Close Relationship between Active Trading on the Hong Kong Stock Market and Capital Inflow amid the China Factors

Research Department, Supervision of Markets Division[1]

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Summary

- *Since the beginning of 2006, there has been a significant increase in trading on the Hong Kong stock market. During Jan-Mar 2006, the average daily turnover in Hong Kong was HK$31.2 bn (US$4.0 bn), 58% higher than the average level for the second half of 2005. This was however a regional phenomenon, as trading activities on other Asian markets also increased. It also appeared that the increased trading activities on the Hong Kong stock market and other regional markets were positively associated with an inflow of capital.*

- *Whilst strong capital inflow is a regional phenomenon, the China factors are characteristic of Hong Kong and have given additional impetus to the trading of Mainland stocks listed in Hong Kong. The trading of H-shares and Red-chips soared 85% and 69% respectively during the first quarter of 2006 from the average level for the second half of 2005. The combined trading of H-shares and red-chips accounted for 40% of the total turnover over the same period.*

- *The growth in the trading of Mainland stocks was supported by sound corporate fundamentals such as the solid earnings of Mainland companies. Despite the rises in share prices, the P/E ratios of the H-share and red-chip indices remained at 13-14 following better-than-expected earnings. In addition, as the market cap of Mainland companies continues to grow, so does the weighting of Mainland stocks in worldwide indices. Funds tracking these indices would naturally allocate a larger amount of capital into Hong Kong. Finally, expectations of a further revaluation of the RMB might have increased investors' interest in Mainland stocks.*

- *This paper also notes that capital flow into Hong Kong topped the Asian markets. However, due to their uncertain nature, capital movements also add volatility to the stock market.*

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1 This paper is for pure fact-finding and research purposes, and is not an attempt to comment on the developments of any markets/companies or interpret the policies concerned. The views expressed in this paper do not represent those of the SFC.

Increased Trading Activities on the Hong Kong Stock Market and Other Asian Markets since January 2006

1. Since the beginning of 2006, there has been a significant increase in trading on the Hong Kong stock market. During Jan-Mar 2006, the average daily turnover in Hong Kong was HK$31.2 bn (US$4.0 bn), 58% higher than the average level for the second half of 2005. The abundant liquidity situation was however a regional phenomenon. Trading activities on other Asian markets also increased during the period, with rises ranging from 9% in Australia to 44% in Singapore.

Average Daily Turnover of Regional Markets (US$ mn)

	2006 Q1	2005 H2	2005 H1	2004 H2	2004 H1	Growth 2006 Q1/2005 H2	Growth 2006 Q1/2005 H1
Australia	3,150	2,896	2,792	2,238	1,978	9%	13%
Hong Kong	3,997	2,525	2,160	1,938	2,159	58%	85%
Japan	23,547	19,512	11,864	10,445	12,567	21%	98%
Korea	6,899	5,733	3,857	2,164	2,845	20%	79%
Singapore	741	515	422	356	438	44%	76%
Taiwan	3,130	2,552	2,212	2,044	3,769	23%	41%

Sources: Bloomberg and WFE

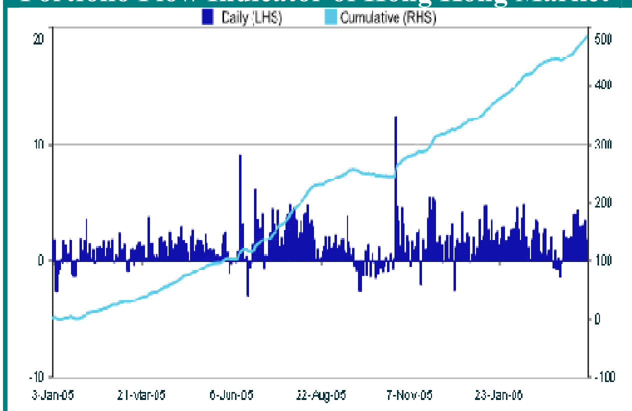
2. The increased trading activities of the Hong Kong stock market and other major stock markets in Asia were in line with the solid growth and improving fundamentals of the regional economies. In Hong Kong, economic conditions are robust, with higher GDP growth, declining unemployment, abated inflationary pressures and rising personal income. Corporates continue with their new recruits, usually accompanied by more attractive remuneration packages. The sound and broad-based corporate earnings and continued resilient retail sales supported by buoyant tourism helped strengthen investor confidence. These have offset the negative impacts arising from higher interest rates and energy costs.

3. The China dimension has also become increasingly important to the Hong Kong stock market. The strong investor interest in the Mainland stocks was reflected in the trading of H-shares and red-chips which soared 85% and 69% respectively during the first quarter of 2006 from the average level for the second half of 2005. The combined trading of H-shares and red-chips already accounted for 40% of the total turnover during the first quarter of 2006. The amount of funds raised for Mainland stocks through IPOs accounted for 84% of the total during 2005. As of the end of March 2006, Mainland stocks constituted 39% of the total market capitalization.

Active Trading was Underpinned by Strong Capital Inflow

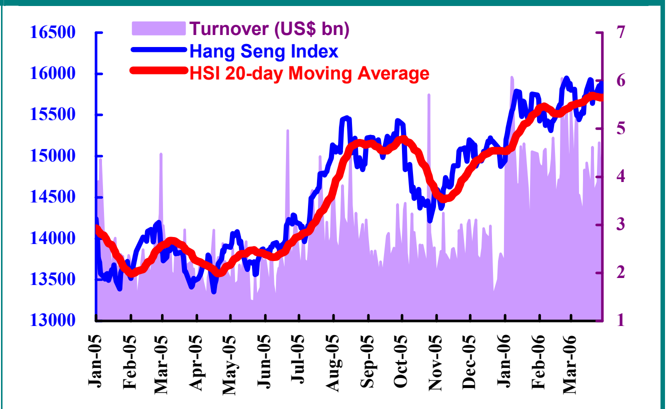
4. There appeared to be signs of strong capital inflow into major Asian stock markets, which might be one of the key factors contributing to the recent increases in trading activities. However, data on capital flow into/out of these stock markets is not readily available and, in most cases, sketchy. State Street[2] has compiled the Portfolio Flow Indicator (PFI) which estimates, in a rough sense, net cross-border transactions of a particular equity market over a certain period of time in basis points (bps) of the market capitalisation. The PFI is depicted as bar on the Chart, scaled on the left hand axis. The cumulative PFI is a rolling sum of individual PFI values for a certain period of time, depicted as line on the chart, scaled on the right hand axis.

Portfolio Flow Indicator of Hong Kong Market



Source: State Street Global Markets Research

Performance of HSI and Turnover



Source: Bloomberg

5. According to the PFI compiled by State Street, most Asian markets have recorded stronger capital inflow since the beginning of 2006. In Hong Kong, the amount of capital flowing into its stock market during the first quarter of 2006 was estimated to be about US$14.2 bn[3]. On an average monthly basis, capital flow was about US$4.7 bn, or about 40 bps of its total market capitalisation (higher than the 35 bps recorded for the

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2 According to the information provided on its website, State Street provides financial services for 15% of the world's tradable assets, which is regarded as representative of what institutions are doing in the financial markets worldwide. Its clients are institutions only, e.g. investment managers, pension plan sponsors, collective investment fund managers, banks, corporations and not-for-profit organizations. It tracks investors' activities in buying/selling securities and subsequently moving funds into/out of a market/country. Their methodology is developed through years of collaboration with academics. Though the PFI depicts the net purchasing by clients in State Street's custody database only and does not attempt to measure overall flows into a particular country, its broad coverage can still identify the general trends in capital flows and facilitates the serial and cross-sectional comparison.

3 This figure was calculated by multiplying the cumulative PFI during the first quarter of 2006 and the total market capitalization of the Hong Kong stock market as at the end of March 2006.

second half of 2005). Capital flow into the Hong Kong market actually topped all Asian markets, followed by 30 bps in Singapore, 16.7 bps in Taiwan and 14.2 bps in Korea.

Estimated Monthly Capital Flow in Major Asian Markets (bps of market cap)

	2006 Q1	2005 H2	2005 H1	2004 H2	2004 H1
Australia	4.7	0.8	4.8	-2.3	4.2
Hong Kong	40.0	35.0	21.7	33.3	-15.0
Japan	6.3	8.7	4.7	6.5	6.2
Korea	14.2	-18.7	19.2	-11.7	18.3
Singapore	30.0	12.0	18.3	6.7	12.0
Taiwan	16.7	13.7	17.5	21.7	5.5

Source: State Street Global Markets Research

6. There appears to be an association between capital inflow and the performance of the Hong Kong stock market, although it is not certain whether it is the inflow of capital which leads to a buoyant performance or vice versa. Capital flowed into Hong Kong during Jan-Sep 2005, and the HSI advanced steadily over the period. In October 2005 when there was a net capital outflow, the HSI receded. Since November 2005, capital has flowed into Hong Kong again, and the HSI has also rebounded.

7. Although capital moved into the Hong Kong stock market massively within a short period of time, it appeared that such capital inflow was supported by strong economic and corporate fundamentals. For instance, many companies listed in Hong Kong reported sound and broad-based corporate earnings for the financial year of 2005. Nevertheless, as such capital could move in and out very quickly, this would add volatility to the market. Therefore, investors should be cautious about the volatile and uncertain nature of the capital flow.

8. Whilst increased capital inflow is a regional phenomenon, the China factor appears to be an additional feature which is unique to Hong Kong. The China factor comprises:
   - the strong earnings of Mainland companies;
   - the increased weighting of Mainland stocks by major international index compilers; and
   - expectations of a further RMB revaluation.

   These factors have given additional impetus to the inflow of capital to the Hong Kong stock market.

Strong Earnings of Mainland Companies

9. Benefiting from the strong growth of the Mainland economy, Mainland companies are able to make solid earnings. Therefore, despite the significant rises in share prices of H-share companies, the P/E ratio of the H-share index remained at around 14 times after the earnings announcements in the first quarter of 2006. The P/E ratio of the red chip even declined from 17 times at the beginning of 2006 to 13 times in early April 2006. Underpinned by strong earnings, it is considered that part of the capital which flowed into the Hong Kong stock market was for investment purpose.

Increased Weighting of Mainland Stocks by International Index Compilers

10. Driven by the robust growth of the Mainland economy, investor interest in Mainland companies has been increasing. As the largest and best-regarded Mainland companies continued to list in Hong Kong, their market cap continued to grow, the weighting of Mainland stocks in worldwide indices also increased. Funds tracking these indices would naturally allocate a larger amount of capital into Hong Kong. For instance, the weighting of Mainland stocks in FTSE All-World Index rose by 9 bps during the first three months of 2006. If major international index compilers raise the weighting by the same magnitude, it is estimated that for every bp increase in weighting, around US$550 mn worth of funds flow into the market[4]. This implies an capital inflow of about US$5 bn was estimated to be allocated to Mainland stocks.

11. In line with the growth of the Mainland economy, both the earnings and size of Mainland companies will grow further. As a result, the increased weighting of Mainland stocks is likely to continue into the future, and this may induce more capital flow into the Hong Kong market.

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4 This is based on the size of funds tracking global indices such as MSCI and FTSE. According to the information released on the websites of these major international index compilers, funds tracking such global indices amount to some US$5.5 trillion.

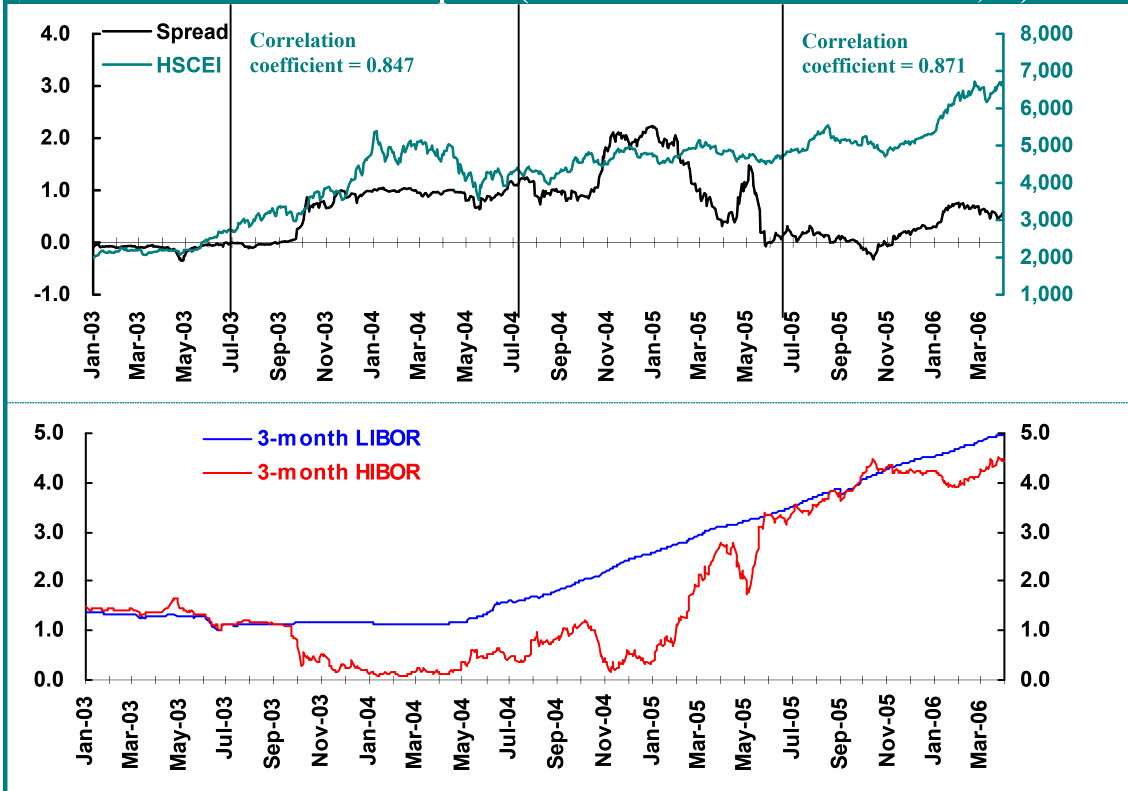
Expectations of a Gradual Appreciation of the RMB

12. Experience showed that when the RMB was expected to re-value or appreciate, capital came to Hong Kong to buy Mainland stocks. At the same time, capital inflow led to drops in local interest rates, and such drops took place even when interest rates in the US were on an uptrend. As a result, local interest rates did not always follow those in the US, leading to a divergence in the cost of funds, i.e. a spread between HIBOR and LIBOR.

13. Due to the robust economic growth in the Mainland and buoyant external trade, the RMB had been on an uptrend since the revaluation in July 2005. Expectations of a gradual RMB appreciation seemed to be one of the major reasons behind the recent increase in capital inflow, which underpinned the active trading on the Hong Kong market and its buoyant performance. The spread (i.e. 3-month LIBOR minus the 3-month HIBOR), an indicator which reflects such capital inflow, is positively associated with the HSCEI. The spread represents the cost of holding HKD assets (e.g. Mainland stocks listed in Hong Kong) by international investors, who expect a gradual RMB appreciation.

14. An inflow of capital for Mainland stocks supported their performance, and this was readily reflected by the HSCEI. There existed a high correlation between the HSCEI and the spread at times.
    - During 2003 Q3 – 2004 Q2, as a result of speculation over an RMB revaluation, there was a capital inflow to the Hong Kong market and the spread increased. In light of the abundant liquidity, banks in Hong Kong did not follow interest rate hikes in the US. The correlation coefficient between the HSCEI and the spread was 0.847.
    - However, during 2004 Q3 – 2005 Q2, when expectations over an RMB revaluation settled, local interest rates began to catch up with their US counterparts. Meanwhile, the HKMA refined the exchange rate system in May 2005 to bring local rates more in line with those in the US. The spread narrowed, but the performance of the HSCEI did not seem to be affected in a significant manner. The correlation appeared to have broken down.
    - During 2005 Q3 – 2006 Q1, the RMB was revalued in July 2005 and continued to appreciate very gradually after that. In addition, supported by the strong growth of the Mainland economy and robust external trade, speculation over a further RMB revaluation revived. The spread widened again, whilst the HSCEI continued to advance. The correlation coefficient between the two was 0.871.

Performance of the HSCEI and Spread (3-month LIBOR – 3-month HIBOR, %)



Sources: Bloomberg and Reuters

Conclusion

15. Trading on the Hong Kong stock market and other major Asian markets was very active. It appeared that the increased trading activities were positively associated with an inflow of capital. Although such capital inflow to the Hong Kong appeared to be supported by strong economic and corporate fundamentals, investors need to be cautious about the uncertain nature of capital flow as it would add volatility to the market.