme in the US may signal the end to the loose credit environment globally. In Europe, as countries impose tightening fiscal measures to control their deficits, this may hurt growth prospects in the eurozone. The Mainland and other Asian countries may be affected as well. In addition, geopolitical tensions in the MENA region will continue to affect oil prices. This, coupled with volatile commodity prices, may add to inflationary pressures and affect economic growth prospects and stock markets. Concerns over monetary tightening measures in the Mainland will also affect market outlook in this region.

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

The European Sovereign Debt Problem

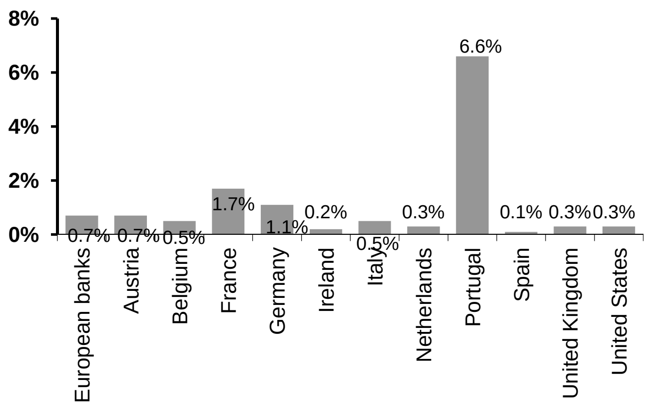
33. In 2010, the sovereign debt problem hit several European markets on heightened concerns over growing budget deficits and government debts. Market attention focused on the European countries collectively known as PIIGS.

34. In May 2010, eurozone finance ministers and the International Monetary Fund (IMF) announced a rescue fund to support these countries. The countries themselves also announced tightening measures aimed at reducing their fiscal deficits. Although the measures helped restore investor confidence in financial markets, some expressed concerns that they might hurt the growth prospects of the respective economies. There was resistance in implementing the measures.

35. Recently, the risks brought about by the European sovereign debt problem seem to have grown. In particular, concerns over the debt problem of bigger nations of Spain and Italy have grown. There are also concerns that the low interest rate environment may end soon, adding to pressure on debt-laden European economies. Also, the debt problem may affect political stability in some European countries, making it more difficult to resolve.

36. We have analysed the participation of major eurozone financial institutions in various segments of the Hong Kong securities markets. In the cash market, their combined share of the market turnover was about 12% in June 2011. In the derivatives market, they accounted for 6% of the trading in HSI futures and 9% of the trading in HSCEI futures. At this stage, there is no evidence to suggest that the sovereign debt problems have had a significant adverse impact on European financial institutions operating in Hong Kong.

37. In December 2010, claims of European banks on Greece amounted to 4.3% of their total foreign claims. However, the interdependence among certain countries in the eurozone can be significant. For instance, claims of French and German banks on Greece amounted to US$53 billion and US$34 billion respectively. The exposure of Portuguese banks to Greek debt accounted for 6.6% of its total foreign claims.



Banks' exposure to Greece (% of total claims) (December 2010)

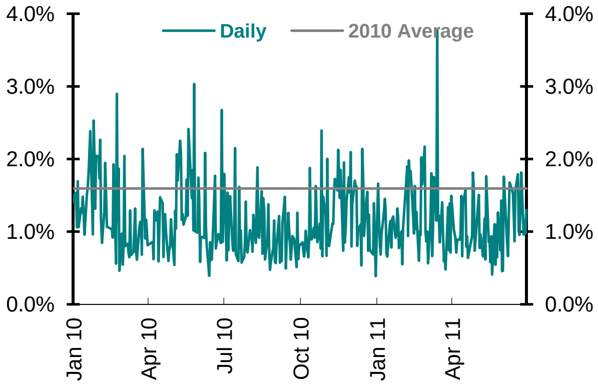
Source: BIS Consolidated Bank Statistics

38. The direct impact of the European sovereign debt problem on the Hong Kong economy seems to be limited at this stage. However, uncertainty remains as to how the sovereign debt problems may impact the balance sheets or earnings of European financial institutions. If the problem affects the stability of European banks, it will affect the global economy and financial markets. Any downgrading of sovereigns and institutions by credit rating agencies may tighten credit market conditions and add to stock market and exchange rate volatility.

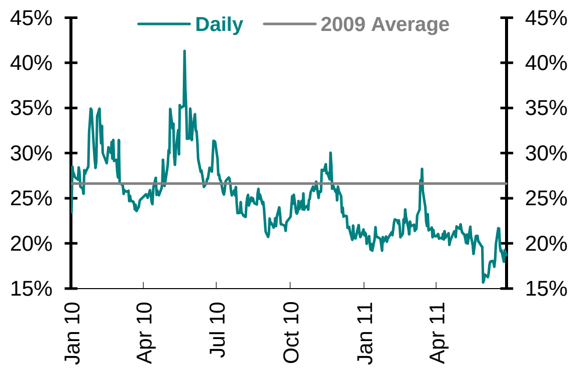
Major statistics of Hong Kong securities market (January – June 2011)

Volatility dropped in 2011

39. The intra-day volatility of the HSI dropped to an average of 1.1% from January to June 2011 (1.2% in 2010 and 2% in 2009). The implied volatility of the HSI options retreated steadily and was about 20% as at end-June 2011.



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

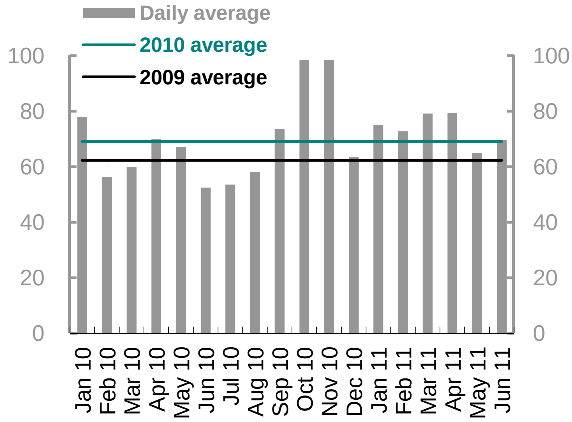
Trading activity in the local stock market

40. Trading activity in the local stock market was moderate during the first half of 2011. The average daily turnover amounted to $74 billion, about the same level as in the second half of 2010 and 15% higher than the level for the first half of 2010. Mainland stocks remained the most actively traded stocks, accounted for 36% of total market turnover. The trading of HSI stocks (excluding H-shares and red chips) was about 14% of total market turnover.

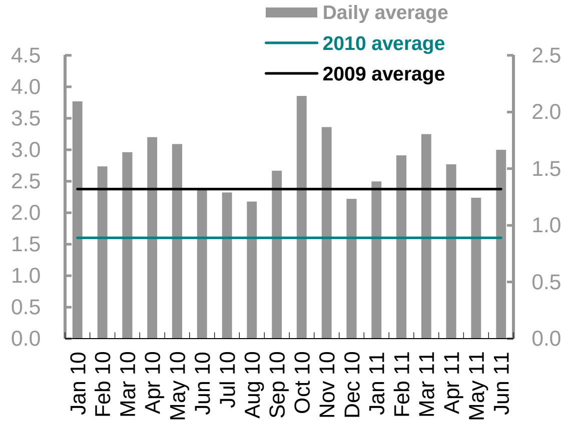
Average daily turnover (HK$ bn)

	1H 2011		2H 2010		1H 2010		% change over	
							2H 2010	1H 2010
HSI (excluding H shares & red chips)	10.5	(14%)	9.0	(12%)	7.9	(12%)	+17%	+33%
Mainland Stocks	26.8	(36%)	27.2	(37%)	26.1	(41%)	-2%	+2%
H-shares	*19.6*	*(27%)*	*19.3*	*(26%)*	*18.6*	*(29%)*	+1%	+5%
Red chips	*7.2*	*(10%)*	*7.9*	*(11%)*	*7.6*	*(12%)*	-9%	-5%
Derivative Warrants	12.1	(16%)	12.2	(17%)	9.3	(15%)	-1%	+30%
CBBCs	5.7	(8%)	6.8	(9%)	4.9	(8%)	-15%	+17%
Others	18.4	(25%)	18.9	(26%)	15.6	(24%)	-3%	+18%
Market Total	**73.6**	**(100%)**	**74.1**	**(100%)**	**63.8**	**(100%)**	**-0.7%**	**+15%**

Sources: HKEx and SFC Research



Trading value of Hong Kong market ($ bn)

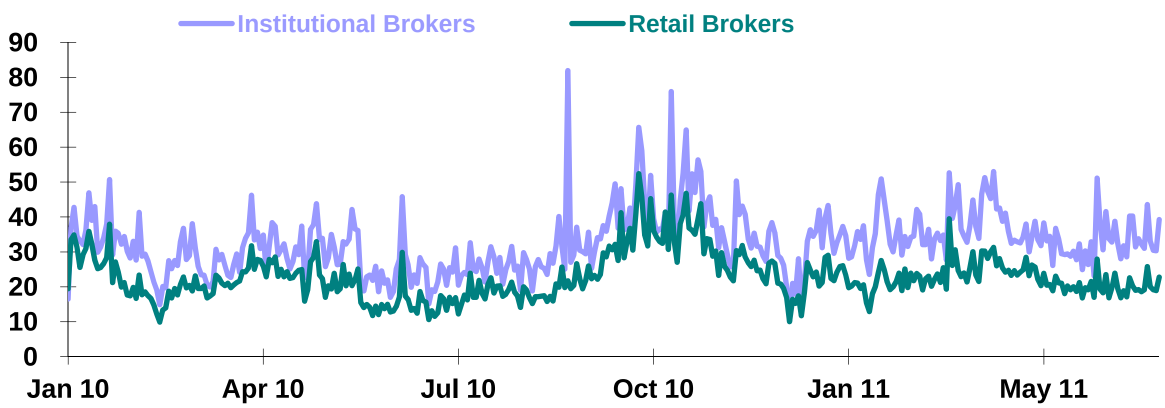


Trading volume of HSI constituent stocks (bn shares)

Source: Bloomberg

41. The trading hours of the local stock market have been extended from four hours to five hours since 7 March 2011. Trading activity has remained stable since the extension of trading hour. The average daily turnover amounted to $73.3 billion from 7 March to 30 June 2011, compared to $74.2 billion from 3 January to 4 March 2011.

42. By broker type, the proportion of equity trading by institutional brokers was 61% between January and June 2011 (compared to 58% and 57% during the first half and the second half of 2010 respectively). Retail brokers made up 39% of the trading volume (compared to 42% and 43% during the first half and the second half of 2010 respectively).



Daily equities trading by broker type during January 2010 to June 2011 (HK$ bn)

Source: SFC research

Short-selling activity

43. Short selling was active during the first half of 2011. Short selling rose in absolute terms and as a percentage of total market turnover from levels recorded in the second half of 2010. The average daily short selling was $4,964 million, or 6.8% of the total market turnover between January and June 2011, compared to $4,404 million or 6.9% in the first half of 2010 and $4,212 million or 5.7% in the second half of 2010.

IPO activity and performance

44. January to April 2011 was quiet for initial public offerings (IPOs) but activities have picked up since May. In the first half of 2011, there were a total of 29 IPOs (excluding Hui Xian REIT) on the Main Board, raising a total of $170.6 billion. This was more than the $50.2 billion raised in the first half of 2010, but less than the $398.6 billion raised in the second half of 2010.

45. The debut performance of these IPOs was mixed. The closing price of 16 of them rose, gaining between 0.3% to 65.9% on the first day of trading, while two closed flat and the remaining 11 suffered losses ranging between 0.3% to 23.2%. As at the end of June 2011, compared to their IPO prices, eight new stocks had risen, gaining 1.4% to 58.8%, one was flat and 20 recorded losses of between 0.2% to 53.8%.

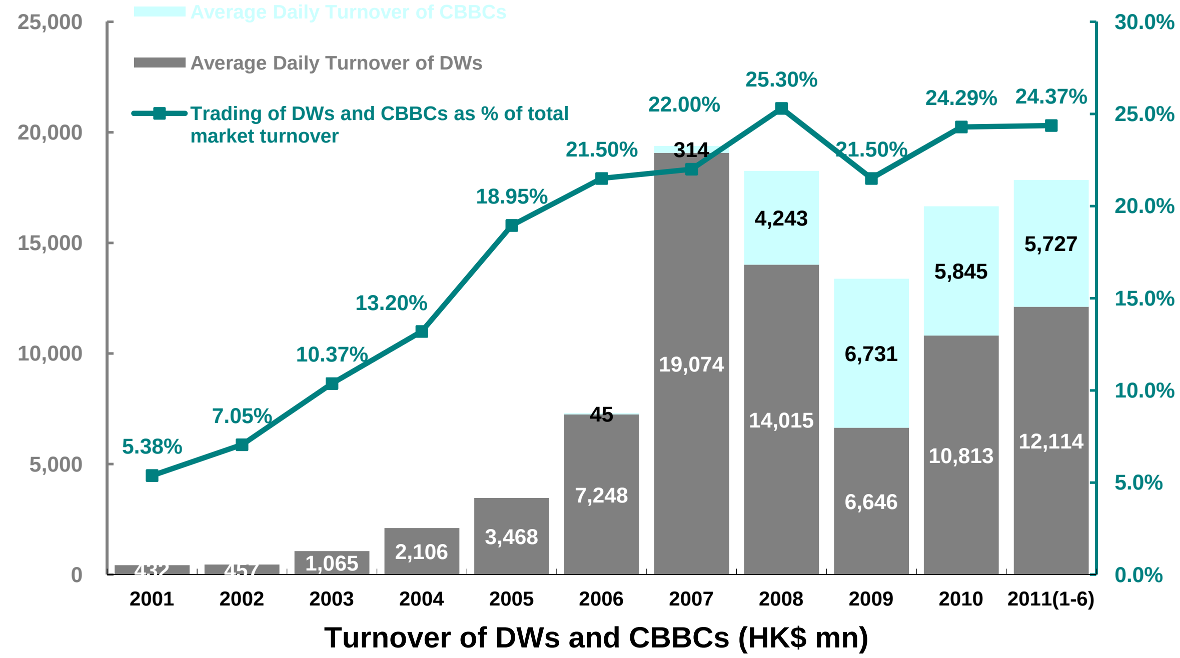
Exchange-traded funds (ETFs)

46. The number of ETFs rose from 71 as at the end of 2010 to 76 as of 30 June 2011. In the first half of 2011, their average daily turnover was $2.4 billion, about the same level as in 2010. They accounted for 3.2% of the total market turnover, slightly less than its share of 3.5% in 2010.

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

47. Trading of DWs was stable both in absolute terms and as a percentage of total market turnover in the first half 2011. Trading of DWs rose to $12.1 billion (16.5% of total market turnover), compared to $12.2 billion (16.5% of total market turnover) in the second half of 2010.

48. The trading of CBBCs decreased both in absolute terms and as a percentage of total market turnover. Trading of CBBCs decreased to $5.7 billion (7.8% of total market turnover), compared to $6.8 billion (9.1% of total market turnover) in the second half of 2010.



Source: SFC research

Exchange-traded derivatives

49. Trading in futures products increased during the first half of 2011. Among futures products, HSI futures remained the most actively traded contract, accounting for nearly half of all futures trading. Its average daily trading volume increased by 4.7% from the second half of 2010. The second most actively traded futures were HSCEI futures. Its trading volume increased by 11.5% and accounted for about one-third of all futures trading. As at 30 June, open interests in HSI and HSCEI futures were 95,917 and 114,333 contracts respectively.

50. In the options market, trading also rose during the first half of 2011. Stock options remained the most actively traded options products and its trading volume rose 7.1% from the second half of 2010.

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

		1H 2011	2H 2010	1H 2010
Futures	HSI Futures	88,903	84,898	84,001
	Mini-HSI Futures	35,846	32,024	34,724
	HSCEI Futures	54,364	48,758	51,147
	Mini-HSCEI Futures	6,279	4,331	3,619
	Stock Futures	1,741	1,305	597
	3-Month HIBOR Futures	2	4	5
	Gold Futures	19	24	21
	Other futures products*	124	53	0
	Total Futures	**187,277**	**171,396**	**174,114**
Options	HSI Options	43,457	37,237	30,981
	Mini-HSI Options	3,433	2,263	1,595
	HSCEI Options	15,086	12,392	10,946
	Stock Options	287,263	268,146	221,512
	Other options products**	66	105	4
	Total Options	**349,304**	**320,144**	**265,037**
Total Futures and Options		**536,582**	**491,540**	**439,151**

Remark: * One-Month HIBOR Futures, Three-year Exchange Fund Note Futures, HSI Dividend Point Index Futures and HSCEI Dividend Point Index Futures
** Flexible Hang Seng Index Options and Flexible H-shares Index Options
Sources: HKEx and SFC Research